



## RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES

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## RUSSIAN ECONOMY IN SEPTEMBER: PRELIMINARY DATA AND MAIN TRENDS

### ***The Social and Political Background: Uncertainty Made Certain***

*In September it was announced that Vladimir Putin is returning to the presidential post, while the post of Prime Minister will go to Dmitry Medvedev who, in addition, will top United Russia's electoral list at the forthcoming elections to the State Duma. This means that the "unbalanced tandem" structure will remain unchanged, and the pro-Medvedev representatives of bureaucracy and the business community are not going to lose their influence. At the same time this leads to the assumption that in the next few years the development of economic policy will be guided mostly by inertia. A stable downward trend displayed by both participants in the tandem will also have a restricting effect on their policy.*

*The tough criticism voiced by Vice Prime Minister Alexey Kudrin and his subsequent dismissal that followed immediately after the publication of "the new political construction" can be regarded as manifestation of some serious disagreements in Vladimir Putin's nearest circle. In fact, Alexey Kudrin's recent statements have often carried a political flavor. Thus, the Minister expressed his strong support of the idea of budget consolidation coupled with the implementation of some structural reforms (among other things, he also spoke of the necessity to alter the authority's political build-up). In this connection, there have been rumors that Alexey Kudrin may head some right-wing party in the forthcoming elections, and then that he aspires to occupy the post of Prime Minister.*

*Anyway, the Minister's sacking and the form in which it was effectuated point to the fact that a reform-oriented scenario for the election of Vladimir Putin for a new term on the post of president has been rejected. Within the framework of this new construction the scenario envisaging an energetic budget consolidation backed up by large-scale reforms appears to be unrealistic. On the other hand, the explicit declarations made by Vladimir Putin concerning the possibility of achieving a growth rate of 6-7% (earlier, Vladimir Putin was demonstratively cautious when speaking of any quantitative growth indices) have made more probable the choice of an alternative way, namely a soft budgetary policy aimed at growth promotion and envisaging increasing borrowings to cover budget deficit.*

*The dramatic deterioration of the situation on the world markets in September that was the background for the Minister of Finance's dismissal have made Russia's economic prospects for the nearest future even more uncertain.*

### ***Macroeconomics and Finances: Import of Instability***

*The overall macroeconomic background in September was determined by the rapidly worsening situation on the world markets, which was primarily the consequence of an exacerbation of budgetary problems in the euro zone; meanwhile, some negative news were also arriving from the American and Asian markets. The increasing tensions and the expectations of a new wave of the global crisis resulted in the dollar's strengthening (over the month, the euro's exchange rate dropped against the dollar by 7.6%), while simultaneously there occurred a decline in the prices of gold (a drop of 11.5%) and raw materials. Non-ferrous metals also became much cheaper (prices of aluminum dropped by 12%, copper – by 20%, nickel – by 25%, and silver – by 30%). As of 30 September, oil prices had dwindled from 115.7 USD/barrel to 102.4 USD/barrel since 07 September.*

*The dollar's strengthening and the decline in the prices of non-ferrous metals determined the ruble's weakening not only against the dollar (by 10.16% over September), but also against the euro (by 6.2%). As a result, the bi-currency basket rose from Rb 34.70 as of 1 September to Rb 37.06 as of 30 September, thus reaching the level of the summer 2009. In face of this generally negative situation, in the last ten days of September the Russian stock market experienced a second wave of sales (the first one took place in early August). It should be noted that in September practically all major stock exchange indices declined; however, while the leading stock exchanges in the USA,*

Japan, the UK and Germany were losing on the average 1.6 – 3.8%, the MICEX index over the same month collapsed by 11% (to 1,380 points), and the RTS index – by 19%.

The significant pressure on the ruble forced the Bank of Russia to resort to interventions on the currency market. Support of the ruble coupled with revaluation of gold and the euro resulted in shrinkage of the gold and foreign currency reserves from \$543.4bn as of 2 September to \$526bn as of 23 September. At the same time, alongside a slowdown of the growth rate of money supply observed since early 2011, the situation with regard to banking liquidity also began to deteriorate in August – September, which resulted in rising interest rates on the interbank market. In September, the Bank of Russia shortened the spread between the interest rates on loans and deposits by lowering by 0.25 pp. the minimum rates on liquidity provision operations on the open market and simultaneously raising the rates on deposit operations (standing facilities) by 0.25 pp. This was the RF Central Bank's response to the worsening situation with liquidity and the overall downward trend displayed by business activity.

Against that background, one factor that supported macroeconomic stability in September was the growth rate of prices, because for a second month in a row Russia had been experiencing deflation. The consumer price index amounted to 99.9% of the previous month's level, the per annum inflation rate was 8.2%, and the cumulative inflation rate since the year's beginning – 4.6%. This was the consequence of the ongoing decline of prices of fruits and vegetables (-1.8%), as well as of the sufficiently low level of basic inflation. At the same time, weakening of the ruble increases the risks of an acceleration of the inflation rate towards the year's end in response to changes in ruble-denominated prices for imported consumer and intermediate products.

### **The Real Sector: In Absence of Demand**

The situation in the real sector of the economy remains controversial. It is being negatively influenced by an unfavorable trend in the behavior of incomes and by the unstable rate of investments. At the same time, companies note their high level of satisfaction with the availability of loans.

The growth of mean nominal per capita incomes in January – August 2011 (equaling 9% per annum) was "eaten up" by inflation, because growth of consumer prices over the same period was 109.3%. As a result, the level of real disposable money incomes of the population in Q2 2011 amounted to 97.9% of that observed in the same period of 2010. The decline in inflation over the summer months had somewhat improved the situation, and so real disposable money incomes in January – August amounted to 99.3% of their level observed in the same period of 2010. At the same time, the population's consumer activity remains high: retail turnover in January – August 2011 rose by 5.8% (which corresponds to last year's growth rate), and sales of non-food products were increasing at a higher rate (by 10.1% over January – August against 5.9% recorded over the same period of 2010). The high consumption level was supported by a 25% growth in consumer credits and by a 4.7 pp reduction in the share of savings in incomes. However, the increase in spending on currency purchases can be regarded as an alarming trend.

The August surveys of the economic situations conducted by the Gaidar Institute have yielded a controversial picture. In actual terms, demand for industrial products continues to dwindle: in August, the growth rate of sales became negative (when cleared of seasonal factors) in every sector except machine-building. At the same time, companies are optimistic about the future growth of their sales and are comparatively satisfied with the level of demand. The estimates of finished product stocks remain at a high level for a second month in a row, which was not typical of the post-crisis period. Growth of finished stocks occurred because in August, in spite of the evidently worsening demand indices, the intensity of output growth increased.

Such a broad gap between the output and demand indices can be explained by the ready availability of credits on the one hand, and a dramatic drop of the growth rate of costs on the other. In August, the crediting conditions offered by banks to industrial companies became the most comfortable since the onset of the crisis: 72% of companies estimated those conditions as 'normal', another 5% stated that they were even "above the norm", which can be regarded as a manifestation of insistent offers of money from banks to companies. On the other hand, in August the growth rate of product costs hit its historic low for the entire period of monitoring since 1997. Besides, forecasts of changes in the behavior of costs for the current quarter predicted a further slowdown of their growth rate.

*Possibly this was the main reason why the growth rates of output and finished stock replenishment remained high (against that of demand), thus creating reserves for future sales in autumn and winter when prices and costs will continue their habitual growth. However, this explanation of the current growth of output and finished stocks can hardly sustain forecasts of industrial production growth over the next few months. In addition, the terms of crediting may also become worse in the nearest future in response to a deteriorating macroeconomic situation and lowering liquidity in the banking system. ●*

## POLITICO-ECONOMIC RESULTS OF SEPTEMBER 2011

S.Zhavoronkov

*It was announced in September that Mr. V. Putin would run for presidency. Given the extension of the President's term in office and the constitutional construction, it de facto means his lifetime tenure. Meanwhile, Mr. D. Medvedev will be appointed as Russia's Prime Minister. Mr. Putin refused to head United Russia's party list this time and assigned this task to Mr. Medvedev, which means that Russia's leaders are likely to have acknowledged a substantial challenge in United Russia clinching the constitutional majority and do not want to hold Mr. Putin responsible for its ultimate score. The party lists display that in addition to United Russia, CPRF, LDPR and Just Russia also have a good chance to make it for the Parliament. In September, two prominent figures resided on disagreement in the national leadership's policy- namely, Mr. A. Kudrin, Vice Premier and Finance Minister, and Mr. M. Prokhorov, a famous entrepreneur and the leader of the Right Force party.*

At the United Russia's convention in September 2011, the ruling group let the nation know their vision of their future in the medium term, due to the looming parliamentary and presidential elections. It is Prime Minister Putin who should become next President, while Mr. Medvedev should head the RF Government once the new President is sworn in. Besides, unlike the previous parliamentary elections, it will be Mr. Medvedev, not Mr. Putin, to lead the United Russia, while Mr. Putin's name will not appear on the party list at all.

While just very few would foretell Mr. Medvedev's future role and the new UR list, the scenario of Mr. Putin's comeback has remained a basic one since he had transferred the power to Mr. Medvedev back in 2008. Those suspicions have grown literally since the first year of Mr. Medvedev's nominal tenure, for he neither failed to form his team, nor was he ready to act on his own and de facto played the role of some kind of Mr. Putin's press secretary and pleader. He would consistently put forward some abstract slogans, while genuine democratic institutions continued to deteriorate and judicial and economic fundamentals remained unchanged. For instance, it was during Mr. Medvedev's tenure that the President's term in office was extended, a small number of political parties was further reduced twice, election deposits, which allowed opposition candidates to register, were abolished, public associations were deprived of the right to form party lists for local elections, the mass removal from office of elected heads of municipalities started, and the crackdown on peaceful political activities intensified by means of enforcement of respective law, including articles on extremism, defamation and abuse of the public official. Despite repetitious declarations, the economy saw no substantial privatization of state-owned assets, while the judicial sphere witnessed a genuinely farcical development, that is, the so-called "second YUKOS trial", which made it clear that Russian authorities are eager to punish entrepreneurs far harsher than killers. During the past half-year, the Government was displaying defiance with regard to Mr. Medvedev's orders.

Given the current legislative framework and law enforcement practice, it is hard to question that United Russia and Mr. Putin's future victories.

The major result of the ruling group's declared plans is that Mr. Putin is going to be a de facto lifetime ruler, as the two upcoming constitutional terms in office will come to an end in 2024. At the time, Mr. Putin will turn 72, and he will have ruled for nearly twenty-five years by then. If in a good shape and providing the current system remains unchanged, in 2024, he may once again put a nominal President in office and rule on his behalf to be back in office, etc. That is to say, if the system does not collapse because of domestic or external factors, the year of 2024, which some political scientists have just suddenly started tagging as a milestone one, would become the year of just an automatic prolongation of powers. There is no dearth of long-standing quasi constitutional authoritarian regimes in the world's history, including those wherein a dictator can nominally step

down from time to time (such as P. Diaz in Mexico, or H. Gomez in Venezuela, or to cite a recent example, S. Miloshevic, who for eleven years in a row was the head of the Parliament of Yugoslavia, President of Serbia and President of Yugoslavia, thus keeping the real power in his hands). As to Mr. D. Medvedev, he will remain in Russia's history as a unique example of a nominal ruler, let alone his historical predecessor of the 16<sup>th</sup> century, prince Simeon Bekbulatovich whom Ivan the Terrible enthroned for 11 months.

Deprived of any hints to conventionality, the form of the letting the Russian citizenry know who is going to take what post (V. Putin: *"We know that it is anticipated from the President of Russian Federation and the Chairman of the Government that post-elections they would put forward proposals on the structure and configuration of power. Let me put it boldly: two of us have long reached consensus on what to do in the future..."*) means that the ruling group is going to preserve the current authoritarian regime with no fundamental changes thereinto, as well as to preserve the state capitalism system wherein formal indicators of the state interference in the economy (the proportion of the public sector in GDP, etc.) are high and continue increasing, plus private property, which concerns, at least, large assets, has been de facto replaced by conditional holding, which means that the ruler de facto appoints and dismiss corporate heads, approves transactions, and issues binding political and economic directives for enterprises.

By contrast to an open, Soviet- or Libya-type dictatorship, the peculiarity of such a political system<sup>1</sup> lies in the formal retention of alternative elections. That said, it is only approved by the rulers parties and candidates seeking a small percentage of vote and a small number of mandates who can stand elections, while opposition is not allowed to run. Other democratic institutions are also retained to the extent they pose no threat to the government (such as, for instance, independent or opposition printed media with a small circulation, while there is no independent or opposition TV). Economy-wise, the system in question contrasts with the Soviet one in some regards: first, having extensive powers, the ruler does not use them very often and most of time he does not interfere with the existing status-quo on the market. Second, corporate heads are not necessarily appointed and dismissed by a police way (as in the "YUKOS case"), but using economic levers as well – namely through financing (or refusal to finance) transactions by state-owned banks, or conclusion or refusing to conclude contracts. Whether in the form of ministries and agencies that allocate budget resources, or in the form of public corporations, the state directly or indirectly has become the largest proprietor and economic agent vis-a-vis the others (which does not rule out existence of some sectors with no concentration whatsoever and relatively small owners continuing to hold most of assets, as evidenced, for instance, by the liquor sector or fishery where a largest owner holds a mere 10 to 15% of the market).

Both the society and the elites have recently entertained themselves with the discussion on plausibility of some other way (a "thaw") and whether the ruling group could revisit at least the "closed democracy" regime of 2000–2003, when fundamental legal institutions had not been yet rooted out and the ruling party/candidate would win elections thanks to far greater resources, rather than by force or mass falsifications. Some would associate the hope with the outgoing President's personality, while there also were some believers in Mr. Putin's good intentions. The fundamental opportunity for the latter is there of course – suffice it to restore the political legislation of Mr. Putin's first tenure). However, the ruling group is not going to take the path of self-restraint. So, as a paradox, the current regime finds itself stable and unstable at the same time. Its instability lies in the fact that the elites and economic agents are under control of a single person and subjected to the rule of force, which is not limited by anything but his own concept of good and evil. So, once dethroned or passed away, nothing would preclude a new ruler to apply his own concept of good and evil, which may distinguish from his predecessor's. The same model is replicated throughout all other tiers of power, no matter regional or municipal ones, where local "putins" arise. Capital

1 Political scientists have been at pains to define it, and we believe the most adequate definition was coined by German ones: V. Merkel and A. Croissant labeled it the "defect democracy" (See: Formal and informal institutions in defect democracies (I) // Polis. 2002. №1) and asserted that it is «*The system of sway wherein access to power is regulated by means of a meaningful and effective "electoral regime" (by means of secret, direct and popular elections), while there are no solid guarantees of fundamental political and civil rights and freedoms and the horizontal authoritative control of democratically legitimate power has been seriously restricted*». –

flight, emigration of the elite and educated population to countries enjoying a genuine rule of law are becoming inevitable, for recent years have shown that a decent macroeconomic performance, high prices of carbohydrates no longer can help the nation. The situation is yet more gloomy, as the ruling group has no articulated ideology which authoritarian regimes would have, but the Orwellian “The purpose of power is power” one.

While Mr. Putin is going to (at least as planned) become a lifetime ruler, the role of institutions continues to decline. The past four years displayed a phenomenal degradation of even the institution of presidency per se, notwithstanding its extensive constitutional powers. Personal roles within the national leadership have begun to be determined by closeness to and trust by Mr. Putin, rather than a formal position. Hence no doubt during the upcoming cycle the post of Russia’s prime Minister is set to undergo a drastic degradation, too, as during his four years in office, Mr. Medvedev exhibited no desire or ability to run anything. It will be heads of major ministries and Vice Prime Ministers tasked to oversee critical projects who will play major roles in the Cabinet (for example, in 2008-2012 it was Mr. I. Shuvalov who played such a role, while other Vice Prime Ministers’ roles were a far cry in this regard).

The ruling party, United Russia, is fairly likely to undergo transformation, too. It has lately been positioned as Mr. Putin’s personal project and elections were perceived of as a kind of vote of confidence to him. That was why United Russia was so victorious back in the 2007 parliamentary elections, when Mr. Putin headed it for the first time (65% of vote), and in regional local elections: Mr. Putin’s personal high rating combined with regional and municipal authorities’ vigorous efforts (for United Russia’s scores have become nearly the sole criterion of their efficiency) did have their effect. But this scheme was increasingly glitching, with United Russia failing to keep up the pace. More specifically, in a number of regions (Sverdlovsk, Kirov, Tver oblasts, to name a few), United Russia collected less than 40% of vote, down by 20-25% vs. its 2007 scores, while the average cross-regional performance does not exceed 50-53%. Having Mr. Putin atop the party list would create a situation in which the party’s quite possible poorer performance at the parliamentary elections would form a negative background for the presidential elections. That is why Mr. Medvedev became #1 in the party list, though he is not even its member. Now that he leads the party, any further failure would not be interpreted as Mr. Putin’s defeat. Meanwhile, Mr. Putin will most likely gradually distance himself from the project and position United Russia as an independent party. In certain cases, perhaps, in order to form the constitutional majority in the federal Parliament or even a simple majority in regional ones, United Russia would have to form blocks with other parties, which should substantially increase their weight. The “People’s Front” project meanwhile would prove just a PR lever, rather than an attempt to re-establish corporate structures within the party (similarly to the Young Communist League or the Soviet Trade Union Association, etc. back in the Soviet times). Quite illustratively, none of the participants in Mr. Putin’s meeting with the Front representatives in May 2011 have made it for the United Russia electoral list, and the most independent fellow travelers found themselves at the bottom of that. Remarkably, governors appear missing in numerous UR regional party lists, which should be ascribed to their low popularity<sup>1</sup>, and they were replaced by federal public officials, or MPs, or businessmen, etc.

Other political parties also formed their party lists. The second strongest political party, CPRF (judging its current ratings and outcomes of the most recent regional elections, it can claim some 15-17% of popular vote), put Mr. G. Zuganov atop its party list, with Admiral V. Komoedov being nominated the party’s No.2 and ex-businessman and currently MP, Mr. Yu. Afonin – No.3. That said, like four years ago, the list seems bleaker than the sum of CPRF’s regional party lists. The CPRF party list mostly comprises Mr. Zyuganov’s old parliament mates, with just a handful of businesses or other regional “nobility” representatives, who enjoy their personal rating or financial resources. It is not unclear why the Nobel Laureate Zh. Alferov, who was party’s #3 in 2007, has found himself this time downgraded to the fourth position in the list. The CPRF will traditionally exploit a combination of etatist and left-wing declarations.

The LDPR party list proved very peculiar this time. Traditionally, it is led by Mr. V. Zhirinovskiy and his son, Mr. I. Lebedev, with the former’s close buddy, Mr. A. Ostrovskiy being No.3. Mr. E.

1 Back in 2007, governors sat atop of most of regional party lists, but since that time the federal center has replaced many popular and strong governors.

Lugovoi, the suspect in the “Litvinenko case”, who was the party’s No.3 back in 2007, has been included in just the regional “basket” this time. Contrast to the party’s long-standing tradition of securing certain financial resources, there are far fewer businessmen, in the list, while low-level regional officials are plentiful, which compels one to assume that the latter were included on some clandestine agreement with the Kremlin. So, once United Russia would face challenges in the future Parliament, these cadres will surely back it with their votes. Traditionally, Mr. Zhirinovskiy exploits a combination of the left-wing and nationalistic rhetoric.

After jettisoning Mr. Mironov from the Federation Council, the future of the Just Russia party raised many questions. The media controlled by Mr. V. Surkov, deputy Chief of the presidential Administration vigorously alluded to doom of the party’s list. As well, Mr. Mironov presence on radio and TV networks was minimized. However, the last year’s regional elections outcomes, with JR getting 20%-plus vote, as well as sociological studies, indicate that the party is able to make it for the Duma. Plus, Mr. Mironov managed to retain and attract the greatest number of regional nobility, i.e. funds, and his party is second to United Russia in this regard. Meanwhile, with no personal rating whatsoever, Mr. Mironov enjoys the absence of anti-rating, which is a grave challenge facing both CPRF and LDPR. Atop the JR list are Mr. Mironov himself, his aide, Mr. N. Levichev, and Ms. O. Dmitrieva, who is very popular in St. Petersburg. The party’s ideology focuses on left-wing populism, albeit without the CPRF’s Stalinist hue and appealing to the Soviet times.

That said, while for the time being they have every chance to get to the Duma, everything can change for CPRF, LDPR and Just Russia, depending on the cost and success of their performance.

As in 2007, both Yabloko led by Messrs. G. Yavlinsky and S. Mitrokhin and Patriots of Russia (Mr. G. Semigin’s pocket party) have no chance to make it for the Duma. They lack resources, strong regional branches in most regions, while Yabloko has a maximum anti-rating. Likewise, led by notorious Kremlin “technologists”, Messrs. A. Dunaev and A. Bogdanov, the Right Case party will miss the Duma. In short, it is highly unlikely that each of the above parties would earn at least 2% of vote.

In this context, the Right Case experienced a stunning development, which should be classified, along with Mr. Kudrin’s dismissal, as an inter-elite problem, rather than an electoral one. It is common knowledge that after being idle for three years, in June 2011 the Right Case saw a new leader – that is, Mr. M. Prokhorov, a controversial billionaire. He allocated considerable resources (some dozens of millions of US Dollars, with some 25 mln. transferred to the party’s official bank account) for the campaign. He also counted on regional administrations’ sympathy, if not help, and launched a extensive and expensive PR campaign. That said, all that guaranteed nothing, with the party’s basic rating across the country oscillating around zero, the Kremlin’s appointees controlling the administrative staff, while results of the search for regional leaders left much to be desired, as in many regions, new leaders clearly did not add much value.

Mr. Prokhorov’s past record and behavior clearly displayed no opposition intents. Meanwhile, on the eve of the party congress he accused Mr. Surkov, the deputy chief of the presidential Administration in charge for domestic policy, of exerting pressure on the party and demanded his dismissal. However, as Mr. Surkov controlled the party congress, Mr. Prokhorov had to resign himself.

There are several versions of what actually happened. First, the Kremlin’s order to cross a very few really popular names out of the party list, including Mr. E. Roizman, the former MP and an anti-narcotics crusader who was supposed to run on the party’s ticket in Sverdlosk oblast. That occurred in a situation when after a two month-long campaign, the Right Case’s rating accounted for a statistical error. That could sober Mr. Prokhorov up and make him realize the Kremlin was not going to back him and he was needed for some other purpose, such as, for example, to become a comfortable sparring partner for United Russia. Second, no matter how bizarre his declarations about readiness to work as the Prime Minister or, in particular, as the RF President, could seem (Mr. Prokhorov maintained that hypothetically, should the Right Case collected 15% of vote), they could offend hypochondriac Mr. Putin who was contemplating what to do with both offices. Third, the Kremlin could suggest that if launched, a large-scale campaign might have inevitably helped the Right Case to strip United Russia, not any other party, off a fraction of vote.



Any rationale notwithstanding, the Russian leaders first granted Mr. Prokhorov a license for political activity and subsequently revoked it. What is striking is the fact that Mr. Prohorov did not break the rules of the game. Though it is clear he will not fight any longer, he has got enough self-esteem to adequately define certain things

Somewhat different development, albeit with similar motives behind it, formed Mr. A. Kudrin's case. Russia's Vice Premier, Minister of Finance and an old Mr. Putin's associate, Mr. Kudrin has been one of the most influential Russian officials in the past decade and one of those very few who dared publicly challenge his patron with regard to economic issues. When the news of the reshuffle on the top broke, he immediately announced that he would not be a member of Mr. Medvedev's Cabinet on the grounds of the disagreement with the future Prime Minister's course towards giving a massive boost to military expenditures and raising taxes<sup>1</sup>. It is not a secret that Mr. Kudrin was shortlisted for the PM office and he used to claim publicly that he was ready to lead the Cabinet, so his reaction bore a great deal of personal sentiments. In just one day after that, Mr. Kudrin openly defied Mr. Medvedev at a governmental commission meeting. The outgoing President suggested he should resign, while Mr. Kudrin objected by asserting he should take the issue up with Mr. Putin. Such kind of squabble discredits the government's authority as a whole, and the form of Mr. Kudrin's *dǎmarche* clearly did not suggested any retreat. So, Mr. Kudrin was eventually released from office and Mr. A. Siluanov, his deputy, stepped in. The Russia's budget will soon face hard times, for Mr. Kudrin's enjoyed an impeccable reputation plus had the ability to repel lobbyists' attacks by exploiting the resource of the long-standing personal relationship with Mr. Putin. With all his professional qualifications, Mr. Siluanov fell short of boasting an equal resource on hand.

Meanwhile, Mr. Kudrin has no more political ambitions, let alone prospects, than Mr. Prokhorov, but to his credit, he has not lost self-respect, either. That three huge political scandals unfolded in a span of just a few months (the first one was Mr. Mironov's resignation as the Speaker of the Federation Council) is a unique case for Mr. Putin's whole term in office. Something similar was noted between mid 2003 and early 2004: at the time, in just six months Mr. Kasyanov was dismissed in a follow-up to the arrest of Mr. Khodorkovsky. The recent developments may evidence than even Mr. Putin's immediate circle and the political elites alike are becoming increasingly dissent from his authoritarian and dirigist course. ●

1 In all fairness, it was Mr. Putin himself who set this course after 2008.

## INFLATION AND MONETARY POLICY

N.Luksha

*August 2011 became the first month of the year which saw deflation (-0.2%). The main factor behind the slowdown of price rise was the seasonal downfall in food prices (-1.4%). Inflation accumulated between the beginning of the year and 19 September was 4.6% vs. 6% reported in 2010. Deceleration of price increase rates for gasoline and the continuing downfall in food prices drove consumer prices down in September, with CPI making up -0.1% over nearly three weeks of the month. As the previous month, August likewise saw continuation of the net capital outflow from Russia. According to CBR's preliminary assessments, it accounted for some \$3bln. On 21 September, the RF Government approved draft Main Directions of the Uniform Public Monetary Policy for 2012 and for the period of 2013-2014.*

In August, for first time this year, Russia's economy saw deflation, which by results of the month accounted for -0.2%. It was back in August 2005 when monthly deflation was reported last time. The main driver of the downfall in consumer prices became food deflation, with food prices being down by 1.4% in August. Specifically, down went fruits and vegetables prices, with prices of potato having sunk by 33.8%, beet-root – by 31.1%, cabbage – by 26.8%. The prices of fruits and vegetables tumbled by 16% (vs. 9.2% reported in July 2001). Some other food stuffs prices were down, too: gruels and legumes prices lost 2.2%, while sugar – 1.6%. Meanwhile, it was eggs that posted the greatest price increase rate in August (+9.3%).

The price increase rate for paid services continued to decelerate and accounted for 0.3% over the month (0.6% in July). Prices of passenger transportation services were down by 0.3% because of lower railway and air transportation tariffs. Meanwhile, because of the high tourist season, prices of overseas tourism services continued added 1.8% over the month in review. Prices of educational services increased by 1.6% on the eve of the new educational year

The renewed price rise for gasoline entailed increasing price rise rates for non-food goods (by 0.5% vs. 0.3% back in July). Price rise-wise, leaders in this group once again became gasoline and tobacco goods, which added 1.9% and 1.6%, respectively. Meanwhile, TV- and radio goods continued to cheapen (-0.1%).

Thanks to the seasonal deflation, the inflation rate was down by 8.2% on a year-on-year basis. By results of August 2010, the respective index accounted for 6.1% (Fig. 1).

The basic consumer price index remained unchanged in August 2011 and made up 0.4% by the end of the month (in 2010 it was – 0.7%).

As in the month before, deflation rate over the first three weeks of September likewise made up 0.1% (0.6% over the same period of 2010). The inflation rate accumulated between January and 19 September accounted for 4.6%, or down by 1.4 p.p. vis-a-vis the same period of 2010. Inflationary trends typical of August were there in September, too. Thus, seasonal food stuffs continued to cheapen. Plus, the fuel inflation rates were somewhat down, with gasoline prices adding 0.5% by results of nearly three weeks of September.

That said, despite the food deflation and the decelerating increase rates of money supply, inflation may accelerate already in Q4 this year. The depreciation of the Rb exchange rate between August and September should inevitably affect prices of imports, whose share in the Russians' consumer basket is high. The basic consumer price index, which has steadily been at the level of 0.3-0.4% a month, also speaks of a high inflationary pressure.

