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# RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES

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MONTHLY BULLETIN:

## RUSSIAN ECONOMY IN THE CURRENT YEAR: BASIC TRENDS

*In the first six months of this year (for which the essential data is available)* ***negative trends were dominating*** *in the Russian economic development.*

• *Relatively* ***sluggish growth rate*** *within the period of post-crisis recovery,* ***despite the extremely favorable global oil prices****. The GDP growth rate for the first quarter made* ***4.1%*** *(same as for the complete 2010); according to the Ministry of Economic Development estimates, over the second quarter it decreased to* ***3.7%*** *and overall for the first half of the year – up to* ***3.9%.*** *In the second half of the year the Ministry expects growth by* ***4.5%.*** *In general for the year it will be close to the growth rate of the global economy (about 4.3%), but significantly lower than the dynamics of developing markets, where the growth rate of 6-6.6% is expected in 2011.* ***The average world price of «Urals» oil over six months was $108.1 per barrel, which is slightly more than the average price for the relevant period before the crisis in 2008.***

• ***Special backlog of investment demand****, which in a normal situation would be the key factor in pulling the economy out of crisis. The past period has been characterized by* ***stagnation in investment in fixed capital and construction industry.*** *Growth of gross savings in GDP in the first quarter was almost entirely dependent on increased reserves. The growth of investment in fixed assets was lower than the GDP growth over the first half of the year and totaled to* ***2.7%****, the scope of construction works reached* ***0.9%****, the commissioning of residential buildings has* ***decreased by 3.7%.***

• ***Transformation of consumer demand is virtually the only engine of the economy****. The growth of household final consumption in the first quarter made 5.7%, the retail turnover growth for 6 months reached* ***5.3%.*** *However,* ***the new phenomenon of this year is that this is happening at the background of lower real disposable income (by 1.4% for the first half of the year) and low growth in real average wages by 2.4%.*** *In other words,* ***the demand is growing mainly due to reduction of the share of savings in the expenses of population and expansion of consumer credits.*** *It is difficult to assume that the decline in the share of savings can become a stable factor in the favorable dynamics of consumer demand. However, it is possible that the decline in real disposable incomes and stagnation in wages are associated with the departure of the earnings to the shade under the influence of a substantial increase of insurance premiums in 2011. In this case, the shadow incomes can continue to maintain the current dynamics in consumer demand.*

• ***In the second quarter in manufacturing industry,*** *which suffered greatly during the crisis,* ***the recovery rate has slowed down nearly by half.*** *If in the first quarter the growth was rather advanced and reached* ***10.6%*** *as compared with 5.9% for industry in general, in the second quarter it made only* ***5.8%,*** *with the overall level of 4.8% in the industry.* ***Already small growth rate in mineral production has further decreased*** *from 3.3% in the first quarter of the year, which is twice less than in the same quarter of 2010 (6.7%), to 1.7% in the second quarter.*

• *Approximation of foreign trade monthly volume to the maximum values, reached in 2008 before the crisis. Herewith,* ***the high export growth rates were based almost entirely on the price factors.*** *According to the Federal State Statistics Service information on the GDP, in the first quarter the export volume has not increased against the first quarter of 2010 and exports did not contribute to GDP growth. In May, as compared with May of the last year, growth of exports due to physical volume growth is estimated by the Ministry of Economic Development at 2.6%, but due to the prices - at 35.5%.* ***The growth of imports has outpaced the increase in exports*** *and was happening predominantly (by 26.5%) due to increased physical volume, the impact of prices was only 12.2%. In general, within 5 months the imports growth amounted to 42.2%, export growth made 30%.* ***In the first quarter imports ensured more than half of growth in the domestic***

***demand***. *Despite the advanced growth rate of imports,* ***the absolute values of trade surplus remained rather high*** *and reached over 5 months $85.07 bn, having exceeded the results of the relevant period of 2008.*

• *Sustained* ***appearance of the budget welfare*** *in the situation of increased export oil prices. According to preliminary estimates, federal budget revenues for the six months of the year were higher as compared with the same period of preceding year in both, absolute terms and in regard to GDP. Expenditures versus GDP are slightly less. The* ***surplus*** *amounted to* ***2.7%*** *of GDP.* ***Non-oil deficit remained high, at the level of 7.9%****, though it is somewhat reduced as compared with the first six months of 2010, when it made 10.8%. However, it is difficult to estimate the real prospects for the coming months by these indicators, as budget expenditures, as is known, are spent most intensively at the end of the year and it seems unlikely that this year will be an exception. Meanwhile,* ***in the federal budget for 2011, estimated expenditures are approved at a dangerously high level of 20.7% of GDP****, and this level (21%) is proposed to be retained for the next two years (in the period of prudent fiscal policy in 2004-2006 expenditures amounted to about 16% of GDP). As a result,* ***risks of serious financial consequences are significantly increasing*** *in case of falling global oil prices and other Russian commodity exports in the absence of substantial financial reserves, which were available before the 2008 crisis.*

• ***Retention of high, though somewhat slower, rate of inflation.*** *Consumer price index in the first six months of 2011 in annual terms (against the first six months of 2010) made 9.5%, while in the last year it was* ***6.6%.*** *At the same time****, in June, as compared with May, the CPI growth decreased to 0.2% versus 0.5%, or by 2.5 times, and in the first three weeks of July, consumer prices were not growing.*** *This was based on a seasonal reduction in prices for food products and slower growth in prices for commodities. On July 25, as compared with December of the last year, inflation made 5.1%, which is by 0.4 percentage points higher against the same period in 2010. Further curbing of inflation acceleration can be contributed by the reduction of broad monetary base over the first half of the year by 9.5% and a slight increase in monetary base $M_2$ by 3.7%.*

A significant increase was also observed among the producers' prices for industrial goods, which in the first half of 2011 amounted to 20% against the same period of 2010, with the previous year indicator of 19.6%. As compared with December 2010, producers' prices rose by 7.9%, whereas a year earlier – by 5.5%.

• ***The growth of foreign currency and gold (international) reserves*** *of the country at the background of high export prices. Since the beginning of the year, they increased by 49.1 billion dollars (more than for the total 2010) and reached a* ***maximum value since October 2008 - 528.5 billion dollars****. The historical maximum in early August 2008 reached 598. 5 billion dollars.*

• ***The sustained tendency for the ruble strengthening****. In June 2011, as compared with December of the last year, it made 8%, given that over the same period in 2010 it was 9.7%.*

• ***Resumption of foreign debt growth in the private and quasi-public sector*** *(due to the structures with a high public participation). Herewith, this growth is accelerating. If in the second half of 2010 the growth of the total external debt amounted to $31.6 bn, for the first half of 2011 it reached $43.2 bn and the total amount of debt amounted to $532.2 bn (the maximum value before the crisis was $534.5 bn). Herewith, in the first quarter the debt growth was $20.9 bn and in the second quarter $22.3 bn. During the period under review some reduction in public external debt was dominating, so that the debt growth was happening due to the debt of banks and corporations. It is worth reminding that the high external debt of private and quasi-public sector was one of the key factors that aggravated the depth of the Russian crisis, which began in 2008.*

• ***Long term (for ten consecutive months) of net capital outflow from the country****. According to tentative estimates of the Bank of Russia, in the first half of 2011 it reached* ***$31.2 bn****, which is* ***2.7 times*** *higher as compared with the same period of the last year****. In June, for the first time this year, the outflow of capital was replaced by a small inflow of about $3 bn****, but still, there are no grounds to judge fairly on further developments.*

• ***Uncertain dynamics of the stock market in the past period****, without clearly defined trend (though in 2010 a growth prevailed in the MICEX index). If the rise in oil prices usually contributes to the quotations growth, the negative foreign information on the situation in the EU, USA, etc. leads to the opposite process.* ***In July, a moderate growth was prevailing in the market of***

***public debt and bonds. Turnovers and indices of corporate bonds have again reached their historical maximum.***

*Preservation of a number of negative trends for a long term indicates the presence of* ***systemic factors*** *that impede normal development.* ***The key, and in fact, universally recognized one among those factors is poor investment situation and business climate in general, which is deteriorating for several years.*** *New ratings published by several international agencies that assess various aspects of business climate in different countries, used by international investors, do not give grounds for positive changes to the better in our country.* ***This situation indicates a serious danger of stagnation in the Russian economy even under favorable oil prices.***

*However****, some trends provide grounds to expect some improvement*** *in the dynamics of economic development in the second half and for the year in general.*

• *As a rule, within one year,* ***from month to month****, with some exceptions,* ***the volume of investment in fixed assets is increasing,*** *and reaches its peak in December. If in the first quarter of this year its physical volume was lower by 0.8% versus the relevant period of preceding year, in the second quarter it has exceeded 4.9%.* ***Preservation of such a trend can lead to a greater investment demand and increasing investment in fixed assets during the year by 5-8%****. All the more so, that the production of other non-metal products, mainly* ***construction materials****, is steadily and for a long* ***term growing at a faster pace****, having made* ***11%*** *over the first six months of the year. This allows to hope that construction industry will gradually come out of stagnation.*

• *According to the tentative estimates of the Bank of Russia* ***balance of payments for the first half of this year, the inflow of direct investment into the country amounted to $26.9 bn against $17.7 bn over the same period of the last year.***

• *Conducted by the Gaidar Institute* ***surveys among business Heads in June demonstrated the most optimistic results*** *in comparison with previous month* ***in demand, output growth, the state of stocks.*** *It is too early to judge whether these are new trends, but the fact is symptomatic. Probably, it can be connected with still weak increase in the growth rate of manufacturing output in June to 7.1% - by 2 percentage points higher versus April-May.*

*The prospect of development will, of course, to a large extent depend on the global economy, especially in high-risk regions.*

# POLITICO-ECONOMIC RESULTS OF JULY 2011

S.Zhavoronkov

*July 2001 proved a fairly quite month.* ***The RF Government*** *confirmed that de-facto it* ***is not going to lower social insurance premiums****, and not only does the respective draft document published by the RF Finance Ministry suggest lowering payments for a part of residents, but even their increase for corporations whose employees' monthly salaries exceed Rb. 45,000. However, a final solution has not yet landed on Pres. D. Medvedev's desk. The Government de-facto continues ignoring his commissions and procrastinating the matter, with the President having no real leverages at hand to make the Government deliver on the matter. Meanwhile, it became known that* ***the bailout of the Bank of Moscow****, which previously belonged to the City Hall and currently to the state-owned VTB,* ***requires colossal budget capital*** *in the region of at least Rb.295bn. Turns out, even the largest Russian banks may face such challenges and black holes in their balance sheets that can either momentarily drive them into bankruptcy, or, so conveniently for bureaucrats of all sorts, engender an urgent need for government subsidies. The Russian authorities found themselves in thrust and parry with the US Department of State on the ban to entry the US imposed on an uncertain group of individuals involved in the "Magnitsky case".*

In July, the nation was rocked by yet another manmade catastrophe: the 55-year old tourist cruiser Bulgaria sank on July 10 at Kyubyshev reservoir on Volga river, with more than 100 passengers subsequently found drowned. The head of the company that had leased the vessel and the expert who had signed the operator certificate were detained on charges by p.3 Art. 238 of the Criminal Code of RF "Provision of services not meeting safety requirements". No legislative or normative decisions were taken as a follow-up on the grievous development, except for the RF Ministry of Transportation imposing a ban on a dozen of the most obsolete cruisers and other river vessels' operations. As a reminder, the month before, an old Tupolev-134 crashed while landing in Petrozavodsk, and some 50 passengers were killed in the crash. In July, in Tomsk oblast, Antonov-24 crashed and the death toll was 7 people. In a bizarre move shortly thereafter, the Ministry of Transportation decided to ban operations of Tupolev-134, Antonov-24 and Yakovlev-40 aircraft not equipped with a terrain awareness and warning system effective of 1 January 2012 and proposed to the RF Ministry of Industry to discontinue extending operational endurance of Tupolev-134 and some other aircraft of this sort. That said, there is no alternative to the said types of aircraft across a whole string of domestic routes, for instance in Siberia or in the south of Russia, as local airports there cannot accommodate huge aircraft. Plus the necessary extra equipment is not particularly costly[1]. In light of this, a lenient stand towards operating obsolete vessels practically fully used for leisure purposes seems bizarre.

In July, the government circles continued an unhurried discussion on short-term privatization programs. More specifically, while meeting big businesses, Pres. D. Medvedev said he anticipated from the RF Government more radical privatization proposals until 1 August 2011. As a reminder, all recent privatization programs were sabotaged (eg. the 2010 program – at the time, Mr. Medvedev had already announced the start of the "mass privatization" – was completed at some 10%) as groups of bureaucrats in control over public companies are keen not to lose shadow incomes from those assets, which would happen, should a controlling stockholder show up therein. A series of meetings within the Cabinet in July has not practically changed the situation, and possible privatization of VTB, JSC Sheremetyevo, Inter RAO UES, Sovkomflot, Rosneft is still discussed for the span of a few years to come (with 2017 being cited as a timeline), which de-facto equals shelving the issue for an uncertain period of time.

The banking system in July witnessed two major developments. First, one of the backbone banks, VTB, worsened its earlier made assessments in conjunction with Bank of Moscow. Specifically,

1 Under $20,000 per 1 aircraft

after VTB had secured control of the bank, it was discovered that the latter's loan book consisted of hundreds of billions of rubles in related-party loans disbursed by the previous management. The Central Bank of Russia ultimately lent Bank of Moscow through the Russian Deposit Insurance Agency (DIA) Rb295bn at the discounted rate of 0.51%, ie. far below the regular refinancing rate ,over 10 years. The capital will be provided by means of printing money, which, as the CBR management vows, will be sterilized by the Bank of Moscow buying domestic bonded securities. Furthermore, VTB is going to boost its stake in Bank of Moscow to 75 percent by buying the stakes from the latter's former President, Andrey Borodin's corporations and from V. Yusufov (who in turn had acquired his stake using a Bank of Moscow's loan against a meager collateral) to ensure the legitimate cooperation with DIA.

So, the bail out of a bank whose management by some miraculous way waived collateral for gargantuan amounts lent requires roughly the same capital as the one spent at the onset of the 2008 crisis on recapitalization of the whole domestic financial system, or equivalent to more than a half of the aggregate budget spending on education or health care. And if it were not enough, there continues discussion about redemption of the bankrupt bank's stock from the former management and their affiliated parties, as if the problem of such magnitude did not need the legislators' engagement or the government lacked the majority in the Parliament to amend the legislation which makes such an absurd possible. Previously residing in London, the former head of Bank of Moscow Andrei Borodin was put on international wanted list only in May, when his whereabouts incidentally was no longer known.

The Vice-Premier and Finance Minister A. Kudrin admitted that *"<D>uring preliminary checks carried out by the Central Banks and auditors, they were presented with the part of the portfolio that looked more or less normal or were presented with falsified documents. Here the supervision and auditors are also responsible to a certain extent"*, but, in his words, the bulk of the blame belongs with previous management and ex- Mayor of Moscow. In reality, however, as of the moment of Mr. Luzhkov's ousting, the Bank of Moscow experienced no problems whatsoever. It was shortly after the Moscow Mayor' dismissal that it became possible to withdraw astronomical amounts out of the bank and waive collateral for loans, while VTB has been boldly acquiring stakes in the Bank of Moscow and assume respective losses. This story appears hortative in some regards: first, the quality of the CBR's oversight is unsatisfactory even as far as big banks are concerned, and, second, in a situation when the RF Government and CBR are keen to provide unlimited resources, bureaucrats and management of state-owned banks see no incentives to save the public funds. Plus, CBR is a regulator, overseeing agency and creditor to private banks at the same time, and the law leaves an ample room for the regulator's discretionary actions.

The other scandalous, albeit not so big, development in July was the CBR's revoking the license from AMT-bank owned by M. Ablyazov. The bank held Rb15bn in private deposits (and some Rb.7bn in the CBR bonds). The collapse of the AMT-bank became the biggest insurance case in the DIA's record to date. As of the moment its license was revoked, the bank was operating normally; more than that, its debt before the CBR (like many other banks, it has received the CBR's aid during the crisis) was diminishing steadily. The CBR leadership justified their move by asserting the bank was too active in attracting deposits, thus establishing conditions for a classical Ponzi scheme[1]. Oddly enough, the bank's business model that had for long remained unchanged suddenly no longer pleased the Bank of Russia.

In July, the RF Government still failed to submit any proposals on decreasing the tax burden of insurance premiums for 2012 and onwards, despite Mr. Medvedev' order to do so by 1 June. It was only the RF Finance Ministry which put forward its model in the form of a draft "Tax policy guidelines for 2012 and 2013-2014". The document was immediately attacked by Mr. A. Dvorkovich, the President's aide.

In short, the Finance Ministry proposed to concurrently lower the insurance premium rate from 34 down to 30% and introduce an additional 10% rate (7% for SME) in costs in excess of Rb.512,000 a year, ie. for corporations whose employees' salaries exceed Rb. 45,000 a month. According to the Ministry, this would lower budget losses from the lowering of the rates by one-third. Thus,

1 For two straight years the bank has been attracting deposits under 10% annualized, which proved one of the highest deposit attraction rates on the market.

the RF Government took a further reverse course vis-a-vis the ideology of the tax reform of the early 2000s. Seeking to encourage taking salaries out of the shadow zone, not only did the latter suggest the overall tax cuts, but the flat personal income tax rate and even regression in social contributions. The Ministry's novelty would result in differentiation of rates, which will increase "grey" labor compensations payment schemes (eg. by splitting salaries into parts) and "black" ones, with the most honest payers finding themselves in the worst situation. The Ministry hold that most corporations accrue salaries far less than Rb. 45,000 a month, so most employees would be held harmless. The counterargument to this is that it is not the number of potential "victims" that matters – rather, contrary to earlier made promises, those who legally accrue fairly decent salaries will see taxes raised, rather than lowered.

Mr. Dvorkovich maintained that he is in favor of an extra insurance premium on high salaries, but to a lesser degree than the one put forward by the Ministry: for instance, *" 6% for all, and it might be possible to install a 2% privileged rate for small businesses. Or, better still – 2% for all".* In all fairness, though, as the RF Government has not cared much of its immediate senior's orders, Mr. Dvorkovich's voice has far lesser chances to be heard of. The Government's strategy still is to procrastinate the discussion, as six months after Mr. Medvedev's statements, just slightly over half a year left until the end of his term in office. Meanwhile, super-high oil price notwithstanding, the budget will still pensions, law enforcement and arms purchases costs on the upswing.

In July, Msrs. S. Sobyanin, Moscow's Mayor, and B. Gromov, Governor of Moscow Oblast, submitted to Pres. D. Medvedev proposals on changing the borders between the capital city and the neighboring region. Mr. Medvedev first raised the issue at the St. Petersburg Economic Forum in June referencing to the need to take government offices beyond the Moscow Ring Highway. The Moscow City and Moscow Oblast governments in tandem with federal agencies were tasked to submit until 10 July proposals on new borders of the city and the region for the sake of extending the capital's territory, placing legislative and executive bodies of government, as well as establishing and developing an international financial center in particular.

The ultimate decision is as follows: there will be no new federal super-region. Moscow is going to be allocated a 144,000 hectare site South-West of today's Moscow, in between Warsaw and Kiev highways and limited by the so called Big Round Railroad, thus increasing the city's area 2.4 times. The territory in question currently comprises the research city of Troitsk, while other large urban centers of Moscow oblast will not be included in the new capital's area. It is not clear as yet which institutions will be relocated onto the new territory. An international financial center (whatever this term, in usage for many years already, means, is going to be established in another corner of the present Moscow oblast – that is, along the prestigious Rublevka highway. Praising the proposed city expansion option, Mr. S. Sobyanin maintained that, "*<T>he development density rate across new territories will be twice as low as in the <current> Moscow. With relocation of a huge number of offices and jobs, Moscow should breathe easier. Today, erecting anything in Moscow is a challenge. But it is impossible not to build, which is why the decisions taken ensure opportunities for an absolutely different city's development model".* That said, it will take no less than a year to design a development plan. In addition, the law requires holding local referendums on changing borders of the settlements concerned, so the new project will ultimately take years to complete. Besides certain pluses cited by Mr. Sobyanin, the decision has its minuses. First, it will aggravate the Moscow oblast's standing, as the region is going to lose favorable from the tax and resource perspective territories, while the oblast administration is left with the challenge of funding remote depressive areas. Second, redemption of sites for public needs may ignite numerous conflicts. Third, residents of soon-to-be new Moscow municipal districts are at risk of losing a full-fledged local self-government to be replaced with a castrated Moscow-style one, which implies powers like lower wedding age. So, basically it is premature to run a cost-benefit analysis on the matter.

July was crowned with a diplomatic incident between Russia and the US. As a reminder, the State Department announced that an uncertain circle of individuals allegedly engaged in Mr. S. Magnitsky's death and embezzlement of Rb5.4bn from Russia's budget are banned from entry the US. Ms. N. Timakova, the RF President's spokeswoman, commented the move by asserting that, *"<W>e are perplexed by the stance taken by the US Department of State, which, in anticipation of completion of investigative activities and a Russian court's verdict assumed irrelevant functions.*

*Such measures were not taken even in the most complicated years of the Cold War…..Dmitry Medvedev commissioned the RF Ministry of Foreign Affairs to prepare analogous measures with regard to US citizens"*. The case proved to be domestic one, too: in Russia, Pres. D. Medvedev has long vowed to investigate into the case, but the process was advancing very slowly. So, it seems that the suspects[1], including Mr. Anichin, Mr. Putin's university mate and ex-Deputy Minister of Interior, and his junior staff, are not really suspects at all but specially protected citizens who are in a far greater need for the right to entry the US than, for instance, such businessmen as Messrs. O. Deripaska and J. Kobzon who had long been denied the entry and failed to earn the grace of the presidential Press Secretary's advocacy. Quite notably, the Obama administration was likely to really lend a helping hand to the RF Government by introducing sanctions against God knows whom and blocking a far more concrete bill currently under consideration by the US Congress, which contains 60 names with Mr. Anichin's atop the list. As to the "analogous" measures against the US citizens, they are just nonsense, for the US top cops are not at all going to ever entry Russia' territory and will not suffer from any discomfort. That Russian authorities have engaged themselves in the polemics on the case will form a perfect reason to further attribute them to Mr. Magnitsky's death and the embezzlement of public funds, while they have recently been trying to distance themselves from these malpractices after criminal cases were formally instituted and Mr. Anichin quitted the job.

1 Switzerland announce an arrest of assets held by a number of suspects, who are former and acting staff with the RF Ministry of Interior, Federal Tax Service, Attorney General's Office; the Dutch Parliament called for similar measures

# INFLATION AND MONETARY POLICY

N.Luksha

*The seasonal fall in prices of food stuffs in tandem with deceleration of the price rise for non-food products **in June** drove consumer inflation down 2.5 times **(to 0.2%)** vs. the May figures. The accumulated since the beginning of the year **inflation hit 5.1% as of 25 July**, or up by **0.4 p.p**. on a year-on year basis. In July, **international reserves** were on the upsurge and in the middle of the month **accounted for $528.5bn**, which is the highest figure ever observed **since October 2008**. According to the Bank of Russia's preliminary estimates**, in June, for the first time this year,** there was registered **capital inflow** in the amount of **some $3bn. The net capital outflow dropped in Q2** from $21.3bn **to $9.9bn. By results of H1 of 2011, capital outflow remained a considerable one and accounted for $31.2bn, or 2.7 times greater** than the respective figure of 2010**.***

In June, the increase rate of consumer prices slowed down 2.5times vs. the May figure: by results of the month CPI was down to 0.2%. That occurred due to the seasonal drop in food prices and deceleration of the price rise for non-food products.

The food deflation rate in the first summer month accounted for 0.2%, and major trends noted on the food market in May were still there in June, too. More specifically, down went prices for eggs (-12.1%), fruits and vegetables (-3.2%) and sugar (-2.4%). Plus, for the first time since last summer, when the new harvest suffered from draught, prices for gruels and legumes slid by 0.9%, while over the year they added 82.3%. For the first time since the beginning of the year prices of sunflower seeds oil were down by 0.2%, milk and dairy products – by 0.1%.

In June, the price rise rate for non-food products was twice as low compared with the May figures and accounted for 0.4%. The downfall in prices was driven largely by slowdown of the fuel inflation: the gasoline price rise rate dipped from 6% to 1.7%. The prices of TV- and radio goods declined by 0.7%. Meanwhile, the price rise rate for other non-food products also slowed down 1.5-2 times.

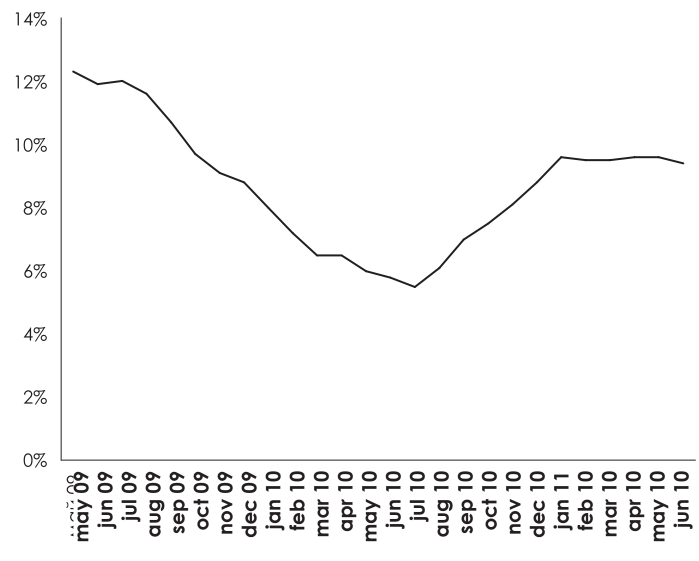
The paid services to the population posted the same increase rate of 0.7% as they did in May. The most intense price rise was still noted with regard to sanatorium-rehabilitation services (+6.7%), passenger transportation services (+2.1%) and overseas tourism services (+1.9%). There was no price decrease across paid services under monitoring.

In June 2011, the basic Consumer Price Index[1] tumbled to 0.3% (0.2% over the same period of 2010).

The June inflation deceleration drove its annual index down from 9.6% to 9.4% (*see Fig.1*).

Inflation over the first half of the year accounted for 5% (4.4% in 2010). It continued decelerating in July in annual terms. As a result, as of 25 July, CPI accounted for 0.1%, or down by 0.3 p.p. vs. its respective figure of 2010.

Inflation may continue slowing down in Q3, thanks to the seasonal drop in food stuffs. Favorable weather conditions this summer




*Source*: Rosstat

*Fig. 1. The growth rate of the CPI in 2009 – 2011 (% year to year)*

1 The basic Consumer Price Index is the indicator which mirrors the inflation level on the consumer market, except for the seasonal (prices of fruits and vegetables) factor and the administrative (tariffs of regulated kinds of services) one, which is also calculated by Rosstat.

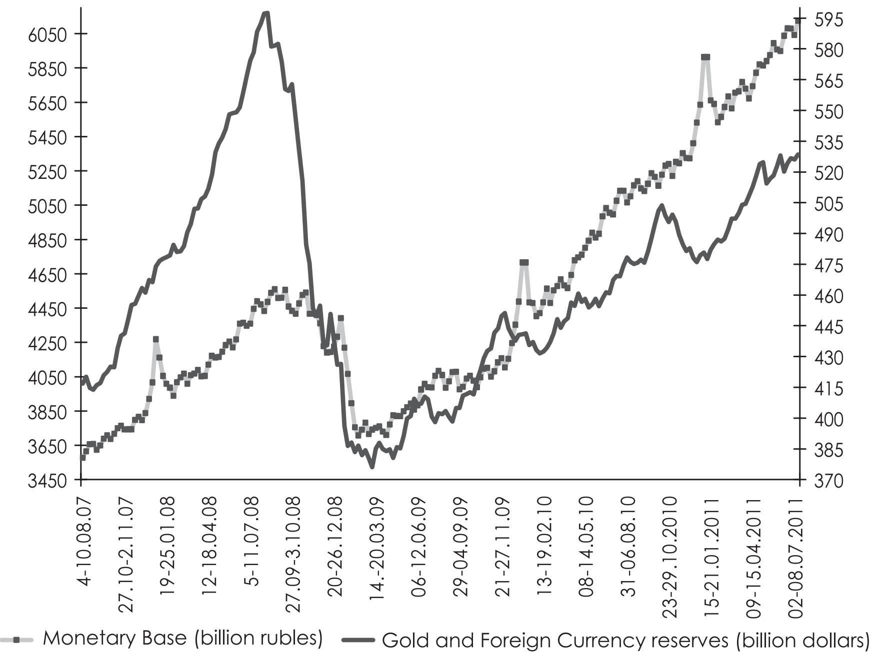
and prospects of a good harvest will be having a constraining impact on the price rise. Plus, the monetary pressure on inflation has diminished. The $M_2$ increase rate continued decelerating: between January and May it made up 0.9%, while last year, this particular indicator accounted for 7.9%. We suggest that in the absence of unfavorable shocks, CPI may ultimately hit the level of 7.5-8% by the end of the year.

The broad monetary base shrank by 9.5%, from Rb8,190.3bn to 7,410.3bn over the first six months of the year. In June, the monetary base expanded by 1.9%. The increase was fueled by a triple, up to Rb486.4bn, surge in credit institutions' deposits with CBR and a 2.1% growth (up to Rb5,787.8bn) in cash in circulation, with account of credit institutions' cash balances. It should be noted that the volume of CBR bonds held by credit institutions was down considerably – from $461.1bn to 18.3bn.

That commercial banks' deposits with CBR were on the upsurge is likely to be ascribed to the raising of deposit interest rates in May under relatively high risks of other investment options (lending to non-financial sector in the first place). Meanwhile, the fall in investments in CBR's bonds can be ascribed to their low yields. After their planned redemption was over, commercial banks opted for more favorable terms offered by placement of funds on deposits with CBR. In June, commercial banks' excessive reserves[1] soared by 1.7%, up to Rb1,291.2bn.

The 2.1% increase in the volume of cash in circulation and the 1.2% decrease of compulsory reserves in June led to a 2% (up to Rb6,119.1bn) expansion of the narrow monetary base (cash plus mandatory reserves)[2] (*see Fig. 2*).

In July, international reserves continued growing and in the middle of the month they hit their peak of USD528.5bn - the figure which has not been reported since October 2008. That said, as a reminder, their historic peak was registered back in August 2008: at the time, international reserves stood at $598bn. This year, behind the acceleration of their increase rate were high international oil prices: international reserves have added $49.1bn since the beginning of the year. So, in just slightly more than half-year their increase (+10.2%) proved at $9.2bn more than the respective figure reported over the whole 2010 (+9.1%). Meanwhile, the increase was tamed by a sizeable capital outflow and a CBR's gradual scaling back on interventions in the frame of the transition to the inflation targeting policy.




*Source:* CBR

*Fig. 2. Changes in the Monetary Base and in the Gold and Foreign Currency Reserves in 2007 – 2011*

According to the CBR's preliminary estimates, by results of H1 of 2011 the net capital outflow accounted for $31.2bn, or 2.7 times greater than the respective figure a year before. In Q2, the outflow somewhat slowed down from $21.3bn to 9.9bn. More than that, for the first time this year June saw capital inflow of some $3bn. That said, it is still premature to speak of a change in the existing tendency. In the pre-election period and under

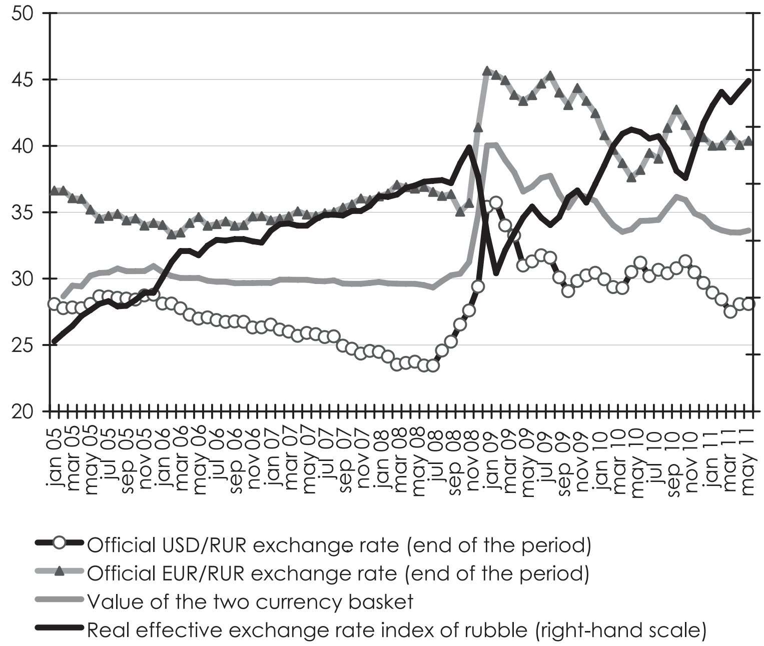
1 Commercial banks' excessive reserves with CBR are understood as the sum of their corresponding accounts, deposits with CBR and CBR's bonds held by commercial banks.

2 As a reminder, the broad monetary base is not a money aggregate. Rather, it characterizes the Bank of Russia's liabilities in the national currency equivalent. The narrow monetary base is a money aggregate (one of characteristics of money supply) and as such, it is fully controlled by CBR.

relatively low interest rates in RF, a renewal of a sizable private capital inflow is unlikely to happen.

The Rb. effective exchange rate was being on the rise for the second straight month: in June, it added 1.2%, with the real effective exchange rate index hitting 153.1[1] (*see Fig.3*).

