



## RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES

08'2011

### MONTHLY BULLETIN:

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## THE RUSSIAN ECONOMY IN AUGUST: PRELIMINARY RESULTS AND MAJOR TRENDS

*The socio-political situation in August 2011 was rather calm although more 'businesslike' than usually. The most notable event was Georgy Poltavchenko's appointment to the post of St Petersburg governor. In his previous role of the RF President's Representative in the Central Federal District, Poltavchenko had definitely failed to achieve much in the public sphere, and proved himself one of the most lackluster officials of this rank. In all likelihood, he was appointed head of St Petersburg so as not to play any independent role but to materialize instead the decisions made by this country's top leadership. The 'semi-clandestine' election of Valentina Matvienko to St Petersburg parliament as a member for two of the city's districts at once (which was necessary for her to be appointed Speaker of the Council of the Federation) stirred a high and noisy scandal.*

*On the whole, at the beginning of the electoral period, the population's attitude towards the existing authorities and its assessment of the current state of affairs in the country are steadily becoming more and more negative, representing the trend that has become evident since early 2011. Thus, the balance of assessments of the situation in this country ('the country is moving in the right direction / has taken a wrong path', as stated in the polls conducted by the Levada Center) which had fluctuated, since January 2011, around the zero point, dropped in August to -8 points. The last instance when this index had fallen to such low values occurred in 2005. The balance of those who believed that the Government would be capable of improving the situation slid to 14 points (according to the poll conducted by the Levada Center), representing yet another negative high of the past five years. The ratings of the President and the Prime Minister also continued to worsen. Thus, a survey conducted by the Public Opinion Foundation revealed that in August the number of respondents trusting Vladimir Putin amounted to 49 % against 69 – 70 % in 2008 and 2009, 64 % in 2010, and 57 – 58 % in 2011, while the last time this index dropped to below 50 % was in early 2006. Thus, the controlled and manipulated elections of 2011 and 2012 will take place against the backdrop of the population's growing increasingly weary of the group in power and of the decreasing legitimacy of its leader, which can make these elections even more burdensome than expected for the state treasury.*

*The macroeconomic situation was determined in August by three major factors – the shocks to global financial markets caused by the lowering of the US credit rating; the seasonal factor; and the political factor of the forthcoming elections.*

*In August, one of the most notable events in the macro-economic sphere was deflation amounting to 0.2 %, which resulted in annual inflation dropping to 8.2 %, and brought the inflation accumulated since the beginning of the year to 4.7 %. The main contributor to these results was the seasonal deflation of fruit and vegetable products, although it should be noted that the prices of food commodities other than fruit and vegetable products, on the contrary, rose by 0.3 %. Attention should also be paid to the fact that the prices of non-food commodities increased by 0.5 % (a more significant rise than in August 2010) and that the Core Consumer Price Index amounted, in August 2011, to 0.4 %. All this means that, starting from the second half of September, the rate of inflation is going to somewhat increase.*

*However, in the medium-term, monetary pressure on inflation will decrease. The  $M_2$  continues to decline: in January – July it amounted to 4.2 % against 11.8 % in the corresponding period of 2010. This phenomenon should be viewed primarily in its political context: inflation is one of the most powerful irritants affecting the social mood of the population. It has already become a tradition for the Russian socio-political system to consciously compress the monetary base in anticipation of an election and thus to decelerate inflation. At the same time, the fruits of the pre-election generosity demonstrated by the authorities on the eve of the voting would be reaped after the election is over. This scenario will be perfectly fitted by the two-stage increase in the tariffs for natural monopolies (this variant is currently being discussed): from the New Year the tariffs will be raised only moderately,*

but their next rise will inevitably come in the spring or in the middle of 2012. Thus, the Bank of Russia's resumption of its long-term policy in the field of monetary regulation can be expected no earlier than the second half of next year.

In early August, in connection with the shocks experienced by world financial markets after the lowering of the US credit rating by Standard & Poor's, which caused, among other things, a drop in oil prices, the ruble weakened against the dollar (from 27.52 rubles per dollar as of 2 August to 29.41 rubles per dollar as of 10 August). As a result, in the second half of August the Bank of Russia resumed its practice of purchasing foreign currency (in August, the Bank's net purchase amounted to \$ 260 m against \$ 3.5 bn in July), and began to restrain the ruble's strengthening in connection with the growth in oil prices. Consequently, as of 31 August, the exchange rate for the rubles stood at 28.85 rubles for one dollar.

In connection with the events of early August, stock market indices also collapsed: the MICEX index dropped from 1,725 pp as of 1 August to 1,431 pp as of 10 August. At the same time, in spite of the fact that, by the end of the month, oil prices had climbed almost to their early-August level, the stock market indices managed to achieve only a partial rebound: having hit the bottom, the index lost 17 % of its value as of the beginning of the month; by the end of the month it amounted to just 90 % of its initial value (1,546 pp).

According to preliminary data, Russia registered zero net capital outflow in August; the balance between June inflow and July outflow was also close to zero. Russia's economic authorities are expecting that the inflow of capital will slightly increase in the last few months of the year. Thus, the capital outflow cycle that has lasted for four consecutive quarters is now apparently over. Over those four quarters, net capital outflow from Russia amounted to \$ 53.5 bn. On the whole, over the period from 2008 through the first half of 2011, net capital outflow from the Russian Federation amounted to \$ 255 bn, or two times more than the amount of net private capital inflow in 2006 – 2007 (\$ 123 bn).

In the summer of 2011, the situation in Russia's real sector of the economy was determined by stagnation of demand and low investment activity of enterprises at the beginning of the year. The Russian economy demonstrated symptoms of growth deceleration in comparison with the previous year. The index of production of goods and services by basic type of economic activities for January – July 2011 amounted 104.2 % against 106.5 % for the same period of 2010. Indicators for Q2 were also worse than those for Q1: in the first quarter of 2011, the index of the physical volume of GDP amounted to 105.0 % of that of Q1 2010, while in the second quarter of 2011 this index amounted to 103.4 % of that of Q2 2010.

The characteristic feature of the summer of 2011 was a decline in industry's contribution to economic dynamics. On the whole, in July 2011, industrial production rose by 0.4 % on June, while the processing industry registered a 1.9 percent decline in output. Growth deceleration in the processing industry was registered with regard to all types of economic activity except for the production of machinery, equipment and all the other non-metal mineral products whose development dynamic is most heavily influenced by the low base of 2009 and 2010. Over January – July 2011, the rate of industrial development dropped to 105.3 % against 109.6 % registered in the corresponding period of 2010. A similar decline in the rate of growth was typical of both the extracting and processing industry.

By July, the dynamic of the actual incomes of the population had become generally stable (in January – July 2011, these incomes amounted to 99 % of those registered in the corresponding period of 2010). Same was true of investments, whose growth in January – July 2011 amounted 3.6 %. Despite these achievements, we believe that economic life is not going to become significantly more robust in the second half of the current year. Its failure to do so will be determined not by the reputed uncertainty of the electoral results, but rather by the above-mentioned political decision of Russia's economic authorities aimed at containing inflation during the pre-election period. The restriction on the money supply will have a negative effect on the economic activity of enterprises: economic growth will be sacrificed in the interest of social stability. ●

## THE POLITICAL AND ECONOMIC RESULTS OF AUGUST 2011

S.Zhavoronkov

*Contrary to Russian traditions, August 2011 was surprisingly calm and uneventful. The job of St Petersburg governor was awarded to Georgy Poltavchenko, former Representative of the RF President in the Central Federal District, whose ten – year service in this capacity had been generally lackluster. The RF Government persisted in its aversion to reducing contributions to social insurance funds: no corresponding draft decision was introduced for consideration either by the RF President or the State Duma, while the preliminary estimates published by the RF Government envisaged that the contributions should be reduced only for incomes below Rb 512,000 per annum, while those above that level should, on the contrary, be increased. Rosneft and ExxonMobil signed a strategic partnership agreement which can be characterized, in its present form, as little more than a not-too-exacting protocol of intentions.*

In August, a new Governor of St Petersburg was appointed. The job was given to the Representative of the RF President in the Central Federal District Georgy Poltavchenko, who had spent his formative years in St Petersburg<sup>1</sup> and worked there in the 1990s as the head of the regional tax police administration. As is true of many other members of Putin's cohort, his attempts at winning in a free election were a failure – he was defeated in the 1998 elections to the St Petersburg Legislative Assembly. It can be safely said that both his rating and anti-rating in that city amount to zero, which is a major plus by comparison with the former Governor. When Poltavchenko was appointed to the post of the RF President's Representative in the Central Federal District, many people thought that he would eventually become Mayor of Moscow and expected that Poltavchenko would be called to restrict the powers of Yury Luzhkov. However, Poltavchenko's ten-year-long stay in office was completely lackluster not only with regard to the capital city, but to the Central Federal District as well. Poltavchenko proved to be one of the most inconspicuous representatives of the RF President (although he is clearly a record holder in terms of the length of his stay in office). In 2003, Valentina Matvienko had a similar status whilst she was being elected St Petersburg Governor – her appointment was an attempt to keep at arm's length all the biggest St Petersburg clans. Nevertheless, the balance of forces among them remained very much in flux, which inevitably resulted in rising political tensions. To make matters worse, additional complications arose when it suddenly became clear that Matvienko's son was a businessman. In August 2011, it turned out that Russia's authorities once again gave preference to a weak governor – at least at the initial stage – and so chose not to appoint to this post one of the federal politicians of St Petersburg origin (Boris Gryzlov, Dmitry Kozak, etc.).

In August 2011, Valentina Matvienko was elected municipal deputy for two St Petersburg municipal formations at once (*"The Red Rivulet"* and *"Petrovskoye"*), and then was delegated to the Council of the Federation to hold a ceremonial post of Chairperson of the Upper Chamber of Parliament, whose influence on the legislative and political processes is even lower than that of the State Duma. Matvienko's election instantly brought to light the following two facts. First, her election revealed the inconsistency of Russian electoral legislation reflecting the authorities recent trend to introduce some cosmetic innovations, and thus to disguise their reluctance to abolish the main antidemocratic norms and embark on true reform. These innovations include a provision stipulating that any member of the Council of the Federation must initially be elected as a regional or municipal deputy. Now the authorities are confronted with the task of overcoming the hurdles of their own making, and so they need to stage a comedy with simultaneous mass resignations of deputies in many municipal formations, in order to make it more comfortable for Matvienko to

<sup>1</sup> Like Valentina Matvienko, Georgy Poltavchenko was born not in St Petersburg, but while Matvienko, prior to being nominated for Governorship had had nothing to do with St Petersburg for the preceding twenty years of her career, Poltavchenko came to Moscow as late as 2000.



choose between them. Secondly, the elections caused a loud scandal by the fact that they had been launched as a clandestine affair. Before the candidates for deputies to the *Petrovskoye* and *Black Rivulet* municipalities had completed their registration, nobody but the organizers of this special operations was aware that any the elections of this sort were to take place at all: the relevant information was published *post factum*, after the event had already taken place, thus making it impossible for the opposition not only to nominate any candidates of their own, but even to appoint election supervisors – which was even more important. So, the authorities evidently have a way of preparing local officials for forthcoming elections to the State Duma without paying attentions to anything or anybody, and this happens not only in faraway Chechnya, but also in the totally European city of St Petersburg.

August also saw a continuation of the rather amusing no-go situation with the “reduction” of insurance contributions, which in practice has resulted, for many citizens, not only in their increased rates but in an outright abandonment of the flat rate income tax system, the introduction of which was one of the key elements of the major tax reform of the 2000s. In March, Dmitry Medvedev instructed the Government that proposals concerning rate reductions be developed by 1 June; in June he specified that the case in point was the need to lower the rates from 34% to 26 – 30%, depending on the type of business. However, the Government has so far failed to introduce any proposals that could be submitted for the consideration by either President Medvedev or the State Duma. On the contrary, the proposals aired at the Government’s meetings in July were aiming at reducing the rate to 30 % only for those taxpayers whose incomes did not exceed Rb 512,000 per annum, while amounts in excess of that threshold should not be granted any tax reduction, being subjected instead to a tax increase of 10 % (a 6 – percent rise on the current rate). In August, Vladimir Putin once again stated: “*We are not reneging on our previously formulated proposals, they are practically ready... There is nothing to be worked further on there, the whole thing needs to be simply put into form*”. What these words mean precisely has remained unclear to the general public.

However, the RF Ministry of Finance has published a final version of “*The Main Directions of the Tax Policy of the Russian Federation for the Years 2012 – 2014*”. This document sets the rates of insurance contributions for the year 2012 at 30 % per annum for annual salaries of up to Rb 512,000, plus 10 % for any amounts in excess of that threshold, with a provision that the said threshold can be further raised in 2013.

It is quite evident that the logic of tax increases was accepted by the Russian authorities as early as 2008, and that they are not going to abandon it. As for RF President Dmitry Medvedev and his assistant Arkady Dvorkovich, who have already put themselves in an uncomfortable situation by promising to cut taxes, everybody knows that their terms in office will soon expire, and that with each consecutive month the Government has less and less reasons to additionally consult them on tax matters. For the Russian middle strata who, although not making up the majority of the population, nevertheless number tens of millions of people, these government initiatives imply that they will need to resort to a more intricate procedure of keeping their accounting records, or that their own position will become more difficult, while the Russian budget will have to undergo a long – term test for stability.

However, in August it was announced that in the first half-year of 2011 the state budget was executed with a surplus of 2.9 % of GDP, thus presenting a chance that a deficit – free budget could be achieved even in the current year, provided that the existing prices of energy carriers, and first of all oil prices, will remain intact. The RF Ministry of Finance, whose opinion was voiced by Deputy Minister of Finance Anton Siluanov saying that ‘most probably, we will have a budget deficit’, happens not to share the Government’s optimism, putting the blame on the new obligations it is feverishly taking upon itself in the pre-election year.

In August, the RF Government continued the discussion on the tariffs to be established for Russian monopolies. So far, although no final decision has been reached yet, *Gazprom* has asked that the price of natural gas be increased by 15 %, and *Russian Railways* – that the tariffs for freight and passenger transportation be hiked by 7 and 10 % respectively. The RF Ministry of Economic Development has summarized the data from the Russian energy sector at 10 to 11 % on average. It should be reminded that in May 2011, when speaking at the United Russia conference

in Volgograd, Vladimir Putin stated that ‘*The RF Government can limit the 2012 increase in the tariffs on natural monopolies to the next year’s inflation rate*’. Most probably, the tariffs will be increased gradually in two steps, with the heaviest increase taking place in April 2012 after the Presidential election.

In late August, a new agreement was concluded between *Rosneft* and its new foreign partner – this time, instead of *BP*, the contract with which had been terminated through foreign courts by the Russian co-owners of *TNK-BP*, *Rosneft*’s strategic partner was declared to be *ExxonMobil*. Despite the pompous ceremony of signing the agreements (this time attended by Prime Minister Putin), the new alliance has raised even more questions than the previous one did. While the transaction with *BP* had envisaged a mutual exchange of shares, which was important for *Rosneft* in order to legalize its presence in the international legal field in the wake of the ‘UKOS affair’, its transaction with *ExxonMobil* does not envisage any provisions of that sort. It has only been stated that *ExxonMobil* will become *Rosneft*’s partner in developing the deposits of the Kara and Black Seas, and also in a number of unspecified *ExxonMobil*’s projects in Texas and in the Mexican Gulf (*ExxonMobil* will receive 33 % of shares in Russian assets, while *Rosneft* will receive a similar package in American ones). Any actual extraction of oil within the framework of these projects, especially in the Kara Sea covered in perpetual ice and in the fissures of the Black Sea’s floor, still belongs to the domain of virtual reality – it is yet to be proved that it can be profitable or even technically possible. It should be remembered that a similar project in the Black Sea was recently abandoned by *Chevron*. As regards *Rosneft*’s participation in American projects, it also remains equally unspecified so far. At present, all that we can speak about is cooperation in theory between the two parties, which can make it possible for *ExxonMobil*, in exchange for a pro-Russian-authorities public resonance, to hold on to its major Russian asset – the *Sakhalin-1* project, which the company is still operating at a time when foreign shareholders have already lost control over many other projects, for example *Sakhalin-2*. ●

## INFLATION AND MONETARY POLICY

N.Luksha

***In July 2011, for the first time in the recent history of Russia, consumer prices were not growing. The main restricting factors were deflation in food products (-0.7 per cent) and decrease in fuel inflation (from 6 per cent in May to 0.5 per cent in July). During three weeks of August, consumer prices have declined by 0.1 per cent. As a result, cumulative inflation since the beginning of the year amounted to 4.9 per cent by August 22. Increase of gold quotations and foreign currency revaluation contributed to the August growth in foreign currency and gold reserves: as of August 19, they increased to \$544 bn. A downfall in the global stock markets and falling oil prices in August, which followed the decrease of the US credit rating, have affected the rating of the Russian currency, which on the first week of the month fell down by 6.4 per cent against the currency basket to Rb35.11.***

In July 2011, for the first time in the recent history of Russia, consumer prices were not growing. This was due to food deflation, as well as slower growth in prices for non-food goods and commercial services. In the last week of the month, the deflation was recorded at 0.1 per cent.

For the second consecutive month, food prices are declining: in July deflation reached 0.7 per cent (0.2 per cent in June). The main constraint to the food inflation has become a seasonal reduction in prices for fruit and vegetable products (-9.2 per cent). In July, a decline in prices was observed in a number of other products: cereals and beans (-0.9 per cent), sunflower oil (-0.2 per cent). However, if not for falling prices for fruit and vegetables, the increase in food prices in July would amount to 0.4 per cent. Sugar and eggs, which were growing in price in June, have grown in July by 1.7 per cent and 1.1 per cent, respectively.

In July, there was a slightly slower rate of increase in prices for non-food products - 0.3 per cent. This is due, primarily, to a slowdown in fuel inflation rate: gasoline prices growth has decreased by nearly 3.5 times, to 0.5 per cent per month. In July, depreciation of audio-video was continued (-0.2 per cent).

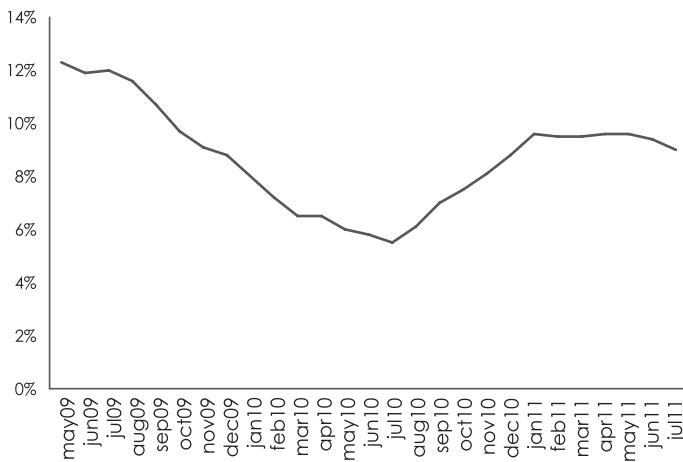
The rate of prices growth for commercial services has also somewhat declined, having reached 0.6 per cent in July. As a result of the seasonal increase in demand for tourism services, prices for the recreational-health services were growing (5.1 per cent), as well as for passenger transportation (+2.6 per cent) and tourism (0.9 per cent). In July, no decline in prices for paid services was observed in July.

In July, year to year inflation continued to slow down, having reached over the month from 9.4 per cent to 9 per cent (see *Fig. 1*). During three weeks of August the consumer price index decreased by 0.1 per cent. We would like to recall that during the same period of 2010 due to the negative aggregate supply shock, associated with weather anomalies, the increase in prices made 0.6 per cent.

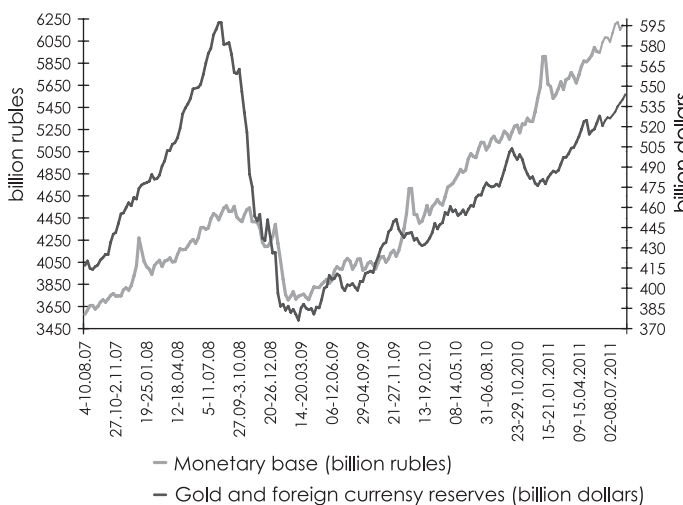
Despite the decline of the total inflation indicator, the monetary inflation remained high. This is evidenced by the growth in basic consumer price index<sup>1</sup>. In July, it rose to 0.4 per cent from 0.3 per cent a month before, having matched the indicator of the same period of the last year.

