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**RUSSIAN ECONOMY IN 2015**  
**TRENDS AND OUTLOOKS**  
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The review provides a detailed analysis of main trends in Russia's economy in 2015. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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## **Section 1. Russian Economic Policy in 2015: Anti-Crisis Measures or Structural Reforms<sup>1</sup>**

### **1.1. Global trends: the general and the specific**

Today, the world is looking for the new equilibrium that should occur after the global structural (systemic) crisis that began in 2008 and still more or less continues. We are witnessing the formation of a new macroeconomic (including the nature of monetary policy and economic growth potential) and institutional growth model, a change in the roles of certain economic sectors, the emergence of a new model for globalization and international trade, and a re-thinking of the role of inequality in the economic and social development of the leading states.<sup>2</sup> The situation remains unstable, although the global crisis itself is nearing completion.

Nevertheless, the end of the *global crisis* will not necessarily mean that the situation in all affected countries and regions will improve. It will depend on the ability of countries to “exploit the crisis,” i.e., to find institutional solutions to help them adapt to the new reality – technological, economic, social, and even ideological. Some countries may come out of the crisis renewed and more competitive, but others will continue trying to overcome the negative trends. However, this will no longer be a global crisis, but rather a crisis of specific national models.<sup>3</sup>

We can identify a number of features that were characteristic of the global crisis during the past year and that will remain relevant in 2016.

*The first is the staged nature and lack of geographical synchrony to the global crisis.* Although the crisis affected almost all developed and leading emerging economies, its progress was asynchronous across the countries and regions of the world. At first, it seemed that the crisis might engulf the majority of the leading countries, and therefore, global economic coordination institutions were created in 2008: the G20 was formed, and the mandate of the Financial Stability Board was expanded.

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<sup>1</sup> Author of this section: Mau V. – RANEPА. The author should like to express his sincere gratitude to V. Gurevich, S. Drobyshevsky, G. Idrisov, P. Kadochnikov, A. Mamedov, and M. Khromov for their assistance in preparing this section and fruitful comments in the course of its discussion.

<sup>2</sup> These issues are discussed in detail in Mau and Ulyukaev (2014). *Global Crisis and Trend of Economic Development*. *Voprosy Ekonomiki*. 2014, No 11. pp. 4-24.

<sup>3</sup> In fact, the crisis with the Soviet system during the 1980s and 1990s represented this particular kind of deferred crisis. It was a result of the failure of the Soviet elite to adapt to the new reality that emerged during the crisis in the 1970s. Thus, the crisis in the Soviet system was not part of the structural crisis in developed countries but undoubtedly arose as its consequence.

The decoupling hypothesis appeared, arguing that the leading developing countries were, to a certain degree, independent of the trends in developed countries. This provided a basis for the idea that emerging economies would drive the world out of the crisis. The highest hopes lay with the BRICS countries. However, the crisis soon began to accelerate in Brazil and Russia, and then in other major developing countries. In 2015, it became clear that even China was affected by the crisis, as its growth rate dropped below 7% for the first time in 35 years (since 1981). Although China demonstrates a high rate of growth relative to other countries and that growth contributes much more to the global GDP than it did in the early 1980s, the impact of a slowdown will be felt globally. We should also note the unprecedented volatility of the Chinese stock market, the USD 513 billion contraction in international reserves, and the aggressive (on the Chinese scale) movements of the yuan. The Brazilian economy is also declining, and only India managed to keep growth at approximately 7.3%.

The BRICS countries showed more political unity last year, and provided increasingly fewer reasons for economic positivism. The unity turned out to be more political than economic (as observed 15 years ago, when it was “invented” by J. O’Neil, chief economist at Goldman Sachs).

*The second is overcoming the crisis by developed economies.* The crisis is aggravated in developing countries, whereas developed economies are recovering. First of all, we can point to the United States, where macroeconomic conditions (growth rates and low unemployment) enabled the Federal Reserve to increase interest rates for the first time in nine years. Undoubtedly, the crisis is not yet over: past experience has proven that such large-scale transformations could quite possibly lead to renewed deterioration in economic trends. This, however, does not change the general trend.

The Federal Reserve acted with caution because of the domestic situation (GDP and unemployment trends) and not as a result of evaluating this factor’s impact on other countries, which is tolerably in line with the point voiced by J. Connelly, US Secretary of the Treasury, during the dismantling of the Bretton- Woods system in 1971, “the dollar is our currency and your problem.” The turn- around in US monetary policy supports the “escape to quality” trend (capital flight from emerging markets) and seems to herald the beginning of a long period of an expensive dollar. The latter will factor into amortizing one of the global imbalances that had formed before the outbreak of the global crisis.

The situation in the EU is improving gradually, which is caused, to a lesser extent, by general macroeconomic success and, to a greater extent, by the manifested ability to resolve acute issues with the single currency system. On the whole, the crisis with the single European currency (related to the situation in Greece) is resolved. The euro has persevered under the conditions of, and according to, the paradigm of fiscal austerity (the German approach) and not on the exotics of unfettered budget stimulation, as was advocated by the leftist Greek government and the governments of some southern European countries. At the same time, the European Central Bank (ECB) is continuing its policy of strong quantitative easing, which now turns out to be just the opposite of the course taken by the Federal Reserve in 2015. The euro’s weakening against the dollar may become an additional incentive for the European economy (if the inflation trap can be avoided).

Ireland’s success was less noticeable, but still important: for three quarters in 2015, economic growth was 7%, the best performance in the Eurozone. This is the more important because in 2008 and 2009, Ireland suffered a deep crisis that brought it to the verge of economic disaster. The country’s experience over the past seven years shows that a responsible policy

may resolve complicated issues, even within a currency union and with a lack of monetary tools at the disposal of the national government.

The result in 2015 was the de facto preservation of the euro, which demonstrated the stability of currency unions in current circumstances and, at the very least, provided the post-crisis world with a second reserve currency. In all probability this experience will continue to play a part in the formation of new integrational structures, the importance of which will continue to grow.

However, an overestimation of the recuperation in the Eurozone would be a mistake. It still requires a number of institutions to ensure its stable functioning, including banking regulations and budget system coordination. The results of the referendum in Great Britain concerning its membership in the EU are still open. Europe has not overcome the crisis for economic and political reasons.

The medium-term prospects for the unprecedented monetary expansionism of recent years is still an open issue. Although deflation remains the primary threat for developed countries, the risks of accelerated inflation processes cannot be ignored.

The prospects for overcoming the immigration crisis in Europe are closely related to this matter. The wave of migrants into the EU raises serious short-term issues. The same wave, however, can offer additional possibilities to neutralize the negative demographic trends and increase productivity.

*The third is the search for and development of new economic growth models.* We should seek multiple new models, rather than a single, one-size-fits-all approach. Even with some convergence between developed and leading developing countries during the pre-crisis period (the 1990s and 2000s), the challenges facing them now differ significantly. The difference between the ongoing structural crisis and those of the 1930s and 1970s is the different scope of macroeconomic and institutional reforms needed to achieve a sustainable growth trajectory.<sup>1</sup>

For some countries, it should be about the economy's greater focus on domestic demand (this pertains to quite different countries such as Germany and China). For others, the focus should be on enhancing and diversifying foreign demand (this also pertains to Russia). A number of countries need serious institutional reforms. Some countries need to raise prices to achieve the required inflation targets, whereas others need to suppress them. Nevertheless, all countries need to take measures to enhance economic growth potential given a new technological base. In virtually all of the growth models, human capital development is one of the key priorities.

*The fourth is the prospect for globalization.* Globalization faces serious challenges, economic and political alike. International trade value declined by 11% in 2015. This has been a rare occurrence during the past 30 years, nearly unprecedented, overlooking 2008, when the 22.6% decline was fully offset by 2010.

We have seen the evident enhancement of political forces arguing for protecting national values and identity, in contrast to universalism and globalization. All this is happening against a backdrop of greater rigidity in international relations, including crude protectionism, sanctions, aggressive regulation, and even armed conflicts, all of which had been almost unacceptable until recently. A crucial, albeit not entirely clear, question is what will become of the political

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<sup>1</sup> Mir prognozov 2016. <http://www.mirprognozov.ru/prognosis/economics/neft-skoro-zakonchitsya-syirev-yie-tsiklyi/ru>.

mainstream. A related question is whether the trend towards nationalism, which was marginalized in recent decades (since the end of World War II in Europe), will prevail during the next quarter of a century?<sup>1</sup>

From an economic point of view, globalization is one of the key phenomena and will remain so in the post-crisis world. However, the recent trend towards adjusting the globalization model is becoming increasingly apparent. We are speaking about the shift of the center of gravity from “global globalization” (which has the WTO as its symbol and quintessence) towards “globalization by interests” or regions. Regionalization of globalization has recently gained fresh momentum.

The expansion of the multilateral (universal) integration agenda in the world will apparently experience long-term stagnation: the WTO can provide only liberalization of global trade to a certain degree and define the acceptable boundaries of protectionism, beyond which the global economy will not move. Basically, the architecture of trade and economic relations will be determined by regional and mega-regional blocs, such as the Transatlantic Trade and Investment Partnership, the Trans-Pacific Partnership (TPP; this treaty was signed in February 2016), the Silk Road Economic Belt (SREB), the Euro-Asian Economic Union (EAEU), and other treaties on free trade.

This is manifested in the development of existing and newly emerging trade and economic alliances as well as increased interest in inter-country free trade zones. In 2015, the movement to form the SREB gained new momentum, and economic and political ties also strengthened within the SCO and BRICS. In October, negotiations concluded on formation of the TPP, which involved the United States, Japan, Canada, Mexico, Australia, New Zealand, Singapore, Brunei, Chile, Peru, Malaysia, and Vietnam.

The expansion of the EAEU, joined by Armenia and Kyrgyzstan, should be viewed within the same context. Admittedly, the intensification of post-Soviet integration processes and the trend towards a common economy, which occurred about five years ago, proved to be very well-timed. Further developments showed the error of interpreting this policy as a “look back,” i.e., an attempt to restore the Soviet Union. Even recognizing the Soviet nostalgia prevalent in certain parts of the Russian elite, the establishment of the EAEU addressed not the issues of the past but the challenges of the future, reflecting the new trend towards the “regionalization of globalization.”

*The fifth is the formation of future currency configurations.* Expectations of the imminent collapse of the US dollar, popular among journalists for a certain period of time, have not come true, and the dollar apparently will continue to serve as the global reserve currency. The outcome of the 2015 European crisis indicates that the euro is also likely to retain its status as an international currency. This is evidenced by the resolution of the crisis in Greece. However, Eurozone countries will have to make some difficult institutional decisions concerning the budget and other financial matters to enable the euro to become a full-fledged international currency.

Despite—or, perhaps, thanks to—the 2015 devaluation, the yuan is moving in the direction of becoming a reserve currency. This is also facilitated by its inclusion in the IMF “currency basket.” A weaker currency provides competitive advantages for an economy, which is important for the sustainable economic development of a country largely focused on exports.

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<sup>1</sup> “We may be entering a world dominated by a new paradigm where politicians, including central banks, have fewer opportunities to reduce risks. This suggests the possible beginning of a process by which a number of earlier assumptions will no longer be relevant,” wrote Citi analysts (Citi-GPS, 2016 Global Political Risk, p. 4).

Despite its high volatility, the ruble could still be regarded as a regional reserve currency. By stabilizing the ruble and giving up elements of monetary control, Russian monetary authorities are laying the foundation for improving its international position in the future. It is important for this task to maintain its critical focus, although its practical implementation has been postponed and is inseparable from serious structural and institutional reforms within the country.

*The sixth is the decrease in commodity prices*, particularly for fuel and energy products. The average annual oil price dropped by 50% compared with 2014. A drop of this magnitude over one year's time has almost no precedent in modern history: in the past 50 years, this only occurred in 1986 and 2009 (Fig. 1 and Fig. 2). In the first case, it foreshadowed the beginning of a long period of low oil prices, though they rose slightly in the short term. The situation in 2008 and 2009 may also have indicated a future change in the trend, which became more apparent in 2014 and 2015. However, this suggests no firm conclusions, as the history of oil price cycles is very short and we cannot build responsible forecasts based on two waves.

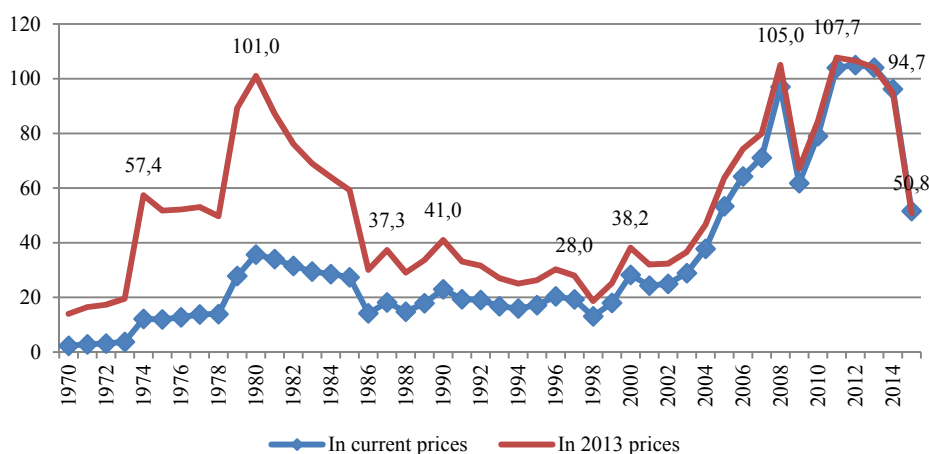


Fig. 1. Global oil price (USD/barrel)

Source: International Monetary Fund.

Moreover, we still do not know whether fluctuations in the oil market follow a wavelike pattern. Demand for oil as a commodity is influenced by technological progress, and it is far from certain that oil as a fuel will always be in demand during an economic recovery. It is possible that the “oil supercycle” mentioned so often in recent years is only a phenomenon of a certain phase of technological progress during the last half of the 20th and early 21st century (a mature industrial society that is becoming post-industrial). It is the high demand for oil that made its price an indicator of not only the economic but also the political well-being of many countries, including both producers and consumers, and the movements of oil prices determined the fate of political regimes and even social systems. When the technological model is changed, oil may once again become an ordinary exchange commodity needed in the energy and chemical industries and could lose the political significance that has been attached to it over the past 40 years.

## RUSSIAN ECONOMY IN 2015

trends and outlooks

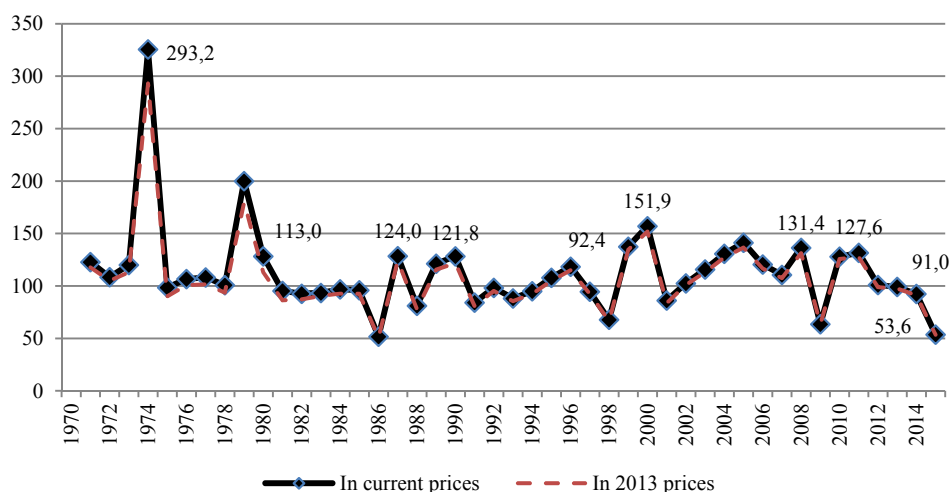


Fig. 2. Changes in the global oil prices (% of the previous year)

Source: International Monetary Fund.

Low commodity prices can result from powerful technological advances that lower the demand for (specific weight of) metals and fuels in the production of modern products. Demand for new products (advanced metals and fuels) is driven by advanced technologies. If this assumption proves to be reasonable, there may be no new cyclical recovery of prices for traditional commodities.

These are just assumptions, however. The practical conclusion is that an economic policy cannot be based on an expected resumption of high oil prices or on maintaining a consistently low level. The only thing we can assume is that oil prices fluctuate within a varying range depending on the interaction of multiple hard-to-predict parameters. The less a country's economy depends on market fluctuations beyond the control of its national government, the better the prospects for sustainable economic growth over the long term. Norway is the most obvious example of this policy, with its oil rent concentrated in a sovereign fund. At the other end of the spectrum is Venezuela, which spent much of its oil rent proceeds: its GDP fell by 10% in 2015 (Table 1). Generally, economic outcomes during 2015 clearly demonstrate that commodity price movements are not a dominant growth factor, even in countries with a significant share of commodity sectors. The quality of institutions is much more important.

Table 1

Macroeconomic indicators for selected countries in 2014 and 2015

Country/group of countries	GDP growth rate, %		Inflation, %		National debt, % of GDP		Budget balance, % of GDP	
	2014	2015	2014	2015	2014	2015	2014	2015
1	2	3	4	5	6	7	8	9
World total	3.4	3.1	3.2	3.6	79.8	80.7	-3.1	-3.6
Developed economies	1.8	1.9	0.7	0.8	104.6	104.5	-3.4	-3.1
Developing economies	4.6	4.0	5.1	5.7	41.4	44.4	-2.6	-4.3
G7	1.7	1.9	0.8	0.7	118.6	117.4	-4.0	-3.5
EU	1.5	1.9	0.0	0.6	88.1	87.7	-2.9	-2.5
United Kingdom	2.9	2.2	0.9	0.3	89.4	88.9	-5.7	-4.2
France	0.2	1.1	0.0	0.1	95.6	97.1	-4.0	-3.8
Germany	1.6	1.5	0.2	0.2	74.6	70.7	0.3	0.5
Italy	-0.4	0.8	-0.1	1.9	132.1	133.1	-3.0	-2.7
Spain	1.4	3.2	-1.0	0.7	97.7	98.6	-5.8	-4.4

Cont'd

Ireland	5.2	4.8	0.2	0.2	107.6	100.6	-4.0	-2.0
Poland	3.4	3.5	-1.0	0.1	50.1	51.1	-3.2	-2.8
Greece	0.8	-2.3	-2.6	1.5	177.1	197.0	-3.9	-4.2
Norway	2.2	0.9	2.1	2.3	28.1	28.1	8.8	6.0
Switzerland	1.9	1.0	-0.3	-1.2	46.3	46.2	-0.1	-0.2
USA	2.4	2.5	0.6	0.9	104.8	104.9	-4.1	-3.8
Canada	2.5	1.2	1.9	1.1	87.9	90.4	-1.6	-1.7
Australia	2.7	2.4	1.6	2.4	33.9	36.0	-2.8	-2.4
Saudi Arabia	3.6	3.4	2.4	2.1	1.6	6.7	-3.4	-21.6
BRICS	5.7	4.7			44.7	47.3	-2.6	-3.8
Brazil	0.1	-3.8	6.4	9.3	65.2	69.9	-6.2	-7.7
India	7.3	7.3	5.3	5.4	66.1	65.3	-7.0	-7.2
China	7.3	6.9	1.5	1.8	41.1	43.2	-1.2	-1.9
South Africa	1.5	1.3	5.8	5.5	46.0	48.4	-3.8	-4.1
Argentina	0.5	0.4	23.9	19.3	45.3	52.1	-2.7	-4.9
Venezuela	-4.0	-10.0	68.5	190.0	51.8	53.0	-15.0	-24.4
EAEU	1.0	-3.1			18.4	21.2	-0.8	-5.3
Russia	0.6*	-3.7	11.4	12.9	17.8*	20.4**	-1.2**	-5.7**
Belorussia	1.6	-3.6	16.2	16.9	40.5	40.4	0.2	-2.4
Kazakhstan	4.3	1.5	7.4	9.0	14.9	18.3	1.8	-3.2
Ukraine	-6.8	-9.0	24.9	45.8	71.2	94.4	-4.5	-4.2

\* Data on RF GDP growth rate in 2014 were upgraded the Federal Service of State Statistics in February 2016 to 0.7%.

\*\* IEP estimates of National debt and budget deficit differ from the IMF data, see Table 5 of the present chapter.

Source: World economic outlook database, January 2016.

Low commodity prices will contribute to an even greater divergence between leading countries, both developed and developing. For commodity importers, it will become a factor in economic growth; for exporters, it will be a source of crisis that will need to be addressed with structural reforms, some of which will be painful, socially as well as politically. They are highly likely to be delayed, but the price of delaying reforms may turn out to be very high in terms of political and economic stability, which was clearly demonstrated by the Soviet experience.

*The seventh is the prospects for the social structure of developed countries and the problem of inequality.* Studies show the existence of social shifts leading to the polarization of society and an erosion of the middle class. Much has been written about the middle class amid the transformational crisis in Russia. Last year, discussions began regarding the impact of the recession on the middle class in 2014 and 2015. In the broader context, this problem is related to deep structural transformations inherent in the global crisis. Although a powerful middle class is forming in developing countries, developed countries are witnessing a dilution of the middle class and increases in the proportions of more affluent strata, on the one hand, and of poorer people, on the other. This is largely connected with the profound changes in the technological structure, with the division of professions into more advanced and financially attractive areas (finance, ICT, biotechnology) apart from traditional fields, where income is not growing.

At the beginning of the 21st century, and especially in the early years of the global crisis, researchers sought to determine the top 1% of the population who concentrated wealth in their hands.<sup>1</sup> There has been an increasing amount of discussion lately about the formation of considerably large segments of the rich and the poor, with the middle class being diluted. In 2015, J. Furman, Obama's chief economic adviser, said, "You have seen a hollowing out of the

<sup>1</sup> See, e.g., Alvaredo F., Atkinson A.B., Piketty Th, Saez E. The top 1 percent in international and historical perspective. *Journal of Economic Perspectives*. 2013, Vol. 27, No 3, pp. 3-20; Mankiw N.G. Defending the one percent. *Journal of Economic Perspectives*. 2013, Vol. 27, No 3, pp. 21-34.



middle of the income distribution, and there's neither one cause for it nor a single answer. It's a big problem, it is decades in the making, and it will require a lot of solutions."<sup>1</sup> This shift is partly evidenced by the labor market structure: in the modern United States, it is much easier to find a low-paying job for a person with a low level of education, or a high-paying job for a graduate of a top university, than a mid-level job that would be most in line with the concept of the middle class.<sup>2</sup>

Social stratification, inequality, and the impact on prospects for economic growth in developed countries will apparently be among the key topics of economic and political discourse in the coming years. These issues are important not only in terms of creating a contemporary model of economic growth but also for ascertaining the more general prospects for preserving the socio-economic system currently known as capitalism. Some of the leading modern social scientists consider the erosion of the middle class as a deferred realization of Marx's forecast about the ejection of workers from the labor process, underlying his conclusion about the doom of social relations based on commodity production.<sup>3</sup>

*The eighth is the substantial increase in global tension, particularly the enhanced use of the military to resolve conflicts.* The number of conflicts has been steadily rising over the past three years. In a sense, it has become a political sequel to the global crisis. It is as yet difficult to fully estimate the real prospects for armed conflict as an indispensable factor in socio-economic and political life.

In summarizing the above, we can draw two conclusions about the development of the global situation. From a purely economic point of view,

it is developing positively. The global crisis is coming to an end, and the growth rates of the world economy and most of the world's leading regions are recovering, albeit relatively slowly and unevenly across countries and regions. Barring major turmoil in China (those risks are related to both economic and political factors), we will see a gradual return to a normal, non-crisis economic and political agenda. The problems for individual countries (e.g., Russia, Brazil and Venezuela), where the processes of structural modernization will be delayed, will not significantly impede the ability to overcome the structural crisis.

However, these completely peaceful prospects are being overshadowed by destabilizing political and military factors. Governments of the leading countries have become increasingly active in resorting to military force to address the challenges they face. This, in turn, dramatically increases risks, and not just economic ones. In other words, the risk of uncontrollable developments is increasing, which further enhances the role of non-economic factors in the implementation and efficiency of economic policies. In practice, it has no advantage over the resolution of military and occasional foreign policy objectives.

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<sup>1</sup> Fleming S., Donnan Sh. America's middle-class meltdown: Core shrinks to half of US homes. *Financial Times*. December 9, 2015. Whereas in 1970, US middle-class households accounted for 62% of the total income, in 2014, they only accounted for 43%. However, the share of the upper-middle class rose from 29% to 49% during the same period (Pew Research Center, 2015. The American Middle Class Is Losing Ground. December 9. <http://www.pewsocialtrends.org/2015/12/09/the-american-middle-class-is-losing-ground/>).

<sup>2</sup> Thompson D. The hollowing out of America's middle class. <http://www.theatlantic.com/business/archive/2010/09/the-hollowing-out-of-americas-middle-class/62330/>.

<sup>3</sup> See: Collins R. Middle class without jobs: Exits are closing. *Does capitalism have a future?* 2015. Gaidar Institute Publishers, pp. 61-62.



## 1.2. Economic situation in Russia: put-off crisis in the context of rent model

In 2015, the economic situation in Russia was driven by two groups of factors. On the one hand, it was the continued effect of the external shocks, including sanctions (especially in the financial sector) and falling prices for key Russian export products. On the other hand, there were apparent and serious structural problems that have reduced growth potential since the middle of the past decade and have caused stagnation in the Russian economy.

Both groups of factors led to the negative trends that appeared as early as 2014, which was reflected in the GDP decline in 2015 (*Table 2*). Almost all experts acknowledge that as important as the external shocks were, the structural crisis was the key problem. Indeed, a decrease in investment activity has been observed since 2012, when growth rates began to decline. These negative processes started before the sanctions and falling oil prices. The reason behind this slowdown was the decreased economic growth potential, first observed during the second half of the 2000s.

The structural crisis of the Russian economy is to some extent bound up with the global crisis that is driving all of the developed countries to search for a new growth model. But to a significant extent the crisis in Russia has been generated by internal problems, and above all by exhaustion of an extensive growth model that is based on the utilization of free resources (capacities and manpower) and the rapid growth of external and internal demand (stimulated by revenues from the export of raw materials). The need for a new model of economic growth was noted in the “Strategy for 2020”, drawn up in 2011.<sup>1</sup>

Historical analogies can help us understand the nature of present-day problems, even if they do not provide us with clear-cut anti-crisis remedies, whether positive (what is to be done?) or negative (what should not be done?). Leaving the global crisis top one side, let us examine the problems experienced in Russia during the second half of the 1980s.<sup>2</sup> The two periods display many macroeconomic, institutional and geopolitical similarities.

- a similarity in the magnitude of the fall in oil prices;
- a double shock to the budget (from the decline in revenues from exports and excise duties consequent upon the anti-alcohol campaign of 1985);
- a slowing down of growth rates, especially when compared with the developed economies of the West and the rapidly growing economy of China;
- confrontation in the geopolitical arena, including external military initiatives, and sanctions.

In both cases we note a delay in dealing with a structural crisis, one that had begun ten years earlier in the more developed economies and led to a reappraisal of the existing economic model. The scale of the inflow of resources from the export of hydrocarbons in both cases made for avoidance (or at least attenuation the impact) of the crisis in its early stages, at a time when the more developed countries were experiencing a period of turbulence. But the subsequent attempt to deal with the crisis was all the more difficult, since by this time other countries were already implementing institutional and structural changes in order to adapt to the new challenges.

As regards present day Russia, overcoming the structural crisis will entail abandoning an economy based on rent, that is, a model based on large-scale redistribution of revenues, the

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<sup>1</sup> Strategy - 2020: New growth model - New Social Policy. Two Volumes (Moscow, Delo, 2013)

<sup>2</sup> A comparison of the current crisis with problems experienced by the post-Soviet economy is to be found in V. Mau, ‘Awaiting a new growth model: the socio-economic development of Russia in 2013’, *Voprosy ekonomiki*, 2014, No. 2, 4-32.

generation and growth of which do not derive from any growth in productivity. This does not mean that we are advocating repudiation of the significant role of the raw materials branches of the economy: an economy based on raw materials is not an economy based on rent. Unlike the economies of the nineteenth and twentieth centuries, economies in the present day are no longer divided into advanced and backward. Nowadays the distinction is between advanced and backward technologies, and both can be found in any branch of an economy.

The history of the last 50 years shows that a country can be highly developed in the technological, institutional and economic spheres, while having a significant share in its economy of raw materials and, specifically, hydrocarbons (Norway, Canada, Australia). In other words, the problem resides not in raw materials so much as in the inefficiency of technologies and institutions. Overcoming this problem requires a complex range of measures that belong to the institutional sphere rather than to the removal of rental revenues (if there are any) from the current budget. This poses the question whether the national élite is capable of creating an appropriate business climate, enhancing the quality of human capital (including immigration of qualified workers), and of thereby creating a country that is efficient and competitive in all of its institutions. The experience of the last 50 years shows that it is extremely difficult to manage the development of an economy based on raw materials: the existence of rent does not facilitate, but, rather, complicates the tasks that confront the national government.<sup>1</sup>

Of course, notwithstanding all similarities, the current situation significantly differs from that which obtained on the eve of the second half of the 1980s. The present day Russian economic and political systems are much more flexible and stable than the Soviet. There are now “automatic stabilizing mechanisms” (market prices, flexible exchange rate), significant gold and foreign currency reserves and a more flexible labour market. There is no longer the burden of being a global super-power. Considerable experience has been acquired of managing the economy in both a favourable and an unfavourable external economic environment.

However there are additional complications of a strategic character that cannot be ignored. It is at present impossible to anticipate that in future prices for hydrocarbons will be comparable with the levels they reached in 2008 or even 2012. As we have indicated above, that these price fluctuations are cyclical is only one hypothesis amongst many. It would appear that a “new oil price reality” is taking shape. It would therefore be a mistake to base economic policy upon an expectation of high price levels. The need for a new “budget rule”, and a more responsible policy for expenditures in the event of an increase in revenues from the export of hydrocarbons, is only one of a number of topics of discussion.

There is another, no less immediate question: what is the mechanism for the development of a country that is rich in reserves of raw materials, in conditions in which the accumulation of rent is no longer appropriate? As we have noted above, what is being proposed is not a limitation of the role of raw materials so much as a change in the technological basis of the raw materials branches of the economy, above all a stimulation of the development value-added products, a transition from the production and export of fuel towards organic chemistry and associated

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<sup>1</sup> When in 1976 José López Portillo became President of Mexico, the country, thanks to a leap in the oil price, acquired huge budget revenues. The new President, who was popular both inside Mexico and in the outside world, assumed that henceforth all difficulties could be overcome and that the principal problem of government would consist in the “management of affluence”. However, the outcome of his six-year administration was the growth of corruption and inefficiency and he became one of the most unpopular Presidents of Mexico in the twentieth century.

production (fertilizers, polymers, plastics, etc.). Russia possesses all the material and intellectual resources needed for such a transition.

While working out this policy it will be important to avoid mistakes that will have fatal long-term consequences. In crisis conditions it is always tempting to have recourse to solutions that are as dangerous as they are simple. We have in mind various exotic and populist economic and political measures that will lead to macroeconomic stabilization and will be supported by the excuse that “this time, everything will be different”.

### **1.3. Anti-crisis economic policy**

The distinguishing feature of external economic shocks on the Russian economy has been that the macroeconomic outcome of the crisis has assumed the form of stagflation. This was not classical stagflation involving price increases and unemployment. Russian stagflation is distinctive in two respects. Firstly, employment has so far not been significantly affected - it fluctuated only to an insignificant degree in 2014-2015. Secondly, the cause of inflation was not monetary but budgetary expansionism, not an attempt to counter the economic downturn by Keynesian methods (as in the West during the 1970s), but a devaluation of the rouble that resulted from a sharp change in the external economic and geopolitical conjunctures and an ensuing “knock-on effect”. This meant that opportunities for acting on inflation, and influencing the dynamic of production were very limited.

Experience shows that external shocks should be addressed with monetary and fiscal consolidation. Cash injections in such a situation would lead to increasing inflation and undermine – rather than stimulate – investment activity. A healthy expansion of budget funding is also very difficult due to the sharp decline in budget revenues as the demand for military funding is increasing.

In December 2014, the situation seemed to be on the verge of disaster. The ruble fell rapidly following the imposition of external sanctions and the decline of oil prices, and monetary authorities opted to hold the reserves, rather than spending them to maintain the national currency. The budget, which the parliament just adopted, was becoming unrealistic before our very eyes.

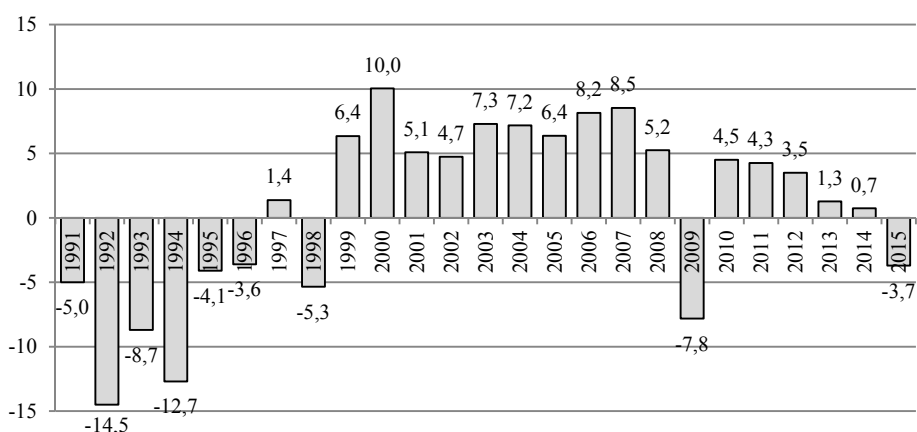
At the beginning of 2015, the government of the Russian Federation adopted a package of anti-crisis measures that included a budget review and reduction of expenditures by an average of 10%. A Government commission (in effect, an anti-crisis commission) set to work on economic policy and integration and this body examined specific problems of the functioning of individual sectors that were important to economic and social stability. The implementation of a number of measures succeeded in stabilizing the situation, but it proved impossible to control certain negative trends. Subsequently, the government was criticized for not having fully implemented the anti-crisis programme (or, rather, for under-expenditure of the resources that had been allocated to it); but it would be more correct to say that the measures adopted had been themselves ineffective.

Due to the anti-crisis policies implemented throughout 2015, the results for the year look somewhat better than expected at the end of 2014. At that time there had been the risk of serious destabilization, and the development of a macroeconomic situation that would be out of control of the government and of the monetary authorities. The worst-case scenarios have not materialized. The timely transition to a floating exchange rate (called a transition to “inflation targeting”), the consolidation of budget expenditures and the implementation of the government’s anti-crisis

plan prevented the situation from spinning out of control, preserved the international reserves, and significantly slowed the GDP slump.

In the following discussion, we will study the main economic and political problems and solutions from 2015 and their impact on the prospects for the country’s socio-economic development.

*Economic trends.* GDP declined by 3.7% in 2015. This is the second recession since 1999, when the Russian economy shrank by 7.8% in the wake of the global crisis (*Fig. 3*). However, whereas in 2009, the decline occurred in the majority of developed countries, growth is now accelerating there. Throughout the year, statesmen and experts discussed the “passing of the bottom” of the recession, i.e., the point at which it should stop (*Table 2*).



*Fig. 3.* Dynamics of GDP of Russia (growth rates to the previous year %)

Source: Rosstat.

*Table 2*

**Industrial production: passing the low point in 2015 (%)**

Industry	Share in the industrial production index	“Bottom” passed	Change in the output index, October 2015 against July 2014
Industrial production index		√ (June)	96.19
Mining and minerals	33.99	√ (May)	101.31
Manufacturing	52.50	√ (July)	93.44
<i>including:</i>			
Food products, beverages and tobacco	17.05		101.65
Textiles and textile products	1.43		83.88
Leather, leather products and footwear	0.32	√ (June)	89.60
Wood processing and wood products	2.20		95.92
Pulp and paper	3.92	√ (May)	96.81
Coke, petroleum products	18.78		100.09
Chemical production	7.46	√ (no reduction)	107.61
Rubber and plastic products	2.26	√ (May)	95.90
Other non-metal mineral products	4.41		86.90
Metallurgy and metal product	17.23		92.39
Machinery and equipment	6.24	√ (July)	86.84
Electrical and optical equipment	6.05		84.04
Transport vehicles and equipment	7.06	√ (July)	81.18
Other production	5.59		87.58
Electricity, gas and water	13.51		98.00

Source: Rosstat.

Two important factors drove the nature and duration of the downturn in 2015 and made it difficult to predict, i.e., the industry structure and exchange rate trends. The changing terms of trade – and, as a consequence, the devaluation of the national currency<sup>1</sup> – had different effects on particular industries, which showed differing trends over the past year. Export-oriented industries demonstrated growth, whereas those associated primarily with domestic consumption shrank. The hardest blow, however, was dealt to those industries that had previously benefited most from the inflow of rental income, i.e., services, trade, and construction. Indeed, an analysis of the problems associated with the Dutch disease has shown that a powerful inflow of rental income undermines competition in most industries producing tradable goods but contributes to the development of sectors in which there are no imports (trade, construction, financial and non-financial services). Accordingly, there can be no import substitution there. Those sectors grew at an especially rapid pace in the past. However, for the same reason, it is these sectors that are most susceptible to decreased demand as a result of the devaluation. Without a doubt, the trend in each particular sector was strongly affected by the share of incoming imported goods and the high proportion of borrowings in foreign currencies within the sector.<sup>2</sup>

A combination of those factors drove the GDP trend. When the devaluation processes had stalled by mid-2015, industry began to show signs of recovery. However, a new round of oil price declines, and the further weakening of the ruble that followed, prolonged the recession.

The investment situation evolved similarly, which appeared to be stabilized by the early autumn. However, the uncertainty about the exchange rate, and accordingly, the effectiveness of the business environment, has led to a continued decline in investment.

We can assume that in the absence of political shocks, a new equilibrium will be achieved in several months. In terms of macroeconomic factors, to restore growth, Russia needs neither high nor low, but stable, oil prices to determine clear conditions for businesses to make decisions.

*Structural policies and import substitution.* Devaluation, for all its drawbacks, has been linked with opportunities for import substitution and diversification of the economy, especially in the sphere of exports. But from the very outset, it became evident that, for a number of reasons, there would be no repetition of the effect of 1999: owing to the global situation (political and economic); owing to a lack of significant spare capacities and manpower; owing to the much deeper integration of the Russian economy in the value-added chain, that is the dependence of domestic production upon supplies of imported equipment or spare parts; and owing to the fact that amongst the developing countries that were in competition with Russia, devaluation was being widely used as an instrument for managing inflation.

In the past (this applies not only to Russia), the consequences of devaluation were deferred, but the main results were already visible during the first year. However, in the context of modern multilateral devaluations and the global contraction of demand, their effect will be uneven across countries and will be deferred, at best, if the devaluation can be enhanced with

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<sup>1</sup> See in detail on mechanism of changes: Idrisov G.I., Ponomarev Yu.Yu., Sinelnikov-Murylev S.G. Terms of Trade and Economic Development of Contemporary Russia. *Ekonomicheskaya Politika*. 2015, № 3. pp. 7–37.

<sup>2</sup> See G.I. Idrisov, ‘Winners and losers: consequences of changes in the terms of trade for Russian industry’, *Russian Economic Development*, 2015, No.4, 26-29; G. Idrisov, A. Kaukin, O. Morgunova, M. Turuntseva, ‘Industry: trends appear worse than the data’, *Operational Monitoring of the Economic Situation in Russia. Tendencies and Challenges of Socio-Economic Development*, 2015, No.7 (April), 21-24.

relevant structural reforms. This has been demonstrated by the experience of many countries, the most prominent being Japan, which failed to start the growth mechanism in this way.

The effect of import substitution is important and possible, but it is not straight-forward or automatic. The following are the reasons behind the modified impact of devaluation on economic growth:

- the structural effects of a long period of Dutch disease physically degrades manufacturing businesses (and related labor resources), which could become a source of import substitution: they simply cease to exist and cannot recover automatically. Therefore, recovery primarily concerns export sectors that have the ability to expand production without significant investment;
- in the absence of free capacity, import substitution requires investment and, consequently, a healthy investment climate. Devaluation could, to a certain extent, compensate for the poor business climate by reducing the risk-profit ratio. However, when making investment (i.e., long-term) decisions, devaluation is not the most important argument;
- devaluation makes the country more attractive for foreign investment. However, Russia's situation is currently aggravated by the sanctions;
- the country's involvement in international trade (global value chains) also limits the potential benefit from devaluation, as some of the cost components are increasing as a result. Thus, the impact of devaluation on import substitution can be discussed only subject to a correct analysis of specific sectors and products.

As a result, the opportunity to benefit from devaluation arose only within specific sectors in 2015. They are primarily associated with exports. At the same time, the devaluation helped identify weak spots and revealed the excessive dependence on imports for a number of manufacturing businesses and certain areas of the consumer market. The business models based on foreign exchange loans and related purchases of imported equipment began to collapse.

As a consequence of devaluation, Russian producers obtained a number of additional competitive advantages in external markets. Results for 2015 showed that the most stable position in the Russian economy was occupied by companies producing goods for export, and not export of raw materials, moreover. It is this group that is becoming the new locomotive for the expansion of exports.

A government commission to support import substitution was established in 2015, as was the Russian Export Center to support non-commodity exports. An understanding of the nature and mechanics of this support formed gradually. President Vladimir Putin and Prime Minister Dmitry Medvedev<sup>1</sup> spoke unambiguously in favor of linking import substitution support with the ability to make products that would be competitive on foreign markets. This means that the government is aware of the risk (known from the experience of a number of countries, particularly in Latin America) that import substitution could actually mean closing off the market to foreign goods and forcing domestic consumers to purchase more expensive and inferior goods produced within the country.

Throughout 2015, attempts were made to limit the exports of goods that benefited from devaluation (e.g., grain, metals, chemicals). This argument was the concern about the physical scarcity of goods for domestic consumption and the idea that exporting those goods would lead to higher domestic prices. (In fact, these are the same argument, only in the former case it acts as

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<sup>1</sup> Medvedev Dmitry. A new reality: Russia and global challenges. *Journal of Russian Economics*, 2015, Vol. 1. No 2, p. 120

the “phantom pain” of the Soviet-era shortages, whereas in the latter, it was embedded in the market economy rhetoric.) However, no tangible action was taken in this area. Only the ban on the exports of hides and skins was extended, and a ban on the export of wastepaper was imposed in December.

*Fiscal policy.* In the face of external shocks, the government pursued a prudent fiscal policy, although it cannot entirely be called conservative. The federal budget deficit totaled 2.4% of the GDP compared with 0.5% in 2014, and national debt remained at 14.3%— a very low value by all international standards—whereas foreign debt actually decreased slightly (obviously as a result of the sanctions, rather than conscious fiscal conservatism).

With export revenues declining, the Russian government should have adjusted the federal budget to reduce expenditures in February and March 2015. A 10% sequestration was selected as the appropriate tool. Technically, it was the simplest solution, not precluding the possibility of using it in the future. However, it can have adverse implications in the medium term.

The problem is that over the past seven to eight years, the allocation of budget expenditures has deteriorated: the proportion of productive expenditures has diminished, and the proportion of unproductive ones has increased.<sup>1</sup> To address the long-term challenges of the country’s socioeconomic development, the economy needs investment in human capital and transportation infrastructure, as these public expenditures increase potential growth. At the same time, it is these sectors that lose the most from sequestration.

Further sequestration of expenditures without structural reforms (including reforms for budget-funded organizations) is posing grave risks for the country’s economic, social and political stability in the coming years (2017–2020). Without structural reforms, fiscal policy will lose the leeway that may be needed in 2017 and 2018, and the positive macroeconomic effects of devaluation will be offset.

Under these conditions, the allocation of budgetary expenditures is becoming as important as a well-balanced budget (low deficit). Achieving balance at the expense of productive sectors threatens to start a vicious cycle: reducing spending on productive sectors will undermine economic development, thereby shrinking budget revenues. Consequently, the key objective now is to optimize expenditures, i.e., to look for more sophisticated budget savings methods through structural and institutional solutions, rather than by mere sequestration.

In 2016, the government will have to resort to increasing the federal budget deficit in light of sharply decreasing hydrocarbon prices.

The key question is – what will be the size of the deficit? The President of the RF in his address of December 2015 stipulated that it should not exceed 3% of GDP. However, there is a considerable likelihood that this level will be exceeded. There will be a complicated search for a compromise – how to ensure socio-political stability while at the same time avoiding a deterioration of macroeconomic indicators.

It is often noted that low debt creates additional macroeconomic problems, particularly by depriving the monetary system of adequate collateral instruments. Proposals have even been made to set a floor for the national debt rather than a cap (“at least” instead of “not more than” a certain level).<sup>2</sup> This is hardly possible or feasible. On the one hand, Russia lacks a

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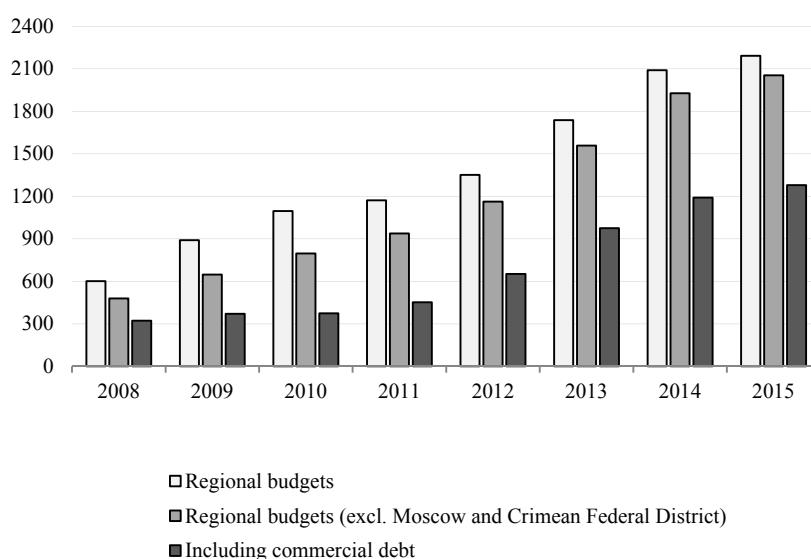
<sup>1</sup> For more detail, see G. Idrisov and S. Sinelnikov-Murylev, “Budget policy and economic growth”, *Problems of Economics*, 2013, No.8, 35-59.

<sup>2</sup> The Stolypin Club’s proposals, published in autumn 2015, state that “the share of domestic national debt should not fall below 60% of the GDP in terms of total borrowings”. (The Stolypin Club. ‘Economic Growth’. Report (Moscow, 2015), 60. [http://expert.ru/data/public/499741/499785/dir-polnaya-versiya-19\\_10\\_15.pdf](http://expert.ru/data/public/499741/499785/dir-polnaya-versiya-19_10_15.pdf))



significant amount of private savings that the state could borrow without prejudice to private investments, let alone the transition to direct funding of the budget deficit through money creation by the Central Bank. On the other hand, given Russia’s unfavorable “credit history,” a substantial increase in borrowings will lead to their significant appreciation. In our opinion, ensuring macroeconomic stability means a rather long period of low debt for Russia.

The budget situation remains difficult for the subjects of the Russian Federation. Although actual tax revenues have fallen in real terms, the debt situation had not deteriorated significantly (*Fig. 4, Table 3*). Nominal income growth prevents uncontrollable developments. A slowdown was observed in spending growth within the consolidated budgets, which increased by only 1.4% (93% of budgeted expenditures were actually made).



*Fig. 4.* Debt of the budgets for subjects of the Russian Federation (RUB billion)

Source: Ministry of Finance of the Russian Federation.

*Table 3*

**Growth rates of main types of tax revenues included in consolidated budgets for subjects of the Russian Federation in 2015, in (%) to the previous year**

	In nominal terms	In real terms*	The share of tax and non-tax revenue, %
<b>Tax and non-tax revenues</b>	<b>6,2</b>	<b>-5,9</b>	<b>100,0</b>
Individual income tax	4,3	-7,6	36,8
Corporate income tax	7,3	-4,9	27,6
Property tax	11,6	-1,1	14,0
Excise duties on excisable goods	1,5	-10,1	6,4
Small business tax	10,4	-2,2	4,6

\* Given the CPI for 2015.

Source: Federal Treasury (Roskazna); Rosstat; Author’s calculations.

An important trend was the slowing down of the growth of the debt of consolidated regional budgets by comparison with 2013 and 2014. Growth in 2015 had been of the order of 11% (compared with 29% in 2013 and 20% in 2014). In 2015, commercial debt was replaced by debt owed to the Ministry of Finance. The share of commercial debt fell in 2015 from 64% to 60%, but by contrast the share of budget credits increased from 31% to 35%. This made possible



a slight improvement in the structure of debt in terms of the cost of debt servicing. Meanwhile, medium term prospects for debt servicing are somewhat problematical and the question periodically arises within the political élite whether it would be sensible to write off a proportion of the budgetary indebtedness of the regions.

A further deterioration of revenues will most likely lead to the need to raise taxes. The official positions remain intact regarding the impermissibility of raising taxes during times of crisis and maintaining a moratorium on decisions in this area until 2018. However, in certain situations, raising certain taxes may be a more appropriate solution than sequestration or increasing domestic debt.

*Monetary policy.* The transition to a floating exchange rate for the ruble has saved the foreign exchange reserves, which in itself is important for long-term economic development. Raising the discount rate was also an important and responsible decision, despite fierce criticism from a significant segment of the political and business elite. It is equally important that V. Putin has repeatedly spoken about supporting the Russian Central Bank's policy. Monetary authorities continue to show support for the goal of bringing inflation down to 4% by 2018, thereby creating qualitatively new business conditions.

In addition to maintaining reserves, the Central Bank's policy has contributed to reducing capital flight, although much of the outflow resulted from Russian borrowers paying off foreign debts (*Table 4*).

Table 4

**Capital outflow (USD billion)**

Indicator	2014	2015
Net capital outflow from the non-governmental sector	-153.0	-56.9
Liabilities to non-residents ("+" means growth)	-36.7	-64.3
FDI in the non-banking sector	18.5	6.7
Other liabilities	-55.2	-71.0
Including foreign debt repayment according to schedule	-208.3	-126.4
New borrowings	153.1	55.4
Foreign assets ("-" means growth; "+" means reduction)	-116.3	7.4

Source: Bank of Russia.

Thus, in 2015, the net outflow of capital equaled USD 57 billion (USD 153 billion in 2014). The main channel for capital outflows was the net repayment of liabilities to non-residents, which dropped by USD 64 billion compared with USD 37 billion in 2014. However, we can assume that capital flight was also driven by geopolitical factors, as concerns about potentially expanding the sanctions could have made foreign investments less attractive. In particular, this is illustrated by the decline in foreign direct investments from USD 18 billion in 2014 to USD 7 billion in 2015.

The propensity towards the "dollarization" of savings also decreased, as household ruble assets grew significantly faster than foreign exchange savings. Although Russian banks, companies and households (in terms of foreign currencies) increased investments in foreign assets in 2014, foreign assets held by Russian residents declined slightly in 2015 amid the intensive external debt re-payment. In 2014, the main channel for capital flight was the growth in foreign assets (by USD 116 billion, including USD 30 billion of investments in foreign currencies in cash), which declined by USD 7 billion in 2015. This decline is almost entirely due to reduced investments in foreign currencies in cash.

The severe criticism of the policy pursued by the Central Bank, which is often blamed for all of the problems with the Russian economy, seems unfair. Paradoxically, those who particularly criticize the “monetarists” turn out to be true monetarists in practice, as they exaggerate the ability of monetary authorities to neutralize negative impacts from the external environment or geopolitical crises.

*The banking sector* remains a focus for the authorities. On the one hand, the efforts to clean up have continued. Licenses were withdrawn from 93 credit organizations (86 in the previous year). Financial recovery (rehabilitation) procedures were initiated for 15 banks in 2015. The total assets for banks that lost their licenses in 2015 were not very large, as they accounted for approximately 1% of the total assets in the banking sector.

On the other hand, some of the major banks have received strong financial support from the state, as the crisis in the banking sector would have led to dire consequences, not only economic but also social and political. Most of the government support went to state-owned banks.

The capital of the largest banks, affiliated to state institutions or state companies (banks of the VTB group, Gazprombank and Rosselkhozbank)<sup>1</sup> increased by more than 900 billion rubles from the beginning of 2015 and that of all other banks by less than 200 billion rubles. A consequence of this preference in state support will be a strengthening of the position of state banks in the key sectors of the banking services sector, primarily in the retail credit sector and in personal savings.

Lending to businesses slowed but still showed a positive trend of almost 7%, and the indebtedness of individuals declined by about the same amount, a much milder reaction than in 2009. The quality of bank loans does raise concerns, however. Past due debts held by corporations under ruble loans have already reached the high set in 2009, and the individual debts broke record values. The quality of loans continues to deteriorate in all segments of the market.

The greatest problem is still poor financial results in the banking sector and losses of a large number of banks. In 2015, almost 30% of operating banks recorded losses, compared with only 11% in 2009. In contrast to the situation six years ago, the current decline in banking profit margins was caused not only by deteriorating asset quality and the need to drastically increase spending on provisioning but also by lower profit margins on core banking operations. The latter was due to the high-interest-rate policy. The value of bank liabilities proved to be more sensitive to increases in the discount rate than the returns on loan portfolios, resulting in a significant reduction in overall net interest income.

*The social situation and the labor market.* In 2015, as in previous post-Soviet crises, incomes decreased against the relative stability in the labor market. Unemployment hovered at approximately 5.5%, which is higher than the US figure, but considerably lower than the European level. In a tense demographic situation, and with the decline in the working-age population, businesses are hesitant to severely reduce employment, instead trimming working hours and payments.

Well-being dropped significantly during the year, with real disposable income decreasing by 3.4% and real wages by more than 9.5%. This fits into the “Russian labor market model,” i.e., reducing wages rather than employment.

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<sup>1</sup> Sberbank did not attract new credits but its capital increased in the first quarter by 215 billion roubles thanks to previously agreed subordinated credits from the Bank of Russia, received in the summer of 2014 in conformity with a new edition of the law “On supplementary measures for the support of the financial system of the Russian Federation”, 173-FZ of 13.10.2008.

At the same time, bank savings have increased, mostly in rubles. This signifies a transition from consumption-driven to savings-driven behavior, which is an additional factor slowing down the economy in the short term, as demand becomes even more limited, but the crisis-related uncertainty does not encourage the transformation of savings into investments. Consequently, retail trade turnover fell by approximately 10%.

As a result, the poor population began to grow rapidly. The share of Russians in the poor category returned to the level of the mid-2000s (20.3 million persons with income below the subsistence level). This is a new phenomenon in recent years. In 2008 and 2009, despite the 7.5% decline in GDP, this figure was 19 million persons, having significantly decreased afterwards (*Table 5*). At that time, the state possessed considerable budgetary savings (the Reserve Fund), which were allocated to maintain the standard of living. The economy had to pay for this with a budget deficit of 6% of GDP in 2009, with the non-oil deficit reaching a record-breaking 14%. Those resources are no longer available in the budget.

Table 5

### Basic economic indicators of the Russian Federation 2007–2015

	2007	2008	2009	2010	2011	2012	2013	2014	2015
1	2	3	4	5	6	7	8	9	10
<b>Macroeconomic indicators (rate of growth as a % of the preceding year)</b>									
GDP	8.5	5.2	-7.8	4.5	4.3	3.5	1.3	0.7	-3.7
Industry	6.8	0.6	-10.7	7.3	5.0	3.4	0.4	1.7	-3.4
Agriculture	3.3	10.8	1.4	-11.3	23.0	-4.8	5.8	3.5	3.0
Construction	18.2	12.8	-13.2	5.0	5.1	2.5	0.1	-2.3	-7.0
Wholesale trade	9.5	5.4	2.0	3.0	4.4	3.6	0.7	-3.9	-9.9
Retail trade	16.1	13.7	-5.1	6.5	7.1	6.3	3.9	2.7	-10.0
Final consumption of domestic economies	14.3	10.6	-5.1	5.5	6.8	7.4	3.7	1.7	-10.1
Investment in basic capital	23.8	9.5	-13.5	6.3	10.8	6.8	0.8	-2.7	-8.4
Share of wages in GDP	46.7	47.4	52.6	49.6	43.9	44.2 <sup>1)</sup>	46.1 <sup>1)</sup>	44.8 <sup>1)</sup>	45.4 <sup>1)</sup>
Share of profit and mixed revenues in GDP	34.1	32.6	30.8	32.6	41.5	41.1	39.7	41.1	43.6
<b>Indicators of public finance and international reserves</b>									
Surplus («+»)/Deficit («-») of the consolidated budget (including extra-budget funds) as % of GDP	6.0	4.9	-6.3	-3.4	1.5	0.4	-1.3	-1.2	-3.5
Surplus («+»)/Deficit («-») of the Federal Budget as % of GDP	5.4	4.1	-6.0	-3.9	0.8	-0.1	-0.5	-0.5	-2.4
Oil and Gas Deficit of the Federal Budget as a % of GDP	-3.3	-6.5	-13.7	-12.2	-9.3	-10.5	-10.4	-10.9	-9.7
Domestic State Debt of the RF in Securities, billion roubles	1248.8	1421.5	1837.2	2461.6	3546.4	4064.3	4432.4	5475.7	5573.1
Foreign State Debt, billion USD (Date of Ministry of Finance)	44.9	40.6	37.6	40.0	35.8	50.8	55.8	54.4	50.0
Consolidated State Debt as % of GDP	7.2	6.5	8.3	9.0	9.5	10.5	11.4	14.4	14.3 <sup>1)</sup>
Reserve Fund (in 2007, Stabilization Fund), end of year, billion USD	156.81	137.09	60.52	25.44	25.21	62.08	87.38	87.91	49.95
National Welfare Fund, end of year, billion USD		87.97	91.56	88.44	86.79	88.59	88.63	78.00	71.72
International Reserves of the Bank of Russia, end of year, billion USD	478.8	427.1	439.0	479.4	498.6	537.6	509.6	385.5	368.4

## RUSSIAN ECONOMY IN 2015

### trends and outlooks

Cont'd

Prices and interest rates									
Growth rates of consumer prices, December to December %	11.9	13.3	8.8	8.8	6.1	6.6	6.5	11.4	12.9
Growth rates of producers' prices, December to December %	25.1	-7.0	13.9	16.7	12.0	5.1	3.7	5.9	10.7
Key rate of the Bank of Russia (until 2013 the minimal one-day REPO rate), annual average, % per annum	6.0	6.9	8.3	5.3	5.3	5.3	5.5	7.9	12.6
Average interest rate on loans to enterprises in roubles, annual average, % per annum	10.0	12.2	15.3	10.8	8.5	9.1	9.5	11.1	15.7
Annual interest rate on deposits of physical persons (excluding no-notice deposits)	7.2	7.6	10.4	6.8	5.4	6.5	6.5	6.7	9.7
Labour Market									
General level of unemployment, year average, %	6.0	6.2	8.3	7.3	6.5	5.5	5.5	5.2	5.6
Average Wage, thousand roubles per month	13.6	17.3	18.6	21.0	23.4	26.6	29.8	32.5	34.0
Growth of real wages, %	17.2	11.5	-3.5	5.2	2.8	8.4	4.8	1.2	-9.5
Dynamic of real disposable income of households, %	12.1	2.4	3.0	5.9	0.5	4.6	4.0	-0.7	-4.0
Numbers of population with money incomes below subsistence level, million persons	18.8	19	18.4	17.7	17.9	15.4	15.5	16.1	20.3 <sup>2)</sup>
Banking Sector									
Number of active credit organizations, end of year, units	1136	1108	1058	1012	978	956	923	834	733
Number of licences for the conduct of banking operations withdrawn during the year, units	49	33	43	27	18	22	32	86	93
Growth of assets, %	46.1	32.7	3.7	14.8	21.4	20.4	14.2	18.6	-1.5
Growth of bank-loan indebtedness of resident legal entities (excluding banks), %	52.4	28.6	0.0	9.6	22.8	15.5	11.6	12.7	5.0
Growth of bank-loan indebtedness of resident physical persons, %	58.3	31.2	-11.7	14.4	35.5	39.1	27.7	11.6	-7.3
Percentage of overdue loans to resident legal entities, excluding banks, %	0.9	2.2	6.0	5.5	4.8	4.6	4.1	4.1	6.0
Percentage of overdue loans to physical persons, %	3.1	3.6	6.9	7.1	5.3	4.1	4.5	6.0	8.4
Profit, billion roubles	508	409	205	573	848	1012	994	589	192

<sup>1</sup> For January- September 2015.

Source: Rosstat, Treasury of Russia, Finance Ministry of Russia, Bank of Russia.

Researchers have begun to note the erosion of the middle class within the country,<sup>1</sup> although one needs to distinguish between the problems of cash flows (reduced current income) and

<sup>1</sup> T. Maleva (Senior Editor). *2014-2015 Economic Crisis - The Social Dimension* (Moscow. Russian Academy of the National Economy and Public Administration, 2015, 12-13.

reserves (accumulated well-being, behavioral stereotypes). The crisis has led to a certain reduction in inequality, with the Gini coefficient decreasing from 0.141 to 0.399 and the decile funds ratio from 15.8 to 14.2.<sup>1</sup> However, this can hardly be called a positive trend.

The data for 2015 indicate that the situation is difficult and tending to deteriorate, but that there is, as yet, no threat of socio-political destabilization. Whereas, during the period of high economic growth an excess of consumer demand adversely affected the structure of growth, and an intensification of measures to stimulate production had to be considered, the situation is now different. At present, the growth of incomes and population consumer behaviour indicate that to re-launch economic growth special measures will be needed to stimulate demand. This does not mean, however, that the need for active measures on the supply side should be ignored.

#### 1.4. Priorities and risks for forthcoming period

Russia's economic policy is facing two key challenges: starting economic growth and dampening reductions in household well-being. These challenges are correlated, as the first leads to increased well-being and the second generates demand for economic growth.

Solving these tasks is tricky because we are facing a structural crisis rather than a cyclical one. The end of the downturn, which cannot last long (much less forever), in this case does not automatically restore growth. Unless we make special efforts to build a new growth model, the potential for growth will remain low, which means that the economy will hover around zero (or within statistical error). Unlike a recession, this may last long enough for the political elite to form a model suitable for modern challenges, with the respective impact on well-being and social stability.

The most serious challenge facing Russia is not overcoming the recession but achieving economic growth. Of course, we mean sustainable, long-term growth accompanied by structural modernization, rather than achieving good-looking statistics. In the foreseeable future, Russia must strive for growth rates exceeding the world average (or somewhere between those of Germany and China).

This is not a trivial task and has no standard solutions, unlike stabilization. Solutions will be contingent upon the features of the current era and our country. An answer to this challenge requires major institutional reforms in all spheres of society, not exclusively in the economy. Here, there will have to be initiatives on the side of demand as well as supply.

If we are to re-launch the growth mechanism, we must first of all identify the sources of growth – external and internal. State procurement, the procurement of corporations with state participation, and social expenditures, must be undertaken with regard to opportunities for influencing the demand for high-quality goods and services. We must also qualitatively change the situation as it develops on the supply side, that is, in relation to factors that influence the decision of entrepreneurs either to develop their business or leave the market.

We suggest the following key points for economic policy that can solve both issues.

*Disinflation* and the realization of a target level for inflation of 4%, if not by the end of 2017 as inscribed in the Basic Goals of Monetary-Credit Policy then in the fairly near future. Steady progress towards this target will provide a number of interlinked results that will be contributory to economic growth:

- the predictability of economic life will be improved, that is, business will acquire the perceptible quantitative guidelines that are essential to its functioning;

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<sup>1</sup> T. Maleva (Senior Editor). *2014-2015 Economic Crisis - The Social Dimension* (Moscow. Russian Academy of the National Economy and Public Administration, 2015, pp. 15-17.

- credit will become accessible, given that the rate of inflation is linked to the key interest rate and the commercial lending rate;
- price stability will contribute to social stabilization and a growth of consumer demand in the economy.

Budgetary policy, including:

- a gradual return to non-deficitary budgets together with constraint on the growth of government debt, this being fundamental to confidence in the country's macroeconomic policy;
- budget manoeuvre in favour of the productive branches of the economy (transport and social infrastructure) as an indispensable precondition of increasing the potential for growth;
- a rationalization of expenditures by optimizing the budget network and budget procedures, while abandoning sequestration as the principle means of balancing the budget;
- adoption of a new budget rule in the event of the return of a favourable conjuncture in the sphere of hydrocarbons.<sup>1</sup>

The *formation of a favourable investment climate* must become a priority at all levels of government. This should become one of the key success indicators of the work of regional administrations. A rating system has been designed to measure the investment attractiveness of regions, and regional investment teams have been formed, with these objectives in mind.

The attainment of a high score in the rating "Doing Business", as experience shows, is a valuable goal, but in itself does not provide an answer. Russia has advanced from 120<sup>th</sup> in the ranking in 2012 to 51<sup>st</sup> in 2015 but the indicators for investment activity and economic growth over this period have been quantitatively worse. We face the paradox that in 2011 Russia was in 120<sup>th</sup> place with a growth of GDP of 4.3%, but when it achieved 51<sup>st</sup> place GDP growth had fallen to 3.9%. Of course, this is not an argument for returning to 120<sup>th</sup> place, but the rating obviously has its limitations as a goal of economic policy. Clearly, improvement of the investment climate should be key.

Priority measures for the improvement of the investment (and entrepreneurial) climate should include:

- deregulation of the economy;
- a reform of the supervisory bodies. Reform should involve a reduction in the number of state functions, which should lead to a reduction in the number of supervisory bodies and in the number of inspections. A risk-oriented approach should be encouraged;
- support for small and medium-sized business. This is the objective of the Federal Corporation for the Development of Small and Medium sized Business, set up in 2015;
- the protection of property and safety for the entrepreneur.

The *growth of competition* provides an important stimulus for the development of entrepreneurial activity. Devaluation complicates this issue since it limits the access of foreign goods to the domestic market.

In this sphere there are serious issues concerning the need for a change in the key tasks of anti-monopoly policy. Russian anti-monopoly authorities must concentrate upon countering administrative and infrastructural monopolies, the sources of which are the political authorities and natural (environmental or technological) constraints upon competition. There should be less preoccupation with private-economic entities that are achieving success (even domination)

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<sup>1</sup> Mau Vladimir. Between crises and sanctions: economic policy of the Russian Federation. Post-Soviet Affairs. <http://www.tandfonline.com/doi/pdf/10.1080/1060586X.2015.1053723>.

in local markets thanks to their superior productivity. At present, the anti-monopoly service is focussing upon precisely such cases.<sup>1</sup>

*Stimulation of non-raw materials exports:* for present-day Russia with its relatively limited market (this is one of the many features distinguishing Russia from China) external demand is extremely important for ensuring stable economic growth. It was for this reason in particular that the Russian Export Centre was founded in 2015. However, the administrative decision needs to be backed up by institutional measures, namely:

- the removal of barriers to exporting and to external economic activity in general. In the rating “Doing Business 2016”, Russia’s position in international trade fell over the year from 155<sup>th</sup> to 170<sup>th</sup>. There must be a radical simplification of procedures for permitting goods to cross the frontier (a reduction in the number of documents to be presented to three or four, completed online and on a single website);
- any extension of the practice of administrative restriction of the export of non-raw materials goods must be prevented;
- a removal of barriers to imports, given that in conditions of global value-added chains the efficiency of exports frequently depends upon the efficiency of imports associated with particular exports;
- the stimulation of exports must be directly linked to a policy for import substitution. In principle, the ability to deliver goods for export must be the main criterion when deciding whether to support the projects for import substitution of particular enterprises.

*Institutional reforms in the sphere of human capital* - education, health care, the pension system. We need to achieve a balanced solution of the tasks that confront us in the social (development of human potential in particular), fiscal (efficient expenditure of available financial resources) and investment spheres.

The objective of *social policy* must be the differentiated delivery of essential assistance, an increase in social support that is concentrated on those in greatest need. Over and above the social effects, targeted social care will act as a factor stimulating demand for the goods and services of domestic producers.

While discussing how to set growth in motion, we should not neglect measures, the implementation of which will be long-term. These include, primarily:

- the formation and development of international economic unions and zones, beginning with the Eurasian Economic Union, but not resting there. Russia must continue to promulgate with the EU the idea of a single economic space (“from Lisbon to Vladivostock”), and strive to participate in the various free trade zones that are at present being formed;
- notwithstanding the complexity of the contemporary currency situation, the monetary authorities must not abandon the objective of making the rouble a regional reserve currency.

The priorities that have been listed are also associated with **risks** that the Russian economy will encounter in the foreseeable future.

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<sup>1</sup> International research into the anti-monopoly policy of 36 countries shows that of 3527 cases of abuse of a dominant position examined by thirty-six participants in the rating, 3056 or 87% of these were carried out by the Federal Anti-Monopoly Agency. Moreover the Russian agency had only 3% of the aggregate budget of participants and 22% of the aggregate personnel. What is significant is that inspections of small and medium sized businesses were much more numerous than those of the first hundred largest companies by turnover, specifically 25 and 6 cases. (See Rating Enforcement 2015: The Annual Rating of the World’s Leading Competition Authorities. *Global Competition Review*, 2015, Vol. 18, Issue 6, p. 28).

It will be a major problem, obviously, if *low growth rates continue* into the foreseeable future and the élite becomes accustomed to these growth rates. At present, no one is contemplating the possibility of a 5% growth rate, and as recently as 2013 many economists considered 3% to be unrealistic and extremely risky. The Prime Minister of Japan has expressed the view that long-term stagnation cannot be ruled out. However, in Russia a growth rate significantly lower than the average for the world economy will result in social and economic degradation.

One source of risk is the *volatility of prices for hydrocarbons*. If there is to be stability of economic development we need stability of the external economic environment, which will translate into relative stability of the exchange rate. From the standpoint of economic policy, stability is preferable to volatility, whether in an upward or downward direction. In present Russian conditions both increases and falls in the oil price have an inflationary effect, in the first instance through the mechanism of the “Dutch Disease”, and in the second through the “knock on effect” on the exchange rate and prices. But containing inflation, is, as we have shown above, is one of the principal preconditions of a return to a trajectory of economic growth.

There is also a risk of adoption of a policy of artificial acceleration - a repeat of the policy of 1986-1989. Experimentation with the exchange rate (fixing the exchange rate), accompanied by state debt and state investments aimed at stimulating rates of growth, can only lead to a repetition of the crisis of the end of the 1980s-1990s.

There is a corresponding risk of the *persistence for an extended period of high inflation*. As it happens, there are powerful economic agents who have a vested interest in this. These include many recipients of budget funds, given that the inflation model makes possible the continuation and even increase of nominal expenditures, thereby easing the current operational burden of the budget sector.

The debate over the relative merits of an inflationary approach to balancing the budget and of sequestration persists in discussions of the economy. Arguments based on considerations of political economy are sometimes put forward, namely that inflation would make it possible to introduce cuts in real expenditure gradually, given that nominal cuts are as a rule introduced at the expense of those sectors that are most important for growth, but politically least influential - education, health care, science, infrastructure. A number of structures in the banking sector and in the services sector that suffer most from the squeezing of demand, also have a vested interest in inflation. In other words, the habit of inflation and a growth of pro-inflation attitudes have become a serious problem in contemporary Russia, and an abandonment of the 4% target would be dangerous not only for monetary stability but also for the prospects for structural modernization.

And, of course, the persistence of a trend towards a reduction in welfare, which could result in acute socio-political destabilization, is also a serious problem. However this topic does not belong in the present section.

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2015 was a difficult year, but the results achieved were better than expected at the end of 2014. The prime objective for the period 2016-2018 must be the formation of a mechanism for a return to economic growth, and the avoidance of populist scenarios. A great many aspects of Russian life, in the post-crisis world that is evolving around us, will be affected by the manner in which this objective is realized.



## Section 2. Monetary and Fiscal Policies

### 2.1. Monetary policy<sup>1</sup>

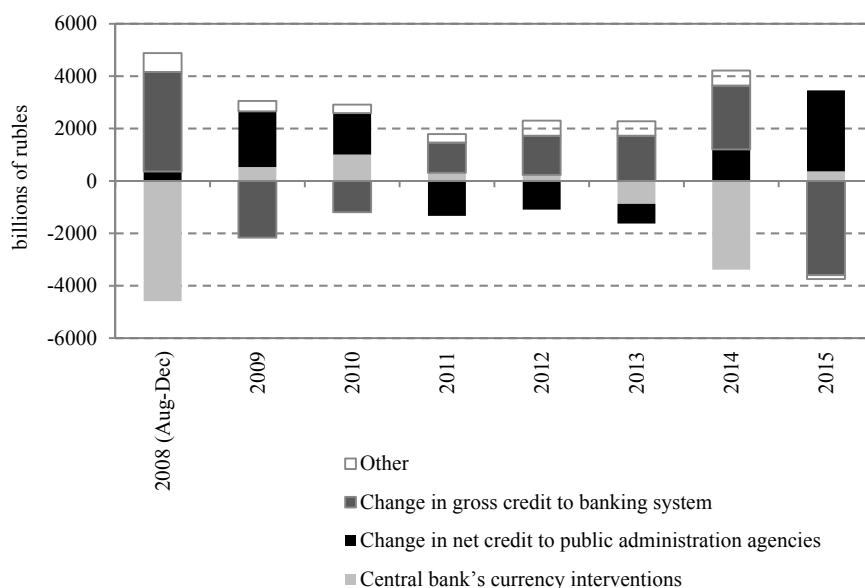
In 2015, the Bank of Russia faced global challenges while implementing measures as part of its monetary policy. The economic situation in 2015 was marked by the following: Western sanctions and Russia's countersanctions remained in effect, prices of Russia's key export commodities continued to fall, economic agents' expectations for high inflation remained intact. The sweeping depreciation of the Russian ruble in late 2014/early 2015 resulted in an inflation shock which kept the year-end inflation at high level: the Consumer Price Index (CPI) stood at 12.9% at the 2015 year-end, much higher than the 2017 mid-term target level (4%) set forth in the central bank's Guidelines for the Single State Monetary Policy for 2015–2017. In its official 2015 forecast, Russia's Ministry of Economic Development predicted inflation will not move beyond 6.3% in late 2014/early 2015, and Russia's central bank expected it to stay at 8.2–8.7% under the baseline scenario and 9.3–9.8% under the risk scenario. At the same time, the Bank of Russia cut its key rate gradually from 17% in January down to 11% in December 2015 as inflation slowed down over the course of the year.

#### 2.1.1. Money market

In the period between January and December 2015, the broad monetary base shrank by 2.5% to Rb 11.04 trillion as of January 2016. It was the first time since 2010 that Bank of Russia's lending operations with commercial banks contributed most to the shrinking of the monetary base. Adding to the factor which contributed to the 2015 increase in the monetary base was the decline of balances on the accounts held by the general government with Russia's central bank, due to spending of funds from the Reserve Fund (see *Fig. 1*). As a reminder, the monetary base in 2014 was up 7.9% to Rb 11.3 trillion, while the Bank of Russia's currency interventions aimed at bolstering the ruble was the main headwind to money supply growth.

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<sup>1</sup> Authors of this section: Bozhechkova A. – Gaidar Institute for Economic Policy, Kiyutsevskaya A. – RANEPА, Trunin P. – RANEPА.



*Fig. 1. Key factors that influenced change in the monetary base (broad definition) in 2008–2015<sup>1</sup>*

*Sources:* Bank of Russia, Gaidar Institute's own calculations.

In 2015, the Bank of Russia diminished substantially its presence in the FX market: the bank's foreign currency net purchases were worth as little as \$780m in the period between January and December 2015. For comparison, yearly net purchases of foreign currency amounted to \$34.1bn in 2010, \$12.4bn in 2011, \$7.6bn in 2012. However, the bank's foreign currency net sales increased to \$27bn in 2013 and to \$83.4bn in 2014. Note that the Bank of Russia decided in November 2014 to abandon its currency intervention policy as part of the transition to an inflation targeting regime. The decision aimed to ensure that the economy adapts faster to change in external conditions and is resilient to negative shocks. In our view, this decision was quite reasonable in view of the fact spending of the international reserves on bolstering the ruble in 2014 failed to prove efficient.

Russia's international reserves in 12M/2015 shrank by \$17.1bn (down 4.4%) to \$368.4bn as of the beginning of January 2016 (see *Fig. 2* and *3*). In 2015, the foreign currency reserves dropped by \$19.9bn (down 5.9%) largely because of foreign currency repos with banks. The year-to-date monetary gold reserves swelled by \$2.5bn (up 5.4%) because the Bank of Russia purchased gold. As a result, as of January 2016, foreign currency accounted for 86.8% (88% in 2014) of the total reserves, and gold made up 13.2% (12% in 2014). Russia now holds sufficient reserves to ensure sustainability of its balance of payments, because they cover both 16 months of imports of goods and services in Russia (11M/2014) and external debt payments that are due in 2016. Note that the adequacy of international reserves which have recently seen no change in volume enhances as imports of goods and services contract and the external debt becomes smaller. This allows Russia to ensure its macroeconomic and financial sustainability amid economic problems arising from worsening terms of trade and from Western sanctions freezing Russian economic agents out of global capital markets.

<sup>1</sup> The period under review covers 2008-2015, for which the data on the central bank's foreign currency interventions and balance sheet were available at the time of this review.

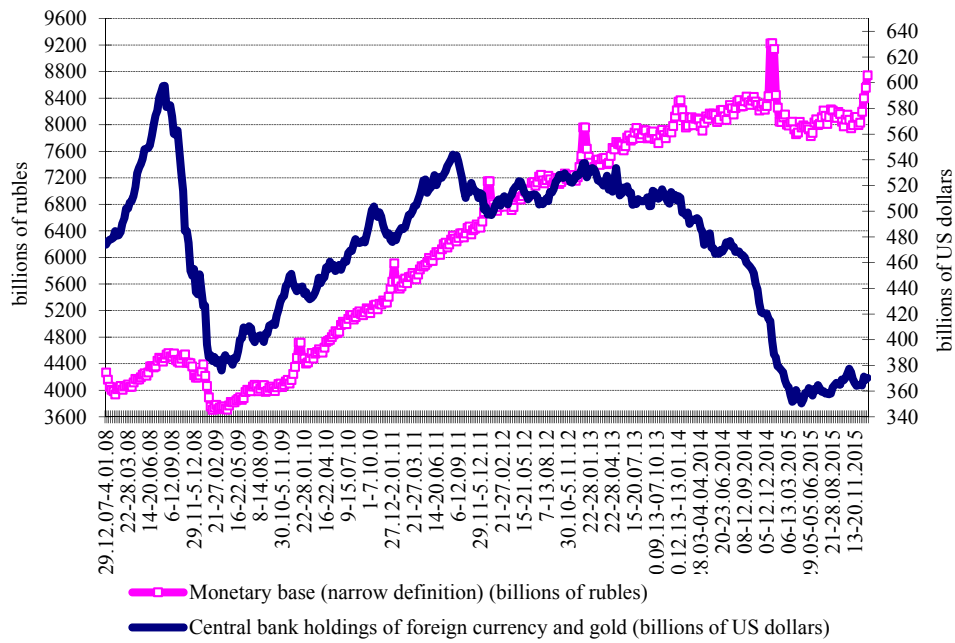


Fig. 2. Dynamics of monetary base (narrow definition) and Central Bank holdings of foreign currency and gold (international reserves) in 2008-2015

Source: Bank of Russia.

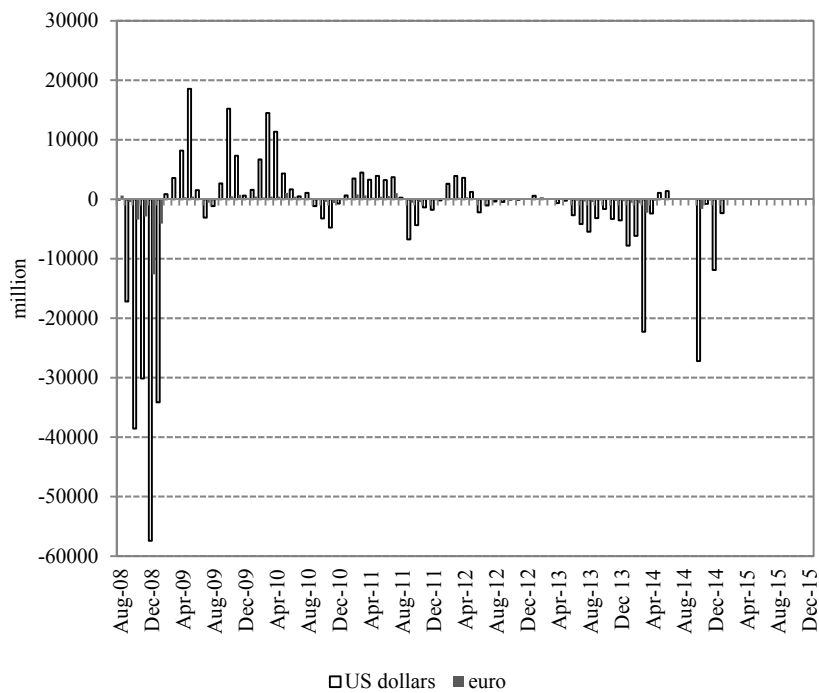


Fig. 3. Bank of Russia's currency interventions (net purchases of foreign currency) in 2008–2015

Source: Bank of Russia.

Table 1

Bank of Russia Balance Sheet, 2013-2015

	January 1, 2014		January 1, 2015		December 1, 2015	
	billions of rubles	% of assets/liabilities	billions of rubles	% of assets/liabilities	billions of rubles	% of assets/liabilities
Funds placed with nonresidents and securities issued by nonresidents	15,091.1	66.9	18,378.6	55.9	19,798.5	62.2
Credits and deposits	4,881.4	21.6	9,950.2	30.3	6,057.4	19.0
Precious metals	1,394.2	6.2	2,726.3	8.3	3,258.9	10.2
Securities	450.3	2.0	622.5	1.9	747.6	2.3
Other assets	99.5	0.4	186.6	0.6	841.6	2.6
<b>Total assets</b>	<b>22,562.4</b>	<b>100</b>	<b>32,897.6</b>	<b>100</b>	<b>31,839.4</b>	<b>100</b>
Cash in circulation	8,307.8	36.8	8,840.9	26.9	7,725.8	24.3
Funds in accounts with the Bank of Russia	10,359.0	45.9	13,876.0	42.2	12,106.2	38.0
<i>of which:</i> <i>Russian government funds</i>	5,848.8	25.9	9,144.3	27.8	8,667.6	27.2
<i>funds of resident credit institutions</i>	2,196.8	9.7	2,869.7	8.7	2,169.7	6.8
Float	5.7	0.03	1.9	0.01	22.4	0.1
Bank of Russia bonds	-	-	-	-	-	3.0
Liabilities to the IMF	500.0	2.2	840.8	2.6	966.9	6.1
Other liabilities	108.8	0.5	100.4	0.3	1,945.9	28.5
Capital	3,151.9	14	9,054.1	27.5	9,072.3	24.3
Profit of a fiscal year	-	-	-	-	-	38.0
<b>Total liabilities</b>	<b>22,562.4</b>	<b>100</b>	<b>32,897.6</b>	<b>100</b>	<b>31,839.4</b>	<b>100</b>

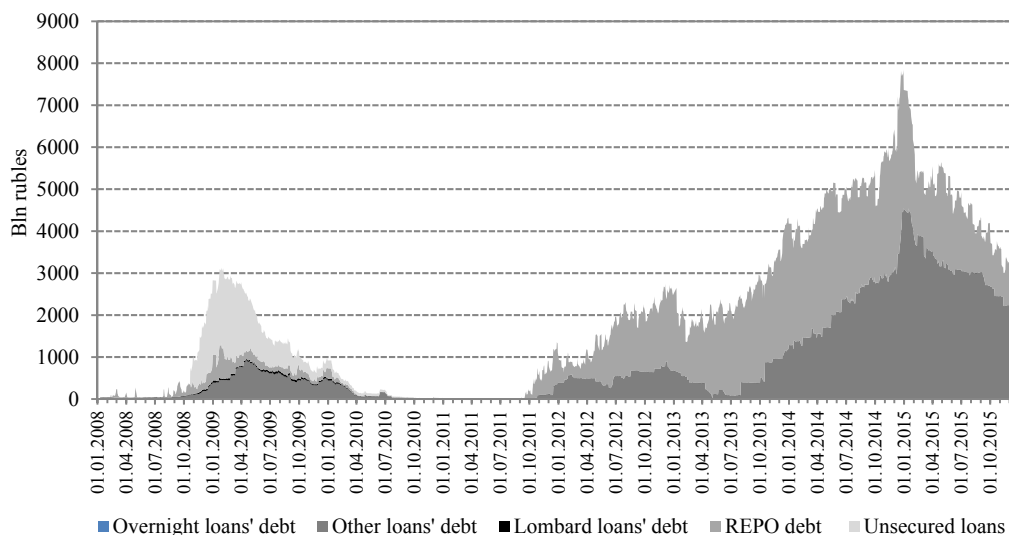
Source: Bank of Russia.

As noted above, the monetary base dynamics in 2015 was largely determined by the debt owed by credit institutions to the Bank of Russia (see Fig. 4). As a reminder, the trend of strong growth of the Bank of Russia's operations to provide loans to credit institutions has been afoot since 2011. As a reminder, the central bank's currency interventions was the key source of money supply prior to the global financial crisis of 2008–2009. However, Russia's central bank began to play key role in providing liquidity to the banking system, because it diminished the volume of its currency interventions in the FX market. In 2014, the debt was twice the peak values seen during the global financial crisis (H2 2008 – 2009), a 2.1-fold 12M increase, staying at Rb 9.3 trillion as of January 2015. The trend reversed in 2015: as of January 2016, loans, deposits and other borrowings of credit institutions stood at Rb 5.4 trillion, down 42% from 2014. The central bank's key lending instrument was one-week repo auctions under which banks borrowed Rb 1.4 trillion (Rb 2.69 trillion in 2014) in 12M/2015, as well as loans secured by non-marketable assets and guarantees, under which banks borrowed an average of Rb 3.0 trillion (Rb 2.3 trillion in 2014) in 12M/2015. The Bank of Russia diminished the volume of liquidity provision to commercial banks due to spending of funds of the Reserve Fund. In particular, banks borrowed Rb 3.1 trillion in January-December 2015, the funds were debited from the accounts held by the general government with the Bank of Russia.

The decline in banks' debt to Russia's central bank under repo auctions had a positive effect on the volume of unencumbered market collateral; in particular, the market asset utilization coefficient varied within a range of 40-50% in Q3 2015, whereas it reached 70% by the end of Q4 2014. According to the Bank of Russia's estimates, with a slowdown in lending and money

supply, there is low risks associated with running short of market collateral in the short run. Hence the volume of market collateral available in banks can be characterized as sufficient or adequate.

In 2015, the Bank of Russia continued to perform fine-tuning liquidity absorption operations through 1- to -6-day deposit auctions which were introduced in February 2014. Such operations were carried out in January (7 operations) and February (3 operations) of 2015, and from Rb 114.2bn to Rb 410bn of liquidity were absorbed per auction. Fifteen to 61 bidders (business entities) attended the auctions, this figure being indicative that the auctions were in low demand.



*Fig. 4. Commercial banks' ruble-denominated debt (the key instruments) to the Bank of Russia in 2008–2015*

*Source:* Bank of Russia.

The Bank of Russia' dollar-denominated loans to credit institutions was one of the key measures as part of its monetary policy, which were introduced in late 2014 and were aimed to push down the rush for foreign currency. Foreign currency swaps, foreign currency repos for a term of one week, 28 days, one year, as well as credit auctions to provide dollar-denominated loans secured by the pledge of claim on dollar-denominated loans to credit institutions were used as instruments of foreign currency refinancing.

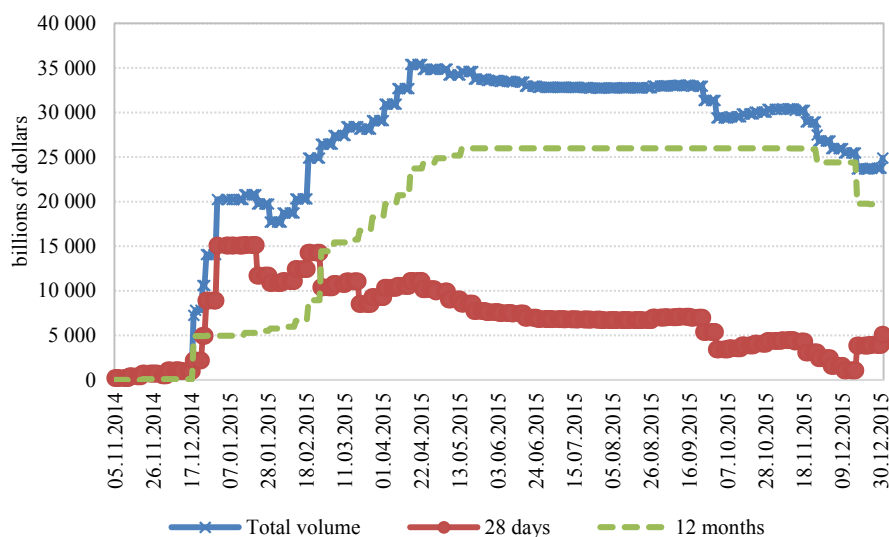
Repos were the key instrument to provide foreign currency. Banks' foreign currency repo debt to the central bank continued to grow till late April 2015, hitting a peak of \$33.9bn, and then declined gradually till December 2015. According to the data available as of January 2015, banks' debt stood at \$24.9bn, including \$19.7bn under one-year foreign currency repos and \$5.1bn under 28-day foreign currency repos (see *Fig. 5*). The average weighted interest rate on one-year repo auctions increased from 1.2% per annum on January 12, 2015 to 3.2% on May 8, 2015<sup>1</sup>, and the average weighted interest rate on 28-day repo auctions was up from 0.68% to 2.36% per annum in the period of January till early January 2016.

<sup>1</sup> On May 18th, the Bank of Russia abandoned 365-day foreign currency repos. See "Key monetary policy decisions" for details.

Note that foreign currency refinancing operations through repo auctions were first of all aimed at calming down panic sentiments in the FX market, and this objective was achieved in January–February 2015. In our view, a wide use of foreign currency repos proved efficient and helped release pressure from the FX market.

As to foreign currency swaps, an average of \$166.4m were allotted to banks through such swaps in 2015. Banks showed low demand for this type of swaps because of high interest rates (the interest rate on the ruble leg (of a swap) was gradually cut from 16% on January 12th to 10% on August 3rd, and the interest rate on the FX leg reached 1.5%).

In 2015, the Bank of Russia held credit auctions to provide 28- and 365-day dollar-denominated loans secured by the pledge of claim on dollar-denominated loans to credit institutions. In Q1 2015, \$2.8bn were allotted at an average weighted interest rate of 1.47% as part of one-year auctions. Later, such auctions were not held because the FX market was stabilized. In January and in February, \$0.6bn and \$2.5bn, respectively, were lent via loans with a maturity of 28 days at a rate of 0.92% per annum. Later, an average of \$0.44bn were lent in loans at an average weighted interest rate of 2.35% per annum (except March, May and November, when no bids arrived from credit institutions). Note that the Bank of Russia’s list of counterparties eligible for this type of lending includes credit institutions with an equity of at least Rb 100bn, as well as Vnesheconombank (VEB).



*Fig. 5. Amount of funds to be repaid by credit institutions under second FX repo leg in 2014-2015*

Source: Bank of Russia.

Let us consider in detail the dynamics of the broad monetary base (see *Table 2*).

Overall, emphasis should be placed on the following contracted components of the broad monetary base: required reserves for banks (down 21.5% to Rb 369.8bn), deposits of credit institutions with the Bank of Russia (down 30.7% to Rb 557.8bn), cash in circulation (down 3.6% in 2015 to Rb 8522bn). Only credit institutions’ correspondent accounts saw an increase (up 31.1% to Rb 1594bn). Overall, surplus reserves in 10M/2015 increased 6.5% to Rb 2152bn.

*Table 2*

**Dynamics of broad monetary base in 2015  
(billions of rubles)**

	January 1, 2015	April 1, 2015	July 1, 2015	January 1, 2016
Monetary base (broad definition)	11,332	9,662.5	9,706.5	11,043.8
- cash in circulation, including cash in vaults of credit institutions	8,840.5	7,522.7	7,639.3	8,522.2
- correspondent accounts of credit institutions with the Bank of Russia	1,215.5	1,342.3	1,308.1	1,594.0
- required reserves	471.3	505.3	466.0	369.8
- deposits of credit institutions with the Bank of Russia	804.6	292.2	293.2	557.8
- Bank of Russia's bonds held by credit institutions	0	0	0	0
For reference: surplus reserves	2,020	1,635	1,601	2,152

Source: Bank of Russia.

In 2015, Russia's central bank cut gradually its key rate following its drastic hike (17% per annum) in December 2014, attempting to stabilize the financial market. The reason for easing the monetary policy was gradual slowdown of inflation amid deep recession (GDP lost 3.3% in Q1, 6.2% in Q2, 5.1% in Q3 over the same quarters of 2014). The key rate was lifted in emergency from 10.5% to 17% per annum in December 2014 amid turmoil in the FX market. In our view, the Bank of Russia's decision to raise the key rate was adequate under the circumstances. Had the real interest rate been cut amid surging inflation, the ruble would have been hit even harder, producing no effect on economic growth rates, because economic agents tend to cut their fixed investment in a volatile FX market.

The key rate cut coupled with offering more options to credit institutions for refinancing in rubles or in foreign currency contributed to the stabilization of the interbank lending market. The interbank lending market rate<sup>1</sup> dropped 34.9% in 12M/2015 (from 17.0% on average in January 2015 to 11.1% on average in December 2015). As a reminder, the MIACR rate overnight interbank ruble-denominated loans moved beyond the upper boundary of the interest rate band in December 10-24, 2014 due to a turmoil in the interbank lending market amid tumbling crude oil prices, a weakening ruble, and a key rate hike. However, the money market was stabilized as early as January. Overall, in 2015, the interbank interest rate did not move beyond the boundaries of the interest rate band, nearing sometimes the lower boundary in H2 2015. Note that the MIACR rate on ruble-denominated interbank overnight loans dropped below the key rate because there was less demand from banks for liquidity, which came via the budget channel while the provision of funds through one-week repos was diminished. Overall, the annual average MIACR rate on overnight interbank ruble-denominated loans increased by 1.5 times, from 8.6% per annum in 2014 to 12.7% in 2015 (see *Fig. 6*). Hence the Bank of Russia's interest rate policy in 2015 proved efficient in terms of achieving the objective of narrowing the gap between interbank lending rates and the key rate.

<sup>1</sup> Interbank interest rate (Moscow InterBank Actual Credit Rate) is monthly average MIACR on overnight interbank ruble-denominated loans.

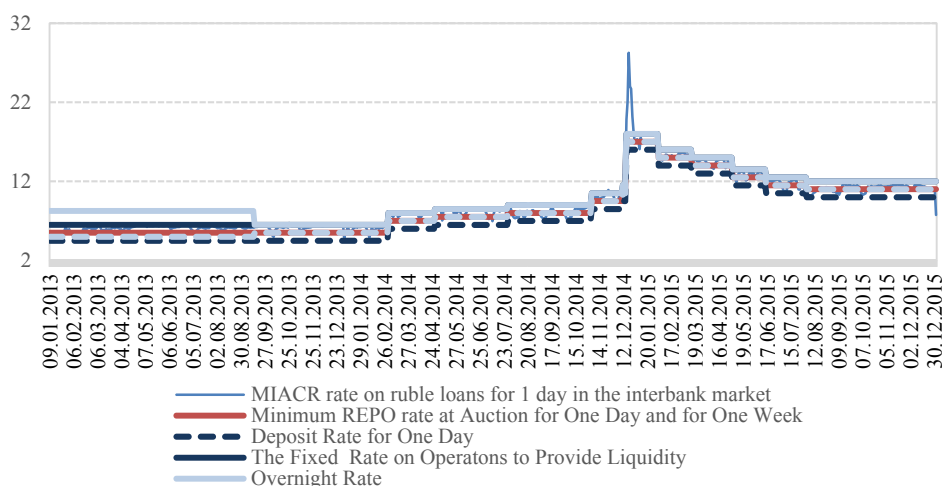


Fig. 6. Bank of Russia’s interest rate band, and dynamics of interbank lending market in 2013–2015.

Sources: Bank of Russia, Gaidar Institute’s own calculations.

Despite gradual key rate cuts in 2015, the money supply increased at moderate pace. In January-December 2015, the annualized M2 was growing at an average of 7.1%. The money supply increased from 2.2% year-on-year in January 2015 to 11.4% year-on-year in December 2015, whereas the money supply saw its annualized growth rate slow down through much of 2014, from 14.6% in January to 5% in December. Note that the annual growth rate of the money supply stood at 32.5% in 2010, 24.3% in 2011, 19.4% in 2012, 15.3% in 2013, 8.4% in 2014. The trend was first of all determined by low lending activity of banks. In 12M/2015, the annualized monetary base increased 1.3% and the annualized money multiplier (ratio of M2 to Monetary Base) advanced 1.1%. The money multiplier increased 14.5% given the fact that in December 2015 the monetary base shrank by 2.5% from December 2014, and the money supply increased 11.4% during the same period. In January-December 2015, the money multiplier averaged 3.3, which is an average value for developing economies (Ukraine, Belarus, Kazakhstan), whereas it tends to vary within a range of 5–8 in developed countries. Note that the money multiplier rose in Eastern Europe countries over the past two decades with the advancement of their banking system. For example, the Poland’s money multiplier increased from 3.1 to 6.5 during the period of 1993–2015.

The level of monetization of the Russian economy (ratio of M2 to GDP) in 1999–2014 tripled to 45% in 2014. According to the data available as of October 1, 2015, the level stood at 45%, either. For comparison, the ratio of M2 to GDP during the same period increased by 1.8 times to 30.8% in Belarus in 2014, by 2.5 times to 33.7% in Kazakhstan, by 3.6 times to 61.1% in Ukraine. However, a higher level of monetization is typical of the most of Central and East Europe countries. For example, the ratio of M2 to GDP in Poland stood at 61.3% in 2014. GDP monetization is even higher in developed countries due to a more advanced financial system: e.g., it reached 164% in Germany in 2014.

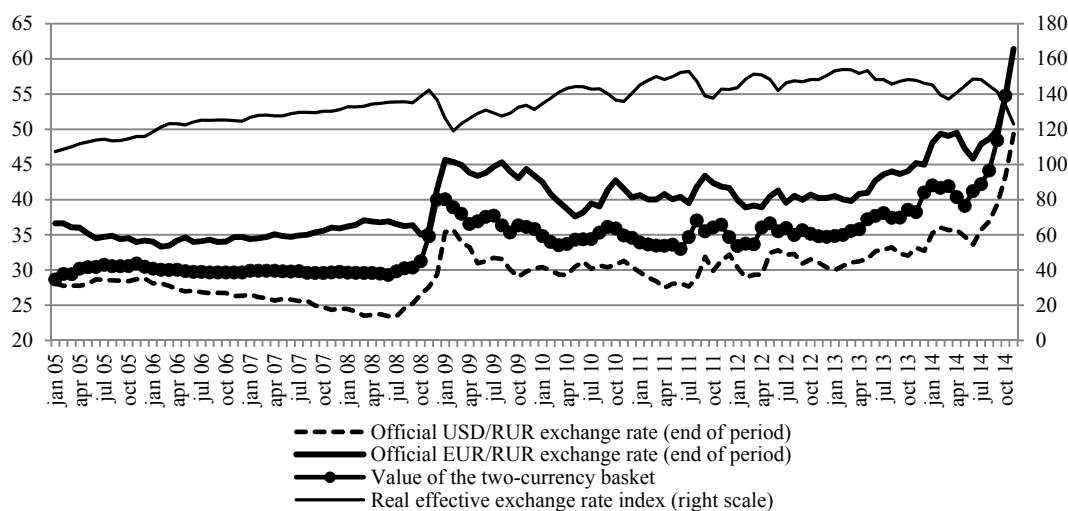
### 2.1.2. Exchange rate policy decisions and exchange rate dynamics

As noted above, in late 2014 the Bank of Russia nearly put on hold its operations in the FX market, restricting itself to foreign currency purchases to replenish sovereign funds by the Federal Treasury. The central bank abandoned its currency interventions on February 3, 2015,



letting the exchange rate be governed by transactions in the private sector. As a result, the ruble exchange rate at that period was driven by a balance between foreign exchange supply and demand in the corporate sector, which was influenced by oil prices, the state of global economy, geopolitical context, as well as development parameters of the Russian economy.

The domestic FX market saw the official US dollar exchange rate strike the highest level on December 31st, up to 72.88 rubles per dollar, and the euro rose to 81.15 rubles per euro on August 25th.



*Fig. 7. Dynamics of ruble real exchange rate*

**Note:** for ruble’s real effective exchange rate in January 2008=100%.

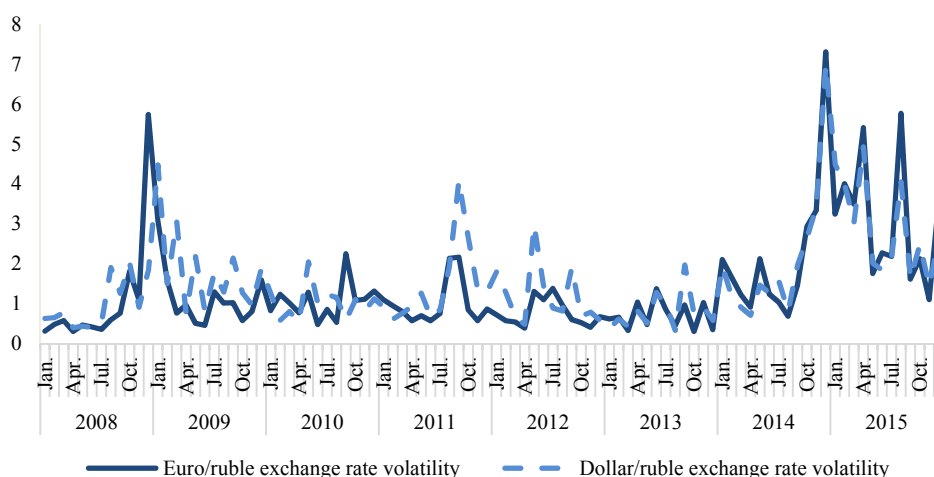
*Sources:* Bank of Russia, own calculations.

The situation in the FX market was improved by surging crude oil prices as well as stabilized geopolitical context. After hitting a local low of \$53.3 a barrel in mid-March, the monthly Brent crude price averaged \$61.6 a barrel as early as April and \$66.8 in the first half of May. As said above, the increase in volume of foreign currency provided by the Bank of Russia to credit institutions through repos contributed considerably to easing the turmoil which reached its highest level in the domestic FX market in December 2014.

With a rapidly strengthening ruble, the Bank of Russia announced on May 14th it will restart daily foreign currency purchases in the domestic FX market to increase its international reserves. The bank was expected to limit itself to purchasing \$100–200m a day. At that period the actual volume of Bank of Russia’s daily purchases neared the upper boundary of \$191m, and the total amount was slightly more than \$10bn in 2015. The Bank of Russia continued its currency interventions to build up the international reserves till July 28, 2015, when the US dollar official exchange rate moved beyond 58.78 rubles per dollar. Facing a new fall of crude oil prices and expectations for high inflation, the regulator decided to abandon its currency interventions. In our view, the decision to restart currency interventions was not rational, because it was inconsistent with the central bank’s key objective of taming inflation. As a consequence, the central bank failed to increase considerably the international reserves, and FX market players took the decision as a signal that the central bank was going to prevent nominal strengthening of the ruble, letting it go down.

The ruble continued to fall for five straight months: by September, the average monthly exchange rate of the US dollar rose to 66.77 rubles per dollar from 50.58 in May and of the euro increased to 75.04 rubles per euro against 56.52 rubles, respectively. Nevertheless, the ruble exchange rate went up as early as October, when Russia-West tensions relaxed a bit and the US dollar edged down, and hence global crude oil prices surged. However, the effect died out soon. In November-December the ruble lost 4.9% against the dollar and 1.0% against the euro following the October annualized increase of 5.9% of the ruble over the US dollar and over the euro.

Note that the swing to a free floating exchange rate policy amid drastically worsening external economic conditions resulted in a highly volatile ruble. As a consequence, intramonth volatility<sup>1</sup> of the dollar/ruble exchange rate in 2015 was more than 10%, which is way below the 2014 level (16.6%), but it is three times the value seen in 2010–2013 and in 2008, when the exchange rate was driven by a guided floating exchange rate policy (see *Fig. 8*).



*Fig. 8.* Volatility of euro/ruble and dollar/ruble exchange rate

*Sources:* Bank of Russia, own calculations.

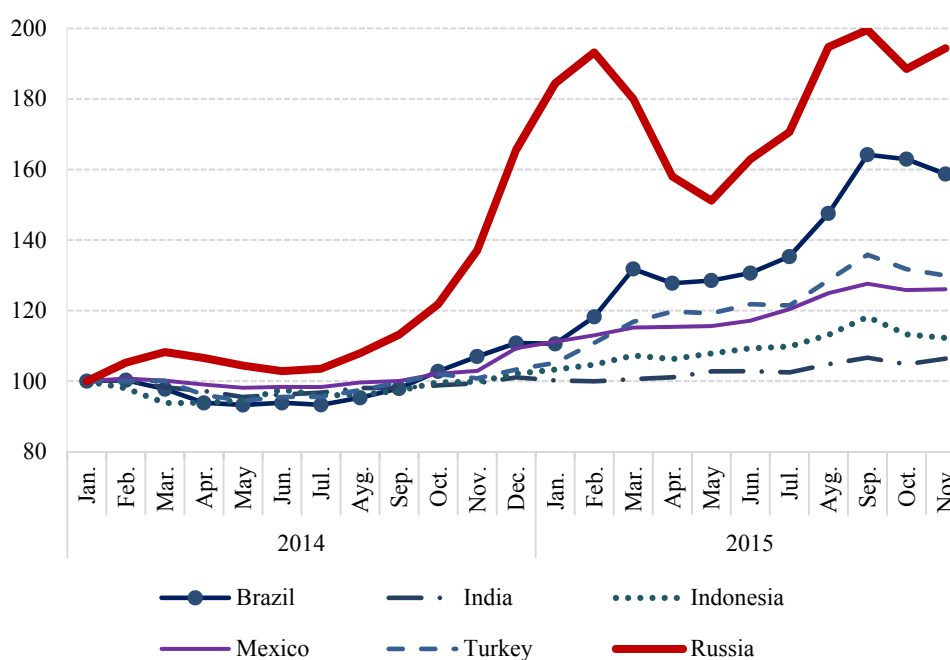
A growth in exchange rate volatility on the one hand may elevate FX risks of economic agents, but on the other hand this is what can curtail both speculative “games” in the FX market and growth rates of foreign currency deposits. As a result, although at the 2015 year-end the Russian ruble’s depreciated by 37.4% year-on-year against the US dollar and by 25.2% year-on-year against the euro, the foreign currency deposits<sup>2</sup> in credit institutions, which are held by the corporate sector (except banks) and individuals increased 18.3% in 2015 from the 2014 increase of 15.4%. Ruble deposits were up to 7.7% compared to a growth of 5.4% in 2014. As a result, the level of dollarization of the Russian economy measured as the ratio of foreign currency liabilities to the corporate sector and individuals to their end-November 2015 total value increased to 30.0% over 25.4% earlier in 2015, reflecting first of all the effect of exchange rate revaluation. For comparison, the level of dollarization stood at 15.7% earlier in 2014.

<sup>1</sup> Intramonth volatility of the ruble exchange rate against foreign currencies is calculated using daily official exchange rates and is expressed as a percentage ratio of exchange rate standard divergence to its average monthly value.

<sup>2</sup> An FX equivalent.

Hence, quick adaptation of the exchange rate to new economic realities helped avoid massive cash outflows from ruble accounts towards foreign currency accounts, as was the case during the crises of 2008–2009 and of 2014.

Overall, the dynamics of Russia’s ruble exchange rate against the key world currencies in 2014–2015 displayed the trends typical of developing countries’ currencies. However, the Russian ruble depreciated at faster rates, thus reflecting the effect of geopolitical risks, as well as a strengthening dollar in the global FX market and falling global crude oil prices. As a result, in that period the Russian ruble saw a 1.9-fold devaluation against the US dollar, while the Brazilian Real was down 1.6-fold, and the Turkish lira saw a 1.3-fold slide (see *Fig. 9*).

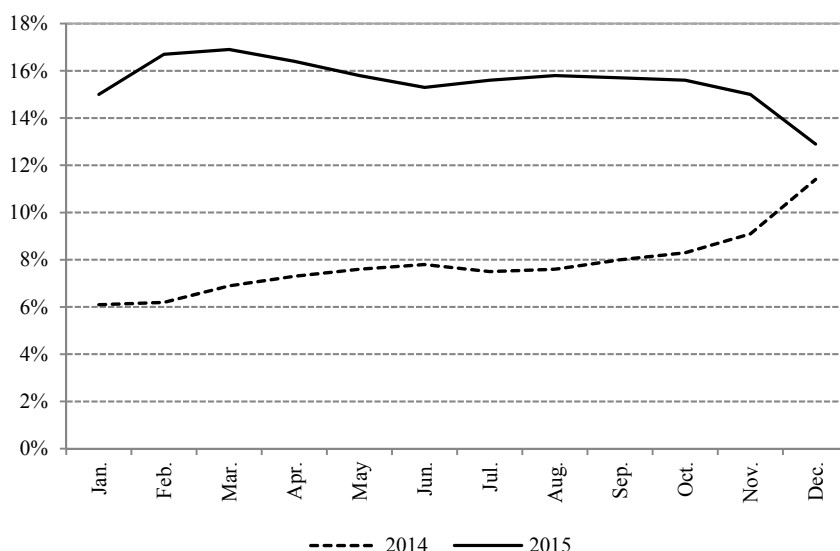


*Fig. 9.* Dynamics of US dollar exchange rate against currencies of developing countries (January 2014 = 100%)

*Sources:* International Financial Statistics (IMF), own calculations.

### 2.1.3. Inflation processes

In December 2015, inflation rate stood at 12.9% from December 2014, which was higher than the 2014 level (11.4%), and it was way above the target inflation rate for 2017 (4%) set forth in the central bank’s Guidelines for the Single State Monetary Policy for 2015–2017. March 2015 saw the highest inflation rate (up 16.9%) because of the peak of exchange rate depreciation pass-through to prices (see *Fig. 10*).



*Fig. 10. CPI growth rates in 2014–2015 (% over the previous 12 months)*

Sources: Rosstat; Gaidar Institute’s own calculations.

Inflation in 2015 was boosted basically by the effect of nonmonetary factors. The key factors that contributed most to the build-up of inflation, considering the fact that Russian economic agents consume a considerable share of imported goods, was the ruble devaluation which reached its peak earlier in the year due to massive capital outflows, expectations for further devaluation and falling crude oil prices, as well as in August 2015 (the ruble lost 10.6%), when the ruble sank in response to plummeting crude oil prices, from \$51.8 to \$42.4 a barrel. Note that, according to our estimates, the effect of exchange rate pass-through to consumer prices in Russia varied from 10% to 20% according to a currency and revaluation period. In other words, consumer prices increase 0.1–0.2% if the ruble slides by 1%. According to our estimates, the 2015 cumulative contribution of the ruble devaluation to the annual inflation as of the beginning of December was 9.5–10.2 percentage points. Note that according to the estimates of Russia’s Ministry of Economic Development, the ruble exchange rate depreciation pass-through contributed 8 percentage points to the annual inflation in August 2015.<sup>1</sup>

Considering the magnitude of exchange rate pass-through to prices and heavy dependence of the Russian economy on highly volatile global hydrocarbons market, as well as rigid expectations for inflation in Russia, the central bank’s mid-term inflation rate target (up 4%) for 2017 will unlikely be fulfilled. Note that the M12/2015 inflation stood at 12.9%, whereas expectations for inflation rose to 16.4%. Furthermore, it should be borne in mind that the Bank of Russia failed since 1999 to reach the inflation targets set forth in its Guidelines for the Single State Monetary Policy, except in 2003 (the actual inflation rate was 12%, the target rate was 10–12%), in 2010, when the actual inflation rate was below the target range (the actual inflation rate was 8.8%, the target rate was 9–10%), and in 2011 (the actual inflation rate was 6.1%, the target rate was 6–7%). In that context, economic agents’ confidence in target inflation rates remains low, thus being a headwind to the fulfillment of the targets set. In our view, Russia’s

<sup>1</sup> Concerning the Current Situation in the Economy of the Russian Federation as of the end of January-August 2015. Russia’s Ministry of Economic Development.

central bank should set more realistic inflation rate targets, including a narrow range of permissible deviations (+/-1 percentage point), in order to increase economic agents' confidence and lower expectations for inflation.

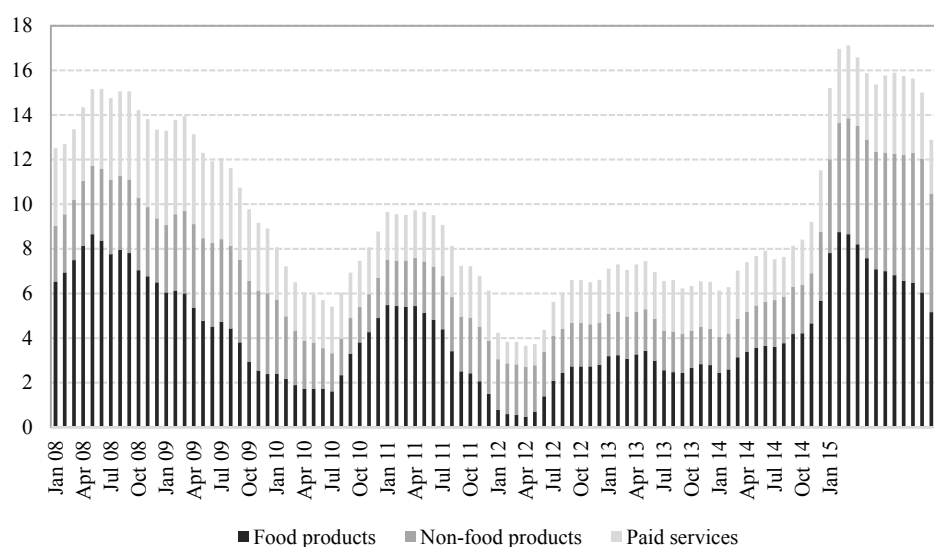
As shown in *Table 3*, consumer prices in the period between January 2015 and December 2015 grew up at slower rate than those in 2014. The price of the following food products contributed much to the increase in food prices: sunflower oil (up 37.2%), fish, other seafood and products thereof (up 20.9%), pasta-based food products (up 19.5%), fruits and vegetables (up 17.4%), cereal grains and beans (up 15.5%), bread and bakery products (up 13.2%). Note that the price of pasta-based food products, bread and bakery products was driven up by a considerable increase in the price of raw materials, including wheat and other grains. The sunflower oil price hikes were driven by the global oleaginous food market as well as lower per-hectare yield of sunflower as a result of a hot summer in some of the Russian regions. At the same time, the exchange rate depreciation pass-through to prices was a main tailwind to inflation build-up for certain types of food products.

In our view, the decision to maintain the ban on food imports from EU countries, Norway, the U.S.A., Canada and Australia, which the Russian government introduced in late June 2015, had no stronger effect on the dynamics of prices of the sanctioned goods, because manufacturers and retailers almost adapted to the ban, as was evident from slowing down growth of prices of the respective types of products.

Nonfood products saw their price grow faster in 2015 (up 13.2%). Prices of tobacco products rose faster (up 26.6%) than of other products in the same group due to an excise tax lift and depreciation of the ruble. A point of note is growth in prices of washing and cleaning agents (up 22.4%), medicaments (up 19.6%), textiles (up 19.7%), electrical and other household appliances (up 16.8%), footwear (up 15.1%). Overall, the price of nonfood products was pushed up by ruble depreciation, too, amid heavy dependence of the Russian market on foreign supplies.

In January-December 2015, the price of paid services to individuals increased 10.2% from 2014. The following services contributed most to the price rise: insurance services (20.5%), outbound travel (tourism) services (19.8%), early childhood education services (16.8%), utility services (12.1%), medical services (11.1%). Note that the increase in prices of outbound travel (tourism) services and insurance services was triggered by a weakening ruble. Insurance rates were affected considerably by the increase in the MTPL (Mandatory Third Party Liability) rates.

According to OOO INFOM's public opinion polls which are published monthly by the Bank of Russia, the median one-year ahead expected inflation rate in late 2014 spurred a considerable increase in the actual inflation rate over the prior 12 months (by 4–5.5 percentage points). The gap was narrowed (by 1.4–1.6 percentage points) in January-February 2015, thus showing that economic agents' panic sentiments settled down a little bit. Expectations for inflation in March-August 2015 were below the actual inflation rate largely due to a stable FX market. Expectations for inflation again rose by 0.5 percentage points to 15.8% in November and by 0.6 percentage points to 16.4% in December, because individuals expected the ruble exchange rate to decline at year's end. Note that high expectations for inflation hampered monetary easing, thus keeping inflation up.



*Fig. 11. Structure of inflation in 2008–2015  
(% over the same month last year)*

Sources: Rosstat; Gaidar Institute’s own calculations.

*Table 3*

**Annual growth rate of prices of certain types of consumer goods and services  
in 2012–2015 (% from December last year)**

	2013	2014	2015	2013–2015 <sup>1</sup>
<b>CPI</b>	<b>6.5</b>	<b>11.4</b>	<b>12.9</b>	<b>33.9</b>
<b>Food products</b>	<b>7.3</b>	<b>15.4</b>	<b>14.0</b>	<b>41.2</b>
Cereal grains and beans	3.2	34.6	15.5	60.4
Butter	18.6	14.5	10.6	50.2
Sunflower oil	-3	5.0	37.2	39.7
Pasta-based food products	4.7	8.4	19.5	35.6
Milk and dairy products	13.1	14.4	11.5	44.3
Eggs	28.8	4.6	9.8	47.9
Bread and bakery products	8.0	7.5	13.2	31.4
Meat and poultry	-3	20.1	4.3	21.5
Fish, other seafood and products thereof	7.6	19.1	20.9	54.9
Fruits and vegetables	9.3	22.0	17.4	56.5
Alcoholic beverages	14.6	13.7	10.7	44.2
<b>Nonfood products</b>	<b>4.5</b>	<b>8.1</b>	<b>13.7</b>	<b>28.4</b>
Medicaments	2.5	13.1	19.6	38.6
Motor gasoline	5.7	8.6	4.8	20.3
Tobacco products	29.3	27.1	26.6	108.1
<b>Services</b>	<b>8.0</b>	<b>10.5</b>	<b>10.2</b>	<b>31.5</b>
Utility services	9.8	9.4	10.1	32.3
Early childhood education services	9.9	15.6	16.8	48.4
Health and leisure services	5.7	7.6	14.4	30.1
Passenger transport services	8.9	7.3	10.7	29.4
Cultural organizations services	10.5	9.9	7.2	30.2

Source: Rosstat.

Finally, we will compare consumer price growth rates in Russia vs. other countries (see *Table 4*).

<sup>1</sup> Inflation rate in 2013–2015

*Table 4*

**Consumer prices dynamics in various countries in 2013–2015,  
% a year**

	2013	2014	2015*	2013–2015**
Azerbaijan	3.5	-0.1	2.7	6.2
Armenia	5.6	4.6	-2.4	7.8
Belarus	16.5	16.2	10.1	49.0
Kazakhstan	4.8	7.4	8.2	21.8
Kyrgyzstan	4.0	10.5	1.4	16.5
Moldova	5.2	4.7	11.5	22.8
<i>Russia</i>	6.5	11.4	11.2	31.9
Tajikistan	3.7	7.4	4.1	15.9
Ukraine	0.5	24.9	39.5	75.1
Germany	1.5	0.9	0.4	2.8
France	0.9	0.5	0.2	1.6
The United States	1.5	1.6	1.3	4.5
The Netherlands	2.5	1.0	1.3	4.9

\* The data for January–October.

\*\* Inflation rate in 2013– October 2015.

Sources: Interstate Statistical Committee of the Commonwealth of Independent States (CIS STAT) (<http://www.cisstat.com/>), OECD database (<http://stats.oecd.org/>).

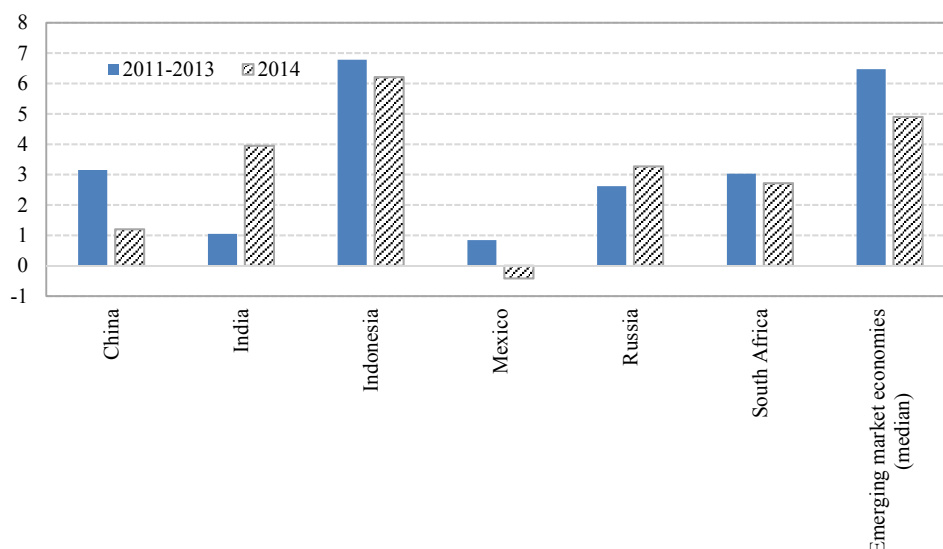
In the period between January and October 2015, Russia was ranked 3rd among CIS countries for consumer price growth rate, after Ukraine and Moldova. The inflation rate in Russia in January–October 2015 was 14 times the inflation rate in developed countries (see *Table 4*). Thus Russia kept facing high inflation vs. both developed countries and emerging market economies.

In 2016, low economic activity, moderate growth of the money supply will present a headwind to inflation build-up. However, the ruble's exchange rate pass-through to prices due to its devaluation by 3% in November 2015 and by 10% in December 2015 will keep inflation up, which will most likely stay at 1.5–2 percentage points (6.4%) above the 2016 level predicted by Russia's Ministry of Economic Development. Note that Russia's economic sanctions against Turkey which took effect on 1 January 2016 may have an extra proinflation pressure in 2016.

Overall, in our view, the target inflation rate (4%) will highly unlikely be reached by 2017 amid geopolitical tensions, highly volatile crude oil prices and exchange rate, although monetary factors have a suppression effect on inflation processes.

#### 2.1.4. Key monetary policy decisions

In 2015, the Bank of Russia carried out a moderately tight monetary policy aimed to tame inflation with due consideration of the slugging economy. Russia's central bank lowered the key rate gradually from 17% in January to 11% in November 2015. On January 30, 2015, the key rate was slashed from 17 to 15% per annum, then it was cut by 1 percentage point to 14% on March 13th, slid to 12.5% on April 30th, to 11.5% on June 15th and to 11% on July 31, 2015. Note that it was absolutely reasonable to retain a relatively high key rate (in nominal terms) because interest rates in Russia are still low in real terms, and they are also low compared with other developing countries (see *Fig. 12–13*).



*Fig. 12.* Real money market interest rates in emerging market economies, G20 states (% per annum)

Source: IMF.



*Fig. 13.* Real interest rate on loans with less than one-year maturity to legal entities in Russia, 2011-2015 (% per annum)

Source: Russia’s central bank.

Note that the price growth rate eased off at very slow pace (on an annualized basis, 15.7% in September, 15.6% in October, 15% in November) after inflation increased 15.8% year-on-year in August 2015. It would be unreasonable to cut the key rate amid expectations for high inflation, ruble depreciation risks attributed among other things to uncertainty about dynamics of oil prices, geopolitical tensions, investors’ expectations for a tighter U.S. Fed’s monetary policy.



With a stable FX market and low risks of financial instability, Russia's central bank in March-April 2015 cut the key rate and lifted (three times) minimum interest rates on foreign currency liquidity provision instruments. In particular, on March 30, 2015, the Bank of Russia lifted minimum interest rates on foreign currency repo auctions to LIBOR plus 1 percentage point (from LIBOR plus 0.5 percentage points). The new rates still remained appealing to borrowers, especially amid financial sanctions, but this measure showed that the Bank of Russia was positive that banks had sufficient liquidity. At the same time, there was still demand for foreign currency repo auctions which allowed foreign currency to be purchased at low rates and invested in, e.g., Eurobonds of major Russian companies, which deliver a much higher yield.

On April 21, 2015, Russia's central bank lifted again minimum interest rates by 0.5 percentage points to LIBOR plus 2 percentage points for 28-day foreign currency repo auctions, and by 2.5 percentage points for 12-month auctions. Furthermore, the central bank lifted minimum interest rates for auctions to provide FX loans secured by the pledge of claim on FX loans to LIBOR plus 2.25 percentage points for such loans with a maturity of 28 days and by 2.75 percentage points for loans with a maturity of 365 days. As in the case with the interest rates lift-off on April 13th, the value of one-year loans was much higher (by 0.75 percentage points) than that of loans with a maturity of 28 days and one week (by 0.5 percentage points). This measure aimed to prevent the ruble from strengthening on the back of stronger optimistic sentiments of investors inspired by raising oil prices and relaxing geopolitical tensions.

With a stable FX market, the Bank of Russia on May 18th abandoned 365-day foreign currency repos. However, the bank announced on November 27th it will restart such repos from December 14, 2015. This measure was dictated by the need to refinance commercial banks' debt on previous one-year foreign currency repo auctions and by the necessity to help Russian companies pay their external debts, as well as by upswing of demand for foreign currency after the U.S. Federal Reserve raised its benchmark interest rate in December 2015. However, we think this instrument should only be used when financial stability is at risk, and a free floating exchange rate regime should continue so that the economy adapts to change in terms of trade.

In order to offer more options for credit institutions to manage their liquidity, the Bank of Russia decided to raise from 0.7 to 0.8 (in effect from September 10, 2015) the averaging ratio used by banks for calculating the averaged value of required reserves. The averaging ratio for nonbank credit institutions involved in deposit/credit operations was elevated from 0.7 to 1.0. The decision aimed to redistribute funds between the balances of credit institutions' required reserves accounts and correspondent accounts with the Bank of Russia. As a reminder, the mechanism of averaging allows a bank to hold a part of its required reserves on its correspondent account, not special accounts, with the central bank.

On June 16, 2015, USD/RUB and EUR/RUB buy/sell fine-tuning 1- to 2-day foreign currency swap auctions were introduced as part of the system of monetary policy instruments introduced. With regard to fine-tuning 1- to 2-day foreign currency swap auctions, the Bank of Russia will decide on the expediency of holding such auctions according to the situation in the money market. A common maximum volume of funds is established for repo auctions and fine-tuning foreign currency swaps. The minimum interest rate on the ruble leg of foreign currency swaps equals the key rate, and there is zero interest rate on the foreign currency leg.

With this decision made, credit institutions were offered a wider range of options for managing their ruble liquidity and assets accepted by the Bank of Russia as collateral for refinancing operations. Such auctions can be held when the Bank of Russia sees more demand from

banks for ruble liquidity, seeks to encourage demand for standing foreign currency swaps, reduce volatility of short-term interest rates in the money market and narrow the gap between them and the key rate, as well as to enhance the effectiveness of the interest rate channel of the monetary policy's transmission mechanism.

With limited collateral available in the market, the Bank of Russia sought to create more options of refinancing for credit institutions. The Bank of Russia Lombard List was updated several times with new issues of securities in 2015. Additionally, the settlement dates of foreign currency repos of various maturities were synchronized with the settlement dates of one-week ruble repos so that credit institutions can manage more efficiently their market collateral portfolio. Furthermore, credit institutions were offered an option of using unrated bonds of non-financial enterprises and mortgage bonds, state guarantees of the Russian Federation, or AHML's (Agency for Housing Mortgage Lending) sureties in security for refinancing operations.

Finally, note that the Bank of Russia in 2015 continued working on making its monetary policy more open through regular releases of analytical reviews and statistics, including information on people's expectations for inflation, an external debt repayment schedule, etc., as well as a series of reports on economic studies of pressing matters. In our view, providing information about goals and performance of monetary policy measures, and discussing the nature of inflation processes in Russia can help raise economic agents' confidence in the central bank's policy, thus making it more efficient.

#### 2.1.5. Balance of payments and ruble exchange rate

In 2015, Russia's balance of payments was adapting to drastically worsened terms of trade. The year-end positive current accounts balance was above the negative financial account balance, and the central bank's gross international reserves saw a small growth. In that context, Russia's net capital outflow in 2015 decreased considerably over 2014 in response to the contraction of bank's foreign assets and substantially slower growth of foreign assets in other sectors.

According to the Bank of Russia's preliminary estimate of Russia's balance of payments, the positive current accounts balance in January-December 2015 stood at \$65.8bn, an increase of 12.7% over 2014 (see *Table 5*). The positive trade balance fell by 23.2% (from \$189.7bn to \$145.6bn) due to a sweeping fall of prices of Russia's key export commodities (see *Fig. 14*). In particular, the 2015 exports of goods dropped by 31.8% (from \$498bn to \$340bn). Imports of goods dropped by 37.0% (from \$308bn to \$194bn) due to a weakening ruble and falling economic agents' income. Imports will quite likely decline considerably in 2016, too, because the ruble continued to tumble in early 2016.

Exports of crude oil, refined petroleum products and natural gas accounted for 58.3% of total exports, declining by 7 percentage points over the same period of 2014 largely because the crude oil fell by 22.5% in 2015, down to an average of \$38.8 a barrel in December 2015 (see *Fig. 15*).

Although the trade balance declined in 2015, the increase in the balance of current accounts was driven up by a decline in the deficit of the service balance, investment income balance and remuneration balance. For instance, the service balance deficit in 2015 reached \$37.1bn, declining by 32.9% (absolute value) over the same period of 2014. Exports of services stood at \$49.7bn, down \$16bn year-on-year (by 24.4%). Imports of services in 12M/2015 dropped by 28.3% to \$86.8bn over 2014, first of all because the Russians retrenched their foreign travel costs.

The remuneration balance in January-December 2015 was down 57.4% to -\$4.3bn (-\$10.1bn in 2014) possibly due to a reduction of the remuneration of migrants whose services were in less demand.

The investment income balance deficit in 2015 decreased by 44.7% year-on-year to \$32.0bn due to a decline in external debt service costs. The investment income receivable dropped 19.2% from \$42.2bn to \$34.1bn. The income payable by nonfinancial enterprises fell by 30.8% to \$55.5bn and by banks by 49.4% to \$8.6bn, cutting the total income payable by 34.0% to \$66.1bn. The rent balance<sup>1</sup> in 2015 stood at \$0.0bn (+\$0.1bn in 2014). The 12M/2015 secondary income balance<sup>2</sup> was -\$6.4bn, (-\$8.2bn in 2014), and the capital transfers balance was -\$0.2bn, (-\$42.0bn in 2014) as a result of the write-off of the debt owed to Russia by Cuba, Uzbekistan and North Korea).

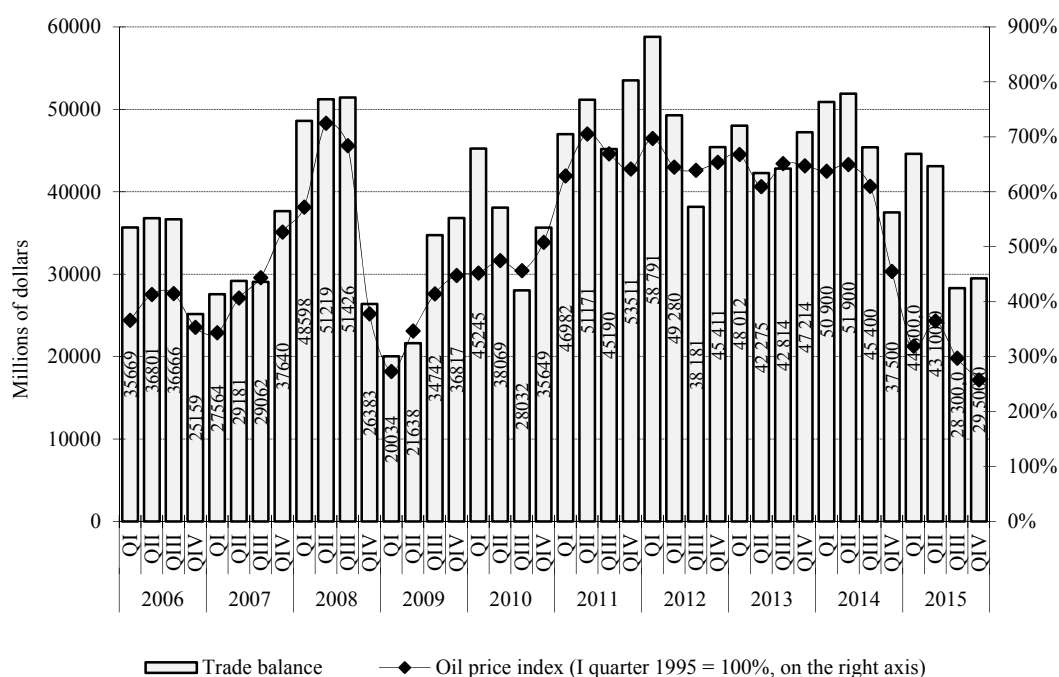
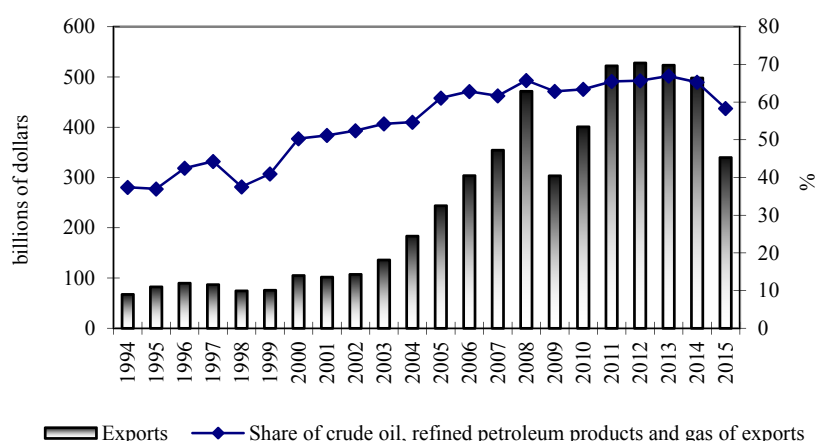


Fig. 14. Russia's trade balance and global oil price index in 2006–2015

Sources: Bank of Russia; EIA; Gaidar Institute's own calculations.

<sup>1</sup> The rent covers income receivable for putting natural resources at the disposal of another institutional unit. Examples of rent include amounts payable for the use of land, extracting mineral deposits and other subsoil assets, and for fishing and grazing rights.

<sup>2</sup> Formerly called the balance of current transfers. According to Russia's central bank, current transfers tend to boost the recipient's disposable income, consumption of goods and services, whereas they tend to diminish the originator's disposable income and potential capacity to consume, e.g., a humanitarian aid provided in the form of consumer goods and services. Current transfers are recognized in the current account. Non-current transfers are by definition regarded as capital transfers. Capital transfers tend to change the volume of assets and liabilities of the originator and the recipient, and they are recognized in the capital account. Should the originator and the recipient be residents of different states, capital transfer alters the level of the national wealth of the economies they belong to. An example of capital transfers is free transfer of title to fixed assets, and debt write-offs.



*Fig. 15. Dynamics of exports of goods and of the share of fuel and energy sector products in 1994–2015*

Source: Bank of Russia.

In 2015, the financial account deficit stood at \$61.1bn (\$130.2bn in 2014). Russian economic agents’ liabilities to foreign economic agents were cut by \$69.8bn in 12M/2015, 20.9% less than the value (\$48.9bn) recorded last year. Federal authorities’ external liabilities decreased by \$7.5bn in 2015. The subjects of the Russian Federation saw their external liabilities increase \$0.1bn. Monetary regulators’ liabilities in 2015 did not go beyond \$2bn. Banks in 2015 continued to slash their foreign liabilities which decreased by \$61.6bn during the year (down \$37bn in 2014). In 2015, nonbank institutions cut their external liabilities by \$2.7bn as compared to an increase of \$1bn in 2014. The inflow of foreign direct investments was \$6.7bn against \$18.5bn in 2014, lowest since 2003. Other external liabilities (portfolio investment, loans and credits and other liabilities) decreased by \$9.5bn in 2015 (a decline of \$17.8bn in 2014). Note that \$82.6bn should have been paid according to schedule in 2015, however external obligations contracted by \$2.7bn possibly due to in-house external debt management operations whereby banks pay debts to related lenders who use the money to pay the “real” external debt.

Residents’ foreign assets (foreign economic agents’ liabilities to Russian economic agents) dropped by \$8.6bn in 12M/2015 (up \$81.3bn in 2014). Monetary regulators’ foreign assets increased \$0.4bn (down \$0.5bn in 2014). Russian banks’ foreign assets were cut by \$28.2bn in 2015 (up \$48.5bn in 2014). The cut of banks’ foreign assets was partially due to banks paying their foreign currency debts to the Bank of Russia. In H2 2015 banks paid back \$10.9bn to the central bank, they also used foreign currency from their correspondent accounts with the Bank of Russia. Note that banks’ assets shrank by \$7.8bn (+\$50.4bn in 2014) due to foreign cash transactions with nonresidents, according to the data available for January-September 2015. Banks’ foreign cash holdings were cut as little as \$0.6bn (-\$38.1bn in 2014) due to retail operations. In other words, in 2015 there was much less foreign cash demand from individuals as compared to the previous year. Foreign cash in hand in 9M/2015 dropped by \$11.8bn to \$40.5bn, according to the Bank of Russia estimates.

Foreign assets held by private nonfinancial enterprises in 2015 increased as little as \$17.8bn as compared to a growth of \$72.6bn in 2014. In absolute terms, Russian residents’ direct investments abroad decreased most of all (from \$54.5bn in 2014 to \$20.5bn in 2015). Also, note that dubious operations continued to see the downtrend in volume, a decline by \$2.8bn to \$4bn.

Portfolio investment abroad dropped from \$5.6bn in 2014 to \$1.5bn in 2015. Other assets held by nonbank institutions in 2015 saw an increase which was 41.2% less than a year earlier (\$4bn against \$6.8bn in 2014).

*Table 5*

**Balance of payments' principal accounts and dynamics of external debt  
in 2013–2015 (billions of dollars)**

Indicator	2013					2014					2015				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4*	Year
Balance of current accounts and of capital accounts	25.0	1.8	-0.3	8.2	34.8	25.8	12.1	6.2	14.3	58.4	29.3	15.9	7.5	13.0	65.8
Financial account (excluding reserve assets)**	13.3	8.2	4.9	19.8	46.2	47.1	27.8	6.0	49.4	130.2	36.7	19.0	2.4	3.1	61.1
Change in foreign exchange reserves ('+' denotes an increase, '-' denotes a decrease in reserves)	4.9	-4.4	-7.4	-15.2	-22.1	-27.4	-10.3	-5.7	-64.2	-107.5	-10.1	-2.2	9.7	3.8	1.3
Net errors and omissions	-6.8	1.9	-2.0	-3.4	-10.3	-5.9	5.4	4.1	2.7	6.2	-2.8	1.1	4.6	-6.1	-3.2
Change in Russia's external debt ('+' denotes an increase, '-' denotes a decrease of debt)	55.3	16.1	8.5	12.6	92.4	-13.0	16.9	-51.9	-81.8	-129.8	-42.9	0.5	-18.5	-22.9	-83.8
Change in Russia's sovereign external debt	3.1	-1.5	6.7	-0.9	7.3	-8.1	3.5	-7.7	-7.8	-20.1	-8.1	2.9	-4.1	-1.6	-10.9
Change in Russian private sector's external debt	48.3	18.2	3.2	15.1	84.8	-4.4	12.6	-43.8	-68.8	-104.3	-35.9	-1.5	-14.4	-22.0	-73.9

\* – preliminary estimate; \*\* – net of foreign currency reserves.

Source: Bank of Russia.

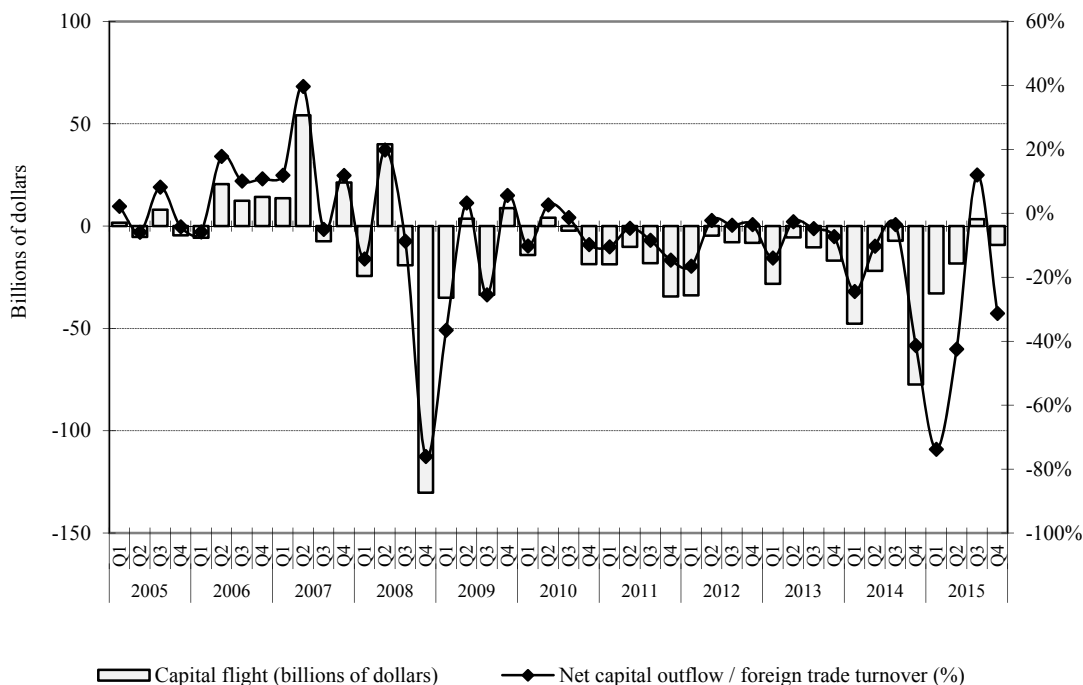
Russia's external debt in 2015 was down by 14% to \$515bn as of January 2016. Note that in 2015 the Russian private sector's external debt was cut by \$73.9bn (down by \$104.3bn in 2014) (see Table 5). Russia's sovereign external debt in 2015 dropped by \$10.9bn, whereas in 2014 it contracted by \$20.1bn.

In its preliminary estimate, the Bank of Russia estimated \$56.9bn in net capital outflow from nonfinancial enterprises in 2015, which is 2.7 times less than in 12M/2014. In 2015, net exports of capital by banks reached \$33.4bn and by private financial enterprises – \$23.5bn. Net capital outflow was worth as little as \$50.2bn, as adjusted for FX operations between banks and the Bank of Russia. Note that in Q3 2015 the Bank of Russia for the first time in a long period

recorded \$1.8bn in net capital inflow in the private sector, as adjusted for operations between banks and the regulator. Q2 2010 was the last time before that, when \$4.1bn in net capital inflow were recorded. The net capital inflow in Q3 2015 was determined by growth of external liabilities of other sectors due to new fundraising, an indication that economic situation was stabilized in some way at that period.

In 2015, net exports of capital by banks reached \$33.4bn, by private nonfinancial enterprises – \$23.5bn. Note that it is extremely difficult to encourage nonresidents to invest in Russia which faces a volatile economic situation worldwide and a recession, the heavy dependence of the Russian economy on exports of energy producing materials, as well as poor quality of institutional environment. As noted above, a key determinant of capital outflow from emerging markets in 2015, like in 2014, was investors’ expectations for the Fed’s QE taper.

We estimate the capital flight (see Fig. 17) was \$7.8bn at the 2015 year-end (\$9.4bn in 2014).<sup>1</sup>



*Fig. 16. Dynamics of net capital outflows in 2005–2015*

Sources: Bank of Russia, Gaidar Institute’s own calculations.

Overall, the trends towards change in the balance of payments lead to a conclusion that the balance of current accounts will continue to grow in the medium term due to the ruble depreciation and lower demand for imported goods. Bank of Russia’s foreign currency repos, as well as a possible increase in volumes of external financing of other sectors, will contribute to releasing the pressure from the FX market. As a result, the 2016 balance of payments will most likely remain stable, thus helping stabilize the ruble.

<sup>1</sup> We use the IMF method to measure capital flight, that is, the sum of “trade credits and advances”, “dubious operations” and “net errors and omissions.”

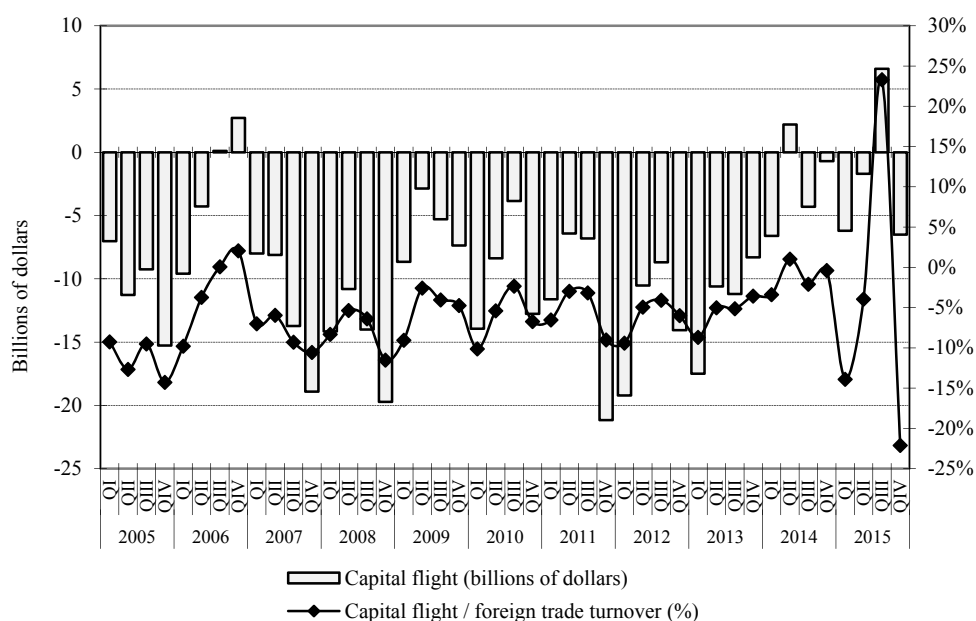


Fig. 17. Dynamics of capital flight in 2005–2015

Sources: Bank of Russia, Gaidar Institute’s own calculations.

## 2.2. State budget<sup>1</sup>

### 2.2.1. Basic parameters of Russia’s budget system

The basic parameters of budget execution at various levels are shown in *Table 6*. In 2015, the general government increased their budget revenues in absolute terms by Rb 123bn from 2014, however the revenues dropped by 0.9 percentage points of GDP and by 13% in real terms (including CPI). The general government increased their budget expenditure both in nominal terms and as a percentage of GDP by 1.5 percentage points of GDP, whereas expenditure in real terms were cut by 7% over values seen in 2014. As a result, the general government ran their budget with a deficit of 3.5% of GDP (the 2014 budget deficit was 1.1% of GDP). Note that the 2015 deficit was many times the value recorded in 2013–2014, both in absolute terms and as a percentage of GDP, whereas a surplus was recorded in 2011–2012. Thus, in 2015 Russia’s budget system saw its balance deteriorate seriously over values seen in 2011–2014.

In 2015, the federal budget revenues fell by Rb 841bn in nominal terms, by 1.6 percentage points of GDP from 2014, and by 18% a in real terms. The federal budget expenditure increased by 0.4 percentage points of GDP, whereas they were cut by 9% in real terms. The 2015 federal budget ran a deficit 2.4% of GDP, by 2.0 percentage points of GDP above values seen in 2014. Note that while according to the originally approved parameters the 2015 federal budget was projected to run a deficit of 0.6% of GDP,<sup>2</sup> the April update expected deficit to reach 3.7% of GDP.

<sup>1</sup> Authors of this section: Belev S. – RANEP, Mamedov A. – Gaidar Institute for Economic Policy, Fomina E. – Gaidar Institute for Economic Policy.

<sup>2</sup> Federal Law “On the Federal Budget for 2015 and the Planning Period of 2016 and 2017” No. 384-FZ dated December 1, 2014. See versions dated April 20, 2015; July 13, 2015; November 28, 2015).

Table 6

State budget revenue and expenditure  
in 2011–2015

	2011		2012		2013		2014		2015		Deviation as percentage points of GDP, 2015 or 2014
	rubles in billions	as % of GDP	rubles in billions	as % of GDP	rubles in billions	as % of GDP	rubles in billions	as % of GDP	rubles in billions	as % of GDP	
<b>Federal budget</b>											
Revenues	11366	19.0	12854	19.2	13020	18.3	14497	18.6	13656	17.0	-1.6
Expenditure	10935	18.3	12891	19.3	13343	18.8	14831	19.0	15611	19.4	+0.4
Deficit (-) / Surplus (+)	431	0.7	-37	-0.1	-323	-0.5	-334	-0.4	-1955	-2.4	+2.0
<b>Consolidated budgets of subjects of the Russian Federation</b>											
Revenues	7644	12.8	8064	12.0	8165	11.5	8906	11.4	9308	11.6	+0.1
Including inter-budgetary transfers	1644	2.8	1680	2.5	1577	2.2	1728	2.2	1617	2.0	-0.2
Expenditure	7679	12.9	8343	12.5	8807	12.4	9353	12.0	9480	11.8	-0.2
Deficit (-) / Surplus (+)	-35	-0.1	-279	-0.4	-642	-0.9	-447	-0.6	-172	-0.2	-0.4
<b>General government budget</b>											
Revenues	20853	34.9	23089	34.5	24082	33.9	26371	33.9	26494	32.9	-0.9
Expenditure	20005	33.5	22826	34.1	24931	35.1	27216	34.9	29308	36.5	+1.5
Deficit (-) / Surplus (+)	848	1.4	263	0.4	-849	-1.2	-845	-1.1	-2814	-3.5	+2.4
<i>For reference: GDP, rubles in billions</i>	59698		66927		71055		77893		80413		-

Sources: Rosstat, Russia's Ministry of Finance, Gaidar Institute's own calculations.

Consolidated budgets of subjects of the Russian Federation saw less serious changes in 2015. Consolidated budget revenues of subjects of the Russian Federation increased by 0.1 percentage points of GDP. Consolidated budget expenditure of subjects of the Russian Federation stood at 11.8% of GDP, by 0.2 percentage points of GDP below values seen in 2014. Consolidated budget deficit of subjects of the Russian Federation in 2015 decreased by 0.4 percentage points of GDP to -0.2% of GDP.<sup>1</sup>

Overall, the general government's budget structure that prevailed in 2015 was characterized by high sensitivity of the Russian budget system to trends in the global energy market, that in 2015 were driven by sharp plunge in prices. Prices of crude oil and of natural gas that started to go down in the mid-2014 continued to fall in 2015. For instance, in 2015, the Urals crude price averaged not higher than \$51 a barrel compared to \$97.6 in 2014.

With shrinking resource base of Russia's budget system, the Reserve Fund at the federal level and debt-based fundraising at regional and municipal levels were important sources of financing of public and municipal expenditure. The dynamics of debt owed by budgets at various levels is shown in *Table 7*.

<sup>1</sup> Refer to the respective section for details on budgets of regions.



Table 7

**Volume of public debt in 2011–2015 by budget system level,  
as % of GDP**

	2011	2012		2013		2014		2015	
	value	value	growth	value	growth	value	growth	value	growth
<b>Federal level</b>									
<b>Russia's internal debt</b>	7.0	7.4	0.4	8.1	0.6	9.3	1.2	9.1	-0.2
<i>excluding state guarantees</i>	6.0	6.1	0.1	6.2	0.2	7.0	0.8	6.9	-0.1
<b>Russia's external debt</b>	1.9	2.3	0.4	2.6	0.3	3.9	1.4	4.5	0.6
<i>excluding state guarantees</i>	1.9	1.8	-0.1	2.0	0.3	3.1	1.0	3.5	0.4
<b>Total, rubles in billions</b>	9.0	9.7	0.8	10.6	0.9	13.2	2.6	13.6	0.4
<i>excluding state guarantees</i>	7.8	7.9	0.0	8.3	0.4	10.1	1.8	10.4	0.3
<b>Subnational level</b>									
<b>Debt owed by subjects of the Russian Federation</b>	2.0	2.0	0.1	2.4	0.4	2.7	0.2	2.9	0.2
<i>excluding state guarantees</i>	1.8	1.9	0.1	2.3	0.4	2.5	0.3	2.8	0.2
<b>Debt owed by municipalities</b>	0.4	0.4	0.01	0.4	0.04	0.4	0.00	0.4	0.02
<i>excluding state guarantees</i>	0.3	0.3	0.01	0.4	0.04	0.4	0.00	0.4	0.03

As of January 1, 2016, the Russian Federation owed Rb 10954bn (13.6% of GDP) in sovereign debt, including Rb 7308bn in public internal debt (9.1% of GDP) and \$50002m in public external debt (4.5% of GDP). The total volume of debt in 2015 stood at 0.4 percentage points of GDP (excluding state guarantees, the growth was 0.3 percentage points of GDP). The public external debt saw a more notable increase of 0.6 percentage points of GDP (excluding state guarantees, the increase was 0.4 percentage points of GDP) amid inconsiderable decline in public internal debt (excluding state guarantees, the decline was 0.2 percentage points of GDP and 0.1 percentage points of GDP). As a result, the structure of public debt in 2015 changed due to shrinkage of the share of public internal debt to 66% (from 70–78% in 2011–2014). The volume of public external debt in ruble terms increased as a percentage of GDP mainly due to depreciation of the Russian ruble, whereas it was lower in foreign currency terms than that seen in 2014. In 2015, the volume of ruble state guarantees dropped both in nominal terms (by Rb 30bn) and as a percentage of GDP (by 0.1 percentage points of GDP). This suggests that state guarantees at the federal level were not used for supporting Russian enterprises amid recession.

At the subnational level, in 2015, subjects of the Russian Federation saw their debts increase by 0.2 percentage points of GDP (excluding state guarantees, the debts saw equal changes in value). At the same time, debts at the municipal level increased by 0.02 percentage points of GDP (excluding state guarantees, the growth was 0.03 percentage points of GDP). The data show that state guarantees at the subfederal level were not used actively, too.

Overall, the volume of both federal and subfederal debts is at safe level, posing no threat to macroeconomic stability. As to the regional level, however, the situation differs largely from one region to another.

2.2.2. New tax revenues in Russia's budget system

2015 was the first year after the crisis of 2009, when revenues from all the main taxes dropped in real terms. For instance, tax revenues to Russia's budget system dropped in general by 13.6%, and the tax burden as a percentage of GDP was eased by 1.8 percentage points to 29.8% of GDP (see *Table 8*). As a result, the level of public withholdings in 2015 turned out to be lower than 30.8% of GDP during the crisis of 2009. Analysis of the basic components of tax revenues as a percentage of GDP shows mixed dynamics: revenues from some taxes declined at slower pace than GDP.

*Table 8*

**Revenues from main taxes in the budget of general government of the Russian Federation in 2008–2015, as % of GDP**

	2008	2009	2010	2011	2012	2013	2014	2015	Percent change 2015 from 2014	
									as percentage points of GDP	in real terms, %
<b>Tax burden level</b>	35.7	30.8	31.1	34.9	34.6	34.3	31.6	29.8	-1.8	-13.6
Profit tax	6.1	3.3	3.8	4.1	3.8	3.1	3.0	3.2	0.2	-3.1
personal income tax	4	4.3	3.9	3.6	3.7	3.8	3.5	3.5	0.0	-7.9
UST/insurance contributions*	5.1	5.5	4.9	6.3	6.3	6.7	6.1	6.6	0.5	-0.4
VAT	5.1	5.3	5.4	5.8	5.7	5.3	5.1	5.3	0.2	-4.8
Excise duties	0.8	0.9	1.0	1.2	1.4	1.5	1.4	1.3	-0.1	-11.7
the mineral extraction tax	4.1	2.7	3.0	3.7	4.0	3.9	3.7	4.0	0.3	-1.6
Customs duties and charges	8.6	6.8	6.8	8.3	8.0	7.6	7.0	4.1	-2.9	-46.4

\* in 2010, the unified social tax (UST) was transformed into insurance contributions charged directly to offbudget funds.

Sources: Russia's Federal Treasury, Rosstat, Gaidar Institute's own calculations.

Drastic decline in the volume of customs duties and charges (by 2.9 percentage points of GDP or by 46.4% in real terms from 2014) contributed most to the decline in general government's budget revenues. In addition to customs duties, only excise duties dropped as a percentage of GDP by 0.1 percentage points of GDP or by 11.7% in real terms. Insurance contributions were ranked first in terms of upward dynamics (an increase of 0.5 percentage points of GDP and a decrease of 0.4% in real terms), followed by the mineral extraction tax (grew up by 0.3 percentage points of GDP and went down by 1.6% in real terms), profit tax (went up by 0.2 percentage points of GDP and slid by 3.1% in real terms), VAT (an increase of 0.2 percentage points of GDP and a decline of 4.8% in real terms), the personal income tax (remained at the level seen in 2014 as a percentage of GDP and dropped by 7.9% in real terms).

The structure of tax budget revenues of the general government is shown in *Fig. 18*. Two aspects are worth noting here. First, insurance contributions became the basic tax withholdings in economy. Second, in 2014 customs duties and charges moved down to third place, giving way to not only insurance contributions but also VAT.

As *Fig. 19* suggests, revenues from the personal income tax and GDP changed at nearly similar pace, so the volume of revenues as a percentage of GDP remained at the level seen in 2014. Given that real personal income continued to fall in 2015 (although cash income increased as a percentage of GDP), regions are expected to face problems while fulfilling their budget commitments in 2016, because their own tax base – with the personal income tax being ranked first – may shrink.

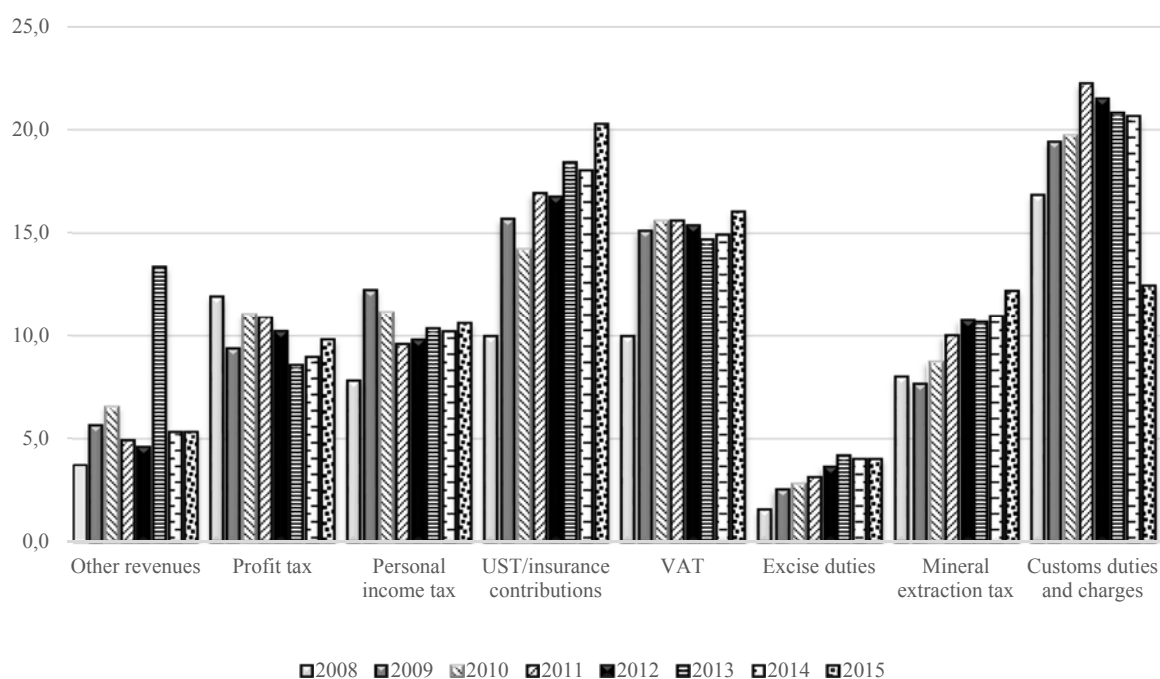


Fig. 18. Share of tax revenues of general government's total budget revenues in 2008–2015, %

Source: Russia's Federal Treasury.

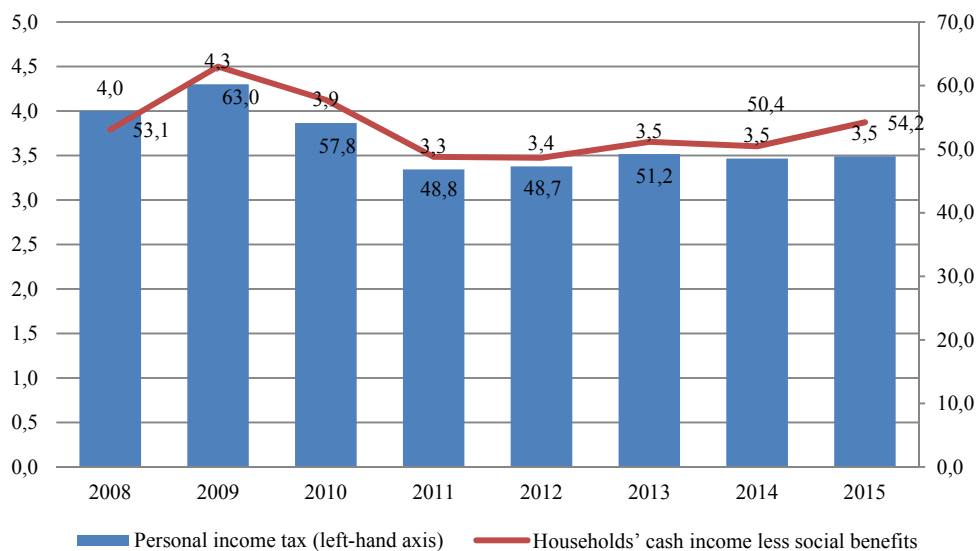
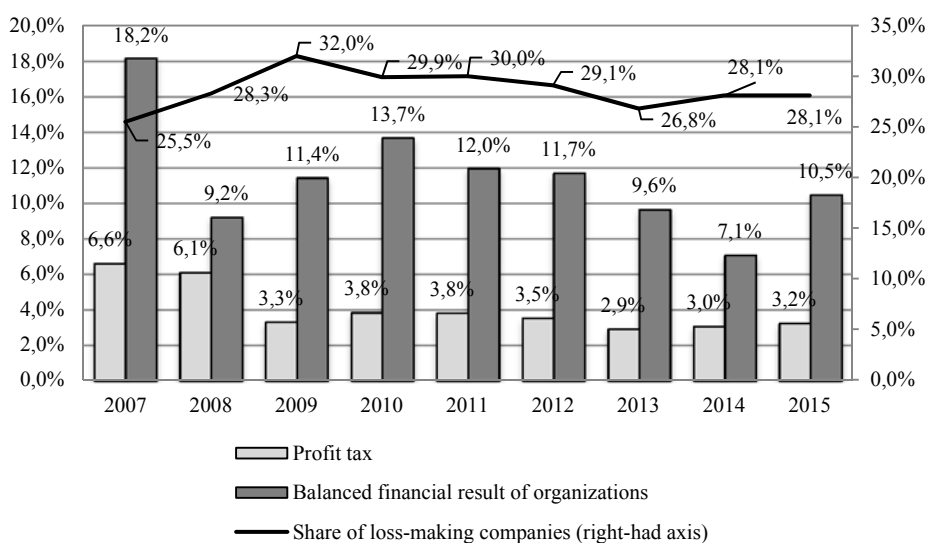


Fig. 19. Comparison between dynamics of personal income tax and dynamics of households' cash income less social benefits in 2008–2015, as % of GDP

Sources: Russia's Federal Tax Service, Rosstat.

2015 saw revenues from profit tax decline in real terms and increase slightly as a percentage of GDP (by 0.2 percentage points). At the same time, the balanced financial result of organizations of all the industries as a percentage of GDP increased more notably from 7.1% to 10.5% of GDP (see *Fig. 20*) in part due to depreciation of the ruble that helped Russian exporting enterprises to enhance competitiveness against foreign manufacturers by partially offsetting the effect of falling aggregate demand, as well as to generate “extra” revenues for such enterprises. At the same time, the share of loss-making organizations of Russia’s economy remained at the level seen in 2014 (28.1%). Overall, the relatively favorable dynamics of the profit tax in 2015 is rather temporal, and it may deteriorate as early as 2016, affecting first of all budget revenues in regions.



*Fig. 20.* Dynamics of profit tax revenues in Russia’s state budget, balanced financial result of organizations and share of loss-making companies in 2007–2015, as % of GDP

\* based on Rosstat’s preliminary estimates.

Sources: Russia’s Federal Tax Service, Rosstat.

The decline of global crude oil prices in 2015 had a strong adverse effect on federal budget revenues from oil and gas (more than \$40 a barrel of Urals crude oil at prices for tax purposes). In 2015, oil and gas budget revenues plunged below the level seen in 2009 (7.4% of GDP in 2015 compared with 7.9% in 2009) (see *Table 9*). The ruble’s devaluation failed to offset the decline in crude oil prices.

Revenues from the mineral extraction tax increased by 0.3 percentage points of GDP, and the dynamics of the second component, that is, export duties on energy-carrying materials (3.4% of GDP in 2015 against 6.5% in 2014) contributed most to pushing down oil and gas revenues as a percentage of GDP. At the same time, revenues from customs duties on natural gas were driven by more favorable dynamics than those on crude oil and refined petroleum products (see *Table 10*). The difference in dynamics of the oil extraction tax (inconsiderable growth) and customs duties on crude oil and refined petroleum products (sharp plunge), as well as more favorable dynamics of customs duties on gas, are determined first of all by the commencement of a so-called ‘tax maneuver’ in the oil sector in 2015. As part of this oil sector taxation reform, the basic rate of oil extraction tax was lifted from 493 to 766 rubles per ton,

whereas the marginal rate (coefficient in equation) of customs export duties on crude oil was cut from 59% to 42%.

*Table 9*

**Volume of oil and gas revenues and mineral extraction tax  
in 2008–2015**

	2008	2009	2010	2011	2012	2013	2014	2015
Oil and gas revenues, as % of GDP	10.9	7.9	8.4	10.3	10.6	10.0	10.2	7.4
the mineral extraction tax, as % of GDP	4.1	2.7	3.0	3.7	4.0	3.9	3.7	4.0
Crude oil extraction, including gas condensates, tones in millions	488	494	506	512	519	522	525	534
Urals crude average annual price, USD a barrel	90.7	60.7	76.2	109.6	110.6	108.0	97.6	51.0
Central bank's average annual RUB/USD exchange rate, rubles per dollar	24.78	31.90	30.37	29.31	31.05	31.20	38.63	60.98

*Sources:* Rosstat; Russia's Central Bank; Federal Customs Service, Federal Tax Service; Gaidar Institute's own calculations.

*Table 10*

**Revenues from customs duties in 2008–2015,  
as % of GDP**

	2008	2009	2010	2011	2012	2013	2014	2015
Export duties on energy-carrying materials	6.8	5.2	5.3	6.6	6.6	6.1	6.5	3.4
- on crude oil	4.3	3.1	3.6	4.2	4.0	3.5	3.7	1.8
- on natural gas	1.2	1.1	0.4	0.7	0.7	0.7	0.7	0.7
- on petroleum derivatives	1.3	1.0	1.3	1.7	1.8	1.8	2.1	0.9
Customs duties and charges	8.6	6.8	7	8.4	8.0	7.6	7.0	4.1

*Sources:* Rosstat; Russia's Federal Treasury; Gaidar Institute's own calculations.

In 2015, VAT on goods sold on the territory of the Russian Federation ("internal VAT") rose slightly as a percentage of GDP (by 0.2 percentage points), whereas VAT on goods imported in the territory of the Russian Federation remained the level seen in 2014 (see *Table 11*). Russia continues to have better tax collection rate of VAT on imported goods over that on goods manufactured in Russia, as well as a downtrend of the VAT effective rate on imported goods.

In 2015, like in 2014, revenues from excise duties went down as a percentage of GDP. As *Fig. 21* suggests, excise duties on tobacco products turned out to be the sole excisable products on which charges increased as a percentage of GDP. At the same time, excise duties on tobacco products were for the first time ranked first in volume of revenues (0.47% of GDP in 2015). A policy of higher-than-inflation indexation of rates resulted in a decline of revenues from excise duties on alcoholic products (from 0.39% in 2014 to 0.34% of GDP in 2015). Revenues from excise duties on refined petroleum products dropped from 0.47 to 0.44% of GDP, too. Revenues from excise duties on sales of motor vehicles and motorcycles continued to make up an inconsiderable share of revenues.

Table 11

**Dynamics of imports and VAT revenues in Russia's budget system  
in 2008–2015, as % of GDP**

	2008	2009	2010	2011	2012	2013	2014	2015
VAT revenues	5.2	5.3	5.4	5.8	5.7	5.0	5.1	5.3
VAT on goods sold on the territory of the Russian Federation	2.4	3.0	2.9	3.1	3.0	2.6	2.8	3.0
VAT on goods imported in the territory of the Russian Federation	2.8	2.3	2.5	2.7	2.7	2.4	2.3	2.3
VAT effective rate <sup>1</sup> , %	8.4	7.6	8.2	9.3	8.3	7.4	7.0	7.2
VAT effective rate on goods sold on the territory of the Russian Federation <sup>2</sup>	5.4	5.5	5.8	6.9	6.4	5.7	5.5	5.8
VAT effective rate on goods imported in the territory of the Russian Federation <sup>3</sup>	12.5	11.0	11.9	12.3	12.1	11.1	10.7	10.4
Imports*	22.1	20.5	21.1	21.9	22.4	21.1	20.9	21.3

\*Share of imports of GDP was measured as the ratio of imports values based on Rosstat's data and GDP.

Sources: Rosstat; Russia's Ministry of Finance; Gaidar Institute's own calculations.

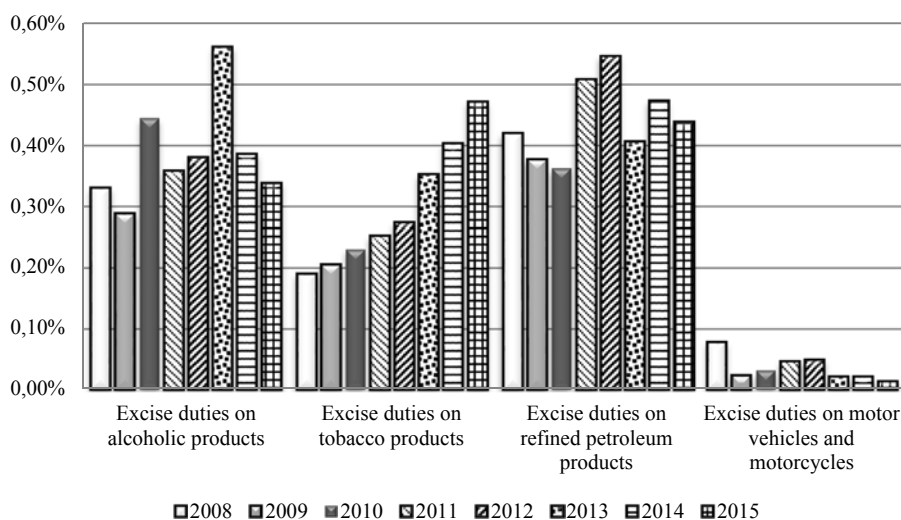


Fig. 21. 2008–2015 revenues from excise duties by group of excisable goods, as % of GDP

Source: Russia's Federal Treasury.

Note that efforts to turn excise duties into a source of budget revenues are exposed to serious risks that elasticity of demand for respective goods might happen to be so high as to lead eventually to decline in charges. Table 12 shows that consumption of all types of alcoholic and tobacco products continued to decline in 2015. Thus, alcoholic products faced the risk in practice.

<sup>1</sup> The ratio of VAT revenues to final consumption.

<sup>2</sup> The ratio of revenues from VAT on goods sold on the territory of the Russian Federation to final consumption less the value of imports.

<sup>3</sup> The ratio of revenues from VAT on goods imported in the territory of the Russian Federation to the value of imports.