In compliance with the draft Main Directions of the Uniform Public Monetary Policy for 2012 and for the period of 2013-2014 the RF Government approved on 21 September 2011, by results of the year the increase in consumer prices is anticipated at the level of under 7% (for reference, it made up 8.8% in 2010). *However, with account of the aforementioned factors, we assume the annual inflation in 2011 should be slightly higher than the official figures and make up 7.5-8%.*

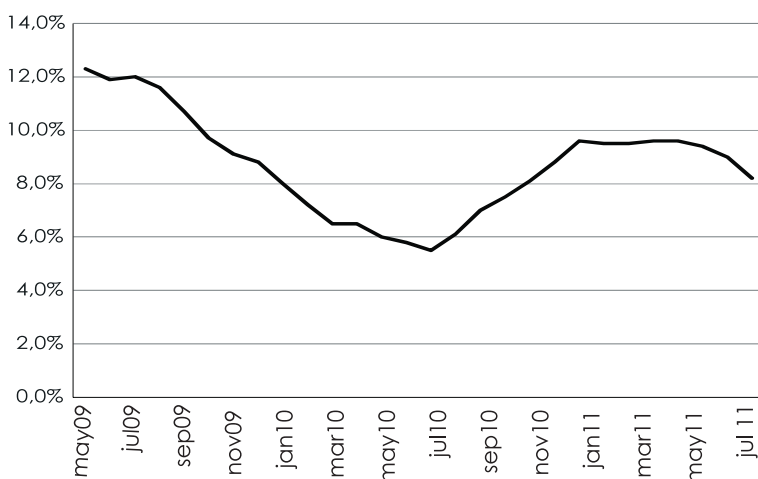
Notably, the Bank of Russia kept unchanged set a year ago annual inflation benchmarks for the period of 2011-2013. According to the draft Main Guidelines, in 2012, inflation is projected to slow down to 5–6%, in 2013 – further to 4.5–5.5%, and in 2014 – to 4–5%. The document also holds that the Bank of Russia sets the objective to accomplish transition to inflation targeting by 2014.

In the draft Main Guidelines, the Bank of Russia considered three monetary policy implementation options for the period of 2012-2014, depending on the oil prices dynamic. In contrast to the previous draft document for 2011-2013, the new scenarios rest upon higher oil prices. According to scenario I, oil prices would sink to \$75/b, scenario II suggests they would be at the level of \$100/b, while scenario III foresees their increase up to \$125/b. Depending on a given scenario, the 2012 forecast suggests the pace of increase of  $M_2$  may account for between 13 and 21%. These figures are down vis-a-vis the last year's ones, for in 2010 the pace of increase of money supply hit 31.1%, and they are a far cry from the pre-crisis 2008 indices.

The increase in broad money proved insignificant in August and accounted for 0.2%. As of 1 September,  $M_0$  made up Rb7,163.1bln. The increase in broad money was fueled by expansion of cash in circulation with account of credit organizations' cash balances and their deposits with CBR up to Rb5,964.1bln (+0.8%) and Rb 196.8bn (+35%), respectively. Meanwhile, credit organizations have diminished their volume of the CBR bonds to the minimum value over the year – that is, to Rb 10.2bn. Commercial banks' corresponding accounts with CBR were down by 8.6% and stood at Rb649.5bln. Commercial banks' excessive reserves continued to shrink – in August, they dropped by 3.7% and hit Rb 856.5bn. The banking sector is facing a growing shortage of Rb-denominated liquidity, which is evidenced by an increased demand for temporarily free funds the RF MinFin provides on bank deposits and rising interbank lending rates (for reference, MosPrime3M, the indicative rate, posted a 1 p.p. increase, up to 5.83%, in just nearly a month). The risk of a rise of the liquidity shortage compelled the Bank of Russia to cut down its liquidity provisions rates by 0.25 p.p. in mid-September.

A 0.8% increase in cash in circulation in tandem with a 0.3% increase in compulsory reserves in August resulted in a 5.1% expansion of the narrow monetary base (cash plus compulsory reserves), up to Rb 6,306.7bn (Fig. 2). Growth rates of money supply continued to be low vis-a-vis the same period of the prior year.

The foreign currency reserves shrunk practically permanently since the second decade of August. In just one month, between mid-August and mid-September, the nation's gold and foreign currency reserves tumbled by 2.2%, down to \$532bn., thus rolling back to the June figures. Between 10 and 16 September, GFCR momentarily lost \$6.8bn.



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

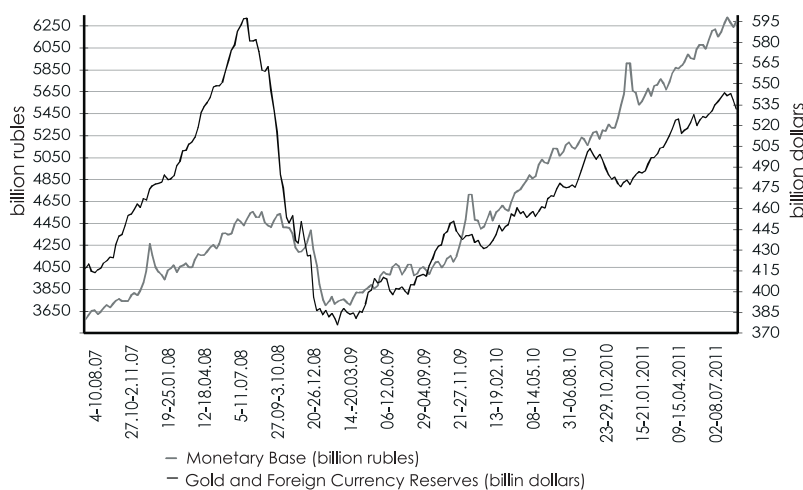
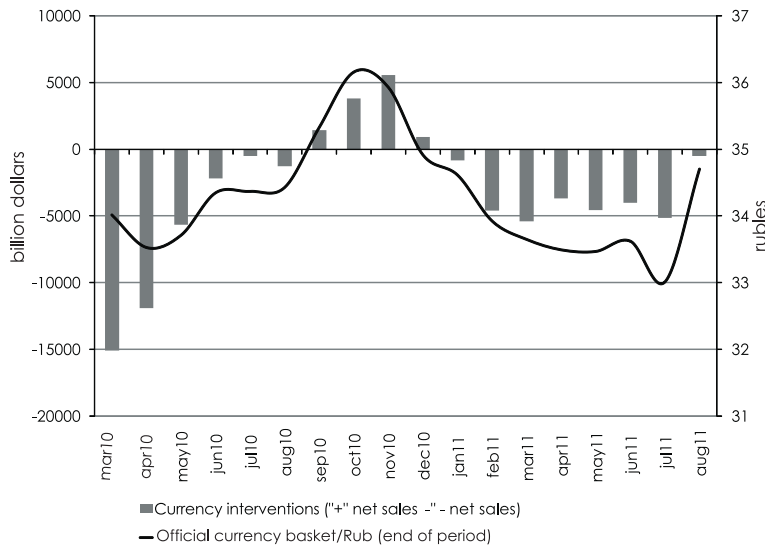
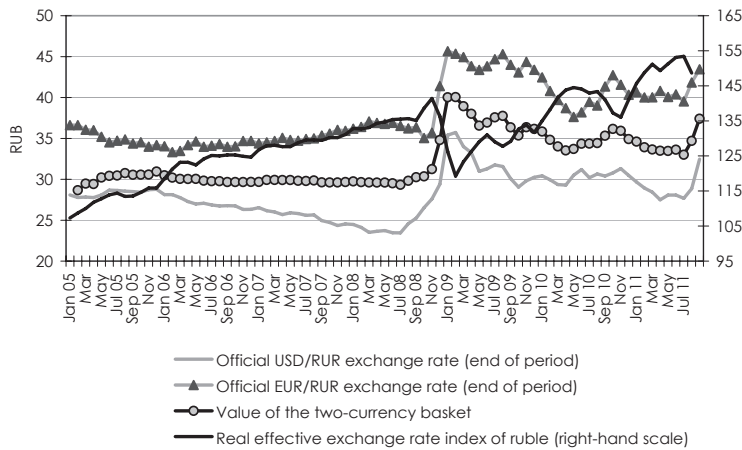


Fig. 2. Changes in the Monetary Base and in the Gold and Foreign Currency Reserves in 2007-2011



Source: CBR, the author's calculations.  
 Fig. 3. Central Bank Currency Interventions and Dynamics of Ruble Exchange Rate in March 2010 - August 2011



Source: CBR, the author's calculations.  
 Fig. 4. Indicators of Ruble's Exchange Rate Dynamics

instability on global markets makes investors withdraw their funds from risky assets in emerging economies, including Russia, and search more reliable ones.

According to the new draft Main Directions, this year, net capital outflow should outrun the last year's one and hit \$36bn. However in 2012 the negative trend may reverse, providing oil prices do not sink below \$100/b.

We believe it is yet premature to speak about a change in the trend, as factors, which would encourage a vigorous capital inflow in Russia, have not been in place as yet. Investors still perceive of investments in Russia as being risky ones, with the upcoming presidential elections adding more uncertainty in this respect.

In August, the Rb. real effective exchange rate was down for the first time since April (by 3.1%). Accordingly, the real effective exchange rate index slid to 148.65 (see Fig. 4).

In September, the Rb. continued depreciating in the wake of the downgrade of the US's credit rating and the sell-off on global stock markets. Over the 25 days of the month Ruble dipped by 11.3% against \$ (down to Rb32.11/\$) and by 3.7% against € (to Rb43.37/€), which has become the bottom figures since the spring of 2009.

On 14 September, the Bank of Russia ruled to keep the refinancing rate unchanged. It currently accounts for 8.25%. Meanwhile, effective of 15 September 2011 the Bank of Russia lowered by

The main cause behind such a drastic shrinking became both an exchange rate revaluation due to the depreciating € and the CBR's sales of foreign currency to smoothen depreciation of Rb.

In August, for the first time since the start of the crisis, the Central Bank has been back on the market to sell foreign exchange. The sales totaled \$700.88m, while by results of the month the net volume of forex purchases within the frame of the CBR's interventions accounted for \$260.76m and € 159.77m (Fig. 3).

Let us note that in the draft Main Guidelines the Bank of Russia specified the last year's forecast of the amount of gold and foreign reserves: increase in reserves by results of 2011 is envisaged to be smaller than before (+\$46bn), while the projected volume of GFCR by the end of the year is to make up some \$515bn. The net capital outflow has continued since the beginning of the year. August was no exception in this respect: according to the CBR's preliminary estimates, the outflow accounted for some \$3bn. Thus, between January and August 2011 net capital outflow exceeded \$37bn, i. e. well in excess of the 2010 annual figure of \$34bn. On a year-on-year basis, capital outflow was considerably smaller and accounted for \$10.5bn. The main cause behind the capital outflow remained the unfavorable investment climate in the country, with external factors also playing a certain part in this process, as

0.25 p.p. minimal rates on liquidity provisions on the open market (Lombard and direct REPO auctions), as well as on most continuous operations (Lombard loans, direct REPO operations, loans secured by gold, non-market assets or guarantees).

At the same time, the Bank of Russia raised interest rates on continuous deposit operations by 0.25 p.p. Thus, CBR narrowed the spread between interest rates and deposits rates, which should bolster efficacy of the regulator's interest policy.

With these measures the Bank of Russia responded to the slowdown of economic activity in Russia that takes place against the background of the continuing deceleration of inflation rate. As a reminder, the seasonal downfall in prices of foodstuffs sent inflation below 8% in annualized terms. Plus, since late 2010 – early 2011 the economy has seen a slowdown of the pace of money supply, which contributed to fall of monetary inflation. Meanwhile, the economy's growth rate remained slow. In addition, lowering interest rates on liquidity provisions might become a consequence of the overstretching at the global financial market and a CBR's demonstration of its readiness to back the domestic banking system.

We suggest that the CBR's policy on narrowing the spread between liquidity provisions and liquidity absorption operations is a correct strategic choice, which beefs up efficiency of the policy in question. As well, we believe that a further cutting down of interest rates would be inappropriate for the time being. Meanwhile, should new challenges appear on the national financial sector's radar screen, the Bank of Russia should be there to promptly provide liquidity to the banking sector. ●

## FINANCIAL MARKETS

N.Burkova, E.Khudko

*The situation on the national financial market aggravated in September, which can be chiefly ascribed to a considerable fall of global markets following publication of negative statistical data on the state of largest economies and on fears of repetition of the 2008 developments. That said, it was the market for government bonds and stock market indices that experienced the biggest drop, while the futures market was shrinking at a lesser pace. All key indicators of the corporate bond market, including the volume and index of the bond market, effective yields, and primary placement indexes, also displayed negative trends. The corporate segment of the market saw a substantial increase in the proportion of long-term bonded debts.*

### The Market for Government Papers

Volatility of the national currency in tandem with the fall of the global markets due to increasing risks facing economic growth in the US and the Eurozone economies put a mounting pressure on activities on the market and fueled increase in yields to maturity rates on the market for government papers in September.

Between 1 and 27 September 2011, the aggregate turnover of the secondary market for OFZ accounted for Rb 8.33bn, with the average daily turnover being at the level of Rb 3.07bn., equivalent of a 37.5% decline in the average daily turnover on a month-on-month basis.

During the period in question, 2 auctions on placement of OFZ on the primary market were held (see *Table 1*). The aggregate actual volume of placement accounted for 77.7% of the planned one (vs. 41% reported over the previous period). Let us note that the greatest volume of placement (98.8%) was noted in the beginning of the month, even a lower rate notwithstanding. On 14 September, in the period the turbulence on the global and Russian financial markets was beginning to emerge, just some 46% of the planned volume was actually placed, even despite a high (8.1%) average yields rate. Meanwhile, the auction on placement of the OFZ of the 26206 issue, which was held on 21 September, was cancelled. No actions were held on extra-placement of OFZ issues on the secondary market.

Table 1

PLACEMENTS ON THE PRIMARY MARKET FOR OFZ

Date of the auction	Issuance	Volume, as Rb.mln.	Face-value, as Rb.mln.	Average-weighted yields
07.09.2011	OFZ-26204-PD	15 000.00	14 825.79	7.94
14.09.2011	OFZ-26205-PD	10 000.00	4 600.07	8.1
Total:		25 000.00	19 425.86	

Source: the RF Ministry of Finance.

### The Stock Market

#### *Factors behind the dynamic of the national stock market*

The major external factors that affected Russia's stock market in September were: the rise of debt problems in developed countries, the absence of the much anticipated by global players new US anti-crisis plan, which at the end of the day was reduced just to the plan to reduce unemployment in the country, expectations of a possible Greece's default, and warning signals from Fitch Rating about a possible downgrading of China and Japan's sovereign ratings.

Overall, the developed and emerging markets were in decline (see *Table. 2 and Fig. 1*).

As concerns domestic factors affecting the dynamic of the Russian stock market, it is worth noting the IMF decreasing its 2011 Russia's economic growth forecast from 4.8% to 4.3%. Plus, the negative sentiments were further intensified by falling global oil prices and the Ruble exchange

rate. In late September, the market was enthused by the G-20 nations' plea to adopt plans to reduce risks facing the global economy.

Table 2

## THE DYNAMIC OF GLOBAL STOCK MARKET INDICES (AS OF 27 SEPTEMBER 2011)

Index	Value	Change (month-on-month) (%)*	Change since the start of the year (%)
MICEX (Russia)	1 380.42	- 10.71	- 18.14
RTS (Russia)	1 369.93	- 19.23	- 22.62
Dow Jones Industrial Average (USA)	11 190.69	- 3.64	- 3.34
NASDAQ Composite (USA)	2 546.83	- 1.26	- 4.00
S&P 500 (USA)	1 175.38	- 3.57	- 6.54
FTSE 100 (UK)	5 294.05	- 1.86	- 10.27
DAX-30 (Germany)	5 628.44	- 2.70	- 18.60
CAC-40 (France)	3 023.38	- 7.17	- 20.54
Swiss Market (Switzerland)	5 564.62	0.65	- 13.54
Nikkei-225 (Japan)	8 609.95	- 3.86	- 15.83
Bovespa (Brasil)	53 920.36	- 4.56	- 22.20
IPC (Mexico)	33 783.68	- 5.42	- 12.37
IPSA (Chile)	3 925.55	- 8.46	- 20.33
Straits Times (Singapore)	2 725.91	- 5.52	- 14.55
Seoul Composite (South Korea)	1 735.71	- 7.68	- 15.37
ISE National-100 (Turkey)	58 261.27	8.00	- 11.73
BSE 30 (India)	16 524.03	- 0.92	- 19.43
Shanghai Composite (China)	2 415.05	- 5.93	- 14.00
Morgan Stanley Emerging&Frontier Markets Index	708.19	- 13.25	- 22.32

\* -- vis-a-vis the respective figures as of 31 August 2011

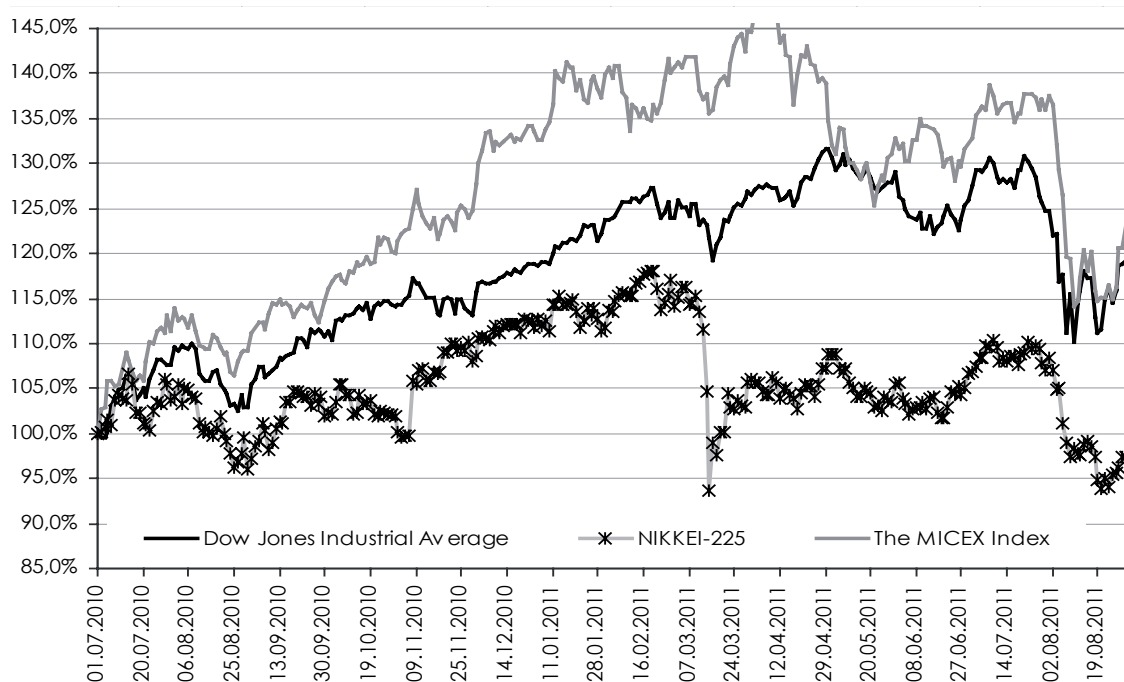
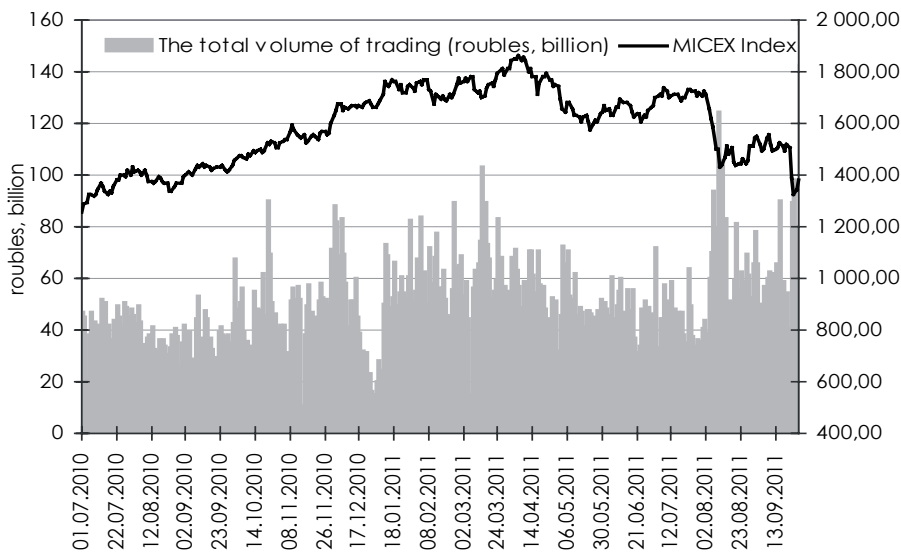
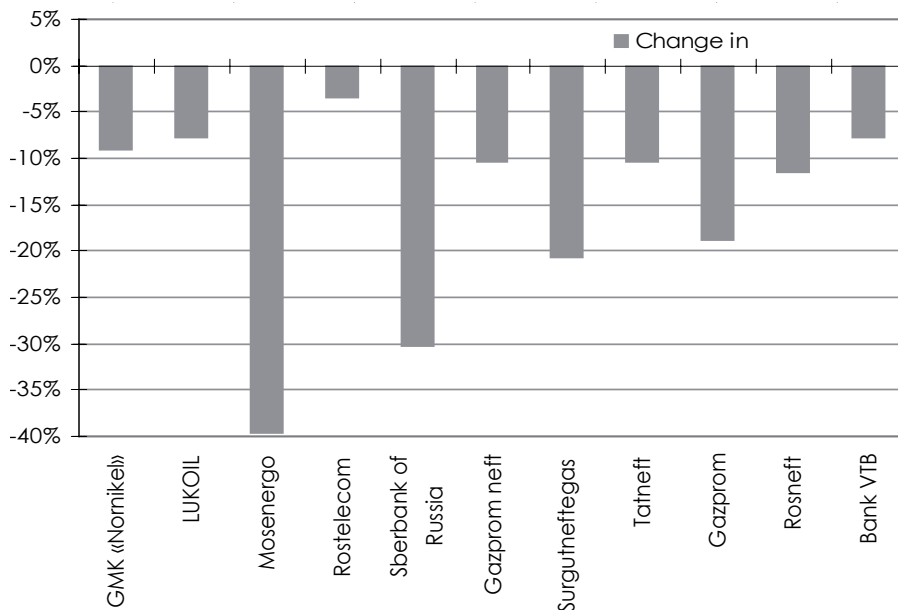


Fig. 1. Dynamics of the Main US, Japanese and Russian stock indexes (in % to the date 01.07.2010)

**State of Affairs on the Stock Market**



Source: MICEX  
Fig. 2 .Dynamics of MICEX Index and Trading Volume



Source: MICEX.  
Fig. 3. Dynamics of the Russian Blue Chips from January 1, 2011 to September 27, 2011

The MICEX index hit its monthly peak of 1,556.46 points on 8 September (vs. 1,725.1 points in the previous month), while its minimum value was reported on 23 September – on that day it made up 1.327.19 points (1,431.41 points) (Fig. 2).

Overall, between 1 and 27 September, the MICEX index plunged by 10.7%, or by 165.53 points in absolute terms (the respective decrease rate reported between 28 September 2010 and 27 August 2011 was 2.11%), while the volume of trading with listed stock hit Rb 202.47bn. The average daily level of investors' activity on the stock market dipped by 7.4% in September vs. the prior period.

It was Mosenergo and Sberbank stock which topped the list of blue chips which suffered the fall of quotations the most: between 1 January and 27 September 2011 they tumbled by 39.62 и 30.2%, respectively (Fig. 3).

**The futures market**

On 9 September 2011, the Federal Antimonopoly Service signaled the green light to the MICEX-RTS merger. Their joint meetings on future markets resulted in a decision to have a single organizer of trading (JSC MICEX) and a sole clearing

organization (JSC CC RTS) for all the MICEX and RTS's futures markets. As well, the merging parties developed recommendations and agreed upon main measures with regard to both exchanges' indexes. It is planned that at the first stage of implementation of the merger the JSC RTS's indexes will be transferred to JSC MICEX.

In September 2011 (between the 1<sup>st</sup> and 27<sup>th</sup> days of the month), the average daily volume of trading on the MICEX futures market slid by 1.5% vs. the previous month. As a month ago, the biggest volume of trading likewise fell on futures on stock assets (Rb 15.7bn., 48,810K transactions). That said, in terms of volume of trading in this particular section of the MICEX futures market, non-deliverable futures contracts on the MICEX index are followed by deliverable futures contracts on Gasporm, LUKOIL, Norilsk Nickel and Sberbank's stock. Let us note that the value of the MICEX



index (the price of concluded deals) for December 2011 found itself within the range of 1,330-1,560 points on average, ie. most market players anticipate the index to rise by 0-13% vis-a-vis its value of 27 September 2011.

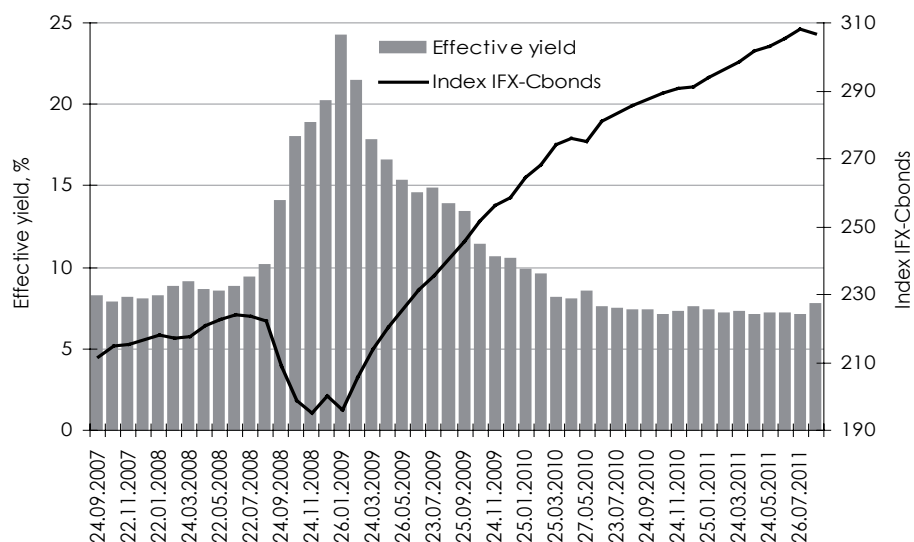
Trading volume-wise, currency futures came in second in September (Rb 9.38bn.), thus trailing behind deliverable futures contracts on USD. The leaders in this section are followed by futures contracts on €/USD and the ones on the € exchange rate. Prices of concluded in September futures contracts on Rb/USD on the MICEX futures market with the date of execution in December 2011 were oscillating within the range of Rb29.4-33/USD on average, i.e. like on the MICEX derivatives market, players anticipate a 0-9.4% appreciation of the national currency vs. the respective value as of 27 September 2011 (Rb32.46/USD). The volume of trading with futures on interest bearing instruments accounted for Rb301mln over the period in question, followed by futures on commodity assets (Rb77m).

On the FORTS derivatives market, which celebrated its 10<sup>th</sup> anniversary on 19 September, the investors' average daily activity rate plunged by 10.34% over the month. That said, atop the list of most traded futures contracts were the ones on the RTS index, followed, with a substantial gap, by futures contracts on Rb/USD, €/USD, Sberbank and Gasporm stock. Notably, on 23 September 2011, against a high volatility on the Russian stock market, there was registered a peak value of the number of transactions with futures on the RTS index on FORTS, which made up 1,048.23000 transactions. On FORTS, prices of most recent deals concluded on futures contracts on Rb/USD with the execution date of 15 September 2011 were largely within the range of Rb29.5–33/USD, ie. Ruble is anticipated to bounce back by 0–9.1% vs. the respective figure of 27 September 2011. Values of the futures contract on the RTS index (basing on the prices of most recent deals) with the execution date of 15 September 2011 was 1,300–1,680 points, ie. the index is expected to add 0–22.6% against its value as of 27 September 2011. Meanwhile, options enjoyed far lesser demand, with the respective volume of trading accounting for some Rb 250.71bn (while the trading volume of futures hit Rb4, 581.4bn).