Nevertheless, in the medium term, the monetary pressure on inflation will decline. The growth rate of M2 monetary supply continues to slow down: within January-July, it made 4.2 per cent, while during the relevant period of 2010 its indicator made 11.8 per cent. An additional counter-inflationary factor can also be a slowing production inflation, which provides an impact on the cost of consumer basket with a time lag: for a second consecutive month the producer price index is getting decreased (production deflation in July made 1 per cent).

<sup>1</sup> Basic index of consumer prices is an indicator of the inflation level without regard to seasonal price reduction (fruit and vegetable products) and to administrative measures (tariffs for government-regulated services, etc.). It is estimated by the RF Statistics Service



Source: RF Statistical Service.  
 Fig. 1. The Growth Rate of the CPI in 2009-2011 (% year to year)



Source: RF Central Bank.  
 Fig. 2. Changes in the Monetary Base and in the Gold and Foreign Currency Reserves in 2007 – 2011

month, they have increased by 2.9 per cent to \$544 bn as of August 19. The main contribution to the increase in reserves in August was made by foreign exchange revaluation, as well as the appreciation of gold. The growth of gold quotations in early August was associated with instability in the currency markets, because of which investors have become out of risk assets, investing in precious metals.

In July, in order to mitigate the fluctuations in the exchange rate of the ruble, the Bank of Russia has again emerged in the market with the net purchases of foreign currency in the amount of \$3,706.6 bn and Euro1,003.8 bn (see Fig. 3). In contrast, in early August, after the collapse in global stock markets and the followed-up drop in oil prices, for the first time since the year beginning, the Bank of Russia has resorted to selling foreign currency to maintain the ruble rate. There is no official data on the volume of foreign exchange intervention yet, but S. Shvetsov, Deputy Chairman of the Central Bank has confirmed the involvement of the Bank of Russia in the foreign exchange market situation. At the same time, we would like to note, that, according to the dynamics of international reserves, the sales of foreign currency of the Bank of Russia were not high. Thus,

Ministry of Economic Development maintains the official estimates of the annual inflation at the level of 6.5-7.5 per cent. We believe, that in the absence of adverse shocks, CPI can reach 7.5-8 per cent as of the year results.

In July, monetary base in broad definition fell down to Rb7,147.3 trillion (-3.5 per cent). This was due to the sharp decline in deposits and correspondent accounts of credit organizations with the RF CB. The volume of deposits in July has declined by more than three times to Rb145.7 bn rubles, having actually returned to the level of May. Correspondent accounts decreased by 9.7 per cent to 710.4 bn. As a result, the excessive reserves of commercial banks<sup>1</sup> have declined by one third to Rb889.5 bn.

The outflow of funds of the banks' assets from the Bank of Russia is based, on the one hand, with a period of quarterly tax payments, and on the other hand, with more favorable terms of the funds placement in the interbank market in July, rather than in the deposits with the Bank of Russia. Thus, the deposit interest rate in the Central Bank in July was 3.5 per cent, while that rate with MBC reached 4.5 per cent.

The growth of cash in circulation by 2.2 per cent and mandatory reserves by 3.1 per cent in July led to the expansion of the monetary base in narrow definition (cash plus required reserves)<sup>2</sup> by 2.3 per cent to Rb6,257.9 (See Fig. 2). In July and August, foreign currency and gold reserves continued to grow. Over the

1 Under the excessive reserves of commercial banks in the Central Bank rating if understood the sum of correspondent accounts of commercial banks, their deposits with the CB and the CB bonds from commercial banks.

2 We would like to remind, that the monetary base in the broad definition is not a monetary instrument, it reflects the obligations of the Bank of Russia in national currency. The monetary base in narrow definition is a monetary instrument (one of indicators of the volume of monetary offer), which is under total control of the RF Central Bank.

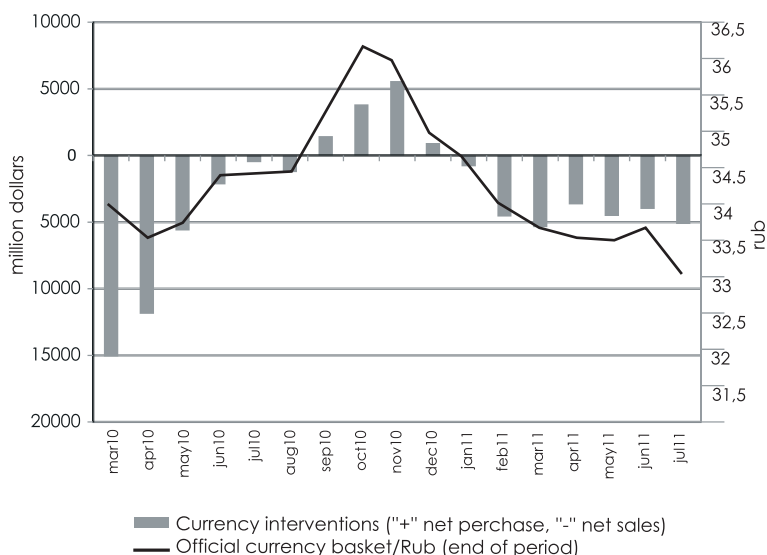


the Bank of Russia has confirmed its intention to reduce its intervention in the foreign exchange market, while avoiding significant interventions to prevent the ruble weakening.

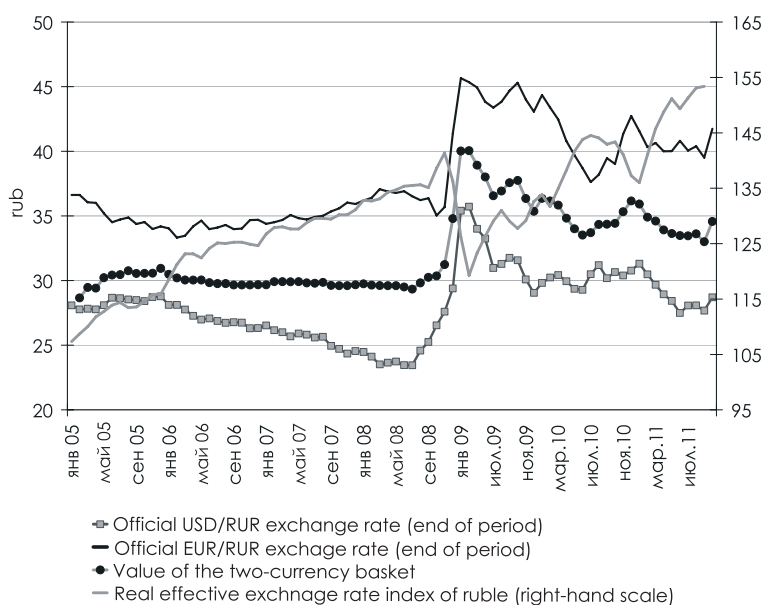
In July, the real effective exchange rate continued to grow (+0.2 per cent). Real effective exchange rate reached 153.4<sup>2</sup> (see Fig. 4).

A key event in August, that has affected the rate of the Russian currency have certainly become the events in the U.S. financial market. At the same time, together with the unprecedented decrease of the US international credit rating by agency Standard & Poor's agency from AAA to AA+, there was a downfall in the international stock markets and a fall in oil prices. Only in a week, the price of Brent crude oil fell down by \$15, from \$118 to \$103 per barrel. As a result, the rate of the Russian currency has fallen sharply, which once again demonstrated the strong dependence of the Russian currency on the external economic situation. The ruble rate to the US currency has decreased immediately by 7 per cent to Rb29.45/\$1, and against the European one - by 6 per cent to Rb42.03/Euro 1. As a result, the two-currency basket has risen by 6.4 per cent to Rb35.11.

On August 26, 2011, the Board of Directors of the Bank of Russia has decided to establish the interest rate on loans secured by gold, provided for up to 90 calendar days, at the rate of 7 per cent per annum. Thus, the RF CB has expanded the list of refinancing of banks' refinancing instruments, previously included lending under securities from the Lombard list, as well as loans secured by non-marketable assets (bills of exchange and of claims on loans). We believe that this tool is quite liable, but it is unlikely it can play a major role in refinancing of the banks in view of the relatively small share of gold in the assets of the Russian banks. ●



Source: RF Central Bank, author's estimates.  
 Fig. 3. Central Bank currency Interventions and Dynamics of Ruble Exchange Rate in March 2010 – July 2011<sup>1</sup>



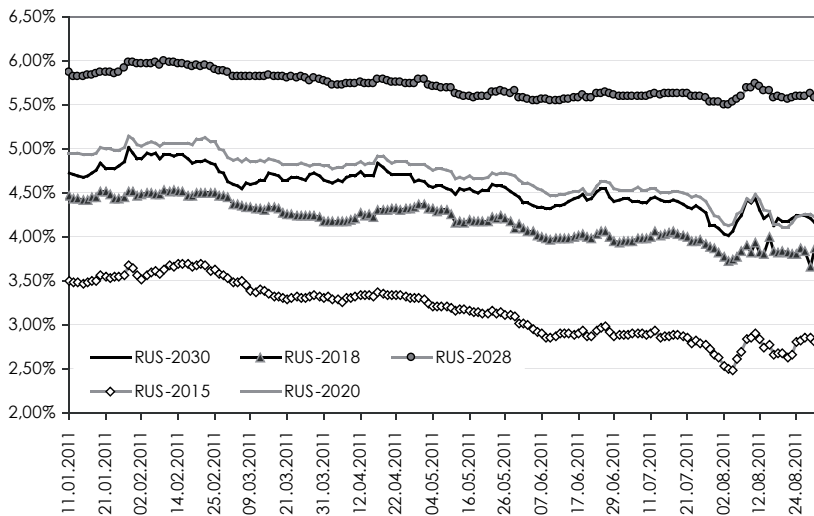
Source: RF Central Bank, author's estimates.  
 Fig. 4. Indicators of ruble exchange rate dynamics in January 2005 – August 2011<sup>3</sup>

1 The level of January 2002 is accepted as 100 per cent.  
 2 The level of January 2002 is accepted as 100 per cent.  
 3 The level of January 2002 is accepted as 100 per cent.

**FINANCIAL MARKETS**  
N.Burkova, E.Khudko

In August, the indices of government securities markets and the main RF stock indices have significantly decreased. In the domestic corporate bonds market the situation with the emitters' performance of their obligations to bondholders has improved. At the same time, the average weighted yield of corporate bonds reached a local maximum for the past eighteen months, what is largely due to the unfavorable situation on foreign markets.

**Government securities market**



Source: "Finmarket" Information Agency data.  
Fig. 1. Yields to maturity of the Russian Eurobonds with maturity in 2015, 2018, 2020, 2028 and 2030 in January – August 2011

The world markets collapse due to decline of the U.S. credit ratings and forecasts has led to significant volatility in the yield to maturity of government securities within August. In addition, the investors' preferences have transferred to the long-term government bonds.

At the same time, as of August 31 of the current year, the Russian Eurobonds yield to maturity has declined as compared with July 26. The greatest decrease in the yield to maturity was demonstrated by the most long-term securities offered in this market, Eurobonds RUS-20 (by 6.75 per cent) and RUS-30 (by 5.95 per cent). (See Fig 1). Within the period from July 27 to August 31, the total turnover of the secondary market

of government bonds amounted to Rb127.73 bn with an average daily turnover at the level of Rb4.91 bn, which is the decline of the daily average monthly turnover nearly two-fold as compared with the previous period.

In the period from July 27 to August 31, like a month before, there were held 5 auctions in federal loan bonds (OFZ) placement in the primary market (see Table 1). The total actual amount of placement made 41 per cent of the planned volume (68 per cent in the preceding period). We would like to note, that the largest amount of placement (50 per cent), despite the lower rates than in the early and mid-August, was observed in late July and late August. On August 10, in the period of instability in the global and Russian financial markets, there were actually placed in only about 0.13 per cent of the planned scope, despite the highest proposed rate of the average weighted yield in August in the amount of 7.8 per cent. There were no auctions on additional OFZ placement in the secondary market.

Table 1

OFZ PLACEMENTS IN THE PRIMARY MARKET

Auction date	Emission	Emission volume, RB m	Emission volume at face value, RB m	Average weighted yield
27.04.2011	OFZ-26204-PD	20 000.00	19 782.05	7.71
04.05.2011	OFZ-25077-PD	40 000.00	31 628.97	7.39

Table 1, cont'd

Auction date	Emission	Emission volume, RB m	Emission volume at face value, RB m	Average weighted yield
11.05.2011	OFZ-25076-PD	20 000.00	19 409.99	6.61
18.05.2011	OFZ-25076-PD	20 000.00	6 883.31	6.60
Total:	100,000.00	77 704.33		

Source: RF Ministry of Finance.

## Stock market

### *External factors of the Russian stock market dynamics*

The key factors of the Russian stock market downfall in early August were the decline of the U.S. credit rating, placing the credit rating of Spain under review by Moody's Investors Service agency and decline the sovereign credit rating of Greece by Standard & Poor's from the level of CCC to CC. Further support to the market were provided by counter-recession measures taken to resolve existing problems in the Euro zone, statements of the U.S. Federal Reserve leaders, as well as recovery in global oil prices.

In general, the markets of developed and developing countries were demonstrating a downward trend (See *Table 2 and Fig. 2*).

Table 2

### DYNAMICS OF THE GLOBAL STOCK INDICES (AS OF AUGUST 31, 2011)

Index	Value	Dynamics within the month (%)*	Dynamics from the year beginning (%)
MICEX (Russia)	1 546.05	-10.22	-8.41
RTS (Russia)	1 696.02	-14.68	-4.19
Dow Jones Industrial Average (USA)	11 613.53	-7.10	0.31
NASDAQ Composite (USA)	2 579.46	-9.17	-2.77
S&P 500 (USA)	1 218.89	-8.49	-3.08
FTSE 100 (UK)	5 394.53	-9.03	-8.57
DAX-30 (Germany)	5 784.85	-21.29	-16.33
CAC-40 (France)	3 256.76	-14.02	-14.40
Swiss Market (Switzerland)	5 528.52	-7.71	-14.10
Nikkei-225 (Japan)	8 955.20	-11.31	-12.45
Bovespa (Brazil)	56 495.12	-4.79	-18.48
IPC (Mexico)	35 721.10	1.07	-7.34
IPSA (Chile)	4 288.35	-5.24	-12.97
Straits Times (Singapore)	2 885.26	-9.46	-9.55
Seoul Composite (South Korea)	1 880.11	-13.31	-8.33
ISE National-100 (Turkey)	53 946.09	-12.12	-18.27
BSE 30 (India)	16 676.75	-9.94	-18.69
Shanghai Composite (China)	2 567.34	-5.02	-8.57
Morgan Stanley Emerging&Frontier Markets Index	816.36	-10.55	-10.46

\* – Versus index indicator valid on July 26, 2011

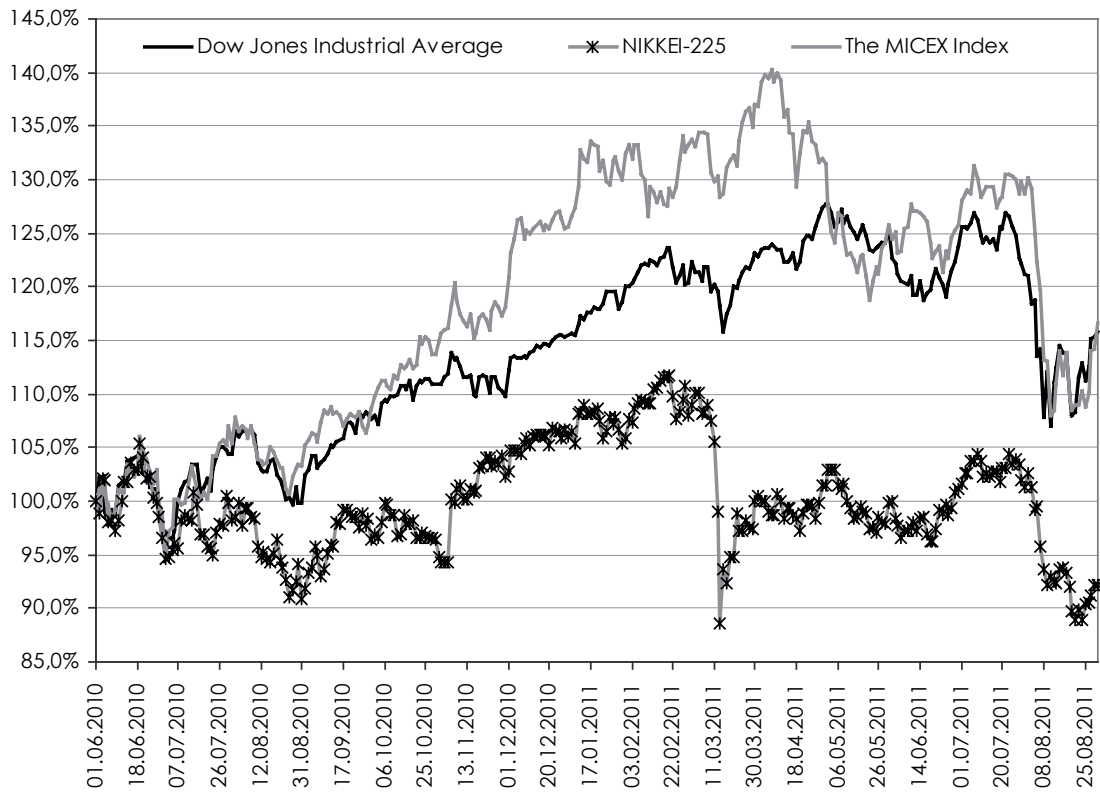
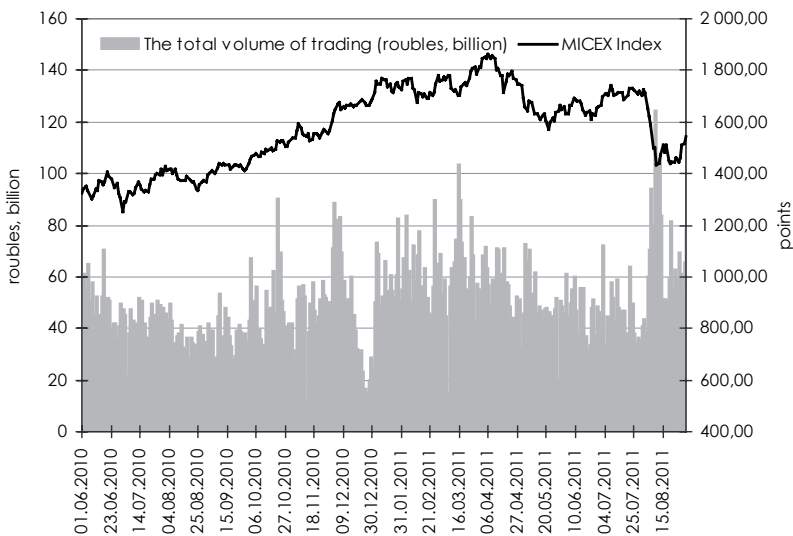


Fig. 2. Dynamics of the main USA, Japanese and Russian stock indices (in % to the date 01.06.2010)

**Stock market situation development**

Uncertainty in deciding whether to increase U.S. government debt in the last three weeks of July has resulted in a lateral trend in the stock market of Russia at the end of July 2011. Poor macroeconomic statistics from the U.S., despite the adoption of the U.S. Senate’s decision to approve the plan to increase the public debt of the country, as well as the dynamics of the Italian and Spanish bonds have reduced the stock market share of the Russian Federation on August 2. Reducing rating outlook of the U.S. government bonds to “negative” by Moody’s Investors Service agency, lowering credit rating of the United States by Standard & Poor’s agency to the level of AA + and rating outlook to “negative” have led to the downfall of the Russian stock market, which lasted until August 11, and to volatile



Source: MICEX.

Fig. 3. Dynamics of MICEX Index and trading volume

dynamics of the Russian stock market over the next two weeks. In the last week of August, a growth in the Russian market has been urged by the increase in oil prices, good financial performance of the Sberbank, as well as confirmation of the RF sovereign credit ratings with “stable” outlook by the Standard & Poor’s rating agency. The maximum value within the month the MICEX index has demonstrated on August 1, having reached 1,725.1 points (1,740.53 points in the preceding month). The minimum value for the period the MICEX index has reached on August 10 – 1,431.41 points (against 1, 687.63 points in the preceding month) (See Fig. 3).



In general, within the period from July 27 to August 31, 2011, the MICEX index has decreased by 10.22 per cent, what makes about 176.06 points in absolute terms (from September 1, 2010 through August 31, 2011, the MICEX index has been upgraded by 10.86 per cent), and the turnover of trades in securities included in the MICEX index has reached Rb1,776.49 bn. The average daily level of investor's activity in the stock market in August has increased as compared with the preceding period by 42 per cent. In addition, on August 9, 2011, against the background of high volatility and increased activity of participants, a record trading volume of shares included in the MICEX index was registered in the total amount of Rb124.38 bn.