*Table 12*

**Volume of alcoholic and tobacco products consumed in Russia  
in 2008–2015,  
dL in millions**

Product	2008	2009	2010	2011	2012	2013	2014	2015
Alcoholic products								
vodka and liqueurs and spirits	177.2	166.1	157.8	156.4	153.0	133.6	112.4	104.9
Vine products (except champagne and sparkling vines)*	102.9	102.5	103.4	97.1	93.6	83.6	90.4	89.6
low-alcohol beverages (with ethanol content of 9% or less)	–	–	31.9	31.4	26.9	23.3	17.8	13.8
cognac, brandy spirits (including brandy, calvados)	10.8	10.6	11.1	11.6	12.4	12.1	11.5	11.0
Champagne and sparkling vines	26.0	25.5	27.3	28.5	28.3	27.7	26.4	24.6
Beer	1138.2	1024.7	1004.0	1011.5	1017.5	984.2	895.9	868.1
Cigarettes, pieces in billions	393.6	398.7	371.8	358.0	355.7	359.1	338.6	326.7

\*Until 2012, ‘Grape and Fruit Vines’.

Source: Rosstat.

Overall, 2015 turned out to be an extremely off year for state budget revenues: all types of tax revenues dropped in real terms. Oil and gas revenues of the federal budget were hit the hardest amid drastic slump of global crude oil prices, whereas budget revenues in regions saw “extra” profit tax revenues due to devaluation of the Russian ruble. However, one should realize that this effect covered a limited number of subjects of the Russian Federation, whose economy relies on export-oriented industries such as oil and gas sector, metallurgy etc.

### 2.2.3 Characteristics of Russia’s budget system

With a decline of 0.9 percentage points of GDP in budget revenues of the general government in 2015, the volume of the country’s budget system saw a reverse dynamics, that is, a growth of 1.6 percentage points of GDP (see *Table 13*).

*Table 13*

**General government budget expenditure in 2011–2015, as % of GDP**

	2011	2012	2013	2014	2015	Change 2015 from 2014, percentage points of GDP
Expenditure, total	35.5	34.1	35.1	34.9	36.5	1.6
General National Issues	2.8	2.7	2.8	2.8	3.1	0.3
Public and Municipal Debt Service	0.6	0.6	0.6	0.7	0.8	0.1
National Defense	2.5	2.7	3.0	3.2	4.0	0.8
National Security and Law Enforcement	2.5	2.9	3.0	2.8	2.6	-0.2
National Economy	4.7	4.9	4.6	5.8	4.7	-1.1
Housing and Utilities	2.0	1.6	1.5	1.3	1.2	-0.1
Environmental Protection	0.06	0.06	0.07	0.09	0.09	0
Education	3.7	3.8	4.0	3.9	3.8	-0.1
Culture, Cinematography and Means of Mass Media	0.7	0.7	0.8	0.7	0.7	0.0
Healthcare and Sports	3.5	3.7	3.6	3.6	3.9	0.3
Social Policy	10.9	11.0	11.8	10.8	12.5	1.7

Sources: Russia’s Federal Treasury, Rosstat; Gaidar Institute’s own calculations.

In 2015, the general government saw serious changes in their budget expenditure: values of financing of various types of expenditure in 2015 varied from 2014 within a range of 0.1 and 1.7 percentage points of GDP.

The biggest expenditure were recorded for ‘Social Policy’ (an increase of 1.7 percentage points of GDP and of 3.5% in real terms). At the same time, expenditure for social policy increased mainly for ‘Pension Provision’ and ‘Other Matters Related to National Policy’. As a result, expenditure for ‘Pension Provision’ remained at the level seen in 2014 (declined by 1.1% in real terms). However, indexation of pensions in 2015, namely the insurance part of labor pension by 11.4% (from February 1, 2015) and social pensions by 10.3% (since April 1, 2015), was not followed by higher pension payments: the actual inflation rate (12.9%) was above indexation rates. Additionally, in 2015 pension accruals were transferred to nongovernment pension funds at 2013 year-end (the transfer was “frozen” in 2014 simultaneously with “freezing” the transfer of new contributions of the then current year of 2014 to the funded pension component), which explains the growth of expenditure for ‘Other Matters Related to National Policy’.

The uptrend since 2011 towards expenditure for ‘National Defense’ continued in 2015, an increase by 0.8 percentage points of GDP. Military spending in real terms reached 11% (total expenditure were cut by 7%). The increase in government spending for this line item is first of all associated with further implementation of measures as part of the State Armament Program for 2011–2020.

Additionally, expenditure for ‘General National Issues’ and ‘Healthcare and Sports’ increased slightly each by 0.3 percentage points of GDP, however a minor decrease within 1% was reported in real terms for each of the line items. A detailed analysis of expenditure for healthcare shows a decline in expenditure for ‘Inpatient Medical Assistance’ and ‘Outpatient Medical Assistance’. At the same time, expenditure for ‘Other Healthcare Matters’ increased notably in real terms by about 8%. The growth in expenditure for ‘Other Healthcare Matters’ was possibly determined by increased funding of, above all, certain measures implemented as part of the Healthcare Development Program financed under this line item. As a result, a redistribution of funds between financing the expenditure for inpatient and outpatient medical assistance was performed in favor of financing the Healthcare Development Program.

In 2015, government spending for ‘National Economy’ were cut considerably by 1.1 percentage points of GDP (nearly 4.7% of GDP). However, note that the decline below the 2014 parameters is technical and related to Rb 1 trillion in asset contribution from the federal budget to the Deposit Insurance Agency (DIA), that took place late in 2014.<sup>1</sup> The appropriation was envisaged as part of state support for the banking sector. Excluding the contribution, the expenditure for the national economy in 2014 would make up less than 4.5% of GDP. Overall, the level of financing measures of support for the national economy in 2015 is comparable with that in 2011–2013 (4.6–4.9% of GDP). Extra spending for support of the banking sector via the DIA can be actually attributed to both 2014 (when the foregoing operation was performed) and to 2015 (when the DIA could have spent the funds). Thus, with mounting crisis developments in the economy, government expenditure for the national economy increased in 2014–2015 as part of spending on anti-crisis measures.

In 2015, national defense expenditure continued to decline to 2.6% of GDP, by 0.2 percentage points of GDP below the level seen in 2014, and they were cut in nominal terms, too. The rest of the budget expenditure line items saw no notable changes in 2015 (within 0.1 percentage points of GDP).

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<sup>1</sup> In December 2014, these funds were transferred using federal government bonds (OFZ) and were allocated to increase banks’ capital. The DIA was entitled to use the contribution to increase the capital of systemically important banks whose capital is worth not less than Rb 100bn.



In general, note that in 2015 the prevailing upward dynamics of the general government's budget and the resource base shrinkage contradict in a way the policy aimed at spending less budget funds in order to prevent the risk of "inflation spiral" and of higher than normal deficit in the budget system. Also, what raises concern is the decrease in real terms of "productive" expenditure for education and healthcare amid growing "nonproductive" expenditure for defense and social policy. It is important to realize that the decline in expenditure for human capital may worsen the problem of Russia's economy entering a new growth path in the mid- and long term perspective.

#### 2.2.4. Basic parameters of the 2015 federal budget and outlooks for 2016

The federal budget revenues in 2015 (see *Table 14*) stood at 17.0% of GDP, a decline of 1.6 percentage points of GDP below the value seen in 2014, and the decline was driven by falling oil and gas revenues. In 2015 they were 2.4 percentage points of GDP below parameters seen in 2014. At the same time, oil and gas revenues reached nearly 9.7% of GDP, an increase by 0.8 percentage points of GDP over the value seen in 2014. The volume of federal budget expenditure increased by 0.4 percentage points of GDP to 19.4% of GDP. Overall, the 2015 federal budget ran a deficit of 2.4% of GDP, a growth of 2.0 percentage points of GDP over the value seen in 2014. Furthermore, oil and gas deficit stood at 9.7% of GDP, a decline by 0.4 percentage points of GDP over the value seen in 2014.

*Table 14*

**Federal budget basic parameters  
in 2011–2016**

	Actually executed				2015	2016		Deviation in 2015 from 2014, percentage points of GDP
	2011	2012	2013	2014	executed	Federal Budget Law for 2015–2017	Federal Budget Law for 2016*	
Revenues	19.0	19.2	18.3	18.6	17.0	19.0	17.5	-1.6
Including:								
oil and gas revenues	9.6	9.8	9.3	9.7	7.3	9.7	7.7	-2.4
oil and gas revenues	9.4	9.4	9	8.9	9.7	9.3	9.8	+0.8
Expenditure	18.3	19.3	18.8	19.0	19.4	19.6	20.5	+0.4
Including: conditionally approved	0	0	0	0	0	0.5	0	0
Deficit (-) / surplus (+)	+0.7	-0.1	-0.5	-0.4	-2.4	-0.6	-3.0	+2.0
Oil and gas deficit	-8.9	-9.9	-9.8	-10.1	-9.7	-10.3	-10.7	-0.4
GDP, rubles in billions	59.698	66.926	71.055	77.893	80.412	83.208	78.673	-
Urals crude price, USD**	109.6	110.6	108.0	97.6	51.0	96.0	50.0	-

\* Federal Law "On the Federal Budget for 2016" No. 359-FZ dated December 14, 2015.

\*\* Average annual value.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The 2015 federal budget parameters were updated due to a worsening macroeconomic situation early in 2015. The federal budget law was updated three times in 2015 (in April, July, and in November). Updates to the key macroeconomic indicators budgeted for 2015 were approved in April, whereby the crude oil price was down from \$100 to \$50 a barrel, the ruble to US dollar exchange rate was up from 37.7 to 61.5 rubles per dollar, the inflation rate was up from 5.5% to 12.2%. Given the approved updates, the forecast for revenues was downgraded by 2.4 percentage points of GDP, and the expenditure plan increased by 0.8 percentage points of GDP,

with the result that budget deficit increased to 3.7% of GDP (a growth of 3.1 percentage points of GDP). The updates in July 2015 concerned Rb 20.1bn in financing of measures to ensure sustainable economic growth and social stability. A share of the funds was allocated to support the economy in the form of deposits and grants to joint-stock companies and federal unitary enterprises; the volume of grants to strategically important organizations of the Military-Industrial Complex (MIC) increased, too. Updates to the basic macroeconomic and budget parameters (increase of GDP, growth in federal budget revenues and expenditure) took effect in November 2015.

Let's analyze in detail the ultimate parameters of federal budget execution in 2015.

Overall, tax revenues dropped considerably by 2.6 percentage points of GDP below the level seen in 2014. Analysis of the structure of tax revenues (see *Table 15*) shows that in relative terms revenues from the mineral extraction tax increased by 0.3 percentage points of GDP, revenues from VAT on goods sold on the territory of the Russian Federation were up by 0.2 percentage points of GDP, and revenues from the corporate profit tax rose by 0.1 percentage points of GDP. In 2015, the year-end revenues from customs duties plunged sharply by 2.9 percentage points of GDP. The dynamics of mineral extraction tax and customs duties was driven by two factors, namely by the decline of global crude oil prices and by the abovementioned "tax maneuver" in the oil sector. Revenues from VAT on goods imported in the territory of the Russian Federation, and from excise duties (both "import" and "internal" ones) remained at levels (expressed as a percentage of GDP) seen in 2014.

*Table 15*

**Main tax revenues of federal budget  
in 2014–2015**

	January-December 2014		January-December 2015		Change as per- centage points of GDP
	rubles in billions	% of GDP	rubles in billions	% of GDP	
<b>Tax revenues, total</b>	<b>13.366</b>	<b>17.2</b>	<b>11.886</b>	<b>14.8</b>	<b>-2.4</b>
corporate profit tax	411	0.5	491	0.6	0.1
VAT on goods sold on the territory of the Russian Federation	2.181	2.8	2.448	3	0.2
VAT on goods imported in the territory of the Russian Federation	1.750	2.2	1.785	2.2	0.0
excise duties on goods manufactured on the territory of the Russian Federation	521	0.7	528	0.7	0.0
excise duties on goods exported to the territory of the Russian Federation	72	0.1	54	0.1	0.0
mineral extraction tax	2.858	3.7	3.160	3.9	0.3
revenues from foreign economic activities (customs duties)	5.445	7.0	3.295	4.1	-2.9

*Sources:* Russia's Federal Treasury, Gaidar Institute's own calculations.

All things considered, the following can be concluded: the dynamics of tax revenues of the federal budget in 2015–2016 was determined basically by a decline in oil and gas revenues amid falling global crude oil prices, whereas main types of non-oil and gas revenues were relatively stable.

*Table 16* presents actual execution of the federal budget in 2015 in terms of functional classification of expenditure.

*Table 16*

**Federal budget expenditure in 2014–2015  
(functional classification of expenditure)**

	2014		2015		Change as percentage points of GDP
	rubles in billions	as % of GDP	rubles in billions	as % of GDP	
Expenditure total, including:	14.831	19.0	15.611	19.4	0.4
General National Issues	1.350	1.7	1.627	2.0	0.3
National Defense	2.479	3.2	3.181	4.0	0.8
National Security and Law Enforcement	2.086	2.7	1.966	2.7	-0.2
National Economy	3.063	3.9	2.324	2.9	-1.0
Housing and Utilities	120	0.2	144	0.2	0.0
Environmental Protection	46	0.1	50	0.07	0.0
Education	638	0.8	611	0.8	-0.1
Culture and Cinematography	98	0.1	90	0.1	0.0
Healthcare	536	0.7	516	0.6	0.1
Social Policy	3.452	4.4	4.265	5.3	0.9
Physical Culture and Sports	71	0.1	73	0.1	0.0
Mass Media	75	0.1	82	0.1	0.0
Public Debt Service	416	0.5	519	0.7	0.1
General Purpose Inter-Budget Transfers	816	1.0	682	0.9	-0.2

*Sources:* Russia's Finance Ministry, Gaidar Institute's own calculations.

Overall, the federal budget expenditure in 2015 were 0.4 percentage points of GDP above those in 2014. However, the inflation-adjusted expenditure in 2015 was down by 9%. Spending for 'Social Policy' increased by 0.9 percentage points GDP, for 'National Defense' by 0.8 percentage points of GDP, for 'General National Issues' by 0.3 percentage points of GDP, and for 'Public Debt Service' by 0.1 percentage points of GDP. Note that in 2015 the expenditure for the above listed line items increased not only as a percentage of GDP but also in real terms: the dynamics of growth varied between 4% and 11%.

In terms of equality in spending, note that in January-March 2015 military spending were higher than other types of expenditure. For instance, in January, allocations accounted for 21.6% of the updated quarterly expenditure worksheet for 2015, and for 49.2% as a whole in January-March. This effect was smoothed in the months that followed in 2015. The drastic growth in military spending in 2015 was driven first of all by financing of measures envisaged as part of the state defense order. The growth of 7% in social spending in real terms was driven first of all by the growth (by 13% in real terms) in the pension provision expenditure due to indexation of pensions.

The expenditure for 'National Economy' were cut the most, by 1.0 percentage points of GDP. As noted above, the wide gap in volumes of expenditure in support of the economy in 2014 and 2015 is partially "technical" and related to appropriations to the DIA for support of the banking sector. Additionally, federal budget expenditure for 'National Security and Law Enforcement' were cut by 0.2 percentage points of GDP, for 'Inter-Budget Transfers' by 0.2 percentage points of GDP and for 'Education' by 0.1 percentage points of GDP. Note that even expenditure related to investment in human capital – most "productive" government expenditure – were cut in nominal terms. In real terms, the federal budget expenditure for education and healthcare reached about 17% in 2015.

*Table 17* presents the dynamics of federal government spending budget as regards to operations in the public administration sector (economic classification of expenditure).

**Federal budget expenditure in 2011–2015  
(economic classification of expenditure)**

	2011	2012	2013	2014	2015
<i>Total expenditure, rubles in billions</i>	10.935	12.891	13.343	14.832	15.611
Growth in real terms, %	-0.3	12.2	-3.0	3.1	-8.9
including:					
<i>Investment expenditure, rubles in billions</i>	1.660	1.753	1.659	1.773	2.476
Growth in real terms, %	7.5	0.5	-11.4	-0.9	20.9
Including growth in the value of shares and other types of shareholding	410	505	315	264	388
Growth in real terms, %	14.4	17.3	-41.6	-22.3	27.3
<i>Current expenses, rubles in billions</i>	9.275	11.137	11.684	13.059	13.135
Growth in real terms, %	-1.6	14.3	-1.7	3.7	-12.9

Sources: Russia's Federal Treasury; Gaidar Institute's own calculations.

The dynamics of federal budget expenditure slowed down in real terms by 8.9% in 2015 from 2014. Current expenses made up most of the structure of federal budget expenditure. The 12.9% decline in current expenses was responsible largely for the decline in total amount of expenditure. By contrast, investment expenditure increased in real terms by 21% against the 0.9% decline a year earlier. Budget investment increased considerably (about 39%) due the growth under the item 'Increase in the value of fixed assets', that was determined possibly by increase in spending related to the state defense order. It is difficult to perform quantitative assessment due to a lack of data as regards to classification of operations in the state administration sector for a few expenditure items in the Federal Treasury's reports. The volumes of budget financing for 'Growth in the value of shares and other types of shareholding' were declining steadily in nominal terms throughout the entire period of 2013–2014, possibly evidencing that charter capital contributions and purchases of shares became a less important tool of supporting enterprises. However, in 2015 this trend gave way to a 27% increase in real terms in these expenditure.

The Russian government's policy aimed at curtailing growth and cutting back gradually on the volume of government spending appears reasonable. It is unreasonable and highly risky to increase the volume of expenditure by increasing the volume of deficit. The current level of federal budget expenditure is above the level of corresponding current macroeconomic context. Government expenditure were too "fat" in the period of high crude oil prices, with further growth thereof during the crisis of 2009–2010, but then they were cut down to the pre-crisis level of 18% of GDP (the expenditure have recently been steadily above 20% of GDP).

The principal feature of the **2016 federal budget** was the need to adapt to the new context of very low oil prices of about \$30–40 a barrel, whereas the federal budget was approved on the assumption that the crude oil price is \$50 a barrel, and the budget balance is reached when the oil is traded at \$82 a barrel, as estimated by Russia's Finance Ministry.<sup>1</sup>

Given the fact that the key macroeconomic indicators are volatile and difficult to forecast, the 2016 federal budget was adopted for a single year (as was the case with the 2010 budget). However, as early as May 2015, the Russian Government considered a three-year budget plan for 2016–2018 (the Urals crude was projected at \$60–65–70 a barrel respectively).<sup>2</sup>

<sup>1</sup> <http://www.minfin.ru/ru/#ixzz3yTTiNNKR>

<sup>2</sup> <http://government.ru/news/17821/>

As early as the fall of 2015, the 2016 federal budget parameters were updated seriously from the original version approved as part of the law on the federal budget for 2015–2017. The resource base of the federal budget was reduced substantially by 1.5 percentage points of GDP (to 17.5% of GDP) below the parameters that were set originally. Federal budget revenues dropped in response to expectations for further decline in oil and gas budget revenues to 7.7% of GDP (against 9.7% of GDP) as a result of falling crude oil prices globally. Federal budget revenues for 2016 were estimated on the assumption that the crude oil price is \$96 a barrel in the original version of the mid-term forecast and \$50 a barrel in the single year version. The approved volume of expenditure reached 20.5% of GDP, nearly 1 percentage point of GDP above the originally set targets. As a result, federal budget deficit increased to 3% of GDP against that of 0.6% of GDP in the original version. However, given that in Q1 2016 the crude oil price was way less than \$50 a barrel, it is highly likely that even the single year budget parameters will have to be updated within the fiscal year.

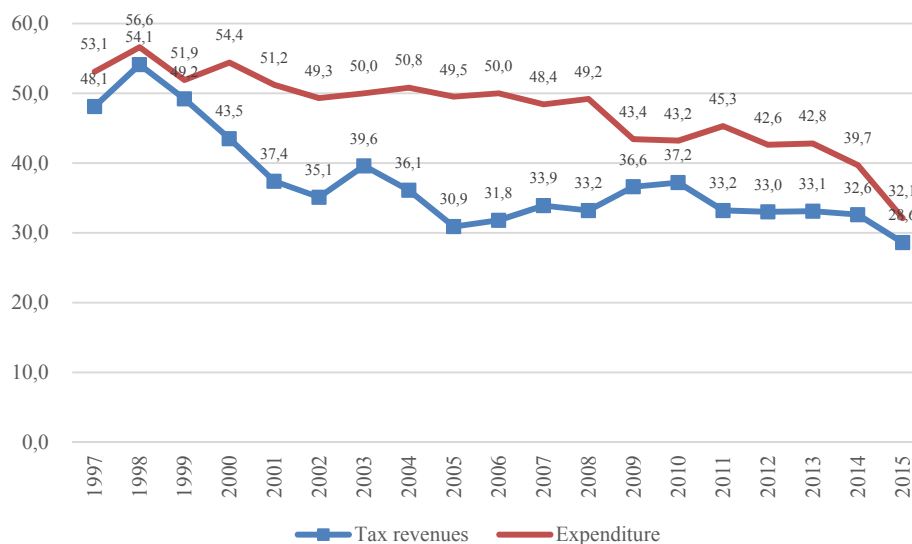
The complexity of the situation is that, on the one hand, a balance between searching for new sources of the resource base and cutting back on inefficient commitments has to be reached, and, on the other hand, the possibility of recovering Russia's economy and entering a new growth path should not be undermined. Budget deficit may double in 2016 and the Reserve Fund may be fully depleted in the absence of government's adequate measures of tactical response (for 2016) and strategic response (for 2017–2019) towards optimizing the 2016 budget expenditure, and if the current crude oil prices remain the same in the medium term,.

In terms of adjusting their expenditure commitments in 2016, the Russian government plan to cut back on the approved volumes of budget expenditure. For instance, plans to optimize federal spending may include a 10% cut-back on all the unprotected budget line items, thereby saving about Rb 500–700bn, as estimated by the Russian government. Budget holders are expected to analyze by themselves their own budgets and to decide on cutting back on inefficient spending thereof (in a volume of 10%). Officially, this is not just cutting volumes in all the expenditure items, this is cutting the inefficient component thereof. This is where the major challenge resides. Each of the federal budget expenditure contains expenditure that may be recognized as inefficient by an audit, as evidenced by audits conducted by Russia's Chamber of Accounts. However, does it suggest 10% cuts on all the expenditure?, especially on the "protected sectors" such as defense and social policy, as well as the "protected items" such as wages of public employees in every expenditure item. Further technical cuts of expenditure for educational and medical institutions may result in some institutions running short of funds and being unable to cover even their current expenses (other than wages). As a result, just mere cuts on financing are exposed to high risks if the budget institution network undergoes no reform. Therefore, while introducing new updates to budget expenditure, it is very important to avoid new "technical cuts" (although this is relatively easy to do) and to identify budget expenditure that are really inefficient. Additionally, it is significant that a variable approach is introduced into the practice of budget planning (like in New Zealand or Austria), predefining beforehand the expenditure to be cut if the macroeconomic context happens to be worse than the forecast (in the Russian practice this could be done as part of state programs, specifying "mandatory" and "supplementary" parts in each program).

## 2.3. Intergovernmental fiscal relations and subnational finance<sup>1</sup>

### 2.3.1. Analysis of principal parameters of consolidated budgets of subjects of the Russian Federation

The revenues and expenditure structure of consolidated budgets of the Russian Federation reflects main trends in relations between various levels of public administration. *Fig. 22* presents data reflecting the share of tax revenues and expenditure of subjects of the Russian Federation, that are expressed as corresponding indicators of Russia's consolidated budget.



*Fig. 22.* Share of tax revenues and of subnational budget expenditure of Russia's consolidated budget in 1997–2015

**Note:** No calculations were made for regions of the Crimean Federal Okrug.

*Sources:* Russia's Federal Treasury, Gaidar Institute's own calculations.

In 2015, the share of subnational budget expenditure of the Russian Federation consolidated budget dropped considerably from 39.7% in 2014 to 32.1% in 2015 (excluding expenditure for the Crimean Federal Okrug). The share of tax revenues shrank to a lesser extent, from 32.6% to 28.6%, during the same period. The decline in the share of subnational budget expenditure of the total volume of Russia's consolidated budget expenditure is explained largely by faster-than-normal growth of the federal budget expenditure (by 5.6% in nominal terms). The federal budget expenditure increased first of all for 'General National Issues' (by 18.6%), 'National Defense' (by 28.3%), 'Housing and Utilities' (by 20.5%), 'Social Policy' (by 23.5%), 'Municipal and Public Debt Servicing' (by 24.8%). Subnational budget expenditure increased in the period under review by 1.4% (excluding expenditure for the Crimean Federal Okrug).

Let us analyze in detail the revenue side of subnational budgets. The dynamics of principal components of consolidated budget revenues of subjects of the Russian Federation are shown in *Table 18*.

<sup>1</sup> Authors of this section: Authors of this section: Alaev A. – Gaidar Institute for Economic Policy, Mamedov A. – Gaidar Institute for Economic Policy, Fomina E. – Gaidar Institute for Economic Policy.

*Table 18*

**Consolidated budget revenues of subjects of the Russian Federation  
in 2008–2015**

	Volume of revenues (in nominal terms), rubles in billions								Growth in real terms, %			
	2008	2009	2010	2011	2012	2013	2014	2015	2009/ 2008	2015/ 2008	2014/ 2013	2015/ 2014
<b>Revenues, total</b>	<b>6.196</b>	<b>5.924</b>	<b>6.537</b>	<b>7.644</b>	<b>8.064</b>	<b>8.165</b>	<b>8.743</b>	<b>9.191</b>	<b>-12.1</b>	<b>-17.2</b>	<b>-3.8</b>	<b>-8.6</b>
<b>Tax and nontax revenues</b>	<b>4.912</b>	<b>4.243</b>	<b>4.980</b>	<b>5.827</b>	<b>6.385</b>	<b>6.588</b>	<b>7.141</b>	<b>7.585</b>	<b>-20.6</b>	<b>-13.8</b>	<b>-2.7</b>	<b>-6.4</b>
<i>Including tax revenues:</i>	4.384	3 792	4.520	5 273	5.800	5.967	6.461	6.890	-20.5	-12.3	-2.8	-6.0
profit tax	1.752	1.069	1.520	1.928	1.980	1.720	1.962	2.099	-43.9	-33.1	2.4	-5.2
personal income tax	1.666	1.665	1.790	1.996	2 261	2.499	2 679	2.788	-8.1	-6.6	-3.7	-7.9
Taxes on total income	161	152	179	215	272	293	314	346	-13.6	19.8	-3.8	-2.7
property taxes	493	570	628	678	785	901	955	1 067	6.1	20.7	-4.8	-1.3
excise duties	189	246	327	372	442	491	479	484	19.2	42.6	-12.4	-10.5
<b>Transfers</b>	<b>1.131</b>	<b>1.486</b>	<b>1.398</b>	<b>1.644</b>	<b>1.624</b>	<b>1.515</b>	<b>1.545</b>	<b>1.538</b>	<b>20.7</b>	<b>-24.1</b>	<b>-8.4</b>	<b>-18.5</b>
<b>Other revenues</b>	<b>153</b>	<b>195</b>	<b>159</b>	<b>173</b>	<b>56</b>	<b>62</b>	<b>57</b>	<b>68</b>	<b>17.4</b>	<b>-75.1</b>	<b>-17.4</b>	<b>4.8</b>

**Note:** No calculations were made for regions of the Crimean Federal Okrug.

**Sources:** Russia's Federal Treasury, Gaidar Institute's own calculations.

The data in *Table 18* show that in 2015 consolidated budget revenues of subjects of the Russian Federation dropped in real terms by 8.6% from the level seen in 2014. The 2015 decline in real terms in the total level of revenues was driven by a fall in retail trade turnover (a 10% decline below the level seen in 2014), in the volume of fixed investment (-8.4%), that is, an economic slowdown that was reflected in the 3.7% fall of GDP. Furthermore, inflation rate reached 12.9% in 2015, the highest since 2003, which affected inevitably the dynamics of fiscal indicators in real terms.

The above listed adverse factors dragged down in real terms all the principal sources of revenues of subnational budgets. The personal income tax fell the deepest among major types of taxes, driven by negative dynamics of revenues for two consecutive years (-3.8% in 2014, -7.9% in 2015). The structure of tax revenues was changed accordingly: the share of the personal income tax was down from 41.5% to 40.5%, whereas the share of profit tax – another source of budget revenues – increased slightly from 30.4% to 30.5%. Note that in 2015 profit tax revenues dropped by 5.2% in real terms, too. Revenues from aggregate income taxes and property taxes declined less, by 2.7% and 1.3% respectively. Subnational budget revenues from excise duties continued to fall at fast pace (a decline of 12.4% in 2014 and of 10.5% in 2015).

In 2015, nontax revenues dropped on an annualized basis (a decline in real terms of 9.5%). As a result, the share of this source of revenues of the total structure of consolidated budget revenues of subjects of the Russian Federation shrank inconsiderably from 7.8% to 7.6%. It is significant that intergovernmental fiscal transfers in 2015 decreased in real terms by 18.5% amid falling tax and nontax revenues of consolidated budgets of subjects of the Russian Federation.<sup>1</sup>

Let us analyze tax and nontax revenues at the regional level (see *Table 19*).

<sup>1</sup> Detailed analysis of the dynamics of federal budget transfers is made below.

Table 19

**Grouping Russia's regions according to changes in major types of tax and nontax revenues of consolidated budgets of subjects of the Russian Federation in 2015**

	Change in major types of tax and nontax revenues of consolidated budgets of subjects of the Russian Federation					
	growth by more than 25%	growth by 10 to 25%	growth by less than 10%	decline by less than 10%	decline by 10 to 25%	decline by more than 25%
<b>in nominal terms</b>						
Tax and nontax revenues, total	2	16	49	15	1	0
Profit tax	15	16	15	12	15	10
Personal income tax	0	4	56	23	0	0
<b>in real terms</b>						
Tax and nontax revenues, total	2	0	9	48	24	0
Profit tax	9	6	10	19	21	18
Personal income tax	0	0	2	41	40	0

**Notes:** 1. Arkhangelsk Region and Nenets Autonomous Okrug are presented as a single subject of the Russian Federation. 2. No calculations were made for regions of the Crimean Federal Okrug.

*Sources:* Russia's Federal Treasury, Gaidar Institute's own calculations.

The presented data show that the situation with own-source revenues of subnational budgets remained as much challenging as it was in 2013–2014 in most Russia's regions.<sup>1</sup> In 2015, 72 regions (71 regions in 2014) saw their own-source revenues of subnational budgets decline in real terms, including 48 regions facing a decline of about 10%. Profit tax revenues dropped across the country, and 18 regions saw their profit tax revenues fall by more than 25% in real terms. The deepest fall in profit tax revenues was recorded in the Republic of Tyva (-50.6%), Chechen Republic (-56%), Republic of Mordovia (-76.1%). Overall, the profit tax dropped in real terms in 58 regions. The rest 25 regions saw their profit tax revenues grow in real terms, and in nine subjects of the Russian Federation this tax increased by more than 25%, namely Tambov Region (29.3%), Republic of Karelia (50.1%), Murmansk Region (34.8%), Kirov Region (32.2%), Chelyabinsk Region (27.2%), Republic of Buryatia (108.6%), Magadan Region (49.1%), Sakhalin Region (64.0%), Chukotka Autonomous Okrug (81.1%). Profit tax revenues in the Sakhalin Region increased considerably as a result of implementation of oil and gas projects Sakhalin-1 and Sakhalin-2 as part of production sharing agreements. Profit tax revenues in the Republic of Buryatia soared due to large export-oriented manufacturing facilities (first of all, the Ulan-Ude Aviation Plant). Accordingly, depreciation of the Russian ruble pushed up currency proceeds, and the profit tax charged to the regional budget was on the rise accordingly. Only two subjects of the Russian Federation saw their own-source revenues grow up by more than 25%: Sakhalin Region (31.4%) and Chukotka Autonomous Okrug (28.3%). Revenues from the personal income declined in almost all the regions (81). A minor growth in the personal income tax was recorded only in Belgorod Region (3.7%) and Republic of Mordovia (8.2%).

Let us next analyze changes to the expenditure side of consolidated budgets of subjects of the Russian Federation in 2015 (see *Table 20*).

Overall, given a decline, in real terms, of both tax/nontax revenues and federal budget transfers, and with the debt accumulated by a few subjects of the Russian Federation, Russian subnational authorities conducted a conservative fiscal policy: total volume of expenditure increased only by 1.4% in nominal terms, resulting in a decline of 10.2%, as adjusted for inflation.

<sup>1</sup> In 2014, 71 subjects of the Russian Federation saw own revenues fall in real terms (51 subjects in 2013). Profit tax revenues dropped in real terms by more than 25% in four regions in 2014 and in 23 regions in 2013.



Table 20

**Consolidated budget expenditure of subjects of the Russian Federation  
in 2014–2015**

	As % of total		As % of GDP		Growth, %	
	2014	2015	2014	2015	in nominal terms	in real terms
General National Issues	6.2	6.4	0.74	0.75	4.5	-7.5
National Security and Law Enforcement	1.1	1.1	0.14	0.13	0.5	-11.0
National Economy	18.8	19.7	2.26	2.32	6.1	-6.0
Including:						
agriculture and fishery	3.0	3.3	0.35	0.39	13.1	0.1
Transport	4.1	4.2	0.49	0.50	4.2	-7.7
Public Road System (Road Funds)	7.6	7.8	0.91	0.92	4.3	-7.6
other issues related to the national economy	2.3	2.4	0.28	0.29	4.8	-7.1
Housing and Utilities	9.6	9.0	1.16	1.06	-5.1	-15.9
Environmental Protection	0.3	0.2	0.03	0.03	-12.7	-22.7
Education	26.2	26.1	3.15	3.07	0.8	-10.7
Including:						
pre-primary education	7.0	7.3	0.84	0.86	5.3	-6.7
general education	15.0	14.6	1.80	1.72	-0.9	-12.3
secondary vocational education	2.1	2.0	0.25	0.24	-2.1	-13.3
other issues related to education	1.4	1.3	0.17	0.15	-8.6	-19.0
Culture, Cinematography	3.4	3.3	0.41	0.39	-2.5	-13.7
Healthcare	13.9	14.3	1.66	1.69	4.6	-7.4
Social Policy	15.1	15.8	1.82	1.86	5.8	-6.3
Physical Culture and Sports	2.0	2.0	0.24	0.24	1.3	-10.3
Mass Media	0.5	0.5	0.05	0.05	2.9	-8.9
Municipal and public debt servicing	1.3	1.6	0.16	0.19	22.4	8.4
<b>Expenditure, total</b>	<b>100.0</b>	<b>100.0</b>	<b>12.01</b>	<b>11.79</b>	<b>1.4</b>	<b>-10.2</b>

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

Analysis of changes in various line items of budget expenditure in regions reveals the following. In 2015, the annualized expenditure for 'Environmental Protection' (a decline of 12.7% in nominal and of 22.7% in real terms) declined the most. However, these expenditure left the total expenditure structure unchanged because the share of the former stood at 0.03%. The structure of expenditure was changed due to a decline in expenditure for 'Housing and Utilities' (down by 15.9% in real terms). Regions' policy aimed at cutting expenditure for 'Housing and Utilities' was a measure to counter fiscal disequilibrium, budget deficit and large debts. Note that the downtrend towards expenditure for the housing and utilities sector is likely to continue in the near term. For example, in 2016 federal budget allocations for the foregoing expenditure are planned to be cut by 47.2% from the value seen in 2015. Running short of their own-source revenues and facing cuts on federal co-financing, regions are unlikely to be able to spend more on 'Housing and Utilities'. Overall, the decline in expenditure in real terms can be seen for all the expenditure line items, except for 'Municipal and Public Debt Servicing'. These expenditure increased first of all because the volume of public and municipal debt rose by 11% and 9% respectively (see below for more details). However, the growth in expenditure for debt servicing slowed down inconsiderably as a result of replacement of a share of commercial debts with budget loans at an extremely low interest rate<sup>1</sup> (the volume of budget loans increased by 24.9% as of 2015 year-end). The 2015 year-end expenditure for 'Municipal and Public Debt Servicing' of the total expenditure structure rose from 1.3% in 2014 to 1.6%, by 0.03 percentage points of GDP: from 0.16% to 0.19% of GDP.

<sup>1</sup> 0.1% per annum.

Overall, expenditure increased in nominal terms for all the line items, except ‘Housing and Utilities’, ‘Environmental Protection’, ‘Culture and Cinematography’. Efforts were made to increase inconsiderably expenditure for ‘National Economy’ as a whole (6.1%) and the subitems related thereto. In particular, expenditure for ‘Transport’ and ‘Public Road System (Road Funds)’ increased by 4.3% and 4.8% respectively. ‘Agriculture and Fishery’ saw the biggest growth in expenditure not only in nominal terms (by 13.1%) but also in real terms (by 0.1%).

Let us next consider the dynamics of principal (not only expenditure) parameters of consolidated budgets of subjects of the Russian Federation, as a percentage of GDP (see *Table 21*).

*Table 21*

**Dynamics of revenues and expenditure of consolidated budgets of subjects of the Russian Federation in 2008–2015, as % of GDP**

	2008	2009	2010	2011	2012	2013	2014	2015
<b>Revenues</b>	<b>15.02</b>	<b>15.27</b>	<b>14.12</b>	<b>12.80</b>	<b>12.05</b>	<b>11.49</b>	<b>12.30</b>	<b>12.93</b>
Including:								
profit tax	4.24	2.76	3.28	3.23	2.96	2.42	2.76	2.95
personal income tax	4.04	4.29	3.87	3.34	3.38	3.52	3.77	3.92
Federal budget transfers	2.65	3.81	2.98	2.42	2.15	2.13	2.17	2.16
<b>Expenditure</b>	<b>15.15</b>	<b>16.12</b>	<b>14.33</b>	<b>12.86</b>	<b>12.47</b>	<b>12.39</b>	<b>12.97</b>	<b>13.17</b>
<b>Deficit (-) / Surplus (+)</b>	<b>-0.13</b>	<b>-0.85</b>	<b>-0.22</b>	<b>-0.06</b>	<b>-0.42</b>	<b>-0.90</b>	<b>-0.67</b>	<b>-0.24</b>
For reference: GDP, rubles in billions	41.277	38.807	46.309	59.698	66.927	71.055	77.893	80.413

**Note:** No calculations were made for regions of the Crimean Federal Okrug.

**Sources:** Russia’s Federal Treasury, Gaidar Institute’s own calculations.

2009 saw the biggest volume as a percentage of GDP of both revenues and subnational budget expenditure in the period of 2008–2015. Revenues rose in 2009 as a result of considerable growth (by 35.2%) of federal budget transfers, and expenditure increased due to the implementation of measures as part of an anti-crisis program (both at the federal level – using subsidies and subventions – and at the regional level). However, tax revenues in regions dropped in 2009 mostly as a result of declining profit tax revenues. It is therefore more appropriate to take the pre-crisis year of 2008 as the comparative base (recessionary trends in the fiscal sector were not visible until the last few months of 2008).

The data in *Table 21* show that in 2015 revenues from the personal income tax, profit tax, federal budget transfers did not reach levels recorded in 2008. Sources of revenues such as the profit tax and intergovernmental fiscal transfers were the farthest behind the 2008 levels. However, expenditure were much less in volume: 13.2% of GDP in 2015 against 15.2% of GDP in 2008.

In 2015, both revenues and expenditure increased as a percentage of GDP from 2014, by 0.63 and 0.2 percentage points respectively. The growth was observed for two consecutive years. Note that total expenditure and revenues increased in volume while they fell in real terms. The dynamics was observed amid slowing down GDP growth rates, with a 3.7% fall in 2015. The processes suggest that the economy is shrinking faster than changes in the principal parameters of subnational budgets of subjects of the Russian Federation. As a result, the deficit in 2015 was reduced in volume from 0.67% to 0.24% of GDP. Furthermore, in 2015, 36 regions reduced their expenditure even in nominal terms compared with the level recorded in 2014. Expenditure were reduced the most in the Amur Region (-13.8%), Yamalo-Nenets Autonomous Okrug (-13.2%) and Pskov Region (-10.6%).

Let us analyze in detail the situation with execution of consolidated budgets of subjects of the Russian Federation (deficit/surplus) in various regions (see *Table 22*).

*Table 22*

**Execution of (deficit/surplus) consolidated budgets of subjects  
of the Russian Federation in 2008–2015**

Year	Number of subjects of the Russian Federation that executed their budgets	
	with a deficit	with a surplus
2008	45	39
2009	62	21
2010	63	20
2011	57	26
2012	67	16
2013	77	6
2014 <sup>1</sup>	74	9
2015 <sup>1</sup>	75	8

<sup>1</sup> Excluding regions of the Crimean Federal Okrug.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The data in *Table 22* show that in 2015 consolidated budgets of subjects of the Russian Federation remained nearly as balanced in terms of quantity of regions as they were in 2014. Seventy five subjects of the Russian Federation ran a budget deficit in 2015 (74 in 2014). At the same time, five subjects (Lipetsk Region, Kaliningrad Region, Republic of Ingushetia, Yamalo-Nenets Autonomous Okrug, Republic of Altai) ran a budget surplus in 2014 and a budget deficit in 2015.<sup>1</sup> Three of the five regions increased their expenditure above the Russia's average level (1.4% in nominal terms).

Overall, in 2015 the parameters of consolidated budgets of subjects of the Russian Federation continued to be affected by adverse macroeconomic factors. Cost optimization opportunities continued to be sought at the subnational level. As a result, in 2015 expenditure were maintained at the year-earlier level, with a minor increase for 'National Economy'. The situation with revenues is more complex, first of all, because of the prevailing downtrend towards personal income and revenues from the personal income tax. Profit tax revenues were kept at a steady level largely due to export-oriented industries. The financial standing of Russia's regions is mixed in general. For instance, subnational budget deficit in 2015 dropped by 2.5 times due to a surplus of Rb 144.3bn in Moscow (a deficit of Rb 54.3bn in 2014) rather than because of financial rehabilitation across the regions. The downtrend towards federal budget transfers had an adverse effect on the volume of revenues in regions, too (see below for details).

### 2.3.2. Financial support from the federal budget

In 2015, total volume of intergovernmental fiscal transfers to consolidated budgets of subjects of the Russian Federation (including the Crimean Federal Okrug) contracted both in nominal terms (-0.2%) and in real terms (-11.6%) from 2014 (see *Table 23*).

Overall, the volume of financial support shrank for almost all types of transfers, except 'Other intergovernmental fiscal transfers' (hereinafter – "other IBTs") that increased by 67.4% in real terms at 2015 year-end as a result of greater support for the development of the public road system as part of the Transport System Development State Program. In 2015, Rb 83.4bn (Rb 3.7bn in 2014) were allocated for this purpose.

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<sup>1</sup> Excluding regions of the Crimean Federal Okrug.

Table 23

**Federal budget transfers to subjects of the Russian Federation in 2009–2015\***

	2009		2013		2014		2015		Growth %, 2015 from 2014	
	rubles in bil-lions	as % of to-tal	rubles in bil-lions	as % of to-tal	rubles in bil-lions	as % of total	rubles in bil-lions	as % of to-tal	in nomi-nal terms	in real terms
<b>Transfers to regions, total</b>	<b>1.480,3</b>	<b>100</b>	<b>1.487,9</b>	<b>100</b>	<b>1.607,0</b>	<b>100</b>	<b>1.603,6</b>	<b>100</b>	<b>-0.2</b>	<b>-11.6</b>
<b>Grants</b>	<b>578.3</b>	<b>39.1</b>	<b>609.1</b>	<b>40.9</b>	<b>774.7</b>	<b>48.2</b>	<b>650.9</b>	<b>40.6</b>	<b>-16.0</b>	<b>-25.6</b>
Including:										
equalization transfers	374.0	25.3	418.8	28.1	439.8	27.4	487.7	30.4	10.9	-1.8
grants for measures to ensure budget balance	191.9	13.0	177.8	12.0	334.9	20.8	163.2	10.2	-51.3	-56.8
<b>Subsidies</b>	<b>530.0</b>	<b>35.8</b>	<b>515.6</b>	<b>34.7</b>	<b>409.9</b>	<b>25.5</b>	<b>400.2</b>	<b>25.6</b>	<b>-2.4</b>	<b>-13.5</b>
Including:										
subsidies to develop the national economy	214.3	14.5	268.3	18.0	241.9	15.1	258.2	16.1	6.7	-5.5
<b>Subventions</b>	<b>284.4</b>	<b>19.2</b>	<b>273.7</b>	<b>18.4</b>	<b>308.2</b>	<b>19.2</b>	<b>336.6</b>	<b>21.0</b>	<b>9.2</b>	<b>-3.3</b>
<b>Other intergovernmental fiscal transfers</b>	<b>87.6</b>	<b>5.9</b>	<b>89.5</b>	<b>6.0</b>	<b>114.2</b>	<b>7.1</b>	<b>215.9</b>	<b>13.5</b>	<b>89.1</b>	<b>67.4</b>

\* Unlike the previous paragraph, here volumes of transfers include the Crimean Federal Okrug.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The structure of transfers was changed drastically due to considerable growth of other IBTs and cuts on other types of transfers. For instance, the share of other IBTs increased from 7.1% to 13.5% while the share of subsidies and subventions rose from 25.5% to 25.6% and from 19.2% to 21.0% respectively. In real terms, the volume of subsidies dropped by 13.5% while subventions decreased in volume by 3.3%. Overall, the decline in the volume of subsidies (both in nominal and real terms) was offset by a sharp hike of other IBTs. The volume of subventions is largely determined by the size of indexation of social benefits, and its growth rate tends to slow down. In fact, subnational budgets have not become less reliant in terms of exercising delegated powers. Although transfers have been reduced in volume, there is still a great number of subsidies with overdetailed spending of budget funds, as well as with considerably wide scope of delegated powers. For instance, 86 subsidies were planned for 2015 (92 subsidies in 2014). However, the 2015 year-end subsidies increased in number to 96 under the amended federal budget law. The mechanism of subsidization is more efficient to ensure proper spending of budget funds than to reach the target, a great number of subsidies facilitates growth of administrative costs on monitoring the spending of subsidies. Under the state sub-program called "Enhancing the system of allocation and reallocation of financial resources between the levels of the budget system of the Russian Federation", federal budget subsidies to budgets of subjects of the Russian Federation are to be reduced in number on a step by step basis, with their number set to be optimized (consolidated) to 70 at Stage I (2013–2015) and to 42 at Stage II (2016–2020).

Note that total number of subventions increased from 18 in 2014 to 21 in 2015. The number of subventions increased on the back of consolidation of nine subventions into a single subvention. The number of subventions increased partly due to delegation of certain powers to budgets of the Republic of Crimea and of the federal city of Sevastopol.

Reducing the share of targeted financial support is a priority of the fiscal policy.<sup>1</sup> The share of grants was formally reduced from 48.2% to 40.6% in 2015, which, however, corresponds to the target value stipulated in the Guidelines of the Fiscal Policy for 2016–2018 (41.2% in 2015, 45.1% in 2016). In 2015, grants were reduced in volume because, first, financing under the state program called “Creation of conditions for efficient and prudent management of regional and municipal finance, enhancement of sustainability of budgets of subjects of the Russian Federation” was completed, whereby Rb 167bn were allocated in 2014 (excluding expenditure as partial compensation for extra expenditure to increase public sector wages). In 2015, as little as Rb 62.7bn were allocated for the implementation of the state program called “Development of federative relations and creation of conditions for efficient and prudent management of regional and municipal finances”. Second, in 2015 the volume of financial support as partial compensation for extra expenditure to increase public sector wages was cut in half to Rb 59.8bn, as a result of which the share of grants allocated in support of measures aimed at ensuring budget equilibrium in the structure of transfers shrank from 20.8% to 10.2% (by Rb 171.7bn).

In general, the decline in the share of grants allocated in support of measures aimed at ensuring budget equilibrium is a positive factor, because the grants are much less transparent than equalization transfers that in 2015 saw the least negative dynamics (-1.8%) compared with other types of transfers. However, the federal government’s policy aimed at a broader application of the budget loan instrument instead of equalization grants raises some questions, because regions will have to repay budget loans. Should Russia’s economy see no improvements in the years to come, there may be risks of regions being unable to repay their federal budget loans, in which case the federal government will have to extend new budget loans to ensure that old budget loans are repaid, or they will have to decide on writing off (or “freezing”) outstanding budget loans. Such a situation will deteriorate the transparency of intergovernmental fiscal relations, and it will inevitably deteriorate the fiscal discipline of regional government authorities.

Analysis of the process of allocation of federal government transfers to regions should consider the effect of federal support on differentiation of revenues of subjects of the Russian Federation, measuring the equalization performance of financial support from the federal budget (see *Table 24*).

*Table 24*

**Variation coefficient of consolidated budget revenues in regions  
(per capita, with consideration for budget expenditure index) in 2008–2015, %**

Year	Tax revenues	Tax revenues and equalization transfers	Tax revenues, grants, subsidies
2008	90.6	80.4	71.5
2009	78.3	66.5	54.5
2010	74.2	63.9	57.8
2011	77.8	68.4	61.6
2012	66.1	57.8	51.9
2013	63.7	55.3	48.1
2014	59.0	51.2	49.9
2015	66.1	60.3	56.0

**Note:** No calculations were made for regions of the Crimean Federal Okrug.

**Sources:** Russia’s Federal Treasury, Ministry of Finance, Gaidar Institute’s own calculations.

The data in *Table 24* show that differentiation of subnational budget revenues increased in 2015. The coefficient of tax revenues of consolidated budgets of subjects of the Russian

<sup>1</sup> See, e.g., the Guidelines of the Fiscal Policy of the Russian Federation for 2016 and for the Planning Period of 2017–2018.

Federation was up from 59% to 66.1%, reaching the level seen in 2012. With equalization transfers, the variation coefficient of budget revenues in regions increased from 51.3% in 2014 to 60.3% in 2015, and with all the allocated grants and subsidies, it increased in 2015 to 56% (49.9% in 2014). Differentiation of regional revenues in 2015 increased largely because the profit tax was up in a few subjects of the Russian Federation, which was related to export-oriented industries. For instance, the profit tax rose by more than 25% from 2014 in 15 regions (in nominal terms) and in 9 regions (in real terms).

### 2.3.3. Debt policy at regional level

Table 25 shows data on the dynamics of volumes of public debt owed by subjects of the Russian Federation and municipal debt in 2010–2015. The Table shows that in 2015 the year-to-date growth in the debt owed by regional budgets was nearly 11% in nominal terms (for comparison: 28.2% in 2013, and 20.3% in 2014), excluding 14% in Moscow and Moscow Region (37.9% in 2013, 23.8% in 2014). The volume of debt owed by municipal budgets rose by 8.9% during the same period (17.8% in 2013, 8.4% in 2014). In December 2015, the debt of subjects of the Russian Federation was equal to or less than 6% over the volumes recorded as of December 1st, which differs notably from the practice of 2012–2014, when the year-end debt increased by 15–20%.

Table 25

#### Subnational budgets' public and municipal debt in nominal terms in 2011–2015, rubles in billions

	As of 2011 year-end		As of 2012 year-end		As of 2013 year-end		As of 2014 year-end		As of 2015 year-end	
	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %
Total in regional budgets	1172	7	1355	16	1738	28	2090	20	2319	11
Total in regional budgets (excluding Moscow and Moscow Region)	832	28	1069	28	1474	38	1825	24	2079	14
Total in municipal budgets	216	27	245	13	289	18	313	8	341	9

Sources: Russia's Ministry of Finance, Rosstat, Gaidar Institute's own calculations.

Regional debt growth rates slowed down considerably in 2015, following the earlier downtrend at the municipal level (municipal debt growth rates slowed down notably as early as 2014). 2015 saw debt growth rates slow down at the subnational level largely as a result of curtailing growth in expenditure that increased in nominal terms by mere 1.4% year-over-year (to compare, 5.6% in 2013 and 6.2% in 2014) amid favorable dynamics in nominal terms of tax and nontax revenues of regional consolidated budgets: a growth of 6.2% (however, a decline of 5.9% in real terms). As a result, subjects of the Russian Federation ran a consolidated budget deficit of 0.3% of GDP in 2015 against 0.6% of GDP in 2014 and 0.8% of GDP in 2013.

Overall, the dynamics of regional debt in 2011–2015 revealed a steady uptrend from 2.0% of GDP as of 2011 year-end to 2.9% of GDP as of 2015 year-end<sup>1</sup> (see *Table 26*). The volume of regional debt is estimated to be insignificant for the budget system and the economy as a whole. Given the slowdown in 2015, the regional debt does not yet pose a serious macroeconomic risk at the national level. However, a more correct assessment of the situation with the regional debt and with related budget risks requires analysis by subject of the Russian Federation.

*Table 26*

**Volumes of public and municipal debt of subnational budgets  
in 2011–2015, as % of GDP**

	As of 2011 year-end		As of 2012 year-end		As of 2013 year-end		As of 2014 year-end		As of 2015 year-end	
	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP
Total to budgets in regions	2.0	-	2.0	0.1	2.4	0.4	2.7	0.2	2.9	0.2
Total for regional budgets (excluding Moscow and Moscow Region)	1.4	-	1.6	0.2	2.1	0.5	2.3	0.3	2.6	0.2
Total for municipal budgets	0.4	-	0.4	0.0	0.4	0.0	0.4	0.0	0.4	0.0

*Sources:* Russia's Ministry of Finance, Rosstat, Gaidar Institute's own calculations.

Note that previously only two subjects of the Russian Federation, namely Moscow and Moscow Region made up the major share of regional debt (as of January 1, 2011, they accounted for 40.7% of the total regional debt), whereas as of January 1, 2016 they accounted for about 10% of the total debt. This reflects the recently mounting problem with executing budgets at the regional level, which prompted not a few but many regions to raise funds to cover their current expenses rather than to finance investment.

The data on regions reveal that many subjects of the Russian Federation increased their debt volumes in 2015 (see *Table 27*). At the same time, it is significant that there was redistribution of regions towards growth in the number of subjects of the Russian Federation with a more moderate (less than 15% a year) growth in indebtedness, as well as the number of regions that reduced the volume of their debt increased notably (from 8 in 2014 to 16 in 2015).

The 2015 debt structure of Russia's regions was changed towards considerable growth in the volume of federal budget loans (see *Fig. 23*). The share of budget loans increased to 34.9%, by 3.9 percentage points above the value seen earlier in 2015. Outstanding budget debts increased as the share of commercial loans and government securities shrank by 0.9 and 2.5 percentage points respectively. In absolute terms, the volume of the commercial share of debts owed by subjects of the Russian Federation (government securities and commercial loans) shrank by about Rb 56bn. Thus, a trend unfolded towards replacing commercial loans with budget loans across regional budgets, reflecting region-focused priorities of the federal government's current policy.

<sup>1</sup> The presented data rely on Rosstat's data calculated using a new method for GDP in 2011–2015.

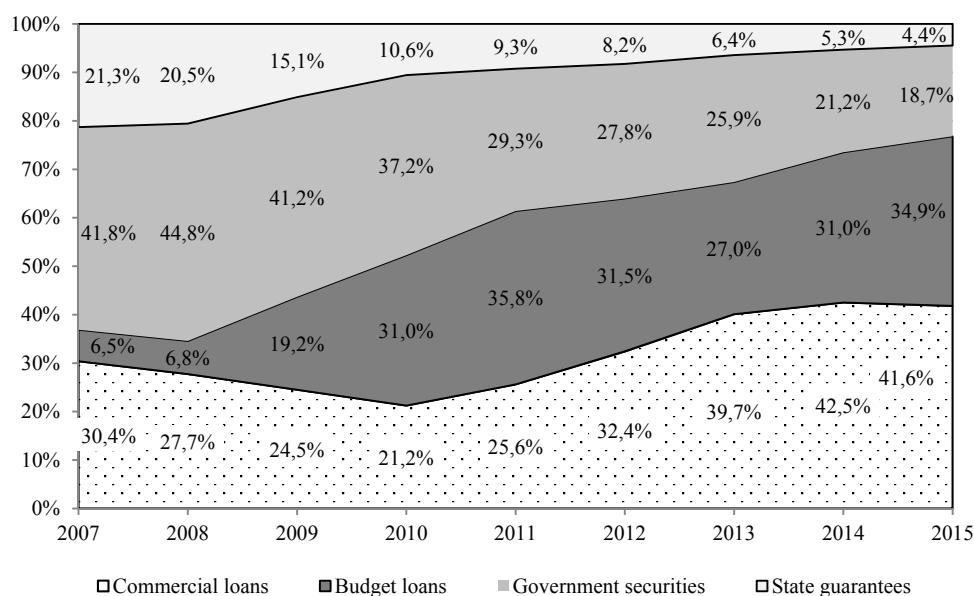
Table 27

**Dynamics of public debt owed by budgets of subjects of the Russian Federation in 2008–2015**

	Dynamics of public debt owed by subjects of the Russian Federation in a certain period (in nominal terms), number of subjects of the Russian Federation					
	growth by more than 50%	growth by 15 to 50%	growth by less than 15%	decline by less than 15%	decline by 15 to 50%	decline by more than 50%
2008	21	20	10	6	12	9
2009	37	18	11	6	4	2
2010	29	24	8	11	7	0
2011	21	27	13	14	6	0
2012	18	29	14	8	10	1
2013	31	36	8	6	1	0
2014	12	44	18	5	1	2
2015	7	27	31	15	1	0

**Note:** Arkhangelsk Region and Nenets Autonomous Okrug are presented as a single subject of the Russian Federation; the presented data exclude the Crimean Federal Okrug (to ensure full compatibility at various years).  
*Sources:* Russia’s Ministry of Finance, Gaidar Institute’s own calculations.

However, the situation differs largely from one region to another, which may necessitate further growth in the volume of budget loans (for regions that continue accumulating commercial debts). This creates risks of even heavier reliance of subjects of the Russian Federation on federal budget loans, which in turn would build up political pressure on Russia’s Ministry of Finance over making a decision on writing off or “freezing” repayments. Although such a measure seems to be simple in terms of tackling the problem of debts accumulated by some subjects of the Russian Federation, it can substantially undermine the fiscal discipline at the regional level and deteriorate the problem of soft fiscal constraints of subnational authorities in Russia.



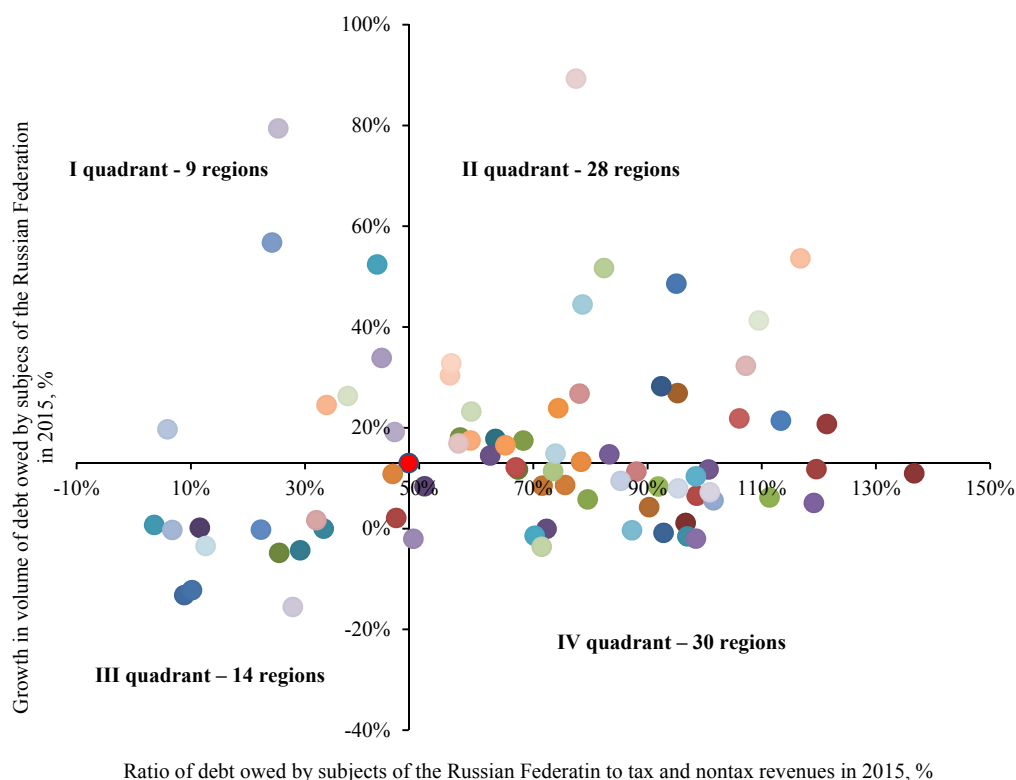
**Note:** The presented data exclude the Crimean Federal Okrug (to ensure full compatibility at various years).

**Fig. 24.** Structure of public debt owed by subjects of the Russian Federation in the period of 2007–2015

*Fig. 23* shows a breakdown of subjects of the Russian Federation according to the dynamics of debt burden and growth rates in debt volumes in 2015. Subjects of the Russian Federation



located in II quadrant are more vulnerable in terms of fiscal sustainability. This group includes 28 regions where the level of debt burden (the ratio of debt amount to the volume of regional budget revenues, excluding transfers) and growth rates of debt volumes in 2015 were higher than Russia's average values (excluding Moscow). In terms of general values (excluding debt structure), the following regions faced the most challenging situation: Republic of Mordovia (in 2015, the debt volume increased by 26.2%, the level of debt burden was 182.5% as of January 1, 2016), Smolensk Region (+20.8% and 121.4%), Republic of Khakassia (+53.6% and 116.8%), Republic of Ingushetia (+21.5% and 113.3%), Jewish Autonomous Region (+41.3% and 109.5%), Zabaykalskiy Territory (+32.3% and 107.2%), Republic of Mariy-El (+21.9% and 106.1%).



**Fig. 24.** Debt burden and change in volumes of public debt owed by subjects of the Russian Federation in 2015

**Notes:** 1. The axes intercept at the point where debt burden and growth of volume of debt owed by subjects of the Russian Federation in 2015 take on Russia's average values (48.2% and 13% respectively, excluding Moscow).  
2. The figure shows Tyumen Region (0.89%, 256.9%), Republic of Mordovia (182.5%, 26.2%).  
**Sources:** Russia's Federal Treasury, Ministry of Finance, Gaidar Institute's own calculations.

However, to assess sustainability of regional budgets, it is important to consider not only the general dynamics of debt but also the structure thereof. Analysis of the structure of indebtedness of the subjects of the Russian Federation located in II quadrant shows that the most challenging situation unfolded in 9 of 28 regions, where commercial loans and bonded loans increased in volumes in 2015. The rest 19 subjects increased the volume of their regional debt due to budget loans and/or state guarantees. Note that in 2015 a few subjects of the Russian Federation in-

creased their commercial debt despite considerable volumes thereof in the regional debt structure as early as 2015. Analysis of the 2015 data shows that six regions faced the most alarming situation: Magadan Region (in 2015, the outstanding commercial debt increased by 95% in nominal terms; the share outstanding commercial debt of the total regional debt was 88% as of the beginning of 2015), Republic of Khakassia (+73%; 71%), Republic of Mariy-El (+55%; 58%), Kurgan Region (+53%; 73%), Ivanovo Region (+52%; 75%), Novosibirsk Region (+38%; 74%).

## Section 3. Financial Markets and Financial Institutions

### 3.1. The key trends in Russia's domestic stock market<sup>1</sup>

#### 3.1.1. The comparative features of two Russian crises

The year 2015 saw a continuation of the longest slump in the history of Russia's stock market, which had started in May 2008. In 1997–1998, after the RTS Index had dropped by 91.3%, and the MICEX Index - by 73.0%, from their pre-crisis highs over a period that lasted slightly more than a year, they both managed to recover their former quotes in 58 and 8 months respectively (*Table 1*). Now, as of February 2016, after their plummet during the acute phase of the 2008 crisis, both these stock indices have never recovered: the MICEX Index over the period of 88 months, and the RTS Index – 85 months.

*Table 1*

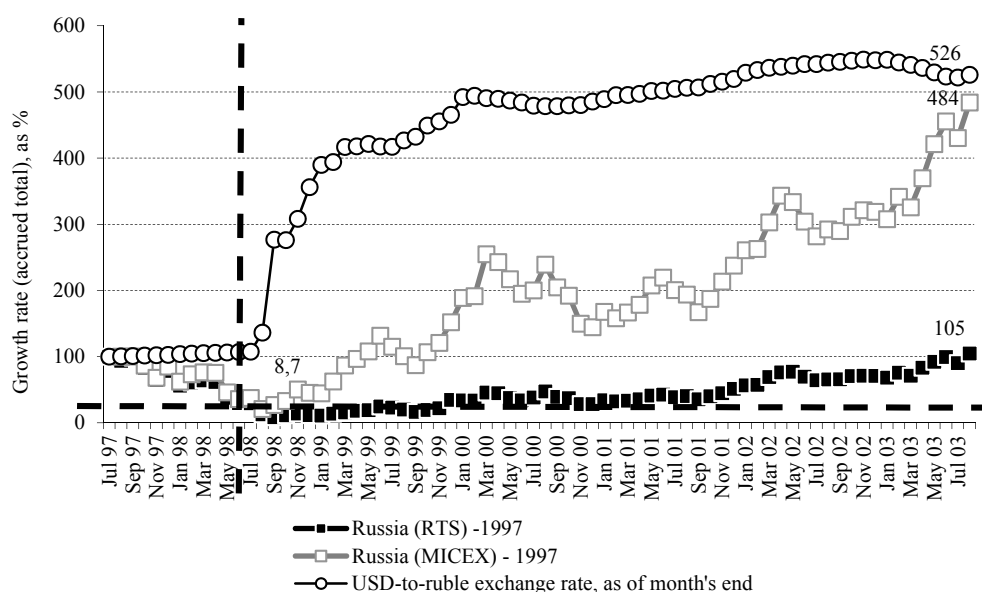
**The financial crises of 1997/98 and 2008/09 in Russia and the subsequent market recoveries (as of 29 February 2016)**

	1997/98 crisis	2008/09 crisis
1. Decline from peak		
1.1. Depth, %		
RTS Index	-91.3	-78.2
MICEX Index	-73.0	-68.2
1.2. Length, months		
RTS Index	14	8
MICEX Index	13	6
2. Recovery, months		
RTS Index	58	85
MICEX Index	8	88

*Source:* own calculations based on data released by the Moscow Exchange.

The prompt recovery, after 1998, of the ruble-denominated MICEX index occurred largely due to the 5-fold depreciation of the ruble (*Fig. 1*), while the recovery of the RTS Index denominated in foreign currencies lasted for nearly 5 years. Russia's stock market had fully recovered only by H2 2003, and this was followed by Russia being assigned an investment grade rating by international rating agencies (Moody's - as of 8 October 2003; Fitch's - as of 17 November 2004; and S&P's - as of 31 January 2005). The access to cheap foreign loans granted to Russian issuers of securities coupled with the soaring oil prices in the mid-2000s ensured that the Russian share and corporate bond market began to grow at a rapid rate.

<sup>1</sup> Author of this section: Abramov A. – RANEPА.



*Fig. 1.* The movement of the USD-to-ruble exchange rate, the RTS Index, and the MICEX Index in 1997–2003 (July 1997 = 100%)

*Source:* data released by the Moscow Exchange and the Bank of Russia.

After the 2008 crisis, the USD-to-ruble exchange rate moved along a W-shaped curve: from May 2008 through February 2009, the ruble lost 50.5%; by April 2009 the ruble had gained 23.0%; from May 2009 through August 2014, it once again lost 34.3%; from September 2014 through February 2016, being pushed down by plunging oil prices and the complete liberalization, by the Bank of Russia, of its foreign exchange policy, the ruble's exchange rate against major foreign currencies further declined by 103.3% (*Fig. 2*). As a result, over the period from May 2008 through February 2016, the USD-to-ruble exchange rate declined 3.2 times, from Rb 23.74 to Rb 75.09. In response to the ruble's fluctuations, the trajectories followed by the MICEX Index and the RTS Index likewise became W-shaped. However, the two indexes noticeably differed in their behavior. Over the period from May 2008 through February 2016, due to the ruble's devaluation, the ruble-denominated MICEX Index climbed to nearly its pre-crisis peak. In February 2016, it regained 95.6% of its record high of May 2008. Meanwhile, over the period from May 2008 through January 2009, the RTS Index denominated in foreign currencies reached its first bottom point at 21.8% of its pre-crisis peak; later on, by March 2009, it had recovered to 83.1%; however, thereafter it once again plunged to its record low of 30–31%, where it stayed from January 2015 through February 2016. So, in contrast to the MICEX Index, the RTS Index is now at its second bottom point. At the same time, it is the behavior of the RTS Index (which reflects the forex equivalent of investment in Russian stocks) that determines the attitude of foreign investors to shares issued by Russian companies.

In contrast to the stock market's recovery in the early 2000s, the current slump in the share market has not been accompanied by a recovery of prices of oil (*Fig. 3*) and an easier access to foreign investment. On the contrary, as a result of the economic sanctions, the Russian government and big companies alike have been effectively denied the possibility of borrowing in the US and EU markets. As estimated by two of the three major international rating agencies, Russia's sovereign credit rating was downgraded from an investment grade to 'junk': *S&P's* – from 25 January 2015; *Moody's* – from 20 February 2015. *Fitch* was the only rating agency to keep

on Russia's investment grade, as confirmed by its decisions as of 3 July 2015 and 16 October 2015. Given these conditions, at present there are no growth opportunities for the RTS Index, in spite of the actual near-recovery achieved by the MICEX Index.

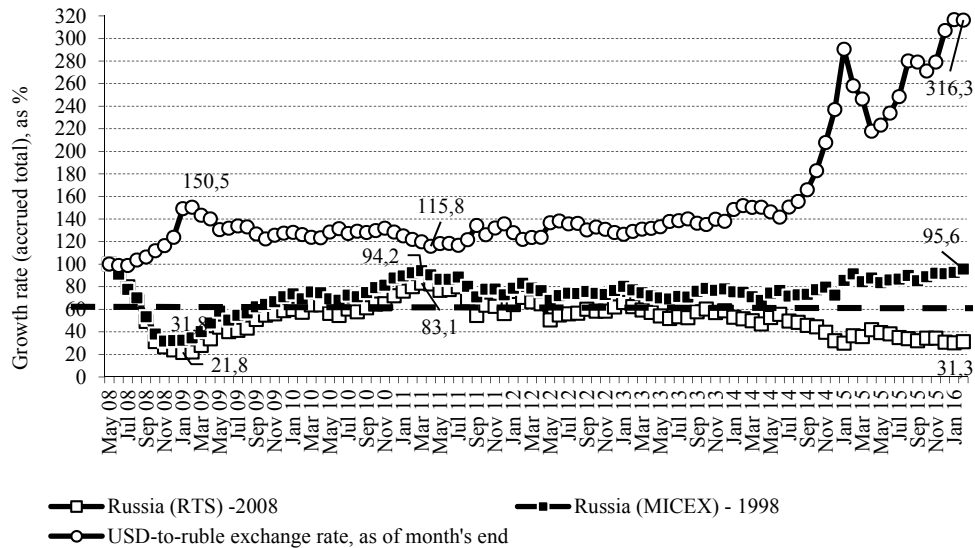


Fig. 2. The movement of the USD-to-ruble exchange rate, the RTS Index, and the MICEX Index from May 2008 through February 2016 (May 2008 = 100%)

Source: data released by the Bank of Russia and the Moscow Exchange.

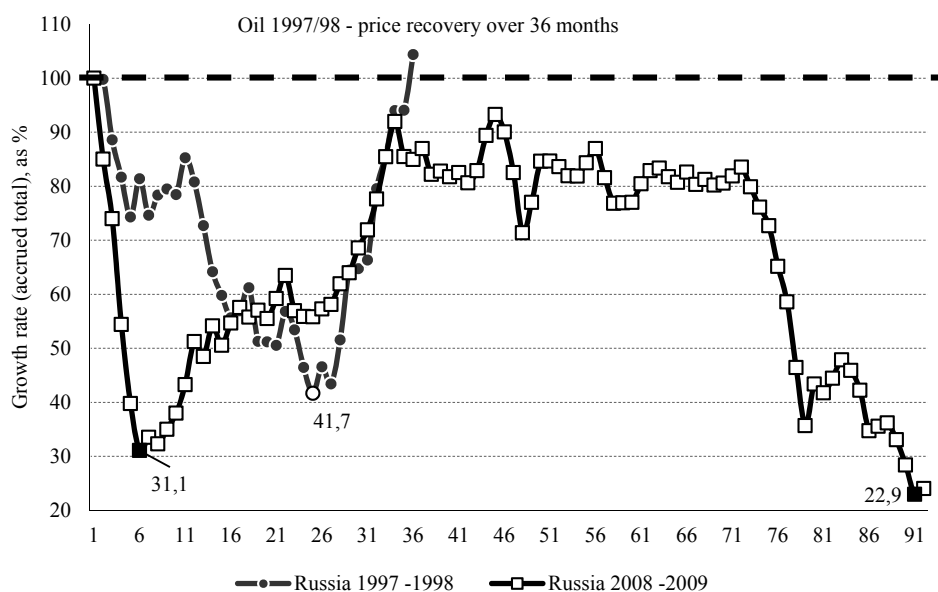
The 1997–1998 crisis was caused not so much by the low prices of oil as a lack of properly balanced fiscal and monetary policies. In the course of that crisis, oil prices demonstrated a one-time plunge to 41.7% of their pre-crisis peak, but their recovery then took only 36 months (Fig. 3).

Having leaped to its average monthly peak of \$133.90 per barrel in July 2008, to this day oil prices have been following a W-shaped trajectory. Within 5 months from July 2008, their index reached its first bottom point at 31.1% of its pre-crisis peak recorded in October 2008 (Fig. 3). Over the next 28 months, it rose to 92.0% of its pre-crisis peak in February 2011; the following 58 months saw its slow decline to 22.9 of its peak value in January 2016. The subsequent upward movement of oil prices has led to the conclusion that in January 2016, their index hit its second bottom point. However, in contrast with the situation observed during the oil crisis of the 1990s, the international financial institutions predict that prices of oil are going to stay at a moderate level for a lengthy period of time, thus creating a 'New Oil Reality', as Rector of the RANEPА Vladimir Mau put it.<sup>1</sup> Thus, for example, according to the World Bank's forecast for 2015, the average price of oil in 2020 is expected to be at the level of \$65.3 per barrel, and in 2025 – at no more than \$88.3 per barrel.<sup>2</sup> This sort of outlook can largely be explained by the development of new energy saving technologies and the reliance on production of shale oil and oil-shale gas, which reestablished the market principles of shaping oil prices. Thus, the current crisis in Russia is structural, and not a cyclical one; and so it follows that the financial market's

<sup>1</sup> Mau V. *To remember the 1980s*. *Vedomosti*, February 16, 2016.

<sup>2</sup> Commodity Markets Outlook. International Bank for Reconstruction and Development. World Bank, October 2015, p. 41.

sustainable growth can only be possible on the basis of in-depth structural transformations in the Russian economy.



*Fig. 3.* The growth rate of price of Brent crude during the financial crises in Russia (peak price =100%), as of January 2015

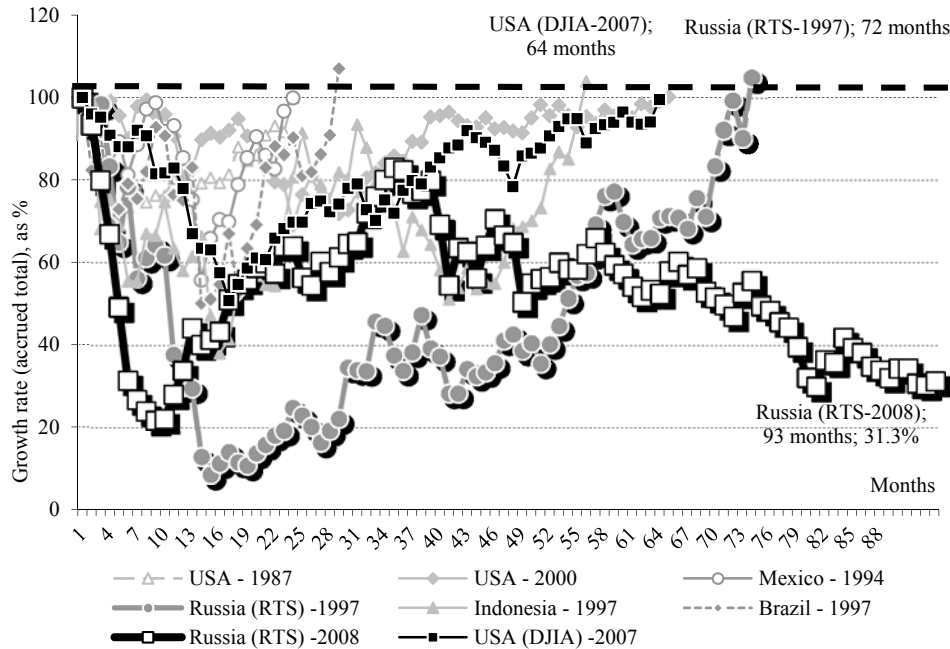
Source: data released by IFS IMF.

### 3.1.2. The current crisis against the backdrop of world financial cataclysms

Against the backdrop of the previously observed short-run financial crises around the world (in the USA in 1987, 2000 and 2007; in Mexico in 1994; in Indonesia and Brazil – in 1997), which lasted for 5–6 years, the current downturn of the RTS Index, that has been continuing for 7.7 years in a row, has already become a record (*Fig. 4*). This crisis, which is being experienced by Russia alongside some other developing countries, is gradually evolving into a medium-run one.

A W-shaped trajectory of an index recovery was typical of countries where financial crises were caused by structural disproportions in the national economy, as exemplified by South Korea in 1989 and the US market for shares in hi-tech innovation companies in 1999 (*Fig. 5*). The recovery after such a crisis usually takes a longer period of time. In order to achieve it, a country must, as a rule, deal with the issue of restructuring the businesses of its domestic issuers of securities and boosting their competitive capacity on a global scale. The two most notorious medium-run crises with W-shaped trajectories – that of shares in South Korean companies and of NASDAQ in USA, with their onsets in 1989 and 2000 respectively, lasted for 183 and 177 months respectively. In other words, their durations are approximately twice as long as the duration of the current slump in the Russian share market. As of February 29, 2016, the RTS Index, having climbed to 31.3% of its pre-crisis peak of May 2008, was tentatively moving towards a new bottom point. The current crisis in the market for shares issued by Russian companies has continued for 93 months in a row, while after its collapse in 1997, the RTS Index

managed to recover within 72 months. In view of the long-term prospects of an unfavorable situation in the markets for energy carriers, there is evidently a need for some other companies capable of becoming the new divers of stock market growth.



*Fig. 4. The depth and length of short-run financial crises around the world, as of 29 February 2016 (peak = 100%)*

*Source:* own calculations based on data released by the Moscow Exchange and [www.finance.yahoo.com](http://www.finance.yahoo.com).

The longest crisis cycles in the history of stock markets are the slump in the US stock market triggered by the Great Depression of 1929–1933 and that in the market for Japanese shares from 1989 onwards. The recovery of the stock index Dow Jones Industrial Average (DJIA) in the USA after the Great Depression took 303 months, or 25.3 years. In 2015, that record was broken by the Japanese index NIKKEI-225, which as of February 2016 had been unable to recover its initial quote for 314 months (or 26.2 years) in a row, amounting to only 41.2% of its monthly record high of 1989.

The slow recovery of the Russian stock market reflects not only the specific internal issues faced by Russia's national economy and finance, but also the challenges that in recent years have been common for most of the developing countries, the BRICS including. Prior to the 2008 crisis, the global economy's accelerated growth had largely been sustained by certain irrational factors like the over-stimulated consumer demand and excessive growth in the housing market in many developed countries; active government support of exports to the detriment of domestic demand in the Asian economies;<sup>1</sup> and the restricted role of market principles in the investment sphere and the production and supply of energy resources in some of the developing

<sup>1</sup> A new term - Chimerica - was coined in the literature on economics to describe the relationship between the consumer boom in the West and the saving boost in China and other developing countries (see, e.g., Mau V., Ulyukaev A. *The global crisis and contemporary Russia's economic policy challenges*. M., Delo Publishing House, RANEP, 2015, p. 29).

markets. So, in the 2000s, the combination of all these factors gave rise to the phenomenon known as *global saving glut*,<sup>1</sup> when the domestic savings generated in the developed countries transformed into investment in the developing economies. Net foreign capital inflow in the BRICS countries triggered growth in their domestic securities markets.

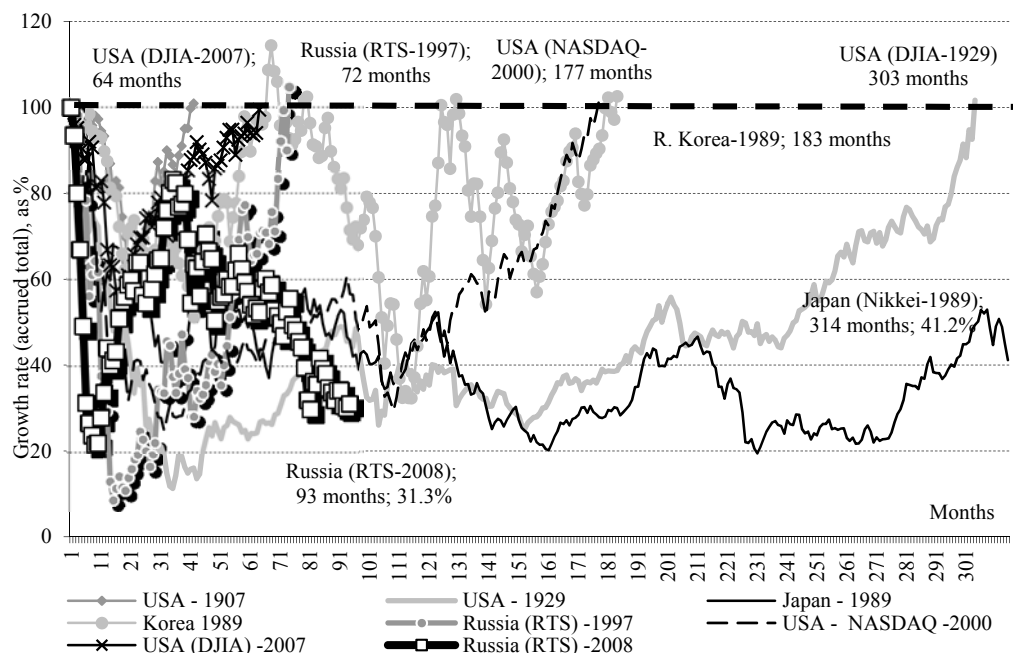


Fig. 5. The depth and length of long-run financial crises around the world, as of 29 February 2016 (peak = 100%)

Source: own calculations based on data released by the Moscow Exchange and [www.finance.yahoo.com](http://www.finance.yahoo.com).

The 2008 crisis and the efforts to control its consequences caused that phenomenon to disappear. The USA and the other developed countries launched the reindustrialization process, introduced a tougher regulation of risks associated with lending and the provision of funding for mortgage loans. China and other Asian countries experienced problems caused by the slower growth of their exports and understood the necessity to reorient their economies to domestic demand. The ‘shale revolution’ (primarily in the USA), alongside the slowdown in global economic growth, resulted in overproduction in the countries that were the principal producers of natural gas and oil, plummeting prices for energy resources, and rising competition for shares in the market for oil and gas. As a result, the BRICS countries were faced with the need for reorientation of their domestic economic growth models, foreign capital outflows, declining returns and increasing volatility of their domestic stock markets. Thus, for example, the UNCTAD over the next few years expects an outflow of investment from the developing and transition economies towards the developed markets.<sup>2</sup>

<sup>1</sup> *The global saving glut and the U.S. current account deficit*. Remarks by Governor Ben S. Bernanke at the Homer Jones Lecture, St. Louis, Missouri. April 14, 2005: <http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm>

<sup>2</sup> World Investment Report 2014: Investing in the SDGs: An Action Plan. UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD), 2014.



As of February 2016, the Brazilian stock index Bovespa over the previous 93 months since May 2008 had gained only 59.0% of its pre-crisis peak quote; the Shanghai Composite Stock Exchange Index (China) over the previous 100 months had gained 45.1% (Fig. 6). Russia's RTS index over 93 months had fallen lowest among all of the BRICS members – to 31.3% of its pre-crisis peak value. Over 94 months, the ruble-denominated MICEX index, due to the plummeting ruble-to-USD exchange rate, gained 95.6% of its record high of May 2008. Among the BRICS countries, the easiest post-crisis recovery was demonstrated by the share markets in India and South Africa. The indices of the Johannesburg Stock Exchange (JTOPI) and the Indian Stock Market (BSE Sensex) regained their pre-crisis quotes over 44 and 70 months respectively.

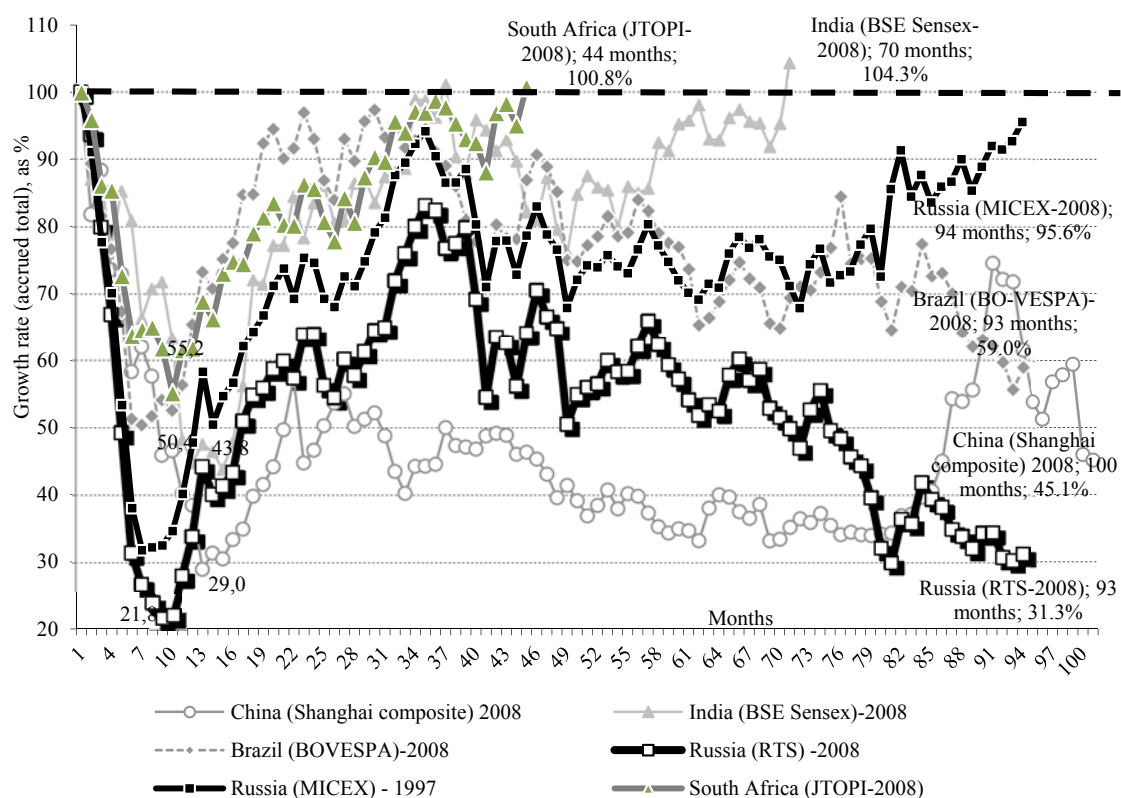
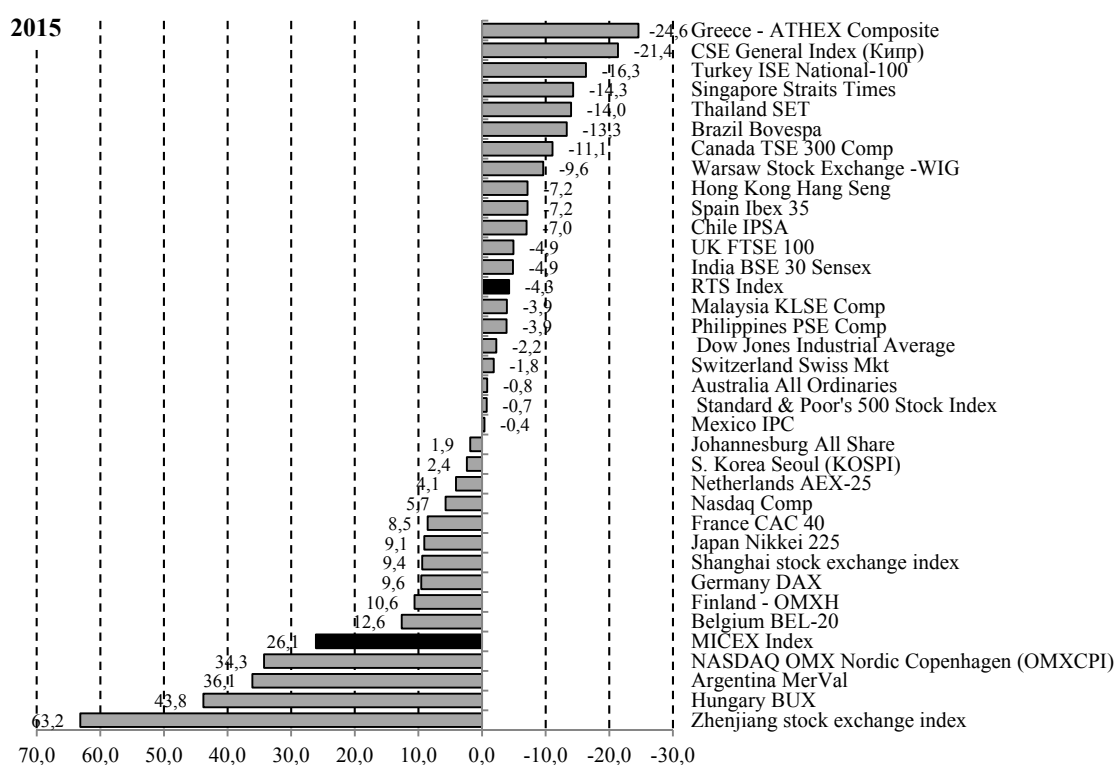


Fig. 6. The depth and length of the current financial crises in the BRICS countries, as of February 29, 2016 (peak = 100%)

Source: own calculations based on data taken from The Wall Street Journal and Thomson Reuters Eikon.

In 2015, by comparison with the other countries, Russia's stock market displayed moderate results (Fig. 7). The RTS Index, which describes the value of shares in Russian companies denominated in USD, declined by 4.3%; meanwhile, thanks to the decline by 29.6% of the ruble-to-USD exchange rate, the MICEX Index rose by 26.1%. The leaders in growth were the following stock indices: Argentina's MerVal, Hungary's BUX, and China's Zhenjiang Composite Stock Exchange Index, which gained in the course of that year 36.1%, 43.8% and 63.2% respectively. The worst results were demonstrated by Turkey's ISE National-100, Cyprus's CSE General Index, and Greece's ATHEX Composite, which over that year lost 16.3%, 21.4% and 24.6% respectively.



*Fig. 7. Rates of return of the stock indices on the world's biggest exchanges in 2015, % per annum*

Source: own calculations based on data released by *The Wall Street Journal*.

### 3.1.3. Liquidity issues in the stock market

In 2015, world exchanges were demonstrating some serious changes in liquidity in the markets for shares, measured in this case as the volume of market (or auction) transactions in securities (*Fig. 8*). Liquidity is important in that it not only reflects the market activity of investors, but also predetermines the pricing of securities traded on the exchanges. Over the year, for all the exchanges reporting their data to the World Federation of Exchanges, the average growth in the volume of market transactions amounted to 38.8%. However, while some exchanges, and first of all those in the countries relying on their oil exports, experienced a notable reduction in the volume of market transactions, in some other exchanges (predominantly in the countries across the Asian region) the value of such transactions surged. The Moscow Exchange was one of the six securities market operators where the plunge in the value of market transactions in shares was deepest in dollar terms. In 2015, the value of market transactions shrank in the Dubai Financial Market by 60.3%, at the Abu-Dhabi Securities Exchange – by 58.5%, at the Qatar Stock Exchange – by 53.3%, at the Athens Stock Exchange – by 49.6%, at the Egyptian Exchange – by 43.3%, and at the Moscow Exchange – by 42.9%. This means that in the situation of a long-run decline of the prices of and demand for oil, the investors operating in these exchanges have significantly reduced both their purchases and sales of shares issued by national companies.

The six exchanges displaying the fastest growth in the volume of market transactions in shares were the Hong Kong Stock Exchange, the South Korea Stock Exchange, the Cyprus

Stock Exchange, the Zhenjiang Stock Exchange, the Shanghai Stock Exchange, and the Kazakhstan Stock Exchange. The increased volume of exchange transactions (by 2.3 times at the Zhenjiang Stock Exchange and by 2.5 times at the Shanghai Stock Exchange) had largely to do with liberalization in the currency market and the access to China's domestic market for shares granted to foreign investors. In 2015, the highest growth rate in the market for transactions in shares - by 3.4 times - was demonstrated by the Kazakhstan Stock Exchange (KASE). This can be explained in part by the low initial rates, but the other relevant factors were the introduction of new listing rules designed to encourage the participation in trading of foreign brokers and the launch of the People's IPO program.

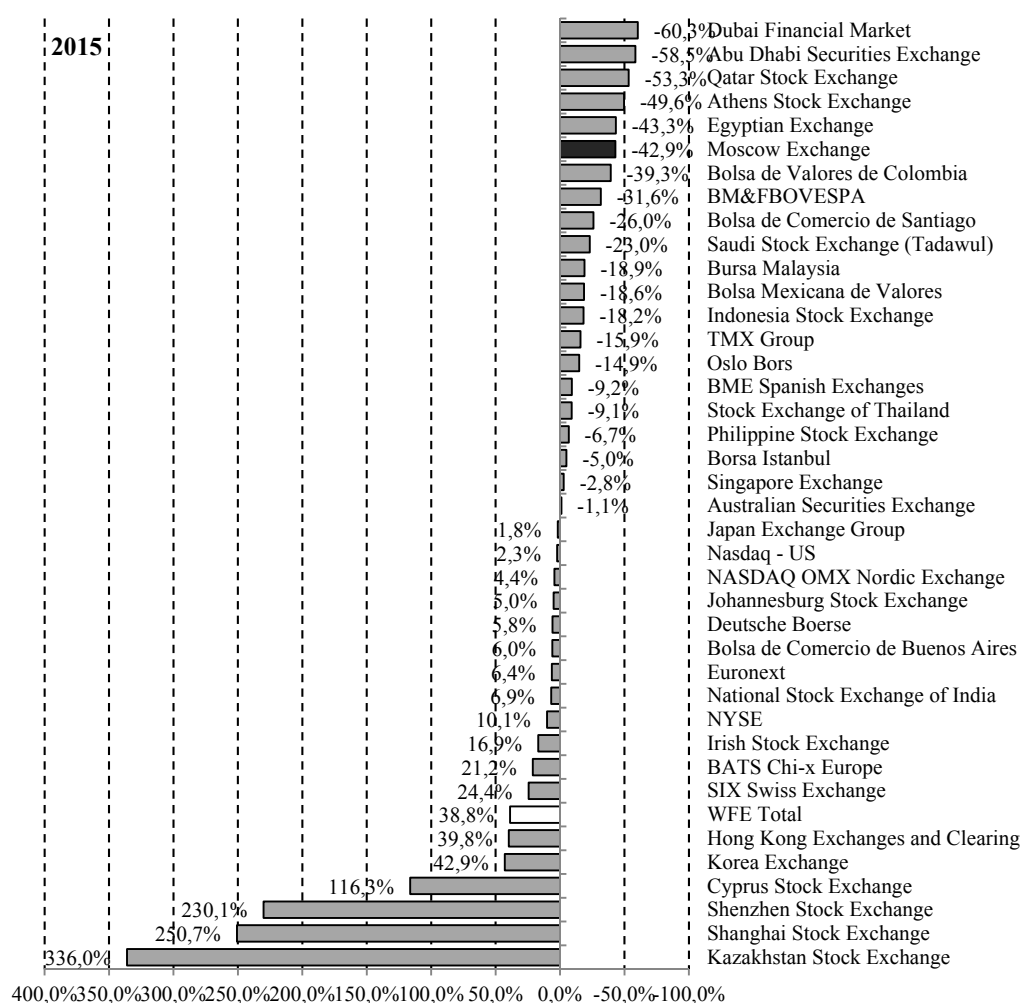


Fig. 8. Rates of return of world stock indices and the volume of market transactions in shares (anonymous market) at exchanges in 2015, % per annum

Source: own calculations based on data released by *The Wall Street Journal* and the World Federation of Exchanges.

The liquidity estimates describing the trade in shares on the world's biggest stock exchanges over a longer period are shown in *Table 2*. As of 2015, only two Chinese exchanges significantly exceeded their 2007 trade volume indices (6.7 times). The trade volume of the Hong Kong Exchange as of the reporting date was 105.2%. All the other major stock exchange had failed to exceed their pre-crisis year's indices. Thus, for example, in 2015 the aggregate volume of trade in shares on the New York Stock Exchange (NYSE) and NASDAQ amounted to only 69.9% of its 2007 level; the same index for the London Stock Exchange was 65.3%, for *Euronext* (Europe) – 45.8%, for *Deutsche Börse* – 46.3%, for Canada's TMX Group and the Australian Securities Exchange – 71.9 and 58.0% respectively.

This trend has to do with the multi-vectored changes currently occurring in the global financial market. On the one hand, after the 2008 crisis many national regulators have been focusing their efforts on pulling the traditionally off-floor financial instruments (those that had triggered that crisis in the first place, e.g., credit default swaps and many other derivatives, housing mortgage securities, etc.) into the zone of organized trade and regular payment-clearing and settlement system). On the other, the stock exchange markets, while keeping intact their common clearing and settlement systems, began to disintegrate into separate segments run by off-floor trading systems – the so-called dark pools. In 2008 in the USA, in place of the two traditionally existing stock exchanges, there were already 13 stock exchanges and alternative trading systems.<sup>1</sup> According to data released by the World Federation of Exchanges, in the USA in 2015, the value volume of market transactions in shares carried on by one alternative trading system – BATS Global Markets – amounted to 47.4% of the corresponding index for the NYSE and NASDAQ. In Europe, the trade volume on BATS Chi-x Europe amounted to 112.0% of the corresponding index for the London Stock Exchange. The commercialization of traditional stock exchanges has transformed them from 'membership organizations' uniting active market participants into rank-and-file providers of services in trading in financial instruments, thus providing an impetus for the formation of a competitive market for this type of services. At the same time, the emergence of high-frequency trading technologies (HFT) created incentives for big banks and brokers to set up their own alternative trading system, where they can more easily launch their new HFT tools. Owing to the combined effects of multiple factors, including the diminishing advantages offered by asset management strategies and the desire to avoid the rising transaction costs associated with the increasingly widespread HFT strategies, many pension and mutual funds significantly reduced the volumes of market transactions with their assets. According to data released by the Investment Company Institute (ICI), in 2014 the average portfolio turnover index of a US mutual fund amounted to only 35% of its 1980 level.<sup>2</sup>

On the Moscow Exchange over the period 2008 to 2015, the downward trend displayed by the volume of transactions in shares was even more pronounced. In 2015, its *index denominated in foreign currency* amounted to only a quarter of its 2007 value. The aggregate volume of transactions in shares carried on in all trading modes on the Moscow Exchange had recovered so promptly to its 2007 level largely due to the accelerated growth of repo deals, which represent a money market segment. However, in 2015, its *foreign currency denominated index* likewise dropped to 69.7% of its 2007 level.

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<sup>1</sup> Lewis M. *Flash Boys: A Wall Street Revolt*. Transl. from the English, M., Alpina Publisher, 2015, p. 51.

<sup>2</sup> *Investment Company Fact Book*, 2015. ICI, 55<sup>th</sup> Edition, p. 37

*Table 2*

**The movement of the value volume of market transactions  
in shares on major stock exchanges  
in 2007–2015 (2007 = 100%)<sup>1</sup>**

	2007	2008	2009	2010	2011	2012	2013	2014	2015
USA (NYSE и NASDAQ)	100	120.1	72.6	71.0	71.7	54.2	54.3	65.5	69.9
China (two stock exchanges)	100	63.0	128.9	132.8	106.9	81.8	124.9	198.0	674.2
Japan Japan	100	87.3	61.2	63.2	66.3	57.5	103.9	86.8	88.3
UK	100	89.0	62.9	63.5	65.7	50.8	51.7	66.4	65.3
Euronext	100	84.7	42.7	44.5	47.1	34.8	36.7	43.1	45.8
Germany	100	95.5	45.1	48.4	52.3	37.9	39.7	43.7	46.3
Hong Kong	100	77.3	70.1	74.1	71.5	54.7	65.5	75.3	105.2
Canada	100	105.3	75.5	83.0	93.5	82.3	83.2	85.4	71.9
Australia	100	77.5	57.9	77.1	86.8	67.9	63.9	58.6	58.0
Russia (Moscow Exchange) *	100	89.0	77.3	75.5	95.2	55.8	44.0	46.0	25.8
Russia (Moscow Exchange)**	100	116.5	74.7	92.4	142.5	127.5	123.6	119.2	69.7
NASDAQ OMX Nordic Exchange	100	84.5	48.8	52.6	58.0	41.1	43.8	50.6	52.9
Members of World Federation of Exchanges (WFE), total	100	100.8	69.5	70.7	70.7	54.8	61.3	87.4	124.4

\* Only market (auction) transactions;

\*\*Market transactions, negotiated deals, repo, Classica and Standart.

*Source:* own calculations based on data released by the World Federation of Exchanges, the London Stock Exchange, and the Moscow Exchange.

*Fig. 9* shows the movement of the Moscow Exchange's market transactions in shares, corporate and regional bonds, from which it becomes obvious that the process of market liquidity recovery after the 2008 crisis was interrupted in H2 2012, and that its index has been displaying practically a zero growth since then. The negative liquidity trends in the secondary securities market persisted even in spite of the merger of the Russian stock exchanges in late 2011. The phenomenon has been caused in part by the outflow of foreign portfolio investment from Russia's share market, which started in 2011 (see *Fig. 24* and *25*) and the crisis in the eurozone, which restricted the access of Russian financial institutions to cheap loans in that market and urged the Bank of Russia to launch its large-scale banking system refinancing program through repo transactions (*Fig. 36*). However, there is another, more fundamental explanation of that phenomenon, namely that over all the years since its exit from the crisis, Russia's domestic stock market has failed to attract the resources of domestic institutional investors.

<sup>1</sup> Including transactions in securities issued by foreign companies on the corresponding stock exchanges.

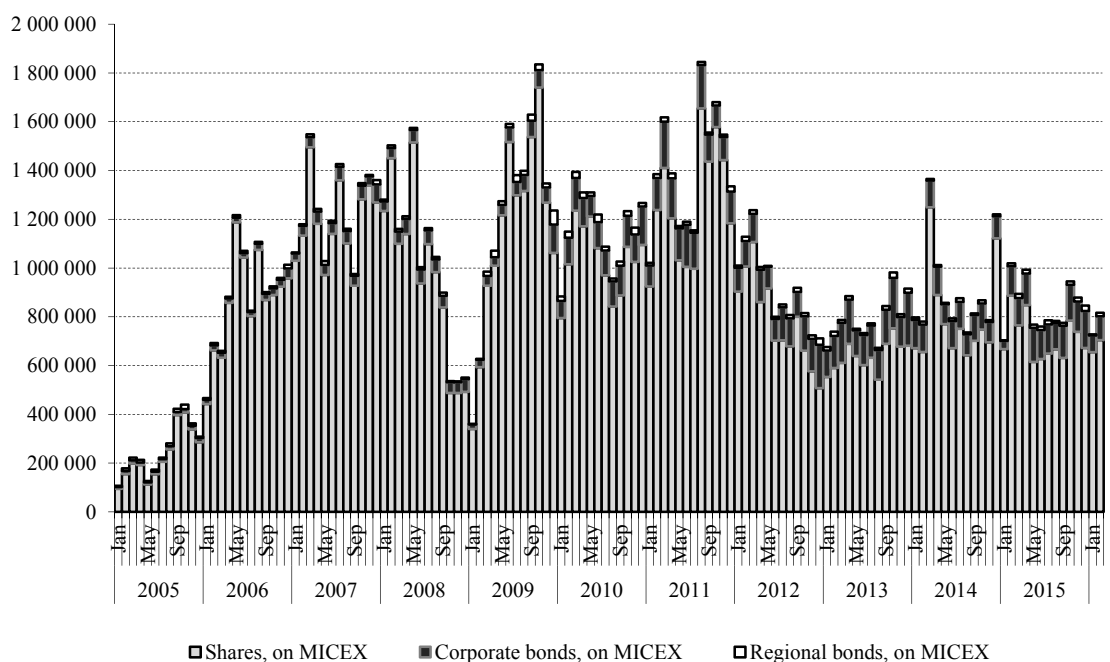


Fig. 9. The movement of monthly volume of market transactions in shares, corporate and regional bonds on the Moscow Exchange from January 2005 through February 2016, m Rb.

Source: own calculations based on data released by the Moscow Exchange.

### 3.1.4. The impact of foreign economic sanctions and the freeze of accumulated pension savings on Russia's financial market

The introduction of sanctions in 2014 was a two-stage process. In March 2014, the USA, the EU and some other countries imposed sanctions against some individuals and companies. In July 2014, these were followed by sectoral sanctions, whereby access to global financial markets was denied to Russia's biggest companies (*Rosneft*, *Transneft*, *Gazprom Neft*, *UralVagonZavod*, *Oboronprom*, *United Aerospace Corporation*, etc.) and state-owned banks (*Sberbank*, *VTB*, *Gazprombank*, *Russian Agricultural Bank*, *Vnesheconombank* (VEB), *Bank of Moscow*). The main ways that the sanctions were influencing the financial market were the restrictions on the amount of borrowing by Russian companies in the form of debt financing,<sup>1</sup> rising borrowings costs and an outflow of foreign investment from the market for shares.

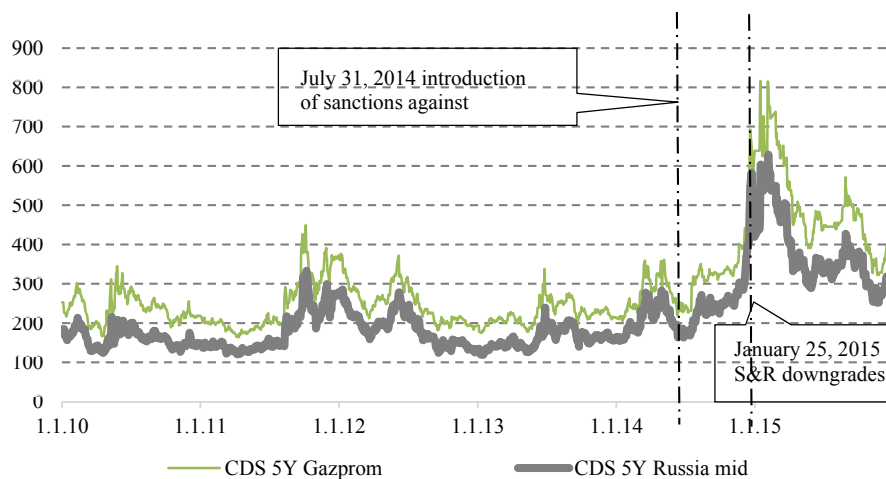
The available estimates of the effect of sanctions on Russia's financial market vary dramatically, but they are expressed mainly as a percentage of the expected slowdown in the GDP growth rate. Few studies have directly analyzed the actual consequences of the imposed sanctions for the financial market. Thus, according to E. Gurvich and I. Prilepsky (2016), the additional cumulative net capital outflow triggered by the sanctions, was estimated to be at the level of \$58bn in 2014 and \$160–170bn in 2014–2017.<sup>2</sup> And the opinion of RF Minister of Finance

<sup>1</sup> Mau V., Ulyukaev A. *The global crisis and contemporary Russia's economic policy challenges*. M., Delo Publishing House, RANEPa, 2015, p. 42.

<sup>2</sup> Gurvich E., Prilepsky I. *The impact of financial sanctions on the Russian economy. Voprosy ekonomiki* (in Russian), No 1, January 2016, p.33.

Anton Siluanov, voiced in late 2014, is that Russia's loss from the sanctions is about \$40bn per annum.<sup>1</sup>

We believe that, although the introduction of the sanctions *per se* indeed resulted in borrowed resources becoming more expensive, this effect was of a moderate scope. As demonstrated in *Fig. 10*, shortly after the sectoral sanctions were introduced in July 2014, the amount of risk premium in the form of credit default swaps (CDS) on the Russian Federation's and Gazprom's 5-year Eurobonds remained practically unchanged. Risk premiums began to rise from October 2014, following the plunge of oil prices coupled with liberalization and the ruble's weakening, so that when later on Russia's sovereign credit rating was downgraded first by S&P on January 25, 2015, and then by Moody's on February 20, 2015, these developments were not the factors responsible for a rising risk premium, but the upshot of something that had already happened. Moreover, from March 2015 until early 2016, the risk premium was displaying a downward trend, plunging from 628.5 basis points (BPS) as of February 5, 2015 for sovereign Eurobonds and 806.0 BPS for Gazprom's Eurobonds to 309.9 BPS and 386.0 BPS as of December 31, 2015 respectively. Such a decline of the risk premium, which happened in spite of the continuing plunge of oil prices and the ruble's exchange rate against major world currencies, was caused by the increasing demand of domestic investors for Eurobonds as a hedging tool against the ruble's devaluation and a first-class security to pledge against a refinancing loan from the Bank of Russia. Thus, for example, as estimated by *Vedomosti* (a business analytical organ), financial corporation (FC) *Holding Otkritie* alone could buy up *Russia, 2030* Eurobonds to the value of \$10-11bn (the total issue value being \$21.3bn).<sup>2</sup> According to RBC, at the FX auction held on March 1, 2015 by the Bank of Russia, *FC Holding Otkritie* attracted a total of \$12.2bn.<sup>3</sup>



*Fig. 10.* The risk premium's movement in Russia (5-year CDS against Russia's and Gazprom's liabilities, basis points) in 2010–2015

*Source:* own calculations based on data released by the Moscow Exchange.

<sup>1</sup> Volkova O. Counter-sanctions against sanctions: which of these are worse. RBC Daily, March 21, 2016, p.4.

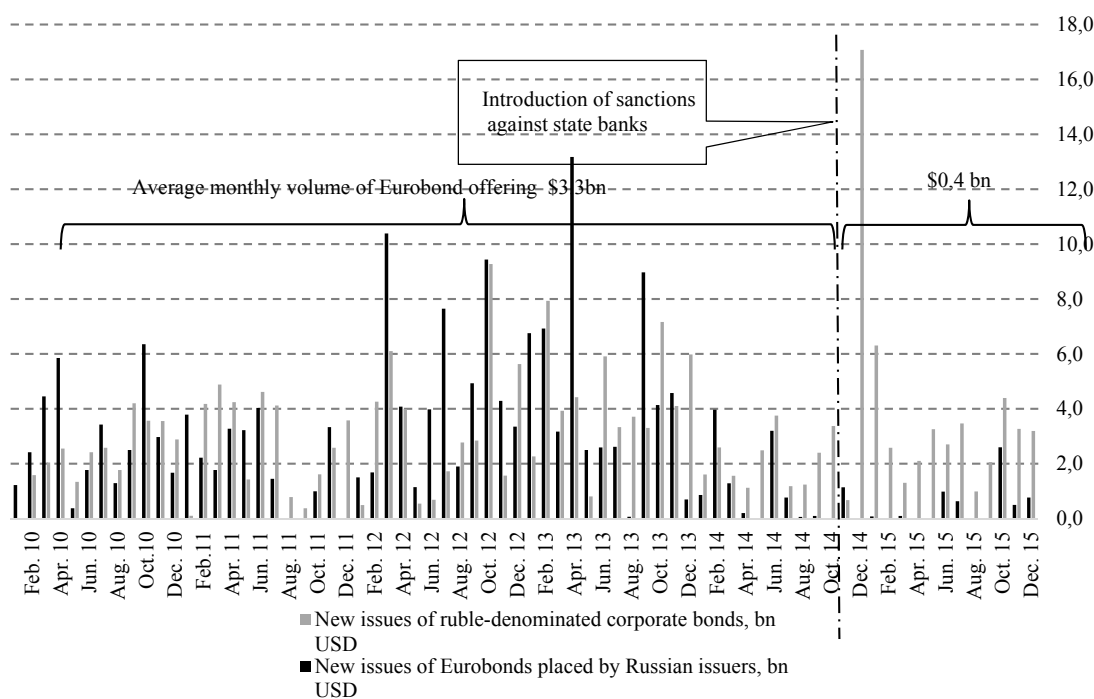
<sup>2</sup> Biyanova N. Over a half-year of 2015, FC Holding Otkritie tripled the amount of its lending to its Eurobonds by Holding Otkritie. *Vedomosti*, August 31, 2015.

<sup>3</sup> Sharoyan S. In 2014, Sberbank and VTB received half of the RF Central Bank's loans. RBC, March 30, 2015. Published at <http://top.rbc.ru/finances/30/03/2015/5516aaed9a794763fa1878fb>

Under such conditions, the main outcome of sectoral sanctions for the financial market was the closure of the US and European markets to a number of Russian companies and state banks. In this connection, the direct ban on lending to individual companies indirectly translated into limited investment in those companies that were not subject to the sanctions, as foreign bankers exercised caution in their dealings with Russian participants in the securities market. As shown in *Fig. 11*, prior to the introduction of sectoral sanctions, over the period from January 2010 through July 2014, the average monthly volume of borrowing by Russian companies in the market for Eurobonds was \$3.3bn; after the sanctions had been introduced, over the period from August 2014 through December 2015, this index dropped to \$0.4bn.

So, in per month terms, the lost income of Russian issuers of Eurobonds amounted to \$2.9bn, or approximately \$50bn over the 17-month period from August 2014 through December 2015. Over the same period, the Reserve Fund shrank by \$41.8bn. Part of that money went to Russia's biggest companies, to smooth the negative effects of sanctions.

For the sake of comparison, these figures can be set against the amount of accumulated pension savings frozen in 2014 and 2015 (Rb 244bn and Rb 310bn respectively). The freeze significantly limited the inflow of new money to the domestic market. Taken in dollar terms, this is the equivalent of approximately \$ 10bn, or roughly one-fifth of the total loss of Russian issuers of securities in the Eurobond market.



*Fig. 11.* New bond issues placed by Russian issuers of securities, bn USD

*Source:* own calculations based on data released by the Moscow Exchange.

The introduction of sanctions altered the behavior of foreign private investors specializing in investing in shares issued by Russian companies. As demonstrated by the movement of accumulated cash flows from private investors (seen *Fig. 12*), their market activity began to display a certain stagnation pattern. On the one hand, as early as March 2014, the investment outflow pattern began to demonstrate a marked slowdown, in anticipation of the RTS Index's



second bottom point. On the other, the sanctions coupled with the negative dynamics of oil prices made it impossible to change in any way the investment strategy - that is, to pour new resources into the investment funds specializing on Russia with a view towards potential recovery growth of the prices of shares in Russian companies.

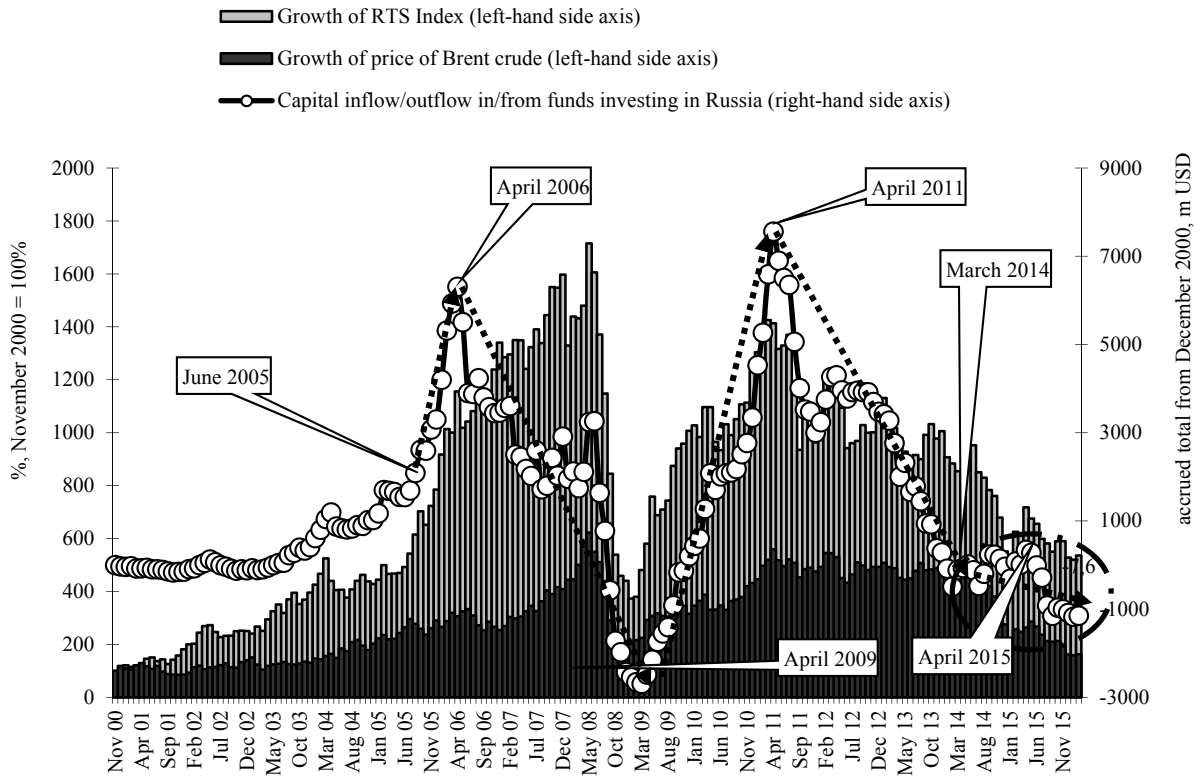


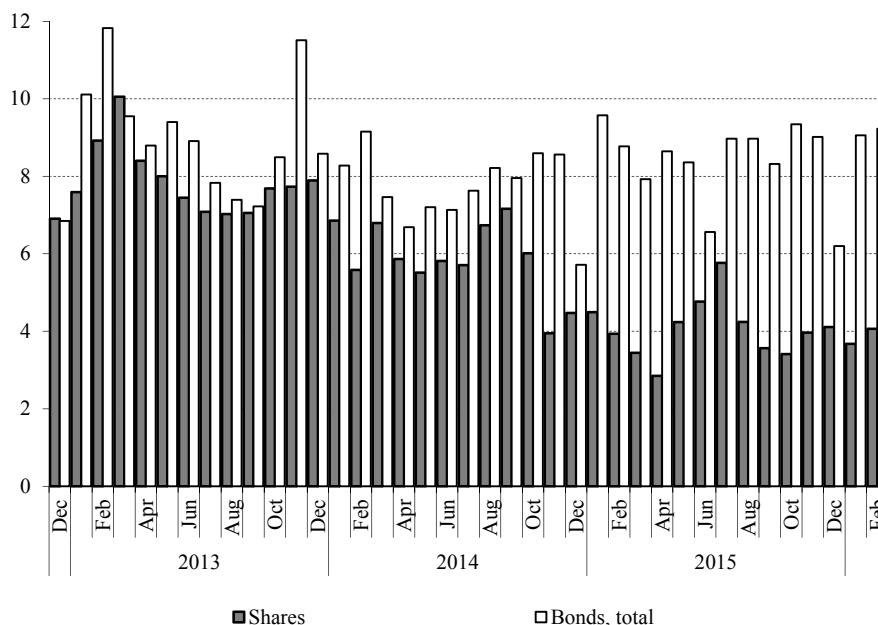
Fig. 12. Growth of the RTS Index and the price of Brent crude, capital inflow (outflow) to/from the investment funds specializing on Russia, calculated by the accrued total method, from November 2000 through December 2015

Source: own calculations based on data released by the IFS IMF, the Moscow Exchange and EPFR.

After the introduction of sectoral sanctions, the market for bonds on the Moscow Exchange displayed practically no decline in the trading activity of the affiliations of major foreign investment banks<sup>1</sup> (Fig. 13). From January 2013 through July 2014, the average share of these entities in the total volume of trading in bonds on the exchange was 8.6%; and from August 2014 through February 2016, it remained nearly unchanged at 8.3%. At the same time, the activity of the same affiliations of non-resident entities on the exchange market for shares became noticeably less prominent as a result of the sanctions. From January 2013 through July 2014, the average share of these affiliations in the total volume of trading in shares was 7.2%; over the period from August 2014 through February 2016, it shrank to 4.5%. However, this was

<sup>1</sup> The market share of taken up by non-residents was estimated on the basis of the volume of trading in securities on the Moscow Exchange carried on by the affiliations of twelve major foreign investment banks: Goldman Sachs, Deutsche Bank, ING Bank (Eurasia), CJSC Bank Credit Suisse (Moscow), Raiffeisenbank, Citibank, UniCredit Bank, CB 'J.P. Morgan Bank International', Rosbank, Barclays Capital, Morgan Stanley Bank, HSBC Bank.

by no means the indication of a deliberate withdrawal of non-residents from Russia's market for joint-stock capital, but rather that of a somewhat diminished trading activity of their clients, including foreign investment funds, as shown in *Fig. 12*.



*Fig. 13.* The participation of the affiliations of major foreign investment banks in the volume of trading in securities on the Moscow Exchange from December 2012 through February 2016, as %

Source: own calculations based on data released by the Moscow Exchange.

### 3.1.5. Competition with foreign stock markets

Prior to the merger of the two Russian exchanges in 2011, it had been intended that the elimination of competition between them in the domestic market should have no negative consequences for market participants, because the single consolidated exchange was expected to compete with global trading systems not only in organizing the market for securities issued by Russian companies, but also in handling the financial instruments of foreign issuers, with the purpose to increase their accessibility for domestic investors.

In 2015, in terms of its overall trade in shares, including all trading modes, the Moscow Exchange managed to retain its role of a major organizer of trade in equity financial instruments (shares and depository receipts) of Russian issuers (*Fig. 14* and *Table 3*). The share of the Moscow Exchange in these transactions increased from 82.6% in 2014 to 85.1% in 2015. The relative shares of the London Exchange, the Hong Kong Exchange, Deutsche Boerse and the two biggest US exchanges shrank. However, this favorable competition ratio has been created in the main by the accelerated growth of the money market volume on the Moscow Exchange, namely equities repo transactions.

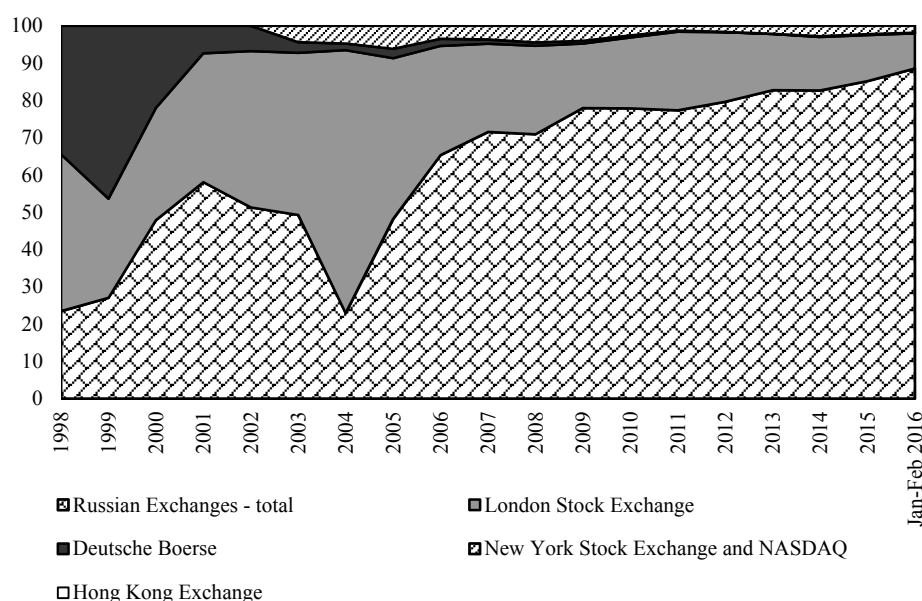


Fig. 14. The relative shares of stock exchanges in the volume of trade in equity financial instruments issued by Russian JSCs in 1998–2015, including all trading modes in the equities market on the Moscow Exchange, as %

Source: own calculations based on data released by stock exchanges.

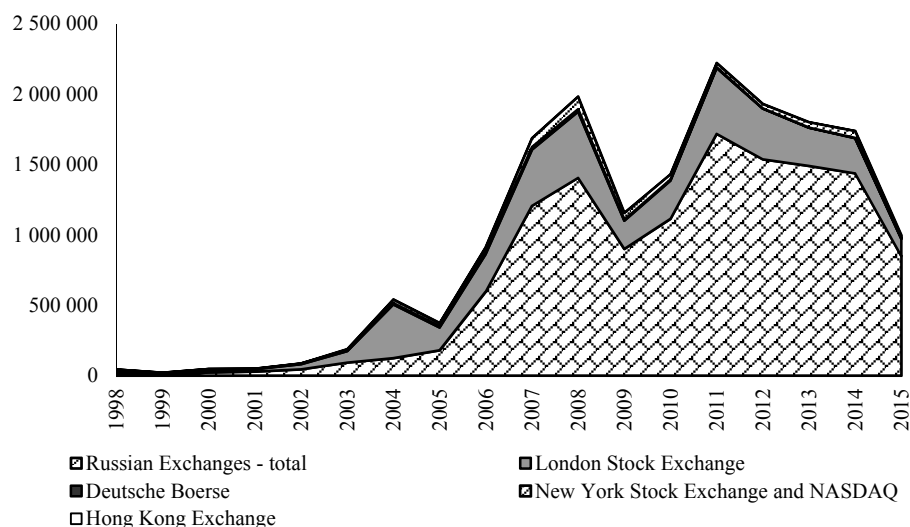
Table 3

The relative shares of stock exchanges in the volume of trade in equity financial instruments issued by Russian JSCs in 1998–2015, including all trading modes in the equities market on the Moscow Exchange, as %

	2000	2005	2010	2011	2012	2013	2014	2015	Jan-Feb 2016
Moscow Exchange's Main Market	36.0	38.1	69.9	72.1	70.3	70.5	82.6	85.1	88.5
Classical and standard markets	11.9	2.0	7.9	5.2	1.9	0.6	0.0	0.0	0.0
Other	0.0	8.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Russian Exchanges - total</b>	<b>47.9</b>	<b>48.2</b>	<b>77.8</b>	<b>77.3</b>	<b>72.2</b>	<b>71.1</b>	<b>82.6</b>	<b>85.1</b>	<b>88.5</b>
London Stock Exchange	30.1	43.1	19.0	21.1	26.2	27.0	14.3	12.3	9.4
Deutsche Boerse	22.0	2.6	0.6	0.3	0.0	0.0	0.2	0.3	0.2
New York Stock Exchange and NASDAQ (USA)		6.2	2.6	1.4	1.5	1.9	2.8	2.2	1.9
Hong Kong Exchange			0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Shares and depository receipts, total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: own calculations based on data released by Russian and foreign stock exchanges.

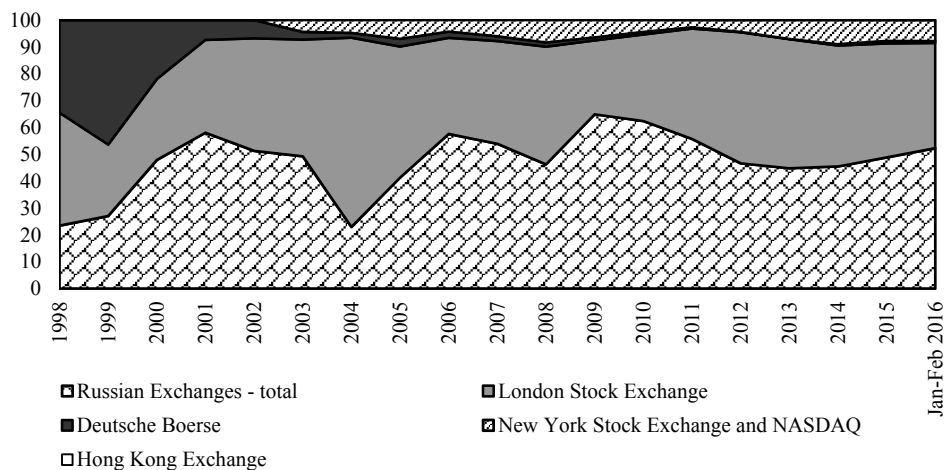
At the same time, as seen from Fig. 15, from 2011 onwards, the strengthening of the competitive position of the Moscow Exchange was taking place against the backdrop of shrinkage, in absolute terms, of the volume of organized trading in equity financial instruments issued by Russian JSCs on all stock exchanges, including the Moscow Exchange.



*Fig. 15.* The volume of trade in equity financial instruments issued by Russian JSCs on various stock exchanges in 1998–2015, including all trading modes in the equities market on the Moscow Exchange, m USD

*Source:* own calculations based on data released by stock exchanges.

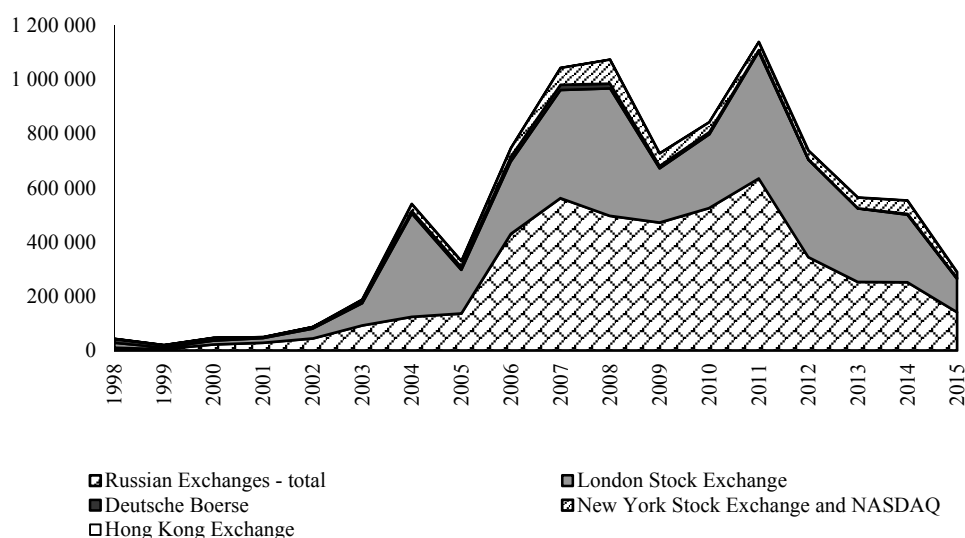
A more objective indicator of a stock exchange's performance is the volume of market (or auction) transactions, on the basis of which stock indices are calculated and the pricing of financial instruments traded on the exchanges is determined. If we take into consideration this indicator alone, the relative share of the Moscow Exchange in the total volume of trading in equity financial instruments issued by Russian companies will appear to be more modest; it increased from 45.5% in 2014 to 48.8% in 2015 (*Fig. 16*).



*Fig. 16.* The relative shares of stock exchanges in the volume of trade in equity financial instruments issued by Russian JSCs in 1998–2015, including all trading modes in the equities market on the Moscow Exchange, as %

*Source:* own calculations based on data released by stock exchanges.

In other words, more than half of the market for equity financial instruments of Russian JSCs is still being operated outside of the RF territory. At the same time, the relative share of the Moscow Exchange in the volume of trade in equity financial instruments has been increasing alongside a shrinkage of volume of trade in shares in absolute terms, which points to the dwindling attention of global investors operating on foreign stock exchanges to the depository receipts issued by Russian companies, rather than to any positive shifts in the ongoing competition between stock exchanges (*Fig. 17*). In spite of the merger of two Russian exchanges completed in 2011, the value volume of market transactions on Russia's stock market declined from \$635.2bn in 2011 to \$141.4bn in 2015, or by 77.7%. In terms of its volume of market transactions in shares, the Moscow Exchange in 2015 practically reproduced its 2005 index, which amounted then to only \$137.7bn.



*Fig. 17.* The volume of trade in equity financial instruments issued by Russian JSCs on various stock exchanges in 1998–2015, including all trading modes in the equities market on the Moscow Exchange, m USD

*Source:* own calculations based on data released by stock exchanges.

The devaluation of Russia's national currency, the sanctions introduced against Russia in the European and US financial markets, the downgrading of Russia's sovereign and corporate ratings by the international agencies, and the deficit of domestic investment resources have all resulted in a situation where, in 2015, the rising volume of IPO-SPO launched on the global markets was coupled with a downfall of the same type of transactions with the participation of Russian companies. In 2015, the latter shrank to \$1.3bn (or Rb 93.3bn) compared to \$1.7bn in 2014. At the same time, in 2015, the volume of IPO-SPO launched on the Moscow Exchange amounted to \$0.6bn (Rb 46.5bn), or 46.2% of the total value of transactions with shares issued by Russian companies.<sup>1</sup> In 2014, the volume of public offering on the domestic exchange amounted to only 29.4%.

<sup>1</sup> In 2015, the mass media repeatedly raised the issue of how the pension savings held by private pension funds could be attracted in the IPO schemes launched by some of the banks attached to those funds (Biyanova N. *The masters are more important than the pensioners. Vedomosti*, February 2, 2016; Biyanova N., Petrova O., Kaverina M. *Mutual credit society. Vedomosti*, February 4, 2016).

In 2014, the Moscow Exchange failed to reverse the downward trends both in the number of listed national issuers of shares and in the number of issues traded on the organized securities market. This trend could not be reversed even after the enactment, from September 1, 2014, of the amendments to the RF Civil Code and the alterations to Federal Law of February 26, 1995 'On joint-stock companies', which was augmented by new Article 7.1,<sup>1</sup> whereby it was established that, in order to obtain the status of a public joint-stock company, prior to the entry of the official documents concerning its new legal status into the single state register, a company must sign a contract with an organizer of trade concerning its shares being listed on the exchange.

According to data released by the World Federation of Exchanges (WFE), the number of companies listed on the Moscow Exchange dropped from 262 in 2013 and 257 in 2014 to 254 in 2015. Our estimations based on the Moscow Exchange's statistics demonstrate that the number of listed issues of shares shrank from 314 in 2014 to 309 in 2015, or by 1.6%.

In contrast to the contracting market for shares as estimated by the number of issues listed on the exchanger, the market for bonds, on the contrary, expanded. The number of listed issues of bonds increased from 395 in 2014 to 474 in 2015, or by 20,0%; that of issues of corporate bonds – from 555 до 568, or by 2.3%; and that of issues of regional bonds – from 113 до 116, or by 2.7% respectively.

As a separate note, we should mention the noticeably decreased transparency, in 2015, of the information concerning the number of listed companies and issues of securities in the statistics published by the Moscow Exchange. Prior to 2015, the official data on the number of issues of securities listed on the exchange and their issuers was disclosed in the quarterly reports of Closed Joint-stock Company *MICEX Stock Exchange*,<sup>2</sup> a 100% affiliation of Moscow Exchange PJSC. In 2015, *MICEX SE* CJSC discontinued the publication of its quarterly reports on its official website.

### 3.1.6. The decline of the capitalization index of Russian joint-stock companies

In 2015, many big markets for shares continued their successful growth since their recovery after the 2008 crisis. Compared to 2007, the capitalization index of the share market in the USA had increased to 127.5%, in China - to 123.1%, in Japan - to 113.0%, in Hong Kong - to 120.0% (*Table 4*). The capitalization of shares in the UK, on Euronext, in Germany, Canada and Australia had recovered to 70–90%. Meanwhile, the value of Russian companies in 2015 had been shrinking for a third year in a row, amounting to only 30.7% when estimated on the basis of data released by S&P and Market Vectors Russia Index, or to 29.6% in accordance with the aggregate capitalization index for shares released by the Moscow Exchange. The factors responsible for the downfall of the capitalization index of Russian joint-stock companies in 2015 were the ruble's devaluation, foreign capital outflow, the deficit of domestic investment resources (caused, among other things, by the freeze of pension savings in 2014–2015). Another important factor that restricts the growth of the capitalization index of Russian companies is the nearly complete absence of any inflow of new big issues of securities onto the market, as confirmed by the downward trends displayed by the number of companies listed on the Moscow

<sup>1</sup> In accordance with Federal Law of June 29, 2015, No 210-FZ.

<sup>2</sup> <http://moex.com/a137>

Exchange (mentioned in subsection 3.1.5). The shares in Russia's biggest state-owned companies, state corporations and private vertically integrated holding companies have remained in the off-floor zone. The exchange listings practically never include shares in new medium-sized companies - those that could have become the foundation for fixture economic growth.

Table 4

The movement of domestic market capitalization in 2007–2012 (2007 = 100%)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
USA (NYSE и NASDAQ)	100	58.3	76.7	87.9	79.5	94.9	122.2	133.9	127.5
China (Shanghai SE)	100	38.6	73.2	73.5	63.8	68.9	67.6	106.4	123.1
Japan Exchange Group (previously - Tokyo Stock Exchange)	100	71.9	76.3	88.4	76.8	80.3	104.9	101.1	113.0
UK	100	48.0	72.5	80.5	75.2	77.5	89.9	90.3	83.1
Euronext	100	49.8	68.0	69.4	57.9	67.1	84.9	78.6	78.3
Germany	100	52.8	61.4	67.9	56.3	70.6	92.0	82.6	81.5
Hong Kong	100	50.1	86.8	102.1	85.1	106.7	116.8	121.8	120.0
Canada (TMX Group)	100	47.3	76.7	99.3	87.4	94.2	96.7	95.8	72.8
Australia (Australian SE)	100	52.7	97.2	112.0	92.3	106.8	105.2	99.3	91.4
Russia (S&P, Market Vector)*	100	26.4	57.3	91.7	72.9	71.8	69.3	34.4	30.7
Russia (Moscow Exchange)**	100	28.1	57.3	71.3	57.6	62.5	58.0	30.9	29.6
NASDAQ OMX Nordic Exchange	100	45.3	65.8	83.9	67.8	80.1	102.1	96.3	102.0

\* Calculations based on data for 2007-2014 released by S&P, and data for 2015 released by *The Market Vectors Russia Index*.

\*\* Calculations based on data on equity capitalization released by the Moscow Exchange

Source: own calculations based on data released by the World Federation of Exchanges, S&P, *The Market Vectors Russia Index*.

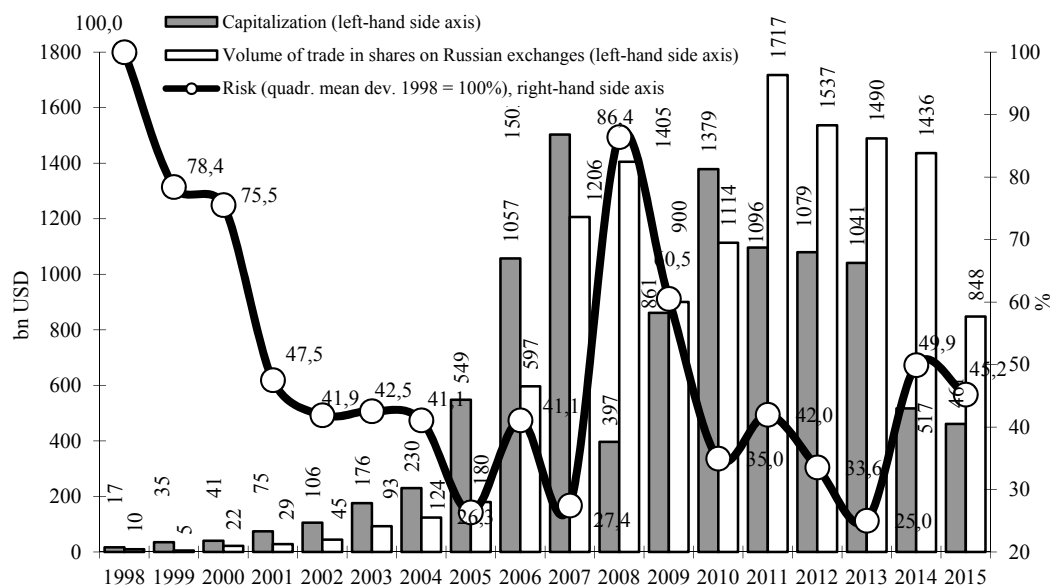


Fig. 18. Capitalization, liquidity and volatility of the Russian share market in 1998–2015

Source: own calculations based on data released by the Moscow Exchange; S&P (capitalization data).

The capitalization of Russian joint-stock companies in 2015 amounted to \$461bn, compared to \$517bn in 2014 (Fig. 18). When taken in terms of share in GDP, the capitalization index for 2015 amounts to 34.8%. The aggregate volume of transactions in shares carried on in all trade

modes on the Moscow Exchange decreased from \$1.436bn in 2014 to \$848bn в 2015, or by 41.0%. The turnover decline in the exchange market for shares has been continuing for a fourth year in a row. In 2015, the share market's volatility (measured in terms of standard deviation of the RTS Index's daily fluctuations) somewhat dropped on the previous year and amounted to 45.2% of its 1998 level. However, its index stayed at the same level as in the early 2000s, when the ratings of all Russian securities, including sovereign bonds, were significantly below the investment grade.

### 3.1.7. The role of government in the financial market

At present, Russia's financial market functions as a powerful channel for redistributing financial resources across the national economy in favor of the public sector. As estimated by Banki.ru,<sup>1</sup> as of February 1, 2016, four state-owned banks (VTB, Sberbank, Russian Agricultural Bank and Gazprombank) accounted for 71.8% of the banking system's total ruble-denominated debt owed to the Bank of Russia. Another 7.3% (approximately) was owed by *Otkritie* FC,<sup>2</sup> which over the last two years had been providing funding for the projects (important for the public sector) that involved the issuance of bonds by state-owned company Rosneft and support of the Eurobond market after Russia's sovereign rating was downgraded to junk by two international rating agencies in early 2015. That bank is also responsible for the bulk of the banking system's debt, denominated in foreign currency, to the Bank of Russia.

According to RBC, which relies on data released by Fitch, in 2014 the relative share of these four state-owned banks (VTB, Sberbank, Russian Agricultural Bank and Gazprombank) in the total volume of ruble-denominated refinancing loans provided to the banking system by the Bank of Russia, the RF Ministry of Finance and other government entities amounted to Rb 5.9 trillion, or 65.2% of all funding sources. Another Rb 0.9 trillion, or 9.7% of the total refinancing volume, was received by *Otkritie* FC.<sup>3</sup>

A number of indicators point to the constantly increasing role of government structures in stock exchange transactions. As shown in *Fig. 19* and *Table 5*, after the 2008 crisis the share of state-owned issuers of securities in the total volume of issued corporate bonds increased from 37.1% in 2010 to 59.7% in 2014. The value of that index for 2009 (55.9%) is largely an anomaly, because only big state-owned entities could place their bonds on the market in the aftermath of the crisis. The share taken up by state-owned companies on the Moscow Exchange increased from 36.3 in 2007 to 56.6% in 2015; they acted as financial intermediaries in the corporate bonds underwriting services market. The role of state-owned entities on the market for shares and bonds on the Moscow Exchange is also stably on the rise. This can largely be explained by the fact that in repo operations with shares and corporate bonds, big state-owned banks and the Bank of Russia were the main providers of liquidity for the other participants in the stock market. The share of state-owned companies and the Bank of Russia in the volume of exchange transactions with shares increased from 10.3% in 2006 to 27.8% in 2015, and the same index

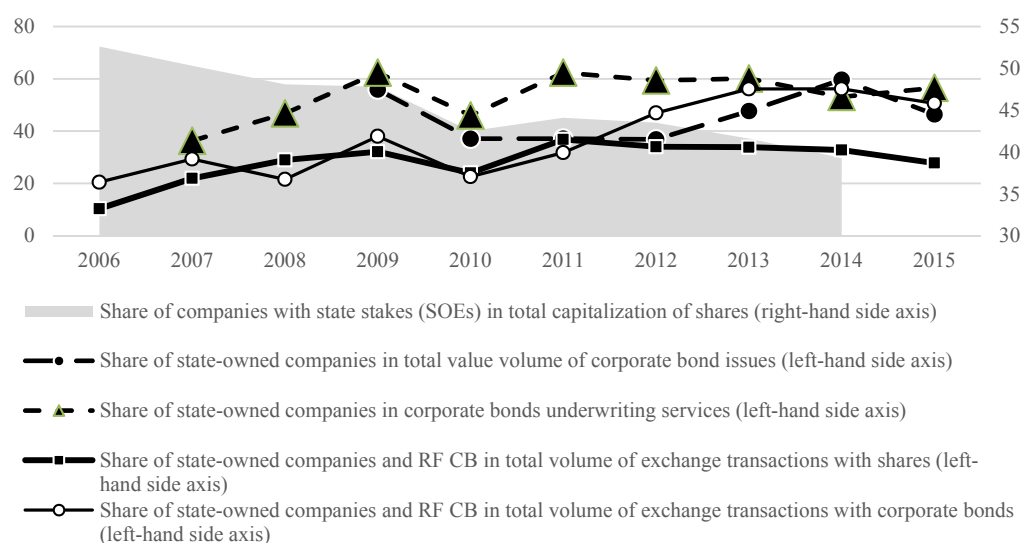
<sup>1</sup> Khasanova S. *The permitted drug: can bans do without the CB's dope*. Banki.ru, March 14, 2016, see <http://www.banki.ru/news/daytheme/?id=8768464>

<sup>2</sup> An entity controlled by *Holding Otkritie*, where a 9.9% stake is held by state-owned bank VTB. Source: <http://www.open.ru/ru/about/stakeholders/>. In December 2015, Forbes named the *Otkritie* FC group as one of likely targets for takeover by VTB (Zubova E. *VTB will start growing: the bank plans to expand by takeovers*. Forbes, December 15, 2015, see <http://www.forbes.ru/finansy/rynki/308371-vtb-poidet-v-rost-bank-planiruet-ras-shiryatsya-za-schet-pogloshchenii>).

<sup>3</sup> Sharoyan S. *In 2014, Sberbank and VTB received half of all the Central Bank's loans*. RBC, March 30, 2015, see <http://top.rbc.ru/finances/30/03/2015/5516aaed9a794763fa1878fb>



for transactions with corporate bonds increased from 20.5% in 2006 to 50.6% over the period of January-July 2015.<sup>1</sup>



*Fig. 19.* The relative shares of the capitalization index of companies with state stakes (state-owned enterprises, or SOEs) in the capitalization index of corporate shares traded on the Moscow Exchange (as %); the relative shares of state-owned entities<sup>2</sup> in the volume of trade in the Russian stock market, as %

*Source:* own calculations based on corporate financial reports, data released by CBonds and the Moscow Exchange.

At the same time, the shifts towards state-owned enterprises (SOEs) displayed by the refinancing flow from the Bank of Russia, the corporate bond issue volume, and the exchange operations in the segment of investment and banking services and the transactions with shares and corporate bonds did not result in their better performance, as estimated by the market capitalization index. In this case, in accordance with the OECD terminology, state-owned entities (state-owned enterprises, or SOEs) are understood to be the enterprises controlled by the State who acts as their sole owner, or the owner of majority stakes or significant minority stakes (blocks of voting shares) in these companies. In this connection, a significant minority stake is understood to be a stake (block of voting shares) amounting to no less than 10%.<sup>3</sup>

During our 2015 study based on a sample of 54 listed companies and complying with the definition of a SOE, we found that their aggregate market capitalization volume shrank from Rb 13.4 trillion in 2006 to Rb 9.1 trillion in 2014, or by 32.1%. Over the same period, the aggregate market capitalization of all the companies operating on the MICEX and the Moscow

<sup>1</sup> Regrettably, without offering any explanation, from August 2015, Moscow Exchange PJSC, referring to Provision of the Bank of Russia as of October 17, 2014, No 437-P on organized traders, significantly reduced the scope of disclosed information on its activity; in particular, from then on it no longer released the statistics on transactions with different categories of bonds (corporate, regional and federal).

<sup>2</sup> Hereinafter, the state-owned entities under consideration are as follows: KIT Finans, CJSC Sberbank CIB, VTB-24, Gazprombank, Bank of Moscow, Sviaz-Bank, VEB, VTB, Sberbank of Russia, VTB Capital, TransCredit-Bank, Bank Saint Petersburg.

<sup>3</sup> OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition, OECD Publishing, Paris, pp. 14–15.

Exchange likewise shrank from Rb 25.5 trillion to Rb 23.2 trillion, or by 9.0%. In other words, over the period 2006 to 2014, the decline rate of the capitalization index of SOEs was higher than that of the aggregate market capitalization of all the companies operating on the exchange. As a result, the relative share of the capitalization index of SOEs in the total capitalization of shares traded on the Moscow Exchange shrank from 52.6% in 2006 to 39.3% in 2014 (*Table 5*). This figure was not influenced by the privatization deals involving stakes in big state-owned companies that were completed over that period (Rosneft, Sberbank, VTB, Alrosa, etc.), because these companies, even after the state stakes in their capital had been reduced, were not deprived of their status of a SOE. Consequently, the shrinking capitalization share of SOEs in the aggregate capitalization index only means that the capitalization index of private companies operating on the exchange was growing faster than that of companies with state stakes, although state-owned entities had advantages over all other companies in terms of financial resources and activity on the exchange.

*Table 5*

**The relative shares of the capitalization index of companies with state stakes (state-owned enterprises, or SOEs) in the capitalization index of corporate shares traded on the Moscow Exchange (as %); the relative shares of state-owned entities<sup>1</sup> in the volume of trade in the Russian stock market, as %**

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Share of companies with state stakes (SOEs) in equities capitalization	52.6	50.3	48.1	47.8	42.5	44.1	43.5	41.6	39.3	
Share of companies with state stakes in value volume of corporate bond issues				55.9	37.1	37.2	36.9	47.7	59.7	46.4
Share of companies with state stakes in corporate bonds underwriting services market		36.3	46.8	62.4	46	62.4	59.4	60.1	53.1	56.6
Share of companies with state stakes and RF CB in total volume of equities exchange transactions	10.3	21.9	29.0	32.1	24.0	36.8	34.0	33.8	32.8	27.8
Share of companies with state stakes and RF CB in total volume of exchange transactions with corporate bonds	20.5	29.3	21.6	38.0	22.6	31.8	47.0	56.1	56.2	50.6*

\* Based on data for January-July 2015.

Source: own calculations.

### 3.2. Stock market infrastructure<sup>2</sup>

#### 3.2.1. The payment settlement infrastructure of the Moscow exchange

In 2011, the two largest Moscow-based exchanges - MICEX and RTS - were merged. This merger had important positive consequences for the development of Russia's stock market. The transactions on the stock and futures markets became easier. All liquidity necessary for carrying on transactions in the markets for government and corporate securities, as well as the futures and forex markets, could now be concentrated in the accounts of participants in trading in the exchange's single clearing and settlement system. The diversification of the exchange in servic-

<sup>1</sup> Hereinafter, the state-owned entities under consideration are as follows: KIT Finans, CJSC Sberbank CIB, VTB-24, Gazprombank, Bank of Moscow, Sviaz-Bank, VEB, VTB, Sberbank of Russia, VTB Capital, TransCreditBank, Bank Saint Petersburg.

<sup>2</sup> Author of this section: Abramov A. – RANEPА.

ing the transactions with different types of monetary and investment assets improved its financial sustainability in face of the widespread decline in the trade volume indices displayed by world stock exchanges and the reluctance of investors to buy risky assets.

After the merger, it now became possible to create, on the basis of the MICEX settlement chamber, the National Settlement Depository (NSD) and the Depository Clearing Company (DCC), a ‘fully-fledged’ central depository. In accordance with Order of the FFMS of 6 November 2012, No 12-2761/PZ-I, this status was granted to non-bank credit institution Close-end Joint Stock Company National Settlement Depository (NSD CJSC). In 2015, the NSD’s equity amounted to Rb 11.4bn vs. Rb 9.5 bn in 2014, thus having increased by 20.0%. The value of securities kept by the NSD rose from Rb 25 trillion in 2014 to Rb 31 trillion in 2015, or by 24.0%.

Over the past three year, the NSD succeeded in implementing a number of important projects. It was granted the official status of an eligible securities depository by the *US Securities and Exchange Commission (in accordance with New Rule 17f-7 under the US Investment Company Act of 1940)*, and so can hold the assets of the US biggest institutional investors. The depository opened accounts for global clearing and settlement systems - *Euroclear Bank S.A./N.V.* and *Clearstream Banking S.A.*, as well as for the central depositories of Armenia, Belarus, Kazakhstan and Ukraine. In 2015, *Euroclear* and *Clearstream* bought minority stakes in the NSD. The establishment of correspondent banking relationships with the world’s two biggest settlement systems enabled the NSD to make the resources of foreign investors accessible for transactions with OFZ and corporate bonds and shares in Russia’s stock exchange market. In accordance with the alterations introduced into the Federal Law ‘On the securities market’ by Federal Law of July 21, 2014, No 218-FZ ‘On introducing alterations into some legislative acts of the Russian Federation’, reform was launched towards transforming the stock market by switching over to an electronic document turnover system. The NSD is actively involved in the creation of a corporate information center, in order to make more transparent the information on securities and their issuers.

From February 6, 2013, the NSD has been performing the functions of a repository for the registration of off-floor transactions with different financial instruments. Currently, these are predominantly swaps and repo operations. The creation of such structures is envisaged by the decisions of G-20 adopted in 2009 at its Pittsburgh summit as one of the measures designed to reduce systemic risks. In 2015, the repository registered repository to the value of Rb 114 trillion vs. Rb 86 trillion in 2014.

Nevertheless, the key goal of the central depository, as it was initially envisaged by the lawmakers, has so far been achieved only in part. The case in point is that, in accordance with Federal Law of December 7, 2011, No 414-FZ ‘On the Central Securities Depository’, it was endowed with a special right: the registers of holders of securities were from then on to include a new personal account – that of the central depository’s nominal holder. So, all registered securities kept on the personal accounts of nominal holders in the registers of other depositories had to be re-registered to that account. In its turn, the depository was obliged to open the nominal holder accounts for all open-ended joint-stock companies, thus promoting the gradual involvement of their shares in operations on the public stock markets. Our estimations show that this goal has not been achieved. Regretfully, the NSD does not release the statistics on the number of joint-stock companies that have opened their personal accounts of nominal holders with it. From the NSD’s reports for 2013 we know that as of December 31, 2013, the accounts of nominal holders had been opened in the registers of more than 1,200 issuers of securities. Our selective calculations, based on the published list of securities for which the NSD has

opened nominal holder accounts, show that over the last two years their number increased by approximately 20% to 1,400 (less various collective investment schemes). However, only 254 among those 1,400 joint-stock companies, or 18% of those serviced by the NSD, are listed on the Moscow Exchange.

Another subsidiary of the Moscow Exchange is *Bank National Clearing Center* (NCC). Since November 2011, the NCC has been rendering clearing services in the securities market, and since December 2012 in the derivatives market. In October 2013, the Bank of Russia recognized Bank National Clearing Center CLSC to be the only qualified central counterparty (CCP) in the financial market. The NCC visualizes its strategic objective in providing the participants in the financial market's different segments with integrated clearing services, in particular the use of a single margin and single positions (limits) for all of them in all the exchange-based markets and over-the-counter markets. In recent years, the Moscow Exchange Group has invested serious effort in boosting the NCC's capitalization index. Over the course of two years, the National Clearing Center's equity increased threefold from Rb 13.2bn in 2012 to Rb 39.6bn in 2014.

### 3.2.2. Segmentation of the stock exchange market

The low yields of Russian shares after 2008, the high volatility of foreign-exchange rates and financial assets, the relatively high rate of refinancing in the banking system, the freeze of pension savings, and lack of any noticeable improvement in domestic investment have resulted in some serious shifts in the Moscow Exchange's market structure. Over slightly more than five years, the capital market share in the total volume of exchange transactions shrank from 13.2% in 2010 to 2.4% in January-February 2016 (*Table 6*). This is a manifestation of the overall negative trend displayed by the stock market in its functioning as a source of funding for the Russian economy and private savings.

On the contrary, the share of the monetary market increased from 72.0% in 2010 to 78.6% in January-February 2016. The highest growth rate over the period under consideration was displayed by the share of the forex market – from 38.1% to 45.8%. The relative share of transactions in the money market shrank from 33.9% to 32.8%, including that of repo transactions from 31.5% to 28.4%. On the one hand, the unstable exchange rate of the ruble against major world currencies and the access to forex operations granted to the private clients of brokers and banks conducted to rapid growth of the Moscow Exchange's forex segment. On the other, the downward trend (visible since 2015) in the volume of refinancing loans issued by the Bank of Russia to the banking system resulted in shrinkage of the money market's share. The positive development on the money market was the rapid growth of the volume of transactions in the repo sector carried on with the central counterparty. This index rose threefold, to 70–72% of the repo market.<sup>1</sup>

Marked growth of the volume of transactions was noted in the futures market. The share of transactions with derivatives in the total trading volume increased from 14.8% in 2010 to 19.0% in January-February 2016. The accelerated growth in the futures market in 2015 and early 2016 was caused by the increasing use of hedging tools by market participants in their attempts to protect their assets from the risks associated with the leaps of the highly volatile exchange rate of the ruble and securities quotes. As estimated by Chairman of the Executive Board and CEO of the Moscow Exchange Alexander Afanasiev, the futures market in Russia, in contrast to the

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<sup>1</sup> Year of the Moscow Exchange: results and plans. Financial One, December 24, 2015.

global futures exchanges with their high shares of forward rate agreements, is still dominated by forex and similar-type operations. In 2015, instead of the expected 5-fold increase, the volume of forward rate agreements shrank threefold.<sup>1</sup>

*Table 6*

**The market structure on the Moscow Exchange, %**

	2010	2011	2012	2013	2014	2015	Jan-Feb 2016
<b>Stock market</b>	<b>13.2</b>	<b>10.3</b>	<b>6.5</b>	<b>5.3</b>	<b>4.1</b>	<b>3.2</b>	<b>2.4</b>
including:							
shares, Russian depository receipts (RDR), investment fund units	8.0	6.6	3.1	1.9	2.0	1.5	1.1
bonds	5.2	3.7	3.4	3.4	2.1	1.7	1.3
secondary turnover	3.4	2.9	2.8	2.8	1.7	1.3	1.0
new offering	1.8	0.8	0.6	0.6	0.4	0.4	0.2
<b>Money and forex market</b>	<b>72.0</b>	<b>70.6</b>	<b>80.0</b>	<b>83.8</b>	<b>84.0</b>	<b>82.1</b>	<b>78.6</b>
including:							
money market	33.9	41.3	48.3	49.1	39.7	33.5	32.8
repo transactions	31.5	38.3	45.8	46.2	35.6	28.3	28.4
lending market	2.4	3.1	2.5	2.9	4.1	5.1	4.4
forex market	38.1	29.3	31.6	34.7	44.4	48.6	45.8
spot trades	18.0	15.8	16.6	12.8	15.1	16.2	19.2
swap trades	20.1	13.4	15.0	22.0	29.3	32.5	26.6
<b>Futures market</b>	<b>14.8</b>	<b>19.1</b>	<b>13.5</b>	<b>10.8</b>	<b>11.9</b>	<b>14.7</b>	<b>19.0</b>
<b>Commodity market</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.02</b>	<b>0.02</b>
<b>TOTAL</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: own calculations based on data on monthly trading volume on the Moscow Exchange.

*Table 7*

**Secondary market on the Moscow Exchange in August-December 2015**

Equity			Corporate bonds		
	m Rb	%		m Rb	%
1. Negotiated trades mode (NTM)	127,184	0.61	1. Main trading mode	657,519	3.23
2. Trading mode <i>Equities D – Negotiated trades mode</i>	1,004	0.005	2. Negotiated trades mode (NTM)	1,536,155	7.54
3. Trading mode <i>Equities D – Main trading mode</i>	876	0.004	3. Trading mode <i>T+ : repo</i>	836	0.004
4. Trading mode <i>T+ : repo</i>	3,321	0.02	4. Trading mode <i>Qualified investors – Main trading mode</i>	483	0.002
5. Trading mode <i>T+ : NTM</i>	13	0.0001	5. Trading mode <i>Qualified investors – NTM</i>	1 205	0.01
6. <i>Odd lots</i> trading mode	22	0.0001	6. Trading mode <i>Qualified investors – Repo</i>	678	0.003
7. Trading mode <i>Main trading mode T+</i>	3,469,309	16.72	7. Trading mode <i>Bonds D – Main trading mode</i>	979	0.005
8. Trading mode <i>Equities repo</i>	3,550,688	17.11	8. Trading mode <i>Bonds D - NTM</i>	55	0.0003
9. Trading mode <i>Repo with the Bank of Russia: repo auction</i>	443,176	2.14	9. Trading mode <i>Repo with the Bank of Russia: repo auction</i>	5,952,042	29.22
10. Trading mode <i>Repo with the Bank of Russia: fixed rate</i>	223,350	1.08	10. Trading mode <i>Repo with the Bank of Russia: fixed rate</i>	4,688,084	23.02
11. Trading mode <i>Repo with CCP - order book orders</i>	7,604,385	36.65	11. Trading mode <i>Bonds repo</i>	4,963,178	24.37
12. Trading mode <i>Repo with CCP - anonymous orders</i>	5,112,841	24.64	12. Trading mode <i>Repo with CCP – order book orders</i>	2,216,941	10.89
13. Trading mode <i>NTM with CCP</i>	154,054	0.74	13. Trading mode <i>Repo with CCP – anonymous orders</i>	347,711	1.71
14. Trading mode <i>Block trading (Dark Pool)</i>	38,425	0.19	14. Trading mode <i>NTM with CCP</i>	1,025	0.01
15. Trading mode <i>Delivery for futures contracts (FC)</i>	19,925	0.10			
<b>Total secondary trades turnover</b>	<b>20,748,573</b>	<b>100.00</b>	<b>Total secondary trades turnover</b>	<b>20,366,891</b>	<b>100.00</b>

Source: own calculations based on data released by the Moscow Exchange.

<sup>1</sup> Year of the Moscow Exchange: results and plans. Financial One, December 24, 2015.

In our opinion, the low turnover rates in the stock market segment on the Moscow Exchange have resulted not only from the objective external problems that are suppressing its growth, but also from some issues in trading organization. *Table 7* shows the turnover data for various segments of the exchange market for equities and corporate bonds over the period from August through December 2015; from these data, it follows that in the secondary market, with its insufficient liquidity, equities were traded in 15 different trading modes, and corporate bonds - in 14 trading modes respectively. In the equity segment, the shares of different trade modes varied from 0.0001 to 36.6%; and in the corporate bond segment – from 0.0003 to 29.2% respectively. Possibly, such a detailed segmentation of trade was not a factor that could boost the overall market liquidity.

### 3.2.3. Development projects and current operations

In 2015, the Moscow Exchange Group implemented the following major market development projects: the introduction of a simplified registration mode for bond issues (beginning with Rosbank's bonds); UC RUSAL's ordinary shares were listed on the Moscow Exchange; a single settlement cycle in T+1 trading mode with a partial deposit for OFZ was introduced; exchange-traded indexed OFZ (with face value adjustment for inflation) were placed on the market; settlements in US dollars were allowed for T+ transactions with foreign securities; the Corporate Governance Code was approved; new listing rules were introduced, with some additional requirements to shares, mortgage participation certificates (MPC) and bonds, including bond concessions; retail investors were allowed to open broker accounts in a remote mode.

Nevertheless, in 2015, the Moscow Exchange did not manage to run its trading systems faultlessly; within one-year's time, no less than 6 serious technical glitches occurred in its futures, equity and forex markets. As estimated by its Chairman and CEO Alexander Afanasiev, its accessibility coefficient (which describes the ability to maintain the IT systems in a properly functioning mode) for 2015 was below the norm<sup>1</sup> due to the rising rate of technical glitches on the market.

### 3.2.4. Equity structure, finances and capitalization

In 2015, the main equity structure of the Moscow Exchange remained relatively unchanged. From the official reports released by the National Settlement Depository (NSD) it follows that as of December 31, 2014 and June 30, 2015, the entities controlled by the Russian Federation held more than 50% of voting shares in Moscow Exchange PJSC - that is, the exchange remained a state-controlled company.<sup>2</sup> We estimate that, in 2015, the aggregate stake held by the Bank of Russia, Sberbank, VTB, VEB, Gazprombank and the RDIF amounted to 39.2% vs. 39.6% a year earlier (*Table 8*).

In accordance with Part 14 of Article 49 of Federal Law of July 23 2013, No 251-FZ 'On introducing alterations into some legislative acts of the Russian Federation in connection with the transfer, to the Central Bank of the Russian Federation the powers of regulation, control and supervision in the sphere of financial markets', the Bank of Russia was required to withdraw

<sup>1</sup> Year of the Moscow Exchange: results and plans. Financial One, December 24, 2015.

<sup>2</sup> The same fact was stated in the Consolidated Intermediate Shorter Financial Report of NPO NSD CJSC, released as of June 30, 2015, p. 21. [https://www.nsd.ru/common/img/uploaded/files/disclosure/hyear/NSD\\_IFRS\\_cons\\_1HY\\_2015.pdf](https://www.nsd.ru/common/img/uploaded/files/disclosure/hyear/NSD_IFRS_cons_1HY_2015.pdf)

its stakes from the Moscow Exchange and the Stock Company Saint-Petersburg Currency Exchange (SPCEX) before January 1, 2016. However, on April 2, 2015, the Bank of Russia officially announced that, 'considering the forthcoming developments in the geopolitical situation and, as a consequence, the necessity to maintain, for an indefinite period of time, the comprehensive control of a regulator over the functioning and development of Russia's national exchange infrastructure, the Bank of Russia believes that it is not feasible for it to fully withdraw from the capital of Moscow Exchange OSJC and SPCEX CJSC.<sup>1</sup> The corresponding amendments were introduced into legislation by Federal Law of June 29, 2015, No 210-FZ.

This decision was taken a result of the economic sanctions and aggravating geopolitical situation, as well as the changes in the Moscow Exchange's equity structure that occurred after a SPO undertaken on July 2, 2014. Then, the Bank of Russia sold a 11.7% stake in the Moscow Exchange, by way of an international offering on the market, in the amount of 267,274,238 ordinary shares traded at Rb 60 per share, to the total value of Rb 16.04bn.<sup>2</sup>

The principal buyers of these shares, according to the mass media, were the RDIF and big foreign investment funds.<sup>3</sup> *Factiva* reports that, as of December 31, 2014, foreign institutional investors, with the exception of China Investment Corporation, held approximately 17.8% voting shares in the Moscow Exchange. So, together with the stakes held by China Investment Corporation and the EBRD (*Table 8*), in 2014 non-residents already held no less than 29.5% of voting shares. This group of shareholders, while not being a consolidated one, was second in importance. Any further sale of any part in the stake held by the Bank of Russia could result in the Moscow Exchange losing its status of a state-owned company, and the control over it being taken over by non-residents. And this would not be only the takeover of control over the exchange itself, but, more importantly, over the two major settlement and clearing systems - the NSD and the NCC.

After the Bank of Russia's decision to keep its stake in the Moscow Exchange, the aggregate stake held therein by foreign institutional investors remained practically unchanged, amounting in 2015, according to *Factiva*, to 17.6% of the total amount of traded shares vs. 17.8% in 2014. However, in February 2016, China's Chengdong Investment Corporation sold its stake, in the amount of 5.6%, with a 11% discount at Rb 89 per share.<sup>4</sup> The Corporation offered no comment on that transaction, but on the whole it may be assumed that this move had largely to do not with its attitude to a one or other issuer of securities, but to a whole group of Russian issuers and the Corporation's policy with regard to restructuring its investment portfolio.

In 2015, the Moscow Exchange's income hit a record high of Rb 46.0bn vs. Rb 30.4bn in 2014 (growth by 51.3% - see *Table 9*). However, beside the moderate growth, by 14.1%, of its commission incomes tied to trading turnover, the income was boosted in the main by the interest received on the temporarily free assets. In 2015, the sum of interest income and other financial incomes rose to Rb 27.0bn, having increased over the year by 93.4%. Some market participants feel critical about the high profitability of the exchange.

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<sup>1</sup> [http://www.cbr.ru/press/pr.aspx?file=02042015\\_102812if2015-04-02T10\\_23\\_50.htm](http://www.cbr.ru/press/pr.aspx?file=02042015_102812if2015-04-02T10_23_50.htm)

<sup>2</sup> In accordance with the norms stipulated in Article 2 of Federal Law of July 10, 2002, No 86-FZ 'On the Central Bank of the Russian Federation (the Bank of Russia)', the Bank of Russia's property is in federal ownership; so it is questionable if that transaction could indeed be regarded as a privatization deal.

<sup>3</sup> RBC, July 1 2014. *The RDIF can buy half of the RF CB's stake in the Moscow Exchange*: <http://top.rbc.ru/economics/01/07/2014/933930.shtml>

<sup>4</sup> M. Stulov. The Chinese withdrew from the Moscow Exchange's capital. *Vedomosti*, February 4, 2016.

Table 8

**The structure of shareholders of the Russian exchanges before  
and after their merger**

	Prior to reorganization		Prior to reorganization	After merger: MICEX-RTS OJSC as of February 15, 2013 - estimated value <sup>1</sup>	As of May 12, 2014 <sup>2</sup>	Estimates as of December 31, 2014	Estimates as of December 31, 2015
	RTS OJSC	RTS OJSC					
Bank of Russia		28.6	24.3	22.5	23.7	12.1	11.8
Sberbank of Russia		7.5	10.4	9.6	10.0	10.0	10.0
VTB		7.1	6.1	5.6	3.8	3.8	3.8*
VEB		10.5	8.7	8.0	8.4	8.4	8.4
Gazprombank		6.2	5.4				
RDIF		1.3	1.3	4.6	5.3	5.3	5.3
<b>Stake held by state-owned structure</b>	<b>0</b>	<b>61.1</b>	<b>56.1</b>	<b>50.3</b>	<b>50.3</b>	<b>39.6</b>	<b>39.2</b>
MICEX Finance		2.8	2.8	5.5	2.3	2.2	1.9
Chengdong Investment Corporation				5.4	5.6	5.6	5.6**
EBRD				5.8	6.1	6.1	6.1
<b>Other shareholders</b>	<b>89.0</b>	<b>36.00</b>	<b>41.0</b>	<b>33.0</b>	<b>34.8</b>	<b>46.5</b>	<b>47.2</b>
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

\* own estimations.

\*\* Chengdong Investment Corporation, as of February 8, 2016, sold its shares in Moscow Exchange PSJC.

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

In April 2015, during brokers' meeting with Chairman of the Supervisory Board of the Moscow Exchange Alexey Kudrin, it was said that the Exchange had begun to display signs of misusing its monopolist status on the market for the sake of gain, and that its goal was not to provide services to issuers of securities, but to increase its income by investing the residuals in the accounts of its clients.<sup>3</sup> However, its high income on the whole enabled the Moscow Exchange to successfully develop its business, pay high dividends on its securities, and secure its own high capitalization index.

Table 9

**Incomes of the Moscow Exchange in 2014–2015, m Rb**

	2014	2015	Change, %
1. Commission income	15,586	17,784	14.1
including:			
- in forex market	3,408	4,326.9	27.0
- in money market	3,235	3,874	19.8
- in equity market	3,150.9	3,275.8	4.0
- in futures market	1,636.6	1,470.8	-10.1
- depository services and settlement operations	3,188.6	3,464.6	8.7
- information services	436.2	688.4	57.8
- IT and technical services	496.2	526.7	6.1
- other	34.5	156.8	354.5
2. Interest and other financial incomes	13,989.7	27,050.0	93.4
including:			
- interests on monetary assets held by financial institutions	7,597.4	14,510.4	91.0
- interest on investment	5,910.8	11,930.1	101.8
3. Other incomes	818.3	1,156.0	41.3
<b>4. Operating income, total</b>	<b>30,394</b>	<b>45,990</b>	<b>51.3</b>

Source: own calculations based on data released by the Moscow Exchange (IFRS).

<sup>1</sup> Data released by the Moscow Exchange as of January 16, 2013; information on the biggest stakeholders in the Moscow Exchange published by *Kommersant* in its statistics section, February 18, 2013.

<sup>2</sup> Quarterly report of Moscow Exchange (MICEX-RTS) OJSC for Q4 2014.

<sup>3</sup> Interfax, April 10, 2015, 17:54. Brokers told Kudrin about the drawbacks in the Moscow Exchange's performance.



The total capitalization index of the Moscow Exchange in 2015 amounted to Rb 211.2bn, or \$2.9bn compared to Rb 138.4bn, or \$2.5bn in 2014. As a result of a SPO placed in July 2014, the amount of shares in circulation offered by the Moscow Exchange rose above 50%, and after the sale of Chengdong Investment Corporation's stake it further increased to 57%, which is one of the best indices in Russia's stock market. However, in early 2012, as estimated by the Bank of Russia and the Moscow Exchange's board of directors, its capitalization index was expected to rise towards the year's end to \$6bn.<sup>1</sup> That is, the actual capitalization index amounted to less than half of the previously set target.