In July, Rb. was alternately on the rise against USD and Euro. The USD exchange rate slid by 1.2% and as of 26 July made up Rb27.74/$. The European currency sank by 1.4%, down to Rb39.84/€ as of the same date. As a result, the bicurrency basket was down by 1.3%, to Rb.33.19.




*Source:* CBR, the author's calculations

*Fig. 3. Indicators of Ruble's Exchange Rate Dynamics*

The Russian currency is backed by stably high oil prices and the US and Eurozone's poor economic performance indicators. On the one hand, the unfolding debt crisis in the latter sends € nosedive; plus, the continuous crisis in Greece, the downgrading of several European economies' credit ratings (Moddy's downgraded those of Portugal and Spain to the level below the investment one) and a possible spread of the crisis onto Italy have had a negative impact on the European currency exchange rate. On the other hand, the Republicans' proposal to hold a short-term technical default and the Moody's move to set the US sovereign debt rating for revision spooked investors and triggered the Dollar's fall on the international market.

1 With January 2002 making up 100.

# FINANCIAL MARKET

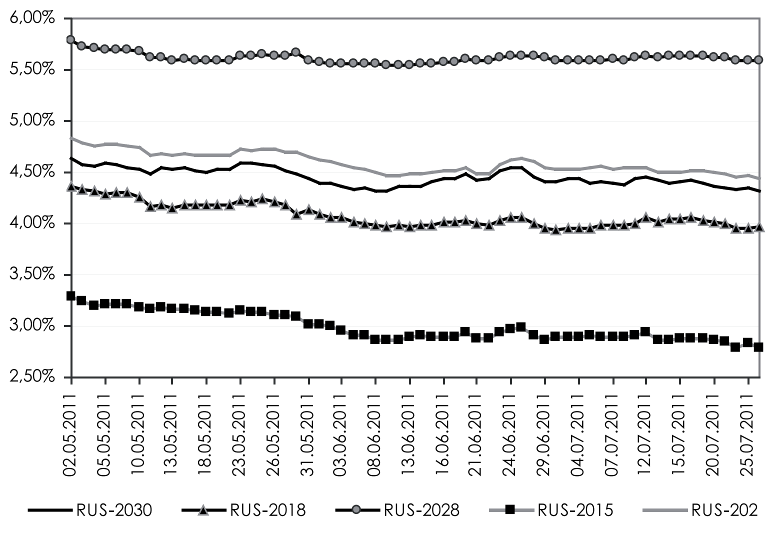
N.Burkova, E.Khudko

*__The public debt and Russian stock market indices were on a moderate upsurge in July.__ Meanwhile the dynamics of stock quotations of the most liquid Russian companies proved multidirectional. By contrast, __the turnover of the spot market__ was down__, despite an increase in main stock indexes__. __The volume and index of the market for corporate bonds renewed their historic highs__. A negative development on this market became __a big number of canceled stock issuances,__ as some issuers have decided not to enter the stock market or failed to place their papers within set deadlines..*

## The Market for Public Stock

The positive dynamic of the public debt market in July was fueled by a growing volume of liquidity on the market because of a 18% increase (up to $101.7bn) on a year-on-year basis of the surplus of Russia's balance of trade in H1 2011. Plus, that the Bank of Russia was holding its refinancing rate unchanged at the level of 8.25% also contributed to the stability of this segment of the debt market. Meanwhile, as far as factors that restrict the growth in question are concerned, it is worthwhile noting information on a 26.9% increase (up to Rb.3.12trln) of Russia's public debt in the form of public papers.

According to the data as of 26 July 2011, the yield to maturity of most Russian eurobonds dipped vs. the 22 June figures, with RUS-15 displaying the biggest drop (by 2.92%). The only exception became RUS-28 that posted a 0.16% growth (*Fig. 1*).




*Source*: according to Finmarket information agency

*Fig. 1 Yields to Maturity of the Russian Eurobonds with Maturity in 2015, 2018, 2020, 2028 and 2030 in May – July 2011*

Between 23 June and 26 July 2011 the aggregate turnover on the secondary OFZ market made up Rb. 225.24bn, with the average daily turnover being on the level of Rb9.39bn, equivalent to a 4.8% increase in the average daily monthly turnover.

During the period in question as many as 5 auctions on placement of OFZ on the primary market were held (against 10 auctions a month before) (see *Table 1*). The overall actual volume of placement accounted for 68% of the planned volume. No auctions on additional placement of OFZ issues on the secondary market were held during the period concerned.

*Table 1*

PLACEMENT ON THE PRIMARY MARKET FOR OFZ

| Date | Issue | Volume of issue, as Rbm | Volume of face-value placement, as Rbm | Average-weighted yields |
|---|---|---|---|---|
| 29.06.2011 | OFZ-25079-PD | 20 000,00 | 19 311,16 | 7.08 |
| 29.06.2011 | OFZ-26206-PD | 50 000,00 | 30 051,08 | 7.85 |
| 06.07.2011 | OFZ-26204-PD | 30 000,00 | 29 859,52 | 7.78 |

*Table 1, cont'd*

| Date | Issue | Volume of issue, as Rbm | Volume of face-value placement, as Rbm | Average-weighted yields |
|---|---|---|---|---|
| 13.07.2011 | OFZ-26205-PD | 30 000,00 | 1 228,47 | 7.90 |
| 20.07.2011 | OFZ-26206-PD | 25 000,00 | 24 945,59 | 7.53 |
| | | 155 000,00 | 105 395,82 | |

*Source*: the RF Finance Ministry

**Stock Market**

***External factors behind the dynamic of Russian stock market***

The retention of the basic interest rate at its previous level of 0-0.25% by the Federal Reserve, the approval by the Greek Government of extra austerity measures and the EU countries' decision to provide financial support to Greece resulted in renewal of the worldwide demand for risky assets. Meanwhile, in late June, the International Energy Agency ruled to put 60m barrels of oil on the market to stabilize prices, which gave rise to a number of major factors that hampered the advancement of Russia's stock market in July. More specifically those were: a price downfall, the US economy running out of steam, Fitch Ratings downgrading its forecast of the 2011 global economic growth to 3.1%, and Moody's Investment Services downgrading the long-term rating of Portuguese public papers from Baa1 to Ba2. Most developed and emerging markets demonstrated multidirectional trends (see *Table 2 and Fig. 2*). It was NASDAQ Composite that posted the highest growth rate of 6.4%.

*Table 2*

DYNAMICS OF GLOBAL STOCK INDEXES (THE DATA AS OF 26 JULY 2011)

| Index | Value | MoM change (%)* | Change since start-year (%) |
|---|---|---|---|
| MICEX (Russia) | 1 722.11 | 5.00 | 2.02 |
| RTS (Russia) | 1 987.79 | 5.82 | 12.29 |
| Dow Jones Industrial Average (USA) | 12 501.30 | 3.23 | 7.98 |
| NASDAQ Composite (USA) | 2 839.96 | 6.40 | 7.05 |
| S&P 500 (USA) | 1 331.94 | 3.48 | 5.91 |
| FTSE 100 (UK) | 5 929.73 | 2.72 | 0.50 |
| DAX–30 (Germany) | 7 349.45 | 0.98 | 6.30 |
| CAC–40 (France) | 3 787.88 | –2.16 | –0.44 |
| Swiss Market (Switzerland) | 5 990.18 | –2.02 | –6.93 |
| Nikkei–225 (Japan) | 10 097.72 | 4.86 | –1.28 |
| Bovespa (Brasil) | 59 339.90 | –3.03 | –14.38 |
| IPC (Mexico) | 35 341.27 | –0.16 | –8.33 |
| IPSA (Chile) | 4 525.30 | –3.94 | –8.16 |
| Straits Times (Singapore) | 3 186.57 | 4.72 | –0.11 |
| Seoul Composite (South Korea) | 2 168.70 | 5.08 | 5.74 |
| ISE National–100 (Turkey) | 61 388.64 | 0.28 | –6.99 |
| BSE 30 (India) | 18 518.22 | 5.51 | –9.71 |
| Shanghai Composite (China) | 2 703.03 | 2.03 | –3.74 |
| Morgan Stanley Emerging&Frontier Markets Index | 912.63 | 3.47 | 0.10 |

* – vis-a-vis the respective figures as of 22 June 2011

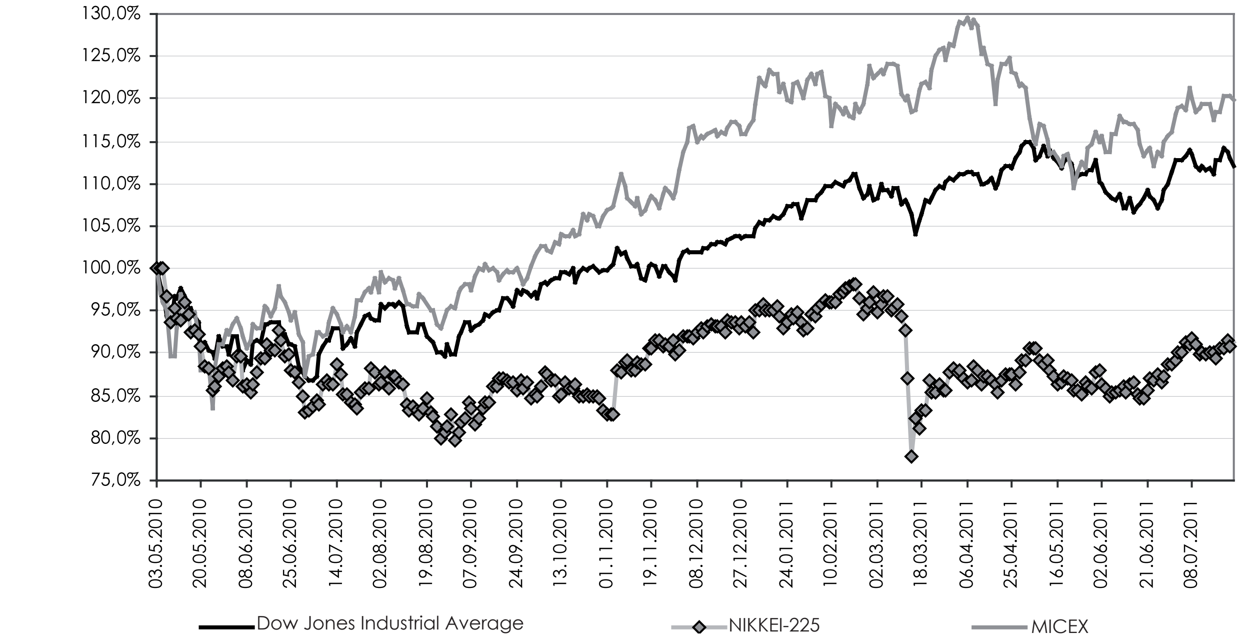


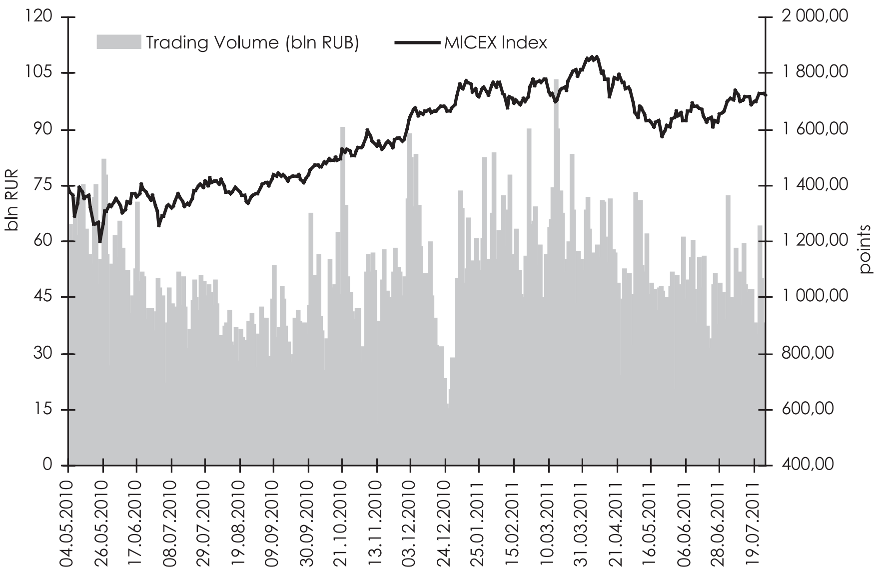

*Fig. 2. Dynamics of the Main USA, Japanese and Russian stock indexes (in % to the date 01.05.2010)*

**State of Affairs on the Stock Market**

The main factors affecting Russian stock market over the month in question became debt crises in the US and Greece and decisions made in these regards. These developments basically drove main Russian indexes upwards, with volumes of trading remaining relatively stable. As concerns factors of the market's surge, it is worth noting the adoption of the budget austerity plan by Greece, the Eurozone nations' decisions to support Greece and positive macroeconomic data from the US about rising business activity and increases in industrial orders. Meanwhile, multidirectional oil prices dynamics, contraction of business activity in China and Europe had an adverse affect the market's surge.

The MICEX's peak value of 1, 740.53 points (1, 692.34 points a month earlier) was registered on 7 July, while the bottom one fell on 18 July (1, 687.63 points (1, 626.14 points)) (*Fig. 3*).

Overall, between 23 June and 26 July 2011 the MICEX index soared by 5%, or by 81.98 points in absolute terms (between 27 July 2010 and 26 July 2011 it rose by 22.87%), and the trading turnover by stock included in the MICEX index hit Rb1,156.61bn. The average daily rate of investors' activity on the stock market in July added 1.5% compared with the previous period.




*Source*: MICEX

*Fig. 3. Dynamics of the MICEX Index and Trading Volume*

Between the beginning of the year and 26 July 2011 the leading blue chips in terms of growth in value became Rostelecom and Tatneft's stock that added 36.76 и 30.24%, respectively (*Fig. 4*).

According to MICEX data, capitalization-wise, the Top-5 leading domestic corporations were: Gasprom – Rb. 4,774.47bn, Rosneft – 2, 564.87bn, Sberbank of Russia – 2,211.8bn, LUKOIL

– 1,592.34bn and Nornickel – 1,424.75bn.

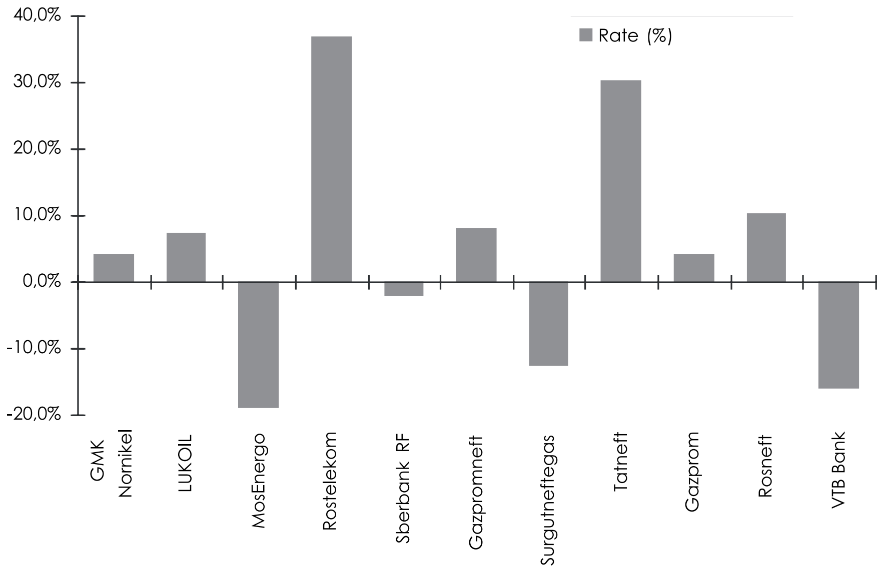



*Fig. 4. Increase Rate in Quotations of Russian Blue Chips between 1 January 2011 and 26 July 2011*

***The spot market***

In July 2011 (between 23 June and 26 July), the average daily trading volume on the MICEX's spot market plunged by 38% compared with the previous month. Like a month before, the greatest volume of trading (Rb. 17.9bn, 51,000 transactions) fell on security assets. Meanwhile, in terms of trading volume in this section of the MICEX spot market, the settlement futures on the MICEX index are followed by supply futures on Gasprom, LUKOIL, Nornickel and Sberbank stock. It should be noted that the value of the MICEX index (the price of concluded deals) on September 2011 found itself on average within the range between 1,620–1,740 points, ie. most market participants anticipate the index to drop by 0–6% against its value as of 26 May 2011.

Transactions with currency futures came in second in July (Rb11.25bn). Settlement futures on $ were unrivaled in this section of the MICEX spot market, followed by futures on € against $ and € exchange rates. Prices of futures on Rb/$ concluded on the MICEX's spot market in July with the date of execution in September 2011 were on average within the range 27.7–28.5 Rb/$., ie. the market anticipates a 0–2.7% depreciation of Rb compared to the respective index as of 26 July 2011 (27.74 Rb/$).). The volume of trading with futures on commodity-based assets over the period in question accounted for Rb2.6bn, followed by futures on interest-bearing instruments (Rb107m).

On RTS FORTS spot market, the investors' average daily activity dropped by 10% vs. the prior month, while trading volume-wise, atop the list were futures on the RTS index, followed, with a substantial gap, by futures on Rb/$ and €/$ exchange rates, on Sberbank and Gasprom stock. On the RTS FORTS spot market, prices of most recent deals concluded on futures on Rb/$ with the closing date of 15 September 2011 found themselves, like on MICEX's spot market, mostly within the range of 27.7–28.5 Rb/$., ie. the market anticipates a 0–2.7% depreciation of Rb. compared with the index as of 26 July 2011. The value of futures on the RTS index (on the basis of the most recent deals) with the closing date of 15 September 2011 averaged 1,800–1,980 points, ie. the average value of the index is envisaged to plunge by 0.4.-9.5% compared with the figure as of 26 July 2011. Options, meanwhile, enjoyed a far lesser demand, with the volume of the respective trading accounting for Rb471.01bn (on futures – Rb4.538.85bn.). As to the FORTS market's novelties, it is worth noting the beginning of trading with four new Rb.-denominated settlement futures on commodity assets in the frame of a joint RTS-JSC St. Petersburg Exchange project: since 30 June 2001- on corn and soya beans and since 5 July 2011- on gasoil and cotton.

***The corporate bonds market***

In July, the volume of the domestic market for corporate bonds in Russia (by face-value of papers in circulation issued in the national currency) continued soaring and had hit the level of Rb3,299.6bn by the end of the month, thus having added over 2.7% when compared with its value as of end-June[1]. Such an increase in the market's capacity was fueled by a surge in the number of bond issuances: 754 Rb-denominated ones vs. 741 issuances as of end-June. Meanwhile, the

1 By Rusbonds data.

number of issuers in the debt segment of the securities market remained practically unchanged: 340 vs. 343. The statistics evidenced that the increase in the average number of loans placed by every issuer has emerged as the most recent trend. As to issues denominated in foreign exchange, there is just a Гo denominated issue which still remains in circulation.

The aggregate volume of transactions on MICEX between 23 June and 26 July made up Rb175.3bn (vs. 172.4bn reported over the period between 23 May and 22 June), while the number of transactions accounted for 27,300 (26,700.)[1].

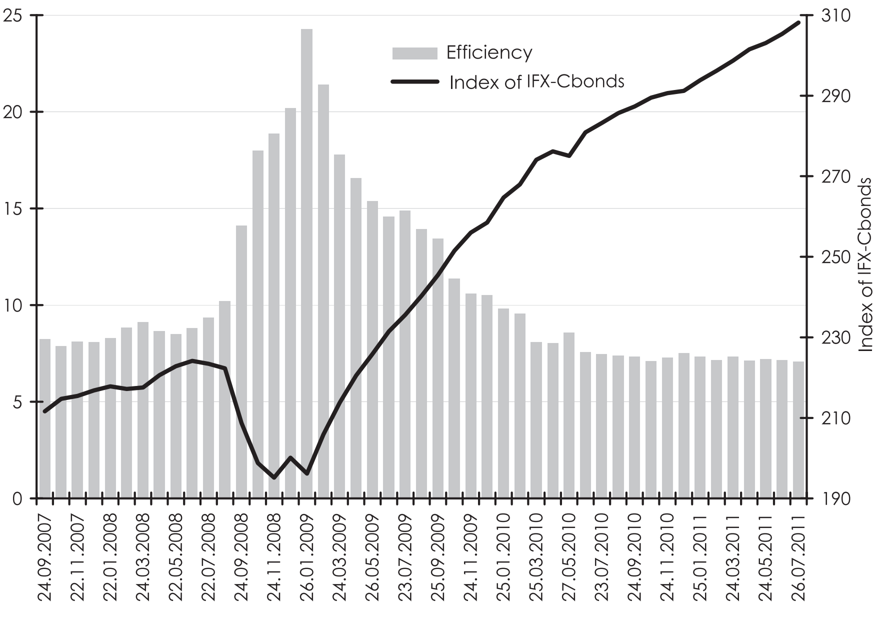
The growth of the Russian corporate bond market index, IFX-Cbonds, also accelerated last month and added 2.8 points, or 0.9%. The index has renewed its highs since the beginning of its calculation. The average-weighted effective yields over the period in question tumbled from 7.15%. in late June to 7.08% in late July, and within the period they would dip even below the 7% mark, albeit during the year were fluctuating within the range between 7.0–7.6% (*Fig. 5*). So, the average yields calculated across the bonds forming the IFX-Cbonds index proved minimum ones over the whole index's life. The duration index of the portfolio of corporate bonds was down by 25 days vis-a-vis the previous month and made up 669 days, thus evidencing contraction of the share of long-term obligations in the corporate segment of the market.

In July, the yields rates of the most liquid bonds issues unanimously demonstrated a downward dynamic, with the drop in interest on bond loans on average making up 0.3-04. p. p.. Atop the list of corporations that have suffered the most dramatic fall in yields between 23 June and 26 July were JSC "Moscow united electronetwork company", JSC Rostelecom and CB Renessaince capital, Ltd.[2]

The largest financials were likewise in decline, except for JSC Agency *for* Housing Mortgage Lending, JSC Raiffeisenbank and JSC Bank Saint Petersburg's papers which posted a fairly substantial increase in yields by some bond issuances (over 0.4 p.p.).

The most liquid issuances by industrial corporations, including Gasprom, Gasprom neft, Bashneft, LUKOIL, Alrosa, Alliance Oil Company, Magnitigorsky Metallurgical Plant, Novolipetsky metallurgical Plant, Norilsk Nickel, and Severstal, demonstrated a meager drop in interest rates (within the range between 0.2 and 03 p.p.). Meanwhile, the telecommunications sector (Mobile TeleSystems, AFK Systema) witnessed a more substantial drop of interest rates.

Most energy corporations' bonds displayed a low volatility rate, with maximum decline in yields rates (by 0.5-0.6 p.p.) reported across individual bond issues by Lenenergo, TGK-9 and Enel-OGK5. Despite positive dynamics of the bond market performance indicators, the month in question saw an insignificant number of bond issues, particularly against the backdrop of the June record-breaking figures. Specifically, between 24 June and 25 July only 18 corporate bonds issues with the aggregate face-value of Rb35.8bn were registered (for reference, the figures reported over the period between 25 May and 23 June were 31 issues and Rb235.7bn, respectively), with exchange-traded bonds of fairly large issuers representing the financial sector accounting for



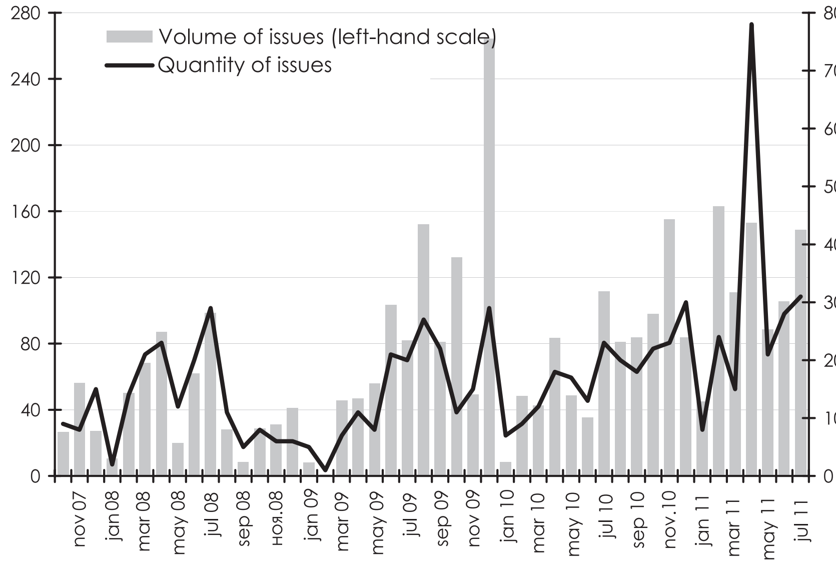

*Source:* basing on Cbonds data.

*Fig. 5. Dynamics of the Index of the Russian Market for Corporate Bonds and Average-Weighted Yields Rate*

1 According to Finmarket information agency data
2 According to Finmarket information agency

the lion's share of the issues. More specifically, the largest issuances were registered by JSC OTP Bank (3 series of exchange-traded bonds with the aggregate face-value of Rb15bn) and JSC Commercial Bank Stroycredit (ten series of exchange-traded bonds with face-value of Rb10 bn)[1].

Bleak registration indexes aside, both investors and issuers were fairly active on the primary market, thus helping the last month figures outrun the previous months' ones. Quite notably, several minor (up to Rb1bn) bond issues were placed during the period concerned. Between 24 June and 25 July as many as 31 corporate bond issues with the aggregate face-value of Rb148.8bn were placed (vs. 28 series of bonds worth a total of Rb.105.6bn. placed between 25 May and 23 June) (*Fig. 6*). Nearly a half of papers bought by investors were formed by exchange-traded bonds that provide for a simplified registration procedure by an issuer with a long record of presence on the market. The bulk of placed issues fell on two series of bonds of JSC FSK UES with the total face-value of Rb30bn, three series of bonds by JSC Russian Agricultural Bank (20bn), three series of bonds by JSC Mortgage Agent AIZHK-2011-2 (16.6bn), and three series of bonds by JSC Saint Petersburg Telecom (Rb13bn).




*Source:* by Rusbonds' data

*Fig.6. Dynamics of Rb- Denominated Primary Placement of Corporate Bonds Issues*

Speaking of these issues, it is worth noticing mortgage bonds with maturity to date of 32 years, which were placed by JSC Mortgage Agent AIZHK-2011-2. As well, long-term bonds were placed by Mekhprachechnaya SvZhD (for 15 years), FSK UES (10 and 13 years), Russian Agricultural Bank, Saint Petersburg Telecom, Alliance Oil Company and Kuzbassenergo-Finance (10 years)[2].

The primary placement figures could have been greater, had there been no numerous issuers' failures to place at least a single paper in July. More specifically, between 24 June and 25 July, the FSFM declared void, due to failure to place any papers, as many as 13 bond issues and canceled their public registration (between 25 May and 23 June – 6 bond issues). Interestingly, following their own financial strategies, upon public registration of their issues, some issuers decided by themselves not to place their papers on the market.

In the period between 24 June and 25 July 24 issuers were to redeem 27 bond issues worth a total of Rb. 69.8bn. However, three of them failed to fulfill their obligations in time and announced technical default with regard to redemption of their papers worth a total of Rb3.3bn. (in the previous period, there were 6 such cases). Another 12 corporate bond issues totaling Rb.19.4bn are due for redemption in August 2011[3]. The situation with issuers honoring their obligations was still remaining complex. Between 24 June and 25 July four issuers failed to pay coupons to bondholders (six issuers between 25 May and 23 June), with just one of them having managed to come to terms with bondholders with regard to debt restructuring. In the period in question, two issuers failed to pay back the face-value of three bond loans, even in the frame of technical default (2 issuers in June). As to an early call date, all the issuers fulfilled their obligations in time.[4].

Overall, speaking of the Russian financial market's development trends, it should be noted that the most urgent challenge, solution to which should have a strongest impact on the market in the short run, is a possible announcement of technical default in the US on 2 August, providing the

1 According to Rusbonds data.
2 According to Rusbonds data.
3 According to Rusbonds data..
4 According to Cbonds data.

US Congress fails to pass a decision on raising the US public debt ceiling. While very few bet on plausibility of such a development, this at the very minimum may result in international rating agencies downgrading the US ratings and, accordingly in aggravation of the state of the Russian financial market. Judging results of trading on Russian spot markets in July, forex transactions therein revealed the anticipation of a drop in the national currency's exchange rate and a plunge of main Russian indexes.

# TRENDS AND FACTORS

O.Izryadnova

*According to the preliminary estimation of the RF Ministry for Economic Development,* ***the increase of the GDP by 3.9% in the first half of 2011 is accounted for by the sustention of the trend for internal market growth,*** *which has been observed since the second quarter of the previous year.*

*In the 2nd quarter 2011 the investments in fixed assets growth rates were observed to accelerate up to 104.9%, the retail trade turnover growth rates – up to 105.6% versus the corresponding period of the previous year.* ***The upsurge at the internal market acted as a positive stimulus for the change in the situation at the labor market.*** *As compared with June 2010 this June the total number of the unemployed decreased by 581,000. GDP growth against the background of moderate increase in labor efficiency implies the maintenance of the development model oriented for raw materials and fossil fuels, thus increasing the dependence of Russia from the situation at the world markets.* ***The situation is aggravated by the trend for the net export decrease*** *that has been observed in the past four years.*

According to the preliminary estimation of the RF Ministry for Economic Development the increase of the GDP in the 1st half of 2011 made 3.9%, the growth rates decreasing from 104.1% in the 1st quarter to 103.7% in the 2nd quarter versus the corresponding period of the previous year. Quarter-by-quarter dynamics of the macroeconomic indices in the current year (*table 1*) is to a considerable extent defined by the effect of the base: the financial crisis reached the bottom in the 2nd quarter 2009, when the output volume in the basic types of economic activities reduced by nearly 15% versus the preceding year, after that the decrease rates were observed to decelerate gradually, macroeconomic indices in the 3rd quarter 2009 stabilizing versus the corresponding period of 2008 and the development rates accelerating sharply in the 1st half of 2010.

*Table 1*

MAIN MACROECONOMIC INDICATORS IN 2009-2011, AS PERCENTAGE TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR

| | 1st half of 2009 | Quarters of 2009 | | 1st half of 2010 | Quarters of 2010 | | 1st half of 2011 | Quarters of 2011 | |
|---|---|---|---|---|---|---|---|---|---|
| | | 1 | 2 | | 1 | 2 | | 1 | 2 |
| Gross domestic product | 89.9 | 90.6 | 89.2 | 104.3 | 103.5 | 105.0 | 103.9* | 104.1 | 103.7* |
| Investments in fixed assets | 79.4 | 82.7 | 77.2 | 101.3 | 95.2 | 105.6 | 102.7 | 99.2 | 104.9 |
| Construction | 80.7 | 80.7 | 80.7 | 93.7 | 88.9 | 96.7 | 100.9 | 101.6 | 100.4 |
| Housing floor area commissioning | 99.7 | 102.4 | 97.2 | 99.4 | 91.1 | 107.3 | 96.3 | 97.8 | 95.1 |
| Industrial goods volume | 85.7 | 84.6 | 85.2 | 110.2 | 109.5 | 110.9 | 105.3 | 105.9 | 104.8 |
| Agriculture production | 100.9 | 102.3 | 100.8 | 102.8 | 103.6 | 102.3 | 100.7 | 100.7 | 100.6 |
| Freight transportation turnover | 82.5 | 82.8 | 82.2 | 112.3 | 111.6 | 113.0 | 104.4 | 103.9 | 105.0 |
| Retail trade turnover | 97.6 | 100.4 | 95.2 | 104.6 | 102.2 | 106.9 | 105.3 | 105.0 | 105.6 |
| Paid services rendered to the population | 97.2 | 99.1 | 95.3 | 100.8 | 99.0 | 101.6 | 102.9 | 102.9 | 102.9 |
| Foreign trade turnover | 55.8 | 56.2 | 55.4 | 141.4 | 144.1 | 139.1 | 135.1* | 129.8 | 139.9* |
| Real disposable monetary incomes | 102.1 | 100.7 | 103.4 | 105.3 | 107.3 | 103.7 | 98.6 | 99.8 | 97.5 |
| Real wages | 97.2 | 99.2 | 96.1 | 104.6 | 103.1 | 106.1 | 102.4 | 101.6 | 103.2 |
| Number of the unemployed | 142.8 | 126.5 | 157.4 | 91.5 | 108.0 | 85.8 | 86.8 | 85.7 | 88.1 |

*) *preliminary data*
*Source*: Federal State Statistics Service

In the 1st half of 2011 the macroeconomic situation was formed under the influence of the dynamic expansion of foreign and internal trade volumes on one hand, and the slow recovery of the investment demand, on the other.

In the 1st half of 2011 the growth of investment in fixed assets made 102.7%, of retail trade turnover – 105.3% and of the volume of the paid services rendered to the population – 102.9% versus the corresponding period of the previous year.

It was the growth of investments in fixed assets by 4.9% versus the corresponding period of the previous year that was a positive trend of the 2nd quarter 2011. However, the comparison of the indices of investments in fixed assets and workload in construction demonstrates that the influence of the factors of low level of financing, decrease in orders and the volumes of unfinished construction that was accumulated in two previous years persists. As a result of the 1st half of 2011 the workload in construction increased by 0.9% versus the 1st half of 2010 and commissioning of residential floor area - reduced by 3.7%. At the same time the dynamics of the executed works in construction as broken by quarters of the current year as well as relatively reserved estimations of the state and prospects for the changes in levels of construction organizations business activity[1] act as factors illustrating the difficulty of the investment demand recovery process. It should be noted that in the 1st quarter 2011 the proportion of the gross national savings made 27.0% of the GDP, having increased by 2.4 percentage points as compared with the corresponding period of the previous year. At the same time the proportion of investments in fixed assets in the GDP over the same period reduced from 13.0% to 11.8%, and whereas in the 1st quarter 2010 the transformation of gross national savings in investments in fixed assets made 53%, in the 1st quarter 2011 it was 42%.