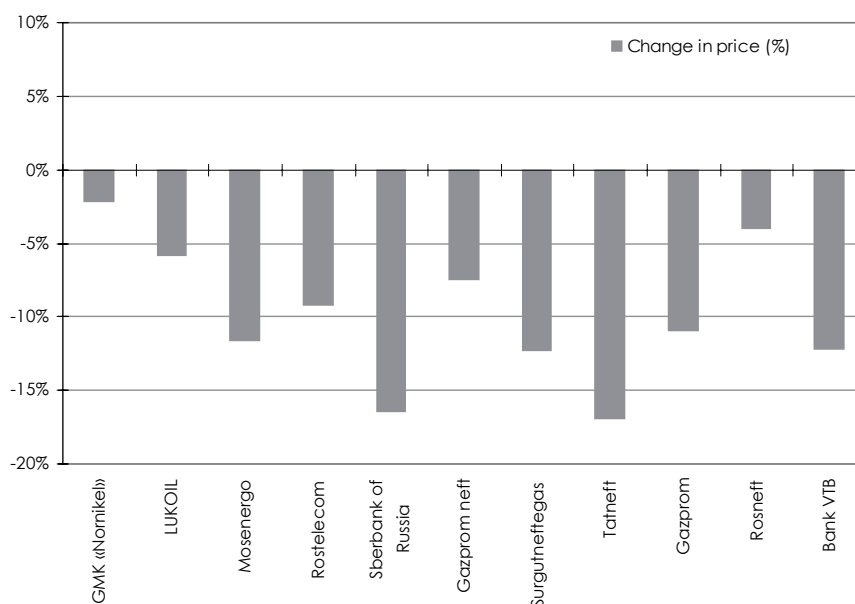


Fig. 4. Dynamics of the Russian Blue Chips from January 1, 2011 to August 31, 2011

In the period from January 1 through August 31, 2011, the leaders in the value decline among the “blue chips” were securities of Tatneft and Sberbank, which have declined by 16.93 and 16.42 per cent accordingly (See Fig. 4).

According to MICEX information, as of August 31, the top five leaders of the domestic stock market in terms of capitalization were: “Gazprom” – Rb4,213.18 bn, “Rosneft” – Rb2,389.15 bn, “Sberbank of Russia” – Rb1,807.26 bn, “LUKOIL” - Rb1,477.6 bn and GMK “Nornickel” – Rb1,36.56 bn.

### **Futures and Options Market**

In August 2011 (from July 27 to August 31) the average daily turnover in the MICEX futures market has decreased by 45 per cent as compared with the preceding month. The largest volume of trading in August, like a month before, was observed in contracts for futures and equity instruments, amounting to Rb25.64 bn (78.8 thousand of transactions). Herewith, in terms of the trading volume in this section of the futures market, the futures contracts for MICEX index are followed by the futures supply contracts for the shares of Gazprom, LUKOIL, Nornickel and Sberbank. We would like to note, that the value of the MICEX index (the price of transactions) for December 2011 was within the range of 1,420–1,730 points, i.e., the majority of the market participants expect a volatile dynamics as compared with the indicator of August 31, 2011.

The second place in terms of trading volume (Rb7.62 bn) within the month of May was taken by foreign currency futures contracts. The first place in terms of trading volume in this section was taken by the futures contracts for US dollar, followed by the futures contracts for Euro/US dollar and Euro/Rb rate. Prices of futures contracts, concluded in August for Rb/US dollar in the MICEX market for December 2011 were within Rb/\$ 28.2–30.2, i.e., 0-4.6 per cent decline is expected as compared with the indicator of August 31, 2011 (28.86 Rb/\$). Within the period under review, trading volume in futures for interest instruments amounted to Rb2.05 bn. It is followed by futures for commodity assets (Rb794 m).

In the RTS FORTS futures market the investors' average daily activity in August has increased by 36 per cent (0.24) as compared with the previous month. Herewith, in the first place in terms of futures trading volume were the futures contracts for the RTS index, which were followed with a significant margin by the futures contracts for the Rb/\$ rate, for Euro/\$ rate and for the shares of Gazprom and Sberbank of Russia shares. Prices of the latest transactions, concluded in the RTS FORTS on futures contracts for Rb/\$ rate for the date of execution on December 15, 2011, were

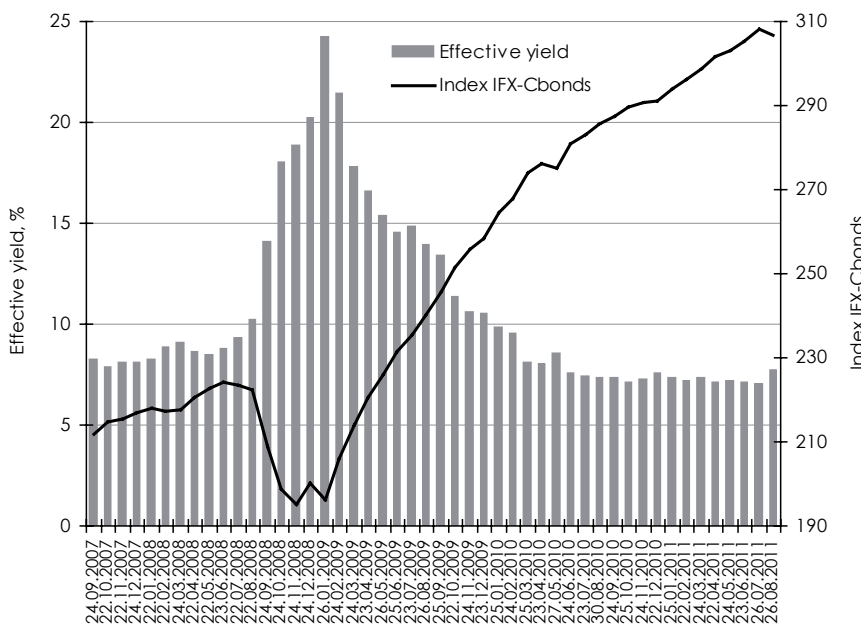
basically within Rb/\$ 28–30.2, i.e., there expected 0-4.6 per cent Rb reduction versus the indicator of August 31, 2011. The value of futures contract for the RTS index (based on the prices of recent contracts) with the execution date on December 15, 2011 made 1,540–1,960, i.e., there expected a volatile dynamics versus the indicator of August 31, 2011. Options enjoyed far less demand, their turnover made about Rb496.88 bn (against Rb6, 878.26 bn in futures).

**Corporate bonds market**

The volume of the Russian domestic corporate bonds market (as per nominal value of shares in circulation, denominated in national currency) in August of the current year continued its regular growth rate and at the end of the month reached the level of RB 3,335.2 bn, having gained 1 per cent against the relevant indicator of the late July<sup>1</sup>. As a result, the volume of the bond market has once again updated the historical maximum. Such significant growth in the market volume took place again due to the increase in the number of emissions: 746 issues of bonds denominated in national currency, against 754 emissions at the end of preceding month. Herewith, the number of emitters represented in the debt segment of the securities market was changed insignificantly: 344 emitters against 340. The above statistics shows once again an increase in the number of loans placed by each emitter on average. Among the emissions denominated in foreign currency, there is still only one emission of bonds in circulation, in Japanese yens.

In the secondary market of corporate bonds investors have shown a very high activity and trade indicators have exceeded the record values of March-April of this year, updating the record indicators over the past few years. Thus, from July 27 through August 31, the total volume of transactions in the MICEX stock exchange amounted to Rb200.9 bn (for comparison, from June 23 to July 26, the turnover was equal to Rb175.3 bn), and the number of transactions made 31.7 thousand (27.3 thousand in the preceding relevant period)<sup>2</sup>.

Index of the Russian corporate bonds market IFX-Cbonds growth, observed since May 2010, was sustained due to the problems in the global financial system and as per august results decreased by 1.6 points or 0.5 per cent. As a result, the index has updated the highest peak since the start of its assessment. Together with this trend, the relative weighted average effective yield of corporate bonds in the period under review has made 7.7 per cent against 7.08 per cent



Source: Cbonds data

Fig. 5. Dynamics of the Russian corporate bonds index and average weighted yield

at the end of July (See Fig. 5). Therefore, the interest rate has overcome the established range of 7.0–7.6 per cent. The situation in the Russian segment of the debt was in the first place influenced by high volatility in the global financial markets.

The yield of the most liquid bond emissions in August has also demonstrated a growing dynamics, though in June-July the rates were declining by 0.2-0.4 p.p. To the greatest extent increased interest rates on bonded loans of the emitters in financial sector. The yield of securities of metallurgical and mining companies increased by 0.6 – 0.8 p.p. Low volatility of interest rates was observed among energy companies,

1 The Russian Federal Financial Markets Service data.  
 2 As per “Finmarket” Information agency.

which as compared with other sectors of the economy, showed minimal yield growth (on average no more than 0.3 – 0.4 p.p.).

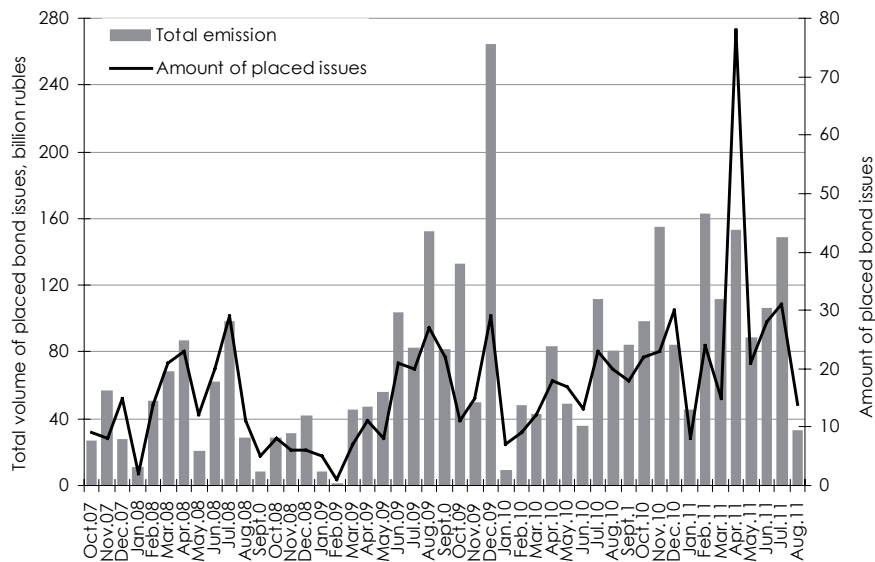
Despite the change in the dynamics of some indicators of the bond market from positive to negative trend, in August there were a lot of bond issues. Thus, in the period from July 26 to August 26, there have been registered 38 corporate bond issues for the total nominal value of Rb146.3 bn (for comparison, from June 24 to July 25, there were 18 issues totaling to Rb35.8 bn). Almost half of the emissions accounted for stock bonds of rather large emitters of the financial sector.

Despite the high activity of the emitters for the debenture issues, there were few new placements in August, probably due to low rates of registration in the preceding month. From July 26 to August 26, 12 emitters have placed 14 issues of bonds with a total nominal value of Rb32.6 bn (from June 24 to July 25, there were placed 31 series of bonds amounting to Rb148.8 bn) (See *Fig. 6*). Herewith, among other emissions, investors were actively purchasing relatively small bond issues - in the range of Rb1-2 bn. Among the largest bond emissions one should highlight a series of exchange-traded bonds of OAO “Magnitogorsk Metallurgical Works” with a face value of Rb5 bn, a series of exchange-traded bonds of OAO “OTP Bank” for Rb5 bn, two series of exchange-traded bonds of Commercial Bank ZAO “Globex” for the total nominal value of Rb5 bn, a series of exchange-traded bonds of CB OOO “Renaissance Capital” with the nominal value of Rb3 bn.

In contrast to previous months, when long-term bond issues enjoyed high demand from investors, in August practically placements were made with three-year issues, which led to a reduction in duration of the debenture bond portfolio. Only “Mehprachechnaya SvZhD” once again attracted funding for a period of 15 years<sup>1</sup>.

In the period from July 26 to August 26, eleven emitters should have to repay their bond debts for the total amount of nearly Rb22.4 bn. However, three emitters have not fulfilled their obligations in the due dates and announced a technical default on repayment of bond loans worth of Rb7.8 bn (for the preceding relevant period three emitters failed to meet the scheduled commitments). In September 2011, 16 corporate bond issues are expected to be paid off for the total amount of Rb47.9 bn<sup>2</sup>.

At the same time, it is necessary to emphasize that the situation with the announcement of the actual default, when the issuer is unable to pay the income to the owners of securities in the nearest days after the scheduled date of performance, has been improved in August. From July 26 to August 26, only two emitters failed to pay coupon income to the bondholders (against four of the emitters from June 24 to July 25). As for the of bonds repayment at par value and early redemption of the securities on offer, all emitters met their obligations on time or within the framework of a technical default (in June and July 2–3 emitters declared an actual default on repayment of securities emissions)<sup>3</sup>.



Source: Rusbonds data  
 Fig. 6. Dynamics of corporate bonds primary placement, denominated in national currency

1 Rusbonds data.  
 2 Rusbonds data.  
 3 Cbonds data.

## REAL ECONOMY: TRENDS AND FACTORS

O.Izryadnova

*In January-July 2011 index of goods and services output as broken by basic types of economic activities made 104.2% versus 106.5% in the corresponding period of the previous year. In July 2011 the increase in investments in fixed assets made 7.9%, in workload in construction – 17.9% as compared with July of the previous year. The index of retail trade turnover made 105.6% in July 2011 versus 108.8% a year ago. At the same time **real incomes of the population reduced by 1.0% over seven months of the current year, while the arrears for wages expanded.** Reduction of industry's contribution in the economic dynamics, low growth rates of investments activities and **renewed growth of unemployment** are negative trends observed.*

According to the Federal State Statistics Service, in the 1<sup>st</sup> half of 2011 the index of the GDP physical volume made 103.7%, the growth rates slowing down from 105.0% in the 1<sup>st</sup> quarter to 103.4% in the second quarter as compared with the corresponding periods of 2010. Despite the acceleration of the growth rates of the investments in fixed assets and retail trade turnover in the 2<sup>nd</sup> quarter 2011 versus the corresponding period of the previous year, the effect of these factors was insufficient to compensate the slackening of the industrial production dynamics.

In July the situation was determined by the factors formed in the first half of the previous year. Services and goods output index for the basic types of economic activities over January-July 2011 made 104.2% versus 106.5% in the corresponding period of the previous year.

In January-July 2011 investments in fixed assets went up by 3.6%, the workload in construction – by 4.8% as compared with the figures of the corresponding period of the previous year, while implementation of residential floor area made only 99.2% of January-July of the previous year.

In January-July 2011 retail trade turnover went up by 5.3% as compared with the corresponding period of the previous year, while the real incomes of the population decreased by 1.0%. In January-July 2011 real wages rose by 2.3% (by 4.9% in January-July 2010), real volume of accrued pensions – by 0.8% (by 41.0%). The growth of consumer activity was supported by the increase in consumer crediting and reduction in savings made by population; it is accompanied by the change in the structure of the demand from the population. In January-July 2011 the increase in foodstuffs retail trade turnover versus the corresponding period of the previous year made 1.1% versus 5.3% in the corresponding period of 2010. The specific features of consumer market formation in 2011 are defined by the dynamic growth of non-food goods sales. Over January-July 2011 non-food goods retail trade turnover index made 109.7% against 105.3% a year ago. The consumer behavior of the population was influenced by the change in prices' proportions and the volume of deferred demand accumulated in two preceding years. However the possibility that the increased consumer activity of the population is also connected with the increased inflation expectations should not be excluded, taking into account the acceleration of prices for non-food goods growth from 102.2% in January-July 2010 to 103.8% in January-July 2011.

The specific characteristics of July 2011 were accounted for by the decrease in the contribution of the industry in the economics dynamics. On the whole throughout the industry the growth of production made 0.4% in July 2011 versus the previous month, while in the manufacturing industries the drop of the production of 1.9% was observed. As a result of January-July 2011 while the growth rates of industrial production slowed down to 105.3% versus 109.6% in the corresponding period of the previous year, the production index in minerals extraction made 102.4% (105.3% a year ago), in manufacturing industries – 107.6% (113.3%), in electricity, gas and water production and distribution – 100.4% (105.3%). Slowdown of the industry recovery rates is accounted for by the internal growth limitations, in particular achievement of pre-crisis level of facilities load, absence of significant changes in the utilization of the main production factors coupled with low investment activity in the economy.



It was manufacturing industries that proved to be the most vulnerable. As compared with June 2010 in July 2011 the slowdown of the manufacturing industry was registered in all types of economic activity excluding machinery and equipment production and other non-metal mineral goods production, which development dynamics is influenced substantially by the low bade of 2009-2010. As to the production of consumer goods, the foodstuffs production volumes stabilizing at the level of July of the preceding year, the production of non-food goods slowed down suddenly. As compared with July 2010 in July 2011 the growth rates of leather, leather goods and footwear production made 104.4% versus 114.6% a year ago, the growth rates of textile and sewing industry – 102.0% versus 101.5%.

Deceleration of industrial output growth rates is accompanied with the increase in import growth rates. The intensification of the trend to the expansion of the investment and intermediate commodities proportion in the import structure is a fundamentally new process for the Russian economy. It seems that further development of the industry in this situation will be determined by the intensity of investments in fixed assets aimed at production modernization and diversification.

Table 1

## STRUCTURE OF IMPORT OF THE RUSSIAN FEDERATION (BASED ON THE BALANCE-OF-PAYMENTS METHODOLOGY), AS PERCENTAGE TO THE TOTAL

	GOODS		
	consumer	investment	intermediate
2010			
1 <sup>st</sup> quarter	43.5	16.8	39.7
2 <sup>nd</sup> quarter	39.6	18.7	41.7
3 <sup>rd</sup> quarter	40.6	19.7	39.7
4 <sup>th</sup> quarter	40.0	21.5	38.5
Year	40.7	19.5	39.8
2011			
1 <sup>st</sup> quarter	39.8	18.2	42.0
2 <sup>nd</sup> quarter	35.4	20.2	44.4

Source: Federal State Statistics Service

Under the existing trend in the investments dynamics the growth of the industrial production as a result of 2011 can make only 5.0% on the condition of the support of the internal industrial demand at the expense of the investment import. Favorable situation at the world market of energy carriers allowed the minerals extraction enterprises obtain the balanced financial result of RUR 978.7 bn as a result of the 1<sup>st</sup> half of 2011, which exceeded by 62.1% the corresponding figure of January-June 2010. The financial situation at the manufacturing enterprises has also improved a little: over the same period their balanced financial result was equal to RUR 991.0 bn, which is 44.7% above the level of the corresponding period of 2010.

Under the existing prices dynamics the profitability of minerals extraction reached 39.1%, profitability in fossil fuels extraction being 36.0%. In the 1<sup>st</sup> half of 2011 profitability of manufacturing industries made 12.9% but remained 0.8 percentage point below the figure of the 1<sup>st</sup> half of 2010. The price politics being reserved, the growth of the financial results and change in profitability level was mainly due to the increase in the output and the growth of production facilities load. Besides, the level and the dynamics of the financial results was also influenced by a small increase in wages with the simultaneous reduction of the excessive number of the employed.

Table 2

 PROFITABILITY OF SOLD GOODS, PRODUCTS, WORKS AND SERVICES AND ASSETS OF THE ORGANIZATIONS AS BROKEN BY TYPES OF ECONOMIC ACTIVITIES IN THE 1<sup>ST</sup> HALF OF 2010 AND 2011, AS PERCENTAGE

	Sold goods, products, works, services		Assets	
	2010	2011	2010	2011
Total	11.1	11.6	3.3	4.2
Minerals extraction	31.8	39.1	6.7	9.8

Table 2, cont'd

	Sold goods, products, works, services		Assets	
	2010	2011	2010	2011
including:				
Fossil fuels extraction	30.4	36.0	6.7	9.7
Minerals extraction, excluding fossil fuels	42.6	66.2	6.5	10.0
Processing industries	13.7	12.9	3.6	4.6
of which:				
Foodstuffs production, including tobacco and beverages	11.7	7.9	3.1	2.4
Textile and sewing industries	4.5	4.8	0.5	1.4
Leather, leather goods and footwear production	6.2	6.8	0.6	1.8
Timber processing and wooden goods production	-0.9	5.7	1.2	0.6
Pulp-and-paper industry; publishing and printing	9.6	11.7	4.4	4.3
Coke and oil products production	22.4	19.9	6.2	8.6
Chemistry industry	18.6	22.3	5.5	8.6
Rubber and plastic goods production	-2.4	8.0	1.9	2.6
Other non-metal mineral goods production	4.8	8.4	0.3	1.5
Metallurgy production and production of finished metal goods	19.6	16.5	5.4	6.2
Machinery and equipment production	7.0	6.1	1.5	1.5
Electric, electronic	7.8	7.4	2.2	2.1
Transport vehicles and equipment production	3.3	5.5	-0.3	1.2
Electricity, gas and water production and distribution	8.9	8.9	3.4	2.9
Construction	3.8	2.5	0.5	0.5
Wholesale and retail trade	8.8	10.1	4.4	6.2
Transportation and communication	14.9	13.7	2.3	2.8
Pipelines transportation	19.9	17.5	4.8	4.8
Communication	28.0	34.6	5.5	6.1

Source: Federal State Statistics Service

In July 2011 the demand for the labor in the industry, construction and agriculture that resulted in the renewal of the unemployment growth. The level of the unemployment versus the economically active population went up from 6.1% in June to 6.5% in July, making 5 million. The growth of the number of the unemployed in July was mainly result the entrance of graduated into the market. Thus, in July 2011 the proportion of the citizens aged 15-19 years among the unemployed made 8.6% and was 2.2 percentage points higher than in June 2010, the proportion of those aged 20-25 years – 21.9% (growth of 1.3 percentage points). The proportion of the inexperienced workers among the unemployed went up by 4.4 percentage points and made 32.7%.