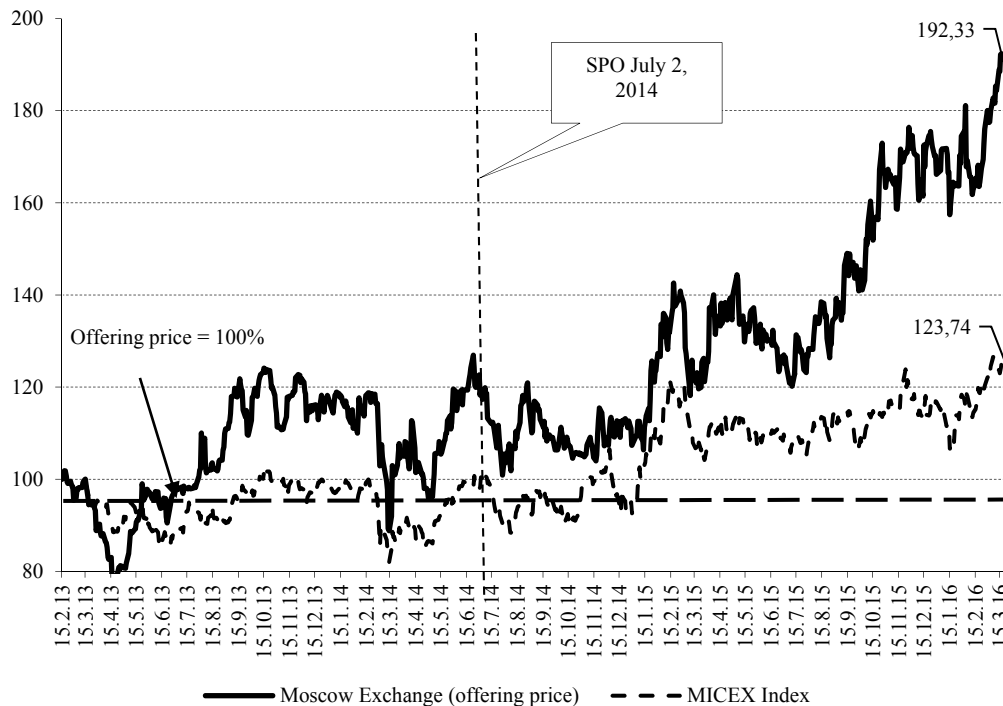


Fig. 20. The movement of offering prices of shares traded on the Moscow Exchange and the MICEX Index over the period from February 15, 2013 through March 17, 2016 (February 15, 2013 =100%)

Source: own calculations based on data released by the Moscow Exchange and the Finam investment company.

Over the period from February 4 to February 15, 2013, in the framework of an IPO, the Moscow Exchange placed shares to the total value of Rb 15bn, or \$500m. While the declared offering price was at Rb 55–63 per share, the actual price was set at its lower margin, or Rb 55 (Fig. 20). On the first day of trade, February 15, 2013, the price underestimation index compared to the offering price amounted to 0%. Usually, the low value of the price underestimation index recorded as of the first day of trade in the framework an IPO of Russian shares points to their being overestimated as of the date of the IPO. Later on, this often results in a negative excess yield, compared to the basis index, over many years.<sup>2</sup>

<sup>1</sup> Interfax-AFI. *The stock exchange valued itself for an IPO*. *Kommersant*, March 26, 2012.

<sup>2</sup> Abramov A. E. *The Problems of IPO-SPO Faced by Russian Companies*. The Economic and Political situation in Russia. Ye. T. Gaidar Institute for Economic Policy, No 10, 2012, pp. 58-54.

However, three years later after the IPO, the long-term yield of shares traded on the Moscow Exchange was steadily on the rise, and rose above the MICEX Index. As of March 17, 2016, compared to the offering price as of February 15, 2013, the cumulative yield of shares traded on the Moscow Exchange amounted to 92.3%, while the yield of the MICEX's portfolio was only 23.7%. Meanwhile, the ruble-denominated price of shares traded on the Moscow Exchange increased over the period under consideration from Rb 55.0 to Rb 105.8, or by 92.3%, whereas when taken in dollar terms, it declined from \$1.83 to \$1.49, or by 18.6%.

### 3.3. The market for shares in Russian companies<sup>1</sup>

#### 3.3.1. Factors determining the share market behavior<sup>2</sup>

The market for shares in Russian companies strongly depends on the behavior of oil prices. The coefficient of determination ( $R^2$ ) between the absolute monthly values of the RTS Index and the price of Brent crude over the period from September 1995 through January 2015 is equal to 0.80 (see Fig. 21), which points to a very close interdependence of these two indicators.

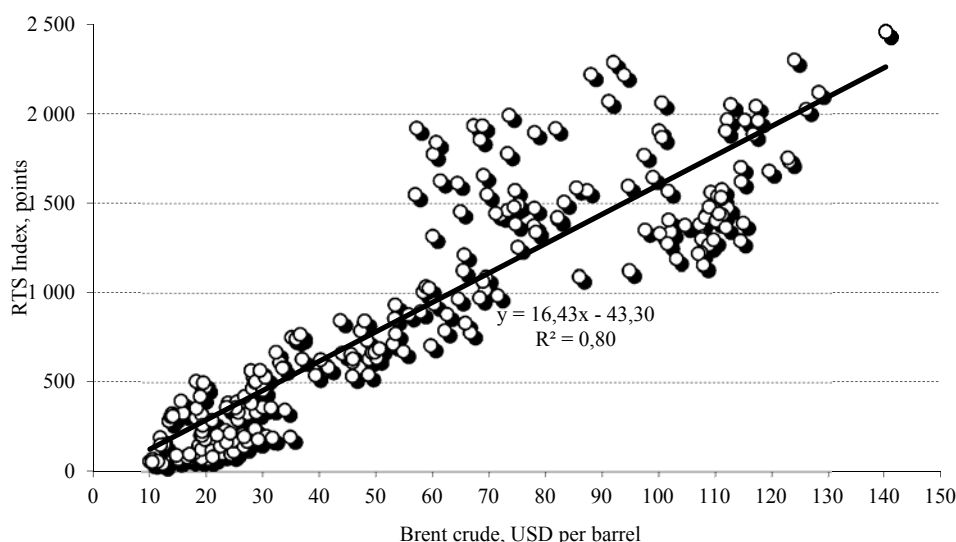


Fig. 21. The dependence of the RTS Index on the price of Brent crude, from September 1995 through February 2016

Source: own calculations based on data released by the Finam investment company and the Moscow Exchange.

However, in actual practice the behavior of Russian stock indexes depends not only on that of prices of oil. Fig. 22 demonstrates the behavior of the coefficient of correlation between the monthly relative movements of the RTS Index and the price of Brent crude over a previous 12-month period. The sliding correlation curve that reflects the interrelation between the two indicators reveals a distinctly cyclical pattern. As a rule, during a period of growth on the stock

<sup>1</sup> Author of this section: Abramov A. – RANEPА.

<sup>2</sup> This section is co-authored with Researcher of the RANEPА *Institute of Applied Economic Research* M. I. Chernova.

market, the correlation coefficient declines towards -1 at a point near the RTS Index's peak value. In other words, when market is on the rise, the price of oil and the accelerating RTS Index begin to change in two different directions. When the share market is plummeting, the correlation between the changes in the Index's value and the price of oil begins to increase towards +1 while the stock index is at its bottom point. That is, when the market is on the decline, the movement patterns of the RTS Index and prices of oil become increasingly synchronous. Moreover, the U-turn point of the sliding correlation curve most often occurs in April or March, depending on a given year.

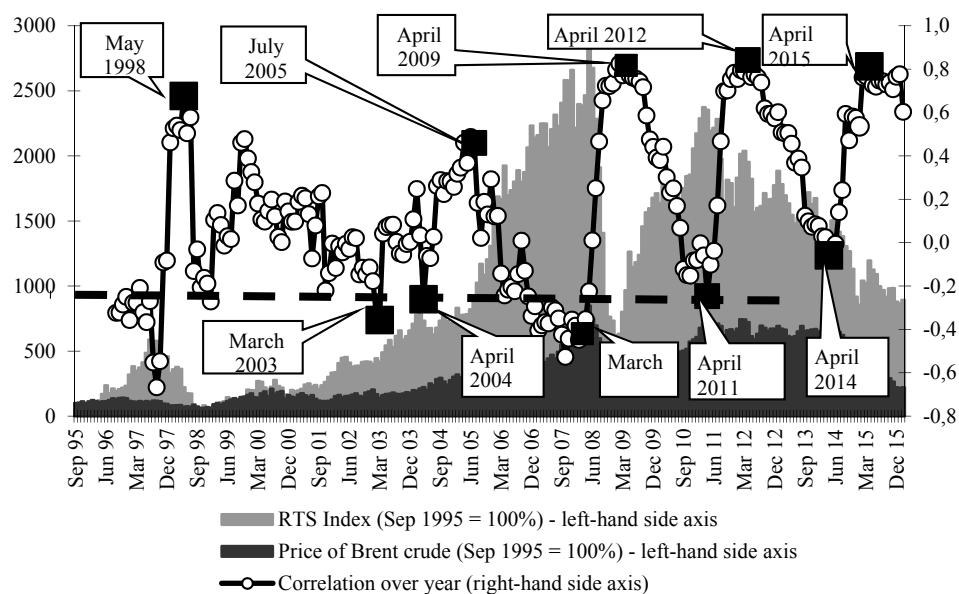


Fig. 22. Correlation between the movement patterns of the RTS Index and the price of Brent crude, from September 1995 through February 2016

Source: calculations based on data released by the IFS IMF and MICEX-RTS.

The cyclical behavior patterns displayed by the RTS Index and prices of oil, in our opinion, can be explained by the counter-cyclical effects (relative to the movement of oil prices) of the foreign portfolio investment flows in the stock market. This mechanism works as follows. As a rule, the strategy of foreign investment funds specializing on Russia is that they buy shares in Russian companies when a crisis reaches its bottom point, and the prices are low; later on, when the market starts its upward movement, they try to catch the moment when it is necessary to withdraw their money from the stocks that have become overestimated (too expensive). Our studies have demonstrated<sup>1</sup> that the signal for withdrawal is the significant decline of the forecast indices published by Consensus Economics Inc., a survey firm that is popular among institutional investors and international financial institutions. It follows the growth rate indices of the world's biggest economies and predicts downturns in the demand for oil and national currency devaluation in the developing countries. The timing of such investor decisions in March

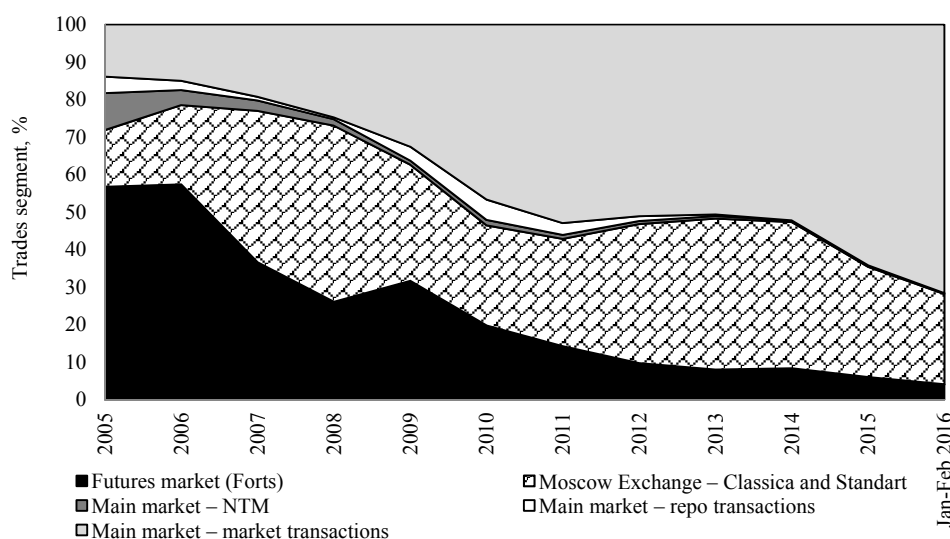
<sup>1</sup> IMF *Financial Stability Report*. September 2011, pp. 11–18, see [www.imf.org](http://www.imf.org); Abramov A. *Differences in the behavior of domestic and foreign private investors on the Russian stock market*. Russian Economic Development, No 11, 2015, pp. 47–52.

or April can probably be explained by the release, during these two months, of the IMF's global economic reviews, which also rely on Consensus Economics' data.

So, Russia's stock market usually functions in accordance with the following scenario. Whenever the bottom point of a crisis is reached, which usually happens alongside the start of recovery growth displayed by prices of oil, foreign portfolio investors begin to buy Russian stocks. At that moment, the correlation between the RTS Index and oil prices is near +1. However, as the market grows, the inflow of foreign investment becomes slower, and at a certain point in time, while oil prices are still on the rise, non-resident investment funds begin to systematically withdraw their money from Russian stocks. Therefore the peak of oil prices usually coincides with the maximum value volume of funds being withdrawn from the Russian stock market. As a result, the correlation between the RTS Index and oil prices declines to -1 when oil prices and the stock index reach their highest points. One example of this behavior pattern displayed by foreign portfolio investors was their withdrawal from Russia's market for shares during the period from May 2006 through February 2009. They started to behave like this in spite of the continuing (until May 2008) growth of prices of oil, and changed their behavior only when the Russian stock market hit its bottom point during the 2008 crisis (see *Fig. 12*).

### 3.3.2. Segments of the domestic share market

In 2015 and early 2016, the growth rate of trading volume in the futures market was significantly ahead that of the equity market. The relative share taken up by the futures market increased to 71.6% in February 2016 vs. 52.2% as shown by the year-end results for 2014. On the one hand, this was a sign of the market participants' desire to rely on derivatives as a hedging tool against potential losses in a highly volatile market, especially in the segment of FX derivatives. On the other, the trading volume in the equity market was on the decline, and so their interest in the segment of equity derivatives was likewise declining. However, on the whole, as seen from *Fig. 23* and *Table 10*, the share of equity market transactions in the spot segment shrank from 8.4% in 2014 to 4.0% in February 2016.



*Fig. 23.* The structure of markets for shares and derivatives on the Moscow Exchange from January 2005 through February 2016

*Source:* own calculations based on data released by Russian exchanges.

*Table 10*

**The structure of markets for shares and derivatives on the Moscow Exchange  
from January 2005 through February 2016**

	2005	2010	2013	2014	2015	Jan-Feb 2016
Main market – market transactions	56.7	19.8	8.0	8.4	6.0	4.0
Main market – repo transactions	15.1	26.7	40.3	39.0	29.4	24.1
Main market – NTM	9.8	1.5	0.7	0.4	0.4	0.3
Moscow Exchange – Classica <sup>1</sup> and Standart	4.4	5.4	0.4	0.0	0.0	0.0
Futures market (formerly Forts)	13.9	46.7	50.7	52.2	64.2	71.6
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

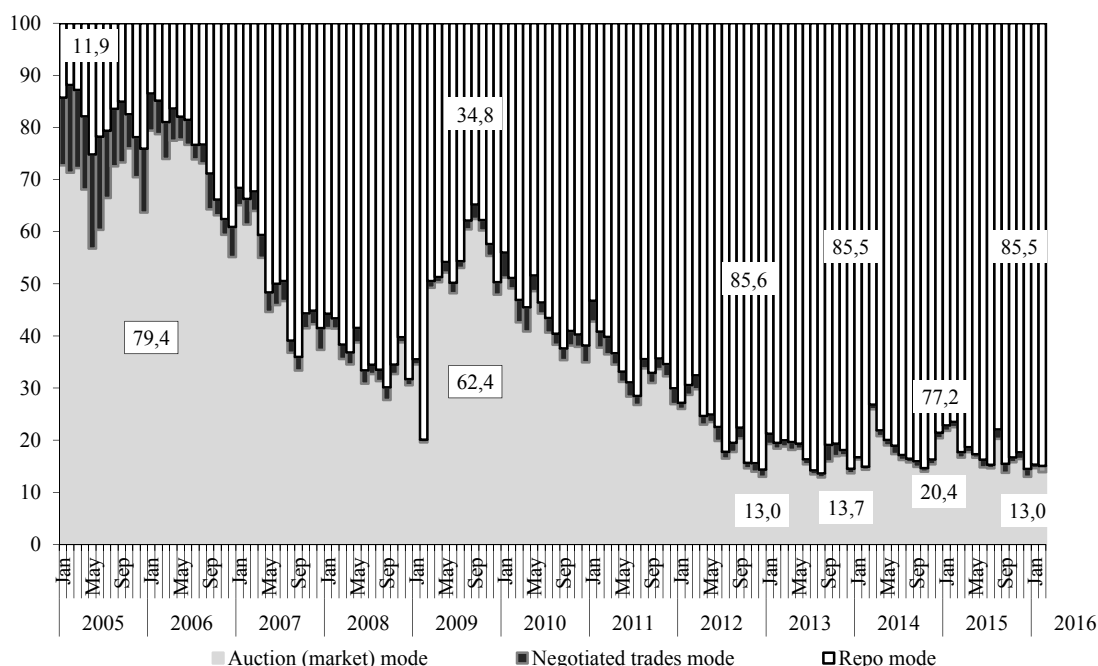
*Source:* own calculations based on data released by Russian exchanges.

The relative index of market transactions with shares issued by Russian companies on the Moscow Exchange in February 2016 was 13.0% compared to 20.4% in 2014. That of repo transactions, on the contrary, rose from 77.2% to 85.5% over the same period (*Fig. 24*). At the same time, as seen from *Fig. 25*, since 2012 the volume of equity market transactions on the exchange in absolute terms has been on the decline, while the ruble-denominated repo turnover has been displaying an upward trend. Such disproportions in the structure of the exchange market for shares are fraught with increased risks for its financial sustainability and proper protection of the rights of private investors. Due to the continuing (for several years in a row) decline of trading activity in the segment of equity market transactions, the equity pricing mechanism has become less effective and less representative, given the higher discounts applied to the fundamental indices coupled with low market liquidity.

The accelerated growth of trades turnover in the money market, which is indicative of the scope of the use of financial levers (borrowed funds) in equity deals on the exchange, points to the fact that even while equity market transactions are on the decline, the volume of borrowed funds attracted by the participants in this market segment is constantly on the rise. Besides, according to our estimations, growth in the equities repo market is indirectly indicative of the increasingly widespread reliance on grey schemes of marginal lending by brokers to their clients, because the bulk of such transactions in the market is represented by money loans issued by big banks to offshore broker companies, which in their turn act as ‘marginal creditors’ of the clients of broker companies, their purpose being to bypass the ‘lending shoulder’ constraints established for the marginal transactions carried on by brokers’ clients.

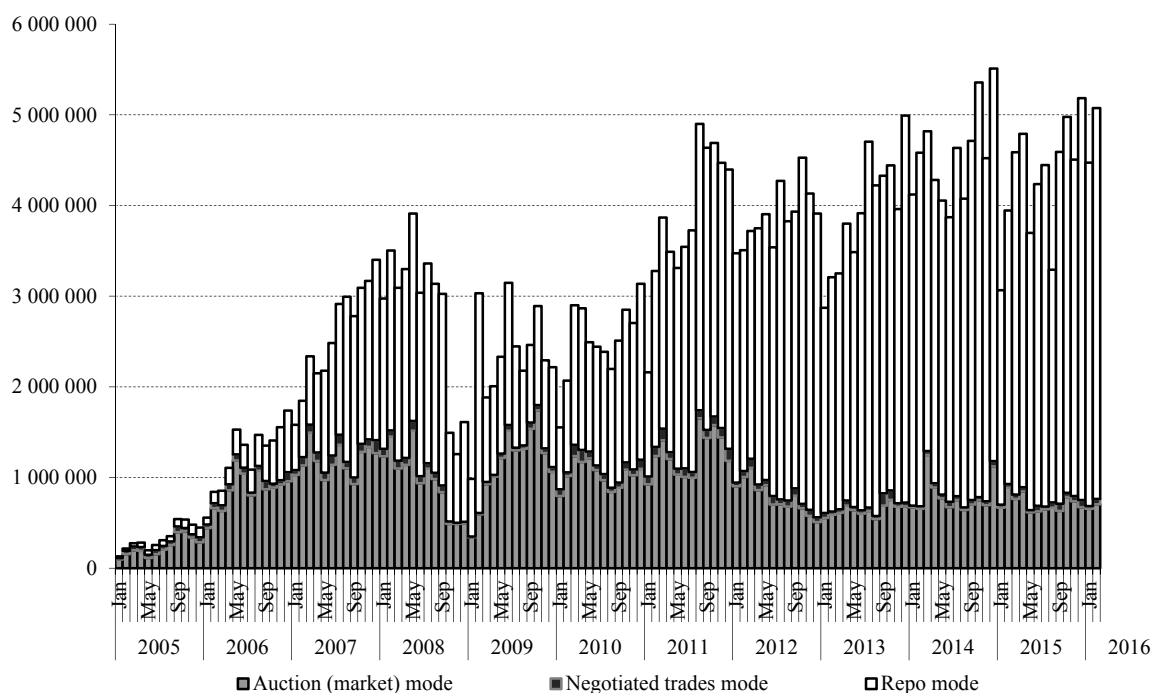
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<sup>1</sup> Trades in the Classica section were officially discontinued from August 3, 2015.



*Fig. 24. The structure of trades in shares on the Moscow Exchange's Main Market from January 2005 through February 2016, %*

Source: own calculations based on data released by the Moscow Exchange.



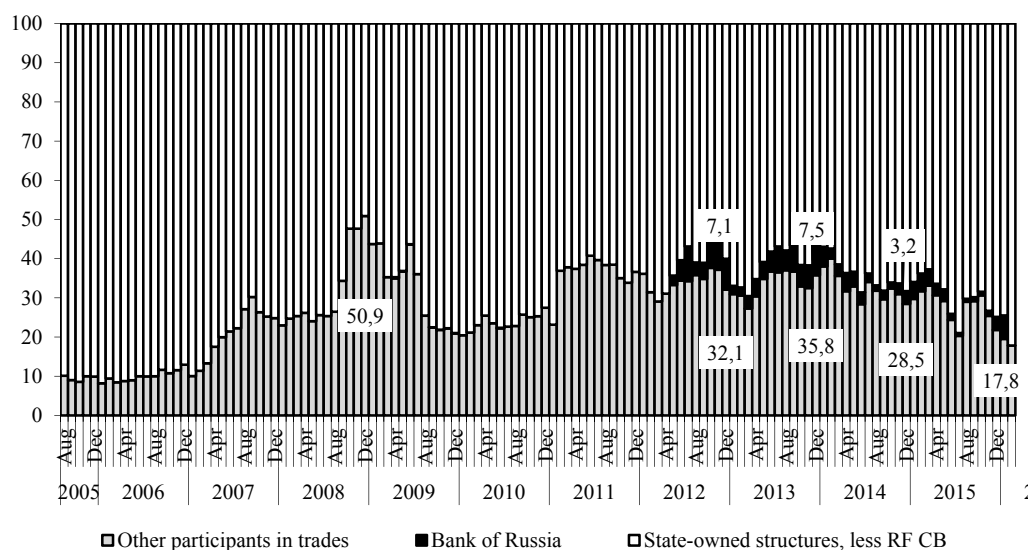
*Fig. 25. The volume of trades in shares on the Moscow Exchange's Main Market from January 2005 through February 2016, m Rb*

Source: own calculations based on data released by the Moscow Exchange.

Thus, the key issue that should be addressed by the exchange, in our opinion, is the need to find more ways to boost growth in the equity market transactions. One of the key solutions could be the development of alternative pension plans, collective investment schemes, individual investment accounts and other forms of money saving for private investors.

### 3.3.3. The institutional structure of and competition in the market for shares

In 2015 and early 2016, we could observe a downward trend in the activity of state-owned companies and the Bank of Russia in the main market for equities transactions on the Moscow Exchange. In February 2016, the participation of state-owned structures in the overall trading volume shrank to 17.8% compared to 28.5% in December 2014 (*Fig. 26*). From February 2016 onwards, the Bank of Russia took equities off its Lombard list, and so discontinued its equities transactions on the exchange. The shrinkage of the role of state-owned structures on the Moscow Exchange's equity market could largely be explained by the Bank of Russia's policy aimed at reducing the scale of its repo operations as the principal mechanism of refinancing the banking system. The upshot of this measure was that banks discontinued their transactions with the RF Central Bank in the equity market, and probably the volume of inter-dealer repos (which had been used by big banks for channeling liquidity to smaller market participants) was likewise reduced.



*Fig. 26.* The participation of private and state-owned broker companies in equity trades on the Moscow Exchange over the period from August 2005 through February 2016, %

*Source:* own calculations based on data released by the Moscow Exchange.

*Fig. 27* demonstrates the movement of the Herfindahl–Hirschman Index, or HHI,<sup>1</sup> on the Moscow Exchange, by market segment, from January 2005 through January 2015. As estimated

<sup>1</sup> The market concentration Herfindahl–Hirschman Index (HHI) is defined as the sum of squares of the volumes of participation of each participant in trading on an exchange:  $HHI = (D_1)^2 + (D_2)^2 + \dots + (D_m)^2$ , where  $D_i$  is the per cent market share of  $i^{\text{th}}$  participant;  $i = 1, 2, \dots, m$ .

by the Federal Antimonopoly Service of the Russian Federation, the market has a low concentration if HHI is below 800; moderate concentration if  $800 < HHI < 1800$ ; and high concentration if HHI is above 1,800.<sup>1</sup> In 2015 and the first few months of 2016, the HHI for the transactions on the Moscow Exchange’s main equity market remained stable at a level of approximately 500, which means that this market segment was low-concentrated.

From August 2015, the Moscow Exchange no longer discloses its by-category data on trades in bonds, making public only the generalized information on bonds turnover. As shown by the HHI curve describing its behavior in the market for bonds, from H2 2015 it has mostly stayed below 800. This is an indicator of an improving competitive environment in the Moscow Exchange's bonds market. This trend could have emerged due to the shrinkage of refinancing in the banking system, which in its turn suppresses the activity of the traditional big players in the repo market.

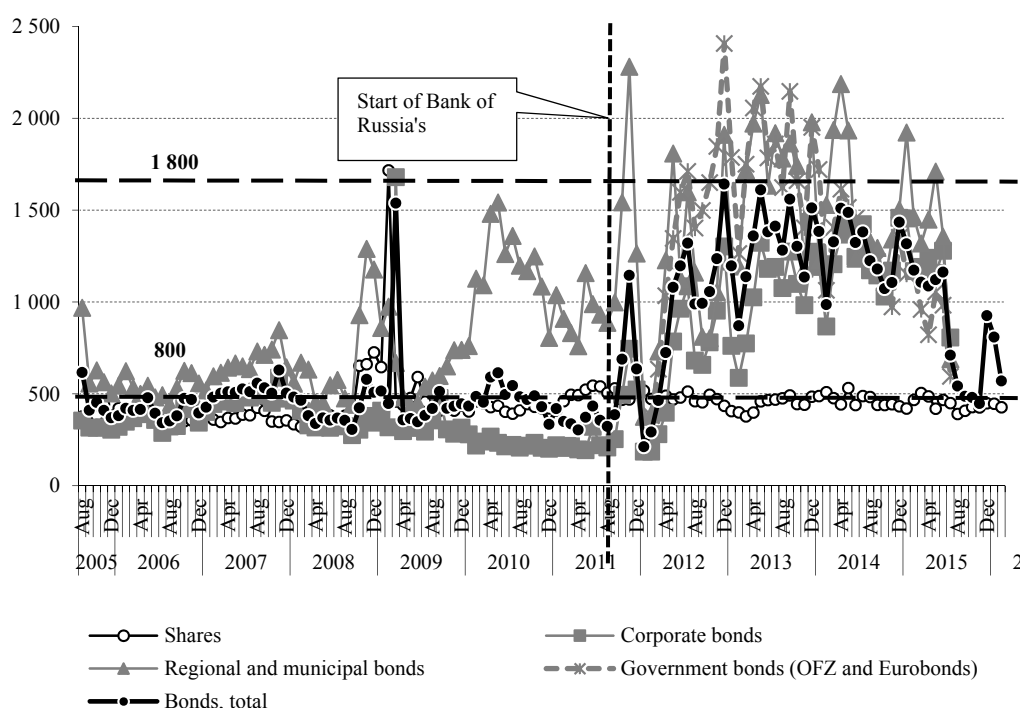


Fig. 27. The Herfindahl–Hirschman index, based on secondary trades volume in the MICEX-RTS’s Main Market (all trade modes)

Source: own calculations based on data released by the Moscow Exchange.

### 3.3.4. The impact of the market for shares on the national economy

The main channels whereby the market for shares conveys its impact on economic growth is through primary placements of securities by companies as a way of attracting investment resources, as well as through merger and takeover deals. As follows from *Table 11*, the biggest public offers of shares took place in 2006 and 2007, when the volume of attracted resources

<sup>1</sup> See section 2.6.4 of the Methodological recommendations for the procedure of analysis and evaluation of the competitive environment on the financial services market, approved by Order of the RF Ministry for Antimonopoly Policy as of March 31, 2003, No 86.



amounted to \$17.0bn and \$33.0bn respectively. In 2015, as an upshot of the generally unfavorable economic and geopolitical situation, the total volume of IPO-SPOs undertaken by Russian companies amounted to only \$0.6bn compared to \$1.7bn in 2014. In 2015, the amount of investment in fixed assets out of the total value of attracted capital over the year's first 9 months was \$0.9bn. In terms of capital volume, IPO-SPO transactions traditionally fall behind merger and takeover deals, which in 2015 generated \$51bn compared to \$71bn a year earlier. Thus, in spite of the overall decline both in the number of public offers of shares and mergers and takeover deals, it can be concluded that the companies operating in the domestic stock market were increasingly orienting towards the merger-and-takeover strategies, rather than towards natural growth.

*Table 11*

**The parameters of market for shares in Russian companies  
(bn USD)**

	Capitalization	Secondary market, including on foreign exchanges	IPO	Investment in fixed assets of capital generated by IPOs			Volume of merger and takeover deals
				Bn USD	as % of capi- talization	as % of IPO volume	
2000	41	47	0.5	0.2	0.5	40.0	5
2001	75	49	0.2	0.1	0.1	50.0	12
2002	106	87	1.3	0.2	0.2	15.4	18
2003	176	188	0.6	0.2	0.1	33.3	32
2004	230	541	3	0.1	0.0	3.3	27
2005	549	374	5.2	3.2	0.6	61.5	60
2006	1,057	914	17	3.2	0.3	18.8	62
2007	1,503	1,687	33	3.6	0.2	10.9	126
2008	397	1,983	1.9	2.1	0.5	110.5*	110
2009	861	1,156	1.7	2.0	0.2	117.6*	56
2010	1,379	1,431	6.3	2.4	0.2	37.9	56
2011	1,096	2,222	11.3	2.6	0.2	23.1	79
2012	1,079	1,931	9.5	3.1	0.3	32.6	135
2013	1,041	1,801	9.0	3.1	0.3	34.4	163
2014	517	1,739	1.7	3.1	0.6	182.0*	71.1
2015	461	996	0.6	0.9	0.2	150.0*	51.5

\* - the value is above 100% because part of capital invested in fixed assets could be generated by way of private offering of shares.

Source: own calculations based on data released by the Moscow Exchange; cBonds; the Bank of Russia; Rosstat.

The volume of funding generated by companies through their market offers of shares and corporate bonds and invested in fixed assets accounts for only a fraction of their total investment in fixed assets. This assumption is confirmed by data in Fig. 28. The aggregate value volume of issued shares and bonds in the overall structure of investment in fixed assets is about 2%. The percentage of new offers of shares in that structure shrank from 1.1% in 2014 to 0.5% in 2015. At the same time, the percentage of new bond issues as a source of investment increased over the same period from 0.1% to 1.6%.

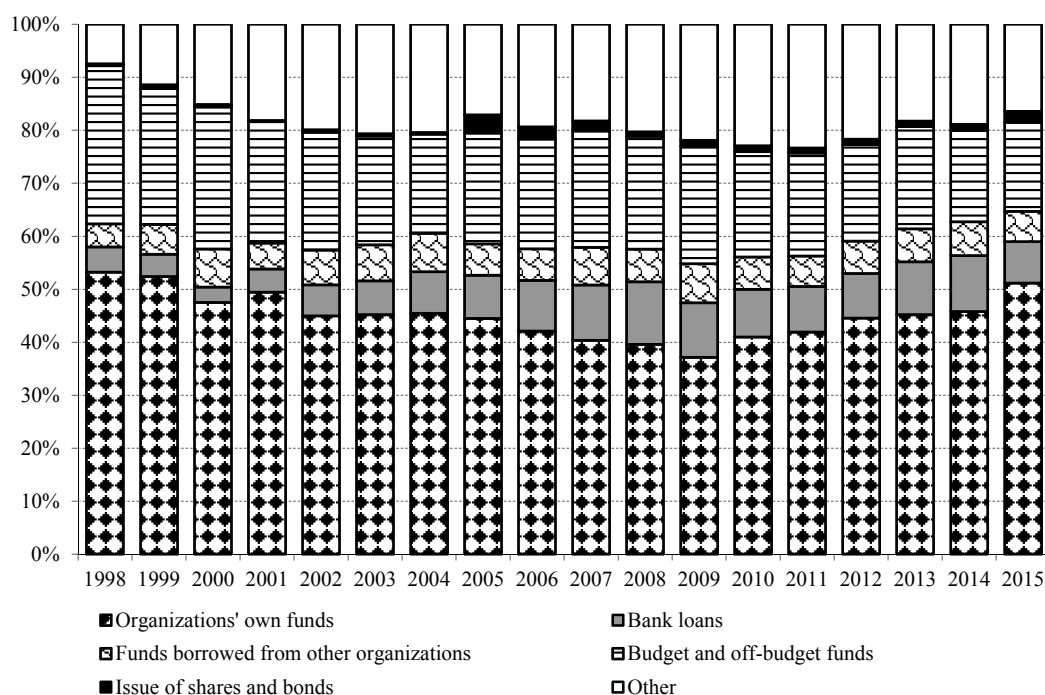


Fig. 28. The structure of sources for investment in fixed assets

Source: own calculations based on data released by Rosstat.

### 3.4. The bond market<sup>1</sup>

#### 3.4.1. General features of Russia's domestic bond market

In 2015, Russia's bond market continued to grow, in part setting off the increased demand for monetary resources displayed by issuers of securities after the introduction of foreign sanctions. The capitalization index of the market for ruble-denominated corporate bonds rose from Rb 6.6 trillion in 2014 to Rb 8.1 trillion on 2015, or by 20.8% (Fig. 29). The value volume of regional bonds over the same period increased from Rb 0.5 trillion to Rb 0.6 trillion, or by 8.3%, while the value volume of government securities remained practically unchanged, amounting in 2015 to Rb 5.6 trillion.

At the same time, in 2015, the value volume of domestic bond issues increased only with regard to corporate bonds, while the same index for the government and regional debt market declined (Fig. 30). The value volume of corporate bond issued in 2015 amounted to Rb 1,765bn compared to Rb 1,748bn in 2014, i.e. its total growth was 1.0%. The volume of government bond issues placed over the same period shrank from Rb 1,349bn to Rb 836bn Rb, or by 38.0%; that of regional bond issues – from Rb 111bn to Rb 100 bn, or by 9.9%.

<sup>1</sup> Author of this section: Abramov A. – RANEPA.

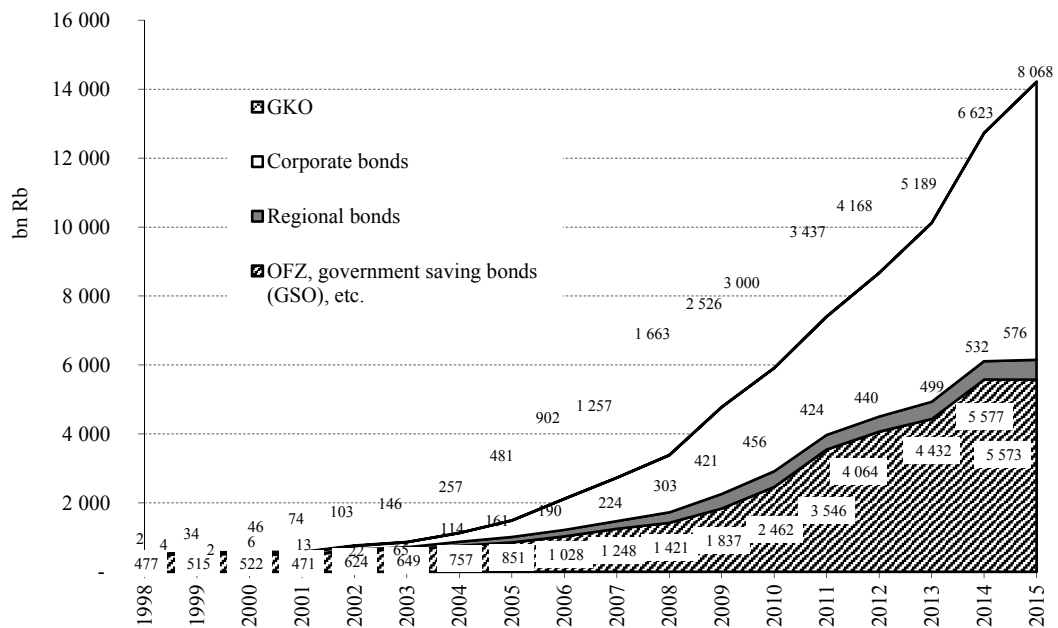


Fig. 29. The volume of ruble-denominated bonds in circulation, bn Rb

Source: own calculations based on data released by the RF Ministry of Finance and Cbonds.ru.

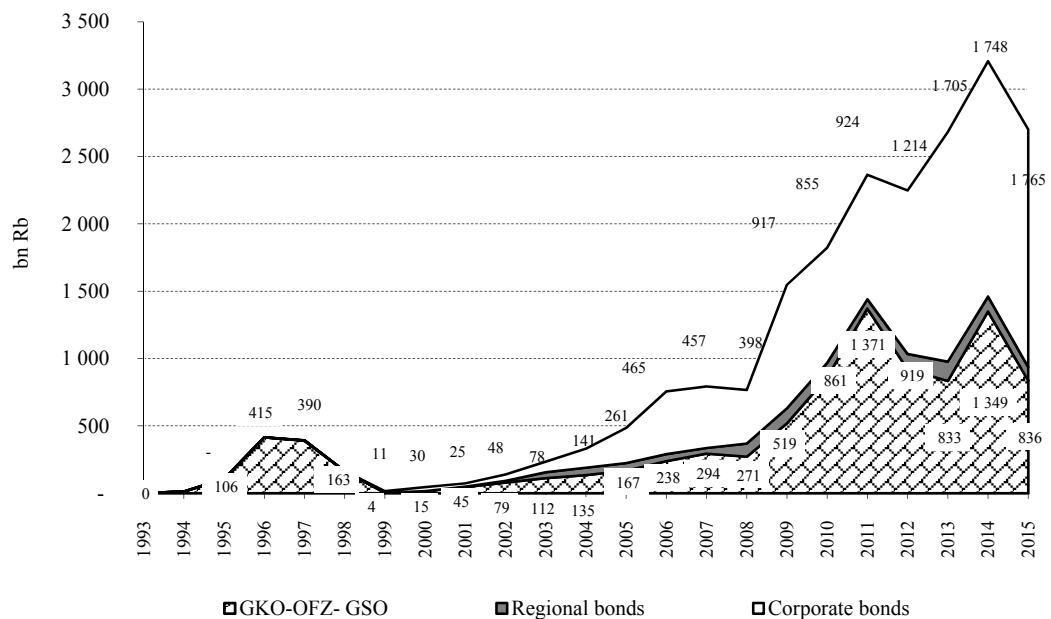


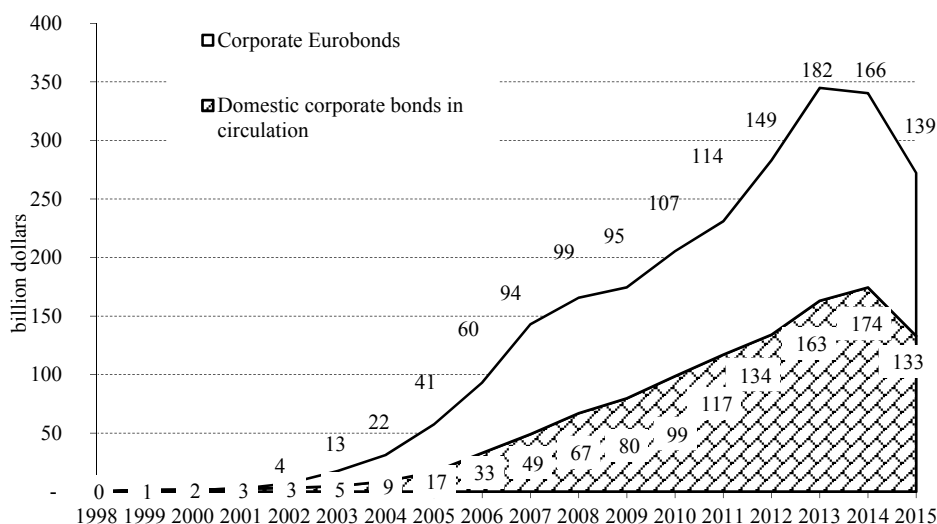
Fig. 30. The value volume of ruble-denominated bond issues placed in 1993–2014

Source: Moscow Exchange; Cbonds.

In 2015, the USD-to-ruble exchange rate jumped from Rb 56.26 to Rb 72.88. This was the factor that significantly influenced the estimated value of debt instruments issued by Russian companies (Fig. 31). Thus, for example, in response to the introduction of sectoral sanctions, the liabilities of Russian issuers of Eurobonds shrank from \$166bn in 2014 to \$139bn in 2015.

This happened because Russian companies, whose access to global lending markets had been restricted, redeemed part of their Eurobond debt.

At the same time, the shrinkage of the aggregate value of domestic corporate bonds in dollar terms from \$174bn in 2014 to \$133bn in 2015 was caused not by debt redemption, but by the revaluation of their bonds. As a result, the total debt owed by issuers of securities was reduced by approximately \$40bn, while part of investment in ruble-denominated corporate bonds had lost its value in foreign-currency terms for their holders (banks, pension funds, unit investment funds, insurance companies, etc.).



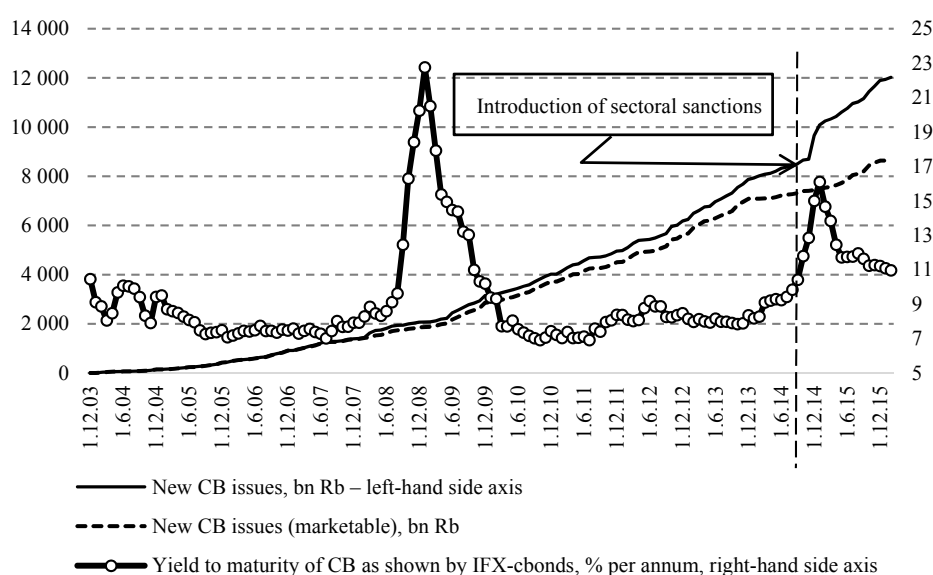
*Fig. 31.* The volume of Russian corporate bonds in circulation, bn USD

Source: own calculations based on data released by CBonds and the Moscow Exchange.

### 3.4.2. The growth factors of the market for corporate and regional bonds

The negative factors that influenced growth of the domestic corporate bond market in 2015 were the persistently high key interest rate and the instable exchange of the ruble against major world currencies in face of the plummeting oil prices. The raise, in December 2014, of the key rate to 17% pushed up the yields on the corporate bond market; in January 2015, the average yield to maturity of IFX-Bonds rose to 16.0% per annum (*Fig. 32*). However, as the key rate was reduced towards early June 2015, the yield to maturity of bonds dropped to 11.7%.

The reduction of the key rate, coupled with the restricted access to foreign financial markets, resulted in 2015 in an increased market offer of corporate bond issues. In 2014, the share of marketable bond issues in the total volume of issued bonds amounted to only 20.1% compared to 53.3% in 2013. In 2015, this index rose to 87.3%. The growth of marketable bond issues in 2015 was boosted in the main by the investment of Rb 550bn by private pension funds, funded by the monies received by them from the RF Pension Fund after the freeze, in 2013, of its accumulated pension savings.



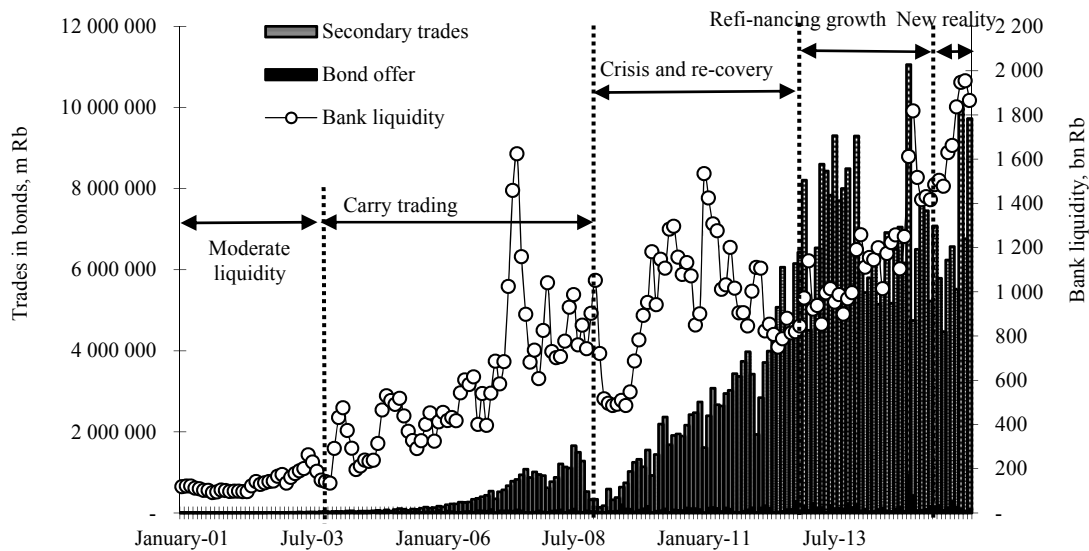
*Fig. 32.* The volume of corporate bond (CB) offer (accrued total) and their yield to maturity, as shown by IFX-cbonds behavior

*Source:* calculations based on data released by Cbonds.

The volume of the corporate bond market is strongly influenced by the banking system's liquidity index, which in its turn was influenced by varying factors over different periods of time. In the evolution of the corporate bond market, the following phases can be noted: moderate liquidity (January 2001 – July 2004); carry trading (August 2004 – March 2009); post-crisis recovery (April 2009 – December 2012); increasing volume of refinancing by the Bank of Russia (from 2013 through December 2014); the switchover to new forms of refinancing funded by the RF Ministry of Finance (*Fig. 33*).

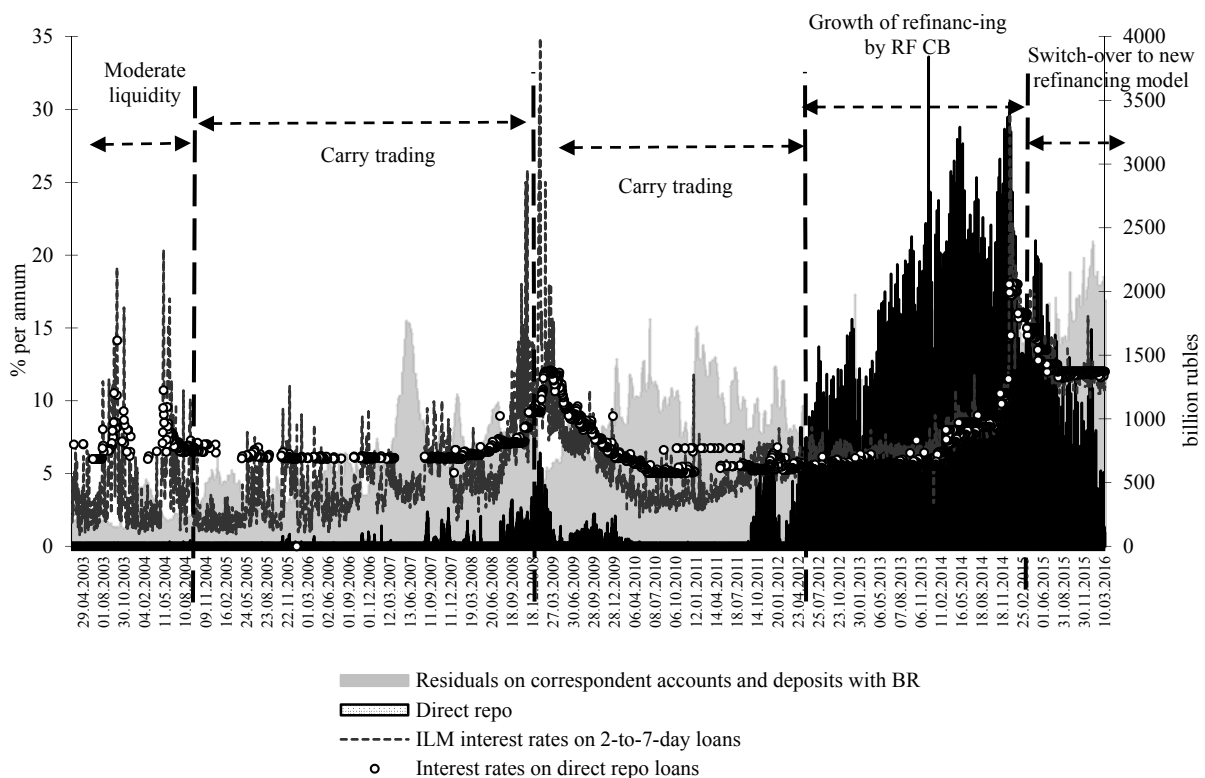
The switchover to a new refinancing model in 2015 did not result in shrinkage of liquidity in the form of bank's residuals on their correspondent accounts and deposits with the Bank of Russia. While in 2014 their average daily index amounted to Rb 1,209bn, in 2015 it rose to Rb 1,595bn. The availability of liquidity in the banking sector made it possible, in 2015, to sustain not only the volume of corporate bond offers, but also the secondary market turnover at their current levels (*Fig. 33*). At the same time, due to the high volatility of the ruble's exchange rate and the key rate, the volume proper of market transactions with bonds dropped to its record low, while the secondary market for debt securities existed primarily in the form of repo transactions with the Bank of Russia or in the interbank lending market (ILM).

As is evident from *Fig. 34*, the switchover to a new refinancing model in the banking system not only did not result in any liquidity shrinkage (bank liquidity being the main prerequisite of the bond market's sustainability), but was also accompanied by declining interest rates in the interbank lending market (ILM) as the key rate was moving downwards. So far we cannot say with assurance just how stable these changes are going to be - for example, if the RF Ministry of Finance refuses to use the Reserve Fund for covering budget deficit. However, from the point of view of the situation in the market for bonds, this process is likely to bring about a redistribution of the functions of the Bank of Russia as the principal supplier of liquidity to the banking system, which will then be taken over by big state-owned banks, in whose accounts the monies allocated to budget recipients will be accumulated.



*Fig. 33. Operations with corporate bonds and bank liquidity over the period from January 2001 through February 2016*

*Source:* own calculations based on data released by the Bank of Russia and the Moscow Exchange.

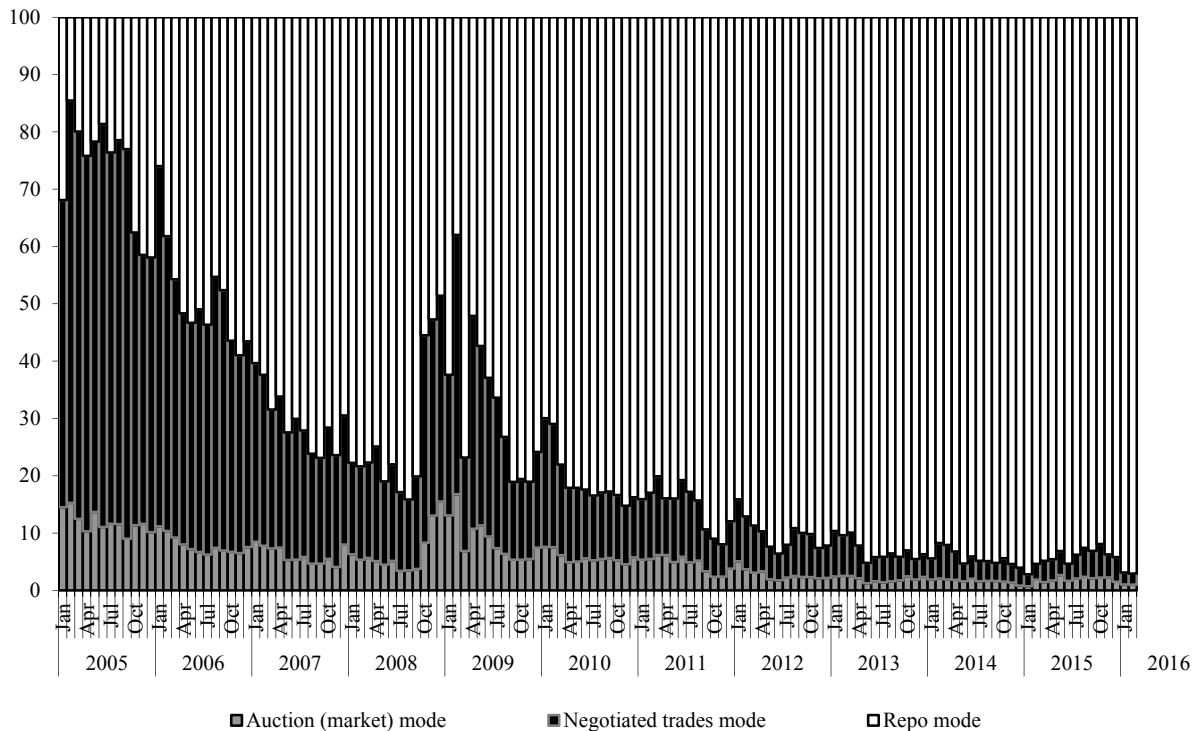


*Fig. 34. The use of direct repo mechanism in regulating banks' liquidity over the period from 2003 through March 2016*

*Source:* own calculations based on data released by the Bank of Russia.

### 3.4.3. The segmentation of the market for corporate and regional bonds

The fact that the market for corporate bonds is increasingly becoming a money market tool (the transformation that runs contrary to the essentially long-term nature of a corporate bond) is graphically illustrated by shifts in the structure of transactions with corporate bonds on the Moscow Exchange (*Fig. 35*). In February 2016, the share of repo transactions in the value volume of trades in corporate bonds hit its absolute record high of 97.1%. At the same time, only 1.0% of trades in corporate bonds were truly market transactions. Such an abrupt shrinkage of the relative share of market transactions significantly elevates the risks that the pricing of corporate bonds traded on the exchange will not be objective and realistic. Our 2014 study of the factors influencing the yield spreads of ruble-denominated corporate bonds demonstrates that fundamental factors like solvency of the issuers of securities, their financial performance indicators, and the liquidity of bond issues had no significant influence of the width of the yields.

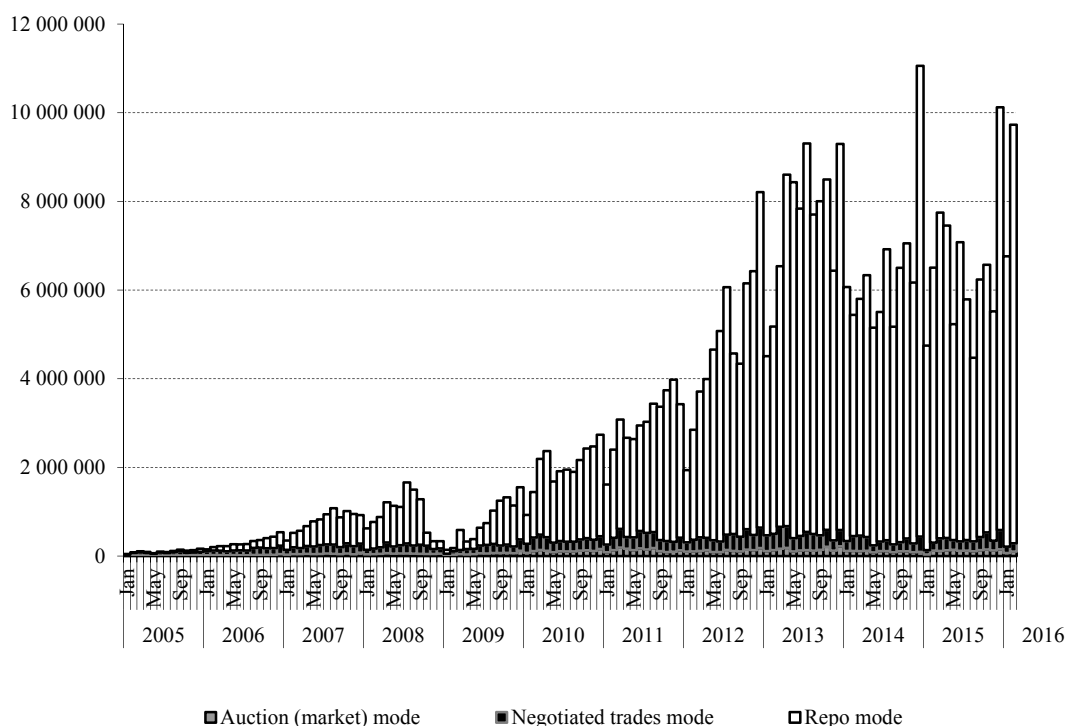


*Fig. 35.* The structure of trades in corporate bonds on the Moscow Exchange, %

*Source:* own calculations based on data released by the Moscow Exchange.

The value volume of trades in corporate bonds on the Moscow Exchange in 2015, which amounted to Rb 77.5 trillion, remained near its previous year's level of Rb 77.2 trillion. However, this value is significantly below the index for 2013 of Rb 90.3 trillion (*Fig. 36*). Meanwhile, the volume of neither market transactions nor negotiated trades in corporate bonds had increased in absolute terms since 2010, which can be explained by the limited base of domestic and foreign investors. This problem can be resolved if the President of the Russian Federation approves the initiative that the coupon payments received by domestic investors should be made

exempt from PIT and profits tax;<sup>1</sup> it is expected that amendments to this effect, which have been introduced into the RF Tax Code, will be approved in mid-2016.



*Fig. 36.* The value volume of trades in corporate bonds on the Moscow Exchange, m Rb

*Source:* own calculations based on data released by the Moscow Exchange.

Similar problems caused by the shrinking relative share market transactions were observed in the exchange market for regional bonds (*Fig. 37*). In February 2016, market transactions amounted to 5.1%, and repo transactions to 91.7% of the total trade volume compared to 1.2% and 90.2% respectively in 2014. In view of this proportional distribution of market and non-market transactions, the objectivity of the market valuation of regional bonds used as a pledge against repo loans issued by the Bank of Russia becomes doubtful as well.

The relative share of market transactions in the main market for regional bonds on the Moscow Exchange somewhat increased in 2015 not because of a higher trading activity of the participants in that segment, but due to the sharp plunge of the volume of repo transactions with regional bonds (*Fig. 38*). The total volume of exchange trades in regional bonds shrank from Rb 7.5 trillion in 2014 to Rb 2.8 trillion in 2015, or 2.7 times; simultaneously, over the same period, the volume of repo transactions shrank from Rb 7.1 trillion to Rb 2.3 trillion, or 3.1 times. The main cause of these dramatic changes in the parameters of trades in regional bonds was the less frequent use of these securities as a pledge against loans issued to financial market participants.

<sup>1</sup> Interfax, December 3, 2015; see <http://www.interfax.ru/business/482987>.



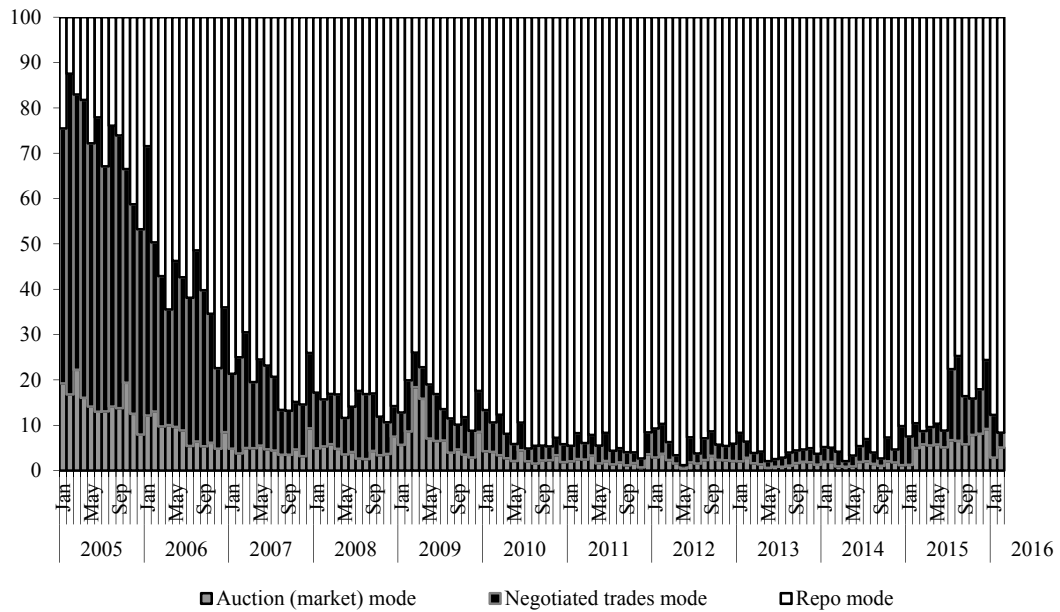


Fig. 37. The structure of trades in regional bonds on the Moscow Exchange, %

Source: own calculations based on data released by the Moscow Exchange.

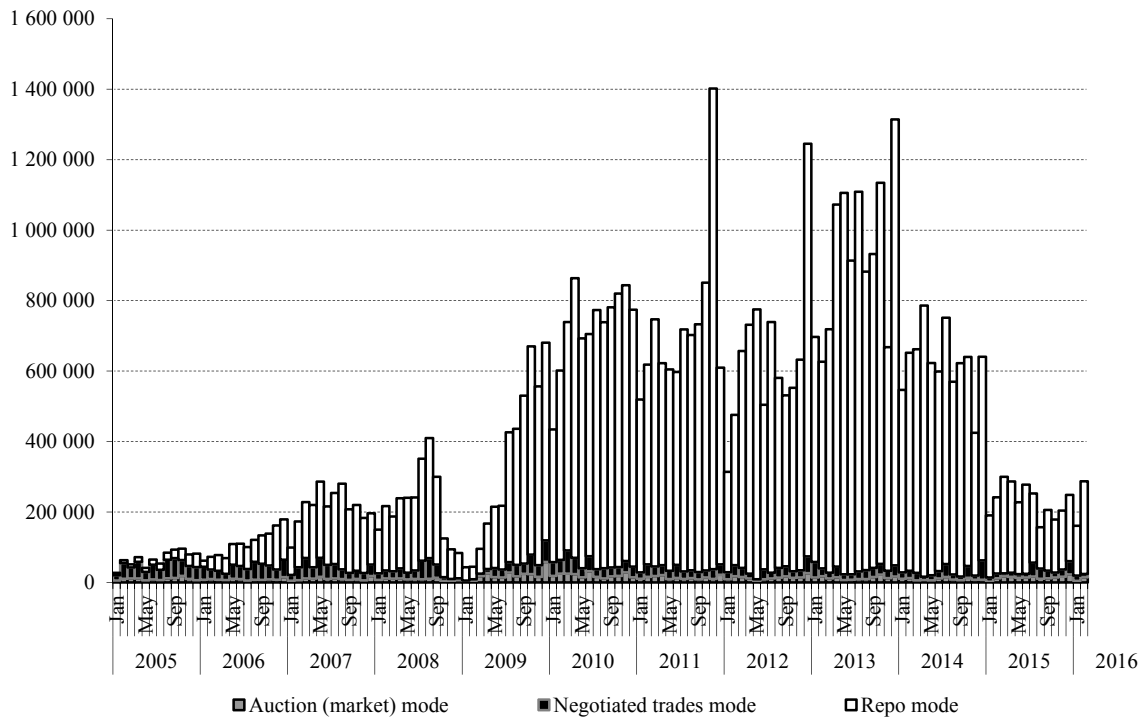


Fig. 38. The value volume of trades in regional bonds on the Moscow Exchange, m Rb

Source: own calculations based on data released by the Moscow Exchange.

3.4.4. Competition in the bond market

Fig. 39 analyzes the relative participation rates of different groups of trading participants (private and state-owned financial institutions,<sup>1</sup> the Bank of Russia) in the total volume of exchange trades in bonds in all trade modes on the Moscow Exchange, including market transactions, negotiated trades and repo operations.<sup>2</sup> In February 2016, the participation of state-owned structures and the Bank of Russia in transactions with bonds amounted to 25.4% and 25.0% respectively compared to 21.9% and 34.5% respectively in December 2014. The significantly reduced scale of the Bank of Russia's direct participation in trades in bonds reflects the change in the mechanism of refinancing the banking system that had taken place beginning from 2015, namely the decline in the volume of lending in the form of direct repo. The somewhat increased participation of state-owned structures in the total volume of transactions with bonds points to their more prominent role, and first of all the role of suppliers of liquidity to the banking system in the repo market. However, this function is also performed by a number of big private banks where major recipients of budget funding hold their accounts.

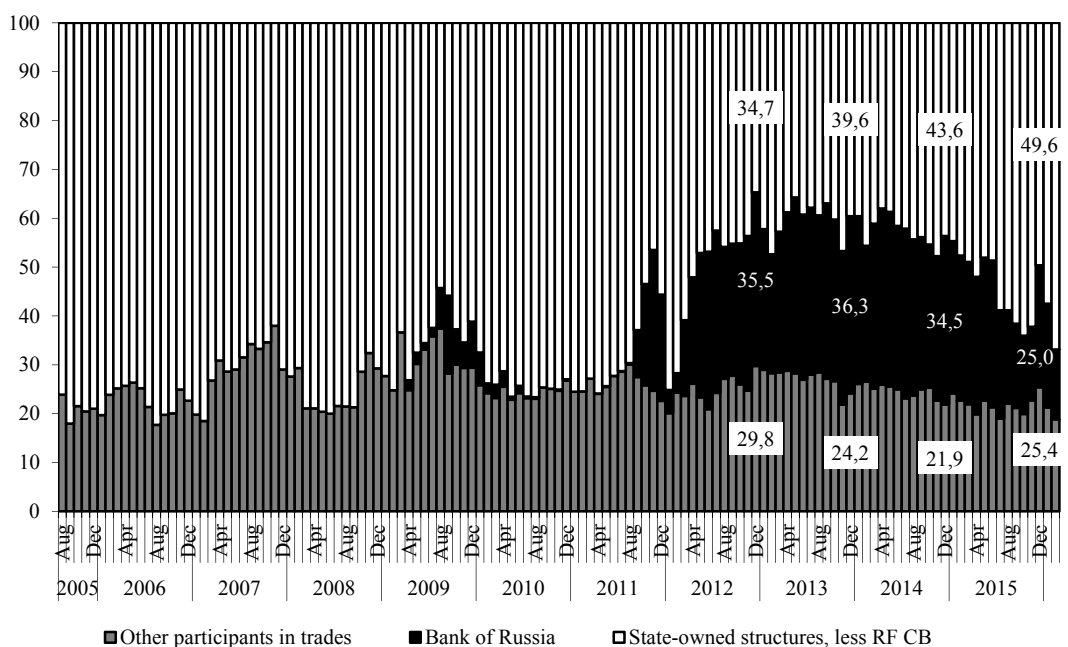


Fig. 39. The participation of private and state-owned broker companies in trades in bonds on the Moscow Exchange, %

Source: own calculations based on data released by the Moscow Exchange.

Based on a variety of data on the concentration of corporate bond issues (presented in Table 12), it can be said that over the period 2014 to 2015, the concentration rate of bond issues placed by biggest issuers of securities, including state-owned companies, was on the decline. Thus, for example, in 2015 the relative share taken up by 10 issuers of largest corporate bond issues amounted to 44.4% compared to 60.4% in 2014. Of these, the share taken up by state-owned companies in the total volume of corporate bond issues shrank from 53.7 in 2014 to

<sup>1</sup> For a list of state-owned structures, see note to Fig. 19.

<sup>2</sup> Including corporate, regional and government bonds. From August 2015 onwards, the Moscow Exchange no longer discloses its monthly by-category trades volume data for bonds.

41.1% in 2015. The lower concentration rate of the market for corporate bonds and the smaller share of big state-owned companies in 2015 can be explained by the presence of two factors. On the one hand, due to the inflow of approximately Rb 550bn of additional resources from private pension funds, the share of marketable issues of bonds surged, including that of issues placed by private companies and banks. On the other hand, the reported data, for 2014, on the concentration rate of issues of corporate bonds and the relative share of state-owned structures turned out to be overestimated due to the anomalously high volume of the non-marketable bond issues to the value of Rb 625bn placed by Rosneft OJSC.

However, on the whole the concentration rate of corporate bond issues has remained high. In 2015, the 24 biggest issuers of securities accounted for 61.5% of the total value volume of issued corporate bonds, including state-owned companies (46.4%). So, this market continues to function as a mechanism for redistributing financial resources in favor of big state-owned structures.

*Table 12*

**The concentration rate of ruble-denominated corporate bond issues  
in 2009–2015**

	Top 5 issuers of securities		Top 10 issuers of securities		Top 24 issuers of securities		Market, total
	Total	including state-owned ones	Total	including state-owned ones	Total	including state-owned ones	
<b>2009</b>							
bn Rb	440	390	610	441	803	513	917
Market share, %	48.1	42.5	66.8	48.1	87.8	55.9	100.0
<b>2010</b>							
bn Rb	177	147	304	200	513	317	855
Market share, %	20.6	17.2	35.4	23.4	59.9	37.1	100.0
<b>2011</b>							
bn Rb	241	191	389	309	642	405	1089
Market share, %	22.0	17.5	35.7	28.4	58.9	37.2	100.0
<b>2012</b>							
bn Rb	265	265	429	334	690	443	1199
Market share, %	22.1	22.1	35.7	27.9	57.8	36.9	100.0
<b>2013</b>							
bn Rb	550	550	705	640	1035	830	1741
Market share, %	31.6	31.6	40.5	36.8	59.4	47.7	100.0
<b>2014</b>							
bn Rb	875	827	1051	934	1334	1038	1739
Market share, %	50.3	47.6	60.4	53.7	76.7	59.7	100.0
<b>2015</b>							
bn Rb	683	683	861	788	1180	891	1919
Market share, %	35.6	35.6	44.9	41.1	61.5	46.4	100.0

*Source:* own calculations based on data released at [www.Cbonds.ru](http://www.Cbonds.ru), [www.rusbonds.ru](http://www.rusbonds.ru) and by the Moscow Exchange.

With each passing year, the corporate bond market is getting increasingly involved in servicing the cash flows between state-owned structures. State-owned companies borrow money from state-owned structures. The secondary market is also sustained in the main by state-owned banks and the Bank of Russia. Moreover, state-owned investment banks also act as underwriters and investment consultants when corporate bond issues are placed on the market (*Table 13*). In 2009–2015, the participation of state-owned banks in the market for underwriting services was stably at the level of 50–60% for corporate bond issues, and 50–80% for regional bond issues.

Table 13

**The participation of state-owned and private financial institutions in the market for services of organizers of domestic bonds issue offers in Russia**

	Organizers of trade:					
	corporate bonds			regional bonds		
	State-owned financial institutions	Private financial institutions	Total	State-owned financial institutions	Private financial institutions	Total
<b>2007</b>						
m Rb	169,668	298,302	467,970	7,551	45,481	53,032
Share, %	36.3	63.7	100.0	14.2	85.8	100.0
<b>2008</b>						
m Rb	219,892	249,900	469,792	42,227	29,716	71,943
Share, %	46.8	53.2	100.0	58.7	41.3	100.0
<b>2009</b>						
m Rb	620,044	373,978	994,022	133,325	22,511	155,836
Share, %	62.4	37.6	100.0	85.6	14.4	100.0
<b>2010</b>						
m Rb	393,743	461,292	855,035	86,613	28,288	114,901
Share, %	46.0	54.0	100.0	75.4	24.6	100.0
<b>2011</b>						
m Rb	620,698	374,146	994,844	7,767	46,177	53,944
Share, %	62.4	37.6	100.0	14.4	85.6	100.0
<b>2012</b>						
m Rb	734,697	502,831	1,237,528	61,925	57,637	119,562
Share, %	59.4	40.6	100.0	51.8	48.2	100.0
<b>2013</b>						
m Rb	1,033,849	686,894	1,720,743	79,980	74,259	154,239
Share, %	60.1	39.9	100.0	51.9	48.1	100.0
<b>2014</b>						
m Rb	621,007	548,729	1,169,736	81,283	29,705	110,988
Share, %	53.1	46.9	100.0	73.2	26.8	100.0
<b>2015</b>						
m Rb	840,664	644,626	1,485,290	57,380	41,075	98,455
Share, %	56.6	43.4	100.0	58.3	41.7	100.0

Source: rankings by organizers of trade in bonds, data for the period 2007 to 2015 released at [www.Cbonds.ru](http://www.Cbonds.ru).

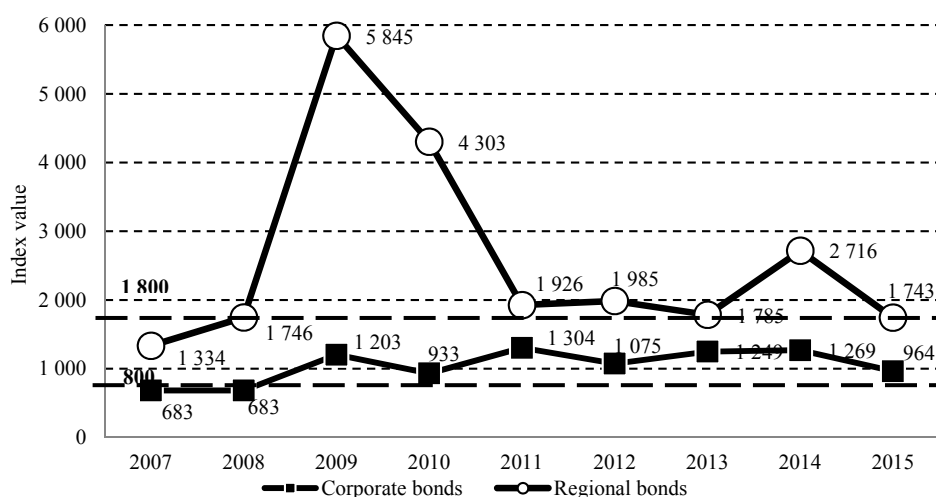


Fig. 40. The Herfindahl-Hirschman index, based on data on trade organization services for ruble-denominated corporate and regional bonds in 2007–2015

Source: rankings by organizers of trade in bonds, data for the period 2007 to 2015 released at [www.Cbonds.ru](http://www.Cbonds.ru).

The low competition rate in the markets for underwriting and consulting services associated with offers of corporate and regional bonds is confirmed by the movement of the Herfindahl–Hirschman index (*Fig. 40*). From 2009 onwards, the market for investment and banking services rendered in the corporate bond market began to transform from a highly competitive into a moderately concentrated one, when the monthly HHI moved within the interval between 800 and 1,800. In 2015, the HHI in the segment of services for corporate bonds amounted to 964. From 2011, the market of services for issues of regional bonds was balancing between moderately and highly concentrated zones. In 2015, when the HHI rose to 1,743, it shifted into the category of markets with a moderate concentration rate.

### 3.4.5. Corporate bonds and economic growth

An important criterion of the corporate bond market's performance is its ability to attract investments in the assets of companies operating in the real sector and banking structures. The information on how the resources attracted by Russian companies through bond offers are used by them to ensure growth of their fixed assets is released by *Rosstat* on the basis of surveys of companies-issuers of securities. *Rosstat's* data demonstrate that, over the period 2000 to 2015, only a small fraction of resources generated by corporate bond issues was actually invested in fixed assets.

In 2014, out of the total annual value volume of bond offers, which amounted to \$46bn, only \$ 0.2bn, or 0.4% was invested in fixed assets; in 2015, out of \$ 26bn of attracted resources, only \$ 2.6bn, or 10% was invested in fixed assets (*Table 14*). The statistics point to the fact that the market for corporate bonds has no noticeable effect either on investment in fixed assets or on the rate of economic growth. Evidently, corporate bonds issues, which are funded by the money market, are *de-facto* the sources of short-term finance, and so companies prefer to use the income generated by bond placement for replenishing their current assets and refinancing their old debt. All these facts point to the need for some alternative forms of refinancing of the banking system by the Bank of Russia, which should rely on a mechanism that will really be capable of making it truly worthwhile for banks to invest in long-run projects in the real sector of the economy, so as to boost economic growth.

*Table 14*

**The parameters of market for ruble-denominated corporate bonds (bn USD)**

	Capitalization	Secondary market, including repo	offer	Investment in fixed assets generated by bond offer		
				bn USD	the same, as % of capitalization	the same, as % of placement volume
2000	2	0.2	1.1			
2001	3	1	0.8			
2002	3	2	2	0.1	3.0	6.7
2003	5	8	3	0.1	2.1	3.8
2004	9	15	5	0.1	1.1	2.0
2005	17	44	9	0.3	1.8	3.3
2006	33	135	17	0.1	0.3	0.6
2007	49	371	18	0.2	0.4	1.1
2008	67	457	16	0.2	0.3	1.2
2009	80	293	29	0.1	0.1	0.3
2010	99	757	28	0.03	0.03	0.1
2011	117	1,237	31	0.014	0.01	0.05
2012	134	1,866	39	0.14	0.1	0.4
2013	163	2,839	54	0.05	0.03	0.1
2014	174	2,032	46	0.2	0.1	0.4
2015	133	1,277	26	2.6	1.9	10.0

*Source:* own calculations based on data released by the Moscow Exchange, cBonds, the Bank of Russia, and *Rosstat*.

### 3.4.6. The market for government securities

In 2014–2015, the market for federal securities was faced with some troublesome developments. The introduction of international sanctions curtailed the opportunities for new foreign borrowings, while the increasing volatility of the domestic financial market suppressed the demand for ruble-denominated OFZ and pushed up the interest rates. After the freeze of the funded part of pension in 2014–2015, the domestic government debt market could no longer be fed by the inflow of pension savings. The access to the OFZ market granted to non-residents in February 2013, when *Euroclear* and *Clearstream* opened their accounts with the NSD, helped attract new financial resources from non-residents in conditions of restrictions imposed on purchases of RF government securities by EU and US investors, while at the same time increased the risk of a sudden outflow of non-residents' funds from OFZ (which, however, did not happen).

In 2015, the volume of issued OFZ declined from Rb 1,349bn in 2014 to Rb 836bn in 2015. In an attempt to make government securities more attractive to potential investors, in 2015, the RF Ministry of Finance launched an issue of OFZ bonds with a floating coupon tied to the RUONIA rate, as well as an OFZ-IN issue with a face value tied to the inflation rate and a moderate coupon rate. In response to the indexation of government bonds, the demand of domestic institutional investors for them surged, generating approximately Rb 150bn for the RF Ministry of Finance.

In the opinion of the Bank of Russia, the nominal holder accounts opened in early 2013 by foreign settlement and clearing institutions with the Russian central depository triggered a rising inflow of foreign investment into Russia's domestic government debt market. The available foreign investment base is sufficiently diversified and consists of market participants following a variety of investment strategies<sup>1</sup>. In 2013, the share of non-residents in the structure of OFZ holders rose to 24.9%. This sudden growth of the participation of non-residents in the OFZ market was unexpected, even for the RF Ministry of Finance. In accordance with the *Guidelines for the public debt management policy in the Russian Federation for 2013–2015* (p. 25), it was expected that this index would rise to only 10% in the medium term, and to 25% in the long-term perspective.

In face of the sanctions coupled with the expected downgrade of the Russian Federation's sovereign rating by the world's top three international rating agencies below the investment grade in late 2014, the risk of an outflow of non-residents' funds from OFZ surged. However, when the sovereign credit rating was downgraded to junk by S&P as of 25 January 2015 and by Moody's as of 20 February 2015, no large-scale sales of OFZ followed. The relative share of non-residents in the structure of OFZ holders shrank from 24.2% in December 2014 to 18.7% in January 2015, and this was the upshot of an increased OFZ offer due to the registration of non-marketable issues, rather than of RF government securities being sold out by foreign investors. However, later on the relative share of non-resident holders of OFZ increased once again - from 18.7% in January 2015 to 21.5% in January 2016 (*Fig. 41*).

In 2012–2015, thanks to the statistics released by the Moscow Exchange, the data on trades in government bonds in different modes became publicly available. Until then, in its financial market overviews, the Bank of Russia had been disclosing only information on the volume of market (auction) transactions and negotiated trades with OFZ. *Fig. 42* shows that the share of

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<sup>1</sup> *Central Bank of the Russian Federation. Overview of the money market, Q4 2014, p.22.*

repo transactions in the government bond market in December 2015 was 96.1%. Market transactions accounted for only about 1.1% of the total trading turnover. In this situation, the function of market transactions is not quite clear, and we cannot say just how accurately, on the basis of these data, we can glean objective information on the actual parameters of the market for OFZ and Eurobonds.

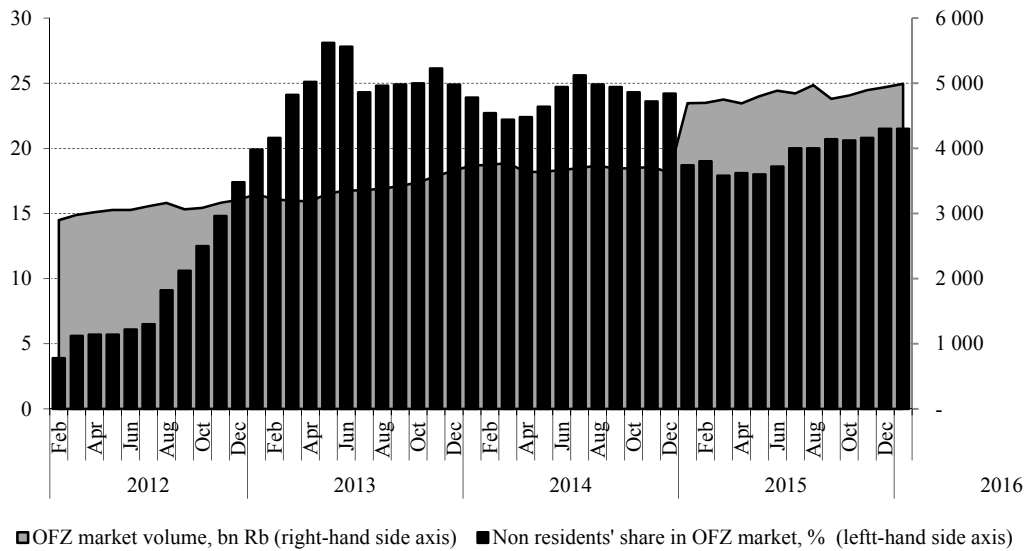


Fig. 41. The participation of non-residents in the OFZ market from February 2012 through January 2016

Source: data released by the Bank of Russia; own calculations based on data released by the Moscow Exchange.

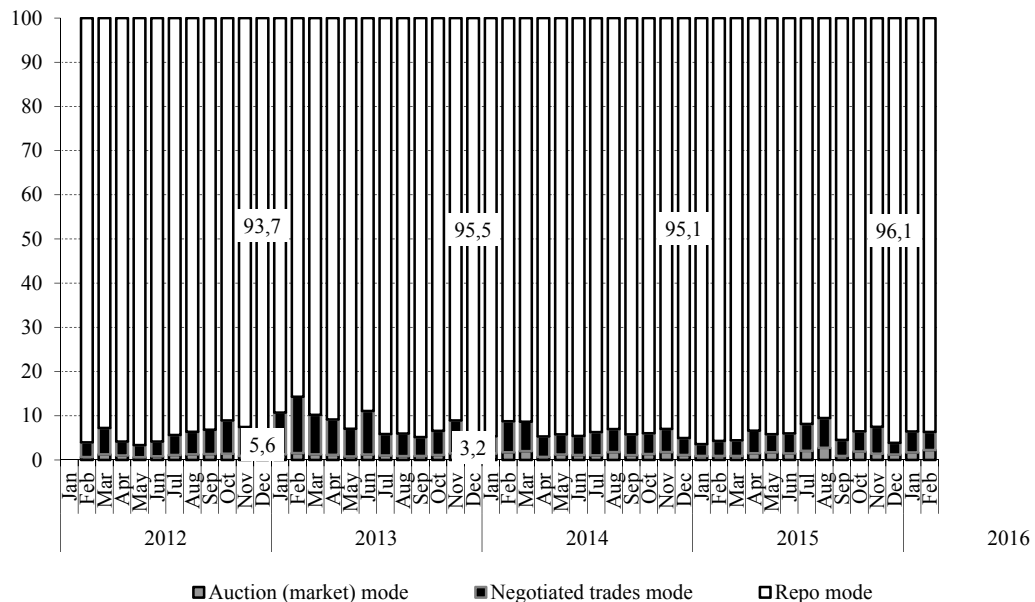


Fig. 42. The structure of transactions with federal bonds on the Moscow Exchange from February 2012 through February 2016, %

Source: own calculations based on data released by the Moscow Exchange.

The total volume of trades in RF government securities on the Moscow Exchange increased from Rb 62.6 trillion in 2014 to Rb 63.7 trillion in 2015, or by 2.0%. The volume of repo transactions over the same period increased from Rb 58.6 trillion to Rb 60.1 trillion, or by 3.0% (Fig. 43). Over 2015, the volume of market transactions rose to Rb 0.9 trillion compared to Rb 0.8 trillion in 2014, or by 8.0%. Nevertheless, when taken in absolute terms, growth of the volume of market transactions with RF government bonds has halted since 2012.

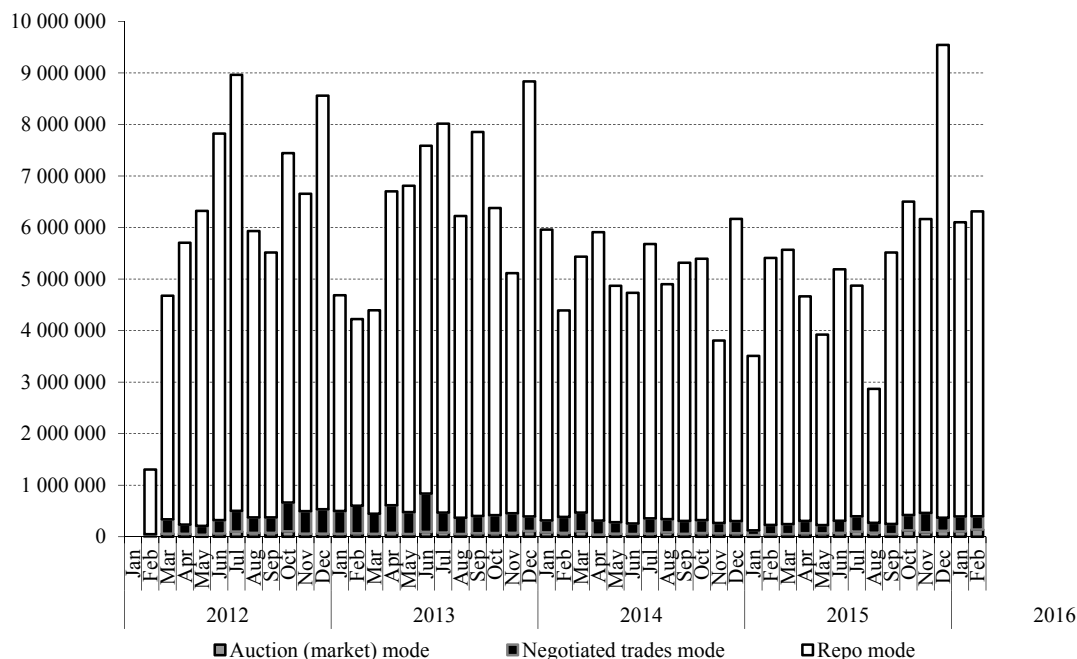


Fig. 43. The value volume of trades in federal bonds on the Moscow Exchange from February 2012 through February 2016, m Rb

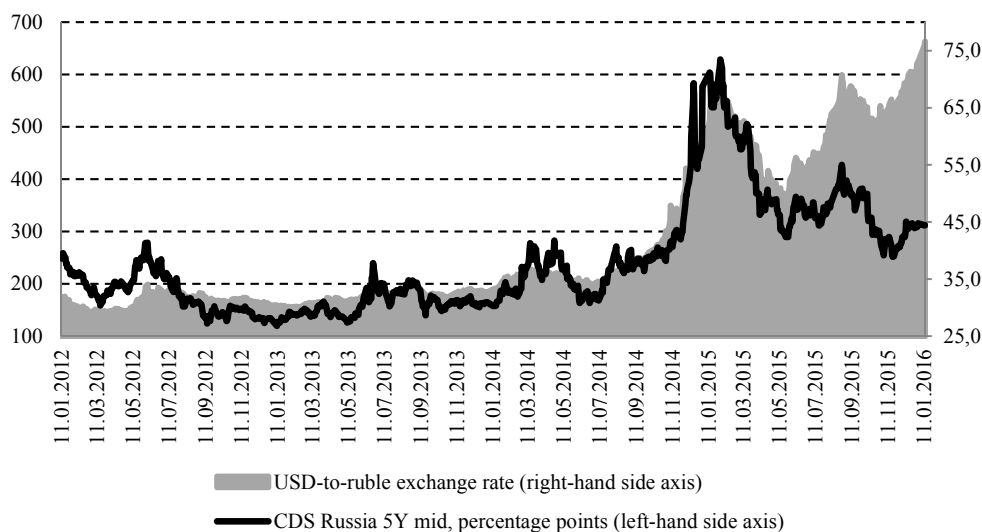
Source: own calculations based on data released by the Moscow Exchange.

By early 2014, against the backdrop of a short-run foreign exchange crisis and the key rate being raised to 17%, the conditions for government borrowing sharply deteriorated, as indicated by data shown in Fig. 44, where the behavior of the ruble's exchange rate is comparable with the upward movement of the value of credit default swaps (CDS)<sup>1</sup> involving RF sovereign bonds with 5-year maturity. Over the period from 11 July 2014 through 31 January 2015, the USD-to-ruble exchange rate rose from Rb 33.84 to Rb 68.73, or 2.0 times, while the value of *CDS Russia 5Y* jumped from 173.3 basis points (b.p.) to 629 b.p., or 3.5 times. However, from February onwards, the situation in the market for Eurobonds gradually began to return to normal, and by May 25, 2015, *CDS Russia 5Y* had fallen to 289 b.p. Thereafter, the value of CDS remained noticeably volatile, while on the whole hovering around 300–310 b.p. Interestingly, from the end of May 2015, the premium for *CDS Russia 5Y* was no longer tied to the movement of the foreign exchange rate, although up to that point they had been moving synchronously. Now the default swap premium began largely to follow the movement of the key rate. These changes probably occurred as a result of the bulk of RF Eurobonds having been bought up by

<sup>1</sup> A credit default swap is a particular type of swap where the seller pays the buyer the security's premium in an event of the debt issue's default. CDS is an indicator of the bond issuer's credit risk.



Russian market participants, who were oriented to the ruble-denominated yield rather than to the yield denominated in foreign currency.

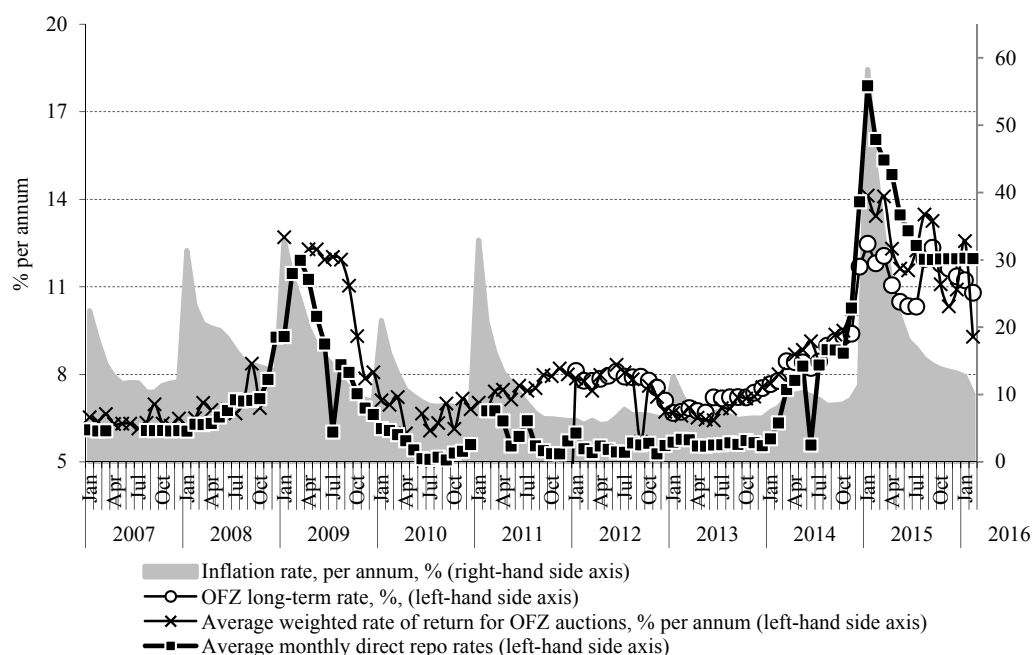


*Fig. 44.* The movement of *CDS Russia 5Y* and the USD-to-ruble exchange rate in 2012 – January 2016

*Source:* own calculations based on data released by CBonds.

In accordance with the *Guidelines for the public debt management policy in the Russian Federation for 2013–2015* (p. 25), it was expected that the increasing share of foreign investment in OFZ will inevitably pull down their yield by one percentage point. In fact, this is exactly what happened in 2012, which was the year when the highest surge in the inflow of non-residents to the OFZ market occurred. The inflation rate in 2012 rose to 6.6% compared to 6.1% in 2011, while the OFZ monthly average long-term rate in December 2012 declined to 7.10% per annum compared to 8.10% a year earlier (*Fig. 45*). In 2013, another trend came to the fore. In spite of the continuing (although at a slower rate) growth of the share of non-residents in the OFZ market and inflation's decline to 6.5%, the OFZ long-term rate increased from 7.1% per annum in December 2012 to 7.53% per annum in December 2013.

In 2014, at the annual inflation rate of 11.4%, the OFZ long-term rate rose from 7.53% per annum in December 2013 to 12.48% per annum in January 2015. In 2015, the Bank of Russia and the RF Government on the whole succeeded in controlling the shock in the forex market and the inflation leap in January. As seen by the year-end results, the inflation rate was at the level of 12.9%, and the OFZ long-term rate – 11.36%. By February 2016, the Consumer Price Index in per annum terms dropped to 10.0%, and the OFZ average monthly long-term rate – to 10.8%.



*Fig. 45. The average monthly rates on the market for OFZ, direct repo and the inflation rate, % per annum*

Source: own calculations based on data released by the Bank of Russia, the RF Ministry of Finance, and Rosstat.

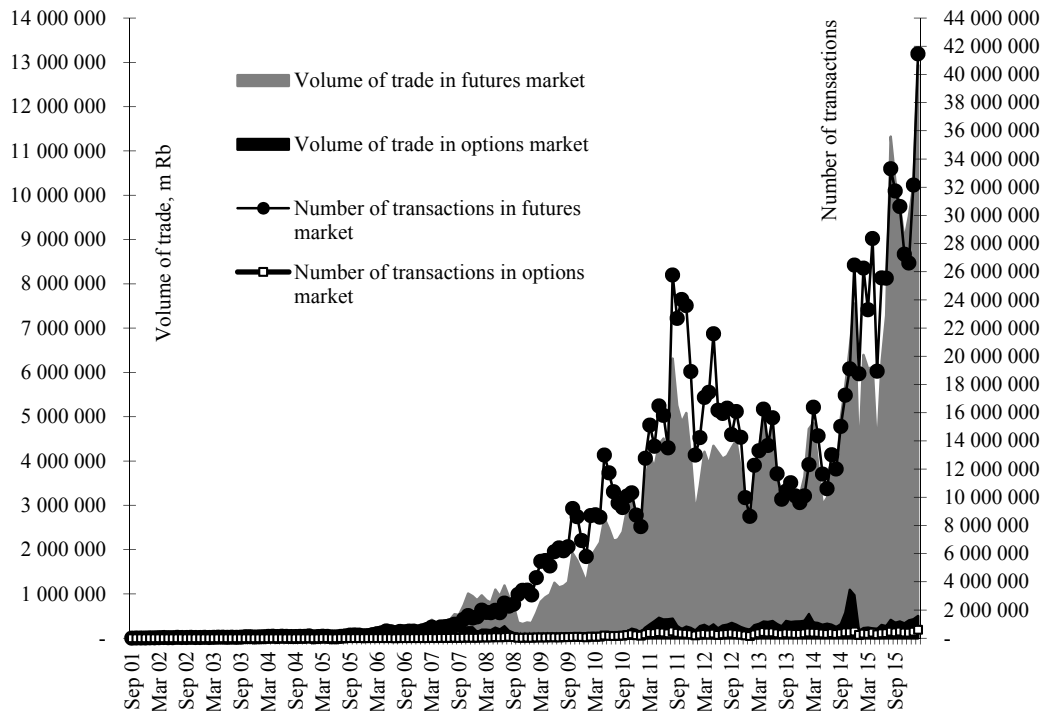
### 3.5. Futures market<sup>1</sup>

In 2015, the futures exchange market demonstrated some serious changes. These had to do, first of all, with a surge of market participants' trading activity, especially in the futures market. Its growth rate was significantly ahead of the growth rates observed in the stock and money markets. The number of clients in the futures market rose from 34,200 in 2014 to 44,900 in 2015, of by 31.2%, whereas the number of active clients of brokers in the stock market shrank from 83,000 to 81,900, or by 1.0%.

The futures trading volume increased from Rb 7.6 trillion in December 2014 to Rb 26.5 trillion in February 2016, or 3.5 times (*Fig. 46*). Over the same period, the number of transactions in the futures market increased from 12.9m to 41.5 m, or 3.2 times. Futures became a popular hedging tool - first of all against the risks associated with the forex rate volatility. The options trading segment, on the contrary, was shrinking in terms of value volume and displaying growth in the number of transactions. The volume of options trading shrank from Rb 1.0 trillion in December 2014 to Rb 0.5 trillion in February 2016, or 2.0 times. At the same time, the number of transactions in the options market increased from 0.5m to 0.6m, or by 20.0%. The more active development of the futures market compared to the options market can be explained by the accelerated growth of futures transactions in the forex market, where futures contracts prevailed. Due to the volatility of the key rate, the market for interest rate options, which in 2015 had been viewed by the exchange as an important and promising driver of futures market growth, likewise declined.

<sup>1</sup> Author of this section: Abramov A. – RANEPA.

In 2015, the smooth operation of the Moscow Exchange's futures market was frequently disrupted by technical errors and technology glitches. So, the key projects set by the Moscow Exchange for 2016 are the improvement of the operating systems' reliability and the introduction of a mechanism that will allow a market participant to open one position for different types of assets.

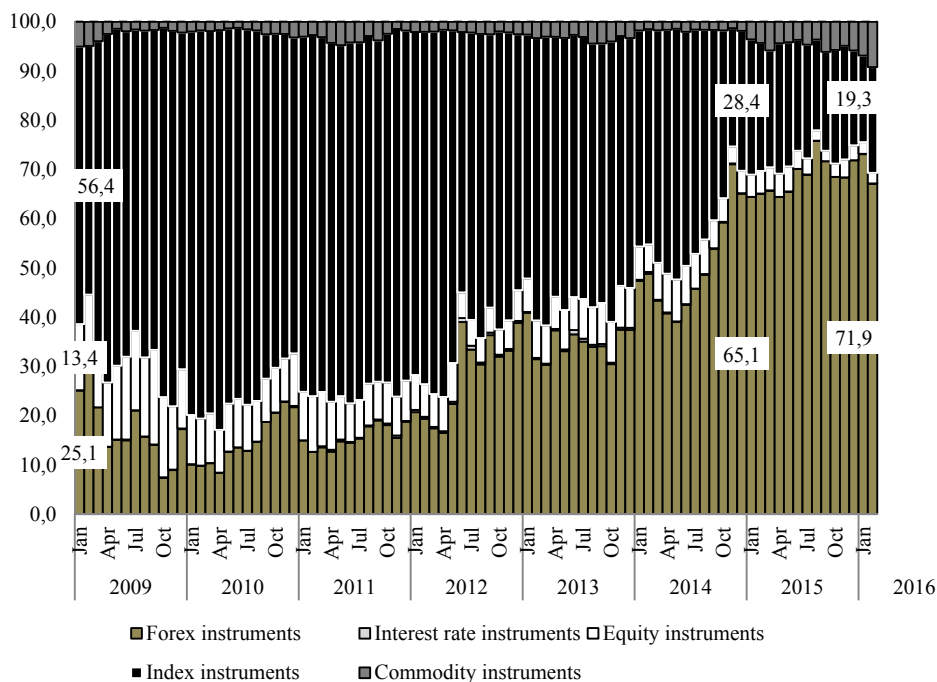


*Fig. 46.* The trading volume and number of transactions in the Moscow exchange's futures market from September 1, 2001 through February 29, 2016

*Source:* own calculations based on data released by the Moscow Exchange

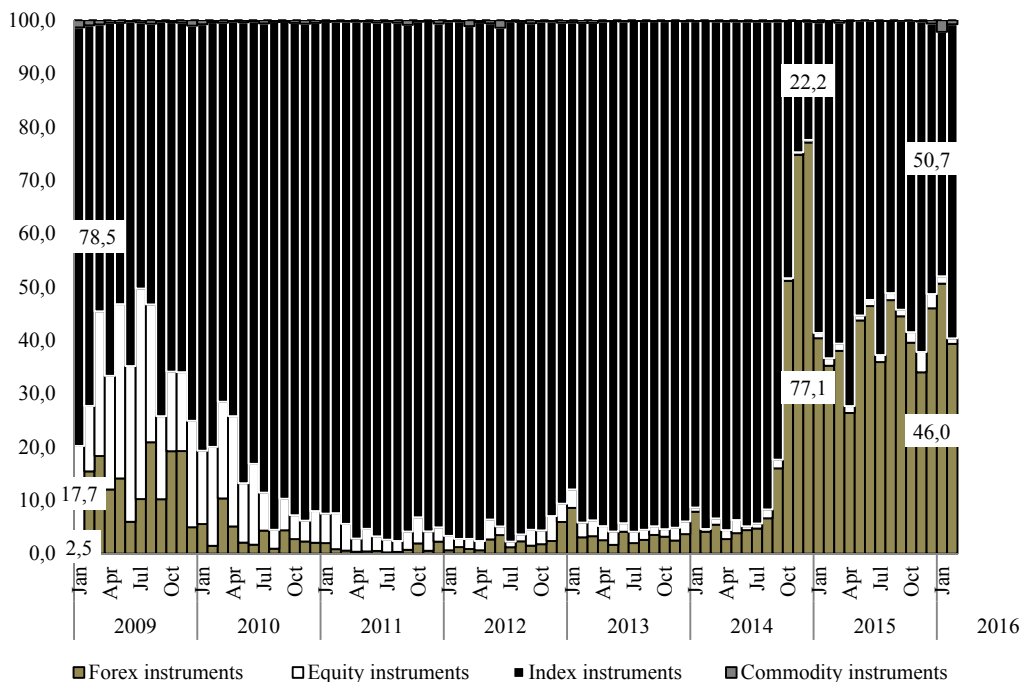
The futures market is becoming increasingly slanted towards forex transactions, while the share of index futures is shrinking at a significant rate (*Fig. 47*). The share of transactions with forex instruments in the futures market increased from 65.1% in December 2014 to 71.9% in December 2015, while that of transactions with index futures over the same period shrank from 28.4% to 19.3%. This trend means that during the acute phase of the current crisis, market participants, in an attempt to hedge against market risks, were relying on forex futures rather than on securities and index futures. In 2015, the volume of trades in index futures shrank, even in absolute terms, from Rb 2.1 trillion Rb in December 2014 to Rb 1.8 trillion Rb in December 2015, or by 14.0%. The role of interest rate futures remained modest.

In the options market, the share of transactions with forex instruments, on the contrary, declined from 77.1 in December 2014 to 46.0% in December 2015, while that of transactions with index options over the same period increased from 22.2% to 50.7% (*Fig. 48*). Nevertheless, these processes were taking place against the backdrop of a decline, in absolute terms, of the trading volume in the options market (from Rb 971bn in December 2014 to Rb 400bn in December 2015).



*Fig. 47. The futures market structure on the Moscow Exchange over the period from 2009 through February 2016, as % of value volume*

*Source: own calculations based on data released by the Moscow Exchange.*



*Fig. 48. The options market structure on the Moscow Exchange over the period from 2009 through February 2016, as % of value volume*

*Source: own calculations based on data released by the Moscow Exchange.*

### 3.6. Investors and financial intermediaries<sup>1</sup>

#### 3.6.1. Domestic institutional investors

In order to increase the household saving norm and attract long-term investment resources, the participation of institutional investors operating on a sustainable basis is necessary (just as in the case of government reserves). The relatively low development level of institutional investors in Russia is the key problem currently faced by this country's financial market. The first phase of pension system reform resulted in a slowdown of the growth rate of pension savings. This happened because insured individuals were granted the right of choice between a zero rate and the 6% deduction to the funded component of pension, as well as due to the temporary freeze of pension savings in 2014–2016.

In 2014, the process of reorganization into joint-stock companies of non-governmental (private) pension funds (NPF) handling the accumulated mandatory pension savings was launched; besides, these funds were incorporated into the system of government guarantees on the *contributions* held by *pension* funds, and subjected to large-scale audits of their financial performance and sustainability. In 2015, the centralization process in the sector of non-governmental pension funds continued. According to the Bank of Russia's *Review of key indicators in non-credit institutions*, the number of NPFs holding pension reserves declined from 115 in 2014 to 103 in September 2015. Over the same period, the number of NPFs acting as managers of pension savings declined from 87 to 78. In accordance with data released by the National Association of Non-governmental Pension Funds (NAPF), as of the end of November 2015, the register of non-governmental pension funds participating in the system government guarantees for insured individuals contained information on 32 NPFs. These funds taken together managed approximately 95.2% of total pension savings. According to data released by the Bank of Russia, the number of insured individuals serviced by NPFs was 26.7m.

In Q3 2015, the volume of pension savings held by NPFs amounted to Rb 1.7 trillion, while that of pension savings held in the RF Pension Fund's accounts and serviced by state-owned and private asset managers, was Rb 1.9 trillion. The bulk of pension savings, amounting to 41% of their total value volume, was invested in corporate bonds. Only 12% of the pension saving portfolio was invested in shares.

The volume of pension reserves held by NPFs as of September 2015 amounted to Rb 984.3bn. The moderate growth of these resources was sustained by contributions to corporate private pension plans. In spite of the existing exemptions from PIT, individuals have taken almost no part in generating pension reserves. According to the period-end results of the first 9 months of 2015, about 24% of the pension reserve portfolio was invested in shares and corporate bonds, and another 18% in units.

According to data released by the Bank of Russia, over the first nine months of 2015, the average weighted return on pension savings held by NPFs was 10.8% per annum, and that on pension savings held by State Trust Management Company VEB – 12.2% per annum.

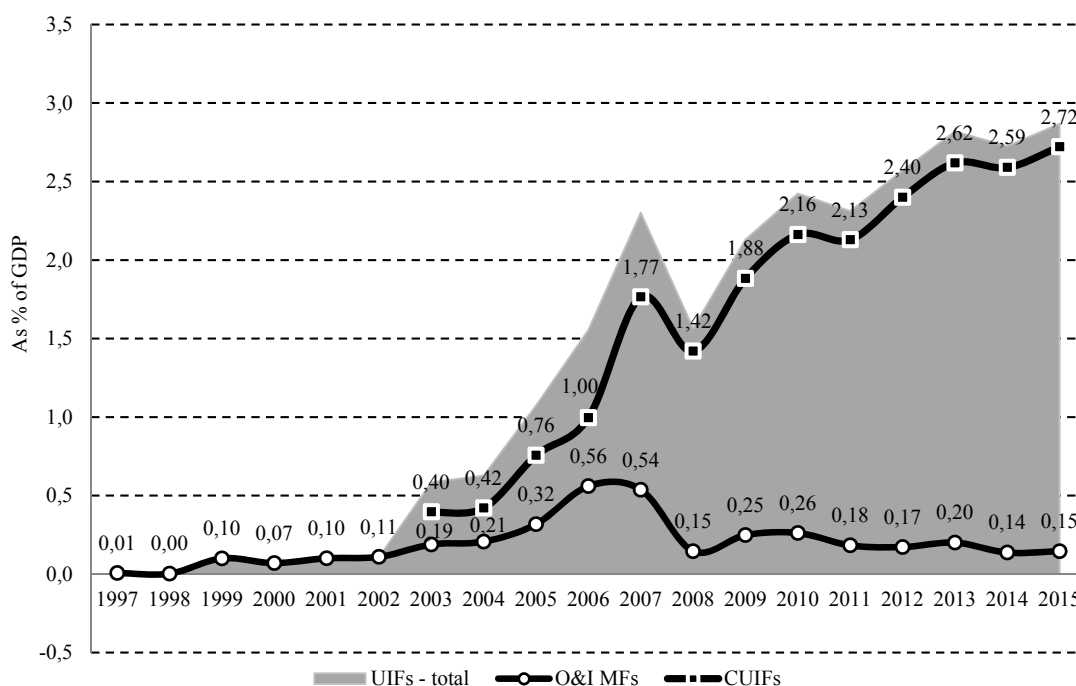
Uncertainty with regard to the future prospects for pension savings was one of the main risks faced by the stock market in 2015. As demonstrated by the results of our studies, the majority of countries around the world, with the exception of Argentina and Hungary, have managed to reverse the negative attitudes to funded pension plans and are continuing to successfully develop their national pension system in that direction. In 2016, Russia will likewise have to make

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<sup>1</sup> Author of this section: Abramov A. – RANEPА.

a conscious choice concerning the prospects for her pension system and the role to be played by non-governmental pension funds. In our opinion, the country whose development trend in this field is closest to Russia's, is the Czech Republic. In 2014–2015, the Czech Republic abolished its mandatory pension saving system and switched over to a system based on individual pension plans. According to data released by insurance company *Allianz*, approximately 95% of its population engaged in economic activities currently participate in individual pension plans.

An active participation of private investors in the domestic stock market will be impossible without an accelerated growth of collective investment. In 2015, the total net value of assets held by unit investment funds (UIF) amounted to Rb 2.3 trillion, or 2.9% of GDP compared to Rb 2.1 trillion and 2.7% of GDP in 2014. Of these, the amount of net assets held by closed-end funds (CUIF) increased from Rb 2.0 trillion or 2.6% of GDP in 2014, to Rb 2.7 trillion or 2.7% of GDP in 2015 (*Fig. 49*).



\* The estimates for 2015 on assets held by closed-end funds for qualified investors are based on corresponding data released by the Bank of Russia for the first 9 months of 2015.

*Fig. 49.* The relative value of assets held by unit investment funds, as % of GDP

*Source:* own calculations based on data released by the National League of Management Companies (MLMC), the Bank of Russia, and *Rosstat*.

Due to the low yields of securities offered by Russian companies, the high volatility of Russia's financial market and the lack of trust in private financial institutions on the part of the population, open-ended and interval (mutual) funds (O&I MF), which are oriented to the savings of private investors, have a very low profile in Russia. Meanwhile, in many other economies around the globe, including BRICS, mutual funds are powerful institutions that handle investment of private savings, and are second only to banks. However, in 2015, the Russian financial market also began to display some signs that private investors are beginning to get interested in

O&I MFs. The assets held by these funds increased from Rb 106.8bn in 2014 to Rb 117.3bn in 2015, or by 10.0% (Fig. 50).

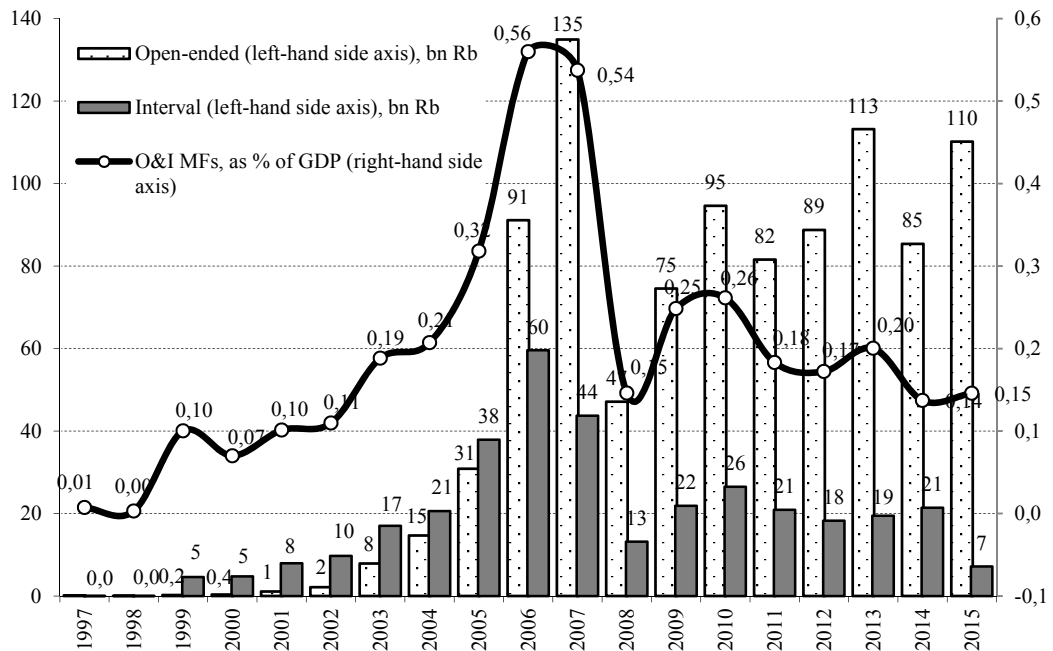


Fig. 50. The size of open-ended and interval MFs, in relative and absolute terms

Source: own calculations based on data released by the National League of Management Companies (MLMC), the Bank of Russia, and Rosstat.

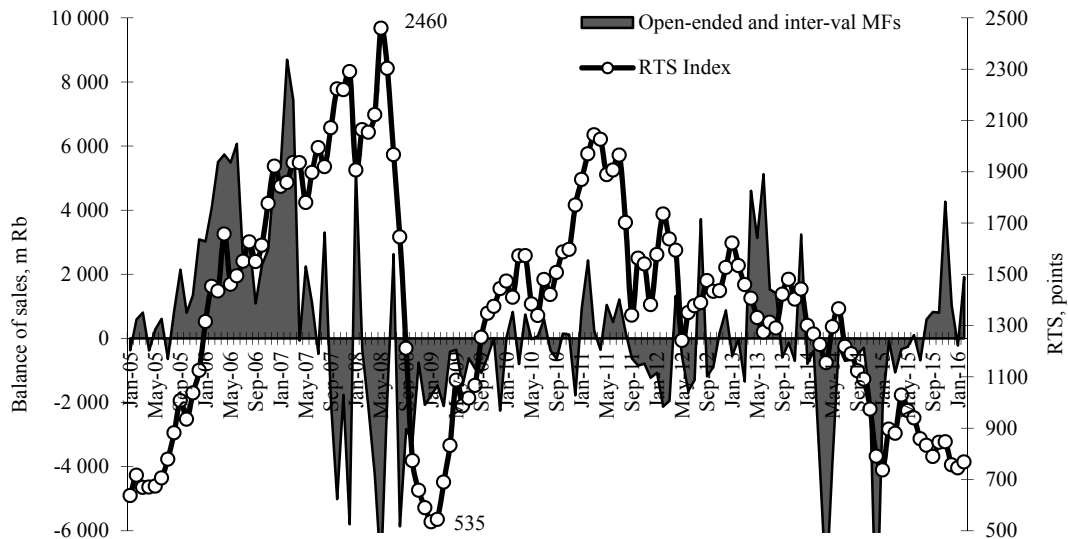


Fig. 51. The balance of sales by open-ended and interval MFs and the RTS Index over the period from January 2005 through February 2016

Source: own calculations based on data released by the National League of Management Companies (MLMC) and the Moscow Exchange.

In 2015, even though the RTS Index (which describes the value of investment in Russian securities denominated in foreign currencies) continued its downfall, from August onwards, for the first time since 2013, a small but stable new private investment inflow into O&I MFs was observed (Fig. 51). These funds demonstrated high rates of return due to their use of mixed investment strategies, global diversification of assets, and by-sector asset allocation strategies.

In order to sustain the investment activity on a proper level, Russia needs to catch up with the developed countries in promoting growth of domestic institutional investors. It means that the banking system must become more reliable and function better, and that pension funds, insurance companies, open-ended and interval funds must implement effective development policies and set the goal of winning public confidence. The government must encourage competition in the financial services market and ensure proper protection of investor rights - that is, exercise its regulatory rather than supervisory function.

### 3.6.2. Brokers and individual domestic investors

In order to get onto an economic growth trajectory, Russia must maintain a high domestic saving norm. The source of saving growth is a rising household saving norm. According to official statistics derived on the basis of *Rosstat's* methodology, Russian households saved 9.8% of their disposable income in 2013, 6.9% in 2014, and 14.1% in 2015 (Fig. 52). In the countries whose economies are leaders in economic growth and modernization (China, India, Singapore, Hong Kong), the ratio of household saving norm to disposable income is much higher. The social and demographic situations in these countries are certainly different from that in Russia, but it must be admitted that any large-scale modernization implies reliance on domestic sources of financing. This rule gained in importance in 2014, after the introduction of economic sanctions against Russia, when opportunities for Russian companies and banks to attract foreign investment became very limited.

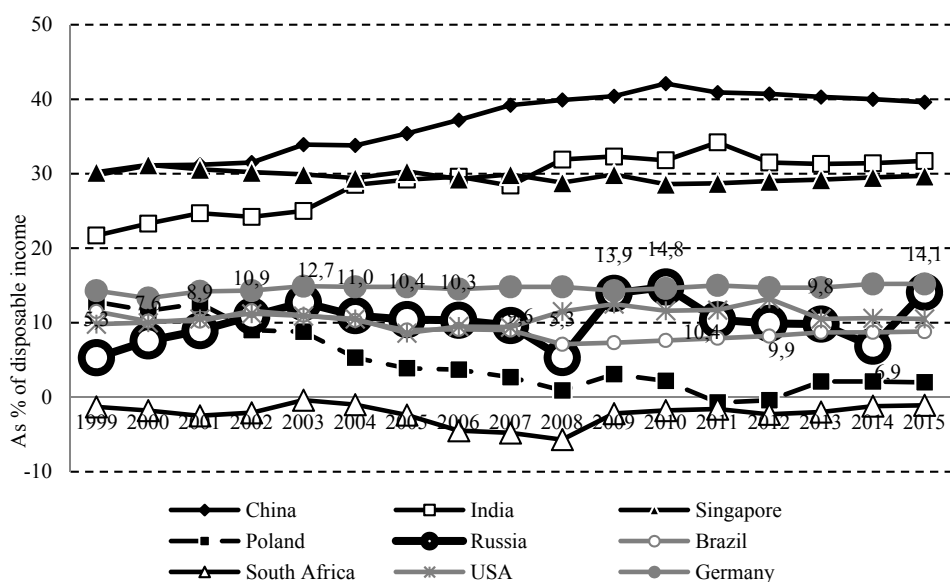


Fig. 52. Household saving norm, as % of disposable income, in 1999–2015

Source: calculations based on data released by *Rosstat*; data for Russia released by *Euromonitor International*.



The declining activity of private investors on the exchange market and the increasingly prominent role of government structures in the financial market, with their privileged status enabling them to rely on the financial resources supplied by monetary authorities, has increased the likelihood of disappearance from the market of many private broker companies and trust managers. In this connection, an important positive development in that sector was the Bank of Russia's initiative that the size of equity capital required for professional securities market participants should be reduced. In accordance with the Bank of Russia's directive of July 21, 2014, No 3329-U *On the requirements to the size of equity capital of professional participants in the securities market and trust managers of investment funds, mutual funds and non-governmental pension funds*, which came into force as of September 1, 2014, the minimum size of equity capital for those dealers and brokers who do not rely on the monies of their clients was reduced from Rb 35m to Rb 3m, and that for depositories – from Rb 60m to Rb 15m. The required minimum size of equity capital for brokers relying on their clients' assets is reduced from Rb 35m to Rb 15m, and that of managers of securities - from Rb 35m to Rb 5m, on condition that they should become members of a self-regulatory organization (SRO), which has approved and coordinated with the Bank of Russia their operational standards of performance. For prime brokers and managers of securities who are not members of a SRO, the requirements to the size of their equity capital have remained unchanged - Rb 35m and Rb 60m respectively. On February 18, 2015, the Board of Directors of the Russian National Association of Securities Market Participants (NAUFOR) adopted the basic standards of professional securities activities and submitted them for the approval by the Bank of Russia. This is an indication that the operating SROs wish to switch over to the new standards as soon as possible.

However, it turned out that it was not enough to simply relieve the excessive administrative pressure on non-bank financial institutions. For six years in a row beginning from 2009, the number of professional securities market participants was on the decline (*Table 15*). The number of brokers shrank from 803 in 2014 to 633 in 2015, and that of dealers over the same period of time shrank from 817 to 651, or by 20.3%. According to data released by the Bank of Russia, the total number of professional participants in the securities market declined from 1,079 in 2014 to 875 in 2015, or by 18.9%. The shrinking number of market participants in the current situation is a positive sign, but the cause of real concern is the absence of new market participants, which should be viewed as a manifestation of the insufficient competition rate on the financial market.

Table 15

### The number of professional participants in the stock market

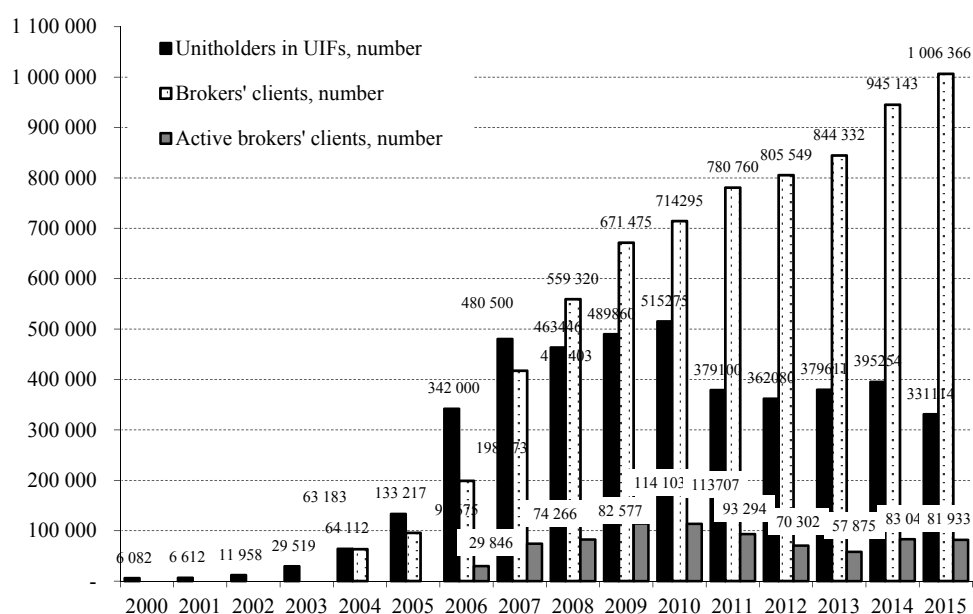
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Number of organizations holding licenses to									
1. Brokerage activities	1,445	1,475	1,335	1,213	1,090	983	885	803	633
change on previous period, %	0.8	2.1	-9.5	-9.1	-10.1	-9.8	-10.0	-9.3	-21.2
2. Dealer activities	1,422	1,470	1,337	1,198	1,088	994	888	817	651
change on previous period, %	2.0	3.4	-9.0	-10.4	-9.2	-8.6	-10.7	-8.0	-20.3

Source: data released by the Federal Financial Markets Service (FFMS) and the Bank of Russia.

*Fig. 53* shows data on the number of individual investment accounts (IIA) opened by brokers and the number of individual accounts in the registers of unitholders in UIFs. In 2015, the Moscow Exchange registered a total of just over 1m private clients of brokers, of which only 82,000 were active clients - that is, those who completed at least one transaction per month on the

Moscow Exchange. The downward trend displayed by the number of active brokers' clients over recent years points to the fact that the existing model applied in dealing with clients on the Russian stock market has exhausted its potential. That model is oriented to clients desiring short-run profit, whereas in all the developed countries the majority of clients of big broker companies are long-term private investors. The outflow of brokers' clients was caused, among other things, by the slow pace of Russia's stock market recovery after the crisis.

In 2014–2015, the most noteworthy event in the sphere of private savings was the introduction of some revolutionary amendments to legislation, whereby it was envisaged that, from January 1, 2014, significant exemptions from PIT should be applied to income generated by securities, provided that the individual to be made exempt from tax had held those securities for no less than three years; and from January 1, 2015 - also to the contributions made by individual to their so-called individual investment accounts (IIA)<sup>1</sup>.



*Fig. 53. The number of retail clients of trust managers and brokers*

*Source:* own calculations based on data released by the Moscow Exchange, the National League of Management Companies (MLMC), and RAEX.

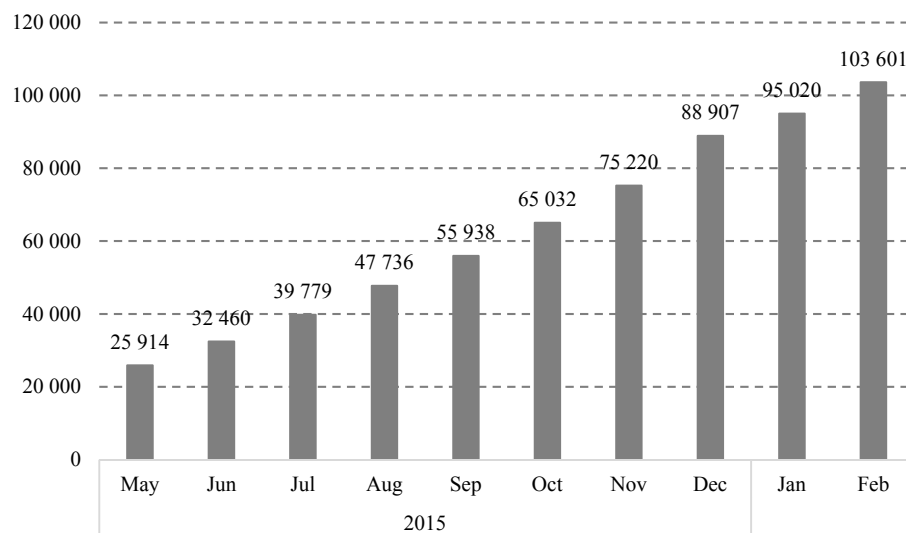
In accordance with Federal Law of December 28, 2013, No 420-FZ ‘On introducing alterations into Article 27.5-3 of the Federal Law “On the securities market” and Parts One and Two of the Tax Code of the Russian Federation’, the income derived in the form of return on investment in newly purchased securities is to be made exempt from tax if their individual owner has been holding them for three or more years. Previously, all incomes derived by citizens in the form of return on investment in securities (held through UIFs, trust management or directly through brokerage accounts) was levied by PIT at 13% rate. The cap on deduction from the tax base is set at Rb 3m for each year of holding a security or a unit. The exemption from PIT is not applicable to income derived in the form of dividends paid on shares and coupons paid on

<sup>1</sup> In terms of their status, these accounts are similar to two investment mechanisms popularly applied in many countries: individual retirement accounts (IRAs) (in the USA, Poland, the Republic of Korea, Canada, etc.) and individual savings accounts (ISAs) (in the UK).

bonds, except in cases when individuals hold securities indirectly through open-ended mutual funds. For this reason, the exemption will be most beneficial for long-term unitholders of open-ended funds.

Besides, the Federal Law 'On the securities market' and the RF Tax Code are augmented by the notion of an individual investment account, which can be opened by a private investor with a broker or trust manager from January 1, 2015. A citizen is granted the right to enter in only one IIA agreement. The limit on the amount of money to be placed on such an account is Rb 400,000 per annum<sup>1</sup>. Based on the choice of an IIA owner, one of the two forms of tax deduction can be applied. The first one implies that, once an IIA is closed, provided that this happens after no less than three years have elapsed since it was opened, the investor is entitled to a 13% tax deduction from the total amount of money placed on that account. In this case, the tax refund is granted on an annual basis. In order to receive this type of exemption, the IIA owner must secure a statement issued by his broker concerning the amount of money received on that account, and attach that statement when filing his tax return. The second scheme does not envisage a deduction from the money received on an IIA, but the entire sum returned to the IIA owner by way of settlement is exempt from PIT.

In our opinion, both these exemptions have created significant incentives for those who invest their private savings in securities for a period of at least three years. According to data released by the Moscow Exchange as of the end of February 2016, the number of IIAs was 103,600 compared to 25,900 as of the end of May 2015 (*Fig. 54*). In other words, over 9 months, the total number of IIAs opened with brokers and trust managers increased 4.0 times.



*Fig. 54.* The number of individual investment accounts (IIA) on the market over the period from May 2015 through February 2016

Source: own calculations based on data released by the Moscow Exchange

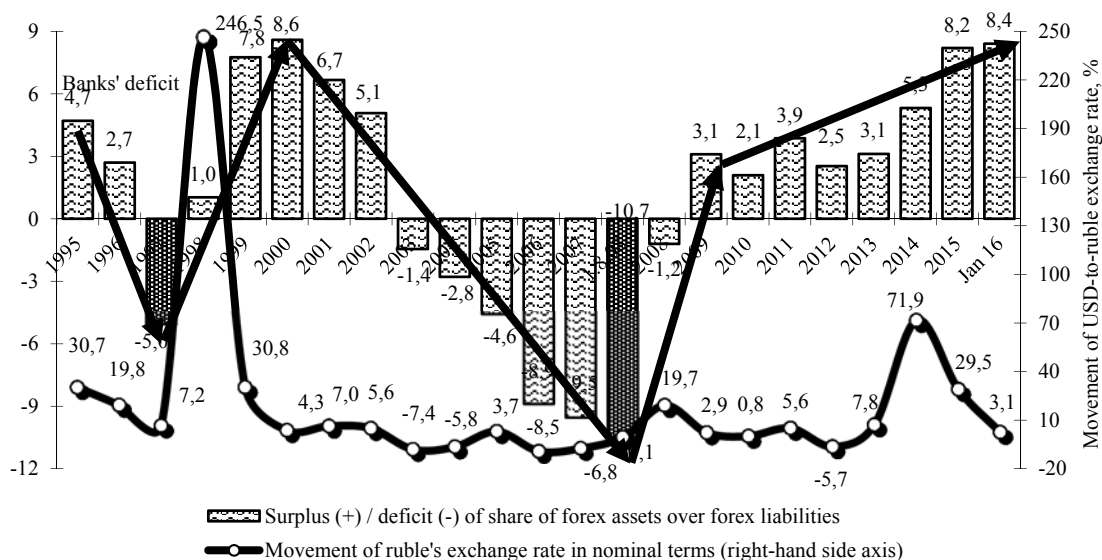
Over recent years, a typical feature of the market for shares has been an accelerated growth of trading volume compared to that of assets held by market participants and their clients. High-

<sup>1</sup> As of now, a draft law has been submitted to the State Duma whereby that cap is to be increased to Rb 1m.

frequency trading is becoming increasingly popular. The data on exchange operations periodically released to the mass media have made it possible to assume that on the average, the private clients of big broker companies completely renew their portfolios every two to three days.<sup>1</sup> Out estimations demonstrate that the average portfolio turnover rate for private investors operating through brokers is 150 per annum, which means a 100% portfolio renewal every two days.

### 3.6.3. The banking system

Despite the unfavorable situation observed in the financial market, the banking system has on the whole remained stable. This conclusion is confirmed by the surplus of the value of banks' foreign exchange assets over that of their foreign exchange liabilities to non-residents (*Fig. 55*). In 2015, for seven years in a row, the value of banks' foreign exchange assets had stayed above that of their aggregate foreign exchange liabilities to non-residents, amounting 8.2% of the total value of banks' assets. During the previous crises in 1998 and 2008, it was the disproportion between the indexes of banks' foreign exchange assets and liabilities that served as the main factor triggering a liquidity crisis in the banking sector in response to the ruble's devaluation following a plunge of prices of oil.



*Fig. 55.* The surplus (+) / deficit (-) of banks' foreign exchange assets over their foreign exchange liabilities (relative share in the value of bank assets (liabilities), as % – left-hand side axis)

*Source:* own calculations based on data released by the Bank of Russia.

From 2012, the deleverage trend became once again visible in the banking system<sup>2</sup> (*Fig. 56*) – that is, a slowdown in the credit portfolio's rate of growth compared to that of the amount of bank deposits. In 2015, the surplus of the credit portfolio's value over that of bank deposits (vs. the index of bank assets) amounted to 2.3 pp. compared to 9.7 pp. in 2014. On the one hand, this is an indicator of the banking system's increasing stability, while on the other, it points to a slowdown in the rate of growth of lending in response to the high risk and high interest rates.

<sup>1</sup> *BCS develops plans. Vedomosti*, June 22, 2010.

<sup>2</sup> The ratio of banks' net liabilities to individuals and businesses to their aggregate assets.

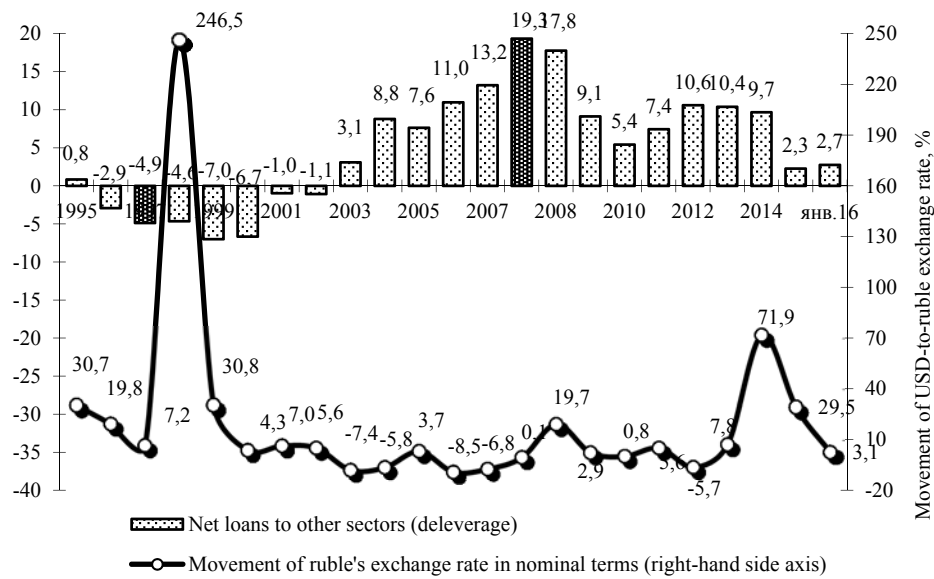


Fig. 56. The surplus of loans over deposits (as % of the value of banks' assets – left-hand side axis)

Source: estimations based on data released by the Bank of Russia.

In 2015, the banking system on the whole remained stable. However, due to the high key rate, the increasing volatility of the ruble's foreign exchange and the financial market in general, and plummeting personal incomes in real terms, the index of ruble-denominated loans increased only in the corporate sector, while that of ruble-denominated retail loans was on the decline.

The amount of personal incomes in nominal terms increased from Rb 47.9 trillion in 2014 to Rb 53.2 trillion in 2015, or by 11.0%. The volume of retail credit portfolio over the same period shrank from Rb 12.2 trillion to Rb 11.5 trillion, or by 5.7%. To a certain extent, this helped to somewhat shorten the gap between the growth of personal incomes and the amount of debt against retail loans that had become rather considerable over the last 10 years (Fig. 57). The size of retail credit portfolio increased 9.8 times on 2005, while that of the personal income index in nominal terms increased only 3.8 times.

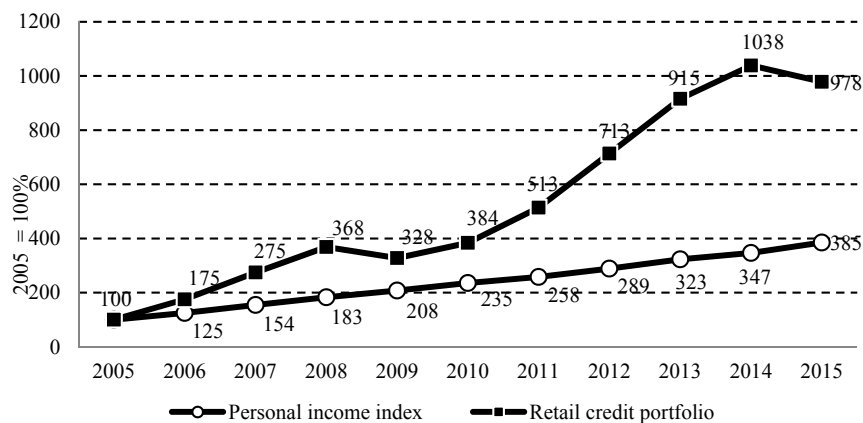
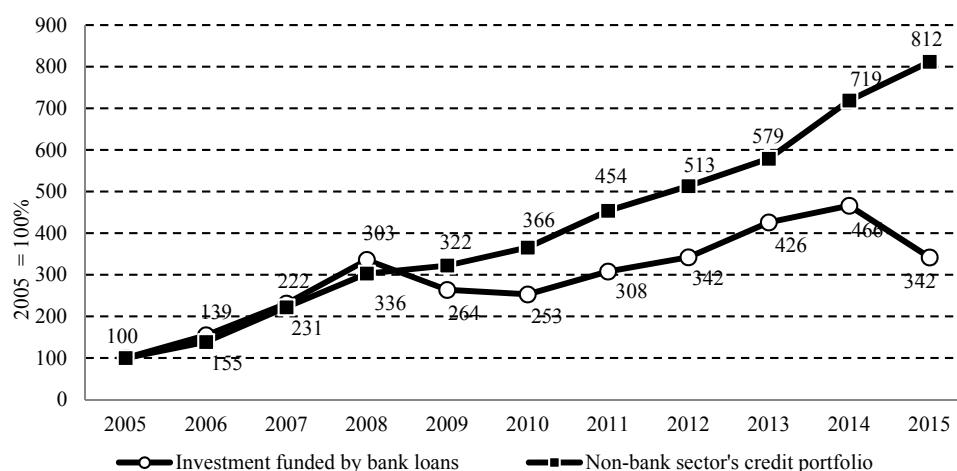


Fig. 57. The movement of personal income and retail credit portfolio indices, %

Source: estimations based on data released by the Bank of Russia and Rosstat.

Some concerns have been associated with the growth rate of the investment index in the business sector (less small-sized businesses) funded by bank loans (*Fig. 58*). The amount of loans issued to non-bank companies rose 8.2 times on 2005, whereas that of investment funded by bank loans - only 3.4 times. While the volume of the non-financial sector's credit portfolio increased from Rb 30.1 trillion in 2014 to Rb 34.0 trillion in 2015, or by 13.0%, that of investment in fixed assets funded by bank loans across the Russian economy declined from Rb 1.1 trillion to Rb 0.8 trillion, or by 27.3%.



*Fig. 58.* The movement of investment funded by bank loans<sup>1</sup> and the non-bank sector's credit portfolio, %

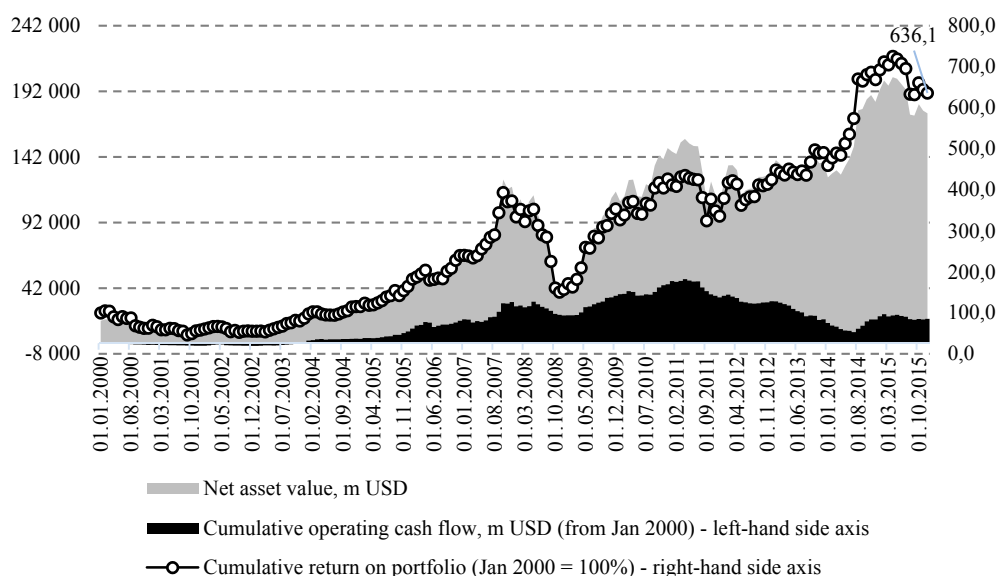
*Source:* estimations based on data released by the Bank of Russia and Rosstat.

### 3.6.4. Foreign portfolio investors

As shown by statistics collected by EPFR, foreign portfolio investors in Russian stocks, similarly to investors in other major developing markets, often display herd behavior patterns. This means that their strategies applied in different developing markets are basically uniform, and that the decision-making concerning capital inflow or outflow are based predominantly on the cyclical movement of the global economy, rather than on the individual features of each developing economy. *Fig. 59* shows summary data on the size of assets, cash flows and the cumulative return on portfolios held by international funds investing in eight major developing economies. As seen from these data, from 2011 onwards, although private investors were mostly withdrawing their monies from these funds, the aggregate assets of the latter were on the rise - due in the main to the high cumulative return on their investment. Each \$100 invested in the early 2000s, over the next 16 years (by 2015) generated net profit in the amount of \$536, which is equivalent to compound interest of 12.3% per annum in dollar terms.

In spite of the somewhat declining returns of these funds in 2015, the stable long-term cumulative return generated by the eight developing markets suggests that in the future, an investment inflow into these markets will occur once again. At present, in response to the existing global risks, private investors are striving to withdraw their principal from the developing markets, leaving there only their cumulative return.

<sup>1</sup> The value of the IV quarter of 2015 to determine the design properly.



*Fig. 59.* Total size, cash flow and cumulative return of funds specializing on investment in Russia, China, India, Brazil, South Africa, the Republic of Korea, Indonesia, and Mexico, from January 2000 through December 2015

*Source:* own calculations based on data released by EPFR.

More details on each of the eight developing markets, Russia including, are presented in *Fig. 60*. They all can be roughly divided into three groups. The first group consists of mainland China and the Republic of Korea (*Fig. 60b* and *Fig. 60f*). Over the 16-year horizon, they demonstrate a relatively stable return on portfolio growth rate. The geometric mean of return on investment in shares of Chinese and Korean companies over that period amounts to 11.1 and 9.3% per annum respectively. The assets of these investment funds demonstrate upward trends. At the same time, private investors have withdrawn from China's market practically all of their previously invested capital, while in the market of the Republic of Korea those same investors have not withdrawn even their principal. All these development can be interpreted as a sign of the generally positive attitude, by investors, to these two markets.

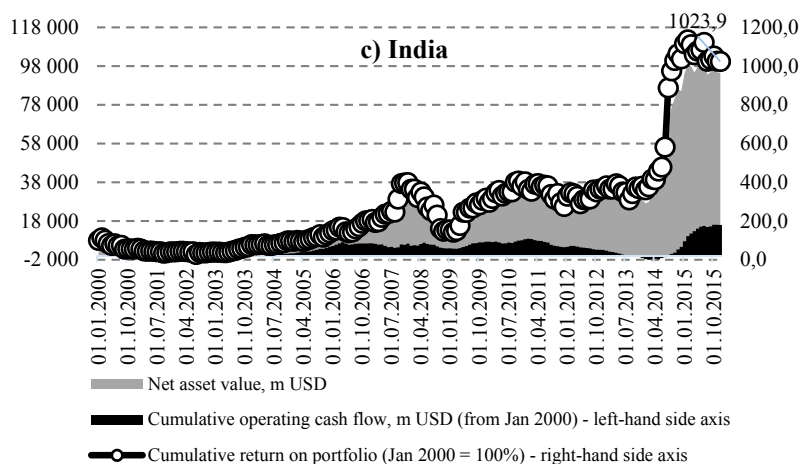
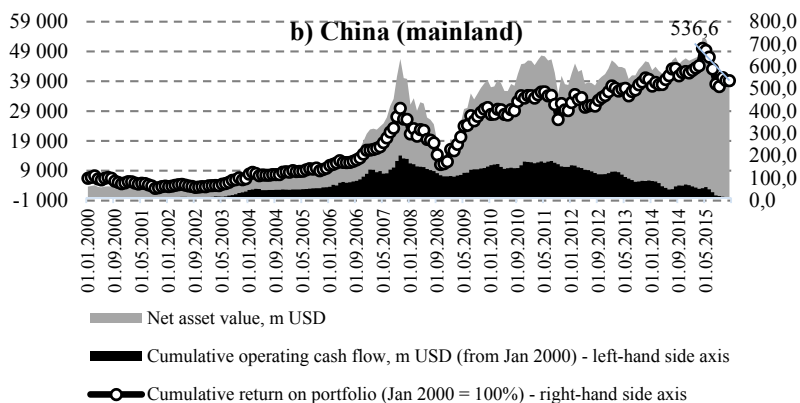
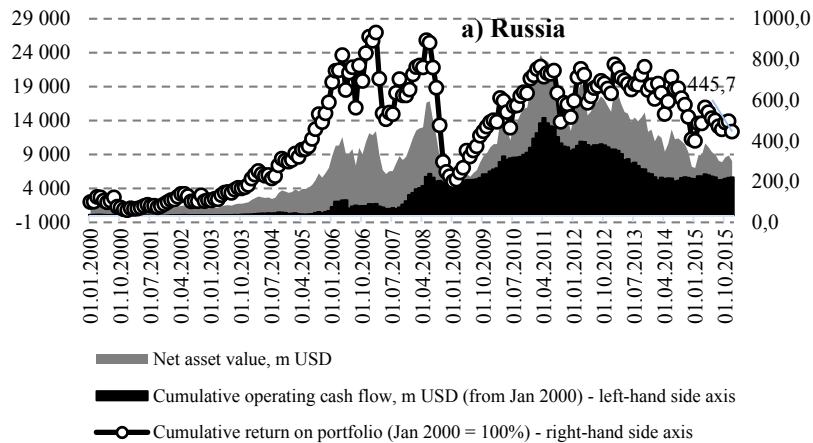
The second group includes foreign investment funds specializing on Russia (*Fig. 60a*), Brazil (*Fig. 60d*) and Indonesia (*Fig. 60g*). For several years in a row, these markets were characterized by plummeting returns on portfolio investment, and so the assets held by foreign investment funds were shrinking. The geometric mean of return for shares issued by companies based in Russia, Brazil and Indonesia amounted to 9.8, 7.3 and 16.7% per annum respectively. Due to the deteriorating investment indices and economic decline observed in these markets, investors have been withdrawing their previously invested capital. So far, Russia has been faring better than Brazil and Indonesia, because capital withdrawal by non-residents from her market is still on a much lesser scale.

The third group is comprised by the investment funds specializing on India, South Africa and Mexico. These countries are characterized by high volatility of the portfolios held by foreign investors. Meanwhile, over the last 2–3 years, stock quotes in these three countries were recovering to their pre-crisis level at a fastest rate, and so portfolio investors received the highest returns. The geometric mean of return for shares issued by companies based in India, South Africa and Brazil over the 16-year period was 15.6, 17.2 and 22.0% per annum respectively.

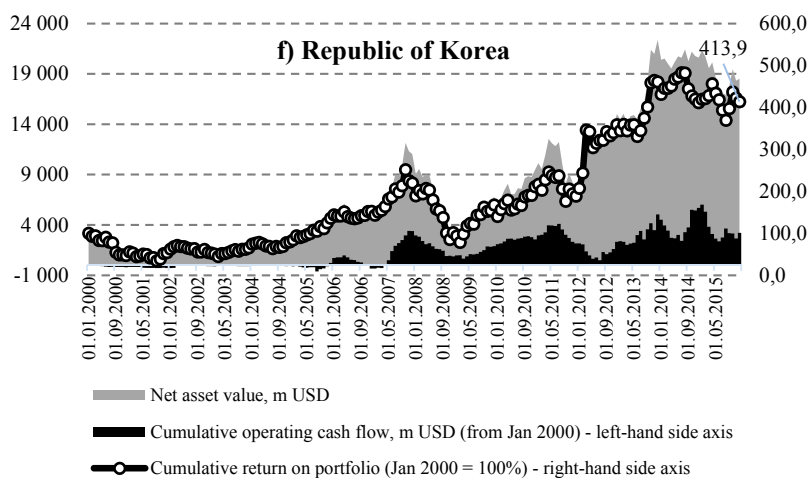
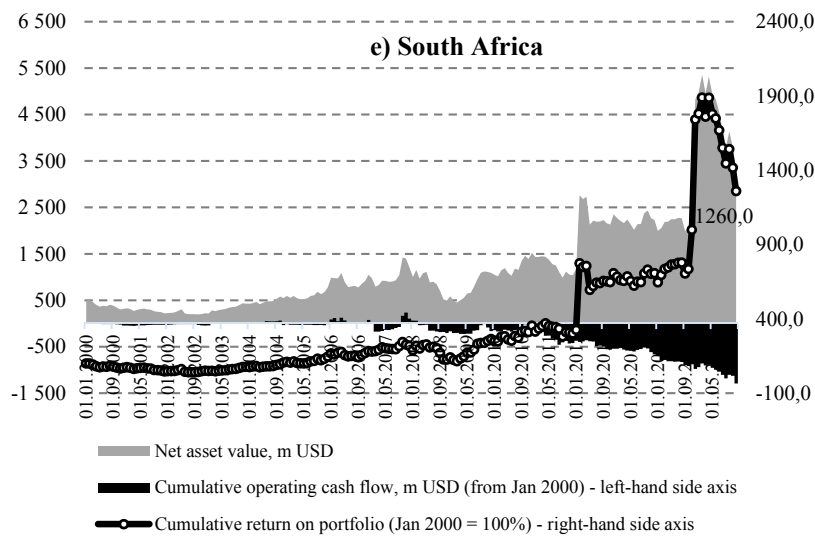
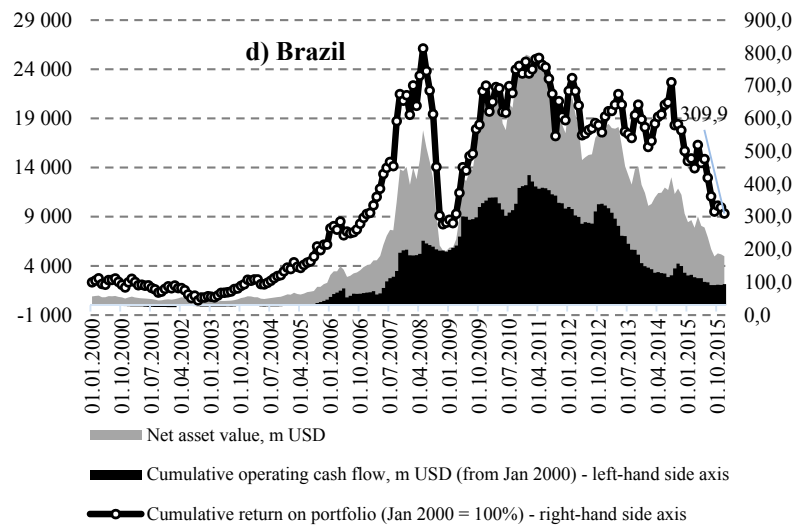
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However, investors think that these markets are too volatile, and so the total amount of capital withdrawn from South African and Mexican companies up until the present moment is much higher than the amount of principal. As for the investment funds specializing on Indian shares, in 2015 they demonstrated an inflow of capital.







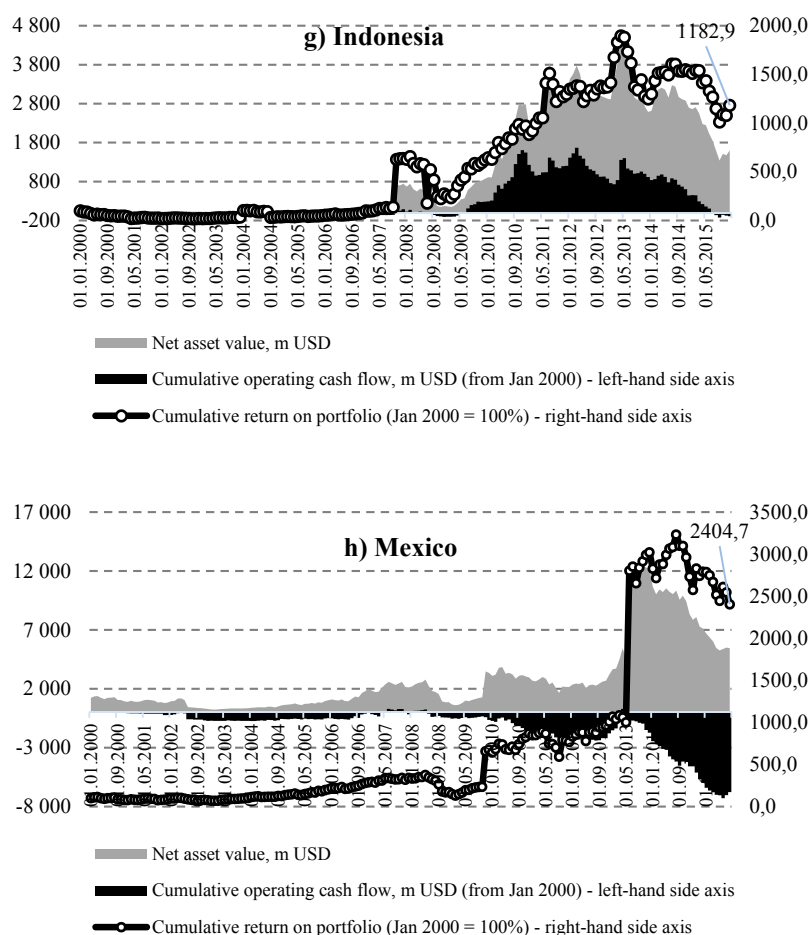
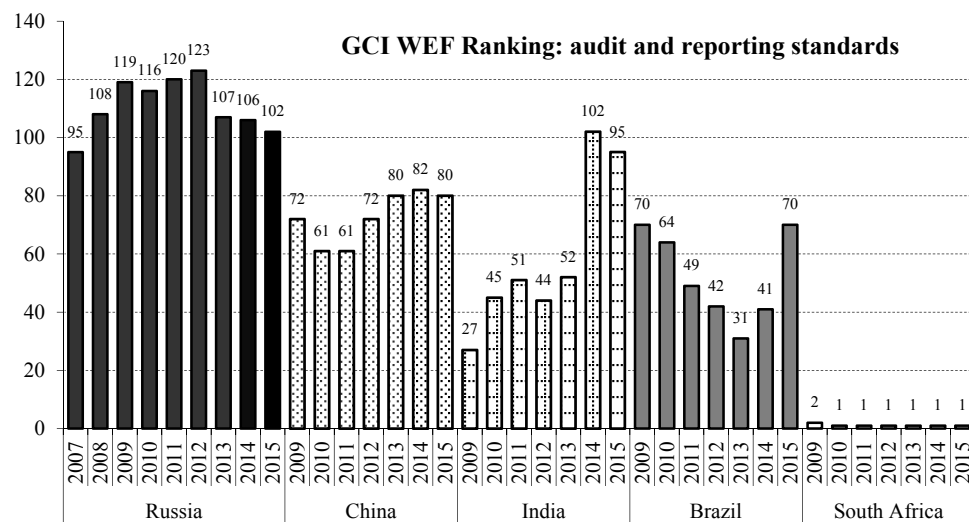
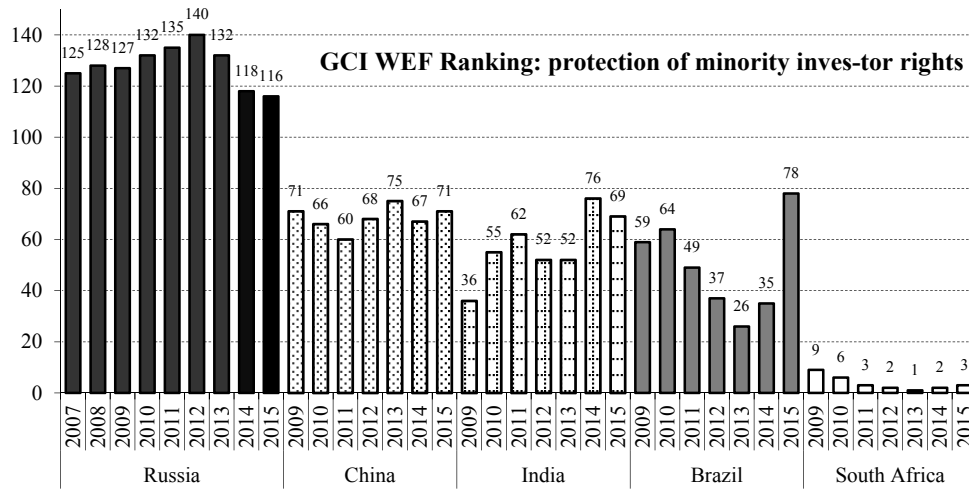
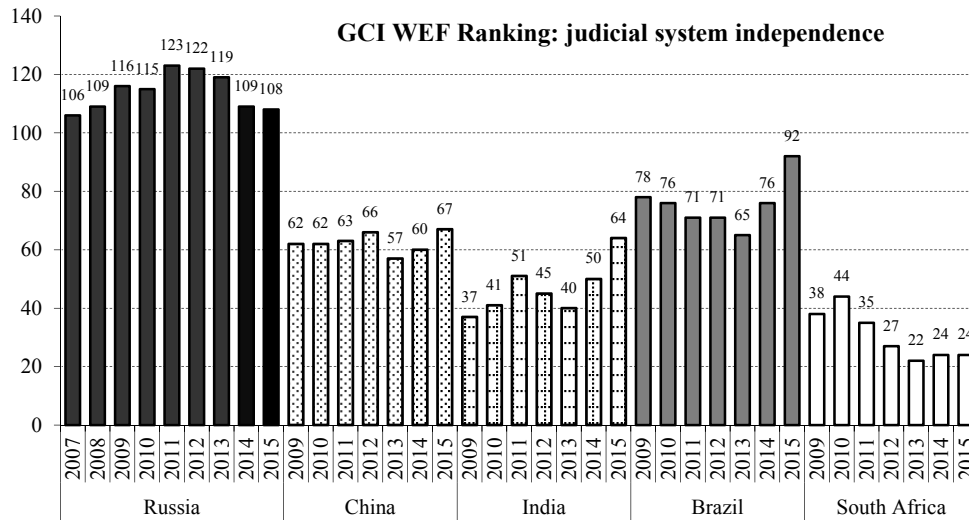


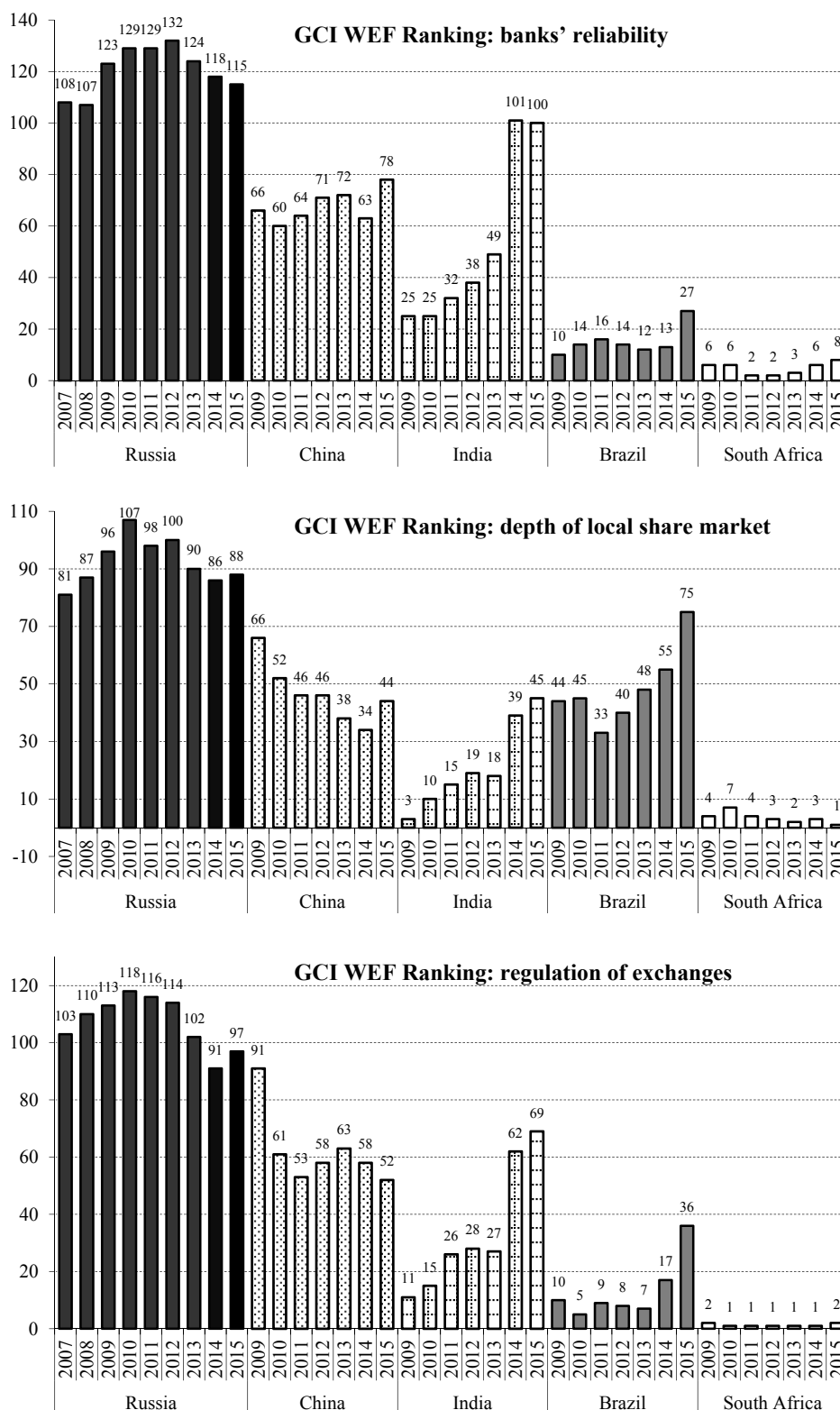
Fig. 60. Total size, cash flow and cumulative return of funds specializing on investment in Russia, China, India, Brazil, South Africa, the Republic of Korea, Indonesia, and Mexico, from January 2000 through December 2015

Source: own calculations based on data released by EPFR.

So, the outflow of foreign portfolio investment from the Russian stock market is the reflection of the general cyclical trend displayed by the developing economies, rather than the upshot of the specific risks created by the economic sanctions, plummeting prices of oil and protracted recession in the national economy. Nevertheless, it is necessary to rely more on the experiences of countries like China, the Republic of Korea and India which, the currently unfavorable conditions notwithstanding, have continued to be attractive for foreign investors.

In our previous reviews of the situation in Russia's financial market, we identified several investment climate criteria applicable to Russia, which in the mid-2000s were viewed by conservative US investors as factors that made it undesirable to invest in shares and bonds of Russian issuers of securities. By way of example, we cited the data released by CalPERS (California Public Employees' Retirement System), a big US public pension fund. Until 2006, CalPERS published the list of criteria and indicators applied as a basis for its decision-making concerning investing in one or other developing market. Here, we present the investment climate estimates for Russia arranged in accordance with Countries' Ranking Based on the World Economic Forum's Global Competitiveness Index (Fig. 61).





*Fig. 61. BRIC members' rankings in the World Economic Forum's Global Competitiveness Index, by several criteria relevant for conservative portfolio investors' decision-making*

Source: GCI WEF Rankings for several years.

In terms of the most problematic issues – independence of the judicial system, the level of protection of minority investor rights, the audit and reporting standards, the depth of the share market, the proficiency of the regulation of exchanges and banks' reliability, Russia's market falls significantly behind the markets of the other BRIC members. However, according to the indexes for 2015–2016 released in September 2014, this gap became noticeably narrower. This happened due to improvement of all of the six ranking parameters. Thus, for example, in terms of judicial system independence in 2015–2016, Russia was ranked 108<sup>th</sup> compared to 109<sup>th</sup> in the previous year. Besides, Russia moved ahead with regard to the following criteria: the use of international audit standards – from 106<sup>th</sup> to 102<sup>nd</sup>; protection of minority investor rights – from 118<sup>th</sup> to 116<sup>th</sup>; reliability of banks – from 118<sup>th</sup> to 115<sup>th</sup>. Somewhat unexpectedly, the 2015–2016 rankings for Brazil and especially for India were moved rather far down. However, two of Russia's indexes also worsened: with regard to access to financing in the local share market, Russia moved from 86<sup>th</sup> to 88<sup>th</sup> place; and with regard to regulation of exchanges – from 91<sup>st</sup> to 97<sup>th</sup>.

### **3.7. Risks on the financial market<sup>1</sup>**

#### **3.7.1. Financial risks in 2015**

The year-end results of 2015 demonstrate that the various risks analyzed in our previous year's overview had become reality. The downfall of oil prices pushed down the ruble's exchange rate against the world's major currencies and triggered yet another plunge of the stock indexes. The situation was further aggravated by the continuing foreign capital outflow. The introduction of international sanctions against Russia dramatically reduced the opportunities for foreign debt refinancing, first of all for banks and non-financial companies. So, corporate borrowers were forced to redeem their foreign debts by their proceeds denominated in foreign currency or other domestic sources, thus imposing additional pressure on the forex market and the ruble's exchange rate. In order to stabilize the national currency and help businesses in settling their foreign debts, the government had to tap on the national gold and foreign currency reserves.

Many public discussions were triggered by the changed priorities of the Bank of Russia's monetary and lending policies and the regulator's decisive switchover to inflation targeting and liberalization of the foreign exchange rate. In our opinion, such a turn was well-justified, both strategically and tactically, in view of the complicated situation in the financial markets. In the long run, such policy may produce useful levers that will help control both the inflation rate and inflation expectations, and ensure macroeconomic stability – a necessary precondition for investment inflow. From the point of view of anti-crisis regulation, this measure conduced to safeguarding the gold and foreign currency reserves and applying market principles to the ruble's exchange rate, which is essential in view of the new economic reality.

In 2016, the main financial market risks will be associated with the following factors: stagnation in the share market (due to slow recovery of oil prices) and foreign investment flows; moderate weakening of the ruble (due to slow recovery of oil prices) and the need to repay corporate foreign debt in spite of the ban on refinancing loans in the foreign markets; an increasing volatility of the foreign exchange rate if the monetary and lending policies should

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<sup>1</sup> Author of this section: Abramov A. – RANEPА.

become increasingly inefficient due to lack of any improvement in the investment climate and liberalization of the conditions for doing business.

### 3.7.2. The risks associated with the domestic financial market's high dependence on foreign investors' behavior

The specific feature of the Moscow Exchange's market for shares, in which it differs from global exchanges, is its high dependence on foreign portfolio investors. As estimated by Sberbank CIB, about 70% of free-float Russian stocks are currently held by non-residents. At the same time, the 14 biggest investment funds jointly accounted for 28% of total foreign portfolio investment in Russia<sup>1</sup>. The list of these funds, according to Sberbank CIB, includes the Government Pension Fund of Norway, Vanguard Emerging Markets Stock Index Fund, Oppenheimer Developing Markets Fund, ISHARES MSCI Emerging Markets ETF, BlackRock, and Lazard Emerging Market Equity Portfolio. The significantly simpler procedures for foreign investors to buy and hold Russian securities, that have been recently introduced on the domestic market, make it more attractive to foreign investors on the one hand, while on the other, they may increase market volatility due to the risk of a speedy foreign capital outflow in response to sudden shocks.

### 3.7.3. The risks associated with the ruble's exchange rate decline in the medium term

The experiences of the previous crises in Russia point to the necessity of maintaining a certain stable ratio between the ruble-denominated money supply (M2) and gold and foreign-exchange reserves (*Fig. 62*). The graphs below demonstrate the relationship between the end-of-month USD-to-ruble official exchange rate (in Rb) and its estimated value, determined by dividing money supply (M2) by the value of RF gold and foreign-exchange reserves.<sup>2</sup> When the estimated exchange rate, which reflects the ratio of ruble-denominated money supply volume to that of gold and foreign-exchange reserves, displays accelerated growth compared to the official rate, this can usually be interpreted as a manifestation of a softer policy of the monetary authorities and the rising risks of the ruble's devaluation. After the 2008 crisis, growth of the gold and foreign-exchange reserves halted, and the monetary authorities resorted to boosting economic growth by increasing money supply. The gap between the estimated and actual official exchange rate once again began to widen. Interestingly, every time that these two indices moved apart by approximately Rb 30 (in both instances when the estimated rate was about twice as much as the official rate), the monetary authorities launched some extraordinary measures designed to shorten this gap.

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<sup>1</sup> Gaidarov V. *Foreign control over free float*. *Kommersant*, January 17, 2014.

<sup>2</sup> This index is by no means universally relevant for every country, especially for countries with highly diversified economies; however, as the ruble's exchange rate is highly dependent on the amount of export proceeds denominated in foreign currencies, its analytical value for Russia's financial system is significant.

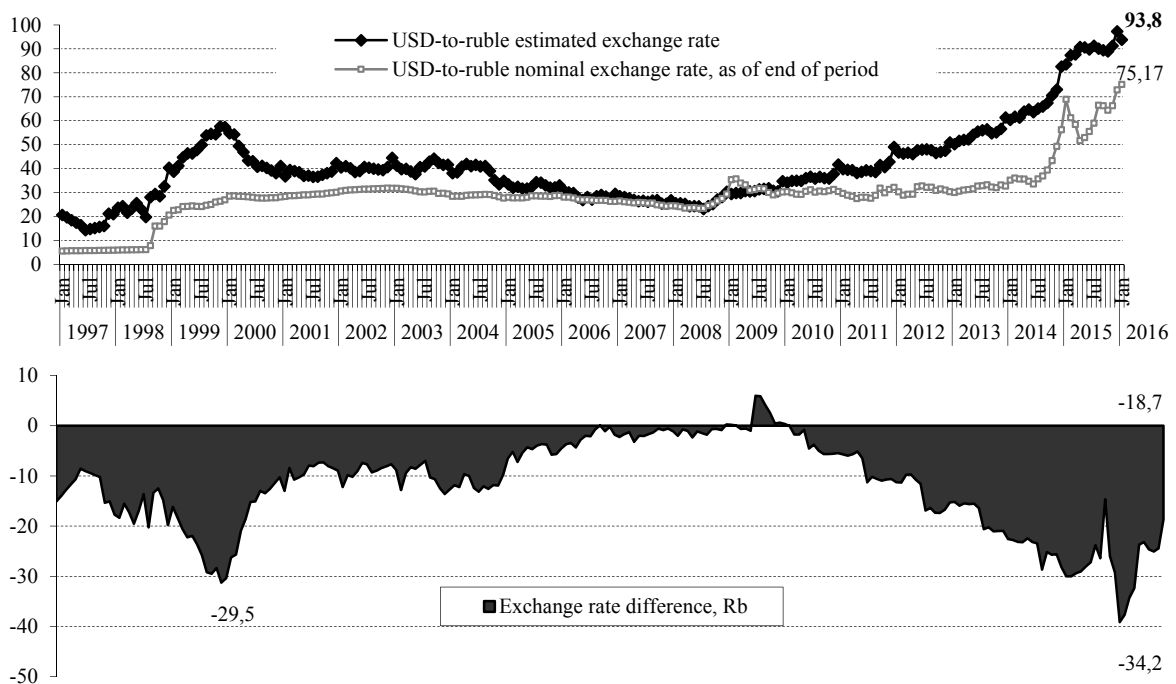
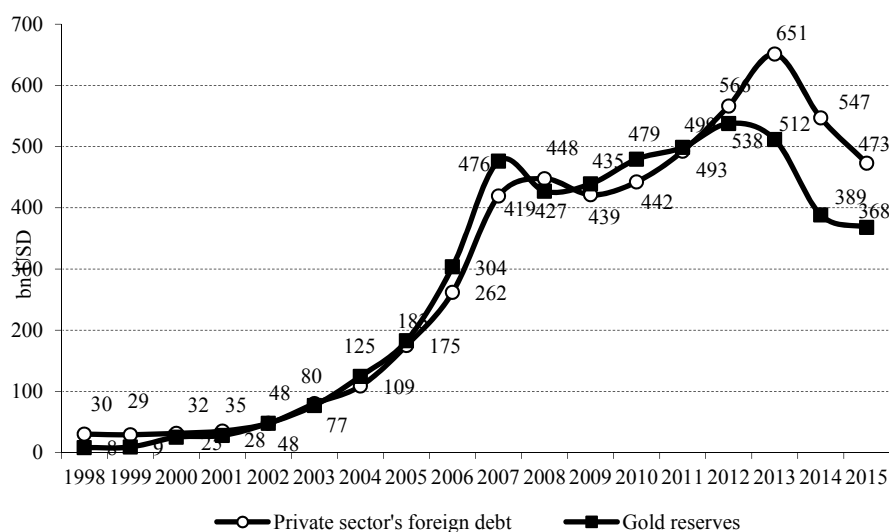


Fig. 62. The dependence of the USD-to-ruble nominal exchange rate on its estimated value, January 1997 – January 2016

Source: calculations based on data released by the Bank of Russia and the RF Ministry of Finance.

