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# RUSSIAN ECONOMIC DEVELOPMENTS

## No.9 2013

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## THE POLITICAL AND ECONOMIC RESULTS OF AUGUST 2013

S.Zhavoronkov

*In August, Victor Ishaev was dismissed from his post as Russia's Minister for the Development of the Far East – his extravagantly costly approaches to solving the region's problems without having made even a feeble attempt at setting any priorities, had finally infuriated both the RF Government and President Putin. The Ministry for the Development of the Far East had been subject to strong criticism on a number of issues, and the latest flooding in the Russian Far East was apparently the last straw. Russia became embroiled in an acute conflict with Belarus, a country heavily subsidized from the RF budget. The crisis in relations between the two countries was sparked by Belarus' having initiated repressions against Russian businesses – apparently in hope of blackmailing Russia into further increasing her aid to Minsk. Belarus's trump card in this latest gamble is the Russian political leadership's reluctance to risk their electoral prospects by admitting the de-facto disintegration of the Union State of Belarus and Russia. Russia made energetic attempts at preventing the conclusion of a free trade agreement between Ukraine and the EU – the Kremlin made it clear that such an agreement was incompatible with the principles of the Customs Union. In the 'far-abroad', Russia was gradually improving her international standing and prestige against the backdrop of the ongoing crisis in the Middle East, by her insistence that any use of force on the part of external players could lead to unpredictable and dire consequences. Russia's position on that matter was (and is) shared not only by some Arab countries, but also by a number of NATO's member states. Yet another benefit brought to Russia by the current aggravation of the situation around Syria is the growth of prices for energy carriers and the corresponding rise in the revenues of Russia's budget.*

In August 2013, Russia's domestic political scene was relatively staid and uneventful. However, it was a month of vigorous activity in the field of her foreign policy. As regards domestic events in Russia, the most important one was severe flooding along the Amur and its subsidiaries, which hard-hit Khabarovsk Krai, as well as Amur and Jewish autonomous oblasts. The scope and intensity of these floods made them the region's worst natural disaster in living memory. The inundated area had a population of more than 30 thousand, almost 1 thousand houses were damaged by water beyond repair. Unlike last year's catastrophic floods in Krasnodar Krai that had claimed numerous lives, those in the Far East did not result in any loss of life because of the excellent work of weather forecasters who had issued timely warnings to the population about the imminent deluge, coupled with the efficient efforts of the local authorities who had managed to evacuate people from the most endangered areas. Vladimir Putin signed an executive order on flood-relief measures in the Far East. The document envisaged that the flood victims who had lost essential personal property (including motor cars) should be compensated in the amount of Rb 100,000, while all flood victims should get Rb 10,000 each; capital repairs of water damaged dwellings should be compensated for in the amount of Rb 5,000 per square meter of floor area; the residents of dwellings damaged beyond repair should be granted new dwellings free of charge.

The relevant regional budgets should receive subsidies from the federal center, designed to compensate them for the damage inflicted on agriculture. The executive order envisaged that, in order to minimize the impact of future flooding (floods, although on a smaller scale than the recent ones, occur on a regular basis in the Far East), a number of special measures designed to ban dwelling construction in endangered areas should be developed. Apparently, such a ban should be imposed on the construction of houses close to the banks of dangerous rivers, unprotected against flooding. As unprotected river banks are typical of rural areas, it is evident that it is in those areas that the ban will be predominantly applied.

Yet another casualty of the floods was Victor Ishaev, Minister for the Development of the Far East and Presidential Plenipotentiary Envoy to the Far Eastern Federal District – this natural disaster was used as a pretext for his dismissal. Once a successful governor of Khabarovsk Krai, he had failed to take root in the new environment. His ministry inundated other agencies with extremely costly proposals worth almost 4 trillion rubles without identifying any priorities. Even some projects repudiated in Soviet times on account of their superfluity, such as the idea of a bridge to Sakhalin or the project of radically increasing the capacity of the BAM railway (in spite of the fact that it currently works at less than half of its potential capacity), had been taken out of mothballs. Accordingly, the

more modest proposals designed to stimulate a number of large projects initiated by private businesses, put forth by the economic bloc of the RF Government, had been ignored by the Ministry. The Ministry had already been subject to criticism on a wide range of issues, and the latest flooding in the Russian Far East apparently became the last straw. So far, nobody has been appointed the new Minister for the Development of the Far East, while the former Minister for Natural Resources, Yuri Trutnev, has been appointed Deputy Prime Minister and Presidential Plenipotentiary Envoy to the Far Eastern Federal District. When heading a ministry vested with the conflict-prone task of issuing licenses for the extraction of natural resources, including hydrocarbons, Trutnev had always managed to find ways to placate various pressure groups. The only chink in Trutnev's armor is that, until now, the Far East has been veritable *terra incognita* to him, which makes it doubtful whether he will actually be able to achieve any successes in his new job.

In August, the Russian authorities acknowledged that federal budget expenditures should be reduced. (However, the situation is by no means tragic: instead of the planned deficit in the first half-year 2013, the federal budget was executed with a small surplus). Statements to that effect were made by Prime Minister Dmitry Medvedev, and later on by President Vladimir Putin. According to Putin, the culprit was the global economic crisis, which had negatively influenced the Russian economy's growth rate, thus frustrating the optimistic expectations on which Russia's budget had been based. Putin even spoke against further increasing state social liabilities, noting that such a policy '*would be dishonest with regard to people who have already been promised some assistance from the State*'. At the same time, the RF Ministry of Finance stated that, according to its estimates, the revenue decline of the Russian budget in 2014–2016 would amount to 1.6 trillion rubles. Everything that has been said is true. After all these statements, only one question remains unanswered: which budget items will be subject to economization? So far, government officials have been hinting that the target for belt-tightening will be social policy (although it is clear that the monies granted to needy people remain in the country and stimulate domestic demand; this, however, cannot be said of the giant purchases being made abroad by some state-owned companies, such as *Russian Railways* (RZhD). Apparently, the State can also economize on defense expenditures, especially bearing in mind that the state defense order has long been only partly implemented because industry does not have capacity to cope with it in full. Nevertheless, it is planned that, in the next few years, Russia's defense expendi-

tures will increase by 40%. Even if some social expenditures can be painlessly reduced – at the expense of numerous 'persons enjoying privileges' (who account for one-third of pensioners) – first of all, military officers who, for some mysterious reasons, are entitled to a state pension at the age of 45. Such pension benefits cannot be rationally explained, because they are allotted not to disabled persons or even former combatants, but to ordinary healthy men. Unfortunately, Vladimir Putin had failed to specify what exactly will be economized on.

In August, Russia was confronted with problems both in the near- and far-abroad. There was a sharp rise in tensions in the Middle East. After the ouster of President Mohammed Mursi, Egypt found itself on the verge of civil war. Syria saw a large-scale use of chemical weapons resulting in a huge loss of life, with government and rebel forces blaming each other for the atrocity. The United States began to discuss the best ways of interfering in the Syrian conflict on the side of Assad's opponents. More resolute than the Americans, Turkey and Saudi Arabia expressed their readiness to launch a major military operation with boots on the ground. If hostilities break up, Syria is likely to be supported by Shia-dominated Iran and Iraq, as well as by the Shiite community in Lebanon. On the other hand, both the Sunni world and NATO lack unity – voices calling for restoring order in Syria through toppling Assad and establishing a provisional government dependent on external sponsors are counterbalanced by warnings that most Syrian rebels are radical Islamists, whose coming to power will lead to dire consequences. So far, Russia has been pursuing a deliberate policy emphasizing the necessity of peace negotiations, etc. In fact, such an approach implies that the conflict should continue at its current intensity, where neither side can win militarily. From an economic point of view, the conflict's continuation is clearly advantageous to Russia: over the course of just one month, oil prices have risen by 10%. It should also be mentioned that Iran has announced its readiness to drop its breach-of-contract lawsuit for \$ 3bn filed against Russia over her refusal to supply Teheran with S-300 antiaircraft missile systems (Moscow had decided not to fulfill that missile deal after the UN Security had imposed economic sanctions on Iran).

August saw a significant deterioration in Russia's relations with Belarus and Ukraine. The reasons behind the two tiffs were quite different. Let us begin with the quarrel with Belarus. In Minsk, there was a scandalous arrest of *Uralkali* Director General Vladislav Baumgartner who had been invited for negotiations with the Belarus Prime Minister. Once the negotiations were over, he was handcuffed and detained. The

essence of Baumgartner's 'sins' causing his detention is as follows. At the end of July, *Uralkali* discontinued its cooperation with *Belaruskali*, a state-owned Belarusian enterprise which had been running a joint trading venture with *Uralkali* since 2005. That joint venture had been a *de-facto* price cartel controlling between 35 and 40% of the highly monopolized potash market. For the time being, that arrangement had been advantageous for both parties. In its turn, the privileged position of *Belaruskali* had had its roots in Alexander Lukashenko's earlier decision that *Belaruskali* should be permitted to trade in potash – thus bypassing the official joint trader, Belarusian Potash Company (in violation of his own previous guarantees). But that potash spat was not the only reason for Baumgartner's arrest. In the autumn, Belarus will receive the final tranche of a huge loan from the EurAsEC anti-crisis fund (in fact, from Russia). Having taken a hostage, Belarus is now asking for a new loan. Quite a daring tactic, bearing in mind that, in 2013, the price of Russian natural gas for Belarus amounted to \$ 189 per 1,000 cubic meters (that is, two times less than the average European price for natural gas). It should also be remembered that Russia does not levy export duties on its oil and petroleum products supplied to Belarus (if Russia had levied such duties, it would have received an additional \$ 4.6bn for its 2012 exports to Belarus). Moreover, nearly half of these Belarusian imports are not consumed domestically but re-exported as 'diluters' and 'solvents'. So far, Russia has trimmed oil supplies to Belarus under the pretext of pipeline repairs and threatened to begin control checks of Belarusian agricultural products. It should be added, however, that Lukashenko has a very dangerous weapon of last resort – that is, dangerous not to Russia as such, but personally to Vladimir Putin. Any official admission of the fact that Russia's policy towards Minsk, which can be characterized as an incessant succession of subsidies provided against the background of empty talk about the 'Union State', has abjectly collapsed, will certainly shock part of the Russian electorate, because the 'Union State' is an integral component of the official mythology. Lukashenko understands this perfectly – and behaves accordingly. The most likely resolution of the current

crisis in Russo-Belarusian relations will be the release of the hostage and a return to the lamentable tactic of subsidizing Belarus.

Russia's relations with Ukraine have deteriorated for entirely different reasons. It is planned that, in November, the EU and Ukraine will sign a comprehensive free-trade agreement. According to this agreement, almost 95% of goods traded between the two parties will be subject to zero customs duties. The share of Ukraine's exports of goods to the EU is approximately the same as that of her exports of goods to Russia – that is, between 25 and 30%. However, trading with the EU is more profitable for Ukraine in money terms. Moreover, it is clear that, after the signing of the agreement, Ukraine's exports of goods to the EU will increase. Russian authorities have explained to their Ukrainian counterparts that the existence of this trade regime will make it impossible for Ukraine to join the Customs Union (Ukrainian authorities had proposed the creation of a special trade regime which would have meant, for Russia, the emergence of a new customs 'black hole' in the form of re-imports of goods from Ukrainian territory) and, for some mysterious reasons, created enormous freight traffic jams at Russia-Ukraine border crossings by introducing laborious extra customs checks on all imports from Ukraine. Simultaneously, Russia imposed a ban on imports from the major Ukrainian candy maker *Roshen*, owned by the Ukrainian politician Petro Poroshenko. Sergei Glaziev, an advisor to President Putin, announced that Russia is still interested in Ukraine's accession to the Customs Union, and promised her extremely generous preferential treatment, including a considerable reduction in the price of natural gas, '*making it almost as low as the price set for Belarusians, which means a two-fold or even three-fold drop in price*'. According to Glaziev, Ukraine's accession to the Customs Union will also result in Russia's abolishing export duties on its oil and petrol products supplied to Ukraine. We can only hope that Ukraine rejects this invitation, because otherwise Russia may be faced with the risk of obtaining a 'second Belarus' – that is, a country that will be absolutely sure that it can get anything in return for bombastic declarations about eternal friendship between the Slavic peoples. ●

## INFLATION AND MONETARY POLICY IN JULY 2013

A.Bozhechkova

*In July 2013, the Consumer Price Index (CPI) amounted to 0.8% (against 1.2% in July 2012), which is by 0.4 p.p. higher than its value recorded in June 2013. Over the period from 1 August through 26 August, the CPI rose by 0.1%. Thus, the inflation rate in per annum terms increased above 5.6%. In Q2 2013, according to the Bank of Russia's preliminary estimates, net capital outflow from Russia reached the level of \$ 10bn; on the whole over the first half year of 2013, it amounted to \$ 38.4bn, which is by \$ 1.7bn below its index for the first half year of 2012.*

In July, the inflation rate in the Russian Federation accelerated: the Consumer Price Index (CPI), as seen by the month's results, amounted to 0.8% (against 0.4% in June 2013), thus declining below its index for 2012 (1.2%). Thus, the inflation rate in per annum terms climbed to 5.6% (Fig. 1). The core inflation rate<sup>1</sup> in July 2013 was 0.3%, which is below its index for the same period of last year by 0.2 p.p.

The prices of foodstuffs in July remained unchanged (against growth by 0.5% in June). This happened due to the decline, on June, of the prices of fruit and vegetable products (-3%) and a slowdown in the growth rate of prices for granulated sugar (from 1.0% in June to 0.1% in July), bread and bakery products (from 0.5% in June to 0.3% in July), and alcoholic beverages (from 0.8% in June to 0.5% in July). At the same time, the growth rate of butter prices increased (from 0.7% in June to 1.1% in July), as well as that of prices for milk and dairies (from 0.2% in June to 0.8% in July).

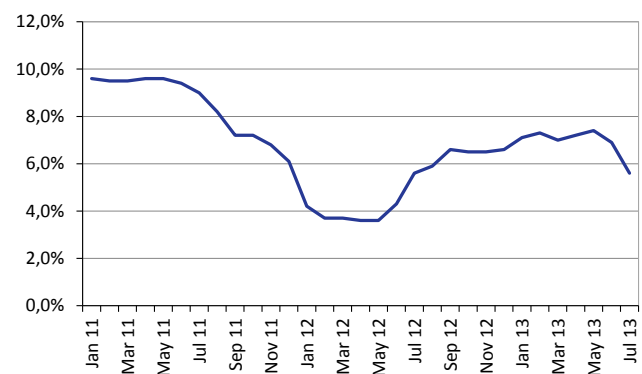
The growth rate of the prices and tariffs established for commercial services rendered to the population in July amounted to 3.1%, thus rising significantly above its June level (0.6%), which was largely due to the upward adjustment, at the month's beginning, of the housing and utilities tariffs – by 7%. The most significant increase was demonstrated by the tariffs for natural gas supply (12.6%) and electricity (11.2%). The prices of passenger transport services continued their upward movement, having increased by 2.2%, which was also true of prices of spa resort services and out-bound tourism – these rose by 4.1% and 3.1% respectively. The prices of personal consumer services (+0.4%), insurance services (+0.4%) and medical services (+0.6%) were also on the rise.

<sup>1</sup> The core consumer price index reflects the level of inflation on the consumer market after adjustment for the seasonal (prices of vegetable and fruit products) and administrative (regulated tariffs for certain types of services, etc.) factors. This index is also calculated by the RF Statistics Service (Rosstat).

In July, the growth rates displayed by the prices of nonfood commodities declined on June 2013, amounting, by the month-end results, to 0.1% (against +0.2% in June). In this commodity group, the steepest upward movement was demonstrated by the prices of tobacco products (+1.2%) (against +1.6% in June 2013), pharmaceuticals (+0.5%) (against +0.6% in June 2013), motor gasoline (+0.1%) (against -0.2% in June 2013). Meanwhile, the prices of radio and television sets moved in the opposite direction in July (-0.1%).

The CPI, as determined by the results of the period of 1–26 August, increased by 0.1%. Thus, the cumulative inflation rate since the year's beginning rose to the level of 4.5% (against 4.7% over the same period of 2012). As of 26 August, the per annum inflation rate increased above 5.6%.

Later on, prices may experience upward pressure in response to the expected lower crop yields resulting from the unfavorable weather conditions in some regions (drought in the south of Russia and rains across the Middle Volga Region and Siberia); another contributing factor may become the weakening of the Russian ruble. The factors suppressing the inflation rate's growth will be the declining domestic demand (a phenomenon that has already been observed for a



Source: Rosstat.

Fig. 1. The CPI Growth Rate in 2011–2013 (% Year-on-Year)

year) and the continuing slowdown in the growth rate of money supply (the per annum growth rate of M2 dropped from 19.1% as of 1 July 2012 to 15.5% as of 1 July 2013).

In July 2013, the broad monetary base shrank by 2.2% to Rb 8,862bn (Fig. 2). Among the shrinking components of the broad monetary base one may point to the monies kept on commercial banks' correspondent accounts with the RF Central Bank (-18.5% to Rb 817.4bn), banks' deposits (by -12.4% to Rb 125.7bn), and cash in circulation, including the cash balances of credit institutions (by -0.1% to Rb 7,411.5bn). The size of required reserves increased by 2.0% to Rb 507.5bn.

The narrow monetary base (currency issued by the Bank of Russia plus required reserves) over July remained practically unchanged, amounting to Rb 7,919bn (Fig. 3).

In July 2013, the surplus reserves held by commercial banks<sup>1</sup> shrank by 17.7% to Rb 943.1bn, while the amount of banks' repo debt increased by 14.8% – to a level in excess of Rb 2.3 trillion. As of 30 August, banks' repo debt remained unchanged, at Rb 2.3 trillion. The interest rate in the interbank market<sup>2</sup> in July was on the average at the level of 6.08% (against 6.3% in June 2013). Over the period from 1 through 29 August, the average interest rate was 6.11%.

As of 1 August 2013, the Bank of Russia's international reserves volume amounted to \$ 512.8bn, having shrunk since the year's beginning by 4.6% (Fig. 3). The downward movement of the volume of international reserves in July resulted from the Bank of Russia's sales of foreign currencies on the domestic market. At the same time, the reserves backed by monetary gold over the month of July increased by \$ 4,082m due to an upward adjustment of asset value. Meanwhile, it should be noted that on the whole, the shrinkage of Russia's international reserves volume denominated in USD over the first half year of 2013 was caused in the main by the upward movement of the euro-to-USD exchange rate, and in part – by the Bank of Russia's currency interventions.

As seen by the month-end results, the scale of currency interventions by the Bank of Russia in July was \$ 4,182.5m and € 376.5m, their purpose being to level down the volatility of the ruble's exchange rate during the periods of its rapid weakening (Fig. 4). The volume of currency sales in July hit its record high since October 2011. Over that month, the regulator three

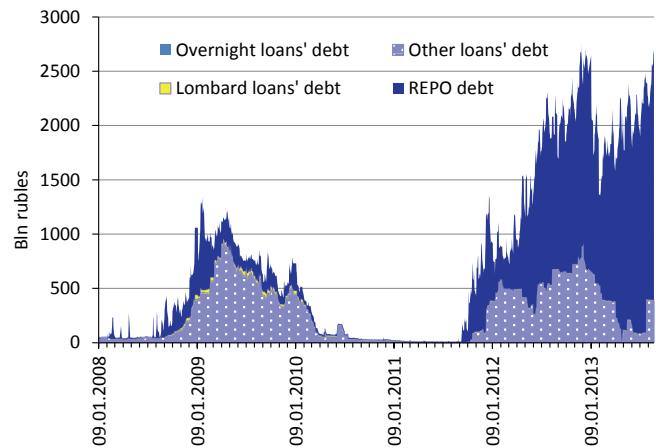


Fig. 2. The Movement of Commercial Banks' debt to the Bank of Russia in 2008–2013

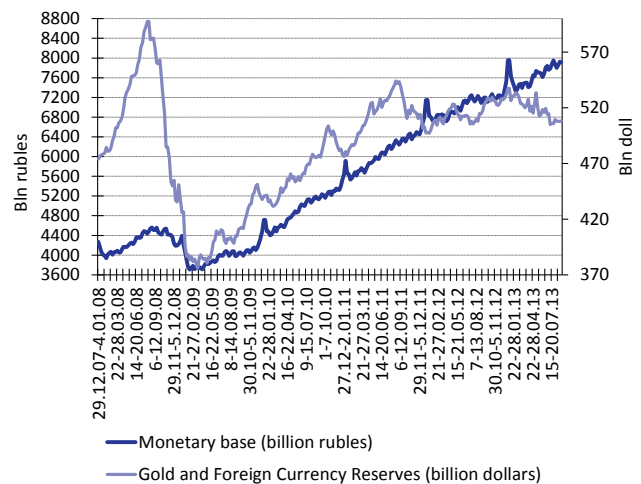
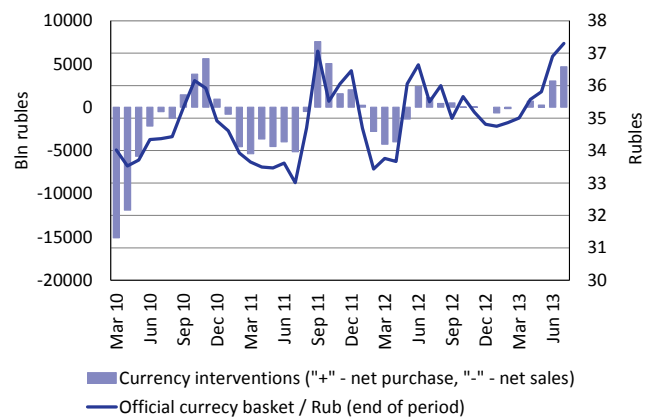


Fig. 3. Behavior of Russia's Narrow Monetary Base and Gold and Foreign Currency (International) Reserves in 2007 – 2013



Source: RF CB; the author's calculations.  
Fig. 4. The Bank of Russia's Currency Interventions and the Ruble Exchange Rate against the Bi-currency Basket in March 2010 – July 2013

1 The surplus reserves held by commercial banks at the RF CB are understood as the aggregate balance of their correspondent accounts, deposits with the RF CB and the bonds issued by the RF CB and held by commercial banks.

2 The interbank interest rate is the average monthly interest rate on overnight ruble-denominated interbank loans (Moscow Interbank Actual Credit Rate – MIACR).

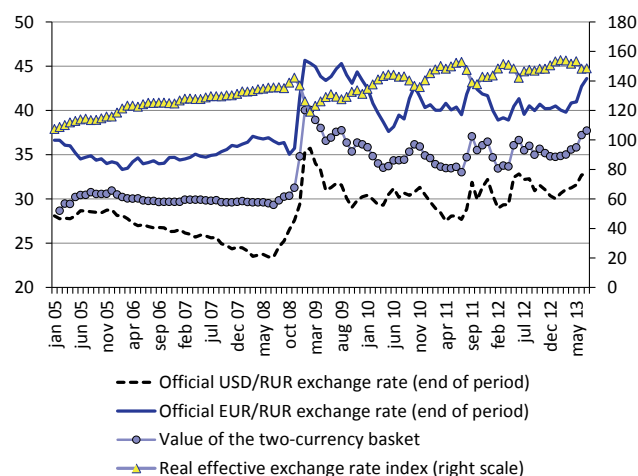
times revised the boundaries of the bi-currency basket's floating corridor by 5 kopecks. As of 31 July, the boundaries of the bi-currency basket's floating corridor were set at Rb 31.85–38.85. The repeated further upward adjustment of the bi-currency basket's corridor by 5 kopecks in August pushed the corridor boundaries up, to Rb 32.15–39.15.

According to the Bank of Russia's preliminary estimates, net capital outflow from Russia in Q2 2013 increased to \$ 10bn, and on the whole for the first half year this index amounted to \$ 38.4bn, which is by \$ 1.7bn less than the same index for the first half year of 2012. From January through June 2013, net capital outflow from the banking sector was \$ 19.4bn, while that from the other sectors amounted to \$ 18.9bn.

In July, the ruble's real effective exchange rate gained 0.1% (against -3.3% in June 2013) (Fig. 5). As seen by the quarter-end results of Q2 2013, the ruble's real effective exchange rate declined by 1.7%.

The exchange rate of the US dollar against the ruble over July rose by 0.1%, to Rb 32.9, which happened as a result of capital outflow from the developing markets in response to the continuing uncertainty as to whether the US Federal Reserve System's third round of quantitative easing (QE3) was going to be halted towards the year's end. The growth of the euro's exchange rate over July amounted to 1.9% (Rb 43.6), which had to do with the expected release of optimistic statistics concerning the situation in the eurozone. In July, the average exchange rate of the euro against the US dollar amounted to 1.31. The value of the bi-currency basket over July increased by 1.02% to Rb 37.7. As seen by the month-end results, in August the USD/ruble exchange rate rose by 0.65%, to Rb 33.2, the euro/ruble exchange rate – by 0.5%, to Rb 44.0. As a result, the bi-currency basket's value increased by 0.6%, to Rb 38.1. Thus, the average euro/USD exchange rate for August was 1.33.

On 12 July, at a planned meeting of the Bank of Russia's Board of Directors, the Bank's main interest rates were left unchanged. At the same time, the Bank of Russia announced the launching of a new instrument for refinancing the banking system – credit auctions for issuing loans secured by non-marketable assets or sureties for a period of 12 months. According to the Bank of Russia's CEOs, the purpose of that new instrument was not to increase the actual refinancing volume, but to redistribute it in favor of instruments with



Source: RF CB; the author's calculations.

Fig. 5. Behavior of the Ruble's Exchange Rate Indicators in January 2005 – July 2013

longer term times. Thus, the limits for overnight direct repo operations may be brought down by a comparable value. The minimum interest rate for this new refinancing instrument will be set at 5.75% per annum, which means that it will be only by 0.25 p.p. higher than the minimum interest rate for direct overnight repo auctions. Besides, the Bank of Russia promised that the evaluation of collaterals will be done promptly. It should be added that, on 29 July, the first auction designed to refinance banks against the collateral of non-marketable assets took place, the ceiling being set at Rb 500bn. The volume of concluded transactions exceeded Rb 306.8bn.

It should be noted that, on the whole, the attractiveness of the new instrument for the bank will largely be determined by the collateral evaluation procedures and the discount on collaterals. It may indeed become possible, in general, to alter the refinancing structure in favor of instruments with longer term times; however, we believe that, given the current macroeconomic situation with high employment and inflation levels, the softening of monetary policy cannot bring about any positive changes. Moreover, to supply the economy with 'long money' is the task for the entire financial system, and not for the central bank. The most efficient methods of boosting economic activity are to bring down inflation risks, develop the institutional environment and deepen the financial sector's capacity. ●

## FINANCIAL MARKET IN AUGUST 2013

N.Andrievsky, E.Khudko

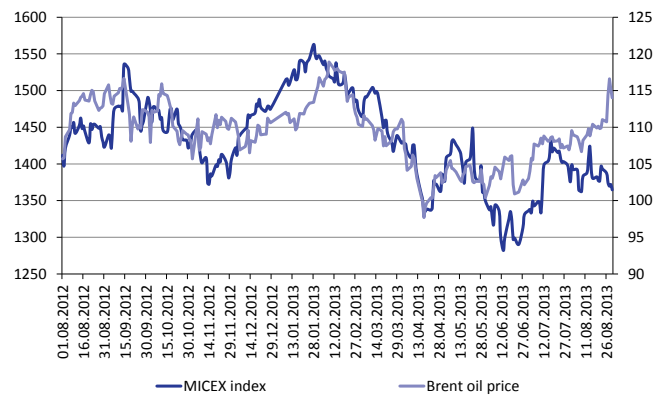
In August 2013, the MICEX index saw a monthly fall of 2.4% after Sberbank and VTB encountered some downtrend in the stock market. Furthermore, stock market capitalization contracted by 2.2% to Rb 23.41 trillion, or 37.4% of GDP.

The domestic corporate bond market was governed by fairly optimistic sentiments, irrespective of adverse trend concerning macroeconomic indicators and forecasts for Russia. The key market indicators were driven by an up-trend, contrary to expectations of a seasonal downtrend.

### Dynamics of Russian stock market basic structural indices

No any significant growth in the MICEX index was triggered by a 2.7% increase (up to \$110.31 per barrel) in the average price of Brent crude oil in August 2013 as compared to July 2013: the index moved around 1383 points and reached monthly highest (1423.9 points) on August 14, 2013 (Fig. 1). Neither did a growth of \$114–116 per barrel in crude oil prices during the last week in August 2013 have any significant impact on the Russian stock market: the MICEX index showed 1364,6 points, or -2.4% against the beginning of the month, as of August 31, 2013.

Major blue chips saw a downtrend at the beginning of August 2013: Norilsk Nickel stocks saw the deepest fall by August 8, 2013, 8.57% against the beginning of the month. Other stocks dropped on the same day by an average of 3.47% against the beginning of the month. However, by August 14, 2013 prices of blue chips saw a correction up to a gain by an average of 0.8% against the beginning of the month, while Gazprom stocks saw a growth of 3.31% against the price as of August 1, 2013. However, state banks' stocks fell in the second half of August 2013: by August 30, 2013 Sberbank common stocks fell 8.89%

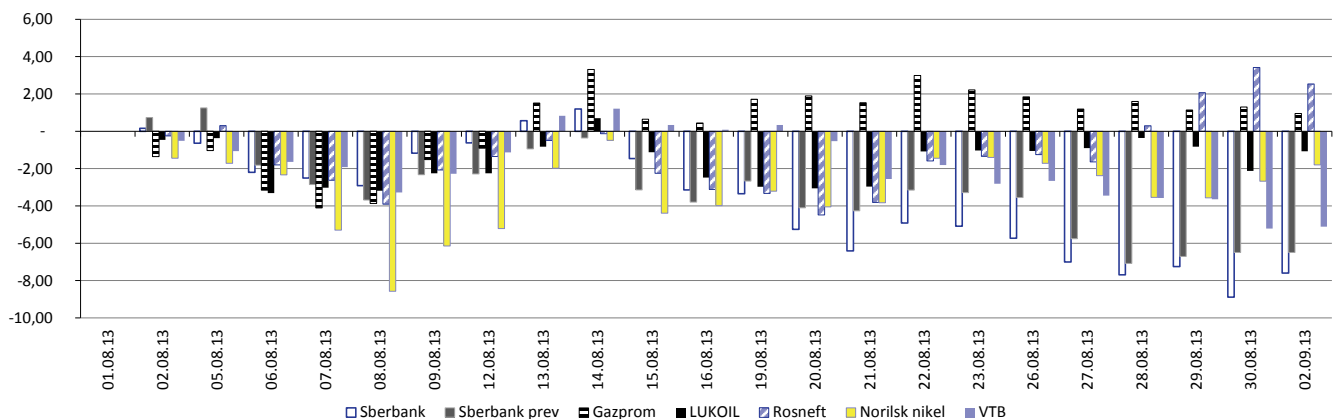


Source: RBK Quote.

Fig. 1. Dynamics of the MICEX index and futures Brent oil prices in the period of August 1, 2012 thru September 2, 2013

against the beginning of the month, while VTB stocks dropped 5.22% during the same period (Fig. 2).

Positive dynamics of Gazprom stocks in August 2013 had no significant effect on their annual yield: the stocks showed a 15% annual loss on August 30, 2012. Norilsk Nickel and VTB stocks were among loss-makers too: their annual fall was 10.5% and 16.4% respectively. In contrast, Rosneft stocks showed a yield of



Source: RBK Quote, author's estimates.