In concordance with scenario conditions for socio-economic development for the period of 2012-2014[2] the expected growth of investments in fixed assets in 2011 is estimated at the level of 106.0% and will make only 95.8% of the figure of 2008. Taking into account that according to the scenario conditions GDP should reach pre-crisis level in 2011, it is still anticipating growth of population's consumption that is the driving force for internal market growth.

The trend for the gross national savings growth recovering, the proportion of final consumption of households in GDP reduced from 57.5% in the 1st quarter 2009 to 53.1% in the 1st quarter 2010 and 52.4% - in 2011. The change in the proportion of the final consumption of households in the GDP was accompanied by the trend towards the decrease in savings inclination and the growth of the demand for consumer credits. The proportion of savings in the incomes of the population reduced to 10.0% versus 15.6% in January-May 2010, in the form of deposits and securities – to 3.9% versus 7.5%. At the same time the credits issued to the natural persons in May 2011 made RUR 4310 bn, which exceeds by 1.2 times the figures of May 2010. Besides, there has been registered a trend towards the intensification of population's real incomes decrease rates and deceleration of wages growth rates. In the structure of the GDP as broken by incomes the labor remuneration of employees (including hidden wages and mixed incomes) made 53.8% in the 1st quarter 2011 and was 0.5 percentage points below the corresponding figure of the previous year. On the whole over January-June 2011 real incomes of the population decreased by 1.4% versus the growth of 5.3% in the corresponding period of the previous year, real wages increasing by only 2.4% versus 4.6% a year ago. As a result of 2011 the expected increase in real wages is estimated to be 3.3%, in real disposable incomes of the population – by 1.5%. [3]

On the whole as a result of sample survey of consumers' expectations[4] the population estimates both the macroeconomic situation and the changes in personal material welfare optimistically, which is connected with the positive trends in labor market development as compared with the 4th quarter 2010 and the 1st quarter 2011.

The growth of consumers' activity supported by the increase in consumer crediting is accompanied by the change in the structure of the demand of the population. The increase in retail foodstuffs trade turnover in the 1st half of 2011 versus the corresponding period of the previous year made 1.0% versus 4.7% in the 1st half of 2010, and in retail non-food goods trade turnover – 9.6% versus 4.6% a year ago. The consumer behavior of the population was considerably influenced by the change in the prices proportions as well as the volume of the deferred demand accumulated in two previous years. However, there is a possibility that the increased consumption activity of the population is

1 Statistical bulletin №5 (176), Moscow Federal State Statistics Service,

2 Scenario conditions for the formation of socioeconomic development variants in 2012-2014. Ministry for Economic Development of the Russian Federation, April 2011

3 Main directions of budget policy for 20122 and for the planning period of 2013 and 2014, http://www.minfin.ru/

4 Consumers' expectations in Russia in the 2nd quarter 2011, Federal State Statistics Service

also connected with the rising inflation expectations taking into account the acceleration of process for non-food goods growth from 101.9% in January-June 2010 to 103.5% in January-June 2011.

It is the industry that makes the biggest contribution into the dynamics of economic development this year. As compared with the 1st half of 2010 in the 1st half of 2011 industrial production index made 105.3%. It should be noted that the growth was observed for all the consolidated types of economic activities in the industry. The index of minerals extraction made 102.3% versus the 1st half of 2010, the index of manufacturing industry – 108.0%, the index of electricity, gas and water production and distribution – 100.2%. The rate of crisis overcoming was considerably differentiated by types of economic activities. In the 1st half of 2011 industrial production index made 99.8% of the figure of 2008, index of minerals extraction being 104.0% and the index of manufacturing industries – 95.9%.

*Table 2*

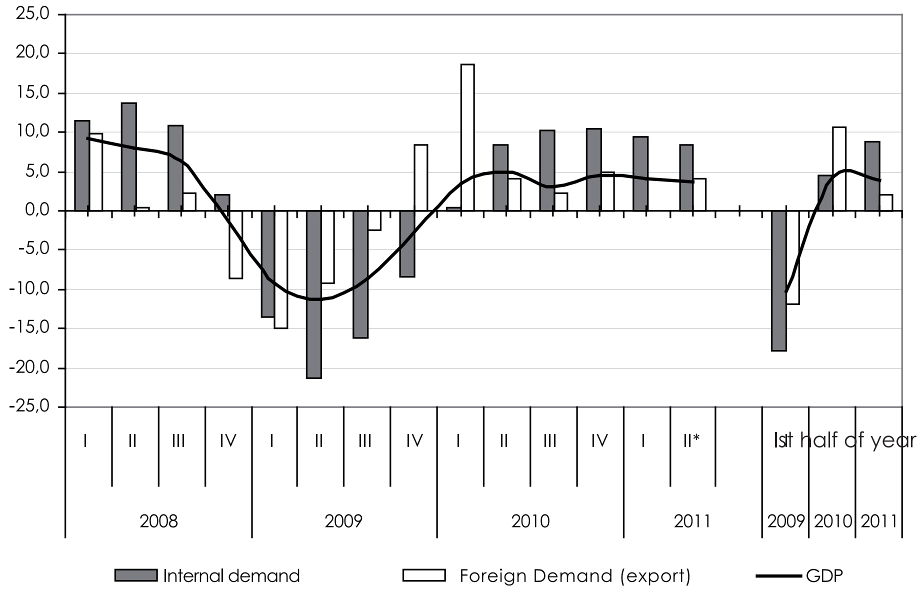
PRODUCTION INDICES AND BROKEN BY TYPES OF ECONOMIC ACTIVITY IN THE INDUSTRY IN THE 1ST HALF OF 2009-2011, AS PERCENTAGE TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR

| | 1st half of 2009 | Quarters of 2009 | | 1st half of 2010 | Quarters of 2010 | | 1st half of 2011 | Quarters of 2011 | |
|---|---|---|---|---|---|---|---|---|---|
| | | 1 | 2 | | 1 | 2 | | 1 | 2 |
| Industry | 85.5 | 84.9 | 86.4 | 110.2 | 109.5 | 110.9 | 105.3 | 105.9 | 104.8 |
| Minerals extraction | 96.1 | 94.9 | 97.3 | 105.8 | 106.7 | 104.8 | 102.3 | 103.3 | 101.7 |
| fossil fuels extraction | 98.0 | 96.8 | 99.2 | 105.6 | 106.4 | 104.9 | 100.8 | 100.3 | 101.4 |
| minerals extraction, excluding fossil fuels | 83.0 | 80.0 | 85.6 | 108.4 | 110.9 | 106.1 | 106.2 | 107.7 | 104.3 |
| Manufacturing industries | 77.7 | 76.1 | 79.3 | 114.3 | 112.1 | 116.3 | 108.0 | 110.6 | 105.8 |
| foodstuffs production, including beverages and tobacco | 97.5 | 97.5 | 97.5 | 105.2 | 103.8 | 106.8 | 101.2 | 101.7 | 100.5 |
| textile and sewing industry | 78.5 | 79.1 | 78.0 | 112.9 | 110.2 | 115.6 | 105.3 | 107.7 | 102.8 |
| leather, leather goods and footwear production | 91.1 | 85.8 | 92.3 | 122.8 | 126.1 | 120.0 | 110.3 | 112.8 | 107.8 |
| timber processing and wooden goods production | 73.2 | 71.7 | 74.7 | 111.9 | 111.1 | 112.6 | 106.6 | 106.9 | 106.2 |
| pulp-and-paper industry; publishing and printing | 80.6 | 78.1 | 82.9 | 109.3 | 106.7 | 111.7 | 100.0 | 99.5 | 100.5 |
| coke and oil products production | 97.8 | 95.8 | 99.8 | 105.0 | 104.7 | 105.3 | 103.9 | 104.6 | 104.8 |
| chemistry industry | 82.2 | 77.9 | 86.4 | 119.5 | 123.8 | 115.7 | 106.9 | 108.0 | 105.8 |
| production of rubber and plastic goods | 79.3 | 72.7 | 84.7 | 120.7 | 122.8 | 119.2 | 118.0 | 120.6 | 115.4 |
| production of other non-metal mineral goods | 65.3 | 63.5 | 66.0 | 110.3 | 104.9 | 114.2 | 111.0 | 112.7 | 109.3 |
| metallurgy and finished metal goods production | 72.7 | 70.0 | 75.2 | 119.2 | 118.8 | 119.6 | 103.0 | 109.1 | 96.5 |
| machinery and equipment production | 59.7 | 56.5 | 62.5 | 121.0 | 109.1 | 130.5 | 111.8 | 111.6 | 113.2 |
| electric, electronic and optic equipment production | 59.1 | 56.8 | 61.3 | 128.8 | 130.4 | 127.5 | 106.5 | 106.3 | 107.8 |
| transport vehicles and equipment production | 60.0 | 61.0 | 59.2 | 128.1 | 113.3 | 141.2 | 134.9 | 159.6 | 115.1 |
| other industries | 69.0 | 67.3 | 68.4 | 133.1 | 130.7 | 135.4 | 106.7 | 105.0 | 108.2 |
| Electricity, gas and water production and distribution | 94.7 | 94.9 | 94.5 | 105.6 | 107.7 | 102.6 | 100.2 | 99.0 | 101.9 |

*Source:* Federal State Statistics Service

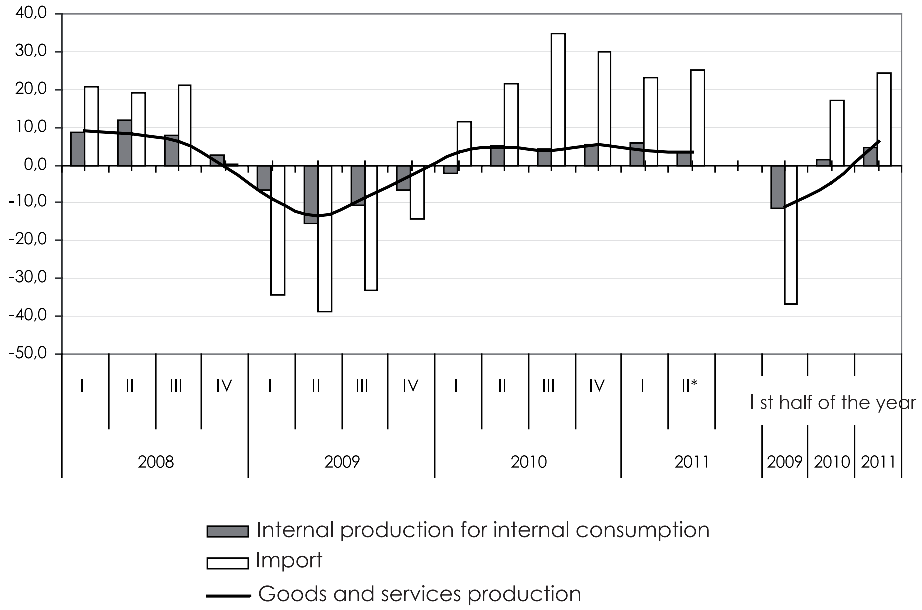
The growth of industrial production versus January-June 2010 was defined by rapid recovery rates of transportation vehicles and equipment production, leather, leather goods and footwear production, rubber and plastic goods production and production of other non-metal mineral goods (*table 2*).

In the 1st half of 2011 the situation at the labor market improved. As a result of June 2011 76.0 mln of the economically active population was classified as employed in the economic activity,




* *Preliminary data
*Source:* Federal State Statistics Service

*Fig. 1 Dynamics of GDP as Broken by Components of Internal and External Demand in 2008-2011, as Percentage to the Corresponding Quarter of the Previous Year*




* Preliminary data
*Source:* Federal State Statistics Service

*Fig. 2 Dynamics of Internal Consumption in 2008-2011 as broken by components, as percentage to the corresponding quarter of the previous year*

4.6 million – as unemployed according to the ILO methodology. As compared with June 2010 the number of the unemployed decreased by 581,000 or by 11.2%. The total number of the unemployed as calculated by the ILO methodology is nearly three times as big as the number of the unemployed registered in the state employment agencies. At the end of June 2011 1515,000 was registered as the unemployed in the state employment agencies.

Estimating the state and development prospects of the Russian economy it is crucial to take into account the trend for anticipating growth of the internal market versus the foreign demand, which has been observed since the 2nd quarter of the previous year. The acceleration of internal solvent demand growth rates was a specific feature of the 1st half of 2011[1]. Taking into account the significance of the internal market expansion as a dominating factor of post-crisis development of economy, it should be noted that the domestic production of goods and services for domestic consumption is considerably inferior to the rates of import goods and services supplies as well as to the dynamics of productions oriented to the external market. The situation is aggravated by the trend for the decrease in net export that has been observed for the past four quarters. The risks of the Russian economy development by the end of the year are accounted for by the recovery of pre-crisis energy and raw materials oriented, according to which the forecast GDP growth will make 4.0%, labor efficiency – 3.4%, the energy intensity of GDP decreasing to the level of 2008 only in 2012.

1 S. Tsukhlo. Index of industrial optimism – IEP, 27 June 2011

# RUSSIAN INDUSTRY IN JUNE 2011

S.Tsukhlo

*According to the Gaidar Institute's surveys*[1]*,* ***in June****, negative tendencies of the previous months did not emerged further on.* ***Demand began to grow*** *and* ***helped improve estimates of inventories, boosted the production increase rate up to its best values ever registered during the crisis period****, helped output plans hit their three – year highs and enabled corporations to shelve their intentions to raise prices with caution.*

**Demand for Industrial Products**

In June, the dynamic of demand experienced the biggest – and what is particularly encouraging -positive changes over the past 24 months. The increase rate of sales (after clearing from seasonality) posted a robust 8-point growth and changed its sign: the decline in sales in May (-4) changed for growth (+4) in June (Fig.1). It was just twice in the past years that yet greater sales increase rates were registered at the stage of exit out of the crisis. The original data (less seasonal clearing) showed the +12-point increase in sales and stayed at its three-year highs.

The original forecasts for June and those cleared from seasonality both demonstrated that the May level of optimism was still there. The May forecasts pre-empted the June upswing in sales, while expectations in June exhibited the hope for, at least, retention of the achieved growth rate in demand.

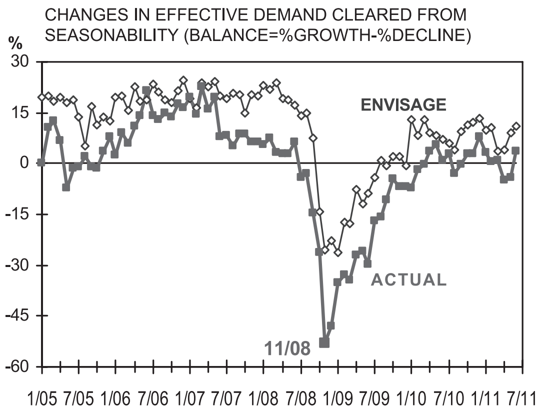



*Fig.1*

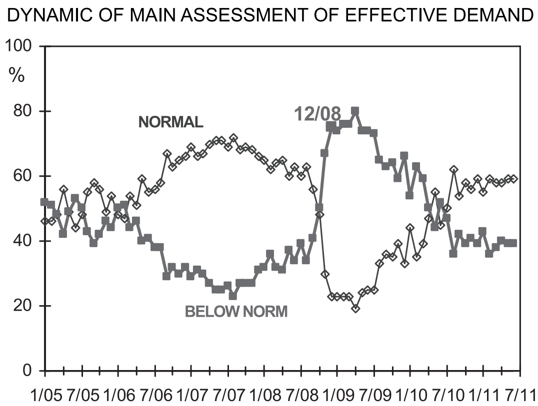



*Fig.2*

That said, satisfaction with demand did not change in June (Fig. 2). Floating within the range between 56 and 59%, the index has been demonstrating a stunning stability over the past 9 months. It looks like most corporations have quite adapted to conditions of the slow exit out of crisis and did not react in any particular way to upticks in sales, like they did in Q1-Q3 2010. In Q2 2010, the maximum demand satisfaction rates were registered in the fuel sector (100%), ferrous metallurgy (86%), non-ferrous metallurgy (64%) and the chemicals sector (70%). The opposite pole was formed by the light industry (40%) and construction sector (43%). The machine-engineering sector reported a 54% satisfaction rate after the 41% one in Q2 2010 and 21% in Q2 2009, with the absolute maximum figure in this particular sector registered in Q2 2007 (68%).

**Finished Goods Inventories**

The healthier sales affected estimates of finished goods stock. The June balance of estimates was down (ie. improved) by 4 points, which proved the most substantial change in this index over the past 4 months (Fig.3). The balance turned zero, ie. the share of answers "above norm" caught up with

1 The Gaidar Institute has run monthly surveys on corporate heads by the European harmonized methodology since September 1992. The surveys encompass the whole territory of the Russian Federation. The panel's size is some 1,100 corporations that employ over 15% of industrial labor. The panel is shifted towards large corporations by each individual sub-sector, with the questionnaire recovery rate of 65–70%.

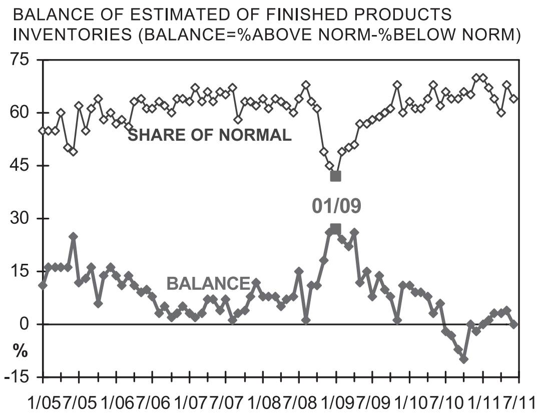



*Fig. 3*

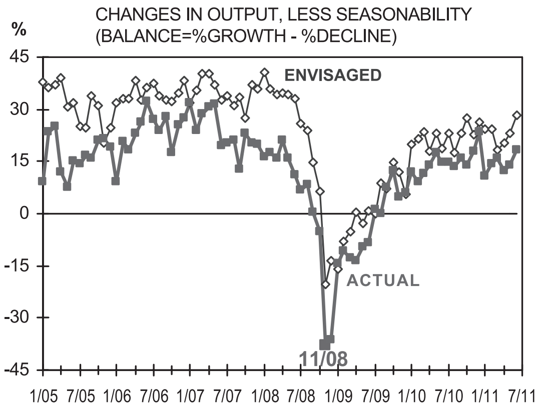



*Fig. 4*

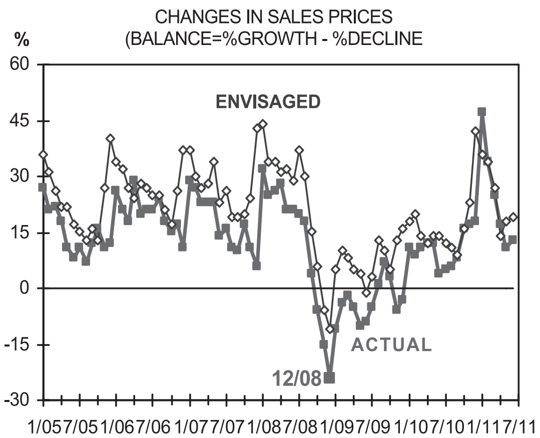



*Fig. 5*

the share of answers "below norm". It was just the light industry which saw the balance of estimates slide from +27 to +33 balance points, while in the metallurgical and food-processing sector not only witnessed their balances drop (improve), but become negative, which means there are shortages with finished goods inventories there.

**Industrial Output**

Output, too, reacted adequately to surging sales: by both original and cleared from seasonality data, the rate of growth in output posted an increase up to the best values over the crisis period (Fig.4), with the cleared from seasonality balance (the rate of increase in output) being up by 4 points. In June, the metallurgical, machine-engineering and construction sectors added their increase rates of output, while after clearing from seasonality, the data on the light and food-processing sectors revealed an absolute decline in their output.

The corporate production plans continued radiating optimism in June and hit (according to the cleared from seasonality data) their three-year highs. That is to say, the national industrial sector has not reported such hopes for growth in output since July 2008, ie. since the eve of the crisis. It is the chemicals, machine-engineering, metallurgical and food-processing sectors that put the biggest bets on increasing rates of their output.

**Producer Prices**

The slowdown of the corporate price rise the surveys have been registering since February seemed to discontinue (*Fig.5*). The balance discontinued to plummet in June, which speaks for retention of the May rate of price change. Quite possibly, the healthier sales volumes enabled corporations to change their price policies and bring to stall the fall of the balance (rate) of price change, which in the previous months lost 36 points.

The corporate pricing plans registered such an intention back in May and subsequently proved its robustness in June. During the two months in question the price-up/price-down ratio has remained practically unchanged and proved to be slightly better than the April figures which displayed the most humble price increase plans since October 2010. As an *obiter dictum*, it was in October last year that because of the draught and in anticipation of the then forthcoming raise in the UST rates the national industrial sector generated an inflation tsunami. It hit its peak in December 2010 (in terms of level of anticipation) and in January 2011 (the actual rise-wise), but has now subsided to its minimum.

**Actual Lay-off Dynamic and Plans**

In response to growing sales, the industrial sector resumed hiring (Fig.6), though with a minimum intensity (+ 4 balance points after -1 b.p. in May). In June, it was machine engineering, construction, and the food processing sector which ensured a positive employment dynamic, while the metallurgical sector, chemicals, forestry and the light industry all reported lay-offs.

Having hit their record –breaking for the crisis period figure in February 2011, the hiring plans plunged between March and May and stabilized in June. The aggregate balance remained positive across the industrial sector, ie. corporations are going to hire new staff, rather than to release them, with the most intense recruiting drive anticipated in the machine- engineering, construction, light and food-processing sectors.

Lending to the Industrial Sector

Loans continued becoming increasingly affordable to the industrial sector. In June 2011, only 8% of corporations believed that banks offered too stringent lending terms. As a result, the index sank to its historic bottom previously registered back in June 2007. While assessing affordability of loans, the average share of "below norm" answers over Q2 tumbled to 10% compared with 11.6% in Q1 2011 (Fig.7). So, in Q2, banks likewise continued softening their lending conditions to the industrial sector as a whole, despite the CBR data on Q1 which suggested that in Q2 they had planned to stop softening lending terms for corporate borrowers.

Given the dynamic of average minimum offered interest rates, banks tried that move between March and April, when the rate was up to 12.8% annualized first and then surged to 13% vs. 12.5% in February. But no demand from the industrial sector, excessive liquidity at hand and hard-to-find decent borrowers forced banks to once again lower the rates to 12.5% in May and 12.2% in June.

That said, an enterprise size-wise analysis of unavailability of loans exposed the banks selectivity in terms of tightening lending terms. Such a policy affected only small- and medium-sized (1-250 employees) firms, as well as large (251-1,000 employees) ones (Fig.8). In these groups, after hitting its crisis minimum in Q1, the level of unavailability of loans soared in Q2 by 3 and 2 p.p., respectively. By contrast, lending terms for very big corporations continued softening and hit their absolute (over the whole period of monitoring of this index since 2000!) peak. This means that today the loan unavailability rates for very large corporations are even lower than in the most generous 2007.

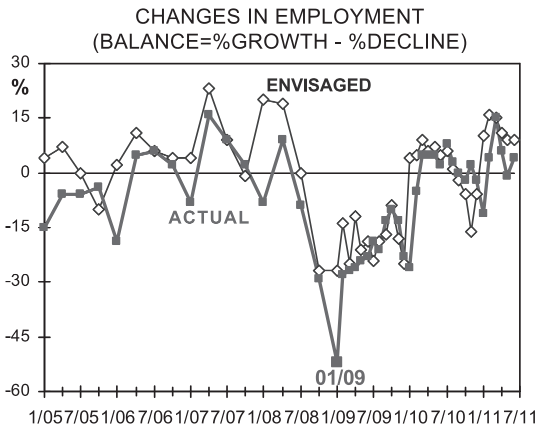



Fig. 6

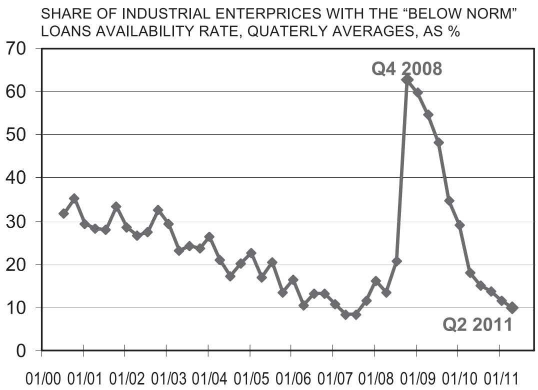



Fig. 7

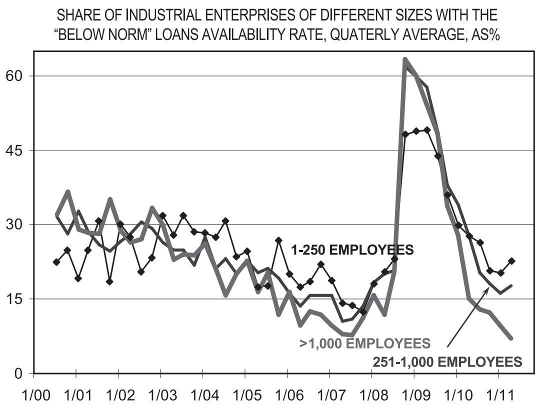



Fig. 8

# FOREIGN TRADE

N.Volovik, K.Kharina

***Main indicators** of Russia's foreign trade **exceeded the pre-crisis figures**. However, both the **export and import commodity structures have not undergone any qualitative changes**. The Commission of the Customs Union imposed anti-dumping duties on import of some kinds of metal products in the single customs territory.*

In May 2011, Russia's foreign trade turnover calculated by the balance-of-payments methodology hit $72.5bn., or was up by 41.6% compared with May 2010. A considerable increase in Russia's foreign trade in May 2011 vis-a-vis May 2010 was driven by both growing exports (in large part thanks to soaring contractual prices) and surging imports (mostly due to their greater physical volumes). The value volume of export rose by $44.6bn, or by 40% on a year-on-year basis, while the increase rate of Russian imports still was slightly higher than exports' and accounted for 44.2%. The value volume of imports in May 2011 made up $27.9bn.

*Table 1*

RUSSIA'S FOREIGN TRADE INDICES (MAY 2011 TO MAY 2010, AS % )

| | Index of physical volume | Average price index |
|---|---|---|
| Export | 102.6 | 135.5 |
| Import | 126.5 | 112.2 |

*Source:* the RF Ministry of Economic Development

Because of a higher increase in export prices against import ones, the "trade conditions" index for Russia improved and made up 120.8.

The May 2011 balance of the nation's foreign trade proved positive and made up $16.6bn, or up by 33.6% on a year-on-year basis.

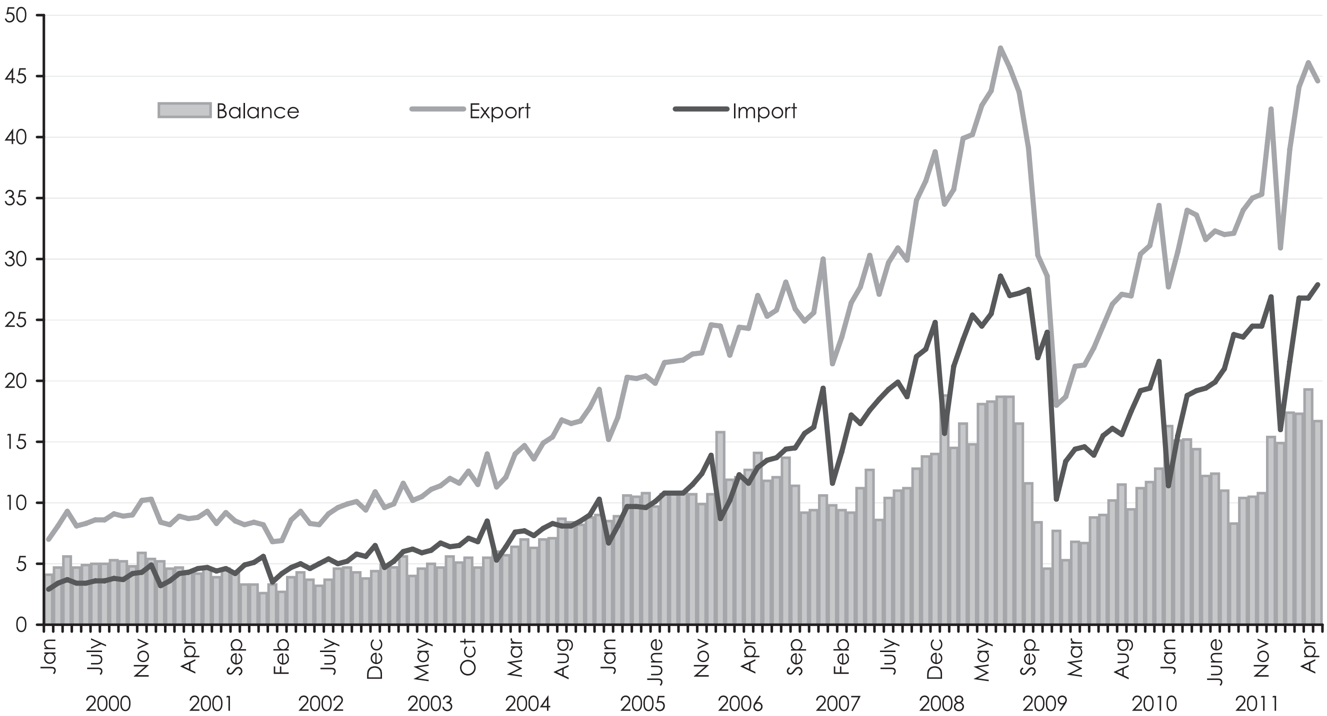



*Fig. 1. Main Indicators of Russia's Foreign Trade (as $ bn.)*

Despite a notable increase in main indicators of Russia's foreign trade, both export and import commodity structures have not seen any qualitative change. Between January and May 2011, the proportion of fuel and energy commodities in the structure of Russia's export remained practically unchanged and stood at 69.5%. Export of this particular group of commodities increased by 28.5% in value equivalent, while physical volumes of oil export tumbled by 5.8% on a year-on-year basis. The share of metals and metal products, timber and paper-and-pulp products, and chemicals slid insignificantly. The proportion of food stuffs and respective prefabricates plummeted from 2.7 down to 1.3%, which can be ascribed to a nearly complete contraction of grain export. The specific weight of machinery, equipment and vehicles surged from 4.6% up to 5%.

The commodity structure of import over the period in question saw a continuous growth in the share of machinery, equipment and vehicles, while shares of other commodity groups shrank, albeit insignificantly.

The increase in the value of export in May 2011 on a year-on-year basis was still driven by soaring export prices. Since May 2010 through May 2011 the Brent price surged by 48.8%, while the one of Urals - by 51.9%. Between January and May 2011, Urals was traded at the average level of $107.3/b, or up by 40.7% on a year-on-year basis.

*Table 2*

AVERAGE WORLD PRICES IN MAY OF RESPECTIVE YEARS

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Oil (Brent), USD/bbl | 27.50 | 28.71 | 25.21 | 25.34 | 37.9 | 47.8 | 68.68 | 67.64 | 119.4 | 58.63 | 76.99 | 114.5 |
| Natural gas, USD/MMBTU | 3.55 | 4.36 | 2.83 | 4.04 | 3.95 | 5.89 | 8.28 | 7.98 | 12.38 | 8.09 | 7.27 | 10.3 |
| Gasoline, USD/gall | 0.957 | 1.095 | 0.767 | 0.835 | 1.342 | 1.44 | 2.072 | 2.293 | 3.22 | 1.71 | 2.111 | 3.04 |
| Copper, USD/t | 1834.7 | 1708.2 | 1596.2 | 1667.5 | 2720.0 | 3254.0 | 8022.0 | 7682.2 | 83825 | 4568.6 | 6837.7 | 8927.05 |
| Aluminum, USD/t | 1464.7 | 1536.7 | 1344.3 | 1397.6 | 1615.7 | 1746.0 | 2852.0 | 2797.4 | 2902.9 | 1460.5 | 2040.53 | 2592.18 |
| Nickel, USD/t | 10141.4 | 7115.7 | 6764.0 | 8351.9 | 11068 | 16930.0 | 21038 | 52179.1 | 25735 | 12635 | 22008.2 | 24210 |

* European market, average contractual price, border price.
*Source:* calculated on the basis of the LME and IOE data (London).

In May 2011, the prices of major Russian exports plummeted against the previous month's ones for the first time over the past 11 months. Specifically, Brent price was down by 7% against the April one, while that of Urals slid by 6.7%. The prices for metals tumbled, too: aluminum prices lost 2.6%, copper ones – 5.9%, and nickel prices were down by 8% on growing concerns about the global economy's possible slowdown in H2 of 2011, the omens of which being deceleration of industrial output in the leading countries and the continuously high unemployment rates in the US and EU. As well, the commodity prices found themselves under the continuous pressure of the growing debt burden in the US and EU, which suggests an inevitable tightening of their monetary policies.