It should be noted that while the unemployment in general went up, in the employment agencies there were 1.4 m of the unemployed registered, which is 41000 less than in June. In July 2011 the number of the unemployed registered in the state employment agencies per 100 advertised vacancies makes 101.4.

## INVESTMENTS IN REAL ECONOMY SECTOR

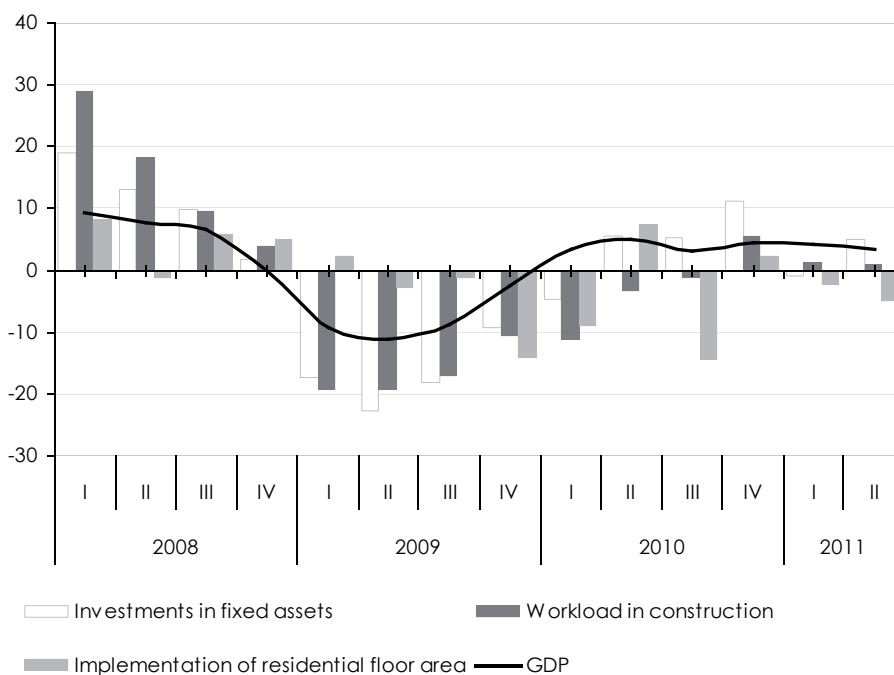
O.Izryadnova

***In January-June 2011 investments in fixed assets increased by 2.7% versus the corresponding period of the previous year. In July 2011 the investments in fixed assets grew by 7.9% as compared with July of the previous year. The reduction of the investments in fixed assets made by small-scale enterprises is a negative trend. The structure of the sources of financing was characterized by the intensification of the trend towards the reduction in banks' credits and funds borrowed from other organizations.***

In the 1<sup>st</sup> half of 2011 investments in fixed assets made RUR 3598 bn or 102.7% versus the level of the corresponding period of the previous year. IN the 2<sup>nd</sup> quarter 2011 the investments went up by 5% as compared with the corresponding period of the previous year, which compensated for the drop of investments in fixed assets of 0.8% in the 1<sup>st</sup> quarter of the current year.

The dynamics of investments in fixed assets was considerably different for large- and small-scale enterprises. In the 1<sup>st</sup> quarter 2011 investments in the fixed assets in the segment of large- and medium-scale enterprises went up by 1.9%, the growth over the 1<sup>st</sup> half of 2011 being 12.3% versus the corresponding period of the previous year, however, the investments made only 90.4% of the corresponding period of 2008. The positive dynamics of the investments activity in the segment of small business did not maintain. The proportion of the investments in the segment of small business in the total volume of the investments in the economy in the 1<sup>st</sup> quarter 2011 made 26.3% and reduced by 7.9 percentage points versus the corresponding period of the previous year. In the 1<sup>st</sup> quarter 2011 the contraction of investments in fixed assets in the segment of the small-scale enterprises was estimated to be 5.5%, the drop in the 1<sup>st</sup> half of the year being 15.8% versus the corresponding period of the previous year.

Unsteady dynamics of investments in fixed assets in the first half of 2011 was one of the reasons for sudden fluctuations of the dynamics of workload in construction and implementation of the residential floor area. Although the results of the 2<sup>nd</sup> quarter 2011 in construction regarding the investments dynamics were quite good, this trend was not supported by the corresponding increase in the workload in the construction complex. As a result of the 1<sup>st</sup> half of the current year the workload in construction went up by 1.2%, while the implementation of the residential floor area made only 96.3% of the corresponding figures of the 1<sup>st</sup> half of 2010.



Source: Federal State Statistics Service.

Fig. 1 GDP, Investments in Fixed Assets, Workload in Construction and Implementation of Residential Floor Area Growth Rates by Quarters of 2008-2011, as Percentage to the Corresponding Period of the Previous Year

In January-June of the current year low investment activity in construction is accounted for both by underinvestment of the construction works at the beginning of the year and the absence of sufficient groundwork. The dynamics of the residential floor area implementation was influenced by the contraction of the funds for share participation in construction by both organizations and population.

In 2009-2011 the trend towards the reduction of the total residential floor area implemented is characteristic, recovery rates of the investments in housing construction being low. In the 1<sup>st</sup> half of 2011 investment expenses for housing construction reduced by 1.2% in the structure of investments as compared with the 1<sup>st</sup> half of 2010, the volume and proportion of the funds of population in financing share construction increasing, while the proportion of organizations' funds reducing.

In the 1<sup>st</sup> half of the current year investments in machinery and equipment went up by RUR 180 bn, including investments in domestically produced models – by RUR 136.7 bn versus the corresponding period of 2010.

Investments in import machinery, equipment, transportation vehicles (excluding subjects of small-scale entrepreneurship and investments not registered by direct statistical methods) made RUR 182.2 bn in the 1<sup>st</sup> half of 2011 (20.9% of the total volume of investments in machinery and equipment) versus RUR 138.8 bn (20.1%) a year ago.

Table 1

STRUCTURE OF INVESTMENTS IN FIXED ASSETS AS BROKEN BY THE TYPES OF FIXED ASSETS IN THE 1<sup>ST</sup> HALF 2009-2011 (EXCLUDING SUBJECTS OF SMALL-SCALE ENTREPRENEURSHIP AND PARAMETERS OF INFORMAL ACTIVITY), AS PERCENTAGE TO TOTAL

	RUR bn			As percentage to the total		
	2009	2010	2011	2009	2010	2011
Investments in fixed assets	2188.7	2108.1	2650.9	100	100	
including: Housing	131.7	122.8	121.8	6.0	5.8	4.6
Buildings (excluding residential) and constructions	1190.2	1108.2	1419.0	54.4	52.6	53.5
Machinery, equipment, transport vehicles	671.2	692.1	872.2	30.7	32.8	32.9
Other	195.6	185.0	237.9	8.9	8.8	9.0

Source: Federal State Statistics Service

Regarding the sources of financing the structure of investments was also subject to considerable changes. In the 1<sup>st</sup> half of 2011 the proportion of the investments made at the expense of own funds expanded by 1.2 percentage points, the proportion of the borrowed funds decreasing correspondingly.

Despite the foreign investments in the Russian economy having increased by 2.9 times in the 1<sup>st</sup> half of 2011 versus the corresponding period of the previous year and making USD 877 bn, their structure did not contribute into the upsurge of the investments activity in the real economy sector. Direct foreign investments made USD 7.9 bn and their proportion in the structure of incoming foreign investments in the Russian economy reduced to 8.8% in the 1<sup>st</sup> half of 2011 versus 17.9% in the corresponding period of 2010 and 23.8% in 2008. In the 1<sup>st</sup> half of 2011 the volume of foreign investments in fixed assets made 63.5% of 2008 figure and their proportion in the volume of investments in fixed assets in the Russian economy contracted to 3.6%.

The structure of the funds borrowed for financing of the investments in fixed assets was characterized by the change in the budget funds role. The expansion of the investments financing volumes from the federal budget was accompanied by the increase in expenses of Russian Federation subjects' budget funds for the investment purposes. In the 1<sup>st</sup> half of 2011 RUR 382.7 bn of investments in fixed assets (14.4% of the total volume of investments in the economy) was financed at the expense of budget funds, including RUR 174.2 bn (6.6%) at the expense of the federal budget and RUR 185.7 bn (7.0%) at the expense of the budgets of subjects of the Russian Federation.

The volume of budget investments envisaged for financing of the capital construction objects of the federal property in 2011 was somewhat expanded in July. Taking into account the changes made the total volume of the budget allotments envisaged for FTIP fulfillment in 2011 made RUR



897.3 bn as on August, 1<sup>st</sup> 2011, including investments from the budget of RUR 771.1 bn, which is RUR 132.9 bn more than in 2010.

Table 2

STRUCTURE OF INVESTMENTS IN FIXED ASSETS AS BROKEN BY SOURCES OF FINANCING IN THE 1<sup>ST</sup> HALF OF 2009-2011 (EXCLUDING SUBJECTS OF SMALL-SCALE ENTREPRENEURSHIP AND PARAMETERS OF INFORMAL ACTIVITY), AS PERCENTAGE TO TOTAL

	RUR billion			As percentage to the total		
	2009	2010	2011	2009	2010	2011
Investments in fixed assets	2188.7	2108.1	2650.9	100	100	100
including by sources of financing:						
own funds	878.5	947.4	1222.4	40.1	44.9	46.1
of which: profit remaining at organizations' disposal	369.3	342.8	476.6	16.9	16.3	18.0
Amortization	437.2	516.0	621.4	20.0	24.5	23.4
borrowed funds	1310.2	1160.7	1428.5	59.9	55.1	53.9
including: banks' credits	263.2	193.0	224.4	12.0	9.2	8.5
of which credits of foreign banks	80.9	60.0	46.5	3.7	2.8	1.8
borrowed funds from other organizations	179.3	139.3	129.6	8.2	6.6	4.9
budget funds	364.7	327.3	382.7	16.7	15.5	14.4
of which: federal budget funds	142.	159.6	174.2	6.5	7.6	6.6
funds of budgets of RF subjects	200.5	148.9	185.7	9.2	7.1	7.0
off-budget funds	4.7	8.8	6.1	0.2	0.4	0.2
Other	498.3	492.3	685.7	22.8	23.4	25.9
of which: funds of superior organizations	371.3	355.6	547.6	17.0	16.9	20.7
funds for share participation in construction (from organizations and population)	50.6	46.0	45.8	2.3	2.2	1.7
including population's funds	20.8	23.1	29.1	1.0	1.1	1.1
funds from corporate bonds issue	0.2	0.9	0.01	0.01	0.04	0.00
funds from stocks issue	10.4	34.8	27.7	0.5	1.7	1.0
Foreign investments in the total amount of investments in fixed assets	124.6	111.3	95.2	5.7	5.3	3.6

Source: Federal State Statistics Service

In January-July 2011 RUR 304.3 bn of the state investments was financed from the federal budget, which makes 44.6% of the annual limit; RUR 30.3 bn was financed by the budgets of subjects of the Russian Federation and other sources.

Table 3

OBJECTS ENVISAGED BY TARGETED INVESTMENT PROGRAM AND VOLUMES OF STATE INVESTMENTS IN 2011 (EXCLUDING CONSTRUCTION SIGHTS AND OBJECTS INCLUDED IN STATE DEFENSE ORDER)

	Number of objects in 2009		Put into commission in January-July 2011		Limit of state investments in 2011		Financed from the federal budget in 2011	Investments used at the expense of all sources of financing in 2011
	total	with the deadline of implementation in 2011	to full extent	partially	total	total		
Total	3555	2078	20	8	754.0	682.6	304.3	178.2
including: transportation complex	935	476	7	1	283.9	252.9	165.8	93.5
agriculture complex	187	102	1	1	8.7	8.4	4.6	1.7

Table 3, cont'd

	Number of objects in 2009		Put into commission in January-July 2011		Limit of state investments in 2011		Financed from the federal budget in 2011	Investments used at the expense of all sources of financing in 2011
	total	with the deadline of implementation in 2011	to full extent	partially	total	total		
special complex	762	558	6	1	53.9	50.2	15.1	9.4
social complex	1488	870	6	5	357.8	327.9	112.4	66.3
other objects	183	72	–	–	49.7	43.1	6.4	7.2

Source: Federal State Statistics Service

On the whole in January-July state customers used RUR 178.2 bn of the state investments or 23.6% of the annual limit of funds envisaged for their construction.

The annual limit of investments in transportation (25.3%) and agriculture (54.8%) has been financed to a considerably higher extent than in general for construction sights and objects for state purposes. In the special complex budget allotments were financed at 30.0% and social complex – at 34.3%.

The structure of investments in fixed assets as broken by types of economic activities was subject to considerable changes in 2009-2011. While the general trend for the large- and medium-scale enterprises is to increase investment activity in the 1<sup>st</sup> half of 2011, the proportion of the investments in industry in the total volume of investments decreased by 0.5 percentage points as compared with the corresponding period of the previous year making 47.8%.

Table 4

INVESTMENTS IN FIXED ASSETS (SUBJECTS OF SMALL ENTREPRENEURSHIP AND INVESTMENTS NOT REGISTERED BY DIRECT STATISTICAL METHODS EXCLUDED) IN THE 1<sup>ST</sup> HALF OF 2009-2011

	RUR bn			As percentage to the total			Growth rate versus the corresponding period of the preceding year		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Total	2188.7	2108.1	2650.9	100	100	100	95	89.8	112.3
Agriculture, hunting and forestry	75.7	70.9	88.5	3.5	3.4	3.3	74.8	96.3	117.3
Fishing and fish breeding	1.1	1.5	1.6	0.1	0.1	0.1	85.8	117.2	105.2
Industry	987.6	1019.6	1268.3	45.7	48.3	47.8			
Minerals extraction	416.5	429.1	555.1	19.0	20.4	20.9	90.7	98.5	116.9
Manufacturing industries	375.5	344.7	439.7	17.8	16.3	16.6	97.8	84.9	110.5
Electricity, gas and water production and distribution	195.6	245.8	273.5	8.9	11.6	10.3	100.6	123.5	95.9
Construction	78.7	61.0	64.6	3.6	2.9	2.4	97.5	98.4	93.9
Wholesale and retail trade	44.9	46.9	54.7	2.1	2.2	2.1	96.2	89.3	102.9
Hotels and restaurants	8.6	9.9	10.5	0.4	0.5	0.4	89.9	111.7	97.1
Transportation and communication	558.5	537.4	729.9	25.5	25.5	27.5	105.4	92.0	121.4
Railway transportation	90.4	140.4	135.6	4.1	6.7	5.1	61.4	121.4	90.0
Pipelines transportation	232.5	197.2	313.5	10.6	9.4	11.8	147.4	87.3	143.3
Communication	66.6	67.6	92.3	3.0	3.2	3.5	75	104.0	135.3
Financial activities	32.1	24.7	33.3	1.5	1.2	1.3	135.3	78.6	121.3
Operations with real estate	233.0	188.5	208.3	10.6	8.9	7.9	76	74.0	99.1

Table 4, cont'd

	RUR bn			As percentage to the total			Growth rate versus the corresponding period of the preceding year		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
State management, military security, social insurance	33.7	26.9	26.1	1.5	1.3	1.0	106.7	77.2	99.9
Education	32.8	32.0	46.0	1.5	1.5	1.7	80.9	94.4	135.8
Health care and social services rendering	38.7	41.3	41.3	1.8	2.0	1.6	93.2	107.9	97.8
Other utilities, social and personal services	48.8	47.5	77.8	2.2	2.2	2.9		98.4	146.9

Source: Federal State Statistics Service

As a result of the 1<sup>st</sup> half of 2011 the situation with investments was relatively better in the types of economic activities traditionally characterized by high proportion of the budget funds in financial sources. Thus, investments in fixed assets in education made 135.8% versus the corresponding period of the previous year, in research and development – 116.2%. The reduction of investments in fixed assets in health care by 2.2% as compared with the 1<sup>st</sup> half of 2010 was a negative factor. ●

## FOREIGN TRADE

N.Volovik, K.Kharina

*In the first half year of 2011, with the world commodity market situation being favorable for Russian exports, the major indicators of Russian foreign trade continued to grow on the same period of 2010. After more than five months of intensive discussions, the relevant agencies came to an agreement concerning the new regime for calculating export duties on crude oil and petroleum products – the “60 – 66” regime, that should come into force from 1 October 2011. From 9 August, Russia removed all restrictions on import of fresh vegetables from the EU that had been imposed more than two months earlier.*

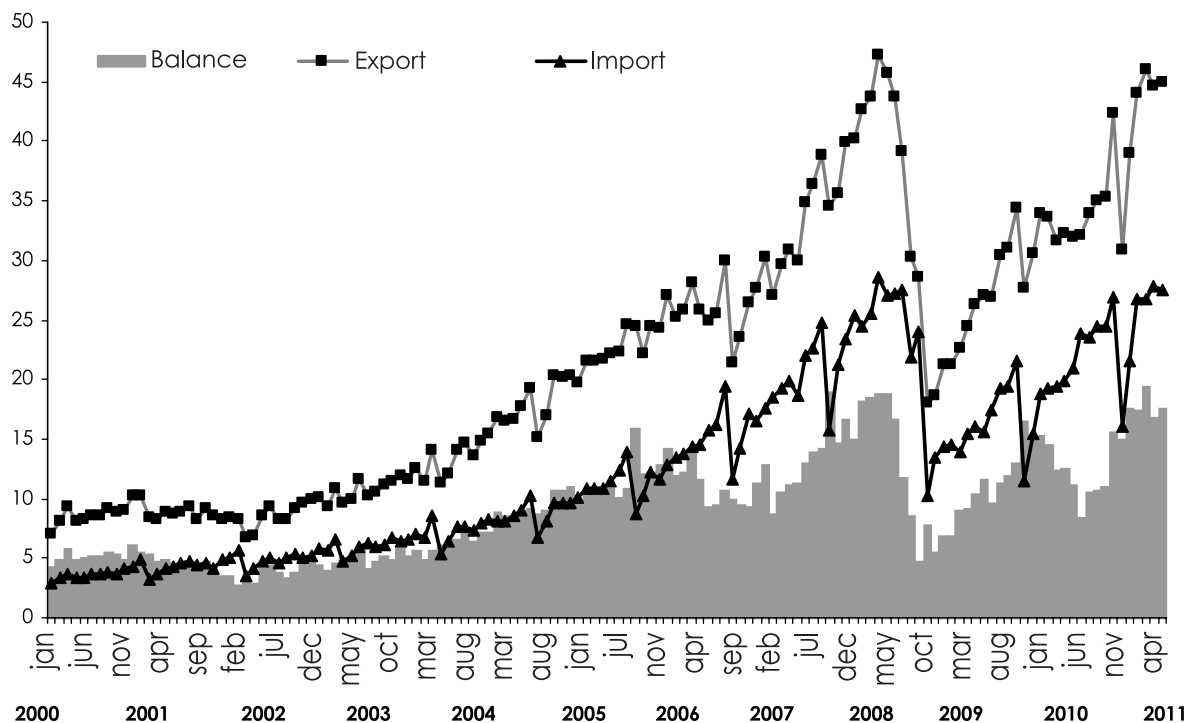
In June 2011, Russia’s foreign trade turnover, calculated in accordance with the balance of payments methodology, amounted to \$ 72.3 bn, representing a 39.2 percent increase on June 2010. In June 2011, exports grew by 38.6 on June 2010, to \$ 27.5 bn. In June 2011, Russia achieved a trade surplus in the amount of \$ 17.4 bn, representing a 36.3 percent increase on June 2010.