Fig. 2. Blue chips growth rates in the Moscow Stock Exchange in August 2013 (month-to-date)



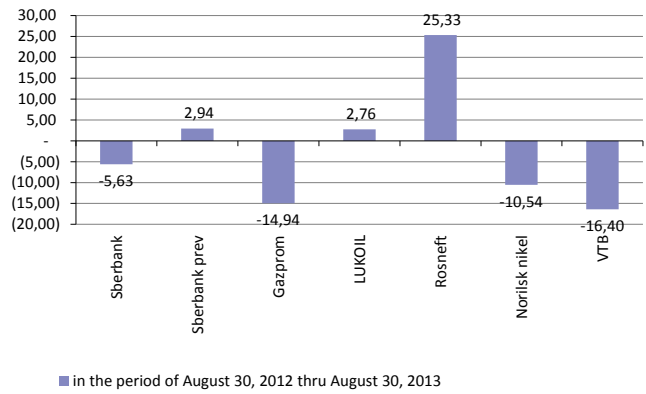
25.3% p.a., the highest among blue chips in the period beginning with August 30, 2012.

One of the most notable changes in sectoral indices in the period of August 1, 2013 thru September 2, 2013 was growth in the machine building sectoral index by 7.43% against the beginning of the month, according to the data available as of August 16, 2013. The index was pushed up by AVTOVAZ and KAMAZ stocks which increased by 15.74% and 45.75% respectively since beginning of the month. The stocks went up in response to a news that both enterprises were going to resume their production after a seasonal suspension in summer. Other sectors were facing a downtrend, and their indices dropped by an average of -2.31% by the end of August 2013. It was the MICEX Innovation Index (MICEX INNOV) that was facing the deepest fall (-11.87%) since the beginning of the month in response to a fall in NAUKA JSC stocks from Rb 232.43 as of August 1, 2013 to Rb 119 as of August 29, 2013. The electric power industry index fell 6.79% against August 30 since the beginning of August basically after E.ON Russia, FGC UES (Federal Grid Company of Unified Energy System), and RusHydro dropped 8.16%, 8.06%, and 7.47% respectively during the same period.

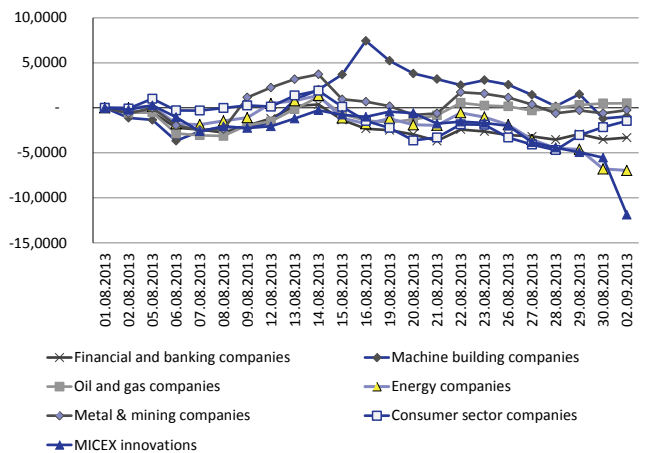
According to the Emerging Portfolio Fund Research (EPFR), a capital inflow of \$336m, or around Rb 11,09bn, to funds oriented toward the Russian market was registered in the period of August 1 thru August 28, 2013. According to the EPFR, capital outflow from such funds totaled \$24m in July 2013. The Russian stock market (MICEX) capitalization totaled Rb 23,41 trillion (37.4% of GDP) as of August 30, 2013, having decreased by Rb 512bn (2.18%) against August 1, 2013. Furthermore, capitalization structure changed in response to different trends in industrial sector indices. In particular, the share of companies operating in the mineral extraction sector increased by 1.63% from the beginning of the month to 49.9% as of August 30, 2013. Moreover, the share of companies operating in the manufacturing sector increased by 0.46% during the same period. The growth in the share of extracting and manufacturing companies was gained basically as a result of a decline in the share of transport companies and financial companies from 9.5% to 8.5% and from 14.9 to 14.1% respectively in the period of August 1, 2013 thru August 30, 2013.

**Corporate bond market**

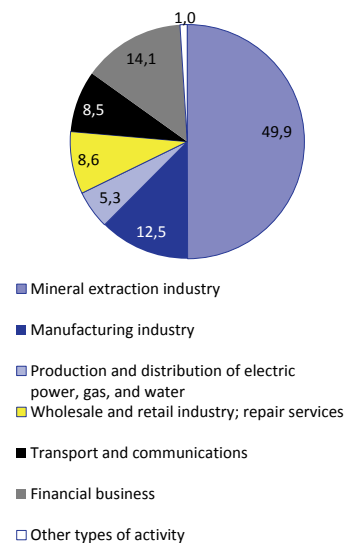
The domestic corporate bond market (measured by the par value of outstanding securities denominated in the national currency, including those issued by non-residents) kept growing in August 2013. By the end of August, this indicator reached Rb 4.701.3bn, hav-



Source: RBK Quote, author's estimates  
 Fig. 3. Blue chips growth rates in the Moscow Stock Exchange in the period of June 31, 2012 thru June 26, 2013



Source: RBK Quote, author's estimates.  
 Fig. 4. Different stock indices growth rates in the Moscow Stock Exchange (month-to-date)



Source: The Moscow Stock Exchange's official website, authors' estimates.  
 Fig. 5. Stock market capitalization structure by type of economic activity

ing exceeded 1.7% the value registered late in July<sup>1</sup>. The market capacity grew up both with increase in the quantity of bond issues (1000 corporate bond issues registered in the national currency against 983 issues by the end of July) and growth in the number of issuers in the debt segment (353 issuers against 348 companies in July 2013). In addition, there are outstanding 12 USD-denominated bond issues and a JPY-denominated bond issue of Russian issuers.

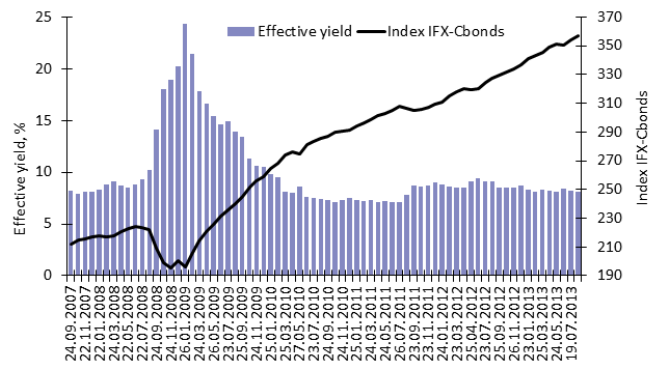
Investment activity in the secondary corporate bond market remained unchanged in August 2013 as compared to July 2013, having shown the average level during the last few months. For instance, trading volume of transactions in the Moscow stock exchange totaled Rb 116.1bn in the period between July 22 thru August 21, 2013 (to compare, trading volume amounted to Rb 115.5bn in the period between June 25 thru July 19, 2013), and the quantity of transactions increased significantly to almost 27,000 over the period under review (against 23,800 in the previous period)<sup>2</sup>, which is indicative of upsurge in interest on the side of relatively small investors.

The Russia corporate bond market index (IFX-Cbonds) started to grow after a short decline. Its value increased by 2.8 points (or 0.8%) by the end of August 2013 against the preceding month. The corporate bond average weighted yield also saw a positive trend, having dropped from 8.20% late in July to 8.15% by the end of August (Fig. 6)<sup>3</sup>.

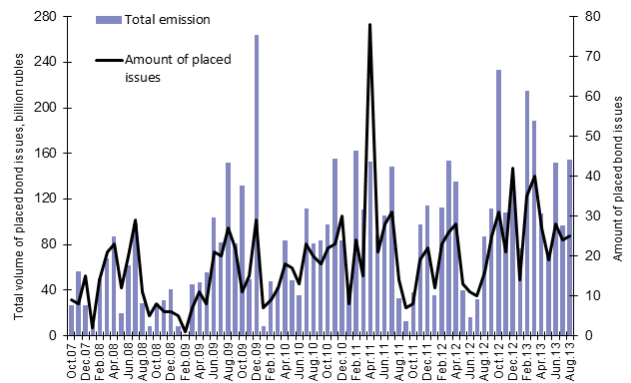
Corporate bond portfolio duration kept decreasing. The duration was 711 days as of August end, being 29 days less than the value as of the previous month end. Gradual reduction in the duration value reflects reduction in duration of outstanding corporate bonds due to a insignificant decline in market interest rates.

Most liquid segment of the corporate bond market saw different trends with regard to bond issues' yield. Absolut Bank (OJSC), Magnitogorsk Iron and Steel Works OJSC and AK BARS BANK saw most strongly pronounced downtrend in the bond yield (within a range of 0.7 to 0.9 p.p.), whereas RUSAL Bratsk OJSC, NOMOS BANK (OJSC) and Russian Agricultural Bank OJSC showed a significant growth in their bond yield (more than 1 p.p.). Production and energy companies saw a pronounced downtrend at an average of 0.1 to 0.2 p.p. in their bond yield, though in August 2013 investment activity in the energy segment was as low as it was in July 2013<sup>4</sup>.

Activity of Russian bonds issuers in terms of bond issue registration remained at a high level, although it



Source: According to Cbonds Information Agency.  
 Fig. 6. Dynamics of the Russian corporate bond market index and average weighted yield



Source: According to Rusbonds Information Agency.  
 Fig. 7. Dynamics of initial public offerings of ruble-denominated corporate bonds

failed to beat the records hit during the recent months. For instance, 19 issuers registered 69 bond issues at an aggregate par value of Rb 279,5bn in the period of July 22 thru August 21 (to compare, 55 bond issues at a total of Rb 466,2bn were registered in the period of June 25 thru July 19, 2013). About a third of the registered bond issues were listed bonds.

In spite of a moderately negative background, investment activity increased in the market as compared to the previous period, having regained the June level. For instance, 22 issuers placed 25 bond issues at an aggregate par value of Rb 154.65bn in the period of July 22 thru August 21, 2013 (to compare, 24 bond issues were placed at Rb 96.6bn in the period between June 25 thru July 19, 2013<sup>6</sup>) (Fig. 7). More than a half of the registered bond issues were listed bonds. In addition, a few debut bond issues were placed. Moreover, FGC UES OJSC managed to obtain financing for a period of 35 years, and a few other issuers managed to obtain financing for a period of 10 to 15 years.

Like in previous month, in August 2013, as little as one debut bond issue was declared void by the Federal Commission for Securities Market of Russia (FCSM) for

1 According to Rusbonds information agency.  
 2 According to Finam Information Company.  
 3 According to Cbonds Information Agency.  
 4 According to Finam Information Company.

non-placement of a single bond. It is quite a positive signal indicative of the demand for corporate debt securities<sup>1</sup>.

Sixteen issuers were to redeem their debt at an aggregate par value of Rb 59,9bn in the period of July 20 thru August 21, 2013. However, one of the issues failed to redeem his debt on the date of maturity (three issuers declared a technical default in the preceding period), which is always regarded as adverse event in the market. Twenty corporate bond issues at a total of Rb 53.8bn are expected to take place in September 2013<sup>2</sup>.

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1 According to the Federal Commission for Securities Market (FCSM).

2 According to Rusbonds company.

In general, the situation with issuers' obligations to bondholders still remains stable. One issuer declared a real default (i.e. the issuer was unable to pay to bondholders even shortly after a regular scheduled due date, the so-called grace period) in coupon yield payment in the period of July 20 thru August 21, 2013. Unlike the previous months, no real defaults took place in the redemption of par value of bond issues and early redemption of securities on put date<sup>3</sup>.

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3 According to Rusbonds company.

## THE REAL SECTOR OF ECONOMY: FACTORS AND TRENDS IN JULY 2013

O.Izryadnova

*In July 2013, the industrial production index stood at 99.3% in annual terms, including 98.5% in the manufacturing industry, and 100.4% in the mineral extraction sector. Slower growth rates in exports of traditional raw commodities and related refinery products made Russian economic growth rates even slower. Index of output of products and services in terms of basic types of economic activity remained within a positive values range in July 2013 vs. July 2012, because agricultural production increased by 5.8%, retail sales turnover by 4.3%, and paid retail services by 2.7%. Labor costs and physical resources kept growing against weakened competitive power and cost-effectiveness of the Russian economy.*

In the period of January thru July 2013, industrial production figures remained at the same period level of the previous year. However, capital investments contracted by 0.7%, volume of works in the construction sector declined by 0.3%, and provision of transport services declined by 0.9% as compared to the same period of last year. During the same period, the index of output of products and services by type of economic activity stood at 100.3% through an increase of 3.1% in agricultural production, 3.8% and 1.0% in retail and wholesale trade turnover, and 2.1% in paid retail services against January–July 2012.

During January over July 2013, economic growth was adversely affected by a 12.6% contraction in net exports year-on-year, according to preliminary data of the Central Bank of Russia. The trend towards outstripping growth rate of imports over exports resumed in the Russian economy in Q2 2013. Exports growth rates have been slowing down by cost in annual terms over the past three quarters, thereby intensifying the trend towards slower growth rates in the Russian economy.

Import growth rates slowed down from 106.3% in Q1 2013 to 102.8% in Q2 2013 as compared to the same periods of last year. Imports kept playing an important role in building up resources in the economy against slow dynamics of domestic production output. At the same time, some changes occurred in the structure of imports – the share of investment and consumer products has been reducing against increased role of intermediate demand products. The share of imports in retail sales turnover remained at 44%, which was the average in 2012.

The structure of domestic demand was heavily influenced by a three-month fall of annual growth rates in the manufacturing industry. During January over July 2013, the manufacturing index stood at 99.8%, whereas in July 2013 it was 98.5% as compared to the same periods of last year.

Sectoral differentiation kept developing in the manufacturing industry. Consumer products manufacturing saw a consistent growth in food production as well as textile and ferment production output. Chemical production, production of rubber goods, and oil products kept leading in the segment of intermediate demand products.

A weaker demand had an adverse effect on the dynamics of mid-tech and high-tech production facilities in machine building and metallurgical sectors. During January over July, machinery and equipment production dropped by 7.1% year-on-year to determine a sluggish growth in production of electrical equipment, electronic and optical equipment which supplies end-demand machine building production facilities. Production index of transport means and equipment stood at 98.7% during January over July 2013, including motorcars (97.4%), motortrucks (93.2%), and buses (96.8%) as compared to the same period of last year. It should be noted that import volumes increased by 16.6% as motorcar production dropped in H1 2013.

A big comparative base should be emphasized as one the factors which determine slowdown rates in the machine-building industry, because H1 2012 saw significant growth rates in production in this industry; decline in the effective demand, and capital investments; weaker customs and tariff protection of the domestic market in response to the accession to the WTO; inefficiency of certain types of Russia-made equipment, machinery and motor vehicles vs. imported products of similar type.

For the purposes of supporting the domestic car market, the Ministry of Industry and Trade of the Russian Federation from 01.07 2013 launched a program on government support to easy-term car loans and established the rules for the allocation of federal budget subsidies to Russian credit organizations to compensate for losses in revenues from retail car loans Issued by Russian credit institutions in 2013–2014.

Weakening in the demand for metals on the side of machine building and construction industries accelerated slowdown rates in the metal production sector. Metallurgical production output over the first seven months and in July 2013 stood at 98.6% and 93.9% against January–July and July 2012 respectively, and production of ready-made metal products at 97.9% and 92.3%.

The non-ferrous metal market has been facing a hard challenge this year. During January over July 2013, the non-ferrous metal production index stood at 96.9% year-on-year, which was caused first of all by decreased export supplies with regard to almost all basic items. From the middle of Q1 2013 global prices of basic non-ferrous metals went down to reach the bottom by July 2013. Stock levels were increasing throughout the entire period. Weakening in the domestic and external demand led to revision of production and investment programs. Decrease in consumption volumes in the domestic market and dynamics of export sales volumes predetermined changes in the output structure of Russian aluminum smelters through growth in more expensive and cost-efficient aluminum casting alloys. Production of primary aluminum alloys during January over July 2013 increased 6.4% against January–July 2012 against a 10.5% decline in primary aluminum output. Primary aluminum production decreased first of all at non-competitive facilities of aluminum smelters whose costs, given payment of interest on loans, exceeded monthly average global prices of primary aluminum. RUSAL Board of Directors considered and approved on August 15, 2013 a long-term program of stage-wise shut-down of inefficient production facilities. Inefficient production facilities will be restructured for production of aluminum alloys and products of other types.

Growth in mineral extraction (0.9%), production of fossil fuels (0.8%), and other types of minerals (1.7%) was one of the factors which maintained industrial production growth rates in 2013 at the level of January–July 2012. During January over July 2013, crude oil production volume increased by 0.7% while the share of crude oil refining in total crude oil production increased up to 52.9% against 51.9% in the same period of 2012. Index of oil product production during January over July 2013 stood at 103.1% year-on-year, including 104.8% in July 2013.

Gas production contracted 0.4% year-on-year during January over July 2013, except for July, when it increased 2.9% year-on-year in response to higher demand for the Russian gas in European countries.

Domestic market dynamics was supported by growth in retail sales turnover and paid retail services. However, growth rates in consumer demand were less than a half of the last year values. Q2 2012 saw a

downtrend in non-food market turnover and paid retail services. Non-food market turnover gained 5.3% during January over July 2013 against 9.1% in the preceding period.

Households consumer behavior experienced some changes: propensity to save was increasing, whereas the share of expenses on purchase of goods declined. Consumer demand dynamics was heavily influenced by an uptrend in real disposable income during January over July 2013 (4.3% against 2.7% in the preceding year), real wages (5.5% against 10.4% in the preceding year) and real volume of granted pensions (2.6% against 5.5% in the preceding year). In addition, the retail sector saw a steadily high borrowing level. Retail loans increased by 33.8% against July 2012.

Analysis of the current situation shows that a trend towards deterioration of the real sector of economy has been accompanied by accelerated growth in real household income and real wages. This has been accompanied by a heavier load upon budgets in the social security sector and weaker resource efficiency and competitive power in the real sector of economy.

In H1 2013, the financial performance result of enterprises and organizations (profit and loss balance) accounted for 77.1% of the same indicator registered in H1 2012, and cost-effectiveness of sold goods deteriorated from 10.0% to 7.7%. Manufacturing industry's financial performance result deteriorated by 28.5% against H1 2012, having impaired cost-effectiveness down to 9.1% against 11.3% in the preceding year. Such developments as growth in labor costs, costs of logistics and cargo transportation, cost of electricity should be emphasized as domestic factors which have been weakening cost-effectiveness in production this year. The situation has been deteriorated through changes in external demand for and prices of exported Russian goods.

Dynamics of the principal macro indicators allows one to note that regardless of slowdown in economic dynamics and growth in labor costs, the situation in the labor market remained stable in July 2013. Employment of economically active population was maintained at the average level of 2012 and amounted to 71.8 million persons. In H1 2013, the number of employees by comparable range of organizations remained unchanged against a significant redistribution of workers from the real sector of economy to the trade and market services sector. Unemployment rate, as calculated by the ILO methodology, stood at 5.3% of economically active population (4 million persons), corresponding to the level of July 2012. During June over July 2013 the need in workforce weakened for the first time in the year and amounted to 1.8 million job vacancies as of end of July, having no adverse ef-

Table 1

**BALANCED FINANCIAL RESULT AND COST-EFFECTIVENESS BY TYPE OF ECONOMIC ACTIVITY IN H1 2013**

	Profit (+) and loss balance as percentage of			Cost-effectiveness of sold goods, products, works, services	
	Q1 2012	Q2 2012	H1 2012	H1 2012	H1 2013
Total	70.9	84.6	77.1	10.0	7.7
of which:					
agricultural sector, hunting and forestry	44.4	78.7	61.3	13.6	6.3
fishing, fish farming	63.9	116.2	68.7	24.8	20.8
mineral resources extraction	88.8	96.2	92.4	30.5	26.8
including:					
production of fossil fuels	92.0	98.6	95.2	27.7	25.7
manufacturing industry	62.2	82.2	71.5	11.3	9.1
electric power, gas and water production and distribution	96.8	29.2	89.1	5.4	5.3
construction industry	38.5	51.0	49.1	2.0	2.7
wholesale and retail trade; repair of motor vehicles, motorbikes, household appliances and personal demand items	76.2	70.1	73.3	8.7	6.9
transports and communication	58.1	124.5	83.0	14.0	10.9
of which:					
railway transport operations	35.0	30.5	33.4	8.8	3.4
pipeline transportation	65.2	132.6	85.5	18.3	15.9
communications	77.4	157.1	108.4	28.0	29.3
financial business	60.2	-	24.1	0.5	0.2

Source: Rosstat..

fect on the tension coefficient in the labor market. The tension coefficient was 60.6 persons per 100 available vacancies in July 2013 (against 72 persons in the same period of 2012).

Growth in part-time employment should be taken into account in assessing the situation in the labor market. In Q2 2013, part-time employment initiated by the employer or under agreement between the employee and the employer accounted for 2.1% of the manning table at organizations (net of small-sized business entities). The biggest part-time employment was noted in organizations manufacturing means of transportation and equipment (part-time workers and those who remained idle accounted for 8.3% of the manning table), at federal railway transport organizations (9.5%), in hotels and restaurants (8.1%). B metallurgical production and production of ready-made metal products, production of machinery and equipment, production of means of transportation and equipment – workers who were on self-initiated and employer-initiated unpaid vacation accounted more than 16% of the manning table, with an average figure accounting for 6.4% of the manning table. These employment manage-

ment mechanisms allow enterprises and organizations to retain human resources amid uncertainty regarding the short-term development.

Given an unprecedentedly slow economic development growth rates during January over July, the Ministry of Economic Development of Russia made another adjustments to forecast values of the principal macro indicators for 2013: forecast GDP growth rate is lowered down to 1.8% in annual terms (-0.6 p.p.), capital investments to 2.5% (-2.1 p.p.), and retail sales turnover to 4.2% (-0.1 p.p.). Industrial production growth rate is estimated at 100.7% in the newly updated forecast against previously forecasted 102.0–103.7%. Given such growth rates in the real sector of economy, the new version of forecast contains estimates of higher growth in real personal income to 103.4% (+0.4 p.p.) and real wages to 106.2% (+1.7 p.p.). Under the circumstances, one should expect reduction in revenues and profit in the economy, which would constrict acceleration potential of economic development growth rates in the near term. The situation has been aggravated by a forecast 2.3-fold annual capital outflow, up to \$70bn. ●

## RUSSIA'S INDUSTRIAL SECTOR IN JULY 2013

### S.Tsukhlo

According to the data obtained during a series of business surveys conducted by Gaidar Institute<sup>1</sup>, the situation with the Russian industrial sector in July 2013 can be evaluated through a few of contradictive components, namely continued demand weakening, mass usage of the price factor for sales support, plans to curtail investments and continued layoffs are combined with minimum output growth, rapid plus adjustment to appreciations of stocks of finished products, and growing optimism with regard to production plans.

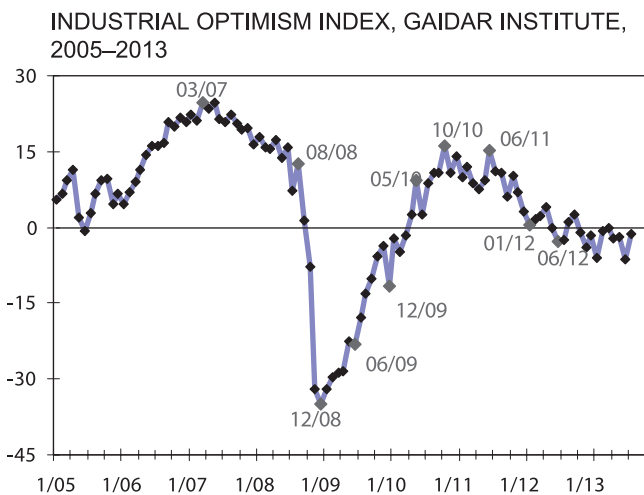


Fig. 1

CHANGES IN ACTUAL DEMAND, DISEASONED VALUE (BALANCE=%GROWTH-%DECLINE)

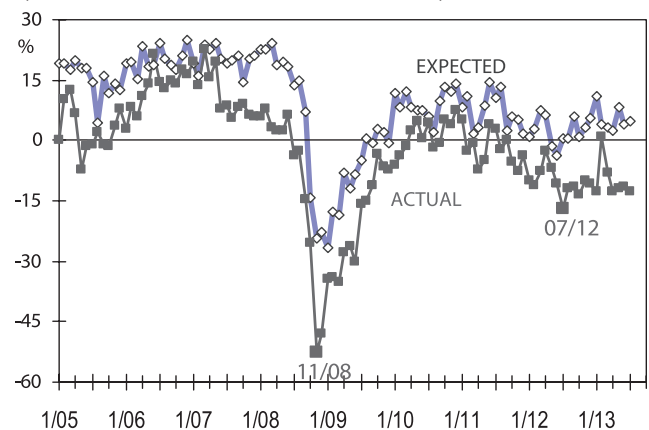


Fig. 2

#### Industrial optimism index

In July 2013, the industrial optimism index restored the June gap basically through changes in assessments of the current situation, thereby making unstable its dynamics (Fig. 1).

#### Industrial products demand

Diseasoned data on the demand dynamics in July 2013 show a continued months-long decline in industrial products sales (Fig. 2), whereas source data on the demand show a curve similar to sales dynamics in 2012: a short-lived revival in the demand at the end of Q1 2013 gave way to accelerated decline. However, the result in July 2012 remains the worst for demand dynamics since mid-2009, while the result in July 2013 is the worst over the last 12 months. However, the Russian industrial sector has been try-

ing to adapt to the existing circumstances: the share of 'normal' answers about the demand in July 2013 was almost equal to the share 'below normal' ones.

Forecasts for the demand, which showed some improvement in May 2013, have been negative over the last two months, according to source data. However, diseasoned data keep them stable and positive, at a low level though.

#### Finished goods stock

After a shoot-up to almost pre-crisis values in June 2013 the balance of evaluations of finished goods stock (Fig. 3) has suddenly "baked up" to the values equal to those in January–April 2013, which are still high but far from pre-crisis values. Such an abrupt correction of assessments of stocks (not volumes!) is unusual against a four-months long decline in sales and generally not very optimistic forecasts of the demand. Growing "uncertainty about the current economic situation and its prospects" might have been one of the reasons of initial rapid growth and subsequent fall in stocks. This fact is likely to lead to such changes in estimates against relatively steady actual changes in values.

<sup>1</sup> Gaidar Institute has been conducting a survey of heads of industrial enterprises in accordance with the European harmonization method in a monthly cycle since September 1992. The survey covers the entire territory of the Russian Federation. A panel comprises about 1100 enterprises with a headcount of more than 15% of industrial sector employees. The panel is biased towards large enterprises for each of selected subsectors. Questionnaires' age is 65–70.

**Output**

No so much-desired positive changes in product output took place in July 2013, (Fig. 4). The indicator kept growing at a moderate rate. However, neither did the June plans look very optimistic, if anything. However, in July 2013 they again showed growth in optimism. And, in general, production-oriented state of mind was better in June-July 2013 than in the previous year.

If product output do increase in the period of August thru September, the Russian production sector plans to use basically road transportation to ship increased number of manufactured products. Road transportation operations might increase by 11 points, whereas railway transportation by mere 3 points. Detailed analysis shows that enterprises plan to replace railway cargo transportation with road transportation. If 8% of enterprises are ready to increase load upon railways “in the prejudice” of motor roads, as many as 20% of shippers in the industrial sector are ready to increase their road transportation by reducing or without increasing railway transportation. A balance is (-12 points) against railways.

**Prices at enterprises**

In July 2013, prices of enterprises kept falling, only slightly easing the rate of decline (Fig. 5). The June rate of decline appeared to be almost highest since the beginning of 2009. Therefore, the industrial sector couldn’t “regain” growth in tariffs which took place in H2 2013, because it still has to recourse to a mass price-cutting with a view to reviving the demand. Though plans in May–July 2013 showed and show prevailing hopes of price rise.

**Layoff actual dynamics and plans**

In July 2013, the number of employees at industrial enterprises kept reducing (Fig. 6). Intensity of this process remained unchanged against June and slightly increased by a few points against May when the industrial sector saw most massive (after traditional January) labor outflow. Therefore, headcount reduction has been occurring for thirteen consecutive months. The biggest reduction over the previous few months occurred in forestry (-22 b.p.), ferrous metallurgy (-19 b.p.) and chemical industry (-16 b.p.). Considerable recruiting took place in food industry only (+13 b.p.), and non-ferrous metallurgy in part (+4 b.p.).

Recruiting plans are very pessimistic too. They have been showing negative values for more than a year, i.e. enterprises have been demonstrating at best their intention to retain the existing headcount, but in June-July 2013 they had to give up such a strategy and forecast already intensive headcount reduction. In short-term, employment is expected to increase only in con-

BALANCE OF EVALUATION OF FINISHED GOODS STOCK (BALANCE=%ABOVE NORMAL-%BELOW NORMAL)

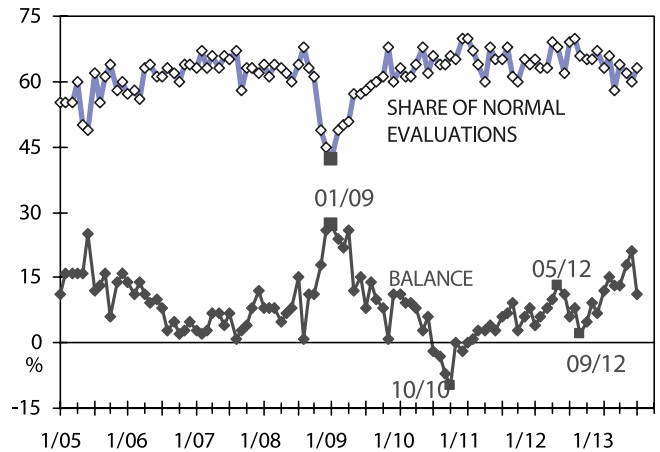


Fig. 3

CHANGES IN OUTPUT VOLUMES, DESEASONED VALUES (BALANCE=%GROWTH-%DECLINE)

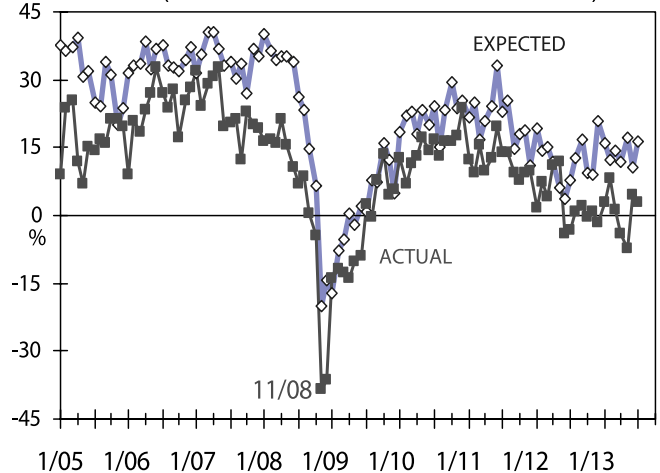


Fig. 4

CHANGES IN WHOLESALERS FACTORY PRICES (BALANCE=%GROWTH-%DECLINE)

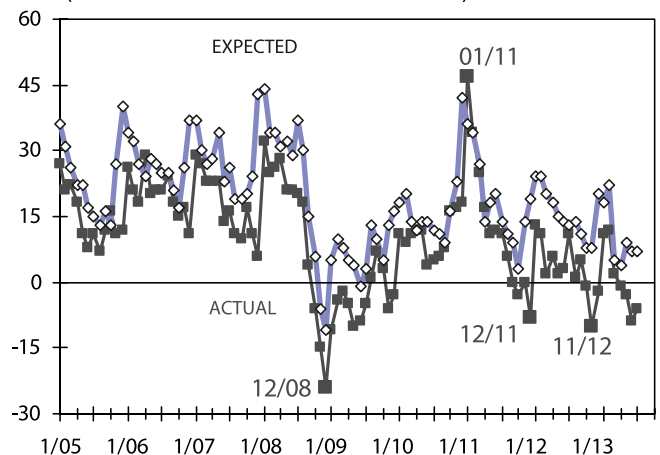


Fig. 5



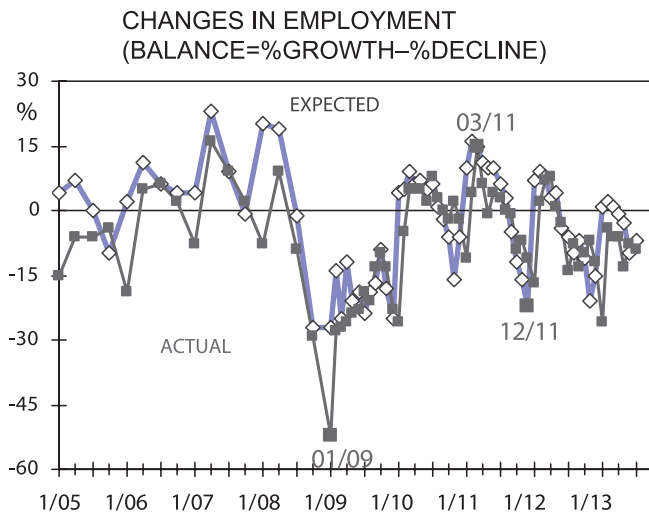


Fig. 6

struction industry, light industry, and food production sector. Most mass layoffs are expected in ferrous metallurgy and chemical industries.

