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The review provides a detailed analysis of main trends in Russia's economy in 2011. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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Section 1. Socio-political Context

1.1. Economics and Politics in 2011: the Global Crisis and the Quest for a New Growth Model

1.1.1. The Results and Lessons of the Year 2011

Russia's socio-economic development in 2011 was determined primarily by two factors: the forthcoming elections on the one hand, and the global economic crisis on the other. Although they considerably differed both by the force and the vectors of their impacts, it was nevertheless these two factors that had predetermined the behavior of all the subjects involved in the economic and political life.

So far, the global crisis has had no negative influence on the Russian economy (see *Table 1*). We may point to three main mechanisms through which the world economy is influencing contemporary Russia: demand for exported commodities; access to investment resources (direct investments and credits); and demand for Russian securities on the stock market. Of course, the slow rate of growth of the world economy was bringing down the demand for Russian exports. However, the prices for the basic exported commodities remained high, although the rate of their growth was lower than in some of the pre-crisis years. Russia's stock market is very vulnerable to the effects of external shocks, which was confirmed by the events of August–September 2011, but so far it has not been playing a prominent role in ensuring this country's economic growth. The volume of external borrowings attracted by the corporate sector continued to be on the rise, thus surpassing its pre-crisis level. At the same time, the understanding of the lengthy character of the global crisis, with its unpredictable geo-political and geo-economic outcomes, has had some impact on the formation of Russia's economic policy in the medium term.

The standard mechanisms whereby elections influence one or other society's economic life are the increasing uncertainty of future economic policy and the equally increasing populism of any authorities striving to be reelected. Both mechanisms have turned out to be effective for Russia in 2011, in spite of the fact that the probability of power remaining in the hands of the ruling party and its leaders seemed to be exceptionally high to everybody – in other words, they did not need any large-scale financial investments in order to ensure public support. However, this fact did not prevent the country's leadership to declare their intention to make some big investments, in the next few years, mostly in the public welfare sphere and the power structures.

Over the past year, Russia demonstrated a sufficient stability of her economic development. Economic growth remained moderate and, on the whole, quite natural for a country with a medium level of economic development – higher than in Germany but lower than in China. In formal terms, the macroeconomic parameters remained favorable – the budget by that year's results was executed with a surplus of nearly 1% of GDP, while the inflation rate dropped to its historic low for the entire 20-year period of Russia's post-communist existence. In the sphere of monetary policy, the RF Central Bank managed to switch over to a floating currency exchange rate and inflation targeting. This has been the most important institutional achievement of the past decade.

Table 1

Russia's Macroeconomic Indices Compared to Those of Some Other Countries (2010–2011)

Country	GDP growth rate, %	Unemployment, %	Inflation Dec./Dec., %	Budget deficit (–), % of GDP	Government debt, % of GDP
2010					
Russia	**4.3**	**7.5**	**8.8**	**-3.2**	**9.2**
USA	3.0	9.6	1.7	-10.3	94.4
EU, including	1.8		2.5	-6.4	79.8
France	1.4	9.8	1.7	-7.1	82.3
Germany	3.6	7.1	1.9	-3.3	84.0
UK	1.4	7.9	3.4	-10.2	67.7
CIS, including	4.6		8.9	-2.6	14.5
Kazakhstan	7.3	5.8	8.0	1.5	10.7
Belarus	7.6	0.7	9.9	-1.8	26.5
Ukraine	4.2	8.1	9.1	-5.7	40.1
China	10.3	4.1	4.7	-2.3	33.8
Brazil	7.5	6.7	5.9	-2.9	66.8
India	10.1	9.3	9.5	-8.4	64.1
2011					
Russia	**4.2**	**6.7**	**6.1**	**0.8**	**11.7**
USA	1.5	9.1	2.5	-9.6	100.0
EU, including	1.7		2.8	-4.5	82.3
France	1.7	9.5	2.1	-5.9	86.8
Germany	2.7	6.0	2.2	-1.7	82.6
UK	1.1	7.8	4.5	-8.5	72.9
CIS, including	4.6		10.2	-0.6	14.9
Kazakhstan	6.5	5.7	9.5	1.8	12.9
Belarus	5.3	0.7	108.7	-0.7	46.3
Ukraine	4.7	7.8	10.7	-2.8	39.3
China	9.5	4.0	5.1	-1.6	26.9
Brazil	3.8	6.7	6.3	-2.5	65.0
India	7.8	9.7	8.9	-7.7	62.4

At the same time, Russia's macroeconomic stability remains extremely vulnerable. It rests on high budget revenue generated by high oil prices, which at present are staying at its historic high and in terms of constant prices are comparable with the level of the late 1970s – early 1980s. The policy of increasing budget spending obligations, which implies that these 'situational' incomes become guaranteed, is very dangerous – as demonstrated by the experience of the USSR in the 1980s. Meanwhile, the non-oil deficit of the federal budget in 2011 amounted to approximately 10% of GDP, while the budget deficit amounts to approximately 4.5% of GDP with the price of oil is on its average level of the past decade (conditionally guaranteed level).

The year 2011 saw a surge in capital outflow, which exceeded $ 85bn. That outflow was produced by a combination of different factors – an unfavorable investment climate, demand for foreign assets on the part of some big Russian investors, increasing competition for capital with the developing markets in Asia и Latin America, the global crisis pushing up demand for placements in a reserve currency (notwithstanding the economic difficulties faced by its issuer country), and the political risks of the pre-election period. However, that systemic problem needs to be studied in-depth, so that a number of acceptable solutions could be found. Its complexity results specifically from its multi-aspect nature involving a variety of closely linked processes, so that in reality it can be broken down into several problems, each of which requires its own individual set of corrective measures.

An economic crisis is always a starting point for modernization. Since the accumulated reserves allowed the Russian authorities to avoid bankruptcies and enforced structural modernization, they began to elaborate an agenda for ‘modernization from above. In 2011, the discussion of the general principles of promoting modernization once again came to the fore (i.e., the discussion of a new economic growth model) and some targeted innovation development projects were initiated. The latter have taken shape as specifically oriented territorial enclaves (Skolkovo, Tomsk) or as some separate sectors for scientific and technological development (information and communication systems, outer space exploration, nanotechnologies, etc.). Two commissions on modernization and technological development were functioning simultaneously – one under the RF President, and the other under the Chairman of the RF Government.

However, modernization cannot be carried on through directives alone – even if these are approved at the topmost level. Modernization (at least in its present form) requires competition – both between economic agents and institutions. In this respect, two important decisions taken in 2011 in the sphere of foreign trade may become relevant modernization factors – namely Russia’s accession to the WTO and the breakthrough achieved in post-Soviet integration (the establishment of the Customs Union and the conclusion of the agreement on the creation of the Common Economic Space between Russia, Belarus and Kazakhstan). The accession to the WTO will intensify competition for Russian producers, while the creation of the Customs Union and the Common Economic Space will supplement competition between commodities with competition between institutions.

A characteristic feature of the year 2011 has been rapid politicization of the population, which could be clearly observed in Russia and elsewhere across the globe. There were anti-government riots in the Arab world, the *Occupy Wall Street* movement in the developed countries, and the growth of political activism in Russia in late 2011 and early 2012. Evidently, the causes and mechanisms of politicization are region-specific in each case, but their coincidental timing cannot be overlooked. So far we can only tentatively assume that the intensity of political activity in the world will be increasing alongside the development of the global economic crisis (which does not necessarily mean its intensification).

One of the dangers that in this connection may threaten Russia’s economic policy a will be an increasing ‘budgetary populism’ in addition to political populism. However, it the latter presents no danger from the point of view of ensuring this country’s long-term stability, the former, while pursuing the noble goals of protecting the welfare of the people and some selective social groups (the military, budget funding recipients, pensioners, etc.), may in the end produce a severe economic and political crisis. At the same time, while the outer world is plagued by the crisis but this country has in store some substantial resources accumulated thanks to its government’s recent conservative policy, the risks fraught in ‘budgetary populism’ may become greater in response to a sudden upsurge of social and political issues.

1.1.2. The Global Economic Crisis: Its General and Specific Features

The global economic crisis that began in 2008 is systemic and structural in its nature. In terms of its basic parameters it is comparable with the crises of the 1930s and 1970s. We can point to a number of fundamental features of such a crisis which, in their turn, may predetermine the factors and preconditions that will help to end it.

First, a structural crisis is determined by the presence of some serious misbalances in the organization of economic life. These are produced by fundamental technological shifts –

namely, the emergence of some fundamentally new technologies (termed *a* new *technological way* by a number of economists). That is why the exit from the crisis is associated with a transformation of the production bases of the leading countries through implementing new technologies. The creation of a new technological base will be playing the same core role in the future development as the one that way played in the mid-20th century by large-scale machine industry, and after the 1970s – by microelectronics and computer systems.

A crisis implies a technological renewal which transforms demand for many industrial and consumer commodities, and especially investment and fuel and energy products. Naturally, this transformation is reflected in the prices for a majority of market commodities, and this implies an achievement of some new balances of prices and leads to a change in the political configurations.

Second, the world accumulates a variety of serious geo-economic and geo-political misbalances. The economic and political potential of each individual country develops slowly, but then comes the moment when a qualitative leap takes place, and so it becomes necessary to switch over to some new system of balances. In contemporary conditions one of the most evident examples of such misbalance has become a change in the distribution of roles between developed and developing (or rapidly developing) countries. How to find a trajectory of a better balanced growth (in terms of savings against investment, exports against domestic consumption, revenue against expenditure) – this is the key issue faced by many developed and developing countries in Europe, America and Asia.

Thus, and *third,* a structural crisis becomes a global one. It spreads to all the leading countries; and in contemporary conditions, globally coordinated efforts will be needed in order to finally overcome it. In other words, *decoupling* (development along different trajectories) – something that so much spoken about back in 2008 – has been effectively taken off the crisis agenda. By now there have remained practically no relevant countries that have not experienced at least some of the crisis-linked process, with a varying degree of intensity. Thus it becomes even more important to ensure the participation of all those countries in working out global anti-crisis measures.

A global character of the crisis by no means rules out the possibility of its movement across the world. Depending on its specific phase, crisis phenomena may be concentrated in some specific regions or countries. Thus, the crisis originated in the USA and then spread on to Europe and a part of Asia; now it is centered mainly in Europe.

Fourth, a structural crisis is conducive to the formation of some new currency configurations – a new world currency emerges (or a number of new world currencies). In the 20th century this occurred as a fundamental change in the role of gold, the prominence of the US dollar, and after the 1970s – as the increasingly bi-currency character of international business settlements. In the present situation there has emerged the issue of the future prospects of the US dollar, the euro and the yuan. And there has also emerged the issue of whether or not regional reserve currencies should play a more prominent role in the future.

Fifth, a structural crisis gives rise to a serious intellectual challenge. It becomes necessary to work out a new agenda of economic and political (and also generally social) analysis. The crisis transforms into a powerful stimulus to rethinking the existing economic and political doctrines both on a global scale and in terms of a given country.

This is specifically true with regard to economic doctrines. Economists must suggest some new approaches to analyzing the economic processes, and first of all to regulating socio-economic life. After the Great Depression the world was transformed into a Keynesian and socialist (*etatiste*) one. After the experience of stagflation those ideas gave way to deregulation and liberal democracy. The new economic model must not only provide answers to the most urgent current questions, but to express these answers in a more distinct and understandable form.

This intellectual challenge become especially important in the early phases of a structural crisis when it is being countered with by means of applying those ideas and recommendations that had proved to be effective over the preceding decades of smooth economic development (with occasional bubbles being the only trouble). It takes some years to finally bring home the realization that to apply the traditional anti-crisis policy in a new setting is quite unreasonable and even harmful.

Sixth, a structural crisis lasts for approximately a decade – a period termed '*a turbulent decade*'. It means that the crisis period can be broken up into separate stages, each marked by the domination of some specific problems originating in a given sector or region. But at the same time this means that no single feature can serve as a criterion for judging whether the crisis is further deepening, or if its end is near. This is also true with regard to recession (a crisis does not begin with a recession, and by no means is limited to it), as well as to the fluctuations of the stock market, and to any other parameters.

Seventh, the struggle against a crisis is associated with applying some drastic but sometimes inadequate anti-crisis measures. On the one hand, this has to do with the acuteness of the structural problems, the overcoming of which requires certain (sometimes great) economic and social sacrifices. On the other, the aforesaid 'intellectual unpreparedness' for a structural crisis – that is, attempts to solve new problems by applying old remedies – produces some additional problems, thus often resulting in a further aggravation of the crisis – its economic and sometimes even political aspects. Thus emerges the issue of an *exit strategy* (the strategy for discontinuing the anti-crisis functioning mode), and so additional time is required not only for overcoming the crisis but also for eliminating the consequences of the anti-crisis measures.

All these factors taken together can explain the fundamental difference between a systemic crisis and a cyclical one. A cyclical crisis recedes with time; it does not imply the necessity to alter a current policy but ends by itself when the economic bubble emerging during a boom period disappears. A systemic crisis, on the contrary, requires a significant transformation of the old economic policy on the basis of a new philosophy of economic life. In other words, structural problems predominate over cyclical ones.

However, the current global crisis has a number of specific features that must be taken into account when elaborating an anti-crisis policy and a viable model of socio-economic development. Many of its specific features have been produced by the technological achievements of the modern era – the development of information and communications technologies that have made the world flat[1] and so make it possible for businesses to rapidly shift their activities from one region or sector to another, carry on instant transactions, and to start and terminate entrepreneurial projects. The increased dynamism gives rise to some new phenomena and the resulting new economic and political conflicts.

Since the current structural crisis is evolving in the era of globalization (or, more precisely, during a qualitatively new phase of globalization), its significant features are global structural misbalances. First of all, these are misbalances between developed and developing countries,

[1] Friedman T. *The World Is Flat. The Global World in the Twenty-First Century*. L.: Penguin Books, 2006.

in particular between the USA as a focus of spending and consumption, and China as a focus of money saving and production. The term *Chimerica (China + America*) suggested in 2008 by N. Ferguson[1] has become a symbol of the issue of global misbalances. As a result, the process of modern globalization produced a regime that is opposite to the model typical of the turn of the 20th century: if a century ago capital was moving from the center (the developed countries) towards the periphery (the then emerging markets), now it is the developing markets that have become the savings centers, and the USA and other developed countries are predominantly the consumers of commodities manufactured in the developing countries.

The category of structural misbalances also includes the growing controversies *between short-term and long-term interests of companies* that manifest themselves in a conflict between capitalization and production growth. In recent decades the attention of shareholders and managers alike was focused in the main on a company's capitalization, which was viewed as the principal indicator of its commercial success. The possibility to easily get rid of stocks (much easier, in fact, that in the times prior to the information revolution) is yet another argument in favor of rapid capitalization growth – a goal that may be quite contrary to the goal of ensuring a company's long-term stability. Consequently, that criterion becomes the main one when estimating management efficiency and elaborating a corporate bonus policy.

Meanwhile, the goal of maximum capitalization comes into conflict with the real foundation of socio-economic progress – growth of labor productivity. It is, of course, linked to capitalization growth, but only in the final analysis. However, shareholders must receive annual reports, and attractive annual reports and current capitalization growth are produced by factors other than those that ensure productivity growth. Nice reports require mergers and takeovers, because asset growth is conducive to capitalization growth. Naturally, it is not advisable to shut down outdated enterprises, because this will result in a lower capitalization level in a current period. As a result, many big industrial corporations continue to keep old inefficient production entities going.

A systemic crisis always implies the emergence of a *new regulation model*, including a basically altered economic role of the State. The Great Depression of the 1930s led to a dramatic expansion of state interference in the economy; the crisis of the 1970s produced deregulation. At the onset of the current crisis, the theme of an inevitable departure from economic liberalism and a return of Big Government actively interfering in society's economic life once again gained popularity. However, there also occurred a rapid realization of the fact that that crisis could be equally explained both by 'market failures' (excessive deregulation) and by 'government failures' – its ineptitude in ensuring stability of economic growth. Gradually, it was becoming clear that government regulation was indeed necessary, but primarily in the sphere of financial markets. In fact, it was the financial sector that had first introduced those institutional innovations that initially produced an unprecedentedly high rate of economic growth that later gave way to an unprecedented crisis. It is a financial crisis (encompassing both the private and public sectors) that generated the current economic problems, and the government's task is to make it a priority to overcome that crisis.

Another specific feature of the new regulation model is that it must necessarily be created as a supranational – if not a global one. There is no sense in carrying on regulation on a national level alone in the presence of modern information and communications technologies. However, it is very difficult to create supranational regulatory institutions. There exist as yet

[1] Ferguson N. *The Ascent of Money: A Financial History of the World*. L.: Allen Lane, 2008.

no mechanisms for ensuring their functioning, including universal decision-making mechanisms.

When developing a modern regulation model, one must give consideration to the qualitatively new global economic process that sometimes is called *financialization*[1]. There exist several types of markets (and exchanges) in the world: the monetary market (the stock market), the currency market, the commodities market. Until recently, they functioned quite independently of one another, were developing under different laws, and were operated by different agents (specializing in a given type of markets). Now we are witnessing the processes of their coming together: the markets have begun to influence one another, and capital is flowing between them. As a result, the logic of pricing the relevant products is undergoing a certain transformation. On the one hand, this seriously hinders the analysis and forecasting of further development of the situations on these markets and throughout the entire world economy. On the other hand, economic agents have obtained some new instruments for their functioning, including for hedging risks. From the point of view of the specific issues of the Russian economy's development, especially interesting is the transformation of oil from a typical product traded on a commodities exchange, whose price is determined by the demand/supply ratio, into a financial market instrument, whose price is influenced by speculators in oil futures, and through that mechanism – also by currency speculators. This significantly increases the degree of uncertainty with regard to the price of oil as one of the most important factors applied in forecasting the prospects of the Russian economy.

The current global crisis is evolving against the backdrop of a *demographic crisis* that has spread to a greater part of the developed world and also to some developing countries. That crisis, in its turn, has given rise to two sets of problems, which must be solved in order to launch a trajectory of stable development. On the one hand, there is the issue of the mechanisms of economic growth, because until now such growth has always implied an increase in population. On the other hand, developed countries, having succeeded in ensuring a high level of social welfare, are now faced with increasingly grave budgetary problems. The social welfare load per worker was constantly increasing throughout the entire 20th century, and in the situation of a demographic crisis this pressure become fraught with very high danger for financial stability – and consequently, for growth. In 2011, European countries became acutely aware of this circumstance; for them, the exit from the macroeconomic crisis will mean a significant restructuring of their budgetary obligations. Russia will be faced with similar problems – not only in the event of a substantial decline in oil prices, but even if these prices remain at a stable level.

This situation has pushed to the fore the task of restructuring all the branches of the social welfare sphere – first of all the educational, public health care, and pension systems. Here we mean specifically structural reforms and the elaboration of new models for the functioning of these sectors, and not only the necessity to save budget resources. It should be emphasized that a financial crisis is a reflection and manifestation of a structural crisis. It can be overcome through in-depth reforming of the relevant sectors and bringing them in conformity with the new technological base and new social structure of postindustrial society.

[1] This term was used by UNCTAD in its Trade and Commodity Report (2009), which contains a chapter entitled The Financialization of Commodity Markets. Also see Gaidar Ye. Golovokruzhenie ot uspekhov. [Dizzy from Success.] // Ekonomicheskaia politika [The Economic Policy]. 2008. No 3.

It will be even more difficult to find solutions to the most pressing social problems because a prominent feature of the current crisis is that the leading developed countries have reached critical levels of sovereign debt. In part this is the result of the irresponsible financial policies of the previous decade, and in part – the consequence of the anti-crisis struggle that involved some measures designed to create budget incentives. The undermined trust in the financial situations and policies of the leading countries, a drop in the credit rating of the USA that has hit its 50-year low, the decline or threat of decline in the credit ratings of the world leaders and their global banks have all been pointing to a profound crisis of confidence in the existing economic and financial institutions. The key to exiting from the global crisis in the foreseeable future will be reestablished confidence.

And finally, the current crisis has *some political consequences*, although so far these have not yet acquired a more or less radical character. The events of 2010 – 2011 have made it possible to define some of these repercussions.

First, there has occurred a general shift to the right in the political mood of a number of important countries: center-right parties have won parliamentary elections in Germany, the UK, Poland, Spain and Portugal. The Republicans have significantly strengthened their representation in the US Congress.

Second, Europe has embarked on an experiment of sorts designed to find an optimal anti-crisis political anti-crisis model – somewhere between a technocratic government that lacks a voters mandate (Italy, Greece) and a party government winning an election (the new center-right governments in Spain and Portugal).

Third, there is the deepening conflict within the US political elite that has already triggered a downgrade of the USA’s sovereign rating, previously deemed to be impregnable. The choice of an economic model (between raising taxes and cutting budget expenditure) in that country has turned to be a purely political problem whose acuteness is further enhanced by the approaching presidential election of 2012. In such a situation, it is only natural that no simultaneous movement in two directions in order to reduce budget deficit becomes possible.

Fourth, numerous large-scale protest actions have taken place – mainly in developed countries. So far, however, such mass protests have had no significant impact of the formation of the governments’ economic and political courses. In any event, in spite of their openly leftist (and sometimes extreme left) slogans, it was the right parties that won last year’s elections.

1.1.3. Russia’s Economic Policy: the End of the Old Model

So far the crisis has had only a limited influence on the situation in Russia. Naturally, the rate of economic growth became slower, thus making it impossible to set the goal of doubling this country’s GDP over the next decade. However, the doubling of Russia’s GDP is by no means a task of critical importance. It is much more important to ensure the realization of progressive structural shifts that can serve as a foundation for the modernization of the Russian economy and policies, including the goal of making this country less dependent on the fluctuations of the world economic situation. That is why the global crisis has revived discussions on the possible ways of Russia’s modernization. In late 2010 – early 2011 Vladimir Putin set for the experts’ community the task of elaborating the possible scenarios and this country’s development strategy until 2020.

Strictly speaking, there exist two sets of causes that have put to the fore the need to elaborate a new strategy. First, there are the consequences of the global crisis which, as noted earlier, has made it necessary to rethink the current socio-economic policy. ‘You never want to see a serious crisis go to waste," said White House Chief of Staff Rahm Emanuel, and these words very accurately describe the goals that the governments of developed countries are now faced with.

Secondly, there also exist some specifically Russian causes for the renewal of the economic course. Last decade's economic policy model was shaped by the powerful intellectual, political, and even psychological impacts of the post-Communist transformation of 1991–1999 in general, and the 1998 financial crisis in particular.

The Economic Policy of 1999–2009: The Demand Economy

The principal features of the economic policy model applied over the pre-crisis decade are as follows:

- to ensure political and social stability as a *sine qua non* condition;
- to gradually increase the role of the State as the source of that stability. This role has become manifest in at least three forms: state property growth; growth of budget revenues and expenditures (in absolute terms and as a share of GDP); compensation for the insufficient trust in financial institutions through developing state financial structures (which was typical of the countries involved in catching-up industrialization);
- to maintain a well-balanced budget against the backdrop of increasing budget revenues and expenditures. However, this situation is unstable in face of a large-scale budget expansion. Any interruption (or even a significant slowdown) in revenue growth will result in a budget deficit;
- to implement a policy aimed at moderating the process of the currency exchange rate's strengthening alongside a high inflation rate and high interest rates. This was viewed as a source of incentives for domestic producers;
- to grant broad access of state, quasi-private and private companies to the international capital market. The high credit value inside the country was counterbalanced by the possibility to borrow on the world market;
- to make the government a major source of demand in the national economy. First of all, this helped to maintain demand on the part of the medium-income and poor strata of the population that depended on the state budget: pensioners, unemployed, government employees and the military, as well as the employees of state corporations attached to them. A prominent role was played by the funding allocated to the power structures – both for the upkeep of the military and arms purchases. It was further enhanced by the evolution of the global crisis in 2008–2010;
- to limit government investments in infrastructure. Being aware of the high corruption level in that sector, the government was very prudent in its policy with regard to it – in contrast to social expenditures;
- to support some big and inefficiently functioning enterprises – as a preventive factor against social destabilization. This explains the political and administrative restrictions imposed on dismissal of workers engaged in inefficient production;
- to limit the administrative reform to constant redefining of the range of functions of various state bodies alongside a refusal to implement any fundamental alterations in the state administration system;
- to raise taxes in order to ensure macroeconomic and social stability.

This type of economic policy inevitably has a number of natural consequences. An economy based on government demand is, in principle, more inclined towards preserving and supporting monopolies – as well as inflation. Monopolies ensured stability of the economic and political situation – although at a heavy price: the quality of goods and services was low, while the rate of inflation increased. The predominance of government demand was mitigating the need of economic agents in a lower inflation rate because government investments had priority over private ones, and it is for the private investor that a low inflation rate is more important as a precondition for lowering interest rates. The government's decisions were becoming increasingly individualized (or targeted) – it granted privileges as incentives for certain types of investors and producers in order to compensate them for the increasing taxes, high interest rates and administrative barriers. In effect, that policy can be described as a *demand economy*.

The Macroeconomic and Structural Limitations of the Model Existing in 1999–2009 (the Demand Economy) Necessitating the Elaboration of a New Growth Model

Budgetary issues. Increasing budget expenditures coupled with a halt in the growth of oil prices resulted in budget deficit. The Russian economy suddenly became very vulnerable to external shocks due to the unpredictable behavior of oil prices.

At the same time, the Stabilization Fund's dual role (that is, the role of the government's reserves generated by the super incomes from oil exports) in dealing with the strategic tasks of Russia's economic development explicitly manifested itself. On the one hand, the reserves helped to avoid budget populism and money supply sterilization, simultaneously serving as a safety cushion in a crisis situation. On the other hand, the presence of substantial reserves in face of a crisis became a powerful factor of modernization slowdown, because social tension was released at the expense of a delay in the restructuring of bankrupt enterprises. A similar situation was observed in the banking sector.

A monetary policy, based on suppressing the process of strengthening the ruble's exchange rate in nominal terms at the expense of an accelerated inflation rate, was also no longer effective in providing solutions to the existing problems. The ruble's exchange rate was strengthening, and in real terms it had long ago surpassed its 1997 level, amounting by the time of the onset of the crisis to 65% of its rate in nominal terms (25% in 1999). In such conditions the exchange rate of the national currency could not seriously protect domestic producers from foreign competition[1]. At the same time, a persistently high inflation rate produced two-digit interest rates on credits, thus making it impossible for domesticy businesses to obtain much-needed resources and creating obstacles to the development of the housing mortgage sphere. Previously, that situation had been in part relieved by availability of cheap foreign credits. Now, in crisis conditions, some serious problems arose. Further growth of the Russian economy will require the emergence of a domestic credit system which, in its turn, requires a low inflation rate.

The pitfall of insufficient competitiveness is contemporary Russia's most dangerous structural challenge. If ten years ago this country had average-quality institutions and a qualified

[1] As calculated by A. Vedev, approximately 75% of Russia's domestic demand produces inflation and growing imports, and only about 25% of it promotes domestic production. (Vedev A. et al. *Na puti k deshevym den'gam*. [On the Way to Cheap Money.] / Bank of Moscow's Strategic Research Center. 2010. June).

and cheap labor force, now the situation has undergone a fundamental change. High labor cost coupled with weak institutions and low labor productivity limit opportunities for increasing industrial exports and satisfying the growing domestic demand by domestic output. In the past decade labor cost was growing at a stable rate, while institutions were stagnating or even somewhat deteriorating[1]. Naturally, both these indices become important only when set against similar indices in the countries with comparable levels of economic development that are competing with Russia for attracted capital and production capacities. In terms of per capita GDP Russia has been rated first among the most dynamically developing markets; in terms of business climate (*doing business*) its position, on the contrary, became worse – now it has joined the 'backward' group together with Brazil, India and Indonesia whose per capita GDP is far below Russia's. So this country is becoming relatively less attractive in terms of investments – for foreign and domestic capital alike. Among other things, this is evidently one of the reasons for the recently started capital outflow from Russia.

In other words, Russia has found itself in a structural 'trap' created by the combination of (relatively) expensive labor and (relatively) bad institutions. Quite understandably, the competitive sectors in such a situation will be services and raw materials production (exploitation of natural resources) which, in fact, are currently dominating Russia's national economy.

There exist two ways out of that trap: either the quality of institutions must be improved to match that of labor, or labor quality will deteriorate to match that of institutions. Russian economists, for evident reasons, prefer to discuss the issues of improving the quality of institutions. However, the scenario of labor deterioration cannot be entirely dismissed, either. It is precisely in this direction that today's Russia is being pushed by the current migration trends.

The demographic crisis represents one more systemic problem that has lately acquired some new outlines.

One facet of this crisis is the natural population decline that can be only somewhat slowed down by the government's measures designed to stimulate natality. Besides, Russia's able-bodied population has recently started to show a downward trend. There exists an opinion that the demographic problem can be solved by means of external migration. However, in reality modern migration may only provide a solution to the issue of quantity, while only aggravating the qualitative problem. Migration is flowing into Russia from countries with lower levels of development and is represented by a population with a much lower demand for political and human potential development institutions (first of all in the spheres of education, health care and science). Thus, the issue of improving the quality of Russia's institutions and human capital becomes hopeless.

Its other facet is the rapid spread among the creative class of an *exit strategy* based on the desire to start a new life in another country. This is a rather new phenomenon requiring some serious consideration. It is probably for the first time in Russian history that this desire to emigrate is associated with a markedly improved well-being level rather than with its worsening. Globalization coupled with rapidly improving domestic living standards have produced a rapidly growing well-educated and mobile class consisting of individuals who feel competitive on the world labor and capital market. There is a demand for them in the most developed

[1] The issue of institutions' quality was considered, in particular, in: Freinkman L., Dashkeev V. *Rossia v 2007 godu: riski zamedlenia ekonomicheskogo rosta na fone sokhraniaiushcheisia institutsional'noi stargnatsii.* [Russia in 2007: the Risks of Economic Growth Slowdown Against the Backdrop of Persisting Institutional Stagnation] // Voprosy ekonomiki [Issues of Economics]. 2008. No 4.

countries of the world, and they may easily move from country to country. As a result, Russia has to compete for her own creative class – as if it has already become international property.

This situation has given rise to some fundamentally new conditions in terms of institutional environment improvement. Members of the creative class, in fact, no longer need better institutions in their country of origin because they can get all the necessary services (a political system, education and public health care) whenever they want. But without a demand for modern institutions there will be no supply. So this has become the most cumbersome structural obstacle in the way of Russia's modernization.

The entrepreneurial climate is yet another serious limitation of the existing economic growth model. If one accepts the hypothesis that the entrepreneurial climate is more favorable in countries with higher levels of economic development, Russia will represent a noticeable exception: here, the quality of the relevant institutions is much lower than in countries with a comparable per capita GDP level. Out of about 200 countries of the world, Russia is at 50th position by its development level, while in terms of institutional quality it is among the second hundred. According to the latest ratings and opinion polls among entrepreneurs, the problem of gaining access to infrastructure has recently become more acute.

Rapidly rising oil prices coupled with a growing economic activity of the State during a certain phase were neutralizing the entrepreneurial climate's negative influence on economic growth. Meanwhile, Russia has found itself at the very bottom of the international competitiveness scale by a number of individual indicators. These are, first of all, the customs regulation; the procedures for starting and closing down a business; the construction business; and investor protection. Besides, serious limitations are imposed by the existing status of basic (law enforcement) and financial institutions.

Russia's *spatial development* serves as another structural limitation to increasing its competitive capacity. Because of the uneven territorial development and insufficient responsibility of regional and municipal authorities for the situations in their own territories the federal budget bears an excessive budgetary load, while the regions are not interested in seeking new resources. The mechanism for appointing heads of regions has become an additional factor for them to lobby for redistribution of federal funding in their favor. In absence of proper incentives for territorial consolidation of human and financial resources, as well as any mechanisms for such consolidation, the financial pressure exerted by the regions on the federal government will be constantly renewed and thus give rise to an inevitably unreasonable allocation of budget expenditures.

1.1.4. The New Growth Model: The Supply Economy

The exhaustion of the potential of the growth mechanisms applied in 1999–2008 in combination with the challenges posed by the global crisis have put forth the question as to the need to generate a new economic growth model. The new growth policy must be able to put forth some mechanisms that will enable Russia to become successfully competitive in the struggle for human and financial resources (human and investment capital) that is currently going on a global scale. Below we are going to look at the key components of the new growth model.

Budgetary policy. The major directions of the budgetary policy are: to reduce the budgetary load relative to GDP; and to lower the budget's dependence on the fluctuations of the world market situation.

The achievement of these goals will be helped by the reestablishment of the rigid budget rule: budget estimations must be based on a fixed oil price level that does not depend on any political negotiations but instead is geared to, say, a decade's average price. In other words, budget rent-generated revenue must be guaranteed with a high degree of probability. If it becomes necessary for expenditures to exceed the amount of revenues calculated on the basis of that assumption (structural revenues), the government must raise taxes or borrow money – and these must be ruble-denominated loans. Their aggregate sum must not exceed 25% of GDP. If oil prices go above the estimated decade's average, the surplus revenues must be transferred into a reserve fund and by no means be spent on current consumption even if there occurs a parallel government debt growth.

Budgetary policy needs to resort to a structural maneuver towards increasing the investment and innovation-oriented (on human capital development) budget expenditures, while simultaneously cutting social welfare expenditures (through expanding the regions' powers) and providing funding to the power structures.

At the same time it is necessary to optimize budget expenditure. The adoption, in recent years, of the laws on autonomous and budget-funded institutions that have significantly transformed their status and separated their obligations from budget obligations can be regarded as only the first step in the direction of budgetary network rationalization. It is important to define more precisely the role of the Stabilization (or Reserve) Fund in order to prevent the use of its resources for the support of inefficient enterprises.

Any further alterations in the tax system must be brought to a minimum, with the exception of those that deal with the expansion of the revenue base of regional and municipal budgets. However, here we mean expansion of the tax powers of the sub-federal bodies of authority rather than the redistribution of the existing tax revenues.

Monetary policy. It is necessary to lower the inflation rate to a level approximately equal to or slightly exceeding the index typical of developed countries – that is, about 5%. This implies a continuation of the policy of modified inflation targeting and a refusal to artificially keep the ruble's exchange rate within an established currency corridor – when the monetary authorities level down its fluctuations. The operations on the monetary market will play a more prominent role in the formation of monetary policy, and crediting of the economy will be further developed by means of listing high-quality securities of domestic issuers.

A separate issue that deserves elaborate consideration is the prospect of making the ruble a regional reserve currency. The ruble has some advantages as a regional currency (these are, first of all, the impressive size of the Russian economy and the gravitation towards it of the neighboring countries), as well as some serious limitations (a resource-based economy implies an increased volatility of the national currency exchange rate). It would be feasible to prepare a special program (a system of measures) aimed at strengthening the ruble's international position.

In this connection there arises one important task – to create in Russia an international financial center. The center's goal will be to ensure appropriate institutional conditions for developing a national financial system and increasing the ruble's competitive capacity as a regional reserve currency (this will also involve increasing the demand for the ruble as an instrument for carrying out financial transactions).

The monetary policy measures are closely associated with the issues pertaining to the organization of ***financial markets***. Here the main directions can be described as follows: toughening the requirements to banks' capital; the introduction of *International Financial Reporting Standards* (IFRSs); the development of a special program designed to promote competition in the banking sector (instead of demonopolization); macroprudential supervision of banks and system-forming non-banking institutions; development and implementation of special programs aimed at training the population in dealing with financial issues.

Development of the entrepreneurial climate and promotion of the activity of private entrepreneurs. With regard to that sphere, it is important to focus efforts on the least favorable components of the entrepreneurial climate – i.e., areas where an improved situation can yield the most rapid results.

Among the principal measures to be implemented here, we can point out the following ones:

– lowering the risks associated with doing business: a revision of the RF Criminal Code in order to abolish a number of its articles envisaging punishment for some economic and tax crimes (de-criminalization of the corresponding deeds), as well as a more precise definition and separation of the functions and powers of the law enforcement agencies supervising economic activities;
– improvement of legal protection of competition, expansion of companies' rights to defend their interests;
– lowering the level of state interference and improving regulation efficiency (measures designed to alter the motivations and increase the control of the state apparatus);
– creating incentives for improving the conditions for doing business at the level of regional and local authorities;
– improving the efficiency of legal regulation of entrepreneurial activity, including the creation of a National Investment Council;
– a more precise definition of the functions of and limitations to the direct and indirect presence of the State in the economy as an economic agent (privatization);
– promoting the elaboration of various forms of public protection of business interests, the activity of business associations and the independent mass media;
– development of a strategy ('a road map') designed to lower those barriers that impose the most serious limitations on economic growth (market access barriers, access to networks, border crossing regimes, and liberalization of the construction market).

Liberalization and greater efficiency of the labor market becomes an especially important task in the situation of a decline in the economically active population.

It is necessary to revise the Labor Code in order to liberalize the procedures for the hiring and dismissal of workers and to abolish the practice of informal (political) regulation of employment within the framework of separate enterprises and in the regions.

Another direction involves a policy designed to stimulate labor mobility (domestic migration), concentration of labor in areas of economic growth, as well as a redistribution of the labor resources that have become redundant in the budget-funded sector. These measures will imply legalization and development of the residential leasing market, and also granting to Russian citizens an easier access to public welfare funds everywhere in Russia's territory (medical insurance, etc.).

And finally, it is necessary to implement a number of measures designed to increase the attractiveness of immigration to Russia. They should include a switchover from the restriction-based principles of migration regulation to differentiating ones; an orientation towards 'sedentary' migration; a policy aimed at attracting a highly qualified workforce (including the promotion of immigration and mobility in the fields of education and academic studies). The migration of qualified workforce is the most difficult to promote, but it would be much more important to practically achieve that goal than to simply discuss the issues of illegal migration of unskilled labor.

Human capital is a key factor in the development of a sound post-industrial society. Investments in human capital have been the most relevant factor in those countries that over the last 50 years have achieved successful modernization leaps. This refers mainly to the development of sectors like education, public health care and the pension system.

According to the traditional (industrial) understanding, these sectors are branches of the social sphere. Although the social welfare aspect has retained its importance in contemporary developed economies, these branches now represent a network also of fiscal, investment and political components. In contrast to the practice that was widespread in the late 19th and most of the 20th century, education, medical services and pension provision are now available to the entire population (taxpayers and consumers of the corresponding benefits alike), and the demographic crisis has only further aggravated the already tense situation. As a result, the deductions to the development of these spheres can undermine the financial stability of any developed country. Besides, these deductions are, as a rule, long-term ones, and so they largely shape up a nation's investment resources. And finally, an efficient functioning of these sectors actually determines the political and social stability of societies with a predominance of the urban population.

Human capital development implies providing solutions to both financial and structural problems. As far as financial targets are concerned, it is advisable to compare Russia's relevant expenditure indices with those of countries with comparable or higher levels of economico development – in particular, the OECD countries. Russia spends on education and public health care approximately 1.5–2 p.p. and 3–4 p.p. of GDP (respectively) less than the OECD.

However, problems hindering the development of the human capital sphere are not limited to insufficient financing. The other, more important, aspects are structural transformation and adequate response to the challenges of postindustrialo society. Below we are determining the five characteristic features (or principles of functioning) that must be taken into account when undertaking their structural modernization. These reflect the distinctive features of modern technologies – their dynamism (a rapid renewal cycle) and the increasing customization of technological solutions.

First, the services are provided on a continual basis. Education and health care are turning into a lifelong process – people train and get medical care as long as they live. The very idea of work is being transformed, thus also making more vague the idea of retirement.

Secondly, the services are becoming increasingly customized. More and more often people will be making a choice of their own educational 'trajectories' and health care mechanisms out of the available variety of educational and medical services. The retirement age is also increasingly becoming a matter of personal decision when people determine individually when they can and want to discontinue their professional activity. With regard to the pension system this will imply a very significant diversification of the forms of support provided to senior citizens.

Thirdly, the services are acquiring a global character. Educational establishments and hospitals are now competing not only with the neighboring or even national ones, but also with those situated elsewhere in the world. Of course, such a broad choice is by no means affordable to everybody, but as people become wealthier and the real cost of the relevant services and transport cheaper, more and more individuals will be participating in that global-scale competition.

Fourthly, the role of private spending on human capital development is becoming more prominent. The first three characteristic features imply expanding opportunities for individuals to buy the services that they need – consequently, the share of private demand is also going to expand at an accelerated rate, getting increasingly ahead of budget-funded demand. Private payments and co-payments become not only a natural but an inevitable outcome of the technological modernization of the social sphere.

Fifthly, the role of new technologies is also on the rise, thus radically changing the character of the services being provided. As the information and communications technologies and transport are getting increasingly more sophisticated, the traditional forms of medical care and education are becoming a thing of the part. This can also be said of organizational innovations.

All the aforesaid features can provide a foundation not only for human capital modernization, but also for the economic and political modernization of the entire country, including its technological base.

Openness of the economy and promotion of competition. The year 2011 saw two major steps towards creating the preconditions for modernizing the Russian economy: the establishment of the Customs Union and the Common Economic Space on the one hand, and a breakthrough on Russia's WTO accession on the other. The importance of these decisions is that they will increase the level of competition for Russian enterprises, which has so far been insufficient. Until recently it was believed that these two goals (post-Soviet integration and Russia's accession to the WTO) cannot really be achieved simultaneously. However, by early 2012 all the contradictions previously existing in that sphere had been successfully removed. One can really expect from the movement in these two directions something more that simply a more intense competition.

Post-Soviet integration may have two important consequences. First, it not only pushes further the market's boundaries but also sets a precedent of reintegration that can be followed by other countries. Secondly, it helps to strengthen the ruble's international positions and becomes *de facto* a significant step towards making it a regional reserve currency. Thirdly, in addition to competition between commodities it creates preconditions for a competition between institutions and jurisdictions. Although the partner countries' institutions are probably not the most attractive ones, the very fact of competition will be conducive to progressive institutional shifts.

Russia's accession to the WTO will help to diversify her exports. Of course, the State and businesses alike must undertake some coordinated efforts in that direction. Nevertheless, Russian companies have been given some additional chances to participate in international production chains.

Besides, the Russian Federation's accession to the WTO will become the first step on the way towards Russia's broader integration in the world economy and its institutions. The next important steps will be accession to the OECD and the start of active efforts towards creating a free trade zone with the European Union. Given that the EU's share in Russia's external trade is approaching the level of 60%, the strategic goal of the RF is to establish a EU-Russia relationship similar to the one that exists between the European Union and Norway.

All these events must be taken advantage of by Russia in order to seek some new niches in the international division of labor through diversifying her raw materials exports, promoting exports unrelated to raw materials, and boosting the international cooperation of Russian companies. The strategic goal in promoting exports unrelated to raw materials (or hi-tech exports) will be to occupy a niche in South-South trade (the exchange of technology and hi-tech products between countries with medium and low revenue levels). It should be emphasized that all the successful modernization breakthroughs of the last 50 years have been based on orientation towards exports.

Spatial development. Spatial policy must rely on two principles: promotion of population inflow into economic growth points (or regions) as a compensation for the demographic crisis (an overall decline in population); and promotion of competition between regions and municipalities for the attraction of population and businesses.

The federal center, when determining the goals of its own development and planning the ways for their achievement, must also guarantee autonomy to each level of authority; provide all the regions with equal conditions for modern growth; ensure transparency, simplicity and predictability of the ‘rules of the game’ applied in the relations within the federation, including interbudgetary relations. These goals can be achieved through expanding the revenue base of regions and municipalities, while at the same time increasing the level of their responsibility and accountability to the population for the execution of their powers in the sphere of social policy. This will require the introduction of some serious alterations in the tax system, including those implying its decentralization.

An important priority for the federal authorities in the sphere of spatial policy must become the task of providing transport links to territories possessing their own economic potential, as well as that of supporting the naturally evolving centers of development. It will be necessary to create incentives for improving the conditions for doing business at the level of regional and local authorities by making federal support performance-based in terms of economic development results (and primarily the rate of investment attraction).

One of the main issues is to ensure that the heads of municipal formations with adequate financial bases, as well as heads of regional bodies of authority, are elected to their posts. In 2011, both the RF President and the Chairman of the RF Government suggested that direct gubernatorial elections should be reintroduced. However, it is very important to consistently implement that principle on the municipal level.

1.1.5. Political Processes and the Economy

The past year was marked by the growing political activity of different social strata. The December elections to the RF State Duma escalated political tensions across the whole of Russia, because a considerable part of society was not prepared to recognize the election results as legitimate.

Over the last decade, Russia has been consistently constructing a ‘one-and-a-half-party democracy’ that has become well-known from the experience of Italy and Japan in the 1950s-80s and Mexico for a greater part of the 20th century. This type of democracy is characterized by a decades-long single-party rule, while there also exist other political forces that participate in elections but are incapable of exerting any significant influence on the decision-making process. The main drawback of that model is a high level of corruption, which is inevitably associated with a long-term rule of one and the same political force. On the brighter side, the government usually achieves political stability and successful economic growth. The model has been quite appropriate for Russia – given her current level of economic development historical features.

On the darker side, one-and-a-half-party democracy is poorly compatible with contemporary technological challenges, and especially with the information saturation of contemporary society. It is these factors that push a country towards liberalization, and these ideas can easily gain support of the more ‘informed’ (and younger) part of the population. Thus, a rise in political activity is not necessarily associated with a worsening economic situation. On the contrary, improved well-being promotes growth of political activity and readiness to present the authorities with some ‘awkward’ questions. It was Alexis de Tocqueville who noted that revolutions happen in countries characterized by dynamic economic and social development, and not in stagnating societies. The experience of the 20th century, including our domestic experiences, can only serve as a confirmation of that statement.

It would be a mistake to view the current intensification of political processes as a manifestation of a revolutionary situation. Russia experienced a full-scale revolution in 1987–1999, and any repetition of those events nowadays is absolutely improbable. However, it seems quite reasonable to analyze the current political developments in Russia through the prism of the historic experiences of revolutions.

The great revolutions of the past always produced an impact on the development of the corresponding countries that lasted for several decades. This was manifested in periodical (once every 15 to 20 years) dramatic turns in the political situation which occurred as if for no reason at all. Such events never resulted in the total dismantling of the existing system and did not introduce any fundamental changes in economic and political relations. Nevertheless, they brought to power some new socio-economic strata and new generations of politicians. These strata and politicians by no means always denounced their predecessors and, as a rule, had belonged to the previously existing elite. But they answered the needs of the new generation, and thus continued the course towards the post-revolutionary consolidation of society[1].

An increasing political uncertainty may have a negative effect on the rate of economic development, and especially on capital movement. However, the economic situation can be threatened not so much by political uncertainty (to which businesses can adapt rather easily) as by political, macroeconomic and social instability. The most important present-day task for the Russian authorities is to avoid destabilization in the forthcoming period.

From the point of view of economics, there exist two sources of destabilization: external and internal.

The *external* source is, most likely, associated with the prospects of the world recession (or at least recession experiences by Russia’s main trading partners). This will be followed by a marked decline in the prices for energy resources, which are the main source of revenues from exports and thus the foundation of Russia’s budget stability. Such a change will produce an internal shock that will have to be countered with some decisive and consistent measures in the spheres of budgetary and monetary policies. The afore-said drop in energy prices will not be a disaster if we duly prepare for it. The introduction of the *budgetary rule* and the discon-

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[1] A classical example of this type of development is, of course, nineteenth-century Post-Revolutionary France, which underwent considerable political changes in 1830, 1848 and 1870. The Restoration of the Bourbons in 1814 returned to power the landed aristocracy, which was replaced at the helm, in 1830, by a financial oligarchy (under a new monarch who was a relative of the previous king), only to be succeeded, in 1848, by the urban bourgeoisie (under an emperor who was a nephew of the previous emperor). The period of turmoil came to an end with the establishment of the Third Republic in 1870, which ensured that all key interest groups were sufficiently well represented at senior levels of government. It may be said, without going into details, that the same trend can be seen in the aftermath of other great revolutions of the past.

tinuation of the policy aimed at sustaining a stable ruble exchange rate (see above) will represent important steps towards mitigating the effects of the possible shocks. However, that will be not enough: the government must also have at hand a well-elaborated plan for actions to be taken in an event of a dramatic deterioration of the global economic situation.

Internal risks are primarily associated with the danger of switching over to the policy of budget populism. An abundance of budget revenues and a formally very beneficial macroeconomic situation (especially by comparison with the European countries) coupled with a threat of growing socio-political discontent may entail a weakening of the budgetary policy – in other words, may result in a rise of expenditure covered by situational revenues from exports and borrowings. Politically, this would be the easiest way – but it is fraught with some serious future problems.

Another form of response to the political events of late 2011 would be to develop a comprehensive modernization strategy. The core problem plaguing the three-century history of Russia’s catch-up modernization has been its non-comprehensive (or, so to say, ‘patchwork’) character. The authorities have always tried to emphasize some separate aspects of modernization (military, technological, economic, scientific, educational, or more rarely – political), but there has never been a single comprehensive program. That is why the results of Russia’s previous attempts at such modernization were inconsistent and unstable.

Now, when modernization has become a slogan of the day, it is becoming absolutely necessary to push it in every direction, and in particular to combine modernization of technologies with modernization of institutions (economic as well as political ones).

Section 2. The Monetary and Budget Spheres

2.1. The Monetary Policy

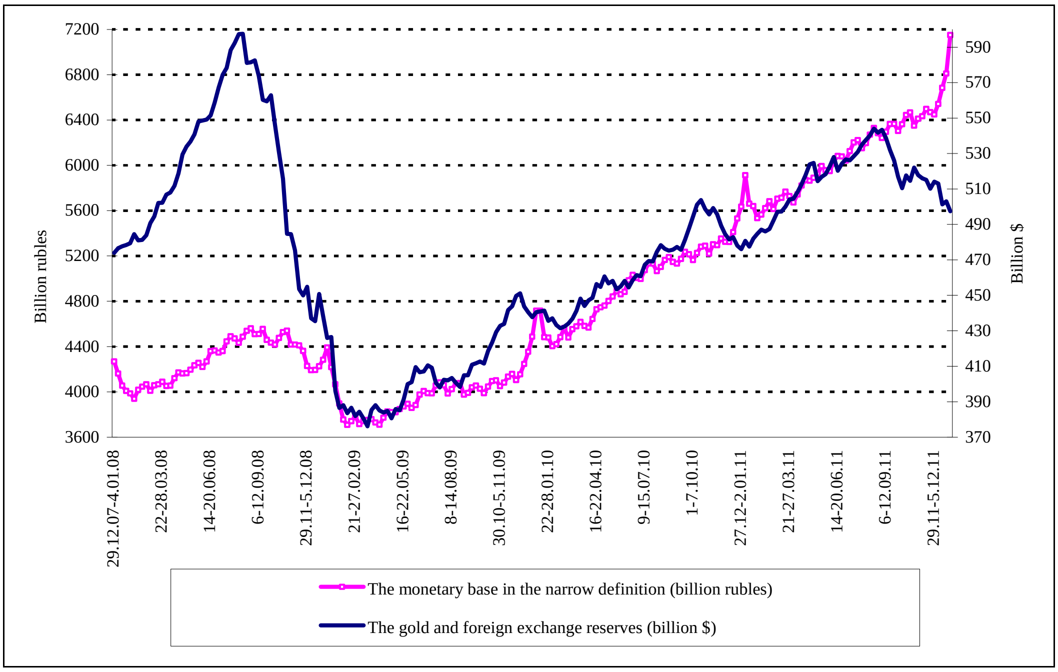
The main developments in the monetary sphere in 2011 can be nominally divided into two periods: from January till August and from August till the end of the year. In the first six months, continuation of the trends typical of the year 2010 was observed, that is, a smooth recovery of the financial sector of the economy with simultaneous growth in the money supply, international reserves of the Bank of Russia and moderate inflation rate. In the above period, the Bank of Russia kept scaling down its anti-crisis support of the financial sector. In August, the second period began and it formally resembled to a great extent the beginning of the crisis of 2008–2009: due to the outflow of the private capital and closing of foreign markets to Russian borrowers the banking sector started to experience again difficulties in attraction of liquid resources, interest rates went up, while the international reserves decreased. It is to be noted that the growth in the outflow of the capital took place in a situation where global prices on the main commodities of the Russian export remained high. The main factors behind that outflow were the negative trend in the global economy (the debt problems in the EU and the USA in a situation of slow economic growth in those countries).

In all appearances, the development of the global economy will be inconsistent within quite a long period of time, so, the above mentioned fluctuations on the Russian financial market are likely to remain in the next few years. In such a situation, the Central Bank of the Russian Federation gradually gave up its substantial interference in the functioning of the foreign exchange market by means of currency interventions and concentrated its efforts to reduce the inflation rate in the Russian Federation by trying to use the interest rates as the main instrument of the monetary and credit policy.

2.1.1. The Money Market

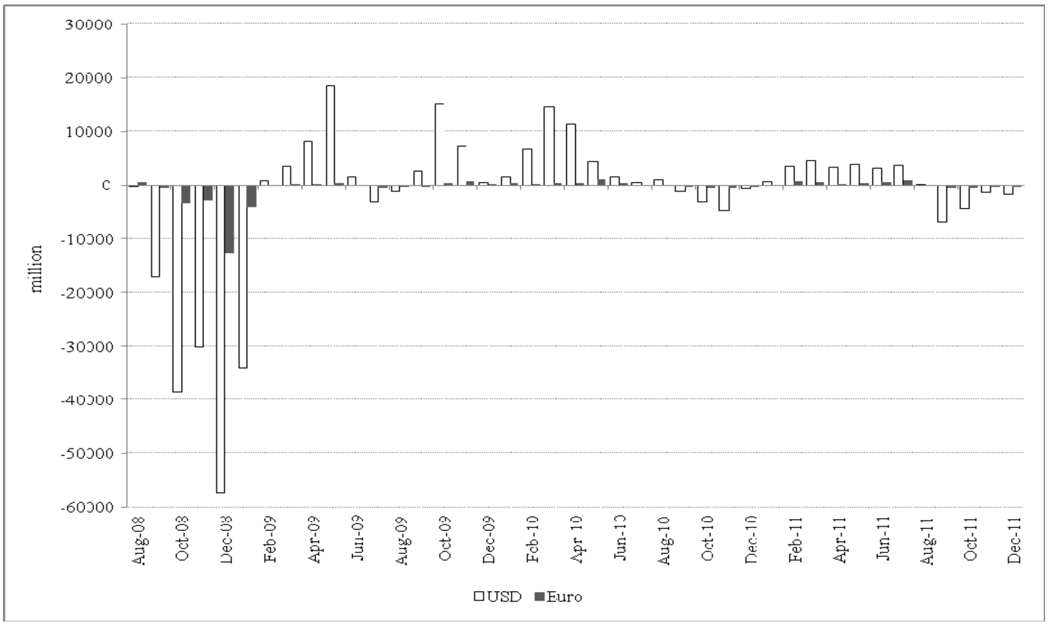
From the beginning of the year till August 2011, as well as in 2010, growth in the international reserve assets of the Bank of Russia was observed (see *Fig. 1*). The main factor behind such growth in reserves became rising oil prices which in the Q2 2011 reached the record-high levels in the past three years. In addition to the above, due to the volatile situation on the global financial markets in the first six months of 2011 prices on gold which is a part of the international reserves of the Bank of Russia rose dramatically. As a result, in August the international reserves amounted to $544bn which is a 13.2% increase from the beginning of the year. The above value was the maximum one since autumn 2008.

Intensification of the capital outflow in September was related to the aggravation of the global financial crisis, that is, downgrading by Standard & Poor's, an international rating agency of the US credit rating from AAA to AA+ and the subsequent fall of international stock markets and oil prices. Investors started to withdraw funds from risk assets worldwide, including the Russian Federation. However, a dramatic decrease in the reserves was primarily related to depreciation of the Euro exchange rate against the USD as a drop in the Euro/USD exchange rate resulted in a decrease in the USD value of the portion of the Euro-denominated reserves. The Russian Central Bank's interventions on the foreign exchange market were insignificant: the mere $7.5bn and Euro 0.6bn were sold (see *Fig. 2*).



Source: The Central Bank of the Russian Federation.

Fig. 1. The dynamics of the monetary base in the narrow definition and the international reserve assets of the Central Bank of the Russian Federation in the 2008 – 2011 period



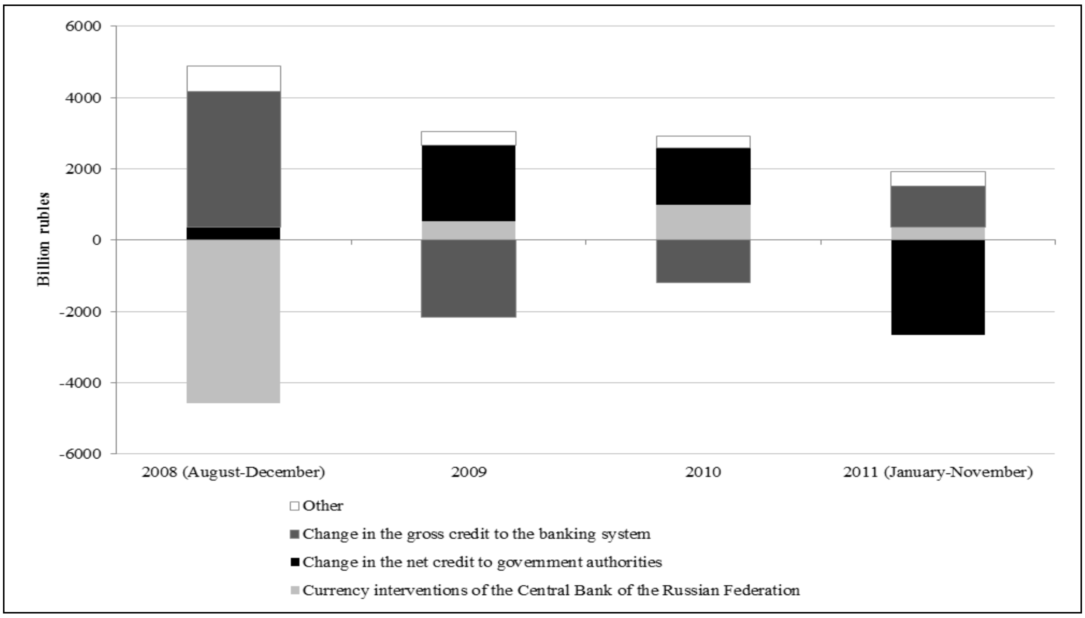
Source: The Central Bank of the Russian Federation.

Fig. 2. Net purchases by the Bank of Russia of foreign exchange in the 2008–2011 period

After the 2008 crisis, the monetary base in the broad definition grew at a higher rate than the international reserves, however, in 2011 the expansion of the monetary base virtually stopped. The rapid recovery of the monetary base in 2009 and 2010 was related primarily with utilization of the resources of the Reserve Fund to finance the budget deficit (see *Fig. 3*). It is to be noted that commercial banks returned loans received during the crisis to the Bank of Russia which situation led to a shrinkage of the money supply.

In 2011, the budget was administered with a surplus and there was no need to spend the resources of the Reserve Fund. In addition to that, the surplus of the budget accumulated in the accounts of the Government of the Russian Federation restrained growth in the monetary base. As was stated above, in 2011 the currency interventions by the Bank of Russia happened to be insignificant as well.

During the 2008–2009 crisis and the post-crisis period, operations of the Central Bank of the Russian Federation as regards provision of funds to commercial banks had a considerable effect on the money supply (see *Fig. 4*). In autumn 2011, when credit institutions were in need of liquid resources again the Bank of Russia increased the volume of funds extended to commercial banks and that situation became the main factor behind the growth in the monetary base. It is to be noted that on a year on year basis the monetary base increased by the mere Rb 0.5 trillion (+5.5%) with the December growth in the monetary base amounting to Rb 1.2 trillion. In 2010, the monetary base grew by Rb 1.7 trillion (+26.6%).



Source: The Central Bank of the Russian Federation, the IEP calculations.

Fig. 3. The main factors behind the change in the monetary base (in the broad definition) in the 2008–2011 period[1]

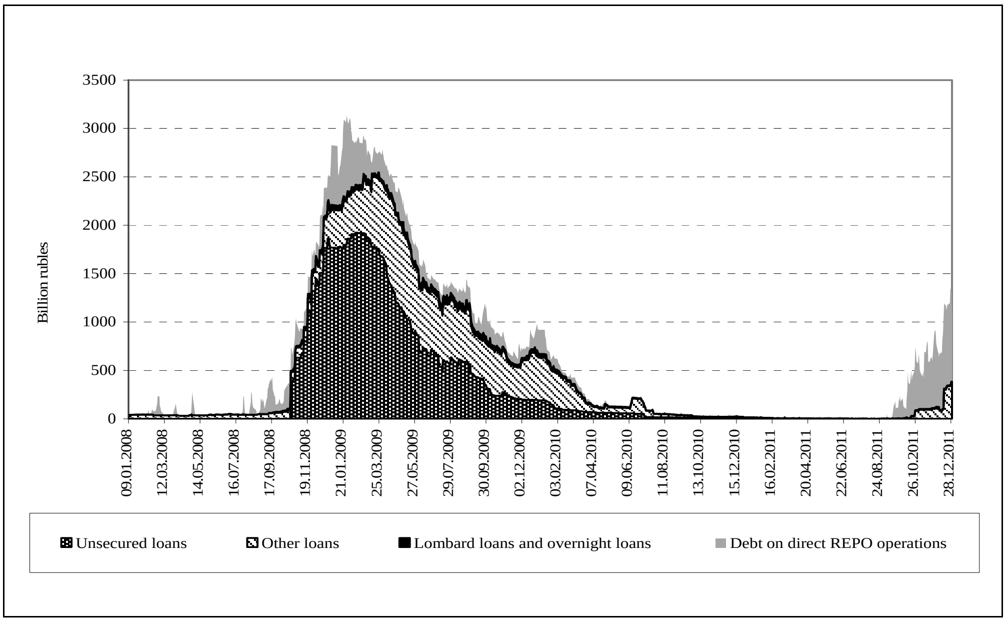
[1] The period under review in 2008 and 2011 is determined by availability of the data on the currency interventions by the Bank of Russia and the balance of the Bank of Russia as of the date of preparation of this review.

Table 1

The balance of the Bank of Russia in the 2010–2011 period

	01.01.2010		01.01.2011		01.12.2011	
	Billion rubles	**% of assets/ liabilities**	**Billion rubles**	**% of assets/ liabilities**	**Billion rubles**	**% assets/ liabilities**
Funds deposited with non-residents and securities of foreign issuers	12383.3	80.3	13272	85.5	14142	76,4
Loans and deposits	1705.8	11.1	514	3,3	1657	8.9
Precious metals	764.6	5.0	1 201	7.7	1602	8.7
Securities	465.9	3.0	441	2.8	421	2.3
Other assets	100.3	0.7	99	0.6	697	3.8
Total assets	**15420**	**100**	**15526**	**100**	**18519**	**100**
Cash in circulation	4629.9	30	5792	37.3	6150	33.2
Funds in accounts with the Bank of Russia	7979.7	51.7	6431	41.4	8532	46.1
Including those of the Government of Russia	4980.2	32.3	3270	21.1	5263	28.4
Resident-credit institutions	1731.3	11.2	1817	11.7	1328	7.2
Funds in settlements	8.4	0.1	7	0.0	33	0.2
Issued securities	283.1	1.8	589	3.8	0	0.0
Other liabilities	168.3	1.1	145	0.9	1397	7.5
Capital	2099.1	13.6	2359	15.2	2407	13.0
Profit of the reporting year	251.4	1.6	204	1.3	0	0.0
Total liabilities	**15420**	**100**	**15526**	**100**	**18519**	**100**

The source: The Bank of Russia.



Source: The Central Bank of the Russian Federation, the IEP calculations.

Fig. 4. The commercial banks' debt to the Central Bank of the Russian Federation on individual instruments of refinancing in the 2008–2011 period

Here is a more detailed analysis of the structure of the monetary base in the broad definition (see *Table 2*). In 2011, the growing components of the monetary base were the cash funds and mandatory reserves. Growth in the mandatory reserves was related to a threefold increase by the Central Bank of the Russian Federation of mandatory reserve requirements in the first six months within the frameworks of return of such requirements to the pre-crisis level. At the same time, lack of channels for such a sustained expansion of the monetary base as was stated above, as well as problems in the global economy which resulted in the capital outflow and difficulties in refinancing of Russian companies caused a reduction in liquidity in the banking sector. As a result, bank's excessive reserves fell within a year: correspondent accounts of commercial banks with the Central Bank of the Russian Federation remained virtually unchanged at on a year-on-year basis (–1.3%), however, banks' deposits decreased by 38.7%, while credit institutions' investments into bonds of the Central Bank of the Russian Federation dropped from nearly Rb 600bn as of the beginning of the year to zero.

Table 2

The dynamics of the monetary base in the broad definition in 2011 (billion rubles)

	01.01.2011	01.04.2011	01.07.2011	01.10.2011	01.01.2012
Monetary base (in broad definition)	8 190.3	7 514.2	7 410.3	7 407.9	8644.1
- cash funds in circulation with cash balances at casher's offices of credit institutions taken into account	5 785.2	5 482.7	5 787.8	6 059.5	6895.8
- correspondent accounts of credit institutions with the Bank of Russia	994.7	597.2	786.5	781.6	981.6
- mandatory reserves	188.4	244.1	331.3	347	378.4
- deposits of credit institutions with the Bank of Russia	633.2	786.7	486.4	209.5	388.3
- bonds of the Bank of Russia with credit institutions	588.9	403.4	18.3	10.3	0

Source: The Central Bank of the Russian Federation.

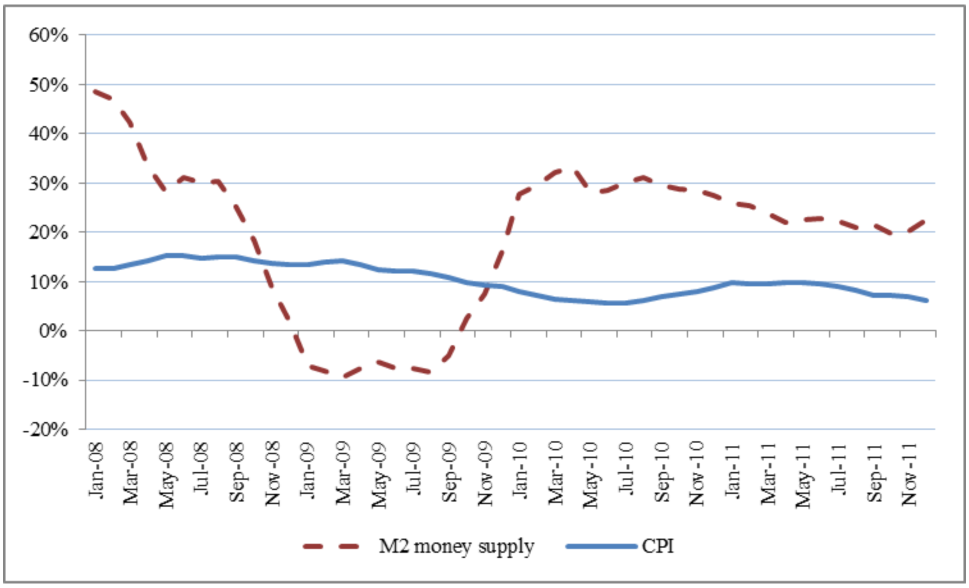
In 2011, the M2 money supply in the national definition increased by 22.6% and amounted to Rb 24.5 trillion as of January 1, 2012 or 45.1% of the GDP. In 2011, monetization of the GDP rose by 0.8%. In 2011, as the financial system of Russia developed the growth of the money multiplier continued; within a year it grew by 16% and was equal to 2.8 as of January 1, 2012 as compared to 2.4 as of January 1, 2011.

Thus, in 2011 the main factors behind slow growth in the money supply became insignificant interventions by the Central Bank of the Russian Federation on the foreign exchange market; the stable and positive balance of payments which was formed as a result of a positive current account balance and negative capital and financial instruments account balance (see the relevant section of the review) contributed to limitation of such interventions. It is to be noted that the Reserve Fund was not spent, but replenished. In such a situation, the main sources of the money supply growth became the Russian Central Bank's operations related to refinancing of the banking sector. At present, it can be asserted that the existing trends are likely to continue in 2012 which factor results in a slow expansion of the money supply in case of absence of external shocks.

2.1.2. Inflationary Developments

At year-end 2011, the inflation rate in the Russian Federation turned out to be the minimum one in the entire latest history of the Russian Federation. Such a result became feasible thanks to a good combination of both monetary and non-monetary factors. It is to be noted that judging by the inflation rate in January-May it was difficult to predict such a slowdown of the growth rates of prices because the growth in prices in that period in general was the same as in the corresponding period of 2010. A drop in the inflation rate against 2010 was achieved in the second half of the year.

As seen from *Fig. 4*, the growth rates of the money supply began to fall from autumn 2010 which situation could not but have an impact on inflationary developments in 2011. Non-monetary factors behind the rate of inflation include, among other things, the stable exchange rate of the ruble (see the section which deals with the analysis of the balance of payments of the Russian Federation), slow economic growth and a good yield of agricultural products. It is to be noted that despite some weakening of the ruble at the end of summer and in autumn the nominal effective rate of the ruble on a year on year basis did not change much (+2.4%) which situation means that with all other things being equal ruble prices on imported goods remain stable.



Source: Rosstat, the Central Bank of the Russian Federation and the IEP calculations

Fig. 5. Growth rates of consumer prices and M2 money supply in the Russian Federation in 2008–2011 (on a year-on year basis)

Here is a more detailed analysis of the dynamics of inflationary developments in 2011. As seen from *Table 3*, the main factor behind the slowdown of the inflation rate was the fact that growth rates of prices on food products were slower as compared to the previous years. Price rises on meat and fowl (+9.2%), fish and seafood (+10.3%), as well as bread and bakery products (+8.9%) made the main contribution to the growth in prices on food products.

Prices on housing and utilities services continued to grow (+11.7%), but at a slower rate than in 2010. A noticeable growth in prices on pre-school education services (+11.3%), health and recreation services (+9.1%) and services rendered by entities of culture (+11.3%) was observed.

In 2011, prices on non-food products grew at a higher rate than in 2010. It can be partly explained by the growth in prices on gasoline (14.9%), tobacco products (21.1%) and building materials (7.9%).

It is to be reminded that in 2012 the annual raising of the tariffs (regulated by the government) on paid services to the households was postponed from January 1 to July 1. Due to the above, in the first six months the inflation rate on a year on year basis is likely to go down. If the Central Bank of the Russian Federation goes ahead with its policy of limited interference into functioning of the foreign exchange market provided that no serious external shocks take place and a reasonable budget policy is carried out a further drop in the inflation rate may be expected in the Russian Federation by the year-end 2012.

Table 3

The annual growth rates on individual types of goods and services in the 2008–2011 period (% of December of the previous year)

	2008	2009	2010	2011	2008 – 2011
CPI	**13.3**	**8.8**	**8.8**	**6.1**	**42.3**
Food products	16.5	6.1	12.9	3.9	45.0
Cereals and bean products	*25.8*	*-2.5*	*58.8*	*-8.0*	*79.2*
Butter	*10.5*	*7.9*	*23.3*	*6.6*	*56.7*
Sunflower oil	*22.1*	*-19.8*	*27.6*	*4.6*	*30.7*
Pasta	*33.8*	*1.6*	*4.7*	*3.4*	*47.2*
Milk and dairy products	*12.2*	*2.3*	*16.7*	*6.3*	*42.4*
Bread and bakery products	*25.9*	*2.4*	*7.6*	*8.9*	*51.1*
Meat and fowl	*22.2*	*5.0*	*5.3*	*9.2*	*47.5*
Fish and sea products	*15.1*	*10.6*	*4.8*	*10.3*	*47.2*
Non-food products	8.0	9.7	5.0	6.7	32.7
Building materials	*11.3*	*2.1*	*4.6*	*7.9*	*28.3*
Motor gasoline	*1.2*	*8.0*	*6.5*	*14.9*	*33.7*
Services	15.9	11.6	8.1	8.7	52.0
Housing and utilities services	*16.4*	*19.6*	*13.0*	*11.7*	*75.7*
Pre-school education services	*20.7*	*16.2*	*7.7*	*11.3*	*68.1*
Health and recreation services	*21.2*	*9.5*	*5.4*	*9.0*	*52.5*
Passenger transport services	*22.5*	*6.5*	*8.7*	*9.1*	*54.7*
Services of entities of culture	*15.5*	*11.3*	*8.6*	*11.3*	*55.4*

Source: Rosstat.

2.1.3. The main measures in the sphere of the monetary and credit policy

Early in 2011, after numerous cuts in the interest rate on its instruments during and after the crisis the Bank of Russia made its monetary and credit policy tough again. Last year, the rate of refinancing was raised twice. It is to be noted that it took place in the first six months (on February 28 and May 3); within that period the rate of refinancing rose from 7.75% to 8.25%. Simultaneously, with raising of the rate of refinancing by a comparable value the interest rates on operations related both to absorption and provision of liquidity increased. Late in May, the rates on deposit operations of the Central Bank of the Russian Federation were raised by 0.25% with other rates (including the rate of refinancing) remaining unchanged.

In the same period, the Central Bank of the Russian Federation raised three times the mandatory reserve requirements. Starting from February, for three months running the Bank of Russia declared about toughening of the reserve requirements: as regards ruble and foreign currency liabilities of credit institutions to non-resident-legal entities the reserve requirements were raised from 2.5% to 3.5% from February 1, then, from 3.5% to 4.5% from March 1 and, for the third time, from 4.5% to 5.5% from April 1; as regards liabilities to individuals and other ruble and foreign currency liabilities of credit institutions the reserve requirements were raised from 2.5% to 3% from February 1, then, from 3% to 3.5% from March 1 and, for the third time, from 3.5 % to 4% from April 1. It is to be noted that reserve requirements as regards liabilities to non-residents were raised to a greater extent which factor reflects the intentions of the Bank of Russia to discourage borrowings from abroad in a situation of financial instability in order to reduce foreign exchange risks. As a result of raising of the reserve requirements, they returned to the level of the first half of 2008.

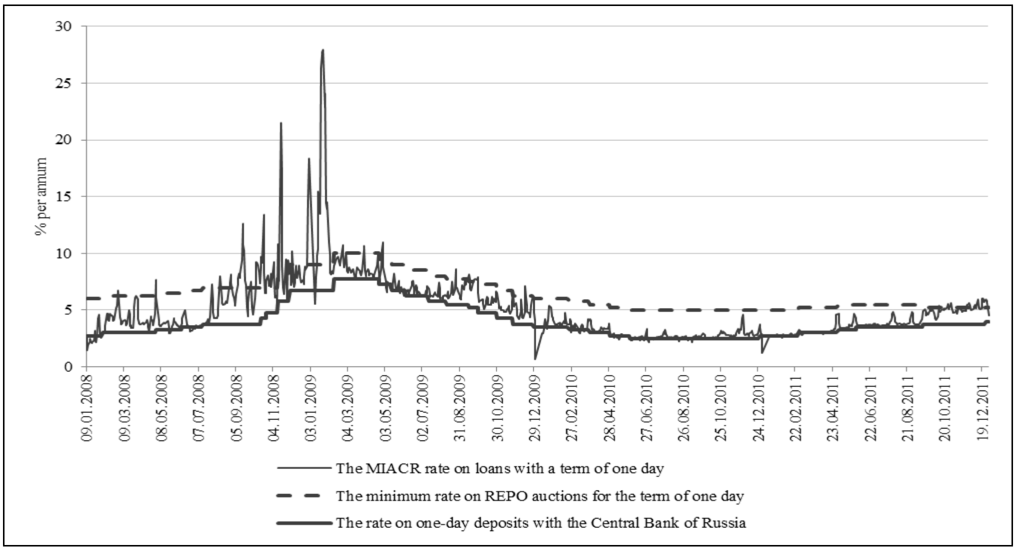
Additional efforts as regards toughening of the monetary and credit policy and scaling down of anti-crisis measures included the following:

- On January 31, 2011, the Central Bank of Russia made a decision to raise requirements to the ratings of issuers whose securities were included in the Lombard list of the Bank of Russia. From April 1, 2011, the minimum rating was raised from B-/B3 to B/B2, while from July 1, 2011, from B/B2 to B+/B1 according to the classification of rating agencies Standard & Poor's, Fitch Rating and Moody's Investors Service.
- From February 10, 2011, the Bank of Russia suspended operations as regards extension to credit institutions of loans (secured with assets or sureties) for the period from 91 days to 180 days, as well as Lombard loans at a fixed interest rate for the period of 30 days.
- From July 1, the Bank of Russia suspended conclusion of direct REPO deals with credit institutions in which deals equities of Russian companies were used as a collateral.

The main reason for toughening of the monetary and credit policy was a speed-up of the inflation rate in the beginning of the year. In addition to that, the above decision was aimed at sterilization of such an accumulated excessive liquidity in the banking system as was formed due to banks' huge profits which were received as a result of reduction of loan loss reserves, growth in the value of investments in securities as a result of the post-crisis recovery of stock markets and increase in the interest margin. To attract banks' available funds into deposits with the Central Bank of Russia, the latter kept raising interest rates on such deposits. It is to be noted that the Central Bank of the Russian Federation narrowed the spread between the rates on provision and absorption of liquidity (see *Fig. 6*). Such a policy contributed to greater role of interest rates as PSA instruments within the frameworks of a switchover to the inflation targeting regime. It is to be noted that in a situation of excessive liquidity the market interest rates were primarily influenced by the rates on deposits with the Bank of Russia (for instance, in 2010), while in the periods of a shortage of liquidity (autumn – winter 2011), by the rates on the Russian Central Bank's liquidity provision instruments. Thus, by changing interest rates and setting limits on provision of loans to commercial banks, the Bank of Russia has a significant impact on the situation on the money market and actually determines both the volume of the supply and the cost of money.

In mid-September, in a situation of the growing financial instability the Bank of Russia reduced by 0.25 % the minimum rates both on operations related to provision of liquidity on the open market (Lombard auctions and direct REPO auctions) and most of its permanent operations (Lombard loans, direct REPO operations, gold-secured loans, non-market assets or sureties). Simultaneously, the Bank of Russia increased interest rates on permanent deposit operations by 0.25 %. Thus, the Central bank of Russia reduced ever more the spread between the rates on loans and deposits which factor is to contribute to higher efficiency of its interest rate policy.

Also, as the situation with liquidity on the banking market was getting worse the Bank of Russia made a decision to expand the banks' refinancing opportunities. From November 1, the Central Bank of Russia resumed extension of loans secured with non-market assets or sureties for the period from 91 days to 180 days at the rate of 7.5%. In addition to that, from the above date the term of the gold-secured loans was extended to 180 days. Thus, the instruments of refinancing which the Bank of Russia used for backing the liquidity of banks during the 2008-2009 crisis became available again to commercial banks.



Source: Rosstat, the Central Bank of the Russian Federation, the IEP calculations.

Fig. 6. The rates of the Central Bank of the Russian Federation on the main operations related to provision and absorption of liquidity, as well as the rate on the inter-bank lending market in the 2008–2011 period

On November 25, the Bank of Russia declared that from December 5, 2011 the minimum ratings which the securities issuers were required to have in order to be included in the Lombard list of the Central Bank of Russia would be lowered. Also, starting from December 1 the Bank of Russia stopped applying a discount in calculation of the cost of a security in direct REPO operations for the period of up to six calendar days with federal loan bonds and bonds of the Bank of Russia. And finally, from December 1 the adjustment ratio which is applied for adjustment of the cost of the federal loan bonds which are accepted as security for loans of the Bank of Russia was raised from 0.98 to 1. The decisions made were aimed at providing commercial banks with more opportunities to attract refinancing from the Bank of Russia.

The activities of the Bank of Russia in the second half of the year were aimed at support of the banking sector and demonstrated that in case of worsening of the global economic situation the Central Bank of Russia was prepared to make up promptly for the shortage of liquidity.

In general, to our opinion, judging by the results of 2011 the Bank of Russia has made progress in its switchover to inflation targeting by means of interest rates. However, it is to be noted that the external factors were favorable for doing that. In particular, the total surplus of the balance of payments was insignificant, a good harvest contributed to reduction in prices on agricultural products and no urgent measures to support the financial sector or “cool” the economy were required. At the same time, the efficiency of further steps in introduction of inflation targeting will depend to a great extent on the global economic situation which remains highly uncertain. However, it is believed that the policy of the Bank of Russia aimed at both reduction of its interference in the functioning of the foreign exchange market and management of the money supply by means of the interest rates is a correct one.

In conclusion of this section, it is to be noted that early in November the Bank of Russia submitted for consideration to the State Duma the draft Guidelines for the Unified State

Monetary and Credit Policy in 2012 and the 2013-2014 period. In the next three years, the Central Bank of Russia is planning to complete the switchover to inflation targeting. Within the frameworks of the strategy of the consistent reduction of the growth rates of prices, a goal was set to reduce the inflation rate to 4%–5% a year by 2014. According to the Central Bank of the Russian Federation, the main objective of its interest rate policy consists in reduction of its direct interference into the exchange rate mechanism and creation of conditions for a switchover to the floating exchange rate regime. With interference of the Central bank of the Russian Federation into functioning of the foreign exchange market becoming less substantial, the interest rate management policy will have a key role to play in the process of monetary and credit regulation. The decision on changing of interest rates will be normally passed on a monthly basis with the analysis of inflationary developments taken into account.

Other important objectives set by the Bank of Russia in the mid-term prospect are as follows:

- Support of financial stability (for that purpose the Bank of Russia will pay a particular attention to a timely identification and evaluation of the risks taken by banks and ensuring of transparency in credit institutions' activities); it is believed that within the frameworks of attainment of the above goal a particular attention is to be paid to the issues of the macro-prudential regulation and counter-cycling supervision over commercial banks;
- Development of the infrastructure of the financial markets and expansion of their capacity; it is believed that the best contribution of the Central Bank of the Russian Federation in solution of that issue is ensuring of financial stability and the low rate of inflation which prompts economic agents to saving;
- Raising of information openness by the Bank of Russia in the sphere of the monetary and credit policy; in the past few years the Bank of Russia has made large progress in making its policy transparent and at present it is catching up with the world's best prototypes; at the same time it has got the potential for upgrading the quality of the analytical work and analysis of the macroeconomic situation.

2.1.4. Balance of Payments[1] and the RUR Exchange Rate

In 2011, continuation of the soft monetary and credit policy by leading global economies and rising tensions in the Middle East and North Africa prompted growth in prices on primary products. As a result, the export of products of the fuel and energy complex from the Russian Federation rose by 34% as compared to the previous year. At the same time, at year-end the capital outflow from Russia turned out to be much higher than it was expected by the Government and the Bank of Russia which situation points to the fact that the risks of investment into the Russian economy are high. As a result, at year-end the country's balance of payments was quite strong, however, in the mid-term prospect its vulnerability to the foreign economic market situation is apparent.

According to the preliminary evaluation of the 2011 balance of payments of the Russian Federation published by the Central Bank of the Russian Federation, the current account balance amounted to $ 101.1bn, which is an increase of 44% as compared to 2010 (*Table 4*). The trade balance rose by 31% (from $151.7bn to $198.1bn) with export of goods increasing by

[1] Analysis of the balance of payments was carried out on the basis of preliminary data of the Central Bank of Russia. http://cbr.ru/statistics/print.aspx?file=credit_statistics/bal_of_payments_est.htm&pid=svs&sid=opb

30% (from $400.4bn to $ 21.4bn) and import, by the same 30% (from $248.7bn to $323.3bn). The share of the export of oil, petroleum products and natural gas amounted to 65.3% of the total value of export and increased by 1.9 % as compared to 2010. It is to be noted that in 2011 the volume of both the export and import turned out to be the record-high in the entire latest history of the Russian Federation.

Thus, as in the previous years the main factor which determined the value of the current account balance was the trade balance which in its turn depended to a great extent on movement of prices on energy carriers and other important goods of the Russian export on global markets. On the basis of the data shown in *Fig. 7*, it is seen that such a relation between the global prices on oil and the trade balance as was observed in the 2002–2010 period was evident throughout 2011 as well.

The deficit of the balance of services amounted to $37.1bn and rose (in absolute value) by 27% as compared to 2010. The export of services amounted to $55bn and rose by $9.9bn as compared to the previous year (+2%). In 2011, the import of services rose by 24% and amounted to $92.1bn.

In 2011, the balance of labor remuneration increased in absolute value and amounted to $9.4bn (as against $8.5bn in 2010). In 2011, the deficit of the balance of investment income rose by 18% as compared to 2010 and amounted to $47.3bn. Investment income receivable rose from $ 3.7bn to $39.3bn. Growth in income receivable as regards non-financial institutions from $ 61.7bn to $73.1bn determined the growth in the total income receivable from $73.8bn to $ 86.6bn.

In 2011, the balance of current transfers[1] amounted to $3.2bn (against $3.6bn in 2010).

So, in 2011 the main factor behind preservation of a considerable current account balance of the balance of payments of the Russian Federation was growth in prices on the main commodities of the Russian export. In particular, the average annual price on Brent oil increased by 40%. It is to be noted that in 2011 growth in the external private sector debt of the Russian Federation renewed (see *Table 4*). If in 2010 the external debt of banks and the non-financial sector decreased by $27bn, in 2011 the growth in their debt amounted to $51.3bn. As regards the external public debt, it did not change much within the year and decreased by $1.3bn. A favorable situation on the market of energy carriers permitted to form the state budget with a surplus and do virtually without borrowings on the foreign market. In the short-term prospect, growth in the external debt, both private and public, due to a shortage and high cost of financial resources on the domestic market, as well as the budget deficit can be expected.

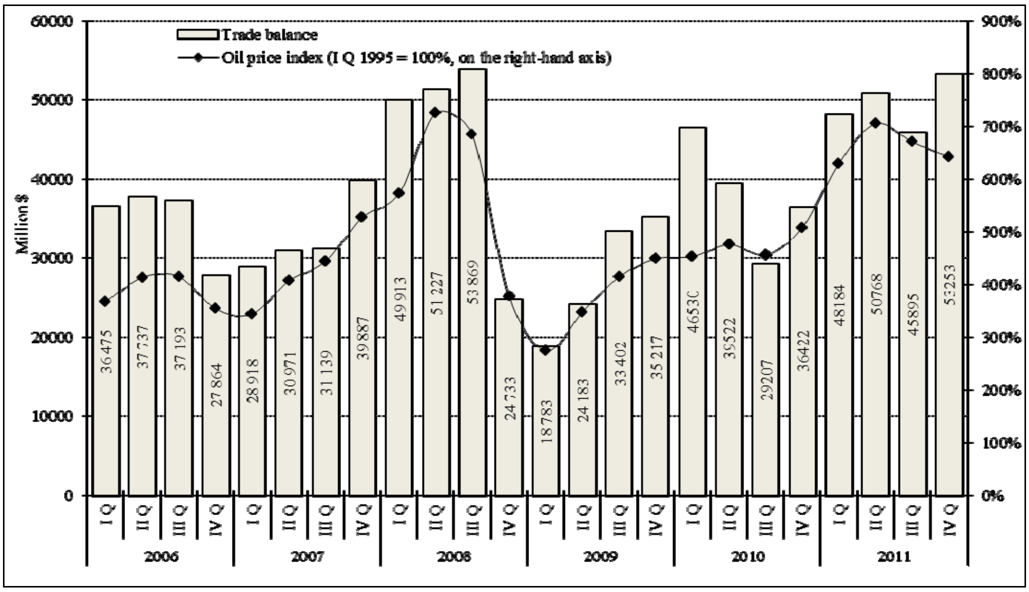
[1] According to the information of the Central Bank of Russia, the current transfers increase the level of the disposable income and consumption of goods and services on the part of recipients and decrease the disposable income and potential consumption opportunities of the donor, for instance, humanitarian aid in the form of consumer goods and services. The current transfers are recorded in the current account. Transfers which are not current by definition are capital ones. Capital transfers result in changes in the volume of assets and liabilities of the donor and the recipient and are recorded in the capital account. If the donor and the recipient are residents of different countries the capital transfer results in a change in the level of national wealth of the economies they represent. An example of capital transfers may be a free of charge transfer of the title to property to capital assets and debt forgiveness.

Table 4

The main items of the balance of payments and the dynamics of the foreign debt in the 2009–2011 period (billion $)

Index	2009					2010					2011				
	I Q.	II Q.	III Q.	IV Q.	*Year*	I Q.	II Q.	III Q.	IV Q.	*Year*	I Q.	II Q.	III Q.	IV Q. [1]	*Year* [2]
Current account	9.7	8.0	15.1	15.9	*48.6*	33.6	18.5	5.5	12.7	*70.3*	31.2	21.9	18.4	29.6	*101.1*
Capital and financial instruments account [3]	-32.4	3.3	-26.7	12.2	*-43.5*	-11.6	9.2	-6.6	-16.5	*-25.5*	-15.9	-8.7	-20.2	-30.5	*-75.3*
Change in the foreign exchange reserves ("+" means reduction, while "-", growth in the reserves)	30.5	-14.2	9.1	-28.8	*5.1*	-16.6	-26.1	-2.7	8.6	*44.8*	-10.1	-12.9	1.8	8.6	*-12.6*
Net errors and omissions	-7.8	2.9	2.6	0.6	*-1.7*	-5.5	-1.6	3.8	-4.8	*-8.0*	-5.2	-0.3	0.1	-7.7	*-13.1*
Change in the external debt of the RF ("+" means growth, while "-", debt reduction)	19.1	51.5	6.3	-60.3	*16.6*	-34.2	19.6	7.9	-6.7	*-13.3*	20.7	29.2	-11.8	11.9	*50.0*
Change in the external public debt of the RF	0.2	-1.5	-2.0	-3.7	*-7.1*	-2.4	4.1	9.4	2.5	*13.7*	1.3	0.0	-2.7	0.0	*-1.3*
Change in the external private sector debt of the RF	19.0	53.0	8.4	-56.6	*23.7*	-31.8	15.5	-1.5	-9.2	*-27.0*	19.4	29.2	-9.1	11.8	*51.3*

Source: The Central Bank of Russia.



Source: The Central Bank of the Russian Federation, ICE Stock Exchange and the IEP calculations.

Fig. 7. Trade balance of the Russian Federation and the global oil price index in 2006–2011

[1] Preliminary evaluation.
[2] Preliminary evaluation.
[3] Without taking into account foreign exchange reserves.

In 2011, capital and financial instruments account balance grew considerably in absolute value and amounted to $75.3bn. In 2011, the balance of capital transfers amounted to $0.1bn. So, in 2011 the deficit of the financial account amounted to $75.2bn.

Growth in liabilities of Russian economic agents to foreign economic agents amounted on a year-on-year basis to $ 65bn which figure is 50% higher than the index of the previous year ($ 44.4bn).

In 2011, external liabilities of federal regulatory authorities rose by the mere $ 0.3bn, while the reduction in external liabilities by the constituent entity of the Russian federation amounted to $0.8bn. A reduction in liabilities of monetary regulation authorities did not exceed $0.3bn.

In 2011, liabilities of the non-financial sector of the Russian Federation to non-residents increased by $58.2bn as compared to + $24.9bn in 2010. Consequently, foreign investors believe that investments in Russia are quite attractive with the existing level of return. Noteworthy, in 2011 direct investments into the non-financial sector amounted to $48.5bn as against $37.8bn in 2010, while portfolio investments decreased by $4bn ($5.1bn a year before). In 2011, the volume of the loan debt of the non-financial sector to non-residents increased by $15bn.

In 2011, it is to be noted that the liabilities of the banking sector to non-residents rose by $7.6bn, while in 2010 the growth in liabilities of the banks exceeded $17.6bn. The main factor behind the slower growth in liabilities was the reduction in the value of the attracted loans from $19.3bn in 2010 to $11.8bn in 2011. Taking into account the high demand of Russian banks in resources of the Central Bank of Russia and the non-financial sector of the Russian Federation, such a dynamics of liabilities points to difficulties of Russian banks in attraction of external financing which situation can be explained by the fact that investment in the financial sector worldwide is becoming less attractive.

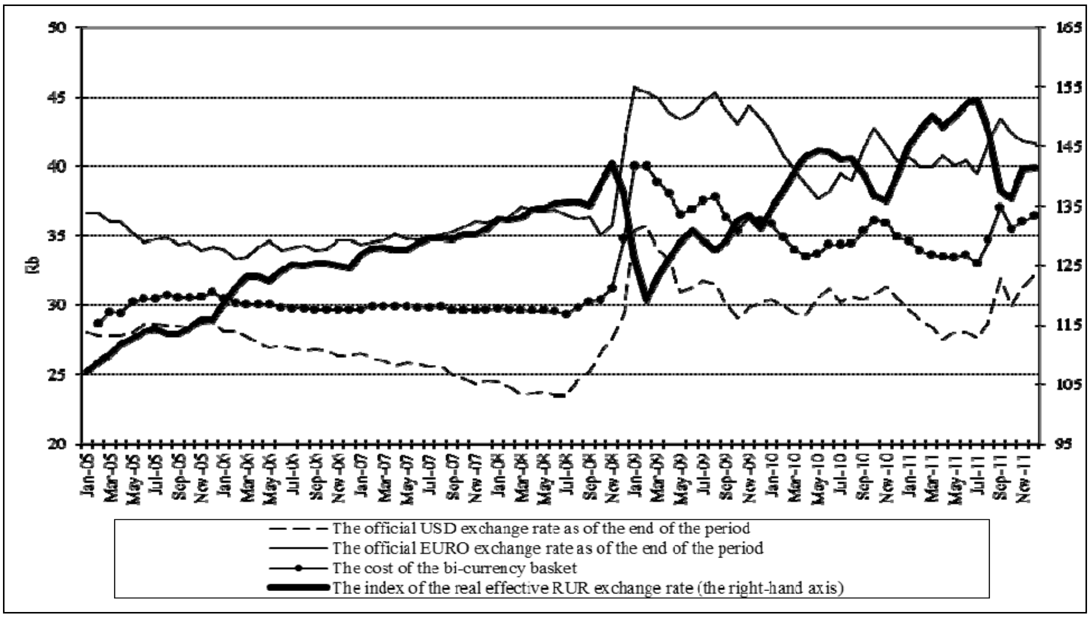
In 2011, foreign assets of residents (foreign economic agents’ liabilities to Russian economic agents) rose by $140.2bn (in 2010, by $70bn.). It is to be noted that foreign assets of monetary regulation authorities virtually did not change, while those of federal regulatory authorities rose by $2.6bn.

In 2011, foreign assets of the banking sector increased by $33.8bn. It is to be noted that growth in Russian banks’ loans and deposits provided to foreign economic agent accounted for $25.5bn of the above amount. In 2010, growth in foreign assets of Russian banks amounted to $1.8bn.

As compared to 2010, the outflow of capital from the sector of non-financial enterprises and households rose by 54% and amounted to $103.8bn of which amount direct and portfolio investments accounted for $70bn. ($19bn more than in 2010). Households and the non-financial sector reduced their investments into cash foreign currency whose volume of import to Russia amounted to $2.7bn.

In 2011, the situation on the foreign exchange market of the Russian Federation was determined by the inflow of the foreign exchange into the country through the current account with a simultaneous outflow of funds in the capital and financial instruments account. As was stated below, the Central Bank of Russia reduced to a great extent its interference in the functioning of the foreign exchange market by permitting the ruble exchange rate to be formed mainly under the impact of market factors and limited its role to smoothing of sharp fluctuations of the exchange rate. In the first six months, the ruble appreciated both in nominal and real terms under the impact of the considerable trade balance surplus despite the large outflow of capital. However, in August-October a considerable depreciation of the exchange rate took place and it was justified by a decrease in the current account balance due to a drop in prices on energy carriers and growth in the outflow of the capital from Russia as a result of worsening of the global economic situation.

Generally, in January-December the real effective exchange rate of the ruble grew by the mere 4.7% (at year-end 2010 it was +9.6%) and by the end of the year remained at the level of the mid-2008 (see *Fig. 8*). In 2011, the official USD/RUR exchange rate grew by Rb 1.72: by the end of December the USD exchange rate amounted to Rb 32.20 against Rb 30.48 as of December 31, 2010. It is to be noted that the ruble depreciated against the bi-currency basket[1]: in the same period the cost of the bi-currency basket appreciated by Rb 1.55 from Rb 34.91 to Rb 36.46. Late in December the Euro/RUR exchange rate amounted to Rb 41.67 and increased by Rb 1.34 on a year on year basis.



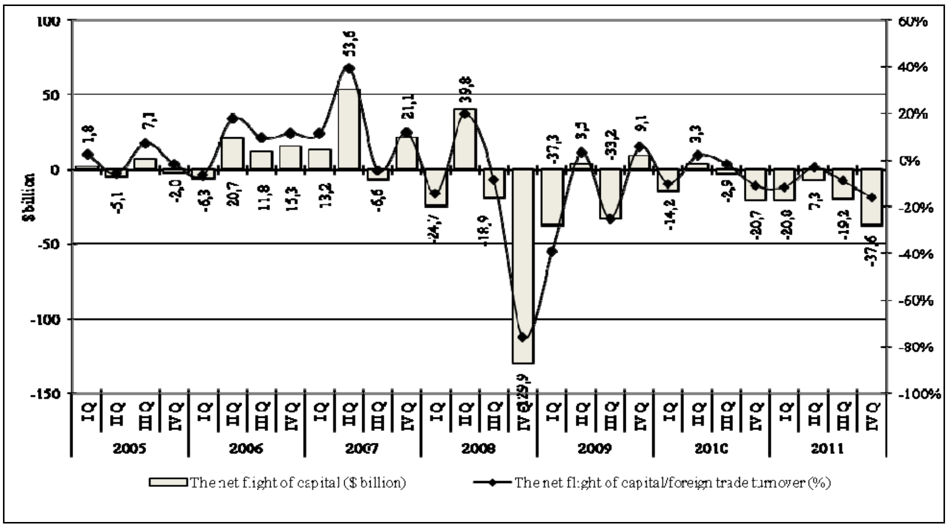
Source: The Central Bank of the Russian Federation and the author's calculations.

Fig. 8. Indices of the RUR exchange rate in January 2005 – December 2011[2]

In 2011, the situation with the balance of payments developed in such a way that on a year on year basis the RUR exchange rate both in nominal and real terms did not change much with virtually no interference by the Central Bank of Russia into functioning of the foreign exchange market. In other words, the situation was favorable to the Bank of Russia and permitted it to switch over to the inflation targeting regime with absence of fundamental changes in the RUR exchange rate. At the same time, the Central bank of the Russian Federation let the RUR exchange rate depreciate in August-October, however, thanks to growing surplus of the balance of payments at the end of the year the RUR exchange rate started to grow again.

[1] Bi-currency basket is an operating benchmark of the Central Bank of the Russian Federation in carrying out of the foreign exchange policy. At present, the share of the Euro in the basket amounts to 45%, while that of the USD, to 55%.
[2] The level of January 2002 is equal to 100.

In 2011, a trend which determined the dynamics of the balance of payment was the dynamics of the net flight of capital from the non-financial sector; on a year on year basis the capital flight amounted to $85bn (in 2010 it amounted to $34.5bn) (see *Fig. 9*). It is to be noted that the flight of capital was observed throughout the year: the minimum flight of capital was registered on the basis of the results of the 2nd quarter (– $7.3bn), while the maximum one, on the basis of the results of the 4th quarter (– $37.6bn). The factor behind the flight of capital was in all appearances the prevalence of high economic and political risks related to investment in the Russian Federation with a level of return comparable to that in other developing countries.



Source: The Central bank of Russia; the IEP calculations.

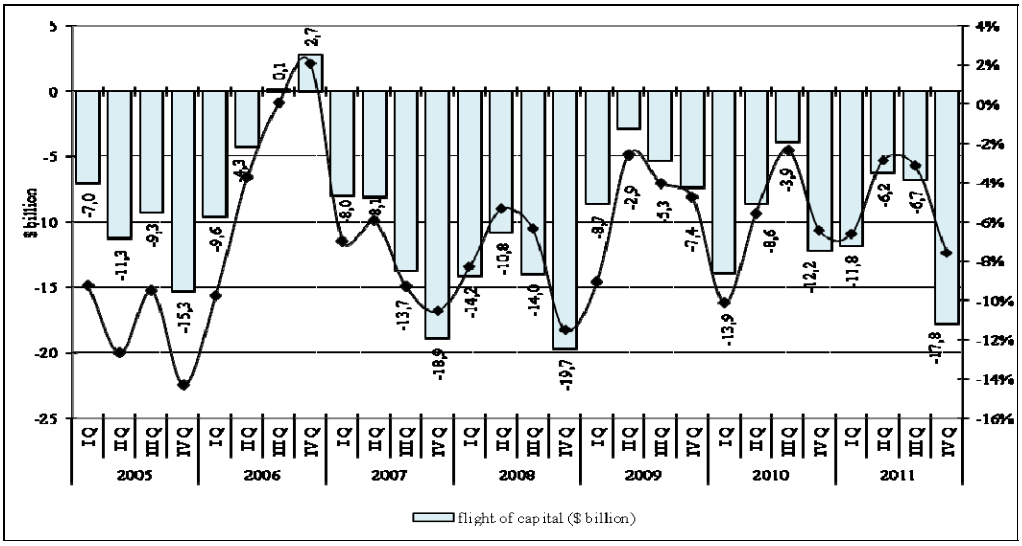
Fig. 9. The dynamics of the net flight of capital in 2005–2011

Another evidence of the unfavorable situation with the inflow of capital is the speed-up of the so called capital flight[1] in 2011. According to our evaluations, in 2011 the flight of capital (*Fig. 10*) amounted on a year on year basis to $ 42.6bn which figure is $ 3.9bn higher than in 2010.

Summing up the result of the analysis of the balance of payments, it is to be noted that in general the insignificant total balance of payments is favorable to the Russian economy as it contributes both to stability on the foreign exchange market and sustained development of the financial system. At the same time, due to the fact that the current account of the balance of payments of the Russian Federation depends to a great extent on the export of several commodities the existing situation with the balance of payments is unlikely to be stable in the long-term prospect due to the unpredicted dynamics of prices on energy carriers and, consequently, the situation of the Russian foreign trade. As regards the capital and financial instruments account balance the flows of capital both to and from Russia are likely to remain quite volatile due to, among other things, uncertainty about the global economic development. However, in case of absence of efforts by the Government of the Russian Federation to reduce

[1] The capital flight was calculated on the basis of the IMF methods and represents the amount of "trade loans and advance payments", "export revenues which failed to be received timely and goods and services which failed to be delivered against remittance of funds under import contracts" and "net errors and omissions".

investment risks in the Russian Federation with all other things being equal (primarily, in case of stability of prices on energy carriers) the inflow of private capital to the country can hardly be expected on the basis of the results of 2012.



Source: The Central Bank of the Russian Federation, the IEP calculations.

Fig. 10. The dynamics of the flight of capital in the 2005–2011 period

2.2. State Budget

Throughout 2011, it still was a favorable state of affairs in the foreign economic area which was a major driver of increase in budget revenues: international carbohydrate prices proved at one-third above the projections made while crafting the draft federal budget for 2011-13. As well, the revenue part of the budget found itself under spurred by increasing business activity which manifested itself in the economy's growth rates notably outpacing the earlier anticipated ones (the 2011growth in GDP was projected at a level of 3.4%, while Rosstat's preliminary estimates suggest it actually accounted for 4.3%).

There also were other factors fueling the increase in budget revenues: arrears before the budget system were down 12% on a year-on-year basis and hit their lows over the past 7–8 years; wage arrears were also down from Rb 2.4bn in 2010 to 1.8bn in 2011; the registered unemployment rate slid by 10.9%.

At this juncture, even the pre-election boost to expenditure obligations failed to "overweight" the increase in the revenue part of the budget. Thanks to that, at the federal level, the 2011 budget posted a surplus, while the public debt remained under 9.6% of GDP. However, many expenditure obligations are deferred and going to manifest themselves in full only in 2012.

So, on the one hand, against a miserable global economic backdrop (the EU member states sharing a -6.2% deficit of the Eurozone's aggregate budget, the US suffering from a deficit of -9.6% of GDP and Japan a deficit of -10.3% of GDP) and a huge public debt (over 80% of GDP across the Eurozone, 69% of GDP – in the US and 208% of GDP – in Japan[1]) Russia's economy appears pretty healthy; however, on the other hand, more and more pre-election ob-

[1]CIA – Central Intelligence Agency.

ligations and expenditure vows were made (e.g. the decision to raise military and law-enforcement agencies personnel's pay proved very costly; meanwhile, the government is facing the challenge of footing the bill for indexation of the social and the public sectors employees' pay) compels one to reassess risks and consequences of the said managerial decisions from the perspective of the national budget system's sustainability.

2.2.1. The General Characteristic of the Budget System of Russian Federation

The 2011 dynamics of main parameters of the enlarged government budget exhibits retention of the trends launched in 2010 – namely, boosting revenues while constraining budget expenditures relative to GDP (see *Table 5*).The 2011 revenue volume to the enlarged government budget accounted for 38.4% of GDP, or up 2.9 p.p. of GDP vis-à-vis the 2010 level. The volume of federal budget revenues hit 20.9% of GDP, or 2.5 p.p. up compared with 2010. The increase was fueled mostly by oil-and-gas revenues boosted by a favorable foreign economic situation. In 2011, international prices of Urals stabilized at a level of USD 109/b (in 2010- USD 78/b) under a 30.3% expansion of foreign trade turnover calculated by the balance-of-payments methodology[1]. In 2011, the recovery of the industrial output continued to advance, with the index of industrial output accounting for 104.7%. The share of the federal budget revenues in overall revenues to the enlarged government budget posted a slight growth on a year-on-year basis – from c 51.8% in 2010 up to 54.5% in 2011.

Table 5

Revenues to and Expenditures of the Budgets in 2008–2011

	2011		2010		2009		2008		Bias in p.p. of GDP, 2011 vs. 2010
	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	
Federal budget									
Revenues	11 365.9	20.9	8305.4	18.4	7337.7	18,9	9275.9	22.5	+2.5
Expenditures	10 935.2	20.1	10 117.5	22.4	9660.90	24.9	7570.8	18.3	–2,3
Deficit(–) / Surplus(+)	+430.7	+0.8	–1 812.1	–4.0	–2322.3	–6.0	1705.0	+4.1	+4.8
Consolidated budgets of RF Subjects									
Revenues	7643.9	14.1	6537.3	14.5	5926.6	15.3	6253.1	15.1	–0.4
including interbudgetary transfers	1644.0	3.0	1398.9	3.1	1487.4	3.8	1132.6	2.7	–0.1
Expenditures	7679.3	14.2	6636.9	14.7	6255.7	16.1	6253.5	15.1	–0.6
Deficit(–) / Surplus(+)	–35.4	–0.1	–99.6	–0.2	–329.0	–0.8	–54.4	–0.1	+0.1
The enlarged government budget									
Revenues	20 853.6	38.4	16 031.9	35.5	13 599.7	35.0	16 169.0	39.2	+2.9
Expenditures	20 004.8	36.8	17 616.6	39.0	16 048.3	41.3	14 157.0	34.3	–2.2
Deficit(–) / Surplus(+)	+848.8	+1.6	–1584.7	–3.5	–2448.6	–6.3	+2012.0	+4.9	+5.1
For reference: GDP, as Rb bn	54 369		45 166		38 809		41 277		–
Increase in Russia's public debt (including issued government guarantees) over the year	+1190.3	+2.2	+921.9	+2.0	+583.1	+1.4	+289.6	+0.7	–

Source: Rosstat, the RF Ministry of Finance, IEP calculations.

[1]At year-end 2010 Russia still was one of the largest exporters, after China, Germany and Japan, in the CIA Sovereignty Rating which is based on assessment of current external balance.

At year-end 2011 the RF Subjects' consolidated budgets received Rb 7,643.9 bn in revenues (14.1% of GDP), or 0.4 p.p. of GDP down compared with the prior year (14.5% of GDP), which should be ascribed both to a drop in revenues noted across most tax and non-tax revenues, as well as a fall in the volume of interbudgetary transfers (by 0.1 p.p. of GDP). An alarm bell was the fact that the last year saw the lowest level of collection of tax revenues to the RF Subjects' consolidated budget since 2008. The fall was most intense with respect to the corporate profit tax (by 0.3 p.p. of GDP), PIT – 0.2 p.p. of GDP, property tax - 0.2 p.p. of GDP. Transport tax revenues remained at a level of 0.1% of GDP thanks to greater contributions by private individuals, while amounts collected from corporate taxpayers were down. In all, the share of tax revenues in the aggregate volume of the RF Subjects' consolidated budgets shrank by 1.2% vs. the previous year's figures.

As to non-tax revenues, when compared with the 2010 figures, there was noted a decline in asset management revenues to the RF Subjects' budgets equivalent to 0.1 p.p. of GDP. At this point, exacerbation of asset management problems at the regional level is quite visible, as collection of the revenues in question was supposed to increase due to annual investment by the Subjects' budgets in creation of state property objects equivalent to up to 2.0% of GDP. Meanwhile, the other non-tax revenues remained unchanged since 2010.

Despite a two-year-long tendency to increase in revenues to Russia's budget, the nation failed to clear the pre-crisis bar of revenues to the enlarged government's budget (39.2% of GDP in 2008). Meanwhile, the enlarged government budget expenditures were being trimmed consistently: from 41.3% of GDP in 2009 to 36.8% of GDP in 2011, or 2.2 p.p. below the 2010 figures, but still above (2.5p.p. of GDP) the pre-crisis 2008 level. That said, expenditure cuts were uneven across the tiers of the budget system: thus, in 2011, federal budget expenditures were slashed by 2.3 p.p. on a year-on-year basis and made up Rb 10, 935.2bn (20.1% of GDP), while expenditures of the RF Subjects' consolidated budget slid by 0.6 p.p. of GDP vs. the previous year's figures and accounted for Rb 7,679.3bn (14.2% of GDP).

The decline in the volume of the budget system's expenditures can be partly ascribed to low pace of spending throughout the year. For example, by results for the first 8 months of the year, expenditure-wise, cash execution of the federal budget was 58.4%, while that of consolidated budgets of RF Subjects – 51.7%. The last month of the year saw spending of some 20% of all the federal budget outlays (in 2010 г. – 17.7%, in 2009 – 15.0%).

At year-end, the situation with cash execution of the federal budget and consolidated budgets of RF Subjects was as follows (see *Table 6*).

Table 6

Cash Execution of the Federal Budget and the RF Subjects' Consolidated Budget in 2010–2011

	Federal budget				RF Subjects' consolidated budget			
	2011		2010		2011		2010	
	Commitments, as Rb. bn	Cash execution, %	Commitments, as Rb. bn	Cash execution, %	Commitments, as Rb. bn	Cash execution, %	Commitments, as Rb. bn	Cash execution, %
1	2	3	4	5	6	7	8	9
Expenditures, total including	11 126.0	98.3	10 301.5	98.2	8400.7	91.4	7175.1	92.5
Non-excludable costs	815.0	96.6	990.3	89.4	510.8	91.8	523.1	92.0
National defense	1524.4	99.5	1288.8	99.1	3.6	95.9	3.3	97.0
National security and law-enforcement activities	1258.1	100.0	1094.6	99.2	291.3	96.8	260.5	97.5
National economy	1861.7	96.2	1253.3	97.5	1485.5	88.6	1256.7	87.8
Public utilities sector	282.9	98.9	236.9	99.2	1335.8	72.5	974.4	85.8

cont'd

1	2	3	4	5	6	7	8	9
Environmental protection	17.8	98.9	13.5	100.0	24.0	90.8	16.5	89.7
Education	556.0	99.5	444.8	99.5	1791.3	96.5	1497.5	96.9
Culture, motion picture industry, mass media	86.9	96.0	126.4	99.2	282.9	95.1	240.1	94.9
Health care, physical culture, sports	513.0	97.3	356.8	97.5	1502.0	89.1	853.5	93.4
Social policy, pension system	3185.9	98.2	346.9	99.4	1273.8	93.6	1237.5	94.3

Source: the RF Ministry of Finance, the IEP calculations.

Despite the national leadership's regular calls to improve payment discipline, the situation with cash execution of the federal budget remained practically unchanged, while in the case of the RF Subjects' consolidated budget it even exacerbated, with the budget having been executed, expenditure-wise, only by 91.4% (92.5% in 2010). In terms of functional sections the worst performance in executing consolidated budget expenditures over recent years was noted across the following sections "Public utilities sector", "National economy", "Health care, physical culture and sports". Factors behind a low dynamic of spending of budget funds are: inclusion in the Budget Act of costs of construction of objects not backed with necessary documents and materials (approved in accordance with the established procedure design documentation on capital construction objects, decisions to make budget investments in the frame of the approved federal target program, etc.) and, according to the RF MinFin, the launch of the system of open e-auctions in the course of placement of public orders, which required setting up an e-document flow system.1.

At year-end 2011 the enlarged government budget was executed with a surplus of 1.6% of GDP thanks to a positive balance of execution of the federal budget (+0.8% of GDP) and budgets of extrabudgetary funds (+0.8% of GDP), including a surplus of the Pension Fun totaling 0.6% of GDP. To ensure the budget balance of the Pension Fund of Russia's budget, during the year, the government injected therein Rb 924.4bn out of the federal budget (1.7% of GDP), while the gap between pension insurance premiums collected into the Pension Fund and payments of the labor and savings parts of pension, less other expenditure items of PFR, accounted for 2.7% of GDP2.

The consolidated budget of RF Subjects was executed with a negligible deficit (–0.1% of GDP). According to data as of 1 January 2012, as many as 57 RF Subjects executed their regional budgets with deficit. Atop the list of such Subjects were the Republic of Tatarstan, Samara oblast and Krasnodar krai.

According to the RF MinFin, the volume of the public debt (with account of issued government guarantees) posted an insignificant increase – from 9.2% of GDP as of late 2010 up to 9.6% of GDP as of 01.01.2012. The major driver behind the surging public debt was the soaring volume of domestic debt – by 1.2p.p. of GDP, up to 7.7% of GDP. By contrast, the volume of foreign debt was down 0.8p.p. of GDP. It should be noted that the ballooning of public debt under a budget surplus (see *Table 5*) is explained by peculiarities of the national budget law. The fact of the matter is that according to Art. 184.2. of the Budget Code of Russian Federation, along with the bill on the budget the government should submit a draft program of borrowings for next financial year. Meanwhile, in accordance with the schedule approved in the beginning of the financial year, a public offer of government bonds is run

[1] http://bujet.ru/article/121904.php
[2] For details, see Section 2.3.

proceeding from the ongoing situation on financial markets, regardless of an actual securing of current expenditures and cash balances. Hence, focus on the current budget balance does not always seem justified in a situation of a continuous anticipation of the budget deficit by the end of the year.

Meanwhile, in anticipation of revenues above the budget projections and of a budget surplus, the MinFin has the right to make decisions to cut back on volumes of borrowings, which may be implemented in the form of an actual suspension or reduction of volumes of bond placements and redemption of earlier placed bonded loans. The Ministry used the right to implement all the planned bond issuances and, consequently, instead of the set in the budget act marginal debt volume of 13.7% of GDP, as of late-2011, the actual figure remained under 10% of GDP.

During the 11 months 2011, the volume of RF Subjects' public debt shrank by Rb 34.1 bn and made up Rb 1,071.9bn (2.0% of GDP). The biggest contraction in the public debt was noted in Moscow oblast (Rb 50bn), the city of Moscow (Rb 36bn). Meanwhile, the figures were on the upsurge in 40 Subjects of RF, with the biggest one – Rb 23bn – reported by the Republic of Tatarstan.

So, while certain positive trends continued to unfold in the nation's budget system in 2011 (e.g. rise in revenues along with a concurrent slashing of expenditure and the enlarged government budget once again in the black), symptoms of challenges to the budget system's stability exacerbating are there. We believe the most critical risk in this regard is the continuous high reliance of budget revenues on the state of affairs on the global markets for energy sources. As a consequence, the budget surplus becomes attainable only under extremely high oil prices. Our estimates show that in 2011 the structural component of revenues to the budget system of RF which takes place under an average long-standing oil price (USD 67/b.) accounted for 32.4% of GDP. This means that with regard to the amount of budget expenditures (36.8% of GDP) the 2011 structural deficit made up 4.4% of GDP.