### The corporate bonds market

The volume of the domestic corporate bonds market (measured by face-value of papers issued in national currency and currently in circulation) in September 2011 has interrupted the long-standing increasing trend and as of the end of the month hit the level of Rb 3,268.7bn, or was down by nearly 2% from its August level.<sup>1</sup> The shrinking capacity of the market was driven both by the declining number of bonded loans (753 bond issues registered in the national currency vs. 764 ones as of the late August) and the decrease in the number of issuers in the debt segment of the securities market from 344 to 334 ones. Out of the string of issues denominated in foreign currency it is the issue denominated in I<sup>1</sup> which still is in circulation..

The index of the Russian corporate bond market, IFX-Cbonds, lost 1.5 points in September, or was down by 0.5%. Meanwhile, the average weighted yields rate has grown over the period in question and hit a local maximum over the past 1.5 years, making up 8.69% against the end-July value



Source: basing on Cbonds' data.

Fig. 4. Dynamics of the Index of the Russian Corporate Bond Market and the Average-Weighted Yields

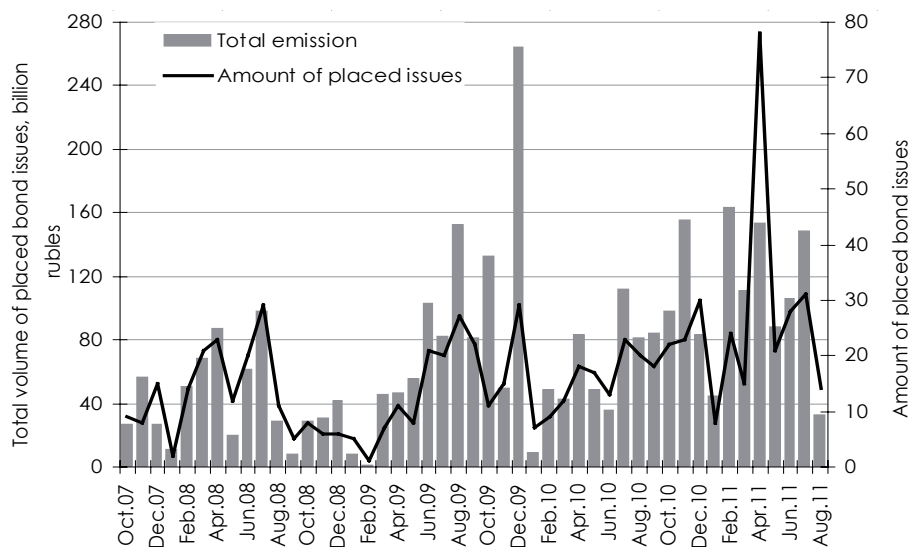
1 According to Rusbonds data.

of 7.76% (*Fig. 4*). That said, it is worth noting that the yields rate discontinued growing in mid-September, but the general negative background on financial markets did not allow the trend to advance further. Plus, the CBR made a decision to raise interest on its fixed-condition deposit operations by 0.25 p.p. effective of 15 September<sup>1</sup>, which to some extent also gave a boost to the average market yield rate. However, the duration index of the corporate bonds portfolio suddenly demonstrated a substantial increase, though it has been tending to decline over the prior months. So, by late September, it made up 861 day, or up by 220 days compared with the value reported in the end of the previous month. This evidences growth in the proportion of long-term obligations in the corporate segment of the market.

Despite the unfavorable state of affairs on the securities market, quite a number of bond issues were registered in September. More specifically, between 27 August and 23 September as many as 31 corporate bond issues with the aggregate face-value of Rb141.1bn were registered (for reference, between 26 July and 26 August 2011 as many as 38 issues worth a total of Rb146.3bn were registered). Notably, commercial papers of large issuers, who have been long present on the domestic securities market, accounted for nearly 2/3 of the total number of issues. More specifically, the largest issues were registered by JSC UniCredit Bank (9 series with the overall face-value of Rb45bn), JSC Bashneft (4 series, Rb30bn) and JSC Pipe Metallurgical Company (2 series, Rb15bn)<sup>2</sup>. It may well be the case that investors' activity in such an unfavorable period is propelled by a desire to attract external financing as soon as possible against the background of increasing interest rates and forecasts of a second wave of crisis.

However, despite robust bond registration issues figures, September saw just very few new placements. Between 27 August and 23 September, just 4 issuers placed 7 bond issues with the aggregate face-value of Rb 13bn (vs. 14 ones, Rb 32.6bn, between 26 July and 26 August) (*Fig. 5*). Unsurprisingly, it was only largest and fairly credible issuers who succeeded in placing their papers. Those were: JSC VTB 24 (two series of mortgage bonds with the face-value of Rb5bn) and JSC UniCredit Bank (one series of mortgage bonds, Rb5bn). It is also worth noting that 2 issuers successfully placed two long-term loans. Those were: VTB 24 – for 32 years and TransFin-M- for 10 years. That in turn propelled increase in duration of the bond portfolio.

Between 27 August and 23 September, FSFM canceled a great number of bond issues – that is, 11 issues by 4 issuers, due to failure to place any paper: (last month, 4 series of bonds were canceled)<sup>3</sup>.



Source: Basing on Rusbonds data.

Fig. 5. Dynamic of the Primary Placement of Corporate Bond Issues Nominated in the National Currency

The list of canceled issues comprises bond issues by such giants as Gaspromneft and Norilsk Nickel. Investors would have been keen to buy these reputable companies' papers, but in all likelihood, the corporations modified their plans on external financing, which is why in one year after their public registration, the issues were canceled. Between 27 August and 23 September as many as 17 issuers were set to redeem 18 bonded loans worth a total of Rb 79.4bn. However, 2 issuers failed to fulfill their obligations within the set timelines and announced technical default

1 <http://stocks.investfunds.ru/news/20017/>  
 2 Basing on Rusbonds data.  
 3 Basing on the FSFM data.

on redemption of securities issues worth a total of Rb 3.4bn (during the previous period, there were 3 such issuers). Another 14 corporate bond issues totaling Rb 46.4bn combined are set for redemption in October 2011<sup>1</sup>.

At the same time, despite the negative background on financial markets, the situation with announcing an actual default (ie. the situation in which the issuer is unable to pay a yield to owners of its papers even within the dates immediately in the wake of the planned date of fulfillment of his obligations) displayed no signs of any dramatic aggravation in September. During the period in question 2 issuers failed to pay coupon yields (with the same number of issuers failing to do between 26 July and 26 August)<sup>2</sup>. Meanwhile, 1 issuer announced a real default on redemption of the face-value of his papers (last month, all issuers honored their obligations either within the set timelines or in the frame of technical default). As to an early redemption of papers within offer, like in August, there were no real defaults on redemption within offer on the obligations market. ●

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1 Basing on Rusbonds data.

2 Basing on Cbonds data.

## REAL ECONOMY: TRENDS AND FACTORS

O.Izryadnova

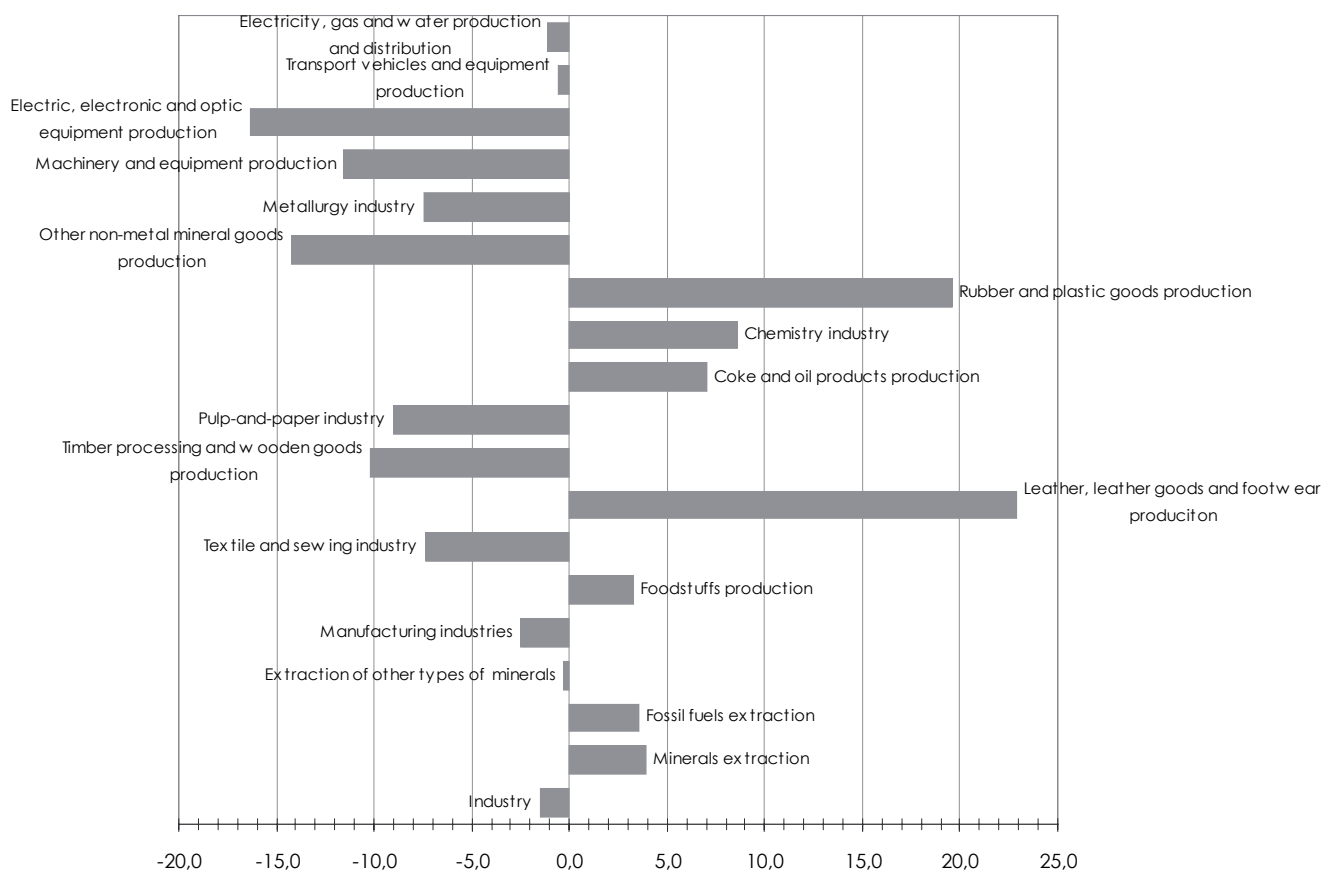
*In July-August of the current year continuing slowdown of the economic dynamics in the basic types of economic activities was observed. The industry growth rates slowing down it was agriculture and construction that made a positive contribution in the industry dynamics. However, in January-August 2011 the investments in fixed assets made only 84.9% of pre-crisis level of 2008. In August the RF Ministry of Economic Development decreased the forecast for the GDP growth in 2011 from 4.2% to 4.1% and inflation rates from 6.5-7.5% to 6.5-7.0%.*

On September 22, 2011 the RF Ministry of Economic Development published “Forecast for socio-economic development of the Russian Federation in 2012 and for the planning period of 2013-2014”. The forecast was developed on the basis of the corrected indices for GDP and investments dynamics in 2011 taking into account the trends and dynamics of the economy recovery in January-August of the current year. According to the Federal State Statistics Service data in the 1<sup>st</sup> half of 2011 GDP physical volumes index made 103.7% in annual terms the growth rates slowing down from 105.0% in the 1<sup>st</sup> quarter to 103.4% in the 2<sup>nd</sup> quarter versus the corresponding periods of 2010. Despite the acceleration of the investments in fixed assets and retail trade turnover growth rates in the 2<sup>nd</sup> quarter 2011 versus the corresponding period of the previous year the impact of these factors was insufficient to compensate the weakening of industrial production dynamics.

Over January-August 2011 the industrial production index made 105.4% in annual terms, as compared with 109.2% a year ago, the figures in minerals extraction being 105.2% versus 104.7%, in manufacturing industries – 107.1% versus 113.0%, in electricity, gas and water production and distribution – 100.6% versus 105.2%. In January-August 2011 on the whole throughout the industry the indices of production volumes made 85.5% of the corresponding pre-crisis figure of 2008, the figure for minerals extraction being 103.9%, in manufacturing industries – 97.7%. Thus, the economy growth rates are dying away despite the fact that the pre-crisis level of the production has not been achieved yet.

The dynamics of the industrial production is considerably differentiated by the types of economic activities. Among the manufacturing industries the pre-crisis levels were exceeded in such types of activities as foodstuffs production, leather, leather goods and footwear production, coke and oil products production and chemistry industry.

Recovery of pre-crisis volumes of production and internal market is achieved due to considerably higher indices of the foreign trade. In January-July 2011 foreign trade turnover of the Russian Federation went up by 134.9% versus the corresponding period of the previous year, the trend being the anticipating growth of the import (139.9%) versus the export (132.1%). The growth of export value volume was accounted for by the increase of the internal demand. The characteristic feature of eight months of 2011 is the increasing dependence of the internal market on the import of goods of intermediate and investment demand the proportion of consumer goods import in the total resources of the retail trade turnover remaining at the level of the previous year. On one hand, it is accounted for by the fact that the dynamics of the internal production is weak, which makes the unsatisfied demand grow, on the other hand – by low competitive ability of the Russian goods at the internal market under the existing prices and technical characteristics of the goods. In January-August of the current year the dynamics of the indices in the investment sphere is considerably influenced by the low base of two preceding years. Despite the acceleration of the business activity growth rates in July-August versus the corresponding period of the previous year, the total volume of investments in fixed assets over January-August made 84.9% of the pre-crisis figure of January-August 2008, the workload in construction – 82.1% and the implementation of the housing floor area – 97.6%. Under the existing dynamics of the investment demand the production of capital goods and components, and the adjacent production of construction materials has not reached the pre-crisis level. In January-August 2011 machinery and equipment production made 88.5% of the figure of January-August 2008, electric, electronic and optic equipment



Source: Federal State Statistics Service

Fig. 1. Changes in the Rate of Industrial Production, as Broken by Types of Economic Activities in January-August 2011, as Percentage to January-August 2008

production – 83.7%, transport vehicles and equipment production – 99.4%, metallurgy production and production of finished metal goods – 92.5%, production of other non-metal mineral goods – 85.7%.

It is the growth of the consumer demand that had a prevailing influence on the dynamics and structure of the internal market. The retail trade turnover over January-August 2011 went up by 5.8% which is comparable with the growth rates of the index in the previous year, the volume of paid services – by 3.9% versus 0.9% a year ago. This year the trend towards the anticipating expansion of non-food goods markets versus foodstuffs market has intensified. Over January-August 2011 the retail trade turnover of non-food goods went up by 10.1% versus 5.9% in the corresponding period of the previous year, while turnover of foodstuffs 0 by 1.5% versus 5.6%. Comparison with the figures of January-August 2008 reveals that the retail trade turnover exceeded the figure of January-August 2008 by 7.2%, foodstuffs turnover – by 5.3%, non-food goods turnover – by 8.7%.

It should be noted that in 2011 it is the dynamic growth of the consumer crediting that is a specific feature of the consumer market recovery in 2011, while the proportion of savings is contracting, the general trend being towards the decrease in the real incomes of the population and slow growth of the wages. In January-August 2011 index of the real incomes of the population made 99.3% versus the corresponding period of the previous year (105.4% in January-August 2010) and real wages -102.3% (105.0%). The discrepancy between the growth rates of the incomes of the population and consumer expenses are growing, population crediting increased by 1.25 times as compared with August 2010, the proportion of savings in the expenses of the population decreasing by 4.7 percentage points, including the savings in securities and deposits – by 3.2 percentage points. Expansion of the demand for non-food goods is connected both with the satisfaction of the deferred demand and the maintenance of the negative inflation and ruble exchange rates expectations of the population at the end of the current year. Starting with May 2011 the trend towards the growth of expenses for foreign currency purchase has been registered, which traditionally reflects the uncertainty of the population in the economic welfare prospects.

The existing situation accounted for the necessity for correction of the main development parameters of the Russian economy till the end of 2011. The RF Ministry of Economic Development decreased the forecast for GDP growth in 2011 from 4.2% to 4.1%. It should be noted that the achievement of the forecast result assumes acceleration of GDP growth rates in the second half of 2011 up to 4.4%, investments in fixed assets growth rates – up to 9.3%. On the whole as a result of 2011 the investments growth rates is estimated at the level of 106.0%, which corresponds to the figure of the previous year<sup>1</sup>. It is supposed that the growth rate of the industry slowing down, it is the agriculture and the construction that will make a positive contribution in the GDP dynamics. On the whole as a result of 2011 the growth rates of the real incomes of the population and the real wages are forecast to be lower than in the previous year. It should be noted that the forecasts for social parameters dynamics made both by the RG Ministry of Economic Development and the IEP as a result of 2011 coincide in main aspects. However, according to the IEP forecast as a result of 2011 it is the industry that remains the driving force for the development (105.3%, exceeding by 1 percentage point the estimation by the RF Ministry of Economic Development). Investments in fixed assets according to the IEP forecast are estimated at the level of 104.2% (1.8 percentage point below the estimation by the RF Ministry of Economic Development).

Table 1

ESTIMATION OF MAIN INDICES OF ECONOMY DEVELOPMENT IN 2011, AS PERCENTAGE TO THE CORRESPONDING PERIOD OF THE PREVIOUS YEAR

	2010 (report)			2011		
	annual	half year		annual	half year	
		I	II		I (report)	II
GDP	104.0	104.3	103.7	104.1	103.7	104.4
Industrial production index	108.2	110.2	106.4	104.8	105.3	104.3
Manufacturing industries	111.8	114.3	109.7	106.7	108.0	105.4
Agriculture production index	88.1	102.8	73.4	113.7	100.7	126.7
Investments in fixed assets	106.0	101.3	110.7	106.0	102.7	109.3
Workload in "Construction" type of activity	99.4	93.7	105.1	106.0	101.2	110.8
Implementation of housing floor area	97.6	99.4	95.8	95.4	96.3	94.8
Real disposable monetary incomes of the population	104.2	105.3	103.1	101.5	98.8	104.2
Real wages	105.2	104.6	105.8	103.6	102.1	105.1
Retail trade turnover	106.3	104.6	108	105.3	105.4	105.2
Volume of paid services rendered to the population	101.5	100.8	102.2	103.1	103.4	102.9
Foreign trade turnover	138.4	149.6	130.3	133.6	135.2	132.4
Export of goods	132.8	152.4	118.9	131.7	131.5	131.9
Import of goods	148.6	144.7	151.5	136.7	141.8	133.1
Consumer prices index at the end of the period	108.8	104.4	104.3	106.5-107.0	105.0	101.4-101.9
Average price of oil grade Urals, USD /barrel	78.2	75.9	80.4	108.0	108.1	107.8

Source: Ministry of Economic Development of the Russian Federation

The estimation of the 2011 results was taken as foundation for elaboration of socio-economic development forecast for 2012 and for the planning period of 2013-2014. For preparation of the federal budget parameters for 2011-2014 moderately optimistic forecast scenario (2) is suggested, which is based on the factors of the increase in the Russian economy competitive ability,

<sup>1</sup> The World Bank decreased the forecast for the real GDP in Russia in 2011 from 4.4% to 4.0% in connection with the worsening of Russian economy's indices in the second quarter, increase in the influence of foreign economy situation on the internal demand, growth of external risks due to recession in the US and the EU, sovereign debt crisis in Europe and accompanying decrease in oil prices. Russian Economic Report, September 2011; <http://web.worldbank.org>

intensification of import substitution trend, improvement of the investment climate the state expenses for the development of infrastructure and human capital increasing moderately in 2013-2014. In spite of the quality of economic growth improving gradually according to the forecast, the general dynamics will be significantly lower than in the pre-crisis period. In 2012-2014 the growth of the GDP is estimated to be at the level of 3.7-4.6% and investments in fixed assets – at the level of – 7.8–7.2%<sup>1</sup>.

Table 2

MAIN INDICES OF MODERATELY OPTIMISTIC FORECAST SCENARIO (2),  
AS PERCENTAGE TO THE PRECEDING YEAR

	2010 (report)	2011	2012	2012	2014	2014 versus 2010
Consumer prices index at the end of the year	108.8	106.5– 107.0	105– 106	104.5– 105.5	104.5– 105.5	
Gross domestic product, growth rate	104.0	104.1	103.7	104.0	104.6	117.4
Industrial production index	108.2	104.8	103.4	103.9	104.2	117.2
Agriculture index	88.1	113.7	101.4	102.2	102.4	120.7
Investments in fixed assets	106.0	106.0	107.8	107.1	107.2	131.2
Retail trade turnover, growth rate	106.3	105.3	105.4	105.3	105.3	123.1
Volume of paid services rendered to the population, growth rate	101.5	103.1	106.0	105.8	105.6	122.1
Real disposable incomes of the population	104.1	101.5	104.8	104.9	105.1	117.3
Real wages	105.2	103.6	104.8	105.9	106.0	121.9
Export, total	132.0	131.7	101.1	100.5	105.5	141.2
Import, total	129.7	136.7	118.1	111.9	108.5	196.1
Economically active population	99.5	100.0	99.9	99.7	99.0	98.6
Employed in the economy	100.4	100.9	100.1	100.0	99.6	100.6
Level of unemployment to the economically active population	7.7	6.8	6.6	6.3	5.8	
Labor productivity	103.4	103.2	103.5	104.0	105.1	116.7

The hypothesis that is fundamental for the forecast for 2012-2013 concerns the acceleration of the internal demand as compared with the GDP dynamics due to the increase of investments in fixed assets and growth of labor productivity starting with 2012. Structural shifts in the investments in fixed assets are oriented towards gradual increase of investments in manufacturing industries and types of economic activities connected with services rendering. Although the proportion of investments in fixed assets is to expand to 23.4% of the GDP by 2014 and exceed pre-crisis level, these funds, according to the forecast, will be insufficient for thorough modernization of the economy. The structural changes and economy growth rates being as forecast, in 2012-2014 the satisfaction of the investment demand will be supported by the anticipating import growth rates of investment goods as compared with the internal production. Besides, the domestic production will still depend on the import of intermediate goods.

The main estimations for 2011 and the forecast for 2012-2014 were elaborated assuming moderate changes in internal and external factors. However, rapidly changing situation at the world and internal financial, monetary and goods markets is likely to require the correction of inflation indices and ruble exchange rates in 2011, which, in turn, will result in the correction of indices of socio-economic development for the end of this year and the forecast figures for 2012-2014. ●

1 Conservative variant (1) assumes the sustention of low competitive ability of the economy and absence of capital inflow the recovery rates of the investments activity being low and the real state expenses for development reducing. According to this scenario, in 2012-2014 annual growth rates in the economy are estimated at the level of 2.8-3.8% and investments in fixed assets – 6.4-5.9%.

## RUSSIAN INDUSTRIAL SECTOR IN AUGUST 2011

S.Tsukhlo

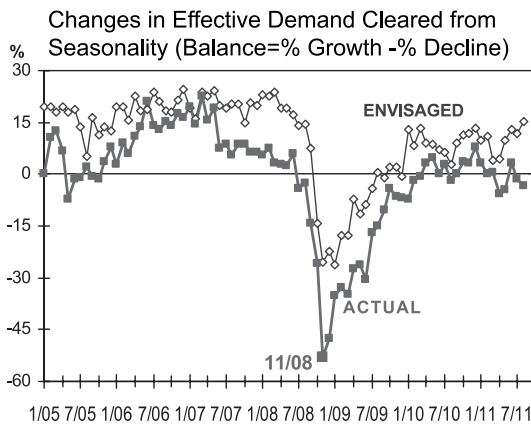


Fig. 1

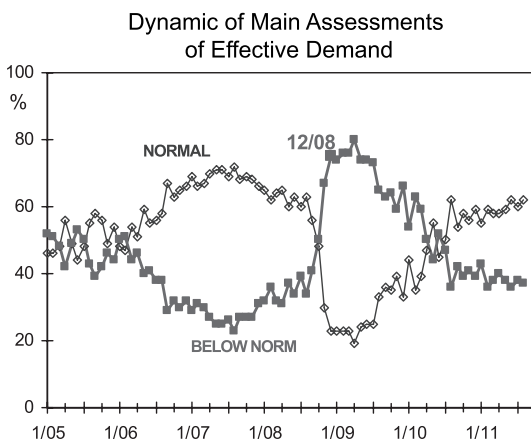


Fig. 2

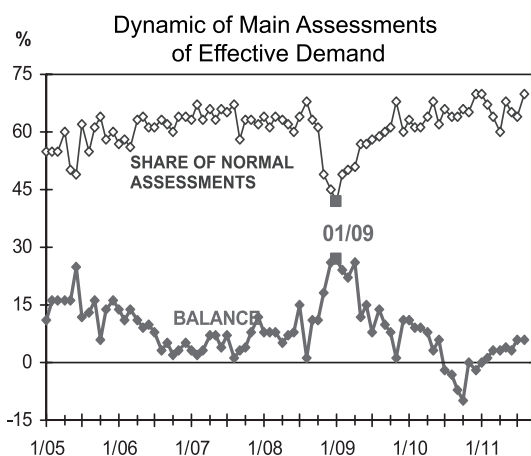


Fig. 3

According to the Gaidar Institute’s surveys<sup>1</sup>, **the negative dynamic of demand for industrial output has not yet affected the output growth rate**, which may be ascribed to corporations’ readiness to replenish their finished goods inventories in the conditions of a drastic slowdown of increase in costs. **That said, the forecasts of demand and output plans have displayed increasing optimism, even against the background of new challenges facing the global economy. Meanwhile, corporations have already ceased hiring new personnel and are unlikely to resume hiring in the autumn.**

### Demand for Industrial Products

The actual dynamic of demand for industrial output continues to aggravate. The original data of August suggest the sales increase rate tumbled to zero and, once cleared from seasonality (Fig.1), became negative – after a hike in June, demand for industrial output weakened once again. Negative changes in the dynamic of sales were registered across all the sectors save machine building.

That said, forecasts of demand demonstrate that enterprises are hopeful for a revival of sales in the autumn. August showed improvement of both original data and those cleared from seasonality, with the latter hitting their three-year (ie. crisis) highs.

Despite a clearly negative dynamic of sales (Fig. 2), satisfaction with demand was up in August – enterprises are likely to have decided to be content with very little while facing prospects of the looming double-dip recession. It was only the construction sector and the light industry where answers “below norm” prevail, while in other sectors answers “normal” retained or even increased their prevalence.

### Dynamic of Main Assessments of Effective Demand

#### Finished Goods Inventories

Assessments of finished goods inventories for the second straight month exhibited a considerable and untypical for the past 12 months level. (Fig. 3). Facing the negative dynamic of sales and still nurturing hopes for an increase in demand, corporations proved unable to overcome the aggravation of this index reported in July.

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



Had the former been adjusted, corporations would have displayed a greater resolve to cut down the inventories and in so doing they would have tamed growth in output in the first place.

**Industrial Output**

Despite an obvious deterioration of the dynamic of demand, all the data suggest the intensity of increase in output in August (*Fig. 4*). As a result, 28% of corporations saw changes in their output begin outpacing changes in demand, while the respective index in the previous two months was just 22% and the 210 median value accounted for 24%. Such a gap between output and demand secured excess of finished goods inventories and boosted the probability of a negative adjustment of output in the autumn. Corporate production plans also improved: they did so insignificantly from the perspective of initial data and up to the crisis peak – after been cleared from seasonality. While such plans in 70% of cases rest upon demand forecasts, their implementation may be questioned because of new challenges facing the global economy.

**Producer Prices**

The growth rate of producer prices has stabilized and undergone no fundamental changes since May 2011 (*Fig. 5*). Industry branches continued to moderately raise their prices save the light industry, that held them unchanged in August, and the food-processing sector which reported a price downfall for their products. Such a dynamic of actual changes in prices appears quite congruent with recently unveiled corporate pricing plans. The August price changes plans do not imply substantial changes in their dynamic over the months to come.