**Enterprises' investment plans**

Neither government officials nor analysts have been offered prospects of revival in investment activity as judged by the Russian industrial sector's investments plans (Fig. 7). Intentions to reduce investments have been prevailing over their increase for the second month in a row. Plans in the previous three months (March-May 2013) were too modest to be able to revive official statistics. The deepest decline in investment activity in the nearest months is expected in ferrous metallurgy (-37 p.) and forestry (-24 p.), whereas a small decline in non-ferrous metallurgy (-6 p.), machine building industry, and light industry (no -5 p.). Investment growth (+16 p.) is expected in construction industry only.

**Loans to industrial sector**

Overall availability of loans has been stable and standing at 72%, according to current estimates made by enterprises. An average minimum interest rate on ruble-denominated loans offered by banks

CHANGES EXPECTED IN INDUSTRIAL INVESTMENTS TO PREVIOUS YEAR (BALANCE=%GROWTH-%DECLINE)

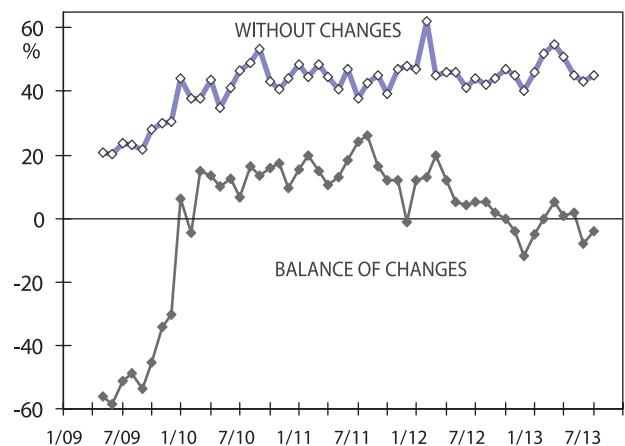


Fig. 7

was 12.5% in July 2013. A three-year historical maximum of 13.1% was registered in February 2013. The average interest rate was reduced basically through large manufacturers. Banks cut off 1.1 points (down to 10.6%) for enterprises with a headcount of more than 1000 employees, 0.6 points (down to 12.0%) for enterprises with headcount of 501 to 1000 employees, and 0.5 points (down to 13.1%) for enterprises with a headcount of 251 to 500 employees. Small- and middle-sized enterprises are often offered a rate of 15.0% p.a.

The effect of shortage of loans on Russia's industrial development remains minimal. As little as 3-4% of industrial enterprises have been considering for eight consecutive quarters that shortage of loans and credits interferes with their production growth (14<sup>th</sup> in the current ranking, 14 obstacles, according to enterprises). High interest rate on loans interferes with only 5% manufacturers in the real sector of economy (13<sup>th</sup> in the current ranking). It should be noted that manpower shortage (first of all, or even only, skilled workers) interferes with 38% of enterprises (2<sup>nd</sup> in the ranking!), but not included into the government's agenda yet.

## THE OIL AND GAS SECTOR IN JANUARY–AUGUST 2013

Yu. Bobilev

*In January–August 2013, the global oil market was characterized by the persistence of high oil prices. The 2013 annual volume of crude oil production in Russia will exceed 520 million tons, hitting record high since 1990. At the same time, according to statistics, the Russian oil industry is approaching its maximum production capacity. In order to compensate for the decline in oil production at the currently exploited oil fields, Russia will have to develop new oil fields in her remote areas with insufficient or nonexistent infrastructure as well as oil deposits on the continental shelf. Russia will also have to develop the currently ignored deposits of poor quality oil situated in the areas where oil production infrastructure already exists. In order to address that problem, Russia recently adopted Federal Law No 213-FZ, containing a number of corresponding fiscal measures designed to stimulate the development of hard-to-extract oil deposits. It is also planned that the Russian State Duma will soon adopt a draft law establishing a special preferential tax regime applicable to oil production from continental shelf deposits. It is hoped that these legal acts will encourage the development of the currently unexploited huge reserves of hard-to-extract oil, thus helping Russia to maintain her present oil production level.*

In January–August 2013, the global oil market was characterized by the persistence of high oil prices. Over the course of that period, the average price of Brent crude oil amounted to \$ 107.6 per barrel (Table 1). The main factors behind the persistence of high oil prices were the rising demand for oil caused by world economic growth, led by the economies of China, India and other Asian countries; the sufficiently conservative policy of the OPEC; and also the geopolitical risks looming over the oil market. August saw a sharp rise in oil prices, caused by the escalation of tensions over Syria and the fears that the USA and other countries would militarily intervene in that country. In the final week of August, the price of Brent crude oil increased to \$ 115–117 per barrel. In the European market, prices for Russian natural gas were also impressively high. At the same time, they experienced a downward influence of the changing situation in the European natural gas market, caused by a considerable increase in natural gas supplies from other producers and a lower level

of natural gas spot prices in comparison with prices for Gazprom's long-term contracts.

In January–July 2013, the volume of oil production in Russia grew by 0.7% on the corresponding period of last year (Table 2). As a result, it can be expected that the 2013 annual volume of crude oil production in Russia will exceed 520 million tons, hitting record high since 1990. At the same time, the growth rate of oil production rapidly declines, which can be explained in the main by the deterioration, for objective reasons, of extraction conditions. A considerable number of the currently functioning oil fields are decreasing their output, while the majority of the new oil fields are characterized by somewhat worse geographical and mining parameters, and so their development is associated with higher capital inputs and higher exploitation and transportation costs.

In the first half-year of 2013, Russian oil exports were characterized by the continuing decline in the volume of crude oil exports (which dropped by 2.5%

Table 1

INTERNATIONAL PRICES OF OIL AND NATURAL GAS IN 2005–2013, USD/BARREL

	2005	2006	2007	2008	2009	2010
Price of Brent (UK), USD/barrel	54.4	65.2	72.5	97.7	61.9	79.6
Price of Urals (Russia), USD/barrel	50.8	61.2	69.4	94.5	61.0	78.3
Price of Russian gas on the European market, USD/1,000 m <sup>3</sup>	212.9	295.7	293.1	473.0	318.8	296.0
	2011	2012	2013 Q1	2013 Q2	2013 July	
Price of Brent (UK)	111.0	112.0	112.9	103.0	108.0	
Price of Urals (Russia)	109.1	110.3	110.8	102.1	107.9	
Price of Russian gas on the European market, USD/1,000 m <sup>3</sup>	381.5	431.3	410.4	414.0	396.0	

Source: IMF, OECD/IEA.

Table 2

**PRODUCTION OF OIL, PETROLEUM PRODUCTS AND NATURAL GAS IN 2005–2013, AS A PERCENTAGE OF THE PREVIOUS YEAR**

	2005	2006	2007	2008	2009	2010	2011	2012	2013 January–July*
Oil, including natural gas condensate	102.2	102.1	102.1	99.3	101.2	102.1	100.8	101.3	100.7
Primary crude oil distillation	106.2	105.7	103.8	103.2	99.6	105.5	103.3	104.9	102.7
Motor gasoline	104.8	107.4	102.1	101.8	100.5	100.5	102.0	104.3	102.8
Diesel fuel	108.5	107.0	103.4	104.1	97.7	104.2	100.3	98.7	103.9
Furnace fuel oil	105.8	104.5	105.2	101.9	100.8	108.5	104.6	101.6	102.9
Natural gas	100.5	102.4	99.2	101.7	87.9	111.4	102.9	97.7	99.6

\* As % of January–July 2012.

Source: RF Federal State Statistics Service. RF Ministry of Energy.

on the first half-year of 2012) and by a simultaneous increase in the output and export of refined petroleum products (which rose by 10.3% on the corresponding period of 2012). Natural gas exports experienced no major fluctuations (Table 3). In the first half-year of 2013, the share of fuel and energy products in the net volume of Russian exports amounted to 71.3%, with the shares of crude oil and natural gas amounting to 33.1% and 12.6% respectively.

In the period under consideration, in response to the considerable deterioration, for objective reasons, of oil extraction conditions, Russia adopted Federal Law, of 23 July 2013, No 213-FZ 'On the Introduction of Alterations to Chapters 25 and 26 of the Second Part of the Tax Code of the Russian Federation and Article 3.1 of the Law of the Russian Federation "On the Customs Tariff"'. The Law contains a number of measures designed to stimulate the development of hard-to-extract oil reserves, and introduces differentiated ad valorem mineral resources extraction tax rates for the regions, depending on the permeability of a particular reservoir, the size of the subsoil plot, and on the degree of depletion of the oil field.

Furthermore, the Law introduces a reduction factor,  $K_d$ , to be applied to the rate of Mineral Resources

Extraction Tax (MRET). The  $K_d$  factor characterizes the difficulty of oil production. Depending on the characteristics of a specific deposit, the reduction factor  $K_d$  will equal to:

- 0.8 for oil extracted from deposits classed with the productive formations belonging to the Tyumen suite;
- 0.4 for oil produced from a reservoir with permeability not exceeding  $2 \times 10^{-3}$  micro square meters and thickness more than 10 meters;
- 0.2 for oil produced from a reservoir with permeability not exceeding  $2 \times 10^{-3}$  micro square meters and thickness not exceeding 10 meters;
- 0 for oil extracted from deposits classed with the Bazhenov, Abalak, Khadum and Domanic productive formations.
- For oil produced from reservoirs with low permeability, the reduction factor  $K_d$  should be used over the course of 120 tax periods (10 years) since 1 January of the year when the depletion of a particular reservoir exceeded 1%.

For oil produced from reservoirs classed with the productive formations of the Tyumen suite and with the Bazhenov, Abalak, Khadum and Domanic productive formations, the reduction factor  $K_d$  should be used

Table 3

**EXPORTS OF OIL, PETROLEUM PRODUCTS AND NATURAL GAS FROM RUSSIA IN 2005–2013, AS A PERCENTAGE OF THE PREVIOUS YEAR**

	2005	2006	2007	2008	2009	2010	2011	2012	2013 January–July*
Oil, total	98.4	98.0	104.0	94.0	101.8	101.2	97.6	98.2	97.5
including:									
to non-CIS countries	99.1	98.0	104.8	92.6	102.9	106.1	95.7	98.7	97.1
Petroleum products, total	117.9	106.3	108.0	105.0	105.3	106.2	98.5	104.4	110.3
including:									
to non-CIS countries	119.1	104.5	107.6	102.0	107.1	109.6	94.6	100.8	118.7
Natural gas, total	103.7	97.6	94.6	101.8	86.2	105.6	104.0	96.6	100.0

\* As % of January–July 2012.

Source: RF Federal Statistics Service.

over the course of 180 tax periods (15 years) since 1<sup>st</sup> of January of the year when the depletion of a particular reservoir exceeded 1%.

In order to determine the reduction factor  $K_d$  in each specific case, one should use the indices of permeability and effective oil-bearing formation thickness relating to a particular reservoir, listed in the State Balance Report of Reserves of Commercial Minerals.

For purposes of tax administration, the Law establishes the following special requirement regarding the determination of the amounts of oil produced from the reservoirs where the reduction factor  $K_d$  is used:

- The amount of produced oil should be determined for each of the wells functioning at a particular reservoir;
- The amount of produced well fluid should be measured, and its physic-chemical properties analyzed, at least 4 times per month.

Federal Law No 213-FZ also introduces an additional factor,  $K_{dv}$ , which characterizes the degree of depletion of a specific reservoir. When a reservoir is highly depleted (by more than 80%),  $K_{dv}$  becomes a reduction factor, calculated by a special formula.

Thus, in the future, the basic MRET rate (currently set at Rb 470 per ton) may be applied with five coefficients characterizing major rent-forming factors. These coefficients are as follows:

- Factor  $K_{ts}$ , characterizing the movement of world oil prices (*Table 4*);
- Factor  $K_v$ , characterizing the depletion of a particular sub-soil plot;
- Factor  $K_z$ , characterizing the amount of reserves at a particular sub-soil plot;
- Factor  $K_d$ , characterizing the difficulty of oil production;
- Factor  $K_{dv}$ , characterizing the depletion of a particular reservoir.

Intended for tax calculations, the  $K_{ts}$  factor makes it possible to take into account the current level of world oil prices, which, along with the volume of oil produc-

tion, determines the producer's net revenue. This factor should be applied to oil produced from all oil fields without exception. The other coefficients are designed to decrease the tax load on the oil fields characterized by higher than normal development and operating costs (depleted and small oil fields, hard-to-extract reserves). Thus, from now on, the higher than normal development and operating costs, typical of such oil fields, will be taken into account due to the imposition of lower tax rates for hard-to-extract oil.

It should be noted that the productive formations for which the  $K_d$  factor is set at 0 are similar to shale oil. Deposits of such oil are being actively developed in the USA. In Russia, such deposits remain undeveloped, although the Russian Federation has huge reserves of this oil, mainly in the areas where oil production infrastructure already exists, primarily in western Siberia.

Federal Law No 213-FZ also introduces a number of amendments to Law No 5003-1 'On the Customs Tariff'. In accordance with these amendments, oil produced from oil fields with more than 80% of reserves consisting of productive formations that belong to the Tyumen suite, should be included in the list of crude oil types entitled to reduced export duty rates calculated by special formulas.

At present, special formulas for calculating export duty rates for oil are applied to oil produced from oil fields in eastern Siberia (in the Sakha Republic (Yakutia), Irkutsk Oblast and Krasnoyarsk Krai), Nenets Autonomous Okrug, Yamalo-Nenets Autonomous Okrug north of the 65<sup>th</sup> parallel north, and also in the Caspian Sea and on Russia's continental shelf.

It should be noted that Russia's continental shelf contains huge untapped reserves of oil. At present, the RF State Duma is considering a draft law designed to envisage the introduction of a preferential tax regime for the development of new offshore oil fields. It is planned that this tax regime will be based on a reduced ad valorem MRET rate differentiated by continental shelf zone (by category of a project's difficulty).

Table 4

RATES OF MRET APPLIED TO OIL PRODUCTION IN 2005–2013

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Basic MRET rate on oil production, Rb/ton	419	419	419	419	419	419	419	446	470
Factor, characterizing movement of world oil prices (Kts)	$(Ts-9) \times P/261$				$(Ts-15) \times P/261$				
Factor, characterizing depletion of particular sub-soil plot ( $K_v$ )	–		$3.8 - 3.5 \times N/V$						
Factor, characterizing amount of reserves at particular sub-soil plot ( $K_z$ )	–							$0.125 \times Vz + 0.375$	

*Symbols:* Ts – the average Urals crude oil price during a tax period, USD/barrel; P – the average official USD to Russian Ruble exchange rate, set by the RF CB; N – the cumulative volume of oil produced from a sub-soil plot; V – the initial recoverable reserves of Class A, B, C1 and C2 oils in a sub-soil plot; Vz – the initial recoverable reserves of oil in a sub-soil plot, millions of tons.

*Source:* RF Tax Code (as amended between 2005 and 2013).

It is planned that new continental shelf projects are to be exempted from the exports duty on oil and property tax. It can be expected that this draft law will be adopted before the end of this year.

The latest statistics indicate that the Russian oil industry is approaching its maximum production capacity. Oil production in traditional oil producing areas is on the decline because of the depletion of their oil fields. In order to compensate for the dwindling of oil production from the oil fields currently in operation, emphasis should be made on developing the new oil fields situated in the areas with insufficient or non-existent infrastructure, including deposits on the continental shelf, as well as on developing the currently

ignored reserves of poor quality oil situated in the areas where oil production infrastructure already exists.

As the production costs of developing new oil fields and hard-to-extract oil reserves are very high, their development under the general tax regime is unprofitable. Therefore, the importance of the adoption of the above-mentioned legislative measures designed to reduce the tax burden of the companies developing hard-to-extract reserves and offshore oil fields cannot be underestimated. These legislative acts will encourage the development of the currently unexploited huge reserves of hard-to-extract oil, thus helping Russia to maintain her present oil production level. ●

## CAPITAL INVESTMENTS IN H1 2013

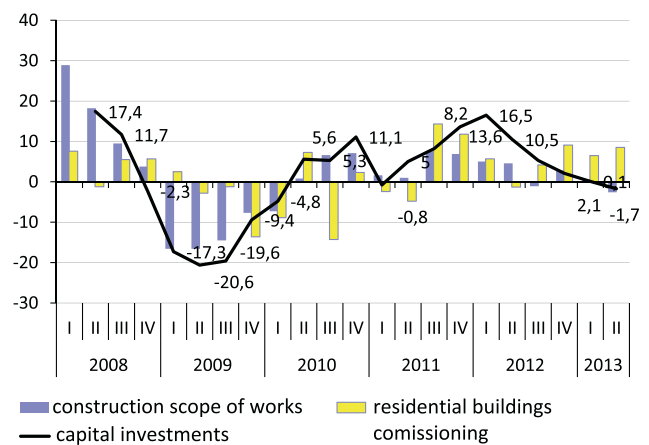
O.Izryadnova

Capital investments stood at 99.3% in real terms in January–July 2013 against the previous year. The structure of sources of investment financing kept showing an uptrend in the share of equity funds and federal budget funds. In H1 2013, general level of investment activity was adversely affected by a decline of 7.9% in investments in the mineral extraction sector, 9.1% in the production and distribution of electric power, gas and water, and 15.9% in the transport industry against H1 2012. In contrast, capital investments in the manufacturing industry increased insignificantly but were used ineffectively, thereby keeping the production output growth rate slowing down. Annual growth rate in capital investments is expected to grow by 2.5% in 2013 against 6.6% in 2012, as estimated by the Ministry of Economic Development of the Russian Federation.

Capital investments stood at 98.6% in real terms year-on-year in Q1 2013. Stabilization of capital investments in Q1 2013 at the 2012 level gave way to a 1.7% fall in Q2 2013, having hit lowest level in annual terms (by 3.3%) on June 2013. Capital investments during January over July 2013 stood at 99.3% and 102.5% year-on-year in July. During January over July 2013, the volume of performed works in the construction industry stood at 99.7% (106.1% in July 2013), commissioning of residential buildings at 106.2% year-on-year (99.4% in July 2013).

Decline in capital investments in 2013 was easily predictable because of an extremely low investment activity late in 2012 and lack of the required potential in the construction industry. It was very well evident in housing construction sector, when during June over July 2013 the trend hit a turning point and rates of commissioning of residential buildings began to slow down in annual terms.

Dynamics of capital investments is differentiated by large and medium-sized enterprises. By the end



Source: Rosstat.

Fig. 1. Capital investment dynamics in 2008 thru 2013, as percentage of a respective quarter in the preceding year

of Q1 2013 the volume of capital investments (net of small-sized business entities which can't be recognized through direct statistical methods) amounted

Table 1

### CAPITAL INVESTMENTS STRUCTURE BY TYPE OF FIXED ASSETS IN Q1 2009–2013 (EXCLUSIVE OF SMALL-SIZED ENTREPRENEURSHIPS AND INFORMAL ACTIVITY PARAMETERS), AS PERCENTAGE OF TOTAL

	Billions of rubles					As percentage of total				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Capital investments	2188.7	2108.1	2650.9	3135.0	3356.1	100	100	100	100	100
including:										
housing	131.7	122.8	121.8	133.7	166.7	6.0	5.8	4.6	4.3	5.0
buildings (other than residential buildings) and facilities	1190.2	1108.2	1419.0	1601.9	1644.9	54.4	52.6	53.5	51.1	49.9
machinery, equipment and means of transportation	671.2	692.1	872.2	1146.9	1241.8	30.7	32.8	32.9	36.6	37.0
of which: purchase of imported machinery, equipment, means of transportation	156.3	138.8	182.2	204.8	231.4	7.1	6.6	6.9	6.5	6.9
others	195.6	185.5	237.9	252.5	320.7	8.9	8.8	9.0	8.0	9.0

Source: Rosstat.

to Rb 3356.1bn, with large and medium-sized enterprises accounting for 70.5% of total volume of capital investments. Capital investments contracted by 5.8% in the segment of large and medium-sized enterprises in response to a 1.4% decline in total volume of capital investments in H1 2013.

The share of investments in housing construction as well as production of machinery, equipment and means of transportation increased significantly whereas the share of investments in construction of non-residential buildings and facilities contracted in the structure of capital investments in Q1 2013. The share of investments in purchase of domestic machinery and equipment has gradually been increasing in total volume of capital investments over the past four years. In Q1 2013, however, the share of investments in imported machinery, equipment, means of transportation increased up to 18.6% (against 17.9% in Q1 2012) in total volume of investments in produc-

tion of machinery, equipment, means of transportation. Outstripping growth in investment imports over capital investments dynamics has been following the recent-period trend and indicative of underdeveloped domestic production of capital goods.

Outstripping growth in volume of investments in residential buildings against total dynamics of capital investments and construction of non-residential buildings was noted in Q1 2013.

Positive dynamics of commissioning of total residential floor space was noted from H2 2011 and determined by certain improvements in financing in this type of activity. In Q1 2013, organizations of all types of ownership commissioned 22.6 million sq. meters of floor space, having increased 7.6% against the same period of the previous year. Private developers constructed residential buildings with 11.6 million sq. meters of total floor space, or 51.5% of total residential space which was commissioned in Q1 2013.

Table 2

**CAPITAL INVESTMENTS STRUCTURE BY SOURCE OF FINANCING IN Q1 2009–2013, AS PERCENTAGE OF TOTAL (EXCLUSIVE OF SMALL-SIZED ENTREPRENEURSHIPS AND INFORMAL ACTIVITY PARAMETERS)**

	billions of rubles					As percentage of total				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Capital investments	2188.7	2108.1	2650.9	3135.0	3356.1	100	100	100	100	100
including by source of financing:										
equity	878.5	947.4	1222.4	1544.0	1678.0	40.1	44.9	46.1	49.3	50.0
fundraising	369.3	342.8	476.6	608.7	н/д	16.9	16.3	18.0	19.4	–
including:										
bank loans	1310.2	1160.7	1428.5	1591.0	1678.1	59.9	55.1	53.9	50.7	50.0
of which										
foreign bank loans	263.2	193.0	224.4	262.8	340.5	12.0	9.2	8.5	8.4	10.2
loans from Russian banks	80.9	60.0	46.5	49.3	40.1	3.7	2.8	1.8	1.6	1.2
other organizations' borrowings	179.3	139.3	129.6	165.4	234.8	8.2	6.6	4.9	5.3	7.0
budget funds	364.7	327.3	382.7	412.9	459.8	16.7	15.5	14.4	13.2	13.7
of which:										
federal budget	142.5	159.6	174.2	199.5	242.8	6.5	7.6	6.6	6.4	7.2
budgets of constituent territories of the Russian Federation	200.5	148.9	185.7	187.0	188.3	9.2	7.1	7.0	6.0	5.6
money of extrabudgetary foundations	4.7	8.8	6.1	6.9	13.4	0.2	0.4	0.2	0.2	0.4
others	50.6	46.0	45.8	64.0	82.1	2.3	2.2	1.7	2.0	2.4
of which:										
funds of senior organizations	20.8	23.1	29.1	42.9	65.2	1.0	1.1	1.1	1.4	1.9
money generated from corporate bonds issue	447.7	446.3	639.9	679	547.5	20.5	21.2	24.1	21.7	16.3
money generated from stock issue	371.3	355.6	547.6	583.6	415.5	17.0	16.9	20.7	18.6	12.4
money obtained for participatory construction projects (organizations and individuals)	0.2	0.9	0.01	0.0	1.8	0.01	0.04	0.00	0.0	0.1
including households' money	10.4	34.8	27.7	38.7	31.5	0.5	1.7	1.0	1.2	0.9
Of total capital investments – foreign investments	124.6	111.3	95.2	100.1	89.5	5.7	5.3	3.6	3.2	2.7

Source: Rosstat.

In analyzing dynamics of absolute volumes of investments in housing construction in the period of 2010 thru 2013, one should take a closer look at structural features of financing which relate to higher volumes and share of individual investments against increasing reduction of corporate investments in co-funded construction of residential buildings. In Q1 2013, investments in co-funded construction of residential buildings increased by Rb 18.1bn, including individual investments (by Rb 22.3bn against H1 2012). More intensive investment activity among individuals was supported by higher levels of lending. A total of Rb 535.1bn of mortgage loans was issued by the end of Q1 2013, having increased 1.21 times year-on-year.

Post-recessional recovery of financing of investments was determined by strengthened focus on the use of internal resources. In Q1 2013, the share of investments through corporate internal resources was 50.0%, having exceeded by almost 10 p.p. the value of Q1 2009. Enterprises are normally very reserved in fundraising when they face decline in financial performance results and cost-effectiveness in production. In

July 2013, corporate loans increased by 15.7%, while deposits by 26.8%. In Q1 2013, bank loans accounted for 10.2% of structure of sources of financing of investments, having increased 1.8% year-on-year. Changes in the structure of bank loans have recently been governed by bigger volumes and share of loans issued by Russian banks which replace loans from foreign banks. Russian banks' loans increased Rb 86.9bn whereas foreign banks' loans contracted by Rb 9.2bn against H1 2012.

In addition, volume of foreign capital investments contracted, and their share in total volume of investments in the Russian economy decreased down to 2.7% in Q1 2013 against 3.2% in 2012. Regardless of that, in general, direct foreign investments increased by 58.9% year-on-year in Q1 2013, their usage for capital investments declined by 15.3%.

The share of budget resources increased in the structure of funds borrowed to finance investments. Budget funds accounted for Rb 459.8bn of total capital investment financing (13.7% of total volume of investments in the economy) in Q1 2013. Growth in

Table 3

**CAPITAL INVESTMENTS BY TYPE OF ACTIVITY (EXCLUSIVE OF SMALL-SIZED ENTREPRENEURSHIPS AND VOLUME OF INVESTMENTS WHICH CAN'T BE SEEN THROUGH DIRECT STATISTIC METHODS) IN Q1 2009 THRU 2013**

	Structure as percentage of total					Growth rate as percentage year-on-year				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Total	100	100	100	100	100	95	89.8	112.3	109.6	94.2
agricultural sector, hunting and forestry	3.5	3.4	3.3	3.4	3.4	74.8	96.3	117.3	106.9	100.8
fishing, fish farming	0.1	0.1	0.1	0.1	0.1	85.8	117.2	105.2	240.0	95.2
industrial sector	45.7	48.3	47.8	51.1	51.3	95.3	98.3	109.4	118.1	94.8
mineral production	19.0	20.4	20.9	22.3	22.7	90.7	98.5	116.9	117.8	92.1
manufacturing industry	17.8	16.3	16.6	17.8	18.2	97.8	84.9	110.5	121.5	100.4
electric power, gas, and water production and distribution	8.9	11.6	10.3	11.0	10.4	100.6	123.5	95.9	113.4	90.9
construction industry	3.6	2.9	2.4	2.3	2.3	97.5	98.4	93.9	97.4	101.5
retail and wholesale trade	2.1	2.2	2.1	1.9	2.8	96.2	89.3	102.9	99.0	130.9
hotels and restaurants	0.4	0.5	0.4	0.3	0.8	89.9	111.7	97.1	81.1	123.5
transports and communication	25.5	25.5	27.5	25.3	21.2	105.4	92.0	121.4	99.6	84.1
railway transport	4.1	6.7	5.1	4.2	4.1	61.4	121.4	90.0	86.8	100.8
pipeline transportation	10.6	9.4	11.8	10.0	6.7	147.4	87.3	143.3	92.0	68.1
communications	3.0	3.2	3.5	3.4	3.4	75	104.0	135.3	112.2	92.8
financial business	1.5	1.2	1.3	1.6	1.6	135.3	78.6	121.3	141.0	110.8
real estate transactions.	10.6	8.9	7.9	6.9	6.9	76	74.0	99.1	102.7	103.1
state administration, and provision of military security; social insurance	1.5	1.3	1.0	1.4	1.4	106.7	77.2	99.9	99.6	83.0
education	1.5	1.5	1.7	1.5	1.4	80.9	94.4	135.8	99.0	101.6
healthcare and provision of social services	1.8	2.0	1.6	1.7	1.7	93.2	107.9	97.8	122.5	103.1
provision of other public utility, social and personal services	2.2	2.2	2.9	1.9	3.2		98.4	146.9	121.5	119.1

Source: Rosstat.



the volume of financing of investments with federal budget funds compensated in part moderate involvement of budgets of constituent territories of the Russian Federation in this process.

The Federal Targeted Investment Program (FTIP) in 2013 provides for allocation of Rb 869.5bn federal budget funds, Rb 41.9bn less than in 2012. Furthermore, in July 2013 the Federal Targeted Investment Program was amended and updated to eventually increase the total volume of budget funds allocated for the implementation of FTIP in 2013, which totaled Rb 894.0bn as of 01.08.2013, including Rb 785.2bn of budget investments.

In accordance with the amendments, Rb 666.2bn were allocated to implement the FTIP, of which Rb 637.0bn were allocated for construction of 2886 fixed assets under construction. 1032 fixed assets are scheduled for commissioning in 2013. During January over July 2013, 26 fixed assets were commissioned, of which 14 were commissioned at full capacity, 12 fixed assets were commissioned below full capacity. During January over July 2013, Rb 301.7bn were allocated from the federal budget to finance in

consideration for the annual limit, and Rb 161.9bn were actually used from all sources of financing. Traditionally, the reason for untimely start of the implementation of actions as part of the FTIP was delayed removal of finance restrictions imposed on the budget controller.

Changes in the structure of capital investments by type of economic activity during Q1 2013 were determined by decline in construction and investment activity in the industrial production and transport industries, both accounting for almost 70% of investments in the economy.