A critical challenge facing the budget system is a broad employment of opaque and uncompetitive conduits, as far as channeling budget resources to contractors is concerned, which manifests itself in a high proportion of use of subsidies. By contrast, developed nations vigorously employ more transparent procurement procedures (across OECD nations, an average 18% of GDP is assigned through public procurement procedures vs. 10-11% in Russia). Clearly, given a sizeable budget sector, the use of subsidies as an instrument of financing the public order for public institutions appears a justified move; however, their vigorous employment to support the real sector[1] is, in our view, an unjustified measure and should be reduced just to individual cases of subsidizing interest rates on loans to agrarian producers and the framework of procedures of rehabilitation or an intense restructuring of backbone corporations.

Another example of employment of opaque budget instruments is contribution to corporate statutory capital (the 2011 spending on boosting stock and other forms of participation in equity capital on the federal level alone accounted for 0.8% of GDP, or 3.7% of the aggregate federal budget expenditures). Not only do investments in a corporation's authorized capital fail to guarantee a target spending of budget allocations for investment purposes, as the state

[1] More specifically, the volume of federal budget spending on subsidizing commercial organizations under the Section "National Economy" remained on a fairly high level: in 2011 – Rb 166.8bn (0.3% of GDP), in 2010 – Rb 175.7bn (0.4% of GDP).

may not directly determine directions of their use, but they engender a conflict between the government's mission to become an arbiter in economic relations and its interests as a stockholder of a given enterprise. Whereas the main advantage of the instrument in question is acquisition of the right to participate in managing the economic agent's operations, we believe that it should be appropriate to limit the practice of contributing to corporations' authorized capital (i.e. a de-facto irrevocable financing) to economic companies with the 100% government participation. That said, while investing in their authorized capital, the government's interest should lie in control over the economic agent's long-term strategy, rather than in implementation of a concrete investment project.

Another recently noted distinctive feature of the state budget became implementation of huge construction projects (eg. the 2014 Olympics, the APEC Summit 2012, the World Cup-2018). They have put a mounting pressure on the federal budget, while effectiveness of such costs does not appear evident.

Thus, reserves to bolster efficacy of budget spending should be sought in a change of the whole system of budget spending control mechanisms and approaches to selection of funding priorities.

2.2.2. Analysis of Revenues from Major Taxes into the Budget System of RF

In 2011, the tax burden was up 12%, resulting both from a favorable foreign economic environment and, accordingly, increase in the oil-and-gas revenues, and improvement of business activity and rise of consumption in Russia's economy, which entailed an increase in collection of corporate profit tax and VAT vs. the prior year.

Table 7

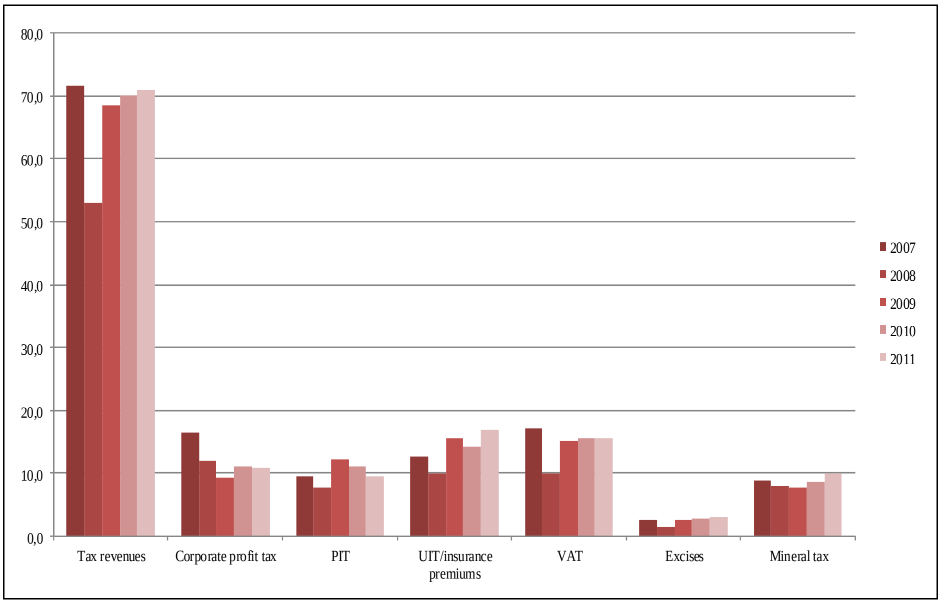
Revenues from Major Taxes into the Budget of the Enlarged Government of Russian Federation in 2007–2011, as % of GDP

	2007	2008	2009	2010	2011	Change in 2011 relative to 2010	
						As p.p. of GDP	in 2011 prices, %
Level of tax burden	36.1	35.7	30.8	31.9	35.8	3.9	16.9
Corporate profit tax	6.6	6.1	3.3	3.9	4.2	0.3	10.9
PIT	3.8	4,0	4.3	4,0	3.7	–0.3	–3.4
UIT/insurance premiums*	5.1	5.1	5.5	5.0	6.5	1,4	34.2
VAT	6.9	5.1	5.3	5.5	6.0	0.4	12.8
Excise taxes	1.0	0.8	0.9	1.0	1.2	0.2	24.8
Mineral tax	3.6	4.1	2.7	3.1	3.8	0.7	29.1
Customs duties and fees	7.3	8.6	6.8	7.0	8.5	1.5	27.1

* Since 2010 UIT was transformed into insurance premiums collected directly to extrabudgetary funds.
Source: the RF Ministry of Finance, Rosstat, the IEP calculations.

The data presented in *Table 7* evidence that in 2011 the level of aggregate tax burden on the economy was practically back to the pre-crisis one. Meanwhile, as far as revenues from individual taxes are concerned, it can be noted that corporate profit-tax and VAT revenues remained at a level notably below the 2007 one, while those from PIT and the mineral tax were close to the 2007 level. In this context, due to the rise of their rates, insurance premiums (earlier known as UST) secured revenues equivalent to 6.5% of GDP vs. 5.1% of GDP in 2007, but posted an disproportionally lesser increase vis-à-vis the rise of the rates, nonetheless. Let us consider in every detail the situation with collection of main taxes.

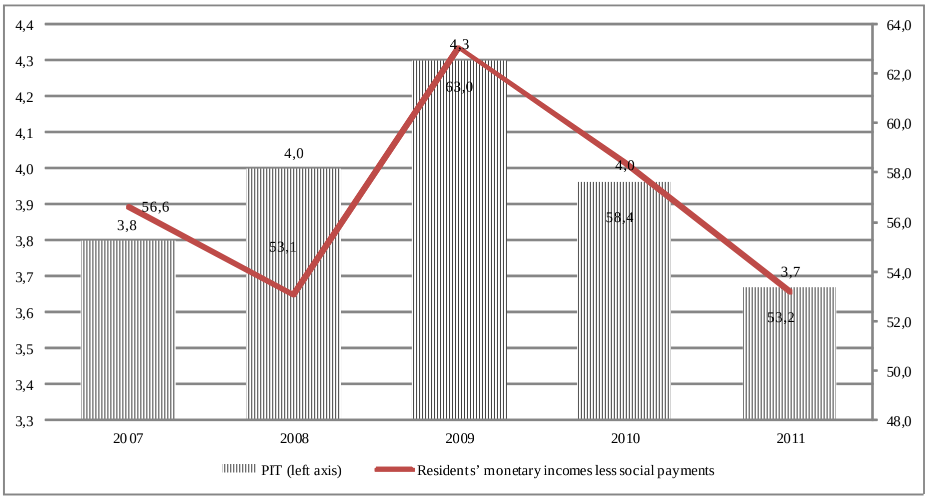
The structure of tax revenues to the enlarged government budget is presented in *Fig. 11*. It was PIT which proved to be the only tax that posted a clearly negative dynamic in 2011.



Source: FTS of RF.

Fig. 11. Proportion of Tax Revenues in Aggregate Revenues to the Enlarged Government Budget in 2007–2011, %

The fall in question should be attributed to its shrinking tax base: the main indicator which characterizes the dynamic of the PIT tax base – namely, the residents' monetary incomes less social payments – tumbled from 58.4% of GDP in 2010 to 53.2% of GDP in 2011 (see *Fig. 12*).



Source: FTS of RF, Rosstat.

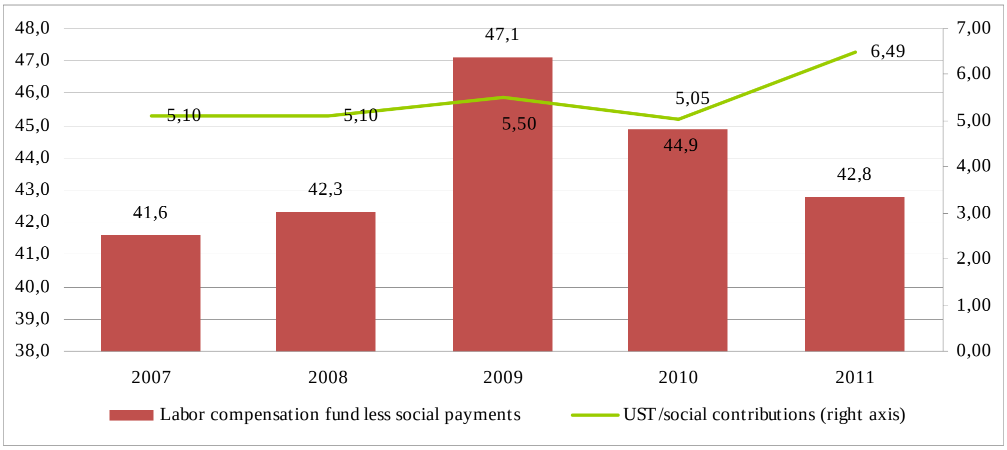
Fig. 12. Dynamics of PIT Revenues to the Budget System of RF and Residents' Monetary Incomes less Social Payments in 2007–2011, as % of GDP

The main factor driving the PIT tax base downwards in 2011 became the increase in social contributions rates, including the raising of the basic rate from 26% to 34% in particular.

According to surveys run by OPORA Rossii[1], in 2011, small- and medium-sized businesses responded to the move by:

1) using various mechanisms to diminish amounts of insurance premiums (paying a part of salaries "in envelopes", etc.) (83% of the surveyed);
2) abandoning earlier planned pay rises or cutting down salaries (90% of the surveyed);
3) dropping plans to expand operations (equipment modernization, other investment in development) (83% of the surveyed).

As a result, being a major component of the PIT tax base[2], the labor compensation fund, less social contributions, plunged in 2011 by 2.1 p.p. of GDP (see *Fig. 13*), which in turn explains a 0.3 p.p. of GDP fall in PIT revenues in 2011 vs. the 2010 figures. By contrast, the volume of collection of social contributions surged by 1.44 p.p. of GDP, as the effect from the increase of their rates proved far in excess of consequences from the shrinkage of the tax base.



Source: FTS of RF, Rosstat.

Fig. 13. The Dynamic of Collection of UST/Social Contributions vs. the Dynamic of the Labor Compensation Fund less Social Contributions 2007–2011, % of GDP

Preferential insurance premium rates were foreseen for a closed list of taxpayer categories, which decreased the effective taxation rate on the whole:

1) for self-employed, attorneys-at-law and notaries – 31.1%;
2) for domestic corporations and self-employed individuals involved in production and publication of printed media, UST payers producing food staffs, footwear, rubber and plastic items, furniture, means of transportation, equipment, etc. – 26%;
3) for corporations operating in IT, economic companies established by public research institutions and universities after 13 August 2009; residents of special R&D economic zones, participants in the Skolkovo project – 14%.

[1] http://opora.ru/legal/analysis/research/polls/#survey/25/

[2] According to Rosstat data, in 2008-11 the share of labor compensations in residents' incomes less social contributions was steadily at a level of 78–83%.

According to the RF MinFin, the overall volume of revenue shortfalls by exemptions and benefits accounted for some Rb 300bn, or some 9% of the 2011 aggregate volume of revenues from insurance contributions.

As to oil-and-gas budget revenues, they posted a notable growth compared with 2010 (see *Table 8*). More specifically, the year of 2011 saw a 0.7p.p. of GDP surge in tax revenues from the mineral tax, fueled both by a notable rise of the tax rate on natural gas and a favorable state of affairs on the global market for energy sources (the 2011 average price of Urals was USD 109.6/b vs. 78.1 in 2010).

That said, despite soaring natural indicators of oil production and a significant price rise for oil, the 2011 level of mineral-tax withdrawals proved to be below the 2008 one. This can be ascribed, first, to the raising in 2009 of the non-taxed threshold with regard to the mineral tax from USD 9/b to USD 15/b and, second, to introduction in the same year of the decreasing coefficient to the mineral tax rate at fields with a high degree of depletion of reserves.

Table 8

Volume of Oil-and-Gas and Mineral-Tax Revenues in 2008–2011

	2008	2009	2010	2011
Oil-and-gas revenues, % to GDP	10.6	7.7	8.6	11.0
Mineral tax, % to GDP	4.1	2.7	3.1	3.8
Oil output, including gas condensate, m.t.	488	494	507.2	509.4
The average annual price level for Urals, USD/b.	94.0	60.7	78.1	109.6

Source: Rosstat, FTS of Russia, IEP calculations.

The price rise for energy sources and growth in output had a positive effect on the dynamic of export duties on energy sources. In 2011, the aggregate revenues from export of energy sources practically caught up with their 2008 level (see *Table 9*). The share of export duties on energy sources in the overall amount of tax duties was oscillating around 76-78% over the period between 2008 and 2011.

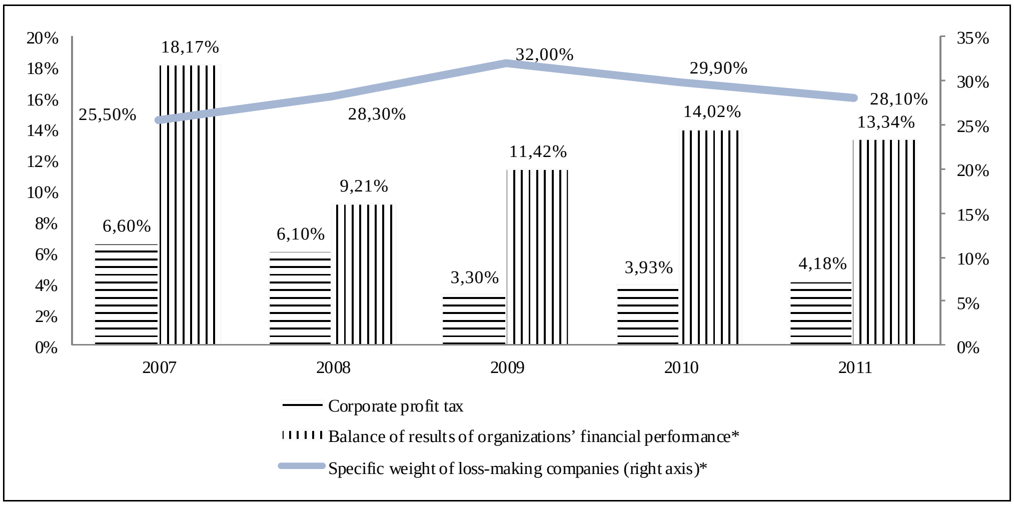
Table 9

Collection of Customs Duties in 2008–2011, as % of GDP

	2008	2009	2010	2011
Export duties on:				
– crude oil	4.3	3.1	3.7	4.3
– natural gas	1.2	1.1	0.4	0.7
– goods manufactured of oil	1.3	1.0	1.3	1.7
Customs duties and fees, total	8.6	6.8	7.0	8.5

Source: Rosstat, the Federal Treasury data, the IEP calculations.

As concerns non-oil-and-gas revenues, those from the corporate profit tax were on the rise primarily because of a more robust business activity in Russia. Specifically, the specific weight of loss-making organizations in the economy was down, while net balance of corporate financial performance (less small-sized businesses) in shares of GDP equivalent was up compared with the same period of 2010, thus evidencing the expansion of the corporate profit tax (see *Fig. 14*). As a result, the 2001 corporate profit-tax revenues stood at 4.2% of GDP, or at 0.3 p.p. of GDP above the prior year's level.



* According to preliminary estimates by Rosstat.
Source: FTS of RF, Rosstat.

Fig. 14. Dynamic of Corporate Profit Tax Collection into the Budget System of RF, Balance of Corporations' Financial Performance and the Specific Weight of Loss-Making Enterprises in 2007–2011

Reinvigoration of Russia's economy also led to growth in volume of final consumption which forms the tax base of indirect taxation. Thus, in 2011, the tax base of VAT kept on reviving after its compression during the crisis period. That fueled an increase in collection of this tax up to 6.0% of GDP vs. 5.5% in the previous year. Yet another explanation of the increased collection of VAT is an improved quality of its administration: specifically, the 2011 VAT collection ratio[1] posted a 6 p.p. increase vis-à-vis the 2010 figure and hit the 53% level, thus basically having closed the gap with its pre-crisis values (See *Table 10*).

Table 10

Dynamic of Final Consumption, Import and VAT Collection in the Budget System of RF in 2005–2011, as % of GDP

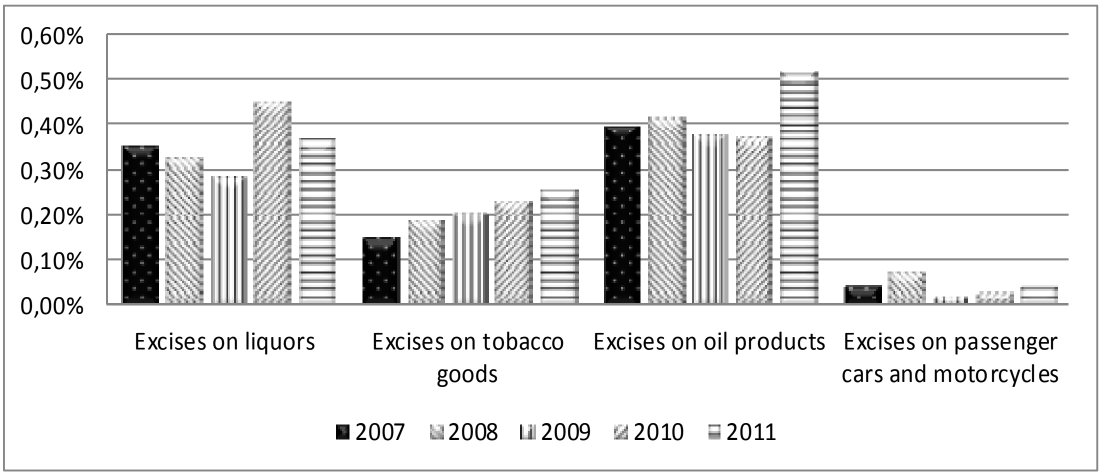
	2005	2006	2007	2008	2009	2010	2011
Revenues from VAT (less revenues from YUKOS)	6.17	5.62	6.13	5.17	5.28	5.53	5.98
VAT on goods sold within RF	4.11	3.44	3.51	2.42	3.03	2.94	3.23
VAT on goods imported in RF	2.06	2.18	2.62	2.75	2.25	2.59	2.75
Tax collection ratio, %	57.0	51.5	56.7	46.6	42.3	47.0	53.0
Import*	12.9	13.9	15.3	16.1	13.7	15.4	16.5

* The share of import in GDP was defined as the value of import data by the customs statistical data to the USD-equivalent GDP value ratio, on the basis of values of the average nominal USD/Rb nominal rate over the respective year.
Source: Rosstat, the RF Ministry of Finance, IET calculations.

[1]This index is calculated as $\dfrac{VAT\ receipts}{VAT\ rate\ x\,(final\ consumption)}$ and shows which share of the base (final consumption less the tax) is effectively taxed. A more detailed discourse on economic interpretation of the index in question can be found in: *Kazakova M., Knobel A., Sokolov I.* The Quality of VAT Administration in OECD Countries and Russia. Reforming the Russian System of Collection of the Tax/ed. by S.G. Sinelnikov-Murylev. M.: IET, 2010.

It is taxation of imported goods which still secures nearly a half (46%) of the structure of VAT collection. The figure remained at the previous year's level, which evidences a match between the dynamic of revenues from VAT on imported in RF goods and the dynamic of import of goods.

In 2001, revenues to the budget system from excise taxes were on the rise – from Rb 501.5bn to Rb 650.5bn in current prices, which in relative terms secured an increment equivalent to 0.2p.p. of GDP. It should be specifically noted that, as evidenced by *Fig. 15*, the increment in question was driven by soaring revenues from excise taxes on oil products (from 0.37% of GDP in 2010 to 0.52% in 2011). Collection of revenues from liquors and spirits plunged in relative terms (from 0.46% of GDP in 2010 to 0.37% of GDP in 2011), while revenues from taxation of sales of two other excised categories of goods stabilized at the 2010 level: the increase with respect to tobacco goods was negligible (from 0.24% up to 0.26% of GDP) and the same can be reckoned with respect to excise revenues from sales of passenger cars and motorcycles (up from 0.03% to 0.05% of GDP).



Source: FTS of RF.

Fig. 15. Collection of Excise Taxes over 2007–2011 by Groups of Excised Goods, as % of GDP

The rise in collection of excise taxes on oil products was caused by a fairly considerable raising of their rates – from 30 up to 100%, depending on a specific kind of the il product, vis-à-vis the 2010 level. The tax base changed insignificantly relative to the 2010 level, while oil-refining plants reported a 1.7% increase in shipments of gasoline, 0.9% – diesel fuel and 4.9% – of fuel oil.

The average value of indexation of excise rates with regard to tobacco products accounted for 17-43%, the one of excise rates for liquors – 12-23%. In 2011, consumption of all kinds of liquors changed insignificantly, while consumption of tobacco goods was in decline (see *Table 11*). The increase in excise rates for tobacco products compensated for the fall in the volume of their consumption, while a poorer administration of excise taxes on liquors, even under indexation of the rates above the inflation rate and the volume of consumption remaining on its 2010 level, resulted in the dynamic of collection falling behind the GDP one.

Table 11

Volume of Consumption of Liquors and Tobacco Goods in RF in 2005–2011

Type of product	2005	2006	2007	2008	2009	2010	2011
Liquors, as dcl m							
Vodka and liquors	203.5	197.2	184.6	177.2	166.1	157.8	159.0
Grape and fruit wine	84.9	81.1	94.9	102.9	102.5	103.4	103.0
Cognacs	6.8	7.6	8.9	10.8	10.6	11.1	12.0
Champaign and sparkling wine	19.4	20.6	24.1	26.0	25.5	27.3	29.8
Beer	892.1	1002.8	1155.3	1138.2	1024.7	1004.0	1077.5
(Russian cigarettes), bn. pcs	395.8	424.1	398.2	393.6	394.3	370.6	366.1

Source: Rosstat.

2.2.3. Budget System Expenditures

The year of 2011 saw expenditures contract by 1.7 p.p. of GDP vs. the prior year by section "Social policy" and by 0.1–0.2 p.p. of GDP across each of the following sections: "General public administration matters", "National security and law-enforcement activity", "Housing and utilities", "Education" and "Culture, motion picture industry, and mass media" (see *Table 12*).

Table 12

Expenditure of the Enlarged Government Budget in 2008–2011, as % of GDP

	2011	2010	2009	2008	2011 figures bias from 2010, p.p. of GDP
EXPENDITURE	36.8	39.0	41.3	34.3	–2.2
General public administration matters*	2.5	2.6	2.8	2.7	–0.1
National defense	2.8	2.8	3.0	2.5	0.0
National security and law-enforcement activity	2.8	3.0	3.2	2.6	–0.2
National economy	5.1	5.1	7.1	5.5	0.0
Housing and utilities	2.2	2.4	2.6	2.8	–0.2
Environmental protection	0.1	0.1	0.1	0.1	0.0
Education	4.1	4.2	4.6	4.0	–0.1
Culture, motion picture industry, and mass media	0.7	0.8	0.8	0.7	–0.1
Health care, physical culture and sports	3.9	3.8	4.3	3.7	+0.1
Social policy	12.0	13.7	12.1	9.1	–1.7
Public debt servicing	0.6	0.6	0,6	0.5	0.0

* Except for expenditures on public debt servicing.

Source: The RF ministry of Finance, IEP calculations .

The volume of expenditures across sections "Public debt servicing", "National defense" and "National economy" in shares of GDP remained unchanged in 2011. The past two years saw volumes of financing by the section "National security and law-enforcement activity" contract by 0.2 p.p. of GDP annually. Despite that, Russia is still ahead of all the OECD member states in terms of level of spending on domestic security and law-enforcement activity, as well as by the number of law-enforcement personnel (for reference: In Russia, this index is 9.8 per 1,000 residents, while in second to Russia Turkey – twice as low). So, there is a certain potential to further reduce spending by this particular expenditure item.

When it comes to the section "National defense", the 2011 volume of the enlarged government budget expenditure relative to GDP remained at the prior year's level – that is, 2.8% of GDP. That said, Russia's defense spending is one of the highest worldwide and second to the US and Israel's[1]. A high level of defense spending in the US has been steadily in decline over the past fifty years, except for periods of the US's military engagement[2].

There was an insignificant increase by 0.1p.p. of GDP in 2011 vs. 2010 by the section "Health care, physical culture, and sports", which should be ascribed to the bolstering of the volume of funding of objects for the World Student Games-2013 and Olympics-2014. By the Accounting Chamber's estimates[3], the initial budget of the latter event was nearly 4-fold greater than those of the Vancouver Olympics-2010 and Torino Olympics-2006, while the cost overrun exceeded all reasonable limits, as costs surged 3-fold and hit USD 29.8bn (the ultimate budgets of the Vancouver and Torino Olympics were USD 6bn and 3.6bn, respectively). That said, there are grounds to assume that the construction budget and, accordingly, volumes of budget outlays for implementation of the Sochi-2014 project in 2012-13 may likewise be increased more than once.

The 2011 volume of spending on health care per se remained on the prior year's level and posted some growth vis-à-vis the 2008 figures, which can be explained by a greater spending on financing health care modernization programs. The RF Subjects' 2011 consolidated budget expenditures on this item posted a 0.07p.p. of GDP increase vs. the previous year thanks to a 0.3 p.p. of GDP increase in expenditures on physical culture and sports, a 0.1p.p. of GDP increase in spending on the ambulance service and a 0.3 p.p. of GDP increase in spending on other kinds of medical assistance. In the structure of the enlarged government spending, the share of expenditures across this item surged up to 10.6% of all the expenditures of the enlarged government vs. the previous year's 9.7%.

The enlarged government budget expenditures on the section "National economy" in 2011 were on the level of 2010, that is, 5.1% of GDP, but when compared with the 2009 figures, they slid considerably – by 2.0p.p. of GDP, because of scaling back on volumes of anti-crisis support to the economy.

Expenditure item-wise, spending was boosted across the following sectors: the fuel and energy complex – by 0.2 p.p. of GDP, agriculture and fishery – by 0.3p.p. of GDP, forestry – by 0.1p.p. of GDP, the public road system – by 0.1p.p. of GDP and subsections "General economic matters" and "Other matters in e the national economy area" – by 0.2p.p. of GDP. The volume of budget appropriations for applied research in 2011 remained at the prior year's level of 0.3p.p. of GDP. As to other subsections, including "Exploration and use of space", "Reproduction of the mineral base", the 2011 enlarged government budget expenditures in shares of GDP equivalent contracted vis-à-vis the previous year.

[1] In 2010, Israel's defense spending accounted for 6.7% of GDP. However, in contrast to the RF budget, that section included both defense expenditures per se along with costs of pensions to, and social rehabilitation programs for, the military and their family members, the border infrastructure maintenance costs, and costs of purchasing weaponry from the US at the expense of the latter's military aid. So, it may well happen that in reality Israel's military spending does not exceed Russia's. Source: http://www.inss.org.il

[2] The US started cutting down its national defense spending back in the Cold War era from 14.2% of GDP in 1953 to 9.2% of GDP in 1962, 6.7% – in 1972, 5.7% – in 1982. The defense spending shrank sizably since the collapse of the USSR: from 5.2% of GDP in 1990 to 3.0% of GDP in 2001 (except for 1992 – 4.8% of GDP due to the War in the Gulf). The figures have been on the rise ever since 2002: from 3.3% of GDP up to 4.0% of GDP in 2005 and further to 4.7% of GDP in 2009 and 5.1% of GDP in 2011, due to financing of military operations in Iraq and Afghanistan. It is planned to scale back on military expenditures post-2011 and bring them down to 3.4% of GDP by 2016. Source: www.whitehouse.gov

[3] On the basis of data provided by the Accounting Chamber of RF in its conclusions on draft budget acts.

Expenditures on the section “Education” have been in decline since 2009. In 2010, they shrank by 0.4 p.p. of GDP and in 2011 – by 0.1p.p. of GDP on a year-on-year basis. The proportion of spending on education in the enlarged government budget accounted for 11.1%, or up 0.3 p.p. vs. the 2010 level.

Since 2008, the volume of financing by the item “Education” has been in decline: in 2010 – by 0.4 p.p. of GDP and in 2011 – by 0.1 p.p. of GDP on a year-on-year basis. The proportion of spending on educationin the aggregate volume of the enlarged government expenditures stood at 11.1%, or up 0.3 p.p. vs. the 2010 figures.

The volume of financing by the item “Housing and utilities sector” likewise has been in decline since 2008 by 0.2 p.p. per annum. In 2011, the enlarged government expenditures were cut practically across all the items, except for expenditures on settlements development (up 0.1 p.p. of GDP thanks to the respective increase in regional budgets’ expenditures) relative to GDP on a year-on-year basis. The cuts are associated with a gradual completion of such measures as provision of housing to veterans of WWII and individual categories of residents. Meanwhile, reserves for further cuts in the sector are unlikely to be huge, despite the fact that Russia on average spends on the housing and utilities sector twice as much as OECD member states. More specifically, at end-year 2011, as many as 99.4m² of housing in the country fell under the category of slum and dangerous structures (up 1.5 times over the decade). As it is, as a rule, regions with poor socio-economic performance indicators or those classified as the “Northern” ones (where climatic conditions predetermine high housing deterioration rates) it is inappropriate to cut down the state financing, as availability of adequate housing is a critical component of residents’ living standards. At the same time, given the magnitude of the challenge, development at the federal level of new approaches to assessment of the need in, and provision of, social housing, perhaps, appears justifiable[1].

In 2011, the item “Culture, the motion picture industry and mass media” saw cuts amount to 0.1 p.p. of GDP compared with 2010; however the share of expenditures on culture in the enlarged government budget remained at the level of 2%.

As to the item “Environment protection”, the respective expenditures have remained unchanged since 2009 and accounted for 0.06 - 0.07% of GDP. In its absolute terms (Rb 38bn, or up 10.3bn vis-à-vis 2010) the 2011 spending on environmental programs is comparable to the enlarged government revenues generated by payments for adverse impact on environment (Rb 22.1bn in 2011).

It should be noted that the volume of budget outlays for environmental measures rose 3.5 times between 2009 and 2011 in nominal terms, but shrank more than twice in the shares of GDP equivalent (from 0.16% of GDP in 2000 to 0.07% of GDP in 2011). Individual moves in this area (eg. implementation of a countrywide energy-saving program in the frame of the energy strategy) does bring about some positive effects, but still appear incapable of reversing the destructive trends in the environmental area.

The 2011 appropriations on the section “Social policy” appear impressive – 12.0% of GDP (Rb 6,512.3bn), including those on pensions provision (8.0% of GDP, or Rb. 4,379.6bn), albeit down 1.3 p.p. on a year-on-year basis. The share of the expenditure item in the aggregate volume of the enlarged government expenditure was likewise down 2.5 p.p. compared with

[1] Expenditures are incurred both by the federal budget and RF Subjects’ budgets; however the procedure of provision of social housing is established at the latter level. The federal budget does not finance provision of housing; rather, social payments, eg. to young academics, in compliance with Resolution of the RF Government of 17.12.2010 No. 1050.

the prior year. In the RF Subjects' consolidated budget, the 2011 social spending was cut down in absolute terms by 28.5% (1.5 p.p. of GDP) relative to 2010, because of cuts in expenditures on the social provision of the population totaling 0.4 p.p. of GDP.

During last three years, the 2011 enlarged government budget expenditures on servicing the public debt remained at a level of 0.6% of GDP; the RF Subjects' consolidated budget expenditures on this section were down 0.1 p.p. of GDP on a year-on-year basis.

An analysis of recent changes in the structure of the enlarged government budget expenditures allows identification of two negative tendencies:

1. Boosting expenditures on financing public goods (social policy, defense and law enforcement and public order) against cuts in expenditures on ensuring economic growth. So, despite the political leadership's declarations about the budget's modernization nature, actual expenditures encourage public and individual consumption, rather than economic development. At this point, emphasis should be made on government support of backbone national infrastructure objects (meaning investment projects and programs in the innovation development area, such as education, research, technoparks, business incubators, special economic zones, technology transfer centers) and upgrade of the production infrastructure (transport, communications, the FEC infrastructure), which would bolster economic stability, fuel innovation, breakthroughs in the technological sphere and environmental safety. That said, the government should scale back on its participation in business and semi-business investment.

2. A notable surge in the number of public and municipal servants[1] and public employees, which, first, evidences an excessive presence of the state in the economy and the social sphere. The volume and the number of public functions and services in tandem with antiquated procedures of their delivery exhibit current defects in their organization and, therefore, preserve the problem of huge public costs in the said areas. Second, it must be admitted that in contrast to temporary effects from boosting the financing of individual directions, which serves just as a temporary remedy, it is a funding of institutional transformations that gives a fillip to entrepreneurial activity and attraction of capital into an economy, and its structural diversification on the basis of innovation-driven technological development[2]. Thirdly, a high proportion of public employees evidences that by hiring an insufficiently qualified workforce to carry out public functions, a state exercise the "social sponsorship" function. As a result, the state budget is engaged in an implicit "subsidizing" of the populace (ie. the government pays salaries for an inefficient exercise of public functions).

2.2.4. Analysis of main Parameters o f the Federal Budget of RF in 2011 and for the Period of 2012–2014.

The budget Act for the upcoming three years does not suggest maintaining the 2011 federal budget revenue increase rates (see *Table 13*): the federal budget revenues should contract by 0.8 p.p. in 2012 and further by 1.3 p.p. in 2013 and 1.5 p.p. in 2014 vs. their 2011 level, with projections of oil-and-gas revenues suggesting their even greater decline – from 10.2% of GDP in 2011 to 7.2% of GDP in 2014.

[1] The 2010 data suggest that in Russia the number of public employees per capita (108 per 1,000 residents) is greater than across OECD and emerging economies (eg. the average figure across 22 OECD nations is 75, Brazil – 45, South Korea – 29 per 1,000 residents).

[2] According to development priorities established by the Long-Term Development Concept approved by Resolution of the RF Government of 17 November 2008 No. 1662-r.

Table 13

Main Characteristics of the Federal Budget in 2008–2014, as% GDP

	Actual				The budget Act		
	2008	2009	2010	2011	2012	2013	2014
Revenues	22.5	18.9	18.4	20.9	20.1	19.6	19.4
Including oil-and-gas	10.6	7.7	8.5	10.2	7.7	7.1	7.2
Expenditures	18.3	24.9	22.4	20.1	21.6	21.2	20.1
Including provisionally approbated	–	–	–	–	–	0.5	1.2
Deficit (–) /Surplus (+)	+4.1	–6.0	–4.0	+0.8	–1.5	–1.6	–0.7
Non-oil-and-gas deficit	–6.4	–13.7	–12.5	–9.4	–9.2	–8.7	–7.9
For reference: GDP	41277	38809	45166	54369	58683	64803	72493

Source: the RF Ministry of Finance.

The 2012 federal budget expenditures should surge by 1.5 p.p. of GDP vs. 2011 and subsequently slide back to the 2011 level again. So, the federal budget for the upcoming three years should be executed with a deficit oscillating within the range of 0.7 – 1.5% of GDP. That said, the value of the basic oil price which ensures a balanced federal budget has been increased for the medium term: while in 2011 the value matching the budget balance was an oil price of USD 115/b[1], already in 2012-13, according to MinFin's estimates, the balance would be secured by a price not lower than USD 120-125/b. So, the budget will become yet more prone to price fluctuations on the global market for carbohydrates.

It should be noted that while crafting main parameters of the 2012-14 federal budget, its authors employed optimistic forecasts of macroeconomic indicators: thus, the forecast with regard to the volume of GDP for 2012 was increased by more than Rb 5bn vs. the figure used while shaping up the 2011-13 federal budget.

Meanwhile, projections of the value of oil-and-gas revenues in the 2012-14 federal budget were based upon a more conservative scenario. On the one hand, that would allow rejecting the need to sequester expenditures during a fiscal year, should budget revenues decline; on the other hand, extra revenues, particularly due to exercising caution while planning them, allow revision of the expenditure part towards increases in individual items, which does not add accuracy to the medium-term budget planning.

Should the 2012 oil-and-gas revenues prove greater than planned, the Budget Act for 2012-14 comprises a clause which holds that extra revenues should be spent on replacement of public borrowings and/or revenues from sales of equity or other form of participation in capital owned by Russian Federation.

In the medium term, main sources of the federal budget revenues should remain collection of indirect taxes, the mineral tax, and customs duties (see *Table 14*).

The data in *Table 14* evidence that the proportion of revenues from main taxes and duties in the aggregate volume of revenues to the federal budget in the shares of GDP equivalent is going to be in decline in the period of 2012-14, because of falling revenues from the mineral tax and export customs duties, which is going to be caused by a downfall in international oil prices and slowdown of growth rate in taxable volumes of oil and oil products.

The budget's reliance on the foreign economic situation can be lowered by stabilizing non-oil-and-gas revenue growth rates. This necessitates maintaining economic growth in the first place, including, in particular, at the expense of reallocation of federal budget revenues from

[1] In 2005–2007, the federal budget surplus was secured under average annual nominal oil prices as follows: in 2005 – USD 50/b (surplus equivalent to 7.5% of GDP); in 2006 – USD 61/b (7.4% of GDP),; in 2007 – USD 69/b (5.5% of GDP).

defense and domestic security in favor of economy restructuring programs, providing there are efforts in place to bolster the efficacy of their implementation.

Table 14

Actual and Envisaged Revenues from Main Taxes to the Federal Budget of Russian Federation in 2008–2014 (% of GDP)

	Actual				The Budget Act		
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Corporate profit tax	1.8	0.5	0.6	0.6	0.6	0.6	0.6
VAT – total:	5.2	5.3	5.5	6.0	6.3	6.4	6.5
On domestic produce	2.4	3.0	2.9	3.2	3.2	3.2	3.2
On imports	2.7	2.3	2.6	2.8	3.1	3.2	3.3
Excise taxes, total:	0.4	0.3	0.6	0.5	0.7	0.9	1.0
On domestic produce	0.3	0.2	0.5	0.4	0.6	0.8	0.9
On imports	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Mineral tax	3.9	2.5	3.0	3.8	3.6	3.4	3.3
Customs duties, total:	8.4	6.5	6.8	8.2	7.4	6.8	6.7
Import	1.5	1.2	1.2	1.4	1.4	1.4	1.4
Export	6.9	5.3	5.6	6.8	6.0	5.4	5.3
Proportion of aforementioned taxes and duties in the federal budget revenues, %	93.3	86.5	89.6	91.4	89.4	92.3	93.3

Source: the RF Ministry of Finance.

Modernization and restructuring of Russia's economy in the medium- and longer-run are closely associated with abrogation of export duties whose presence means subsidizing domestic consumers of minerals and energy sources at the expense of the rent from the use of state-owned natural resources. Preserving, throughout the new Russia's history, lowered domestic prices of carbohydrates, and export duties on oil products at a level below the one of export duties on crudes has failed to ensure a qualitative modernization of its economy, nor it boosted its competitiveness.

Recent moves to encourage the volume of domestic oil refining and increase exportation of oil products by setting respective export duties at a level lower than the ones on crudes did not help bolster intensity of oil processing which made up just 71.2%, or matched the 2000 level. That is to say, the index in question has posted practically no growth over the past decade (for reference, in developed economies, the oil refining intensity rate is 90-95%).

With revenues from the mineral tax and export duties on energy sources in decline and volumes of collection of the corporate profit tax having stabilized (revenues to the federal budget from the corporate profit tax in 2012-14 should remain at their 2011 level – namely, 0.6% of GDP), reserves for increase in tax revenues should be sought in taxation of consumption.

It is forecast to increase collection of VAT from taxation of imports in 2012 by 0.3 p.p. of GDP on a year-on-year basis and further annually by 0.1 p.p. of GDP in 2013-14. Meanwhile, the volume of revenues from the domestic VAT will be soaring just at a rate equal the GDP growth rate.

The annual increase of collection of excise taxes to the federal budget over the period of 2012-14 is planned at a level of 0.2p.p. of GDP, which should be secured by indexation of their rates and reassignment of revenues from these taxes between the federal and regional budgets1. Revenues to the federal budget from excise taxes levied on imports in 2012-14 should remain unchanged (0.1% of GDP).

[1] For greater details see Section 2.3.

The dynamic of the federal budget expenditures in 2010-2014 in terms of functional classification is presented in *Table 15*.

Table 15

Expenditure Obligations of the Federal Budget in 2010–2014, % ВВП

Name	Actual		The Budget Act		
	2010	**2011**	**2012**	**2013**	**2014**
TOTAL	22.4	20.1	21.6	21.2	20.1
General government matters*	1.5	1.4	1.4	1.3	1.1
National defense	2.8	2.8	3.2	3.6	3.8
National security and law-enforcement activity	2.4	2.3	3.1	3.1	2.9
National economy	2.7	3.3	3.1	2.7	2.3
Housing and utility	0.5	0.5	0.2	0.2	0.1
Environment protection	0.0	0.0	0.0	0.0	0.0
Education	1.0	1.0	1.0	0.9	0.7
Culture, the motion picture industry**	0.2	0.2	0.1	0.1	0.1
Health care***	0.8	0.9	0.9	0.8	0.6
Social policy****	0.8	5.8	6.6	6.4	5.7
Physical culture and sports		0.1	0.1	0.1	0.0
Mass media		0.1	0.1	0.1	0.1
Public and municipal debt servicing	0.4	0.5	0.7	0.7	0.8
Interbudgetary transfers of general nature	9.2	1.2	0,9	0.8	0.7
Provisionally approbated expenditures	-	-		*0.5*	*1.1*

* In 2010 – without regard to expenditures on the public debt servicing.
** In 2010 – with regard to expenditures on mass media.
*** In 2010 – with account of expenditures on physical culture and sports.
****In 2011 and onwards – this item includes profile interbudgetary transfers, including those across extrabudgetary funds.
Source: Memorandum on the 2012–2014 federal budget.

The year of 2011 saw the biggest increase in federal budget expenditures (by 0.6 p.p. of GDP on a year-on-year basis) with respect to the item “National economy”. One of the drivers of such an increase in budget allocations became financing of projects across five priority avenues: “Energy efficiency”, “Nuclear technologies”, “Strategic computer technologies and software”, “Space and ICT”, “Medical equipment and pharmaceuticals” approbated by the Commission on Modernization and Technological development of Russia’s Economy under the RF President. The increase in spending was also fueled by implementation in 2011 of new sub-programs aimed at boosting the domestic production, such as “Development of the domestic machine-tool manufacture and the tooling industry for 2011–2016”, “Establishment and organization of production of industrial diesel engines and their next-gen components in Russian Federation in 2011–2016”.

That said, we believe that budget expenditures on the national economy should ensure much-needed institutional and infrastructural conditions of the real sector restructuring in the first place, rather than substitute for the private sector’s funding. Where there is a direct budget support to backbone and strategic corporations, there emerge risks of preservation of the technological backwardness of manufacture and a low quality of management.

Since 2012 expenditures on the economy should slide by 0.2 p.p. of GDP and further by 0.4 p.p. of GDP in 2013 and 0.4 p.p. of GDP in 2014, on a year-on-year basis. The process should be driven by cuts across individual directions of subsidizing the economy, completion of a string of federal target programs and placement in operation of objects of capital construction.

Since 2012 expenditures on the item ‘National defense” should be up 0.4 p.p. of GDP vs. 2011 and subsequently up by another 0.4 p.p. of GDP on a year-on-year basis in 2013 and

0.2 p.p. of GDP in 2014. The increase is associated in part with the military's monetary allowance reform which should result in a more than double rise of the military's material security, which should also affect the level of pensions of the retired military and persons equaled to them, as their pensions should increase 1.6 times on average.

The increase in spending on the item "National security and law-enforcement activity" is driven by the indexation since 2012 of labor compensation funds of employees with federal public institutions, monetary allowance (salaries) of judges and prosecutors, federal public civil servants, monetary allowances of the military and persons equaled to them (except for employees with the RF Ministry of Defense and the RF Ministry of Interior, as both agencies are facing a monetary allowance reform in 2012), and payments linked to the amount of the military allowance. Between 2012 and 2014 the number of law-enforcement agencies' personnel should be optimized, with thus freed funds to be spent on the monetary allowance reform.

Specifically, the volume of budget appropriations for the said reform, including compensations linked to monetary allowances and with account of a 15% reduction in the military and law enforcement personnel (except for RF Ministry of Defense and the RF Ministry of Interior) until 1 January 2014, in 2012 alone should account for Rb 389.3bn, in 2013 – 610.7bn, and in 2014 – 679.2bn.

The 2011 public debt servicing costs posted a 0.1p.p. of GDP increase vs. the previous year. The costs in question (Rb 195.0bn in 2010 and Rb 262.7bn – in 2011) were partly compensated by the federal budget interest revenues from placement of cash balances on the single account of the federal budget which form an extra amount to sums spent on securing a current budget balance per the cash budget (Rb 130.0bn in 2010 and 129.0bn – in 2011).

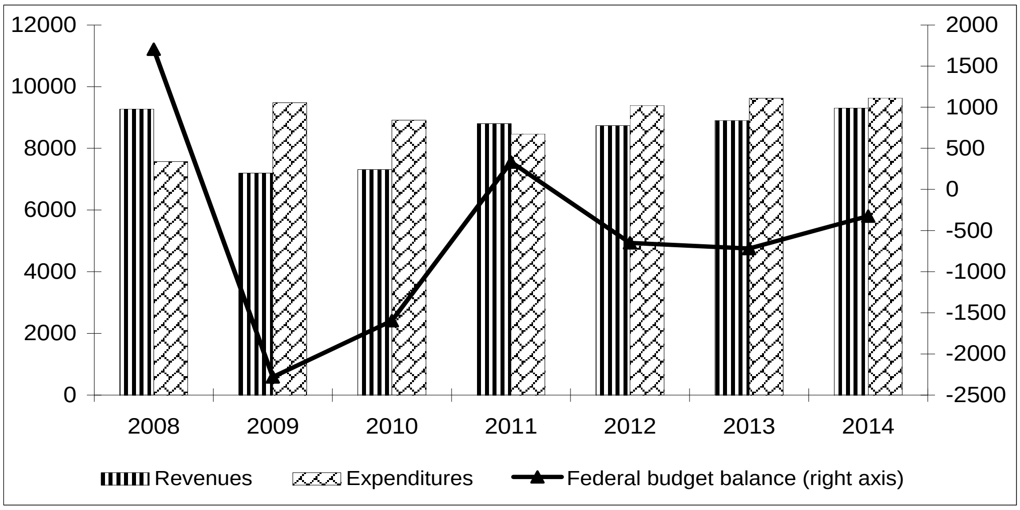
Cuts in spending by the item "Health care" in 2013-14 are associated with reassigning budget funds to implementation of a sector modernization plan out of the RF Ministry for Health Care and Social Development's budget to the Compulsory Medical Insurance Fund's.

It is foreseen to scale back on budget appropriations by the item 'Housing and utilities" in 2012-2013 with respect to implementation of the Federal Target Program and its non-program part, including providing the military with department and permanent housing.

As to other functional directions of federal budget expenditures, the main factor behind changes in their volume are budget outlays provided for implementation of FTPs and their non-program sections.

The dynamic of the federal budget revenues and expenditures in the 2008 constant prices (see *Fig. 16*) matchs the 2008-14 trends of changes in revenues and spending in current prices – that is, substantial revenue cuts in 2009-10 and their annual increase post-2012, and a substantial expenditure increase in 2009, as well as in 2012–14, with a slight decline intermezzo in 2010–11.

The dynamic of main parameters of the federal budget in 2008-14 allows ascertaining that the task to maintain the budget balance is going to fall by the wayside, with priority given to the financial securing of earlier adopted and newly set expenditure obligations. However, a haphazard increase of obligations in a given field of socio-economic development propagates a ripples effect in the form of imbalances throughout other fields, and precise regulation of such imbalances will require extra budget costs. To cite a particular example, the increase in monetary allowance for the military and prosecutors between late 2011 and early 2012 was followed by a debate on the need to raise the university faculty's pay. In the upcoming future, there cannot help but emerge the need for pay rises for such a low-paid category of budget employees as librarians, museum staff, social employees, etc. Clearly, the 2012-14 budget continues the recent trend and is becoming more and more centered on ensuring the public (defense and law-enforcement spending) and individual (expenditures on education, health care, social support) consumption, rather than on giving fillip to economic transformation.



Source: the RF Ministry of Finance, the IEP calculations.

Fig. 16. Dynamic of revenues, expenditure and the federal budget deficit, billion Rb in 2008 constant prices

The share of closed budget items is on the upswing. While in 2006-11 the level of closed expenditures was maintained at the level of 12% of the aggregate budget expenditures (according to IBP, open budget-wise Russia notably trails behind developed nations[1]), by 2014 the respective proportion should account for 22%.

The volume of the Reserve Fund posted a slight growth in 2011 (by Rb. 3.63bn), and so did the National Welfare Fund's (up by Rb. 98.9bn). As of 1 January 2012, cash balances of the Reserve Fund stood at Rb. 811.5bn, or 1.5% of GDP, while those of the National Welfare Fund – at Rb 2,794.4bn, or 5.1% of GDP. The volume of the Reserve Fund is envisaged to gradually increase in 2012-14, with oil-and-gas revenues being a major driver of the process, up to 3.8% of GDP in 2012, 4.3% of GDP and 5.4% of GDP in 2013 and 2014, respectively. Due to exchange rate differences and co-financing of pension savings, the volume of revenues to the National Welfare Fund should likewise increase in 2012-2014; however, the volume of spending of its resources should be greater, thus resulting in a fall of its volume to 3.9% of GDP in 2014.

The federal budget deficit should be covered by public borrowing and revenues from privatization of federal assets[2]. Hopefully, Russia, with its "sound credit record"[3] and credit rat-

[1] In January 2012, the International Budget Partnership published findings of the 2010 Open Budget Survey, which evidence that Russia scored 60 out of 100 open budget-wise (for reference: the US scored 82, Germany – 68, Italy – 58, Brazil – 71, China – 13 out of 100).

[2] According to Roskomimuschestvo, as of 1 January 2012, the government controlled 2,822 joint-stock companies with state-owned stakes in them.

[3] Russia's sovereign investment rating has been on the rise under a stable since 2005. The nations enjoying a roughly similar rating were Bahrain, Brazil, Hungary, Kazakhstan, China, Latvia, Mexico, Thailand, and South

ings no lower than BBB and Baa1 (stable or positive[1]) unchanged since 2010, would face no real problems with placement of debt instruments in the years to come. Plus, a possibility to have extra revenues from privatization (Rosneft, Gazprom, Russian Railways, etc.) should be factored into, too.

2.2.5. Prospects of RF Budgetary and Tax Policy

In recent years, Russia's budgetary policy has been exhibiting a number of trends pointing to her defiance of the rules that countries with resource-based economies typically abide by. At the same time, the resource dependence factor imposes rigid constraints on this country's budgetary policy: as the oil and gas sector generates a very considerable portion of budget revenue, the size of budget revenue becomes susceptible to unpredictable fluctuations.

The government's efforts to mitigate the consequences of the crisis have so far resulted in a higher degree of imbalance in Russia's budgetary policy. During the 2008-2009 crisis the authorities effectively abandoned the budgetary rules adopted in 2004-2004: budget revenues generated as a result of high current oil prices, instead of being transferred to the Reserve Fund and the National Welfare Fund, were now allocated to current expenditure in the federal budget.

The structure of general government expenditure also demonstrates a rise in the current cost of financing the pension system and in expenditures on national defense, national security and law-enforcement activities. The authorities made some costly political decisions with regard to the financing of a number of large-scale projects implemented within the framework of preparations to the 2014 Winter Olympic Games in Sochi, to the September 2012 APEC Summit in Vladivostok, and to the 2018 FIFA World Cup Russia. Considerable resources, in the form of subsidies and contributions, are allocated to the charter capital of state corporations and companies with state participation.

All these circumstances have significantly increased the existing risks of the budgetary system becoming unstable. The risk factors are as follows:

– the possibility that the federal budget will show a deficit even if current oil prices remain high;
– the impossibility to significantly reduce the existing social liabilities, and the prospects of a further rise in budget expenditures owing to the negative demographic trend and the persisting imbalance of the Pension Fund;
– the inadvisability of any increase in the tax load on the economy, and a possible reduction in budget revenues in a medium-term perspective;
– limited opportunities for a structural maneuver needed in order to achieve the economy's modernization.

In the context created by these challenges, the key tasks in the field of budgetary and tax policy should are to maintain Russia's macroeconomic stability, implement the assumed liabilities in a responsible and most effective manner, and create incentives for stable economic growth through the use of the tax and budgetary mechanisms.

Africa. Despite the fact that due to a considerable contraction of foreign reserves and inflow of foreign investment, in December 2008 and February 2009 two agencies downgraded Russia's rating to BBB with negative forecast (and one of them changed the forecast for stable in December 2009), the rating is at a level far higher than many developed European economies'.

[1] Standard&Poor's, Fitch, and Moody's.

In our opinion, the first-priority task associated with *maintaining this country's macroeconomic stability* should be a return to the 'budgetary rule' that regulates the procedure for the use of those budget revenues which depend on fluctuations in the prices of energy resources, while at the same time imposing restraints on the growth of expenditures and government debt.

The unpredictable character of oil and gas revenues makes it imperative that Russia should adopt a conservative approach to determining the level of allocations from that source that may be safely used in order to maintain proper stability of the state budget. We believe that an adequate estimate of the 'guaranteed' level of budget revenue can be obtained on the basis of revenue calculation at the 'base' price of oil. Accordingly, the federal budget should be balanced at the 'base' price of oil.

We suggest that the 'base' price of oil should represent the settlement price of Urals crude estimated as the moving average price of oil for the past 10 years. For example, in 2012 the 'base' price of oil amounts to about $ 60-65 per barrel. It is evident that at that level of oil prices Russia cannot achieve a balanced budget in 2012 (according to our estimates, the 2012 federal budget can be deficit-free only if the average prices of oil do not slide below $ 115 per barrel). However, we believe it possible for Russia to reintroduce the 'budgetary rule' from 2016, when the 'base' price will amount to $ 90-95 per barrel, provided that the behavior of oil prices entered in the RF Ministry of Economic Development's forecast may indeed be materialized. As regards the transition period, the 'base' price of oil, for the purposes of properly drawing up the federal budget, may be set at $ 105 per barrel in 2013, $ 100 per barrel in 2014, and $ 95 per barrel in 2015.

In that case, the upper limit of expenditure should be determined as the sum of the amount of revenues estimated at an established 'base' price of oil and the amount of net debt financing at a level of no more than 1% of GDP. So, if the actual price of oil becomes the same as the 'base' one, the budget will have a deficit under 1% of GDP, thus making it possible to prevent the volume of state debt from climbing above 25% of GDP. Such levels of state debt can be considered safe from the point of view of the size of the debt load on the budget and the economy in the event of short-term drops in oil prices (a period up to 1 to 2 years) and in Russia's country risk level. We believe that, in order to minimize foreign exchange risks, it would be advisable for Russia to issue bonds exclusively denominated in the national currency, although the form of issuing can vary between federal domestic bonds and ruble Eurobonds.

If there occurs a rise in the actual price of oil and, consequently, in the level of revenues, the proceeds should be primarily allocated to the Reserve Fund until the moment when it reaches its prescribed volume (8-10% of GDP, which will enable Russia to smoothly descend, over the course of three years, to a lower level of budget expenditures in the event of a 20% fall in oil prices). The next steps should be a reduction in net drawings (if deemed necessary by the Government) and a replenishment of the National Welfare Fund.

When the price of oil is relatively low, the loss of revenue should be compensated from the Reserve Fund. At the same time, the amount of funds drawn from the Reserve Fund over the course of one year should be determined with taking into account the total volume of the Reserve Fund and the risk of revenue losses in the following years.

As the alternative 'budgetary rules' one may suggest either the concept of oil and gas transfer (applied in Russia prior to the 2008 crisis), or the rule that the 'base' price of oil should be adjusted when the actual oil prices drop below their forecasted values.

At the same time, we believe that for Russia to return to the concept of oil and gas transfer in the current circumstances, when there exists a strong probability of sharp fluctuations in oil prices, would by no means be an optimal solution because, although the oil and gas transfer is equivalent to the 'base' price of oil (which is constantly increasing so as to compensate for the continuing shrinkage of the oil and gas sector's share in Russia's GDP), it cannot be adapted to changes in current prices.

However, the adjustment of the 'base' price level in a situation of declining oil prices – for example, if the previous year's price is taken as the 'base' price for the next budget year (when it is below forecasts) – increases the volatility of budget expenditure.

In order to provide adequate financing for the modernization of the Russian economy and a higher level of investments in human capital, it is necessary to alter not only the structure of government expenditure, but also the approaches to the allocation of budgetary funding.

In fact, the majority of the budget-funded public sectors use rather inefficiently the financial resources allocated to them, and so budgetary funding should be allocated to those sectors on condition that they carry out all the necessary transformations. In other words, this means discontinuation of the practice of increasing the size of budget allocations to the items sensitive to the quality of the institutions that act as recipients of those allocations.

In addition to these measures, it is necessary to gradually diminish the role of the federal budget as the principal source for covering the Pension Fund's deficit; to implement a program of further job cuts in the budget-funded sector; to achieve optimization of the expenditures on national defense and national security, rigidly linking this country's foreign policy strategy with the available resources; to abandon the practice of large-scale involvement of budget resources in 'image-making' construction projects; to limit the use of subsidies strictly to the purposes of recovery of or restructuring of strategic enterprises in the real sector, etc.

According to our estimations, altering the structure of financing in the direction of priority treatment of the issues of infrastructure and human capital development, with a simultaneous improvement of the cost-effectiveness of budget resources allocation, will result in an increase in the size of funding allocated to these items by 4% of GDP over the period until 2020. At the same time, reductions in the budgetary system's ineffective and excessive expenditures will make it possible, as early as 2014, to obtain additional resources in the amount of approximately 2% of GDP, resulting from cuts in the expenditures on national defense and law-enforcement activity by 0.9% of GDP, those on the national economy and the housing and utilities system – by 0.8% of GDP, and those on nationwide issues – by 0.3% of GDP.

In order to provide adequate financing for the modernization of the Russian economy and a higher level of investments in human capital, it is necessary to alter not only the structure of government expenditure, but also – and most importantly – the approaches to the allocation of budget funding.

Besides, it will be feasible, *in order to enhance the incentive-creating function of taxes and the reliability of financial coverage of government obligations*, to abstain, for as long as possible, from increasing the tax load on the economy, by expanding instead the structural component of the tax system. As demonstrated by the world's experience, when taxes on consumption are raised simultaneously with a cut in the tax load on labor and capital, it becomes possible for a country to substantially increase the competiveness of its economy. With regard to Russia's taxes on consumption, acceleration of upward adjustment of the rates of excises on alcohol and tobacco products will be advisable.

In an event of a stable surplus displayed by the general government budget, the best-substantiated measure aimed at achieving a well-balanced budget will be to cut down the rate of insurance contributions – say, to 26%, and to simultaneously increase the revenue margin above which the rate of 5% is to be applied.

Besides, if a truly just and effective taxation system is to be created in Russia, it will be necessary to gradually abolish the export duties on oil and petroleum products and compensate for the resulting loss of revenues by increasing the rate of the Mineral Resources Extraction Tax (MRET), introducing the Tax on Extra Income (TEI) in the oil extraction sector, establishing progressive tax rates in metallurgy, mineral fertilizers production, etc.

The progressivity of income and property taxes should be increased, and the taxation system should be made more environment-friendly (by means of increasing the fines for environment pollution and introducing a tax on carbon emission).

Special attention must be paid to the issues of improving the quality of customs and tax administration. In particular, it is necessary to implement reform of customs administration through introducing selective control based on the results of risks analysis and to complete that process in the sphere of tax administration; and to promote further computerization of the administration procedures and implementation of 'contactless' methods for dealing with taxpayers.

Tables 16 and *17* contain forecasts of the aggregate balances of the general government budget and the federal budget for the period of 2012–2020 if the new budgetary rules are introduced and the aforesaid budgetary and tax policy measures are implemented.

The structural deficit peak (the difference between expenditure and the estimated revenue volume at the 'base' price of oil) will be achieved in 2016 (1.9% of GDP), and then by 2020 it will decline to 0.8% of GDP. This type of deficit is covered by net borrowings from the federal budget. By 2020, the volume of government debt will effectively reach its marginal value of 25% of GDP (22.6% of GDP), which will necessitate balancing the federal budget, from 2021 onwards, at the level of revenue structure.

The aggregate federal budget deficit will reach its peak (1.7% of GDP) in 2013 and then decline to 0.4% of GDP by 2020; it should be noted that between one-third and one-half of this deficit is covered by revenues from privatization of state property. Since the forecasted oil prices are higher than the 'base' ones, and the actual deficit is lower than the structural deficit, part of federal budget revenue is transferred to the Reserve Fund whose size, nevertheless, in 2020 fails to achieve its normative value of 6% of GDP (5.6% of GDP). Consequently, the opportunities for transferring a part of the extra revenues to theв National Welfare Fund will emerge only after 2020.

Over the greater part of the period under consideration, the general government budget appears to be properly balanced, with due regard to the estimated size of revenues from privatization.

Table 16

Parameters of the General Government Budget, % of GDP

	2012	2013	2014	2015	2016	2017	2018	2019	2020
1	2	3	4	5	6	7	8	9	10
Revenue, including:	**38.1**	**37.7**	**37.2**	**37.0**	**37.0**	**36.8**	**36.6**	**36.4**	**36.5**
VAT	5.7	5.7	5.5	5.4	5.4	5.4	5.4	5.5	5.5
Tax on profit	6.3	6.5	6.3	6.3	6.1	6.2	6.3	6.1	6
PIT	4.0	3.8	3.8	3.8	3.9	3.9	4	3.9	4.0
Insurance contributions	5.7	5.8	5.9	5.9	6	6	6.1	6.1	6.2

cont'd

1	2	3	4	5	6	7	8	9	10
MRET/TEI (Tax on Extra Income)	3.3	3	2.9	2.8	2.8	2.7	2.7	2.6	2.6
excises	1.4	1.5	1.6	1.8	1.9	1.9	1.9	1.9	1.9
taxes on property	1	1.1	1.2	1.2	1.3	1.3	1.3	1.4	1.4
customs duties	7.7	7.3	7.0	6.7	6.5	6.3	5.9	5.9	5.9
other revenues	3.0	3.0	3.0	3.1	3.1	3.1	3.0	3.0	3.0
Expenditure, including:	**38.0**	**38.1**	**37.9**	**37.6**	**37.3**	**37.2**	**37.1**	**36.5**	**35.9**
nationwide issues	2.65	2.5	2.5	2.2	2	1.8	1.7	1.6	1.5
national defense	2.8	2.6	2.4	2.4	2.4	2.4	2.4	2.4	2.4
national security	2.6	2.5	2.3	2.3	2.3	2.3	2.3	2.3	2.3
national economy, including	5.8	5.9	6.0	5.9	5.7	5.6	5.2	4.9	4.6
road system	1.5	1.8	2.1	2.3	2.5	2.7	2.9	2.9	2.9
agriculture and fishery	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
communications and informatics	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
national economy, less road system, agriculture, communications and informatics	3.6	3.4	3.2	2.9	2.5	2.2	1.6	1.3	1.0
housing and utilities system	2.2	2.1	2.1	1.9	1.7	1.5	1.3	1.1	0.9
environment protection	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
education	4.1	4.1	4.2	4.3	4.5	4.8	5.3	5.3	5.3
culture, cinematography	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
mass media	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
health care	3.7	4.0	4.2	4.2	4.2	4.2	4.2	4.2	4.2
physical culture and sports	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
social policy, including	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0
aggregate expenditures on labor pensions (less social pensions and budget-funded compensations)	7.9	7.6	7.6	7.7	7.7	7.7	7.6	7.5	7.5
social policy, less expenditures on labor pensions	4.1	4.4	4.5	4.3	4.3	4.3	4.4	4.5	4.5
government debt servicing	1	1.2	1.1	1.2	1.3	1.4	1.5	1.5	1.4
Deficit /surplus	**0.1**	**-0.4**	**-0.7**	**-0.6**	**-0.3**	**-0.4**	**-0.5**	**-0.1**	**0.6**
Revenues from privatization	0.3	0.5	0.5	0.4	0.4	0.4	0.3	0.3	0.3

Source: Estimates made by the Ye. T. Gaidar Institute for Economic Policy and the Higher School of Economics – National Research University.

Table 17

Parameters of the Federal Budget, % of GDP

	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
1	2	3	4	5	6	7	8	9	10
Revenue, including:	**20.1**	**19.5**	**18.9**	**18.4**	**18.2**	**17.9**	**17.4**	**17.4**	**17.4**
VAT	5.7	5.7	5.5	5.4	5.4	5.4	5.4	5.5	5.5
domestic	3.0	3.0	2.9	2.8	2.8	2.8	2.8	2.8	2.8
on imports	2.7	2.7	2.6	2.6	2.6	2.6	2.6	2.7	2.7
tax on profit	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
MRET/TEI (Tax on Extra Income)	3.3	3.0	2.9	2.8	2.8	2.7	2.7	2.6	2.6
on oil	3.1	2.8	2.6	2.5	2.4	2.3	2.3	2.1	2.1
on gas	0.2	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.5
excises	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
export duties	6.3	5.9	5.6	5.2	5.0	4.8	4.4	4.4	4.4
oil	3.8	3.5	3.3	3.1	3.0	2.8	2.6	2.5	2.4
petroleum products	1.6	1.5	1.4	1.3	1.2	1.2	1.0	1.0	1.0
gas	0.9	0.8	0.9	0.8	0.8	0.8	0.8	0.9	1.0
import duties	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5
other revenues	2.0	2.0	2.0	2.0	2.0	2.0	1.9	1.9	1.9
Expenditure	**21.5**	**21.2**	**20.1**	**19.7**	**19.4**	**19.1**	**18.7**	**18.4**	**17.8**
Deficit/ surplus	**-1.4**	**-1.7**	**-1.2**	**-1.3**	**-1.2**	**-1.2**	**-1.3**	**-1.0**	**-0.4**
Revenues from privatization	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.2	0.2
RF government debt	12.4	13.8	14.7	15.8	17.6	19.1	20.5	21.9	22.6

cont'd

1	2	3	4	5	6	7	8	9	10
Revenue at 'base' price of oil (estimate)	*21.8*	*21.5*	*20.6*	*19.4*	*17.5*	*17.5*	*17.1*	*16.9*	*17.0*
Structural deficit	*0.0*	*0.0*	*0.0*	*0.3*	*1.9*	*1.6*	*1.6*	*1.5*	*0.8*
Reserve Fund	2.7	2.6	2.5	2.4	3.3	4.0	4.5	5.1	5.6
National Welfare Fund	4.8	4.4	4.0	3.0	2.8	2.7	2.9	2.8	2.7

Source: Estimates made by the Ye. T. Gaidar Institute for Economic Policy and the Higher School of Economics – National Research University.

2.3. Intergovernmental Fiscal Relations and Subnational Finances

2.3.1. Subnational budgets in 2011

Principal trends regarding relations between different levels of power are reflected in the structure of revenues and expenditures of the consolidated budget of the Russian Federation. *Table 18* shows a share of tax revenues and expenditures of the constituent territories of the Russian Federation in the relevant items of the consolidated budget of the Russian Federation.

Table 18

A share of the selected items of subnational budgets in the consolidated budget of the Russian Federation in the period between 1996 and 2011 (%)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Tax revenues	49.5	53.1	56.6	49.2	43.5	37.4	35.1	39.6	36.1	30.9	31.8	33.9	33.2	36.6	37.2	33.1
Tax revenues net of mineral payments and customs duties	55.8	59.5	59.9	55.0	49.0	42.6	40.1	41.9	47.5	49.1	52.0	50.5	53.7	54.8	57.1	56.0
Expenditures	45.4	48.1	54.1	51.9	54.4	51.2	49.3	50	50.8	49.5	43.4	48.3	49.2	43.4	43.2	46.5

Source: Federal Treasury, Gaidar Institute's estimates.

The data in *Table 18* shows that from 2001 a share of tax revenues of the constituent territories of the Russian Federation in tax revenues of the consolidated budget of the Russian Federation decreased below 40% and remained as such over the following decade (a minimum value of 30.9% was reached in 2005). Such a distribution of tax revenues among the budget system levels over the recent decade has to a large extent resulted from a higher growth rates in federal budget revenues generated from oil and gas[1] vs. growth rates in tax revenues of subnational budgets. Furthermore, the global recession which came to a boil in 2009, resulted in a bigger share, an increase to 36.6% in 2009 from 33.2% in 2008, of tax revenues of the constituent territories of the Russian Federation in the respective consolidated budget revenues of the Russian Federation. It resulted basically from a slump of the federal budget revenues from mineral production tax and customs duties. Meanwhile, a share of re-

[1] Pursuant to Clause 2, Article 96.6 of the Budget Code of Russia, the following federal budget revenues shall be deemed to be revenues generated from the production of oil and gas: tax on the production of minerals as crude hydrocarbons (crude oil, flammable natural gas extracted from all types of raw hydrocarbon deposits, gas condensate extracted from all types of raw hydrocarbon deposits); export customs duties on crude oil; export customs duties on natural gas; export customs duties on petroleum products.

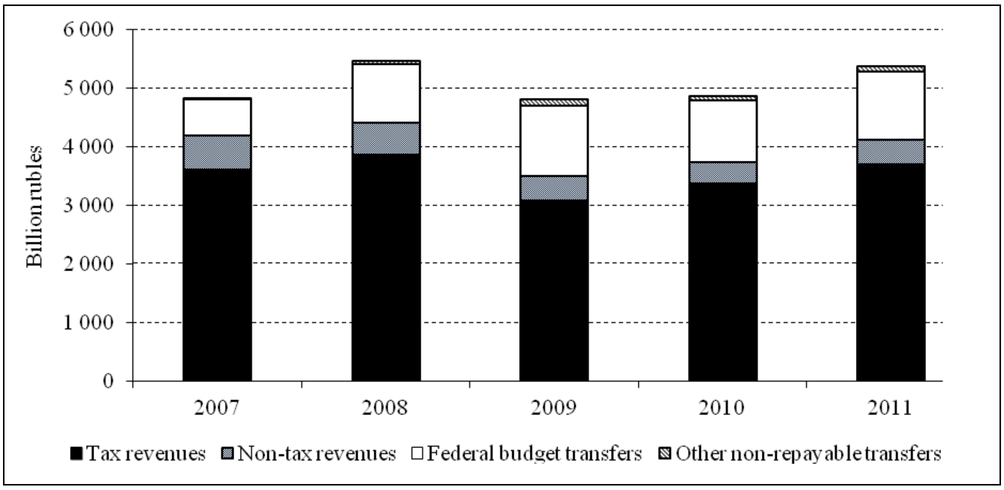
gional budgets, net of mineral payments and customs duties, also increased a bit by 1.1 p.p., to 54.8% from 53.7% in 2009, which was basically conditioned by steady inflow of revenues from personal income tax during the period of recession (Rb 1666,2bn in 2008 and Rb 1665,8bn in 2009).

In 2011, however, a share of tax revenues of subnational budgets in the consolidated budget of the Russian Federation decreased once again by 4.1 p.p. to 33.1% vs. 2010 (the value is close to a pre-recession value of 33.2% in 2008) as prices of exported energy recourses increased. In 2011, revenues from mineral production tax increased by 44.7% in nominal terms while revenues from customs duties, including the revenues generated within the framework of agreements concluded within the Customs Union, increased by 57.5% against 2010. As a result, tax revenues of the federal budget increased in general almost by 40% in nominal terms. Meanwhile, tax revenues of consolidated regional budgets increased merely by 16.7% in 2011 against the percentage reported in 2010. Therefore, in 2011 the decrease in a share of tax revenues of subnational budgets in the consolidated budget of the Russian Federation was basically conditioned by higher growth rates of tax revenues payable to the federal budget vs. the growth in taxes payable to subnational budgets. A share of tax revenues of consolidated regional budgets, net of mineral payments and customs duties, decreased less, by 1.1 p.p., to 56.0% from 57.1%.

However, a share of expenditures of subnational budgets in the consolidated budget expenditures of the Russian Federation increased significantly to 46.5% in 2011 from 43.2% in 2010, which, however, was by 2.7 p.p. less than the relevant value recorded in the pre-recession period of 2008. Budget expenditures of the constituent territories of the Russian Federation accounted for 15.05% of GDP in 2008 and by 0.93 p.p. or 14.12% less in 2011. A share of regional expenditures decreased gradually in GDP from 2009 (max. value of 16.13% of GDP). It should be noted, however, that in 2011 subnational budget expenditures increased in real terms by 9.0% and federal budget expenditures by 1.9% against the relevant percentage reported in 2010. Meanwhile, federal budget expenditures tended to decrease in percentage of GDP (to 20.1% in 2011 from 24.85% in 2009) from the beginning of 2009, the same is true of consolidated budget expenditures of the constituent territories of the Russian Federation. The decrease in expenditures in percentage of GDP in the post-recession period was therefore partially conditioned by outrunning growth in the GDP itself.

Let us examine in detail the situation with subnational budget **revenues**. *Fig. 17* presents the dynamics of the principal components of consolidated budget revenues of the constituent territories of the Russian Federation in the period between 2007 and 2011.

In 2011, consolidated budget revenues of the constituent territories of the Russian Federation increased in real terms by 9.9% y-o-y. A share of such revenues in total regional budget revenues decreased a bit to 69.4% from 69.6%. In spite of growth in tax revenues in the period between 2010 and 2011, the pre-recession level of 2008 was not regained. Tax revenues decreased in real terms by 4.3% in 2011 vs. the percentage reported in 2008. Hence it is a reflection of the fact that tax revenues of regional budgets failed in general to regain the pre-recession level both in terms of inflow volume and a share in total revenues (the value stood at 70.7% in 2008). In spite of a 13.5% growth in real terms in 2011 vs. 2010, non-tax revenues also failed to regain the pre-recession value (a decrease of 16.5% against 2008). High level of non-tax revenues in 2007–2008 was secured basically by increased revenues generated from the use of state- and municipally-owned property assets against 2009–2010. In 2011, these revenues increased in real terms by 17.9% against 2010 but failed to regain the level of 2008 (a decrease of 17.0%). In general, this type of revenues accounted for at least 43.1% of non-tax revenues in the period between 2007 and 2011. As a result, while a share of non-tax revenues accounted for 9.8% of total revenues of the budget of the constituent territories of the Russian Federation in 2008, it decreased down to 8.7% in 2009 and 7.7% in 2010, but increased to 7.9% in 2011. The amount of transfers from the federal budget also increased in real terms and stood at 10.5% in 2011 against the percentage reported in 2010 (budget transfers decreased by 13.5% in the post-recession period of 2010 against 2009). As a result, the amount of transfers in 2011 was bigger in comparable values by 15.6% vs. 2008, which, however, was by 4.3% less than in 2009. Other non-repayable revenues grew in real terms by 3.9% in 2011 against the percentage reported in 2010 It should be noted that in spite of growth in this type of revenues, they have been accounting for 1.7% or less of the total revenues generated over the recent two years. Like in the preceding year, revenues from the Foundation for Support to the Housing and Community Amenities Reform accounted for a major part of other non-repayable transfers. In general, subnational budget revenues increased in real terms by 10.3% in 2011 vs. the percentage reported in 2010, but decreased by 1.2% vs. 2008.



Source: Federal Treasury, Gaidar Institute's estimates.

Fig. 17. Consolidated budget revenues of the constituent territories of the Russian Federation in the period between 2007 and 2011, by component (at 2007 values)

The dynamics of principal taxes payable to the consolidated budget of the constituent territories of the Russian Federation in the period between 2007 and 2011 is shown in *Table 19.*

In general, tax revenues of consolidated budgets of constituent territories of the Russian Federation in percentage of GDP decreased from 10.01% of GDP in 2010 to 9.70% of GDP in 2011, which was even less than by 0.07 p.p. of GDP in 2009. The dynamics of specific taxes was multidirectional. Historically, there are two taxes which account for a major part of tax revenues of subnational budgets, namely corporate tax and personal income tax which accounted for about 74.4% of total tax revenues in 2011, a bit higher than in 2010 (73.2%) but lesser than in 2008 (78%). This can be explained basically by that profit tax revenues were much less than the revenues generated in 2008 (4.24% of GDP), although they increased by 0.19 p.p. of GDP and reached 3.55% of GDP. It should be taken into account that the regional rate of this tax increased from 19.5 to 20% from January 1, 2009. Therefore, though the trend towards economic recovery continued in 2011 thereby resulting in more profit tax revenues, its share in GDP still remained too far from the pre-recession values. The dynamics of another principal type of tax – personal income tax – was not the same. Revenues from personal income tax were found to be most stable among other types of tax revenues of consolidated regional budgets amid recession. In 2011, revenues from this tax saw a decrease by 0.29 p.p. down to 3.67% of GDP vs. 2010. The decrease in revenues from personal income tax in percentage of GDP from 2009 (when a maximum value of 4.29% of GDP was reported) can be explained basically by outstripping growth rates in GDP in the post-recession period against growth in the average gross nominal wages in the economy (which increased by 12.2 in 2011 against 2010, according to the Rosstat's preliminary data). Furthermore, nominal GDP increased in 2011 by 17.8% y-o-y. Personal income tax increased by merely 11.4% in nominal terms over the same period.

Table 19

Tax revenues payable to the consolidated budget of the constituent territories of the Russian Federation in the period between 2007 and 2011 (% of GDP)

	2007	**2008**	**2009**	**2010**	**2011**
Tax revenues, total	**10.88**	**10.62**	**9.77**	**10.01**	**9.70**
including:					
Corporate tax	4.60	4.24	2.76	3.36	3.55
Personal income tax	3.81	4.04	4.29	3.96	3.67
Excise duties on products sold on the territory of the Russian Federation	0.54	0.46	0.63	0.73	0.68
Gross income taxes	0.37	0.39	0.39	0.40	0.40
Property taxes	1.24	1.20	1.47	1.39	1.25
Taxes, duties and regular payments for the use of mineral resources	0.23	0.25	0.19	0.07	0.07
For reference: GDP, trillion Rb	*33.24*	*41.27*	*38.80*	*45.16*	*54.36*

Source: Federal Treasury, Gaidar Institute's estimates.

The following should be noted through examination of the dynamics of other types of tax revenues of the consolidated budget of the constituent territories of the Russian Federation. Revenues from excise duties decreased a bit by 0.05 p.p. in percentage of GDP in 2011 against 2010. Moreover, pursuant to the adopted amendments to the Tax Code of the Russian Federation, the rates of excise duties will grow in the ensuing years[1], which is likely to change the recently visible downward trend in the relevant revenues. A share of taxes payable by small businesses (on their gross income) remained almost the same over the period under review and stood at 0.4% of GDP, like in the preceding year. Property tax revenues also tended to decrease from 1.47% in 2009 to 1.25% of GDP in 2011 (which, however, is 0.05 p.p. above the level reported in 2008). A share of mineral production tax and other payable mineral payments in the regional budget revenues stabilized at the level of 0.07% in period between 2010 and 2011 after a stable downward decrease in 2009–2010. Such a small value of revenues from this source of revenues can be explained by centralization from 2010 of revenues from the tax imposed on the production of minerals as crude hydrocarbons payable to the federal budget[2].

[1] Refer to Clause 1, Article 193 of the Tax Code of the Russian Federation.

[2] The standard for payment of the tax on the production of minerals as crude hydrocarbons to the federal budget (save for flammable natural gas) has been increased from 95 to 100% since January 1, 2010 (under Federal Law No. 218-FZ, dd. 22.09.2009 "On the Amendments to the Selected Legal Acts of the Russian Federation and Cancellation of the Selected Provisions of Legal Acts of the Russian Federation").

The foregoing dynamics refers in general to tax revenues of the consolidated budget of the constituent territories of the Russian Federation. However, it would be reasonable to make analysis by region, because the constituent territories of the Russian Federation differed largely in the depth of recession and the degree of economic recovery. It should be noted that differentiation of tax revenues between regional budgets decreased in 2009, but then increased again in 2010. The relevant variation of per capita tax revenues adjusted for the budget expenditure index stood at 87.2% in 2008 (75.0% in 2009), increased to 91.3% in 2010, but decreased to 77.7% in 2011. The following factors were responsible most to this dynamics. It was the economically developed regions that were hit hardest (they experienced a deeper recession) by the crisis, which resulted in a decrease in the interregional differentiation. From the end of 2009, the Russia's economy began to recover, but the constituent territories of the Russian Federation differed largely in the degree of such recovery and, consequently, growth rates of tax revenues, which resulted in increase of differentiation of per capita tax revenues. In 2011, the differentiation declined as a result of a certain equalization of recovery rates in the economies in different groups of regions.

Tools which allow profit tax revenues to be distributed more evenly among the constituent territories of the Russian Federation, began to work from 2012 in order to reduce differentiation of tax revenues in various regions. This refers to the amendments to the Tax Code of the Russian Federation which concern the control of transfer pricing and introduction of the concept of consolidated group of taxpayers[1]. The amendments imposed a higher degree of control among related companies in order to create extra obstacles against using transfer pricing for the purpose of moving the "profit center" through various regions. However, the amendments allow taxpayers to form a consolidated group thereby allowing them to make special consolidated reports. The advantage of this approach is that corporate profit tax is to be paid on the basis of financial performance results of the consolidated group of taxpayers. In doing so, profit tax is to be accrued and tax revenues are to be distributed between various regions in which companies within the consolidated group operate pursuant to the regulations set forth in Clause 6, Article 288 of the Tax Code of the Russian Federation. A share in the profit of a specific company is to be measured as an arithmetical mean of a share of the average number of workers (wage costs) of the company and a share of depreciation value of amortizable assets in relevant values for the entire consolidated group. The amount of profit tax itself is to be measured on the basis of a tax rate applicable in the constituent territory of the Russian Federation where a certain member (and/or its stand-alone unit) of the consolidated group is located. Therefore, the aforesaid regulations allow the profit tax base to be more evenly distributed among the regions of Russia.

However, legislative regulations concerning transfer pricing and consolidated group of taxpayers, which have been in effect since 2012, impose strict requirements to such consolidated group. This is why the number of companies, i.e. potential members of consolidated groups of taxpayers is not going to be large, up to 40–50, in the short-term period. It should be emphasized that it will be Moscow which will incur most losses from the application of the new regulations vs. other regions, because head offices of most of large Russian companies are located in Moscow. However, considering high fiscal capacity of this region (3,232 in

[1] Federal Law No. 321-FZ, dd. November 16, 2011 "On the Amendments to Part 1 and Part 2 of the Tax Code of the Russian Federation Due to the Creation of the Consolidated Group of Taxpayers"; Federal Law No. 227-FZ, dd. July 18, 2011 "On the Amendments to the Selected Legal Acts of the Russian Federation Due to Perfection of the Pricing Principles for the Purpose of Taxation".

2011[1]), there is no point to expect any significant deterioration of its revenue potential, which disputes the need for large-scale compensatory arrangements. It should be understood that the larger the scale and longer is the duration of such compensations, the lesser the "equalizing effect" of taken measures will be in the short-term period.

Let us examine in detail the situation with tax revenues by constituent territory of the Russian Federation. *Table 20* presents a breakdown of Russia's regions by change in tax revenues in the period between 2008 and 2011.

Table 20

A breakdown of Russia's regions by change in tax revenues of the consolidated budget of the constituent territories of the Russian Federation

Number of regions in which tax revenues in 2011	In nominal terms		In real terms	
	2011 vs. 2010	2011 vs. 2008	2011 vs. 2010	2011 vs. 2008
Increased by more than 25%	8	55	4	6
Increased from 10 to 25%	61	20	20	21
Increased by less than 10%	12	5	53	27
Decreased by less than 10%	1	1	4	20
Decreased from 10 to 25%	0	1	1	7
Decreased by more than 25%	0	0	0	1

Source: Federal Treasury, Gaidar Institute's estimates.

The foregoing data shows that tax revenues of the consolidated regional budget increased in real terms in 54 of 82[2] constituent territories of the Russian Federation in 2011 (the second year of economic recovery) against 2008. The following regions were leading in terms of growth rates: the Republic of Ingushetia, the Karachay-Cherkessia Republic, the Chechen Republic, the Magadan Region, the Chukot Autonomous Area, the Republic of Adygeya. At the same time, tax revenues decreased by 30.41% in the Vologda Region. Comparing the data on 2011 and 2010, one may note that 77 regions saw an increase in tax revenues in real terms. Furthermore, almost all the regions saw an increase in nominal terms, save for the Republic of Altai. The Tyumen Region and Vologda Region experienced a decrease in nominal terms in 2011 vs. the percentage reported in 2008.

Let us examine the changes which took place in the consolidated budget **expenditures** of the constituent territories of the Russian Federation. Aggregate expenditures of the consolidated budge of the constituent territories of the Russian Federation increased in nominal terms by 15.6% in 2011 against 2010. However, their growth in real terms was merely 9.0%. The structure of expenditures of the consolidated budget of the constituent territories of the Russian Federation saw certain changes as well (*Table 21*).

The following should be noted on the basis of analysis of changes in regional budget expenditures by item. A share of expenditures on 'National Economy' and 'Education' increased a bit and stood at 17.1% and 22.5% respectively in 2011 against 16.6% and 21.9% in 2010. On the contrary, a share of expenditures on 'Social Policy' deceased to 15.5% of total expenditures in the same period (17.6% in 2010). Expenditures on 'National Security and Law Enforcement', 'Environmental Protection' and 'Culture, Cinematography and Mass Media' remained the same vs. 2010.

[1] According to the Method for allocation of grants for fiscal capacity equalization of the constituent territories of the Russian Federation for 2011.

[2] The Arkhangelsk Region and the Nenets Autonomous Area are regarded as the single constituent territory of the Russian Federation.

Table 21

Structure of consolidated budget expenditures of the constituent territories of the Russian Federation in the period between 2008 and 2011 (%)

	2008	2009	2010	2011*
Nationwide Issues	7.1	7.3	7.3	7.1
Including State and Municipal Debt Service	*0.6*	*1.0*	*1.1*	*1.0*
National Defense	0.0	0.0	0.0	0.0
National Security and Law Enforcement	4.1	3.9	3.8	3.7
National Economy	19.6	18.1	16.6	17.1
Housing and Community Amenities	16.3	13.7	12.6	12.6
Environmental Protection	0.3	0.3	0.2	0.3
Education	20.8	21.5	21.9	22.5
Culture, Cinematography and Mass Media	3.5	3.4	3.4	3.5
Healthcare and Sports	12.7	12.1	12.0	11.1
Social Policy	12.2	15.3	17.6	15.5
Interbudget Transfers	3.3	4.4	4.5	6.5

*Expenditures in 2011 are presented in a comparable classification which was in force until 2011.
Source: Federal Treasury, Gaidar Institute's estimates.

Expenditures on 'Healthcare and Sports' saw a more considerable change, with a downward trend over the recent four years, from 12.7% in 2008 to 11.1% in 2011. Expenditures on healthcare saw a marked decrease in 2011 basically due to an increase in a share of regional budget transfers to territorial funds for compulsory medical insurance. Examining this dynamics, it should be taken into account that contributions (transfers) for economically enactive population have become standardized and mandatory since 2011, in other words, regions no longer may reduce considerably the amount of such contributions (which resulted in their marked increase also as a result of a certain cut-off in direct regional budget expenditures on healthcare). As a result, the accumulative share of the two items – 'Healthcare and Sports' and 'Interbudget Transfers' – increased to 17.6% in 2011 from 16.5% in 2010. A share of expenditures on 'Nationwide Issues' decreased by 0.2 p.p. to 7.1% in the last year, and a share of expenditures on 'State and Municipal Debt Service' also decreased a bit from 1.1% to 1.0% of total regional expenditures.

A special focus should be placed on 'National Economy'. The dynamics here should be examined both for the item as a whole and its sub-items, because this type of expenditures is quite homogeneous vs. other types. After a stable upward trend, a share of expenditures on agriculture decreased for the first time to 3.0% of total expenditures (a max. of 3.4% was reached in 2010). In general, expenditures on 'General Economic Issues', 'Fuel and Power Sector', 'Applied Research in the Field of National Economy' saw a decrease against 2010. Such sub-items as 'Water Industry' (83.4%) and 'Forestry' (69.4%) were leading in terms of growth rate. However, a share of these expenditures still remains insignificant. A special emphasis should be placed on such sub-items as 'Transport' and 'Road Facilities', which in 2011 accounted for 8.3% of total expenditures on 'National Economy', a growth of 0.4 p.p., 7.9% against 2010 (refer to *Section 2.3.4* for more details on the expenditures on road facilities).

In 2011, a combined subnational budget **deficit** remained unchanged, but its volume decreased to 0.5% of total expenditures, which is much smaller vs. 5.3% in 2009 and 1.5% in 2010. Analyzing the budget deficit value by constituent territory, it should be noted that only 26 of 83 regions saw a surplus of their consolidated regional budget at year-end 2011. As a result, the need for borrowing was maintained at the subnational level. It should be noted that the need for fundraising might have emerged also because of the need for refinancing of the existing debt. The data on volumes of government debt of the constituent territories of the

Russian Federation in the period between 2007 and 2011 and municipal debt in period between 2010 and 2011 is shown in *Table 22.*

Table 22

Government debt due by the constituent territories of the Russian Federation in the period between 2007 and 2011 and municipal debt in the period between 2010 and 2011 (Rb, billion)

	Debt amount, Rb, billion				
	as of January 1, 2008	**as of January 1, 2009**	**as of January 1, 2010**	**as of January 1, 2011**	**as of January 1, 2012**
All constituent territories of the Russian Federation	**456,9**	**599,6**	**889,6**	**1096,0**	**1071,9**
including:					
Moscow	89,3	121,5	243,1	299,3	263,0
Moscow Region	92,1	156,1	163,7	146,8	96,1
Constituent territories (net of Moscow and the Moscow Region)	275,4	322	482,8	649,9	712,7
Municipalities	**n/a**	**n/a**	**134,9**	**169,8**	**197,7**

Source: Ministry of Finance of Russia, Gaidar Institute's estimates.

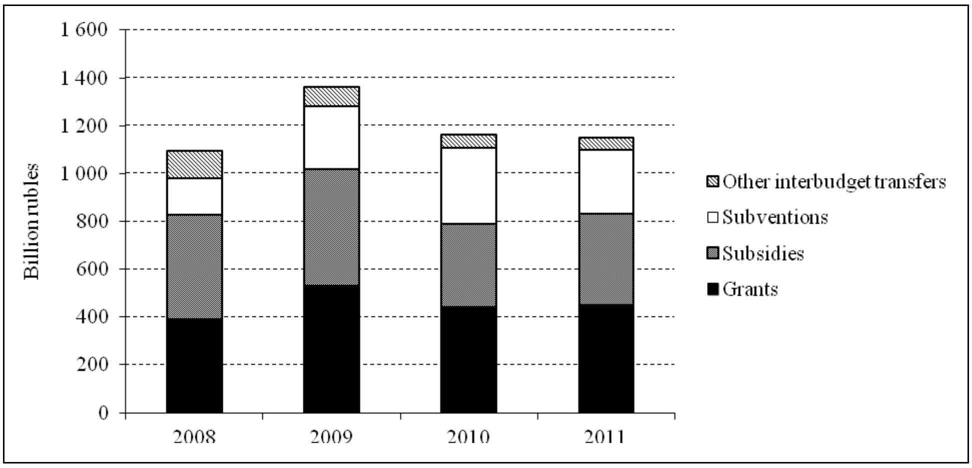
The data on changes in absolute volumes of government debt by constituent territory of the Russian Federation in 2011 show some decrease in borrowings (a decrease of Rb 24,1bn). However, such a decrease resulted basically from a considerable decrease in volumes of government debt in Moscow and the Moscow Region. In addition, these two regions accounted for more than 30% of total government debt due by the constituent territories of the Russian Federation. Examining the dynamics of regional debt amounts, net of Moscow and the Moscow Region, the picture would be different. The amount of government debt due by the other constituent territories of the Russian Federation increased to Rb 712,7bn by January 1, 2012, a growth of Rb 62,8bn vs. the beginning of 2011. Total municipal debt increased by Rb 27,9bn of the period.

The following should be noted on the basis of the results of the second year of Russia's economic recovery. The situation with the fulfillment of subnational budgets in 2011 improved visibly. However, a series of the principal parameters describing the situation with subnational finances remained lower than the pre-recession values. For example, tax revenues decreased in real terms by 4.3% in 2011 vs. the pre-recession values of 2008. No pre-recession values were regained for a series of the principal taxes, namely profit tax (a decrease of 12.4%), personal income tax (a decrease of 4.6%). The level of expenditures failed to reach the pre-recession values (a 2.3% cut-off), above all, through a lower level of capital expenditures. At the same time, expenditures on 'Social Policy' (which is ranked third in size after the 'National Economy' and 'Education') increased in real terms by 24.4% (vs. the percentage reported in 2008). A major part of the regions failed to fulfill their budget without a deficit. As a result, in spite of general easing of the economic situation (growth in GDP and industrial output), a certain tension still remains in place with regard to the budget fulfillment in certain regions.

2.3.2. Financial support from the federal budget

The total amount of federal budget transfers to subnational budgets increased in nominal terms by 4.8% in 2011, but decreased in real terms like in the preceding year (by 1.2% in 2011; 14.4% in 2010 vs. the percentage reported in 2009). The balance of extended and repaid budget loans decreased by 51.5%, from Rb 164,4bn to Rb 79,8bn. It should be noted that in 2011 the amount of extended federal budget loans to the regions decreased by Rb 41,7bn to Rb 128,4bn. The balance decreased visibly as a result of a substantial growth in repayments for budget loans by the regions, from Rb 5,4bn in 2010 to Rb 48,6bn in 2011, which was basically conditioned by repayment of 3-year budget loans extended in 2009.

Let us examine in detail the dynamics of certain types of federal budget transfers (refer to *Fig. 18*).



Source: Federal Treasury, Gaidar Institute's estimates.

Fig. 18. Federal budget transfers to Russia's regions
in the period between 2008 and 2011 (at 2008 values)

Subventions and other interbudget transfers (hereinafter – "other IBTs") decreased in real terms in 2011 vs. 2010. Subventions decreased most, by 16.0%, other IBTs by 8.9%. However, comparing the amounts of these transfers in 2011 with 2008, it should be noted that subventions increased in real terms by 75.4% whereas other IBTs decreased by 56.2%. Subsidies in 2011 increased by 10.2% vs. the percentage reported in 2010 (however, it was 12.1% less than in 2008). The amount of grants decreased markedly and stabilized at Rb 563,5bn in 2011 over the recent two years (a growth of 1.6% in real terms vs. 2010) after a substantial growth in 2009.

The foregoing dynamics resulted in certain changes in the structure of transfers in the period between 2008 and 2011 (refer to *Table 23*).

As evident from *Table 23*, the amount of grants increased in 2011 against 2010 mostly through an increase to Rb 154,3bn from Rb 105,9bn in the amount of grants allocated for the provision of support to budget balancing measures. As a result, a share of grants for fiscal equalization increased from 7.7% to 10.7% of total amount of transfers. However, a share of grants for budget balancing decreased to 27.5% from 28.8%. Grants accounted for 39.0% total interbudget transfers in 2011, a growth of 1.1 p.p. vs. 2010. In general, the data on changes can't be single-valued, because grants for budget balancing are allocated through a more transparent method based on objective factors against grants for fiscal equalization. In spite of the fact that a certain part of grants for budget balancing are allocated on the basis of publicly available methods and rules, many applicable criteria and indicators are less grounded and intrinsic vs. allocation of grants for fiscal equalization. A new type of financial support to the regions appeared in 2011, namely grants to the constituent territories of the Russian Federation which achieved best results in increasing the regional taxable capacity, which are also allocated as grants for budget equalization (refer to Section 2.3.3 for details).

Table 23

Federal budget transfers to Russia's regions in the period between 2008 and 2011, in nominal terms

	2008		2009		2010		2011	
	m Rb	% of total	m Rb	% of total	m Rb	% of total	m Rb	% of total
Transfers to the regions, total	**1,094,680**	**100.0**	**1,480,385**	**100.0**	**1,378,337**	**100.0**	**1,445,581**	**100.0**
Grants	**390,398**	**35.7**	**578,277**	**39.1**	**522,685**	**37.9**	**563,500**	**39.0**
including:								
grants for fiscal capacity equalization	328,648	30.0	375,485	25.4	396,996	28.8	396,996	27.5
grants for the provision of support to budget balancing measures	46,035	4.2	191,886	13.0	105,955	7.7	154,270	10.7
Subsidies	**435,867**	**39.8**	**530,073**	**35.8**	**411,439**	**29.9**	**481,252**	**33.3**
including:								
subsidies for road facilities	101,799	9.3	104,304	7.0	61,437	4.5	57,643	4.0
agricultural subsidies	73,593	6.7	90,641	6.1	87,930	6.4	98,509	6.8
Subventions	**153,170**	**14.0**	**284,440**	**19.2**	**378,650**	**27.5**	**337,467**	**23.3**
including:								
subventions for exercising the powers in employment promotion	37,413	3.4	77,414	5.2	87,090	6.3	74,193	5.1
subventions for GPW veteran housing	0	0.0	45,825	3.1	116,851	8.5	46,054	3.2
Other interbudget transfers	**115,245**	**10.5**	**87,595**	**5.9**	**65,562**	**4.8**	**63,362**	**4.4**

Source: Federal Treasury, Gaidar Institute's estimates.

A share of subventions decreased from to 23.3% in 2011, 27.5% in 2010 in total amount of transfers. The decrease in the amount of subventions was conditioned basically by a decrease in subventions for exercising the authority in promotion of employment and subventions for the Great Patriotic War veterans housing due to the 65th Anniversary of the Victory in the Great Patriotic War (1941-1945)[1] which appeared in 2009. It is the latter type of subventions that resulted in a substantial decrease in 2011, when a share of this subvention became twice as little, i.e. they decreased from 8.5% to 3.2% of total amount of transfers.

A share of subsidies in total amount of transfers decreased continuously in 2009–2010 from 39.8% in 2008 to 35.8% in 2009, and stood at mere 29.9% in 2010. On the contrary, a share of subsidies increased by 3.4 p.p. to 33.3% in 2011.

Following are the principal lines of co-financing of subnational budget expenditures in 2011:

– the state program on agricultural development and regulation of the markets of agricultural products, raw materials and food products for the period of 2008–2012 (20.5% of total amount of subsidies, 21.4% in 2010);

[1] Pursuant to Edict of the President of the Russian Federation No. 714, dd. 07.05.2008 "On the Great Patriotic War (1941–1945) Veterans Housing".

– construction and modernization of motor roads (12.0%; 14.9% in 2010)[1];
– financing additional medical assistance provided by district general practitioners and pediatric physicians, general practitioners (family doctors) (4.5%; 5.1% in 2010).
– implementing additional measures aimed at easing the tension in the labor market of the constituent territories of the Russian Federation (3.7%, in 2010 – 9.4%).

In general, speaking of the principal parameters of federal budget transfers to the regions in 2011, the following should be noted. A share of grants and subsidies increased a bit and a share of other IBTs and subventions decreased in total amount of federal budget transfers vs. 2010. Comparing the transfers made in 2011 with those in 2008 (the 'pre-recession' period), it should be noted that a share of subventions increased substantially and a share of other IBTs decreased in the total amount allocated to subnational budgets transfers. In general, the federal center made efforts concerning intergovernmental fiscal relations in 2011 which were intended to keep gradually curtailing principal "counter-recession" channels of aid to subnational budgets and simultaneously create additional stimuli for increasing the tax base (this refers, above all, to "stimulus" grants whose allocation method is described in detail in the next section).

2.3.3. Stimulating the constituent territories of the Russian Federation which achieved best results in enhancing regional taxable capacity

There has been a visible trend over the last few years towards wider use of the practice of federal budget allocations to the regions on the basis of their economic and financial performance results. Since 2007, the Ministry of Regional Development of Russia has been measuring effectiveness of executive branches of the government of the constituent territories of the Russian Federation[2], and grants are allocated to regions which are found to be most "efficient" based on such measurement. In addition, at the end of 2011, the federal government bodies made a decision on creating a stimulus arrangement for those constituent territories of the Russian Federation which managed to achieve best results in their economic development and fundraising. A total of Rb 10bn was allocated from the federal budget for this purpose in 2011. Ten billion rubles is planned to be allocated in 2012, however the amount may increase in the future based on the development process of the stimulus arrangement. However, a wider use of such tools of intergovernmental fiscal relations is exposed to serious risks which will be examined below.

Russian Government Ordinance No. 798, dd. February 18, 2011, "On the Allocation of Grants in 2011 to the Budget of the Constituent Territories of the Russian Federation to Support Measures of Balancing of the Budget of the Constituent Territories of the Russian Federation Which Achieved Best Results in Enhancing regional taxable capacity" formalized the method of resulting figure calculation and the mechanism of allocation of such stimulus grants. According to this document, a final comprehensive measurement which takes account of economic performance results over the last three year, is to be made to measure the performance of each region. In addition, this comprehensive measurement includes the performance results of the constituent territories of the Russian Federation on the basis of six eco-

[1] The amount of these subsidies includes relevant expenditures as part of all federal special purpose programs.

[2] Edict of the President of the Russian Federation No. 825, dd. 28.06.2007 "On the Measurement of Effectiveness of Executive Government Bodies of the Constituent Territories of the Russian Federation" (as revised on 28.04.2008 No. 606).

nomic performance indicators which are grouped into three segments: investments, taxation, industrial output. Two economic performance indicators are to be calculated for each segment so that each segment be measured both in terms of dynamics and value. As a result, both regions with a low value but high growth rates and those with a high value but without pronounced dynamics may equally be qualified for federal support.

It should be emphasized that according to the Ordinance, all economic performance indicators which are considered for allocation of stimulus grants, are to be calculated without regard to the regions' financial and economic performance results in the industries relating to mineral production. This condition was imposed by the federal government bodies even before February 2011, when the idea of allocation of such grants was advanced, however the focus was originally placed on the oil and gas sector rather than the entire extractive industry[1].

A total of three Draft Ordinances of the Russian Government were considered over six months, which differed mostly in the expression of specific economic performance indicators while the list itself remained unchanged. The only thing that should be emphasized is the Ministry of Economic Development and Trade's initiative to widen the scope of assessment, which suggested that the innovation production segment should be assessed as well (in addition to the aforesaid three segments). The following parameters were selected as indicators: level and growth rate of innovative goods, works, services for all types of economic activity. However, this idea failed to receive the required support. A potential reason is that the notion of *"Innovative goods, works and services"* is not well-defined in the federal legislation[2], which might result in incorrect statistics from both organizations and enterprises and government bodies of the constituent territories of the Russian Federation.

A total of 20 Russian regions received stimulus grants in 2011. Financial support varied within a range of Rb 206,8m to Rb 2bn on the basis of the results obtained through the final comprehensive measurement. The Kaluga Region was ranked first, which managed to be qualified for 20% of total stimulus grants. The Tyumen Region was ranked second and received a significant amount of budget funds (Rb 1,9bn or 19.1% of total), which is a historical recipient of grants for fiscal capacity equalization, as against the Kaluga Region. For example, the Tyumen Region's fiscal capacity stood at 2,347 after Moscow and St. Petersburg in 2011[3]. The Tyumen Region's consolidated budget tax and non-tax revenues totaled Rb 147,9bn, aggregate income Rb 184,7bn at year-end. Comparing these figures with the amount of allocated grants, proves that this amount is unlikely to have any effect whatsoever on the regional government bodies' goal-setting. Other 18 winners received less than Rb 1bn. In addition, it should be emphasized that a total of 13 constituent territories of the Russian Federation received no grants for equalization in 2011, eight of which received the foregoing stimulus grants at the end of the year. Therefore, such grants can hardly be regarded as a serious stimulus instrument. Allocation of stimulus grants within the framework of the applicable arrangement results more likely in dispersion of a part of the federal budget funds.

As noted above, such stimulus tools of intergovernmental fiscal relations are not regarded as novelty for the practice in Russia. Since 2007, the Ministry of Regional Development of

[1] http://www.minfin.ru/ru/press/speech/index.php?pg4=13&id4=12089 – based on A. G. Siluanov's interviews to in agencies at the 8th Krasnoyarsk Economic Forum.

[2] http://www.gks.ru/free_doc/new_site/business/nauka/minnov3.htm – Rosstat defines this notion as products manufactured by applying various types of technological innovations in the accounting year.

[3] According to the Method for allocation of grants for fiscal capacity equalization of the constituent territories of the Russian Federation for 2011.

Russia has been measuring the effectiveness of executive branches of the government of the constituent territories of the Russian Federation, which serves as a framework for allocation of grants to most "efficient" regions (based on their performance measured in 2010, 10 constituent territories of the Russian Federation received grants within a range of Rb 63m to Rb 116m in 2011). The experience gained over the previous periods shows that performance measurement of government bodies is a challenge. A monitoring of 329 parameters is currently under way, which is subject to annual changes in methods. For example, in 2007–2008, the regions were ranked on the basis of an effectiveness achieved by regional government bodies. As a result, a group of 10 regions was formed, whose composition remained unchanged for two years. Later, in 2009, a decision was made to measure the effectiveness of regional government bodies through the dynamics of indicators. Such an approach also failed to stand up for criticism, and from 2010 they started measure the effectiveness on a comprehensive basis, i.e. both in terms of dynamics and level. Today, the Ministry of Regional Development of Russia highlights the following top-priority lines in the development of methodology: reducing the number of applicable indicators; taking more account of regional specifics; providing a more flexible approach towards materiality of factors which have an effect on the comprehensive assessment; enhancing ways of encouragement of the regions[1].

The developers of the method of measurement of the effectiveness of regions which have achieved best results in increasing taxable capacity, appreciated the weaknesses of the method of the Ministry of Regional Development of Russia. However, federal government bodies may face the same problem in using this method, namely it is impossible within the framework of a specific method to take account of all the specifics of a parameter to measure (taxable capacity in this context). As a result, efforts in making the most adequate measurement would result in increased number of indicators in the method thus making it overloaded, complex and non-transparent.

The method of the Ministry of Regional Development of Russia employs 329 parameters whereas the taxable capacity measurement method has only six parameters. Both methods basically employ economically objective parameters. However, regardless of the applicable methods of measurement of the performance of regional government bodies, the same results will be obtained annually. Today about 10 constituent territories of the Russian Federation can be highlighted, which eventually will be found in the group of leaders regardless of the activities of certain governors in the field of regional economics. Such regions as Moscow, St. Petersburg, the Republic of Tatarstan, the Tyumen Region, etc., initially had favorable opportunities for a good start in their development, therefore most of other regions would not be able to catch up with them by virtue of objective factors.

In general, both measurement of the effectiveness of executive bodies of the constituent territories of the Russian Federation and measurement of regions which have achieved best results in increasing taxable capacity, have a series of critical weaknesses. *First*, such measurements can't reflect the current status of regional economic policies, because the results of decisions made by government bodies are normally not short-term (e.g., the results of current large investments can be seen in five years), or assessed economic indicators depend little from the decisions made by federal government bodies. *Second*, stimulation through allocation of grants to financially successful constituent territories of the Russian Federation is ex-

[1] http://www.minregion.ru/press_office/news/1763.html – The Ministry of Regional Development of the Russian Federation.

posed to extra risks of increasing differentiation among the regions and generating interregional contradictions. In addition, a small amount of allocations with a relatively small number of the constituent territories of the Russian Federation subject to rewards, results in dispersion of budget funds. This arrangement can't have a significant effect on the creation of priorities for regional government bodies. *Third*, the federal government bodies' efforts in improving a specific method would result in making constant updates thereto thereby preventing the regions from defining correct priorities in the long-terms period.

It should be emphasized that the practice of financial support to the regions on the basis of their economic and financial performance is quite disputable. For example, to obtain more reliable measurements of the performance of government bodies, the system of indicators would be widened. More indicators will result in distortion of the real system of goal-setting on the side of government bodies of the constituent territories of the Russian Federation, which would replace the performance-based work with the indicator-based work. As a consequence, regional government bodies would tend to achieve currently high indicators (better vs. the previous period) without actually working on long-term strategic development plans. It should be emphasized that the aforesaid effects are similar and result from efforts to introduce different systems of result-based budgeting in the public sector both at the government level and at the level of certain ministries and departments[1]. To reduce the likelihood of facing the aforesaid issues, it is necessary to give up financing of the constituent territories of the Russian Federation on the basis of their economic and financial performance results, but keep up enhancing the measurement systems themselves. The measurement system is needed to build up a data bank which allows regional processes to be detected in terms of different aspects of regional development for the purpose of identifying, disseminating and applying the best regional practice among the constituent territories of the Russian Federation. Furthermore, it should be noted that revival of the institution of direct elections and early resignation of governors may become the best stimulus and measurement of the performance of regional government bodies, including taxable capacity improvement.

2.3.4. Establishing road funds of the constituent territories of the Russian Federation in 2012

Under Federal Law No. 68-FZ, dd. April 6, 2011, "On the Amendments to the Budget Code of the Russian Federation and the Selected Legal Acts of the Russian Federation", a provision on the establishment of road funds at all tiers of authority was set up for the purpose of financing road activities with regard to public motor roads from 2012[2]. To observe the federal legislation requirements, each region had to develop till January 1, 2012 a regulatory act providing for the establishment of the road fund of a constituent territory of the Russian Federation[3]. In addition, regional government bodies had to approve a procedure for financing and use of road fund budget allocations as well as update their regional long-term programs

[1] For details refer to, e.g., de Bruin H. Performance-Based Management in the Public Sector. M.: The Institute for Complex Strategic Studies, 2005.

[2] The Russian legislation requires mandatory creation of the Federal Road Fund (it was stipulated in 2011 under Federal Law No. 357-FZ, dd. December 13, 2010, "On the Federal Budget for 2011 and Planning Period for 2012 and 2013") as well as road funds of the constituent territories of the Russian Federation, since 2012. In addition, municipal road funds may be created by a decision of the representative body of a municipality.

[3] Sixty eight of 83 constituent territories of the Russian Federation adopted special laws on the creation of regional road funds while the other 15 updated their effective regulations for budgetary process.

on road facilities (their parameters were to be brought in accordance with the amounts of financing from the road fund of a constituent territory of the Russian Federation). Pursuant to Clause 4, Article 179.4 of the Budget Code of the Russian Federation, the following revenues are considered as sources of financing of regional road funds:

– revenues from excise duties on motor gasoline, straight-run petrol, diesel fuel, oils for diesel and gasoline (injection) engines manufactured on the territory of the Russian Federation, payable as revenues to the budget of a constituent territory of the Russian Federation;
– transport tax revenues.

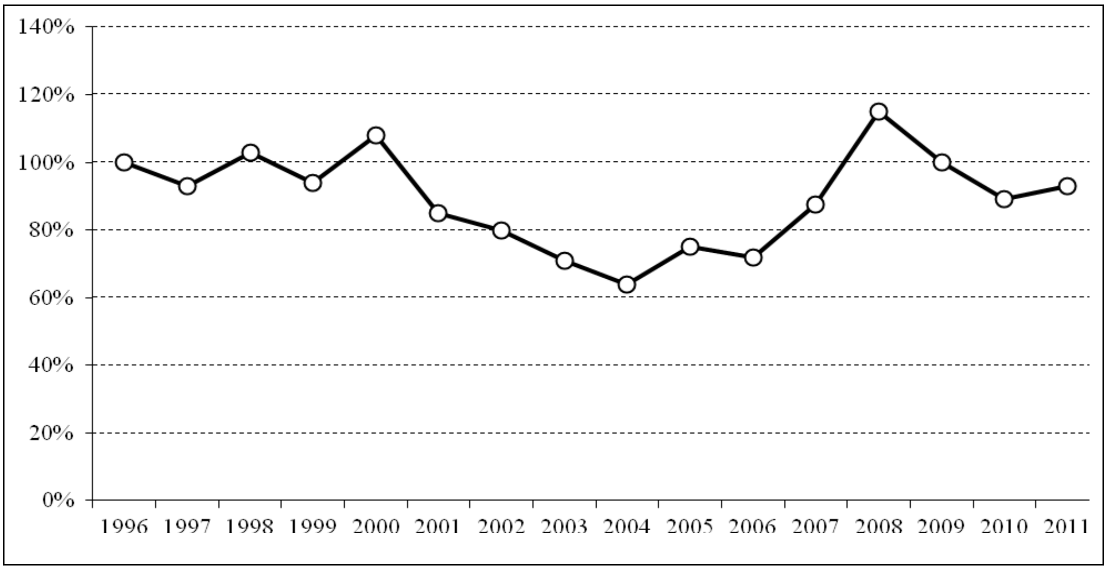
While working on the draft law, some of the regions encountered a problem which was conditioned by the fact that transport tax was included into the sources of financing of the road fund of a constituent territory of the Russian Federation. This tax, however, was long ago placed under the jurisdiction of local government bodies. In analyzing Article 179.4 of the Budget Code of the Russian Federation, one may infer that two specified sources of revenues (transport tax and excise duties on oil products) must be mandatory sources of financing of the road fund of the constituent territories of the Russian Federation. This is because under Clause 1, Article 56 of the Budget Code of the Russian Federation transport tax revenues shall be 100% paid to the budget of a constituent territory of the Russian Federation. Moreover, Article 179.4 of the Budget Code of the Russian Federation specifies that the size of a regional road fund shall be established under the budget law of a constituent territory of the Russian Federation for the ensuing fiscal year (the ensuing fiscal year and planning period) in an amount which should be at least equal to the forecast amount of *budget revenues of a constituent territory of the Russian Federation*. This leads to the conclusion that if the transport tax single standard is transferred to municipal budgets, this source will cease to be a regional budget revenue and, consequently, may not be a souce of financing of the road fund of a constituent territory of the Russian Federation[1]. Following are the regions in which transport tax was assigned to the municipal level: the Vladimir Region, the Voronezh Region, the Kaluga Region, the Lipetsk Region, the Vologda Region, the Krasnodar Territory, the Orenburg Region, the Perm Territory, Khanty-Mansi Autonomous Area, the Republic of Tyva, the Republic of Dagestan, the Republic of North Ossetia (Alania), the Stavropol Territory and the Chechen Republic.

As a rule, the decision on assignment of transport tax (in full or in part) from the regional to the municipal level of authority was made to maintain fiscal capacity at a certain level and create additional stimuli to enlarge the tax base in municipalities. The practice shows, however, that regions which initially assigned transport tax to municipalities, included afterwards transport tax as a source of financing of such funds, through amendments to already adopted laws on road funds. Therefore, forced abolition of transport tax single standards since 2012 in a series of Russia’s regions can be regarded as an adverse effect of the adopted legal regulations concerning road funds. At the same time, transport tax revenues assigned to municipalities could be sources of financing of municipal road funds (however, local government bodies are only entitled rather than obliged to create road funds).

In general, the idea to revive road funds was initiated by the Government of Russia on the basis of analysis of the situation in the road construction sector over the recent 20 years. Advocates of this idea (above all, the Ministry of Transport of Russia and the Federal Road

[1] http://bujet.ru/article/153917.php – Creation of Road Funds: Pros and Cons.