Also, it is evident that the uncertainty about whether the US legislators can mobilize consensus on increase of the upper margin of the public debt will likewise constrain the global price rise. Should no decision be passed until August 2 and if the US default on Treasuries, it will batter the whole global economy, which will result in a downfall in oil prices.

Over the period of monitoring, between 15 June and 15 July, the oil price averaged $112/b. Proceeding from that, according to the effective calculation formula, since 1 August the oil export prices will be $438.2/ton. The export duty for light oil products will be at the level of $293.6/ton, while the one for back oil products will make up $204.6/ton. The export duty rate for commercial gasoline will be $394.4/ton.

The global prices for food stuffs plummeted slightly in May 2011. According to FAO data, the food price index slid from 235 points in April to 232 points in May. The decrease in prices can be explained by huge volumes of sugar and grain on the market. Meanwhile, meat prices were on the upsurge.

Main hopes for a decline in prices for food are associated with expectations of a considerable grain harvest in 2011. According to the UN data, the global 2011 grain harvest should make up over 2bn tons. In Russia, too, the harvest should be substantially higher than last year. The lifting of the ban on wheat export from the country should help bring international prices down.

At its meeting on 22 June 2011, the Commission under the Customs Union imposed anti-dumping duties on import of certain kinds of metal products into the common customs territory of the Union. More specifically, the Commission decided to set the antidumping duty at a rate of 21.8% of the customs value with regard to imported in the Union's customs territory certain kinds of mechanical fasteners (screw-bolts and screw-nuts) from Ukraine.

The Commission imposed an anti-dumping duty on nickel-containing rolled corrosion-resistant steel (in sheet or rolls) from Brazil, China, South Korea and South Africa, whose rate varies from 4.8% to 62.8% depending on the country of origin. The duty will remain in effect through 25 December 2013.

Until 16 June 2013 will be effective a 19.4% anti-dumping duty on Chinese bearing pipes. Anti-dumping duties were also imposed on Ukrainian casing pipes (at the rate of 18.9%), pump-compressor pipes (19.9%), oil- and gas-pipeline pipes with a diameter up to 820 mm (194.-37.8%, depending on producer), effective through 18 November 2015.

Until 17 March 2014 will remain in effect a special duty in the amount of $282.4/ton on manufactured in China individual kinds of mechanical fasteners (bolts, screw nuts and female screws), while Chinese rolling bearings will be subject to an anti-dumping duty of 31.3 to 41.5% effective through 20 January 2013.

The Commission also imposed a special duty in the amount of 9.9% of the customs value, but no less than $1,500/ton on imported in the Customs Union's common customs territory corrosion-resistant steel pipes with the outer diameter of up to 426 mm from Brazil and China. The duty will remain in effect through 1 November 2012.

In addition, an 11.6% antidumping duty was imposed on individual kinds of Ukrainian-made synthetic nylon threads. The duty will remain in effect through 24 September 2013.

## STATE BUDGET

E.Fomina

*In July 201, the RF Finance Ministrypresented "Main guidelines of the budget policy for 2012 and the planned period of 2013 and 2014". According to the document,* ***federal budget revenues would be plummeting steadily in 2012-2014****, while* ***expenditures would be changing multidirectionally****.In 2012–2013, expenditureswillberetained at a fairly high level (a. 21% of GDP) (20.7% of GDPin 2011) and their rise to a significant degree will be associated with an increase in funding across the law enforcement, security and military items.* ***The federal budget surplus over the first 6 months of 2011****accountedfor 2.7% ofGDP;* ***however****, asbudgetfundsarespentunevenlyd uringtheyear,* ***a considerable fraction of public spending falls on the end of the year, which may substantially adjust the emerging positive trend****. Thenon-oil-and-gasdeficitshrankby 2.9 p.p. ofGDPcomparedwiththe 2010 figuresandaccountedfor 7.9% ofGDP.* ***Despite a substantial plunge, the volume of the non-oil-and–gas deficit has remained pretty high.***

### Analysis of main parameters of execution of the enlarged government budget between January and May 2011

The month of July 2011 saw a preliminary recapping on execution of the enlarged government budget in the first 5 months of the year. *The revenue volume of the enlarged government budget* between January and May 2011 increased by nearly 3.4 p. p. of GDP on a year-on year basis[1]. Meanwhile, the volume of the budget'sexpenditure component tumbled by 2.1 p.p. of GDPin relative terms, while the increase in expenditures in absolute terms made up a. Rb.665bn. As a consequence, the enlarged government budget was executed with a notable surplus of 7.3% of GDP, or up by 5.6 p.p. of GDP vis-a-vis the level reported over the same period last year (*Table 1*).

*Table 1*

EXECUTION OF REVENUE AND EXPENDITURE OF BUDGETS OF ALL THE LEVELS OF GOVERNMENT BETWEEN JANUARY AND MAY 2011

| | January-May 2011 | | January-May 2010 | | Bias, as p.p. of GDP |
|---|---|---|---|---|---|
| | Rbbn. | % of GDP | Rbbn. | % of GDP | |
| Federal budget | | | | | |
| Revenue | 4 200.0 | 21.3 | 3 195.7 | 19.2 | +2.1 |
| Expenditure | 3 814.8 | 19.3 | 3 659.0 | 21.9 | –2.6 |
| Deficit (–) / Surplus (+) | 385.3 | +2.0 | –463.3 | –2.8 | +4.8 |
| Consolidated budgets of RF Subjects | | | | | |
| Revenue | 3 122.9 | 15.8 | 2 658.9 | 15.9 | –0.1 |
| Expenditure | 2 345.7 | 11.9 | 2 138.0 | 12.8 | –0.9 |
| Deficit (–) / Surplus (+) | +777.2 | +3.9 | +520.9 | +3.1 | +0.8 |
| The enlarged government budget | | | | | |
| Revenue | 7 992.0 | 40.5 | 6 182.8 | 37.1 | +3.4 |
| Expenditure | 6 549.4 | 33.2 | 5 893.9 | 35.3 | –2.1 |
| Deficit (–) / Surplus (+) | +1 442.6 | +7.3* | +288.9 | +1.7 | +5.6 |
| For reference: GDP, Rbbn | 19 745.0 | | 16 677.9 | | |

* The considerable surplus of the enlarged government budget vis-a-vis the level of the federal budget and RF Subjects' budgets surplus is explained by the 2010 modification of the procedure of collection of revenues to extra budgetary funds, which provides for bypassing the federal budget.

*Source:*The RF Finance Ministry, calculations by the Gaidar Institute

1 While analyzing the volume of revenues to the national budget system, one should factor into collection of the investment return from management of oil-and-gas funds' resources, which accounted for Rb.133.9bn in January-May 2010 and 54.1bn in January-May 2011.

*The consolidated budget of RF Subjects* was likewise executed with a surplus of 3.9% of GDP over the period in question vs. 3.1% of GDP registered in the same period last year. The increase in the surplus of the RF Subjects' budgets both in relative and absolute terms should be ascribed to a lower tempo of budget spending against resources available. As of 1 June, the regions spent some 31% (vs. 34% in 2010) relative to the expenditure volume set by the 2011 consolidated budget breakdown.

The reallocation of budget mandates between the federal center and regions is currently underway. More specifically, since 2012 the funding of police's operations shall be mandated to the federal level; in parallel with that, regional budgets shall partly loose a fraction of revenues from excise taxes on alcohol and state levies. In addition, it is planned to reassign a string of mandates in the area of heath care, education and employment policy to the regional level and back them with an additional funding of regional budgets. Overall, the prospective reassignment of budget obligations and compensations should ease financial pressure on 47 Subjects of the Federation[1].

While evaluating the structure of formation of the enlarged government budget revenues (*Table 2*), let us note that the value of budget revenues continues being strongly reliant *upon oil-and-gas proceeds*.

The volume of collection of *the mineral tax and revenues from foreign trade*over the period in question soared by 0.6-0.8 p.p. of GDP on a year-on-year basis by each kind of revenues. The main cause behind the increase in collection of these taxes and levies both in relative and absolute terms became the global price rise for oil on a year-on year basis ($107.5/b vs. $76/b).The medium-term budget strategy is based on more conservative expectations: the 2012-14oil prices are forecast at the level of $93-97/b. Accordingly, volumes of oil-and-gas revenues are expected to fall in relative terms, especially in the conditions of a low rate of increase in oil output.

*Table 2*

DYNAMIC OF COLLECTION OF MAIN TAXES TO THE ENLARGED GOVERNMENT BUDGET BETWEEN JANUARY AND MAY 2010–2011, AS % OF GDP

| | January–May 2011 | January–May 2010 | Bias, as p.p. of GDP |
|---|---|---|---|
| Tax burden level (1+2+3) | 38.2 | 34.3 | +3.9 |
| 1. Tax receipts, including: | 23.1 | 21.6 | +1.5 |
| Corporate profit tax | 5.4 | 4.8 | +0.6 |
| PIT | 3.6 | 3.9 | –0.3 |
| Vat | 6.3 | 5.6 | +0.7 |
| Excise taxes | 1.2 | 1.1 | +0.1 |
| Mineral tax | 4.0 | 3.4 | +0.6 |
| 2. Insurance premiums on compulsory social insurance | 6.8 | 5.2 | +1.6 |
| 3. Foreign trade revenues | 8.3 | 7.5 | +0.8 |

*Source:*the RF Finance Ministry, Rosstat, calculations by the Gaidar Institute.

*Non-oil-and-gas* revenues are also on the upsurge in nominal and relative terms, following a notable increase in oil-and-gas ones. The only exception is PIT, revenues from which demonstrate some decline in relative terms.

The volume of collection of *PIT*to the enlarged government budget over the five months of the year accounted for 3.6% of GDP, or down by 0.3 p. p. of GDP vs. the value reported over the same period of the previous year. Meanwhile, the PIT receipts continued to grow in nominal terms: the increase made up 10% and is associated with expansion of the tax base. Specifically, the dynamic of the average monthly salaries and wages due posted an increase,both in nominal and real terms,vis-a-vis its 2010 level (by 13.4 and 3.5%, respectively)[2].

Receipts from the *corporate profit tax* to the enlarged government budget over the period in question soared by 0.6 p.p. of GDP on a year-on-year basis, which can be ascribed to expansion of

1 http://bujet.ru/article/143782.php
2 http://www.gks.ru/bgd/free/B11_00/IssWWW.exe/Stg/dk06/6-0.htm

the tax base. In the 5 months of the year, the corporate sector grossed Rb.3,559.7bn in profits, or up by 45% vs. the same period of the prior year, with the proportion of profit-making corporations having increased by 0.5p.p., or up to 65%[1].

Despite the indexation of rates for excised goods in 2011, a humble 0.1 p.p. of GDP *increase in collection of excise taxes* between January and May 2011 proved greater than in the same period of 2010. Let us note that in late July, the government presented a bill, according to which excise taxes rates are supposed to be indexed in 2012-14 due to the rise in the average level of prices of consumer goods and with account of the target inflation level. It is proposed to index excise rates for liquors and tobacco products in two stages in 2012 – since 1 January and 1 July. In addition to fiscal burden, raising the excise rates is in line with the government's concept of limiting availability of liquors and tobacco products to the populace.

In all, it can be noted that the level of *tax burden* on the economy over the period in question increased by 3.9 p.p. of GDP on a year-on-year basis and hit 38.2% of GDP.

The increase in collection of *insurance premiums on compulsory social insurance* (by 1.6% of GDP relative to the 2010 level) formed a notable factor of the mounting tax burden on the economy, due to both their increase from 26 to 34% and the introduction of new exemption brackets.

As a reminder, the rate in question is going to be lowered to 30% (20% for small businesses) since 2012. To compensate for budget revenue losses (in the region of Rb.460bn in 2012 alone) the fiscal regime in regard to calculation of the premiums is expected to tighten. More specifically, it is suggested to introduce additional rates for salaries above Rb.512,000[2]. Earlier, the tax base for calculation of insurance premiums was formed by annual incomes below Rb. 463,000 (year-to-date). According to government projections made public in July, it is suggested to introduce a 10% rate on incomes above Rb. 512,000 (the 7% one for small businesses).

According to the submitted by the RF Finance Ministry "Main guidelines of budget policy for 2012-2014", in the medium term, main sources of increase of the tax burden will become: an increased mineral tax on natural gas, abrogation of some oil benefits, and an increase in excise taxes rates for tobacco products. Meanwhile, the increase of excise taxes on strong alcohol was put off until 2013 (previously, it was suggested to raise them considerably already since 2012)[3].

Meanwhile, relative expenditure level is in decline against the backdrop of growing revenues to the enlarged government's budget: budget expenditures were cut by 2.1 p.p. of GDP vs. the same period of 2010.

*Table 3*

EXECUTION OF THE ENLARGED GOVERNMENT BUDGET WITH REGARD TO EXPENDITURES BETWEEN JANUARY AND MAY2011–2010, AS % OF GDP

| | January-May 2011 | | January-May 2010 | | Bias in p.p. of GDP |
|---|---|---|---|---|---|
| | Rb.bn | % of GDP | Rb.bn | % of GDP | |
| Expenditures, total | 6 549.4 | 33.2 | 5 893.9 | 35.3 | –2.1 |
| including | | | | | |
| General government matters | 421.4 | 2.1 | 492.7 | 2.9 | –0.8 |
| Including servicing the public and municipal debts | 119.0 | 0.6 | 109.6 | 0.7 | –0.1 |
| National defense | 536.2 | 2.7 | 495.8 | 2.9 | –0.2 |
| National security and law enforcement | 493.4 | 2.5 | 469.5 | 2.8 | –0.3 |
| National economy | 722.6 | 3.7 | 632.9 | 3.8 | –0.1 |
| Housing and utilities | 278.5 | 1.4 | 261.0 | 1.6 | –0.2 |
| Environmental safety | 8.2 | 0.04 | 8.2 | 0.05 | –0.01 |
| Education | 721.1 | 3.7 | 643.2 | 3.9 | –0.2 |
| Culture, cinema, mass media* | 129.7 | 0.7 | 110.5 | 0.7 | 0.0 |

1 According to Rosstat's"On financial performance of organizations in January-May 2011"data.

2 http://bujet.ru/article/142869.php

3 The RF Finance Ministry presented "Main guidelines of the budget policy for 2012 and the planned period of 2013 and 2014" in July 2011.

*Table 3, cont'd*

| | January-May 2011 | | January-May 2010 | | Bias in p.p. of GDP |
|---|---|---|---|---|---|
| | Rb.bn | % of GDP | Rb.bn | % of GDP | |
| Health care and port* | 640.5 | 3.2 | 561.4 | 3.4 | –0.2 |
| Social policy | 2 478.4 | 12.6 | 2 218.6 | 13.3 | –0.7 |

* The functional classification of the 2011 budget expenditures has undergone modification: items "Culture, cinema"and "Mass media", as well as "Health care"and "Physical culture and sport" are now presented as individual budget items.
*Source*: *the RF Treasury,*calculations by the Gaidar Institute.

Absolutely all expenditure items of the enlarged government budget were axed in relative terms. To the greatest degree decline in public spending is associated with a 0.8 p.p. of GDP cut in the "general government matters" item. As well, the rates of funding of social expenditures of the enlarged government budget proved notably (by 0.7 p.p. ) lagging behind the 2010 figures.

**Execution of the federal budget of RF in the first half 2011**

According to the RF Finance Ministry's preliminary estimates, in H1 of 2011, federal budget revenues accounted for 22.1% of GDP, or up by 2.3 p.p. of GDP the respective figure of 2010 (*Table 4*). Gauged in absolute terms, the increase in the federal budget revenue exceeded Rb 1.3trln.

Between January and July 2011, the 2010 revenues from management of the oil-and-gas funds worth a total of Rb. 54.1bn were collected to the budget. The aggregate volume of the oil-and-gas revenues hit 10.6% of GDP, or up by 1.7 p.p. vs. the previous year's level. As of 1 June 2011, the volume of the Reserve Fund made up Rb. 745.9bn (vs. 775.2 bn. as of 1 January 2011), while that of the National Welfare Fund tumbled down to Rb. 2,597.6bn (2,695.5bn on 1 January 2011).

According to preliminary budget projections, the federal budget revenues should plummet in 2012-14 to 18% of GDP (the stipulated in the law figure for 2011is 19.3% of GDP). It is envisaged that the current prevalence of oil-and-gas revenues in the budget revenue structure will be replaced by an increase in the proportion of non-oil-and-gas receipts (from the current 9.5% of GDP to 10.3% of GDP by 2014)[1].

*Table 4*

MAIN PARAMETERS OF THE FEDERAL BUDGET OF RF IN JANUARY-JUNE 2010–2011

| | January-May 2011 | | January-May 2010 | | Execution, as % to the 2011 annual budget breakdown | Bias | |
|---|---|---|---|---|---|---|---|
| | Rb.bn | % of GDP | Rb.bn | % of GDP | | Rb.bn | p.p. ofGDP |
| Revenues, Including: | 5 304.2 | 22.1 | 3 997.9 | 19.8 | 51.5 | +1306.3 | +2.3 |
| Oil-and-gas revenues | 2 540.4 | 10.6 | 1 790.9 | 8.9 | 48.6 | +749.5 | +1.7 |
| Contributions to the National Welfare Fund | 0.0 | 0.0 | 26.5 | 0.2 | – | –26.5 | –0.2 |
| Expenditures, including: | 4 664.0 | 19.4 | 4 386.2 | 21.7 | 42.3 | +277.8 | –2.3 |
| Interest based expenditures | 108.2 | 0.5 | 95.4 | 0.5 | 30.9 | +12.8 | +0.0 |
| Non-interest based expenditures | 4 555.8 | 18.9 | 4290.8 | 21.2 | 42.7 | +265.0 | –2.3 |
| The federal budget surplus (deficit) | +640.2 | +2.7 | –388.3 | –1.9 | – | +1 028.5 | +4.6 |
| Non-oil-and-gas deficit | –1 900.2 | –7.9 | –2 179.2 | –10.8 | 32.0 | +279.0 | +2.9 |
| GDP (est.) | 24 052.0 | | 20 195.3 | | | | |

*Source:*TheRFFinanceMinistry (preliminary estimates),calculations by the Gaidar Institute

Preliminary assessments of the expenditure-wise execution of the federal budget between January and June 2011 evidence their substantial contraction (by 2.3 p.p. of GDP vs. the prior year's figures). In all, in 2011, they should be cut by 1.8 p.p. of GDP. As of 1 July 2011, public

1 As stipulated in "Main guidelines of the budget policy for 2012 and the planned period of 2013 and 2014"

obligations were executed in the volume of 42.3% of the annual budget breakdown vs. 43.3% reported a year earlier.

Dynamics of changes in expenditures are anticipated to become multidirectional. More specifically, they are expected to increase up to the mark of 21.3% of GDP between 2012-13 and subsequently plunge to 20.3% in 2014. The envisaged increase in expenditures will be driven by a substantial boost of funding across the "power block" items (up by 20-26% annually in nominal terms). The army's technical modernization will be coupled with pay rises for the military and persons equaled to them: in 2012, the indexation should make up 6%. Budget funding of the highway sector will be raised dramatically: by 3.5% on a year-on-year basis in 2012 and by 17.7% in 2013. Meanwhile, spending on human capital development (education, health care, culture) will basically remain at the 2011 level.

According to preliminary data over the six months of 2011, the federal budget was executed with a surplus of 2.7% of GDP vs. the deficit of 1.9% of GDP reported in the same period of 2010. In all, the 2011 budget law set the value of the federal budget deficit at the level of 3.6% of GDP (with the oil price being $75/b). However, the recent favorable state of affairs on the global market for energy sources allowed a substantial adjustment of the official budget deficitprojections up to 0.6-0.8% of GDP by results of the year[1].

The volume of the non-oil-and-gas deficit shrank by 2.9 p.p. of GDP vs. the 2010 figures and accounted for 7.9% of GDP. A substantial adjustment notwithstanding, the volume of the non-oil-and-gas deficit has remained fairly high.

1 http://bujet.ru/article/133021.php

# RUSSIAN BANKING SECTOR

S.Borisov

*The May increase in Russian banking system's assets was fueled largely by soaring volumes of lending to corporate clients and the populace.* ***It was Rb-denominated loans with the term of up to 180 days*** *that proved* ***the most vigorously advancing part*** *of the corporate lending portfolio between January and May 2011. Despite a rapid rise of short-term loans,* ***it was the ones extended for a term over one year that still accounted for the biggest part of the portfolio of Rb-denominated loans to non-financial corporations****. Mortgages contributed substantially to the increase in the retail lending portfolio.* ***The average-weighted interests on loans with the term of up to one year continued declining both in the retail and corporate sectors.***

*Table 1*

MAIN INDICATORS OF RUSSIAN BANKING SYSTEM, AS RB. BLN.

| | As of 01.06.2010 | As of 01.01.2011 | As of 01.06.2011 | | |
|---|---|---|---|---|---|
| | | | Face-value | Growth since the start of the year, % | Year-on-year growth, % |
| Assets | 29 725.0 | 33 804.6 | 34 752.3 | 2.8% | 16.9% |
| Loans to non-financial organizations | 12 769.3 | 14 062.9 | 14 883.9 | 5.8% | 16.6% |
| Loans to private individuals | 3 613.7 | 4 084.8 | 4 441.9 | 8.7% | 22.9% |
| Loans to banks | 2 655.7 | 2 921.1 | 3 189.8 | 9.2% | 20.1% |
| Investments in bonds | 3 944.8 | 4 419.9 | 4 594.4 | 3.9% | 16.5% |
| Deposits with the CBR | 434.9 | 325.7 | 311.3 | -4.4% | -28.4% |
| Banks' deposits | 3 093.4 | 3 754.9 | 3 687.8 | -1.8% | 19.2% |
| Corporate deposits | 5 492.6 | 6 035.6 | 6 279.2 | 4.0% | 14.3% |
| Private deposits | 8 176.0 | 9 818.0 | 10 280.3 | 4.7% | 25.7% |
| Impairment | 2 200.9 | 2 192.0 | 2 219.2 | 1.2% | 0.8% |
| Profit (in the current year) | 198.2 | 573.4 | 365.9 | | 84.6% |

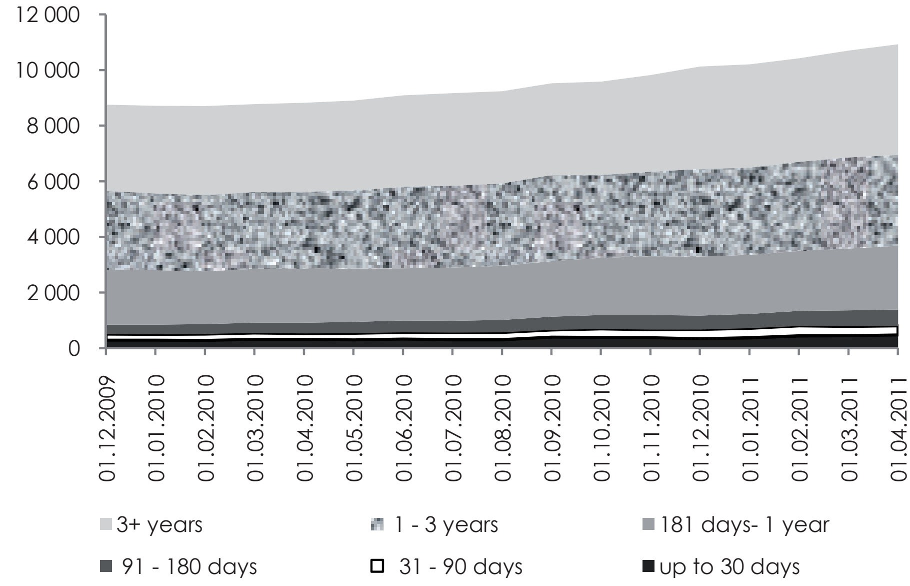
*Source:* the Bank of Russia.

In May, the banking sector's assets posted a Rb570bn increase, thus having ensured a 2.8% growth in the balance-sheet total. That said, increase in lending to the real sector and private individuals emerged as a key factor behind the growing banks' assets.

Over the month in question, the lending portfolio available for non-financial organizations added Rb273bn, thus hitting the record-breaking since early 2010 figure of Rb14,884bn (up by 5.8% since the beginning of 2011). According to the Bank of Russia's data, it was Rb-denominated loans with the term of up to 180 days that proved the most vigorously advancing part of the corporate lending portfolio between January and May 2011: the volume of such loans was up by 19%, from Rb1,177bn to Rb1,398bn, over the period in question. By contrast, the portfolio of loans disbursed for the term between 180 days and 1 year expanded by 8% over the same period. A sizeable increase in short-term loans constitutes an indicator of a growing intensity of banks' lending operations on providing liquidity to non-financial organizations. In the first four months of the year, by late April, the average-weighted interests on Rb-denominated corporate loans had slid by 0.4p.p., to the level of 8.7%. The share of Rb-denominated corporate loans for the term of less than one year in the aggregate portfolio of loans to non-financial organizations has soared from 32.5% up to 33.7% since the beginning of the year.

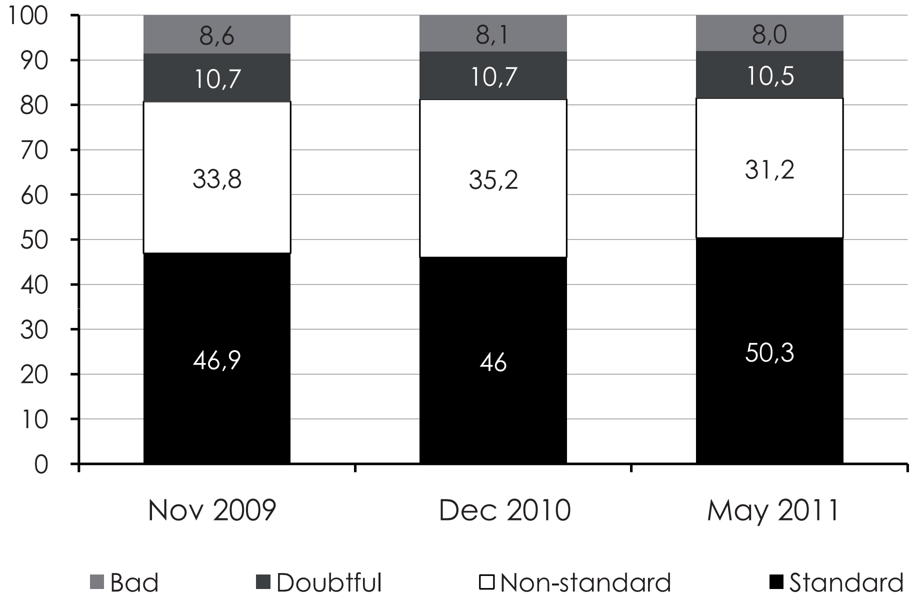
Despite a rapid rise in short-term loans, it was the ones extended for the term over one year that still accounted for the biggest part of the portfolio of Rb-denominated loans to non-financial corporations (*Fig.1*): as of 1 June, they combined accounted for 66.3% of the whole portfolio. That said, a particular notice should be paid to the fraction of such loans extended for the term over 3 years: those mostly are investment loans, business development loans and revolving lines of credits. The volume of the portfolio of corporate loans for the term of over three years has added 8% since the beginning of the year, while the specific weight of such loans in the portfolio has remained at the level of 36.4%. The average-weighted interest rate on corporate loans for the term over one year rose by 0.6 p.p. and hit 10.4% over the period between late-December 2010 and late-April 2011.

According to the Bank of Russia, it were proceeds from lending to corporate customers (in the amount of Rb240bn) that contributed the most to the increase in the national banking system's operating income in Q1.




*Source:* the Bank of Russia.

*Fig.1*




*Source:* the Bank of Russia.

*Fig.2*

By results of May, the share of arrears by the corporate lending portfolio accounted for 5.1% (down by 0.2 p.p. since the beginning of the year). Importantly, the increase in the arrears volume proved substantially lower than the increase of the corporate lending portfolio: 1.9% vs. 5.8% since the beginning of the year. According to the Bank of Russia's data as of 1 June 2011, the proportion of standard loans in the portfolio held by Top-30 largest banks accounted for 50.3%, or at 4.3 p.p. greater than the respective figure as of the beginning of the year (*Fig.2*). Meanwhile, the proportion of bad loans and doubtful ones tumbled over the five months of the year by 0.1p.p. and 0.2. p.p., respectively.

The private lending portfolio surged by Rb132bn in nominal terms in May, thus having secured its 8.7% increase by results of the five months and made the second biggest contribution (after the corporate lending) to the increase in the domestic banking system's assets over the period in question. CBR does not supply a detailed breakdown of the structure of the retail lending portfolio

Fig.2

by repayment terms; however the official reporting data allows assessing mortgages' contribution to the increase in the retail portfolio.

According to the Bank of Russia's data, between January and April 2011 the mortgage portfolio added 20.4%, or Rb225bn in nominal terms (*Fig.3*). Quite notably, the increase of the retail lending portfolio as a whole between late-December 2010 and late-April 2011 also accounted for Rb225.2bn, which allows ascertaining that mortgages have had a substantial impact on the retail lending dynamic across the whole banking system.

The average-weighted interest rates on Rb-denominated loans to private individuals for the term under one year slid between January and April 2011 by 1.7 p.p., from 24.7% down to 23%, as of 1 May 2011. These loans are chiefly various kinds of consumer credits to residents to purchase goods and services. Let us note that reduced costs of the attracted by the banking system resources enabled banks to retain a fairly high level of interest margin by consumer lending against the background of cuts in market lending rates. Meanwhile, banks cut interest rates on consumer loans nonetheless, despite high credit risks, because of a strong competition in this particular sector.

Mortgage and housing loans rates constitute a separate important aspect of analysis of development of retail lending. The dynamic of mortgages is often driven not only by economic incentives it happens to find itself under some political pressure, as provision the populace with housing is a particularly socially significant issue. It is large state-owned banks which in Russia in many ways form trends of changes in interest rates in the mortgage segment of retail business. As of 1 May 2011 (the housing lending data is published with a certain lag), the volume of the housing loan portfolio accounted for Rb1,327bn, or 31% of the banking system's retail portfolio. According to the Bank of Russia's data, the average-weighted interest rate on Rb-denominated housing loans was down from 13.3% as of 1 January 2011 to 12.5% as of 1 May 2011.

The quality of the banking system's retail lending portfolio continued improving. According to the CBR's data, the proportion of delinquencies slid from 6.9% as of the beginning of the year to 6.5% as of 1 June. Meanwhile, in nominal terms, the volume of delinquencies was growing at a pace 2.9 times lower than the increase rate of the retail portfolio volume.

A record-breaking volume of profits posted by the domestic banking system over the five months of 2011 in parallel with the increase in the lending portfolio was secured, in particular, by lowering costs of the banks' resource base. According to the Bank of Russia's official data, the January-to-May average-weighted rates on attracted from private individuals and corporations Rb-denominated deposits for the term of up to one year dropped by 0.8 p.p. (down to 4.1%) and 0.2 p.p. (down to 2.8%), respectively. The drop in costs of attracted private individuals' deposits for the term up to one year, whose weight in the retail portfolio as of 1 June accounted for 34%, proved particularly important to banks. Meanwhile, the average-weighted rate on attracted from private individuals Rb-denominated deposits for the term of up to one year (as of 1 June, the weight of this fraction in the aggregate retail portfolio accounted for 53%) remained stable at the level of 5.5-5.6%. In addition, let us note a small level of costs of loan loss provisions that has been emerging in the banking system over the last three months. According to the Bank of Russia's data, balances of reserves on the banking system's balance sheet posted a meager Rb.27bn increase vis-a-vis their fall by Rb25bn a month before. The decline in intensity of reserve building costs was determined by an acceptable level of borrowers' quality.

Below, we cite the most significant developments in the banking sector that took place between January and July 2011:

• The CBR admitted that the Bank of Moscow was on the verge of bankruptcy. Its bailout will cost nearly Rb.400bn, the figure comparable with capital of VTB which has recently acquired nearly a half of the Bank of Moscow.

• In the frame of its privatization, Sberbank planned a road show in August and September. In mid-June, FSFM gave green light to circulation of up to 25% of the bank's stock overseas. The Sberbank's management asserted repetitiously that a launch of an ADR program would allow a substantial extension of the circle of prospective investors in the frame of privatization of a Sberbank's 7.6% stake due in September.

• The national banking system witnessed the rise of the largest insurance case, with the Bank of Russia having ruled to revoke the license from AMT-bank with which private clients have been holding Rb15bn- plus in deposits. The bank also owes the same amount to the CBR and its corporate clients.

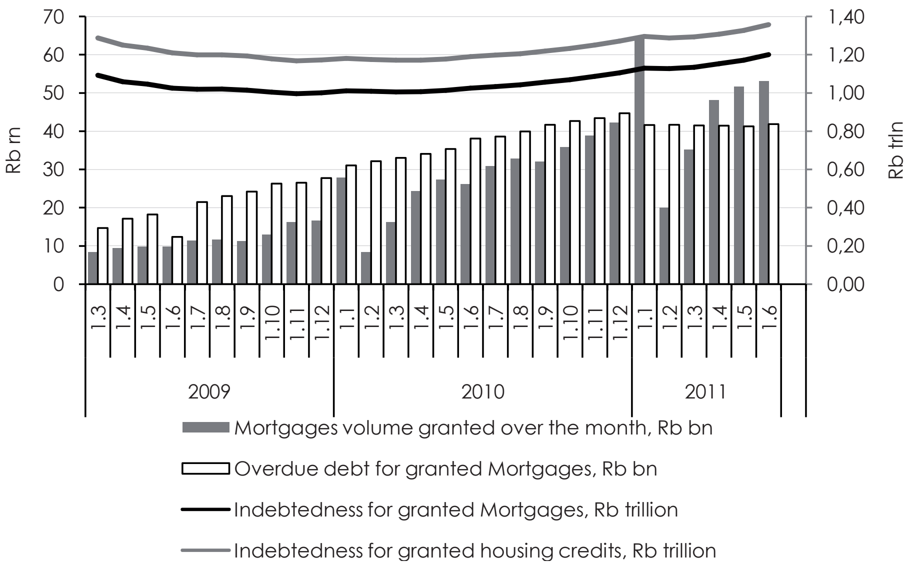
• On 30 June, the Bank of Russia's Board ruled to keep the refinancing rate and interest rates on the Bank's operations unchanged. The decision was taken on the basis of assessment of inflation risks and the ones facing sustainability of economic growth, including risks engendered by the continuous uncertainty about development of the situation in the area of foreign trade.