Capital investments in Q1 2013 increased insignificantly in the manufacturing sector (100.4% against H1 2012) against decline in investments in mineral resources extraction (92.1%). Capital investments in production of means of transportation (132.2%), machinery and equipment (111.2%), ready-made metal products (116.6%), chemical production (119.4%), rubber and plastic goods (113.3%), coke and oil products (105.7%) increased at outstripping rates against the average in the manufacturing industry in Q1 2013. ●



Table 1

## MONTHLY AVERAGE GLOBAL PRICES IN JUNE IN 2003-2013

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Brent crude oil, USD per barrel	27.06	35.2	53.9	68.3	70.13	135.2	65.7	75.36	113.76	95.59	103.11
Natural gas (Europe), USD/1 million BTU	4.05	4.01	5.91	8.29	8.03	12.63	7.95	7.74	10.26	11.49	11.92
Gasoline, USD per gallon	0.858	1.228	1.499	2.107	2.213	3.435	1.90	2.08	3.13	3.18	–
Copper, USD per ton	1703	2669	3524	7198	7469	8263	5014	6499	9067.0	7423	7000.2
Aluminum, USD per ton	1410	1676	1731	2477	2672	2957	1570	1931	2558.0	1890.0	1814.5
Nickel, USD per ton	8761	13322	16160	20755	41407	22556	14960	19378	22421	16549	14280

Source: calculations were made based on the data provided by the London Metal Exchange (London, UK), the Intercontinental exchange (London), the World Bank.

2012. Prices of aluminum dropped by 0.8%, nickel by 4.6%, copper by 3.1% as compared to May 2013. In H1 2013 aluminum was sold 7.7% cheaper, copper (6.8%), nickel (12.4%) than in H1 2012.

In June 2013, the FAO food price index decreased by 1.5% against May 2013 to 210.1 points. Average prices of all commodity lines in the index were lower than the values they showed in May 2013. The biggest fall was registered in the 'dairy products' commodity line.

Russia's export in H1 2013 amounted to \$252.5bn, having declined 4.1% year-on-year, including non-CIS countries (\$217.0bn) (a decline of 2.6%), CIS countries (\$35.5bn) (a decline of 12.3%).

Reduction in Russia's exports in H1 2013 vs. H1 2012 was governed by decrease in average prices of exported Russian products which stood at 96.6%, whereas the index of physical volume of production stood at 102.6%.

The 'food products and agricultural raw materials' commodity line saw the lowest decline in export: exports of products of this commodity declined by 19.6% through decline in physical volumes with an insignificant growth in prices. Export of metals and articles made therefrom contracted by 14.7% through reduction in prices and physical volumes of export supplies. Reduction in prices resulted in decrease of exports of products manufactured by the fuel-and-energy sector and chemical industry. Insignificant growth in physical volumes of supplies of these products failed to compensate for slide in prices.

Russia's import amounted to \$160.9bn in H1 2013, having increased 3.7% year-on-year, including import from non-CIS countries (\$137.9bn) (a growth of 4.3%), from CIS countries (\$23bn) (a growth of 0.6%). The growth in import was governed by increased import prices against contraction in physical volumes of goods imported to the territory of the Russian Federation.

Procurement of textile fabrics, textile goods and footwear increased most of all (by 9.4%), chemical industry products (by 7.5%), metals and articles made therefrom (by 7.0%).

The share of consumer and investment goods in total import volume contracted through increase in the share of intermediate goods in Q2 2013 against Q2 2012.

Table 2

## THE SHARE OF CONSUMER, INTERMEDIATE, INVESTMENT GOODS IN TOTAL IMPORT VOLUME IN THE RUSSIAN FEDERATION (%)

	Goods		
	consumer	investment	intermediate
2012			
I quarter	40.2	23.0	36.8
II quarter	38.0	25.1	36.9
III quarter	37.8	25.1	37.1
IV quarter	36.9	26.1	37.0
Year	38.1	24.9	37.0
2013			
I quarter	38.4	23.2	38.4
II quarter	36.4	24.7	38.9

Source: Federal Service of State Statistics (Rosstat).

New rates of import customs duties, which were approved by the Council of the Eurasian Economic Commission on July 2, 2013, Decision No. 45, as part of Russia's obligations to the WTO, took effect on September 1, 2013. Duty rates were lowered for about 5100 tariff lines, almost a half of the Customs Union Unified Customs Tariff. Duty rates saw an insignificant reduction as per each specific line within a range of 1 to 3 percentage points. Import duties increased for an insignificant number of commodity lines.

The reduction covered basically food products, including fish, exotic fruits, confectioneries, raw ma-

materials for production of juices. Duties on equipment (washing machines, tractors), as well as tropical oils, a few types of fabrics and clothing were reduced too.

For instance, rates of import customs duties were reduced from 10% to 8–9% for certain types of products of commodity lines 0302, 0303 (fresh, refrigerated, and frozen fish), 0304 (fish meat). Duty rates on the products in the commodity line 0402 (milk and cream with sweeteners) saw a reduction from 20–25% to 18.3–22.5%, from 15% to 13.3% on the products in the commodity line 0407 (eggs). However, the duty rate on dairy fats and butters, dairy spreads (0405), certain sorts of cheese and cottage cheese (0406) increased from 15.0%, but at least 0.5 euro per kilo to 22.5%, but at least 0.45 euro per kilo, i.e. the ad valorem rate increased to the level of obligations, because it was lower until September 1, 2013.

The combination rate was replaced with the ad valorem rate for a series of commodity lines. For instance, a combination rate of 10.0%, but at least 3.0 euro per kilo, was imposed on 'articles of textile fabric clothing and other articles of clothing'. An ad valorem duty of 18.3% on import of these products took effect on September 1, 2013.

Orderly reduction of customs duties will continue until 2018, as provided for by periods in transition for different categories of goods.

The Council of the Eurasian Economic Commission issued its decision (No. 42) on July 2, 2013, which extended the effect of higher rates of import duties on dairy butter, dairy spreads, other milk fats and butters, young cheese and cottage cheese, which were in effect until thru August 31, 2013. They varied within a range of 17.5% to 18.3% of the customs value, but at least 0.16–0.4 euro per kilo. The original duty rate was imposed for the period of April 1, 2013 thru June 30, 2013 in order to protect dairy food manufac-

turers in the countries within the Customs Union. The ad valorem rate stood at 15% prior to the increase.

With its Decision No. 181 dd. August 27, 2013, the Council of the Eurasian Economic Commission imposed a three-year special protection duty on tableware and porcelain ware. The duty is to be in effect over the period of September 28, 2013 thru September 28, 2016.

An investigation was launched on September 3, 2012 with regard to an application submitted by *DO Promysly Verbilok (Verbilki Craftworks LLP)* and supported by *CJSC Farfor Verbilok (Verbilki Porcelaine)*, *OJSC Imperatorsky Farforovy Zavod (Royal Porcelain Works)*, *CJSC Dobrushinsky Farforovy Zavod (Dobrushinsk Porcelain Works)* and *Dulyovsky Farforovy Zavod (Dulyovo Porcelain works)*. The investigation revealed the existence of grounds for imposing a special protection measure. During the period of 2009 thru 2011 import volume increased more than 70% and then by another 15.9% in H1 2012 against H1 2011. Furthermore, porcelain ware were imported to the territory of the Customs Union from other countries at prices which were much lower than those offered by the manufacturers within the Customs Union, thereby having impaired production and sales volumes, market share of the enterprises in the Customs Union countries, and made production run at a loss.

The size of duty will be \$1479 per ton from September 29, 2013 thru September 28, 2014. Then, the special duty will be reduced to \$1035.3 per ton over a period thru September 28, 2015. The size of duty will be \$591.6 per ton over a period thru September 28, 2016.

Basically, this measure has been imposed against China and Ukraine, the principal suppliers of such products to the Customs Union markets. Moreover, China accounted for 83% of total volume over the period under review. ●

## THE STATE BUDGET IN JANUARY–JULY 2013

T.Tishchenko

According to the Federal Treasury's estimates, the volume of federal budget revenue over the first 7 months of 2013 dropped by 2.2 p.p. of GDP on the corresponding period of 2012. As a positive fact, it can be noted that the rate of decline in the volume of federal budget expenditure as a share of GDP over the five recent months of 2013 against its levels recorded over the corresponding periods of last year has not been accelerating, being stable at the level of 2.1–2.2 p.p. of GDP. At the same time, the situation with regard to the dynamics of revenue of the consolidated budget of RF subjects has been aggravating: while the results of the first three months of 2013 pointed to its decline by 1.8 p.p. of GDP on January–March of last year, the volume of revenue for the period of January–July 2013 dropped still further – to 2.1 p.p. of GDP on the first six months of 2012. Thus, the medium-term risks for the Russian budgetary system's sustainability will depend on the ability of the consolidated budgets of RF subjects to remain well-balanced, as well as on the regions' ability to provide financing for their assumed obligations without drawing on additional allocations from the federal budget.

### Analysis of the Main Parameters of Federal Budget Execution in January–July 2013

Over the period of January–July 2013, the volume of federal budget revenue amounted to Rb 7,329.0bn or 19.8% of GDP, which is by 2.2 p.p. of GDP less than its level for the same period of last year (Table 1). Oil and gas revenues in the federal budget shrank by 1.5 p.p. of GDP against the first seven months of 2012. The cash-based execution of federal budget expenditure over the period of January–July 2013 amounted to 53.0% of its approved per annum target, or to Rb 7,092.3bn (19.1% of GDP), which is by 2.0 p.p. of GDP below its volume for the same period of last year (the cash-based execution of federal budget expenditure over the first 7 months of 2012 being 53.3%).

Based on the results of the first seven months of 2013, the federal budget is executed with a surplus of Rb 236.7bn (0.6% of GDP), which represents a drop on

the surplus figure achieved over the period of January–July 2012 by 0.3 p.p. of GDP. The volume of non-oil and gas deficit declined on the same period of 2012 by 1.4 p.p. of GDP (or 9.1% of GDP).

Over the first seven months of 2013, the volumes of the majority of tax-generated and non-tax receipts in the federal budget declined on the corresponding period of last year, including: tax on profits – by 0.1 p.p. of GDP; domestic VAT – by 0.4 p.p. of GDP; VAT on goods imported into RF territory – by 0.3 p.p. of GDP; tax on mineral resources extraction – by 0.5 p.p. of GDP; and revenues from foreign trade – by 1.2 p.p. of GDP (Table 2). The receipts of excises on domestic goods in January–July 2013 rose by 0.1 p.p. of GDP on the same period of last year, while receipts in the federal budget of excises on imports over the first seven months of 2013 remained at the same level as in January–July 2012 (0.09 p.p. of GDP).

Table 1

MAIN PARAMETERS OF THE RF FEDERAL BUDGET IN JANUARY–JULY 2012–2013

	January–July 2013		January–July 2012		Deviation, p.p. of GDP
	bn Rb	% of GDP	bn Rb	% of GDP	
Revenue, including:	7,329.0	19.8	7,245.9	22.0	-2.2
Oil and gas revenues	3,635.7	9.8	3,734.5	11.3	-1.5
Expenditure, including:	7,092.3	19.1	6,960.8	21.1	-2.0
interest	201.3	0.5	184.6	0.6	-0.1
non-interest	6,891.0	18.6	6,776.2	20.5	-1.9
Federal budget surplus (deficit)	236.7	0.6	285.1	0.9	-0.3
Non-oil and gas deficit	- 3,399.0	- 9.1	- 3,449.4	-10.5	1.4
GDP estimations	37,079		32,917		

Source: RF Ministry of Finance; RF Federal Treasury; IEP's calculations.

Table 2

## RECEIPTS OF THE MAIN TAXES IN THE FEDERAL BUDGET IN JANUARY–JULY 2012–2013

	January–July 2013		January–July 2012		Deviation, p.p. of GDP
	bn Rb	% of GDP	bn Rb	% of GDP	
1. Tax receipts, including:					
Tax on profits of organizations	201.9	0.5	207.9	0.6	-0.1
VAT on goods sold in RF territory	1,114.8	3.0	1,134.0	3.4	-0.4
VAT on goods imported into RF territory	921.7	2.5	911.6	2.8	-0.3
excises on goods produced in RF territory	251.8	0.7	197.9	0.6	0.1
excises on goods imported into RF territory	32.2	0.09	28.9	0.09	0.0
Tax on mineral resources extraction	1,420.8	3.8	1,405.7	4.3	-0.5
2. Revenues from foreign trade	2,756.5	7.4	2,847.8	8.6	-1.2

Source: RF Federal Treasury; IEP's calculations.

The results of the first seven months of 2013 (Table 3) demonstrated a decline on the period of January–July 2012 in the volumes of expenditures, in terms of share in GDP, under the following items: *Nationwide Issues* – by 0.1 p.p. of GDP; *National Economy* – by 0.4 p.p. of GDP; *Education* – by 0.1 p.p. of GDP; *Health Care* – by 0.3 p.p. of GDP; *Social Policy* – by 1.2 p.p. of GDP; and *Interbudgetary Transfers* – by 0.1 p.p. of GDP.

The growth on January–July 2012, in terms of share in GDP, of federal budget expenditure over the first seven months of 2013 occurred under the item *National Security and Law-enforcement Activity* – by 0.1 p.p. of GDP; *Housing and Utilities Sector* – by 0.1 p.p. of GDP; and *Physical Culture and Sports* – by 0.01 p.p. of GDP. As for the other federal budget expenditure items, the

figures for the first seven months of 2013 in terms of share in GDP remained at the same level as recorded for the period of January–July 2012.

According to data released by the RF Ministry of Finance, the Reserve Fund's residuals on the accounts with the Central Bank of the Russian Federation (recalculated in accordance with the exchange rate) for January–July 2013 amounted to Rb 207.86bn, and as of 1<sup>st</sup> of August 2013 the Reserve Fund's volume was Rb 2,807.0bn. In July 2013, part of the National Welfare Fund's assets denominated in foreign currency and kept on accounts with the Bank of Russia was realized, and the monies in the amount of Rb 5.9bn were transferred into the federal budget account. The aggregate volume of the National Welfare Fund as of 1<sup>st</sup> of August 2013 was Rb 2,858.0bn. At present, the vol-

Table 3

## EXECUTION OF FEDERAL BUDGET EXPENDITURE IN JANUARY–JULY 2012–2013

	January–July 2013		January–July 2012		Deviation, p.p. of GDP
	bn Rb	% of GDP	bn Rb	% of GDP	
Expenditure, total	7,092.3	19.1	6,960.8	21.1	-2.0
including					
Nationwide issues	454.1	1.2	429.6	1.3	-0.1
National defense	1,236.2	3.3	1,102.2	3.3	0.0
National security and law-enforcement activity	1,019.4	2.7	860.1	2.6	0.1
National economy	822.9	2.2	844.7	2.6	-0.4
Housing and utilities sector	67.5	0.2	43.1	0.1	0.1
Environment protection	16.1	0.04	13.5	0.04	0.0
Education	402.0	1.1	397.5	1.2	-0.1
Culture and cinematography	43.6	0.1	48.2	0.1	0.0
Health care	266.7	0.7	333.0	1.0	-0.3
Social policy	2,120.9	5.7	2,281.2	6.9	-1.2
Physical culture and sports	34.3	0.09	25.8	0.08	0.01
Mass media	49.0	0.1	46.4	0.1	0.0
Government debt servicing	201.3	0.5	184.6	0.6	-0.1
Interbudgetary transfers	358.0	1.0	350.9	1.0	0.0

Source: RF Federal Treasury; IEP's calculations.

umes of the two funds are being pushed up exclusively by the exchange rate's differences, while the problem of efficient asset management persists and so, when coupled with the overall shrinkage of the budgetary system's revenues, gives rise to some additional risks that threaten the system's sustainability.

At the 17<sup>th</sup> International Economic Forum recently held in St. Petersburg the RF President pointed out three key directions for possible spending, on a refundable basis, of allocations from the National Welfare Fund in the amount of Rb 450bn. However, quite possibly, the list of projects to be financed from the National Welfare Fund can be further extended in the future, and thus the problem associated with the need to search some new approaches and asset management strategies will be effectively removed from the agenda.

In our opinion, until some adequate mechanisms for managing the implementation of infrastructure projects are created that will minimize the risks of corruption and ensure repayment and profitability of budget-funded investments, any decisions concerning the allocation of resources to project funding from the National Welfare Fund and the RF Pension Fund can only be described as untimely and irresponsible.

#### Execution of the Consolidated Budget of RF Subjects in January–June 2013

According to the Federal Treasury's estimates, the consolidated budget revenue of RF subjects in January–July 2013 amounted to Rb 3,698.5bn, or 11.8% of GDP, which by 2.1 p.p. of GDP below its level achieved over the same period of 2012 (Table 4).

A decline in the amount of receipts in the consolidated budget of RF subjects over the first six months of 2013 on the same period of 2012 was noted with

regard to the following items: tax on profits – by 1.2 p.p. of GDP; PIT – by 0.2 p.p. of GDP; and gratis transfers from other budgets of the RF budgetary system – by 0.7 p.p. of GDP. The revenues in the budgets of RF subjects generated by tax on property over the period of January–July 2013 increased by 0.1 p.p. of GDP on the first six months of last year. The receipts of excises on domestic goods, tax on aggregate income and tax on property in the consolidated budget of RF subjects over the first six months of 2013 in terms of share in GDP remained at the same level as in the period of January–July of last year.

The consolidated budget expenditure of RF subjects over the first six months of 2013 dropped on the same period of last year by 0.7 p.p. of GDP, thus amounting to 11.8% of GDP, or Rb 3,693.2bn (Table 5).

A growth of expenditure in the consolidated budget of RF subjects over the first six months of 2013 on the same period of 2012 was displayed only by the item *Education* (by 0.1 p.p.). The following items of the consolidated budget demonstrated a decline over January–July 2013 on the first six months of 2012 in terms of share in GDP: *Nationwide Issues* – by 0.1 p.p. of GDP; *National Economy* – by 0.1 p.p. of GDP; *Housing and Utilities Sector* – by 0.2 p.p. of GDP; *Health Care* – by 0.2 p.p. of GDP; *Social Policy* – by 0.2 p.p. of GDP; and *Interbudgetary Transfers* – by 0.02 p.p. of GDP. As for the other expenditure items of the consolidated budget of RF subjects, the figures for the first six months of 2013 in terms of share in GDP remained at the same level as recorded for the period of January–July 2012.

The cash-based execution of the consolidated budget of RF subjects over the first six months of 2013 amounted to 39.5% (over the same period of 2012 – 39.9%). One of the reasons for the low level of execution of regional budgets is the delay in adopting, at the

Table 4

#### MAIN PARAMETERS OF THE CONSOLIDATED BUDGET OF RF SUBJECTS IN JANUARY–JUNE 2012–2013

	January–June 2013		January–June 2012		Deviation p.p. of GDP
	bn Rb	% of GDP	bn Rb	% of GDP	
Revenue, including:	3,698.5	11.8	3,899.6	13.9	-2.1
- tax on profits of organizations	834.8	2.7	1,119.9	3.9	-1.2
- PIT	1,119.3	3.4	1,006.4	3.6	-0.2
- excises, domestic	233.6	0.7	209.7	0.7	0.0
- tax on aggregate income	159.0	0.5	142.3	0.5	0.0
- tax on property	406.1	1.3	351.1	1.2	0.1
- gratis transfers from other budgets of RF budgetary system	671.2	2.1	795.3	2.8	-0.7
Expenditure	3,693.2	11.8	3,496.6	12.5	-0.7
Consolidated budget surplus (deficit)	5.3	0.02	403.0	1.4	-1.4
GDP estimations	31,215		28,062		

Source: RF Federal Treasury; IEP's calculations.

Table 5

## EXECUTION OF THE CONSOLIDATED BUDGET EXPENDITURE OF RF SUBJECTS IN JANUARY–JUNE 2012–2013

	January–June 2013		January–June 2012		Deviation, p.p. of GDP
	bn Rb	% of GDP	bn Rb	% of GDP	
Expenditure, total	3,693.2	11.8	3,496.6	12.5	-0.7
including					
Nationwide issues	234.5	0.7	218.9	0.8	-0.1
National defense	1.6	0.005	1.5	0.005	0.0
National security and law-enforcement activity	36.4	0.1	35.1	0.1	0.0
National economy	596.7	1.9	561.7	2.0	-0.1
Housing and utilities sector	291.0	0.9	314.5	1.1	-0.2
Environment protection	8.8	0.03	7.2	0.03	0.0
Education	1,115.6	3.6	985.7	3.5	0.1
Culture and cinematography	123.9	0.4	111.8	0.4	0.0
Health care	563.5	1.8	560.2	2.0	-0.2
Social policy	597.7	1.9	584.8	2.1	-0.2
Physical culture and sports	64.3	0.2	57.6	0.2	0.0
Mass media	17.2	0.05	16.0	0.05	0.0
Government debt servicing	38.2	0.1	33.0	0.1	0.0
Interbudgetary transfers	3.5	0.01	8.5	0.03	-0.02

Source: RF Federal Treasury; IEP's calculations.

federal level, of the relevant normative-legal acts on the allocation of subsidies to the budgets of RF subjects<sup>1</sup>. Such a situation is typically observed every year; it can be explained by the lengthy period during which

<sup>1</sup> Many RF Government decrees on the allocation of subsidies to the budgets of RF subjects in 2013 were actually adopted only as late as the end of July or August 2013.

the actual amounts to be allocated are being coordinated – which, in its turn, happens due to inadequacy of the interbudgetary planning mechanisms.

As seen by the results of the period of January–July 2013, the budgets of RF subjects are executed with a surplus of Rb 5.3bn or 0.02% of GDP, which is by 1.4 p.p. of GDP less than the figure for the corresponding period of 2012. ●



## THE RUSSIAN BANKING SECTOR IN JULY 2013

M.Khromov

*In July 2013, the bulk of banks' lending operations shifted towards corporate loans: the growth rate of debt against loans issued to companies for the first time over several months in a row became noticeably higher than that of the retail credit portfolio. The shrinkage of monies on corporate clients' accounts coupled with a slowdown in the rate of growth of individual deposits produced the biggest gap observed over the course of 2013 between the volumes of loans and deposits.*

In July, the growth rate of banks' assets became significantly lower. Over that month, their size increased by only 0.9%<sup>1</sup>, which represents a record low since January 2013. The growth rate of assets over the past 12 months as seen by July's results dropped to 17.4%, which is its record low since the spring of 2011.

The main cause of the slowdown in the rate of aggregate growth of bank assets was the slower growth of their resources. By way of compensation, banks had to increase their debt to the Bank of Russia and the RF Ministry of Finance.

In July, the regulatory capital of the banking sector<sup>2</sup> increased by 0.9%, while the risk adjusted value of assets grew by 1.6%. Accordingly, capital adequacy (norm N1) dwindled by 0.1 pp. to 13.4%. In this connection, the overall decline of Russia's banking sector's capital adequacy occurred due to changes experienced by its two biggest banks – *Sberbank* and *VTB*. Over that month, *Sberbank's* capital increased by 0.8%, while its capital adequacy dropped from 13.2 to 13.1%; *VTB* capital shrank by 1.8%, which in combination with an increasing volume of risky assets pushed down the level of capital adequacy from 15.2 to 14.5%. The capital of all the other banks over the same month rose by 1.4%, while their capital adequacy remained unchanged, staying at the level of 13.4%.

In July 2013, the banking sector's profit amounted to Rb 80bn. Profit less operations with reserves against potential losses (over July, these reserves grew by Rb 56bn – only slightly less than in May 2013, when reserves growth hit record high) amounted to Rb 136bn. This is also a record high for the period of more than three past years.

In June, return on assets and return on equity were 1.8% and 16.3% respectively. This fact points to a con-

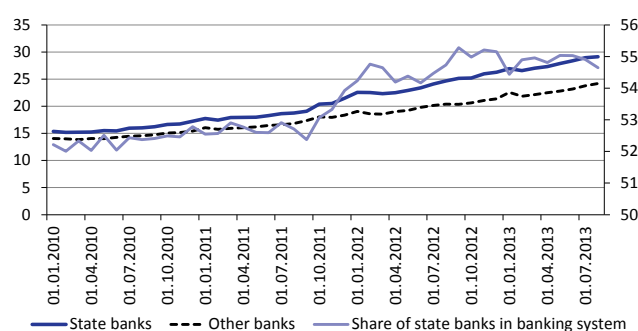


Fig. 1. Movement of Bank Assets (State Banks vs Other Banks, Trillion Rb) and State Banks' Share in Aggregate Assets (% , Right-hand Scale)

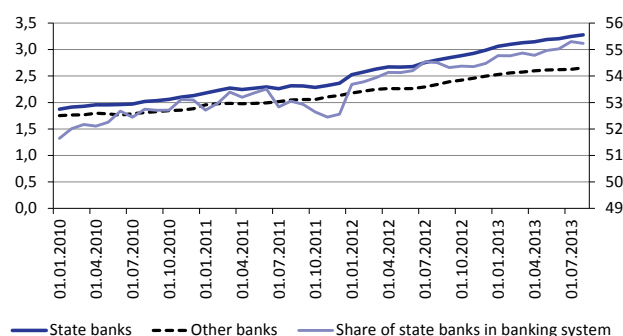


Fig. 2. The Movement of Equity<sup>3</sup> of State and Other Banks (Trillion Rb) State Banks' Share in Equity (% , Right-hand Scale)

tinuation of the downward trend displayed by return on assets and return on equity for banks since their hitting post-crisis highs (2.5 and 20% respectively) in the summer of 2011.

### Attracted Funds

In July 2013, the bank accounts and deposits of the population increased by 0.8% (Rb 129bn), which is by 0.3 pp. below that index's value observed a month earlier. This could be the effect of seasonal factors. Over recent years, the period of July-August is usually marked by a slowdown in the growth rate of the aggregate volume of individual deposits with banks. The

1 Hereinafter, if not otherwise specified, the growth rates of balance-sheet indices are adjusted by changes in the value of their components denominated in foreign currencies.

2 Calculated in accordance with Credit Institutions Financial Reporting Form No 134.

3 Calculated on the basis of balance-sheet accounts (Form No 101).

per annum rate of growth of the population's monies on bank accounts increased over July from 20.0 to 20.8%. This is an upshot of last year's situation when the growth rate of that index in July was even lower (0.2%).

A slower growth rate was displayed in the main by the ruble-denominated component of bank deposits, which fell to 0.6%. Deposits denominated in USD over the same month increased by 2.1%.

The monies of corporate clients kept on bank accounts shrank over July by Rb 57bn, or by 0.5%. The per annum growth rate of that index as of the end of July amounted to 15.8%.

The shrinkage of corporate clients' monies was observed in the main in their current and settlement accounts, whose volume declined by 1.2%. The same index for fixed date deposits, on the contrary, rose by 0.7%. As a result, the share of fixed date deposits in the aggregate funds of corporate clients increased to 54%.

Over July, the banking sector's debt to Russia's financial regulatory bodies noticeably increased. The liabilities against deposits with the RF Ministry of Finance over that month rose by Rb 40bn, or by 6.6%, to Rb 639bn. The amount of debt to the Bank of Russia increased by Rb 271bn, or by 11.7%, to Rb 2.6 trillion. Thus, the total amount of government support received by the banking sector exceeded the level of Rb 3.2 trillion, or 6.1% of aggregate bank assets.

The considerable growth of the scale of refinancing of the banking sector by the Bank of Russia resulted from the first auction where credit institutions could get loans from the Bank of Russia secured by assets or sureties at a floating interest rate. This enabled banks to obtain long-term resources for a period of 12 months at a low interest rate. The floor for interest rates at that auction was set at 5.75% per annum, which is only slightly higher than the lowest rate for overnight and one-week repo operations (5.5% per annum). At the same time, the fixed interest rate on the Bank of Russia's loans secured by assets or sureties for periods up to one year is set at present at 7.5% per annum.

**Invested Monies**

Over the course of July 2013, the amount of outstanding debt of physical persons against bank loans issued to them increased by Rb 248bn, or by 2.6%. Its per annum growth rate, as shown by July's results, amounted to 33.1%.

In spite of the ongoing decline in the growth rate of the population's payables owed to banks, the share of bank loans in household final consumption

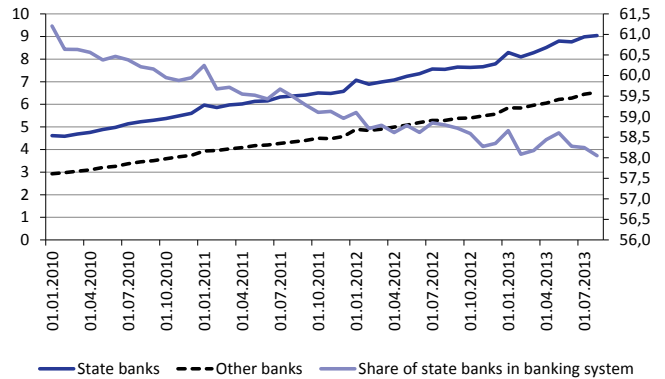


Fig. 3. The Movement of Individual Deposits<sup>1</sup> with State and Other Banks (Trillion Rb), and State Banks' Share in the Market for Physical Persons' Deposits (% , Right-hand Scale)

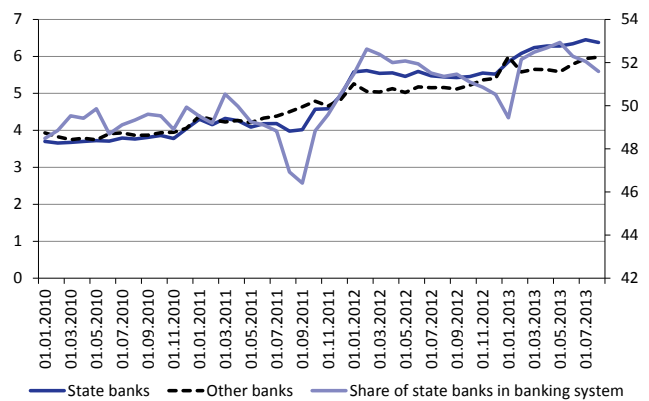


Fig. 4. The Movement of Corporate Clients' Deposits with State and Other Banks (Trillion Rb), and State Banks' Share in the Market for Corporate Clients' Accounts (% , Right-hand Scale)

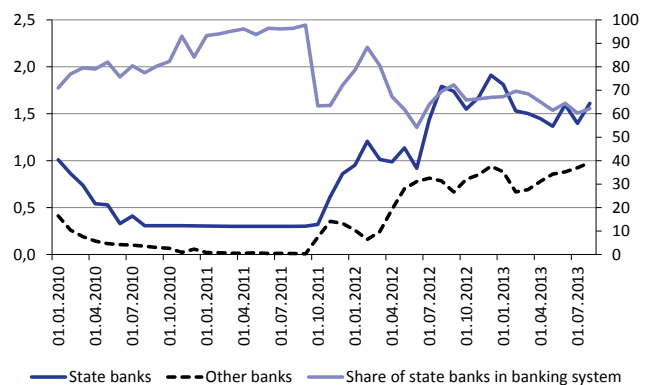


Fig. 5. The Movement of the Bank of Russia's Loans to State and Other Banks (Trillion Rb), and State Banks' Share in the Loans Issued by the Bank of Russia (% , Right-hand Scale)

1 Calculated on the basis of balance-sheet accounts (Form No 101).

Table 1

## THE STRUCTURE OF RUSSIA'S BANKING SYSTEM'S LIABILITIES (AS OF MONTH'S END), AS % OF TOTAL

	12.08	12.09	12.10	12.11	06.12	09.12	12.12	03.13	04.13	05.13	06.13	07.13
Liabilities, bn Rb	28,022	29,430	33,805	41,628	44,266	45,861	49,510	49,839	50,693	51,587	52,744	53,353
Equity	14.1	19.3	18.7	16.9	16.8	16.9	16.2	16.7	16.6	16.5	16.3	16.3
Credits allotted by Bank of Russia	12.0	4.8	1.0	2.9	5.1	5.1	5.4	4.5	4.4	4.8	4.4	4.9
Interbank operations	4.4	4.8	5.5	5.7	4.8	5.1	5.6	5.4	5.0	4.9	5.2	5.1
Foreign liabilities	16.4	12.1	11.8	11.1	11.3	11.0	10.8	10.4	10.8	10.7	10.8	10.6
Physical persons' monies	21.5	25.9	29.6	29.1	29.4	28.7	28.9	29.6	30.0	29.5	29.6	29.6
Enterprises and organizations' monies	23.6	25.9	25.7	26.0	24.0	23.3	24	23.9	23.4	23.5	23.5	23.2
Accounts and deposits of state administrative bodies and local governments	1.0	1.0	1.5	2.3	1.5	2.5	1.6	1.4	1.9	2.0	2.4	2.6
Securities issued	4.1	4.1	4.0	3.7	4.5	4.8	4.9	5.2	5.2	5.1	5.1	4.9

Source: RF Central Bank; the IEP's estimates.

expenditure is on the rise. In July, newly issued bank loans amounted to 29% of household expenditures on goods, public catering and commercial services. When applied to the entire period since the year's beginning, this index amounts to 27%. By comparison with last year's index, the share of bank loans in household consumption has risen by 2 p.p.