Agency under the Ministry of Transport of Russia) often provide the following data. In 1991–2001[1], when a system of financing of road facilities through road funds was in place, about 6,000 to 7,000 km of roads was constructed annually vs. about 2,000 km after the transfer to budget financing. It should be noted that road funds were abolished basically because of a great deal of corruption schemes and reports on improper use by government bodies of accumulated financial resources. Refusal of this type of financing was a logical stage in enhancing the budget policy. However, advocates of road fund revival believe that in spite of a great deal of road funds' inherited problems, volumes of construction and financing of road facilities were bigger when road funds were in place. In general, over the recent 11 years without road funds, expenditures on road facilities have decreased to 0.7% from 1.6% of GDP and even a bigger decline to 0.6% from 2.7% of GDP took place at the regional level. The data presented in *Fig. 20* shows that expenditures on road facilities decreased in real terms after the Federal Road Fund of the Russian Federation was liquidated in 2001. However, these expenditures increased in the period between 2005–2008 and reached the max. value in 2008. Therefore, steady downward trend in expenditures on road facilities was overcome long before road funds were established in 2012. Furthermore, the following should be emphasized. The single undisputable advantage of special purpose road funds against budget financing is a higher degree of "transparency" for car owners – actual taxpayers who form a road fund, because such approach allows them to "see" a price of the actual benefit as motor roads. Financing of road facilities could have been increased without creating special purpose road funds, as partially evident by the "pre-recession" dynamics of the relevant expenditures.



Source: M.Y. Blinkin. Strategy – 2020. Development of the Transport Infrastructure.

Fig. 19. Amounts of financing of road facilities from the budgets at all levels in comparable prices (1996 = 100%)

It was the financial and economic crisis that was basically responsible for interfering with further increase in expenditures on road facilities (after 2008). Subnational budget expendi-

[1] The Federal Road Fund was abolished in 2001. Regional road funds existed until 2003, when they were liquidated upon the abolishment of road tax.

tures on the development of road facilities decreased in real terms by 24.0% in 2009 against 2008 (refer to *Fig. 20*), which was conditioned by both a slump of tax revenues in regional budgets (by 13.5% in nominal terms vs. the percentage reported in 2008) and a decrease in federal subsidies for road facilities (the relevant allocations were cut off within 2009 by 33% against the initial budget projections). Expenditures on road facilities continued to decrease in 2010, but as early as 2011, expenditures on road facilities of the consolidated budget of the constituent territories of the Russian Federation grew up substantially to Rb 424,5bn, a 9.6% growth in real terms against 2010, as the regional economics recovered. It should be noted, however, that the level of related expenditures was much lower in 2011 than the pre-recession level of 2008 (a decrease of 26.1% in real terms). It is hard to make an ambiguous assessment of the decrease in expenditures on road facilities both at the regional and federal levels amid economic recession. International practice proves that increase in expenditures on road construction amid economic recession may be an efficient "counter-recession" channel of expenditures which facilitate (besides direct effect as newly constructed roads) creation of new jobs and recovery growth in industries relating somehow to the road construction sector.

Source: Federal Treasury, Gaidar Institute's estimates.

Fig. 20. Expenditures on road facilities and principal sources of financing of road funds of the consolidated budget of the constituent territories of the Russian Federation in the period between 2008 and 2011 (in real terms)

The following should be noted through a detail examination of the dynamics of federal budget allocations on the development of road facilities for subnational budgets in 2008-2011, (refer to *Fig. 20*). A share of road subsidies decreased gradually to 12.0% in 2011 from 23.4% in 2008 in the structure of federal budget subsidies. In addition, subsidies for roadway replacement and repair of public motor roads will cease to exist from 2012 at the administrative centers of constituent territories of the Russian Federation and administrative centers of Moscow and Leningrad Regions, as well as subsidies for full repair and repair of the territory and facilities adjacent to blocks of flats, access roads to the territory and facilities adjacent to blocks of flats. Moreover, subsidies on the development of road facilities allocated within the framework of various federal special purpose programs (a 2.4-fold decrease in real terms) decreased substantially in the period between 2008–2011. In addition, it should be emphasized that special budget loans to finance road facilities will no longer be extended from 2012[1].

In Russia at large, given the amount of expenditures on road facilities which were allocated in the period between 2008 and 2011 (refer to *Fig. 20*), they would have been covered 64.9% in 2011 from 29.8% in 2008 (had regional road funds existed in that period) by principal taxes – transport tax and taxes on oil products. Considering the fact that Rb 47,6bn of federal subsidies for road facilities is expected to be paid to the regional budgets in 2012[2], a decrease of Rb 10bn vs. the level of 2011, no substantial increase in expenditures on road facilities is expected in all regions without a visible increase in the relevant taxes. This will be implemented in part. Article 193 of the Tax Code of the Russian Federation provides for a stagewise increase in the rates of excises payable to the road fund of the constituent territories of the Russian Federation. However, the planned increase is unlikely to be sufficient for all regions. Analysis of regional expenditures on road facilities and revenues from transport tax revenues and excises on oil products revealed that creation of road funds in a series of the constituent territories of the Russian Federation may give rise to serious risks in terms of implementing a balanced budget policy. Had regional road funds (with relevant rates) existed in 2011, 53 constituent territories of the Russian Federation would have had to increase their expenditures on road facilities, with more than double increase in 19 of the regions (refer to *Table 24*). As a result, it would have required an involuntary reallocation of cash flows towards the development of road facilities, which would have forced a major revision of other budget expenditures and regional priorities.

Table 24

A breakdown of Russia's regions by the ratio of the amount of certain excises and transport tax to the amount of expenditures on road facilities in the consolidated budget of a constituent territory of the Russian Federation (net of subsidies)

	2008	2009	2010	2011
More than 200%	0	4	20	19
From 150% to 200%	1	4	10	18
From 100% to 150%	2	22	14	16
From 75% to 100%	9	14	16	8
From 50% to 75%	28	19	6	8
From 25% to 50%	24	13	13	6
Less than 25%	19	7	4	8

Source: Federal Treasury, Gaidar Institute's estimates.

As noted above, only 26 of 83 regions showed consolidated regional budget surplus at year-end 2011. Creation of road funds may result in growth in total amount of regional budget expenditures and the need to look for extra reserves to generate budget revenues or reduce financing of other important items, namely healthcare or education. As a result, one may detect some "tricks" concealed by the government bodies of certain constituent territories of the Russian Federation in the adopted regional laws on road funds. For instance, the government bodies of the Republic of Khakassia updated the standards for payments by source of financ-

[1] Russian Government Ordinance No. 1062, dd. December 18, 2010, "On the Approval of Rules for the Extension (Use, Repayment) of Federal Budget Loans to the Budget of the Constituent Territories of the Russian Federation for 2012" (as revised on 30.12.2011).
[2] Now it includes subsidies for road facilities only within the frameworks of a federal special purpose program.

ing of the road fund[1]. It was established that 60% for revenues from excises on oil products were to be paid to the budget the Republic of Khakassia, while 40% to the regional budget and allocated to other items which have nothing to do with road facilities.

In should be emphasized that regions which have insufficient funds to finance the road fund and road facilities are entitled to special subsidies under Russian Government Ordinance No. 293, dd. April 18, 2011 "On the Amendments to the Federal Special Purpose Program "The Development of Transport System of Russia (for the period of 2010–2015)". However, these subsidies only can be allocated to co-finance property assets designed to increase the number of rural settlements which have a year-round access to public hard-top motor roads, as well as regional and municipal property assets of national or regional importance being under construction (reconstruction) in pursuance of regulations and orders issued by the President and the Government of the Russian Federation.

In spite of ambiguous nature of creation of road funds in the Russian Federation, such funds have long been existing in many foreign countries. Furthermore, the international practice classifies all road funds into first generation road funds and second generation road funds. First generation road funds are a budget form, as a budget-funded entity or, like in Russia, funded from the budget of a government authority. Second generation road funds may have founders represented by the state or social agencies, organizations of road users which may provide an extra control of spending and take part in discussions of projects. International experience shows that first generation road funds lack of effectiveness to be able to stepwisely develop the road construction sector. However, road funds in Russia are currently based on this form. More questions arise with regard to sources of financing of road funds. Expenditures on road facilities could be 'linked tighter' to revenues from car owners by introducing a motor road toll (i.e. imposing a charge on road users rather than a tax). Furthermore, advanced technologies allow administration costs to be reduced by using GPS navigation technologies intended to accurately measure the distance covered by a specific car driver over a certain period of time.

In general, the following should be noted. Creation of special purpose road funds results in bigger amount of administration costs against budget financing, lower degree of transparency in spending, poor flexibility of the budgetary process. In addition, creation of road funds may have a heavy impact on the balancing of the consolidated budget of the constituent territories of the Russian Federation in 2012. Should funds' revenues undergo substantial reallocation, the regions would have to either reduce their expenditures or increase fundraising, or wait for support from the federal budget.

2.3.5. The Federal Law "On the Federal Budget for 2012 and the Planning Period of 2013 and 2014" with regard to allocation of interbudget transfers to other levels of the budget system

Federal Law No. 371-FZ, dd. November 30, 2011, "On the Federal Budget for 2012 and for the Planning Period of 2013 and 2014" provides for a total of Rb 1275,0bn of federal budget transfers allocated to the budget of the constituent territories of the Russian Federation, a decrease in nominal terms of 13.4% vs. the year-end 2011. The following types of transfers are to be reduced in 2012: a decrease of 11.5% for grants, 24.1% for subventions,

[1] Law of the Republic of Khakassia No. 93-ZRX, dd. 8.11.2011, "On the Road Fund of the Republic of Khakassia".

42.4% for other interbudget transfers. The decrease was related to both allocation of large amounts of transfers to the regions as part of the governmental counter-recession program, which was almost completed in 2011, and reallocation of spending powers between the federal center and the regions as a result of the transfer of powers of financial provision of the police force from 2012. On the contrary, from 2012 subsidies are planned to see a small increase of 0.5% in the amount of financing against the level of 2011.

The amount of **grants** in 2012, as noted above, must be reduced in nominal terms by 11.5%, to Rb 498,9bn from Rb 563,5bn (in 2011). This dynamics is maintained through the planned reduction of 40.9%, to Rb 91,2bn in 2012 from Rb 154,3bn in 2011 of grants for the provision of support to measures of budget balancing. During 2012, however, the amount of this type of grants is likely to increase like in 2011 (the initial amount totaled Rb 115,6bn, i.e. an increase of Rb 38,7bn or by 25.0% took place within the fiscal year). It should be noted that allocation of grants for budget balancing still remains one of the least transparent tools of intergovernmental fiscal relations. The following expenditure items specified in the Federal Law "On the Federal Budget for the Period of 2012–2014" (which are recognized as a separate entry beyond any methodological framework of allocation of remaining sums of grants for budget balancing) is a good illustration of non-transparency of this arrangement is This refers to the following transfers:

– Rb 26994,1m grants for balancing of the Chechen Republic budget in 2012,
– Rb 1000,0m grant for balancing of the Omsk Region budget (and the same amount in 2013–2014),
– Rb 20000,0m grants to the budget of St. Petersburg for the purpose of increasing the charter capital of OJSC Zapadny Skorostnoi Diametr in 2012 (as well as Rb 20000,0m in 2013, Rb 10709,7m in 2014).

The latter amount allocated to the budget of St. Petersburg arises more questions. Though this is definitely a special purpose transfer, as may be seen by its title, it was allocated in the form of no-purpose transfer, i.e. grants.

The amount of grants for fiscal capacity equalization of the constituent territories of the Russian Federation in 2012–2014 is to be maintained at the level of 2010–2011, i.e. Rb 397,0bn. Therefore, no indexation of the amount of the Fund for Financial Support for Regions (FFSR) is planned within the entire 5-year period, i.e. visible reduction in real terms of the amount of this Fund was actually planned. It is obvious, however, that the need to narrow interregional differences at least remains the same. This issue is related to the effective legislative regulations under which "total amount of grants shall be determined on the need to achieve the minimum degree of estimated fiscal capacity of a constituent territory of the Russian Federation, which shall be determined as an arithmetic mean value of total indicators of the degree of estimated fiscal capacity prior to allocation of grants among the constituent territories which are ranked neither among the 10 constituent territories with the maximum degree of fiscal capacity, nor 10 constituent territories with the lowest degree of fiscal capacity"[1]. Furthermore, the FFSR's size must not be reduced in nominal terms.

In the period between 1994 and 2002, the FFSR's size was determined as a share of tax revenues in the federal budget (initially, as a share of VAT, a share of all tax revenues, save

[1] Pursuant to paragraph 1 of the Method of Allocation of Grants for Fiscal Capacity Equalization of The Constituent Territories of the Russian Federation approved by Russian Government Ordinance No. 670, dd. November 22, 2004 (as may be amended).

for customs duties, since 1996). In the period between 2003 and 2007, the FFSR's size was determined by multiplying the last year's Fund's size by the inflation rate forecasted for the ensuing fiscal year (consumer price index). This regulation was established in the Budget Code of the Russian Federation in 2005[1]. Since actual inflation rate often was equal to or lower than the forecast, this method of measurement of the FFSR's size resulted in a visible decrease in real terms over the period under review. Furthermore, this approach failed to take account of the real need of the regions for fiscal capacity equalization. To overcome this problems, the measurement procedure was changed in 2008. However, a new approach also had some serious weaknesses.

The following arrangement is offered to enhance the measurement procedure:

1) first, the amount of grants should be determined for equalization by using the procedure in effect;

2) if a resulting amount of grants is bigger than that of the preceding year multiplied by a forecast consumer price index, the amount of grants for equalization should be determined based on the following procedure;

3) if the amount is less than the previous year's amount of grants multiplied by the forecast consumer price index, then the amount of grants for equalization for the planning year should be determined by multiplying the amount of grants for the current year by a planned growth in consumer prices;

4) beginning with the 3rd year of application of the new procedure for measurement of the Fund's size, it would be possible to adjust calculation of the size given the difference between actual inflation and budgeted figures.

Such approach will prevent any substantial reduction in real terms of the Fund's size and make, with a certain lag though, adjustment given the difference between actual and forecast inflation. As a result, the proposed method combines the advantages of the effective approach towards measurement of the FFSR's size and the method of indexation of its size in 2003–2007, and a combination of these approaches allows one to a large extend to cope with the weaknesses of the methods severally.

Total amount of **subsidies** is planned to increase to Rb 483,5bn in 2012 from Rb 481,3bn in 2011 or by 0.5% in nominal terms.

It should be noted that no subsidies are provided for several lines of co-financing of regional expenditures in 2012:

– subsidies for roadway replacement and repair of public motor roads at the administrative centers of the constituent territories of the Russian Federation and the administrative centers of the Moscow and Leningrad Regions, as well as subsidies for full repair and repair of the territory and facilities adjacent to blocks of flats, access roads to the territory and facilities adjacent to blocks of flats;
– measures of social support to rehabilitees and persons recognized as victims of political repressions;
– child support in the foster family and home, as well as remuneration payable to the adopting parent.

Complete cessation of co-financing of road facilities in this line was related to the establishment of regional road funds from 2012. The other two lines relate to redivision of powers

[1] In Clause 2, Article 131 of the Budget Code of Russia.

within the framework of a balanced package on assigning of financing of the police force to the federal budget from 2012.

Let us examine in detail the redivision of revenue and spending powers among the federation and the regions within the framework of delegation of financing of the police force under the federal jurisdiction. The following amendments will take effect from 2012:

– federal secondary vocational education institutions and disinfection institutions, as well as the powers to promote employment (save for social benefits to the unemployed) and the powers to pay a lump-sum benefit for adoption of orphan, will be placed under the jurisdiction of the constituent territories of the Russian Federation;
– the state due on vehicle registration (which is currently payable to budgets municipal and urban districts), as well as 60% of revenues from excise duties on alcoholic products with a.b.v. of more than 9% (100% of such excises were payable to the budget of the regions until 2012) will be payable to the federal budget;
– financial aid to child support in foster families and homes, as well as measures of social support to rehabilitees will be covered by exclusively with the budget of the constituent territories of the Russian Federation.

The aforesaid redivision of powers seems to be disputable from the point of view of both the fiscal federalism theory and the practice of intergovernmental fiscal relations in most of the developed countries with multilevel budget systems. First of all, there are doubts regarding the rationale of placing all powers of ensuring public security as part of law enforcement under the jurisdiction of federal branch of power. Police services constitute a local benefit whose primary recipient is, above all, the local community. In addition, international practice shows that financing of the police force normally falls under the jurisdiction of regional/local government bodies, not the central government (United States, Canada, etc.). It should be noted that Paragraph b), Article 72 of the Constitution of the Russian Federation reads that the joint jurisdiction of the Russian Federation and the constituent territories of the Russian Federation includes: "… ensuring the rule of law, law and order, public security …"; and Paragraph 1, Article 132 thereof reads that "the local self-government bodies shall independently … ensure the protection of public order …". Therefore, the Constitution of the Russian Federation already laid the ground for law enforcement powers of regional and municipal government bodies. In addition, there are questions regarding the cessation of federal budget co-financing of measures of social support to rehabilitees and persons recognized as victims of political repressions. These categories of persons entitled to benefits emerged by virtue of decisions made in due time by the central government. From this point of view, it would have been more logical to place these powers under the federal jurisdiction. Generalizing the aforesaid, it should be noted that effectiveness of implementation of the proposals within the framework of placing all powers of financing of the police force under the jurisdiction of the federal government is disputable.

In accordance with budget projections, total number of federal budget subsidies allocated to the budget of the constituent territories of the Russian Federation must decease to 94 in 2012 from 105 in 2011 and then keep deceasing gradually to 70 in 2013 and 62 in 2014. In general, this trend should be regarded as positive. The effective system of large number of odd subsidies with the amount being less than (or slightly more than) Rb 1bn for some items is responsible for a visibly lower degree of effectiveness and transparency of the Russia's system of intergovernmental fiscal relations, above all, in terms of restricting the freedom of decision-making on the side of regional government bodies amid non-conformity of federal and regional priorities in some cases. However, the proposed decrease in the number of subsidies seems to be insufficient.

It should be noted that transition to a result-oriented method of formation of the federal budget creates certain obstacles on creating an intersectoral consolidated (block-based) subsidies. Even this fact, however, fails to explain 62 subsidies planned for 2014. Russian Government Ordinance No. 1950-r, dd. November 11, 2010, approved a list of 40 public programs of the Russian Federation (as amended and updated). These programs cover more than 97% of the federal budget expenditures in 2012–2014. It is also obvious that not every program provides for federal budget co-financing of regional expenditures, simply because relevant powers fall exclusively under the jurisdiction of the federal government. This refers to such programs as “Russia’s Space Activity” (No. 21), “Development of the Nuclear Power Generation Complex” (No. 22), “National Defense Capability” (No. 31), “Federal Property Management” (No. 37), “Foreign Policy” (No. 40), etc. Therefore, one may say that the number of subsidies planned for 2014 is twice as much as the number of public programs. The aforesaid proves that the proposed measures of streamlining the system of subsidies in the Russian Federation are insufficient.

Total amount of **subventions** is planned to decrease in nominal terms by 24.1%, to Rb 256,0bn in 2012 from Rb 337,5bn in 2011. Again, the decrease is conditioned mainly by redivision of powers among the federal center and the regions due to the fact that the police force will be financed by the federal budget from 2012. As noted above, a part of the powers will be placed under the regional jurisdiction (lump-sum benefit payable for any type of adoption of children with are deprived of parental care; promotion of employment, save for unemployment benefits). In addition, in 2012, no subventions will be allocated for exercising powers of preparation and carrying out statistic censuses, because relevant measures have been completed.

Total amount of **other interbudget transfers** must be reduced to Rb 36,5bn in 2012 from Rb 63,4bn in 2011, or by 42.4% in nominal terms, mostly due to the cessation of allocation of interbudget transfers providing an increase, which is equal to that in the Ministry of the Interior of Russia, in the money allowance payable to the personnel and wages of the employees of public security police units (the amount of this transfer accounted almost 35% of the total amount of other interbudget transfers allocated in 2011).

The following regulations stipulated in the Federal Law "On the Federal Budget for 2012 and the Planning Period of 2013 and 2014" should be noted. *First*, an increase in the cost of budget loans (Clause 2, Article 13 thereof) from 1/2 to 2/3 of a refinancing rate quoted by the Central Bank of the Russian Federation (save for financing of measures relating to natural and man-made disaster management). *Second*, a new regulation appeared, under which transfers can be allocated exclusively pursuant to legal acts issued by the Government of the Russian Federation rather than federal executive bodies (Clause 2, Article 12 thereof). These changes can be regarded as positive and improving the effectiveness of the effective system of intergovernmental fiscal relations. It should be noted, however, that the second regulation must, strictly speaking, be applicable to the Budget Code of the Russian Federation on a long-term basis.

In general, it should be noted that the parameters of the Federal Law "On the Federal Budget for 2012 and the Planning Period of 2013 and 2014" with regard to intergovernmental fiscal relations with the constituent territories of the Russian Federation give rise to a series of serious questions in terms of enhancing the effectiveness of the Russian’s system of federalism.

Section 3. Financial Markets and Financial Institutions

3.1. The Russian Financial Market Post-Crisis Recovery

In 2010, it seemed that after the 2008-2009 collapse, the Russian market will bounce back to its pre-crisis values faster than it had done after the 1997-1998 crisis. However, the 2011 fell short of justifying the hopes. During the year, the Russian indices tumbled once again: specifically, RTS plunged by 21.9% and MICEX - by 16.9%. The indexes' recovery trajectory was increasingly less resembling the V-shaped form and beginning to gradually drift closer to the W-shaped one.

The fall of indexes during the 2008-2009 crisis proved less intense and shorter vis-à-vis the one noted back in 1997-1998 (*Table 1*). In the late '90s, the RTS index plummeted by 91.3% and the MICEX index - by 73.0%; the intensity of the fall of both indices in 2008-2009 was 78.2% and 68.2%, respectively. In 1997-1998 the RTS index has been tumbling for 14 months, while the MICEX index - for 13 months; by contrast the duration of the indexes' fall over 2008-2009 was 8 and 7 months, respectively.

Table 1

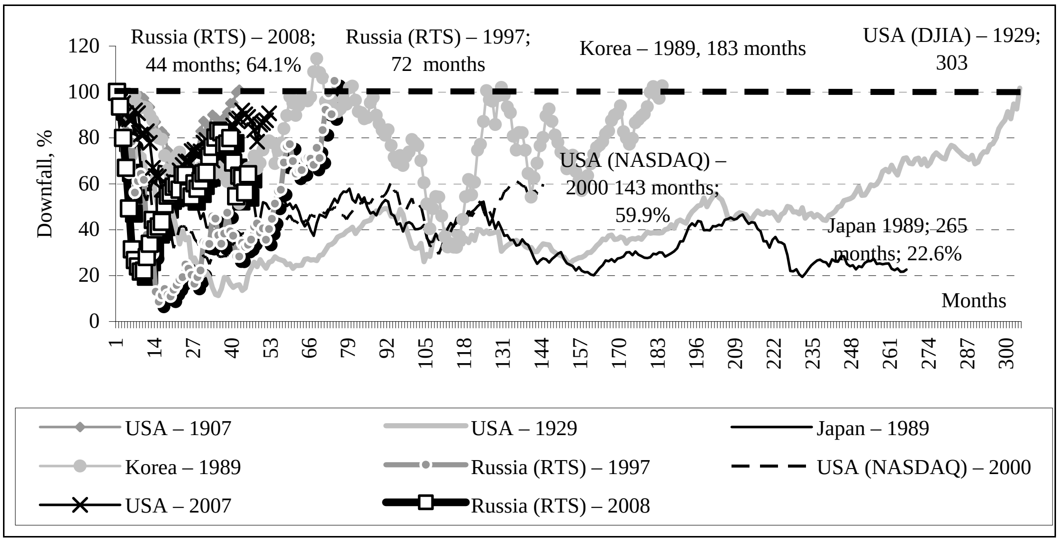
Financial Crises of 1997/98 and 2008/09 and the Subsequent Recovery of the Market

	Crisis 1997/98	Crisis 2008/09
1. Fall from the peak		
1.1. Intensity, %		
RTS index	-91.3	-78.2
MICEX index	-73.0	-68.2
1.2. Time-line, months		
RTS index	14	8
MICEX index	13	7
2. Recovery, months		
RTS index	58	36
MICEX index	8	37

Source: the RTS and MICEX data as of 01.02.2012.

However, it has become increasingly evident that the process of recovery of stock quotations during the recent financial crisis has been delayed. During the 1997-1998 crisis, because of a 5-fold depreciation of the Ruble, the MICEX Rb-denominated index bounced back to its pre-crisis peak values just in 8 months, while the RTS exchange index did it in 58 months. In 2008-2009 the Ruble depreciated by about 50% and won back roughly a half of the fall in the course of its subsequent appreciation. For this reason, both indices are now recovering at a roughly equal pace: the RTS index has done so for 36 straight months, while the MICEX index - for 37 months.

Against the background of major long-term financial crises of the last century (see *Fig. 1*) the Russian 2008-2009 financial crisis appears a short one, being even shorter in terms of duration of the "peak-to-recovery" than the domestic crisis of 1997-1998. When it comes to the W-shaped trajectory it is gaining, the crisis in question can be compared with the Korean 183 month-long financial crisis of 1989, albeit Russia's current slump to recovery process has thus far lasted for 44 months. As of January 2012, the RTS index recovered by 64.1% of its peak value reported in May 2008. The change in its recovery path from V- to W-shaped trajectory does not appear critical as yet. That said, given accumulation of challenges facing the global economy (the looming new wave of recession in numerous economies, the global economic growth running out of steam, the Eurozone crisis, among others), it should be remembered that in the modern history, stock market indices have not always been capable to bounce back to their earlier peak values. After its fall in 1989, Japan's Nikkei-225 has been struggling for 265 months to clear a bar above 22.6% of its pre-crisis value. In a three-year span, the index would be able to beat the 303 month-long recovery record DJIA had set in the wake of the Great Recession of 1929-1933. NASDAQ has likewise struggled to recover for 143 months and in January 2012 ended up being at just a 59.9% level of its peak value of 2000.

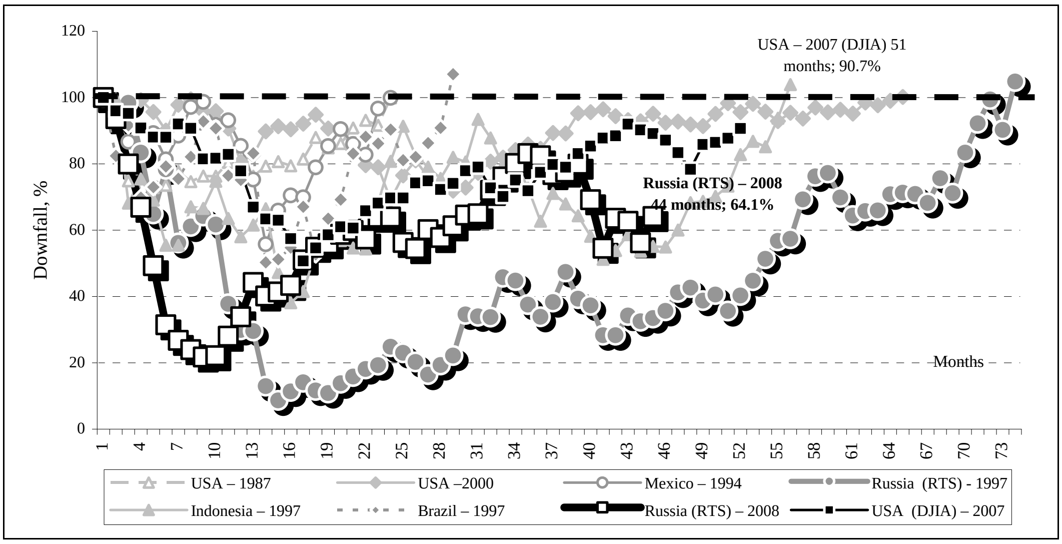


Source: the RTS and MICEX data, and www.finance.yahoo.com.

Fig. 1. Intensity and Duration of Long-Lasting Global Financial Crises as of February 2012

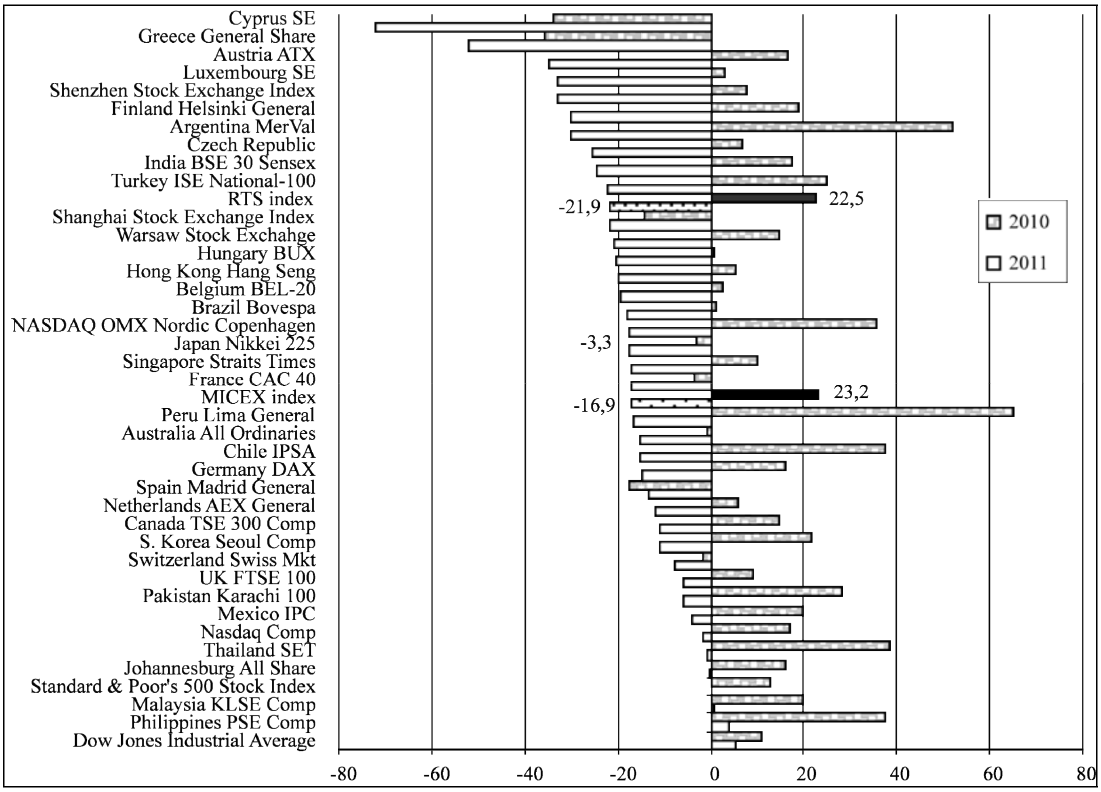
Against the background of the strongest over past decades short-term shocks, such as the "blue chips" crises in the US in 1987 and 2007, the fall of the DJIA in 2000, the 1994 Mexican, 1997 Indonesian and 1997 Brazilian crises (*Fig. 2*), the Russian current crisis appears more intense and one of the most long-lasting ones. By its length it can be compared with the 1997 Indonesian crisis when it took the local market 55 months to recover.

In 2011, the dynamics of the MICEX-RTS indices was atypical vis-à-vis other nations' indicators. Yield-wise, Russian stock indices typically hold leading positions, or, on the contrary, trail behind other markets. In 2008, the RTS and MICEX plunged by 72.4% and 67.2%, respectively, thus outpacing all other markets worldwide by intensity of the fall. In 2009, the Russian indices boasted the highest return in the world: specifically the RTS index was up 128.6% and the MICEX index - 121.1%. In 2010, the RTS index added 22.5% and the MICEX index - 23.2%, which catapulted the Russian stock market into the Top Ten most profitable markets worldwide (*Fig. 3*). In 2011, against the background of a significant fall of indices across nearly all the countries, because of the new wave of recession, with their rates of return of -21.9% and -16.9%, respectively, the RTS and MICEX indices found themselves in the middle of the list. The reason behind the failure was that at that time the impact of a relatively favorable situation with international oil prices in 2011, which would usually help the Russian stock indices to keep leading positions growth-wise, was largely neutralized by such unique for the situation factor as the outflow of foreign investments from Russia and bank liquidity challenges which exacerbated in H2 of the year.



Source: the RTS and MICEX data, and www.finance.yahoo.com.

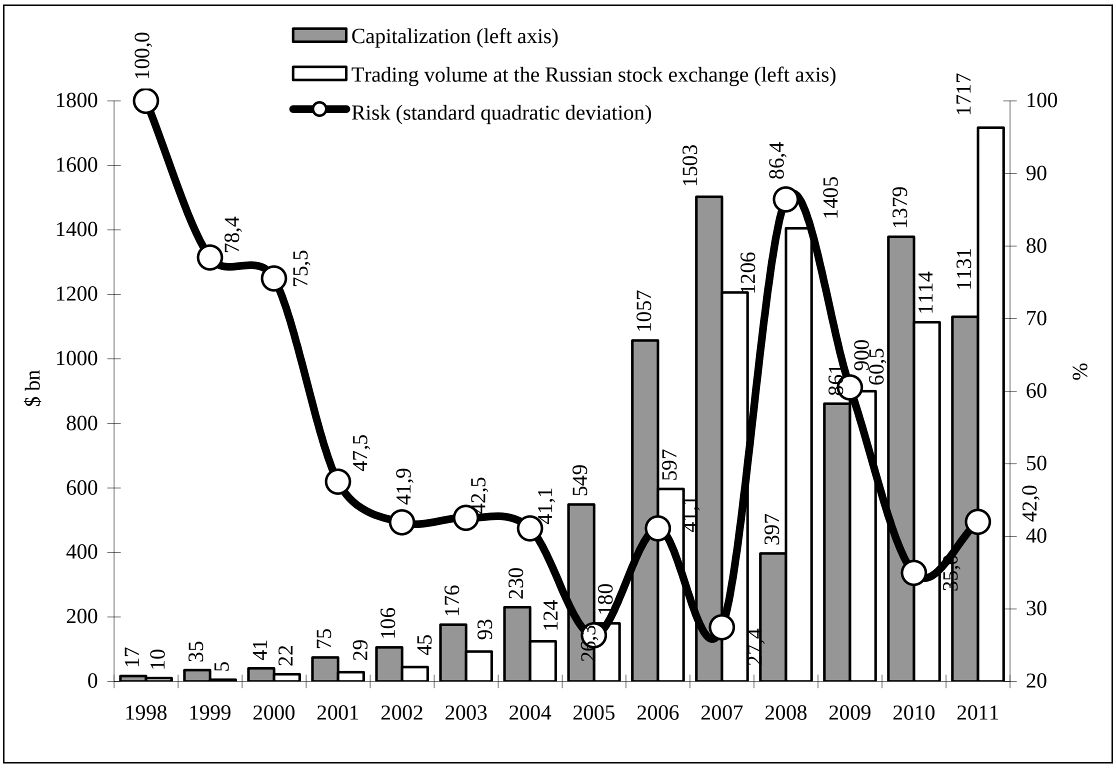
Fig. 2. Intensity and Duration of Short-Term Financial Crises
as of 2012/09 (Peak value=100%)



Source: RBC and WFE data.

Fig. 3. Yield Rates of Stock Indices Worldwide in 2010–2011, %

In 2011, the aggregate capitalization of Russian companies amounted to $1,131 trillion, down 18.0% when compared with the previous year (*Fig. 4*). The volume of trading on Russian exchanges in 2011 reached $1,717 trillion, up 54.1% vis-à-vis the 2010 figures. The advancement of stock exchange trading found itself arrested by a slowdown of growth in the number of active domestic investors on the stock exchange, decline of stock prices, no real progress made with attraction of new institutional investors, as well as measures to streamline the growth of high-frequency trading at stock exchanges. For example, on March 1, 2011, MICEX set new tariffs providing for a minimum, Rb. 0.18, commission fee with regard for transactions across all the trading regimes, except for REPO transactions[1]. In 2011, the volatility index rose from 36.0% in 2010 to 42.0% (the 1998 as 100%)

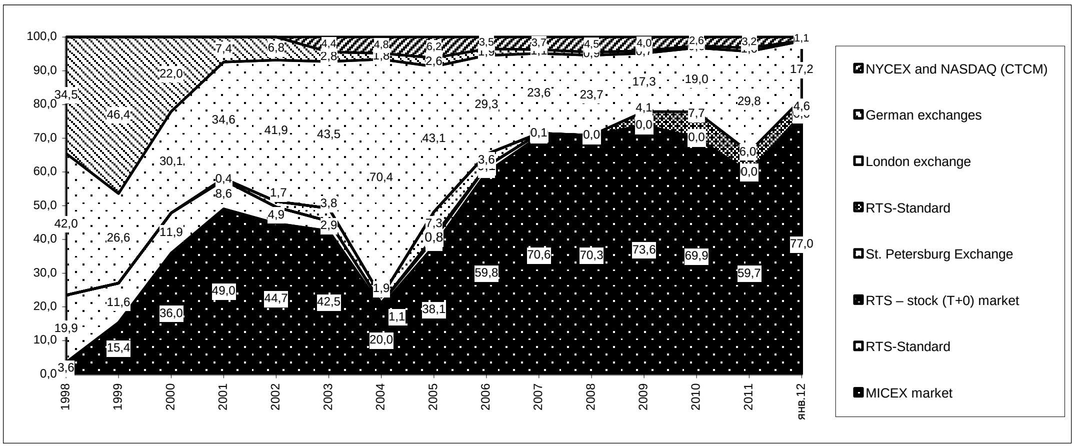


Source: by MICEX-RTS, S&P, IMF data.

Fig. 4. Capitalization, Liquidity and Volatility of Russian Stock Market

Trading-wise, the Russian stock exchange market has thus far managed to keep up with its global competitors. This is evidenced by data on the trading volume in equities and depositary receipts for Russian corporate stock on the national stock exchanges to those at foreign stock exchanges ratio (see *Fig. 5*). In this context, a positive development to maintain the Russian stock exchanges competitiveness was the stock exchange holdings MICEX and RTS merging into a single company, JSC "MICEX-RTS," which was closed on December 19, 2011.

[1] Trifonov A. MICEX is not up to nickeling-and-diming. Vedomosti, 8 February 2011.



Source: calculated on the basis of Russian and foreign exchanges' data

Fig. 5. Specific Weight of Exchanges in Volume of Trading in Russian Equities

The proportion of the merged MICEX-RTS in the organization of trading in shares and receipts for Russian corporate stock plunged from 77.9% in 2010 to 65.9% in 2011 on a year-on-year basis. The Russian stock exchange's equity market for shares is dominated by two segments – namely, the main market of MICEX and RTS-Standard. The share of each of them plummeted from 69.9% to 59.7% and 7.7% to 6.0%[1] respectively over the year. The contraction of the MICEX – RTS's proportion in volume of trading in Russian issuers' equity instruments is not yet critical. However, a tendency to a string of major issuers walking away from the exchange due to relocation of their HQ to overseas, transforming a company's status from public into private and corporate insolvency, which manifested itself in 2011, may emerge as a real threat to competitiveness of Russian organizers of trading.

The weak link of the Russian stock exchange remains the market for IPO-SPO, as the share of MICEX-RTS in the total volume of public offering of Russian corporations remains close to zero. According to Dealogic, in 2011 Russian companies ran IPO-SPO worth a total of $11.3bn. At the same time, NAUFOR suggests that Moscow-based MICEX-RTS ran only two IPOs amounting to $0.75bn[2]. Furthermore, according to NAUFOR, MICEX-RTS faced an adverse tendency of large issuers delisting their stock. A number of companies (JSC "Polymetal", OJSC "Polyus Gold") completed restructuring and moved their headquarters abroad. It is only equities of their foreign subsidiaries, Polymetal International and Polyus Gold International Ltd, that continue being quoted, but they are set for delisting soon, nonetheless. Other issuers (RBC "Information Systems", Ufaneftekhim, Ufaorgsintez, Red October, LOMO, Power Machines, Tulamashzavod, JSC "Concern" Kalina", to name a few) are busy carrying out or have already completed delisting for other reasons, including restructuring,

[1] The way correlation between the main market and the merged MICEX-RTS's Standart one is going to unfold will form one of major intrigues on the market for Russian equities, as the main market is an embodiment of a clearly outdated system of guarantees of execution of deals basing on advance reservation of assets by parties to a transaction. Meanwhile, the Standart market is a prototype of a more modern system of guarantees of execution of exchange deals to a pre-set date without advance reservation of assets. Transition to the more modern system of settlements is most likely to suggest an advanced expansion of the Standart segment vis-à-vis the main market of MICEX-RTS.

[2] Improving the securities issuance procedure (the NAUFOR report). December 13, 2011. The document is posted on the NAUFOR website:http://naufor.ru/tree.asp?n=9411&hk=20111216

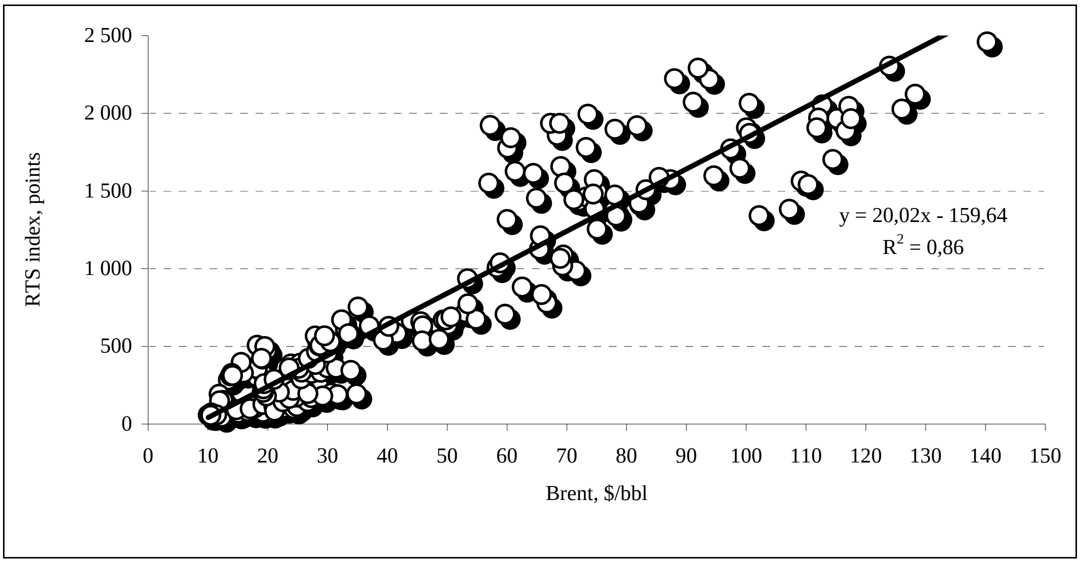
more stringent requirements to listing introduced by the merged stock exchange vis-à-vis the earlier JSC RTS's ones, among others.

3.2. Russian Equity Market

As in the previous years, the main drivers of the price dynamics corporate stock were the global commodity prices, primarily the ones of oil and gas; the foreign portfolio investors' behavior, the Ruble exchange rate; the tumultuous global economy and the swelling financial crisis in Europe. Most of these factors are independent of the Russian authorities' economic policy.

3.2.1. Dependence on the Global market prices

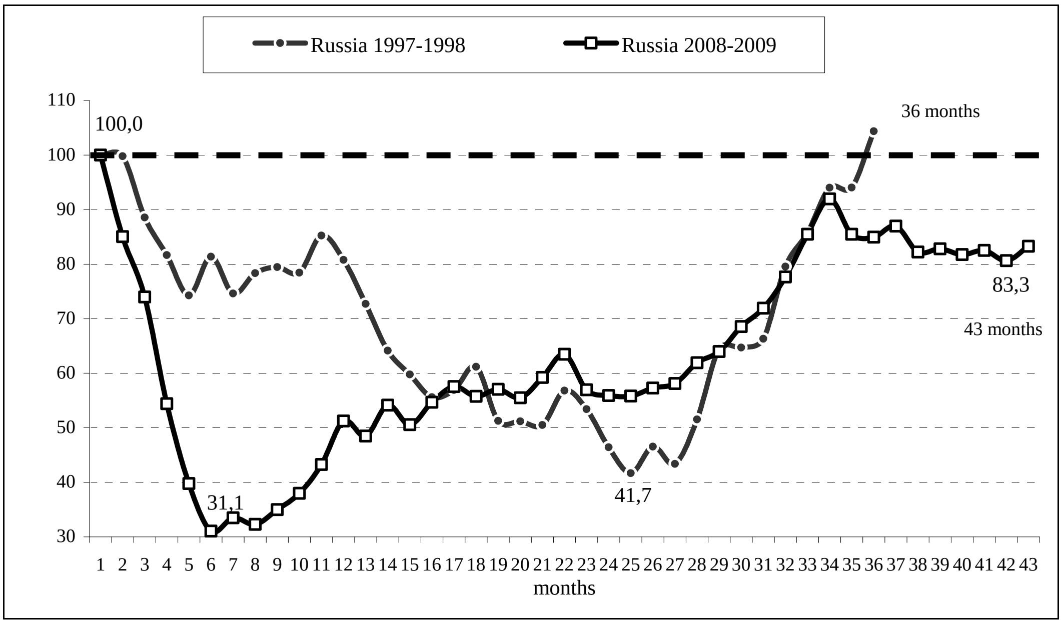
The dependence of the Russian equity market on oil prices is hardly a surprise. The coefficient of determination (R^2) between the absolute monthly values the RTS index and the Brent crude price between September 1995 and December 2011 depicted in *Fig. 6* makes up 0.86, thus evidencing a very intimate relationship between the said indexes.



Source: by IFS IMF and MICEX-RTS data.

Fig. 6. Dependence of RTS index on Brent Prices from September 1995 through December 2011

According to the international financial organizations and the RF Ministry of Economic Development's forecasts, no rapid rise in oil prices is anticipated in years to come. Moreover, due to the looming global economic recession, it looks like that since mid-2008 the dynamic of oil prices was taking a W-shaped trajectory (*Fig. 7*). When compared with the 1997-1998 crisis, it is going to take the current prices far longer time to recover and hit their pre-crisis (June 2008) values. Whether they are able to do so, time will show. According to the RF ministry of Economic Development's innovation-based scenario forecast of February 8, 2011, which formed the basis of the Strategy-2020, the price of Urals oil in 2020 would remain at the level of $ 109/b. The average 2012 oil price per barrel is projected to tumble from the today's $ 111 to about $ 100.



Source: by the IFS IMF data.

Fig. 7. Downfall and Recovery of Brent Prices during Financial Crises in Russia (the Price Peak = 100%)

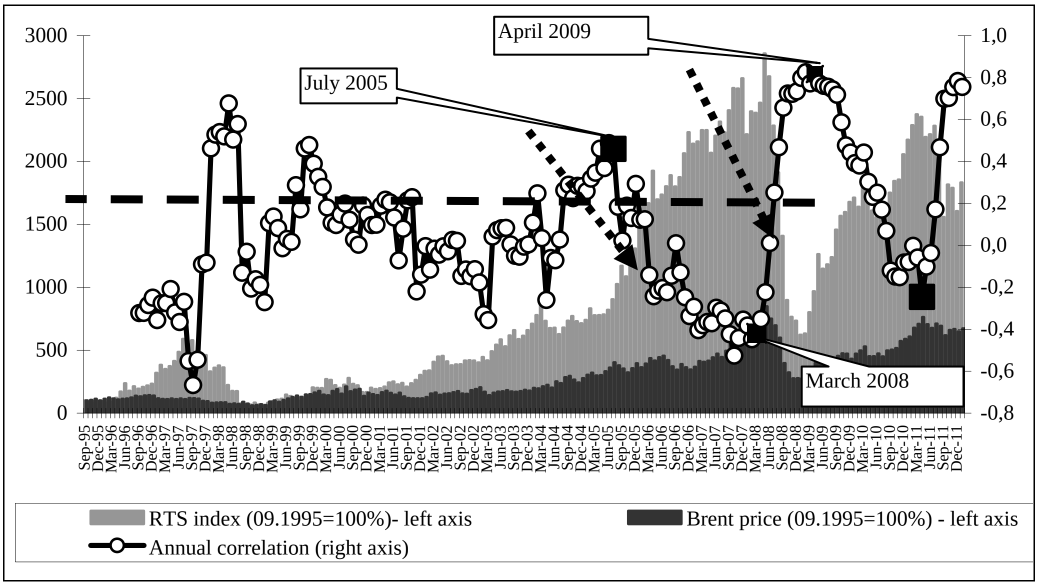
A more adequate picture of the correlation between stock prices and oil prices can be drawn from an analysis of relative changes in the said indices. *Fig. 8* depicts results of changes in the correlation coefficient between the monthly relative changes of the RTS index and prices of Brent crudes during the 12-month period. The peculiarity of a moving correlation curve lies in its reflecting intensification or weakening of the link between the two indicators with one-year lag.

The curve of the correlation between changes in the RTS index and the oil price has cyclical nature. The correlation coefficient is down and becomes negative once the index is on its way to the precrisis peak or right in between it having passed the peak and prior to the acute phase of the crisis. This means that the oil price and the value of the index suddenly begin to change in different directions. During the collapse of the stock market a positive correlation between changes in the index and oil prices is back, while once the crisis developments are on their way to the bottom phase, the correlation value once again heads to "minus" one.

The dynamic of the correlation curve in the last decade allows a clear distinguishing of five periods:

– between the early 2000’s. and July 2005 - an increase of correlation coefficients from the level -0.2 to 0.5, the oil price and the RTS index are on the uprise;
– between July 2005 and April 2008 - the correlation coefficient is down from 0.5 to -0.5, the oil price and the RTS index are on the upsurge, in H2 2006 and H1 2007 oil prices are down;
– between April 2008 and April 2009 – the correlation coefficient skyrockets from its level of -0.5 up to 0.8, and the period in question sees oil prices and Russian equities collapse;
– between April 2009 and April 2011 - the correlation coefficient is down from the level of 0.8 to 0.2, the oil price increases moderately and remains volatile, while the RTS index is experiencing a rapid recovery growth;

– between May 2011 and December 2011, the RTS index is down drastically , while the oil prices slide fairly insignificantly.



Source: calculated by data of IFS IMF and the MICEX-RTS Exchange.

Fig. 8. Correlation between Changes in the RTS Index and Prices of Brent between September 1995 and January 2012

3.2.2. Cash inflow / outflow of foreign portfolio investment

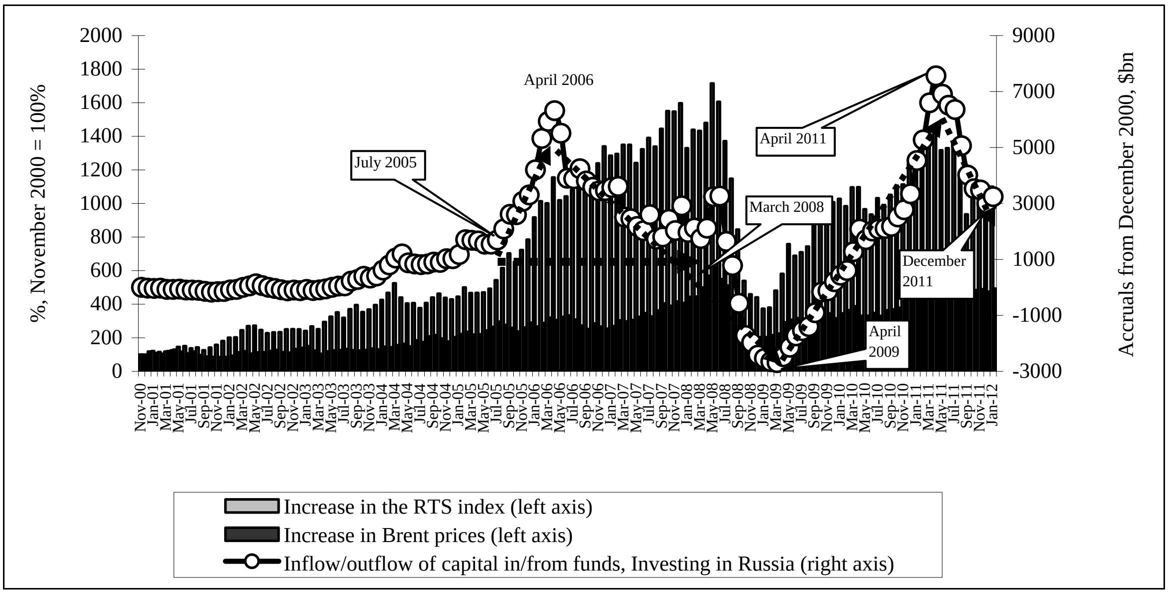
The cyclicality of the correlation between relative changes in oil prices and Russian corporate stock quotations is explained by a significant impact on the latter by outflows and inflows of foreign portfolio investors' monies, as documented by the Emerging Portfolio Fund Research (EPFR)[1]. In terms of its impact on Russian stock prices this factor is equivalent of oil price dynamics, as evidenced by data in *Fig. 9*.

Back to the five aforementioned periods during which the nature of the correlation between changes in the RTS index and the oil prices dynamics was changing, it is an analysis of investment accumulated by foreign funds specializing in Russia which can explain the phenomenon in question.

The growth in the correlation coefficient between changes in the index and the oil price between the early 2000's and July 2005 was due to the fact that during that period, both factors that affect the dynamics of the stock market – namely, oil prices and cash inflow into foreign

[1] The EPFR data of in-and outflow of funds in/out of foreign funds whose profile is investment in Russia can be regarded as an indicator of investment behavior pattern of larger foreign portfolio investors, including global and regional funds. By our estimates, the specialized funds' portfolios make up some 50% of regional and global investment funds' investment in Russia. Should, for instance, investors in a specialized fund withdraw their investments therefrom, that does not yet mean capital flight out of Russia. Capital flight would occur only when a fund begins selling out its investments in Russian equities to honor its obligations before its investors. If cash is withdrawn out of global or regional funds, it is practically impossible to quantify the impact of this transaction on contraction of these funds' investment in Russian equities, which accounts just for a fraction of the funds' aggregate portfolio. That said, if cash is withdrawn out of foreign funds specializing in Russia, global and regional portfolio investors are most likely to be scaling back on their investments in Russia too.

funds investing in Russia – exhibited a unidirectional effect. Oil prices were being on the rise, portfolio investments were pouring in, and the RTS index was climbing up steadily. As shown in *Table 2*, between November 2000 and June 2005 the specialized funds cashed in $ 1.5bn of investors' money.



Source: by data of IFS IMF, MICEX and EPER.

Fig. 9. Increase in the RTS Index, Oil Prices, Inflow (Outflow) of Resources in Funds Investing in Russia

The fall of the correlation coefficient between July 2005 and April 2008 to -0.5 was driven by multidirectional dynamics of oil prices and foreign portfolio investors' funds. Between July 2005 and April 2006, despite the increase in the volatility of oil prices, the funds investing in Russia absorbed new investments worth a total of $ 4.8bn (see *Table 2* and *Fig. 9*). Behind the spike of the inflow of short-term investments was international investment rating agencies awarding Russia their investment ratings. More specifically, FITCH did that on November 17, 2004, and S&P followed the move on January 31, 2005. Besides, on May 31, 2005, the first verdict on the first of Mikhail Khodorkovsky's trials was rendered, and many portfolio investors bought the Russian authorities' assurances that the case would be an exception. However, since April 2006 through nearly April 2008, investors in the foreign funds drastically revised their preferences. Despite a steady increase in oil prices, the funds investing in Russia began seeing a hectic withdrawal of funds (see *Fig. 9*). As a result of the portfolio investment outflow, the RTS index growth rate decelerated significantly vis-à-vis a rapid rise in oil prices.

Between April 2008 and April 2009, the increase in the correlation coefficient up to 0.8 fell on the stock market's collapse. At the time, a sharp decline in oil prices was accompanied by a vigorous withdrawal of cash out of the foreign funds investing in Russia, while the RTS index was likewise sent nose-diving over the period in question.

The fall of the correlation coefficient, as well as of the oil price index to -0.2, between April 2009 and April 2011 was once again due to the fact that the accelerated growth of the RTS index was based largely on an active cash inflow in the foreign funds in parallel with a moderate rise in oil prices. During that period, the funds received a new $10.2bn of investors' funds.

That the coefficient of the correlation between the index and oil prices between May and December 2011 bounced back to 0.8 should be ascribed to the fact that the oil price factor and the foreign investment one once again began working unidirectionally. Oil prices were down in the second half of the year, and private investors began to withdraw their cash from the funds that invested in Russian equities. Between May and December 2011 the funds lost $ 4.6bn and the RTS index, accordingly, was notably down, too.

Table 2

Cash Inflow/Outflow in/from Foreign Funds Investing in Russian Equities according to EPFR

	Inflow (+)/ Outflow (–) in/from the funds, as $ mn
November '00 – June '05	1,538
July'05 – April '06	4,769
May '06 – March '09	-9,005
April' 09 – April '11	10, 255
May '11 – December '11	-4, 560

Source: calculated on the EPFR data.

Displayed in *Fig. 9,* the graph of cash flows accumulated by foreign investment funds specializing in investments in Russia shows that radical changes in the investors' behavior were there in May 2006 and May 2011 This allows identification of main factors that affect major portfolio investors' decisions, as well as estimating volumes of cash flows that can generate price shocks across the market for Russian equities. According to *Table 2*, between May 2006 and March 2009 as much as $ 9.0bn was withdrawn from the foreign funds that specialize in investing in Russian equities, and another $ 4.6bn was withdrawn between May and December 2011. Even if one doubles the estimates with account of a possible similar behavior of managers of regional and global funds which were disinvesting in Russia at the time, it turns out that shock changes in stock prices on the Russian market can engender a gradual withdrawal of an amount equal to an aggregate 1-2-day volume of trading on the MICEX-RTS.

A provocative explanation of factors which predetermine adverse changes in the behavior of foreign investors in funds specializing in investment in certain markets was offered by the IMF experts in the September 2011 Global Financial Stability Report[1].They employed the EPFR data on the in- and outflow of cash in/from special investment funds for the period between January 2005 and May 2011 across equity funds worldwide, in Asia, Latin America, Europe and the Middle East, and in developed economies. According to the study, the most substantial factors with the significance rate at a level of 1% with regard to cash in- and outflow were:

– official projections of real GDP growth rates (with «+»);
– volatility of GDP growth rates (with «–»);
– volatility of exchange rate(s) (with «–»);
– indicator of expected volatility in the stock market - index VIX (with "-").

Meanwhile, the indicators of the level of interest rates and strictness of forex regulation proved to be among loosely significant factors.

[1] IMF. Financial Stability Report. September 2011, p. 11–18. Posted at: www.imf.org.

These factors can be regarded as harbingers of future crises on financial markets. Investment funds' portfolio managers specializing in certain markets fairly successfully employ such factors. Interestingly, the said IMF study maintains that the strongest shock in the form of a maximum amount of $ 4.4bn withdrawn from funds investing in Europe, Middle East and Africa fell right on June 2006. It was the very month when, as displayed *in Fig. 5,* there occurred a reverse in the tendency that concerned the funds investing in Russian equities. In the circumstances, in April 2006, the IMF report on the global economy noted a trend to reduction in GDP growth rates in H2 of the year in the most significant developed and emerging economies[1] as well as disturbances of VIX index that became visible since Q2 2005[2]. Both phenomena might signal an outflow of portfolio investors' funds. Spikes of volatility of projections of GDP growth and stock price hikes mirrored experts and markets' concerns about disproportions of national trade balances, the looming crisis on the U.S. market for mortgage-backed securities and other factors that ultimately led to the 2008 recession.

Interestingly, while withdrawing cash out of the funds investing in European equities, including Russian, Middle-East and African corporations, in June 2006, global portfolio investors displayed a phenomenal foresight, thus outrunning in this regard the most courageous prophets of the future financial crisis. The famous statement by Prof. N. Rubini about the looming mortgage crisis at the IMF meeting was made only in September 2006. At the Davos meeting in February 2008, Mr. A. Kudrin, Russia's Finance Minister, argued that Russia was going to be a safe harbor amid the global financial crisis. However, foreign investors began running out of Russia and the other emerging markets already as early as in May 2006.

The causes behind the capital outflow from the funds investing in Russia in May 2011 proved in many ways similar to those noted back in May 2006. Last time, global portfolio investors were likewise alerted by the increasing volatility of the global economic growth projections and the international financial organizations having cut their projections of GDP growth rates in the biggest economies.

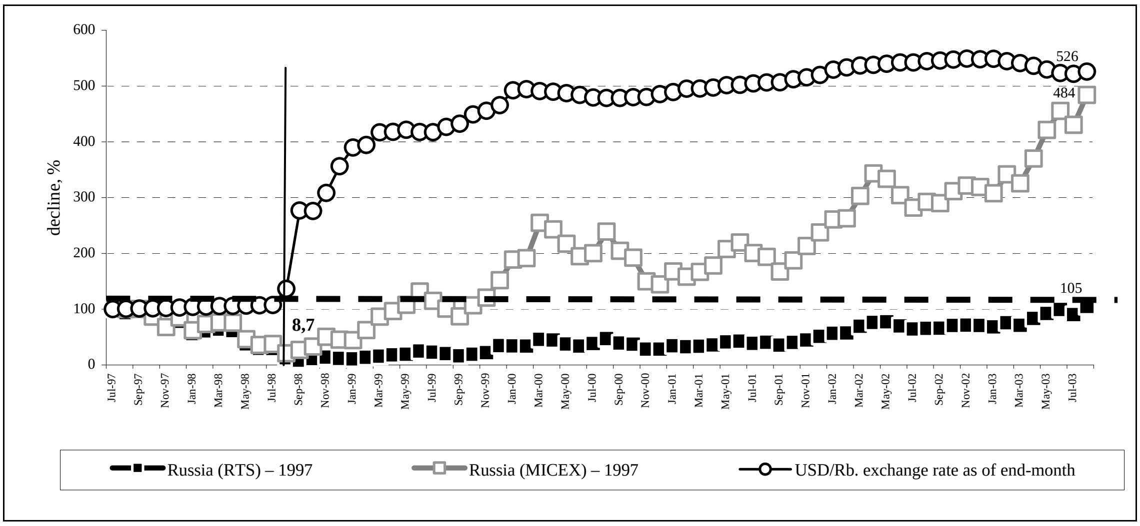
3.2.3. Forex Rates

The differences in the intensity of depreciation of the Ruble during the crises in question determined different dynamics of the RTS and MICEX indexes' recovery. As equities in the portfolio MICEX index are valued in the Ruble equivalent, while those in the RTS index's – in the USD equivalent, the subsequent recovery of the MICEX index following a more than 5-fold depreciation of Ruble[3] in 1998 was outpacing that of the RTS index (Fig. 10). It was already May 1999 when the MICEX index bounced back to its pre-crisis peak value, i.e. just in 8 months after it had hit the bottom of the crisis. By contrast, it took the RTS index 58 months to recover after a similar plunge.

[1] World Economic Outlook (WEO), April 2006, Fig.1.8. Posted at: www.imf.org.

[2] In his book, "Fault Lines" (Moscow, Delo Publishers, 2011, p. 272) R.Rajan noted that between Q2 2005 to Q2 2007 two-year implied volatility of S&P500 option price was at 30–40% above the short-term one-month volatility.

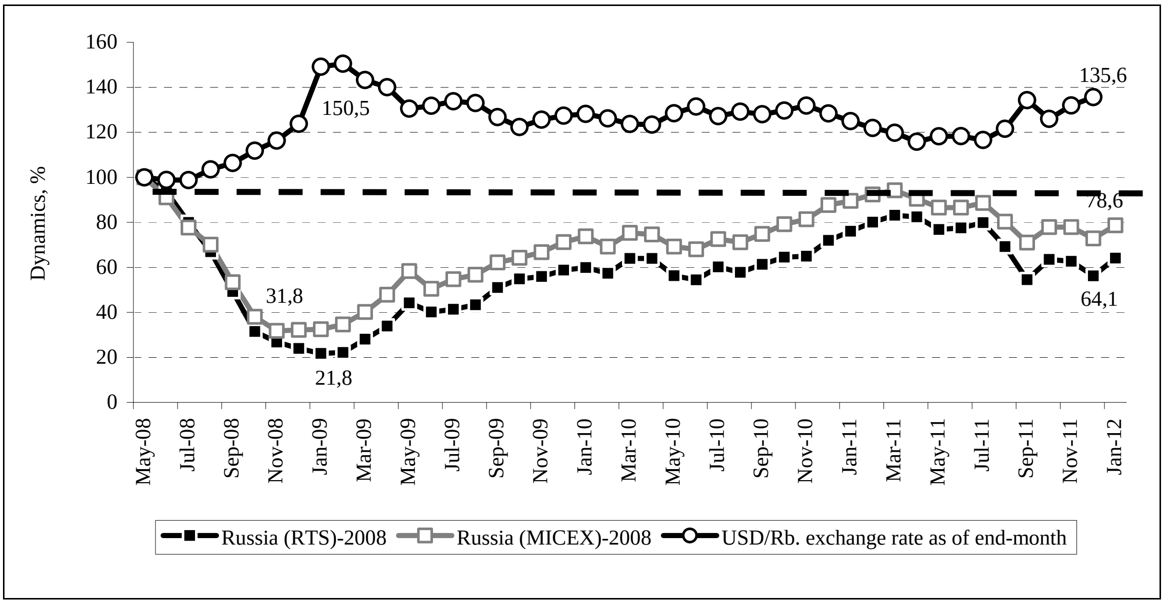
[3] Between 1998 and 2003.



Source: MICEX-RTS and the Bank of Russia.

Fig. 10 Changes in the USD Exchange Rate, the RTS Index and the MICEX Index during the 1997-98 Crisis (July 1997 = 100%)

During the 2008-2009 crisis, the peak level of the Ruble devaluation accounted for 50% (*Fig. 11*), followed by its appreciation. For that reason, the RTS and MICEX indexes had been recovering at a practically equal pace, with the latter index slightly outpacing the former one. In January 2012, the RTS index hit 64.1% of its peak value registered back in May 2008, while the MICEX index climbed up to 78.6% of its respective peak value.



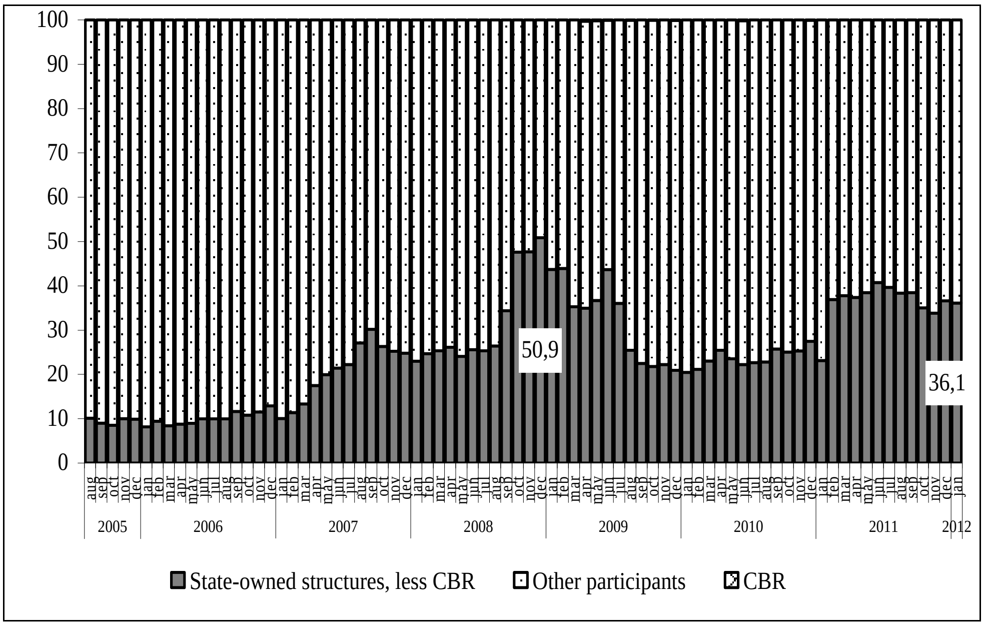
Source: by data of JSC RTS, MICEX, and the Bank of Russia.

Fig. 11. Changes in the USD Exchange Rate, the RTS Index and the MICEX Index during the Crisis between May 2008 and January 2012 (May 2008 = 100%)

3.2.4. Competition on the Domestic Equity Market

The year of 2011 saw a notable increase in public corporations and agencies' influence on the stock market, which manifested itself in expansion of the proportion of state-owned financial institutions in the volumes of equity trading, their role in managing the merged MICEX-RTS exchange, public agencies' powers with regard to regulation of, and control over, infrastructure organizations, and enactment of the law on insider trading on the financial market.

Fig. 12 displays results of state-owned banks and their associated structures'[1] equity transactions on the major MICEX-RTS market. At the peak of the crisis, between September 2008 and July 2009, this segment of the market witnessed a notable increase in state-owned players' activity. In December 2008, their proportion in the volume of market equity transactions surged to 50.9%. It was in many ways determined by the process of transition of a string of large agents (KIT-Finance, Svyaz-bank) under state-owned banks' control, as well as by implementation by VEB of the stock market support program with the use of a repayable loan of Rb 175bn from the National Welfare Fund. During the market recovery period, the share of state-owned banks and their related structures in the volume of equity trading tumbled, but the tendency has reversed since February 2011, and the said share hit the level of 36.1% in December 2011. This can be ascribed to Troika Dialogue having transited under Sberbank of Russia's control in tandem with the rise in the company's trading activity.



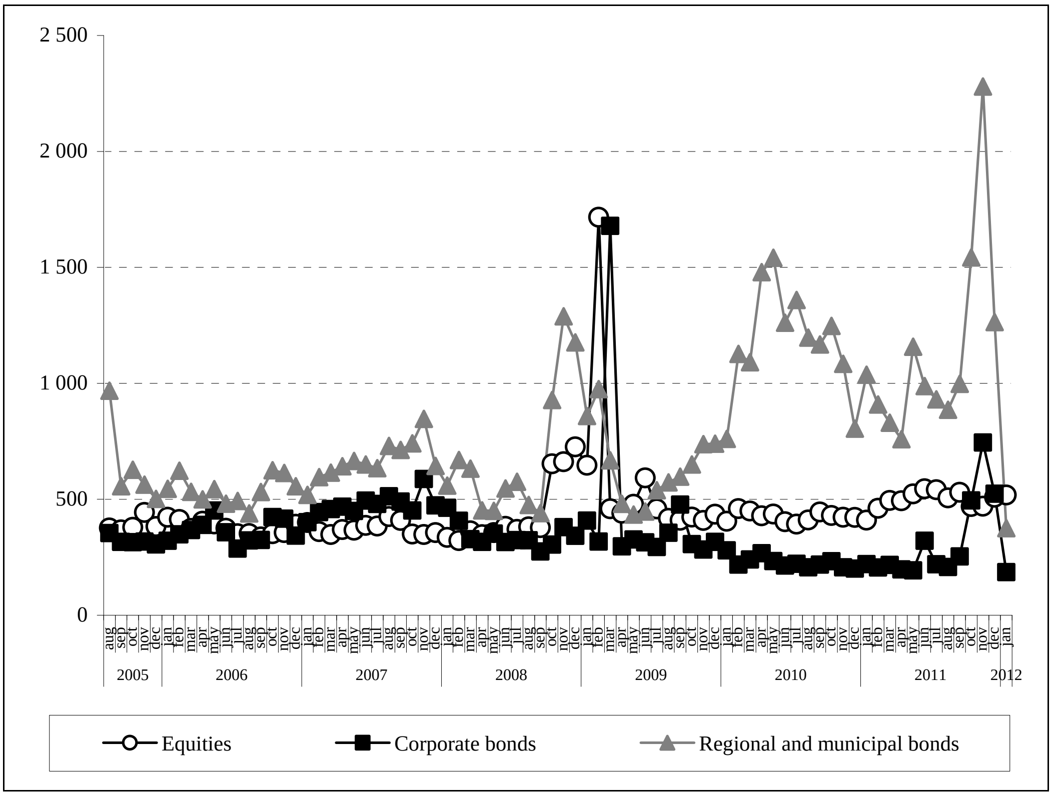
Source: calculated by the MICEX-RTS data.

Fig. 12. Shares of Private and Public Brokers in Volumes of Stock Trading at MICEX-RTS, as %

The presence of a considerable number of players on the stock exchange market, including servicing non-residents, a vigorous application of algorithmic trading patterns and other short-term strategies ultimately resulted in a highly competitive domestic stock market, despite of

[1] VEB, VTB, VTB Capital, VTB24, Gazprombank, Sberbank, KIT Finance, Svyaz-bank, the Bank of Moscow, Transcreditbank, and Troika Dialogue (since 2001).

the rise in the proportion of public structures operating therein. The finding is proved by data in *Fig. 13*, which comprises information of the dynamic of the Herfindahl-Hirschman Index (HHI)[1] with regard to turnover at the MICEX-RTS securities market between January 2005 and January 2012. According to FAS, the market appears low concentrated with the value of HHI being below 800, moderately concentrated in the event 800 < HHI < 1,800, and highly concentrated with HHI above 1,800[2]. Throughout 2011, HHI with respect to transactions on the major MICEX-RTS stock market was steadily being at a level in the region of 500.



Source: calculated by the MICEX-RTS data.

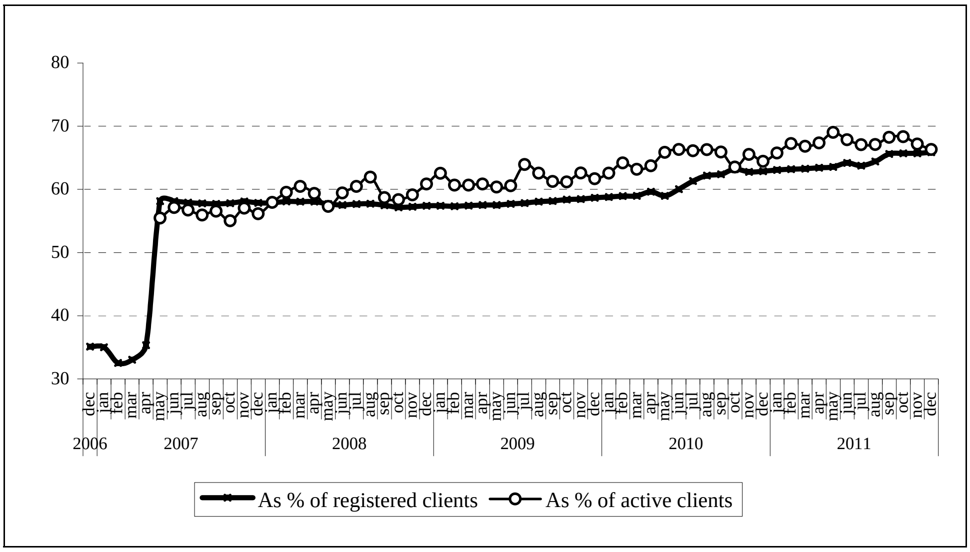
Fig. 13. Herfindahl-Hirschman Index by Volume of Secondary Stock Exchange Trading on the Major MICEX-RTS Market (All the Regimes)

Fig. 14 comprises data on the proportion held by Top 7 brokerages in the overall number of registered and active clients[3] of participants in stock trading at the Major Market Section at SE MICEX. During 2010–2011, the said share in both indexes has been soaring steadily and, as of December 2011 hit 65%.

[1] The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. The HHI number can range from close to zero to 10,000. The HHI is expressed as: HHI = $(D1)^2 + (D2)^2 + ... + (Dm)^2$, where D*i* – the market share of *i*- participant expressed in percent; $i = 1, 2, ..., m$.

[2] See item 2.6.4. of the Methodological Guidelines on the procedure of conduct of analysis and assessment of the state of the competition environment on the market for financial services as approbated by Executive Order of the Anti-Monopoly Ministry of RF of 31.03.2003 No. 86.

[3] According to the MICEX-RTS rules, a client who completes at least one deal a month at the SE MICEX qualifies for the “active client” status.

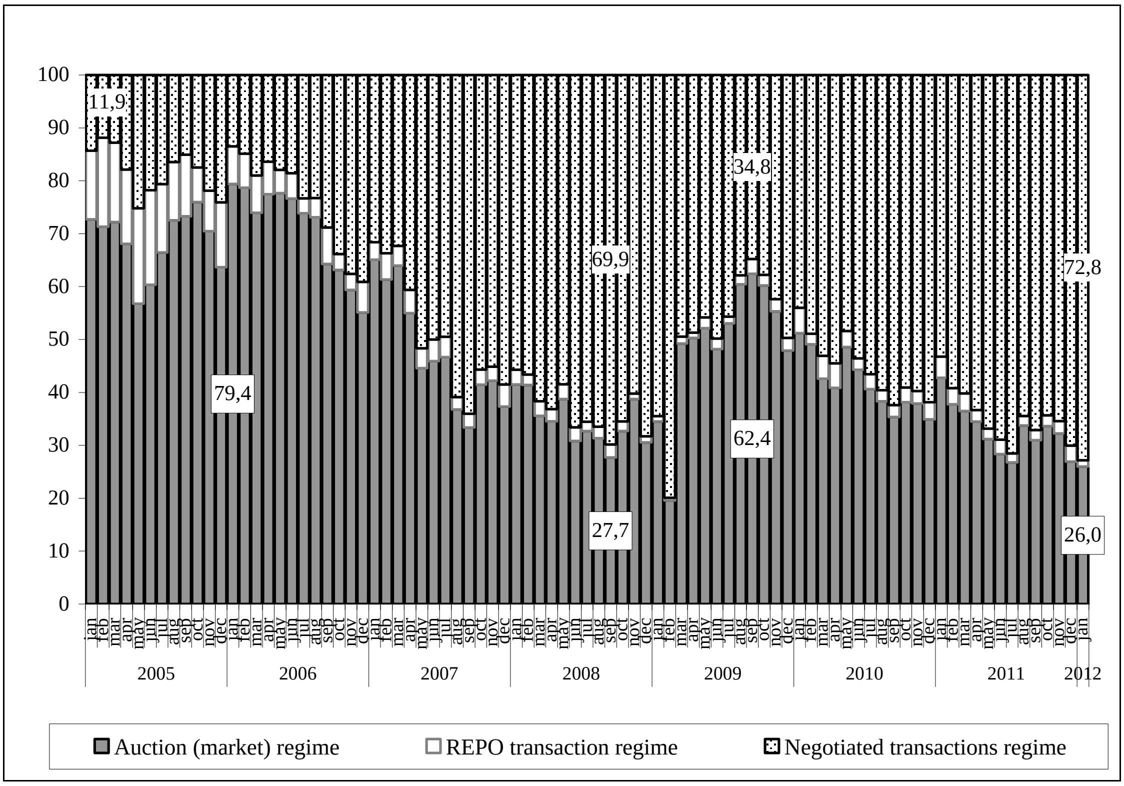


Source: calculated by the MICEX-RTS data

Fig. 14. The Share of Top 7 brokerages in Clients' Assets, as %

Fig. 15 provides reference to the change in the structure of transactions with equities at MICEX-RTS. The data exposes existence of a tendency to post-crisis recovery of the proportion of REPO deals in the structure of market equity transactions. By using REPO deals on the stock market, brokerages, as a rule, attract short-term borrowed resources to carry out a subsequent marginal lending to their clients. In January 2012, the proportion of REPO deals hit 72.8% of the volume of trading in the major market section of JSC MICEX-RTS, thus outstripping the 69.9% pre-crisis (September 2007) record-breaking level. The expansion of the proportion of REPO transactions evidences renewal of marginal lending of securities trading. This, on the one hand, means that investors are getting increasingly keen on the market for risky assets, while on the other hand, exhibits growing risks of speculative activity of the Russian equity market. The data on the correlation between market transactions and REPO ones are of interest because they allow an indirect assessment of the degree of advancement of marginal transactions on the stock market. The fact of the matter is using REPO deals on the exchange market for equities, participants in the trading obtain resources for marginal lending. An increase in the proportion of REPO transactions means a surge in the volumes of marginal loans to strike deals under the market regime. Data in *Fig. 15* show that the period between 2010 and 2011 saw volumes of marginal lending be on the upsurge, even despite the fact that equity prices were falling in 2011, which should have lowered the need in marginal loans, which are used, as a rule, to implement trading strategies on the bullish market.

A critical aspect of advancement of the stock exchange market is the growing popularity of short-term and, primarily, high-frequency, trading, and deployment of trading robots. This is evidenced by outcomes of "The Best Private Investor" contests RTS and MICEX ran separately in 2010 and jointly, as MICEX-RTS, in 2011. It was traders who deployed trading robots who won the contests. According to the Russian exchanges' data quoted by Kommersant daily, up to 90% of stock market orders and 50% of turnovers on the RTS FORTS spot market fall on robots; on the MICEX's spot market, hyper-active trading robots hold 45% of orders and 11-13% of trading volumes. Meanwhile, 95% of the said orders at MICEX are subsequently called off with no deals stricken[1] in their wake. In March 2011, MICEX kept on attempting to regulate trading robots' operations. Since 1 March 2011, the exchange set up a minimum commission fee of Rb 0.14 per transaction; plus, its management established requirements to a minimum size of the lot with regard to stocks and shares in an amount of no less than Rb 1,000, which should result in consolidation of most lots on stock and shares issues[2]. The measures aim at encouraging large-scale deals and minimizing the number those not charged a commission fee.



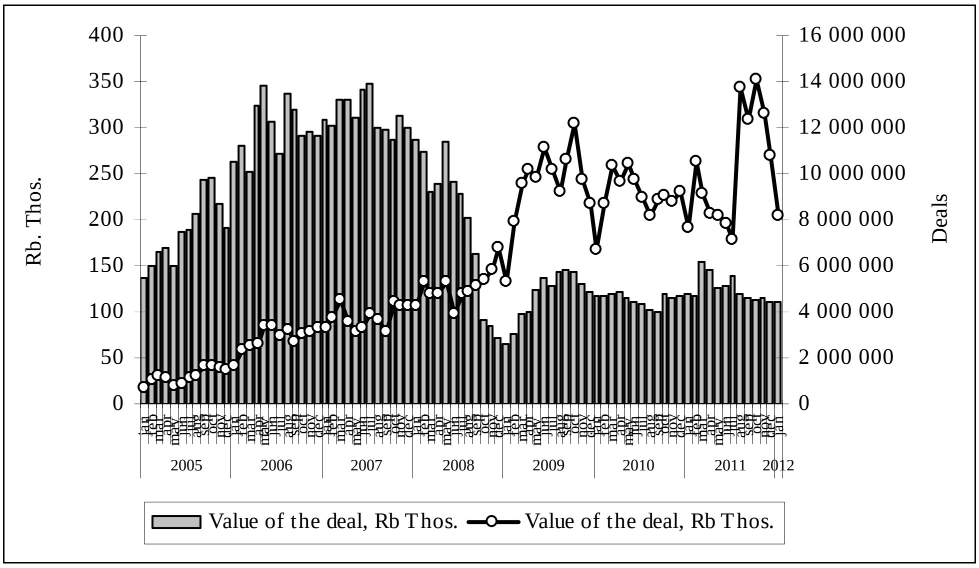
Source: calculated by the MICEX-RTS data

Fig. 15. Structure of Equity Transactions on the main MICEX-RTS Market, as %

Fig. 16 displays data on the number of transactions and an average size of an individual transaction in the market (anonymous) regime of stock trading at MICEX. The data show that several recent years have witnessed a steady tendency to the rise in the number of such transactions vis-à-vis a notable dimunition in their volumes. In the past three years, the average monthly number of transactions increased from 6.8m in December 2008 up to 10.6m in February 2011, or by 55.9%. Meanwhile, the average volume of market exchange equity transactions was down notably, despite the continuous process of stock quotations' recovery. In September 2009, the average amount of the equity transaction in the said trading regime at MICEX was Rb 145,200, while in February 2011 – Rb 117,300 or down 19.2%. The rise of the algorithmic trading manifests itself, in the first place, in an increase in the flow of orders in the trading system. However, in 2010-11, the amount of market equity transactions discon-

[1] Smorodskaya P. MICEX took on robots: the trading is distanced from automats. Kommersant, 20 July 2010.
[2] Trifonov A. MICEX is not up to nickeling-and-diming. Vedomosti, 8 February 2011.

tinued plummeting, which may be ascribed to private investors losing appetite for high-frequency trading against the background of the stagnating inflow of brokerages' new active clients.



Source: calculated by the MICEX-RTS data.

Fig. 16. Market Equity Transactions on the MICEX-RTS Main market

With its new Head in office in 2011, FSFM adjusted its requirements to capital adequacy ratio of professional operators on the securities market. On 30 July 2009, the agency approved an Executive Order regarding modifications introduced in capital adequacy standards for professional participants in the securities market, as well as managing companies of investment funds, mutual funds and non-government pension funds. In compliance with the document, capital adequacy rates were raised for professional participants in the security market who exercise:

– brokerage and securities trust management – from Rb 10mn up to Rb 35mn effective since 1 July 2010 and further up to Rb 50mn – since 1 July 2011;
– dealer operations – from Rb 5mn up to Rb 35mn effective since 1 July 2010 and further up to Rb 50mn – since 1 July 2011;
– depository operations (except for clearing depository) – from Rb 40mn up to Rb 60mn effective since 1 July 2010 and further up to Rb 80mn – since 1 July 2011;
– operations on running registers of owners of registered securities – from Rb 10mn up to Rb 100mn effective since 1 July 2010 and further up to Rb 150mn – since 1 July 2011.

Against the background of the discontinuation of expansion of investment and managing companies' client bases, the absence of a real progress with adoption of tax measures to encourage the residents' long-term investments, the current concentration of financial services in the hands of a narrow circle of participants represented by state-owned banks and companies, the measure in question could have resulted in a mass exodus of brokers, dealers, trust and pooled investment managers. The decision on raising the standards since 1 July 2011 was abrogated, and the standard rates were kept at the level effective as of 1 July 2010.

Because of the above conditions unfavorable for expansion of financial intermediaries' businesses, the year of 2011 saw the process of contraction of the number of professional participants in the securities market continue, nonetheless, as evidenced by *Table 3*. In 2010 alone, particularly due to introduction of increased capital requirements effective as of 1 July 2010, the number of brokers was down by 9.1%, and that of dealers – by 10.4%, while the number of participants in trading at MICEX plunged by 0.8%. According to NAUFOR (the Russian National Association of Securities Market Participants), at year–end 2010 FSFM revoked 236 licenses for their former corporate holders' non-compliance with the agency's capital adequacy requirements[1]. According to Mr. A. Timofeev, head of NAUFOR, "those actions yielded no positive results"[2]. In 2011, the number of brokers and dealers shrank by 10.6% and 9.4%, respectively, while the number of participants in MICEX trading slid by 2.3%.

Table 3

The Number of Professional Stock Market Participants

	2007	2008	2009	2010	2011
1. The number of organizations awarded a FSFM license to exercise:					
1.1. Brokerage	1,445	1,475	1,335	1,213	1,084
change in % vs. the previous period		2.1	-9.5	-9.1	-10.6
1.2. Dealer operations	1,422	1,470	1,337	1,198	1,085
change in % vs. the previous period		3.4	-9.0	-10.4	-9.4
2. The number of participants in MICEX trading	636	669	654	649	634
change in % vs. the previous period		5.2	-2.2	-0.8	-2.3

Source: by data of FSFM, NAUFOR, SE MICEX.

Unfortunately, the absence of publicly available financial reports of brokers, dealers, trust managers, and requirements to their mandatory submission in compliance with the IFRS standards does not allow an objective assessment of the impact increase or lowering of barriers to entry/exit this kind of business have on its efficiency. Without such an analysis, any decisions on tightening or loosening requirements to capital adequacy will be doomed to remain subjective. Yet greater concerns about effects of drastically intensified regulatory influences on financial institutions' business are stirred by the fact that the governmental measures have not yet been coupled with real steps to implementing an adequate stock market development strategy. The beefing-up of regulatory and oversight measures, with no robust efforts in the business development area missing, may entail just a rise in public structures' monopoly, supplanting of legal forms of financial mediation by illegal ones, particularly in regions, and domestic investors increasingly picking foreign financial service providers.

That private financial structures are increasingly concerned about public agencies' interferences in their business is evidenced by acquisition, upon FAS's consent, by Zoulian Trustees Limited (Cyprus) of 99.5% of voting stock of JSC "Investment Holding "Finam". The Finam representative commented on the deal in the following manner: "…we have not faced any hostile takeover, but anything may happen in Russia…"[3]. The banking sector statistics also mirrors growing doubts about the domestic market' prospects. Between 2009 and 2011 shareholders of as many as ten foreign banks[4] announced scaling back on their presence in Russia, including International Personal Finance, Santander, Rabobank, Barclays, Swedbank, HSBC, RBC Group,

[1] Trifonov A. No indulgency for managers. Vedomosti, 23 June 2011.
[2] Smorodskaya P. Capital adjustment. Kommersant, 16 May 2011.
[3] Zhelobanov D., Gubeydullina G. "Finam" is going off-shore. Vedomosti, 1 July 2010.
[4] Dementieva K., Khvostik E. A foreign body. Kommersant, 31 March 2011.

Morgan Stanley. Numerous investment companies and banks in Russia declared personal banking services to wealthy Russians as the most preferred alternative to retail banking.

3.2.5. Consolidation of Stock Exchanges and their Transition under the Control of the Bank of Russia and State-Owned Banks

The year of 2011 saw the MICEX and RTS merger deal close. The merger will have a huge impact on the future development of Russian stock market. The establishment of a single exchange on the basis of MICEX and RTS can, given other conditions being equal, ensure a positive effect in the form of liquidity concentration, acceleration of conclusion of transactions across different segments of the financial market, saving participants in trading and investors' direct and indirect transaction costs, solidification of Russia's standing on international capital markets. The merger can also ensure a synergy effect by saving on staff, market makers, IT systems maintenance, operational costs and other costs. By end year-2011 MICEX-RTS had already joined Top-20 largest global exchanges and Top-10 leading platforms in terms of the derivatives market turnover.

The substance of the merger is as follows: for the sake of merging, JSC RTS was appraised at $1.15bn, or Rb 34.5bn, while CJSC MICEX – $3.45bn, or Rb 103.5bn. The reorganization is exercised in the form of takeover of RTS by MICEX. In the course of the takeover RTS's shareholders have been given a possibility to sell 35% of their stock to CJSC MICEX and convert the remaining stock into JSC MICEX shares. Meanwhile, ordinary and preferential registered uncertified shares in JSC RTS are converted into ordinary registered uncertified shares of CJSC MICEX redeemed from the CJSC MICEX shareholders and into additional ordinary registered uncertified shares of CJSC MICEX placed for the sake of conversion. While completing the takeover, the conversion of the JSC RTS stock into the CJSC MICEX one was run using the following ratios: 0.309393 ordinary registered uncertified shares of JSC RTS with face-value of 1 Rb each and 0.309393 preferential registered uncertified shares of JSC RTS with face-value of 1 Rb each were converted into one ordinary registered uncertified shares of CJSC MICEX with face-value of 1 Rb each. The number of CJSC MICEX stock to be allocated to each shareholder in JSC RTS is calculated by dividing the number of shares of a given category he/she has in JSC RTS into a respective conversion ratio. The milestones of the merger are presented in *Table 4*.

Meanwhile, the first fruits of the deal raise certain controversies among different market participants. "Company" magazine labeled the deal as the "Deal of the Year". By contrast, when between 29 June and 1 July www.exchange-integration.ru ran a survey "How do you feel about the merger of the exchanges?", as many as 73% out of a total of 849 visitors of the resource who took part in the ballot responded negatively to the question.

Behind concerns about a positive impact of the merger there is a string of factors. First, the merger eliminated the long-lasting competition between them MICEX and RTS which had long been a major driver of their development. Mr. A. Savatyugin, the RF Deputy Finance Minister, cited this factor in an interview to the "Securities Market" journal[1]. The dream that in that case the domestic competition between the exchanges would be substituted by the competition between MICEX-RTS and foreign exchanges may not come true, as most participants in trading currently appear loosely integrated in the global market. To this end, on

[1] I am confident in the correctness of the existing market regulation system. The Securities Market, 2012, No.1, p. 19.

4 August 2011 FSFM registered and submitted to the RF Ministry of Justice an Executive Order which allows circulation on foreign exchanges of 100% (vs. the previous maximum of 25%) of Russian issuers' stock in the form of receipts, except for strategic corporations for whom the ceiling is 25% and companies associated with mineral production, whose cap is 5%. However, it is envisaged that the Order shall take effect as of the date of enactment of a federal law which regulates conditions and procedure of the central depository's operations.

Table 4

Russian Exchanges Merger Milestones

29 December 2010	At a meeting on creation of an international financial center, market participants and representatives of agencies concerned ruled to merge to exchange holdings and have the Bank of Russia withdraw from the MICEX's capital until the end of 2011
1 February 2011	The Top five shareholders of JSC "SE RTS" – Troika Dialog, Aton, Alfa Bank, Renaissance Broker and the managing company Da Vinci Capital – who combined owned 53.7% of the exchange's capital, signed an agreement on intention to sell their shares in the capital. The deal suggested that CJSC MICEX would acquire a control stake in JSC SE RTS and the two exchanges would then merge. RTS was appraised at $1.15bn, and it was suggested that 35% of its stock would be purchased for cash, while the remaining packages will be swapped for CJSC MICEX stock with the 1 to 3[1]. Symbolically, the event was held on the Bank of Russia's premises
10 March 201.	To complete the transition to the single share within the exchange holding shareholders of CJSC MICEX ruled to increase the authorized capital by placing additional ordinary shares to be swapped for those of CJSC SE MICEX
22 June 2011	FSFM registered a report on the outcome of the issuance of JSC MICEX's shares in the frame of the transition towards the single share
29 June 2011	Signing of the deal on the merger of MICEX with RTS by taking over JSC SE RTS by CJSC MICEX.
5 August 2011	The deal and its parameters were approved at general shareholder meetings of JSC SE RTS and CJSC MICEX, with 93.4% of MICEX's shareholders and 99.7% of RTS's shareholders having voted in favor of it. Those shareholders who voted against the deal or failed to take partake in the voting became eligible for putting option. More specifically, it was representatives of Eurofinans Capital who voted against the merger. Plus, the RTS's shareholders voted in favor of acquisition of assets of non-commercial partnership "SE RTS" and planned to spend $37mn on that. Meanwhile, the MICEX's shareholders decided to run an additional stock issuance to redeem an RTS stake worth a total of Rb 553.3mn
9 September 2011	FAS approbated the deal
19 December 2011	The two exchange holdings merged legally, and MICEX-RTS kicked off its operation
Q4 2012	Takeover of settlement and clearing structures of the RTS Group (the Clearing House of RTS and the Depository Clearing Company) by NCO JSC "NSD"
Until mid-2013	JSC MICEX-RTS going for IPO

The exchange merger deal resulted in an excessive strengthening of the influence the state-owned structures and banks exert on the stock market infrastructure to the detriment of private corporations' interests. Furthermore, according to Mr. A. Savatyugin, the merger was carried out under administrative pressure on market participants[2].

According to our estimates (*Table 5*) the Bank of Russia and the public banks basically have managed to retain their share in the merged exchange. But because of the merger, the exchange "JSC RTS", where private structures would control managing bodies, sank in non-existence. As a result, according solely to open sources, the newly formed exchange is at 53.53% controlled by the Bank of Russia and the four public banks, without regard to the share of controlled by Sberbank Troika Dialog. That is to say, the united group is controlled by public structures and the Bank of Russia in the first place. One of deputies to the CBR

[1] Smorodskaya P. RTS was traded with MICEX. Government has disposed the exchanges to merger. Kommersant, 2 February 2011.
[2] I am confident in the correctness of the existing market regulation system. The Securities Market, 2012, No.1, p. 19.

Chairman presides over the Board of the exchange[1]. At the first stage of the deal, it was envisaged that the Bank of Russia would quit the group of owners of the exchange as early as in 2011 – now it is envisaged this is going to happen between 2013 and 2015[2].

Table 5

The pre- and post-Merger Structure of MICEX and RTS Shareholders

Prior to the restructuring		**Post-restructuring, as of 13.02.2012**	
JSC "RTS"	**$1,150mn**	**JSC MICEX-RTS**	
Aton LLC	9.82%	The Bank of Russia	24.33%
Renaissance Broker LLC	8.21%	Sberbank of Russia	10.36%
JSC Deutsche Securities[3]	9.00%	VTB	5.35%
JSC MC Troika-Dialog	10.00%	VEB	8.71%
JSC Alfa-Capital	9.59%	Gasprombank	4.78%
KIT Finance LLC[4]	10.03%	CJSC UniCredit Bank	9.59%
Da Vinci Capital	14.9%	EBRD	6.29%
Other shareholders	28.45%	Other shareholders*	30.59%
CJSC "MICEX"	**$3,450mn**		
The Bank of Russia	28.60%		
Sberbank of Russia	7.51%		
VTB	7.08%		
VEB	10.52%		
Gasprombank	6.15%		
CJSC UniCredit Bank	11.59%		
Other shareholders	28.45%		

*By RBC data of 27 January 2012, EBRD and the Russian Equity Fund were going to acquire 7.54% of the MICEX-RTS stock combined, with EBRD getting 6.29% and REF - another 1.25%, according to the exchange's press release.
Source: calculated by the data of the exchanges' reporting.

The merger in question does not appear to have been quite transparent from the perspective of the property structure. As of today, the information the exchange disclose about its stockholders does not allow one to understand who makes key decisions and how the balance of interests between government and private structures, banking and non-banking institutions is maintained. It seems that the effect of item 72 of the Statute on operations on organization of trading on the securities market approbated by Executive Order of FSFM of 28 December 2010 No. 10-78/pz-n, which provides for the commitment for organizers of trading to disclose information solely about ownership of stock packages of above 5%, is an outdated one. Stock exchange is a major infrastructure organization on the stock market and as such it has a strategic significance. In this context it was not accidental that in the summer of 2010 FSFM and FSB of Russia blocked an attempt by KIT Finance to sell a stake in JSC "SE RTS" to a foreign bank (EBRD). Thanks to their interference, an 11% stake was ultimately acquired by a structure of the MICEX group.

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[1] According to the RBC daily Publishers of 9 February 2012, MICEX-RTS is to change the composition of its Board of Directors prior to the IPO. According to a source close to the Government, one of frontrunners will be A.S. Voloshin, the head of the task force on creation of the International Financial Center. Furthermore, he may become the Chairman of the Board in his capacity of an independent director.

[2] Ulyukaev A. We have underperformed with regard to oversight. An interview to Vedomosti Daily of 6 June 2011; presentation of the Bank of Russia "On merging CJSC MICEX with JSC RTS" and the procedure of the Bank of Russia stepping out of the list of shareholders in CJSC MICEX

[3] According to mass media, this stake was acquired in favor of IC Troika Dialog proceeding from an appraisal of JSC RTS at an amount of $920mn (Asker-Zade N. How to part from RTS. Vedomosti, 21 February 2011)

[4] The stake was acquired by MICEX FINANS LLC proceeding from an appraisal of JSC RTS at an amount of $840mn. (Smorodskaya P. Investors play the merger. Kommersant, 21 February 2011).

Stock exchange should remain exemplary when it comes to high standards of information about the shareholder structure. The Bank of Russia currently demand from banks to fully disclose the list of their beneficiaries, while FSFM is keen to encourage all shareholders of Russian JSC to disclose themselves as beneficiaries under to the threat shareholders who fail to disclose themselves in the register of suspension of the right to vote at general meetings. Against such a background the lenient requirements to exchanges with respect to disclosure of the structure of their owners seem incongruous.

The merger deal was accompanied with withdrawal of sizeable amounts out of both exchanges' equity capital:

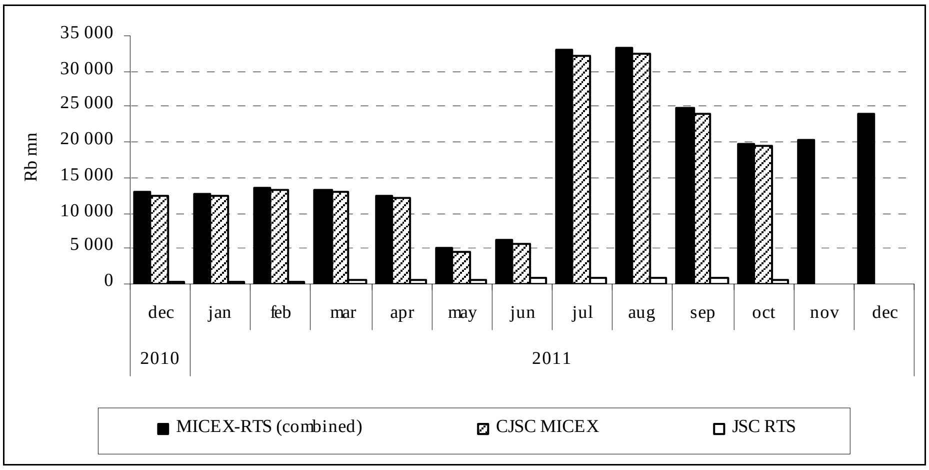
– payment of Rb 1.5bn in dividends to stockholders of JSC RTS by results of the 2010 performance, per the memorandum of understanding between MICEX and RTS, for the sake of "equalization of valuation of both exchanges"[1];
– a sum to redeem JSC RST stock from shareholders who joined the takeover deal and voted for it (in a volume no more than 35% of the shareholders' packages, with the rest of the stock to be converted into the united exchange's stock); according to the current calculations, this volume should not exceed Rb. 8.9bn[2];
– a sum to redeem JSC MICEX stock from shareholders who voted against the takeover of JSC RTS in an amount of Rb 5.6bn (in compliance with p.1 of Art. 75 of the Federal Law "On joint-stock company", no more than 10% of the amount of the company's net assets as of the last reporting date, i.e. Rb 56bn)[3];
– payment of Rb 81.6mn in interim dividends to shareholders of JSC RTS for H1 2011;
– payment of $20mn, or some Rb 0.6bn, towards acquisition of assets of non-commercial partnership "SE RTS", including the RTS Plaza trading system and the data processing center;
– payment of Rb 11.7bn in dividends to shareholders of JSC MICEX payable partly in shares of JSC "SE RTS" and partly in cash[4];
– in the event the merged exchange fails to complete an IPO by mid-2013, the RTS shareholders would be able to sell their stakes in JSC "MICEX-RTS" proceeding from the current valuation of RTS in an amount of $1.15bn plus a 12.5% annualized interest; the amount in question can total some Rb 36.4bn.[5]

So, given all the dividends due, including those payable in the form of JSC RTS stock, the aggregate amount of payments made in favor of shareholders in the process of preparation for, and completion of, the deal on reorganization of the stock exchange holdings made up some Rb. 28.4bn, or a. $1bn. Plus, in the event of a failure with the IPO, the MICEX-RTS exchange will have to pay its participants up to Rb 36.4bn. In this context it was not accidental that, according to media sources, the acquisition of a 6.29% stake in the merged exchange by EBRD and another 1.25% stake by REF was made at a discount in the region of 10%[6].

[1] Smorodskaya P. RTS is sold in pieces. Kommersant, 13 April 2011
[2] www.exchange-integration.ru/voprosyotvety
[3] *Ibid.*
[4] *Ibid.*
[5] Rudenko P. The two-in-one exchange. Kommersant, 19 December 2011
[6] Butrin D., Rudenko P., Mazunin A. A national security stockholder. Kommersant, 31 January 2012

According to Mr. A. Ulyukaev, First Deputy Chairman of the Central Bank, and MICEX-RTS representatives, in the course of the upcoming IPO the united exchange is going to hit the level of capitalization of $6bn[1].

Fig. 17 illustrates the dynamics of change in the exchanges' equity capital as the deal on their merger progressed. The amount of the equity capital was very volatile, which may stir potential investors' concerns. Perhaps the official statement should be appended with explanations of such sizeable changes in accounting data.



Source: calculations by data on equity capital posted on the MICEX-RTS's homepage on the Internet.

Fig. 17. The Russian Exchanges' Equity Capital

The formal legal merger of the exchanges does not mean as yet establishment of an integral infrastructure of trading and settlements on the spot and futures market. Since the completion of the merger, 19 December 2011, there still have operated two parallel sections of the futures market, the two technological platforms remained different and clearing and depository and settlement operations have not been consolidated in a single center.

Integration of the IT, trading and clearing systems appears a slower process vis-à-vis the pace of the legal and administrative merger. The problem manifested itself in serious operational failures in 2011. More specifically, on 9 August, trading was halted for an hour and a half at the futures section of RTS. The same occurred on 17 August at SE MICEX, with no updates available over the first quarter of an hour after the failure occurred[2]. Subsequently, because of glitches, SE MICEX suspended operations on 1 and 8 November, with an incorrect interaction between software components of a string of nodes that ensure participants' access to the trading system cited as a cause behind a two hour-long suspension of trading on 1 November and an incorrect mirroring of information of cash balances of participants in trading as a main reason for an hour-long suspension of trading on 8 November[3]. On 24 November 2011, JSC RTS delayed trading sessions on the futures market RTS and the RTS Standart market for a half an hour, and they kicked off at 7-30pm, instead of 7pm. The day of the legal merger of the exchanges, 19 December 2011, was darkened by an unprecedented failure in the futures market section, with unauthorized transactions starting to run after the clearing by re-

[1] Rudenko P. The exchange overvalued the placement. Kommersant, 13 February 2012.
[2] Mazunin A., Rudenko P. MICEX partly shut down America. Kommersant, 19 August 2011.
[3] Trifonov A. The morning without an exchange. Vedomosti, 9 November 2011.

sults of main session across participants in trading was over. As a result, numerous private investors suffered losses[1].

Meanwhile, the exchange's executives and numerous brokers through whom the deals were concluded argued that they were not bound to compensate for such investors' losses[2]. The exchange staff asserted that the cause for the glitch was that after completion of settlements by the main session, inaccurate data about the participants' trading and monetary positions were uploaded onto the trading system. According to Mr. D. Pankin, head of FSFM, as MICEX and RTS were busy with financial and legal aspects of the merger, they failed to ensure uninterruptable trading sessions.[3]

3.2.6. The Increase of the Role of the Government in the Area of Regulation and Oversight

In 2011, the Government firmed up the regulating authorities' functions on the securities market and replaced the previous head of FSFM, Mr. V. Milovidov, with Mr. D. Pankin. In compliance with Decree of the RF President of 4 March 2011 No.270 "On measures on improving of state regulation in the sphere of financial market of Russian Federation", the Federal Insurance Oversight Service (Rosstrakhnadzor) was integrated in the structure of FSFM. At the same time, the Ministry of Finance was granted powers with regard to normative and legal regulation of the financial market, thus sharing these powers with FSFM. The Decree also reads that in its capacity of a body of executive power FSFM reports directly to the RF Government.

On 31 August 2011, Prime Minister V. Putin approved reallocation of responsibilities between the Ministry of Finance and FSFM. The respective Resolution was signed on 29 August and posted on the RF Government's homepage on 31 August. The major principle underpinning the reassignment is delegation to the Ministry of Finance the power to develop the government policy and normative and legal regulation in the sphere of financial markets, including powers with regard to development of strategic avenues of advancement of the securities market. Meanwhile, FSFM will exercise normative and legal regulation aiming at improvement of oversight and control in an established form of operation. The current authority sharing by FSFM and the Ministry of Finance does not appear an optimal one, as, in our view, it means scattering the regulatory powers across various organizations and gives rise to a conflict of interest for the Ministry of Finance in its capacity of the securities market regulator and a participant therein. Once the new division of powers took effect, it decelerated the pace of adoption of new bills advocated by numerous market operators, in particular, draft amendments to the Federal Act "On Investment Funds" which concerns index funds. It is not accidental that in the follow-up of the meeting of the International Advisory Council on creation and development of the international financial center in Russian Federation of 28 October 2011, the RF Government was tasked to submit by 1 February 2012 proposals on extension of the FSFM's powers with respect to prevention of abuses on financial markets, protection of investors' interests, in particular, in the court of law, as well as on granting it the right to design and submit to the RF Government federal bills and other drat normative and legal acts in the financial markets regulation area.

[1] Rudenko P., Mazunin A. Stock-Majeure. Kommersant, 20 December 2011.
[2] Rudenko P., Mazunin A. MICEX-RTS's clients were wasted. Kommersant, 21 December 2011.
[3] Verzhbitsky A. Dmitry Pankin is displeased with failures. RBC daily, 17 November 2011.

The year of 2011 witnessed adoption of three fundamental federal acts on infrastructure organizations- namely, Federal Act of 7 February 2011 No. 7-FZ “On clearing and clearing operations” (The Law on clearing), Federal Act of 21 November 2011 No. 325-FZ “On organized trading” (The Law on trading) and Federal Act of 7 December 2011 No.414-FZ “On the central depository” (The Law on central depository). The main positive impact of the above acts is that they establish legal grounds for operation of a centralized system for conclusion of deals, running clearing and settlement operations on the domestic market for investment assets. That said, the aforementioned federal acts have failed to dissipate concerns about the growing impact public agencies and the state-owned banks have on infrastructure organizations’ operation. As the operating clearing organizations and settlement depositories are at nearly 100% subsidiaries to the JSC MICEX-RTS, it is regulation of the exchange which is worth exploring in the first instance.

We believe the Law on trading substantially strengthened the public agencies’ leverage effect on the exchange. Whereas the Law on trading changed dramatically the concept of organizer of trading, stock exchange and items traded at the exchange, after its adoption, MICEX-RTS will have to claim a new license in 2012. The Law on trading does not contain any restrictions for public structures and the Bank of Russia in their capacity of stockholders of the exchange. In compliance with p.9 Art.6 of the Law on trading, election (appointment) of the person who exercises functions of the sole executive body and other top managers of the exchange is permitted only upon a preliminary consent of the federal body of executive power in the financial markets area (FSFM of Russia). In accordance with Art.6, the principal managing body of the exchange is its Board of Directors, which at MICEX-RTS is currently dominated by public structures and companies, while decisions of the exchange Council, which is at 75% formed by participants in trading (Art. 10), are recommendatory. In accordance with Art.25, practically all the exchange’s operations and entitling documents are subject to FSFM’s approval. What is more, Art.25 holds that the regulatory body even sets up the index calculation procedure.

The Law on the central depository has been designed and enacted in the atmosphere of heated debate. The swords were crossed over the issue of the central depository’s exclusive right to open the nominal holder’s accounts with the registers and the mandatory requirement to keep the central depository as a sole structure[1]. In 2012, it is envisaged to accredit one of the currently operating clearing depositories – most likely the National Settlement Depository (NCD) - as the central depository. The Law on the central depository does not restrict public agencies’ participation in its authorized capital, either. Like the exchange’s tariffs, those of the central depository should be set up by the Board of Directors, while the central depository should coordinate them with FSFM. Granting the status of the central depository falls under the FSFM’s purview, per the procedure established by the Ministry of Finance.

On 31 July 2011, a number of provisions of Federal Act of 27 July 2010 No. 224-FZ “On countering illegal use of insider information and manipulation of the market and on introducing amendments to individual legislative acts of Russian Federation” became effective. In furtherance of the Law, FSFM adopted a series of normative and legal acts. The financial market participants were to submit to the exchanges insider lists until 31 December 2011. According to the FSFM Head, in 2011 the regulator held three audits and exposed just 16 cases of ma-

[1] Mazunin A., Rudenko P. Depository memorandum. Kommersant, 22 August 2011; Rudenko P. A center for securities has popped up. Kommersant, 10 October 2011.

nipulation. The documents were forwarded to law-enforcement agencies and a number of individuals who had committed manipulations were brought to administrative responsibility[1]. These facts suggest that the oversight of compliance with the insider law has thus far been limited.

One of the challenges to advancement of the stock market is establishment of a favorable tax regime for domestic market agents and residents. The Strategy of Development of the Financial Market of Russian Federation for the period through 2020 approved by Resolution of the RF Government of 20 December 2008 No. 2043-p (Development Strategy) meant to address the problems, but unfortunately, like in the prior year, in 2011 regulatory bodies once again failed to effectively tackle problems in the taxation area. On 23 June 2011, there took effect Federal Act No. 132-FZ "On introducing amendments into Art. 95, Section One, Section Two of the Tax Code of Russian Federation with regard to formation of favorable tax environment for innovation activity and Art. 5 of the Federal Act "On introducing amendments to Section Two of the Tax Code of Russian Federation and individual legislative acts of Russian Federation", which abrogated the tax on foreign investors' income from sales of publicly traded stock. In the past, such incomes were taxed at a rate of 20% which was withheld by the broker in his capacity of tax agent. The abrogation of the tax concerns legal relations arisen since 1 January 2011.

In December 2011, the RF Ministry of Economic Development designed a draft Resolution of the RF Government on exemption of long-term venture investors in innovation corporations' equity from the corporate profit tax[2]. But other than that, there have been no more serious moves in the taxation area, albeit the problem of tax incentivizing of private investment is one of critical challenges facing Russia's stock market. While presenting at the "Government Hour" at the Federation Council on 9 November 2011, Mr. D. Pankin, Head of FSFM, reckoned that his agency was on the same page with the Ministry of Finance in regard to reinstatement of tax benefits for long-term investors who have owned papers for more than three years[3].

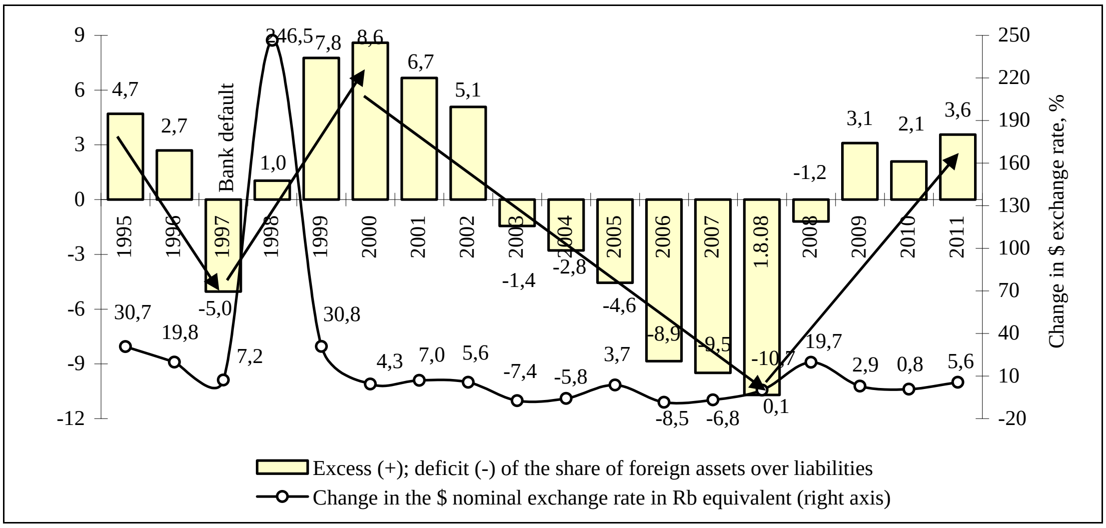
3.3. Financial Institutions in Search for New Ideas for Growth

3.3.1. Constraints to the Carry Trading Strategy and Increase of the Financial Leverage

The year of 2011 saw the RF authorities search for a sustainable development pattern for the domestic banking system in the conditions of a constrained implementation of the carry trading (CT) strategy. The constraints were determined by the closure of global financial markets for borrowers from emerging economies, the capital outflow from Russia, and the effect of measures on limiting implementation of the strategy by Russian banks. The magnitude of engagement of banks in CT is exhibited by the indicators of deficit (–) and surplus (+) of banks' foreign assets vis-à-vis costs of non-residents rights of claim to banks compared with the overall value of banks' assets displayed in *Fig. 18*. The year of 2011 became the third year in a row when the cost of banks' forex-denominated assets proved to be in excess of the amount of their liabilities to non-residents and accounted for 3.6% of the amount of banks' assets.