Meanwhile, the increase rate of costs in the industrial sector changed fundamentally (*Fig. 6*). The corporate assessments suggested that in August 2011 production costs posted the lowest growth rate over the whole period of monitoring of this particular index, ie. since 1997 (!). Even before the 1998 default the intensity of increase of costs was thrice as high. At the same time, the respective forecasts suggested a clear deceleration of the production costs growth rate for the current quarter, albeit a far cry from the actual fundamental one. That, perhaps, formed a major cause behind a continuously high (relative to demand) rate of growth in output and replenishment of finished goods inventories which will be put for sale in the autumn and winter, when prices and costs will continue their routine rise. But such an explanation of the current growth in output and inventories is unlikely to fuel industrial output over upcoming months.

**Actual Lay-off Dynamic and Plans**

The negative dynamic of demand resulted in industrial corporations ceasing to hire personnel. In August, the proportion of reports on increase in the number of employees equaled the share

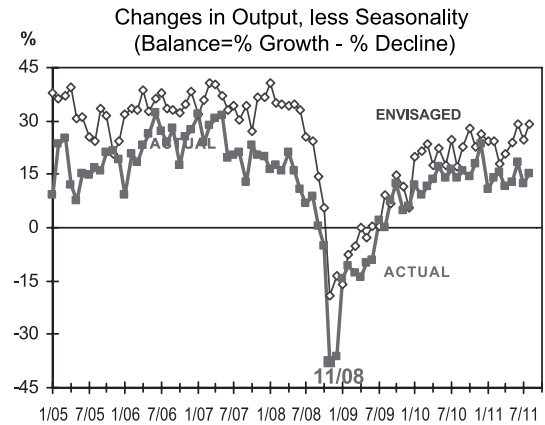


Fig. 4

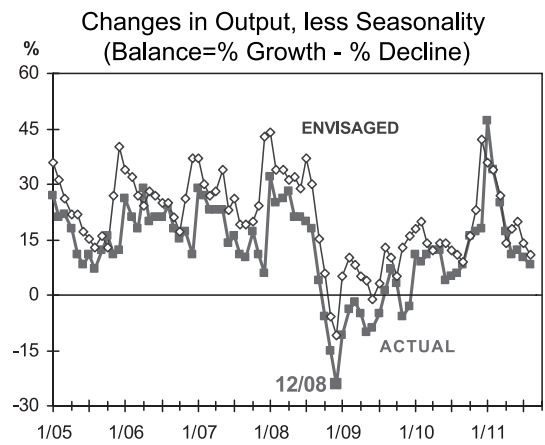


Fig. 5

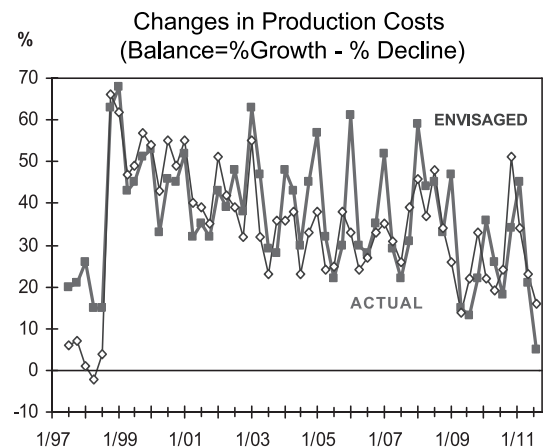


Fig. 6

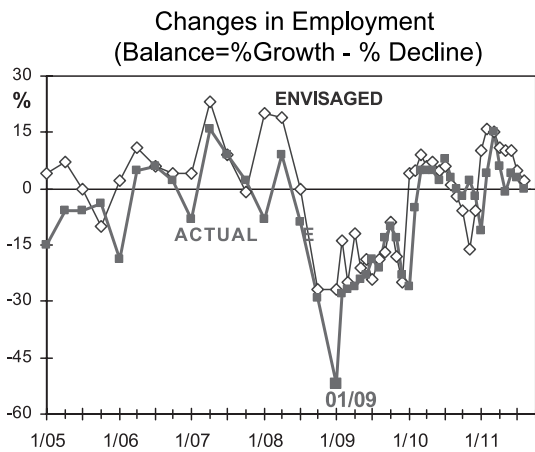


Fig. 7

of reports on its decrease across the industrial sector on the whole. It was only the food-processing sector that continued to intensively hire employees, while other sectors started either laying off employees (metallurgy, machine building, the light sector), or lowering the intensity of the hiring (forestry, the construction sector). No fundamental changes are envisaged in the HR policy in the short run, either. Corporate plans reveal intents not to change the number of employees in the national industrial sector. (Fig. 7).

### Lending to the Industrial Sector

The lending terms for the industrial sector in August have proved the most affordable ones since the beginning of the crisis with 72% of enterprises assessing them as «normal», while another 5% even considering them to be

«above norm» (Fig. 8). Between June and August the latter indicator stabilized within the range of 5–6%, which evidenced that banks were keen to offer financing (not so much needed in the conditions of a slack demand, though) to the corporate sector. The best lending conditions in the summer of 2011 were offered to the fuel sector (with 85% of corporations of the sector considering them to be “normal”), the metallurgical sector (80%), the machine-building sector (76%) and the chemicals (70%). The other pole was formed by the construction sector (51%), the light industry (44%) and forestry (40%). The average minimal interest on Ruble-denominated loans in August remained at the level of 12.3% annualized (Fig. 9).

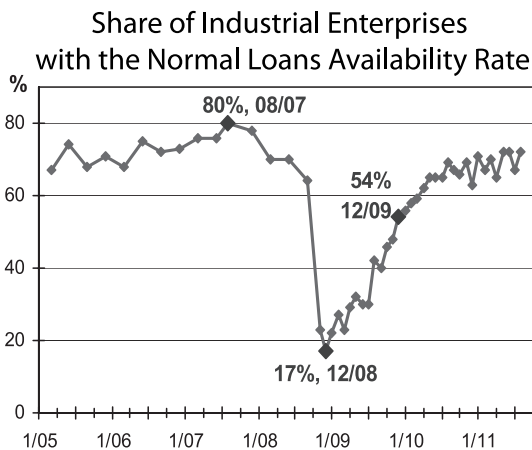


Fig. 8

Dynamic of the Average Minimal Offered Interest Rate on Rb-Denominated Loans, as %

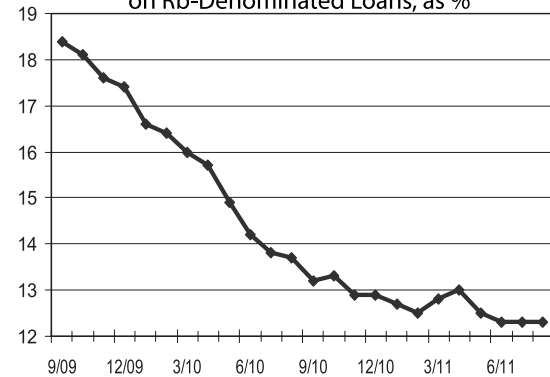


Fig. 9

## FOREIGN INVESTMENTS IN THE RUSSIAN ECONOMY IN THE 1<sup>ST</sup> HALF OF 2011

E.Ilukhina

*The 1<sup>st</sup> half of 2011 was characterized by the intensification of the foreign investors' interest in the Russian economy. The volume of foreign investments in the Russian economy made \$87.7bn, exceeding by 2.9 times the figure of the 1<sup>st</sup> half of 2010. The biggest growth was observed in the segment of other investments made on the return basis – their share in the aggregated structure of foreign investments went up to 91.7%. The inflow of direct investments went up by 29.8% up to \$7bn. The proportion of direct investments decreased to 8.0%. It is the financial activity that is the most attractive for the foreign investors. In the 1<sup>st</sup> half of 2011 investments from Russia to foreign countries continued to grow making 76.6% of the volume of foreign investments received over the period.*

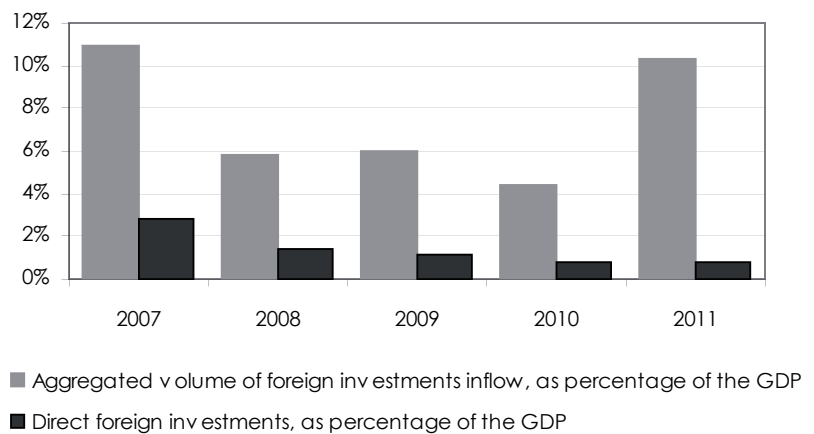
According to the data of the federal State Statistics Service, in the 1<sup>st</sup> half of 2011 foreign investments in the Russian economy made \$87.7bn, which exceeds by 2.9 times the figure of the 1<sup>st</sup> half of 2010. The level of foreign investments inflow as percentage of the GDP also went up.

As on July 1, 2011 the aggregated foreign investments in the Russian economy including investments from CIS countries made \$315.0bn, which is 19.9% above the figure of July 1, 2010 and 5% above the level reached by January 1, 2011. The volume of accumulated foreign capital is observed to grow after two-year decrease.

In the 1<sup>st</sup> half of 2011 \$81.7bn was retired in the form of incomes of foreign investors transferred abroad as well as interests payment for credits use and credits settling, which is 2.5 times more than the figure of the corresponding period of the previous year, the volume of retired capital being 93.2% of the received foreign investments (in the 1<sup>st</sup> half of 2010 106.4% of the volume of received foreign investments retired).

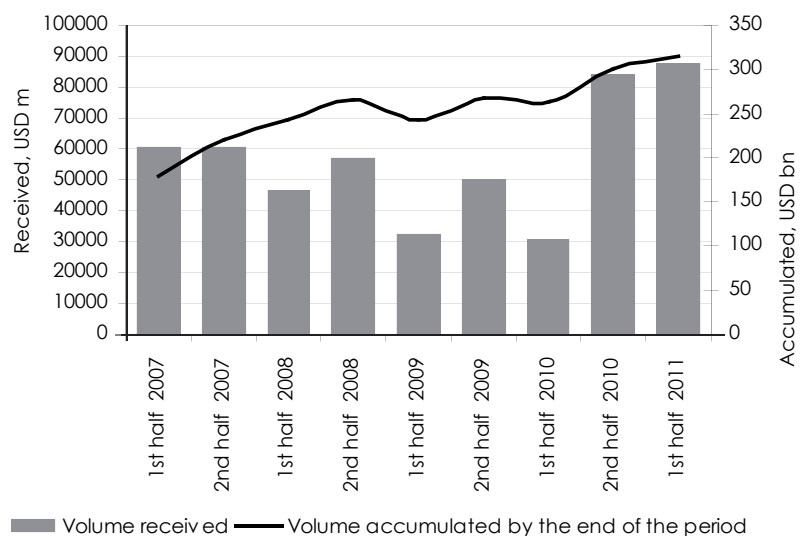
It is the other investments that accounted for the main part in the structure of the foreign investments received by the Russian economy.

In the 1<sup>st</sup> half of 2011 direct foreign investments growth rates were below the corresponding figures for other



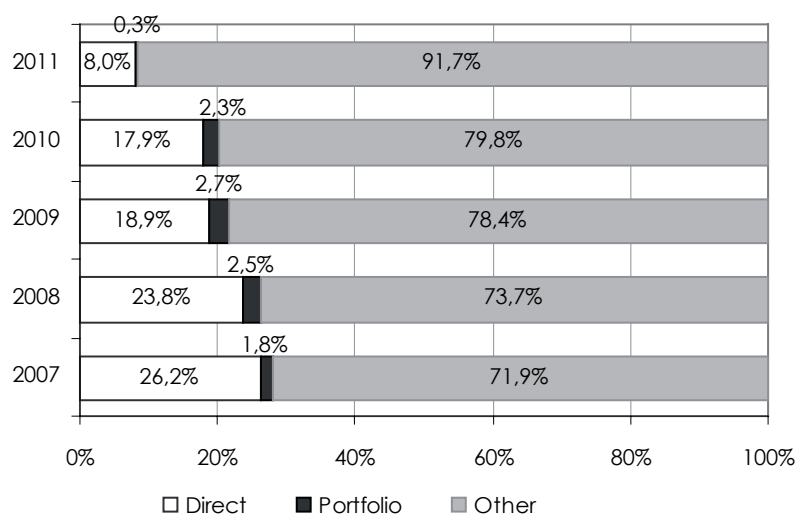
Source: Federal State Statistics Service

Fig. 1. Level of Foreign Investments Inflow in the Russian Economy in the 1<sup>st</sup> half of 2007-2011, as Percentage of the GDP



Source: Federal State Statistics Service

Fig. 2. Dynamics of Foreign Investments Volume in the Russian Economy (Not Taking into account Monetary and Crediting Regulation and Banking Sector)



Source: Federal State Statistics Service

Fig. 3. Structure of Foreign Investments in the Russian Economy in the 1<sup>st</sup> half of 2007-2011, as percentage

investments in financial activity (by 33.6 times as compared with the corresponding period of 2010). Thus, this economy sector accounted for more than a half of the foreign investments received by the Russian Federation.

Table 1

STRUCTURE OF FOREIGN INVESTMENTS IN THE RUSSIAN ECONOMY AS BROKEN BY INDUSTRIES IN THE 1<sup>ST</sup> HALF OF 2008-2011

	As USD m				As percentage to the total			
	2008	2009	2010	2011	2008	2009	2010	2011
Industry	21 078	13 230	18 047	28 149	45.3	41.1	59.4	32.1
Transportation and communication	1 096	6 511	3 082	4 751	2.4	20.2	10.1	5.4
Trade and catering	13 479	7 995	4 620	6 788	29.0	24.9	15.2	7.7
Operations with real estate, rent and services rendering	7 101	2 670	2 553	2 956	15.3	8.3	8.4	3.4
Finances, crediting, insurance, pensions provision	1 672	1 025	1 321	44 432	3.6	3.2	4.4	50.7
Other industries	2 104	732	761	622	4.4	2.3	2.5	0.7

Source: Federal State Statistics Service.

In the first half of the current year the volume of the foreign investments in the industry went by 56.0% as compared with the 1<sup>st</sup> half of 2010. Foreign investments in trade and catering increased by 46.9%, in transportation and communication – by 54.2%, in operations with real estate – by 15.8% against the background of faster growth rates of the aggregated investments the proportion of the industry in the structure decreased from 59.4% to 32.1%.

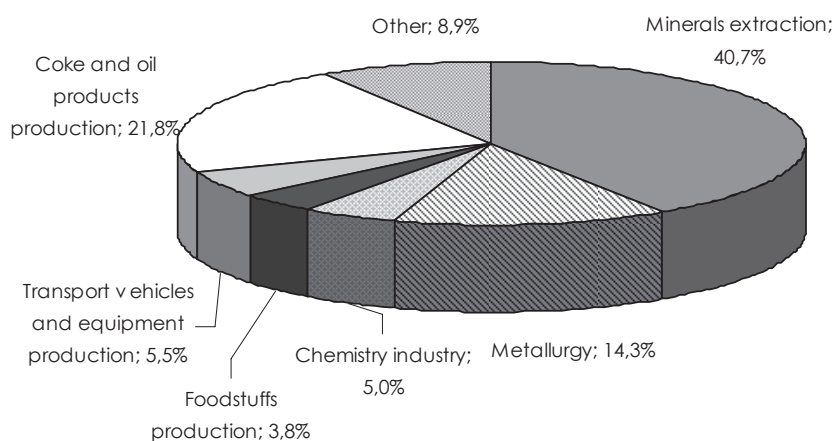
It is the manufacturing industries that were the most attractive in the industry, they accounted for \$16.3bn investments or 58.0% of the total investments in the industry (in the 1<sup>st</sup> half of 2010 – \$10.9bn or 60.5%). Investments in minerals extraction over the period under consideration went up to 70.3% up to \$11.5bn, in coke and oil products production – by 2.2 times up to \$6.1bn, in metallurgy – by 37% up to \$4.0bn. Investments in foodstuffs decreased by 8.4% down to \$1.1bn.

1 There is a considerable remaining difference between the volume of direct foreign investments measured by the Federal State Statistics Service on one hand and by the balance-of-payments method by the Bank of Russia on the other. The latter figure is usually utilized to make international comparisons. According to balance-of-payment method the estimation of direct investments received in the 1<sup>st</sup> half of 2011 made \$26.9bn as compared with \$17.7bn in the 1<sup>st</sup> half of 2010.

Thus, the structure of the foreign investments in the industry this year is the following.

In the 1<sup>st</sup> half of 2011 as compared with the corresponding period of the previous year the proportion of the direct investments in the structure of investments in the industry reduced from 17.0% to 16.22%. The proportion of other and portfolio investments is estimated at 83.3% and 0.5%, correspondingly (81.3% and 1.7% in the 1<sup>st</sup> half of 2010).

In the 1<sup>st</sup> half of 2011 the industry accounted for 64.8% of the total direct, 64.8% of the portfolio and 29.2% of other foreign investments in the Russian economy (56.5%, 44.6% and 60.5% in the 1<sup>st</sup> half of 2010).



Source: Federal State Statistics Service.  
Fig. 4. Structure of Foreign Investments in Industry in the 1<sup>st</sup> Half of 2011

Table 2

FOREIGN INVESTMENTS IN INDUSTRY IN THE 1<sup>ST</sup> HALF OF 2011

	As USD m			As percentage to the 1 <sup>st</sup> half of 2010		
	Direct	Portfolio	Other	Direct	Portfolio	Other
Industry	4 558	146	23 445	148.8	46.8	159.8
Including:						
Minerals extraction	2 802	33	8 628	301.3	Increase by 330 times	148.8
Metallurgy	87	3	3 940	65.9	2.4	146.7
Chemistry	152	2	1 254	74.1	18.2	252.3
Foodstuffs	252	1	805	102.9	33.3	88.8
Other industries	1 265	107	8 818	81.5	61.5	184.4

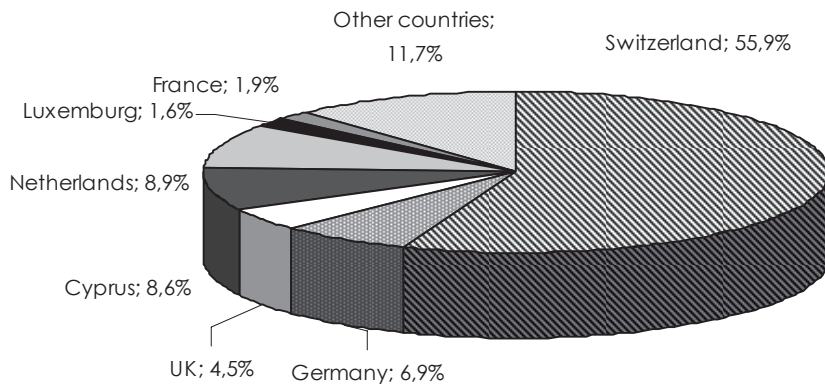
Source: Federal State Statistics Service

In the 1<sup>st</sup> half of 2011 the extractive industry received 39.8% of the direct foreign investments (17.1% in the 1<sup>st</sup> half of 2010). The manufacturing industry received 23.1% of the total direct foreign investments in the Russian economy (37.3% in the 1<sup>st</sup> half 2010), trade and catering – 7.0% (14.8% in the 1<sup>st</sup> half of 2010), operation with real estate and services rendering – 17.5% (13.4% in the 1<sup>st</sup> half of 2010).

In the 1<sup>st</sup> half of 2011 it was electricity, gas and water production and distribution that was the priority sector for portfolio investors, which accounted for 35.3% of the total volume of portfolio investments in the Russian economy (22.4% in the 1<sup>st</sup> half of 2010), the manufacturing industry receiving 11.6% of foreign portfolio investments (22.1% in the 1<sup>st</sup> half of 2010) and trade - 18.7% (0% in the 1<sup>st</sup> half of 2010).

In the 1<sup>st</sup> half of 2010 the biggest volume of other investments was received by the financial sector – 55.0% of the total volume of other investments in the Russian economy (4.1% in the 1<sup>st</sup> half of 2010). The share of manufacturing industry made 18.2% of the total volume of other investments (36.0% in the 1<sup>st</sup> half of 2010), the share of minerals extraction – 10.7% (22.1% in the 1<sup>st</sup> half of 2010), of trade – 7.8% (15.7% in the 1<sup>st</sup> half of 2010), of transportation and communication – 5.6% of other foreign investments (11.3% in the 1<sup>st</sup> half of 2010).

As to the geographic structure of the foreign investments attracted in the 1<sup>st</sup> half of 2011, Switzerland held the leading position among the countries exporting biggest capital in the Russian Federation, having invested \$49.0bn in the Russian Federation or 55.9% of the total volume of foreign investments received by the Russian economy. 87.4% of this volume was directed into the financial sector.



Source: Federal State Statistics Service  
 Fig. 5. Geographic Structure of Foreign Investments Received by the Russian Economy in the 1<sup>st</sup> Half of 2011

The Netherlands have increased their investments by 87.5% up to \$7.8bn. Germany that was a leader in the 1<sup>st</sup> half of 2010 accounted for 19.1% of the foreign investments received by the Russian Federation decreased its investments in the Russian economy as compared with the corresponding period of 2010 by 3.1% down to \$5.6bn. Over the period under consideration the investments from China were also observed to decrease (by 22.9% to \$959bn). The US are not included in the first ten countries investing in the Russian economy in the 1<sup>st</sup> half of the current year.

Cyprus investors demonstrated one of the highest investments in the Russian economy growth rates having increased their investments by 2.4 times as compared with January-June 2010 (up to \$7.5bn). Investments from the UJ went up by 65.8% (up to \$3.9bn), from Luxemburg – by 11.4% (up to \$1.4bn), from Ireland – by 57.7% (up to \$1.8bn).

In the 1<sup>st</sup> half of 2011 10 largest countries-investors in the Russian economy accounted for 83.8% of the total volume of foreign investments accumulated by July, 1<sup>st</sup> (83.2% in the 1<sup>st</sup> half of 2010), including: 78.6% in the sphere of direct accumulated investments (77.6% in the 1<sup>st</sup> half of 2010), 87.1 (92.9%) and 87.2% (86.6%), respectively, in the sphere of portfolio and other investments.

Table 3

CHANGES IN ACCUMULATED FOREIGN INVESTMENTS AS BROKEN BY MAIN INVESTING COUNTRIES AS ON 01.07.2011

	As percentage to 01.07.2010 г.				As percentage to 01.01.2011 г.			
	Total	Direct	Portfolio	Other	Total	Direct	Portfolio	Other
Ireland	131.7	117.6	83.3	132.5	111.4	103.3	125.0	111.8
Germany	129.6	137.8	41.7	125.3	105.3	117.5	90.9	99.2
Japan	110.7	132.3	150.0	108.6	106.3	118.7	150.0	105.0
UK	109.7	103.4	196.2	96.6	98.5	104.2	101.4	96.1
Cyprus	129.8	127.1	99.1	140.4	112.8	108.8	88.9	126.9
Netherlands	101.6	103.0	0.7	128.2	106.4	105.8	362.5	107.1
Luxemburg	93.9	55.6	54.7	95.3	97.8	88.4	74.9	98.1
China	236.9	131.9		245.7	97.0	125.9	12000.0	95.9
Other countries	116.6	111.4	87.8	126.0	104.6	102.8	88.5	108.0
Total	119.9	116.7	77.5	125.5	105.0	107.1	95.2	104.0

Source: Federal State Statistics Service

Against the background of a considerable growth of the foreign investments in the Russian economy, investments from Russia to foreign countries went up by 31.5% up to \$67.2bn in the 1<sup>st</sup> half of 2011, which makes 76.6% of the volume of foreign investments in the Russian economy in January-June of the current year. The main part of the investments was directed in Switzerland (36.7% of the total investments from Russia to foreign countries), \$10.7bn (16.0%) was directed in Austria, \$7.4bn (10.9%) – in the Netherlands, \$5.4bn (8.0%) and \$3.0bn (4.5%) was exported to Cyprus and Belorussia. ●

## FOREIGN TRADE

N.Volovok, K.Kharina

*The growth rate of Russian imports slightly slowed down in July 2011, with the trend to the advanced increase in imports vis-a-vis exports about to begin reversing. In July, Russia increased export of food stuffs, and domestic grain producers were back to the global market. Besides, thanks to this year's record-breaking production of sugar-beet, Russia, as one of largest importers of raw sugar, can start exporting refined sugar.*

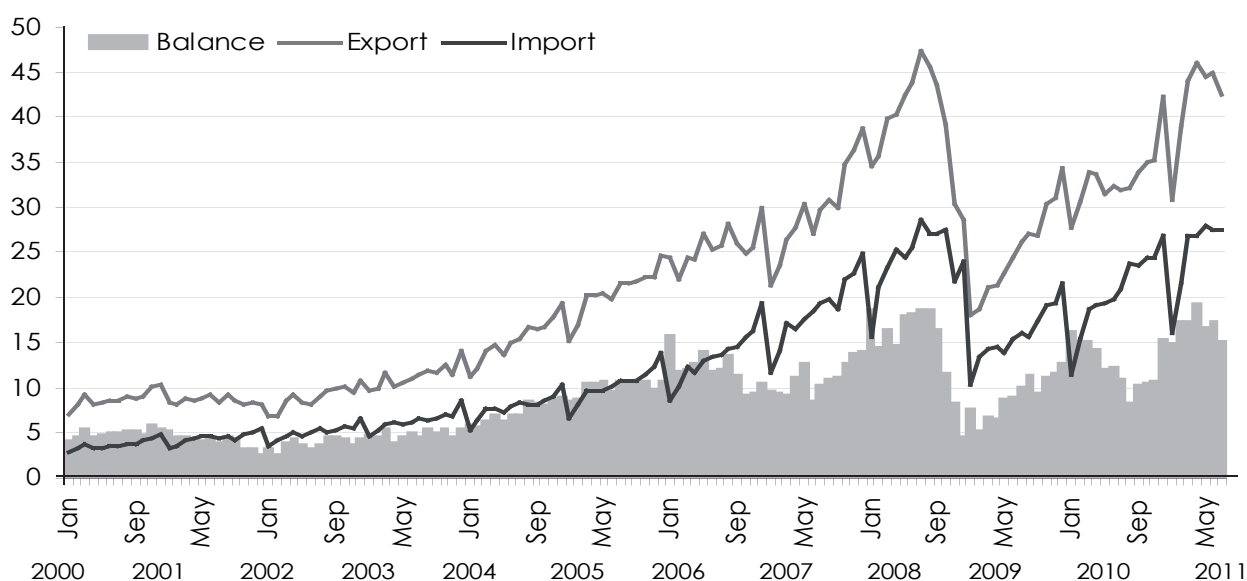
In September 2011, WTO decreased its 2011 forecast of growth of global trade volume from 6.5% to 5.8%. The Organization suggests that the global GDP should rise by 2.5%, with developed economies' exports adding 3.6%, while their GDP would advance by 1.5%. The developing nations should see their export supplies soar by 8.6%, with their economies projected to add 5.9%.

That said, Russia's foreign trade indices retain high growth rates. The nation's foreign trade turnover calculated by the balance-of-payments methodology added 33.7% in July 2011 on the year-on-year basis and accounted for \$70.1bn. The volume of exports hit \$42.6bn, or up by 35.7% on the year-on-year basis, while imports soared by \$27.5bn, or up by 30.6% on the same basis. The balance of trade in July 2011 made up \$15.1bn.

Against the background of volatility of financial markets and investors' concerns about the developed markets' health prices of a string of commodities were down on global markets in Q3 2011. That said, major Russian exports enjoyed a favorable market situation in July 2011, nonetheless.

Between January and July 2011, the average price of Urals was \$109.17/b, or up by 44.3% on the year-on-year basis.