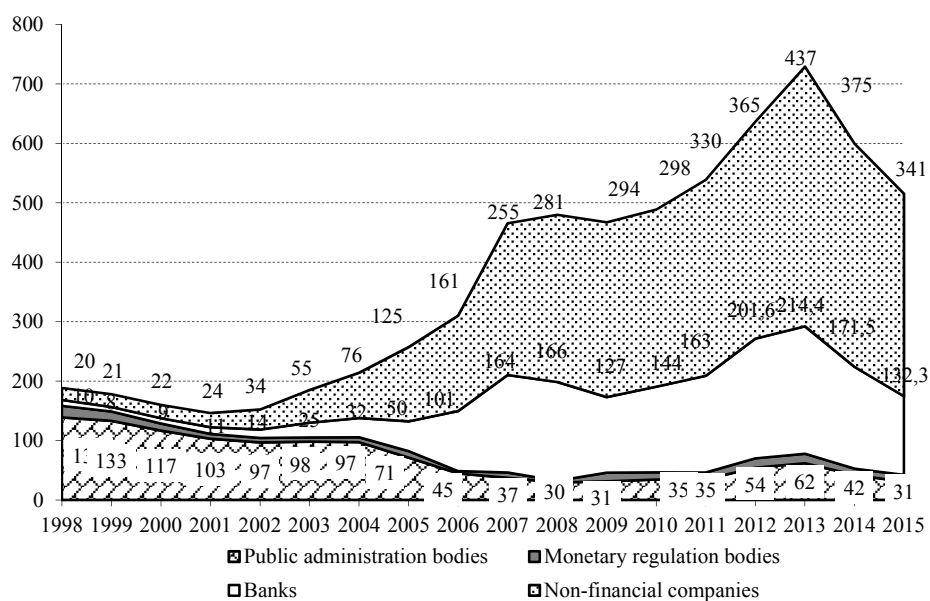
#### 3.7.4. The risks associated with foreign debt servicing by banks and non-financial companies

The economic sanctions prevented Russian companies and banks from getting refinancing loans in international markets, and so in order to repay their foreign debts, they had to purchase foreign currency in the domestic forex market. As a result of the sanctions, the amount of foreign debt shrank from \$651bn in 2013 to \$473bn in 2015, or by \$178bn (Fig. 63). At the same time, the volume of gold and foreign exchange reserves declined in 2015 from \$512bn to \$368bn, or by \$144bn. This sum was spent in order to sustain the ruble's position on the forex market in 2014, while simultaneously, in indirect ways, it replenished the forex reserves of Russian organizations necessary for repaying their foreign debts. For reference: during the period of controlled devaluation of the ruble from August 2008 through February 2009, the volume of gold and foreign exchange reserves shrank by \$212bn, hitting its record low of \$384bn.



*Fig. 63. Growth of debt in the private sector and government budget surplus*

Source: own calculations based on balance of payments data for several years.



*Fig. 64. Foreign debt of the Russian Federation in 1998–2015, bn USD*

Source: balance of payments data for several years.

In 2015, the decline of foreign debt occurred in the main in the sector of banks and non-financial companies (*Fig. 64*). The debt owed by banks to non-residents shrank from \$214bn in 2013 to \$132bn in 2015, or by 38.3%. The foreign debt of non-financial companies over the same period shrank from \$437bn to \$341bn, or by 22.0%. The troubles experienced by Russia in 2014–2015 in connection with the need to repay the foreign debts of national businesses under the constraints imposed by the international sanctions point to the vital necessity of careful regulation of the foreign debt burden taken on by Russian companies. In 2014–2015, without the urgent measures in the form of forex interventions, forex loans to banks issued by the Bank



of Russia in the form of FX swaps and repo, and part of government gold and foreign-exchange reserves being spent on financial support provided to the business sector, Russian companies would have been unable to service their foreign debts.

### 3.8. Municipal and subfederal loan market<sup>1</sup>

#### 3.8.1. Market development dynamics

The regions' consolidated budgets and the budgets of subnational state off-budget funds ran with a deficit of Rb 178.7bn (0.22% of GDP) at the 2015 year-end. In terms of percentage of GDP, the regions' consolidated budget deficit was over three times as little as the value recorded in 2014. For example, in 2014, subnational budgets ran a deficit of Rb 485.6bn (0.68% of GDP).

In 2015, the subjects of the Russian Federation ran a budget deficit of Rb 108.2bn, urban districts ran a budget deficit of Rb 52.1bn, municipal units of Moscow and St. Petersburg ran a budget surplus of Rb 1.4bn, municipal districts ran a budget deficit of Rb 10.5bn, urban and rural settlements ran a budget surplus of Rb 2.2bn, subnational state off-budget funds ran a budget deficit of Rb 7.1bn.

In 2014, the subjects of the Russian Federation ran a budget deficit of Rb 393.2bn, urban districts ran a budget deficit of Rb 38.4bn, municipal units of Moscow and St. Petersburg ran a budget surplus of Rb 1.2bn, municipal districts ran a budget deficit of Rb 20.1bn, urban and rural settlements ran a budget surplus of Rb 2.6bn, subnational state off-budget funds ran a budget deficit of Rb 37.8bn.

*Table 16*

#### **Ratio of regions' consolidated budget surplus (deficit) and of regions' budgets to budget expenditure, %**

Year	Regions' consolidated budgets*	Regions' budgets
2015	-1.6	-1.3
2014	-4.6	-4.9
2013	-6.4	-8.1
2012	-3.0	-3.5
2011	-0.2	-0.3
2010	-1.4	-1.6
2009	-5.3	-5.3
2008	-0.7	-0.7
2007	0.8	0.6

\* including state off-budget funds.

*Source:* Gaidar Institute's own calculations based on the data released by Russia's Federal Treasury.

As of January 1, 2016, 76 subjects of the Russian Federation ran a consolidated budget deficit (including subnational state off-budget funds) (75 regions in 2014). The total deficit stood at Rb 377.6bn, or 5.1% of the revenue side of budgets (Rb 559.5bn, or 6.3% in 2014).

<sup>1</sup> Shadrin A. – Ministry of Economy of Russia.

Table 17

**Ratio of subnational budget surplus (deficit) to budget expenditure  
in 2007–2015, %**

Year	Budget of municipal units of Moscow and St. Petersburg	Budget of urban districts	Budget of municipal districts	Budget of urban and rural settlements
2015	6.7	-3.0	-0.7	-0.6
2014	6.0	-2.2	-1.4	0.7
2013	-3.47	-2.61	-5.59	2.24
2012	2.26	-2.01	-0.08	1.34
2011	6.15	-2.10	1.13	0.64
2010	-1.12	-1.16	-0.11	1.72
2009	-0.63	-3.32	-1.88	2.63
2008	-1.47	1.09	-0.26	2.72
2007	5.34	1.23	-0.04	2.34

Source: Gaidar Institute's own calculations based on the data released by Russia's Federal Treasury.

The median budget deficit was 5.7% to the revenue side of budget. The biggest ratio of budget deficit to the revenue side of budget was seen in Republic of Mordovia (20.3%), Magadan Region (18.2%), Murmansk Region (16.5%), Smolensk Region (15.2%), Republic of Khakasia (14.7%) (see Table 19).

In 2015, nine subjects of the Russian Federation ran a consolidated budget surplus (10 subjects ran a consolidated budget surplus in 2014). In total, these regions ran a budget surplus of Rb 199.0bn, or 6.0% of the revenue side of the budgets (Rb 73.9bn in 2014, or 6.1% of the revenue side of the budgets). The median budget surplus was 7.2% to the revenue side of budget.

The biggest ratio of surplus to consolidated budget revenues was seen in Sevastopol (11.7%) and in Moscow (8.0%).

With a budget surplus of Rb 145.7bn, Moscow accounted for the biggest share (73.2%) of the regions' total consolidated budget surplus.

### 3.8.2. Change in structure of accumulated debt

According to the data released by Russia's Ministry of Finance, the volume of debt accumulated by the subjects of the Russian Federation in 2015 increased by Rb 239.6bn to Rb 2318.6bn and the volume of debt accumulated by municipalities increased by Rb 28.1bn to Rb 341.3bn.

Table 18

**Net borrowing of regional and subnational budgets, as % of GDP**

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Net borrowing subfederal and local government authorities	0.17	0.29	0.74	0.51	0.21	0.33	0.61	0.53	0.33
Including:									
repayable loans from budgets at other levels	-0.01	0.03	0.33	0.37	0.15	0.01	0.06	0.24	0.21
subfederal (municipal) bonds	0.08	0.17	0.24	0.07	-0.11	0.06	0.12	-0.01	-0.01
Other borrowings	0.10	0.09	0.17	0.07	0.17	0.26	0.43	0.30	0.13

Source: Gaidar Institute's own calculations based on the data released by Russia's Federal Treasury.

### 3.8.3. Loan structure

Regions and municipalities borrowed a total of Rb 2541.2bn. The top-ranked borrowers were Sverdlovsk Region (Rb 165.6bn), Novosibirsk Region (Rb 147.1bn), Omsk Region (Rb 129.2bn), Stavropol Territory (Rb 102.1bn), Perm Territory (Rb 98.3bn), Republic of Tatarstan (Rb 96.4bn), Smolensk Region (Rb 51.7bn).

Securities accounted for 3.9%, loans from upper-level budgets (budget loans) for 49.5%, loans from commercial banks and international credit institutions for 46.6% of the total volume of regions' consolidated budget loans.

The total net borrowing of the regions' consolidated budgets stood at Rb 263.1bn. The highest ratio of net borrowing to budget revenues was seen in Magadan Region (21.0%), Republic of Mordovia and Republic of Khakasia (17.0% each) (see *Table 19*).

The top-ranked net borrowers were Krasnoyarsk Territory (Rb 19.0bn), Sverdlovsk Region (Rb 17.7bn), Rostov Region (Rb 14.6bn), Krasnodar Territory (Rb 12.1bn), Samara Region (Rb 11.5bn).

Thirteen regions reduced their accumulated debt because the amount they repaid on their previous loans was bigger than the amount they raised through new loans, including Moscow (down Rb 22.0bn), Moscow Region (down Rb 3.9bn), Yamalo-Nenets Autonomous Area (down Rb 2.3bn), Chelyabinsk Region (down Rb 2.0bn), Sakhalin Region (down Rb 1.3bn).

*Table 19*

**Execution of consolidated budgets of subjects of the Russian Federation in 2015**

	Budget revenues, rubles in billions	Budget deficit (surplus), rubles in billions	Ratio of deficit (surplus) to revenues, %	Ratio of borrowing to revenues, %	Net borrowing to revenues, %	Loan repayment costs to revenues, %	Net borrowing to deficit (surplus), %
1	2	3	4	5	6	7	8
<b>Central Federal Okrug</b>							
Belgorod Region	94.1	2.5	2.7	13.5	2.3	10.9	83.0
Bryansk Region	60.38	3.0	5.0	18.3	2.5	8.2	50.4
Vladimir Region	69.6	-0.5	-0.7	2.9	0.0	16.9	3.2
Voronezh Region	118.3	6.6	5.6	29.4	4.0	38.3	71.4
Ivanovo Region	45.5	3.5	7.7	109.3	8.1	56.9	104.8
Tver Region	73.4	0.6	0.9	12.6	-0.2	7.0	-21.7
Kaluga Region	63.9	7.3	11.4	27.9	10.5	26.1	91.7
Kostroma Region	30.9	3.4	11.1	68.2	6.7	108.9	60.2
Kursk Region	61.0	0.4	0.7	66.6	0.3	35.6	37.7
Lipetsk Region	68.6	0.3	0.5	8.3	2.0	41.8	444.3
Moscow Region	611.1	0.7	0.1	5.9	-0.6	2.6	-584.0
Orel Region	38.7	2.8	7.3	22.4	6.1	11.6	83.4
Ryazan Region	59.9	1.5	2.5	10.8	-0.1	51.2	-4.6
Smolensk Region	46.7	7.1	15.2	110.7	11.8	58.7	77.4
Tambov Region	57.4	3.6	6.2	54.8	3.8	51.4	60.8
Tula Region	88.6	0.8	0.9	12.9	-0.2	25.9	-25.9
Yaroslavl Region	75.8	4.4	5.8	50.4	3.8	22.3	64.5
Moscow	1.828.6	-145.7	-8.0	0.0	-1.2	1.2	15.2
Baikonur	3.7	0.1	3.4	0.0	0.0	3 235.5	0.0
<b>Total</b>	<b>3.495.7</b>	<b>-97.4</b>	<b>-2.8</b>	<b>11.1</b>	<b>0.3</b>	<b>6.0</b>	<b>-9.0</b>
<b>North-West Federal Okrug</b>							
Republic of Karelia	44.0	3.8	8.7	42.6	6.1	86.8	69.8
Republic of Komi	81.3	8.7	10.8	80.4	6.3	82.7	58.6
Arkhangelsk Region	95.9	2.7	2.8	71.2	4.9	35.3	176.2
Vologda Region	69.4	1.9	2.7	18.6	0.2	20.7	6.4
Kaliningrad Region	67.2	11.1	16.5	21.4	5.0	14.2	30.5
Leningrad Region	147.0	-11.4	-7.7	3.0	-0.5	13.1	6.0
Murmansk Region	79.5	1.6	2.0	40.2	1.5	27.3	74.7

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*Cont'd*

1	2	3	4	5	6	7	8
Novgorod Region	35.3	1.3	3.8	56.9	3.6	41.5	94.8
Pskov Region	32.4	2.2	6.8	41.8	4.3	19.0	63.4
St. Petersburg	503.0	-7.7	-1.5	1.6	0.0	1.6	-1.4
Nenets Autonomous Area	19.3	2.1	11.0	5.3	5.3	247.2	48.3
<b>Total</b>	<b>1.174.2</b>	<b>16.4</b>	<b>1.4</b>	<b>22.0</b>	<b>1.7</b>	<b>10.6</b>	<b>124.1</b>
<b>South Federal Okrug</b>							
Republic of Kalmykia	13.6	1.1	8.1	28.4	8.0	93.9	98.1
Krasnodar Territory	281.8	17.1	6.1	14.8	4.3	14.0	70.9
Astrakhan Region	47.0	3.9	8.3	63.8	3.1	45.2	36.8
Volgograd Region	121.8	7.2	5.9	29.5	5.8	16.8	96.9
Rostov Region	205.6	14.2	6.9	9.1	7.1	0.8	103.0
Republic of Adygei (Adygei)	20.7	1.1	5.5	10.9	1.5	477.2	27.8
<b>Total</b>	<b>690.5</b>	<b>44.6</b>	<b>6.5</b>	<b>19.2</b>	<b>5.3</b>	<b>7.0</b>	<b>81.9</b>
<b>North-Caucasian Federal Okrug</b>							
Republic of Dagestan	111.7	4.1	3.6	11.7	2.2	22.7	60.0
Kabardino-Balkar Republic	35.8	3.3	9.3	108.5	2.2	65.7	23.9
Republic of Northern Ossetia-Alania	30.832.150.860.8	0.8	2.7	56.5	2.1	26.3	76.6
Republic of Ingushetia	28.2	2.0	7.1	13.2	3.5	189.8	48.9
Stavropol Territory	116.5	10.3	8.8	87.7	6.4	44.3	72.3
Karachayevo-Cherkessian Republic	26.1	0.7	2.5	60.4	2.2	29.1	85.4
Chechen Republic	84.3	0.8	0.9	0.9	0.0	321.0	0.0
<b>Total</b>	<b>433.3</b>	<b>21.9</b>	<b>5.1</b>	<b>44.2</b>	<b>3.0</b>	<b>20.5</b>	<b>58.6</b>
<b>Privolzhskiy Federal Okrug</b>							
Republic of Bashkortostan	214.6	2.6	1.2	2.3	0.4	1.4	31.0
Republic of Mariy-El	33.3	2.4	7.2	36.7	7.2	77.8	99.1
Republic of Mordovia	44.7	9.1	20.3	109.3	17.0	65.2	83.6
Republic of Tatarstan (Tatarstan)	274.0	6.7	2.4	35.2	3.2	33.2	130.0
Udmurt Republic	80.7	8.0	10.0	43.0	5.6	45.5	56.2
Chuvash Republic — Chuvashya	55.1	3.0	5.7	63.7	5.2	252.9	92.1
Nizhniy Novgorod Region	179.9	12.1	6.7	117.6	5.2	54.1	77.4
Kirov Region	67.0	43.0	5.9	49.1	4.8	51.0	81.7
Samara Region	186.4	14.0	7.5	23.5	6.2	12.1	81.8
Orenburg Region	111.2	4.3	3.9	17.1	2.4	6.5	61.8
Penza Region	60.0	3.0	5.0	15.2	1.2	76.3	23.5
Perm Territory	151.6	6.8	4.5	64.8	4.7	38.7	104.6
Saratov Region	108.9	5.7	5.3	30.0	3.1	25.1	59.3
Ulyanovsk Region	56.2	7.7	13.8	27.3	9.3	182.5	67.1
<b>Total</b>	<b>1.623.7</b>	<b>89.5</b>	<b>5.5</b>	<b>42.8</b>	<b>4.3</b>	<b>22.0</b>	<b>78.2</b>
<b>Urals Federal Okrug</b>							
Kurgan Region	42.3	5.1	12.1	19.5	9.5	175.5	78.4
Sverdlovsk Region	264.3	18.1	6.8	62.6	6.7	29.1	98.0
Tyumen Region	166.0	-11.9	-7.2	0.0	0.0	6.6	0.0

*Cont'd*

1	2	3	4	5	6	7	8
Chelyabinsk Region	186.7	2.2	1.2	5.2	-1.1	1.7	-89.0
Hanty-Mansiysky Autonomous Area – Yugra	301.1	-6.1	-2.0	0.7	-0.1	4.0	4.8
Yamal-Nenets Autonomous Area	149.4	0.5	0.3	6.6	-1.6	150.7	-516.7
<b>Total</b>	<b>1.109.9</b>	<b>7.8</b>	<b>0.7</b>	<b>17.6</b>	<b>1.5</b>	<b>7.4</b>	<b>218.6</b>
<b>Siberia Federal Okrug</b>							
Republic of Buryatia	65.1	1.1	1.6	20.2	3.4	7.6	207.7
Republic of Tyva	25.8	1.4	5.5	10.0	3.5	10.7	62.6
Altai Territory	118.5	2.5	2.1	2.0	0.5	8.8	21.4
Krasnoyarsk Territory	249.8	21.2	8.5	17.8	7.6	16.3	89.8
Irkutsk Region	160.0	10.0	6.2	53.5	6.3	34.0	100.6
Kemerovo Region	159.0	8.9	5.6	13.3	4.9	51.4	87.3
Novosibirsk Region	158.0	13.6	8.6	93.1	8.0	83.2	92.6
Omsk Region	97.3	5.1	5.3	132.8	4.2	81.4	80.4
Tomsk Region	74.7	2.8	3.7	85.9	4.9	52.3	132.0
Republic of Altai	20.1	0.7	3.4	11.5	0.1	35.2	3.8
Republic of Khakassia	34.9	5.1	14.7	63.9	17.0	37.9	115.8
Zabaikalsky Territory	66.5	6.6	9.9	39.3	10.0	94.9	101.0
<b>Total</b>	<b>1.229.7</b>	<b>79.0</b>	<b>6.4</b>	<b>45.6</b>	<b>6.0</b>	<b>21.8</b>	<b>93.0</b>
<b>Far East Federal Okrug</b>							
Republic of Sakha (Yakutiya)	207.3	4.4	2.1	5.0	2.8	7.9	130.2
Primorsky Territory	130.4	0.6	0.4	11.1	0.0	15.7	8.8
Khabarovsk Territory	109.9	11.3	10.3	39.2	8.1	19.6	78.0
Amur Region	62.7	4.2	6.8	28.8	3.8	17.1	55.4
Kamchatka Territory	72.1	0.7	0.9	9.2	2.1	7.8	222.6
Magadan Region	30.8	5.6	18.2	43.8	21.0	20.0	115.0
Sakhalin Region	232.6	-10.7	-4.6	0.0	-0.6	0.7	12.2
Jewish Autonomous Region	12.6	1.4	10.9	57.8	10.9	34.8	99.7
Chukotka Autonomous Region	29.4	-2.1	-7.2	17.7	-3.4	21.1	46.7
<b>Total</b>	<b>887.8</b>	<b>15.5</b>	<b>1.7</b>	<b>13.4</b>	<b>2.7</b>	<b>5.5</b>	<b>155.8</b>
<b>Crimean Federal Okrug</b>							
Sevastopol	24.5	-2.9	-11.6	0.0	0.0	0.0	0.0
Republic of Crimea	112.1	4.3	3.8	0.0	0.0	0.0	0.0
<b>Total</b>	<b>136.6</b>	<b>1.4</b>	<b>1.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Total Russian Federation</b>	<b>10.781.5</b>	<b>178.7</b>	<b>1.7</b>	<b>23.6</b>	<b>2.4</b>	<b>12.7</b>	<b>147.2</b>

Source: Gaidar Institute's own calculations based on the data released by Russia's Federal Treasury.

### *Domestic bonded loans*

In 2015, 18 subjects of the Russian Federation and 3 municipalities registered bond prospectus (compared with 31 regional and 5 municipal bond prospectuses issued in 2014). The fol-

lowing regions registered bond prospectuses with Russia's Ministry of Finance in 2015: Volgograd Region, Krasnoyarsk Territory, Nizhniy Novgorod Region, St. Petersburg, Tomsk Region, Republic of Sakha (Yakutiya), Yaroslavl Region, Udmurt Republic, Samara Region, Republic of Bashkortostan, Belgorod Region, Tula, Orenburg, Irkutsk Region, Republic of Mordovia, Republic of Komi, Republic of Khakasia, Krasnodar Territory, Novosibirsk, Tomsk, Volgograd.

In 2015, the volume of placed bonds stood at Rb 98.5bn, a decline of 18% in nominal terms from the volume seen in 2014. Hence subfederal and municipal bonds decreased in volume from 0.16% to 0.12% of GDP during the year (see *Table 20*).

*Table 20*
**Volume issued subfederal and municipal securities, % of GDP**

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Issuance	0.26	0.43	0.41	0.25	0.10	0.19	0.23	0.16	0.12
Redemption	0.18	0.26	0.16	0.18	0.21	0.13	0.12	0.17	0.13
Net financing	0.08	0.17	0.24	0.07	-0.11	0.06	0.12	-0.01	-0.01

Source: Gaidar Institute's own calculations based on the data released by Russia's Ministry of Finance.

The top-ranked security issuers were Krasnoyarsk Territory (Rb 16.8bn, or 17.0% of the total volume of internal loans), Samara Region (Rb 7.0bn, or 7.1%), Nizhniy Novgorod Region (Rb 12.0bn, or 12.2%), Republic of Komi (Rb 9.9bn, or 10.0%).

Hence, the top-4 issuers accounted for 46.3% of the total volume of placed regional and municipal bonds (see *Table 21*).

*Table 21*
**Placement of subfederal and municipal securities in 2015**

	Issuing volume, rubles in billions	Issuer's percentage of total issuing volume, %	Issuing volume to internal loans, %
<b>Central Federal Okrug</b>			
Belgorod Region	5.25	5.3	41.5
Tula Region	5.00	5.1	43.9
Yaroslavl Region	1.89	1.9	5.0
<b>North-West Federal Okrug</b>			
Republic of Komi	9.87	10.0	15.1
<b>South Federal Okrug</b>			
Krasnodar Territory	4.80	4.9	11.5
Volgograd Region	6.30	6.4	17.5
<b>Privolzhskiy Federal Okrug</b>			
Republic of Bashkortostan	1.50	1.5	30.5
Republic of Mordovia	3.00	3.0	6.1
Udmurt Republic	3.00	3.0	8.6
Nizhniy Novgorod Region	12.00	12.2	5.7
Samara Region	7.00	7.1	16.0
Orenburg Region	5.00	5.1	26.3
<b>Siberia Federal Okrug</b>			
Krasnoyarsk Territory	16.75	17.0	37.7
Novosibirsk Region	2.00	2.0	1.4
Omsk Region	4.07	4.1	3.1
Tomsk Region	2.16	2.2	3.4
Republic of Khakasia	2.84	2.9	12.8
<b>Far East Federal Okrug</b>			
Republic of Sakha (Yakutiya)	5.50	5.6	53.2
Magadan Region	0.52	0.5	3.9
<b>Russian Federation Total</b>	<b>98.46</b>	<b>100.0</b>	<b>3.9</b>

Source: Gaidar Institute's own calculations based on the data released by Russia's Federal Treasury.

The highest level of securitization (43.9%) was seen in Tula Region.

The volume of redeemed securities exceeded the volume of placed securities by Rb 5.8bn versus Rb 9.2bn in 2014 (see *Table 22*).

*Table 22*

**Volume of net borrowing in domestic market  
of subfederal and municipal securities,  
thou. rubles**

	Regions' consolidated budgets	Regions' budgets	Municipalities' budgets
<b>2015</b>			
Net borrowing	-5.817.814.4	-7.108.555.7	1.290.741.3
Fundraising	98.458.019.0	94.251.869.0	4.206.150.0
Repayment of principal	104.275.833.3	101.360.424.7	2.915.408.6
<b>2014</b>			
Net borrowing	-9.235.928.1	-7.410.458.9	-1.825.469.2
Fundraising	111.494.394.7	110.094.379.7	1.400.015.9
Repayment of principal	120.730.322.8	117.504.838.6	3.225.484.2
<b>2013</b>			
Net borrowing	77.610.485.8	75.454.011.5	2.156.474.3
Fundraising	154.642.004.9	149.641.823.0	5.000.181.9
Repayment of principal	77.031.519.1	74.187.811.5	2.843.707.6
<b>2012</b>			
Net borrowing	38.175.959.8	36.797.479.3	1.378.480.5
Fundraising	119.855.045.4	115.953.169.3	3.901.876.1
Repayment of principal	81.679.085.5	79.155.690.0	2.523.395.5
<b>2011</b>			
Net borrowing	-58.202.600.7	-57.113.066.4	-1.089.534.3
Fundraising	55.050.750.6	53.366.195.4	1.684.555.1
Repayment of principal	113.253.351.3	110.479.261.9	2.774.089.4
<b>2010</b>			
Net borrowing	29.774.599.3	28.611.970.0	1.162.629.3
Fundraising	111.106.318.3	105.854.346.2	5.251.972.1
Repayment of principal	81.331.719.0	77.242.376.2	-4.089.342.8
<b>2009</b>			
Net borrowing	95.457.576.8	97.916.509.1	-2.458.932.3
Fundraising	158.114.034.3	153.992.570.1	4.121.464.2
Repayment of principal	62.656.457.5	56.076.061.0	6.580.396.5
<b>2008</b>			
Net borrowing	68.851.271.9	72.984.947.8	-4.133.675.9
Fundraising	178.565.731.4	177.324.359.3	1.241.372.1
Repayment of principal	109.714.459.5	104.339.411.5	5.375.048.0
<b>2007</b>			
Net borrowing	25.867.011	23.691.970	2.175.041
Fundraising	84.159.197	79.889.761	4.269.436
Repayment of principal	58.292.185	56.197.791	2.094.394

*Source:* Gaidar Institute's own calculations based on the data released by Russia's Federal Treasury.

Most of the regions that raise money by issuing bonds on a regular basis continued to issue bonds in 2015. Volgograd Region has been issuing bonds every year since 1999, Krasnoyarsk Territory since 2003, Nizhniy Novgorod Region since 2004 (see *Table 23*).

**Registration of prospectuses of subfederal and municipal securities in 1999–2015**

Issuer	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
<b>Subjects of the Russian Federation</b>																	
Volgograd Region	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Krasnoyarsk Territory					*	*	*	*	*	*	*	*	*	*	*	*	*
Nizhniy Novgorod Region						*	*	*	*	*	*	*	*	*	*	*	*
St. Petersburg	*	*	*	*	*	*	*	*	*	*		*	*	*	*	*	*
Tomsk Region		*	*	*	*	*	*	*	*	*		*	*	*	*	*	*
Republic of Sakha (Yakutiya)				*	*	*	*	*	*	*		*	*	*	*	*	*
Yaroslavl Region					*	*	*	*	*	*		*	*	*	*	*	*
Udmurt Republic							*		*	*		*	*	*	*	*	*
Samara Region					*		*	*	*	*	*		*	*	*	*	*
Republic of Bashkortostan			*	*		*	*	*	*				*	*	*	*	*
Belgorod Region				*	*		*	*		*				*	*	*	*
Tula Region								*						*	*	*	*
Orenburg Region														*	*	*	*
Republic of Mordovia				*											*	*	*
Republic of Khakasia													*	*	*	*	*
Republic of Komi		*	*	*	*	*	*	*		*		*	*	*	*	*	*
Republic of Karelia						*	*	*	*	*	*	*	*	*	*	*	*
Tver Region				*	*		*	*	*	*	*	*	*	*	*	*	*
Stavropol Territory			*							*			*	*	*	*	*
Lipetsk Region						*	*	*	*	*				*	*	*	*
Voronezh Region						*	*	*	*					*	*	*	*
Novosibirsk Region	*				*	*	*	*	*						*	*	*
Smolensk Region															*	*	
Omsk Region															*	*	
Sverdlovsk Region												*	*	*		*	
Chuvash Republic — Chuvashia	*	*	*	*	*	*	*	*	*	*	*		*	*	*	*	*
Republic of Mariy-El														*	*	*	
Hanty-Mansiysky Autonomous Area				*	*						*				*	*	
Leningrad Region			*	*	*	*									*	*	
Magadan Region															*	*	
Kostroma Region				*	*		*		*				*		*		
Moscow	*	*	*	*	*	*	*	*	*	*	*	*			*		
Kemerovo Region															*		
Kaluga Region						*		*	*	*			*	*			
Vologda Region													*	*			
Ryazan Region														*			
Krasnodar Territory					*	*		*	*			*	*	*			*
Irkutsk Region			*	*	*	*	*	*	*	*	*			*			*
Ivanovo Region									*				*				
Republic of Buryatia													*				
Murmansk Region				*	*							*					
Penza Region								*	*	*							
Ulyanovsk Region								*	*	*							
Kurgan Region								*	*	*							
Moscow Region				*	*	*	*	*	*	*							
Republic of Kalmykia									*								
Khabarovsk Territory				*	*	*	*										
Kabardino-Balkar Republic		*					*										



*Cont'd*

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Yamal-Nenets Autonomous Area					*	*											
Bryansk Region						*											
Sakhalin Region				*													
Kursk Region				*													
Primorsky Territory		*															
<b>Municipalities</b>																	
Novosibirsk					*	*	*	*				*	*	*	*	*	*
Volgograd	*	*	*	*	*		*	*		*	*	*	*	*		*	*
Tomsk					*	*		*	*	*		*		*		*	*
Omsk																	*
Volzhskiy, Volgograd Region																	*
Kazan							*	*	*		*	*	*				
Krasnodar												*	*				
Krasnoyarsk					*	*	*		*	*	*	*	*	*			
Ufa				*	*	*						*					
Elektrostal, Moscow Region									*		*						
Smolensk											*						
Lipetsk								*	*	*							
Magadan								*	*	*							
Bratsk										*							
Novorossiysk										*							
Yekaterinburg		*	*	*	*	*	*	*	*								
Klin District, Moscow Region							*	*	*								
Noginsk District, Moscow Region						*		*	*								
Blagoveshchensk								*	*								
Cheboksary	*						*		*								
Balashikha, Moscow Region									*								
Odintsovo District, Moscow Region							*	*									
Astrakhan								*									
Bryansk								*									
Voronezh								*									
Orekhovo-Zuevo, Moscow Region								*									
Yaroslavl								*									
Yuzhno-Sakhalinsk					*	*	*										
Novocheboksarsk	*		*			*	*										
Angarsk							*										
Vurnask Region, Chuvash Republic							*										
Sumerlya, Chuvash Republic							*										
Barnaul						*											
Perm						*											
Nizhniy Novgorod				*													
Kostroma	*	*															
Arkhangelsk	*																
Dzerzhinskiy	*																

Source: Russia's Ministry of Finance.



## Section 4. The Real Sector of the Economy

### 4.1. Production of the microstructure<sup>1</sup>

#### 4.1.1. Dynamics of the Russian economy in 2015: the effect of external and internal demand

The main factors behind development of the Russian economy in the past two years were as follows: shrinkage of external demand and depreciation of prices on Russia's main primary sector commodities which make up the basis of the export potential; weakening of domestic demand due to a drop in revenues of the economy and growth in costs; narrowing of the extent of imports which formed over one-third of domestic market resources; reduction of volumes of domestic and foreign capital investments.

*Table 1*

**Dynamics of the main factors behind development of the economy  
in the 2009–2015 period, % of the previous period**

	2009	2010	2011	2012	2013	2014	2015
GDP	92.2	104.5	104.3	103.5	101.3	100.7	96.3
Domestic demand, including:	85.3	108.3	108.8	105.5	100.5	101.3	89.7
Households' ultimate consumption	94.9	105.8	106.8	107.4	103.7	101.7	89.9
Capital investments	84.3	106.3	110.8	106.8	100.8	97.3	91.6
External demand	95.3	100.7	100.3	101.4	104.8	99.4	92.4
Average export prices	66.5	123.1	132.9	101.6	95.7	94.3	64.8
Average import prices	99.1	101.7	109.2	97.3	102.5	98.2	81.1
Consumer price index	108.8	108.8	106.1	106.6	106.8	109.1	112.9
Oil prices	63.4	128.7	139.3	101.0	97.2	90.9	52.9
Official rate (Rb/USD)	102.9	100.7	105.6	94.3	107.8	171.9	129.5

*Source:* The Rosstat.

In the 2009–2015 period, economic growth rates gradually fell, disparities in production and consumption consolidated, manufacturers' investment activities fell and imbalances between technological parameters of capital assets and investments in capital assets by the base type of economic activities increased. Development based on extensive utilization of the main factors reduced competitiveness of the Russian economy and dynamics of its development. Growth in investments in capital assets observed in H2 2012 failed to result in a higher return per unit of

<sup>1</sup> Author of this section: Izryadnova O. – Gaidar Institute for Economic Policy.

invested funds and labor. Expansion of domestic consumer demand prior to H2 2014 is related to growth in wages which exceeded a great deal the dynamics of labor efficiency.

*Table 2*

**The main macroeconomic indicators of the socioeconomic development in the 2008–2015 period, % of the previous period**

	2008	2009	2010	2011	2012	2013	2014	2015
GDP	105.2	92.2	104.5	104.3	103.5	101.3	100.7	96.3
Industrial production index	100.6	90.7	107.3	105	103.4	100.4	101.7	96.6
Production of primary products	100.4	99.4	103.8	101.8	101	101.1	101.4	100.3
Manufacturing	100.5	84.8	110.6	108	105.1	100.5	102.1	94.6
Agricultural products	110.8	101.4	88.5	123.0	95.2	105.8	103.7	103.0
Business volume in building	112.8	86.8	105.0	105.1	102.5	100.1	97.7	93.0
Capital investments	109.5	86.5	106.3	110.8	106.8	100.8	97.3	91.6
Retail trade volume	113.7	94.9	106.5	107.1	106.3	103.9	102.5	90.0
Volume of paid services to households	104.3	97.5	101.5	103.0	103.7	102.0	101.3	97.9
Foreign trade turnover	132.5	63.7	132.7	130.6	103.5	100.2	93.2	66.6
Export	134.6	63.7	132.1	131.3	102.3	99.2	95.1	68.2
Import	130.7	64.1	131.1	128.4	105.3	102.3	92.2	63.0
Consumer price index as of year-end	113.3	108.8	108.8	106.1	106.6	106.8	109.1	112.9
Industrial producer price index as of year-end	93.0	113.9	116.7	112.0	105.1	103.4	106.1	110.7
Households' real disposable cash income	102.4	103.0	105.9	100.5	104.6	104.0	99.3	96.0
Real accrued wages	111.5	96.5	105.2	102.8	108.4	104.8	101.2	90.5
Real size of granted pensions	118.4	110.7	134.8	101.2	104.9	102.8	100.9	96.2
General unemployment level, %	6.2	8.2	7.3	6.5	5.5	5.5	5.2	5.6
Balanced financial result	62.9	116.6	144.1	114.2	110.8	82.7	90.9	148.6
Labor efficiency	104.8	95.9	103.2	103.8	103.0	101.9	100.8	96.8

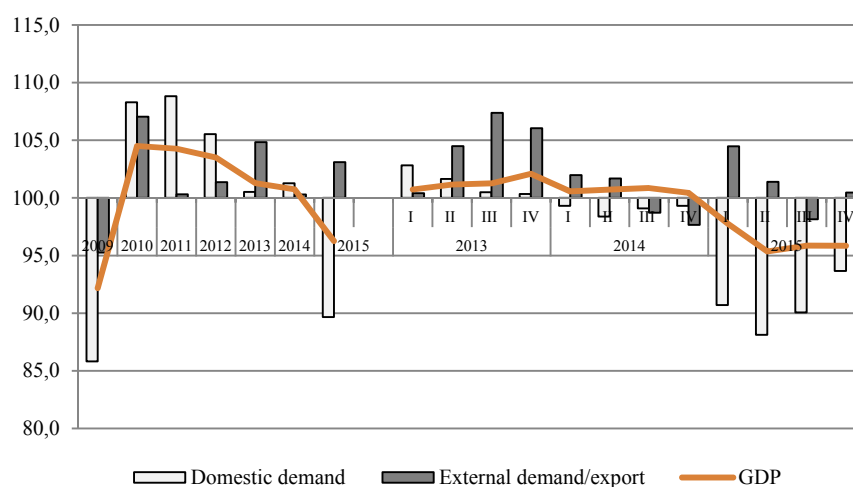
Source: The Rossta.

On the basis of the 2015 results, GDP amounted to 96.3% on the 2014 index and decreased for the first time after the 2008–2009 crisis. As compared to the 2008–2009 crisis, in 2015 GDP reduction was less dramatic and determined by differences in the dynamics of individual components of the aggregate demand over the past five years.

The common factor behind the situation of 2009 and 2015 was a drop in domestic demand, while the difference of the 2015 situation consisted in prevalence of positive dynamics of external demand. Such correlation of rates of external and domestic demand in 2015 was registered only during the acute phase (Q3 1998 – Q2 1999) of the crisis.

If in the 2010 – Q1 2013 period domestic demand grew at an advanced rate as compared to GDP and external demand, from Q2 2013 the situation changed – the dominating factor behind stagnation of the Russian economy was a sudden slowdown of growth rates of domestic demand. It was in the above period a trend of slowdown of consumer demand started to emerge. From H2 2014, the situation became much more complicated due to formation of radically new political and economic factors. Changes in the global market situation with a simultaneous introduction of sanctions and countermeasures had a great effect on the main parameters of functioning of the economy. In Q3 2014 and Q4 2014, the ruble exchange rate started to depreciate and the rate of inflation sped up with reduction of external demand. In Q4 2014, domestic demand was formed under the effect, on one side, of a sudden surge in feverish consumer demand initiated by households' higher inflation expectations, while, on the other side, by shrinkage of investment demand due to appreciation of credit resources with dynamic growth in the

key rate within a year from 5.5% (February 03, 2014) to 17% (December 16, 2014). That combination of factors determined the starting conditions of 2015.



*Fig. 1.* GDP dynamics by components of domestic and external demand in the 2009–2015 period, % of the respective period of the previous year

Source: The Rosstat.

*Table 3*

**Contribution of net exports to GDP in the 2011–2015 period  
(according to the SNA methods)**

	2011	2012	2013	2014	2015
<b>Current prices, billion Rb</b>					
GDP	59698.1	66926.9	71055.4	77893.1	80412.5
net export	4854.4	4537.9	3988.4	5167.8	6511.3
export	16865.2	18324.8	18909.3	21464.2	23606.5
import	12010.8	13786.9	14920.9	16296.4	17095.2
<b>% of result</b>					
GDP	100	100	100	100	100
net export	8.1	6.8	5.6	6.6	8.1
export	28.3	27.4	26.6	27.6	29.4
import	20.1	20.6	21.0	20.9	21.3
<b>% of previous year in comparative prices</b>					
GDP		103.5	101.3	100.7	96.3
net export		80.8	113.2	119.3	171.8
export		101.1	104.6	98.0	103.1
import		108.7	103.8	93.2	74.4

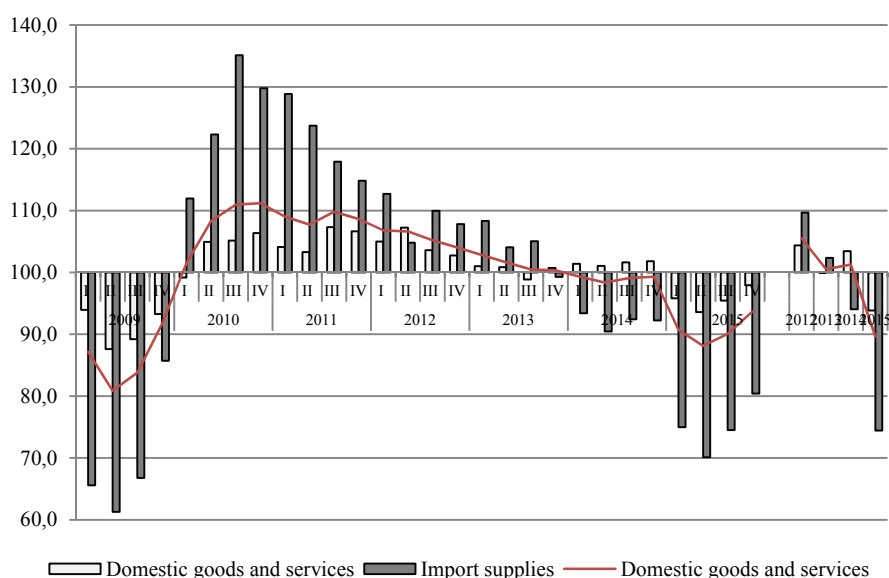
Source: The Rosstat.

In Q1 2015, for the first time after the 2009 crisis a 2.2% drop in GDP on the respective period of the previous year was registered. Changes in the situation and prices on the global market had an adverse effect on the demand on Russian export goods. Limitations related to sanctions determined reduction and structural shifts in imports. In 2015, the monetary volume of exports of goods fell by 31.8%, while that of imports, by 37.0% as compared to 2014. Reduction of the exports of goods was justified by worsening of the global market situation: average prices on Russian export goods fell by 35.2% as compared to 2014. A drop in prices was partially offset by growth of 5.2% (according to the methods of the balance of payments) and 3.1% (according to the methods of the system of national accounts (SNA)) in physical volumes of exports.

The dynamics of imports is affected greatly by depreciation of the ruble, reduction of the economy's and households' revenues and restrictive measures introduced in respect of individual categories of goods. In 2015 a main factor behind a drop in import volumes of goods was reduction of 22.3% and 25.6% of physical volumes of import supplies according to the methods of the balance of payment and SNA methods, respectively, as compared to the previous year.

With the existing correlation between the rates and the pattern of the foreign trade turnover in 2015, Russia retained foreign trade surplus and its contribution to GDP dynamics grew to 8.1% against 6.6% in 2014.

Depreciation of the ruble exchange rate had an ambiguous effect on the Russian economy. On one side, it diminished the effect of external factors on individual sectors of the Russian economy, while on the other side it resulted in growth in production costs due to appreciation of imports of intermediate goods. Amid economic uncertainties, manufacturers' worsening expectations, inflation rate growth and limited options of replacement of lost external sources of funding, shrinkage of the domestic market consolidated.



*Fig. 2. GDP dynamics by components of domestic and external demand in the 2009–2015 period, % of the respective quarter of the previous year*

Source: The Rosstat.

From the beginning of 2014, the dynamics of domestic demand was in the area of negative values, while in 2015 it was complicated by simultaneous drops in domestic production of goods and services and imports.

In 2015, a large-scale drop in imports determined structural changes in the domestic market: with reduction of consumer demand and depreciation of the ruble exchange rate the share of domestic goods in retail trade resources rose to 63% in Q3 2015 (59% a year before).

A large share of imports in the retail trade volume and the volume of intermediate consumption and capital investments made the balance of gross resources of the economy more dependent on changes in the foreign economic situation. In the pattern of imports, supplies of consumer and investment goods decreased more than those of intermediate consumption goods. It is to be noted that reduction of the share of consumer goods in the patter of imports can be

explained both by formation of import substitution as regards food products and a general drop in households' demand with advanced growth in prices on import goods as compared to domestic ones.

*Table 4*

**The pattern of retail trade commodity resources in actual prices, %**

	Retail trade commodity resources	including	
		domestic production	import
<b>2014</b>			
Q 1	100	57	43
Q 2	100	59	41
Q 3	100	59	41
Q 4	100	56	44
Year	100	58	42
<b>2015</b>			
Q 1	100	59	41
Q 2	100	66	34
Q 3	100	63	37
Q 4	100	61	39
Year	100	62	38

Source: The Rosstat.

*Table 5*

**The pattern of imports by the functional mode of utilization  
(according to the methods of the balance of payments), % of the result**

	Goods		
	consumer	investment	intermediate
2010	40.7	19.5	39.8
2011	36.6	21.4	42.0
2012	38.1	24.9	37.0
2013	37.6	24.3	38.0
2014	37.8	24.5	37.7
Q I	39.6	23.2	37.2
Q II	36.1	26.0	37.9
Q III	37.2	22.4	39.4
Q IV	38.4	25.5	36.1
2015	36.4	23.2	40.4
Q I	37.7	21.6	40.7
Q II	36.4	21.7	41.9
Q III	35.2	23.6	41.2
Q IV	36.4	23.2	40.4

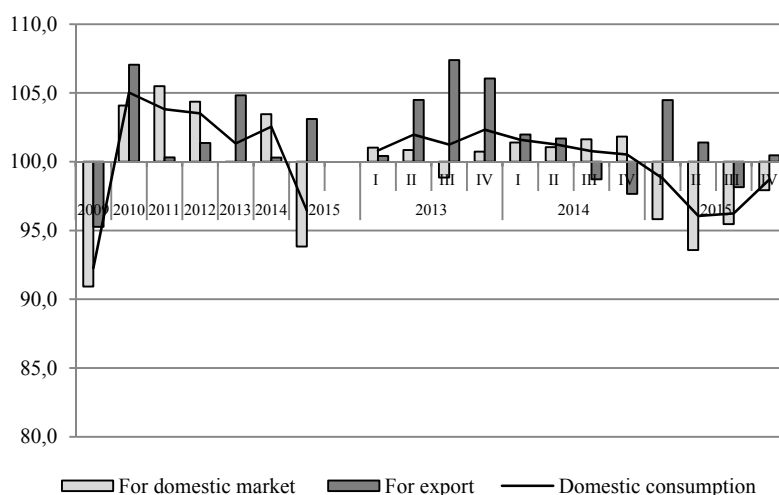
Source: The Rosstat.

In 2015, the dynamics and pattern of imports of intermediate and investment goods were greatly affected by further slump in capital investments and shrinkage of demand on investment goods. Growth in the share of intermediate consumption goods reflected an insufficient level of localization of main production and components in the segment of production with a high share of industrial assembly.

A drop in capital investments resulted in a simultaneous decrease in demand on domestic and import capital goods and prompted development of negative trends on the domestic market. Further problems arose due to sanctions imposed on deliveries of individual types of technological equipment needed for implementation of investment plans of the primary sector and manufacturing industries, as well as infrastructure projects.

Slowdown of domestic production was justified both by low competitiveness of domestic goods and services as compared to import analogues and low efficiency of production in the segment of non-tradable goods and services as compared to export-oriented sectors of the

economy. In 2015, a 6.2% decrease in the output of goods and services for domestic consumption intensified a slump in production as compared to the previous year.



*Fig. 3. Dynamics of domestic production of goods and services by components in the 2009–2015 period, % of the respective quarter of the previous year*

Source: The Rosstat.

**4.1.2. Utilization of GDP in the 2011–2015 period: consumer and Investment demand**

The pattern of utilization of GDP was determined by a change in the ratios between ultimate consumption, gross savings and change in the net export contribution.

*Table 6*

**The pattern of utilization of GDP in the 2011–2015 period, % of the result, in current prices\***

	2011	2012	2013	2014	2015
Gross domestic product, including:	100.0	100.0	100.0	100.0	100
Expenditures on ultimate consumption	68.8	70.4	73.6	72.3	73.5
households	50.2	51.3	53.6	53.2	53.8
state government	18.2	18.7	19.7	18.8	19.3
Non-profit organizations rendering services to households	0.4	0.4	0.4	0.4	0.4
Gross savings	23.1	22.9	21.1	21.1	20.9
Gross accumulation of capital assets	20.0	20.2	20.2	21.4	22.0
Changes in inventories	3.1	2.7	0.9	-0.3	-1.1
Net export	8.1	6.8	5.6	6.6	8.1
Statistical discrepancies	0.0	-0.1	-0.4	-0.1	-2.5

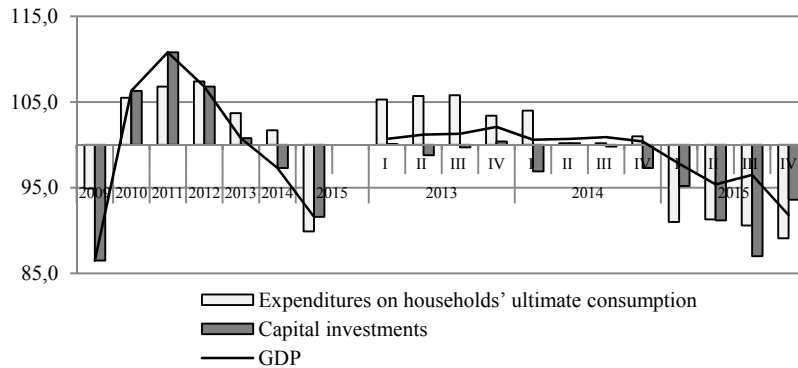
\* The data differs from the previous publications by the amount of change related to introduction of international methods of valuation of housing services, consumption of capital assets and reconciliation of the data on exports and imports with the data of the balance of payments.

Source: The Rosstat.

The specifics of 2015 consisted in a more dramatic drop in households’ ultimate consumption as compared to the dynamics of capital investments. If in the 2010–2014 period the main factor which underpinned a positive trend of development of the Russian economy was households’ consumption, in 2015 a drop in real income, a higher burden on households as regards



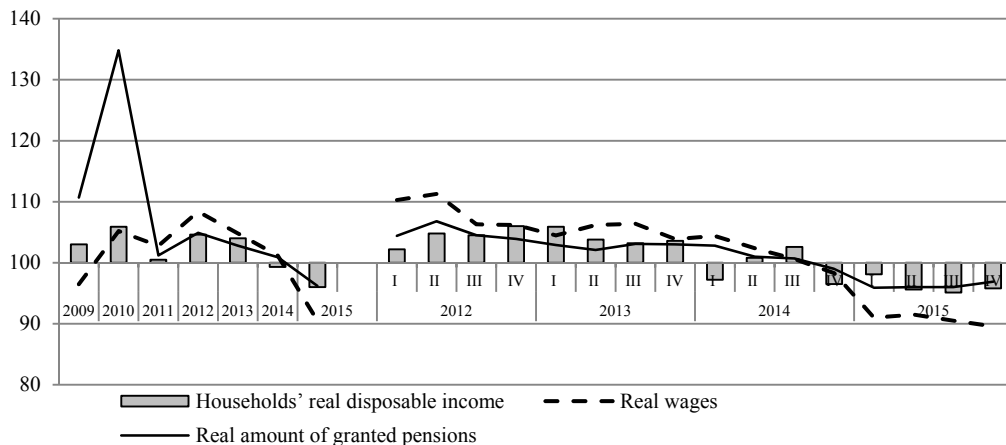
repayment of debts on loans and growing inflationary expectations resulted in a 10.1% reduction of households' ultimate consumption as compared to the previous year.



*Fig. 4.* The dynamics of households' ultimate consumption and investments in capital assets in the 2009–2015 period, % of the previous year

*Source:* The Rosstat.

Amid growing rate of inflation and economic uncertainties, changes took place in the consumer behavior model: the share of savings in households' incomes rose to 14.1%, including that in deposits and securities amounting to 6.5% (6.9% and 0.8%, respectively, in 2014). In 2015, households' interest in buying foreign currency amid dramatic depreciation of the ruble weakened a great deal and shifted to the area of organized forms of saving at credit institutions which raised interest rates on deposits from the end of 2014.



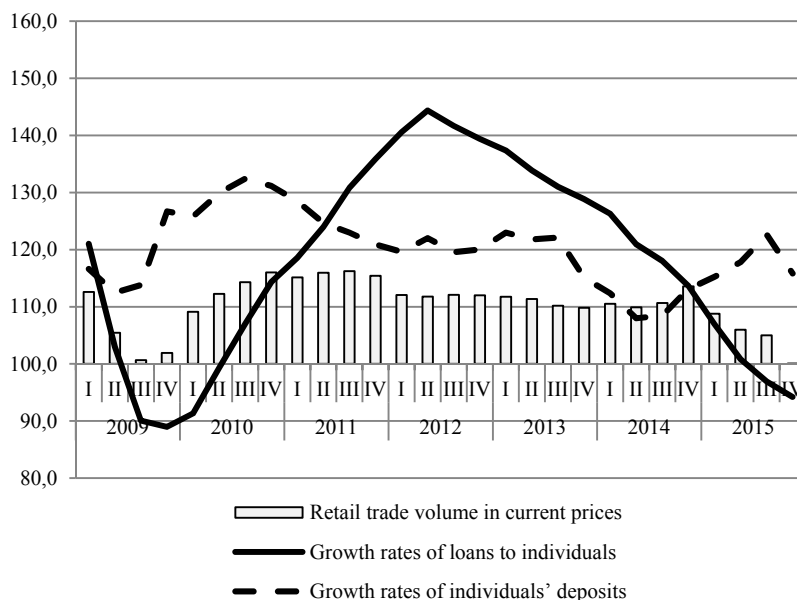
*Fig. 5.* Dynamics of households' real income in the 2009–2015 period, % of the respective period of the previous year\*

\* the quarterly data on households' revenues in the 2014–2015 period are preliminary and need be specified.

*Source:* The Rosstat.

With the existing GDP dynamics and utilization of the main factors of production, by 2014 the potential of further growth in labor remuneration costs was exhausted and in 2015 the dynamics of the main indices of households' standard of living was characterized by a gradual slowdown. In 2015, households' real disposable incomes fell by 4.0%, including monthly

average accrued wages (9.5%) and the average amount of granted pensions (3.8%). As labor remuneration has a dominating effect on the level of households' incomes (66.0% of households' incomes), a trend of further reduction of real wages – the trend emerged late in 2015 – is becoming a major factor which determines social parameters of households' standard of living in 2016. The situation is further complicated by the fact that in 2015 households' revenues from property and entrepreneurial activities fell, too.



*Fig. 6. Dynamics of loans to households and households' deposits in the 2009–2015 period, % of the respective period of the previous year*

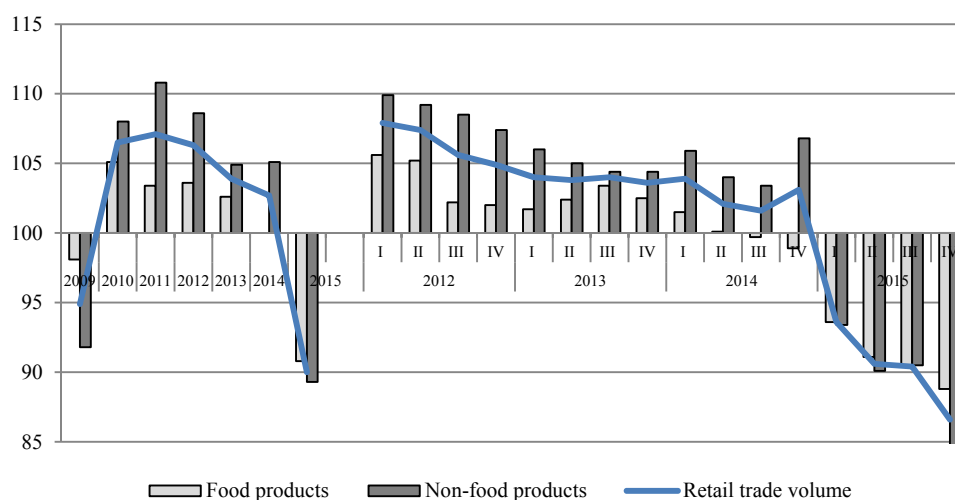
Source: The Rosstat.

In 2015, the retail trade volume and the volume of paid services fell by 10.0% and 2.1%, respectively, as compared to the previous year. Such a dramatic drop in the retail trade volume was neither observed in the 1999 crisis, nor in the 2009 crisis. In 2015, the share of households' expenditures on purchasing of goods fell by 3.1 p.p. as compared to 2014 and amounted to 54.5% of households' incomes.

Reduction of consumer demand was accompanied by shrinkage both of markets of food and non-food products. In 2015, the market of food products amounted to 90.8%, while that of non-food products, to 89.3% on the 2014 indices. Negative developments on the food market were registered from June 2014, while those on the non-food market, from the beginning of 2015. If before October 2014 the retail trade volume was underpinned by positive dynamics of households' revenues, in November 2014 – December 2015 the situation changed due to a sudden slowdown of growth in households' nominal income and high rates of inflation. In 2015, the consumer inflation index amounted to 112.9%, including 114.0%, 113.7% and 10.2% as regards food products, non-food products and services, respectively.

In 2015, in GDP dynamics by components of ultimate consumption the share of gross savings in GDP fell to 26.5% with the index of 31.2% in 2011. In 2015, gross accumulation amounted to 20.9% with the pattern changed. A drop in economic growth rates resulted in reduction of inventories. The share of gross accumulation of capital assets rose as compared to

the previous year, however, the unit weight of capital investments in GDP remained at the average level throughout the 2013–2014 period and amounted to 18%.



*Fig. 7.* The dynamics of the retail trade volume in the 2009–2015 period, % of the respective month of the previous year

*Source:* The Rosstat.

The specifics of the Russian investment model consists in substantial volumes of savings whose major portion is not transformed into capital investments. A low level of transformation of gross national savings and gross accumulation into capital investments is a deep-rooted phenomenon of the Russian economy over quite a long period of time.

*Table 7*

**The main indicators of the economy’s investment potential  
in the 2011–2015 period, % of GDP**

	2011	2012	2013	2014	2015
Gross savings	31.9	29.6	26.4	27.7	26.5
Gross accumulation of capital assets	20.0	20.2	20.2	21.4	22.0
Individuals’ deposits as of year-end	19.9	21.3	23.9	23.8	27.1
Resources of Federal Fund as of year-end	1.3	1.2	2.7	3.7	4.5
Resources of National Welfare Fund as of year-end	4.5	4.2	3.8	3.7	6.5
Capital investments	18.5	18.8	18.7	17.8	18.1

*Source:* The Rosstat.

From Q3 2014, a slump in investment activities intensified due to a higher cost of credit resources, limitation of companies’ access to borrowing on global financial markets and high geopolitical risks. In 2015, capital investments fell by 8.4% as compared to the index of the previous year.

The analysis of the pattern of utilization of GDP and capital account illustrates asymmetry in formation of domestic saving resources and utilization thereof for investment purposes. The Russian investment model is characterized by substantial volumes of savings whose major portion the economy fails to transform into capital investments.

### 4.1.3. The GDP pattern by sources of income

The development of the Russian economy is characterized by diminishing development potential which fact is underpinned by high loading of production capacities, lack of large-scale investments and a low level of unemployment. In addition to the above, long-term growth in production costs related to the tariff policy of infrastructure monopolies and advanced growth in wages as compared to labor efficiency make the situation even more complicated.

In the pattern of production costs, there is still high unit weight of material costs at the expense both of primary products and a fuel and energy component. Low efficiency of utilization of inputs is a major factor behind low efficiency of production and competitiveness of domestic goods on the domestic and foreign markets. Amid a drop in economic growth rates, in the 2014-2015 period the pricing policy was adjusted and determined the specifics of dynamics of financial performance of economic activities and efficiency indices. In 2015, production profitability grew by 2.5 p.p. as compared to 2014.

*Table 8*

#### **Profitability of sold goods, products, jobs and services by the type of economic activities in the 2010–2015 period, %**

	2010	2011	2012	2013	2014	2015
<b>Total in the economy</b>	<b>10,0</b>	<b>9,6</b>	<b>8,6</b>	<b>7,0</b>	<b>7,3</b>	<b>9,3</b>
Agriculture, hunting and forestry	9,1	9,1	10,7	5,2	17,4	21,3
Fishery and fish-farming	19,6	18,2	16,2	16,5	28,6	59,4
Mining	31,9	31,4	28,0	22,1	19,2	26,8
Manufacturing	14,8	13,2	10,7	8,8	9,9	12,4
Production and distribution of electricity, gas and water	7,1	6,4	3,9	4,4	3,7	5,5
Building	4,5	4,3	5,0	8,3	3,4	5,4
Wholesale and retail trade	8,3	8,9	6,7	6,5	6,1	7,1
Hotels and restaurants	6,2	5,9	5,9	6,0	4,4	5,8
Transport and communications	13,5	11,4	11,1	9,7	8,4	10,6
Communications	27,7	21,9	23,7	23,6	20,8	21,4
Financial activities	0,6	-0,3	0,8	0,5	1,5	0,5
Real-estate operations, leasing and provision of services	9,3	9,2	10,6	10,4	10,7	9,7
Public administration and military security; social insurance	12,8	6,8	8,3	7,8	10,3	11,7
Education	6,6	4,1	2,5	11,8	2,3	6,2
Healthcare and provision of social services	5,6	1,7	6,6	4,8	6,2	7,6

Source: The Rosstat.

*Table 9*

#### **Indices of prices and tariffs in the 2010-2015 period, December on December**

	2010	2011	2012	2013	2014	2015
Consumer price index	108.8	106.1	106.6	106.5	111.4	112.9
Industrial producer price index	116.7	112.0	105.1	103.7	105.9	110.7
Mining	117.1	126.3	109.3	107.0	98.4	109.8
Production of fuel and energy primary products	116.1	128.1	110.5	107.7	97.0	109.8
Production of primary products, except for fuel and energy	130.9	112.4	98.9	101.0	109.9	110.0
Manufacturing	116.9	108.3	103.2	101.6	108.5	112.2
Production and distribution of electricity, gas and water	113.8	105.1	107.0	108.1	104.5	109.3
Agricultural producer price index	123.6	94.9	110.8	102.7	114.1	108.5
Construction product composite price index	109.1	108.0	106.9	104.9	107.2	110.3
Cargo carriage tariff index	133.1	107.7	107.5	108.0	100.9	111.5

Source: The Rosstat.

In the 2010–2013 period, weakening of the dynamics of producers' prices and tariffs was justified by the objective to maintain demand on the domestic market. In 2014, the trend which prevailed for four years changed and producers' prices in industry and building started to grow dynamically. In 2015, prices in manufacturing industries rose by 12.2% and 21.7% as compared to 2014 and 2013, respectively. In 2015, in mining a 9.8% growth in prices made up for their drop in the previous year, while growth in prices amounted to 8.1% as compared to 2013. Building reacted to changes in investments by a 18.2% growth in prices in 2015 as compared to 2013. It is to be noted that growth rates of wages and salaries were more moderate than before. Advanced growth in manufacturers' prices, depreciation of the ruble and a relative decrease in labor remuneration costs had a positive effect on financial performance. In 2015, the share of the economy's gross profit amounted to 43.6% of GDP and exceeded by 2.5 p.p. the 2014 index.

*Table 10*

**The pattern of formation of GDP by sources of income in the 2011–2015 period,  
% of the result, in current prices**

	2011	2012	2013	2014	2015
Gross domestic product, including:	100	100	100	100	100
Labor remuneration of hired workers, including concealed remuneration and mixed incomes	43.9	44.2	46.1	44.8	45.4
Net incomes on production and import	14.6	14.7	14.2	14.1	11.0
Gross profit of economy and gross mixed incomes	41.5	41.1	39.7	41.1	43.6

*Source:* The Rosstat

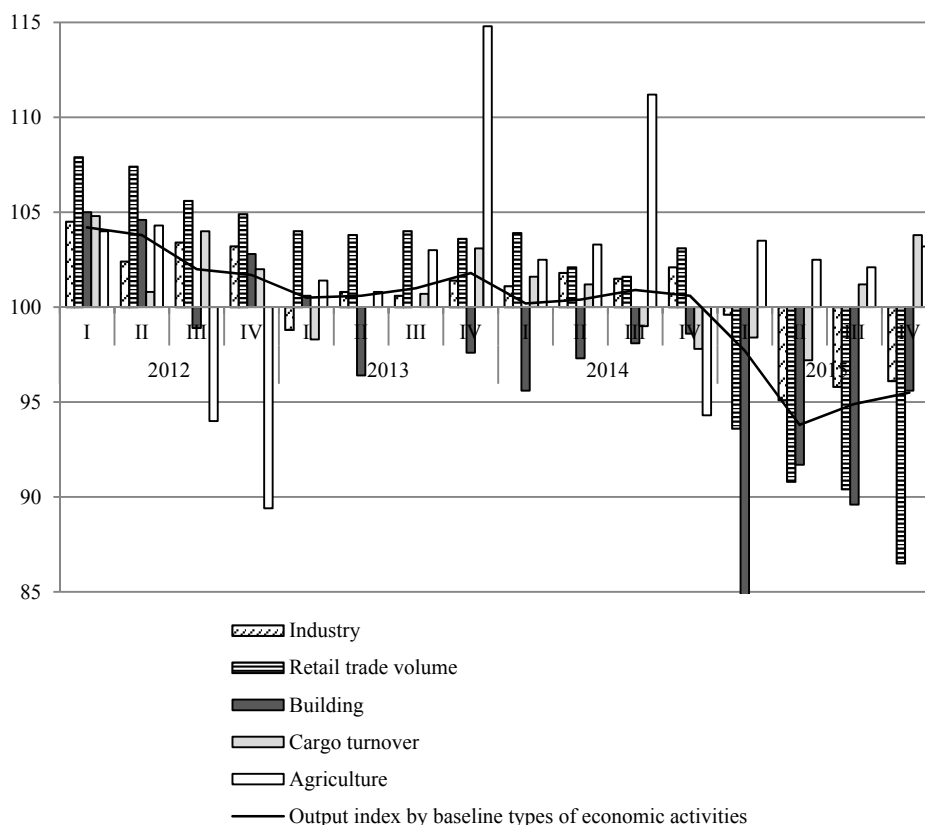
With reduction in absolute terms of net taxes on production and imports from Rb 11.0 trillion in 2014 to Rb 8.8 trillion in 2015, the share of labor remuneration in GDP amounted to 45.5%. It is to be noted that with taking into account the trend – which prevailed from 2012 – of reduction of growth rates of production and labor efficiency and dynamic growth in nominal wages and salaries, in particular, in the public sector in the 2012-2013 period as compared to 2014, serious limitations on further growth in labor remuneration costs were formed. In the 2014–2015 period, further growth in labor remuneration costs was greatly limited by changes in the situation on commodity markets, appreciation of price and higher production costs.<sup>1</sup>

#### 4.1.4. Dynamics and the pattern of production by the type of economic activities

Slowdown of quarterly dynamics of economic development during the past three years was accompanied by weakening of growth rates of industrial production, retail trade volume and building and investment activities. In 2015, for the first time after the 2008–2009 crisis a drop in the index of the physical volume of output by the baseline type of economic activities was registered as compared to the previous year with consolidation of the output downward trend by quarters. If in 2014 instability of indices of investment activities was partially made up for by positive dynamics of retail trade volumes and outputs of manufacturing and agricultural, in 2015 the situation became more complicated due to a simultaneous drop in consumer and investment demand with a slump in industrial production getting worse. In 2015, the industrial production index amounted to 96.6%, while the volume of jobs in building and the retail trade volume, to 93.0% and 90.0%, respectively, as compared to the previous year. An output drop

<sup>1</sup> For more information on the effect of structural factors, see Section 4.2.

in the real sector of the economy resulted in shrinkage of demand on infrastructure services. In 2015, only a 3.0% growth in output of agricultural products as compared to 2014 had a positive effect on the economic dynamics.

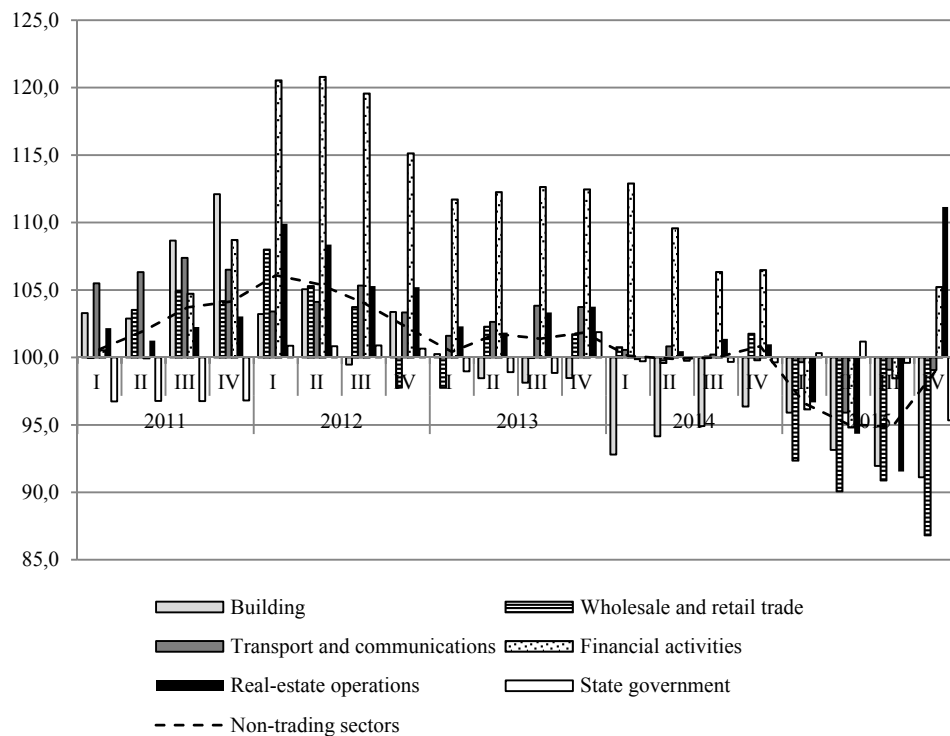


*Fig. 8. Dynamics of baseline types of economic activities in the 2012-2015 period, % of the respective quarter of the previous year*

Source: The Rosstat.

The specifics of 2015 consisted in a simultaneous drop both in trading and non-trading sectors of the economy (in the trading and non-trading sectors of the economy output amounted to 98.0% and 96.3%, respectively, as compared to 2014).

In 2015, for the first time after 2009 a drop in production of gross added value in the non-trading sector of the economy was registered as compared to the previous year. A drop in growth rates of added value in the non-trading sector of the economy was registered by all the aggregated types of activities under review. Due to a greater slump in building and investment activities, revenues from real-estate operations decreased dramatically. With a speed-up of negative quarterly dynamics taken into account, in 2015 reduction of the rates of wholesale and retail trade became more substantial. The above situation is related to a sudden shrinkage of households' demand on services due to a decrease in households' incomes and constriction of building and investment activities and related types of financial services.

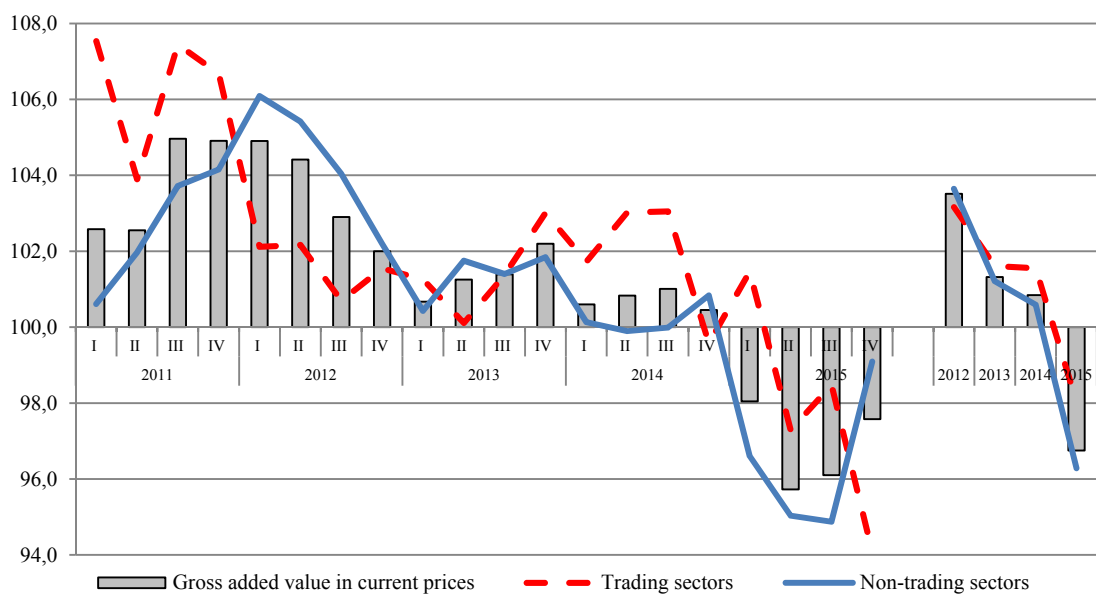


*Fig. 9. Dynamics of gross added value in the non-trading sector of the economy in 2011-2015 period, % of the respective quarter of the previous year*

*Source:* The Rosstat.

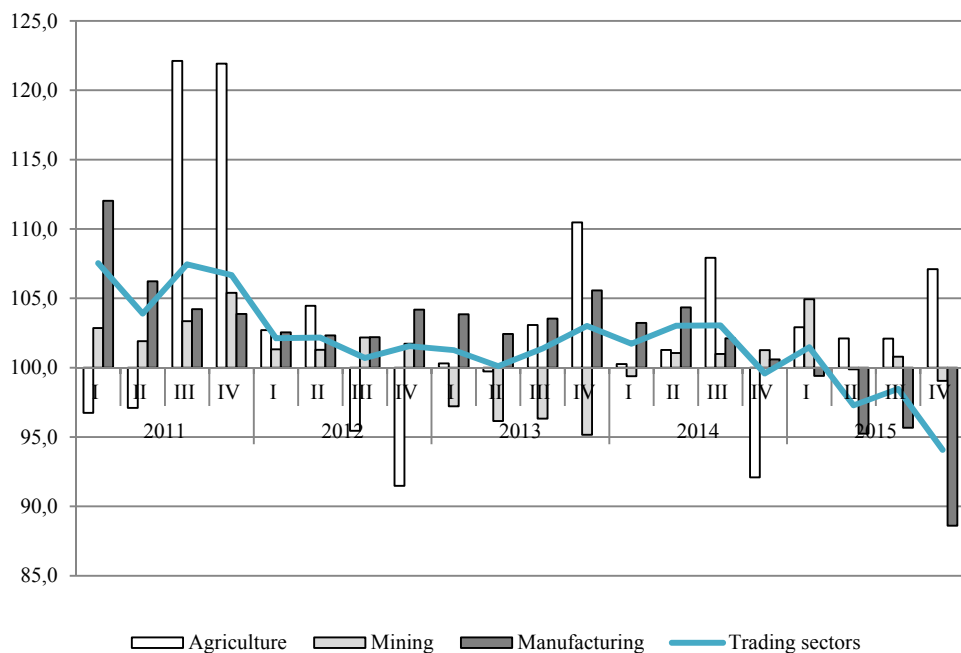
In 2015, the crisis in the Russian industry was characterized by a more dramatic slump in manufacturing amid relatively weak positive dynamics of production of fuel and energy primary products. Evidence of crisis phenomena by the type of economic activities points to a lack of domestic business restructuring processes aimed at formation of new competitive markets of domestic products. Having achieved the pre-crisis level, from H2 2012 the Russian economy demonstrated evidence of slowdown of growth. In that situation, domestic restrictions related to the fact that the economic pattern did not undergo substantial changes, while the potential of factors contributing to growth happened to be virtually exhausted had a particularly strong effect. From Q2 2013, a drop in output volumes was registered in manufacturing. In 2015, the industrial production index amounted to 96.4% against the index of 2014. In 2015, structural specifics of industrial dynamics as compared to 2014 were determined by sluggish growth in mining (100.3%) with a slump in manufacturing getting more dramatic (94.5%).

In 2015, year-on-year positive dynamics was registered only in the chemical industry (106.3%), production of charred coal and petrochemicals (100.3%) and the food industry (102.0%).



*Fig. 10.* Dynamics of GDP as regards the trading and non-trading sectors of the economy in the 2011–2015 period, % of the respective quarter of the previous year

Source: The Rosstat.



*Fig. 11.* Dynamics of gross added value in the trading sector of the economy in the 2011–2015 period, % of the respective quarter of the previous year

Source: The Rosstat.



*Table 11*

**Indices of production by the main type of manufacturing in the 2010–2015 period,  
% of the previous year**

	2010	2011	2012	2013	2014	2015
Manufacturing	110.6	108.0	105.1	100.5	102.1	94.6
Production of food products, including beverages and tobacco	103.2	103.9	104.1	100.6	102.5	102
Textile and sewing industry	108.8	100.8	100.7	104.3	97.5	88.3
Production of leather, leather articles and footwear	119.9	105.7	98.1	95.6	97.2	88.6
Woodworking and production of wood articles	113.4	110.2	96.2	108.0	94.7	96.6
Pulp and paper production, publishing and printing	103.1	106.5	105.8	94.8	100.4	93.7
Production of charred coal and petrochemicals	106.0	103.8	103.1	102.3	105.7	100.3
Chemical industry	110.6	109.5	104.1	105.4	100.1	106.3
Production of rubber and plastic articles	124.4	111.4	112.8	105.9	107.5	96.3
Production of other non-metal mineral products	114.5	107.4	110.7	98.0	101.8	92.2
Metallurgy and production of finished metal articles	112.4	107.0	104.8	100.0	100.6	93.5
Production of machines and equipment	115.2	111.1	102.7	96.6	92.2	88.9
Production of electric, electronic and optical equipment	118.9	111.9	106.4	99.0	99.5	92.1
Production of transportation means and equipment	127.2	117.2	110.3	102.2	108.5	91.5
Other industries	120.6	105.3	102.6	95.4	102.7	94.0

*Source:* The Rosstat.

In the current year, changes in the pattern of demand had a favorable effect on the dynamics of chemical production. Amid depreciation of the ruble, reduction of volumes of appreciated imports permitted chemical enterprises to expand on the one side the niche for domestic goods on the domestic market, while on the other side to build up export volumes in physical terms. The factor of import substitution influenced the most the dynamics of production of pharmaceuticals and household chemicals whose output in 2015 increased by 8.9% and 6.6%, respectively, as compared to the previous year. It is to be noted that in the mid-term prospect, pharmaceutical production has a growth potential thanks both to state support and higher investment attractiveness for Russian and foreign investors. In the past three years, over 10 new pharmaceutical plants have been put into operation with a simultaneous modernization of the existing capacities and acquiring by Russian producers of new competences and knowledge. Despite a complicated macroeconomic situation, cooperation with international companies is expanding: in St. Petersburg the Bayer Company signed a contract with the Polisan Company on production of three preparations in Russia; the Novartis Company is building a plant; in the Kaluga Region AstraZeneca, a Swedish-British pharmaceutical company opened up a local production (commercial output starts in Q1 2016), while Novo Nordisk, a Danish company built an insulin-producing, cartridge-filling and packing plant; in the Kirov Region an agreement was concluded with the Merck Company on localization of production at the Nanolek plant (euro 10m worth of investments).

In October 2015, a 4.1% growth in production of the main chemical agents as compared to the previous year was justified, in particular, by attainment by new petrochemical plants – which were put in operation in previous years – of projected capacities: two large polypropylene-producing plants – Poliom (the Omsk Region) and Tobolsk-Polimer (the Tyumen Region) - and RusVinil, a polyvinylchloride-producing plant (the Nizhny Novgorod Region).

As regards sectors of chemical production, it is to be noted that gradual recovery of varnish-and-paint production and artificial fiber production is observed. In 2015, unstable output dynamics of the above productions can be explained both by reduction of the domestic demand and lack of development alternatives with products being non-competitive on foreign markets even at lower prices.

In 2015, producer price index in the chemical industry amounted to 118.1% on the beginning of the year and exceeded producers' prices in manufacturing (111.2%). As a result, in January-November 2015 the balanced financial result in the chemical industry rose 15.5 times over. In that situation, in January-November a 9.5% growth in nominal wages in the chemical industry (8.1% in manufacturing) was a factor behind retention of personnel in that industry.

The problem of the Russian economy consists in a lack of a well-coordinated system of comprehensive measures aimed at modifying general business conditions; instead a target support of individual industries is practiced. If in the beginning the production of intermediate demand goods with a high share of export-oriented production reacted to appreciation of prices due to depreciation of the ruble by renewal of output growth, from April 2015 a drop in output in that segment of manufacturing was registered. An additional factor behind a further slump in the segment of intermediate demand goods was reduction of demand on domestic components and materials by industries of the investment complex. Reduction of output of domestic intermediate demand goods resulted in structural changes in the import: in 2015 the unit weight of intermediate goods in the total volume of imports rose as compared to the previous year.

A decrease in production and imports of capital goods was justified by low investment demand. In 2015, in engineering the index of domestic production of machines and equipment amounted 88.9%, the index of production of electric, electronic and optical equipment, to 92.1% and that of production of transportation means, to 91.5%. In 2015, the index of production of building materials amounted to 92.2%, while in metallurgy, to 93.5% as compared to 2014.

A decrease in output volumes in metallurgy was the result of shrinkage of metal consumers' demand, particularly, on high value-added products both on domestic and foreign markets, as well as a drop in global prices virtually on all ferrous and non-ferrous metals. However, it is to be noted that domestic metallurgy as a highly competitive industry has a great potential of growth. Large projects which liquidated shortages of individual types of products and contributed to import substitution have been completed.

In 2015, a year-on-year index of production of petrochemicals amounted to 100.4%. A 2.7% decrease in oil refining volumes as compared to the previous year was determined by structural changes in exports in favor of growth in physical volumes of crude oil exports.

#### **4.2. Decomposition of Russia's GDP growth rates, 2015–2016<sup>1</sup>**

Russia's officials made multiple statements in 2015, saying Russia had hit the bottom of its recessionary valley. For example, a few top members of Russia's government and representatives of the Russian business community (in particular, First Vice-Prime Minister Igor Shuvalov and Sberbank CEO/Chairman German Gref) said in May 2015 the current crisis in Russia had reached its peak and the economy was expected to see some recovery. In late 2015, Russia's Minister of Economic Development Alexey Ulyukaev said the recession was over and the bottom was hit. At the same time, Russia's Ministry of Economic Development (MED) and some other international organizations – such as Bank of America, JP Morgan, IMF and World Bank – upgraded (not for long though) their 2015 forecast for Russia. The Ministry of Economic Development made similar statements, in particular in July and October 2015. Andrei Klepach, Chief Economist of Vnesheconombank, questioned these statements, noting in late August that the bottom was still to be reached, and he expected Russia to continue facing a

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<sup>1</sup> Author of this section: Drobyshevsky S. – Gaidar Institute for Economic Policy, Kazakova M. – Gaidar Institute for Economic Policy.

downturn in investment and construction sectors, while budget and consumer demand ceased to be the drivers of positive growth rates in economy. As early as December, Herman Gref predicted that Russia's economy would face a downturn in 2016, and then it might "decay" unless across-the-board reforms are undertaken.

In November 2015, Russia's Ministry of Economic Development released an updated forecast for the socio-economic development in Russia for 2015–2016, which affords a basis for drafting the 2016 federal budget. The forecast includes baseline, conservative and target scenarios.

The baseline scenario for 2016 "describes the basic macroeconomic parameters of economic development against the backdrop of conservative trends towards changes in external factors, and a conservative fiscal policy in place."<sup>1</sup> For example, this scenario expects GDP in 2016 to pick up 0.7% from 2015 (in other words, the economy is expected to come out of the recession at weak positive growth rates), the yearly average Urals crude price to stay at \$50 a barrel, fixed investment to drop 1.6% year-on-year, the number of employed to change insignificantly. Hence, the baseline scenario for 2016 relies on the assumption that the Russian economy continues to follow the current trends, and that no other economic growth drivers are expected to emerge.

Russia's Ministry of Economic Development noted that the conservative scenario expects Russia to face extremely troublesome global economic trends (the yearly average Urals crude price is down to \$40 a barrel), investment to drop further (6.4% over 2015) and consumer demand to weaken, inflation rate to hike and some other economic sectors (industry and retail sales) to be driven by negative dynamics. In other words, this scenario expects Russia's consumer sector and investment to be hit hardest. The conservative scenario of economic development in 2016 is therefore worse than the other scenarios, and it expects GDP in 2016 to drop 1.0% over 2015.

The target scenario, which is more optimistic, aims to comply with the Executive Order of the President which requires the economic authorities to ensure that the Russian economy enters a path of growth equal to the world's average long-term growth and is steady in the long term, and to achieve a macroeconomic equilibrium on the back of low inflation rate and enhanced labor productivity. This scenario actually suggests switching to a new model of economic growth based on optimizing and enhancing the effectiveness of federal budget expenditures and revising state programs in order to achieve the target parameters of the socio-economic development of Russia. The target scenario expects economic growth rates in 2016 to increase 2.3% from 2015, fixed investment to resume growth (up to 3.1%), inflation rate to be low (4% or less), and labor productivity to increase. The Ministry of Economic Development highlighted some factors that would "contribute most to accelerating economic growth rates in 2016–2020:

- growth of investment in production expansion and production infrastructure;
- growth of investment in boosting exports of non-primary commodities and stimulating exports of high-tech products;
- increase of the total factor productivity by boosting investment in innovation sectors of economy;
- introducing resource and cost saving measures, including labor costs and natural monopoly tariffs;

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<sup>1</sup> <http://economy.gov.ru/minec/about/structure/depmacro/20151026>

- SME development, creating better conditions for entrepreneurship, and some other factors.”<sup>1</sup>

The scenarios of Russia’s socio-economic development for 2016 contain forecasts for oil prices, fixed investment dynamics and the number of population involved in the economy, which let us decompose, using our own algorithm, the forecast GDP growth rates under the foregoing three scenarios of economic development of Russia. We used a method based on breaking down macroeconomic indicators into structural, foreign-trade and cyclical components (business cycles and random shocks) to see the effect of the key factors on GDP growth. This method is applied in developed countries (OECD), and we modified it to capture the specifics of the Russian economy, that is, heavy dependence on foreign trade terms approximated through the dynamics of global oil prices.<sup>2</sup>

Rosstat published in late January 2016 the preliminary results of 2015<sup>3</sup>: GDP fell 3.7% from 2014 (in absolute terms, this is slightly less than MED’s official forecast); fixed investment dropped 8.4%; global Brent crude prices in 2015 averaged \$52.4 a barrel, according to IMF.<sup>4</sup>

Fig. 12–15 show the 2015 actual, structural and foreign-trade growth rates of GDP in Russia, as well as the cyclical component (i.e., the sum of the components of business cycles and random shocks), and the three scenarios forecasting the development of the Russian economy for 2016.

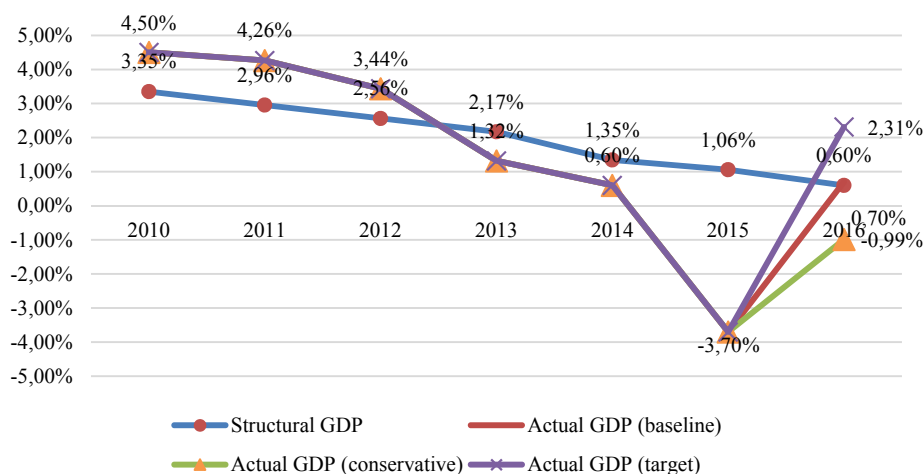


Fig. 12. Year-on-year actual and structural growth rates of GDP in Russia, 2010–2016 (all the forecast scenarios)

Sources: Rosstat, Ministry of Economic Development, IMF, own calculations.

<sup>1</sup> <http://economy.gov.ru/minec/activity/sections/macro/prognoz>

<sup>2</sup> The method of decomposing Russia’s GDP growth rates, as well as our interpretation of the results obtained, are described in detail in *Sinelnikov-Murylev S., Drobyshevsky S., Kazakova M. Decomposition of Russia’s GDP growth rates in 1999–2014. Ekonomicheskaya Politika [Economic Policy]. 2014. No. 5. PP. 7–37, as well as <http://iep.ru/ru/publikacii/7125/publication.html>.*

<sup>3</sup> [http://www.gks.ru/bgd/free/B15\\_00/Main.htm](http://www.gks.ru/bgd/free/B15_00/Main.htm)

<sup>4</sup> <http://www.imf.org/external/np/res/commod/index.aspx>

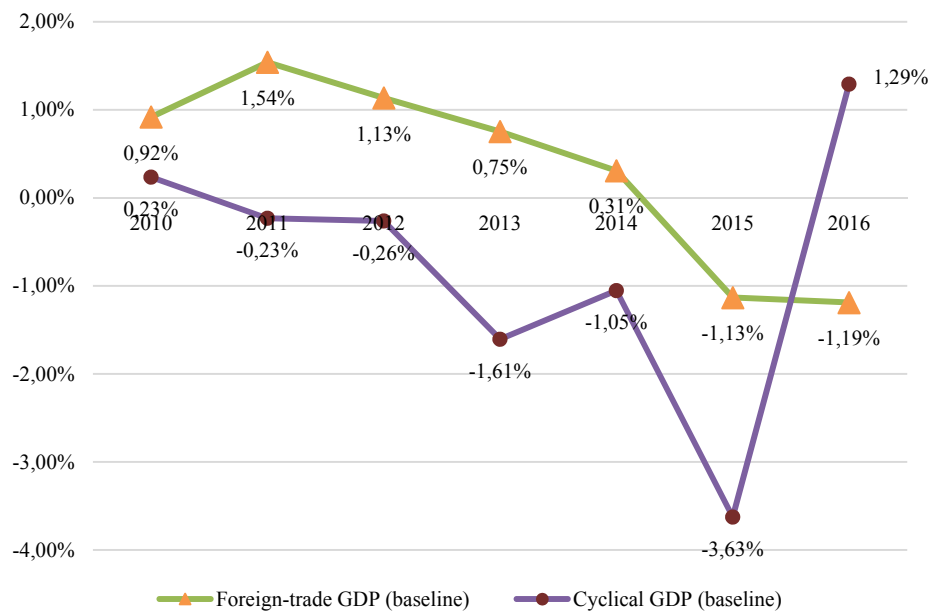


Fig. 13. Year-on-year foreign-trade and cyclical growth rates of GDP in Russia, 2010–2016 (baseline scenario)

Sources: Rosstat, Ministry of Economic Development, IMF, own calculations.

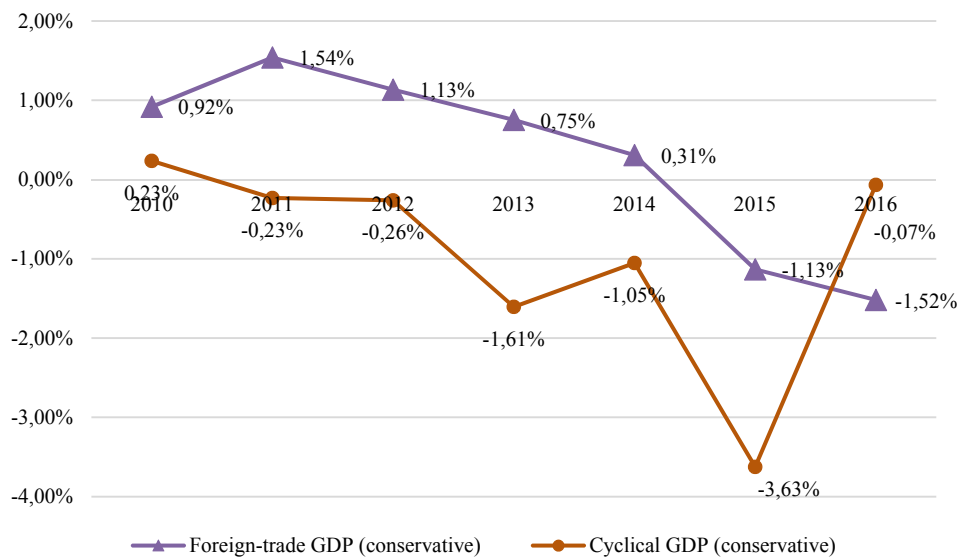
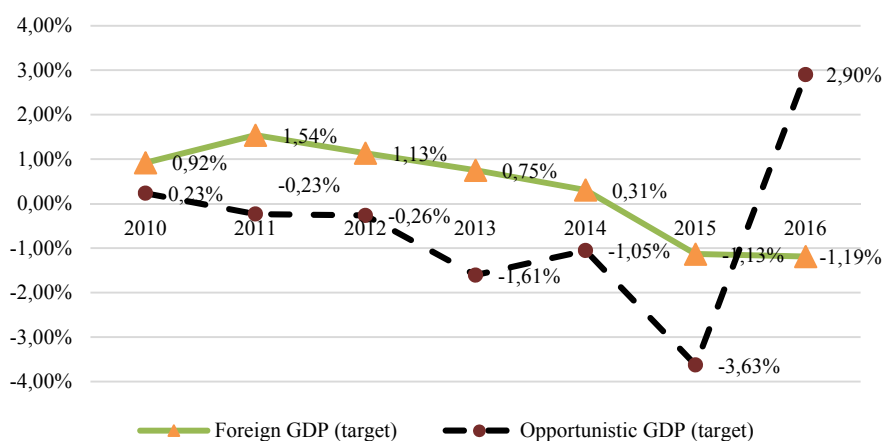


Fig. 14. Year-on-year foreign-trade and cyclical growth rates of GDP in Russia, 2010–2016 (conservative scenario)

Sources: Rosstat, Ministry of Economic Development, IMF, own calculations.

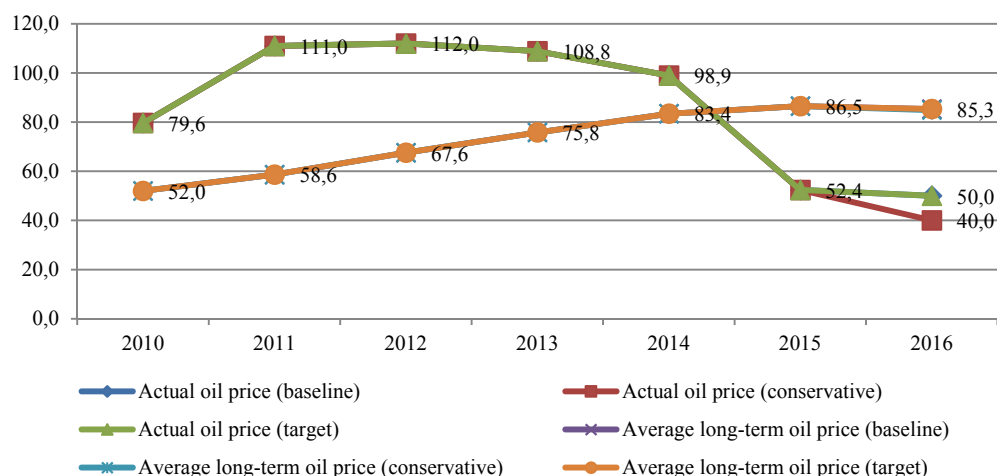


*Fig. 15. Year-on-year foreign-trade and cyclical growth rates of GDP in Russia, 2010–2016 (target scenario)*

Sources: Rosstat, Ministry of Economic Development, IMF, own calculations.

We estimate that in 2016 the forecast structural component of GDP growth will continue to decline under all the scenarios (from 1.1% in 2015 to 0.6% in 2016, see *Fig. 12*). Just like in prior years, this is determined by the negative dynamics of fundamental growth factors (a reduction in the number of economically active population due to demographic trends and in the volume of capital due to its retirement amid negative investment dynamics), as well as a decline of total factor productivity.

With oil prices in the 2015–2016 scenarios being lower than average long-term prices (\$80–85 a barrel, see *Fig. 16*), the foreign-trade component of Russia’s GDP growth rates in 2016 is expected to become negative under all the scenarios (-1.2% under the baseline and target scenarios, and -1.5% under the conservative scenario).



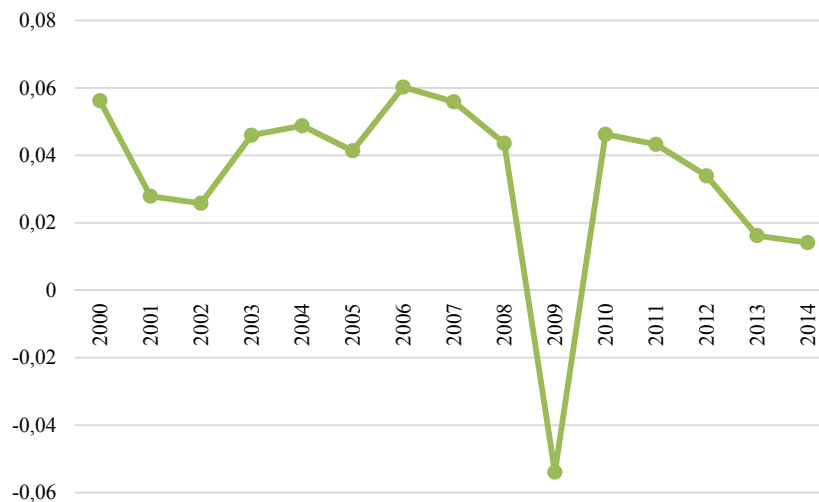
*Fig. 16. Actual and average long-term Brent crude prices, US dollars a barrel, 2010–2016 (forecast)*

Sources: IMF, own calculations.

The cyclical component of Russia’s GDP growth rates in 2015 is still negative, whilst the cyclical downturn was possibly deepened by a negative shock estimated 2.5–3.0 percentage points of GDP growth. This shock is a combination of the adverse effects of Western economic sanctions and Russia’s countersanctions, increased uncertainty and risks in economy amid an extremely volatile ruble, increased inflation and limited access to capital markets.

Continuing with the decomposition of Russia’s GDP growth rates in 2016, it is worthy of note that the forecast GDP growth rates for Russia may hold true under the three scenarios amid relatively low oil prices and no growth of the total factor productivity, provided that the cyclical component increases sharply, from -3.8% in 2015 to 2.9% in 2016 under the best-case scenario and from -3.8% in 2015 to -0.07% in 2016 under the worst-case scenario. The cyclical component may see such growth, provided that the cyclical GDP accelerates abruptly on the back of the “died-down” negative shock of 2015, or assuming that the economy remains at the bottom of the business cycle – a marked positive shock – whose nature seems uncertain.

At the same time, our results (and, accordingly, conclusions) are based on the 2000-2014 model-based estimates of the total factor productivity (see *Fig. 17* and *18*) and hence model-based Russia’s GDP structural growth rates facing a steady downtrend (see *Fig. 12*).

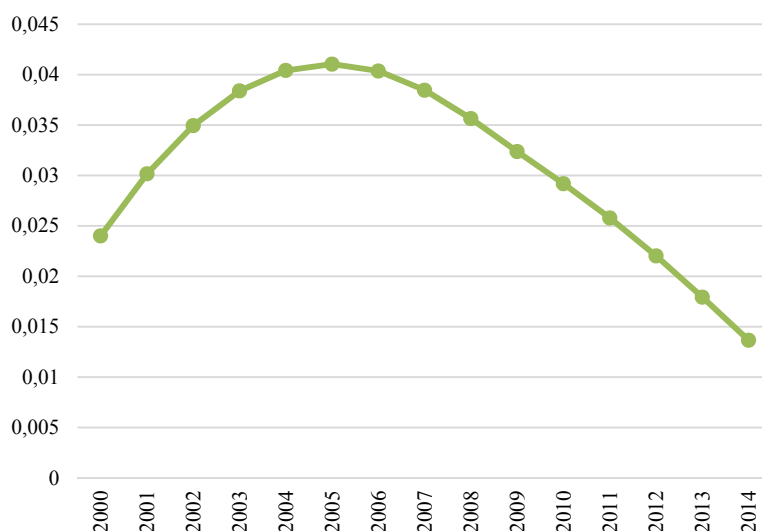


*Fig. 17.* Total factor productivity of Russia’s economy, percentage points YoY, 2000–2014

*Sources:* Rosstat, Ministry of Economic Development, IMF, own calculations.

Supposing that the dynamics of total factor productivity has changed and Russia’s structural GDP growth rates have stopped declining (e.g., due to a boost in competitiveness of the domestic production sector after the ruble’s devaluation or economy’s enhanced performance, during the current crisis, on the back of a few bankruptcies, nonmanufacturing cost cuts, partial labor saving and “clean-up” of the banking system), then a part of the 2016 forecast growth of GDP may be attributed to this very component. In this case, the dynamics of the cyclical component (within a range of -1.5 and 2.0 percentage points of GDP growth) seems logical in the context of the died-down negative shock of 2015 and the progressive movement towards the upward phase of business cycle (in the target scenario – boosting the cyclical component by switching to a new model of growth). The econometric data of the change in structural growth rates can

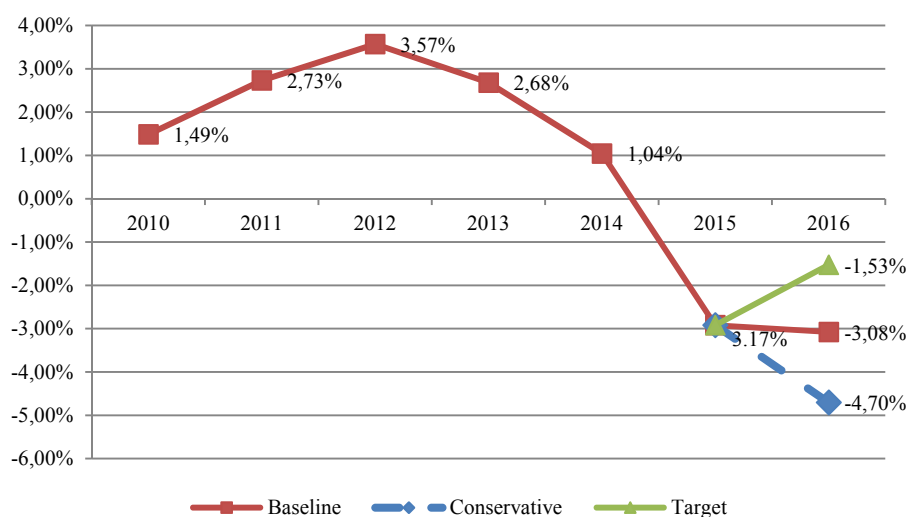
only be assessed by adding new actual annual observations of GDP, i.e., in at least 1–2 years, in the simulated series.



*Fig. 18.* Total factor productivity of the Russian economy (smoothed), percentage points YoY, 2000–2014

Sources: Rosstat, Ministry of Economic Development, IMF, own calculations.

The results of decomposition of Russian economic growth rates provide a way of estimating an output gap of the Russian economy for 2015–2016, which in 2015 turns negative due to a negative contribution of the foreign-trade and cyclical components, the latter has been negative for five straight years since 2011) amid decreasing structural growth rates. Note that the output gap is still negative in 2016, even under the MED’s best-case (target) scenario (see *Fig. 19*).



*Fig. 19.* Output gap in Russia (%), 2010–2016 (forecasted under the three scenarios)

Sources: own calculations.



Thus, the actual output for 2015–2016 is below the potential output in all the scenarios. In terms of economics, incentive monetary and fiscal measures may have a positive effect on the economy in at least the short term. However, structural rates stemming from fundamental growth factors and total factor productivity should be increased first in order to accelerate economic growth rates in a longer term. In modern economic environment, this implies making foreign capital and foreign direct investment available for Russian companies, increasing investment from Russian companies, and relaxing the limits on available labor resources.

The above listed measures will enhance the efficiency of using production factors (i.e., TFP will grow). Good institutions is the only way of stimulating new production factors and structural reforms (including diversification of the economy and making it a less resource-based economy), and investment in the economy (transport infrastructure, social protection, etc.) will accelerate economic growth and ensure that steady growth rates are maintained in the long term. Note that no such changes are assumed under the scenarios, except for the target scenario, of Russia's Ministry of Economic Development.

Today, it is widely believed that Russia was hit by crisis before 2014, and external political developments turned the spotlight on the internal problems accumulated during past periods, including the “fat” period between 2000 and 2007. Indeed, an intriguing picture was observed over the past few years: on the one hand, global oil prices stood at a very high level until late 2014 (\$102 a barrel on average in the period between 2010 and 2014); on the other hand, not only did economic growth rates see no growth after the crisis of 2008–2009, but they also began to slow down steadily, from 4.5% y-o-y in 2010 to -3.7% in 2015.

The collapse of oil prices in late 2014 stirred a discussion on how Russia's economy will be functioning amid low oil prices. Weakly positive growth rates that followed the economic overheating of 2008 were maintained on the back of favorable terms of trade, although their role was declining progressively, but now high oil prices will contribute less than before to growth. Anyway, is there a chance for Russia to take a different track and cease to be an “oil-dependent state?”

On the one hand, economic growth can be accelerated by undertaking serious structural reforms and by switching, at least in part, the focus from the extracting sector to other higher value-added sectors. On the other hand, bad institutions (high level corruption, politicized judicial and law enforcement systems, weak protection of property rights, inefficient system of public administration) hamper reforms and lead to useless (in terms of economic development) spending of natural resource revenues.

Ultimately, speaking of possible ways of developing the Russian economy, a few scenarios may be outlined. The first scenario assumes a status quo is maintained, that is, the economy depends heavily on terms of trade while the oil-and-gas and industrial sectors are kept down. This scenario assumes no slump, but rather a slow stagnation or a weakly positive growth (about 0.5%) while the crude oil price is on the rise.

The second scenario assumes Russia will undertake structural reforms by adopting the practice of major developing economies (such as Brazil, India or China). This scenario assumes the economy is diversified and aimed at achieving high growth rates in the long term. In other words, energy export revenues can be spent to either maintain or improve the current state of economy.

Under the third scenario, Russia may benefit from its resource-dependence by counting on upgrading the oil-and-gas sector (as a reminder, this sector is not less (if not more) innovative

than, say, manufacture of cell phones). Thus, the “resource curse” may be turned into a blessing for this country.

### **4.3. Russian industrial enterprises in 2015 (on the basis of business surveys)<sup>1</sup>**

This section is prepared using the data of monthly business surveys conducted by the Gaidar Institute for Economic Policy (IEP) among managers of industrial enterprises since September 1992. The surveys are conducted on the basis of the European harmonized methodology and encompass the entire territory of the Russian Federation. The size of the panel is around 1,000 enterprises, which employ over 13% of the total number of employed in industry. The panel is biased towards large enterprises in each of the selected branches. The rate of response to questionnaires ranges from 70% to 75%.

The business survey questionnaire contains quite a small number of questions (not more than 15-20). They are of qualitative rather than quantitative nature. The simple formulation of questions and answers allows the respondents to fill in the forms quickly and without consulting any documentation. It is essential that the respondent at each enterprise is an executive of the highest level possible who is fully aware of the situation at the enterprise and is directly involved in its management.

When analyzing the results of business surveys a specific derivative indicator is used which is termed “balance.” The balance is calculated as the difference between the percentage of respondents who answered “will grow” (or “above normal”) and the percentage of respondents who answered “will decrease” (or “below normal”). The resulting difference allows to present the distribution of answers to each question by one figure with “+” or “-” sign.

The balance is interpreted as the first derivative or the rate of the process. If the balance of responses to the question about expected change in prices has the “+” sign, it means that in the near future average prices will grow (e.g. the prevailing number of enterprises reported their intention to raise prices). For instance, the increase of balance from +10% to +17% over a month implies that average prices in industry will grow at a higher rate as the prevalence of enterprises anticipating their growth became more convincing. A negative balance is the sign of future reduction of average prices (more enterprises intend to cut their prices). The changing of the balance from -5% to -12% is interpreted as greater intensity (rate) of price decline.

#### **4.3.1. Year 2015: was there an industrial recession?**

Year 2015 has been labeled as a crisis one for the Russian economy. However, the majority of indicators describing changes and the state of Russian industry are barely similar to the crisis developments on the 1990s or 2008-2009 crisis. Moreover, part of the indicators failed to demonstrate manifestation of any crisis changes in 2015. Analysis of a representative set of business surveys’ indicators, the majority of which are absent from the set of indicators used in state statistics, and a part – in similar surveys carried out by other organizations, hardly allows us to call 2015 a recession year *for Russian industry*.

First of all, let us analyze the dynamic of aggregate indicators used by the Business Surveys Laboratory of the Gaidar Institute for Economic Policy in order to provide a composite assessment of Russian industry. By the end of 2015, three such indicators were compiled: Industrial

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<sup>1</sup> Author of this section: Tsukhlo S. – Gaidar Institute for Economic Policy.

Confidence Indicator, Forecast Indicator, and Industrial Adaptability Indicator. First two indicators are calculated on a monthly bases and the third one – on a quarterly basis.

**Industrial Confidence Indicator**<sup>1</sup> has demonstrated that the initial (January) assessments of the situation in Russian industry labeled year 2015 as a recession one were far from critical ones. The indicator has remained in the positive zone and even has improved its value in comparison with November-December last year. However, February value of the indicator demonstrated optimistic responses of enterprises regarding the situation in Russia industry at a marked decrease. The indicator dropped 5.5 points and was negative following three months of being sustainably positive in the course of the currency and credit shocks. In March, the February decline of the indicator halted – the aggregate indicator moved up by mealy 1.7 points and turned out to be around zero mark. Thus, industry has managed to avoid critical reduction of confidence, which was definitely expected to happen by the authorities and experts. In April, this IEP indicator demonstrated an obvious improvement in enterprises' assessment of the situation unfolding in Russian industry. The Industrial Confidence Indicator has parted from around zero mark of Q1 2015 and has reached in the context of recession not bad levels of late 2014 due to growth of some components and non-deterioration of other. Aggregate assessments obtained in May 2015 still considered a recession year demonstrated still more solid rebound of the industry from the shock it found itself at the turn of the year. The indicator went on growing even amid flat demand and small fluctuations of assessments of stocks of finished products. However, in June, enterprises' managers, finally, noticed certain crisis developments in Russian industry. However, that was true to actual movements of book orders (part of Confidence Indicator) and actual movements of output (out of the indicator). Negative changes of these two indicators have resulted in the growth of dissatisfaction of current sales volumes. However, other components of the Indicator have not suffered sharp crisis changes. As a result, the aggregate indicator although negative but so far failed to approach its worst intercrisis values (see *Fig. 20*). July 2015, failed to add clarity to the assessment of the current situation in Russian industry. The months' results failed to produce both an obvious deterioration of the situation and obvious bottom out. The Industrial Confidence Indicator remained at the former notably negative level but without further downward trend. Such situation again forced experts and officials yet again in 2015 to review both assessments of the actual state of affairs in industry and their vision of its future.

The August share of surveys' results showed continuation of negative trends in Russian industry and further adjustment of enterprises to those trends. In August 2015, the Industrial Confidence Indicator demonstrated a symbolic increment albeit hovering about zero. September assessments of the situation in this sector produced rather not bad results amid the crunch period. The industry steadily was overcoming the period of minimum change of traditionally observed by the official statistics of volume terms preserving at the same time a steady control

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<sup>1</sup> The indicator is built as the simple arithmetic average (differences in responses) to four questions from the IEP's monthly business questionnaire:

- 1) Actual change of demand, balance = % growth – % decrease;
- 2) Assessment of book orders, difference of responses = % above normal + % normal – % below normal;
- 3) Assessment of stocks of finished products, balance = % above normal – % below normal, opposite sign;
- 4) Output projections, balance = % growth – % decrease.

Balances of questions 1 and 4 are seasonally and calendar adjusted. The indicator can range from -100 to +100. A positive value of the indicator implies the prevalence of positive estimates. A negative value of the indicator means that negative estimates prevail. Lowering of the indicator value is the sign of deteriorating situation while its growth – the sign of ameliorating situation.

over stocks of finished products and demonstrating satisfaction with sort of crisis low volumes of book orders. In October, the IEP's Indicator lost three points but remained in the positive area. Such negative movement of the aggregate indicator was due to a drastic decrease of only one component – satisfaction with current book orders' volume. This fact was quite characteristic of the situation in Russian industry. In November, it continued adjustment to the protracted 2015 recession. The IEP Industrial Confidence Indicator moved up by symbolic two points, stayed in 'plus' and again surprised experts traditionally judging about the state of Russian industry by output volumes, which are barely informative in current context. By the end of 2015, the Industrial Confidence Indicator overcame a significant negative change: it lost 3.5 points and crossed into negative area.

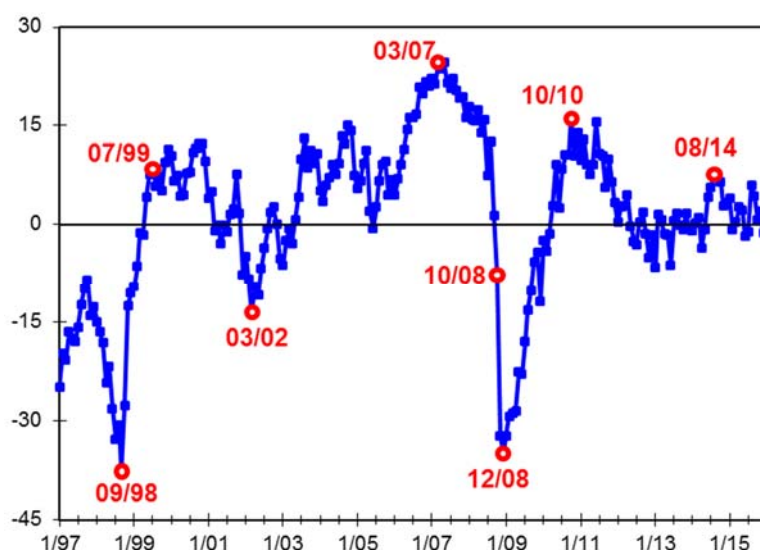


Fig. 20. IEP's Industrial Confidence Indicator 1997–2015

Thus, the Industrial Confidence Indicator showed features of 2015 recession. First, in the past year the indicator's values were in the narrow interval between -2 to +5 points, i.e. no sharp changes of the indicator were registered. Second, nothing similar to recognized crisis of 1990s and 2008-2009 crisis took place in Russian industry in 2015. The Industrial Confidence Indicator fell to below -30 points during those crises and in 1996, it decreased to -41 points. The worst values of the indicator for 2015 turned out to be superior to the minimum levels of inter crisis period of 2010-2014, which were obtained in 2013 and were inferior by -6 points. Third, 2012-2015 local maximum of the Indicator was registered in August 2014, which seems to be a watershed month when the Russian economy was drawn into the long promised 'second wave of recession'.

At the turn of 2015, in the wake of turmoil on financial and currency markets as well as amid proactive actions taken to the authorities to develop anti-crisis measures the **Industrial Projection Indicator**<sup>1</sup> posted a downward trend, which, by the way, failed to result in complete loss

<sup>1</sup> The indicator is the simple arithmetic average of the balances (in percentage points) of the answers to three questions from the IEP's monthly business questionnaire: a) projections for change of demand for the products of enterprise, balance = % growth – % decrease; b) plans of output change, balance = % growth – % decrease; c) plans of employment change, balance = % growth – % decrease. Balances are cleared of seasonal and calendar factors. The indicator can range from -100 to +100. A positive value of the indicator implies the prevalence of positive

of confidence in the sector. In March-May, the Indicator stabilized at the minimum positive values. Solely in June, the Indicator was negative: pessimistic expectations in industry, finally, prevailed over confidence. However, it happened in minimum volume and only for a month. Already in July, the Indicator moved up 2 points and again turned positive. In August, the Indicator went up by another 2.5 point and following September halt continued growing through the end of the year. As a result, (according to final 2015 data) according to enterprises' projections was the worst month of the year. However, the June Indicator's value barely differs from zero, indicator's decrease over H1 2015 (7.4 points) is insignificant in comparison with its decrease (51 points) prior to 2008-2009 crisis. By the end of the year, all losses incurred over H1 2015 were offset. The Indicator came to a level of maximum values registered in 2013-2015. Thus, there were no extraordinary changes in the aggregate Industrial Projections Indicator in 2015 (see Fig. 21).

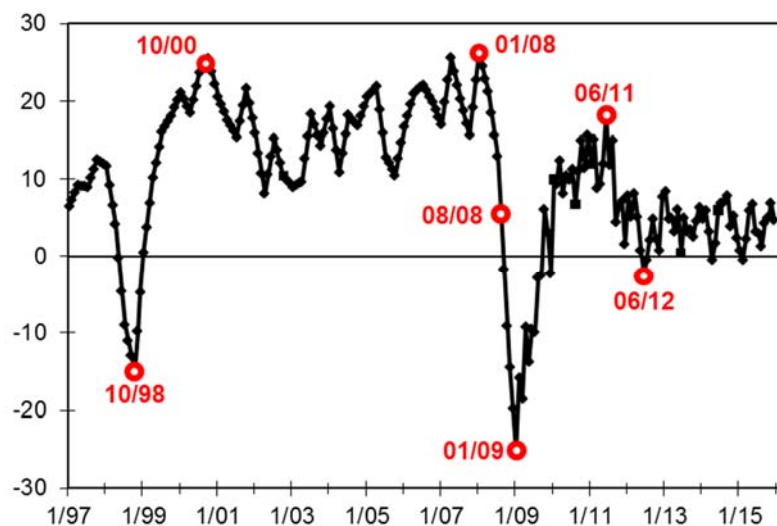


Fig. 21. Industrial Projections Indicator, 1997–2015

The **Industry Adaptability (Normality) Indicator**<sup>1</sup> provides the final assessment by enterprises of the crisis year of 2015.

First, the year 2015 has not seen any crisis abnormal in Russian industry as a whole. The indicator steadily preserved high values the latest of which was equal to all-time high of 72% registered in Q3 2007 and Q2 2012. Russian industry was not in the mood of panic regarding emotionally most difficult Q1 2015 compared to the Russian authorities and observers' sentiments. We can draw an unusual conclusion that the industry long ago and steadily came to

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plans (estimates). A negative value of the indicator means that negative plans (estimates) prevail. Lowering of the indicator value is the sign of deterioration of expectations while its growth – the sign of amelioration of plans (forecasts).

<sup>1</sup> The Indicator is the arithmetical average of the balances (in percentage points) of the answers to the questions about six components: order books, stocks of finished products, stocks of raw materials, available production capacities, current employment, financial and economic state of enterprises. Gaidar Institute for Economic Policy has been analyzing a set of these assessments since 1994. The Indicator is compiled on a quarterly basis. The Adaptability Indicator (normality) shows the level of adaptability of Russian industry to current economic conditions. In other words: to what extent current operating conditions for Russian industry are considered normal.

terms with the slow rolling dynamic of recent years. Moreover, the Indicator shows that since late 2010, Russian industry *constantly* retained high resilience for adaptability to unfolding economic conditions of each quarter of that period. During these 5 years, the Indicator was in the range of 68-72%. Maximum three months reduction came to 2 points and ‘worst’ values of the indicator (68%) were obtained by far from crisis 2015 but in late 2013 – early 2014.

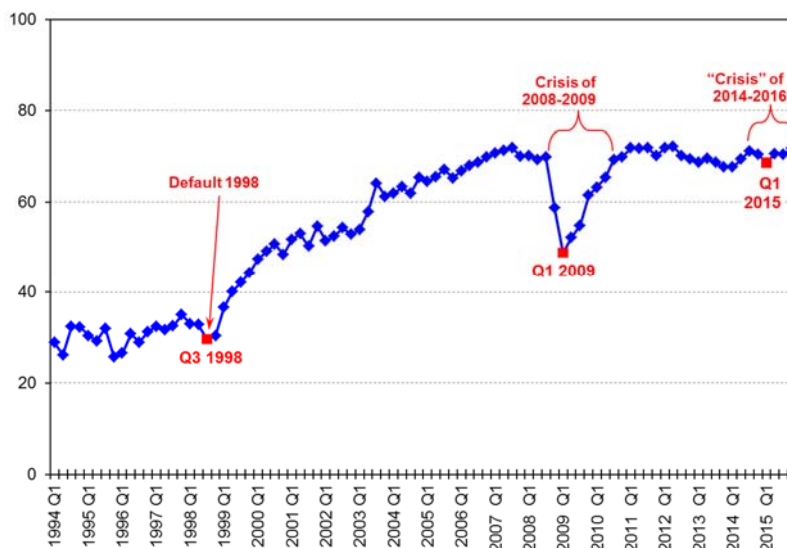


Fig. 22. Russian Industrial Adaptability Indicator, 1994–2015, % (share of enterprises assessing their indicators as “normal”)

Second, the crisis of 2008-2009 has turned out to be more painful for the industry. Then this indicator lost 21 points over two quarters and its recovery took one and a half years long. In other words, businesses required 1.5 years in order to come to terms with the new economic conditions.

Third, the Indicator managed to reach its all-time high only after 1998 default. Prior to that event, Russian industry resided in a state of high ‘abnormality’ where not more than one third of producers managed to adjust.

However, along industrial branches adaptability to the current recession of 2015 differs in principle. Metallurgy, chemical industry and food industry demonstrate high (80%) level of normality is their assessments of the current situation while light industry and construction materials industry are at the other end. Especially the light industry, which undergoes the current crisis as painfully as the crisis of 2008-2009. Consequently, devaluation of 2014-2015 failed to become a lifesaver for this industry. Machine building enterprises occupy an intermediate place with 70% of the adaptability level to the current recession. At the height of the last crisis, the Industrial Adaptability Indicator decreased to 46%. The recovery has taken 7 quarters.

Calculations show that the adaptability level grows with the increment of factory size. During 1994-2015, very large enterprises reached 75% of adaptability level whilst small and medium enterprises managed to reach not more than 63% (see Fig. 23).

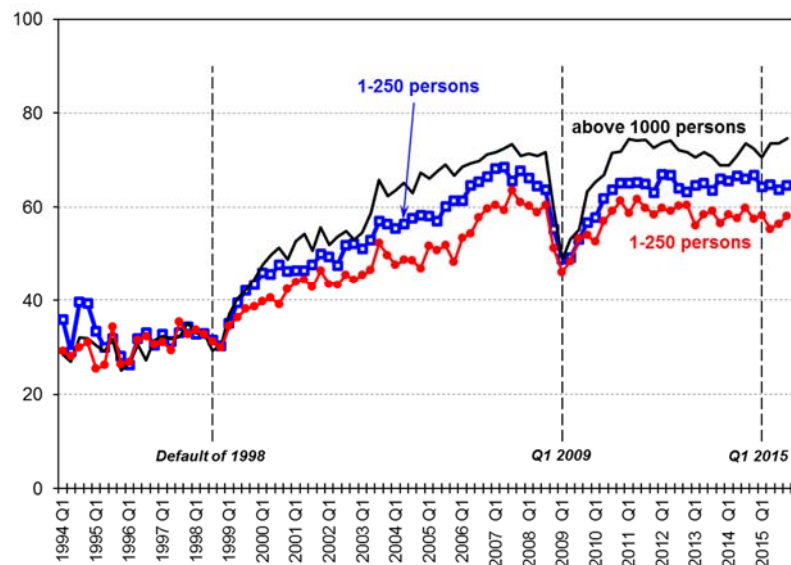


Fig. 23. Adaptability indicators along size of enterprises 1994–2015, % (share of enterprises assessing their indicators as “normal”)

Significant deviations in the Industrial Adaptability Indicator along factory size were registered, as a rule, during relatively good state of the industry. During crunch periods, the level of adaptability of businesses of all sizes decreased to around similar level. For example, in Q1 2009, the Industrial Adaptability Indicator for small and medium producers constituted 46%, for large and very large enterprises – 49%. Similar picture was observed prior to 1998 default when the difference in the adaptability did not exceed, as a rule, 3 points. With the recovery of Russian industry, enterprises’ divide increases due to much superior results obtained by large enterprises and traditionally less high – by small and medium producers.

Year 2015 has not seen critical decrease of the adaptability level in a single group of enterprises under analysis. Group indicators were falling in 2015 by not more than 3 points against the previous quarter, following which the Indicator could recover. Final (average) value of 2015 Indicator was below 2014 value by 1 point for small and medium enterprises, by 2 points for large and, and on the contrary, very large enterprises demonstrated the Indicator’s growth by 2 points. In 2015, there was no convergence of economic situation assessments: very large enterprises showed 73% adaptability (average for 4 quarters of the year), small and medium enterprises – 57% adaptability.

Therefore, industrial enterprises of all sizes have gone through 2015 recession without critical losses.

#### 4.3.2. Movement of major indicators of Russian industry in 2015

First data regarding the state of Russian industry boasted of few crisis features reported in 2015. Actual movements of demand and output, assessment of stocks of finished products, plans of hiring workers were habitual for January and even looked promising in the wake of panic. The latter, by the way, affected projections of demand, output, and investment plans, which failed to gain traditional for the turn of the year confidence. Industry pricing policy and terms of bank corporate lending, on the contrary, reacted decisively to the authorities’ policy.



Dynamic of demand in January 2015 showed traditional for the turn of the year path: the balance of responses decreased to values commonly registered during a month with first ten days of national holidays. That is why, seasonal adjustment demonstrated unchanged rate of the indicator's deviation around previous levels even with a symbolic improvement compared to December. Therefore, industry did not see any critical decline of demand then. This development received a fair assessment by businesses, the majority of which considered unfolding sale volumes as normal in early 2015.

However, demand projections failed to recover to the common for the turn of the year confidence levels due to panic raging on the currency and financial markets as well as public anti-crisis activity of the authorities. The industry began waiting for the promised recession. It started to get ready for it.

Exactly this way looked the management policy of stocks of finished products in Russian industry. Since H2 2014, assessment of balances of stocks showed minimum surplus (+2... +5 points) and in 2015, the first value of the indicator was already negative. In other words, producers' responses 'below normal' started to dominate over responses 'above normal'. However, overall majority of managers (over 70% in November 2014 – January 2015) considered their stocks as 'normal'. Consequently, projected critical worsening of the output dynamic would have been partly flattened out by a deficit of stocks of finished products at 14% of businesses.

Sure enough, industrial production plans reflected the fact that producers expected deterioration of the output movement. According to initial data, January 2015 plans went up to only +20 points while during previous years they reached +30...+40 points. Seasonal adjustment showed deterioration of January projections balance by 5 points against the previous months and by 11 points – to the three-year maximum registered in September 2014.

As expected, 2015 commenced with a considerable price hike. However, its value turned out to be non-traditional at all due to foregone reasons: balance of changes became a four-year maximum. Moreover, solely indicator's growth of January 2011 (when authorities raised the rate insurance contributions) exceeded the outcome of January 2015.

As anticipated, enterprises' investment plans in January 2015 remained at the level of five-year minimum, whereinto they literally crashed in December 2014. Not a single branch of Russian industry projected Investment growth.

In January 2015, the industry had a chance to assess the magnitude of previous measures taken by the RF Central Bank regarding corporate lending terms to the real sector of the economy. Minimal average lending rate in rubles hiked to unprecedented heights of around 20% per annum not observed during recent 5 years of monitoring. Although in November 2014, the lending rate totaled 14% and in February 2014 – 12.3%. In January 2014, aforementioned lending rate was good enough for 70% of producers that was the share of enterprises, which considered credit availability as 'normal' or 'above normal'. In January 2015, credit availability indicator fell to 45%.

In February, recovery of book orders failed to reach customary levels, which resulted in surplus growth of stocks of finished products in the context of exceeding output over demand. Herewith, projections of book orders remained at their minimum since 2009. Apprehension was gaining momentum regarding output and investment plans. While corporate lending terms and conditions were getting tougher.

However, slack sales movement has failed to lead to a significant adjustment in assessment of current book orders volume. The share of responses 'normal' still exceeded the share of responses 'below normal'. Therefore, even decreased sales volumes in the wake of the currency



and lending shocks and unfolding anti-crisis measures undertaken by the government were acceptable for the majority of Russian enterprises.

In Q1 2015, the industry retained an intensive growth of costs. In the intervening three months production costs growth rate went up by another 16 points (growth over Q4 2014 came to 22 points), reached +51 points and totaled seven-year maximum, i.e. production costs did not register such intensive growth since early 2008. However in Q2 2015, the industry planned to halt growth of this indicator. Plans to curb production costs growth to a large extent were explained by a turn in the movement of factory prices. Following the four-year maximum registered in January, price growth rate down by 5 points in February. Price projections made by the industry, which hiked in December-January to nearly inter-crisis maximum level, also began falling in February.

In February, investment plans crumbled by another 12 points reaching the bottom level since October 2009. Just for September 2014 - February 2015 investment projections balance lost 45 points. Surveys failed to register such sharp fall of this indicator ever (its monitoring commenced solely in May 2009).

Another record is also impressive: the share of responses with plans to decrease investment reached 50% in the industry as a whole in February 2015. Producers considered shortage of own funds as a major hindrance to the investment because precisely profit remains the major source of investment in Russian industry. Nevertheless, the RF Central Bank monetary policy stripped producers of another classical source of investment – bank lending. At the turn of 2015, nearly half of Russian industry considered high lending rate as an impediment to investment. In 2014, barely 21% of producers reported this fact and in 2013 – 19%. The picture is completed by the assessment of hardships related to obtaining a bank loan even where the offered lending rate is acceptable for the producer. Other barriers related to obtaining an investment loan in this case were increased by banks in 2015 by nearly twofold (from 10 to 19%). Foreign exchange policy of the regulator enhanced downward pressure of another significant factor for Russian industry – prices on equipment. Following the ruble's devaluation, Russian producers have to pay through their noses for foreign made equipment. For many businesses investment import substitution is impossible due to the fact the required equipment is not built in Russia. Another part of Russian buyers of foreign machines and equipment will be unable to refuse to purchase it due to the fact that domestically manufactured equipment considerably differs in quality from the foreign analogues (quality-price ratio). As a result, in 2015, 42% of enterprises (in 2013 – 34%) consider high prices on equipment and on construction and installation works as a negative factor for investment.

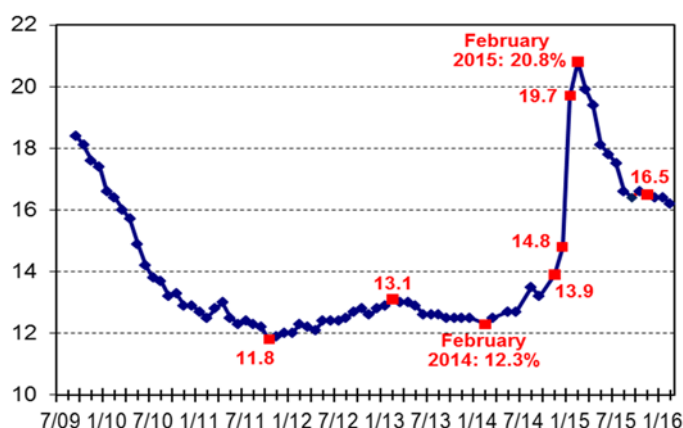
However, results of Q1 2015 clearly turned out to be positive against the backdrop of pre-crisis panic of late 2014 – early 2015. The industry managed to avoid crisis production slump in spite of slow demand recovery following January holidays. The latter development was not acceptable for the considerable part of businesses, which judging by assessments of stocks of finished products, exercised a steady control over demand and supply balance. Commenced slowdown of price growth, decrease of the lending rate and March turning point in the negative trend regarding investment plans all looked positive amid the authorities' crisis rhetoric.

In the context of unfolding (or declared) dismissals in other sectors of the economy and amid slowdown of wages growth, Russian industry as a whole received more chances to resolve their personnel issues. According to the data of IEP surveys, even in early Q1 2015, (when panic mood overwhelmed all economic agents) quarter of industrial enterprises came short of workers required for securing current production volume and 15% of them were expecting its retention

in the short term taking into account projected order books changes. In this context, positive employment dynamic reported in March 2015 (i.e. excess of the share of recruitment responses over the share of lay-offs responses) seemed quite logical. It should be noted that such situation was not registered in the industry during three years, i.e. solely in early 2012 the industry managed to increase the number of workers in the sector. However, forthcoming wage growth in other sectors of the economy (especially in the budget one) stripped industry of its competitiveness on the labor market and led to a steady decrease of the headcount number in the sector, which resulted in the current shortage of personnel at 37% of businesses.

Obviously, non-catastrophic results of Q1 2015 turned around the negative trend in the investment plans of Russian industry. Following the six-month period of downward trend and decrease of expectations balance to the lowest level since the end of 2009, in March 2015 this indicator improved by 10 points. One of the reasons for the turning point in the sentiments in Russian industry was a sharp decline of satisfaction with the production investment volumes. Solely, 42% of businesses assessed investment in Q1 2015 as ‘normal’ following 55% normal assessments of investment in Q4 2014.

Termination of tightening of credit conditions for the industry (see *Fig. 24*) was another positive signal reported in March. First, the lowest bank rate for businesses began falling at last. In March, it decreased by 1 p.p. following an all-time high of 20.8% in rubles per annum posted in February. Second, general corporate lending terms and conditions stopped tightening. In March, unavailability of corporate loans for producers stopped growing and even decreased by barely 2 p.p. following the February level of 45% the share of producers, who assessed their accessibility to credits as ‘below normal’. This value was an all-time high since October 2009 when the indicator was falling following the crisis hike to 65% registered in December 2008.

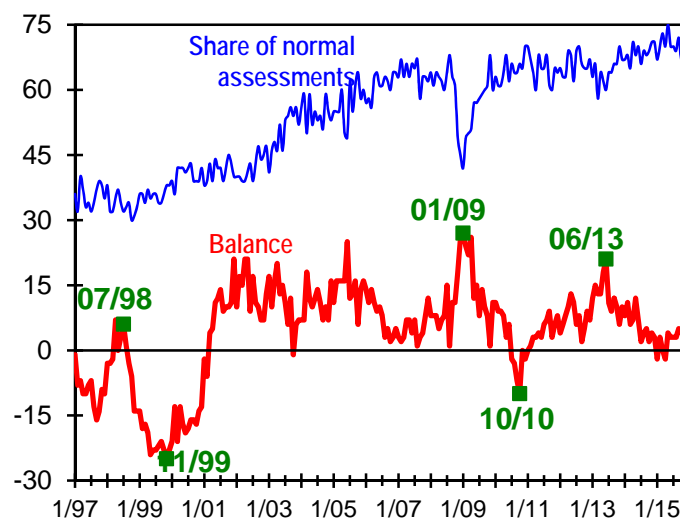


*Fig. 24. Average minimum bank rate on ruble loans, 2009–2015, % per annum February*

In April, Russian industry again avoided critical downturn in demand and production while retaining steady control over stocks of finished products, further slowdown of price growth and drastic positive review of their sales and production plans. In this context, satisfaction with order books remained low, however, strange as it may appear, it was better than during similar months of 2013 and 2014. Hereby, the industry even amid powerful crisis rhetoric of both authorities and experts did not succumb to the official panic mood. Change of key taken by the authorities who were very happy with Q1 results registered in the economy as a whole and in the industry, seems significantly affected businesses. The latter order books projects measured

in April took a sharp hike following staying at the 69-months bottom during three months. Similar turning point was true of the production projections. In April, surveys registered their drastic positive development. As a result, this indicator reached its 44-months minimum. Previously (in October 2014 – March 2015) it was declining reaching 40-months minimum. Assessments of stocks of finished products have confirmed the high level of exceptionally unclear economic outlook. The share of responses ‘normal’ remained at the all-time high, assessments balance of ‘above normal’ and ‘below normal’ remained around zero mark. Corporate lending conditions continued recovering following December shock. In April, the level of loans unavailability responses declined to 35% after reaching post-crisis maximum of 45% in February. Average minimum ruble bank rate moved down by another 0.5 p.p. and reached 19.5% per annum.

In May, industrial production showed a more positive dynamic than demand, which led to a deterioration of assessments of stocks of finished products. Balance moved up by 8 points reaching +6 percentage points. Although May value of assessments balance was the worst for the previous 12 months, its absolute value was not catastrophic for 2011-2015. This value was perceived rather than a small loss of businesses’ control over balance of demand and supply following a very successful management of stocks during shock periods of late 2014 and panic rhetoric of the authorities of early 2015. At the same time, the vast majority of enterprises assessed their stocks as ‘normal’: in May 2015, this indicator reached all-time maximum (of all 23 years of monitoring) (see *Fig. 25*).



*Fig. 25.* Assessment of stocks of finished products, 1997–2015, %

In May, the industry continued its pricing policy characteristic of the previous months aimed at scaling down its price growth. Balance (rate) of growth fell by another 12 and reached +2 p.p. Such moderate growth of factory prices the surveys did not register since early 2014. Balance (rate) of production costs in Q2 2015 crashed to record 40 points: from +53 p.p. to +13 p.p. However, sharp slowdown of production costs and factory prices growth in Q2 affected sales little. In this context, projections of book orders and production stopped gaining confidence. The May investment plans improved but remained within the corridor where they were staying for six months: from December 2014. Barely 16% of businesses planned to increase investment in production in the coming months against 39%, which wanted to reduce investment.

Terms and conditions of corporate lending continued recovering slowly. According to the assessments of industrial borrowers, normal availability of loans went up in May by several points and reached 43%. Following regular CBR decision on the key rate, the ruble bank rate shrank to 18% per annum.

Stocks of finished products still failed to demonstrate any signs of the unfolding crisis or even of its prospects. The industry regularly alerted by the authorities and experts over a year kept stocks under control. Their assessment balance did not hike (as it happened in late 2008 – early 2009) nor went drastically low (as it was following 1998 default or in H2 2010). Since July 2014, the indicator remained in a very comfortable for producers interval -2...+5 points with stable and total (66%-75%) predominance of responses ‘normal’.

At the beginning of H2, Russian industry was slowly drawn into the ‘bog’ of a slow rolling recession. However, not a single major indicator demonstrated changes expected in line with the previous crises developments. This is confirmed by the demand satisfaction assessments: the share of responses ‘below normal’ went up to 53%. Such insignificant level of demand dissatisfaction in the wake of announced recession speaks at least about a number of its features. First, prolonged drawing into recession together with powerful PR-campaign conducted by the authorities aimed at the preparation for the recession allowed businesses to implement preventive measures and psychologically get ready to the demand and output decrease. Second, producers do not perceive highly moderate scale of reduction of the aforementioned indicators as a critical one, following a relatively recent across-the-board recession of late 2008. Third feature (or is we can say – weakness) of the current recession was instability (uncertainty) of industrial demand projections. In 2008, this indicator began drastically falling since September, reached maximum in December 2008, and already in January equally sharply went up. In 2015, the situation is different. Sluggish recovery of the initial demand projections registered in Q1 2015 (mainly due to panic) after the seasonal adjustment looked as expectation of sales contraction. However, absence of recession at the turn of the year added confidence to Q2 expectations. Fourth feature of the slow rolling industrial recession of 2015 one can consider the absence of any problems experienced by businesses with stocks of finished products. Assessments of stocks along the scale ‘above normal’, ‘normal’, and ‘below normal’ show a steady control of producers over demand and supply balance even amid high uncertainty. On average in industry, surplus of stocks nearly totally counterbalances by their shortage. To note, at the height of 2008-2009 crisis balance hiked to +27 points. All-time high of the indicator comes to +28 points, which was registered in January 1996.

The year 2015 signified an investment crisis for the industry especially in H1. However, by mid-2015 investment plans of Russian Industry stabilized at -20 points following four months of fluctuations (search for adequate to current conditions investment strategies) in the interval of -36..-26 points. However, even minimal values of investment plans of the current ‘crisis’ year (-36 points) significantly exceed minimal values (-58 points) posted in H1 2009 (monitoring of the indicator commenced from May) and consequently do not take into account the period of maximum panic of that crisis, which as in this case fell for the beginning of the year.

Other indicators, according to businesses assessments, have not undergone crisis changes. This fact allowed producers to ‘highly assess’ both demand for their products and stocks of finished products. In August, satisfaction with demand in Russian industry went up straight by 10 p.p. and reached 59%. The industry, thus, yet again managed to ‘take a breath’ in the context of constantly accelerated tensions and expectation of across-the-board and instantaneous recession of November 2008. Assessments of stocks of finished products reduced the feasibility of

catastrophe scenario in Russia industry along traditionally monitored by authorities and experts indicators.

In August, businesses reported significant reduction of ruble loan bank rate. Its average minimum value contracted over a month by 1 p.p. and reached 16.5% per annum. During three previous months, the rate decrease came to barely 0.6 points. As a result, general availability of loans (taking into consideration not only rate value) increased in August by 5 p.p. and came to 51%: the number of businesses that consider its availability as normal. Therefore, the indicator's growth following the crisis minimum (34% as of March 2015) reached 17 p.p. Average value of this indicator for the inter-crisis period (April 2010-August 2014) equals 70%.

September showed high ability of Russian industry to come to terms with the recession of 2015. Slow rolling negative demand dynamic as before satisfied the majority of producers and allowed them to continue steady control over stocks of finished products. Major crisis indicator for responses 'above normal' demonstrated in the crisis 2015 a surprising consistency and by far non-crisis level. September survey registered production growth, which was not buttressed by revision of producers' plans and projections. In 2015, production plans of the industry did not exceed their values for 2012-2014. Even panic of Q1 failed to decrease the indicator's balance down to (pre)crisis level. However, its best values failed to give an impression that the industry wished to bottom out the current slow rolling recession. Consequently, in the autumn Russian industry did not see grounds for transition to a positive and sustainable dynamic of production.

Nevertheless, in October, Russian industry decided to retain production growth. However, a limited set of indicators of official statistics does not allow assessing all peculiarities of the situation where Russian industry found itself making another attempt to recover from recession. Data on sales of industrial products were not so optimistic as the data on production dynamics. In October, initial indicator's balance outright fell by 11 points against modest values of July-September. Seasonal adjustment showed reduction by 2 points: not so critical against the backdrop of previous values of the year but obvious inadequate to the latest production developments. Such situation stopped satisfying Russian industry. In October, satisfaction with order books fell by 10 p.p. to 46%. Businesses definitely needed greater volumes of order books in order to maintain production growth.

Projections of order books, which were formulated by producers neither inspired confidence. Following the crash of the indicator in Q1 2015 due to the panic on the currency market and expectations of a crisis of 2008-2009 type, demand projections balance increased to zero level and remained in the interval of -3..+2. In other words, no fundamental changes in demand expectations on the enterprises' level took place including in September-October. Solely production plans demonstrated moderate positive dynamic following the July crash of the indicator. However, in September-October they increased solely to the level of Q2 2015. Consequently, there were no special (post-crisis) expectations for the output growth in the industry. Although, there were no crisis demise of this indicator either.

By the way, businesses were still ready to take risks and refused to revise stocks of finished products even amid exceeding demand changes in output. Assessment of socks balance remained in a small and far from crisis 'plus' since May 2015. Its 2015 maximum value of +5 p.p. did not look ludicrously low after +12 p.p. which was 2014 maximum, +21 p.p. – 2013 maximum, and crisis maximum of 2009 of +27 p.p. To note, this indicator did not decline in 2015 into a significant 'minus' as it happened in 1997, 1999-2000 and 2010 when the industry did

not really trust unfolding then demand growth and preferred to hold insufficient (even according to proper assessments) stocks of finished products.

In October, decrease of the bank lending rate finally terminated (see *Fig. 24*). The ruble lending rate stabilized at 16.5% per annum waiting for the RF Central Bank Board decision on the key rate on October 30. However, during August-October creditors and borrowers searched for a compromise on other terms of lending under a fixed rate. This was reflected in instability of aggregate assessments of loans availability, which showed fluctuations in the range of 43% to 52% after a rare stability registered in May-June, brief growth and prolonged decline of the indicator during previous months.

In November, flat demand made businesses hold back production growth at the current high confidence in production plans and without revision of assessments of stocks of finished products. However, frustration with the sales volumes remained far from classical crisis of 2008-2009 when the share of responses 'below normal' reached 80%. Herewith, demand projections were unlike the crisis ones. During entire H2, they remain (after seasonal adjustment) around zero, i.e. expectations of the sales growth are counterbalanced by expectations of their reduction, which, to note, is quite adequate the current economic situation. They are characterized by the authorities as stability. "The situation in the economy and financial system is sufficiently stable," – said Dmitry Medvedev speaking before the participants of CEO Summit APEC on November 17, 2015.

Despite flat demand and assessments zero balance regarding its change production plans after the July crash were gaining confidence. Major hike of the indicator fell for August (5 p.p.), than its values were growing by 1-2 points monthly and hit +22 balance points by November, which was four-year maximum of the indicator. Thus, the industry retained the wish to bottom out from the current recession, including at the expense of price decrease on its products even in the wake of continuing costs growth.

Still to the end of 2015, Russian industry failed to demonstrate statistically indisputable output growth. Sluggish demand, which resists revival attempts made by producer's price decrease, by ruble's depreciation, and by import substitution, resulted solely in deterioration of assessments of stocks of finished products and negative revision of output plans by businesses. Production plans, which were gaining confidence in August-November and which finally hit by far non-crisis four-year maximum, in December fell by 4 points and triggered new and 'unpleasant' trend in the movement of indicator.

Terms of corporate lending to the industry stabilized at the end of 2015 together with the CBR key rate. Average minimum ruble bank rate averages 16.5% per annum. Aggregate availability of loans (taking into account all terms of borrowing) during the period of fixed rates (both CBR and commercial banks) demonstrated obvious but damped fluctuations. Eventually, average availability of loans in August-December of 2015 constituted 48% following stable 46% level registered in May-July.

Capacity of Russian industry to service current loans in 2015 was sustainable and sufficiently high (did not go below 80%). During the crisis of 2009, this indicator fell to 52%.

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Monitoring of the representative set of indicators of the IEP business surveys allowed to reveal *peculiarities of 2015 recession in Russian industry*. First, during the year dynamic of

major indicators (demand, output, and prices) differed by uncharacteristic for the previous crises and unexpected for observers sluggishness. *Second*, psychological preparation for 2015 crisis commenced several year before when the term ‘second wave of crisis’ was coined. These developments have formed *third feature* of 2015: Russian industrial enterprises without serious consequences have overcome this crisis year, which is reflected by *assessments* of demand, stocks of finished products, employment, production capacities, and financial and economic situation. *Fourth*, single manifestations of the crisis of 2015 for Russian industry were the hike of bank lending rate and crash of investment plans. At the same time, actual investment volumes in 2015, the majority of businesses assessed as sufficient due to expected demand changes.

#### **4.4. Industrial production dynamics in particular sectors of industry<sup>1</sup>**

Russia’s real economy continued throughout 2015 to accommodate itself to new terms of trade and a new geopolitical context, both of which rendered the dynamics of domestic market’s key indicators less stable and less foreseeable.

To make sure that sectoral dynamics are interpreted correctly, analysis of time series in the short term should be attended with seasonal and calendar adjustments. In order to be certain that the available dynamics of industrial production indicates that a period of downturn (or growth) is over, recovery (or slowdown) processes are afoot, monthly series should be decomposed into calendar, seasonal, irregular and trend components.<sup>2</sup> It is the changes of the trend component that should be analyzed in order to provide a substantial interpretation of sectoral trends.<sup>3</sup>

Rosstat publishes adjusted values of the industrial production index as a whole, not furnishing industry-specific production indices; the Gaidar Institute has been making such calculations since earlier in 2015.<sup>4</sup> *Fig. 26* presents the dynamics of the industrial production index, and the

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<sup>1</sup> Authors of this section: Idrisov G. – Gaidar Institute for Economic Policy, Kaukin A. – Gaidar Institute for Economic Policy, Ponomarev Yu. – Gaidar Institute for Economic Policy. The authors thank Marina Turuntseva and Olga Morgunova for their invaluable help with this material.

<sup>2</sup> See Bessonov V.A., Petronevich A.V., Seasonal adjustment as a source of false signals // HSE Economic Journal, Vol. 17 (2013), No. 4, pp. 554–584.

<sup>3</sup> The values of industrial production indices as a whole and of its components within a certain period of time are classical time series, so various methods of their analysis have to meet the eligibility requirements. In particular, interpretation of changes of raw values of such indicators may result in potential errors. For example, the increase of the post-downturn value of any series in question may not only reflect certain fundamental causes but also, e.g., the calendar effect: worked hours in various months (and at various industries) may vary considerably due to the difference in the number of weekends and public holidays, which naturally has an effect on production volumes, too. It is common practice to perform a so-called calendar adjustment so that the foregoing effects are considered while analyzing time series. See Idrisov G., Kaukin A., Morgunova O., Turuntseva M. Industrial downturn: worse than desired, better than it seems to be // Real-time monitoring of the economic situation in Russia. Trends and challenges of socio-economic development, No. 5 (March) 2015.

Besides the calendar component of time series, there is the seasonal component. Production volumes in many industries are distributed unevenly for various months and seasons. For instance, the bulk of production volumes in agriculture fall for obvious reasons on summer and fall seasons, and the bulk of thermal and electric power are produced in winter, etc. Seasonal variances of production volumes are cyclical, and like calendar variances they can be separated from raw values of time series in order to avoid misinterpretations of the changes observed. See Bessonov V.A., Petronevich A.V., Seasonal adjustment as a source of false signals // HSE Economic Journal, Vol. 17 (2013), No. 4, pp. 554–584.

<sup>4</sup> See, e.g., Idrisov G., Kaukin A., Morgunova O., Turuntseva M. Russia’s industry bounces off the bottom // Real-time monitoring of the economic situation in Russia. Trends and challenges of socio-economic development,

trend component of the index. From the data presented it transpires that Russia’s economy in 2014–2015 managed to avoid falling as deep as it sank during the crisis of 2008–2009.

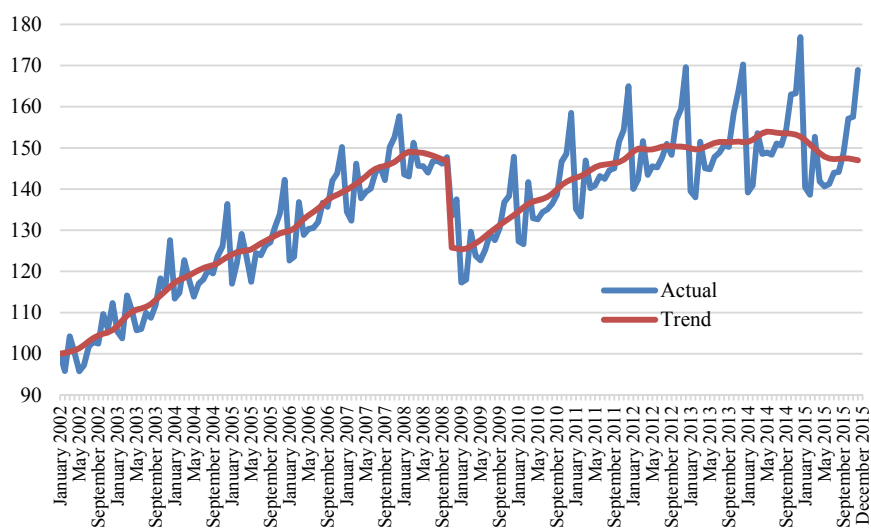


Fig. 26. The dynamics of industrial production index in 2002–2015 (January 2002 = 100)

Sources: Rosstat, own calculations.

One of the key issues, which throughout 2015 were in the focus of industry-specific analysts and government authorities, was the timing of passing the “bottom” for the economy as a whole and industries in particular. The issue of understanding the current stage of economic development is, indeed, of high importance for managing, inter alia, expectations and for pursuing a short- and medium-term economic policy. However, it should be realized that passing the “bottom” (i.e., taking a new growth path) is linked to that of which macroeconomic context can be regarded as equilibrium at least in the short-term perspective. Perceptions of new equilibrium parameters (first of all, the global crude price and the exchange rate) for the Russian economy, as well as respective expectations as to the prospects for industrial production dynamics, underwent some changes in 2015.

#### 4.4.1. Late 2014/early 2015 (March–April): uncertainty and polarization of industries

A new economic context (first of all, terms of trade) was viewed as temporal in late 2014/early 2015, economic agents built their expectations on having to wait for some time

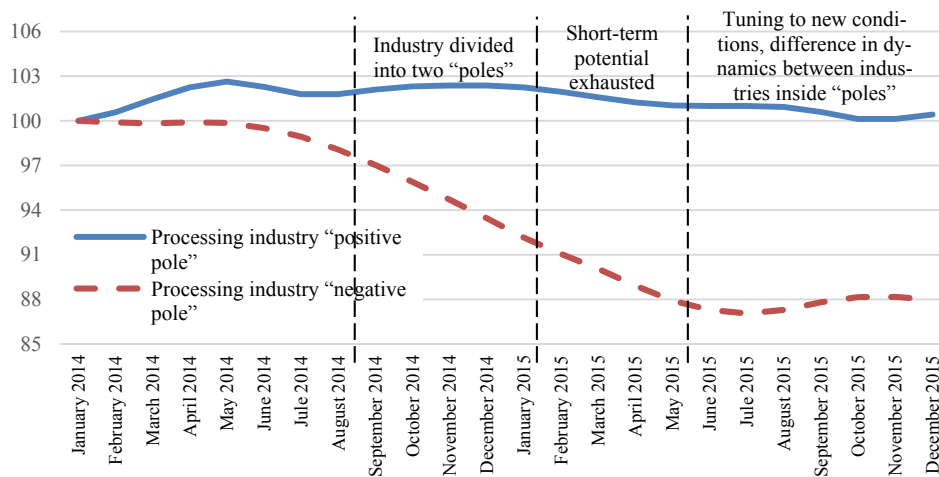
No. 15 (November) 2015; Idrisov G., Kaukin A., Morgunova O., Turuntseva M. Two poles of Russia’s industry // Real-time monitoring of the economic situation in Russia. Trends and challenges of socio-economic development, No. 12 (September) 2015; Idrisov G., Kaukin A., Morgunova O., Turuntseva M. Industrial downturn worsens: trends turn into reality // Real-time monitoring of the economic situation in Russia. Trends and challenges of socio-economic development, No. 9 (June) 2015; Idrisov G., Kaukin A., Morgunova O., Turuntseva M. Industry: trends are worse than data // Real-time monitoring of the economic situation in Russia. Trends and challenges of socio-economic development, No. 7 (April) 2015; Idrisov G., Kaukin A., Morgunova O., Turuntseva M. Industrial downturn: worse than desired, better than it seems to be // Online Monitoring of Russia’s Economic Outlook. Trends and Challenges of Socio-Economic Development, No. 5 (March) 2015.



until the period of economic and geopolitical tensions is over. That period was characterized by contracted investment, some recovery of industrial production on the back of falling imports from Ukraine, as well as Western sanctions and Russia’s countersanctions. In the period between December 2014 and March 2015, Russia’s export crude saw its price fall smoothly from \$68 to \$52 a barrel,<sup>1</sup> thereby triggering negative expectations as to which way the economic situation would develop. The industrial sector embarked on revising its development plans in the face of Russia’s ruble drastic slump, unlikely prospects of quick improvement of external conditions and internal demand, restricted access to foreign loans, and the onset of industrial and consumer inflation.

As a result, Russia’s industrial sector was divided into “positive” and “negative” poles in late 2014/early 2015. In terms of production dynamics, the “positive” pole (which includes industries that contribute about 35% to the overall industrial production index) was assessed positive as a whole (the manufacture of food products, other nonmetallic mineral products (incl. construction materials), rubber and plastics products, metallurgy, and the manufacture of chemicals and chemical products) largely due to recovery of industries benefiting from replacing goods imported from Ukraine (as a result of profound rift between Russia and Ukraine), disrupted regularity of the pace of production processes of Ukrainian enterprises, introduction of sanctions, increased competitiveness in external markets due to ruble’s devaluation, as well as favorable external economic conditions. The opposite or “negative” pole (a contribution about 17% to the overall industrial production index) comprised sectors such as the manufacture of textiles and wearing apparel, pulp, paper and paperboard, leather, machinery and equipment, means of transport, electrical equipment, whose output was indicative of a downturn due to the price growth of foreign intermediate goods and equipment (which is a major problem facing most import-led industries), overall decline of demand due to a drop in buyers’ income, and economic agents’ negative expectations amid uncertainty and falling access to loans.

The foregoing trends are shown in *Fig. 27*.



*Fig. 27.* The dynamics of “positive” and “negative” poles in Russia’s processing industry in 2014–2015 (January 2014 = 100)

Sources: Rosstat, own calculations.

<sup>1</sup> The data released by Russia’s Federal Customs Service.

Despite some kind of recovery of some sectors of Russia's industry in late 2014/early 2015, they saw their growth rates begin falling as early as March-April 2015. This holds true for the manufacture of food products, rubber and plastics products, as well as metallurgy. The manufacture of chemicals and chemical products was the only industrial sector to see its production grow steadily in Q2 2015. Actually, the change in the dynamics of industrial production was an evidence that import replacement potential had been exhausted for industries that managed in late 2014 to benefit from a weakening ruble, sanctions and favorable external economic conditions. A further growth required structural changes, higher quality of goods, that is, the competitiveness of such goods should be enhanced through internal rather than external factors.

#### 4.4.2. April–September 2015: building new expectations and gradual economic stabilization

By the mid-2015, the crude price and, accordingly, the ruble's exchange rate against the US dollar faced more stable dynamics, and they even bounced back to the level seen in January 2015. During that period, economic agents built their new expectations for long-term equilibrium macroeconomic parameters, as was also reflected in the forecast of Russia's Ministry of Economic Development, on which a federal budget bill was drafted. The Ministry of Economic Development fore in May that in 2015 the ruble's yearly average exchange rate would be 60 rubles per dollar (53 rubles per dollar by 2018), and the Urals crude yearly average price would be \$50 a barrel.<sup>1</sup>

Russia's industrial sectors that were hit most by the changes in terms of trade began in Q2 2015 to dampen the fall which varied in pace. For example, in terms of volume, the manufacture of leather and means of transport stabilized, whereas the manufacture of pulp, paper and paperboard, means of transport, electrical equipment, etc. continued to fall, at lower paces, though. Production volumes of these sectors were stabilized due to common factors (less dependence on imported raw materials and component parts) and some specific factors.

By September, the dynamics of industrial production of some sectors was an evidence that industrial production passed the lowest output. The bulk of the growth of the industrial production index at that period was attributed to sectors such as the fuel and energy sector, the manufacture of food products (partial replacement of imported products, a slight increase in demand, e.g., growth of demand for agricultural raw materials<sup>2</sup>), the manufacture of coke and refined petroleum products, chemicals and chemical products (import cuts amid simultaneous growth of domestic manufacture of a wide spectrum of goods of the industry: household chemicals, pharmaceuticals, crop protecting agents<sup>3</sup>; there were sufficient capacities available (first of all, manufacture of polymers) to compete successfully with imported goods).

Approximately in the mid-2015, an important trend began to manifest itself (see *Fig. 28*) as a visible growth of the trend component of the extracting series (a contribution of about 34% to the overall production index). As this took place, a fall of the index in early 2015 and the following recovery growth were driven by changes in the production of fossil fuels. Production

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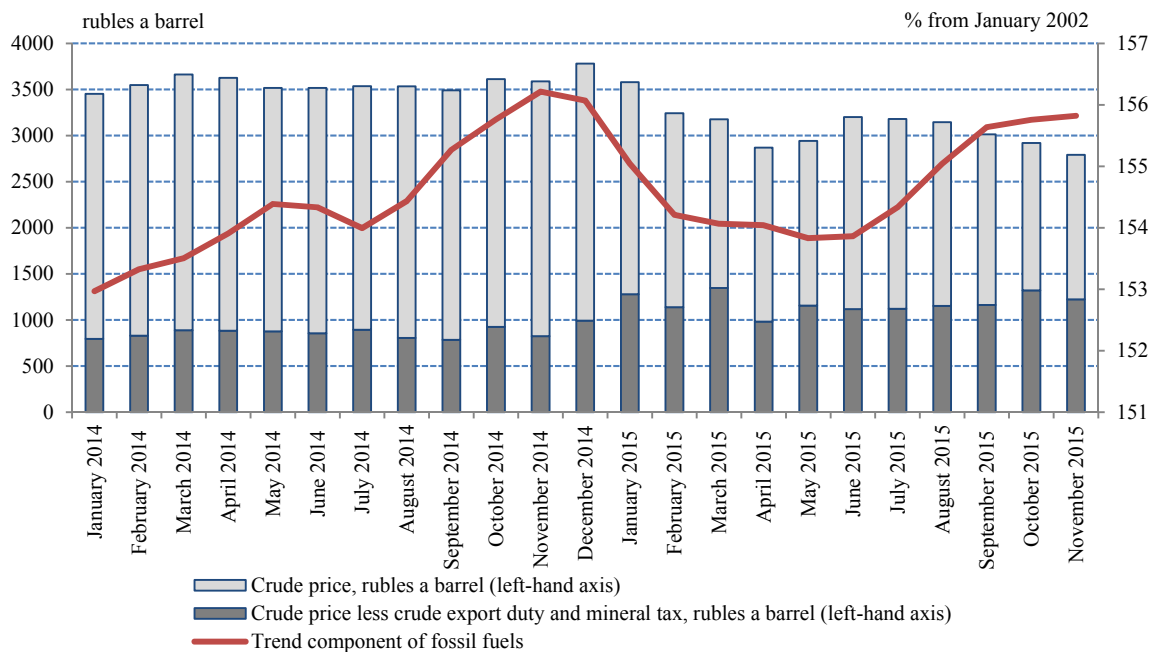
<sup>1</sup> Scenario-based conditions, basic parameters of the socio-economic development forecast for the Russian Federation and the ceiling of prices (tariffs) of services provided by infrastructure sector companies for 2016 and the planning period of 2017 and 2018 // Ministry of Economic Development of Russia, May, 2015

<sup>2</sup> Ministry of Economic Development notes growth rates increase in the manufacture of food products // IA Regnum, July 31, 2015 [<http://regnum.ru/news/1947866.html>]

<sup>3</sup> Chemical industry takes advantage of import replacement factor. RIA Rating, July 10, 2015 [<http://riarating.ru/comments/20150710/610662472.html>]

volumes of other commercial minerals (metal ores, raw materials for construction, and the manufacture of chemicals and chemical products) remained unchanged throughout the entire period under review, which can possibly be explained by the fact that these types of products are neither exported nor processed in Russia, especially by sectors facing a relatively favorable conditions during the crisis (the manufacture of chemicals and chemical products, metallurgy, construction sector), which makes them less sensitive to exchange rate and external economic conditions.

The decline in the extraction of fossil fuels, which began in early 2015, was triggered by the effect of delayed<sup>1</sup> fall of actual ruble denominated prices of Russia's crude exports (and the falling market value of global dollar-denominated crude prices) against the ruble's devaluation. As this took place, there was no decline in supplies, and ruble-denominated prices began to recover as early as the middle of the spring season, which collectively resulted in growth and gradual stabilization of the trend component of the production index of this industry. Lukoil CEO Vagit Alekperov<sup>2</sup> said producers can increase their output with oil prices staying near \$50 a barrel, because, first, the bulk of the costs in the industry are expressed in rubles and, second, it is the state, not oil companies, whose revenues (crude export duty) are hit most by the decline in crude prices.



*Fig. 28.* The dynamics of Russia's export crude price, and the trend component of the mineral production index in 2014–2015

Sources: Rosstat, own calculations.

<sup>1</sup> The delay is actually explained by a new policy of the Bank of Russia, which has abandoned its managed exchange rate policy.

<sup>2</sup> See, e.g., an interview with Vagit Alekperov: Chinese loans are most expensive in the world. *Vedomosti*, September 6, 2015 [<http://www.vedomosti.ru/business/characters/2015/09/07/607751-kitaiskie-krediti-samie-dorogie-v-mire>]

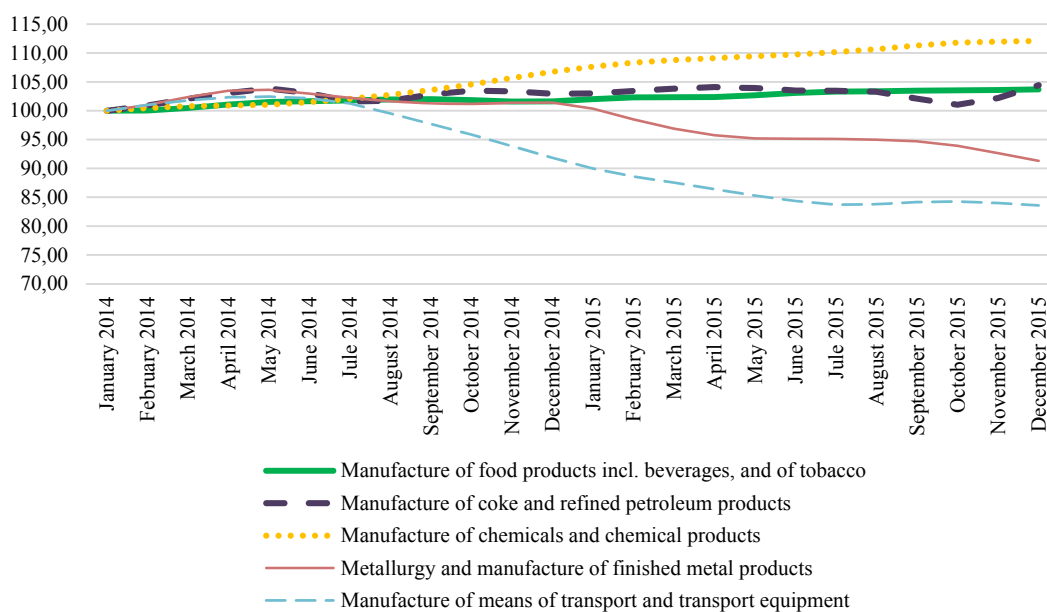
The described dynamics of industrial production indices allowed one to draw conservative assumptions that Russia’s economy may resume growth by the end of 2015, unless terms-of-trade shocks strike again.

**4.4.3. October–December 2015: worsening macroeconomic context and a new round of downturn**

Terms of trade passed a new downturn phase in Q4 2015. The macroeconomic context again stripped Russia’s economy of a long-term target for oil prices and ruble’s exchange rate. Experts slashed their forecasts, some of which predicted the value of the US dollar would be equal to 75 rubles, and the crude would be traded at \$40 a barrel.<sup>1</sup> The expectations were reinforced by the dynamics of crude oil prices and of exchange rate during the last months of the year, and the fall continued in early 2016.

Like earlier in the year, the 2015 year-end context will inevitably affect production volumes of fossil fuels, but there will be a delay (provided that crude prices fail to recover, e.g., if oil-producing countries reach an agreement).

A new fall of global oil prices and the following (in late 2015) depreciation of the ruble seem to have a smaller scale effect than in late 2014, yet the effect was visible on the dynamics of the manufacturing sector (see *Fig. 29*).



*Fig. 29.* The dynamics of trend components of the processing industry’s key sectors in 2014–2015 (January 2014 = 100)

Sources: Rosstat, own calculations.

There may be two reasons the effect of terms of trade on the Russian economy in late 2015 was weaker than that at the end of 2014. First, in late 2014, the market was driven not only by the ruble’s devaluation and falling oil prices, but it was also affected by Western sanctions and

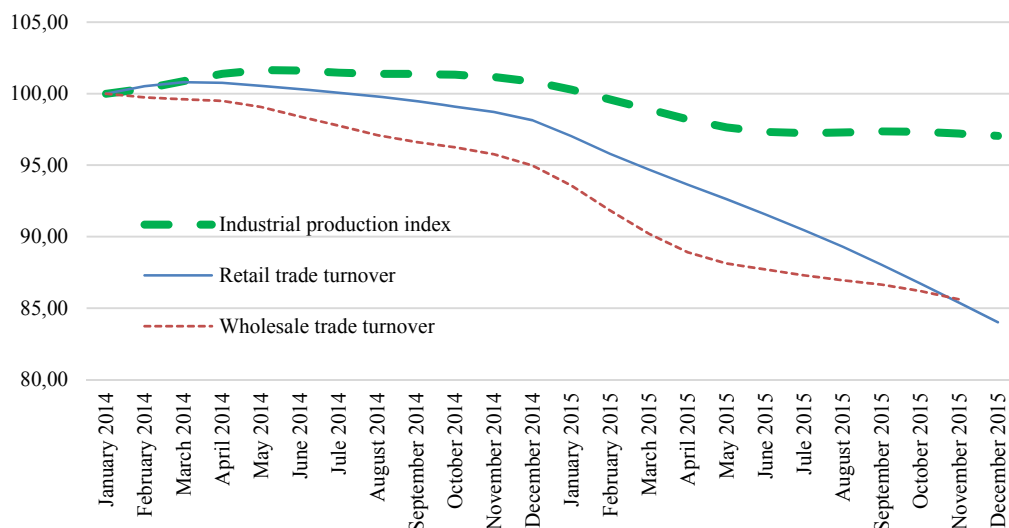
<sup>1</sup> Economists predict ruble’s weakening continues after key rate cut. RBC: October 26, 2015 [<http://www.rbc.ru/finances/26/10/2015/562e29e19a794753623969a6>]

Russia's countersanctions, the worsening situation in Ukraine and heightened uncertainty about the nature (temporal or permanent) of the oil price shock observed. Under the circumstances, the basket of factors as a whole had no strong effect on further dynamics of production volumes. Second, the past year saw businesses somehow adapt to new conditions, or rather to unstable environment, thereby affecting the H2'15 production indices.

Unlike the situation which developed immediately after the onset of the crisis in the fall season of 2014, no growth was seen in late 2015 in sectors that managed to take short-term advantage of favorable external economic conditions or increased competitiveness with partly sanctioned foreign-made products. Instead, growth was seen in industries that, first, are feebly dependent on foreign raw materials, second, have traditionally thick domestic market for their products or, third, compete successfully in external markets, taking advantage of the squeezed share of ruble-denominated costs of dollar-denominated finished products, and of a noncritical gap in quality between them and their competitors. Among the sub-sectors in the manufacturing sector the manufacture of coke and refined petroleum products (domestic market, cost cuts), chemicals and chemical products, and rubber and plastics products, woodworking (domestic and external markets, cost cuts) fit into this group.

Industries whose 2015 year-end production volumes continued to decline are first of all characterized by their being heavily dependent on imported raw materials and component parts (the manufacture of textiles and wearing apparel, electrical equipment), and by being sensitive to falling global and domestic economic growth rates (metallurgy). The other industries moved to some kind of new equilibrium production level, and they do not expect any serious changes to happen in the short term. *Table 12* presents drilled down values of the trend components of production indices by key industry.

Production volumes of Russia's manufacturing and extracting sectors kept falling by the end of 2015, as seen in *Fig. 30*. The economy may pass a "second bottom" of downturn in the short term, provided that the terms of trade remain intact.



*Fig. 30.* The dynamics of trend components of economy sector indices in 2014–2015 (January 2014 = 100)

*Sources:* Rosstat, own calculations.

#### 4.4.4. Wholesale and retail trade: protracted fall

Note that the dynamics of industrial production is indeed important indicator of the state of economy, although industrial production accounts for about 26–27% of gross value added. It is therefore important that other major sectors of economy are considered, too.

For example, the turnover of wholesale and retail trade, whose collective share of gross value added is traditionally about 20%, continues to decline (see *Fig. 30*) as it did during the entire period under review. A similar trend is observed in the construction sector, real estate transactions, and in the provision of related services.

The rapid weakening of the ruble since late 2014 (except some short periods of time) and throughout 2015 forced down turnover volumes of wholesale and retail trade. As a result, the Q1'15 total retail trade turnover decreased by 18% from Q4 2014, and later, in 2015, the wholesale and retail trade turnover dropped, despite some growth in nominal terms, by an average of 9% and 10% year-on-year, respectively. Additionally, non-network trade formats were responsible for the bulk of the fall in the 2015 trade turnover (near 77% of the total retail trade in 2014), because major retail networks delivered a positive financial performance throughout the entire period and at year's end.