In the first half year of 2011, the price situation on the world’s markets for major Russian exports remained favorable. By comparison with the first half year of 2010, world prices on energy commodities climbed an average 36 %, and those on non – energy commodities rose an average 19 %.

In the first half year of 2011, the behavior of oil prices was in many respects determined by the aggravation of the political situation in the countries of North Africa and the Middle East. The continuation of the soft monetary policy in the USA and the EU also contributed to the price rise.

While in January 2011 the average price of Brent amounted to \$ 93.8 per barrel, its average price in July 2011 hit \$ 111.7. As a result, in the first half year of 2011, the price of Urals amounted to \$ 108.3 per barrel, representing a 42.7 rise on the same period of 2010.

During the period of monitoring, from 15 July through 15 August 2011, the average price of oil was \$ 112.5 per barrel. Thus, in accordance with existing legislation, from 1 September 2011, it



Source: RF CB.

Figure 1. Major Indicators of Russian Foreign Trade (bn US dollars)



should be set at \$ 444.1 per ton. The preferential duty on crude oil from a number of eastern Siberian and northern Caspian oil fields should amount to \$ 205.1 per ton against the duty of \$ 201 per ton which was in effect in August. From 1 September, the duty on white petroleum products should increase from \$ 293.6 per ton to \$ 297.5 per ton, and that for dark petroleum products – from \$ 204.6 per ton to \$ 207.4 per ton.

In September, the existing methodology for calculating the export duty on gasolines will remain unchanged. From 1 May 2011, the duty on straight – run and commercial gasolines was increased to 90 % of the duty on crude oil because of the problems with gasoline supply that arose in a number of RF regions. From 1 September, the export duty rate on gasoline will rise from \$ 394.4 per ton to \$ 399.7 per ton.

It should be reminded that duties on dark and white petroleum products should be calculated in accordance with the methodology approved by the RF Government Decree of 27 December 2010. According to this document, from February 2011 onwards, duties on dark petroleum products should be set at 46.7 %, and those on white petroleum products – at 67 % of the crude oil duty.

From 1 October 2011, a new regime for calculating export duties on crude oil and petroleum products – the “60 – 66” regime – will come into force. The new regime envisages that the export duty on oil should be reduced approximately by 7 % in the event of the formula for export duty calculation being changed. In particular, in the process of calculation, one should take into consideration, instead of 65 % of the difference between the monitor and the price of oil at \$ 182.5 per ton, 60 % of that difference. At the same time, the rates of duties on white and dark petroleum products will be unified: in accordance with Decree of the RF Government No 716 of 26 August 2011, “*On the Introduction of Alterations in Decree of the Government of the Russian Federation, of 27 December 2010, No 155*”, from 1 October 2011 through 31 December 2014 the duty on all petroleum products, except for gasolines, should amount to 90 % of the duty on oil. Set at 90 % of the duty on crude oil, the duty on gasoline will be prohibitive. Thus, the export of gasolines will become economically unprofitable, while that of fuel oils will become less profitable. Moreover, from 2015, the export duty on mineral oil will equal that on crude oil, which will make the export of mineral oil economically unreasonable as well.

As regards metal prices, their rise was markedly restrained by the current problems faced by Greece (and the possible risks of the debt crisis spreading to other EC countries as well); the low indicators of Chinese non-ferrous metals exports; the expectation of high inflation and of yet another toughening of China’s monetary policy; and by the slowness of economic recovery in Japan. However, in spite of the fact that prices for metals in Q2 2011 were predominantly on the decline (especially those for nickel), they were still higher than those recorded in Q2 2010. As a result, in the first half year of 2011, prices for aluminum, copper and nickel were higher than in the first half year of 2010 by 20 %, 32 % and 21 % respectively.

Table 1

## MONTHLY AVERAGE WORLD PRICES FOR JUNE (2001 – 2011)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Oil (Brent), \$/barrel	27.14	24.66	27.06	35.2	53.9	68.3	70.13	135.2	65.7	75.36	113.76
Natural gas*, \$/mln BTU	4.33	2.90	4.05	4.01	5.91	8.29	8.03	12.63	7.95	7.74	10.26
Gasoline, \$/gallon	0.820	0.767	0.858	1.228	1.499	2.107	2.213	3.435	1.90	2.08	3.13
Copper, \$/ton	1,615.3	1,686	1,703	2,669	3,524	7,198	7,469	8,263	5,014	6,499	9067.0
Aluminum, \$/ton	1,467.7	1,355	1,410	1,676	1,731	2,477	2,672	2,957	1,570	1,931	2558.0
Nickel, \$/ton	6,629.2	7,110	8,761	13,322	16,160	20,755	41,407	22,556	14,960	19,378	22421

\* European market, average contract price at franco frontier.

Source: Calculations are based on data from the London Metal Exchange (London, UK) and the International Petroleum Exchange (London).

Global food commodity markets began to show a downward trend in prices, while a trend towards growth deceleration was revealed for some commodities. In June 2011, the FAO Food Price Index rose by 1 % to 234 pp, representing a 39 percent growth on June 2010. Nevertheless, it was still 4 points lower than its historic high of 238 pp recorded in February 2011. The FPI's rise was generally due to a sharp increase in sugar prices.

In June, the FAO Cereal Price Index amounted to 259 pp, representing a 1 percent drop on May. Nevertheless, it was still 71 pp higher than in June 2010. The fall in prices was mainly caused by the improvement of weather conditions in Europe and the lifting of the ban on the export of cereals in the Russian Federation. However, the situation on the maize market remained tense because of the United States' maize stocks being at their record low, and the unfavorable forecasts for the maize harvest in the USA. In June, rice prices experienced an increase, reflecting their stable rise on the global market and the uncertainty with regard to export prices in Thailand – the world's largest rice exporter.

In the first half year of 2011, Russia's foreign trade turnover amounted to \$ 397.1 bn, representing a 35.1 percent rise on the corresponding period of 2010.

The export of commodities increased by 31.5 %, from \$ 189.9 bn in the first half year of 2010 to \$ 249.8 bn in the first half year of 2011. In the main, this rise in exports was caused by growing prices. On the whole, the physical volume of exports was relatively smaller than in the first half year of 2010. Decline was demonstrated by shipments of oil, petroleum products, ferrous and non-ferrous metals (except for aluminum), and a number of other commodities. The physical volumes of such exports as natural gas, aluminum, mineral fertilizers, non-processed and processed timber, and motor vehicles, on the contrary, experienced a rise.

In the first half year of 2011, the cost volume of imports rapidly increased to above its pre-crisis level (that is, the level of the first half year of 2008). The cost volume of imports rose by 41.8 % – from \$ 103.9 bn in the first half year of 2010 to \$ 147.3 bn in the first half year of 2011. More than two thirds of this rise in imports was accounted for by the increase in the physical volume of imports, while almost one third of the rise was caused by the price rise. Investment good imports grew faster than food imports. The growth rates of commodity imports were positively influenced by a relative rebound in internal demand and the strengthening of the real effective exchange rate of the ruble.

By comparison with the first half year of 2010, trade conditions faced by the Russian Federation in the first half year of 2011 visibly improved as a result of export prices displaying a more robust growth than import prices.

In the first half year of 2011, Russia's balance of trade amounted to \$ 102.5 bn, representing a 19 percent rise on the corresponding period of 2010.

From 1 June 2011, the customs duties levied on export, to Russia and the territory of the Customs Union, of buckwheat, potato and cabbage, which had been reduced to zero since 23 November 2010, were returned to their previous level. The decision that the duties on these types of agricultural produce should be temporarily reduced to zero had been adopted by the Commission of the Customs Union on 14 October 2010 in connection with the negative effects of the anomalous heat wave of summer 2010.

From 1 July 2011, in accordance with the findings of the May monitoring of the exchange prices of raw sugar, the member countries of the Customs Union increased the import duty on raw sugar from \$ 50 to \$ 85 per ton. Currently, towards the end of the period when the processing of locally grown beet is usually completed, the import regime for raw sugar is temporarily relaxed.

From 1 August 2011, on the eve of sugar beet harvesting, another range of duties designed to increase the protection of the sugar market came into force. In accordance with this scale, the ceiling for the import duty on raw sugar was set at \$ 140 per ton, while the floor was set at \$ 270 per ton. The principal goal of the existing mechanism is to provide stability to the home market in the event of a considerable rise in world raw sugar prices, so as to safeguard the interests of the national beet sugar industry. It should be noted that in the first half year of 2011, because of last year's drought, Russia was forced to import 2,257 thousand tons of raw sugar, including 2,146.6 thousand tons in March and June, when the reduced import duty was in force.

From 9 August 2011, Russia once again gave permission to the import and turnover of vegetable produce from EU countries, and also lifted the special import regime, which required the issuance

of special certificates for each shipment of vegetables. The ban on the import of vegetables from the EU was introduced on 2 June in order to counter a dangerous outbreak of infection caused *E. coli* in several European countries. Initially it was presumed that the outbreak was caused by cucumbers from Spain or soya shoots from Germany, but then the European Commission came to the conclusion that all the blame should be placed on the shipments of fenugreek seeds from Egypt. Starting from the end of June, the RF Federal Supervision Agency for Customer Protection and Human Welfare (*Rospotrebnadzor*) gradually lifted the ban on vegetable imports from individual European countries. At the same time, some additional requirements were imposed on imports: from then on, each shipment of vegetables needed a special certificate of absence of *E. coli*. Thus, on 28 June 2011, Belgium and The Netherlands were allowed to import vegetables to Russia; on 1 July this permission was granted to Denmark and Spain; on 11 July came the turn of Czechia and Greece, etc. As a result, by early August, the ban had not been lifted only from five states – Lithuania, Latvia, Estonia, Slovenia and Germany. ●

## STATE BUDGET

E.Fomina

*Within January-July 2011, the federal budget was executed with a surplus of 2.5 per cent of GDP. In general, the Russian Ministry of Finance expects the federal budget deficit does not exceed 1 per cent of GDP. One should take into regard, that against the background of increased federal revenues, a number of additional commitments were adopted, that require funding already in the current year. The major source of the budget deficit recovery in 2012-2014 will be domestic borrowings, the amount of which will exceed Rb2 trillion annually. Public debt extension can be dangerous in terms of significant reduction in indicators of debt sustainability at the background of external economic situation deterioration.*

### Analysis of the RF federal budget execution in January–July 2011.

According to the tentative estimates of the Russian Ministry of Finance, *federal budget revenues* over 7 months of 2011 amounted to 21.8 per cent of GDP, which is by 2.4 percentage points of GDP exceeds the indicator of the relevant period in 2010 (See *Table 1*). In absolute terms, the growth of federal revenues exceeded Rb1.5 trillion. We would like to note, that in January-April 2011 revenues from oil and gas assets management in 2010 in the amount of Rb54.1 billion were credited to the budget. As of August 1 of the current year, the cash execution of budget in terms of revenues has exceeded 60 per cent of the annual budget estimates.

Table 1

#### BASIC INDICATORS OF THE RF FEDERAL BUDGET EXECUTION IN JANUARY-JULY OF 2010-2011

	January-July 2011		January-July 2010		Execution against annual budget estimates for 2011, %	Change	
	Rb, bn	GDP, %	Rb, bn	GDP, %		Rb, bn	GDP, p.p. of GDP
Revenues, including:	6 234.1	21.8	4 658.4	19.4	60.5	+1 575.7	+2.4
Oil and gas revenues	3 019.8	10.6	2 105.9	8.8	57.8	+913.9	+1.8
Contributions to the Reserve Fund and National Welfare Fund	0.0	0.0	26.5	0.1	–	–26.5	–0.1
Revenues, including:	5 511.4	19.3	5 171.2	21.6	50.0	+340.2	–2.3
Interest expenditures	134.9	0.5	112.7	0.5	38.5	+22.2	+0.0
Non-interest expenditures	5 376.5	18.8	5 058.5	21.1	50.4	+318.0	–2.3
Surplus/Deficit of the federal budget	+722.7	+2.5	–512.7	–2.1	-	+1 235.4	+4.6
Non-oil deficit	–2297.1	–8.1	–2 618.7	–10.9	38.6	+321.6	+2.8
GDP estimates	28 544.0		23 968.3				

Source: RF Ministry of Finance (tentative assessments), Gaidar Institute estimates.

The key factor in the federal budget revenues growth remains the sustainability of favorable situation in the global energy market. The average price for Urals oil has increased by 44.3 per cent over 7 months of 2011 and reached \$109.2/barrel. (\$75.7 / barrel in January–July 2010). As a result, total oil and gas revenues of the federal budget reached 10.6 per cent of GDP, which exceeds their value of the last year by 1.8 percentage points.

Further growth of the global oil prices will boost the short-term budget revenues. Thus, in August 2011 the Ministry of Economic Development of Russia has submitted for approval an updated macroeconomic forecast for 2011-2014. The average estimates for Urals base price for 2011 are increased from \$105 to \$108 per barrel. In contrast to the previous forecast, the Ministry believes

that before 2014 the average annual price of oil does not fall below \$100 per barrel. (In the previous forecast, it did not rise above \$95-97 per barrel).

According to the basic indicators of fiscal policy over the medium term, changes are coming in the assessment of the severance tax rates on natural gas: in 2012-2014, the tax rate will be set with regard to the global prices for hydrocarbons, similar to the taxation of oil production, as well as depending on the rate of growth in domestic gas prices<sup>1</sup>.

In addition, the work will be continued on the elaboration of mechanisms for the long-term transition to the taxation of mineral resource extraction on the basis of financial and economic activity results (introduction of tax on additional (surplus) income (SIT)). This type of rent exemption is applied in the tax systems of some developed oil-producing countries, particularly in Norway, UK and USA. The transition to SIT can lead to a change in the entire system of taxation of natural resource rent – from the mineral extraction tax and export customs duties to excise taxes on oil products.

Tentative estimates of the *federal budget execution in terms of expenditures* for January-July 2011 indicate a significant decrease in non-interest component – by 2.3 percentage points of GDP against the value of 2010. The relative volume of budget expenditures on debt service remained at the level of 2010 and amounted to 0.5 per cent of GDP. Cash execution of public commitments of the federal budget as of August 1, 2011 reached 50 per cent of the annual budget estimates, versus 48 per cent of the corresponding period of 2010.

According to tentative data, over seven months of 2011, the federal budget *was executed with a surplus* of 2.5 per cent of GDP against the deficit to 2.1 per cent of GDP over the relevant period in 2010. Overall, in 2011 the Russian Ministry of Finance assumes to execute the budget with a deficit of less than 1 per cent of GDP. We would like to recall, that in the original version of the budget law, the federal budget deficit has been estimated at 3.6 per cent of GDP with the oil price of \$75 per barrel, whereas in the June version of the law its value was reduced to 1.3 per cent of GDP against the background of oil prices growth to \$105 per barrel. Thus, the assessment of the federal budget deficit growth was reduced by 2.3 percentage points of GDP. Herewith, it can be noted that non-oil deficit has been decreased only by 0.6 percentage points of GDP, and its level will still remain high - over 11 per cent of GDP, which is reflecting the continued vulnerability of the budget to the sharp fluctuations in oil prices. As of August 1, 2011, the non-oil deficit has decreased by 2.8 percentage points of GDP as compared with the previous year and amounted to 8.1 per cent of GDP. Despite the substantial adjustment, the amount of non-oil deficit remains high.

As of August 1 of the current year, the Reserve Fund amounted to Rb735.0 bn (Rb775.2 bn on January 1, 2011); the volume of the National Welfare Fund has reduced to Rb2,566.00 bn (Rb2,695.5 bn on January 1, 2011).

In the situation of projected budget deficit in the medium term until 2014, the major source of its coverage will be the government borrowings. Following the basic trends of the debt policy, adopted for 2012-2014<sup>2</sup>, 90 per cent of deficit will be covered by domestic government borrowing, the gross involvement of which will exceed Rb2 trillion per annum. As of July 1, 2011, the aggregate amount of public debt reached Rb4.6 trillion: domestic debt – Rb3.6 trillion, external debt – \$36.8 billion (equivalent to Rb1.0 trillion).

The amount of public debt will increase annually and reach the level of Rb12 trillion, or 17 per cent of GDP at the end of the 2014. Herewith, the volume of the government foreign liabilities will increase nearly two-fold, amounting to about Rb2.0 trillion and the Internal debt will grow 2.8-fold, reaching nearly Rb10 trillion.

We would like to note, that the policy of increasing government borrowing could result in a substantial drop in indicators of debt sustainability together with deterioration in the external environment.

### **Basic indicators of the RF Subjects consolidated budget execution in 2011**

According to the updated information of the Russian Ministry of Finance, the consolidated budget of the RF Subjects for the six months of 2011 was executed with a surplus of Rb709 bn (3.0

1 [http://www.minfin.ru/common/img/uploaded/library/2011/07/03.08.2011\\_ONNP\\_-pravki\\_v\\_sootv\\_s\\_zamech\\_TIV-zavizir\\_SHatalovym.doc](http://www.minfin.ru/common/img/uploaded/library/2011/07/03.08.2011_ONNP_-pravki_v_sootv_s_zamech_TIV-zavizir_SHatalovym.doc)

2 [http://www.minfin.ru/common/img/uploaded/library/2011/08/Dolgovaya\\_politika\\_na\\_sayt\\_SSHA.pdf](http://www.minfin.ru/common/img/uploaded/library/2011/08/Dolgovaya_politika_na_sayt_SSHA.pdf)



per cent of GDP), which is by 1 percentage point of GDP higher than the indicator of the last year. The budgets of the two Subjects are executed with deficit, whereas in 2010 there were 12 such regions.

*Revenues of the RF Subjects consolidated budget* made 15.5 per cent of GDP (vs. 15.6 per cent of GDP within January-June 2010), expenditures made 12.6 per cent of GDP (vs. 13.6 per cent of GDP over the relevant period in 2010). Despite a slight decline in revenue in relative terms, one can note an expressed increase in the budget revenue in absolute terms. In particular, proceeds over the period under review from corporate income tax have increased by 34 per cent, from individual income tax – by 12 per cent, from corporate property tax – by 11 per cent, from excise tax - also by 11 per cent. Proceeds from the gratuitous share of the federal budget have grown by 18 per cent<sup>1</sup>.

An innovation of 2012 will be the formation of regional road funds in all regions of Russia. The budget allocations for the Road Fund of the Russian Federation is approved in the amount not less than estimated revenues from the excise duties on the RF Subject on oil products, subject to be credited to the budget of the region, vehicle tax, as well as other revenues, approved by the regional law providing for the establishment of the Road Fund of the Russian Federation<sup>2</sup>. The purpose of such funds formation will be the support of public roads condition. In a number of Russian regions it will lead to many-times increase in spending for roads maintenance, which would create additional risks to the balanced budgets. In this regard, the Russian Ministry of Finance has prepared an initiative, approved by the Russian government on a possibility of addressing a share of the road funds (up to 20 per cent) to repay the cost of budget loans made for the development of road infrastructure.

In addition, significant changes are coming in lending to regional budgets from the federal budget. The volume of lending will be substantially reduced with the prospect of the RF Subjects to obtain budget credits only in emergency cases. In particular, in 2012-2014, it is planned to reduce the amount of budget credits to the regions by more than 6 times, from Rb128.6 bn in 2011 to Rb20.0 billion in 2014<sup>3</sup>.

Since 2012, it is not planned to provide budget loans for construction, upgrading, overhaul repair, renovation and maintenance of public roads. ●

1 <http://www.minfin.ru/ru/press/interview/index.php?id4=13689>

2 <http://bujet.ru/article/143700.php>

3 [http://www.minfin.ru/common/img/uploaded/library/2011/08/Dolgovaya\\_politika\\_na\\_sayt\\_SSHA.pdf](http://www.minfin.ru/common/img/uploaded/library/2011/08/Dolgovaya_politika_na_sayt_SSHA.pdf)

## RUSSIAN BANKING SECTOR

S.Borisov

*In the first six months of 2011, the RF banking system showed a record financial result under the impact of reducing the banks' resource base and significantly lower spending for the formation of the reserve, as compared with the relevant period of the last year, as well as a result of growth in demand for credits from the real sector and individuals.*

Table 1

MAIN INDICATORS OF THE RUSSIAN BANKING SYSTEM, RB, BN

	As of 01.07.2010	As of 01.01.2011	As of 01.07.2011		
			Nominal	Growth since the start of the year, %	Year-on- year growth, %
Assets	30 416.7	33 804.6	35 236.6	4.2%	15.8%
Loans to non-financial organizations	13 032.3	14 062.9	15 120.5	7.5%	16.0%
Loans to private individuals	3 672.4	4 084.8	4 552.9	11.5%	24.0%
Loans to banks	2 709.4	2 921.1	3 212.8	10.0%	18.6%
Investments in bonds	4 082.5	4 419.9	4 269.5	-3.4%	4.6%
Deposits with the RF CENTRAL BANK	510.3	325.7	312.2	-4.1%	-38.8%
Banks' deposits	3 237.7	3 754.9	3 537.4	-5.8%	9.3%
Corporate deposits	5 396.4	6 035.6	6 535.7	8.3%	21.1%
Private deposits	8 435.3	9 818.0	10 516.5	7.1%	24.7%
Impairment reserves	2 241.2	2 192.0	2 255.6	2.9%	0.6%
Profit (in the respective year)	249.6	573.4	444.2		78.0%

Source: the Bank of Russia

According to the Bank of Russia, the Russian banking sector's profit over the six months amounted to Rb444 bn, having reached a record indicator for the period of 2008-2011. Herewith, the ratio of return on equity (ROE) of the banking system has increased over the same period of the last year from 5.5 per cent to 9.5 per cent, and the ratio of expenses to income (in this case, the operating income before reserves) has declined from 46.9 per cent to 46.6 per cent.