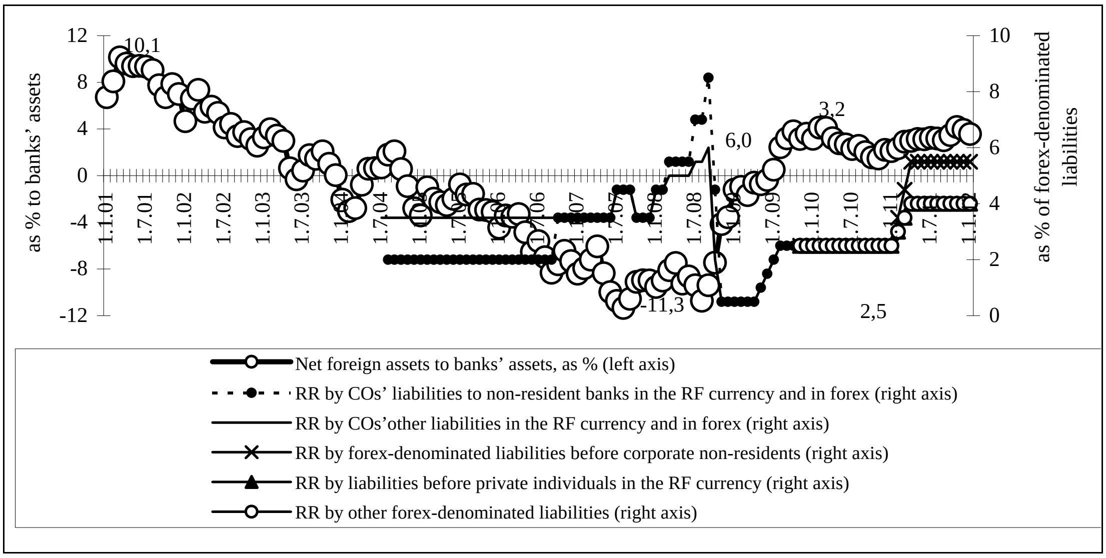
[1] Trifonov A., Voronova P. The driver of quotations. Vedomosti, 27 December 2011.
[2] Visloguzov V. Tax benefits take a long time to come. Kommersant, 6 December 2011
[3] Rudenko P. FSFM recommended to "hold". Kommersant, 10 November 2011.

Fig. 19 displays that in H1 2011, the Bank of Russia raised its reserve requirements (RR) to liabilities before corporate non-residents in forex equivalent by 2.5% up to 5.5% of costs of the liabilities. As for liabilities before private individuals in the RF currency and other forex-denominated liabilities, RR over the period in question were raised from 2.5% up to 4.0%. That has had a notable effect on the rise of the excess of forex-denominated assets over liabilities. The CBR's strategy of a freer oscillation of the Rb exchange rate in the frame of a gradual transition to inflation targeting proved an efficient move to constrain attractiveness of CT. In March and December 2011, the Central Bank announced broadening the trading band against dual-currency basket from Rb 4 to 5 and from Rb 5 to 6, respectively.



Source: calculated by the CBR data.

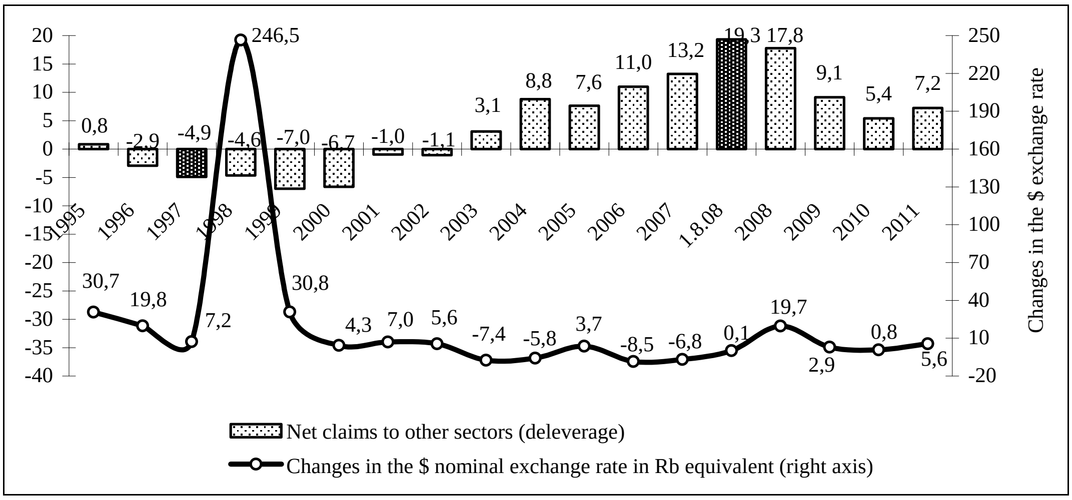
Fig. 18. Excess (+) and Deficit (-) of Banks' Forex-Denominated Assets over Liabilities (Proportion of the Value of Banks' Assets (Liabilities) as %)



Source: calculated by the CBR data.

Fig. 19. Regulation of Carry Trading by the Bank of Russia, as of 1 January 2012

The 2011 restrictions on CT were exercised in tandem with the trend to discontinuation of deleverage of the banking system[1], as shown in *Fig. 20*. In other words, the banking system saw renewal of the advanced increase in credit portfolio against the deposit base. We believe that the combination of the said tendencies generated problems with funding of banks, thus having become a critical factor behind exacerbation of the problem with bank liquidity in H2 of the year. The other reason that aggravated the bank liquidity problem was a notable increase of the federal government borrowing on the domestic stock market in 2010 by issuing government bonds (for more details, see the section on the bond market).



Source: calculated by the CBR data.

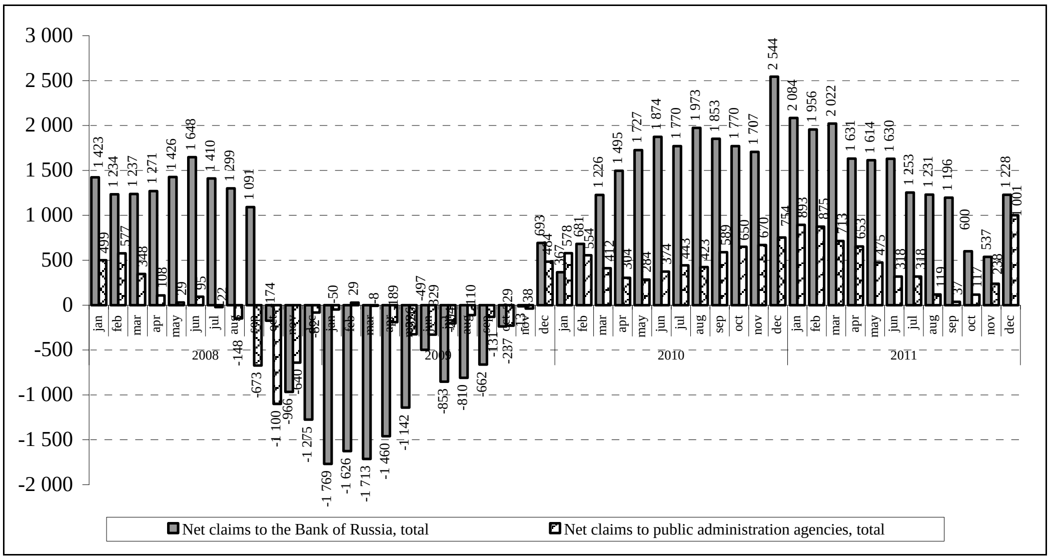
Fig. 20. Excess of Loans over Deposits – Deleverage (as % of the Value of Banks' Assets (Liabilities))

3.3.2. Liquidity and the Current Stability of the Banking System

As shown in *Fig. 21*, Russian banks entered 2011 with a sizeable surplus of short-term liquidity. In December 2011, their net claims to the Bank of Russia accounted for Rb 2.5 trillion, while those to public administration agencies – Rb 0.8 trillion. But by end-November 2011, the said amounts of net claims shrank to Rb 0.5 trillion and 0.2 trillion, respectively. That de facto meant that the size of short-term injections government and monetary authorities made in the banking system accounted for some Rb 2.6 trillion by the end of 2011, i.e. the value comparable to the one the banks received during the 2008 crisis. In December alone, thanks to a drastic increase in federal budget expenditure, as much as about Rb 2.0 trillion poured in the domestic market[2]. Bank deposits increased by roughly the same amount, while M2 grew from Rb 22.0 trillion up to Rb 24.5 trillion, or by 11.7%. Extra bank liquidity was sterilized thanks to the amount of banks' net claims to the Bank of Russia being up to Rb 1.2 trillion and those to public administration agencies – up to Rb 1.0 trillion.

[1] Index of costs of banks' net claims to residents and businesses relative to banks' aggregate assets.

[2] According to Mr. A. Siluanov, the RF Minister of Finance, in December 2011 the federal budget spending was set to increase 2-fold vs. the average size of budget expenditures over the year and account for a. Rb 2 trillion. (Sapozhkov O. The 2012 budget overhang exceeds a usual size 2012. Kommersant, 7 December 2011).



Source: by data of the Bank of Russia's review of credit organizations.

Fig. 21. An Estimate of Amount of Support to Banks, as Rb bn

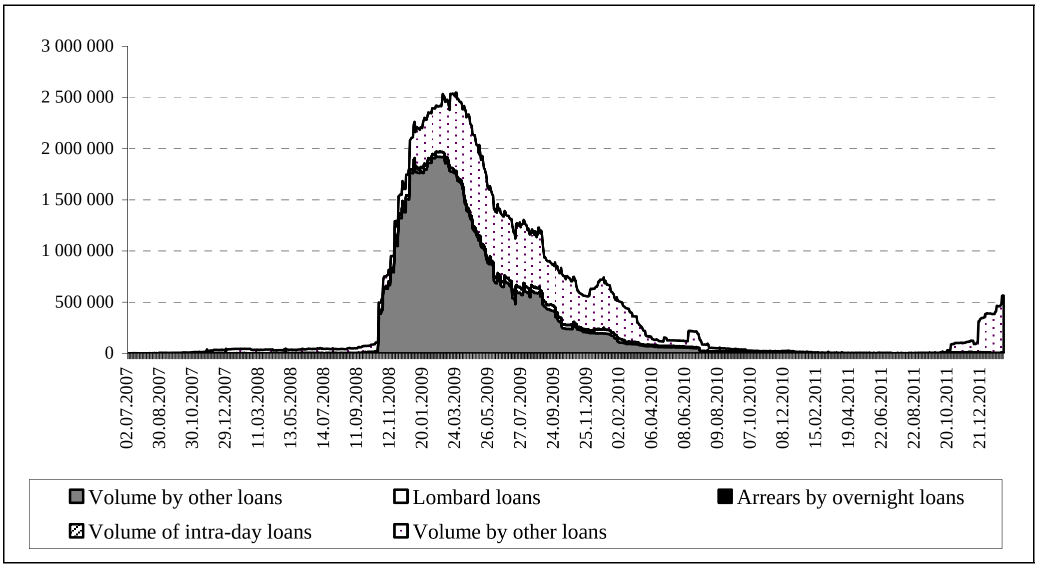
Fig. 22 displays findings of an analysis of forms of the CBR's support of banks during the 2008-09 crisis and in the year under review. During the crisis, it was non-collateral loans, whose disbursement kicked off on 20 October 2009, which became a major form of credit support to banks. Various bank support programs at the expense of centralized lending have been practically stopped since September 2010. However, once the liquidity crisis exacerbated in H2 2011, the Bank of Russia began to vehemently disburse loans to banks in the form of direct repo operations, the debt on which is displayed in the graph in the form of debts on other loans. According to a CBR spokesperson, had the liquidity crisis intensified, the monetary authorities were ready to consider a renewal of non-collateral lending to banks[1].

While attracting borrowed funds from the Bank of Russia and the Ministry of Finance, in the period of exacerbation of the situation with bank liquidity it was state-owned banks that found themselves in an advantageous position. According to Fitch Rating, they consumed 84% of the total volume of placed funds, while their proportion in the aggregate volume of the banking sector's assets accounts for some 55%[2].

A traditional method of the Bank of Russia's influence on stability of the banking system is lending to banks by means of direct repo transactions. *Fig. 23* displays two periods in development of Russia's banking system depending on prevalence of different sources of maintaining bank liquidity. The first period - between 2004 and July 2008- was the heyday of the carry trading strategy, with banks enjoying the opportunity to raise cheap money on foreign markets. In the period of increasing liquidity, the Bank of Russia resorted to direct repo only occasionally and in a relatively moderate scale. The second period encompasses the 2008 crisis and the subsequent recovery of the market. During the acute phase, direct repo deals were increasingly in use to stabilize the interbank lending market. They were carried out on a regular basis, and their volumes surged drastically vis-à-vis the pre-crisis figures. The stabilization of the situation with short-term liquidity in banks in 2010 drove the interbank lending rates

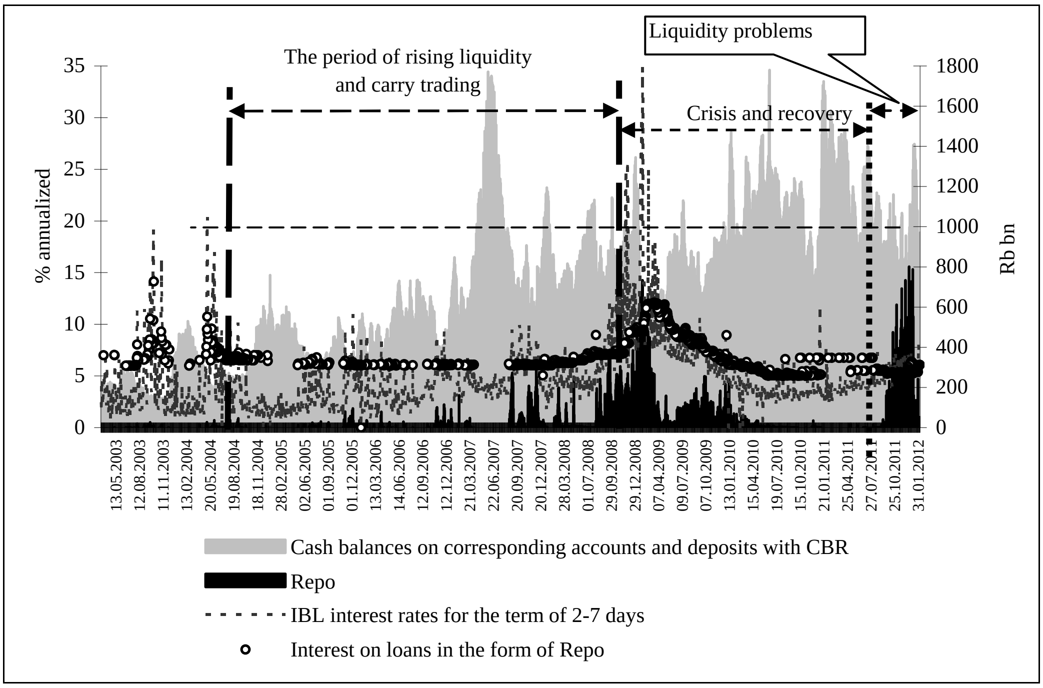
[1] Dementyeva S. Money is served. Kommersant, 28 October 2011.
[2] Public funds have been dispersed across state –owned banks. Kommersant, 2 December 2011.

down to the pre-crisis level, while the Bank of Russia discontinued an active use of direct repo. However, once the situation with liquidity aggravated in H2 2011, repo deals became a principal means for the CBR to provide lending to banks. In a number of cases their volume in 2011 was in excess of maximum volumes of lending to banks with the use of repo deals at the peak of the 2008 crisis.



Source: by the Bank of Russia's data.

Fig. 22. The Bank of Russia's Lending to Banks, as Rb mn.



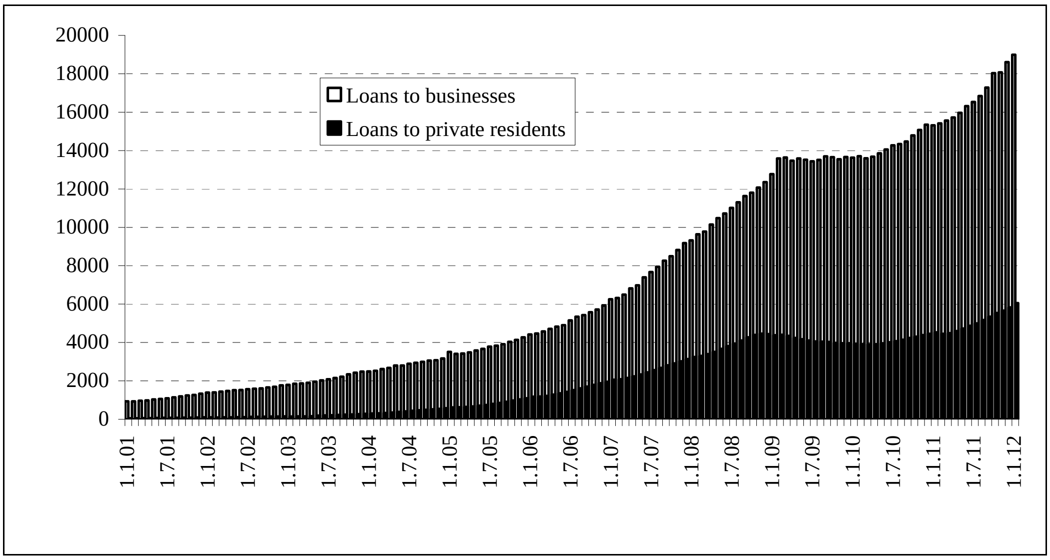
Source: by the Bank of Russia's data.

Fig. 23. Use of the Repo Mechanism for Regulation of Bank Liquidity between 2003 and December 2012

3.3.3. Lending on the Rise

The instability of the resource of funding of banks in 2011, which manifested itself in a limited employment of Carry trading, a slower pace of expansion of the deposit base, a compelled attraction of short-term resources from the Bank of Russia and public administration bodies, did not hamper the renewal of banks' lending activity nonetheless (*Fig. 24*).

While in 2010 the volume of lending to the non-banking sector was up 12.8% and loans to the population – up 14.3%, at year-end 2011, the increase in the said credit portfolios accounted for 39.3% and 54.0%. That was lower than the average growth rates of the credit portfolio over the pre-crisis 2000–2007 which accounted for 47.3% for the non-banking sector and 81.3% for private residents, but far greater than an annual 25% growth rate which is considered internationally to be a pace sufficient for a normal, without overheating, advancement of the banking sector.



Source: by data of the Bank of Russia's Review of Credit Organizations.

Fig. 24. Russia: the Volume of Credit Disbursed, billion of Rb as of 1 January 20102

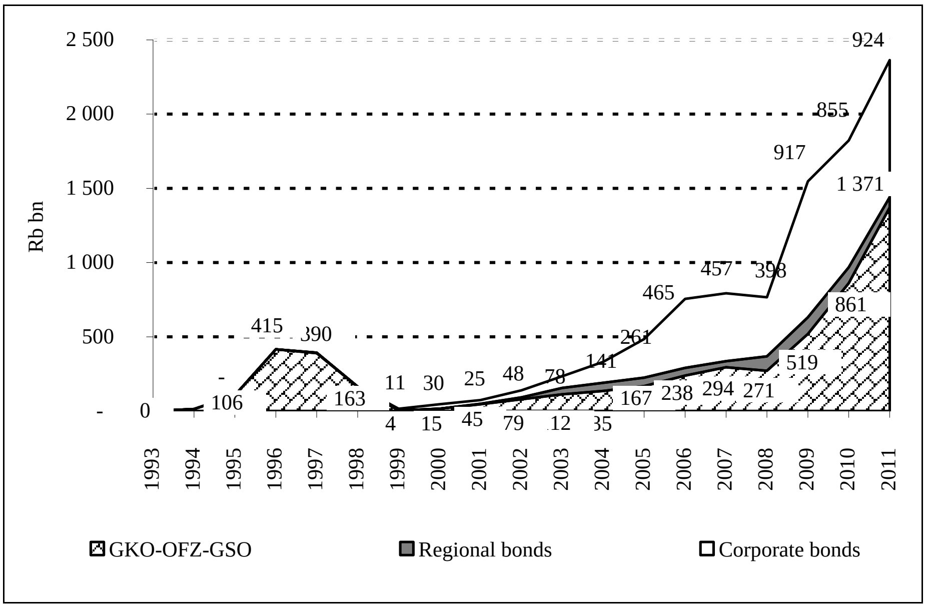
So, in 2011, despite the reinvigoration of lending activity, the banking sector, whose proportion in the overall volume of Russian financial organizations' assets stands at a. 95%, has thus far failed to find resources sufficient to ensure its sustainable progress. Its funding to a significant degree remains reliant on the Bank of Russia and public administration agencies' short-term financial resources, which generates substantial risks for the financial system.

3.4. Governmentalization of the market for Rb-Denominated Bonds

3.4.1. An Adanced Growth of Placement of Government Bonds

The government notably increased its role on the domestic bond market in 2011, primarily in its capacity of one of key operators on the market in question. That manifested itself in an accelerated rise in public borrowing on the domestic market, a greater impact the state has on the exchange infrastructure, the Bank of Russia and public structures' growing activity with regard to trading in bonds, prevalence of state-owned corporations in their capacity of borrowers on the market for corporate bonds and a growing activity of state-owned banks in the segment of investment and banking services. As well, the year of 2011 witnessed adoption of the document entitled "The fundamental objectives of the public debt policy of Russian Federation for 2012–2014[1]. The document holds that, "…development of the debt market is regarded as an absolute priority of the public debt policy in the medium term". The MinFin plans that the federal budget deficit would be met at 90% at the expense of domestic public borrowing. We believe this means a domestic bond market's growing dependence on risks engendered by an imbalanced state budget.

The data dispalyed in *Fig. 25* evidences that in 2011 the aggregate volume of placement of government bonds posted a higher pace of growth than the aggregate volume of placement of corporate bonds. While in 2010 the volume of placement of government papers worth a total of Rb 861bn was just slightly above the volume of issued corporate bonds, which accounted for Rb 855bn, in 2011 the value of new issues of government papers hit the mark of Rb 1,374bn, a way up vs. a Rb 855bn- worth aggregate value of placed corporate bonds. However, at this point, we should make a reservation that the estimate of the 2011 volume of the government bonds issuance was made with account of the value of the issue of 15-year OFZ bonds worth a total of Rb 295 bn, which the MinFin placed by way of a closed subscription in the frame of a Bank of Russia's rehabilitation program, the control stake in which was acquired by VTB. That said, the development testifies that MinFin's need in attraction of funds on the debt market are on the rise, and in 2011 it was in many ways associated with the RF Government's decision to employ resources attracted by issuing government papers on the domestic market, rather than resources spent out of the Reserve Fund, as a source of meeting the Pension Fund's budget deficit. The decision in question enabled the MinFin to transfer some Rb 1.0 trillion of oil-and-gas revenues to the Reserve Fund in early 2012 and compensate for those funds by boosting up borrowings on the bond market.



Source: MICEX-RTS and IMF data.

Fig. 25. Volume of Placement of Rb-Denominated Bonds

[1] Posted on the MinFin web-site.

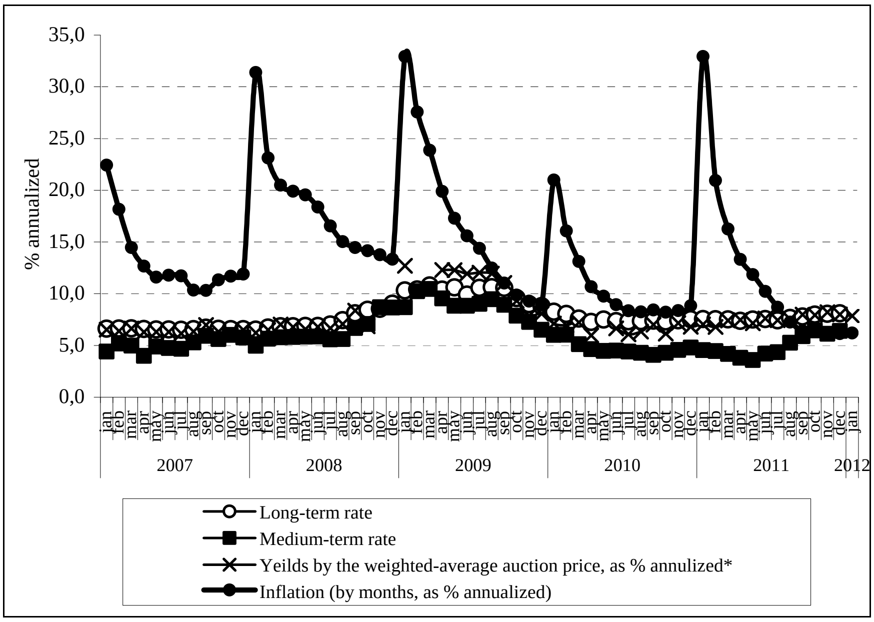
The MinFin plans an increase in placement of government bonds in 2012, too. According to a preliminary schedule of auctions on placement of OFZ for Q1 2012, it is planned to raise Rb 285bn, or nearly 8-fold above the figure reported in the same period of the previous year.

The growing attractiveness of the market for government bonds is driven by measures the MinFin undertakes to enhance the level of transparency and ensure a greater predictability for investors operating on this particular market, simplify and beef up the clearing system's reliability, unify the procedures of trading in, and depository servicing of, government, corporate and regional bonds. The above concerns the transition to a regular publication of quarterly schedules of OFZ placement and yields to maturity of new bond issues, cancelation of requirements about a preliminary depositing of cash on the day the auction is held, and transition to placement of benchmark issues of OFZ. Since 13 February 2012 all transactions involving OFZ have been transferred to the main trading regime at MICEX-RTS, which, according to the exchange's estimates, will allow increase of the number of participants in trading in this particular instrument from 304 до 640[1]. That also allowed a substantial simplification of, and bringing depository operations on the organized security market in consistency with, the rules on the market for equities and corporate bonds. More specifically, the head depository for GKO-OFZ is no longer bound to maintain duplicated data on custody accounts of owners of papers run at dealers' sub-depositories together with the head depository in the frame of the so called Dealer Sub-Depository Technical Provision Center. Uniformity of procedures of running depository operations across all the segments of the securities market facilitates solving the task of attraction of non-residents to the domestic market for GKO-OFZ. To this end, the major attraction for investors will be the possibility to open an account of a nominal holder of international clearing organization with the Russian central depository.

The successful placement of government papers in 2011 was also fueled by a favorable situation in the national economy, with inflation rates going down notably and having hit their all- time lows (6.1%) by the end of the year. For the first time in a multi-year history of OFZ placement, their yields at an auction and on the secondary securities market were substantially above the inflation rate (*Fig. 26*) since August-September 2011. Meanwhile, it can be assumed that despite the declining inflation rates, the MinFin did not opt for lowering the borrowing rates in H2 2011, thus creating a competition pressure on free cash resources on the financial market.

Let us note that the continuous expansion of government papers on the domestic financial market entails ambiguous consequences. A positive effect of the process is the rise of a liquid market for robust financial instruments which for the first time over a long-lasting period began playing the role of an indicator of risk-free rate of borrowing. In addition to tackling fiscal challenges, this is important as an impulse to growth in long-term domestic savings and expansion of the financial services sector. Meanwhile, given a narrow array of domestic institutional investors and sources of bank liquidity, an increase in public borrowings under market terms forms a substantial hurdle to corporate and regional borrowers. More than this, we believe that the rise in public borrowing on the domestic market in H2 2011 was one of the factors behind the temporary crisis of bank liquidity which did not let banks compensate for the closure of the "credit window" on the global markets by bolstering borrowing on the domestic debt market.

[1] Mazunin A. Investors came for a long Ruble. Kommersant, 9 February 2012.



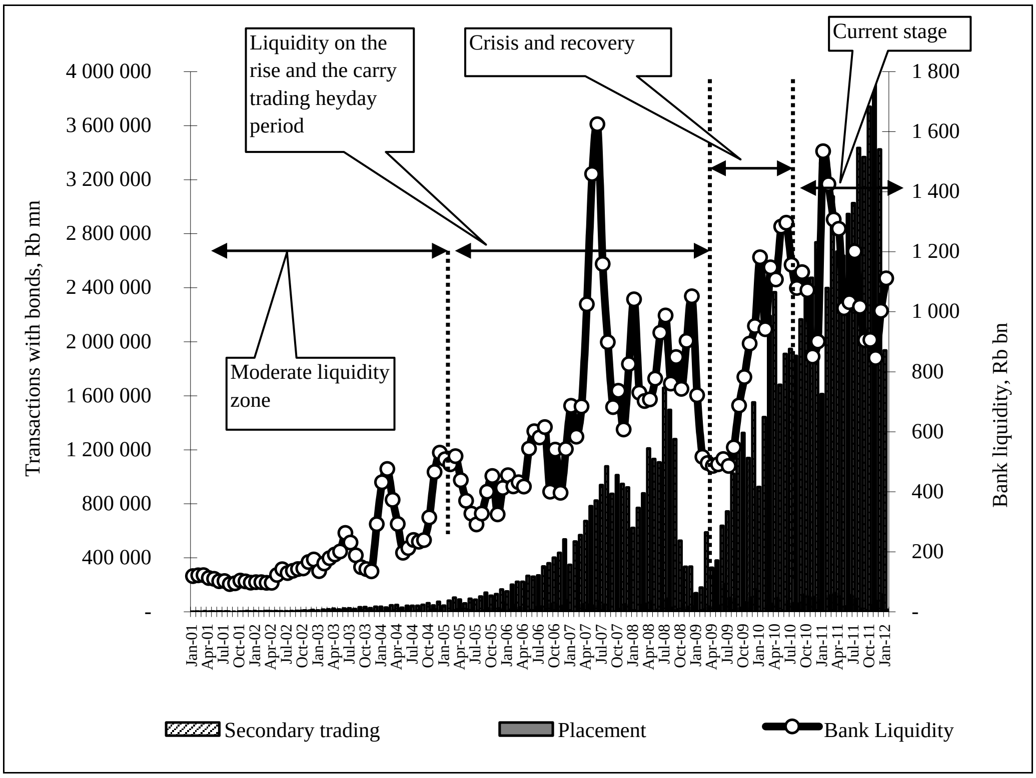
* averaged over the month average-weighted rate by results of auctions weighted with account of placed bonds.
Source: by data of the Bank of Russia and Rosstat.

Fig. 26. The Average Monthly Rates on the OFZ Market and Inflation

3.4.2. The State of the Corporate Bond Market

Ha *Fig. 27* displays monthly data on volumes of issues of Rb-denominated corporate bonds and the turnover of the respective secondary market at MICEX between 2001 and January 2012. In addition, *Fig. 27* exhibits data on bank liquidity which is presented as average monthly cash balances on banks' correspondent accounts and deposits with the Bank of Russia. In 2011, the volumes of the secondary market for corporate bonds soared up to Rb 36.3 trillion vs. Rb 23.0 trillion in 2010 and 9.3 trillion in 2009. For many years, despite frequent roller-coaster effects on the global market, the secondary exchange market displayed a phenomenal starch and was expanding steadily. In the pre-crisis years, when liquidity was on the upsurge, the rise of corporate bonds was secured largely by the carry trading strategy. In 2010, the growth factor became a rapid inflow of short-term liquidity as a consequence of an accelerated increase in monetization of the economy. The shrinkage of bank liquidity in 2011 was once again accompanied by an increase in the number of transactions on the secondary exchanging market for bonds, as it was repo transactions using which banks borrowed short-term capital in the form of interbank loans and from the Bank of Russia.

Another peculiarity of the corporate bond market has become the fact that significance of the secondary market has been constantly on the rise vis-à-vis the role played by the bond placement process. In 2010, with volumes of issues of corporate bonds plunging 6.8%, the turnover of the papers in question on the secondary market was up 147.0%. In 2011, the value of the respective transactions soared by 8.1% and 58.0%, respectively. On the one hand, an outstripping growth rate in liquidity of the secondary market for corporate bonds has a positive effect on the term and rates of borrowing, while funding long-term loans with short-term resources bears greater risks for the market, including the risk of issuers' lower possibilities to refinance their loans in the future.

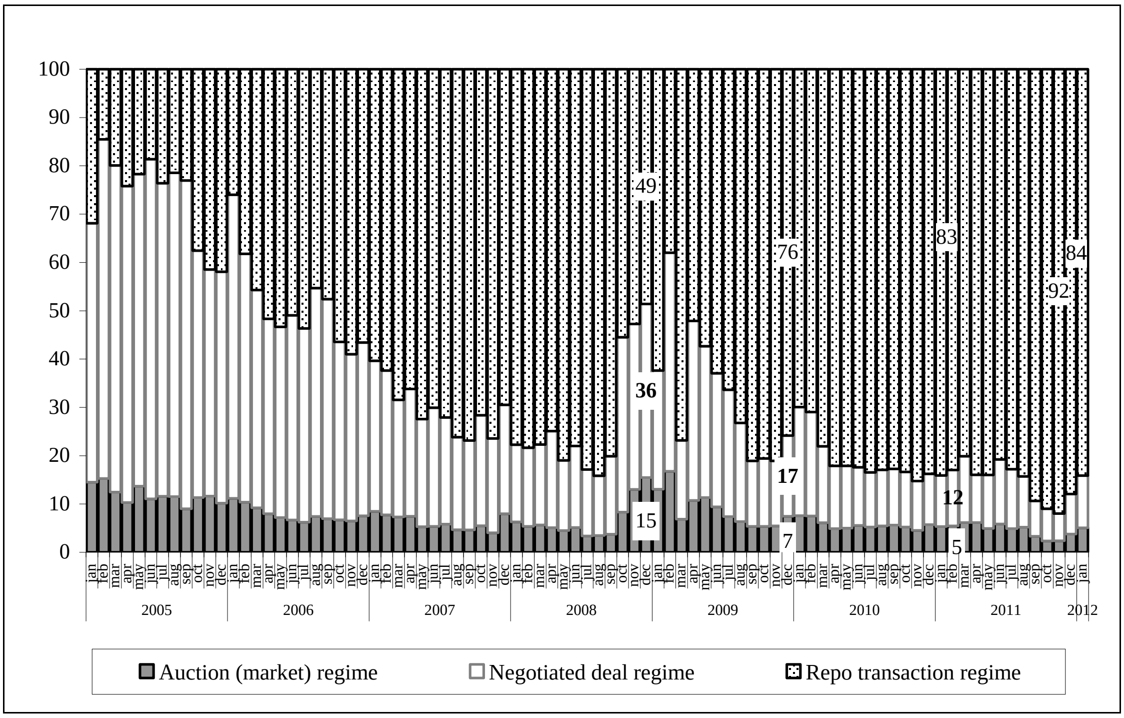


Source: by data of the Bank of Russia and MICEX-RTS.

Fig. 27. Transactions with Corporate Bonds and Bank Liquidity between 2001 and January 2011

The markets for public and corporate bonds face the most pressing and yet unresolved challenge of attraction of domestic and external investors' long money. It was banks that thus far have prevailed on this market as a source of capital: their share in the structure of sources of financing of corporate bonds first rose from 31.9% in 2008 to 42.7% in 2010 and then plummeted to 37.7% in 2011. An effective measure to support the market for Rb-denominated corporate and regional bonds became the passing of amendments to the law on pension system. The amendments resulted in the possibility to invest a fraction of money from the savings system in non-governmental bonds. In compliance with Federal Act of 18 July 2009 No. 182-FZ "On introducing amendments to the Federal Act "On investing of funds for financing the savings part of the labor pension in Russian Federation", the state-owned managing company whose functions are exercised by VEB was granted the right to invest residents' pension savings in an extended investment portfolio, which is formed by Russian issuers' corporate bonds, guaranteed by the state Rb- and forex-denominated deposits with credit organizations, mortgage-backed papers, and international financial institutions' bonds, among others. The proportion of VEB and private managing companies' investments formed by pension savings in 2009 accounted for 0.5% of the aggregate value of corporate bonds in circulation. In 2010 and by results of the 9 months of 2011, it surged up to 3.5% and 3.9%, respectively. The share of mutual investment funds and the money market in financing corporate bonds has been negligible and accounted for 0.3% of the value of capitalization of corporate borrowers' bonds in 2009, 0.5% - in 2010 and 0.6% - in 2011.

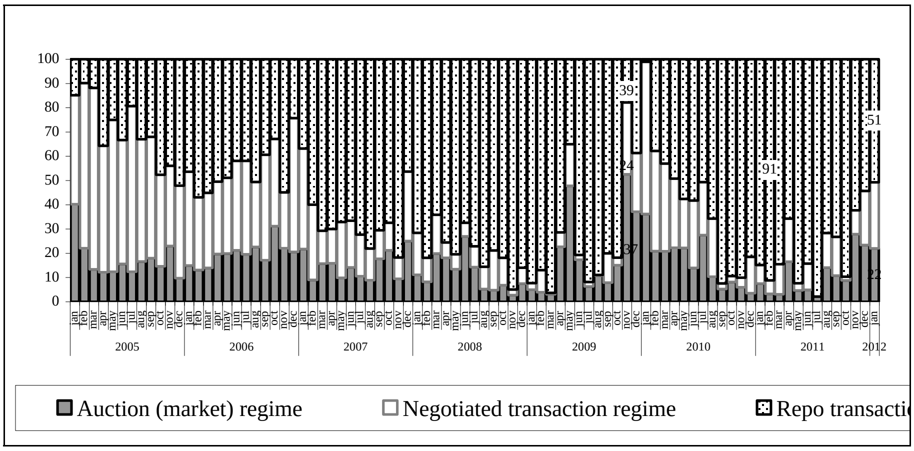
That the corporate bond market has increasingly turned into an instrument of servicing interbank lending deals vs. the long-term nature of corporate bonds per se is demonstrated by the structure of transactions with corporate bonds at MICEX-RTS (*Fig. 28*). At the peak of the problem with bank liquidity, in November 2011, the proportion of repo deals in the aggregate value of exchanging deals with corporate bonds hit its all-time highs and accounted for 92%. That the corporate bond market has increasingly turned into an instrument of servicing interbank lending deals vs. the long-term nature of corporate bonds per se is demonstrated by the structure of transactions with corporate bonds at MICEX-RTS (*Fig. 28*). At the peak of the problem with bank liquidity, in November 2011, the proportion of repo deals in the aggregate value of exchanging deals with corporate bonds hit its all-time highs and accounted for 92%. Today, only less than 5% of transactions with corporate bonds are market ones, i.e. are used indeed for the sake of portfolio formation and restructuring. The risk of the current situation with corporate bonds is that should market participants switch to government bonds as a naturally simpler and more efficient mutual lending instrument on the repo market, they would trigger a systemic crisis on the market for corporate borrowings.



Source: by data of MICEX-RTS.

Fig. 28. Structure of Transactions with Corporate Bonds at MICEX, as %

In contrast with the corporate bond market, the structure of exchanging deals with regional bonds (*Fig. 29*) displays positive changes. In early 2011, the share of repo deals on this particular market accounted for some 92%; however, it slid to 51% in H2 of the year, with the proportion of market deals hitting 22% in 2011. This evidences that regional bonds proved to a lesser degree be engaged in interbank lending and, per haps, investors more vigorously use them to shape up and restructure their portfolios

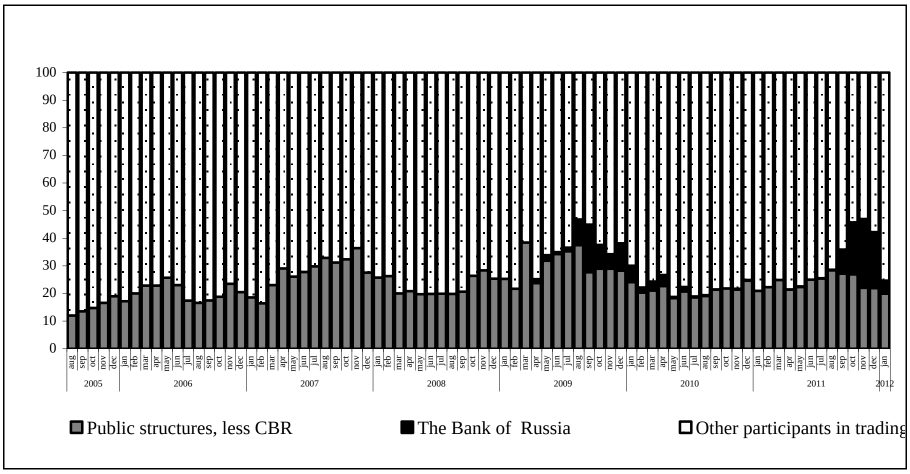


Source: by data of MICEX-RTS.

Fig. 29. Structure of Transactions with Corporate Bonds at MICEX, as %

3.4.3. Competition on the Market for Corporate and Regional Bonds

Fig. 30 displays findings of an analysis of proportions of different groups of participants in trading (private and state-owned corporations[1], and the Bank of Russia) in volumes of exchanging trading in corporate bonds at MICEX-RTS in all the regime, including market, negotiated deals, and repo transactions. The share of public structures in the volume of transactions with corporate bonds underwent practically no change throughout 2011; that said, between August and December, it was Bank of Russia which held the lion's share of volumes of transactions with the said instrument, for in the period of exacerbation of the situation with liquidity, the Bank of Russia has been crediting banks by means of repo deals with corporate bonds. In so doing, the magnitude of the said operations proved to be greater than during the acute phase of the 2008 crisis.

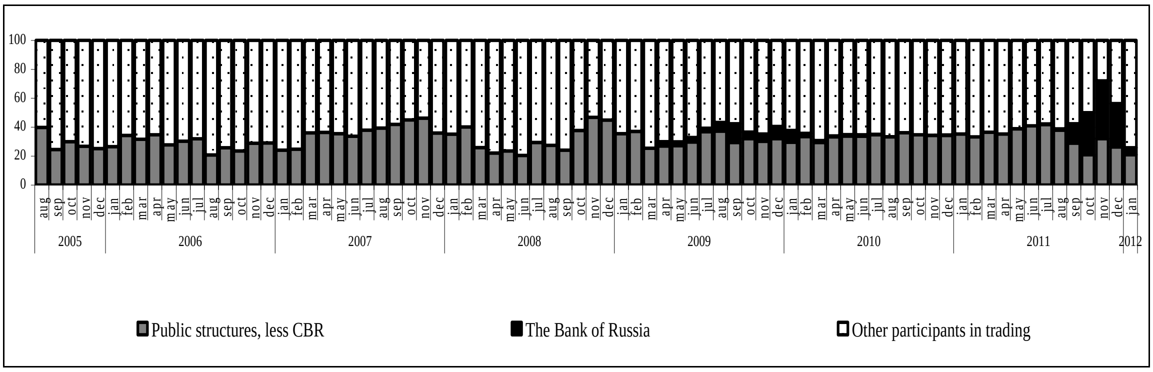


Source: by data of MICEX-RTS.

Fig. 30. Proportion of Private and Public Brokers in Volumes of Trading in Corporate Bonds at MICEX-RTS, as %

[1] VEB, VTB, VTB Capital, VTB24, Gazprombank, Sberbank, KIT-Finance, Sviaz-Bank, Bank of Moscow, Transcredit, and from 2011 IC Troika Dialogue.

Fig. 31 shows the proportion of public structures and the Bank of Russia in volumes of exchanging trading in regional bonds. During the last four months 2011, the Bank of Russia has been vigorously participating in transactions with regional bonds, and during some periods would hold up to one-third of volumes of deals with regional bonds.

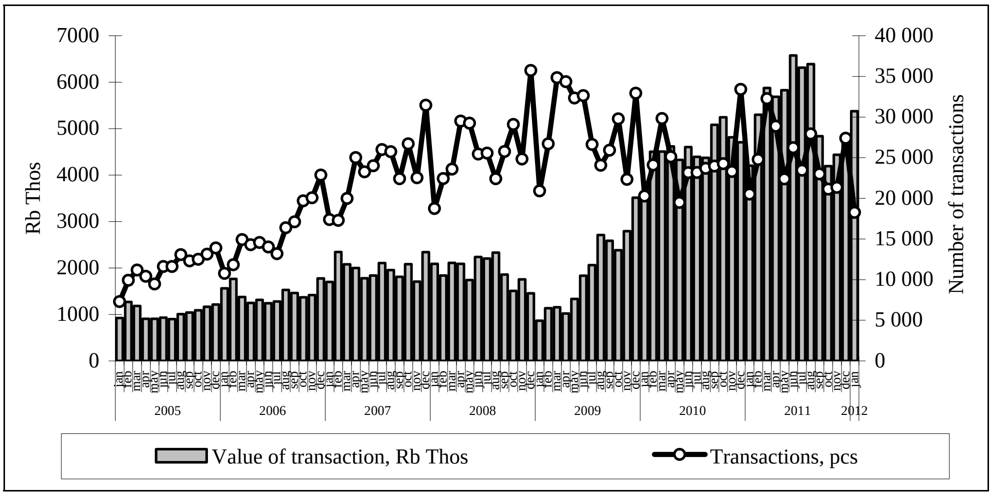


Source: by data of MICEX-RTS.

Fig. 31. Proportion of Private and Public Brokers in Volumes of Trading in Corporate Bonds at MICEX-RTS, as %

The market for corporate bonds appears substantially different from the one for regional bonds in terms of level of concentration measured by Herfindahl-Hirscmann Index (*Fig.13).* The corporate bond market appears low concentrated, with its HHI index value being nearly twice as low as the one of the equity market at MICEX-RTS. This can be ascribed to the fact that in the conditions of an insufficiently liquid OFZ market, corporate bonds are used largely as an interbank lending mechanism. It is vigorously employed by all banks, which is why the circle of participants in trading in corporate bonds at the exchange is a very broad one. By contrast, the market for regional bonds in 2010-11 was moderately concentrated, with its monthly HHI values fluctuating within the band between 800 and 1,800. It was only in November 2011 that HHI on transactions hit above the 1,800 mark and the market for a while became highly concentrated. There are a few players on the market (Sberbank, VTB, Bank of Russia, Centrocreditbank, among others), and it is used at least as a platform for interbank lending.

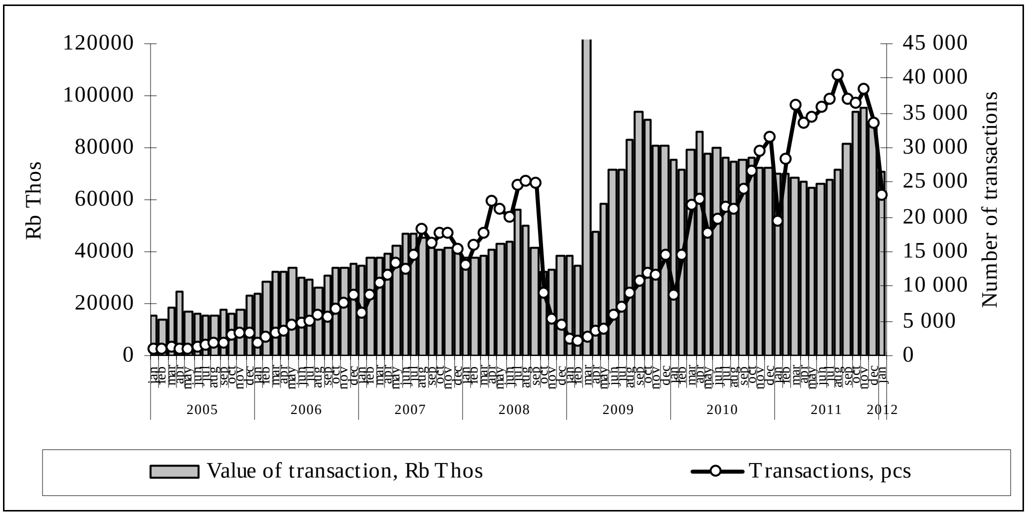
Fig. 32 displays data on the number of transactions and the value of an average transaction with corporate bonds on the order-driven market at MICEX-RTS. In contrast to the market segment with trading in stock (*Fig. 16*), the number of market transactions with corporate bonds has been in decline between 2009 and mid-2011, with the average per-transaction volume being on the rise. This evidences that in contrast to the market deals with equity, this particular segment of the market exhibits a lesser degree of advancement of high-frequency trading. The fall in the number of transactions and the value of the average market deal in H2 2011 is explained by the effect of “dying” trading activity in the segment of order-driven transactions in the period of exacerbation of the problem with liquidity.



Source: by data of MICEX-RTS.

Fig. 32. Market Transactions with Corporate Bonds at MICEX

Findings of an analysis of the segment of repo transactions with corporate bonds at MICEX-RTS presented in *Fig.33* evidence that in contrast to the market regime of transactions, in the period of aggravation of the situation with liquidity in 2011, the number of transactions and the average transaction value in the repo segment were on the rise, which apparently mirrored the banks' increasing demand for loans against corporate bonds. The value of an average repo transaction proved to be roughly twice as high as the value of a market deal with corporate bonds. That is hardly surprising, as the amount of a bank loan extended to a financial company cannot be small.



Source: by data of MICEX-RTS.

Fig. 33. Repo Transactions with Corporate Bonds at MICEX

As concerns placement of corporate bonds, the drivers of expansion of the respective market for several years have been large, primarily state-owned, corporations. *Table 6* demonsrates that the proportion of issues placed by Top-24 largest issuers in the aggregate value of corporate bond issues in 2009 was 87.7%, in 2010 - 60% and in 2011 - 59%. In 2007, of the overall volume of placement of corporate bonds worth a total of Rb 476.7bn the share of their issues accounted for just 42.1%, while all other issuers'– 57.9%. In the 2009 and 2010 lists, out of the top ten corporations therein 6 ones were state-owned, while in 2011 there already were 7 of them.

Table 6

The Largest Issuers of Rb-Denominated Corporate Bonds in 2009–2011 гг.

	2009			2010			2011		
	Issuers	**Rb bn.**	**%**	**Issuers**	**Rb bn.**	**%**	**Issuers**	**Rb bn.**	**%**
1	Russian Railways	145	15.8	FSK UES	50	5.8	Rosselkhozbank	62	5,7
2	Transneft	135	14.7	Rosselkhozbank	35	4.1	FSK UES	55	5.0
3	VEB	60	6.6	Rosnanotech	33	3.9	Uralkaliy	50	4.6
4	Lukoil	50	5.5	Evrazholding	30	3.5	Rostelecom	39	3.5
5	Atomenergoprom	50	5.5	AHML	29	3.3	AHML	35	3.2
6	Bashneft	50	5.5	VEB	27	3.2	Rosnano	33	3.0
7	AFK Systema	39	4.3	Alrosa	26	3	VEB	30	2.8
8	MTS	30	3.3	MTS	25	2.9	Gaspromneft	30	2.8
9	AHML	28	3.1	Mechel	25	2.9	Rusal Bratsk	30	2.8
10	VTB (VTB 24)	23	2.5	Wimm-Bill-Dann	24	2.8	Veb-Leasing	25	2.3
11	SIBMETINVEST	20	2.2	VTB (VTB 24)	20	2.3	Mechel	25	2.3
12	Gaspromneft	18	2	Gaspromneft	20	2.3	Oboronprom	21	1.9
13	VTB-Leasing Finance	15	1.6	VympelkomInvest	20	2.3	Mortgage agent AHML	20	1.9
14	Mechel	15	1.6	Russian Railways	15	1.8	Gasprombank	20	1.8
15	MMK	15	1.6	Severstal	15	1.8	NLMK	20	1.8
16	Gasprom	15	1.6	Globex Bank	15	1.8	RusHydro	20	1.8
17	NLMK	15	1.6	Norilsk Nickel	15	1.8	AFK Systema	20	1.8
18	Severstal	15	1.6	Unicredit	15	1.8	NK Alliance	17	1.6
19	NIA VTB 001	14	1.6	EBRD	14	1.6	Uranium One Ink	17	1.5
20	Bank Petrocom-merz	11	1.2	MMK	13	1.5	Gasprom Capital	15	1.4
21	MBRD	10	1.1	Bank Saint Peters-burg	13	1.5	EvrazHolding	15	1.4
22	Rosbank	10	1.1	Aeroflot	12	1.4	Kuzbass-Energo Finance	15	1.4
23	Rosselkhozbank	10	1.1	Transcreditbank	12	1.4	MMK	15	1.4
24	VympelkomIn-vest	10	1.1	Atmoenergoprom	10	1.2	Moscow Credit Bank	13	1.2
	Other issuers	113	12.3	Other issuers	342	40.0	Other issuers	448	41.2
	Total	**917**	**100**		**855**	**100**		**1089***	**100**

* - including non-public offering.

Source: by data of www.cbonds.ru, www.rusbonds.ru and MICEX-RTS.

The corporate bond market has increasingly shaped up as a process locked between public structures: state-owned corporations borrow funds from their peers, while it is mostly state-owned banks in tandem with the Bank of Russia which steer the secondary market. More than this, it also is public investment banks which become underwriters and investment consultants in the course of corporate offerings. This is evidences by data of *Table 7*. In 2007, state – owned banks rendered underwriting services to 36.3% of bond issues (value-wise); in 2008, their proportion surged 46.8%, in 2009 – 62.4%. In 2010 it slid to 46.0%, but in 2011 bounced back to 62.4%.

The situation with investment banking services on the market for regional bonds appears different. In 2008 and 2009, the share of state-owned banks in the value of these bond issues rose from 14.2% in 2007 up to 58.7% and 85.6%, respectively. But in the next two years, 2010 and 2011, it slid first to 75.4% and then to 14.4%. The cause behind such a drastic decline in the proportion of state-owned structures in regional offerings in 2011 lies in the termination of Mosfinagency’s operation - once a key player on the market for regional loans, the Moscow City Hall has revised its budget strategy priorities.

Table 7

Proportion of State-Owned Investment Banks in Volumes of Rb-Denominated Bond Issues on the Domestic Market

	2007		2008		2009		2010		2011	
	Rb mn	share, %	Rb mn	share, %	Rb mn	share, %	Rb mn	share, %	Rb mn	share, %
Corporate bonds										
Total	467 970	100.0	469 792	100.0	994 022	100.0	855 035	100.0	994 844	100.0
Public investment banks	169 668	36.3	219 892	46.8	620 044	62.4	393 743	46.0	620698	62.4
Other	298 302	63.7	249 900	53.2	373 978	37.6	461 292	54.0	374 146	37.6
Regional bonds										
Total	53 032	100.0	71 943	100.0	155 836	100.0	114 901	100.0	53 944	100.0
Public investment banks	7 551	14.2	42 227	58.7	133 325	85.6	86 613	75.4	7767	14.4
Other	45 481	85.8	29 716	41.3	22 511	14.4	28 288	24.6	46 177	85.6

Source: by data of ratings of organizaers of bond placements www.cBond.ru over 2007–2011.

3.5. The Main Risks on the Financial Market

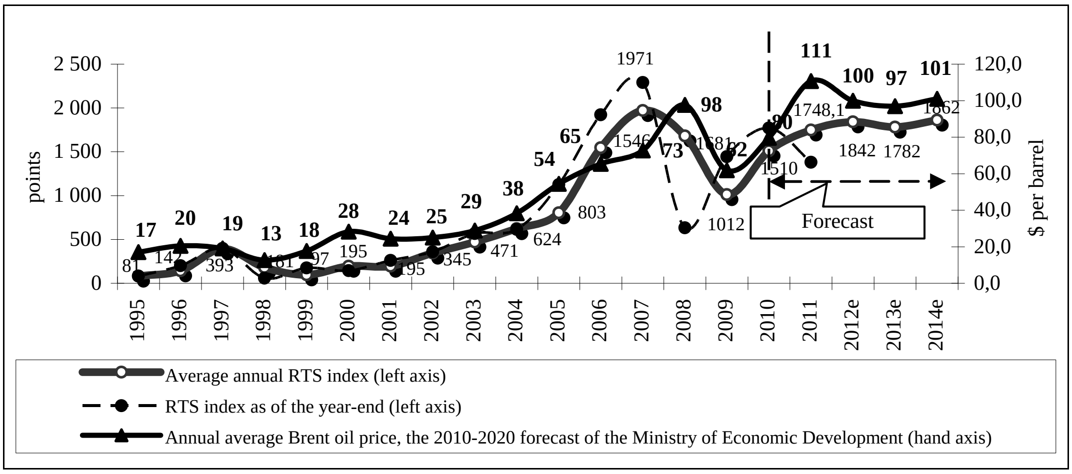
The main risks of the financial market are related to the following factors: stagnation of the equity market due to a halt of the growth in prices on energy carriers; risks related to the outflow of foreign capital; depreciation of the ruble; advanced growth in external borrowings by banks and the non-financial sector; growth in the volume of trading on the term market with insufficient level of surety of deals; growing risks on the REPO market and low capacity of the financial services market which hindered growth in financial intermediaries.

3.5.1. Halt of the Growth in the Equity Market Due to the Pricing Factor

As shown in Section 3.2.1. (*Fig. 6* and *8*), the Russian stock market is dependent on oil prices. That price is an indicator of the state of the global economy, stability of the financial system and the level of cash liquidity in it, political stability in oil exporter countries and other factors. The current forecasts of the Ministry of Economic Development and international financial institutions – which forecasts all point to the fact that in the mid-term prospect no growth in oil prices is expected – reflect concerns over both the slowdown of the global economic growth and risks to stability of the global financial system due to the outstanding problem of sovereign debts, Euro-zone crisis, insufficiently stable banking system and other factors.

If an equation of correlation between the price on oil and the index shown in *Fig. 6* is applied to the short-term forecast of oil prices of the Ministry of Economic Development in the 2012–2014 period there will be a stagnation of the equity market as shown in *Fig. 34*. The RTS Index will be volatile, but its average value will stop at the level of 1900 points. To renew the stock market’s growth, new ideas of economic growth are required and even if they are implemented it is unlikely that they start working at once[1].

[1] In different versions of Strategy-2020, such ideas include a radical change in the business climate, a new industrial policy and innovations.



Source: calculated on the basis of the data of the forecast of the Ministry of Economic Development and MICEX-RTS.

Fig. 34. The forecast of the RTS index until 2014 on the basis of the forecast of oil prices of the Ministry of Economic Development

On the basis of the equation of correlation between the RTS index and prices on oil, in the 2009 report[1] in 2010 the annual average value of the index was expected to be at the level of 1503 points, while the actual one was equal to 1510. When analyzing the market results of 2010, the average annual oil price per barrel was expected to grow in 2011 from $80 to $105[2]. Actually, it grew more to nearly $111 per barrel. However, instead of the expected growth in the annual average value of the RTS index to 2017 points in 2011, that index actually grew merely to 1748 points. Furthermore, as of the year-end the RTS index fell from 1770 points in 2010 to 1381.87 in 2011 (a decrease of 21.9%). The factor behind the difference between the actual data and the expected one is a more sizable capital outflow from Russia than it was expected.

According to our evaluations, in 2012 with an insignificant drop in the average annual prices on oil the average annual value of the RTS index will grow from 1748 points to 1842 (an increase of 5.4%). Multidirectional dynamics of average values of oil prices and the index will be explained by a slowdown in volumes of the capital outflow from Russia.

3.5.2. The Risks of the Outflow of Foreign Capital

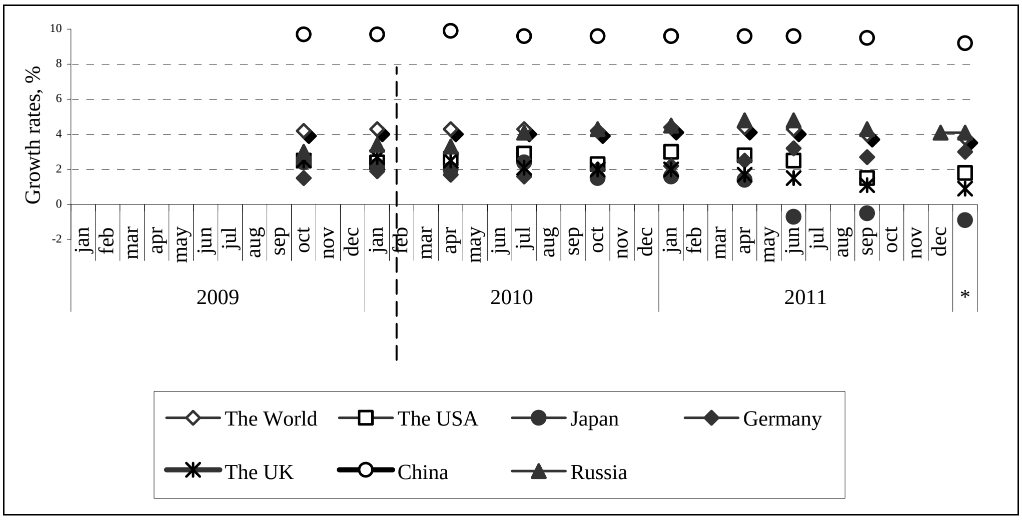
In Section 3.2.2., correlation between the Russian equity market and the flow of cash funds of foreign investment funds which invest in Russia was analyzed. As was shown with reference to the IMF survey, investment decisions of portfolio investors are based on the dynamics and volatility of the GDP growth rates forecasts of international financial institutions, evaluations of volatility of foreign exchange rates and indices of the expected volatility of the developed and emerging markets.

As was shown in *Fig. 9*, the outflow of capital from foreign funds specializing in investments in Russia – which outflow was registered in May-December 2011 – was replaced in January 2012 by a trend of inflow of resources to those funds. It remains to be seen if a

[1] The Russian Economy in 2009. Trends and Prospects. M.: IEP, 2010, p.154.
[2] The Economic and Political Situation in Russia. 2011 , No.7, Trends and Prospects. M.: Publishing House of the Gaidar Institute, 2011, p.154.

change in the trend of portfolio investors' behavior took place. In our opinion, there are no prerequisites for that so far. In particular, in the latest Report on the State of the Global Economy whose update was published on the Internet site in January 2012 the dynamics of the IMF forecasts as regards the GDP of the world's largest economies point to that fact, too. In that Report, as compared to the forecast of September 2011 the IMF revised downward the forecasts of the GDP growth rates in 2012 for the global economy from 4.0% to 3.3%, Japan from 2.3% to 1.7%, Germany from 1.3% to 0.3%, the UK from 1.6% to 0.6%, China from 9.0% to 8.2% and Russia from 4.1% to 3.5%.

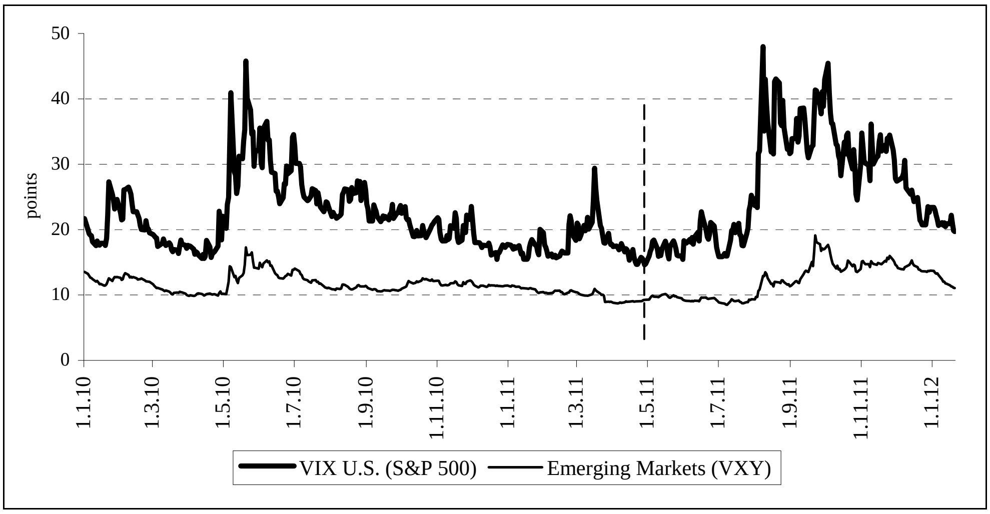
Developments of 2011 point to the fact that there is a correlation between downward revision of GDP dynamics forecasts and behavior of investors of investment funds. As shown in *Fig. 35*, in April 2011 the IMF revised downward the 2011 forecasts of the GDP growth rates in the USA, the UK and Japan. In subsequent quarters, the forecasts of economic growth were revised downward as regards Germany, China, Russia and the world as a whole. Not surprisingly, according to the data of EPFR in May 2011 portfolio investments started to leave steadily the Russian equity market as a kind of response to the growth in uncertainties in the global economy.



* jan. 2012 (2011 – value).
Source: calculated on the basis of the data of the quarterly WEO IMF in the 2009–2011 period.

Fig. 35. The IMF quarterly forecasts of the real GDP growth in 2011, %

More inconsistent are indicators of indices of the expected volatility as regards US equities and equities of developing countries (*Fig. 36*). In the second half of 2011, the above indices showed a considerable surge which can be taken as warning of growing risks on the equity market. However, in January 2012 the VIX index and the VXY index fell a great deal which situation is evidence of the fact that term market participants expect a drop in volatility of prices on equities of both US companies and companies from emerging markets in the next few months. At the same time, growth in the above indices does not always mean that the risks are getting higher. For instance, a surge of the index in May-June 2010 was not accompanied by the outflow of capital from funds which invest in Russia and other emerging markets.



Source: on the basis of the data of the WEO IMF January 2012 with reference to the Chicago Board Options Exchange.

Fig. 36. The index of expected volatility

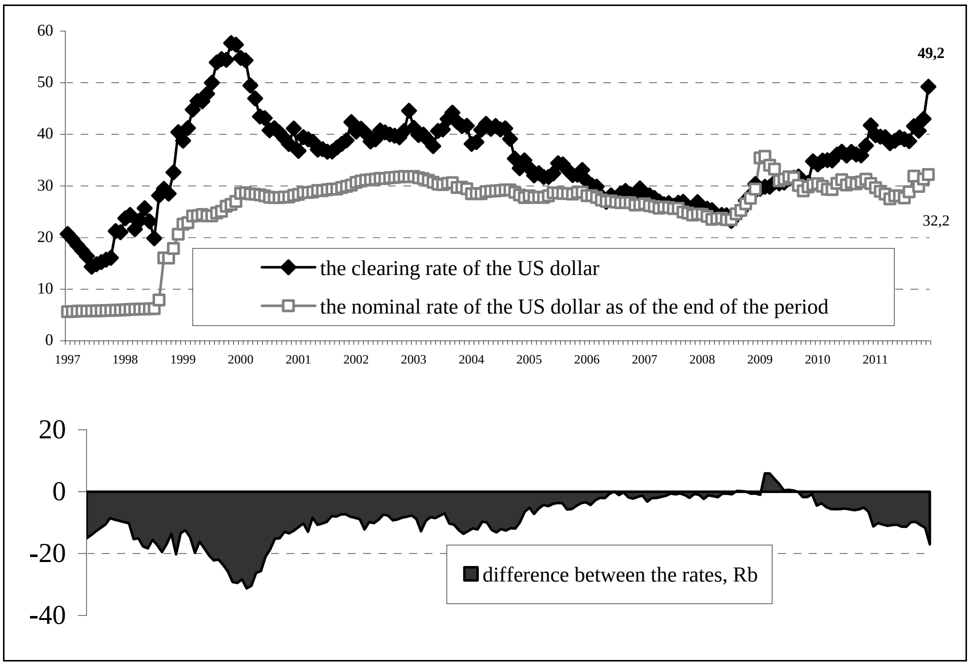
The above approach permits to identify conditions in which the funds of portfolio investors start to come back. It will take place once the IMF and other international financial organizations' forecasts of economic growth rates of large countries are not revised downward and fluctuations of the VIX index have become less volatile. With the looming economic crisis in the European Union and lack of positive changes in the US economy taken into account, it is unlikely to happen in the first half of 2012. So, in that period the outflow of foreign portfolio investments will continue, but, probably, on a smaller scale.

3.5.3. Risks of Depreciation of the Ruble in the Mid-Term Prospect

A trend of a slowdown of the inflow to Russia of new foreign exchange revenues – which trend emerged in 2011 as well – due to both stabilization of prices on the global commodity markets and the outflow of foreign capital which has continued for four years running, a transfer to a more flexible formation of the ruble exchange rate and a switchover by the Bank of Russia to targeting of the level of the inflation rate, primarily, by means of the instruments of the interest rate policy will eventually result in a situation where the dynamics of the money supply is no longer dependent on the foreign exchange reserves. The flow of foreign exchange revenues ceases to have a decisive effect on the money supply growth.

Generally, the above process is a positive one. In 2011, it resulted in the unprecedentedly low level of the inflation rate in this country. However, there is a risk that in case of shocks on financial markets advanced growth in the ruble money supply as compared to the foreign exchange reserves will result in a dramatic depreciation of the national currency. In case of a crisis on the global market or a panic on the domestic financial market when speculative demand by people and companies in foreign exchange has prevailed, the government and the Central Bank may lack foreign exchange reserves to meet such a demand and a devaluation of the national currency will be required.

The data shown in *Fig. 37* gives an idea of the extent of such a devaluation. The above data shows the ratio between the official USD exchange rate in rubles as of the end of a month and the clearing rate of the US dollar which is determined by means of division of the value of the money supply (M2) by the value of the gold and foreign exchange reserve of the Russian Federation. From the end of 2009, the official ruble exchange rate started to fluctuate to a greater extent from the clearing rate, while in December 2011 the difference between those two rates reached the maximum level in the past decade. The clearing rate of Rb 49.2 per one US dollar can be regarded as a potential benchmark for the official ruble exchange rate in case of the most unfavorable development of the situation on the financial market; fortunately, such a development is highly unlikely. However, with the existing difference between the official ruble exchange rate and its foreign exchange provision, the monetary authorities or simply an "invisible hand" of the market will gradually weaken the ruble in the mid-term prospect. Such a scenario would be preferable for the domestic economy as well, since a smooth devaluation of the national currency is one of the most effective instruments of support of national manufacturers and it does not run counter to the WTO principles.

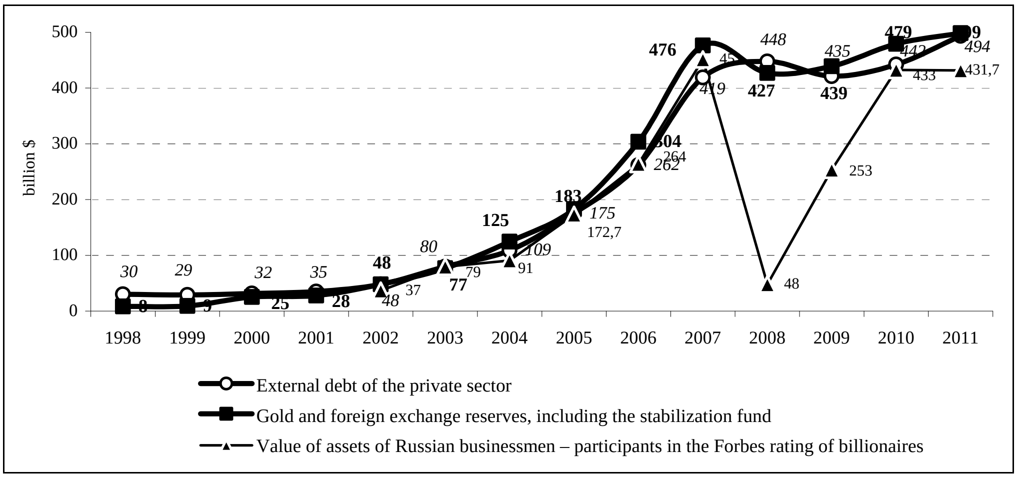


Source: calculated on the basis of the data of the Bank of Russia and the Ministry of Finance of the Russian Federation.

Fig. 37. Dependence of the nominal USD exchange rate in rubles on the clearing rate

3.5.4. Risks of Accumulation of the External Debt by Banks and Non-Financial Companies

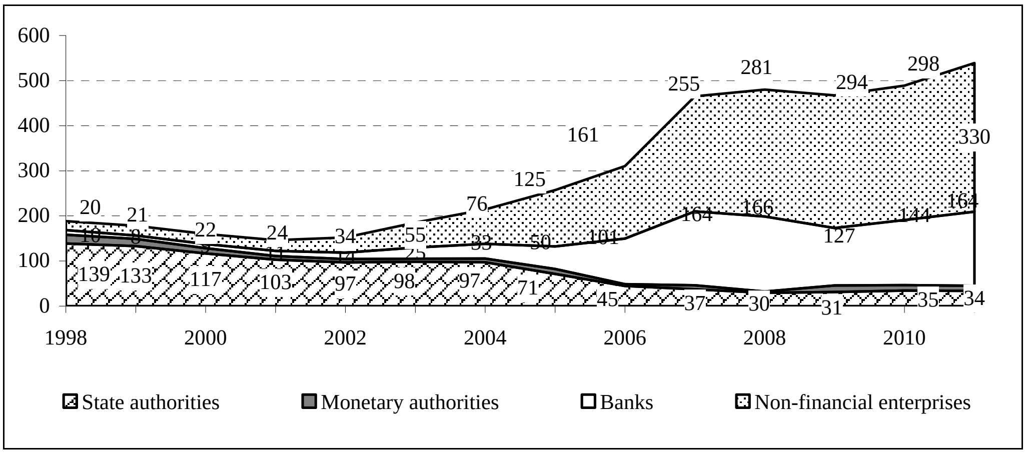
The external debt of the non-public sector which is actually equal to the value of the entire gold and foreign exchange reserve of the Russian Federation (*Fig. 38*) is still one of the main risks of the financial system. A stable relationship between the size of the gold and foreign exchange reserves and that of the external debts of the private sector points to correlation between the above indices. On the one hand, centralization of a portion of the value made by the business in the form of the gold and foreign exchange reserve creates the required margin of safety for the financial system and limits the excessive appreciation of the ruble. On the other hand, in conditions of the global economy withdrawal of such an amount of funds from the revenues of the business creates inevitable difficulties for businessmen to maintain the expanded reproduction. To maintain it at the same level, they will need to compensate by means of external borrowings a portion of funds allocated to the state's gold and foreign exchange reserves. It is for that reason – despite the crisis and a pressure on the part of the government to make large state corporations reduce external borrowings – a considerable reduction in the volumes of external borrowing fails to be achieved.



Source: on the basis of the data of the balance of payments for a number of years.

Fig. 38. Growth in debts of the private sector, financial surplus of the state and assets of Russian participants in the Forbes rating of billionaires

In *Fig.* 39, the external debt data is provided separately in respect of banks and non-banking companies. The external debt of banks increased from $144bn in 2010 to $164bn in 2011 (an increase of 13.9%). The debt of non-banking companies rose from $298bn in 2010 to $330bn in 2011 (an increase of 10.7%). The paradox of the situation with growth in the external debt of the private sector consists in the fact that the debt increased despite the considerable net outflow of foreign capital from Russia (about $85bn) and difficulties related to refinancing of external debts due to growing problems on global financial markets.



Source: on the basis of the data of the balance of payment for the number of years.

Fig. 39. The external debt of the Russian Federation in the 1998-2011 period, billion $

3.5.5. Operating Risks of the Stock Market and the Term Market

In the past few years, the specifics of the stock market of equities consists in the advanced growth in the trading volumes as compared to assets of market participants and their customers. The data provided in *Fig. 16* indirectly points to that fact; it shows growth in the number of anonymous transactions with a decrease in the size of the average transaction on the MICEX-RTS primary equity market. High-frequency trading is getting more popular. Annual contests for the name of the best private investor have actually turned into an indirect advertizing of high-frequency trading. The data on customers' operations which is occasionally published in the mass media permits to believe that private customers with large brokerage companies renew on average their portfolio completely once in two-three days[1]. Unlike the developed markets, the tariff policy of Russian brokers does not imply any limitations on high-frequency trading by customers irrespective of the extent to which they are prepared to risks[2].

Increased trading activity not only impairs often investment results of the bulk of private investors, but also creates higher operating risks to trading systems. In Section 3.2.5., the problem of frequent technical failures at Russian exchanges in 2011 was considered. Each year, the exchange actively makes efforts to process the ever-growing flow of bids in a situation where it is opposed by nearly 600 participants, some of which have got at their disposal enough resources – no less than those of the exchange itself – to buy state-of-the-art computers and software programs which permit to reduce frequency of trading decisions. It is to be noted that the effect of such a competition on growth in capitalization of issuers, attraction of new funds and upgrading of efficiency of investment is not clear at all. So, in the years to come due to operating problems in infrastructure organizations the issue of introduction of balanced measures to regulate high-frequency trading may be raised.

The RTS term market causes similar concerns. The number of transactions and trading volumes in the above market grow at a high rate (*Fig. 40*), while customers' assets increase at a slower rate and the information on the number of participants in that market and their operating activities is not transparent.

It is to be noted that as compared to the earlier stage of development of the term market in the mid-2000s at present a lower level of surety of futures and options contracts is observed and the data in *Fig. 41* points to that effect. Here is the information on the volumes of open positions on the futures and options market as well as surety of transactions in each market segment. The latter index is calculated by means of division of the monthly volume of open positions by the volume of trading in respective fixed-term contracts. From March 2009, recovery of trading volumes on the futures and options markets was accompanied by a drop in the level of surety of futures transactions from 10% of the trading volume in December 2008 to 5% at the present day while in the options market in the same period it fell from 146% to 74%.

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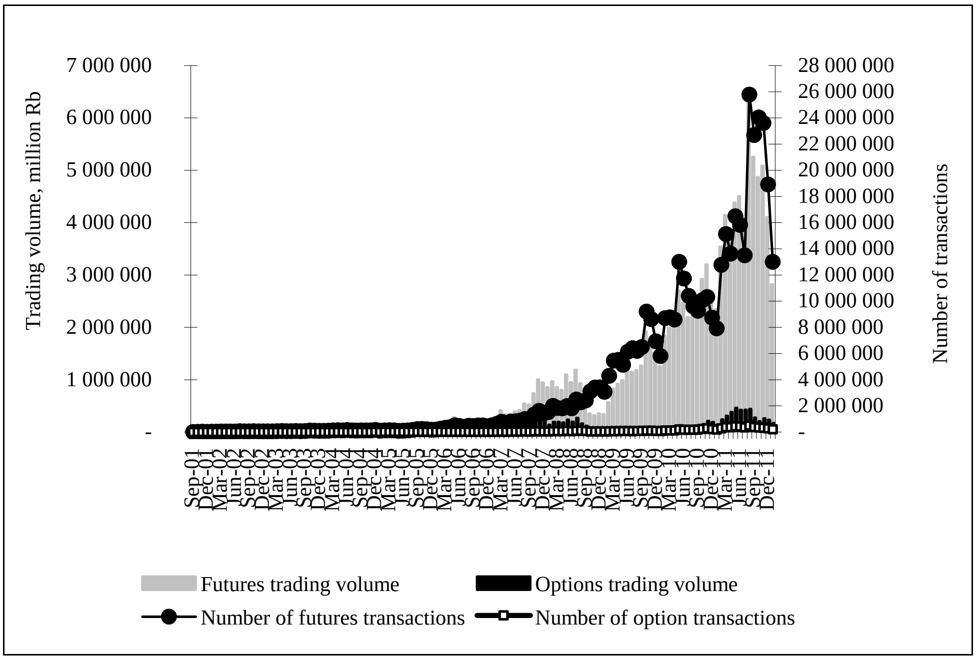
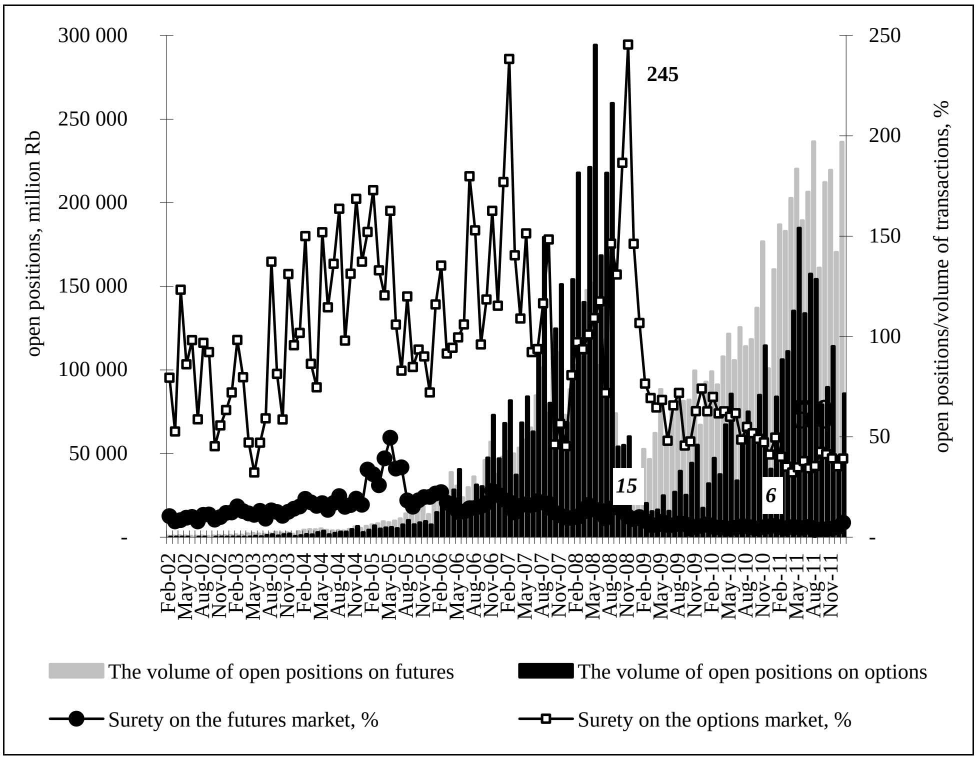
[1] BKS Makes Plans. Vedomosti, June 22, 2010.

[2] Tariffs of US brokers imply charging of a flat brokerage fee in the absolute amount ($5 to $8 per transaction) of the sum of transactions which practice prevents persons who lack substantial assets in a brokerage account from high-frequency trading.



Source: on the basis of the data of JSC RTS.

Fig. 40. Trading volumes and the number of transactions on the RTS term market from September 9, 2001 through January 31, 2012



Source: on the basis of the data of JSC RTS.

Fig. 41. Open positions and surety of deals on the RTS term market from February 1, 2001 through January 31, 2012

3.5.6. Risks Related to REPO Deals

Rapid development of the financial crisis on the stock market in August 2008 resulted in the crisis of the REPO market where a number of large market participants failed to meet their financial liabilities. The system crisis of non-payments was managed to be avoided thanks to interference by the Bank of Russia into in settlements and the problem of mutual non-payments was fixed up. In the period that followed the crisis, the infrastructure of the exchange managed to solve the problem of establishment of a guaranteed system of settlements on REPO deals.

At the present stage, the problem on the REPO market consists in the fact that for individual types of securities, for example, corporate bonds they became a dominating type of transactions. Corporate bonds became an instrument which specializes in provision of sureties in inter-bank lending deals. It has a positive effect as it ensures an influx of short-term liquidity to the market of corporate borrowings and a partial transformation of such liquidity into more long-term investment resources. At the same time, corporate bonds are much less convenient instruments for such a type of operations as compared, for instance, to OFZ. As regards output volumes, liquidity, affordability and reliability, OFZ have either already surpassed or will surpass in the next two years most issues of corporate bonds. It appears that as the strategy of development of the term market is carried out by the Ministry of Finance of the Russian Federation OFZ will become more liquid and popular with many investors. Gradually, they will oust corporate bonds from the inter-bank lending segment. If by that time corporate bonds have failed to find more long-term resources of funding the corporate debts market may collapse.

3.5.7. Lack of the Financial Market Development Strategy

The industry of provision of investment and financial services as well as readjustment of that industry to a long-term private investor requires considerable investments. To do that, financial institutions and investors should be well aware of the prospect of development of the industry in the next few years. So, a strategy of development of the financial market is to be agreed upon both by market participants and state authorities. The existing Strategy of Development fails to perform guideline functions as forecasted indices of the financial market stated in it refer to the distant year 2020. The indices were prepared without breakdown by the year and those indicators which were approved before the crisis have not been revised with taking into account the actual data in the 2008–2011 period. Not surprisingly, on the basis of the results of the strategic audit of development of the Russian financial market the Accounts Chamber of the Russian Federation stated that with current growth rates of indices which characterize the dynamics of development of the financial market "goals can be achieved as regards only two out of twenty target indices of development of the financial market set by the Strategy …»[1].

Within the frameworks of the course in the economy of non-banking financial brokerage, in the 2009–2010 period NRU HSE carried out evaluation of the capacity of the Russian fi-

[1] On January 10, 2012, the Accounts Chamber carried out a strategic audit of development of the financial market of Russia. The Information Department of the Accounts Chamber of the Russian Federation. Published on the Internet site of the Accounts Chamber of the Russian Federation at the following address www.ach.gov.ru

nancial market in the 2010–2020 period.[1] On the basis of different sources and expert surveys, the value of assets which different categories of individual and institutional investors keep in brokerage accounts and transfer into trust management, including unit investment funds was estimated. Also, an evaluation of the market of investment services both in offering of different securities and carrying out of merger-takeover deals was made. Then, the amount of intermediaries' income from rendering of non-banking financial services was calculated on a yearly basis and it eventually permitted on the basis of the DCF-model to determine potential capitalization of the business of investment banks, brokers and trustees. The above calculations were carried out in accordance with the following three scenarios: an optimistic one which is close to KDR-2020 (the Concept for the Long-Term Social and Economic Development of the Russian Federation in the Period until 2020) of the year 2008; a base one which is aimed at the current growth path of the GDP and market capitalization and a moderate one which virtually allows for stagnation in economic growth and financial parameters.

On the basis of the results of the research, it was revealed that the entire business of Russian investment banks, brokers and trustees was evaluated at \$22.7bn, \$20.5bn and \$11.8bn according to the optimistic scenario, base scenario and moderate scenario, respectively. In 2011, the above calculations were not updated completely, however, matching of the initial data with the actual outputs in the 2010–2011 period shows that the financial services market is developing according to the trend which is worse than the most moderate scenario.

An illustration of both a drop in demand in financial services and growth in a lack of confidence by the middle class to the domestic financial market in 2011 became a large-scale shutdown of once popular financial publishing houses which were aimed at an average investor. On June 27, 2011, the last issue of the *Finans* weekly came out. In April 2011, the *Zhurnal D'* magazine aimed at persons with work experience on the stock market ceased to exist. Those developments became a continuation of a shutdown of the *Smart Money* magazine in May 2009 and the *Russian Newsweek* magazine in October 2010.

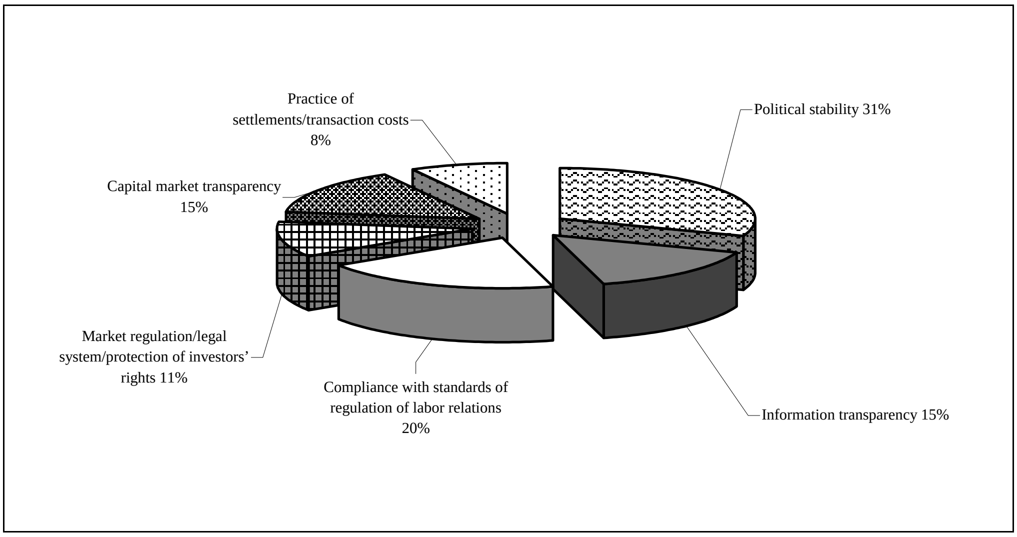
With lack of strategy, the entire financial business is doomed to degradation. Without clear and justified goals there are no investments, while without investments into development the financial business turns into industry which is dangerous to the consumer of services where growth in income is achieved not through attraction of new participants and investment assets to the market, but by means of intensifying the pressure of commissions on the existing customers. The present trend of strengthening of the role of state regulation and supervision should be combined with raising of responsibility of representatives of the state for different financial services industries. One of the state authorities should be responsible for the policy of development of financial organizations, including indicative planning of key indices of the industry. In May 2009, Decree of the President of the Russian Federation on the Principles of Strategic Planning in the Russian Federation was signed; at present special legislation on indicative planning is being developed. The ideas of the above documents are topical to the financial market. A center for coordination of the work on development of modern strategies of development of the industry and its participants can become self-regulating entities represented by the National League of Management Companies (NLMC), the Russian National

[1] See more detailed results published in the NAUFOR Bulletin (Bulletin of the Russian National Association of Securities Market Participants), No.3. March 2010.

Association of Securities Market Participants (RNASMP) and the National Securities Market Association (NSMA)[1].

3.6. Problems of Attraction of Conservative Institutional Investors

The Russian stock market remains unattractive to the most capitalized conservative investors, primarily, western pension funds. To understand the reasons, it would be expedient to turn to the experience of the California Public Employees' Retirement System (Calpers), the US largest pension fund whose reserves amount to about $200bn. For many years until 2007, Calpers used methods of preparing the emergency markets rating as regards opportunities of investing its assets in such markets. The above methods were public and were based on research of authoritative organizations, including the Freedom House, the World Economic Forum, the Oxford Analytica, the Heritage Foundation, the Wall Street Journal and other research centers. On the basis of Calpers's research, the most important factors which prevent active investment by western pension funds and other conservative investors in the Russian stock market are shown in *Fig. 42*.



Source: www.calpers.ca.gov

Fig. 42. The factors which prevented Russia from receiving the maximum investment ratings in accordance with methods of the CalPERs Pension Fund (USA) in 2007

In 2007, Calpers changed the methods of making decisions as regards investment in emerging markets; portfolio managers were granted the right to select at their own discretion companies from emerging markets for making investments with taking into account risks incidental to different countries and stock markets. In the 2008–2010 period, Calpers invested in equities of a number of Russian companies (*Table 8*). Analyzing investments by Calpers in ADR of Russian companies in the above period, it has been found that investments in ADR of

[1] According to Academician V.M. Polterovitch "… practically all the countries which managed in the past six decades to become developed states used indicative planning based on a close cooperation between the government and business associations (Strategy of Modernization of the Russian Economy/ executive editor V.M. Polterovitch. – SPb.: Aleteya, 2010, p.57).

Gasprom and Lukoil were reduced as a reaction to sanctions against foreign companies operating in Iran.

Table 8

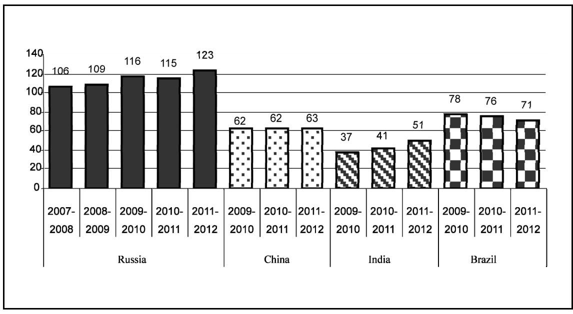
Investments by Calpers in equities of Russian companies, million $

	2008*	**2009***	**2010***
Gasprom	144.7	46.0	55.1
Lukoil	189.1	93.5	80.6
Mechel	9.1	1.0	1.8
GMK Norilsky Nikel	4.6	1.4	14.3
Novatek		20.6	10.4
Novorossiisky Torgovy Port	10.3	8.4	7.7
Rosneft	11.4	31.4	15.7
Polus Zoloto		5.5	2.3
Rostelekom		3.4	1.0
Sberbank of Russia	5.5	30.8	9.3
Severstal	7.0	4.7	7.0
AFK Sistema	9.7	3.8	62.0
Surgutneftegaz	4.5	20.5	18.9
Wimm-Bill-Dann		20.2	2.2
Magnit		7.3	15.5
MMK		6.1	2.0
VTB	31.6	6.9	14.3
LSR		2.9	4.4
Other open-end joint-stock companies (OAO)			12.9
Equities of Russian companies – total	**427.4**	**314.4**	**337.4**
Equities on the domestic and foreign markets	**122 281.2**	**80 728.6**	**91 776.3**
The share of equities of Russian companies in Calpers's portfolio	**0.35**	**0.39**	**0.37**
The share of Russian companies in the global capitalization	**1.21**	**1.85**	**1.91**

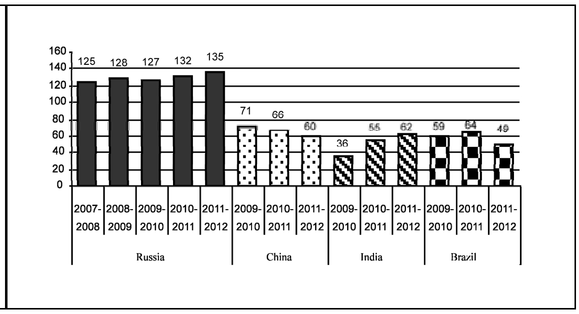
*the fiscal year ending in June; the detailed data on the composition and structure of Calpers's portfolio at its Internet site is published with nearly a year delay, probably, in order to limit strategies of following to that pension fund's portfolio.
Source: on the basis of the report on Calpers's investments for a number of years.

The value of Calpers's investments in equities of Russian companies is a symbolic one. In 2008, it was estimated at $427m or 0.35% of the cost of the equities portfolio of the state pension fund, in 2009, at $314m or 0.39% of the cost of the equities portfolio and in 2010, at $337m or 0.37% of the cost of the portfolio. For comparison, the share of equities of Russian companies in the global capitalization amounted to 1.21%, 1.85% and 1.91% in 2008, 2009 and 2010, respectively.

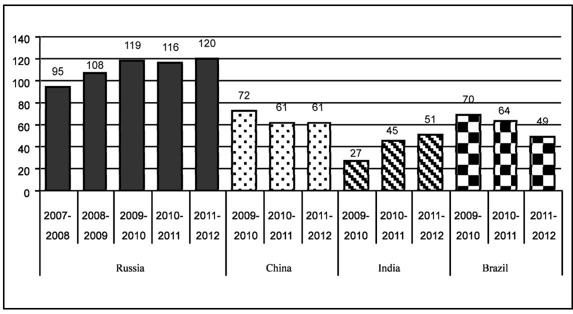
As regards the main criteria which restrained Calpers from investing into Russian equities when they officially declared the methods of selection of emerging markets for investments, no positive changes have taken place so far. In *Fig. 43*, the data of the Global Competitiveness Index of the World Economic Forum for a number of years is presented. The above data shows those spheres where Russia received low rating grades in terms of Calpers's former methods.



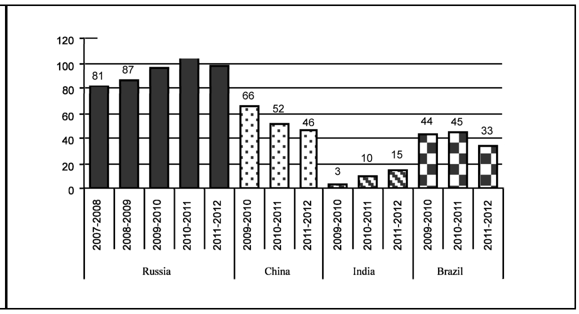
Position in the GCI WEF: independence of justice



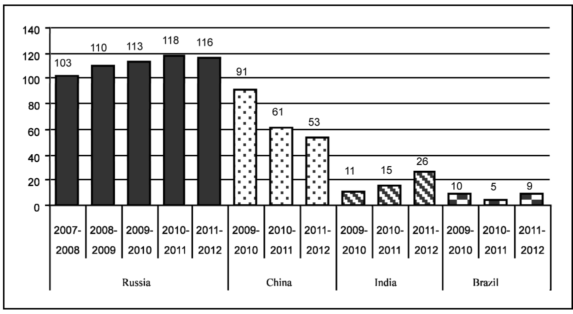
Position in the GCI WEF: protection of the rights of minority shareholders



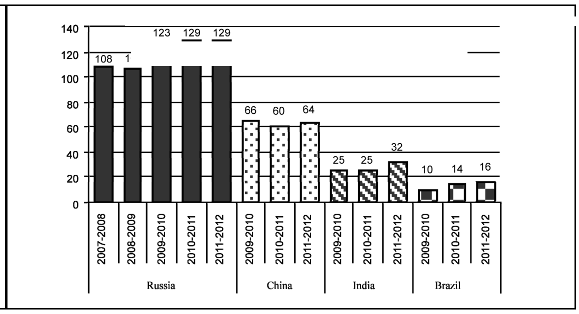
Position in the GCI WEF: efficiency of the standard of audit and reporting



Position in the GCI WEF: depth of the domestic equity market



Position in the GCI WEF: regulation of exchanges



Position in the GCI WEF: reliability of banks

Source: The Global Competitiveness Index of the World Economic Forum for a number of years.

Fig. 43. Position of BRIC states in the global competitiveness index as regards a number of criteria which are important for decision-making by conservative portfolio investors

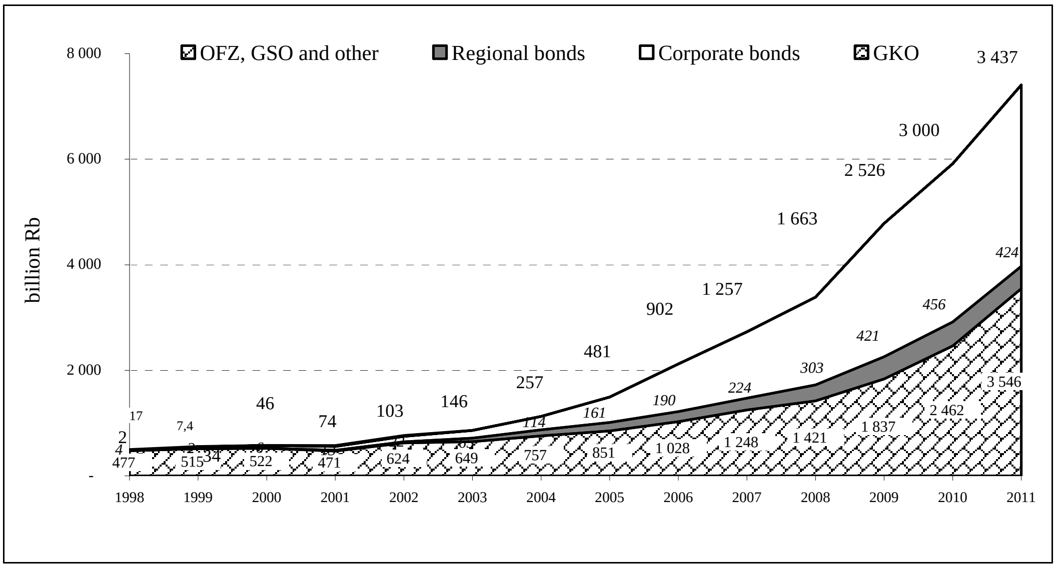
As regards the most problematic issues such as independence of justice, protection of minority shareholders, efficiency of standards of audit and reporting, depth of the equity market, efficiency of regulation of exchanges and reliability of banks, Russia lags significantly behind other BRIC states. It is to be noted that in 2011 Russia's position changed for the worse as regards two of the above six indices, remained unchanged as regards one index and somewhat improved as regards the remaining three indices.

3.7. The Role of the Stock Market in Modernization of the Economy and Promotion of Innovations

The crisis has revealed deep-rooted problems and inconsistencies of the Russian economy, as well as its unpreparedness to challenges of globalization. Russia has adopted a policy of economic modernization. The financial market should play an important role in implementation of that policy. However, it remains to be seen if it is prepared for such large-scale objectives?

3.7.1. Contribution of the Market of Corporate Bonds in Real Capital Growth

An important financial achievement of the 2000s was development of the market of ruble-denominated bonds (*Fig. 44*). Capitalization of the market of ruble-denominated bonds rose from Rb 0.6 trillion in 2000 to Rb 7.4 trillion in 2011 or 12.3 times over. Of all ruble-denominated bonds, the market of corporate bonds was growing at a higher rate. Their aggregate capitalization rose from Rb 46bn in 2000 to Rb 3.4 trillion in 2010 or nearly 75 times over.



Source: on the basis of the data of the Ministry of Finance of the Russian Federation and Cbonds.ru.

Fig. 44. Volumes of outstanding ruble-denominated bonds

Such parameters of the market of ruble-denominated corporate bonds in the 2000-2011 period as were recalculated in US dollar terms are shown in *Table 9*. Despite the rapid growth in volumes of offering of corporate bonds from $1.1bn in 2000 to $31.5bn in 2011, the volume of such funds spent on capital assets growth remains low. With the total volume of offering of bonds in the amount of $28.2bn in 2010, only $0.03bn out of the above amount or 0.1% of the volume of the placed bonds was spent on purchase of capital assets. Altogether, in the 2000s the share of volumes of corporate bonds issues spent on capital assets varied from 0.00% to 6.7%. The data for January-September 2011 reflects positive changes. Only in the first nine months of 2011, for replenishment of capital assets $1.6bn was spent out of the total volume of the corporate bonds offering ($31.5bn), that is, ten times more than in all the previous years altogether.

Table 9

The parameters of the market of ruble-denominated corporate bonds (billion $)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Capitalization	1.6	2.5	3.3	4.8	8.9	17	33.2	49.2	67	79.7	98.8	117,1
Secondary market, including REPO	0.2	1.1	2.3	8.2	14.7	44.2	134.9	371.1	457.4	293	756.8	1237,2
Placement	1.1	0.8	1.5	2.6	4.9	9.2	17.1	17.9	16.1	29.0	28.2	31,5
In capital assets	0	0	0.1	0.1	0.1	0.3	0.1	0.2	0.2	0.1	0.03	1,6*
the same as % of the capitalization			3.0	2.1	1.1	1.8	0.3	0.4	0.3	0.1	0.03	
the same as % of the volume of placement			6.7	3.8	2.0	3.3	0.6	1.1	1.2	0.3	0.1	

* for January-September 2011.
Source: calculated on the basis of the data of MICEX-RTS, cBonds, the Bank of Russia and Rosstat.

3.7.2. The Impact of IPO of Equities on the Economy

The more effective instrument of raising funds for financing of capital assets as compared to issuing of corporate bonds is a public offering of equities in the form of IPO and SPO. It is justified by the fact that funds raised by means of IPO are more long-term ones. In *Table 10*, parameters of the market of equities of Russian companies are shown. As seen from the Table, the most active IPOs of equities were carried out in 2006 and 2007 when companies managed to raise $17.0bn and $33.0bn, respectively. In 2006, 18.8% of receipts from IPO-SPO was spent by companies on purchase of capital assets, while in 2007 that index decreased to 10.9%. In individual years, for example, in 2008 and 2009 110.5% and 117.6% of the volume of IPOs was spent on capital assets, respectively. It can be explained by the fact that a portion of investments in capital assets was received by companies by means of a private offering and not IPO-SPO. In 2010, Russian companies, including RUSAL and Mail.ru – which are both off-shore-registered companies – raised $6.3bn by means of IPO-SPO; generally as a result of issuing of equities $2.6bn or 46.0% of the volume of IPO-SPO was invested in capital assets. In 2011, only in the nine months $1.6bn out of the total value of IPO ($11.3bn) was spent on capital assets. A considerable portion of funds raised on the stock market was spent on buying out of business from former owners, refinancing of debts and serving of merger-takeover deals, including purchasing of large equity stakes. At present, the volumes of IPO and investments in real capital through issuing of shares are much lower than those of merger-takeover deals. From 2000 till 2001, the total volume of IPO-SPO of Russian companies amounted to $72.0bn, while the volume of merger-takeover deals, to $644.3bn, that is 8.9 times more.

However, it is too early to say that a large portion of receipts from offering of equities and, especially, corporate bonds contributes to modernization of the economy and promotion of economic growth[1]. The volume of funds which companies raise by means of offering of equi-

[1] In Russia, for some reason the q-Tobin rule does not work well. Under the above rule, if there is a high coefficient characterizing the ratio of market capitalization to replacement cost of the business it will be profitable for businessmen to make investments in real capital. (F. Mishkin The Economic Theory of Money, Banking and Financial Markets, 7th edition: Translated from English. – M.: OOO I.D. Williams, 2006, p. 738). Interestingly,

ties and corporate bonds and then spend on purchase of fixed-capital assets accounts for a small portion in sources of financing of capital assets. The data in *Fig. 45* on the sources of financing of investments in fixed-capital assets points to that effect.

Table 10

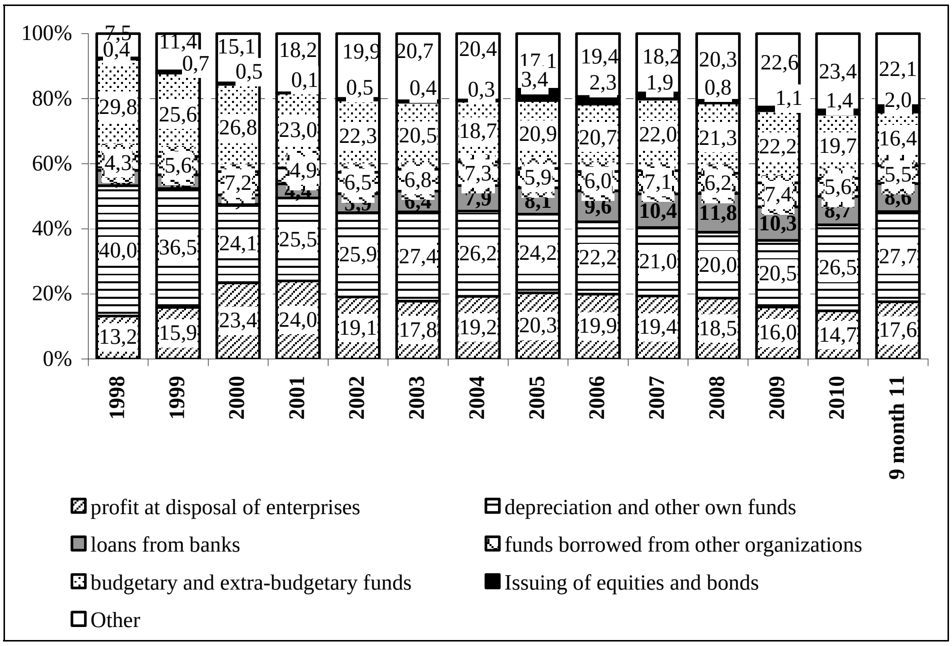
Parameters of the market of equities of Russian companies (billion $)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Capitalization	40.7	74.6	105.5	176.3	230.0	548.6	1057.2	1503.0	397.0	861.4	938.3	1130**
Secondary market. including foreign exchanges	46.7	49.4	86.8	188.3	541.3	374.0	914.2	1687.1	1982.5	1155.7	1430.5	2221.5
IPO of equities	0.5	0.2	1.3	0.6	3.0	5.2	17.0	33.0	1.9	1.7	6.3	11.3
In capital assets	0.2	0.1	0.2	0.2	0.1	3.2	3.2	3.6	2.1	2	2.9	1.6***
the same as % of capitalization	0.5	0.1	0.2	0.1	0.0	0.6	0.3	0.2	0.5	0.2	0.3	
The same as % of the volume of IPO	40.0	50.0	15.4	33.3	3.3	61.5	18.8	10.9	110.5*	117.6*	46.0	
The volume of merger-takeover deals	5.0	12.4	17.9	32.3	27.0	60.4	61.9	125.9	110.4	56.1	55.7	79.3

* - the value is more than 100% because a portion of investments in capital assets might have been carried out through private offering;
**- evaluation;
***- for January-September 2011.
Source: calculated on the basis of the data of MICEX-RTS, the Bank of Russia, Rosstat and www.mergers.ru

Throughout the 2000s, the share of funds raised through issuing of bonds and equities in the sources of financing of capital assets varied in the range of from 0.1% in 2001 to 3.4% in 2005. In 2010, the above index amounted to 1.4%, while on the basis of the outputs of the nine months of 2011, to 2.0%.

according to the IMF Report on Global Financial Stability Russia differs from other developing countries by a lower value of the P/BV ratio which fact does not contribute to investments in real capital. It seems that the problem of Russia is of a dual nature: first, prices on equities are overrated and, second, the cost of non-efficient assets is tremendously high.

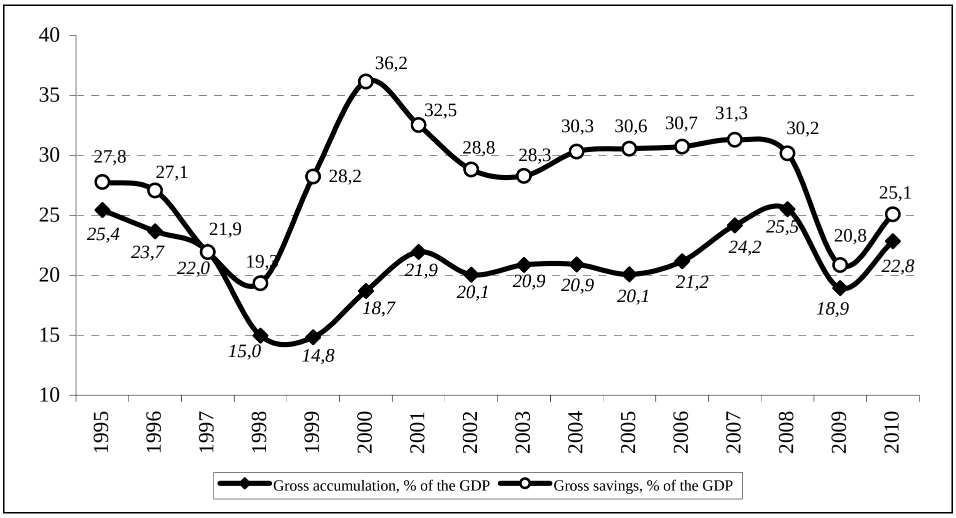


Source: calculations on the basis of the data of Rosstat.

Fig. 45. The structure of sources of investment in fixed-capital assets

3.8. The Impact of the Crisis on the System of Domestic Savings

To maintain high rates of growth and modernization of the economy of Russia, high rates of domestic savings and accumulation are required. However, if the rate of savings in Russia is relatively high and only below those of some states of the Asian region the rate of accumulation, that is, investments in capital assets and inventories is much lower than in many developing and developed countries. In *Fig. 46*, the data on the rate of savings and the rate of accumulation in Russia in the 1995-2010 period is presented.



Source: calculations on the basis of the data of Rosstat.

Fig. 46. The rates of savings and accumulation in Russia
in the 1995-2010 period, % of the GDP

The difference between rate of savings and the rate of accumulation amounts from year to year to 5–10 percentage points. The main factor that a portion of domestic savings in this country fails to turn into real capital can be explained by the fact that a large portion of the savings surplus is left in the gold and foreign exchange reserve which is deposited abroad. Such a situation is a necessity because at the current level of development of financial instruments and investment climate the financial system is unable to make the above reserves work efficiently in Russia. The system itself needs modernization, new knowledge and expertise. That problem should be attached key importance in development of the new long-term strategy of development of Russia till 2020.

Another reserve of growth in accumulation implies raising of the rate of savings by households. According to the official data of Rosstat, Russian households save 14–15% of their income. In leader-states as regards economic growth and modernization (China, India, Singapore and Hong Kong), the rate of savings by households to the amount of the disposable income is much higher. The social and demographic situation in those countries is, certainly, different from that in Russia, however it is to be admitted that any large-scale modernization is to rely on internal financing. In addition to the above, in the current situation a high rate of consumption in Russia actually means motivation at the expense of the domestic demand of foreign manufacturers.

To raise the rate of savings of households and attract long-term resources, as well as in a case of reserves of the state, conservative institutional investors are required. A relatively low level of development of such investors in Russia (*Table 11*) is a principal problem to the Russian financial market.

Table 11

The composite data on the level of development of institutional investors in Russia

Average index in the 2001–2010 period as regards mutual funds and in the 2001–2009 period as regards pension funds and insurers	Number of countries in samples of ICI[1] and OECD	Position of Russia in samples	Share as % of the GDP	
			Average in the 2001–2010 period	2010
Assets of open investment funds*	46	45	0.3	0.3
Reserves of private pension funds**	47	44	1.0	1.4
Assets of insurance organizations***	33	32	1.0	1.1

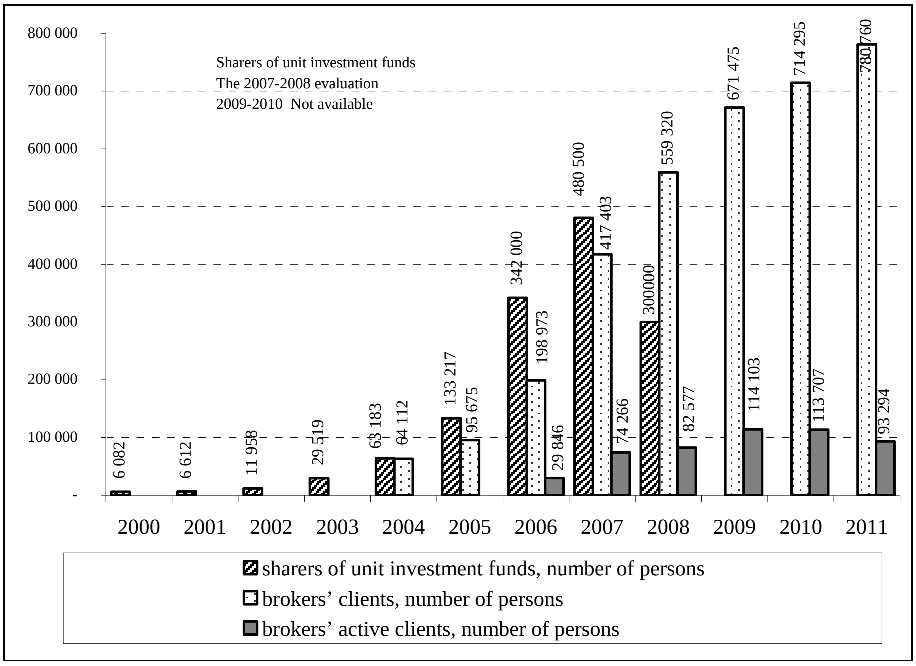
* Russia – open-end and interval unit investment funds;
** Russia – reserves of non-government pension funds;
*** Russia – insurance reserves.
Source: calculated on the basis of the data of the Investment Company Institute, stat.org OECD and IFS IMF base.

As compared to countries where there is a domestic stock market, Russia is the only country which is a global outsider as regards the level of development of all the three forms of institutional investors. Among 46 countries in respect of which the data on the assets of open-end investment funds is collected, Russia is rated 45th; as regards the standard of the relative level of development of private pension funds, 44th among 47 countries and as regards the assets of insurance organizations, 32nd out of 33 countries. In 2010, the share of assets of open-end unit investment funds and interval unit investment funds to the GDP of Russia amounted to 0.3%, reserves of non-government pension funds, to 1.4% and assets of insurance organizations, to about 1.1%. The above data points to the fact that in Russia the mechanism of mobi-

[1] Investment Company Institute.

lization of savings through institutional investors does not virtually work. Unlike all other countries, in Russia the main ways of savings are real-estate and bank deposits.

In *Fig. 47*, the data on the number of accounts of individual investors with brokers and the number of personal accounts in registers of owners of investment shares of unit investment funds is presented. Unfortunately, at present the National League of Management Companies (NLMC) does not promptly reveal the number of market sharers of unit investment funds. However, if is assumed that in the 2009-2011 period the number of sharers of unit investment funds did not decrease as compared to 2008 then it may be concluded that in 2011 the number of individual investors which carry out operations with securities directly or by means of collective investments amounts to about a million investors. It is to be noted that the specifics of the 2010–2011 period was a trend of a slowdown of the growth in the number of brokers' clients registered in the MICEX trading system. If in 2009 the growth in registered clients within a year amounted to 112,200 persons, in 2010 it was equal to the mere 42,800 persons, while in 2011, to 66,500 persons. The number of active clients with brokers fell from 114,100 persons in 2009 to 93,200 persons in 2011. The above data may point to the fact that the existing scheme of attraction of clients to the Russian stock market has started to exhaust itself. The number of people who are attracted by manipulation on stock exchange is a limited one in any country. The new scheme of growth requires involvement of long-term investors, but it cannot be done without establishment of an efficient system of pension savings and restructuring of the pattern of provision of services by financial institutions.



Source: calculations on the basis of the data of the MICEX-RTS, RNASMP and NLMC.