The quality of the retail credit portfolio in July slightly worsened. The growth rate of the number of credits with repayment in arrears over that month was 5.2%, while the amount of reserves against potential loss of monies lent to physical persons in the form of credits increased by 4.6%. As a result, the share of outstanding debt as of 1 August 2013 amounted to 4.4%, and the ratio of reserves against potential losses to payables – to 6.9%.

The volume of corporate debt against bank loans over July increased by Rb 437bn, or by 2.2%. The per annum growth rate rose by 0.8 pp., but it still remains low – at the level of 13.9%.

The credit portfolio quality in the market's corporate segment in July 2013 remained practically unchanged. The share of outstanding debt remained at the level of 4.4%, while the ratio of reserves to the size of credit portfolio shrank by 0.1 pp. from 7.3% to 7.2%.

The increase, over July, of the size of corporate debt against bank loans can be explained by the upsurge of activity of big state banks in that market segment. Previously this year, the scale of corporate lending had been increasing mostly at the expense of small and medium-sized banks, which accounted for almost 80% of corporate lending growth over the first half year of 2013, whereas the share of big state banks had been only 8%. However, in July big state banks were already responsible for 50% of corporate lending growth. As part of that growth, the size of Sberbank's corporate

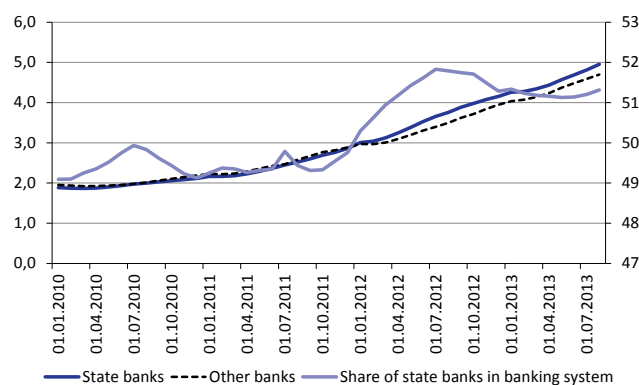


Fig. 6. The Movement of Retail Loans Issued by State and Other Banks (Trillion Rb), and State Banks' Share in Retail Lending (%), Right-hand Scale

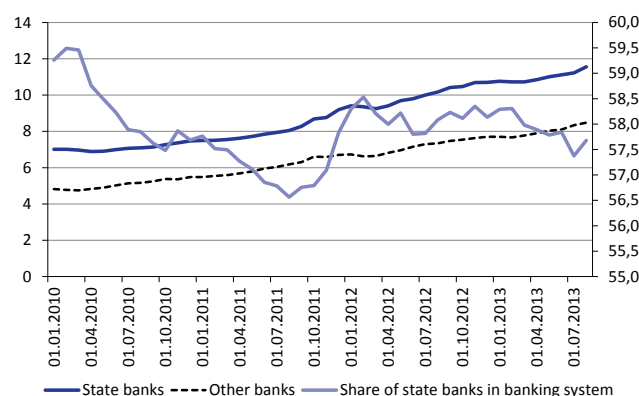


Fig. 7. The Movement of Loans Issued to Enterprises and Organizations by State and Other Banks (Trillion Rb), and State Banks' Share in the Market for Loans to Enterprises and Organizations (%), Right-hand Scale

Table 2

## STRUCTURE OF RUSSIA'S BANKING SYSTEM'S ASSETS (AS OF MONTH'S END), AS % OF TOTAL

	12.08	12.09	12.10	12.11	06.12	09.12	12.12	03.13	04.13	05.13	06.13	07.13
Assets, bn Rb	28,022	29,430	33,805	41,628	44,266	45,861	49,510	49,839	50,693	51,587	52,744	53,353
Cash and precious metals	3.0	2.7	2.7	2.9	2.5	2.6	3.1	2.5	2.7	2.4	2.4	2.3
Monies placed with Bank of Russia	7.5	6.9	7.1	4.2	3.0	2.8	4.4	3.3	3.0	3.1	3.3	3.0
Interbank operations	5.2	5.4	6.5	6.4	5.8	5.8	6.8	6.4	6.1	6.0	6.0	5.9
Foreign assets	13.8	14.1	13.4	14.3	14.2	13.9	13.0	14.5	15.0	15.6	15.1	15.0
Population	15.5	13.1	13.0	14.4	16.0	16.8	16.8	17.4	17.7	17.8	17.9	18.1
Corporate sector	44.5	44.5	43.6	44.0	43.6	43.4	41.3	41.9	41.5	40.9	40.9	41.0
State	2.0	4.2	5.1	5.0	3.8	3.3	3.2	3.2	2.9	2.8	3.2	3.4
Property	1.9	2.7	2.6	2.3	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.1

Source: RF Central Bank; the IEP's estimates.

credit portfolio increased by Rb 120bn (whilst in the first half year it had shrunk by Rb 20bn). The corporate credit portfolios of other big state banks (the banks belonging to *VTB Group*, *Gazprombank* and Russian Agricultural Bank) in July increased by a total of Rb 101bn,

although their cumulative growth over the previous half year had amounted to only Rb 86bn. Thus, the aggregate growth of this index for Russia's top group of state banks over July exceeded Rb 220bn – against only Rb 66bn over the first half year of 2013. ●

## HOUSING MORTGAGE IN THE RUSSIAN FEDERATION IN H1 2013

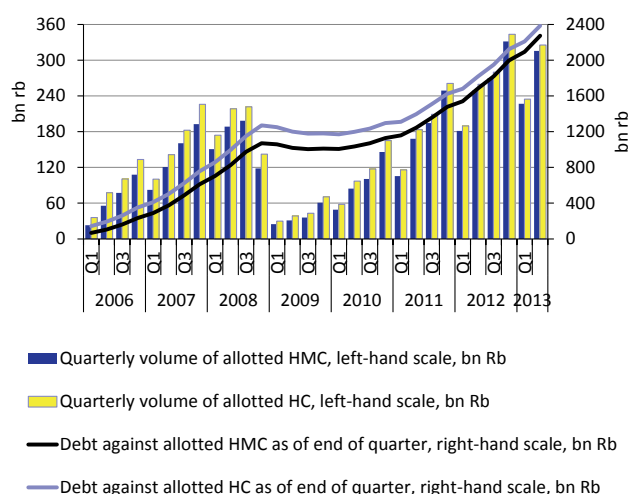
G.Zadonsky

In Q2 2013, the monthly weighted average interest rate on ruble-denominated housing mortgage loans was no longer on the rise, after a more than year-long period of growth: the interest rate for June was 12.6% against its record high of 12.9% in March 2013. The volume of housing mortgage lending in Q2 2013 amounted to Rb 315.5bn, which is by 26.63% higher than the volume of similar loans granted over Q2 2012. The share of outstanding ruble-denominated debt against housing mortgage credits relative to the sum of residual debt continues to be on the decline (1.24% as of 1 July 2013 against 1.41% as of 1 April 2013.); the same is true with regard to the corresponding share of outstanding debt denominated in foreign currencies (12.45% as of 1 July 2013 against 11.78% as of 1 April 2013.). The share of debt against defaulted housing mortgage credits (HMC) (with payments overdue for periods over 180 days) in the sum of total debt denominated in all currencies shrank to 1.15%.

Over first half year of 2013, according to data published by the RF Central Bank (CB), credit institutions issued a total of 357,311 housing credits (HC) in the amount of Rb 560,16bn. Of these, 206,106 housing mortgage credits (HMC) in the amount of Rb 325,43bn were issued in Q2 2013. The total number of housing mortgage credits allotted in the first half-year of 2013 was 336,043, their total volume – Rb 542.50bn; of these, in Q2 2013, a total of 193,639 credits in the amount of Rb 315.51bn were allotted. The volume of housing mortgage credits allotted in Q2 2013 was 26.63% above the same index for the period of Q2 2012, whereas the volume of housing mortgage credits issued in Q2 2012 had risen by 48.16% on Q2 2011. In terms of credit value, the share of HMC denominated in foreign currencies and issued over the first half year of 2013 in the total volume of allotted HMC was 1.37% against 1.48% in the first half year of 2012. The sum of residual debt against housing mortgage credits as of 1 July 2013 amounted to Rb 2.27 trillion, including Rb 2.15 trillion against ruble-denominated credits (Fig. 1). At the same time, the share of debt outstanding against HMC denominated in foreign currencies was 5.31%, or by 3.47 pp. lower than the same index registered as of 1 July 2012.

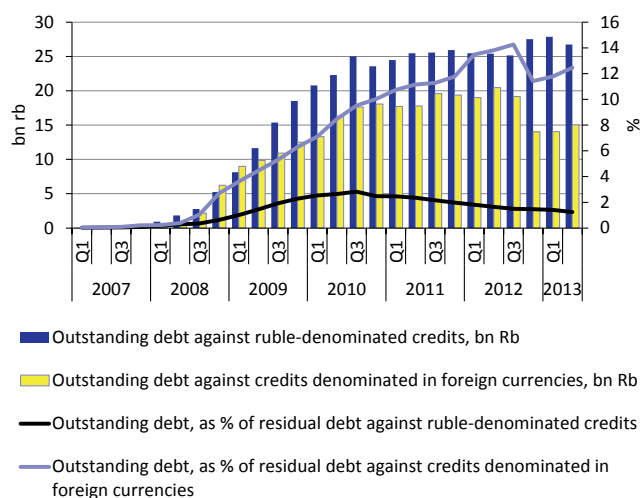
As of 1 July 2013, according to the RF CB, a total of 714 credit institutions were operating on the primary market, of which 665 credit institutions were issuing HMC, while 129 credit institutions were attracting refinancing in the secondary housing mortgage market. As of 1 July 2012, HC were issued by 723 credit institutions, HMC – by 660 credit institutions, while refinancing in the secondary market was attracted by 149 credit institutions.

According to data published by the RF CB, the amount of debt outstanding against HMC as of 1 July 2013 was Rb 41.79bn (Rb 26.75bn against ruble-



Source: data released by the RF Central Bank.

Fig. 1. Dynamics of Allotted Housing Mortgage Credits



Source: data released by the RF Central Bank.

Fig. 2. Changes in Outstanding Debt Against Housing Mortgage Credits, As of End of Quarter

denominated credits and Rb 15.04bn against credits denominated in foreign currencies). The sum of total outstanding debt against ruble-denominated credits as of 1 July 2013 was 4.01% less in money terms than that recorded as of 1 April 2013, while in terms of per cent share of residual debt (1.24%) it dropped by 0.17p.p. Over the same period, outstanding debt against HMC denominated in foreign currencies rose in money terms by 7.11%, while in terms of per cent share of residual debt (12.45%) it increased by 0.67 p.p. (Fig. 2).

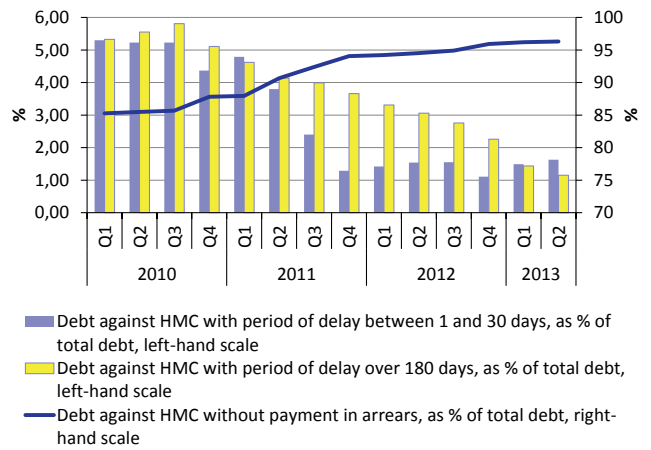
According to data published by the RF CB, the total sum of debt against HMC, less outstanding debt, as of 1 July 2013 had risen on the same index registered as of 1 July 2012 by Rb 596.75bn, and so amounted to 96.32% of the sum of total debt (Fig. 3). Over the same period, the sum of debt against HMC with payments in arrears for periods between 1 and 30 days increased by 11.1bn and amounted to 1.63% of total debt, and the sum of debt against defaulted HMC (i.e., credits with payments in arrears for over 180 days) dropped by Rb 25.45bn to 1.15% of total debt (Fig. 3).

As reported by the RF CB, in the first half-year of 2013, the average weighted interest rates on HMC denominated in rubles and issued over one month rose to its record high of 12.9% in March, and then declined 12.6% in June (Fig. 4). The average weighted interest rate on HMC issued since the year's beginning over the first half-year of 2013 amounted to 12.7%.

As shown by the data released by the RF CB, over first half year the lowest average weighted interest rate on ruble-denominated HMC (12.2%) was offered by credit institutions rated 21st to 50th by the size of their assets, while the highest interest rate (13.2%) – by small-sized credit institutions rated 501st to 956th on the same list; the average market interest rate was 12.7%. The average weighted interest rate over first half year of 2013 on HMC denominated in foreign currencies and issued since the year's beginning amounted to 9.8% – similar to its value for the entire period of 2012.

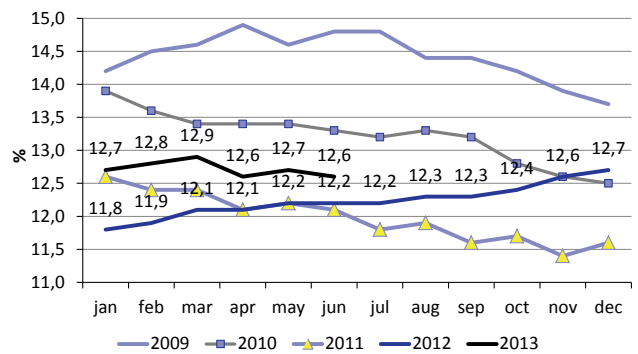
As of 1 July 2013, the average weighted crediting period for HMC issued since the year's beginning declined, as compared to 1 April 2013, by 1.05% to 14.88 years for ruble-denominated HMC, while for HMC denominated in foreign currencies it increased by 1.09% to 13.18 years.

The average by-region amount of ruble-denominated HMC issued in the first half-year of 2013 increased across the board on the same period of 2012. Similarly to the situation in the first half year of 2012, the lowest credit value (Rb 1.182m) was recorded in the Volga Federal District, the highest (Rb 3.595m) – in the city of Moscow. The average weighted interest rates on HMC for the first half year as of 1 July increased on 1 July



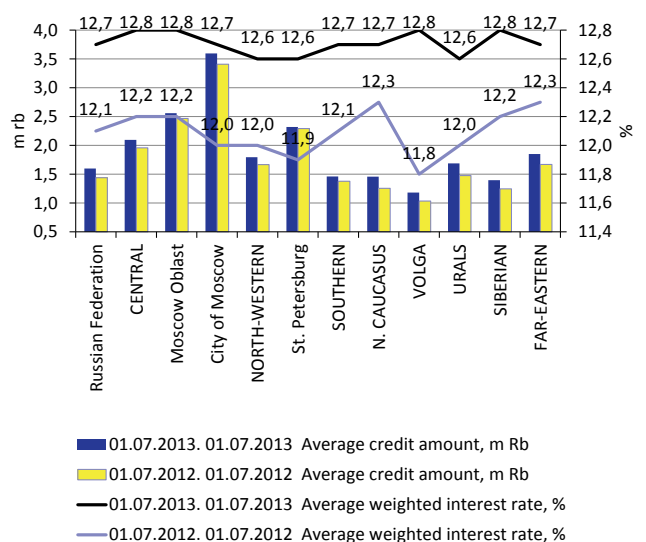
Source: data released by the RF Central Bank.

Fig. 3. Debt Against Housing Mortgage Credits Broken by Period of Delay in Payment, As of End of Quarter



Source: data released by the RF Central Bank.

Fig. 4. Average Weighted Interest Rate on Ruble-denominated HMC Allotted Over Month



Source: data released by the RF Central Bank.

Fig. 5. Average Weighted Data on Housing Mortgage Credits Allotted Since Year's Beginning, by Region

Table 1

## FEATURES OF HMS REFINANCED BY THE AHML IN JUNE 2013, BY FEDERAL DISTRICT\*

	RF	CFD	NWFD	SFD	NCFD	VGD	UFD	SFD	FEFD
Average amount of HMC, thousand Rb	1,248	1,367	1,342	1,234	1,115	1,147	1,253	1,252	1,438
Average weighted interest rate on ruble-denominated HMC, %	11.61	11.79	11.26	12.15	12.82	11.66	11.89	11.04	12.04
Average weighted crediting period for HMC, years	17.3	17.2	16	18.2	16.9	17.4	18.3	17.5	15.9
Average age of borrower, years	34	36	36	33	35	34	33	34	34
Average aggregate income of borrower, thousand Rb per month	29.5	33.2	34.7	29.1	23.1	25.3	30.3	30.2	38.3
Average size of purchased dwelling, m <sup>2</sup>	49.1	49.6	50.4	56.7	54	47.8	48.8	48.9	45.5
Average price of dwelling purchased on mortgage, Rb/m <sup>2</sup>	45,289	51,454	52,509	39,713	32,773	41,999	43,379	42,398	60,597

\* Data for products *Standard*, *Novostroika* [New Construction Projects], *Young Teachers – Standard*.  
Source: data released by the Agency for Housing Mortgage Lending.

2012 all federal districts and regions, rising to the record high value of 12.8% in some of them (Fig. 5).

Over the first half year of 2013, the average weighted interest rate on ruble-denominated HMC refinanced by the Agency for Housing Mortgage Lending (AHML) across the Russian Federation (products *Standard*, *Novostroika* [New Construction Projects], *Young Teachers – Standard*, *Young Scientists* and *Military Housing Mortgage* was 11.35%, the average weighted crediting period – 14.5 years. Over the same period of 2012, the average weighted interest rate on standard products and on *Military Housing Mortgage* was 10.5%, the average weighted crediting period for standard products – 16.5 years. The average weighted interest rate on the AHML's credits for June 2013 amounted to 11.61%, while the average age of borrowers was 34 years, their average aggregate income – Rb 29.5 thousand per month (Table 1). The lowest interest rate was registered in the Siberian Federal District (SFD) – 11.04%, the lowest price per square meter of dwelling (Rb 32,773) – in the North Caucasus Federal District. The average initial installment size across the Russian Federation was 40.5% of the mortgage value.

Over the first half year of 2013, the AHML refinanced 15,591 credits in the amount of Rb 22.3bn, which is less by 22.07% in quantitative terms and by 14.37% in terms of value than the parameters for the corresponding period of 2012. The volume of mortgages bought out by the AHML amounted to 4.4% of the total housing mortgage market volume. In 2013, the Agency bought out mortgage bonds held by market participants to the total value of Rb 10.71bn and

concluded contracts for buying out older mortgage bonds to the value of Rb 32.68bn with maturity dates between 1 November 2013 through 31 December 2014. At present, the AHML is elaborating interaction schemes for the interbank market and a set of model documents for banks' mutual credits secured by housing mortgages. Such schemes are designed to enable banks – issuers of housing mortgage credits to attract interbank credits in order to cover their expenditures on issued housing mortgage loans, to increase the volume of their housing mortgage lending, and to accumulate a sufficient volume of liabilities for issuing mortgage-backed securities. It is expected that under this scheme the AHML will be able to guarantee mortgage buyouts in cases when mortgage banks are unable to repay loans to creditor banks.

From 1 August 2013, the Agency introduced a special deduction from interest rates under its housing mortgage programs in the amount of 0.5 pp. for the staff of those companies that have envisaged special financial support of their employees participating in housing acquisition or housing construction projects.

The results of sociological survey conducted in the spring of 2013 by the AHML in conjunction with the *Institute for Market Research – GfK Rus* demonstrate that the number of citizens who consider themselves to be potential borrowers under housing mortgage lending programs increased over the half-year period by 5 p.p. to 24% (13.1m households), and that 6% of citizens, if they should need to buy a dwelling, will certainly take out a housing mortgage. ●

## THE LIVING STANDARDS OF THE POPULATION OF THE RUSSIAN FEDERATION

E.Grishina, S.Misikhina

*The real disposable money income of the population over the first 7 months of 2013 rose by 4.3% on the corresponding period of 2012, which happened due to an increase in wages and a somewhat less pronounced increase in pensions. The year 2013 saw a persisting though negligible upward trend in the movement of the money income inequality index. The alterations introduced in 2013 into the methodology applied for estimating the subsistence level resulted in its upward adjustment which, in its turn, pushed up the poverty level indices. When calculated in accordance with the previously applied subsistence level estimation methodology, the poverty level indices for Q1 2013 turned out to be lower than the corresponding indices for Q1 2012.*

**The money income of the population.** The nominal per capita index of the population's money income in July 2013 amounted to Rb 25,072, which is by 3.2% below its June value. The decline of the population's real disposable money income over that period amounted to 4.9%. In 2012, the July drop of that index on its previous month's value was more noticeable – 6.7%.

Growth of the population's real disposable money income in Q2 2013 resulted in its climb, over the second half year of 2013, by 4.4% on the corresponding period of last year.

Over the first 7 months of 2013, the population's real disposable money income increased by 4.3%.

onions (by 12%), fresh white head cabbage (by 17%), potatoes (by 18%), while the same index for pork and frozen fish increased by 14% and 12% respectively.

The average monthly charged wage in July 2013 was at the level of Rb 30,366, having increased on the corresponding period of last year by 13.5%, and over the period of January–July 2013 – by 12.9%. The real average monthly charged wage in Q2 2013 rose by 9% on Q1 2013, and then in July it slightly declined – by 2.8% on June 2013. The real wage over the period of January–July 2013 was above its level recorded over the corresponding period of last year by 5.5%.

In spite of the fact that in the first half year of 2013 the average monthly charged wage index rose significantly on the corresponding period of 2012 in some areas of economic activity like education and healthcare & social services (by 24% and 17% respectively), the actual wage level in these areas amounts to only 79% of Russia's average.

In the first half year of 2013, labor pension indexation was carried out twice:

- on 1 February 2013, labor pensions were increased by 6.6 %;
- on 1 April, due an increase in the RF Pension Fund's revenues, an additional upward adjustment of labor pension size by 3.3% was carried out.

State pensions, including social pensions, from 1 April 2013 were increased by 1.81%.

In June 2013, the average size of allotted pension amounted to Rb 10,019, having risen on June 2012 by 9.5%. The growth of the real size of allotted pension over Q1 2013 amounted to 2.4%, that over Q2 – to 3%. Over the first half year of 2013, the real size of allotted pension increased on the corresponding period of the previous year by 2.5%.

**Socioeconomic differentiation.** In 2013, the trend of negligibly increasing inequality in the distribution of the population's money incomes remained unchanged.

Table 1

### CHANGES IN THE REAL DISPOSABLE MONEY INCOME, %

	as percentage of	
	corresponding period of previous year	of previous period
2012		
Q1	101.6	75.7
Q2	104.4	115.9
1 <sup>st</sup> half year	103.1	
July	100.3	93.3
January–July	102.7	
Year	104.4	
2013		
Q1	106.1	76.2
Q2	102.9	112.4
1 <sup>st</sup> half year	104.4	
July	104.2	95.1
January–July	104.3	

Source: data released by Rosstat.

By comparison with July 2012, in July 2013 the share of mandatory payments and fees in total money income rose from 11.1% to 11.9%. Over the period of January–July 2013, the purchasing power of per capita money income declined on the same period of 2012 with regard to some foodstuffs like bread (by 4%), carrots (by 10%),



Table 2

## DISTRIBUTION OF THE AGGREGATE VOLUME OF POPULATION'S MONEY INCOME, %

	2011			2012			2013	
	Q1	1 <sup>st</sup> half year	Year	Q1	1 <sup>st</sup> half year	Year	Q1	1 <sup>st</sup> half year
Money income – total	100	100	100	100	100	100	100	100
including between population quintiles								
first quintile (lowest income group)	5.6	5.5	5.2	5.5	5.3	5.2	5.5	5.3
second quintile	10.4	10.2	9.9	10.3	10.1	9.8	10.3	10
third quintile	15.4	15.2	14.9	15.2	15.1	14.9	15.2	15
fourth quintile	22.8	22.7	22.6	22.7	22.6	22.5	22.7	22.6
fifth quintile (highest incomes)	45.8	46.4	47.4	46.3	46.9	47.6	46.3	47.1
Gini coefficient (income concentration index)	0.398	0.405	0.417	0.403	0.411	0.42	0.404	0.414
R/P 10%, times	14	14.8	16.2	14.5	15.4	16.4	14.7	15.7

Source: data released by Rosstat.

Over the first half year of 2013, the income inequality indices rose on the first half year of 2012 as follows:

- the Gini coefficient: from 0.411 to 0.414;
- the ratio of the average income of the richest 10% to the poorest 10% (R/P 10%): from 15.4 to 15.7.

All other conditions being equal, such an increase in the values of these indices may trigger their growth on 2012 that will push them up to the level of 0.422–0.423 for the Gini coefficient and 16.6–16.7 for R/P 10%.

The increasing inequality in the distribution of the population's money incomes has largely been caused by the accelerated income growth rate in the fifth quintile (highest incomes) by comparison with that in the other population groups with lower incomes. The accelerated income growth in the most wealthy group of the population resulted in a situation where the fifth quintile's share in the aggregate volume of population's money income over the first half year of 2013 rose on the corresponding period of last year from 46.9% to 47.1%, while the shares of the second and third quintiles declined by 0.1 p.p. each.

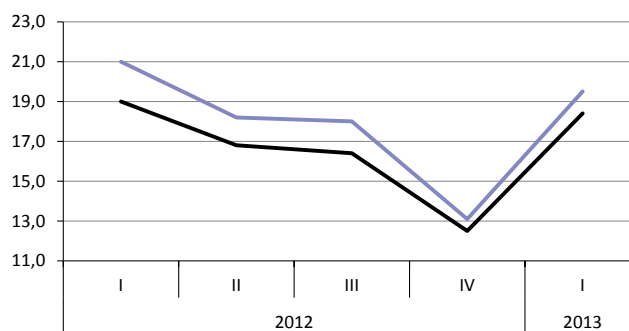
**Subsistence level and poverty.** The subsistence and poverty level estimates require some additional explanations as the methodology for calculating the subsistence level has been altered from the year 2013 onwards. Thus, the share of food in the consumer basket was increased due to the markedly raised consumption norms with regard to expensive foodstuffs (meat, fish, dairies, fruits) and slightly reduced shares of other foods (bread, potatoes), as well as the higher shares of non-food products and lower relative shares of services.

The alterations introduced in the methodology for calculating the subsistence level resulted in its higher value by comparison with that calculated in accordance

 Table 3  
 NUMBER OF PEOPLE WITH INCOMES BELOW  
 SUBSISTENCE LEVEL

	Million	As % of total population
2012		
Q1	19.1	13.5
1st half year	17.7	12.5
Year	15.6	11.0
2013		
Q1	19.6	13.8

Source: data released by Rosstat.



— based on the subsistence level estimated in accordance with the consumer basket established by Federal Law of 31 March 2006, No 44-03 "On the Consumer Basket Across the Russian Federation"  
 — based on the subsistence level estimated in accordance with the consumer basket established by Federal Law of 3 December 2012, No 227-03 "On the Consumer Basket Across the Russian Federation"

Fig. 1. Changes in the Number of Population with Per capita Income Below Subsistence Level, million persons

with the previously applied methodology, which in its turn pushed up the poverty indices.

The subsistence level indices in Q1 2013 were as follows: monthly average for total population – Rb 7,095; monthly average for able-bodied population – Rb 7,633;

monthly average for retired population – Rb 5,828; and monthly average for children – Rb 6,859.

The poverty index in Q1 2013 was at the level of 19.6m, or 13.8% total population – i.e. higher than in Q1 2012. However if the poverty index is estimated in accordance with the previously applied methodology, its value will become actually lower than in Q1 2012, thus giving rise to hopes that, all other conditions being equal, it may become stabilized at its current level or even continue its downward movement over the course of 2013.

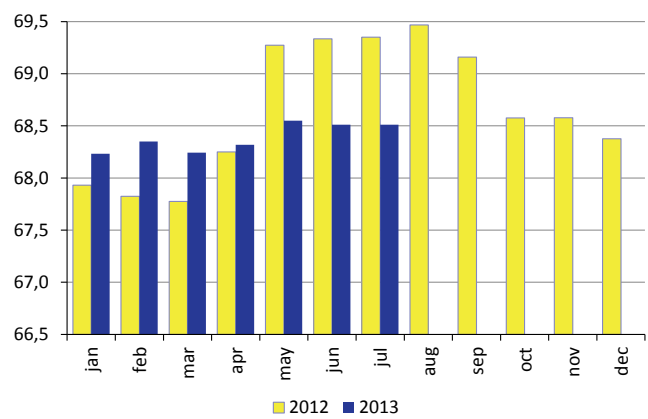
**Economic activity, employment and unemployment levels.** As shown by the results of a sample survey of the population addressing employment issues, as of the second week of July 2013 the number of economically active people in the 15–72 age groups amounted to 75.8m, or to 68.5% of the population belonging to the 15–72 age groups, or approximately 53% of the total population.

While over the period of January–March 2013 the economic activity of the population was higher than in the corresponding periods of 2012 by 0.3–0.5 p.p., in May and June 2013 the population’s economic activity level was lower by 0.7–0.8 p.p. than in the corresponding periods of 2012.

It is noteworthy that the most pronounced decline in the level of economic activity was noted among women (by 1.2 p.p. in June 2013 on June 2012), while men’s economic activity level in June 2013 dropped by 1.1 p.p. on the same period of 2012.

In accordance with the results of the sample survey of the population addressing employment issues, in July 2013 the employment level for total population was 652%.

In January–March 2013, the level of employment was by 0.5–0.9 p.p. higher than the same index for the corresponding period of 2012. Later on, in May and June 2013, employment declined below its levels recorded in

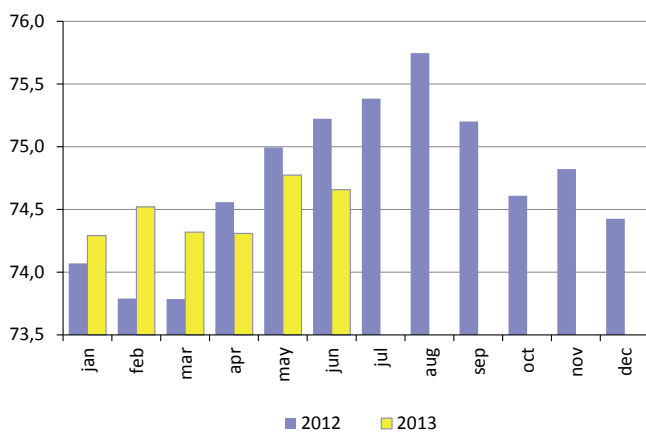


Source: data released by Rosstat.