In our view, the main influence on the profitability

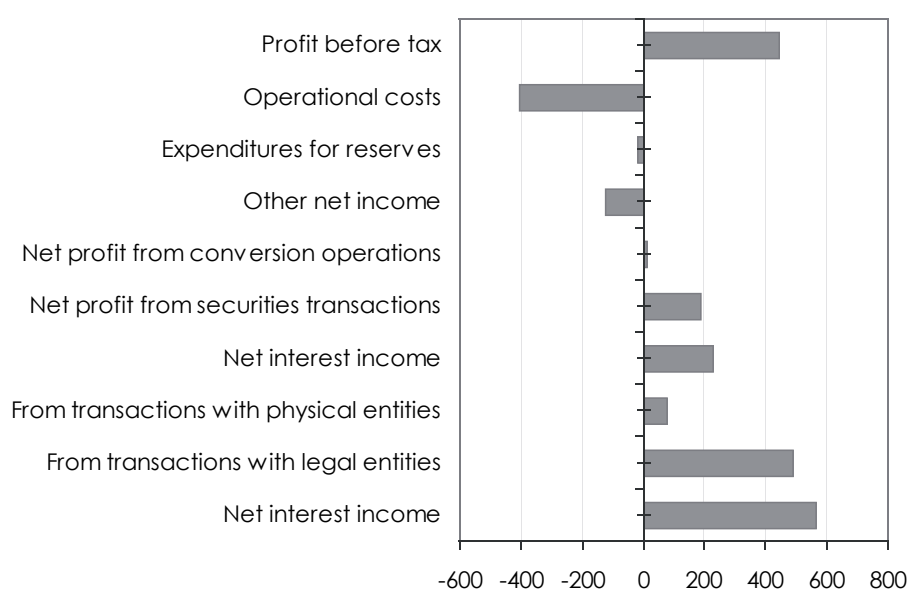


Fig. 1. Aggregate structure of gains and losses of the RF banking sector, RB bln.

of the banking sector had four factors: the growth of interest income, fees and reducing expenditure on creation of reserves for possible loan losses and increased operating costs (See *Fig. 1*).

1. According to the RF CB, the amount of net interest income of Russian banks from lending to non-financial institutions within 6 months has reached Rb486.5 bn, having, however demonstrated a 2 per cent reduction in the relative results for the six months of 2010. Let us consider individually two factors determining the amount of interest income from legal entities lending, - volume factor and the interest rate factor.

*Volume factor.* As of July 1 of this year, credit portfolio growth of legal entities made 7.5 per cent, which is significantly higher than the values of the same period in 2010 (4 per cent). The main reason for the intensive extension of credit portfolio was a steady growth of the real economy demand in credit resources, accompanied by improving financial condition of borrowers. According to Russian Statistical Service, net financial standing of organizations (less banks and small businesses) in the first six months has reached Rb4.054 bn, which is nearly by 43 per cent more than the result for the same period in 2010. Along with the improved financial performance of borrowers of non-financial institutions, industrial production growth in the first half of the year by 5.3 per cent also indirectly indicates an increase in demand from the real sector for working capital financing. At the same time, the share of overdue debt, sustained at the level of its local annual minimum (5–5.1 per cent) for four consecutive months, confirms a steady improvement in the quality of the debt service of the corporate sector. The share of “standard” loans in the portfolio of the 30 largest Russian banks since the beginning of the year has increased already by 5.4 percentage points. Given the current favorable external conditions, the banks are willingly increasing the volume of lending to the real sector, adequately mitigating the credit risk assessment policies.

*Interest rate factor.* Balance yield of corporate credit portfolio, estimated as the ratio of interest income derived from corporate clients’ lending to the average volume of term loans to non-financial organizations, in the second quarter was slightly lower than in the first quarter: 11.48 per cent (in Q1) versus 11.50 per cent (in Q2.). This fact is confirmed by the RF Central Bank data on the dynamics of the average weighted ruble rate. For loans in rubles provided up to 1 year, the decrease in average rate by 1 p.p. is partially offset by increased rates of similar loans to corporate clients for over the year by 0.9 percentage points. Higher yield of credit portfolio of legal entities in the first half of 2010 was due to sustained high credit risk, which banks take into account in the loan interest rate (*Fig. 2*).

*Credits to physical entities* provided to Russian banks net interest income of Rb76 bn, which is 6 times more than the revenue for the same period of the last year. The increase in interest income from lending to physical entities in the first half of the year had a positive impact on both above-mentioned factors: growth of the loans volume and rates. According to the Federal State

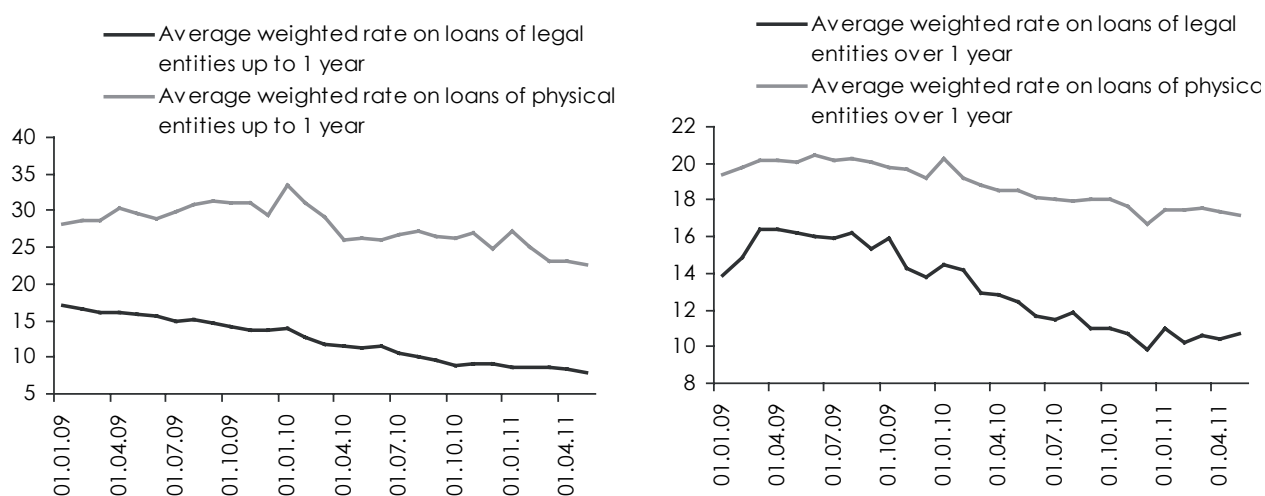


Fig. 2. The dynamics of the average weighted loan rate in Rb, %

Statistics Service, retail turnover growth in first half of 2011 made 5.3 per cent, which confirms the increase in population propensity to consume, even despite the declined real disposable household income over this period (-1.3 per cent). Increasing domestic demand, in its turn, resulted in the banking sector extension of the volume of new consumer, mortgage and other types of bank loans. The retail loan portfolio of the Russian banking system from the beginning of 2011 has grown by 11.5 per cent, which is almost three times more than the corresponding result of the last year. A separate contribution to increasing the volume of retail loans was made by mortgage and housing programs of the Russian banks. Portfolio of housing loans in five months grew by a record 23 per cent. Herewith, the profitability of retail portfolio, despite the development of low-cost mortgages, in the second quarter was higher than the first one: 17.7 per cent versus 17.6 per cent.

The ratio of net loan portfolio to the total borrowed assets from legal and physical entities since the beginning of 2011 has increased from 89 to 93 per cent (still not exceeding the value of 100 per cent). This actually means that banks do not feel the need for additional liquidity to finance ongoing operations. At the same time, raised funds from the population remain the main source of funding the active operations of the Russian banks: as of July 1, their share in total liabilities was 30 per cent. Reduction in the value of deposits directly affects the amount of net interest income of the banking system. In comparison with the first half of 2010, average weighted rates on ruble deposits up to one year are currently below the average of 2 percentage points. Significantly less decrease in the value of deposits is noted in the ruble funds raised from physical entities for a period of more than a year, as compared with the first six months of 2010 - on June 1, the difference was 0.6 percentage points.

2. Growth of Russian banks interest income is largely associated with the number of bank loans to legal entities, as well as with the development of banking services (non-credit commission) to enterprises and individuals. The contribution of net commission income to the growth of operating income of the banking sector of Russia in the first half of 2011 was Rb227 bn, which is by 7.8 per cent higher than the indicator of the same period of the last year.

3. Reduction in the cost of reserves formation was due to recovery of the banking sector after the financial crisis. Utilization of reserves created in the period of deteriorating financial condition of borrowers, are making a significant contribution in the formation of the current earnings of the banking sector. Thus, expenses on formation of reserves for loans in the first half of 2011 were by 91 per cent lower than over 6 months of the last year and amounted to Rb15 bn. Improvement of service quality for loans and financial standing, primarily to corporate customers, will continue to encourage the orderly dissolution of reserves to an acceptable level of credit portfolio coverage ratio.

4. Operating costs extension is one of the key factors that had a negative impact on the financial performance of the banking system of Russia in the first half of the year. According to the RF CB, the rate of growth in operating expenses of banks reached 23 per cent against the same period of the last year. The main rounds for such growth are the increase in labor costs of employees of the banking sector, the massive expansion of staff of financial institutions involved in direct sales, front office (the part of the company, which interacts directly with the client) and an increase in contributions to the extra-budgetary funds from January 1 of this year.

In summary, let us designate a number of emerging trends, which in our view, will have a key impact on the financial performance of the Russian banking sector in the next six months:

- decline in the value of liabilities will gradually slow down. By the end of 2011 we can expect stabilization of interest rates on deposits and even some increase thereof;
- the reserves of the banking system, formed during the financial instability, in the next six months in the absence of new shocks in the global economy also will cease to have a key impact on the financial performance in connection with the disposal and extensive restructuring of problem loans;
- following the rising cost of liabilities, competitive price “wars” in the banking sector should be reformatted into a struggle for the client by improving the quality and range of banking services, which can result in increased role of non-credit commissions in the profits formation of the banking sector.

**Here are the most important developments in the banking sector in August 2011**

- On August 4, 2011, the Board of Directors of the Bank of Russia decided to leave unchanged the level of refinancing and interest rates on the Bank of Russia operations;
- Deposit Insurance Agency continues to consolidate its banking assets. Reorganized by the State Corporation “Deposit Insurance Agency” (DIA) bank “Russian Capital” intends to take over on a network of branches of AMT bank, whose license was revoked. DIA has a resource for the formation on the basis of “the Russian capital” a quality retail player and its subsequent sale;
- In line with increasing the amount of insurance premium, DIA found an opportunity reduce premium rates once again (to 0.1 per cent). Thus, further mitigation of policy in allowed the participants of the deposit insurance system to improve their financial standing. ●



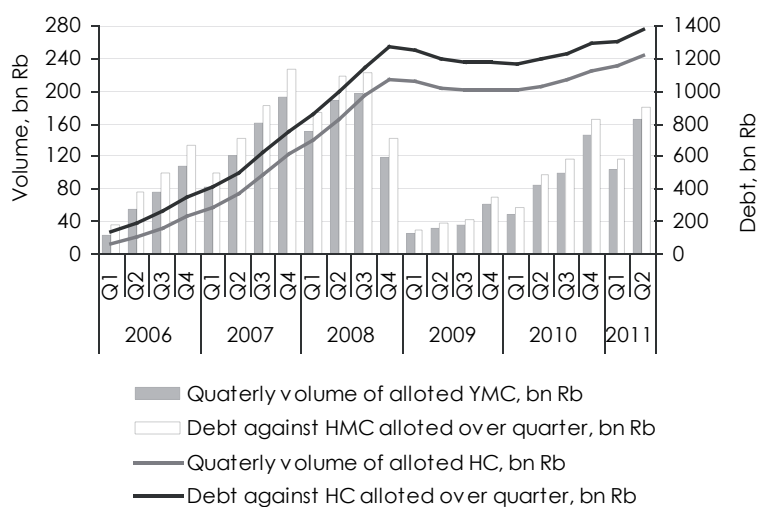
## HOUSING MORTGAGE IN THE RF

G.Zadonsky

In the first half year of 2011, the average weighted interest rate on housing mortgage credits (HMC) issued since the year's beginning (denominated in rubles and in foreign currencies) continued to display a downward trend (up to 12.2 %, for those denominated in rubles and up to 9.6 % for those denominated in foreign currencies). The share of outstanding ruble-denominated debt against housing mortgage credits relative to the sum of residual debt also continued to decline (2.34 % as of 1 July 2011), while the corresponding share of outstanding debt denominated in foreign currencies was, also as before, on the rise (11.47 %). There was a stable decline of the share of debt against defaulted HMC (with payments overdue for periods over 150 days) in the sum of total debt.

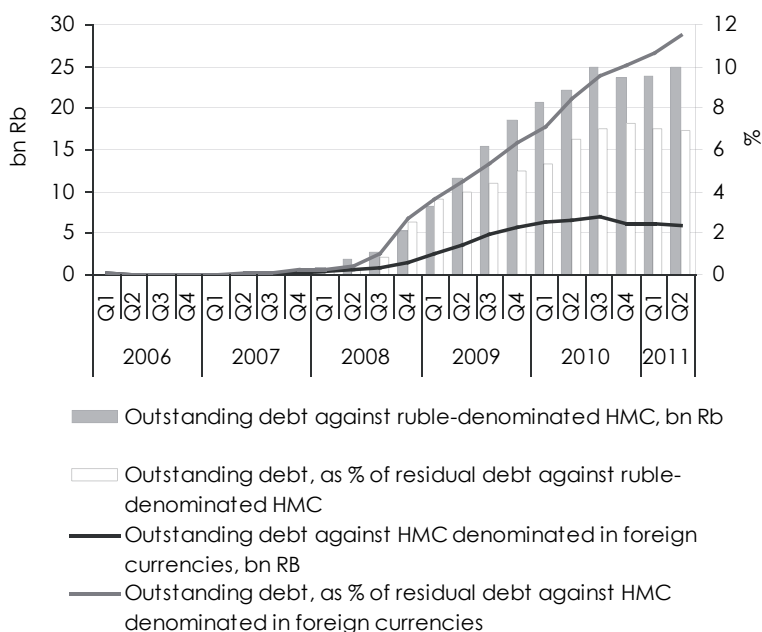
In the first half year of 2011, according to data published by the RF CB, credit institutions issued a total of 232,648 housing credits (HC) in the amount of Rb 295.7 bn, including 140,927 housing mortgage credits (HMC) in the amount of Rb 180.1 bn in Q2. The total number of housing mortgage credits allotted in the first half-year of 2011 is 195,544, their total volume – Rb 268.6 bn; of these, in Q2, a total of 121,300 credits in the amount of Rb 165.2 bn were allotted. The volume of housing mortgage credits allotted in Q2 2011 is nearly twice as high (1.96) as the same index for the period of Q II 2010 (Rb 84.4 bn), and by more than five times higher than that for Q2 2009, but still amounts to only 87.68 % of the volume of HMC allotted in Q2 2008. The sum of residual debt against housing mortgage credits continues to be on the rise, and so as of 1 July 2011 it amounted to Rb 1.22 trillion, including Rb 1.069 trillion against ruble-denominated credits (Fig. 1).

According to data published by the RF CB (Fig. 2), the amount of outstanding debt against HC as of 1 July 2011 was Rb 42.3 bn (Rb 24.9 bn against ruble-denominated credits and Rb 17.3 bn against credits denominated in foreign currencies). The sum of total outstanding debt as of the end of Q2 2011 was 1.96 % less than that as of 1 April 2011. At the same time, outstanding debt against ruble-denominated HMC rose in absolute terms on its value as of 1 April 2011, while in terms of per cent share



Source: RF Central Bank.

Fig. 1. Quarterly Dynamics of Allotted Credits



Source: RF Central Bank.

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

of residual debt it dropped by 0.08 pp. Outstanding debt against HMC denominated in foreign currencies over the same period declined in terms of volume, while in terms of per cent share of residual debt it increased by 0.78 pp.

According to data published by the RF CB, the total sum of outstanding debt against HMC in June 2011 rose by 0.98 %, and so, as of 1 July 2011, amounted to Rb 1,106.16 bn, while in terms of share in total debt it remained unchanged (90.68 %). Over the same period the sum of debt against defaulted HMC (i.e., credits with payments in arrears for over 180 days) dropped by Rb 356 bn (by 0.07 pp. in terms of per cent share of total debt) (*Table 1*).

Table 1

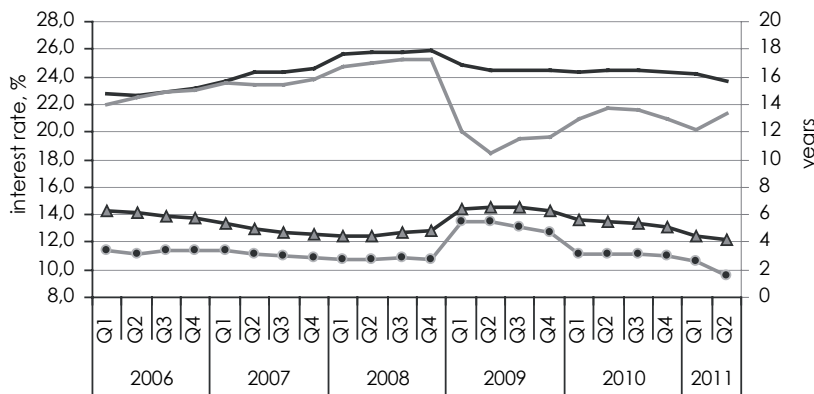
## DEBT AGAINST HOUSING MORTGAGE CREDITS BROKEN BY PERIOD OF DELAY IN PAYMENT, FOR 2011

2011.	Total amount of debt against HMC	Including							
		less payments in arrears		with payments in arrears between 1 and 90 days		with payments in arrears between 91 and 180 days		with payments in arrears for over 180 days	
		in Rb m	as % *	in Rb m	as % *	in Rb m	as % *	in Rb m	as % *
1 Jan	1,129,373	991, 928	87.83	66, 859	5.92	12, 875	1.14	57, 711	5.11
1 Feb	1,127,796	977, 348	86.66	84, 585	7.50	12, 293	1.09	53, 570	4.75
1 Mar.	1,134,168	982, 983	86.67	86, 764	7.65	11, 909	1.05	52, 512	4.63
1 Apr	1,152,800	1 014, 003	87.96	73, 318	6.36	12, 220	1.06	53, 259	4.62
1 May	1,171,833	1 038, 947	88.66	68, 318	5.83	11, 015	0.94	53, 553	4.57
1 Jun	1,208,040	1 095, 451	90.68	54, 362	4.50	7, 369	0.61	50, 858	4.21
1 Jul	1,219,850	1 106, 160	90.68	55, 869	4.58	7, 319	0.60	50, 502	4.14

\*) - as % of total amount of debt.

Source: RF Central Bank.

As reported by the RF CB, in the first half-year of 2011, the average weighted interest rate on HMC (denominated both in rubles and foreign currencies) allotted since the year's beginning continued to display a downward trend. The average weighted interest rate as of 1 July 2011 with regard to ruble-denominated credits dropped by 0.2 pp to 12.2 %, and with regard to credits denominated in foreign currencies – by 0.1 pp to 9.6 % (*Fig. 3*). In June, the average weighted interest rate on ruble-denominated HMC



- ▲ Average weighted interest rate on ruble-denominated HMC, %
- Average weighted interest rate on HMC denominated in foreign currencies, %
- Average weighted crediting period of ruble-denominated HMC, years
- - - Average weighted crediting period for HMC denominated in foreign currencies, years

Source: RF CB's data.

Fig. 3. Average Weighted Data on Housing Mortgage Credits Allotted Since Year's Beginning

allotted over that month was 12.1 %. The average weighted rate for the first half-year of 2011 on ruble-denominated HMC refinanced by the Agency for Housing Mortgage Lending (AHML) relatively to that for Q1 2011 dropped by 0.01 and thus amounted to 11.70 % (the AHML's average weighted rate for 2010 was 11.16 %)

As of 1 July 2011, the average weighted crediting period for HMC issued since the year's beginning decreased, as compared to 1 April 2011, by 0.51 years to 15.73 years for ruble-denominated HMC, while for HMC denominated in foreign currencies it increased by 1.18 years to 13.39 years (*Fig. 3*). The average weighted crediting period in the first half-year of

2011 for ruble-denominated HMC refinanced by the AHML, similarly with that established for Q1 2011, was 17.58 years (the average weighted crediting period for 2010 was 16.83 years).