The average oil price in July 2011 was \$115.29/b, or up by 55.4% on the year-on-year basis. Signs of the fading growth in the largest economies, which are major consumers of oil, are mirrored by the dynamic of oil quotations. In the period of monitoring, between 14 August and 15 September, the average price of Urals slid to \$112.26/b. As a result, in accordance with Resolution of the RF Government of 23.09.2011 r. № 782, the export duty on crude oil was cut from the previous (September) \$444.1/t to \$411.4/t effective of 1 October 2011. Exportation of liquid fuels, oils, waste oils will be carried out under the customs duty of \$271.5/t (it currently stands at \$207.4/t). The



Source: the Central Bank of Russia

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

duty rate on exportation of light and medium distillates, gasoil, toluene, xylene will be raised from the current \$207.4/t to \$271.5/t. The duty rate on propane, butanes, ethylene, propylene, butylenes and butadiene, other liquefied gases will be \$196.6/t (vs. \$192/t in September). The duty rate on gasoline was set at the level of \$370.2/t (\$399.7/t since 1 September).

The world market for major industrial metals displayed multidirectional price dynamics over the month in review. As a result, in July 2011 aluminum prices at LME tumbled by 1.7% on the year-on-year basis, while nickel and copper prices posted, respectively, a 6.2% and 6.3% increase relative to the June 2011 figures. Meanwhile, on the year-one –year basis, world aluminum prices posted a 27% growth in July 2011, while copper prices added 43.3% and nickel ones – 22.2%

Table 2

## AVERAGE WORLD PRICES IN MAY OF RESPECTIVE YEARS

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Oil (Brent), \$/bbl	24.62	25.7	28.25	38.2	56.4	72.5	75.09	139.23	65.74	75.6	116.46
Natural gas*, \$/MMBTU	3.75	2.95	4.04	4.28	6.42	8.585	8.13	14.37	6.67	8.04	10.99
Gasoline, \$ /gall	0.732	0.804	0.896	1.306	1.601	2.271	2.182	3.313	1.771	2.06	3.13
Copper, \$/t	1541.4	1589.0	1730.3	2813.0	3614.0	7712	7962.7	8415.3	5215.5	6735.3	9650.5
Aluminum, \$/t	1412.2	1338.4	1434.9	1710.0	1779.0	2513	2730.7	3071.2	1668	1988.3	2525.4
Nickel, \$/t	5956.8	7143.1	8790.6	15038	14581	26585	33373	20160	15985	19518	23848

\* European market, average contractual price, border price.

Source: calculated on the basis of the LME and IOE data (London).

With their physical volume in decline, the considerable increase in the value volume of Russia's export supplies is still driven by the price factor. More specifically, between January and July 2011 the physical volumes of oil export plunged by 6.5% vs. the same period of 2010, while the physical volume of export of oil products was down by 8%. Facing lowering demand, the volume of export of copper fell by 72.9%, while that of unprocessed nickel – by 35.5%.

In contrast to export, the increase in imports should be ascribed chiefly to its growing physical volumes, while average import prices exhibited a slower pace of increase.

Table 2

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

	Physical volume index	Average price index
Export	95.2	139.5
Import	117.6	110.9

Source: The RF Ministry of Economic Development

Because of a higher growth rate of export prices vs. that of import ones, trade conditions in July 2011 proved favorable for Russia, with the respective index improving and making up 125.8.

It is worth noting that the growth rate of Russian imports somewhat slowed down in July 2011: while in H1 the average monthly increase rate was 41.9%, the respective figure in July was 30.6%. In all likelihood, the trend would be there until the end of the year, which is determined, in the first place, by depreciation of the Rb against major foreign currencies.

Perhaps, July saw a turnaround of the trend to the advanced growth of imports vs. exports. As a reminder, in January 2011, exports increased by 12.1% annualized, while imports posted a 43.3% growth. Six month later, the indices in question accounted for 38.6% and 40.1%, while in July – 35.7% and 30.6%. That said, if challenges facing the global economy send mineral prices nose diving, Russian exports are doomed to tumble value-wise.

According to the Bank of Russia, over the 7 months of 2011, the nation's foreign trade turnover made up \$467.2bn (up by 134.9% on the year-on-year basis), including export - \$292.4bn (+132.1%) and import – \$174.8bn (+139.9%). Russia's trade balance remained positive and accounted for



\$117.6bn (vs. \$96.4bn reported between January and July 2010). Against the background of a prospective downfall in oil prices and depreciation of the Ruble exchange rate, the surplus of the nation's balance of trade may shrink.

As a reminder, because of abnormal weather conditions in the summer of 2010, the RF Government ruled to impose the ban on grain exports effective of 15 August 2010. The ban formally was in effect through 30 June 2011. Behind the move was the need to save grain inventories to secure domestic consumption and stabilization of the national market.

The ban on grain export failed to tame the price rise in Russia: by December 2010 wheat quotations had hit the level of Rb6,300-6,900/t, thus being well in excess of the August i.e. the date of introduction of the ban, figures. That is to say, the embargo did not help lower food prices in Russia. What's worse, food prices continued to soar after its imposition: eg, between July and December 2011 flour prices added 18% and bread - 10% on average.

Russia is the third biggest grain producer in the world, which is why the embargo momentarily propagated a ripple effect across the global markets. It was importers in developing economies which suffered the most from the RF Government's move.

So, the ban on grain export was not well grounded and thought through enough, which gave rise to negative consequences both for Russia and the global community, particularly because there are other regulation options, such as, for instance, export duties and tariff quotas. If employed, they would have to a lesser degree constrained the trade than the grain embargo did, but would have allowed solving the market stability and food security problems. If the ultimate objective is to maintain a low level of domestic food prices, one could effectively resort to directly subsidizing food (eg. bread or flour) producers. Meanwhile, if there arose a peril of hikes of food prices, one might also employ targeted support to the most vulnerable strata of the population.

According to the Federal Customs Service, in July 2011, Russian exported 2.4 million t. of wheat and meslin. This figure may further increase up to 2.5-3 mn t in August and September. To win back their positions on the global markets, Russian exporters are compelled to sell grain at a \$20-30/t discount, i.e. the Russian grain is currently marketed at \$235/t on average. This price already helped win several tenders on grain supplies to Tunisia, Jordan, Sudan and Egypt (prior to the embargo, the latter would buy up to one-third of Russian grain export, or 5-6 mn t a year). For reference, the French grain stands at the market at an extra \$35/t.

According to the IGC forecast for August 2011, between 1 July 2011 and 30 June 2012 Russian wheat exports may account for 15.5mn t vs. 4 mn t a year ago. Meanwhile the US department of Agriculture's data suggest that the above amount will fall short of taming the price rise caused by the shortage of global grain inventories caused by extreme weather conditions noted for the second year in a row. This year, major climatic cataclysms were the draught across the Great Plains in the US, the world's largest grain exporter, and the most droughty spring in Europe over the past 30 years.

The 2011 sugar-beet harvest in Russia is projected to beat all and any records. As a consequence, the nation should produce some 4.3-4.6 mn t of sugar. Meanwhile, according to FCS, the volume of raw sugar imports increased by 21.6%, up to 2.3 mn t, over the 7 months 2011.

Because of saturation of the domestic market, sugar prices therein are in decline. Specifically, according to the national Sugar Producers Union (Soyuzrossakhar), between 22 and 26 August 2011 wholesale sugar prices in Krasnodar region slid by 1.5%, down to Rb.22.7/kg, while since early August they tumbled by 26%. Meanwhile, world prices of white sugar still are high: for instance, October futures on white sugar at LCE are traded at the level of some \$785/t.

Hence, Russian sugar produced from domestic sugar-beet has proved competitive enough to export it to Ukraine, Moldova and Middle Asian countries. According to the profile association, contracts were already concluded on its shipment to Tajikistan and Kyrgystan.

Those export contracts became the first ones over the past 12 years. This became possible thanks to measures on boosting domestic sugar production, which were implemented over the past 6 years.

According to Soyuzrossakhar's data, some 400,000 t. of white sugar can be exported from Russia between late 2011 and Q1 2012. With the average supply price being at the level of some \$700-750 t, the domestic sugar sector may cash in some \$280-300mn from export sales of sugar. ●

## STATE BUDGET

T.Tishchenko

*The most important event in the public budget sector in September 2011 was the adoption of the budget draft for the next three years. Reduction of the deficit of the federal and consolidated budgets within January - July of this year apparently influenced the draft budget for 2012-2014 and made it more optimistic than the current budget law.*

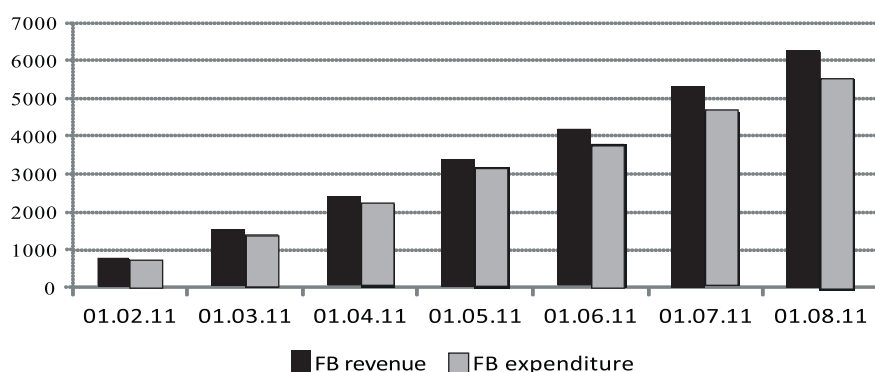


Fig. 1. Income and expenditure of the federal budget dynamics in January-July 2011, Rb, FB

In the rating of events in the sphere of government management the approval of the draft federal budget and extra-budgetary funds by the Government of the Russian Federation takes the first place. At the present time, there remain grounds for a balanced budget (without deficit) as a result of 2011, because for eight months of this year, there continued a favorable external economic environment and the positive dynamics of GDP<sup>1</sup>.

Due to favorable external and internal conditions the federal budget over the seven months<sup>2</sup> of this year was performed with a surplus (see *Figure 1*), which in the 1st quarter of 2011 made 1.6% of GDP, and in the 1Q equaled 5.6% of GDP.

Budget surplus is due not only to increase revenue based on the favorable macroeconomic environment, but also a relatively low level of executive discipline: as a result of 7 months, the cash execution in terms of income made more than 60% of the annual budget estimate, and less than 50% in terms of expenditures. In case of cash budget execution in terms of expenditures at the same level as in terms of income, the budget would be executed with a deficit of Rb 300 bn.

It should be noted that the RF government was prudent when making decisions to increase the federal budget expenses, which is supported by changes, introduced in June of this year, to the federal budget revenues and expenditures indicators. Originally planned expenditures have increased by 0.7 percentage points of GDP, while revenues have been adjusted to the higher level, by 2.7 percentage points of GDP (See *Table 1*), thus reducing the overall budget deficit.

Table 1

AMENDMENTS TO THE INCOME AND EXPENSES INDICATORS OF THE RF FEDERAL BUDGET FOR 2011, ADOPTED IN JULY

Changes in the FB indicators	Fb revenues				Fb expenses				Deficit, % of GDP
	Rb, bn	% of GDP	Growth to 01.01.11		Rb, bn	% of GDP	Growth to 01.01.11		
			%	% of GDP			%	% of GDP	
As of 01.01.11	8844.5	16.7	-	-	10658.5	20.1	-	-	3.4
As of 01.07.11	10303.4	19.4	16.5	2.7	11026.2	19.4	3.5	0.7	2.0

Source: Ministry of Finance, Gaidar Institute estimates.

1 See Sections "Foreign Trade" and "Real Sector of Economy: Factors and Trends" of this Review.

2 The lack of performance data on FB for September 1, 2011 at the site of the Federal Treasury does not allow to make a complete analysis of the budget execution for 8 months.

Favorable macroeconomic situation in the country has been reflected in the performance indicators of the consolidated budget by the RF Subjects. As of result of seven months of 2011, revenues of the RF subjects in absolute terms amounted to Rb 4.5 trillion (an increase by 17.3% against the same period in 2010), with the expenses of Rb3.6 trillion (growth by 8.6% versus the same period in 2010). Low efficiency in the cash execution of budget expenditures is typical of the regional level: within 7 months of the current year, the federal Subjects have consumed about 45% of the allocated limits.

Increase in revenues to the budgets of the Russian Federation Subjects in January-July was observed in almost all revenues as compared with the same period of 2010, especially in corporate income tax (+19.9%). The growth rates from other taxes were as follows: the property tax – +8.6%; tax on personal income – +10.8%; for excise taxes on goods manufactured in the Russian Federation +12.7%.

Apparently, the reduction of the deficit of the federal and consolidated budgets in January-July of this year, influenced the draft budget for 2012-2014 presented in September this year and made it more optimistic than the current budget law for 2011-2013. For example, the budget deficit for 2012 was set at 3.1% of GDP (in the draft budget presented in September of the current year – 1.5% of GDP), and for 2013 – 3.1% of GDP (in the September draft – 1.6% of GDP) (See *Table 2*).

Table 2

KEY INDICATORS OF THE FEDERAL BUDGET IN 2011 AND THE DRAFT FEDERAL BUDGET FOR 2012-2014

	2011 (estimates)		2012 (draft)		2013 (draft)		2014 (draft)	
	Rb, bn	% of GDP	Rb, bn	% of GDP	Rb, bn	% of GDP	Rb, bn	% of GDP
Revenues, including:	11019.1	20.7	11789.1	20.1	12715.0	19.6	14101.1	19.5
Expenditures, including:	11019.1	20.7	12658.3	21.6	13719.9	21.2	14579.5	20.1
Federal budget Surplus (Deficit)	0	0	-869.2	-1.5	-1004.9	-1.6	-478.5	-0.7
GDP estimate, Rb, bn	53231.9		58683.0		64803.0		72493.0	

Source: web-sites of the RF government and RF Ministry of Finance, Gaidar Institute estimates.

In addition, as compared with the forecast of 2010, in the budget for 2012-2014 the average price of Urals oil in the base option lies within the limits comfortable to maintain the financial stability of the budget - about \$100 / barrel. (in 2010 that price was estimated within \$75 / barrel). Despite the increase in the federal budget balance, there is still a concern about non-oil sector deficit, which should be reduced from 2010 to 2014 only by a quarter (from 12.5 to 9.2% of GDP). At the same time, according to A.L. Kudrin, former Finance Minister, the acceptable to the stability of the budgetary system can be considered in the range of 5-6% of GDP, i.e., at the rate in 2008.

We would like to note, that by mid-September the situation in the world economy has worsened, which has led to changes in the forecasts of GDP growth, inflation, exchange rates in the world and in Russia, which increases the risks for the stability of the budget system of Russia. As a result, an adjustment of the budget law for 2011 and a draft budget for 2012-2014 may be required.

In the situation of growing uncertainty, which is observed in the world economic system, the Russian government has soberly to assess the real potential for increasing the revenue base and improvement of the efficiency of budgetary allocations for the medium term. Another issue for discussion in the coming months can be a need to elaborate a package of measures for budget support strategically important industries.

In our view, the important issues to balance the budget system in 2011 will be the indicators of the federal and consolidated budgets for September and October of this year: according to the first 9 months, one can provide more balanced assessment of the consequences of September events on income and expenditures of the federal budget. ●

## RUSSIAN BANKING SECTOR

S.Borisov

*The growth of Russian banking assets in July was urged by an increased loan portfolio. The **growth in corporate lending under the impact of seasonal factors has slowed down**, and retail lending, by contrast, **has developed a record pace**. In the sectoral structure of the corporate portfolio there was noted a **widespread reduction of arrears, especially in the portfolio of borrowers of transport sector and trade**. Most of the loans to legal entities are still concentrated in trade, manufacturing and real estate.*

Table 1

MAIN INDICATORS OF THE RUSSIAN BANKING SYSTEM, RB ,BN.

	As of 01.08.2010	As of 01.01.2011	As of 01.08.2011		
			Nominal	Growth since the start of the year, %	Year-on- year growth, %
Assets	30 606.5	33 804.6	35 589.9	5.3%	16.3%
Loans to non-financial organizations	13 032.3	14 062.9	15 370.7	9.3%	17.9%
Loans to private individuals	3 672.4	4 084.8	4 721.8	15.6%	28.6%
Loans to banks	2 709.4	2 921.1	3 259.9	11.6%	20.3%
Investments in bonds	4 082.5	4 419.9	4 345.9	-1.7%	6.5%
Deposits with the RF CENTRAL BANK	397.0	325.7	311.3	-4.4%	-21.6%
Banks' deposits	3 301.6	3 754.9	3 777.5	0.6%	14.4%
Corporate deposits	5 463.1	6 035.6	6 624.5	9.8%	21.3%
Private deposits	8 616.6	9 818.0	10 618.9	8.2%	23.2%
Impairment reserves	2 274.4	2 192.0	2 248.6	2.6%	-1.1%
Profit (in the respective year)	274.5	573.4	528.5		92.5%

Source: the Bank of Russia

*Growth factors of banking system assets in July.* The growth of banking sector assets in July made 1% against the previous month. The main growth drivers of the balance sheet was an increase in lending in both, corporate and retail segments. However, as per results of two recent reporting months (June-July), there is a slower growth in assets, which happens under the impact of seasonal reduction in business activity in the corporate sector in summer. According to the RF CB, the growth of corporate portfolio of the banking system during this period slowed down to the level of 1.6-1.7% per month (as compared with the May growth by 1.9%). Lending to individuals in July, by contrast, has accelerated: the growth in June made 3.7% or Rb 169bn.

*The portfolio of loans to non-financial organizations.* According to the RF CB, the portfolio of loans to legal entities in July rose to Rb 250bn. Despite the recorded decline in growth, the result of July 2011 is much greater than the values of the same period of the last year: in July 2010, the growth of the loans portfolio to legal entities amounted to only Rb 46bn. In the term structure of corporate lending portfolio in rubles, there is a trend of increasing the share of loans granted for a period of less than one year. Demand for one-year loans is formed to a greater extent due to the need to finance working capital companies in the real sector and the increase in medium-and short-term lending, in turn, indicates an increased readiness of the banking sector to run the risks. The share of ruble-denominated loans to legal entities for up to 180 days in the loan portfolio increased from 11.6% on January 1, 2011 to 13.0% on June 1, and the share of credits for the period from 180

days to 1 year increased from 20.9% to 21.1% (See Fig. 1). Investment loans and lines of credit open for a period of one year or more, were on August 1. 66% of the corporate loan portfolio, although their share was reducing during the year.

The average weighted rate on ruble loans for a period of less than a year in June was 8.6%, which is in general in line with the level of interest rates for a similar portfolio in the first half of the year. In the medium term there is a probability of increase in corporate lending rates because of rising credit risk due to deterioration in the economy.

In terms of allocation of corporate credit portfolio of the banking system on economic activities, the main consumers of credit products are such sectors as trade, manufacturing and construction. For the first seven months of 2011 increased share of non-financial institutions in the portfolio of loans has been noted in such economic activities as real estate operations (0.4 percentage points), construction (+0.4 p.p.) and transport (+0.5 p.p.) (See Fig. 2).

A sign of improving service quality of loans has become a mass reduction of arrears in the credit loan portfolio of legal entity. The share of overdue loans as of seven months results reduced most of all in transport (-0.9 percentage points), trade (-0.7 percentage points) and in portfolio of loans to enterprises of manufacturing industry (-0.5 percentage points). Traditionally, the lowest level of arrears as of 01.08.2011 was maintained in the loan portfolio of enterprises whose activities are related to minerals production (1.6%) (See Fig. 3).

The retail loan portfolio in July has grown to Rb 169bn (+3.7% versus June), which became a record monthly growth over the past 18 months. Herewith, the main factor in the growth of retail lending in July was the intense growth in consumer loans. Virtually all of the July growth was in the ruble share in the retail loan portfolio (+ Rb 166bn), while the volume of loans to individuals in foreign currency grew only by Rb 3bn. The share of ruble-denominated retail loans in the portfolio for July rose from 93.4% to 93.6%. The share of mortgage credits in the retail loan portfolio continues to grow: as of June 1, she was fixed at 30%, which is by 3 percentage points more than the results on January 1 this year. The volume of outstanding housing loans in June rose by Rb 14bn. The weighted average

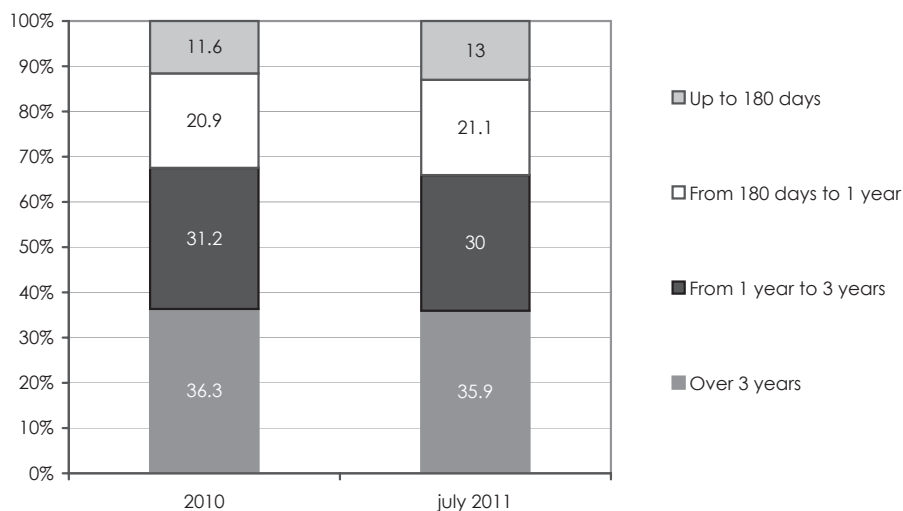


Fig. 1. The structure Rb credit portfolio to non-financial organization in terms of maturity, %

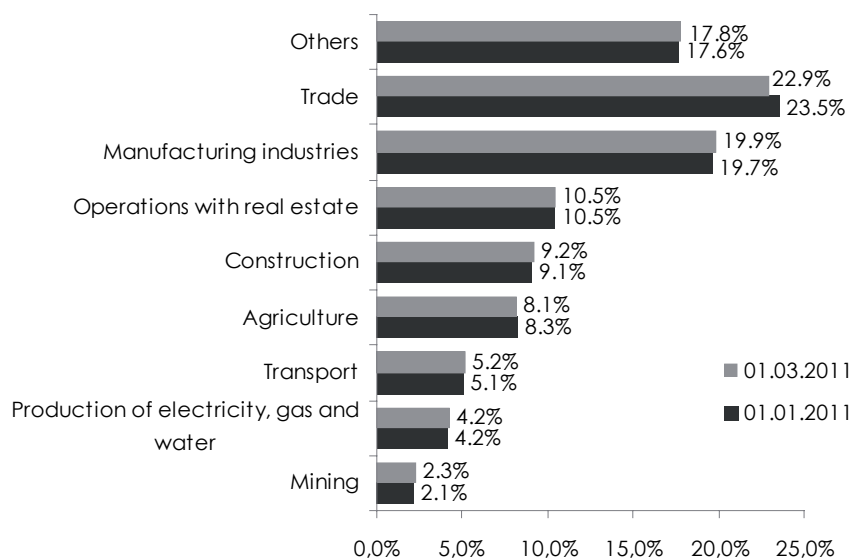


Fig. 2. Share of borrowers by type of economic activity in the portfolio of loans to non-financial organizations, %

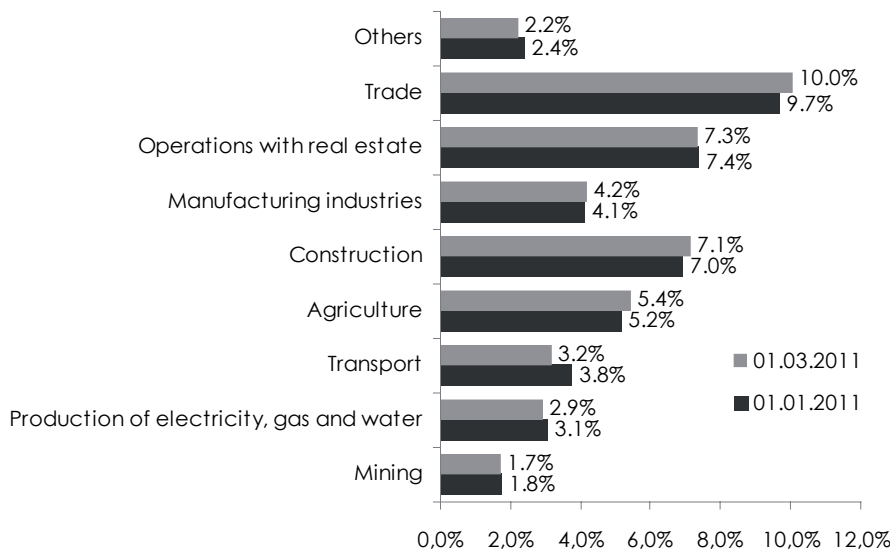


Fig. 3. Share of overdue debt of borrowers in the loan portfolio by economic activity, %

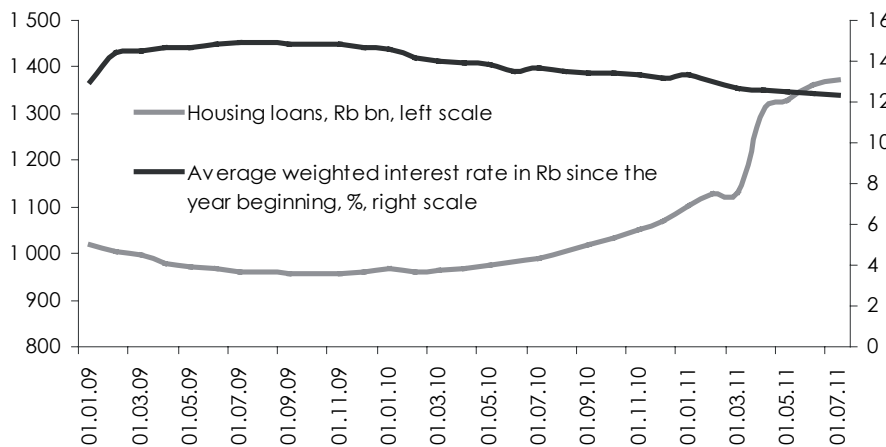


Fig. 4. Dynamics in the volume of housing loans and weighted average interest rates on mortgages in rubles since the beginning of the year

interest rate on housing loans denominated in ruble in June declined and made already 12.3% (See Fig. 4).

Average weighted interest rate in Rb since the year beginning, %, right scale

The share of overdue loans in the retail loan portfolio in July has decreased by 0.2 percentage points and reached 6.2% – a record low level over the past eighteen months.

Thus, the growth of retail trade turnover, observed in recent months, is largely due to the growth of consumer crediting. Herewith, the real incomes are not growing. In our view, this makes for a sharp rise in overdue debt in the event of deterioration in the economic situation.

Portfolio of inter-bank lending increased in July by 1.5% (Rb 47bn). At the same time, portfolio of loans to banks growth rate remained low for the third consecutive month. The level of outstanding debt as of August 1 was only 0.2%. Indicative Mosprime 3M rate in July has increased slightly, having grown from 4.25% to 4.3%. Thus, in the absence of

a liquidity shortage, the inter-bank lending market largely functioned as an alternative way of available funds investment, and as a means of maintaining the required level of liquidity.

Profits of the banking sector in the first seven months this year reached Rb 528.5bn. The number of profitable credit institutions in July decreased by 43 units, and the amount of unprofitable ones, on the contrary, increased by 37.

The volume of equity (capital) of the banking sector of the Russian Federation in July increased by Rb 45.6bn, at the background of reducing the capital adequacy ratio (N1) in the system from 16.7% to 16.1%. The share of problem loans and bad loans in the total volume of loans decreased to 7.6% (8.2% on January 1, 2011).

Here are the most important developments in the banking sector in September:

- The Bank of Russia has published draft amendments to the Instruction “On procedure of obtaining the prior approval of the Bank of Russia for the purchase and receipt of shares (stakes) for trust management”. These amendments remove the existing administrative barrier in the conversion of shares issued by the Russian public banks in the foreign depository receipts, thus increasing the attractiveness of this instrument. The essence of the amendments is to relief foreign banks-depositories, acting as custodians of the Russian banks shares in the interests of foreign investors, from the obligation to obtain the consent of the Central Bank to change their “own” shares status. In future these amendments may be helpful to most public banks.