Below listed are the key factors responsible for the decline in trade turnover volumes in 2015:

- decline of real disposable income by 4% from 2014;
- growth of consumer prices by 12.9%. In early 2015, retail prices of certain food and non-food products increased considerably largely due to the exchange rate pass-through to prices. In specific cases prices were driven up by a speculative growth, which was the reason supervisory authorities initiated inspections of the retail trade sector. At the same time, in Q1 2015 major retail networks announced a 2-month price freeze on basic socially desirable products in order to stabilize the food market;
- cut in consumption of durable goods because the bulk of purchases were deferred to early 2014/late 2015, when a feverish demand was afoot.

\* \* \*

The 2015 production dynamics of Russia's industries were determined by terms of trade and geopolitical tensions (which emerged a year earlier and worsened the long-standing problems facing the Russian economy): the ongoing fall of oil prices and exchange rate, the effect of Western sanctions and Russia's countersanctions, actual wind down of economic cooperation with Ukraine, overall slowdown in global economic growth, heightened uncertainty. At year's end only a few sub-sectors of the processing sector and the fuel and energy sub-sector of the extracting sector managed to advance towards a small growth, whereas the other industries continued to fall or stagnated.

*Table 12*

**Trend component of industrial indices in 2014–2015**  
**(January 2014 = 100)**

	2014											
	January	February	March	April	May	June	July	August	September	October	November	December
Industrial production index	100.00	100.35	100.88	101.40	101.65	101.61	101.47	101.38	101.38	101.33	101.17	100.85
Extraction of commercial minerals	100.00	100.23	100.47	100.78	100.99	100.90	100.71	100.84	101.13	101.32	101.63	101.71
Manufacturing	100.00	100.37	100.82	101.22	101.37	101.27	101.10	100.92	100.76	100.49	100.08	99.59
Electricity, gas and water	100.00	99.97	99.95	99.93	99.92	99.89	99.87	99.86	99.84	99.82	99.80	99.78
Manufacture of food products, including beverages, and tobacco	100.00	100.03	100.46	101.08	101.51	101.64	101.76	101.94	101.99	101.82	101.57	101.62
Manufacture of textiles and wearing apparel	100.00	99.53	98.31	97.71	97.17	95.53	92.65	89.28	87.15	86.28	85.34	83.86
Manufacture of leather, articles of leather, and manufacture of footwear	100.00	100.86	100.81	99.75	98.09	96.59	95.33	93.94	92.47	91.06	90.01	89.10
Woodworking and manufacture of articles of wood	100.00	98.52	98.28	98.18	97.40	96.87	97.11	97.33	97.89	98.58	98.70	98.25
Manufacture of pulp, paper and paperboard	100.00	99.85	99.87	99.23	98.07	97.00	95.96	95.02	94.29	93.83	93.61	93.30
Manufacture of coke, refined petroleum products	100.00	100.90	102.06	103.08	103.84	103.03	101.59	101.74	102.81	103.48	103.37	102.97
Manufacture of chemicals and chemical products	100.00	100.47	100.80	100.89	101.06	101.48	102.07	102.78	103.59	104.56	105.69	106.76
Manufacture of rubber and plastics products	100.00	103.48	107.68	110.28	111.50	111.94	111.57	111.02	111.96	113.65	114.39	112.84
Manufacture of other nonmetallic mineral products	100.00	100.81	101.87	102.80	103.15	102.99	102.77	102.53	102.21	101.69	101.35	101.05
Metallurgy and manufacture of finished metal products	100.00	100.99	102.36	103.47	103.64	102.96	102.23	101.63	101.27	101.19	101.37	101.39
Manufacture of machinery and equipment	100.00	98.74	98.19	98.54	99.04	98.77	98.13	97.56	96.81	95.76	94.47	92.71
Manufacture of electrical, electronic and optical equipment	100.00	99.83	99.76	99.77	99.86	99.97	100.06	99.95	99.53	98.78	97.87	97.05
Manufacture of means of transport and transport equipment	100.00	101.01	101.79	102.33	102.45	102.18	101.25	99.54	97.71	95.88	93.88	91.86
Other industries	100.00	100.45	100.18	100.21	100.51	100.48	100.33	99.65	98.07	96.05	94.39	93.31
Extraction of fossil fuels	100.00	100.23	100.35	100.61	100.93	100.89	100.67	100.96	101.50	101.83	102.12	102.03
Extraction of commercial minerals, except energy-producing products	100.00	100.15	100.42	100.66	100.77	100.76	100.78	100.79	100.78	100.85	101.07	101.34
Retail trade turnover	100.00	100.52	100.80	100.76	100.55	100.31	100.08	99.80	99.48	99.09	98.72	98.14
Wholesale trade turnover	100.00	99.75	99.61	99.49	99.08	98.41	97.76	97.10	96.62	96.25	95.77	94.98

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*Cont'd*

	2015											
	January	February	March	April	May	June	July	August	September	October	November	December
Industrial production index	100.28	99.60	98.91	98.21	97.64	97.33	97.24	97.29	97.36	97.34	97.21	97.05
Extraction of commercial minerals	101.29	100.92	100.79	100.68	100.62	100.75	101.06	101.45	101.79	101.88	101.79	101.82
Manufacturing	98.86	98.05	97.22	96.34	95.63	95.21	94.94	94.81	94.78	94.68	94.51	94.36
Electricity, gas and water	99.75	99.72	99.70	99.68	99.66	99.64	99.62	99.60	99.58	99.57	99.56	99.55
Manufacture of food products, including beverages, and tobacco	101.99	102.29	102.33	102.36	102.65	103.07	103.30	103.36	103.45	103.53	103.58	103.67
Manufacture of textiles and wearing apparel	82.24	81.13	80.58	80.62	81.42	82.72	83.69	83.93	83.25	81.81	80.20	78.93
Manufacture of leather, articles of leather, and manufacture of footwear	87.98	87.05	86.38	85.44	84.34	83.62	83.67	84.59	85.39	85.14	84.83	85.03
Woodworking and manufacture of articles of wood	97.97	97.75	96.26	94.19	92.93	92.59	92.79	93.43	93.97	93.89	94.05	94.55
Manufacture of pulp, paper and paperboard	92.69	91.86	91.17	90.93	91.05	91.31	91.60	91.87	92.04	92.01	91.74	91.41
Manufacture of coke, refined petroleum products	103.01	103.42	103.82	104.11	103.94	103.52	103.46	103.29	102.10	101.04	102.20	104.43
Manufacture of chemicals and chemical products	107.65	108.34	108.79	109.12	109.44	109.77	110.17	110.68	111.31	111.80	111.99	112.13
Manufacture of rubber and plastics products	109.20	105.87	103.36	101.92	102.58	104.25	105.20	106.53	108.74	109.53	109.42	110.04
Manufacture of other nonmetallic mineral products	100.21	99.15	97.86	96.24	95.08	94.25	93.03	91.98	91.30	90.63	90.02	89.47
Metallurgy and manufacture of finished metal products	100.34	98.50	96.89	95.75	95.19	95.14	95.10	94.98	94.71	93.90	92.63	91.32
Manufacture of machinery and equipment	90.42	88.33	86.68	85.17	84.11	84.02	84.79	85.86	86.94	87.77	88.10	88.16
Manufacture of electrical, electronic and optical equipment	96.24	95.40	94.63	93.85	93.03	92.25	91.47	90.71	90.07	89.56	89.12	88.63
Manufacture of means of transport and transport equipment	90.00	88.61	87.56	86.42	85.30	84.35	83.73	83.79	84.17	84.26	83.99	83.58
Other industries	92.49	92.02	91.42	89.77	87.60	85.82	84.68	85.05	86.91	88.82	89.92	90.10
Extraction of fossil fuels	101.36	100.81	100.72	100.70	100.56	100.58	100.89	101.36	101.75	101.82	101.87	102.14
Extraction of commercial minerals, except energy-producing products	101.49	101.54	101.60	101.64	101.73	101.86	101.99	102.15	102.30	102.37	102.32	102.25
Retail trade turnover	97.03	95.79	94.69	93.64	92.62	91.55	90.45	89.30	88.03	86.73	85.38	84.02
Wholesale trade turnover	93.57	91.83	90.21	88.91	88.13	87.71	87.30	86.95	86.65	86.20	85.62	



## 4.5. Investment in fixed assets<sup>1</sup>

### 4.5.1. Conditions and factors of investment activity

The crisis of 2008-2009 determined main structural changes in the formation of investment resources during post-crisis period up to 2015. Easing of economic growth rates was accompanied by a contraction of the share of gross savings in GDP from 30.2% in 2008 to 22.9% in 2014 and 23.1% in 2015 (*Table 13*). During 2010-2013 investment in fixed assets constituted around 20.0%. In 2014, owing to a reduction of revenues in the economy the share of investment in fixed assets fell to 17.8% and in 2015 came to 18.1% of GDP.

*Table 13*

**Main characteristics of investment resources in 2008–2015, % to GDP**

	2008	2009	2010	2011	2012	2013	2014	2015*
Gross savings	30.2	21.1	26.4	29.5	27.2	23.2	22.9	23.1
Gross fixed assets formation	22.3	22.0	21.6	21.4	21.9	21.8	20.6	16.2
Investment in fixed assets	21.3	20.6	19.8	19.7	20.2	20.3	17.8	18.1
Gross profit and other mixed income	32.7	30.7	32.6	31.0	33.9	33.0	32.4	30.8
Consolidated budget revenues	38.8	35.0	34.6	37.3	37.7	36.9	37.5	37.4
Budget funds for investment	3.4	3.4	2.8	2.9	2.8	2.9	2.5	2.1
Including at the expense of federal budget funds	1.3	1.8	1.4	1.5	1.5	1.5	1.3	1.2

\*) Preliminary data.

Source: Rosstat.

Characteristic feature of the 2009-2015 Russian investment model consists in a decreasing norm for the transformation of gross national savings into fixed investment. If in 2008, the investment purposes accounted for 71.0% of gross savings and 95.0% of gross saving in fixed assets, then in 2015 these indicators came to 63.0% and 90.0%, respectively.

While analyzing volume, dynamics and structure of resource sources for financing investment, it is important to monitor changes in the investment potential of institutional sectors. In 2010-2015, the share of non-financial corporations and households was growing in the structure of investment resources and the share of the state sector was decreasing (*Table 14*).

*Table 14*

**Structure of investment resources across institutional sectors,  
% to total**

	2008	2009	2010	2011	2012	2013	2014	2015
Investment resources, total	100	100	100	100	100	100	100	100
Corporations	40.7	52.2	51.6	45.7	48.9	54.3	59.5	68.0
Including:								
Non-financial corporations	33.7	36.8	46.1	41.0	42.7	45.4	54.3	61.2
Financial corporations	7.0	15.4	5.5	4.7	6.2	8.9	5.2	6.8
Non-profit organizations servicing households	0.4	0.3	0.5	0.5	0.5	0.6	0.1	0.1
Households	28.2	68.3	46.2	30.7	31.5	36.1	32.1	31.7
Public administration	30.7	-20.8*	1.7	23.1	19.1	9.0	0.0	0.3

\*) Negative value arose due to excess of capital transfers cost conveyed by state agencies to other sectors of the economy over its savings.

Source: Rosstat.

The sector of non-financial corporations forms the majority share of the economy's investment resources. Easing of the economic growth dynamics in 2009-2015 was accompanied by the instability of indicators of the financial results of economic activity and limited saving of

<sup>1</sup> Author of this section: Izryadnova O. – Gaidar Institute for Economic Policy.

the investment resources. In 2014, balanced financial result constituted 63.4% of indicator a year earlier, which became one of the factors restricting the scale of the investment resources for the coming year. Amid decrease of economic growth rates and increased investment risks the non-financing sector responded with buildup of deposits whose rate of return was steadily increasing from 2009 and by late 2014 average weighted deposit rate for organizations hit 14.83% and exceeded the rate of annual inflation and composite price index on capital goods. Aside from that, behind the increased propensity of enterprises and organizations to save was the growth of credit resources cost from 5.5% (February 2, 2014) to 17.25% (December 16, 2015). In 2015, the impact of these factors remained and enhanced the fall of investment in fixed assets in the construction sector (*Table 15*). In the course of 2015, key rate was cut five times – to the level of 11.0% (August 3). However, it had no effect on the state of economic activity in construction and investment complex because as before possibilities to replenish working assets were limited by high cost of credit resources. Dominant source of investment resources in the Russian economy are own assets of enterprises and organizations.

Dynamics of investment resources have been significantly affected by the negative shift in the situation with the attraction of foreign investment in Russian economy. After more than twofold decrease of direct foreign investment in Russian economy in 2009, despite positive dynamics during subsequent four years there was no recovery of their volume to pre-crisis level. Russia's ratings downgrade and increasing risks have negatively told on the investment behavior of foreign investors. With the imposition of sanctions and restriction of borrowing on the external market direct foreign investment in the Russian economy in 2014 shrank threefold. By the period-end for 2016 constituted less than 20% of the indicator a year earlier. In 2014, Russian direct investment abroad shrank by 35% against 2013 amid increased contraction in 2015 to 62,1% against the of the previous year (*Table 15*). Thus, simultaneous decrease of direct investment in the Russian economy and reduction of revenues from the investment activity abroad was the factor for contraction of investment resources not only in 2015 but determined starting conditions for 2016.

*Table 15*

**Financial conditions for investment activity  
in 2010–2015**

	2010	2011	2012	2013	2014	2015
GDP in % to previous year	104.5	104.3	103.4	101.3	100.6	96.3
Investment in fixed assets, in % to previous year	106.3	110.8	106.8	100.8	98.5	91.6
Volume of work in construction, in % to previous year	105.0	105.1	102.5	100.1	97.7	93.0
Commissioning of fixed assets, in % to previous year	93.4	129.0	108.7	101.0	97.3	n/a
Key rate (year-end), %	-	-	-	5.50	17.25	11.0
International reserves of the Russian Federation (year-end), USD billion	479.4	498.6	537.6	509.6	385.5	368.0
Net inflow (-) / outflow (+) of capital by private sector, USD billion	30.8	81.4	53.9	61.6	153.0	56.9
Price indices, in % December-on-December						
Consumer prices on goods and services	108.8	106.1	106.6	106.5	111.4	112.9
Producers' prices on industrial goods	116.7	112.0	105.1	103.7	105.9	112.4
Prices on building products (composite index)	109.1	108.0	106.9	104.9	107.2	110.3
including						
Construction and installation works, %	109.6	109.3	108.3	104.3	104.6	104.1
Machinery and equipment	106.1	105.6	103.9	103.1	112.3	120.1
Official rate USD/Russian ruble (by year-end) RB/USD	30.48	32.20	30.37	32.73	56.26	72.88

Source: Rosstat.

*Table 16*

**Dynamics of direct investment. Balance of payments transactions. USD million**

	2008	2009	2010	2011	2012	2013	2014	2015
Direct investment	-19120	6697	9448	11767	-1766	17288	35051	16734
Abroad	55663	43281	52616	66851	48822	86507	57082	21575
In Russia	74783	36583	43168	55084	50588	69219	22031	4839

Source: Bank of Russia.

4.5.2. Material and productive resources of investment activity

One of the factors, which determine the character of investment activity in 2014-2015 was a firm reduction of efficiency of fixed assets usage. Dynamics of commissioning of fixed assets is significantly lagging behind the investment dynamics. Volumes of unfinished construction are growing. Indices of operation efficiency of the construction and investment complex are falling (*Table 17*).

*Table 17*

**Commissioning of fixed assets per 1 ruble of investment across main types of economic activity. Annual average prices. Kopecks \***

	2008	2009	2010	2011	2012	2013	2014
Total	65.1	80.6	68.6	80.5	80.8	82.4	80.9
Agriculture	70.0	88.9	101.2	102.0	81.1	81.5	84.5
Fishery, fish-farming	70.8	76.1	142.8	99.2	94.1	82.8	127.8
Extraction of raw materials	74.6	118.1	67.4	77.9	81.6	86.0	70.9
Manufacturing industries	63.7	78.4	67.8	77.3	69.7	79.5	79.0
Production of electricity, gas and water supply	51.9	57.4	60.3	89.5	87.8	89.5	88.0
Construction	49.8	55.5	41.0	72.2	66.2	51.7	51.6
Wholesale and retail trade	81.0	99.0	83.9	101.7	78.4	73.4	114.5
Transport and communications	59.9	65.5	44.5	69.7	77.6	67.3	71.5

\*Data for 2015 will be available in late 2016.

Source: Rosstat.

With change in business climate, the share for spending on purchase of machinery and equipment began shrinking with increasing share of spending on construction of buildings and facilities (*Table 18*).

*Table 18*

**Composition of investment in fixed assets across types of capital stock 2010—2015 (less small businesses and parameters of informal activity), % to total**

	2013	2014	2015
Investment in fixed assets	100	100	100
including:			
Housing	6.1	6.6	5.9
Buildings (less residential) and facilities	50.2	48.9	50.3
Machinery, equipment and means of transport	35.1	34.6	32.8
Other	8.6	9.9	11.0

Source: Rosstat.

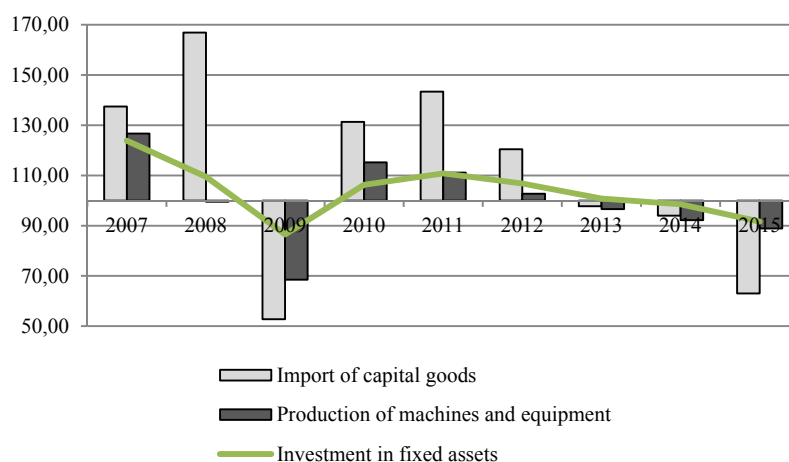
High level of wear and tear of fixed assets, unfavorable age structure of the part of machinery and equipment represents a tight constraint of economic growth. Amid prolonged downward trend in the share of gross savings in fixed assets, GDP underwent a disruption of the normal cycle of the renewal of fixed assets. With existing level of saving in fixed assets in GDP, the investment activity was limited by the functions of maintenance of accumulated potential. Positive fact during the recent years was the change of proportions of main funds by types with

outstripping growth of fixed assets in manufacturing industries against extraction of raw materials and production of electricity, gas and water supply. Highest share in the composition of fixed assets of the Russian economy has been taken by fixed assets of transport and communication (27.1%), transactions with real estate, lease and provision of services (24.8%), extraction of natural resources (10.6%). By early 2015, manufacturing industries accounted for 8.5% of fixed assets of the economy.

Insufficient volume of commissioning of fixed assets in order to ensure their renewal is also attested by the ratio between commissioning and depreciation of fixed assets. Taking into consideration the difference in prices, the cost of annual commissioning of new machinery, equipment and means of transport barely offsets their annual depreciation. Furthermore, it is obviously insufficient to overcome observed during a prolonged period the trend of aging machinery and equipment.

Comparison of output indices movement and characteristics of labor and capital utilization demonstrate that while technical and economic features of productive facilities are decreasing, the industry was subject to “tradeoff” of inputs. High level of employment of manual labor and labor on outdated equipment allowed to offset the shortage of investment resources but at the same time resulted in technological stagnation of production. Shifts in structural characteristics of utilization and renewal of fixed assets have been accompanied by a reduction of the return of capital productivity ratio and increment of capital-labor ratio. Across types of economic activity and certain years ratio of utilization of labor and capital indices rather significantly differed and were determined both by structural and business environment factors.

In 2009-2015, major factors, which hampered the investment activity of organizations were flat demand, high interest rates as well as uncertain economic situation. The share of businesses indicating the shortage of own funds as a restriction for their economic activity remained high but stayed at average values during recent five-six years.



*Fig. 31. Dynamics of domestic output of machine-building complex, import of machinery and equipment and investment in fixed assets in 2007–2015, % to previous year*

Source: Rosstat.

The Russian machine-building complex regarding the development rates is lagging behind the dynamics of investment in fixed assets (*Fig. 31*). The shortage of domestic production of

capital goods over a prolonged period was compensated for by import of machines and equipment. Procurement of foreign made equipment was advantageous for businesses for a score of reasons: owing to its low price, high quality, and envisaged after sale service. In the course of 2012-2014, the share of import of machines and equipment was gradually falling. In the economy as a whole, insufficient supply of new types of equipment was hampering replacement of the outdated and consumed assets, which negatively affected economic growth rates. From 2013, simultaneous contraction of imports and manufacture of capital goods enhanced the downward trend of investment in fixed assets. The 2015 situation was plagued by the retention of ramifications of 2009 acute crisis in domestic manufacture of machines and equipment.

#### 4.5.3. Investment in fixed assets by type of ownership

In the course of 2010-2015, private enterprises retained growth rates of the nominal investment volumes and offset the instability of the investment activity performed by state owned and municipal enterprises. In 2015, the share of private property came to 46.2% of the total volume of investment in fixed assets and moved up by 1.8 p.p. compared to 2014.

The investment crisis developing in the state owned enterprises has taken a protracted character and has reflected low efficiency of their performance. If at the initial stage of emerging market economy the underdevelopment of the institutional structure in the short-term was partially compensated by utilization of the main factors of production then while resolving issues related to maintaining long-term growth increase of efficiency of the subjects of the investment process was getting paramount importance.

Participation of state enterprises and organizations in financing investment in fixed assets was declining from 19.1% in 2014 to 18.3% in 2015. However, one should bear in mind that the Russian economy still has a considerable share of mixed types of ownership both with state participation and private business. This enhances the uncertainty of the investment process mechanism and presupposes accelerating efforts aimed at optimization of the institutional structure and reduction of state participation in the economy and implementation of privatization programs.

Gradual weakening of the state companies' economic activity in 2012-2014, which was followed by an absolute decrease of investment in 2015 by around 21.4% from a year earlier, exerted negative impact on the investment processes.

Crises of 2008-2009 and 2014-2015 greatly affected the level of economic activity in the segment of foreign companies. In 2010, foreign companies' investment constituted 63.3% of the indicator for 2008. Recovery of the positive dynamics of foreign companies' investment in 2011-2012 was replaced by their decline during subsequent three years against general dynamics of investment in fixed assets in the Russian economy.

Investment strategy of the state effective in 2009-2015 proceeded from the recognition of big business as a major driver of national modernization and global competition. In recent years, the state was fully engaged in creation of state holding companies in aerospace, shipbuilding industries, and rail transport and oil sector. Another way of state participation in the investment process as a driver and source of financial resources was development of public-private partnership.

Crises of 2008-2009 and 2014-2015 enhanced disproportions in public investment management underlying inadmissibility of increased state participation policy and upscale of public investment in the wake of budget deficit in the absence of efficient mechanism for increasing return on investment.

Main factors, which determine the level of economic activity in Russia still remain: inequality of rights of market agents; excessive influence and inefficient regulation of state and monopolistic sectors; lack of radical measures aimed at the restructuring of old companies, which receive state support; high barrier to entry for new companies; weak development of public-private partnership instruments aimed at stimulating investment and creation of new highly-productive work places.

#### 4.5.4. Features of financing investment in fixed assets

Slowdown in rates of economic growth have determined enhancement of commitment to usage of own funds of enterprises for financing investment projects. The share of enterprises' own funds used for investment purposes moved up from 41.0% in 2010 to 45.7% in 2014 and to 55.1% in 2015 (*Table 19*).

Contraction of volumes and share of raised funds in the sources of financing was accompanied by a change in their structure. State demand for goods and services of Russian enterprises has been maintained via realization of planned investment projects in the sphere of transport, telecommunications, etc. realized within Federal Target Programs and Federal Target Investment Program. In line with the priorities of state investment, the investment funds have been allocated on modernization and development of strategically important for the country facilities of industrial infrastructure, as well as implementation of investment projects on introduction of modern technologies for the production of competitive goods at enterprises of machine-building complex as well as carrying out works for ensuring security of power engineering, transport, waterworks and forestry facilities. The share of budgetary funds in the sources of investment funding in 2009-2013 constituted around one fifth of the total volume of fixed investment.

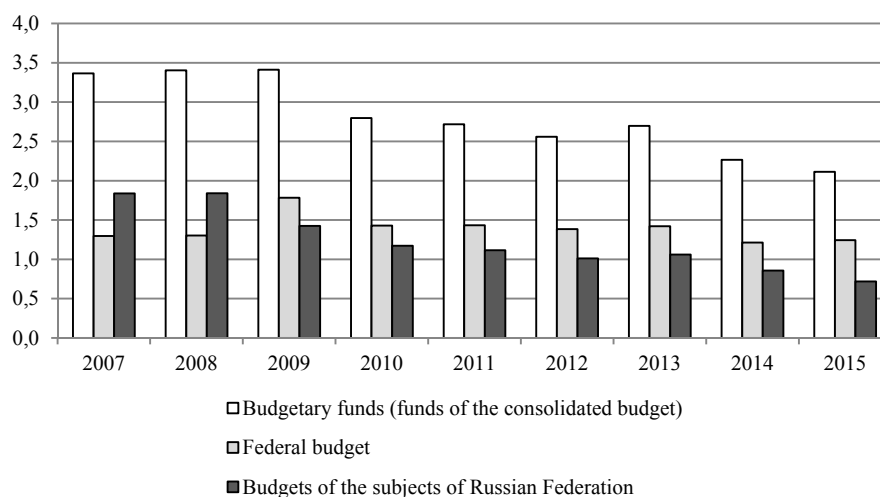
*Table 19*

#### **Structure of investment in fixed assets by funding sources (less small businesses and investment non-observable by statistical methods), % to total**

	2009	2010	2011	2012	2013	2014	2015
Investments in fixed assets, total	100	100	100	100	100	100	100
Including by funding source:							
own funds	37.1	41.0	41.9	44.5	45.2	45.7	55.1
raised funds	62.9	59.0	58.1	55.5	54.8	54.3	48.9
Including:							
bank credits	10.3	9.0	8.6	8.4	10.0	10.6	7.8
among them the credit granted by foreign banks	3.2	2.3	1.8	1.2	1.1	2.6	1.9
borrowed funds of other organizations	7.4	6.1	5.8	6.1	6.2	6.4	5.7
investments from abroad					0.8	0.9	0.9
budgetary funds	21.9	19.5	19.2	17.9	19.0	17.0	16.5
Of which:							
from the Federal budget	11.5	10.0	10.1	9.7	10.0	9.0	9.7
from the budgets of the subjects of the Russian Federation	9.2	8.2	7.9	7.1	7.5	6.5	5.6
resources of extra-budgetary funds	0.3	0.3	0.2	0.4	0.3	0.2	0.3
funds of organizations and individuals, raised for shared construction	2.6	2.2	2.0	2.7	2.9	3.5	3.0
including individuals' own funds	1.3	1.2	1.3	2.1	2.3	2.7	2.4
other	20.4	21.9	22.3	20.0	15.6	15.7	14.7
including							
funds of higher level organizations	15.9	17.5	19.0	16.8	13.0	13.2	10.5
funds received from the issue of corporate bonds	0.1	0.01	0.00	0.04	0.02	0.1	1.6
funds received from share issues	1.0	1.1	1.0	1.0	1.0	0.1	0.5

Source: Rosstat.

The situation has not changed from H2 2014 when reduction of budget funds in the sources of financing of fixed investment was registered. In 2014, the share of budgetary funds in fixed investment contracted by 2p.p. compared to a year earlier. In 2015, contraction of the share and volumes of funds of the RF subjects in financing fixed increased to 0.7% of GDP (*Fig. 32*).



*Fig. 32.* Share of budgetary funds in fixed investment in 2007–2015, % of GDP

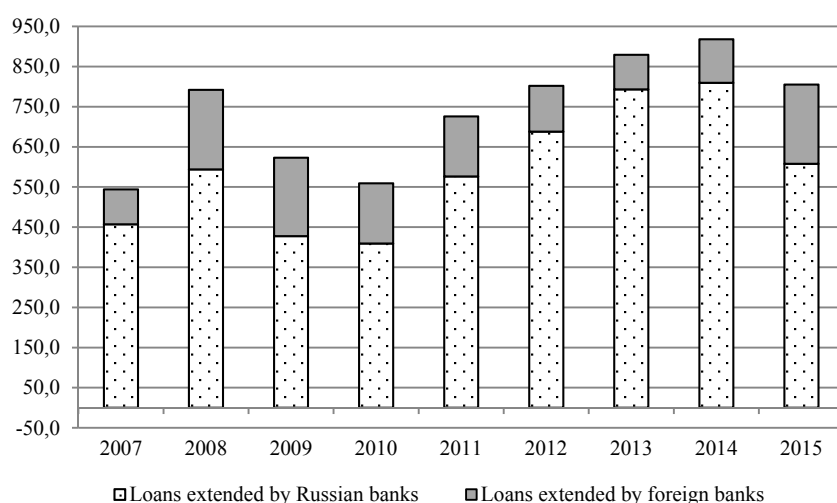
*Source:* Rosstat.

The banking sector's participation in financing the investment activity has noticeably weakened. In 2015, the share on bank loans in the structure of sources of funding constituted 7.8% and was 2.6 p.p. below the index of last year. Changes in the structure of bank lending is characterized by a decrease of volumes and share of loans extended by Russian banks. Compared to 2014, loans extended by the Russian banks plummeted to Rb 200.7bn (*Fig. 33*). Increase in the volume and share of loans extended by foreign banks and investment originated from abroad are explained by the nature of transfer of foreign currency into rubles in current prices.

In 2015, retention of capital outflow trend exerted a negative influence on the level of banks' participation in the financing of investment programs. According to preliminary assessment of the Bank of Russia, net capital outflow carried out by the private sector constituted \$56.9bn, including that by the banking sector - \$33.4bn

Crisis of 2014-2015 was characterized by high of decline of foreign investment in Russian economy against dynamics of domestic investment. Contraction of foreign lending volumes together with simultaneous decline of direct foreign investment predetermined a stable decrease of the share of total volume of investment proceeding from abroad in the structure of fixed investment to the minimum level for the twenty years of monitoring – 0.9% in 2015.

In 2015, there was a turning point in the housing construction trend. Following an increase in the volume of housing construction observed in 2011-2014, commissioning of new living floor space in 2015 constituted 99.5% of the previous year. The share of private housing construction in total commissioning of houses in 2015 came to 40.9% of the total volume of housing and by 2.6 p.p. less than in 2014.



*Fig. 33. Bank loans for financing fixed investment in 2007–2015, Rb bn*

Source: Rosstat.



*Fig. 34. Funds obtained for shared construction in 2008–2015, Rb bn*

Source: Rosstat.

In 2015 against the previous year, absolute drop in the investment volume in housing construction was registered (*Fig. 34*). In the structure of fixed investment in the economy as a whole the share of investment in housing construction fell to 3.0% in 2015.

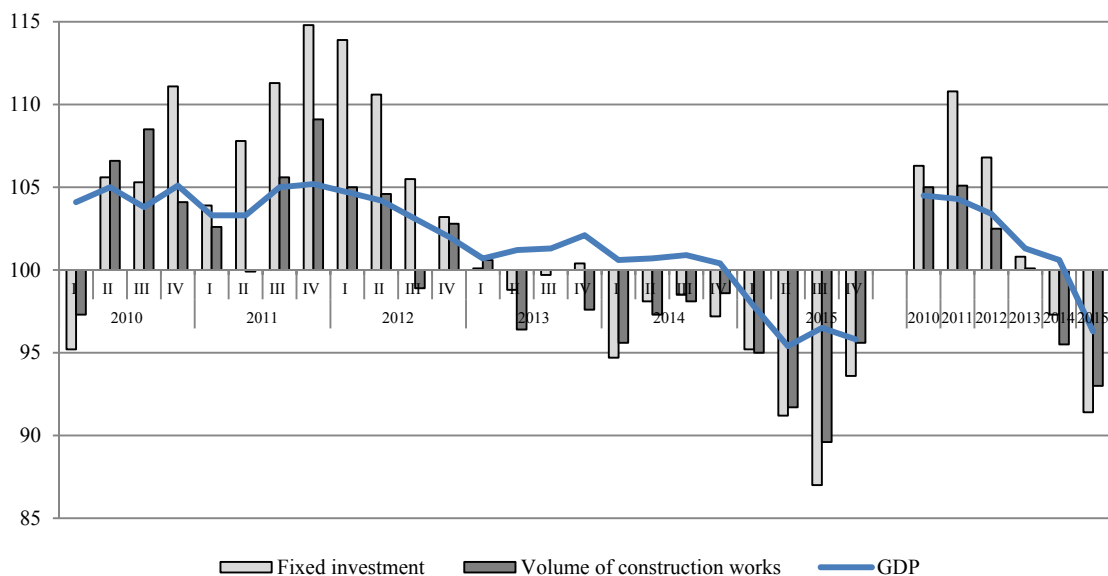
#### 4.5.5. Dynamics of fixed investment in 2015

The trend towards contraction of fixed investment was rather predictable and was determined by slackening of the investment activity dynamics from H2 2012. In 2014-2015, the situation was complicated by general deterioration of macroeconomic conditions. As a reaction to ruble devaluation, key rate hike and inflation spiral the construction and investment complex



responded in 2015 with contraction of activity in construction by 7.0% and fixed investment by 8.4% against the previous year (*Fig. 35*).

Dynamics of fixed investment is different for small and large enterprises. With the reduction of the general volume of fixed investments by 8.4% posted in 2015, decrease of fixed investments in the segment of large and medium size enterprises constituted 10.2% (*Table 20*). The fall of the investment activity of large and medium size enterprises has been observed over last four quarters. Negative dynamics of fixed investments across the full circle of industries has been observed over eight quarters. Amid growing unpredictability of the situation on the domestic market, medium and small business with great caution treat investment decisions.



*Fig. 35.* Dynamics of fixed investment in 2010–2015, % to corresponding period of previous year

Source: Rosstat.

*Table 20*

**Dynamics of fixed investment volume in 2009–2015, % to corresponding period previous year**

	2010	2011	2012	2013	2014	2015
Fixed investment (across full circle of organizations, including recalculations on investment, unobserved by direct statistical methods)	103.7	105.0	109.6	98.6	98.5	91.6
Large and small organizations (fixed investments without small businesses and investment volume unobserved by direct statistical methods)	96.2	112.1	108.6	93.1	102.3	89.8

Source: Rosstat.

The structure of fixed investments across types of economic activities in 2015 suffered some changes compared to the previous year. Decrease of investments in industry in 2015 amounted to 6.1% in comparison with the previous year. At the same time, growth acceleration in the

extraction of natural resources by 10.7% was accompanied by the contraction of fixed investments in manufacturing industry by 9.5% and in production of electricity, gas and water supply by 29.1%.

In the wake of the downward trend in fixed investments, there was a fall of investment in the development of associated productions in metallurgical and building complexes and in construction materials.

Structural changes in manufacturing industries were defined by the fall of fixed investments in machine building complex by 11.3%, in metallurgy – by 6.2%, in production of coke and petroleum products – by 13.2%, and in consumer complex – by 13.6% compared to 2014. In 2015, changes in the investment pattern in the machine building complex were defined by the growth of investment in production of electric equipment, electronic and optical equipment by 12.2% amid contraction of fixed investment in manufacture of means of transport by 21.0%, and in manufacture of machines and equipment by 4.4% on 2014.

Another specific feature of 2015 was fixed investment acceleration in chemical industry by 1.14-fold, which was both due to increased export potential of these industries and to import substitution.

In short- and medium-term, the Fund for Industrial Development can provide financial assistance in the sphere of industry according to the Federal law “On Industrial Policy in the Russian Federation” (No 488-FZ of December 31, 2014). In 2016 the Fund approved loans to the tune of Rb 20 bn for the implementation of 59 import substitution projects to the total value of over Rb 162bn, of which private investments amount to Rb 142bn. In the context of issues related to provision of incentives for economic growth, the priority should be given to the infrastructure development. However, the decrease in investments in transport and communication came to 13.6% compared to 2014. Meanwhile, investments in pipeline transport contracted by 11.4%. Reduction of domestic demand determined contraction of investment in the development of retail trade, hotel industry and restaurants. Long-term trend in investment reduction in education and healthcare is alarming (*Table 21*).

*Table 21*

**Fixed investments (excluding small businesses and volumes of investment, not observable by direct statistical methods), % to previous year**

	2010	2011	2012	2013	2014	2014
Total	106.0	108.3	106.6	99.8	95.7	89.8
Agriculture	89.1	114.6	92.8	96.0	93.0	89.1
Fishery, fish-farming	108.8	137.4	127.4	77.4	83.3	60.1
Industry	106.1	110.9	107.4	96.8	99.9	93.9
Extraction of natural resources	106.6	113.8	111.8	93.6	105.9	110.7
Manufacturing	101.5	105.3	106.7	101.4	98.6	90.5
Production of electricity, gas and water supply	112.5	114.7	101.7	95.8	92.9	70.1
Construction	110.9	90.6	79.9	84.0	81.2	83.7
Wholesale and retail trade	120.2	90.0	107.1	103.1	110.7	102.9
Transport and communications	102.4	118.3	98.4	88.5	92.1	86.4
Financial activity	112.9	136.8	111.4	80.8	74.9	81.5
Real estate operations	125.4	91.9	100.8	104.4	103.1	84.3
State administration	115.2	112.4	98.7	93.7	84.4	88.7
Education	84.9	122.0	85.2	77.9	97.4	81.9
Healthcare and social safety net	109.7	113.0	93.6	98.8	71.9	79.8
Provision of other services	103.6	103.5	111.8	75.0	72.7	82.7

Source: Rosstat

Current situation in the investment sphere does not give sufficient grounds for optimistic assessments for the development of construction and investment complex in 2016.

## 4.6. Oil and gas sector<sup>1</sup>

Oil and gas industry remains the basic sector of Russian economy playing the key role in shaping the state budget revenues and the country's trade balance. In 2015, the oil sector's development was marked by positive dynamics. Due to investments made in the previous years, the crude oil production in Russia has reached peak levels since 1990 and crude oil export hit all time maximum. Restructuring of the oil sector taxation system has been launched. The reform envisages significant reduction of the economic role of export duties. Low global crude oil prices together with financial and technological sanctions imposed on Russia have hampered the development of this sector.

### 4.6.1. Dynamics of the global oil and gas prices

In recent years, the situation on the global crude oil market was characterized by sustainable excess of oil supply over demand, which resulted in a significant fall of global crude oil prices. Main factor, which determined the oil glut, was fast production growth of shale oil in the US due to application of new technologies and high oil prices during preceding years. Despite the oil price reduction, the OPEC member states refused to scale down oil production and turned to the policy of preservation of their share of the world oil market. As a result, in 2015, average price on Brent crude oil fell to \$51.2 per barrel, which is half the average price of the preceding three years. Herewith, in December 2015, the price for Russian oil declined to \$36.4 per barrel. Thus, the low prices became a new normal on the oil market.

Under the effect of the low prices crude oil production on cost-intensive fields began falling, drastically decreased investments. Oil production in the US began falling as well as production in other high-cost regions: Norway, Great Britain and Mexico. Sharply fell investments in the development of unconventional petroleum deposits including shale oil in the US, bituminous sands in Canada, and deep-sea deposits in various regions of the world.

At the same time, reduction of oil production on cost-intensive oilfields was offset by the production growth in OPEC, which members strive to increase their market share. By increasing their supplies, they strive at least partially compensate income contraction due to oil price fall. As a result, there is a constant excess over the fixed aggregate oil production quota set by OPEC (30 mb/d). Production went up significantly in Saudi Arabia and Iran, which are the leading OPEC producers of oil.

*Table 22*

**World prices for crude oil in 2000–2015, \$/barrel**

	2000	2005	2010	2011	2012	2013
Price for Brent crude oil, Great Britain	28.5	54.4	79.6	111.0	112.0	108.8
Price for Urals crude oil, Russia	26.6	50.8	78.3	109.1	110.3	107.7

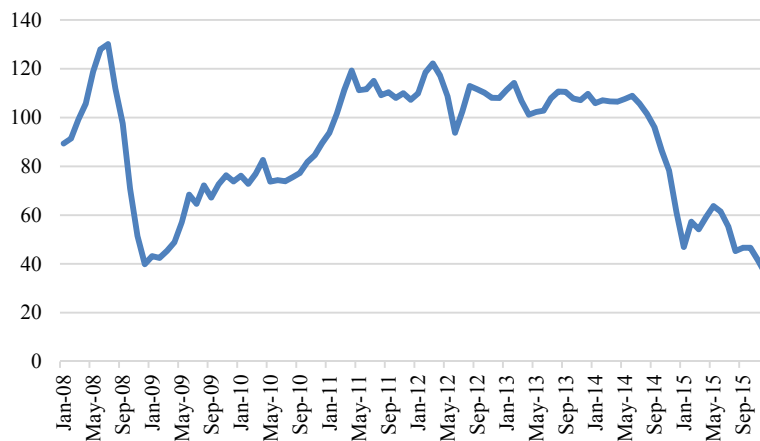
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	2014	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2015
Price for Brent crude oil, Great Britain	98.9	54.0	62.1	50.0	43.4	52.4
Price for Urals crude oil, Russia	97.7	52.8	61.4	49.1	41.5	51.2

Sources: IMF, OECD/IEA.

<sup>1</sup> Author of this section: Bobylev Yu. – Gaidar Institute for Economic Policy.

The price for Russian natural gas on the European market also displayed a downward trend. The prices for gas supplied under long-term contracts are usually tied to prices for petroleum products and with a certain lag follow the world prices for oil (*Table 23*). Meanwhile, in recent years prices for Russian gas were also pulled down by the changing situation on the European gas market, i.e. the growing competitive supply from other gas producing countries and lower spot prices for gas in comparison with prices under long-term Gazprom contracts. All this has forced “Gazprom” to bring down its sale prices for gas on the European market. In 2015, the price for Russian gas on the European market decreased by 29% compared to the previous year.



*Fig. 36.* Price for Urals crude oil in 2008–2014, \$/barrel

Source: Ministry of Economic Development of the Russian Federation.

*Table 23*

**World prices for oil and natural gas in 2010–2015**

	2010	2011	2012	2013	2014	2015
Basket price, \$/barrel	79.0	104.0	105.0	104.1	96.2	50.8
Price for Russian gas on the European market, \$/1,000 m <sup>3</sup>	296.0	381.5	431.3	402.0	376.0	267.9

Sources: IMF, Rosstat.

**4.6.2. Dynamics and Production Pattern in the Oil and Gas Sector**

In 2015, the crude oil production in Russia hit 534 million tons which is the record high over the period since 1990 (*Table 24*). A positive effect on the dynamics of oil recovery was produced by the recent putting in operation of several large new fields in Eastern Siberia and in the north of the European part of the country as well as the changes in taxation system, which provide incentives for the development of new production regions and better oil recovery at the producing fields. At the same time, the growth rates of oil production in recent years have been notably falling (*Table 25*) primarily due to the worsening of recovery conditions. A great share of producing fields have entered the stage of declining output while new deposits in most cases have worse mining, geological and geographic parameters and their development requires higher capital, operational and transport costs. At the moment, Russian oil industry has approached the ceiling of its production capacities. To make up for the declining production of oil at the producing fields, one has to develop both new fields in regions with poorly developed or lacking infrastructure and idle reserves of lower quality oil in the developed regions

*Table 24*

**Oil production and refining in the Russian Federation in 2000–2015**

	2000	2005	2010	2011	2012	2013	2014	2015
Production of crude oil including gas condensate, million tons	323.2	470.0	505.1	511.4	518.0	523.3	526.7	534.0
Primary oil refining, million tons	173.0	208.0	249.3	258.0	270.0	278.0	294.4	287.0
Ratio of oil refining to crude oil production, %	53.5	44.3	49.4	50.4	52.1	53.1	55.9	53.7
Crude oil conversion rate, %	71.0	71.6	71.1	70.8	71.5	71.7	72.4	74.1

*Sources* : Federal Service of State Statistics, Ministry of Energy of the Russian Federation.

In 2015, the structural reshuffling has been underway in the oil sector’s taxation system (the “tax maneuver”), which envisaged gradual reduction of export duties on oil and petroleum products to be compensated by the increased rate of the Mineral Extraction Tax (MET).<sup>1</sup> In accordance with adopted in 2015-2017 parameters of the “tax maneuver” the marginal rate of export duty on crude oil was cut from 59% in 2014 to 42% in 2015, and the export duty rate on heating oil was raised from 66% to 76% of the export duty rate on crude oil, respectively. In 2017, the marginal export duty rate on oil should be reduced to 30%, and the export duty rate on heating oil will be raised to the level of the export duty rate on oil.<sup>2</sup>

2015 results speak about the noted change of a number trends due to the “tax maneuver” (Table 25). Among them, one should specify first, fall of the heating oil production, which happened for the first time in recent years, second, also for the first time in recent years there was an increase in export of crude oil (beneficial for the state budget compared to heating oil export), third, contraction of oil refining due to first two factors. At the same time, crude oil conversion rate moved up to 74.1%. These results should be viewed as the first positive outcome of the tax maneuver.

*Table 25*

**Production of crude oil, petroleum products and natural gas in 2000–2015,  
% to previous year**

	2000	2005	2010	2011	2012	2013	2014	2015
Crude oil including gas condensate	106.0	102.2	102.1	100.8	101.3	100.9	100.7	101.4
Primary oil refining	102.7	106.2	105.5	103.3	104.9	102.7	104.9	97.3
Gasoline	103.6	104.8	100.5	102.0	104.3	101.3	98.8	102.3
Diesel fuel	104.9	108.5	104.2	100.3	98.7	103.1	107.4	98.9
Heating oil	98.3	105.8	108.5	104.6	101.6	103.3	102.0	91.1
Natural gas	98.5	100.5	111.4	102.9	97.7	102.1	95.7	98.7

*Sources*: Federal Service of State Statistics, Ministry of Energy of the Russian Federation.

The structure of the oil-extracting sector is characterized by domination of large vertically integrated companies with high share of state participation. In Russia, 164 companies are engaged in crude oil extraction, including: 9 large oil and gas companies; 3 companies operating on production sharing agreement; and 152 independent oil producing companies. The share of 5 largest oil producers (“Rosneft”, “LUKOIL”, “Surgutneftegaz”, “Gazprom” and “Tatneft”) account for 78% of the total oil production in the country (Table 26). At the same time, the

<sup>1</sup> See: Yu.N. Bobylev, G.I. Idrisov, S.G. Sinelnikov-Murylev. Export Duties on Oil and Petroleum Products: Need to Abolish and Scenario Analysis of the Consequences. Moscow, Gaidar Institute Publishers, 2012; Yu. Bobylev. Development of the Oil Sector in Russia. *Voprosy Ekonomiki*. 2015. № 6, pp. 45–62.

<sup>2</sup> See: Yu Bobylev. The Tax Maneuver in the Oil Sector. *Russia’s Economic Development*. 2015. № 8, pp. 45–49.

share of state companies in the total oil extraction (taking into account their shares in other companies) amounts to 59%.<sup>1</sup>

The sector of small and medium oil producing companies is underdeveloped. The share of companies with production of 2.5 mn tons per year (up to 50 thousand barrels per day) stand barely at 3% of production. In the United States where sector of small and medium oil producers has demonstrated its efficiency, the share of companies with production volume up to 50 thousand barrels per day accounts for 46% of the total oil production in the country.

*Table 26*

**Oil Producing Companies 2010–2015**

	Oil output in 2010, mn/t	Share in total output, %	Oil output in 2014r., mn/t	Share in total output, %	Oil output in 2015, mn/t	Share in total output, %
<i>Russia, total</i>	505.1	100.0	526.7	100.0	534.0	100.0
Rosneft	112.4	22.3	190.9	36.2	189.2	35.4
LUKOIL	90.1	17.8	86.6	16.4	85.7	16.0
TNK-BP	71.7	14.2	-	-	-	-
Surgutneftegaz	59.5	11.8	61.4	11.7	61.6	11.5
Gazprom including Gazprom neft	43.3	8.6	49.8	9.5	51.3	9.6
including: Gazprom	13.5	2.7	16.2	3.1	17.0	3.2
Gazprom neft	29.8	5.9	33.6	6.4	34.3	6.4
Tatneft	26.1	5.2	26.5	5.0	27.2	5.1
Bashneft	14.1	2.8	17.9	3.4	19.9	3.7
Slavneft	18.4	3.6	16.2	3.1	15.5	2.9
RussNeft	13.0	2.6	8.6	1.6	7.4	1.4
NOVATEK	3.8	0.8	4.3	0.8	4.7	0.9
Operators of PSA	14.4	2.9	14.4	2.7	15.0	2.8
Other producers	38.2	7.6	50.1	9.5	56.5	10.6

*Source:* Ministry of Energy of the Russian Federation, author’s calculations.

Besides low global oil prices, another factor, which can negatively affect further development of Russia’s oil and gas industry are economic sanctions imposed on Russia in 2014 by the United States, EU and some other countries in response to the events in Ukraine. Aside from financial sanctions, which limit access of Russian companies to external financial sources, a number of developed countries have imposed a ban on supply to Russia of equipment and technologies for the development of three categories of oilfields: deposits in the Arctic shelf, deep-water deposits and shale oil deposits. All three categories depend on foreign technology. The investment cycle of projects for the development of Arctic shelf and deep-water fields is rather protracted and from the oil production point of view the negative effect of blocking such projects may show up only in the long term. Furthermore, in case of persistent low crude oil prices the implementation of the majority of projects of the kind will be postponed due to their economic inefficiency.

Amid low crude oil prices, the development of significant part of shale oil deposits will also be inefficient. However, technologies used for the development of shale oil deposits (horizontal drilling, hydraulic fracturing) are applied as well for the development of traditional oil deposits, first of all the ones with high level of resource depletion, in order to provide better oil extraction. Therefore, the ban on supply of equipment for horizontal drilling and hydraulic fracturing may also lead to the premature closing of producing fields owing to the impossibility of their enhanced recovery.

<sup>1</sup> Yu. Bobilev. Development of the Oil Sector in Russia. *Voprosy Ekonomiki*. 2015. № 6, p. 48.

Meanwhile, the potential for additional extraction on existing oilfields due to deeper recovery is rather significant. In Russia, oil recovery index stands barely at 28%, which is significantly less the average world level. In the US, this index hits the range of 35-43%, and in Norway, it reaches 46%.

The HIS research showed that Russia was among those countries, which can obtain the largest increment in oil extraction due to the application of horizontal drilling and hydraulic fracturing technologies on the “old” low production traditional oilfields. The potential of additional oil recovery through the application of these technologies constitutes 12 billion barrels. According to this indicator, Russia is second to Iran among the most hopeful countries outside North America.

In the wake of low global oil prices and technological sanctions, deeper recovery at traditional oilfields assumes crucial importance for the maintenance of oil production and export. In this regard, both more active use of respective foreign technologies not included in the sanction list and the development of own import substitution technologies for enhancing oil recovery are necessary.

Positive effect on the development of this sector could be produced by the introduction of the windfall profits tax with a progressive taxation scale depending on the project’s profitability level.<sup>1</sup> This tax takes into account all rent-shaping factors and automatically brings tax burden in line with the actual economic efficiency of certain oilfields’ development. In case of highly efficient projects, application of the windfall profits tax ensures progressive resource rent extraction in profit of state and simultaneously create required conditions for the implementation of low efficiency projects.

#### 4.6.3. Dynamics and structure of oil and gas export

In 2015, the volume of Russian crude oil and petroleum products exports hit 416 million tons, which is the all-time high. This being said, the share of crude oil and petroleum products net export constituted 77.1% in 2015 (*Table 27*). Export growth was due to both increased crude oil production and the decline of domestic consumption in the wake of the economic recession. Furthermore, significant increase of crude oil export should be noted due to the tax maneuver effect (by 9.4% against 2014, *Table 28*). The share of oil exports in its production has gone up to 45.8%. Meantime, the share of exports in the production of heating oil has come to over 90%, diesel fuel – 67.6%, gasoline – 11.8% (to compare: in 2005 the share of export in production of gasoline came to 18.5%, in 2010 – 8.2% and in 2014 – 10.9%).

*Table 27*

#### **Ratio between production, consumption and export of oil and natural gas in 2000–2015**

	2000	2005	2010	2011	2012	2013	2014	2015
1	2	3	4	5	6	7	8	9
<b>Crude oil, million tons</b>								
Production	323.2	470.0	505.1	511.4	518.0	523.3	526.7	534.0
Exports, total	144.5	252.5	250.4	244.6	239.9	236.6	223.4	244.5
Exports to non-CIS countries	127.6	214.4	223.9	214.4	211.6	208.0	199.3	221.6
Exports to CIS countries	16.9	38.0	26.5	30.2	28.4	28.7	24.1	22.9
Net exports	138.7	250.1	249.3	243.5	239.1	235.8	222.6	241.6

<sup>1</sup> See: Yu. Bobilev, M. Turuntseva. Taxation of Natural Resource Sector of the Economy. Moscow, IEP Publishers, 2010.

*Cont'd*

1	2	3	4	5	6	7	8	9
Domestic consumption	123.0	123.1	125.9	140.7	142.1	137.5	141.3	122.2
Net exports as % of production	42.9	53.2	49.4	47.6	46.2	45.1	42.3	45.2
<b>Petroleum products, million tons</b>								
Exports, total	61.9	97.0	132.2	130.6	138.1	151.4	164.8	171.5
Exports to non-CIS countries	58.4	93.1	126.6	120.0	121.2	141.1	155.2	163.3
Exports to CIS countries	3.5	3.9	5.6	10.6	16.9	10.3	9.6	8.3
Net exports	61.5	96.8	129.9	127.2	136.8	150.0	162.8	170.2
<b>Crude oil and petroleum products, million tons</b>								
Net exports of oil and petroleum products	200.2	346.9	379.2	370.7	375.9	385.8	385.4	411.8
Net exports of oil and petroleum products as % of oil production	61.9	73.8	75.1	72.5	72.6	73.7	73.2	77.1
<b>Natural gas, billion m<sup>3</sup></b>								
Production	584.2	636.0	665.5	687.5	671.5	684.0	654.2	645.9
Exports, total	193.8	207.3	177.8	184.9	178.7	196.4	172.6	185.5
Exports to non-CIS countries	133.8	159.8	107.4	117.0	112.6	138.0	124.6	144.7
Exports to CIS countries	60.0	47.5	70.4	67.9	66.0	58.4	48.0	40.7
Net exports	189.7	199.6	173.5	179.2	171.6	189.3	165.5	178.4
Domestic consumption	394.5	436.4	492.0	508.3	499.9	494.7	488.7	467.5
Net exports as % of production	32.5	31.4	26.1	26.1	25.6	27.7	25.3	27.6

*Sources:* Federal Service of State Statistics, Ministry of Energy of the Russian Federation, Federal Customs Service, author's calculations.

Exports of natural gas have moved up (by 7.5% compared to the previous year). However, so far it remains below the level registered in mid-2000s. In recent years, the basic factor of gas exports' decline was the shrinking of supplies to the European market where the share of other gas producing countries has greatly increased. As a result, exports of Russian gas to the non-CIS countries in 2015 fell by 11% as compared with 2006 when the volumes of gas supplies from Russia to Europe reached their maximum. Herewith, the ratio of net exports to the output of gas dropped from 31.4% in 2005 to 27.6% in 2015.

*Table 28*

**Dynamics of Russian export of oil, petroleum products and natural gas  
in 2010–2015, % to previous year**

	2010	2011	2012	2013	2014	2015
Crude oil	101.2	97.6	98.2	98.6	94.4	109.4
Petroleum products	106.2	98.5	104.4	109.6	108.7	104.1
Natural gas	105.6	104.0	96.6	109.9	87.9	107.5

*Sources:* Federal Service of State Statistics, Federal Customs Service.

The analysis of dynamics of Russian crude oil exports over a long term reveals a notable strengthening of oil sector's export orientation as compared to the pre-reform period. The ratio of net exports of crude oil and petroleum products to the output of oil increased from 47.7% in 1990 to 77.1% in 2015. However, one should keep in mind that this is due not only to the increase of absolute export volumes but also to the remarkable drop of domestic oil consumption following market transformation of the Russian economy, improvement of oil utilization efficiency and replacement of heating oil by natural gas. It's noteworthy that the share of petroleum products in the total petroleum exports increased from 18.2% in 1990 to 41.3% in 2015. Still, one should take into account that due to the low depth of oil refining the major part of Russian export of petroleum products consists of heating oil that in Europe is used as an input for further processing and production of light oil products.



Amid decline of the global oil and gas prices, the share of fuel and energy products in Russian export moved down to 62.5% in 2015. Herewith, the share of oil and petroleum products in Russian export constituted 45.4% (in 2014 – 54.2%), and the share of natural gas – 12.1% (Table 29).

*Table 29*

**Value and share of export of fuel and energy products 2010–2015**

	2010		2014		2015	
	\$ bn	%*	\$ bn	%*	\$ bn	%*
Fuel and energy products, total	267.7	67.5	345.4	69.5	216.1	62.5
including:						
crude oil	134.6	34.0	153.9	31.0	89.6	25.9
natural gas	47.6	12.0	54.7	11.0	41.8	12.1

\* as % of the total Russian exports.

Source: Federal Service of State Statistics.

#### 4.6.4. Dynamics of prices for energy products on the domestic market

Prices for oil and petroleum products on the domestic market are basically determined by the corresponding global prices so that to provide equal profitability of supplies to foreign and home market, i.e. are net-back prices equaling the world price minus export customs duty and export shipment costs. In recent years, the growth of global prices for crude oil and petroleum products drove the prices up on the domestic market. However, in the second half of 2014–2015, lower world prices and ruble exchange rate resulted in a notable decline of domestic prices in dollar terms (Table 30, Fig. 37). It's noteworthy that due to the high export duties there still remains a significant gap between the global and domestic prices. In the meantime, due to the “tax maneuver” the reduction of export duty rate led to convergence between domestic and global price. In 2014, the domestic price for oil (producer price) came to \$42.0 of the global one (price for Urals oil on the European market) than in 2015 – 55% of the global price.

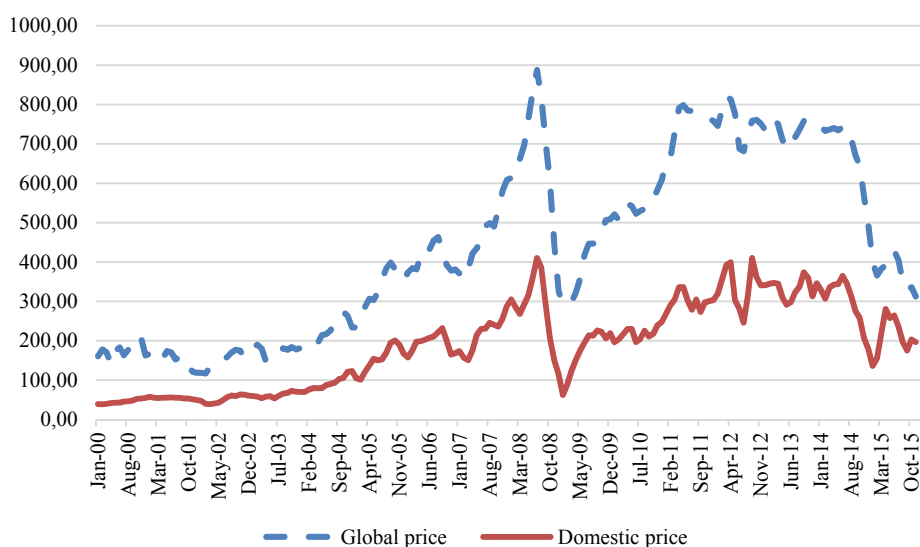
*Table 30*

**Domestic prices for oil, petroleum products and natural gas in dollar terms in 2005-2015 (average producer prices, \$/ton)**

	2005	2010	2011	2012	2013	2014	2015
Oil	167.2	248.2	303.3	341.1	346.1	178.9	156.7
Gasoline	318.2	547.9	576.9	628.7	614.4	372.3	301.8
Diesel fuel	417.0	536.1	644.9	774.2	698.0	419.3	349.4
Heating oil	142.7	246.3	274.6	275.3	235.8	128.7	49.5
Gas, \$/1,000m <sup>3</sup>	11.5	20.5	21.3	40.3	39.8	29.1	24.5

Source: calculated on the data released by Federal Service of State Statistics.

Domestic prices for gas remain the subject of state regulation. In order to ensure the competitiveness of national economy the government supported far lower level of the domestic gas prices in comparison with that of the world market. In 2015, the domestic price for gas (the price paid by industrial consumers less indirect taxes) averaged only 26.0% of the price for Russian gas on the European market.



*Fig. 37. Global and domestic oil price in 2000–2015, \$/t*

*Source:* calculated on data released by Federal Service of State Statistics.

#### 4.6.5. Prospects

Russia boasts of rather significant crude oil reserves, which allow sustaining high levels of extraction and export in the course of many years. There is a considerable potential for crude oil production both due to putting into operation undeveloped reserves in developed regions and to deposits in the new production regions. At the same time, there is a rather considerable potential for additional production at existing fields by means of their deeper recovery. Moreover, the potential of presently undeveloped non-traditional crude oil reserves is immense. According to the US Energy Information Administration, by technically recoverable shale oil resources Russia is second to none in the world (US takes second place). Crude oil refining potential is also high, however by its technological level, it significantly lags behind the level achieved by the developed countries. Depth of refining in Russia stands only at 74%, meanwhile in the leading industrially developed countries it hits 90-95%. Raising depth of refining allows satisfying domestic needs in motor fuel with lower volumes of oil consumption.

In the long view, the global demand for crude oil will be growing, which allows Russia to preserve and even to increase current volumes of oil export. Herewith, owing to demographic trends and rising energy efficiency one should expect a reduction of oil demand in Europe, which is the main export market for Russia. Meanwhile, one can forecast a significant growth of oil demand in Asia, first of all, in China. In this regard, it is necessary to change regional pattern of Russian export of oil by expanding infrastructure potential for oil supplies to the East.

At the same time, the development of the Russian oil industry will significantly depend on global oil prices. Conditions of the oil market are characterized by predominance of factors, which will contribute to the retention of relatively low oil prices. Among major factors are significant shale oil resources in the US, which will be quickly developed and increase supply with global oil prices above \$60 per barrel, slowdown of economic growth in China, decline of discipline in the OPEC as well as growth of shipments from Iran.

In Russia, in the wake of low oil prices, potential for the development of new oilfields and nontraditional resources will be significantly limited because investments in the most cost-intensive projects will be economically inefficient. First of all, the Arctic shelf projects will be economically inefficient.

Financial and technological sanctions imposed on Russia will limit the development of the oil sector. Financial sanctions will hamper access for Russian companies to foreign financing and technological sanctions actually block the development of deep-water oilfields, resources on the Arctic shelf and shale oil resources. Imposed ban on deliveries of equipment required for horizontal drilling and for hydraulic fracturing considerably limits deeper recovery on the operating oilfields.

In the context of low global crude oil prices and effect of sectoral technological sanctions, the traditional crude oil reserves should become the basis for further development of the Russian oil sector. This being said, deeper recovery on the producing oilfields and increased oil recovery rate will be very important. It is necessary to both actively use of free of sanctions foreign equipment applied in this sphere and accelerated development of import substitution technologies required to increase oil recovery rate. Potential for the oil production maintenance will to a greater extent depend on the technological progress in this sector.

Further development of the oil industry will require the creation of fiscal conditions. First of all, restructuring of the oil sector's taxation system is necessary, which includes gradual reduction of export duties on crude oil and petroleum products (down to their abolition) and increased role of MET. Reduction of export duties will cut ongoing subsidization of the oil refining sector and will create real incentives for its modernization and increase of oil refining index. Besides, it will greatly decrease the subsidizing of other Customs Union member-states by Russia that occurs owing to duty-free supplies of Russian oil and petroleum products. At the same time, the growth of domestic prices for oil and petroleum products (amid low world oil prices, it will be relatively slower) will strengthen incentives for the improvement of energy efficiency.

Imposition of the windfall profits tax at the new oilfields should be the next step. This tax will ensure a wider differentiation of tax burden and will create required conditions for investment in the development of new deposits. In the future, it can be applied at the already producing fields, in particular on projects with the use of methods to increase oil recovery.

Creation of conditions for the operation of small and medium companies will be important for further development of the oil sector. The activity of major oil companies, as a rule, focuses on the implementation of large-scale and highly profitable projects and small and less profitable projects turn out to be beyond their interests. This creates potential for expanded activity of small and medium companies in the oil producing business. They can be rather efficient in such spheres as deeper recovery on the producing fields, development of small deposits and tight oil resources, geological exploration works and provision of services.

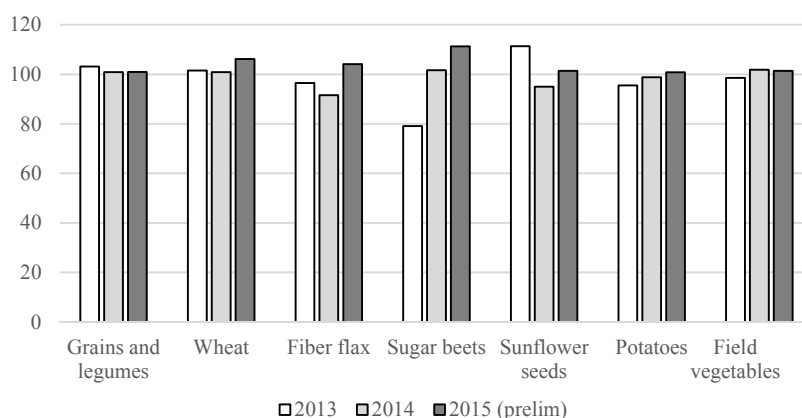
Development of small and medium oil producing companies requires the creation of corresponding organizational and legal regime including significant reduction of the administrative barriers in granting the use of subsoil areas.

Implementation of these measures will contribute to maintenance of production and export of crude oil and to more rational use of oil resources.

## 4.7. Import substitution in the conditions of food embargo<sup>1</sup>

### 4.7.1. Production of agricultural and food products

In 2015 the war of sanctions and the shutting down of access to Russian food markets for countries included in the sanction list<sup>2</sup> created favourable conditions for domestic farm producers. The limiting factor was the drop of ruble exchange rate that dramatically lifted prices for many farm inputs, both imported (hybrid seeds, pesticides, breeder stock, etc.) and exported (fertilizers, fuels). Therefore, there were fears that farmers would fail to benefit from the shutting down of markets and to increase domestic agricultural output. However, farm producers did not reduce areas sown in all major crops as compared with the previous year (*Fig. 38*).



*Fig. 38.* Index of areas sown by farms of all types (as % of the previous year)

Source: Rosstat.

The growth of prices for inputs, first of all the imported ones, could have prompted a shrinkage of their application but so far annual indicators show no signs of it. For instance, the gross output of grain in 2015 was only slightly below that of 2014. The outputs of other major crops were above the 2014 indicators. The five-year averages prove that agriculture is on the upswing (*Table 31*).

*Table 31*

### Average annual output of major farm crops, million tons

	1990–1994	1995–1999	2000–2004	2005–2009	2010–2014	2014	2015*
Grains and legumes	99	65	76	89	85	105	104
Sugar beets	24	15	17	27	38	34	38
Sunflower seeds	3	3	4	7	9	9	10
Potatoes	35	34	29	29	29	32	34
Field vegetables	9	10	11	12	13	14	16

\* Preliminary data as of February 1, 2016.

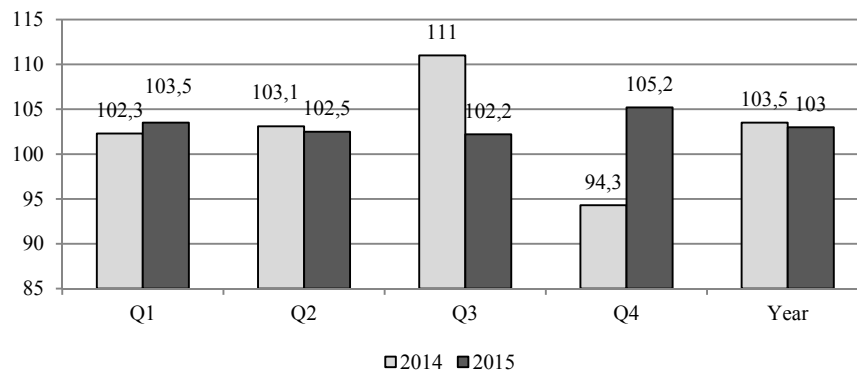
Source: Rosstat.

<sup>1</sup> Authors of this section: Gataulina E. – RANEPА, Shagaida N. – RANEPА, Uzun V. – RANEPА, Yanbykh R. – RANEPА.

<sup>2</sup> Resolution of RF Government “On measures for the implementation of Decree of the President of the Russian Federation No. 560 of August 6, 2014 “On the application of selected special economic measures for ensuring the security of the Russian Federation.”

In 2015 positive trends were also observed in livestock production except for dairy cattle breeding where cow inventories fell at a higher rate as compared with the previous year and the average monthly output of milk ranged from 98% to 101% of the 2014 indicators. Poultry production showed monthly increases from 1% to 3% as compared with the respective figures of 2014, the production of meat – from 3% to 6%.

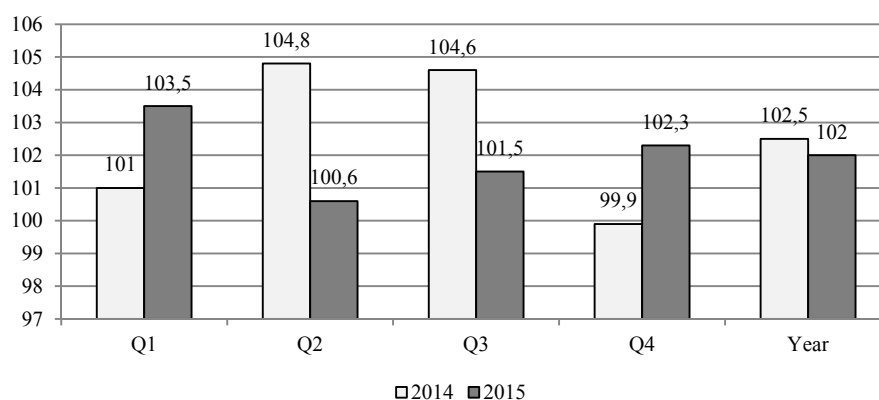
At the same time the dynamics of farm production in 2015 was not stable. For instance, in the first and the second quarters of the year the increase of output was approximately the same as in 2014 while in the third quarter it fell to a notably lower level. The excellent performance in the fourth quarter leveled off the situation to some extent – the annual index shows the increase of output in the sector. However, its rates are somewhat below the growth rates of 2014 (*Fig. 39*).



*Fig. 39.* Indices of farm production as % of the respective period of the previous year

*Source:* Rosstat, data as of February 1, 2016.

The performance of food industry in 2015 has also preserved positive dynamics. The situation therein was similar: in the second and the third quarters growth rates were far below the respective indicators of 2014 but over the year the output increased. However, the growth rates were also slightly lower than in the previous year (*Fig. 40*).



*Fig. 40.* Indices of food production as % of the respective period of the previous year

*Source:* Rosstat.

4.7.2. Affordability of food products for population

Despite the increase of output in agriculture and food industry prices for basic foodstuffs have been rising since August 2014. The causes and dynamics differed by products, the periods of price growth and price drop alternated. For instance, such dynamics was displayed by prices for pork and chicken meat, the increase of which reached up to 1% per week in the first months after the introduction of embargo but later in the year these items got cheaper. The leader of price growth after August 2014 was vegetable oil (Fig. 41) largely due to the fact that this is an export product and the devaluation of ruble was to result in higher domestic prices for it.

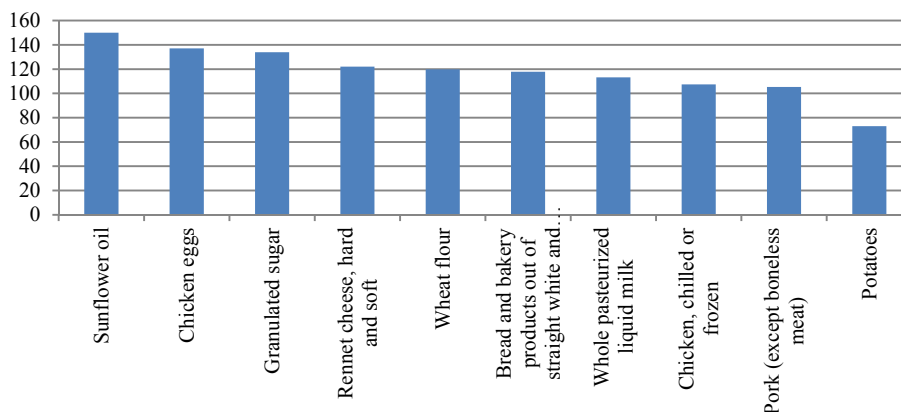


Fig. 41. Weekly chain price index for basic food products (August 4, 2014 – December 28, 2015), %

Source: Rosstat.

Prices for basic food products grew in the situation of falling real disposable money incomes of population. The rates of their decrease as stated by Rosstat were below the rates of price growth for basic foodstuffs. For instance, in 2015 the decrease of real incomes relative to 2014 was as low as 4%. Meantime, the purchase of food items by population notably fell. Over the year retail sales of food products in comparable prices (the all-Russia total) fell by 9.2% relative to the previous year, the decrease relative to December being even bigger – 11% (Table 32).

Table 32

**Retail sales of food products in Russia (in comparable prices), as % of the previous year**

	2009	2010	2011	2012	2013	2014	2015
January	103.6	103.3	100.1	105.6	101.6	101.8	95.3
February	99.1	103.7	102.7	105.6	100.6	103.1	92.7
March	98.8	104.1	101.4	105.7	102.8	101.6	92.9
April	101.6	104.8	101.1	104.6	102.0	101.9	91.3
May	98.1	105.7	100.6	105.7	102.5	100.5	91.3
June	97.8	106.6	101.0	105.3	102.7	98.9	90.9
July	96.5	108.5	101.1	102.8	103.6	99.5	91.0
August	94.5	108.0	103.4	102.1	103.9	99.8	89.9
September	94.3	105.6	105.8	101.6	102.8	99.5	90.2
October	96.2	104.4	106.3	101.6	102.7	99.4	89.3
November	97.8	104.2	106.8	102.2	103.2	98.3	88.5
December	100.4	102.4	107.6	102.2	101.8	99.5	88.6
<b>Annual total</b>	<b>98.1</b>	<b>105.1</b>	<b>103.4</b>	<b>103.6</b>	<b>102.6</b>	<b>100.0</b>	<b>90.8</b>

Source: Rosstat.

The situation differs by regions of Russia. In 2015 the biggest decrease of sales was registered in Omsk oblast and the Mary-El Republic (January-November) where the retail turnover in comparable prices fell by 22-25%. This indicator is an indirect sign of poorer economic access to food products and the worsening of situation with food security.

#### 4.7.3. Trends in imports and exports of agricultural and food products

The drop of food imports (groups 1-24 by Foreign Economic Activity Commodity Nomenclature (FEACN)) as seasonally adjusted was observed from August 2014 – the moment when Russia introduced a ban on import of food items from some countries. By December 2014 the shortfall in supplies as compared with 2013 reached 24% (Fig. 42). In January 2015 imports of food items were 42% below those of January 2014. Beginning from March 2015 the falling of imports was halted – their value varied from \$2.1bn to \$2.3bn.

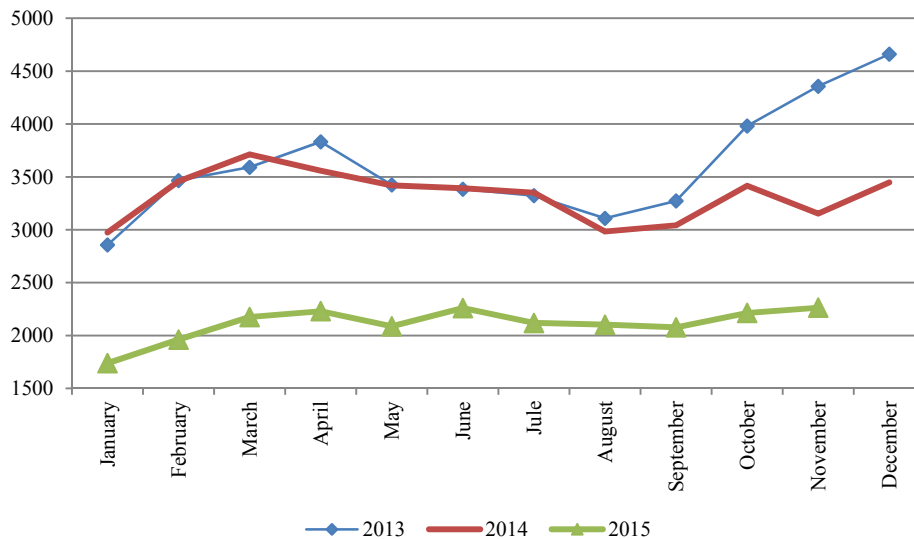


Fig. 42. Imports of food products, million dollars

Source: Rosstat.

In the recent years Russia has been intensely increasing exports of agricultural and food products. In 2014 foreign currency revenues from selling the output of agrifood sector were ¼ above those from selling the produce of military industrial complex. In the situation of sharp drop of prices for energy products domestic agribusiness can to some extent offset the losses from exports of gas. Even more so, if the price of gas for farm producers is reduced, their production costs will fall making them more competitive. In 2013 foreign currency revenues from the export of foodstuffs corresponded to 22% of the revenues from the export of gas while in January-November 2015 – to 33%. In January-November 2015 currency receipts for the exported gas fell by \$9.7bn. A part of this shortfall (\$2.7bn) was offset by bigger receipts from the export of agricultural and food products.

The dramatic devaluation of ruble has inspired expectations that given relatively stable prices on the world food markets exports of agricultural and food products will grow remarkably. However, it hasn't happened. Beginning from February 2015 monthly exports have never

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once exceeded the 2014 figures. To only a small extent this can be attributed to the growth of home consumption of domestic foodstuffs owing to the shrinkage of import supplies. Exports largely decreased due to the internal policies of curbing them (introduction of export duties on grains, non-tariff restrictions of export, etc.) (Fig. 43).

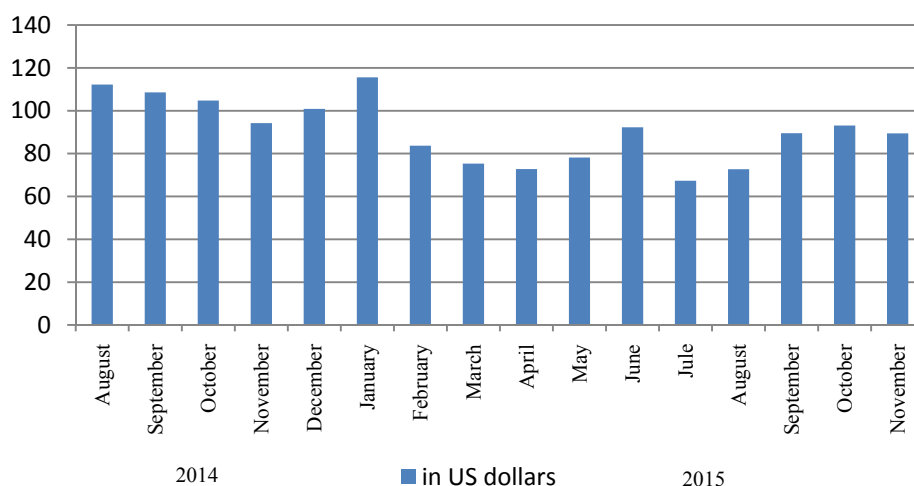


Fig. 43. Exports of agricultural and food products by months in 2014-2015 as compared with 2013-2014 (groups 1-24 by FEACN), %

Source: Federal Customs Service.

Owing to the devaluation of ruble export transactions have preserved their financial appeal. Over all the examined months ruble revenues from exports were well above those of the previous year (Fig. 44). Export revenues over 11 months 2015 exceeded the respective figures of 2014 by more than 36%.

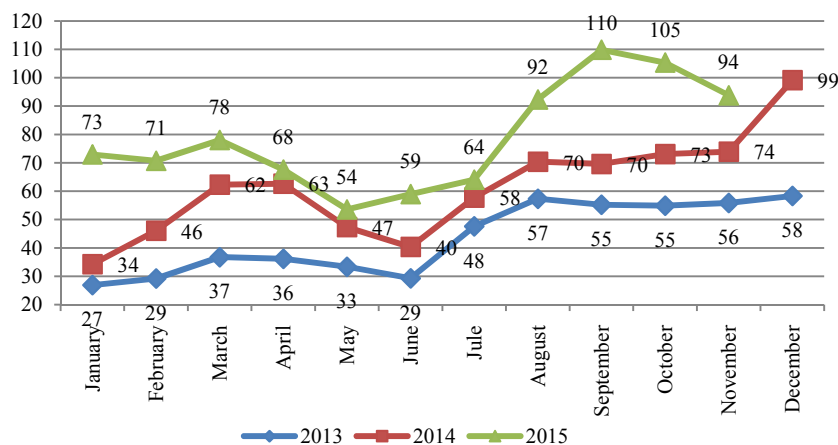


Fig. 44. Receipts from export of agricultural and food products from Russia by months (groups 1-24 by FEACN), billion rubles

Source: Federal Customs Service.



#### 4.7.4. Import substitution

Import substitution usually stands for the replacement of an imported commodity by the same or similar by quality domestic product<sup>1</sup>. This definition is quite acceptable for examining import substitution in respect of a specific commodity. Since there is a wide range of commodities (taking into account their brands, grades, etc.), the indicators of in kind import substitution are also numerous. The trends of their change can be opposite and therefore it's difficult to make general conclusions on their basis. In order to examine import substitution for a group of commodities one needs to shift from physical to value indicators.

Value substitution is the switch from paying foreign suppliers to paying domestic producers. The indicators of value import substitution depend not only on the volumes of imported and domestic items but also on the prices for them and the exchange rate of ruble. Value import substitution takes place in case domestic producers increase their share in the wallet of food consumers, i.e. in case the share of imported food products in the total consumer expenditures on buying foodstuffs reduces<sup>2</sup>.

In Russian statistics there are two indicators reflecting the cost of imported food products. Customs statistics shows their cost in border prices. The amount stated in this statistics goes to foreign suppliers of food items. The major part of these deliveries (about 70%) moves to retailers. The other part – imported inputs (seeds, feeds, live animals, meat for processing, etc.) – are not sold in retail stores but go to the production of food items that later enter retailing as domestic products.

Rosstat surveys the cost of imported foodstuffs in retailing but does it in retail prices. It's quite obvious that these statistical records disregard the part of imported products used for production purposes. Nevertheless, the cost of imported items in retailing is about 3 times higher than the cost of all imported foodstuffs in border prices (*Table 33*). It's hard to explain this difference by import duties (approximately 15% of border price). The major receivers of markups on imported food products are domestic companies – importers and commercial networks. They benefit from their monopoly position and imperfect legal regulation of the named markups.

As can be seen from data in *Table 33*, import substitution in consumer wallet was really the case. One of the above mentioned indicators – the share of imported products in retail sales to consumers – was gradually falling: in the third quarter of 2015 it amounted to only 27% while in the respective quarter of 2014 – to 32%, in 2013 – to 35%. The decrease of imported products' share in retail turnover was proceeding despite the fact that in the first three quarters of 2015 the total value of imports in border ruble prices was approximately the same as in the previous years. Reasoning from that, one can come to the conclusion that the share of imports in retail sales was falling primarily due to the reduction of markups on the way of imported products from the border to retail shelves.

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<sup>1</sup> Animitsa E.G., Animitsa P.E., Glumov A.A. *Importozameshcheniye v promyshlennom proizvodstve regiona: kontseptual'no-teoreticheskiye i priklandniye aspekty* [Import substitution in industrial production of a region: conceptual, theoretical and applied aspects]. *Ekonomika regiona* [Economy of a region], 2015, No.3, pp. 160-172.

<sup>2</sup> Uzun V. *Prioritety agropodovol'stvennoy politiki: importozameshcheniye ili export?* [Priorities of agrifood policies: import substitution or export]. *Economist*. 2015, No.7, pp. 17-29.

Table 33

Share of imported food products in retail turnover, 2013–2015

Year and quarter	Retail turnover of food products (including beverages) and tobacco			Imports of food products, beverages and tobacco (groups 1-24 by FEACN) (in border prices)	
	Billion rubles	Including imported products		Billion rubles (at current exchange rate of US dollar)	Share in retail turnover, %
		Billion rubles	%		
2013	11143	3956	35.5	1379	12.4
I	2482	894	36	301	12.1
II	2691	942	35	336	12.5
III	2818	986	35	318	11.3
IV	3152	1135	36	423	13.4
2014	12381	4243	34.3	1527	12.3
I	2730	983	36	355	13.0
II	2966	979	33	363	12.2
III	3140	1005	32	339	10.8
IV	3545	1276	36	470	13.3
2015*	9721	2877	29.6	1122	11.5
I	3098	991	32	372	12.0
II	3252	976	30	352	10.8
III	3371	910	27	397	11.8

\* 2015 – the total for 3 quarters.

Source: Rosstat, customs statistics.

In the previous sections it has already been shown that after the introduction of embargo in August 2014 imports of food reduced in both physical and value terms. This statement is true if the value of imports is estimated in US dollars (in border prices). But the exchange rate of dollar has markedly grown over this period. Population buys imported products for rubles and therefore it's reasonable to estimate the value of imports in ruble equivalent. Fig. 45 shows that over the examined period there were only three months (March, April and May of 2015) when the ruble value of imports was lower than in the respective months of pre-crisis period. In all the remaining months the nominal ruble value of imports was noticeably higher than before the introduction of embargo. This is an indirect sign that despite the falling incomes population continues to spend the same or even bigger amounts on imported products. So, no import substitution has taken place in the consumer wallet – on the contrary, the share of payments to foreign suppliers has grown.

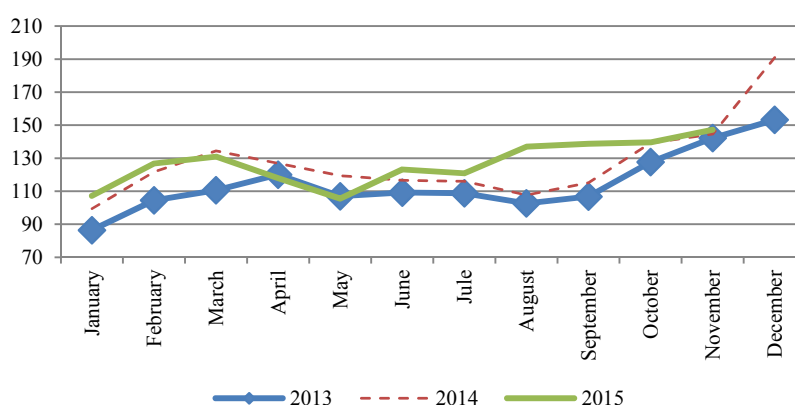
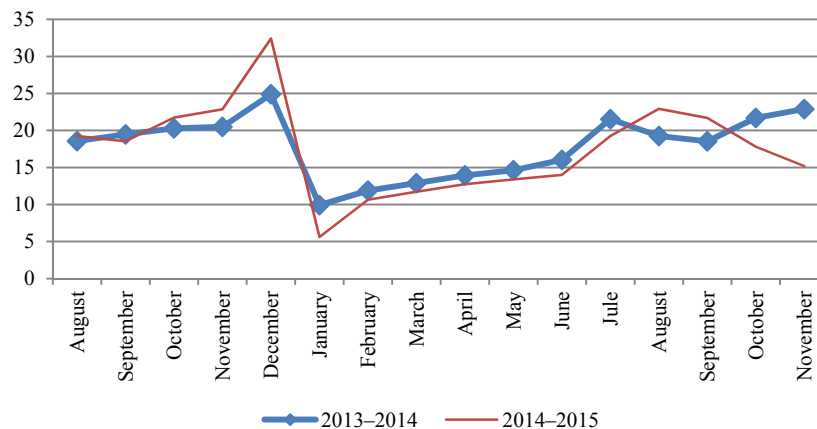


Fig. 45. Dynamics of food imports (groups 1-24 by FEACN), billion rubles

Source: Federal Customs Service.

The reasons of growing consumer expenditures on imported foodstuffs require a special examination. Consumers with high level of incomes are ready to increase expenditures and buy more expensive imported products in the same or approximately the same quantities. Additional expenditures of this population group offset the reduction of expenditures on these products by poor families.

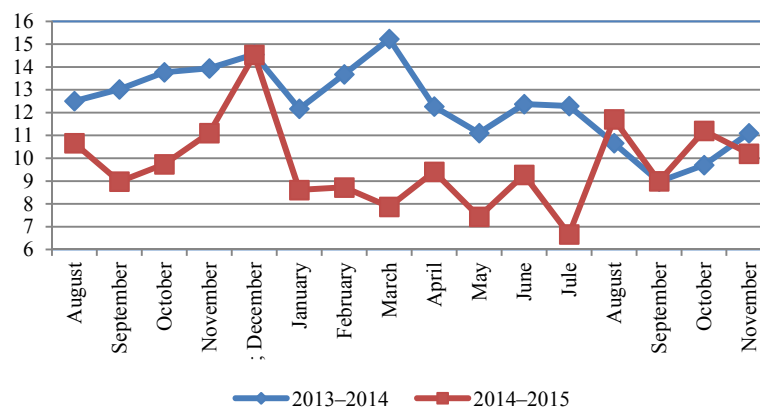
This is the situation for agricultural and food products in general. For selected groups of commodities import substitution did take place. For instance, nominal ruble expenditures on imported meat and meat products in 9 months 2015 were somewhat below those of the respective period of 2014 (*Fig. 46*).



*Fig. 46.* Dynamics of imports of meat and meat products, billion rubles

Source: Federal Customs Service.

The physical volume of imported milk products and their value in dollar terms was reducing throughout almost all months of the examined period. The value of their imports in ruble terms was also smaller than in the previous year (*Fig. 47*).



*Fig. 47.* Dynamics of imports of milk and dairy products, billion rubles

Source: Federal Customs Service.

Over 11 months 2015 imports of milk and dairy products totaled Rb 88.6bn while in the respective period of 2014 they amounted to Rb 129.7bn. So, one can state that relative to the previous year consumers started to spend a smaller share of their budget on purchasing imported dairy products.

In 2014-2015 the share of domestic output in commodity resources was expanding quite rapidly as compared with 2013 (*Table 34*). There were three reasons for that: growth of domestic production, shrinking of imports and smaller consumption of some products.

*Table 34*

**Self-sufficiency in food products, 2013–2015**

Item	Year	Domestic production, 1,000 tons	Imports, 1,000 tons	Commodity resources – total, 1,000 tons	Self-sufficiency in food products, %
Pork	2013	2816	980	3796	74
	2014	2974	426	3400	88
	2015	3115	250	3365	93
Poultry meat	2013	3831	527	4358	88
	2014	4164	453	4617	90
	2015	4492	250	4742	95
Cheese and curds	2013	1167	466	1633	71
	2014	1257	349	1606	78
	2015	1378	210	1588	87
Butter	2013	225	165	390	58
	2014	251	158	409	61
	2015	265	110	375	71
Vegetables and melons	2013	16109	2817	18926	85
	2014	16885	2929	19815	85
	2015	17474	2500	19974	88
Fruit	2013	3380	7201	10581	32
	2014	3525	6680	10204	35
	2015	3585	5560	9145	39

Source: RF Ministry of Agriculture.

The growth of domestic production has ensured import substitution and increase of consumption of only two of the examined products. The output of poultry meat grew by 661 thousand tons while imports reduced by 277 thousand tons, so consumption was up by 384 thousand tons. The situation was similar for vegetables and melons (*Table 35*).

*Table 35*

**Change of production, imports and consumption in 2015 as compared with 2013, 1,000 tons**

Item	Growth of production	Reduction of imports	Change of consumption
Pork	299	-730	-431
Poultry meat	661	-277	384
Cheese and curds	211	-256	-45
Butter	40	-55	-15
Vegetables and melons	1365	-317	1048
Fruit	205	-1641	-1436

Source: RF Ministry of Agriculture, authors' calculations.

For all other products the rates of imports' reduction were higher than the rates of production growth. Accordingly, import substitution was only partial and the consumption of these products eventually dropped. Given the falling incomes, population could not buy the same quantities of imported products that became more expensive while domestic producers failed to supply sufficient quantities of cheaper products.

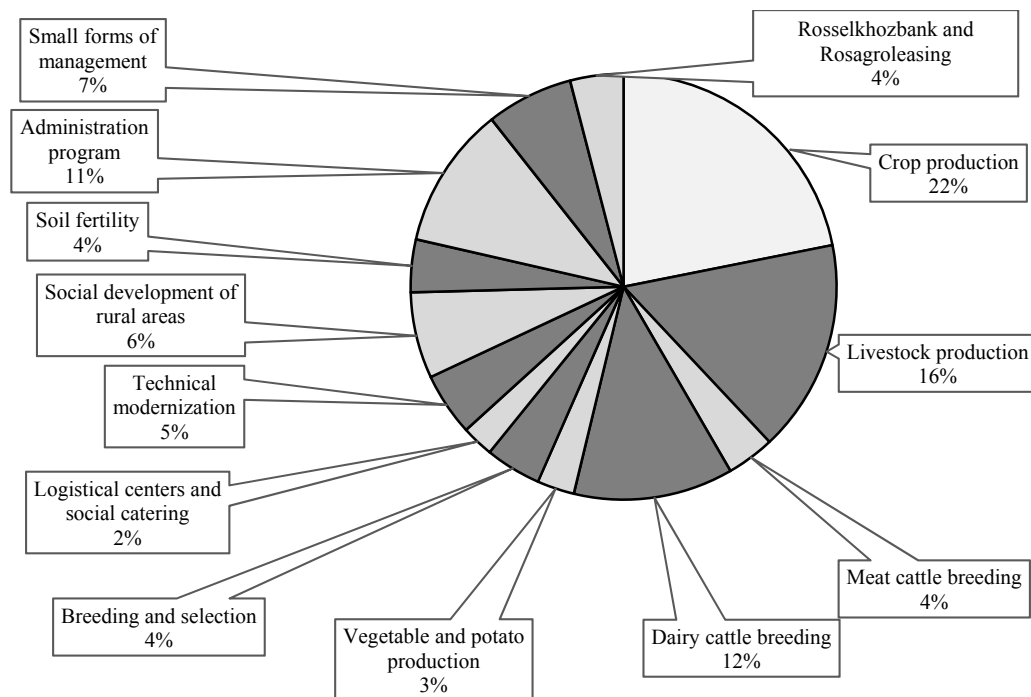
#### 4.7.5. Changes in budget support

Following the set course for import substitution some changes were introduced in the basic regulatory document pertaining to agriculture – “State program for agricultural development and regulation of agricultural, input and food markets for 2013-2020”. In particular, there appeared *five new sub-programs* targeted at the development of most vulnerable spheres in the domestic agribusiness:

- 1) Pedigree livestock breeding, selection and seed production;
- 2) Dairy cattle breeding;
- 3) Vegetable growing in the open and protected ground and production of seed potatoes;
- 4) Wholesale distribution centers and social catering infrastructure;
- 5) Financial and credit system of the agrifood sector.

The perfecting of agricultural policy mechanisms is in progress, some regulatory acts are at the stage of examination. New amendments to the “State program” are to be introduced in February 2016 (the term earlier specified in the “Roadmap for encouraging import substitution in agriculture for 2014-2015” was September 15, 2015).

In 2015 the new sub-programs will account for 23% of the total State program’s financing with dairy cattle breeding having the biggest share (*Fig. 48*). Allocations to the sector’s modernization are decreasing while administrative expenditures grow year after year (Rb 26.7bn): by the amount of allocated funds they rank fourth right after the development of dairy cattle breeding. The top two positions belong to the development of crop production (Rb 54.1bn) and livestock production (Rb 39.9bn).



*Fig. 48.* Financing of State program in 2015, billion rubles

*Source:* RF Ministry of agriculture.

According to data of the RF Ministry of Agriculture, the approved budget outlays as of October 1, 2015 envisage allocation of additional Rb 34.3bn from the federal budget to supplement

the initially planned expenditures on the State program (as specified in RF Government Resolution No. 1421 of December 1, 2014). Respectively, the total financing has amounted to Rb 222.15bn instead of Rb 187.8bn. The figure is not final. The increase of allocated funds *per se* is a positive fact but their distribution by items is not quite faultless.

Following the appearance of new sub-programs respective amendments were introduced in the rules of granting and distribution of subsidies for the reimbursement of interest rate on credits and loans (RF Government Resolution No.766 of July 28, 2015, new edition of the fundamental Resolution on agricultural subsidies No.1460 of December 28, 2012). The Resolution complements the list of potential receivers of subsidies by including therein farm producers and processors whose activities contribute to the progress of dairy cattle breeding, to the development of selection and seed production centers in crop growing and of selection and genetic centers in livestock breeding as well as to the purchase of raw livestock and crop output (vegetables, fruit, grapes, potatoes, melons and greenhouse products) from farmers for primary and/or further processing. The full list of subsidized activities is usually approved by the RF Ministry of Agriculture.

While for all investment credits reimbursement from the federal budget amounts to 2/3 of the refinancing (official discount) rate of the RF Central Bank, for credits (loans) received for the expansion of meat and dairy cattle breeding and for the development of selection and seed production centers in crop growing and of selection and genetic centers in livestock breeding the size of this reimbursement reaches 100% of this rate.

Besides, those borrowers who implement investment projects in meat or dairy cattle breeding have an opportunity to extend the term of credit agreements signed between January 1, 2008 and December 31, 2012 inclusive, from 10 to 15 years. The same Resolution increases up to 5% the minimal rate of partial subsidizing of expenditures on paying interest rate on credits to be reimbursed by regional budgets. All these amendments came into force on August 1, 2015.

Over 1/3 (35%) of the additional financing – Rb 12bn – instead of going to farm producers in import substituting sectors was spent on the increase of capital of Rosselkhozbank (Rb 10bn) and on the contribution to the authorized capital of OJSC Rosagroleasing (Rb 2bn). The State Program's passport did not envisage the financing of these measures in 2015. These allocations raise questions since farm producers can apply for a credit to any Russian credit organization, not exclusively to Rosselkhozbank that has got these injections for its ordinary activities without any commitments to grant additional privileges to farm producers as compared with other banks crediting agribusiness. For instance, Sberbank, the second largest creditor of the agrifood sector has got no such allocations in the framework of the State Program despite the fact that in 2015 it demonstrated better dynamics of providing credits for the seasonal field works: according to data of the RF Ministry of Agriculture as of December 3, 2015 the amount of such credits issued by Rosselkhozbank grew by 19% as compared with the respective period of the previous year while in Sberbank the increase was 85%<sup>1</sup>.

Rosagroleasing offers preferential federal leasing to agricultural producers and the contribution to its authorized capital makes it possible. At the same time it weakens competition as there are other leasing companies that could also provide this service in case of similar support by the state. But at the moment they have no opportunities to do it.

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<sup>1</sup> <http://www.mcx.ru/news/news/show/46040.355.htm>

This direction is not new at all. The increase of capital of Rosselkhozbank and Rosagroleasing was regularly carried out in the framework of the first State program and now is being continued but already as a separate direction.

The Government has also attended to the criteria of selecting investment projects the implementation of which fosters import substitution. The rules of allowing grants to promising innovational projects in the agrifood sector have been specified in the RF Government Resolution No.678 of July 7, 2015. The measures are financed in the framework of sub-program “Technical and technological modernization, innovational development”.

A new mechanism of support – compensation of direct expenditures incurred on the creation and modernization of agribusiness facilities – was first announced in 2014. The rules of granting and distribution of subsidies for these purposes were approved by the RF Government in Resolution No.624 of June 24, 2015. The mechanism of reimbursing direct incurred expenditures suggests that:

- 1) The selection of investment projects is done on the federal level;
- 2) Compensation from the federal budget covers the following part of expenditures: up to 20% - for the creation and modernization of facilities in the agrifood sector; 30% - for the creation and modernization of selection and genetic centers for breeding and transplantation of dairy cattle embryos; for the Far East regions the rate is higher – 25% and 35%, respectively, but not above the size of normative expenditures.

Direct financing to the amount of Rb 11.4bn is envisaged for the creation and modernization of:

- fruit storages (Rb 1.2bn);
- potato and vegetable storages (Rb 1.5bn);
- greenhouse complexes (Rb 3bn);
- dairy farms (Rb 4bn);
- selection and genetic centers and selection and seed production centers (Rb 0.7bn);
- creation of wholesale and distribution centers (Rb 1bn).

In 2015 400 projects to the amount of Rb 150bn were selected. Besides, Rb 2bn of subsidies were allocated to producers of farm machinery to let them sell their machines with a discount.

The shortage of logistical infrastructure largely curbs sales and the development of domestic market of farm products. Reasoning from that, a new sub-program “Development of wholesale and distribution centers (WDCs) and social catering infrastructure” was adopted. As follows from the name, its main target is the creation of WDCs; the principal mechanism of support – a partial compensation of direct incurred expenditures from the federal and regional budgets (20% of the estimated cost from the federal budget (for subjects in the Far East Federal District – 25%) in case of co-financing from the regional budgets)<sup>1</sup> for the selected investment projects. The State Program envisages that WDCs will service up to 20% of supplies in the framework of the state order including the system of social catering. In 2015 it was suggested to build about 15 pilot WDCs with the support of Rb 1.5bn from the federal budget<sup>2</sup>. On the whole, in 2015 the total financing of the sub-program from the federal budget increased from Rb 2.4bn specified in the passport of the State Program to Rb 7.4bn under budget breakdown as of October 1, 2015. However, only 4% of these funds or Rb 0.3bn were intended specifically for the creation of WDCs. It’s clear that in this case plans for the construction of 15 WDCs

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<sup>1</sup> RF Government Resolution No.624 of June 24, 2015.

<sup>2</sup> [http://www.mcx.ru/news/news/v7\\_show\\_print/37729.285.htm](http://www.mcx.ru/news/news/v7_show_print/37729.285.htm)

won't come true. Moreover, according to data of the RF Ministry of Agriculture as of October 1, 2015 these amounts remained unused. The remaining 96% of the sub-program's funds (Rb 7.1bn) were allocated to the subsidizing of interest rate on short-term credits to processors for the purchase of raw agricultural products (not exclusively of domestic origin) for primary and industrial processing according to the list of the RF Ministry of Agriculture (RF Government Decree No.1586-r of August 18, 2015). According to the rules of WTO and the Eurasian Economic Union Russia cannot provide preferences for the subsidizing of purchases from domestic producers; therefore, the named subsidy fails to encourage import substitution.

The support of dairy cattle breeding shrank as compared with the previous year. The financing of badly needed subsidy per 1 liter of marketed milk from the federal budget fell down to Rb 6.2bn (-26% relative to 2014). The subsidizing of interest rate on investment credits for the building and reconstruction of dairy farms was one of the principal measures of support to dairy cattle breeding. Nevertheless, in 2015 the allocation of funds under this article (according to the budget breakdown as of October 1, 2015) shrank more than 2 fold as compared with the State Program's passport: from Rb 11.8bn to Rb 5.15bn. Even taking into account these subsidies, high interest rates set by banks make the conditions of crediting investment projects in the sector worse than in the previous years. For instance, in 2012 the average weighted interest rate of commercial banks was 11.1%. Given the 100% reimbursement of the Central Bank's refinancing rate that amounted to 8.1%, the borrower was to pay 3% (not including the regional part of the subsidy). According to data of the RF Central Bank, in January-September 2015 the average weighted interest rate set by commercial banks on credits to non-financial institutions for terms exceeding one year was 15.4%<sup>1</sup>. Under the terms of subsidizing, given the 100% reimbursement of the Central Bank's refinancing rate (8.25%) the borrower was to pay 7.15%. This means that credit terms deteriorated more than 2 fold. The same is true for meat cattle breeding to which similar terms of subsidizing are applied. Besides, without subsidies the 2015 interest rates were prohibitively high while in 2012 credits were much more available.

So, in 2015 the support of "prioritized" dairy cattle breeding was actually cut down. Even the restriction of imports under sanctions that enlarged the market niche for domestic farm producers has failed to offset the reduction of budget support. It's no wonder that the production of milk shows actually no growth.

The support of vegetable growing in the open and protected ground and of the production of seed potatoes – the sectors that were declared to be of priority importance – was as low as 14% (!) of the level initially envisaged in the State Program's passport for 2015: Rb 0.7bn instead of Rb 5bn. The principal part of support (Rb 4.5bn) was to be provided through a partial reimbursement of expenditures on the construction and modernization of potato and vegetable storages and greenhouses. However, after the amendments to the budget only Rb 0.2bn were left for these purposes.

The subsidy for purchasing elite seeds has grown remarkably – it amounts to Rb 2.8bn. However, if formerly it was provided for the purchase of Russian seeds, now it applies to all seeds included in the State register of selection achievements, i.e. to the supplied by foreign producers as well. Given that the major part of hybrid seeds of sugar beets and corn is imported, this subsidy supports foreign rather than domestic producers. This fact is due to the Russia's membership in WTO. According to Article 3 Part II of the WTO "Agreement on subsidies and

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<sup>1</sup> Simple average of the monthly weighted average rates of the RF Central Bank.



countervailing measures”, “subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods” shall be prohibited. This clause should be taken into account when choosing forms of state support in the future.

The support of production of fine wools and comeback is a new subsidy targeted at the substitution of imported raw inputs for enterprises in textile and consumer goods industries. The financing of this import substitution sector was also cut almost 3 fold: from Rb 153.5m under the State Program’s passport to Rb 53.5m according to the budget breakdown. Given the amounts allocated and the great range of claimants this subsidy is unable to solve the problem. At the same time the funds may remain unused due to the requirement to prove the quality of wool in an accredited laboratory. There is no information about the number of such laboratories and whether it is sufficient. At the moment there are only plans to build two such laboratories with public co-ownership – one in Chita and one in Elista. The rules of distributing this subsidy were approved only on July 2, 2015 and the Decree on distributing it between the subjects of the Russian Federation – only on August 25, 2015. Such a delay does not contribute to the efficient utilization of the subsidy.

It should be noted that over the whole period of the programs’ existence the major part of support has been provided in the form of subsidizing interest rate on credits and loans with the state debt under investment credits growing at the highest rate. Only in 2014 the amount of subsidies on the reimbursement of interest rate increased by 14% (from Rb 93bn to Rb 102.5bn). Under no other provision of the State program the government has carried forward obligations. So, for all its significance, the program of subsidizing interest rate has got hypertrophied importance in the structure of state support. At present it accounts for over 50% of the total financing under the State Program. The problem also resides in the multiplicity of subsidies (altogether there are more than 40 of them). The Accounts Chamber repeatedly stresses that such a big number of subsidies is hard to administrate.

In 2015 subsidies on the reimbursement of interest rate fell down to Rb 84bn including Rb 38bn on short-term credits and Rb 46bn on investment credits. For instance, Rb 29.3bn were allocated to the development of livestock breeding including production and processing of livestock products, development of infrastructure and logistical support of the markets, Rb 15.4bn – to the development of crop production. A separate budget item was the financing of dairy cattle breeding: subsidies on short-term credits – Rb 0.3bn, on investment credits – Rb 5.2bn. In meat cattle breeding investment subsidies amounted to Rb 5.1bn. Subsidies on short-term credits for processing crop and livestock products totaled Rb 7.6bn.

Besides, new executive orders provided for the allocation of additional Rb 150m to the construction of drip irrigation systems for perennial plantations including vineyards in Crimea.

In spite of repeated declarations of the importance of small-scale farming in the production of agricultural products and the welfare of rural community, the support to household farms and their cooperatives has not increased. The amount of subsidies for the support of beginner farmers and family livestock farms from the federal budget totaled Rb 6.3bn. In 2015 20 supply-marketing and processing agricultural cooperatives from 14 regions each got up to Rb 40m as pilot grants for the development of physical facilities but for Russia at large it’s very little.

Rb 8bn from the federal budget are to be spent on the implementation of federal target program “Sustainable development of rural areas in 2014-2017 and for the period till 2020”. In 2015 for the first time certain funds (Rb 152bn) were allocated to the complex improvement of social and engineering infrastructure in rural settlements.

So, among the existing sub-programs (including the newly launched) there is actually not a single one that really contributes to the breakthrough in import substitution. The financing is cut so dramatically that import substitution in the sectors declared to be the priority ones is in fact problematic. Subsidies on the purchase of elite seeds and on the reimbursement of interest rate on credits for the purchase of raw inputs by processors support not only domestic producers. This proves the need for a serious revision of Russia's agricultural policies.

The following *directions of policy improvement* are most important for the strengthening of food security:

1. Shifting of emphasis in the ideology of "Doctrine of food security": instead of food independence, import substitution and self-sufficiency the main accent should be made on the economic availability of quality foodstuffs for all families including the poorest ones with import supplies being one of the tools.
2. Inclusion of the following target indicators in the "Doctrine": a composite index of the country's food independence (for all products); the rate of compliance of an actual food ration with the recommended one; the threshold level of satisfying the requirements of the poorest families making them eligible for food aid; the level of technological independence of the agrifood sector.
3. Changes in the import and export policies: the abolition of regulations restricting export and the working out of measures supporting it; switching from the prioritized support of import substitution for all types of foodstuffs to the prioritized support of export, i.e. the production of commodities the prices for which are competitive on the world market.
4. Working out of the program for targeted food aid to the poorest families whose incomes per family member are below the threshold level. It should be preceded by arrangements for the registration of such families, definition of the monthly amount of aid per capita, the list of foodstuffs' groups, the categories of producers and sellers eligible for the participation in the program. If at the first stage of the food aid program's implementation the threshold income is set at the average actual level in the first decile group, about one half of families in this group will claim for assistance, i.e. approximately 7 million people. Given that the size of assistance is Rb 1,000 per capita each month, the total amount of funds for food aid in the country will amount to Rb 84bn annually.
5. Abolition of food embargo. There are the following reasons for its abolition: the embargo results in higher prices for foodstuffs and bigger share of food expenditures in the budgets of families especially the poorest ones; the human rights for consuming certain types of food are violated; the control over embargo's abidance is complicated especially inside the Eurasian Economic Union (none of the EEU countries has supported Russia's embargo); the accelerated import substitution is not efficient; there are more efficient alternatives (for instance, the embargo on import of business and premium class vehicles).
6. The lifting of requirement for compulsory regional co-financing of the State Program's measures in order to get the federal part of allocations. Given the dramatic budget deficit in the RF regions and their failure to comply with this requirement farm producers do not get any support at all.
7. Development of dairy cattle breeding in individual private farms encouraged by larger grants and greater number of supported farms. According to data of the RF Ministry of Agriculture, in 2015 4,500 individual private farms got the grants. But the actual number of applicants is much bigger. There are plans to increase the amount of grant to beginner farmers

- for the creation of dairy farms from Rb 1.5m to Rb 3m and to allocate to the overall support of individual private farms Rb 14bn in 2016, of which Rb 8bn are grants.
8. The changing of subsidy system: shifting from the transfer of funds for the reimbursement of interest rate on credits to farm producers to the transfer of funds directly to agent banks. This will enable farm producers (1) not to divert their funds to the payment of interest rate in full with reimbursement provided later; (2) to cut transaction costs of paperwork needed for getting the reimbursement of interest rate.
  9. In order to supervise the situation and trends in ensuring food security it's advisable (1) to complement the system of statistical survey with the system of studying opinion of both individuals and entrepreneurs engaged in the production, importing and further movement of commodities to consumers; (2) to introduce the system of preparing annual national reports "On the situation and threats to Russia's food security". This will enable authorities to give a prompt response to new challenges in the sphere of food security and to timely adjust the state agricultural policies.

## 4.8. Foreign trade<sup>1</sup>

### 4.8.1. State of global trade

In 2015, economic growth rates in countries, which are main trade partners of the Russian Federation, turned out to be below forecast of a year earlier.

In 2015, according to the data released by the National Bureau of Statistics of China<sup>2</sup>, the China's GDP went up by 6.9% annualized, which is the minimum over the recent 25 years. Production growth in 2015 has slowed down to 6.0% and growth of the service sector up to 8.3%. In 2014, growth rates posted 7.3% and 7.8%, respectively.

According to the data of CIS Macromonitoring<sup>3</sup> released by Eurasian Development Bank, in Q1 2015, GDP of CIS member states contracted by 2.6% compared to the same period of last year. In Q2, reduction of CIS GDP accelerated and hit 4.4%. In Q3, aggregate GDP of CIS member states contracted by 3.9% in comparison with the same period of 2014.

At the same time, economic situation in *advanced economies* in 2015 is gradually improving contributed by easy financial conditions and low global prices on energy resources and metals as well as neutral budget and fiscal policy.

According to Eurostat<sup>4</sup>, *Eurozone* economy (EU-18)<sup>5</sup> in Q2 2015 up 0.4% compared to the previous quarter and up 1.5% annualized. In Q3 2015, compared to Q2 of the same year, economic growth of Eurozone slowed down to 0.3%, and GDP of entire *European Union* (EU-28) up 0.4%. In comparison with Q3 2014, growth of Eurozone GDP came to 1.6% and of European Union – 1.9%. Growth of consumer demand and public spending maintained the Eurozone economy. That helped compensating low export growth rates.

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<sup>1</sup> Author of this section: Volovik N. – Gaidar Institute for Economic Policy.

<sup>2</sup> [http://www.stats.gov.cn/english/PressRelease/201601/t20160119\\_1306072.html](http://www.stats.gov.cn/english/PressRelease/201601/t20160119_1306072.html)

<sup>3</sup> [http://www.eabr.org/r/research/publication/makromonitor\\_cis/](http://www.eabr.org/r/research/publication/makromonitor_cis/)

<sup>4</sup> <http://ec.europa.eu/eurostat/web/products-press-releases/-/2-08122015-AP>

<sup>5</sup> Eurozone (EU-18) include Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cypress, Luxemburg, Latvia, Malta, Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

## RUSSIAN ECONOMY IN 2015

### trends and outlooks

In Q2 2015, the US GDP moved up compared to Q1 by 3.9%, which is the maximum since July-September 2014. According to the US Bureau of Economic Analysis<sup>1</sup>, the US GDP estimate was revised upwards from 1.5% to 2.1% in annual terms. In Q4 2015, the US economy went up by 0.7% in annual terms. By the end of 2015 as a whole, the US economy grew by 2.4% as in 2014. The economy is stimulated by growing consumer demand and by positive shifts on the labor market.

According to the IMF<sup>2</sup> estimates, in 2015, the growth of global economy turned out to be the lowest since the end of the financial crisis (-3.1%). Meanwhile, the strongest slowdown of growth rates is observed in China and other developing economies, which leads to a reduction of growth rates of world economy despite the fact that advanced economies demonstrate better indices for economic growth since 2010 (*Table 36*).

Table 36

### Dynamics of Global GDP and World Trade (growth rates in % to previous year)

	2010	2011	2012	2013	2014	Estimate 2015	Forecast		Difference between forecasts, data in October 2015 and January 2016	
							2016	2017	2016	2017
<b>Global GDP</b>	<b>5.1</b>	<b>3.9</b>	<b>3.4</b>	<b>3.3</b>	<b>3.4</b>	<b>3.1</b>	<b>3.4</b>	<b>3.6</b>	<b>-0.2</b>	<b>-0.2</b>
<b>Advanced economies</b>	<b>3.0</b>	<b>1.7</b>	<b>1.2</b>	<b>1.4</b>	<b>1.8</b>	<b>1.9</b>	<b>2.1</b>	<b>2.1</b>	<b>-0.1</b>	<b>-0.1</b>
United States	2.4	1.8	2.3	2.2	2.4	2.5	2.6	2.6	-0.2	-0.2
Eurozone	2.0	1.5	-0.7	-0.4	0.9	1.5	1.7	1.7	0.1	0.0
Germany	4.0	3.4	0.9	0.5	1.6	1.5	1.7	1.7	0.1	0.2
France	1.7	2.0	0.3	0.3	0.2	1.1	1.3	1.5	-0.2	-0.1
Italy	1.8	0.4	-2.4	-1.9	-0.4	0.8	1.3	1.2	0.0	0.0
Spain	-0.3	0.1	-1.6	-1.2	1.4	3.2	2.7	2.3	0.2	0.1
Japan	4.5	-0.6	1.5	1.5	-0.1	0.6	1.0	0.3	0.0	-0.1
Great Britain	1.8	1.1	0.3	1.7	2.9	2.2	2.2	2.2	0.0	0.0
Canada	3.2	2.5	1.7	2.0	2.5	1.2	1.7	2.1	0.0	-0.3
Other advanced economies	5.9	3.2	2.0	2.3	2.8	2.1	2.4	2.8	-0.3	-0.1
<b>Emerging and developing economies</b>	<b>7.4</b>	<b>6.2</b>	<b>5.1</b>	<b>4.7</b>	<b>4.6</b>	<b>4.0</b>	<b>4.3</b>	<b>4.7</b>	<b>-0.2</b>	<b>-0.2</b>
Commonwealth of Independent States	4.8	4.8	3.4	2.2	1.0	-2.8	0.0	1.7	-0.5	-0.3
Russia	4.3	4.3	3.4	1.3	0.6	-3.7	-1.0	1.0	-0.4	0.0
Less Russia	6.0	6.1	3.6	4.2	1.9	-0.7	2.3	3.2	-0.5	-0.8
Developing countries of Asia	9.5	7.8	6.7	6.6	6.8	6.6	6.3	6.2	-0.1	-0.1
China	10.4	9.3	7.7	7.7	7.3	6.9	6.3	6.0	0.0	0.0
India	10.1	6.3	4.7	5.0	7.3	7.3	7.5	7.5	0.0	0.0
Latina America and Caribbean	6.2	4.6	2.9	2.7	1.3	-0.3	-0.3	1.6	-1.1	-0.7
Brazil	7.5	2.7	1.0	2.5	0.1	-3.8	-3.5	0.0	-2.5	-2.3
Mexico	5.6	4.0	4.0	1.1	2.3	2.5	2.6	2.9	-0.2	-0.2
<b>Global trade of goods and services</b>	<b>12.6</b>	<b>6.1</b>	<b>2.9</b>	<b>3.0</b>	<b>3.4</b>	<b>2.6</b>	<b>3.4</b>	<b>4.1</b>	<b>-0.7</b>	<b>-0.5</b>
<b>Import</b>										
Advanced economies	11.4	4.7	1.2	1.4	3.4	4.0	3.7	4.1	-0.5	-0.4
Emerging and developing economies	14.9	8.8	6.0	5.3	3.7	0.4	3.4	4.3	-1.0	-1.1

Source: IMF, <http://www.imf.org/external/pubs/ft/weo/2016/update/01/>

<sup>1</sup> <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>

<sup>2</sup> <http://www.imf.org/external/pubs/ft/weo/2016/update/01/>

In the forecast released in January 2016, IMF revised global GDP growth rate in 2016 downward compared to October (2015) Report from 3.6% to 3.4%. Economic development of the US was projected less dynamic (+2.6% against +2.8% in October Report). At the same time, Eurozone as a whole will accelerate growth rate to 1.7% against projected earlier 1.6%. The IMF forecast on Chinese economy stayed unchanged: growth projected at 6.3%, which is below projection of the Chinese authorities (+6.8% according to the Central bank of China).

In October 2015, The World Trade Organization (WTO) released “World Trade Report”<sup>1</sup> which provides main indicators characterizing current development trends of the global commerce in goods and services. Herewith, the world trade growth has come up with global GDP growth and constituted merely 2.5%, which was determined by many factor combinations. Principal among them are slowdown of GDP growth in countries with developing economy, uneven economic recovery in advanced economies and growth of geopolitical tensions.

High exchange rate volatility including strengthening of the American dollar against a broad basket of currencies and currencies of developing countries further complicated the trade situation and outlook. Collapsing world crude oil prices in 2014-2015 and weakness in other commodity classes hit export receipts and reduced import demand in exporting countries. However, there was no significant growth of import in countries-importers.

In 2014, foreign trade turnover of *China* amounted to \$4,301bn (41.5% of GDP), which exceeded 2013 indicator by 3.4%. Since 1994, Chinese had trade surplus. In 2014, it hit \$383.0bn (3.7% of GDP).

*The United States* whose foreign trade turnover in 2014 constituted \$4,034bn (32.2% of GDP) were second. Herewith, the US retains a significant deficit of balance of trade: in 2014, it amounted \$792bn (4.5% of GDP).

*Germany* was third. Its foreign trade turnover in 2014 amounted to \$2,724bn (71.3% of GDP). Trade surplus amounted to \$292bn (7.6% of GDP).

*The Russian Federation* with the exports volume of \$498bn sank to the 11<sup>th</sup> place (in 2013 – 10<sup>th</sup>, in 2012 – 8<sup>th</sup>). The share of Russian exports on the total volume of world merchandise exports came to 2.6%. Regarding exports Russia took 17<sup>th</sup> place by purchasing abroad goods in the amount of \$308bn (in 2013 – 16<sup>th</sup>). The share of Russian imports in the total volume of world imports fell to 1.6% against 1.8% in 2013.

In September 2015, The World Trade Organization revised downward its forecast for world trade growth in 2015 to 2.8% from 3.3%<sup>2</sup> expected in April. Revision of the forecast reflects a number of factors, which weigh on the world economy in H1 2015 including reduced demand for exports from China, Brazil and other developing countries, easing of prices on crude oil and other commodities as well as significant volatility of currencies exchange rate

Forecast for world trade growth in 2016 was revised downwards from 4.0% to 3.9%. Thus, growth rates remain significantly lower the average level of recent 20 years (5%). Further easing of economic activity in developing countries and financial instability, which can reveal itself as a result of continuation of tight monetary policy pursued by the US pose the most serious risks.

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<sup>1</sup> [https://www.wto.org/english/res\\_e/publications\\_e/wtr15\\_e.htm](https://www.wto.org/english/res_e/publications_e/wtr15_e.htm)

<sup>2</sup> [https://www.wto.org/english/news\\_e/pres15\\_e/pr752\\_e.htm](https://www.wto.org/english/news_e/pres15_e/pr752_e.htm)

**4.8.2. Russia’s terms of trade: prices on major goods of Russian exports and imposts**

2015 saw the continuation of price fall on commodities. For instance, the aggregate Bloomberg Commodity Index (BCOM), which embraces 22 types of commodities fell by 25% during a year to the lowest level since 2009. In early December 2015, for the first time since 1999 BCOM decreased below 80 points.

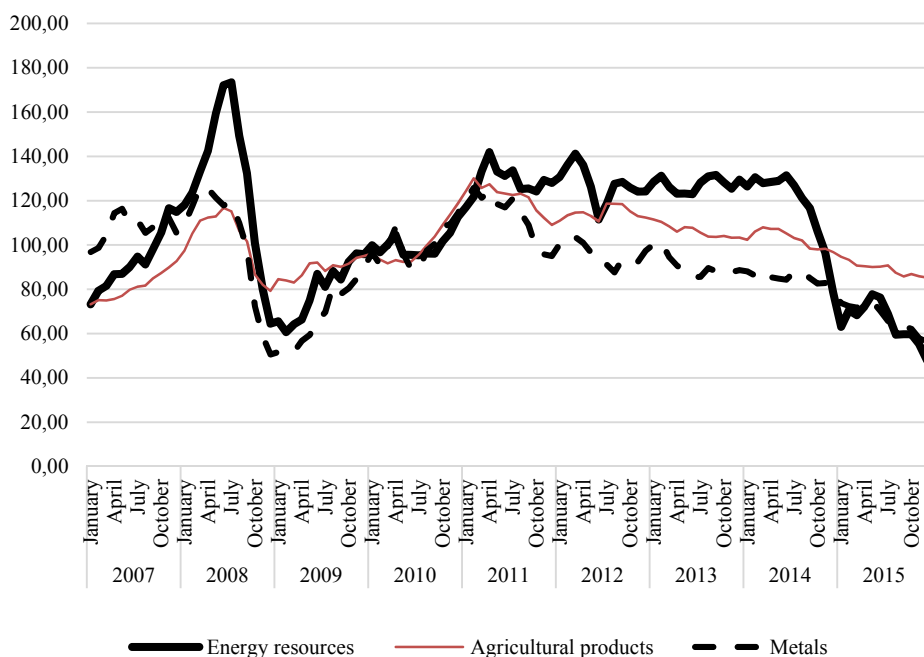
In Q3 2015, the World Bank price index on energy resources shrank compared to the previous quarter by 17%, which was due for the first time to the slowdown of the world economy, especially in China and other developing economies. This resulted in contraction of demand amid high supply of these goods on the world market. In Q4 decrease of this indicator continued. Compared with the previous quarter it contracted by 13.6%. During the year as a whole, energy resources became cheaper by 45.1%

In Q3, prices on other commodities decreased on average by 5%, and in Q4 – by 3.7%. In 2015, non-energy resources became cheaper by 15.1% compared to 2014.

Prices on metals fell in Q3 compared to Q2 by 12%, and in Q4 compared to Q3 – by 8.0%. At the same time, fifth quarter recession was observed, which reflected slowdown of demand especially from China. In 2015, prices on metals have fallen by 21.1%.

Precious metals went down in Q3 2015 compared to Q2 by 7.0%, and in Q4 compared to Q3 – by 1.7%. In 2015c in comparison with 2014, contraction of precious metals sale was observed by 10.4% due to low investment demand.

Prices on agricultural raw materials went down by 2.5% in Q3 compared with the previous quarter and by 2.3% in Q4 compared to Q3. In 2015 in comparison with 2014, they contracted by 13.1%, reflecting high level of supplies and existing stock of grains.



*Fig. 49. Price index on commodities of World Banks (2010 = 100)*

Source: <http://www.worldbank.org/en/research/commodity-markets#1>

One of the main factors of reduction of world prices on raw materials was slowdown of the world economy especially decline of the economic growth in China. Chinese leaders promise to preserve in 2016 economic growth within “reasonable limits” by increasing domestic demand and increasing efficiency of delivery system.

One more factor for reduction of raw materials prices in 2015 was expectation of the hick of the prime rate in the US. At the meeting of the Federal Committee for Open Markets (FOMC) held on December 15-16, 2015, a decision was taken to raise the target range for the federal funds rate to 1/4 to 1/2 percent.<sup>1</sup> This decision coincided with the expectations of economists and market agents. In medium-term perspective, the Federal Reserve Board is planning to raise the prime rate to 1.5% in 2016 and to 2.5% in 2017.

The prime rate was raised last time in June 2006. During 2008, it was reduced 7 times and in December 2008 was set at an unprecedented low level of 0-0.25% where it stayed for 7 years.

Prime rate hike in the US means strengthening of the dollar against other currencies as well as continuation of price fall on commodities.

Decline of the world oil prices weighs most painfully on the Russian economy. Factors, which determine oil price fall in 2015, were formed in 2014: significant oversupply on the world oil market, strengthening of the US dollar on the background of relatively fast recovery of the American economy, expectations of tightening of the monetary policy by FRB.

Slowdown of the world economy growth resulted in contraction of demand on energy resources. The OPEC decision not to cut the level of crude oil production in response to the price fall contributed to retention of high volumes of supply on the oil market. Meanwhile, production of shale oil in the US decreased less than was expected by the market agents. Additional pressure on the oil price was exerted by the expectations of further increase of oil supply from Iran due to lifting of sanctions. Simultaneous impact of all factors resulted in a significant reduction of oil prices.

In early 2015, the price of oil was recovering following a reduction by more than twofold in 2014. Peak of growth was in May (quotations were approaching \$70 per barrel). However, then prices again began falling by renewing multi-year low. As a result, in December 2015, quotations fell to the levels of mid-2014.

Prices of Brent crude in 2015 averaged \$52.37 per barrel, which was 47.1% cheaper than in 2014 (\$98.94 per barrel).

In December 2015, price of Brent crude fell below \$38 per barrel. The main reason for that was unwillingness of OPEC to cut oil production. Following the results of the summit held on December 4, 2015, the cartel decided to preserve the existing oil production quota. Herewith, since early year to November oil production of the OPEC member states went up by 1.7 mn barrels per day. Moreover, Iran’s declaration to sell oil below \$30 per barrel, expectations of the market regarding the US lifting a self-imposed ban on oil export and FRB decision to raise the prime rate exerted pressure on the oil quotations.

The price of Urals crude fell in 2015 against 2014 by 47.5% to \$51.23 per barrel. In November, price of Urals fell below the watermark of \$40 per barrel, below which according to “Main Directions of Monetary Policy” of the Bank of Russia, Russia faces ‘risk’ scenario of the economic development, which envisages accelerated contraction of GDP, ruble depreciation and the federal budget deficit growth.

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<sup>1</sup> <http://www.federalreserve.gov/newsevents/press/monetary/20151216a.htm>

In 2015 against 2014, the price of gas on the European market decreased by 27.8\$ amid high level of stock and adjustment of contract prices tied to oil prices.

In 2015, world market condition for nonferrous metals continued deteriorating on the back of slowdown of demand from China. In November, prices on nonferrous metals high minimal levels since the crisis year of 2009.

During the year, aluminum went down by 10.95 from \$1,867.42 per ton in 2014 to \$1,664.68 per ton in 2015, i.e. to the level of 2009.

Prices on nickel during the year fell by 29.8% from \$16,893.37 per ton in 2014 to \$11,862.63 per ton in 2015. This is the lowest price since October 2003 when nickel was \$11,047.17 per ton. In the crisis year of 2009 nickel moved down in March to \$9,696.4 per ton not dropping further and in April began growing. Now London Metal Exchange boasts of significant stock of this metal, which weighs on the price.

During the year copper moved down by 19.7%. In 2014, copper was \$6,863.39 per ton and in 2015 solely \$5,510.45 per ton.

*Table 37*

**Average annual world prices, 2005–2015**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Brent crude, \$/bbl.	54.38	65.15	72.32	97.64	61.86	79.64	110.9	111.97	108.86	98.94	52.37
Natural gas (USA), \$/million BTU*	8.92	6.72	6.98	8.86	3.95	4.39	4.00	2.75	3.73	4.37	2.61
Natural gas (European market), \$/million BTU	6.33	8.47	8.56	13.41	8.71	8.29	10.52	11.47	11.79	10.05	7.26
Natural gas (Japan), \$/million BTU	5.99	7.08	7.68	12.55	8.94	10.85	14.66	16.55	15.96	16.04	10.42
Copper, \$/ton	3679	6722	7118	6956	5149	7534	8828	7962	7332.1	6863.4	5510.4
Aluminium, \$/ton	1898	2570	2638	2573	1665	2173	2401	2023.3	1846.7	1867.4	1664.7
Nickel, \$/ton	14744	24254	37230	21111	14655	21809	22910	17557	15032	16893	11862

*Source:* calculated using data of the World Bank.

In 2015, Russia's terms of trade with countries of far abroad deteriorated considerably. In January-September 2015, terms of trade index came to 73.6 points. Meanwhile, in January-September 2014 it amounted to 97.3 points. This is owing to the fact that exports to the countries of far abroad went down in price much more than imports from these countries. Average export price index during 9 months of 2015 constituted 65.2% and index of average import prices – 88.6%.

Russia's terms of trade with CIS member states, on the contrary, improved. In January-September 2015, terms of trade index amounted to 118.8 points, meanwhile in January-September 2014 – 100.5 points. Imports to Russia from CIS member states lost less in price than exports from Russia to those countries. Index of average export prices during 9 months of 2015 amounted to 78.9%, and index of average import prices – 66.4%.

The same picture was observed in the crisis year of 2009 (*Fig. 50*).



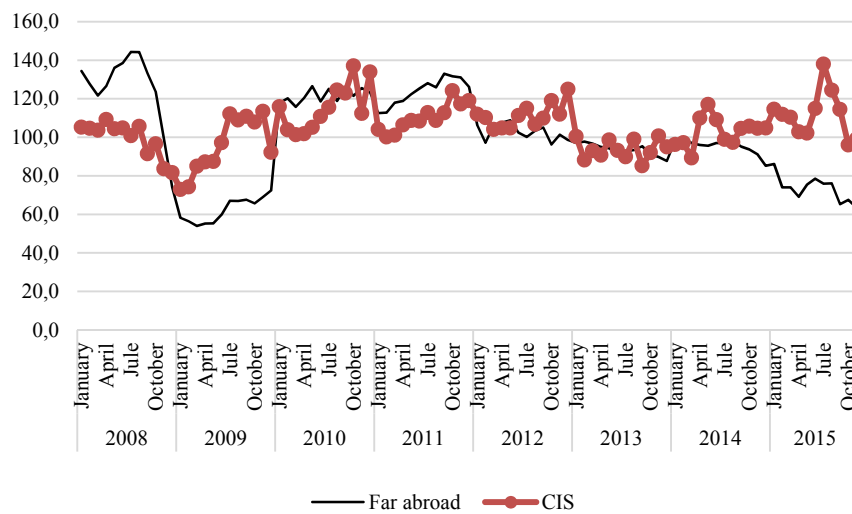


Fig. 50. Russia's terms of trade, 2008–2015

Source: Ministry of Economic Development.

#### 4.8.3. Main indicators of Russian foreign trade

In 2015, reduction of foreign trade indicators was observed similar to the crisis one of 2009. According to data released by the Bank of Russia, foreign trade turnover calculated according to the balance of payments' methodology amounted to \$534.4bn, which is down 33.7% against the same indicator last year. Foreign trade turnover with countries of far abroad contracted by 33.9% to \$463.2bn, with CIS member states down 32.1% to \$71.2bn.

In 2015, Russian export shrank compared to 2014 by 31.8% to \$340.3bn, and Russian imports down 37% to \$194.1bn. Thus, imports were contracting faster than exports due to slow-down of economic growth and ruble devaluation as well as in the context of international trade sanctions. Consequently, in 2015, there was trade surplus in the amount of \$146.2bn, but contracted by 22.9% compared to 2014 (Fig. 51).

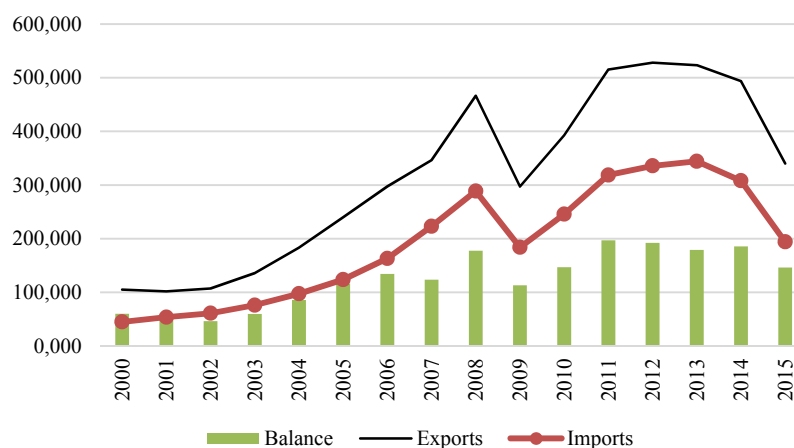


Fig. 51. Main indicators of Russian foreign trade in 2000–2015, USD bn.

Source: Bank of Russia.

As in 2014, negative dynamics of Russian exports in 2015 was owing to mainly price factor amid insignificant growth of exports volume. Reduction of the imports volume was due both to a decline of average import prices and to contraction of delivered to Russia imports physical volumes of goods.

*Table 38*

**Indices of Russian foreign trade in 2011–2015 (% to previous year)**

	2011		2012		2013		2014		2015	
	Volume	Average prices	Volume	Average prices	Volume	Average prices	Volume	Average prices	Volume	Average prices
Exports	97.8	132.9	99.9	101.6	104.9	95.7	100.0	94.3	105.4	64.8
Imports	122.2	109.1	105.1	97.3	97.8	102.5	92.5	98.2	77.7	81.1

Source: FCS of Russia.

Despite the easing of foreign demand, exports volume moved up by 5.4% which was due to a significant ruble devaluation in real terms in late 2014 - early 2015. This fact supported export oriented sectors of the Russian economy and partially offset enterprises losses incurred due to the fall of commodities prices. Prices on Russian goods have fallen by 35.2% with outstripping rates on energy resources including on crude oil by 46.8% and on oil products by 44.0%.

Reduction of imports was driven by a contraction of physical volumes of deliveries by 22.3% with price fall at 18.9%. Main factors were recession in the Russian economy, Russia's restrictive measures regarding imports of certain categories of goods and contraction of income of the population. Ruble depreciation positively affected imports.

Excess of exports over imports went up from 160.3% in 2014 to 175.1% in 2015.

Coefficient of foreign trade imbalance (ratio between balance and trade turnover) moved up from 23.15% in 2014 to 27.29% in 2015.

**Structure and dynamics of exports**

In 2015, Russian exports shrank compared to 2014 by 31.6% to \$340.3bn. Herewith, significantly fell proceeds from exports to the countries of far abroad (by 31.8%) and to CIS member states (by 30.3%). In the total exports volume the share of far abroad countries decreased to 85.9% compared to 86.2% in 2014 (*Table 39*).

*Table 39*

**Dynamics of Russian exports in 2004–2015**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Exports, USD bn	183.2	243.8	303.6	354.4	471.6	303.4	400.6	515.4	529.1	523.3	493.6	340.3
Including far abroad	153.0	210.2	260.2	300.6	400.5	255.3	338.0	436.7	443.8	445.2	428.6	292.4
<b>Growth rates, % to previous year</b>												
Volume index	110.7	104.7	105.8	105.0	96.8	97.0	110.0	97.8	99.9	104.9	100.0	105.4
Price index	122.7	126.9	119.7	110.9	137.4	76.4	119.8	132.9	101.6	95.7	94.3	64.8

Sources: Bank of Russia, RF Ministry for Economic Development.

Growth of exports efficiency due to the ruble devaluation has contributed to increase of physical volume of shipments of goods abroad. For instance, in 2015 compared to 2014, exports volume of crude oil moved up by 9.4%, oil products – by 4.1%, natural gas – by 7.5%, potassium fertilizers – by 6.9%, mixed fertilizers – by 7.1%, lumber – by 10.7%, plywood – by 12.2%, wood pulp – by 10.1%, cotton cloth – by 6.6%, ferrous metals – by 7.5%, refined copper – by 94.1%, and green aluminum – by 18.9%.

Growth of Russian exports volume could not compensate losses incurred from the decrease of average export prices on practically all products exported abroad. Significant contraction of exports value volumes was observed across all merchandise line of extended classification. “Mineral products” suffered most of all. This group of products of Russian export shrank by 37.4% since 2014. Therewith, the share of this merchandise group in the overall structure of Russian exports fell by 6.7 p.p. to 63.8%. Export of metals and metal products contracted by 18.6%, timber and pulp and paper products – by 15.5% and chemical products – by 13.0%.

By 2015-end compared to 2014, the Russian exports pattered suffered the following changes: with the reduction of share of mineral products the share of metals and metal products, machines, equipment and means of transport, chemical products and rubber, foodstuffs and agricultural raw materials and timber and pulp and paper products went up (Fig. 52). The share of hi-tech products increased to 10.1% of the overall exports volume (in 2014 it constituted 8.5%).

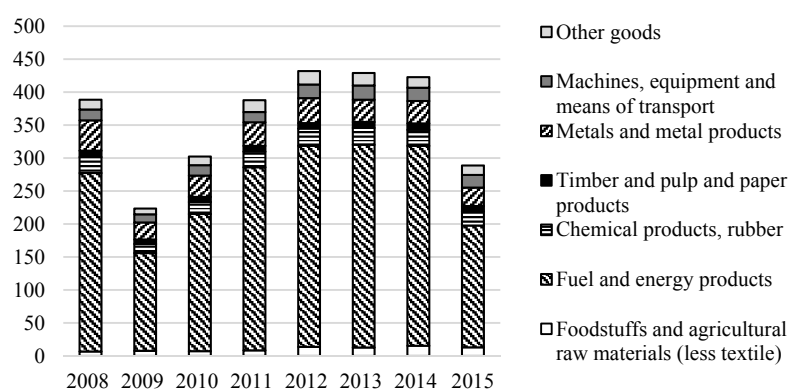


Fig. 52. Goods dynamics of Russian exports, 2008–2015, USD bn.

Source: FCS of Russia.

*The Netherlands* are the main customer of Russian goods. That country is the largest gateway for Russian energy resources. In 2015, the share of that country amounts to 11.9% of total Russian exports (in 2014 – 13.7%). *China* stays second importing 8.3% of the total Russian exports (in 2014 – 7.5%). *Germany* is third with 7.4% of the total Russian exports in 2015 (in 2014- 7.5%).

### Structure and dynamics of imports

In 2015, Russian imports contracted compared to 2014 by 37% to \$194.1bn. Reduction of imports volume was owing to a decrease of deliveries both from countries of far abroad, which exported goods to the tune of \$170.9bn (down 37.2% against the same indicator of 2014) and from CIS member states, which exported to Russia goods to the tune of \$23.2bn (down 35.6% against 2014). In the total volume of imports the share of countries of far abroad remained at the 2014 level of 88%.

Contraction of imports was observed across all major classification of goods. The largest reduction was observed in relation to imports of automobiles (by 50.5%) and trucks (by 57%), flying machines (by 56.2%) and spare parts for means of transport (by 45.1%).

At the beginning of august 2014, Russia banned imports of foodstuffs from countries, which imposed sanctions against it: from the US, EU member states, Canada, Australia and Norway. The following foodstuffs were banned: beef, pork, poultry, sausages, fish, vegetables, fruit,

dairy products, etc. In 2015 compared to 2014, import of banned products in value terms fell by 46% to \$7.6bn. The biggest reduction was observed in relation to meat (cattle and pork), dairy products (first of all, cheeses and butter), apples and pears, fresh and frozen fish.

Table 40

**Dynamics of Russian imports, 2004–2015**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Imports, USD bn.	97.4	125.4	164.3	223.5	291.9	191.8	248.6	318.6	335.8	341.3	308.0	194.1
Including countries of far abroad	76.4	103.5	138.6	191.2	253.1	167.7	213.3	275.5	288.5	295.0	271.7	170.9
<b>Growth rates, % to previous year</b>												
Volume index	124.2	122.4	130.1	127.1	113.5	63.3	135.4	122.2	105.1	97.8	92.6	77.7
Price index	106.1	106.5	105.5	107.6	117.8	99.1	101.6	109.1	97.3	102.5	99.8	81.1

Sources: Bank of Russia, Ministry of Economic Development.

Imports of many consumer goods shrank due to decrease of real income of the population. Russian import pattern (Fig. 53):

- Increased the share of chemical products and rubber, fuel and energy products, foodstuffs and agricultural raw materials, textile and textile products and footwear;
- Fell the share of machines, equipment and means of transport, metals and metal products;
- The share of timber and pulp and paper products remained unchanged.

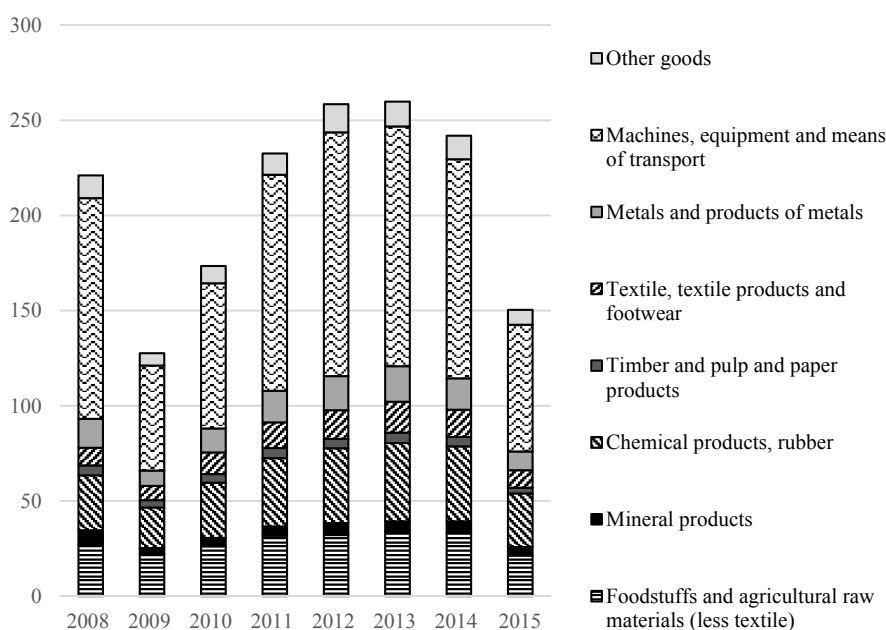


Fig. 53. Goods dynamics of Russian imports, USD bn.

Source: FCS of Russia

Since 2008, China is the principal exporter on the Russian market. In 2015, the share of China in Russian imports moved up to 19.2% (in 2014 – 17.9%). Germany is the second largest

exporter to Russia. Prior to 2008 Germany was second to none. In 2015, the share of that country amounted to 11.2% of total Russian imports (in 2014 – 11.5%). *The United State of America* was third with 6.3% (in 2014 – 6.5%).

#### 4.8.4. Regional pattern of Russian foreign trade

In 2015 on 2014, regional pattern of Russian foreign trade suffered reduction in the share of EU countries (from 48.1% to 44.8%). The share of CIS member states remained at the 2014 level of 12.5%. Herewith, the share of APEC member states moved up from 26.9% to 28.1% (Fig. 54).

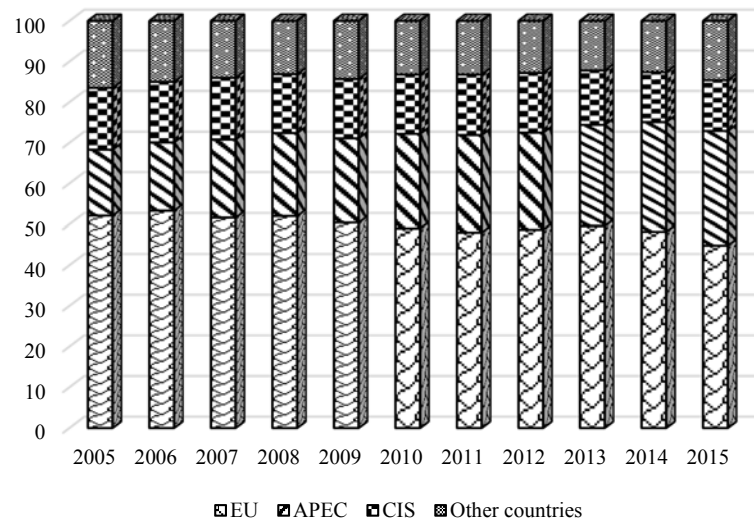


Fig. 54. Regional pattern of Russian foreign trade, 2005–2015, %

Source: FCS of Russia.

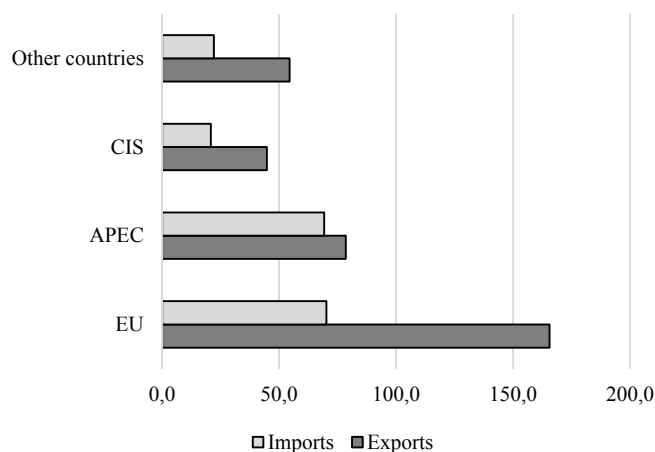


Fig. 55. Main indicators of Russian foreign trade regional pattern in 2015, USD bn

Source: FCS of Russia.

In 2015, the share of the European Union in Russia's foreign trade turnover continued falling. Most of all trade turnover contracted with the following countries: Estonia – by 49.6%, Sweden – by 46.7%, Slovenia – by 42.4%, Latvia – by 44.9%, and Great Britain – by 41.9%. Despite reduction of Russian trade turnover and EU, the European Union remains principal partner of the Russian Federation. However, relation between them are complicated by many factors: both domestic problems of economic development in Russia and external – controversy on the situation in Ukraine and Syria, sanctions and counter sanctions.

Russia's trade deficit was with 20 countries whose share in total Russian trade turnover constituted 24.2%. Russia's largest trade deficit was with China (-\$6.3bn), USA (-\$1.9bn), Indonesia (-\$1.1bn), Thailand (-\$0.9bn), Brazil (-\$1.0bn), and Argentina (-\$0.7bn).

#### 4.8.5. Regulation of Russia's foreign trade<sup>1</sup>

##### *Tariff regulation*

###### *Export duties*

In compliance with the Regulation of the RF Government of March 29, 2013 No 276<sup>2</sup> the Ministry of Economic Development of Russia carried monthly adjustments of customs duty rates on crude oil and certain categories of petroleum products.

On November 25, 2014, The RF President Vladimir Putin signed a Law “On Amending Part II of the Russian Federation Tax Code”, in compliance with which from January 1, 2015 Russia launched ‘tax maneuver’ in the oil and gas sector. The maneuver is aimed at reducing dependence of the Russian budget on export duties that fall together with the oil price. The maneuver envisages gradual decrease by 1.7-fold of export customs duties of crude oil and on petroleum products – by 1.7-5 times depending on the type of the product. The Mineral Extraction Tax (MET) rate on crude oil during the period will grow 1.7 times and on gas condensate – by 6.5 times. This will result in growth of domestic price of crude oil and correspondingly the price of gasoline will move up. In order to avoid a sharp hike of prices on petroleum products, the maneuver envisages reduction of excises on gasoline and diesel fuel.

Change in the taxation scheme in the wake of decline of world oil prices led to a considerable fall of export duty on crude oil in early 2015 (*Table 41*).

During 2015, 4 regulations were adopted by the RF Government, which referred to export customs duties rates:

- of May 28, 2015 № 513 “On Amending Rates of Export Customs Duties on Goods Exported from the Russian Federation outside the Territory of the Customs Union Member States” (envisages introduction of rates of export customs duties in the range of 50-5.5 rubles per ton, but no less than 50 rubles per ton on wheat and meslin);
- of May 29, 2015 № 514 “On Amending Rates of Export Customs Duties on Goods Exported from the Russian Federation outside the Territory of the Customs Union Member States” (envisages introduction of export customs duty rate in the amount of 6.5% regarding certain types of metals of the platinum group, codes 2843 90 900 0 и 7115 90 000 0 CN FEA EEU);

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<sup>1</sup> In preparation of this chapter, materials from garant.ru were used.

<sup>2</sup> Regulation of the RF Government of March 29, 2013, № 276 “On calculation of export customs duties on crude oil and certain categories of petroleum products revocation of certain decision of the Government of the Russian Federation”.

- of August 4, 2015 № 786 “On Amending Rates of Export Customs Duties on Goods Exported from the Russian Federation outside the Territory of the Customs Union Member States” (envisages introduction of amendments in CN FEA EEU and ETT EEUU in relation to certain types of goods in compliance with the obligations taken by Russia regarding WTO);
- of September 29, 2015 № 1032 “On Amending Rates of Export Customs Duties on Goods Exported from the Russian Federation outside the Territory of the Customs Union Member States” (envisages introduction of amendments in CN FEA EEU and ETT EEUU in relation to certain types of wheat and meslin).

*Table 41*

**Export duty rates on crude oil and petroleum products in 2014–2015, USD/t**

	Crude oil	Petroleum products	
		<b>2014</b>	
1 January	401.0	264.6	
		<b>Diesel fuel</b>	<b>Other types of petroleum products, less gasoline and diesel fuel</b>
February 1	386.3	251	254.9
March 1	384.4	249.8	253.7
April 1	387.0	251.5	255.4
May 1	376.1	244.4	248.2
June 1	385.0	250.2	254.1
July 1	385.2	250.3	254.2
August 1	388.4	252.4	256.3
September 1	367.6	238.9	242.6
October 1	344.7	224.0	227.5
November 1	316.7	205.8	209.0
December 1	277.5	180.3	183.1
		<b>2015</b>	
January 1	170.2	81.6	129.3
February	112.9	54.1	85.8
March 1	105.8	50.7	80.4
April 1	130.8	62.7	99.4
May 1	116.5	55.9	88.5
June 1	144.4	69.3	109.7
July 1	143.1	68.6	108.7
August 1	133.1	63.8	101.1
September 1	109.2	52.4	82.9
October 1	91.5	43.9	69.5
November 1	97.1	46.6	73.7
December 1	88.4	42.4	67.1

*Sources:* Regulation of RF Government; information released by RF Ministry of Economic Development.

*Import duties*

During 2015, amendments were introduced in the rate of import duties: as of the period-end for 9 months of 2015, 11 decision was taken by the Board of the Eurasian Economic Commission and 27 decisions were taken by Collegium of the Eurasian Economic Commission.

Also in the framework of Russia’s obligations before the WTO, the Eurasian Economic Commission adopted Decision № 44 “On Introduction of Amendments in the unified Goods Nomenclature for Foreign Economic Activities of the Eurasian Economic Union and Single Customs Tariff of the Eurasian Economic Union Regarding Certain Types of Goods According to the Obligations of the Russian Federation Within the WTO”, according to which from 1 September import customs duties will be reduced on 4,061 items. Weighted average customs tariff rate will constitute 5-5.3%. Arithmetic average customs duty on food products will fall from 13.88% to 13.28%, on textile products down from 9.31% to 8.66%. Reduction of duties will

cover the following goods: fish, milk, butter, cheese, plants, potatoes, onions, cabbage, beetroot, cucumbers, apples, strawberries, rice, starch, rape oil, margarine, sausage, sugar, confectionary, pea, nuts, fruit and berry preserves, corn and juices. It will also cover aviation fuel, various chemicals, medicine, medical products and materials, washing and cleaning products, explosives, articles made of polymers, construction materials, textiles, clothes, footwear, machine tools, furniture, etc. The most substantial reduction of duties will affect electric machines and electronics. Duties on terminals for credit card payments will fall from 6.7% to zero.

***Nontariff regulation***

*Safeguard measures*

From 23 September 2015, Decision of the Collegium of the Eurasian Economic Commission of August 18, 2015 “On implementation of anti-dumping measures regarding steel seamless pipes for drilling and exploitation of oil and gas wells originated from the People’s Republic of China and imported to the customs territory of the Eurasian economic Union” in compliance with which anti-dumping duty is introduced for the period of 5 years on Chinese seamless pipes used for drilling and exploitation of oil and gas wells. The rate of anti-dumping duty will constitute 12.2% to 31% of the customs price.

Presently the Customs Union boasts of 13 measures aimed at protection of domestic market (Table 42).

*Table 42*

**Measures to protect domestic market in the Customs Union**

<b>№</b>	<b>Product</b>	<b>Measure type</b>	<b>Exporter</b>	<b>Expiration date</b>
AD-1	Certain types of steel pipes	Anti-dumping	Ukraine	05.07.2016
SG-7	Combine harvesters and modules	Special protective	All countries	21.08.2016
SG-8	Dishware and kitchen utensils made of porcelain	Special protective	All countries	28.09.2016
AD-8	Rolled steel with polymer coating	Anti-dumping	China	30.06.2017
AD-3	Rolling bearings	Anti-dumping	China	20.01.2018
AD-12	Enamel-painted cast-iron baths	Anti-dumping	China	25.01.2018
AD-9	Graphitized electrodes	Anti-dumping	India	25.01.2018
AD-11	Cold-worked seamless stainless steel pipes	Anti-dumping	China	14.05.2018
AD-10	Light commercial motor vehicles	Anti-dumping	Germany, Italy, Turkey	14.06.2018
AD-7	Forged steel rolls for rolling mills	Ukraine	Ukraine	25.06.2019
AD-15	Citric acid	Anti-dumping	China	09.04.2020
AD-14	Kitchen utensils and table wear from steel	Anti-dumping	China	18.06.2020
AD-16	Seamless steel pipes for drilling and exploitation of oil and gas wells	Anti-dumping	China	22.09.2020

Source: [http://www.eurasiancommission.org/ru/act/trade/podm/mery/Pages/measures\\_list\\_applied.aspx](http://www.eurasiancommission.org/ru/act/trade/podm/mery/Pages/measures_list_applied.aspx)

*Restrictive measures against goods from EEU member states*

In December 2015, the Eurasian Economic Commission released a report on restrictive measures applied to products from the EEU member states.<sup>1</sup> The Eurasian Economic Commission on the findings of monitoring conducted in H2 2015 disclosed implementation of 138 measures, which have negative impact or can negatively affect the access of EEU member states goods on the markets of third countries. Nearly 64% of all disclosed restrictions represent

<sup>1</sup> <http://www.eurasiancommission.org/ru/act/trade/dotp/Pages/dostup.aspx>



protectionist measures (89 measures) of which 58 measures (42%) represent antidumping measures and investigations, 22 measures (15.9%) are special protectionist ones and investigations and 3 represent compensatory (*Table 43*).

*Table 43*

### Types of restrictive measures used by third countries

Restrictive measure	2014	2015
Anti-dumping measures (including agreements on suspension anti-dumping investigations)	46	48
Anti-dumping investigations	6	10
Special safeguard measures	10	22
Special protective investigations	15	6
Compensatory investigations	1	3
HWDP measures (including threats brining in HWDP measures)	13	14
SPS measures	6	6
Quotas (including tariff quotas)	7	6
Excises and levies	6	5
Ban on imports (including threats to impose ban)	4	3
Other nontariff measures	14	15
<b>Total</b>	<b>128</b>	<b>138</b>

*Source:* EEC report on restrictive measures applied to the goods from EEU member states.

2015 saw high-intensity protectionism on the part of third countries in relation of the key export products from EEU member states such as metal products, fertilizers and well as agricultural goods. The most difficult from the point of view of entry are steel markets. For example, in 2015, a number of American companies (Nucor, US Steel Corp, ArcelorMittal USA, etc.) launched the US exit from the Agreement on discontinuing anti-dumping investigation regarding hot-rolled iron from the Russian Federation signed in July 1999. The US Department of Commerce have launched an anti-dumping and countervailing investigation in relation to Russian cold-rolled mill products.

In 2015, European Union extended until 2020 anti-dumping duties on welded pipes from the Russian Federation and the Republic of Belarus. Following the investigation results the EU took a decision to apply anti-dumping measures against grain-oriented steel. It also started an anti-dumping investigation against cold-rolled mill products and applied preliminary duty in the framework of the ongoing anti-dumping investigation against aluminum foil from the Russian Federation.

Anti-dumping and special safeguard measures against products of the metallurgical industry of the Republic of Belarus, Republic of Kazakhstan and the Russian Federation are effective on the markets of key Asian partners (Turkey, India, Thailand and Indonesia).

Out of all existing technical barriers, one can point out the bans on trade in and use of asbestos-containing materials in the EU and Iran, the EU REACH chemicals policy, the EU classification of nickel compounds as potentially hazardous and corresponding tougher regulations governing trade in such compound.

SPS measures having the effect of barriers to trade were identified in the EU, Ukrainian and Chinese markets. Measures of this kind apply to meat, animal products, grain and fodders, which originate from the Russian Federation.

Ограничительные меры в отношении товаров ЕАЭС применяются 26 странами. The highest number of restrictions apply EU (22 measures), Ukraine (21), India (13), Turkey (12), the USA (9) and Uzbekistan (7).

Russian products face 109 measures, including anti-dumping duty – 39, special safeguard duty – 15, countervailing duty – 1 and other non-tariff measures – 54 (administrative measures including additional levies and restrictions on nomenclature – 21, technical barriers – 9, non-

tariff quotas – 3, quota restrictions – 1, excises on discriminatory basis – 4, bans on imports - , sanitary and phytosanitary measures – 7 and prospects to apply measures – 6).

#### 4.9. Russia's participation in WTO trade disputes<sup>1</sup>

With Russia's accession to the World Trade Organization (WTO) on August 22, 2012, the country joined the mechanism of settlement of trade disputes in the WTO. Such a mechanism operates in the WTO in accordance with the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU).<sup>2</sup> So, from August 2012 Russia has the right to protect its trade interests by means of the above instrument.

The procedure for settlement of trade disputes in the WTO consists of the following five subsequent stages:

1) *holding of bilateral consultations* (within 60 days from the day of request to hold consultations);

2) *establishment of a panel* at the request of any party to the dispute and selection of panel members for considering the essence of the dispute (within 45 days from the day of submission of request to establish a panel);

3) *work of the panel* (within 6–9 months from the day of commencement of the work of the panel) and acceptance of the panel's findings by the Dispute Settlement Body (DSB) and the DSB's recommendations (about 60 days from the day of submission of the panel's findings);

4) *consideration of the case by the Appellate Body* in case of appeal by a party to the dispute (within 60–90 days from the day of filing of an appeal), acceptance of the Appellate Body's findings and notification of the DSB's recommendations to the parties (within 30 days from the day of submission of the findings by the Appellate Body);

5) *supervision by the DSB* over fulfillment of recommendations (maximum 15–18 months from the day of acceptance by the DSB of the findings by the panel or the Appellate Body).

According to the data as of the end of 2015, Russia participates in 38 WTO disputes: as a complaining country and defendant in 4 and 6 WTO disputes, respectively, while as a third party in 28 disputes.

##### 4.9.1. WTO trade disputes in which Russia participates as a complaining country

From the day of Russia's accession to the WTO, Russia filed 4 complaints to the DSB: 3 complaints against the EU and one against Ukraine.

##### ***DS474: The EU – Methods of Cost Adjustment and Determination of Measures in Respect of Imports from Russia (Russia)***

On December 23, 2013, Russia turned to the WTO with a request to hold consultations with the EU on cost adjustment methods used by the EU in calculation of a dumping margin in antidumping calculations.<sup>3</sup>

In 2002, the EU granted Russia the status of a country with a market economy, but despite that fact in determination of the dumping the EU kept using the so-called energy adjustments in respect of Russian exporters. With such an approach, the fact of a dumping was determined

<sup>1</sup> Authors of this section: Baeva M. – RANEP, Knobel A. – Gaidar Institute for Economic Policy.

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/dispu\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm).

<sup>3</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds474\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds474_e.htm).

on the basis of comparison of Russian export prices with those on internal markets of third countries. So, in calculation of a fair cost of goods the EU did not take into account prices at which Russian exporters bought gas or electric power, but used higher prices on the above commodities in other countries which did not have such a large amount of energy resources as Russia. As a result, the European antidumping measures largely limit Russian exports of such commodities to the EU.

It is to be noted that the EU replaces the duly supplied information on costs from Russian manufacturers and exporters by that from alternative sources, including statements by European manufacturers on introduction of antidumping measures. In addition to the above, the EU does not stop the antidumping investigation or antidumping measures when they are not needed and charges unreasonably higher antidumping duties above the dumping margin. Also, according to the Russian side the EU uses antidumping duties as a measure against alleged government subsidies.

As the dispute in question between Russia and the EU failed to be resolved at the stage of consultations, on June 4, 2014 Russia turned with a request to the DSB to establish a panel and at the DSB meeting held on July 22, 2014 such a panel was established. At present, that dispute is at the stage of selection of panel members.

***DS476: The EU – Measures which Have an Effect on the Energy Sector (Russia)***

On April 30, 2014, Russia turned to the WTO with a request to hold consultations with the EU on application of measures of the so-called *Third Energy Package*.<sup>1</sup>

The EC adopted the Third Energy Package in July 2009. The main document dealing with the natural gas market (Directive 2009/73/EU) sets general requirements to transportation, distribution, supply and storage of natural gas (including liquefied natural gas) in the territory of the EU.

According to the Third Energy Package, in the territory of the EU owners of main pipe-lines cannot be companies engaging in production of gas. They should either sell their assets in the EU or assign the right to manage pipe-lines to independent companies from the EU. In addition to that, if operator-companies are controlled by foreigners they have to go through a special certification procedure which sets additional requirements to such operators. For example, they have to prove that there is no threat to the EU energy security which procedure is not required if the pipeline is controlled by an EU company. According to Russia, that and other provisions of the Third Energy Package are in conflict with obligations of the EU in the WTO as regards the fundamental principles of nondiscrimination and access to the market.

As the dispute in question failed to be resolved at the stage of consultations, on May 11, 2015 Russia turned to the WTO with a request to establish a panel and at the DSB meeting held on July 20, 2015 such a panel was set up. At present, the dispute between Russia and the EU as regards the Third Energy Package is at the stage of selection of panel members.

***DS493: Ukraine – Antidumping Measures in Respect of Ammonium Nitrate (Russia)***

On May 7, 2015, Russia turned to the WTO with a request to hold consultations with Ukraine as regards Ukraine's antidumping measures introduced in respect of imports of ammonium nitrate from Russia.<sup>2</sup>

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds476\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds476_e.htm).

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds493\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds493_e.htm).

In accordance with Decision No.AD-315/2014/4421-06 of July 1, 2014 of Ukraine's Inter-Agency International Trade Commission, duties on ammonium nitrate imports from Russia were doubled – from 11.91% to 36.03% (for OAO Dorogobuzh – up to 20.51%) – with extension of their period for another five years. In 2014, the share of exports of ammonium nitrate (customs commodity code: 310230) to Ukraine amounts to 6.5% in Russia's total volume of that commodity, while its share in Ukraine's total imports, to nearly 89%.<sup>1</sup>

The essence of Russia's claim consists in adjustment of the cost in carrying out of anti-dumping investigations as it was in the dispute with the EU (DS474). In carrying out antidumping investigations in respect of ammonium nitrate, Ukraine does not take into account in calculation of the cost of production prices at which Russian producers bought electric power, but used instead prices from third countries, that is, applied the so-called "energy adjustments". According to Russia, Ukraine committed a number of violations in determination of the fact of dumping, in particular, no comparison of export prices on ammonium nitrate exported from Russia to Ukraine with the fair cost of similar goods meant for consumption in Russia was made.

So, Ukraine applies antidumping duties that exceed the dumping margin which was determined by means of comparison of the constructed fair cost of ammonium nitrate calculated by Ukraine on the basis of the information on costs and prices which have nothing to do with those on similar goods in Russia. In addition to the above, in carrying out antidumping investigation Ukraine did not give an opportunity to all the interested parties to protect their own interests as it failed to provide either non-confidential information or a summary of confidential information. Also, Ukraine carried out revisions of antidumping measures without any sufficient evidence of the need to do that.

Despite the fact that the recommended deadlines for holding consultations have already expired, the dispute in question is still at the stage of consultations.

***DS494: The EU – Methods of Cost Adjustment and Determination of Antidumping Measures in Respect of Imports from Russia (Russia) (the second complaint)***

On May 7, 2015, Russia filed another complaint against the EU as regards energy adjustment methods used by the EU as per Article 2.3 and Article 2.5 of the EU Council's Regulations No. 1225/2009 of November 30, 2009 on Protection from Dumping Imports from Countries which are not EU Member-States for calculation of a dumping margin in carrying out of anti-dumping investigations and revision of antidumping measures.<sup>2</sup>

Russia's above complaint against the EU is related in particular to the EU's antidumping measures in respect of Russian ammonium nitrate; those measures were applied within a five-year period as a result of revision of antidumping measures. As complaints are actually similar, the complaint in question comprises also antidumping measures introduced against imports of some Russian welded tubes and tubes made of steel and alloy-free steel, including measures applied within a five-year period as a result of revision of antidumping measures.

Russia believes that in carrying out by the EU of antidumping investigations in respect of ammonium nitrate and welded tubes the EU violated its obligations in the WTO as in calculation of the cost of production they used third countries' prices on electric power rather than Russian domestic prices, that is, energy adjustments were utilized and that situation caused considerable damage to Russian suppliers. According to the estimates of Russian experts, the

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<sup>1</sup> UN COMTRADE database // <http://comtrade.un.org/>.

<sup>2</sup>[https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds494\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds494_e.htm).

above EU's measures against Russia resulted in a situation where exports of Russian welded tubes to the EU virtually stopped (the measures have been in effect from 2008), while exports of ammonium nitrate from Russia to the EU fell 1.5 times over as compared to 2012 (in 2012 it amounted to nearly \$220m).<sup>1</sup> According to the data of 2014, about 30% of exports of Russian disputable goods goes to the EU, that is, it covers nearly 11% of European imports of ammonium nitrate (customs commodity code: 310230) and welded tubes (customs commodity code: 7305).<sup>2</sup>

In the course of consultations with the EU, Russia raised a number of disputable issues specified among other things in the first complaint against the EU on that matter (DS474). In addition to the above, according to the Russian side the EU carried out revisions of antidumping measures due to expiry of the period without substantial evidence of dumping's resumption or continuation. At present, the dispute in question is at the stage of consultations though the recommended deadlines for them are already over.

#### 4.9.2. WTO trade disputes in which Russia acts as a defendant

Within the frameworks of the WTO, Russia acts as defendant in six disputes. In most cases, complaints have been filed by the EU; Japan and Ukraine lodged one complaint each.

##### ***DS462, DS463: Russia – Car Recycling Tax on Transportation Means (DS462 (The EC), DS463 (Japan))***

On July 9, 2013 and July 24, 2013, the EU<sup>3</sup> and Japan<sup>4</sup>, respectively, turned to the WTO with a request to hold consultations as regards the so-called car recycling tax imposed on transportation means. The above tax was introduced in Russia from September 1, 2012 due to approval of Article 24 “Car Recycling Tax” of Chapter V of Federal Law No.89-FZ of June 24, 1988 on Industrial and Consumption Waste and Article 51 as amended of the Budget Code of the Russian Federation.<sup>5</sup>

The EU's main claim consists in the fact that while domestic transportation means in Russia may formally be subject to a car recycling tax, in reality under certain conditions they were actually exempted from it. The car recycling tax is not charged on vehicles manufactured by entities which have assumed a responsibility to ensure a subsequent safe handling of waste occurred as a result of a loss by transportation vehicles of their use properties. It is to be noted that a manufacturer-entity should be a legal entity registered in the territory of the Russian Federation. Under certain conditions, exemption from payment of the car recycling tax is granted to vehicles imported from Belarus and Kazakhstan.

In addition to the above, according to the EU the pattern of the car recycling tax is a kind of protection of national production. The above tax is a progressive one in respect of different categories of transportation vehicles. Also, the difference is made between “new” transportation vehicles and “those manufactured over three years ago”, so the levels of tax rates greatly vary.

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<sup>1</sup> Russia filed a complaint in the WTO against Ukraine and the EU // <http://www.wto.ru/2015/05/07/>

<sup>2</sup> UN COMTRADE database // <http://comtrade.un.org/>.

<sup>3</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds462\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds462_e.htm).

<sup>4</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds463\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds463_e.htm).

<sup>5</sup> Resolution No. 870 of August 30, 2012 of the Government of the Russian Federation on Car Recycling Tax on Wheeled Vehicles.

As consultations failed to resolve the dispute in question, on October 11, 2013 the EU turned with a request to the DSB to set up a panel and on November 25, 2013 it was established. From 1 January 2014, the Russian Government obligated domestic manufacturers to pay a car recycling tax on a common basis.<sup>1</sup> Despite that, the EU did not recall its request in the WTO to set up a panel as it believes that the amount of the tax should not depend on a car engine volume and there is a big difference between the tax amount charged on new and used cars in tax calculation methods. At present, the dispute in question is at the stage of selection of panel members.

Japan which filed a request for consultations with Russia as regards car recycling tax, too, has similar claims and reasons. In addition to the above, Japan believes that Russia violated the Agreement on Technical Barriers in Trade.

***DS475: Russia – Measures Affecting the Imports of Live Hogs, Pork and Other Pork Products (the EU)***

Early in April 2014, the EU turned to the WTO with a request to hold consultations with Russia as regards a ban on delivery to Russia of pork and hogs from the EU countries due to a threat of African pig plague (APP) and introduction of limitations on delivery of all the types of prefabricated pork meat products from Poland and Lithuania.<sup>2</sup>

The Rosselkhoznadzor proposed to carry out regionalization of the EU territory as regards APP and introduce a new veterinary health certificate in respect of pork meat; the certificate should reflect changes in the epizootic situation in the EU. The EU calculated that the total ban on pork deliveries to Russia was a disproportionate measure which was in conflict with WTO norms as in reality there were only a few insignificant cases of APP infection of wild boars on the border with Belarus and those cases were effectively localized.<sup>3</sup> In addition to the above, the EU accused Russia of a failure both to notify properly WTO-members of goods in respect of which the measures in question were applied and provide a summary report on substantiation of those measures and their goals. So, Russia does not provide a reasonable period of time to other WTO-members to prepare comments and discuss the issue.

It is to be noted that the share of the EU's exports of pork and pork products to Russia in the total volume of the EU's exports of those products amounts to 9%, the share of the imports of pork and pork products from the EU in Russia's total imports of those products, to 57%, the share of exports of live hogs from the EU to Russia in the EU's total exports of live hogs, to 0.6%, while the share of imports of live hogs from the EU in Russia's total imports of live hogs, to 54%.<sup>4</sup>

As consultations failed to resolve the dispute, on June 27, 2014 the EU turned with a request to the DSB to set up a panel and a month later it was established. On April 22, 2015 the chairman of the panel informed the DSB that submission of the panel's findings was expected in February 2015 in accordance with the time schedule approved upon consultations between the parties.

The dispute in question points to importance of application of sanitary and phytosanitary measures in accordance with the WTO rules and the need of abandoning utilization of such

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<sup>1</sup> Federal Law No.278-FZ of October 21, 2013 on Amendment of Article 24.1 of the Federal Law on Industrial and Consumer Waste.

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds475\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds475_e.htm).

<sup>3</sup> The WTO Expertise Center // <http://wto.ru/documents.asp?f=sogl&t=13>.