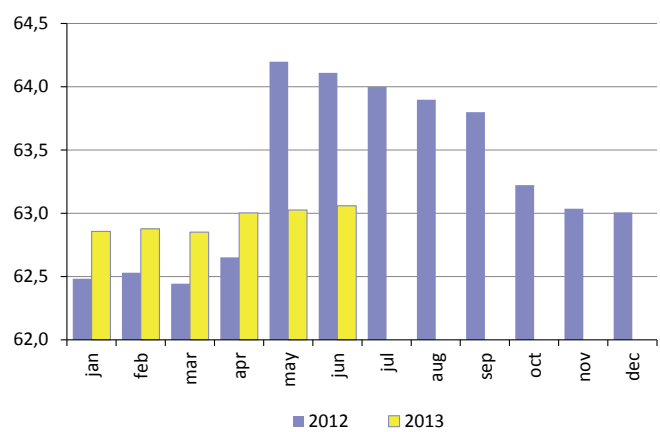
Fig. 2. The Population’s Economic Activity Level in 2012–2013, %

the corresponding periods of 2012 by 0.6 and 0.9 p.p. respectively. At the same time, the level of employment dropped lower among women: in May and June 2013, it was lower than its index recorded over the same periods of 2012 by 1.1 and 1 p.p. respectively.

On the whole, the level of employment among women was by more than 10 p.p. lower than among men. At the same time, the employment index for women was significantly dependent on the number of their children. The results of population employment surveys for Q2 2012 and Q2 2013 demonstrate that the level of employment among women aged 20–49 years with three or more children aged under 18 years was by more than 20 p.p. below the same index for women with only one child aged under 18 years. While the employment index for women aged 20–49 years with two children aged under 18 years dropped in Q2 2013 on the corresponding period of 2012 by 2.7 p.p., the same index for women with three or more children rose by 1 p.p., which may in part be explained by the progressive evolution of ‘family



Men



Women

Source: data released by Rosstat.

Fig.3. The Population’s Economic Activity Level in 2012–2013, %

kindergartens', which had made it possible for women with many children to find suitable jobs.

Table 4

**EMPLOYMENT LEVEL FOR WOMEN AGED 20–49 YEARS WITH CHILDREN UNDER 18 YEARS OF AGE, Q2 2012 AND Q2 2013, %**

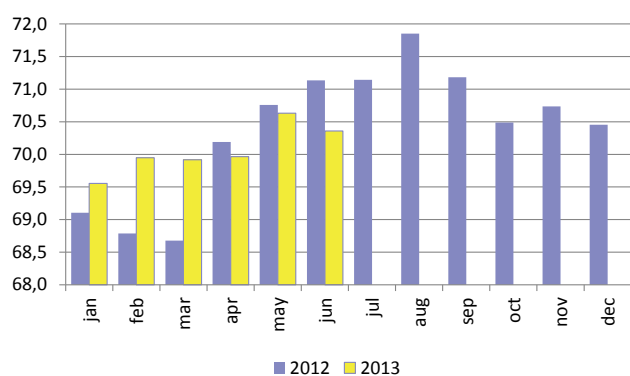
	2012	2013
Women with children under 18 years of age, total	77.3	75.9
Including those with		
1 child	80.2	79.3
2 children	74.5	71.7
3 or more children	56.7	57.7
Out of the number of women with children under 18 years of age, those with children in the pre-school age group (0–6 years)	65.7	63.8

Source: data released by Rosstat.

Although the level of employment in May and June 2013 was below that recorded in the corresponding periods of 2012, the share of those employed in the 'informal' sector in the total number of employed in May and June 2013 became higher by 0.2 and 0.7 p.p. respectively than the same index for the corresponding periods of 2012. On the whole, the share of those employed in the 'informal' sector in the period from January through June 2013 increased from 18.3 to 20.5%.

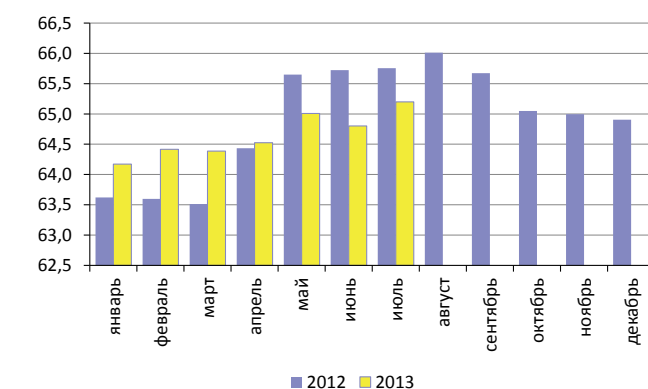
The level of unemployment in July 2013 was 5.3% (when not adjusted by the seasonal factor). Over the period of January–March 2013, the unemployment index was on the decline and fell below its levels in the corresponding periods of 2012 by 0.4–0.6 p.p. Then, although in June and July 2013 the unemployment index continued on a downward trend, it demonstrated a slight rise on its level in the corresponding periods of 2012.

It should be noted that the unemployment level among the rural population was markedly higher than that for the urban population. Thus, for example, in July 2013 the difference was 1.6 times, and in April 2013 – 2.1 times.



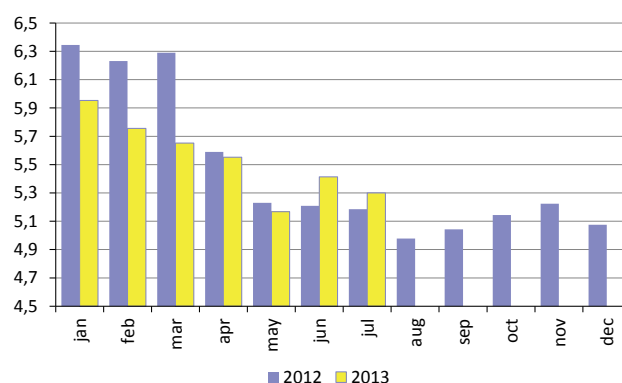
Men

Source: data released by Rosstat.



Source: data released by Rosstat.

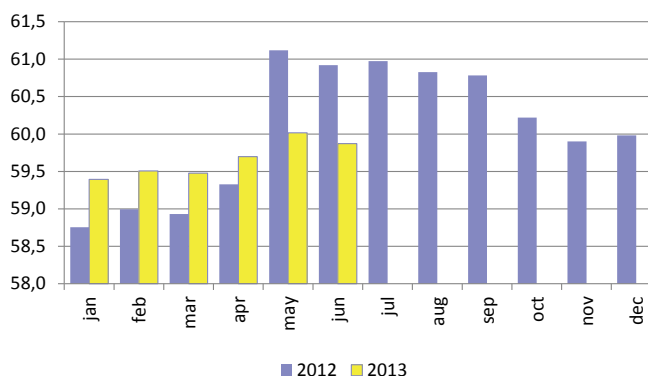
Fig. 4. Employment Level in 2012–2013, %



Source: data released by Rosstat.

Fig. 6. Unemployment Level in 2012–2013, %

The total number of unemployed estimated in accordance with the International Labor Organization's criteria was 4.2 times than the number of unemployed registered by the government unemployment agencies. As of the end of July 2013, a total of 945 thousand people were entered in the unemployment records, which is by 2.6% less than in June 2013, and by 13.0% less than in July 2012.



Women

Fig. 5. Employment Level in 2012–2013, %

## SOME SPECIAL FEATURES OF THE CURRENT FINANCIAL POLICY AND A REVIEW OF TAXATION REGULATORY DOCUMENTS ISSUED IN THE PERIOD OF JULY THRU AUGUST 2013

L. Anisimova

*It is impressive what the Supreme Arbitration (Commercial) Court of the Russian Federation (the SAC of Russia) managed to achieve in order to adapt Russia's law enforcement practices to a free-market environment against general uncertainty regarding the state financial policy. First of all, measures to establish relationship between the Russian legislation and international practices in the context of economic and financial regulation are worth mentioning. In the period under review, the SAC of Russia followed up the issues which are relevant for the benefit of Russia's budget. The SAC of Russia managed to successfully develop decisions, which are universal from the international law point of view, on making Russian regulations applicable to Russian and foreign parties to legal proceedings.*

Economic growth rates continued to slow down in Russia in the period of July thru August 2013. According to the Ministry of Economic Development and Trade of Russia, growth rate in 2013 may slow down to a level below 2%<sup>1</sup>. Capital outflow deepened in the same period. In Russia, several facilities of extraction and primary treatment of many raw commodities have been suspended due to decline in export of raw materials which was caused by slowdown in growth rates in China, the principal consumer of raw materials. For example, RUSAL announced that it suspended its aluminum production at certain of its aluminum smelters due to high costs and uncertainty in the tariff policy, until the world market price of aluminum resumes \$2000 – 2400 per ton (presumably, for a period of four years at five plants). Being the most important source of a relative federal budget's affluence, still high crude oil prices have become a source of constant tension, since they dependent largely upon the FRS's policy: once costs on repurchase of US government bonds go down, the US dollar is to get stronger, i.e. US-dollar inflow into global markets is to slow down followed by falling crude oil prices.

In order to prevent social-related consequences of stagnation and a likely weakening of the national currency, the government has been strengthening financing of budget sectors, thereby having produced such a phenomenon as growth in personal income tax revenues against reduction of profit tax revenues<sup>2</sup>. In

our opinion, the phenomenon may suggest that another problem, which in short term would strongly impede the development of the domestic market, has aggravated – a gap in salaries paid in the public sector and the domestic market. In a free market, salaries of government employees are generally many times lower than labor remuneration in the business sector. In contrast, in the Russian Federation, the federal government provides top-ranking government officials and those employed at state-owned corporations with a risk-free salaries which are several and dozens times as much as the labor remuneration of employees in the private sector<sup>3, 4</sup>.

Generally, the federal government intentionally maintains a relatively low level of public servants' salaries in competitive market environment, which simply can be explained from the economical point of view by inducing people to go to earn money in business in a free market. If people go into business, a free market

enues. According to the data provided by the Federal Treasury of Russia, profit tax revenues in regional budgets have contracted by Rb 285bn (by 26%) against the previous year. Personal income tax revenues increased in H1 2013 by 11% year-on-year, thereby having prevented regional budget revenues from shrinking. See [kommersant.ru/doc/2259759](http://kommersant.ru/doc/2259759) for more details.

3 А. Алексеевских, Т. Ширманова, «Зарплаты региональных чиновников в 1,5 раза выше, чем у сограждан», сайт [Izvestia.ru](http://Izvestia.ru) от 21.08.2013. (A. Alekseevskikh, T. Shirmanova, "Regional bureaucrats' salaries are 1.5 times the average wages of those employed in other sectors"). Salaries of regional bureaucrats are 56% higher than the average wages across the country. Bureaucrats earn twice as much money as their compatriots in as many as 12 regions.

4 «Передовики доходопроизводства» ("Top earners") See the website: [gazeta.ru/business/2013/08/26/5606229.shtm](http://gazeta.ru/business/2013/08/26/5606229.shtm) dated 26.08.2013. This is the first time that CEO journal has published its rating of salaries paid to corporate board members of Russian state-owned companies. Sberbank is ranked No1, where a board member's monthly earnings equal to Rb 11,7m on average. VTB Group is ranked No2 (Rb 10m), followed by Russian Railways and Gazprombank (both Rb 6.1m) which are ranked No3 and No4 respectively.

1 Ф.Сморщков, Газета.ru от 26.08.2013 «Улюкаев умеряет оптимизм». (F. Smorshkov, Gazeta.ru, dated 26.08.2013 "Ulyukayev mitigates optimism").

2 А.Зотин, «Дыру по прибыли считают», Журнал «Коммерсант Деньги», № 33 (941) от 26.08.2013. (A. Zotin, "The profit dependant hole", No. 33 (941) dated 26.08.2013.) According to the Rosstat (Federal State Statistics Service), the balanced financial result of enterprises in the H1 2013 is 21.7% less year on year. This was the cause that lead to a gap in profit tax rev-

will be developing. If the federal government pays high risk-free salaries to government employees, it thereby stimulates imports. This is why consumer demand promotion through simply paying higher salaries for government employees, as some experts recommend to do, would have no effect whatsoever on the domestic market development in Russia. Instead it would further widen the spiral of salary (pension) and price and result in degradation of the domestic production market which would become uncompetitive and unable to afford a “salary race” offered by the budget<sup>1</sup>, as well as tariffs of public utility services. In our opinion, this is the key factor which constrains the appearance of a small business segment in Russia. It is at least subsidized regions that have already been facing the issue of monitoring the population of bureaucrats<sup>2</sup>.

However, the situation is unlikely to improve in a short term period. The guidelines of the fiscal policy for 2014–2016 provide for additional (against current expenditure obligations approved for execution) budget funds which are to be allocated mostly to: pay salaries to the personnel employed at federal healthcare, educational, cultural, research and social security facilities; federal state civil servants and holders of public offices (i.e. senior government officials); increase pensions for retired servicemen by a least 2% above inflation rate; increase the strength of contract servicemen, and some other payments, including the monthly third-child benefit and contributions to investment funds. In doing so, expenditures is expected

1 «Росстат: зарплаты сотрудников администрации президента РФ выросли на 66% в 2013 году» (“Rosstat: The Presidential Executive Office personnel’s salaries have increased by 66% in 2013”, see the website: [kommersant.ru/news/2263034/rubric/3](http://kommersant.ru/news/2263034/rubric/3). “In H1 2013, salaries of the personnel at the Presidential Executive Office have increased 66.5% against the previous year ..., with average salary having reached more than Rb 171,300. Average salaries of those employed at the Russian Government Administrative Office have increased 50.8% to reach Rb 167,000, State Duma personnel’s salaries have raised 28% to reach Rb 67,000 during the same period. Salaries of those employed in the Federal Drug Control Service of the Russian Federation have increased by 40% to reach Rb 75,200, and of those employed at the Ministry of Defense have grown up by 50% to reach Rb 75,700. In contrast, salaries of the personnel at the Ministry of Healthcare have dropped by almost 24% to Rb 61,800, and at the Ministry of Regional Development by 25.5% to Rb 49,500”.

2 Н. Городецкая, «Популяция региональных чиновников будет взята под контроль. Депутаты хотят дать правительству право ограничивать их численность» (N. Gorodetskaia, “The population of regional bureaucrats will be put under control. PMs are ready to let the government limit the size of bureaucratic population”), see the website: [kommersant.ru](http://kommersant.ru) dated 30.08.2013. “...According to Rosstat, as of October 1, 2011 (these are the latest data available on the Rosstat’s official website), a total of 667,140 persons were holding “public offices and civil offices in the Russian Federation”, and 454,600 persons were holding federal government offices, and just 182,600 persons were holding regional government offices”.

to increase 22% (i.e. more than Rb 5 trillion) in a period of three years, and deficit (which is planned to be maintained at about 0.6% of GDP) will be covered mainly by increasing state debt which is expected to increase by about Rb 4 trillion<sup>3</sup> in three years, and the remainder – through revenues from privatization of state-owned property.

It is impressive what the Supreme Arbitration (Commercial) Court of the Russian Federation (the SAC of Russia) has managed to technically achieve in order to adapt Russia’s law enforcement practices to a free-market environment against general uncertainty regarding the public financial policy. First of all, measures to establish relationship between the Russian legislation and international practices in the field of economic and financial regulation are worth mentioning.

In the period under review, the SAC of Russia worked out the issues which are most important for the benefit of Russia’s budget. The SAC of Russia managed to successfully develop decisions, which are universal from the international law point of view, on making Russian regulations applicable to Russian and foreign parties to legal proceedings, namely: 1) the SAC of Russia established that it is only parties to transactions which act in good faith that are to be entitled to seek judicial protection of their ownership interests; 2) according to legal actions concerning infringement of legal entity’s ownership interests, top managers of such legal entity are to be entitled to judicial protection to the extent that they were acting in good faith and in compliance with their assigned functions.

The foregoing can be illustrated with a few examples of how worked out legal positions can be used to protect the interests of Russia’s budget and economic interests of Russia’s legal entities.

There are some principal channels which manufacturers generally use for tax-free transfer of revenues from Russia to states with low-tax jurisdictions, namely: a) transfer pricing, b) moving consideration of economic disputes to foreign jurisdictions, c) exploiting opportunities provided by domestic legislation for moving actual headquarters of a Russian organization to foreign jurisdictions.

With regard to transfer pricing, it is often used as part of transactions, when revenues of a party to a transaction may actually be assigned to the other party thereto due to the use of non-market prices between the counterparties, i.e. the revenues are moved out for the purpose of taxation in a state which offers a preferential tax regime. Since such transactions are generally closed between related parties, the Tax Code of the Russian Federation (the TC of Russia) contains

3 In other words, it will exceed Rb 12 trillion to account for more than 13% of GDP against 10% as recommended by the IMF.

a mechanism of identifying an aggregate shareholding proportion in case of multi-way inter-company shareholding schemes for the purposes of legal recognition of parties as related parties, as well as specifies criteria of classifying transactions between related parties (affiliates) к category of entities subject to control by Russian tax authorities.

In its Letter dated August 16, 2013 No. 03-01-18/33535 the Ministry of Finance of Russia explained the provisions of the TC of Russia which concern related parties and recognition criteria for transactions between such parties as controlled for tax base assessment purposes, application of the inter-company shareholding interest assessment rules provided for by the TC of Russia, market price valuation by types of transactions between related parties, recalculation of revenues and costs of parties to a transaction for banking sector entities.

Rules for valuation of prices, revenues and costs for transactions between related parties for the purposes of recognizing such transactions as controlled ones and assessing a tax base for profit tax imposed on parties to such transactions are regulated by Section V.1 of the TC of Russia (Articles 105.1–105.17 of the TC of Russia).

The Ministry of Finance of Russia explains that all revenues of related parties must be taken into account in determining a sum criterion with a view to recognizing transactions as controlled ones for profit taxation purposes. In cases when revenues which are recognized in determining a corporate profit tax base don't derive from direct settlement of transactions between related parties, such revenues are to be ignored in determining the sum criterion, namely revenues as an excess of the amount of revaluation of assets over the amount of revaluation of liabilities due to changes in the currency exchange rate; positive differences from an excess of positive revaluation of precious metals over negative revaluation; amounts of recovered reserves whose build-up costs were previously recognized as expenses; revenues from shareholding interest in other organizations, including dividends etc.

At the same time, Ministry of Finance of Russia gave comments about specific features which taxpayers should consider in calculating the sum criterion for financial transactions which may be recognized as controlled ones. In particular, under credit agreements, repo transactions, in determining compliance with the sum criterion, interests should be considered according to their recognition specified in Chapter 25 of the TC of Russia (given the rule of capitalization, i.e. interests which exceed the established standard are to be recognized as dividends), no stock market transactions executed as part of regular stock mar-

ket trading are to be recognized, since prices of such stock market transactions are market prices *a priori*; in contrast, over-the-counter transactions with debt securities executed by related parties are to be qualified as controlled ones, in which case the amount of accrued (accumulated) interest income (coupon yield) as well as regular payments of accumulated interest income (coupon yield) by the issuer (originator) under debt security issue terms and conditions are to be considered in calculating the sum criterion; under transactions which refer to the placement of issued stocks (interests, units), revenues and costs of the issuer (taxpayer) and revenues and costs of the buyer (taxpayer) of such stocks (interest, units) are not to be considered for the purposes of determining the sum criterion, and, consequently, neither quantifiable revenues as property nor proprietary rights received as contributions to the charter (pooled) capital (fund) of an organization are to be considered in determining the sum criterion and; the amount of a remuneration received, etc. are to be considered for the purposes of determining the sum criterion for deals involving bank guarantees and sureties for the benefit of a related party.

Technically, Ministry of Finance's explanations are not juridically legitimate. Similarly, we believe that calculation of a shareholding interest is not quite correctly illustrated in the scheme available in Schedule 2 to the explanation letter. Nevertheless, the letter is an illustration of Ministry of Finance's position concerning recognition or non-recognition of specific financial transactions between related parties as controlled ones, whereas Article 105.16 the TC of Russia reads that it is the taxpayer who is to be obliged to notify tax authorities of executed controlled transactions. This means that failure to provide such a notice will be treated as breach of the law on the taxpayer side. We will further explain herein that Russian tax payers should be very careful with all general recommendations of the Ministry of Finance of Russia so as to avoid violations of the law which actually may lead to a liquidation under the Law.

Ministry of Finance's explanations have made it clear how difficult it is to determine an inter-company shareholding interest, especially if parties to transactions are located outside the Russian Federation and end beneficiaries can't be identified. Moreover, it is difficult to determine the real price of an intra-group transaction which may comprise a set of separate, not synchronized in time operations, as well as revenues and costs of all the parties to a controlled transaction.

In order to trigger a mechanism of control over transactions between related parties with multi-way, cross-border shareholding, all participants and their

shareholding interest should be identified first. This task can be accomplished much easier with the help of a solution which the SAC of Russia found as part of the Ruling awarded by the Presidium of SAC of Russia on 26.03.2013, No. 14828/12, on the case No. A40-82045/11-64-444. The reason of a conflict was that an off-shore company which was not obliged to identify its beneficiary owner under the law of the country of incorporation was a party to a deal concerning establishment of the title to a property located on the territory of the Russian Federation.

Since the Presidium of SAC of Russia is to rely on the precedence of the international agreements over the local legislation, the suggested method of beneficiary identification for such cases, if they are considered on the territory of the Russian Federation, is neat and technically universal.

In particular, the Presidium of SAC of Russia noted that "It is in itself not illegal if a legal entity, which is incorporated in an off-shore zone and therefore not obliged to publicly disclose its beneficiary, obtains registration of title to a real property located in the Russian Federation".

However, such a legal arrangement of holding real property located on the territory of the Russian Federation should not imply that rights and legal interests of unlimited range of third parties appear to be affected or breached because of their participation (including involuntary participation too) in legal relations to which an off-shore company is acting as the other party.

Due to non-public structure of share/interest-holding in the off-shore company, in this legal case it was hard to prove that the property was acquired in bad faith or other factors legally related to protection of third party interests, because a respective foreign legal system have special rules for disclosure of information about off-shore companies' beneficiaries.

In this regard, in case when the issue of application of Russian legal provisions on third party protection refers to an off-shore company, it is the off-shore company that must justify the presence or absence of circumstances protecting the off-shore company as a separate entity in its relations with third parties. Justification first of all means disclosure of information of who is really behind the company, in other words, who is the beneficiary owner.

To make it simpler, the position of SAC of Russia relies upon the following: if the beneficiary owner of a legal entity may not be disclosed under the off-shore legislation, then it is only bona fide parties to a transaction that may be entitled to legal protection on the territory of the Russian Federation, thereby identifying real shareholders and beneficiaries. In other

words, the off-shore company may register its title to a property, but the beneficiary owner must be identified when action proceedings take place in a Russian court.

There is another scheme designed to avoid disclosure of the beneficiary under an agreement, when such an agreement contains a provision that economic disputes must be considered within a non-Russian jurisdiction.

The SAC of Russia examined such a situation in its Information Letter No. 158 concerning the practice of consideration in arbitration courts of cases in which foreign parties are involved. The Letter was posted in the official SAC of Russia website on 26.07.2013.

In the first section of the Information Letter No. 158 the Presidium of SAC of Russia explained that arbitration courts must not interfere with parties' agreement on the selection of a competent court (prorogation agreement), unless there is a reasonable need to do so.

The following conditions are to be met to recognize that a dispute in which a foreign party is involved falls within the jurisdiction of Russian arbitration court, where the other party denies such jurisdiction:

- The Russian arbitration courts possess the exclusive jurisdiction (Article 248. Arbitral Procedural Code of the Russian Federation, hereinafter – the APC of Russia);
- A prorogation agreement<sup>1</sup> on the submission of a dispute to a Russian arbitration court have been concluded between the parties (Article 249 thereof);
- There is close relationship between legal relations in dispute and the territory of the Russian Federation (Article 247 thereof).

According to Article 247, exclusive jurisdiction of an arbitration court of the Russian Federation arises under transactions: at the place where the respondent resides or respondent's property is located; the dispute has arisen from an unjust enrichment, which has taken place on the territory of the Russian Federation; the dispute has arisen from relations involved in the circulation of securities which were issued on the territory of the Russian Federation, etc.

According to Article 248 thereof, the exclusive jurisdiction of arbitration court of the Russian Federation arises in the following cases: with regard to disputes on a property owned by the Russian Federation, including disputes related to privatization of state-owned property and forcible alienation of the property for public needs; with regard to disputes whose object

1 Prorogation agreements (derived from latin prorogatio) refer to agreements on jurisdiction which define a country whose courts will possess the jurisdiction for the settlement of disputes concerning foreign trade transactions.

immovable property, if such property is located on the territory of the Russian Federation, or the title to this property; *with the regard to disputes concerning the establishment, liquidation or registration on the territory of the Russian Federation of legal entities and of self-employed entrepreneurs, as well as challenge of the decisions taken by such legal entities, etc.*

According to Article 249 thereof, if the parties of which at least a single one is a foreign person, have concluded an agreement, while laying down in it that an arbitration court in the Russian Federation possesses jurisdiction for the investigation of a dispute involved in the performance by them of business or other economic activity, that has already arisen or that may arise, the arbitration court in the Russian Federation shall possess the exclusive jurisdiction for an investigation of the given dispute on the condition that such agreement does not modify the exclusive competence of a foreign court.

Therefore, if the parties have agreed that a foreign court will possess jurisdiction over their transactions and they will submit no disputes under the Russian court system, then in order to stop disinvestment and tax-free transfer of revenues from the Russian Federation, a Russian arbitration court possesses an important jurisdiction such as the right to liquidate the Russian party to a transaction, which will not be deemed to be an illegal action as long as it meets the requirements set forth in Paragraph 2, Article 61 of the Civil Code of the Russian Federation (the CC of Russia) which stipulates that legal entity may be liquidated by the court decision in case of repeated or gross violations of the law or other regulations.

As noted above, violation of the rules which require notification of the existence of controlled transactions may well be recognized as violation of the Russian legislation and the ground for liquidation of a Russian legal entity as a party to such transactions. The fact that liquidation of law violators by the decision of local judicial authorities is a common practice is evidenced by the situation which *En+ Group* encountered after the Montenegro Government initiated bankruptcy proceedings against one of its subsidiaries, *Aluminum Plant Podgorica* (APP), situated in *Podgorica*. In the summer of 2013, the Ministry of Finance of Montenegro submitted an APP bankruptcy lawsuit to the Podgorica Arbitration Court on the ground of a €24.4m debt owed by the plant which was accumulated after the Ministry of Finance of Montenegro paid €24.4m to Deutsche Bank under a government guarantee (APP previously breached covenants<sup>1</sup> on a €135m loan and failed to repay that loan)<sup>2</sup>.

1 Covenant refers to a binding agreement to perform or refrain to perform particular actions.

2 О. Алексеева, А. Топалов, «Дерипаска засудит Черногорию на миллиард евро», сайт Газета.Ru от 13.08.2013. (O. Alekseyeva,

Another channel designed for disinvestment and tax evasions refers to mala fide usage of formal opportunities provided by the Russian legislation.

In its ruling No. 62 issued on July 30, 2013 according to Article 13 of the Federal Constitutional Law dated 28.04.1995 No. 1-FKZ "On Arbitration Courts in the Russian Federation" the Plenum of Supreme Arbitration Court provided arbitration courts with detailed explanations concerning recovery of legal entity's losses by persons that make up the corporate management body of the legal entity.

According to Paragraph 3, Article 53 thereof, a person that makes up the corporate management body of a legal entity must act in good faith and wisely for the benefit of the legal entity. Such person shall be obliged to recompense the losses he has inflicted through his actions or omissions upon the legal entity. At the same time, the claimant must prove the existence of circumstances which can evidence that the director has failed to act in good faith and/or wisdom through his actions (omissions) (Paragraph 5, Article 10 thereof).

The SAC of Russia pointed to the fact that courts must not apply formally Paragraph 5, Article 10 thereof. Generally, in practice the claimant has no sufficient documented evidence, because corporate performance documents are kept by the director. With a view to settling this collision, the SAC of Russia refers to the good faith formula of those involved in the process. Should the director refuse to provide explanations or his explanations be apparently incomplete, if the court decides that director has failed to behave in good faith (Article 1 thereof), the court may charge the director with the burden of proving that the director has not neglected his duty to act in good faith and wisely for the benefit of the legal entity.

Furthermore, the SAC of Russia specified the cases in which director's mala fide actions (omissions) are deemed to have been justified, in particular when the director: was acting without approval of his/her superior authorities where there was a conflict between his/her personal interests (interests of director's affiliated persons) and legal entity's interests; has concealed information about the transaction or provided unreliable documents on the transaction; withheld legal entity's documents after his/her resign, etc.

However, the explanations failed to cover many still unresolved controversial issues, thereby creating legal channels for a large-scale disinvestment and weakening legal entities.

For instance, the SAC of Russia provides the definition of a transaction under disadvantageous terms and conditions and even specifies criteria (signs) thereof:

va, A. Topalov, "Deripaska files a 1 billion euro lawsuit against Montenegro", Gazeta.ru dated 13.08.2013.



“Transaction under disadvantageous terms and conditions refers to a transaction whose price and/or other terms and conditions are much worse for the legal entity than the price and/or other conditions for similar transactions executed under comparable circumstances (e.g., if a consideration which the legal entity has received under the transaction is twice or more the value of consideration executed by the legal entity in favor of the counterparty)”.

This case only refers to prices. However, one may not rule out the situation when manipulation with inputs becomes the reason for disinvestment at the enterprise. For example, if amortization of fixed assets (extracting, pipeline and other companies) have a big share in costs in an industry, it (amortization) is recognized in pricing and accrued in costing. One may not rule out that revenues from accrued amortization recovery simply remain on an off-shore account. In such a case, profit from the difference between revenues and costs which include the accrued amortization is paid as benefits in Russia. The amount of recovered amortization constitutes corporate internal resources, a real source of replacement of fixed assets, modernization, and investments, and also equity capital which the company is free to dispose of at its own discretion. It is therefore not always that amounts obtained for amortization recovery return to Russia. Sometimes they seem to be deposited into third parties' accounts from which the third parties allocate them as direct investments or loans to the same enterprise, thereby making it possible to draw more money from Russia through accrued interest and even more legally reduce the taxable profit<sup>1</sup>. Huge dividends are paid from time to time from such corporate resources instead of investing in the corporate development and modernization.

However, all of the foregoing schemes don't fall within the definition of “transaction on disadvantageous terms and conditions”. These amounts stay out of tax control – tax authorities deal with profit tax, whereas only the Central Bank of Russia deals with capital outflow<sup>2</sup>. It is minority shareholders

1 It is obvious that the Russian Government is determined to regain control over capital movements. See: «Путин: налоги с угля должны платиться в РФ, а не уходить в офшор. Путин отметил, что такой подход сформирован во всех развитых странах», сайт BFM.ru от 26.08.2013. (“Putin: coal taxes are rather to be paid in the Russian Federation than go offshores. Putin noted that such an approach is applied worldwide” website: BFM.ru dd. 26.08.2013.) “Centers of profit and tax revenues generated from coal companies should be situated in Russia rather than offshore. Since the resource base of our coal companies is located in Russia, profit centers and, consequently, taxation should also be located in Russia rather than somewhere abroad ..., in offshores”, said President Putin at a fuel-and-energy complex meeting.