Fig. 47. Number of retail and wholesale customers with management companies and brokers

Thus, the financial market has exhausted to a great extent the former scheme of growth and it needs to be changed. A particular attention is to be attached to a long-term investor, representative of the middle class. To solve that problem, it is important to work out a new strategy of development of the financial market.

3.9. Development of the Banking Sector in Russia in 2011

3.9.1. The Post-Crisis False Start

The financial sphere of Russia was the first sector of the national economy which was affected by the global economic crisis of 2008. Financial markets were hit first and then the banking sector experienced the liquidity problem to be followed by a full-scale economic crisis in Russia.

The two factors permitted to prevent the collapse of the banking sector: the government's financial aid and growth in households' savings. From the beginning of 2009, within the frameworks of anti-crisis measures the government allocated the largest resources to the banking sector. Households became a prominent participant (though an involuntary one) in rehabilitation of the banking system: during the crisis prevalence of the cautious behavior prompted people to save more money, rather than take loans from banks. In the 2009–2010 period, the growth in households' bank deposits amounted to Rb 4 trillion which figure exceeded the volume of all the consumer loans as of the end of 2009.

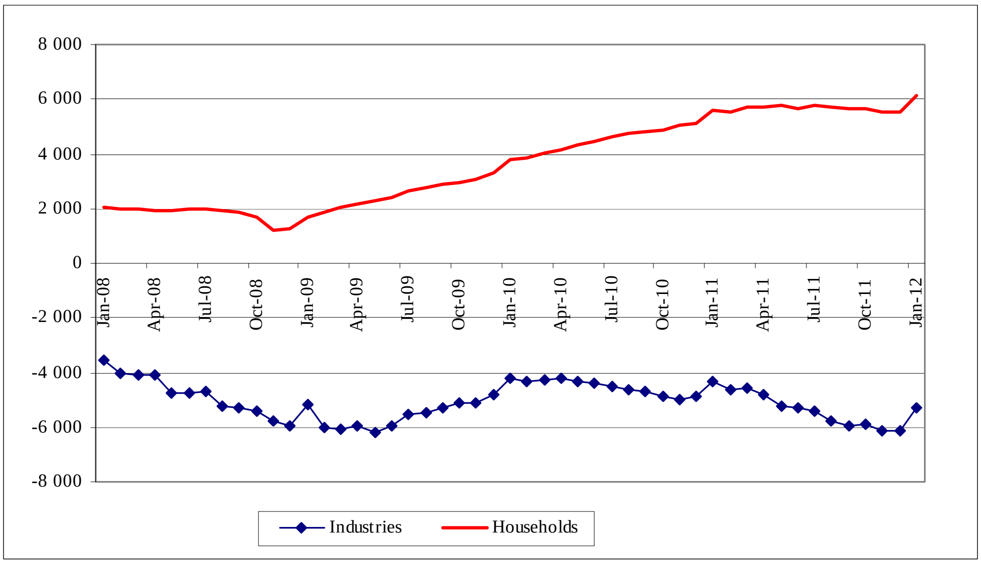
Early in 2011, all the factors pointed to the fact that the banking sector overcame the crisis, and it seemed the upward development began. The banking sector had at its disposal huge available resources for expansion of lending to the non-financial sector. The bank savings of the non-financial sector exceeded the volume of loans to industries and households by Rb 1.1 trillion, while the excessive banking liquidity amounted (according to our evaluations) to at least Rb 1 trillion. Thus, there were all the reasons to believe that in 2011 the Russian banking system would keep developing in a balanced way and overcome the structural problems which dated back to the pre-crisis period.

In reality, the situation was different: the balanced development failed, while rather intense growth took place in individual segments of the banking sphere and it was accompanied by dramatic structural imbalances. Lending to the non-banking sector of the economy increased considerably with fairly moderate growth in the depositary base. As a result, in the second half of 2011 the banking sector faced the liquidity crisis. More importantly, recovery of the acceptable level of liquidity will inevitably be accompanied by a decrease in the bank lending to the non-financial sector with the bad debt problem being, probably, aggravated. In reality, to achieve the mid-term curve of sustained development the complete restructuring of the banking sector may be required.

3.9.2. The Structure of Institutional Financial Flows in 2011

The structure of institutional financial flows which are redistributed by the banking sector provides the important information for evaluation of trends both in the financial and real sectors of the national economy. In 2011, the structure of flows actively shifted from the stable condition to the crisis one. If at the beginning of the last year the high level of excessive liquidity and lower growth rates of lending were typical of the banking sector by the end of the year the situation changed the other way round.

On the basis of the results of 2010, growth in loans to industries amounted to 9.8%, while that to households, to 14.4%. In 2011, more than twofold increase in the growth rates of lending took place (24.2% and 36.1%, respectively). A similar speed-up took place in a situation of sustained growth in the depositary base both in 2010 and 2011; the aggregate volume of funds of industries and households in accounts with banks rose by 23% (*Fig. 48*). That gap naturally "swallowed" the excessive savings which were accumulated in the 2008–2010 crisis period.

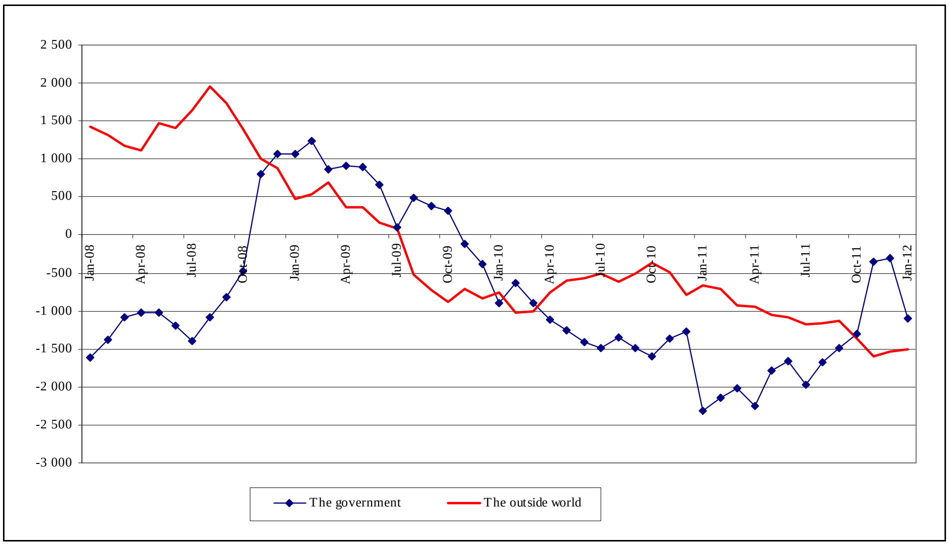


Source: The Central Bank of the Russian Federation and the IEP's Structural Research Center calculations.

Fig. 48. The net credit of households and industries to the banking system of the Russian Federation, billion Rb.

An important trend in 2011 was the outflow of capital from the banking sector: if in 2010 the net capital inflow was registered in the amount of $ 15.9bn in 2011 the net capital outflow amounted to $ 26.2bn. The growing gap between foreign assets and lending to the non-financial sector, on the one hand, and the disposable resource base, on the other hand, was financed at the expense of a decrease in the bank liquidity and attraction of government funds. During the year, the level of liquidity fell by over Rb 600bn (from 8.7% to 5.6% of assets). On the contrary, the deposits of the Ministry of Finance and the loans of the Bank of Russia increased by Rb 1.3 trillion (from 1.4% to 4.3% of the liabilities) (*Fig. 49*). It is to be noted that the balance value of the own funds of the banking sector increased within a year by the mere 13.7%, while the capital adequacy norm decreased from 18.1% to 14.7% in 2011.

Generally, in 2011 the following principal changes took place in the structure of institutional financial flows in Russia. To start with, the role of households as a net creditor of the banking system decreased: on the basis of the results of the year the amount of deposits placed by households with banks was only Rb 390bn more then the amount of loans which households received, while in the past two years the net credit to banks from households amounted to Rb 2.1 trillion and Rb 1.9 trillion, respectively. As regards the corporate sector, the situation is quite the opposite: the volume of the extended loans exceeded by over Rb 900bn the volume of the attracted funds and deposits. Finally, a net loan of Rb 740bn was granted to the outside world. As a result, in 2011 the net loan to the non-financial sector and the outside world increased by Rb 1.3 trillion. The sources of such a substantial loan were the reduced bank liquidity and government resources.



Note. Government loans – loans of the Ministry of Finance of the Russian Federation, including debt on federal bonds, and the Central Bank of the Russian Federation.
Source: the Central Bank of the Russian Federation and the IEP's Structural Research Center calculations.

Fig. 49. The net credit of the government and the outside world, billion Rb.

3.9.3. The Main Trends in the Banking Sector

Growth in Bank Assets

In 2011, the dynamics of bank assets somewhat accelerated as compared to 2010 (with adjustment to the revaluation of assets in foreign currency the growth amounted to 21.4% against 14.8% in 2010). Such growth rates are quite moderate as they exceed the GDP deflator and the domestic market deflator[1] by the mere 6% and 11%, respectively. It is to be noted that in 2011 the growth rates of the bank assets exceeded by the mere 3.4% the growth in the nominal GDP in 2011, and, accordingly, the ratio of the value of bank assets to the GDP increased insignificantly within a year from 74.8% to 76.5%. As it is shown below, even such growth rates of the banks' asset operations were difficult to achieve. The main sources of the banking sector's funds --account balances and customers' deposits – failed to ensure growth rates which were equal to the nominal growth in the economy in general without further participation of government authorities.

In 2011, in the group of the largest banks, the highest growth rates of assets were observed with state banks[2] (without the Sberbank – 34%). Undoubtedly, a considerable contribution to the assets growth of the above group was made by the state's participation in the rescue of the Bank of Moscow. In September, the Deposit Insurance Agency (DIA) placed with the Bank

[1] Such a volume of goods and services consumed on the domestic market as is determined as the GDP, less the net export.
[2] For the purpose of the structural analysis of the banking sector, the following groups of banks were used: Sberbank, large state banks and banks of state companies (VTB, VTB24, GPB (Gasprombank), RSKhB (Russian Agricultural Bank), The Bank of Moscow and Transkredit), large foreign banks, large private Russian banks which are in the top 30 list and other (mid-sized and small banks).

of Moscow a long-term deposit in the amount of Rb 295bn which figure was equal at that time to about 35% of that bank's assets.

The lowest rates were registered with the group of large private banks (14%). It is to be noted that such results conform to the outputs of the polls of Russia's largest banks: 72% of the polled banks believe that in competition on the market of banking services the state banks[1] have the best advantages.

Own Funds

A factor behind the insufficiently dynamic development of the banking sector in 2011 was slow-down of growth in the banks' own funds. In 2011, the regulatory capital of the banking sector (calculated in accordance with the methods of the Bank of Russia) rose by 10.7%, which figure is twice as little as the growth rates of assets. As a result, capital adequacy fell from 18.1% as of January 1, 2011 to 14.7% as of January 1, 2012. That level is still far from the minimum admissible benchmark of 10%. However, it is important to take into account the following two factors. Firstly, even with such a seemingly significant average level of capital adequacy its index with individual banks, including large ones may be close to a critical value. For instance, the capital adequacy of the VTB bank – the second largest bank as regards the value of the assets – as of January 1, 2012 amounted to the mere 11.2%. Secondly, capital adequacy of the banking sector fell below 15% only twice before and each time capitalization of the banking sector was supported one way or another by participation of the state. It took place for the first time late in 2006 when capital adequacy of the banking sector fell to the minimum level of 14.4%. Later, bank capitalization grew considerably as a result of placement of equities of Sberbank and VTB. A similar decrease took place for the second time in autumn 2008 (a drop to the level of 14.5%) when the financial crisis was in full swing; after that banks received government support in the form of subordinated loans for which purpose resources of the National Welfare Fund were used.

In 2011, the main factor behind slowdown of growth in own funds was the fact that the banking sector became less attractive to investors and, as a consequence, no new contributions to banks' authorized capital were actually made. In 2011, the amount of the authorized capital and additional capital increased by the mere 4.6%, that is, the minimum rate in the past few years.

Raising of requirements to banks' minimum amount of own funds does not change the situation for the better, either. From January 1, 2012, banks need the capital of at least Rb 180m. Consolidation of small banks could become a factor behind growth in the own funds of the banking sector. However, the dynamics of the value of the authorized capital does not point to the fact that bank owners are seeking to secure their banks against a possible withdrawal of the license. As of January 1, 2012, the own funds of over 100 credit institutions were less than Rb 180m.

Profit and the Rate of Return

Profitability of the banking sector remains low. The maximum level of profitability after the crisis was achieved in summer 2011 and then the rate of return started to go down. As regards ROA, the first half of 2011 corresponds to the year 2003 (2.6% on a year on year basis),

[1] A. Vedev, S. Grigoryan. Development of the Russian Banking System in the Current Decade. The Outputs of Polls of Large Russian Banks (http://www.vedi.ru/bank_sys/bank5411_banks%20poll.pdf).

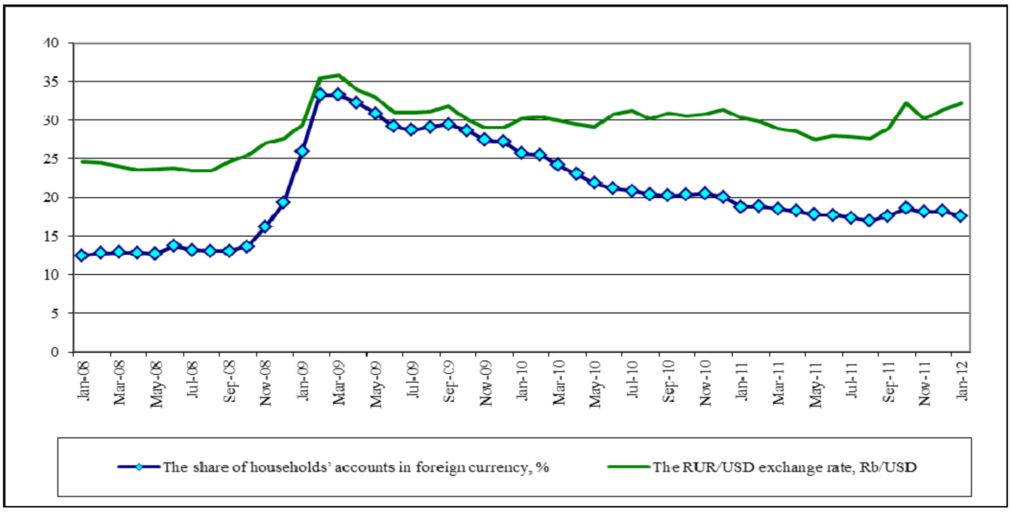
while as regards ROE (21.0%), to the year 2004. In the pre-crisis period of the credit boom (2005–2006) the profitability of the banking sector was much higher (ROA 3%–3.5%, and ROE 25%–30%). In the second half of 2011, the efficiency of the banking sector as regards the return on assets and return on equity went down further and, as a result, the annual figures turned out to be even lower: ROA – 2.3% and ROE – 19.6%.

3.9.4. Raised Funds (Resources for the Banking Activities)

Households' Funds

In 2011, in the deposit market the major event was the slow-down of the savings activity of households. In the past year, the volume of funds in deposits grew[1] by Rb 1.9 trillion which figure is nearly 20% lower than in 2010 (Rb 2.4 trillion). The growth rates of households deposits in the banking system decreased by over 33.4%: 19.5% against 31.2%.

In 2011, the process of dedollarization of households' accounts and deposits slowed down (virtually stopped) (*Fig. 50*). If in 2010 the share of deposits in foreign currency in the total volume of households' deposits fell by 7% from 25.7% as of January 1, 2010 to 18.7% as of January 1, 2011 in 2011 it decreased by the mere 1.1 % (to 17.6%). It is to be noted that in the second half of the year the share of accounts in foreign currency increased (from 16.9% as of August 1).



Source: The Central Bank of the Russian Federation and the IEP calculations

Fig. 50. The RUR/USD exchange rate and the share of households' deposits in foreign currency with banks

Slow-down of growth in bank deposits should not be regarded as evidence of a loss of households' confidence in banks. It rather shows that the norm of households' savings has generally decreased. An alternative instrument of savings can be cash national currency, but in 2011 the demand in cash funds slowed down as well. M0 monetary aggregate (that is, the cash funds outside the banking system) grew within a year by Rb 876bn which figure is 15% lower than a year before (Rb 1,025bn). It is to be noted that the ratio of nominal growth in

[1] With adjustment to the USD revaluation of deposits in foreign currency.

cash funds in 2011 and 2010 is comparable to a similar bank deposits indicator. It is to be noted that in respect of sales turnover the volume of cash funds remains to be excessive. The value of cash funds is sufficient enough for a three-month consumption of goods and services.

The main factor behind slow-down of households' savings activities was stagnation of households' real disposable income. In 2011, households' real disposable income was only 0.8% higher than in 2010. Simultaneously, ultimate consumption of goods and services in real terms increased by 5.8% (IEP evaluation as regards the aggregate volume of retail trade, public catering and paid services). Stable growth in consumption was supported by simultaneous reduction in the norm of savings and growth in demand in consumer lending (see below).

Stagnation of the depositary base (in August-September 2011 the influx of households' deposits to banks was close to nil) made banks to raise interest rates on retail deposits. The average weighted rate on one-year deposits (except for demand deposits) rose from the minimum values (5% per annum) in July to 7% per annum in December. An indicator of "the maximum interest rate (on deposits in rubles) of ten credit institutions which attract the largest volume of deposits of individuals" – which indicator is monitored closely by the Bank of Russia – rose from the summer minimum of 7.85% per annum to 9.42% per annum in December.

However, proceeding from the macro conditions which justified the frontal decrease in the norm of households' savings it is believed that growth in interest rates on deposits will not have a serious impact on the dynamics of the market of deposits. Individual banks which were more aggressive in raising of deposit rates are likely to strengthen their market positions. But, generally, the growth rates of that type of bank liabilities will be quite moderate in future. In 2012, households' deposits are expected to grow by 15%–18%, including ruble deposits (18%–20% and deposits in foreign currency (7%–10%).

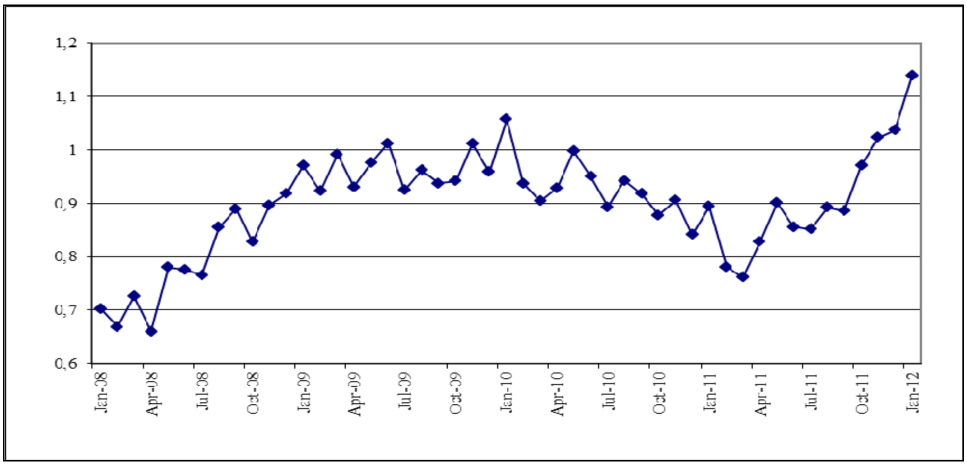
Corporate Customers' Funds

Funds in corporate customers' accounts are prone to serious fluctuations, on the one hand, due to both payment of taxes (a quarterly decrease) and a December surge in budget expenses and, on the other hand, due to the fact that fluctuations in the capital inflow and outflow have an impact on the amount of account balances of corporate customers. In the past few months, the weak dynamics of that type of bank liabilities can be mainly explained by the outflow of capital despite the favorable situation which prevailed on the market of Russia's main export commodities.

Generally, within a year, the funds of industries in bank accounts and deposits rose by 24.8%. However, December – the period of large-scale growth in budget expenses – accounted for nearly a half of that growth (Rb 1.05 trillion out of Rb 2.15 trillion). Within a year, account balances in rubles grew faster than those in foreign currency (28.9% against 3.7%); it is to be noted that virtually all the dedollarization fell into December when account balances in foreign currency decreased by 10%, while those in rubles grew by 16.2%.

The fact that most corporate funds are placed in term deposits, rather than current accounts which serve the economic turnover can be regarded as a negative factor in terms of economic activities. In the second half of 2011, the volume of term deposits of corporate customers exceeded again the amount of funds in settlement accounts. It is to be noted that about 45% of term deposits of industries and entities are placed for the term of over one year, that is, such funds have been withdrawn for a long period of time from companies' current operating plans.

The term deposits of corporate customers exceeded for the first time the amount of current settlement account balances in the mid-2009, that is, in the period of stagnation of the economic activities. At that time, such a ratio in the structure of bank accounts of the corporate sector evidently pointed to the low level of business activities and a lack of motivation to economic development. Companies preferred to receive the minimum return on funds placed in bank deposits, rather than take the risk of expansion of production. In 2010, the volume of industries' current account balances grew faster than the volume of deposits which actually remained stable in nominal terms. As of March 1, 2011, the ratio of the value of term deposits to that of current ones fell to 76%.



Source: The Central Bank of the Russian Federation and the IEP calculations

Fig. 51. Ratio of the volume of funds in term deposits of the corporate sector to the value of current account balances

However, later the banking sector returned to the policy of accumulation of savings in bank deposits. As a result, in 2011 the volume of the current and settlement account balances grew by 10.4%, while that of term deposits, by 40.7%, and the volume of term deposits, that is, funds which are not involved directly in serving of the turnover exceeded again the value of settlement accounts balances (*Fig. 51*).

Foreign Liabilities

In 2011, external financing did not have a decisive role in formation of the resource base of the banking sector. The inflow of foreign liabilities to the banking sector in 2011 (according to the methods of the balance of payments) amounted to the mere $ 7.6bn which figure is 56.5% lower than in the previous year ($ 17.7bn). It is to be noted that according to the balance statements in 2011 the value of foreign liabilities increased only by $ 11.9bn. Accordingly, banks' foreign liabilities ensured only 4% of the growth in the aggregate resources of the banking sector in 2011. It is to be noted that in the total volume of banks' debt on borrowed funds foreign liabilities amount to 11% as of January 1, 2012. Taking into account the current volatility of the global financial markets it is unlikely that in the short-term prospect banks will manage to return to active external financing.

Forced Growth in State Support in Autumn 2011 – Reaction to the Increased Outflow of Capital

A combination of a relative revival of activities on the credit market (see below) and stagnation of the banking sector's main sources of funds resulted in depletion of the reserve of liquidity which was accumulated during the crisis. Starting from summer 2011, banks started to take an active part in auctions of the Ministry of Finance on placement of temporarily available resources of the budget in bank deposits. In September, simultaneously with their debt to the Ministry of Finance remaining considerably high banks started to show demand in different instruments of liquidity provision by the Bank of Russia.

As a result, as of the end of August the total volume of funds of the monetary authorities placed with commercial banks amounted to Rb 950bn, while by the end of the year, to Rb 1.8 trillion. In 2011, the monetary authorities' total depositing of funds in formation of the resource base of the banking sector amounted to 19%.

Table 12

The structure of liabilities of the banking system of Russia (as of the end of the month), % of the total

	12.05	12.06	12.07	12.08	12.09	06.10	12.10	03.11	06.11	09.11	12.11
Liabilities, billion RB.	**9696**	**13963**	**20125**	**28022**	**29430**	**30417**	**33805**	**34009**	**35237**	**38443**	**41628**
Own funds	15.4	14.3	15.3	14.1	19.3	19.7	18.7	18.9	18.5	17.3	16.9
Loans of the Bank of Russia	0.2	0.1	0.2	12.0	4.8	1.7	1.0	0.9	0.9	1.3	2.9
Inter-bank operations	4.0	3.4	4.1	4.4	4.8	5.1	5.5	5.2	5.2	5.4	5.7
Foreign liabilities	13.7	17.1	18.1	16.4	12.1	11.5	11.8	11.2	10.9	11.4	11.1
Individuals' funds	28.9	27.6	26.2	21.5	25.9	28.3	29.6	30.0	30.4	29.0	29.1
Funds of industries and entities	24.4	24.4	25.8	23.6	25.9	25.4	25.7	25.1	24.3	24.4	26.0
Accounts and deposits of state and local authorities	2.0	2.2	1.5	1.0	1.0	1.8	1.5	2.3	3.5	4.9	2.3
Issued securities	7.6	7.2	5.8	4.1	4.1	4.2	4.0	4.1	4.0	3.8	3.7

Source: The Central Bank of the Russian Federation and the IEP's Center for Structural Research calculations.

3.9.5. Assets of the Banking Sector

Growth in Retail Lending as a Factor of Support of the Level of Households' Consumption

In 2011, dynamics of retail lending was determined to a great extent by the ratio of households' income and expenses. As was stated above, in 2011 households' real disposable income increased by the mere 0.8% as compared to the previous year, while expenses, by 5.8%. As a result, the share of consumer expenses in households' cash income rose from 68.8% in 2010 to 72.0% in 2011. Such a situation resulted, on one hand, in reduction of the share of the income allocated for savings in cash funds and with banks. On the other hand, support of the consumption growth required additional resources which situation resulted in growth in households' demand in bank loans.

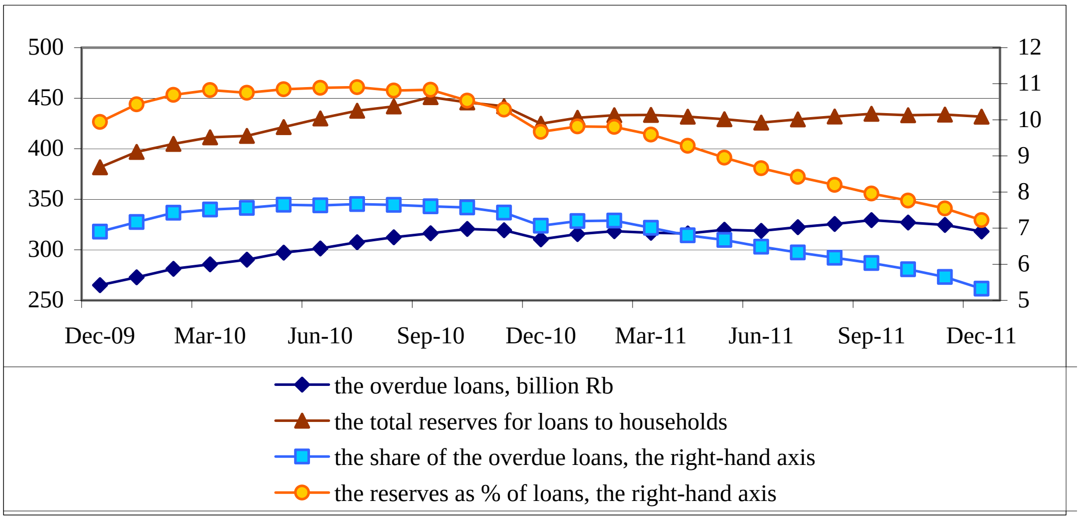
In 2011, the volume of loans was nearly 50% higher that in the same period of 2010 (Rb 5,420bn against Rb 3,649bn). In 2011, growth in extension of new loans[1] to individuals amounted in real terms to 37%. Such a situation resulted in the speed-up of the growth in the

[1] Deflated by the average index of consumer prices in that period.

households' aggregate debt to banks. Within a year, its volume grew by 35.9% (against 14.4% a year before).

In the currency structure of retail lending, loans in rubles oust loans in foreign currency. As of January 1, 2012, the share of loans in foreign currency fell to 5.5%, which figure is the minimum level in the entire period of development of the Russian banking sector. The pre-crisis minimum level of lending in foreign currency (10.4%) was registered in summer 2008 in the period of the highest appreciation of the ruble exchange rate (the US dollar cost then less than Rb 24). After the revaluation which was caused by the ruble devaluation late in 2008 and early in 2009, that share rose somewhat (to 13.0% as of March 1, 2009). Simultaneously, the process of restructuring of the households' currency debt to banks began. It is to be noted that the demand in new loans in foreign currency does not exceed the value of the repaid debts from autumn 2008. Such a situation can be regarded as a favorable trend which points to the fact that most retail customers have adopted a more weighted approach to evaluation of currency risks related to lending in foreign currency, particularly, such exotic ones to the Russian market as the Swiss francs and the Japanese yens[1].

The speed-up growth in provision of retail loans usually conceals the accumulated problems related to the quality of the banking credit portfolio. In 2011, the share of the overdue loans to individuals fell from 7.1% to 5.3%, while the ratio of the formed reserves for retail loan losses to the aggregate retail credit portfolio, from 9.7% to 7.5%. It is to be noted that both the value of the overdue debt and the volume of the reserves remain at the stable level; such a situation points to the fact that the problem of bad loans accumulated during the crisis actually remains unresolved and is merely concealed by the renewed speed-up growth in the credit portfolio (*Fig. 52*).



Source: The Central Bank of the Russian Federation and the IEP calculations.

Fig. 52. Indices of the quality of loans to individuals

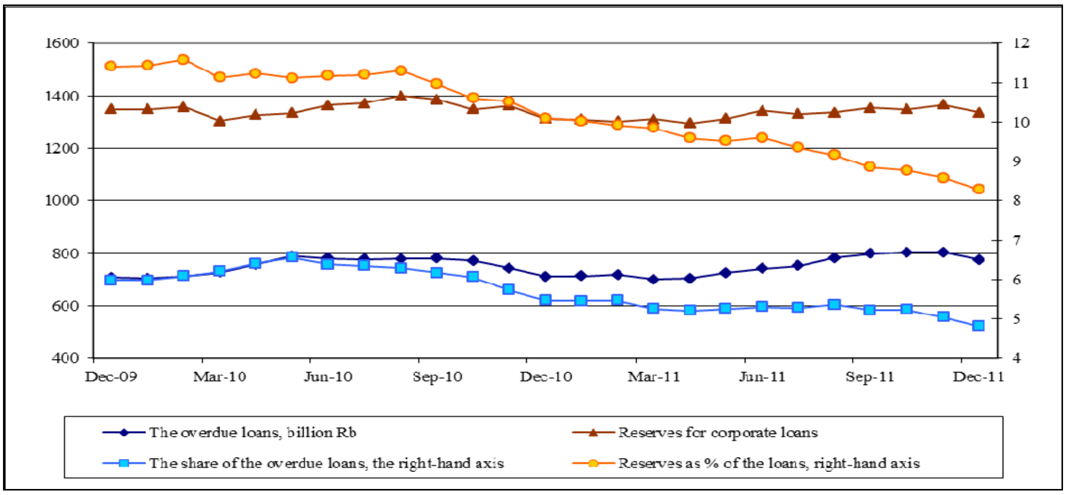
[1] In 2007, in the midst of the credit boom the supply of long-term loans in such currencies to individuals (mostly mortgage loans) rose actively. However, as seen from the experience of the previous crisis the negative effect of the foreign exchange revaluation of loans in those currencies has considerably exceeded the expected profit from low interest rates.

Lending to Corporate Customers

Along with active retail lending in 2011, banks increased lending to corporate borrowers as well. During the eleven months of 2011, the volume of new loans to industries and entities rose by 40% as compared to the similar period of 2010 and amounted to over Rb 25 trillion. The growth rates of the loan debt increased from 9.8% in 2010 to 24.2% in 2011. Rise in intensity of lending can be seen in the growth in the ratio of the volume of the extended loans to the total output. In 2011, that index amounted to 27% against 24% in 2010. It means that over a quarter of the economic turnover is carried out with use of credit funds. It is to be noted that in the pre-crisis year of 2008 that index amounted to 33%.

As in the retail segment of the credit market, the process of gradual dedollarization is observed in corporate lending. The share of debt in foreign currency of the corporate customers fell from the peak value of 29%–30% in spring 2009 to 19%–20% by the end of 2011. It is to be noted that the share of foreign currency in the newly extended loans decreased to 11% (in 2009 it amounted to 17%, while in 2010, to 13%).

Dynamics of the quality of the portfolio of corporate loans is similar to a great extent to the situation in the retail segment of the market. Relative indices show positive changes. The share of the overdue debt fell from 5.5% as of the beginning of the year to 4.8% by the end of the year, while the volume of the reserves, from 10.1% to 8.3% of the aggregate portfolio of corporate loans. It is to be noted that within the year the volume of the reserves did not actually change, while the volume of the overdue debt grew by 9%[1].



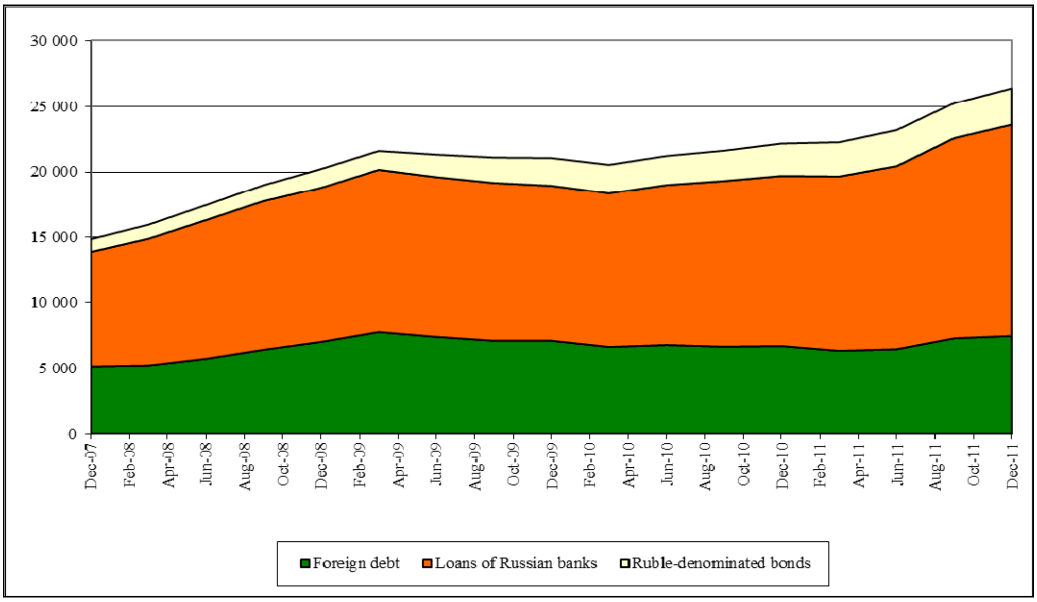
Source: The Central Bank of the Russian Federation and the IEP calculations.

Fig. 53. Indices of the quality of corporate loans

The borrowed funds of the corporate sector have the following three main sources *Fig. 54* : external borrowings from non-residents, bank loans in rubles and foreign currency and bonds placed in the domestic market. The external borrowings account nearly for the one-third of

[1] In 2011, growth in the overdue debt in the banking sector in general was justified by the situation related to the Bank of Moscow. If in general the volume of the overdue debts in the banking sector grew by Rb 60bn within 12 months the volume of the overdue debt in the portfolio of the Bank of Moscow increased in the same period by Rb118bn. Thus, without taking into account the Bank of Moscow the share of the overdue debt in the corporate loans fell to 4.4%.

the aggregate borrowed resources of the corporate sector. It is to be noted that from the beginning of the crisis of 2008 the share of the external financing keeps gradually declining. Before the crisis, the volumes of non-banking corporations' outstanding debt obligations on the domestic market amounted to about 10% of the borrowings on the domestic market (excluding foreign debts) and 6%–7% of the aggregate liabilities of the corporate sector.



Source: The Central Bank of the Russian Federation and the IEP calculations

Fig. 54. Borrowed funds of the corporate sector, billion Rb

In 2009, in a situation where foreign markets were closed and bank lending was stagnant domestic bonds became the main channel for attraction of borrowed funds to the corporate sector. As a result, their share in the total volume of the corporate debt rose to 11% (16% on the domestic market). At present, the unit weight of the market borrowings in the total volume of attracted credit resources remains relatively stable. In the 2010–2011 period, the average growth rates of the volume of outstanding ruble-denominated bonds are almost similar to the growth rates of bank credit portfolios. Accordingly, their share in the domestic borrowings remains at the level of 14%–16%.

It is to be noted that the aggregate investments of banks in corporate debt obligations do not exceed 35%–40% of the market and amount to the mere 4%–5% of the total volume of banks' claims to industries and entities (loans and debt obligations). If in 2011 the growth rates of lending to corporate customers amount to about 22% banks' investments in corporate bonds increase at a slower rate (16%). The outputs of the polls of large Russian banks show that the existing ratio between investments in securities and lending is quite stable. According to the polls of large banks[1], over the two-thirds of the polled banks are not prepared to invest in bonds more than 10% of the aggregate portfolio of claims to corporate customers. Bonds do not became a real alternative to a bank loan either for borrowers or banks.

[1] A. Vedev, S. Grigoryan. Development of the Russian Banking System in the Current Decade. The outputs of Polls of large Russian Banks (http://www.vedi.ru/bank_sys/bank5411_banks%20poll.pdf)

Liquidity

The banking sector entered the year 2011 with excessive liquidity. During the first quarter of 2011 (without taking into account the seasonal peak of January 1) the volume of excessive reserve assets of banks placed in deposits with the Bank of Russia and invested in its bonds amounted to Rb 1.1 trillion– Rb 1.3 trillion or 3.5%–4.0% of the banks' aggregate assets. Meant for lending to the real sector, that volume of resources could ensure growth of 30% in retail lending (which figure is comparable to the actual annual growth in 2011) or growth of 10% in corporate loans (nearly a half of the actual annual growth). With multiplicative factor taken into account, the aggregate volume of the reserve assets as of the end of the 1st quarter was sufficient enough to the banking sector to double the money supply (judged by the pre-crisis structure[1] of the money multiplier and the decreased share of cash funds in the money supply).

However, a potential credit boom did not materialize due to changes both in the structure of assets of the non-financial sector and preferences of the banks. Households started to switch over to a credit model of consumption which situation deprived banks of the main institutional creditor. Starting from July, households borrowed more funds than placed in deposits. In the first three quarters of 2011, the aggregate growth in loans to households (Rb 1,059bn with adjustment to revaluation of assets in foreign currency) turned out to be higher than the influx of households' deposits to banks (Rb 1,002bn with a similar adjustment).

However, it was banks' activities that contributed most to transformation of excessive liquidity into a liquidity squeeze, namely – a withdrawal of liquid assets abroad from the Russian economy. So, in 2011 the net foreign assets of the banking sector rose by $24bn or more than Rb 740bn (over 60% of the excessive liquidity at the beginning of the year). On the basis of the results of the year, an excess of foreign assets over foreign liabilities amounted to the record-high level of $46bn, while foreign assets in foreign currency amounted to $185bn.[2]

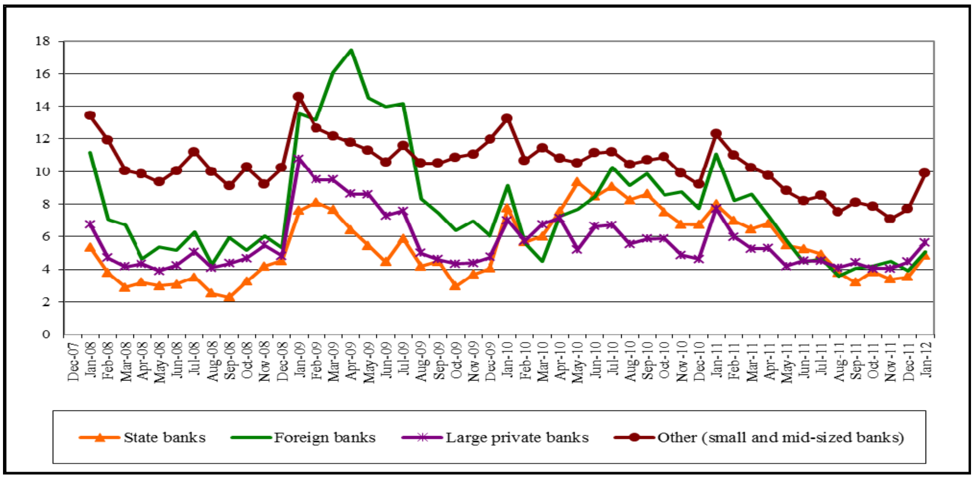
The main channels of capital outflow were state banks and subsidiary banks of non-residents. Out of $24bn of the net foreign assets growth, Sberbank and other state banks accounted for $15bn, while another $9.5bn was withdrawn by foreign banks. Thus, other private banks even ensured insignificant growth of about $ bn in the net inflow of capital.

In 2011, the specifics of the shrinkage of the bank liquidity consisted in its overall nature. The ratio of liquid assets to the aggregate assets kept declining with all the groups of the banks (*Fig. 55*). However, state banks were still in a more advantageous situation. Only in that group of banks, a drop in liquidity did not amount to the pre-crisis minimum of 2.5%–3.0% having retained a small reserve for a further decline. As regards other groups of banks, liquidity amounted as a minimum to the pre-crisis level with a group of small banks and mid-sized banks being in the most disadvantageous situation. If in the 2007-2008 period liquidity of those banks did not fall below 9%–10% (due to low diversification of the business small banks need higher liquidity to maintain normal activities) in autumn 2011 that index amounted to the level of 7%–8%. Such a situation points to considerable liquidity shortages

[1] In this context, the structure of money multiplier means the aggregate of actual relations between individual components of the monetary base: cash funds, banks' mandatory reserves, correspondent account balances with the Bank of Russia and respective components of the banks' resource base. For mandatory reserves – volumes of reserve liabilities, while for other reserve assets – the aggregate depositary base of the banking sector.

[2] Insignificant differences in data with Section 2.1.4 are justified by differences in calculating methods of the balance of payments and banks' balance sheet.

and rising risk level in that group of banks. Due to a lower business diversification, smaller banks need to maintain a higher volume of reserve (liquid) assets for comfort business activities. A further drop in liquidity makes such banks critically dependent on access to refinancing of the Bank of Russia and the inter-bank market.



Source: The Central bank of the Russian Federation and the IEP calculations.

Fig. 55. Dynamics of the share of liquid assets in different groups of banks

Table 13

The structure of assets of the banking system of Russia (as of the end of the month), % of the total

	12.05	12.06	12.07	12.08	12.09	06.10	12.10	03.11	06.11	09.11	12.11
Assets, billion Rb.	**9696**	**13963**	**20125**	**28022**	**29430**	**30417**	**33805**	**34009**	**35237**	**38443**	**41628**
Cash funds and precious metals	2.7	2.6	2.5	3.0	2.7	2.1	2.7	2.2	2.2	2.3	2.9
Funds deposited with the Bank of Russia	7.3	7.5	6.9	7.5	6.9	7.8	7.1	5.9	4.5	3.5	4.2
Inter-bank operations	6.3	5.8	5.4	5.2	5.4	6.2	6.5	6.5	6.4	6.2	6.4
Foreign assets	9.1	9.9	9.8	13.8	14.1	12.7	13.4	13.6	13.8	14.6	14.3
Loans to households	12.1	14.7	16.1	15.5	13.1	13.0	13.0	13.3	14.0	14.2	14.4
Loans to the corporate sector	47.0	45.3	47.2	44.5	44.5	45.1	43.6	44.5	45.3	45.1	44.0
State	6.6	5.2	4.1	2.0	4.2	4.2	5.1	5.7	5.8	6.0	5.0
Property	2.4	2.4	2.2	1.9	2.7	2.7	2.6	2.6	2.5	2.4	2.3

Source: The Central Bank of the Russian Federation and the IEP's Center for Structural Research calculations.

3.9.6. Forecasts of Development of the Banking Sector

In 2012, development of the banking sector in Russia will be determined by a number of factors. On one side, the dynamics of the macro indices which reflect the condition of banks' main customers – industries and households – will have an effect on banks. On the other side, the situation will be determined by solution (or prevalence and aggravation) of acute structural problems inside the banking system.

According to the official forecasts (prepared by the Ministry of Economic Development of the Russian Federation), in 2012 a considerable decrease in the growth rates of the main macroeconomic indices is expected: real GDP (from 4.3% in 2011 to 3.7%), industrial production (from 4.7% to 3.6%), retail sales volume (from 7.2% to 5.5%). There is still a direct risk of investment activities being at a low level, but it is clear that growth in material assets will be the minimum (after soaring growth in 2011). The above factors will determine both the decrease in the growth rates of savings of the non-financial sector in the banking system and prevalence of the low demand in bank loans on the part of industries. In addition to the above, growth in households' real disposable income (from 0.5% to 4.5%) which corresponds to growth in the retail sales volume is expected; implicitly, such a situation may result in a decrease in the demand in consumer credit. In general, in 2012 the expected macroeconomic situation in no way contributes to the speed-up of development of the banking sector.

In the second half of 2011, structural problems in the banking sector became more acute – growth rates of the resource base kept consistently falling, while those of lending, increasing. As a result, the Russian banking system turned out to be "loaned up" while expansion of assets and maintaining of the minimum required level of liquidity were carried out by means of refinancing and deposits of the Ministry of Finance.

Generally, it appears that in a situation of moderately positive or moderately negative (depending on expectations) macroeconomic conditions development of the banking sector will be determined by structural problems which prevailed late in 2011. Such problems are characterized by a growing gap between the resource base of the banking system and volumes of loans which are financed by means of loans of the Central Bank and deposits of the Ministry of Finance of the Russian Federation. It is to be noted that the liquidity shortage is aggravated by the segmentation of the banking system and its low capitalization. Generally, the situation may develop in accordance with the following three scenarios:

1. *Prevalence of the existing trends*. In such a case, the liquidity crisis is highly likely to occur in the banking sector as soon as February-March 2012. The crisis will be justified both by the short-term nature of deposits of the Ministry of Finance and problems related to refinancing of a large number of small and mid-sized banks. A relatively simple solution of the problem may consist in provision of another portion of state resources and modification of the system of refinancing (in order to ensure that an ever larger number of participants join it). Within the frameworks of that scenario with a simple solution of the problem, the situation will not radically change and the next large-scale aggravation of the liquidity crisis will take place early in autumn.
2. *Expansion of external financing.* The gap between the resources of the banking system and the volume of the extended loans can be covered by means of the external financing. A similar process was observed in the 2006–2008 period; it is to be noted that that process was accompanied not only by a drop in the volumes of refinancing to the zero level, but also by the growth in the gross (not net) capital outflow. In other words, as seen from the experience of the past decade growth in the inflow of external resources to the Russian banking sector encourages not only further growth in lending to the non-financial sector, but also growth in excessive liquidity and capital outflow which factor points to existence of both system difficulties and structural problems in the banking system. Realization of that scenario is far from being clear due to the fact that an unstable situation, primarily, in the banking sector of the developed economies is highly likely to remain.
3. *A drop in the growth rates* of lending to the non-financial sector. Such a scenario is of a crisis nature for a number of reasons. First of all, a drop in the growth rates of lending is possible not only due to toughening of requirements to the borrower, but also due to growth in interest rates. With loans becoming more expensive, economic activities will

decline, prices will go up and the number of debt service payments will increase. Then, the bad debts problem will get worse due to both more expensive refinancing of old debts and the "effect of the base". The latter means that indices of problem debts aggravate purely statistically when growth rates or absolute volumes of the extended loans fall.

In case of implementation of any scenario listed above, the banking system of Russia will face instability in 2012. Apart from the fact that bank lending will not be able to be a factor behind the economic growth, the very feasibility that it will meet the adequate demand in loans on the part of the non-financial sector appears highly doubtful. An important observation of the development of the banking system in 2011 consists in the fact that no proper conclusions have been drawn from the 2008–2009 crisis, and as soon as the first evidence of stabilization appeared structural problems got aggravated again. It is quite clear that restructuring of the banking sector is badly needed to ensure sustained development. However, such an operation is related to high costs and risks in a situation of unstable recovery growth.

3.10. Market for Municipal and Sub-Federal Borrowings

3.10.1. Dynamic of Market Development

By results of 2011, the consolidated regional budget and budgets of territorial state extrabudgetary funds had been executed with a deficit of Rb 14.2bn (0,03% of GDP). When compared with 2010, the amount of the deficit of the consolidated regional budget shrank in the shares of GDP equivalent nearly 7.5 times. Thus, the 2010 deficit of territorial budgets accounted for Rb. 99.3bn (0.22% of GDP).

In 2011, budgets of RF Subjects were executed with a deficit of Rb 20.4bn, budgets of urban okrugs – with a deficit of Rb 31.1bn, budgets of intracity municipal entities of the city of Moscow and St. Petersburg – with a surplus of Rb 0.8bn, budgets of urban and rural settlements – with a surplus of Rb 1.8bn, balances of territorial public extrabudgetary funds – with a surplus of Rb 20.9bn. In 2010, the RF Subjects' budgets were executed with a deficit of Rb 88.1bn, budgets of urban okrugs – with a deficit of Rb 15.1bn, budgets of intra-city municipal entities of the city of Moscow and St. Petersburg - with a deficit of Rb 0.1bn, budgets of municipal districts – with a deficit of Rb 1.2bn, budgets of urban and rural settlements – with a surplus of Rb 4.5bn.

Table 14

The Territorial Budget Surplus (Deficit) to Budget Expenditure Ratio (as %)

Year	Consolidated Regional Budget*	Regional budgets
2011	–0.2	–0.3
2010	–1.4	–1.6
2009	–5.3	–5.3
2008	– 0.7	– 0.7
2007	0.8	0.6
2006	3.7	4.4
2005	1.6	2.3
2004	1.1	1.6
2003	–2.6	–2.3
2002	–2.7	–3.0

* With account of state extrabudgetary funds.

Source: calculations by IEP on the basis of the Federal Treasury's data.

Table 15

The Territorial Budget Surplus (Deficit) to Budget Expenditure Ratio in 2007–2011 (as %)

year	Budgets of intra-city municipal entities in the city of Moscow and St.	Budgets of urban ok-rugs	Budgets of municipal districts	Budgets of urban and rural settle-ments
2011	6.15	–2.10	1.13	0.64
2010	–1.12	–1.16	–0.11	1.72
2009	–0.63	–3.32	–1.88	2.63
2008	–1.47	1.09	–0.26	2.72
2007	5.34	1.23	–0.04	2.34

Source: calculations by IEP on the basis of the Federal Treasury's data.

As of 1 January 2012, as many as 55 RF Subjects had executed their consolidated budgets (including territorial extrabudgetary funds) with a deficit (in 2010, the respective figure was 63 regions). The aggregate amount of the deficit was at the level of Rb 189.2bn, or 4.4% of the revenue part of their budgets (в 2010 – Rb 202.5bn, or 5.2%).

The median level of the budget deficit accounted for 4.6% of revenues of a respective budget. Atop the list of regions with the highest value of the budget deficit to budget revenue ratio were Republic of Mordovia – 21.4%, Sakhalin oblast – 14.3%, Vologda oblast – 14.0%, Smolensk oblast – 12.6%, Republic of Khakassia – 11.5%, Saratov oblast – 10.1% (*Table 18*).

Meanwhile, 28 RF Subjects executed their consolidate budgets with a surplus (20 in 2010). The aggregate volume of the budget surplus in those regions accounted for Rb 175.0bn, or 4.7% of the value of the revenue part of their budgets (in 2010 – Rb 128.9bn, or 3.5% of the revenue part of the said budgets). The median value of the budget surplus accounted for 2.2% of the revenue part of the budget.

The highest value of the surplus to the expenditure level of the consolidated budget was reported in Nenetsky AO – 18.8%, Irkutsk oblast – 8.1%, Moscow oblast – 7.6%, Tyumen oblast – 7.2%. The bulk volume (84.3%) of the aggregate surplus of the consolidated regional budget was secured by 5 Subjects of the Federation: the city of Moscow – 47.1%, or Rb 82.5bn, Moscow oblast – 17.1%, or Rb 29.9bn, Tyumen oblast – 7.7%, or Rb 13.4bn, Khanty-Mansy AO – 6.8%, or 11.9bn, Irkutsk oblast. – 5.7%, or Rb 9.9bn.

3.10.2. Structure of the Accumulated Debt

According to the RF Ministry of Finance, the 2011 volume of the RF Subjects' accumulated debt was up Rb. 72.6bn on a year-on-year basis and made up Rb 1,172.2bn (2.1% of GDP), while the respective increase for municipal entities was Rb 45.7bn (Rb 215.5bn, or 0.4% of GDP).

Table 16

Net Borrowing by Regional and Local Budgets (as % of GDP)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Borrowings by subfederal and local governments Including:	–0,29	–0,04	0,47	0,37	0,26	0,09	0,21	0,17	0,29	0,74	0,51	0,21
Repayable loans out of budgets of other levels	–0,03	0,04	0,12	–0,1	–0,02	–0,03	–0,04	–0,01	0,03	0,33	0,37	0,15
Subfederal (municipal) bonds	–0,27	–0,07	0,16	0,31	0,29	0,09	0,14	0,08	0,17	0,24	0,07	–0,11
Other kinds of borrowings	0,01	–0,02	0,19	0,6	…	0,03	0,11	0,10	0,09	0,17	0,07	0,17

Source: calculations by IEP on the basis of the Federal Treasury's data.

Meanwhile, according to the Federal Treasury, the 2011 volume of net borrowings by regional consolidated budgets stood at Rb 113,170.1mn, or 0.21% of GDP (*Table 16*). The volume of accumulated external borrowings by regional consolidated budgets shrank by Rb 16,172.0mn, while the volume of net domestic borrowings accounted for Rb 129,342.1mn.

Structure of borrowings

The 2011 aggregate volume of the consolidated budget's borrowings accounted for Rb 604,708.5mn (1.1% of GDP), of which external borrowings made up Rb 785.3mn. Like in 2009-10, it was the Republic of Bashkortostan which became a sole region-recipient of foreign loans.

The aggregate volume of regions and municipalities' domestic borrowings accounted for Rb 603, 923.2mn. The largest borrowers on the domestic market became: Nizhny Novgorod oblast – Rb 64.4bn, Moscow oblast – Rb 40.9bn, Omsk oblast – Rb 29.9bn, Republic of Tatarstan – Rb 26.1bn, Krasnodar krai – Rb 24.6bn, Saratov oblast – Rb 23.3bn. Their aggregate share in the overall volume of borrowings accounted for 34.6%. When compared with the 2010 figure, the volume of domestic borrowings in nominal terms was down by Rb 104.0bn.

Issuance of securities in the overall volume of consolidated regional budget accounted for 9.1%, loans out of higher-tier budgets (budget loans) – 21.3%, other borrowings (borrowings from commercial banks and international credit organizations) – 69,6%.

The most significant change in the structure of regional budgets' borrowings became continuation of the 2010 trend to a relative increase in borrowings from credit institutions against a shrinking share of securities issues from 15.7 to 9.1% (*Table 17*).

Table 17

The Structure of Domestic Borrowings by Subnational Budgets (as %)

	2011			2010			2009		
	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets
Securities issuances	9.1	10.9	4.3	15.7	18.1	4.3	24.9	28.5	4.4
Budget loans	21.3	26.2	…	24.0	29.0	…	26.9	31.5	0.4
Other borrowings	69.6	62.8	95.7	60.3	53.0	95.7	48.2	40.0	95.3

Source: calculations by IEP on the basis of the Federal Treasury's data.

The greatest net borrowings to budget revenues ratio was exhibited by: the Republic of Mordovia – 23.1%, Vologda oblast – 13.1%, Smolensk oblast – 13.0% (*Table 18*).

The largest net borrowers became: the Republic of Tatarstan – Rb 21.9bn, Krasnodar krai – Rb 21.6bn.

To the greatest degree the accumulated debt was reduced by having the volume of repayment of earlier made borrowings be in excess of new ones: the city of Moscow – at Rb59.5bn, Moscow oblast – at Rb 38.8bn, Murmansk oblast – at Rb 3.1bn.

Table 18

Execution of Consolidated Budgets of RF Subjects in 2011

	Budget revenues (Rb mn)	Budget deficit (surplus) (Rb mn.)	The deficit (surplus) to revenue ratio, %	The attracted borrowed capital to revenue ratio, %	The net borrowing to revenue, %	Borrowing redemption expenditures to revenue ratio, %	Net borrowings to deficit (surplus) ratio, %
1	2	3	4	5	6	7	8
Central federal okrug							
Belgorod oblast	84 315.4	2 123.5	2.52	7.39	2.44	4.96	0.97
Bryansk oblast	41 150.2	–7.8	–0.02	12.24	1.79	10.45	–94.07
Vladimir oblast	50 771.3	–1 976.7	–3.89	2.05	1.70	0.35	–0.44
Voronezh oblast	82 543.1	1 996.4	2.42	10.05	6.91	3.15	2.85
Ivanovo oblast	34 260.6	1 504.6	4.39	18.47	7.79	10.68	1.77
Tver oblast	53 877.5	3 694.1	6.86	18.61	10.50	8.11	1.53
Kaluga oblast	47 974.4	2 119.2	4.42	13.30	6.80	6.50	1.54
Kostroma oblast	23 864.9	1 241.8	5.20	29.36	4.78	24.59	0.92
Kursk oblast	44 902.3	2 056.9	4.58	2.30	1.92	0.38	0.42
Lipetsk oblast	44 493.2	2 048.2	4.60	9.23	4.90	4.33	1.06
Moscow oblast	392 927.8	–29 846.8	–7.60	10.40	–9.89	20.29	1.30
Orel oblast	28 026.6	–505.1	–1.80	4.92	1.74	3.18	–0.96
Ryazan oblast	44 050.8	3 381.5	7.68	26.41	8.48	17.93	1.11
Smolensk oblast	36 432.3	4 600.6	12.63	50.06	13.00	37.06	1.03
Tambov oblast	40 637.5	–271.8	–0.67	9.77	4.31	5.46	–6.45
Tula oblast	53 856.5	–2 806.6	–5.21	12.51	–3.83	16.34	0.74
Yaroslavl oblast	55 641.3	3 197.169 066.41	5.75	20.39	1.61	18.78	0.28
City of Moscow	1 525 923.7	–82 488.0	–5.41	0.98	–3.90	4.88	0.72
Total	**2 685 649.4**	**–89 938.9**	**–3.35**	**6.13**	**–2.37**	**8.50**	**0.71**
North-West okrug							
Republic of Karelia	38 546.6	90.0	0.23	15.28	–0.70	15.98	–3.01
Republic of Komi	61 801.4	1 112.3	1.80	4.41	4.10	0.31	2.28
Arkhangelsk oblast	68 072.6	5 388.8	7.92	20.01	7.03	12.99	0.89
Vologda oblast	53 292.2	7 460.3	14.00	21.49	13.14	8.35	0.94
Kaliningrad oblast	50 946.2	–240.0	–0.47	9.66	6.63	3.03	–14.08
Leningrad oblast	85 989.0	–2 217.1	–2.58	0.71	0.07	0.64	–0.03
Murmansk oblast	60 017.1	–927.7	–1.55	2.21	–5.13	7.33	3.32
Novgorod oblast	29 760.2	–73.3	–0.25	13.47	5.99	7.49	–24.33
Pskov oblast	29 423.4	267.8	0.91	9.58	9.40	0.18	10.33
St. Petersburg	422 000.8	2 850.5	0.68	0.46	0.45	0.01	0.67
NenetskyAO	14 613.6	–2 718.080 967.69	–18.60	0.21	–0.05	0.26	0.00
Subtotal	**914 463.2**	**10 993.5**	**1.20**	**5.40**	**2.28**	**3.12**	**1.90**
Southern federal okrug							
Republic of Kalmykia	10 065.7	272.5	2.71	5.41	2.97	2.45	1.10
Krasnodar krai	227 158.7	9 078.9	4.00	10.81	9.49	1.32	2.38
Astrakhan oblast	35 394.1	1 646.9	4.65	47.63	7.14	40.49	1.53
Volgograd oblast	83 755.8	7 578.0	9.05	17.32	8.46	8.86	0.94
Rostov oblast	142 158.3	3 202.5	2.25	2.92	2.62	0.30	1.16
Republic of Adygeya (Adygeya)	14 145.6	410.4	2.90	5.90	3.92	1.98	1.35
Subtotal	**512 678.1**	**22 189.2**	**4.33**	**11.99**	**6.97**	**5.01**	**1.61**
Volga federal okrug							
Republic of Bashkortostan	143 901.9	5 053.4	3.51	2.69	0.83	1.86	0.24
Republic Mary-El	23 173.8	1 182.5	5.10	13.79	5.90	7.90	1.16
Republic Of Mordovia	35 716.6	7 643.4	21.40	28.79	23.11	5.67	1.08
Republic of Tatarstan (Tatarstan)	200 245.0	14 205.4	7.09	13.04	10.95	2.10	1.54
Udmurt Republic	57 103.3	1 288.4	2.26	11.03	3.28	7.75	1.45
Chuvash Republic – Chuvashia	40 205.6	–265.9	–0.66	9.60	0.37	9.23	–0.55
Nizhny Novgorod oblast	132 127.8	5 976.8	4.52	48.77	9.47	39.31	2.09
Kirov oblast	51 580.8	1 456.9	2.82	15.56	5.73	9.82	2.03
Samara oblast	138 092.6	10 909.3	7.90	16.81	7.71	9.09	0.98
Orenburg oblast	81 619.2	652.6	0.80	1.65	0.73	0.91	0.92
Penza oblast	50 703.9	4 213.4	8.31	16.04	8.84	7.20	1.06

cont'd

1	2	3	4	5	6	7	8
Perm krai	114 314.3	–1 171.3	–1.02	0.06	–0.01	0.08	0.01
Saratov oblast	81 296.5	8 216.8	10.11	28.67	10.94	17.73	1.08
Ulyanovsk oblast	43 337.4	1 777.8	4.10	8.96	6.87	2.09	1.68
Subtotal	**1 193 418.**	**61 139.5**	**5.12**	**15.59**	**6.52**	**9.07**	**1.27**
Ural federal okrug							
Kurgan oblast	34 795.0	815.4	2.34	1.72	0.56	1.16	0.24
Sverdlovsk oblast	195 319.8	4 036.1	2.07	4.65	3.80	0.85	1.84
Tyumen oblast	187 542.0	–13 437.3	–7.16	0.00	0.00	0.00	0.00
Chelyabinsk oblast	127 653.5	7 316.8	5.73	0.94	–0.16	1.10	–0.03
Khanty-Mansy AO	211 679.1	–11 873.9	–5.61	0.98	–1.36	2.34	0.24
Yamal-Nenetsky AO	140 487.5	8 934.8	6.36	0.00	0.00	0.00	0.00
Subotal	**897 476.9**	**–4 208.1**	**–0.47**	**1.44**	**0.51**	**0.94**	**–1.08**
Siberian federal okrug							
Republic of Buryatiya	47 618.8	–261.4	–0.55	5.70	–2.27	7.97	4.13
Republic of Tyva	17 498.7	–31.6	–0.18	4.37	1.98	2.39	–10.97
Altay krai	87 575.1	–1 041.6	–1.19	0.83	0.27	0.56	–0.22
Krasnoyarsk krai	197 677.4	4 353.7	2.20	7.73	3.80	3.92	1.73
Irkutsk oblast	121 885.1	–9 910.3	–8.13	1.10	–2.42	3.52	0.30
Kemerovo oblast	136 362.1	2 908.7	2.13	2.93	1.61	1.32	0.75
Novosibirsk oblast	119 827.2	1 263.2	1.05	10.57	2.80	7.77	2.65
Omsk oblast	72 871.4	3 353.6	4.60	41.04	5.10	35.95	1.11
Tomsk oblast	55 488.4	–828.2	–1.49	10.69	0.72	9.97	–0.48
Republic of Altay	15 855.9	869.9	5.49	10.03	5.80	4.24	1.06
Republic of Khakas-sia	23 317.9	2 673.3	11.46	10.34	7.64	2.70	0.67
Trans-Baikal krai	51 204,9	2 506,9	4,90	8,40	2,16	6,24	0,44
Subtotal	**947 183,1**	**5 856,3**	**0,62**	**8,62**	**1,85**	**6,77**	**2,99**
Far-East federal okrug							
Republic of Sakha (Yakutiya)	130 474.4	–4 681.4	–3.59	2.34	–0.37	2.71	0.10
Primorsky krai	109 222.7	–2 183.1	–2.00	2.58	0.66	1.91	–0.33
Khabarovsk krai	87 489.7	–1 070.9	–1.22	1.39	1.00	0.39	–0.82
Amur oblast	53 486.3	3 608.3	6.75	18.25	10.26	7.99	1.52
Kamchatka krai	56 318.2	–1 323.2	–2.35	1.84	–1.27	3.11	0.54
Magadan oblast	23 645.1	–836.4	–3.54	4.86	0.97	3.89	–0.27
Sakhalin oblast	57 804.2	8 270.9	14.31	9.83	4.57	5.26	0.32
Jewish AO	8 916.4	786.9	8.83	9.13	9.13	0.00	1.03
Chukotka AO	20 208.2	–1 060.5	–5.25	0.00	–0.14	0.14	0.03
Subtotal	**547 565.2**	**1 510.7**	**0.28**	**4.66**	**1.74**	**2.92**	**6.32**
North-Caucasian federal okrug							
Republic of Dagestan	77 572.6	3 506.4	4.52	5.29	3.83	1.46	0.85
Kabardino-Balkar Republic	26 471.3	49.3	0.19	5.67	1.13	4.53	6.09
Republic North Ossetia-Alania	21 023.7	1 248.9	5.94	20.69	6.16	14.53	1.04
Republic of In-gushetia	18 873.6	–965.8	–5.12	0.15	0.15	0.00	–0.03
Stavropol krai	88 729.1	505.8	0.57	10.89	4.31	6.58	7.56
Karachaevo-Cherkes Republic	15 628.6	810.9	5.19	7.28	4.22	3.06	0.81
Chechen Republic	81 537.9	1 491.4	1.83	2.82	2.08	0.74	1.14
Subtotal	**329 836.9**	**6 646.9**	**2.02**	**7.00**	**3.27**	**3.73**	**1.62**
Russian Federation, total	**8 028 271.7**	**14 188.9**	**0.18**	**7.53**	**1.41**	**6.12**	**7.98**

Source: calculations by IEP on the basis of the Federal Treasury's data.

Domestic Bond Issues

In 2011, as many as 21 RF Subjects and 5 municipal entities registered prospectuses of bond issues (in 2010 – 17 Subjects and 6 municipalities).

The following regions registered prospectuses of their bond issues with the RF MinFin: republics of Karelia, Komi, Sakha (Yakutiya), Bashkortostan, Buryatiya, Udmurtia, Chuvashiya, Krasnoyarsk, Krasnodar, Stavropol krais, St. Petersburg, Volgograd, Vologda, Ivanovo, Kaluga, Kostroma, Nizhny Novgorod, Ryazan, Samara, Sverdlovsk, Tver, Yaroslavl oblasts, Volgograd, Kazan, Krasnoyarsk, Novosibirsk, Krasnodar.

In 2011, the volume of placed bonds continued to decline and accounted for Rb 55.1bn vs. 111.1bn in 2010 and 158.1bn in 2009. The annual contraction in nominal terms accounted for Rb 55.6bn (53.3% in real terms). The volume of issuance of subfederal and municipal bonds over the year was down from 0.25 to 0.10% of GDP (*Table 19*).

Table 19

Volume of Issuance of Subfederal and Municipal Papers (as % of GDP)

year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Issuance	0.19	0.17	0.27	0.46	0.47	0.37	0.28	0.26	0.43	0.41	0.25	0.10
Redemption	0.46	0.23	0.10	0.15	0.19	0.28	0.14	0.18	0.26	0.16	0.18	0.21
Net financing	–0.27	–0.07	0.16	0.31	0.29	0.09	0.14	0.08	0.17	0.24	0.07	-0.11

Source: calculations by IEP on the basis of the RF MinFin data.

The largest securities placements were reported by Samara oblast (Rb. 12.2bn, or 22.2% of the aggregate volume of territories' issuances), Krasnoyarsk krai (Rb 9.1bn, or 16.4%), Nizhny Novgorod oblast (Rb 8.0bn, or 14.5%).

So, the share of the top three largest issuers in the overall volume of issuances of placed regional and municipal bonds accounted for 53.1% (*Table 20*).

Table 20

Placement of Subfederal and Municipal Securities in 2011

Subject of the Federation	Volume of issuance (Rb mn)	The issuer's share in the aggregate volume of issuances (%)	Issuance volume to domestic borrowings ratio (%)
Central federal okrug			
Kaluga oblast	2 500.0	4.5	39.2
Kostroma oblast	2 044.3	3.7	29.2
Yaroslavl oblast	2 322.1	4.2	20.5
North-West federal okrug			
Republic of Karelia	1 000.0	1.8	17.0
Komi Republic	1 154.8	2.1	42.4
Vologda oblast	2 510.0	4.6	21.9
Southern federal okrug			
Krasnodar krai	1 100.0	2.0	4.5
Volgograd oblast	3 400.0	6.2	23.4
Volga federal okrug			
Republic of Tatarstan (Tatarstan)	131.0	0.2	0.5
Udmurt Republic	2 000.0	3.6	31.8
Chuvash Republic – Chuvashiya	1 009.6	1.8	26.2
Nizhny Novgorod oblast	8 000.0	14.5	12.4
Samara oblast	12 200.0	22.2	52.6
Ural federal okrug			
Sverdlovsk oblast	3 000.0	5.4	33.1
Siberian federal okrug			
Krasnoyarsk krai	9 050.0	16.4	59.3
Tomsk oblast	1 125.3	2.0	19.0
Far-East federal okrug			
Republic of Sakha (Yakutiya)	2 500,0	4.5	81.7
Russian Federation, total	**55 050,7**	**100**	**9.1**

Source: calculations by IEP on the basis of the Federal Treasury's data.

By today, a high level of secutirization has been exhibited mostly by the largest issuers: the Republic Sakha (Yakutiya) – 81.7%, Krasnoyarsk krai – 59.3%, Samara oblast – 52.6%.

The aggregate volume of redeemed regions and municipalities' papers proved to be at Rb. 58.2bn greater than the 2011 volume of their placement, while the volume of net borrowings on the securities market in 2010 accounted for Rb 29.7bn. (*Table 21*).

Table 21

Volumes of Net Borrowings on the Market for Subfederal and Municipal Papers (as Rb Mn)

	Consolidated regional budget	Regional budgets	Municipal budgets
2011			
Net borrowings	-58 202.6	-57 113.1	-1 089.5
Attraction of capital	55 050.7	53 366.2	1 684.5
Redemption of the body of the debt	113 253.3	110 479.3	2 774.1
2010			
Net borrowings	29 774.6	28 611.9	1 162.6
Attraction of capital	111 106.3	105 854.3	5 251.9
Redemption of the body of the debt	81 331.7	77 242.4	-4 089.3
2009			
Net borrowings	95 457.6	97 916.5	–2 458.9
Attraction of capital	158 114.0	153 992.6	4 121.4
Redemption of the body of the debt	62 656.4	56 076.1	6 580.4
2008			
Net borrowings	68 851.3	72 984.9	–4 133.7
Attraction of capital	178 565.7	177 324.4	1 241.4
Redemption of the body of the debt	109 714.5	104 339.4	5 375.1
2007			
Net borrowings	25 867.0	23 691.9	2 175.0
Attraction of capital	84 159.2	79 889.8	4 269.4
Redemption of the body of the debt	58 292.2	56 197.8	2 094.4
2006			
Net borrowings	36 489.7	35 161.6	1 328.1
Attraction of capital	73 288.6	66 524.8	6 763.8
Redemption of the body of the debt	36 798.9	31 363.2	5 435.7
2005			
Net borrowings	20 887.6	16 939.9	3 947.7
Attraction of capital	81 220. 5	75 016.8	6 203.7
Redemption of the body of the debt	60 332. 9	58 076.9	2 256.1
2004			
Net borrowings	47 880. 3	44 470.1	3 410.2
Attraction of capital	79 436. 7	74 995.9	4 440.7
Redemption of the body of the debt	31 556. 4	30 525.8	1 030.5
2003			
Net borrowings	41 908. 2	40 043.5	1 864.7
Attraction of capital	61 712. 6	59 012.9	2 699.7
Redemption of the body of the debt	19 804. 4	18 969.4	835.0
2002			
Net borrowings	17 696. 5	17 153.8	542.8
Attraction of capital	29 141. 8	28 169.2	972.6
Redemption of the body of the debt	11 445. 2	11 015.4	429.8
2001			
Net borrowings	6 601. 4	6 667.6	–66.1
Attraction of capital	15 123. 8	14 226.9	896.8
Redemption of the body of the debt	8 522. 3	7 559.3	962.9
2000			
Net borrowings	–1 877. 3	–2 286.2	408.8
Attraction of capital	13 042. 2	10 090.2	2 952.0
Redemption of the body of the debt	14 919. 5	12 376.4	2 543.1

Source: calculations by IEP on the basis of the Federal Treasury's data.

Most regions which were regularly issuing bonds kept on doing so in 2010 too. More specifically, Volgograd oblast has issued bonds since 1999, Krasnoyarsk krai – since 2003, Republic of Karelia – since 2004, and Nizhny Novgorod oblast – since 2004 (*Table 22*).

Table 22

Registration of Issue Prospectuses of Subfederal and Municipal Securities in 1999–2011

Issuer	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
1	2	3	4	5	6	7	8	9	10	11	12	13	14
Subjects of the Federation													
Volgograd oblast	*	*	*	*	*	*	*	*	*	*	*	*	*
Krasnoyarsk krai					*	*	*	*	*	*	*	*	*
Republic of Karelia						*	*	*	*	*	*	*	*
Nizhny Novgorod oblast						*	*	*	*	*	*	*	*
Tver oblast				*	*		*	*	*	*	*	*	*
St. Petersburg	*	*	*	*	*	*	*	*	*	*		*	*
Tomsk oblast		*	*	*	*	*	*	*	*	*		*	*
Republic of Sakha (Yakutiya)				*	*	*	*	*	*	*		*	*
Yaroslavl oblast					*	*	*	*	*	*		*	*
Udmurt Republic							*		*	*		*	*
Komi Republic		*	*	*	*	*	*	*		*		*	*
Sverdlovsk oblast												*	*
Republic of Chuvashiya	*	*	*	*	*	*	*	*	*	*	*		*
Samara oblast					*		*	*	*	*	*		*
Kaluga oblast						*		*	*	*			*
Stavropol krai			*							*			*
Republic of Bashkortostan			*	*		*	*	*	*				*
Kostroma oblast				*	*		*		*				*
Ivanovo oblast									*				*
Republic of Buryatiya													*
Vologda oblast													*
The city of Moscow	*	*	*	*	*	*	*	*		*	*	*	
Krasnodar krai						*			*			*	
Murmansk oblast				*	*							*	
Republic of Khakassia												*	
Ryazan oblast												*	
Khanty-Mansy oblast				*	*						*		
Irkutsk oblast			*	*	*	*	*	*	*	*	*		
Penza oblast								*	*	*			
Ulyanovsk oblast									*	*			
Belgorod oblast				*	*		*	*		*			
Kurgan oblast								*		*			
Moscow oblast				*	*	*	*	*	*	*			
Lipetsk oblast						*	*	*	*	*			
Voronezh oblast						*	*	*	*				
Novosibirsk oblast.	*				*	*	*		*				
Republic of Kalmykiya									*				
Tula oblast								*					
Khabarovsk krai				*	*	*	*						
Kabardino-Balkariya Republic		*					*						
Leningrad oblast			*	*	*	*							
Yamal-Nenetsky AO					*	*							
Bryansk oblast						*							
Republic of Mordovia				*									
Sakhalin oblast				*									
Kursk oblast				*									

cont'd

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Primorsky krai		*											
Municipalities													
Volgograd	*	*	*	*	*		*	*		*	*	*	*
Kazan							*	*	*		*	*	*
Novosibirsk					*	*	*	*				*	*
Krasnodar												*	*
Krasnoyarsk					*	*	*		*	*	*	*	*
Tomsk					*	*		*	*	*		*	
Ufa				*	*	*						*	
Electrostal (Moscow oblast)									*		*		
Smolensk											*		
Lipetsk								*	*	*			
Magadan								*	*	*			
Bratsk										*			
Novorossiysk										*			
Ekaterinburg		*	*	*	*	*	*	*	*				
Klin district of Moscow oblast							*	*	*				
Noginsk district of Moscow oblast						*		*	*				
Blagoveschensk								*	*				
Cheboksary	*						*		*				
Balashikha (Moscow oblast)									*				
Odintsovo district of Moscow oblast							*	*					
Astrakhan								*					
Bryansk								*					
Voronezh								*					
Orekhovo-Zuevo (Moscow oblast)								*					
Yaroslavl								*					
Yuzhno-Sakhalinsk					*	*	*						
Novocheboksarsk	*		*			*	*						
Angarsk							*						
Vurnarsky district of Chuvash Republic							*						
Town of Shumerlya (Chuvash Republic)							*						
Barnaul						*							
Perm						*							
Nizhny Novgorod				*									
Kostroma	*	*											
Arkhangelsk	*												
Dzerzhinsky	*												

Source: MinFin RF.

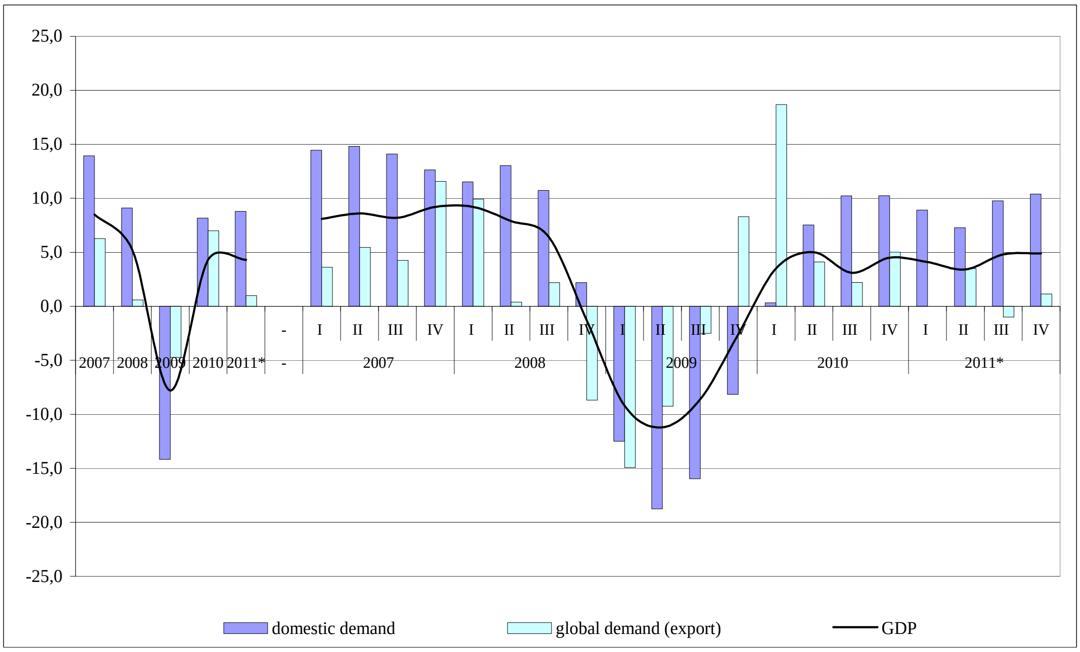
Section 4. The Real Sector of the Economy

4.1. Production Macrostructure

4.1.1. Major trends and economic drivers in 2011

Macroeconomic trends of 2011 were determined by factors having formed during the preceding two years of post-crisis recovery. As an outcome of 2010–2011, average annual rate of GDP growth made 4.3%, and thus, judging by this development indicator, Russian economy has achieved the pre-crisis level of 2008.

The analysis of financial and economic recovery drivers and conditions allows for identifying special characteristics of economy rehabilitation in 2010–2011.



*preliminary estimates.
Source: Federal Statistics Service, RF Ministry of Economic Development.

Fig. 1. GDP dynamics by domestic and global demand components during 2007–2011, % to the respective period of the previous year

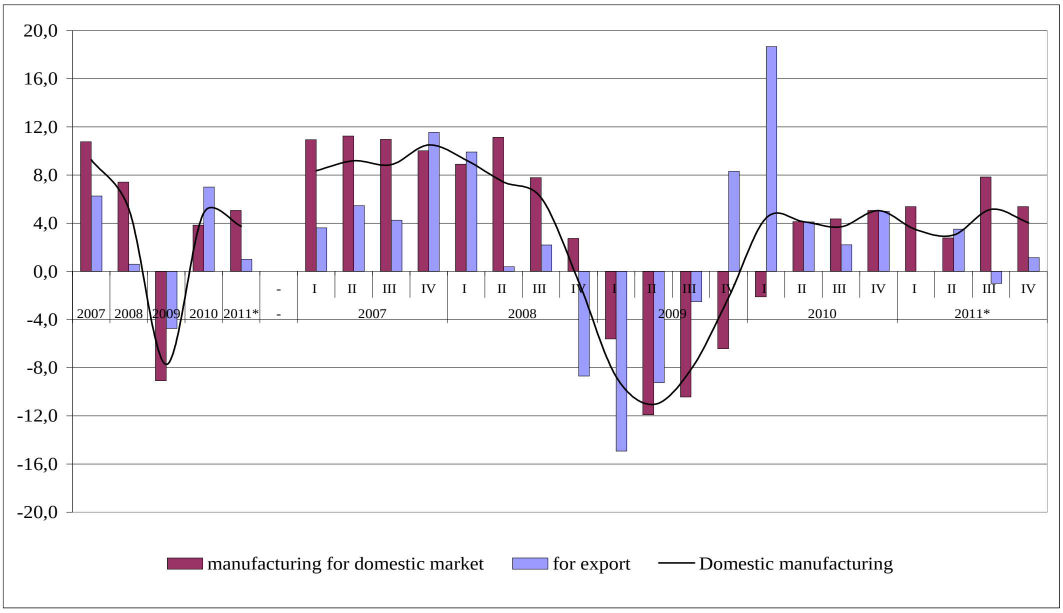
Low investment activity is a real characteristic feature of the recovering growth of the recent two years. In 2011 fixed capital investment constituted 96.7, the amount of work in construction constituted 94.4% and the amount of residential space commissioned – 97.1% of 2008 performance. In 1998 post-crisis recovery was completely based on dramatic business activity boom in the investment sector of the economy and was one of the key drivers for overcoming all the negative consequences of production shrinking. On the contrary, in 2010-2011 low investment activity during the recovery period was impeding the growth both in production and financial sectors of the economy.

Another special feature of 2010-2011 was pretty quick recovery of the consumer demand. Household demand in 2011 exceeded 2008 level by 6.1%. Contrary to the situation of 1998–2001 when low consumer demand limited the pace of domestic market expansion, 8.1% retail turnover growth in 2011 versus 2008 supported by approximately equal increase of the real income of the population became the dominating driver of economic recovery, including recovery of the financial sector at the expense of intensive growth of demand for cash loans.

When comparing the processes of post-crisis recovery in 1998 and in 2008, the impact of foreign trade should be noted. In the environment of rapid global economic recovery after 1998 crisis and favorable dynamics of global energy and raw materials markets, Russian economy was able to restore its export during one year. After long global economic recession in 2008 Russia was able to regain its export at the pre-crisis level only in 2010, and as of the end of 2011 its physical export volumes exceeded 2008 level by 3.0%.

Given GDP growth in 2011 at the level of 4.3%, the domestic demand grew by 8.8% (in 2010 – by 8.2%), including the domestic production – by 5.1% (3.8%), and the external demand – by 1.0% (7.1%) versus the preceding year.

Te domestic market dynamics was defined by the ratio between the domestic production growth rates for domestic and foreign consumption, on one hand, and imports dynamics and structure – on the other hand. In 2010 the outrunning growth of the exporting sector defined the intensity of post-crisis recovery for domestic manufacturing targeted at the domestic market, but in 2011 acceleration of domestic production growth (5.1% versus 3.8% in the preceding year) obviously turned out to be insufficient to counteract the consequences of abrupt export slowdown. Eventually, in 2011 the domestic manufacturing growth rate made 103.7% and was 1.2 p.p. lower, than in 2010. Let us note, that slowdown of the growth rate was accompanied by maintaining high import dynamics.



* preliminary estimates.
Source: Federal Statistics Service, RF Ministry of Economic Development.

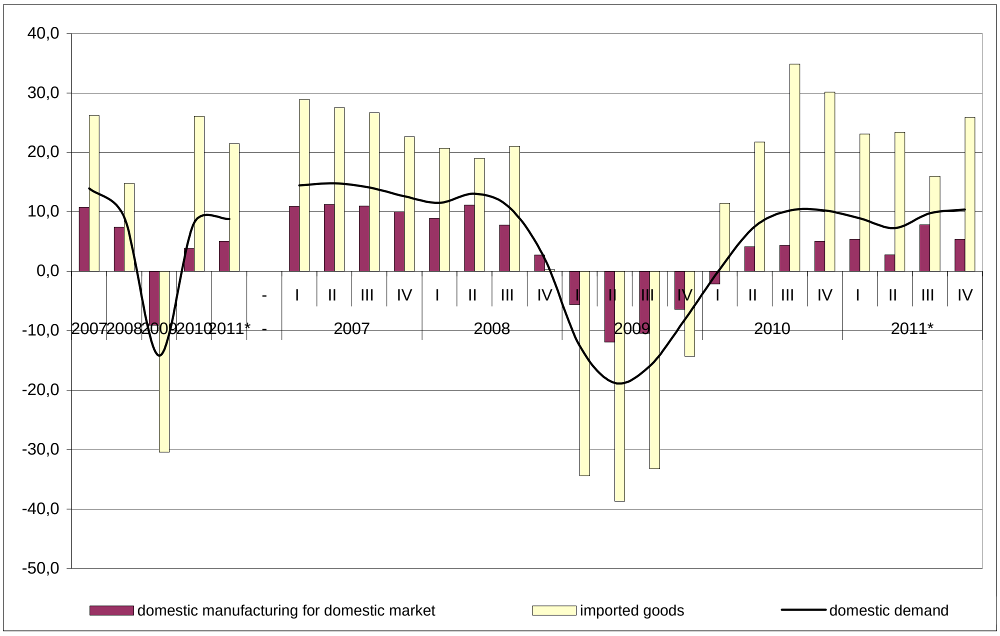
Fig. 2. Domestic manufacturing dynamics by components of usage in 2007–2011, % to the respective period in the preceding year

In terms of descending import, 2009 is comparable with 1998-1999; however, the recovery was completely different. 4.53 devaluation of ruble versus dollar in 1998–1999 resulted in dramatic fall of import efficiency in the domestic market and stimulated intense growth of import-substituting production and expansion of niches for domestically manufactured products (in that period domestic inflation was 251.7%). In 2008–2009 dollar versus ruble exchange rate went up only by 23.2% compared to 2007, which correlated with inflation growth rate. Quick recovery of global market demand starting from Q2 2009 and global prices change in favor of Russia throughout 2010 resulted in foreign trade price conditions index exceeding the post-crisis value.

In 2010–2011 the effective exchange rate of ruble got up and the domestic market situation was formed in the context of increased imports and pretty modest dynamics of domestic manufacturing of consumer goods. Besides, the recovery of demand for imported goods was supported by the maintained positive growth dynamics of the real income of population.

No large-scale import-substituting production growth was observed in 2009-2011 in the context of the ratio between ruble exchange rate and domestic inflation, as well as production dynamics and structure and lack of competitive back-up production capacities.

The out-running physical import growth rate versus export and GDP was a special characteristic in 2010–2011. As of the end of 2011, foreign trade turnover (physical volumes, as of SNA methodology) went up by 8.7%, including export – by 1.0% and import – by 21.5% versus the preceding year[1].



* preliminary estimates.
Source: Federal Statistics Service, RF Ministry of Economic Development.

Fig. 3. Internal demand dynamics by components
in 2007–2011, % to the respective period in the preceding year

[1] Foreign trade turnover index value (balance of payments methodology) in 2011 versus the preceding year made 130.2%, export – 130.4% , import – 129.9%

Domestic market expansion was an important dominating driver for post-crisis economic development in 2010–2011. In this context special attention needs to be paid to the following trend which is growing stronger: supplies of imported goods outgrow the domestic production dynamics. The domestic production targeted at domestic market needs was recovering very slowly despite the fact that during the acute phase of the crisis (2009) its fall had been not as deep as import shrinking.

The share of import in 2011 goods/materials retail circulation was 43%, including 33% for food products and 51% for non-foods.

Table 1

Retail trade resources structure in 2010–2011, %

	Retail trade resources	Including	
		domestically manufactured	imported
2010			
Q1	100	56	44
Q2	100	58	42
Q3	100	55	45
Q4	100	55	45
Annual	100	56	44
2011			
Q1	100	57	43
Q2	100	58	42
Q3	100	57	43
Q4	100	55	45
Annual	100	57	43

Source: Federal Statistics Service.

In the producer goods market gradual raise of imported goods share was also observed. The shifts in the overall structure of imported goods were defined by the trend for increased share of the intermediate demand goods. During H1 2011 the share of imported producer goods made 19.2% versus 17.8% in the preceding year, and the share of imported intermediate goods made 42.9% versus 40.7%. Despite the increase of imported producer goods share starting from Q3 2011, the share of intermediate goods continued to remain much higher than in 2008–2010.

The increase of producer and intermediate goods share in the import structure with simultaneous decrease of the consumer goods share was a qualitatively new process in the Russian economy, which may turn out to be the start of priority change and increased incentives to production development in the environment of limited domestic material and technical resources. It seems that further development of the real economy sector in such situation will be dependent on the intensity of fixed capital investment targeted at modernization and diversification of the production. Besides, adjustment of capital goods and associated goods volumes characteristic for the period 2007–2008 has led to changes in industrial sector recovery structure in 2010–2011.

In industrial sector the post-crisis recovery both in 2008 and in 1998 started with the recovery of the growth rates in mineral wealth extraction driven by changes both in the global and domestic markets. In 2011 the mineral wealth extraction index made 104.9% versus the pre-crisis values of 2008. In processing crisis was more protracted during 2008–2009 compared to 1998 crisis, so getting back to the upward curve took twice as much time. Recovery of yields in processing and achieving the pre-crisis level of 2008 took place as late as in 2011.

The dependence of domestic production development dynamics, specifically – of enterprises operating under the industrial assembly regime, on the imported goods supplies was growing. In this context the import-replacing production and localization issues are becoming more and more relevant taking into account the special characteristics of development and modernization of certain processing industries of Russian economy. In the "Social and Economic Development Forecast for the RF in 2012 and for the Planned Period of 2013 and 2014" it is declared that the key economic growth driver in the mid-term perspective should be not just in increase of investment and consumption, but more – in increasing the level of competitiveness of domestic goods, which is to balance-off ruble exchange rate strengthening. However, the domestic market dynamics forecast for 2012–2014 is still based on import boom.

Table 2

Russian Federation Import Structure (balance of payments methodology), % to the outcome

	Goods		
	consumer	**producer**	**intermediate**
2006	46.2	17.0	36.8
2007	44.4	18.9	36.7
2008	41.8	23.8	34.4
2009	44.3	19.7	36.0
2010	40.7	19.5	39.8
Q1	43.5	16.8	39.7
Q2	39.6	18.7	41.7
Q3	40.6	19.7	39.7
Q4	40.0	21.5	38.5
2011	36.6	21.4	42.0
Q1	40.2	18.2	41.6
Q2	35.2	20.3	44.5
Q3	35.0	23.0	42.0
Q4	37.0	23.0	40.0

Source: Federal Statistics Service.

As of the end of 2011 the GDP growth rate made 104.3% versus the preceding year. During H1 2011 this growth was mainly associated with favorable situation in the global market for raw materials and with consumer market expansion. Capital investment in H1 2011 grew by 2.7% with GDP growing by 3.7% versus the similar period of the preceding year.

In H2 of 2011 the accelerated GDP dynamics is connected with the structural specifics of the economic growth: capital investment growth rates were speeding up, as well as construction and agricultural production volumes, versus the similar period of the preceding year. In the end of 2011 capital investment grew by 6.2%, construction volumes – by 5.1%, and agricultural production – by 22.1%. As a result, 2011 domestic market dynamics was determined by simultaneous growth of the demand both for consumer goods and for investment. Retail trade turnover made 107.2% versus 2010, and the level of fee-based public services made 102.9%. The cumulative impact of these factors was enough to weaken the trend for slowing down the domestic demand for industrial products and infrastructure services.

In 2011 the industrial production growth was that of a recovery nature targeting the pre-crisis development trajectory. As of the year end, the industrial production index made 104.7% versus 2010. The outrunning growth rate in processing had the dominating impact on the whole industrial sector dynamics and structure. In processing production index made 106.5%, and in mining – 101.9% versus the same indicators of 2010.

Table 3

Major macroeconomic indicators indices in 2010–2011,
% to the preceding year

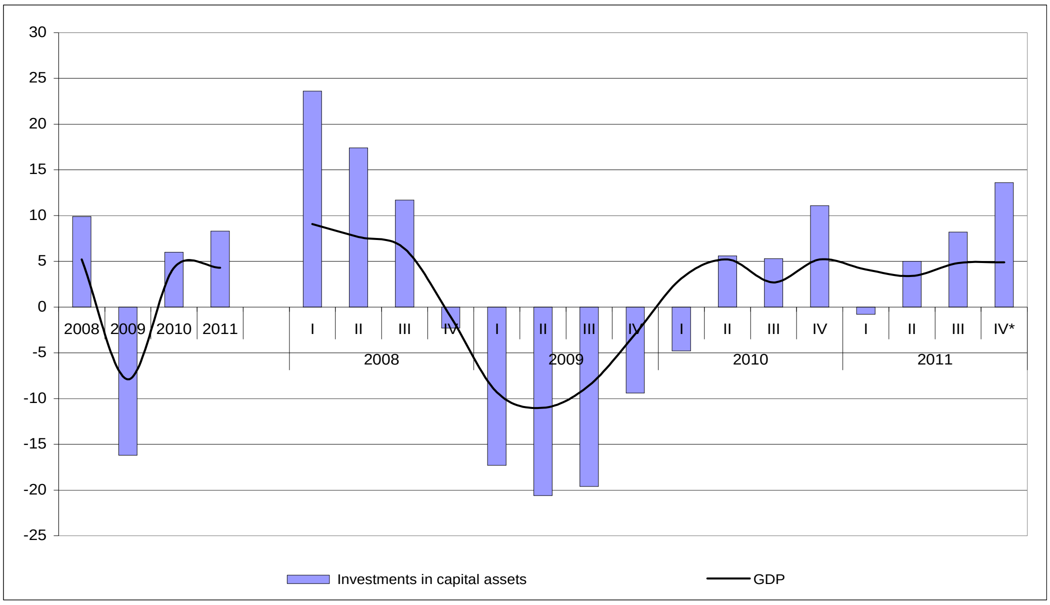
	2010	Quarters				2011	Quarters			
		Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4
Gross domestic product	104.3	103.5	105.0	103.1	104.5	104.3	104.1	103.4	104.8	104.9*
Capital investment	106.0	95.2	105.6	105.3	111.1	108.3	99.2	105.0	108.2	113.6
Construction	103.5	92.7	100.8	106.6	107.1	105.1	101.6	101.0	107.6	106.9
Residential space commissioning	97.6	91.1	107.3	85.7	102.3	106.6	97.8	95.1	115.0	111.4
Industrial output	108.2	109.5	110.9	106.4	106.5	104.7	105.9	104.8	105.1	103.3
Extraction of mineral resources	103.6	106.7	104.8	101.3	102.0	101.9	103.3	101.7	102.2	101.3
Processing / manufacturing	111.8	112.1	116.3	109.5	109.9	106.5	110.6	105.8	105.7	104.6
Production of electric energy, gas and water	104.1	107.7	102.6	103.9	101.6	100.1	99.0	101.9	101.4	98.5
Agricultural output	88.7	100.5	98.6	79.2	96.2	122.1	100.7	100.6	116.9	132.6
Freight turnover	106.9	111.6	113.0	101.7	102.5	103.4	103.9	105.2	102.4	102.3
Retail turnover	106.3	102.2	106.9	108.4	107.4	107.2	105.2	106.1	107.9	109.1
-food products	105.1	103.7	105.7	107.3	103.7	103.6	101.4	101.3	103.8	107.1
-non-food products	107.6	100.9	108.1	109.5	111.0	110.7	109.0	111.0	111.8	110.9
-fee-based public services	101.5	99.9	101.6	101.5	102.6	103.0	102.9	103.8	102.4	102.8
Foreign trade turnover	131.1	144.1	139.0	126.3	121.4	130.2	129.8	139.5	130.0	124.1
-export	132.0	161.1	143.4	118.4	118.1	130.4	123.8	138.4	134.2	128.2
-import	129.7	118.8	132.4	139.5	126.7	129.9	141.9	141.5	124.1	118.0
Real disposable cash income	104.2	107.3	103.7	104.5	102.1	100.8	100.0	99.0	101.6	102.7
Real wages	105.2	103.1	106.1	105.1	104.2	104.2	101.6	102.7	103.8	108.5
Total number of unemployed	88.9	96.2	86.6	86.8	85.2	89.1	85.7	88.1	91.8	91.6
Number of officially registered unemployed	90.0	114.2	91.1	81	74.9	76.9	73.1	75.4	78.0	80.2

* preliminary estimates.
Source: Federal Statistics Service, RF Ministry of Economic Development.

Last year's domestic market expansion was taking place in the context of changes in the structure of the demand for domestic goods. Special feature of 2011 situation was growth of stock in the second half of the year. Dynamic growth of stock remained one of the key drivers for higher GDP growth rates in the second half of the year despite the fact that production growth in industry overall was slowing down. Let us note, that the forecast for 2012 by the RF Ministry of economic development assumes some slowdown of the economic growth to 103.7%, including – due to exhaustion of the stock contribution into the recovery growth of the economy.

4.1.2. Major characteristics of GDP utilization

The trend of investment growth acting across the whole period between 2000 and 2008 demonstrated a breaking point in 2009, so the decline of capital investment was registered for the first time after 1998 crisis. Recovery of capital investment in 2010–2011 was characterized by pretty slow pace and was taking shape under the inertial influence of the preceding three years and factors acting at that time. Starting from Q2 2010 investment started to grow. In 2010 capital investment growth rate made 106.0%, and in 2011 it was 108.3% в 2011. However, when evaluating the dynamics of this indicator, one needs to take into account that in 2009 the base line was very low. In 2009 capital investment fell by 15.7%, so the decline was much deeper than during 1998 crisis. As the result, capital investment in 2011 made 96.7% of 2008 level.



Source: Federal Statistics Service.

Fig. 4. GDP and capital investment dynamics in 2008–2011, % to the preceding year

In the context of the situation with capital markets and savings resources the capital investment share in GDP structure during 2009–2010 period went down to 20.4% (compare with 21.3% - the maximum value for the last decade registered in 2008). In 2011, despite the savings ratio going up to 31.9% GDP thus exceeding the average of the preceding two years by almost 3 p.p. GDP, the capital investment share in GDP structure made 19.4% and remained below the average of the preceding two years by 1 p.p. GDP.

Table 4

Gross savings, gross capital formation and capital investment shares in GDP structure during 1998–2010, % of total

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Gross savings	30.8	31.4	32.6	33.2	33.8	33.9	33.3	24.6	29.0	31.9
Gross capital formation	20.0	20.7	20.8	20.0	21.2	24.4	25.1	18.6	22.3	24.9
including:										
gross fixed capital formation	17.9	18.3	18.3	17.7	18.5	21.2	22.0	21.6	21.3	20.5
Capital investment	16.3	16.6	16.8	16.7	17.6	20.2	21.3	20.6	20.3	19.4

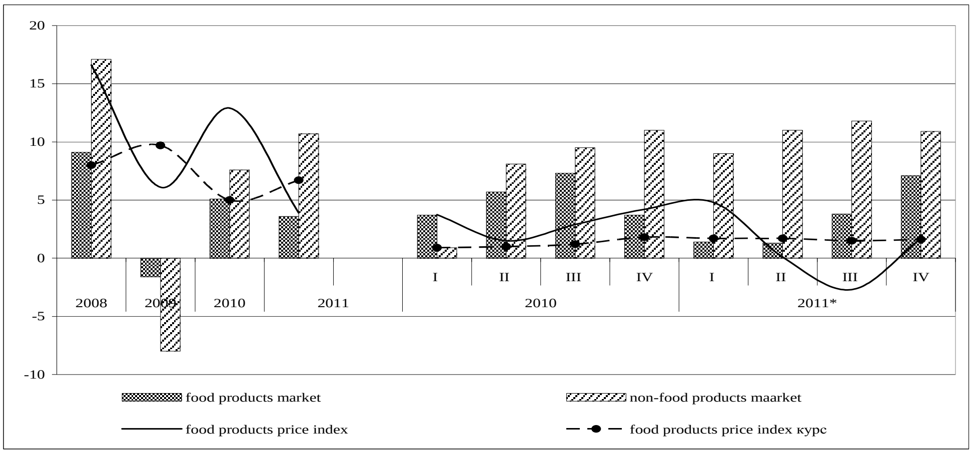
Source: Federal Statistics Service.

Consumer demand growth across the whole 2011 remained one of the main supporting economic growth drivers. In 2011 real income of the population made 100.8%, real wages – 104.2%, and real granted pension amounts – 101.2% to the respective 2010 values.

Overall, during the period of 2009-2011 real disposable income of the population went up by 9.8% versus the pre-crisis indicator of 2008. Let us note that structural specifics of real income dynamics were determined by the growth of the granted pensions (161.1% to 2008) outrunning the growth of the real wages (105.8%).

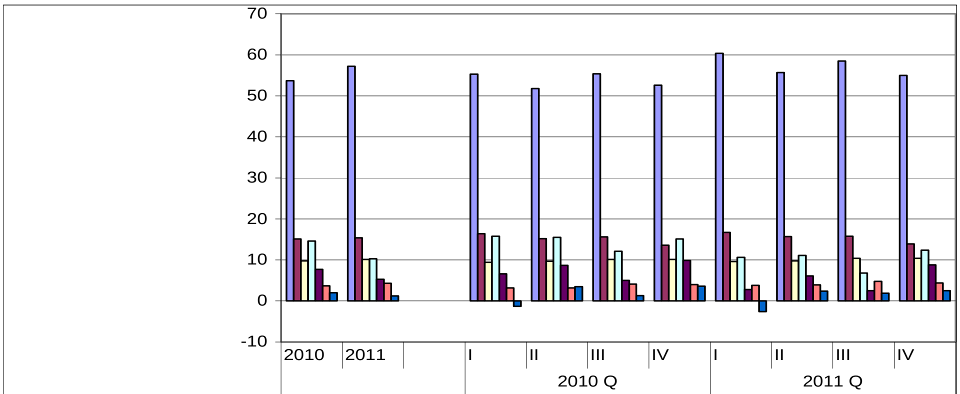
In the context of growth of the real income of population in 2010 the consumer market recovered at the pre-crisis level of 2008. Retail sales turnover in 2011 went up by 7.2% versus the preceding year. Snap acceleration of the non-food goods markets growth rate in the context of food products retail turnover rates slowdown became the characteristic feature of

2011. Non-food market turnover growth index made 110.7% versus 2010, and for food products it was 103.6%. At the same time, it is worth noting that while the food product market exceeded the pre-crisis level of 2008 by 3.3% in 2010 and by 7.1% in 2011, the non-food market was able to recover at the pre-crisis level only in 2011. Inflation rate slowdown in 2011 had a significant impact on forming of this trend: in food products market inflation rate went down to 103.9% (compare with 112.9% in the preceding year), and the price change was bigger in non-food market (106.7% in 2011 versus 105.7% in 2010) and fee-based public services market (108.7% versus 108.1%).



*preliminary estimates.
Source: Federal Statistics Service, RF Ministry of Economic Development.

Fig. 5. Consumer markets and prices growth rates in 2008–2011, % to the respective period of the preceding year



	2010	2011		2010 Q I	II	III	IV	2011 Q I	II	III	IV
Purchase of goods	53,7	57,2		55,3	51,8	55,4	52,6	60,4	55,7	58,5	55
Paying for services	15,1	15,4		16,4	15,2	15,6	13,6	16,7	15,7	15,8	13,9
Making mandatory payments and charges	9,8	10,1		9,4	9,7	10,1	10,1	9,6	9,8	10,4	10,4
Savings – total	14,6	10,3		15,8	15,5	12,1	15,1	10,6	11,1	6,8	12,4
including in deposits and securitie	7,7	5,3		6,6	8,7	5	9,9	2,8	6,1	2,5	8,8
Purchase of currency	3,7	4,3		3,2	3,2	4,1	4	3,8	3,9	4,8	4,4
Cash in hand	2	1,2		-1,3	3,5	1,3	3,6	-2,6	2,4	1,9	2,5

Source: Federal Statistics Service.

Fig. 6. Structure of using cash income of population in 2010–2011, % of total

Retail sales growth factors in 2011 remained based on savings ratio going down and consumer crediting going up. The share of savings in the income of population went down to 10.3% versus 14.6% in 2010, including savings in deposits and securities going down to 5.3% versus 7.7%. As of the end of December 2011 loans to individuals were issued for Rb 5,550.9bn and increased 1.36 times versus the same month of 2010.

4.1.3. Changes in GDP structure formation – by revenue sources

Domestic market growth support in 2011 was based on redistribution of income from enterprises to the population. The share of wages in GDP in 2011 made 49.9% versus the average of 46.1% in the period between 2002 and 2008. The insurance premiums increase impacted the structure of GDP formation from the revenues point of view. It resulted in decrease of the gross profit of the economy as GDP share in 2011 by 1.2 p.p. versus the preceding year remaining below the pre-crisis level of 2008[1].

Table 5

Structure of GDP formation by revenue sources in 2008–2011, % of total, on current basis

	2008	2009	2010	2011	2011			
					Q1	Q2	Q3	Q4
Gross domestic product	**100**	**100**	**100**	**100**	**100.0**	**100.0**	**100.0**	**100.0**
including:								
Wages of hired employees, including latent salaries and mixed income	47.4	52.6	49.9	49.3	53.8	51.7	47.5	45.4
Net production and import taxes	20.0	16.7	18.2	20	19.4	20.8	19.6	20.3
Gross profit in economics and gross mixed income	32.6	30.7	31.9	30.7	26.8	27.5	32.9	34.2

Source: Federal Statistics Service.

Within the structure of employed population employers providing for full-time employment of their hires and the self-employed make 8%. This is the factor determining the specific characteristics of GDP and population income structure. Almost 66% of population income in 2011 was formed at the expense of hired employees' wages.

High level of salary differentiation by types of business is a characteristic feature of Russian economy. In industrial production the degree of differentiation is determined by the growing gap in manufacturing and in sectors associated with mineral resources extraction. In the latter the nominal gross payroll in 2011 was 1.88 times higher the average level of wages across the economy. As for fuel-and-energy sector, the wages there were 2.2 times above the average. In manufacturing wages were 93% of the average level and only 45% of the wages at producing facilities. Gross payroll on petroleum products production and transportation of fuel and energy resources, as well as in financial sector was 2.3 higher than average level across the economy. In education and healthcare average wages got down to 65–74% of average level across the economy. The specifics of wages by types of business significantly impacted the structure of both revenue and expenditure formation, on consumer demand, on employment profile and distribution of resources across the economy.

[1]As per the RF Ministry of Finance, in 2009 at 26% rate insurance premiums revenues made 5.93% of GDP and in 2011 at 34% rate – 6.49% of GDP. In 2009 Individual Income Tax made 4.29% of GDP, in 2010 – 3.96%, and in 2011 – 3.67%. Aggregate IIT + insurance premiums revenues decreased from 10.22% of GDP down to 10.16%. It may be assumed, that the insurance premiums increase has led to increase in the latent salaries and mixed income.

Mitigation of labor market tension and recovery of demand for labor force in 2011 were the major outcomes of 2009–2010 anti-crisis program. The number of economically active population in 2011 was 75.7m persons, including 70.7m of gainfully employed and 5.0m of unemployed (using ILO methodology). The level of employment in 2011 made 63.8% exceeding the preceding year level by 1.1 p.p. in the context of the overall unemployment rates going down to 6.6% (by 0.9 p.p. versus 2010).

The total number of unemployed as of the end of 2011 exceeded the number of unemployed registered with government employment agencies 3.6 times in December 2011. 1,286,000 people were registered as unemployed with government employment agencies. The tension coefficient (the number of registered unemployed per 100 vacancies) in December 2011 was 175.9 (compare with 120.7 persons in January of the same year).

Table 6

Labor market fundamentals dynamics in 2009–2011

	2009	2010	Quarters				2011	Quarters			
			Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4
Number of employed in economy, m pers.	69.4	69.8	68.0	70.0	71.1	70.1	70.7	69.4	70.7	71.9	70.9
Number of unemployed, m pers.	6.3	5.6	6.6	5.6	5.2	5.2	5.0	5.6	5.0	4.8	4.7
Unemployment level, % to economically active population	8.4	7.5	8.8	7.4	6.8	6.9	6.6	7.5	6.6	6.2	6.3
Number of unemployed registered with government employment agencies, m pers.	2.1	2.2	2.2	2.0	1.7	1.5	1.4	1.6	1.5	1.3	1.2
Registered unemployment level, % to economically active population	2.8	2.5	3.0	2.7	2.2	2.1	1.9	2.2	2.0	1.7	1.6
Average monthly accrued nominal wages, Rb	18,785	21,090	19,485	20,809	21,031	23,045	23,532	21,354	23,154	23,352	26,202
% to the same period of the preceding year											
Number of employed in the economy	97.8	100.6	99.6	101.0	101.0	100.9	101.3	102.1	101.0	101.1	101.1
Number of unemployed	131.1	89.1	96.3	86.7	87.2	85.2	89.1	87.5	88.1	91.8	91.6
Number of unemployed registered with government employment agencies	148.0	90.0	114.2	91.1	81.0	74.9	73.6	73.1	75.4	78.0	80.2
Average monthly accrued nominal wages, RB	108.5	112.4	110.5	112.4	111.6	112.7	112.2	111.2	112.5	112.2	113.1
Average monthly accrued real wages, RB	97.2	105.2	103.1	105.1	104.2	102.4	104.2	101.6	102.7	103.8	105.9*

* preliminary estimates.
Source: Federal Statistics Service.

During 2000–2011 deviations in the demand for labor force were based on shifting the majority of employed to the services sector. Employment decrease was registered in the industrial sector practically for all types of business. This decrease of employment was especially intensive in the manufacturing sector. During the last three years the situation became even more complicated due to 2008 crisis which caused abrupt decrease in number of jobs in trade and construction.

Comparing the dynamics of employment, wages and GDP one can see that outrunning growth of wages versus labor productivity resulted in increased load on the economy and impacted financial performance of companies.

In 2011 positive balanced financial result of companies' performance was obtained in the amount of Rb 7,252.7bn, which is 20.0% above the preceding year performance. However, despite certain positive trends, overall in the economy the pre-crisis profitability level was not achieved. Profitability of goods sold, production output and work done as of the end of 2011 made 11.0% and were 2.0 p.p. below 2008 level. Extraction of mineral resources continued to remain the most profitable business activity in 2011.

Table 7

Labor productivity in Russia, % to the preceding year

	Code of business activity by All-Russian Classifier	2003	2004	2005	2006	2007	2008	2009	2010
Total for the economy		107.0	106.5	105.5	107.5	107.5	104.8	95.9	102.7
including:									
Agriculture, hunting and forestry	A	105.6	102.9	101.8	104.3	105.0	110.0	104.4	89.3
Fishery and fish-breeding	B	102.1	104.3	96.5	101.6	103.2	95.4	106.2	101.4
Extraction of commercial minerals	C	109.2	107.3	106.3	103.3	103.1	100.9	108.5	101.3
Processing and manufacturing	D	108.8	109.8	106.0	108.5	108.4	102.6	95.9	109.0
Production and distribution of electric energy, gas and water	E	103.7	100.7	103.7	101.9	97.5	102.1	96.3	98.9
Construction	F	105.3	106.8	105.9	115.8	112.8	109.1	94.4	94.8
Wholesale and retail	G	109.8	110.5	105.1	110.8	104.8	108.1	99.0	98.5
Hotels and restaurants	H	100.3	103.1	108.5	109.2	108.0	109.2	86.7	93.7
Transport and communications	I	107.5	108.7	102.1	110.7	107.5	106.4	95.5	103.9
Real estate transactions, leasing and provision of services	K	102.5	101.3	112.4	106.2	117.1	107.5	95.3	94.2
For reference: real accrued wages		110.9	110.6	112.6	113.3	117.2	111.5	96.5	105.2

Source: Federal Statistics Service.

Favorable situation at the global market of hydrocarbons and mineral resources allowed for producing companies quick recovery. Their profits continued to grow across the entire 2010 (151.7% versus the preceding year). This trend was maintained in 2011, the financial performance of these companies made Rb 1981.0bn (148.7% versus 2010), the drivers of which were such as producers’ prices growth by 29.1% and global prices growth by 39.3% (Brent) in the context of production growth by 1.3% in 2011 versus the preceding year. The total profit margin for mineral resources extraction sector made 35.7% having grown by 2.2 p.p. versus 2010. The cost-effectiveness of hydrocarbons production in 2011 made 32.1%, of other mineral resources extraction – 64.5%, which was the maximum level starting from 2005.

Financial performance of processing and manufacturing companies in 2011 made Rb 1904.1bn, thus exceeding 2010 level by 20.4%, and production output growth made 6.5%. Let us note that given unstable external demand in H2 2011, reduction of balanced financial result by 3.1% to the respective period of the preceding year was registered due to weaker dynamics of export-oriented enterprises operations. The balanced financial result of companies trading in foreign markets increased by 15.1% in 2011, and for companies oriented towards domestic markets – by 32.9%.

During the post-crisis period financial performance in oil refining were also gradually improving. As of the end of 2011, financial performance of oil refineries made Rb 735.0bn, which is 22.9% above the preceding year level. During 2011 oil refining output increased by 3.3%, and the producers’ prices grew by 17.6% versus 2010. However, the refining margin in 2011 went down to 19.8% versus 23.1% in the preceding year due to the increase of production costs and lack of positive trends in upgrading the feedstock processing technology.

Chemical enterprises have been demonstrating improvement of financial metrics since 2010. In 2011 balanced financial result of such enterprises made Rb 274.4bn having increased by 65.1% versus the same period of the preceding year. Let us note that in chemical sector the producers' prices growth in 2011 was 110.3% and production output growth – 105.2% versus the preceding year. High level of machines and equipment wear-and-tear, poor product mix and poor quality of domestic supplies versus the exported products had a very negative impact on chemical enterprises performance. Profitability in chemical sector in 2011 made 24.9% and exceeded the level of 2010 by 5.1 p.p. at the expense of intensive reduction of production costs due to reduction of the employed people number.

Table 8

Profitability of goods sold, production output, work done, services rendered and assets of companies in 2008-2011 by types of business, %

	Profitability of goods/work/ services sold,				Profitability of assets				For reference		
									2011 versus 2010		December 2011 vs. December 2010
	2008	2009	2010	2011	2008	2009	2010	2011	Financial performance rate	Gross Value Added physical indices	Prices indices
Total	13.0	11.5	11.4	11.0	5.4	5.7	6.8	7.0	120.0	104.3	
including: Agriculture, hunting and forestry	10	8.4	10.3	10.3	4.8	3.1	3.4	4.2	144.5	116.1	94.9
Fishery and fish-breeding	7.4	21.4	20.8	22.0	1.0	14.5	13.9	13.8	129.2	113.2	
Extraction of commercial minerals	25.4	29.2	35.5	35.7	10.5	11.3	14.5	18.4	148.7	101.7	126.7
Processing and manufacturing	17.1	12.5	14.3	13.2	8.6	5.6	7.8	8.2	120.4	106.1	108.3
Production and distribution of electric energy, gas and water	4.9	7.6	7.2	6.7	2.3	3.6	5.3	1.4	33.3	100.4	105.1
Construction	5.6	6.6	5.7	6.6	3.1	2.9	2.2	2.4	102.9	104.8	108.0
Wholesale and retail; maintenance of motor vehicles, bikes, household appliances and individual supplies	10.8	8.3	9.2	8.9	5.3	7.9	6.9	10.4	178.0	105.0	
Transport and communications	14.2	14.1	13.8	12.8	5.4	4.5	5.0	4.7	107.6	102.9	108.4

Source: Federal Statistics Service.