As of 1 July 2011, the average credit amount for ruble-denominated HMC allotted across the Russian Federation since the year's beginning (Rb 1.346 m) had somewhat dropped since 1 April 2011 (Fig. 4). The actual changes that occurred during the first half year of 2011 are multivector, depending on a given region. The highest index of average credit amount (Rb 3.66 m – Moscow) rose on Q1 2011 by 9.66 %. On the contrary, the lowest index (Rb 0.944 m – Volga Federal District) dropped on the same period by 3.69 % (Fig. 4). The average weighted interest rates on HMC as of 1 July 2011 declined in all the regions except the North Caucasus Federal District, where the interest rate remained unchanged since 1 April 2011.

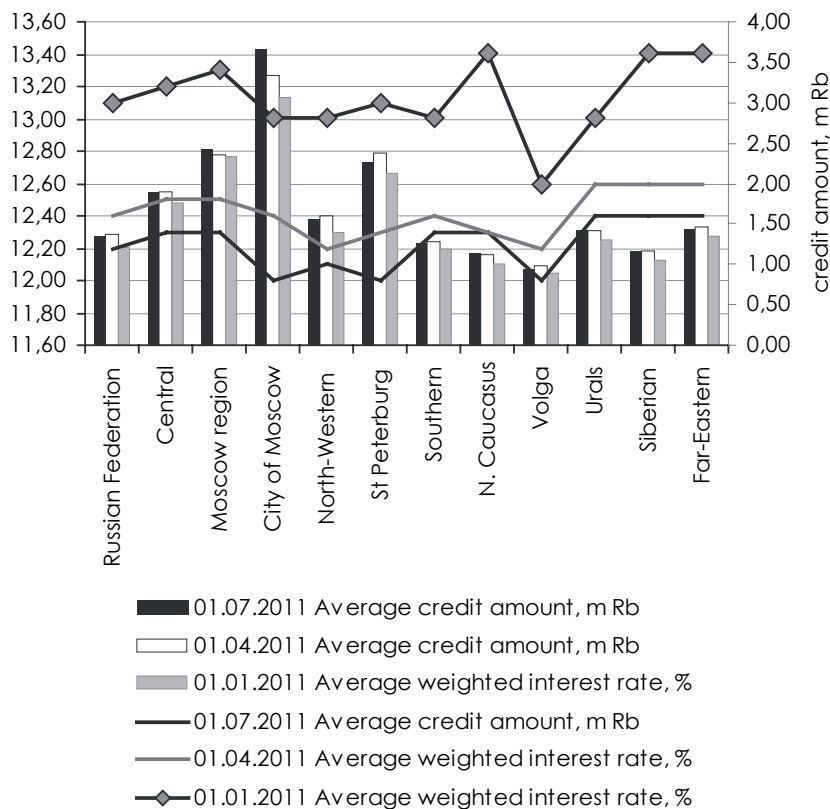
The lowest rates (12.0 %) were recorded in Moscow, St. Petersburg and the Volga Federal District, the highest (12.4 %) – in the Urals Federal District (Fig. 4).

Over the first half year of 2011, the AHML refinanced 18,145 HMC in the total amount of Rb 22.4 bn, which is equal to 9.3 % in quantitative and 8.4 % in money terms of all HMC issued over that period (in Q1 – 5,602 mortgages in the amount of Rb 5.69 bn). In July, the AHML refinanced 2,967 credits in the amount of Rb 3.8 bn.

In August 2011, in accordance with 'The Strategy for the Development of Mortgage Housing Lending in the Russian Federation until 2030' and the Instruction of the RF Government of 3 March 2009, the RF Government introduced into the State Duma a draft law on alterations in the Law 'On Mortgage Securities'. Those alterations were aimed at further promoting the securitization of the mortgage market. In accordance with Article 10 of the Law 'On Mortgage Securities', 'payment of interest on mortgage – backed bonds shall be carried out at least once a year'. 'A mortgage cover can be built into the guarantees of implementing the liabilities under bonds of two or more issues'... In the event of 'two or more issues having been floated, the issuer shall have the right to set up the sequence for implementing the liabilities under mortgage-backed securities of various issues. In such cases, the right to implement the liabilities under the mortgage-backed bonds of each tranche shall be granted only after the liabilities under the mortgaged-backed bonds of the previous tranche have been properly implemented'.

Such a sequence of payments inevitably results in a situation when the bonds of each of the subsequent tranches (junior tranches) bear heavier risks than the preceding ones (senior tranches). The minimum number of payments under tranches, that is, once a year, is usually accorded to the most junior tranche, with all the risks of mortgage coverage concentrated thereon. It is not infrequent that a junior tranche fails to attract demand, thus making it necessary for the initial owner of the mortgage cover to buy it out, so as to increase the attraction of senior tranches.

From our point of view, the abolition of the current maximum repayment period of one year is unlikely to substantially benefit the securities market, because any normal (knowledgeable)



Source: RF CB's data.

Fig. 3. Average Weighted Data on Housing Mortgage Credits Allotted Since Year's Beginning, by Region

investor, before buying bonds of a junior tranche, will assess the ratio between the dead-lines for payments and the expected risks, and so certainly abstain from purchasing excessively risky bonds. The excessive freedom of securitization on a narrow mortgage market with high interest rates 'profitable' for the creditor is fraught with the threat of the requirements to the reliability of credits being lowered, as it was clearly demonstrated by the recent mortgage crisis even with regard to long established vast markets. As far as the development of a market is concerned, it depends on the numbers of solvent debtors, that is, on the ratio between the level of incomes and residence prices, as well as on the stability of incomes and economic stability.

From August 2011, under the *Mortgage + Maternal Capital* program of the *VTB 24* bank, the right to obtain credit in absence of an initial contribution is granted not only to customers who are going to buy dwellings on the secondary market but also to those purchasing dwellings in the stage of construction.

*VTB 24* and the Agency for Housing Mortgage Lending intend to float the first issue of mortgage-backed bonds to the value of Rb 10 bn within the framework of the RF Bank for Development and Foreign Economic Affairs' mortgage promotion program, worth Rb 150 bn. ●

## ECONOMIC GROWTH FACTORS IN 2010 – THE FIRST HALF YEAR OF 2011<sup>1</sup>

E.Astafieva

*The results of decomposition of output growth rates across the Russian Federation demonstrate that in the period of 2010 – the first half year of 2011 the rate of GDP growth was predominantly influenced by the inputs provided by the main production factors. Labor and capital inputs fully determine the rate of output growth, that is, the Russian economy's exit from the crisis is being achieved mostly due to the effect of extensive factors against the backdrop of a favorable situation with regard to prices on world raw materials markets. In 2011, the input components are redistributing in terms of relevance of their main factors in favor of reserves (the number of employed and the volume of fixed assets) in response to the diminishing intensity of their load.*

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

According to data published by *Rosstat*, the period of 2010 through the first half year of 2011 demonstrated a positive rate of GDP growth amounting on the average to 3.9 %. Considering that in 2009 the average quarterly rate of GDP decline was over 8 %, the volume of output achieved so far has not yet compensated for its drop over the crisis period. In particular, in the first half year of 2011 the volume of quarterly GDP in real terms amounts to 97 % of its pre-crisis level, and in 2010 – to 96 %, which approximately corresponds to the 2007 level.

The changes in GDP volume occurring in 2010 and the first half year of 2011 displayed the same direction as those in the inputs contributed by the main factors: output growth is followed by growth of the main extensive factors.

As shown by factor decomposition (*Table 1, Fig. 1*) over the period under consideration, 23 % of GDP growth can be explained by changes in labor input. The input provided by that component was nearly the same during 2010 and in Q1 2011, and then dropped to almost one-third of its previous value in Q2 2011 (7.4 %). The input provided by changes in the volume of used production capital to the rate of GDP growth was on the average 84 %. It should be noted that the domination of capital input over labor input in the structure of output growth is also demonstrated by GDP decomposition in the pre-crisis period. In this connection, over the entire period under consideration capital input acts as the most relevant economic growth factor, determining a major part of the rate of GDP growth, and in Q1 and Q3 2010 it was the only growth-inducing factor. In 2010 and the first half year of 2011, contrary to the situation observed over the preceding years, CFP was no longer the predominant output growth factor.

<sup>1</sup> This section presents the results of decomposition of output growth index (GDP) in 2010 through the first half year of 2011 obtained by applying the methodology described in the IEP's publication (*Faktory ekonomicheskogo rosta* [Economic Growth Factors], series *Nauchnye tridy* [Scientific Works], No 70, IET, M. 2003, 390 P., www.iet.ru).



Table 1

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

	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011
growth rate						
GDP	3.5	5.0	3.1	4.5	4.1	3.4
I. Factor inputs	4.8	4.9	5.5	3.9	2.6	2.6
I.1 Labor	0.8	1.4	0.9	1.1	1.1	0.3
Employment	-0.2	0.5	0.5	0.4	1.2	0.5
Working hours	1.0	0.9	0.4	0.7	-0.1	-0.2*
I.2 Capital	4.0	3.5	4.6	2.8	1.6	2.4
Fixed assets	1.4	1.4	1.6	1.6	1.4	1.5
Capacity load	2.6	2.1	3.1	1.2	0.2	0.9
II. CFP	-1.3	0.1	-2.4	0.6	1.5	0.8
as % of GDP growth rate						
GDP	100.0	100.0	100.0	100.0	100.0	100.0
I. Factor inputs	137.2	99.0	177.3	86.1	64.3	77.9
I.1 Labor	23.0	28.8	28.1	24.9	26.1	7.4
Employment	-6.1	10.0	14.7	9.2	28.3	14.4
Working hours	29.1	18.8	13.4	15.7	-2.2	-7.0
I.2 Capital	114.2	70.2	149.2	61.2	38.2	70.5
Fixed assets	39.5	28.8	50.0	35.1	34.3	43.4
Capacity load	74.7	41.4	99.2	26.1	3.9	27.1
II. CFP	-37.2	1.0	-77.3	13.9	35.7	22.1

\* The values of working hours for Q2 2011 are based on a regression model where the explained variable is represented by the total working hours of all employees, and the factors are the numbers of those employed full time, those employed part-time, and those on leave, assessed on the basis of data for the previous years.

The quarterly structure of labor input over the period under consideration is rather heterogeneous. Thus, in Q1 2010, positive labor input in the rate of output growth is determined by increased working hours coupled by shrinking number of employed. From Q2 2010 onwards, the number of employed in the economy increases, and so the input of labor reserves in the rate of output growth shifts onto the positive side. Growth of employment is accompanied by shrinkage of the growth rate of its load intensity, but until the end of 2010 that component of labor input remained a predominant one: on the average in Q2 – Q4 2010, the input component determined by changes in working time values is nearly 1.5 times higher than that determined by changes in the number of employed. In 2011 there occurred a redistribution of input components by their relevance in favor of labor reserves caused by the diminishing intensity of labor load input. The mean quarterly decline in the growth rate of working hours was 0.5 pp., the mean quarterly rise in the growth rate of the number of employed was 0.3 pp. It is noteworthy that the changes in labor rate were determined in the main by an increasing share of the employed population in the total amount of economically active population, while the share of the able-bodied population in the total population and that of the economically active population in the total able-bodied population remained virtually unchanged.

The period under consideration is characterized by the reestablished predominance of capital input in the rate of output growth. In accordance with the applied assessment methodology,<sup>1</sup> the dynamics of capital reserves was determined by changes in the volume of investments in fixed assets, whose growth rate was increasing on the average by 1.9 pp every quarter (from – 4.8 % in Q1 2010 to 4.9 % in Q2 2011). It should be noted that, in spite of the growth registered in that period, the volume of investments in fixed assets in real terms remained below not only its level in 2008, but also its 2007 level. As a result, in conditions of rapid wear and tear of fixed assets coupled with shrinkage of funds

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

allocated to their renewal and repair, the growth rate of capital reserves remains practically unchanged. On the average, in 2010 and the first half year of 2011 the growth rate of fixed assets was responsible for 38 % of the rate of GDP growth, while the fluctuations in their load – for 45.4 % thereof. However, just as in the case of labor input, the structure of capital input is characterized by redistribution, by relevance, of its components' inputs. The mean quarterly decline in the growth rate of the intensity of use of fixed assets was 0.8 pp. As a result, from Q4 2010 onwards, changes in capital reserves reveal their more substantial input in the rate of GDP growth by comparison with the input determined by fluctuations in their load.

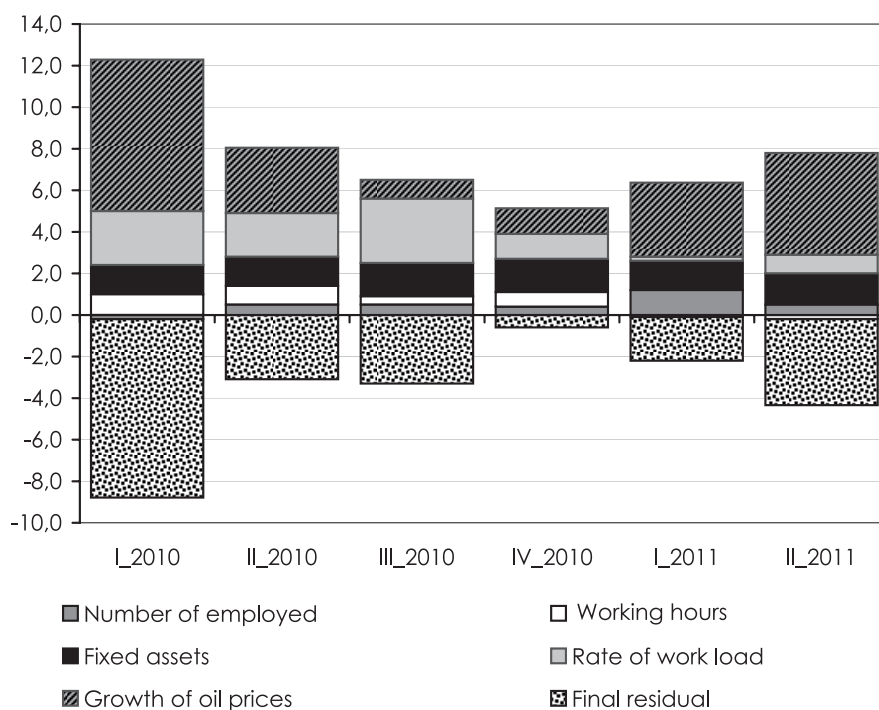


Fig. 1. By-factor Decomposition of GDP Growth (Against Same Periods of Previous Years), with Estimates of Input Provided by Oil Prices

Over the period under consideration, the impact of combined factor productivity (CFP) on output growth is also distributed unevenly between different quarters: thus, in Q1 and Q3 2010 the input of that component in GDP growth rate was negative, while in all the other periods it determined on the average only 18 % of the rate of output growth.

The observed influence of CFP on output dynamics by no means reflects only the impact of productivity factors determined by technological changes. It also incorporates some components not included in the estimates of the main factors, as well as biases caused by the specific assessment methodology, in particular those determined by uneven dynamics of the value indices applied in the decomposition (output and capital)<sup>1</sup>. As shown by the estimates obtained for earlier periods, these biases are significant in conditions of Russia's economic system, which is strongly influenced by changes in prices on international raw materials markets, especially in a short-term perspective.

In accordance with the obtained results<sup>2</sup>, changes in oil prices determine a major part of the rate of GDP growth. On the average, during the period under consideration, changes in the price factor determined approximately 93 % of the rate of output growth, while technological productivity ('final residual') is conducive to a slowdown in the rate of GDP growth. ●

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

2 The singling out, in CFP's structure, of a "situational" component and further decomposition of the rate of output growth is based on the existence of a statistically significant correlation between the growth rates CFP and world oil prices, which is estimated by applying regression based on annual data for the period 1993 – 2010. The resulting 'final residual', cleared of the effects produced by fluctuations of prices on world raw materials markets, represents a more correct index of technological productivity, i. e., the intensive component of output growth.

**ECONOMIC LEGISLATION REVIEW**

I.Tolmacheva

*In August, the following amendments were introduced in legislation: the Government of the Russian Federation envisages to pay scholarships to students and postgraduate students studying in areas of training and professions, consistent with priority areas of modernization and technological development of the Russian economy. Individuals will have an access to notifications on taxes due electronically on the RF Federal Tax Service website in the "Personal Account of the Taxpayer". During the electronic auctions, a contract for the supply of goods, works and services for public needs, concluded as a result of the electronic auction, shall be executed only in electronic format.*

**I. RF Government Resolution**

«On SCHOLARSHIPS OF THE GOVERNMENT OF THE RUSSIAN FEDERATION TO STUDENTS AND POSTGRADUATE STUDENTS STUDYING IN AREAS OF TRAINING AND PROFESSIONS, CONSISTENT WITH PRIORITY AREAS OF MODERNIZATION AND TECHNOLOGICAL DEVELOPMENT OF THE RUSSIAN ECONOMY» No. 600 from 20.07.2011.

From January 1, 2012, students and postgraduate students studying in areas of training and professions, consistent with priority areas of modernization and technological development of the Russian economy will be paid a monthly scholarship of the Government of the Russian Federation in the amount of Rb5,000 for students and Rb10,000 for postgraduate students. A draft list of training areas and specialties of the Russian Federation Ministry of Education and Science will be submitted to the Government before October 1, 2011. There envisaged 4,500 bonuses for students and 500 bonuses for postgraduates.

**II. Instructions, letters, orders**

1. Order of the RF Federal Tax Service «ON APPROVAL FORMATS AND THE PROCEDURE OF FORWARDING NOTIFICATION TO THE TAX TAXPAYER ELECTRONICALLY VIA TELECOMMUNICATION CHANNELS» No. MMV-7-11/324 @, dated 23.05.2011,

Registered with the RF Ministry of Justice No. 21 401 as of 19.07.2011.

Individuals will be able to get notifications on taxes due electronically on the RF FTS website in the «Personal Account of the Taxpayer.» Individual taxpayers pay vehicle tax, land tax and property taxes based on tax notices sent by the tax authority. There are approved formats and procedure for forwarding a tax notice in electronic form to a taxpayer. In particular, it is established that documents forwarding is performed through the instrument administered by the RF FTS Internet service of the «Personal account of the taxpayer.» All documents should be generated in PDF format. If before September 1, notification and payment documents are not received by the taxpayer in electronic format, the tax authority is obliged to send them to an individual in hard copy.

2. RF FAS letter «O CONTRACT BASED ON THE RESULTS OF THE ELECTRONIC AUCTION» No. ATS/27696 dated 15.07.2011.

It is informed that in accordance with the Federal Law No. 94-FZ of 21.07.2005 «On placing orders for goods, works and services for the government and municipal needs» in conducting electronic auctions, entire workflow is carried out exclusively in electronic format via e-media. According to the results of the electronic auction, a contract must be in the form of an electronic document. A different form of the contract, including a paper version is not allowed. The Bidder, who signed a contract in writing on paper instead of an electronic document, is regarded as evaded from the contract and shall be included in the register of incompliant suppliers, and funds deposited by such Party to secure the bid, shall be transferred to the customer after the information about the bidder is included in the said register. An official representative of the customer or the authorized agency, who signed the contract in a paper version instead of signing an electronic document, shall be brought to administrative responsibility in the form of a fine.

Thus, FAS explains that the contract for the supply of goods, works and services for public needs, concluded a contract as per results of the electronic auction in a hard copy, is void.

3. Letter to the RF Treasury «ON THE QUESTIONS ARISING AT THE OPENING AND SERVICING OF PERSONAL ACCOUNTS OF BUDGETARY INSTITUTIONS (SEPARATE ACCOUNTS OF BUDGETARY INSTITUTIONS)» No. 42-7.4-05/3.5-542 dated 12.08.2011.

Federal Treasury has prepared answers to the questions of territorial bodies, arising in the course of experiment conducted in the 2011, in opening and servicing of accounts of budgetary institutions. In particular, the letter informed on:

– the transfer of cash balances reflected in the federal budget agencies personal accounts, which are to be closed due to changes in order of the financial activities of the institution (transfer from budget estimates to the provision of subsidies);

– transfer to a new personal account the funds transferred to the old personal account;

– specifics of the old personal accounts closure;

– transfer of rent for use of federal real estate at the expense of the Federal Treasury authority, designated to reflect the income to be distributed among the budgets of the RF budgetary system, after opening a new customer account. ●

**REVIEW OF THE RUSSIAN FEDERATION GOVERNMENT  
IN AUGUST 2011**

M.Goldin

*At the sessions of the Presidium of the RF government in August 2011, among others, the following issues were addressed: the main trends of the Russian Federation debt policy for 2012-2014, amendments to the RF Tax Code, establishing a lower tax rate for corporate income tax for resident organizations of technology-innovative special economic zone.*

At the RF government meeting on August 11, 2011 the main trends of the debt policy of the Russian Federation in 2012-2014 were approved. According to them, the government debt policy will be directed to funding of the federal budget deficit by attracting resources from domestic and international capital markets.