2 А.Башкатова, «Российский инвестиционный бум в офшорах. Сделки госкомпаний обернулись аномалиями в

that seems to be the only way to prevent such disinvestment schemes, especially if they are employed and make up the corporate management body at the same company: nobody but them can really see that neither upgrade nor modernization have been performed against a significant increase of prices of products. According to the explanation of the SAC of Russia, in accordance with Part 2, Article 225.8 of the APC of Russia, the founder's (participant's) claim for recovery of losses is to be satisfied in favor of the legal entity in whose interests the claim was filed. Furthermore, the order of enforcement is to specify the founder (participant), who exercised claimant's procedural rights and obligations, as recoveror, whereas the legal entity in whose interests the claim was filed is to be specified as a person in whose favor the recovery is exacted.

In our opinion, when requested by an employee, the administration is to be obliged to purchase for him/her a specific stock of shares of the company in which he/she is employed, provided that it would repurchase thereof in case of his/her voluntary termination of employment.

Following are the documents issued in the period under review which are worth noting.

The SAC of Russia published a decision on August 2, 2013, No. BAC-6446/13 which may be of interest in the context of study of pricing in the area of natural monopolies. The decision explains the principles of regulated pricing (tariffication) in the electric power industry with regard to the claim of Rayonniye Elektricheskiye Seti (District Electric Power Grids) LLP on incompliance with the applicable legislation of Subparagraph 5, Paragraph 28 of *The Guidelines for Regulated Pricing (Tariffication) in the Electric Power Industry* which were approved by the Russian Government on 29.12.2011, No. 1178. In particular, according to the claimant, pricing rules prevent him from refunding all related costs through revenues generated from retail electric power supply services, because the rental price paid to the equipment owner for the usage of power grid facilities only may be deduced in respect to a part of accrued amortization and property tax paid, which relate to the leased facilities.

The SAC of Russia explained that the challenged regulation is economically feasible and legally reasonable, because the rental fee also contains lessor's – the

первом квартале 2013 года», сайт ng.ru 19.08.2013. (А. Башкатова, “Russian investment boom in offshores. State-owned companies' transactions have led to anomalies in 1Q 2013”, website: ng.ru 19.08.2013. ) “Central Bank's statistics on Russian companies' investments to other countries boggles the imagination. During Q1 2013 alone our companies invested in non-CIS countries almost half as much as they did throughout the entire 2012”.

owner of leased facilities – profit. If the entire amount of rental fee was built into tariffs, the owners of such facilities would gain an unreasonable extra income built into the rental fee and paid by electric power consumers in the region.

At the same time, as noted by the SAC of Russia, restricting other leaseholder's mandatory costs to property tax only is unfair, because the leaseholder has to pay other mandatory payments relating to leasehold of power grid facilities, namely transport tax, land tax, environmental charges for negative impacts on natural habitats, which the owner of the facilities includes into the rental fee – being built into revenues and paid as part thereof, these costs must be refunded to the leaseholder, because the owner of property is legally obliged to pay such taxes.

However, the SAC of Russia denied leaseholder's claim for refund of a few other taxes. For instance, according to the SAC of Russia, the claimant for no good reason referred the following taxes to be included into leaseholder's costs as part of the rental fee: value added tax, personal income tax and lessor's profit tax. Payment of these taxes are paid because of lessor's rental income rather than property possession. Therefore, the court made a clear division between lessor's mandatory payments to be refunded to the leaseholder in respect to leasehold of the power grid facilities and lessor's mandatory payments referred to the revenue side of rental fee which are not refundable to the leaseholder.

The Letters issued by the Federal Tax Service of Russia on August 15, 2013, No. AC-4-3/14908@ and the Ministry of Finance of Russia on 06.08.2013 No. 03-03-10/31651 contained explanation of the tax treatment for amounts generated when a limited liability partnership (LLP) reduces its charter capital to a value less than the value of its net assets.

It was explained that if the charter (pooled) capital has been reduced in accordance with the requirements set forth in Article 30 of the Federal Law dated 08.02.1998 No. 14-FZ "On Limited Liability Partnerships" due to reduction in the value of net assets lower than nominal level of the charter (pooled) capital of a year following the accounting year, such a reduction of the charter capital may not be deemed to be LLP's revenue. The Ministry of Finance of Russia referred to the position of SAC of Russia set out in the Court Ruling dated 13.10.2009 No. SAC-11664/09, under which the reduction amount of the charter capital will be deemed to be LLP's extraordinary revenue and considered for profit taxation purposes to the extent that the charter capital is reduced on a voluntary basis and the charter capital reduction is not accompanied by re-

spective payment (refund) of a part of a contribution to the partnership capital.

The Letters issued by the Federal Tax Service of Russia on August 15, 2013, No. AC-4-11/14909@ and the Ministry of Finance of Russia on 06.08.2013 No. 03-04-07/31472 contained explanation of taxation of personal income (personal income tax) of board members whose tax residency is outside the Russian Federation. The Federal Tax Service and the Ministry of Finance of Russia explained that the 30% standard tax rate is to be applicable to all non-resident incomes, save for incomes generated by highly qualified employees (Paragraph 3, Article 224 of the TC of Russia). A 13% rate is established for such specialists.

The term *highly qualified specialist* is defined in Article 13.2 of the Federal Law dated 25.07.2002 No. 115-FZ "On the Legal Status of Foreign Nationals in the Russian Federation". If the amount of payment (labor remuneration) for employment duties performed (based on a labor contract or civil law contract) to a foreign specialist is at least Rb 2m annually (this amount is established for other foreign nationals, save for academicians and professors; persons engaged by residents of special economic zones; persons who participate in the implementation of the Skolkovo Project and are subject to different labor remuneration criteria), the foreign specialist, if other requirements of the provision of the Law are met, may be deemed to be highly qualified and his/her income is subject to personal income tax at a 13% rate. Consequently, if the labor remuneration of board member paid by the employer or owner of works (services) is less than the established minimum (Rb 2m annually), the board member shall be deemed to be highly qualified specialist for personal income taxation purposes.

The Russian Government Decree dated August 8, 2013, No. 680 authorized the Ministry of Economic Development and Trade of Russia within three months to develop and approve a technique intended to determine the ceiling amount of payment for the provision of a public service provided for by Paragraph 30 of the Russian Government Decree dated May 6, 2011 No. 352 "On the Approval of the List of Services which are Necessary and Compulsory for the Provision of Public Services by Federal Executive Bodies" when such services are provided by organizations other than federal state agencies or federal unit enterprises.

It refers to the service of checking applicant's compliance with accreditation requirements for the purpose of certification of agencies and testing laboratories (centers) under the Law on Technical Regulation.

It is not quite clear, why this only refers to the ceiling amount of payment for being eligible to provide public services and nothing about the criteria to be met by a business eligible for the provision of paid public service of checking applicant's compliance with accreditation requirements for the purpose of certification of agencies and testing laboratories (centers) under the Law on Technical Regulation. Perhaps, this refers to engaging intermediary firms for accreditation of international experts, because accreditation must be approved by the Ministry of Economic Development of Russia or a self-regulatory organization

which unites major manufacturers in respective areas. The amount of payment is unlikely to be established unless the issue of who is entitled to perform accreditation is resolved. Once again we are facing the situation, when the Law authorizes the Russian Government to determine the amount of mandatory payment, and eventually this function has eventually been redirected to the relevant ministry. We believe that in a free market environment ministries should perform such cost calculations for public services exclusively with the participation of self-regulatory organizations. ●

## THE CURRENT ENTREPRENEURIAL CLIMATE IN RUSSIA

V.Starodubrovsky

*The most serious obstacles in the way of Russia's economic development have to do with this country's underdeveloped market institutions and institutional environment, and an unfavorable entrepreneurial climate. The stagnation in the Russian national economy is indicative of the business community's evident lack of confidence in the future. The RF President has set the goal – to improve Russia's ranking on her ease of doing business from 120<sup>th</sup> to 20<sup>th</sup> in 2018 (Doing Business, the project launched by the International Finance Corporation and the World Bank). The Doing Business rating specifically ranks the economies in 10 areas of business regulation. The importance of removing excessive barriers is self-evident. But is this measure alone sufficient for forging confidence and making businesses alter their current behavior? An analysis of the existing negative features of the entrepreneurial climate, including those reflected in international rating systems, has revealed the true, much larger, scale of that problem. Stagnation has its roots primarily in the insufficient protection of property rights, rampant corruption, and the lack of a truly independent judicial system. By looking at Russia's current rankings, one may estimate the degree of this country's backwardness. Its economic potential thus can only be improved by means of a systemic upgrading of the existing institutional environment, starting with its most backward components.*

The results of the past seven months are depressing. They vividly testify to a stable situation of economic stagnation in this country. Industrial growth has halted. The volumes of investment and cargo turnover are on the decline. Retail turnover continues to be somewhat on the rise, but at a very modest and sluggish pace over the last few years. Exports are dwindling in face of rising imports. Demand remains at a stable low level and fails to show any signs of growth. Production capacities continue to be underused. The rate of return is declining. Many companies with available funds prefer to keep their monies with banks as fixed deposits instead of investing in production development (fixed deposits representing the bulk of corporate deposits), because thus they can exist on interest – however low it may be. The monthly rate of net capital outflow from Russia is increasing. All this happens in spite of the fact that oil prices, while demonstrating some fluctuations, remain high.

The relatively steady decline of the growth rates of many basic economic indicators has been observed for a period of more than one-and-a-half years. The growth rate of GDP dropped from 5.1% in Q4 2011 to 1.6% in Q1 and 1.2% in Q2 2013, and that of goods and services in basic areas of economic activity – from 5.6% to 0.3% respectively on the whole over the first 7 months of 2013 (data for other indicators will also be presented for the period of the first 7 months); growth in industry – from 5.7% in Q1 2011 to 0%, including in the processing industries – from 10.6% to -0.2%; the growth rate of investments in fixed assets – from 14.8% in Q4 2011 and 16.1% in Q1 2012 to -0.7%; the growth rate in the construction industry – from 9.1% in Q4 2011 to -0.3%;

the growth rate of rail freight turnover – from 9.1% in Q1 2011 to -2.9%; and that of retail turnover – from 9% in Q4 2011 to 3.8%. Although it is true that the higher rates were recorded during the economic recovery period, the stable pace and the degree of their decline are, nevertheless, a self-evident fact.

Obviously, such a situation in the national economy and the ongoing trends are by no means conducive to boosting Russia's economic potential.

Given the current situation in the world economy, when Europe is still experiencing a recession, whilst the top international agencies are competing in downgrading their forecasts of future development in various regions across the globe, it is indeed very tempting to dismiss Russia's problems as part of the overall global situation. However, the global situation cannot altogether be dismissed, either. On the one hand, Europe absorbs approximately half of Russia's exports, while on the other, the danger of yet another crisis wave coming from abroad is very real. At the same time, so far (while the prices of hydrocarbons are not declining) the Russian economy has not yet been influenced by those factors that prevent the recovery of the European economy: high budget deficit and government debt. Besides, if we look at the developing countries, it will also become evident that their growth rates, although declining, still remain at levels far above our own growth rate. It means that, when faced with the same external conditions, they are capable of more efficiently utilizing their inner potential. It also means that we likewise possess a substantial inner potential.

Of course, as the situation in Western economies improves, some economic revival will also be likely in

Russia. A number of economists are hoping for a better economic growth rate already in the second half year of 2013. The second half of last year was characterized by lower growth rates of the basic economic indicators than in the first half year, thus making less significant the per annum growth rate against which this year's indicators are set off. If one wishes to believe so, that level may be considered as an easy threshold to overcome. Some additional stimuli may arise in an event of the ruble's depreciation. Besides, the crop yield outlook this year is reasonably favorable, and this may become one positive factor influencing the results to be expected over the remaining part of the year 2013.

Nevertheless, whatever the effect of factors depending on the economic conjuncture may be, there undoubtedly exists a long-term trend of economic stagnation, with the inevitable conclusion that the difficulties being experienced by the Russian economy have some intrinsic causes. These have to do, first of all, with the institutional environment, as well as with the investment climate and the general entrepreneurial climate in this country. It would be wrong to describe it as simply unfavorable, because the existing situation in this respect is downright disastrous.

The state authority is not unaware of the acute problems associated with the existing entrepreneurial environment. It is not by chance that RF President Vladimir Putin set for Russia the task of to leap from her current 120<sup>th</sup> (!) place in the World Bank and International Finance Corporation's *Doing Business* ranking to 20<sup>th</sup> place in 2018. In this connection it should be noted that this task is not about the ambitions to push Germany from its current 20<sup>th</sup> place – rather, it is about the importance to create in Russia the same conditions for doing business that currently exist in the developed countries with quite respectable rankings even somewhat below Germany's ranking. The experience of some countries is a vivid proof that fundamental economic progress may indeed be achieved after 7–9 years of diligent work.

There exist many systems for estimating and rating various parameters of the entrepreneurial climate applied by international organizations. These inevitably contain some biases. Some specialists have expressed their concerns that such ratings may to a certain degree be applied as a tool of political discrimination. However, they are based on well-tested methodologies and are elaborated by highly qualified and experienced experts, are usually also rely on surveys conducted in relevant countries. Nevertheless, it must be taken into consideration that the results of such surveys may be influenced by personal 'level of demands' demonstrated by respondents who sometimes have elevated expectations with regard to the conditions

for doing business, and so yield lower estimates than the respondents in countries with less favorable conditions. And *vice versa*. The highest caution is usually exercised by respondents in countries with authoritarian or totalitarian regimes. The rating of a certain country may vary even if its domestic business climate remains unchanged: it may go down the scale if the formerly backward countries begin to move forward, or go up if the situation in the former leader countries begins to deteriorate. Rating also depends on the actual number of countries, which can also vary from year to year. However, notwithstanding all these shortcomings, the rich experience accumulated over the years when the international comparison methodologies have been applied demonstrates that the comparative rankings of different countries offer sufficiently accurate results. We will now attempt to estimate the situation with institutional environment in Russia on the basis of a number of ratings that apply sufficiently comprehensive information on this country's institutions.

Let us begin with *Doing Business*. This index averages the country's percentile rankings on 10 areas, made up of a variety of indicators which describe the spheres of economic regulation with the most typical barriers set in the way of setting up and developing small and medium-sized businesses. The specificity of approach depends on exact targeting of the better and worse procedures conducive for doing business, and to estimate all positive and negative changes in these spheres. In each sphere, as a rule, the number of required procedures and/or documents is estimated, as well as the length and cost of formalization and registration procedures. The importance of improving this ranking is evident. According to *Doing Business 2013*<sup>1</sup>, Russia since 2012 has moved from 118<sup>th</sup> to 112<sup>th</sup> among the total of 185 countries. Previously, her rating had been progressively worsening from being 78<sup>th</sup> in 2006 to 123<sup>rd</sup> in 2011 (all *Doing Business 2012* rankings have been recalculated to reflect changes to the methodology and revisions of data due to new information, so any specific indices that it contains are comparable only with 2013, and not with the previous years, but the overall trends can be traced rather reliably on the basis of the formerly applied methodology). It is a good sign that this trend has been reversed, but Russia's ranking itself is no good at all. Another factor to be taken into consideration is that the information applied in the latest report was collected as of 1 July 2012 – that is, a year ago, and much has happened since then, and by no means all the developments have been favorable. In accordance with the estimates published in *Doing Business 2013*, Russia's best aspect of the business

1 <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-full-report.pdf>.

regulatory environment is the effective commercial dispute resolution – an area where this country is already among the top 20, having moved from 13<sup>th</sup> to 11<sup>th</sup> place. However, the most impressive leap has been achieved in the sphere of taxation – from 105<sup>th</sup> to 64<sup>th</sup> place. This can probably be the result of lowered insurance contribution, which a year earlier had been steeply raised. Some progress can also be observed with regard to resolving insolvency (from 60<sup>th</sup> to 53<sup>rd</sup> place) and starting a business (although in this latter case Russia only moved from 105<sup>th</sup> to 101<sup>st</sup> place). While the ranking itself has changed little, the actual situation with regard to registering property has relatively improved (46<sup>th</sup> place). The ease of getting credit was downgraded (from 97<sup>th</sup> to 104<sup>th</sup> place), which is also true (and especially important from the point of view of business environment) of Russia's 'protecting investors' ranking (from 114<sup>th</sup> to 117<sup>th</sup> place). The worst results were achieved in the areas measured by 'getting electricity' (where Russia is 184<sup>th</sup>, followed only by Bangladesh), by 'dealing with construction permits' (178<sup>th</sup> place), and by 'trading across borders (customs procedures etc. – 162<sup>nd</sup> place).

There evidently exist serious obstacles in the way of improving Russia's current ranking. It is a well-known fact that any bureaucratic barriers provide a good foundation and fertile ground for corruption. So, it is not difficult to imagine the scale of resistance to any improvements. Although *Doing Business* is an important ranking system, the question remains as to whether it truly encompasses all the basic features of the entrepreneurial climate determining the behavior of businesses. In other words, suppose that – no matter how difficult it may actually be – a country through applying a specific economic policy succeeds in upgrading its *Doing Business* ranking in a particular sphere, will then all its problems associated with an unfavorable business environment be removed, so that business could gain confidence in their future and accordingly alter their behavior?

There exist some other ratings that can help in providing answers to such question. Here we are going to look at several ranking systems that address the situation with regard to entrepreneurial environment. One of them is the **Index of Economic Freedom** developed by The Heritage Foundation – an independent organization that does not rely on any government support. The Index applies 10 benchmarks that gauge the economic success of 185 countries around the world. These benchmarks measure ten components of economic freedom in the spheres of economics and law, assigning a grade in each using a scale from 0 to 100, where 100 represents the maximum freedom. The countries ranked from 80 to 100 are designated as

truly "free" economies; those ranked from 70 to 79.9 are considered to be "mostly free"; from 60 to 69.9 – moderately free; from 50 to 59.9 – "mostly unfree", and those ranked below 50 – "repressed". In the 2013 Index,<sup>1</sup> predominantly information for the period from mid-2011 through mid-2012 was applied. The leader over many years had been Hong Kong, whose index hovers around and sometimes directly hits the 90 score. In 2013, the USA came 10<sup>th</sup> (ranked 76.0); the UK – 14<sup>th</sup> (74.8); Germany – 19<sup>th</sup> (72.8); Japan – 24<sup>th</sup> (71.8); and France – 62<sup>th</sup> (64.1). Across the post-Soviet space, the leader is Estonia whose ranking is 13<sup>th</sup> (75.3), and in addition to the Baltic states and Georgia – also Kazakhstan, in 68<sup>th</sup> place (63.0).

Russia comes **139<sup>th</sup>**, its Index of Economic Freedom being **51.1**, which means that it belongs to the group of "mostly unfree" countries<sup>2</sup>. However, the Index rose on last year by 0.6 points. Its record high was observed in 2004 – 52.8; in other words, over the past few years the situation has been worsening. The highest ranking has been achieved by the index of fiscal freedom – 86.9 (38<sup>th</sup> spot), which has improved on last year by 4.4 points. This index is most strongly influenced by a low level of personal income tax, and its improvement is evidently associated with the lowering of the excessively high insurance contribution rate. It is followed by the index of trade freedom – 77.4 (83<sup>th</sup> spot), which demonstrated the steepest climb since last year – by 9.2 points. This happened due to the relatively low average level of customs duties and Russia's accession to the WTO, although there still remain many non-tariff barriers that hinder free movement of goods and services. Next comes the index of business freedom, which implies first of all freedom from any direct interference on the part of the State, – 69.2 (75<sup>th</sup> spot), with an increase on last year by 4.1 points. In this connection it is noteworthy that the business environment has improved only slightly, and bureaucratic regulation remains excessive, which makes any business decisions unreliable. The index of monetary freedom amounts to 66.7 (152<sup>th</sup> spot), having risen by 0.4 points. Russia's low overall ranking in view of the relatively good value of that index (above average) means that the majority of countries have higher indexes in this area. Here, the negative factors are the significant influence exerted by the government on the level of prices through numerous subsidies and a large number of state-owned companies. The index of government spending rose to 54.4, having improved by 5.8 points (117<sup>th</sup> spot). A slight decline of this index relative to GDP is noted, as well as budget surplus (although this has been influenced by high oil

1 <http://www.heritage.org/index/ranking>

2 <http://www.heritage.org/index/country/russia>

prices), and a low level of government debt. The index of labor freedom amounts to 52.6 (123<sup>th</sup> spot), having dropped significantly – by 10.9 points because, in the author’s opinion, the outdated provisions of the labor code are obstacles to improving the level of employment and labor productivity. At the same time, it can be assumed that the real factor behind this trend is the government policy aimed at making workers keep their jobs, in order to bring down the unemployment growth rate and to ease the problems associated with high levels of unemployment. These are followed by the ‘bottlenecks’ in Russia’s institutional environment: the index of financial freedom, which amounts to 30 (130<sup>th</sup> spot) after having declined by 10 points due to the domination of government financial institutions, which narrow the niche available to private banks; the index of investment freedom, which remained unchanged since last year and amounts to 25 (148<sup>th</sup> spot); the index of property rights – 25, likewise unchanged (135<sup>th</sup> spot) due to the general weakness of the judicial system experiencing, among other things, also pressure from the government, with the resulting weak protection of property rights, including intellectual property; and, finally, the index of freedom from corruption which come last with the lowest value – 24 (140<sup>th</sup> spot), although it has increased by 3 points, probably due to the recent well-publicized major exposures of rampant corruption at the RF Ministry of Defense and some other institutions.

Thus, Russia’s Index of Economic Freedom is also very low, and so it explicitly and adequately reveals the weakest features of our entrepreneurial climate, including those overlooked by *Doing Business 2013*.

The level of institutional development is analyzed in a number of ratings as one of the most important factors that cannot be overlooked when describing each of the spheres to be ranked in a given country. Its key role is recognized by **The Global Innovation Index (GII)**, which acknowledges the need for a broad horizontal vision of innovation that is applicable to both developed and emerging economies, with the inclusion of indicators that go beyond the traditional measures of innovation. The importance of innovation is self-evident. The project was jointly launched in 2007 by Cornell University, the Business School for the World (INSEAD), and the World Intellectual Property Organization (WIPO, a specialized agency of the United Nations). The *GII Report* encompasses 142 countries and is composed of individual indicators (84 in total), being based on approximately 30 sources, including the results of surveys designed to determine the levels of five input pillars that capture the elements of the national economy that enable innovative activities. These factors are grouped so as

to determine that innovation as a driver of economic growth and prosperity depending both on a country’s individual innovation potential and the level of its actual utilization. The *GII 2013* is calculated as the average of two sub-indices. The Innovation Input Sub-Index gauges elements of the national economy which embody innovative activities grouped in five pillars: (1) Institutions, (2) Human capital and research, (3) Infrastructure, (4) Market sophistication, and (5) Business sophistication. The Innovation Output Sub-Index captures actual evidence of innovation results, divided in two pillars: (6) Knowledge and technology outputs and (7) Creative outputs indicators. The Index is determined in absolute terms (in *GII 2013*,<sup>1</sup> Switzerland (66.59) tops the list), and so the other countries are ranked accordingly. Switzerland is followed by Sweden, the UK, The Netherlands, the USA, and Finland. Russia’s ranking is **37.2**, and it now comes **62<sup>nd</sup>**, having lost 11 points since last year. It is ranked 72<sup>th</sup> on the first Sub-Index and 52<sup>th</sup> on the second Sub-Index, and stands 104<sup>th</sup> on the Innovation Efficiency Ratio. Relatively more favorable are Russia’s estimates with regard to human capital and research – 33<sup>rd</sup>, knowledge and technology outputs – 48<sup>th</sup>, infrastructure – 49<sup>th</sup>. However, as far as the ‘institutions’ pillar is concerned (the most relevant for us), Russia comes only 87<sup>th</sup>. The other rankings are as follows: political environment – 117<sup>th</sup> (including the level of political stability – 117<sup>th</sup>, government performance – 90<sup>th</sup>, freedom of the media – 119<sup>th</sup>), regulatory environment – 100<sup>th</sup> (including regulation quality – 102<sup>nd</sup>, and rule of law – 113<sup>th</sup>). Somewhat better is the ranking of business environment – 55<sup>th</sup>. This may be found surprising, because a business environment is in principle determined by the entire existing system of institutions, which has lower ranking scores. However, in this context it is considered in a more narrow sense and encompasses only three factors: the simplicity of starting a business (69<sup>th</sup>); the simplicity of resolving insolvency (49<sup>th</sup>); and the simplicity of taxation procedures (53<sup>th</sup>). The ranking of market development is low – 74<sup>th</sup>. It is also strongly dependent on institutional factors. In terms of crediting Russia is ranked 116<sup>th</sup>, by the level of investor protection – 102<sup>th</sup>, by domestic competition intensity – 121<sup>st</sup>. Russia’s creative outputs indicators are also very low – in this area, Russia is ranked 101<sup>st</sup>.

Innovative activities represent a key feature of a modern highly developed economy. The advantage of *GII* is its comprehensive approach based on multiple related factors. Its parameters graphically illustrate

1 <http://www.globalinnovationindex.org/content.aspx?page=gii-full-report-2013#pdfopener>

how Russia is prevented from moving forward by the poor state of her institutional environment.

However, from the point of view of the issues most relevant for us, the most informative indicator is **The Global Competitiveness Index**, determined in a yearly report under the auspices of the World Economic Forum (WEF) and based on statistical data and the results of Executive Opinion Survey conducted in 144 countries by its 150 partner organizations. The Index looks at 113 competitiveness variables, which are organized into twelve pillars, the first being *Institutions* (the parameters of their quality). The other pillars are as follows: Infrastructure; Macroeconomy; Health and Primary Education; Higher Education and Training; Market Efficiency; Labor Markets: Flexibility and Efficiency; Financial Markets: Sophistication and Openness; Technological Readiness; Market Size; Business Sophistication; and Innovation. The Index is calculated in absolute terms and applies a 1–7 score (from low to high competitiveness levels), by which the respondents in each country are asked to estimate each variable. The collected data are then weighted in accordance with the accepted methodology to obtain a cumulative index value, and each country is assigned its ranking score. The methodology clearly pursues the principle of maximum objectivity: the indexes and ranks are determined on the basis of statistics, and for most part – the outcomes of surveys. The specificity of the score applied in calculating the index (up to 7) means that its change by 0.1 points may push a given country up or down the list by several spots.

*The Global Competitiveness Report 2012–2013*<sup>1</sup> was released in 2012, and so the actual latest data, at best, refer to that year. For the fourth year in a row, Switzerland ranks as the most competitive country in the world with a score of 5.72, followed by Singapore and Finland. Germany comes 6<sup>th</sup>, the USA – 7<sup>th</sup>, Japan 10<sup>th</sup> with a score of 5.4.

Russia experienced its best situation shortly before the crisis (*The Global Competitiveness Report 2008–2009*), when her index was 4.3, and it ranked 51<sup>st</sup>. However, already a year later Russia's index dropped to 4.15, and the country moved to 63<sup>rd</sup> place. Over the last three years, it continued its movement down the list to 67<sup>th</sup> place, whilst the index remained practically unchanged – 4.2. Evidently, some of the previously more backward countries began to catch up and come ahead of Russia's score.

The specific factors and the impact of each pillar on competitiveness varies across countries, and the ratios between each country's index and its actual place

may differ, because these depend on the variations of each of the estimates offered by the respondents in the course of surveys. Thus, for example, Russia by the level of business sophistication was scored 3.3 and ranked 119<sup>th</sup>, and by the level of innovation, with a lower score of 3, it came 85<sup>th</sup>. This means that, by comparison with business sophistication, many countries have even lower innovation scores.

We are now going to look more closely at Russia's competitiveness scores as demonstrated by the specific variables and their pillars<sup>2</sup>, on the basis of the latest *Report*. First, we will consider more favorable parameters. Evidently, by Russia's **market volume**, the ranking is high – it comes 7<sup>th</sup>. Then it comes 22<sup>nd</sup> in terms of its **macroeconomic situation**, which is also not surprising given the Russian Federation's low level of government debt (9<sup>th</sup>) and the still favorable budget balance (20<sup>th</sup>); however, the inflation index (in per annum terms) places Russia only 111<sup>th</sup>. Then it comes 47<sup>th</sup> by the **level of infrastructure**, and 136<sup>th</sup> by the quality of motor roads – thus ranking amongst the most backward countries (with this variable being lowest among all the 113 variables – 2.3). The situation with regard to railway infrastructure is better – Russia comes 30<sup>th</sup>; in terms of air transport infrastructure, Russia is 104<sup>th</sup>, although by the scale of passengers turnover of air transport (passenger traffic and mileage) it comes 12<sup>th</sup>; besides, Russia is at the top of the list by the number of cellular telephone users (coming 5<sup>th</sup>). A better score is achieved by Russia only in the field of malaria prevention, where this country tops the list. Russia is 52<sup>th</sup> by the quality of higher **education and training**, but in terms of management quality in that sphere it comes 115<sup>th</sup>. Russia ranks relatively favorably (57<sup>th</sup>) – by its **technological readiness level**, although by the level of **innovation**, as noted earlier, it comes only 85<sup>th</sup>, with a very low score of 3.0. In terms of **health and primary education** this country ranks 65<sup>th</sup> (the success achieved in malaria prevention notwithstanding), including 50<sup>th</sup> by infant mortality, 62<sup>th</sup> by primary education quality, and 100<sup>th</sup> by life expectancy. Then Russia comes 84<sup>th</sup> in terms of **labor market flexibility and efficiency**. The most remarkable feature in this connection is the high rate of employment of women where Russia ranks 38<sup>th</sup>; by the flexibility of wage determination it comes 65<sup>th</sup>, by the level of reliance on professional management – 110<sup>th</sup>, 'brain drain' – 111<sup>th</sup>, and cooperation in labor-employer relations – only 125<sup>th</sup>.

The worst situation can be observed in the following spheres: the level of **business sophistication** – 119<sup>th</sup>, the level of **financial market development** – 130<sup>th</sup>, the **sophistication of the goods and services market** –

1 The Global Competitiveness Report 2012-2013. Full Data Edition. [http://www3.weforum.org/docs/WEF\\_GlobalCompetitivenessReport\\_2012-13.pdf](http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2012-13.pdf)

2 For better emphasis, each pillar name is highlighted in bold italics, followed by some of the specific variables belonging to that pillar.



134<sup>th</sup>; and, sadly, in the sphere of *institutions* (institutional environment) Russia ranks only 133<sup>th</sup>. However, the low level of sophistication of the goods and services market is also determined in the main by institutional factors. Thus, by the intensity of local competition and effectiveness of antitrust policy Russia comes 124<sup>th</sup>; by the number of procedures needed to start a business – 97<sup>th</sup>, and by the number of days needed to open a business – 104<sup>th</sup>; by the extent and effect of taxation – 121<sup>th</sup>, by prevalence of trade barriers – 132<sup>th</sup>, by customs procedures – 137<sup>th</sup> (these indicators on the whole correlate well with Russia's previously considered other rankings). In terms of *institutions* proper, Russia went down from 110<sup>th</sup> in 2008 with a score of 3.3 to 133<sup>rd</sup> in 2012 with a score of 3.1. The institutions are analyzed by 22 variables describing the most important features of the entrepreneurial environment. It is a well-known and long-established fact that the core feature of that environment in a market economy is the protection of property rights. Here we come 133<sup>rd</sup>, although in 2008 Russia's place was 122<sup>nd</sup>, and in 2009 – 121<sup>st</sup>. This issue is closely associated with that of independence of the judicial system, which is a guarantee of entrepreneurial right protection and where Russia ranks 122<sup>nd</sup> with an extremely low score of 2.6, whereas in 2008 its ranking had been 109<sup>th</sup>. However, in 2011, when the score was the same, the ranking was a bit lower – 123<sup>rd</sup>. Both the progress and status of that indicator point to a very unfavorable situation. By the level of illegal payments and bribes Russia comes 120<sup>th</sup> (vs. 115<sup>th</sup> a year earlier). One of the variables is termed 'diversion of public funds', where Russia ranks 126<sup>th</sup> with a score of 2.4, which is below only that of the quality of motor roads (in 2008 it had ranked 102<sup>nd</sup>). Some variables determine the level of state administration. In terms of public trust of politicians, we come 86<sup>th</sup> with a score as low as 2.5, undue influence on official decisions – 127<sup>th</sup>, undue government spending – 103<sup>rd</sup>, the burden of government regulation procedures – 130<sup>th</sup>, government policy transparency – 124<sup>th</sup>, government services aimed at promoting business activity – 120<sup>nd</sup>. By the level of police efficiency in public safety protection Russia comes 133<sup>rd</sup>, in terms of the level of government infrastructure aimed at discussion promotion – 124<sup>th</sup>. The lowest ranking describes the level of protection of minority shareholders' interests (140<sup>th</sup>).