• The Bank of Russia will monitor bank executives' reputation both at the stage of their appointment and afterwards. The Ministry of Justice registered amendments to the instruction "On the procedure of the Bank of Russia making decision on public registration of credit institutions and granting licenses on exercise of banking operations". The amendments have broadened the CBR's powers on suspension of bank executives with dubious reputation from managing credit institutions.

# MORTGAGE IN THE RF

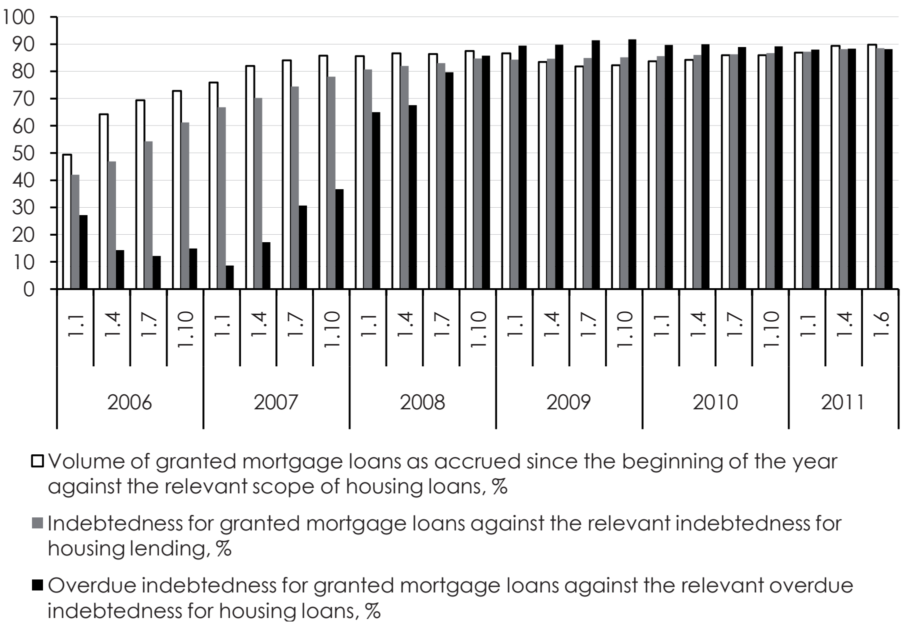
G.Zadonsky

***Within five months of 2011, mortgage loans were granted by 2.03 times more than in the relevant period of 2010.*** *In May 2011, the share of indebtedness undermortgage loans (without overdue payments) has further increased (up to 90.68%) and the share of default arrears(with overdue payments exceeding 180 days) in mortgage has decreased (to 4.21%) in the total debts.* ***Having overestimated the risks of its mortgage products*** *and, consequently, reducing the margin for risk,* ***OAO "Agency for Mortgage Housing Lending" (AMHL) decreased from July 1, 2011 the minimum refinancing rate on the various products of the Agency****.*




*Source:* RF Central Bank information.

*Fig.1. Mortgage loans provision dynamics*




*Source:* RF Central Bank information.

*Fig.2. Share of Mortgage Loans and Housing Loans in General*

According to the RF Central Bank, within five months of 2011, there were provided 151,413 mortgage loans for the amount of Rb208,198mil, which is 2.03 times more than in the relevant period of 2010. In May 2011, 40,033 mortgage loans were granted for the amount of Rb53,136 billion *(See Fig. 1*). On June 1, 2011 mortgage residual debt grew by 17.2%, as compared with June 1, 2010, and amounted to Rb1.2 trillion (*See Fig. 1*)

The volume of mortgage loans granted within the first five months of2011 amounted to 89.8% on the total amount of housing loans provided over that term (*See Fig.2*), having increased by 4.3 percentage points as compared with the corresponding period of 2010. The residual indebtedness for mortgage loans on June 1, 2011 made 88.5% having grown by 2.4 percentage points as compared with the data of June 1, 2010. Arrears in mortgage loans as a percentage in housing loans overdue indebtedness on June 1, 2011 amounted to 88.2% (*See Fig. 2*), which is by 1.0 p.p. lower as compared with the data on

June 1, 2010. Presence of nearly matching indicators between the residual debts under mortgage loans and overdue debts under housing loans demonstrates that a certain equilibrium in the market of housing loans, accompanied by the proximity of loan risks in housing loans with or without mortgage guarantee.

Overdue indebtedness (*See Fig. 1*) under mortgage loans on June 1, 2011 (Rb41,855 billion) exceeds the debt on June 1, 2010 by to Rb3,803 billion (9.08%), and by Rb0.605 billion (1.5%) on May 1, 2011. The share of overdue debt in mortgage loans in the total debt for residential housing loans made on June 1, 2011 3.48%, for loans in rubles - 2.34%, while loans in foreign currency - 10.98%.

The first place among the regions is steadily kept by Moscow in terms of the volume of arrears under residential mortgage loans. The first place in the share of overdue indebtedness in the total debt among the leaders is taken by Alania, Republic of North Ossetia (17.82%), followed by Republic of Chechnya (12.26%), Moscow (7.43%), Moscow Region (6.66% ) (*Table 2*).

In May 2011, the trend of increasing the share of debt on residential mortgage loans without overdue payments was sustained, and the share of overdue debts with different terms of payment delays has decreased (See *Table 1*). The share of indebtedness under mortgage without overdue payments in May 2011 has increased as compared with April by 2.02 percentage points and reached 90.68% of the total debt while the share of debt under mortgages with overdue payments over 180 days has decreased by 0.36 percentage points to 4.21% of total debt (See *Table 1*).

*Table 1*

OUTSTANDING DEBTS UNDER MORTGAGE LOANS AS BROKEN DOWN BY PAYMENT DELAYS IN 2011

| | Total indebtedness under mortgage loans, Rb, mln | Including | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | without overdue payments | | with overdue payments from 1 to 90 days | | with overdue payments from 91 to 180 days | | with overdue payments over 180 days | |
| | | Rb, mln | % * | Rb, mln | % * | Rb, mln | % * | Rb, mln | % |
| Jan 01 | 1,129,373 | 991,928 | 87.83 | 66,859 | 5.92 | 12,875 | 1.14 | 57,711 | 5.11 |
| Feb 01 | 1,127,766 | 97,321 | 86.66 | 84,583 | 7.50 | 12,293 | 1.09 | 53,569 | 4.75 |
| March 01 | 1,134,117 | 982,939 | 86.67 | 86,760 | 7.65 | 11,908 | 1.05 | 52,510 | 4.63 |
| Apr 01 | 1,152,705 | 1,013,919 | 87.96 | 73,312 | 6.36 | 12,219 | 1.06 | 53,255 | 4.62 |
| May 01 | 1,171 ,732 | 1,038,858 | 88.66 | 68,312 | 5.83 | 11,014 | 0.94 | 53,548 | 4.57 |
| June 01 | 1,201,007 | 10,89,074 | 90.68 | 54,045 | 4.50 | 7,326 | 0.61 | 50,562 | 4.21 |

*Source:* RF Central Bank information.

Urals Federal Region remained the leader in the regions' rating of the mortgage housing loans granted to a thousand of individuals in the first quarter of 2011 among federal districts, as in the late 2010 (See *Table 2*). Leading positions were also retained by the Khanty-Mansi Autonomous Region, Tyumen Region, Yamalo-Nenets Autonomous Region, the Republic of Tatarstan.

The peculiarity of the leaders is that with a higher number of mortgage loans per thousand of individuals, they have a lower level of overdue arrears. Regions with high cash volumes of mortgage lending, such as Moscow, Moscow region, St. Petersburg, on the contrary, have a higher share of overdue loans in the residual debt with a lower number of credits per a thousand of individuals (*Table 2*).

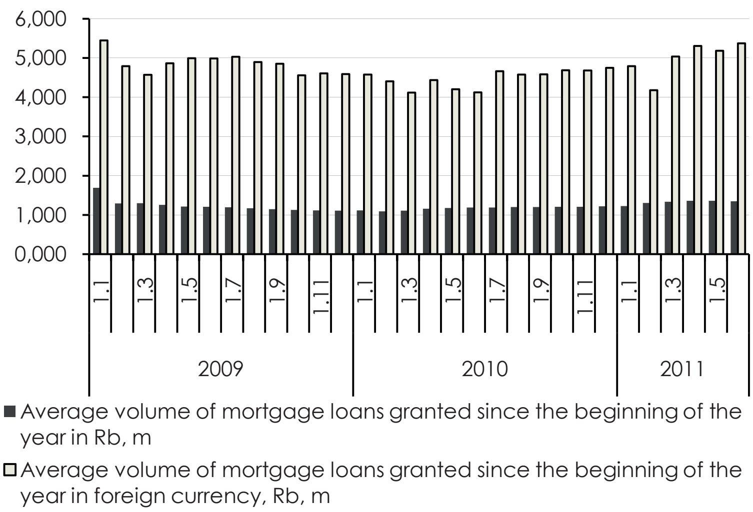
On June 1, 2011 the average volume of mortgage loans granted since the beginning of the year in rubles, decreased by 1.24% as compared with May 1, 2011 and amounted to Rb1.347 mln (See *Fig. 3*). At the same time, the average volume of mortgage loans granted since the beginning of the year in foreign currency during the same period amounted to Rd5.373 mln, which is by 3.69% more than on May 1, 2011 (See *Fig. 3*).

*Table 2*

REGIONS' BREAK-DOWN BY THE NUMBER OF MORTGAGE HOUSING LOANS GRANTED PER THOUSAND OF INDIVIDUALS

| 01.01.2011 | | 01.04.2011 | | | |
|---|---|---|---|---|---|
| Regions' rating in terms of the number of mortgage housing loans granted per thousand of individuals | Region | Regions' rating in terms of the number of mortgage loans granted per thousand of individuals | Number of mortgage housing loans per thousand of individuals, units | Region's rating in terms of overdue debt in % of residual debt | Overdue debt in % of residual debt |
| 3 | Khanty-Mansiysk a/o | 1 | 1.923 | 84 | 0.41 |
| 5 | Tyumen Region | 2 | 1.548 | 77 | 0.78 |
| 2 | Yamalo-Nenets a/o | 3 | 1.524 | 87 | 0.34 |
| 6 | Republic of Tatarstan | 4 | 1.081 | 51 | 1.81 |
| 7 | URAL F / O | 5 | 0.935 | 53 | 1.77 |
| 23 | Samara Region | 6 | 0.887 | 13 | 4.95 |
| 16 | Tomsk Region | 7 | 0.831 | 57 | 1.60 |
| 9 | Chelyabinsk Region | 8 | 0.827 | 19 | 4.08 |
| 13 | Krasnoyarskc Territory | 9 | 0.801 | 36 | 2.53 |
| 10 | Chuvash Republic | 10 | 0.778 | 43 | 2.19 |
| 28 | PRIVOLZHSK F/O | 22 | 0.647 | 29 | 2.89 |
| 22 | SIBIRSKY F / O | 24 | 0.621 | 27 | 2.99 |
| 42 | ROSSIAN FEDERATION | 38 | 0.523 | 21 | 3.60 |
| | FAR EAST F / O | 40 | 0.514 | 60 | 1.50 |
| 52 | NORTH-WEST F / O | 46 | 0.476 | 37 | 2.49 |
| 68 | St. Petersburg | 49 | 0.443 | 32 | 2.80 |
| 66 | Moscow region | 53 | 0.435 | 5 | 6.66 |
| 65 | CENTRAL F / O | 60 | 0.405 | 7 | 5.82 |
| 69 | SOUTHERN F / O | 69 | 0.359 | 24 | 3.47 |
| 77 | Moscow | 70 | 0.350 | 3 | 7.43 |
| 79 | Leningrad Region | 74 | 0.341 | 28 | 2.97 |
| 86 | NORTH KAUKASSIAN F / O | 86 | 0.157 | 15 | 4.70 |

*Source:* RF Central Bank information.




*Source:* RF Central Bank information.

*Fig. 3. Dynamics in the Average Volume of Mortgage Loans Granted since the Beginning of the Yea*

In May, the share of mortgage loans in foreign currency in the volume of credits, provided since the beginning of the year decreased to 2.75%, which is by 0.04 p.p. less than in April 2011.

In May 2011 the trend of reducing the weighted average term for the mortgage loans issued during the month in rubles. On June 1, 2011, the weighted average period for mortgage loans provided during the month in rubles decreased by 3.32% as compared with April and amounted to 15.53 years. On the mortgage loans provided in foreign currency since the beginning of the year, the weighted average loan term continues to increase in the same period, which amounted to

13.36 years in May, having increased by 4.63% as compared with April 2011. The weighted average interest rate on residential mortgage loans in rubles issued during the month, in May 2011 has grown as compared with April by 0.1 percentage points to 12.2%. The weighted average interest rate on loans, granted since the beginning of the year in foreign currency decreased in May to 9.7% (by 0.1 percentage points as compared with April 2011).

Having overestimated the risks of its mortgage products and, consequently, reducing the margin for risk, OAO "AMHL» has lowered the minimum refinancing rate on standard products of the Agency to 8.9% (11.5% earlier), and up to 8.65% for the product «mother's capital» for the secondary market housing. For the primary housing market the basic minimum interest rate for loans in rubles from July 1, 2011 is 7.9% per annum (10.5% earlier), and 6.4% with regard to the total amount of special deductions. Fixed rates of the leading mortgage banks on their own programs for purchasing real estate in the secondary market (before the Agency reduced interest rates since July 1, 2011) are varying from 9.99 to 23.25% for loans in rubles, and from 8 0 to 21.0% for the loans in foreign currency (See *Table 3*).

*Table 3*

FIXED RATES OF THE LEADING MORTGAGE BANKS ON THEIR OWN PROGRAMS FOR PURCHASING REAL ESTATE IN THE SECONDARY MARKET (AS OF JUNE 5, 2011)

| Bank | Interest rate in Rb | | Interest rate in foreign currency | |
|---|---|---|---|---|
| | minimum | maximum | minimum | maximum |
| 1. Absolut Bank | 9.99 | 16.75 | - | - |
| 2. Alfa-Bank | 12.5 | 14.25 | 10 | 12.2 |
| 3. AMT Bank | 11.75 | 13.75 | 8 | 10 |
| 4. Bank of Moscow | 13.3 | 18.05 | 10.2 | 14.95 |
| 5. Barclays Bank | 10.5 | 15.75 | - | - |
| 6. BSGV | 11.5 | 23.25 | 8 | 21 |
| 7. VTB 24 | 10 | 17.65 | 8.45 | 14.15 |
| 8. Gazprombank | 11 | 13.5 | 10.5 | 11.5 |
| 9. DeltaCredit | 11.75 | 20.25 | 8 | 16.5 |
| 10. ZhilFinans | 11 | 20.25 | 8 | 16.5 |
| 11. Investtorgbank | 11.9 | 16.7 | 10.9 | 15.5 |
| 12. NOMOS-Bank | 10.5 | 19.5 | - | - |
| 13. Nordea Bank | 12.5 | 18.5 | 10 | 16 |
| 14. Raiffeisenbank | 12.25 | 14.05 | 9.25 | 11.05 |
| 15. Russia | 15 | 19 | - | - |
| 16. Sberbank | 12.25 | 14 | 10.1 | 12.1 |
| 17. Svyaz-Bank | 10.5 | 18 | - | - |
| 18. Sobinbank | 10.9 | 14.9 | 9.9 | 13.9 |
| 19. Uralsib | 12 | 13.5 | - | - |
| 20. UniCredit Bank | 11.5 | 16 | 9.5 | 13.5 |

* Regardless different actions, corporate programs and other constraints, i.e., the rates for standard programs, accessible to a wide range of borrowers.

*Source:* Monitoring of the banks websites by Analytical Center "Rusipoteka"

It is assumed that the implementation of the "AMHL Group Strategy Development for 2011-2020», approved on June 28, 2011 by the Supervisory Board of the "Agency for Mortgage Housing Lending» will reduce the spread between the cost of attracting resources in the secondary mortgage market and the average rate for the final borrower by 2015 to 3.5%, and in 2020 - to less than 3%. In addition, by 2015, the issue of mortgage bonds is expected to be made in the amount of 50% of the mortgage loans, and in 2020 it can reach 55%. The Supervisory Board also extended the AMHL federal program «Stimulus», and as a result, economy-class housing projects may be included in the program, subject to completion of construction and commissioning of buildings, not later than on December 31, 2013.

In AMHL of Kemerovo region a pilot phase of the new federal program, «Moving», developed by OAO «Agency for Restructuring of mortgage loans» (ARML). In the framework of «Moving» program, ARML accepts a purchased apartment as collateral mortgage and provides a loan up to 80% of its appraised value, providing a transparent mechanism for moving «from mortgage to mortgage.» Thus, the borrower is relieved of the need to repay the loan at the old place of residence for purchasing a new housing mortgage.

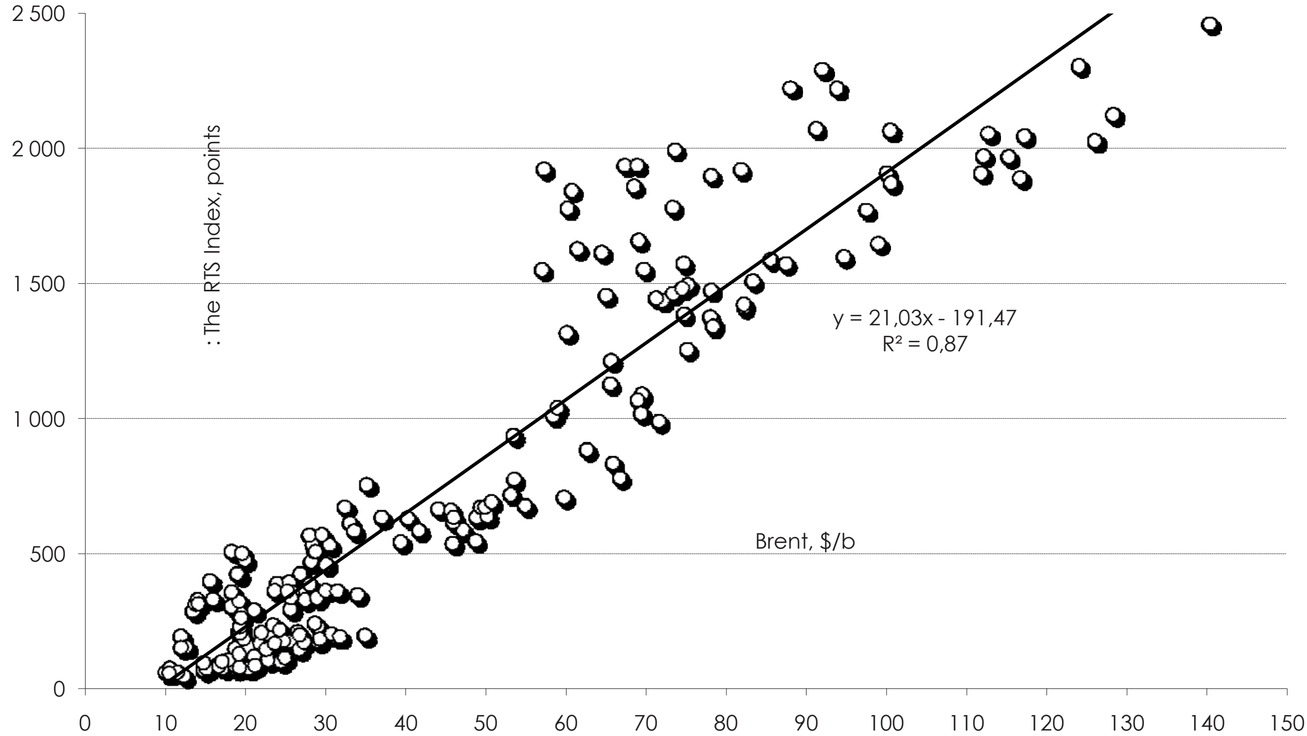
# RISKS ON RUSSIA'S FINANCIAL MARKET

A.Abramov

*The* ***downfalls in oil prices*** *during the last two financial crises ultimately resulted in the* ***collapses of Russia's financial market****. The state of affairs can be changed only by pursuing a successful policy of diversification of the national economy****. Russia's stock market in the short run is prone to effects of foreign portfolio investors' short money****, and gauged* ***by impact on Russian stock prices, this factor is as strong as oil prices****. Between April 2009 and April 2011 foreign funds investing in Russian corporate stock saw a stable influx of capital worth a total of some $10.3bn. However,* ***the growth potential of oil prices clearly exhausted****. At this juncture, the inflow of capital to the said overseas funds investing in Russia is unlikely to continue.* ***With the price rise for crude running out of steam, portfolio investors should radically review their strategies****.* ***In all likelihood, this is going to happen in mid-2011****, and* ***the recovery growth of Russia's stock market*** *of 2009- early 2011 should consequently be replaced by its* ***serious long-term correction****. That this twist is looming is evidenced by the fact that between May and June 2011 foreign funds investing in Russia withdrew $658m. and $392m, respectively.*

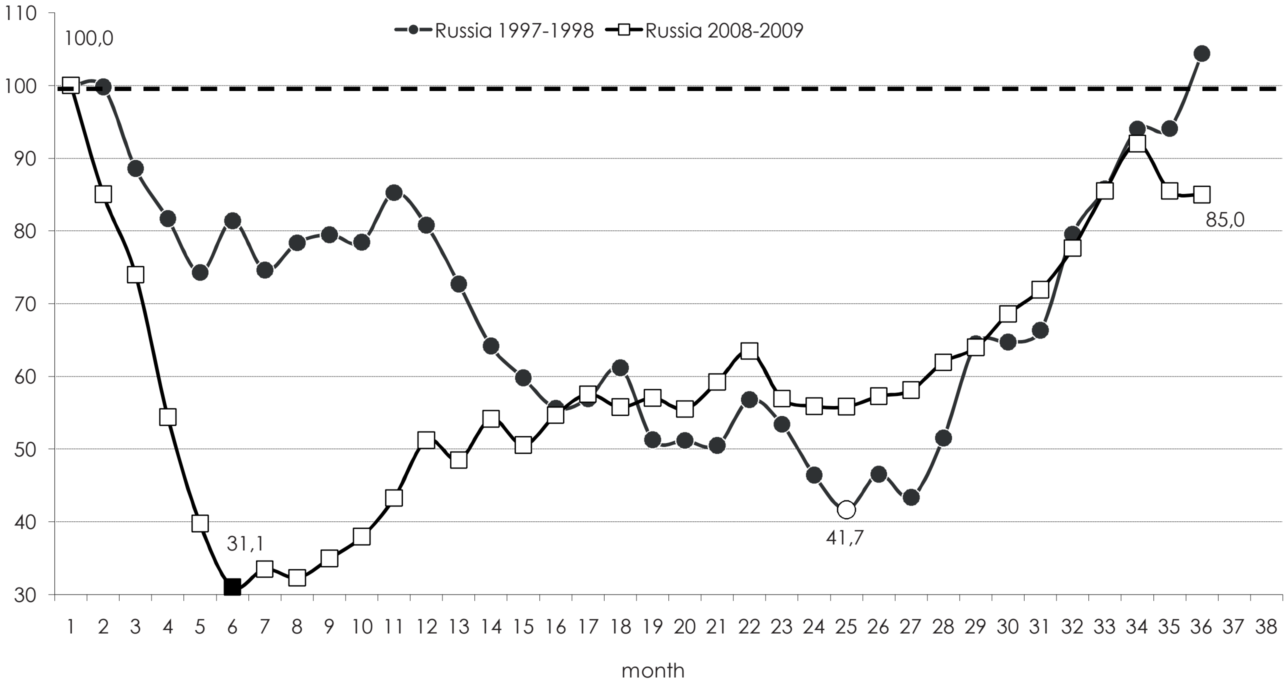
Crude prices form one of key factors that affect the national stock market. The oil price downfalls during the last two financial crises ultimately resulted in the collapses of Russia's financial market. What's more, the plunge of stock, as a rule, precedes a downfall in oil prices, for international investors keep a very close eye on overheating effects of these or those local markets and take away their investments even under slightest changes in trends thereon.

The presence of the correlation between the stock market and oil prices is illustrated by *Fig. 1*, which highlights the determination coefficient between absolute monthly figures of the RTS index and Brent prices between September 1995 and June 2011. The determination coefficient ($R^2$) between the said indices makes up 0.87 and evidences a very strong correlation.




*Source:* calculated using the IFS IMF and RTS data.

Fig. 1. Correlation between the RTS Index and Brent Prices in September 1995-June 2011




*Source:* by the IFS IMF data.

*Fig. 2. The Downfalls and Recovery of Brent Prices during Financial Crises in Russia (the price peak=100%)*

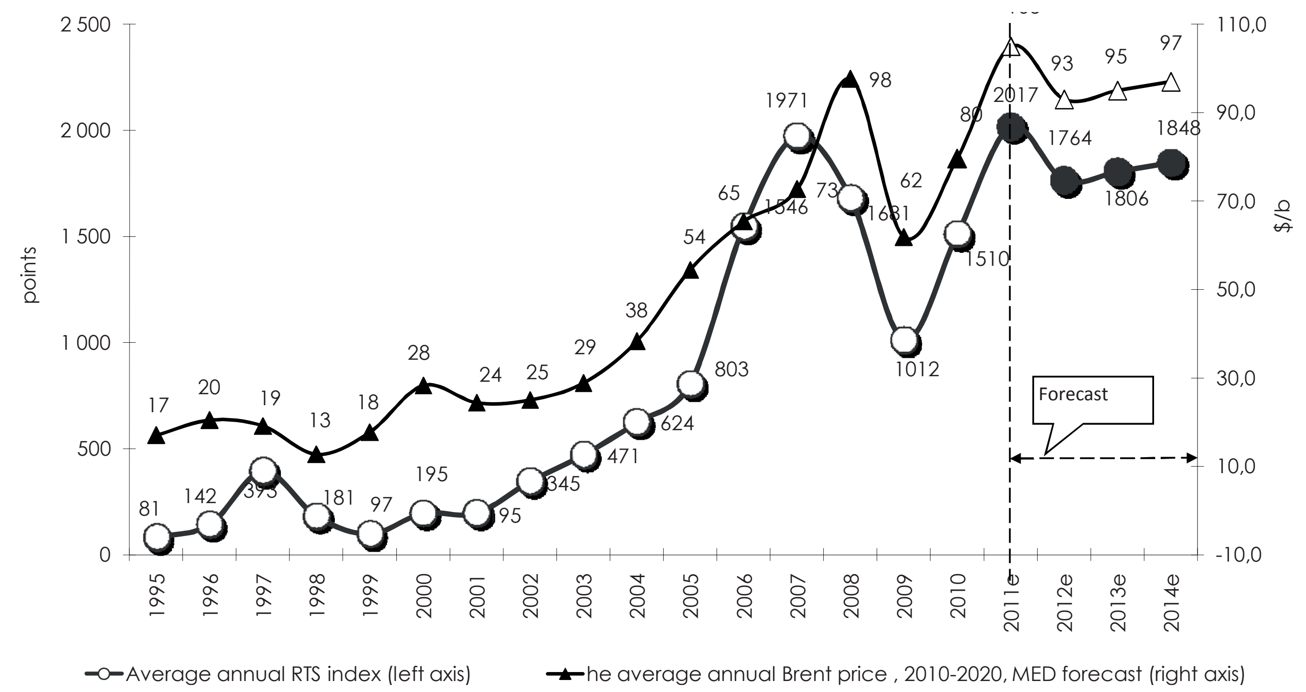
It may seem a stunning coincidence, but during the past two financial crises, the period between the downfall in oil prices to their renewal lasted roughly three years. (*Fig. 2*). The difference is, in the late-1990s, oil prices had been tumbling for long, but recovered promptly thereafter. By contrast, during the 2008-2009 crisis, oil prices hit the bottom fast, but it took them longer to bounce back.

From the perspective of the stock market's expansion, however, the current situation appears substantially different from the crisis of the late-1990s. At the time, crude prices enjoyed a huge growth potential, while today most forecasts do not hold any prospects for a notable price rise for oil over 10 years to come. According to the RF Ministry of Economic Development's Scenario-based conditions and main parameters of the long-term forecast of socio-economic development of RF for the period through 2030, by 2020 prices of Urals would hit $101/b and just $140/b - by 2030.

Rendering the equation of the correlation between crude prices and the index noted in *Fig. 1* to the MED's medium-term forecast of oil prices for the period of 2011-14, the market will stagnate, as shown on *Fig. 3*. The RTS index would remain volatile, but its average value would stall at a level of a. 1,900 points. The state of affairs can be changed solely by pursuing a successful policy aiming at diversification of Russia's economy. The time when players on the domestic stock market ate the ginger of a favorable foreign trade environment is likely to have come to an end, and the market is in dire need for new ideas of growth.

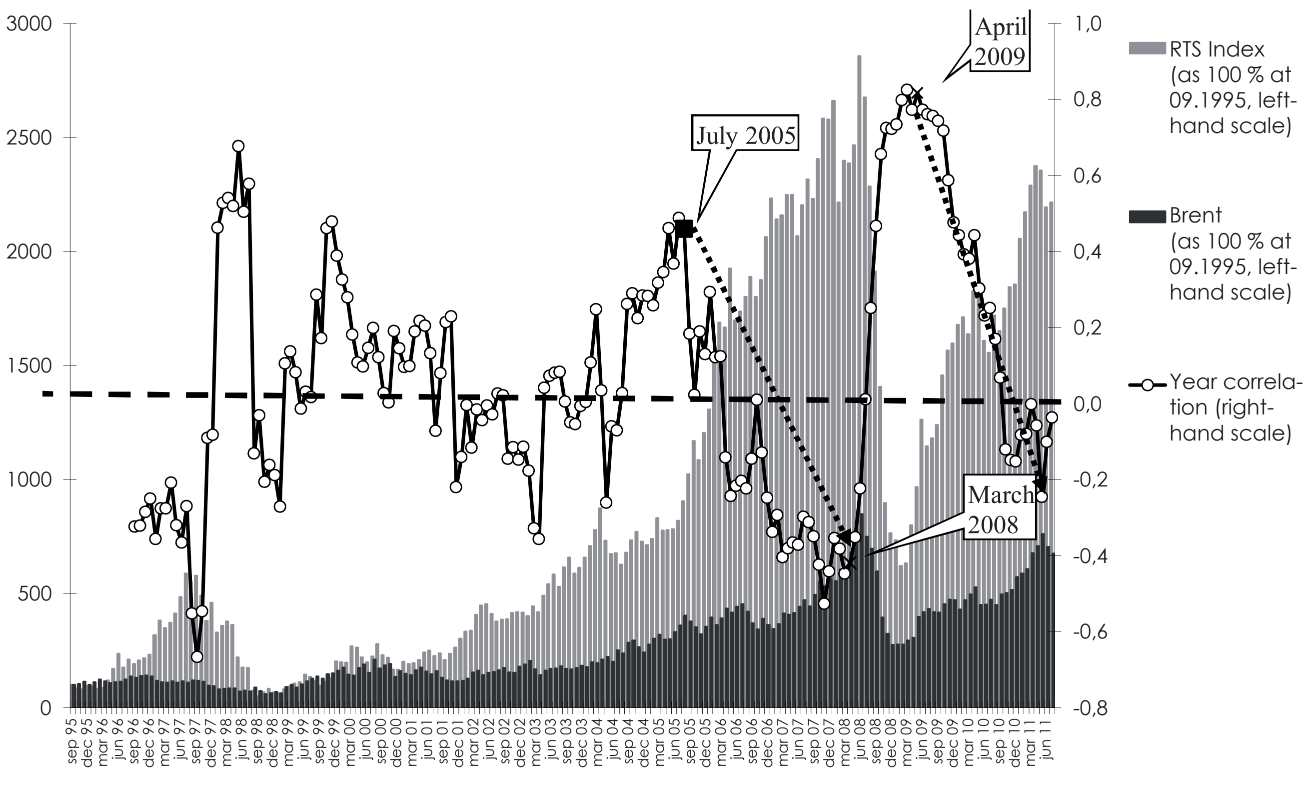
In the report on advancement of the stock market in 2009, proceeding from the formula of the correlation between values of the RTS index and crude prices, we projected the 2010 average annual value of the index to be at a level of 1,503 points, while in reality it made up 1,510 points. That is to say, the correlation is credible and allows fairly accurate forecasts of average annual values of stock market indices.

These risks should be considered from both the short-and long-term perspective. In the former case, Russia's stock market is prone to the impact of foreign portfolio investors' short money. The moving of such flows is gauged by the index of capital in-or outflow to/from overseas investment funds investing in Russia. The data is published by the Emerging Market Portfolio Research (EMPR). Judged by its effect on Russian issuers' stock this factor appears equivalent to oil prices. It was after Fitch, on 17 November 2004, and S&P, on 31 January 2005, granted Russia investment credit ratings that the factor of foreign portfolio investment in/outflow began exerting the most notable influence on the domestic market.