In metal industry balanced financial result in 2011 made Rb 370.9bn meaning 8.1% decrease versus the preceding year. Starting from H2 2011 external demand for Russian metallurgic products was going down, which became the cause for deterioration of balanced financial result. Production profitability in metal industry decreased by 2.8 p.p. versus 2010 and made 15.9%. As of the end of 2011 the production output level in metal manufacturing and metal goods manufacturing grew only by 2.9% versus 12.4% growth in the preceding year, and producers' process growth went down from 122.4% to 104.7%.

In timber industry balanced financial result decreased by 12.3% versus 2010. In the environment of production rates slowing down in wood processing and in pulp-and-paper production the profitability level was maintained at the expense of increased producer's prices.

Currently the pre-crisis levels of production capacity utilization have been achieved in processing sector. Hitting the intensive growth limit at the expense of increasing the capacity utilization rates is accompanied by intensive import of foreign goods. Combination of these two factors leads to volatile dynamics of processing industries output.

Companies producing goods non-marketable in foreign markets are in the majority of cases inefficient. It is worth noting that despite financial performance improvement in business activities targeted at meeting the internal investment demand, the situation in these fields remains not quite favorable.

In construction materials production the profitability rate in 2011 was 11.8%, which is a 3.9 p.p. increase versus the preceding year. However, this indicator is still significantly lower than the pre-crisis level (18.9% in Q1 2008). Last year the profitability growth was driven by gradual growth of demand and by production output growth by 9.3% versus 2010, on one hand, and by facilitated growth of prices for products and services in this sector – by 113.5% versus 103.6% a year earlier.

In the mechanic engineering sector the balanced financial result of 2011 exceeded the level of the preceding year 1.86 times, but significant differentiation by types of business may be observed here. Given a pretty much restrained pricing policy, indicative for this sector, the dynamics of production yield and the level of production costs had the dominating impact on the profitability level. Also, performance of mechanical engineering companies was significantly impacted by the outrunning growth of production costs in this sector versus the economy in general and processing enterprises in particular at the expense of labor costs growth. The profitability of machines and equipment manufacturing in 2011 made 7.0% versus 7.3% in the preceding year, and the profitability of electric equipment, electronic and optical equipment manufacturing – 10.0% versus 10.1% respectively.

In 2010-2011 significant growth was observed in transportation vehicles and equipment manufacturing, which was related with implementation of car-manufacturing anti-crisis support programs. In 2011 transportation vehicles and equipment manufacturing maintained its leading position with regard to production output growth rates versus other areas of mechanical engineering sector. As of the end of 2011 the balanced financial result in transportation vehicles and equipment manufacturing made Rb 86.4bn, and sales profitability exceeded the pre-crisis level making 7.5%, which was 2.7 p.p. versus the preceding year.

In consumer goods manufacturing output growth rates slowdown was accompanied by facilitated dynamics of manufacturers' prices and gradual slowdown of wages growth rates. Profitability of textile and clothing manufacturing in 2011 grew up to 7.1% versus 5.4% in the preceding year, and in leather and leather garments manufacturing profitability went down to 7.5% versus 8.0%. In food products manufacturing profitability decreased by 4.1 p.p. versus 2010 and made 8.1%. Slowdown of foods products manufacturing growth rates (down to 101.0%) in 2011 with simultaneous growth of the manufacturers' prices by 1.8% became one of the key factors here determining poorer performance. Financial result in food products manufacturing in 2011 made Rb 147.0bn, which was 25.8% lower the result of 2010.

In general, the analysis of production dynamics and financial results allows for making a conclusion about gradual post-crisis recovery of the economy and overcoming of 2008–2009 phenomena. However, financial results were improving versus the preceding year mainly due to pricing factors. Given a slowdown in the economy growth rates, the production costs did not go down, and the efficiency of labor and capital utilization went down. Surely, the increase in labor costs and insurance premiums on salaries (from 26% up to 34% in 2011) impacted the financial performance of businesses and companies. In 2011 the financial result growth rate under the cumulative impact of all the above listed factors made 120.0% versus 142.8% in 2010, and profitability went down by 0.4 p.p. versus the preceding year.

4.1.4. Production dynamics and structure by types of economic activity

Overcoming the negative consequences of 2008–2009 crisis and hitting the growth trajectory is determined by specific features of operations in certain sectors of the national economy and certain types of business. In general, the structure of restored economic growth of 2009–2011 period mirrors the post-crisis development pattern of 1998–2000, when the growth emerged in food products manufacturing and in mineral resources extraction, as well as other processing enterprises associated with processing hydrocarbons and other mineral resources. Then this growth rolled-out to sectors of industrial production. Speaking of the basic sectors, the biggest decrease of production was registered in H1 2009, when the decline made 13.9% to the level of the respective period of the preceding year. Starting from H2 2009 due to recovery of external demand and due to government anti-crisis measures the situation began to improve and as of the end of the year the decline in industrial production was making only 9% of the preceding year level. Recovery of demand for energy in domestic and foreign markets resulted in mineral resources extraction growth in Q4 2009, which, in its turn, contributed to further development of processing manufacturing sectors. In H1 2010 the industrial output growth rate was 110.2%, including 105.8% for extraction and 141.3% for processing.

Starting from Q3 2010 some slowdown of the economic growth could be observed, caused by decline of export growth rate. In Q3 2010 industrial production index made 106.3%. However, in Q4 while rather high rates of investment growth and consumer market development were preserved, total industrial growth rate was 6.5%, including 9.9% in processing.

During 2011 the growth rates in industry slowed down, which was to a great extent determined by high base of the previous year. In 2011 industrial production index made 104.7%, including 101.9%, for mineral resources extraction, 106.5% in processing and 100.1% in producing and distributing electric energy, gas and water. In 2011 situation in industrial sector was unique – contrary to the entire period of 2000th when the growth was supported mainly by mineral resources extraction, last year the growth in industrial production took place mainly at the expense of processing sectors output growth.

As of the end of 2011 processing industries achieved the level of 2008, but the growth rates differ significantly by certain types of business. The recovery growth of 2010–2011 identified structural misbalances of Russian industrial sector. On one hand, the sectors which are of strategic priority for Russian economy – i.e., mineral resources extraction; food products, leather and footwear manufacturing; coke and petroleum products production; chemical production; rubber and plastic goods manufacturing; transportation vehicles and equipment manufacturing – proved their sustainability and exceeded the pre-crisis output level in 2011. On the other hand, some serious lag still exists in the recovery dynamics of mechanical engineering, electrical equipment manufacturing, metallurgy, timber production and construction materials manufacturing, where 2008 level has not been achieved yet.

Slow recovery rates in mechanical engineering constituted the dominating factor negatively impacting the level of business activity in adjacent sectors of manufacturing of structural materials and other producers’ goods.

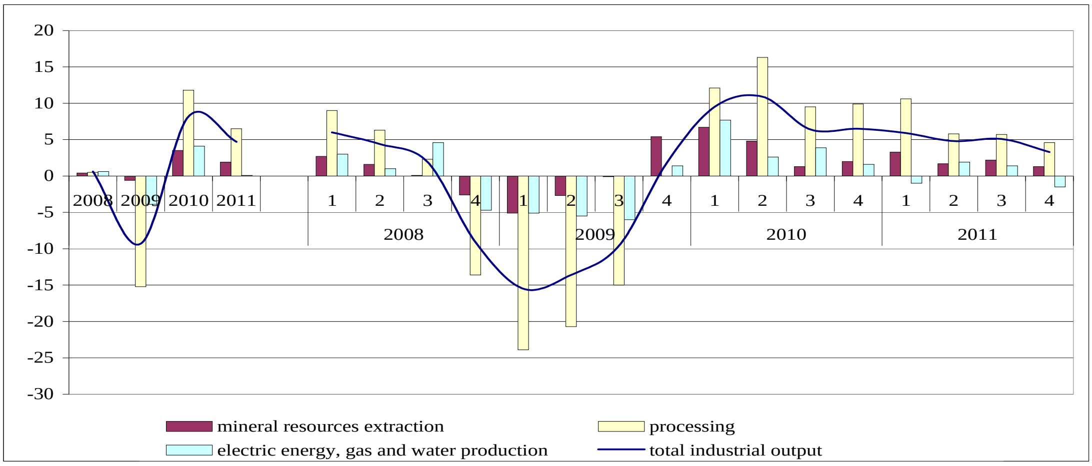
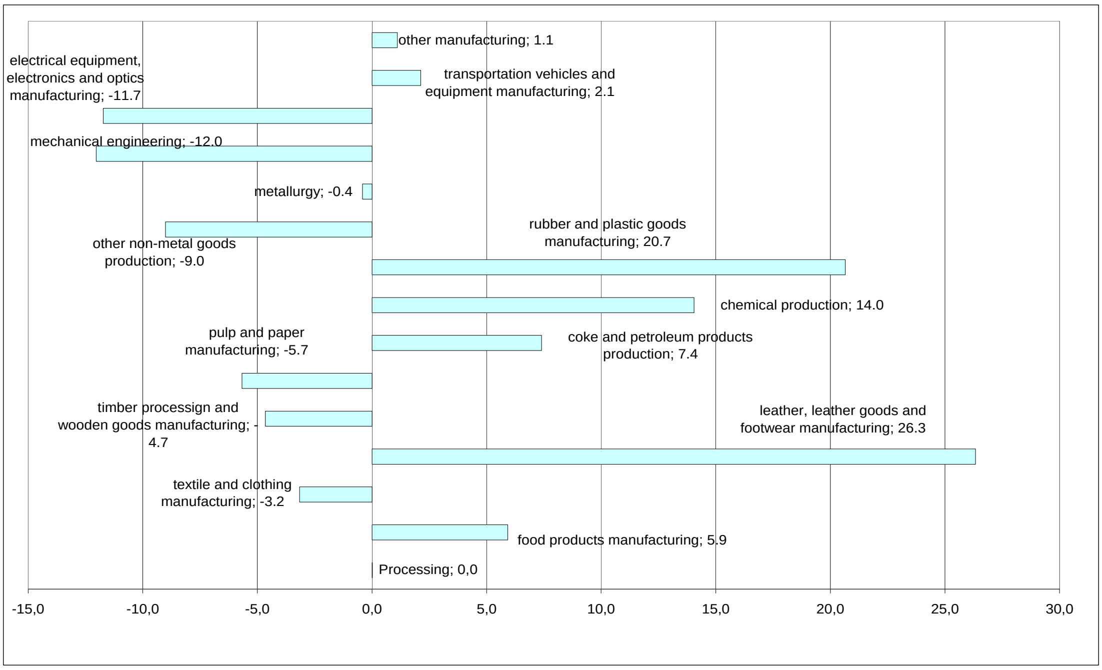


Fig. 7. Industrial growth rates by types of business and sectors in 2008–2011, % to similar period of the preceding year



Source: Federal Statistics Service.

Fig. 8. Industrial growth rates by types of business in 2011, % to 2008 level

We can discuss the specifics of post-crisis recovery in mechanical engineering only in connection with transportation vehicles manufacturing. This is determined by a big-scale government support of domestic passenger cars manufacturing and growth of foreign brands assembly lines output.

Situation with strategically important high-tech and mid-tech sectors (electrical equipment, electronics and optics manufacturing, as well as mechanical engineering) constituted one of the most serious problems. These sectors turned out to be the most vulnerable in the conditions of crisis, because the accumulated issues of poor compatibility of various types of engineering products versus imported foreign analogues judging by "value-for-money", as well as due to lack of capacity for manufacturing state-of-the-art machinery. All of those factors significantly impeded the recovery of domestic mechanical engineering. At the same time abrupt import shrinkage took place in the crisis conditions, while as over the course of the last several years it was import which significantly impacted the pattern of mechanical engineering development and machines market.

Overestimated market positions of domestic construction and investment sector during the period of intensive growth in 2006–2008, when no adequate measures were taken to improve efficiency of capital investment, resulted in unprecedented decline in construction and structural materials manufacturing, as well as in adjacent mechanical engineering and metallurgic enterprises.

In 2011 index of machines and equipment production versus 2010 made 109.5%. Such growth is associated with implementation of measures supporting domestic manufacturers. Growth was observed for all sub-glasses of this group of goods. Utilizing the resources of OJSC Rosselkhozbank and OJSC Rosagroleasing for incentivizing the demand for Russian machines and equipment for agriculture and timber husbandry, as well as increase of capital investment in agriculture resulted in accelerated production of machinery for these businesses: 37.6% versus 2010. Implementation of long-term projects in technical modernization of metallurgic, mining, oil-and-gas enterprises, high degree of depreciation and obsolescence of equipment, as well as growth of mineral resources production in 2011 contributed to 23.0% growth of machines and equipment production (versus 2010). Consistent implementation of investment programs for technology modernization of companies provided for increased effective demand for process equipment, thus determining the growth of machines production in 2011 by 14.6%, and for mechanical equipment – by 6.9% versus 2010. Incentivizing customer demand utilizing loan mechanisms went along with increase in household appliances production by 8.8% versus 2010.

In 2011 electrical equipment, electronics and optics manufacturing grew by 5.1% versus 2010. It was not sufficient to compensate for the downfall of the preceding two years. In 2011 transportation vehicles and equipment production index was 124.6% versus 2010. That was mainly determined by financial and economic stabilization of key manufacturers and customers transportation vehicles and equipment after 2008–2009 crisis.

The railway cargo turnover growth during 2011 made 5.7% versus 2010 and provided for growth of production of railway machinery used for cargoes transportation. At the same time with passenger turnover at 2011 level manufacturing of passenger railcars decreased by 2.6% during the year.

In 2011 production of passenger cars grew by 44.5% versus 2010, and trucks production grew by 33.4%. Implementation of programs to incentivize the demand for automobiles (including old cars utilization and concessional car loans programs) was a significant driver of passenger cars production growth. For trucks production similar role was played by development of mechanisms for domestic vehicles sales via leasing and loans schemes. Implementation of such programs accounted for 11.7% and 10% of total sales at passenger cars and light commercial vehicles markets respectively. However, in 2011 the share of imported passenger cars and truck in 2011 grew even more versus 2010 (51.9%, and 87.5% respectively).

The lag in recovery of production is concentrated in metallurgy, timber industry and production of construction materials. In 2011 metals and metal ware production index made 102.9% versus the preceding year including for metallurgy – 105.2%, for metal ware production – 98.2%. Non-ferrous metals production index in 2011 made 108.7% versus 2010. The growth of production yields in this sector is maintained due to growing final process stages output (118.9% versus 2010), utilized primarily in the domestic market.

In mid-2011 the overall situation in the non-ferrous metals markets got worse leading to suspension of export supplies, deterioration of financial and economic indicators of companies and enterprises' performance slide down. Despite all of that, some rehabilitation of investment activities was observed in non-ferrous metallurgy compared to 2010 – specifically in non-ferrous ores production and concentration.

Production index in timber processing and wooden goods manufacturing in 2011 made 104.0% versus 2010; in pulp-and-paper manufacturing, publishing and printing – 101.8%; for timber harvesting – 103.1%. Business activity in this sector was supported by the state. Thus, the following subsidies were granted from the federal budget in 2011: partial compensation of costs incurred by Russian exporters of industrial products when paying interest on loans received in Russian credit institutions; subsidizing interest rates on loans received by timber industry enterprises from Russian credit organizations in 2008–2009 to set-up inter-seasonal stock of timber, feedstock and fuel; subsidizing interest rates on loans which Russian companies operating in agricultural and tractor vehicles manufacturing and in timber industry received from Russian credit institutions and from Vnesheconombank in 2008–2011 for technical re-equipment for 5 years.

Construction materials production index in 2011 made 109.3% versus the preceding year. However, despite its high dynamics during the last two years, it remained 9% below the pre-crisis level of 2008. Simultaneously with expansion of scope of work in construction and growth of demand for construction materials in 2011 production growth for practically all types of goods of this sector was observed. Given the outrunning growth rates of construction materials domestic market capacity, the demand was satisfied at the expense of both re-routing cement supplies from external market to domestic market and import volumes growth.

The key macroeconomic trends analysis provides for the following conclusion: in 2011 Russian economy in general was able to recover from the crisis. In the environment of integration between Russian and global economy the 2009–2011 recovery growth illustrates the preserved dependency of growth rates on the global situation with commodities prices and demand for them in foreign markets. Respectively, quick recovery of production growth rates in export-oriented sector of mineral resources extraction provided incentives for development of domestic manufacturing sectors. However, the delayed response of domestic manufacturers to the domestic demand changes resulted in outrunning growth of import versus the domestic manufacturing recovery rates. The situation grew even more complicated due slow recovery of investment and financial crediting sectors. The inertial impact of these factors determines the system of growth limitations in the short-term perspective.

4.2. Russian industry in 2011

The section was prepared using data of monthly surveys conducted by the Gaidar Institute for Economic Policy (IEP) among managers of industrial enterprises since September 1992. The surveys are based on the European harmonized methodology and encompass the entire territory of the Russian Federation. The size of the panel is about 1100 enterprises that employ over 15% of the total number of employed in industry. The panel is biased towards large enterprises in each of the selected sub-industries. The rate of response to questionnaires ranges from 65% to 70%.

The industrial survey questionnaire contains quite a small number of questions (not more than 15-20). They are of qualitative rather than quantitative nature. The simple formulation of questions and answers allows the respondents to fill in the forms quickly and without engaging other staff members or consulting documentation. It's essential that the respondent at each enterprise should be an executive of the highest level possible who is fully aware of the situation at the enterprise and is directly involved in its management.

When analyzing the results of industrial surveys a specific derivative indicator is used which is termed "balance". The balance is calculated as the difference between the percentage of respondents who answered "will grow" (or "above normal") and the percentage of respondents who answered "will decrease" (or "below normal"). The resulting difference allows to present the distribution of answers to each question by one figure with "+" or "-" sign.

The balance is interpreted as the first derivative or the rate of the process. If the balance of responses to the question about expected change in prices has the "+" sign, it means that in the near future average prices will grow (e.g. the prevailing number of enterprises reported their intention to raise prices). The increase of balance from +10% to +17% over a month implies that average prices in industry will grow at a higher rate as the prevalence of enterprises anticipating their growth became more convincing. A negative balance is the sign of future reduction of average prices (more enterprises project to lower their prices). The changing of balance from -5% to -12% is interpreted as greater intensity of price decline.

4.2.1. Is Russian industry recovering from the crisis?

The estimate of general trends in the Russian industry both in the crisis situation and at the stage of recovery from it does not seem to be an easy task. Low immediacy and insufficient frequency of the official data release became evident at the end of 2008 – the beginning of 2009.

In 2011 users of official industrial statistics faced one more problem: the insignificance of monthly changes in output complicates interpretation of this data while possible (or at least expected) second wave of the crisis reinforces demand for anticipatory indicators. In this situation the Business Surveys Department of IEP resumed regular calculation of IEP's Industrial Optimism Index (IEP IOI)[1].

In the situation of economic crisis this index helps to tackle several important tasks. First, it provides an opportunity for an actually real-time (as compared with the frequency and immediacy of official statistics) insight into the performance of domestic industry. Second, enterprises participating in the IEP surveys are "the middle class" of Russian industry. They are located all over the country's territory and operate basically in processing industries. Authorities and experts not always get timely and sufficient information on the performance of such

[1] The index is calculated as the simple average of balances (differences in responses) for four questions from the IEP questionnaire:
1) actual change of demand, balance = % growth – % decrease;
2) estimate of demand, balance = % above normal + % normal – % below normal;
3) estimate of finished goods stocks, balance = % above normal – % below normal;
4) output projections, balance = % growth – % decrease.
Balances of responses to the 1st and the 4th questions are adjusted for the seasonal and calendar factors.
The index can range from -100 to +100. A positive value of the index implies the prevalence of positive estimates. A negative value of the index means that negative estimates prevail. Lowering of the index value is the sign of deteriorating situation while its growth – the sign of ameliorating situation.

enterprises. Third, the index is calculated on the basis of indicators having no analogues in the system of state statistics but describing the key features of real situation in the Russian industry (demand, stocks, output projections). The 19-year experience of conducting such surveys (the number of which exceeded 230) and analyzing their results proves that they provide a very precise and comprehensive outline of enterprises' performance. Long-standing, personified and non-formal relationships with respondents (90% of which are chief executive officers of enterprises) facilitate gathering of the most objective information on the performance of Russian industry. As a result the IEP's Industrial Optimism Index illustrates the true state of affairs therein.

The post-crisis maximum of the indicator was achieved in October 2010, followed by 4 months of unsuccessful attempts to continue recovery from the recession. But by March 2011 the optimistic spirit in industry faded away. In April the indicator of optimism lost two more points. In May no principal changes took place as compared with April, with the index remaining at the minimum level over the previous 11 months. So, a relatively steady (with few exceptions) overcoming of the late 2008 crisis has evidently come to an end (see *Fig. 9*).

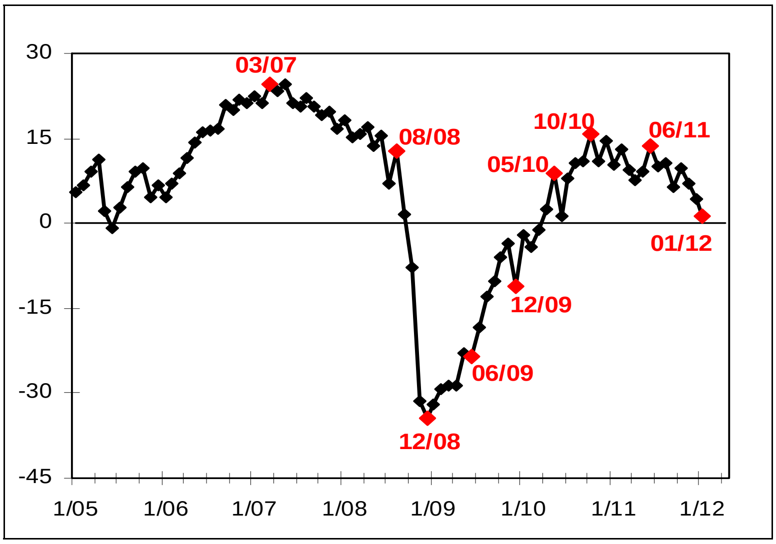


Fig. 9. IEP's Industrial Optimism Index, 2005–2012

The major contributor to the loss of industrial optimism in 2011 was the demand trend. From December 2010 the growth rates of sales were down 16 points. An evident growth of demand was replaced by an equally evident decline. The indicators for May were the worst since autumn 2009 (!). In the following months enterprises hoped to reverse this negative trend. At least, those were their projections.

According to opinion of enterprises' executives, in June the situation clearly improved. The basic driver of the Index growth was the dynamics of demand. In June it experienced positive changes that were the most sizable over the previous 24 months. The growth rates of sales (when seasonally adjusted) increased and changed the sign: the decline of demand in May was superseded by the growth of sales in June. The latter pushed up production projections of enterprises. In June they improved by 5 more points and peaked (after seasonal adjustment) to a 3-year maximum. The stocks of finished goods made a very modest positive contribution to the growth of enterprises' optimism. The estimate of (satisfaction with) demand had no impact on the Index. This indicator demonstrates astonishing stability ranging from 56% to 59%. Most enterprises seem to get accustomed to the situation of sluggish recovery from the crisis and are reluctant to respond to swings of sales.

However, in a month it became clear that the surge of optimism in June was occasional and the spirits in industry returned to their worst patterns in the past 12 months. The sharp drop of the Index (having no analogues in the previous 13 months) was conditioned by the negative dynamics of all its components.

The greatest changes occurred in the level of satisfaction with the sales volumes. Within a month this indicator lost 6 points and plunged down to a 6-month minimum. Such a dramatic revision of demand estimates was due to the evident slow-down of demand growth. When adjusted for the seasonal factor, this indicator demonstrated a complete halting of growth as regards sales of industrial produce in July. The divergence of actual demand trends in July from the June forecasts pushed the estimates of demand even lower. Enterprises anticipated continuing growth of sales in July. The latter circumstance impelled them to revise their estimates of stocks of finished goods downwards. After a long period of stability and proximity to zero, in July this indicator fell down to a 15-month minimum (see *Fig. 10*).

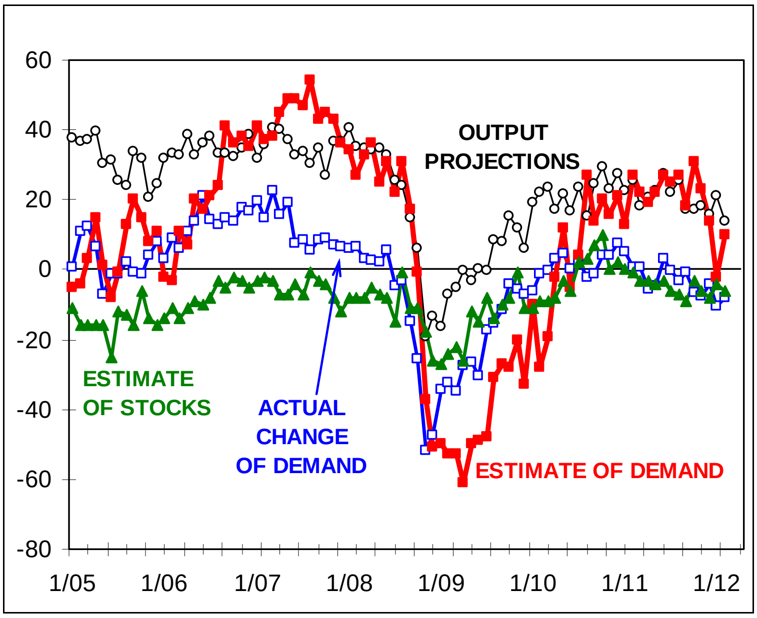


Fig. 10. Components of Industrial Optimism Index, 2005–2012

The discontinued growth of sales and the worse estimates of finished goods stocks had a negative effect on output projections. After a 3-month rebound enterprises decided to notably cut production growth rates in the nearest months. Meantime, forecasts of demand growth remained optimistic, i.e. industry planned (would have liked to) meet the demand by utilizing stocks of finished goods. Indeed, in the following months enterprises anticipated further and more intense decrease of stocks.

In August the situation in Russian industry on the whole did not deteriorate. The positive trends in output projections and satisfaction with sales were leveled off by weaker demand and worsening estimates of finished goods stocks.

The September estimates of Russian industry's performance showed the lowering of enterprises' optimism. On the whole the IEP Index did not demonstrate a pre-crisis (and already expected) drop similar to the one registered 3 years before. As compared with the 2011 maximum the decrease was only 5.3 points. But the dynamics of Index components and other indicators, monitored by IEP experts on a monthly basis, then caused concern.

First, the demand for industrial goods was stagnating for the third month in turn. However, till August industry went on hoping for its revitalization. In September these illusions were superseded by a drastic revision of forecasts: within a month the balance of expectations dropped from +13 to -5 points as judged from initial data. The September demand forecasts suggested a very sizable negative adjustment of the actual sales dynamics in the last months of 2011. Second, after a period of relative stability, the satisfaction with demand level instantly fell by 10 points. Industry could no longer bear slack demand. Although in September it preserved the same output growth rates but – third, - production projections lost 12 points within a month and 37 points as compared with the year's maximum. When adjusted for seasonality, the indicator displayed reduction to a 5-month minimum. Fourth, estimates of finished goods stocks showed their apparent surplus which could be due to both the stagnant demand and the slowing down of unit costs' growth. Fifth, in order to revive demand enterprises once again refrained from raising prices. Russian industry does not often resort to price tools: the halting of growth of ex-factory prices and their further reduction was recorded by surveys before the 1998 default, prior to and on the exit from the 2008 crisis.

At first glance, the value of Index calculated in October 2011 did not evidence the strengthening of negative trends in the performance of Russian industry. It improved by 4 points and reached the average level for that year.

But detailed analysis revealed that the Index grew owing to two subjective indicators: the estimate of finished goods stocks and the satisfaction with demand. The first of them instantly improved by 12 points and as a result quite a sizable surplus of stocks typical for the previous months was superseded by their shortage. The latter fact in the situation of apparent weakening of demand and faint hopes for resumption of sales growth rather evidenced that industry "cleared" its stocks of finished goods and did not plan to replenish them in the near future. Therefore, the shortage of stocks in the situation of sluggish (or decreasing) demand was rather a sign of the firm conviction in the development under negative scenario than of the industry's inability to satisfy the effective demand.

The satisfaction with sales in October also improved. This indicator instantly grew by 10 points and achieved a post-crisis maximum. It appears that even modest demand seemed normal for most (65%) enterprises in the situation of nervousness on the world markets and uncertainty about even the nearest future. The demand for industrial output continued to decrease. The rate of change (after seasonal adjustment) reached a 20-month minimum, i.e. no such an intensive drop of sales had been observed since February 2010. The output projections plunged to a 14-month minimum.

In November the situation in industry deteriorated as compared with October and returned back to the September level when minimal since June 2010 value of the indicator was recorded.

The principal cause of the November lowering of Index was the intensifying drop of demand for industrial products. As a result, the satisfaction with sales volume fell. One more sequence of the shrinking demand was the worsening balance of estimates of finished goods stocks even despite reduction of their physical volumes. To the opinion of enterprises, revitalization of industry in these conditions and, moreover, on the eve of nation-wide New Year holidays was unlikely. In November their initial production projections plummeted to the minus area down to the value that had never been registered either in the pre-crisis years or in the current year. However, the adjustment for seasonality flattened this nose-dive up to the level of the previous two months.

The Index for December showed that situation at enterprises continued to deteriorate. The industrial performance indicators by the end of 2011 were apparently worse than in the previous year. In the last months of the year the most sizable changes for the worse were observed in estimates of sales. Despite positive dynamics of demand, this indicator lost 11 points after its October surge. However, the positivity of demand trend was relative. In December the growth rates of sales demonstrated just the slowing down of decline, the intensity of which in the two previous months was record for 2010-2011. The aggravation of the European debt crisis became the turning point for output projections. In September they fell by 9 points and failed to restore till the end of the year. It appeared that managers of enterprises adequately assessed the prospects for Russian industry.

At the beginning of 2012 the Industrial Optimism Index fell to the minimum level recorded in the last 18 months. And even higher optimism of projections failed to make up for the worsening of actual dynamics and its estimates. The situation in Russian industry has evidently deteriorated.

Summing up, one can state that according to IEP's IOI in 2011 the recovery of Russian industry from the crisis has apparently slowed down. The rally registered in June turned out to be incidental and failed to reverse the general trend of the past year when optimism sooner fell than grew. The results of the recent months show that the industry is plunging into the second wave of the crisis rather than finding a way out of it.

Following the aggravation of European problems in autumn and the growing uncertainty on the world markets, the Index of Industrial Projections which is based on three projections of enterprises (demand, output and employment) and in all other respects is similar to the Industrial Optimism Index, demonstrated a sharp decline of enterprises' expectations and their stabilization at the level which was minimal since August 2010 (see *Fig. 11*). The initial plans and projections of enterprises had been decreasing with different intensity since August 2011.

However, in January 2012 surveys recorded a cardinal improvement of projections for all the basic indicators: those of demand, output, employment and investments. As a result the Index of Industrial Projections was up 5 points. Most probably, there are no economic grounds for such a surge in the situation of aggravating crisis of Eurozone and the growing pessimism of experts' expectations. But it can have a political explanation. It seems that home politics have intervened in home economy: the national peculiarities of counting votes at the elections to the State Duma, the society's response to them and convulsive attempts of authorities to extinguish discontent with a view to remain in power. Which of the taken away from the society and the economy within the previous 10 years will be given back, who will attend to this and which of the pre-election promises will be materialized – these seem to be the factors concerned by Russian enterprises when making projections for recovery from the protracted crisis.

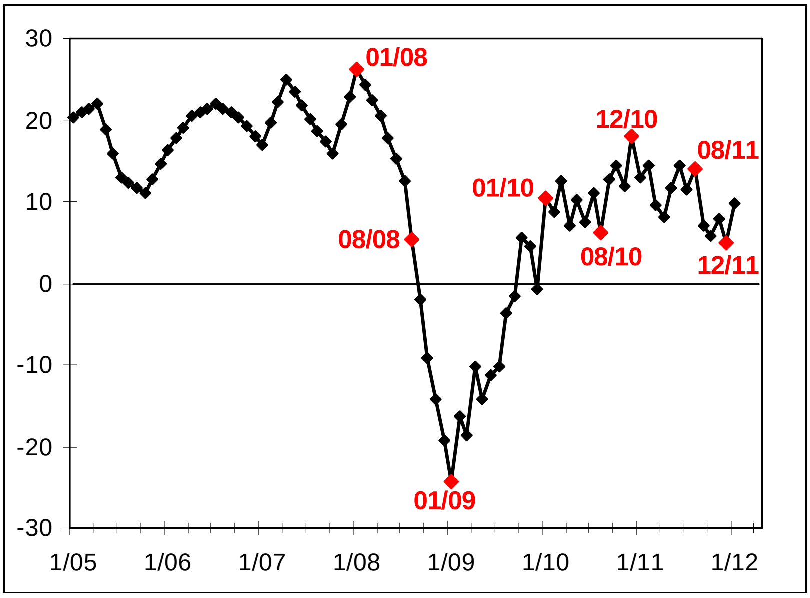


Fig. 11. Index of Industrial Projections, 2005–2012

So, the second wave of the crisis, or its new stage, or the continuation of the recent crisis is quite possible and is just a matter of time. Other issues in question are certainly the scale, deepness and other specifics of future developments as compared with the ones that took place in Russian industry at the end of 2008. With regard to this in September-October 2011 managers of enterprises participating in IEP's surveys were asked the question, "What is your enterprise going to do (what can happen) in case of the second wave of the crisis and the lowering of demand for the produced output?", and the following 13 variants of response were suggested:

1) lowering of ex-factory PRICES;
2) significant (15% and more) reduction of OUTPUT;
3) lowering of COSTS;
4) increase of DELAYED payments by buyers;
5) increase of NON-MONEY settlements with buyers;
6) lowering of WAGES, part-time working week;
7) DISMISSAL of employees;
8) halting of enterprise OPERATION;
9) complete or partial changing of OWNERS;
10) real risk of BANCRUPTSY;
11) forced LEAVES of employees without pay;
12) more active MARKETING, searching for new buyers and markets;
13) NONE of the above mentioned.

First time we included (or, to be more exact, managed to include) this question in the questionnaire in December 2008, after the IEP's surveys were the first to register the actual rather than expected beginning of the crisis (the record of November 18, 2008). Later the questions about the actual business responses and expectations were asked four more times, the last in March 2010. As a result we obtained a unique by its immediacy and frequency array of data on expectations, plans and responses of enterprises to the crisis that began in Russian industry in November 2008. The question posed in 2011 can help both Russian enterprises and Russian ministers to get prepared for the possible new wave of the crisis.

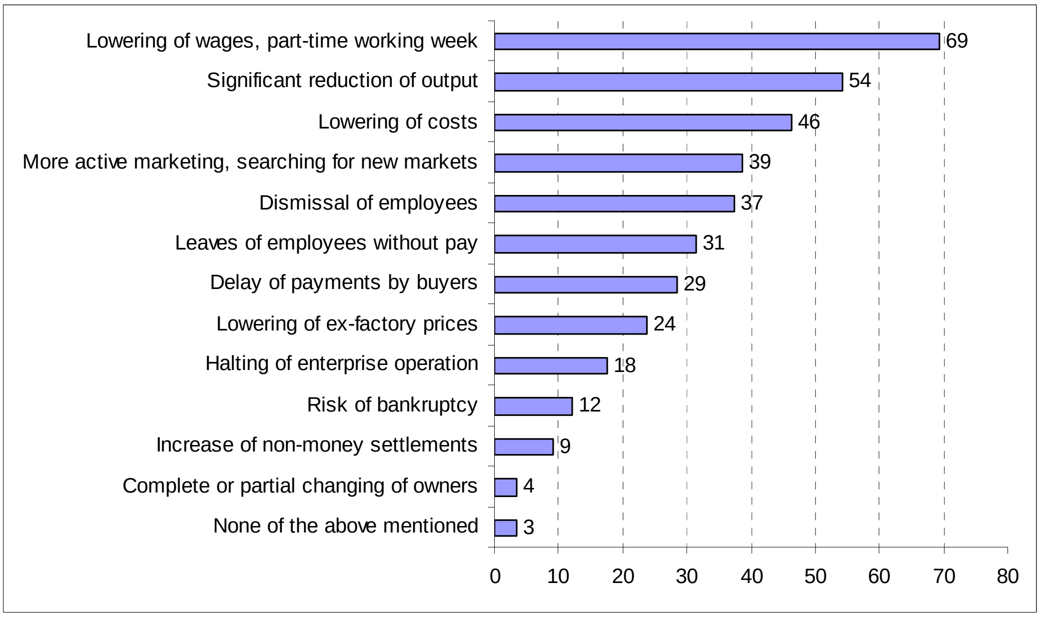


Fig. 12. Possible responses of enterprises to the second wave of the crisis, %

In case of the second wave of the crisis (let's term so possible negative developments in the nearest future) Russian industrial enterprises first of all plan to cut wages and switch to a part-time working week (see *Fig. 12*). 69% of enterprises will take such actions. These anti-crisis measures hold the first place by their popularity with enterprises of all sizes and among respondents of different ranks (from the director to an average executive). The latter fact illustrates a sort of "class" consensus that formed in the industry during the first three years of the crisis. But the possibility of such response greatly differs by branches. While in ferrous metallurgy, machine-building and construction materials industry over 80% of enterprises are ready to take such measures (and except for ferrous metallurgy they are the most widely spread), in timber processing they are possible at 40% of enterprises, in food industry – at 28%, in electric power industry – at 14% and not at a single enterprise in the non-ferrous metallurgy.

One can suggest that the most likely reason why Russian enterprises name the lowering of wages and switching to a part-time working week first in the list of measures to be taken in response to the crisis is the normalization of situation with wages in the Russian industry after the acute (first?) phase of the current crisis was overcome. This indicator was included in the quarterly questionnaire in 2007 and now permits to trace the assessment of employees' wages by executives. According to estimates of enterprise managers (and these are the ones who take decisions on revision of wages), at the end of 2011 wages reached "normal" levels at 64% of enterprises. On the eve of 2008 crisis only 53% of respondents could provide "normal" wages to their workers (see *Fig. 13*). So, one can assume that in autumn 2011 industrial enterprises had much better opportunities for wage maneuver in case of the crisis escalation as compared with the end of 2008.

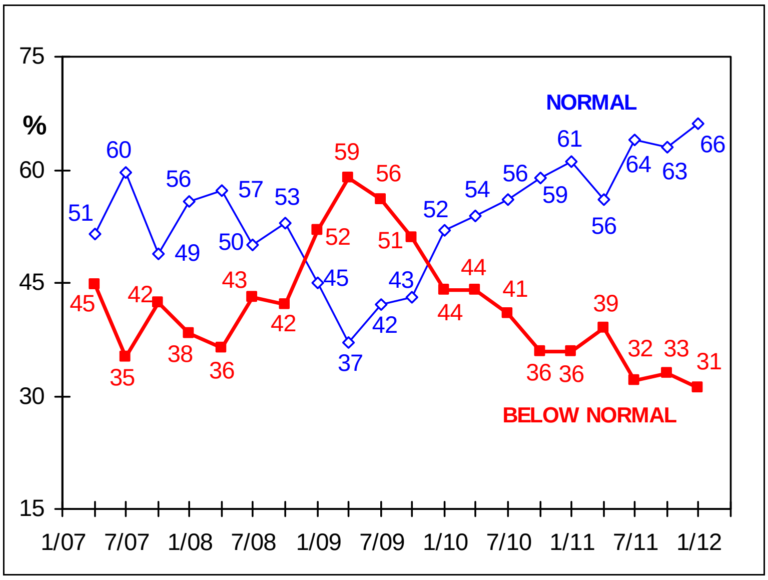


Fig. 13. Assessment of wages paid to workers and specialists by enterprise managers

To check this hypothesis, let's compare the probability of wage responses to the second wave of the crisis by enterprises that pay "normal" wages to their workers and by the ones that assess the paid wages as being "below normal" (see *Fig.14*). It turned out that the "normal" level of wages is not conducive to the lowering of wages and enforcement of a part-time working week in case of the second wave of the crisis. It's rather *vice versa*.

But it seems that the second wave of the crisis can "finish off" enterprises which have failed to restore after the peak of the first wave and still pay insufficient wages to their workers. Such enterprises 1) four times more often expect that their operation will be halted; 2) two times more often are ready to send their workers on unpaid leaves or just simply dismiss them; 3) will more often be forced to reduce output thus further aggravating the situation. Meantime, "delayed payments by buyers" are less acceptable for enterprises with insufficient wages; they are in desperate need of pay for their produce, even in the form of "non-money settlements" which they are twice more ready to accept as compared with enterprises that are able to provide "normal" wages to their workers. The latter will assume more active (aggressive) position in case of the new escalation of the crisis: they are 1.5 times more disposed to intensify marketing and search for new markets.

In December 2008 the lowering of wages and switching to a part-time working week ranked third (59% probability) being surpassed by such classical anti-crisis measures as the lowering of costs and searching for new markets and buyers. As the crisis was overcome, its expected application fell from 43% in the II quarter of 2009 to 28% in the I quarter of 2010. But the actual extent of its use was greater and ranged from 64% to 53%.

Only 37% of enterprises in industry at large are ready to apply the most severe measures – dismissals – in relation to their employees. The probability of such actions does not depend on the size of enterprise but apparently varies by branches (see *Fig.15*). While in non-ferrous metallurgy, timber processing and food industry dismissals are possible at approximately 20% of enterprises, in ferrous metallurgy, machine-building and consumer goods industry this share is as high as almost one half of enterprises. There is also less consent about this extreme measure between executives of different ranks: top-managers are ready to reduce personnel in 40% of cases while average executives – twice more rarely.

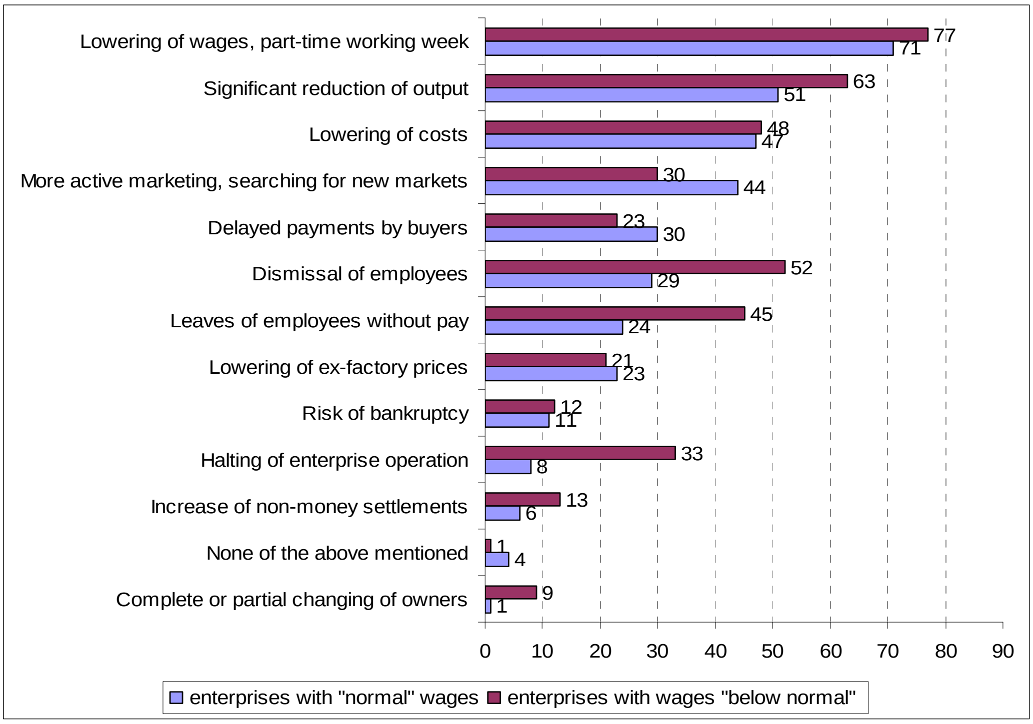


Fig. 14. Possible responses to the second wave of the crisis by enterprises with "normal" wages and those with wages "below normal", %

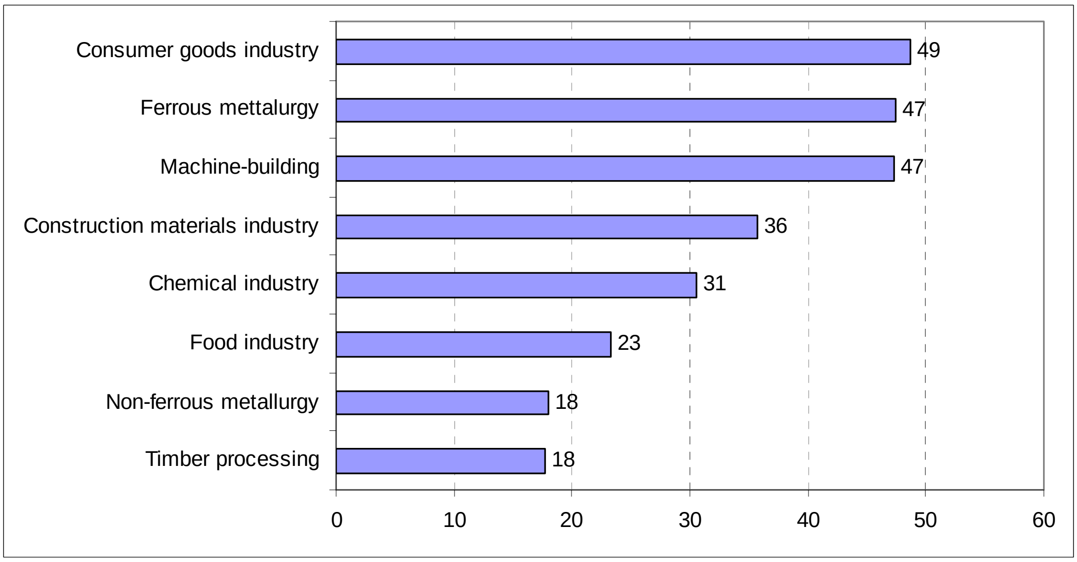


Fig. 15. Probability of dismissals in case of the second wave of the crisis by branches, %

In 2008 the probability of dismissals was estimated by enterprises at 47% and ranged 7th among the after-effects of the crisis. As the situation developed (2009-2010), the lay-off projections were initially registered at 30% of enterprises and then fell down to 24%. Actually they were implemented at 38% of enterprises in the II quarter of 2009, with further reduction of this share down to 30% in the I quarter of 2010. The higher initial estimate of lay-offs' probability as compared with later projections and even the actual implementation is most likely due to the surprisingly active (sometimes even too active) efforts of the government to halt dismissals as compared with the respective efforts (or, to be exact, their total absence) during the previous crisis of 1998. In 2011 enterprises already "adjusted" their projections taking into account the experience of the first wave of the crisis and, probably, national peculiarities of the election campaign. Lay-off projections are also constrained by chronic shortage of skilled labour in industry even in the situation of sluggish and/or fading industrial growth in 2010-2011.

The sending of employees on unpaid leaves is the last in the list of HR policy measures that enterprises are ready to take. The probability of such actions in industry at large is 31%. Their application rate won't depend on the size of enterprises but will differ greatly by branches. Similar to dismissals, their most active use is probable in ferrous metallurgy (56% of enterprises), consumer goods industry (39%) and machine-building (37%). As compared with other HR policy tools, their probability is high in non-ferrous metallurgy (33%). Such practices will be less spread in food industry (15%) and timber processing (17%).

In 2011 "significant (15% and more) reduction of output" held the second place among possible anti-crisis actions of enterprises. 54% of producers in industry at large were ready to take this step. It was named second by enterprises of all sizes and by only two branches (machine-building and construction materials industry). At the same time, in ferrous metallurgy the reduction of output will be the most popular response to the crisis as claimed by 96% of factories in this sector (see *Fig. 16*). No other anti-crisis measure has such a high rating neither in industry at large nor in any of the surveyed categories of enterprises. Meantime, in food industry and non-ferrous metallurgy the probability of output reductions in case of the second wave of the crisis is the lowest.

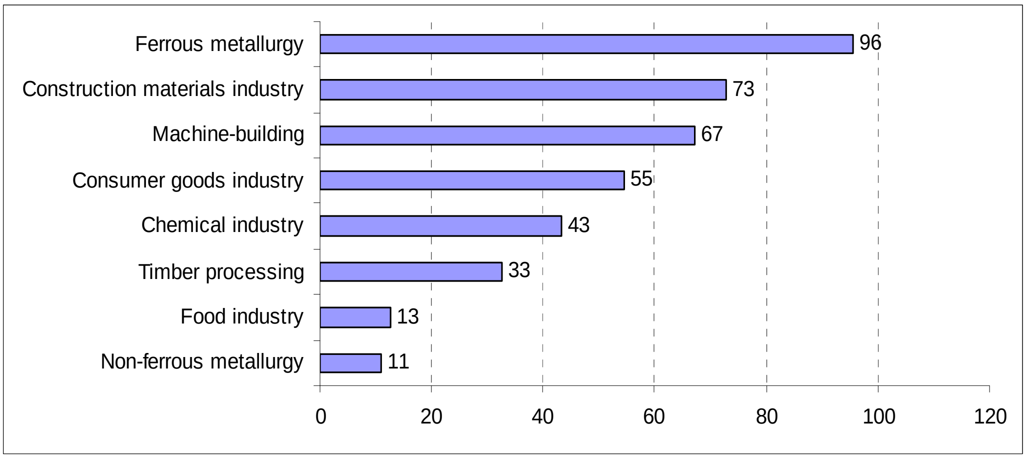


Fig. 16. Probability of output reductions in case of the second wave of the crisis by branches, %

Although at the end of 2008 the reduction of output ranked only 4th in the list with 56% probability, the realities of the first quarters of the crisis turned out to be more tough. At the beginning of 2009 75% of enterprises reported the actual reduction of output. By the I quarter of 2010 this figure fell down to only 62%. For this indicator the gap between enterprise projections and the severe reality was the biggest. In the II quarter of 2009 the reduction of output was projected by only 40% of enterprises, and by the end of monitoring their share fell down to 24%. But in fact no such (or even close) results were obtained within that period.

At the onset of the crisis (i.e. in December 2008) Russian industrial enterprises gave preference to the two classical anti-crisis measures: the lowering of costs (77% probability) and more active marketing and search for new buyers and markets (78%). The almost three-year-long crisis experience of 2009-2011 made them revise their attitude towards these measures. In 2011 only 46% of producers were ready to cut costs and only 39% of enterprises believed in the efficiency of efforts to intensify marketing and search for new markets and buyers. The probability of (and opportunity for) lowering unit costs in case of the second wave of the crisis is the highest in metallurgy (53% in ferrous metallurgy and 62% in non-ferrous metallurgy). Similar projections are made by enterprises of chemical (53%) and food (48%) industries. The reserves for cutting costs in case of the new phase of the crisis are the smallest in machine-building (43%) and construction materials industry (36%). The most optimistic about the effects of marketing and search for new buyers and markets are enterprises of food industry (60%) and ferrous metallurgy (53%) while enterprises of non-ferrous metallurgy have almost lost belief in these tools – only 9% of them will attempt to take respective steps.

The analysis of possible responses of enterprises to the second wave of the crisis revealed that industry at large is ready to face it with due regard to its own experience and actions of authorities during the first wave thereof. Enterprises will respond to the inevitable reduction of output by the lowering of costs and dismissal of employees. The switching to non-money forms of settlement for the produce with a view to preserve the staff and continue operation is very unlikely as proved by the first wave of the crisis in 2008-2009. Therefore, one should not expect the growth of barter transactions (so much feared by observers at the onset of the crisis). But the second wave of the crisis can lead to the liquidation of inefficient enterprises that have survived owing to the state support and resources accumulated in 2003-2008. Three years of sluggish crisis have lowered the safety margin of our industry, and the feebleness of hopes for the restoration of former economic growth rates appears to undermine the optimism of owners and managers in fighting for survival of their enterprises.

4.2.2. Dynamics of demand and output

At the beginning of the year the volumes of sales traditionally demonstrated negative dynamics according to the initial (prior to adjustment for seasonality) data. The growth rates (the balance of change) lost 21 points and fell deep below zero, which, however, was the pattern observed in all the non-crisis years and became habitual for enterprises. Adjustment for the seasonal and calendar factors leveled off the situation: sales of industrial products continued growing. On the contrary, demand projections in January seriously improved. Within a month the balance of initial responses increased by 32 points which is also a normal change for this indicator. Adjustment for seasonality flattened out the January surge of optimism and as a result a slight worsening of projections compared with December expectations was registered.

The dynamics of output in the early 2011 was also quite typical. The initial data indicated the reverse from December growth to January decline with the balance decreasing by 45 points at a time. However, adjustment for seasonality flattened out this sharp swing in output dynamics: just a slowing down of growth took place in January. Production projections also underwent expectable changes in January: the pessimism of November-December was superseded by high optimism traditional for the start of a year. When adjusted for seasonality, no principal changes were traced in enterprises' projections: as before, industry expected quite acceptable (by crisis standards) rates of production growth in February-March.

The February data demonstrated only the halting of decrease in demand but not its growth. Adjustment for seasonality also revealed no growth of sales in February. Demand projections (initial) in February improved by 10 more points and reached a maximum for the pre-crisis and crisis period. No similar prevalence of sales growth expectations over their decline expectations had been registered since July 2008. Adjustment for seasonality flattened out the optimism of initial expectations down to the average level of the 5 preceding months: beginning from October 2010 the most stable and optimistic projections for demand growth were registered in industry.

In February the initial output growth rates (in case of surveys – the balance of responses) restored after the January decrease up to the average indicators of the IV quarter of 2010. Adjustment for seasonality left this result unchanged. According to estimates of enterprises, production growth rates remained at approximately the same level since May 2010. Initial production projections grew by 15 points in February and also attained a maximum for the pre-crisis and crisis period. Growth of output was expected in all branches, the most intensive one – in ferrous metallurgy and construction materials industry. Adjustment for seasonality leveled off the January-February soaring of projections down to the level typical for previous months.

In March the formal increase of initial sales growth rates up to +9 points from +3 points in February was flattened out by adjustment for seasonality: the growth of sales at the end of the quarter apparently ceased. So, the balance of demand change (growth rates) lost 9 points from the start of the year and became zero after having been apparently positive. No similar slowdown in recovery from the crisis had been ever recorded. Negative dynamics of sales affected projections made for them. After the most optimistic crisis expectations recorded in December 2010, by the end of the I quarter of 2011 the balance of projections lost 7 points and fell to an 8-month minimum.

However, the rates of output change still demonstrated (albeit slow) resumption of production growth after the traditional January drop and the return to average levels recorded in the previous 11 months. As a result the divergence between output and demand dynamics grew bigger. In March 2011 only 58% of enterprises reported similar changes in sales and output (in January – 65%, in February – 62%) while at 35% of enterprises output outpaced demand (in January – at 14% of enterprises, in February – at 28%). Such a low level of the first indicator and such a high level of the second had not been observed in the Russian industry since April 2008. Meantime production projections of enterprises indicated that they were not ready to bring output growth rates in compliance with demand dynamics. In March the share of factories where the projected increase of output exceeded the increase of demand projections, reached 25% which was an 8-month maximum. And only 68% of enterprises were ready to change output in line with the expected demand dynamics (a minimum for the same 8 months).

In April the initial rates of demand growth fell down to zero after the crisis record they set in March, i.e. sales ceased growing. Adjustment for seasonality further worsened the April indicators that consequently showed an absolute reduction of demand by -7 points (see *Fig. 17*). Such an intensive decrease of demand for industrial products had not been registered by surveys since January 2010. Similar radical revisions took place in sales projections. According to initial data, by April they fell down to +12 points following the previous crisis record of +31 points that was registered in February 2011. Adjustment for the seasonal and calendar factors indicated stabilization of sales projections at +4 points which was a 15-month minimum.

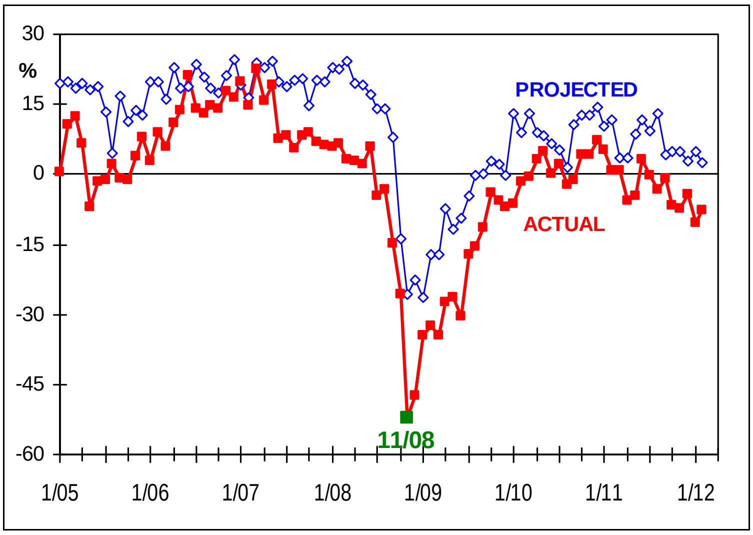


Fig. 17. Change of solvent demand adjusted for seasonality
(balance = % growth - % decrease)

In May the lowering of demand for industrial products continued. The seasonally adjusted data displayed a decrease at the rate of -5 points. As a result sales growth rates lost 13 points from December 2010, i.e. an apparent growth of demand was superseded by its equally apparent reduction. But enterprises expected that in the following months this negative trend would be reversed. In May output growth rates (according to initial data) continued falling but remained positive, i.e. production went on growing. Adjustment for seasonality indicated the preservation of April growth rates (minimal from February 2010) in May.

In June the dynamics of demand underwent the greatest positive changes. Sales growth rates (after seasonal adjustment) increased by 9 points within a month and altered sign: reduction of demand in May (-5 points) was followed by increase of sales in June (+4 points). Higher growth rates of sales at the stage of recovery from the crisis were registered only twice. Production quite adequately responded to larger sales: output growth rates according to both the initial and seasonally adjusted data demonstrated rise up to the best crisis levels. The adjusted balance (output growth rate) was up 4 points. In June production projections of enterprises continued to improve and reached a 3-year maximum (according to data adjusted for seasonality), i.e. the Russian industry had never been so optimistic about the growth of output since July 2008.

But in July 2011 sales failed to sustain the June achievements and demonstrated an apparent slowing down as judged from initial data and zero growth as judged from seasonally adjusted data. So, the demand for industrial products was still slack and its growth – unstable. However, demand projections remained optimistic. In the three previous months they improved by 9 points and as a result reached a 3-year maximum, i.e. the expectations of sales expansion in industry were the most positive since July 2008. Negative dynamics of demand resulted in the slowing down of production growth in July. After seasonal adjustment the balance of this indicator returned to the average level of January-May 2011. The halting of sales expansion and worse assessments of finished goods stocks had a negative impact on production projections. After 3 months of their improvement enterprises decided to reduce output growth rates in the following months.

In August the actual dynamics of demand for industrial products continued to deteriorate. The growth rates of sales fell down to zero as judged from initial data and became negative as judged from seasonally adjusted data – after the June upsurge, the demand for industrial products resumed weakening. Negative trends in sales were registered in all branches except machine-building. But then demand projections evidenced that enterprises still went on hoping for revitalization of sales in autumn. Both initial and seasonally adjusted expectations improved in August. The latter even attained a 3-year (i.e. crisis) maximum. Despite a clear worsening of demand dynamics, the intensity of output growth in August increased according to all data. As a result the changes in production outpaced changes in demand at 28% of enterprises while in the previous two months this indicator equaled only 22% and in 2010 averaged 24%. Production projections of enterprises improved as well: slightly – as judged from initial data, and up to a crisis maximum – as judged from seasonally adjusted data.

According to estimates of enterprises, in September the demand for produce in industry at large apparently stopped growing. Surveys indicated its stagnation for the second month in turn as judged from initial data and for the third month in turn – as judged from seasonally adjusted data. However, if one excludes a slight increase of sales in June, the stagnation went on since the start of the year.

Until August industrial enterprises still cherished hopes for the revival of demand. In September these illusions were superseded by a drastic revision of projections: within a month the balance of expectations dropped from +13 to -10 points as judged from the initial data. Adjustment for seasonality indicated its lowering from +13 to +4 points. Negative trends in the expected dynamics of sales (either a slowing down of growth or an absolute reduction) were recorded in all branches except for food industry.

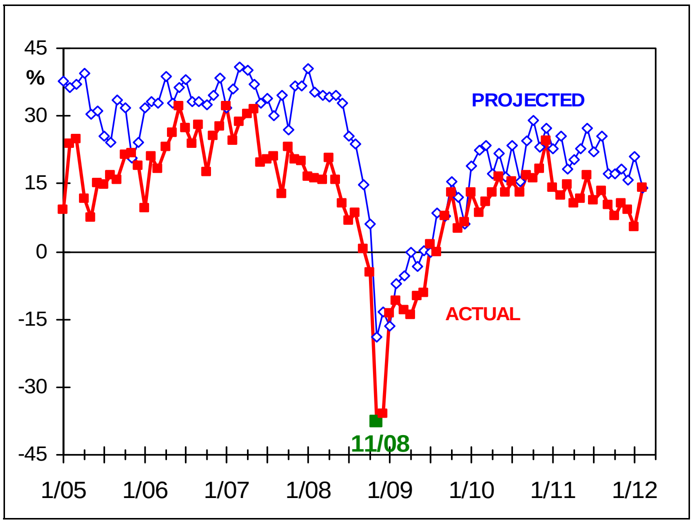


Fig. 18. Change of output adjusted for seasonality
(balance = % growth - % decrease)

According to initial data, in September the intensity of production growth decreased by 10 points as compared with August, and when adjusted for seasonality hit the bottom for the previous 18 months (see *Fig. 18*). Russian industry was struggling to sustain output growth in the conditions of clearly stagnating demand, growing surplus of stocks and nervousness on the world markets. In August dynamics of production outpaced dynamics of demand at 30% of enterprises, in September – at 26%, and projections for October-November suggested that this trend would persist at 26% of enterprises. The latter indicator was a 45-month maximum. In other words, production projections had never diverged so much from the demand projections since January 2008. And all this even despite the fact that the balance of output projections in September fell to +7 points down from +25 points in August as judged from initial data and down to a 13-month minimum as judged from seasonally adjusted data.

In October the absolute reduction of demand continued. The initial balance fell to -7 points and when adjusted for seasonality – down to -4 points. Since the start of 2010 a more intensive drop of sales was registered only once – in April 2011. Initial demand projections remained negative for the second month in turn, i.e. downward expectations in industry prevailed over upward expectations. Adjustment for seasonality changed the sign of October projections' balance for "+"; however, the value of this indicator was the lowest since May 2011.

In November 2011 surveys revealed more intensive lowering of demand for industrial products. The initial balance (growth rate) of sales fell by 6 more points (down to -16 points) and as a result became comparable to indications that used to be registered in January in pre-crisis years and in the current year. Adjustment for seasonality corrected the balance to -9 points which was the worst indicator since September 2009. Demand projections after the September nose-dive by 22 points lost 15 more points in November. As a result the November balance of projections (before adjustment for seasonality) was as low as -20 points. Over the 20-year history of surveys the values of this indicator were worse only 3 times: in 1998, 2008 and 2009. So, at the end of the year industry had very faint hopes for the revival of demand. However, formal methods of adjustment for seasonality leveled off the pessimism of enterprises and reversed the sign of demand projections balance from "-" to "+". Still, its value remained minimal for the current year and was clearly behind projections of late 2010.

In November production growth rates didn't change as judged from either initial or seasonally adjusted data. The initial balance in November (as well as in the previous months) was around zero and remained the worst (certainly, excluding the nation-wide January time-out) since the start of 2010. Adjustment for seasonality increased its absolute value but left it at the minimal level since March 2010. Enterprises didn't trace any revival in industry.

They didn't expect it in the coming months either. In November production projections of enterprises (before adjustment for seasonality) fell by 16 more points and became negative (there appeared more enterprises planning to cut output) thus continuing the downward trend that formed at the beginning of the second half of 2011. As a result within the 5 preceding months these projections lost 45 points while within the same period of the previous year the loss was 25 points. Adjustment for seasonality smoothed out the situation and stabilized output projections for September-November at one level, albeit the lowest in 2011 and 9 balance points below the level of September-November 2010.

At the beginning of 2012 the demand for industrial products sharply dropped which was usual for the period of national vacations. However, this time the January plunge of sales was a continuation of negative trends in demand dynamics that formed in September 2011 when sales stopped growing and started to fall with increasing intensity. In January 2012 these accelerating rates of decline were as high as in no other January since the 1998 default (certainly, except for the crisis January of 2009). Adjustment for seasonality smoothed out this result but only to the level of the worst growth rate since September 2009. Meantime, an apparent lowering of sales is going on since October 2011.

In 2011 a new configuration of constraints to production growth started forming in industry that reflected the specifics of sluggish recovery from the 2008 crisis (see *Fig.19*). First, in the first three quarters of 2011 the constraining effect of short demand increased by 8 points after the crisis minimum of late 2010. Enterprises clearly expected a more dynamic revival of demand. Second, the negative impact of working capital shortage reduced (as judged from the average annual data) down to the historical minimum. In 2011 it was mentioned by only 30% of enterprises while the best indicator for inter-crises period equaled 34% (in 2007). So, as it's customary to say nowadays, industry has surpassed the pre-crisis level by this indicator. Third, staff constraints to industrial growth continue to aggravate. In 2011 the share of enterprises where shortage of employees constrained production equaled 28% as compared with 25% in 2010, notwithstanding slow and unstable growth of both demand and output. Fourth, in the first three quarters of 2011 the constraining effect of competition with import decreased and stabilized after a steady growth in 2009-2010. It's all the more noteworthy given a sizable increase of imports according to the official statistical data and an apparent stagnation of demand for domestic products. This combination of factors leads to the conclusion that in early 2011 imported items were not considered by enterprises as competing. And one more conclusion: domestic statistics are sometimes not as bad as their … interpretation. Fifth, the negative impact of non-payments, so much feared of at the beginning of the crisis, has stabilized although not at such a low level that was registered in 2007 – early 2008. Sixth, in the III quarter of 2011 the mentioning of shortage of credits (as a hindrance to output growth) fell down to a concern-triggering level of 2%. The effective supply (and terms) of credits is such that industry does not need its further expansion for increasing output.

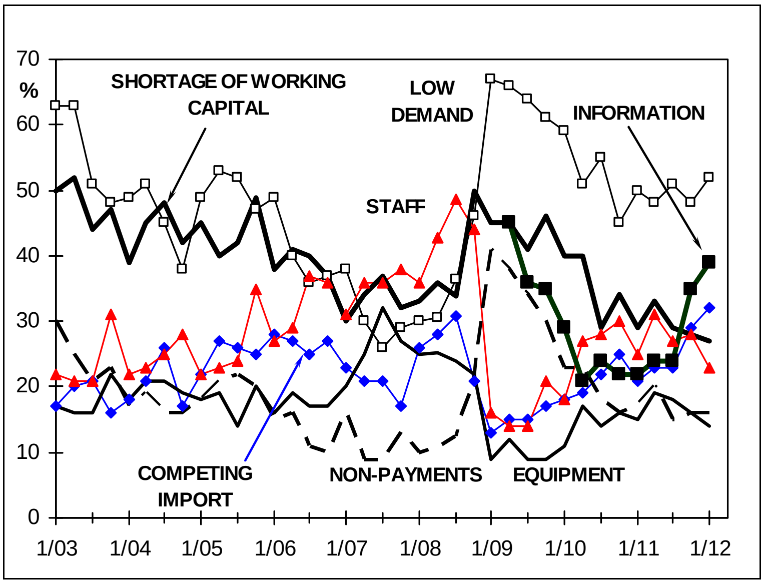


Fig. 19. Constraints to production growth in 2003–2012

At the end of the year the structure of constraints to industrial growth changed due to the growing uncertainty in the world economy and the temporary devaluation of ruble. As before, enterprises regard low demand as a key hindrance to production growth. This factor has been ranking first in the quarterly rating of constraints since the start of the crisis (which is quite explainable). However, in the IV quarter the frequency of its mentioning reduced to 47% as compared with 52% in the III quarter of 2011 and almost reached a post-crisis minimum (45%) registered a year before. The shortage of working capital that ranked second during all the phases of the current crisis was also mentioned less frequently. Moreover, in the IV quarter its constraining effect on the growth of output fell down to a historical minimum (!) over the whole period of monitoring since 1993. The third crisis factor which is hallmark for Russia – non-payments by consumers – now ranks only 8th with a stable share of 17%.

But the IV quarter of 2011 was marked by an apparent increase of constraining effects of two factors: the uncertainty of current economic situation and its further development and the competing import. Within a quarter the mentioning of the former grew from 22% to 38% and as a result brought it to the second place in the rating. Such a surge seems absolutely normal taking into account the persisting uncertainty about the outcome of European debt crisis, other problems on the world markets and poor understandability of Russian state statistics, the monthly interpretation of which looks like guessing from the childish rhyme “maybe snow, maybe hail, maybe sour grapes”.

At the end of 2011 after notable swings of the ruble exchange rate, competing import was considered to be a hindrance to production growth at 27% of Russian industrial enterprises while in the first three quarters of the year it was mentioned by 21-23% of producers. Moreover, the indicator of the last quarter became a post-crisis maximum and closely approached the pre-crisis (and absolute!) maximum of 31% registered in July 2008. It seems that the uncertainty about the ability and/or wish of authorities to safeguard ruble from devaluation makes consumers to more actively spend their savings on the purchase of imported products at not yet inflated prices to the detriment of domestic commodities.

At the beginning of 2012 the new configuration of constraints to output growth continued forming in the Russian industry. Factors that earlier one could hardly suspect of great influence on enterprises are becoming “leaders”, while traditional “sores” of our industry are losing their negative impact on its performance

However, insufficient demand remains a definite and logical leader of the current crisis. It’s mentioned by 51% of enterprises which is 16 points less than at the peak of the crisis but is still the maximum level over the recent 6 quarters.

The factor of uncertainty of the current economic situation and its further development climbed to the second place in autumn 2011 (as the crisis of Eurozone started to aggravate) and seriously reinforced its positions at the beginning of 2012. Its mentioning grew up to 41% although back in summer 2011 only 24% of enterprises complained of it.

The negative impact of competing import on the domestic industry attained its historical (1995-2012!) maximum and now ranks third. At the beginning of 2012 one third of surveyed enterprises suffered from the pressure of import that ousts Russian products from the markets. The pre-crisis maximum of this indicator registered in July 2008 was 31%. Before the 1998 default only 16% of enterprises complained about import. At present its pressure is most detrimental for enterprises in machine-building (41%), ferrous metallurgy (35%) and consumer goods industry (34%).

The negative effect of shortage of working capital fell down to 27% which is a historical minimum (!) of mentioning this constraint. At the peak of the current crisis 50% of enterprises were affected by this factor, while the absolute maximum was registered in 1995 and reached 83%. The picture is completed by an actual lack of negative effect of credit shortage on the output dynamics in Russian industry. For the fourth quarter in turn only 2-3% of enterprises complain about it.

4.2.3. Price policies of enterprises

In January 2011 factory prices demonstrated the highest growth rates over the past 15 years (!), i.e. they had not grown so rapidly since the end of 1995. Within a month their growth rates (i.e. balance in case of surveys) increased from +18 to +50 points. While in December 2010 78% of enterprises (in 2010 – 77% on the average) reported constancy of their prices, in January 2011 the share of such responses fell down to 46%. Certainly, a month before enterprises planned a sizable increase of prices at the beginning of 2011 – but not to such an extent! Plans of enterprises showed their intentions to preserve the high rates of price growth in the coming months. It's projected intensity was somewhat lower but not low enough to stop a powerful inflationary wave that formed in the Russian economy at the end of 2010.

In February the growth of factory prices slowed down by 12 points after the January surge. However, its intensity did not return to the pre-New Year levels: the actual balance of price growth was as high as 35 points while in the IV quarter of 2010 – 17 points. So, enterprises had to raise their prices twice faster than at the end of the previous year. The most intensive growth was registered in ferrous metallurgy, chemical and petrochemical industries. In February factory prices stopped growing only in food industry. Enterprises' projections suggested possible maintaining of February growth rates in March-April. The balance of expected change of this indicator equaled 37 points and remained at the level of January projections.

In February 2011 unit costs at industrial enterprises demonstrated the most intensive growth since the onset of the crisis which was quite exactly forecasted back in November 2010. The biggest increase took place in ferrous metallurgy (balance +73 p.p.), timber processing, consumer goods industry and machine-building (+64 p.p. in each), chemical and petrochemical industries (+61 p.p.).

However, in March the inflationary wave that formed in the Russian economy at the end of 2010 – the beginning of 2011 started to fade out. The actual rates of price growth halved as compared with the January surge – down from 47 to 23 balance points. It's worth noting that in the IV quarter of 2010 surveys registered growth of factory prices at the rate of 17 b.p., in the III quarter – 7 b.p. In March the actual growth of prices decelerated in all branches except for chemical industry and construction materials industry. For the second month in turn it was the slowest in food industry. Price projections experienced similar adjustments. After the December surge they lost 14 points and approached the level of November 2010.

In April inflation continued to decelerate (see *Fig. 20*). As compared with January the rate of price growth fell by 28 points and returned to the level of the IV quarter of 2010. Similar changes occurred in price projections: as compared with the peak of December 2010 they lost 27 points.

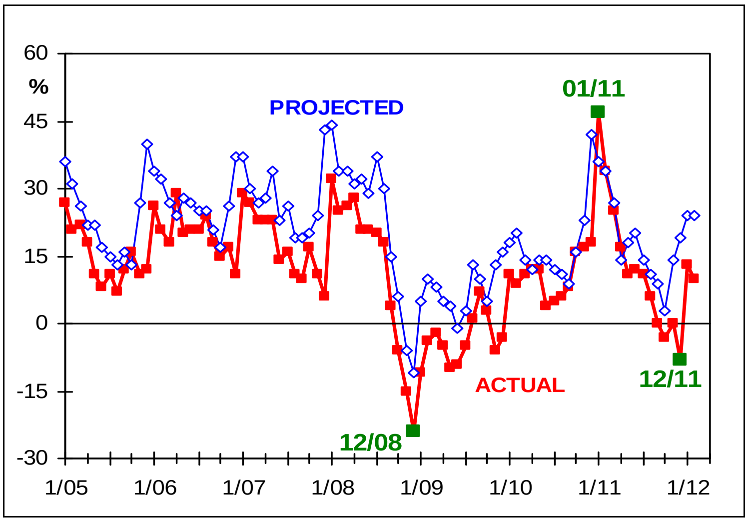


Fig. 20. Change of factory prices (balance = % growth - % decrease)

In May the growth of factory prices slowed down once again but only by 4 points. As a result within the 4 preceding months its intensity decreased 3.5 fold (as judged from balance). However, further lowering of this indicator was already questionable. In May enterprises' projections indicated the reversal of their price policies. While from January to April price projections steadily declined, in May this trend discontinued, and for the first time in 2011 Russian producers declared their intention to accelerate growth of prices or at least stop its deceleration.

Indeed, in June the slowing down of price growth recorded by surveys since February seemed to halt. The balance stopped falling which indicated the preservation of May growth rates. It's possible that the increase of sales enabled enterprises to modify their price policies and halt the decline of price change balance (rate) that lost 36 points within the previous 4 months. Price projections of enterprises reflected this intention in May and proved it in June. Within these 2 months the balance between upward and downward price projections remained actually unchanged and was somewhat above the indications of April that were the lowest since October 2010. It's noteworthy that it was last October when an inflationary wave formed in Russian industry, generated by drought and the forthcoming raising of unified social tax (UST). In December 2010 (as judged from expectations) and in January 2011 (as judged from the actual growth) it reached its peak.

In July the growth rates of prices for industrial products remained the same as in June. Price projections of enterprises didn't change either and reflected the intention of producers to halt the slowdown of factory price growth that was observed in the first months of the year.

Principal changes took place in the growth rates of unit costs in Russian industry (see *Fig. 21*). According to estimates of enterprises, in the III quarter of 2011 unit costs of industrial products grew at minimal rates over the whole period of monitoring this indicator since 1997 (!). Even before the 1998 default the intensity of their growth was 3 times above the current level. Unit cost projections for the III quarter suggested the slowing down of their growth, but not as critical as was actually observed. Probably, it was this factor that primarily conditioned the preservation of high (as compared with demand) growth rates of output and replenishment of finished goods stocks that enterprises planned to sell in autumn and winter when prices and costs returned to their usual growth patterns.

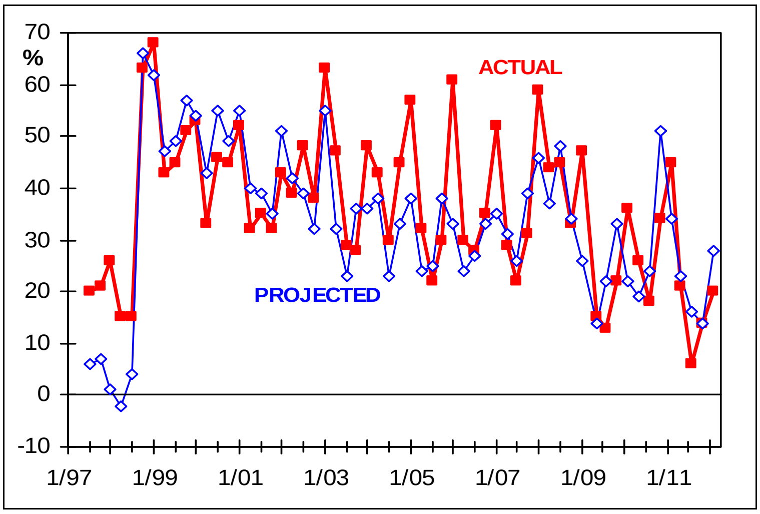


Fig. 21. Change of unit costs (balance = % growth - % decrease)

Long-term stagnation of demand and attempts to sustain output growth made enterprises return to the application of price levers. In August the growth rates of prices once again declined and in September producers refrained from raising prices for the first time since January 2010. Russian industry rarely resorted to this tool: the halting of factory prices growth and their further lowering was registered by surveys on the eve of the 1998 default, on the eve of the 2008 crisis and on the exit from the 2008 crisis.

Price projections of enterprises also continued falling but not as rapidly as in the first half of the year when industry restored status quo after the traditional New Year surge of tariffs that this time was reinforced by the increase of social insurance rates. Within the III quarter price projections of enterprises lost 11 points, in September – only 2 points.

Negative dynamics of sales forced industrial enterprises to more actively use price policies with a view to revive demand. While in September factory prices stopped growing, in October they started to decline absolutely. Last time industry resorted to this tool in December 2009. But then the actual lowering of prices was accompanied by projections of their traditional growth at the beginning of next year. In October 2011 the situation was principally different. The decision of the RF Government to protract the raising of tariffs (that used to take place in January) and thus to smoothen the usual surge of prices at the beginning of the year prevented the traditional rise of enterprises' price projections at the end of the year. From the beginning of the second half of the year the balance of industrial price projections lost 17 points, from the start of the year – 40 points and was close to demonstrating the industry's intention to refrain from raising prices at the stage of projections as well. Similar situation was earlier observed only in 1998 and 2008.

In November industrial enterprises attempted to reverse the downward trend in price growth for the second time since the start of the year. The first attempt was made in May-July. Then price growth rates stabilized at the level of 11 points after 4 months of lowering from the record 47 points (the highest indicator in the post-default period). In November the general balance experienced actually no change and remained in the zero area: factory prices neither grew, nor fell.

In November price projections of enterprises were most seriously revised. While a month before growth expectations were minimal, at the end of the year industry planned to return to the sizable raising of prices. Within a month the balance of projections was up 9 points.

During almost all months of 2011 industrial enterprises pursued similar price policies of halting factory price growth after the January surge of this indicator that was due to both the man-made factors (the raising of unified social tax) and natural calamities (the drought of 2010). The combination of these two factors conditioned the soaring of price change balance up to the record level in January 2011. The end of the year was no less unique: in December 2011 enterprises shifted to quite an intensive lowering of their prices. Over the 17 years of monitoring a higher rate of decrease was observed only in December 2008 and in July 1998. And one more remark: within the pre-crisis 2008 the balance fell by 56 points (the indicator of the crisis December being -24 balance points), in 2011 – by 55 points (the December indicator being -8 balance points).

4.2.4. Staff problems of Russian industry

The dynamics of employment in Russian industry in 2011 experienced minimal state interference as regards both the prevention of dismissals at the stage of slowing recovery from the crisis and the provision of industry with personnel. In the situation of constant shortage of staff enterprises pursued cautious HR policies.

Last year the annual rates of employment change were close to zero, i.e. on the average the share of responses stating lay-off of employees was equal to the share of responses stating their hire. Similar result was obtained in 2010. In 2009 dismissals prevailed over hire by 23 p.p. But 2011 differs from all the previous crisis and inter-crises years by the maximum share of responses stating no change in the number of employed. This indicator reached 76% as compared with 73% in 2010. It was minimal (62%) in 2009 when dismissals in industry were most sizable over the whole period of monitoring actual employment in 2003-2011.

At the beginning of 2011 the number of employed in industry notably reduced. After 4 months of fluctuations around zero in late 2010, in January the initial (i.e. not adjusted for seasonality) balance of staff change lost 10 points and reached a 12-month minimum – enterprises carried out the most radical lay-offs (see *Fig. 22*). However, adjustment for seasonality reversed zero and negative balances into positive (i.e. industrial enterprises still hired staff).

Equal by importance but opposite by direction changes took place in HR projections of enterprises. In January the initial balance of employment projections increased by 16 points, became clearly positive and reached a crisis maximum. In other words, after 3 months of prevailing lay-off intentions enterprises planned to switch to the most intensive recruiting of personnel. Adjustment for seasonality revealed the highest optimism of recruitment projections in December 2010 and its slight decline in January 2011.

Industrial enterprises were impelled to intensively hire personnel in order to adjust employment to demand projections. At the beginning of the year the balance between these indicators once again (similar to mid-2010) became negative – enterprises felt short of employees for the expected growth of sales and output. Facility projections also supported hopes for the resumption of demand and output growth. In January 2011 after 3 quarters of stabilization (in 2010) the balance of these projections fell by 11 points and became zero – industry got rid of surplus facilities (so far – only as related to demand projections).

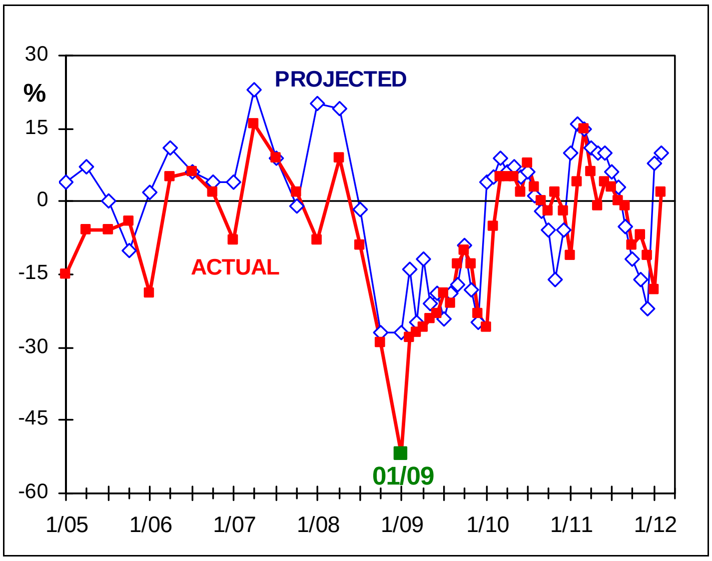


Fig. 22. Change of employment (balance = % growth – % decrease)

In February enterprises resumed hiring of personnel (as judged from initial data). However, seasonal adjustment reduced this indicator down to zero implying that the recruitment was not intensive enough when compared with previous years. Meantime, the initial HR projections for March-April reached a crisis maximum (i.e. the prevalence of hire intentions over lay-off intentions in industry had never been so convincing since the III quarter of 2008). Adjustment for seasonality lowered the post-crisis record but not much, leaving the early 2011 projections at one of the highest levels over this period (see *Fig. 23*). So, the high optimism of demand and output projections as well as the vanishing of labour surplus (however – only as related to demand projections) pushed up both the actual and the projected intensity of staff recruitment.

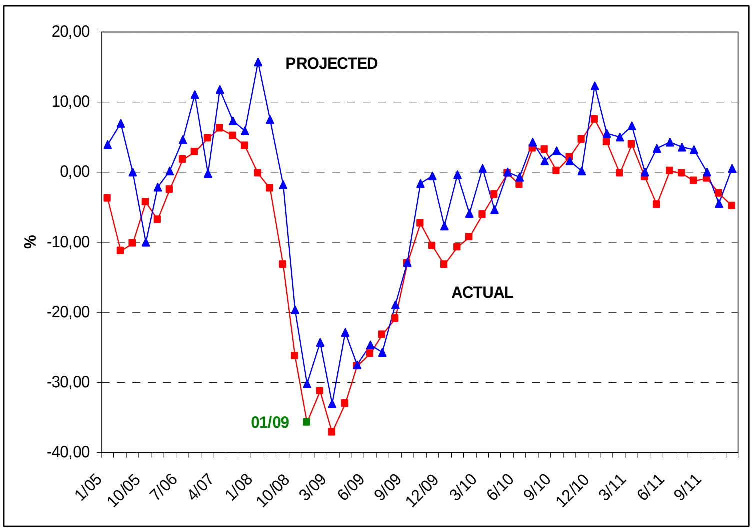


Fig. 23. Change of employment adjusted for seasonality
(balance = % growth – % decrease)

The end of the I quarter was marked by record by its intensity hiring of personnel in Russian industry. In March its rate increased up to +17 balance points and reached the maximum level of the last 4 years (!), i.e. such a massive recruitment had not been observed since the spring of 2007. Adjustment for seasonality lowered the initial result but not much, leaving it on the second place after an absolute post-crisis record of December 2010. So, in February enterprises made quite correct projections about the scale of personnel recruitment in March. Then they amounted to +15 balance points and reached a crisis maximum.

In April the rates of hiring employees in industry fell (when adjusted for seasonality – down to zero) after being maximal in March. HR projections underwent similar adjustment. It seems that enterprises continued hiring labour as a reserve because of the fear (quite well-grounded, by the way) to face a deficit of this input in case of sustainable growth of demand. Shortage of personnel as related to demand projections had been registered in industry since the III quarter of 2010. In the II quarter of 2011 it was recorded in all branches except for the construction materials industry.

Since the II quarter of 2010 the shortage of personnel ranked third in the rating of constraints to industrial growth (as assessed by enterprises). Only insufficient demand and deficit of working capital were mentioned more often. In the II quarter of 2011 32% of enterprises considered shortage of personnel to be a hindrance to output growth. The crisis (2008) minimum of its mentioning was 14% registered in the II and the III quarters of 2009. The pre-crisis and absolute maximum equals 46% registered in the III quarter of 2008.

In May industry halted (according to the initial data) the hiring of personnel that went on in the previous 3 months. After being record in March, the rate of employment growth lost 15 points within 2 months and approached zero. Further adjustment for seasonality revealed an absolute reduction of the number of employed. However, as judged from HR projections, at that time Russian industrial enterprises did not intend to continue lay-offs. In May the initial balance of HR projections remained actually at the April level and when adjusted for seasonality even improved.

In June in response to larger sales industry resumed hiring personnel and continued it in July which could be due to the persisting shortage of workers. According to estimates of enterprises, in the III quarter of 2011 industry still experienced deficit of staff as related to demand projections. It was registered at 15% of enterprises versus surplus of labour at 8% thereof. Both figures were close to the post-crisis records. As a result their balance fell down to nearly a post-crisis minimum. But at the stage of recovery from the crisis most enterprises still managed to improve labour sufficiency as related to demand projections. In the III quarter of 2011 the share of enterprises with sufficient number of employees reached 78% which became an absolute record over the whole period of monitoring this indicator since 1996.

However, the deficit of personnel seems to have produced a positive effect on the Russian industry. Shortage of workers made enterprises improve the productivity of labour. In the middle of 2011 it was estimated as “normal” by already 70% of enterprises (see *Fig. 24*). The pre-crisis maximum equaled 65%, the crisis minimum – 44%. Fully satisfied with labour productivity were all enterprises in fuel industry and metallurgy, 86% - in chemical industry and 79% – in food industry. The lowest satisfaction with this indicator was noted in construction materials industry (49%), timber processing (55%) and consumer goods industry (56%). Such estimates of labour productivity by enterprises reduce the number of advocates of state industrial policies assessing its level as low and definitely requiring improvement.

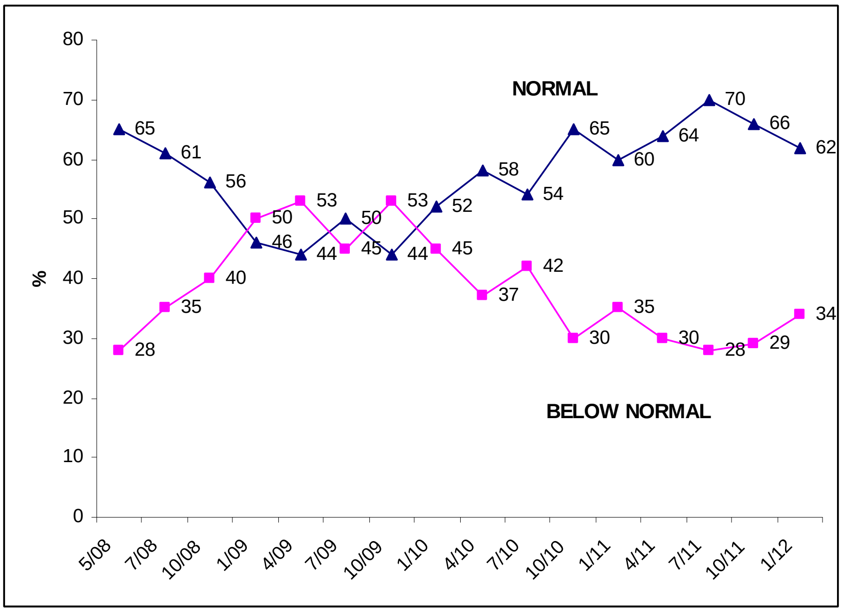


Fig. 24. Assessment of labour productivity by Russian industrial enterprises

Another consequence of the deficit of personnel was the growth of wages in industry or, to be more precise, - of the share of enterprises, the administration of which considered the level of wages to be "normal" and thus not requiring raising. In the III quarter of 2011 such level of labour remuneration was attained at 65% of enterprises which was also an absolute record over the whole period of monitoring this indicator since 2007. The biggest share of enterprises with "normal" wages was observed in fuel, metallurgical, chemical and food industries.

In August the negative dynamics of demand resulted in the halting of personnel recruitment by industrial enterprises: in industry at large the share of responses stating expansion of staff equaled the share of responses stating its reduction. Adjustment for seasonality left the zero value of August balance unchanged.

But in September industrial enterprises switched to dismissing employees. Then the intensity of dismissals was minimal but it was well "in tune with" the trend of the previous months. Projections of enterprises showed their readiness for more intensive lay-offs. Within a month the balance of HR projections deteriorated by 6 points and changed the sign: from +3 points in August (indicating moderate plans for hiring personnel) down to -3 points in September (indicating equally moderate plans to cut the number of employed). However, adjustment for seasonality leveled off the situation bringing the balance up to zero.

Large-scale dismissals started in industry in October. While in the previous 8 months enterprises managed to enlarge staff or at least preserve the number of employed, at the beginning of the IV quarter dismissals clearly prevailed over hiring according to both the initial and seasonally adjusted data. This was the case for actually all industries. The only exception was food industry where the balance remained zero. The most intensive lay-offs were registered in chemical, construction materials and consumer goods industries. Projections of enterprises definitely showed their intentions to go on cutting personnel and do so at even higher rates. Indeed, in November dismissals continued. The intensity of this process didn't change and remained at the October level – the highest since March 2010. Adjustment for seasonality gave similar results.

In December the intensity of lay-offs in industry again increased. The balance (rate of change) of this indicator fell to a 23-month minimum, i.e. the number of employed hadn't reduced so rapidly since February 2010. At the end of the year dismissal projections of enterprises also reached record levels since December 2009. This means that the most intensive over the past 2 years reduction of personnel is expected in industry at the beginning of 2012. The value of this indicator was only 10 points behind the record for the current crisis period (registered at end of 2008 – the beginning of 2009). Within 2011 the balance of HR projections lost 33 points and after August (as the crisis of Eurozone started to aggravate) became negative and fell by 20 points within 4 months. In the IV quarter of the last year dismissal (lay-off) projections prevailed in all industries and at all enterprises irrespective of their size and type of ownership. At the end of 2011 enterprises refrained from more massive lay-offs out of fear that in case industrial growth resumed they might fail to find necessary workers and restore the required production volumes. Russian industry remains in this situation since July 2010 when for the first time after the crisis one registered "the shortage of employees as related to demand projections". In October 2011 deficit of personnel was stated by 19% of enterprises which is a post-crisis maximum of this indicator. Before the 2008 crisis it amounted to 26%.

4.2.5. Crediting of industry

In 2011 the credit terms for Russian industry improved by 5 percent points as compared with the 2010 annual average and approached the 2005 level (see *Fig. 25*). Just 9 percent points are separating this indicator from the best annual average registered in 2007. But its achievement in a short time is not as evident as it may seem. First, the bettering of credit terms over the past year is close to the average annual growth rates of this indicator in 2000-2007. Second, the post-crisis restoration of credit terms took place mainly in 2009 (then the indicator was up by 29 points and recovered all losses of late 2008) and is most likely over. The relationships between banks and industrial enterprises are entering the trajectory of smooth changing ("growth" doesn't seem to be the right term for it any longer). Third, the annual curve of credit terms for industry in 2010-2011 supports the thesis that their improvement withers away. Fourth, in the situation of sluggish industrial growth enterprises themselves have smaller need for credits, the shortage of which is no longer a constraint to the increase of output in Russian industry (as stated by producers). It seems that insufficient crediting and low rates of its growth are now becoming a problem of banks rather than industrial borrowers.

At the same time, an insight into the overall picture of improving credit terms reveals the existence of "growth points" in Russian industry.

First, banks have reserves for softening the credit terms up to the pre-crisis levels depending on the size of an enterprise. The estimate of average annual availability of credits by size groups of enterprises indicates that banks have made the biggest progress in restoring the pre-crisis level of access to credits for very large entities (with over 1,000 employees). In 2011 the ""normal" average annual availability of credits for this category of borrowers amounted to 78% and was only 5 points behind the record set in 2007. In the group of large enterprises (with 251-1,000 employees) this indicator equaled 57% which was 12 p.p. below the 2007 record for this group. Small and medium enterprises (up to 250 employees) restored "normal" availability of credits in 42% of cases which is 16 p.p. below the pre-crisis maximum (see

Fig. 26). So, banks can improve the general credit terms for industry primarily by more active crediting of small and medium business.

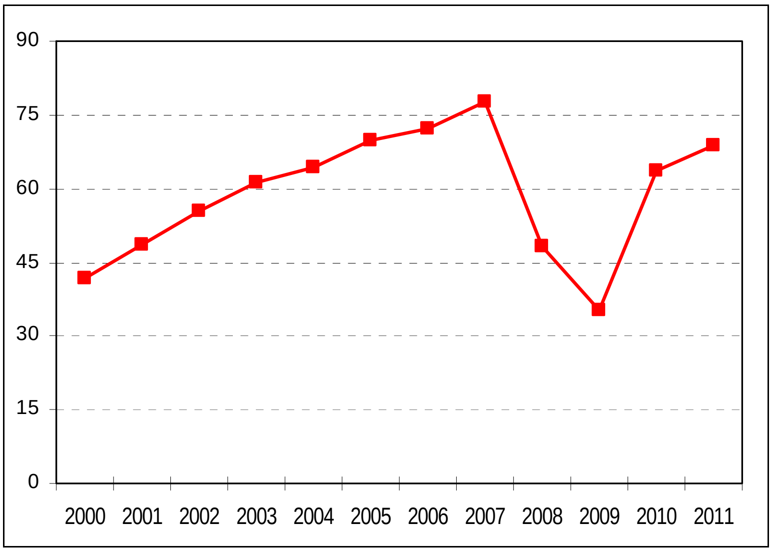


Fig. 25. Share of enterprises with normal availability of credits, %

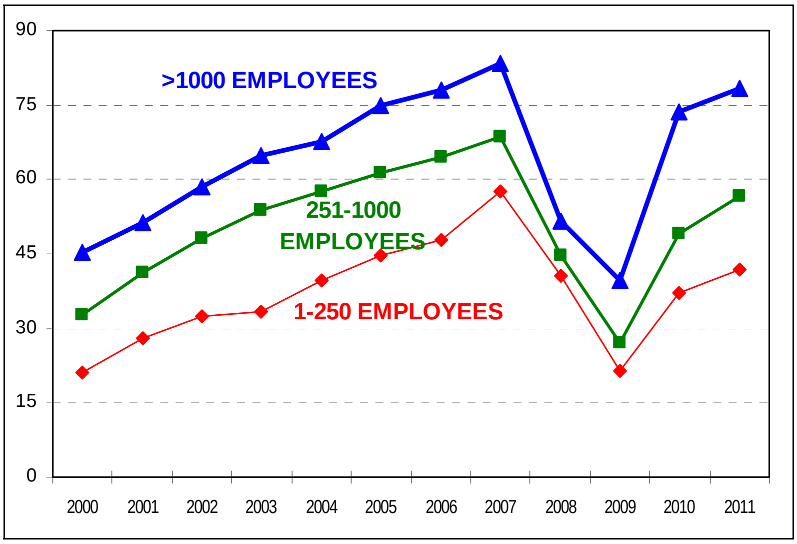


Fig. 26. Share of enterprises with “normal” availability of credits by size groups, %

Second, similar conclusions can be made when analyzing dynamics of “normal” credit availability by branches. The biggest progress in post-crisis crediting was made by banks in metallurgy where already in 2010 81% of enterprises had “normal” access to credits (which was only 5 points below the pre-crisis record) (see *Fig. 27*). But the slowing down of recovery from the crisis in 2011 halted the facilitation of access to credits and probably the very extension of lending scope in the sector as well. In machine-building banks followed quite different policies. In 2010 they improved the availability of credits therein up to the level of 64% and in 2011 raised it to 75%. As a result within 2 years the availability of credits grew by 41 p.p., with the 2011 indicator falling behind the pre-crisis maximum by only 4 points and ranking second among all branches (metallurgy showing somewhat better result). In case these trends continue, machine-building may leave metallurgy behind by the convenience of bank crediting as well. The restoration of access to credits in consumer goods industry faces more difficulties. In 2011 only 39% of enterprises stated "normal" availability of credits which is the lowest indicator among all industries. 22 points separate the current indicator from the pre-crisis maximum (the second result after timber processing). In 2011 banks began to tighten credit terms for the industry notwithstanding the fact that in 2010 the availability of credits therein was the lowest as compared with other branches.

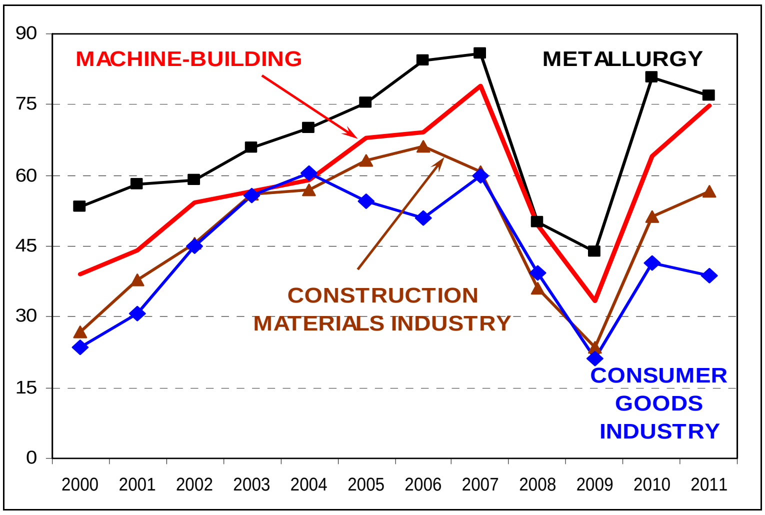


Fig. 27. Share of enterprises with "normal" availability of credits by branches, %

Let's examine the changes in credit terms for Russian industry in 2011.

At the beginning of the year the availability of credits for industry overcame the December drop of 2010. Then the indicator fell by 6 points and became an 8-month minimum. In January it grew by 8 p.p. and reached the pre-crisis level of summer 2008. The minimal interest rate on ruble credits charged by banks resumed falling. In January 2011 credit institutions were ready to lend rubles at 12.7% per annum on the average while enterprises considered "normal" interest rate to be 11.9% (the value of this indicator in case of "normal" availability of credits). The difference between the interest rate for very large enterprises and that for small and medium businesses was 4.5 p.p. although in September 2009 it hardly exceeded 1 p.p.

In February the availability of credits for industry failed to maintain the weak upward trend that formed in November and January. As a result 69% of industrial enterprises were satisfied with their access to bank credits. Meantime the priorities of banks didn't change. The most convenient credit terms were offered to enterprises in metallurgy (in January-February 85% of enterprises therein had "normal" access to credits, the minimal interest rate in February averaged 9.4% per annum), food industry (76% and 11.8%, respectively), chemical and petrochemical industry (72% and 11.2%) and machine building (74% and 12.0%). As usual, on the other pole were consumer goods industry (38% and 13.9%) and construction materials industry (53% and 14.5%). At the beginning of the year credits to small- and medium-sized enterprises (1-250 employees) were available at 14.7% per annum, to very large enterprises (over 1,000 employees) – at 10.6%.

In the I quarter of 2011 the need of industry for borrowed funds remained positive, i.e. the share of enterprises that planned to increase demand for credits (24%) was higher than that of enterprises that planned to reduce it (7%). As compared with the IV quarter of 2010 the balance (i.e. the rate of growth) of this indicator didn't change. But Russian industrial enterprises were not strongly concerned about the shortage of credits. On the one hand, in 2010 banks clearly softened credit terms as regards both interest rates and other parameters. On the other hand, slack economic growth conditioned low demand for credits by enterprises. Therefore, in the I quarter of 2011 the deficit of credits had the smallest constraining effect on the growth of industrial output as compared with other inputs.

At the beginning of the year the ability of industry to service credits amounted to 82%. The credit solvency was the highest in metallurgy (100% of enterprises considered themselves to be solvent), machine-building (83%) and food industry (82%).

Results of the I quarter of 2011 revealed that banks restored credit terms for industry at large to the pre-crisis level and did not intend to further soften them. The evidence of that was the share of enterprises discontent with the availability of borrowed funds. Since August 2010 this indicator stabilized in the interval between 11% and 14%. In the pre-crisis period its smaller (i.e. better) values were registered only in summer 2007. Then 8% of enterprises weren't content with the terms of bank offers (the absolute minimum of 11 years of monitoring). In the I quarter of 2011 ruble credits were available to enterprises at 12.6% per annum at best (similar indicator of the IV quarter of 2010 was 13.0%).

At the beginning of the II quarter the terms of bank credits did not change. “Normal” access to credits was stated by 70% of enterprises in industry at large, by 92% - in metallurgy, by 71% - in chemical industry, by 69% - in machine building. The greatest difficulties in getting credits were encountered by enterprises in consumer goods industry (only 28% of them stated “normal” access to credit funds) and in timber processing (47%). At the start of the year the minimal interest rate charged by the banks also stabilized and amounted to 12.7% per annum. However, the shortage of credits had actually no effect on the output dynamics. In the II quarter of 2010 only 5% of enterprises considered it to be a constraint to production growth.

In the middle of the year the ability of enterprises to service credits already extended to them deteriorated. In May this indicator fell down to 81% (of the number of enterprises having debts under credits) from the record 87% in December 2010. This negative trend is due to an apparent worsening of enterprises' financial performance registered in the II quarter of 2011. Coupled with an absolute decrease of sales and the lack of confidence in the future, it forced enterprises to revise their borrowing projections. In the II quarter of 2011 this indicator fell to +10 b.p. down from +18 b.p. in the IV quarter of 2010. In the middle of the year the highest demand for credits was observed in electric power industry (+32 b.p.), timber processing (+19 b.p.) and consumer goods industry (+16 b.p.). The reduction of demand for credits was projected in metallurgy and construction materials industry.

Despite the uncertain economic situation the availability of credits for industrial enterprises continued to improve. In June 2011 only 8% of enterprises found that banks offered them too rigid credit terms. As a result this indicator reached the historical minimum registered in June 2007. Within the II quarter of 2011 the average share of responses “below normal” in respect to the availability of credits fell to 10% down from 11.6% in the I quarter of 2011 (see *Fig. 28*). So, in the II quarter banks went on softening credit terms for industry.

However, according to the data of RF Central Bank for the I quarter of the year, they planned to stop this softening for corporate borrowers.

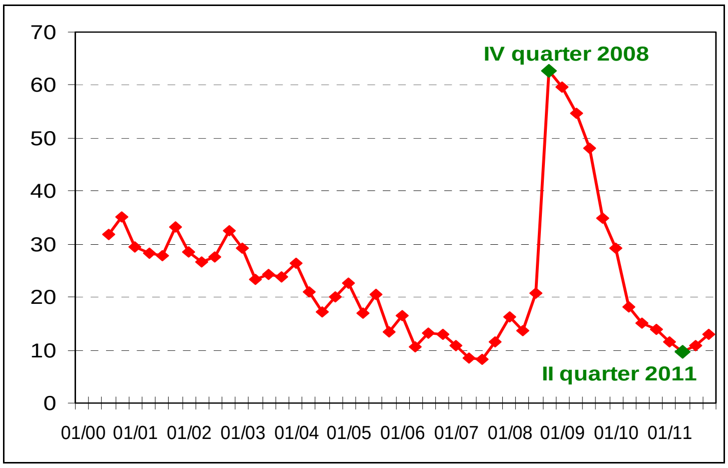


Fig. 28. Share of industrial enterprises with "below normal" availability of credits, average % per quarter

Judging by the dynamics of average minimal interest rates, banks made such an attempt in March-April when they raised the rate first up to 12.8% per annum and then – up to 13% from 12.5% charged in February. But the lack of demand for credits from industry, the pertaining surplus liquidity of the bank system and the difficulty of finding reliable borrowers once again forced banks to reduce interest rates down to 12.5% in May and 12.2% in June.

In July the credit terms for industrial enterprises did not undergo any principal change. The average minimal interest rate on ruble credits offered by banks to industry at large remained at the level of 12.3% per annum. The dependence of interest rate on the size of enterprise persisted as well. In May-July for small- and medium-sized enterprises credits were available at 14.8% per annum, for very large (over 1,000 employees) – at 10.5%.

In August the credit terms offered by banks to industry remained the most convenient from the onset of the crisis: 72% of enterprises considered them to be "normal" and 5% - even "better than normal". In June-August the latter indicator stabilized in the interval from 5 to 6% which was a sign of insistent offering of money (not much needed in the situation of sluggish demand) by banks to enterprises. In August the average minimal interest rate on ruble credits offered by banks remained at the level of 12.3% per annum.

Within the III quarter the availability of credits for industrial enterprises fell by 3 points as compared with the II quarter of 2011 when a quarter maximum (71%) of this indicator since the 2008 crisis was registered. In the second half of the year commercial banks seemed to start the tightening of credit terms that they had promised to the RF Central Bank. But they did it selectively. As judged by borrowers (see *Fig. 29*), this tightening affected only very large enterprises (with over 1,000 employees). However, it looked rational as it was this group of enterprises that enjoyed the most convenient credit terms in the first half of 2011, more rapidly regained the trust of banks in 2009-2010 and as a result actually restored the pre-crisis level of this indicator.

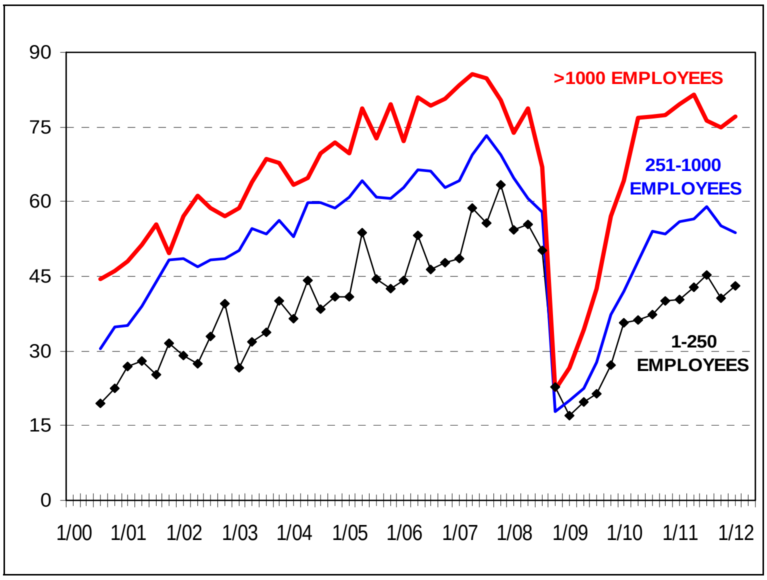


Fig. 29. Share of enterprises with "above normal" and "normal" availability of credits by size groups, average % per quarter

In October industrial enterprises did not experience the tightening of credit terms proclaimed by banks and expected by experts. The general estimate of "normal" availability of credits remained at the level of 68%. Very large enterprises were content with the availability to credits in 80% of cases while small and medium ones – in 35% thereof. Branch priorities persisted in the crediting of industry as well: while in metallurgy and chemical industry over 70% of enterprises had "normal" access to borrowed funds, in the consumer goods industry this share was only 35%.

In October the increase of interest rate charged by banks on credits extended to enterprises didn't take place either. Moreover, it fell to 11.8% down from 12.2% in September. For enterprises stating "normal" availability of credits the rate was as low as 10.8%. To small and medium enterprises credits were offered at 14.3% per annum, to very large (over 1,000 employees) – at 10.0%.

In November the terms of crediting Russian industrial enterprises didn't change. The share of enterprises with "normal" availability of credits stabilized at the level of 68% with the average minimal interest rate charged by banks remaining the same – 11.8%. Banks reduced (although very slightly) only the surplus ("above normal") offering of funds. The share of credits being pressed upon enterprises fell from 6% in June to 3% in November. In the IV quarter of 2011 the most convenient credit terms were offered to ferrous metallurgy (82% – "normal" availability of credits, 10% - "above normal"), chemical industry (68% and 7%, respectively), machine-building (75% and 1%) and construction materials industry (68% and 1%). In food industry 58% of enterprises had "normal" access to credits and 4% – the one "above normal".

However, the projections of banks to credit primarily ferrous metallurgy will hardly come true. Most enterprises in the sector do not plan to enlarge the amount of borrowings in the coming months and prospective changes are likely to have the "minus" sign: in this sector the number of enterprises intending to reduce borrowings prevails over that of enterprises planning to enlarge them. At the beginning of 2012 the most active demand for credits is possible in the consumer goods industry (the balance of credit projections is +29 points), timber processing (+25 points) and construction materials industry (+25 points). In the IV quarter of 2011 in industry at large the ratio of adequate credit supply by banks to credit projections of enterprises fell to 60% down from 69% in the III quarter while the share of "unsecured" industry projections grew up to 31% after being 22% a quarter before.

The improvement of credit terms for industry can be examined in connection with demand of enterprises for credits. Indeed, if banks offer very good credit terms to a certain group of enterprises but the latter do not need them or do not plan to enlarge borrowings, a greater availability of credits won't do much good. An opposite situation will be observed in the group of enterprises that intend to borrow more but have not deserved the respective loyalty of banks. Certainly, one can suggest that these are unreliable borrowers who want to get larger credits, and bank refusals to them are quite justified. But in any case such analysis involving principally new initial indicators (availability of credits, borrowing projections, ability to pay under credits, estimate of actual financial and economic performance of enterprises) can further the investigation of relationships between banks and industrial enterprises as regards the crediting of the latter.

The monitoring of enterprises' ability to service already received credits was launched in 2009 and now allows to estimate this indicator over the 3 recent years, which is certainly good but not comparable to opportunities for analyzing other indicators included in the IEP's business surveys and monitored for 10-15 and even 18 years. The first estimates (to be more precise – self-estimates) of the ability to service credits showed that only 61% of enterprises that had borrowed funds considered themselves to be solvable in 2009. For the first entirely crisis year this figure looked quite acceptable. But one should not exclude the possibility that it was overstated since a certain part of enterprises could have overestimated (either intentionally or unintentionally) their ability to pay under credits. 39% of enterprises openly admitted that they had credits but were not quite able to service them. The latter fact evidenced that respondents had enough trust in the surveyor and the data received in the course of surveys was quite reliable. In 2010 the ability of industrial enterprises to service credits grew up to 82%, in 2011 – up to 85% (see *Fig. 30*). So, the principal changes in industry's credit solvency took place in 2010 while 2011 consolidated the earlier made progress.

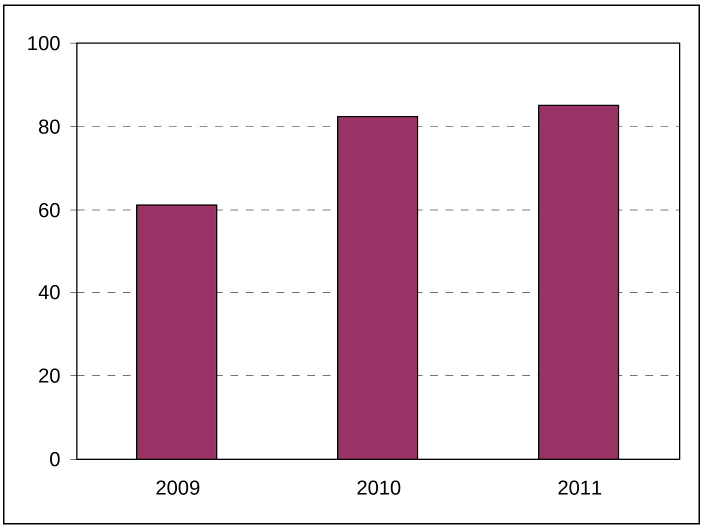


Fig. 30. Average annual share of enterprises able to service the received credits, %

The results of ranging branches by credit solvency of enterprises in 2011 were quite logical (see *Fig. 31*) given that not all enterprises in the sector but only the ones having credits were taken as 100%. Metallurgy with its great export potential and high degree of monopolization ranks first. In non-ferrous metallurgy the credit solvency amounts to unprecedented 97%. The third place expectedly belongs to food industry, the financial well-being of which is secured by regular demand of population for food. The fourth and the fifth places are taken by machine-building and construction materials industry, respectively, which can be explained by greater caution of banks when crediting these branches and the selection by them of really reliable borrowers. Chemical industry, timber processing and consumer goods industry round out the rating. While quite low credit solvency of consumer goods industry and timber processing seems quite understandable, the inclusion of chemical industry in this group is explained sooner by insufficient accuracy of banks when crediting enterprises of this branch than by poor financial performance of the latter.