Although any ratings are to a certain degree arbitrary, and each of the ratings is based on its own specific methodology, the estimates of the different features of Russia's entrepreneurial climate are close enough and appear to be sufficiently reliable. When, for example, tax agencies present claims to taxpayers after the period of time allowed under a statute

of limitations has expired and, in spite of the evident unlawfulness of such claims, the defendants lose their cases, or when corporate property is confiscated unlawfully with the help of power structures, the upshot is that the public starts to believe that it is dangerous to achieve success in business. When investigators and judges appropriate the right to determine, in conditions of a market economy, the so-called 'fair price', and any deviations from that price are interpreted as damages, and so the entire price of a transaction can be treated as material damage – this gives rise to arbitrary decisions on a broad scale, and almost any entrepreneur may fall victim to it. Under such conditions any private business unattached to government structures will feel unprotected, and so the business community loses trust and confidence in the authorities and in its own future prospects. The most natural response to such a situation is capital outflow and the flight of businesses abroad. Property protection issues and the law enforcement and judicial systems are currently experiencing a profound crisis, and this is a source of additional barriers in the way of doing business and using the country's economic potential. So, to solve the existing problems, it will not be enough to simplify the procedures – instead, it will be necessary to systematically work at improving the institutional environment itself, and this will take a lot of time. Otherwise, any ambitious hopes to succeed in upgrading Russia's *Doing Business* ranking will remain wishful thinking and a *Fata Morgana*.

The lack of self-confidence in the business community is further underlined by the lack of consistency in the government's regulatory acts. An especially vivid illustration is the sharp increase, in 2011, of the insurance contribution rate from 26 to 34% of the wages fund, with its subsequent lowering to 30%. As noted RF Minister of Finance Anton Siluanov<sup>1</sup>, the State on the whole did not benefit from the raised insurance contribution rates – moreover, it even suffered some losses. However, in 2012 the rates of insurance contributions were increased for individual entrepreneurs, and the introduction of that measure was promptly followed by a dramatic decline in their number – resulting, most probably, from their flight into the shadow economy. The pension system is also undergoing reorganization – and even more changes are evidently to be expected in the future.

Some specialists believe that the Bank of Russia deliberately delayed its decision concerning the lowering of the refinancing rate as a signal aimed at boosting growth. However the fundamental factor determining the rise of that rate, as well as the level of interest

<sup>1</sup> See an interview with him in *Izvestia* [The News], 7 March 2012, p. 5.

rates in general, is rate of inflation. Interest rates on loans must be above the inflation rate, otherwise lending will be loss-making. And any responsible decisions with regard to lowering the refinancing rate (which, most probably, will soon be adopted and made public) can be possible only when it becomes clear which level of inflation will actually be achieved towards the year's end. Consequently, the principal condition for bringing down excessively high interest rates on loans, which can serve as a real obstacle to large-scale lending and thus eliminate one of the most important incentives for economic activity, is to suppress the inflation rate. However, so far only very modest success has been achieved in this direction.

As for politically biased approaches practiced by the authors of various rating systems, this consideration is true for Russia probably no more than, for example, for Kazakhstan. While Russia moved 11 spots down the list in World Economic Forum's Global Competitiveness Index, Kazakhstan over one year surged 21 points up from its former 72nd place (below Russia) with an index of 4.2 to 51<sup>st</sup> place with an index of 4.4. The estimate of that country's institutions significantly improved – by 28 points, and that of property protection – by 30 points. However, in the case of countries that cannot be perceived as models of democracy, one may reason to wonder if such results were really achieved after the respondents, prior to participating in surveys, had been properly prepared to give the right answers. Such doubts become even more plausible when we consider the fact that in terms of the innovation index, which is less dependent on the results of surveys than the above indices, Kazakhstan not only demonstrated no progress at all, but moved down in its rank by one point. The index of economic freedom also somewhat declined, but in this particular sphere Kazakhstan is far ahead of Russia, being ranked 68th against Russia's 139th. However, if the changed estimates are caused by real achievements in the development of the institutional environment, Kazakhstan's experience may be especially interesting for us.

The current level of corruption in Russia is a very grave negative factor. The World Economic Forum's data demonstrate that corruption is perceived as the main obstacle to efficiently doing business, which was pointed out by 21% of respondents. This is a high level, and it is very illustrative, because only one answer could be picked out of the suggested list of answers. The second obstacle – low performance level of the central state apparatus – gained a little more than half of the votes by comparison with the first one (11.9%). Thus it can be concluded that the situation with regard to corruption significantly depresses the development of business activity, even if the operating companies

(whose representatives were selected as respondents) have found ways to adjust to it and shift the extra costs onto their clients.

The world's countries are scored on how corrupt their public sectors are seen to be by Transparency International, a global civil society organization leading the fight against corruption. In 2012<sup>1</sup>, the organization altered its methodology applied in scoring its **Corruption Perceptions Index**, and so that year's results are incomparable with those obtained for the previous years. The Index is based on a 0–100 score, where 0 means that a country is perceived as highly corrupt, and a 100 means that a country is perceived as very clean. The Index measures the perceived levels of public sector corruption 176 in countries and territories around the world. The ranking list is topped jointly by three 'cleanest' countries – Denmark, Finland and New Zealand, each with a score of 90. The worst score of 8 is assigned to Afghanistan, North Korea and Somalia, each ranked 174<sup>th</sup>. Russia is ranked **133<sup>th</sup>**, with a score of **28**, which she shares with another six countries with similar scores. Among Russia's companions are Kazakhstan and Iran. The difference between the scores of 90 and 28 speaks for itself. In accordance with the previously applied methodology based on a 0–10 score, Russia enjoyed its best outlook for the preceding decade in 2004 with an index of 2.8, which then with some fluctuations began to decline to 2.1 in 2010, and then in 2011 again increased to 2.4, amounting to slightly more than 25% of its best previously achieved value. Thus, the level corruption in a given country is also considered to be one of the key factors undermining the confidence of companies in their prospects for doing business.

A typical feature of the last few years has been the revelation, on a large scale, and publication of the facts of corruption in various government structures. Until the first relevant court cases are completed and court verdicts pronounced, it is hard to decide if these activities reflect some genuine efforts to combat corruption. If the responsibility is placed only with a few selected 'scapegoats', these measures will be perceived by society only as an imitation of a true anti-corruption campaign. Of course, the public exposure of numerous existing facts may indeed be aimed at scaring the corrupt officials, who will then become aware that they, too, may be publicly exposed. Meanwhile, very often the consequences of such campaigns are reduced only to narrowing the range of people who are involved in bribing, while the amount of a bribe is further increased. Thus, according to the results of the Business Environment and Enterprise Performance Survey (BEEPS) conducted by the World Bank together

1 <http://www.transparency.org/cpi2012/results>

with the European Bank for Reconstruction and Development (EBRD) in 2011, over the period from 2008 through 2011 in Russia, the number of respondents believing that corruption is no obstacle to doing business increased from 21 to 40%. However, the companies that admitted to having given bribes, stated that the amount of a bribe over the same period increased from 4.6 to 7.3% of their annual sales!<sup>1</sup>

The economic results achieved over the past months of 2013 can be regarded as a vivid proof of the existing situation, where the current entrepreneurial climate not only prevents this country from taking full advantage of its development potential, but simply eliminates all its economic growth prospects. It seems that, instead of any serious efforts to improve the existing system, the authorities are hoping to boost growth by relying on government mega-projects – funded, among other things, from the National Welfare Fund. We mean here the recent decisions concerning the Moscow–Kazan Highway and the Central Ring Road construction projects, and the reconstruction of the East-Siberian Railway (*Transsib*). These projects will further increase the already excessive burden on government budget spending, in violation of the adopted budget rule, and push up the risks for this country's budget in the event of a drop in oil prices. It is difficult to believe that such projects have indeed been properly substantiated and subjected to expert's estimation. Judging by the past experiences, one can only be certain that the currently approved budgets for each project will prove to be insufficient, and that public funds will be grossly overspent – perhaps by several orders above the initially earmarked sum, the period of project implementation – extended well beyond the deadline, while the quality of work may be questionable. It is still too early to draw any conclusions as to whether these decisions will entail any rise, however slight (by 2.5%), of the amount of investment in fixed assets in July 2013 on July 2012, while the cost of construction materials (production of all other non-metal mineral products) has increased by 4%, and

construction costs – by 6.1%, and whether this growth can indeed be relatively sustainable. Nevertheless, one must not overlook another factor – the very high pragmatism and adaptability of businesses, and their ability to develop not only under good conditions, but also – and in spite of – very unfavorable ones. Incidentally, according to data released by *Rosstat*, the inflow of foreign investment over the first half-year increased on the same period of last year by 32.1%, and – most importantly – that of direct investment increased by 59.8%. However, so far – and for a long time already – any hopes for a stable rise in the level of investment demand and the overall dynamic of economic development have been futile. Besides, the decline in machine-building continues, and in some subsectors its rate has become significantly higher.

By of adding a spoonful of sugar to the medicine, as of 1 July the World Bank released its annual data on gross national income (GNI) per capita rankings for the previous year. Based on its GNI per capita, every economy is classified as low income (\$ 1,035 and below); lower middle income (\$ 1,036–4,085); upper middle income \$ 4,086–12,615); and high income (\$ 12,616 and above). Under the new classification, Russia has moved into the high income group – in other words, the group of wealthy countries. It seems that for Russia it will be important at least to keep that position, because some countries have moved in the opposite direction. Thus, for example, for Hungary the renewed classification means that she has been downgraded from her former place in the high income group. However, Russia – notwithstanding her current status in the World Bank's GNI per capita classification – falls behind in her growth rate by comparison with the global trends, and so other, formerly more backward, countries may begin to move ahead of Russia. So, once again, these results highlight the goal of a systemic transformation of the institutional environment and the creation of favorable conditions for doing business, which is decisive for preventing the downward movement of Russia's ranking in terms of economic development, and later on – for upgrading Russia's status in the world economy. ●

1 [http://slon.ru/economics/ebrr\\_vzyatki\\_v\\_rossii\\_stali\\_rezhe\\_no\\_masshtabnee.913765.xhtml](http://slon.ru/economics/ebrr_vzyatki_v_rossii_stali_rezhe_no_masshtabnee.913765.xhtml).

## ECONOMIC GROWTH FACTORS IN 2010 – THE FIRST HALF OF 2011

E. Astafieva

*The results of decomposition of output growth rates demonstrate that in the period of 2012 – the first half year of 2013 the rate of GDP growth was predominantly influenced by the inputs provided by the main production factors. Labor and capital inputs, on the average, determine 80% of the rate of GDP growth; in other words, at present the Russian economy's growth is achieved in the main due to the effect of extensive factors. At the same time, labor and capital inputs display a declining growth rate.*

It has become a widespread international practice, when analyzing the prospects of economic development, to apply methods based on by-factor decomposition of economic growth. Decomposition means that the rate of output growth is broken into extensive and intensive components depending on the specific values of differential production function. Labor and capital inputs are considered to be extensive factors whose value is derived by multiplying the values of both factors (the actual number of the employed and the volume of fixed assets) by the intensity of their use (the working hours of one employed person and the load on production capacities). Intensive growth components are represented by the residual that cannot be explained by the effect of the main factors and is called *combined factor productivity* (CFP). The results of decomposition reflect transformations in the structure of economic growth, thus making it possible to single out the most relevant factors determining changes in the dynamics of the rate of output growth.

According to data published by *Rosstat*, the period of 2012 through the first half year of 2013 demonstrated a positive quarterly rate of GDP growth amounting on the average to 2.9%. At the same time, in the first half year of 2013 the rate of output growth was found to be significantly below its level recorded in 2012 (1.8% against 3.5%). On the average over the period under consideration, the decline of the quarterly growth rate of GDP amounted to 0.6 p.p. (when fitted to a linear trend – 0.7 p.p.<sup>1</sup>)

In 2012 and the first half year of 2013, changes in the GDP volume displayed the same direction as those in the inputs contributed by the main factors: output growth was followed by growth of the main extensive factors. In 2012, changes in labor and capital inputs on the average determined 93% of the rate of GDP growth; in the first half year of 2013 – 59%.

As shown by factor decomposition (*Table 1, Fig. 1*) over the period under consideration, 11% of GDP growth can be explained by changes in labor input. In 2012, the input provided by that component was responsible on the average for 13% of the rate of output growth, and in the first half year of 2013 its input was on the average negative, which was determined by the declining labor inputs in Q2 2013. The input provided by changes in the volume of used production capital to the rate of GDP growth was on the average 71%. Similarly to labor input, capital input in the rate of GDP growth displayed a downward trend over the first half year of 2013, being on the average responsible during that period for 64% of GDP growth. At the same time, over the entire period under consideration (with the exception of Q1 2013), capital input acted as the most relevant economic growth factor, thus determining a major part of the rate of GDP growth. In 2012 and the first half year of 2013, CFP was determining on the average 18% the rate of GDP growth.

Labor input demonstrated a downward growth rate, which on the average, over that period, amounted to 0.4 p.p. The decline in the growth rate of labor input was determined by the downward movement of both its components; moreover, the growth rates of both the number of employed and their working hours towards the period's end shift onto the negative side. The quarterly structure of labor input over the period under consideration is rather heterogeneous. The intensity of the use of labor reserves was displaying stronger fluctuations of its input in the rate of growth: the number of working hours was on the decline in Q3 2012 and the first two quarters of 2013, and so the input of that component in the growth rate of GDP over those periods was negative. The average quarterly decline of the growth rate of employment intensity was 0.2 p.p. The drop of the growth rate of labor reserves also amounted to 0.2 p.p., but in contrast to the other component the growth rate of employment was negative only in Q2 2013. It should be noted that, for the first time over the entire post-crisis period, labor reserves began to shrink.

<sup>1</sup> A linear trend is fitted to the rate of growth in order to make the resulting estimates less dependent on the choice of first and last estimation periods.

Table 1

## STRUCTURE OF GDP GROWTH RATE (AGAINST SAME PERIOD OF PREVIOUS YEAR)

	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013	Q2 2013
growth rate						
GDP	4.75	4.26	3.00	2.10	1.59	1.90*
I. Factor inputs	4.86	3.54	1.42	2.96	0.81	1.25
I.1 Labor	1.49	1.10	-0.65	0.81	0.16	-0.40
Employment	0.44	0.75	0.31	0.35	0.66	-0.34
Working hours	1.05	0.35	-0.96	0.46	-0.50	-0.05**
I.2 Capital	3.37	2.44	2.08	2.15	0.65	1.65
Fixed assets	1.74	1.79	1.85	1.69	1.41	1.47
Capacity load	1.63	0.66	0.22	0.46	-0.76	0.18
II. CFP	-0.10	0.72	1.58	-0.86	0.78	0.65
as % of GDP growth rate						
GDP	100.0	100.0	100.0	100.0	100.0	100.0
I. Factor inputs	102.2	83.2	47.3	140.7	51.1	66.0
I.1 Labor	31.3	25.8	-21.7	38.3	9.9	-20.8
Employment	9.2	17.7	10.4	16.4	41.3	-18.1
Working hours	22.1	8.1	-32.1	21.9	-31.4	-2.7
I.2 Capital	70.9	57.4	69.1	102.4	41.2	86.8
Fixed assets	36.6	42.0	61.7	80.6	88.7	77.5
Capacity load	34.3	15.4	7.4	21.9	-47.6	9.3
II. CFP	-2.2	16.8	52.7	-40.7	48.9	34.0

\* the RF Ministry of Economic Development's estimates

\*\* the values of working hours for Q2 2011 are based on an autoregressive – moving-average model, calculated by applying data submitted over the period from Q1 1999 through Q1 2013.

Similarly to labor inputs, capital inputs demonstrated a declining growth rate, its average quarterly drop amounting to 0.3 p.p. Nevertheless, capital input remains the most important factor whose predominant role in the growth rate of GDP was evident over the entire period under consideration (except in Q1 2013). In accordance with the applied assessment methodology,<sup>1</sup> the dynamics of capital reserves was determined by changes in the volume of investments in fixed assets, whose growth rate was increasing on the average 3.6 p.p. every quarter (from 16.5% in Q1 2012 to -1.7% in Q2 2013). It should be noted that, in the first half-year periods of 2012 and 2013, the volume of investments in fixed assets in real terms remained below its level in 2008. As a result, in conditions of the existing degree of wear and tear of fixed assets, the growth rate of capital reserves remains practically unchanged, demonstrating only a negligible decline. On the average, in 2012 and the first half year of 2013, the growth rate of fixed assets was responsible for 64% of the rate of GDP growth, while the fluctuations in their load – for 7%. However, the

structure of capital input is characterized by redistribution, by relevance, of its components' inputs, so over the entire period changes in capital reserves reveal their more substantial input in the rate of GDP growth by comparison with the input determined by fluctuations in their load. The mean quarterly decline in the growth rate of the intensity of use of fixed assets was 0.3 p.p., and the decline of the volume of fixed assets – 0.1 p.p.

Over the period under consideration, the impact of combined factor productivity (CFP) on output growth was distributed unevenly between different quarters: thus, in Q1 and Q2 2012 the average input of that component in GDP growth rate was 35%; in Q1 and Q4 it was negative; and the first half year of 2013, SFP determined on the average 42% of the rate of output growth. Thus, the growth rate SFP displayed an upward trend: the average quarterly increase in the productivity growth rate was 0.2 p.p. (when fitted to a linear trend – 0.1 p.p.).

The observed influence of CFP on the movement of output by no means reflects only the impact of productivity factors determined by technological changes. It also incorporates some components not included in the estimates of the main factors, as well as biases caused by the specific assessment methodology, in particular those determined by an uneven movement of the value indices applied in the decomposition (out-

1 In the absence of quarterly statistics, growth of the main factors is assessed on the basis of the assumption that the coefficient of retirement of fixed assets and the share of investments earmarked for their renewal are constant values. It should be noted that the estimates thus obtained may be biased because they are not adjusted by the time lag between the receipt of investments and the moment of their use.

put and capital)<sup>1</sup>. As shown by the estimates obtained for earlier periods, these biases are significant in conditions of Russia’s economic system, which is strongly influenced by changes in prices on international raw materials markets, especially in a short-term perspective.

In accordance with the obtained results<sup>2</sup>, from Q2 2012 onwards, the input of changes in oil prices in the rate of GDP growth began to be negative. On the average, during the period under consideration, changes in the price factor were conducive to a slowdown of the growth rate of GDP, while technological productivity (‘final residual’) was determining approximately 48% of the rate of output growth. Changes in the growth rate of the ‘technological’ component obtained as a

1 The ‘value’ estimate of productivity becomes similar to its physical estimate in a situation of long-term balance in the economy and perfect competition. In other words, this similarity can be possible only when a system’s current balance incorporates all the potential exogenous shocks.

2 The singling out, in CFP’s structure, of a ‘situational’ component and further decomposition of the rate of output growth is based on the existence of a statistically significant correlation between the growth rates CFP and world oil prices, which is estimated by applying a regression model based on annual data for the period 1993 – 2012. The resulting ‘final residual’, cleared of the effects produced by fluctuations of prices on world raw materials markets, represents a more correct index of technological productivity, i. e., the intensive component of output growth.

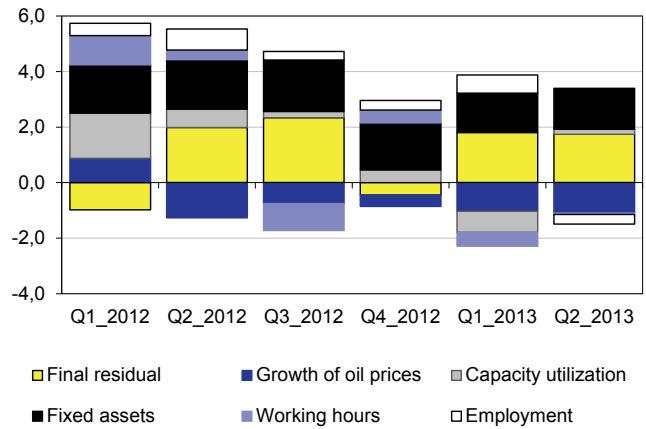


Fig. 1. By-factor Decomposition of GDP Growth (Against Same Periods of Previous Year), with Estimates of Input Provided by Oil Prices.

result of singling out, as a separate factor, the situation on world raw materials markets, differ little from the movement pattern displayed by SFP. The growth rate of ‘final residual’ was negative in Q1 and Q4 2012. However, on the whole over the period under consideration, the movement of the ‘technological’ component demonstrated an increasing growth rate – on the average by 0.5 p.p. per quarter (when fitted to a linear trend – by 0.3 p.p.). ●

## A REVIEW OF RUSSIAN GOVERNMENT'S MEETINGS HELD IN AUGUST 2013

M.Goldin

*Following are some of the issues and problems that were considered at Russian Government's meetings held in August 2013: a draft law which introduces a special form of on-the-ground control by tax authorities of how banks discharge the functions established by the legislation on taxes and levies, as well as a draft law which further defines procedures for state control (supervision) over local self-government bodies and local self-government officials, including regulation of scheduled and spot inspections.*

A federal draft law "On the Introduction of Amendments to Part 1 of the Tax Code of the Russian Federation and Article 1 of the Federal Law "On the Protection of Rights of Legal Entities and Self-employed Entrepreneurs In the Course of Public Control (Supervision) and Municipal Control", as well as Concerning the Annulment of Certain Acts of Legislation of the Russian Federation in the Context of the Enhancement of Control over the Fulfillment by Banks of the Obligations Established by the Law on Taxes and Levies of the Russian Federation" were considered at Russian Government's meeting which was held on **August 1, 2013**.

The draft law is intended to regulate the procedure for control by tax authorities to ensure that banks fulfill their obligations established by the law on taxes and levies.

In addition to the existing cameral inspection procedure which is normally conducted at location of a tax authority, the draft law introduces a sort of on-the-ground inspection of banks which is to be conducted in banks' premises. Moreover, it is banks, not their customers, that are to be subject to such inspection.

In general, the foregoing procedure for inspection of banks is harmonized with the existing "common" procedure designed for on-site tax inspection of taxpayers to be introduced.

For instance, the draft law offers the same scope of information to make a decision to conduct inspection, a three-year inspection period, a two-month period of inspection which can be extended for as long as four months according to the procedure established by the Federal Tax Service of Russia (FTS of Russia), identical mechanism and terms of discontinuation of inspection (up to six months, and, in case of a request of information from foreign government bodies, up to nine months), as well as the grounds for a re-inspection.

The draft law was approved and submitted to the State Duma of the Russian Federation for consideration.

A federal draft law "On the Introduction of Amendments to Article 77 of the Federal Law "On the General Principles of the Local Self-Governance in the Russian

Federation" was considered at Russian Government's meeting which was held on **August 21, 2013**.

The draft law establishes the principles of legal regulation of public control (supervision) over local self-government bodies and local self-government officials, including organization of scheduled and spot inspections.

The draft law establishes a general rule under which supervisors will conduct scheduled inspections no more than once in two years on the basis of annual plans approved by the public prosecution office of a constituent territory of the Russian Federation. Spot inspections will be conducted optionally, whose closed list established by the draft law. At the same time, the foregoing cases are not clearly defined in terms of contents – "the existence of facts of infringement of the legislation of the Russian Federation which may result in emergencies, life/health threatening situation, as well as large-scale violations of citizens' rights", therefore the difference between scheduled inspections and spot inspections are quite conventional.

Spot inspections must be approved by the public prosecution office of a constituent territory of the Russian Federation.

Public supervisory and control authorities are to forward their proposals concerning the annual plan of inspections to the public prosecution office of a constituent territory of the Russian Federation not later than on the 1<sup>st</sup> of September of a year preceding the year in which inspections are to be conducted.

Based on the proposals made by the public supervisory and control authorities, the public prosecution office of a constituent territory of the Russian Federation is to design an annual plan not later than on the 1<sup>st</sup> of October of a year preceding the year in which inspections are to be conducted.

The annual plan is to include the following information:

- The name and location of local self-government bodies and local self-government officials who are subject to inspection ;

- The name of a public supervisory and control authorities who plan to conduct inspections;
- Goals and grounds for inspections, as well as terms thereof.

The annual plan is to be posted in the official website of the public prosecution office of a constituent territory of the Russian Federation and the respective public supervisory and control authorities not later than on the 1<sup>st</sup> of November of a year preceding the year in which inspections are to be conducted.

The procedure for inspections is as follows: supervisory bodies are to request information from a local self-government body. No limits for the volume of

such information are specified by the amendments. At the same time, the draft law imposes a single restriction on the volume of information provided to supervisory bodies: it is prohibited to request the information which is available on the local self-government body's official website or published in mass media. Furthermore, in its response to such a request the local self-government body will be obliged to disclose the source where the respective information is officially published or posted.

The draft law was approved and submitted to the State Duma of the Russian Federation for consideration. ●



## AMENDMENTS AND UPDATES TO THE BUDGET PROCESS REGULATORY FRAMEWORK

M. Goldin

*Some amendments were made to a series of federal laws in August 2013, in particular to the Budget Code of the Russian Federation and the Administrative Offences Code of the Russian Federation. These amendments are to significantly alter the framework of public (municipal) control in the area of fiscal relations.*

**Federal Law dd. 23.07.2013, No. 252-FZ** “On the introduction of amendments to the Budget Code of the Russian Federation and Certain Legal Acts of the Russian Federation” (hereinafter referred to as “the Law No. 252-FZ”) took effect on August 4, 2013. The law introduced amendments concerning public (municipal) financial control in the field of budgetary relations to a series of federal laws, including the Budget Code of the Russian Federation (hereinafter referred to as “the BC of Russia”) and the Administrative Offences Code of the Russian Federation (hereinafter referred to as “the AOC of Russia”).

The law defines public (municipal) control in the field of budgetary relations as public (municipal) financial control which is exerted for the purpose of ensuring compliance with the fiscal legislation of the Russian Federation and other laws and regulations which regulate budgetary legal relations.

Legal regulation in the field of public (municipal) financial control is focused on supervising over those who involved in the budgetary process, above all, public authorities and government agencies.

Public (municipal) financial control can be divided into external and internal, preliminary, and follow-up types of public (municipal) financial control.

External public (municipal) financial control refers to supervisory activity performed respectively by the Accounts Chamber of the Russian Federation, auditing & accounting bodies of the constituent territories of the Russian Federation, and municipalities.

Internal public (municipal) financial control refers to supervisory activity performed by the Federal Service for Financial and Budget Supervision, public (municipal) financial control bodies of constituent territories of the Russian Federation, local administrative bodies, the Federal Treasury (finance bodies of constituent territories of the Russian Federation or municipalities).

Preliminary control and follow-up are distinguished by their place in the budgetary process rather than controlled entities. Preliminary control is generally performed prior to any financial operation with a view to preventing or restraining budgetary violations in the course of implementation of budget of the Rus-

sian budget system. Follow-up control is generally performed in arrears on the basis of the results of implementation of budgets of the Russian budget system with a view to checking legality of their implementation, and reliability of accounting and reporting.

Following are the methods (procedures) of public (municipal) financial control that are defined in the BC of Russia, as amended by the Law No. 252-FZ:

1) *inspection* refers to performance of control actions with regard to the activity of an entity during a certain period, including documentary and actual examination of financial and economic operations for legality, budget accounting and budget reporting for reliability. Inspections can be divided into cameral and field (on-site) ones;

2) *audit* refers to a comprehensive inspection of operations and activities of an entity, including performance of control actions such as documentary and actual examination of the entirety of performed financial and economic operations for legality and correct recognition thereof in the entity’s accounting book and budgetary reporting;

3) *survey* refers to analysis and assessment of the status of a certain type of activity of an entity, including internal financial control and internal financial statement audit which may be performed by chief budget controllers, chief budget revenue controllers, chief budget deficit sources of financing controllers;

4) *authorization to operate* refers to an endorsement which is made after the examination of documents submitted for the purpose of financial operations. The endorsement confirms that the aforementioned documents contain information and/or this information meets the requirements set forth in the budget legislation of the Russian Federation and other laws and regulations which regulate budgetary legal relations.

Results of inspections and audits are documented in the form of inspection or audit certificate, whereas results of surveys are documented as final report.

Grounds and procedure for inspections, audits, and surveys, including a list of government officials authorized to make decisions on initiation thereof and other

procedural issues, are set forth in a regulation which establishes the legal status of a respective public (municipal) financial control body.

As a general rule, once an inspection (audit) has revealed budgetary violations, the officer of the public (municipal) financial control body will be entitled to forward a representation and/or ordinance to the entity which has been subject to control actions, and a notice of fiscal measures of enforcement to the financial body which is authorized to take decisions on fiscal measures of enforcement.

The foregoing amendments make significant changes in the legal regulation of liability for violations of the budget legislation of the Russian Federation. Previously, violation of the budget legislation was defined as violation of nothing but the provisions set forth in the BC of Russia. However, the provisions of the budget legislation of the Russian Federation are also available in other laws and regulations which make up the budgetary law framework, and the foregoing provisions may be breached not only by those involved in the budgetary process, but also other persons, which, in its turn, entails taking not only budgetary and legal but also other penalties.

Therefore, a new term (budgetary violation) has been introduced into the BC of Russia, which is defined as violation of all legal acts regulating budgetary legal relations, and contracts (agreements) under which budgetary funds are allocated, action (omission) of finance bodies, chief budget controllers. Furthermore, liability of those not involved in the budgetary process is regulated by other branches of law.

In addition, the BC of Russia establishes classification of fiscal measures of enforcement in case of budget violations:

- indisputable recovery of the amount of funds allocated from a budget of the Russian budget system to other budget of the Russian budget system ;
- indisputable recovery of the amount payable for the use of funds allocated from a budget of the Russian budget system to other budget of the Russian budget system ;
- indisputable collection of fines payable for overdue repayment of budgetary funds ;
- suspending (reducing) the provision of inter-budget transfers (save for subventions) ;
- delegating a part of the powers of the chief budget controller, controller and recipient of budgetary funds to a respective budget controller.

Amendments to the AOC of Russia contain some new provisions in addition to the restated provisions such as “unintended use of budgetary funds” (Article 15.14. of the AOC of Russia) and “failure to repay

or default in repayment of the state budget loan” (Article 15.15. of the AOC of Russia):

- failure to pay or default in payment for the use of the state budget loan (Article 15.15.1. of the AOC of Russia);
- violation of the terms of the state budget loan (Article 15.15.2. of the AOC of Russia);
- violation of the terms of inter-budget transfers (Article 15.15.3. of the AOC of Russia);
- violation of the terms of budget investments (Article 15.15.4. of the AOC of Russia);
- violation of the terms of subsidies (Article 15.15.5. of the AOC of Russia);
- violation of the procedure for submission of budgetary reporting (Article 15.15.6. of the AOC of Russia);
- violation of the procedure for compiling, approval, and maintaining of budget estimates (Article 15.15.7. of the AOC of Russia);
- violation of the ban on budget loans and/or subsidies (Article 15.15.8. of the AOC of Russia), and some more provisions. ●