*Source*: calculated basing on the data of the MED's forecast to the Long-term development concept-2030 and the RTS data
*Fig. 3. Forecast of the RTS Index through 2014 Basing on the MED's Crude Price Forecast*

*Fig. 4* displays data on changes in the correlation coefficient between the monthly dynamic of the RTS index and prices of Brent. At this point, a moving correlation curve with the mean period of 12 years is used. The *Fig.* displays two periods wherein the correlation between the index and oil prices vanished, ie. the indicators would start changing in opposite directions. Without going to much into detail, let us note that it was changes in the direction of the short-term portfolio investment flow fixed by EMPR that formed a major factor that triggered such phenomena.




*Source*: calculated basing on the IFS IMF and RTS data
*Fig. 4. Correlation between Changes in the RTS Index and prices of Brent between September 1995 and June 2011*

Capital inflows and outflows from overseas funds investing in Russia have cyclic nature. That said, the mechanism of formation of such cycles and their impact on the domestic stock market so far has been studied into pretty poorly. *Fig. 5* displays the dynamic of the aggregate amount of foreign portfolio investment in Russian corporate stock since 2000. So far as the domestic stock market was recovering in the early 2000s, there was noted a gradual influx of capital in foreign funds. It intensified dramatically once Russia had earned an investment rating in 2005 and continued through April 2006.

But the most stunning development was noted in May 2006: at the time, capital inflow into the funds reversed and, except for the period of oil boom in H1 2008, the portfolio investors' capital has been streaming out of Russia for practically 2.5 years, until March 2009. During that period, investors withdrew some $9bn out of funds investing in Russia.

That portfolio investors were withdrawing their funds from Russia in the 2.5-year span speaks about a foreign investors' stable behavioral pattern. Their foresight cannot help but amaze. Back in May 2006, such credit risks indicators as spreads on corporate bonds, the implied volatility indices, and CDS premiums had not yet signaled a coming storm. The IMF's April 2006 review of financial stability and global economy only superficially cited some individual imbalances on global financial markets, and oil prices had been on the upsurge through June 2008. Market "prophets" kept silent. N. Rubini made his famous warning of the looming mortgage crisis only in September 2006. The RF Finance Minister A. Kudrin ascertained in Davos in February 2008 that Russia was a safe harbor amid the global financial turmoil. But foreign investors have begun fleeing Russia since May 2006.

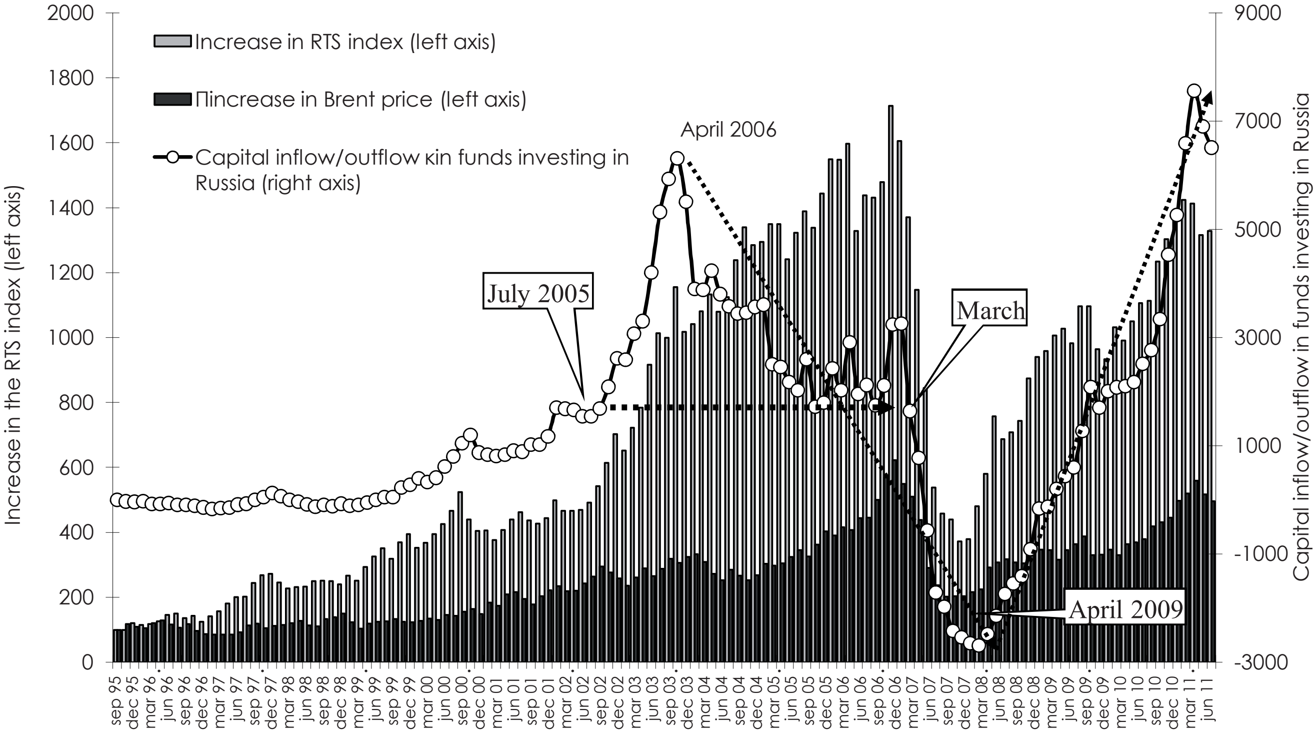
In the hindsight, with the chronology of the financial crisis' development at hand, it can be assumed what triggered the foreign speculator investors' exodus from Russia. It looks like the situation with the looming mortgages crisis had become clear to many global investors long before Mr. Rubini made his prophecy. The price rise for housing in the US changed for the downward trend in early 2005, as fixed by S&P/ Case-Shiller Home Price Index. Tracking down stories in the media, the most far-sighted speculators started playing against mortgage-backed securities and CDOs by using default CDSs swaps as early as in May 2005 and already by July had acquired $bn.-worth CDS portfolios. In late-2005, the largest investment banks started mass purchases of CDSs. In November 2005, there began a mass process of defaults on mortgages. This allows an assumption that numerous investment banks and hedge funds had realized the magnitude of the looming financial peril already by early 2006. So, no wonder several months later, they began withdrawing capital out of emerging markets, Russia's including.

Thus, despite the fact that the center of pricing of Russian stock is located in the country (more than 70% of trade with Russian JSCs's stock falls on the domestic exchanges' turnover), the motives behind foreign investors' operations, which exert a serious influence on Russian stock quotations, are often hidden overseas and domestic players are not always aware of those.

As shown on *Fig. 5*, between April 2009 and April 2011, ie. for 25 months in a row, there was noted a stable influx of capital into foreign funds investing in Russia. During that period, those funds accumulated some $10.3bn. in investments. But oil prices clearly exhausted their growth potential, and the capital influx in foreign funds investing in Russia is unlikely to continue perpetually under such circumstances. Once the recovery rise in oil prices comes to an end, portfolio investors should reverse their strategies. A first sign of that became withdrawal from foreign funds investing in Russia fixed by EMPR in May and June 2011, which accounted for $658m and $392m., respectively.

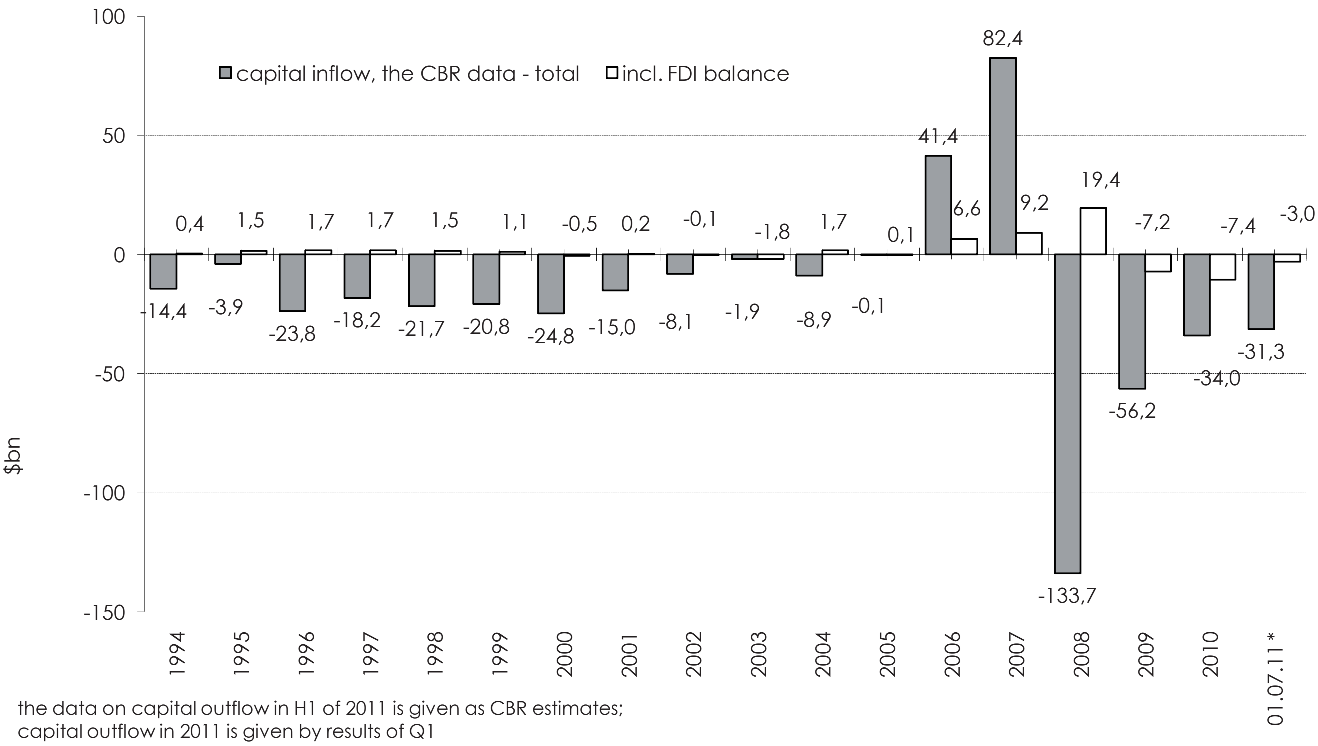
Long-term growth prospects of the domestic stock market, as well the domestic economy as a whole, are closely associated with how successful the economy will be in attracting long-term foreign investments, including direct foreign investment in the first place. As displayed by *Fig. 6,* despite appreciation of the Rb. between 2010 and early 2011, Russia so far has failed to manage capital flight, including FDI. In 2008, capital flight accounted for $133.7bn., in 2009 – 56.2bn, in 2010 – 34.0bn., and in H1 of 2011 – 31.3bn. Meanwhile, a negative balance of FDI is reported for the third straight year: in 2009 it accounted for $ 7.2bn, in 2010 - 7.4bn, and in Q1 of 2011 – 3.0bn.

*Fig. 7* exhibits that in 2008-2011, the outflow of the bulk of short money was channeled through non-bank institutions, albeit banks were snapping at their heels. The capital flight – and the outflow




*Source*: calculated basing on the IFC IMF, RTS and EMPR data

*Fig. 5. Increase in the RTS Index and Oil Price, Capital Inflow and Outflow to Funds Investing in Russia (November 2000-June 2011)*

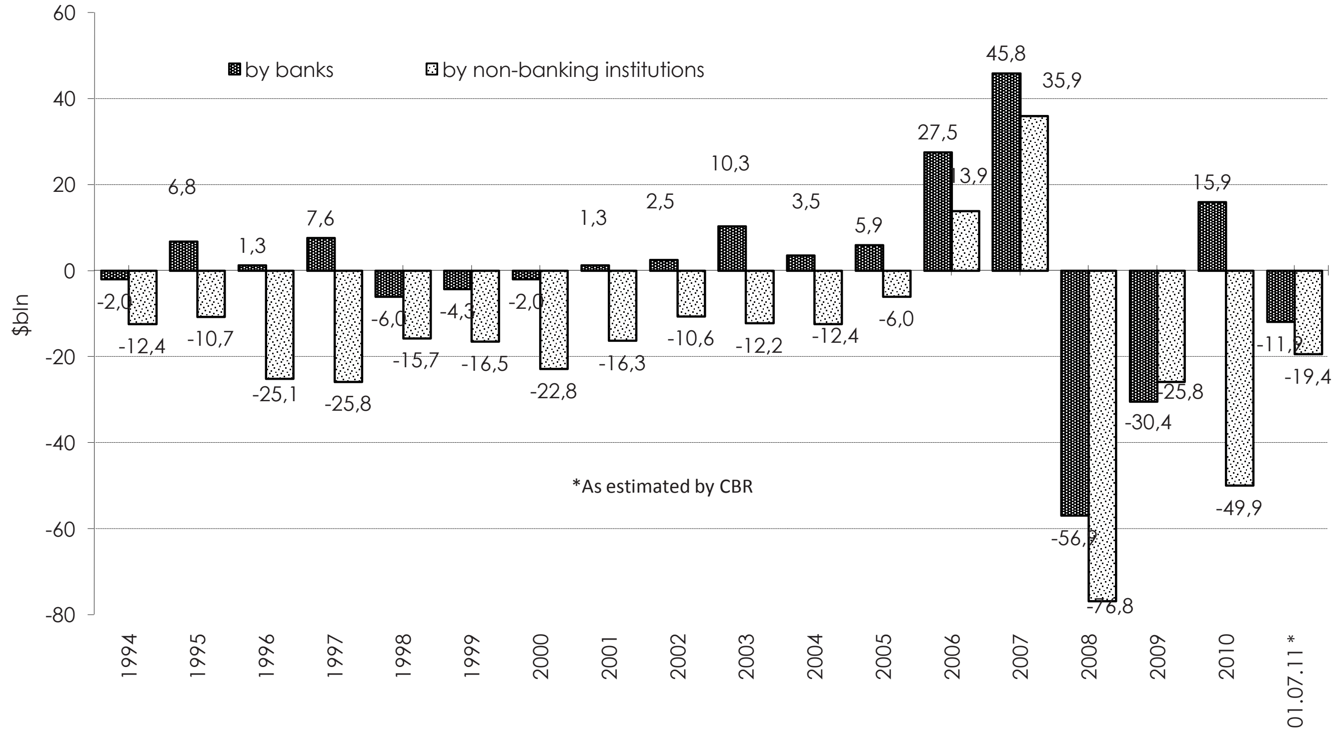



*the data on capital outflow in H1 of 2011 is given as CBR estimates; capital outflow in 2011 is given by results of Q1

*Source*: by the CBR data

*Fig. 6. Capital Inflow/Outflow – Total, Including Foreign Direct Investment*

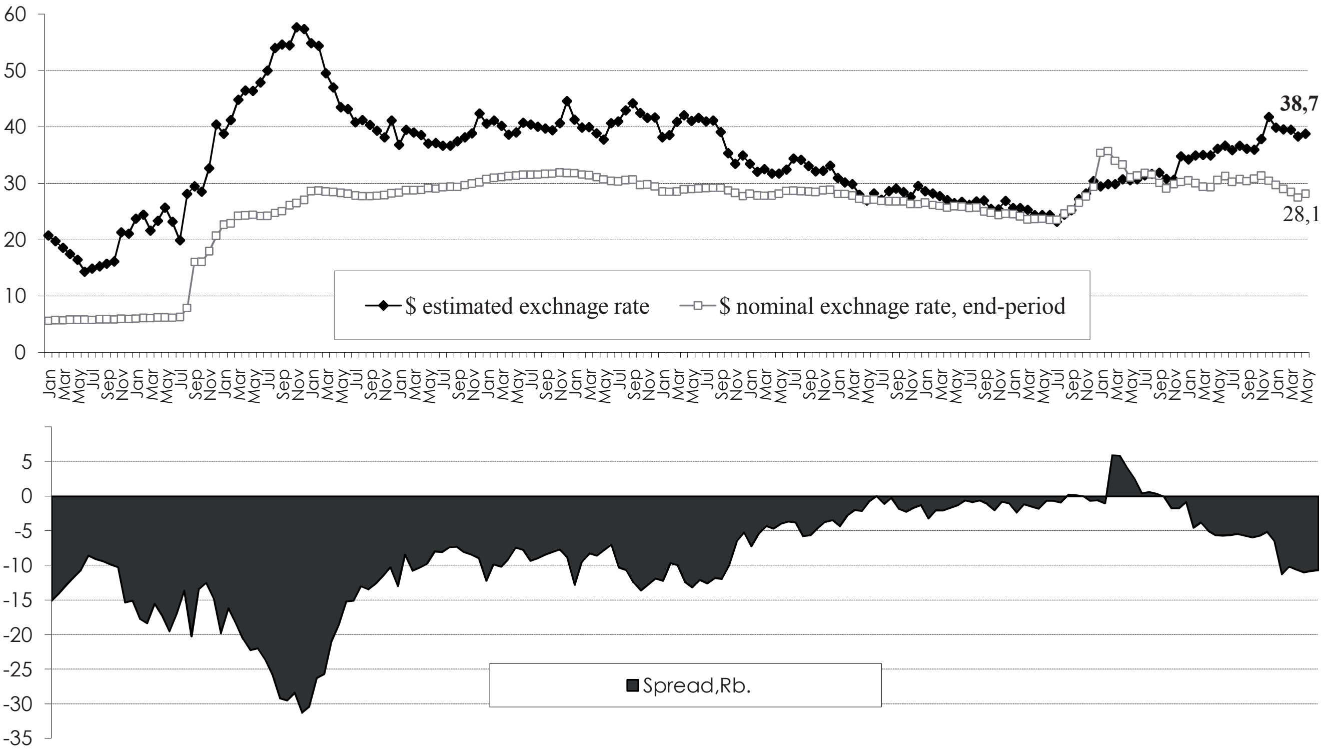
of FDI in particular – clearly evidences that business climate in Russia remains unfavorable and such a fundamental pool of modernization of its economy as FDI has so far been unavailable for most Russian corporations.




*As estimated by CBR
*Source*: by the CBR data

*Fig. 7. Inward (+)/Outward (-) Investment*

The Rb. appreciates now; however, it faces the risk of depreciation in the medium term. The data of *Fig. 8* evidences that the official exchange rate of the Rb. has begun increasingly biasing from the estimated one, which can be found by dividing M2 into the value of international reserves. In other words, the economy sees an advancing growth of M2 vs. international reserves. The financial




*Source:* by the CBR and MinFin data

*Fig. 8. Correlation between the Nominal Exchange rate of the USD in Rb. Equivalent and the Estimated Exchange Rate*

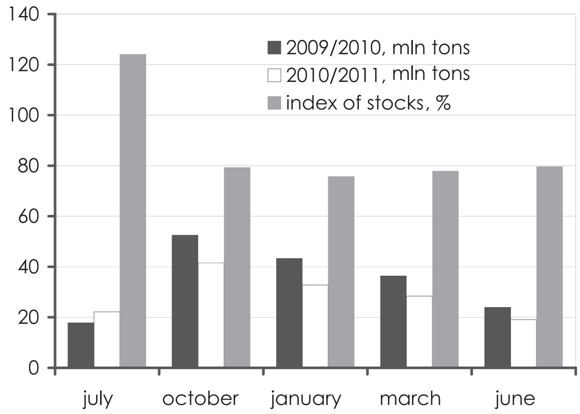
market's long record shows that a greater pace of increase of the Rb.-denominated money supply vis-a-vis international reserves often heralds in Russia depreciation of the national currency. This scenario might become the reality, should oil price tumble dramatically.

So, after two crises, Russian stock market retained its cyclic nature. Meanwhile, foreign portfolio investors did not change their strategies and remained keen to identify the resultant moment - that is, when to enter and exit the market for Russian corporate stock. The recovery cycle of Russia's stock market is due to end in 2011, with factors behind its recovery growth due to exhaust by the beginning of H2 of the year, while oil prices are likely to have already hit their peak values. So, it is high time foreign portfolio investors made a decision and complete taking profit made on Russia's recovery growth.

# RUSSIAN GRAIN MARKET: CURRENT TRENDS AND OUTLOOK FOR 2011/2012 MY[1]

N.Karlova

*By the beginning of new 2011/2012 MY* ***a set of factors has shaped on the domestic grain market that pulls prices down: high carry-over stocks*** *in some regions of Russia,* ***good prospects for the new crop*** *and* ***the need to sell at lower prices in order to return foreign markets*** *lost during the period of embargo on grain export that has been lifted only recently.*




*Source:* SovEcon.

*Fig. 1. Russia: dynamics of grain stocks in 2009/2010 and 2010/2011 MY (million tons)*

Beginning from August 15, 2010 till July 1, 2011 the embargo on export of grain was in effect in Russia. This measure was imposed as a response to the poor 2010 crop (60.9 million tons - below the 2009 indicator by one third) and the tight grain balance on the domestic market.

The result of this export ban was the building of high grain stocks in some regions by the beginning of new 2011/2012 MY. At the same time in other regions grain stocks were low. But on the whole the index of grain stocks showed small but still positive growth from November 2010 to May 2011 *(Picture 1*).

High surplus stocks of grain accumulated in the major producing regions in the country's South. They were well above the previous year indicators in Krasnodar kray (as of June 1, 2011 – 158.6% of the level of June 1, 2010), Stavropol kray (122.0%) and Rostov oblast (111.3%). The supply of grain is also abundant (owing to deliveries under grain market interventions) in such large consuming areas as Moscow (143.2%), Saint Petersburg (138.2%) and Leningrad oblast (2.5 fold).

In the Volga and some central regions the stocks of grain by the end of 2010/2011 MY were far below the previous season's level: in the republics of Volga region they were down 2-3 fold, in Belgorod, Voronezh and Tambov oblasts fell to 57-63%. In the Siberian and Urals regions the index of grain stocks shifted downward as well.

So, the situation with surplus grain stocks is most critical in the South of Russia. As the harvesting of new crop approaches, the demand for southern grain is weakening. Besides, the market prospects for surplus grain in the South have become even worse due to the railroad deliveries of grain from other regions anticipating the opening of export (since sea ports servicing export supplies of grain are situated in the southern regions).

The ban on export of grain crops from Russia was lifted beginning from July 1, 2011. In the first three weeks of July Russia exported 1.4 million tons of grain. According to different estimates the country's export potential ranges from 15-17 to 20 million tons of grain.

During the action of export embargo Russia has lost several foreign markets – the Arab countries (Egypt, Turkey, Syria) have switched to buying grain from the US, Canada, France and Germany. Russia will have to pay for its return to the world market by offering grain at lower price. According to estimates of Vice-President of the Russian Grain Union the discount can reach up to 20-30 dollars per ton, the current price for Russian wheat supplied under export contracts being about 244 dollars per ton. The results of July tender held by the Egyptian state company GASC indicate that Russia returns to the Egyptian market. 180 thousand tons of Russian wheat, FOB, for delivery on August 1-10, 2011 was bought at the tender. 60 thousand tons will be supplied by Cargill at 243.5 dollars per ton, freight rate 17.48 dollars per ton, 60 thousand tons – by Nidera at 244.5 dollars

1 Prepared using data of SovEcon.

per ton, freight rate 17.51 dollars per ton and 60 thousand tons at the same price – by Alegrow, freight rate 18.25 dollars per ton. Despite being of the same quality, Russian wheat was offered at the price 30 and even more dollars below the price paid for French wheat. The tender prices for French wheat ranged from 275.9 to 289.89 dollars per ton, freight rates being lower by 2.5-4.5 dollars per ton. At the same tender the US SRW wheat was offered for 252.73-261 dollars per ton, i.e. its price was 13-14 dollars per ton higher and taking into account freight – about 31-32 dollars per ton higher.

The opening of grain export has prompted faster drop of domestic prices on the Russian grain market driven by both the need to sell at dumping prices on the world market and the general lowering of grain prices in the world. From the end of May till the beginning of July 2011 the quotations for wheat in Chicago fell by approximately 30%. In this situation exporters have halted wheat purchases in Novorossiysk - not only because the steady downward trend on the world market persists but also because many of them already have large grain stocks sufficient for closing the signed contracts.

By the end of the first decade of July 2011 prices for wheat #3 on the Russian market fell down to 5975 rubles per ton. Two weeks earlier they amounted to 6475 rubles per ton[1]. Within the same period prices for wheat #4 dropped from 5900 to 5575 rubles per ton, for forage wheat – from 5500 to 5250 rubles per ton.

One more factor pushing domestic prices down are better prospects for the new crop. According to forecast of SovEcon based on July data the output of grain in 2011 will reach 87-92 million tons. This estimate was raised as compared with the one made in June due to the improvement of ripening conditions in the European part of Russia and in the Urals region at the end on June and the first decade of July. The estimate of Russian Hydrometcenter is lower – 85-89 million tons (*Table 1*), the current estimate of RF Ministry of Agriculture is 85 million tons. So, the gross output of grain in 2011 is expected to exceed the poor crop of the previous year but still to be below the 2009 indicators (*Table 2*).

The expected outputs of grain will be above the recent 5-year averages in all federal districts except the Siberian one.

The biggest increase over the last year is anticipated in the Volga federal district (three fold) and in the Central federal district (two fold) that last year were the most afflicted by severe drought. Higher grain outputs are also expected in the Urals and in the South of Russia. The forecast of new grain crop is below the previous year indicator only in Siberia.

*Table 1*

RUSSIA: FORECAST OF GRAIN OUTPUT BY MAJOR PRODUCING FEDERAL DISTRICTS IN 2011 (MILLION TONS)

| Federal district | 2006–2010 average | 2010 | Forecast for 2011 | |
|---|---|---|---|---|
| | | | Hydrometcenter | SovEcon |
| Russia, total | 85.3 | 61.0 | 85.0–89.0 | 87.0–92.0 |
| Central | 16.5 | 9.7 | 16.2–17.0 | 18.0–20.0 |
| Southern | 20.0 | 18.8 | 20.0–21.0 | 19.7–21.7 |
| North-Caucasian | 8.6 | 8.4 | 8.9–9.3 | 9.0–9.5 |
| Volga | 19.7 | 6.6 | 20.4–21.0 | 20.5–22.5 |
| Urals | 5.0 | 3.3 | 5.0–5.5 | 5.1–5.9 |
| Siberian | 14.5 | 13.4 | 13.6–14.3 | 12.9–13.9 |

*Source:* SovEcon.

In case one examines the forecasts of future crop by types of grain crops, the biggest increase of output (by about 15 million tons) is expected for wheat – according to estimate of SovEcon it will range from 54 to 58 million tons, according to estimate of Roshydromet – from 53 to 58 million tons. The June forecast of USDA is 53 million tons (*Table 2*). SovEcon has raised its forecast of barley output up to 16-18 million tons as compared with the USDA estimate of 14.5 million tons and the Roshydromet estimate of 13-15 million tons (summer barley).

1 Average quotations, EXW European part of Russia.

*Table 2*

RUSSIA: FORECAST OF GRAIN OUTPUT BY TYPES OF GRAIN CROPS IN 2011 (MILLION TONS)

| | Grain, total | Wheat | Barley |
|---|---|---|---|
| 2005 | 77.8 | 47.6 | 15.7 |
| 2006 | 78.2 | 44.9 | 18.0 |
| 2007 | 81.5 | 49.4 | 15.6 |
| 2008 | 108.2 | 63.8 | 23.2 |
| 2009 | 97.1 | 61.7 | 17.9 |
| 2010 | 60.9 | 41.5 | 8.4 |
| Forecast of SovEcon, 2011 | 89.5 | 56.0 | 17.0 |
| Forecast of USDA, 2011 | 0.0 | 53.0 | 14.5 |
| Forecast of Roshydrometcenter, 2011 | 87.0 | 56.0 | 14.0 |

*Source:* SovEcon.

The total areas planted in grains in 2011 are estimated at 43.6 million hectares (*Table 3*). They are expected to increase most noticeably in Siberia and to reduce in the Volga region. When examined by crop types, areas under barley will display the highest growth but will still remain at historically low level. Due to the reduction of areas sown in winter wheat the total areas under this crop will shrink by about 1 million hectares as compared with the last year.

*Table 3*

AREAS SOWN IN GRAIN CROPS (HECTARES)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 forecast of SovEcon |
|---|---|---|---|---|---|---|---|---|
| Grains, total | 43745 | 43785 | 43367 | 44269 | 45742 | 47563 | 43194 | 43600 |

*Source:* SovEcon.

So, by the beginning of new 2011/2012 MY a set of factors has shaped on the domestic grain market that pulls prices down: high carry-over stocks in some regions of Russia, good prospects for the new crop and the need to sell at lower prices in order to return to the world market. Active export supplies can alleviate pressure on domestic prices. However, at the most they will help to stabilize domestic prices but will hardly drive their growth.

As different from 2010/2011 MY, when wheat was actively used for forage purposes in order to compensate shorter supply of other crops, first of all barley, in the new season its utilization for feeding will reduce resulting in the decrease of domestic consumption down to 37.5 million tons (41.5 million tons in 2010/2011 MY). According to estimates of SovEcon this will allow to export about 14 million tons of wheat while preserving ending stocks at the same level as in 2010/2011 MY – 13 million tons.

In the southern regions of Russia producers get prepared to store the new crop grain for a long time and to sell it promptly in case the market price situation improves.

# ON THE FUND OF MONETARY ALLOWANCE FOR THE RF SERVICEMEN

A.Privetkin, E.Trofimova

*The Russian government has submitted to the State Duma the drafts of two new federal laws dealing with radical reorganization of the monetary allowance for servicemen. The Duma has accepted them in the first reading. In accordance with the draft laws, the structure of the cash payments is changed, and some of them are significantly increased. In addition, there is a new point in the legislation, "introduction of the Fund of Monetary Allowance for the Servicemen. However, there are no mechanisms, who and how will spend assets ofthis fund, who and how will monitor this process.*

Increasing the monetary allowance (MA) and military pensions is a priority in the formation of the new image of the Russian Armed Forces (AF). With a view of DD revision, on June 1, 2011 the Russian government has submitted to the State Duma the drafts of two new federal laws: "On monetary allowance for the servicemen and individual payments to them"[1] and «On Amendments and repeal of some legislative acts of the Russian Federation in connection with the adoption of the Federal law «On monetary allowance for the servicemen and individual payments to them»[2]. According to the draft laws, from January 1, 2012 the monetary allowance of the Russian Armed Forces servicemen will consist of monthly pay (salary for military rank, plus the salary for a military position) and 9 additional fees and extra payments.

The explanatory memorandum to the draft law «On monetary allowance ...» states that «as a result of monetary allowance reform, it is supposed to increase by 2.5-3 fold» the military pay, which is certainly a positive factor. However, it is not reflected quantitatively in the draft laws. Thus, the law initially provides a possibility of manipulating with the monetary allowance on the sub-law level.

The new point in the above draft law, as stated in the accompanying memorandum, is «the introduction of the Fund of monetary allowance for the servicemen, and its formation procedure is determined by the Government of the Russian Federation.» The reasons for the Fund of monetary allowance formation are not named. It should be noted that previously a similar «Fund for payroll of civil servants and public authorities officials»[3] has been institutionalized in Russia. Meanwhile, there are no such items of expenditure in the Budget Code and the federal budget. There are similar in meaning lines under different names. In this year's budget there is a target article «military personnel» and such sub-items as «monetary allowance of servicemen and law enforcement officials,» «extra monetary for the incentives for the servicemen of the Defense Ministry and law enforcement officers», «payment in accordance with the Russian legislation, depending on the amount of monetary allowance ». Herewith, the amounts are not so small: Rb193 bn, 42, and about Rb14 bn, respectively. In other sections of the budget the expenditures on monetary allowance are specified separately, for example, in education, but what exactly is included in the Fund of monetary allowance? There are other questions, which are to be answered when discussing the draft laws in the Duma and which should be reflected in the laws. It is not specified in the draft laws, in what way the fund monetary allowance will be spent, who would get its assets, who will monitor the expenditure of the Fund, what criteria will be applied to judge that the Fund is spent effectively? Finally, what is most important - whether it is eligible at all to establish such funds outside the Budget Code framework?

It is proposed to divide the Fund of monetary allowance into two separate funds: military service for a regular term (for "conscripts") and for military service under the contract (for "contractors") which will also include another sub-fund for "Headquarters". There was already an experience of its creation and use in the RF Defense Ministry since 2007, under the "supervision" of the then Deputy Defence Minister L.K. Kudelina. There is no information on the effectiveness of that

1 http://asozd2.duma.gov.ru/main.nsf/%28SpravkaNew%29?OpenAgent&RN=556556-5&02
2 http://asozd2.duma.gov.ru/main.nsf/%28SpravkaNew%29?OpenAgent&RN=556510-5&02
3 Federal Law No. 79-FZ of July 27, 2004 "On State Civil Service of the Russian Federation." Art. 51.

experience. There is only leaked information about the fantastic bonuses to certain officials of the RF Defense Ministry.

Let's start with an attempt to systematize the cash payments to servicemen and streamline the current legislation framework (see *Table 1*) and the structure of the monetary allowance.