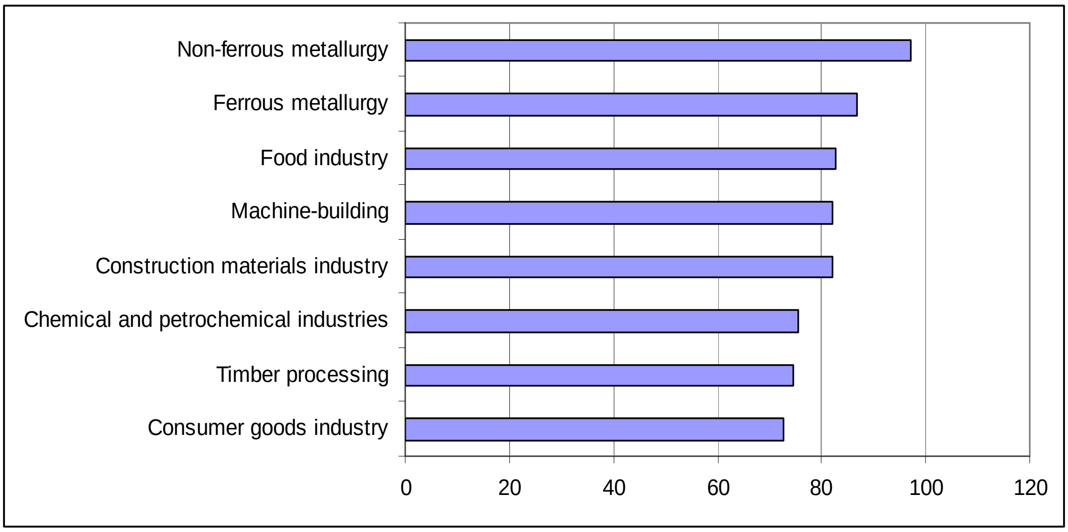


Fig. 31. Share of enterprises able to service the received credits by branches in 2011, %

Since in the regular IEP's questionnaires there are questions about both the availability of credits (i.e. the position of banks towards enterprises) and the ability of enterprises to service received credits (i.e. the self-estimate of credit solvency by enterprises), one can analyze to what extent these positions coincide (i.e. how adequately banks treat borrowers) or diverge (i.e. how mistaken are banks in estimating the credit solvency of enterprises). Two types of bank mistakes can be examined:

a) banks are too stringent in their estimates of credit solvency and do not extend credits to enterprises that could well pay under them;
b) banks inconsiderately credit enterprises unable to service credits.

In 2011 the estimates of credit availability and credit solvency on the average coincided for 75% of enterprises having liabilities to creditors. This is the best result since the start of monitoring in 2009. As compared with 2010 the indicator grew by only 3 p.p. while between 2009 and 2010 the increase was as big as 15 points. So, by 2010 industrial enterprises and banks had largely overcome the crisis of confidence between creditors and borrowers and in 2011 the situation improved just slightly.

Within 2011 the best result was registered in the I quarter when the availability of credits and credit solvency coincided for 80% of enterprises. Then this indicator fell down to 75, 72 and 74% in the respective quarters of the year. Unfortunately, this coincidence between estimates of enterprises and banks can be compared only with the figures for early 2009 when the economy had already touched the bottom of the crisis and started a slow recovery from it. In the I quarter of 2009 banks extended credits in accordance with credit solvency of borrowers to only 47% of enterprises. For the remaining 53% the availability of credits did not coincide with their credit solvency. As it was noted, this non-coincidence was of two types. Ill-considered crediting of enterprises that should not be credited amounted then to 10%. But the major mistake of banks was lower availability of credits as compared with credit solvency of borrowers. In the I quarter of 2009 the share of such mistakes was 43% which is the maximum value over the 16 quarters following the onset of the crisis. Then the level of mistakes of this kind started to reduce and by the III quarter of 2010 fell down to 10% - its minimum value. But by the end of 2011 banks were over-cautious in respect to already 19% of industrial enterprises. The level of mistakes of opposite kind (crediting of enterprises that should not be credited) within the 3 years rose up to 14% at the most and only twice surpassed the level of over-caution mistakes.

In 2011 banks most often were over-cautious when crediting timber processing. 39% of enterprises in this branch considered that banks underestimated their ability to pay under credits and limited their access to bank loans. The second place with a big gap belonged to consumer goods industry where the level of over-caution was 27%. Then followed chemical industry with 15% and construction materials industry with 14%. The maximum coincidence between assessments of banks and enterprises was registered in ferrous (with the level of banks' over-caution being only 9%) and non-ferrous metallurgy (where the estimates of credit availability fully coincided with the estimates of credit solvency).

The dynamics of unduly limited access to credits relative to credit solvency of enterprises in 2009-2011 shows the development of relationships between banks and enterprises at the stage of recovery from the crisis that started in late 2008. In the I quarter of 2009 banks had the weakest confidence in enterprises of metallurgical sector (see *Fig. 32*). Then 63% of enterprises in this branch assumed that banks unreasonably constrained their access to credits. But already in a year the metallurgical sector fully restored the confidence of banks and became the leader by this indicator. And one more year later the estimates of credit availability made by enterprises absolutely coincided with the estimates of their credit solvency made by banks, i.e. not a single enterprise in the sector assumed that banks unreasonably constrained its access to credits relative to its credit solvency, and 4% even found that banks overestimated their solvency when providing access to loans. Other branches started recovery from the crisis in more favourable conditions as regards availability of credits but the restoration of banks' confidence in their solvency proceeded at lower rate. However, by the end of 2011 the level of unreasonable limitation of access to credits had almost evened out in most branches. An exception was consumer goods industry where 31% of enterprises believed that banks tightened credit terms for them relative to their actual credit solvency. Similar estimates were made in timber processing. But since 60% of enterprises in these branches found that banks provide them access to credits in accordance with their credit solvency, one can hardly consider the terms of crediting these sectors to be unreasonably stringent.

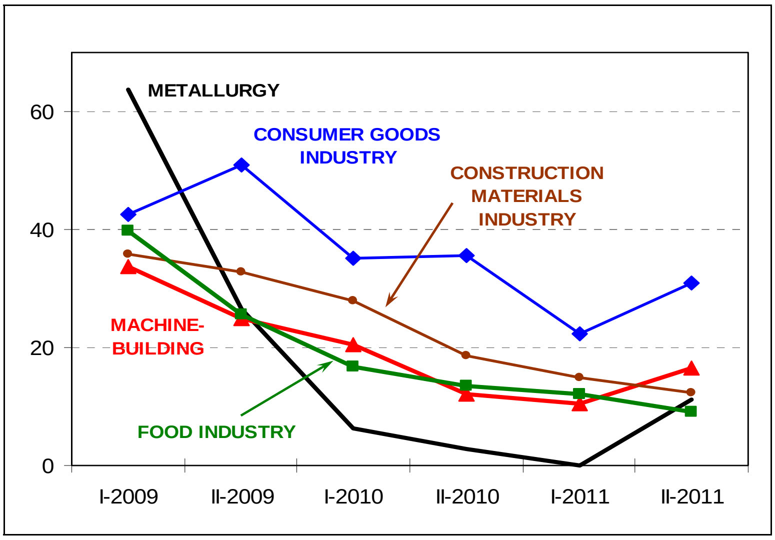


Fig. 32. Dynamics of unduly limited access to credits relative to credit solvency of enterprises by branches, average % per 6 months

In 2011 significant (although quite explainable) differences in the level of banks' over-caution were also registered for enterprises of different sizes. While small enterprises (up to 100 employees) find that banks unduly limit their access to credits in 37% of cases, in the group of medium-sized enterprises (from 101 to 250 employees) this indicator is 29% and loses 10 more percent points for the group of enterprises employing from 250 to 1,000 workers – there it totals 19%. And for enterprises with over 5,000 employees the level of unreasonable non-confidence of banks as regards their solvency is as low as 8%. Banks are more aware of the solvency of such enterprises and respectively are more precise in establishing credit terms for them.

According to estimates of enterprises in 2011 the credit terms for industry were the best in the post-crisis period. However, in the second half of the year the positive dynamics of monitored indicators discontinued pointing to the exhaustion of banks' capabilities to soften credit terms. Still, in the situation of sluggish recession the industry's demand for credits is almost fully satisfied. Therefore the possible tightening of credit terms in case of preservation of the current macroeconomic trends won't create much problem for the Russian industry.

4.2.6. Response of industrial enterprises to the raising of compulsory insurance contributions (unified social tax – UST)

In May 2010 we included in the regular business survey the question about how enterprises SUPPOSED to respond to the raising of contributions for compulsory pension, social and medical insurance (UST) from 26% to 34% in 2011. A year later we again posed this question but then industrial enterprises were to describe their ACTUAL response to the tax innovation. This allowed us to get adjusted and most reliable first-hand information on the response of enterprises to higher tax burden which seemed to be quite timely in the situation of heated dispute about the abolition of this new regulation.

The most commonly projected response of enterprises to the raising of UST (let's use this elder term) in the period of its active discussion in 2010 was the lifting of prices (see *Fig. 33*). 70% of enterprises planned to resort to it. This share was the highest for small enterprises (less than 100 employees) – 82% of them made such projections. The analysis by branches showed that the raising of prices was most likely in consumer goods industry, machine-building, chemical and petrochemical industries. 80% of state enterprises, 68% of open joint-stock companies, 73% of closed joint-stock companies and 80% of limited liability companies reported their intention to lift prices.

In 2011 65% of enterprises stated that they actually raised prices in response to higher UST. The deviation from the projected 70% is very small. Small enterprises decided to do it in only 65% of cases; the leaders in this respect (77%) were entities employing from 251 to 500 workers. As projected, consumer goods industry used the raising of prices as a protective measure against new UST most often as compared with other industries (in 85% of cases), then followed machine-building (78%) and chemical industry (71%). Meantime, in the food industry only 42% of enterprises reported the increase of prices although 64% of them planned to do it. Apparently, the autumn-winter (2010) period of higher prices for food products enabled the industry to alleviate the problem of UST. State enterprises raised prices in 80% of cases just as they had projected. The leaders by price growth were limited liability companies (89%).

The lowering of profits, i.e. the readiness of enterprises to cover the increase of compulsory insurance contributions at their own expense, ranked second among possible responses to higher UST. In 2010 59% of enterprises mentioned it. Almost all enterprises in fuel industry and ferrous metallurgy, ¾ of enterprises in timber processing and about 60% of enterprises in non-ferrous metallurgy and machine-building were ready to take such a step. On the other pole was consumer goods industry where only 30% of enterprises could afford using profits for payment of higher contributions.

The 2011 survey revealed that profits became the most commonly used source of funds for meeting public commitments. 67% of enterprises resorted to it. In food industry, timber processing and metallurgy profits were used for this purpose by 80% of enterprises. This fact seemed to have a negative effect on the estimates of financial and economic performance of enterprises in the II quarter of 2011 when it clearly deteriorated. For the first time since January 2009 the balance of estimates decreased and the decrease was quite sizable – from -5 to -13 points. This was the result of higher share of "poor" estimates (up from 15 to 21%) and the dropping share of "satisfactory" estimates (down from 71 to 65%). At the stage of recovery from the crisis these indicators had never demonstrated negative dynamics before.

In 2010 29% of industrial enterprises intended to cut investments in case of higher tax burden. These projections turned out to be quite precise. In 2011 the same 29% of enterprises actually responded to tax innovations in such a way. A year before this response was most frequently mentioned as possible in non-ferrous metallurgy (49% of enterprises stated such intentions in 2010 and 39% actually halted development plans in 2011), timber processing (46% and 39%, accordingly) and consumer goods industry (40% and 34%, accordingly). In 2011 machine-building also joined the group of leaders by the decrease of investments due to higher UST: 31% of enterprises in the industry had such intentions and 36% actually materialized them.

In 2010 the reduction of employment benefits (voluntary health insurance, other social benefits to employees, soft loans) ranked third by popularity among 10 possible responses to higher UST rates. Most frequently it was mentioned by large enterprises (which is understandable as such benefits are more widely spread in this group), enterprises in non-ferrous metallurgy and construction materials industry.

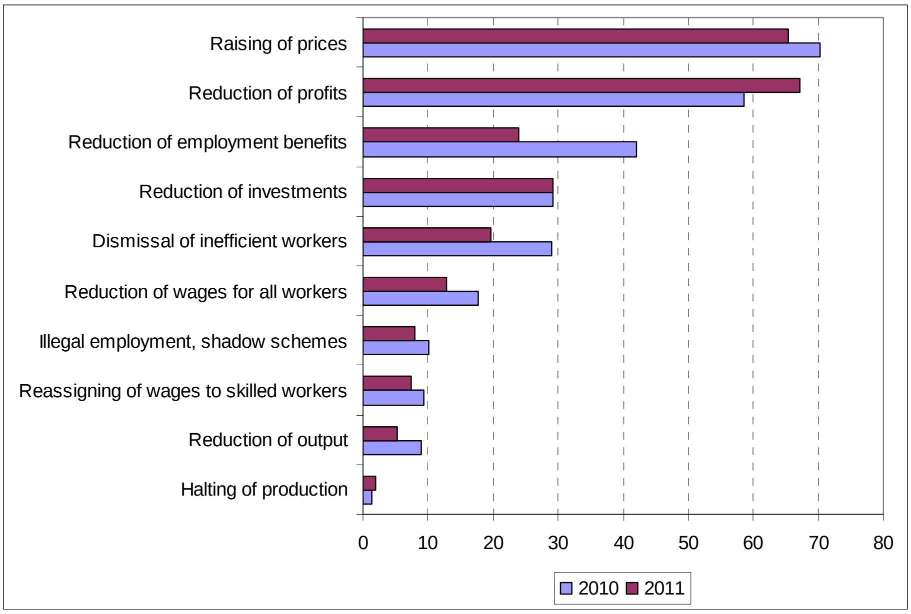


Fig. 33. Projected (2010) and actual (2011) responses of enterprises to the raising of compulsory insurance contributions, as % of respondents

But the actual saving at the expense of employment benefits turned out to be more modest. In 2011 only 24% of enterprises reported using such “sources of financing” bigger expenditures on UST. The accuracy of enterprises’ projections regarding this protective measure was the lowest. As a result by the frequency of actual application it stepped backed to the fourth place. It was more often used by small enterprises than by large ones. Among industries the leaders were food industry, timber processing and non-ferrous metallurgy.

Dismissals of inefficient workers due to higher rates of UST were planned by 29% of enterprises in 2010. They could be most sizable in non-ferrous metallurgy and consumer goods industry. Actually 20% of industrial enterprises (first of all small and very large ones, engaged in machine-building and consumer goods industry) managed (opted) to take such steps.

In 2010 18% of enterprises planned to lower wages in order to reduce the amount of compulsory insurance contributions. This measure was more popular with small enterprises; the probability of its implementation reduced in line with the growth of enterprise size. In ferrous metallurgy and construction materials industry 25% of enterprises were ready to take such unpopular steps. However, in 2011 only 13% of enterprises actually cut wages. As expected, small enterprises resorted to this measure more often. Among branches only food industry stood apart with the indicator amounting to 24%.

To our mind, the low popularity of responses affecting employment and labour remuneration can be explained by big problems that Russian enterprises encounter and will continue to encounter on the labour market. On the eve of 2008 crisis the availability of skilled personnel became a serious constraint to production growth in Russian industry. Half of enterprises stated that in July 2008. At the stage of recovery from the crisis producers start to realize that labour can soon become the scarcest resource. The shortage of personnel relative to “expected changes in demand” has long been observed in industry. Therefore the solving of problems at the expense of workers is the last thing enterprises are going to do.

In 2010 only 9-10% of enterprises projected to use "criminal" protective measures (reassignment of wages to the most qualified workers with further redistribution "in envelopes", the reduction of these payments by means of illegal employment, the general escape into the shadows). In 2011 7-8% of enterprises implemented these schemes.

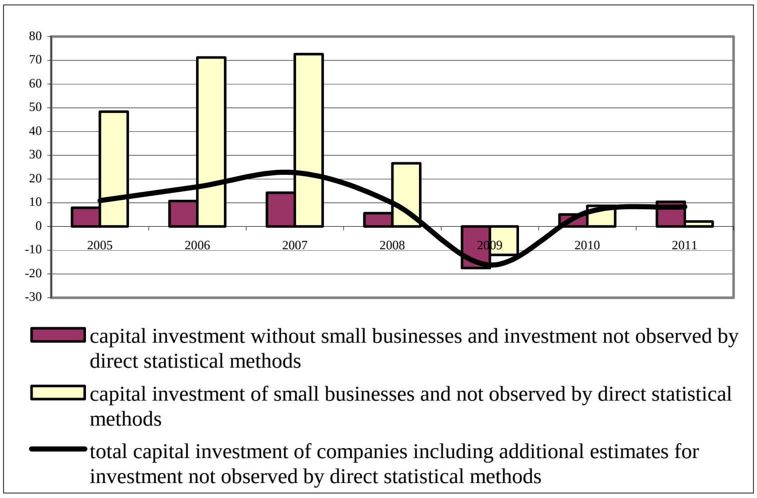
4.3. Investment into Real Economy

4.3.1. Domestic capital investment

The crisis of 2008 drastically changed the situation in the investment sector. During the period from 1999 until 2008 the trend of investment demand expansion with the average annual rate of 112.6% was supported by favorable situation both domestically and in foreign markets. This trend was abruptly terminated by acute crisis in construction and investment complex. In 2009 capital investment slowed down by 15.7% while GDP decline was 7.8%, so this slide of investment was much deeper than during 1998 crisis. The specificity of post-crisis recovery after 2008 was demonstrated in extremely slow recovery rates for business activity in the sphere of investment. In 1999–2000 increasing the share of capital investment in the overall GDP structure was the key driver for intensive recovery of GDP and hitting the pre-crisis level of 1997 quite soon shaping the preconditions for dynamic economic growth in the following years. On the contrary, during the three-year period between 2009 and 2011 the share of capital investment in the GDP remained at the same level of 20.4% having led to slow down of recovery after 2008 financial crisis. In 2011 the level of capital investment still did not reach the 2008 level being 3.3% below it.

After financial crisis of 1998 economic recovery was underpinned by active engagement of standby and under-loaded production capacities. This was the key driver of outrunning capital investment rates for major enterprises. However, simultaneously the impeding factors limiting growth were becoming more and more important: high level of fixed assets depreciation and shortage of skilful workforce. Their negative impact was partially compensated by increased economic activity of small and medium sized businesses. Their share of capital investment (in the total volume of capital investment in Russian economy) grew from 10% in 2000 up to 24% in 2008. During this period of time the average annual capital investment growth rates for small and medium sized businesses were significantly exceeding investment performance of major enterprises.

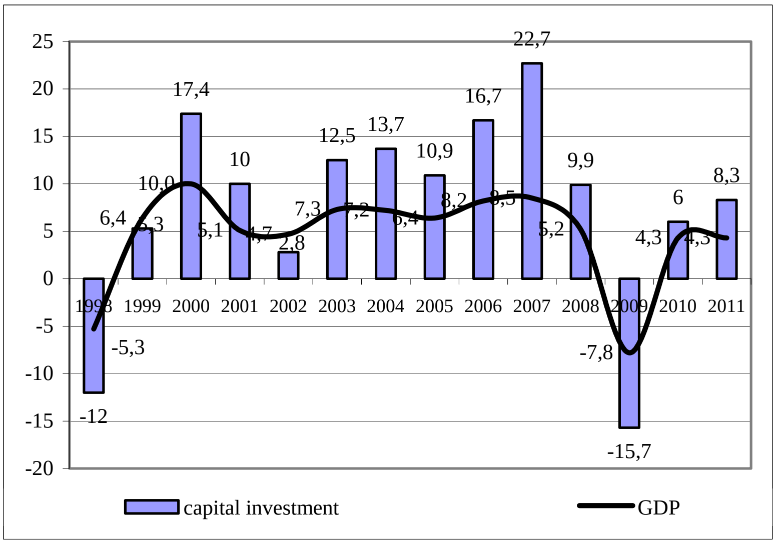
The situation changed drastically in 2009, when rin the context of financial and economic crisis the decreased volumes of loans and growing of average weighted interest rate for small and medium sized businesses (up to 20%) led to capital investment in this segment falling down almost by 13.4% versus the preceding year, which negatively impacted the situation in investment sector in general. In 2010 financial support of small and medium sized businesses became of the state priorities: the overall budget appropriations for such support made Rb 17.97bn; capital investment grew by 8.7% versus 2009, and their share in the total volume of investment in the economy grew up to 27.6%. In 2010 the dynamic growth of investment demand in small and medium sized businesses segment compensated the retarded dynamics of capital investment of major companies *Fig. 34*. Unfortunately, these structural changes were rather of opportunistic character and were not supported by the fundamental changes in the overall investment climate of Russia.



*preliminary estimates.
Source: Federal Statistics Service.

Fig. 34. Dynamics of capital investment for major companies and small businesses in 2005–2011, % to the preceding year

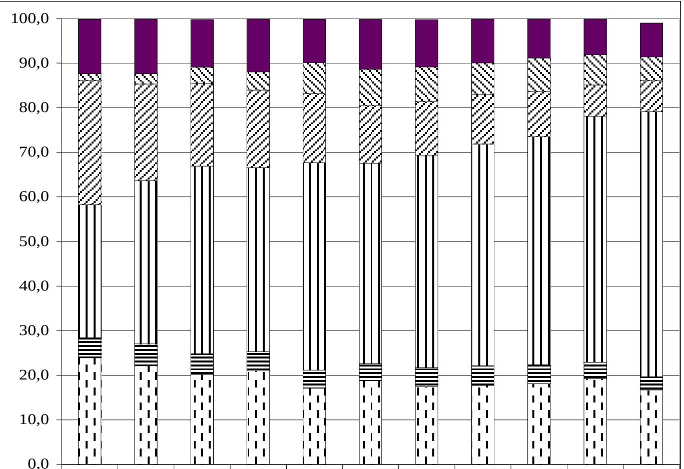
In 2011 the positive dynamics of investment activities in small and medium sized businesses segment was maintained (*Fig. 35*). Capital investment rates of small businesses in 2011 were 2.3% higher than in the preceding year, which allowed for hitting the pre-crisis level of 2008. In major companies segment the investment dynamics was positively impacted by implementation of a set of measures from the government's anti-crisis program. In 2010 incremental capital investment for major companies was 5.1%, and in 2011 – 10.1%. Let us note here, that in 2011 increase in capital investment activity by major companies became the driver for improving capital investment growth rates up to 108.3% versus 106.0% in the preceding year (*Fig. 35*).



Source: Federal Statistics Service.

Fig. 35. GDP and capital investment dynamics in 1998–2011, % to the preceding year

Over the recent decade the profile of investment by forms of ownership has changed (*Fig. 36*). The major portion of capital investment falls on private enterprises and organizations, their share in total investment grew from 29.9% in 2000 up to 51.1% in 2008 and 59.4% in 2010. Another characteristic feature is increased share of investment by enterprises and organizations with foreign capital. These investments reached their peaks in 2005–2007. In the following years due to lack of systematic measures targeted at investment climate improvement foreign investors suspended their activity.



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Joint Russian and foreign capital	12,2	12,2	10,7	11,8	9,7	11,2	10,6	9,8	8,7	8	7,6
Foreign capital	1,5	2,3	3,6	4,1	6,9	8,2	7,8	7,1	7,5	6,8	5,3
Mixed Russian ownership (without foreign capital)	27,8	21,6	18,6	17,4	15,5	12,9	12,2	11,1	10,1	7	7
Private ownership	29,9	36,7	42,0	41,2	46,5	44,9	47,5	49,7	51,1	55,2	59,4
Municipal ownership	4,5	4,9	4,7	4,3	4,1	3,8	4,2	4,4	4,3	3,6	3
State ownership	23,9	22,1	20,2	21,0	17,1	18,8	17,5	17,7	18,1	19,3	16,7

Source: Federal Statistics Service.

Fig. 36. Capital investment profile in the Russian Federation by forms of ownership, % to the outcome

During the period of 2000–2010 investment profile by funding sources also changed. The share of capital investment at the expense of borrowed funds grew, and at the same time investment funded by equity capital fell down to 40.4% in 2007, and even during the post-crisis development in 2009–2010 it remained below the average level of the preceding years. However, slow recovery rates of domestic market and overall economy income recovery dictated enterprises and organizations using more equity to fund their investment programs in 2011. As of the end of 2011 the share of equity investment in the overall capital investment grew up to 42.7% and exceeded the preceding year indicator by 1.7 p.p. (*Table 9*).

Table 9

Capital investment profile by funding sources (without small business entities and investment amounts non observable by statistic methods), % to the outcome

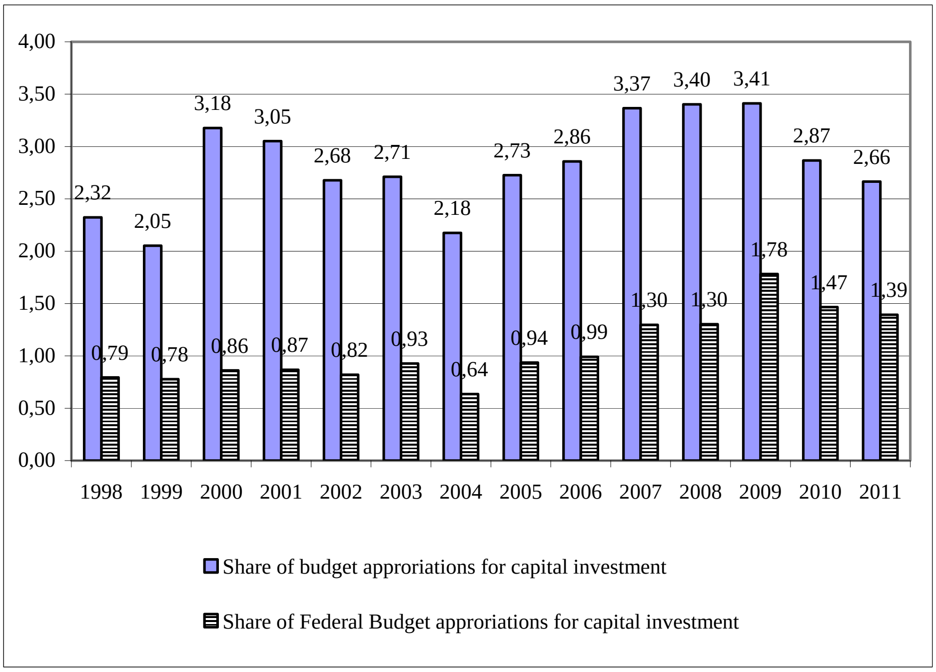
	1999	2000	2005	2006	2007	2008	2009	2010	2011
1	2	3	4	5	6	7	8	9	10
Capital investment, total	100	100	100	100	100	100	100	100	100
Including by funding sources:									
Equity capital	52.4	47.5	44.5	42.1	40.4	39.5	37.1	41.0	42.7

cont'd

1	2	3	4	5	6	7	8	9	10
Withheld profit (accumulation fund)	15.9	23.4	20.3	19.9	19.4	18.5	16.0	17.1	17.2
Borrowed funds	47.6	52.5	55.5	57.9	59.6	60.5	62.9	59.0	57.3
including:									
Bank loans	4.2	2.9	8.1	9.5	10.4	11.8	10.3	9.0	7.7
Including loans by foreign banks	…	0.6	1.0	1.6	1.7	3.0	3.2	2.3	1.5
Borrowing from other organizations	5.6	7.2	5.9	6.0	7.1	6.2	7.4	6.1	5.0
Budget funds	17.0	22.0	20.4	20.2	21.5	20.9	21.9	19.5	18.8
including:									
Funds from the Federal Budget	6.4	6.0	7.0	7.0	8.3	8.0	11.5	10.0	9.8
Funds from sub-national budgets (RF constituents)	9.6	14.3	12.3	11.7	11.7	11.3	9.2	8.2	7.9
Extra-budgetary funds	8.6	4.8	0.5	0.5	0.5	0.4	0.3	0.3	0.2
Others	12.2	15.6	20.6	21.7	20.1	21.2	23.0	24.1	25.6
including:									
Superior organizations funds			10.6	12.5	11.3	13.8	15.9	17.5	20.2
Funds received from share participation in construction (from organizations and individuals)			3.8	3.8	3.7	3.5	2.6	2.2	1.9
Including funds from the citizens				1.3	1.5	1.9	1.3	1.2	1.1
Funds from issuing corporate bonds			0.3	0.04	0.1	0.1	0.1	0.01	0.0
Funds from capital stock issues	0.7	0.5	3.1	2.3	1.8	0.8	1.0	1.1	1.0
Within overall capital investment – foreign investment		4.7	6.6	6.9	5.4	4.3	4.3	3.8	3.1

Source: Federal Statistics Service.

Change of the borrowed funds volumes and shares in the overall funding sources profile was accompanied by some structural change. The demand for products and services of Russian enterprises on behalf of the government was supported by implementation of the planned investment projects in transportation, ICT and some other spheres within the framework of federal target programs and Federal Targeted Investment Program (FTIP), as well as by implementation of major infrastructure programs of the Investment Fund. In accordance with the government investment priorities such funds were mostly channeled for modernization and development of strategically important production infrastructure sites, implementation of investment projects focused on introduction of state-of-the-art technology to improve competitiveness of Russian mechanical engineering products, as well as improvement of industrial safety in energy, transportation, waters and forests management. In the crisis environment the government provided incentives for introducing innovations through implementation of "producible" federal target programs. Appropriations for such programs were either maintained at the previously planned level, or immaterially reduced. The share of budget appropriations channeled into capital investment made 3.1% of GDP in 2009 versus 2.54% of GDP in 2007, including Federal Budget appropriations making 1.62% of GDP in 2009 versus 0.98% of GDP in 2007. In 2010 the share of budget funds used as capital investment grew even more and made 2.87% of GDP, and then immaterially decreased in 2011 making 2.66% of GDP. Similar dynamics was observed for investment at the expense of the Federal Budget – 1.47% of GDP and 1.39% of GDP respectively (*Fig. 37*). In 2010–2011 the ratio between the Federal Budget and regional budgets appropriations channeled to investment changes. In the overall amount of investment at the expense of budget appropriations the Federal Budget share in 2011 was increased up to 52.2% versus 38.2% in 2008.



Source: Federal Statistics Service.

Fig. 37. Share of budget appropriations for capital investment during the period of 1999–2011, % to GDP

In 2011 it was planned to channel Rb 895.0bn from the Federal Budget to construction, revamp, technical re-equipment and acquisition of facilities, as well as to implement major integrated investment projects included into Federal Targeted Investment Program, including budget investment of Rb 769.6bn (subsidies – Rb 125.4bn)[1].

As of the end of 2011 taking into account all the changes actual Federal Budget funds allocated for construction and measures within Federal Targeted Investment Program constituted Rb 946.0bn (1.74% of GDP) exceeding 2010 level by Rb 181.6bn.

In 2011 Rb 573.8bn (60.7% of total FTIP investments) were allocated for projects included into federal target programs (program element of FTIP). Rb 372.2bn were allocated for construction of facilities and implementation of measures beyond federal target programs (39.3% of total FTIP investments). Rb 160.2bn were reserved within FTIP for funding specialized work associated with State defense order in 2011 (16.9% of total FTIP investments).

According to the Federal Statistics Service (Rosstat), the level of budget appropriations for FTIP construction sites and facilities (without account of special facilities included into state defense procurement) monitored by Federal Statistics Service in January-December 2011 made Rb 504.6bn, i.e. 70.9% of the annual limit (*Table 10*).

In accordance with the Federal Targeted Investment Program for 2011 as amended by January 1, 2012, budget appropriations were made for construction and acquisition of 3842 sites with 2226 sites to be commissioned. In reality 500 sites were commissioned in

[1] Starting from 2011 Federal Targeted Investment Program includes not only Russian Federal property and property of legal entities not being state or municipal institutions / unitary enterprises, but also capital construction property of the RF constituents (regional governments) and municipal property co-funded out of the Federal Budget.

2011: 425 – at full capacity, 75 – partially. As of January 1, 2012, technical availability for 876 sites was within the range from 51.0% to 99.9%.

Table 10

Sites included into FTIP and CAPEX funded out of the federal budget объемы in 2011 (without account of sites included into state defense procurement)

	Number of sites in 2011		Commissioned in 2011		Limit of state CAPEX for 2011		Funded out of Federal Budget	Utilized investment from all funding sources in 2011
	total	Including those with commissioning deadline in 2009	at full capacity	partially	total	Including funded out of the federal budget		
	sites				Rb bn			
Total	3842	2226	425	75	771.4	711.6	504.6	515.6
including: transport complex	1110	532	127	11	295.3	276.9	248.9	237.7
agricultural complex	184	107	49	13	8.6	8.4	7.7	6.8
special complex	753	545	111	14	55.3	50.4	31.0	31.9
social complex	1611	966	131	34	362.6	332.8	186.2	214.0
Other sites	184	76	16	3	49.5	43.0	30.8	25.2

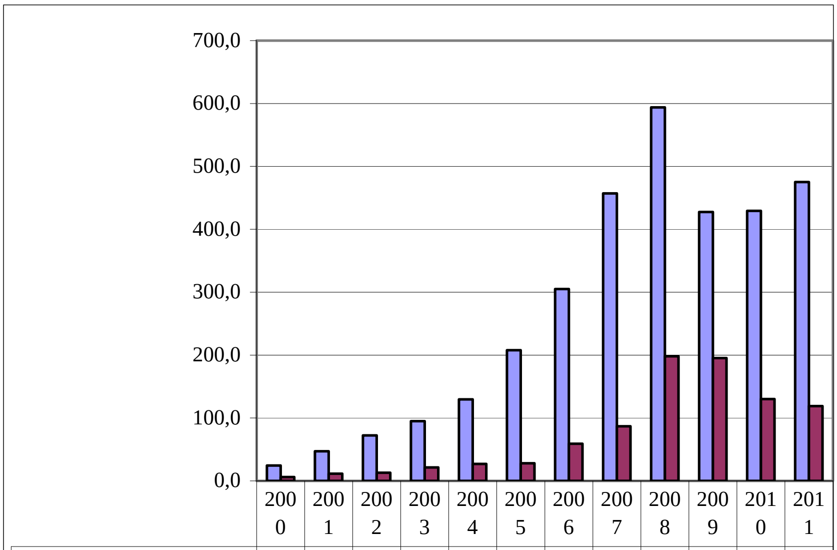
Source: Federal Statistics Service.

At the expense of annual limit in 2010 Rb 504.9bn were allocated out of the Federal Budget (70.9% of total annual appropriations) and Rb 51.0bn were allocated out of regional budgets (69.4% of the overall funds of regional budgets). In January-December 2011 state customers utilized Rb 515.5bn of state CAPEX, i.e. 66.8% of the annual limit of construction appropriations. The level of budget funding utilization of the total actual appropriations at the expense of all funding sources made 92.8%.

Prior to 2008 crisis the amount of borrowed funds for investment was growing due to increased activity of the banking sector, growth of citizens' investment into housing construction and intensive in-flow of foreign capital. In 2009 absolute shrinkage of bank loans for investment purposes was registered. The key factors suppressing further deepening of the crisis at the investment market during that period were: growth of loans from foreign banks and active borrowing from other companies[1]. The share of loans from foreign banks for capital investment in the overall banks' loans made 31.4% and reached its maximum over the last decade.

In 2010 the trend of decreasing the share of bank capital and borrowed funds in the overall capital investment started to decrease: out of Rb 2,769.0bn of total borrowed funds Rb 559.2bn fell on bank loans, i.e., 14.8% versus 18.4% in 2008. In this context in 2010 given the trend for stabilization of loans for capital investment issued by Russian banks, loans from foreign banks decreased by Rb 62.5bn and determined the aggregate decrease of bank loans share in the overall funding of capital investment. In 2011 growth of loans from Russian banks fully compensated for decrease of loans from foreign banks. During one year period incremental loans for capital investment issued by Russian banks made Rb 46.0bn (*Fig. 38*)

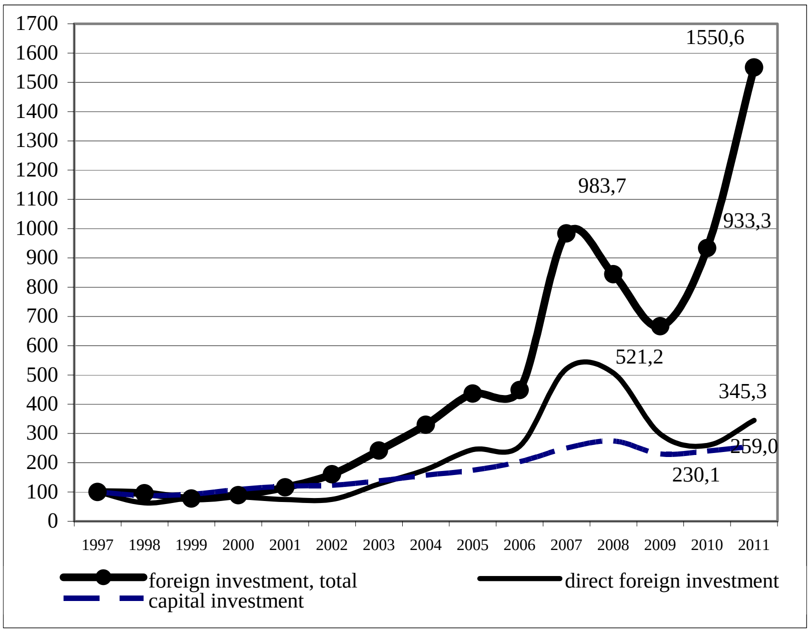
[1] According to the Methodology Regulations for Statistical Indicators in Construction and Capital Investment (Order by the Federal Statistics Service No.37 issued on March 11, 2009) borrowed funds for capital investment include: bank loans, share sale revenues, charity donations and other contributions, funds from superior joint-stock companies (holdings, industrial and financial groups) on a grant basis; funds borrowed from other organizations including loans from the government on a pay-back basis, loans from foreign investors, bonded debt, loans from institutional investors: equity funds and investment companies, insurance companies, as well as promissory notes and other funds. See,



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
loans from Russian banks	24,5	47,1	72,2	94,9	129,	207,	305,	457,	593,	427,	429,	475,
loans from foreign banks	6,2	11,5	12,9	21,3	26,9	27,9	59,2	86,9	198,	195,	130,	119,

Source: Federal Statistics Service.

Fig. 38. Bank loans for capital investment in 2000–2011, Rb bn



Source: Federal Statistics Service.

Fig. 39. Indices of capital investment, foreign investment and direct foreign investment during 1998–2011, % of 1997 level

During the period of 1998–2007 foreign investment into Russian economy increased 9.8 times, including direct foreign investment growth of 5.2 times. This resulted in increased share of foreign investment and loans from foreign banks in funding capital investment. Foreign investment share in the overall capital investment into Russian economy grew from 4.7% in 2000 up to 5.4% in 2007.

2008 crisis featured greater decrease of foreign investment into Russian economy versus domestic investment. Besides, net capital flight (disinvestment) reached its historic maximum of $ 133.9bn in 2008 fully offsetting the positive trends of the preceding two years (*Table 11*).

In 2009–2011 the foreign investment profile transformed due to sharp decline of the amount and share of direct investment and increase of other investment. In 2010 foreign investment into Russian economy constituted 94.8%, and direct foreign investment constituted 49.7% of 2007 level. At the same time domestic investment decreased by 1.8%. In 2011 direct foreign investment grew by 33.3%, but they still constituted only 2/3 of the pre-crisis level of 2007–2008. The situation was aggravated by the trend to capital flight which persisted during the last three years. Net private capital export in 2009 was making $ 56.9bn, and in 2011 – $ 84.2bn. Eventually the share of foreign investment in the total capital investment fell down to 3.1% in 2011 versus 3.8% in 2010.

Table 11

Net private capital import/export as per balance of payments, $ bn

	Net capital import/export in private sector	Net capital import/export by banks	Net capital import/export in other sectors
1998	-21.7	-6	-15.7
1999	-20.8	-4.3	-16.5
2000	-24.8	-2	-22.8
2001	-15	1.3	-16.2
2002	-8.1	2.5	-10.6
2003	-1.9	10.3	-12.2
2004	-8.9	3.5	-12.4
2005	-0.1	5.9	-6
2006	41.4	27.5	13.9
2007	81.7	45.8	35.9
2008	-133.9	-56.9	-76.9
2009	-56.9	-30.4	-26.5
2010	-33.6	15.9	-49.5
2011	**-84.2**	**-26.2**	**-57.9**
Q1	-20.1	-7.7	-12.5
Q2	-7.3	-2.6	-4.7
Q3	-19.0	-8.5	-10.4
Q4 (estimate)	*-37.8*	*-7.5*	*-30.3*

Source: Central Bank of Russia.

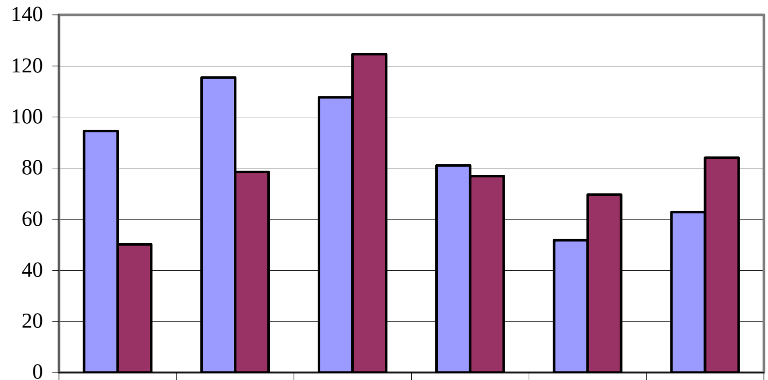
In 2009 we can observe a turning point of such trend in the sphere of housing construction. After pretty sustainable growth of housing construction during the period of 2001–2008, in 2009–2010 housing commissioning declined by 8.9%, including commissioning of housing funded by citizens and borrowed funds – by 6.9% versus the pre-crisis level of 2008.

In H1 2011 the decline in housing commissioning was making 3.7% versus similar period of the preceding year. The situation changed in Q3 2011, when housing commissioning grew by 15% versus similar period of the preceding year, and as a result as of the end of the year the increment of commissioned housing made 6.6% of 2010 level. At the same time 26.7m sq. m was commissioned in 2011 at the expense of citizens funds and borrowed funds, which exceeds the level of the preceding year by 1.4m sq. m. As for housing commissioned at the expense of companies/organizations' funds, it demonstrated growth by 3.5m sq. m.

The share of individual housing construction in the overall housing commissioned declined and in 2011 made 42.9% versus 43.7% in 2010 and 47.7% in 2009. Investment activity of the population in 2011 was supported by growing demand for loans in the context of decreasing the interest rates. However, the impact of this growth on the dynamics of housing commissioning is determined by the time lags within the construction cycle and is visible beyond the preceding year. The amount of issued residential loans in 2011 made Rb 749.2bn (1.38% of GDP) versus Rb 418.2bn (1.28% of GDP) in 2010, including Rb 693.8bn in mortgages (0.93% of GDP) versus Rb 346.6bn (0.77% of GDP) one year before.

Absolute growth of investment into housing construction (by Rb 25.5bn) was observed in 2011, including growth by Rb 14.5bn at the expense of citizens funds invested into construction under shared ownership terms (*Fig. 40*). However, in the overall capital investment in the economics the share of investment into housing construction in 2011 went down to 1.9% versus 2.2% in 2010 and 3.5% in 2008.

In the capital investment profile by types of fixed assets the share of housing construction expenses decreased in 2011, while the share of expenses for non-residential construction was decreasing (*Table 12*). Total area of non-residential buildings grew in 2011 by 9.9% versus the preceding year. Along with the increase of share of expenses for industrial construction the share of investment into machines and equipment acquisition was also growing. Let us notice that in 2011 given the unstable dynamics of domestic capital goods production, the share of investment into acquisition of imported machines, equipment and transportation vehicles (without small business entities) in the total investment into machines, equipment and transportation vehicles made 18.6% versus 18.0% in 2010.



	2006	2007	2008	2009	2010	2011
organizations' funds invested into construction under shared participation terms	94,5	115,5	107,7	81,1	51,8	62,8
citizens' funds invested into construction under shared participation terms	50,2	78,5	124,6	76,9	69,6	84,1

Source: Federal Statistics Service.

Fig. 40. Funds channeled to construction under shared ownership terms in 2007–2011, Rb bn

Purchasing foreign equipment is more profitable for a number of reasons: its relative price, high quality and post-sale maintenance support. Purchasing foreign equipment became the major type of innovation activities of industrial enterprises.

Table 12

Capital investment by types of fixed assets in 2008–2011 (without small businesses and informal activities), % to the outcome

	Rb bn				% to the outcome			
	2008	**2009**	**2010**	**2011**	**2008**	**2009**	**2010**	**2011**
Capital investment, total	6272.1	5769.8	6413.7	7701.2	100	100	100	100
Including:								
housing	467.2	343.5	372.3	361.8	7.5	6.6	5.7	4.7
buildings (without residential) and facilities	3286.8	3221.2	3495.8	4172.5	52.4	53.8	53.6	54.3
machines, equipment, transportation vehicles	2071.3	1798.2	2109.6	2644.3	33.0	32.2	33.4	34.3
other	446.8	406.9	436.0	522.6	7.1	7.4	7.3	6.8

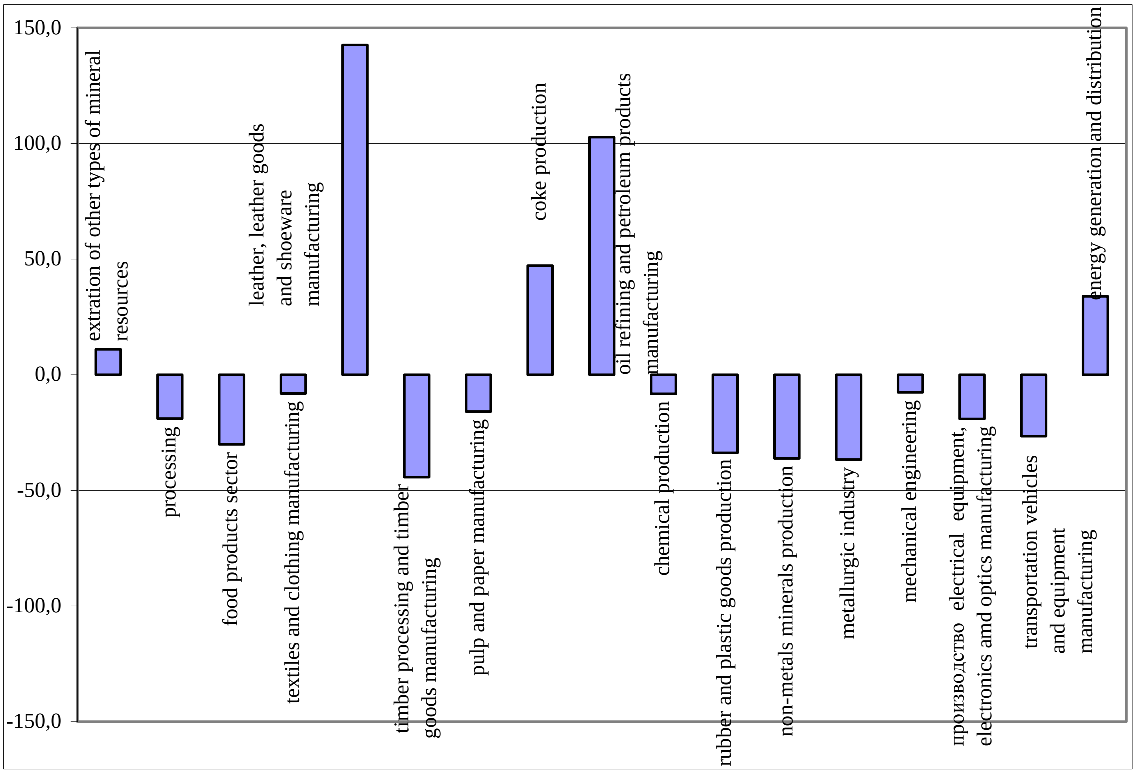
Source: Federal Statistics Service.

The major portion of capital investment during 2010–2011 was channeled to purchasing new machines and equipment. According to Federal Statistics Service, 32–46% of companies/organizations invested into improving the efficiency of production (automation or mechanization of the existing processes, introduction of new technology, reduction of production costs, energy savings); 32% of companies/organizations were seeking increase of production capacity without changing the product slate, and 29% of companies/organizations were striving for increasing production capacity with simultaneous expansion of the product slate. Changes in the capital investment profile by types of business over the last two years allow for identifying the most characteristic features of investment demand transformation. In 2009–2011 an immaterial increase of the industry share in the total capital investment was observed (without small businesses). At the same time quite significant differentiation of capital investment rate by types of business was observed. The post-crisis recovery was determined by both higher growth rates in mineral resources extraction sector and higher growth dynamics of demand for investment in this sector. It also needs to be taken into account that capital investment sagging in mineral resources extraction sector, in generation and distribution of energy, gas and heat was not as deep as in processing. In 2011 capital investment in mineral extraction sector grew by 13.8% versus the preceding year, in generation and distribution of energy, gas and heat – by 8.1% and in processing sector – by 6.3%. Capital investment in mineral extraction sector exceeded 2008 level by 9.4% and in generation and distribution of energy, gas and heat – by almost one third.

In 2011 capital investment growth in processing was observed in the majority of areas, however, the crisis manifestations persisted. Total capital investment in processing made 81.0% versus 2008 (*Fig. 41*).

The most prominent growth of investment among processing industries was registered in timber processing and timber items production (148.4% of 2010), in chemical production (123.4%), coke and petroleum production (115.5%). Stable high level of investment activity in textile manufacturing and leather production during the preceding three years needs to be highlighted. The key driver here is the change in customs regulations with regard to importing equipment and raw materials.

Slow recovery of demand for capital goods and structural materials determined the volume of investment in metallurgy and commercial metal goods production, which remained at 2010 level. At the same time investment into commercial metal goods production declined by 22% versus the preceding year.



Source: Federal Statistics Service.

Fig. 41. Capital investment by sectors of industry in 2011, % of 2008

Investment activity in mechanical engineering is recovering a lot slower than in other businesses. In 2011 the share of capital investment in mechanical engineering constituted 2.3% of total investment into economy and 13.5% of investment into processing. Investment into machines and equipment manufacturing increased by 13/0% in 2011, while in transportation vehicles and equipment manufacturing the investment went down by 3.8% versus the preceding year.

The share of investment into transportation development in 2011 went up to 25.3% of total capital investment into the economy. Investment into transportation and communication grew 1.3 times versus 2008, which is connected with intensive implementation of pipeline transportation investment programs during 2009–2011 (*Table 13*).

Investment into social sphere development is still below the pre-crisis level.

Growth of investment into research and development was registered during the last three years. Between 2009 and 2011 investment into R&D grew 1.7 times and in 2011 made 1.0% of total capital investment into economy.

The conditions of material resources and facilities remain the key factor of successful functioning of R&D sector. Despite positive quantitative characteristics of GDP dynamics, capital investment, labor market and state budget, Russian economy is still lagging behind many developed economies judging by many qualitative parameters. Labor productivity makes only 2/3 of the level of EU countries, and capital investment share in GDP is still insufficient to modernize the economy and intensive progress of scientific research and development.

Table 13

Amount and dynamics of capital investment in 2008-2011 by types of business (without smaller businesses and informal activities parameters)

	Rb bn				% to the preceding year			
	2008	**2009**	**2010**	**2011**	**2008**	**2009**	**2010**	**2011**
Total	6272.1	5769.8	6413.7	7701.2	105.6	82.5	105.1	110.4
including: agriculture, hunting and forestry	243.0	192.6	190.9	251.3	95.7	75.2	88.9	110.9
mineral resources extraction	1040.9	967.8	1109.8	1312.2	103.9	88.3	108.9	113.8
including: production of fuel and energy reserves	950	893.5	1021.5	1187.5	104.8	89.1	108.7	112.3
processing industry	1034.0	881.9	993.7	1172.3	107.8	78.2	103.3	106.3
generation and distribution of energy, gas and water	558.2	585.6	786.3	918.5	111.3	99.8	124.1	108.1
construction	91.7	162.7	194.1	165.1	91.7	66.1	117.3	89.9
wholesale and retail	168.7	138.4	158.4	171.7	95.6	75.7	108.9	88.4
transportation and communications	1628.0	1624.6	1696.1	2223.7	112.4	99.1	109.0	120.6
including communications	257.4	180.6	207.3	274.7	95.1	66.6	108.6	113.4
financial activity	74.7	74.6	77.2	124.3	95.6	99.4	107.1	142.2
transactions with real property, leasing and provision of services	733.8	558.2	658.3	607.1	100.9	70.8	92.8	94.9
including R&D	31.9	48.9	62.8	74.1	101.9	131.9	114.4	112.5
government administration and defense; mandatory social insurance	128.2	133.0	120.5	131.5	109.7	89.5	87.0	108.4
образование	162.9	117.4	142.9	170.2	96.9	78.7	113.7	111.3
healthcare and social services	188.0	145.7	161.3	175.9	116.0	82.1	105.6	104.1
other communal, social and personal services	128.8	168.6	185.8	239.9	127.9	85.1	102.8	117.7

Source: Federal Statistics Service.

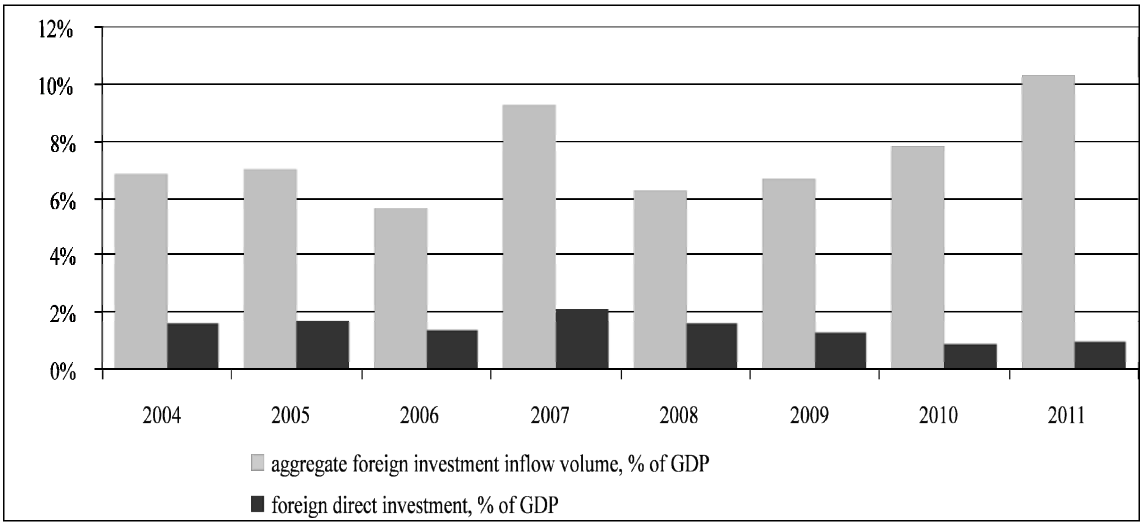
4.3.2. Foreign Investments

In 2011, the inflow of foreign investment into the RF increased by 66.1% on 2010 - to $ 190.6bn, thus rising 57.6% over the historic high registered in 2007 (*Table 14*).

At the same time, foreign investors continued to leave the Russian market. As seen by the results of the year 2011, the outflow volume amounted to $ 165.2bn, or to 86.6% of the foreign investment inflow observed over that same period. Investment outflow took the form of foreign investors' incomes transferred abroad, as well as the payment of interest on credits and credit redemption. As compared to the 2010 level, capital outflow increased by 36.7%. Besides, in 2011 the volume Russia's overseas investment rose to $ 151.7bn, or by 57.6% on 2010, thus amounting to 79.6% of the volume of investment in the Russian economy (in 2010 – 83.9%).

On the whole, the inflow of foreign investment in the Russian economy increased from 7.8% of GDP in 2010 to 10.3% of GDP in 2011 (*Fig. 42*).

In 2011, the highest investment growth (by $ 71.6bn) was noted in the 'other investments' segment. Direct investment increased by $ 4.6bn. This growth was contributed to by all categories of direct investment. The bulk of direct investment was constituted by contributions to charter capital and credits obtained from foreign stakeholders in organizations. The former, as seen by the results of the year 2011, rose by 17.9% to $ 9.1bn. The volume of credits received from foreign stakeholders rose by 62.6% to $ 7.5bn. Thus, the share of credits issued by foreign stakeholders in the structure of foreign direct investment (FDI) in the RF increased from 33.4% in 2010 to 40.7% in 2011, while the share of contributions to charter capital dropped from 55.8% to 49.3%.



Source: Rosstat.

Fig. 42. Foreign Investment Inflow in the Russian economy in 2004–2011 (as % of GDP)

In 2011, the major rating agencies estimated the RF rating credit to be at the same level as in 2010.

Table 14

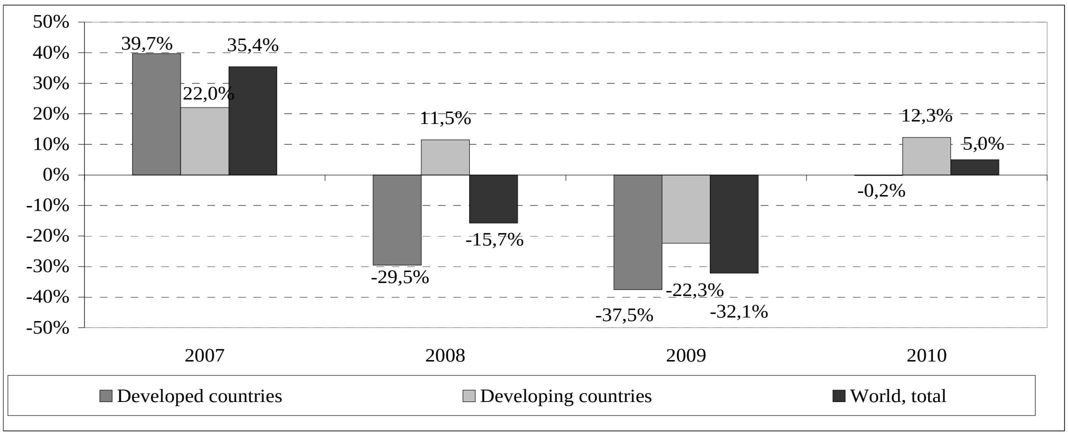
Structure of Foreign Investment in the Russian Economy[1]

	In m USD				As % of previous year			
	Total	**Direct**	**Portfolio**	**Other**	**Total**	**Direct**	**Portfolio**	**Other**
2007	120,941	27,797	4,194	88,950	219.5	203.2	131.8	232.6
2008	103,769	27,027	1,415	75,327	85.8	97.2	33.7	84.7
2009	81,927	15,906	882	65,139	79.0	58.9	62.3	86.5
2010	114,746	13,810	1,076	99,860	140.1	86.8	121.9	153.3
2011	190,643	18,415	805	171,423	166.1	133.3	74.9	171.7

Source: Rosstat.

According to the UNCTAD's *World Investment Report* published in July 2011, in 2010 the RF was the 7th most successful country in terms of the volume of attracted foreign direct investment (in 2009 – the 6th; in 2008 – the 5th; in 2007 – the 9th; in 2006 – the 10th; in 2005 – the 15th). As in the previous year, as far as the large developing economies were concerned, Russia came second after China in terms of the FDI volume. As stated in the *Report*, in 2010 Russia received 3.3% of the world foreign direct investment volume (in 2009 – 3.5%; in 2008 – 4.1%), and 7.1% of the volume of foreign direct investment inflow into developing countries (in 2009 – 8.2%; in 2008 – 11.9%) (*Fig. 43*).

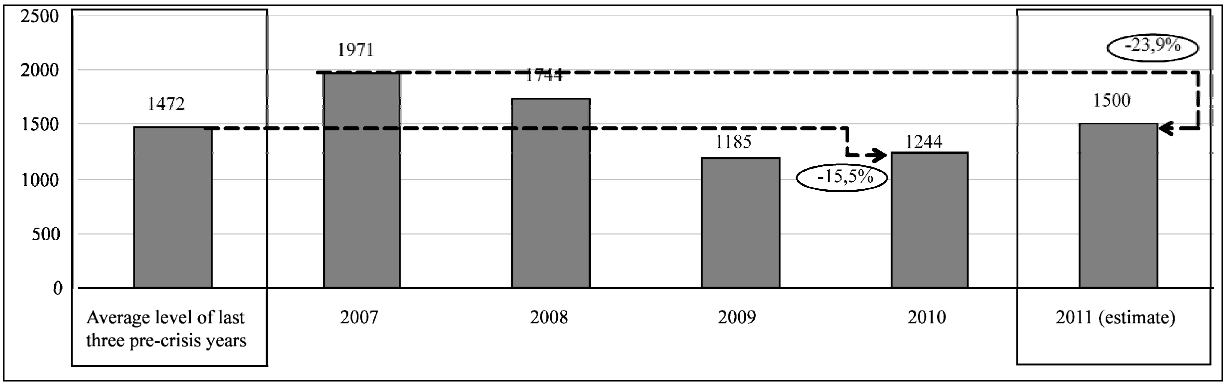
[1] Direct investments are investments in real assets, acquisition of a controlling stake or a stake with the right of participation in management; portfolio investments are investments in securities solely for deriving income; other investments are returnable investments (credits issued by international financial organizations, commercial credits, etc.).



Source: UNCTAD, World Investment Report 2011, 26.07.2011.

Fig. 43. Movement of Foreign Direct Investment Inflow in 2007–2010

In accordance with the UNCTAD's report, the world's aggregate foreign direct investment volume in 2010 rose slightly above its 2009 level (*Fig. 44*) According to preliminary estimates, in 2011 that index returned to its pre-crisis value, amounting to $ 1.4–1.6 trillion; in 2012 it will increase to $ 1.7 trillion; in 2013 the historic high of 2007 at the level of 1.9 trillion will be reached.



Source: UNCTAD, World Investment Report 2011, 26.07.2011.

Fig. 44. World's Foreign Direct Investment Inflow, bn USD

The implementation of that scenario can be possible in absence of any serious problems in the world economy. According to the pessimistic scenario, in 2011–2013 the aggregate foreign direct investment volume will remain at the level of 2010.

The segment of portfolio investments in the Russian economy in 2011 demonstrated a decline by 25.1% on 2010. Their structure displayed growth of investments in stock capital by 67.6%, with the resulting increase in their share from 32.0% in 2010 to 71.7% in 2011 (in 2007 – 95.5% of portfolio investment volume; in 2008 – 79.6%l un 2009 – 42.9%).

Other investments rose in 2011 by 71.7% on 2010 – by $ 71.4bn. The share of commercial credits within the 'other investments' structure dropped from 17.6% (by the results of the year 2010) to 16.2% in 2011 (in 2008 – 21.5%; in 2009 – 21.4%). In terms of loan period, the share of credits issued for periods over 6 months declined to 28.3% against 38.0% in 2010. (in

2008 – 68.1%; in 2009 – 67.9%). The share of credits issued for periods less than 6 months rose to 53.4% (in 2010 – 10.1%; in 2009 – 10.1%; in 2008 – 8.8%).

Thus, in 2011 the structure of foreign investment in the Russian economy remained practically the same as in the previous year (*Table 15*).

Table 15

Structure of Foreign Investment in the Russian Economy in 1996–2011, %

	Direct investment	Portfolio investment	Other investments
2000	40.4	1.3	58.3
2001	27.9	3.2	68.9
2002	20.2	2.4	77.4
2003	22.8	1.4	75.8
2004	23.3	0.8	75.9
2005	24.4	0.8	74.8
2006	24.8	5.8	69.4
2007	23.0	3.5	73.5
2008	26.0	1.4	72.6
2009	19.4	1.1	79.5
2010	12.0	1.0	87.0
2011	9.7	0.4	89.9

Source: Rosstat.

In 2011, as before, foreign investment was directed in the main towards the financial sphere, industry and trade. These sectors of the Russian economy accounted for 90.5% of the aggregate foreign investment volume (in 2010 – 86%). Investor interest in investing in transport and communications became less pronounced.

The lower rate of growth of foreign investment in industry and real estate transactions alongside increasing aggregate foreign investment indices and substantial growth of investments in trade and financial activity resulted in certain changes in the structure of foreign investment by comparison with the previous year. The distribution of foreign investment across the main sectors of the Russian economy is shown in *Table 16*.

Table 16

By Sector Structure of Foreign Investment in the Russian Economy in 2009–2011

	In m USD			As % of previous year			As % of total		
	2009	**2010**	**2011**	**2009**	**2010**	**2011**	**2009**	**2010**	**2011**
Industry	32 980	47 558	61 145	66.4	144.2	128.6	40.3	41.4	32.1
Transport and communications	13 749	6 576	5 943	282.8	47.8	90.4	16.8	5.7	3.1
Wholesale and retail trade; repair of motor vehicles, motorcycles, and personal and household goods	22 792	13 334	24 456	95.3	58.5	183.4	27.8	11.6	12.8
Real estate, renting and service rendering	7 937	7 341	9 237	51.6	92.5	125.8	9.7	6.4	4.8
Financial activity	2 658	37 913	86 885	53.4	1426.3	229.2	3.2	33.0	45.6
Other sectors	1 811	2 024	2 977	36.6	111.8	148.1	2.2	1.8	1.6

Source: Rosstat.

Within the structure of foreign investment in industry, as seen by the results of the year 2011, the leader in growth was the mining sector (extraction of mineral resources); investments in that sector rose by 34.5% on 2010 (in 2010 - by 34.2%) (*Fig. 45*). The volume of foreign investment in the processing industry rose by 23.9% (in 2010 – by 49.2%).

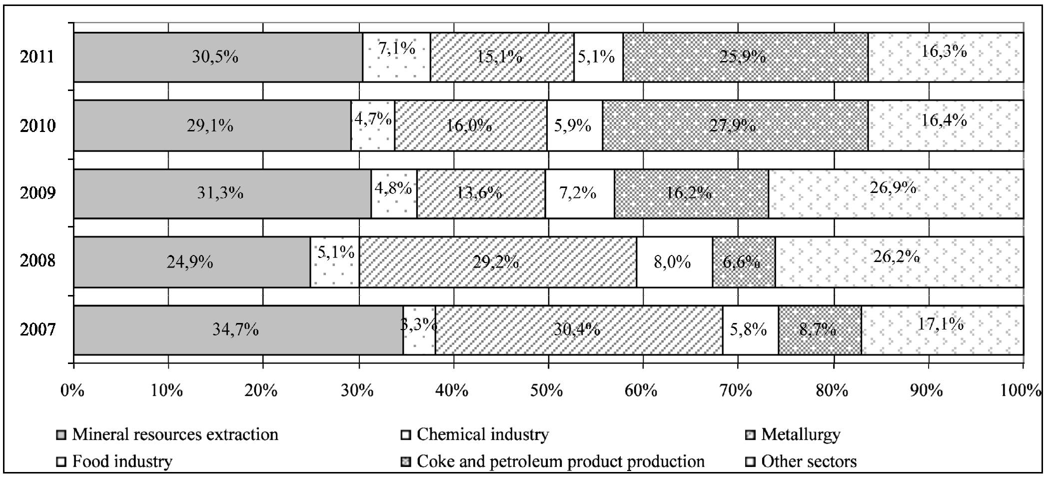
Within the processing industry, investments in the production of coke and petroleum products increased by 19.4%, and those in the chemical industry nearly doubled, amounting to

$ 15.8bn and $ 4.4bn respectively (in 2010, the former index increased 2.5 times, and the latter – by 41.3%). Foreign investment in metallurgy in 2011 rose by 21.1% on 2010 – to $ 9.2bn (in 2010 - by 69.7%).

The volume of direct and other investment in industry rose on 2010 by 40.6% and 26.4% respectively (in 2010, the former index declined by 7.9%, and the latter rose – by 62.0%). The volume of portfolio investment in industry increased by 39.9% (in 2010 that index dropped by 41.6%). Thus, the share of the volume of other investment in industry shrank from 84.9% in 2010 to 83.4% in 2011, and those of direct and portfolio investment over the same period increased from 14.3% to 15.7% and 0.8% to 0.9% respectively.

Some changes also occurred in the structure of foreign investment broken down by type of economic activity in industry. Direct investment in mineral resources extraction in 2011 increased 2.3 times to $ 4.6bn, resulting in growth of its share in the aggregate volume of investment in that sector to 24.8% (in 2010 – 14.7%; in 2009 – 30.7%; in 2008 – 40.2%). The share of other investment in mineral resources extraction, which in 2011 increased by 17.8% (to $ 13.9bn), dropped to 74.4% (in 2010 – 85.0%; in 2009 – 65.8%; in 2008 – 59.0%).

In 2011, the bulk of the investment volume in the processing industry was also constituted by other investment, whose volume rose on 2010 by 28.0%, thus amounting to 88.3% of the resulting volume of investment in the processing industry (in 2010 – 85.4%; in 2009 – 80.6%). The volume of direct foreign investment in the processing sectors remained almost unchanged, its growth amounting to 0.8%. The share of direct investment in the processing industry in 2011 shrank to 11.4% (in 2010 – 14.0%; in 2009 – 18.5%).

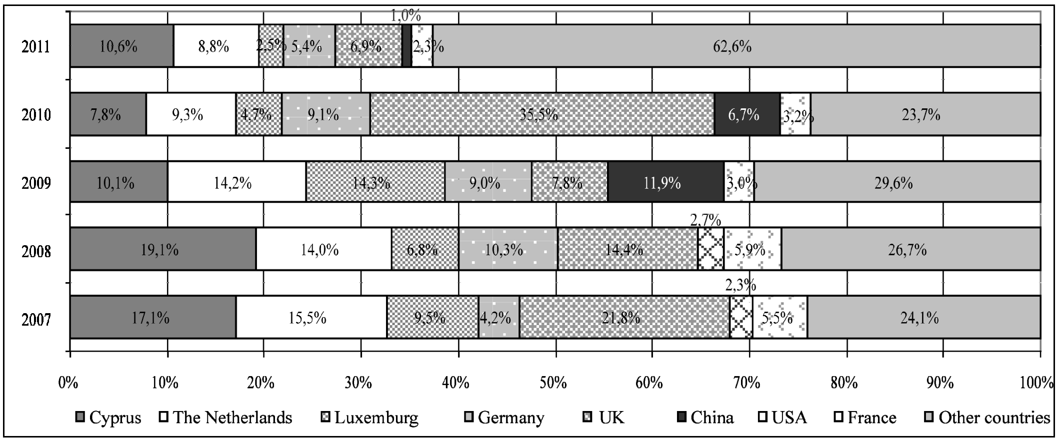


Source: Rosstat.

Fig. 45. Structure of Foreign Investment in Industry in 2007–2011

A noteworthy feature of the **geographical structure** of foreign investment flowing in the Russian economy in 2011 is the altered order of countries in the list of biggest capital exporters in the RF. In 2011, the highest volume – $ 20.3bn (10.6% of the total foreign investment volume in the Russiany economy over that period) – was transferred from the Cyprus, followed by The Netherlands ($ 16.8bn). The UK came third, its volume of investment in the Russian economy amounting to $ 13.1bn.

In 2011, the highest growth rate was displayed by investments from the Cyprus – 2.3 times on 2010; investments from The Netherlands increased by 57.2%, and those from Luxemburg and the UK declined by 12.9% and 67.9% respectively. The investment flow from China shrank by 75.3% (*Fig. 46*).



Source: Rosstat. Data for investments from the USA are for 2009–2011; China's investments in 2007–2008 are listed as other investment.

Fig. 46. Geographical Structure of Foreign Investment in the Russian Economy in 2007–2011

As of the end of the year 2011, the accumulated foreign capital volume, less that of monetary regulation agencies, commercial and savings banks and including that of ruble-denominated investments recalculated in US dollars, amounted to $ 347.2bn, which is 15.7% more than the value of that index as of the year's beginning. The volume of accumulated direct investment since the year's beginning increased by 19.8%, other investment – by 13.2%.

As seen by the results of the year 2011, the leaders in terms of the accumulated foreign capital volume are Cyprus, The Netherlands, Luxemburg, Germany, and China, their aggregate share amounting 63.5% (in 2010 – to 64.4%; in 2009 – to 66.3%). At the same time, the share of the top five investor countries in the other investment segment is estimated to be at the level of 63.2% (in 2010 – 64.8%; in 2009 – 62.9%), their shares in the structure of direct and portfolio investment is estimated to be 66.9% and 22.1% respectively (in 2010 – 67.1% and 21.9%; in 2009 – 69.0% and 85.1%).

In the structure of foreign investment accumulated as of the end of the year 2011 the share of other investment is highest and amounts to 57.1% (in 2010 – to 58.3%). The same index with regard to foreign direct investment is 40.1% (in 2010 – 38.7%).

4.4. The Oil and Gas Sector

Oil and gas production remain the core sector of Russia economy, which has a leading role in generating federal budget revenue and this country's balance of trade. The factors that exerted the most significant influence on the development of the oil and gas sector of the Russian economy in 2011 were the situation on the world oil market; the situation on the European gas market; and the objective deterioration of the conditions for the extraction of oil and natural gas, which is associated with a declining production at the 'old' deposits and the considerably higher costs of the development of new ones, especially in unpopulated areas with no infrastructure.

4.4.1. The Dynamics of International Prices of Oil and Natural Gas

A decisive influence on the situation on the world oil market in 2011 was produced by the relative rebound of the world economy after the financial and economic crisis of 2008–2009. The price of Brent in 2011 rose to the level of 111.0 USD/barrel, while that of Russia's Urals on the world (European) market increased to 109.1 USD/barrel, which is 39.3% above the previous year's level and 15.4% above the pre-crisis historic high achieved in 2008 (*Table 17*). The principal factors that determined price growth were as follows: an increasing demand for oil (*Table 18*) that resulted from growth of the world economy, and first of all the national economies of China, India and other Asian countries; the OPEC's conservative policy towards increasing the volumes of oil extraction in its member countries; the low rate of growth of oil production outside of the OPEC; and the drop in the supplies of oil from Libya as a result of the military actions in that country's territory. In conditions of the shrinking Libyan oil supplies, in April 2011 the international price of Brent surged to 123.1 USD/barrel To compensate for the decline in the supply of oil from Libya, and in fear of a negative effect of high international oil prices on international demand, some OPEC countries (and first of all Saudi Arabia) increased oil production in excess of the quotas established by the OPEC. This pushed down the international oil price to 110 USD/barrel (*Table 19, Fig. 47*).

In December 2011, on the basis of an estimated demand on the international market for additional supplies of oil, the OPEC increased the aggregate quota for oil extraction by its member countries to 30m barrel per day (including Iraq, on whose extraction volumes no restrictions had been imposed previously, and Libya). The new quota effectively corresponded to the level of oil extraction achieved by the OPEC in 2011. That level, however, is still below the OPEC countries' oil extraction level in 2008 (31.6m barrel per day).

Table 17

International Oil Prices in 2000–2011, USD/barrel

	2000	2005	2006	2007	2008	2009
Price of Brent, UK	28.5	54.4	65.2	72.5	97.7	61.9
Price of Urals, Russia	26.6	50.8	61.2	69.4	94.5	61.0

cont'd

	2010	2011				2011
		Q1	Q2	Q3	Q4	
Price of Brent, UK	79.6	104.9	117.1	112.5	109.3	111.0
Price of Urals, Russia	78.3	102.2	114.0	111.5	108.6	109.1

Source: IMF, OECD/IEA, OPEC.

Table 18

International Demand for Oil in 2008–2011, As % of Same Period of Previous Year

	2008	2009	2010	2011
World, total	–0.6	–1.2	3.2	0.8
OECD countries	–3.6	–4.2	1.1	–1.2
including: North America	–5.2	–3.7	2.0	–1.4
Europe	–0.6	–4.7	–0.5	–1.9
Asia-Pacific Region	–4.0	–4.6	1.7	0.5
Non-OECD countries	3.3	2.5	5.5	3.0
including: Asia (without Near East countries and former USSR republics)	1.7	4.4	7.0	3.5

Source: OECD/IEA.

Table 19

International Oil Prices in 2011, USD/barrel

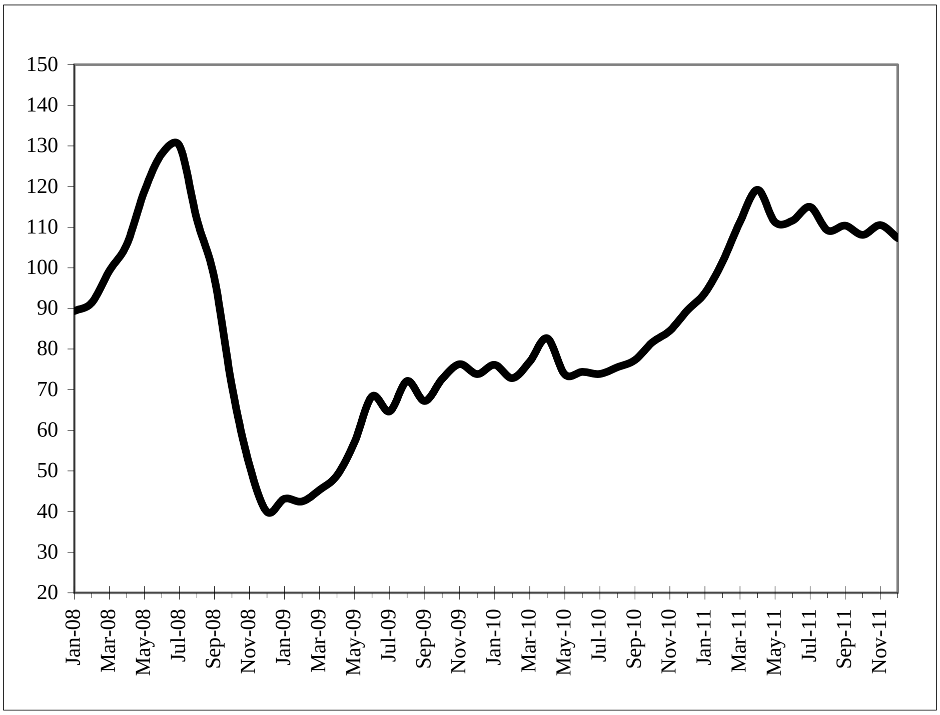
	January	February	March	April	May	June
Price of Brent, UK	96.3	104.0	114.4	123.1	114.5	113.8
Price of Urals, Russia	93.8	101.5	111.3	119.2	111.2	111.6

cont'd

	July	August	September	October	November	December
Price of Brent, UK	116.5	110.1	110.9	109.5	110.7	108.0
Price of Urals, Russia	115.0	109.2	110.4	108.1	110.5	107.3

Source: OECD/IEA, OPEC.

The prices of natural gas on the international market are determined, as a rule, by the level of prices of alternative energy carriers, in the main gasoil/diesel fuel and fuel oil, whose prices, in their turn, depend on international oil prices. Therefore the movement of the international prices of natural gas follows, with a certain lag, that of the international oil prices. The price of Russian natural gas on the European market reached its peak in 2008 followed by a historic low in 2010 (*Table 20*). In 2011, when international oil prices were on the rise, the price of Russian gas natural gas on the European market also rose significantly and amounted to 381.5 USD/1,000 m³, thus climbing 28.9% above the previous year's level. At the same time, the prices of Russian natural gas were declining in response to the changing situation on the European gas market, namely the rising natural gas supply, and in particular, the considerably increased supplies of liquefied natural gas (LNG), coupled with a lower level of natural gas spot prices by comparison with long-term contract prices (*Table 21*).



Source: RF Ministry of Economic Development.

Fig. 47. Price of Urals in 2008–2011, USD/barrel

Table 20

International Prices of Oil and Natural Gas in 2002–2011, USD/barrel

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Mean international price of oil, USD/barrel	24.95	28.89	37.76	53.4	64.3	71.1	97.0	61.8	79.0	103.9
Price of Russian natural gas on the European market, USD/1,000 m³	96.0	125.5	135.2	212.9	295.7	293.1	473.0	318.8	296.0	381.5

Source: IMF.

Table 21

Prices of Oil and Natural Gas on the European market in 2010–2011, USD/barrel

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Price of Brent, USD/barrel	76.7	78.7	76.4	86.8	104.9	117.1	112.5	109.3
Price of Russian gas on the European market, USD/1,000 m³	273.2	291.4	306.5	313.0	329.4	360.6	401.0	434.9
Natural gas spot prices gas on the European market (The Netherlands), USD/1,000 m³	145.4	178.8	204.0	224.5	244.7	246.3	239.3	247.1

Source: IMF, Bloomberg.

4.4.2. Production Dynamics and Structure in the Oil and Gas Sector

Growth in the volume of oil extraction in Russia in the first half of the 2000s occurred in response to the expanding opportunities for exports, in particular as a result of the creation of the Baltic Pipeline System, a more intensive development of the existing deposits and the increasing investment potential of oil companies due to the rising international oil prices. In the following years the rate of oil extraction growth dramatically dropped. If in 2002–2004 it was at the level of 8.9 to 11% per annum, in 2006–2007 the rate’s per annum growth amounted to only 2.1%, and in 2008, for the first time over the recent period, the volume of oil extraction declined. This was a clear sign that the reserves for increasing oil extraction in this country through intensifying the development of the existing oil fields had been exhausted, and Russia had, from now on, to more actively develop new oil fields. In 2009, the volume of oil extraction once again began to rise, although its growth rate remained relatively low. In 2011, Russia’s oil output rose by 0.8% on the previous year (*Table 22*, *23*). This positive dynamics was determined by both the putting in operation of several big oil fields in the north of the European Russia and in Eastern Siberia and by some alterations introduced in taxation with the purpose of lowering the tax load on the oil sector, creating incentives for deeper oil extraction from existing oil fields and to encourage the development of new oil deposits in untapped regions.

Table 22

Oil Production and OIL Refining in the Russian Federation in 2000–2011

	2000	2005	2006	2007	2008	2009	2010	2011
Oil extraction, including natural gas condensate, m tons	323.2	470.0	480.5	491.3	488.5	494.2	505.1	511.4
Primary crude oil distillation, m tons	173	208	220	229.0	236.3	236.0	249.3	258.0
Share of oil refining in oil extraction, %	53.5	44.3	45.8	46.6	48.4	47.8	49.4	50.4
Oil refining efficiency, %	71	71.6	71.9	71.7	72.0	71.9	71.1	70.8

Source: RF Federal State Statistics Service.

Table 23

Production of Oil, Petroleum Products and Natural Gas in 2000 – 2011, as a Percentage of the Previous Year

	2000	2005	2006	2007	2008	2009	2010	2011
Oil, including natural gas condensate	106.0	102.2	102.1	102.1	99.3	101.2	102.1	100.8
Primary crude oil distillation	102.7	106.2	105.7	103.8	103.2	99.6	105.5	103.3
Motor gasoline	103.6	104.8	107.4	102.1	101.8	100.5	100.5	102.0
Diesel fuel	104.9	108.5	107.0	103.4	104.1	97.7	104.2	100.3
Furnace fuel oil	98.3	105.8	104.5	105.2	101.9	100.8	108.5	104.6
Natural gas	98.5	100.5	102.4	99.2	101.7	87.9	111.4	102.9

Source: RF Federal State Statistics Service.

The volume of oil refining in recent years has been increasing at a faster rate than that of oil extraction, mainly due to a more rapid growth of RF exports of petroleum products induced by the lower exports duties on them as compared to the exports duties on crude oil. In 2005–2011, the growth rate of primary oil refining was 3.2–6.2% per annum (with the exception of 2009), while that of oil extraction was 0.8–2.2% per annum (with the exception of 2008). As a result, the share of the volume of oil refining in the volume of oil extraction rose from 42.5% in 2004 to 50.4% in 2011. At the same time, Russia's oil refining efficiency over the last decade did not increase, and in 2011 it amounted to only 70.8%, which effectively corresponds to the level of 2000 (it can be noted that in the leading industrially developed countries oil refining efficiency is 90–95%). As before, Russia's oil refining efficiency and the quality of its petroleum products remain significantly below international levels.

In 2011, the largest volumes of oil were produced by the oil companies *Rosneft*, *LUKOIL*, *TNK-BP*, *Surgutneftegaz,* and *Gazprom.* These five companies accounted for 74 % of Russia's total oil production. Medium-sized companies (*Tatnef*, *Slavneft*, *Bashneft* and *RussNeft*) accounted for 14.4 % of this country's crude oil output. In 2011, the operators of production sharing agreements accounted for 3 % of all oil extracted in Russia. The share of all the other oil producers that comprised more than 100 small oil-extracting establishments amounted to only 8% (*Table 24*). State companies (federally owned) accounted for 31.1% of Russia's crude oil output. For reference it can be noted that, in 2003 (i.e., before their takeover of the assets of private oil companies), the share of *Rosneft* and *Gazprom* in Russia's crude oil output was only 7.3%.

Table 24

Structure of Oil Production in 2008–2011

	Oil extraction in 2008, m tons	Share in total output of crude oil, %	Oil extraction in 2010, m tons	Share in total output of crude oil, %	Oil extraction in 2011, m tons	Share in total output of crude oil, %
1	2	3	4	5	6	7
Russia, total	488.5	100.0	505.1	100.0	511.4	100.0
Rosneft	113.8	23.3	112.4	22.3	114.5	22.4
LUKOIL	90.2	18.5	90.1	17.8	85.3	16.7
TNK – BP	68.8	14.1	71.7	14.2	72.6	14.2
Surgutneftegaz	61.7	12.6	59.5	11.8	60.8	11.9
Gazprom + Gazprom Neft	43.4	8.9	43.3	8.6	44.8	8.8
including: Gazprom	12.7	2.6	13.5	2.7	14.5	2.8
Gazprom Neft	30.7	6.3	29.8	5.9	30.3	5.9
Tatneft	26.1	5.3	26.1	5.2	26.2	5.1
Slavneft	19.6	4.0	18.4	3.6	18.2	3.6
Bashneft	11.7	2.4	14.1	2.8	15.1	3.0

cont'd

1	2	3	4	5	6	7
RussNeft	14.2	2.9	13.0	2.6	13.6	2.7
Novatek	2.7	0.6	3.8	0.8	4.1	0.8
Operators of PSA	12.0	2.5	14.4	2.9	15.1	3.0
Other producers	24.1	4.9	38.2	7.6	41.1	8.0
State companies, total: Rosneft + Gazprom + + Gazprom Neft	157.2	32.2	155.7	30.8	159.3	31.1

Source: RF Ministry of Energy; the author's calculations.

Natural gas production was traditionally dominated by *Gazprom*. At the same time, its share in this country's output of natural gas in recent years has noticeably declined: from 83.2% in 2008 to 75.5% in 2011. At the same time, the share of other producers increased, including that of oil companies, *Novatek*, and the operators of production sharing agreements. The share of state companies (federally owned) in 2011 accounted for 78.2% of Russia's natural gas output (*Table 25*).

The decline in the growth rate of oil output can be explained in the main by the deterioration, for objective reasons, of extraction conditions. A considerable number of the currently functioning oil fields are decreasing their output, while the majority of the new oil fields are characterized by somewhat worse geographical and mining parameters, and so their development is associated with higher capital inputs and higher exploitation and transportation costs.

Table 25

Structure of Natural Gas Production in 2008–2011

	Gas extraction in 2008, bn cubic meters	Share in total output, %	Gas extraction in 2010, bn cubic meters	Share in total output, %	Gas extraction in 2011, bn cubic meters	Share in total output, %
Russia, total	664.9	100.0	665.5	100.0	687.5	100.0
Gazprom + Gazprom Neft)	553.1	83.2	513.9	77.2	519.0	75.5
including: Gazprom	550.9	82.9	509.0	76.5	510.1	74.2
Oil companies	54.8	8.2	66.6	10.0	69.1	10.1
Novatek	30.8	4.6	37.8	5.7	53.5	7.8
Operators of PSA	8.5	1.3	23.3	3.5	25.2	3.7
Other producers	17.6	2.6	23.9	3.6	20.7	3.0
State companies, total: Rosneft + Gazprom + + Gazprom Neft	566.1	85.1	531.2	79.8	537.6	78.2

Source: RF Ministry of Energy; the author's calculations.

4.4.3. The Dynamics and Structure of Oil and Gas Exports

While the value of Russia's exports of oil and petroleum products considerably increased due to the rise in international oil prices, its physical volume somewhat declined: according to preliminary estimates, net exports of oil and petroleum products in 2011 amounted to 373.3m tons (*Table 26, 27*). The share of net exports of oil and petroleum products in total oil output was at the level of 73.0%. Oil exports in 2011 rose to 48.1% of oil output. Over that year, the share of exports in fuel oil and motor gasoline production amounted to 89.5% and 55.5% respectively. At the same time, motor gasoline exports in 2011 rose by 12.4%, while the share of motor gasoline exports in its output rose to 10.6% (for reference: in 1999 the share of exports in motor gasoline production was 7.2%, in 2005 – 18.5%, in 2009 – 12.6%, and in

2010 – 8.2%). Besides, the year 2011 saw a noticeable growth of imports of oil products (by 1.4 times on 2010) and a decline in the share of imports in the coverage of domestic demand. The share of imports in the total volume of motor gasoline resources rose from 0.6% in 2009 to 1.4% in 2010 and to 2.5% in 2011 (for reference: in the first half-tear 1998 share of imports in motor gasoline resources was 8.7%, in 2008 – 0.7%).

Table 26

Exports of Oil, Petroleum Products and Natural Gas from Russia in 2002 – 2011, as a Percentage of the Previous Year

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 11 months*
Oil, total	113.9	117.8	115.0	98.4	98.0	104.0	94.0	101.8	101.2	98.2
including: to non-CIS countries	109.9	118.9	116.3	99.1	98.0	104.8	92.6	102.9	106.1	96.2
Petroleum products, total	118.5	103.6	105.5	117.9	106.3	108.0	105.0	105.3	106.2	99.6
including: to non-CIS countries	119.1	102.6	104.9	119.1	104.5	107.6	102.0	107.1	109.6	96.1
Natural gas, total	102.4	102.0	105.5	103.7	97.6	94.6	101.8	86.2	105.6	106.5

* As % of relevant period of 2010.
Source: RF Federal State Statistics Service.

Table 27

Relationship between the Production, Consumption and Exports of Oil and Natural Gas in 2000 – 2011

	2000	2005	2006	2007	2008	2009	2010	2011*
Oil, m tons								
Output	323.2	470.0	480.5	491.3	488.5	494.2	505.1	511.4
Exports, total	144.5	252.5	248.4	258.4	243.1	247.4	250.4	245.9
Exports to non-CIS countries	127.6	214.4	211.2	221.3	204.9	210.9	223.9	215.4
Exports to CIS countries	16.9	38.0	37.3	37.1	38.2	36.5	26.5	30.5
Net exports	138.7	250.1	246.1	255.7	240.6	245.6	249.3	244.8
Domestic consumption	123.0	123.1	131.2	124.1	130.4	125.3	125.9	138.1
Net exports, as % of output	42.9	53.2	51.2	52.0	49.3	49.7	49.4	47.9
Petroleum products, m tons								
Exports, total	61.9	97.0	103.5	111.8	117.9	124.4	132.2	131.7
Exports to non-CIS countries	58.4	93.1	97.7	105.1	107.6	115.4	126.6	121.7
Exports to CIS countries	3.5	3.9	5.8	6.7	10.3	9.0	5.6	10.0
Net exports	61.5	96.8	103.2	111.5	117.5	123.3	129.9	128.5
Oil and petroleum products, m tons								
Net exports of oil and petroleum products	200.2	346.9	349.3	367.2	358.1	368.9	379.2	373.3
Net exports of oil and petroleum products, as % of oil output	61.9	73.8	72.7	74.7	73.3	74.6	75.1	73.0
Natural gas, bn m³								
Production	584.2	636.0	656.2	654.1	664.9	596.4	665.5	687.5
Exports, total	193.8	207.3	202.8	191.9	195.4	168.4	177.8	189.4
Exports to non-CIS countries	133.8	159.8	161.8	154.4	158.4	120.5	107.4	118.2
Exports to CIS countries	60.0	47.5	41.0	37.5	37.0	47.9	70.4	71.2
Net exports	189.7	199.6	195.3	184.5	187.5	160.1	173.5	185.1
Domestic consumption	394.5	436.4	460.9	469.6	477.4	436.3	492.0	502.4
Net exports, as % of petroleum products	32.5	31.4	29.8	28.2	28.2	26.8	26.1	26.9

* Estimation.
Source: RF Federal State Statistics Service; RF Ministry of Energy; Federal Customs Service; the author’s calculations.

After a significant drop in natural gas exports in 2009, when as a result of the sharp reduction in its deliveries to Europe it declined to 13.8%, in 2010–2011 the volume of gas exports once again rose and approached its pre-crisis level. At the same time, the share of net exports in natural gas output somewhat shrank – from 28.2% in 2008 to 26.9% in 2011.

While the share of petroleum products in the structure of oil exports had somewhat increased, it nevertheless remained smaller than the share of crude oil exports – in 2011 it amounted to 65.6% of the total volume of exported oil and petroleum products. The bulk of exported petroleum products was constituted by furnace fuel oil (which in Europe is used as raw material for further refining) and diesel fuel. And the bulk of exported energy carriers (in 2011: 88% of crude oil; 92% of petroleum products; and 62% natural gas) was exported to countries outside of the CIS.

An analysis of the changes in Russian oil exports over a long period of time demonstrates an increasing share of petroleum products, which rose from 18.2% in 1990 to 34.4 % in 2011 (*Table 28*). In conditions of shrinking domestic consumption of oil (according to our estimations, it dropped from 269.9m tons in 1990 to 138.1m tons in 2011), the share of net exports of oil and petroleum products in oil output rose over that period from 47.7 to 73.0%.

Table 28

Net Exports of Petroleum Products in 2002–2011

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011*
Net exports of petroleum products, m tons	74.8	78.2	81.4	96.8	103.2	111.5	117.5	123.3	129.9	128.5
Share of petroleum products in net exports of oil and petroleum products, %	29.2	26.8	24.3	27.9	29.5	30.4	32.8	33.4	34.3	34.4

* Estimated values.

Source: RF Federal State Statistics Service; Federal Customs Service; the author’s calculations.

These data point to a significant strengthening of the oil sector’s orientation towards exports by comparison with the pre-reform period. However, it should be remembered that this phenomenon has been associated not only with growth in the volume of exports in absolute terms, but also with a significant drop in the domestic oil consumption as a result of market transformation of the Russian economy. Rapid economic growth in the years preceding the financial and economic crisis of 2008–2009 was accompanied by stable volumes of domestic oil consumption, which is a manifestation of a declining oil intensity of Russia’s GDP.

In 2011, the rising international oil prices triggered dramatic growth of incomes in the oil sector of Russia’s economy (*Fig. 48, 49*). The aggregate revenues from exports of oil and the major types of petroleum products (motor gasoline, diesel fuel and fuel oil) in January–November 2011 reached the level of $ 235.7bn – a historic high for the entire post-reform period (*Table 29*). For reference it can be noted that the historic low of revenues from oil exports was observed in 1998, in response to the drop in the international oil prices, when proceeds from exports amounted to only $ 14bn.

Table 29

Revenues from the Export of Oil and Petroleum Products in 2000 – 2011, bn USD

	2000	2005	2006	2007	2008	2009	2010	2011 (11 months)
Revenues from export of oil and major types of petroleum products	34.9	112.4	140.0	164.9	228.9	141.2	193.9	235.7

Source: calculations are based on data provided by the RF Federal State Statistics Service.

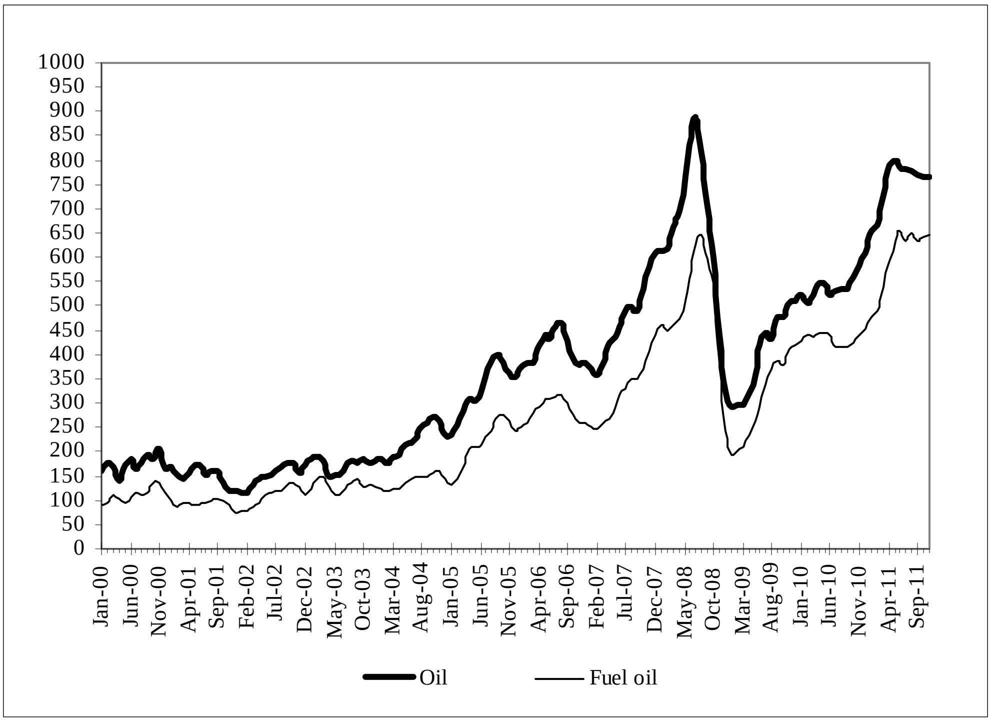
In 2011, under the influence of rising international oil prices, the share of fuel and energy products in Russian exports hit the level of 69.2%, including crude oil – 34.7% (*Table 30*).

Table 30

Value and Share of Exports of Fuel and Energy Products in 2005–2011

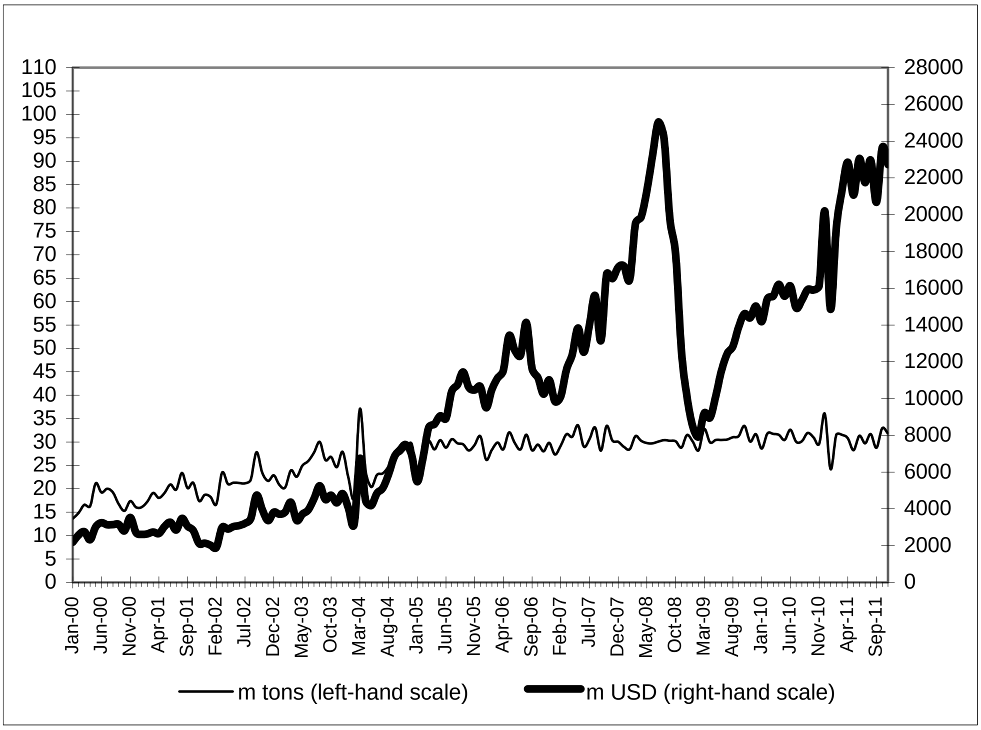
	2005		2008		2009		2010		2011	
	bn USD	%*	bn USD	%*	bn USD	%*	bn USD	%*	bn USD	%*
Fuel and energy products, total	154.7	64.1	321.1	68.6	201.1	66.7	267.7	67.5	357.2	69.2
including: oil	83.8	34.7	161.2	34.4	100.6	33.3	134.6	34.0	179.1	34.7
natural gas	31.4	13.0	69.1	14.8	42.0	13.9	47.6	12.0	63.8	12.4

* As % of total Russian exports.
Source: RF Federal State Statistics Service.



Source: calculations are based on data provided by the RF Federal State Statistics Service.

Fig. 48. Mean Export Prices of Oil and Fuel Oil in 2000–2011, USD/ton



Source: calculations are based on data provided by the RF Federal State Statistics Service.

Fig. 49. Exports of Oil and Petroleum Products (Physical Volume and Value) in 2000–2011, in m tons and m USD

4.4.4. The Behavior of Prices for Energy Products on the Domestic Market

The changes in international oil prices in 2011 induced a noticeable growth in the prices of oil and petroleum products on the domestic market. However, their prices so far have not reached their historic peaks of July 2008, when the average domestic oil price (producer price) in dollar terms hit the level of 410.2 USD/ton, and the average price of motor gasoline amounted to 810.3 USD/ton. In late 2008 – early 2009, in response to the decline of international oil prices, the domestic prices of oil and petroleum products likewise dropped in dollar terms. However, later on, as international oil prices once again began to climb, the domestic prices also demonstrated a significant growth (*Table 31, Fig. 50, 51*).

Table 31

Domestic Prices of Crude Oil, Petroleum Products and Natural Gas Expressed in US dollars in 2000 – 2011 (Average Producer Prices, USD/ton)

	2000 December	2005 December	2006 December	2007 December	2008 December	2009 December
Crude oil	54.9	167.2	168.4	288.2	114.9	219.3
Motor gasoline	199.3	318.2	416.5	581.2	305.1	457.4
Diesel fuel	185.0	417.0	426.1	692.5	346.5	394.8
Furnace fuel oil	79.7	142.7	148.8	276.5	125.0	250.8
Natural gas, USD/thousand cubic meters	3.1	11.5	14.4	17.6	18.1	16.9

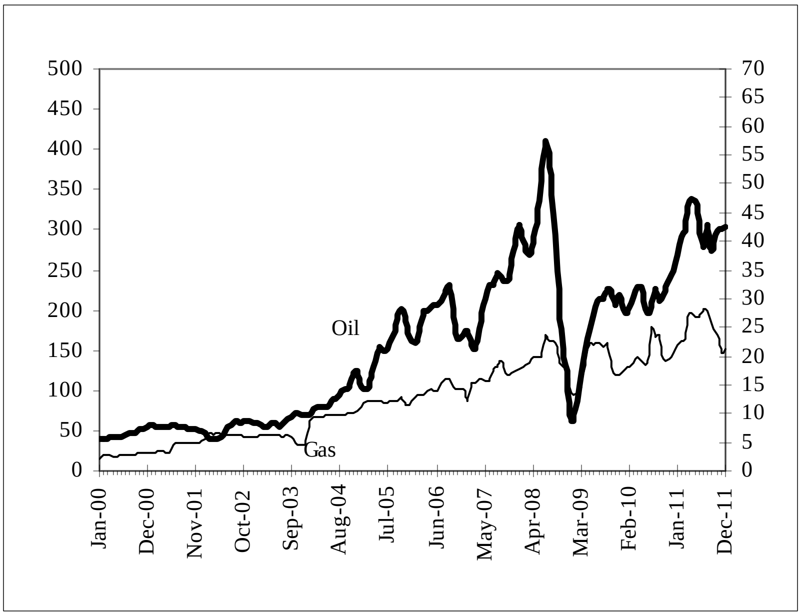
cont'd

	2010 December	2011 January	2011 March	2011 June	2011 September	2011 December
Crude oil	248.2	269.2	304.4	302.7	273.2	303.3
Motor gasoline	547.9	524.9	556.7	647.7	607.5	576.9
Diesel fuel	536.1	570.9	584.5	605.2	553.0	644.9
Furnace fuel oil	246.3	264.0	281.7	308.8	303.0	274.6
Natural gas, USD/thousand cubic meters	20.5	21.9	23.1	26.8	25.7	21.3

Source: calculations are based on data provided by the RF Federal State Statistics Service.

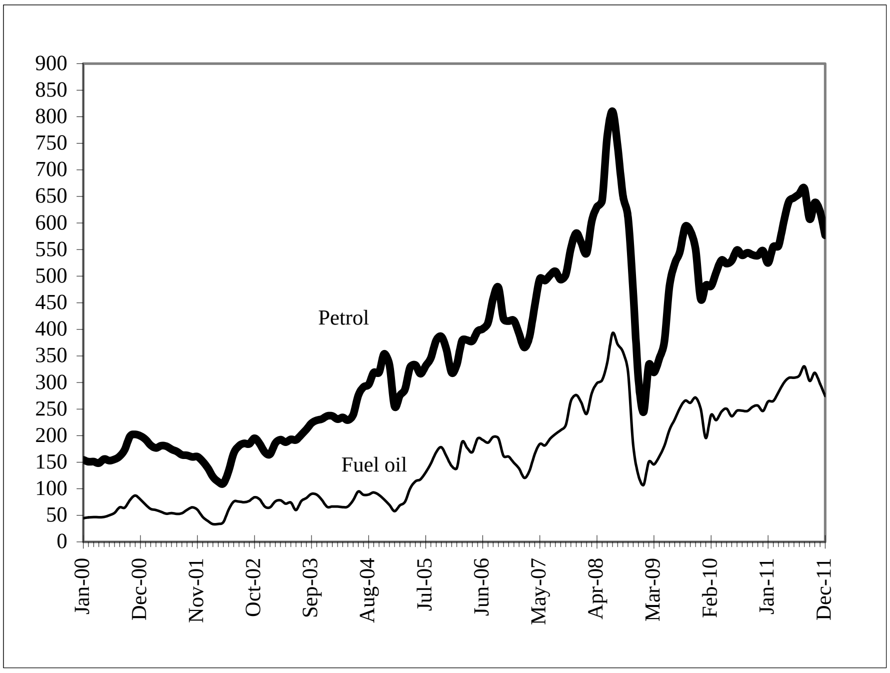
At the same time, Russia's domestic oil prices, as before, remain at a level significantly below that of international oil prices. The gap between the international and domestic oil prices is caused by objective factors: the export duty on oil and the additional transportation costs associated with oil exports. As for the domestic prices of natural gas, these so far have been subject to government regulation. In order to sustain the competitive capacity of Russia's national economy, the RF government maintains the domestic prices of natural gas at a significantly lower level that the prices on the European market.

An extraordinary event for Russia was the so-called *gasoline crisis* in April – May 2011, whose manifestation was an acute shortage of gasoline in some regions. As a result, these regions experienced a rapid surge of gasoline prices (thus, for example, in mid-May in the Republic of Tyva the prices of gasoline at independent filling stations that did not belong to the vertically integrated structures of oil companies were as high as 50 Rb/liter, while Russia's average price was only 24.8 Rb/liter). Such a situation became possible due to increasing gasoline exports coupled with their shrinking supplies on the domestic market. In this connection, in order to limit exports and fill the domestic market, the export duty on gasoline from May onwards was raised from 67% to 90% of the export duty on oil.



Source: calculations are based on data provided by the RF Federal State Statistics Service.

Fig. 50. Average Producer Prices of Oil and Natural Gas in Dollar Terms in 2000–2011, USD/ton, USD/1000 m³



Source: calculations are based on data provided by the RF Federal State Statistics Service.

Fig. 51. Average Producer Prices of Motor Gasoline and Furnace Fuel Oil in Dollar Terms in 2000–2011, USD/ton

The gasoline crisis had two main causes: the government's pricing policy – namely, the freezing of the prices of gasoline on the domestic market; and the introduction of new technical standards for motor fuel. In January 2011, in response to the rise in international prices and increased rates of excises, the domestic price of petroleum products also climbed up. However, already in early February the RF government, operating, as it frequently happens, in micro-management mode, recommended Russia's oil companies that the prices of gasoline and diesel fuel should be reduced, after which the prices obligingly dropped. In February, March and Aprile the retail prices of gasoline in Russia were below the January level and only slightly above the December 2010 level, while the producer prices were below their December level (*Table 32*).

Table 32

Prices of Motor Gasoline in Russia in 2010–2011, ruble/liter

	2010 December	**2011 January**	**2011 February**	**2011 March**	**2011 April**	**2011 May**
Consumer prices of Au92 motor gasoline (Au93, etc.)	23.42	24.25	23.66	23.42	23.63	25.11
Au95 and higher	25.29	26.11	25.60	25.42	25.56	26.89
Producer price of: Au92	12.33	11.48	11.98	11.56	12.21	13.36

Source: RF Federal State Statistics Service.

At the same time, the prices of oil and petroleum products on the world market displayed rapid growth. The price of Urals on the European market rose from 89.5 USD/barrel in December 2010 to 119.2 USD/barrel in Aprile, or by 33%. The price of gasoline on the European market (less indirect taxes) over the same period rose from 0.566 euro/liter to 0.738 euro/liter, or by 30% (*Table 33*). In Russia, on the contrary, the domestic price of gasoline (producer price) in April was below its December level by 1%, while the retail price of Au92 gasoline rose only by 0.5%. As a result, exports turned out to be more profitable than supplies on the domestic market, and so oil companies responded to that situation by increasing their volume of gasoline exports. According to *Rosstat*'s data, exports of motor gasoline in January – April 2011 rose on the same period of 2010 by 16.0%, while the share of exports in gasoline output increased to 13.6%.

Table 33

Prices of Motor Gasoline in Germany* in 2010–2011, euro/liter

	2010 December	2011 March	2011 April
Consumer price	1.453	1.587	1.658
Tax on consumers	0.887	0.908	0.920
Price less taxes	0.566	0.679	0.738

* Price of Au95.
Source: OECD/IEA.

In this connection, an important role was also played by the introduction of new technical standards for fuel. From 1 January 2011, Russia introduced Euro-3 fuel standard for motor gasoline, with the result that class 2 gasoline (of lower quality) was either no longer produced, or was produced exclusively for exports. Some oil companies, for technical reasons, were unable to replace the production of that class of gasoline by class 3 gasoline, which had a negative impact on the overall gasoline supply. In January – April 2011, the volume of gasoline production amounted to 99.7% of that in the same period of 2010; in particular, the April 2011 volume was only 96.4% of the volume produced in April 2010.

In these conditions, the introduction of an elevated (restrictive) export duty on gasoline in the amount of 90% of the rate of the export duty on oil, as well as a weaker administrative pressure on prices made it possible to increase the supplies of gasoline on the domestic market and thus bring the situation back to normal. Later on, it was decided that this rate of the export duty on gasoline should be maintained.

4.4.5. Tax Regulation of the Oil and Gas Sector

A positive influence on the oil sector was produced by alterations in the system of taxation designed to lower the tax load, create incentives for deeper oil extraction from existing oil fields and to encourage the development of new oil deposits in untapped regions and on the continental shelf. From the year 2009 onwards, the non-taxable minimum in the formula for calculating the *Cp* coefficient (which reflects the movement of world oil prices and is applied to the Mineral Resources Extraction Tax (MRET) basic rate for oil) was increased from 9 USD per barrel to 15 USD per barrel (*Table 34*). This resulted in a significant reduction in the MRET rate for oil extraction. Besides, the requirement that the direct method for calculating the physical quantity of oil extracted from each ring-fenced field should be used when applying the regressive coefficient to the MRET rate for highly depleted deposits was abolished. This measure made it possible to extend this benefit to all depleted deposits, thus creating incentives for the prolongation of their exploitation and making some additional oil extraction feasible.

Table 34

The MRET Rate for Oil Extraction in 2005 – 2011

	2005	2006	2007	2008	2009	2010	2011
MRET basic rate for oil extraction, Rb/ton	419	419	419	419	419	419	419
Coefficient characterizing movement of world oil prices (*Cp*)	(P–9) x R/261				(P –15)× R /261		
Coefficient characterizing degree of deposit depletion (Cd)	–		3.8–3.5×N/V				

Note: P = average price of one barrel of Urals (USD per barrel) for tax period; R = average Rb / USD exchange rate for tax period as established by the RF Central Bank; N = cumulative oil production per ring-fenced field; V = initial producible oil reserves of A, B, C1, and C2 categories per ring-fenced field.
Source: RF Tax Code; Federal Law of 22 July 2008, No. 158-FZ; Federal Law of 27 July 2006, No. 151-FZ; Federal Law of 7 May 2004, No. 33-FZ.

In order to stimulate the development of untapped basin provinces, tax holidays with regard to MRET were established for the new oil fields situated in territories with no infrastructure (*Table 35*). Thus, for example, for the development of new oil fields in the East Siberian Oil and Natural Gas Basin Province within the border of the Republic of Sakha (Yakutua), in Irkutsk Oblast and in Krasnoyarsk Krai, the zero rate export duty was introduced on oil production up to the volume of 25m tons per ring-fenced field if the established period of 10 years for its development is not exceeded; or for a period of 10 years under a license obtained for the use of land for the purpose of exploration and extraction, or for a period of 15 years under a license obtained for the simultaneous geological prospecting and exploration work and extraction, beginning from the moment of State registration of a license.

In order to additionally stimulate the development of the oil deposits of the East Siberian Oil and Natural Gas Basin Province, the RF Government introduced, from 1 December 2009 onwards, the zero rate export duty on oil from new oil fields in East Siberia, which was applied until 1 July 2010. Then the RF Government with regard to that oil switched over to a lower rate of export duty. From December 2010, the lower rate of export duty was also applied to the oil fields in the Caspian Sea.

Table 35

Russia's Regions Eligible for and the Parameters of MRET Tax Holidays Applied to Oil Extraction

Region	Cumulative oil extraction per ring-fenced field, m tons	License period for exploration and extraction, years	License period for geological prospecting and extraction, years	Date of introduction
1. Republic of Sakha (Yakutua), Irkutsk Oblast, Krasnoyarsk Krai	25	10	15	01.01.2007
2. Continental shelf north of Arctic Circle	35	10	15	01.01.2009
3. Nenets AO, Yamal Peninsula	15	7	12	01.01.2009
4. Azov and Caspian Seas	10	7	12	01.01.2009
5. Black Sea	20	10	15	01.01.2012
6. Sea of Okhotsk	30	10	15	01.01.2012
7. Yamalo-Nenets AO north of 65°N	25	10	15	01.01.2012

Source: RF Tax Code; Federal Law of 21 July 2011, No. 258-FZ.

The year 2011 saw the introduction of some more amendments to the RF Tax Code in connection with the alteration in the taxation of the oil and gas sector, which came into force from January 2012. In order to create incentives for developing small oil fields, from the year 2012 onwards a downward coefficient is to be applied to the rate of MRET levied on oil extraction, which specifies the size of oil reserves in a given ring-fenced field (*Cr*). That coefficient is computed by applying a special formula to ring-fenced fields with initial producible oil reserves of up to 5m tons and depletion of up to 0.05. Prior to that, the procedure for computing MRET levied on oil extraction envisaged no gearing of the tax rate by the size of oil reserves. The result was that, as a rule, the development of smaller oil fields with producible oil reserves of up to 5m tons was not feasible due to the high per unit capital and exploitation costs. At the same time, the register of state reserves of mineral resources incorporates about one thousand oil fields with producible oil reserves of up to 5m tons and depletion of less than 5%, with cumulative untapped oil reserves of 1bn tons.

The downward coefficient Cr when applied to the rate of MRET must create appropriate conditions for developing new small oil fields the operation of which would not be feasible under the generally applied taxation system. Thus, it will become possible to recover some additional oil reserves accumulated in such fields.

Within the framework of implementing the policy designed to stimulate the development of new region for oil production, in 2011 the MRET holidays regime was extended to the new oil fields situated in Yamalo-Nenets AO north of 65°N. It is suggested that, to the oil fields situated in that region (with the exception of those in the Yamal Peninsula), the zero rate of MRET is to be applied until the cumulative oil production volume of 25m tons per ring-fenced field is achieved, or for a period of 10 years under a license obtained for the use of land for the purpose of exploration and extraction, or for a period of 15 years under a license obtained for the simultaneous geological prospecting and exploration work и extraction, beginning from the moment of State registration of a relevant license.

The MRET holidays regime was also extended to the oil fields situated in the Black Sea and the Sea of Okhotsk.

These measures are designed to create the necessary economic conditions for developing the oil fields in Yamalo-Nenets Autonomous Okrug, the Black Sea and the Sea of Okhotsk, the operation of which under the generally applied tax regime is not cost-effective because of the huge capital inputs needed for building an appropriate infrastructure compatible with their geographic and geological specificities.