<sup>4</sup> UN COMTRADE database // <http://comtrade.un.org/>.

measures as non-tariff ones which limit trade without substantial evidence confirmed on the basis of research.

***DS479: Russia – Anti-Dumping Duties on Light Commercial Motor Vehicles from Germany and Italy (the EU)***

On May 21, 2014, the EU turned to the WTO with a request to hold consultations with Russia as regards introduction of anti-dumping duties against light commercial motor vehicles from Germany and Italy.<sup>1</sup>

On May 14, 2013, the Eurasian Economic Commission (EEC) introduced for the term of five years anti-dumping duties on light commercial motor vehicles – with full weight of 2.8 tons to 3.5 tons included, diesel engine working cylinder volume of max. 3000 cubic cm and a “van” or “hatchback” body style – manufactured in Germany, Italy and Turkey. The duties were set as follows: 11.1% of the customs value in respect of Ford Otosan Sanayi Anonim Sirketi; 23% in respect of Italian Peugeot Citroen Automobiles SA; 29.6% in respect of manufacturers from Germany; 23% and 11.1% in respect of other manufacturers from Italy and Turkey, respectively<sup>2</sup>. In 2004, the import of light commercial vehicles from Germany in the total volume of Russian imports of disputable goods amounted to nearly 30%, while in Germany’s total exports of those goods, to 4%. As regards Italy, the above values are somewhat lower: 12% and 3%, respectively. As regards Turkey, in 2014 the share of imports of disputable goods from Turkey to Russia fell from less than 1% to 0% as compared to 2013.<sup>3</sup>

The EU believes that in carrying out antidumping investigations and taking measures in respect of light commercial vehicles from Germany and Italy Russia has violated a number of requirements of the Antidumping Agreement. In particular, it failed to determine properly the fair value, export prices and a dumping margin for each exporter on the basis of the available information, nor did Russia analyze all the economic factors affecting the state of its relevant industry, so, the damage caused to the industry was incorrectly attributed to the dumping imports as other factors were not taken into account. A cause-and-effect relation between imports and alleged damage to the domestic industry in question was not confirmed, either.

In addition to the above, according to the EU throughout the entire period of investigation Russia failed to provide the interested parties with the information related to identification of the fact of dumping or damage and treated for no good reasons the information from domestic manufacturers as confidential. It is to be noted that Russia does not require domestic manufacturers to provide a non-confidential summary which includes the essence of the information supplied on a confidential basis.

On September 25, 2014, the EU turned to the WTO with a request to set up a panel and at the DSB meeting on October 20, 2014 it was established. On June 11, 2015, the chairman of the panel informed the DSB that the work of the panel was postponed due to a lack of lawyers with the required experience at the Secretariat, so final findings for the parties involved could be expected not earlier than the end of 2016.

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds479\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds479_e.htm).

<sup>2</sup> Decision No.113 of May 14, 2013 of the Eurasian Economic Commission on Application of Antidumping Measures by Way of Introduction of Antidumping Duties in Respect of Light Commercial Vehicles Manufactured in Germany, Italy and Turkey and Brought to the Single Customs Territory of the Customs Union.

<sup>3</sup> UN COMTRADE database // <http://comtrade.un.org/>.

***DS485: Russia – Calculation of Import Duties on Some Agricultural and Industrial Goods (the EU)***

On October 31, 2014, the EU turned to the WTO with a request to hold consultations with Russia due to the fact that Russia charged import duties on some goods and that was in conflict with its obligations when it joined the WTO.<sup>1</sup>

In particular, duties of 15% or 10% on paper and cardboard applied in compliance with Decision No. 9 of January 29, 2014 of the Collegium of the Eurasian Economic Commission on Setting of the Customs Union's Import Customs Duty Rates of the Single Customs Tariff in Respect of Individual Types of Paper and Cardboard exceed the combined level of 5%. In addition to the above, as regards other goods, including palm oils and their fractions, refrigerators and combined refrigerators-freezers in cases where the customs value is below a certain level duties are charged above the combined level and that situation is a violation of the statutes on estimation of the customs value.<sup>2</sup>

In 2014, the share of imports from the EU to Russia of disputable goods amounted to 50% of the volume of Russian imports of those goods and nearly 4% of the total volume of European imports of those goods.<sup>3</sup>

As the dispute in question failed to be resolved at the stage of consultations, the EU turned to the WTO on February 26, 2015 with a request to set up a panel and at the DSB meeting on March 25, 2015 it was established. At present, the dispute in question between the EU and Russia is dealt with by the panel.

***DS499: Russia – Measures Limiting Imports of Railway Equipment and its Components (Ukraine)***

On October 21, 2015, Ukraine turned to the WTO with a request to hold consultations with Russia as regards measures limiting imports of railway equipment and its components (in particular, cars and railway points).<sup>4</sup>

On July 15, 2011, the Commission of the Customs Union of the Republic of Belarus, Republic of Kazakhstan and the Russian Federation (CCU) took Decision No.710 on Approval of Technical Regulations No.01/2011 of the Customs Union on Safety of Rolling Stock, Technical Regulations No.002/2011 on Safety of High-Speed Railway Transport and Technical Regulations No.003/2011 on Safety of the Railway Transport Infrastructure (hereinafter – Decision No.710 of the CCU). According to new rules, from August 2, 2014 all the certificates confirming components' and rolling stocks' compliance have to be registered with the Federal Budget Entity "Certification Register on the Federal Railway Transport" (FBE CRFRT).

By Decision No.285 of December 2, 2013 of the Collegium of the Eurasian Economic Commission on Amendment of Decision No.710 of July 15, 2010 of the Commission of the Customs Union, Decision No.710 of the Commission of the Customs Union was amended. A transition period (till August 1, 2016) for application of compliance certificates issued to manufacturers of components and rolling stocks before introduction of the above Technical Regulations was set. In addition to the above, a transition period (till August 1, 2016) was set for those goods

<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds485\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds485_e.htm).

<sup>2</sup> Decision No.52 of July 16, 2014 of the Collegium of the Eurasian Economic Commission on Setting of the Rates of Import Customs Duties in Respect of Individual Types of Goods in Accordance with Obligations of the Russian Federation Within the WTO Frameworks.

<sup>3</sup> UN COMTRADE database // <http://comtrade.un.org/>.

<sup>4</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds499\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds499_e.htm).



which earlier were not subject to mandatory confirmation of compliance in the form of certification. Compliance certificates earlier registered with the FBE CRFRT and issued to Ukrainian manufacturers of railway goods started to be suspended late in 2013.

Ukraine believes that Russian competent authorities justified suspension of those certificates both by technical issues and “a lack of relevant conditions for annual inspections to be carried out” of Ukrainian manufacturers’ production facilities. Despite the repeated requests, Ukraine’s exporters and authorized authorities did not receive from Russia explanations of suspension of compliance certificates. It is to be noted that in other countries of the Customs Union, there is no problem to receive such compliance certificates on the basis of Technical Regulation No.001/2011. However, those certificates are regarded invalid by Russian authorized authorities.

In December 2014, Ukrainian manufacturers of railway points applied for certificates in accordance with new requirements specified in the Customs Union’s Technical Regulations No. 003/2011. However, in February 2015 those applications of Ukrainian manufacturers were turned down by Russian competent authorities.<sup>1</sup>

As a result of the above, the export of railway equipment and its components from Ukraine to Russia fell considerably: from \$1.7bn in 2013 to \$600m in 2014. It is to be noted that from 2014 to 2014 there was a considerable reduction of nearly 66% in Ukrainian exports of disputable goods in general. The share of imports of disputable goods from Ukraine to Russia in the total Ukrainian exports of those goods fell within that period from 61% to 35%, while in Ukraine’s exports it remained virtually on the same level and amounted to 73%.<sup>2</sup>

Ukraine’s main claims are related to the fact that Russia discriminates against goods of the Ukrainian origin as compared to similar goods from other WTO member-states and domestic products. It is to be noted that Russian measures resulted in creation of excessive obstacles in the international trade, but Russia did not respond to Ukraine’s request to explain the need of such controversial measures. In addition to the above, Ukraine believes that the Russian competent authorities violated a number of procedures for evaluation of compliance. It is to be noted that requirements of Russian competent authorities as regards evaluation of compliance were beyond the required ones set to the information and amount of payment. At present, the dispute in question is at the stage of consultations.

#### 4.9.3. WTO trade disputes in which Russia participates as a third party

From the day of Russia’s accession to the WTO in August 2012, Russia participated in 28 disputes within the WTO frameworks as a third party. Russia’s participation in one or another dispute is usually justified not only by substantial trade interest alone, but also, to a greater extent, a practice of participation in disputes on concrete issues, as well as interest in application of some or other WTO’s norms and rules. In most cases, Russia joins the disputes against the EU, China and the US.

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<sup>1</sup> Letter No. 01305 of February 9, 2015 of the Federal Budget Entity “Certification Register on the Federal Railway Transport” on Rejection of the Application to Issue New Compliance Certificates in Respect of Some Railway Goods (Railway Points).

<sup>2</sup> UN COMTRADE database // <http://comtrade.un.org/>.

All the WTO disputes which Russia joined as a third party can be notionally divided in the following three main issues<sup>1</sup> related to:

- 1) a ban on imports (for ecological or other reasons) (DS400, DS401, DS469, DS484, DS495);
- 2) antidumping, compensation and special protectionist investigations and measures introduced on the basis thereof (DS414, DS437, DS449, DS454, DS468, DS471, DS473, DS480, DS488, DS490, DS496);
- 3) export limitations (DS431, DS432, DS433);
- 4) intellectual property rights (DS441, DS458, DS467);
- 5) subsidies (including tax and other privileges) (DS456, DS472, DS487, DS497, DS489);
- 6) tariffs (DS492).

It is to be noted that sometimes formally different disputes originating from different complaining countries are related to one and the same alleged limitation/violation of the defendant, for example, disputes of Canada (DS400) and Norway (DS401) over the ban on imports and sale of seal products to the EU.

***DS400, DS401: The EU – Measures Banning Imports and Sale of Seal Products (DS400 (Canada), DS401 (Norway))***

On November 2, 2009 and November 5, 2009, Canada<sup>2</sup> and Norway<sup>3</sup>, respectively, turned to the WTO with a request to hold consultations with the EU as regards the ban on imports and sale of seal products introduced in compliance with EU Regulations No. 1007/2009 and EU Regulations No. 737/2010.

The main claim of complaining countries is related to a discriminating component of the measure as there are certain exceptions (in case of the natives' traditional hunting) which grant privileged access for seal products produced in the EU and some third countries (Greenland) to the EU.

The disputes in question failed to be resolved at the stage of consultations, so, on October 4, 2012 at the request of Canada and Norway a joint panel was set up and it presented its findings on November 25, 2013, while the Appellate Body (both complaining countries and defendants lodged an appeal) issued its findings on May 22 2014. The Appellate Body came to a conclusion that the EU's technical measures were not a technical regulation, however, it recognized that they violated the WTO's main principle, that is, the most favorable treatment regime (MFT) as the same privileges which were granted to seal products from Greenland were not granted unconditionally and promptly to those from Canada and Norway. In addition to the above, the Appellate Body believes that the EU failed to justify properly application of the above measures by "general exceptions" in accordance with Article XX of the 1994 General Agreement on Tariffs and Trade (GATT-1994).

The DSB's recommendations as regards harmonization of the EU's measures with the norms and rules of the WTO were made public on June 18, 2014. The parties agreed on a reasonable period for the EU – 16 months from the day of approval of the panel's findings – to implement the decision of the DSB.

Russia took interest in participation in that dispute as from March 16, 2009 it stopped seal production and banned trade in Greenlandic seal skins (including those imported from other

<sup>1</sup> See Bayeva (2014) Trade Disputes in Which Russia Participates within WTO Frameworks and Mechanisms of Resolution Thereof // The Russian Foreign Economic Bulletin, 3. pp. 75-90.

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds400\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds400_e.htm).

<sup>3</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds401\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds401_e.htm).

countries). In accordance with Decision No.134 of August 16, 2012 of the Eurasian Economic Commission and amendments introduced by Decision No. 30 of April 21, 2015 of the Collegium of the Eurasian Economic Commission, the list of goods banned for import to the customs territory of the Eurasian Economic Union and (or) export from the customs territory of the EEU includes Greenlandic seal and seal calf products. In accordance with the legislation of the EEU, the imports of the above products are permitted if they were produced by way of traditional hunting carried out by the natives of the Arctic and Subarctic regions, including the Yupiks and the Inupiats (Alaska), the Inuits and the Inuvialuits (Canada) and the Kalaallits (Greenland) and that fact is to be proved by a certificate – issued in conformity with the form approved by the European Economic Commission – of the country of origin.

Prior to 2009, Russia used to be a major sales market for seal skins; it imported up to 90% of seal skins from Greenland. The dispute in question is the case where Russia is on the side of the defendant and not the complaining party as Russia has a regulation which is similar to that of the defendant.

***DS469: The EU – Measures in Respect of Atlantic-Scandinavian Herring (Denmark)***

In November 2013, on behalf of the Faroe Islands Denmark turned to the WTO with a request to hold consultations with the EU as regards measures taken against the Faroe Islands regarding Atlantic-Scandinavian herring and North-Eastern Atlantic scomber.<sup>1</sup>

In accordance with the international law principles, the Faroe Islands use sovereign rights for the purpose of utilization, preservation and management of living marine resources. The EU banned imports to its territory of the above types of fish which was caught by fishing boats sailing under the flag of the Faroe Islands; in addition to the above a ban was introduced on production in the EU of products made of the above types of fish.

According to the complaining country, the EU's above measures mainly violate the most favorable treatment regime and provisions of the article on general abolishment of quantitative limitations – under the above article it is prohibited to introduce any bans on imports or quantitative limitations (by way of quotas, import or export licenses and other measures) apart from tax duties or other charges with the exception of a number of cases – and limit freedom of transit.

Despite the fact that on January 8, 2014 Denmark turned to the WTO with a request to set up a panel which was established by the DSB two months later the dispute in question was settled by means of a mutually acceptable solution achieved on August 21, 2014. The EU agreed to put an end to the ban on imports and other measures against the Faroe Islands in respect of disputable goods.

Russia's interest in participation in the dispute in question is mainly justified by the fact that Russia is one out of five coastal states between whose respective zones Atlantic-Scandinavian herring is distributed. So, an indirect benefit for Russia consists in the fact that if the EU does not have the right to ban imports of Atlantic-Scandinavian herring and herring-processed products from the countries between whose respective zones that sort of fish is distributed the EU has no right to ban imports of disputable goods from Russia, either.

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds469\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds469_e.htm).

***DS484: Indonesia – Measures in Respect of Chicken Meat and Chicken Meat Products (Brazil)***

On October 16, 2014, Brazil turned to the WTO with a request to hold consultations with Indonesia on some measures introduced by the latter in respect of imports of chicken meat and chicken meat products.<sup>1</sup>

According to Brazil, Indonesia applies restrictive measures and procedures which impede imports of Brazilian chicken meat and chicken meat products to the Indonesian market. For example, Indonesia does not accept the Brazilian hygienic certificate despite the fact that Brazil provided all the required and even additional information. According to the Brazilian side, Indonesia's measures which are not based on relevant international standards, rules and recommendations, in particular, those related to the quarantine on imports of chicken meat and chicken meat products are introduced beyond the necessary level of control and limit and discriminate against Brazilian exports.

Indonesia actually introduced a non-automatic import licensing regime in respect of chicken meat and chicken meat products. According to Brazil, that regime unjustifiably limits the trade. A license can be secured only for a short period of time and includes limitations as regards ports of arrival. In addition to the above, imports of chicken meat and chicken meat products are to be approved in advance by the Ministry of Agriculture which has the right to limit the quantity, places of destination and/or use of those products. The relevant documents have short terms of validity, too, and the mode of issuing thereof is not quite transparent. According to Brazil, Indonesia introduces pre-shipment inspection requirements which may be of a discriminatory nature and cause unjustified delays. In addition to the above, measures related to a new pricing policy and import management – which measures may impose limitations on the domestic supply of “strategic goods” including chicken meat – are applied.

On October 15, 2015, Brazil turned to the WTO with a request to set up a panel and on December 3, 2015 it was established. At present, the dispute in question is at the stage of selection of panel members.

Participation in that dispute is interesting to Russia primarily in terms of procedural insight into a wide-range of the WTO's norms and rules, including those in the field of sanitary and phytosanitary measures and technical barriers. It is to be noted that Russia does not export disputable goods to Indonesia which situation may be related to some extent to Indonesia's limitations on imports.<sup>2</sup>

***DS495: Republic of Korea – A Ban on Imports and Requirements to Carrying Out of Testing and Certification of Radioactive Materials (Japan)***

On May 21, 2015, Japan turned to the WTO with a request to hold consultations with the Republic of Korea as regards the following measures introduced by the latter after the accident at the Fukushima-1 nuclear power plant due to the earthquake in Japan in March 2011<sup>3</sup>:

- 1) a ban on imports of some food products;
- 2) additional requirements to carrying out of testing and certification of existence of specific radioactive materials;

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds484\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds484_e.htm).

<sup>2</sup> UN COMTRADE database// <http://comtrade.un.org/>.

<sup>3</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds495\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds495_e.htm).

3) a number of alleged violations of obligations as regards transparency in accordance with the Agreement on Application of Sanitary and Phytosanitary Measures.

Japan complains mainly about lack of transparency and not about the fact that those measures were introduced because the Republic of Korea failed to publish properly the list of those measures with specification of evidence on the basis of the information supplied on burial of radioactive waste in Japan. Japan repeatedly made an effort to discuss those measures with the Republic of Korea and hold joint meetings of technical experts. Japan sought to show the Republic of Korea that sanitary and phytosanitary measures used in both the countries were similar. According to the complaining country, the Korean measures limit exports from Japan and are not based on relevant international standards and recommendations; it is to be noted that the Republic of Korea failed to provide Japan with the information which could help Japan understand the position of the Republic of Korea as regards those measures and resolve the dispute. Japan believes that the measures in question violate the principle of the national regime as the requirements to the information used for control and checking and approval procedures in respect of import goods were higher than those established for similar domestic products.

As the dispute in question failed to be resolved through consultations, on August 20, 2015 Japan turned to the WTO with a request to set up a panel and at the DSB meeting on September 28, 2015 it was established.

Russia participates in that dispute as after the Fukushima accident it introduced a ban on imports of fish from Japan; the ban was lifted only in July 2015. Also, the dispute in question is interesting to Russia in terms of procedures, while the practice of participation in the discussion is useful to Russia in terms of application of sanitary and phytosanitary measures in compliance with the WTO's norms and rules.

***DS414: China – Compensation and Antidumping Duties on Cold-Rolled and Regular Grain-Oriented Steel from the USA (the USA)***

On September 15, 2010, the US turned to the WTO with a request to hold consultations with China as regards introduction of compensation and antidumping duties in compliance with Public Notification No.21 of 2010 of the Ministry of Trade of China in respect of cold-rolled and grain-oriented steel from the US.<sup>1</sup>

The US's main claims are related to the procedure for carrying out compensation and anti-dumping investigations in China. In particular, according to the US in such investigations there is lack of an adequate summary of confidential information, important facts are concealed, duties for all other exporters are determined incorrectly, price effects of the alleged dumping imports were determined without unbiased analysis and proper evidence and the cause-effect relation between the alleged dumping of imports and damage to the industry was determined improperly.

To solve that dispute a panel was established on March 25, 2011. The panel's findings were presented on June 15, 2012. Late in July 2012, China filed an appeal to the Appellate Body whose findings were presented on October 18, 2012. In mid-November 2012, the DSB rules that China introduced antidumping and compensation duties in respect of cold-rolled and regular grain-oriented steel from the US in a way which violates China's obligations under the agreements on antidumping, subsidies and compensation measures and advised China to bring those measures in compliance with provisions of the above agreements.

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds414\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds414_e.htm).

On July 31, 2013, China adjusted measures which caused the dispute in accordance with the procedure provided for by Public Notification No.51 of 2013 of the Ministry of Trade of China and annexes thereto. However, in mid-January 2014 the US requested consultations, while on February 13, 2014 the US turned to the WTO with a request to set up a panel on the procedure for fulfilment of obligations and such a panel was later established. The US believes that China's revision of its measures does not fully comply with the WTO's norms and rules. On March 27, 2014, a panel for checking compliance was established and on July 31, 2015 the panel's findings were presented to the parties to the dispute. A month later, at its meeting the DSB accepted the above findings with recommendations to bring the measures in compliance with the WTO's norms and rules. In the meantime, China reported that on April 10, 2015 it abolished antidumping duties on anisotropic electrical steel not only from the US, but from Russia, as well.

From February 26, 2014, Russia joined that dispute as a third party. For Russia, that issue is very important as those antidumping and compensation measures are applied not only in respect of cold-rolled and regular grain-oriented steel from the US, but from Russia, as well. So, apart from the practice of settlement of disputes regarding antidumping and compensation measures Russia indirectly benefited from participation in that dispute because those duties were abolished.

#### ***DS437: the US – Compensation Duties on Some Goods from China (China)***

On May 25, 2012, China turned to the WTO with a request to hold consultations with the US as regards introduction by the latter of compensation duties on some Chinese goods.<sup>1</sup>

According to China, it encounters various difficulties in accessing the US investigation findings on which basis compensation measures against China were introduced. China refers to about 20 such investigations initiated by the US and related mainly to metallurgical and steel industry goods (for example, pipelines, steel wheels, steel wires and other). China believes that the US determines incorrectly a state-owned enterprise which grants similar subsidies by way of sale from a parental company to a subsidiary as a "public agency". Also, China noted that the US Trade Department initiated an investigation without sufficient evidence; in particular, it could not prove that a subsidy was specific to the enterprise or industry. It is to be noted that the US Trade Department determines incorrectly the advantage (as the basis for dismissal of the existing actual sale prices in China as a reference point), thus distorting the current market conditions in China.

On August 20, 2012, China turned with a request to the DSB to set up a panel, a month later the panel was established and it presented its findings on July 14, 2014. Late in August, both the sides filed appeals to the Appellate Body. On January 16, 2015, the DSB accepted the Appellate Body's and the panel's findings with recommendations to bring measures in compliance. On October 9, 2015, arbitration set a reasonable period (which expires on April 1, 2016) for the US to bring its measures in compliance with the WTO's norms and rules.

Russia's interest in participation in the dispute in question is justified not only by substantial trade interest in disputable industries (the metallurgy and steel industries), but also the practice of participation in disputes on compensation measures to get a better understanding of enforcement of relevant provisions of the Agreement on Subsidies and Compensation Measures.

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds437\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds437_e.htm).

***DS449: The US – Compensation and Antidumping Measures in Respect of Some Goods from China (China)***

On September 17, 2012, China initiated a dispute with the US as regards compensation and antidumping measures in respect of some goods from China.<sup>1</sup>

China carries out about 30 compensation investigations and 30 antidumping investigations which mainly deal with metallurgical and steel industry goods. China's main claims are related to:

- Part 1 of US Public Law 112-99 “Act on Application of Compensation Duties under US Tariff Act 1930 in Respect of Non-Market Economies and For Other Purposes” which became effective on March 13, 2012;
- Existence of antidumping measures along with compensation measures under which “dual means of damage compensation” arise in 25 parallel compensation and antidumping investigations initiated in the 2006-2012 period and covering imports from China as a country with a non-market economy in accordance with the US legislation.

In addition to the above, China believes that the US violates the 1994 GATT as provisions of the US legislation were not “published immediately” to be available for familiarization with by governments and traders and started to be applied in the US prior to official publication. It is to be noted that according to China US laws and norms related to application of compensation measures in respect of imports from countries with non-market economies are not “unified, impartial and justified”.

To solve the dispute, at China's request a panel was established on December 17, 2012 and it presented its findings late in March 2014. In April 2014, both the parties to the dispute filed appeals as regards legal norms used in the panel's findings and interpretation thereof. The Appellate Body's findings were presented on July 7, 2014. At its meeting on July 22, 2014, the DSB accepted the findings of the Appellate Body and the panel's findings – adjusted by those of the Appellate Body – with recommendations for the US to bring its measures in compliance with the US obligations in the WTO. On February 20, 2015, China and the US informed the DSB that they agreed on a reasonable period needed by the US for fulfillment of the recommendations and requirements of the DSB, that is, 12 months from the day of acceptance of the findings of the Appellate Body and the panel; then the above period can be extended by the parties. On August 21, 2015, China and the US informed the DSB of the application procedure.

Russia participated in the dispute in question as it had substantial interest in disputable industries (the metallurgy and steel industry). In addition to the above, Russia is interested in the practice of participating in disputes related to antidumping and compensation measures to get a better understanding of enforcement of the WTO's relevant provisions.

***DS454: China – Antidumping Measures in Respect of Heavy Duty Seamless Stainless Steel Pipes (“HP-SSST”) from Japan (Japan)***

On December 20, 2012, Japan turned to the WTO with a request to hold consultations with China as regards antidumping measures in respect of heavy-duty seamless stainless steel pipes (“HP-SSST”) from Japan set out in Notification No.21 and Notification No.72 of 2012 of the Ministry of Trade of China.<sup>2</sup>

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds449\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds449_e.htm).

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds454\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds454_e.htm).

Japan's main claims are related to the fact that antidumping investigations carried out by China and antidumping measures introduced on the basis of those investigations in respect of disputable goods do not comply with the WTO's norms and regulations. In particular, it is related to the beginning of the investigations and their progress, determination of the fact of damage, evidence, public notification and explanation of decisions. In addition to the above, the Ministry of Trade of China failed to provide in a proper way its methods of calculation of a dumping margin.

On April 11, 2013, Japan turned to the WTO with a request to set up a panel and it was established on May 24, 2013, while on February 13, 2015 the panel presented its findings. Late in May 2015, both the sides filed appeals, and the Appellate Body presented its findings on October 14, 2015. On October 28, 2015 the DSB accepted the findings of the panel and the Appellate Body with recommendations for China to bring its measures in compliance with the WTO's norms and rules.

Russia's interest in participation in the above dispute is justified both by its trade interest in the dispute and the fact that procedures for carrying out antidumping investigations in China are important to Russia in terms of antidumping measures applied by China in respect of Russian goods (mainly chemical industry goods).

***DS468: Ukraine – Special Protective Measures as Regards Determination of Motor Cars (Japan)***

On October 30, 2013, Japan turned to the WTO with a request to hold consultations with Ukraine as regards protective measures introduced by the latter in respect of imports of some cars and the investigation which resulted in application of those measures.<sup>1</sup>

On April 28, 2012, Ukraine's Interdepartmental Commission on International Trade approved Decision No.SP-275/2012/4423-08 under which special protective measures in the form of the following two additional duties – 6.46% and 12.95% for cars with gasoline engine volumes of 1000-1500 cubic cm and 1500–2200 cubic cm, respectively – were introduced.

Japan's claim consists in the fact that the special protection investigation was carried out in Ukraine with errors and violations of relevant provisions of the WTO. In particular, serious damage or a threat of serious damage to the industry, effective period of those measures and the period of gradual liberalization thereof, the level of concessions and other obligations were determined incorrectly. In addition to the above, proper conclusions as regards the cause-effect relation between alleged growth in imports of disputable goods and damage to the industry failed to be made. It is to be noted that Ukraine introduced special protection duties beyond the necessary level. As regards procedural requirements, Japan's claims are related to the investigation which was carried out prior to introduction of special protective measures, the investigation's findings which included the main conclusions and the obligation to notify WTO members and hold consultations with exporters from WTO countries on disputable issues.

On February 13, 2014, Japan turned to the WTO with a request to set up a panel and at the DSB meeting on March 26, 2014 it was established; the panel presented its findings to the parties to the dispute on June 26, 2015. At its meeting on July 20, 2015, the DSB accepted the findings of the panel and rules that Ukraine should abolish special protective measures in respect of cars. On October 6, 2015, Ukraine informed the DSB that Ukraine's Interdepartmental

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds468\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds468_e.htm).



Commission on International Trade approved Decision No. SP-335/2015/4442-06 of September 10, 2015 to lift protective measures in respect of cars starting from September 30, 2015.

Russia's participation in the dispute can be explained by Russia's substantial trade interest as the share of Russia's exports of disputable goods to Ukraine in Russia's total exports of such goods amounted to about 20% in 2013, while special protective measures are introduced against all the imports regardless of the source and, consequently, affect Russia's interests, too.<sup>1</sup> In addition to the above, the dispute in question is important in terms of better understanding of the procedure for application of protective measures in compliance with the WTO's norms and rules and the practice of participation in such disputes.

***DS471: The USA – Specific Methods and Application Thereof in Examination of Anti-dumping Cases in Which China is Involved (China)***

On December 3, 2013, China turned to the WTO with a request to hold consultations with the US as regards determination of methods used in antidumping investigations in which China is involved.

The subject matter of consultations is the methods of “nullification” used by the US in anti-dumping investigations to prevent point dumping, as well as methods used in antidumping procedures related to imports from countries regarded by the US as non-market economies. Point dumping is a kind of sale of goods at dumping prices only to individual buyers in individual geographic regions or at certain periods of time. In such cases, in antidumping investigations asymmetrical methods of comparison of a fair value and the export value of goods are normally applied for calculation of a dumping margin where the weighted average price of domestic sales is compared with each particular export deal.

In cases listed by China, the US Trade Department applied the methods of “nullification” when the weighted average price of export deals which was either higher or equal to the fair value was made equal to the zero and due to that factor such deals were disregarded in calculations of the dumping margin and the latter became overestimated. According to China, methods of “nullification” are in conflict with a number of provisions of the Antidumping Agreement as regards establishment of the fact of dumping, evidence and introduction and charging of antidumping duties.

On February 13, 2014, China turned to the WTO with a request to set up a panel and it was established on March 26, 2014, while five months later its members were selected. At present, the panel's findings are expected.

Russia filed an application for participation in the dispute as examination of complaints about application of methods of reviewing antidumping cases was of interest to it. Then, Russia filed similar claims against the EU as regards their methods of calculation of antidumping duties (DS474 and DS494). In addition to that, in 2013 the US carried out various antidumping investigations, including those in respect of Russian goods.

***DS473: The EU – Antidumping Measures in Respect of Bio-Diesel Fuel from Argentina (Argentina)***

On December 19, 2013, Argentina turned to the WTO with a request to hold consultations with the EU as regards antidumping investigations and antidumping measures introduced by the EU on the basis of the above investigations in respect of bio-diesel fuel from Argentina.<sup>2</sup>

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<sup>1</sup> UN COMTRADE database // <http://comtrade.un.org/>.

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds473\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds473_e.htm).

On August 29, 2012, the EU started an antidumping investigation as regards imports of bio-diesel fuel from Argentina and Indonesia, while on May 28, 2013 relevant antidumping measures were introduced. According to the complaining country, temporary and final antidumping measures introduced by the EU in respect of imports of bio-diesel fuel and the investigation procedure were in conflict with some provisions of the 1994 GATT and the Antidumping Agreement. In particular, it concerns violations related to establishment of the fact of dumping and damage, provision of evidence and introduction and charging of antidumping duties as antidumping duties introduced by the EU exceeded the dumping margin.

On March 13, 2014, Argentina turned to the WTO with a request to set up a panel and it was established on April 25, 2014, while panel members were selected on February 15, 2015. At present, the panel's findings are expected.

Generally, Argentina's claims are similar to those of Russia as regards value adjustment methods used by the EU in carrying out of antidumping investigations and calculation of antidumping duties (see disputes DS474 and DS494 in which Russia acts as a complaining country against the EU on similar issues).

***DS480: The EU – Antidumping Measures in Respect of Bio-Diesel Fuel from Indonesia (Indonesia)***

On June 10, 2014, Indonesia turned to the WTO with a request to hold consultations with the EU on the following issues:

- Provisions of Regulations No. 1225/2009 of the EU Council on Protection from dumping Imports from Non-EU Countries; and
- Antidumping measures introduced by the EU in May 2013 in respect of imports of bio-diesel fuel, including that from Indonesia.

Indonesia's main claims are related to the European methods, procedures and practice of cost adjustment in carrying out of antidumping investigations and calculations of antidumping duties.

On June 30, 2015, Indonesia turned to the WTO with a request to set up a panel and on August 31, 2015 it was established. At present, the dispute is at the stage of work of the panel.

Like the previous one, the dispute in question is closely related to Russia's complaints as regards cost adjustment methods used by the EU in carrying out of antidumping investigations and calculations of antidumping duties (DS474 and DS494).

***DS488: The USA – US Antidumping Measures in Respect of Specific Oil and Gas Pipes and Line Pipes from Korea (the Republic of Korea)***

On December 22, 2014, the Republic of Korea turned to the WTO with a request to hold consultations with the US due to antidumping measures taken in respect of oil and gas and line pipes from Korea and the methods of investigations which preceded introduction of those measures.

The Korean side's main claims are related to the fact that antidumping investigation procedures and US antidumping measures introduced on the basis of those procedures in respect of pipes from Korea were taken in violation of the WTO's norms and rules. It concerns violations in establishment of the fact of dumping, provision of evidence, information, public notification and explanations of decisions taken and publication of trade rules. For example, for the purpose

of determination of the fair value the US Trade Department used a constructed value and ignored mandatory respondents' data on actual sale prices on third countries' markets as the basis of determination of the fair value.

On February 23, 2015, the Republic of Korea turned with a request to set up a panel; at the DSB meeting on March 25, 2015 the panel was established and its members were selected on July 13, 2015. At present, the panel's findings are expected.

As the dispute in question is related to concrete issues which are of methodological importance to Russia, that is, utilization of certain methods due to application of the Antidumping Agreement (in particular, Article 2 "Establishment of the Fact of Dumping"), Russia is very interested in participation in that dispute between the US and the Republic of Korea. In addition to the above, the dispute in question is of substantial trade interest to Russia, as the share of Russia's exports of disputable goods to the US in the total volume of Russia's exports of those goods amounts to just over 35%, while in the total US imports of those goods it is equal to about 4%.<sup>1</sup>

***DS490, DS496: Indonesia – Special Protective Measures in Respect of Some Steel and Iron Products (DS490 (Chinese Taipei), DS496 (Vietnam))***

On February 12, 2015 Chinese Taipei turned to the WTO with a request to hold consultations with Indonesia as regards special protective measures introduced by Indonesia in respect of goods with customs commodity code: 7210611100 (metal-faced flat rolled iron or non-alloyed steel (min. 600 mm wide) products with galvanic or other coating with carbon content of less than 0.6% and thickness of max. 1.2 mm) and special protective investigation on which basis those measures were introduced.<sup>2</sup>

On June 1, 2015, Vietnam turned to the WTO with a request to hold consultations with Indonesia on the same issue.<sup>3</sup>

On December 19, 2012, Indonesia started an investigation into special protective measures; on the basis of the outputs of that investigation special protective measures were introduced. According to complaining countries, the investigation and special protective measures do not comply with the WTO's norms and rules. In particular, using the outdated data on imports Indonesia failed both to show properly substantial growth in imports and prove that it was a factor behind serious damage (or a threat of serious damage) to the domestic industry. In addition to the above, no explanations were given as to in what way factors which were not related to those imports could have caused serious damage to the domestic industry. Indonesia did not provide an opportunity to hold consultations on the information related to protective measures, either.

In addition to the above, complaining countries note that special protective duties introduced by Indonesia violate the total RNB as they are applied only to goods manufactured in certain countries, thus providing other countries with an advantage which is not granted immediately and unconditionally in respect of similar goods produced in all the WTO member-states. Indonesia excluded 120 developing countries, including Russia from the list of countries on whose certain types of flat rolled products special protective duties are charged.

On August 20, 2015 and September 17, 2015 Chinese Taipei and Vietnam applied, respectively, to the WTO with a request to set up a panel and it was established on September 28, 2015, however, its members are not appointed yet.

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<sup>1</sup> UN COMTRADE database // <http://comtrade.un.org/>.

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds490\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds490_e.htm).

<sup>3</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds496\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds496_e.htm).

Russia is interested in the practice of dealing with disputes related to application of special protective measures and carrying out relevant investigations on which basis those measures can be introduced. It is to be noted that despite the fact that special protective measures are introduced by the country due to dramatic growth in imports regardless of the source thereof (that is, against all the countries) Indonesia exempted developing countries (including Russia) from paying special protective duties.

In addition to the above, Russia's interest in that dispute may be indirectly linked to anti-dumping measures which are in effect in Indonesia from December 27, 2013 till December 26, 2018 against Russian-made flat hot-rolled products in coils. Those antidumping duties are rather high and amount to 20% in respect of some companies.<sup>1</sup>

***DS431, DS432, DS433: China – Measures Related to Exports of Rare-Earth Metals, Wolframium and Molybdenum (the US) (DS432 (the EU), DS433(Japan))***

On March 13, 2012, the US<sup>2</sup>, the EU<sup>3</sup> and Japan<sup>4</sup> initiated in the WTO disputes against China as regards measures limiting exports of rare-earth metals, wolframium and molybdenum: export duties, export quotas, minimum export price requirements, export licensing requirements and additional requirements and procedures in respect of quantitative limitations.

China accounts for nearly one-third of the known reserves of rare-earth metals and it produces over 90% of all the rare-earth metals consumed in the world. Rare-earth metals are utilized in different high-tech industries, such as electronic engineering, instrument engineering, nuclear engineering, machinery, the chemical industry and the glass industry. The complaining countries' claims are mainly related to the fact that China's measures as regards exports of rare-earth metals, wolframium and molybdenum are not unified, impartial and justified, nor are they published properly. In addition to the above, the complaining countries believe that China failed to prove that those measures were "general exceptions" (Article XX of the 1994 GATT), nor did those measures justify China's failure to fulfil its obligations to lift export duties in accordance with the Protocol on China's accession to the WTO.

As the disputes failed to be resolved at the stage of consultations, a panel was established on September 24, 2012. On March 26, 2014, the panel presented its findings, while in April 2014 the US and China filed appeals against the panel's findings to the WTO' Appellate Body which presented its findings on August 7, 2014. At the DSB meeting on May 20, 2015, China informed the DSB that in accordance with the notification of the Ministry of Trade and Customs of China export duties and export quotas in respect of rare-earth metals, wolframium and molybdenum, as well as other limitations in respect of enterprises exporting rare-earth metals, wolframium and molybdenum recognized as incompatible with the WTO rules were abolished. So, China fulfilled in full the DSB's recommendations.

Russia benefited indirectly from participation in the dispute as by virtue of cancelation by China of export limitations on rare-earth metals, wolframium and molybdenum the Russian steel industry gained an advantage (the above oars needed for production of special hard-melting steel are exported from Russia to China and after enrichment thereof are brought back

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<sup>1</sup> The Review of Substantial Limitations on Russian Goods Access to Foreign Markets // [http://www.ved.gov.ru/rus\\_export/partners\\_search/torg\\_exp/](http://www.ved.gov.ru/rus_export/partners_search/torg_exp/).

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds431\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds431_e.htm).

<sup>3</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds432\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds432_e.htm).

<sup>4</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds433\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds433_e.htm).

to Russia). In addition to the above, by participating in that dispute Russia learnt much about procedural issues related to settlement of trade disputes in the WTO.

***DS441, DS458, DS467: Australia – Some Measures in Respect of Trade Marks, Names of Place of Origin of Goods and Other Requirements to Simple Packing of Tobacco Products (DS441 (the Dominican Republic), (DS458 (Cuba), DS467 (Indonesia))***

On July 18, 2012, May 3, 2013 and September 20, 2013, the Dominican Republic<sup>1</sup>, Cuba<sup>2</sup> and Indonesia<sup>3</sup> turned, respectively, to the WTO with a request to hold consultations with Australia.

Australia approved a number of statutory acts which require that all the tobacco products should be sold in simple packings without any trade marks, colors, design and companies' logos. The complaining countries' main claim consists in the fact that the requirement to sell all the tobacco products in simple packings without any trade marks, colors, design and companies' logos is in conflict with intellectual property rights. In particular, Australia does not ensure effective protection from unfair competition, takes technical regulation measures beyond the level required in that situation and violates the principle of a national regime by granting domestic producers a more favorable regime than to foreign ones.

At its meeting on April 25, 2014, the DSB established a panel (including the one on disputes initiated by Ukraine (DS434) and Honduras (DS435) which Russia did not formally participate in). At present, the panels' findings are expected.

Russia's interest in participation in the dispute may be related to methodological issues of protection of intellectual property rights in accordance with the WTO's rules and norms. Many countries which joined the dispute believe that they should oppose the Australian law in question, otherwise a negative precedent may arise and other countries may follow the suit. Also, the practice of participation in disputes related to issues of technical regulation and intellectual property protection is important to Russia. At the same time, Russia may support the defendant in the dispute in question as it carries out an antismoking policy.

***DS456: India – Some Measures in Respect of Solar Cells and Solar Modules (the USA)***

On February 2013, the US turned to the WTO with a request to hold consultations with India as regards India's measures related to the share of domestic components for solar cells and solar modules.<sup>4</sup>

India demands that designers or users of solar energy plants should buy and use domestic solar cells and modules for the purpose of participation in the *National Mission of Solar Energy Development* program which major goal is to ensure India's leading position on the solar energy market by 2022. Designers and users of solar energy plants receive certain benefits (including subsidies) as they are guaranteed long-term tariffs on electric power. According to the US, the above policy is in conflict with the national regime principle as it results in a more favorable regime for import goods as compared to domestic ones. In addition to the above, those measures are a kind of prohibited subsidies in case of use of domestic, rather than import goods.

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds441\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds441_e.htm)

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds458\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds458_e.htm)

<sup>3</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds467\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds467_e.htm)

<sup>4</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds456\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds456_e.htm)

On April 14, 2014, the US turned to the WTO with a request to set up a panel and it was established on May 23, 2014; four months later panel members were selected. At present, the panel's findings are expected.

The dispute in question is of interest to Russia as the share of Russia's exports of those goods to India in Russia's total volume of exports of such goods exceeds 5%. Also, it can be stated that development of alternative energy sources is important to Russia. In addition to the above, the practice of participation in disputes related to provision of subsidies, including those granted due to utilization of domestic components in production is of interest to Russia.

***DS472, DS497: Brazil – Certain Measures Related to Taxes and Charges (DS472 (the EU), DS497 (Japan))***

On December 19, 2013, the EU turned to the WTO with a request to hold consultations with Brazil as regards measures related to taxes and charges in the motor sector, electronics and technology sector and free economic zones, as well as tax privileges for exporters.<sup>1</sup>

On July 2, 2015, Japan turned to the WTO with a request to hold consultations with Brazil on the same issues.<sup>2</sup>

The discriminatory tax privileges in question are related in particular to programs in the motor sector (Inovar Auto), as well as the electronics industry and related sectors (the Program for Promotion of the Semiconductor Sector (PADIS), the Program for Facilitation of Technological Development of Digital TV Equipment (PATVD) and the Program for Upgrading Availability of Digital Technologies for Broad Segments of the Population).

According to the complaining countries, such measures provide preferential treatment and support to Brazil's domestic producers and exporters which situation is in conflict with the national regime, a fundamental principle of the WTO. In particular, it happens due to a higher taxation of import goods as compared to domestic ones, tax privileges in utilization of domestic intermediary goods, as well as subsidies granted to exporters which export over 50% of their gross sales. In the course of consultations, only the issue related to tax privileges for goods manufactured in free economic zones was resolved, while other issues remained outstanding, so a panel was established in December 2014.

According to the 2013 data, the shares of both Russian exports to Brazil and imports from Brazil of respective groups of commodities amounted to less than 0.5%<sup>3</sup> due to which factor participation in the dispute was interesting to Russia in terms of application of the practice of taxes and duties and resolution of such disputes.

***DS487: The USA – Tax Privileges under Some Conditions for Large Civil Airplanes (the EU)***

On December 19, 2014, the EU turned to the WTO with a request to hold consultations with the US as regards tax privileges introduced by the State of Washington in respect of development, production and sales of large civil airplanes under certain conditions.<sup>4</sup>

In November 2013, the US largely expanded tax privileges to the aircraft industry to stimulate production by the Boeing Company of new models of large civil aircraft 777X in the State

<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds472\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds472_e.htm).

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds497\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds497_e.htm).

<sup>3</sup> UN COMTRADE database // <http://comtrade.un.org/>.

<sup>4</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds487\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds487_e.htm).

of Washington and granted additional subsidies worth billion US dollars to the Boeing Company, including those for utilization of components manufactured in the State of Washington. The EU maintains that the above measures are a type of subsidies prohibited in the WTO.

On February 12, 2015, the EU turned to the DSB with a request to set up a panel and it was established on February 23, 2015, while two months later panel members were selected.

Russia has a substantial trade interest in that dispute. According to the 2013 data, position 8802 imports from the US to Russia amounted to 38% of the entire Russian imports of the above position and 45% of the entire US exports of those goods. However, in 2014 the trade between Russia and the US in disputable goods decreased dramatically, while the share of imports from the US fell to 6% and 8% in the total Russian imports of those goods and the total US exports of those goods, respectively. The share of exports of disputable goods from Russia to the US in the total Russian export of those goods fell from 3% in 2013 to 0.5% in 2014.<sup>1</sup> Furthermore, the dispute in question is practice for Russia to participate in WTO disputes related to tax privileges which result in specific subsidies.

***DS489: China – Measures Related to Demo Base Programs and Public Service Platforms (the US)***

On February 11, 2015, the US turned to the WTO with a request to hold consultations with China on determination of measures granting subsidies to enterprises provided that they took part in export activities of some industrial sectors of China.<sup>2</sup>

According to the US, by means of the *Transformation of the International Trade and Modernization of Demo Bases* program (hereinafter, demo bases) and the *Public Service Platform* China provides export subsidies. Demo bases are industrial clusters of enterprises in China's some economic sectors, including the textile industry, agriculture, medical goods production, the light industry, chemical engineering, as well as metalworking and the building materials industry. Public service platforms are service providers designated in China for rendering services to enterprises in a demo base. China singles out an industrial cluster of enterprises in a separate industry as a demo base and then grants export subsidies to the demo base enterprises. The above subsidies include provision of services of a public service platform free of charge or at a discount or in the form of monetary grants. As by means of a demo base program and public service platform subsidies are granted to Chinese-based enterprises engaging in export activities, the US believes the above measures are in conflict with Article 3.1(a) and Article 3.2 (Ban) of the Agreement on Subsidies and Compensation Measures.

For Russia, China is an important producer, importer and exporter of goods which manufacturers allegedly receive an advantage from measures discussed at the consultations. So, the result of resolution of the dispute may have an impact on manufacturers, importers, exporters and consumers in Russia. With regard to the above, for Russia the most sensitive industries can be the following: the textile industry, agriculture, medical goods production, the light industry, special chemical engineering, metalworking and the building materials industry.

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<sup>1</sup> UN COMTRADE database // <http://comtrade.un.org/>.

<sup>2</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds489\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds489_e.htm).

***DS492: The EU – Measures Related to Tariff Concessions in Respect of Certain Poultry Meat Products (China)***

On April 8, 2015, China turned to the WTO with a request to hold consultations with the EU as regards changes in the EU's tariff concessions in respect of some poultry meat products.<sup>1</sup>

The measures introduced as result of the EU's two requests due to changes in the EU's tariff concessions in respect of certain poultry meat products under Article XXVIII (Changes in the Lists) of the 1994 GATT in 2007 and 2012 and the EU's refusal to change tariff quotas at China's request are controversial. China's main claims are related to the fact that the EU carried out negotiations on tariff concession changes with Thailand and Brazil which had substantial trade interest in those goods, however, China was denied such negotiations despite the fact that it had substantial trade interest, too. It is to be noted that in both cases tariff quotas were granted in full to Brazil and/or Thailand, while the related rates of the customs tariff beyond the quota happened to be much higher than the related rates before changes in concessions were made.

As consultations between China and the EU failed to resolve the dispute, on June 8, 2015 China turned to the DSB with a request to set up a panel and it was established on July 20, 2015. At present, panel members are being selected.

The dispute in question is interesting to Russia in terms of procedures as the role of a third party in the dispute is for Russia a kind of practice of participating in disputes on changes in the lists of related tariffs and helps Russia to have a better understanding of such changes, negotiation procedures and other. In addition to the above, the dispute in question is of practical interest to Russia as the EU remains Russia's main trade partner though not in exports of poultry meat products from Russia to the EU. Also, the above regulations provide for a quota on other countries' supplies (including Russia), however, its volumes were insignificant and amounted to nearly 30 tons of poultry meat and processed poultry meat products.<sup>2</sup>

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So, it can be stated that Russia actively participates in settlement of trade disputes in the WTO, including those on mutual claims which arose prior to Russia's accession to the WTO. In most cases, Russia participates as a complaining country and defendant in WTO disputes with the EU and Ukraine. As a complaining country, Russia is primarily interested in issues of antidumping investigations and antidumping measures, particularly, in the iron and steel industry and the chemical industry. In the WTO, Russia is mainly complained about by other countries as regards the following issues: technical barriers in trade, sanitary and phytosanitary norms, antidumping measures and investment measures which affect trade and tariffs.

As a third country, Russia normally participates in disputes concerning products of the iron and steel industry, the agriculture, the motor industry and the aircraft industry. Russia's participation as a third country is normally related not only to a substantial trade interest, but also the practice of participating in disputes. Also, the issues of application of the WTO's norms and rules are of interest to Russia.

For Russia, it is highly important to have the right position and tactical strategy of participating in the WTO disputes to develop mutual trade with other member-states and defend its interests on the basis of the WTO norms and rules.

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<sup>1</sup> [https://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds492\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds492_e.htm).

<sup>2</sup> The Review of Substantial Limitations on Russian Goods Access to Foreign Markets // [http://www.ved.gov.ru/rus\\_export/partners\\_search/torg\\_exp/](http://www.ved.gov.ru/rus_export/partners_search/torg_exp/).



## Section 5. Social Sphere

### 5.1. The standard of living<sup>1</sup>

#### 5.1.1. The formation of money income

In 2014, the real money incomes of the population declined by 0.5% on the previous year, with most of the decline taking place in Q4. In 2015, real money incomes amounted to 95.4% of that index one year earlier.

Over the course of 2015, the average money income in nominal terms increased by 10.1%, to Rb 30,311 per capita. Although the year 2015 saw a rise in the growth rate of nominal money incomes relative to 2014, a 12.9% increase in consumer prices caused a sharp decline in the indicators of the standard of living in real terms. In 2015, the real disposable incomes of the population, real wages, and the real size of allotted pension amounted to 96.0%, 90.5% and 96.2% respectively, of their values in 2014 (*Table 1*).

*Table 1*

**Major socio-economic indicators of the standard of living**

	2010	2011	2012	2013	2014	2015
<b>Nominal income, Rb</b>						
Average money income	18,958	20,780	23,221	25,928	27,766	30,311
Average nominal charged wage for employees of organizations	20,952	23,369	26,629	29,792	32,495	33,925
Average size of allotted pension	7,476	8,203	9,041	9,918	10,786	11,983
<b>Real income, % of previous year</b>						
Real disposable money income	105.9	100.5	104.6	104.0	99.3	96.0
Real charged wage	105.2	102.8	108.4	104.8	101.2	90.5
Real size of allotted pension	134.8	101.2	104.9	102.8	100.9	96.2

*Source:* Rosstat.

When analyzing the changes in the main parameters of the standard of living, it should be borne in mind that the active social policy pursued by the State resulted in a 2.2-fold increase in the nominal size of pension in 2013 relative to 2009. In the period 2009-2013, there emerged an upward trend in the coefficient applied to the average size of allotted pension, the goal being to gradually raise it to the same level as the average wage, as a result of which the share of social payments in the incomes of the population was expected to increase. In 2015, the financial status of pensioners significantly worsened – the ratio between the average size of allotted pension and the minimum subsistence level amounted to 148.9%, thus falling to its record low since 2010.

<sup>1</sup> Author of this section: Izryadnova O. – Gaidar Institute for Economic Policy.

The downfall of real wages during the 2009 crisis was fully compensated in 2010. The implementation of measures designed to increase the average monthly charged wage was accompanied by an accelerated growth rate of wages in the budget sphere, as compared with the corresponding indices in the economy as a whole. In 2013, the average nominal wage in budget-funded institutions and organizations rose 2.0 times vs. 1.6 times in the economy as a whole (relative to 2009).

From the second half of 2013, the economy experienced a decline in the growth rate of the population's incomes, these phenomena being especially pronounced in the budget-funded sector. In 2015, the growth of incomes petered out into a 9.5% fall of real wages in the economy as a whole. Also, the dynamics of the standard of living parameters in 2015 was negatively affected by a 3.8% drop in the real size of allotted pension, relative to the previous year. The sharp fall in the real incomes of the population in 2015 resulted in a 7.9% contraction of the actual final consumption of households relative to 2014 (*Table 2*).

*Table 2*

**Indices of physical volume of actual final consumption of households, in comparable prices, as a percentage change to the previous year**

	2010	2011	2012	2013	2014	2015
Household final consumption expenditure	104.3	105.8	106.1	103.1	101.4	92.1
including, due to:						
household expenditure	105.5	106.8	107.4	103.7	101.7	89.9
state administration	98.5	101.4	102.5	101.4	100.4	98.2

Source: Rosstat.

The drop in the level of real incomes was accompanied by a number of structural changes which had first manifested themselves in Q4 2014 (*Table 3*). In 2015, remuneration for labor and social benefits accounted for 66.0% and 18.1% respectively of the money incomes of the population, while the share of incomes from property and entrepreneurial activity continued to decline. Bearing in mind that remuneration for labor exerts a determining influence on the level of incomes of the population, it should be assumed that the trend towards the decline in real wages will remain the main factor determining the social parameters of the standard of living of the population in 2016.

*Table 3*

**The structure of the money incomes of the population in 2010-2015, % of total**

	2010	2011	2012	2013	2014	2015
Total money income	100	100	100	100	100	100
Compensation for labor, including hidden wages	65.2	65.6	66.0	65.3	65.8	66.0
Incomes from entrepreneurial activity	8.9	8.9	8.6	8.6	8.4	7.3
Social benefits	17.7	18.3	18.3	18.6	18.0	18.1
Incomes from property	6.2	5.2	5.1	5.5	5.8	6.6
Other incomes	2.0	2.0	2.0	2.0	2.0	2.0

Source: Rosstat.

According to preliminary data, the level of income slightly reduced in 2015:

- the Gini coefficient declined to 0.412 from 0.419 a year earlier;
- the assets ratio declined to 15.5 times from 16.0 times in 2014 .

On the one hand, the drastic fall of the exchange rate of the ruble resulted in a relative gain of the owners of dollar-denominated assets and individuals with incomes denominated in foreign currencies. On the other hand, there was a growth of the share of wages in the incomes of the population, as well as a decline in wage differentiation among various categories of workers.

As wage differentiation is lower than the differentiation of incomes from property and entrepreneurial activity, the latter factor has led to a certain decline of the final indices of the wage difference in the population as a whole. Apparently, it is partly for this reason that the final income differentiation indices have remained practically unchanged over the course of the last five years (*Table 4*).

*Table 4*

**Distribution of the total volume of the population's money income, %**

	2011	2012	2013	2014	2015
Money income	100	100	100	100	100
Including by population quintile:					
first (with lowest income)	5.2	5.2	5.2	5.2	5.2
second	9.9	9.8	9.8	9.9	10.0
third	14.9	14.9	14.9	14.9	15.1
forth	22.6	22.5	22.5	22.6	22.6
fifth (with highest income)	47.4	47.6	47.6	47.4	47.0
Assets coefficient (income differentiation)	16.2	16.4	16.3	16.0	15.5
Gini coefficient (index of income concentration)	0.417	0.420	0.419	0.416	0.412

*Source:* Rosstat.

According to preliminary estimates, in 2015 the minimum per capita subsistence income level amounted to Rb 9,701, which represented a 20.5% rise on 2014. Much of the growth of the minimum per capita subsistence income level took place in H1 2015, while H2 saw a relative decline in its growth rate. The considerable increase of this index at the beginning of 2015 resulted in a rise in poverty rates. In the period January-September 2015, the share of the population with incomes below the subsistence level amounted to 14.1% of the total population, which represented a 1.5 pp. rise on the previous year (*Table 5*). On the whole, the percentage of the population living below the poverty line in 2015 amounted to 13% of the total population, similar to the percentage registered in 2009.

*Table 5*

**The number of population with money income below the minimum subsistence level, 2013-2015**

	Million persons	As percentage of total population
2013	15.4	10.8
Q1	19.7	13.8
Q2	17.3	12.1
Q3	17.3	12.1
Q4	12.2	8.5
2014	16.1	11.2
Q1	19.8	13.8
Q2	17.4	12.1
Q3	16.6	11.5
Q4	13.1	9.1
2015		
Q1	22.9	15.9
Q2	20.1	14.0
Q3	17.9	12.4
January-September	20.3	14.1

*Source:* Rosstat.

The Government of the Russian Federation's action plan to ensure socio-economic development in 2016 envisages a number of measures designed to decrease tensions in the labor market; the provision of assistance to pensioners (the indexation of pensions is to be carried out in H2 2016); an increase in the level of financial assistance to families with children, including through payments out of the Maternity Capital (Family) Grant Funds, an increase in the social

protection of families with children, and a continuation of the health and fitness programs for children from troubled families. Some measures are also planned in the sphere of healthcare and pharmaceutical supply.

5.1.2. The monetary expenses of the population

In 2015, the volume of the population’s money income amounted to Rb 53,202.9bn, which represented a 10.2% rise on 2014. The population spent Rb 37,903bn on goods and services, or 5.0% more than in the previous year. In 2015, the population’s savings amounted to Rb 9,384bn, which represented a 1.5-fold rise on 2014.

In 2015, the dynamics and structure of household expenditure was significantly affected by inflation. Consumer price inflation amounted to 12.9% in 2015. As a result of the influence exerted by various factors on the behavior of prices in individual sectors of the consumer market, the structure of inflation underwent significant changes due to a notable acceleration of growth in food products prices relative to the aggregate index of consumer prices for goods and services. In 2015, the consumer price index for food products amounted to 114.0%. The behavior of prices for non-food products was formed under the influence of the decline in the exchange rate of the ruble and the reduction in imports. The consumer price index for non-food products amounted to 113.7% vs. 08.1% in 2014. The transformation of price ratios determined a number of changes in consumer behavior (*Table 6*). The share of own income spent on goods and services remained relatively low: in 2015 it amounted to 71.3% vs. 75.3% a year earlier, including expenses on goods which amounted to 54.5% vs. 57.4% in 2014.

*Table 6*

**Household final consumption expenditure structure, %**

	Money income	Of these, expenditures on:						Growth (+), decline (-) in cash on hand	
		purchase of goods & services	including			sav-ings	including in deposits & securi-ties		purchase of forex
			purchase of goods	purchase of ser-vices	mandatory payment & contribu-tions				
<b>2014</b>									
Q1	100	82.2	61.5	17.9	12.2	0.3	-6.9	7.0	-1.7
Q2	100	73.2	55.5	15.5	11.7	9.9	5.0	4.6	0.6
Q3	100	75.7	57.6	15.6	11.7	7.3	2.7	4.5	0.8
Q4	100	72.0	56.0	14.0	11.9	8.5	1.0	7.1	0.5
<b>Full year</b>	<i>100</i>	<i>75.3</i>	<i>57.4</i>	<i>15.6</i>	<i>11.8</i>	<i>6.9</i>	<i>0.8</i>	<i>5.8</i>	<i>0.2</i>
<b>2015</b>									
Q1	100	78.3	59.3	16.7	11.1	12.9	2.2	4.0	-6.3
Q2	100	69.8	53.5	14.6	10.8	15.0	7.1	4.1	0.3
Q3	100	72.4	55.3	15.1	11.2	12.0	5.6	4.8	-0.4
Q4	100	66.6	51.3	13.3	11.7	16.0	10.0	3.9	1.9
<b>Full year</b>	<i>100</i>	<i>71.3</i>	<i>54.5</i>	<i>14.8</i>	<i>11.2</i>	<i>14.1</i>	<i>6.5</i>	<i>4.2</i>	<i>-0.8</i>

Source: Rosstat.

While the nominal incomes of the population grew at a relatively slow pace, the bulk of household expenditure was going to the purchase of food products and basic commodities. As a result, the share of food products, including beverages and tobacco products, in the structure of retail turnover increased to 48.6%, which represented a 1.86 pp. rise on the same period of 2008, while the share of non-food products dropped correspondingly. On the whole, over the course of 2015, turnover in the market for food products shrank by 9.2%, while that in the market for non-food products – by 10.7%. On the whole, the most prominent negative trend

was a notable decline in retail turnover in various segments of the market, relative to last year. At the end of the year, this trend clearly gained momentum.

One of the typical features of 2015 was the population's increased propensity to save as a precautionary measure in crisis conditions.

People were resorting to a variety of instruments in saving their income. While in 2014, 5.8% of the population's money income had been converted into foreign cash, in 2015 this index dropped to 4.2%, while saving in the form of bank deposits and securities increased to 6.5% of the population's money income index. In Q4 2015, the share of saving rose to 16.0% of money income, including saving in the form of bank deposits and securities (to 10%). The behavior of the personal saving index was strongly influenced by the interest rates on deposits in late 2014 – H1 2015. The total volume of individual bank deposits in Russia in late 2015 amounted to Rb 23,219.1bn, having risen by nearly a quarter on its year-end index for 2014. However, as the interest rates on deposits fall below the inflation rate, it is very likely that pensioners will remain the biggest group of individual clients still keeping their deposits with banks, as they have grown used to the negative interest rates in real terms offered by banking institutions.

Among the main consequences of the crisis we may point to shrinkage of the assortment of available commodities, dwindling supplies of many expensive items to the market, and the disappearance from the market of many of the previously active suppliers and producers. Demand shrinkage occurred not only in the relatively hi-tech segments of the consumer market (computers, electronics, telecommunications), but also in the more expensive segments of the food market oriented to higher-income social strata.

The volume of commercial services rendered to the population decreased by 2.1% on 2014. The deepest plunge was demonstrated by the volume of outbound tourism and recreational services, while that of education, spa and healthcare services declined at a more modest rate. The downward trend in retail turnover and the turnover of commercial services rendered to the population will prevail over H1 2016 and push domestic demand even further down.

The results of population surveys conducted by *Rosstat* in Q4 2015 point to a downward trend in consumer expectations. The consumer confidence index dropped on Q3 2015 by 2 pp., while its level reflects the collective consumer opinion on the overall situation in Russia's economy and individual material status. Social and political stability will depend on the success of government measures designed to support the most vulnerable population groups.

## **5.2. Migration processes in Russia<sup>1</sup>**

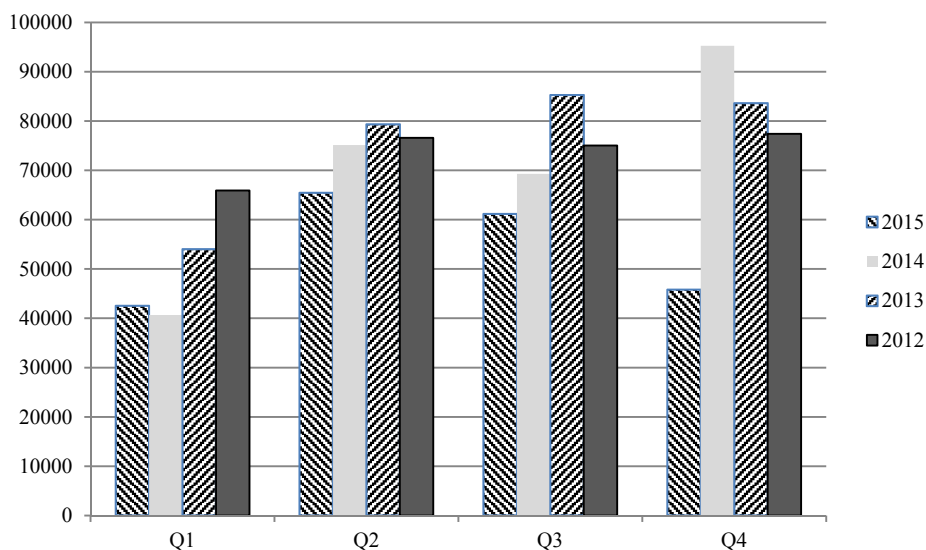
### **5.2.1. Long-term migration**

In January-November 2015 compared to the corresponding period of the previous year, Russia's positive migration balance moved down by around 20% and came to 214,900 persons. Negative migration balance resulted not so much from the contraction of the number of inflows as could be figured by the current Russia's economic situation as from the 15 percent growth of outflows. Monthly/quarterly registration posted positive balance of the number of inflows solely in Q1, later there was balance and in Q4 there was an obvious decrease. Evidently, by the end of the year previously planned and finally implemented resettlements into Russia as well as statistical lag were "eroded" by the ruble devaluation and general economic recession. In the course of the year, the outflows from Russia demonstrated steady downward trend against

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<sup>1</sup> Author of this section: Karachurina L. – NRU HSE.

the corresponding indices of 2014. As a result, Russia’s net migration starting with Q2 2015 was constantly less than compared to the same period of 2014. In November negative migration balance came to around 30 p.p. (*Fig. 1*).



*Fig. 1. Migration flow to Russia, Q1-Q4 2012–2015, persons.*

\*Q4 2015 – data for October and November.

Source: Rosstat.

Owing to the fact that the CIS member states still determine the picture of international migration into Russia, migration exchange precisely with these countries created the above-mentioned situation. A significant “division” in Russia’s migration relations with certain countries has taken place (*Table 7*). Noticeable increase in migration gains was related solely to Ukraine and was related to the acute crisis in that neighbor country which unfolded in 2014-2015.

No shift in migration exchange was registered with Moldova. All other CIS countries post decrease of net migration into Russia. It is especially true of the Central Asian republics. Migration exchange with Uzbekistan became negative altogether for Russia owing to more than 40% decrease of the number of inflow while the number of outflows from Russia remained unchanged. During entire post-Soviet period, such situation was not observed. Insofar as, there were no drastic changes in socio-economic and political situation in Uzbekistan, there are grounds to believe that decrease of the number of migrants from that country is a temporary phenomenon. It is determined by a delayed effect of a sharp growth of the number of inflows from Uzbekistan posted in 2012-2013 as well as issues related to issuance of biometric international passports in Uzbekistan, which were to be obtained by all citizens leaving for abroad prior to December 31, 2015.<sup>1</sup>

<sup>1</sup> Uzbekistan Foreign Ministry: old passports are valid through 2016, sticker is required solely for departure from ten countries. Uzbekistan Chronicles. <https://rpg15.wordpress.com/2014/12/05/мид-узбекистана-старые-паспорта-дейс/>

Table 7

**Inflow Migration to Russia from Foreign Countries, 2012–2015, thousand persons**

Country	2012*	2013*	2014*	2015**
International migration, total	294.9	295.9	270.0	214.9***
Including:				
Azerbaijan	18.1	17.3	12.3	9.6
Armenia	32.0	32.2	24.0	19.1
Belarus	10.2	3.7	6.7	4.5
Kazakhstan	36.7	40.2	40.8	31.5
Kirgizia	24.1	19.8	15.3	8.3
Moldova	18.6	20.6	17.5	15.8
Tajikistan	31.4	33.6	19.3	9.0
Turkmenistan	3.9	3.8	2.6	2.0
Uzbekistan	56.4	67.3	36.7	-21.6
Ukraine	37.0	36.4	84.9	130.8
All far abroad countries	26.5	21.0	9.9	5.9

\* less Crimea Federal Okrug.

\*\* January-November.

\*\*\* Migration growth of Crimea FO for January-November 2015 came to 32,000 persons.

Source: Rosstat.

On the whole, the level of predominance of one country (Ukraine) in Russia's positive migration balance represents a new phenomenon for modern Russia. If we exclude Ukraine from the total volume of Russia's net migration, then we will find out that in January-November 2015 Russia's population went up by merely 84,000 persons. Meanwhile, during the same period of 2014, it went up by 167,700 persons.

Situation with forced migration from Ukraine resulting from 2014 crisis has stabilized somewhat. For January-September 2015, the total number of those who asked for refugee status came to 1,079 persons including 245 persons from Ukraine and 249 persons from Syria. Those who asked for temporary asylum totaled 131,200 persons including 129,600 from Ukraine. Number of persons who got temporary asylum went up from 237,800 persons as of January 1, 2015 to 329,900 persons as of October 1, 2015. All this increment was due to immigrants from Ukraine. In the event the situation in Ukraine is stabilizing, Russia's net migration with this country will depend on whether there will be large-scale repatriation of Ukrainian nationals. However, at present we observe wait-and-see approach: the number of registered at the place of arrival in 2014-2015 failed to keep up at the same pace as the number of inflow migrants from Ukraine.<sup>1</sup>

Prior to August 1, 2015, migration from Ukraine was unfolding amid specially privileged regime of stay for its nationals on the territory of the Russian Federation. This regime allowed to stay in Russia indefinitely<sup>2</sup> without leaving the country (instead of 180 days for migrants from other CIS countries), obtaining new Migration Card and reapplication to the Federal Migration Service of Russia as it is required for other nationals of CIS countries. From August 1, 2015, the rights of the citizens of Ukraine regarding their stay in Russia were balanced with the rights of the citizens of other CIS countries. Prior to November 30, Ukrainian nationals had to apply to the Federal Migration Service in order to obtain papers for work in Russia. Privileges remain solely for the citizens who arrive in extreme order from southeastern regions of Ukraine.

<sup>1</sup> Head of the RF FMS Konstantin Romodanovsky noted the outflow of the citizens of Ukraine from Russia through border crosses located in Rostov region in October 2015. Ukrainian refugees are leaving Russia. Gazeta.ru, October 8, 2015. [http://www.gazeta.ru/social/news/2015/10/08/n\\_7748267.shtml](http://www.gazeta.ru/social/news/2015/10/08/n_7748267.shtml)

<sup>2</sup> To be more precise, Ukrainian nationals independently of their status had the right to stay in Russia up to 90 days and then this term could be extended every three months automatically.

Positive migration balance in exchange with the far abroad countries although declined but still retains positive thanks to the exchange with the Baltic States and mainly with Georgia, which ensures half of inflow. However as a whole, as it was before, the real picture of the migratory movements with the far abroad countries remains hidden. Emigration intentions of the Russian people and their realization, which could have gone up amid the economic crisis, still are not registered by statistics because the outflow takes place without deregistration.

Latest data on emigration intentions of Russian people registered by sociological centers are related to summer-autumn 2015. They are exceptionally uniform in their assessments. For example, regular survey of the emigration intentions of Russian people conducted by The Levada-Center in mid-September 2015 showed one of the lowest level of emigration readiness (11%<sup>1</sup>) during entire period of monitoring (since October 1990). Around the same number (13%) would rather move to permanent residence to another country according to the results obtained by VCIOM's survey. Along with this, similar "low" level of intentions the Levada-Center experts observed in April 2009, i.e. during in the midst of the previous financial crisis.<sup>2</sup> Sociologist and Director of the Levada-Center Lev Gudkov associates it with "the policy and upsurge of patriotism" as well as with the first reaction to the crisis: "People prefer to look around in the new conditions and only then decide to emigrate or not. Immediately following the crisis of 2009, the emigration wave of 2011-2014 followed (ready to stay amount varied between 69-77% and to emigrate – around 22%). The same picture we can observe in 2016-2017."<sup>3</sup> The Head of VCIOM Valery Fedorov explains the obtained results this way "many Russians 'have suffered from the sanctions, curtailment of ties with the West,' however, this is only 'one side of the coin', the majority of citizens understand that there is 'nowhere' to move, and that the 'West has a lot of their problems', including those related to migration."<sup>4</sup>

### 5.2.2. Novations in migration legislation

A whole number of amendments into the legislation on migration (first of all, in FZ "Concerning the Legal Status of Foreign Nationals in the Russian Federation") adopted in 2014, came into effect from 2015. Including:

- Starting from January 1, 2015, admission (and departure from) in Russia for the migrants coming from the states that remain outside the Eurasian Economic Union member states (Belorus, Kazakhstan and Armenia – from January 2015, Kirgizia – from August 2015) will be permitted solely for international passports holders;<sup>5</sup>
- Migrants from the visa-free regime countries who fail to indicate in their Migration Card upon arrival to Russia in the box 'Purpose of arrival' is 'Work' will not be able to obtain authorization documents for work in the country;<sup>6</sup>

<sup>1</sup> "West": perception and intention to emigrate. The Levada-Center. 13.10.2015. <http://www.levada.ru/2015/10/13/zapad-vospriyatie-i-stremlenie-emigrirovat/>

<sup>2</sup> The Crisis Forced Russians to Forget about the Emigration. The Levada-Center. 20.03.2015. <http://www.levada.ru/2015/03/20/krizis-vynudil-rossiyan-zabyt-ob-emigratsii/>

<sup>3</sup> The Crisis Forced Russians to Forget about the Emigration. The Levada-Center. 20.03.2015. <http://www.levada.ru/2015/03/20/krizis-vynudil-rossiyan-zabyt-ob-emigratsii/>

<sup>4</sup> Korchenkova N. Russian Are not Ready to Leave. *Kommersant*. July 13, 2015, <http://www.kommersant.ru/doc/2767127>

<sup>5</sup> The RF Foreign Ministry's commentary on crossing the state border of the Russian Federation by foreign nationals.

<sup>6</sup> Federal Law of 21.07.2014 № 230-FZ «On Introduction of Amendments in the Federal Law 'On Legal Status of Foreign Nationals in the Russian Federation'».



- The simplified procedure for acquiring Russian citizenship for foreign nationals permanently residing on the territory of Russia and certified as Russian speakers;<sup>1</sup>
- Foreign students who graduated from Russian colleges and Universities and with three years work record can apply for Russian citizenship through the simplified procedure. At the same time, in the past those citizens of the former USSR who have received secondary vocational education or higher education after July 1, 2002 in Russian educational organizations, were eligible for the simplified scheme in acquiring Russian citizenship. In particular, they had to wait for 9-12 months for their Russian citizenship and the work record, which is in the new amendment to the law, was not required. For these citizens the procedure for acquiring Russian citizenship became more complicated. However, the procedure is uniform for all foreign nationals including those from far abroad;
- The simplified scheme for acquiring Russian citizenship also applies to self-employed entrepreneurs with work record of no less than three years and annual income of no less than 10 million rubles proceeding from the sale of goods or services as well as for investors whose share in equity capital of a Russian legal entity constitutes no less than 10%.<sup>2</sup> At the same time, the types of activity list whereunder one can apply for the simplified procedure in acquiring Russian citizenship turned out to be extremely short. In particular, wholesale and retail commerce, automotive maintenance, hotel and catering business, advertising activities, real estate transactions, etc. were deleted from the list.<sup>3</sup>

Major legislative novations, which came into force in 2015, however, do not relate to the inflow procedure and acquiring Russian citizenship, but with the possibility for labor activity. From 2015, the visa-free migrants could be employed by legal entities without a work permit. Now, irrespective of the fact the migrants are employed by factories or organizations (legal entities) or employed by individuals, they have to purchase Work Patents.<sup>4</sup> Work patents are valid solely on the territory of those RF subjects which issued work patents and regions have the right to set fee for work patents (PIT<sup>5</sup>).

Transition to Work Patent regime for foreign labor migrants was viewed by the experts as a tool to simplify legalization and as an anticorruption measure. However, as it happens, its implementation was ill-designed whose consequences have been resolved in the course of realization of already adopted legal documents. A number of additional mechanisms and conditions were attached to its implementation. At the same time, requirements for the registration procedure at the place of stay remained and have even been made more complex.

Among the new mandatory requirements currently are not only voluntary medical insurance policy and a medical certificate stating absence of dangerous diseases but a proof of knowledge

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<sup>1</sup> Federal Law of 21.07.2014 № 230- FZ «On Introduction of Amendments in the Federal Law ‘On Legal Status of Foreign Nationals in the Russian Federation’».

<sup>2</sup> Federal Law of 23.06.2014 № 157- FZ «On Introduction of Amendments in the Federal Law ‘On Citizenship of the Russian Federation’».

<sup>3</sup> Regulation of the Government of the Russian Federation of September 30, 2014. № 994 «On Determination of the Types of Economic Activities where a Foreign National or a Stateless Person Who are Individual Entrepreneurs, as well as a Foreign National or Stateless Person Who are Investors are Granted the Right to Apply for the Citizenship of the Russian Federation in Accordance with a Simplified Procedure».

<sup>4</sup> Federal Law of November 24, 2014. № 357- FZ «On Introduction of Amendments into Federal Law ‘On Legal Status of Foreign Nationals in the Russian Federation’».

<sup>5</sup> According to the new migration legislation, monthly fee paid for the work permit is considered as a personal income tax and is changed as an advance payment.

of Russian language, History and Legal System.<sup>1</sup> Practically in all European countries, migrants face the need to purchase medical insurance policy and this measure is aimed at protecting regions' budgets from additional burden owing to rendering free medical services to migrants and simultaneously provide them with some social guarantees. The test on Russian language skills for migrants<sup>2</sup> who do not intend to stay for a long period and naturalization (permission for temporary stay, residence permit, or citizenship) seems to be an excessive requirement. Moreover, there are no conditions for the large-scale Russian language courses in the country. This requirement does not apply to: highly qualified specialists and their family members (when obtaining residence permit of work permit) as well as those who got "Matriculation certificate" or "Diploma" in the USSR prior to September 1, 1991; men and women of pension age (65 and 60 years) and people younger 18 years; members of the State program of voluntary migration of fellow nationals and their family members; students arriving to Russia intramural studies and intending to work part-time.<sup>3</sup>

In order to obtain a Work patent a foreign national must have a voluntary insurance policy for the term of his/her work, or his/her employer must submit a document, which will guarantee provision of medical services at his expense.

From January 1, 2015, employers have to make contributions in the amount of 1.8% of the foreign national's wages into the Fund of Social Insurance of the Russian Federation, which, in its turns, guarantees the right of a foreign national for receive a benefit for temporary incapacity to labor. At the same time, foreign national become eligible for the benefit when insurance contributions have been paid during six months prior to the insurance even, in other words a foreign national has to work in a company no less than six months.

### 5.2.3. External labor migration

According to the data of the central database of the FMS of the Russian Federation on registration of foreign nationals and stateless persons (CDB AFN), the number of foreign nationals staying in Russia contracted by around 10% as of December 2015 compared to the corresponding period of the last year. This number includes both foreign national with migration registration during the year and those staying in Russia. In absolute numbers, this means a reduction by over 1.1 million of foreign nationals' inflow and by 800 thousand registered foreign nationals.

Because of events in Ukraine, sharply increased the inflows number and registered in the FMS territorial offices participants and their family members of the State program of voluntary migration of fellow nationals (183,000 persons compared to 106 000 in 2014) who acquired Russian citizenship and residence permit.

Indicators of obtaining authorization documents for legal work activity have contracted more drastically (*Table 8*).

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<sup>1</sup> In addition, Migration Card with the purpose of entry is "Work", international passport, application, registration at the place of stay. Totaling 8 positions.

<sup>2</sup> Validity term for "federal certificate" – 5 years, "regional" - 1 year.

<sup>3</sup> Federal Law of April 20, 2014. № 74- FZ «On Introduction of Amendments into Federal Law 'On Legal Status of Foreign Nationals in the Russian Federation».

Table 8

**Authorization documents applications filed for foreign nationals’  
legal work in Russia**

Index	2015	2014	2015/2014, %
Work permit for foreign nationals*, thousand	217.0	1 328.1	16.3
Work permits for highly qualified specialists and qualified specialists, thousand	65.7	194.9	33.7
Patens**, thousand	1788.2	2386.6	74.9
<b>Total</b>	<b>2070.8</b>	<b>3909.7</b>	<b>52.7</b>

Sources: FMS of Russia, 1-RD form (part 2).

\* – from January 1, 2015, issued solely for visa required countries.

\*\* – From January 1, 2015, issued for foreign national from visa-free regime countries for employment both by individuals and legal entities.

Multiple contraction of the number of issued *work permits* is connected with the fact that migrants from visa-free regime countries are no longer required to obtain these documents. Another factor, which affected the number of obtained *Work patents*, was accession of Armenia and Kirgizstan to the Eurasian Economic Union. That exempt migrants from these countries, as it is true of nationals from Belarus and Kazakhstan, from obtaining Work patents (together with all other documents including proof of knowledge of Russian language, History and Legal System). The RF FMS data for 2015 reveals the number of labor agreements concluded with Armenia and Kirgizstan nationals who work on the Russian territory without work permits and Work patents amounted to 62.200 and 103.100, respectively. If we add these parameters to the number of issued Work patents and standard work permits, then the fall of issued work permits and Work patents will come to a bit over 40% in 2015 against 2014 parameters. However, data released by the FMS of Russia is based on the statistics of issued Work patents (and standard work permits) in units. At the same time, one migrant theoretically can apply for a Work patent 12 times during one calendar year. That is why, it is hardly possible to estimate by the number of issued authorization documents the real number of people who actually work under these authorization documents. From 1-RD form of the FMS of Russia it follows that the number of formalized by the foreign nationals Work patents in 2015 constituted 1,780 thousand units, and in 2014 – 2,379 thousand units, thus declining not by 40% (as per number of issued documents) but by 25%.

In any case, these changes cannot be written off solely for legislative novations. They can be linked either with a real drop in the number of labor migrants inflow to Russia or with their “withdraw into” the shadows or, which is more realistic, in the unknown proportion with both these factors.

If we analyze monthly dynamics of obtaining authorization documents (*Fig. 2*) then it becomes clear that the problems were getting more pressing gradually. The collapse with obtaining of Work patents observed in January and February of 2015 was partly offset in April. However, further on and contrary to traditional (non-crisis) trends, there was no summer migration peak, which was always due to seasonal work.

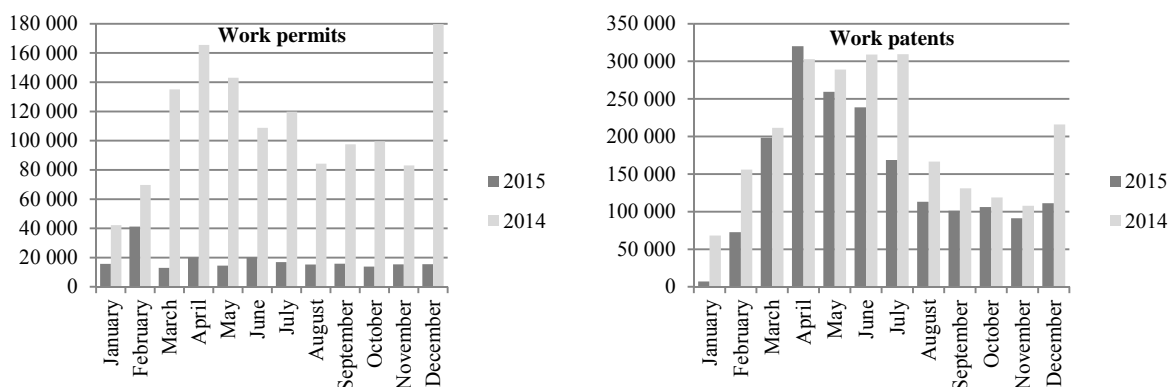


Fig. 2. Issue of work permits and Work patents for foreign labor migrants, Russia, January-December 2014–2015, units

Source: data released by the FMS of Russia.

Seemingly, replacement of nontransparent and corruption mechanism of work permit quotas allocation with Work patents should have led to an increase in the number of legalized foreign nationals. It should have happened by the second half of the year, when the system of obtaining Work patents should have been worked-out and become clear (precisely this way it happened in the past when, for example, Work patent was introduced for employment by individuals). However, so far these expectations have not come true. Possible reasons for the existing situation:

1. Economic recession, which reduced the extent of work places supply and requirement in legal foreign workers. Some benchmark for this is the registered in the employment agencies the required number of workers. By end-November 2015, it constituted 1,206.6 thousand against 1,697.7 thousand persons the year earlier;<sup>1</sup>

2. Ruble devaluation, depreciation of migrants’ wages and, consequently, reduction of attractiveness of Russia as a place for income;

3. Exiting problem with registration at the place of stay, which conditions obtaining a work patent;

4. General tightening of control over migration kick started in 2014;<sup>2</sup>

5. High price paid for a Work patent and accompanying expenses. Set monthly payment for Work patents greatly differed across regions and in itself was aimed at becoming a signal for migrants about their desirability (requirement) in regions:

- a number of RF subjects did not introduce regional coefficients and on their territory the price of work patent established by the Federal law was effective (to the tune of 1,568.4 Rb). As a rule, this was true of the regions, which were not popular with migrants (Ivanovo, Kostroma, Kurgan regions, Zabaikalsky Krai, Karachaevo-Cherkessk Republic, Karelia and other, total 34 regions);
- the price of work patent in other regions was in the range of Rb 2,038.92 in Orenburg region to Rb 7,056.2 in Sakha (Yakutiya) and Rb 8,000 in Sakhalin region;

<sup>1</sup> Presentation on socio-economic situation in Russia-2015. Moscow, Rosstat.

<sup>2</sup> Corresponding federal laws were adopted in 2013. See. Russian Economy in 2014. Trends and Outlooks. (Issue 36). V. Mau et al. Edited by Sergey Sinelnikov-Murylev, Alexander Radygin. Gaidar Institute for Economic Policy. Moscow, Gaidar Institute Publishers, 2015. Chapter 5.2. pp. 315-331.

- in Moscow and Moscow region work patent cost Rb 4,000 and in St. Petersburg and Leningrad region – Rb 3,000.

Separate issue and a new corruption mechanism became obtaining of regional or federal certificate of proof of knowledge of Russian language, history and legal system (federal certificate is more expensive but it is valid on the entire territory of the Russian Federation). According to experts in Moscow where Russian language text is very simple, the share of migrants failing to pass it comes to 18%. In other regions where the federal test is difficult solely between 7% and 15% of foreigners fail to pass it, which is explained by the corruption component.<sup>1</sup> Moreover, passing a test does not provide a migrant with knowledge of Russian language and even does not contribute to it.

According to experts' estimates, total lump sum for legalization in Moscow including payment for certificate, VMI, notes came to around Rb 20,000<sup>2</sup> (hereafter Rb 4,000 monthly) and in Primorsky Krai – around Rb 40,000.<sup>3</sup>

According to the migrants themselves, there is no benefit in the cost of work patent compared to the previously effective standard work permit. *“Labor migrants working in the capitol regions confirm that the standard work permit valid for a year together with preparation of documents with the help of intermediaries were several time cheaper. ‘It could be filed for Rb 30,000,’- said Uzbekistan national working in a Moscow firm. – ‘For obtaining standard work permit we took a blood test, received medical certificates but to file application by oneself was impossible. You come and they say there are no quotas. Firm also buys quotas and sells them. Currently cost of services for filing all documents application services together with monthly payment for work patent will total around Rb 68-70 thousand annually. Reckon twice as much as previously”.*<sup>4</sup>

Our findings<sup>5</sup> demonstrated that each procedure for issuing work patent to a certain degree placed a role of additional barrier for migrants' legalization. The need for some of them is questionable.

6. In the wake of the crisis, most likely, migrants face greater problems with filing labor agreements. Interview taken with representatives of non-commercial organizations dealing with provision of assistance to migrants in Moscow demonstrated the urgency of this barrier: *“to obtain a work patent does not mean that one works legally. In order to work legally one has to sign a labor contract. Employers never wanted to sign labor contracts and the same is true of today. The Moscow government does not want to motivate them to do it and does not want. Because Muscovites do not have signed labor contracts. 30% of Muscovites do not have signed contracts. And there are migrants to worry about. That is why the sword of Damocles is hanging over migrants. According to legislation: if during two months labor contract application was not filed, i.e. the employer has not submitted a notice on conclusion of written labor contract the work patent is revoked.”* Fake labor contracts, according to experts, as before are in high

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<sup>1</sup> Economic crisis – social dimension: information and analytical bulletin. RANEPА. Edited by Tatiana Maleva. 2015. № 3, p. 90.

<sup>2</sup> Labor Migration Situation in Russia: Costs Increase, Benefits Dwindle, Stocks Drop. Russian Migration Brief. March 2015. Issue 1. p.2.

<sup>3</sup> For guest migrant it is cheaper to live in Russia than work. Information agency REGNUM. March 3, 2015. <http://www.regnum.ru/news/society/1901202.html>

<sup>4</sup> Nikolskaya P. On work patent basis, «Kommersant-Vlast», April 20, 2015.

<sup>5</sup> Hereinafter – Project of HSE NRU Higher School of Economics «Analysis of Social Sphere of a Region by Method of Inclusive Observation», within which in autumn 2015 interview were taken from representatives of noncommercial organizations, which deal with migrants in Moscow.

demand, which is explained, on the one hand, by the unwillingness of major part of employers to officially formalize labor relations with migrant workers, and on the other hand, aspiration of migrant workers, at least, to formally observe requirements of the migration law;

7. Procedural problems, in particular, delayed and solely for certain regions (in particular, for Moscow<sup>1</sup>) administrative decision related to prolongation of work patents effectiveness, which were issued in 2014. In late 2014, foreign migrant held over two million effective work patents, which according to the decision taken in late December 2014 had to be reapplied in 2015. The majority of regions failed to cope with such inflow of applications;

8. Subjective reasons – foreign migrants wish to save on application of authorization documents and monthly payments and intention of employers to save on increased from 2015 payroll taxes of foreign migrants. For example, assessing expenses of cost and time spend on legalization and risks of illegal stay in life in Moscow representatives of noncommercial organizations expressed a belief that *“the fact that the share of legalization of foreign workers increased following adoption of the new legislation in 2007 was due to the fact that foreign migrants got a change to file work permits applications themselves. Previously they could do it solely via employers and the latter did not want to do it. This demonstrates the fact that foreign migrants to observe laws and work legally. Euphoria faded after that. When they introduced work patents, it was treated as a new surge for greater legality. However, now there is a new setback because migrants say that a work patent is Rb 4,000 for 12 months and to pay additionally for medicine, for the test and they threaten that without signed labor contract the work patent will be revoked. In addition, migrants think: “Go to blazers, I will work as long as I succeed.”*

All-Russia 25% reduction of the number of formalized work patents in 2015 against 2014 is differently represented across Russian regions.

Out of 30 RF regions,<sup>2</sup> which in 2015 formalized over 10 thousand work patents, 22 regions demonstrated negative dynamics in 2014 (*Fig. 3*), including 50% reduction was observed in Moscow region, 40% - in Moscow, 35% - in Tyumen region and Krasnoyarsk Krai. Simultaneously, St. Petersburg and Leningrad region, Kaluga, Volgograd regional and especially in Yamal-Nenets Autonomous Okrug and Khanty Mansi Autonomous Okrug registered significant increase of the number of issued work patents. These regions and especially Yamal-Nenets Autonomous Okrug and Khanty Mansi Autonomous Okrug boast of a significant share of legal labor migration due to their employment by large enterprises. Observed during the recent years high concentration of migrants in several Russian regions is retained: first ten regions ranked by the number of foreign migrants account for 68.8% of all issued work patents, in 2014 – 69.6% and first twenty regions – 81.6% and 81.1%, respectively. In the majority of regions the inflow on labor migrants from visa-free regime countries is insignificant. There are leaders among them: Lipetsk, Yaroslavl, Saratov and Omsk regions, Altai and Primorsk Krai. Inter alia, this fact characterizes social and economic situation in these regions.

Important watermark of the crisis is the number of issued work permits for highly qualified specialists and qualified specialists. In comparison with the previous year, this number shrank 3-fold and during the entire year, it remained unchanged.

<sup>1</sup> FZ № 56 of March 8, 2015. «On Introduction of Amendments in Article 13-2 of Federal Law «On Legal Status of Foreign Nationals in the Russian Federation and Certain Legal Acts of the Russian Federation».

<sup>2</sup> St. Petersburg and Leningrad region due to the fact that they share a single FMS territorial office are studied together.

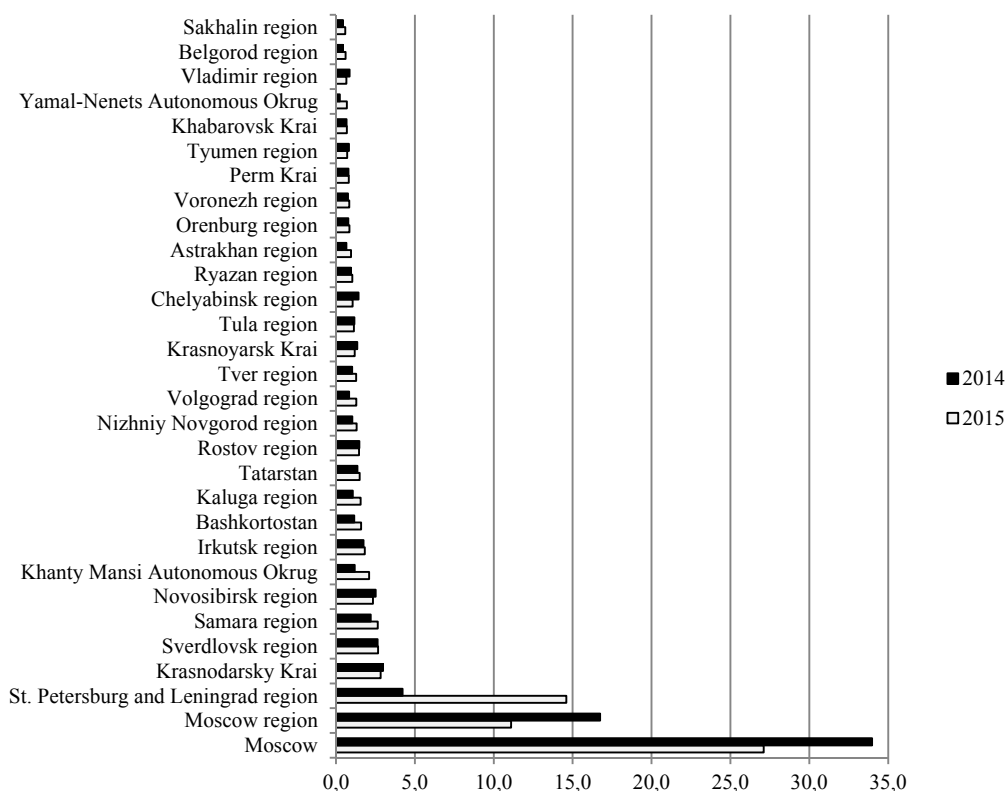


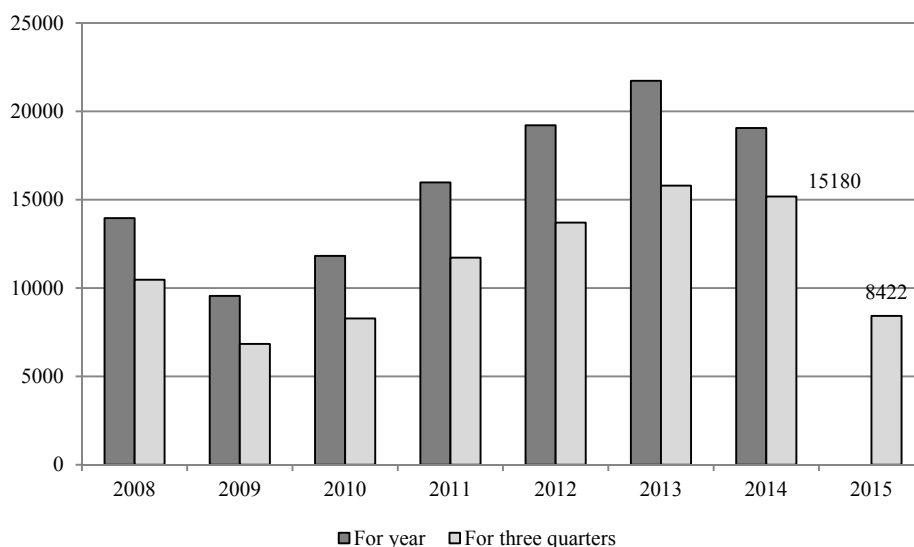
Fig. 3. Breakdown of RF regions across the number of issued work patents for visa-free foreign migrants, 2015-2014, % (RF=100%)

Source: data released by RF FMS.

However, the main indicator for the complexity of the current crisis comes from cross-border remittances made by individuals. Never since the onset of the regular statistical observations of the remittances dynamics (from 2006) their volume fell so drastically: according to the data for three quarters of 2015, they decreased nearly 2-fold against the same period of last year, although crisis alarms regarding remittances were already noticeable in 2014 (Fig. 4). Average amount of one transaction fell below \$200 in Q1 2014, insignificantly growing by Q2 and again fell by Q3 (\$229), which, starting with 2008, always was the ‘fattest.’ Change in the currency exchange rates and contraction of remittances took a toll on the economies of dependent on migrant workers’ remittances countries, first of all, Tajikistan, Kirgizstan and Moldova. According to the World Bank data, in 2012 remittances made by migrant workers to Tajikistan equal 52% of GDP, to Kirgizstan equal 31% of GDP and to Moldova equal 25% of GDP.<sup>1</sup> At the same time, remittances do not support budgets but households and, first of all, current household spending.<sup>2</sup>

<sup>1</sup> Migration and Development Brief. The World Bank. April 11, 2014, p. 4.

<sup>2</sup> According to the findings from questionnaire survey of individuals making remittances carried out by credit organizations through intermediary of the Central Bank of Russia in February 2014, around 68% of remittances are directed to current households’ expenses. The RF Central Bank. [http://www.cbr.ru/statistics/?Prtid=svs&ch=Par\\_17101#CheckedItem](http://www.cbr.ru/statistics/?Prtid=svs&ch=Par_17101#CheckedItem)



*Fig. 4. Cross-border remittances made by individuals from Russia to CIS member states, 2008–2015, USD million.*

*Source:* data released by the Central bank of Russia.

Comparing two crises: the crisis of 2009-2010 and the current one, it is necessary to note that the current recession has to a greater extent affected the migrant inflows: the number of legal foreign workforce in Russia in 2009 shrank by 8.3% against 2008. Solely from CIS member states migrant inflows shrank by 7.6%. In 2010, compared to 2009 it decreased by 26.2% and 24.2%, respectively.<sup>1</sup> During 2015, the fall constituted 47.3% for all categories of migrant workers.

On the whole, in 2015, indicators demonstrated by foreign labor migration in contrast to long-term migration stayed under the effect of crisis processes unfolding in Russian economy. Against this background, the only positive effect represent the sum generated by the sale of work patents Rb 34,061 million in 2015 against Rb 18,312 million in 2014.

#### 5.2.4. Internal migration

The scale of internal migration in Russia continue growing, although its increase in not big against January-November 2014 (by 2%). However, on the whole, the number of internal movements registered by statistics by the year-end again will exceed 4 million persons, i.e. will be twice as much as in 2000s. The reasons for continuing growth of migration activity of Russian people remain unclear. Crisis developments unfolding in the Russian economy, as a rule, do not prompt migration activity. For example, studies of potential mobility of unemployed and jobseekers during the previous crisis demonstrated low levels and did not grow with mounting

<sup>1</sup> Labor and Employment in Russia-2011. Moscow, Rosstat.



unemployment in 'native' settlements.<sup>1</sup> Rostrud projects aimed at providing incentives for moving from localities with significant levels of unemployment have virtually fallen through. High migration levels registered by current record could have been boosted by previous changes introduced into 2011 methodology and limited easing of the registration system at the place of arrival (compared to 2000s when sanitary standards of floor space required for the number of residents and registered, broad packet of documents were in place. People did not understand the difference between 'registration at the place of residence' and 'at the place of arrival' and grudgingly registered tenants at the place of arrival.<sup>2</sup> Moreover, the volume of housing construction, apparently, plays a certain role. This housing construction affects long-term migration. All this leads to growing number of registered migrants. As with long-term international migration, the internal migration so far does not react to the crisis economic developments.

Slightly fell the number of attractive for migration regions. However, their nucleus does not change year-on-year. They are Moscow and Moscow region, St. Petersburg and Leningrad region, Krasnodarsky Krai, Kaliningrad and Novosibirsk regions. From the 2015 list of attractive for migrants regions (14 regions including Sebastopol) were removed Sverdlovsk, Chelyabinsk and Belgorod regions. Moscow's in-migration increment in 2015 compared to the previous year went up by the same number Moscow region posted decrease of in-migration. Apparently, reasons for such volatility stem from the delayed regarding commissioning of new housing system of registration as well as from the recording system.

Practically all regions eastward of the Volga River register migration outflow. Stand-alone islands of migration happiness are solely Novosibirsk and Tyumen regions (without okrugs).

Despite a migration growth owing to international migration, 52 regions of the country registered migration loss during January-November 2015.

Thus, labor migration can be a certain barometer of the crisis economic situation. Long-term migration can never be such a barometer: neither international, not internal one. However, indicative functions of the labor migration are hampered by regular legislative and statistical novations. Crisis developments are better diagnosed by the dynamics of migratory transfers.

### **5.3. Challenges facing higher education in Russia<sup>3</sup>**

The following public's common perception of higher education continues to be prevalent in Russia: the quality of higher education keeps deteriorating; higher education fails to meet the requirements of the labor market; higher education graduates do not work in jobs strictly or closely related to their degrees or major; there is an oversupply of students in the country; there is need to train specialists with secondary vocational education and blue collar workers that are in shortage.

This is enough to list, because the issue is plain to see: the quality of education continues to deteriorate, employers are dissatisfied with the level of training of young specialists who have to be trained up to the required level, the structure of personnel training is neither quantitatively

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<sup>1</sup> Expressed migration intentions posted 4.2% of respondents in 2008 and 4.4% in 2009. For further information please refer to Karachiruna L., Mkrтчian N. Potential of Spatial Mobility of Jobless in Russia. Sotsys. 2012. № 2. pp. 40-53.

<sup>2</sup> To note, that from 2011 those registered at the place of arrival for a period over 9 months fall in the statistics of long-term migration (independently of the fact if it is international or internal).

<sup>3</sup> Author of this section: Klyachko T. – RANEPА.

nor qualitatively consistent with the structure of Russia's economy, the labor market is in demand for graduates with secondary vocational education.

State budget expenditure for education should be curtailed because Russia's system of higher education fails to perform the functions vested therein. However, note that today some analysts use this argument which was previously adduced only by Russia's Ministry of Finance.<sup>1</sup>

Previously, the consideration of Russia's education issues, especially the quality thereof, used to lead to the exact opposite conclusion, that is, both budget spending and wages of teaching staff at higher education institutions should be increased with the introduction of "effective contracts" set forth in the Strategy-2020 and Executive Order of the President No. 597 of May 7, 2012.

It became apparent, especially in 2015, that with new conditions facing the higher education system (and the education system as a whole), it would be difficult to develop and finance higher education without understanding the prevalent public's perception thereof.

### 5.3.1. Dynamics of number of students of Russia's higher education institutions

Today, universities in many countries enroll 70–90% of birth cohort as compared to less than 15% in the 1930s and 25–30% in the 1970s/1980s.

Yet at the same time, countries may differ largely in economic conditions and the role of higher education in fulfilling their socio-economic objectives. For example, U.S. universities enroll 82% of birth cohort, 94% in Finland, 96% in South Korea, while higher education institutions enroll 91% of birth cohort in Greece which faces absolutely different socio-economic conditions compared with the foregoing states. However, there is a common uptrend towards growth of the percentage of birth cohort enrolling in universities.

In China the percentage increased from 16 to 26% over eight years (2006 to 2013), and the total number of students of higher education institutions rose above 30 million. India's universities enroll as little as 15% of birth cohort (a growth of 3% over eight years), yet this is more than 20 million persons. China and India's student body of local universities and universities abroad comprise 50 million persons in aggregate, surpassing the total number of students across the entire Europe, including foreign students of European universities.<sup>2</sup>

In late 1927, Russia (the Russian Soviet Federated Socialistic Republic (RSFSR)) had 90 higher education institutions comprising a total of 114,200 students. As early as 1940, the number of higher education institutions increased to 481, comprising 478,100 students, a 4-fold growth over 13-year period. The RSFSR reached 1.5 million students in the 1960s, above 3 million in the 1980s, then the number decreased slightly to 2.8 million by 1990.<sup>3</sup>

The Federal Law on Higher and Postgraduate Vocational Education of 1996 set the lower threshold of 170 budget-funded students per 10,000 of Russia's population (which then was equal to 2.5 million) because the number of budget-funded students was declining. Student bodies began to grow fast in 1995. Even the crisis of 1998 was not a headwind for the growth: in 2000, 965 Russia's higher education institutions (of which state institutions made up 607) comprised as much as 4.7 million students, including 2.6 million budget-funded students, that is, less than in the RSFSR in 1990. The student body reached a peak of 7.5 million in 2008

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<sup>1</sup> *Inozemtsev V.* How to enhance higher education? To cut sharply education spending. <https://slon.ru/po-sts/55592>.

<sup>2</sup> World in figures. 2007, 2014. M.: ZAO Olymp-Business.

<sup>3</sup> Rosstat: [http://www.gks.ru/free\\_doc/new\\_site/population/obraz/vp-obr1.htm](http://www.gks.ru/free_doc/new_site/population/obraz/vp-obr1.htm). Although this information is publicly available, the people in Russia are either unaware of this information or they are not interested in it.

which was marked as the year of the “great turn”. Since then the number of students began to decline drastically as a result of demographic changes. In 2015, Russia’s higher education institutions comprised less than 4.8 million students, of which budget-funded students made up as little as 1.9 million (see Fig. 5).

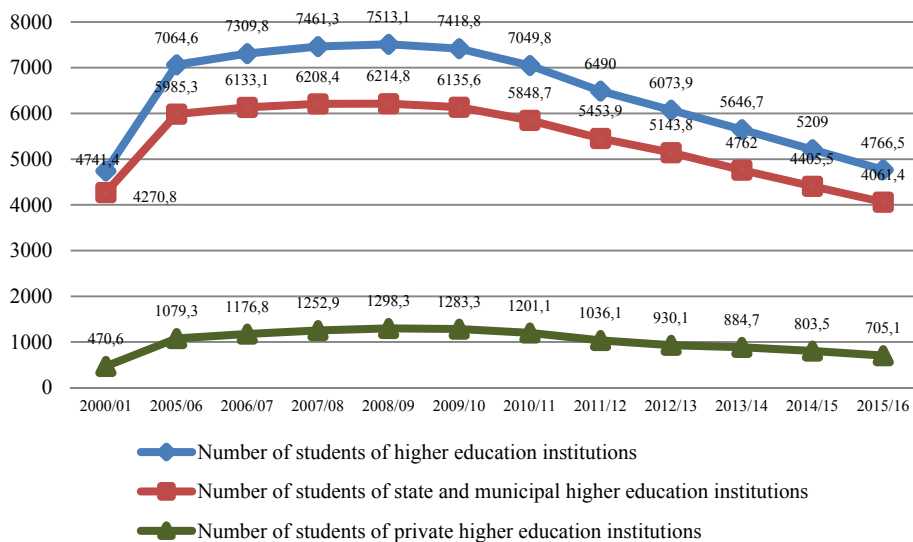


Fig. 5. Number of students of Russia’s higher education institutions in 2000/2001–2015/2016 academic years, thou. Persons

Source: Rosstat, <http://www.gks.ru/free doc/new site/population/obraz/vp- obr1.htm>.

It was the rapid growth in the number of students that in the late 1990s and in the 2000s gave rise to the perception that there is an “oversupply” of higher education in Russia.

However, the student body will continue to fall to 4.1–4.2 million until 2021. The trend will then reverse to a small growth up to 4.4–4.5 million. Hence, Russia’s higher education institutions are expected in 2025 (under the best-case scenario) to comprise less students than in 2000 (see Fig. 6).

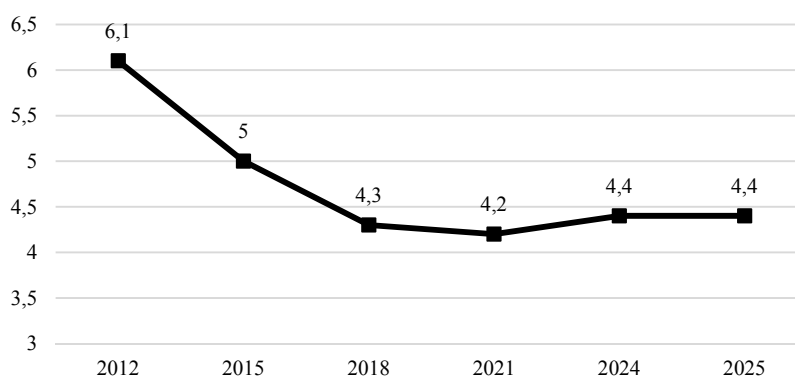
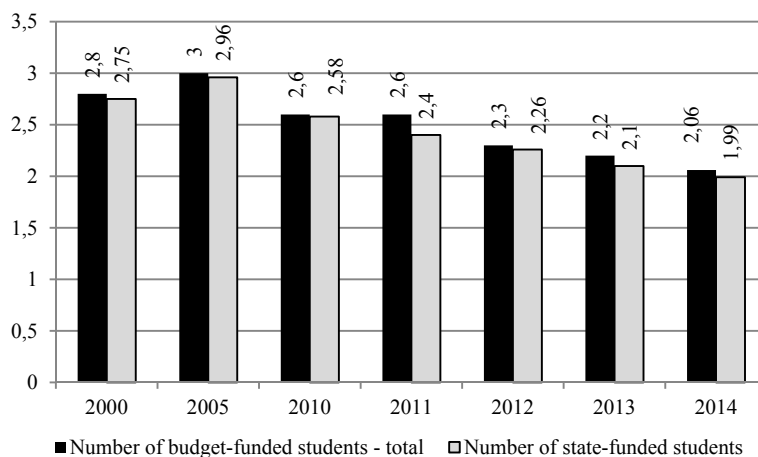


Fig. 6. Forecast for number of students of Russia’s higher education institutions until 2025, mln persons

Source: RANEPА Center for Continuing Education Economics’ own calculations based on Rosstat’s demographic forecast.

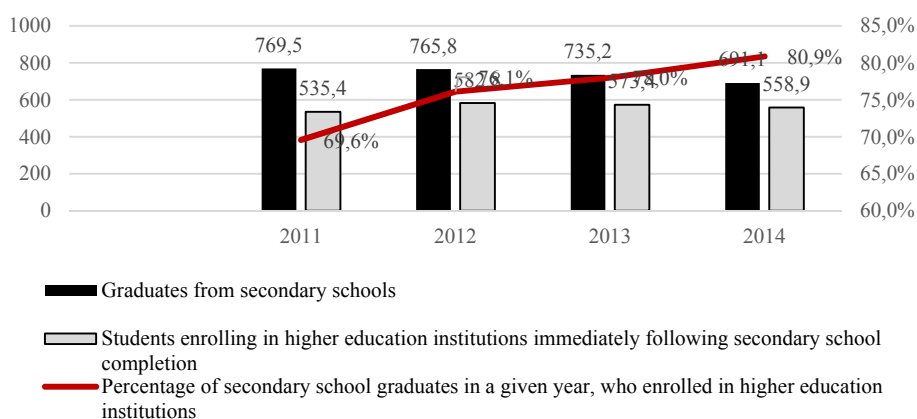
However, as early as 2014, the number of budget-funded students dropped below the lower threshold provided for by the Federal Law on Education in the Russian Federation No. 273-FZ of December 29, 2012, whereby there must be at least 800 budget-funded students per 10,000 of the population at the age of 17–30 (2.08 million persons during the foregoing year). Note that there were less than 2.0 million state-funded students in 2014 (see *Fig. 7*).



*Fig. 7.* Number of budget-funded students of Russia’s higher education institutions, 2011–2015, mln persons.

*Source:* Russian statistical yearbook 2015, Table 7.53. [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/publications/catalog/doc\\_1135087342078](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/publications/catalog/doc_1135087342078)

Since 2005, the number of budget-funded students of Russia’s higher education institutions decreased by 31.3% while the number of state-funded students dropped by 32.8%. Note that Russia’s higher education institutions year by year enrolled an increasingly higher percentage of graduates from secondary (complete) general education schools (see *Fig. 8*).



*Fig. 8.* Graduation from secondary schools and enrollment in higher education institutions in 2011–2014 (thou. persons., left-hand scale), percentage of secondary school graduates in a given year, who enrolled in higher education institutions (% , right-hand scale)

*Source:* calculated on the basis of Rosstat’s data.

Note that the enrolment of budget-funded students was steady enough for a long period of time, but then it started to decline. The decline was driven by a policy aimed at increasing budget expenditure for funded study places, rather than by demographic reasons (see Fig. 9).

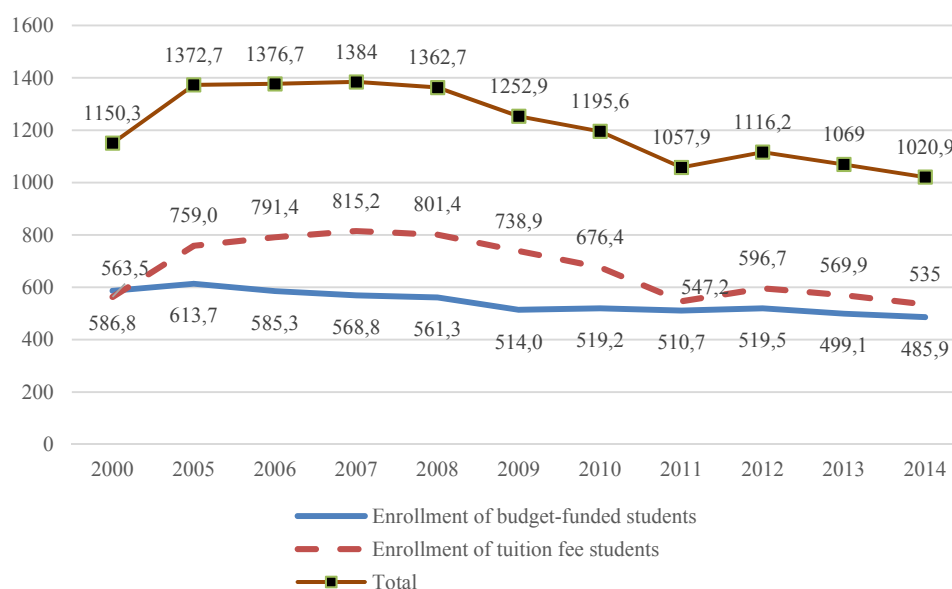


Fig. 9. Enrollment of budget-funded students and tuition fee students in Russia's higher education institutions, 2000–2014, thou. persons.

Source: Rosstat, higher education institutions enrollment annual data.

According to Rosstat, 504,000 state-funded students were enrolled in 2015, because, as shown above, in 2014 the number of budget-funded students of Russia's higher education institutions reached the lower threshold which could have been breached by decreasing further the number of budget-funded study places. However, a way of bypassing this legislative provision through cut scores at unified state examinations was found. In other words, the state budget will cover the enrollment of budget-funded students in higher education institutions according to the admission quotas approved by the Ministry of Education and Science, yet the number of applicants with a score above the cut score may happen to be smaller than the number of allocated budget-funded study places. Hence the legislative provision will be observed and less budget funds will be spent. A situation in which the number of secondary school graduates passing the unified state examinations with a score above the cut (scores) score may happen to be bigger than the number of allocated budget-funded study places is not considered because cut scores can always be made fit as required. Apparently, this approach will open new channels for corruption and will facilitate more tutoring and teaching to the unified state examinations in secondary schools (and it will fuel the recently weakened criticism of the state unified exams as such).

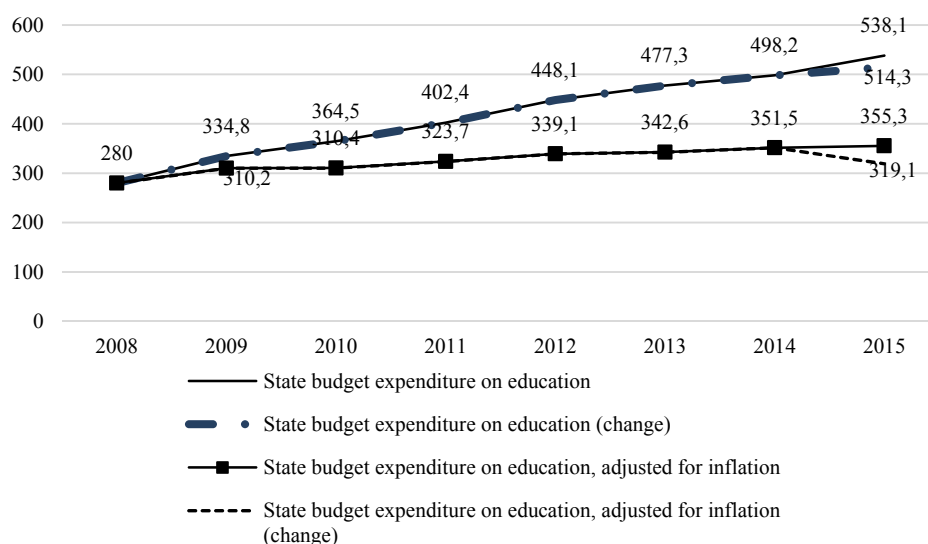
Finally, the quantitative parameters of the number of budget-funded students in 2015 were found to be much lower than those reported at the end of the Soviet era. With regard to tuition fee students, it should be admitted that higher education institutions depend largely on tuition fees despite a considerable increase in budget expenditure for higher education.

5.3.2. Quality of higher education

No wonder a sharp swing to general higher education tends to create a perception that the overall higher educational attainment is deteriorating. Perhaps other countries were exposed to similar shocks as they switched from elementary four-year education to seven- or eight-year education. This is history now, a routine, and it is hard to believe someone saying seven (eight) year education is wrong or in oversupply, especially if there is no data available to prove that the quality of education is deteriorating. One may just as well refer to the data for unified state examinations to argue that high-performing secondary school graduates prefer socio-economic sciences and humanities, whereas others tend to go to technical and natural science higher education institutions. However, this argument has limits, too, because high performers also enroll in institutions such as the Moscow Institute of Physics and Technology, the Moscow Engineering Physics Institute, the Bauman State Technical University, the St. Petersburg Polytechnic University, Department of Physics of the Moscow State University, and it is inappropriate to compare scores in social science with scores in, say, physics at the unified state examinations.

Much has changed in the perception of high-quality education since the past century. For example, it is now acknowledged that the U.S. higher education – like vocational education – begins with the master degree.

In the 1990s/2000s, budget expenditure for higher education was very small (Rb 30bn, which equals \$1bn at the exchange rate of 2000). Although it increased in recent years (see *Fig. 10*), the growth will unlikely result forthwith in a higher quality of higher education. Budget expenditure for higher education was for the first time curtailed in 2015, when the state budget was updated. The 2015 higher education expenditure was worth \$17.1bn according to the exchange rate of 2013 (about 30 rubles per US dollar), whereas the amount would decrease to \$7.9bn according to the current RUB/USD exchange rate.



*Fig. 10.* State budget education expenditure in nominal terms and adjusted for inflation, bln rubles

Sources: Russia’s Ministry of Finance and Federal Treasury.

Another quality aspect of higher education pertains to the fact that extramural students account for the bulk of Russia's students since 2000, but things have recently changed. However, extramural, intra/extramural and external students accounted for 50.6% of the total number of students in 2015, while intramural students made up slightly more than 49.4% (see Fig. 11).

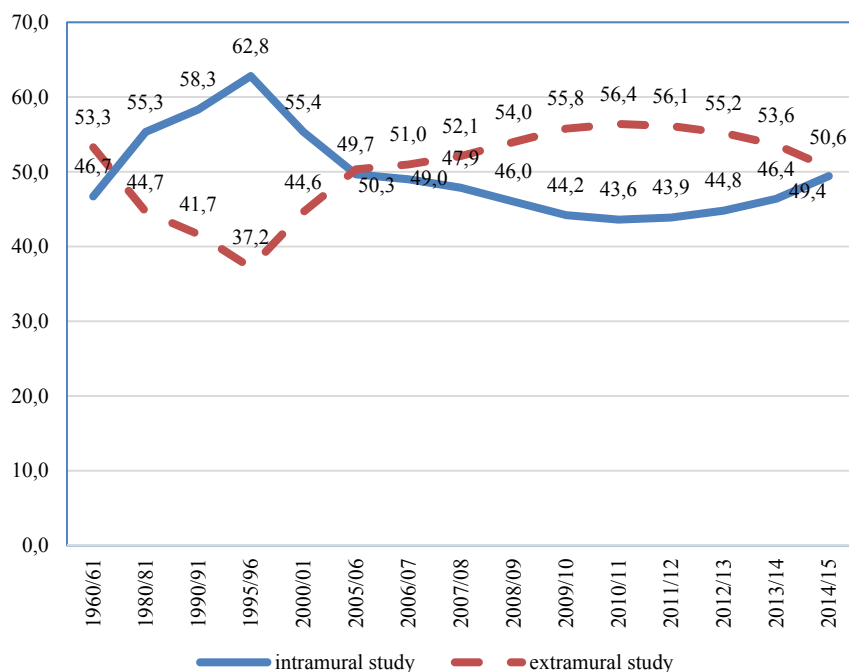


Fig. 11. Ratio of number of intramural students to extramural students of Russia's higher education institutions (the RSFSR until 1991), %

Source: Rosstat: <http://www.gks.ru/free doc/new site/population/obraz/vp- obr1.htm>.

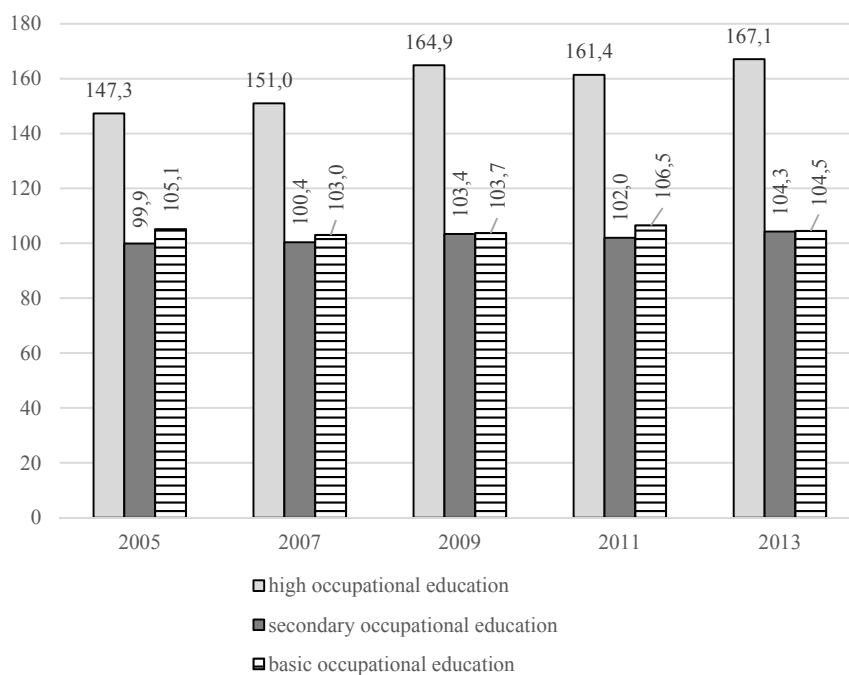
The presented data do not back up the common opinion that young men tend to enroll in higher education institutions because they want to dodge the military draft. Young adults at the age of 25 and beyond (e.g., about 1.7 million students in 2013<sup>1</sup>) combine education and work, and some obtain a second higher education degree (extramural study is based mostly on tuition fees, and a second higher education is always based on tuition fees).

### 5.3.3. Employers' need for employees with secondary vocational education

Until recently, the Russian economy exhibited an extremely positive attitude towards workers with higher education degrees, whose average wages in 2013 were roughly 1.67 times the average wages of workers who had no vocational education.<sup>2</sup> Average wages of workers with secondary vocational degrees were only 2–4% above average wages of workers with secondary education levels (see Fig. 12).

<sup>1</sup> The latest data available.

<sup>2</sup> The data for 2013, no data have yet been released for 2015, Rosstat performs this survey once every two years.



*Fig. 12. Premium for education in the Russian Federation, 2005–2013, %*

**Note.** Premium for education is the ratio of wages of workers with a certain level of vocational education to wages of workers with secondary (complete) general education.

*Source:* Rosstat: [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/wages/labour\\_costs/#](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/wages/labour_costs/#)

This wage ratio explains in part why some (about 35%) of the students graduated in recent years from secondary technical schools and secondary vocational schools enrolled in higher education institutions immediately following secondary school completion, without entering the labor market, and why others (about 35%) did the same within five years after secondary school completion. Also, employers who argue they run short of specialists with secondary vocational education did not, for some reason, rise wages of such workers, and a wage rise economically would imply an undersupply of such workers.

In 2014, there were 32.2% of employees with higher education degrees in Russia and 54% in the United States (complete and incomplete higher education). Including workers with tertiary levels, that is, secondary vocational and higher education credentials, the share of such workers in Russia would be 58.1%.<sup>1</sup> This is what possibly leads to a confusion when arguing that Russia is ranked 1st for the share of employees with higher education degrees.

There were 50% of workers with higher education degrees and 76.9% with tertiary education in Moscow and 44.6 and 67.4%, respectively, in St. Petersburg. This complies with the employment structure of big cities in advanced countries. Unfortunately, Russia has only two of such cities (see *Fig. 13*).

<sup>1</sup> Economic activity of Russia's population in 2015, Attachment, Table 1.9. [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/publications/catalog/doc\\_1139918584312](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/publications/catalog/doc_1139918584312)



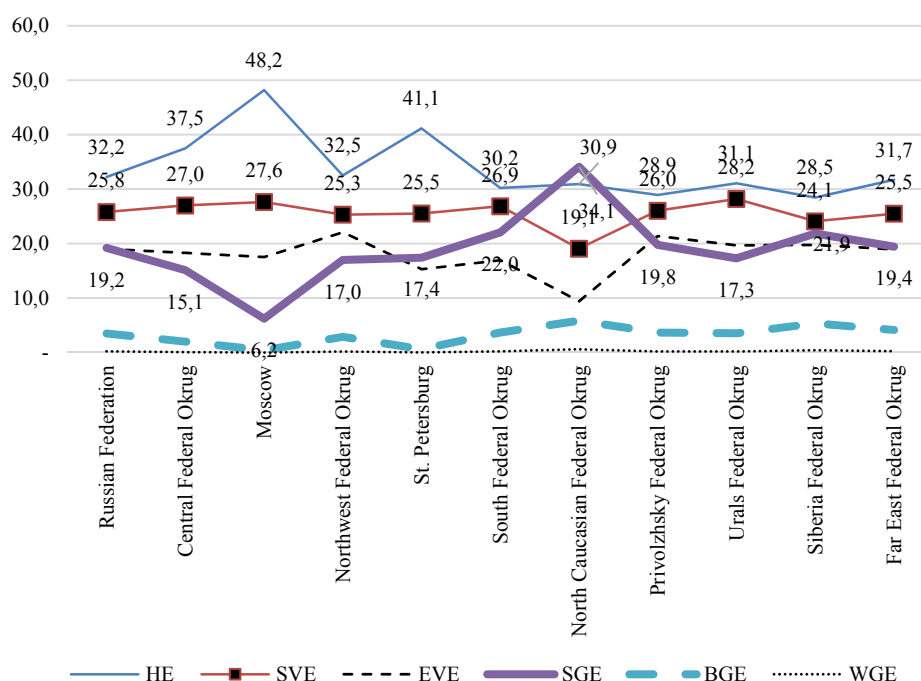


Fig. 13. Structure of employment by educational attainment in the Russian Federation, in federal okrugs, in Moscow and St. Petersburg, 2014, %

**Note:** HE stands for higher education, SVE denotes secondary vocational education, EVE is elementary vocational education, SGE stands for secondary (complete) general education, BGE denotes basic general education, WGE means w/o general education.

*Source:* Economic activity of Russia’s population in 2015, Attachment, Table 1.9. [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/publications/catalog/doc\\_1139918584312](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/publications/catalog/doc_1139918584312)

#### 5.3.4. Higher education graduates working in jobs related to their degrees

In 2013 (there is no Rosstat’s data available for a period beyond 2013), 95% of higher education graduates in the field of medicine (2010–2012), 66.5% of graduates in the field of pedagogy (more than in the Soviet era), 84.5% of graduates in the field of aerospace engineering, 83.5% of graduates in the field of informatics and computer engineering had jobs strictly or closely related to their degrees. The average share of graduates that worked in jobs related to their degree was more than 65%. Graduates in the field of service sector (of which 50.6% has jobs related to their degree) and in the field of reproduction and processing of forest resources (45.6%) faced the worst situation.

A much lesser percentage of graduates from secondary vocational institutions worked in jobs related to their degree: 40.2% of graduates in the field of agriculture and fishing, 28.2% of graduates in the field of geodesic and land surveying, 31.8% of graduates in the field of chemical and biological engineering, 34.1% of graduates in the field of reproduction and processing of forest resources. The average percentage of secondary vocational graduates working in jobs related to their degrees was roughly 54.6% (see Table 9).

Table 9

**Job and degree (major) match for graduates (from vocational education institutions in 2010–2012) in 2013**

Degree (major)	Total graduates, thou. persons	Including job and degree (major) match	
		related	not related
<b>Higher vocational education</b>			
Physics and mathematics	45	68.8	31.2
Natural science	40	59.9	40.1
Humanities	468	69.3	30.7
Social science	29	56.1	43.9
Education and pedagogy	414	66.5	33.5
Healthcare	138	95.0	5.0
Culture and arts	60	80.9	19.1
Economics and management	1100	68.8	31.2
Information security	17	84.5	15.5
Service sector	36	50.6	49.4
Agriculture and fishing	67	52.7	47.3
Geodesic and land surveying	14	78.1	21.9
Power generation, energy and electrical engineering	86	75.0	25.0
Metallurgy, machine engineering and materials processing	70	65.7	34.3
Aerospace engineering	26	84.4	15.6
Weapons and weapon systems	8	73.2	26.8
Marine engineering	12	78.6	21.4
Means of transport	75	65.3	34.7
Professional and optical equipment engineering	13	53.1	46.9
Electronics, radiotechnics and communications	42	73.7	26.3
Automatic control and systems engineering	14	66.7	33.3
Informatics and computer engineering	148	83.5	16.5
Reproduction and processing of forest resources	15	45.6	54.4
Technology of food products and consumer goods	43	61.1	38.9
Construction and architecture	120	70.7	29.3
Health and safety, environmental engineering and protection	27	70.0	30.0
Chemical and biological engineering	19	66.8	33.2
Geology, exploration and exploitation of mineral resources	43	77.3	22.7
<b>Secondary vocational education</b>			
Natural science	1	37.2	62.8
Humanities	86	52.1	47.9
Social science	4	66.5	33.5
Education and pedagogy	103	69.3	30.7
Healthcare	160	87.9	12.1
Culture and arts	30	62.5	37.5
Economics and management	285	55.8	44.2
Service sector	39	65.3	34.7
Agriculture and fishing	53	40.2	59.8
Geodesic and land surveying	9	28.2	71.8
Geology, exploration and exploitation of mineral resources	25	63.5	36.5
Power generation, energy and electrical engineering	63	56.1	43.9
Metallurgy, machine engineering and materials processing	54	48.2	51.8
Aerospace engineering	7	56.8	43.2
Marine engineering	12	55.8	44.2
Means of transport	138	56.7	43.3
Professional and optical equipment engineering	4	38.0	62.0
Electronics, radiotechnics and communications	21	60.7	39.3
Automatic control and systems engineering	10	41.1	58.9
Informatics and computer engineering	64	53.5	46.5
Chemical and biological engineering	7	31.8	68.2
Reproduction and processing of forest resources	14	34.1	65.9
Technology of food products and consumer goods	44	49.3	50.7
Construction and architecture	59	50.6	49.4
Health and safety, environmental engineering and protection	8	62.1	37.9
Information security	0.5	69.4	30.6

Source: Economic activity of Russia's population in 2014, Tables 2–44. <http://www.gks.ru/bgd/regl/b1461/Main.htm> /

One may assume that if higher education graduates did not work in middle manager jobs, such jobs would be occupied by secondary vocational graduates. However, as noted above, employers would rather hire the former, paying them much more than to the latter.

### 5.3.5. Employers' qualitative assessment of employees' basic job skills

In the mid-2015, the RANEP Center for Continuing Education Economics carried out a survey of employers' qualitative assessment of the level of skills training of workers of various categories. The survey covered enterprises of Russia's priority industries.<sup>1</sup>

An average level of requirements to the workers of surveyed enterprises is presented in *Table 10*.

*Table 10*

**Level of job skills requirements, 2015, % by row**

Staff level	Level of job skills requirements		
	High	Medium	Low
Blue collar workers	49.0	43.8	7.3
Specialists	80.0	20.0	0.0
Managers	85.0	15.0	0.0

*Table 10* shows that the highest level of job skills requirements is applied to managers (as a rule, these are workers with higher education degrees), whereas blue collar workers must meet the lowest level. In addition, economically efficient enterprises differ visibly from ailing enterprises in the level of job skills requirements (see *Table 11*).

*Table 11*

**Level of job skills requirements at efficiently-run enterprises and ailing enterprises, 2015, % by row**

Staff level	Level of job skills requirements		
	High	Medium	Low
<b>Efficiently-run enterprises</b>			
Blue collar workers	64.1	33.3	2.6
Specialists	83.3	16.7	0.0
Managers	88.1	11.9	0.0
<b>Ailing enterprises</b>			
Blue collar workers	38.6	50.9	10.5
Specialists	77.6	22.4	0.0
Managers	82.8	17.2	0.0

Hence efficiently-run enterprises and ailing enterprises differ first of all in the requirements to blue collar workers, which are much stricter at efficiently-run enterprises, however there is a smaller difference between them in the requirements to specialists and managers, yet the foregoing categories of workers must meet higher requirements at efficiently-run enterprises.

A comparative analysis of the assessments of the level of basic skills training of workers of economically efficient enterprises and ailing enterprises (see *Table 12*) reveals very pronounced differences: efficiently-run enterprises' assessment of their specialists and managers neared 100%, and that of blue collar workers was close to 70%.

<sup>1</sup> The survey covered enterprises (firms, organizations) operating in the ICT, energy, transport and communications sectors.

Table 12

**Level of basic skills training at efficiently-run enterprises  
and ailing enterprises, 2015, % by row**

Staff level	Level of training (expertise)		
	High	Medium	Low
<b>Efficiently-run enterprises</b>			
Blue collar workers	69.2	30.8	0.0
Specialists	97.6	2.4	0.0
Managers	95.2	4.8	0.0
<b>Ailing enterprises</b>			
Blue collar workers	52.6	42.1	5.3
Specialists	72.4	25.9	1.7
Managers	78.9	19.3	1.8

The assessment of basic skills training of the workers of ailing enterprises was much lower than that of efficiently-run enterprises, except that of managers and specialists, which was close to 80% for managers and more than 70% for specialists.

The bulk of economically ailing enterprises made a good assessment of the quality of basic skills training of their management staff, which, in our view, is an indication that they attribute economic failures of their enterprises mostly to external conditions rather than to a lack of education attainment.

\* \* \*

Thus in recent years in Russia, the number of budget-funded students of higher education institutions decreased as compared with the number recorded in the Soviet era, the bulk of higher education graduates worked in jobs related to their degrees, employers prefer hiring workers with higher education credentials, although they argue they need workers with secondary vocational degrees. Employers at modern/efficiently-run enterprises are satisfied with the basic skills level of their employees, whereas there is a lack of high skill workers at ailing enterprises. Given the fact that there is more ailing enterprises than efficiently-run enterprises in Russia, it is easy to spot the source of the prevalent perception of the quality of personnel training. Additionally, back in the Soviet era, enterprises were dissatisfied with the level of training of young specialists, too, which now seems to be almost forgotten. And there is still no way around in-house and advanced training. Russia's higher education faces numerous problems which have nothing to do with considerable budget expenditure for higher education institutions.

## **5.4. The situation in the science and innovation sphere<sup>1</sup>**

### **5.4.1. Budget constraints**

In 2015, the budget allocations to civilian research and development (R&D) were cut by approximately 8% at current prices by comparison with the targets set in the basic version of

<sup>1</sup> Author of this section: Dezhina I. – Gaidar Institute for Economic Policy.

the *Law on the 2015 Federal Budget and 2016–2017 Budget Plan*<sup>1</sup> (Table 13). The reduction in the amount of budget funding is of critical importance for the science sector, because the federal budget has remained the principal source of funding for research and development, covering about 70% of the aggregate expenditures on R&D.

Table 13

**Changes in budget allocations to R&D in 2015, by core program, bn Rb**

Title	Law No 384-FZ*	Actual allocation**	Deviation, %
<i>State Program of the Russian Federation for the Development of Science and Technology in 2013–2020</i>	164.4	151.68	-7.7
<i>Federal Targeted Program Research and Development in the Priority Areas of Development of the Russian Scientific and Technological Complex for 2014–2020</i>	23.7	21.39	-9.7
<i>Subprogram Fundamental Scientific Research</i>	109.0	102.0	-6.4

\* Federal Law of 1 December 2014, No 384-FZ (amended as of July 13, 2015) on the 2015 Federal Budget and 2016–2017 Budget Plan.

\*\* Summary of the quarterly spending profiles of the federal budget as of October 1, 2015.

Source: RF Ministry of Finance.

Although fundamental research represents an expenditure category that has been cut in the least degree, the overall downward trend displayed by it has become obvious. While back in 2008 the allocations to fundamental research amounted to 25.7% of the aggregate expenditures on R&D, by 2013 their share had shrunk to 17.4%.<sup>2</sup> In 2015, the most substantial budget cut was made to the programs of the Russian Academy of Sciences (RAS), as the actual funding allocated to them amounts to only half of the initial planned target. At the same time, the amount of basic expenditure allocations to the Academy's subordinated institutions was reduced by only 5%<sup>3</sup>.

The plans for 2016 indicate that in spite of the increased funding allocated to some special expenditure items, the allocations to fundamental research will be subject to major cuts. This conclusion is vividly illustrated by available data on changes in the amount of budget funding earmarked for the foundations set up to support fundamental research (Table 14). The planned budget allocations to the following three entities – the Russian Science Foundation (RSF), the Russian Foundation for Basic Research (RFBR) and the Russian Humanitarian Science Foundation (RHSF) – are below the corresponding indices for 2015, even in absolute terms.

However, the situation faced by each of the foundations is by no means the same: thus, the RSF was able to offset the loss of budget funding by the gift of Rb 14.9bn received from OJSC *Rosneftegaz* to cover its research projects. In this connection, *Rosneftegaz* put forth no specific conditions as to how the funding should be spent (for example, that it should be earmarked for those projects that are of interest to the sponsor)<sup>4</sup>. Earlier, the RFBR had also received gifts of money from commercial companies, but on a much more modest scale and always to cover the costs of targeted contests, where projects were to be launched in those fields that were relevant for the sponsoring companies.

<sup>1</sup> Federal Law of December 1, 2014, No 384-FZ (amended as of July 13, 2015) on the 2015 Federal Budget and 2016–2017 Budget Plan.

<sup>2</sup> *UNESCO Science Report: towards 2030*. Paris: UNESCO, 2015, p. 347.

<sup>3</sup> A. Subbotin. *Program malfunction. The sequester disrupts scientific research plans*. *Poisk* (in Russian), No 43 2015, October 23, 2015 <http://www.poisknews.ru/theme/science-politic/16167/>

<sup>4</sup> N. Volchkova. *To begin and to continue. The RSF's grants will grow in size and in time*. *Poisk* (in Russian), No 46, November 13, 2015. See <http://www.poisknews.ru/theme/science-politic/16440/>

Table 14

**Budget allocations to science foundations, bn Rb**

Foundation	2015	2016 – law	2016 – draft	Draft to law, %
1	2	3	4	$5 = 4/3 \times 100$
Russian Science Foundation	17.2	18.8	15.5	90.1
Russian Foundation for Basic Research	12.2	14.0	11.0	90.2
Russian Humanitarian Science Foundation	2.0	2.3	1.8	90.0

Source: RF Ministry of Finance.

The *State Program of the Russian Federation for the Development of Science and Technology in 2013–2020* retains its central place among the budget-funded civilian R&D. The amount of expenditures on this program has shrunk by 12.5%, while that allocated to the Federal Targeted Program *Research and Development in the Priority Areas of Development of the Russian Scientific and Technological Complex for 2014–2020* (large-scale applied research) has remained practically unchanged. It is important to maintain the planned level of allocations to R&D in the framework of that program because it is mostly from this source that the creation of new technologies (for example, photonics, neurotechnology) is being funded.

At the same time, the cuts in budget expenditures on R&D at the macrolevel occurred approximately in the same proportion as the cuts on other items. Therefore, when taken as a share in GDP, the volume of funding allocated to the principal research and development fields has demonstrated no change either on the targets set in Federal Law No 384-FZ or on the previous year, and its indices are as follows<sup>1</sup>:

- basic research – 0.2% of GDP;
- applied research in the field of national economy – 0.2% of GDP;
- applied research in the field of national defense – 0.4% of GDP.

#### 5.4.2. New target indication in the field of research and development

In 2015, the *Strategy for Innovative Development of the Russian Federation Until 2020* was revised, and some relevant alterations were made in respect of its targets and the content of tasks to be accomplished. The *Strategy*, in its new version, has undergone significant alterations both with regard to the targets set therein, and the essential features of the planned measures.

*First*, it is suggested that the share of funding competitions in the field of research and development should be increased, while the principles governing the operation of the science funds be left unchanged. At present, it is expected that the work carried out in the framework of research projects funded by grants issued by the RFBR and the RHSF should be done in the researchers' spare time, on their days off and holidays, while the travel to conferences covered by conference participation grants should take place during their vacation periods. So, it appears feasible to increase the amount of funding allocated to grants alongside the introduction of new terms for spending these funds.

*Second*, it is intended to make it compulsory for the RFBR and the RSF to conduct more competitions that will require co-funding from private sources. Given the low business activity in the field of R&D, such a requirement will translate into pressure on scientific research organizations and higher educational establishments, but not into positive incentives for commercial companies. In addition, the government has already voiced its demand that the science

<sup>1</sup> In accordance with Annex 8 to the Explanatory Note attached to the draft of the *Federal Law on the 2016 Federal Budget*.

foundations should not only provide financing for fundamental and exploratory research project initiatives, but also to develop medium- and long-term programs along the lines of the current government programs – that is, to single out priority themes. This requirement is stipulated in the alterations to the Federal Law *On Science and State Scientific and Technological Policy*, introduced in July 2015.<sup>1</sup> So, the amount of funding allocated to fundamental research projects addressing the issues suggested by the scientist community is being reduced, and so the new progressive research fields that cannot be properly identified and recognized by the priority-setting government agencies may suffer from lack of funding.

The logic behind the government's actions can be perceived as a threat to the independence of the RFBR and the RHSF (and consequently to the allocations assigned to them in a separate line in the state budget, which can also be lost), when these two foundations will become subordinated to the RF Ministry of Education and Science. The Ministry has already released for public discussion the drafts of its decrees whereby alterations are to be introduced in the RFBR and the RHSF's charters<sup>2</sup>, in accordance with which 'some of the functions and powers of the Foundation's founder envisaged in the charter shall be executed by the Ministry of Education and Science of the Russian Federation'. To be more precise, 'some powers' include those of appointing and dismissal of the Foundation's director, approving the membership of the Foundation's Board, preparing and approving government assignments, and a number of other important regulatory and supervisory functions. If the governance functions should be divided in this way, the foundations will have to reorient their activities to the achievement of those goals that are important not from their own point of view, but from the point of view of the RF Ministry of Education and Science. Thus, only one foundation will remain independent – the RSF.

The alterations introduced into the *Strategy for Innovative Development of the Russian Federation Until 2020* with regard to the main R&D targets are also noteworthy. By comparison with the *Strategy's* previous version, most of these targets have been downgraded. Thus, it is planned that the expenditures on research and development should be increased to 1.77% of GDP by 2020, while earlier this target was already to be reached by 2015. The new target, while being low, is sufficiently realistic, if one is to consider the general movement pattern displayed by Russia's expenditures on R&D as a share in GDP over the past decade. At the same time, in the developed countries the R&D expenditure index varies from 2.6% to nearly 5% of GDP. So, the new low target implies that the gap between Russia and the developed countries will be widening, as far as the intensity of investment in R&D is concerned.

Another index describing the performance level in the sphere of scientific research – the share of publications by Russian authors in the total number of publications in international scientific journals indexed in the Web of Science database – was likewise moved to 2020. Initially, this index was to rise by 2015 to 2.44%. In the *Strategy* it is stated that as of 2014, it amounted to 2.05%.<sup>3</sup>

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<sup>1</sup> Federal Law *On Introducing Alterations to the Federal Law 'On Science and State Scientific and Technological Policy' in the Part of Improving the Financial Instruments and Mechanisms of Support of Scientific and Technological Activity in the Russian Federation*, No 270-FZ dated July 13, 2015. See <http://pravo.gov.ru/laws/acts/54/5055484510601047.html>

<sup>2</sup> A. Gorbatova. *Alterations will be made to the charters of the RFBR and RHSF*. August 20, 2015. See [http://www.strf.ru/material.aspx?CatalogId=221&d\\_no=103488#.Vm3FQb8yTOA](http://www.strf.ru/material.aspx?CatalogId=221&d_no=103488#.Vm3FQb8yTOA)

<sup>3</sup> Bibliometric experts note that this index may vary depending on the specific methodology applied in the calculations. As a result, according to data released by the National Training Foundation, the Web of Science citation index of the articles written by Russian authors had increased by 2014 to 2.28%, and that of Russian publications of any type – to 1.7%. As stated by Thomson Reuters, the overall citation index of Russian publications amounts

### 5.4.3. Science at higher educational establishments

The development of science-related activities at higher educational establishments remains one of the priorities of the government policy in the field of science. Much attention in this connection was paid to the universities participating in Project 5-100.<sup>1</sup> Their latest ranking in the world's top ratings were discussed, as well as the movement of their scientific research indices and the factors that can either speed up or slow down their development. The current estimates of the progress of scientific research at Russia's leading universities demonstrate that none of the 15 higher educational establishments that have received hefty chunks of budget resources specifically for that purpose were able to follow the letter of the Executive Order of the RF President (which requires that no less than five universities should by 2020 be ranked among the world's top hundred).<sup>2</sup> So, *de facto* this goal has been adjusted, and Russia's universities are now expected only to get into the top segments of by-subject rankings, which is achievable in view of the current trends. Thus, for example, the Times Higher Education (THE), two of Project 5-100 higher educational establishments – National Research Nuclear University MEPhI and Novosibirsk State University<sup>3</sup> were ranked among top 100 for 2015 in the field of physics. The other fields where Russia ranks above average in the world publication stream (and so its higher educational establishments specializing in these subject areas have the potential for getting ranked among top 100), are outer space exploration, Earth science, mathematics and chemistry<sup>4</sup>.

In part, the increasing number of publications assigned to higher educational establishments can be explained by the fact that their authors, who hold academic posts at those higher educational establishments as a second job, in addition to their research posts at the institutes belonging to the RAS system, have begun to state their university affiliation. As a result, the share of articles authored jointly with RAS research institutes in the total number of publications released by Project 5-100 universities has increased<sup>5</sup>. Some higher educational establishments developed special programs for boosting the citation index of their publications. A noteworthy

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to 1.73%. According to data released by the RF Ministry of Education and Science for 2014, the share of Russian publications over that year amounted to 2.17%. Source: *To improve the quality and increase the number of scientific products by Russian authors*. Presentation materials, Ural Federal University, October 6–7, 2015. See [http://urfu.ru/fileadmin/user\\_upload/common\\_files/events/Pismo\\_v\\_Instituty\\_UrFU\\_Seminar\\_po\\_naukometrii.pdf](http://urfu.ru/fileadmin/user_upload/common_files/events/Pismo_v_Instituty_UrFU_Seminar_po_naukometrii.pdf)

<sup>1</sup> Project 5-100 is aimed at boosting the competitive potential of Russia's leading universities among global research and education centers. Its goal is to maximize the competitive position of a group of leading Russian universities in the global research and education market. Source: <http://5top100.ru/>

<sup>2</sup> Executive Order of the RF President dated May 7, 2012, No 599 *On Measures on Implementation of National Policy in Education and Science*, see <http://5top100.ru/documents/regulations/671/>

<sup>3</sup> K. Bolokhova. *From general to specific: why are the by-subject ratings of higher educational establishments more attractive for Russia?* November 23, 2015. See [http://www.strf.ru/material.aspx?CatalogId=221&d\\_no=110329#.Vm2mf78yTOA](http://www.strf.ru/material.aspx?CatalogId=221&d_no=110329#.Vm2mf78yTOA)

<sup>4</sup> V. Ivanov, V. Markusova, L. Mindeli. *Money and its yield. Analysis of the cost-effectiveness of investment in Russia's higher school, with regard to publications*. Poisk (in Russian), No 22, May 29, 2015. See <http://www.poisknews.ru/theme/science-politic/14780/>

<sup>5</sup> The champion was the National Research University Higher School of Economics (NRU HSE) where, as demonstrated by data for 2014, the number of publication increased 8.8 times, and the number of articles co-authored by written by scientists working in the RAS system - 13 times on 2010, respectively. Source: V. Ivanov, V. Markusova, L. Mindeli. *Money and its yield. Analysis of the cost-effectiveness of investment in Russia's higher school, with regard to publications*. Poisk (in Russian), No 22, May 29, 2015. See <http://www.poisknews.ru/theme/science-politic/14780/>



example is the Hirsh citation index program launched by Tomsk Polytechnic University, nicknamed the *Hirsh Rocket*, which offers services that involve translation and publication of scientific articles in international journals<sup>1</sup>. A number of higher educational establishments began to pay for the publication of their articles in India's and China's journals, where the access was much easier<sup>2</sup>, and by doing so they managed to boost their international citation indexes. However, this effect proved to be temporary, because the databases run by the Web of Science and Scopus are subject to regular cleanups, when all 'trash' journals are removed from their data sets. Besides, the ranking criteria for scientific publication are also being regularly revised – as did QS in 2015<sup>3</sup>, when it began to reject articles signed by more than 10 names and introduced coefficients when counting the citation rates for each subject. The upshot was that eight of Project 5-100 higher educational establishments (that is, more than half) got downgraded in their QS ranking<sup>4</sup>. Thus, the incentives for getting a higher ranking boosted ingenuity in finding ways to improve formal citation indexes, but not a genuine interest in scientific research.

In this connection, the official have pointed out many times that getting the required ranking should not be a goal *per se*<sup>5</sup>, but only an indicator of a higher educational establishment's profile in the international landscape, and its quality market in the fields of science and education. Project 5-100 was officially recognized to be successful, and the funding allocated to it (which was initially geared to a three-year period (until 2015) was increased to last until 2020<sup>6</sup>. Meanwhile, the number of higher educational establishments competing for a higher ranking increased: after an additional contest in October, another 6 higher educational establishments were included in Project 5-100<sup>7</sup>.

Almost simultaneously, the report *5-100: The price of a failure* prepared by the social movement organization *Supervision in Education in Science*<sup>8</sup> was released, where it was concluded that the budget resources to the value of Rb 30bn that had already been spent yielded no relevant results, and that the project management system is inefficient and expensive. Indeed, over the three years while the project was being implemented, only two higher educational establishments were able to get ranked in the third hundred in one of the ratings (THE). To be fair to university researchers, it should be noted that the policy towards higher educational establishments has continued to be restrictive rather than conducive to increasing their visibility on an international level. We are speaking first of all of the human resources policies, when in order to boost their average salary indices<sup>9</sup> the administrations of higher educational establishments

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<sup>1</sup> *Hirsh Rocket* (Hirsh citation index): *We can help you in getting your article published*. See <http://rh.tpu.ru/>

<sup>2</sup> *QS has run out of citations* // Kommersant, September 22, 2015. See <http://www.kommersant.ru/doc/2815455>

<sup>3</sup> QS World University Rankings is a global career and education network that highlights the world's top universities, set up by (QS) Quacquarelli Symonds Ltd, a UK consulting company.

<sup>4</sup> Ibid.

<sup>5</sup> See, for example, A. Chernykh. *Universities will be distributed among industries*. Kommersant, No 193, October 19, 2015 <http://kommersant.ru/doc/2836046>; K. Bolokhova. *From general to specific: why are the by-subject ratings of higher educational establishments more attractive for Russia?* November 23, 2015 [http://www.strf.ru/material.aspx?CatalogId=221&d\\_no=110329#.Vm2mf78yTOA](http://www.strf.ru/material.aspx?CatalogId=221&d_no=110329#.Vm2mf78yTOA)

<sup>6</sup> K. Bolokhova. *From general to specific: why are the by-subject ratings of higher educational establishments more attractive for Russia?* November 23, 2015 [http://www.strf.ru/material.aspx?CatalogId=221&d\\_no=110329#.Vm2mf78yTOA](http://www.strf.ru/material.aspx?CatalogId=221&d_no=110329#.Vm2mf78yTOA)

<sup>7</sup> *6 new higher educational establishments were selected for Project 5-100*. October 26, 2015. See <http://5top100.ru/news/20951/>

<sup>8</sup> Published on November 20, 2015, see <http://обрнадзор.рф/вдействи/5-100/>

<sup>9</sup> In accordance with Executive Order of the RF President No 599 *On Measures on Implementation of National Policy in Education and Science*, by 2018 the average salary level of the faculty members of higher educational

began to increase the academic workload of their staff.<sup>1</sup> Such an approach can hardly improve the incentives for scientific research growth in terms of volume and quality. Some problems have also occurred in Project 5-100 management system, where the rate of red tape in reporting is higher than in the projects funded by grants or under government contracts.

#### 5.4.4. The main directions of reform in the RAS

The ongoing reform in the Russian Academy of Sciences has continued to be the focus of public attention in the science sphere. When cleared of all the hullabaloo, it all boils down to this: a lot of ideas, programs and measures have been discussed, but few of the actually adopted decisions can be called truly reformatory - that is, reaching beyond the inventory and record-keeping issues. Among these, the following ones are the most noteworthy:

1) doubled amount of the special supplementary payments to Academicians and Corresponding Members of the RAS; the introduction of the title of Professor of the RAS;

2) rotation of the directors of research institutes in order to get younger people occupy major administrative posts in the field of academic science;

3) continuation, in an 'initiative mode', of the process of merger of institutes within the RAS system, and not only those with similar profiles, but also some of the institutes with different profiles, including those situated in different cities at a considerable distance from one another.

Among the innovations introduced in 2015, we may also note the palliative solution to the issue of division of functions between the RAS and the Federal Agency for Scientific Organizations (FASO) - the so-called 'rule of two keys', whereby the areas of responsibility for each of the two entities should be clearly outlined.

All the other initiatives are now undergoing the discussion phase, including (1) the system for assessing the performance of scientific research organizations, where the discussion hot-point was the principles to be applied in creating the reference groups for comparative assessment of organizations;<sup>2</sup> (2) the principles of drawing up government assignments for fundamental and exploratory research, including definition of the types of activities to be funded through a competitive process, and their relative proportions; (3) the program for creating a reserve of human resources for the FASO (training of efficient managers for scientific research organizations).

The progress of reform in the academic sector is estimated by scientists and experts to be on the whole more negative than positive. Thus, the academicians and the activists of the scientist community (for example, those who are members of the Council on Science under the RF Ministry of Education and Science) believe that negative consequences prevail.<sup>3</sup> At the same time,

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establishments should be twice above the average salary of the region where a given higher educational establishment is registered.

<sup>1</sup> By way of illustration, see the case of Moscow Institute of Physics and Technology (State University): A. Arutiunov, M. Balashov, R. Karasev, D. Tereshkin. *MIPT: Questions without answers*. Troitsky Variant - Science (Newspaper), No 193 of 8 December 2015, p. 5, see <http://trv-science.ru/2015/12/08/mipt-voprosy-bez-otvetov/>

<sup>2</sup> This discussion was underway throughout 2014. See *The State of Science and Innovation. Russian economy in 2014. Trends and outlooks* (Issue 36) – M.: Gaidar Institute, 2015, pp. 348–349.

<sup>3</sup> Thus, in particular, the Council on Science under the RF Ministry of Education and Science, at its meeting on October 29, 2015 stated that 'no positive changes have occurred so far in the institutes of the RAS, a surge in paperwork was noted'. Source: [http://sovet-po-nauke.ru/sites/sovet-po-nauke.ru/files/data/Presentation\\_A.R.Khokhlov\\_29\\_10\\_2015.pdf](http://sovet-po-nauke.ru/sites/sovet-po-nauke.ru/files/data/Presentation_A.R.Khokhlov_29_10_2015.pdf)

the officials responsible for the development of science in this country<sup>1</sup> estimate the reform to be positive. It should be noted that the critics of reform have used many arguments to support their negative viewpoint, while its proponents can offer practically nothing to counter those arguments.

For the scientist community on the whole, the major threat associated with the measures that are being implemented as part of reform is that they may bring about a dramatic shrinkage of the human resources potential involved in scientific research, the liquidation (by means of a merger) of some of the existing research institutes, and distortions in the structure of scientific research as a result of cuts in basic budget funding. On the positive side, as noted by some academicians, the ongoing processes resulted in the following major achievements:

- 1) the transfer of the function of managing the economic activities, properties and land from the RAS to the FASO in the situation of a perpetually changing normative-legal base and the high costs associated with the procedures of property right formalization and property registration;<sup>2</sup>
- 2) the appointment of younger people to the posts of heads of scientific research organizations (the Presidium of the RAS should coordinate the list of candidates for the posts of heads of scientific research organizations);<sup>3</sup>
- 3) the temporary character of the increased bureaucratic workload. It has increased because the initial phase of reform involves inventory checks; meanwhile, the scientists working in the well-run research institutes do not feel any additional workload.<sup>4</sup>

#### *The decisions concerning human resources*

From 1 July 2015 onwards, the supplementary academic payments for the titles of Academician and Corresponding Member of the RAS were raised to Rb 100,000 and Rb 50,000 per month respectively.<sup>5</sup> The amounts of supplementary academic payments for the other state academies were also doubled. The government explained the increase in the size of supplementary payments by the planned increase of the expert responsibilities of the academicians.<sup>6</sup> Indeed, the range of these supplementary responsibilities had become so wide that the Presidium

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<sup>1</sup> Andrei Fursenko, Aide to President of Russia, saw some positive shifts in the development of Russian science after the launch of reform in the RAS (Fursenko sees positive shifts in the development of science after the reform in the RAS. TASS, August 26, 2015. See <http://tass.ru/nauka/2211616>; RF Minister of Education and Science Dmitry Livanov views as the positive outcome of the reform that science '...will increasingly move into universities' (Livanov: *Every higher educational establishment gets money to increase its salaries, but not every one of them uses it in the right way*. Business FM.RU, November 3, 2015. See <http://www.bfm.ru/news/307034>. However, at the same time the Livanov noted that so far, 'only the zero phase has been passed, the phase of alterations introduced into the order of subordination'.

<sup>2</sup> Academician Fortov: *About the reform of the Academy – without anger or bias*. The Independent Newspaper, February 10, 2016. See [http://www.ng.ru/science/2016-02-10/9\\_reform.html](http://www.ng.ru/science/2016-02-10/9_reform.html)

<sup>3</sup> Academician A. Aseev. *Reform of the RAS as a threat to national security*. REGNUM, December 8, 2015. See <http://regnum.ru/news/innovatio/2029988.html>; Academician Fortov: *About the reform of the Academy – without anger or bias*. The Independent Newspaper, February 10, 2016. See [http://www.ng.ru/science/2016-02-10/9\\_reform.html](http://www.ng.ru/science/2016-02-10/9_reform.html)

<sup>4</sup> Academician A. Kuleshov. *Science is degrading every year, every hour*. Gazeta.ru, December 9, 2015. See [http://www.gazeta.ru/science/2015/12/09\\_a\\_7943969.shtml](http://www.gazeta.ru/science/2015/12/09_a_7943969.shtml)

<sup>5</sup> Decree of the RF Government No 480 *On Introducing Alterations into Item 1 of Decree of the Government of the Russian Federation of 22 May 2008, No 386* dated May 19, 2015. See <http://government.ru/media/files/FW9S5mwJevWvkqKAdUAkc4zrpldwRYX.pdf>

<sup>6</sup> I. Dezhina. See *The State of Science and Innovation. Russian economy in 2014. Trends and outlooks* (Issue 36) – M.: Gaidar Institute, 2015, p. 355.

of the RAS also approved the introduction of a new academic title - that of Professor of the RAS. In this way, they hope that some new human resources can be attracted for performing expert estimations and other duties.<sup>1</sup> The title of Professor of the RAS is not associated with any money benefits, but its bearer must shoulder many responsibilities, including an active participation in the achievement of the goals set for the Academy, promotion and consolidation of the links between education and science, and popularization and promotion of scientific knowledge. It is intended that Professors of the RAS will be putting forth proposals concerning the choice of priorities, participate in the academic, expert and coordinating councils, and act as experts on behalf of the Academy. A Professor of the RAS may not be older than 50 years of age; he or she must have the degree of doctor of science or an academic degree awarded by a foreign state (the title Professor of the RAS may also be awarded to foreign scientists). The attractiveness of this title, in addition to it being prestigious, is that Professors of the RAS have a greater chance, by comparison with the rank-and-file scientists, to be promoted later on to the status of a Corresponding Member of the RAS or an Academician of the RAS.

In December 2015, the RAS Departments held their General Meeting, where 497 candidates for the title of Professor of the RAS were approved (out of a total of 656 submitted applications)<sup>2</sup>. The title of Professor of the RAS was granted by the academicians at their own discretion, the list of candidate was not made public, and there was no public discussion of it, and so this event compares rather unfavorably with the procedure of elections to Academy members (just to name one example). Such an approach caused some sharp criticism on the part of the scientist community, who made the conclusion that the very title of a Professor became devalued<sup>3</sup>.

Alongside this 'rejuvenation' of the RAS, the replacement of those directors of research organizations in the FASO system who had reached the age of 65–70 years took place. According to data released as of mid-2015, 48% of the directors were older than 65 years,<sup>4</sup> and so the scale of the forthcoming 'rotation' will be impressive. Last year, the process, once started, gave rise immediately to several scandalous situations. Thus, in particular, a 'sample group' of the newly appointed directors (its list is published at the FASO's website) were subjected to a 'quality test' on the basis of the Russian Map of Science. Although the Russian Map of Science has been criticized in many of its aspects, it is promoted by the RF Ministry of Education and Science as the most complete source of information on human resources in the science sphere, because it contains data on publications and citations, as well as on patents, completed R&D projects, and distribution of grants. The database is renewed on a regular basis. The selective screening of the new directors in accordance with the Map of Science demonstrated that many of them lack

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<sup>1</sup> Decree of the Presidium of the RAS *On introducing the title of Professor of the RAS and approving the Provision on the title of Professor of the RAS*, No 204 dated September 29, 2015. See <http://www.ras.ru/presidium/documents/directions.aspx?ID=adf67dc8-84b3-4350-b4be-7e1dce9b71ec>

<sup>2</sup> M. Aleksandrov. *Adding reinforcements. Professors of the RAS will add energy to the Academy*. Poisk, No 52, December 25, 2015. See <http://www.poisknews.ru/theme/science-politic/17007/>

<sup>3</sup> A. Moiseev. *Professors as a substitute for representatives?* Troitsky Variant - Science (Newspaper), No 2, 2016, p. 12; A. Fradkov. *One step backwards, then bury your head in the sand*. Troitsky Variant - Science (Newspaper), No 2, 2016, p. 12.

<sup>4</sup> Source: FASO. A. Mekhanik. *The management of science is impossible without well-defined procedures*. Expert, No 23, June 1, 2015. See <http://expert.ru/expert/2015/23/upravlenie-naukoj-nevozmozhno-bez-opredelennyih-protsedur/>

not only notable achievements in scientific research, but even proper degrees in science.<sup>1</sup> Such an outcome would have been easily explainable if the relevant decisions had been made exclusively by the FASO on the basis of only two criteria: 1) suitable age, 2) administrative (managerial) experience. However, the candidates were agreed upon with the Presidium of the RAS, and so this state of affairs can only be explained by the fact that the Presidium of the RAS is actually subordinated to the Federal Agency even in those spheres where the Academy does not simply offer advice, but coordinates the decision-making process.

The truth of such a conclusion is further supported by the evidence that the 'rule of two keys', in accordance with which the relevant functions are clearly divided between the RAS and the FASO, is effectively dysfunctional, and that the main 'governance' functions are consolidated to the FASO; in an event of a major conflict, it is resolved 'in a manual mode' at the government level. Indeed, in accordance with the RF Government's Decree approved in May 2015,<sup>2</sup> the RAS conducts independently the performance assessment of the scientific research organizations of the FASO and the expert estimations of the results of scientific research projects, while all the other functions are performed by the FASO; meanwhile, the RAS either coordinates the FASO's decisions (the development programs and scientific research plans for the scientific research organizations subordinated to the FASO), or puts forward proposals (government assignments to organizations). According to the CEOs of the RAS, the goal of proper delineation between the functions of the two entities have not been achieved, and a 'soft variant' has been implemented instead.<sup>3</sup> Another remarkable feature of the procedures applied in 'renewing' the 'director corps' is that, while the appointment procedures are more or less coordinated with the RAS, the dismissal of directors is solely the FASO's prerogative. And so their rotation, and consequently the choice of new cadres, depends on the FASO.

In addition to the replacement of directors, the FASO suggested that the performance of the administrative staff of the institutes could also be improved, and developed for that purpose a draft program for creating the reserve of human resources for scientific research organizations.<sup>4</sup> The reserve of human resources, according to the FASO, is to consist of three categories: operative reserve – the candidates for the posts of deputy directors or directors of institutes; perspective reserve – the specialists desiring to work as project directors; and development reserve – the researchers capable of commercializing the results of their research. The project continues to be discussed, and its critics believe that the FASO is going to retrain scientists to be employed as managers, which will be detrimental to science proper.<sup>5</sup> This project was also opposed by the members of the Science *Coordinating Council* under the FASO, who estimated it to be of little use, unpractical and costly,<sup>6</sup> and beneficial only for a few institutes and universities directly involved in the retraining programs. While all these observations are certainly true, it

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<sup>1</sup> E. Kalle. *Rejuvenating glee in the RAS: lower, lower and lower we direct the flight of our ...* REGNUM, October 16, 2015. See <http://regnum.ru/news/1992799.html>

<sup>2</sup> Decree of the RF Government *On Some Issues of the Activity of the Federal Agency for Scientific Organizations and the Federal State Institution 'Russian Academy of Sciences'*, No 522, dated May 29, 2015. See <http://pravo.gov.ru/proxy/ips/?docbody=&nd=102372866&rdk=&backlink=1>

<sup>3</sup> The opinion of President of the RAS V. E. Fortov. Source: Yu. Medvedev. *The keys to the RAS. Vladimir Fortov: the hardest part of the Academy's reform has not been started yet.* The Russian Newspaper, No 6790 (219), September 29, 2015. See <http://www.rg.ru/2015/09/29/fortov-site.html>

<sup>4</sup> See <http://fano.crowdexpert.ru/personnel-reserve>

<sup>5</sup> *The triad of the cadre reserve.* August 17, 2015. See [http://www.ng.ru/editorial/2015-08-17/2\\_red.html](http://www.ng.ru/editorial/2015-08-17/2_red.html)

<sup>6</sup> N. Volchkova. *For the sake of a report? Reform of the RAS is put on paper.* Poisk (in Russian), No 18, May 1, 2015. See <http://www.poisknews.ru/theme/science-politic/14414/>

should be noted that the governance culture practiced in the institutes formerly belonging to the RAS is far from being up-to-date. That is why they encounter problems associated with the increased bureaucratic load on their staff involved in scientific research, which means that the responsibilities of administrative departments are being shifted onto scientific research departments. It is by all means necessary to improve their managerial skills, but now is not the best time for setting such a goal, in view of the shortage of budget funding allocated to the most vital expenditure items of scientific research institutes.

### *Restructuring of the FASO's network of institutes*

In 2015, the FASO planned to establish 23 merged scientific and research centers; the decisions were finalized for 15 of these centers. Typically, this speedy reorganization took place in absence of any clear-cut criteria for placing each organization in one of the four specific categories (federal research centers, national research institutes, etc.)<sup>1</sup> The Presidium of the RAS, as well as the institutes that were being merged, quite often disapproved of their merger plans, which triggered several scandals, when the institutes revolted against the decisions made by the FASO. In some cases it was possible to prevent a merger;<sup>2</sup> this possibility arose, among other things, due to the fact that the relevant organizations were participating in major government projects, and so their restructuring could negatively affect the outcome of those projects of national importance. In this connection, the Presidium of the RAS suggested that the restructuring should proceed gradually, after its principles, criteria and procedures had been properly tested in the course of pilot projects.<sup>3</sup> However, the mergers occurred not on a systemic basis, but on the initiative of certain groups or individual scientific research organizations. Moreover, in some cases the institutes put forth the proposal of a merger as a 'preventive measure', not because they really wanted to improve their performance, but because they feared that later on they would be forced to merge against their will.

Simultaneously, the leader institutes were determined, later to be made responsible for major fields of research. The three main criteria for selecting these institutes were as follows: their compliance with the established priority directions of development in the field of science and technology; their high importance for achieving certain fundamental and/or socioeconomic goals; and the availability, for a given organization, of adequate human resources and an innovation potential.<sup>4</sup> In this connection, at the meeting of the *Presidential Council for Science and Education* held on January 21, 2016, a hot discussion took place with regard to the relative feasibility of the selection of such organizations.<sup>5</sup>

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<sup>1</sup> For more details on the typology of these centers, see *The State of Science and Innovation. Russian economy in 2014. Trends and outlooks* (Issue 36) – M.: Gaidar Institute, 2015, pp. 351–352.

<sup>2</sup> N. Volchkova. *With a thought on the meaning. The RAS is against reform imitation*. Poisk (in Russian), No 49, December 4, 2015. See <http://www.poisknews.ru/theme/science-politic/16706/>; A. Mekhanik. *The ball is hosted by interests that are far from being true*. Expert, No 22, May 25–31, 2015; see <http://expert.ru/expert/2015/22/balom-pravyat-interesy-dalekie-ot-istiny/>

<sup>3</sup> N. Volchkova. *American mixed with German. The models applied in reforming the RAS*. Poisk (in Russian), No 17, April 24 2015. See <http://www.poisknews.ru/theme/science-politic/14333/>

<sup>4</sup> The Science *Coordinating Council* under the FASO approved the criteria for creating scientific centers, which should conduct a significant volume of fundamental and (or) applied studies and ensure the implementation of projects in the relevant areas of scientific and technological development of the Russian Federation. November 16, 2015. See [http://fano.gov.ru/ru/official/news/index.php?id\\_4=25585](http://fano.gov.ru/ru/official/news/index.php?id_4=25585)

<sup>5</sup> Meeting of the *Presidential Council for Science and Education*. January 21, 2016. See <http://krem-lin.ru/events/president/news/51190>

So far, we have obtained no ready estimates for making a conclusion as to whether the merger of institutes and the appointment of leader institutes among them is a good or bad undertaking. The experience of merging the institutes accumulated over the past two years has shown neither the obvious benefits nor serious harm produced by of such a change. However, we may rely on the successful experience of the implementation of the nuclear project and the outer space exploration programs in the USSR, when a number of competing research centers were set up in this country. There is also the precedent of incorporating research institutes into the National *Research Center Kurchatov Institute*, which did not improve the performance of that organization. Thus, when budget allocation indices are set against performance indices, it becomes evident that, for example, the productivity of Moscow State University, which is endowed with significantly lower budget allocations earmarked for research and development (Rb 2.68bn for 2016) by comparison with the National *Research Center Kurchatov Institute* (Rb 14.6bn),<sup>1</sup> is four times as high as that of the latter: in 2014, the citation index in the Web of Science of the articles authored by Moscow State University's scientists amounted to 7.26% of all publications by Russian authors, while the share of the NRC *Kurchatov Institute* was only 2.02%.<sup>2</sup> Moreover, the budget of the NRC *Kurchatov Institute* is 1.5 times larger than the entire budget of the RFBR (Rb 10.99bn for 2016), but the cost-effectiveness of the budget resources allocated to it (calculated on the basis of the citation index) is incomparably lower.

Beside the mergers, another painfully important issue for the FASO's institutes was that of budget funding. In 2015, the principles of funding based on government assignments were put forth by the RF Ministry of Education and Science in its draft order *On Approving the Methodological Recommendations for the Distribution of Subsidies Granted to the Federal State Institutions Involved in Government Work in the Sphere of Science (Scientific Research) and Science and Technology Activities*. The Board of Directors of the FASO institutes came to the conclusion that 'the subdivision of a government assignment, as suggested in the draft, into initiative-based (no less than 60%) and directive-based do not alter, in effect, the existing system of developing a government assignment, when it is drawn up by the institutions, in practical terms - by them for themselves'.<sup>3</sup> However, the suggested per cent ratio of different types of government assignments takes no account of the specificities of the actual research projects, and so it can do harm. Besides, a government assignment does not cover the cost of equipment and reagents.<sup>4</sup> And finally, the structure of resources to be allocated under a government assignment is geared to a fourfold increase of the salaries of leading researchers, and given the existing budget constraints, this will result in insufficient funding of the other scientists, and then, most probably, in personnel cuts. Therefore, the proposal put forth by the RF Ministry of Education and Science was met with active and diverse resistance<sup>5</sup>. Towards the year's end, an agreement had

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<sup>1</sup> Annex No 7 to *Federal Law on the 2016 Federal Budget* (The by-department structure of expenditure federal budget expenditure for 2016).