- Savings Bank has officially announced that placement of 7.6% of shares in the process of the bank privatization, scheduled for mid-September, is postponed for an uncertain term. Quotes of the bank's depository liabilities traded in London fell down at once by more than 4%. Signals that the privatization of public package can be postponed, were available in early August, when the situation in the world markets was seriously deteriorated. In the past eighteen months the Savings Bank's capitalization declined by \$20bn, and in such circumstances it is unreasonable to make any placements.

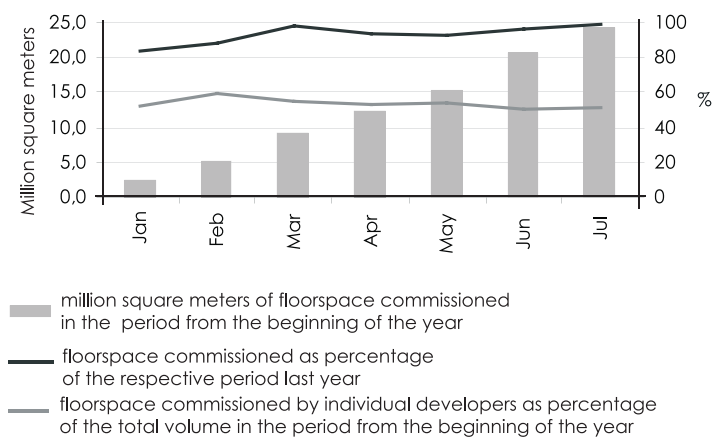
- On September 29 the RF CB comes into effect, according to which non-bank credit organizations will have to submit to the Bank of Russia their statistics on capital adequacy and liquidity on a daily basis.

- On September 14, 2011 the Board of Directors of the Bank of Russia decided to leave unchanged the refinancing rate, increase from September 15, 2011 on deposit interest rates of the Bank of Russia by 0.25 p.p. on fixed terms and to reduce by 0.25 p.p. interest rates on some transactions for liquidity provision. ●

## THE REAL PROPERTY MARKET IN THE RUSSIAN FEDERATION

G.Zadonsky

**In January-July 2011, entities of all the forms of ownership built 287,000 apartments with the total floorspace of 24.4 m square meters which figure amounted to 99.2% compared to the respective period of 2010. The highest result (207.8 square meters per thousand persons) was registered with the Southern Federal District, while the lowest one (73.0 square meters per thousand persons, with the Far Eastern Federal District. By the estimates of the Ministry of Economic Development, at most 70% of entrepreneurs had their titles to land plots under industrial enterprises re-registered on the privileged buyout conditions which expire in 2011. As of August 1, 2011, the average weighted rate on mortgage housing loans (MHL) extended in rubles within a month fell to the record-low level of 11.9%, however, lending rates are expected to go up as deposit rates tend to grow.**



Source: The Rosstat's data.

Fig. 1. The dynamics of commissioning of housing (on an accrual basis from the beginning of the year)

In January-July 2011, entities of all the forms of ownership built 287,000 apartments with the total floorspace of 24.4 m square meters (which figure amounted to 99.2% compared to the respective period last year), including 12.4 m square meters of floorspace of dwelling houses built by individual developers or 51.1% of the total volume of housing which was commissioned in January-July 2011 (Fig. 1). In July 2011, entities of all the forms of ownership built 43,800 new apartments with the total floorspace of 3.7 m square meters.

As a result of realization of state housing certificates for persons dismissed from service at low enforcement agencies and persons made equal them, in the first six

months of 2011 465 apartments were bought (327 apartments, in the 1<sup>st</sup> quarter of 2011). The total floorspace of apartments purchased amounted to 24,400 square meters and Rb 796.5m were spent on it, including Rb 756.8m provided through social payments.

In the first six months of 2011, the highest volume of housing per thousand persons of the population (314.9 square meters) was commissioned in the Krasnodar Territory (Table 1). In the first six months of 2010 and in 2010 in general, the leader was the Moscow Region which on the basis of the results of the first six months of 2011 was rated the fourth. Among the federal districts, the highest result (207.8 square meters per thousand persons) was registered with the Southern Federal District, while the lowest one (73.0 square meters per thousand persons), with the Far Eastern Federal District (Table.1). As regards that index, Moscow moved up from the 84<sup>th</sup> place in 2010 to the 68<sup>th</sup> place.

According to the Rosstat's data, in the 2<sup>nd</sup> quarter of 2011 the average actual cost of building of a square meter of residential floorspace increased by 1.31% as compared to the 1<sup>st</sup> quarter of 2011 and amounted to Rb 32,311 (Fig.2). In the first six months of 2011, the above index amounted to Rb 32,131; it increased 2.97% as compared to the first six months of 2010 (Rb 31,205). In the first six months of 2011, the average actual cost of building of a square meter of residential floorspace was 50% and more higher than the national average level in the Nenets Autonomous Region (Rb 59,865), the Sakhalin Region (Rb 54,578) and the Archangelsk Region (Rb 49,363), while it was below the average national level in 52 constituent entities of the Russian Federation with the



lowest average cost of building registered in the Kursk Region (Rb 19,162), the Astrakhan Region (Rb 20,575) and the Novgorod Region (Rb 21,368).

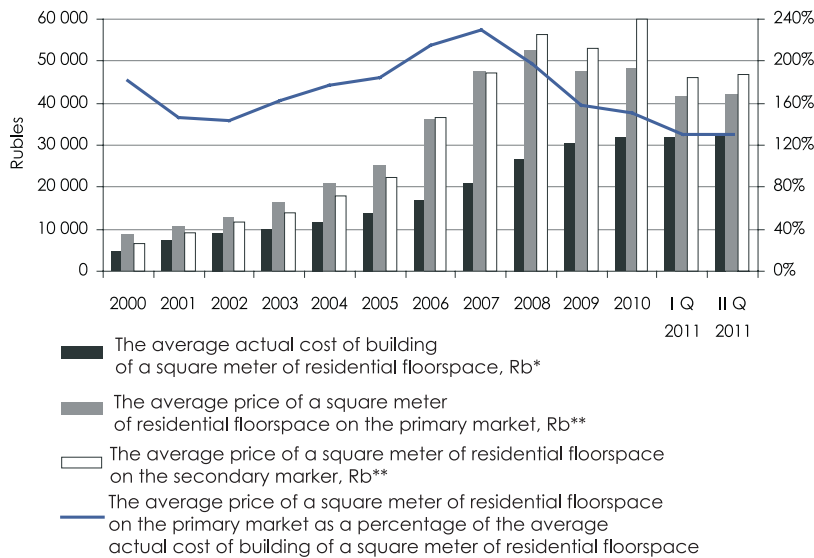
Table 1

DISTRIBUTION OF REGIONS OF THE RUSSIAN FEDERATION BY THE VOLUME OF THE FLOORSPACE COMMISSIONED PER THOUSAND PERSONS OF THE POPULATION IN JANUARY-JUNE 2011

Region	Rating of the region			Total floorspace commissioned				Commissioned by individual developers out of the total volume	
	In the 1 <sup>st</sup> six months of 2010	In 2010	In the first six months of 2011	Thousand square meters	% of the floorspace commissioned in the Russian Federation	Square meters per thousand persons	% as compared to the first six months of 2010	% of the total volume	% as compared to the first six months of 2010.
Krasnodar territory	2	4	1	1624.9	7.86	314.9	90.5	52.3	84.3
Republic of Tatarstan	5	10	2	1171.4	5.67	310.0	124.8	41.4	106.2
Tyumen Region	4	12	3	940.4	4.55	274.1	98.2	34.4	116
Moscow Region	1	1	4	1850.3	8.95	274.0	73.8	61.1	90
Belgorod Region	8	3	5	353.3	1.71	230.9	100.8	88.2	102.1
Kaliningrad region	6	9	6	212.9	1.03	227.0	94.1	23.3	91.2
Leningrad Region	3	6	7	364.4	1.76	223.6	74	55.0	92
Lipetsk Region	15	7	8	245.4	1.19	211.9	107.6	66.6	85.5
Southern	10	17	9	2849.5	13.79	207.8	93.5	62.7	91.5
Chuvash Republic	14	5	10	260.2	1.26	203.5	101.4	80.3	112.4
Republic of Mariy-El	16	23	11	135.2	0.65	193.6	102.5	68.3	100.7
Republic of Bashkortostan	17	15	12	781.8	3.78	192.3	103.1	78.7	109.5
Nizhny Novgorod Region	18	22	13	631.1	3.05	189.9	103.8	72.1	104.6
St. Petersburg	12	8	14	871.2	4.22	189.4	87.1	3.9	49.8
Rostov Region	20	24	15	798.9	3.87	188.9	107.9	75.2	97.5
Ryazan Region	7	30	16	211.4	1.02	183.6	77.8	18.9	87.1
Pivolzhsky	26	27	21	4874.6	23.59	161.9	107.6	59.9	103.5
Urals	28	35	27	1865.2	9.03	151.9	103.6	42.6	106.8
Russian Federation	25	28	30	20662	100.00	145.6	96.3	50.8	97.2
Central	22	19	34	5228.1	25.30	140.9	87.5	49.2	91.8
North-Western	23	26	38	1855.3	8.98	138.1	88.3	26.7	92.2
Siberian	44	44	41	2473.2	11.97	126.4	106.1	43.7	107.6
North-Caucasian	33	49	49	1019.7	4.94	110.2	80	61.6	84.7
Moscow	70	84	68	872.2	4.22	82.6	107.2	1.7	259.1
Far Eastern	77	70	74	470.1	2.28	73.0	119.9	47.7	118

The source: The Rosstat's data.

In the 2<sup>nd</sup> quarter of 2011, the average price of a square meter of residential floorspace on the primary market (Rb 42,201.23) increased by 1.6% as compared to the 1<sup>st</sup> quarter of 2011, however, it remained 12.1% lower than the average price of a square meter of residential

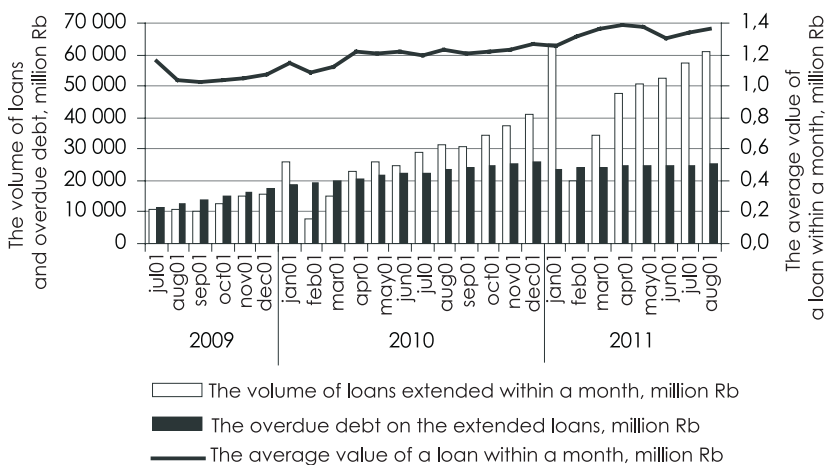


\*The average actual cost of building of a square meter of floorspace of detached dwelling houses (all the apartments) without extensions, overstories and built-in facilities in the Russian Federation (without those built by households at the their own expense and with use of borrowed funds);

\*\*all the apartments.

Source: The Rosstat's data.

Fig. 2. The dynamics of the cost of building of a square meter of residential floorspace and the price of a square meter of residential floorspace on the primary and secondary markets of the Russian Federation.



Source: on the basis of the data of the Central Bank of Russia.

Fig. 3. The dynamics of provision of mortgage housing loans in rubles

higher than that in July 2010 (Fig. 3), while the total sum of mortgage housing loans in foreign currency amounted to Rb 1,660 m which figure is 36.73% higher than that in July 2010 (Fig. 4).

In the 2<sup>nd</sup> quarter and July 2011, the residual debt on ruble mortgage housing loans kept growing and as of August 1, 2011 it amounted to Rb 1,112.20bn which figure is 29.89% higher than that as of August 1, 2010. As of August 1, 2011, the debt on mortgage housing loans in foreign currency amounted to Rb 155.28bn which figure is 16.5% lower than that as of August 1, 2010.

In July 2011, the average value of ruble mortgage housing loans amounted to Rb 1,369m and exceeded by 5.35% the minimum value of May (Fig. 7). After growth in May and June, the average value of mortgage housing loans fell by 30.23% to Rb 4.5m in July 2011 (Fig. 4).

floorspace in the 2<sup>nd</sup> quarter of 2010. In the 2<sup>nd</sup> quarter of 2011, the ratio between the price of a square meter of residential floorspace on the primary market and the cost of building of it amounted to 130.61% against 130.2% in the 1<sup>st</sup> quarter of 2011 (Fig. 2).

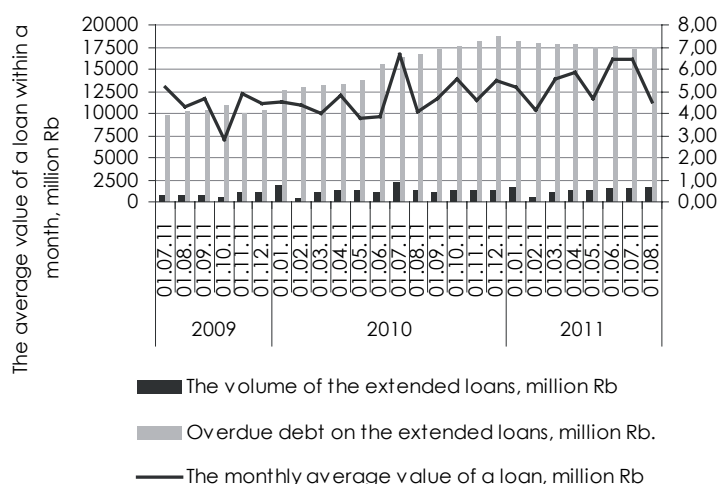
From January 2012, in execution of the title to land plots under industrial enterprises privileged buyout conditions expire (2.5% of the cadastral cost) and market prices come into effect. According to the data of the Ministry of Economic Development, as of today maximum 70% of entrepreneurs with such privileges have had their titles re-registered. In summer 2011, amendments which make the procedure for execution of the privileged buyout simple due to the fact that land plots are permitted to be bought without cadastral evaluations came into effect. However, the above amendments will be applied only after the Ministry of Economic Development has introduced relevant changes in the list of documents which are required for re-registration.

In January-July 2011, according to the data of the Central Bank of the Russian Federation 283,718 housing loans for the total amount of Rb 364.73 bn were provided, including 240,318 mortgage housing loans for the total amount of Rb 331.32bn, which figure exceeds by 99% the volume of mortgage housing loans extended in January-July 2010. The total sum of ruble mortgage housing loans extended in July 2011 amounted to Rb 60,755m, which figure is 92%

In 2010 and the first six months of 2011, the volume of the extended mortgage housing loans expressed as a share of GDP in current prices was steadily growing (Fig. 5). However, in the first six months of 2011 the volume of the extended mortgage housing loans expressed as a share of the GDP (1.11%) was 0.66 percentage points lower than the maximum value in the first six months of 2008.

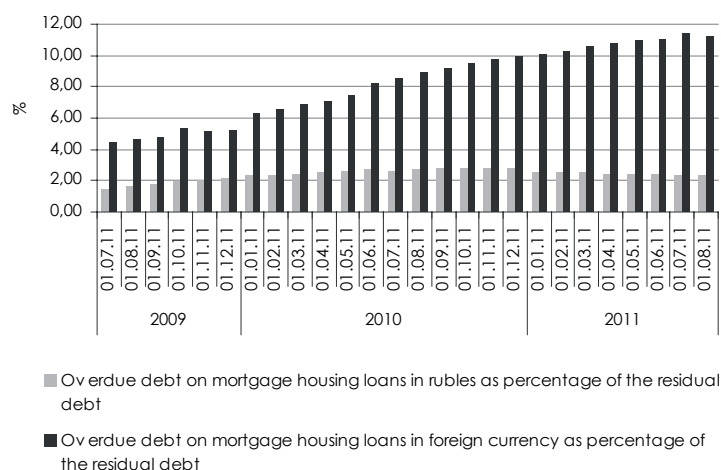
In the second quarter of 2011 and July 2011, the overdue debt on ruble mortgage housing loans kept growing in absolute terms (Fig. 6), but fell against the value of the residual debt (Fig. 6). As of August 1, 2011, the overdue debt on ruble mortgage housing loans amounted to Rb 25.37 bn, that is, 2.28% against the residual debt. In the 2<sup>nd</sup> quarter, the absolute value of the overdue debt on mortgage housing loans in foreign currency lacked an explicit trend (Fig. 4), however, it keeps steadily growing against the residual debt (Fig. 6). As of August 1, 2011, the overdue debt on mortgage housing loans in foreign currency amounted to Rb 17.39bn, that is, 11.2% of the residual debt.

According to the data of the Central Bank of Russia, as of August 1, 2011 the debt on defaulted mortgage housing loans (which were overdue for more than 180 days) amounted to Rb 50,699bn and 4.0% of the total amount of the debt, which figure is 0.14 percentage point lower than that a month before. As of August 1, 2011, the share of the debt on mortgage housing loans without overdue payments increased both in money terms and as a percentage of the total amount of the debt (Table. 2).



Source: on the basis of the data of the Central Bank of Russia.

Fig.4. The Dynamics of provision of mortgage housing loans in foreign currency



Source: on the basis of the Rosstat's data

Fig. 5. The volume of the extended mortgage housing loans accrued within a year, % of the GDP in current prices

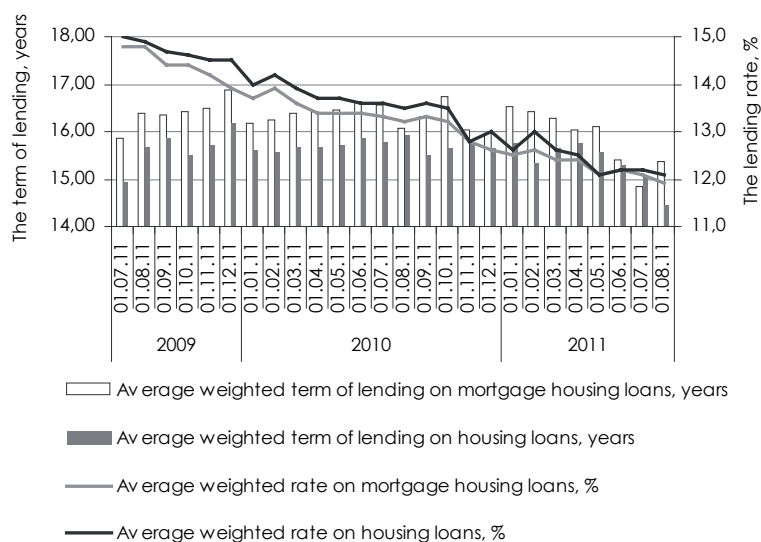
Table 2

#### GROUPING OF THE DEBT ON MORTGAGE HOUSING LOANS BY THE PERIOD OF DELAY IN PAYMENTS IN 2011

	Total amount of debt on mortgage housing loans	Without overdue payments		With overdue payments					
				from 1 to 90 days		from 91 to 180 days		over 180 days	
		Million Rb	%*	Million Rb	%*	Million Rb	%*	Million Rb	%*
01.Jan	1 129 373	991 928	87.83	66 859	5.92	12 875	1.14	57 711	5.11
01.Feb	1 132 463	981 392	86.66	84 935	7.50	12 344	1.09	53 792	4.75
01.Mar	1 138 395	986 647	86.67	87 087	7.65	11 953	1.05	52 708	4.63
01.Apr	1 158 137	1 018 697	87.96	73 658	6.36	12 276	1.06	53 506	4.62
01. May	1 178 074	1 044 480	88.66	68 682	5.83	11 074	0.94	53 838	4.57
01.Jun	1 208 218	1 095 612	90.68	54 370	4.50	7 370	0.61	50 866	4.21
01.Jul	1 220 091	1 106 378	90.68	55 880	4.58	7 321	0.6	50 512	4.14
01.Aug	1 267 482	1 157 212	91.3	52 220	4.12	7 351	0.58	50 699	4.00

\* % of the total amount of the debt.

The source: the data of the Central Bank of Russia.



The source: on the basis of the data of the Central Bank of Russia.

Fig. 6. Average weighted terms and average weighted interest rates on ruble loans extended within a month

As of August 1, 2011, the average weighted rate on ruble mortgage housing loans amounted to the record-low level of 11.9%, while that on ruble housing loans extended within a month exceeded by 0.2 percentage points the rate on mortgage housing loans (Fig. 6). As of August 1, 2011, the average weighted rate on foreign currency mortgage housing loans extended from the beginning of the year amounted to the minimum value of 9.6%, while that on housing loans, to the minimum value of 9.8%.

In July 2011, the average weighted term of lending on ruble mortgage housing loans extended within a month increased by 0.53 years and amounted to 15.38 years, while that on housing loans decreased by 0.63 years and amounted to 14.46 years (Fig. 6). In August 2011, the average weighted term of lending on

foreign currency mortgage housing loans extended from the beginning of the year amounted to 13.63 years, while that on housing loans in foreign currency, to 11.1 years.

The share of foreign currency mortgage housing loans in the total volume of the residual debt kept decreasing and as of August 1, 2011 it amounted to 12.25%, while in the volume of mortgage housing loans extended within that period it amounted to 2.7%.

According to the leading mortgage banks' operation results in the first six months of 2011 (Table 3), a number of banks have increased several times over the volume of the extended mortgage loans as compared to the similar period of 2010. Sberbank together with VTB account for more than a half of the mortgage market as regards the volume of the extended mortgage loans (58%).

Table 3

THE OPERATION RESULTS OF THE LEADING MORTGAGE BANKS  
IN THE FIRST SIX MONTHS OF 2011

N	Bank	The volume of the extended mortgage loans, million Rb.	The number of the extended mortgage loans	Increase in the volume of the extended loans as compared to that in the first six months of 2010, %
1	Sberbank	129 000	110 485	84
2	VTB 24	27 043	16 706	139
3	Gasprombank	16 386	8 496	183
4	Deltacredit	7 157	3 005	151
5	Absolut bank	4 292	2 576	504
6	Zapsibkombank	4 092	2 537	126
7	Raiffeizen Bank	3 933	1 498	448
8	Vozrozhdenie	3 850	2 000	265
9	BSGV	3 679	1 414	235
10	Khanty-Mansiisk Bank	3 339	1 749	442

The source: Rusipoteka's data.

A draft law has been introduced in the State Duma to reduce the tax base of households with two and more children in case of another purchase of housing or extension of it by means of a repeated tax deduction for that purchase, including the situation where a loan is granted. The Chairman of the Board of Sberbank predicts growth in lending rates as deposit rates tend rising.

## THE LIVING STANDARDS OF THE POPULATION

S.Misikhina

*In January – August 2011, the gap between the growth rate of consumer prices and the growth rate of the nominal per-capita income of the population was wider than in the corresponding period of 2010: 109.3% vs. 109%. The real disposable income of the population registered over the first 8 months of 2011 was lower than in the corresponding period of 2010, although the rate of its decline has displayed a slow-down. The rise in nominal wages and the fall in the volume of outstanding wage arrears resulted in a 2.3% climb in real wages over the first 8 months of 2011. The indexation of labor pensions carried out in February 2011 made it possible to preserve, in the first half-year of 2011, the ratio between the average monthly size of an allotted pension and the average monthly size of a charged wage at the same level as in the corresponding period of 2010. The seasonal drop in the money income of the population registered in Q1 2011 was so considerable that it caused a rise in both the number of the poor and the level of poverty in Q1 2011 in comparison with Q1 2010.*

**The real disposable money income of the population.** The growth in the nominal per-capita money income of the population over the period from January through August 2011, which increased by 9% on the corresponding period of 2010 and resulted in the average per-capita money income of the population rising to 20 thousand Rb as of August 2011, was completely ‘eaten up’ by inflation, because the growth rate of consumer prices over that period amounted to 109.3%. The significant decline in the real disposable money income of the population in Q1 2011 in comparison with Q1 2010 was not compensated for by its rise in Q2 2011, although the climb in real disposable money income of the population amounted to 12.1%. In Q2 2011, the gap between the level of the real disposable money income of the population registered in 2010 and 2011 palpably increased: in Q1 2011, the real disposable income of the population lagged behind the figures of Q1 2010 by only 0.2 %, while in Q2 2011 the gap grew to 2.1%.

This situation also had an impact on the half-year values of this index: in the first half-year of 2011, the real disposable money income of the population was 1.2% smaller than in the first half-year of 2010. The higher growth rates of real disposable money income of the population in July and August 2011 by comparison with the corresponding one-month growth rates in 2010 resulted in the real disposable money income generated by the population over January-August 2011 lagging behind that generated over the corresponding period of 2011 by 0.7%.

The general economic situation in Russia, as well as the fact that the real disposable money income of the population over the course of almost three quarters of 2011 lagged behind the corresponding figures of 2010, have made it possible to assume that, by the end of the year, the real disposable money income of the population will be able to rebound, at best, to its 2010 level.

Table 1

CHANGES IN REAL DISPOSABLE MONEY INCOME OF POPULATION, %

	As percentage	
	of corresponding period of 2010	of previous year
	2010	
Q1	107.3	78.7
Q2	103.7	114.4
First half-year	105.3	
July	106.8	100
August	105.2	94.6
January – August	105.4	
Q3	104.5	97.3

Table 1, cont'd

	As percentage	
	of corresponding period of previous year	of previous period
Q4	102.1	116.5
Year	104.2	
2011		
Q1	99.8	77
Q2	97.9	112.1
First half-year	98.8	
July	100.4	98.6
August	101.4	95.7
July – August	99.3	

Source: Preliminary data of Rosstat.

Over January – August 2011, the nominal average monthly charged wage of a worker grew by 11.8% to 23 thousand Rb as of August 2011.

In the course of the first 8 months of 2011, the outstanding average monthly arrears of wages dropped by one quarter on the corresponding period of 2010 (the value of the absolute drop exceeded Rb 0.9bn), which resulted in the volume of outstanding average monthly arrears of wages sliding to about 2.3 bn Rb as of 1 September 2011 (less than 1% of the one-month wages fund of the workers employed in the monitored types of economic activities). The 34.7% drop in the number of workers affected by arrears of wages was even more considerable than the drop in the volume of outstanding arrears of wages accumulated over the first 8 months of 2011 in comparison with the corresponding period of 2010. This resulted in a rise in the indicator denoted as “the value of the outstanding arrears of wages per one worker affected by such arrears”.

In Q2 2011, the real average monthly charged wage of a worker rose by 2.7% on the corresponding period of 2010. This indicator climbed both in July and August 2011. This trend resulted in a 2.3% growth in the real average monthly charged wage of a worker over the first 8 months of 2011 by comparison with the corresponding period of 2010.

In 2011, pension indexation was carried out twice:

- on 1 February labor pensions were increased by 8.8%;
- on 1 April social pensions rose by 10.27%.

According to estimates of the Pension Fund of the Russian Federation, the February rise in labor pensions should have resulted in a 678 Ruble climb in the average monthly labor pension, raising it from Rb 7,820 to Rb 8,498.

In July 2011, the average monthly value of an allotted pension amounted to 8.3 thousand Rubles. Over January-July 2011, the actual value of an allotted pension rose by 0.8% on the corresponding period of the previous year.

The February rise in labor pensions and the zero growth of wages in the course of that month resulted in an increase in the ratio between the average monthly size of an allotted pension and the average monthly size of a nominal charged wage, which brought this ratio 39.7% as of February 2011. However, the rise in the average wage, which amounted to 109.6% in March, once again reduced the ratio between the average monthly size of an allotted pension and the average monthly size of a nominal charged wage, bringing it back to about 36.3%. In the first half-year of 2011, this ratio stood at about 36.5% – exactly at the same level as during the corresponding period of 2010.