*Table 1*

PAYMENTS STRUCTURE COMPRISING THE MONETARY ALLOWANCE FOR SERVICEMEN (ON THE EXAMPLE OF THE RF ARMED FORCES)

<table>
<tr><td colspan="12">Federal Law No. 76-FZ of 1998 «On the Status of Servicemen»</td></tr>
<tr><td colspan="3">direct evidence establishing the individual payments and amount thereof</td><td colspan="3">references to other federal laws</td><td colspan="3">references to Presidential Decrees and Resolutions of the Government of the Russian Federation</td><td colspan="3">references to the orders of the Heads of federal executive bodies</td></tr>
<tr><td colspan="3">P. 1 and P.4 Art. 12, P. 6 Art. 13, as well as Art. 16,18,19,20,21,23</td><td colspan="3">P. 5.1 Art. 13, P. 6.1 Art. 13</td><td colspan="3">P. 2 Art. 12, P. 1 Art. 13</td><td colspan="3">P. 3 Art. 12, P. 9 Art. 13</td></tr>
<tr><td colspan="12">Federal constitutional laws and federal laws</td></tr>
<tr><td colspan="6">establishing social guarantees to certain population groups</td><td colspan="6">establishing social guarantees for certain categories of servicemen</td></tr>
<tr><td colspan="6">Federal Constitutional Law No. 1-FKZ of 1999 "On Military Courts of the Russian Federation", Federal Law No. 2202-1 of 1992 "On the Procuracy of the Russian Federation», Federal Law No. 21-FZ of 2002 «On Additional monthly financial support to Russian citizens for outstanding achievements and outstanding merit to the Russian Federation"</td><td colspan="6">RF Law No. 4328-1 of 1993 «On additional guarantees and compensations to participants in military service in the territories of the Caucasus, the Baltic States and the Republic of Tajikistan, as well as those carrying out tasks in a state of emergency and armed conflicts"</td></tr>
<tr><td colspan="12">Presidential Decrees and Resolutions of the Government of the Russian Federation</td></tr>
<tr><td colspan="6">issued in accordance with reference norms</td><td colspan="6">issued by their own initiative</td></tr>
<tr><td colspan="12">issued in accordance with reference norms</td></tr>
<tr><td colspan="4">applicable to all military personnel (and / or citizens discharged from military service)</td><td colspan="4">applicable to specific categories of servicemen (and / or citizens discharged from military service)</td><td colspan="4">applicable to all (or specific) categories of civil servants and/or to certain categories of population</td></tr>
<tr><td colspan="4">RF Government Resolution No. 909 of 2004 "On procedure of payment of monetary compensation for the lease (sublease) of residential premises for servicemen - citizens of the Russian Federation, performing military service under the contract, the citizens of the Russian Federation, retired from the military service and their families"</td><td colspan="4">RF Government Resolution No. 816 of 2004 "On providing servicemen performing military service by conscription, monetary allowances for travel by all public transport means, urban, suburban and local (except for taxi)"</td><td colspan="4">RF Government Resolution No. 573 of 2006 "On providing social guarantees to citizens, having access to the Official Secrets on a regular basis, and employees of departments for the protection of state secrets"</td></tr>
<tr><td colspan="12">issued by their own initiative</td></tr>
<tr><td colspan="3">applicable to all military personnel (and / or citizens discharged from military service)</td><td colspan="3">applicable to specific categories of servicemen</td><td colspan="3">applicable to all (or specific categories) of civil servants</td><td colspan="3">applicable to certain categories of population</td></tr>
<tr><td colspan="3">RF President Decree No. 177 of 2005 "On the monthly monetary incentive to individual categories of military personnel and servicemen possessing special ranks"</td><td colspan="3">RF President Decree No. 1509 of 2001 "On additional measures of financial incentives for certain categories of servicemen," Russian Federation Government Resolution No. 918 of 1992 "On measures to gradually transfer to recruitment of servicemen of the Armed Forces on a voluntary contract basis "</td><td colspan="3">RF President Decree No. 528 of 2001 "On some measures to strengthen the legal departments of government authorities," RF President Decree No. 1258 of 2004 "Issues of monetary allowance to the servicemen"</td><td colspan="3">Russian Federation Government Resolution No. 396 of 2000 "On certification of flight crews of national aviation"</td></tr>
</table>

<table>
<tr><td colspan="6">issued by their own initiative (expanding monetary allowance system )</td></tr>
<tr><td colspan="3">RF Government Resolution No. 449 of 1999 "On special scholarships of the Government of the Russian Federation, paid to adjuncts, students and cadets of military schools and institutions of higher education and vocational training from military personnel, law enforcement bodies of Russia, the State Fire Fighting Service under the Russian Ministry of Civil Defense, Emergencies and Elimination of Consequences of Natural Disasters and the penal system "</td><td colspan="3">RF President Decree No. 1556 of 1996 "On payment of the RF President scholarships to adjuncts, students and students and cadets of military schools and institutions of higher education from military personnel, law enforcement bodies of Russia and members of the State Fire Fighting Service under the Russian Ministry of Civil Defense, Emergencies and Elimination of Consequences of Natural Disasters, in addition to their monthly salaries "</td></tr>
<tr><td colspan="6">Orders of Heads of federal executive bodies, issued in accordance with reference norms</td></tr>
<tr><td colspan="2">applicable to all military personnel</td><td colspan="2">applicable to specific categories of servicemen</td><td colspan="2">applicable as the execution of administrative rights</td></tr>
<tr><td colspan="2">Order of the RF Defense Ministry No. 200 of 2006 "On approval of monetary allowances for the Armed Forces servicemen," Order of the RF Defense Ministry No. 555 of 2007 "On payments for the pre-school education for children of servicemen- citizens of Russia"</td><td colspan="2">Order of the RF Defense Ministry No. 55 of 2011 "On additional payments to certain categories of servicemen, performing military service under a contract with the Military Academy of the Headquarters of the RF Armed Forces"</td><td colspan="2">Order the RF Defense Ministry No. 1010 of 2010 "On additional measures to improve the efficiency of the funds of monetary allowance for servicemen and payments to civilian personnel of the Russian Armed Forces" (in accordance with the RF President Decree No. 1459 of 2006 "On additional measures to enhance effective use of funds for payments to employees of federal executive authorities ")</td></tr>
</table>

The total number of legislative acts in RF Armed Forces on the monetary allowance for servicemen (excluding documents establishing regional and northern coefficients, benefits to preferential categories of citizens, payments in self-financing payments to organizations, and others) includes about 10 laws, 30 decrees of the RF President and the RF Government Decrees, as well as more than 40 Orders of the RF Defense Ministry. In other federal bodies of executive power, where the law provides for military service, there are internal orders, in many respects different from the orders of the RF Defense Ministry. In addition, there are payments set outside of the monetary allowance system, in particular, on the orders of the RF Defense Ministry, issued in accordance with the Disciplinary Regulations of the RF Armed Forces[1]. This is the *package* of existing instruments. But will the *system* of monetary allowance, established in the form of a new institution, i.e., the Fund of monetary allowance?

To estimate the total expenditures for monetary allowance for servicemen of the Armed Forces, let's first define the approximate number of servicemen Armed Forces by groups. In March 2011, the expanded board of the Ministry of Defense by President D.A. Medvedev «has endorsed the proposals of the Ministry of Defense for content in the armed forces positions of 220,000 of positions of officers and 425,000 servicemen, serving under contract»[2]. However, as the Minister of Defense said, the data on the change in population are promising, and 425,000 professional soldiers will be recruited in the Armed Forces only by 2017.[3].Using these data, as well as the statement made by A.E. Serdyukov that the number of Armed Forces will remain the same - one million people, it can be shown, in what way will the structure of Armed Forces in the near future change (see *Fig. 1*).

Although the official information is not available yet, the amounts of future salaries for military posts and salaries of military ranks, as well as the additional allowances are widely discussed in the mass media[4]. A Table is also published with the tentative assessments of monetary allowance fund various supplements to the monthly basic salary. Based on this information, as well as approximating the missing data and using calculations based on the number of Armed Forces,

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1 Orders of the Defense Ministry No. 400 of August 2, 2008 "On monetary awards to the officers of the RF Armed Forces", No. 400-A of December 17, 2009, "On additional payments to officers who are performing military service in the military forces, formations and units of the RF Armed Forces in 2010", No. 400 of February 24, 2011 "On additional payments to officers who are performing military service in the forces, formations and units of the RF Armed Forces in 2011."

2 D.A.Medvedev's speech at the expanded meeting of the Board of the RF Defense Ministry on March 18, 2011 http://news.kremlin.ru/news/10677

3 Yu Gavrilov. Land transaction / / Rossiyskaya Gazeta. July 4, 2011

4 The state has determined the price of military labor / / Military-Industrial Courier. April 13, 2011

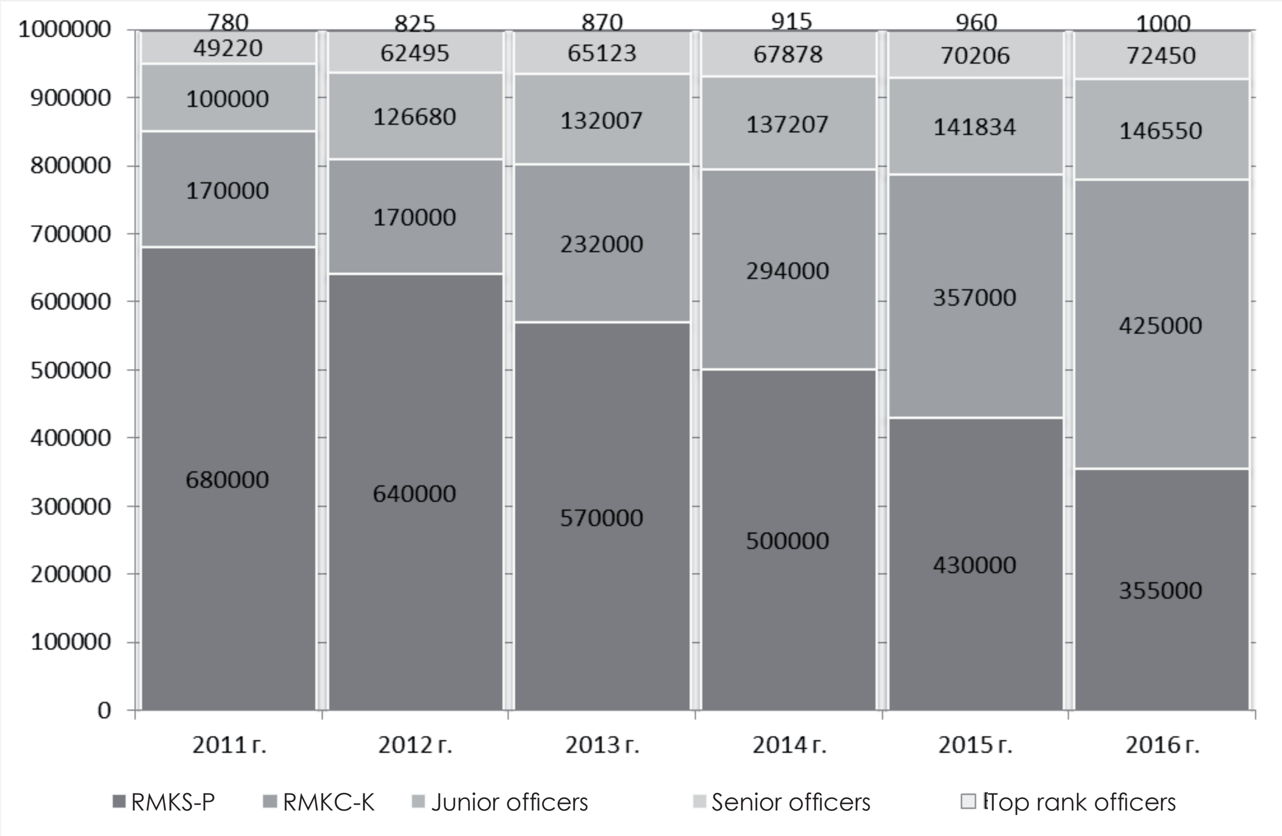


*Fig. 1. Estimated Dynamics of Personnel Changes in the Russian Armed Forces (people) Note. The number of soldiers and junior commanders as conscripts (RMKS-P), and soldiers and non-commissioned officers serving on contract (RMKS-K), obtained by calculation.*

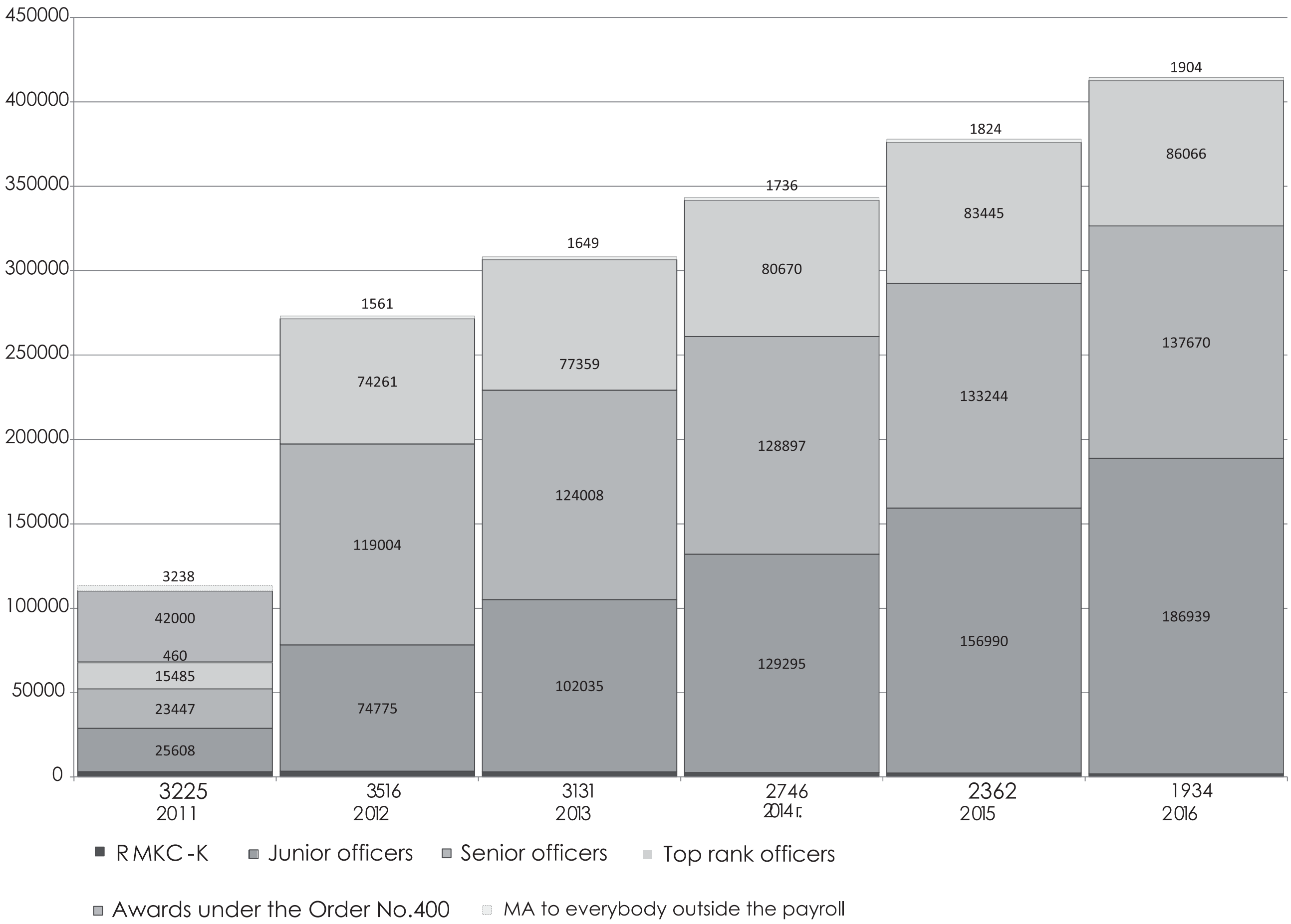


*Fig. 2. Estimated Dynamics of the Russian Armed Forces Servicemen (Rb, mln)*

one can imagine how will the structure of future monetary allowance spending on all servicemen change with regard to monetary allowance Fund, as well as its components (for «regular soldiers» and to «contractors»).

*Fig. 2* shows that the Fund of monetary allowance for "conscripts" is vanishingly small as compared with the Fund of monetary allowance for "contractors". At the same time the number of servicemen, recruited to military service for a regular term, as seen in Fig. 1, will decrease from two thirds in 2011 (680,000 out of one million) to one third in 2016 (355,000 out of one million people) of the total number of RF Armed Forces. Thus, the draft law preserves and strengthens the social inequality that exists in the Armed Forces today.

According to Fig. 2, in 2011, the amount of the total monetary allowance for servicemen, obtained by our estimates (Rb 3,225 + 25,608 + 23,447 + 15,485 + 460 + 42,000 + 3,238 = 113,463 m), is much smaller than provided for these purposes in the budget for 2011 - Rb253,351 m. It can be assumed that such a difference is based on the fact that though payments are made to servicemen though the federal budget, but as shown above, in accordance with numerous federal and departmental legal acts and regulations. Therefore, to calculate precisely who and how much got actually paid, is very difficult, which provokes difficulties for control over spending of budget funds intended for monetary allowance for servicemen.

The emergence of the Fund for monetary allowance for servicemen in 2012, we believe, would make the procedure of allocation and spending of money on the Fund more transparent and easier to be accounted. However, this requires restricting the agencies' powers in issuance orders for provision additional funds to the servicemen in excess of the Fund for monetary allowance. However, the proposed draft law on monetary allowance not only permits, but provides such legal rights to the President and the Government of the Russian Federation which bring to zero the overall point of introducing the "Fund for monetary allowance".

An example of such additional funds is allocation of assets in accordance with the above-mentioned orders of the Ministry of Defense, grouped under the number 400. What's next is not clear. Russian Defense Minister A.E. Serdyukov proposed to maintain the practice of encouragement for the best officers, and Russian President D.A. Medvedev agreed with him[1], despite the fact that there are extra payments for incentives for servicemen, included in the Fund for monetary allowance. At once there arises a lot of questions: will the amount of such additional payments be revised in view of the anticipated increase of monetary allowance; will the amount allocated for additional encouragement (Rb42 bn for each year from 2011 to 2013) be changed; will those amounts be included in the Fund of monetary allowance for servicemen; will this practice be extended to all the «militarized» agencies, whether the bonus, the allowance for special achievements in the service and payment under this incentive are similar in economic terms; will the Order be canceled or the right for such payment will be established in the law? Meanwhile, there are no answers.

Draft law retained also other shortcomings of the current system of monetary allowance[2], as well as introduced new ones. Some of them are shown us in *Table. 2*.

*Table 2*

ANALYSIS OF SOME PROVISIONS OF THE DRAFT LAW
ON THE NEW MONETARY ALLOWANCE SYSTEM

| Draft law provision | Comments |
|---|---|
| According to P.5 Art.3 of the draft law, when considered together with other statutory provisions[1], it appears that unspent assets from one fund may be allocated for payments to servicemen who are getting allowances from other funds. | This raises the question of the targeted use of each fund and availability of opportunities for corrupt redistribution of assets. For example, despite the fact that the fund of monetary allowance for "conscripts" will be relatively small, its amount, with the "skillful" redistribution of its "balances" can be very useful for a limited number of "interested" parties! |

1 Expanded meeting of the Board of the RF Ministry of Defense of Russia //http://news.kremlin.ru/news/10677

2 V.I.Tsymbal, A.A. Privetkin The failure of the social development strategy on the financial front / / Independent Military Review. June 3, 2011. http://nvo.ng.ru/concepts/2011-06-03/1_proval.html

*Table 2, cont'd*

| Draft law provision | Comments |
|---|---|
| Developers of the draft law forgot to include the traditional phrase "to offer the RF President and authorize the RF Government to bring its legal regulations in compliance with this federal law." | This may be due to either incompetence of the draft law developers, or deliberately – for the purpose to leave a loophole in the "unified monetary allowance system" for legal freedom of "militarized" agencies. |
| According to the draft law, all extra payments and bonuses are assessed as a percentage of monetary allowance or salary for the post. | Some of the cancelled payments were "piece-rate" and depended on, for example, the number of parachute jumps or cleared mines. In the draft law this relationship is lost! |

Thus, introduced to the Duma draft laws will not contribute to «establishment a new system of monetary allowance for servicemen» and elimination of social inequality among the servicemen, but ultimately can not meet the high level of national defense. And the attempt to institutionalize the Fund of monetary allowance for servicemen without legislative restrictions in the final list of expected payments can hardly be helpful.

# PROTECTING INTELLECTUAL PROPERTY RIGHTS

A.Makarov, A.Pakhomov

*The RF government's ambitious objective to boost export of domestic Hi-Techproducts andensure the economy's transition to their novation based development model makes iturgenta task to addres the problem of bringing protection of intellectual property rights (IPR) inline with the best practices set by multi- and bilateral international treaties.*

Russia currently faces systemic challenges in the innovation development area whose major drivers are invention incentives, patenting (including efficiency of the respective systems and procedures and the subsequent commercialization of promising technologies), while hindrances lie in an insufficiently efficient regime of protection of intellectual property on the whole.

Giving boost to export of Hi-Tech merchandiseby means of transfer and employment of foreign technologiesin particular, is possible only if one has succeeded in creating a competitive product with an innovation component, which forms the basis of its further successful commodization.

As there is no systemic public policy of support of research and invention in Russian Federation, the country practicallyfinds itself beyond the global technological development processes framework, is losing its best and brightest scientists and incurs gargantuan costs because of unpatented developments. Meanwhile, commercialization of legally protected IP forms a major source of expansion of Russia's high-tech export as a driver of the national economy and its competitiveness.

That said, implementation of the beast practices in the area of legal regulation of relations in the IP sphere on the basis of ratified international treaties constitutes a major direction of championing a nation's Hi-Tech export. The system of international multi- and bilateral IP protection treatieshas an immediate effect on improvement of national sectoral law and its enforcement. This generates prerequisites for creation of a favorable innovation environment, including fostering invention, patenting and commodizationof IP.

Nowadays, underpinning the international cooperation in the IP area are: multilateral treaties under the aegis of the WIPO[1], which is a specialized UN institution; international bilateral agreements, including those in the trade area[2]; the WTO Agreement on trade-related aspects of intellectual property rights (ATRAIPR), which is based on the WIPO standards and sets minimal standards of IP protection the WTO member states exercise in the course of mutual trade[3].

Russian Federation is compliant with the minimum global IP protection standards, and the nation's profile law is basically in line with the ATRAIRP and international treaties under WIPO. That said, as far as protection of intellectual property rights is concerned, Russia faces a set of systemic challenges and constraints, nonetheless. Theyare associated primarily with innovationbased development and diversification of Hi-Tech exports. Discouraged by the absence of a systemic government support of research and invention, as well as by underdevelopment of private (including intellectual) property institutions and their legal protection, a considerable bunch of

1 WIPO currently exercises administrative control over 23 international treaties to which 184-plus nations became signatories; Russian Federation is a signatory of most of the said treaties.

2 The shining examples in this respect are the USSR-US Agreement on trade relations of 1 June 1990 and the mutually exchange letters thereto in respect to intellectual property rights, the Treaty between the RF Government and the US Government on protection of intellectual property rights of 19 November 2006 (the mutually exchanged letters to the bilateral Russia-US treaty on granting access to the market for goods in the framework of the process of negotiations on Russia's accession to WTO).

3 The Treaty comprises minimum standards and procedures with regard to regulation of issues associated with specific intellectual property objects, including copyright and allied rights (musical, fiction, artistic and scientific products, software and databases, as well as performance, audio recording, phonograms, theater performances, orchestrations, etc.) trademarks, including service marks; geographicalnames; patented objects (industrial samples, kinds of pants and animal species; topologies of integral microchips; undisclosed information

Russian inventors has opted to sell their products overseas on the cheap and see commercialization of protected (patented) IP objects there, rather than to patent them on home soil.

The problem is further aggravated by the brain drain problem, with the best Russian scientists opting to work and make their breakthroughs overseas, where they feel far more comfortable from both the scientific and socio-economic perspective. Thus, according to the UNPF, between 1992 and 2010 Russia has lost some 3m specialists[1], who subsequently often made their major breakthroughs already overseas. Today, more than 900,000 of them work in the US, 150,000 – in Israel, 100,000 – in Canada, 80,000 – in Germany, 35,000 – in UK, 25,000 –in China, and some 3,000 – in Japan[2].

Russia's innovation based development requires addressing the problem of complex and bureaucratized patenting systems and procedures. The procedure of obtaining a patent in general is regulated by provisions of Section 4 of the Civil Code of RF and comprises the following stages: submission of the patentapplication, its formal evaluation, publication of the application, its *ad rem* evaluation, decisionto award the patent or to decline it, and registration and issuance of the patent.

In 2010, as many as 30,322 patents were awarded in Russia, or 87% on a year-on-year basis. It is worth noting that the patenting of industrial property objects has been steadily on the rise since 23,299 patents were issued in 2006[3]. Meanwhile, the data clearly evidences systemic pitfalls for the patenting and Russia's innovation based development on the whole. The number of patents awarded in the most advanced invention-wise countries proves incomparably greater than in Russia, and their number is rising in literally geometrical progression. To cite particular examples, in 2010, China granted 815,000 patents, or up by 140% vs. the prior year's mark[4], while the US – 220,000 patents (+176% on a YoY basis)[5].

In practice, there are several patenting systems overseas, with none of them implying the concept of the socalled "international patent". Rather, those nations acknowledge an international application submitted to the WIPO International Bureau via the Federal Institute of Industrial Property in compliance with the Patent Cooperation Treaty. Such a PCT backs the international application[6] attests to the authorship, priority, and signifies the inventor's intention to obtain a respective patent in the countries which are signatories to the Paris Convention for the Protection of Industrial Property.

Russian inventors and businesses see no commercial appropriateness in patenting their developments because of the imperfect mechanism of their commercialization. So, because the invention sphere in broad terms is in crisis, there has been no capacitygeneration to boost development of Hi-Tech products in Russia. The existence of overly bureaucratized, technically complex, long and costly procedures of patenting industrial property objects both in Russia and overseas, the absence of a systemic government support of patenting exerts an adverse influence on both the Russian inventors' innovation activity and the nation's overallmodernization advancement record[7].

Yet another today's challenge is an imperfect mechanism of transition of the IP rights to a most efficient owner, who is ready for, and capable of,their commercialization. In the meantime, the RF government's share in all R&D costs accounts for more than 60%.

The government is also an owner of a huge number of unidentified and non-documented IP rights, a part of which dates back to the Soviet period and is not presently used. As a result, their relevance and prospects of their commercialization are fading from year to year, as there are no market agents eager to find and complete prospective developments, and to start commercializing

1 United nations Population Fund, http://www.unrussia.ru/en/institutions/unfpa.html

2 «Brain Drain: Brain Hunters», O. Uskova, Vedomosti daily, №237, 15.12.2010, http://www.vedomosti.ru

3 The 2010 performance report of the Federal service for intellectual property, patents and trademarks (Rospatent), http://www.rupto.ru

4 China Patent Agent (H.K.) Ltd, http://www.cpahkltd.com

5 The US Patent and Trademark Office http://www.uspto.gov

6 The procedure applies solely to inventions and useful models

7 A meager government support in the form of subsidizing of the patenting of inventions in Russia and overseas for small- and medium-sized businesses basically proves an inoperative mechanism, due to its inefficient enforcement and an insignificant demand for it in practice.

them. That is why Russian Federation currently owns just 1,310 patents on all kinds of intellectual property, with practically a half of them (561 patents) issued only in 2010[1].

As far as protection of IP rights (both the industrial property and copyright and allied rights) is concerned, the critical aspect is designing legislative, enforcement and administrative measures on identification, countering and prevention of offenses in the intellectual property sphere. A significant level of piracy engenders additional image problems for Russia and affects attraction of much-needed foreign investments and technologies.

More specifically, by results of a review of the “301$^{st}$ special” article of the US Free and Fair Trade Act of 2011, Russia once again was left in the category of “priority monitored nations” where an irrelevant and inefficient protection of IP rights is still there, which implies the possibility of imposing economic sanctions to a country violating the provisions therein[2]. At this point, it should be noted that while Russia has been kept in this status for the past 12 years, it has substantiallyimproved its legislation and increased efficiency of its law enforcement mechanisms, as evidenced by international statistical data.

According to findings of the 8$^{th}$ Global Software Piracy Study the Business Software Alliance – BSA[3]) runs annually in tandem with the International Data Corporation (IDC), the overall level of piracy in the segment of imported software in Russia tumbled dramatically between 2004 and 2010 from 87% (7$^{th}$ position in the global software piracy ranking) to 65% (50$^{th}$ position). These indices are basically already comparable with the average level of piracy in the Central and Eastern European countries.

Meanwhile, in 2004-10, the BSAcorporate members have seen their financial losses on the Russian market soar dramatically. That said, it is the US herself and China that contributed most to the losses concerned - \$9.5bn and 7.8bn, respectively, while Russia came in third[4] (*Table 1*).

*Table 1*

MAINFINDINGSOFTHE 8TH GLOBAL SOFTWARE PIRACY STUDY BY BSA AND IDC ACROSS INDIVIDUAL COUNTRIES IN 2010

| | |
|---|---|
| The average global level of piracy | 42% (43%) Thisindexiscalculatedonthebasisofcountry-specificindicatorsfoundasp ercentage of the estimated number of pirated software units in a country in the total number of installed software |
| Regional average piracy levels | NorthAmerican, WesternEuropean, Latin American and EU nations: 21% (21%), 33% (34%), 64% (63%) and 35% (35%), respectively.<br>Central and Eastern European nations: 64% (64%).<br>Middle Eastern and African nations: 58% (59%).<br>APECnations: 60% (59%).<br>TheBRICScountries: 71% (71%), includingBrazil - 54%, India – 64%,Russia - 65%, China - 78%, South Africa (35%) (the 2009 data in brackets.) |
| Countries with the highest levels of piracy | Georgia (93%), Zimbabwe (91%), Bangladesh, Moldova, Yemen(90%), Azerbaijan, Armenia, Belarus, Venezuela, Libya (88%), Indonesia (87%), Ukraine and Sri-Lanka (86%), Iraq (85%), Pakistan (84%), Iraq, Ukraine and Vietnam (85%), Algeria and Pakistan (84%) |

1 The 2010 performance report of the Federal service for intellectual property, patents and trademarks (Rospatent), http://www.rupto.ru

2 In compliance with the Act, the US Administration runs an annual evaluation of relations with its trade partners with regard to effect of mechanisms of an adequate and efficient protection of intellectual property rights and existence of fair conditions of access to the market of US private individuals and corporations whose interests depend on protection of IPR. Should the US consider developments unsatisfactory, there will arise a threat of imposing such trade-political sanctions on the violator nation as, for instance, depriving it of the status of the participant in the US Generalized System of Preferences. In compliance with Art. 502 of the 1974 Free and Fair Trade Act, the respective decision falls under the US President’s mandate. A Proclamation: To Modify Duty-Free Treatment, by the President of the United States of America, January 13, 2003, The White House, The Office of The Press Secretary, Washington DC, p.1. http://www.whitehouse.gov

3 BSA is a leading international organization of foreign copyright owners with the dominance of transnational corporations headquartering in the US (Microsoft, Adobe, Apple, Oracle, etc.).

4 Eighth Annual BSAandIDC Global Software Piracy Study, Washington, D.C., May 12, 2011. http://www.bsa.org

| | |
|---|---|
| Countries with the lowest levels of piracy | US, Japan, Luxemburg (20%), NewZealand (22%), Austria, Australia (24%), Belgium, Finland, Sweden (25%), Denmark, Switzerland (26 %), Germany, UK (27%), Canada, the Netherlands (28%), Norway (29%), Israel (31%), Singapore (34%) |
| The aggregate loss of copyright owners | $58.8 bn.(51.4bn.in 2009).<br>The estimated number of installed pirate software units in the country multiplied by a average cost of the licensed product unit. Thehypothesisisthatl egalproducers' gains are in proportion to the level of piracy, while the copyright holders' losses are equal to the overall costs of the pirated software in a country. |
| Countries with the highest levels of copyright owners' financial losses (as $bn) | US (9.5), China(7.,7), Russia (2.8), India (2.7), Brazil (2.6) France (2.5), Germany (2.0), Italy and UK(1.8), UK and Germany (2.2 each.), Japan (1.6), Indonesia (1.3). |

*Source:* Eight Annual BSAandIDC Global Software Piracy Study, Washington, D.C., May 12, 2010, http://www.bsa.org

As to much-needed measures of government support, these should comprise a building of a system of trade and political measures to protect Russian intellectual property objects on overseas markets – the move domestic copyright holders, producers and exporters have long needed.Specifically, rather pressing is the problem of protection of Russian copyright and allied rights in Australia, Israel, Germany, Canada, US, and other foreign countries with huge ex-USSR diasporas (who have already become their permanent residents or hold the dual citizenship) who are potential consumers of Russian authors' fiction and audio-visual works.

Similar problems exist in the industrial property area, including the Russian MIC's products that account for a half of the nation's Hi-Tech export. As a result, not only are Russia's intellectual property rights violated, as the country fails to collect license payments due, but domestic products are supplanted from the global market by their illegal overseasanalogues.

It seems that in this case it might be appropriate to follow the US's 301$^{st}$ "special" article as a means of legal protection of national IP rights on overseas markets. As well, it would be expedient to ensure a more efficient employment of the existing trade-and-politics diplomacy leverages – that is, intergovernmental commissions on trade-economic and research-and-technical cooperation with foreign nations, as well as Russia's Trade Missions overseas.

The aforementioned systemic challenges in the area of protection of intellectual property (both copyright and allied rights and industrial property) have a critical impact on expansion of Russia's Hi-Tech exports, which find themselves in dire straits. While with regard to "innovation brains" Russia is a clear donor to developed nations, it is a net recipient from the technology perspective. According to IMF, Russia's 2009 volume of export of intellectual property was nearly 8.5 times smaller than import ($493m vs. 4.1bn). This is a harsh contrast with technologically advanced nations: eg., Japan and US are large net exporters of innovation technologies and intellectual property objects associated therewith (see *Table 2*). Specifically, US grossed some $90bn from such exports, with their import accounting for $25.2bn, while Japan – $21.7bn (16.8bn)[1].