<sup>2</sup> Poliakov A. M., RF Ministry of Education and Science. *The publication activity of Russian scientists: current status, main trends and development goals*. Presentation at the Ural Federal University's seminar *Improvement of the quality and quantity of the scientific products by Russian authors*. October 6, 2015. See [http://elar.urfu.ru/bitstream/10995/33921/1/seminar\\_06.10.15\\_Polyakov.pdf](http://elar.urfu.ru/bitstream/10995/33921/1/seminar_06.10.15_Polyakov.pdf)

<sup>3</sup> See <http://fano.gov.ru/common/upload/library/2015/07/main/zakluchenie.docx>

<sup>4</sup> G. Georgiev. *What kills Russian science, and how to struggle against it? Part II. Troitsky Variant - Science (Newspaper)*, No 194, December 22, 2015, pp. 6-7, see <http://trv-science.ru/2015/12/22/chto-gubit-rossijskuyu-nauku-i-kak-s-etim-borotsya-2/>

<sup>5</sup> E. Onishchenko. *Dismissal vs. support*. *Troitsky Variant - Science (Newspaper)*, No 189, October 6, 2015, p.1, see <http://trv-science.ru/2015/10/06/uvolit-nelzya-podderzhat/>; P. Chebotarev. *On the new principles of funding*

been reached with regard to a number of alterations, but there still remained the possibility of personnel cuts in the future due to the unclear prospects of the government program of reform in the science sector. Among other things, so far the FASO has not officially presented any reform program.

Just as it had happened in 2014, the issue of mergers of the institutes and the principles of their subsequent funding was being dealt with separately from the performance assessment of scientific research organizations and higher educational establishments. The assessment methodology was still in the phase of coordination, one of its core issues being the choice of the correct approach to selecting the reference groups of institutes, for their subsequent comparison on a group level, and the identification of leaders and losers in each group. In the end, it was decided that the reference groups should be formed with due regard for both the areas of scientific research (approximately 40 scientific research areas were identified) and the specific profile of each organization (which could belong to one of the following three categories: generation of knowledge; development of technologies; or services in the sphere of science and technology). The pilot tests of this approach revealed that it can indeed be applied in estimating the performance of scientific research organizations, but much will depend on the quality of data submitted by them<sup>1</sup>. Besides, some additional issues arise in connection with the multi-profile structures, because it is difficult to estimate their performance on the basis of their comparison with other research organizations.

The ongoing reform in the academic complex has begun to manifest itself in the declining number of publications by the former academic institutes. Over the last two years, this index for the FASO's institutes dropped. At the same time, so far the institutes have been demonstrating the highest quality of human resources trained for scientific research in this country. According to *Dissernet*, no instances of fake dissertations have been detected in the RAS system, which is more than can be said of higher educational establishments and some of their rectors<sup>2</sup>. However, *Dissernet's* estimates refer to the 'pre-reform' period, while it cannot yet be predicted what the institutes will really be like after their merger, replacement of their old directors, and retraining of their staff.

And finally, in spite of the evidence that the RAS is gradually being pushed aside and can no longer manage the FASO's institutes, some academicians do not give up their hopes that the old system may be reestablished. This is confirmed by the repeatedly voiced proposal that the FASO should be subordinated to the RAS<sup>3</sup>. Indeed, some of these hopes have proved to be realistic: thus, for example, RF President Vladimir Putin, at the request of the President of the RAS, for the third time extended the moratorium (until January 2017) on deals involving property of the FASO's institutes.<sup>4</sup>

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*the institutes*. *Troitsky Variant - Science (Newspaper)*, No 189, October 6, 2015, pp. 1-3. <http://trv-science.ru/2015/10/06/o-novykh-principakh-finansirovaniya-institutov/>; N. Shatalova. *The time to explain. It is important for scientists to see the perspective*. *Poisk*, No 27-28, July 10, 2015, see <http://www.poisk-news.ru/theme/science-politic/15147/>

<sup>1</sup> *Innovations in Russia often remain on paper only*. November 30, 2015, see <http://www.opec.ru/1896521.html>

<sup>2</sup> A. Rostovtsev. *Negative selection*. *Troitsky Variant - Science (Newspaper)*, No 193, December 8, 2015, pp. 1-2. See <http://trv-science.ru/2015/12/08/otricatelnyj-otbor/>

<sup>3</sup> Academician A. Aseev. *Reform of the RAS as a threat to national security*. REGNUM, December 8, 2015, see <http://regnum.ru/news/innovatio/2029988.html>

<sup>4</sup> List of assignments, based on the results of the *Presidential Council for Science and Education's* meeting. February 11, 2016, Order Pr-260, Item 1g). See <http://kremlin.ru/acts/assignments/orders/by-date/11.02.2016>



#### 5.4.5. Trends in the technological innovation sphere

The core problem in the technological innovation sphere was the same as in the previous years: little interest in innovation on the part of the business community, and insufficient investment in research and development by companies. In Russia, similarly to the situation in the developed countries, the bulk of investment in R&D is made by big companies. However, these are, in the main, big state companies, and for five years in a row the RF Government has been attempting to 'force' them to invest in innovation through the 'innovative development programs for the companies with state stakes' (IDPs). In 2015, the intermediate results of applying this innovation policy tool were reported.

According to their formal indices, state companies had been successfully implementing their IDPs. Thus, for example, their annual expenditures on research and development over the program implementation period had climbed 2.1 times at current prices.<sup>1</sup> At the same time, the situation is highly polarized: 10 companies account for 80% of the aggregate growth of off-budget funding allocated to research and development.<sup>2</sup>

However, increased funding is by no means always a sure sign of more innovations being implemented. Thus, the resources may be invested instead in the upgrading of the existing technologies. And indeed, the majority of state companies invest in modernization, and only 34% of them invest in R&D projects that are new for the market<sup>3</sup> (*Fig. 14*).

Such results are quite logical: state companies, in fact, practically abstain from any assessment of priority technologies, technology monitoring, or long-run priority-setting. It is in this respect that Russian state companies differ from the big corporations in Europe, the USA and Japan, where more than 80% of them devise their special technology development plans. In Russia, state companies rely first of all on government orders, and so their planning horizon is short-run, they 'adjust' it to the government budget cycle.

State companies have remained, in many of their features, self-centered: their interaction with higher educational establishments in the science sphere is on the rise, but it is proceeding at a very slow pace, the reason (in the opinion of the companies) being the insufficient competence of higher educational establishments in dealing with research issues. Higher educational establishments are attractive primarily in their capacity as educators. As for the cooperation with small businesses, the most preferable form is the purchase of small-sized companies or stakes in their capital.<sup>4</sup> Big companies seldom involve them in their outsourcing programs.

So far, IDPs have not become a suitable tool for developing new technologies and creating value added chains. Therefore, on the basis of their performance assessment, the RF Ministry of Economic Development recommends that the companies should improve the procedures for elaborating and implementing their programs. The programs revised in accordance with the new regulation procedures must be submitted by April 2016<sup>5</sup>. Their main new features should be the elements of strategic planning, the top-down approach to priority setting (so that the

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<sup>1</sup> M. A. Gershman, T. S. Zinina, M. A. Romaniv et al. *Innovative development programs for companies with state stakes: intermediate results and priorities*. Ed. by L. M. Gokhberg, A. N. Klepach, P. B. Rudnik et al. National Research University Higher School of Economics (NRU HSE). M.: NRU HSE, 2015, p. 18.

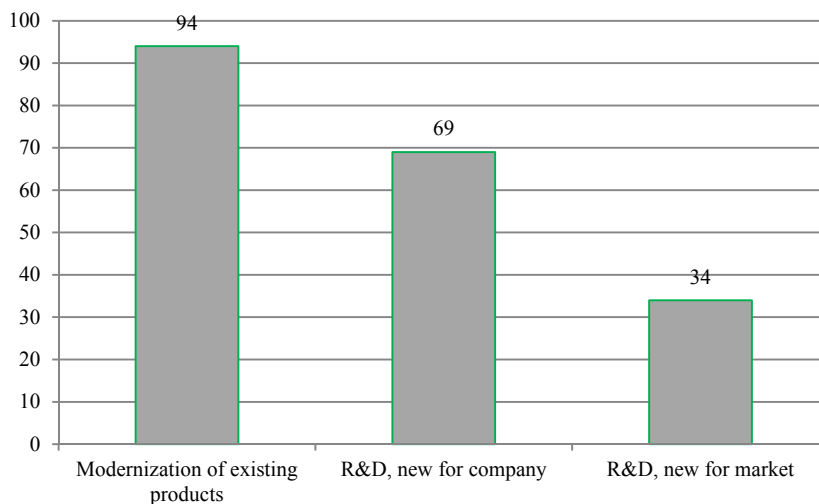
<sup>2</sup> Ibid, p. 22.

<sup>3</sup> Ibid, p. 12.

<sup>4</sup> Ibid, p. 91.

<sup>5</sup> A. Gorbatova. *Weightless innovations*. July 6, 2015, see [http://www.strf.ru/material.aspx?CatalogId=223&d\\_no=100667#.VnBdvb8yTOA](http://www.strf.ru/material.aspx?CatalogId=223&d_no=100667#.VnBdvb8yTOA)

priorities could be relevant for an entire company), and the assessment of the commercial potential of projects to the value in excess of Rb 1bn<sup>1</sup>. Thus, the planned improvements have to do with reporting procedures and some organizational and logistic issues, while the overall paradigm of 'enforced innovation' remains intact.



*Fig. 14.* The degree of involvement of state companies in various types of innovative activity, % of the number of respondents

*Source:* M. A. Gershman, T. S. Zinina, M. A. Romanov et al. *Innovative development programs for companies with state stakes: intermediate results and priorities*. Ed. by L. M. Gokhberg, A. N. Klepach, P. B. Rudnik et al. National Research University Higher School of Economics (NRU HSE). M.: NRU HSE, 2015, p. 12.

For all its importance, strategic planning is only indirectly linked to companies' interest in innovative activity. Under the government's pressure, companies may indeed learn how to better draw up their long-term plans, but it will hardly boost their motivation for investing in innovation. The problem encompasses a broader sphere of economic regulation of state companies, and so one-time targeted measures aimed at the innovation component of their activity yield only negligible results.

In contrast to big businesses, the medium-sized hi-tech ones are not involved in special government measures. Nevertheless, it is in this segment that a group of rapidly growing hi-tech companies is currently demonstrating impressive results in boosting their investment in R&D, their proceeds, and their hi-tech exports. The results of a study of such companies based on a sample of 75 entities, which were published in 2015, reveal that the companies were established in the main about 20 years ago - that is, on the basis of resources created in the Soviet period. Throughout the entire period of their development, 77% of the companies received various forms of government support (which vary from grants and loans to tax and duty-free exemptions). However, such support was of critical importance only for 17% of the companies.<sup>2</sup> Not

<sup>1</sup> T. Edovina. *Innovations look for a bigger share*. Kommersant, July 3, 2015, see <http://www.kommersant.ru/doc/2759787>

<sup>2</sup> D. Medovnikov, S. Rozmirovich, T Oganessian. *The candidates for champions: the peculiarities of rapidly growing Russian technological companies, their development strategies and the potential of the State for supporting the implementation of these strategies*. RVC, NRU HSE, PWC, SME Bank. – M., NRU HSE, 2015, p. 28.

unexpectedly, the companies highly estimated subsidies and the grants received from the Bortnik Fund, while the role of development institutions was considered to be of little importance (*Rusnano*, Skolkovo, the Russian Fund for Technological Development, Russian Venture Company (RVC)). Of little use was indirect regulation in the form of duty-free exemptions granted to the residents of Skolkovo and special economic zones.<sup>1</sup> In this connection, companies believe that the most serious obstacle to growth is not the inefficiency of government support, but the administrative barriers set up by the government. The development process suffers primarily from the lack of proper normative base for the use of new technologies, as well as the cumbersome procedures of government control over business activities.<sup>2</sup>

As far as value added chains are concerned, medium-sized companies are rather actively getting involved in such structures: nearly half of them collaborate with higher educational establishments in the field of R&D, and they heavily rely on contracts with state companies in their supplies of necessary products. However, state companies are also interested in getting government order, and so the circle closes: everybody expects money from the government. Thus, in particular, out of all the types of available government support, medium-sized companies prefer direct financial support (on preferential loans, R&D grants<sup>3</sup>), and only 15% of the respondent companies are interested in tax exemptions.

The survey demonstrates that the rapidly growing companies are not the startups that have unexpectedly rushed forward, but the steadily developing small businesses that have gradually been evolving into medium-sized ones. It is rather typical that in 2015, it became fashionable to launch startups<sup>4</sup> in absence of any system in Russia for their further support and monitoring. The launch of startups became a goal in itself for some development institutions, and so it does not translate into an increased input of small-sized innovative businesses into the national economy. So, according to experts, the government support of small-sized innovative businesses is still inadequate (*Fig. 15*)<sup>5</sup>.

One of the components of government support, which is important for the development of small business, startups including, is the existence of technology infrastructure (technoparks, incubators, special economic zones) and availability of venture capital. While Russia does display some development (while not always with successful results) with regard to the first parameter, venture funding in this country has nearly halted. This is the upshot of the new geopolitical situation on the one hand, and the lack of proper attention to the creation of venture funds on the part of the development institutions, on the other. In effect, after RVC had been reoriented to the National Technology Initiative, no new public-private venture funds were created. This is one of the reasons why Russia's venture market is shrinking.<sup>6</sup> Besides, according to data

<sup>1</sup> D. Medovnikov, S. Rozmirovich, T Oganessian. *The candidates for champions: the peculiarities of rapidly growing Russian technological companies, their development strategies and the potential of the State for supporting the implementation of these strategies*. RVC, NRU HSE, PWC, SME Bank. – M., NRU HSE, 2015, p. 28, p. 29.

<sup>2</sup> Ibid, p. 31.

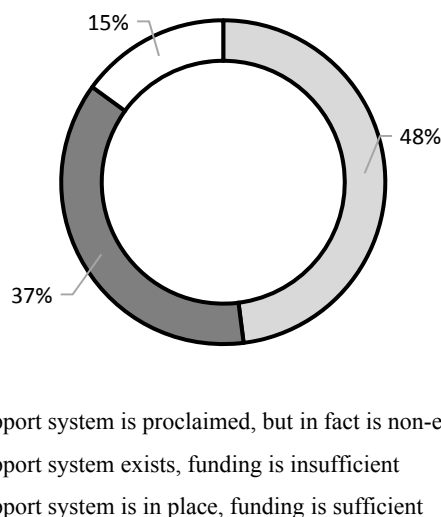
<sup>3</sup> Ibid, p. 30.

<sup>4</sup> B. V. Kanin. *Why startups are no longer needed by anyone*. RBC, November 9, 2015, p. 19, see <http://www.rbcdaily.ru/industry/562949998112082>

<sup>5</sup> The survey was conducted in May 2015 and involved 176 respondents from the business community (46%), government structures and development institutions (21%), the science and education spheres (12% each), and consultants (9%). Source: *Russia: a course towards innovations. Issue III*. M.: RVC, F&S, 2015, p. 100.

<sup>6</sup> According to data released by the Russian Venture Investment Association, over the first 9 months of 2015, the capitalization index of venture fund lost 8%, and the volume of investment in Russian companies shrank threefold on its previous year's index. Source: T. Edovina. *Venture investors are afraid of taking risks*. Kommersant, December 11, 2015, see <http://www.kommersant.ru/doc/2874219>

released by the OECD, all this occurs against the backdrop of Russia falling behind the developed countries in terms of its investment volume, which now is below 0.012% of GDP. For reference: in Israel this index amounts to 0.38%, in the USA to 0.28%, in Canada to approximately 0.1%.<sup>1</sup>



*Fig. 15.* The estimated role of government support of small and medium-sized technology companies, %

Source: Russia: a course towards innovations. Issue III. M.: RVC. M.: RVC, F&S, 2015, p. 65.

Technoparks, as one of the important infrastructure entities designed to support small-sized innovative businesses, has become once again the focus of increased attention due, among other things, to the emergence of big territorial infrastructure projects like *Innopolis* and the Technological Valley of Moscow State University. In UNESCO's Science Report released in 2015 it was noted that Russia had 88 technoparks, of which only 15 were truly functional.<sup>2</sup> A more detailed analysis of technoparks can be found in *Insider's Guide to Russian Hi-Tech Hubs*,<sup>3</sup> where some of the reasons of the deviation of Russian technoparks from world standards are explained. In Russian technoparks, only 27% of companies actually survive, while in foreign countries this index can be as high as 85–90%.<sup>4</sup> Experts believe that this happens because technoparks have poorly defined development goals, while the government has not created an efficient system for providing them with funding and other means of support.<sup>5</sup> As a result, the CEOs of technoparks derive their income in the main from leasing their premises (about 70% of their aggregate income), while the international norms require that at least half of a technopark's income should be generated by services rendered to companies.<sup>6</sup> And finally, Russian technoparks operate separately from venture funds, each type of infrastructure functioning independently. But in foreign countries they always cooperate.

<sup>1</sup> Source: *OECD Science, Technology and Industry Scoreboard 2015: Innovation for growth and society*. OECD Publishing, Paris, 2015, p. 174.

<sup>2</sup> *UNESCO Science Report: towards 2030*. UNESCO, Paris, 2015, p. 359.

<sup>3</sup> *Insider's Guide to Russian Hi-Tech Hubs*. Russia Direct, No 9, June 2015.

<sup>4</sup> *Ibid*, p.6.

<sup>5</sup> *Ibid*, p.10.

<sup>6</sup> *Ibid*, p. 12.

However, there exist some exceptions. Thus, Novosibirsk Akadempark has become the biggest floor of its type in the region. Over the crisis years 2014–2015, the average growth rate of the proceeds of companies operating in that technopark was 25%.<sup>1</sup> Their success, most probably, builds upon the following three factors: a considerable share of private investment in the construction of Akadempark; a low share of government orders; and an original a model of doing business (technological services, the construction of special technological service centers inside the technopark).<sup>2</sup> In other words, success was achieved mostly by reliance on private businesses and a good understanding of their needs.

#### 5.4.6. New infrastructure projects

In 2015, two infrastructure projects – the Technological Valley of Moscow State University (MSU) and *Innopolis* (near Kazan) - were actively implemented.

*Innopolis* is an extension of the Skolkovo model, but it is implemented in the framework of one sector only – that of information technologies (IT). The features that make it similar to Skolkovo are as follows: the construction of urban infrastructure; the establishment of a new university jointly with a US higher educational establishment (Carnegie Mellon University); and the support of innovative companies based on a territorial principle. *Innopolis* evolved from a technology development special economic zone. Since 2013, a total of Rb 12.1bn was spent on its creation, and the state share in total investment amounted to 97.5%.<sup>3</sup> In June 2015, *Innopolis* was unveiled. That project was remarkable by its very rapid rate of construction work, the large number of students enrolled in the first year (400, which is twice as many as those enrolled in the Skolkovo Institute of Science and Technology – *SkolTech*); all this was achieved on the basis of a relatively modest amount of budget investment (the cost of the other projects - Skolkovo and the Technological Valley of Moscow State University - is much higher).

The project's goal is to attract 60,000 specialists in the field of IT to fill the new jobs created in the town. Seven years ago, a more modest idea – that of attracting 10,000 software developers to Dubna - ended in a failure. Meanwhile, it should be borne in mind that Dubna has a better infrastructure than *Innopolis*, and so, for such an ambitious project to succeed, it is being implemented in a 'manual mode', under the protection of the President of the Republic of Tatarstan and the RF Minister of Telecom and Mass Media.<sup>4</sup> For the time being, these factors may ensure an inflow of off-budget funding by 'involving' private companies in investing in the project. However, the effect will be only temporary, because no incentives for private initiative have been created. Nevertheless, the project may still give rise to a precedent of a successful construction of a new town with a Western type university.

The 'manual management mode' is also typical of the Technological Valley project launched by Moscow State University. It was first announced in 2013, to be completed in 2018. In accordance with its charter documents, the project is aimed at providing young researchers with well-paid jobs - by creating, among other things, a number of new laboratories, as well as

<sup>1</sup> In 2015, Akadempark became the most productive enterprise in Novosibirsk Oblast. 26 January 2016, see <http://sib.fm/news/2016/01/26/akadempark-samy-proizvoditelnym-v-novosibirskoj-oblasti>

<sup>2</sup> For further details concerning the technological service centers, see *The meeting point of ideas and money*. 29 October 2014, <http://sib.fm/interviews/2014/10/29/mesto-vstrechi-idej-i-deneg>

<sup>3</sup> И.И. Королёв. *The RF Ministry of Telecom and Mass Media established fictitious targets for Innopolis, so as not to repay any money*. November 20, 2015, see [http://www.cnews.ru/news/top/2015-11-20\\_minkomsvyazi\\_ustanovilo\\_innopolisu\\_fiktivnyye](http://www.cnews.ru/news/top/2015-11-20_minkomsvyazi_ustanovilo_innopolisu_fiktivnyye)

<sup>4</sup> A.A. Shchukin. *An IT town in an open field*. Expert, No 29, July 13, 2015, see <http://expert.ru/expert/2015/29/it-gorod-v-chistom-pole/>

launching joint research projects with industrial companies. Besides, it is intended to erect scientific research facilities and residential buildings in the vicinity of Moscow State University. An important role in this project, including in the procedure of selection of suitable laboratories and research centers to be established in the Technological Valley, is to be played by NPO *Innopraktika*,<sup>1</sup> which functions as an intermediary between young researchers and big businesses that might be interested in participating in the Technological Valley project. In 2015, in cooperation with *Innopraktika*, 16 interdisciplinary laboratories focused on applied research were opened.<sup>2</sup>

The volume of funding to be allocated to the construction of the Valley is not specified, and it varies in different sources from Rb 110bn to nearly Rb 150bn.<sup>3</sup> In this connection, approximately 65% of the funding is to be earmarked for the development and construction of Moscow State University's laboratories. It is also expected that a number of Russia's biggest companies will take an active part in providing the necessary funding and help Moscow State University to replenish the target capital fund. A similar scheme was already applied in the early phase of the *Skoltech* project (Skolkovo Institute of Science and Technology), but later on the government decided that it was not feasible to compel businesses to act as sponsors. In the new project, history repeats itself, but this time the outcome may be different because it was RF President Vladimir Putin himself who addressed the business community with the request to help Moscow State University.<sup>4</sup>

#### 5.4.7. The national technology initiative

The year 2015 was marked by the emergence of a new 'big project' – the National Technology Initiative (NTI). The term *national technology initiative* was for the first time used by President Vladimir Putin in his Message to the Federal Assembly in December 2014, when he announced the launch of the NTI and explained that this initiative was to help in defining the development priorities and goals for the next 10–15-year period.<sup>5</sup> An ambitious goal was set: to elaborate a mechanism capable of coordinating the global goals of Russia's economic development, the technology priorities created by those goals, and the mechanisms to be applied in their implementation.

In the first phase, at the year's beginning, many different organizations were busily elaborating the notion of the NTI, its content and its component. The Agency for Strategic Initiatives (ASI), the RF Ministry of Education and Science, and the RF Government Expert Council suggested their own visions of the NTI.

In the draft of *The Fundamentals of the National Technology Initiative* elaborated by the Russian Academy of Sciences, the main focus is placed on the task of ensuring Russia's parity on a global scale with the countries that are leaders in world technological progress; this parity would be impossible to achieve without developing fundamental science: '...the contemporary

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<sup>1</sup> A lot of speculations and gossip are centered on *Innopraktika* because, according to Reuters and RBC, it is headed by the RF President's daughter Ekaterina Tikhonova. However, this information has neither been officially confirmed nor disproved.

<sup>2</sup> V. Koriagin. *Why MSU is gaining in the world ratings of best higher educational establishments*. October 21, 2015, see <http://lenta.ru/articles/2015/10/21/msugetshigh/>

<sup>3</sup> R. Badanin, A. Voronina, F. Rustamova, E. Osetinskaya. *The valley of knowledge*. RBC Daily, January 29, 2015, see <http://rbcdaily.ru/economy/562949993816447>

<sup>4</sup> T. Melikian. *The gold Sparrow Hills*. *Putin suggested that the billionaires should provide solidarity help to MSU*. Lenta.ru, May 28 2015, see <http://lenta.ru/articles/2015/05/28/mgutext/>

<sup>5</sup> *Annual Presidential Address to the Federal Assembly*. December 4, 2014, see <http://www.kremlin.ru/news/47173>

status of fundamental science determines the situation in business in the long run.<sup>1</sup> On this basis, substantiation was provided for the goals of import substitution, reindustrialization, and improvement of the methodology applied in setting the science and technology priorities. The draft prepared by the Russian Academy of Sciences determines seven priorities for science and technology development, represented either by entire industries or by more narrow specific technologies and industries – power engineering, national defense and national security, pharmaceuticals, medical technologies, food industry, information technologies, nanomaterials, and new chemical substances<sup>2</sup>.

The Government Expert Council viewed the NTI as a comprehensive program aimed at ensuring Russia's global competitive capacity in its dealing with the developed countries in the most promising sectors of the world economy and specific segments of world markets<sup>3</sup>. The concepts of the NTI put forth by the Government Expert Council and the Russian Academy of Sciences are alike in many of their aspects; they are largely based on the modifications of approaches that have been traditional for Russia's policy in the sphere of science and technology.

From the viewpoint of the Agency for Strategic Initiatives (ASI), the NTI implies first of all the formation of new, network-based consumer markets: 'the selection will be done with due regard for the basic trends in world development, on the basis of priority network technologies centered around man as the end consumer.'<sup>4</sup> It was expected that, in 10–20 years, the volume of these markets should be in excess of \$ 100bn, and Russia would have a chance to win a respectable position in that sphere.<sup>5</sup> The approach applied by the ASI was subsequently applied in developing the roadmaps for the NTI.

In order to precisely identify the markets, a detailed study was launched, which was focused on four interrelated parameters: 'markets', 'technologies', 'infrastructure' and 'institutions'. By May 2015, 9 'markets of the future' had been determined. These are subdivided into three groups – those associated with national security and the provision of necessary resources (food, energy and security markets); the development of the transport system (automobile transport, air transport and sea/river transport); the markets where technologies are currently being upgraded on a revolutionary scale (digital health markets, new financial markets, and neurocommunications markets).<sup>6</sup> A similar approach with a pre-determined set of priority directions had been applied in 2009, when President Dmitry Medvedev announced the choice of 5 'strategic vectors' of the country's modernization,<sup>7</sup> which later on were used as the basis for the Skolkovo project and the clusters created in its framework. In the case of the NTI, the choice of specifically these 9 markets was based on two major criteria – the prospects for development in the global context and the presence, in this country, of companies (or people) prepared to become leaders and assume the responsibility for the development of relevant sectors and entry onto new markets. Consequently, the NTI will be considered to have been implemented in the event of emergence

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<sup>1</sup> *The fundamental principles of the National Technology Initiative*. Russian Academy of Sciences, Information and Analytical Center. Version as of May 22, 2015, p. 7.

<sup>2</sup> *Ibid*, p. 8.

<sup>3</sup> *Draft of the Concept of developing and implementing the National Technology Initiative*. RF Government Expert Council. March 16, 2015.

<sup>4</sup> See <http://asi.ru/nti/>

<sup>5</sup> *Dmitry Peskov: we are to expect a fundamental restructuring of all the core industries*. Kommersant, April 1, 2015, see <http://www.kommersant.ru/doc/2698958>

<sup>6</sup> *National Technology Initiative: 'uncomfortable' questions and honest answers*. Foresight Fleet materials, May 12–16, 2015. ASI, RVC, Fund for Assistance to Small Innovative Enterprises in Science and Technology, p. 5.

<sup>7</sup> Dmitry Medvedev. *Go Russia!* September 10, 2009, see <http://kremlin.ru/events/president/news/5413>

of Russian companies capable of becoming leaders on the global technology markets in 2025–2035.

In October, 4 roadmaps were approved: the development of automobile transport, air transport and sea/river transport (to be supervised by the RF Ministry of Industry and Trade), and the development of neurocommunications (the responsibility of the RF Ministry of Education and Science). This is a speedy process, and the first results are expected to appear as early as 2016.<sup>1</sup>

The idea behind the NTI has several new and positive aspects. First, this is the switchover to personal responsibility; second, it means an emphasis on horizontal links; third, this is an open system – the discussion of promising markets can be continued in 2016.

The intermediate result achieved in 2015 was essentially the choice of new technology priorities, including multi-functional technologies, which are important for the simultaneous development of several targeted markets of the future. The system of priority directions has come to closely resemble the structure of initiatives that are being implemented by the developed countries, which in itself can already be regarded as a step forward. Indeed, in 2015 the issue of priorities was the focus of special attention; thus, in particular, this was the theme of one of the meetings of the *Presidential Council for Science and Education*.<sup>2</sup> It was a manifestation of a certain 'crisis' in the existing approaches to setting priorities, which had changed little since 1996 (the year when the list of priority development directions in the sphere of science and technology was approved at the federal level).

At the same time, the accepted approach to developing and implementing the NTI makes its success dependent on some rather unpredictable parameters, in particular the following ones:

- 1) correct forecasts of future developments, which means the opportunities and abilities to select appropriate experts;
- 2) opportunities for identifying truly charismatic leaders;
- 3) possibilities for launching the implementation mechanisms and the movement towards the targeted market niches.

The NTI may trigger restructuring of the activity of the development institutions, and not only that of RVC, which has become the project's headquarters.<sup>3</sup> In the Annual *Presidential Address to the Federal Assembly* in December 2015 it was noted that the development institutions should be oriented to technology modernization, and for this end their structures and the mechanisms that they employ should be optimized, because 'Unfortunately, many of them, to put it bluntly, have turned into dumping grounds for bad debts.'<sup>4</sup> However, the first step along this way was not optimization, but the announcement of the creation of yet another structure – the Technological Development Agency (NPO). It is intended that the new Agency should operate in the interests of companies and organize centralized transfer of foreign technologies into Russia (by means of concluding licensing agreements, establishing joint ventures), as well as provide legal and consulting support.<sup>5</sup> Among other things, the Technological

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<sup>1</sup> *On the National Technology Initiative*. Meeting of the *Presidential Council for Economic Modernization and Innovative Development*. October 16, 2015, see <http://government.ru/news/20118/>

<sup>2</sup> Meeting of the *Presidential Council for Science and Education*. June 24, 2015, see <http://kremlin.ru/events/president/news/49755>

<sup>3</sup> See <https://www.rusventure.ru/ru/nti/>

<sup>4</sup> *Annual Presidential Address to the Federal Assembly*. December 3, 2015, see <http://www.kremlin.ru/events/president/transcripts/messages/50864>

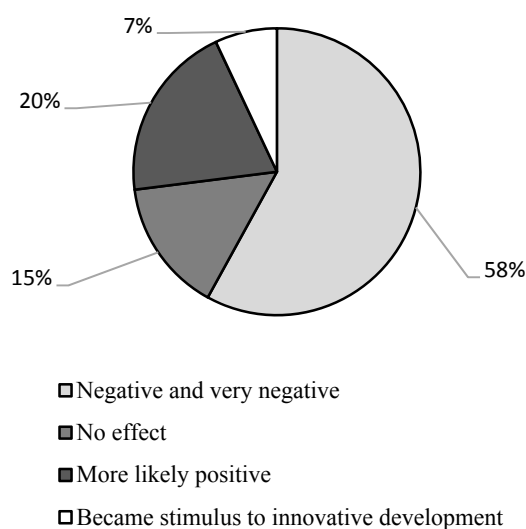
<sup>5</sup> *Transfer of technologies – import substitution without detriment to quality for the consumer*. Head of Business Russia Alexey Repik – about the Agency for Technological Development. *Kommersant*, January 27, 2016, see



Development Agency must look for technologies that can be relevant for the implementation of the NTI and Russia's entry onto new network markets. Thus, the launch of the NTI will influence the 'innovation ecosystem' by means of adjusting and supplementing the system of government instruments employed in promoting Russia's technological development.

#### 5.4.8. The effects of economic sanctions

In 2015, the economic sanctions and the response to them across the country visibly influenced the sphere of science and innovations. The poll conducted in May 2015 among 176 experts who represented both the business and the academic communities revealed that the majority of respondents believed that the new geopolitical situation had an adverse effect on innovative development (*Fig. 16*).



*Fig. 16.* The estimated effects of the geopolitical situation on the innovative activity in Russia

*Source:* A course towards innovations. Issue III. M.: RVC, F&S, 2015, p. 15.

The links between the introduction of economic sanctions against Russia and the changes that became visible in Russia's science sector due to the emergence of the new external conditions are by no means direct and clear. In addition to economic changes, the overall atmosphere in the sphere of science is undergoing transformation. To a certain degree, the marker of the onset of changes was the *Law on Undesirable Foreign Organizations*<sup>1</sup> (introduced in May 2015). Coupled with the already existing Law of the Russian Federation *On Foreign Agents*, it launched the process of serious transformations in the system of non-governmental support of science through not-for-profit foundations.

<http://www.kommersant.ru/doc/2902055>; *On the Technological Development Agency*. Meeting of the Presidential Council for Economic Modernization and Innovative Development. February 5, 2016, see <http://m.government.ru/news/21674/>

<sup>1</sup> Federal Law 'On Introducing Alterations to Some Legislative Acts of the Russian Federation', No 129-FZ dated May 23, 2015, see <http://publication.pravo.gov.ru/Document/View/0001201505230001?index=0&rangeSize=1>

In accordance with the *Law on Undesirable Foreign Organizations*, the fact of an organization being recognized as such means a ban on its activity in Russia. This status is assigned to those organizations whose activity is deemed to be threatening the fundamental principles of Russia's constitutional order, defense potential and security. Often the undesirable organizations are those that provide funding to NPO (non-commercial organization), the latter then being recognized to be 'foreign agents'<sup>1</sup>.

***The direct consequences of economic sanctions***

The direct effects of economic sanctions began to be manifest at an early stage in the form of rising costs and declining competitive capacity of the research projects in Russia. They began to suffer from shortage of foreign equipment and reagents, which had been purchased in the main in those countries that participated in the sanctions, while the cost of that equipment and reagents plunged due to the sharp decline of the ruble's exchange rate against the world's major currencies. Many foreign companies, including those based in the EU, began to refuse to supply equipment<sup>2</sup> and materials for scientific research to Russia for fear that they might be used in military projects.<sup>3</sup>

After the sanctions had been introduced, even the IT sector began to experience difficulties, although it is considered to be one of Russia's best-developed and successful sectors. Thus it became obvious that the reliance on foreign software in this country is very high (*Table 15*).

*Table 15*

**The share of foreign software products in the RF, %**

Product	Share, %
Office applications	100
Visualization systems	93
Operating systems for computers	93
Databases	86
Operating systems for servers	75
Collaborative software	68
Geoinformation software	45
Engineering software	34

Source: Yu. Voronina. *One's own soft is closer*. The Russian Business Newspaper, 2014, No 46, p. 4.

The initiatives of universities and scientific research organization in restricting the foreign travel of their staff in the framework of scientific research projects and tracing their publications abroad may also be treated as a form of response to the external pressure, and its purpose is not limited to identifying those individuals who are entitled to a supplementary payment for a publication in a highly ranked journal. Special security departments for supervising foreign connections began to be reestablished at universities and research institutes.<sup>4</sup> In this connection it should be emphasized that no formal orders to this effect have been issued at the federal level, and words like 'internationalization of science' can still be found in official documents and heard in official speeches.

<sup>1</sup> G. Peremitin. *Putin signed the Law on Undesirable Foreign Organizations*. See <http://top.rbc.ru/politics/23/05/2015/55609f719a794774b30bd2a7> 23.05.2015 г.

<sup>2</sup> *Sanctions have reached Russian science*. See <http://уcrop.org/sanctionsи-дошли-и-до-Russian -science/>, August 14, 2015.

<sup>3</sup> For example, spare parts for laser systems.

<sup>4</sup> E. Gerden. *Russia faces international scientific blockage*. See <http://www.rsc.org/chemistryworld/2015/08/russia-faces-international-scientific-blockade>, August 13, 2015.

### *Indirect consequences*

The indirect consequences of the introduction of sanctions was the growing aversion to the activity of the representative offices of those foreign organization providing support in education and science whose countries of origin participated in the sanctions against Russia, or to those Russian entities that were associated in one or other way with the support and promotion of 'foreign' ideas and views.

The upshot of all this was that Russia's science sphere, which could never boast of a large number of non-governmental foundations working there, began to lose those organizations that for many years had been implementing their science support and training programs - in natural as well as in social sciences. The most notorious move was the entry into the list of 'foreign agents', in May 2015, of the *Dynasty* Foundation (a Russian charity). The reason was that the assets of its founder Dmitry Zimin, which were the source of funding for Russian science projects, were kept abroad. *Dynasty* was accused of political activities because of its support of the Liberal Mission Foundation headed by Yevgeny Yasin.<sup>1</sup> Thus, according to the RF Ministry of Justice's logic, Zimin's Foundation deserved to be assigned the status of a 'foreign agent' for its support of political activities from foreign resources.

Many Russian research organization and scientists, the international community, as well as the Council on Science under the RF Ministry of Education and Science, tried to support *Dynasty* and get it removed from the list<sup>2</sup>. However, all protests were in vain, and in July 2015 the board of *Dynasty* Foundation approved the decision of its liquidation<sup>3</sup>.

The two less publicized events, which followed the same logic and resulted in the same consequences, are the closure of the Russian office of the MacArthur Foundation and the two charities established by George Soros – the Open Society Foundation and the Assistance Foundation.<sup>4</sup> In July 2015, these foundations were put on the 'patriotic stop-list'<sup>5</sup> drawn up by the Federation Council as candidates for the status of 'undesirable organizations'.<sup>6</sup>

The CEOs of the MacArthur Foundation decided to withdraw from Russia.<sup>7</sup> The Foundation had launched its first programs in Russia in 1992; it provided support both to individual researchers in the field of social science and to Russian universities. Its biggest initiative in Russia's science sphere was the Program on *Basic Research and Higher Education*, on which it spent a total of \$ 32m over the period 1998–2009. The program was implemented and financed

<sup>1</sup> B. Grozovskiy, N. Epple, P. Aptekar. *Dmitry Zimin and Yevgeny Yasin as a threat to Russian security*. *Vedomosti*, No 3838, May 26, 2015, see <http://www.vedomosti.ru/opinion/articles/2015/05/26/593621-dmitrii-zimin-i-evgenii-yasin-kak-ugroza-rossiiskoi-bezopasnosti>

<sup>2</sup> A. Khokhlov. *The disaster is happening before our own eyes*. [http://www.gazeta.ru/science/2015/05/28\\_a\\_6736753.shtml](http://www.gazeta.ru/science/2015/05/28_a_6736753.shtml) 28.05.2015; L. Tagaeva, E. Antonova, F. Rustamova. *The decline of Dynasty*. RBC, No 88, May 26, 2015, pp. 10-11 (See <http://rbcdaily.ru/industry/562949995305596>)

<sup>3</sup> *The Dynasty Foundation makes the decision of its liquidation*. See <http://newsru.com/russia/08jul2015/dynasty.html>, July 8, 2015.

<sup>4</sup> *The Open Society Foundation and the Assistance Foundation were recognized to be undesirable in Russia*. Interfax, November 30, 2015, see <http://www.interfax.ru/russia/482304>

<sup>5</sup> *The Federation Council made public the 'patriotic stop-list' of 12 foreign NPOs*. See <http://www.interfax.ru/russia/452158> 07.07.2015 r.

<sup>6</sup> A. Bratersky. *The 'undesirable' George Soros*. See [http://www.gazeta.ru/politics/2015/08/12\\_a\\_7683475.shtml](http://www.gazeta.ru/politics/2015/08/12_a_7683475.shtml) August 12, 2015.

<sup>7</sup> E. Mukhametdinova. *The first of the organizations entered in the 'patriotic stop-list' leaves Russia. The closure of its Russian office was announced by the US MacArthur Foundation*. *Vedomosti* (in Russian), July 23, 2015. See <http://www.vedomosti.ru/politics/articles/2015/07/23/601800-iz-rossii-ushla-pervaya-iz-organizatsii-vnesennih-v-patrioticheskii-stop-list>

jointly with the RF Ministry of Education and Science. In its framework, 20 education and research centers (ERC) were established at Russian universities; they specialized in natural sciences. The ERC model was officially recognized to be efficient, and so the centers became to a certain extent the prototype of the ERC yet to be created, the activity of Russian universities and scientific research organization in that direction being funded by the resources allocated to the federal targeted program *Scientific and educational human resources for innovative Russia in 2009–2013*.

In December 2015, one more organization was closed, which had been an active partner of the RF Ministry of Education and Science in promoting the research and innovation activity of Russian higher educational establishments – the US Russia Foundation for Economic Advancement (USRF). The next day after it had been placed on the list of undesirable organizations, the Foundation announced that it was to discontinue its operation in Russia and to close its Moscow office<sup>1</sup>.

The closure of foreign foundations is a reasonable act on the part of their management, because once an organization is assigned the status of a 'foreign agent', it can effectively do little. Thus, in actual practice this means a ban on collaboration with budgetary institutions, while the bulk of entities operating in the fields of science and education are budgetary institutions. A similar situation is faced by 'undesirable organizations', because it becomes very risky to receive any grants from them.

The reasons why certain foundations that for many years had been supporting education and science, whose activity had been positively estimated by Russian authorities, were suddenly deemed to be 'undesirables' and foreign agents, are purely political and have nothing to do with their support of science. This peculiar response to the economic sanctions will have a negative impact on the situation in Russian science not only on an economic, but also on a psychological plane, as it will alter the atmosphere inside the academic community.

### ***International cooperation and the sanctions***

In face of the rising tension between Russia and the countries that are world leaders in innovation, we are still hearing official rhetoric in support of international cooperation in the field of science. Moreover, it is constantly emphasized that science is international, and that international cooperation in scientific research is the foundation of growth. Thus, Project 5-100 encourages higher educational establishments to publish their works abroad and to participate in international events, as well as to invite foreign specialists. This is indeed important, as Russian publications have low citation indexes, and in this aspect Russia differs from many other countries, even the developing ones. Over the period 2004–2015, only 6% of the Russian articles with high citation indexes were written by Russian authors on their own, while all the rest were co-authored with their foreign colleagues<sup>2</sup>.

However, the priorities are gradually changing. On a national scale, the BRICS group is playing an increasingly important role, and on a personal level, new hopes are associated with the developing cooperation with the Russian expat diaspora.

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<sup>1</sup> *Address to the partners and recipients of benefits from the USRF*. December 8, 2015. See [http://www.usrf.ru/news\\_feed/general\\_rus/news\\_article\\_1449567272.html](http://www.usrf.ru/news_feed/general_rus/news_article_1449567272.html)

<sup>2</sup> According to data presented by P. Kasianov, Thomson Reuters. Source: K. K. Bolokhova. *Scientists and organizations with high citation indexes were awarded at VUZPROMEXPO-2015*. December 4, 2015, see [http://www.strf.ru/material.aspx?CatalogId=222&d\\_no=110553#.Vm2wAb8yTOA](http://www.strf.ru/material.aspx?CatalogId=222&d_no=110553#.Vm2wAb8yTOA)

An analysis of scientific research activity indices across the BRICS group shows that so far, the links between its member countries in the field of scientific research have been weak. Moreover, the BRICS members tend to cooperate not between themselves, but with those countries that are world leaders in scientific research<sup>1</sup>. The achievements of the BRICS proper are not very impressive.

The diaspora is actively collaborating with Russia, getting involved, among other things, in the creation of modern laboratories at higher educational establishments funded in the framework of Project 5-100.<sup>2</sup> The recent poll of 150 representatives of the Russian academic diaspora abroad demonstrates that those among its members who are closely interacting with Russia are loyal and tend to promote cooperation while staying away from political issues, including the economic sanctions.<sup>3</sup>

The diaspora to a certain degree represents a 'soft force' in the situation of imposed economic sanctions and the generally unfavorable geopolitical climate. Its more active representatives are ready to teach, participate in research projects (including those funded by international grants), as well as to train Russian postgraduates. Approximately 2/3 of the respondents suggest some new mechanisms of cooperation or improvement of the existing government initiatives. It is difficult to group all the ideas as a number of 'typical blocs'. However, there are two types of activity that can be readily participated by many representatives of the Russian diaspora. These are international exchange programs (training programs) that can have various formats (including postgraduate and undergraduate training programs and travel by foreign scientists), as well as joint postgraduate and undergraduate training programs. It should be noted that some of these proposals can be immediately implemented by research institutes or higher educational establishments, without developing special federal or regional program for that purpose. In this connection, it would have been feasible for universities and scientific research organizations to grant open access to more information, because foreign scientists are experiencing difficulties in finding on the websites of Russian organizations any well-structured information concerning the existing opportunities for cooperation.

At the same time, the attitude of the Russian public to the expat diaspora activists is controversial. Thus, a poll of those higher educational establishments that collaborate with Russian-speaking foreign scientists indicates that the key problems are as follows: foreign scientists 'cost dear' (they have to be paid a lot of money); they spend little time in Russia; and they do not understand Russian realities. In the academic community, there exists a rather widespread opinion that the qualifications of the diaspora representatives are by no means always so high as to enable them to rapidly upgrade that of the Russian researchers.<sup>4</sup> Nevertheless, the cooperation

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<sup>1</sup> I. Dezhina. *BRICS countries possible areas for scientific cooperation*. World Economy and International Relations, 2015, No 9, pp. 14-23.

<sup>2</sup> Russian expat scientists in the USA, Europe and Asia plan to create six laboratories on the basis of Tomsk Polytechnic University. See <http://news.tpu.ru/news/2015/05/05/23341/> May 22, 2015. At St. Petersburg Polytechnic University, the first multidisciplinary RASA (Russian-speaking Academic Science Association) Research center in Russia was established, see <http://www.sdelanounas.ru/blogs/53229>

<sup>3</sup> The survey took place in February-March 2015, it consisted in a poll among Russian expat scientists working abroad followed by interviews via Skype with a selected sample group of respondents. Source: I. Dezhina. *Russian scientific diaspora: experience, motivation and prospects for cooperation with Russia*. Sociology of Science and Technology, 2016, No 1 (soon to be published).

<sup>4</sup> See, for example, the interview with Academician A. Aseev: A. Mekhanik. *The ball is hosted by interests that are far from being true*. Expert, May 25, 2015; see <http://expert.ru/expert/2015/22/balom-pravyat-interesy-dalekie-ot-istiny/>

was already established long ago, the universities participating in the poll had a history of 'working with the diaspora' that was on the average twice as long as that of the government cooperation programs.<sup>1</sup> At the same time, it is the representatives of the academic diaspora that can help strengthen the ties with the international academic community.

In this connection, it appears feasible to place a greater emphasis on network collaboration with Russian laboratories created in recent years with the participation of the diaspora representatives. Russia has already acquired a 'critical mass' of such structures, and network projects can further improve their performance, while simultaneously promote and expand the contacts with Russian-speaking expat scientists. Besides, the training project Global Education<sup>2</sup> launched in 2015 can also rely on the expat potential, in particular by involving the university laboratories headed by Russian expat scientists in training Russian specialists in that program's framework.

\* \* \*

The strategic position of the science sphere has altered: we see a transition from the former ambitious goals to those of moderate growth. The key indices of expenditures on R&D and the scientific research targets that were to be achieved by 2015 are now set for 2020. This happened, among other things, due to the shrinkage of budget allocations to science and the uncertainty with regard to the future growth of investment of the business sector in research and development.

The reform in the academic sector proceeds at a slow pace, the coordination procedures between the government departments are tricky, and there are no clearly defined medium-term restructuring plans. The 'civilian science' component represented in this segment by the activity of the Council on Science under the RF Ministry of Education and Science and the Science *Coordinating Council* under the FASO<sup>3</sup> helped to smooth the controversies and to properly coordinate the standpoints. Nevertheless, the obvious positive results of reform in that sector are yet to be achieved. Higher educational establishments are no alternative for the Academy, although they rapidly increase the formal indices of their performance with regard to scientific research. So far, the potential of universities in the R&D sector has remained insufficient, the testimony of which is the higher quality of the Academy's research and the poorly developed cooperation of higher educational establishments with industry.

The most notable development in the innovation sphere was the change in ideology, when the slogan *from science to market* was replaced by another one – *from markets of the future to their technology and scientific projections into today*. The upshot of this change is the National

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<sup>1</sup> I. Dezhina. *Answers to open questions*. November 13, 2015 <http://sk.ru/news/b/articles/archive/2015/11/13/otvety-na-otkrytye-voprosy.aspx>

<sup>2</sup> In the framework of this program, the RF Ministry of Education and Science pays for the training of Russian students at the best foreign universities, on condition that after graduation they must return to Russia to work in scientific research organizations, higher educational establishments and commercial companies. Priority is given to the technical, medical, and IT fields, as well as to chemistry and power engineering. Source: <http://educationglobal.ru/ns/overview/>

<sup>3</sup> The Science Coordinating Council was established on November 25, 2014 in accordance with order of the FASO Order *On the Science Coordinating Council under the Federal Agency for Scientific Organizations*, No 1087 of November 25, 2014 (see <http://fano.gov.ru/common/upload/library/2014/11/main/prikaz1087.pdf>), and some of its members also sit in the Council on Science of the RF Ministry of Education and Science.

Technology Initiative. The reliance on the potential development of new technologies in a situation where the science sector is weakened by reform is very risky. That is why the Technological Development Agency is being created, which will be assigned the task of purchasing new technologies abroad. In fact, this will mean a switchover to an imitation development model in the field of innovation. Indeed, at present Russia can hardly hope for successful domestic R&D projects and prompt implementation of their products, and so it is reasonable to transfer foreign technologies in order to achieve the goals set in the framework of the NTI. At the same time, within such a pattern, businesses must be highly interested in innovations. In theory, one may rely on the successful rapidly growing medium-sized technology companies. If the production paradigm is also altered (by switching over to new industrial technologies in a broad sense), they may become the foundation for technological development. However, when viewed on a broader scale, the business sector is still underactive – not because of the weakness of the development institutions, but largely due to the existence of administrative and economic barriers created by the government.





## Section 6. Institutional Changes

### 6.1. The situation in the public sector and privatization<sup>1</sup>

#### 6.1.1. The scope of public property

According to the Federal Property Register, the movement, over the period 2013–2015, of the number of organizations registered as holders of ownership rights and economic societies with state stakes appears to be as follows (*Table 1*).<sup>2</sup>

*Table 1*

**The number of organizations - users of federal property, in 2013–2015**

Date	Number of joint-stock companies with federal stakes (including by special right), units	Number of holders of ownership rights to registered federal property entities other than economic societies or partnerships, units			
		total	including		
			FSUE <sup>3</sup>	FTE	FSI
As of 1 January 2013	2,442/2,337 <sup>a</sup>	22,330	1,800/1,795 <sup>b</sup>	72	20,458
As of 1 April 2013	2,412	21,459	1,775	73	19,611
As of 1 October 2013	2,281	20,175	1,742	73	18,360
As of 1 January 2014	2,203 <sup>c</sup>	19,733	1,727/1,181 <sup>d</sup>	76	17,930
As of 1 April 2014	2,142	19,603	1,789	78	17,736
As of 1 July 2014	2,100	19,318	1,704	77	17,537
As of 1 December 2015	1,783/1,719 <sup>e</sup>	...	1,257/ 1,178 <sup>f</sup>	43 <sup>g</sup>	16,802 <sup>g</sup>

<sup>a</sup> – as stated in the current privatization program for 2013–2016; besides, according to the Federal Property Register as of 31 December 2012, in addition to shares in 2,442 JSCs, there were also data on shares in 19 limited liability companies (LLC), which makes a total of 2,461 units;

<sup>b</sup> – as stated in the current privatization program for 2013–2016;

<sup>c</sup> – according to the Annual Report on Alterations to the Federal Property Register Resulting from the Arising and Termination of Russian Federation Ownership Right to Immovable and Movable Property for 2013, this figure (2,203 units) includes those 17 LLCs and 90 JSCs where the RF holds the special right to participate in their management without holding any shares;

<sup>1</sup> Authors of this section: Malginov G. – Gaidar Institute for Economic Policy, Radygin A. – RANEPa.

<sup>2</sup> Hereinafter we rely on data published in the documents of the RF Federal Agency for State Property Management (*Rosimushchestvo*) posted to its official website at [www.rosim.ru](http://www.rosim.ru) (including the 2014 and 2015 Reports on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2014–2016; 2011 and 2014 Reports on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC's Management ('Golden Share'); 2013 Annual Report on Alterations to the Federal Property Register Resulting from the Arising and Termination of Russian Federation Ownership Right to Immovable and Movable Property, etc.); the materials released by the RF Ministry of Economic Development at [www.economy.gov.ru](http://www.economy.gov.ru); and the data released by the Federal Treasury (Report on Federal Budget Execution as of January 1, 2016 (monthly report), [www.roskazna.ru](http://www.roskazna.ru)).

<sup>3</sup> FSUE stands for *federal state unitary enterprise*.

<sup>d</sup> – according to the Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2014–2016, by early 2014 the Russian Federation had been the owner of property of 1,181 FSUEs, which is nearly by 1/3 less than the figure reported in the Federal Property Register, and so gives rise to many serious questions;

<sup>e</sup> – according to the presentation by the RF Federal Agency for State Property Management (*Rosimushchestvo*) delivered during the discussion, in late 2015, of the alterations to the government program (GP) *Federal Property Management* suggested on the basis of recommendations put forth by the RF Accounts Chamber, the Federal Property Register contains information on 1,783 OJSC, CJSC and LLC, with slightly lower (by 3.5%) number of stakes and shares;

<sup>f</sup> – according to the presentation by *Rosimushchestvo* delivered during the discussion, in late 2015, of the alterations to the government program (GP) *Federal Property Management* suggested on the basis of recommendations put forth by the RF Accounts Chamber, the Federal Property Register contains information on 1,257 FSUEs, while the number reported as of the beginning of Q4 is somewhat lower (approximately by 6%);

<sup>g</sup> – according to the presentation by *Rosimushchestvo* delivered during the discussion, in late 2015, of the alterations to the government program (GP) *Federal Property Management*.

Source: Forecast Plan (Program) of Federal Property Privatization and the Main Directions of Federal Property Privatization for 2014–2016; www.economy.gov.ru, April 23, 2013, January 17, 2014, April 18, 2014, August 7, 2014; 2013 Annual Report on Alterations to the Federal Property Register Resulting from the Arising and Termination of Russian Federation Ownership Right to Immovable and Movable Property; 2014 Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2014–2016, www.rosim.ru, February 19, 2015; www.rosim.ru, December 21, 2015.

Over a period of approximately one year and a half (from mid 2014 to the end of 2015), the number of organizations involved (in any way) in the use of federal property somewhat declined. This trend was strongest in the group of federal treasury enterprises (FTE) (a decline by nearly 45%), and weakest in the group of federal state institutions (FSI) (a decline by approximately 4%). The movement pattern of the number of federal state unitary enterprises (FSUE) largely depends on a particular source of information: if one relies on data in the Federal Property Register, then since early 2014 their number shrank to a little more than ¼; if the data applied by *Rosimushchestvo* are to be relied on, their number remained practically unchanged. The total number of economic societies with state stakes dropped by more than 15%.

The most complete available data on the structure of joint-stock companies relative to the size of the stake held by the State, and especially on the specific features of the mechanisms applied in their management can be found in the 2014 Report on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share').<sup>1</sup> According to the data from the Federal State Information Systems Operator *Single Federal Property Management System (FGIAS ESUGI)* presented in the Report, as of August 1, 2015 the Federal Property Register contained information on 1,864 JSCs with state stakes (in federal ownership), including those 103 JSCs where the State held the special right to participate in a company's management granted by 'golden share'.

Compared to data as of July 7, 2014, when the Federal Property Register contained information on a total of 2,096 JSCs with a state stake in federal ownership<sup>2</sup>, their number shrank by 11%.

However, *Rosimushchestvo* could fully exercise its shareholder rights in only 980 JSCs out of a total of 1,864 JSCs (or only 52.6% of all JSCs vs. 54.7% as of summer 2014 and vs. 57.7% as of summer 2013).

The composition of the remaining group of 884 companies was as follows:

<sup>1</sup> www.rosim.ru, September 3, 2015.

<sup>2</sup> 2013 Year-end Report on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share').

- societies with state stakes amounting to less than 2% of their charter capital, where, in accordance with Item 1 of Article 53 of Federal Law, of December 26, 1995, No 208-FZ 'On Joint-stock Companies', no proposals put forth by shareholders can be entered on the agenda of a general shareholder meeting) (373 units,<sup>1</sup> or approximately 20% of all JSCs);
- economic societies where the ownership rights to state stakes are delegated to other federal bodies of executive authority (FBEA) and state corporations (for example, the RF Ministry of Defense, *Rostec* Corporation (formerly *Rostekhnologii*), *ROSATOM* Corporation), or JSC operated under a trust management agreement) (291 JSCs, or 15.6% of all JSCs);<sup>2</sup>
- economic societies undergoing a proceeding in bankruptcy (151 JSC, or 8.1% of all JSCs);
- economic societies undergoing a liquidation procedure (60 JSC, or 3.2% of all JSCs);
- economic societies currently with no stakes effectively in the ownership of the Russian Federation (for example if an entity has been privatized, or transferred as a contribution to the charter capital of a vertically integrated structure (hereinafter – VIS) (9 JSCs, or 0.5% of all JSCs).

In this connection it should be noted that the number of JSCs with regard to which *Rosimushchestvo* can exercise only a limited shareholder right, had declined on 2013 by 6.9% (or by nearly 65 units), these being in the main economic societies with state stakes amounting to less than 2% of their capital (by 63 units, or by 14.4%) and the societies the shareholder right to which had been transferred to other subjects (by 11 units, or by 3.6%). It can be said that in principle, the number of JSCs undergoing a proceeding in bankruptcy or a liquidation procedure changed insignificantly (by 3-5 units).<sup>3</sup> This is also true of the group of JSCs with no stakes effectively in the ownership by the Russian Federation (an increase by 1 unit).

Now we are going to look at the structure of JSCs from the point of view of the size of the stake held by the State in their charter capital, and its movement pattern over the last 5–6 years (*Table 2*).

In the structure of those JSCs where, as of summer 2015, *Rosimushchestvo* was not restricted in its shareholder rights, the aggregate share of those companies in respect of which the State enjoyed the right of corporate control at the level of a 100% stake or majority stake was approximately 2/3. Meanwhile, if we separate JSCs with state stakes amounting to less than 2% of the charter capital (373 units), the State would exercise corporate control over less than half of all JSCs.

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<sup>1</sup> Including 75 JSCs where the State holds the special right to participate in a company's management granted by 'golden share'.

<sup>2</sup> It does not seem to be quite correct to place in one and the same group those JSCs where the ownership rights to state stakes are delegated to federal bodies of executive authority other than *Rosimushchestvo*, state corporations, and companies operated under a trust management agreement, because one of the basic features of a state corporation (SC) as a legal entity (defined by Russian legislation as a non-profit organization) is the right of ownership to its property, and, generally speaking, that right should also be exercised with regard to those state stakes that have been transferred to other entities as property contributions to their charter capital.

<sup>3</sup> In this connection it should also be added that another 181 JSC (vs. 137 JSCs a year earlier) whose financial and economic operations have not been conducted on a sustainable basis (because they are not engaged in a financial and economic activity or are entering the initial phase of bankruptcy procedures (have filed a petition in bankruptcy, undergoing the phase of supervision or external management)) belong to the category of JSC in regard to which *Rosimushchestvo* has been exercising an unrestricted shareholder right.

Table 2

**The movement and structure of the group of economic societies with state stakes (less those JSCs where the State holds the special right granted by 'golden share' without holding any stake) in 2010–2015**

Date	Economic societies (JSC and LLC) where RF is shareholder (or participant)									
	total, units	share, %	Of these, with RF stake in charter capital amounting to							
			100%		100%		100%		less than 25%	
			units	%	units	%	units	%	units	%
as of January 1, 2010										
- JSCs, total <sup>a</sup>	2,950	100.0	1,757	59.6	138	4.7	358	12.1	697	23.6
as of August 1, 2012.										
- JSCs where <i>Rosimushchestvo</i> is not restricted in its shareholder rights <sup>b</sup>	1,371/ 2,629 <sup>a</sup>	100.0	886	64.6	76	5.55	211	15.4	198 <sup>d</sup>	14.45
as of January 1, 2013										
- JSCs, total <sup>c</sup>	2,337	100.0	1,256	53.7	100	4.3	227	9.7	754	32.3
as of August 1, 2013										
- JSCs where <i>Rosimushchestvo</i> is not restricted in its shareholder rights <sup>b</sup>	1,345/ 2,333 <sup>c</sup>	100.0	874	65.0	83	6.15	185	13.75	203 <sup>d</sup>	15.1
- JSCs included in forecast privatization plans for 2010 and 2013 <sup>f</sup>	975	100.0	716	73.4	41	4.2	116	11.9	102 <sup>d</sup>	10.5
as of July 7, 2014										
- JSCs where <i>Rosimushchestvo</i> is not restricted in its shareholder rights <sup>b</sup>	1,147/ 2,096 <sup>c</sup>	100.0	709	61.8	66	5.8	171	14.9	201 <sup>d</sup>	17.5
- JSCs included in forecast privatization plans for 2010 and 2013 <sup>f</sup>	842	100.0	596	70.8	36	4.3	113	13.4	97	11.5
as of August 1, 2015										
- JSCs where <i>Rosimushchestvo</i> is not restricted in its shareholder rights <sup>b</sup>	980/ 1,864	100.0	589	60.1	55	5.6	142	14.5	194	19.8
- same JSCs, plus JSCs where state stake is less than 2% <sup>g</sup>	1,353 (980 + +373)	100.0	589	43.5	55	4.1	142	10.5	567 (194 + +373)	41.9
- JSCs included in forecast privatization plans for 2010 and 2013 <sup>f</sup>	668	100.0	469	70.2	18	2.7	90	13.5	91	13.6
- same JSCs, plus JSCs where state stake is less than 2% <sup>h</sup>	1041 (668 + +373)	100.0	469	45.1	18	1.7	90	8.6	464 (91 + +373)	44.6

<sup>a</sup> – number of JSC according to the privatization program for 2011–2013;

<sup>b</sup> – less the following entities: (1) JSCs with state stakes less than 2%; (2) JSCs where the shareholder rights on behalf of the Russian Federation are exercised by other subjects (other bodies of executive authority, state corporations, or subjects appointed under trust management agreements); (3) JSC undergoing bankruptcy procedures (in the phase of a bankruptcy proceeding); (4) JSCs undergoing a liquidation procedure, (5) JSCs with state stakes that are *de facto* not registered as federal property (previously privatized or transferred to the charter capital of a vertically integrated structure);

<sup>c</sup> – denominator shows total number of JSCs entered in the Federal Property Register;

<sup>d</sup> – only JSCs with state stakes between 2% and 25%;

<sup>e</sup> – number of JSCs according to the privatization program for 2014–2016;

<sup>f</sup> – only those JSCs where *Rosimushchestvo* is not restricted in its shareholder rights;

<sup>g</sup> – on condition that, with regard to all JSCs with state stakes less than 2%, the relevant shareholder rights belong to *Rosimushchestvo*;

<sup>h</sup> – on condition that all the JSCs with state stakes less than 2% are included in a privatization program.

Source: Forecast Plan (Program) of Federal Property Privatization and the Main Directions of Federal Property Privatization for 2011–2013; Forecast Plan (Program) of Federal Property Privatization and the Main Directions of Federal Property Privatization for 2014–2016; 2011 Year-end Report on the Management of Federal Stakes in

OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share'); 2012 Year-end Report on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share'); 2013 Year-end Report on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share'); 2014 Year-end Report on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share'); own calculations.

In the group of JSCs included in the privatization program among those 668 companies where *Rosimushchestvo* was not restricted in exercising its shareholder rights on behalf of the State, approximately 3/4 appear were those fully owned by the State (70.2%) or those where the State held a majority stake (2.7%). As follows from the Report on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share') prepared by *Rosimushchestvo*, the forecast privatization plan lists more than 80% of all 100% stakes, more than 63% of all blocking stakes, but only less than 47% of all minority stakes (between 2% and 25%) in those companies where *Rosimushchestvo* could exercise its shareholder rights on behalf of the State without any restrictions.

In the category of JSCs with controlling stakes, the share of those included in the privatization plan was approximately 1/3. Even if we count all the companies with a state stake amounting to less than 2% in their charter capital (373 units) those included in the privatization program, the number of minority stakes earmarked for privatization will be lower than the number of those enabling the State to exercise corporate control (100% stakes and majority stake, even less the latter).

Over one year (summer 2014 – summer 2015), the share of JSCs with a 100% state stake or a majority stake in the group of those where *Rosimushchestvo* was not restricted in exercising its shareholder rights shrank by 17%, in the same proportion as did the number of JSCs with a blocking stake, whereas the share of those with minority stakes (between 2% and 25% of charter capital) shrank by 3.5%. The difference becomes even more striking if we compare this movement pattern with the situation in summer 2012. While the number of JSCs with a minority state stake (between 2% and 25%) shrank by only 2%, the number of JSCs with a 100% state stake or a majority stake shrank by 1/3, similarly to the number of JSCs with a blocking state stake (between 25% and 50% of charter capital).

As for the public sector monitoring results released by *Rosstat*, this source is no longer available in accordance with Decree of the RF Government of January 29, 2015, No 72<sup>1</sup>. This document deemed to be null and void the RF Government's Decree of January 4, 1999, No 1 (as amended as of December 30, 2002), whereby the public sector of the national economy was defined as consisting of the following entities (1) state unitary enterprises, including treasury enterprises, (2) state institutions, (3) economic societies where the State held a stake amounting to more than 50% of their charter capital, and (4) economic societies where a stake amounting to more than 50% of their charter capital was held by economic societies belonging to the public sector of the national economy.

The system of performance estimates introduced by the aforesaid Decree in 2015 for the purpose of monitoring the efficiency of public property management and deriving relevant statistics is to be applied to the following group of economic subjects (in place of the public sector):

- state unitary enterprises, including treasury enterprises;

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<sup>1</sup> The final statistics bulletin with data on the public sector's development was released in autumn 2014. Also see *Russian economy in 2014. Trends and Outlooks* (Issue 36). M., Gaidar Institute, 2015, pp. 377–378.

- state institutions (autonomous, budget-funded and treasury-funded);
- economic societies with a state stake in their charter capital;
- joint-stock companies where the State holds the special right to participate in their management granted by the 'golden share').

While the newly emerged group is seemingly the same as the 'public sector' in the previously applied definition, one cannot but notice the disappearance of one important component of the public sector, namely economic societies where a stake amounting to more than 50% of their charter capital is held by economic societies belonging to the public sector of the national economy.

Essentially, the system to be applied in estimating the management of public property and deriving relevant statistics of 64 indices grouped into 5 sections as follows:

I. The structure of economic subjects comprising public property (with records to be kept separately for the RF and RF subjects);

II. The management of JSCs with stakes in federal ownership, federal state unitary enterprises (FSUE) and federal state institutions (FSI) (with records to be kept separately for the 3 subsections);

III. Privatization of federal property entities;

IV. Management of federal immovable property entities (with records to be kept separately for the two subsections: land plots and other property entities);

V. Redistribution of federal immovable property, including redistribution between different tiers of public legal formations.

Besides, the aforesaid RF Government's Decree introduced the necessary alterations into the 2008 Federal Statistics Plan, and then the RF Ministry of Economic Development approved, as of April 16, 2015, No 229 the Methodological Recommendations for calculating the state property management performance indices and keeping statistical records.

Naturally, it will be possible to make valid conclusions concerning the relevance of all these innovations for estimating the share of the public sector in the Russian economy only after the statistics in the new format are released<sup>1</sup>.

#### 6.1.2. Privatization policy

The past year was the second year of the implementation of the Forecast Plan (Program) of Federal Property Privatization and the Main Directions of Federal Property Privatization for 2014–2016, approved by Directive of the RF Government of July 1, 2013, No 1111-r. This is already the second 3-year privatization program developed with a view towards a longer planning period established for a forecast plan (or program) of federal property privatization (extended from one to three years) on the basis of the alterations introduced into the prevailing legislation on privatization in the spring of 2010.

As was the case with the previous privatization program, numerous adjustments and alterations soon began to be introduced into the new document as well. Since the moment of approval of the Forecast Plan (Program) of Federal Property Privatization and the Main Directions of Federal Property Privatization for 2014–2016 and until early February 2016, a total of 65 normative legal acts (NLA) pertaining to these issues were adopted, 22 of which were issued in 2014, and then 3 more were issued in December 2013, and 3 in January 2016. By the first

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<sup>1</sup> For a more detailed discussion of the theoretical aspects and core problems associated with the role of commercial organizations owned by the State, see Radygin A.D., Simachev Yu. V., Entov R. M. *State-owned company: detection zone of government failure or market failure? Issues of Economics* (in Russian), 2015, No 1, pp 45–79.

directive, the privatization program was augmented by another 431 joint-stock companies that had not been privatized in the period 2011–2013; by the second one, 426 (mostly) immovable property entities in federal ownership (previously non-privatized) were also added to the list of entities earmarked for privatization. So, last year, in terms of 'intensity' of legislation adjustment (37 NLA), is far ahead of the previous one-and-a-half-year period (2014 and H2 2013).

As a result, the list of assets earmarked for privatization in an ordinary procedure noticeably increased. The highest share was taken up by entities to be privatized in the category of 'other' property entities, their number in the privatization program rose from 94 to 1,562 (or nearly 17 times), while the number of economic societies rose from 440 to 977 (or more than 2.2-fold). Meanwhile, the number of federal state unitary enterprises (FSUEs) earmarked for privatization, on the contrary, dropped from 514 to 491 (or by 4.5%).

Unitary enterprises represent an asset that is most likely to be taken off the privatization program at any time. In 2015, there were a total of 46 units in this category (vs. 31 in 2014), while the number of economic societies excluded from the program was 19 (vs. 5 in 2014), and that of 'other' property entities – only 12.

Although the progress of the privatization program is obviously influenced by the current macroeconomic situation and the situation in the stock market, the intermediate results of the past year (as estimated by the results of its first quarters) made it possible to hope that the targets set in the current privatization program can be achieved, meaning the exact privatization-generated revenue target in the federal budget, less biggest property sales (Rb 3bn per annum).

In this connection, in September 2015, *Rosimushchestvo* was assigned the task of increasing the annual revenue generated by privatization deals from Rb 3bn to Rb 5bn. As of November 11, 2015, asset sale deals to the total value of Rb 5.5bn (111% of that year's target) were completed, so the target was achieved earlier than planned<sup>1</sup>. Nevertheless, the total value of sales of shares declined in 2015 on 2014 by 8.5% (Rb 7.34bn vs. Rb 8.02bn)

At the same time, no sale of shares in biggest companies, in respect of which the specific timeframe and method of privatization are to be determined by the RF Government with due regard to the market situation and to the recommendations of top investment consultants, took place that year. The only possible deal - the alienation of shares in PJSC *Sovkomflot* [Modern Commercial Fleet] - was postponed due to the worsening macroeconomic situation and low investment activity on the domestic market, as well as the currently unfavorable situation in the tanker shipping market and the introduction of restrictive measures against big Russian companies.

On the whole, the number of sales of state stakes and immovable property entities rose on 2014 by 35%, while the number of property entities put up for sale in the framework of privatization deals by independent sellers nearly doubled (increasing from 159 in 2014 to 306 in 2015).

Among the deals accomplished without relying on investment consultants, the sale of Murmansk Sea Fishing Port (the entire 100% stake) for Rb 1,027bn clearly stands out. The other big privatization deals are the sales of state stakes in the Moscow-based company JSC *Aviatechnab* (for Rb 986m), JSC Murmansk Shipping Company (25.5%, to the value of Rb 660m), *Fundamentproekt* (Rb 454.8m) and E. I. Rytvin Scientific and Industrial Complex *Supermetal* (Rb 307m) (both in Moscow), *Labinsky* Poultry Breeding Farm (Krasnodar Krai, Rb 303.3m), and one of Moscow's Bread Baking Plants (Rb 216.4m). The stakes in JSC *Northern Shipping*

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<sup>1</sup> www.rosim.ru, November 12, 2015.

*Company* (20%, based in Arkhangelsk) and 2 road maintenance enterprises in Moscow Oblast were sold to the value of more than Rb 150m each. In this connection it should be noted that the staked to be sold in almost all these deals, with the exception of stakes in the two shipping companies (the size of which is specified), amounted to 100% of charter capital, and the deals were closed by an independent (non-governmental) seller, OJSC *Auction House of the Russian Federation* (OJSC *RAD*).

The year 2015 can be described as the first year when non-governmental sellers began to be active in the market, and for a good reason. Thus, OJSC *RAD* sold 34 stakes to the total value of Rb 5.3bn, or more than 72% of total proceeds from sales of this type of assets, which is more than the aggregate index for the two previous years<sup>1</sup>. Another non-governmental seller, LLC *VEB Capital*, also launched its operations, although the scale of its involvement in the privatization program is incomparable with that of OJSC *RAD*<sup>2</sup>.

Another innovation aimed at boosting the efficiency of handling sales is the delegation, by *Rosimushchestvo*, of some of its powers in the framework of the privatization program to its territorial agencies (TA)<sup>3</sup> which, as far as the number of state stakes actually sold by them is concerned (51 units), got far ahead of both OJSC *RAD* (34 units) and *Rosimushchestvo*'s central apparatus (CA) (18 units). However, when compared to 2014, this privatization channel still demonstrates a downward trend in terms of the number of accomplished sales (51 vs. 74) and generated proceeds (Rb 0.9bn vs. Rb 1,360bn). In this connection it should be noted that the results achieved by *Rosimushchestvo*'s CA are even less impressive, as it sold only 18 state stakes (vs. 29 in 2014) to the value of Rb 1.1bn (vs. Rb 5,772bn in 2014). Due to such a sharp decline of proceeds, the relative shares of *Rosimushchestvo*'s CA and TAs with regard to this index became comparable in 2015. In effect, the operation of independent sellers offset the effects of the declining activity of the government agencies in implementing their privatization policy<sup>4</sup>.

Among the optimization measures attempted by *Rosimushchestvo* in order to boost efficiency, increase openness, and improve performance in the framework of privatization procedures, we may also note the following ones:

- to involve in more active promotion of the assets earmarked for privatization in order to boost market demand, by posting information on forthcoming biddings to websites [www.avito.ru](http://www.avito.ru), [www.irr.ru](http://www.irr.ru), to the news feeds of the major news agencies ITAR-TASS and RIA *Novosti*, placing promotion leaflets in the mass media and as out-of-homer advertizing, distribution of printed ads at Russian and international business forums and other events (depending on the type and value of each asset to be privatized);

- to make the process more comfortable for potential investors by granting free access to additional information concerning the properties earmarked for privatization (special presentations for potential investors and their publication on the Internet, and placement there of detailed information on the assets held by the economic societies to be privatized, as well as copies of the relevant documents in confirmation of the titles to these assets);

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<sup>1</sup> In 2014, OJSC *RAD* sold only 6 stakes to the total value of Rb 923.3m, and in 2013 – 15 stakes to the value of Rb 1.97bn.

<sup>2</sup> While *VEB Capital* received state stakes in only 11 OJSCs for their subsequent sale, OJSC *RAD* was given state stakes in more than 200 JSCs and 81 immovable property entities, although no bidding took place with regard to the latter.

<sup>3</sup> In 2014, the TAs were delegated the powers to sell state stakes in 200 JSCs and 219 'other' property entities.

<sup>4</sup> [www.rosim.ru](http://www.rosim.ru), December 24, 2014, February 24, 2016.



– to increase the period of market exposure of the assets earmarked for privatization (the time lapse between the offer of a given asset and the date of bidding) by creating at Rosimushchestvo's website special 'soon to be sold' pages and placing there, in advance, in the phase of their market valuation and preparatory procedures, detailed information on each of the assets to be privatized);

– to toughen control over the financial and economic status of the joint-stock companies earmarked for privatization, so as to prevent any loss of their market value and attractiveness for potential investors in the pre-privatization phase by issuing a special set of instructions (directives) for their board of directors and recommendations for audit commissions (quarterly monitoring of financial and economic activity);

– the creation of a special system for protecting the assets of companies to be privatized during the privatization and pre-privatization periods as an additional guarantee that the quality of assets offered to potential investors will not deteriorate, by restricting the powers granted to the CEOs of those companies with regard to disposal of their property and by increasing personal responsibility for the decision-making process through introducing provisions to this effect into the charters of all JSCs earmarked for privatization.

In 2015, the stakes (or shares in charter capital) in a total of 103 economic societies were sold, while in respect of 35 federal state unitary enterprises (FSUE) the relevant decisions concerning the terms of their privatization were taken. On the whole, such results follow the overall trend of recent years - the constant reduction in the number of sold stakes (or participatory shares). As for the progress of privatization of unitary enterprises, if we rely on the number of those of them that were subject to specially issued directives concerning the terms of their privatization, the observed trend is compatible with the corresponding indices for the last two years of the previous privatization program (2012–2013) (see *Table 3*).

*Table 3*

**The movement of the number of privatization deals involving federal state unitary enterprises and the number of sales of federal stakes in 2009–2015**

Period	Number of privatized enterprises (entities) formerly in federal ownership (data released by <i>Rosimushchestvo</i> )	
	privatized FSUEs <sup>a</sup> , units	sold stakes in JSCs, units
2009	316+256 <sup>b</sup>	52 <sup>c</sup>
2010	62	134 <sup>c</sup>
2011	143	317 <sup>d</sup> /359 <sup>c</sup>
2012	47 <sup>d</sup>	265 <sup>c</sup>
2013	26	148 <sup>c</sup>
2014	33	107
2015	35 <sup>f</sup>	103

<sup>a</sup> – all preparatory work is completed, and the relevant decisions concerning the terms of privatization are issued;

<sup>b</sup> – the number of FSUEs in respect of which the decisions concerning their reorganization into JSC were made by the RF Ministry of Defense in addition to those cases where a similar decision was made by *Rosimushchestvo*;

<sup>c</sup> – including those stakes which were put up for sale in a previous year;

<sup>d</sup> – estimated value based on data on the total number of FSUEs in respect of which directives concerning the terms of their privatization in the form of reorganization into OJSC (216 units) were issued, taken from *Rosimushchestvo*'s Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2011–2013, and the year-end results of 2011 and 2013;

<sup>f</sup> – less sales of shares with the participation of investment consultants;

<sup>e</sup> – for 2 enterprises, the decisions concerning the terms of their privatization canceled in 2015 and then reissued, and so the total number of FSUEs for which privatization decisions were made over the 2-year period (2014–2015) is somewhat lower than follows from the data shown in the Table (65).

*Source:* Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2009, M., 2010; Report of the RF Ministry of Economic Development on the Results of Federal Property Privatization in

2010; Report of the RF Ministry of Economic Development on the Results of Federal Property Privatization in 2011; Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2011–2013; 2014 Year-end Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2014–2016; 2015 Year-end Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2014–2016, [www.rosim.ru](http://www.rosim.ru), February 19, 2015.

At the same time, compared to the year-end results of the crisis year 2009, which are roughly comparable to the situation under consideration (stakes in 52 economic societies were sold to the value of Rb 1.37bn), we may conclude that the privatization process in 2015 was more successful (stakes in 103 economic societies were sold to the value of Rb 7.34bn). *Rosimushchestvo* explains this success by the systemic changes in the privatization procedures applied to federal property entities and the implementation of comprehensive measures designed to ensure the pre-sale preparation and proper management of the assets to be privatized. However, in this connection necessary to remember that inflation had surged since then nearly 1.5 times, that in 2009 more than half of the sales involved minority state stake, and that no non-governmental sellers participated in the privatization process.

In recent years, the purpose of involving non-governmental sellers was that of boosting the number of sales, because it was expected that a seller working for a commission calculated as a percentage of the value of a deal and received from the budget, must necessarily be competent in marketing and possess the skills necessary for attracting investors. Based on this assumption, one could expect that a higher number of participants will take part in the biddings held by the independent non-governmental seller, and that prices will surge higher in the course of bidding. However, the statistics concerning the operation of non-governmental sellers in 2015 was by no means always indicative of such achievements. The effectiveness index of property sales, measured as cumulative growth of asset value during an auction, was found to be lower for OJSC *RAD* than for *Rosimushchestvo* (growth by 11% vs. 17%), in spite of the fact that some relatively liquid assets from among the properties listed in the privatization program were handed over to the non-governmental seller.<sup>1</sup>

In this connection it should be mentioned that some of these sales gave rise to big scandals. The most notorious was the cancellation of bidding for the 100% state stake in the Training & Testing Dairy Plant (*UOMZ*) under N.V. Vereshchagin Vologda State Dairy Academy (Vologda Butter™) and the suspension of the auction involving the sale of the state stake in OJSC *Diamond World* (52.37%). In the latter case, an arbitration court ruled that special measures should be enforced to protect the company's private shareholders. Besides, the starting price of the relevant state stake also appeared to be underestimated.

Problems also arose in connection with some other deals handled by OJSC *RAD*, due in the main to the resistance of regional authorities: the sale of Murmansk Sea Fishing Port (the biggest deal, according to the year-end results of 2015) and JSC *SIC Supermetal*, the privatization of the latter having been previously suspended by *Rosimushchestvo* (more than 40 state stakes were suspended out of a total of 204 transferred to OJSC *RAD* for sale); the sales of the Saratov Polygraphic Combine and *Sverdlovskavtodor* set for Q1 2016.<sup>2</sup>

The most notorious case is that of the Training & Testing Dairy Plant (*UOMZ*) in Vologda, which put to light many problematic aspects of Russia's privatization process: the feasibility of

<sup>1</sup> The performance level assessment of non-governmental sellers participating in the implementation of the privatization program compared to that of the model procedures followed by government bodies must rely on information concerning the amount of commission paid to the former.

<sup>2</sup> Pushkarskaia A., Butrin D. *Rosimushchestvo lacks courage*. *Kommersant*, January 14, 2016.

selling one or other asset currently held by the State, its objective valuation, transparency, co-ordination of the interests of the parties in a deal. In this particular case, it was the regional authority who, with public support, opposed the privatization deal. Their arguments were as follows: that the enterprise was profitable; that it was implementing an investment program; that its privatization might entail rising unemployment and production reorientation, loss of the traditional product recipes and its unique brand; and the loss of a base for training qualified personnel. So, in the spring of 2015, the sale was canceled. However, in early 2016, OJSC *RAD* made another attempt at its sale, which was contrary not only to the clearly proclaimed standpoint of the regional authority, but also to that of some federal bodies of executive authority (*Rosimushchestvo*, the RF Ministry of Agriculture, etc.). The upshot of all this was that the sale was canceled once again, and it was declared that an investment consultant will be selected in order to determine the key conditions and elaborate the structure of a potential deal, so as to attract strategic Russian investors and enforce the terms whereby no production reorientation may be attempted<sup>1</sup>.

On the whole in 2015, stakes (or shares in charter capital) in 462 economic societies were put up for sale, of which stakes (or shares in charter capital) in 103 economic societies were actually sold, vs. 341 and 107 respectively in 2014. The results for stakes in another 85 JSCs put up for sale are to be summed up in Q1 2016. Thus, due to the shrinking investment demand for properties earmarked for privatization in response to the high volatility of financial markets and rising lending costs, the share of accomplished sales of all types declined in 2015 on 2014 from 31% to 22%, which means that on the average, only one of every five stakes put up for sale were actually sold.

In many cases the low interest of potential buyers in privatization auctions can be explained by their hope to buy properties put up for sale in the framework of a public offer at a 50% discount, which is the main method employed in secondary sale deals. In the crisis situation, the expectation that the number of participants in bidding may increase (as the principal precondition for asset prices to achieve equilibrium - something that in theory could indeed happen after such a deep plunge) proved to be futile. As a result, the stakes in 92% of public offer deals were sold at a minimum price, i.e. at half their market value.

When, in 2015, nearly 1.200 immovable property entities were added to the group included in the privatization program, the entire structure of property earmarked for privatization was changed, in that the privatization of stakes in economic societies acting as owners of property complexes was replaced by privatization of singular immovable property entities.

Compared to 2014, this segment has demonstrated some noticeable shifts. The number of sold immovable property entities (38 units) increased on 2014 by approximately 3.5 times (vs. 11 units in 2014). However, the amount of proceeds of these sales to be transferred to the federal budget in 2015 was nearly the same (Rb 48.92m vs. Rb 47.46m in 2014). These sales were more successful than the sales of stakes in JSCs. Over the course of 2015, out of the 81 immovable property entities put up for sale, about half were actually sold (38 units), the total number of biddings being 118. The results for stakes in 20 entities put up for sale in the category of 'other property's are to be summed up in Q1 2016.<sup>2</sup>

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<sup>1</sup> [www.rosim.ru](http://www.rosim.ru), February 12, 2016.

<sup>2</sup> For further reading on these issues, see Malginov G., Radygin A. Management of state treasury properties in the Russian Federation: some actual trends. *Economic Policy*, 2015, V. 10, No 4, pp. 20–46.

In 2015, in the framework of execution of 24 executive orders of the RF President and 5 decisions of the RF Government concerning the creation/expansion of vertically integrated structures (VIS), *Rosimushchestvo* implemented a broad array of relevant measures and established 18 VIS, of which all the necessary formalities had been completed for 10. This part of the 3-year privatization program includes 40 FSUEs and state stakes in 129 JSCs. By the end of 2015, decisions were also issued with regard to the terms of privatization of 20 FSUEs (including for 9 in 2015) and 122 JSCs (including for 75 in 2015).

The Federal Law on the Federal Budget for 2016 (No 359-FZ) adopted in early December 2015, similarly to the corresponding law approved a year earlier, contains no specific information as to the amount of revenue to be generated by privatization deals neither in the main body of the document, not in the annexes. Only in the explanatory note attached to the text of the draft law submitted to parliament it was stated that the revenue generated by privatization of federal properties was to be treated, alongside government borrowings, as an independent source of funding to cover federal budget deficit.

Due to the fact that currently the forecast plan (program) of federal property privatization for 2014–2016, approved by Directive of the Government of the Russian Federation of July 1, 2013, No 1111-r, is not yet completed, the switchover to a one-year budget planning cycle will not require any adjustment of the timelines set for the three-year privatization program, as it will be over exactly in one-year period. In this connection, the timelines and specific privatization methods to be applied to biggest companies - leaders in their industries will be determined by the RF Government with due regard for the current market situation, as well as the recommendations of eminent investment consultants.

The important distinctive feature of this draft law from similar documents submitted over the previous years was the attachment, among the other supplementary materials, of data for the forecast plan (program) of federal property privatization for 2016, where the targets for federal budget revenues generated by privatization deals are presented; besides, they are presented in the explanatory note attached to the draft law and in the classification of sources of funding to cover federal budget deficit.

The total sum to be generated by this source in 2016 is to amount to more than Rb 33.2bn. In this connection it is worthwhile to note the secondary role assigned to the revenue generated by privatization as a source of funding to cover federal budget deficit. Thus, in 2016, the expected privatization-generated revenue will amount to approximately 8.5% of the total sum of government borrowing.

It is planned that approximately 36% (or Rb 12bn) of the total planned revenue generated by privatization (in the amount of Rb 33.2bn) will result from the alienation of state stakes in PJSC (Public Corporation) *Sovkomflot* (reduced to 25 % minus 1 share). The functions of the organization and completion of this deal in accordance with Directive of the RF Government of September 20, 2012, No 1739-p will be executed by Deutsche Bank LLC. In this connection, more than 60% in the total amount of revenue generated by privatization (or more than Rb 21.2bn) is expected to be taken up by proceeds of sales of federal property entities, not counting the value of stakes in biggest companies.

However, this revenue target does not appear to be very realistic. It should be reminded that, in the forecast plan (program) of federal property privatization for 2014–2016, the target for federal budget revenue to be generated by federal property privatization is set with no account for the value of stakes in biggest companies (expected to generate Rb 3bn per annum. And in

the first three-year privatization program for 2011–2013 this target was set at Rb 6bn for 2011 and Rb 5bn for 2012–2013 (per annum) (a total of Rb 16bn).

In actual practice, from the moment when the period of the forecast plan (program) of federal property privatization was extended to 3 years, this index rose above Rb 10bn only in 2011, when it amounted to Rb 13.3bn. In fact, the target amount of budget revenue of Rb 21.2bn to be generated by privatization in 2016 (less revenue generated by biggest deals) is comparable with the corresponding index for the entire 3-year period of the implementation of the privatization program for 2011–2013, when the federal budget received Rb 25.67bn, or 160% of the target set in that document. However, this result was achieved within the framework of an economic and political situation that was radically different from what we have been experiencing over the course of two recent years (large-scale capital outflow, the introduction of economic sanctions, the ruble's plummeting exchange rate, and the probability of recession in the national economy).

The target for federal budget revenue to be generated by federal property privatization appears to be even more dubious in view of its forecasted structure, where biggest deals are expected to generate only less than half of the revenue to be received from that source. Meanwhile, according to the year-end results of 2014, the total value of the 2 deals completed on the basis of special decisions of the RF Government (the sale of a 13.76% stake in OJSC *Inter RAO EES* and 100% stake in OJSC *Arkhangelsk Trawl Fleet (ATF)* (100% of shares) amounted to Rb 20.9bn, which is more than 2.5 times above the ordinary amount of revenue generated by model privatization procedures (Rb 8.05 bn).

Among other things, it should be reminded that the current privatization program for 2014–2016 sets no target for the bulk of revenue to be received as a result of sale of stakes in biggest companies with a high investment attractiveness index, in the event of issuance of a special decision to this effect by the RF Government; meanwhile, the previous document set the target of Rb 1 trillion for the period 2011–2013.

However, the mechanism currently applied in the budgetary process, when the approved text of a budget law contains no stipulations concerning the effect of privatization in the context of budget revenue, opens up unlimited opportunities for any decision-making with regard to privatized assets and the timelines and format for their sale. The developments observed over the past year and in early 2016 have confirmed this assumption. It is suffice to point out the instance of JSC *Rusnano* being excluded from the current privatization program in April 2015 and the privatization issues associated with medium-sized public assets of regional importance, mentioned earlier in our discussion.

The evident difficulties experienced by the budgetary system prompted the decisions concerning the expansion of the privatization program in early 2016 and the potential for generating revenue from privatization in an amount up to Rb 1 trillion. The candidates for the privatization of part of their state stakes were *Alrosa*, *Bashneft*, *VTB*, *Rostelecom*, *Transneft*, *Aeroflot*, *Rosneft*, *Sovkomflot* and some other biggest companies; however, the prospects for and format of each of these deals are still unclear.

The comprehensive work that was underway throughout 2015 to implement the necessary measures designed to consolidate the assets of Vnukovo and Sheremetyevo airports is an important phase in their pre-privatization preparation in the context of decisions of the RF President and the Government concerning the strategic development of Moscow's airport system based on the principle of public-private partnership (PPP).

The structure and stages of the consolidation of airport assets of Vnukovo and Sheremetyevo, elaborated in cooperation with investment consultants and private shareholders, were in 2015 approved by Executive Orders of the President of August 1, 2015, No 393 and of August 28, 2015, No 442 respectively.

OJSC *Sheremetyevo International Airport* (SIA) will be reorganized by merging it with JSC *Sheremetyevo*, to be founded jointly by the State and a private shareholder, LLC *Sheremetyevo Holding*, its charter capital made up by the contribution, by the Russian Federation, of its stake of more than 83% in JSC SIA, and the contribution by the private shareholder of its property; meanwhile, the participation of the State in the charter capital of the new company, JSC *Sheremetyevo Airport* (without any additional property contribution), is to be secured by a stake amounting to no less than 30%. For this purpose, the RF Government together with the private shareholder are to determine the composition of property to be contributed by the latter to the new JSC's charter capital, and to ensure valuation of that property in accordance with existing legislation, as in the case of valuation of federal property to be contributed as a RF stake to the charter capital of JSC *Sheremetyevo Airport* at the moment of its founding. This is to be the basis for determining the size of the stakes to be held by the State and the private shareholder in the charter capital of JSC *Sheremetyevo Airport*.

Besides, it was envisaged that a shareholder agreement should be concluded between the RF and the private shareholder, whereby the procedure for executing the rights secured by the stakes in JSC *Sheremetyevo Airport*, including the private shareholder's responsibility to abstain from alienating of its shares in JSC *Sheremetyevo Airport* until the termination of that joint-stock company as a result of its reorganization, the procedure for executing the rights secured by shares in JSC SIA, and the ownership rights to such shares should be determined<sup>1</sup>.

Based on the results of JSC SIA's reorganization, new alterations to the list of strategic organizations should be prepared with regard to the size of stake to be held by the State in the charter capital of JSC SIA in the new format. The new floor for the state stake after the charter capital of JSC SIA is increased by means of an additional issue (or issues) of shares after its reorganization is set at 30%, without any additional property contribution by the RF.

The scheme to be applied to JSC *Vnukovo International Airport* is somewhat similar. By way of covering the cost of additional shares issued in order to increase its charter capital, the stake held by the State in OJSC *Vnukovo Airport* (74.74%) will be contributed to the charter capital; its size (without any additional property contribution), with due regard for the size of stakes contributed by the private shareholders, should be no less than 25% + 1 share. The procedures of property valuation and the terms of the shareholder agreement with private shareholders are in many ways identical to those applied to JSC SIA, except that there were no responsibilities assigned to private shareholders to put in operation new facilities, and no entry of this airport onto the list of strategic organizations. Besides, in contrast to the norms stipulated for JSC SIA, the Executive Order of the President appoints no particular organization to act as a private shareholder.

In February 2016, the relevant shareholder agreements between the State and private shareholders were signed, whereby the airport assets at Sheremetyevo and Vnukovo were consolidated so as to secure for the State the right of control over the activity of the merged company and key decision-making. On the basis of valuation of the property contributions by each of the

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<sup>1</sup> It is also envisaged that an important part of the shareholder agreement should be the obligation assumed by the private shareholder, to construct infrastructure for the new terminal in the northern zone at *Sheremetyevo*, in preparation for the 2018 FIFA World Cup in Russia.

stakeholders, the state stake in the charter capital of JSC *Sheremetyevo Airport* will amount to about 31.6%, and that in the charter capital of JSC *Vnukovo International Airport* – 25.1%, which means that a symbolic excess over the government corporate control threshold will be secured in advance<sup>1</sup>. However, due to the intricacies of such a scheme, it is unlikely that budget revenues can be expected any time soon from a possible sale of shares currently held by the State, although such a possibility cannot be ruled out altogether because the shareholder agreements do stipulate the option of buying out the state stake, alongside various valuation alternatives and premiums for the buyer.

Shares in OJSC *Rosneft*, which have been thoroughly prepared for sale, can generate revenues in the event of the company's privatization that can be transferred to the federal budget as dividends of OJSC *Rosneftegaz*.

However, the main obstacle to success here is the situation in the stock market. The RF President and the RF Government's decisions made in 2014 do allow the alienation of those shares at a price no lower than their market price determined on the basis of a market valuation report prepared by an independent valuator, and no lower than the price of their initial public offer in 2006, which is twice as high as the quotes of *Rosneft*'s shares in early 2016.

The standpoint of OJSC *Rosneftegaz*, which owns 69.5% of shares in OJSC *Rosneft*, is that it is prepared to continue the cooperation with its strategic partners in doing the necessary preparatory work for the forthcoming privatization deal, while orienting to the even higher price at which the shares formerly held by the State had been sold to *BP* in 2013. The compliance with the requirement concerning the price floor can be possible in the medium-term perspective if proper conditions are created for boosting the market value of shares in OJSC *Rosneft*.

At present, the decision that the state stake in PJSC (Public Corporation) VTB Bank, which is entered on the List of Strategic Organizations, should be reduced to 45% in February 2016 can be regarded as an indirect indication of the privatization program's further expansion. In this connection it should be reminded that a similar decision regarding VTB was already made previously, in 2006, when the government corporate control threshold was moved down from a nearly 100% stake (99.9%) to 50% + 1 share. Thereafter, the size of state stake continued to consistently shrink: initially in the form of the so-called 'people's IPO' in 2007, and then the sale of 10% of shares for Rb 95.68bn in 2011.<sup>2</sup> And finally, as a result of an additional issue to the value of Rb 102.5bn in 2013, its size shrank from 75.5% to 60.93%.

Meanwhile, the current privatization program envisages a shrinkage of the state stake in VTB to 50% + 1 share, and any further movement below this threshold should be coordinated with the measures designed to diminish the government's participation in *Sberbank of Russia*'s capital.<sup>3</sup> However, in *Rosimushchestvo*'s commentaries on this issue it is stated that the shrinkage of the state stake has been caused by the necessity to make the size of state stake (as envisaged in the List of Strategic Organizations) compatible with that of the existing state as it emerged after the completion of the purchase, by State Corporation *Deposit Insurance Agency*

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<sup>1</sup> www.rosim.ru, February 15, 2016, February 29, 2016.

<sup>2</sup> The first deal completed with the participation of investment consultants (*Merill Lynch Securioties*) took place after the approval, in May 2010, of amendments to the law on privatization whereby it was allowed to sell certain assets on conditions determined by the RF Government.

<sup>3</sup> It is interesting that the annexes to the 2015 Report on the Implementation of the Forecast Plan (Program) of Federal Property Privatization in 2014–2016 contain information on the sale, in an open auction, of shares in *Sberbank of Russia* to the value of Rb 21,225m without any rise on the starting price. The actual size of the stake relative to the charter capital is not specified, as it is not specified in the current privatization program (only the number of shares, in units).

(DIA) of a big chunk of preference shares in *VTB*. As a result, the total stake held by the State, including the share held by the RF Ministry of Finance, amounts to 45.01% of its charter capital. The State, represented by *Rosimushchestvo*, retains its right of corporate control through its bundle of voting shares<sup>1</sup>.

As for another two companies named among the candidates for privatization, these are noteworthy for their involvement in the relations between the federal center and the regions.

JSC *Bashneft*, the bulk of its capital previously held by SSA *Sistema JSFC*, last year was transferred, by a court ruling, back to federal ownership.<sup>2</sup> It was placed on the List of Strategic Organization with a federal stake of 50% + 1 share. The rest of its capital (25% + 1 share, including some preference shares) was transferred to regional ownership,<sup>3</sup> on condition that the Russian Federation and the Republic of Bashkortostan conclude a shareholder agreement, whereby the procedure for executing the rights secured by shares in JSC *Bashneft* and the ownership rights to those shares with due regard for the requirements stipulated in Russian legislation, including the regulatory procedure of managing and disposing of stakes held by the State, was determined<sup>4</sup>.

A sort of precursor to this document was the agreement of major shareholders in OJSC *Alrosa*, signed in autumn 2013 soon after the successful placement, by an international public offer, of its shares on the MICEX (7% of shares held by the RF, 7% held by the Republic of Sakha (Yakutia), and another 2% controlled by the company itself). The agreement reflects the strategic goals of the government to retain a controlling stake in state ownership, as well as the interaction mode between the Russian Federation and the Republic of Sakha (Yakutia) in exercising corporate governance of OJSC *Alrosa*. The shareholder agreement is concluded for the period of 5 years, with the possibility of its auto-prolongation.

The mandatory requirements for conducting the deals of sale of public assets, as they were put forth by this country's political leaders, will make it very difficult to proceed with privatization in the foreseeable future in view of the existing macroeconomic conditions.

These are as follows: (1) strict compliance with the norms stipulated in legislation when completing privatization deals, (2) retaining government corporate control over system-forming companies, (3) budget efficiency and avoidance of asset sale at throwaway prices, (4) topmost priority should be given to 'quality owners' who must possess not only a good business reputation and experience, but offer a development strategy for the company being purchased, (5) the new owners must be subject to Russian jurisdiction, there should be no 'gray schemes' or withdrawal of assets to offshore zones and concealment of their real owners, (6) the use, by buyers, only of their own means or loans issued by private banks<sup>5</sup>.

The issue of finding the sources of funding necessary for participating in privatization deals is self-evident. Russian businesses are now faced with an economic slump, the need to pay their foreign debts and implement the ongoing investment projects, and many other problems. The

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<sup>1</sup> www.rosim.ru, February 8, 2016.

<sup>2</sup> See the IEP's previous annual overview *The Russian economy in 2014. Trends and outlooks* (Issue 36). M., Gaidar Institute, 2015, pp. 393–394.

<sup>3</sup> www.rosim.ru, July 3, 2015.

<sup>4</sup> This document was signed in mid-September 2015. The federal center and RF subjects assumed the responsibilities to coordinate the execution of shareholder rights during voting at a general shareholder meeting and the functions of the board of directors relative to the key issues of running the company (the approval of its strategy, its budget, the size of dividend amounting to no less than 25% of net profit, major deals, personnel appointments, etc.), as well as the responsibilities relative to disposal of shares. www.rosim.ru, September 16, 2015.

<sup>5</sup> www.rosim.ru, February 2, 2016.



imposed economic sanctions restrict the inflow of foreign capital to Russia's stock market. However, more problems are associated with the desire of many investors to gain control over the companies and their financial flows, their strong incentives to a prompt resale, their tendency to be more interested in natural resources and infrastructure as the least risky (and in some cases guaranteed) sources of future profits compared to investment in the development of industries unrelated to raw materials extraction - the latter being the necessary precondition for successful import substitution and export diversification.

The issue of de-offshorization does not lose its importance, as demonstrated by the prolongation of the period of amnesty for Russian individuals returning capital to Russia. The orientation of authorities to preventing asset outflow is substantiated by the new draft law envisaging a ban on participation in the privatization of offshore companies and companies controlled by entities situated in offshore zones, as well as endowing the relevant agencies with the right to check the applicants for participation in privatization deals and the documents submitted by them by criminal investigation methods.<sup>1</sup>

### 6.1.3. Improvement of legislation on privatization

In 2015, by five federal laws (introduced in April, June, July and December 2015), numerous alterations and amendments were made to the current law on privatization, adopted as of 2001.<sup>2</sup>

*Firstly*, throughout the text of the law, the term open-ended joint-stock companies is replaced by joint-stock companies. This is the upshot of the enactment, from September 1, 2014, of alterations to Part One of the RF Civil Code, introduced by Federal Law of May 5, 2014 (No 99-FZ), whereby the differentiation of joint-stock companies (JSC) into close-ended and open-ended ones was abolished, and a separate group of 'public societies' (JSCs), i.e. those whose shares and convertible securities are placed as a public offer (by open subscription) or circulate publicly on conditions established by the laws regulating the securities market<sup>3</sup>. In its previous version, the Law envisaged, as a method of privatization, only the reorganization of a unitary enterprise into an open-ended joint-stock company (OJSC), and from 2011 onwards - also into a limited liability company (LLC).

Another fundamental alteration was the introduction of a more precise definition of a transfer by way of compensation, as one of the basic principles of privatization (Article 2). The previously applied definition implied a transfer of property by way of alienation for a compensation, or a transfer to state or municipal ownership of shares in those joint-stock companies where state or municipal property was to become a state stake in the charter capital. Now, these forms of property transfer are augmented by a transfer of shares or stakes in the charter capital of economic societies created as a result of reorganization of state or municipal unitary enterprises. The motive behind this alteration is not quite clear, because in actual practice this had been

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<sup>1</sup> *Currencies' deceit*. Interview with Chairman of the RF Investigative Committee Alexander Bastrykin. *The Russian Newspaper*, January 15, 2016, No 6 (6874), pp. 1, 9.

<sup>2</sup> For further details on the newest alterations to privatization legislation introduced after the issuance of that document see Radygin A. D., Entov R. M., Malginov G. N. et al. Privatization in the modern world: theory, empiricism, "a new dimension" for Russia. Ed. A. D. Radygin. In 2 vols. (In Russian). M., Delo, RANEPa, 2014, pp. 191–220; *The Russian economy in 2013. Trends and outlooks* (Issue 35). M., Gaidar Institute, 2014, pp. 403–404; See the IEP's previous annual overview *The Russian economy in 2014. Trends and outlooks* (Issue 36). M., Gaidar Institute, 2015, pp. 389–393.

<sup>3</sup> The rules on public societies also apply to those JSCs whose charter and name reflect their status of a public society.

done before the introduction of this legislative provision. Probably its purpose is to coordinate the specific procedure of reorganization of unitary enterprises with the legal backing for the entire privatization process and the mechanisms applied therein.

*Secondly*, the property segment that is not subject to the law on privatization has been further expanded (Article 3). Now this segment consists of 20 categories.

In 2015, it was augmented by the category of securities traded in organized biddings held in accordance with Federal Law of November 21, 2011 (No 325-FZ) and the RF Government's decisions. The upshot of this innovation was that the sale of shares in OJSC on a stock exchange (in the initial wording of the law – through a trade organizer in the securities market) was taken off the list of permitted privatization methods. In this connection it should be reminded that the transaction category previously taken off that list at the very end of 2014 was the transfer of property to the ownership of an asset manager as a property contribution by the State (including at the regional and municipal levels) in the procedure established by Federal Law 'On the Areas of *Russia's* Priority *Socioeconomic Development*' of December 29, 2014 (No 473-FZ)<sup>1</sup>.

Besides, another 3 property categories, which are listed in the Law and not subject to the provisions stipulated in the privatization law that provided the basic framework for the privatization process, are defined in a more detailed way.

The category of state corporations (SC) and not-for-profit organizations (NPO) created as a result of reorganization of unitary enterprises and state institutions has been augmented by 'other' NPOs, and regions and municipalities, alongside the Russian Federation, are now directly defined as subjects endowed with the right to make property contributions to these entities.

The category of shares in a joint-stock company (JSC) and convertible securities, in the event of their buyout in the procedure established by the 1995 law on joint-stock companies (Article 84.8), was augmented by shares and securities specified in another 2 articles of that law (84.2 and 84.7).

The first article stipulates that the buyer of more than 30% of the total number of shares (including affiliated entities) is obliged to come forth with the offer of purchase of shares in a public society, as well as other issued convertible securities. The second one envisages that the buyer of more than 95% of shares in a public society is obliged to buy out the other stakes in that society held by other entities, as well as other issued convertible securities, at the request of their owners.

The category of federal property to be alienated in accordance with the RF Government's decisions for the purpose of attracting investment, boosting the stock market's development, and promoting modernization and hi-tech development across the national economy was augmented by property alienated for the purpose of boosting the development of small and medium-sized businesses, including the activity of JSC Federal Corporation for the Development of Small and Medium-sized Entrepreneurship, set up in accordance with special Federal Law adopted in 2007 (No 209-FZ) as a development institution operating in the sphere of small and medium-sized businesses. This was the second norm introduced in order to coordinate other

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<sup>1</sup> For the Far-eastern Federal Okrug, in spring 2015, JSC *Far East Development Corporation* (formerly *Moscow Materisl-Technical Base*), with a 100% stake in federal ownership, was appointed in this capacity. The shareholder rights in that JSC are executed by the RF Ministry for the Development of the Far East, and the model provision for the management of shares in joint-stock companies held in federal ownership (introduced in 2004) is not applicable to it.

laws with the laws on privatization. In 2008, the law was augmented by the provision that specified the participation of small and medium-sized businesses in the procedure of privatizing leased immovable property entities in regional and municipal ownership.

Besides, the law on privatization has been augmented by the newly introduced norm that specifies the participation of notaries and notary chambers in the privatization of regional and municipal property by means of sale at an auction or in the framework of a tender, as stipulated in the Russian Federation's Fundamental Principles of Legislation on the Notariat, adopted as of 1993.

Among the new alterations to privatization legislation we may point to the norms that define the procedure of privatizing various public assets as applied specifically to the newly established public corporation, *Roscosmos*, or the Russian Federal Space Agency (set up in accordance with specially issued Federal Law of July 13, 2015 (No 215-FZ)). We may also note its similarity with the previously introduced special norms applied to the reorganization of state railway enterprises into JSCs (in 2003) and the creation of state corporations *Rosatom* and *Rostec* (in 2007).

*Thirdly*, important changes were introduced with regard to the information backing for privatization procedures (Article 15). Now it involves the publication, on official websites, of privatization programs and reports on their implementation at all levels of state authority, of the decisions concerning the terms of privatization of state and municipal property entities, and announcements of forthcoming sales and their results.

The law on privatization no longer contains any mention of the other channel that can be used for information backing (publications in the mass media, including official print media organs, public information systems, including communications networks). Throughout the text of the law, the term 'publication' was replaced by 'posts to websites', and any references to publications in official printed organs disappeared.

The requirement concerning the placement of information on a sale deal involving privatized property (at least 30 days prior to the date of sale of a given property entity) is augmented by the requirement that the decision concerning the terms of a privatization deal should be published within 10 days from the date of making that decision.

The information to be released in connection with the decision concerning a privatization deal is augmented by the requirements to the formalization of the relevant documents and the information on all the previously held biddings for a given property entity over the year preceding its sale, as well as the information on the results of bidding.

With regard to the sale of stakes in JSCs and LLCs, the necessary information to be released (in addition to the existing 5 information items) should be as follows:

- 1) the link to the website where the annual and intermediate accounting (financial) reports of a given economic society should be posted in accordance with newly introduced Article 10.1 of the Law;
- 2) the area of the land plots (or plots) where the real estate held by a given economic society is situated;
- 3) the number of its employees;
- 4) the area occupied by the real estate units held by a given economic society and their list, where the encumbrance on the real estate, both previously existing and identified as of the date of their privatization, should be specified;
- 5) information concerning previous biddings for a given property entity over the year preceding its sale, which did not take place, were cancelled, recognized to be null and void, with

specifying the reasons for each of these events (no bids, only one potential buyer, or other reason). Previously, this information was listed as a separate item in the text of the Law, where the requirements for the information release concerning the sale of a state or municipal property entities to be published on the Internet were specified.

The period for publishing information on the Internet concerning the results of a privatization deal was shortened from 30 to 10 days, and the presentation format was altered.

The obvious information<sup>1</sup> was augmented as follows: the time of a bidding, as well as the name of the individual or legal entity participating in the bidding who offered the highest price for a given property entity compared to the bids by the other participants, with the exception of the bid made by the winner (in the event of closed bidding) or the participant who made the last but one bid for the property entity offered for sale (in the event of open bidding). The latter provision is introduced in place of the information on the number of bids and those who were recognized to be participants in the bidding.

*Fourthly*, a number of new provisions were introduced with regard to privatization planning and privatization procedures, the majority of these having to do with the technical backing for the management processes.

The government powers (Article 6) were augmented by the right to make relevant decisions concerning the approval of the list of legal entities to be assigned the task of organizing an electronic sale of state and municipal property.

With regard to the conduct of a sale (Article 32.1), a direct reference to Article 15 was introduced, the latter determining the forms of information backing for a privatization deal. At the same time, the norm concerning the formalization, in the form of a protocol, of the results of an electronic sale no longer requires their publication, on the day following the day of signing that protocol, on the official website marketplace where the sale was completed.

The norm requiring that the Government of the Russian Federation is obliged to submit to the State Duma a year-end report on the results of federal property privatization was augmented by the requirement that the report should be simultaneously posted to its official website (Article 9).

The Law on Privatization was augmented by a new article (Article 10.1) to the effect that the unitary enterprises, JSCs and LLCs included in privatization programs should submit to the empowered bodies at all levels of state authority their annual and intermediate accounting (financial) reports within 30 days from the end of the relevant reporting period, and that the information contained in those reports should be posted to the official websites determined for this purpose by relevant bodies of authority.

An important special provision was added with regard to setting the price of a property entity earmarked for privatization (Article 12). The stipulation to the effect that its starting price is to be set in accordance with RF legislation on pricing has been limited to the condition that the period between the date of drawing up a valuation report and the date of posting to an official website information concerning the forthcoming sale of a state or municipal property entity should be no longer than half-year.

*Fifthly*, the mechanisms applied in several privatization methods were properly adjusted.

With regard to auctions, while the period for submitting applications for participation remained unchanged (no less than 25 days), the period for recognizing the applicants to be participants in an auction was established to be 5 workdays after the deadline. The timelines for

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<sup>1</sup> The description of a property entity, the name of the seller, the date and place of a bidding, the price of the deal, the name of the buyer (winner in the bidding).

holding an auction were shortened (no later than on the 3rd workday from the date of recognizing the applicants to be participants in an auction vs. no earlier than after the elapse of 10 workdays). The amount of down payment necessary for securing the participation in an auction was doubled (20% vs. 10% of the starting price).

The notification concerning the recognition of a participant in an auction to be the winner is issued on a written receipt to the winner or its attorney on the day of announcing the auction results (vs. 5 days from the date of announcing the auction results), while the stipulation concerning the possibility of notification by registered post was abolished. The period for concluding a purchase and sale contract with the auction winner was shortened from 15 to 5 workdays from the date of announcing the auction results).

With regard to tenders and sales effectuated by means of a public offer, the norms regulating the timelines for recognizing the applicants to be participants in the privatization procedures, the conduct of these procedures, the increase of the amount of down payment necessary for securing participation (from 10% to 20% of the starting price), the issuance to the winner of a notification concerning the signing of a purchase and sale contract were all made to be identical to the norms regulating the auction procedure.

So, the norms that forbade the conclusion of a contract based on the results of a bidding, a sale by means of a public offer, and a sale without the selling price being announced earlier than 10 workdays from the date of posting the protocol of the results of sale of state or municipal property to the relevant websites were abolished accordingly.

In addition, the provisions concerning the formalization of purchase and sale deals involving privatized property entities (Article 32) were augmented by a norm to the effect that a violation of the established procedure for conducting a sale of state or municipal property, including an unsubstantiated refusal to recognize an applicant to be a participant in a bidding, should entail a recognition of that sale deal to be null and void.

Another norm (formerly stipulated in Article 43) to the effect that in an even when a property entity is identified that should have been contributed to the charter capital of a given OJSC, but which was not included, at the moment of its creation, into the privatized property complex, that OJSC should enjoy a priority right to purchase that property entity at a market price, while the property that has not been bought by that OJSC should be privatized in the established procedure, is now abolished.

On the whole, the innovations introduced in legislation in 2015 are designed to boost the privatization process. The suggested upgrading, to an electronic form, of the information backing for state and municipal property privatization mechanisms is aimed at increasing the overall transparency of the privatization process and preventing corruption and crime in that sphere.

To achieve that goal, it is important to draw up the list of legal entities to be assigned the task of conducting the electronic sales of state and municipal property. The necessity to involve electronic trading floors in government purchases has already been discussed for a long time. The arguments in favor of relying on such forms of commerce were the rich experience that has been accumulated in electronic transactions in various sectors, as well as the available high-quality infrastructure with its high level information security policy.

By the RF Government's Directive of December 4, 2015, No 2488-p, the list of 6 organization providing electronic trading floors was drawn up, including OJSC *RAD*, the private trader that has been for three years the organizer of sales of state properties earmarked for privatization. It is now assigned the task of selling approximately 200 JSCs currently in federal ownership, and more than 80 treasury property entities. Beside OJSC *RAD*, the list of legal entities to

be assigned the task of conducting electronic bidding, contains 5 other organization, including 2 JSCs, CJSC *Sberbank – Automated Trading System*, LLC ‘RTS-Tender’ and SUR Agency for Government Order, Investment Activity and Interregional Connections of the Republic of Tatarstan<sup>1</sup>.

The improved mechanisms applied in sales at auctions, tenders and by means of a public offer have made it possible to shorten the organization procedures (the period between the date of determining the participants in a bidding and the date of bidding, the period of processing the results of bidding, the signing of purchase and sale contracts), to speed up the sale of assets earmarked for privatization, to shorten the period of holding the down payments of the participants in a bidding, and to lower the potential risk of conspiracy between them, thus ensuring an adequately competitive environment.

It is noteworthy that the requirements to the amount of down payments are now similar to those that existed prior to 2010, when it was reduced by half (from 20% to 10% of the starting price specified in the property sale announcement). The previously applied timelines for signing contracts with the auction winners and for completing sales in the framework of a public offer (5 workdays) are now reestablished<sup>2</sup>.

One cannot overlook the increasingly widespread practice of abolishing the norms stipulated in the law on privatization. From the moment of its approval in late 2001, the number of property categories the alienation of which is no longer regulated by it has almost doubled (having increased from 11 to 20), in spite of the currently broader interpretation of some of these norms.

#### 6.1.4. The presence of the State in the economy and issues relating to the management of subjects operating in the public sector

Several serious alterations were made in 2015 to the list of strategic enterprises and joint-stock companies.

As of early December 2015, only one company was placed on that list: JSC *Bashneft*. Over the same period, 2 FSUEs and 2 JSCs, including JSC *Concern Sea Underwater Weapons – Gidropribor*, were struck off that list. The latter is a big vertically integrated structure (VIS), where all shares (but one) are earmarked as a contribution to the charter capital of another VIS (Tactical Missiles Corporation JSK) by way of payment for its additional issue and placement of shares.

In addition to the enlargement of Tactical Missiles Corporation JSK, there were some other important decisions concerning the development of other integrated structures, including OJSC Concern *VKO Almaz–Antey* (where all 100% of shares are in federal ownership), to be renamed as Aerospace Defense Concern *Almaz–Antey*<sup>3</sup>, and State Research Center of the Russian Federation Concern CSRI *Elektropribor* JSC, its charter capital consisting of the contribution of 100% – 1 shares in the JSC established on the basis of a FSUE to be struck off the list of strategic companies and blocking stakes in another JSC.

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<sup>1</sup> [www.economy.gov.ru](http://www.economy.gov.ru), December 8, 2015.

<sup>2</sup> It should be noted that in the initial wording of the law it was calendar days, and not workdays (as amended in 2011). Initially, the period for signing the contract in the framework of a tender was 10 days.

<sup>3</sup> The property integration scheme applied in the enlargement of *Almaz–Antey* is described in detail in the previous year's overview *The Russian economy in 2014. Trends and outlooks* (Issue 36). M., Gaidar Institute, 2015, pp. 396–397.

Another two important alterations in the list of strategic organizations are as follows. PJSC (Public Corporation) *ROSSETI* was allowed to increase its charter capital, at a higher government corporate control threshold (85.31%, vs. 61.7% in 2013 and 54.52% in 2012); and the state stake in the charter capital of JSC *SIA* was reduced very significantly (vs. 50% + 1 share in 2011 and 100% initially), as part of the overall context of the Moscow airport system's development based on the principles of a PPP (as described earlier).

Among the issues involved in managing economic societies with state participation, we can naturally point out those associated with the JSCs entered in the Special List approved by Directive of the Government of the Russian Federation of 23 January 2003, No 91-r, where the standpoint of the State as a shareholder on a number of the most important issues is to be determined at the government level. In accordance with the decisions of the Government of the Russian Federation issued with regard to general shareholder meetings, in the course of the corporate year 2015 a total of 390 candidates to the boards of directors (supervisory boards) of JSCs entered in the Special List<sup>1</sup> were approved, including 197 professional attorneys (out of a total of 219 persons recommended by the special Commission (attached to *Rosimushchestvo*) assigned the task of selection of independent directors, representatives of the shareholder interests of the RF, and independent experts to be elected to the managerial and control bodies of joint-stock companies), 94 independent directors (instead of 112 recommended persons) and 118 civil servants (instead of 106 recommended persons).<sup>2</sup>

Over the last 5 years, the structure of state participation in the managerial bodies of JSCs entered in the Special List has undergone noticeable changes (*Table 4*).

*Table 4*

**The movement and structure of state representatives in the managerial and control bodies of JSCs entered in the Special List, in 2010–2015**

Year	JSC, units	State representatives in boards of directors (supervisory boards)								In audit commissions: independent experts, number
		Total		Civil servants		Professional attorneys		Independent directors		
		number	%	number	%	number	%	number	%	
2010	49	386	100.0	193	50.0	117	30.3	76	19.7	...
2011	51	416	100.0	181	43.5	150	36.1	85	20.4	...
2012	57	434	100.0	141	32.5	205	47.2	88	20.3	15
2013	63	452	100.0	127	28.1	228	50.4	97	21.5	27
2014	51	402	100.0	106	26.4	199	49.5	97	24.1	45
2015 <sup>a</sup>	50	390	100.0	118	30.3	178	45.6	94	24.1	54

<sup>a</sup> – including OJSC *Novorossiysk Commercial Sea Port*, where only civil servants were elected to the board of directors and audit commissions;

*Source:* Year-end 2014 Report on the Management of Federal Stakes in OJSC and the Use of the Russian Federation's Special Right to Participate in an OJSC's Management ('Golden Share'); own calculations.

The changes within the boards of directors that occurred in 2015 had to do only with the relative share of civil servants, which increased to more than 30% vs. 26% a year earlier, due to the reduced number of professional attorneys (to 45.6%). The share taken up by independent directors remained unchanged (about 24%). On the whole over a longer period (2010–2015), the group of JSCs included in the Special List demonstrated stable growth in the number of

<sup>1</sup> Including data on candidates to the managerial bodies of OJSC "*United Grain Company*", taken from the documents issued by the special Commission's decisions (RF Government's approval was granted without delay), but less data for OJSC *State Transport Leasing Company* (GTLK) (the shareholder rights are executed by the RF Ministry of Transport) and *GLONASS* (a newly created company).

<sup>2</sup> The final decisions concerning the approval of candidates to the boards of directors and supervisory boards of the JSCs entered in the Special List are made by the RF Government.

professional directors, as a result of which their number per company increased from 3.94 to 5.44, while the number of civil servants dropped from 3.94 to 2.36.

As for the structure of the audit commissions in 2015, although civil servants still prevailed, their number shrank to 70% vs. 3/4 a year earlier (or 128 vs. 54 independent experts). However, the total number of the latter tripled over the past 3 years, their number per company increased from 0.26 in 2012 to 1.08 in 2015.

As for the structure of the managerial bodies of companies not included in the Special List, it should be said that in 527 JSC, where the possession of right to a controlling or blocking stake ensured that state representatives took up a total of 3,231 positions in the boards of directors (or supervisory boards) of JSCs,<sup>1</sup> more than half of them were professional directors (1,660 or 51.4%), while the share of civil servants (1,571) was 48.6%. However, in another 178 JSCs with the RF stakes in their charter capital amounting to less than 25%, 100% of the representatives of government interests in the boards of directors (or supervisory boards) were civil servants (approximately 270 positions). However, even if we give consideration to this factor, the total number of civil servants participating in the boards of directors (or supervisory boards) of the JSC off the Special List shrank on 2014, when it had amounted to 2,126.

Table 5

**The movement and structure of professional directors in the capacity of state representatives in the managerial and control bodies of JSCs off the Special List, in 2009–2015**

Year	JSC, units	State representatives in boards of directors (supervisory boards) (other than civil servants)						In audit commissions: independent experts, number
		Total		Professional attorneys		Independent directors		
		number	%	number	%	number	%	
2009	233	521	100.0	310	59.5	211	40.5	...
2010	389	707	100.0	493	69.7	214	30.3	...
2011	512	1,109	100.0	830	74.8	279	25.2	...
2012	822	1,860 <sup>a</sup>	100.0	1,350	72.6	510	27.4	...
2013	637	1,715	100.0	1,092	63.7	623	36.3	335
2014	683	2,094	100.0	1,382	66.0	712	34.0	498
2015	527 <sup>b</sup>	1,660	100.0	1,267	76.3	393	23.7	330

<sup>a</sup> – data are also available on the election of 1,869 professional directors;

<sup>b</sup> – in addition to those 527 JSCs where professional directors were elected to the managerial bodies, there were another 151 JSCs with a controlling or blocking stake held by the State, where decisions concerning their approval had not been passed for various objective reasons.

Source: Year-end 2014 Report on the Management of Federal Stakes in OJSC and the Use of the Russian Federation's Special Right to Participate in an OJSC's Management ('Golden Share'); own calculations

As follows from data presented in *Table 5*, the changes in the structure of professional directors were quite remarkable. While their total number shrank by 1/5, the number of independent directors surged much deeper (by 45%), their relative share among state representatives (other than civil servants) hit its record low since 2009 (less than 24%). The number of independent experts in audit commissions also surged, by 1/3. However, the number of professional directors sitting on boards of directors (supervisory boards) per company increased from 3.07

<sup>1</sup> Other than (1) 178 JSCs where the State does not hold a blocking stake, (2) 151 JSCs where the State holds a controlling or blocking stake, but the decisions concerning their approval had not been passed for various objective reasons, (3) 37 JSCs whose documents were submitted to the special Commission for the selection of professional directors and independent experts but never considered, due – among other things – to the fact of their privatization, transfer of shares under a trust management agreement, and the initiation of a proceeding in bankruptcy, when shareholders are deprived of their right to set up a company's management and control bodies.



to 3.15, while the number per company of independent experts in audit commissions shrank from 0.73 to 0.63.

The past year saw some serious progress in the development of model documents designed to standardize the management procedures applied by state-owned companies.

*Rosimushchestvo* developed its methodical instructions concerning the preparation of internal normative documents designed to regulate the activity of public corporations, public companies, and JSCs entered into the Special List.

According to the Government of the Russian Federation, these documents are as follows:

- the long-term development program (LDP);
- the provision on key performance indices (KPI);
- the regulation on investment and operative performance improvement and expenditure reduction;
- the provision on internal audit;
- the provision on a quality management system;
- the provision on a risk management system;
- the provision on the procedure for elaborating and implementing an innovative development program<sup>1</sup>.

As far as the practical aspects are concerned, the last 5 documents listed above (that is, less LDP and KPI) were approved, as of August 1, 2015 in no more than ten out of 52 JSCs entered in the Special List (the provision on internal audit was approved in 15 companies), and another 30+ companies began to elaborate such documents.

The meetings of boards of directors and supervisory boards approved drafts LDPs in 42 companies, and draft KPIs – in 40 companies. The prospects appear to be more problematic for the vast body of those companies off the Special List where the total stake held by the State is more than 50%, and the shareholder rights are executed by *Rosimushchestvo* (469 units). As of the aforesaid date, only 147 of them had approved their LDPs (while another 97 JSCs were still elaborating their draft programs), and 210 companies approved their KPIs (while in another 65 JSC these were still being elaborated).

In addition to creating a medium-term development planning systems for companies (in based on LDP and KPI), much effort was focused on the implementation of measures designed to boost labor productivity.

In 40 JSCs entered on the Special List, a set of measures aimed at boosting labor productivity is introduced, in 39 companies the relevant indices are incorporated in the managerial LDPs and KPIs, and in 29 companies alterations were made to the labor contracts concluded with independent executive bodies. The rate of implementation of these measures was lower in the larger group of 469 companies off the Special List and with the total stake held by the State of more than 50%. Only in 100 of these JSCs the labor productivity index is incorporated in their LDPs, in 106 companies it is incorporated in their managerial KPIs, and in 58 companies alterations were made to the labor contracts concluded with independent executive bodies.

In the framework of the decision, made in 2014, that centralized control should be established over the cash flows, liquidity and financial risks of public corporations, JSCs with state stakes, their affiliations and dependents, it was also necessary to set up single treasuries for the core companies, their affiliations and dependents. For this purpose, *Rosimushchestvo* issued relevant directives for state representatives in the boards of directors and supervisory boards,

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<sup>1</sup> www.rosim.ru, July 2, 2015.

established the schedule for setting up the special treasuries and prepared recommendations on the companies' major financial management functions. However, later on these goals were suspended, and the issue of their implementation, with regard to the creation of special treasuries, is to be further elaborated by the RF Ministry of Finance and the Federal Financial Monitoring Service (*Rosfinmonitoring*)<sup>1</sup>.

Also in 2015, the Model Provision on the procedures of purchases for the needs of JSCs, introduced in late 2014, was newly amended, with a more detailed elaboration of the regulation of purchase activity. Draft methodological recommendations for internal risk management and internal control organization were prepared, so as to prevent corruption in JSCs with state stakes, as well as the methodological recommendations for preparing the provision on the internal control system in such companies.

An important goal for the managerial bodies of all the companies with state participation for the next few years will be the implementation of the norms stipulated in the new Corporate Governance Code, which is only recommendatory, but is already being applied by 13 biggest public companies<sup>2</sup>.

*Rosimushchestvo* prepared materials titled 'The formation of a methodological base for corporate governance', and planned measures designed to assist in implementing the provisions stipulated in the Code. The CEOs of JSCs were to assess the feasibility of applying its principles in each company, with due regard for the potential costs and risks. On the whole, the plan aims at increasing transparency in JSCs, boosting the performance of their boards of directors and corporate secretaries, and ensuring better protection of shareholder rights. The process of implementing the Code's principles and issuing the relevant corporate document is to be over in 2016.

As for the normative-legal innovations introduced in 2015 with regard to corporate governance in the public sector, we may note the alterations introduced into the Code of Administrative Offenses of the Russian Federation, whereby the amount of fines for CEOs for failing to implement the necessary measures designed to prepare a unitary enterprise for its reorganization into a joint-stock company were raised; and the approval, by *Rosimushchestvo*, of a detailed step-by-step algorithm of preparing a unitary enterprise for privatization. Besides, *Rosimushchestvo* completed the preparation and coordination with all the relevant branch federal bodies of executive authority of the unified draft of a model charter of a JSC where *Rosimushchestvo* is the sole shareholder, and whose shares are to be alienated within the framework of the privatization program. Some alterations were introduced into the structure of the annual report of a JSC whose shares are in federal ownership (its initial wording approved by Decree of the RF Government of December 31, 2010, No 1214), These have to do with specifying a company's main areas of development and main risk factors; besides, a new section was added, which describes the approaches to organizing the risk management and internal control systems, as well as the internal audit functions.

The total amount of federal budget revenues administered by *Rosimushchestvo*, in the form of dividends charged on the shares held by the RF, with due regard for the decisions approved by annual general shareholder meetings as of 1 August 2015, was in excess of 237.7 bn Rb.<sup>3</sup>

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<sup>1</sup> Year-end 2014 Report on the Management of Federal Stakes in OJSC and the Use of the Russian Federation's Special Right to Participate in an OJSC's Management ('Golden Share').

<sup>2</sup> www.rosim.ru, November 12, 2015; November 16, 2015; November 23, 2015.

<sup>3</sup> The final year-end data for 2015 based on budget statistics are shown later, among other types of property-generated revenues.

The bulk of this sum (59%) was provided by the JSCs on the Special List (vs. 2/3 a year earlier). The group of 11 biggest payers of dividends to the federal budget (in amounts in excess of Rb 1bn) consists of OJSC *Gazprom*, *Rosneftegaz*, PJSC (Public Corporation) *Bashneft*, PJSC (Public Corporation) VTB Bank, OJSC *Alrosa*, PJSC (Public Corporation) *Rostelecom*, OJSC *Zarubezhneft*, *Rusgidro*, JSC *Transneft*, the Agency for Housing Mortgage Lending (AHML), and PJSC *Sovkomflot*.

Meanwhile, the number of companies on the Special List earmarked for the payment of dividends no less than 25% of their net profit, as determined on the basis of their year-end reports of 2014, declined on the previous year (21 vs. 34 JSCs). The main reason for the downward deviation of the amount of dividends from the target norm established by RF Government Directive No 774-r of 29 May 2006, introduced in the wording approved as of the end of 2012, was the loss incurred by state-owned companies by the end of a reporting period. Out of the 14 JSCs on the Special List with regard to which the Government of the Russian Federation issued decisions that they were not to pay dividends, 11 companies were allowed not to pay dividends specifically due to their losses.

As seen by the year-end results of 2014, for 7 JSCs on the Special List (the AHML, JSC *Bashneft*, OJSC *Zarubezhneft*, *Rosneft*, *Rostelecom*, *Rusgidro*, PJSC *Sovkomflot*) the amount of dividends to be paid to the federal budget was charged on the basis of financial reports drawn up in accordance with the International Financial Reporting Standards (IFRS), while the aggregate amount of dividends charged by these companies for the year 2013 increased 1.9 times on the corresponding index for the same period of the previous year (calculated in accordance with the Russian Accounting System (RAS)).<sup>1</sup>

#### 6.1.5. The budgetary effect of government property policy

In 2015, similarly to the situation in 2014, the movement of federal budget revenues associated in one or other way with state property was multi-directional. The revenues generated by the use of state property (renewable sources) increased alongside the declining revenues from privatization and sale of property (non-renewable sources).

Below, in *Tables 6* and *7*, we present the data on revenues taken from the laws on federal budget execution for 2000–2014 (with the exception of data for 2015) generated by the use and sale of state property belonging to specified categories of tangible property entities<sup>2</sup>.

<sup>1</sup> 2014 Year-end Report on the Management of Federal Stakes in OJSC and the Use of the RF Special Right to Participate in an OJSC 's Management ('Golden Share').

In this connection it should be noted that in the Report for the previous year *Rostelecom* and *Rusgidro* were already named among the companies applying IFRS.

<sup>2</sup> We do not consider here the federal budget revenues generated by payments for the use of natural resources (including biological water resources, revenues from the use of forest fund, and the extraction of mineral resources); compensation of losses incurred by agricultural production sector; revenues from the confiscation of agricultural land; revenues generated by financial operations (revenues from placement of budget funds (revenues from federal budget residuals and their investment; from 2006 onwards these include the revenues from the management of the RF Stabilization Fund (from 2008 onwards – the Reserve Fund and the National Welfare Fund); revenues from investment of monies accumulated in the course of trading RF stocks in the auction market); interest on domestic loans funded from the federal budget, interest on government loans (monies received from the governments of foreign countries and foreign legal entities as interest payments on RF government loans; money transfers from legal entities (enterprises and organizations), RF subjects, municipal formations received as interest and guarantee payments on loans received by the RF from foreign governments and international financial organizations)); revenues generated by paid services rendered to the population or monies received by way of compensation of government expenditures; transfers of the RF Central Bank's profits; certain categories of payments from

Table 6

**Federal budget revenues generated by use of state property (renewable sources)  
in 2000–2015, m Rb**

Year	Total	Dividends on shares (2000–2015) and revenues generated by other forms of participation in capital (2005–2015)	Payment for lease of land in state ownership	Revenues generated by lease of property in state ownership	Revenues for transfer of part of net profits of FSUEs after taxes and other mandatory payments	Revenues generated by Joint Venture <i>Vietsovpetro</i>
2000	23,244.5	5,676.5	-	5,880.7	-	11,687.3 <sup>a</sup>
2001	29,241.9	6,478.0	3,916.7 <sup>b</sup>	5,015.7 <sup>c</sup>	209.6 <sup>d</sup>	13,621.9
2002	36,362.4	10,402.3	3,588.1	8,073.2	910.0	13,388.8
2003	41,261.1	12,395.8		10,276.8 <sup>e</sup>	2,387.6	16,200.9
2004	50,249.9	17,228.2	908.1 <sup>f</sup>	12,374.5 <sup>e</sup>	2,539.6	17,199.5
2005	56,103.2	19,291.9	1,769.2 <sup>b</sup>	14,521.2 <sup>i</sup>	2,445.9	18,075.0
2006	69,173.4	25,181.8	3,508.0 <sup>h</sup>	16,809.9 <sup>i</sup>	2,556.0	21,117.7
2007	80,331.85	43,542.7	4,841.4 <sup>h</sup>	18,195.2 <sup>i</sup>	3,231.7	10,520.85
2008	76,266.7	53,155.9	6,042.8 <sup>h</sup>	14,587.7 <sup>i</sup>	2,480.3	-
2009	31,849.6	10,114.2	6,470.5 <sup>h</sup>	13,507.6 <sup>i</sup>	1,757.3	-
2010	69,728.8	45,163.8	7,451.7 <sup>h</sup>	12,349.2 <sup>i</sup>	4,764.1	-
2011	104,304.0	79,441.0	8,210.5 <sup>h</sup>	11,241.25 <sup>i</sup>	4,637.85	773.4
2012	228,964.5	212,571.5	7,660.7 <sup>k</sup>	3,730.3 <sup>i</sup>	5,002.0	-
2013	153,826.2	134,832.0	7,739.7 <sup>k</sup>	4,042.7 <sup>i</sup> +1,015.75 <sup>m</sup>	6,196.1	-
2014	241,170.6	220,204.8	7,838.7 <sup>k</sup>	3,961.6 <sup>i</sup> +1,348.5 <sup>m</sup>	7,817.0	-
2015	284,471.3	258,872.2	9,032.3 <sup>k</sup>	5,593.8 <sup>i</sup> +1,687.8 <sup>m</sup>	9,285.2	-

<sup>a</sup> – according to data released by the RF Ministry of Property Relations, in the Law of Federal Budget Execution in 2000 this item was not specified separately, instead the amount of payment received from state-owned enterprises was entered (Rb 9,887.1m) (without any components being specified);

<sup>b</sup> – the amount of lease payments (i) for the use of agricultural land and (ii) for the use of land plots in the territories of towns and settlements;

<sup>c</sup> – the amount of revenues from the lease of property consolidated to (i) scientific research organizations, (ii) educational establishments, (iii) healthcare institutions, (iiii) state museums, state cultural and arts institutions, (iiiii) archival institutions, (iiiii) the RF Ministry of Defense, (iiiii) organizations subordinated to the RF Ministry of Railways, (iiiii) organizations providing research-related services to the academies of sciences with the status of a state entity, and (iiiii) other revenues from the lease of property in state ownership;

<sup>d</sup> – according to data released by the RF Ministry of Property Relations, in the Law of Federal Budget Execution in 2001 this item was not specified separately, this value turned out to be the same as the amount of other revenues received as part of payments transferred by state and municipal organizations;

<sup>e</sup> – total amount of revenues generated by the lease of property entities in state ownership (without specifying the amount of lease payments for land);

state and municipal enterprises and organizations (patent duties and registration fees for official registration of software, databases, integral microcircuit topologies; and other revenues which until 2004 were part of mandatory payments of state organizations (except revenues generated by the operations of Joint Venture *Vietsovpetro* (from 2001) and transfers of part of profits generated by FSUEs (from 2002)); revenues from the implementation of product share agreements (PSA); revenues from the disposal of confiscated and other property earmarked as government revenue (including property transferred to state ownership in the procedure of inheritance or gift, or treasure trove appropriation); revenues generated by lotteries; other revenues from the use of property and rights in federal ownership (revenues from the execution of rights to the results of intellectual activity (R&D and technologies) intended for military, special or dual use; revenues generated by the execution of rights to the results of scientific and technological research held by the RF; revenues generated by the exploitation and use of property relating to motor roads, motor road levies imposed on transport vehicles registered in the territories of other states; execution of the Russian Federation's exclusive right to the results of intellectual activity in the field of geodesy and cartography; and other revenues from the use of property in the ownership of the Russian Federation); revenues generated by organizations from the permitted types of economic activity and earmarked for transfer to the federal budget; revenues from realization of government reserves of precious metals and precious stones.

<sup>f</sup> – the amount of lease payments (i) for the use of land plots in the territories of towns and settlements (ii) for the use of land plots in federal ownership after the delineation of titles to land plots between different tiers of government;

<sup>g</sup> – the amount of revenues from the lease of property consolidated to (i) scientific research organizations, (ii) educational establishments, (iii) healthcare institutions, (iiii) state cultural and arts institutions, (iiiii) state archival institutions, (iiiii) institutions of the federal postal service of the RF Ministry of Communications and Informatization, (iiiii) organizations providing research-related services to the academies of sciences with the status of a state entity, and (iiiii) other revenues generated by the lease of property in federal ownership;

<sup>h</sup> – the amount of lease payments after the delineation of titles to land plots between different tiers of government and revenues generated by the sale of right to conclude lease agreements in respect of land plots in federal ownership (with the exception of land plots held by federal autonomous institutions (2008–2011) and budget-funded institutions (2011));

<sup>i</sup> – the amount of revenues from the lease of property held by right of operative management by federal bodies of state authority and by the state institutions established by them, and property held by right of economic jurisdiction by FSUEs: properties transferred for operative management to organizations with the status of a state entity (i) scientific research institutions, (ii) organizations providing research-related services to the Russian Academy of Sciences and to sectoral academies of sciences, (iii) educational establishments, (iiii) healthcare institutions, (iiiii) federal postal service institutions of the Federal Communications Agency (*Rossvyaz*), (iiiii) state cultural and arts institutions, (iiiii) state archival institutions, and (iiiii) the lease of property held by right of operative management by federal bodies of state authority and by the state institutions established by them, and property held by right of economic jurisdiction by FSUEs<sup>1</sup> (for the period 2006–2009 - less revenues from the permitted types of economic activity and revenues from the use of federal properties situated outside of RF territory, which are received abroad and were not listed as a separate item in the previous years<sup>2</sup>);

<sup>j</sup> – the amount of revenues from the lease of property held by right of operative management by federal bodies of state authority and by the state institutions established by them ((with the exception federal autonomous institutions and budget-funded institutions): properties transferred for operative management to organizations with the status of a state entity (i) scientific research institutions, (ii) organizations providing research-related services to the Russian Academy of Sciences and to the ‘branch’ academies of sciences, (iii) educational establishments, (iiii) healthcare institutions, (iiiii) state cultural and arts institutions, (iiiii) state archival institutions, (iiiii) properties held by right of operative management by the RF Ministry of Defense its subordinated institutions (2010), (iiiii) properties in federal ownership disposed of by the Executive Office of the RF President (2010), and (iiiii) revenues from the lease of property held by right of operative management by federal bodies of state authority and by the state institutions established by them (less revenues from the permitted types of economic activity and revenues from the use of federal properties situated outside of RF territory, which are received abroad);

<sup>k</sup> – the amount of lease payments after the delineation of titles to land plots between different tiers of government and revenues generated by the sale of right to conclude lease agreements in respect of land plots in federal ownership (with the exception of land plots held by federal autonomous institutions and budget-funded institutions), and (i) lease payments received for the lease of land plots in federal ownership, situated in public motor road precincts of federal importance (2012–2015), and (ii) payments for the execution of agreements on the establishment of servitude with regard to land plots situated within public motor road precincts of federal importance for the purposes of construction (or reconstruction), capital repairs and exploitation of road service entities, installation and exploitation of utility networks, installation and exploitation of elevated advertizing structures (only for 2012 and 2014–2015), и (iii) payments for the execution of agreements on the establishment of servitude with regard to land plots in federal ownership (only for 2015);

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<sup>1</sup> For the period 2008–2009, there is no mention of FSUEs as sources of revenues generated by the lease of property consolidated to them by right of economic jurisdiction, while the revenues from the lease of property held by right of operative management by federal bodies of state authority and by the state institutions established by them does not include revenues generated by property held by autonomous institutions.

<sup>2</sup> According to data released by the RF Ministry of Property Relations, the revenues from the use of federal properties situated outside of RF territory (except revenues generated by the operations of Joint Venture *Vietsoyptero*) amounted to Rb 315m in 1999 and Rb 440m in 2000. From then on, the principal role in handling the commercial use of federal immovable property entities situated abroad began to be played by FSUE Enterprise for the Management of Property Situated Abroad.

<sup>l</sup> – the amount of revenues from the lease of property held by right of operative management by federal bodies of state authority and by the state institutions established by them (with the exception of autonomous and budget-funded institutions): properties transferred for operative management to organizations with the status of a state entity (i) scientific research institutions, (ii) educational establishments, (iii) healthcare institutions, (iiii) state cultural and arts institutions, (iiiii) state archival institutions, (iiiii) other revenues from the lease of property held by right of operative management by federal treasury institutions, (iiiii) federal bodies of state authority, the Bank of Russia, and the managerial bodies of government off-budget funds (iiiii) federal treasury institutions (only for 2015) (less revenues from the use of federal properties situated outside of RF territory, which are received abroad);

<sup>m</sup> the amount of revenues from the lease of RF treasury property (with the exception of land plots).

*Source:* Law of Federal Budget Execution for the period 2000–2014; Report on Federal Budget Execution as of January 1, 2015 (monthly report), [www.roskazna.ru](http://www.roskazna.ru); own calculations.

In 2015, the aggregate revenue generated by renewable sources increased on the previous year by nearly 18%.

The amount of dividend receipts and the transfer of part of their profit by unitary enterprises displayed growth by approximately 17–18%. These indices in absolute terms hit their record high of the entire period since the early 2000s, having risen to Rb 258.9bn and Rb 9.3bn respectively.

Somewhat lower growth (by 15.2%) was demonstrated by the amount of budget revenues generated by lease of land, amounting to more than Rb 9bn.<sup>1</sup> However on the positive side, for the first time in many years, the aggregate revenues from lease of federal property surged at an accelerated rate (by more than 37%) to Rb 7.3 bn. In contrast to the situation in 2013–2014, this result was achieved due to the growth (by 41%) of revenues from the lease of property held by right of operative management by federal bodies of state authority and by the state institutions established by them (with the exception of budget-funded and autonomous institutions), while the revenues generated by lease of RF treasury property (with the exception of land plots) increased by 25%.

As a result, the structure of federal budget revenue received from renewable sources remained unchanged. Dividends accounted for the bulk of federal budget revenue received from renewable sources (approximately 91%). The relative shares of the other sources were almost negligible: profits transferred by FSUEs – 3.3%; lease of land – 3.2%, lease of property – 2.6%.

While proceeding to an analysis of federal budget revenues generated by privatization and sale of state property (*Table 7*), it should be noted that, from 1999 onwards, the revenues from sales of such assets (state stakes, and over the period 2003–2007 - also land plots<sup>2</sup>) have been treated as a source of funding to cover budget deficit.

<sup>1</sup> The amount of lease payments for land plots, just as a year earlier, includes lease payment received for the lease of land plots in federal ownership situated in public motor road precincts of federal importance, payments for the execution of agreements on the establishment of servitude with regard to land plots covered by the right-of-way for general-use motorways of federal importance for the purposes of construction (or reconstruction), capital repairs and exploitation of road service entities, installation and exploitation of utility networks, and installation and exploitation of elevated advertising structures, which are not specified as a separate item in the budget reports for 2013. In addition, in 2015, the revenues generated by the lease of land plots for the first time were augmented by payments for the establishment of servitude with regard to land plots in federal ownership.

<sup>2</sup> Data for the period 2003–2004 include revenues generated by sale of leasing rights.

*Table 7*

**Federal budget revenues generated by privatization and sale of property  
(non-renewable sources) in 2000–2015, m Rb**

Year	Total	Sale of shares in federal ownership (2000–2015) and other forms of participation in capital (2005–2015) <sup>a</sup>	Sale of land plots	Sale of miscellaneous properties
2000	27,167.8	26,983.5	-	184.3 <sup>b</sup>
2001	10,307.9	9,583.9	119.6 <sup>c</sup>	217.5+ 386.5+0.4 (ITA) <sup>d</sup>
2002	10,448.9	8,255.9 <sup>e</sup>	1,967.0 <sup>d</sup>	226.0 <sup>e</sup>
2003	94,077.6	89,758.6	3,992.3 <sup>h</sup>	316.2+10.5 <sup>i</sup>
2004	70,548.1	65,726.9	3,259.3 <sup>j</sup>	197.3+1,364.6+0.04 (ITA) <sup>k</sup>
2005	41,254.2	34,987.6	5,285.7 <sup>l</sup>	980.9 <sup>m</sup>
2006	24,726.4	17,567.9	5,874.2 <sup>l</sup>	1,284.3 <sup>n</sup>
2007	25,429.4	19,274.3	959.6 <sup>o</sup>	5,195.5 <sup>p</sup>
2008	12,395.0	6,665.2+29.6	1,202.0 <sup>q</sup>	4,498.2+0.025 (ITA) <sup>f</sup>
2009	4,544.1	1,952.9	1,152.5 <sup>q</sup>	1,438.7 <sup>r</sup>
2010	18,677.6	14,914.4	1,376.2 <sup>q</sup>	2,387.0+0.039 (ITA) <sup>f</sup>
2011	136,660.1	126,207.5	2,425.2 <sup>q</sup>	8,027.4 <sup>r</sup>
2012	80,978.7	43,862.9	16,443.8 <sup>q</sup>	20,671.7+0.338 (ITA) <sup>f</sup>
2013	55,288.6	41,633.3	1,212.75 <sup>q</sup>	12,442.2+0.310 (ITA) <sup>f</sup>
2014	41,155.35	29,724.0	1,912.6 <sup>q</sup>	9,517.7+1.048 (ITA) <sup>f</sup>
2015	19,792.4	7,203.9	1,634.55 <sup>q</sup>	10,953.9+0.062 (ITA) <sup>f</sup>

<sup>a</sup> – treated as an internal source of funding to cover federal budget deficit, amount to Rb 29.6m for 2008 (as stated in the Report on Federal Budget Execution as of January 1, 2009); this is a federal budget revenue item, but it is absent in the Law of Federal Budget Execution in 2008;

<sup>b</sup> – revenues generated by privatization of entities in state ownership and treated as an internal source of funding to cover federal budget deficit;

<sup>c</sup> – revenues generated by sale of land plots and the right to lease land plots in state ownership (with special entry concerning those land plots in which privatized enterprises are situated), treated as federal budget revenues;

<sup>d</sup> – the amount of revenues generated by (1) sale of property in federal ownership, treated as an internal source of funding to cover federal budget deficit, (2) revenues generated by (i) sale of apartments, (ii) sale of state production and non-production assets, transport vehicles, other equipment and tangible assets, and (3) revenues generated by sale of intangible assets (ITA), treated as federal budget revenues;

<sup>e</sup> – including Rb 6m generated by sale of shares held by RF subjects;

<sup>f</sup> – revenues generated by sale of land and intangible assets, their amount not specified as a separate entry, treated as federal budget revenues;

<sup>g</sup> – revenues generated by sale of property in state ownership (including Rb 1.5m generated by the sale of properties held by RF subjects), treated as an internal source of funding to cover federal budget deficit;

<sup>h</sup> – this figure includes revenues generated by: (1) sale of land plots in which immovable property entities are situated, which prior to their alienation were federal property, the proceeds being transferred to the federal budget, (2) sale of other land plots, as well as sale of the right to conclude lease agreements in respect of those land plots, (3) sale of land plots after delineation of titles to land plots, as well as sale of the right to conclude lease agreements in respect of those land plots, the proceeds being transferred to the federal budget; these are treated as an internal source of funding to cover federal budget deficit;

<sup>i</sup> – the sum of (1) revenues generated by sale of properties in federal ownership, treated as an internal source of funding to cover federal budget deficit, and (2) revenues generated by sale of intangible assets, treated as federal budget revenues;

<sup>j</sup> – this figure includes the revenues generated by: (1) sale of land plots after delineation of titles to land plots, in which immovable property entities are situated, which prior to their alienation were federal property, the proceeds being transferred to the federal budget, (2) sale of other land plots, as well as sale of the right to conclude lease agreements in respect of those land plots, (3) sale of land plots after delineation of titles to land plots, as well as sale of the right to conclude lease agreements in respect of those land plots, the proceeds being transferred to the federal budget; these are treated as an internal source of funding to cover federal budget deficit;

<sup>k</sup> – the sum of (1) revenues generated by sale of properties in federal ownership, treated as an internal source of funding to cover federal budget deficit, (2) revenues generated by (i) sale of apartments, (ii) sale of equipment, transport vehicles and other tangible assets, the proceeds being transferred to the federal budget, (iii) sale of the products of ships recycling industry, (iiii) sale of property held by state unitary enterprises and state institutions,

as well as sale of military property, (iiii) sale of the products of recycled armaments, military technologies and ammunition, (3) revenues generated by sale of intangible assets (ITA); these are treated as federal budget revenues;

<sup>l</sup> – this figure includes the revenues generated by: (1) sale of land plots after delineation of titles to land plots, in which immovable property entities are situated, which prior to their alienation were federal property, (2) sale of land plots after delineation of titles to land plots, the proceeds being transferred to the federal budget, (3) sale of other land plots, which prior to the delineation of titles to land plots between different tiers of government were state property, and which are not earmarked for housing construction (this subdivision is true only with regard to data for 2006), treated as sources of funding to cover federal budget deficit;

<sup>m</sup> – revenues generated by sale of tangible and intangible assets (less federal budget revenues generated by disposal and sale of confiscated property and other property treated as government revenue), this figure includes revenues generated by (i) sale of apartments, (ii) sale of property held by FSUEs, (iii) sale of property held by right of operative management by federal institutions, (iiii) sale of military property, (iiiiii) sale of the products of recycled armaments, military technologies and ammunition, (iiiiiii) sale of other properties in federal ownership, (iiiiiiii) sale of intangible assets; these are treated as federal budget revenues;

<sup>n</sup> – revenues generated by sale of tangible and intangible assets (less revenues received as profit share in the framework of product share agreements (PSA) and federal budget revenue generated by the disposal and sale of heirless property, confiscated property, or other property earmarked as government revenue), this figure includes revenues generated by (i) sale of apartments, (ii) sale of property held by FSUEs, (iii) sale of property held by right of operative management by federal institutions, (iiii) sale of military property, (iiiiii) sale of scrapped armaments, military equipment and ammunition, (iiiiiii) sale of other properties in federal ownership; these are treated as federal budget revenues;

<sup>o</sup> – revenues generated by sale of land plots after delineation of titles to land plots formerly in federal ownership, treated as sources of funding to cover federal budget deficit;

<sup>p</sup> – revenues generated by sale of tangible and intangible assets (less revenues received as profit share in the framework of product share agreements (PSA) and federal budget revenue generated by the disposal and sale of heirless property, confiscated property, or other property earmarked as government revenue, and revenues from sale of timber confiscated from timber poachers), this figure includes revenues generated by (i) sale of apartments, (ii) sale of property held by FSUEs, (iii) sale of property held by right of operative management by federal institutions, (iiii) sale of redundant movable and immovable military properties and other properties held by federal bodies of executive authority that are equated to military service, (iiiiii) sale of military-purpose products from the stores of federal bodies of executive authority within the framework of cooperation in the field of military technologies, (iiiiiii) revenues generated by sale of other properties in federal ownership; these are treated as federal budget revenues;

<sup>q</sup> – revenues generated by sale of land plots in federal ownership (less land plots held by federal autonomous and budget-funded institutions (data for 2011–2012)), treated as federal budget revenues; in 2015, these were augmented by payments for the area added to land plots in private ownership as a result of redistribution of land between these land plots and those in federal ownership;

<sup>r</sup> – revenues generated by sale of tangible and intangible assets (less revenues received as profit share in the framework of product share agreements (PSA), and federal budget revenue generated by the disposal and sale of heirless property, confiscated property, or other property earmarked as government revenue, and revenues from sale of timber confiscated from timber poachers) (data for 2008–2011), revenues generated by the release of tangible assets from the state reserve of special raw materials and divisible materials (in the part of revenues generated by sale, temporary lending, and other uses); and with regard to data for 2012–2015, also revenues generated by sale of timber produced as a result of measures designed to safeguard, protect, reproduce forests in the framework of government order for the implementation of such measures without sale of forest plantations for timber production, and timber produced as a result of use of forests situated in the lands belonging to the Forest Fund of the Russian Federation, in accordance with Articles 43–46 of the RF Forest Code; revenues generated by commodity intervention from the reserve stocks held in the federal intervention fund of agricultural products, raw materials and food-stuffs, revenues generated by the release of tangible assets from the state reserve, revenues generated by the involvement of convicts in reimbursable labor (in the part of sales of finished product), revenues generated by sale of products requiring special storage conditions), this figure includes revenues generated by (i) sale of apartments, (ii) sale of property held by right of operative management by federal institutions (with the exception of autonomous and budget-funded institutions (data for 2011–2015), including revenues from the activity of institutions situated outside of RF territory (2015) (iii) sale of redundant movable and immovable military properties and other properties held by federal bodies of executive authority that are equated to military service, (iiii) sale of the products of recycled armaments, military equipment and ammunition, (iiiiii) sale of products intended for military



use and placed on the list of properties held by federal bodies of executive authority in the framework of cooperation in the field of military technologies (data for 2008 and the period 2010–2015), (iiiiii) sale of scrapped armaments and other military hardware in the framework of Federal Target Program of Industrial Recycling of Armaments and Military Equipment (2005–2010), (iiiiiii) revenues generated by sale of immovable property held by budget-funded and autonomous institutions (2014–2015), (iiiiiiii) revenues generated by sale of other properties in federal ownership and revenues generated by sale of intangible assets (ITA); these are treated as federal budget revenues.

*Source:* Laws on Federal Budget Execution for the period 2000–2014; Report on Federal Budget Execution as of January 1, 2016 (monthly report), [www.roskazna.ru](http://www.roskazna.ru); own calculations.

The amount of property-generated federal budget revenue from non-renewable sources in 2015 shrank by more than half, approximately to its 2010 level.

The main cause of this decline was the shrinkage (more than fourfold - to Rb 7.2 bn) of the revenues generated by sale of shares. This is one of the lowest indices for the entire period since the 2000s, which is only above the indices for the crisis period 2008–2009. At the same time, this result is more than 44% above the budget target.

In 2015, the amount of revenues generated by sale of land plots shrank by 14.5% to Rb 1.6bn vs. Rb 1.9bn a year earlier, which is above the indices for 2008–2010 and 2013, but below the year-end result for 2011.

At the same time, growth (by 15%) was demonstrated by revenues generated by sale of miscellaneous properties. For the first time, this revenue source became topmost in the structure of revenues from non-renewable sources (more than 55%). In the crisis years 2008–2009, the amount of revenues from sale of miscellaneous properties accounted for more than 30% of the aggregate revenues from non-renewable sources, and over period 2012–2013 – for more than 20%, although in absolute terms their amount was higher than the corresponding index for 2015.

The revenues generated by sale of shares, which over the last few years accounted for more than 70% of the aggregate revenues from non-renewable sources, in 2015 shrank nearly by half (to 36%). In spite of their shrinkage in absolute terms, the share of revenues from sale of land increased significantly (from 4.6 to 8.3%).

The aggregate federal budget revenue generated by privatization (or sale) and use of state property in 2015 (*Table 8*) increased on the previous year by 7.8%. Its amount in absolute terms (Rb 304.3bn) comes second after the record high (achieved in 2012) of the entire period since the early 2000s, rising several times above the corresponding indices for period 2008–2009.

While in 2014 the ratio between non-renewable and renewable sources in the structure of aggregate revenues generated by privatization (or sale) and use of state property was roughly comparable with the corresponding indices for the crisis period 2008–2009, in 2015 the share of renewable sources shrank more than twofold – to 6.5%, this hitting its record low of the entire period since the early 2000s.

The share of revenues generated by the use of state property, on the contrary, increased from nearly 85.4% to 93.5% in 2015. This index represents a record high for the entire period since the early 2000s, whereas the amount of revenues from property privatization (or sale) shrank by half on 2014, which is still somewhat above the indices for the periods 2001–2002 and 2008–2010.

Table 8

**The structure of property-generated federal budget revenues from miscellaneous sources, 2000–2015**

Year	Aggregate revenue generated by privatization (or sale) and use of state property		Privatization-generated revenues (non-renewable sources)		Revenues generated by use of state property (renewable sources)	
	m Rb	% of total	m Rb	% of total	m Rb	% of total
2000	50,412.3	100.0	27,167.8	53.9	23,244.5	46.1
2001	39,549.8	100.0	10,307.9	26.1	29,241.9	73.9
2002	46,811.3	100.0	10,448.9	22.3	36,362.4	77.7
2003	135,338.7	100.0	94,077.6	69.5	41,261.1	30.5
2004	120,798.0	100.0	70,548.1	58.4	50,249.9	41.6
2005	97,357.4	100.0	41,254.2	42.4	56,103.2	57.6
2006	93,899.8	100.0	24,726.4	26.3	69,173.4	73.7
2007	105,761.25	100.0	25,429.4	24.0	80,331.85	76.0
2008	88,661.7	100.0	12,395.0	14.0	76,266.7	86.0
2009	36,393.7	100.0	4,544.1	12.5	31,849.6	87.5
2010	88,406.4	100.0	18,677.6	21.1	69,728.8	78.9
2011	240,964.1	100.0	136,660.1	56.7	104,304.0	43.3
2012	309,943.2/ 469,243.2 <sup>a</sup>	100.0	80,978.7/ 240,278.7 <sup>a</sup>	26.1/ 51.2 <sup>a</sup>	228,964.5	73.9/ 48.8 <sup>a</sup>
2013	209,114.85	100.0	55,288.6	26.4	153,826.25	73.6
2014	282,325.95	100.0	41,155.35	14.6	241,170.6	85.4
2015	304,263.7	100.0	19,792.4	6.5	284,471.3	93.5

<sup>a</sup> including the proceeds received by the RF Central Bank as a result of sale of a stake in *Sberbank* (Rb 159.3bn), which is probably an overestimation of the actual aggregate share of non-renewable sources, as the budget did not receive that sum in full but minus the balance sheet value of those sources and the costs of the sale of that stake. Consequently, the share of renewable sources is, on the contrary, somewhat underestimated

Source: Laws on Federal Budget Execution for the period 2000–2014; Report on Federal Budget Execution as of January 1, 2016 (monthly report), www.roskazna.ru; own calculations.

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So, the situation in the sphere of ownership relations in 2015 revealed the following basic trends.

The implementation of the three-year privatization program for 2014–2016 was characterized by an unfavorable economic and political background. No big sale deals took place. Compared to the year-end results of 2014, the number of sold stakes slightly dropped, while the rate of unitary enterprises being reorganized into joint-stock companies remained unchanged, and the volume of sales of immovable property entities tripled.

Thanks to *Rosimushchestvo's* efforts aimed at improving the system of sales and the information backing for privatization deals, the federal budget was augmented by revenues in an amount that exceeds the forecasted revenue figure stipulated in the privatization program (less biggest sale deals), and also exceeds the overall budget target for revenue to be generated by sale of shares. With some reservation, we can still say that due to the active involvement of non-governmental sellers in the sales of state stakes, the privatization process proceeded at a faster rate than is had done in the comparably tough conditions of the crisis year 2009. Some alterations were made to the privatization law, but these were of minor importance, and their true effect (shorter time needed for concluding privatization deals and a higher competition rate) will become manifest only in the future.

The movement of the public sector of the national economy cannot be estimated more or less accurately for lack of necessary statistics, which is the upshot of a switchover to a new methodology, and it is still unclear whether this methodology is appropriate or not. In absence

of significant deals, the process of creating vertically integrated structure with the participation of state companies was actively evolving in the corporate control market; besides, the applied instruments for managing the economic subjects operating in the public sector continued to be further improved at the level of model documents.

The structure of federal budget revenues generated by privatization (or sale) and use of state property, just as a year earlier, was dominated by revenues from renewable sources, and their share actually rose to a record high of the entire period since the early 2000s. Growth in absolute terms was demonstrated with regard to all types of renewable sources, the highest increase being noted in the amount of federal budget revenues generated by payments for the use of federal property entities (other than land plots). As for non-renewable sources, growth was observed only with regard to revenues generated by sale of miscellaneous properties (other than land plots).

## **6.2. Evolution of bankruptcy institution: from insolvency of state-owned enterprises towards electronic SRO trading facilities<sup>1</sup>**

### 6.2.1. Bankruptcy legislation in post-Soviet Russia

Bankruptcy legislation in the post-Soviet Russia was for the first time introduced in 1992 by the Executive Order of the President “On Measures for the Support and Rehabilitation of Insolvent State-Owned Enterprises (Bankrupt Debtors) and the Application of Special Proceedings to Them” No. 623 of June 14, 1992, which stipulated grounds for liquidation of enterprises, special liquidation proceedings such as reorganization, rehabilitation, direct administration of the enterprise, independent management, auctions for sale of enterprise, and other provisions concerning bankruptcy.

The *first law on bankruptcy* – Federal Law “On Insolvency (Bankruptcy) of Enterprises” No. 3929-1 dated November 19, 1992 – was adopted in late 1992. Although the number of bankruptcy petitions in commercial courts increased visibly in 1995–1997, the number of bankruptcy proceedings remained small in Russia.

The law was based on the concept of inability to pay due to the assets-to-liabilities ratio, and if an enterprise is worth less than its liabilities, it is deemed to be insolvent on a book value basis. The law practice revealed that creditor rights were limited considerably because commercial courts faced difficulties in determining a fair value of debtor’s assets, thus delaying with issuing a bankruptcy order against the debtor. Additionally, the state was acting as senior creditor by collecting through tax penalties all liquid assets with the aim of paying tax liabilities.<sup>2</sup>

The *second federal law on bankruptcy* was adopted in 1998, because the first law proved inefficient. The second law was based on the concept of default. An enterprise is deemed to be bankrupt if it is unable to fulfill its obligations as they come due, which is recognized as insolvency on a cash basis.

The law lowered the barriers to initiating bankruptcy proceedings and strengthened the status of creditors. As a result, the scope of insolvency proceedings was broadened progressively. The number of bankruptcies soared because prior to the introduction of bankruptcy proceeding in

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<sup>1</sup> Authors of this section: Apevalova E. – RANEPА, Polezhaeva N. – RANEPА, Radygin A. – RANEPА.

<sup>2</sup> See Apevalova E., Radygin A. Bankruptcies in the 2000s: from takeover tool towards double standard policy. – V: Ekonomicheskaya Politika, 2009, No. 4, pp. 91-124.

1998 companies accumulated a great deal of liabilities to the federal budget and regional budgets, as well as to private creditors.

Under the second law the creditor may file for bankruptcy against the debtor if the latter fails to fulfill its obligations within three months and if the outstanding amount is more than 500 times the wage floor, thereby creating equal opportunities for creditors to initiate bankruptcy proceeding. However, no consideration was made for cash gaps that occurred in practice and for the scope of business operations.

The state had no right to vote on crucial resolutions passed at meetings of creditors, and the issues of affiliation of bankruptcy trustees worsened, etc. The institution of bankruptcy was found to be widely used as a tool of distributing the debtor's estate and of asset stripping. In 1998–2002, the initiation of bankruptcy proceeding was actually turned into a cost effective alternative to hostile takeover by way of purchasing shares in the secondary market. Russia's Federal Service on Financial Rehabilitation and Bankruptcy (FSFO) reported that one in five bankruptcy cases exhibited signs of malicious intentions (in particular, filing for bankruptcy with the aim of writing off debts).

The *third federal law on bankruptcy* which is currently in effect was adopted in 2002. The adoption was necessitated by an array of problems which the first (1992) and the second (1998) laws failed to address. Below listed are most pressing issues that were observed at that period:

- widespread practice of using bankruptcy as takeover tool;
- infringements of the rights of the debtor and of the debtor's founders;
- infringements of the rights of the state as tax creditor;
- writing off the debtor's assets for the benefit of a certain group of creditors as part of receivership and trusteeship proceedings;
- lack of transparency, inadequate regulation of bankruptcy proceedings, allowing bankruptcy trustees and other parties to a bankruptcy process to misuse the loopholes therein;
- lack of efficient arrangements holding bankruptcy trustees liable for bad faith and ineffective performance, etc.

The third law aimed to address these issues and it was adopted as a result of trade-off between the supporters of two opposite views as to further development of the institution of bankruptcy.<sup>1</sup> The law was updated with some critical provisions as follows:

- the state and bankruptcy creditors enjoy equal rights, and claims of the state are consolidated;
- owners acting in good faith enjoy better protection of their rights;
- the risk of abusing the right by creditors is mitigated;
- a new reorganization proceedings – financial rehabilitation – was introduced;
- parties to bankruptcy proceedings, which are acting in good faith are protected from fraudulent actions of other persons;
- supervision over bankruptcy trustees has become more efficient;
- specifics of bankruptcy of certain categories of debtors are set out in a single law;
- a wider-than-normal usage of bankruptcy proceedings for winding up absent debtors is limited.

The introduction of the law resulted in drastic slump of the number of bankruptcy proceedings from 106,600 in 2002 to 14,300 in 2003 because tax authorities almost stopped filing for bankruptcy against absent debtors due to no allocation of budget resources for this purpose.

<sup>1</sup> See Radygin A., Simachev Y. Russia's bankruptcy institution: specifics of evolution, issues and prospects. – V: Russian Management Journal, 2005, Vol. 2, No. 2, pp. 43-70.

Later, the peak of bankruptcies of absent debtors was reached in 2006, and it was never hit again since then.

The principal initiator of bankruptcy proceedings was identified since the inception of the new law. Most of the bankruptcies until 2011 were initiated by competent public authorities, predominantly by tax authorities which in 2006 accounted for 87% of the total petitions for bankruptcy. The percentage decreased gradually in the following years, reaching 31% by 2011. 2009 and 2010 saw the biggest number of substantiated bankruptcies, 35,200 and 36,600, respectively.<sup>1</sup>

An extremely low effectiveness of using the bankruptcy mechanism for the purpose of *restoring the solvency of enterprises* in the course of bankruptcy proceedings is one of the strongest trends.

As regards critical updates, the principal emphasis should be placed on amendments made in the peak of the crisis, that is, between December 2008 and April 2009 (Federal Law of “On the Amendments to the Federal Law “On Insolvency (Bankruptcy)” No. 296-FZ dated December 30, 2008 and Federal Law “On the Amendments to Certain Legislative Acts of the Russian Federation”) No. 73-FZ dated April 28, 2009. The amendments aimed first of all to *increase transparency of bankruptcy proceedings*, namely the performance of bankruptcy trustees (updating the payment system, broadening powers and raising liability of bankruptcy trustees) and respective self-regulatory organizations (enhancing control over such organizations, introducing mandatory disclosure of the performance of such organizations, establishing a procedure for using the compensation fund).

Additionally, asset stripping countermeasures – mechanisms that challenge debtor’s assets stripping transactions – “suspicious transactions” and “transactions giving preference to one of the creditors over the others” were introduced. Thus legislative measures were introduced with the aim of narrowing the “grey” background in the field of bankruptcy. In addition, the liability of debtor’s owners – “persons controlling the debtor” – was introduced.<sup>2</sup>

The rest of the 2002–2013 updates were mostly of technical nature. They first of all baked up the state expansion policy (state-owned companies’ activity) in the economy or protected the interests of certain groups of persons, and they were not general measures of systemic development of the institute of bankruptcy.

The context changed again in 2014–2015, when the number of bankruptcies reached more than 14,500 in 2014 (against 12,000 in 2013) and was maintained at 14,600 in 2015.<sup>3</sup> Accordingly, this required a response from the regulator, and some systemic updates had to be introduced, too.

### 6.2.2. Bankruptcy law of 2014–2015: systemic updates

The Federal Law On Insolvency (Bankruptcy)<sup>4</sup> saw many amendments of various types since the start of 2014, which relate to both the general provisions and the specifics of bankruptcy of certain categories of debtors.

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<sup>1</sup> Apevalova E.A. Bankruptcies in 2011–2012: decline in bankruptcies, new regulation and debt restructuring bill. // Russian Economy in 2012: Trends and Outlooks. – M., Gaidar Institute, 2013

<sup>2</sup> Apevalova E.A. Bankruptcies in 2009–2010: Dynamics and trends // Russian Economy: Trends and Perspectives, M., Gaidar Institute, October 2011

<sup>3</sup> Bazanova E. Late last year saw growth of bankruptcies due to ruble devaluation. – Vedomosti, January 13, 2016.

<sup>4</sup> Federal Law “On Insolvency (Bankruptcy)” No. 127-FZ dated October 26, 2002 // RG, No. 209-210, November 2, 2002.

The amendments to the *general provisions* were in part related to the disclosure practice (basically Article 28 thereof), the meeting of creditors (Articles 12, 13, 18 thereof), the sale of the debtor's enterprise and estate (Articles 110, 139 thereof).

To prevent any abuse on the debtor and creditor side, the minimum value of creditors' outstanding claims admissible by a commercial court as a grounds for initiating insolvency proceedings against the debtor (legal entity) was raised from RUB 100,000 to RUB 300,000 (Clause 2 of Article 6, Clause 2 of Article 33 thereof). As regards monitoring, it was established that from the date of the commercial court ruling on the initiation of monitoring no financial sanctions shall be imposed on the failure to fulfill financial obligations and mandatory payments, except current payments; the amount of claims of the bankruptcy creditors and of the authorized body is subject to an interest charge equal to the key rate of interest quoted by the Bank of Russia on the date of initiation of monitoring (Clauses 1, 4–6 of Article 63 thereof).<sup>1</sup>

It was clarified that bankruptcy is not only the commercial court's declaration of inability of the debtor to satisfy in full the creditors' claims of monetary obligations and/or to fulfill the obligation of mandatory payments, but it is also inability to satisfy the claims of severance benefits and/or of remuneration for the labor of the persons working or worked under labor contract (Article 2 thereof).<sup>2</sup> The other articles were amended and updated accordingly (Articles 3–5, etc. thereof).

The former debtor's employees may file for bankruptcy against the debtor, including but not limited to pooling their claims (Clause 1 of Article 11, Clause 5 of Article 39 thereof).<sup>3</sup> Unlike other claimants, the debtor's employees and former employees have no obligation to cover court costs, fees payable to bankruptcy trustees where the debtor's resources are insufficient to cover such costs (P. 3 Clause 3 of Article 59 thereof).

A new article (Article 12.1) was introduced, which regulates the meeting of debtor's employees, former employees, the appointment of a representative of the debtor's employees, whose services shall be paid by the debtor. This creates preconditions under which qualified representatives of debtor's employees, that are independent of the employer, may emerge in the legal market.<sup>4</sup>

The priority ranking of the claims of creditors was updated (from four to five) because claims of remuneration for the labor of the foregoing persons and the severance benefit claims were classified as second priority claims aside from the claims of remuneration for the labor of the persons engaged by the bankruptcy trustee. Furthermore, a proceedings for satisfying second priority claims on a pro rata basis was established (see Clause 2 of Article 134, Clause 5 of Article 136 thereof).<sup>5</sup>

Hence an attempt was made to *protect the most vulnerable category of creditors, namely the debtor's employees*. However, bankruptcy and further liquidation of the employer may entail

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<sup>1</sup> See Subclause "a", Clauses 2, 18 of Article 1, Federal Law "On the Amendments to the Federal Law "On Insolvency (Bankruptcy)"..." No. 482-FZ dated December 29, 2014 // RG, No. 299 of December 31, 2014.

<sup>2</sup> Federal Law "On the Amendments to Certain Legislative Acts of the Russian Federation" No. 186-FZ dated June 29, 2015// RG, No. 146, July 7, 2015.

<sup>3</sup> Previously, the claims of remuneration for the labor were considered for detecting signs of the debtor's bankruptcy, but they did not serve as the grounds for submitting the application in question.

<sup>4</sup> Substantial amendments to Federal Law On Insolvency (Bankruptcy) concerning the status of the enterprise's employees // ConsultantPlus SPS. 2015.