The climb in actual wages and the February increase in labor pensions did reflect, although insignificantly, on the structure of the money income of the population:

- in Q1 2011, there occurred an increase in the share of social payments, in comparison with the corresponding period of 2010, and a simultaneous drop in the share of payment for labor (including the ‘concealed’ wages) and incomes from property;

- in Q2 2011, there occurred a rise in the share of payment for labor (including the “concealed” wages) and incomes from entrepreneurial activities, in comparison with the corresponding period of 2010, and a simultaneous drop in the share of social payments and incomes from property (*Fig. 1*).

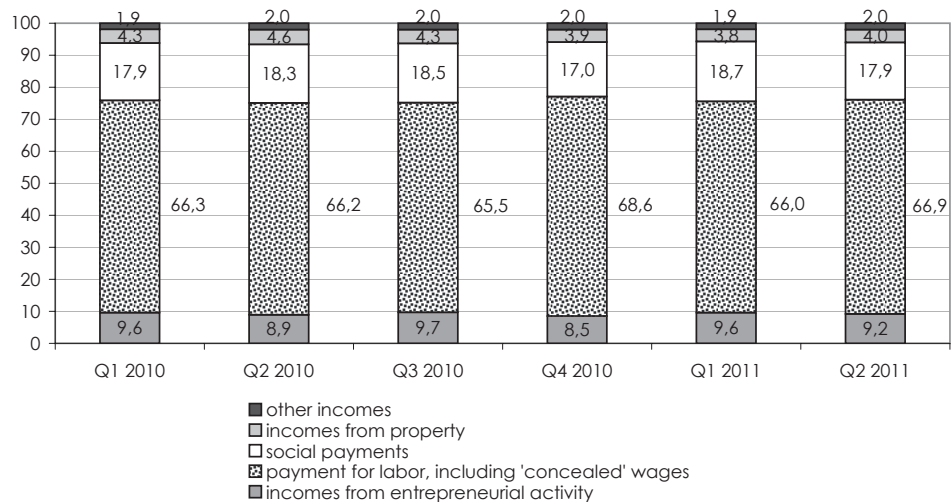
The subsistence level and poverty. In comparison with Q4 2010, the subsistence level rose by 9.7% both on the average with regard to the population as a whole, and with regard to all the major socio-demographic categories of the population, except for pensioners, where the increase amounted to 9.4%. At the same time, the cost of foodstuffs within the consumer basket rose by 10.6%, while the cost of non-food products and services climbed by 3.5% and 11.0% respectively.

In Q2 2011, the subsistence level remained practically unchanged in comparison with Q1 2011: the increase amounted to about 0.5% (0.4 % for pensioners) (Fig. 2).

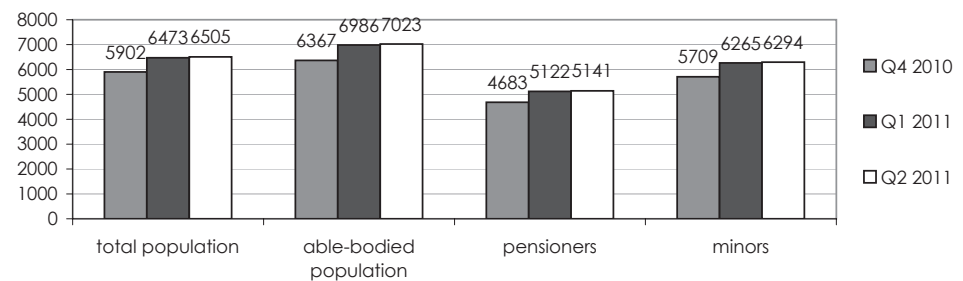
In Q2 2011, the ratios between the major indicators of the money income of the population and the subsistence level were smaller than their ratios in Q2 2010. They amounted to 306.9% for the average per-capita money income of the population, to 329.7% - for the average nominal monthly charged wage, and 160.6% - for the average size of allotted pensions.

As of today, Rosstat has published data on the number of the poor<sup>1</sup> and the subsistence level only for Q1 2011. According to those data, 22.9m persons

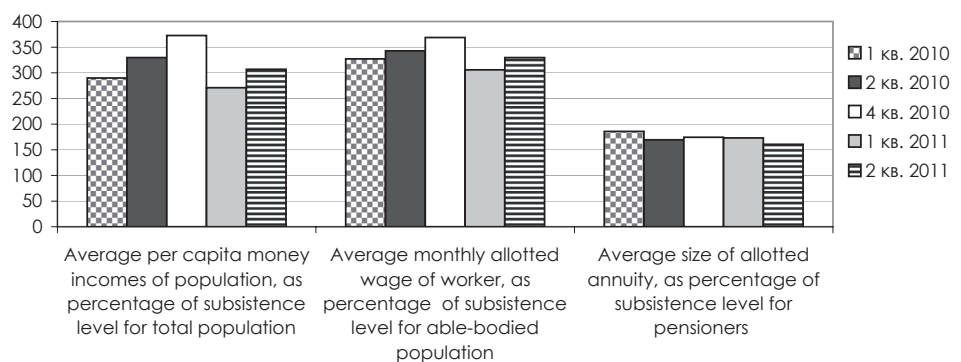
then lived below the poverty line, which exceeded the number of the poor population registered in Q1 2010 by 11.2%. In Q1 2011, the percentage of the poor amounted to 16.1% against 14.5% in Q1 2010. A rather unfavorable trend displayed by the money income of the population in Q2 and Q3 2011 makes it possible to assume that the poverty rate for the whole year will be higher than in 2010, even though the growth rate of the subsistence level considerably declined in Q2 2011. ●



Source: preliminary estimates of Rosstat.  
Fig. 1. The Structure of the Money Income of the Population in 2010 – Q2 2011, as a Percentage of the Result.



Source: data of Rosstat.  
Fig. 2. The Subsistence Level, as Calculated Per Capita and for the Major Socio-Demographic Categories of the Population, in Q4 2010 – Q2 2011



Source: calculated on the basis of data issued by Rosstat.  
Fig. 3. Ratio Between the Major Indicators of the Money Income of the Population and the Subsistence Level in Q1 2010 – Q2 2011, in %

1 According to the official methodology, persons should be deemed to be poor when their average per-capita income is below the subsistence level.

**MIGRATION PROCESS: SPRING—SUMMER 2011**

L.Karachurina

*The first six months of 2011 were marked by **active discussion of the effective migration legislation**, including amendments to the “Strategy 2020”, which was actively developed in the period under review. The **new edition of the Migration Policy Concept is being prepared**.*

However, the word “new” is only partially true. Work on the Concept draft began back in 1998, when the Federal Migration Service was a civil authority. That first draft has been widely discussed, and scientific and public organizations actively participated in its elaboration. The key trend of the Concept was repatriation migration (from the CIS to Russia). In autumn 2001, after the transfer of the FMS under the jurisdiction of the Ministry of Internal Affairs, the approach to the Concept has changed: the focus was shifted to combating against illegal migration and promotion of temporary labor migration. Based on this logic, the document was entitled “The Concept of Migration Processes Regulation” and in this form it was adopted in March 2003. Herewith, while it was approved by the Russian Government, rather than by the Decree of the President, which has somewhat downgraded its status. Thus, despite the ever-increasing importance of migration in the socio-economic life of modern Russia, as well as an abundance of migration laws (and later amendments) and regulations adopted in the 2000s, there is still no proper Concept of migration policy in the country.

The last Russian migration reform (2006-2007) focused mainly on the streamlining of temporary labor migration, and almost did not affect migration for permanent residence. Even in its relatively completed part of the Concept (temporary labor migration), it caused a lot of fair criticism and misunderstandings, the main of which is the mechanism of quotas, which will be discussed below.

The widely discussed new version of the Concept is based on the fact that in the upcoming “battle” of the developed countries for “one of the main resources of the economy development”, as migration was defined by Igor Shuvalov, the First Deputy Prime Minister<sup>1</sup>, we need effective mechanisms and programs of an ongoing, rather than just temporary migration, the purpose of which is not only to maintain the national population, but also a qualitative improvement of its human potential. It is proposed to abolish the temporary residence permit; an applicant for a residence permit (and later Russian citizenship) will be able to get it on so-called “score system” with regard to language skills, education, training and other individual characteristics.

The abolition of quotas for work permits is a hotly debated issue. Migration quota – a mechanism formed by the opaque, often distributed basing on purely administrative, not economic logic, and most importantly, not free from corruption schemes. The Ministry of Healthcare and Social Development of Russia is the developer and promoter of this management tool. At the same time, survey data of the “Support of Russia” organization show that 70% of small business registration procedure of a foreign worker is “too difficult”, 40% of entrepreneurs over 8 months before the beginning of the calendar year are not aware of their needs for workers for the next year, as required by the current quota mechanism<sup>2</sup>. Exposed in this way the barriers for small businesses are clearly inconsistent with the Government announced plans to increase the share of small business in GDP from 20 to 60% in 2020.

Established back in November 2010 quota for work permits for 2011 (1,745,584 units, including 523,675 pieces in the framework of reserve<sup>3</sup>) were adjusted upward already 5 times (March, May, July, August, September), the quotas for issuing invitations for foreign citizens entrance in

1 From the speech of I. Shuvalov at the meeting of the Governmental Committee on Migration Policy. L. Grafova. Migration reversal // Rossiyskaya Gazeta. March 3, 2011.

2 D. Nikolaeva. Temporary migration is not justified // Kommersant. March 9, 2011.

3 RF Government Resolution No.895 of 12.11.2010 “On the identification of the need for involvement of foreign workers and approval of the relevant quota in the Russian Federation”.



Russia (for those who need visas) - 4 times. Each time this procedure requires from the regions and the center the grounds preparation of a relevant package of documents, a number of approvals and bureaucratic procedures. Every time the need of a quota selection, “hit or miss”, with it forms the basis for the purchase of quotas, bribes, etc. As in previous years (since 2008), migrants from non-visa countries can stay legally in the country, but not always can legally work. That’s why some of the migrants prefer to buy the necessary documents; the price of a work permit (without regard for official state tax of Rb 2,000) of firms, specializing at this business in Moscow starts from Rb 12,000.

In addition to numerical quotas, in 2011 there still acted the order providing for the distribution of regional quotas by the professions, specialties and qualifications of foreign workers, as well as a list of non-quotable trades.

The situation is absurd: at the state level, the Ministry of Healthcare and Social Development issues the Decree “On Amendments to the Annex to the Order ‘On approval of the list of professions (specialties, positions) of foreign nationals - qualified professionals, who are employed at their existing profession (specialty), which are not eligible to quotas for 2011” (No. 427n of May 25, 2011), the essence of which is to supplement the existing list of positions by “circus artist”, “sound engineer”, “ringmaster”<sup>1</sup>. In the initial version (Appendix to the Order of the Ministry of Healthcare and Social Development No. 22N of January 24, 2011) there were 32 entries in this list. Among them - “CEO”, “Director”, “Chairman of the Board” (22 positions), “Engineer” of various specializations (10 positions).

Regional quotas as broken down by professions, specialties and qualifications of foreign employees, recorded in the Annex to the appropriate Order of the Ministry of Healthcare and Social Development<sup>2</sup>, are multi-page lists of trends (in accordance with the National Classification of occupations), which involve foreign employees in each region, including each vacancy. For example, in Belgorod region two work permits are required for 2011 for the “sellers, goods demonstrators, models and clothes presenters”, but in Kursk Region there is a need for one permission for “low-skilled workers, common to all sectors of the economy”.

It is clear that in these changing economic conditions or other requirements in the labor force indeterminable in April of this year for the next calendar year (and namely at this time businesses should make applications for foreign labor involvement) and are not satisfied a priori.

In accordance with this list, the Russian retail business, especially in Moscow and its region and other major cities, would have ceased to exist long ago: in Moscow, the declared need for «salesman» is 440 pc for 2011, which is approximately one and a half times less than the average number of employees of one store “Auchan”<sup>3</sup>. Consequently, the operation of large stores in Moscow is almost completely “tied up” to the use of various “schemes” of recruitment.

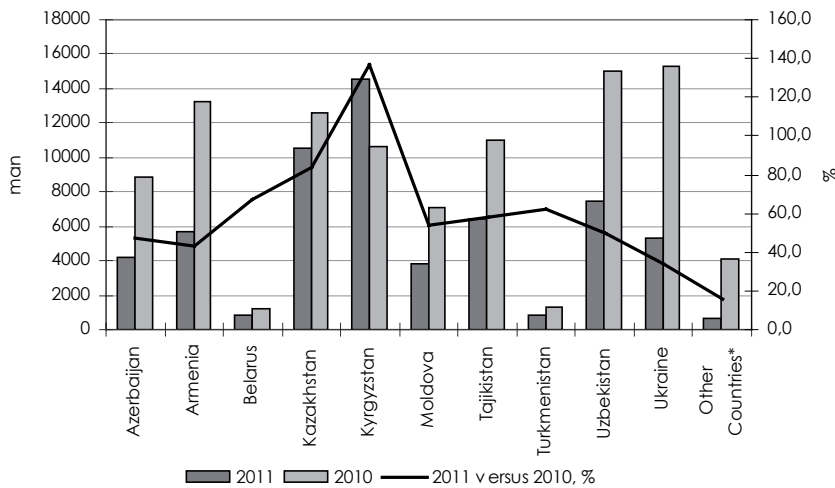
The discussed version of the migration policy Concept proposes to abandon the quota system and to introduce such “differentiated mechanisms” as the attraction of migrants with different skills through different programs, short and long term migration, seasonal migration, organizational recruitment, holiday migration to foreign students.

Current amendments to the effective legislation directly involve the category of high-skilled professionals (HSPs). Now they are allowed to get registered in immigration records within 90 days, but it can be done only by place of residence, rather than by the legal address of the organization, hiring a foreign employee. Such is the Russian immigration procedure today: there are as many prohibitive measures as permissive ones. If we add that there is the only unit of the FMS in the country, which draws up the documents for HSP (the Moscow Center for applications of citizens on the passport and visa issues of FMS of Russia), we find that there are even more actions that hamper the receipt of applications for HSP. For the 6 months of 2011 (January-June) there were issued

1 Official site of the Ministry of Healthcare and Social Development <http://www.minzdravsoc.ru/docs/mzsr/migration/23>

2 Annex 2 to the Order of the Ministry of Healthcare and Social Development No.080n from 08.12.2010 “On the distribution of the quota for issuing permits to foreign citizens work by the Subjects of the Russian Federation, approved by the Russian government in 2011”.

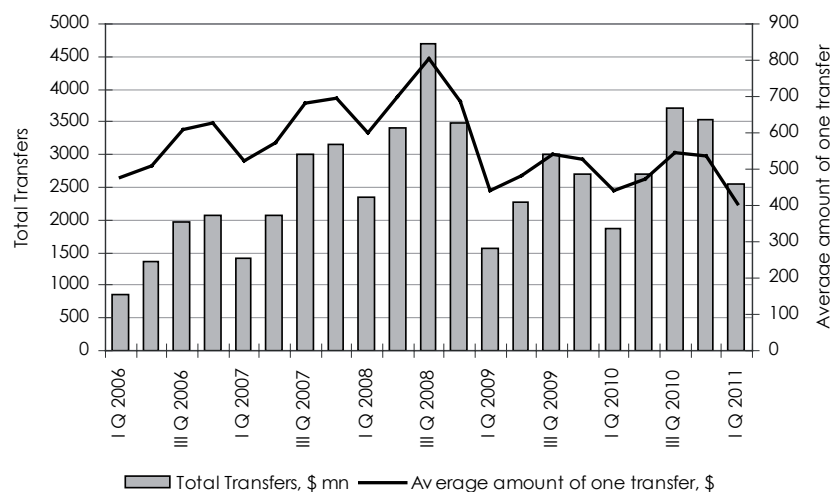
3 “Auchan” stores in Moscow have suspended trading of alcohol. RIA Novosti, May 20, 2009 <http://ria.ru/moscow/20090520/171736039.html>



\* Other countries - non-CIS countries, Baltic states and Georgia.

Source: Russian State Statistical Service (demography in January-July 2011).

Fig. 2. Migration growth as a result of exchange between Russia, the CIS and other countries in 2010-2011. (data for January-July), registration at the place of residence



Source: RF Central Bank

Fig. 2. Cross-border transfers of natural persons (residents and nonresidents) from Russia to CIS countries in dollars, 2006 - first quarter 2011

geography of the source countries shows that the reduction did not affect only the Kyrgyz Republic (See Fig. 1), where the special procedure for acquiring citizenship is still in effect<sup>2</sup>.

FMS statistics on involvement of temporary foreign workers does not show any noticeable changes. In 2011 the number of work permits issued to individuals made 989.8, i.e., almost the same as in 2010. Among them, the number of those who don't need visa has slightly grown. At the same time, since the current year, in the framework of the Customs Union, Kazakhstan citizens have the opportunity to work in Russia without a work permit, like the earlier inhabitants of Belarus Republic. This is an indirect evidence of a slight increase in the number of those legally involved in labor of workers who don't need visa, although the share of Kazakhstan in labor migration in Russia has always been very low (less than 1%).

about five thousand work permits for HSP, and 92% of them are foreigners from the so-called "visa" countries.

Another innovation in the legislation in 2011 is associated with reduced rates of income tax for members of the national program "Compatriots" and their families, who migrated to Russia for permanent residence, from 30 to 13%<sup>1</sup>. It is unlikely that this single measure can help to overcome the situation with the failed implementation of the State program, but it can serve as a positive signal for the immigrants. Much greater number of participants in the State Program may be affected and, apparently, already were affected by removal of a simplified procedure for obtaining citizenship for residents of the former USSR. To participants of the State Program the simplified procedure is sustained. The number of members of the State program has grown by 36% during the first six months of 2011 as compared with the same period of the last year, but it is still small (over six months 7,500 participants and 4,400 members of their families joined the State program).

Abolishment of the simplified procedure for obtaining citizenship, which occurred in the summer of 2010, has drastically reduced the recorded migration growth. Over January-July 2011 it was 60,200 against 100,400 for the same period of the last year. Analysis of the

1 The relevant amendments made to the Tax Code and Federal Law "On Legal Status of Foreign Citizens in Russia".

2 Agreement between the Republic of Belarus, the Republic of Kazakhstan, the Kyrgyz Republic and Russian Federation on the simplified procedure of the acquisition of citizenship, dated of February 26, 1999.

Effects of the 2009-2010 crisis in terms of cash transfers have been partially overcome: the amount of transfers from Russia to the CIS countries in the first quarter of 2011 reached a maximum level for the beginning of the year<sup>1</sup>. Simultaneously, the average amount per transaction is less than ever – it is minimal over the past 5 years (See *Fig. 2*). Apparently, the reduction of the transfers amount is provoked by the devaluation of ruble against dollar: migrant workers receive salaries in rubles, while the bulk of transfers is made in dollars. ●

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<sup>1</sup> The volume of transfers in the first quarter is traditionally lower than over the rest of the year. This is due to the fact that the number of migrant workers at the beginning of the year is always lower, as well as the amount of payments – they are always higher at the end of the year.

## AN OVERVIEW OF ECONOMIC LEGISLATION

I.Tolmacheva

*In September 2011, a number of alterations were introduced in Russia's legislation. These legislative innovations established **the size of the RF President's scholarships for full-time and post-graduate students** being educated in fields corresponding to high-priority areas of modernization and technological development of the Russian economy; established **the magnitude of the subsistence level** for the Russian Federation as a whole for Q2 2011; and authorized **new model agreements** on the conduct of various activities in the territory of special economic zones.*

### I. Edicts of the RF President

1. "On the President of the Russian Federation's Scholarships for Students and Post-Graduate Students Being Educated in the Fields (Specialties) Corresponding to the High-Priority Areas of Modernization and Technological Development of the Russian Economy", of 14 September 2011, No 1198

From 1 January 2012 onwards, 2,700 full-time and 300 post-graduate students being educated in the fields corresponding to the high-priority areas of modernization and technological development of the Russian economy will be entitled to the RF President's scholarships. It is established that the student scholarship will amount to Rb 7,000 per month, while the post-graduate scholarship will be Rb 14,000 per month.

### II. Decrees of the RF Government

1. "On the Establishment of the Size of the Subsistence Level, on the Per-Capita Basis and for the Major Socio-Demographic Categories of the Population, in the Russian Federation as a Whole, for the Second Quarter of 2011", of 14 September 2011, No 772

For Q2 2011, the subsistence level for the Russian Federation as a whole is established at 6,505 Rb per capita of the total population, at 7,023 Rb per capita for able-bodied persons, at 5,141 Rb for pensioners, and at 6,265 Rb for minors.

The subsistence level is to be established monthly, on the basis of the consumer basket and Rosstat's data on the level of consumer prices for foodstuffs, non-food products and services, as well as on the level of expenses related to mandatory payments and charges.

### III. Instructions, Letters and Orders

1. Order of the RF Ministry of Economic Development "On the Approval of the Model Forms of Agreement on the Implementation (Conduct) of Industrial and Production, Technical and Innovative, and Tourist and Recreational Activities in the Territory of Special Economic Zones", of 25 July 2011, No 366

Registered at the RF Ministry of Justice on 20 September 2011 under No 21830.

In connection with the abolition of the Federal Agency for Special Economic Zone Control and the transfer of its functions to the RF Ministry of Economic Development, the texts of the new model agreements on the implementation (conduct) of industrial and production, technical and innovative, and tourist and recreational activities in the territory of special economic zones should refer to this ministry, and not to the abolished agency, whenever it comes to denoting the party to the agreement that represents the State. Also, the new model agreements have established the size of the fine to be paid by the person that has lost its status of a special economic zone resident, in the event of an early cancellation of the agreement in connection with a considerable violation, by the said person, of one or other term of the agreement. This fine should amount to 5% of the total investments envisaged by the agreement, less the volume of implemented investments; at the same time, it should not exceed Rb 5 million or be less than 150 thousand Rubles. The new model agreements also specify the *force majeure* circumstances that should release the parties from any responsibility for their failure to fulfill their obligations, and thoroughly regulate the procedures for informing the parties about the emergence of such circumstances. ●

## AN OVERVIEW OF NORMATIVE DOCUMENTS ON TAXATION ISSUES IN AUGUST–SEPTEMBER 2011

L.Anisimova

*In view of the aggravated economic situation at the end of September 2011, the negative dynamics of oil prices, the weakening ruble, the Russian Ministry of Finance leadership replacement, special attention, in our view, requires the analysis of Tax Policy Key Trends (Guidelines) for 2012 and the planned period for 2013 and 2014.*

*The preamble to the Guidelines indicated a balance of revenue and expenditure sides of the budget as a priority in tax policy. Very careful attention is drawn to the possibility of increasing the tax burden (especially on the consumption and production of raw materials) with a further increase of public expenditures, some measures were announced as aimed at creating conditions for the formation of the International Financial Center in Russia.*

*In our opinion, the proposed recommendations cannot really constrain public spending in the difficult period of time, as part of the proposed measures are ineffective from the financial point of view.*

*We will analyze the proposals in more detail.*

1) (P. 1.4)<sup>1</sup> In regard to personal income tax, it is proposed to abolish the standard deduction in the amount of Rb 400 and establish a deduction for each 2nd and subsequent child in the amount of Rb 3,000 (currently a deduction is made in the amount of Rb 1,000 per child per month). Additional budget revenues in connection with the abolition of standard deduction is estimated at Rb 53.0bn. (Rb 400 \* 85 million of taxpayers \* 13% tax rate on personal income \* 12 months)<sup>2</sup>. However, assets mobilized to the budget as a result of the abolition of standard deduction rate will be offset by the reduced revenue from children's deductions. Indeed, Rb 2,000 of additional deduction for one (each 2nd or subsequent) child is equivalent to the shortage of budget revenues in the amount of 35% \* 28.6 million children \* Rb 2,000 \* 13% = Rb 31,3bn (where 35% is the share of children who are the 2nd and 3rd child in the family, 28,6 million children is the number of Russian citizens under the age of 18 years, 13% is the tax rate on personal income). In total, the budget revenue will be increased only by (53.0-31.3) Rb 21.7bn.

In fact, we see the following situation: in the regions, where there are many children in families (traditionally in less economically developed republics) the revenue to local budgets will decrease and require subventions from the federal budget, and in the northern regions (where it is much more complicated and expensive to raise children due to climatic conditions, and women work and pay taxes on their income to the budget system) there actually will be restored payment for the reduced reproduction, which will affect many citizens. This will clearly reflect the redistribution of personal incomes of some regions for the maintenance of the citizens in other regions (through the channels of budget subsidies) and may provoke inter-ethnic tension. In addition, the measures themselves are ineffective because savings from the introduction of benefit for the children makes Rb 8.5 per day for a child (= Rb 2,000 \* 12 \* 13%: 365 days).

1 Hereinafter the proposals are discussed by key Points of tax policy for 2012 and the planned period for 2013 and 2014.

2 According to official census of the population of Russia in 2010, for the period from 2002 to 2010, i.e., within 8 years, 12.7 million people were born. That is, in 2010 the number of people under 18 years of age makes about  $12.7 * 2 * 18/16 = 28.6$  million people (we assume that in the previous nine years, there was born the same number of children as in the period from 2002 to 2010). In the assessment of the projected budget revenues there were used the indicators of the total Russian population census of 2010 - 142.3 million people; the share of births of the 2nd and subsequent children in the total number of births, estimated at 35% (for example, in Vladimir Region it is currently 38%, and according to statistics, in 2002 in Russia in general it was 28%), the number of taxpayers of personal income tax (PIT) in view of working pensioners (according to the Federal State Statistics Service of Russia, there are about 35 million retirees, including 30 million people of old age, and the number of old-age working pensioners is about 20% of workers) is 85 million people. (142.3 million people. - 28.6 million people. - 3 5 million people + 20% \* 30 million people).

2) (P. 4) Special attention is paid in the Guidelines to measures proposed for the development of financial sector. Some of the measures are of a technical nature, for example, those aimed at introduction in the text of the RF Tax Code provisions similar to those accepted in international agreements on avoidance of double taxation. It is proposed to withdraw from taxation interest paid on bonds. In most agreements such interest is taxable at the place of residence of recipients. Therefore, the introduction of new provisions in the RF Tax Code will not lead to budget losses, all the more so, because the restrictions on the amount of taxable interest for the taxpayer are still valid in accordance with Art. 269, the rule of arm's length (or the method of thin capitalization) is applied in the RF. If interest expense is higher than the standard, it is not taxable and re-classified as dividends, with further reassessment of tax base for profit tax. There will be no losses for the budget as a result of this proposal.

The effect of other proposals on the budget is not so obvious. For example, in order to integrate into the international financial market, the Russian Federation is ready to renounce the tax regime applied to proceeds from the sale of stock (shares) of Russian companies, more than 50% of whose assets consist of real property, which are subject to taxation of income from the sale of the immovable property, i.e., at the place of the property owner residence. Currently, in accordance with Para 5 of Article 309 of the Tax Code, that rule is applicable only when the shares are sold by the Russian owner to a foreign partner. If the shares of the Russian buyer are purchased from a foreign owner, tax is not withheld to the Russian budget. This measure has been for a long time a protection scheme for the Russian budget, which does not allow tax-free redistribution of property, obtained by the owners in the free privatization in favor of foreign investors. Its abolition in a crisis situation will be favorable to the Russian owners of shares of extractive industries (namely those sectors have real estate shares exceeding 50%), which are incorporated outside of Russia and do not want to pay tax on income as the difference between the price of shares on the balance sheet (especially if they were recorded in the balance at low prices, prevailing during the voucher privatization) and their actual market price at the point of capital withdrawal from Russia.

It is noteworthy that the proposal to abolish the provision of Section 5 of Art. 309 of the Tax Code coincided with another proposal - to recognize in the Tax Code, that the exchange of ADR (American Drawing Rights), GDR (Global Drawing Rights) and other similar foreign securities issued in respect of the Russian companies shares as they are, is not a sale transaction. Recall that ADR and other such "voucher" are independent securities issued by foreign emitters under the laws of other states where they are resident taxpayers. That is, the replacement of foreign securities for the Russian ones is a formal property exchange, because according to the RF Civil Code, security is a kind of property. If such an exchange is removed outside the scope of sale transaction by the Tax Code, in our opinion, the federal budget may also lose revenue in the form of tax from the sale of securities for a fair market value in excess of the cost, recorded at the balance sheet during voucher privatization. Given the complexity of the situation, we believe that before making any amendments to the Tax Code, the issue of such transactions definition in the Russian legislation must be thoroughly investigated from a legal point of view.