In the period of 2012-2014, the Russian Ministry of Finance plans to implement the government internal borrowings (mainly through the issuance of government securities totaling to Rb6.3337 trillion, including Rb1.9779 trillion in 2012, Rb 2.0822 trillion in 2013 and Rb2273.6 billion in 2014).

Also at the the RF government meeting on August 11, 2011 the amendments to the Tax Code were reviewed, establishing a reduction in the tax rate on corporate income tax for resident organizations of technology-innovative special economic zone. The draft law proposes to set the tax rate for corporate income tax at the rate of 0 percent for the period from January 1, 2012 to January 1, 2018, as well as to envisage the establishment by the laws of the Russian Federation a reduced rate of tax on profit to be credited to the budgets of the Russian Federation, not exceeding 13.5 percent.

The said tax rate shall be applicable to profits from activities in the technology-innovative special economic zone, subject to separate accounting of income (expense), received (incurred) from activities in the technology-innovative special economic zone, and income (expenditures), received (incurred) in activities outside the territory of technology-innovative special economic zone.

The draft law is submitted to the State Duma. ●



## AN OVERVIEW OF NORMATIVE DOCUMENTS ON TAXATION ISSUES FOR JULY AND AUGUST 2011

L.Anisimova

In view of the fact that a large number of alterations were introduced in the RF Tax Code in July 2011, late July and August turned out to be a rather uneventful period in terms of norm making. During that period, experts were busily discussing issues dealing with the expected increase in the alcohol and tobacco excise taxes. This issues were becoming increasingly urgent in connection with the establishment of the Customs Union (hereinafter – the CU). The discussion of excise-related issues in the Russian press was launched in response to the introduction in the State Duma of a draft law, prepared by the RF Ministry of Finance, which envisaged an indexation of excise tax rates on alcohol and tobacco in connection with the ongoing climb in consumer prices and inflation forecasts for 2012 – 2014 ( for some types of products, prices were expected to grow more than two-fold), as well to the publication, by the RF Ministry of Finance to its official website, of a draft law on the protection of public health from the harmful effects of tobacco use (which also envisaged a hike in the corresponding excises). Experts diametrically differed then, and still continue to differ in their assessments of the results of the expected sharp rise in the excise taxes. A number of experts (including some of the authors of *Strategy-2020*) believe that, if the excises are simultaneously increased to a level comparable with the European one, the state budget will suffer no losses; these experts view the growth in the excises as a fiscal reserve to increase budget revenues. Other experts (for example, specialists from the Center for Federal and Regional Alcohol Market Studies) believe that such measures are fraught with dangerous consequences, in particular that they will devalue the previously achieved positive results in the field of curtailing the alcohol market (according to their estimates, the legal market can shrink more than three-fold over the period of three to four years). The excises' possibility to exert influence on the redistribution of the legal and illegal tobacco product markets is also noted by representatives of *Tabakprom Association* (Tobacco Industry Association). To justify their opinion, they refer to the experience of the UK, where the share of the illegal market has drastically increased (more than ten-fold) since the excises were considerably raised. These experts note that Russia's excise rates have turned out to be the highest in the Customs Union (in Belarus and Kazakhstan, the excise rates on tobacco are respectively 6 and 4 times lower than in Russia), and that any further rise in the rates can render the legal tobacco market inefficient and eventually totally destroy it.

One phenomenon in the field of the excise regulation of the tobacco and alcohol markets should be characterized as definitely positive. This phenomenon is a step-by-step approach so far adhered to by the state with regard to this regulation: e.g., the authorities announce that they are going to make further moves to toughen the rules of work at these markets well in advance (for example, the introduction of a ban on smoking in public places, with the subsequent expansion of the list of non-smoking areas; a ban on night-time alcohol sales and the strengthening of responsibility for selling alcohol to juveniles; the placement of beer in the category of strong alcoholic beverages; the introduction of the mandatory use of cash registers and point of sale equipment when selling beers with an alcohol content of 5 percent (previously, 12 percent), etc); all this is designed to make it possible for businesses to timely develop acceptable solutions or to redirect their capital to other fields of economic activity. The step-by-step policy of gradually increasing the financial burden and the strengthening of control over alcohol and tobacco sales enabled the state to rather successfully deal with some complicated social tasks and so, without losses in revenue, to forcibly restrict access to those markets to new customers. However, such a policy requires very fine tuning, because it would be unreasonable to wreck an already functioning market: a deficit of alcohol and tobacco sold at prices affordable for the existing range of consumers can force the latter to shift to products of lower quality, which would inflict financial losses upon the entrepreneurs operating on these markets and so (in the event of the legal sector's shrinkage) would create an impetus to an explosion-like development of the shadow market. Such a deficit would also result in a massive loss

of budget revenues and a simultaneous increase in social expenditures. Therefore, bearing in mind the specific features of these markets, we believe that it will be a big mistake to see the excise taxes on alcohol and tobacco as an efficient alternative to other categories of budget revenues (although it has been frequently proposed in recent months that a rise in these excises should be used almost as the principal means of curbing the budget deficit and as a replacement for the revenues from insurance contributions that are going to be lost through their planned reduction).

It is highly commendable that the RF Ministry of Finance and the Federal Tax Service should thoroughly elaborate the technical aspects of the issues dealing with the introduction of the new rules on repayment of excise taxes on alcohol-containing products, which are aimed at strengthening financial discipline and at promoting compliance with regulatory payment timelines.

1. Letter of the RF Federal Tax Service, of 1 August 2011, No ED-4-3/12378@ clarifies the changes in payment of excises on alcohol-containing products. In the course of ethanol and (or) cognac spirit sales by distilleries, the taxpayers – manufacturers of alcohol and (or) excisable alcohol-containing products – should pay the excise, on the day of shipment, at a rate of: a) 0 % per 1 liter of anhydrous alcohol, if the manufacturers of alcohol products have paid the excise in advance and have submitted to the alcohol manufacturer a notification on the relevant advance payment (or exemption from the payment), verified by the tax body at the place of State registration; b) 34 rubles per 1 liter of anhydrous ethanol contained in the excisable commodity, if the alcohol is being sold by organizations that have not made an advance payment of excise tax on alcohol and alcohol-containing products. The amount of excise presented by the seller should be charged to the cost of the alcohol product purchased by the buyer (Item 2 of Article 199; Item 2 of Article 200 of the RF Tax Code). In the event that the notification on the execution of the advance payment has been submitted by the buyer after the shipment of the alcohol, recalculation of the excise included in the cost of the commodity at a rate of 0 % should not be carried out on the part of the buyer.

Thus, the payment of the excise is timed to be as close as possible to the moment of shipping the alcohol outside the distilleries. Violation of the payment timelines results in an automatic rise in the price of the relevant raw materials for the violators, which will inevitably entail financial losses on their part. If any amount of tax is charged to costs by a distillery, this would automatically deprive it of a possibility to subsequently set off the amount of excise presented to the buyer against its liabilities under this tax. As a result, in the event of excise payment deadline violation, the State has the right to additionally claim 27.2 Rb for each liter of anhydrous alcohol. [Calculation:  $(\text{market price} - \text{costs} - 34 \text{ Rb}) * 20\text{-percent rate of profits tax} + 34 \text{ Rb} = (\text{market price} - \text{costs}) * 20\% - 6.8 \text{ Rb} + 34 \text{ Rb} = (\text{market price} - \text{costs}) * 20\% + 27.2 \text{ Rb}$ ]. The technology of this calculation is rather simple: the ‘penal’ excise tax is charged to costs, and so decreases the taxation base of profits tax. Therefore, on the whole, the budget additionally receives slightly less than the established amount of 34 rubles per each liter of anhydrous alcohol.

2. Letter of the RF Federal Tax Service, of 3 August 2011, No AS-4-3/12540@ continues the theme discussed above, and thus clarifies the issues relating to the procedures for excise taxes to be accepted for deduction with regard to manufacturers of alcohol and (or) excisable alcohol-containing products during the transition period from 1 July 2011 through 31 July 2011, in connection with the introduction of an advance payment system for excise taxes.

The outline of this transition is as follows. Federal Law No 306-FZ, of 27 November 2010 established that, from 1 July 2011 onwards, producers of alcohol and alcohol-containing products (alcohol consumers) should be liable to pay excise tax by way of advance payments. In the course of alcohol sales, such consumers of alcohol should be liable to pay excise tax at a rate of 0 %. At the same time, prior to 31 July 2011, alcohol manufacturers were liable to pay excise tax at a rate of 34 Rb per one liter of anhydrous alcohol. From 1 August 2011, the 34-ruble excise tax rate should be used by alcohol manufacturers (distilleries) only when selling alcohol to organizations that have failed to make an advance payment of excise tax. Thus, conflicts of the following type are definitely likely to take place during the transition period: the buyer has already paid excise tax in advance, and then is once again charged with the payment of excise tax by the seller in the corresponding documents.

In order to regulate such situations, the tax authorities explain that tax deductions for the alcohol used as a raw material in manufacturing excisable alcohol and (or) alcohol-containing products that were shipped by their manufacturers before 1 August 2011 should be calculated in accordance with Article 201 of the RF Tax Code in its version that was in effect until 1 January 2011; that is, instead of applying the excise tax rate of 0 % established by item 1 of Article 193 of the RF Tax Code for ethanol or cognac alcohol sold by organizations – advance excise tax payers, the excise should be calculated and charged for the amounts actually paid.

At the same time, the RF Federal Tax Service points it out to taxpayers that the organizations engaged in the manufacturing of alcohol products must make an inventory of the whole volume of their ethanol stocks acquired as of 31 July 2011, included those ethanol products that were being shipped, either in the form of finished products or in an unfinished state, in instances when, firstly, the said alcohol had been acquired prior to 31 July 2011, and secondly, when the amount of excise that had been presented by those manufacturers had not been accepted for deduction.

In the event when a taxpayer has presented a bank guarantee to a tax body for the purpose of getting an exemption an advance excise tax payment (item 12 of Article 204 of the RF Tax Code), it will be necessary to take into consideration the fact that this guarantee must be valid for no less than six months after the end of the tax period during which the ethanol or cognac alcohol was bought. If, for example, the purchase took place on 1 August 2011, the bank guarantee must not expire before 1 March 2012. (In accordance with Article 192 of the RF Tax Code, the duration of a tax period is one month). The tax authorities warn that, in an event when the tax guarantee expires before this date, exemption from advance excise tax payment would not be granted.

Thus, a lack of discipline with regard to advance excise tax payments can result in some additional losses on the part of taxpayers, that would be well above the standard penalty.

3. Inconsistency in the implementation of financial policy that has frequently been mentioned in our previous overviews, was once again clearly manifested.

On 29 July 2011, the Russian Council of Ministers passed Decree of the RF Government No 633 to the effect that the RF Ministry of Economic Development should be granted the right to carry out expert examination of normative legal acts, or their individual provisions, adopted by federal executive authorities, for the purpose of detecting, in the said acts, any provisions that unjustifiably complicate smooth running of entrepreneurial and investment activities. In the event that such provisions are detected in the said acts, the RF Ministry of Economic Development should submit to the RF Ministry of Justice a proposal that the relevant normative legal acts or their individual provisions be abolished, or should forward, to the Government Commission on Administrative Reform, its proposals on introducing alterations in those laws, decrees and regulations of the RF President and/or in the RF Government's resolutions and regulations forming the basis for those normative legal acts issued by the federal executive authorities that unjustifiably complicate smooth running of entrepreneurial and investment activities.

However, Letter of the RF Ministry of Finance, of 15 August 2011, No 02-04-10/3338, reminds those concerned that, in accordance with Article 9 of Federal Law, of 21 April 2011, No 69-FZ, the supreme executive authorities of RF subjects are liable to develop, before 1 September 2011 (each of those bodies for the relevant territory under its jurisdiction), a procedure for determining the amount of payment for the issuance of permits (or copies of permits) for carrying out activities involving the transport of passengers and cargo by taxi cabs. It should be reminded that this mandatory payment is not envisaged by the RF Tax Code, and so its status (and, therefore, the maximum load level) remains undetermined – the payment is not included in the State duty for the issuance of a license, nor represents a form of patent acquisition (according to the clarifications contained in Letter of the RF Ministry of Finance, of 20 July 2011, No 03-11-11/190; Letter of the RF Federal Tax Service, of 16 August 2011, No AS-4-3/13351@; and Letter of the RF Ministry of Finance, of 5 August 2011, No 03-11-09/52, taxi services should be regulated under category 029-2001, code 60.24, of the All-Russian Classifier of Types of Economic Activities, Products, and Services, thus apparently placing them in the category of entrepreneurial activities in the field of the transport services provision that should be levied by tax under the simplified system of taxation, on the basis of a patent; as a result, a taxi driver, in addition to making the mandatory payment,

will have to buy a patent!). Besides, it is not recognized as a form of payment for services provided by a natural monopoly (with the right of price control on the part of the RF Federal Tariff Service). Equally unacceptable is the explanation that the money paid for the patent represents payment for the outsourcing of a service that the population of given subject of the Russian Federation should be provided with by the authorities of the relevant region, because the afore-mentioned Law envisages that a ceiling should be established for the number of taxi cabs (Article 23), and that licenses should be issued on the basis of the results of a tender (Article 24); however it does not stipulate that the authorities should be obliged to determine the primary price of transport service provision. Thus, the terms of tenders are placed within the competence of RF subjects by the Law, and therefore no changes can be introduced in these terms either by the RF Ministry of Economic Development or the RF Federal Tariff Service, or by any other competent state bodies, unless such changes are motivated by a violation of Russia's Constitution or her international treaties.

The RF Ministry of Finance notes that the RF Budget Code and other normative legal acts regulating budgetary legal relations contain no definition of a budget whose revenue source is to be generated by the new payment, because no existing normative legal act envisages its exaction. The RF Ministry of Finance suggests that, before any relevant normative legal act is put into effect, the afore-said revenues should be included in full in the budgets of RF subjects under the revenue classification code "*Fees Levied by State Organizations of RF Subjects for Discharge of Certain Functions*".

Thus, on the one hand, the RF Ministry of Economic Development is instructed to carry out a revision of the existing normative, legal-normative and other subordinate acts for the purpose of detecting obstacles to business and investment development, while on the other hand, one can see continuation of the practice of establishing mandatory payments whose main parameters are not determined by laws. Moreover, these payments do not fall under the sphere of application of the requirements and restrictions regulated by the RF Tax Code and aimed at protecting entrepreneurs. On the contrary, the said payments forcibly and uncontrollably increase the costs shouldered by commodity producers and therefore the prices set by them. This phenomenon is evidently destructive to business.

4. The letters of the RF Ministry of Finance and the RF Federal Tax Service, which contain annotations of the decisions on tax disputes passed by the Presidium of the RF Supreme Arbitration Court in 2010 and the first half-year of 2011, can be characterized as technically very helpful. Thus, Letter of the RF Federal Tax Service, of 12 August 2011, No SA-4-7/13193@, offers a wide selection of decisions practically on all taxes and special tax regimes. Letter of the RF Ministry of Finance, of 2 August 2011 (circulated Letter of the RF Federal Tax Service, of 12 August 2011, No AS-4-3/13133@), contains clarifications on the issues of using the VAT zero-rate in export-import transactions and associated transactions.

5. From the point of view of technical clarifications reflecting the RF Ministry of Finance's position on complicated issues, we can emphasize the importance of the Ministry's clarification, of 11 August 2011, on "*Protocol on Consultations Regarding the Elaboration of Joint Approaches to Interpretation of Provisions of the Russian – Ukrainian Agreement on Avoidance of Double Taxation of Incomes and Properties and on Prevention of Tax Evasion in the Part of Other Incomes not Mentioned in the Agreement*". The Russian Federation and Ukraine have come to an agreement that "other incomes" should be understood as those incomes that are received by individuals in the form of winnings, prizes, charitable donations, gifts, alimonies, social insurance payments, inherited funds, properties, property and non-property rights, as well as incomes derived from applying non-traditional financial instruments (derivatives). The specified types of incomes emerging from sources in one of the two States – parties to the Agreement – should be taxed in the territory of that state.

The chosen approach does not fully correspond to methods traditionally applied for eliminating double taxation. Thus, for example, prizes and bonuses are usually taxed at the place of the recipient's physical presence, and not at the source of the income. Movables (derivatives) and rights, as well as incomes from movables and rights, also are usually taxed at the place of residence of their owner, and not at the source of the income.



It can be assumed that the competent bodies of the Russian Federation have achieved the maximum possible protection of the interests of Russia's budget in this issue, by having managed to link payments to the budget of the State where the source of income is situated. But the adopted decision will have one negative consequence in the form of economic difficulties that will have to be faced by taxpayers. The general principle of devising a tax system in market conditions is to levy tax on incomes at the place of residence of a taxpayer. However, in the situation under consideration, income recipients will be forced to prove the fact that taxes on their incomes have already been collected on the behalf of the budget of another state. This will be a rather complicated task, which can potentially give rise to tax disputes or result in double taxation of incomes.

6. Letter of the RF Ministry of Finance, of 1 August 2011, No 03-03-06/1/441, clarifies the situation arising in connection with writing-off accrued dividends unclaimed by their recipient. According to Article 266 of the RF Tax Code, a dubious debt to be written off at the expense of reserves created out of profits, before the taxation of the said reserves, should be understood as any kind of a taxpayer's receivables that have arisen in connection with realization of goods (or work, or services), if those have not been settled before the deadline established in a relevant contract, or are not secured with a pledge, surety or bank guarantee.

The relations arising in connection with the payment of dividends are not linked to realization of goods (or work, or services), and so, for purposes of taxation of profit, cannot result in the emergence of any dubious or irrecoverable debts incurred by a recipient of dividends. Therefore unclaimed dividends, with regard to their recipients, cannot be written off as losses or charged against reserves earmarked to cover dubious debts. ●



## AMENDMENTS TO THE BUDGETING LEGAL FRAMEWORK

M. Goldin

*In August 2011 the RF Government has adopted the Resolution, establishing the rules for granting subsidies to socially-oriented NPOs and to the Subjects of the Russian Federation for the implementation of regional support programs for socially-oriented NPOs.*

By the RF Government Decree No. 713 dated of August 23, 2011 “On providing support to socially-oriented non-profit organizations” the Rules were approved for granting to the Subjects of the Russian Federation budgets for the implementation of programs on the support of socially-oriented non-profit organizations, as well as rules for providing subsidies from the federal budget for the support of socially-oriented non-profit organizations.

The rules were approved in accordance with paragraph 5 of Article 31.1 of the Federal Law “On Non-Profit Organizations” No. 7-FZ dated 12.01.1996. This Article stipulates that assets allocation from the federal budget for financial support to socially-oriented non-profit organizations, including grants to the budgets of the Russian Federation Subjects shall be provided in accordance with procedure stipulated by the Government of the Russian Federation.

According to the Rules for granting subsidies to the RF Subjects, the subsidies are granted in order to co-financing of the Russian Federation Subjects budgetary commitments, arising from the implementation of support programs in terms of financial support to socially-oriented non-profit organizations engaged in activities on the following areas:

- a) prevention of child abandonment, support for mothers and children;
- b) improving the quality of life of elderly people;
- c) social adaptation of people with disabilities and their families;
- d) development of additional education, technical, scientific and artistic creative activities, mass sports, activities of children and young people in local history and ecology;
- e) development of international cooperation;
- f) other activities, which are performed by the Subjects of the Russian Federation in accordance with the approved Program of Support.

Grants are provided to the regions selected under a tender in accordance with procedures, approved by the Ministry of Economic Development of Russia.

The Rules for granting subsidies to the RF Subjects include criteria for competitive selection of the Subjects of the Russian Federation, which get the budget grants, as well as methods of distribution of the subsidies among the budgets of the RF Subjects and define the amount of the subsidy to each Subject of the Russian Federation.

The rules for grants provision to NPOs define the procedure for subsidies granting from the federal budget for the government support to socially-oriented non-profit organizations, with the exception of public (municipal) institutions involved in certain activities under paragraphs 1 and 2, Art. 31.1 of the Law “On NPOs”, including the same priorities, as granted to the RF Subjects (with the exception of Item “e”).

Grants are provided as per results of the tender, arranged in accordance with the procedure established by the Ministry of Economic Development of Russia.

The Rules for granting subsidies to NPOs have also approved the criteria for competitive selection of socially-oriented non-profit organizations and methods of distribution of subsidies between socially oriented non-profit organizations. ●