<sup>5</sup> First, the claims of severance benefits and/or of remuneration for the labor, not more than Rb 30,000 a month per person. Second, the rest of the claims of severance benefits and/or of labor remuneration. Third, the claims of fees payable to persons for their intellectual deliverables (results of their intellectual activity).

undesirable job loss, which to some part will restrain misconduct of workers but not of other persons acting in bad faith (e.g., competitors) who might misuse this tool. This can be avoided by the employer satisfying promptly the claims of remuneration for the labor of the employees.

There is another big package of amendments to the general provisions of the Federal Law “On Insolvency (Bankruptcy)”, which govern *bankruptcy trustees* and their self-regulatory organizations (SROs).<sup>1</sup>

For example, the SRO governing board may decide to increase the legally prescribed minimum sum insured under the agreement on compulsory insurance of liability of the bankruptcy trustee (Rb 3m a year). Besides a compulsory liability insurance sub-agreement that is approved by a commercial court in the course of bankruptcy proceedings, the governing board may also bind the bankruptcy trustee to enter into a separate agreement whereby the sum insured is set by the SRO governing board (Clauses 2, 2.1 of Article 24.1 thereof).

If while approving the bankruptcy trustee under a bankruptcy case the SRO provides information proving that the nominee fails to meet the prescribed requirements, the commercial court may rule not to appoint the nominee as bankruptcy trustee or appoint the nominee as bankruptcy trustee and bind him/her to enter into a liability insurance sub-agreement. The insured sum thereunder must be not less than the SRO’s compensation fund value (Clause 5 of Article 45 thereof).

Furthermore, the SRO’s compensation fund minimum value must be equal to Rb 20m, and the general rule is that a compensatory payment from the fund may be equal to or less than Rb 5m for a single case of losses (Clauses 2, 11 of Article 25.1 thereof). The bankruptcy trustee whose actions entail a compensatory payment must compensate the SRO members for losses incurred as a result of having to bring the compensation fund value in compliance with the applicable law (Clauses 4, 5 of Article 20.4 thereof).

Hence the subsidiary nature of the SRO liability to the extent of funds available in the compensation fund regarding the bankruptcy trustee and his/her insurer (i.e., the liability occurs only if the trustee and his/her insurer fails to satisfy the damaged party’s claims) and the organization’s right to increase the sum insured under agreements on compulsory insurance of liability of the bankruptcy trustee *contributes to safety of the SRO’s compensation fund*. The bankruptcy trustee’s liability to compensate the SRO members for losses incurred as a result of having to recover the compensation fund, and the introduction of the upper level of compensatory payment from the SRO’s compensation fund aim to reach the same objective. With the compensation fund minimum value in place, damaged parties have more chances of full compensation for losses incurred by the failure of the bankruptcy trustee to perform his/her duties in a bankruptcy case.

The Federal Law “On Insolvency (Bankruptcy)” rules that the SRO governing board’s decision on termination of the bankruptcy trustee’s SRO membership if he/she is expelled for the SRO is deemed to be made when approved by two-thirds of the member votes cast (Clause 7 Article 21.1 thereof). Since SRO membership is a mandatory condition for working in the capacity of bankruptcy trustee, it appears that legislators set strict requirements for the expulsion from SRO membership in an effort to *prevent building up barriers to accessing the market*.

As regards bankruptcy hearings in commercial courts, the debtor’s application may not specify the nominee interim receiver and it may only specify a SRO duly chosen on a random basis,

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<sup>1</sup> Federal Law “On the Amendments to the Federal Law “On Insolvency (Bankruptcy)” No. 405-FZ dated December 1, 2014 // RG, No. 275 of December 3, 2014; Federal Law No. 482-FZ dated December 29, 2014.

and one of the SRO members must be approved as interim receiver (Clauses 2, 5 Article 37 thereof).<sup>1</sup>

Extended is the list of grounds allowing SROs to apply to court on dismissal or expulsion of the bankruptcy trustee (a SRO member) from a bankruptcy case, e.g., when an administrative penalty in the form of disqualification for committing an administrative infraction is imposed on the bankruptcy trustee (Clause 2 of Article 22, Clause 2 of Article 20.5, etc. thereof).

Overall, the amendments relating to bankruptcy trustees and their SROs aim first of all to prevent potential abuses by bankruptcy trustees acting in bad faith and to enhance the quality of duties they perform.

Since December 29, 2015 (1) the term of holding bankruptcy trustees administratively liable was extended to three years;(2) a provision was made for disqualifying the bankruptcy trustee for a period of six months to three years if he/she commits another administrative infraction;(3) it is not permitted to appoint the bankruptcy trustee for new bankruptcy proceedings within three years of the date of his/her exclusion from previous proceedings. On January 1, 2017 the SRO's compensation fund minimum value will increase to Rb 50m and compensatory payment will make up 50% of the compensation fund value.<sup>2</sup>

These strict requirements to bankruptcy trustees and their SROs and the strengthened role of the state may lead to *an increase in bankruptcy proceedings costs*, a reduction in the number of SROs, a *higher corruption in this field* and lower economic value of bankruptcy trustees, wherefore legislators should be extremely cautious with regard to the proposed amendments.<sup>3</sup>

An important amendment is that the debtor's estate or enterprise may be sold electronically in the course of the proceedings as part of a bankruptcy case, provided that the electronic trading facility<sup>4</sup> with whom the bankruptcy trustee or the auction organizer enters into a sale agreement is a member of *electronic SRO trading facilities* established for the purpose of developing and regulating the activity of its members (Clause 20 Article 110 thereof).

Eight new articles governing this new type of SROs were introduced, which regulate the electronic SRO trading facility membership, bodies, rights and obligations, compensation fund, supervision over electronic SRO trading facilities, the liability of electronic trading facilities, and agreement on compulsory insurance of such liability (Articles 111.1–111.8 thereof).

Electronic SRO trading facilities must meet the general requirements set out in the Federal Law "On Self-Regulatory Organizations"<sup>5</sup> and the special strict requirements set forth in the Federal Law "On Insolvency (Bankruptcy)". For example, an electronic SRO trading facility may be registered as nonprofit organization if 50% of the members have 2 years of experience in electronic trading and all the members have a record of 5,000 trading sessions. The value of mandatory compensation fund of electronic SRO trading facilities is equal to Rb 3m per member, and the electronic trading facility must compensate to other members of the electronic SRO trading facilities for damages incurred by a compensatory payment from the fund. To become

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<sup>1</sup> This rule is not applied to the application of the bankruptcy creditor and authorized body (Clause 2 of Article 39, Clause 3 of Article 41).

<sup>2</sup> Federal Law "On the Amendments to Certain Legislative Acts of the Russian Federation" No. 391-FZ dated December 29, 2015 // RG, No. 297, December 31, 2015.

<sup>3</sup> Okun S. Regulated self-regulation: bankruptcy proceedings costs to rise // Kommersant, December 25, 2015. URL: <http://kommersant.ru/doc/2887181>.

<sup>4</sup> Any legal entity or individual as self-employed entrepreneur engaged in electronic trading.

<sup>5</sup> Federal Law "On Self-Regulatory Organizations" No. 315-FZ dated December 1, 2007 // RG, No. 273, December 6, 2007.



a SRO member, the electronic trading facility must have an agreement on compulsory insurance of liability. The minimum value of the insured sum thereunder is Rb 30m a year.

Thus, although only 10 members are required for the registration of electronic SRO trading facility, the foregoing requirements counteract establishing low-quality organizations in large quantities.

Some of the amendments covered *certain categories of debtors* such as nongovernmental pension funds, real estate developers, agricultural organizations, clearing members and clearing members' customers. The requirements for the minimum value to be considered for instituting a bankruptcy proceedings were increased from Rb 500,000 to Rb 1m for enterprises and organizations of strategic importance as well as for natural monopoly entities (Clause 4 Article 190, Clause 3 of Article 197 thereof). In an effort to create an efficient legal regulation of the securitization process, which facilitates an increase of financial resources in Russia's economy and broadens the spectrum of securities available for investors, the chapter regulating simplified proceedings in bankruptcy cases was updated with a new paragraph on bankruptcy of special-purpose vehicles and mortgage agents (§ 3, Chapter XI thereof),<sup>1</sup> which contains provisions on irreversible assignment of securitized financial assets to ensure true sale of financial assets for the purpose of securitization.<sup>2</sup>

The provisions on bankruptcy of credit institutions and on bankruptcy of citizens were modified most of all.

The provisions on *bankruptcy of credit institutions* were moved from Articles 181, 182 to a stand-alone paragraph (§ 4.1, Chapter IX)<sup>3</sup> made up of about 100 articles, which makes it the biggest among the sections regulating the specifics of bankruptcy of certain categories of debtors. It is the right time to make sure the legislation on bankruptcy of credit institutions is up to the modern environment and allows for creating a unified regulatory environment and enhancing the effectiveness of law enforcement, because drastic (often adverse) developments in the financial sector in 2014–2015 (devaluations of the ruble, revocations of banking licenses, etc.) posed serious challenges for all Russia's financial institutions.<sup>4</sup>

Two paragraphs came into force on October 1, 2015, namely the paragraph on *citizen's debt restructuring* and sale of the citizen's property, as well as the paragraph on the specifics of hearing the bankruptcy case of a citizen in the event of his/her death<sup>5</sup> (§ 1.1, 4, Chapter X

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<sup>1</sup> See Clause 38 of Article 1 of Federal Law No. 482-FZ dated December 29, 2014; Clause 13 of Article 12 of Federal Law "On the Amendments to Certain Legislative Acts of the Russian Federation" No. 379-FZ dated December 21, 2013 // RG, No. 291, December 25, 2013.

<sup>2</sup> Borisov A.N. Comments to Federal Law "On Insolvency (Bankruptcy)" No. 127-FZ dated October 26, 2002 (CbC). 2nd issue, revised and updated // ConsultantPlus SPS. 2014.

<sup>3</sup> Because Federal Law "On Insolvency (Bankruptcy) of Credit Organizations" No. 40-FZ dated February 25, 1999 *ceased to be in force* // RG, No. 41-42, March 4, 1999. See Clause 22 of Article 7 Federal Law of December 22, 2014 No. 432-FZ "On the Amendments to Certain Legislative Acts of the Russian Federation..." // RG, No. 296, December 26, 2014.

<sup>4</sup> Sintsov V. A few amendments to the legislation on bank bankruptcy // *Bankovskoye Pravo*. 2015. No. 3. PP. 17-20.

<sup>5</sup> The principal amendment – the bankruptcy case of a citizen may be initiated after his/her death or after the announcement of his/her death, i.e., this refers to bankruptcy of assets of estate.

thereof).<sup>1</sup> The older version of the Federal Law “On Insolvency (Bankruptcy)” contained a paragraph regulating bankruptcy of citizens (§ 1, Chapter X thereof), which did not work<sup>2</sup> and therefore ceased to be in force.<sup>3</sup> A new paragraph includes special provisions – unregulated thereby cases related to bankruptcy of citizens shall be regulated by the provisions regulating bankruptcy of legal entities (Clause 1 of Article 213.1 thereof).

Petitions to initiate bankruptcy proceedings against a citizen may be filed to a commercial court by the citizen, bankruptcy creditor, and the authorized body. A petition may be accepted by the court to the extent that the claims against the citizen are not less than Rb 500,000 (previously Rb 10,000) and have been unsatisfied for a period of three months from the date when they have come due (Article 213.3 thereof). The bankruptcy creditor or authorized body may file petition approved by the court’s order entered into legal force and upholding the claims of creditors. No court’s order is required for claims of mandatory payments; notarized claims, etc. (Clauses 1, 2 of Article 213.5 thereof).

The petition of bankruptcy against a citizen shall specify the SRO whose member must be approved as financial manager, but it shall not specify the trustee as required for the petition of bankruptcy against a legal entity filed by the bankruptcy creditor or authorized body (the debtor’s (legal entity) petition shall specify only SRO) (Clause 2 Article 39, Clause 3 of Article 41 thereof). The money spent on the financial manager fee equal to the fixed fee paid to the financial manager for a single proceedings, which is used in the bankruptcy case of a citizen (Rb 10,000 (Clause 3 Article 20.6 thereof)), shall be deposited with the commercial court (Clause 4 Article 213.4, Clauses 3, 4 Article of 213.5 thereof).

After considering the validity of the petition the court shall determine that the petition is either invalid or valid and that the citizen’s debt restructuring is to be instituted. The citizen must be proved insolvent in the latter case (see Clauses 1–3 of Article 213.6 thereof). If the citizen fails to meet the requirements for approving the debt restructuring plan, the court may declare the citizen bankrupt on the basis of citizen’s petition and institute the proceedings of sale of his/her property (Clause 8 Article 213.6 thereof).

However, note that the original amendments suggested that general jurisdiction courts, not commercial courts, should hear bankruptcy cases against citizens, although the former have not much judicial experience in this category of cases. However, the respective provisions were abolished before they came into force.<sup>4</sup> A draft bill is currently under consideration of the State Duma (the lower house of Russia’s parliament), which provides for distribution of citizen bankruptcy cases between the foregoing courts.<sup>5</sup>

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<sup>1</sup> See Subclause “б”, Clause 23 and Subclause “е”, Clause 4 of Article 6 Federal Law “On Regulation of the Specifics of Insolvency (Bankruptcy) on the Territory of the Republic of Crimea and the Federal City of Sevastopol.” No. 154-FZ dated June 29, 2015 // RG, No. 144, July 3, 2015.

<sup>2</sup> See hereinafter: Lotfullin R. Bankruptcy of individuals. Proceedings and consequences that creditors to be prepared for // *Yurist Companii*. 2015. No. 9. P. 16.

<sup>3</sup> See Subclause “а”, Clause 23 of Article 6 of Federal Law No. 154-FZ dated June 29, 2015.

<sup>4</sup> See Clause 6 of Article 1 of Federal Law “On the Amendments to the Federal Law “On Insolvency (Bankruptcy)”..” No. 476-FZ dated December 29, 2014 // RG, No. 299, December 31, 2014; Article 12 of Federal Law No. 154-FZ dated June 29, 2015.

<sup>5</sup> Draft bill No. 831972-6 “On the Amendments to the Federal Law “On Insolvency (Bankruptcy)” (with regard to changing court jurisdiction for hearing bankruptcy cases against individuals) // URL: <http://asozd2.duma.gov.ru/main.nsf/%28SpravkaNew%29?OpenAgent&RN=831972-6&02>.

The bankruptcy proceedings against citizens, namely debt restructuring, sale of assets, amicable agreement (Article 213.2 thereof), is a simplified version of the bankruptcy proceedings against legal entities.<sup>1</sup>

In terms of *amicable agreement*, citizens and legal entities are governed by the same regulations (Chapter VIII, Article 213.31 thereof).

Restructuring of citizen's debts combines proceedings for monitoring and financial rehabilitation of the legal entity (debtor) and aims to restore the citizen's solvency and repay his/her outstanding debt to the creditors under the debt restructuring plan. The citizen's debt restructuring proceedings aims to ensure the citizen's estate are safe, analysis of the citizen's financial status is made, the list of creditors' claims is compiled and the first meeting of creditors is held (Article 213.11 thereof).

Not later than within 10 days from the date of expiration of the two months allocated for filing claims against the citizen (Clause 2 of Article 213.8 thereof),<sup>2</sup> the citizen, creditor or authorized body may forward a draft citizen's debt restructuring plan to the financial manager, bankruptcy creditors, authorized body. However, there is a problem with creditor's access to the information (the list of citizen's assets, the data on accounts payable, etc.) attached to the draft plan (Article 213.15 thereof), and with uncertainty of the consequences of failure to forward the draft plan within the prescribed time limit.

Should the financial manager receive no draft plan, he/she shall submit a proposal for consideration of the meeting of creditors for the citizen's bankruptcy and for the initiation of sale of his/her property. The financial manager must hold the first meeting of creditors<sup>3</sup> in no event sooner than 20 days from the date of submission of the draft plan, but not later than within 60 days from the date of expiration of the two months allocated for filing claims against the citizen (Clauses 1, 4, 5 of Article 213.12 thereof).

After considering the citizen's debt restructuring plan, the commercial court may determine that the plan is either approved or not approved, that the citizen is declared bankrupt and that the sale of his/her property is initiated (see Article 213.18 thereof on the grounds for rejection) (Clauses 1, 3 of Article 213.17 thereof).<sup>4</sup>

The plan must be implemented within three years (Clause 2 of Article 213.14 thereof). After considering the results therefrom, the court shall determine that the citizen's debt restructuring is completed or that the plan is abolished and the citizen is declared bankrupt (Clause 5 of Article 213.22 thereof).

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<sup>1</sup> In order to cut the citizen's costs, it is not required to publish in an official edition information on the progress of the proceedings as part of the citizen's bankruptcy case (Clause 1 of Article 213.7).

<sup>2</sup> In case of excusable failure to timely file the claims within the prescribed time line, the time line may be restored by court (Clause 2 of Article 213.8 thereof).

<sup>3</sup> Unlike the meeting of debtor's (legal entity) creditors, the meeting of creditors in the event of citizen's bankruptcy may be held by absentee voting (without a physical meeting) (Clauses 4, 8 of Article 213.8).

A few words concerning the specific features of the legal status of the creditor whose claims are secured by the property owned by the citizen. Such creditor may vote at the meeting of creditors in the course of the proceedings as part of the citizen's bankruptcy case (Clause 4 of Article 213.10) because the debtor (citizen) often has a single secured creditor. In addition, 80% of the amount earned from the sale of the collateral is used to satisfy the secured creditor's claims (Clause 5 of Article 213.27); the citizen's debt restructuring plan must provide for seniority of such creditor's claims which shall be satisfied by using the amount earned from the sale of the collateral (Clause 3 of Article 213.14).

<sup>4</sup> See Articles 213.19-213.23 on the consequences of approval of the plan, on making amendments thereto, on the completion thereof and on the abolishment thereof.

*Sale of citizen's property* is rehabilitation proceedings similar to trusteeship proceedings for legal entities (as debtors), which for the purpose of equitable satisfaction of the claims of creditors is applied in bankruptcy cases to citizens declared as bankrupt.

If the commercial court declares a citizen bankrupt, the court shall institute the sale of the citizen's property within a period of six months (unlike in trusteeship, the specified term may be extended) (Clause 2 of Article 213.24 thereof).

All the citizen's property that are available as of the date of court's order declaring the citizen is bankrupt and the sale of the citizen's property is initiated, as well as the citizen's property that are identified after the date of the court's order, are referred to as the bankruptcy estate,<sup>1</sup> except the property that cannot be seized and sold, e.g., household goods (Clause 1 of Article 446 of the Civil Procedure Code of the Russian Federation<sup>2</sup>) (Clauses 1, 3 of Article 213.25 thereof).

In order to minimize costs of bankruptcy cases against citizens, the financial manager by him/herself shall appraise the citizen's property. Should the meeting of creditors resolve to outsource an appraiser, the appraisal costs shall be paid by the persons who voted for the resolution (Clause 2 of Article 213.26 thereof). However, the Federal Law "On Insolvency (Bankruptcy)" does not specify how the financial manager must appraise the citizen's property (Clause 6 of Article 213.26 thereof). In practice, the financial manager receives information of the citizen's property only from the citizen himself/herself and public authorities (Clause 7 of Article 213.9 thereof), and the financial manager has no access to the debtor's premises, whereas the bankruptcy trustee does have access to the debtor's (legal entity) premises.<sup>3</sup>

The legislators' attempts to curtail costs of bankruptcy cases against citizens, including a financial manager's small fee<sup>4</sup> coupled with heightened requirements to the financial manager, may discourage financial managers to duly perform their duties.

As regards the specifics of selling the citizen's property, note that the financial manager shall submit the provision regulating the procedure, terms and conditions for selling the property, including the starting price, to the commercial court for approval, not to the meeting of creditors as required for bankruptcy cases against legal entities (Clause 1 of Article 213.26 thereof).

With some exceptions, the property of citizen must be sold by auction, unless otherwise stipulated by the resolution of the meeting of creditors or court's order (Clauses 3, 7 of Article 213.26 thereof). The procedure for satisfying the claims of citizen's creditors are basically similar to the procedure for satisfying the claims of the creditors of a legal entity (Article 213.27 thereof).

As soon as the settlements with the creditors are completed, the citizen declared as bankrupt shall be exempted from satisfying further claims of creditors (Clause 3 of Article 213.28 thereof). In order to prevent potential abuses by debtors, the cases when citizens may not be exempted from their obligations were specified (Clauses 3–6 of Article 213.28 thereof). For example, the claims of creditors on current payments shall remain in force. Furthermore, the

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<sup>1</sup> The citizen's property for sale could have been given a proper name instead of the "bankruptcy estate" which is used in the course of trusteeship proceedings – bankruptcy proceedings against legal entities.

<sup>2</sup> The Civil Procedure Code of the Russian Federation No. 138-FZ dated November 14, 2002 // RG, No. 220, November 20, 2002.

<sup>3</sup> Lotfullin R. Exec. wr. P. 28.

<sup>4</sup> Fixed one-time amount of Rb 10,000 and 2% of the satisfied claims of creditors or the amount earned from selling the citizen's property (Clause 4 of Article 213.4, Clause 4 of Article 213.5, Clauses 3, 4 of Article 213.9, Clause 3, 17 of Article 20.6).

rule that exempts the citizen from obligations shall not be applied to the citizen if he/she is once again declared bankrupt within the next five years (Clause 2 of Article 213.30 thereof).

However, it appears the institution of bankruptcy of citizens favors more the interests of debtors, whereas creditors would rather recover debts in court and through enforcement proceedings. This fact coupled with some of the abovementioned loopholes in the applicable regulation allows one to expect new amendments to be made in this field.

It is remarkable that in other countries the citizen debtor is treated as consumer debtor, not as self-employed entrepreneur, because the issue of individuals' bankruptcy is unbreakably bounded to consumer lending. Thirty four million Russians (45% of economically active population) are reported to have outstanding consumer loans. In addition, the total amount of loans to individuals exceeded Rb 9 trillion by the end of 2015, and delinquencies increased more than 40% in 2014 alone. The state of the consumer lending sector has turned into a macroeconomic issue, posing a threat to the sustainability of the Russian banking system.<sup>1</sup>

For a short period of time since the new paragraph regulating the citizen's debt restructuring and the sale of his/her property has been in effect, there have been known cases when petitions for bankruptcy of citizens were declared valid by commercial courts, followed by instituting debt restructuring proceedings and selling the citizen's property.<sup>2</sup>

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All in all, in summary, note that in 20-plus years Russia's bankruptcy legislation has advanced from the first law on bankruptcy which was not widely used, through the second law on bankruptcy which was often used as a takeover tool, to the third law on bankruptcy which is currently in effect and is more viable compared to the previous ones.

Being pro-creditor, the law has solve a number of issues:

- owners acting in good faith enjoy better protection of their rights;
- the risk of abusing the right by creditors is mitigated;
- parties acting in good faith in bankruptcy proceedings are protected from other parties acting in bad faith;
- supervision over bankruptcy trustees has become more efficient;
- specifics of bankruptcy of certain categories of debtors are set out in a single law and some other laws.

The amendments to the third law on bankruptcy in the peak of the crisis of 2008–2009 narrowed the “grey” background in the field of bankruptcy by introducing mechanisms challenging asset-stripping transactions, and enhanced the transparency of bankruptcy proceedings by updating the regulation of bankruptcy trustees of respective self-regulatory organizations.

The 2014–2015 systemic amendments to the third federal law aimed to prevent abuses by persons acting in bad faith mostly in bankruptcy cases, and to ensure the institution of bankruptcy works more efficiently. Overall, although the amendments are positive, not that the issue

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<sup>1</sup> Sishmareva T.P. Federal Law “On Insolvency (Bankruptcy)” and its application in practice: the manual for exams as part of the Single Program on Arbitrazh Receivers Training. M.: Statut, 2015. P. 416; Grishev S.P. Consumer lending. Comments to the legislation // ConsultantPlus SPS. 2015.

<sup>2</sup> See, e.g., Case No. A56-71378/2015. URL: [http://kad.arbitr.ru/PdfDocument/eaf44644-d31e-4a2e-a1c0-90600e2d831a/A56-71378-2015\\_20151223\\_Opredelenie.pdf](http://kad.arbitr.ru/PdfDocument/eaf44644-d31e-4a2e-a1c0-90600e2d831a/A56-71378-2015_20151223_Opredelenie.pdf); Case No. A41-94274/15. URL: [http://kad.arbitr.ru/PdfDocument/b81ba9a4-cdba-4ed8-85a7-eda7e58b1176/A41-94274-2015\\_20151221\\_Reshenija%20i%20postanovlenija.pdf](http://kad.arbitr.ru/PdfDocument/b81ba9a4-cdba-4ed8-85a7-eda7e58b1176/A41-94274-2015_20151221_Reshenija%20i%20postanovlenija.pdf).

of inefficient bankruptcy proceedings for restoring the debtor's solvency is still pressing and it could guide the way towards further enhancement of the legislation.

### 6.3. The real estate market in the Russian Federation

#### 6.3.1. The market of land plots<sup>1</sup>

According to the data released by the Rosreestr, the area of land plots owned by Russian nationals keeps decreasing and as of 1 January 2015 amounted to 115,400,000 ha or 6.8% of the land of the Russian Federation against 117m ha (6.84%) as of 1 January 2014 (*Table 9*). On the contrary, the area of land in public and municipal ownership and ownership of legal entities keeps growing. Within a year, the area of land plots owned by legal entities increased by 1.3m ha and amounted to 17.2m ha or 1.0% of the land of the Russian Federation. The area of land plots in public and municipal ownership increased by 37,900 ha. As of 1 January 2015, Russian nationals' land shares decreased by 3.0m ha and amounted to 5.2% (89.3m ha) of the country's land or 67.3% of land in private ownership. A decrease in the area of land in shared ownership is regarded as positive factor as land plots in shared ownership by virtue of incompleteness of that title are used inefficiently.

*Table 9*

**The pattern of land plots of the Russian Federation by the form  
of ownership, 2012–2015**

Form of ownership	01.01.2012		01.01.2013		01.01.2014		01.01.2015	
	Million ha	%	Million ha	%	Million ha	%	Million ha	%
Public and municipal ownership	1576.7	92.2	1576.8	92.22	1576.9	92.23	1577.3	92.25
Individuals' ownership	119.6	7	118.3	6.92	117	6.84	115.4	6.8
including: Individuals' land shares; On the basis of individuals' other titles of ownership	97.6	5.7	94.9	5.55	92.3	5.4	89.3	5.2
	22	1.3	23.4	1.37	24.7	1.57	26.1	1.52
Legal entities' ownership	13.5	0.8	14.7	0.86	15.9	0.93	17.2	1.0
TOTAL land in ownership	133.1	7.8	133	7.78	132.9	7.77	132.6	7.8

*Source:* State (national) Report "On the status and utilization of land in the Russian Federation in 2014".

As of 1 January 2015 as in 2014, in 14 constituent entities of the Russian Federation the share of privatized land exceeded 40% of the land of constituent entity. It is mainly southern and southwestern regions. In 12 constituent entities of the Russian Federation, the share of privatized land amounts to less than 0.40%. The Southern Federal District boasts of the highest index (43.11%) while the Far Eastern Region has the lowest one (0.32%). Russia's average nationwide index amounts to 6.75%. In Moscow and St Petersburg individuals own 6.99% and 6.41% of land, respectively (*Table 10*).

<sup>1</sup> Author of this section: Zadonsky G. – RANEPА.

Table 10

**The level of privatization of land by federal districts and subjects of the Russian Federation as of 1 January 2015\***

Federal districts and subjects of the Russian Federation	Level of privatization by individuals, %	Level of privatization by legal entities, %	Total area, thousands ha	Land owned by individual, thousand ha	Land owned by legal entities, thousand ha	Place by the level of privatization by individuals
<b>Southern Federal District</b>	<b>43.11</b>	<b>4.60</b>	<b>42 087.6</b>	<b>18 43.3</b>	<b>1937.3</b>	<b>I</b>
Rostov Region	61.54	6.57	10 096.7	6 213.5	662.9	1
Volgograd Region	55.79	5.65	11 287.7	6 296.9	637.2	4
Astrakhan Region	18.16	1.81	4 902.4	890.1	88.7	38
<b>Privolzhsky Federal District</b>	<b>29.26</b>	<b>4.96</b>	<b>10 3697.5</b>	<b>30 341.5</b>	<b>5143</b>	<b>II</b>
Orenburg Region	58.29	2.43	12 370.2	7 210.2	301.2	3
Saratov Region	54.52	8.36	10 124	5 520	846.3	5
Perm Krai	7.54	2.26	16 023.6	1 207.8	362.9	52
<b>Central Federal District</b>	<b>28.89</b>	<b>8.69</b>	<b>65 020.5</b>	<b>18 786.6</b>	<b>5651.9</b>	<b>III</b>
Orel Region	50.82	9.56	2 465.2	1 252.7	235.6	6
Voronezh Region	47.98	8.37	5 221.6	2 505.5	436.8	8
Moscow Region	16.59	12.07	4 432.9	735.3	535.2	41
Moscow	6.99	12.61	256.1	17.9	32.3	53
<b>North-Caucasian Federal District</b>	<b>24.60</b>	<b>3.06</b>	<b>17 043.9</b>	<b>4 192.6</b>	<b>520.7</b>	<b>IV</b>
Stavropol Territory	58.68	7.51	6 616	3 882.5	496.7	2
Republic of Karachaevo-Cherkessia	18.59	0.48	1 427.7	265.4	6.8	36
Republic of North Osetia-Alania	1.29	0.79	798.7	10.3	6.3	77
<b>Russia</b>	<b>6.75</b>	<b>1.01</b>	<b>1 709 911</b>	<b>115 385.7</b>	<b>17 213.6</b>	<b>V</b>
<b>Siberian Federal District</b>	<b>5.65</b>	<b>0.38</b>	<b>514 495.3</b>	<b>29 050.7</b>	<b>1 946.6</b>	<b>VI</b>
Altai Territory	37.16	2.13	16 799.6	6 243.3	358.2	15
Omsk Region	32.28	3.80	14 114	4 556.3	536.8	24
Republic of Tyva	0.42	0.02	16 860.4	71.6	3.2	71
<b>Urals Federal District</b>	<b>4.85</b>	<b>0.49</b>	<b>181 849.7</b>	<b>8 822.1</b>	<b>887.7</b>	<b>VII</b>
Kurgan Region	41.40	3.45	7 148.8	2 959.5	246.7	12
Chelyabinsk Region	33.01	2.13	8 852.9	2 922	188.6	56
Yamal-Nenets Autonomous Region	0.00	0.00	76 925	1.6	0.7	82
<b>North-Western Federal District</b>	<b>2.40</b>	<b>0.44</b>	<b>168 697.2</b>	<b>4 049</b>	<b>740.8</b>	<b>VIII</b>
Kaliningrad Region	29.50	9.55	1 512.5	446.2	144.5	27
Pskov Region	26.54	2.88	5 539.9	1 470.2	159.6	30
St. Petersburg	6.41	17.11	140.3	9	24	55
Nenets Autonomous Region	0.00	0.00	17 681	0.2	0.1	83
<b>Far Eastern Federal District</b>	<b>0.32</b>	<b>0.06</b>	<b>616 932.9</b>	<b>1 989.4</b>	<b>384.1</b>	<b>IX</b>
Primorsky Krai	4.28	1.00	16 467.3	704.3	164.1	59
Jewish Autonomous Region	2.85	0.03	3 627.1	103.4	1.1	61
Chukotka Autonomous Region	0.00	0.00	72148.1	0.2	0.2	84
<b>Crimea</b>						<b>X</b>
Sebastopol	12.15	1.74	86.4	10.5	1.5	47

\* In each federal district, two constituent entities of the Russian Federation with highest indices as regards the share of land plots in individuals' ownership and a constituent entity of the Russian Federation with the lowest index are presented. Additionally presented are the Moscow Region, Moscow, and St. Petersburg.

Source: State (national) Report "On the status and utilization of land in the Russian Federation in 2014".

By the beginning of 2015, 8041.2 households were provided land plots totaling to 1,002,900 ha for individual housing development, which is 1.37% and 2.46% higher as regards the number of households and the area of land, respectively than in 2013. In 2014, over 158,600 citizens acquired land plots for individual housing development with total area of 15,400 ha. The highest

number of citizens owing land plots envisaged for housing construction accounts for Krasnodarsky Krai (454,400), Moscow (406,900), Rostov (343,000), Kemerovo (317,900), Sverdlovsk (299,600), Irkutsk (252,300) regions, Republic of Bashkortostan (220,500), Stavropol Krai (210,900), Chechen Republic (206,500), Voronezh region (203,800), Perm Krai (182,100), Republic of Tatarstan (180,400), Saratov (178,500), Volgograd (177,400), Nizhny Novgorod (154,200), Leningrad (152,400), Orenburg (148,300) regions, Krasnoyarsk Krai (157,700), Altai Krai (144,300), Republic of Dagestan (133,900), Penza (139,100), and Belgorod (132,500) regions (*Table 11*).

*Table 11*

**The pattern of ownership of land allocated for individual housing development, 2012–2014**

Pattern of ownership	2012		2013		2014	
	Thousand ha	%	Thousand ha	%	Thousand ha	%
Private ownership	546.2	56.7	576.9	58.4	606.5	60.5
State and municipal ownership, including:	417.6	43.3	410.6	41.6	396.4	39.5
Permanent (timeless) utilization	202.7	21	197.4	20	187.9	18.7
leasehold	119.1	12.3	120.4	12.2	121.4	12.1
Free of charge limited utilization (temporary utilization)	3.5	0.4	2.5	0.2	1.2	0.1
lifetime ownership with hereditary succession	54.8	5.7	54.0	5.5	52.4	5.2
Without execution of the title to land	37.5	3.9	36.3	3.7	33.5	3.4
Total	963.8	100	987.5	100	1002.9	100

*Source:* State (national) Report “On the status and utilization of land in the Russian Federation in 2014”.

According to data released by Rosreestr, the procedure of the “summer cottage” amnesty, that is registration in accordance with a simplified procedure of individual’s title to land plots provided prior to the adoption of the Land Code of the Russian Federation for individual subsidiary, summer cottage husbandry, vegetable gardening, horticulture and individual garage and housing building slowed down (*Fig. 1*).

According to the data released by the Rosreestr, as of October 1, 2015, the overall volume of registration of individuals’ titles to land plots (4,420,376 deeds) increased by 1.07% as compared to October 1, 2014. The number of registered titles of legal entities to land plots during the same period decreased by 13.72%, having amounted to 176,357 deeds (contrary to growth as of October 1, 2014 by 5.1% against October 1, 2013). As of October 1, 2015, lease of land plots by individuals (63,252 deeds) went up by 11.8% as compared to October 1, 2014 (as distinct from reduction by 3.84% as of October 1, 2014 compared to October 1, 2013). Lease of land by legal entities (15,677 deeds) fell by 55.1% during the same period (in addition to a reduction by 41.9% as of October 1, 2014 against October 1, 2013).

As compared to October 1, 2014, the number of registered mortgages on land plots for individuals (429,157 deeds) fell by 12.61% (when compared with October 1, 2014 reduction constituted 29.1% against October 1, 2013). The number of registered mortgages for legal entities (95,141 deeds) in 2015 fell by 12.4%.



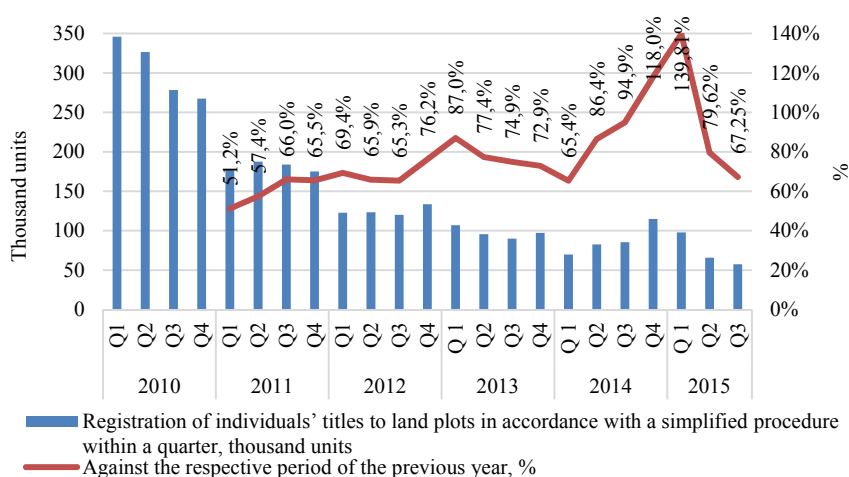


Fig. 1. Dynamics of registration of individuals' titles to land plots in accordance with the simplified procedure

Source: The Rosreestr.

### 6.3.2. Housing mortgage lending<sup>1</sup>

In 2015, according to the data released by the Central Bank of the Russian Federation, credit institutions extended 691,943 housing mortgage loans (HML) to the tune of Rb 1,147.339bn, which constituted 68.32% of the total amount of HML extended in 2014 and 65.04% in monetary terms. In the same period, 706,786 housing loans were originated totaling to Rb 1,168.222bn, which in quantity of loans comes to 66.71% and in monetary terms 64.14% of the extended loans.

The volume of consumer lending in 2015 contracted to 67.92% against 2014 and constituted Rb 5.861 trillion. In Q4 2015, the volume of consumer lending fell to Rb 1.738 trillion, which constituted 77.75% of Q4 2014 (Fig. 2).

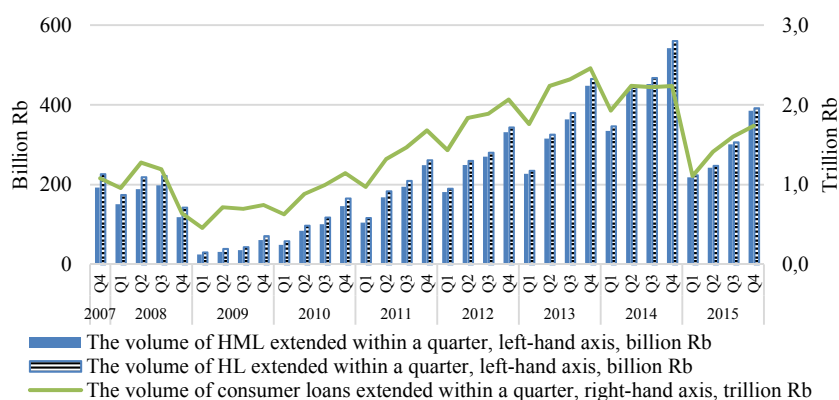
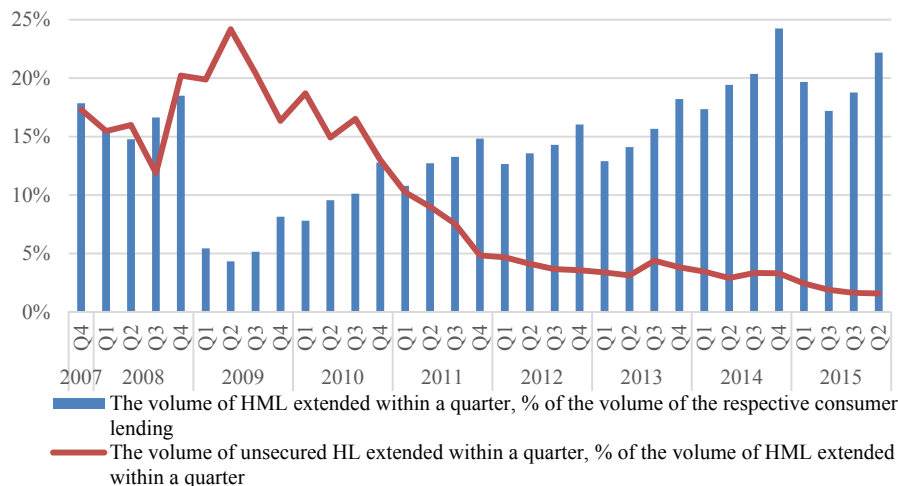


Fig. 2. Dynamics of retail housing mortgage lending, 2007–2015

Source: The Central Bank of the Russian Federation.

<sup>1</sup> Author of this section: Zadonsky G. – RANEPА.

In 2015, the share of extended HML in the volume of consumer loans decreased by 2.08 p.p. compared to 2014 and hit 22.18%. A trend of decrease in the share of unsecured housing loans (UHL) in the HL and HML volume remained in 2015. The share of UHL in the HML volume was in 2015 lower the UHL in 2014 by 1.73 p.p. and came to 1.58% (*Fig. 3*).

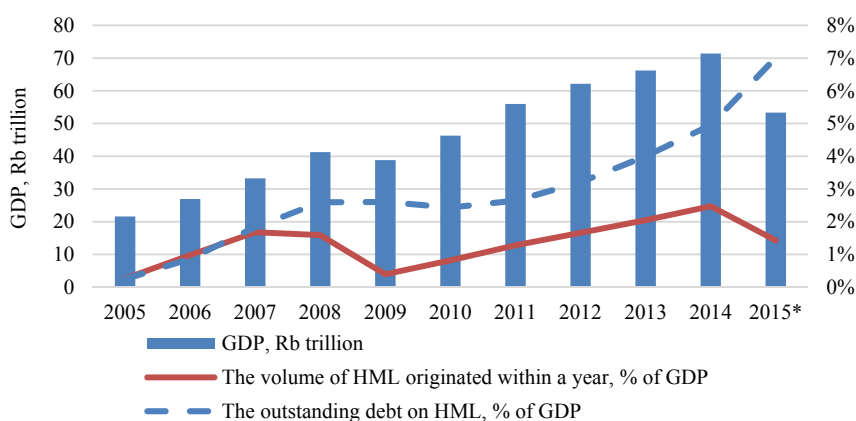


*Fig. 3.* Dynamics of the ratio between the volumes for quarter of HML, UHL and consumer lending, 2007–2015 гг.

Source: The Central Bank of the Russian Federation.

According to the data released by the Rosreestr provided by the JSC AHML in Q3 2015 the share of mortgaged real property units in the total number of real property units registered in transactions with housing decreased by 2.9 p.p. against Q3 2014 and constituted 24.8%, that is a quarter of apartments in Q3 2015 were bought with mortgages.

The volume of HML extended as of October 1, 2015, in shares of the respective value of GDP fell to 1.43% against 2.47% as of October 1, 2014. As of October 1, 2015, the debt on HML up to 7.02% of corresponding GDP against 4.96% as of October 1, 2014 (*Fig. 4*).

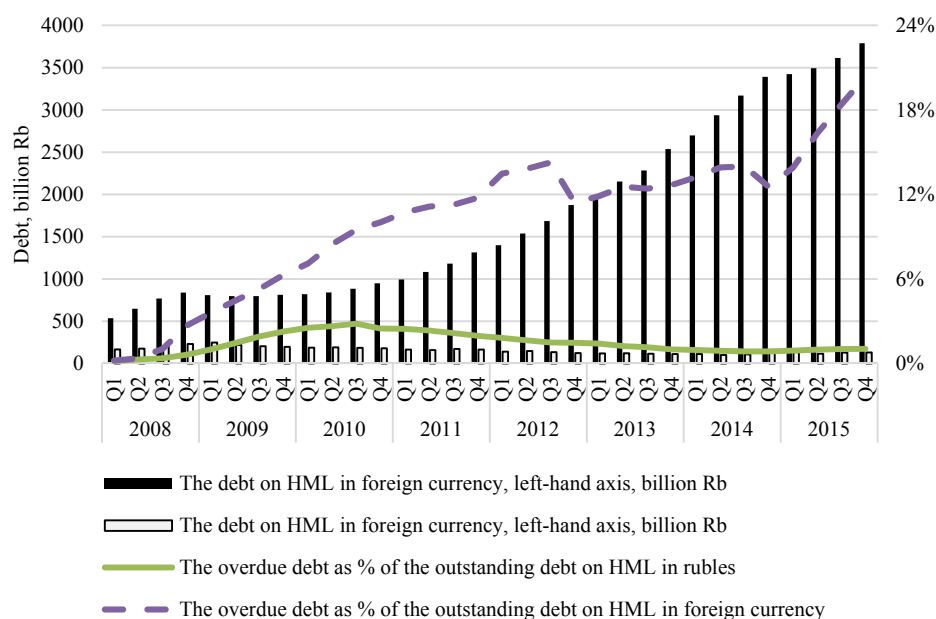


*Fig. 4.* Dynamics of housing mortgage loans, % GDP

\* January-September 2015

Source: The Central Bank of the Russian Federation.

As of 1 January 2016, the debt on HML in rubles increased by 11.72% as compared to 1 January 2015 and amounted to Rb 3,789.4bn. The overdue debt on ruble HML on those loans (Rb 39.4bn) rose by 36.06% on January 1, 2015, while as percentage of the outstanding debt it amounted to 1.04%, which is 0.19 p.p. more than that as of January 1, 2015. The latter is the evidence of lower quality of the portfolio of ruble mortgages for this period in comparison with the previous year (*Fig. 5*).

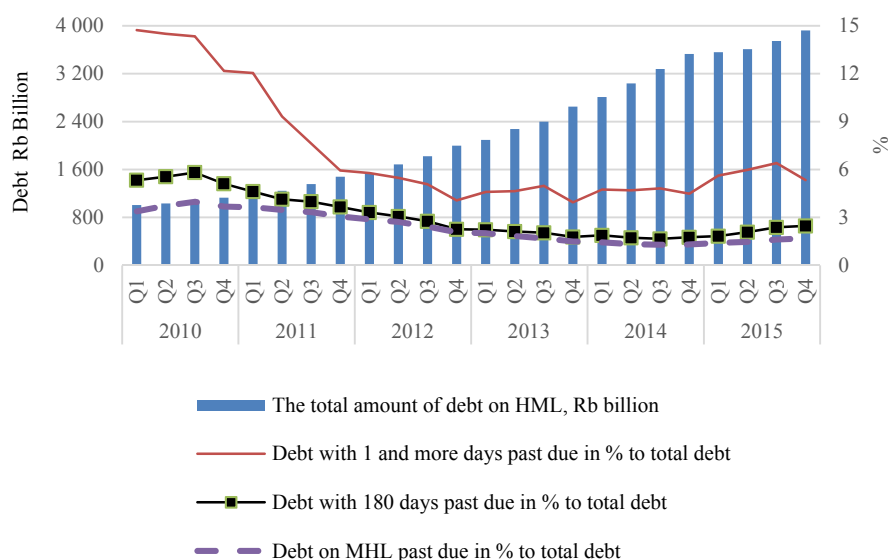


*Fig. 5.* Dynamics of outstanding and overdue debt on housing mortgage loans

*Source:* The Central Bank of the Russian Federation.

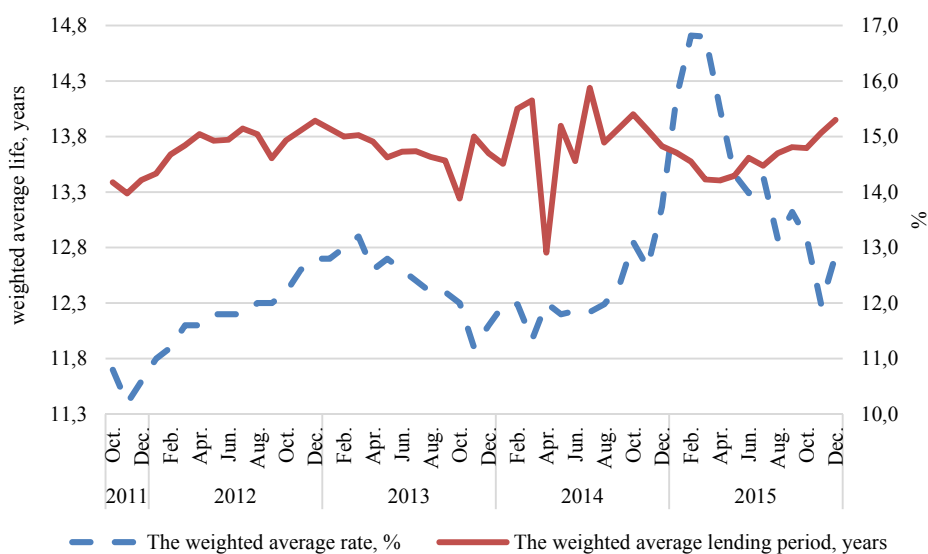
The share of debt on HML with 1 and more days past due in total amount of debt in 2015 constituted 5.34%, which is up 0.85 p.p. against 2014. At the same time, the share of debt on HML with 180 days past due (debt on default loans) in the total amount of debt increased in 2015 and came to 2.47%, which is by 0.71 p.p. more than in 2014. Outstanding debt on HML in percent to the total amount of debt constituted for 2015 1.69%, which is by 0.38 p.p. more than for 2014 (*Fig. 6*).

In 2015, the weighted average rate on HML in rubles extended within a month decreased from the maximum value of 14.71% in February to 12.73% in December. Nevertheless, the December rate turned out to be higher the November rate by 0.44 p.p. The annual rate constituted 13.33%. The weighted average period of lending as regards HML in rubles extended within a month varied from 14.21 years to 15.3 years (*Fig. 7*).



*Fig. 6. Dynamics of debt on HML by the payment delay terms*

Source: The Central Bank of the Russian Federation.



*Fig. 7. The weighted average rate and lending period on HML in rubles extended within a month*

Source: The Central Bank of the Russian Federation.

As of January 1 2015, the weighted average rate on HML in foreign currency fell to 9.82% as of January 1, 2016, with the highest rate of 11.8% registered as of April 1, 2015. As of January 1, 2016, the weighted average lending period as regards HML in foreign currency extended from the beginning of the year amounted to 3.97 years.

As of 1 July 2015, Rb 162bn worth of HML was repaid by borrowers prior to maturity which value is 4.76% higher than that as of 1 July 2014. The above sum amounts to 35.1% of the volume of HML extended in H1 2015. It is to be noted that Rb 1.655bn worth of HML was repaid early by means of funds received from foreclosure sale of mortgaged property, that is, a decrease of 16.62% as compared to H1 2014.

Government Regulation No 404 the implementation term of the project “Housing for a Russian family” has been extended through December 31, 2017.

According to the Government Regulation No 373 of April 20, 2015, JSC AHML has been implementing HML restructuring program (loans) for the borrowers who are in dire straits. In December 2015, the program was amended and the maximum amount for compensation by JSC AHML was raised from Rb 200 to Rb 600 thousand.

From October 1, 2009 through November 1, 2015, within the frameworks of the *Stimul* in 48 regions according to concluded Agreements the JSC AHML’s existing liabilities amounted to Rb 119.5bn. The volume of extended by AHML loans to banks which finance housing development projects within the program *Stimul* amounted to Rb 72.6bn at the rate of 8.0%. The volume of extended by loans to banks legal entities which finance housing development projects within the program *Stimul* amounted to Rb 129.611bn at an average rate of 13.2%. Total gross residential area commissioned by the participants of *Stimul* program amounts to 6.4m sq.m.

During January-October 2015, 15 issues of mortgage-backed securities were issued totaling to Rb 64.3bn. As of November 1, 2015, 24 issues of JSC AHML securities were in circulation totaling to Rb 156.5bn ensued by government guarantees and 3 issues of exchange bonds of JSC AHML to the tune of Rb 15bn.

### 6.3.3. Price dynamics on residential property<sup>1</sup>

The main indices of the dynamics of prices on the secondary housing market of Russian cities are shown in *Table 12*. The data is presented by real-estate market analysts who collect, verify, and process the data on the basis of unified methods recommended by the Russian Guild of Realtors (RGR).<sup>2</sup>

The research sample includes 28 cities and one region (Moscow region in respect of which averaged readings on 85-90 population centers are presented) including 23 cities which are centers of the RF subjects with total population of over 42.1m people.<sup>3</sup>

The sample presents:

- Moscow (about 12.2m people);
- The Moscow region (with the aggregate urban population of 5.9m) and St. Petersburg (over 5.2m people) – aggregately 11.1m people;

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<sup>1</sup> Authors of this section: Malginov G. – Gaidar Institute for Economic Policy, Sternik G. – Moscow Association of Realtors on Analytics and Consulting, JSC Sternik’s Consulting.

<sup>2</sup> Sources of data: Committee of the Moscow Association of Realtors on Analysis and Consulting (on data of “MIEL”, “MIEL-New Construction), JSC “Sternik’s Consulting”, GK “Real-Property Bulletin”, JSC “Industria” (Vladivostok), as well as Online figure of price dynamics on the secondary market of Russian cities (URL: <http://realtymarket.ru/Publi-nii-grafik-cen-vtori-noi-nedvijimosti-gorodo/>).

<sup>3</sup> As compared to the sample, which was used for the analysis of the pricing situation on the secondary market in the previous annual review (see G. Malginov and G. Sternik. Prices on the Real-Estate Market // Russian Economy in 2014. Trends and Prospects (Issue 36). M., The IEP. 2015, pp. 526-531), it does not include Rostov-on Don, Krasnodar, Orenburg, Cheboksary, Tver, small groups of cities (district centers) of Bashkortostan and Samara region but added Chelyabinsk, Vladivostok and Yaroslavl.

## RUSSIAN ECONOMY IN 2015

### trends and outlooks

– 9 cities with the population of over 1m people apart from two capitals (Novosibirsk, Yekaterinburg, Kazan, Chelyabinsk, Samara, Omsk, Krasnoyarsk, Perm and Voronezh) – totaling to 10.6m;

– 9 cities with the population from 500,000 people to 1m people (Togliatti, Barnaul, Tyumen, Ulyanovsk, Irkutsk, Vladivostok, Yaroslavl, Kemerovo, and Ryazan) – totaling to over 5.6m people;

– 6 cities with the population from 200,000 to 500,000 people (Kirov, Stavropol, Vladimir, Surgut, Smolensk, and Shakhty) – totaling to over 2.2m;

– 2 cities with the population below 200,000 people (Pervouralsk and Tobolsk) – totaling to over 0.2m people.

Table 12

### Prices on the secondary housing market in Russian cities in 2013–2015

City (Region)	Average unit asking price, thousand Rb/ sq. meters			Price index in December 2014 against December 2013		Price index in December 2015 against December 2014	
	December 2013	December 2014	December 2015	nominal	real (IGS)	nominal	real (IGS)
Moscow	203.3	226.6	218.5	1.115	1.000	0.964	0.854
St. Petersburg	96.0	103.0	103.0	1.073	0.963	1.000	0.886
Vladivostok		95.0	96.8			1.019	0.903
Moscow Region	88.2	93.4	90.9	1.059	0.951	0.973	0.862
Surgut (Tyumen Region)	87.0	78.5	71.3	0.902	0.810	0.908	0.804
Yekaterinburg	72.8	76.2	70.7	1.047	0.940	0.928	0.828
Tyumen	65.7	63.8	58.9	0.971	0.872	0.923	0.818
Kazan	63.7	66.6	65.3	1.046	0.939	0.980	0.868
Novosibirsk	61.4	65.6	60.4	1.068	0.959	0.921	0.816
Krasnoyarsk	61.0	61.4	54.8	1.007	0.904	0.893	0.791
Irkutsk	59.7	60.9	57.9	1.020	0.916	0.951	0.842
Samara	58.5	64.6	62.6	1.104	0.991	0.969	0.858
Yaroslavl	57.7	57.3	53.6	0.993	0.891	0.935	0.829
Perm	54.7	52.6	52.7	0.962	0.863	1.002	0.888
Vladimir	52.7	55.1	52.7	1.046	0.939	0.956	0.847
Kemerovo	52.1	53.5	49.1	1.027	0.922	0.918	0.813
Tobolsk (Tyumen region)	51.1	49.2	44.3	0.963	0.864	0.900	0.797
Voronezh	48.8	52.0	45.8	1.066	0.957	0.881	0.780
Kirov	48.5	50.9	47.7	1.049	0.942	0.937	0.830
Barnaul	48.3	49.8	46.5	1.031	0.926	0.934	0.827
Smolensk	48.1	51.3	46.9	1.067	0.957	0.914	0.810
Omsk	47.4	48.7	46.7	1.027	0.922	0.959	0.849
Ryazan	45.8	48.0	45.8	1.048	0.941	0.954	0.845
Tolyatti (Samara region)	45.7	48.3	44.8	1.057	0.949	0.928	0.822
Chelyabinsk	43.0	47.0	41.6	1.093	0.981	0.885	0.784
Ulyanovsk	42.3	43.5	41.2	1.028	0.923	0.947	0.839
Pervouralsk (Sverdlovsk region)		42.9	38.6			0.900	0.797
Stavropol	35.5	39.0	37.6	1.099	0.986	0.964	0.854
Shakhty (Rostov region)	30.9	34.2	34.8	1.107	0.994	1.018	0.902

In Moscow, the secondary housing market saw a continuation of price rise through March 2015 (Rb 244,400 per sq. meter). Then under the influence of subsidized mortgage the demand moved to the primary housing market, by May prices somewhat fell (to Rb 235,000 per sq.

meter), and stabilized at this level in summer. From autumn price reduction took on and the end of the year was below the level of December 2014 by 3.6% constituting Rb 218,500 per sq. meter.

On the secondary housing market of the Moscow region prices were growing through May (Rb 95,800 per sq. meter) and then were gradually falling to Rb 94,000 per sq. meter in August-September. This trend was observed later as a result of which at year-end the prices as in Moscow fell below the level of December 2014 by 2.7% to Rb 90,900 per sq. meter.

In St. Petersburg housing prices on the secondary market were growing through March (Rb 107,300 per sq. meter) and then by June fell to Rb 104,500 per sq. meter returning by the end of the year to the level of December 2014 (Rb 103,000 per sq. meter). Thus, the capital regions did not register housing price dynamics during the year. In the wake of significant changes in the scale of mortgage support and volumes of transactions with apartments, the sellers stubbornly maintained asking prices without significant changes,

In other regions, the situation was developing the same way. On the secondary housing market in the majority of sample cities during the first one-two months asking prices were growing and then were falling.

At year-end as a whole, housing price reduction took place in practically all cities except St. Petersburg, Perm, Vladivostok and Shakhty (Rostov region). In those cities insignificant (less than 2%) growth of nominal prices was observed, which was within the framework of the general trend of growth in Q1 with further gradual reduction (in case of Vladivostok and Perm). The group of cities with less obvious decrease of prices (within 5%) besides Moscow and the Moscow region, were Kazan, Samara, Omsk, Vladimir, Ryazan, and Irkutsk. At the other end were Voronezh, Chelyabinsk, Krasnoyarsk, Tobolsk, and Pervouralsk where prices fell by 10–12%. In other cities price decrease constituted between 5-10%.

In the larger portion of the sample, growth of the nominal housing prices by the end of 2014 gave way to their decline in 2015. Somewhat aside, stand St Petersburg where after the growth in 2014 prices remained at a year earlier level and Perm where following price reduction posted in 2014 followed their symbolic growth. In Shakhty compared to 2014, price growth rates fell five-fold, which allows to speak about their stabilization.<sup>1</sup> Another exception were Yaroslavl and cities of the Tyumen region: in Tyumen and Tobolsk last year prices continued falling at a growing rate and in Surgut price decrease turned out to be comparable with 2014.

At the same time, in most cities of the sample a drop in real price on housing (with the inflation rate on the consumer market excluded, which constituted in 2015 12.9%) took place (IGS index).<sup>2</sup> In the largest portion of the sample, decline stayed within 11-20%. Lower (around 10%) is was solely in Vladivostok and Shakhty exceeding 20% in Pervouralsk, Tobolsk, Krasnoyarsk, Chelyabinsk, and Voronezh.

The data on prices on the primary market was collected on 13 cities and the Moscow Region (*Table 13*).

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<sup>1</sup> Price stability in Shakhty registered during the year, most likely, is affected by the proximity of the Ukrainian conflict.

<sup>2</sup> Calculation of the IGS index is carried out on the basis of the following formula:  $IGS = I_{hp}/I_{cp}$ , where  $I_{hp}$  – housing price index in rubles;  $I_{cp}$  – consumer price index.

Table 13

**Prices on the primary market of Russian cities in 2013–2015**

City (Region)	Average unit asking price, thousand Rb per sq. meter			Price index in December 2014 against December 2013		Price index in December 2015 against December 2014	
	December 2013	December 2014	December 2015	nominal	real (IGS)	nominal	Real (IGS)
Moscow	215.5	216.0	182.6	1.002	0.900	0.845	0.749
St. Petersburg	90.5	98.0	100.4	1.083	0.972	1.024	0.907
Moscow Region	76.5	81.0	80.3	1.059	0.950	0.991	0.878
Yekaterinburg	60.8	65.5	66.4	1.077	0.967	1.014	0.898
Kazan	49.4	57.1	62.9	1.156	1.038	1.102	0.976
Samara	49.4	57.0	54.2	1.154	1.036	0.951	0.842
Tyumen	55.9	57.0	55.1	1.020	0.915	0.967	0.856
Rostov-on-Don		53.1	50.6			0.953	0.844
Yaroslavl	48.2	50.6	52.9	1.050	0.942	1.045	0.926
Ryazan	37.0	40.5	38.0	1.095	0.983	0.938	0.831
Ulyanovsk		38.0	38.0			1.000	0.886
Stavropol	30.4	34.5	34.8	1.135	1.019	1.009	0.893

In Moscow, in January 2015, on the primary market housing price growth continued due to reaction of the population on the ruble devaluation in December 2014. However, by March 2015 prices fell to Rb 203,400 per sq. meter (against Rb 216,900 per sq. meter in January) and later with somewhat ruble strengthening and stability through August remained at the level of around Rb 200,000 per sq. meter. In autumn, prices resumed their decline and turned out to be by the end of the year (Rb 182,600 per sq. meter) below the level of December 2014 at 15.5%. According to different data, the amount of rebate on the primary housing market constituted in Russia in 2015 on average 10-15% (from 2-15% in summer and 5-25% in autumn). The share of apartments sold with a discount was estimated at 60-80%. Price negotiation index (ratio between average asking prices to average prices of transactions) stands at 1.07-1.10.

In the Moscow region on the primary housing market prices were growing through February (Rb 83,600 per sq. meter) and then by April fell to Rb 81,800 per sq. meter. Further, prices stabilized at Rb 82,000 per sq. meter, which was followed by price decline commencing from September. However, in contrast with Moscow, they hardly differed from the level of December 2014 by the end of the year (Rb 80,300 per sq. meter against Rb 81,000 per sq. meter, the difference constituted less than 1%).

The situation on the primary housing market in St. Petersburg was characterized by somewhat higher volatility. In January, prices went up to Rb 102,900 per sq. meter and then by June fell to Rb 98,800 per sq. meter. Followed unexpected growth pushed prices by October to the level exceeding the January level (Rb 103,800 per sq. meter). However, later, they began falling to Rb 100,400 per sq. meter at the end of the year, which nevertheless was above the level registered in December 2014 by 2.4%.

At year-end, in other cities changes in the average housing prices on the primary market were differently directed. Like in St. Petersburg prices moved up in Stavropol, Yekaterinburg, Yaroslavl, and Kazan, and in the latter by more than 10%. However, the growth rate was weaker than a year earlier. In Ulyanovsk, they remained unchanged. In Tyumen, Rostov-on-Don, Samara, and Ryazan price reduction took place but it was lower than in Moscow where its depth was the greatest (more than 15%).



Principal factors, which affected the level of price reduction on the Moscow primary housing market were external ones (drop in income, contraction of migration, decrease of investors activity) in principle are effective in other cities. However, Moscow faces the influence of other additional important internal factors.

One of them consists in the structural shift due to the change in the share of apartments supply inside Moscow in modern borders (Big Moscow) with existing difference in price level. For example, the share of supply in Moscow in former borders (Old Moscow) fell over the year from 75% to 68% (with price in December 2015 at Rb 242,700 per sq. meter) and the proportion of added territories (New Moscow) moved up from 25% to 32% (with price at Rb 103,100 per sq. meter). Calculations demonstrate that impact of this structural shift on the average price across Bid Moscow constituted 4.8%.

Another shift was due to the change in the class of quality of commissioned housing: in December 2014 around 35% supply in Moscow as a whole was in the business-class segment and elite class (average price – Rb 307,300 per sq. meter), 65% - comfort and economy-class segment (average price – Rb 122,100 per sq. meter). In December 2015, the share of housing in prestige class changed slightly (37%), but average price fell to Rb 283,300 per sq. meter (or around 8%). The share of large-scale housing constituted 63% with price at Rb 116,400 per sq. meter. In other words, decrease amounted to less than 5%. These structural changes added 1.8% to the decline of the average price across Big Moscow.

In all cities indicators of real housing price (IGS index) fell compared to 2014, meanwhile, the value of contraction of this index was bigger than year earlier. In the smallest degree this trend was in Kazan, Yaroslavl, and St. Petersburg where reduction of real housing price did not exceed 10%, although in 2014 in Kazan as in Samara and Stavropol IGS index demonstrated growth.

The data of *Table 14* show that in the past three years the average unit price of housing on the secondary market was everywhere ahead of that on the primary market.

*Table 14*

**Correlation of prices on the secondary and primary housing markets  
in Russian cities in 2013–2015**

City (Region)	December 2013			December 2014			December 2015		
	Average unit asking price		(2)/(1), %	Average unit asking price		(2)/(1), %	Average unit asking price		(2)/(1), %
	On the secondary market, thousand Rb/sq. meters (2)	On the primary market. Thousand Rb /sq. meter (1)		On the secondary market, thousand Rb/sq. meters (2)	On the primary market. Thousand Rb /sq. meter (1)		On the secondary market, thousand Rb/sq. meters (2)	On the primary market. Thousand Rb /sq. meter (1)	
Moscow	203.3	215.5	94.3	226.6	216.0	104.9	218.5	182.6	119.7
St. Petersburg	96.0	90.5	106.1	103.0	98.0	105.1	103.0	100.4	102.6
Moscow Region	88.2	76.5	115.3	93.4	81.0	115.3	90.9	80.3	113.2
Yekaterinburg	72.8	60.8	119.7	76.2	65.5	116.3	70.7	66.4	106.5
Kazan	63.7	49.4	128.9	66.6	57.1	116.6	65.3	62.9	103.8
Samara	58.5	49.4	118.4	64.6	57.0	113.3	62.6	54.2	115.5
Tyumen	65.7	55.9	117.5	63.8	57.0	111.9	58.9	55.1	106.9
Ryazan	45.8	37.0	123.8	48.0	40.5	118.5	45.8	38.0	120.5
Stavropol	35.5	30.4	116.8	39.0	34.5	113.0	37.6	34.8	108.0

Earlier, an important exception was the capital of Russia. However, by the end of 2014, after joining to it of a portion of the territory of the Moscow Region the situation changed and in December 2015 prices on the secondary market in Moscow started to exceed those on the primary market by around 20%. Slightly higher prices were registered in Ryazan, and in localities near Moscow and Samara it constituted more than 13–15%. In Stavropol, Tyumen and Yekaterinburg higher prices of the secondary market averaged between 6.5 and 8.0%, and in St. Petersburg and Kazan, it constituted less than 3–4%.

In more than half of sample cities (St. Petersburg, Yekaterinburg, Kazan, Tyumen, and Stavropol) during 2013-2015 price convergence between primary and secondary housing prices was observed. At year-end 2015, localities near Moscow added. In Samara and Ryazan changes year-on-year had differently directed character. Only Moscow demonstrated exceeding price growth on the secondary market.

Thus, prices on primary and secondary housing market of Russian cities were falling but there was no housing price crash. On the whole, the housing market turned out to be the most stable segment of the economy, which speaks about a relative efficiency of anti-crisis measures adopted by the authorities and developers.

### *Internal factors which determined price dynamics and activity on the market*

Following the slide of the mortgage transactions volume posted in January-February 2015 due to the key rate hike, which correspondingly led to high mortgage lending rates, measures adopted by the government aimed at support of the building industry (March decision on subsidizing mortgage lending rate on the primary market)<sup>1</sup> resulted in the growth of the number of mortgage transactions, which prevented collapse of the housing construction industry. Hereafter, with the gradual decrease of the key rate mortgage rate was also falling. If in Q1 it averaged 14.5%, then during H1 – 13.9% and at year-end 2015 – 13.3% (in 2014 – 12.45%). On mortgage loans denominated in foreign currency the rate, on the contrary, moved up from 9.25% to 9.82%.<sup>2</sup> However, they accounted for less than 0.5% of the total loans originated, which demonstrates a rather limited importance of the issue with currency borrowers. According to estimates of AHML's General Director, A. Plutnik, out of the total number of mortgage borrowers (3.5m people) there are solely 18,000 including 2,000 who are in financial straits. During the year, banks have restructured 30% of the currency mortgage portfolio.<sup>3</sup>

Despite the State Program of mortgage interest rates subsidization under which 210,000 mortgage loans were originated, the total amount of extended mortgage loans contracted in 2015 by 35% (Rb 1,143.6bn against Rb 1,753.3bn a year earlier).<sup>4</sup> Owing to a reduction in the volume of mortgage absorption and decline in solvency of the population on the whole, decrease in the volume of demonstrated demand in the country constituted according to experts' estimates up to 40%. Correspondingly, there was a contraction in the volume of transactions on the secondary and primary residential housing markets. Their dynamics across Moscow is presented in *Fig. 8*.

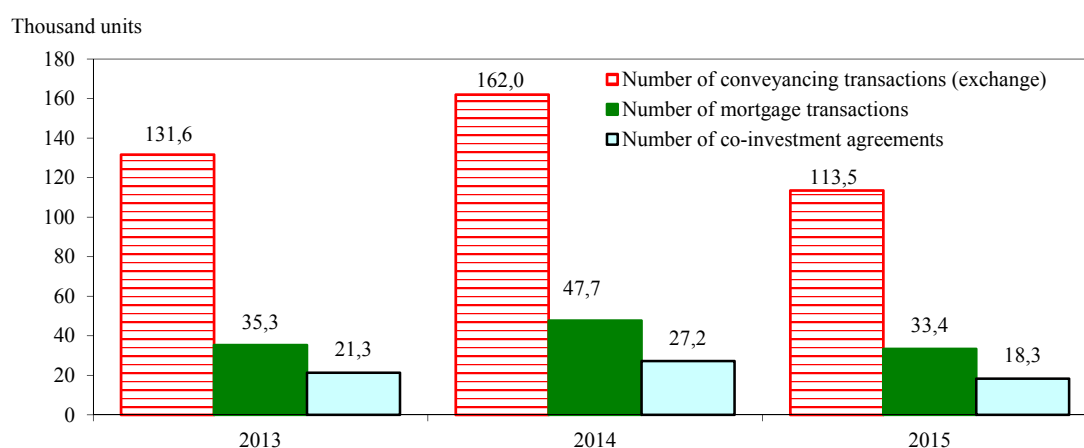
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<sup>1</sup> Within the framework of the state program on preferential mortgage lending rate does not exceed 12.0%. It is applicable solely to the primary housing market. The Program was effective from March 1, 2015 through March 1, 2016 and then was extended through the end of 2016. In 2016, the Program will absorb Rb 16.5bn, and a number of parameters can be changed compared to the previous year.

<sup>2</sup> Socio-economic state of Russia. January 2016. Moscow, Rosstat, pp. 198–200.

<sup>3</sup> Tonus for construction. Big Moscow, 17.02 2016, № 6 (87), p. 6.

<sup>4</sup> Total amount of housing loans somewhat exceeds indicated mortgage volume denominated in rubles but it accounts for around 98% of the overall volume of housing lending.



*Fig. 8.* Number of registered transactions on Moscow housing market in 2013–2015

Source: Rosreestr.

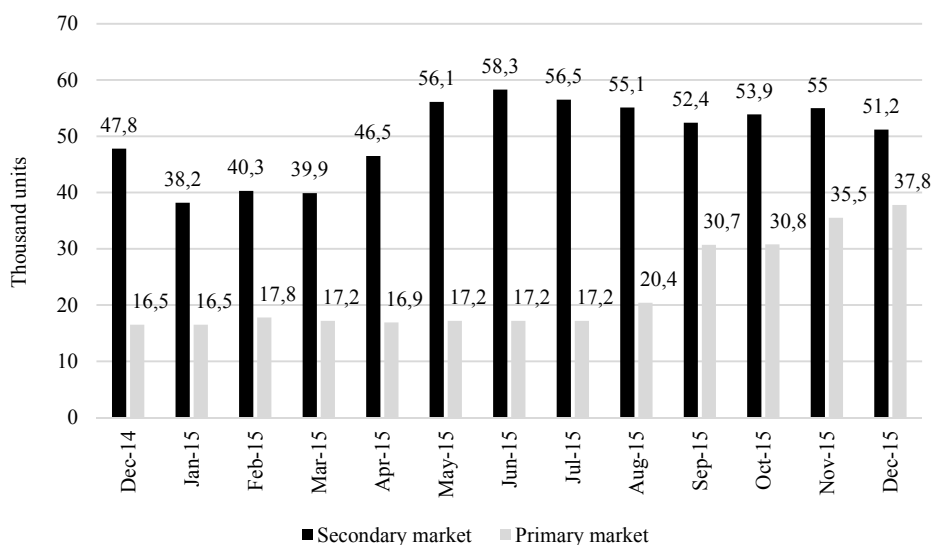
In Moscow the number of mortgage transactions contracted from 4,500 posted in December 2014 to 1,700 registered in January 2015. Hereafter, growth was observed from 2,300-2,700 transactions registered in February-March to 3,500 by June and 4,100 by July. However, in H2 against the background of income contraction and unstable situation on the currency market and in the financial sphere, growth of mortgage absorption stopped and merely 2,600-2,900 mortgage transactions were registered in a month. For a year as a whole, this indicator fell by 30.0% (from 47,700 to 33,400 loans).

Number of registered co-investment agreements in Moscow declined from 3,200 in December 2014 to 1,300-1,400 in February-March 2015. In April, this number moved up to 2,100 but further started falling and in August-November went back to 1,300-1,600 agreements per month. In December this indicator constituted only 1,143 registered co-investment agreements. Total number for the year in the capital fell by nearly 1/3 – from 27,200 to 18,300 agreements.

On the secondary housing market the number of conveyancing (exchange) transactions fell from 16,900 in December 2014 to 5,900 in January 2015. Further on, obvious instability of monthly indicators was observed. If in March the number of transactions moved up to 13,000, then the number fell to 7,000 in May with a somewhat growth by July to 8,800 transactions. In August-September, this segment registered new reduction in the number of transactions to 7,400 and 7,700, respectively. However, in the last quarter of the year the value of this indicator went up to 9,300 transactions in October-November and to 15,000 in December. During the year as a whole, the number of registered deeds on the capital secondary housing market decreased by 31.0% (from 162,000 to 113,500 registered conveyancing transactions (exchange)).

Thus, compared to 2014, decrease in activity in principal segments of the Moscow housing market was approximately equal. Some special details pop up when we compare with the pre-crisis 2013. If activity on the secondary market and involvement in cost sharing construction has contracted by around 14-15%, then in relation to mortgage – solely by 5.4%.

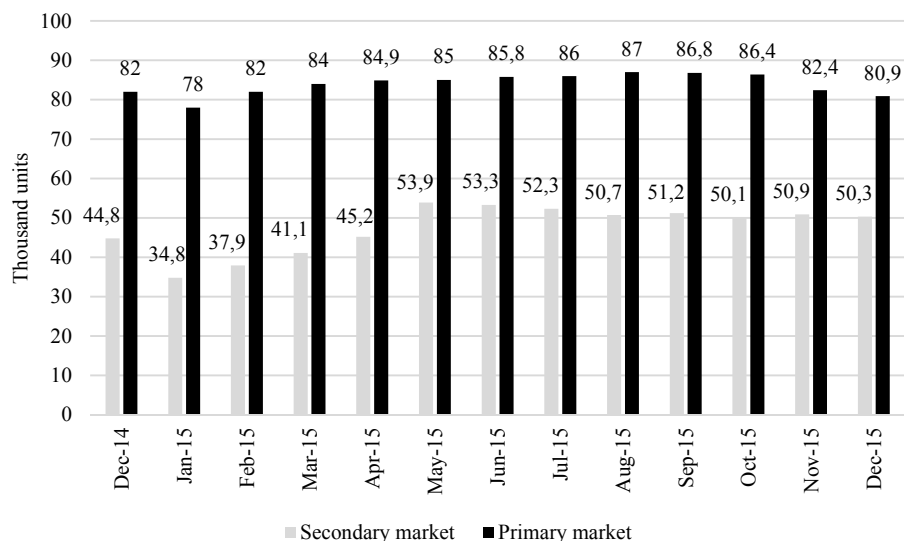
Contraction of demand and absorption of housing resulted in growth in 2015 of the volume of a “hung” supply in the capital region (*Fig. 9 and 10*).



*Fig. 9.* Supply volume of apartments on the Moscow housing market

Sources: GK MIEL; MIEL-Novostroiki.

The Moscow secondary market (*Fig. 9*) registered supply growth in April to 46,500 apartments against 38,000-40,000 posted in previous months. Starting from May, it did not move down below 51,000-52,000 apartments per month (minimums were registered in September and December). Supply growth on the primary market happened in August to 20,400 apartments against 16,000-18,000 per month in the course of H1 as well as in July. In September-December, it moved up to 30,000-38,000 apartments per month.



*Fig. 10.* Supply volume of apartments on the Moscow region housing market

Sources: GK MIEL; MIEL-Novostroiki.

On the Moscow region secondary housing market (*Fig. 10*) the volume of supply was moving up from 34,800 apartments in January to 53,000-54,000 apartments in May-June, hereafter staying at 50,000-52,000 apartments per month. On the primary market starting with Q2 the supply was more stable (85,000-86,000 apartments), which is explained by approximately the same rate of absorption and the new construction-supply. However, in November-December, it decreased to 82,000-81,000 apartments together with contraction of the number of new developing sights.

“Hung” supply was owing to a reduction of absorption rates together with fallen demand have led to price decrease on the market. While the developers were announcing various sales promotions, discounts, installment sale, buyers concentrated their demand on below budget apartments as a result of that transactions’ prices during spring-summer averaged 10-15% below the asking price. In the autumn developers finally moved beyond the policy of high asking prices and individual discounts to a general reduction of asking prices.

#### 6.3.4. Building, commissioning and supply of new housing<sup>1</sup>

In 2015, despite the impact of financial and economic crisis the housing construction industry managed to retain the volume of commissioning of new housing practically at the previous level. Generally in 2015, 1,169,400 apartments with the total floor space of 83.3m sq. meters were commissioned (*Table 15*).

*Table 15*

**Commissioning of housing in Russia in 1999–2015**

Year	Million sq. meters of housing	Growth rates, %	
		Against the previous 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	167.0
2007	61.2	120.9	202.0
2008	64.1	104.7	211.5
2009	59.9	93.4	197.7
2010	58.4	97.5	192.7
2011	62.3	106.6	205.6
2012	65.7	104.7	216.8
2013	70.5	107.3	232.7
2014	84.2	119.4	277.9
2015	83.8	99.5	276.6

*Source:* The Russian Statistical Yearbook. 2007: Statistical collected volume/ The Rosstat M., 2007, p. 507; The Russian Statistical Yearbook. 2015: Statistical collected volume. Rosstat, Moscow, 2015, p. 435; On Housing Development in 2015, www.gks.ru and own calculations

In 2015, individual developers commissioned 264,000 residential buildings with the total floor space of 34.3m sq. meters which is 5.4% less than in 2014. For the first time in many years individual developers demonstrated inferior dynamics compared to the housing construction as a whole. This decreased its share in the total floor space of completed housing nationwide was equal to 40.9% meanwhile during previous five years it consistently exceeded 43.0%.

<sup>1</sup> Authors of this section: Malginov G. – Gaidar Institute for Economic Policy, Sternik G. – Moscow Association of Realtors on Analytics and Consulting, JSC Sternik’s Consulting.

Positive dynamics of housing development was observed in Russia's most regions, including 2/3 of the territories where the aggregate volumes of commissioning of housing exceeded 1m sq. meters (*Table 16*).

*Table 16*

**Dynamics of commissioning of housing in Russia's regions in 2014  
(arranged by the rates of commissioning)**

Region	Growth rates of housing commissioning, % to 2014
Leningrad region	130.0
Samara region	117.1
Moscow	115.8
Novosibirsk region	112.3
Dagestan	109.2
Krasnoyarsk Krai	108.5
Kaliningrad region	108.1
Belgorod region	105.8
Lipetsk region	105.2
Voronezh region	103.8
Rostov region	103.6
Perm Krai	103.5
Orenburg region	103.3
Tyumen Region (with autonomous regions)	103.2
Sverdlovsk region	102.5
Bashkortostan	101.5
Tatarstan	100.0
Krasnodar Krai	97.1
Stavropol Krai	94.0
St Petersburg	92.9
Kemerovo region	91.3
Moscow region	85.4
Chelyabinsk region	85.4
Nizhny Novgorod region	79.1
Saratov region	75.0

Source: On Housing Development in 2015 URL: [www.gks.ru](http://www.gks.ru).

As seen from *Table 16*, the dynamics of commissioning of housing which was largely above the average nationwide (over 5%) was observed in Leningrad, Samara, and Novosibirsk regions, Moscow, Dagestan, Krasnoyarsk Krai, Kaliningrad, Belgorod, and Lipetsk regions. Seven regions posted positive dynamics of housing commissioning but with lower rates. At the same time, there was a drop in the volumes of commissioning of housing in 8 regions including Moscow, Chelyabinsk, Nizhny Novgorod, and Saratov regions where it fell by 15-25.

Despite a deep fall, the Moscow region retained its leading position among Russian regions as regards the volume of housing commissioning in absolute terms (around 8.5m sq. meters). Moscow, on the contrary, registered growth of commissioning of housing in about the same proportions the Moscow region registered decline (15%). The unit weight of the capital region in the overall volume of housing development in Russia amounted to 14.7% of which the Moscow region accounted for a larger portion (10.1%), while the share of Moscow proper was equal to 4.6% (around 3.9m sq. meters). At the same time, for the third year in a row the Old Moscow observed a decrease in the volumes of commissioning after a year ban on issuing permissions for the housing construction due to change of city's authorities (to around 1.3m sq. meters or by 17).

It is to be noted for comparison that in St Petersburg the depth of contraction (over 7%) of the volumes of the housing construction (to 3m sq. meters) turned out to be half of those registered in the localities near Moscow. The Leningrad region retains its leadership on the rates of housing commissioning among all regions of the country with absolute values of this indicator

exceeding 1m sq. meters (30%). Among the five regions that are leaders in housing commissioning are Krasnodar Krai (4.6m sq. meters), and Tyumen region with autonomous districts (3.3m sq. meters).

At year-end 2015, on the whole one can acknowledge that in 2015 the housing construction industry managed to avoid decrease. Together with preferences on mortgages, the industry received support from the inertia production cycle, which consisted in the realization of already previously undertaken building sights in the era of favorable business climate. However, high annual result<sup>1</sup> was ensured only thanks to the results for H1 and already starting from June monthly volume of housing commissioning began falling in absolute terms compared to 2014 indices.

Furthermore, as can be well seen from Table 8, with retaining volume of housing commissioned across the country as a whole, last year contrary to 2014 the situation with the housing construction revealed noticeable regional specific character. In 2016-2018, in the wake of the crisis not only regions but Moscow as well faces serious reduction of the volumes of the housing construction by one third. According to data released by Moskomstroyinvest, the capitol market has registered a decrease by 30% of applications for obtaining urban development plans land plots from investors.

Even more contradictory is the situation in the Moscow region. On the one hand, the Moscow region for several years retained its leading position among all regions of the country as regards the volume of commissioned of housing as well as regards resettlement of slum dwellings and dilapidated housing. Despite the crisis, the developers as on the territory of the New Moscow announce new housing projects.

On the other hand, there is an obvious underdevelopment of transport, communal, and social infrastructure that are highly pressured. Proliferate protest sentiments against urban infill, high-rise development, and unfounded mass development, which makes regional authorities introduce local bans on housing development (for example, in Balashikha, Korolev, and Khimki). At the same time, amid decline of demand the profitability of the housing development is falling and the developers experience multiple financial problems. According to G. Elianyushkina, deputy head of the government of the Moscow region, construction works on 67 housing complexes have been completely or partially halted.<sup>2</sup> That is why, we can expect further reduction of supply volumes and continued fall in absorption of housing.

The impact of this factor on the primary market of the capitol region has led to a decrease of the volume of attracted investors' funds, which together with a contraction of bank lending to the developers has created for them considerable difficulties and place some of them on the brink of bankruptcy. Special attention was given to the situation around the developer SY-155, which resulted not only in the worse outcome of the construction industry performance in entire Moscow region but required attention from the federal authorities for its resolution. Courts consider many lawsuits against the developer filed by a number of banks (Sberbank, Rosbank, and Rossiskiy capital). The developer has become a victim of both a crisis and wrongly chosen financial model oriented on the constant growth of the housing market. Bank Rossiskiy capital

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<sup>1</sup> As was noted in the previous Annual Report (see: *Malginov G., Sternik G.* Prices on the Housing Market. Russian Economy in 2014. Trends and Outlooks. Issue 36. Moscow, IEP, 2015. p. 524). 2014 saw significantly exceeded over the late Soviet period (1988-1989) indicators. In 2015 amid actual retention of this result, there was approximate achievement of indices for late 1980s and on the number of commissioned apartments owing to increased construction of economy class housing, increased share of one-room apartments and studios.

<sup>2</sup> *Berezina E.* What is to be done with construction outrage. MK. 4.03–10.03.2016, № 45 (243). p. 12.

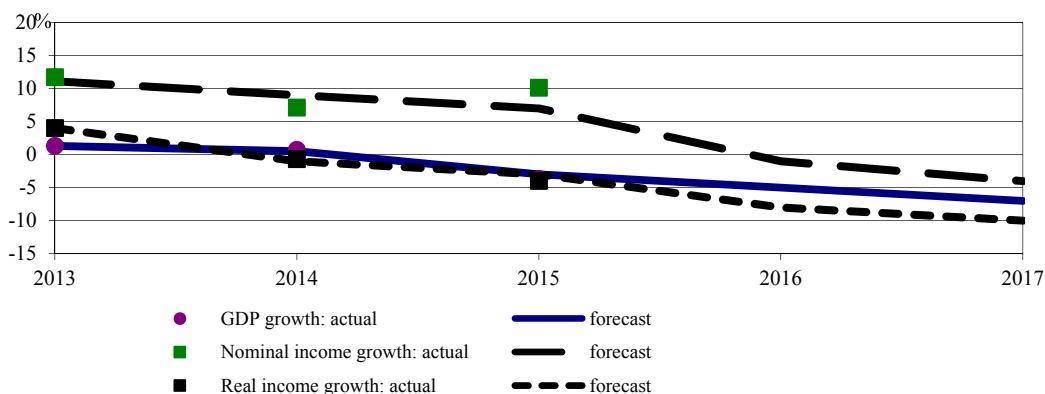
took over responsibilities for settling obligations before investors of the developer. Regarding the results of the all-Russia meeting on completion of construction sights of SY-155, as of year-end 16,000 out of 30,000 families must receive apartments from this developer (in 14 regions).<sup>1</sup>

Most likely, the issue of hoodwinked investors has a nationwide character. According to the RF Office of the Procurator General, the developers virtually everywhere fail to observe terms for the delivery of apartments according to the cost-sharing contracts. Only 29 regions do not have problems with housing, which is being built on the law on cost sharing construction. During nine months of 2015, the number of participants in cost-sharing construction who turned to the law enforcement agencies (537 persons) and the number of criminal investigations (362) went up by more than 70% against the same period of the previous year.<sup>2</sup>

Thus, the housing market in Russia in 2015 was in recession. Contrary to the complicated macroeconomic situation, there was no significant decline of main indicators (asking prices on the secondary and primary markets, construction volumes and commissioned housing, absorption volumes and mortgage), which does not exclude further buildup of complications this year.

### 6.3.5. Forecast of the residential housing development in the capitol region<sup>3</sup>

The forecast of the capitol housing market is closely linked with the prospects of the Russian economy as a whole. Computed in June 2014 for the use in mathematical model of the housing market performance long-term expert macroeconomic forecast for 2015 had the following parameters (*Fig. 11*).



*Fig. 11.* Long-term expert forecast of RF macroeconomic dynamics as of June 2014

Sources: forecast as of June 2014 – JSC Sterniks Consulting, actual data for 2013 and 2014 – Rosstat 2015 – RF VED estimate.

In comparison with the real data, it becomes evident that for 2014 the practically coincided with forecast data, which allowed not to revise model calculations for the next year. As of year-end 2015, forecast proved to be excessively optimistic: actual GDP reduction constituted 3.7%

<sup>1</sup> URL: [www.minsroyrf](http://www.minsroyrf), 15 February 2016.

<sup>2</sup> Rossiiskaya Gazeta. 25 November 2015.

<sup>3</sup> Authors of this section: Malginov G. – Gaidar Institute for Economic Policy, Sternik G. – Moscow Association of Realtors on Analytics and Consulting, JSC Sternik’s Consulting.



(instead of 3.0% according to forecast), growth of the nominal income of population – 10.2% (instead of 8.0%), and real income decrease – 4.0% (instead of 3.0%).

Regarding 2016 forecast, one can state a whole number of different assessments, which spread in values can be determined by the impact of the energy resources market (*Table 17*).

*Table 17*

**Forecast of macroeconomic parameters for 2016**

Source	Oil price, USD./bbl.	Exchange rate, Rb./USD	GDP growth, %
RF MED, November 2015	50	60–65	+1.0
Morgan Stanley			-0.8
A. Abramov (HSE, RANEPА, K. Adrianov (ISPN RAS), Ya. Mirkin (MEMO RAS)	40–47	70–77	-1.0
Fitch, Bloomberg, Goldman Sachs	20–30	110–120	-3.0
RF MED, January 2016	30–40	60–70	-3.0
Forecast JSC Sternik Consulting June 2014	35–40	80–90	-5.0

Originally, in autumn two scenarios of the development of the Russian economy were feasible. First, pessimistic: continuation and deepening of the recession. Second – optimistic: following currency and financial crisis as of year-end 2014 and economic recession in 2015, recovery commences. The RF Ministry viewed the latter for Economy as the main one even after continuation of the oil price fall and abandoning three-year budget planning. However, actual dynamics of macroeconomic and financial indices in late last year forced authorities to abandon optimistic scenario.

According to Gaidar Institute experts, data on the Russian economy development during 2015 coupled with current trends on the world energy markets present grounds to revise for the worse feasible scenarios of economic development in 2016-2017. For example, current scenario with average annual oil price in 2016 of \$35 per barrel is the base one, and the oil price at \$50 per barrel (included in the federal budget for 2016) seems optimistic. Modeling of the main macroeconomic indicators in 2016-2017 within chosen scenarios lead to conclusion of unavoidable recession during period under review. Transition to growth is feasible solely in scenario with stable oil price above \$50-55 per barrel.<sup>1</sup>

Based on the above, significance of the macroeconomic forecasts as of June 2014 remains. Main parameters of this forecast are: GDP contraction by 5%, reduction of the nominal income of population by 1%, and the fall of the real income by 8% (with average annual oil price at \$35-40 per barrel, and ruble exchange rate at 80-90 per USD).

Calculated in June 2014 forecast of the Moscow housing market for 2015 in relation to the primary market (*Fig. 12, a*) proved to be overestimated regarding absorption indicators (by 17%), equal actual data on price (decline by 9-10% against actual data of December 2014), but underestimated the supply volume (by 12%). In 2016, further price reduction by 3-4% was projected. Forecast for the secondary market (*Fig. 12, b*) closely coincided with the assessment of main indicators (demand, supply, and price), except lower estimate of absorption (by 12%).

<sup>1</sup> *Drobyshevsky S., Petrenko V., Turuntseva M., Khromov M.* Forecast 2016–2017: recession remains. OMEO. 2016. № 1(19).

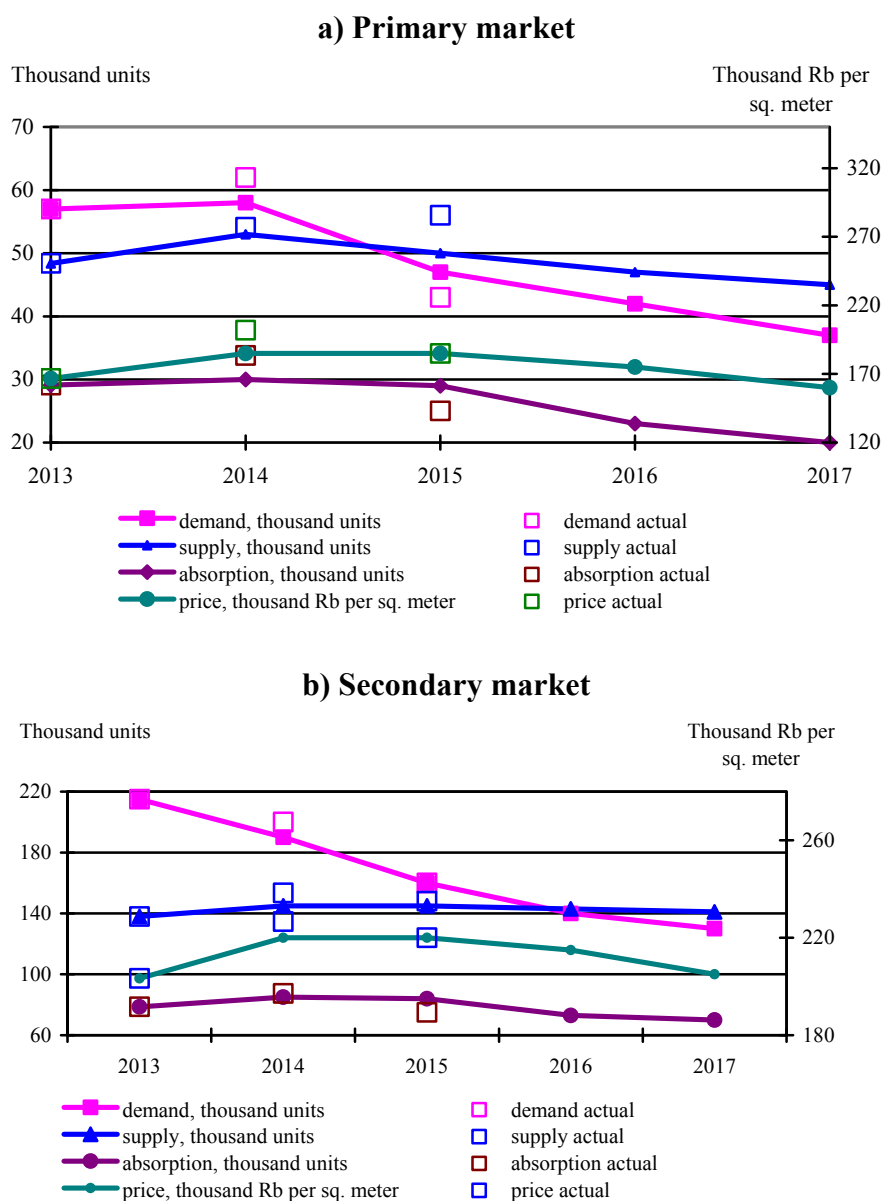


Fig. 12. Forecast of demand, supply, absorption of apartments and price dynamics on primary and secondary markets of Moscow

Source: JSC Sternik Consulting.

Forecast of the main parameters of the Moscow housing market of June 2014 seems justifiable for 2016. Further decrease of demand and prices on both markets by 4-5% with reduction of supply below demand on the primary market and its retention on the secondary one.

Computed in March 2015, forecast of the Moscow housing market development regarding the primary market (Fig. 13, a) proved to be overestimated in relation to demand and absorption and underestimated regarding supply. Price projection practically coincided with actual data (reduction by 1.3%). Forecast for the secondary market (Fig. 13, b) for 2015 somewhat overestimated demand and absorption, supply as well as happened to be above actual data on price

(by 2%). For 2016, further decline of demand, supply, absorption, and price by 2-3% is projected.

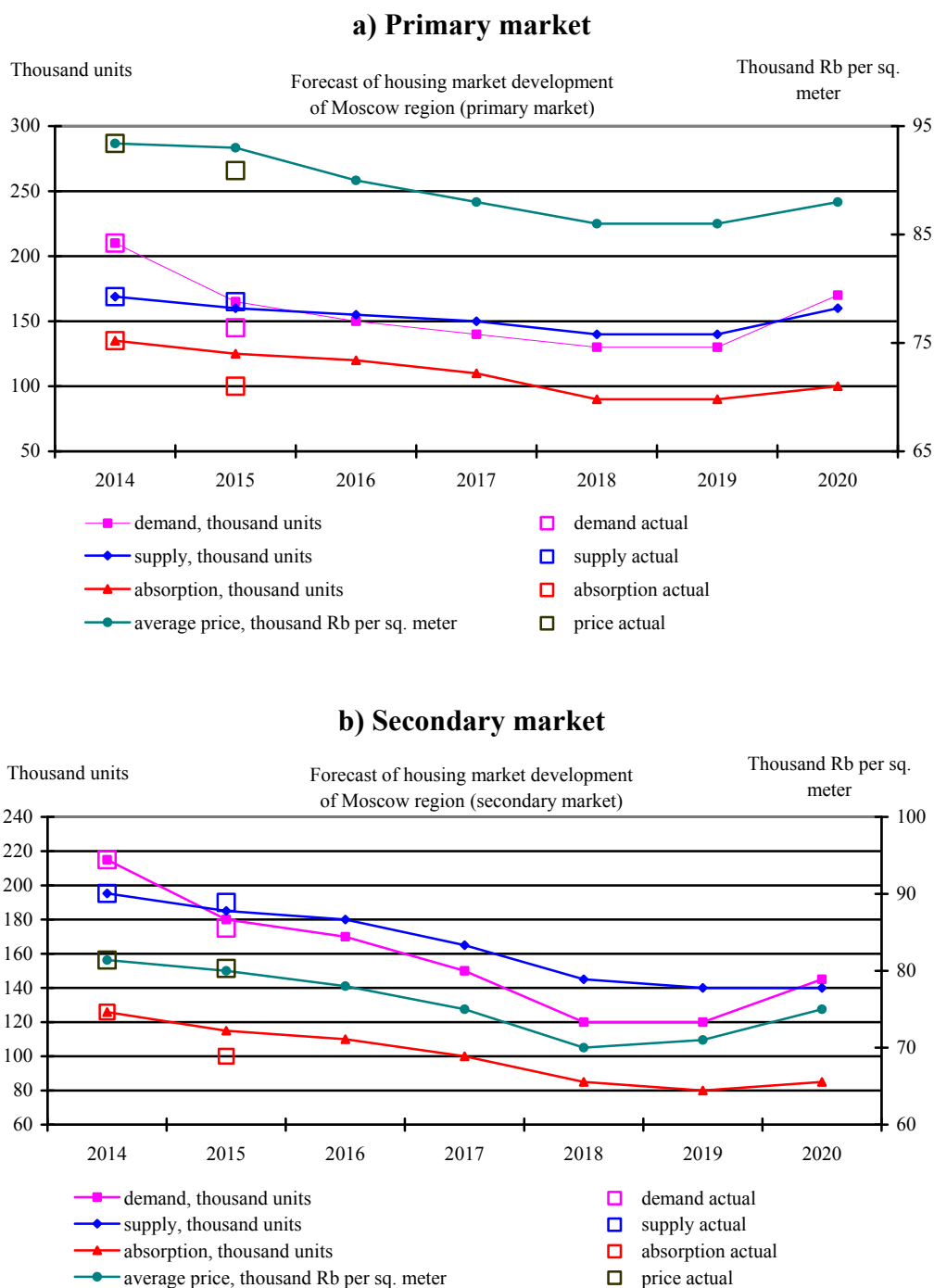


Fig. 13. Forecast of demand, supply, absorption of apartments and price dynamics on primary and secondary markets of Moscow region

Source: JSC Sternik Consulting.

In 2016, significance of the March 2015 forecast remains. Both on the primary and secondary markets further decline of demand, supply, absorption and price is projected by 2-3%.

Expert assessments of the market participants contradict model calculations. For example, A. Nazarov, Chairman of the board of directors of group of companies Granel, expects a contraction in the building industry by 10-15%.<sup>1</sup> Head of the RF Ministry of Building, Mikhail Men, estimates the building industry outlook as complicated one due to contraction of the consumer demand. Possibilities of the government to support the industry are limited due to expected problems with pumping up the budget where subsidized mortgage creates long-term liabilities for the whole life of such loans. In this context, a lot depends on the ability of the developers to self-adjust to the market and cater for the reasonable profit.

Projected continuation of the recession on the housing market of Russian cities does not signify the market collapse, at least in 2016. The housing market demonstrated resilience to unfavorable effect of macroeconomic and political difficulties due to both its lower level of globalization and timely support on the part of the government.

## 6.4. The North Caucasus: risks are on the rise

### 6.4.1. An aggravation of the situation around the inter-Islamic conflict in the North Caucasus<sup>2</sup>

Since mid-2015, the republics of the north-eastern Caucasus (Dagestan, Chechnya and Ingushetia) have been experiencing a new round of escalation of the conflict, which is rather simplistically interpreted by many observers as a controversy between Sufis<sup>3</sup> and Salafis. It should be noted that the law enforcement agencies and even the authorities of the North Caucasian republics are also most heavily involved in that conflict.

It should be reminded that, beginning from the early post-Soviet era, the religious life in the North Caucasian republics has been complicated by an ongoing conflict between different Islamic religious movements: traditional Islam (represented in the north-eastern Caucasus by a variety of Sufi orders) and nontraditional Islam (represented by fundamentalist movements that call for a return to the fundamentals - the Quran and Sunnah, and rejecting any innovations, including anything that has to do with Sufism; usually they all are referred to as Salafis - a general term that is not quite correct). The conflict rather promptly flared into violent confrontations (the catalyst being the war in Chechnya), and until the late 2000s the principal method to be applied in resolving the situation was considered to be suppression by force of nontraditional Islam. However, since the late 2000s, in a number of the North Caucasian republics (most actively – in Ingushetia and Dagestan) the powers-that-be began to make attempts to find some alternative civilian methods of settling the conflict on the basis of amicable agreements. At the level of republican authorities, it was admitted that the fact of belonging to one or another Islamic movement is by no means a crime *per se*, as it complies with the right of religious belief as stated in the Constitution of the Russian Federation up until the moment when an individual becomes a proponent of violence or actually takes up arms. So, the Salafi mosques began to function relatively without constraints, and those Salafi leaders who were not calling for *jihad*

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<sup>1</sup> Tonus for Building. Big Moscow. February, 17, № 6 (87) p. 6.

<sup>2</sup> Author of this section: Starodubrovskaya I. – Gaidar Institute for Economic Policy.

<sup>3</sup> Sufism is defined as a mystical dimension of Islam; it implies commitments of the murids (believers) to the sheiks who have access to superior mystical knowledge.

were allowed to preach freely. Negotiations were launched between representatives of the conflicting Islamic movements with the purpose of separating the religious processes from politics and to elaborate some civilized forms of interaction in a social context. The commissions for the adaptation to peaceful life of the persons who have decided to discontinue their terrorist and extremist activities began to function. All these developments conducted to reestablishing a normal life in the republics and significantly brought down the scale of violent acts.

Nevertheless in early 2013, nearly all these processes were brought to a halt, and the suppression-by-force scenario once again came to the fore. Large-scale counter-terrorist operations, persecution of Salafi preachers, and pressure on the believers were on the agenda once again. The adaptation commissions were no longer active. The only republic where the process of appeasement by civilian means was more or less continued thanks to the position of its head, Yunus-bek Yevkurov, is the Republic of Ingushetia.

The cause of strongest indignation among the believers - and first of all in Dagestan - is the so-called *prophylactic registration*, or *Wahhabi* lists. On the basis of some arbitrary superficial features (personal appearance, apparel) people are taken to police stations, photographed and made to take blood and DNA tests, and then are required to also bring their families for the same sort of testing. Thereafter, those who have been put on these lists experience difficulties in traveling freely across the territory of the North Caucasus, as well as elsewhere in Russia; besides, they are regularly called for 'prophylactic' interviews and subjected to house searches. In other words, they are unlawfully restricted in their constitutional rights, and the normal flow of their everyday life is disrupted. Quite often, even those individuals who never go to a mosque or perform salah, or even those who drink alcohol, are put on these lists. We know one case when a man who worked at the mayor office in Makhachkala was listed as a *Wahhabi* in his native village.

Here is one more example of how people can be placed on a *Wahhabi* list. *'My friend was stopped while driving his own car, so that his documents could be checked at the Sulak checkpoint. This was at 1 pm. It turned out that he had a prophylactic registration, he was a Wahhabi. So he, with his car, was taken to district police headquarters, and released only as late as 2 am the next morning. He, and others like him, sat there waiting for a prophylactic interview, a total of 15 people. It is a good thing that he had not taken his family with him, I cannot imagine how all this would proceed if you have your wife and children with you. They practically ate nothing, except some buns that they bought at the canteen with their own money. ... And when will a man have time to work, to earn his living, if he is taken every time to police headquarters? People have families with small children, who need to be fed.'*

However, in contrast to the developments observed over the period from the mid-1990s to the late 2000s, the new use-of-force scenario did not translate into an outburst of violence. Moreover, the scale of violence has begun to recede at a rapid pace. In 2015, the following indices declined on 2014 in the North Caucasus: the number of victims in armed conflicts dropped by half - from 525 to 258; the number of casualties dropped by 39%, that of wounded – by 73%; the number of terrorist attacks declined by 33%, that of bomb explosions – by 45%. The total number of incidents with the use of weapons in the North Caucasus went down from 141 in 2014 to 86 in 2015 - that is, by 39%<sup>1</sup>. We may point to the following main factors behind this situation.

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<sup>1</sup> See <http://www.kavkaz-uzel.ru/articles/277423/>

*Firstly*, the antiterrorist policy in this case by no means targeted only the rank-and-file militants. Some representatives of the Dagestani elite, who are accused of having connections with the *armed* underground resistance movements, have also been subject to criminal prosecution. By doing so, the authorities have undermined the support of unlawful armed formations by the elite, and managed to disrupt their cash flows. There is no doubt that this helped to suppress the activity of the militants.

*Secondly*, we can observe an outflow, on a mass scale, of the radically-minded young people to Syria, where they join either the terrorist organization *Islamic State* (or ISIS, whose activity is banned in the territory of the Russian Federation) or the jihadist groups that oppose the ISIS. According to available information, until recently the law enforcement agencies have not been preventing their exit from Russia in any serious way. Thus, a group of popular Islamic preachers managed to leave Makhachkala and join the ISIS, although one of them had been placed under house arrest.

*Thirdly*, some serious changes have occurred in the underground resistance movement itself. In 2015, Aliashab Kebekov and Muhammad Suleimanov – two leaders of *Imarat Caucasus* (an organization that is also banned in the Russian Federation, because since November 2007 it had led and coordinated the activity of unlawful armed groups across the region) were killed. Since then, in all evidence, no new leader of *Imarat Kavkaz* (the Caucasus Emirate) has been elected, and the organization is experiencing a deep crisis - if it still functions at all. At the same time, it is a known fact that in 2015, these armed groups on a mass scale took an oath of allegiance to the ISIS. Their oath was accepted, and the ISIS set up its *vilayat* (branch) in the Caucasus. However, it is still unclear what the consequences of this recognition might be. In December 2015, the Federal Security Service's Director Alexander Bortnikov stated that out of the 26 leaders of groups in the North Caucasus that have taken an oath to the ISIS, 20 had been killed in 2015<sup>1</sup>.

Nevertheless, the currently receding violence can hardly be considered as a legitimate reason for conceited self-satisfaction. It is evident that under the influence of ISIS ideology, and also as a form of popular response to the wholesale resort to force by law enforcers, the hidden radicalization of the believers is an ongoing process. In 2015, armed attacks on the civilian population, with casualties, once again became a fact of life, and such incidents are most typically reported in the south of Dagestan, and particularly in Derbent, where a group of tourists came under fire, which claimed the life of one person and wounded another eleven. The information on counter-terrorist operations in Kabardino-Balkaria began to appear with increasing frequency. Besides, in response to the interference of the Russian Federation in the Syrian conflict, a number of prominent radical preachers declared *jihad* against Russia; there were calls for Muslims not to go to Syria, but to fight in the Caucasus. So far, it is difficult to make any definite conclusions as to the seriousness of this new factor (according to available evidence, radicalized young people still cherish the hope of departing to Syria. However, it is clearly not conducive to any improvement in the existing state of affairs.

It is against this background that the onset of the dramatic conflict around the so-called Salafi mosques began in Dagestan and Ingushetia.

The first manifestation of that conflict was the confrontation in the Nasyr-Kort mosque in early June 2015. Nasyr-Kort is the name of a large village that has become a suburban district of Nazran, the capital of the Republic of Ingushetia. The imam of that mosque is Khamzat

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<sup>1</sup> See <http://www.kavkaz-uzel.ru/articles/277423/>.

Chumakov, a religious leader who has gained popularity across the entire North Caucasus. He is famous not only for his criticism of Sufi religious rites, but also because in his sermons he speaks about acute social issues and criticizes the authorities for their failure to provide proper protection to the poorer and socially vulnerable strata of the population.

The direct trigger of the conflict was the purely theological issue of the difference between Sufi and Salafi rites. After an international theological conference, where some globally acclaimed Muslim theorists sided with Chumakov, and not with the Ingush *Mufti*, the Salafi Imam took a tough standpoint, and so an attempt was made to dismiss him from his post, to be replaced by somebody who would be loyal to the *Muftiyat*. In spite of the special measures that had been planned in advance in order to prevent violence, a fight took place inside the mosque, and gunshots rang in its courtyard. Obviously, the confrontation resulted from some deeper-rooted controversies in Ingush society that go far beyond the minor theological issue that had actually triggered it, and with regard to which the Salafi imam was prepared to take a more relaxed attitude (and this is what happened later on).

This incident deeply shocked Ingush public. Various civil organizations immediately got actively involved in deescalating the conflict. On June 10, a roundtable was held at Magas by the Cultural and Educational Center *Ezdel*, the Non-governmental Organizations Coordination Council and the Ingush Regional Branch of the Russian Red Cross, its theme being 'The Role of Non-governmental Organizations in Consolidating Ingush Society'. At the end of the discussion, the roundtable participants called to each side in the conflict not to resort to the use of force and to start a dialogue in order to settle the disputed issues. Head of the Republic of Ingushetia Yunus-bek Yevkurov, who had promptly condemned the conflict at the mosque, was for some time uncertain as to which measures were actually necessary for its resolution, and he even put forth the idea that the mosque should be closed down until the situation returned to normal. However, a few days after the conflict, he himself took part in *Jummu'ah* (*Friday Prayer*) at the Nasyr-Kort mosque, where all had become peaceful by then. So the conflict receded for the time being. But this was the end of the matter.

In late December 2015, the head of Ingushetia called for the *mufti* to leave his post, and for the *Muftiyat* to cooperate with the representatives of all Muslim groups, to abstain from dividing the community into 'friends' and 'enemies', and to work towards consolidation of Ingush society. He also emphasized the necessity to transfer the functions associated with the organization of *hajj* (pilgrimages to Mecca and Medina) from the *Muftiyat* to a body subordinated to the government of Ingushetia in order to rule out any speculations about corruption schemes being applied in the relevant procedures. A few days later, an assistant adviser on religious issues to the head of Ingushetia was appointed, who belonged to the same *taip* as the republic's *mufti*. He was assigned the task of creating an Administration for Religious Affairs.

However, the *mufti* (who had been previously supported by Yevkurov during his second electoral campaign) refused to resign, pointing out that the *Muftiyat* was independent of the civilian government. Moreover, he effectively turned for help to the head of neighboring Chechnya, Ramzan Kadyrov. On 29 December, the Spiritual Directory of Muslims in the Chechen Republic held a meeting of the religious activists of Chechnya and Ingushetia, whose goal was to denounce the legitimacy of any religious current deemed to be an alternative to Sufism; the followers of such currents were dubbed 'preudo-Salafis'. In his speech at the meeting, Ramzan Kadyrov resorted to threats and personal accusations aimed against some eminent Salafi imams in Ingushetia, as well as gave a promise to fight *Wahhabism* across the entire North Caucasus,

if the authorities of other North Caucasian republics are not sufficiently active and vigorous in this respect.

It should be noted that the 'wave' of transition, over period 2009–2012, from the pure use-of-force scenario to attempts at civil appeasement bypassed the territory of Chechnya. Here, the monopoly of the *Qadiriyya* (a Sufi order [tariqa]) is fully supported by the authorities, and the struggle against *Wahhabis* (the name being applied to everybody who is critical of Sufism and the Chechen authorities) is constantly being proclaimed as one of the top priorities of the republic's leaders. As a result, Chechnya has become the natural center of attraction for all those who are against religious tolerance and resort to the use of force in dealing with all theological issues.

In this particular case, the situation is further complicated by the rather chilly relationship between the leaders of Ingushetia and Chechnya, which becomes manifest now and then in connection with various issues. Because of this, the *mufti's* call to the Chechen authorities was viewed by certain groups in Ingushetia not just as the next phase in a religious conflict, but as a betrayal of their ethnic interests, Kadyrov's tough stance with regard to Salafis in the North Caucasus as his interference with the affairs of a neighboring republic.

So far, no solution to the conflict has been achieved. The *mufti* is still in his post. Different political forces in the Republic of Ingushetia publicly voice their various opinions on this issue. Several meetings of Ingush *taips* took place, as many of their eminent representatives had been dragged into the conflict. There was even a suggestion that the leaders of the republic and the *Muftiyat* should simultaneously resign.

The situation in Dagestan has been in no way less dramatic. It all started with an isolated tragic event in the village of Novy Kurush in Khasavyurt district (the village is a big Lezgian enclave with a population of more than 7,000), where on 9 September an imam was murdered. That village can be described as a 'deeply divided community' with two functioning mosques, one of them subordinated to the Spiritual Directory of Muslims, and the other considered to be 'Salafi'. It is the imam of the former mosque that was killed. Two of the village's natives, who had joined the illegal armed groups and then were liquidated in the course of a special operation, were accused of the murder.

It is difficult to reconstruct a veritable picture of these events on the basis of available information. According to some sources, the village was the site of severe conflicts based on religious differences, and the imam who fell victim to this feud had tried to struggle against the Salafi 'heresy'. According to other sources, in spite of the community split and the two mosques, the imam was respected by the village residents, including representatives of the 'enemy camp', because he tried to rely on a well-substantiated dialogue. The imams of the two mosques interacted and joined their forces in dealing with the common issues of rural life (a situation that is not very typical of Dagestan). According to some available information, the two persons accused of the imam's murder had close ties with the village's Salafi community, while in accordance with another version they were born in the village, but at the time had no contacts with its residents.

In any event, the murder of the imam evidently made the situation even more tense. On 22 September, the Salafi mosque in the village was closed down, and its imam and 20 members of the congregation arrested. The mosque was closed down by force: its doors were welded shut, and the congregation's apparel and the mosque's property, including religious books, was burnt. In all this, the law enforcement agencies took no part.



From late autumn 2015 onwards, the struggle against those mosques that refused to be controlled by official Islamic structures began to spread across the region. In late November, one Salafi mosque (in Kotrov Street in Makhachkala) that was famous not only in Dagestan, but across the entire North Caucasus, was closed down. The process was rather chaotic. Against the background of large-scale detentions of worshipers, the Spiritual Directory of Muslims at first made an attempt to replace the imam of the mosque. This decision immediately sparked mass protests, and the Spiritual Directory backtracked, suggesting to replace the new imam with a person highly respected by both Sufis and Salafis – the Imam of the Central Mosque of Makhachkala, Magomedrasul Saaduev. When the congregation rejected his candidature, the Spiritual Directory of Muslims washed its hands of the matter and announced that the replacement of the imam had been caused not by its intention to establish control over the mosque, but by the threats of the law enforcement structures that otherwise they would close down the mosque. The law enforcers were true to their word, and in two day's time the mosque was closed down and has not been reopened since then.

The closure of the mosque in Kotrov Street has not resulted in active opposition on the part of the Muslim community of Makhachkala. It can be assumed that there were two main reasons for this. Firstly, according to a number of Islamic activists who shared their opinion of this issue with the authors, at that time the mosque's congregation was engulfed in a severe crisis. Mosque activists had isolated themselves from the rank-and-file worshipers, and the congregation as a whole was deeply divided and fragmented. To make matters worse, the mosque had not had a permanent imam for quite a long time. Secondly, there were (and still are) plenty of other mosques in Makhachkala that could be attended by representatives of non-traditional Islam. The most well-known of them is the mosque in Hungarian Fighters Street. Although this mosque and its imam were also subjected to pressure and threats, this house of worship is still smoothly functioning.

The events in Kortov Street had their direct continuation in a new round of Salafis mosque-closures which began in early 2016. On 29 January, a mosque in the settlement of Shamkhal (a sub-municipality of Makhachkala) was forcibly closed down. On 31 January, came the turn of the so-called North Mosque in Khasavyurt, one of the Salafis mosques, whose imam had been detained in December 2015 (it is widely believed in Dagestan that charges against him were fabricated). As in the case with the Novyi Kurush mosque, the entrance door of the mosque was welded shut, under the pretext that the application for permission to hold religious services at the mosque had been improperly composed. It turned out later that all the relevant documents and applications were composed absolutely properly. According to available information, the imams of the other Salafi mosques in this area also came under pressure to stop their activities in both Khasavyurt and the nearby districts.

In contrast with the closure of the mosque in Kotrov Street, the situation in Khasavyurt was met by an active response from the worshipers. On 1 February, between 5,000 and 8,000 people (mostly young) took to the streets. They headed towards the town administration Khasavyurt, and the ensuing negotiations ended in the keys of the mosque being handed back to the community. The demonstration was not marked by any criminal incidents. Meanwhile, in Makhachkala the editorial office of the *Chernovik* Newspaper hosted a roundtable with the participation of religious activists, representatives of the public and journalists, who discussed the issue of the closed mosque. The participants urged all the sides in the conflict to settle their disagreements by way of a peaceful dialogue, and not in the form of a violent confrontation.

While this text was being prepared, the conflict around the closure of mosques refocused on Derbent, where accusations were brought against one of the local imams, and the law enforcement agencies there prevent the congregation from gathering in the mosque where he had performed *salah*.

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So, what are the *conclusions* that can be made on the basis of our analysis?

*Firstly*, attacks on Salafi mosques take place under the following conditions:

- the use-of-force scenario applied recently in the struggle against non-traditional Islam appears to be successful, because the incidence of terrorist attacks and the number of their victims plunged sharply (although it is by no means evident that this trend will persist throughout 2016);
- increasing concerns are associated with the outflow of young people to the war in Syria, including with the purpose of fighting for the terrorist group Islamic State;
- there exist mosques where the outflow of the members of their congregations and religious activists to Syria, sometimes to join the ISIS, is very intense.

It can be assumed that the closure of such mosques is an effective method of neutralizing those radicals who urge young people to go to Syria. However, in reality the effect of their closure may be quite opposite. Those religious radicals who had been attending those mosques will not disappear into thin air, and the young people who listen to them will hardly go with the wind. But the imams, with their much more moderate attitude, will no longer be able to prevent such recruitment, because it will be taking place in private apartments or in clandestine houses of prayer. And the recruiters will be able to use stronger arguments – the closure of mosques will be relied upon as a precedent that confirms the fact of Muslims being oppressed and prevented from exercising freely their religion.

*Secondly*, such increasingly frequent conflicts evolve into open manifestations of protest, while at the same time remaining peaceful and not translating into acts of violence. Recently, protesters have become better organized and more disciplined (as noted earlier, the demonstration in Khasavyurt proceeded without a single breach of the law). The participants in the conflict are becoming more active in the mass media, and there have been attempts on the part of civil society to act as a mediator in such situations. So, how can these processes be estimated?

On the one hand, the desire to settle the disputed issues peacefully, on the basis of constitutional principles, without hooliganism and plunder is a positive development. It should be noted that the group of Dagestani religious activists who joined the ISIS (and are now responding rather eloquently from its ranks to the current events in the Caucasus) estimated very negatively the outcome of the conflict around the North Mosque: in their opinion, instead of *jihad*, the people meekly followed those who had been calling to cooperation with the ‘authority of the infidels’ in a civil rights framework.

On the other hand, it would have been much better for the authorities to resolve such conflicts in a dialogue mode, by organizing negotiations between representatives of the bodies of state authority, law enforcement agencies and civil society (including the Muslim communities acting within the framework set out by law). To fall into the habit of mass mobilization for protest actions, and moreover, when it leads to success and creates the impression that the only available method of settling any issue would be to get large crowds of no less than 5,000 people out

onto the streets, is a dangerous course, and there are no guarantees that such actions will always remain so well-organized and non-violent.

And *thirdly* and lastly, the recent conflict once again demonstrates that everything that we are witnessing now has not originated solely from the controversies within the Islamic community. Religious conflicts have sometimes been taken advantage of, and sometimes have been purposefully provoked within the framework of those political processes that have been going on in the North Caucasus and elsewhere in Russia. And it should be pointed out that in this context, the forthcoming election of the head of Chechnya is no less (or probably even more) important that the controversies concerning *Jummu'ah* (*Friday Prayer*) between different Islamic movements.

#### 6.4.2. Local self-government: alterations in regional legislation as risk triggers<sup>1</sup>

One of the vectors of change in the North Caucasus in 2015 was the abolition of direct popular vote in the elections of heads of municipal formations. Very few of the municipal districts, urban districts, urban-type and rural settlements across the North Caucasus are still applying the system of forming the bodies of local self-government (LSG) that envisages that the head of a given administrative entity should be elected by direct popular vote. The most drastic changes in this respect occurred in 2015 in the Republic of Dagestan, where new legislation was adopted whereby a uniform method for forming the bodies of LSG was introduced for the entire region, when only the deputies of rural settlement and urban district assemblies are elected directly by popular vote. That region can serve as an illustration of how the 'rolling back' of direct popular elections to LSG is fraught with significant risks, and so cannot be regarded as a stabilizing factor.

The process of changing the municipal administration system aimed at the unification of methods of forming the bodies of LSG without direct popular election of district heads was launched after the approval, by the People's Assembly of the region, of Law of the Republic of Dagestan of 16 September 2014, No 67 'On the Procedure for the Formation of the Representative Bodies of Municipal Districts of the Republic of Dagestan and for the Election of the Heads of Municipal Formations of the Republic of Dagestan'. By that law, direct popular elections were abolished in all the municipalities across the republic's territory<sup>2</sup>. Then, by Law of the Republic of Dagestan of 16 March 2015, No 26 'On the Introduction of Alterations to Article 2 of the Law of the Republic of Dagestan 'On the Procedure for the Formation of the Representative Bodies of Municipal Districts of the Republic of Dagestan and for the Election of the Heads of Municipal Formations of the Republic of Dagestan', a single procedure for the formation of local self-government bodies was introduced for the entire region, which envisaged that the heads of the administrative bodies of municipal formations should be elected through contest. In accordance with that law, heads of districts and towns are to be elected by the assemblies of rural districts and towns, whose members, in their turn, are selected from among the deputies of the assemblies of rural settlements or urban districts. The assemblies of rural districts and towns may also include the administration heads of rural settlements or urban districts elected

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<sup>1</sup> Author of this section: Kazenin K. – RANEPА.

<sup>2</sup> It should be noted that, according to observers, the hasty adoption of this law was determined by the entry into force of the verdict in the criminal case of Mayor of Mahachkala Said D. Amirov: in order to avoid direct popular election of mayor of Dagestan's capital, the republican authorities had had to legislatively alter the procedure for the formation of LSG bodies before Amirov was officially convicted.

to their posts through contest. It should be noted that the last provision of the regional law is made disputable by the Ruling of the Constitutional Court of the Russian Federation of 1 December 2015, which states that Federal Law of 6 October 2003, No 131-FZ 'On the General Principles of the Organization of Local Self-government in the Russian Federation' does not envisage that the representative body of a municipal district should include the heads of settlements elected by the representative bodies of the corresponding settlements from among the candidates presented by a contest commission in accordance with the results of a contest. Some of the innovations introduced by the new laws have to do with Dagestan's capital Makhachkala, where three urban districts were set up, and it was established that the deputies of the assemblies of these urban districts should elect, from among themselves, the deputies to the city assembly to participate in the procedure of electing the city mayor.

The republic's new legislation was applied in the municipal elections on 13 September 2015. On that day, Dagestan held elections to five town assemblies, to the district assemblies of the city of Makhachkala, and to the assemblies of deputies in all the rural settlements across 37 municipal districts. After the elections, the town assemblies launched the process of appointing through contest the heads of urban administrative bodies, while the assemblies of deputies in rural settlements and the district assemblies of cities and towns began to elect, from among themselves, the deputies to rural district assemblies or town/city assemblies. The latter, in their turn, were to take part, at a later stage, in the appointment through contest of the heads of administrative bodies of their rural districts or towns.

As of the end of 2015, the process of forming the bodies of local self-government in accordance with the new procedure had still not been completed in some of the municipal and urban districts. However, the progress of that campaign as a whole has led to a number of conclusions as to the consequences of the changes in the region's LSG system. *The main consequences* may be summed up as follows:

1. There was a further decline in the personnel stability in the system of local self-government. In a number of Dagestan's towns, for the period until the head of a town was elected through contest, the Head of Dagestan appointed an acting head thereof. In conditions when the decision on the candidacy for head of a town is rendered by a contest commission, where the regional authorities have considerable powers, the appointment, by the decree of the region's head, of one or other official to the position of acting head of a town, there is a high probability that this official will be supported by the regional authorities in the framework of the contest commission. Accordingly, each of the appointed acting heads of towns was always seen as a *de facto* head of the corresponding town whose appointment to this position was practically guaranteed. The appointee would then begin reappointments to positions controlled by the urban self-government, local businesses would begin establishing informal relations with him... and then suddenly he would be replaced as acting head of the town by another official. It is obvious that this situation inevitably resulted in an unpredictable situation at the municipal level. If the heads of towns were to be elected by popular vote, such destabilizing scenarios would be far less possible because nobody's election to this post would be seen in advance as guaranteed and predetermined.
2. The opponents of the elected district and urban administrations have got a good reason for claiming that their election was illegitimate because the urban or district assemblies that elected them included the heads of village or urban district administrations, who had been elected through contest, which, according to the RF Constitutional Court, is not envisaged

- by federal legislation. Such claims have already been made, which adds a new element of instability into the LSG system.
3. Some difficulties are associated with the distribution of powers between town and urban districts administrations. As far as the city of Makhachkala is concerned, by the end of 2015 the republic's normative acts had been adopted, whereby the distribution of tax-generated and non-tax revenues between the city budget and the budgets of the urban districts inside a city are regulated. However, no normative acts to regulate the distribution of property between the bodies of local self-government at the city and district levels were adopted. No uniform approach have been elaborated, to be relied upon in preparing such normative acts. The general uncertainty of the municipal property issue is by no means the only negative feature of the current state of affairs. At present, a number of land disputes have remained unresolved in the territory of Makhachkala; one of the sides in that conflict is represented by the residents of those rural settlements that became part of the city in the last years of the Soviet era or after the collapse of the USSR. The conflict has arisen because the residents demand the allotment to them, for private housing construction, of those plots of land that had been assigned to the settlements to be used as agricultural land before each of the settlements was included in the city territory. Some of these conflicts are very acute, and have a political resonance at the regional level. At present, there is a risk that tensions related to these conflicts may increase due to the stalemate situation, when lands ownership rights are not delineated between the district and urban self-governments, and so the residents of settlements have nobody to apply to in search of a solution.
  4. The perpetually present risks of violence in the struggle for influence in the municipalities. One of the examples of this phenomenon is the situation in the town of Buinaksk (63,000 residents), where the town assembly election in September 2015 was won by the opponents of the then head of this town. After all attempts to reach a compromise over the candidature of head of the town turned out to be fruitless, the conflict of interests spilled over into the streets, where a series of non-sanctioned rallies took place with the participation of 'opposition' deputies. In the course of these rallies, demonstrators repeatedly clashed with law enforcers. It can be said with confidence that the main argument against heads of municipal formations being elected by direct popular election – the risk of violent incidents and the risk of general destabilization accompanying such elections – has proven groundless, because such risks have remained high in the course of the struggle for power in the municipalities in spite of cancellation of direct popular vote.

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Thus, the example of the Republic of Dagestan shows that the changes in the system of LSG formation introduced in 2015 in the republics of North Caucasus are not conducive to the achievement of the goals set by the initiators of those changes - namely, the strengthening of the socio-political stability at the municipal level, and the minimization of the risks of violent confrontations and manifestations of extremism in the course of struggle for seats in LSG bodies. As a matter of fact, the first experience of LSG-bodies formation under the new system was far from being devoid of conflicts between contenders for positions in LSG. Moreover, it exerted a negative impact on the course of a number of conflicts that were not directly related to local self-government. On the whole, last year has shown that the trend towards decreasing the role of direct popular vote in LSG formation in the North Caucasus is fraught with negative consequences.

## 6.5. Military economics and military reform in Russia

Unlike previous years, the findings of analysis of Russia's military economics and policy in 2015 fail to match what is perceived as absolute peacetime. The IISS, a world-leading authority on global security,<sup>1</sup> argues that Russia is conducting a so-called hybrid warfare. The published views of western experts on hybrid warfare reflect the events occurred in Ukraine over the last two years.

The spring of 2015 saw changes in accusations against Russia following Russia's air strikes and cruise missiles strikes on the positions of ISIS terrorists in Syria. The fact that Russia is conducting special-purpose military operations is indisputable. Russia took the terrorist attack that brought down the Russian plane in Egypt, killing all 224 Russian passengers on board, as military assault against Russia's nationals, thus forcing Russia to introduce retaliatory military counteractions against not only the ISIS in Syria but also against organizers and sponsors of terrorism. Later there were acts of terrorism in France, that prompted the French government to join the war against the ISIS, acting in conjunction with Russia and with a few other countries. Being unhappy with these developments, the Turkish government prepared the shoot down of a Russian military jet along the Syrian border. Russia responded with economic countersanctions, warning more sanctions could follow. Therefore, it appears logical that a new version of the Russian Federation National Security Strategy (Executive Order of the President No. 683 dated December 31, 2015) was approved on the very last day of 2015.

### 6.5.1. Economic and political preconditions for new type of warfare<sup>2</sup>

The born of a new era of warfare has in recent decades been in the focus of military-political and military-science experts. The new warfare differ basically from the old warfare in the military application of latest scientific and technical achievements basically in the field of informatics, telecommunications, cybernetics, as well as social psychology, etc. Traditional methods of waging and carrying on wars are passing. Following the first brand new war of 1991 (against Iraq), military specialists began to talk about their understanding the novelty of such wars. The focus was first of all placed on the "non-contact" nature of military operations<sup>3</sup> conducted over great distances. Later it turned out that there is much more novelty in new-type wars, especially regarding the waging, conduct and the outcome of such wars.

Specialists distinguish the information aspect which they call information warfare (IW) as the principal characteristic of modern warfare, whereas information security is viewed as a countermeasure. The second specific feature is deliberate chaotization of social relations, the involvement of paramilitary forces, private military corporations in the warfare, and turning a well-ordered peace-time situation into a so-called "controlled chaos".

Russia's Information Security Doctrine has been in effect since 2000, the provisions thereof were recognized in the Russian Federation National Security Strategy in 2010 and enhanced in the updated version thereof. Information security is considered a pressing issue in other countries, too. A new "Cyber" section has recently been added to the Military Balance's traditional sections that describe the state of armed forces and branches, combat power (missiles, air jets, tanks, etc.). The section contains data on national military capabilities in the cyberspace and, broadly speaking, in the information domain.

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<sup>1</sup> Military Balance 2015. London: The International Institute for Strategic Studies, 2015. P. 17.

<sup>2</sup> Author of this section: Tsymbal V. – RANEPА.

<sup>3</sup> Slipchenko V., *Garaev M.* The future of war. M.: OGI (Polit.ru), 2005.

When the new-type warfare became a widespread practice, Russia's Foreign Ministry submitted in 2011 to the UN a draft Convention on International Information Security<sup>1</sup>. It was suggested to limit new (information) weapons and the application thereof similarly to what was done with the application and the spread of nuclear, chemical, biological and other types of weapons of mass destruction (WMD). However, Russia's initiative was not supported, and on July 24, 2013 Russia's President approved the Basic Principles for State Policy of the Russian Federation in the field of International Information Security until 2020<sup>2</sup>.<sup>2</sup> (Note that in 2015 the US military-political leadership agreed to discuss internationally the issues of confrontation in the cyberspace). The above-mentioned official documents of the Russian Federation contain a definition of IW, which is quite useful, although it has not yet been universally accepted. The IW is referred to as "confrontation between two or more states in the information domain with the aim of causing harm to information systems, processes and resources and to other critical units; undermining political, economic and social systems; producing a massive psychological effect on the population in order to destabilize society and the state; and forcing a state to take decisions in the interests of the opposing side". This is forceful *persuasion* of a state by any other state (states) in the interests of the latter that prompts one to consider such confrontation a *war*.

The above-mentioned objective of undermining the economic system is of special interest. Belligerent states had the same objective during past wars, too. However, sanctions have become an efficient tool in modern warfare in the context of globalized economy. Furthermore, Western IW military analysts and practitioners *include sanctions in the list of new warfare means*, as evidenced by a special section of another handbook<sup>3</sup> on the theory and practice of dealing with defense issues.

With such a broad definition of IW, it is difficult to separate the conventional military component from the others, all the more so, because new-type wars tend to begin exclusively in the information domain. Paramilitary forces and troops, less often regular armed forces, enter gradually the confrontation, which is followed by conventional, although limited, warfare with great losses of military personnel and civil population. In this case, it is common to say *information war gives way to hybrid war*. Hybrid warfare (HW) can be a part of a hybrid war. An illustration of new-type warfare is Iraq, Yugoslavia, Livia, etc.

What is most woeful in IW and then HW is floods of misinformation by opposing sides, and lies disguised as truth using unprecedented psychological techniques of massive effect on population, and sophisticated, cutting-edge devices designed to process and deliver information to the population. Of special interest is that new-type wars are normally not declared as such, and most of the work is done by others rather than by the aggressor itself. Any IW is conducted within purportedly peaceful relations with purportedly non-military sanctions.

Considering the above-mentioned opinion of foreign experts, as well as the Russian experts' definition of IW, the following argument can be presented.

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<sup>1</sup> Convention on International Information Security. The concept prepared by the UNSC and Russia's Ministry of Foreign Affairs. 2011. URL: [www.mid.ru/bdcomp/ns-osndoc.nsf/e2f289bea62097f9c325787a](http://www.mid.ru/bdcomp/ns-osndoc.nsf/e2f289bea62097f9c325787a) (accessed date: December 11, 2015).

<sup>2</sup> Basic Principles for State Policy of the Russian Federation in the field of International Information Security until 2020. Executive Order No. 1753 dated July 24, 2013

<sup>3</sup> *Kaempfer W.H., Lowenberg A.D.* The Political Economy of Economic Sanctions // Handbook of Defense Economics. Ch. 27. Vol. 2. Defense in a Globalized World. 2007.

In the modern new-type warfare Russia is confronting the states that imposed economic and political sanctions against Russia, as well as Russia is fighting with organizers of acts of terrorism. Hence it is these states that are opposing Russia in the ongoing IW. And the new version of the Russian Federation National Security Strategy for the first time named the United States and NATO and the ISIS as a threat to Russia. Russia imposed similar countersanctions against the states that joined sanctions against Russia, whereas Russia is using means of armed fight against those who use arms.

Indeed, the term “war” appears to be extremely violent, therefore, while using this term one should name all the opposing sides and point to the fact that in this war (IW and HW) Russia is fighting for its political and social-economic interests. In this war Russia is countering an adverse effect of political, financial, economic and other sanctions that are used as special means in the confrontation.

#### 6.5.2. Information-related aspect of defense control<sup>1</sup>

Absolute domination of information technologies and means of information as mainstay of new-generation warfare prompted the development of means of information. Short-term experience in the new-type warfare shows that the mankind surprisingly easily reacted to the way IW-aggressors used information to “brainwash” their victims. Quasi-independent mass media unexpectedly pooled their efforts in “attacking” not only target-countries but also the global community as a whole. And similar quasi-independent IT companies arranged data exchange networks in the cyberspace beyond the government control, thus operating against lawful authorities. One may recall the information “tsunami” that covered the world when IW was waged against Yugoslavia, Iraq, Libya, etc.

The same holds true for Russia. The Russians were exposed to the same effect more than once: in 2008, when a strike on Russia’s peacekeeping forces was followed by Georgia’s military operation in South Ossetia; in 2014, following the coup in Ukraine and the referendum in Crimea; in the fall of 2015, when Russia joined the fight against the ISIS in Syria. One can only guess what kind of methods and means were used to pool efforts of numerous mass media to meet the demand of initiators of each new IW.

Note that economic aspects of military and security agencies’ operations aimed at not only intelligence and counterintelligence but also at propaganda were always confidential. At the same time, the necessity and utility of financial investment in the field of informatics and cybernetics became apparent when the National Defense Control Center of the Russian Federation (NDCC) was established by the end of 2014 and upgraded in 2015. The establishment of the NDCC has proved its value.

First, the cross-sectoral exchange of military-economic data has been streamlined substantially in Russia. “Federal executive authorities and organizations send daily more than thousand information arrays to the National Defense Control Center. The data exchange has tripled over the recent period”, said Head of NDCC general Mizintsev at a meeting with members of the Defense Ministry Public Council.<sup>2</sup> The NDCC sends to mass media official information on Russia’s defense activities. Second, efficiently coordinated control from the NDCC by combined efforts of military and top non-military (local) government authorities, as well as troops

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<sup>1</sup> Author of this section: Tsymbal V. – RANEPА.

<sup>2</sup> URL: <http://www.mk.ru/politics/2015/10/20/obshhestvennyy-sovet-pomogaet-shoygu-navesti-poryadok.html>



(forces) of various armed forces' services and branches, including representatives of other states, was tested during military drills.

Third, the system of military logistics and of supply, jointly with the EMERCOM, of vital goods to the Donetsk and Lugansk People's Republics ran flawlessly. This was performed in cooperation with OSCE representatives. A more sophisticated system was put into operation in the fall of 2015, designed to deliver and deploy in Syria military personnel, equipment and means of armed fight with the so-called ISIS. At the same time, the issues of ensuring cooperation with the Syrian military command authorities and coordination of Russia's forces with the forces of other states involved in fighting against terrorists were tackled successfully.

Forth, what is most important and unusual for military command authorities is that the NDCC helps to implement the idea of end-to-end supervision of all stages of financing, production and delivery of military products while the State Defense Order (SDO) is implemented pursuant to the new Federal Law on the SDO. Quarterly holding of the single day of acceptance of military products was put into practice. In particular, summarizing the outcomes of Q3 2015, Russia's Defense Minister Sergey Shoigu noted "we have learned how to commission facilities and how to supply equipment on a rhythmic basis throughout the entire year, thus avoiding the year-end rush that affected seriously the quality of supplied products and hence their acceptance and distribution in the armed forces".<sup>1</sup>

Since new-type wars, as noted above, are attended with floods of misinformation, the NDCC and the administration of public mass media are seeking to ensure that information is credible. For example, the information on air strikes on ISIS positions in Syria is communicated to all the mass media, specifying the source of such information and not citing unspecified "evidence" from unidentified "witnesses". Summarizing the analysis of information-related aspects of IW, note that from the military-theoretical point of view the world community is witnessing a fight between the initiators of a new global IW and Russia. To win the fight, it is critical not to simplify Russia's actions, and to avoid the news-release technique that withholds the real military capacity of the ISIS and of other opponents of Russia.

### 6.5.3. Military-technical procurement of armed forces<sup>2</sup>

There are two main lines of military-technical procurement of Russia's Armed Forces that have been identified.

On the one hand, the mounting threat that the United States and NATO might have the so-called Prompt Global Strike and the Pan-European ABM System has prompted Russia to keep up its nuclear deterrent capabilities which have had to be given priority. Not incidentally, President Putin at the Defense Ministry Board held on the eve of 2015 stressed upon the need to complete a plan of Russian Federation defense and development of strategic nuclear forces (SNF) as "a factor of maintaining the global equilibrium", excluding the "possibility of major aggression against the Russian Federation".<sup>3</sup> The defense plan was approved as instructed by the President, and Russia's SNF were equipped with more than 50 intercontinental ballistic missiles. In addition, Russia embarked on modernization of its missile carrying bombers fleet including TU-160 and TU-95MS, and put on combat duty the project 955A Borei-class nuclear-powered submarines Vladimir Monomakh and Alexander Nevsky. In addition to this, a new branch of Russia's Armed Forces – Airspace Forces (VKS) – was established in 2015, embracing

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<sup>1</sup> URL: [http://function.mil.ru/news\\_page/country/more.htm?id=12060449@egNews](http://function.mil.ru/news_page/country/more.htm?id=12060449@egNews).

<sup>2</sup> Author of this section: Tsymbal V. – RANEPА.

<sup>3</sup> *Safronov I.* Armed Forces aimed to targets // Kommersant. December 20, 2014.

the air force, airspace and air defense forces. VKS's combat effectiveness was crucial not only in tactical military operations against the ISIS, but also in showing combat capability of the military deterrent forces. On the other hand, the military drill experience and, most importantly, the specifics of military operations against terrorists in Syria prompted the development of operative-tactical means of combat, especially extra supply of tactical precision-guided weapons to destroy ISIS combat control centers and arsenals of weapons. A positive thing regarding this aspect of armament is that the NDCC demonstrated and mass media retranslated the successful employment of guided aircraft missiles, especially X-29 and 500 and 1500 kg caliber guided air bombs. In terms of IW, the facts of employing Russia's precision-guided weapons as well as the facts of rational unification of means of combat, cost-efficiency of their modular design were perhaps more important than the damage they delivered to the ISIS. It appeared that the data on the employment of these weapons were reasonably declassified. The demonstration of the employment of VKS to enhance fire and radio-electronic support of the Syrian ground forces is also useful but less efficient.

It is very important that Russia's actions in Syria proved high efficiency of electronic warfare weapons (EWW) as a key factor of confrontation typical of IW and HW. Adding to the efficient employment of air-based EWW in "forcing" US combat ships to leave some waters of the Black Sea in 2014, which was reported by Russia's mass media,<sup>1</sup> was the well-timed demonstration of the efficiency of Russia's modern warplane IL-20 ELINT (Electronic Intelligence platform) and EWW in Syria.

It appears that such "victories" in the IW are more illustrative than, e.g., the provision of summarized data for Russia and the global community. For example, the fact that "more than 3,000 state contracts have been concluded this year, whereby the armed forces have received more than 17,000 pieces of standard armament, military and special-purpose equipment", as a result of which "the armed forces armament with cutting-edge weapons and military equipment under the 2015 SDO has already reached the parameters planned only for the current year". General data of the armed forces rearmament amid IW are important but they are poorly digested even by military economists.<sup>2</sup>

In addition, Russia's mass media information on increasing stockpiles of precision-guided weapons in Russia's Armed Forces is effective in terms of IW. An information published by *Kommersant-Vlast* with reference to a source in the Military Industrial Complex<sup>3</sup> noted explicitly that Tactical Missiles Corporation, a Russian joint stock company, switched to a three-shift work schedule due to an increase in demand for arms delivery for the military operation in Syria.

It is difficult to say how the IW and HW events reflect the parameters of the new State Armaments Program, but the critique of heavy military spending at the expense of socio-economic spending appears to be reasonable not only because a military effect thereof is not obvious. The point is that there has been found no evidence of fulfilling the promise to turn military spending into a driver for the development of the national economy as a whole and the non-military sector thereof.

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<sup>1</sup> *Bozhyeva O.* The 6th generation war: how we jam hostile radars, satellites and computers. *Moskovskiy Komsolets*. January 8, 2015.

<sup>2</sup> *Vzglyad* dated October 28, 2015 URL: <http://vz.ru/news/2015/10/26/774510.html>

<sup>3</sup> URL: [http://ria.ru/defense\\_safety/20151026/1308245566.html#ixzz3pf4jP87v](http://ria.ru/defense_safety/20151026/1308245566.html#ixzz3pf4jP87v)

#### 6.5.4. Recruitment policy<sup>1</sup>

In our previous reviews we wrote about the issues of the recruitment policy, facing Russia's armed forces; in particular, complete abandonment of peacetime conscription. While the idea of voluntary military service is still pressing, the context was changed after the onset of IW and HW. It appears that the complete abandonment of conscription has to be postponed.

It is extremely important that the nature and terms of one-year conscription have been improved dramatically. Moreover, non-military higher school students have an opportunity to obtain military skills at senior divisions while keeping up the quality of civil education.

The enlistment rate of new contracted military personnel in the armed forces is satisfactory (54,000 persons in 2015), and "the total number of contracted military personnel has recently increased 327,000 persons", noted the Head of NDCC at the above-mentioned meeting.

The Russian government have achieved notable results in providing military personnel with all types of allowances. Even in 2015, despite difficulties due to sanctions, the government managed to compensate in part servicemen and retired military personnel for the fall of living standards. In 2015, the issue of housing provision in Russia's armed forces and other military and security forces was nearly tackled. The system of housing provision management was re-organized with success, which previously comprised about 3,500 full-time managers and above 6,000 members of various commissions, and the central Department for Housing Provision was established with local branches located in each military district, as well as its cells were established in Kazakhstan and Tajikistan. The new system is comprised of about 700 managers, and Alushta software designed in 2011 is employed for real-time unified recordkeeping of all the military personnel in need of housing, and of all the housing stock. It took these bodies five years to tackle housing issues facing about 300,000 families. The number of persons in need of housing dropped from 82,000 to 34,000, with new military personnel being enlisted every year (up to 50,000 families). Furthermore, all the options of housing provision suitable for military personnel still remain in force. At the same time, outlooks were updated: Russia will have a single procedure for housing provision via the savings and mortgage system beyond 2024. Previously, all the military personnel who signed their first military service contract after January 1, 2008, including graduates from military higher schools, were covered on a mandatory basis by the savings and mortgage system.

As noted at a meeting of the NDCC management with the Defense Ministry Board, military service is acquiring more prestige and popularity, as evidenced by the fact that "over the past three years the armed forces have seen the situation with higher military schools change from shortage of applicants to an enrollment competition of 3 to 10 applicants per place this year". Furthermore, not only was military training of students resumed, but it was also focused on new needs. In particular, a well-equipped cadet ITC school for gifted children was opened under the auspices of the Budenny Military Academy of Communications in St. Petersburg.

The disciplinary practice will be enhanced by the establishment of military police in Russia. The legal framework is based on Federal Law "On amendments to certain legal acts of the Russian Federation regarding the military policy in the Armed Forces of the Russian Federation" No. 7-FZ dated February 3, 2014. The Federal Law stipulates the rights and tasks of the military police. A Military Police Charter governing the military police's key duties, functions and powers was approved by the Executive Order of the President, which was signed in late March 2015.

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<sup>1</sup> Author of this section: Tsymbal V. – RANEPА.

#### 6.5.5. Reform to implement the state defense order<sup>1</sup>

The standoff qualified as specific (information) warfare at the international level, which has entered the stage of hybrid warfare, has resulted in the growing need for (high-accuracy, technologically sophisticated and expensive) warfare means. Naturally, efficient spending of state budget funds has become most pressing issue in this context.

In his 2015 annual state-of-the-nation address to the Federal Assembly, Russia's President noted that "misuse of state budget funds allocated for the purpose of implementing the State Defense Order is posing a direct threat to the national security of the state"; therefore, the President instructed to develop a system of strict monitoring of the proper use of SDO funds. A interdepartmental system of this kind was established in Russia. "A new interdepartmental control system comprises a set of interrelated elements such as the single unique state order number across the entire chain of SDO settlements, and the opening by all the contractors of special bank accounts with authorized banks which have become full-fledged parties to the monitoring of proper use of state budget funds", noted Deputy Minister of Defense Tatiana Shevtsova.<sup>2</sup> Hopefully, this will "color" the cash flow allocated for implementing the SDO, separating it (the cash flow) from the rest of the monies held by an enterprise, as well as this will ensure that cash flows are transparent across the entire chain of contractors. Pursuant to the SDO law, the Ministry of Defense has established a single information system of SDO settlements for analyzing the data for SDO settlements. As a reminder, the SDO implementation monitoring has become one of the NDCC's key functions. A list of operations prohibited for specific accounts has become the key tool of preventing misuse of SDO funds. Authorized banks will conduct the compliance monitoring. All in all, this package of measures is assumed to tame corruption within the SDO framework.

#### 6.5.6. Military-financial policy<sup>3</sup>

In 2015, unlike the previous year, the federal budget was executed using more than a single intra-year adjustment, and the federal budget law was updated three times in the period between April and November.<sup>4</sup> Originally, the 2015 federal budget law allocated Rb 3 trillion 274bn of under the National Defense budget function,<sup>5</sup> an increase of Rb 247bn over the amount planned by the government a year earlier<sup>6</sup>. In April and July, allocations under the same budget function were cut to Rb3 trillion 108bn, but in November they were up to Rb 3 trillion 163.8bn (3.9% of GDP). In real terms, the allocations under the same budget function increased 19% (28% in nominal terms) over 2014.

All the foregoing military expenditure are not included into the published laws and are recognized under explanatory notes to the draft budget laws and to the federal budget laws. The transparency of the 2015 federal budget expenditure continued to worsen, exceeding the highest

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<sup>1</sup> Author of this section: Tsymbal V. – RANEPА.

<sup>2</sup> URL: [http://function.mil.ru/news\\_page/country/more.htm?id=12044981@egNews](http://function.mil.ru/news_page/country/more.htm?id=12044981@egNews).

<sup>3</sup> Author of this section: Zatsepin V. – RANEPА.

<sup>4</sup> Federal Law "On the Federal Budget for 2015 and the Planning Period of 2016 and 2017" No. 384-FZ dated December 1, 2014, which was amended by Federal Laws No. 93-FZ dated April 20, 2015, No. 211-FZ dated July 13, 2015 and No. 329-FZ dated November 28, 2015.

<sup>5</sup> "Budget of individuals" to the Federal Law "On the Federal Budget for 2015 and the Planning Period of 2016 and 2017". Moscow. December 2014, p. 8.

<sup>6</sup> The Council of the Federation Committee on Defense and Security's report on Federal Law "On the Federal Budget for 2014 and the Planning Period of 2015 and 2016" No. 3.3-04/1891 dated November 26, 2013.

level of 2014 by 4.2 percentage points while confidential expenditure stood at Rb 2 trillion 980bn (3.7% of GDP, 19.1% of the federal budget expenditure as a whole).

*Table 18* presents absolute and relative values of the key components of direct military expenditure in the 2015 federal budget, including the change in real terms over 2014, which are based on Federal Treasury's reports. Conversion into the 2014 prices was performed using Russtat's second estimation<sup>1</sup> of the 2015 GDP deflator index (107.7%).

*Table 18*

**Federal budget direct military expenditure under 'National Defense'  
budget function in 2015**

Function and subfunctions	2015, rubles in millions/ same in 2014 prices	Changes in 2015 over 2014, rubles in millions/ growth, %	Share of allocations, % / changes from 2014, percentage points	
			of 2015 federal budget	of GDP
NATIONAL DEFENSE	3.181.367 2.953.915	474.841 19.15	20.38 3.66	3.94 0.75
Armed Forces of the Russian Federation	2.432.905 2.258.964	373.105 19.78	15.58 2.87	3.01 0.59
Mobilization and paramilitary training	6.296 5.845	-616 -9.53	0.04 -	0.01 -
Mobilization preparation of economy	4.020 3.733	-218 -5.53	0.03 -	<0.01 -
Nuclear-weapons complex	44.385 41.212	4.495 12.24	0.28 0.04	0.05 0.01
International obligations in military- technical cooperation	10.325 9.587	3.123 48.30	0.07 0.02	0.01 -
Applied research in the field of national defense	318.521 295.749	51.112 20.89	2.04 0.39	0.39 0.08
Other matters pertaining to national de- fense	364.914 338.825	43.840 14.86	2.34 0.35	0.45 0.07

*Source:* own calculations.

Military expenditure under other federal budget sections are presented in *Table 19*. Expenditure for civil defense and for the EMERCOM troops are not included into the military expenditure under other budget functions due to changes in the UN military expenditure reporting standards that have been in effect since 2012.<sup>2</sup>

*Table 19*

**Direct and indirect military expenditure under other federal budget  
functions in 2015**

Subfunction, target function or type of expenditure	2015, rubles in millions/ same in 2014 prices	Changes in 2015 from 2014, rubles in millions/ growth, %	Share of expenditure, % / changes from 2014, percentage points	
			of 2015 federal budget	of GDP
1	2	3	4	5
<b>Nationwide matters</b>				
<i>Defense Ministry Expenditures</i>	8 7	1 17.62	<0.01 -	<0.01 -
<b>National Security and Law Enforcement</b>				
Interior Troops	120.525 112.909	-16.733 -13.01	0.77 -0.10	0.15 -0.02
Border Troops	136.709 127,935	-15.681 -11.00	0.88 -0.09	0.17 -0.01

<sup>1</sup> Concerning the production and usage of the 2015 gross domestic product (GDP). M.: Rosstat. April 1, 2016.

<sup>2</sup> The government expert group's report on the overview of functioning and further development of the United Nations system for the standardized reporting on military expenditure. A/66/89. UN, June 14, 2011.

1	2	3	4	5
<b>National Economy</b>				
Organization of alternative civil service	<u>2</u> 1	<u>&lt;1</u> 8.49	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
Presidential program "Destruction of chemical weapons stockpiles in the Russian Federation"	<u>464</u> 431	<u>7</u> 1.73	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
Subsidies to transport organizations purchasing motor vehicles to increase the military convoy rolling stock	<u>38</u> 35	<u>-17</u> -33.14	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
Subsidies to the Russia-NATO Coordination Center	<u>35</u> 32	<u>-6</u> -15.01	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
Federal Target Program "Industrial Utilization of weapons and military equipment (2011-2015) and until 2020"	<u>66</u> 61	<u>-17</u> -22.05	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
<i>Contributions to charter capital of and subsidies to organizations pertaining to the military-industrial complex</i>	<u>56.760</u> 52.702	<u>13.369</u> 33.99	<u>0.36</u> 0.10	<u>0.07</u> 0.02
Scholarships to young personnel employed by organizations pertaining to the military-industrial complex	<u>237</u> 210	<u>-29</u> -12.21	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
<i>Confidential expenditure</i>	<u>128.034</u> 118.880	<u>9.020</u> 8.17	<u>0.82</u> 0.08	<u>0.16</u> 0.02
<b>Housing and Utilities</b>				
<i>Defense Ministry Expenditures</i>	<u>22.479</u> 20.872	<u>-11.207</u> -34.94	<u>0.14</u> -0.07	<u>0.03</u> -0.01
Presidential Program "Destruction of chemical weapons stockpiles in the Russian Federation"	<u>60</u> 55	<u>55</u> -	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
<b>Education</b>				
<i>Defense Ministry Expenditures</i>	<u>66.704</u> 61.935	<u>1.371</u> 2.26	<u>0.43</u> 0.02	<u>0.08</u> 0.01
<b>Culture and Cinematography</b>				
<i>Defense Ministry Expenditures</i>	<u>3.009</u> 2.794	<u>50</u> 1.82	<u>0.02</u> -	<u>&lt;0.01</u> -
<b>Healthcare</b>				
<i>Defense Ministry Expenditures</i>	<u>56.407</u> 52.374	<u>-3.874</u> -6.89	<u>0.36</u> -0.02	<u>0.07</u> -
<i>Provision of medicines to ZATO FMBA</i>	<u>86</u> 80	<u>-71</u> -46.89	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
<b>Social Policy</b>				
<i>Defense Ministry Expenditures</i>	<u>442.831</u> 392.198	<u>61.892</u> 18.74	<u>2.84</u> 0.61	<u>0.55</u> 0.13
<i>Expenditure for Interior Troops of the Ministry of Internal Affairs and for Border Troops</i>	<u>38.241</u> 33.868	<u>-1.497</u> -4.23	<u>0.24</u> 0.01	<u>0.05</u> -
Material support to specialists employed by the nuclear weapons complex of the Russian Federation	<u>7.172</u> 6.352	<u>-126</u> -1.94	<u>0.05</u> -	<u>0.01</u> -
Repairing individual residential houses owned by military personnel' families who lost their bread-winner	<u>200</u> 186	<u>-39</u> -17.39	<u>&lt;0.01</u> -	<u>&lt;0.01</u> -
Military personnel survivor benefits	<u>1.908</u> 1.690	<u>6</u> 0.35	<u>0.01</u> -	<u>&lt;0.01</u> -
One-time pregnancy allowance to spouses of conscripts, as well as monthly child's benefit to conscripts	<u>1.006</u> 891	<u>-158</u> -15.04	<u>0.01</u> -	<u>&lt;0.01</u> -
<b>Physical Culture and Sports</b>				
<i>Defense Ministry Expenditures</i>	<u>4.202</u> 3.902	<u>1.822</u> 87.64	<u>0.03</u> 0.01	<u>0.01</u> -
<b>Mass Media</b>				
<i>Defense Ministry Expenditures</i>	<u>2.280</u> 2.117	<u>51</u> 2.46	<u>0.01</u> -	<u>&lt;0.01</u> -

*Cont'd*

1	2	3	4	5
<b>General Purpose Inter-Budget Transfers to Budgets of the Budget System of the Russian Federation</b>				
Subsidies to budgets of Closed Administrative-Territorial Units (ZATOs)	9.988 9.273	-2.292 -19.82	0.06 -0.01	0.01 -
Relocation of persons from ZATOs	314 292	-209 -41.77	<0.01 -	<0.01 -
OTHER BUDGET FUNCTIONS	1.099.764	43.918	7.04	1.36
TOTAL	1.021.136	4.30	0.46	0.11

Source: own calculations.

As a result, the 2015 total military allocations (see *Table 20*) in Russia's federal budget, that are calculated according to the UN standards for military expenditure, increased 0.9 percentage points GDP over the past year, to 5.3% of GDP.

*Table 20*

### Total military and military related federal budget expenditure in 2015

Expenditures	Amount, rubles in millions	Share of expenditure, % / changes from 2014, percentage points	
		of 2015 federal budget	of GDP
Total military expenditure related to current and previous military operations	4.281.130	27.42 4.12	5.30 0.86
Total expenditure for 'National Defense' and 'National security and law enforcement' budget functions	5.146.977	32.97 2.19	6.37 0.51

Source: own calculations.

In 2015, the peak of expenditure under the 'National Defense' budget function – Rb 1453bn (45.7% of the total allocations under this budget function stipulated in the budget law, an increase of 6.4 percentage points over the amount a year earlier) – was reported again in Q1 (27.4% in Q4). According to the federal budget quarterly breakdown, the highest amount of expenditure (Rb 24bn) over the limit of allocations stipulated under the budget law for this budget function was seen in December. As a result, the expenditure under the 'National Defense' budget function in 2015 were executed with an excess of Rb 17bn 567m over the allocations stipulated in the budget law's latest version. Furthermore, the Ministry of Defense's overdue accounts receivable increased Rb 242bn in 2015.<sup>1</sup>

In 2015, the Ministry of Defense's military personnel costs stood at Rb 429bn 836m (0.53% of GDP), a decline in real terms by 5% on an annualized basis. Military compensation for the conscripted military personnel continued to be Rb 2,000,<sup>2</sup> the average level of military compensation for other military personnel increased Rb 100 over 2014 to Rb 62,200.<sup>3</sup>

Labor costs of the civil personnel of the Ministry of Defense stood at Rb 203bn 722m (0.25% of GDP), a decline in real terms of 14.6% on an annualized basis.

In 2015, the Ministry of Defense's costs on combustibles and lubricants (CL) contracted in real terms by 2.5% year-over-year to Rb 68bn 759m while costs on subsistence support dropped in real terms by 0.8% year-over-year to Rb 53bn 728m. The Ministry of Defense's costs on individual military clothing dropped notably by 27.3% to Rb 26bn 938m, which can be explained by completed change-over to a new military uniform.

<sup>1</sup> Single acceptance day for military products. URL: <http://www.kremlin.ru/events/president/news/51496> (accessed date: March 11, 2016).

<sup>2</sup> Executive Order of the President "Concerning the extension of the term of experiment on cash allowance unification for the conscripted military personnel in the Armed Forces of the Russian Federation" No. 136 dated March 10, 2014.

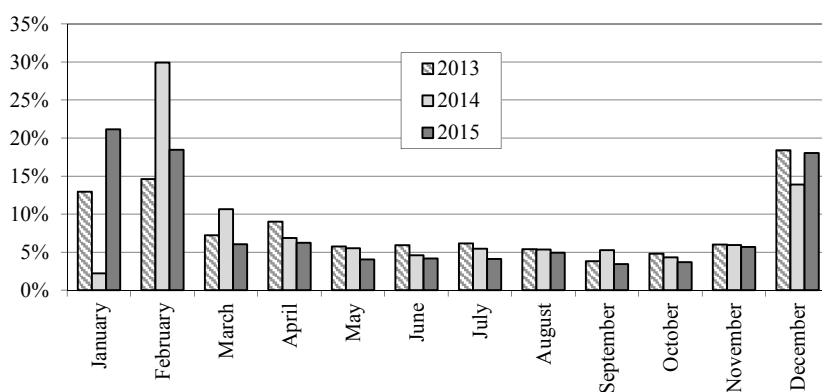
<sup>3</sup> *Falichev O.* Financial Mobilization . Voenno-promyshlenny kurier. February 3, 2016 (No. 3–4).

The Ministry of Defense's capital investment in real estate in 2015 increased 27.3% to Rb 226bn 578m (0.28% of GDP) under the 'National Defense' budget function, an increase of Rb 20bn 407bn, or 9.9% over the amount stipulated in the budget law. The expenditure under the 'Housing and Utilities' budget subfunction contracted by 34.9% to Rb 22bn 479m (0.03% of GDP). The federal budget expenditure for the saving and mortgage system of housing provision for the Ministry of Defense's military personnel contracted in real terms by 3.5% year-over-year to Rb 81bn 547m (0.1% of GDP).

In 2015, the Ministry of Defense spent Rb 305bn 286m (0.38% of GDP) on military personnel retirement pensions, a decrease in real terms by 5.9% on an annualized basis.

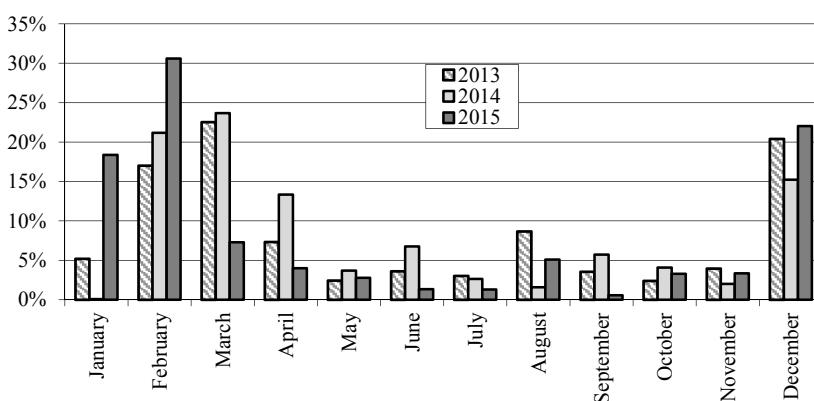
In 2015, the expenditure under 0208 'Applied Research in the Field of National Defense' subfunction were again ranked first in terms of growth rates in 0200 'National Defense' budget function, an increase in nominal terms of 30% year-over-year to Rb 318bn 521m (0.39% of GDP).

The dynamics of expenditure monthly execution under the major subfunctions of 0200 "National Defense" budget function of the federal budget in 2013–2015 is shown in Fig. 14–16.



*Fig. 14. Federal budget expenditure execution under 'Armed Forces of the Russian Federation' budget function in 2013–2015*

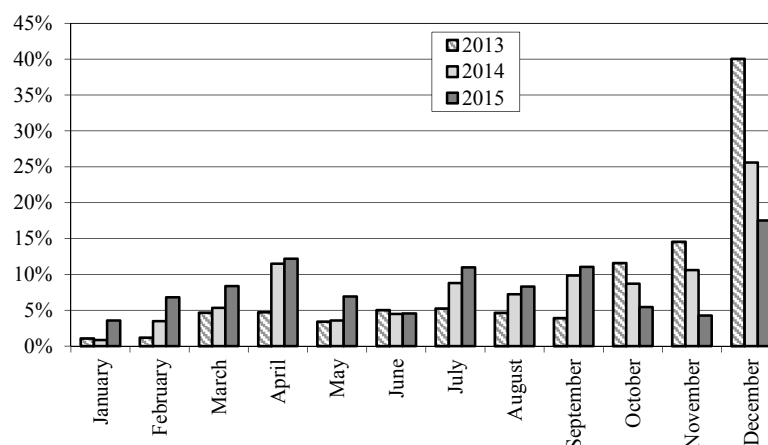
Source: own calculations based on the data released by Russia's Federal Treasury.



*Fig. 15. Federal budget expenditure execution under 'Applied Research in the Field of National Defense' in 2013–2015*

Source: own calculations based on the data released by Russia's Federal Treasury.





*Fig. 16.* Federal budget expenditure execution under ‘Other Matters Pertaining to National Defense’ budget function in 2013–2015

*Source:* own calculations based on the data released by Russia’s Federal Treasury.

B *Table 21* shows military expenditure of the subjects of the Russian Federation. The expenditure did not exceed 0.01% of GDP, adding about one third to the federal budget mobilization expenditure.

*Table 21*

**Military expenditure of consolidated budgets of subjects of the Russian Federation in 2007–2015, rubles in millions**

Expenditure classification subfunction	2007	2008	2009	2010	2011	2012	2013	2014	2015
Armed Forces of the Russian Federation	0,3	0,3	–	–	–	–	–	–	–
Modernization of Armed Forces of the Russian Federation and military units	–	0,5	–	–	–	–	–	–	–
Mobilization and paramilitary training	1 245,6	1 702,2	2 021,6	1 958,4	2 187,3	2 316,4	2 444,7	2 518,9	2 494,7
Mobilization preparation of economy	840,9	1 063,9	989,7	1 247,8	1 266,3	1 689,1	1 935,1	1 580,9	1 332,6
Other matters pertaining to national defense	5,7	0,5	4,4	<0,1	2,7	3,0	2,9	3,0	16,9
Interior Troops	1,0	0,3	–	–	–	–	–	–	–
Total	2 093,5	2 767,7	3 015,7	3 206,2	3 456,3	4 008,5	4 382,7	4 102,8	3 884,1
Net military expenditure*	2 093,5	2 767,7	3 015,7	3 206,2	1 216,4	1 671,5	1 921,3	1 592,2	1 326,0

\* The difference between executed consolidated budget expenditures and federal budget expenditures.

*Sources:* Russia’s Federal Treasury; Gaidar Institute’s own calculations.

After cessation in 2014 due to international sanctions, granting of state guarantees to MIC organizations to ensure SDO execution was resumed on a very limited basis in 2015: the federal budget provided for granting guarantees worth Rb 26bn, 53% of which remained unallocated.

*Table 22* presents Russia’s military expenditure in the period between 2005 and 2015, which include total net military expenditure of the consolidated budgets of subjects of the Russian Federation (*Table 21*).

Table 22

**Key functions of military expenditure in the Russian Federation in 2005–2015**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
1	2	3	4	5	6	7	8	9	10	11	12
<b>1. In nominal terms (current prices), rubles in billions</b>											
Federal budget allocations under the National Defense budget function: in accordance with the current budget classification	578,4	686,1	839,1	1 031,6	1 192,9	1 278,0	1 537,4	1 846,3	2 111,7	2 470,6	3 163,8
Execution of federal budget expenditures under the National Defense budget function in accordance with the current budget classification <sup>a</sup>	581,1	681,8	831,9	1 040,8	1 188,2	1 276,5	1 516,0	1 812,3	2 103,6	2 479,1	3 181,4
Military expenditures according to the data submitted to U.N. <sup>b</sup>	659,0	815,9	942,0	1 118,0	1 166,1	1 162,5	1 423,3	1 689,3	1 660,1	1 962,1	–
Total military appropriations related to current and past military activities <sup>c</sup>	778,6	947,8	1 133,5	1 448,8	1 748,7	1 880,3	2 143,9	2 654,2	2 993,5	3 457,9	4 282,5
<b>2. In real terms (2015 prices)<sup>d</sup>, rubles in billions</b>											
Federal budget allocations under the National Defense budget function: in accordance with the current budget classification	1 582,3	1 629,9	1 751,5	1 825,4	2 069,6	1 941,8	2 015,3	2 234,4	2 437,9	2 660,8	3 163,8
Execution of federal budget expenditures under the National Defense budget function in accordance with the current budget classification	1 589,9	1 619,6	1 736,5	1 841,8	2 061,4	1 939,5	1 987,1	2 193,3	2 428,5	2 670,0	3 181,4
Military expenditures according to the data submitted to U.N.	1 802,8	1 938,2	1 966,4	1 978,3	2 023,1	1 766,3	1 865,7	2 044,4	1 916,6	2 113,2	–
Total military appropriations related to current and past military activities	2 130,1	2 251,6	2 366,0	2 563,6	3 033,8	2 847,0	2 810,3	3 212,2	3 455,9	3 724,1	4 282,5
<b>3. In real terms (2000 prices)<sup>e</sup>, rubles in billions</b>											
Federal budget allocations under the National Defense budget function: in accordance with the current budget classification	578,4	595,8	640,2	667,2	756,5	709,8	736,6	816,7	891,1	972,6	1 156,4
Execution of federal budget expenditures under the National Defense budget function in accordance with the current budget classification	581,1	592,0	634,7	673,2	753,5	708,9	726,3	801,7	887,7	975,9	1 162,8
Military expenditures according to the data submitted to U.N.	659,0	708,5	718,7	723,1	739,5	645,6	681,9	747,3	700,5	772,4	–
Total military appropriations related to current and past military activities	778,6	823,0	864,8	937,0	1 108,9	1 044,3	1 027,2	1 174,1	1 263,2	1 361,2	1 565,3

*Cont'd*

1	2	3	4	5	6	7	8	9	10	11	12
<b>4. Military encumbrance on economy<sup>f</sup>, % of GDP</b>											
Federal budget allocations under the National Defense budget function: in accordance with the current budget classification	2,68	2,55	2,52	2,50	3,07	2,76	2,58	2,76	2,97	3,17	3,92
Execution of federal budget expenditures under the National Defense budget function in accordance with the current budget classification	2,69	2,53	2,50	2,52	3,06	2,76	2,54	2,71	2,96	3,18	3,94
Military expenditures according to the data submitted to U.N.	3,05	3,03	2,83	2,71	3,00	2,51	2,38	2,52	2,34	2,52	–
Total military appropriations related to current and past military activities	3,60	3,52	3,41	3,51	4,51	4,06	3,59	3,97	4,21	4,44	5,30
<b>5. By purchasing power parity (current prices), dollars in billions</b>											
Federal budget allocations under the National Defense budget function: in accordance with the current budget classification	45,4	54,4	60,0	71,9	85,0	80,7	88,6	102,3	114,3	129,6	128,3
Execution of federal budget expenditures under the National Defense budget function in accordance with the current budget classification	45,6	54,1	59,5	72,6	84,7	80,6	87,4	100,5	113,9	130,0	129,0
Military expenditures according to the data submitted to U.N.	51,7	64,7	67,4	78,0	83,1	73,4	82,0	93,6	89,9	102,9	–
Total military appropriations related to current and past military activities	61,1	75,2	81,1	101,0	124,6	118,8	123,6	147,1	162,1	181,3	173,7
<b>6. By yearly average exchange rate (current prices), dollars in billions</b>											
Federal budget allocations under the National Defense budget function: in accordance with the current budget classification	20,5	25,2	32,8	41,5	37,6	42,1	52,3	59,9	66,3	64,4	51,9
Execution of federal budget expenditures under the National Defense budget function in accordance with the current budget classification	20,5	25,1	32,5	41,9	37,4	42,0	51,6	58,8	66,1	64,6	52,2
Military expenditures according to the data submitted to U.N.	23,3	30,0	36,8	45,0	36,7	38,3	48,4	54,8	52,1	55,1	–
Total military appropriations related to current and past military activities	27,5	34,9	44,3	58,3	55,1	61,9	73,0	86,1	94,0	90,1	70,3

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*Cont'd*

1	2	3	4	5	6	7	8	9	10	11	12
<b>For reference</b>											
GDP deflator, % year-over-year	119,3	115,2	113,8	118,0	102,0	114,2	115,9	108,3	104,8	107,2	107,7
Purchasing power parity <sup>g</sup> , RUB/USD	12,74	12,61	13,98	14,34	14,03	15,83	17,35	18,04	18,47	19,07	24,66
US dollar exchange rate (yearly average) <sup>h</sup> , RUB/USD	28,28	27,19	25,88	24,85	31,74	30,37	29,38	30,84	31,84	38,38	60,96

<sup>a</sup> - For 2015 – the data from the Federal Treasury's monthly report on federal budget execution as of January 1, 2016

<sup>b</sup> - Russia's government will submit the data for 2015 to the U.N. in 2016, including expenditures for MIA's interior troops and for border troops.

<sup>c</sup> - Including retirement pensions of military personnel and costs on the destruction of chemical weapons stockpile and utilization of military equipment.

<sup>d, e</sup> - Deflated using the GDP deflator.

<sup>f</sup> - In italics – with regards to GDP values not including the most recent updates in the Rosstat methodology.

<sup>g, h</sup> - For 2015 – own calculations.

*Sources:* The federal laws on the federal budgets of 2005–2015 and on the execution of the federal budgets of 2005–2014; Budgets for individuals; Objective information on military issues including military spending transparency. The U.N. General Secretary's reports in dated 2006–2015; Russia's Central Bank; Russia's Federal Treasury.

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# **RUSSIAN ECONOMY IN 2015**

## **Trends and Outlooks**

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