Another controversial proposal is to allow to the owner of securities to reduce the tax base for income tax by receivable on securities in liquidation of the issuer (drawer). Protecting the interests of professional participants of securities market is often built by analogy with the mechanisms established for banking. However, in our opinion, there is no full similarity in this respect. Banks work on other people's money and on the basis of agreements valid for a long term. Difficulties in the banking sector provoke great socio-economic losses to society in general. Since banks distribute funds between depositors and borrowers, the state takes measures to protect the interests of depositors who have placed their temporarily free funds into the economy through the intermediation of banks. To protect the viability of banks, there established a state deposit insurance system, the bank are allowed to form reserves and have the right to write-off bad debts and short-received percent interest. As regards the provision for impairment of securities owned by professional participants of the financial market, it is an evident benefit. Provisions for impairment of securities have been imposed for dealers, i.e., owners of securities. It is still not clear why the commercial risk of the owner, who bought the asset (security) should be insured in the state by reducing the obligations of the dealer's income tax. Dealer, unlike other manufacturers,

banks, insurance companies, has a long production cycle, and the real risks are limited to losses in value of securities within the 1st trading day. In Russia, as well as in other countries, there is a maximum limit of price fluctuation over the trading day, which serves as a damper against significant exchange losses and thus protects the interests of participants of the stock market. In Russia, as a result of lobbying the interests of the dealers are protected to a much greater extent than in other countries.

Now, under the Guidelines of the key tax policy trends it is proposed to allow also to write off against reserves, i.e. to reduce the overall tax base (but not at the expense of income from those securities) by unearned interest (discount) in case of bankruptcy of the drawer. According to the Geneva Conventions on bills, a promissory note is a special kind of liability (promissory note relations are not even regulated by the Civil Code). Obligation under the promissory note is the unlimited extraterritorial unconditional right to claim payment of bill amount. Interest (discount) on the promissory note also is not regulated and can be claimed for any amount. It is not clear, why Russia should allow to reduce the tax base for the interest (discount), not limited and not regulated under Russian law.

In all the proposals discussed above it is difficult to trace a rational connection with the provided in the Guidelines balance of revenues and expenses during the crisis, which may increase the tax burden. We would like to recall that we are not talking about increasing the tax burden on foreign investors, because they are taxed at their place of residence. In fact, the issue is in the refusal of Russia to levy taxes to the budget for the withdrawn privatized for minor cost business from Russia through various financial schemes. It is noteworthy, that tax on the balance between the purchase price and the market price of assets is a fair tax revenue of the Russian budget, and it is not worth to reject it.

Other amendments to the RF Tax Code on the taxation of financial instruments and financial market participants are of a technical nature and can generally be supported. This applies, in particular, to amendments in Section 1, Art. 301 of the RF Tax Code on the recognition of a financial instrument of futures contract, subject to judicial protection, not only in Russia but also at the applicable foreign law; leveling the VAT for financial services provided by Russian professional participants sing exemption schemes of financial transactions from VAT, accepted global financial markets and changes in dividend taxation of repos in order to avoid double taxation of the same amount.

3) (*P. 3*) One of the important sections of the Guidelines is the section on raising excise taxes on alcohol and tobacco. Our view on this issue, with regard to the position of Russian experts has been described in the previous survey. Briefly it can be summarized as follows: in terms of Customs Union (CU) in its policy on excise taxes, it should be kept in mind that the excise tax on tobacco and alcohol in other countries of TC (Belarus and Kazakhstan) are 3-4 times lower than in Russia. In such conditions, it is too early to be guided by the European level of taxation for these goods, which in turn is 3-4 times higher than in Russia, and it is prematurely sharply to increase excise taxes, because such policy could lead to the destruction of the existing legal market and is associated with budget losses. This opinion is openly expressed by experts in tobacco and alcohol markets. So far, the Russian Ministry of Finance held a consistent sound policy in excise duties on those goods. One may agree with the declared in the Guidelines advanced growth of excises as compared with GDP growth, but the rate of increase in excise rates for 3 years in 2.5-3 times, incorporated in this document, in our opinion, requires clarification and agreement with the experts.

4) (*P. 5*) Proposals in the area of corporate income tax are of a technical nature and relate to determining the time of the tax liability occurrence in uncertain situations; when the state re-registration of ownership of the purchased fixed assets; write-offs for bad debts, which inability to be recovered has been confirmed by the decision of a bailiff about the end of the executive production. These proposals are fair and aim to clarify the order of fulfillment of tax obligations.

5) (*P. 6*) Proposals of the Russian Federation Ministry of Finance concerning change in the procedure of the tax on mineral extraction (MET) payment, provide a gradual transition from the individual rates, differentiated by gas fields, to the scheme similar to taxation of oil extraction (depending on changes in world prices for hydrocarbons and the rate of growth in domestic prices for gas). In the long term, the RF Ministry of Finance is planning to transfer to the taxation of

mineral resource extraction on the basis of financial and economic activities of the company (tax on surplus income). This form of taxation, as explained by the Russian Ministry of Finance, is the most efficient from an economic point of view and used in the tax systems of a number of developed oil-producing countries, particularly in Norway, UK and USA. Since its introduction the whole system of taxation of natural resource rent may be changed - from the mineral extraction tax and export customs duties to excise taxes on petroleum products.

In addition, changes are proposed to the procedure for payment of water tax, tax on use of wildlife, to improve the efficiency of their operation.

6) (P. 7) Changes related to special tax regimes provide for the introduction of a special chapter to regulate the procedure of tax payment in the form of license fees. On January 1, 2014, the tax system in the form of a single tax on imputed income for certain types of activities will be canceled. For individual entrepreneurs there will be a possibility to choose between the common taxation regime, a simplified system of taxation, or license system. Small businesses will be able to choose between a common system of taxation and simplified tax system

7) (P. 8) Once again, the transition to the tax on real estate is declared and once again it is stated that the work on cadastre is unfinished, in the absence of which it is impossible to estimate the market value for tax assessment.

8) (P. 9) A separate section is devoted to the improvement of tax administration, in which special attention should be paid to the declaration of intention to reduce the number of benefits provided by agreements on avoiding double taxation.

Among the issues that were not yet covered, one should highlight the intention to monitor the effectiveness of tax incentives (P. 2). This objective is commendable. The RF Ministry of Finance gave the following data: total number of tax incentive mechanisms is 191, and 60 among them are corporate income tax, 80 - value added tax, 20 - property tax, 16 - land tax, 12 - Income tax on mineral extraction, and 3 - charges for the use of wildlife and water resources.

Unconditional support deserves the RF Ministry of Finance proposal on the new benefits to be provided only on a temporary basis. In our opinion, this comment should be included in the text of the general part of the Tax Code.

9) With regard to such serious issue, as insurance contribution rates, in our opinion, it is time to correct the attitude to this issue.

(P. 1.1) As a temporary measure for the period 2012-2013, it is envisaged to reduce the maximum rate of insurance contributions to the state non-budgetary funds from 34 to 30%, levied on payments to individuals, to the set limit value of Rb 512,000 in 2012 to Rb 567,000 in 2013. Concurrently, for this category of taxpayers premium rates will be set for amounts exceeding the limit value for insurance premiums to be paid to the Pension Fund of Russia at a rate of 10%. Since the rate of contributions to the funds are differentiated depending on the type of the taxpayer activities (in respect of organizations working in socially important areas, information technologies, etc. lower rates are set), the corresponding decrease in tax rates is foreseen for the organizations of these spheres. It is envisaged to allocate federal funds to compensate the decreased income of Pension Fund.

Let us look at the situation from another point of view. Those generations of citizens who have been forcedly involved in non-market relations of Soviet realities, are gradually retiring, and the number of such individuals due to natural reasons is rather decreasing, than increasing. The peak is passed. The government obligations to those persons who have been involved in the market at a young age, are not so high as to the citizens of the older generations (who went through the front, the recovery period and found themselves in the market in the disabled or close to a disabled age). 20 years ago this issue was indeed critical, but the situation is restored to a common level of the market economy – the retiring people come to the market at the age of 30 years and had enough time to take care of themselves. As individuals of working age have an access to other forms of savings to support themselves in old age, except for state pensions, it is necessary gradually to stabilize the overall level of commitments to the state pensions, taking into account the capacity of public finances. Children and young people are more vulnerable to the market situation. It is in the interest of the state, that they to come o the market with necessary health and working skills. In our opinion, it is time to gradually transfer the focus of the state social policy towards the new



generations, reducing withdrawals from their earnings, rather than increasing expenses in favor of those who had to take care of themselves.

10) (*P. 1.2, 1.3*) A very typical feature of the Russian tax system is demonstrated – a kind of relic of the Soviet era is a permanent transfer of current policy conclusions and estimates of the government leaders to specific economic measures and tax incentives. In fact, national policy and taxation should not be so directly interconnected. Politics largely reflects the current public expectations, based on the perception of the observable space within the country and beyond its boundaries, while the economy is based on real possibilities of a specific region. The objective of the national tax policy is: not to put extra burden on the regional economy, preventing withdrawal of resources that could lead to the oppression of business activity in the area, to pursue «the art of achieving the possible». If such approach is not applied as fundamental, the investment situation in the region will remain unstable, and the capital will flow out from this region.

Once the relationship of financial leasing is no longer considered as an effective tool for equipment updating – in the Guidelines there appears the deletion of the relevant tax benefits of the RF Tax Code. As soon as the leading party takes the direction on modernization and technical upgrading, there appears a proposal to introduce tax benefit in the form of accelerated depreciation of energy-efficient equipment with inflation index of 2 to normal depreciation.

In fact, such benefits show that such benefits demonstrate only that there is no real market and the monopolies in the economy still exist. Russian products (with very few exceptions) are not competitive in the global market. In the non-competitive market application of depreciation rate exceeded by times will be accompanied by higher prices for products from the manufacturer, using such equipment. Buyers of Russian products at high prices are only the Russian state and its institutions, Federal State Unitary Enterprises, etc. In a competitive market the objective of equipment purchase is usually productivity growth or production of radically new products in high demand - the manufacturer will agree to increase the rate of depreciation, only if it does not lead to a decrease in the rate of return on invested capital. Without such grounds the producer is unlikely to increase depreciation and reduce profit. Therefore, in Russia, improving energy-efficient equipment depreciation is a form of budgetary financing in the form of pseudo-tax incentives. In fact, such special tax benefits do not contribute to the development of competitive production, but on the contrary, lead to the preservation of unprofitable enterprises at the expense of public funds.

Another issue that should be mentioned in this overview is the so-called “regime of 60-66-90,” introduced by the Resolution No. 716 of August 26, 2011 “On Amending Resolution of the Russian Federal Government No. 1155 of December 27, 2010 “On assessment of the rates of export customs duties on certain categories of goods produced from crude oil”, coming in effect from October 1, 2011. The new regime implies reduction of export duties on crude oil to 60%. At the same time, duties on light and dark oil are equalized to 66% of the export duty on crude oil. Earlier they accounted to 46.7% of the duty on crude oil for dark petroleum products and to 67% for light ones. For gasoline the duty of 90% is introduced.

The experts (the discussion took place on the BFM.ru site) believe that the regime of “60-66-90” will first affect the refining sector: oil refining volume can be reduced by at least one-third in the first year of the tax regime. The RF Ministries of Finance and Energy, on the contrary, consider the “60-66-90” regime the best under existing conditions. According to experts the Ministry of Energy, the reduction of difference between the rates of duty on crude oil and petroleum products will reduce the loss of duty-free oil supplies to Belarus, as well as to reduce the tax burden on the industry in general by \$3bn per year. Under the “60-66-90” regime, exports of gasoline would be less profitable, thereby preventing the probability of a petrol crisis.

But the problem is that the price of crude oil is determined by the global market. In this situation, it is preferable to domestic producers to hold oil, rather than to refine it into gasoline and hold in view of additional costs. That is, the petrol shortage could become an ongoing problem, regardless of changes in tax regime. ●

## AMENDMENTS TO THE FEDERAL LAW “ON SCIENCE AND STATE SCIENCE AND TECHNOLOGY POLICY”

A.Kireeva

*In the current quarter of 2011, the State Duma adopted a number of amendments to the Federal Law “On Science and State Science and Technology Policy”. The said amendments have augmented legislation with the definition of innovations and clarified the status of state research foundations.*

In July 2011, the text of the Federal Law ‘On Science and State Science and Technology Policy’ was altered by a number of amendments, which are designed to:

- clarify the status of those research foundations that are designed to play the role of one of the major institutions of innovative development (Federal Law, of 20 July 2011, No 249-FZ “On the Introduction of Alterations in the Federal Law ‘On Science and State Science and Technology Policy’; and Article 251 of the Second Part of the Tax Code of the Russian Federation in the Part of Clarifying the Legal Status of the Funds Designed to Provide Support to Scientific, Scientific and Technical, and Innovative Activities” (the Law entered into force from 1 October 2011));

- create a legal basis for providing innovative activities with state support (Federal Law, of 21 July 2011, No 254-FZ “On the Introduction of Alterations in the Federal Law ‘On Science and State Science and Technology Policy” (the Law entered into force from the moment of its publication)).

In this connection it should be noted that, while the amendments concerned with the definition of innovations and the forms of state support for innovative activities are predominantly of a declarative character (they require the adoption of some additional legal acts that can establish a detailed procedure for implementing the new norms), those amendments that deal with the status of research foundations have, at least partly, covered the gap caused by the absence of proper regulation of their activities.

The existing system of state foundations whose purpose is to finance research and development emerged in the early 1990s, with the creation of the Russian Foundation for Fundamental Research, the Russian Foundation for the Humanities, the Foundation for the Promotion of Small Enterprise Development in the Field of Science and Technology, the Russian Foundation for Technological Development, as well as the inter-sector and inter-departmental foundations established by organizations. To a large extent, the creation of these foundations was determined by the necessity to provide support to the system of research institutions inherited by the Russian Federation from the Soviet Union in a situation that was at that time characterized by a chronic lack of budget funding, which made it imperative to find some new ways for financing small inter-sector and inter-departmental research groups engaged in promising long-term studies<sup>1</sup>.

In the course of two decades of these foundations’ existence there emerged a unique system for selecting and supporting research projects. This system considerably differs from the one for selecting projects that are going to be financed via the system of academies of sciences and directly from the budget. However, until recently, the specific features of this system were not taken into account at the legislative level, and even the legal status of research foundations remained unregulated. Thus, prior to the adoption of the amendments that will enter into force in October 2011, the foundations have been operating on the basis of the “old” by-laws, most of which were adopted long ago, in the early 1990s, without being specifically regulated in legislation.

*The place of research foundations in the system of state support for innovations.* Despite the absence of the much-needed legal basis, the research foundations had managed to occupy one of

1 See, for example, V.V. Kiseleva and T.E. Kuznetsova, *Itogi nauchnoi politiki 1990–1995 godov: tseli i posledstviia* // *Vestnik RGNF* [Results of the Science Policy of 1990 – 1995: Aims and the Consequences // the RGNF Herald] – 1996, No 1; See also V.A. Koptiug and Iu.I. Shokhin, *Itogi 1994 goda v Sibirskom Otdelenii RAN* // *Vestnik RGNF* [Results of the Year 1994 at the Siberian Branch of the Russian Academy of Sciences // The RGNF Herald] – 1996, No 1, pp. 262 – 263; E.V. Semenov, *Granty v rossiiskoi nauke: Opyt rossiiskogo gumanitarnogo fonda* [Grants in Russian Science: The Experience of the Russian Foundation for the Humanities]. <http://sceptic-ratio.Nearod.ru/po/pNe-1.htm>

the key positions in the system of research funding. While the system of research institutions as such was financed on a budget basis (to a minimum extent, which was by no means sufficient for any active research), and the development of each specific area of science was financed within the framework of target programs, each individual research projects was funded on the basis of state orders and/or by grants provided by research foundations. Thus, by allocating grants<sup>1</sup> and by placing some of the state orders for research and development<sup>2</sup>, the foundations were primarily implementing the task of providing pin-point support to specific fields of science and individual research. It should be noted that the research-support functions performed at the expense of grants provided by research foundations could not be completely taken over by the system of state orders or by other channels of funding. State orders are predominantly oriented towards applied studies – that is, research that is expected to yield some practical results, while the grants provided by research foundations can be also used for supporting fundamental research and other types of studies whose immediate results do not necessarily lead to any practical application.

There is one more important function of research foundations that cannot be performed by means of placing a state order or through the use of the mechanisms for state assignment funding. This function is the allocation of funding within the framework of joint international and joint inter-regional contests, where the winning projects are selected by boards incorporating representatives of “partner” organizations from abroad or from another level of legal public formations<sup>3</sup>.

Thus, it happens that research foundations represent the only channel for the provision of state support to international and inter-regional research and research projects; to investigations that require irretrievable and irrevocable funding in the form of grants; to investigations being implemented at their early stages; and to investigations that yield no applied results or have any immediate commercial importance (fundamental science, humanitarian projects, etc.)<sup>4</sup>.

*The status of state research foundations.* Having been founded in the early 1990s, state research foundations have been functioning as budget-funded institutions, although that status was by no means a universal provision that determined all their activities. In fact, the status of each foundations was determined at the level of the acts on its establishment. After the reform of the budget-funded sector carried out in the mid-2000s, one of the foundations, the Russian Foundation for Technological Development, has changed its organizational form and acquired the status of an autonomous institution. The amendments that will enter into force in October 2011 are going only to legally confirm the existing situation, without eliminating any of the legal problems that arise in connection with the fact that state research foundations have the status of budget-funded institutions.

The major problem presented by the status of budget-funded institutions is the lack of freedom that state research foundations need for proper managerial decision-making. In this connection, those research foundations that function in the form of institutions (both budget-funded and autonomous ones) are confronted with a greater number of budget-related procedural barriers than those development-oriented institutions that function in the form of joint-stock societies and state corporations.

Theoretically there existed two solutions to the problem represented by the status of research foundations. The first solution (which we believe to be the best one) envisaged the introduction of a special organizational form of a non-profit organization denoted as a “research foundation” that could be used by both state and non-state organizations. For this purpose, their special status, aims, tasks and specific features of managerial activities, as well as the procedure for the conduct of contests, could be regulated by a separate Federal Law “On State Research Foundations” and by

1 For example, the Russian Foundation for Fundamental Research and the Russian Foundation for the Humanities.

2 For example, the Bortnik Foundation.

3 The possibility for financing the projects selected by those categories of persons through the mechanism of state orders is envisaged by neither Federal Law No 94-FZ nor the RF Tax Code.

4 It is the funds of research foundations that support research and R&D projects in the seed and earlier phases (from the concept phase to the pre-seed phase inclusive). It should be noted that no other source can provide financial support to these phases of projects. In fact, all the other development institutions, including the Russian Venture Company which is formally oriented to providing support to projects in early stages, are engaged not so much in venture investing as in ordinary investing in well-advanced projects.

a number of amendments to the Federal Laws “On Non-Profit Organizations” and “On State Science and Technology Policy”. The second solution consisted in maintaining their existing organizational form of budget-funded institutions, on condition that the legal regulation of their activities was to be thoroughly detailed. In actual practice that was the way chosen by the lawmakers.

The alterations in the Law “On Science...” regulate the specific features of the structure of the managerial bodies of state research foundations. They also introduce general provisions concerning the procedure for the conduct, by state research foundations, of contests for financing research, scientific, and technical-and-innovation projects, including the general requirements to the conduct of expert examination of the applications submitted for a contest. As far as the state research foundations are concerned, the draft law establishes the rule that all applications for funds to be spent on research, scientific and technical-and-innovation projects should undergo an expert examination on a mandatory basis. Besides, the managerial bodies of state research foundations should include a collegiate managerial body and a body of experts.

The amendments also envisage that, for the purposes of financing research, scientific and technical-and-innovation activities, legal entities and (or) physical persons should enjoy the right to create foundations for providing support to research, scientific and technical-and-innovation activities (non-state foundations). The legal status of such foundations should be determined by the Federal Law “On Non-Profit Organizations”.

Although the amendments to the Law “On Science...” fully legalize and perpetuate the existing system of managing the state research foundations, they have not provided adequate solutions to a number of problems that have arisen in this sphere. Some of these problems are as follows:

1. Budget legislation (the RF Budget Code and other legal acts) does not regulate the concept of grant applied in the Federal Law “On Science...”. As a result, state research foundations, by the sheer fact of being budget-funded institutions, are forced to determine on their own the specific type of financing that they should provide to grant recipients in accordance with the norms stipulated in the RF Budget Code. Article 69 of the RF Budget Code, which regulates forms of budget allocations, mentions the following types of financing: allocations to state services provision; provision of investments to legal entities; provision of subsidies to legal entities and individual entrepreneurs – producers of goods, work and services (except for subsidies to budget-funded institutions). Article 69.1 of the RF Budget Code places subsidies to budget-funded and autonomous institutions, including subsidies earmarked for compensating them for their normative expenses pertaining to implementation of state assignments and subsidies for state service provision granted to those non-profit organizations that do not have the status of state institution, in the category of allocations to provision of state services. Thus, the current version of the RF Budget Code establishes that funds should be transferred to state research foundations only in the form of subsidies. State research foundations, in their turn, are similarly obliged to provide grants to research and innovation companies only in the form of subsidies. At the same time, the essence of the concept of subsidy is by no means identical with that of the concept of grant. In particular, the RF Budget Code contains no provisions concerning subsidies to physical persons and to small research groups that do not have the status of a legal entity. As a result, state research foundations are forced to create certain ‘bypasses’ in order to be able, for example, to provide support to young scholars or to a specific research laboratory at a higher educational establishment<sup>1</sup>;

2. Being an autonomous institution, the Russian Foundation for Technological Development can provide retrievable financing to innovation sector subjects, in fact lending money to them. However, the RF Budget Code envisages no possibility of issuing credits to private persons at the expense of budget-funded and autonomous institutions. Moreover, amendments to the Federal Law “On Science...” contain a provision to the effect that research foundations should have the right to

<sup>1</sup> For example, young scholars receive financial support from the Bortnik Foundation within the framework of the U.M.N.I.K program [a play on words abbreviation: in Russian, the word *umnik* means “a clever guy”]. Eligible for taking part in the Program are physical persons aged 18 to 28, holding Russian citizenship, who submit for consideration their science and technology projects matching the requirements specified in the Program. However, the impossibility of issuing grants directly to young scholars makes it necessary to conclude project implementation agreements with small enterprises. These agreements should be concluded between the Foundation and the enterprises and between the grant recipient and the enterprises. Thus, the contest winner – that is, the end recipient of the grant - should in fact be enrolled in the organization through which the grant is to be allocated on the basis of a state contract.

allocate grants to their recipients (item 1, Article 15 of the Federal Law “On Science...”), but mention no possibility of credits being issued to subjects of innovation activity at the expense of state research foundations;

3. The alterations introduced in the Federal Law “On Science...” in the main overlook the status of experts. It is simply mentioned, as a matter of fact, that experts are ‘specialists in the field of science and technology’. At the same time, as far as expert examination of projects applying for grants is concerned, there exist a number of unresolved problems. Thus, for example, research foundations have no uniform expert-assessment base; the experts community of each of the foundations is formed in accordance with that foundation’s own principles; there is no motivation for improving the quality of expert conclusions because experts face no risks to their reputations; the independence of experts is not fully secured – first of all, from pressure on the part of state authorities; and so on. In our view, the most transparent and independent expert-assessment system currently existing in Russia is the system adopted by the Russian Foundation for the Humanities<sup>1</sup>, while the expert-assessment system applied by the Russian Foundation for Technological Development is the least independent, with projects being assessed by officials from the core state agency<sup>2</sup>;

4. The amendments to the Federal Law “On Science...” regulate only the most general terms of the contest-based selection of projects financed from the funds held by state research foundations. They do not resolve the issue of compatibility between the contest procedures applied by research foundations and the requirements of Federal Law, of 21 July 2005 “On the Placement of Orders for Delivery of Goods, Implementation of Work and Provision of Services for State and Municipal Needs”. State research foundations use their own systems for selecting appropriate projects that differ from the system of contest-based placement of state orders for the execution of research and development work. The system of grants applied by research foundations is much more responsive to the specific needs of research projects with uncertain results, those implemented by exceptional individuals, and those implemented in fields of research characterized by absence of competition.

In those instances when a state customer claims no exclusive rights with regard to the results of research and development work, the state order for R&D and the grant for R&D are interchangeable, because their economic results are similar, and all the rights for R&D results remain in the hands of the executor. As a consequence, we believe it advisable that Federal Law No 94-FZ should be amended in such a way that it would clarify that its norms do not apply to contests carried out by research foundations. Later on, it might be feasible to consider the possibility of extending the contest system used by research foundations to other R&D projects that do not envisage that property rights for the end results of R&D should pass to the customer in the person of the State.

5. And finally, we believe that the new norms of taxation introduced for research foundations by the recently adopted amendments create a loophole for tax evasion. Until recently, the Tax Code contained a number of restricting conditions that had to be complied with if grants were to be exempted from tax on profit of organizations. In order to receive an exemption from profits tax for targeted financing, it was necessary for the grantor or the research foundation that acted as the grantor’s representative to be included in the government list.

However, Federal Law, of 20 July 2011, No 249-FZ has abolished the rule requiring that the lists of research foundations – providers of targeted financing should be approved by the Government. For this purpose, the wording of paragraphs 13 and 14 of sub-item 1, Article 251 of the RF Tax

1 From the year 2010, experts and members of the expert councils of the Russian Foundation for the Humanities are selected in accordance with the results of an open public contest. This guarantees better transparency of the Foundation’s activities, as well as equal opportunities for Russian scholars to become experts of the Russian Foundation for the Humanities and to take part in the contest-based selection of research projects. The Foundation publishes data on the structure and composition of its expert assessment system. Data on the experts of the Foundation are published annually in the “Vestnik RGNF” (The RGNF Herald), while the lists of expert councils are published in the newspaper *Poisk* [The Search].

2 Applications for R&D funding from the Foundation are considered, first, by the experts and then by the Research and Technological Council of the Russian Foundation for Technological Development. However, the Council is a consultative body, and so its opinion is deemed to be only recommendatory. The final decision on whether or not a project should be financed is taken by officials from the RF Federal Agency for Science and Innovation. Thus, the selection of projects is carried out not by representatives of the academic community but by state officials from one of the bodies of state authority. On the whole, the system for expert assessment of projects, as well as the structure of the Foundation itself, were “inherited” from the Soviet past.

Code has been altered accordingly. These alterations have made it possible to exempt from profits tax “the financial means received from the foundations created in accordance with the Federal Law ‘On Science and State Science and Technology Policy’”, and also the financial means allocated to these foundations in order to form their funds (Article 251 of the RF Tax Code).

It is specifically these innovations that have been assessed controversially. On the one hand, the concept of targeted financing, as it is practiced by the ‘old’ research foundations of the federal level (the Russian Foundation for Fundamental Research, the Russian Foundation for the Humanities, the Bortnik Foundation, and the Russian Foundation for Technological Development) should certainly be defined more precisely. Among other things, clarification is needed with regard to the question of whether or not the funds allocated by research funds to R&D in the form of a state order for R&D instead of a grant should be recognized as targeted financing. As is shown above, in the event when a state order for R&D does not envisage that the right to use the results of intellectual activity or the exclusive rights thereto should pass to the customer, R&D financing should be equivalent to a grant. In this connection, it is advisable to amend the RF Tax Code in order to clarify that the same tax regime should be applied to grants and to profit received by organizations as a result of their implementation of R&D for state needs in those instances when this work does not imply that the customer should be vested with any rights to its results. However, the amendments under consideration have evidently failed to do so.

Instead of clarifying the issue, the alterations recently introduced in the RF Tax Code envisage that the right to carry out tax-exempt financing of R&D should be vested not only in the “old” federal research foundations but also in any state or private research foundations. In other words, by establishing a research foundation, a body of state authority or a private company will be able to release from taxation any R&D ordered by it. This situation is especially risky bearing in mind that the RF Tax Code distinguishes between the concept of *grant* and the concept of *targeted financing* received from research foundations. When financing research through a specially created foundation, the customer, under the pretext of charitable purposes, may aim at gaining profit from the results of intellectual activity obtained in the process of scientific research. ●