*Table 2*

INTELLECTUAL PROPERTY INTERNATIONAL TURNOVER ININDIVIDUAL COUNTRIESIN 2009, AS $M

| | Payments (import) | Revenues (export) |
|---|---|---|
| Russia | 4106 | 493 |
| China | 11065 | 429 |
| USA | 25230 | 89791 |
| Germany | 14104 | 13785 |
| Japan | 16834 | 21698 |
| Singapore | 11686 | 1339 |

*Source:*International Monetary Fund, http://www.imf.org

1 International Monetary Fund, http://www.imf.org

A nation's ultimate performance in this respect can be assessed using such a criterion as the proportion of Hi-Tech in its export structure. For Russian Federation, this indicator made up 7%, while US boasts of 27% and China – 29%[1]. Over the past decade, Russia has been considering itself satisfied with a humble share of 0.3-0.4% of the global market for science-intensive products, which clearly does not match the nation's innovation based development needs.

That said, the recent practice has demonstrated that in Russia, the current system of export of intellectual property objects is a far cry from perfection. Attempts to reform the mechanism of support of industrial export, including the one of Hi-Tech products, faces systemic administrative barriers, including poor coordination at the governmental level, no intellectual property assessment and audit methodology, and imperfection of financial incentives, to name a few.

At this juncture, effective measures aiming at boosting export of science-intensive products should imply both legal instruments of protection of copyright holders' rights and economic encouragement of legal producers, who sell their own R&D products, domestic exporters of innovation products, and creation and promotion of national Hi-Tech brands.

It is also appropriate to work out and implement urgent measures to ensure a more efficient use of the state budget funds to subsidize procedures of protection of intellectual property rights, including patenting domestic manufacturers' products both in Russia and overseas.

A core element of the solution to the problems in question remains improving the bilateral international treaty framework with a view to protect Russian intellectual property objects overseas. It goes without saying, equally important also is Russia's efficient positioning on the international level as a nation that cares for protection of intellectual property rights, including those held by foreign players, and creates a favorable environment to foster invention collaboration, commercialization and export of innovation products.

Expansionof the domestic Hi-Tech economic agents' operations, which would be backed by an efficient system and procedures of protectionof intellectual property resting on the best international practices, should result in a greater competitiveness of domestic products, employment growth, exportdiversification, and transition to the innovation developmenttrajectory. All the above can help overcome risks and perils associated with the mineral-export based model of economy, as well as help Russia integrate into the global system of economic tiesas a legitimate player.

So, once implemented, international standards of regulation of legal relations in the intellectual property area are fundamental for creation of a favorable environment that allows fostering innovation, including support to invention and patenting, on the international area *inter alia*, commercialization, and protection of intellectual property overseas by means of trade and political diplomacy instruments. As a consequence, that would form a catalyst of a further expansion of Russia's Hi-Tech export – the nation's central mission for today.

1 Database UN Comtrade http://www.comtrade.un.org

# BUSINESS CLIMATE. RUSSIA IN 2011 INTERNATIONAL RATINGS

A.Abramov

***The previous reviews repetitiously cited an unfavorable business climate as a major cause for negative phenomena in Russia's economy.*** *The state of business climate is mirrored, in particular, by country* ***ratings*** *various international organizations compile on the basis of special research. Such ratings form investor guidelines.* ***In such international ratings as*** *ratings of cities exercising the international financial centers functions, the innovation index, the progress index, the Economic Freedom Index, the Corruption Perceptions Index* ***Russia permanently finds itself at the bottom of the list****. Despite heated debate in high echelons of power on challenges facing attempts to improve the investment climate, modify the law and departmental acts, the* ***investor and entrepreneurial communities have not yet witnessed any real change for the better****.*

In March 2011, the Z/Yen Group published its regular rating of cities exercising International Financial Center (IFC) functions – the Global Financial Centres Index. Two Russia's capital cities, Moscow and St. Petersburg, routinely found themselves at the bottom of the list. Since March 2010 there have practically been no changes in their ranking: Moscow still is 68$^{th}$ out of 75 financial centers, while St. Petersburg slightly improved its ranking by leapfrogging from the 71$^{st}$ to 69$^{th}$ position. This proves that in the global investors' eyes, there has been no actual change in both cities. What's worse, the RF governmental action plan on launching the Moscow IFC has de-facto been sabotaged.

In July 2011, INSEAD published its Global Innovation Index (GII). With account of modifications in its calculation methodology Russia advanced from the 64$^{th}$ position to the 56$^{th}$ in the list of 125 nations and trails far behind China (29$^{th}$), Brazil (47$^{th}$), Slovenia (30$^{th}$), Estonia (23$^{rd}$) and Moldova (39$^{th}$). According to the rating, Russia's innovation process shortfalls are institutions, the degree of the market and infrastructure development and results of creative activities. This ranking resonates with the recent **UBS** and **Campden Research's** business survey which cited that as many as 85% of Russian businessmen are keen to sell business for a handsome price.

In July, 2011, FBK, an auditing firm, published a provocative aggregate indicator of international competitiveness ratings, **the Progress Index,** compiled on the basis of seven highly credible rankings, including the GEF's Global Competiveness Index, the IBRD's Ease of Doing Business Global Index, the UN Human Capital Index, the Cato Institute's Index of Economic Freedom, the Transparency International's Corruption Perceptions Index, the Heritage Foundation and WSJ's Economic Freedom Index, and the International Living Journal's Best Countries to Live ranking. The FBK's Progress Index illustrates the development dynamic – that is, how individual nations have advanced or underperformed along the above rankings since 2007. In the current FBK rating, Russia scored just 97$^{th}$ out of 101 nations, which reflects a substantial **deterioration** of business climate in the country. More specifically, when compared with 2006, Russia was down by 40 points in the Quality of Life Index, 33 ones- in the Corruption Perceptions Index, 26 points– in the Ease of Doing Business Index and 14 points by the Heritage Foundation's index. The country made some progress just in the Global Competitiveness Index - 1 point up, the Human Capital Index – 3 points up and in the Cato Institute's Index –12 points up.

As a reminder, according to the Word Bank's recent Ease of Doing Business report published in December 2010, Russia slid from the last year's 116$^{th}$ position to the 123$^{rd}$ one (out of 183 nations). By the last WEF GII, in 2010-11, Russia scored 63$^{rd}$ out of 139 nations, thus holding the same ranking as the year before (albeit at the time, there were 133 nations in the list). The joint Heritage Foundation and WSJ **Economic Freedom Rating** in 2010 and 2011 stably puts Russia on the 143$^{rd}$ position out of 183 nations. Likewise, Russia earns stably low scores by the

TI's Corruption Perceptions Index: in 2010, the country was 147th out of 180 nations, while in 2011 it added 4 points and became 143rd out of 179 nations.

The above data allow assumption that despite heated debate on higher levels of government on how to improve the investment climate and attempts to modify the law and departmental acts, the investor and business communities have not yet noticed any real change for the better.

# REVIEW OF THE RUSSIAN FEDERATION GOVERNMENT SESSIONS IN JULY 2011

M.Goldin

*At the sessions of the Russian Government Presidium in July 2011, the following issues were reviewed: draft guidelines of the Russian Federation the tax policy in 2012 and for the planned period of 2013 and 2014; draft rules of selection and coordination of priority investment projects of federal regions implementation and amendments to some acts of the Russian Federation Government.*

At the session of the Russian government Presidium on July 7 draft guidelines for tax policy in 2012 and the planned period of 2013 and 2014 were discussed (hereinafter – the Project), submitted by the Russian Ministry of Finance.

In 2012-2014, the Project proposed to improve the tax system, in particular, in the following areas:

1. Tax incentives for innovation activity and human capital development;
2. Monitoring of the effectiveness of tax benefits;
3. Excise taxation;
4. Improving the taxation of transactions with securities and financial instruments, forwarding transactions;
5. Corporate income tax.

1. Tax incentives for innovation activity and human capital development implies:

1) decrease of the total rate of insurance premiums from 34% to 30%, levied on payments to an employee at the rate of up to Rb512,000 per year (according to accruals for 2012), with the establishment of a tariff rate of 10% of the amount paid in excess of the limit. Thus, the insurance premiums get similar to the procedure of the single social tax with a regressive schedule of rates, abolished on January 1, 2010;

2) changing the rules of depreciation policy, which are, in particular:

– the actual narrowing of the list of fixed assets in respect of which the provision of (getting) a lease an inflation index may be applied to the main depreciation rate;

– approval by the Resolution of the Russian Federation Government the list of facilities with high energy efficiency, to which the depreciation rate is applied by using a specific factor, but not more than 2;

- rules of depreciation amendment, so that the renovation, upgrading and technical re-equipment of fixed assets would not restore the application 30-th% bonus depreciation thereto, while providing mechanisms to prevent abuse of this benefit by incompliant taxpayers, repeatedly applying the specified premium to the same fixed assets at their resale;

3) development of allocation of shares of the Russian companies traded in the organized market in the shares of high (innovation) economic sector for the purposes of taxation for the application of zero tax rate to transactions in the shares of the Russian companies;

4) tax exemption for certain types of income or tax deductions for the implementation of socially important NGOs expenditures (in particular, for medical services payment);

5) increasing the amount of some tax deductions for the taxpayers.

2. Monitoring the effectiveness of tax benefits means analyzing the actual mechanisms of tax incentives (including tax benefits) in order to identify inefficient and unclaimed benefits.

3. In regard to excise tax, a regular indexation of excise tax rates will be performed with regard to the current economic situation. Herewith, the increase in excise duties on alcohol, alcoholic beverages and tobacco products will be performed at a faster rate than inflation. With regard to other categories of excisable goods, it is planned to retain the previously established rates of excise taxes for 2012 and 2013 with their indexation by 10% in 2014.

4. Improving the taxation of transactions with securities and financial instruments of forwarding transactions and other financial transactions will be performed by exempting from corporate income tax at source on interest paid on bonds of the Russian emitters, exemption from taxation of companies' shares, more than 50% of the assets of which is invested in real estate in the Russian Federation, as well as a series of other measures.

5. Corporateincome tax reporting simplification for tax purposes, to organizations in regard to the sale of real estate, as well as clarification of the recognition of losses procedure in the form of bad debt for the purposes of profit taxation.

At the meeting of the Russian Federation Presidium on July 21 the Draft Resolution of the Government of the Russian Federation was reviewed on the procedure for selection and coordination of the priority investment projects of federal regions and amendments to certain acts of the Russian Federation Governmen (hereinafter - the Project), submitted for discussion by the Ministry of Regional Development.

The Project envisages adoption of the Rules for selection and coordination of investment projects of federal regions. Adoption of these rules is aimed at setting goals and objectives of the investment projects, requirements thereto. The above rules will also regulate the order of selection of priority investment projects for federal regions, the approval of the list of priority investment projects of federal regions and relevant amendments thereto, and coordination the implementation of priority investment projects of federal regions.

# AN OVERVIEW OF NORMATIVE DOCUMENTS ON TAXATION ISSUES IN JUNE–JULY 2011

L.Anisimova

*Over the period under review there have been several federal laws designed to refine the tax system of Russia. A large number of amendments are aimed at improving the text of the Tax Code. Careful review of the Tax Code technical details will help to eliminate many obscure issues in the application of tax law at the pretrial procedure, and allow tax authorities to formulate their legal requirements more clearly and justify their position in court. Part of the changes is intended to promote the equalization of conditions for business activities and (or) the provision of benefits to organizations and individuals in the circumstances similar to those for which the Tax Code has already provided benefits to other subjects. There are changes that need to be improved to avoid unnecessary litigation.*

1. **By Federal Law No. 227-FZ dated 18.07.2011, there** were made changes to the Tax Code, prepared under the instruction of the RF President, associated with a more detailed regulation of taxation in terms of transfer pricing. Transfer prices can be defined as the prices at which the goods are transferred under transactions between related persons or persons linked by common interests, based on a conspiracy to minimize the total tax (for instance, through cross-border transactions or transactions with persons having beneficial tax treatment).  In order that tax authorities could detect and prove the existence of transfer prices for transactions, a special section is introduced in the Tax Code on the definition of interdependent entities. The basic criteria for the interdependence of individuals identification are: the share of one organization in another organization in excess of 25%, the existence of a common party whose shares in each of them exceeds 25%, the presence of family (related) links or official affiliation with members of the organization. It is important that the list of criteria is unrestricted, and the court is granted the right to establish the interdependence of people for other reasons as well.  Equity shares are estimated by calculating the proportion of the direct involvement of an entity in each subsequent entity of the chain. This allows, in the presence of chains of cross shareholdings between organizations, to assess the share of each participant in the capital of the organization by summing up the direct shares, estimated for each such chain participant.

If prices are used interrelated persons, differ significantly from the market ones, the tax base for transactions between such persons is calculated at market prices. Changes to the law under review set up a specific mechanism for the tax authorities to match transaction prices, as well as the ways for comparing the transactions terms (comparable market price method, the method of follow-up of prices, cost method, the method of comparative cost-effectiveness, the method of profit distribution) for the purposes of income taxation of interdependent persons. The concept of transactions controlled by tax authorities is introduced, namely for the transactions, the turnover of which between the related parties exceed Rb1bn per year (Rb60m, If one party is the MET payer or is exempt from income tax, or is a resident of special economic zone; R100 m rubles, if at least one party uses a special tax treatment - a single agricultural tax, single imputed tax), or the cross-border transactions between interrelated parties with key exchange market commodity turnover with more than Rb60 m. (oil and oil products, ferrous and nonferrous metals, fertilizers, precious metals and precious stones).

Taxpayers are required to notify tax authorities about the presence of their controlled transactions.

2. By **Federal Laws No. 254-FZ dated 21.07.2011 and No. 249-FZ dated 20.07.2011** changes are introduced to Federal Law “On Science and State Science and Technology Policy”, as well as to the RF Tax Code. Changes made by the Federal Law No. 254-FZ to the laws on science, involve the extending of the terminology and the legislative definitions of a number of key terminology concepts,

such as commercialization of scientific and (or) R&D achievements, innovations, innovative design, innovation infrastructure, innovation activities, as well as the legal status of the funds for scientific, R&D and innovation activities.

Federal Law No. 249 dated 20.07.2011 is also aimed at streamlining the system of state support to scientific, R&D and innovation activities. Changes in the law are aimed at regulating the activities of public funds that can be created in the form of budgetary or autonomous institutions. Functions and powers of public of public funds founders are performed by the Government of the Russian Federation, funds' managers are also appointed by the Government. According to the amendments to the law, public fund provides grants to research and training staff, other individuals and organizations, providing financial support for research, R&D programs and projects, innovative projects, the selection of which is based on the results of tenders. It is expected to disclose the results of examination of selected projects for which the grants are allocated to the public, including Internet.  Grants from public funds can be allocated also in the form of the equity in the financing of scientific and technical programs, formed and implemented through international and intersectoral scientific and technical agreements, including the development of dual-use technologies.

Assets received from those public funds for R&D and related works, as well as targeted proceeds for those public funds' formation are exempt from income tax.

Unfortunately, in the proposed scheme there is primarily viewed outdated unprofitable "free" financing principle of budgetary funds allocation for science. If workers the public funds employees, beyond the simple allocation of budgetary financing (which is important to support the basic research) would be able to provide part of the allocated budget funds for applied research on commercial basis, the effectiveness of such funds' activity, in our opinion, would be higher.

Provision of funds under repayment and payable basis is applicable in the effective legislation only to banks. The RF Civil Code provides borrowing as a form of relationship between the market participants. But it is not clear from the text of the law under review, whether the public funds are authorized to perform such activities with the budget funds. To understand the power of the public funds in terms of the budget funds disposal, one should wait for the adoption of the Regulation on Public Funds for the Support of R&D and Innovation Activities.

3. **Federal Law No. 245-FZ of 19.07.2011** has made significant novelties and edi-torial clarifications to Chapter 21 of the RF Tax Code concerning VAT payment. In particular, the transfer of quotas to reduce anthropogenic emissions in the framework of Kyoto Protocol is now regarded as VAT - taxable activity with the place of services provision in Russia.

The Russian Federation is also recognized as the place of services provision for VAT, if the works and services are carried out for geological study, exploration and production of hydrocarbons in the subsurface areas located totally or partly on the continental shelf and (or) in the exclusive economic zone of the RF.

Sales transactions with goods (works, services), carried out by the state and municipal unitary enterprises (GUP MUP) are VAT exempt , if the average number of disabled persons among their employees is not less than 50% and if their share in the wage fund is at least 25%. In fact, it equates the terms of taxation for GUP MUP in terms of VAT to the conditions of taxation of organizations whose authorized capital is made up entirely of contributions from public organizations of disabled.

Operations not subject to VAT in Russia are specified - their number includes insurance services, coinsurance and reinsurance of export credits and investments against business and political risks.

Very interesting is the abolition of the previously adopted VAT benefit for the goods imported for use in the Olympic Games in Sochi. We think this is the right decision, because it enables individuals using such products to offset VAT. Otherwise, the incoming VAT would lead to a strong and unnecessary rise in the cost costs of the Olympics.

In order to facilitate the confirmation of the legality of the zero VAT rate, bank statement confirming the actual receipt of proceeds from the sale of goods imported for the use in the Olympics in Sochi, on the account of the taxpayer is excluded from the list of required documents. The incoming VAT is offset under the application procedure is quite risky form of compensation (offset) of VAT, as it is performed without confirmation of the receipt of proceeds from the goods (works, services).If the produced goods (work, service) are not realized, there will be no economic reason to compensate the input VAT. The manufacturer, who does not sell the goods, is the same consumer as other ordinary citizens. The VAT deduction acceptance under the application procedure in the Russian Federation is based on the provision of bank guarantees to taxpayers.

Changes in the Tax Code excluded the requirement for a bank providing guarantees to taxpayers, to have a registered capital of at least Rb500 m. The requirement for the banks to have own funds (capital) of at least Rb1 bn is preserved. Deletion of the requirement on the registered capital in the amount of Rb500 m is harmless, since the actual provision of obligations guarantee are real assets of the bank, rather than statutory liabilities.

4. By **Federal Law No. 235-FZ of 18.07.2011** changes are introduced to the Tax Code in terms of expanding the list of nonprofit organizations involved in various types of social and charitable activities, in respect of which tax benefits are provided.

VAT-exempt are services to care for sick, disabled and elderly people, who need care as confirmed by the conclusions of the relevant health organizations, social security authorities, and (or) federal institutions of medical and social protection, services for maintenance and education of children in preschool educational institutions, hobby groups, sections, income from the sale of food products directly prepared by cook-shops of educational and medical institutions, other social services (related to the selection of trustees, the identification of failed or not fully capable citizens in need of care, conducting physical education and sports and recreational activities with the citizens, services for retraining of citizens, provided by the employment service, and some other types of social services).

Exempt from tax on personal income (PIT) are payments to volunteers (volunteers), free of charge providing socially important services, travel cost of these volunteers pay for their return trips to the place of charity work, payments for personal protective equipment, voluntary health and life insurance during implementation of volunteer activities. Amounts paid in the form of charity care provided in accordance with the laws of the Russian Federation of Russian and foreign charity funds are exempt from taxation.

The structure of social tax deductions provided to citizens on personal income tax, includes the amount of income transferred by citizens to charitable and socially-oriented organizations (deduction for this purpose is provided at a rate of not more than 25% of taxable income).

Benefits are provided for income and expenditures for social and charitable purposes and for income tax. Income of nonprofit organizations, granted (transferred) to conduct authorized activities of structural divisions created by them (structural units), the cost of production (distribution) promotional social materials, the cost of forming reserves for future payments to nonprofit organizations - estimated for a period of not more than 3 years in the amount not exceeding 20% of the total income for the reporting (tax) period are tax exempt.

5. By **Federal Law No. 147-FZ of 21.06.2011** changes are introduced to the Tax Code Chapter on the tax on personal income of physical entities (PIT), addressed at the alignment of conditions for attraction of budgetary funds for the development of private farming by an individual, similar to the assistance of financial aid in the form of budgetary subsidies to small and medium-sized businesses. But unlike the scheme applied to small and medium-sized businesses, according to which revenues in the form of budgetary funds are accounted for as taxable income of the taxpayer, the Budget Code identifies such term as a budget subsidy (Article 78 of the RF BC). Under the scheme, implemented by amendments a different approach is applied to the personal income tax - directly in the text of the Tax Code (in art. 217) was included a confidential list of specific expenses recognized as target ones for the use of budget funds.

Therefore, the fundamental difference in approach lies in the fact that the for taxation of budget funds attracted by small and medium-sized businesses the list of subsidized costs is not closed, whereas the taxpayers, attracting budgetary funds for the development of private farming, are now faced with the problem of justification each target of their expenses. Why the legislators have returned to such outdated pattern of costs recognition, as a closed list, is unclear. Closed lists have already repeatedly been the subject of harsh criticism, as is impossible there to provide economic rationale for their composition. As a result, the terms of business activity become completely different, which violates the principle of fairness of taxation. Recovery in the text of the Tax Code of the closed list, allowing to deduct expenses, in our opinion, is erroneous and violates the basic principles of taxation in the Russian Federation.

6. The specific scheme of tax accounting for budgetary institutions, introduced in the text of the Tax Code by **Federal Law No. 239-FZ of 18.07.2011** requires follow-up development, or its application will be accompanied by numerous lawsuits on the part of public institutions.

The newly introduced in the text of the Tax Code, Article 331.1 provides that, when budgetary allocations are made for utilities, communications, transportation costs, maintenance of administrative personnel, on all types of repairs of capital assets, the sources (budgetary and extrabudgetary) for these purposes will be allocated in proportion to their shares in total income. If the budget funding is not foreseen to cover the above-mentioned expenditures, those costs, according to the text of the newly adopted changes are deductible from income from paid services only "under condition that the operation of such capital assets is associated with the provision of paid services and other income-generating activities ". The wording is not quite clear, as it does not explain the situation with financing costs incurred in teaching students (trainees), enrolled within the target number in the absence of budgetary subsidies for specific purposes (for example, in the case of subsidies only for wages or property and land taxes). It turns out that, if purchased at the expense of the budget capital assets (such as computers, communication means, etc.) during the reporting (tax) period are used only for training students (trainees), enrolled within the target number, and is not used for training students (trainees), taken on a commercial basis, the cost of repairs and maintenance of fixed assets, according to the law (in the absence of subsidies for this purpose) cannot be attributed to the costs of the organization to be considered for taxation. It is not clear, whether this means that they have to be paid out of profits of the organization after tax ? And if extra-budgetary resources are insufficient to finance the costs for common training of commercial students (trainees) and those enrolled within the target number? From what source should the losses of the budget of the organization be covered in this case? In contrast to the previous position, when the legislator did not admit the possibility of recognizing as insufficient the budget funding for education, it looks that changes to the text of the Tax Code under review included a "loophole", that allows to refer expenses for tax purposes the cost of property acquired from the budget and commonly used for budgetary and commercial students. However, the possibility of acceptance for deduction the expenditures made from the funds of an educational institution to train budgetary students, has not been resolved. As a result, the costs for training of budgetary students in the absence of sufficient budgetary funding, can be covered only from the profit of educational organization after tax.

7. **Federal Law No. 258-FZ of 21.07.2011** has expanded the list of oil, tin, petroleum gas and gas condensate, for which the tax rate is set on minerals extraction (MET) at 0% for a fixed term and before achievement a certain level of output for each individual field. The procedure for MET assessment is specified for the imposed tax with due regard to a special adjustment coefficient for each particular subsoil area (Cs).

8. In the **budget message of the RF President to Federal Assembly of 29.06.2011** «On the budget policy in 2012-2014,» the basic trends of fiscal policy for 2012-2014 are outlined. Among them, in particular: a decline of insurance rates to the state extrabudgetary funds from 34 to 30% by 2012–2013 (for small businesses and nonprofit organizations engaged in core activities in social services, as well as charities organizations and those that use the simplified tax system - up to 20%), increasing the role of taxes paid by companies operating in the oil and gas sector, as well as alcohol and tobacco industries; adoption of the decision on accelerated introduction of property tax and the expansion of the patent system of taxation for small business, providing the possibility for large holdings to assess and pay corporate profit tax for the consolidated tax base of the holding;

clarification on benefits for depreciation bonus in the reconstruction, modernization and technical upgrading of fixed assets - allow not to restore a 30% depreciation bonus, previously provided to them.

9. **Letter of the Federal Tax Service of the Russian Federation No. ED-4-3/9835 @ of 21.06.2011** clarifies the application of some provisions of the Federal Law No. 23-FZ of 07.03.2011, dealing with accounting for tax purposes of income and expenses for small and medium-sized businesses in providing them financial support from the budget, as well as accounting for tax purposes of subsidies received for promoting self-employment of the unemployed in accordance with the Federal Law No. 41-FZ of 05.04.2010.

Reviewed by the RF Federal Tax Service example of a scheme for recording income and expenditure, in our opinion, does not fully comply with the rules of budgetary funds allocation, stated by amendments to the text of the Tax Code.

Let us consider the situation in detail. Thus, small and medium-sized businesses and self-employed individuals are granted budget subsidies.

According to Section 1, Art. 78 of the RF BC, subsidies to legal entities (with the exception of subsidies to state (municipal) institutions), individual entrepreneurs and individuals - producers of goods, works and services are provided at no charge and on non-refundable basis to recover costs or lost revenue during production (sale) of goods, works and services for reimbursement of costs or lost revenue.

It is noted in a case study, that these subsidies should be recorded in the Book of revenues and expenses of the taxpayer, applying a simplified system of taxation or a payer of the unified agricultural tax at the same time in income in an amount equal to the expenditures; that is, the income and expenses are reflected, for example, in the amount of Rb300,000. Proceeds from the sale of products (in this example - Rb350,000), according to the situation under review, is included in taxable income, but without repeated reflection of expenses.

If one follows the text of the Law, then, in our opinion, the taxable base should be the sum of Rb50,000, i.e., the difference between sales proceeds and expenditures (subsidies were granted for expenses reimbursement). But if sales proceeds exceed expenses, why non- chargeable and on non-refundable subsidies should be granted? In the case study under review the tax base included Rb350,000, i.e., the total amount of proceeds. Total income recorded Rb650,000, expenses – Rb300,000. If the subsidy is included in the income the organization, and sales proceeds, fully overlapping expenses are recorded in the same section, the funds received from the budget cannot be considered as subsidies for reimbursement of expenses specified in the in Art. 78 of the RF BC.

To illustrate the concept of subsidies, in our opinion, another example would be most suitable, in which revenues from sales amounted to Rb300,000 and the expenses - Rb350,000. In this case, indeed, the sum of Rb50,000 could be qualified as a subsidy for costs recovery. Herewith, if the market price of the goods was Rb410,000 and the state regulated price would be Rb300,000, then another Rb60,000 could be a subsidy for reimbursement of lost revenue.

The problem of the case study, in our opinion, is that the funds used in violation of Art. 78 of the RF BC, although they are called in the example of a subsidy, in fact, cannot be treated as such, and should be withdrawn to the budget.

Another controversial issue in this example is that, according to the RF Tax Service, the funds provided as a subsidy, used for other than reimbursement of expenses or lost revenue purpose, are to be included in taxable income. On our behalf, we can add that such pseudo-subsidies can be considered as part of taxable income, but only so long until they are withdrawn to the budget. According to the results of withdrawal of inappropriately used budget funds, the taxpayer’s income should be reversed.

10. Clarifications related to the delimitation of territorial jurisdiction of income and tax collection procedures in connection with the RF entry in the Customs Union (CU) are still of great importance. The most significant fact in the period under review is the agreement reached in respect of the territorial jurisdiction of tax bonuses (discount prices). **Information letter of the Russian Federation Ministry of Finance No. 03-08-06/BELARUS of 23.06.2011** (communicated by

letter of the Federal Tax Service of Russia No. ED-4-3/11069 of 8.07.2011 ) has clarified that members of the CU have agreed to consider the bonuses paid under delivery contracts, as profits from business activities, since such awards (bonuses) should not be considered as a separate type of income, but as compensation (reduction) of expenses incurred in connection with the purchase of goods. Herewith, in accordance with the Agreement, business profits of an enterprise located in one country shall not be taxable in another country. In other words, the Parties agreed to consider the actual transaction value (i.e., minus bonuses). This allows the Russian tax authorities to credit additional revenue to producers in case of deviation of actual selling price from the market price in cross-border transactions and thus to avoid tax evasion schemes.

# AMENDMENTS TO THE BUDGETING LEGAL FRAMEWORK

M.Goldin

*In July 2011 the following changes were introduced in the budget legislation: amendments were made to the Federal Law "On privatization of state and municipal property", which in particular, establish one more way of state and municipal enterprises privatization, i.e., the transformation into a limited liability company. Important amendments were made to a number of legislation acts that change the conditions of state and municipal agencies, as well as autonomous institutions activities.*

**Federal Law No. 201-FZ of 11.07.2011 "On Amending the Federal Law «On privatization of state and municipal property" No. 178-FZ of 21.12.2001** (hereinafter - the Law No. 178-FZ) has established a new way of privatization the state and municipal enterprises (SUE (MUE) is transformation into a limited liability company (LLC). This transformation can be achieved under certain conditions. Herewith, the transformation can be performed under certain conditions. It can be done in the event that the average number of its employees, the proceeds from the sale of goods or services, the cost of fixed assets and intangible assets do not exceed the limit indicators established for small businesses. In addition, to the conversion of a state or municipal enterprise in LLC is mandatory, if the volume of the share capital of a business entity, created in the process of privatization, is lower than the minimum capital of an open joint stock company, established by the legislation of the Russian Federation

Provisions of Art. 16 of the Federal Law "On privatization of state and municipal property" in regard to the list of documents, to be submitted by the buyers of state and municipal property documents re changed. In the previous edition of the Law No. 178-FZ, buyers of the state or municipal property, were to provide not only documents referred to in Art. 16 of the Law, but any other documents, the requirement for submission of which could be established by Federal Law. As amended by Federal Law No. 201-FZ of 11.07.2011, applicants are obliged to submit documents as per requirements established by Federal Law, if such documents (their copies, the information contained in them) are not possessed by public authorities, local authorities, or subordinated public organizations or local self-government authorities. In other words, buyers of the state or municipal property are relieved, in particular, of the burden of any documents not mentioned in Article. 16 of Law No. 178-FZ, execution of which is carried out by public authorities, local self-government authorities or their subordinate organizations. Apparently, if necessary, such documents should be submitted by public authorities, local governments or organizations subordinate to them, directly to the owner of the state or municipal property

Federal Law No. 201-FZ of 11.07.2011 has also modified the provisions of paragraph 2 of Art. 17 of Law No. 178-FZ on guarantees of labor rights of employees of privatized state and municipal enterprises. Now management of OJSC or LLC, created in the process of privatization of state or municipal enterprise can be offered to conclude a new collective agreement or to extend the previous agreement for up to three years. Earlier, OAO management could propose to revise he provisions of the effective collective agreement. The previous edition of Section 2, Art. 17 of the Law No. 178-FZ was compliant with Art. 44 of the RF Labor Code, according to which amendment of supplements to the collective agreement should be made in accordance with the Labor Code or in the manner prescribed by the collective agreement.

With regard to **Federal Law No. 239-FZ of 18.07.2011 "On Amendments to Certain Legislative Acts of the Russian Federation in connection with the improvement of the legal status of autonomous institutions"** (hereinafter - the Law No. 239-FZ), a number of important amendments have been introduced in the laws, that change the conditions of state and municipal agencies activities.

1) By the Law No. 239-FZ amendments are introduced to the Federal Law No. 7-FZ of 12.01.1996 “On Noncommercial Organizations” amendments are introduced in accordance with which the state and local agencies in case of changing the type of business are entitled, under their charter activities under the license, certificate of state accreditation, and other permits issued to them before the end of such documents validity term. Therefore, the change in the type of budgetary institution / public agency for the purpose of establishment an official government agency as well as changing of the type of the existing budget or public agency, or vice versa does not lead to the need to restructure the permitting documents.

2) Also, the Law No. 239-FZ of the RF Tax Code was amended with new provisions:

A) a list of transactions that are not recognized as subject to VAT in accordance with paragraph 2 of Art. 146 of the RF Tax Code, including: services and works of treasury, budget and autonomous institutions, performed (rendered) in the framework of state (municipal) assignment t the expense of budgetary subsidies;

B) the tax base for corporate income tax does not include revenues of public institutions as reported in due course before July 1, 2012, as the limits of budget liabilities (budget allocations);

C) Tax Code is supplemented with Art. 331.1, which establishes some of the features of tax accounting by budget institutions (for these innovations, see above under Section “Overview of regulations on tax issues for June-July 2011”).

3) Law No. 239-FZ has introduced amendments to the Federal Law No. 174-FZ «On Autonomous Institutions” of November 3, 2006, in particular, for sanctioning of transactions with funds that are transferred to the accounts of autonomous institutions, and establish the procedure for use in the current fiscal year budget surpluses provided to autonomous agencies.

In addition, amendments have established, that autonomous institutions, in respect to which there was no decision on reorganization, no liquidation or change of type before January 1, 2012, since this date will be automatically regarded as budgetary institutions. An exception is made for the institutions, established prior to January 1, 2011 in the form of autonomous agencies for facilitating of funds crediting, business-incubators and microfinance institutions.

Therefore, the change in the type of a budgetary institution in order to create the official government agency or agencies in the form of budgetary institution, as well as changing the type of the existing budget or treasury agency in order to create an autonomous entity, or vice versa, does not involve the need for re-execution of statutory documents.