It appears feasible to introduce, within the framework of the existing tax system, differentiated tax loads for regions where mineral resources extraction is associated with higher costs, because this will ensure adequate returns on the investments in the development of new deposits. At the same time, the mechanism of tax holidays, while being simple to apply from the point of view of tax administration, is rather imperfect. It means one and the same generalized approach to all the oil fields situated in a given region (or shelf zone), which does not take into account the real (very broad) variations in the cost of development of each specific oil field. As a result those fields that require highest investments may remain undeveloped.

A better form of levying tax on oil extraction would be taxation of the additional (net) income. Such an approach would ensure an automatic differentiation of tax load depending on the specific conditions of oil production. In this case, not only a producer's gross proceeds are taken into account (as it happens when MRET and export duties are applied), but also the cost of oil extraction in a given oil field. This regime makes it possible to create the necessary preconditions for developing new oil fields the operation of which is associated with higher capital input and exploitation and transport costs.

The amendments introduced in 2011 in the RF Tax Code have dramatically increased the rate of MRET on natural gas. Over the period of 2006 to 2010 its rate remained at the same level, while the wholesale prices of natural gas more than doubled. As a result, the rate of MRET on natural gas during those years significantly declined both in real and relative terms (as a percentage of its price). From 1 January 2011, as index of 1.61 was applied to the tax rate, which effectively corresponded to the cumulative inflation rate over the period of 2007–2010. However, the high profitability indices of the activities relating to the production, transmission and sale of natural gas were indicative of a lower level of tax load on the Russian gas sector as compared to the oil sector, and thus of the existence of a potential for a further substantial increase of the rate of MRET. In this connection, from the year 2012 onwards the rate of MRET levied on natural gas was raised to 509 rubles per 1,000 cubic meters, or by 2.15 times on 2011. It is envisaged that in 2013–2014 the rate of MRET on natural gas will be raised somewhat further (*Table 36*). At the same, a downward coefficient is to be applied to those organizations that do not own any objects belonging to the Unified Gas Supply System of Russia, or in which the stakes owned by the owners of objects belonging to the Unified Gas Supply System of Russia are no more than 50%: in 2012 – 0.493; in 2013 – 0.455; and from 2014 onwards – 0.447.

Table 36

Rate of MRET Applied to Oil and Natural Gas Production in 2010–2014

	2010	2011	2012	2013	2014
MRET on oil production, Rb/ton	419	419	446	470	470
MRET on natural oil production, Rb/1,000 m³	147	237	509	582	622

Source: RF Tax Code.

Thus, the recently adopted decisions have significantly increased the tax load on OJSC *Gazprom*. That company owns the Unified Gas Supply System of Russia and derives the corresponding income from transmission and export of natural gas. For independent natural gas producers, on the contrary, the rate of MRET is only indexed according to the inflation rate and thus remains at a relatively low level (in 2012 – 251 rubles per 1,000 cubic meters).

Besides, in 2011 the scheme for levying taxes on exports of oil and petroleum products was altered, From 1 October 2011 onwards, the general rate of the export duty on oil was decreased by changing the coefficient value from 0.65 to 0.60 (*Table 37*). This measure resulted in a diminished tax load on the oil extracting industry, which must promote oil production.

Table 37

Marginal Rates of Export Duty on Oil

International price of Urals	Rate, USD/ton
Up to 15 USD/barrel	0
From 15 to 20 USD/barrel	0.35×(P–15)×7.3
From 20 to 25 USD/barrel	12.78+0.45×(P–20)×7.3
Over 25 USD/barrel	29.2+0.65×(P–25)×7.3

Note. P is price of Urals (USD/barrel)
Source: RF Law ‘On Customs Tariff”.

The rates of export duties on petroleum products are set at a lower level than those of export duties on oil, which represents a form of subsidizing Russian oil refineries and promotes exports of petroleum products. In recent years, the rate of the export duty on white petroleum products amounted to approximately 0.72 of the rate of the export duty on oil, while that on dark petroleum products – to approximately 0.39.

The lower export duties on petroleum products are conducive to increasing domestic volumes of oil refinement and growth of exports of its products. While the volume of oil production over the period of 2006–2010 rose by 7.5%, that of primary oil refining increased by 19.9%, and exports of petroleum products – by 36.3%. The growth by 85% of oil refining volumes over the same period occurred due to increased exports of petroleum products.

At the same time, this differentiation of export duties was by no means conducive to increasing Russia's oil refining efficiency. In 2011, the depth of oil refining in Russia was only 71%, which means that it had changed little over the previous decade (in developed countries this index now amounts to 90–95%). The growth of Russia's exports of petroleum products was caused in the main by increasing volume of exports of fuel oil, which in Europe is used as raw material for further refining and conversion into white petroleum products.

In 2006–2010 the nearly 3/4 growth of exports of petroleum products resulted from an increase, by 55.8%, of exports of fuel oil, while the share of fuel oil in aggregate exports of petroleum products rose to 54.5%. In this connection, the share of exports of fuel oil in the volume of its output exceeded 90%.

In this situation it is becoming increasingly evident that in order to promote modernization of Russia's oil refining industry and the depth of oil refining it would be feasible to switch over to a single rate of export duty on white and dark petroleum products, and also to approximate it to the export duty on oil. In late 2010 it was decided that, over the next two years, a single rate of export duty on petroleum products amounting to 60% of the rate of export duty on crude oil would be introduced (*Table 38*).

Table 38

Rates of Export Duties on Petroleum Products Established from 1 January 2011 (Coefficients Applied to the Rate of Export Duty on Oil)

	2011	2012	2013
White petroleum products (middle and light distillate products, diesel fuel, etc.)	0.67	0.64	0.60
Dark petroleum products (fuel oil, lubricants, etc.)	0.467	0.529	0.60

Source: Decree of the RF Government of 27 December 2010, No. 1155.

However, in 2011 it became clear that the newly introduced rates had not provided an adequate solution to the problem. The volumes of fuel oil production and exports continued to grow, while the depth of oil refining remained at the same level. Moreover, in April and May 2011 some Russian regions experienced acute shortages of gasoline ('the gasoline crisis') that resulted from its increasing volume of exports coupled with declining volumes of production. In that situation, in May 2011, in order to satisfy domestic demand, an increased (restrictive) export duty on oil was introduced. Then the rates of export duties on the other petroleum products were also revised. The new rates of export duties were introduced from 1 October 2011 (*Table 39*).

Table 39

Rates of Export Duties on Petroleum Products Established from 1 October 2011 г. (Coefficients Applied to the Rate of Export Duty on Oil)

	From 1 October 2011 through 31 December 2014	From 1 January 2015
Commercial gasolines, straight run gasolines	0.90	0.90
Middle and light distillate products, diesel fuel	0.66	0.66
Fuel oil, lubricants, etc.	0.66	1

Source: Decree of the RF Government of 26 August 2011, No. 716.

The purpose of the alterations introduced in 2011 in the taxation system is to promote oil production, to intensify modernization of the oil refining industry and to increase Russia's oil refining efficiency.

4.5. Russian agrifood sector: performance and trends

4.5.1. General outline of agricultural performance

20 years have passed since the start of reforms in Russian agriculture. It's a term allowing to draw some conclusions. Despite all the inconsistency, contradictoriness and non-integrity of government efforts, remarkable changes have taken place in the sector. This review is not supposed to provide a comprehensive analysis of these transformations but the partial analysis of agricultural performance in 2011 is made on the background of these 20 years.

At the moment the implementation of the first State program for agricultural development and regulation of agricultural and food markets in 2008-2012 is proceeding to completion in Russia. It was enacted in compliance with Article 8 of Federal Law No. 264-FZ of December 29, 2006 "On development of agriculture" that envisages adoption of five-year state programs. Although there are serious drawbacks in the effective Program and the mechanisms of its implementation, it has two strong points. First, it lays the foundation for relative sustainability of state policies within the program term – 5 years. Second, it determines the set of support measures to be applied and the sources of their financing from budgets of different levels, and first of all from the federal budget. One can state that the Program facilitates access to credit resources and contributes to modernization of agriculture and rural infrastructure. Still, it has smaller effect on the desired outcome – the growth of agricultural output – than such factors as bioclimatic potential and rural population size in a certain region. The latter assertion is supported by a set of studies[1].

In Russia climatic conditions are one of the main factors of increased riskiness of farming in the country. The previous 2010 was extremely unfavourable, with drought afflicting 43 regions-constituents of the Federation and resulting in a sharp drop of yields and outputs of basic farm crops. One could expect that dramatic decrease of grain output and poor supply of feeds would affect the performance of livestock sector[2].

However, the implemented measures of government regulation, and first of all the ban on export of grain[3], allocation of additional Rb 5bn for the preservation of breeding stock and Rb

[1] E.Gataulina. Estimated effect of state regulation on development of agricultural production. // Mathematical methods, models and information technologies in the agrifood sector (Nemchinov's readings): Proceedings of Russian Independent Agricultural Economics Association. Issue 15. Publishing house of Russian State Agrarian University – MTAA named after K.A.Timiryazev, 2011. Pp. 84-89.

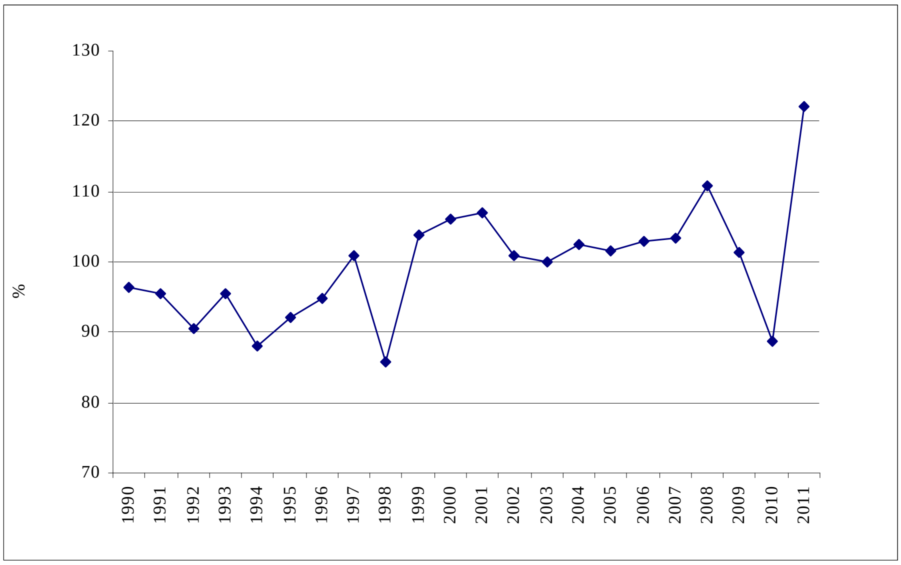
[2] By the beginning of January 2011 the available supply of feeds in corporate farms was 25.2% below the indicator of early 2010. Taking into account that the share of feed grain (except corn) in the structure of grain output reduced, the situation with feed supply caused concern.

[3] In general the effect of grain export ban is estimated as negative: it impaired the image of Russia as a reliable partner, weakened the hard-won positions of exporters on the world grain market, reduced profitability of agricultural producers in the year of low grain yields, entailed non-transparent procedure of distributing grain to large livestock producers, etc. However, the ban also had positive effect on the livestock sector. Certainly, its primary beneficiaries were poultry and pig plants.

9bn for the partial compensation of feed costs[1] to pig and poultry farms as well as payment of subsidies for the maintaining of cow inventories have helped to prevent production decline in dairy farming and sustain upward trends in livestock population and output of pig and poultry meat.

The past 2011 was favourable for Russian agriculture. The index of agricultural production[2] amounted to 121.8%[3] (in 2010 – 88.7%). This is the best indicator since 1990 evidencing rapid recovery of agriculture after the hard 2010 (*Fig. 52*).

The gross output of grains and grain legumes amounted to 97.5m tons in bunker weight. It exceeded the past year crop by almost 50%. In the last 20 years *gross* outputs were higher only in 2008, 1992 and 1993. The gross output of sugar beets – about 45m tons – is more than twice above the previous year indicator; moreover, it's the highest yield of this crop ever harvested in Russia. The yield of sunflower seeds – 9.4m tons – is also the highest ever in the Russian history. Yields of other oilseeds, i.e. soybeans and rapeseeds, are record as well. The outputs of potatoes and vegetables exceed last year indicators. The expansion of areas under 2012 winter grains lays the basis for further growth of gross grain output in 2012 provided that climatic conditions are favourable. Gross outputs of grains and grain legumes approach those of the Soviet period while the ones of sunflower seeds, sugar beets and vegetables have already surpassed the pre-reform indicators. Taking into account the reduction of rural population and employment in agriculture one can state the improving self-sufficiency in these products and higher productivity of labour as compared with the pre-reform level (*Table 40*).



Source: Rosstat.

Fig. 52. Index of agricultural production

[1] Report of the RF Minister of Agriculture E.B.Skrynnik at the All-Russian conference "On the implementation of measures envisaged in the State program for agricultural development and regulation of agricultural and food markets in 2008-2012" on November 25, 2011, Moscow. http://mcx.ru/news/news/show/5107.195.htm

[2] It is calculated as the percent ratio of agricultural output of the current year to that of the previous year. Comparable prices are used – the ones of the previous year.

[3] Data as of November 1, 2012.

Table 40

Gross output of basic farm crops, million tons

	Annual average			2005	2008	2011
	1986-1990	1991-1995	1996-2000			
Grain (after primary processing))	104.3	87.9	65.2	74.3*	102.8	92.6
Potatoes	35.9	36.8	34.5	37.3	28.9	32.1
Vegetables	11.2	10.2	11.4	15.2	13.0	13.5
Sunflower seeds	3.1	3.1	3.3	6.4	7.3	9.4
Sugar beets	33.2	21.7	14	21.4	29.0	43.0

* from 2005 to 2011 adjusted for weight after processing with coefficient 0.95.
Source: Rosstat.

The structure of areas under crops is changing. By the end of 2011 the share of grains and grain legumes in the total acreage of basic crops grew by 4% as compared with 1990 and reached 57.5%; the share of industrial crops almost tripled (up 9.6%) and amounted to 14.5%. This increase is due to a notable reduction of the share of feed crops – from over 38% to 24% (*Fig. 53*).

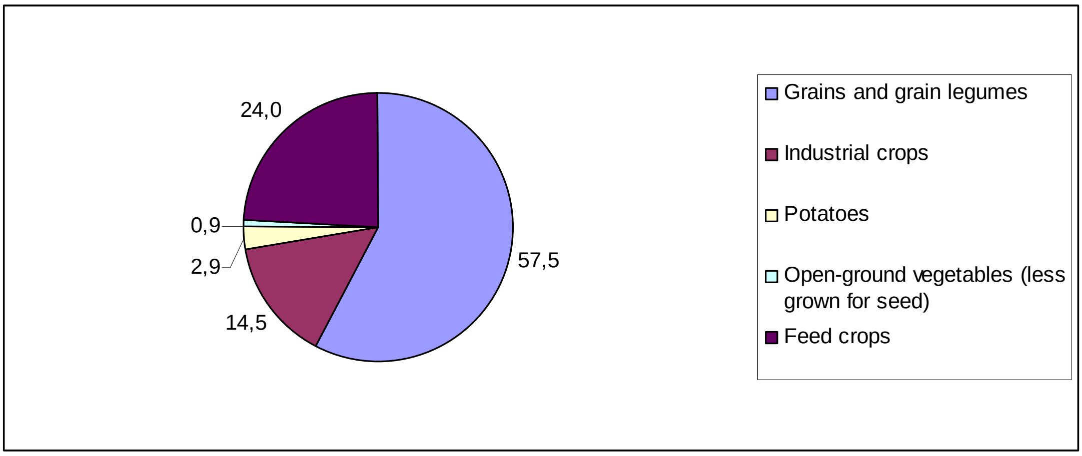


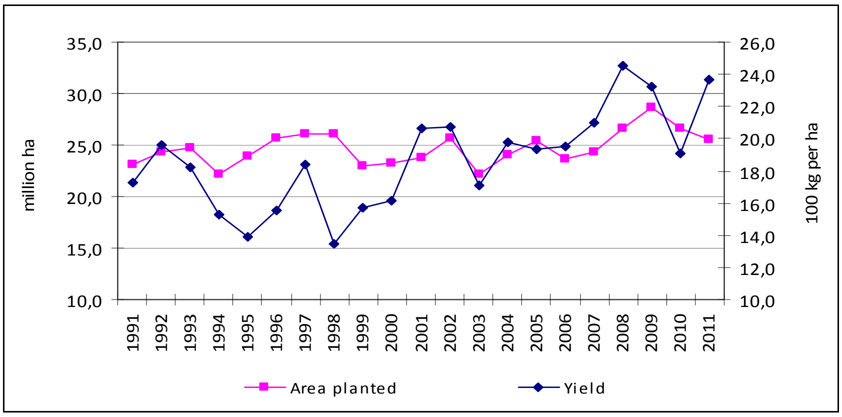
Fig. 53. Structure of acreage planted in basic farm crops in 2011, %

While the total acreage planted in grains reduced by 36% as compared with 1990, acreage under wheat increased by 10%, acreage under corn – by 63%. Meantime, areas under rye and barley experienced the sharpest decrease – by 78% and 68%, accordingly. Areas under feed crops fell by 59%, of them areas under root crops – by 93%, under perennial grasses – by 63%, under fodder corn – by 85%. So, the shrinking of acreage and consequently gross output was primarily observed in production of crops that were used for feeding cattle. The exception was rye. The reduction of fodder crop areas was due to the drop of cattle inventories that decreased 2.85 fold between 1990 and 2011 and started to grow slightly only in 2011.

Wheat holds the first place in the structure of areas planted (35.4%)[1]. Perennial grasses continue to rank second (15.2%). The shares of barley and sunflower seeds are approximately the same – 9.6% and 9.5%, accordingly. The areas under potatoes (as one of the basic food items) and sugar beets (as input for production of sugar) are rather small – respectively 1.5% and 2.9% of the total areas planted. Acreage under food crops produced primarily in corporate

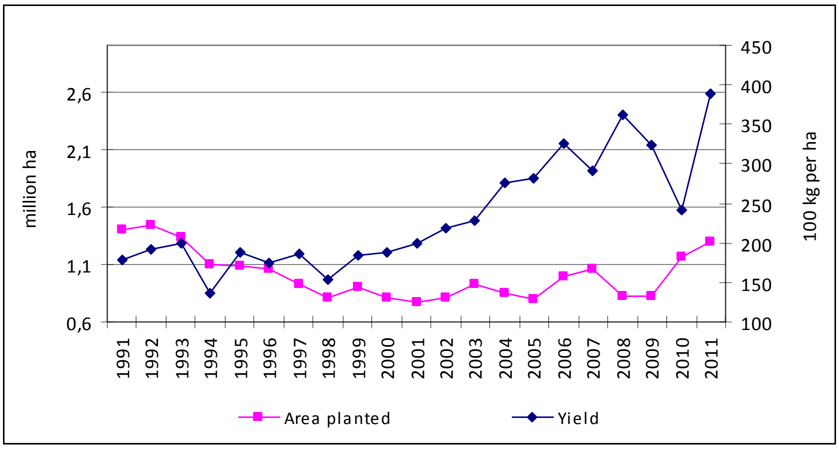
[1] Hereinafter the data relates to 2011 if no other year is indicated.

farms didn't demonstrate any notable reduction and acreage under sunflower seeds grew sustainably (*Fig. 54–56*). Yields of these crops increased in all regions.



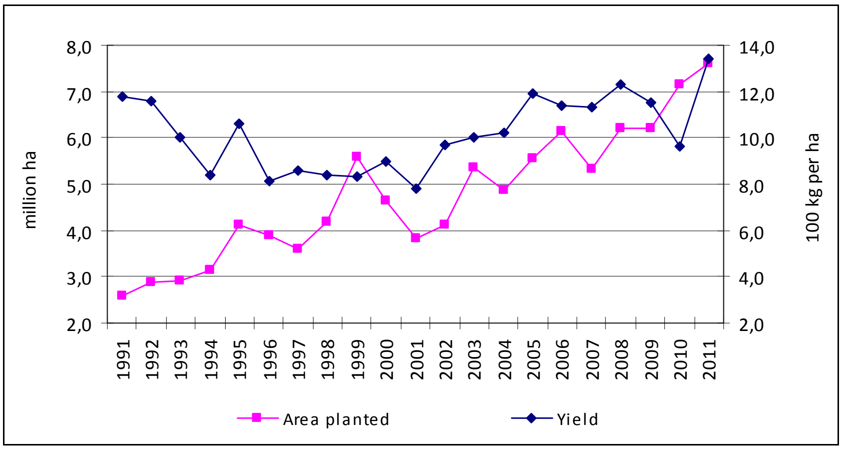
Source: Rosstat.

Fig. 54. Wheat: areas planted and yields



Source: Rosstat.

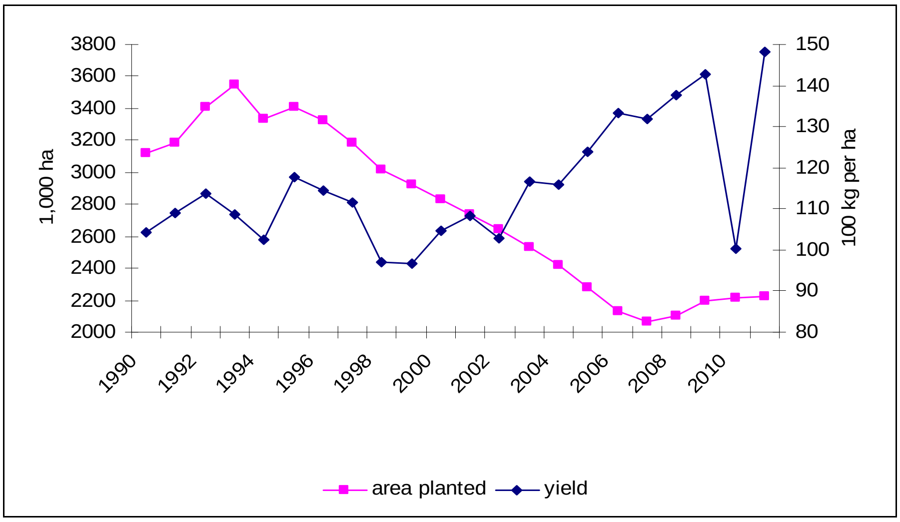
Fig. 55. Sugar beets: areas planted and yields



Source: Rosstat.

Fig. 56. Sunflower seeds: areas planted and yields

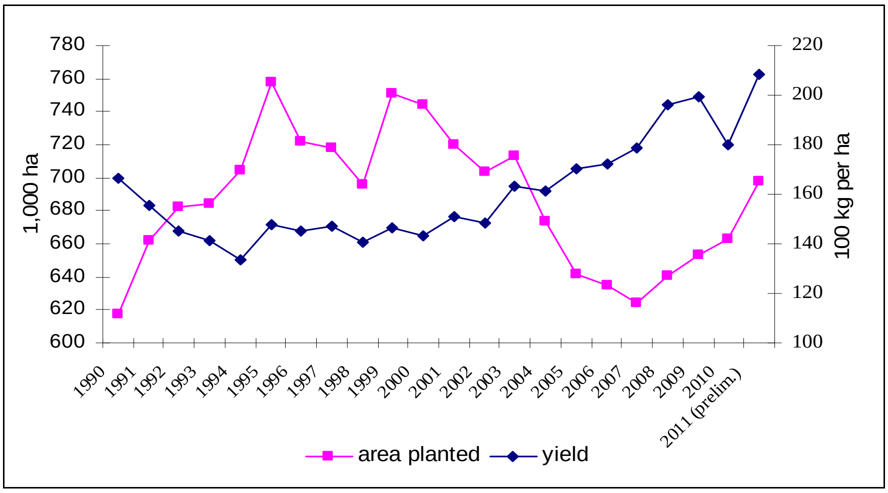
Acreage under potatoes dropped notably but this reduction (2011 indicator being only 66% of the 1991 level) is largely compensated by higher yields (with the index of yields amounting to 1.42). 2011 output equals 94% of the 1991 indicator (*Fig. 57*).



Source: Rosstat.

Fig. 57. Potatoes: areas planted and yields

Production of vegetables is still primarily concentrated in smallholder farms. The total acreage under them demonstrates a steady downward trend since 1999 (index of its change equaling 0.98). However, vegetable yields are also growing (in 2011 the respective index amounted to 1.44 relative to 1991) which ensures the general growth of output that in 2011 was 1.41 fold larger than in 1991 (*Fig. 58*).

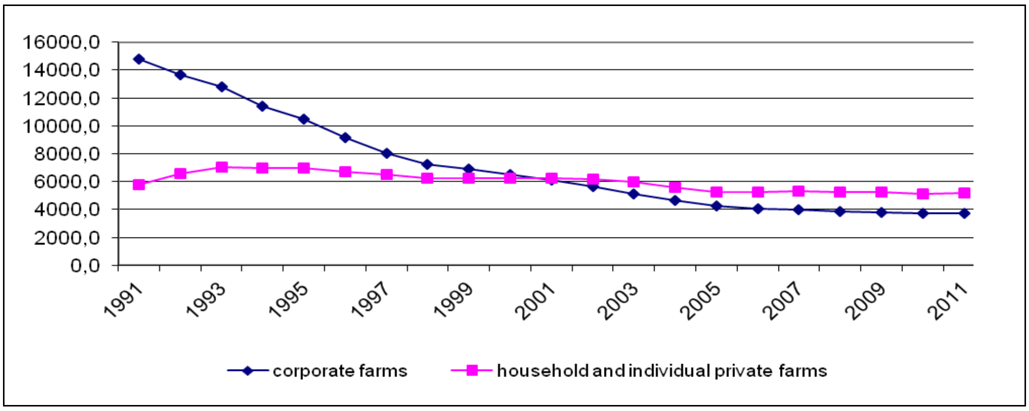


Source: Rosstat.

Fig. 58. Open-ground vegetables: areas planted and yields

Developments in livestock production continued the trends of recent years: slow decline of cattle inventories (the reflection of this trend is the restructuring in crop production – areas under crops used for feeding cattle are shrinking) and growth of pig and poultry population.

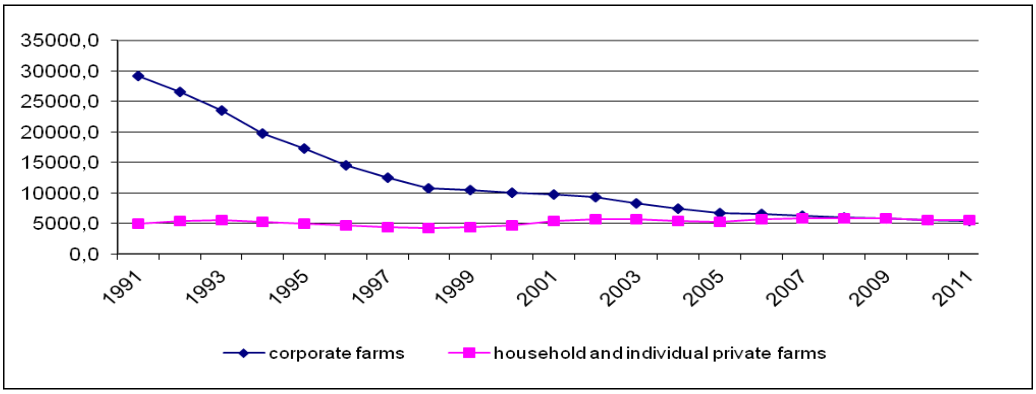
The trend of cow population is shown at *Fig. 59*. By the end of 2011 its overall decline in all categories of farms reached 57% as compared with 1991. In corporate farms this indicator was as high as 75%, in smallholder farms – about 10%. In corporate farms the biggest losses in cow population were observed between 1992 and 1998 (annual losses ranging from -7% to -13%) and from 2002 to 2005 (within the interval from -7% to -9% a year). The number of cows kept in smallholder farms notably increased in the first years of reform but then it declined. However, this decline was not as dramatic as the one in corporate farms. The biggest losses took place in 2006-2008 (the annual reduction reaching -4%) and in 2003-2005 (within the interval from -4% to -6%). 58% of all cows are still kept in household farms and few individual private farms engaged in dairy production. The sharp decrease of cow population was partially compensated by higher animal productivity – in 2011 it was 55% higher than in 1991, the average milk yield per cow in 10 months 2011 approaching 4 tons. The result of these opposite trends was the decrease of total milk production down to 67.5% in 2011 as compared with 1991.



Source: Rosstat.

Fig. 59. Cow population, 1,000 head

The trend of feeder cattle population largely repeats the one of cow population (*Fig. 60*). By the end of 2011 the number of animals was slightly over 32% of the 1991 level.



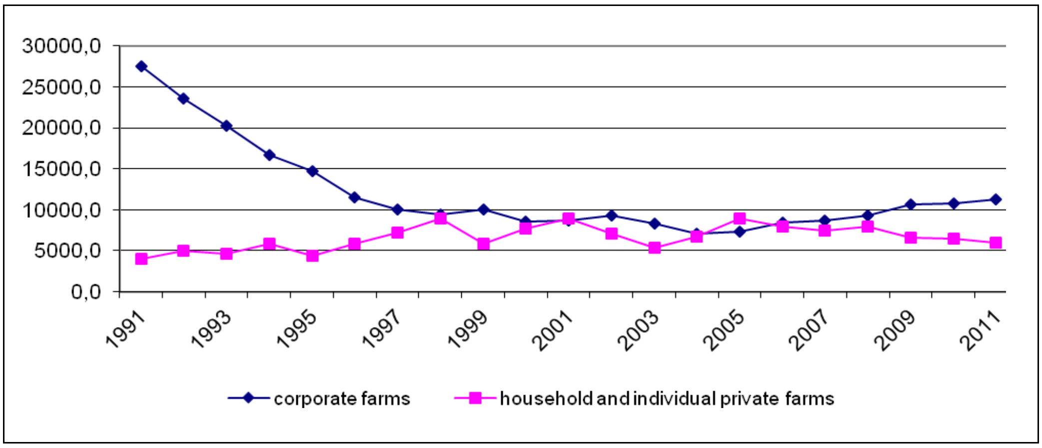
Source: Rosstat.

Fig. 60. Feeder cattle population, 1,000 head

Corporate farms lost 81% of their feeder cattle inventories by the end of 2011. From 1992 to 1998 annual losses ranged from -9% to -16% of the previous year level. The second period of maximum losses was 2003-2005 when they ranged from -9% to -11% annually.

On the contrary, in household and individual private farms the population of feeder cattle within these two decades increased: by the end of 2011 there were 11.5% more animals than in 1991. For this type of producers difficult years were 1994-1998 (annual losses ranging from -5% to -7%) and 2004-2005 (annual losses being about -3%). Despite the government measures to support beef cattle breeding, no increase of animal population is observed in the sector beginning from 2008 and in 2010 it even fell by 5%.

Pig population also decreased – in 2011 it was down 45% as compared with 1991. By 2005 corporate farms lost 73% of their inventories. Beginning from 2005 a stable growth trend formed in the sector: by the end of 2011 the increase of pig population reached 60% (being encouraged by government support and rates of customs duties); in some years (2006, 2009) annual increases amounted to 15% but in the last two years (2010 and 2011) they equaled 2% and 4%, respectively. Pig raising has firmly shifted to the sector of corporate farms that now keep 65% of animals (*Fig. 61*).



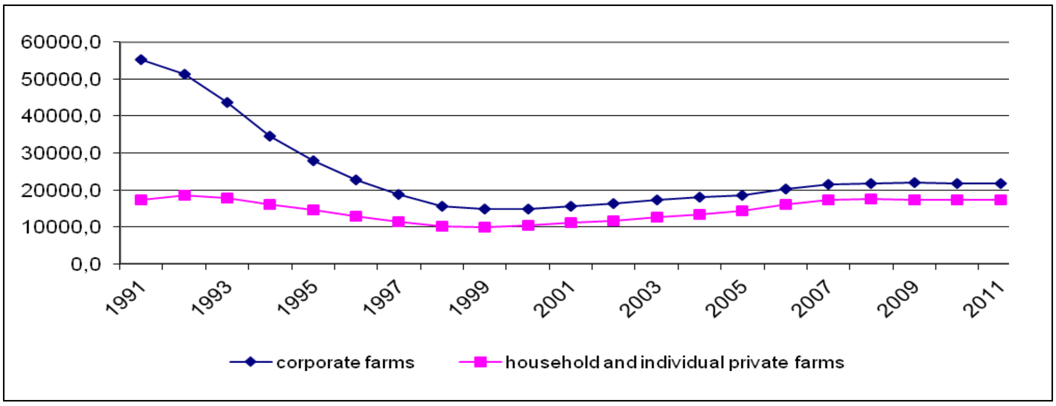
Source: Rosstat.

Fig. 61. Pig population, 1,000 head

The number of pigs in household and individual private farms was growing: it more than doubled by 2005 when corporate farms lost about 2/3 of their pig population. As pig raising in corporate farms developed, the number of animals in smallholder farms reduced but even now they keep 1.5 fold more pigs than in 1991.

The population of sheep and goats by 2011 dropped down to about 40% of the 1991 indicator (*Fig. 62*). In corporate farms it stopped falling and stabilized at the level of 21.9m head, or 56% of the total population in all types of farms[1]. Population of animals in household and individual private farms has restored up to the pre-crisis level.

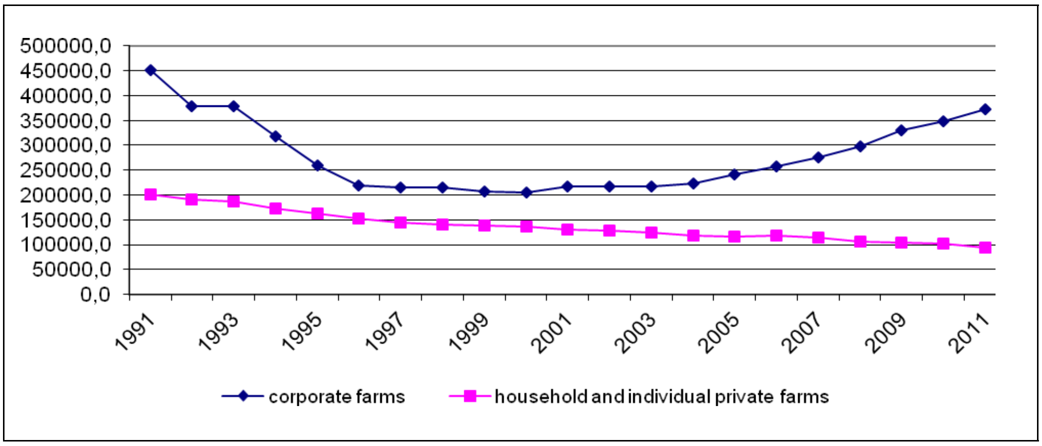
[1] In most corporate farms animals are only listed but are actually passed over to families of employees on contract terms.



Source: Rosstat.

Fig. 62. Population of sheep and goats, 1,000 head

The population of poultry is steadily growing after the fall by 55% between 1991 and 2000. At present it amounts to 71% of the 1991 level with 80% thereof concentrated in corporate farms. This is a rare sector of farming being evidently abandoned by smallholder farms (*Fig. 63*). The quality, availability and prices for poultry products in retail stores must have become acceptable for households. In the period between 2001 and 2011 the annual increases of poultry population in corporate farms were below 5% only 4 times; in all the other years they ranged from 7% to 11%.



Source: Rosstat.

Fig. 63. Poultry population, 1,000 head

The analysis of trends in different types of farms shows that livestock population is restoring except for feeder young stock. The population of cows has stopped falling. Household and individual private farms are important producers of beef, milk and sheep products[1]. Corporate farms became principal producers of pork and poultry products. Household and individual private farms either preserved livestock population at the pre-reform level of 1991 or have already restored it after the fall. The only exception is poultry breeding that smallholder farms abandon despite its seeming simplicity and switch to buying respective products. At present there are some constraints to the development of livestock production in household farms.

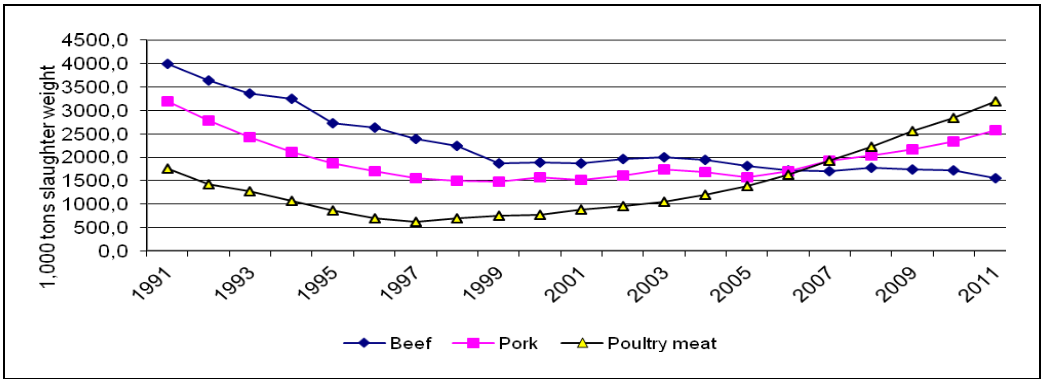
[1] Including production of contract sheep breeders.

First of all, the size of household plots has natural limits in build-up areas; consumer cooperation that could help to form wholesale lots for trade networks and independent stores is not developed; there are no stable links with buyers of raw agricultural products; population that was traditionally engaged in livestock farming is getting older. Until recently rural residents could use plots outside settlements for haying and pasturing as well as for growing feed crops for their farms. The possibility to get such plots appeared at the very start of land reform. But in the middle of 2011 the law was adopted[1] that undermines the basis for performance of large household farms: at the federal level the total area of such a plot is limited to 0.5 hectares; regions-constituents of the Russian Federation are granted (but may not use) the right to enlarge it up to 2.5 hectares. These constraints directly affect more than two million rural families (with over six million members) that cultivate about 70% of all lands entitled to household farms[2]. Institutional restrictions of this kind force agricultural business out to individual private and corporate farms. Despite the attractive goal of the law – to draw agricultural production out to the entrepreneurial field – it brings about more negative than positive effects. Not less than 2 hectares of land are required for keeping one cow and rural families will either use them illegally or will stop keeping cows; the formal abandoning of additional plots will decrease incomes of municipal budgets from land tax, etc.

The aim of this detailed analysis of trends in livestock population was to provide a better understanding of developments in production of basic livestock products. *Figure 64* shows dynamics of meat production. It can be seen that after the decline between 1991 and 1998-1999 production of different kinds of meat (except beef) displays an upward trend and the output of poultry meat in 2011 even exceeds the 1991 level 1.8 fold. Production of beef stabilized at the 2007 level.

Figure 65 shows trends in production of milk and eggs. Beginning from 2004 production of milk stabilized at the level of 31-32m tons and in 2011 equaled only 61% of the 1991 indicator.

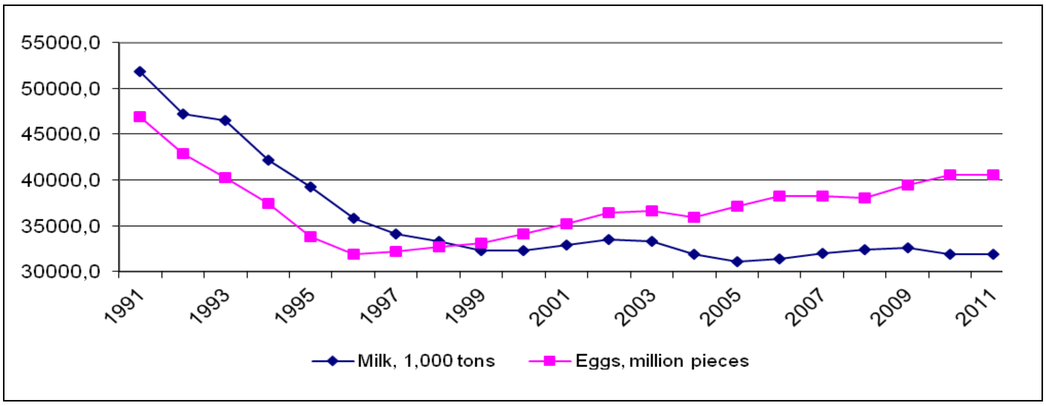
In 2011 the trend towards restoring production of eggs (that began since 1996) continued. At present their output reaches 87% of the 1991 level. *Table 41* contains data on production of basic livestock products.



Source: Rosstat.

Fig. 64. Production of meat

[1] Federal Law No. 147-FZ "On introducing amendments to Article 217 of Part Two of the RF Tax Code and to Article 4 of the Federal Law "On household farm"" of June 21, 2011.
[2] V.Ya.Uzun. http://www.agronews.ru/news/detail/116750/



Source: Rosstat.

Fig. 65. Production of milk and eggs

Table 41

Production of basic livestock products in farms of all types

	1986-1990	19991-1995	1996-2000	2005	2008	2011*	2011/1991%
Livestock and poultry, million tons slaughter weight	9.7	7.5	4.7	4.9	6.3	7.2	74
Milk, million tons	54.2	45.4	33.6	32.3	32.4	31.8	59
Eggs, million pieces	47.9	40.3	32.8	37.1	38.1	40.6	85

*estimate.
Source: Rosstat.

The increase of meat output after its sharp drop since the start of reform is due to the growing production of, firstly, poultry meat and, secondarily, – of pork. These shifts notably change the structure of meat production and consequently consumption. In 1991 the share of beef in the total for the three major types of meat was about 44.7%, the share of pork – 35.7%, of poultry meat – 22.5%. In 2011 the share of beef dropped down to 21.2% while the share of poultry meat more than doubled – up to 43.7% and the share of pork reduced slightly. The pre-reform level of egg production hasn't been restored as yet but will be attained in the medium term. The output of milk is still far below the pre-reform indicators. However, there form conditions for positive developments in dairy and beef cattle breeding – the structure of animal population is improving, although the rate of change is very slow and the extent is limited. In the last two years the share of pedigree beef cattle stock grew up to 60% of the total beef cattle herd (1.488m head). In the dairy herd the share of pedigree stock increased up to 12.3% which is almost twice above the 2005 indicator[1]. However, production costs haven't been reduced yet and this is a hindrance to larger production of these products, and first of all beef [2].

[1] Report of RF Minister of agriculture E.Skrynnik at the meeting with top officials of regional bodies administering agrifood sector and rectors of higher education institutions on January 12, 2012, Moscow. http://mcx.ru/news/news/show/5198.195.htm

[2] Production of beef is falling everywhere except three territories: Dagestan, Kalmykiya and Republic Altai. In these regions production is growing since there are local breeds of beef cattle and traditional technologies of its pasture raising with maximum utilization of forage lands which allows to reduce production costs. However, the scale of production here is very small.

The change of product structure of output is due to the shifts in division of labour in agriculture. The end of centralized planning in economy entailed the change of production location principles. In the Soviet period production was located with regard to the location of population. It can be seen from the simplest correlation analysis: in the early 1990s there was a close linear correlation between the size of population in a certain region-constituent of the Russian Federation and production of milk and eggs therein, and a mid-level correlation between regional population and production of beef, pork and poultry meat. There was also a weak correlation between population and production of grain in a region. At present these relationships are not so strong: the proximity to market is no longer regarded as the decisive factor for locating production. It’s being shifted to regions with the lowest unit production costs[1]. Areas under farm crops and livestock population are concentrating therein.

The trends in output of farm products evidence that agriculture is restoring after the production declines that accompanied restructuring in the sector. The government declared that in 2011 outputs of grain, sugar, potatoes, vegetables and poultry meat achieved the target indicators set in the Doctrine of food security. The trend in pig raising allows to expect that within the coming 2-3 years the output of domestic producers will fully satisfy the demand for pork[2]; besides, in 2012 Russia will become a net exporter of vegetable oil. It’s evident that the future structure and volumes of agricultural production will be primarily determined by the ability of Russian farm producers to produce competitive output and not by the pre-reform performance patterns.

4.5.2. Situation on selected agricultural and food markets

Grain market

In 2011 the share of milling wheat in the total wheat crop amounted to 73%, the share of wheat #3 – to 30%, of wheat #4 – to 43%[3]. Feed wheat is in the greatest demand on the domestic market and its deficit is increasingly compensated by the use of milling wheat for feeding purposes.

Last year 16.9m tons of barley were harvested. It’s above the previous year level but below the 2008-2009 indicators. This decline of barley output is due to the reduction of areas planted to 7.2m ha down from 9-10m ha sown in the period after 2000. The shrinking of acreage was most remarkable in the southern regions where barley is ousted by higher-yielding winter wheat. The decline of barley production in Russia entails the rise of prices for pork and its derivatives.

From the start of 2000s exports of grain from Russia grow at higher rate than its production. From August 2010 till July 2011 the ban on export of grain was in effect in Russia. After the lifting of embargo the ratio of exports to output in 2011/2012 MY can set a record: 25% for grain in general and 35% for wheat[4]. Along with Ukraine, Kazakhstan and the United States Russia is one of leading world exporters of grain. In 2011/2012 MY it can take the sec-

[1] The process is facilitated by the development of technologies that allow to transport fresh products to longer distances and by the lowering of administrative barriers.
[2] Report of RF Minister of agriculture E.Skrynnik at the meeting with top officials of regional bodies administering agrifood sector and rectors of higher education institutions on January 12, 2012, Moscow. http://mcx.ru/news/news/show/5198.195.htm
[3] Estimate of Sovecon.
[4] Estimate of Sovecon.

ond place in the world wheat exports after the US. In the recent decade the share of young countries-suppliers (Russia, Ukraine, Kazakhstan) in the world wheat exports grew from 13% to 27% while the share of traditional exporters fell from 11% to 9%.

So, Russia's integration into the world grain market is increasing. In this respect the question arises as to whether Russia will manage to become the largest exporter of grain.

The growth of exports resulted in shifts in the regional structure of grain production in Russia. For the southern regions of the country export became more attractive than supply to the domestic market. Their export orientation encouraged development of respective infrastructure. Meantime, the infrastructural isolation of Siberia and the Urals aggravated. As a result the share of export-oriented South of Russia in the total grain production increased from 26% in 2000 to 35% in 2011.

Export demand furthered growing production of wheat and the enlargement of its share in the total grain output up to 64%. So, grain production becomes less diversified and grain export – increasingly mono-crop. Exports primarily consist of wheat (mostly wheat #4) while barley is losing its importance as an export item.

The increasing domination of a single crop and a single region in the total grain output entails the risk of sharp production drops and consequently export swings in case of unfavourable climatic conditions and outbreaks of crop diseases.

In the longer term growth of exports is constrained by several factors.

First, there are strong limitations to increasing output by means of expanding areas planted. The potential for enlarging grain acreage in the South is actually exhausted. In Russia the reclamation of abandoned lands that are mostly situated in areas with low bioclimatic potential is likely to be more costly and less efficient than in the EU, the US and other countries.

Besides, the expansion of acreage under grains is hindered by their perpetual competition for land with oilseed crops.

Second, the increase of production by means of extensive factors requires notable growth of investments in agriculture. At present the average yield of wheat in Russia is slightly over 2 tons per hectare while the world average is 3 tons. The sector gets increasingly dependent on import supply of grain and oil crop seeds.

Third, domestic demand for grain in Russia is expected to rise due to the development of livestock breeding. It was the deepest drop in livestock sector in the 1990s that conditioned Russia's entry to the world grain market as a large exporter.

By the beginning of November 2011 high volumes of wheat exports resulted in substantial reduction of producer stocks. For instance, in Krasnodar kray the stocks of wheat were 1/3 below the ones of the previous year. The possibilities for replenishing export resources from the wheat stocks remaining at farms in the southern and central regions were limited.

The replenishment of resources for both export supplies and domestic processing through deliveries from the eastern regions met with a whole range of logistical difficulties. The decisive factor of supply from these regions was not the purchase price for grain but the possibility to deliver it.

The remarkable reduction of wheat stocks conditioned the strengthening of prices for this crop, first of all in the central and southern regions of Russia. From the point of view of regaining impact of Russia's grain export on the world market, the principal consequence of embargo was the discount with which Russian wheat was marketed after its lifting. Time was needed to restore the country's positions on the world grain market. The main partners expected Russia to dump like it was the case in 2002 when the country was entering export markets. So, till the end of October 2011 the FOB price for wheat shipped from the Black Sea ports was the lowest. By November the price advantages of Russian wheat faded away. On the one hand, domestic prices were rising due to the growing exports and lowering grain stocks. On the other hand, prices for Australian and Argentinean wheat fell – by $20-30 per ton as compared with the end of October, down to $222 per ton (ASW, shipment from the eastern states) and $230 per ton, respectively. At the same time, at the Egyptian GASC tender Russian grain was offered for $247.7-249 per ton[1]. So, Australia and Argentina are becoming the principal competitors of Russia on the world grain market.

According to estimates of USDA, the world production of wheat in 2011 reached 691.5m tons (*Table 42*). In 2011/2012 MY record exports of Australian wheat are expected that can put competitive pressure on the Black Sea grain in countries of South-East Asia, Persian Gulf and East Africa.

Table 42

World balance of wheat in 2009/2010-2011/2012 MY*, million tons

MY	Production	Supply	Trade	Consumption	Ending stocks
2009/10	685.4	852.5	135.8	650.3	202.1
2010/11	651.7	853.8	131.8	653.9	199.9
2011/12 (forecast)	691.5	891.5	139.4	681.4	210.0

* MY for wheat - July-June.
Source: USDA.

Market of sunflower seeds and sunflower oil

In 2011 a record crop of sunflower seeds was harvested – 9.35m tons. Production of sunflower oil in Russia grew by 1.28m tons – up to the record 3.47m tons. Export is supposed to become the major channel for marketing this surplus output – it’s volume is projected to grow by 1.05m tons up to 1.23m tons.

Table 43

Russia: supply and utilization balance of sunflower seeds in 2007/2008-2010/2011 MY and forecast for 2011/2012 MY*, 1,000 tons

	2007/08	2008/09	2009/10	2010/11	2011/12, forecast	Difference
Beginning stocks	51	80	171	106	88	–18
Gross output in standard weight	5670	7300	6300	5690	9350	+3660
Imports	11	16	15	40	25	–15
Total supply	5732	7396	6486	5836	9463	+3627
Processed into oil	5335	6760	6040	5380	8300	+2920
Other consumption	250	275	290	330	390	+60
Used for seeds	30	30	30	30	30	–
Exports	37	160	20	8	520	+512
Ending stocks	80	171	106	88	223	+135

* MY for sunflower seeds – October-September.
Source: Sovecon.

[1] Data of Sovecon.

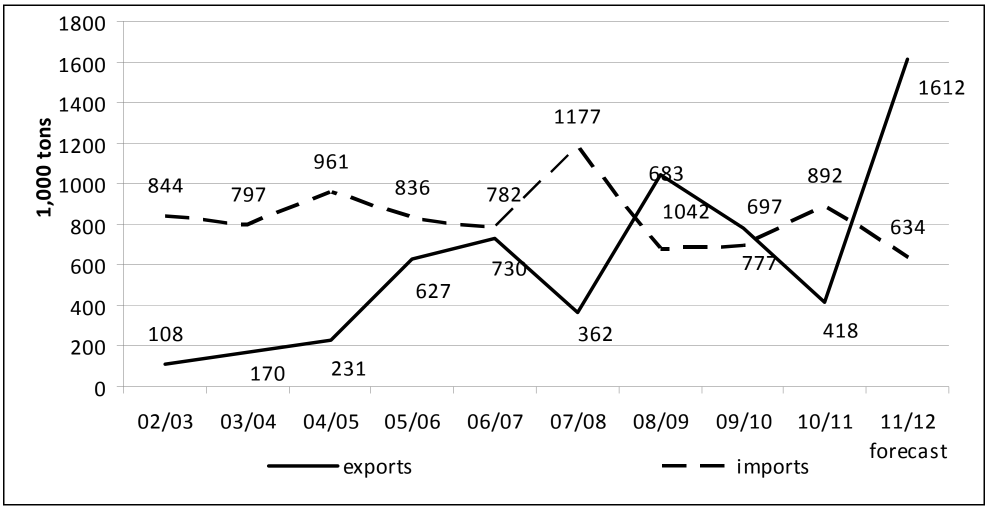
Table 44

Russia: supply and utilization balance of sunflower oil in 2007/2008-2010/2011 MY and forecast for 2011/2012 MY, 1,000 tons

	2007/08	2008/09	2009/10	2010/11	2011/12, forecast	Difference
Beginning stocks	86	149	134	100	187	+87
Production	2190	2815	2598	2190	3470	+1280
Imports, total	146	35	52	148	10	–138
including bottled oil	62	5	7	9	5	–4
Total supply	2422	2999	2784	2438	3667	+1229
Consumption	1950	2025	2179	2070	2300	+230
Exports, total	323	840	505	181	1230	+1049
including bulk oil	226	663	358	68	1000	+932
bottled oil	97	177	147	113	230	+117
Ending stocks	149	134	100	187	137	–50
Structure of aggregate consumption						
- bottled oil (market capacity)	1170	985	1020	890	930	+40
- bulk oil (household consumption)	70	80	95	105	95	–10
- mayonnaise	320	400	430	400	430	+30
- margarine	92	250	245	225	345	+120
- paint and varnish products	82	73	90	123	135	+12
- formula feed	123	122	171	195	210	+15
- soap	5	16	17	7	15	+8
- other (production of canned food, bakery products, etc.)	88	99	111	125	140	+15

Source: Sovecon.

After a deep drop in 2010/2011 MY record exports of all main kinds of vegetable oil are expected. Russia will again become its net exporter. Exports will grow almost 4 fold up to 1.6 million tons while imports will reduce from 892 to 634 thousand tons (*Fig. 66*). The biggest reductions are expected in imports of bulk sunflower and palm oil.



Source: Sovecon.

Fig. 66. Russia: trends in export and import of vegetable oils in 2002–2011

Domestic consumption of sunflower oil in Russia is about 2.1-2.2m tons (*Table 45*). Production of margarine and mayonnaise accounts for its bigger share. In the new 2011/2012 MY the expected replacement of palm oil by sunflower oil (prices for which fell due to the abundant crop) on the domestic market will result in the growth of sunflower oil utilization for margarine production up to 345 thousand tons.

For several years in turn the principal company-exporter of sunflower oil from Russia has been "Yug Rusi" ("South of Russia") whose share reached 47% in 2010/2011 MY. Other suppliers of Russian sunflower oil are "Aston", "SolPro", "Bunge", "Glencore", "Efko".

Table 45

Russia: structure of bulk sunflower oil exports by companies-exporters

	2008/2009	2009/2010	2010/2011
«Yug Rusi»	34	32	47
«Aston»	10	22	16
«SolPro»	8	5	9
«Bunge»	8	8	4
«Glencore»	9	4	1
«Efko»	1	2	4
Other	30	27	19

Source: Open JSC "Sunny products".

In November 2011 the Russian market of sunflower seeds reached its seasonal minimum while the market of sunflower oil – its seasonal maximum. Domestic prices for sunflower oil amounted to Rb 33,200-34,000 per ton (EXW). The level of domestic prices for sunflower seeds in the South or Russia was about Rb 11,500 per ton, in the Volga region – Rb 8,500 per ton, in Voronezh – Rb 9,300 per ton[1]. As output of oil grows, prices for it will fall since one will have to market record export volumes in the situation of gradual strengthening of prices for oilseed inputs. Prices for sunflower oil are expected to rise at the end of the season owing to the reduction of its manufacture and stocks.

Market of vegetables

The climate of Russia allows to grow a wide range of vegetables and fruits. Still, Russia is among the five leading importers of these items in the world. The share of imports on the vegetable market amounts to 25%, on the fruit market – to 80%[2]. The basic problems of the sector stem from its low productivity, insufficient financing of the production process, complicated logistics, the risk of unfavourable weather conditions in the production regions, the lack of long-term planning.

In 2010 due to the dry spring and hot summer vegetable and fruit producers sustained great losses that resulted in the surge of prices for respective products. The output of potatoes fell noticeably – by 30% as compared with the previous year while selling prices more than doubled – from Rb 8.5 per kg on the average in 2009 up to Rb 23 per kg in 2010.

In 2011 the situation changed cardinally as the gross output of vegetables notably increased. The output of potatoes was record for the last 10 years – over 32.1m tons and areas planted in commercial farms (not including smallholder farms) grew by 10-15%. The output of onions set an absolute record – 1.7m tons. Production of cabbage, beets and carrots also grew as compared with 2010.

The positive dynamics of output will result in lower imports and smaller areas planted in vegetables (onions, cabbage) and potatoes in the 2012 season.

[1] Data of Sovecon.
[2] Data of "APK-Inform: vegetables and fruits".

Despite the over-production of vegetables in Russia in 2011, retail networks continue to give preference to imported products. This is due to the fact that the quality of domestic fruits and vegetables does not satisfy retailers and even given lower prices domestic products cannot compete with the imported ones. Retail networks are more willing to work with importers since in the season of relatively low prices the marketable condition of commodities plays an important role in their sales.

A serious problem of fruit and vegetable market is the under-development of capacities for storing produce and its further marketing "out of season". Therefore those producers that are short of adequate storage facilities have to sell large volumes of output before the end of the year.

So, by the end of 2011 low demand for domestic root crops coupled with their abundant supply exerted strong pressure on prices. Comparing wholesale prices for vegetables in Moscow region in the middle of December 2011 with the respective prices of 2010, one can see that for potatoes they were Rb 6 and Rb 23 per kg, for carrots – Rb 7.5 and Rb 18 per kg, for onions – Rb 7 and Rb 21 per kg, for beets – Rb 5 and Rb 15 per kg, accordingly[1].

The 2011/2012 MY revealed serious problems of the fruit and vegetable sector. In the last two marketing years, when prices were high, producers concentrated on enlarging areas planted and construction of vegetable storage facilities. At the same time, small attention was paid to the development of marketing and improvement of product quality that play the decisive role in the situation of high supply and low prices.

Producers of vegetables and fruits will hardly make profit in the 2011/2012 MY. Those of them who invested in after-treatment and quality of products as well as development of marketing and establishment of ties with retail networks will find themselves in a better situation.

4.5.3. Russia's accession to the WTO

On December 16, 2011 at the Ministerial Conference of the World Trade Organization (WTO) held in Geneva Russia was officially accepted in this organization. Negotiations on the country's accession to the WTO went on for 18 years (!). Russia will become the full-fledged member of this organization beginning from September 2012.

Accession to the WTO imposes certain commitments regarding both the level of customs tariffs applied to imported agricultural and food commodities and the level of state support to agriculture.

The final bound import tariffs[2] on agricultural and food products will be 10.8%, lower than the current average of 13.2%. In particular, by the end of implementation period import tariffs for dairy products should be reduced from 19.8% to 14.9%, for cereals – from 15.1% to 10.0%, for oilseeds, fats and vegetable oils – from 9.0% to 7.1%.

The final bound rate will be implemented on the date of accession for more than one third of national tariff lines with another 30% of the tariff cuts to be put in place three years later. The longest implementation period is established for pork.

Tariff quotas are preserved for import of meat – see *Table 46*.

[1] Data of "APK-Inform: vegetables and fruits".

[2] The final bound import tariff is the maximum level of tariff allowed by the end of implementation period that cannot be raised without notification of the WTO members or compensation (e.g. lower tariff for another imported item). Implementation period is the period within which a country – member of the WTO should meet its commitments.

One of the basic challenges for the domestic pig raising will be the cut of import duty for live pigs down to 5%, which will notably reduce the level of domestic prices for pork in live weight and increase imports of animals. According to data of the Institute for Agricultural Market Studies (IKAR) imports of live pigs in 2013 may exceed 1m head and amount to nearly 2m head by 2015 entailing the lowering of price by about Rb 10 per kg.

The accession to the WTO will also have a negative effect on the cattle raising and first of all the segment of "high-quality" beef. At present an actually prohibitive duty of €8 per kg is applied here. In summer 2012 it will fall down to 15% and this may entail the growing supply of "non-high-quality" beef since this item is not subject to import quotas. Thus domestic producers that are not numerous as it is may face unfair competition.

Table 46

Measures of customs and tariff regulation of meat import to Russia in compliance with the WTO rules

Items and their customs codes	Currently applied quota	Currently applied tariff rates		Quota upon WTO accession	Beginning bound tariff rates		Final bound tariff rates	Analysis of risks and problems
		Within the quota	Outside the quota		Within the quota	Outside the quota		
Beef and veal (fresh, chilled, frozen) 0201	560,000 tons	15% but not less than €0.2 per kg	50% but not less than €1 per kg	570,000 tons	15%	55%	27.5% in case no tariff quotas are applied	Former regulation practices are preserved
Beef by-products	no	25% but not less than €0.35 per kg		no	15%		15%	Growing imports of cheap by-products
High-quality beef 0201 30 00 5, 0202 30 100 5, 0202 30 500 5 and 0202 30 900 5	no	15% but not less than €8 per kg		no	15% but the price criterion does not apply to the USA, Canada and Argentina		15%	Worse investment prospects for the sector
Pork 0203	320,000 tons	15% but not less than €0.25 per kg	75% but not less than €1.5 per kg	400,000 tons	0%	65%	25% from 01.01.2020	The basic challenge for domestic pig raising is the lowering of domestic price by 6-8% (Rb 10 per kg of live weight). The loss of domestic pig producers may total from Rb 18bn to Rb 24bn depending on the level of state support
Pork trimmings 0203 29	30,000 tons	15% but not less than €0.25 per kg	75% but not less than €1.5 per kg	30,000 tons	0%	65%	25% from 01.01.2020	
Pork by-products and fat	no	25% but not less than €0.35 per kg		no	15%		15%	
Live pigs 0103	no	40% but not less than €0.5 per kg		no	5% but not less than €0.1 per kg		5% but not less than €0.1 per kg	

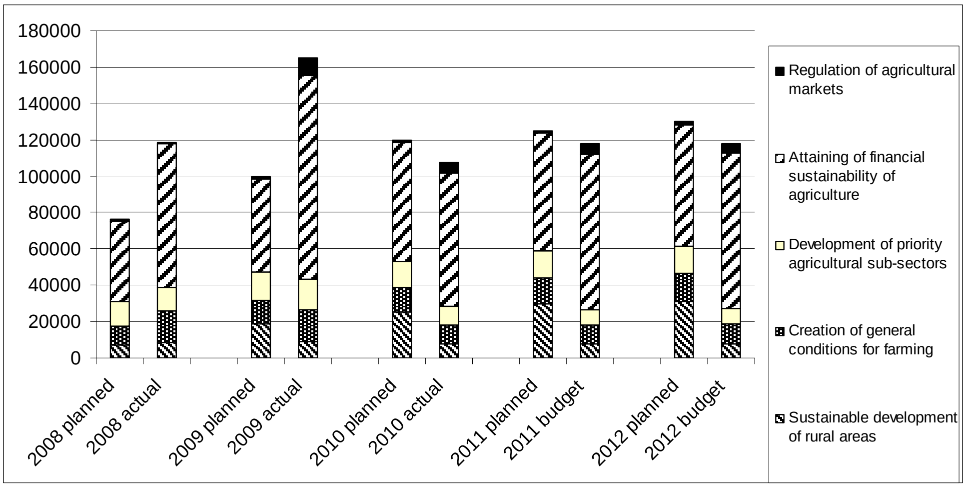
Source: http://www.wto.org/english/news_e/news11_e/acc_rus_10nov11_e.htm; the Institute for Agricultural Market Studies (IKAR).

The total trade distorting state support to agriculture should not exceed \$9bn in 2012 and by 2018 should be reduced to \$4.4bn. Still, there remains an opportunity for unlimited increase of “green box” support measures (research, training, extension, infrastructural services, food aid, decoupled income support, payment insurance, etc.) that can be used for indirect support of farm producers.

4.5.4. Modification of agricultural policies in 2011

As different from 2010 with its abnormal drought and other natural calamities, the past year was relatively favourable for farming and large allocations from the agricultural budget were not hastily switched from one destination to another. But it has not saved the State program for agricultural development and regulation of agricultural and food markets in 2008-2012 (hereinafter referred to as the State Program)[1] from further amending.

Although the State Program sets five guidelines for allocating funds (I – Sustainable development of rural areas; II – Creation of general conditions for farming; III – Development of priority agricultural sub-sectors; IV – Attaining of financial sustainability of agriculture; V – Regulation of agricultural and food markets) and declares sustainable development of rural areas as its main objective, the bulk of budget funds are spent on increasing subsidizing of farm producers’ expenditures on interest rate (see *Fig. 67*), and this share is growing year after year.



Source: data of the RF Ministry of Agriculture.

Fig. 67. The structure of planned and actual budget expenditures by guidelines set in the State program for agricultural development in 2008–2012

This is primarily due to the fact that the restructuring of debts under agricultural credits not only increased their amounts but also induced “a spiral” of subsidies for reimbursing interest rate on credits. The growing share of respective subsidies in the State Program budget (under the guideline “Attaining of financial sustainability”, see *Fig. 67*) resulted in smaller allocations to soil improvement, sustainable rural development, rural infrastructure, consulting and

[1] Approved by the RF Government Resolution No. 446 of June 14, 2007 “On the State program for agricultural development and regulation of agricultural and food markets in 2008-2012”.

other services to farm producers[1]. But one will hardly manage to halt this trend within the framework of ending State Program for 2008–2012 due to both the increased budget commitments on subsidies and the fact that the budget for the 3 coming years has already been adopted.

Similar to the previous year, the financing of section "Sustainable development of rural areas" was cut most severely. According to the initial version of the State Program it was to get 20% out of Rb 552bn projected for 2008–2012. In 2011 Rb 7.7bn were allocated for the improvement of social and engineering infrastructure in rural areas – instead of the initially adopted Rb 28.4bn (*Table 47*).

The amount of subsidies for reimbursing interest rate was almost twice above the initially projected. 71% of such subsidies from budgets of all levels are allocated to the support of investment projects.

At the same time, the financing of efforts to develop priority agricultural sub-sectors was reduced: in livestock production – by Rb 2bn, in crop production – by 25% (from Rb 4.5bn to Rb 3.4bn). Funds aimed to support farm producers in the Extreme North regions and to establish perennial plantations were again negligibly small, measures to encourage flax and rape production were actually discontinued. An actual withdrawal of support to rape producers is a sign of growing disillusionment and no wish to finance development of alternative bio-energy sources.

Table 47

Basic indicators of the State Program implementation in 2011

Components	2011 indicators		Financing from the federal budget, million rubles	
	planned*	as of the reporting date	planned*	actual
1	2	3	4	5
1. Efficiency indicators				
1.1. Index of agricultural production in farms of all types as % of the previous year (in comparable prices)	104.1	122.1	X	X
1.2. Share of domestic output in available supply of				
1.2.1. meat and meat products, %	68.1	54.6	X	X
1.2.2. milk and dairy products, %	80.4	63.3	X	X
2. Sustainable development of rural areas				
2.1. Financing of measures to improve social and engineering infrastructure in rural settlements, total	X	X	28 362	7 720
3. Creation of general conditions for farming				
3.1. Total financing under the section	X	X	14 659.5	11 512
3.2. including subsidies to farm producers for the purchase of domestically produced mineral fertilizers and pesticides	X	X	4 950	5 500
3.3. including creation of the system of state informational support to agriculture	X	X	1 050	467
3.4. including development of consultative assistance to farm producers	X	X	1 113.5	0
4. Development of priority agricultural sub-sectors				
4.1. Development of livestock production				
4.1.1. Subsidies to support pedigree livestock breeding	X	X	4 807	3 500
4.1.2. Supply of pedigree livestock to Rosagroleasing, head	30 000	8 597	X	X
4.1.3. Supply of equipment for livestock production to Rosagroleasing, number of stalls	65 000	11 350	X	X

[1] In 2010-2011 the growth of carry-over budget commitments on subsidizing of interest rate on credits extended to agriculture entailed more than 3-fold reduction of expenditures on measures under special federal program "Social development of rural areas till 2012".

cont'd

1	2	3	4	5
4.2. Development of crop production				
4.2.1. Subsidizing of measures to support elite seed breeding	X	X	513.2	1 716
4.2.2. including financing of measures to support farm producers in the Extreme North regions	X	X	1 000	405.6
4.2.3. including financing of measures to support flax production	X	X	542	246.6
4.2.4. including financing of measures to support rape production	X	X	1 025	252.7
4.2.5. including financing of measures to establish perennial plantations	X	X	725	522.5
5. Attaining of financial sustainability of agriculture				
5.1. Total amount of subsidized credits (loans), billion rubles	208	200.8	X	X
5.1.1. including short-term credits	168	152.3	X	X
5.1.2. including investment credits	140	48.5	X	X
5.2.1. Subsidizing under short-term credits	X	X	10 500	18 713
5.2.2. Subsidizing under investment credits	X	X	29 738	38 591
5.3. Amount of subsidized credits received by smallholder farms	35	31.6	X	X
5.4. Subsidizing of interest rates on credits (loans) received by smallholder farms	X	X	7 400	5 897
5.5. Purchase of tractors by all types of farms, units	41 000	9 799**	X	X
5.6. Purchase of grain harvesters, units	12 500	2 144**	X	X
5.7. Purchase of fodder harvesters, units	3 500	745**	X	X
6. Carrying out of grain purchase and commodity interventions, support of export	X	X	1 430	7 938
TOTAL	X	X	**125 000**	**125 000**

* Resolution No. 446 as in force on July 14, 2007.
** RF Ministry of Agriculture, preliminary data.

In the section "Creation of general conditions for farming" only one indicator – subsidies to farm producers for the purchase of domestically produced fertilizers and pesticides – displays stable growth. The primary beneficiaries of this form of state support are producers of mineral fertilizers and petrochemical enterprises. Capital investments in building, reconstruction and restoration of meliorative systems are falling. Allocations to create the system of state informational support to agriculture dropped 2.5 fold. Financing of consultative assistance to farm producers and re-training of agricultural specialists ceased completely despite the most acute deficit of skilled labour. Meantime, allocations to grain purchase and commodity interventions grew 5.6 fold.

So, the range of economic policy tools applied in agriculture gets narrower year after year. They are basically limited to subsidizing of large corporate farms and mega-large agricultural holdings regardless of their technical and financial efficiency[1]. Development of land and rural infrastructure is not paid due attention to. The set of applied measures is the same for all regions of the country. Meantime, the All-Russian Agricultural Census of 2006 revealed that their farm structure is absolutely different: large-scale corporate agriculture, corporate agriculture, family commodity and non-commodity production. Besides, even within a prosperous region-constituent of the Federation some areas can be classified as zones of agricultural devastation[2]. It's obvious that for territories with a certain farm structure one should apply spe-

[1] H. Hockmann (IAMO), E. Gataulina. The significance of market transaction costs and technical efficiency for economic performance (cost rentability) in Russian agriculture. – http://conf.hse.ru/2011/prog_sections (R-05). – 2011.

[2] Uzun V.Ya., Saraykin V.A., Gataulina E.A. Classification of farm producers based on data of the All-Russian Agricultural Census of 2006. Moscow, the All-Russian Institute of Agrarian Problems and Informatics named after A.A.Nikonov (VIAPI), ERD, 2010. www.viapi.ru

cific policy measures with due regard to the actual situation. However, this aspect is not taken into account when developing agricultural policies. The data of Agricultural Census does not even serve as one of the basic sources of information that should be considered in this process. The evidence of its extremely limited use is the fact that there are just a few scientific publications based on the analysis of census results and the latter are very rarely referred to in reports of officials determining state policies in the sector[1].

At the end of 2011 a draft of the new 8-year State Program for 2013-2020 was submitted to the government.

The new State Program sets the following tasks and objectives:

– sustainable development of rural areas, creation of favorable and attractive social environment for rural residents including housing conditions, health care, education, road, transport and other kinds of infrastructure;
– ensuring commodity farm producers the rate of return sufficient for expanded reproduction of agricultural products and maintenance of their financial sustainability and competitiveness on domestic and foreign markets;
– modernization and switching to the innovational pattern of agrifood sector development, accelerated adoption of advanced research and technology enabling to improve productivity of labour and reduce per-unit input requirements;
– recultivation and more efficient use of land and other natural resources;
– development of smallholder farming and cooperation as an important factor of income growth for farm producers and facilitation of their access to agricultural and food markets;
– informational support to agrifood sector operators and providing them with state services in electronic form;
– increase of export resources of grain and other agricultural products with the view to expand Russia’s share on the world food market.

However, the draft Program fails to cope with some risks that became evident in previous years. In particular, the need to pay subsidies under the already issued long-term credits will notably reduce the amount of subsidies for new credits. The Program does not set limits for subsidizing interest rate to specific participants of food chains. This can lead to the rechanneling of subsidies in favour of processing and logistical companies. Their great lobbying capacities can result in the worsening of farm producers’ access to credits, especially the short-term ones. Experts[2] recommend to establish limits on compensating expenditures on credits to processors and logisticians, for instance not more than 30% (at present their actual share is already about 45%).

Regrettably, at the last stage of adoption the principal measures for developing agricultural cooperation were withdrawn from the sub-program “Support of small-scale farming”, i.e.:

– granting of subsidies to agricultural credit cooperatives for replenishment of the fund for mutual financial assistance;

[1] One of the reasons is that the primary impersonal results of the census are actually unavailable for researchers and the opportunity to analyze aggregated data published by Rosstat is very limited.

[2] See, for instance, V.Ya.Uzun, E.A.Gataulina et al. Agrarian protectionism: scientific fundamentals and implementation mechanisms in the market environment. – Moscow, the All-Russian Institute of Agrarian Problems and Informatics named after A.A.Nikonov (VIAPI), 2010, p. 278.

– reimbursement of 50% of documented expenditures of agricultural consumer cooperatives – non-credit cooperatives – on establishment of their material basis (construction, purchase of machinery and technological equipment, etc.).

These support measure were proposed after the monitoring of implementation of the effective State Program (carried out by the RF Ministry of Agriculture[1]) revealed that the principal hindrances to development in the opinion of small farm producers were the under-capitalization of material and technical basis in input supply and marketing cooperation and the shortage of current capital in credit cooperation. The pre-revolution Russia's experience proved the efficiency of such measures for supporting cooperation: the state granted respective loans and they were repaid prior to maturity. Notwithstanding all the above, these measures have not been included in the draft of the new State Program. Now the prospects for development of agricultural cooperation are rather vague and progress will be made only in the regions that have their own programs of support to cooperation.

Measures concerning development of market transfer of farmlands and its monitoring are not well thought over. For instance, it's planned to monitor up to 90% of lands of agricultural designation. Meantime, over half of them are not farmlands and are covered with forest, shrubs, swamps, etc. Their area is constantly reducing as non-agricultural lands are transferred to other categories of lands. Besides, one discusses the possibility to eliminate the notion of "lands of agricultural designation" as a category of lands. It would be more rational to monitor farmlands suitable for agricultural production rather than lands of agricultural designation.

The distribution of funds in the draft State Program is not duly substantiated. For instance, it envisages providing subsidies to individual private farms for registration of ownership titles to 9m hectares of land. The question arises: why farm producers of only this organizational type are eligible for subsidies and how was this acreage determined given that individual private farms use more than 20m hectares without legal registration? Besides, the total amount of compensation per farm or per hectare is not limited. This provides ample opportunities for abuse – compensation of highly overstated prices for works of cadastral engineers facing no competition and the use of limited resources to the benefit of selected farmers having access to authorities that chose recipients of such compensations. There are a lot of such inconsistencies and discrepancies in the draft of the new State Program.

According to the State Program's draft version of November 11, 2011[2] allocations to soil improvement and rural development are to increase 7.5 fold while allocations to subsidizing of interest rate on credits – less than 2 fold as compared with the previous State Program. About 41% of the planned Rb 2,113bn of state support will be used for compensating input costs and supporting market prices. A great share of state support is tied to selected products and inputs and thus can be referred to as "amber box" measures. It should be noted that despite many years of negotiations with the WTO, traditional measures of state support are not adjusted to the requirements of this organization.

4.5.5. Recommendations

1. The analysis of farm performance shows that the sector has restructured after the protracted crisis that accompanied the structural reform in agriculture in the post-Soviet period.

[1] Monitoring of State Program implementation (2008–2009). Moscow, Kolos, 2010.
[2] http://www.mcx.ru/documents/document/show/16834.342.htm

Production of basic crop products as well as poultry and pig meat, eggs, and to a smaller extent products of sheep raising, is growing. Corporate farms concentrate not only on cultivation of grain and industrial crops but also on breeding of poultry and pigs; the share of cattle kept by them is growing as well. It's obvious that smallholder farms have been the buffer that throughout the twenty years provided for the maintaining of livestock population at an actually constant level while the drop of the latter in corporate farms was disastrous. The role of smallholder farms is especially important in raising of cattle, the population of which fell most dramatically. It's clear that until production of beef and milk becomes profitable for corporate farms, the maintaining of the country's food security necessitates stronger support to smallholder farms in proportion to their contribution to the production of these products. But in fact the government supports corporate farms instead of smallholder farms. The evidence of that is the level of state support to smallholder farms[1], the limitations imposed on the acreage of household plots that were introduced in 2011[2] and other similar constraints.

2. The duty to monitor implementation of the State Program for supporting agriculture is assigned to the department that bears the principal responsibility for it – the RF Ministry of Agriculture. At present the Ministry gathers the bigger share of information from farm producers including that on the implementation of the State Program. The access to this information is actually closed: only general information is available that does not allow to carry out detailed analysis and research in the field of agriculture and its state support. Due to that it's hard to speak about the real results of the program, its efficiency for different groups of producers, areas and products and to work out proposals for improving the state support to agriculture.

Formally, there are no infringements in providing access to information: the government and departmental documents specify the general list of information and declare the principle of its availability. However, the summarized data does not allow to reveal latent problems of agricultural performance.

At the same time, the draft of the new State Program for supporting agriculture again envisages expenditures on different kinds of monitoring and data collection carried out by the Ministry of Agriculture. In case the existing practice of providing access to information is maintained and the Ministry continues to perform the function of monitoring the State Program implementation, these funds can be regarded as the funds for supporting the Ministry itself.

In order to put a stop to the formal approach to ensuring access to information that is currently practiced by the RF Ministry of Agriculture, one should publicly discuss and adopt the rules in compliance with which the department will provide informational services. They should concern the list, way and terms of submitting information and the procedure of getting access to it.

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[1] For instance, in Pskov oblast corporate farms receive 13.7 kopecks of state subsidies per 1 ruble of gross output, individual private farms – less that 2 kopecks. At the same time household farms get for only 1 kopeck of subsidies per 100 rubles of output. Data of Zernov I.V., dissertation paper "Family entities and their role in the agrarian sector (the case of Pskov oblast)", www.vak.ru.

[2] An amendment was made in the Federal Law No. 112-FZ of July 7, 2003 "On household farm" that limits the size of such a farm to 0.5 hectares. This amendment concerns plots of all legal titles, not just the ones privately owned. The law envisages that regions-constituents of the Russian Federation can enlarge this acreage but in fact no such decisions are taken. www.consultant.ru.

Besides, the function of preparing the national report on implementation of the State program for agricultural development and regulation of agricultural and food markets should not be performed by the Ministry of Agriculture as it is the chief agency responsible for this implementation. The national report should be drawn up by an external organization, not subordinate to the Ministry of Agriculture. This will help to give an objective estimate of all aspects of the State Program implementation and its efficiency, to make the necessary adjustments and improve the quality of state support in order to serve the public rather that departmental interests.

3. In the context of Russia's accession to the WTO one should examine measures of state support to domestic agricultural producers applied in the country. These measures should be adjusted to the requirements to "green box" support that is not subject to any restrictions. It's worth examining the possibility to apply such measures as payment of subsidies per hectare or per livestock unit (in order to diminish the ties between output of a selected product and the level of state support), partial compensation of expenditures on new machinery and equipment (in order to stimulate modernization of farm sector) and other measures, the application of which gave good results in other countries – members of the WTO.

4. In order to provide equal access to state support, it would be rational to set limits on its amount received by one farm producer, either physical or legal body.

5. When elaborating federal agricultural policies one should take into account the whole variety of farm structures in regions-constituents of the Federation and administrative districts within them. Federal policies should be designed so that not only regions and districts with large-scale corporate farming but also areas with prevailing small-scale farming could get access to state support. Special measures are needed for areas of agricultural devastation. The efficiency of support should be taken into account when shaping the mechanisms of state support to agriculture. In regions showing good return per ruble of investments it's worth supporting farm production. Meantime, in territories where the return of support allocations is low but rural population is still preserved, it's rational to use state funds for the development of rural areas and any kinds of business.

4.6. Foreign Trade

4.6.1. Situation in the World Economy

The succession of events that occurred in 2011 created some real threats to the world economy's revival that had begun in 2010. The political instabilities in the Near East and North African countries, natural disasters in Australia and Japan made the world economy's exit from the crisis more difficult. In the spring of 2011, Europe was hit by yet another wave of sovereign debt crisis which mainly affected the peripheral eurozone countries – Greece, Ireland and Portugal. In early June, the US government debt situation took a turn for the worse. By the end of the year, economic conditions in Europe had continued to deteriorate.

The World Bank's report *Global Economic Prospects*, published on 18 January 2012[1], emphasizes that the world economy has entered a very difficult phase which is characterized by some considerable vulnerabilities and uncertainties. The present course of world events fully corresponds to one of the decelerating economic growth scenarios considered to be risky

[1] http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1322593305595/8287139-1326374900917/GEP_January_2012a_FullReport_FINAL.pdf

in the previous Report (June 2011). As a result, the World Bank has significantly downgraded its global economic growth forecast:

– the growth rate of the global economy will amount to 2.5% in 2012 and to 3.1% in 2013, vs. 3.6% for both these years as forecasted in the June 2011 Report;
– in 2012, high-income countries are expected to have a 1.4% economic growth (a 0.3% drop for the eurozone and a 2.1% growth for the other high-income countries); in 2013 – a 2% growth (vs. a 2.7% growth in 2011 and a 2.6% growth in 2013 predicted in the June 2011 Report);
– the growth forecast for developing counties is reduced, by comparison with the June 2011 Report, from 6.2% in 2012 and 6.3% in 2013 to 5.4% and 6% respectively;
– the 2012 growth forecast for the Russian Federation is cut from 4.1% to 3.5%.

According to the World Bank, the growth rate of world trade in 2011 amounted to 6.6% (vs. 12.4% in 2010). Bearing in mind the forecasted reduction in the growth rate of the global economy in 2012, the World Bank expects that the growth rate of world trade will drop to 4.7% in 2012, but then will rebound to 6.8% in 2013.

The IMF *World Economic Outlook (WEO) Update*[1] published on 24 January 2012 also registers a slowdown in the global economic recovery and an escalation in downside risks. According to the *Update*, in late 2011 the crisis in the eurozone entered a ‘dangerous new phase’; in 2012 the eurozone economy is expected to go into a mild recession that will also affect other countries of the world, including the United States, emerging market countries and developing economies (*Table 48*).

Table 48

Changes in World Output and World Trade Volume

	Growth Rates as Percentage of Previous Year				Difference between September 2011 WEO Projections and January 2012 WEO Projections	
1	2				3	
	2010	2011	2012	2013	2012	2013
World Output	**5.2**	**3.8**	**3.3**	**3.9**	**–0.7**	**–0.6**
Advanced Economies	**3.2**	**1.6**	**1.2**	**1.9**	**–0.7**	**–0.5**
United States	3.0	1.8	1.8	2.2	0.0	–0.3
Eurozone	1.9	1.6	–0.5	0.8	–1.6	–0.7
Germany	3.6	3.0	0.3	1.5	–1.0	0.0
France	1.4	1.6	0.2	1.0	–1.2	–0.9
Italy	1.5	0.4	–2.2	–0.6	–2.5	–1.1
Spain	–0.1	0.7	–1.7	–0.3	–2.8	–2.1
Japan	4.4	–0.9	1.7	1.6	–0.6	–0.4
United Kingdom	2.1	0.9	0.6	2.0	–1.0	–0.4
Canada	3.2	2.3	1.7	2.0	–0.2	–0.5
Other Advanced Economies	5.8	3.3	2.6	3.4	–1.1	–0.3
Newly Industrialized Asian Economies	8.4	4.2	3.3	4.1	–1.2	–0.3
Emerging and Developing Economies	**7.3**	**6.2**	**5.4**	**5.9**	**–0.7**	**–0.6**
Central and Eastern Europe	4.5	5.1	1.1	2.4	–1.6	–1.1
Commonwealth of Independent States	4.6	4.5	3.7	3.8	–0.7	–0.6
Russia	4.0	4.1	3.3	3.5	–0.8	–0.5
Excluding Russia	6.0	5.5	4.4	4.7	–0.7	–0.4
Developing Asia	9.5	7.9	7.3	7.8	–0.7	–0.6
China	10.4	9.2	8.2	8.8	–0.8	–0.7
India	9.9	7.4	7.0	7.3	–0.5	–0.8
Latin America and the Caribbean	6.1	4.6	3.6	3.9	–0.4	–0.2
Brazil	7.5	2.9	3.0	4.0	–0.6	–0.2
Mexico	5.4	4.1	3.5	3.5	–0.1	–0.2

[1] http://www.imf.org/external/pubs/ft/weo/2012/update/01/pdf/0112.pdf

cont'd

1	2				3	
World Trade Volume (Goods and Services)	**12.7**	**6.9**	**3.8**	**5.4**	**–2.0**	**–1.0**
Imports						
Advanced Economies	11.5	4.8	2.0	3.9	–2.0	–0.8
Emerging and Developing Economies	15.0	11.3	7.1	7.7	–1.0	–1.0
Exports						
Advanced Economies	12.2	5.5	2.4	4.7	–2.8	–0.8
Emerging and Developing Economies	13.8	9.0	6.1	7.0	–1.7	–1.6

Source: The IMF World Economic Outlook (http://www.imf.org/external/pubs/ft/weo/2012/update/01/index.htm#tbl1).

On the whole, the IMF forecasts that, in 2012, activity in the advanced economies will expand by a meager 1.2 % on average (representing a 0.75 p.p. drop on the September 2011 *WEO*), while in 2013 it will increase by 1.9%. The current year's global economic growth is expected to hover around 3.3%.

Growth in emerging and developing economies is expected to weaken owing to the deterioration in the external environment and the slowdown in the domestic demand. The average economic growth rates in these countries are forecasted at around 5.4%, which represents a considerable drop on the growth rates registered in 2010-2011, and a 0.7 p.p. – decline by comparison with the September 2011 WEO.

The highest growth rates are still expected to be achieved by the developing countries of Asia. According to the IMF, their economies will grow at 7.3 to 7.8% on average. Despite a substantial downward revision of their growth rates, China and India remain the most dynamically developing economies of the world.

4.6.2. The Terms of Russia's Foreign Trade: Prices for Major Russian Exports and Imports

In 2011, the terms of Russia's foreign trade considerably improved by comparison with the previous year due to the prices of exports rising at a higher rate than the prices of imports: Russia's Terms of Trade Index amounted to 121.8. In 2010, this index was notably lower – 117.9 (*Fig. 68*).

In 2011, the price situation on the world markets of major Russian exports was notably favorable (*Table 49*). The prices of raw commodities peaked in Q1, but then experienced a decline owing to a contraction in demand. Over the course of the year, the prices of non-energy goods dwindled by 11%, which involved practically all goods of that category, except for fertilizers, timber and grain. The prices of energy goods rose by 14%[1].

In 2011, the behavior of oil prices was determined by the worsening political situation in the countries of North Africa and the Middle East and by the slowdown in global economic growth that had resulted from the public debt problems in the USA and the EU. On 7 February 2011, the price of Brent crude dropped to its 2011 low of $ 99.23 per barrel, but then quickly recovered and never sank below $ 100 per barrel over the remaining course of that year.

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[1] http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1111002331357/829378-1326493099587/CommodityMarketsReview_January2012.pdf

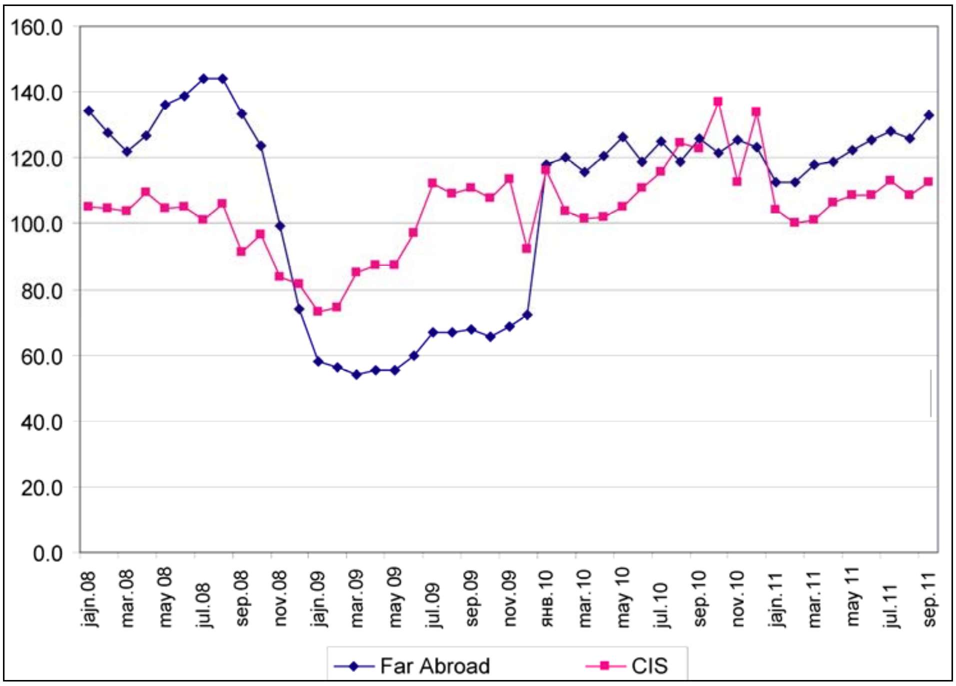


Fig. 68. The Terms of Trade Index

On 9 April 2011, the political developments in the Middle East and North Africa pushed up the price of Brent crude to its 2011 high of $ 126.9 per barrel. On 5 May 2011, oil prices experienced a strong downward adjustment: the price of a barrel of Brent crude shed $ 11.39 in one day (a 9% drop), thus returning to its March 2011 level. This adjustment was caused by fears that demand for oil would decline against the background of the latest (quite unimpressive) release of US macroeconomic statistics.

Over the course of 2011, the average price of Brent crude was $ 110.94 per barrel, or by 39.3% more than in 2010[1].

The price of Urals crude hit its 2011 high on 28 April, when it climbed to $ 123 per barrel (its historic high of $ 139.8 per barrel was registered on 11 June 2008). In 2011, the average price of Urals crude was $ 109.3 per barrel, which represented a 39.8% rise on 2010.

In 2011, natural gas prices in the European market rose by 26.5% on 2010[2].

The behavior of prices[3] in the non-ferrous metals market went through a number of notable phase changes over the course of 2011. Over January-February 2011, prices were growingt rapidly, spurred on by political developments in North Africa and Middle East. Thus, in February, the price of copper soared to its historic high of more than $ 10,000 per ton. The behavior of the prices of aluminum, lead and zinc was more moderate. The prices of these metals were rising only in January, while in February they became stabilized.

[1] http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1111002388669/829392-1325803576657/Pnk_0112.pdf
[2] *Ibid*.
[3] http://www.lme.com/dataprices_historical.asp

Table 49

Average Per Annum World Prices

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Oil (Brent), $/barrel	24.84	25.02	28.83	37.4	54.38	65.15	72.32	97.64	61.86	79.64	110.94
Natural gas, European market, $/m BTU	4.06	3.05	3.91	4.28	6.33	8.47	8.56	13.41	8.71	8.29	10.52
Gasoline, $/gallon	0.792	0.755	0.891	1.197	1.508	1.81	2.06	2.703	1.68	2.13	
Copper. $/ton	1,578	1,559	1,779	2,866	3,679	6,722	7,118	6,956	5,149	7,534	8,828
Aluminum,. $/ton	1,444	1,350	1,431	1,715	1,898	2,570	2,638	2,573	1,665	2,173	2,401
Nickel, $/ton	5,945	6,772	9,629	13,823	14,744	24,254	37,230	21,111	14,655	21,809	22,910

Source: estimates are based on data published by the London Metal Exchange (London, UK) and the World Bank.

The earthquake in Japan caused a fall in metal prices. The biggest price-losers were pewter, nickel and copper. The prices of aluminum, lead and zinc were less affected by the disaster. And as early as late March the prices of all metals began to rise once again.

It should be noted that the non-ferrous metals market is heavily influenced by the situation in the foreign exchange market. From late March through early May 2011, the euro was strengthening against the US dollar, which became one of the crucial factors behind the rise in non-ferrous metals prices that was taking place during that period.

However, on having reached their peak values in April 2011, the prices of non-ferrous metals began to descend in May. Thus, in April, the price of nickel at the London Metal Exchange climbed to its post-crisis high of about $ 28,000 per ton, and then started to decline. The main factor behind the downward trend in non-ferrous metals prices observed during that period was the contraction of demand for those metals on the part of their biggest consumers – Europe, hard hit by its budgetary and debt problems, and China, whose GDP growth rate had significantly shrunk by then.

The downward trend in non-ferrous metals prices lasted until the end of 2011. As a result, in December 2011, the price of aluminum hit its lowest level since July 2010. The price of copper shrank by 20.8% since the beginning of 2011, while the price of nickel dwindled by 28.8%, to its lowest level since December 2009. However, in 2011 the prices of aluminum, copper and nickel were by 10.5%, 17.2% and 5.0% respectively higher than in 2010.

After having reached their record highs in February 2011, the prices of food commodities and agricultural raw materials in the world market persistently declined over the remaining course of that year. In February 2011, the FAO Food Price Index, which reflects the monthly change in international prices of the basket of food commodities, including cereals, vegetable oils, dairy products, meat and sugar, averaged 237.9[1] - its highest level since 1990 when the FAO first introduced its food price index.

The second half-year of 2011 saw a drop in food commodities prices. In December 2011, the FAO Food Price Index averaged 211 points, which represented a 27-point drop on its record-high value registered in February 2011. That drop was determined by the sharp reduction in world prices for cereals, sugar and oils resulting from the good harvests in 2011, by the dwindling demand for those products, and by the strengthening of the US dollar.

[1] http://www.fao.org/news/story/ru/item/119849/icode/

However, despite the afore-said drop in prices in the second half-year of 2011, the global FAO Food Price Index averaged 228 points in 2011, which represents its highest level since the beginning of price monitoring. The previous record high was achieved by the FAO Food Price Index in 2008, when it averaged 200 points (*Table 50*)

Table 50

Changes in the Average World Prices of Some Agricultural Goods

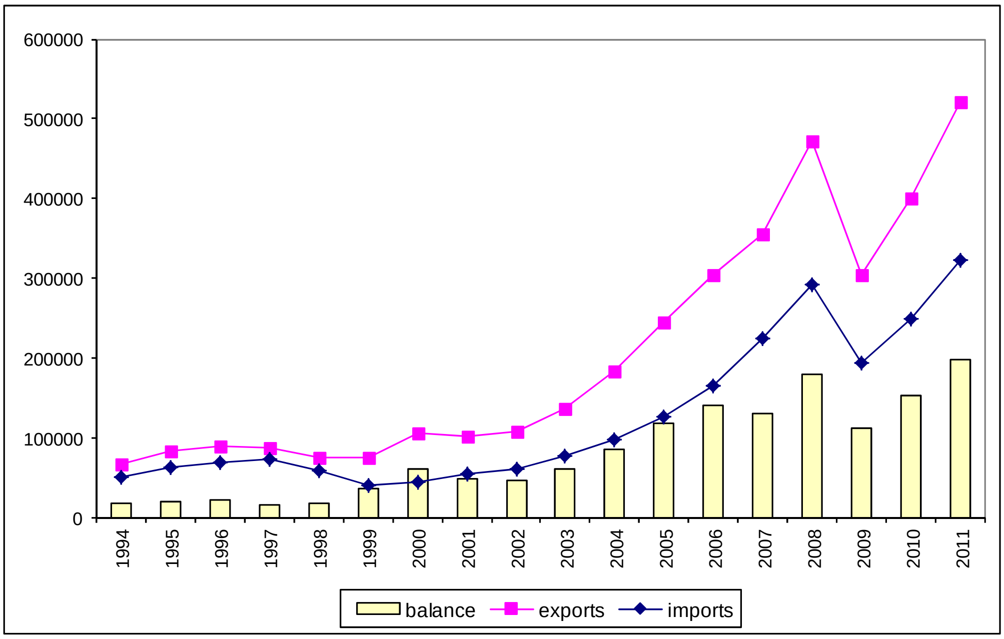
	2006	2007	2008	2009	2010	2011
Wheat, USD / t						
Canadian, CWRS	216.8	300.4	454.6	300.5	312.4	439.64
US, HRW	192.0	255.2	326.0	224.1	223.6	316.26
US, SRW	159.0	238.6	271.5	186.0	229.7	285.9
Corn, US, USD / t	122.9	163.0	223.1	165.5	185.9	291.7
Barley, USD / t	117.0	172.0	200.5	128.3	158.4	207.2
Soya beans, USD / kg	268.4	384.0	523.0	437.0	450.0	540.9
Soya oil, USD / t	598.6	881.0	1,258	849.0	1,005.0	1,299.3
Rice, Thailand, USD / t	304.9	326.4	650.1	555.0	488.9	543.0
Raw sugar in USA, import price, price c.i.f. New-York quotation, US cents / kg	48.76	45.77	46.86	54.88	79.25	83.92

Source: World Bank.

4.6.3. Major Indicators of Russian Foreign Trade

In 2011, Russia's foreign trade turnover, calculated in accordance with the balance of payments methodology, amounted to $ 845.2bn, representing a 30.3% increase on 2010, and a 10.7% increase on 2008. Thus, Russia's foreign trade turnover hit its record high since the beginning of its monitoring.

The export quota (the ratio of the value of exports to that of GDP) amounted to 28%.



Source: RF Central Bank.

Fig. 69. Major Indicators of Russia's Foreign Trade (million US dollars)

Throughout 2011, Russian foreign trade volumes continued to recover to their pre-crisis highs registered in July 2008; the recovery process had, in fact, actually started in 2010 (*Fig. 69*). In the first half-year of 2011, the growth rate of imports considerably exceeded that of exports. In July 2011, as a result of the low base effect having worn out in the first half-year of 2010, the accelerated growth trend in imports finally came to an end. In January 2011, exports grew by 12.1% in annual terms, while imports rose by 43.4%. In June 2011, these indicators amounted to 38.6% and 40.1% respectively, in July – to 35.7% and 30.6% respectively, and in November – to 34.4% and 22.7% respectively.

In the main, the rise in the value of exports was taking place in response to the price situation in world markets remaining favorable for Russian exporters throughout 2011 against the background of a reduction in the physical volume of exports. The rise in imports was taking place in response to an increase in both the physical volume and the price of imports (*Table 51*).

Table 51

Russia's Foreign Trade Indices
(As % of Same Periods of 2010)

	Q1 2011		1st half-year 2011		January-September 2011		2011	
	physical volume	average prices	physical volume	average prices	physical volume	average prices	physical volume	average prices
Exports	97.2	119.9	99.5	127.2	97.9	131	97.8	132.9
Imports	135.4	106.2	130	109.8	125.5	109.8	122.2	109.1

Source: RF Ministry of Economic Development.

Russia's balance of trade remained positive. Its surplus amounted to $ 198.8bn, representing a 31.1% rise on 2010 and a 10.6% rise on 2008.

In 2011, the imbalance coefficient of foreign trade (the ratio of the trade balance to the trade turnover) amounted to 0.235, thus remaining practically at the same level as in 2010 (0.234).

The Structure and Dynamics of Exports

In 2011, Russian exports rose to $ 521.97bn, which represented a 30.4% increase on 2010 and a 10.7% increase on 2008. In the main, that rise in exports was due to the ongoing increase in contract prices concurrent with a reduction in the physical volume of exports. The average export price index amounted to 132.9%, while its physical volume index – to 97.8% (*Table 52*).

Table 52

The Dynamics of Russian Exports

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Exports, bn USD dollars	105.0	101.9	107.2	135.4	183.2	245.3	303.9	355.2	471.6	303.4	400.0	521.97
Including:												
To far abroad	90.8	86.6	91.0	113.9	152.9	211.6	260.6	301.5	400.5	255.3	337.7	438.3
Growth rate as percentage of previous year												
Physical volume index	110.2	104.2	115.0	109.5	110.7	104.7	105.8	105.0	96.8	97.0	110.0	97.8
Price index	128.2	93.8	86.0	113.4	122.7	126.9	119.7	110.9	137.4	76.4	119.8	132.9

Source: RF Central Bank, RF Ministry of Economic Development.

Fuel and energy products remained the most important item in Russian exports. In 2011, their share increased to 71.2% vs. 69% in 2010. The value of exported fuel and energy products increased by 32.49% in response to the favorable foreign trade situation in the world energy resources market.

As before, the principal item of Russian exports was oil, whose share in the net volume of Russian exports in 2011 amounted to 34.9% (vs. 33.9% in 2010). According to the RF Federal Customs Service, in 2011 Russia exported 219.1m tons of crude oil worth $ 171.7bn, which means that the physical volume of oil exports declined by 6.3% on 2010, while their value rose by 33.1%. The share of oil experts in the volume of oil extraction dropped to 47.7% in 2011 from 49.1% in 2010. Russia remained the world's biggest oil producer: in November 2011 it produced 9,867 thousand barrels per day, while the daily oil production of all OPEC members taken together amounted to 30,367 thousand barrels (including Iraq's 2,681 thousand barrels and Saudi Arabia's 9,597 thousand barrels).

Despite a considerable growth in the physical volume of petroleum product exports to CIS countries (by 83.8%), Russia's net volume of petroleum product exports dwindled by 4.9% due to a 5.2% drop in petroleum product exports to far abroad countries (which accounted for 96.1% of Russian petroleum product exports). Owing to the rise in contract prices, the value of petroleum product exports grew by 31.5%.

In 2011, as a result of the European Union's growing demand for Russian natural gas which was taking place against the background of a decline in the energy production of nuclear power plants, Russian natural gas exports increased by 5.9% on 2010, while their value shot up by 34.3%.

Metal and metal products remained the second most important item in Russian exports. In 2011, their share in the net value of exports amounted to 9.1%, which represented a 1.5 percentage-point drop on 2010. The value of metal and metal products exports rose by 9.9% on 2010, while their physical volume shrank by 9.7%.

The year 2011 saw a considerable reduction in Russia's participation in the international nickel and refined copper market, caused by a number of factors, including an increase in the stocks of these metals traded on stock exchanges, and a reduction in China's and Japan's demand for refined copper. To a certain extent, the drop in copper and nickel exports was caused by the re-introduction, from early 2011, of the 10-percent exports duty on these metals. The physical volume of copper exports declined by 60.1%, while that of nickel exports – by 18.7%. On the other hand, the physical volume of aluminum exports rose by 2.4%.

The year 2011 also witnessed a rise increase in the average contract prices for most types of exported chemical products. Thus, there were price increases for ammonia (by 45.3%), methanol (by 22%), mineral nitric fertilizers (by 28.4%), and synthetic rubber (by 33.6%). As a result, the rise in the value of exports belonging to this category of goods amounted to 27.6%. In 2011, the share of chemical product exports in Russia's total exports remained at its 2010 level of 6%.

The share of machinery and equipment exports dropped from 5.2% in 2010 to 4.4% in 2011. This exports category yielded $ 21.1bn, which represented a 7.8% rise on 2010.

In 2011, the physical volume of passenger car exports rose by 49.2% on the previous year. This rise was accounted for solely by a 65.9% increase in the number of cars exported to CIS countries. Russia's passenger car exports to far-abroad countries fell by 19%.

A considerable share in exports belonging to the *machinery and equipment* category of goods was accounted for by military-purpose products. According to OJSC *Rosoboronex-*

port[1], in 2011 Russia's military-purpose exports amounted to over $ 10.7bn (vs. $ 8.7bn in 2010). *Rosoboronexport*'s leading export item was Air Force arms and equipment (51%), followed by Ground Forces arms and equipment (21%), Navy arms and equipment (11%), Air-Defense arms and equipment (11%), and arms and equipment designated for other categories of armed forces (4%). In 2011, OJSC *Rosoboronexport* maintained its military-technical co-operation with 57 countries. During that period, the main importers of Russian arms and military equipment were India and Venezuela.

The rise in the average contract prices for most products belonging to the *timber, wood-pulp and paper products* category of goods caused a 12.6% increase in the value of those exports. Thus, the price of veneer rose by 25%, the price of newsprint – by 21.5% and that of wood pulp – by 8.8%. The share of exports belonging to that category of goods in Russia's total exports dropped from 2.5% in 2010 to 2.2% in 2011. The physical volumes of saw timber exports, pulp wood exports and veneer exports increased by 12.3%, 8.2% and 1.9% respectively, while the physical volume of newsprint exports dwindled by 6.1%, and that of unprocessed timber exports – by 1.5%.

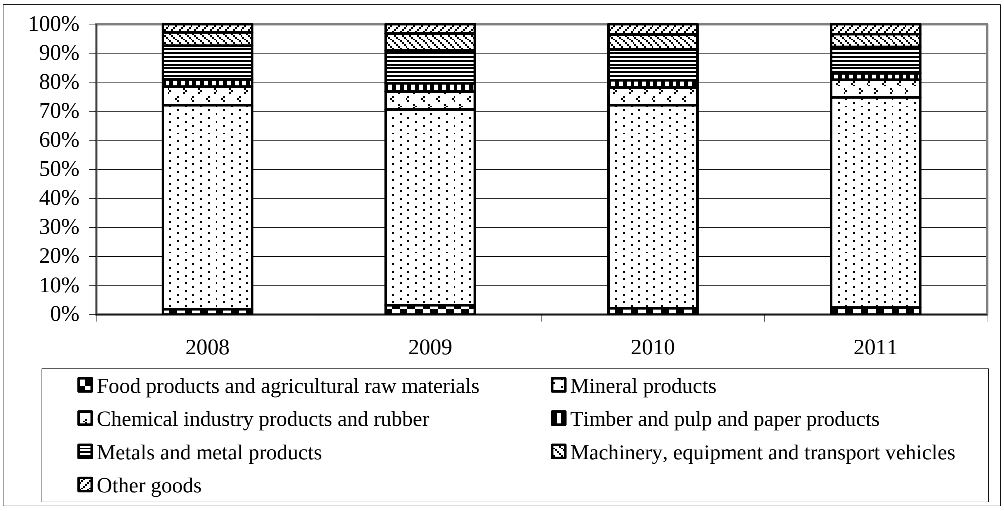
After having dropped by 10.2% in 2010 due to the introduction of a grain export embargo, Russia's export of food products and their raw materials began to gradually recover over the course of 2011. The embargo had been in effect from 15 August 2010 through 1 July 2011. On having lifted the embargo in July 2011, Russia managed to reclaim its position as one the world's biggest grain exporters. According to the Russian Federal Statistics Service (*Rosstat*), in 2011 Russia harvested 93.9 million tons of grain, which represented a 28.1% rise on the previous year.

Russia's 2011 sugar beet harvest was 2.1 times larger than that of 2010. As a result, her beet sugar output increased, over the course of 2011, to 4.7 million tons, which represented a 69.9% rise on 2010. The surge in beet sugar production and the resulting drop in domestic sugar prices made it possible for Russia to substantially increase the physical volume of sugar exports. According to the Russian Sugar Producers Association (*Soyuzrossakhar*), over the course of 2011, Russia exported more than 240,000 tons of sugar, which represented its all-time high. Traditionally, a large part of Russian sugar exports went to the CIS countries, primarily Kazakhstan. In 2011, the geographic spread of Russian sugar exports was extended to Syria, the United Kingdom and Montenegro. Small amounts of powdery sugar, pressed refined sugar and small-packaged sugar were exported to Belize, China, Norway, Japan, Mexico, Panama, the USA, and a number of other countries.

In 2011, Russia's export of food commodities and their raw materials surged by 40% on the previous year. The share of these exports in her total exports rose to 2.4% from 2.2% in 2010.

Thus, the year 2011 saw no changes in the commodity structure of Russian exports. The improvement of its quantitative indicators was almost exclusively brought about by the ongoing increase in the prices of raw materials, primarily oil – a clear indication that the Russian export commodity pattern remained heavily dependent on the situation in the world raw materials market (*Fig. 70*).

[1] http://www.roe.ru/news/pr_rel/pr_rel_rus/pr_rus_12_02_03.html



Source: RF Federal Customs Service.

Fig. 70. The Commodity Structure of Russian Exports (%)

The Structure and Dynamics of Imports

In the first half-year of 2011, the value of Russia's imports rapidly grew in response to a notable rise in external demand caused by the intensified credit activity of the population and the strengthening of the ruble. In the second half of 2011, the rate of import value growth reduced. Nevertheless, over the course of 2011 the value of imports rose by 10.7% from its pre-crisis level registered in 2008. As compared with 2010, the value of imports grew by 29.9% to $ 323.2bn. The latter increase in imports value was caused both by the growth of their physical volume, whose index shot up to 122.2%, and the import price index's rise to 109.1% (*Table 53*).

Table 53

Imports into Russia (billion US dollars)

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Imports, bn USD	44.9	53.8	60.5	76.1	97.4	125.3	163.9	223.1	291.97	191.8	248.4	323.2
Including:												
From far-abroad countries	31.4	40.3	48.2	60.1	76.4	103.5	138.6	191.2	253.1	167.7	213.3	275.5
Growth rates, as percentage of previous year												
Physical volume index	129.2	129.1	117.6	119.2	124.2	122.4	130.1	127.1	113.5	63.3	135.4	122.2
Price index	86.7	94.3	93.4	98.7	106.1	106.5	105.5	107.6	117.8	99.1	101.6	109.1

Source: Bank of Russia, RF Ministry of Economic Development.

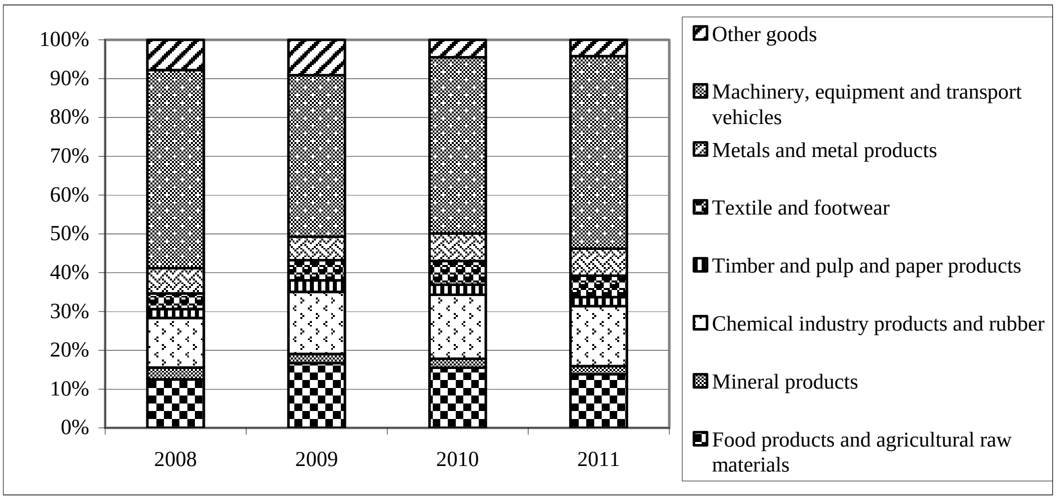
As before, the main commodity group imported by the Russian Federation was *machinery, equipment and transport vehicles*, whose share in Russia's total imports increased from 45.4% in 2010 to 49.6% in 2011 (*Fig. 71*). This commodity group was the biggest contributor to the rise in the value of Russian imports: in 2011, the value of machinery imports grew by 43% on 2010. The physical volume of passenger car imports surged by 43.3%, while that of trucks – by 85.7%.

The share of Russia's imports of food commodities and their raw materials in her total imports declined from 15.5% in 2010 to 13.8% in 2011. As compared with 2010, the value of food commodity imports grew by 16.3%. At the same time, it should be noted that the rise in their value was predominantly caused by the across-the-board price increase with regard to practically all food commodities. Thus, the price of meat rose by 11.1%, the price of poultry meat – by 6.5%, the price of butter – by 29.5%, the price of coffee – by 41.5%, the price of sunflower oil – by 29.2% and the price of white refined sugar – by 20.6%. The big harvests of wheat, sugar beet and sunflower made it possible for Russia to reduce sunflower oil imports and white refined sugar imports by 19.2% and 42.9% respectively, and to reduce her 2011 wheat imports almost to zero.

In 2011, the share of chemical products in Russia's total imports amounted to 15.5% (vs. 16.5% in 2010). As compared with 2010, the value of chemical product imports rose by 22.8%.

The share of textile articles and footwear in Russia's total imports amounted to 5.5% (vs. 6.1% in 2010). Clothes and footwear were predominantly imported from far-abroad countries, and only 6.2% of clothes imports and 1.2% of footwear imports came from CIS countries.

In 2011, the share of metals and metal articles in Russia's total imports amounted 7% (vs. 7.1% in 2010). The value of imports belonging to this commodity group rose by 28.4% on 2010 in response to a 23.1% increase in the value these imports. The physical volume of Russia's imports of ferrous metals and ferrous metal articles grew by 16.2%, including imports of rolled steel and ordinary carbon steel by 14.6%.



Source: RF Federal Customs Service.

Fig. 71. The Commodity Structure of Russian Imports (%)

The growth rates of major imports substantially exceed the growth rates of domestic output of the corresponding products, driving up their share in Russia's domestic market (*Table 54*). According to the Bank of Russia, in 2010 the share of imports in retail trade commodity resources rose on 2009 by 3.0 percentage points – to 44%. In the first half-year of 2011, their share dropped to 42%, while the share of non-food imports amounted to 50.5%, having remained at the same level as in the corresponding period of 2010. The share of food commodity imports decreased by 1 percentage point to 34%. At the same time, according to the Russian Federal Statistics Service (*Rosstat*), the share of meat and poultry imports in retail trade commodity resources rose from 29.7% in 2010 to 30.4% in 2011, the share of butter imports rose from 29.8% to 32.6%, and the share of vegetable oil increased from 20.7% to 26.2%.

Table 54

Changes in the Output of Some Russian Industries and the Behavior of the Corresponding Imports (as a Percentage of the Corresponding Period of the Previous Year)

	2010					2011				
	Q1	**Q2**	**Q3**	**Q4**	**year**	**Q1**	**Q2**	**Q3**	**Q4**	**year**
Output of food products, including beverages & tobacco	103.8	106.4	105.4	105.9	105.4	101.7	100.5	99.3	102.5	101.0
Imports of food commodities & agricultural raw materials (excluding textile ones)	124.0	125.2	118.1	118.4	121.5	131.4	183.2	123.8	119.5	116.3
T textile & apparel output	110.2	115.6	111.4	111.3	112.1	107.7	102.8	103.1	97.1	102.6
Leather, leather articles & footwear output	126.3	120.0	111.4	118.4	118.7	112.8	107.8	109.3	104.0	108.6
Imports of textile, textile articles & footwear	114.7	138.1	151.3	150.3	149	141.4	215.7	119.9	117.4	117.2
Timber processing & wood articles production	111.1	112.6	111.4	110.5	111.4	106.9	106.2	103.8	99.0	104.0
Pulp & paper production; publishing & graphic arts activities	106.7	111.7	106.7	97.8	105.9	99.5	100.5	100.4	107.0	101.8
Imports of timber & pulp-and-paper articles	119.0	120.8	115.6	114.8	115.6	128.0	199.2	122.8	115.1	113.8
Chemical industry output	123.8	115.7	112.5	108.1	114.6	108.0	105.8	105.9	101.0	105.2
Imports of chemical products & rubber	137.2	136.0	139.9	134.2	133.6	129.8	204.1	123.7	123.7	122.8
Metallurgical and metal product output	118.8	119.6	107.3	104.8	112.4	109.1	96.5	102.4	102.8	102.9
Imports of metals & metal products	138.4	152.6	157.1	153.4	155.1	143.8	222.4	133.9	130.5	128.4
Machinery & equipment output	109.1	130.5	101.4	110.5	112.2	111.6	113.2	112.5	103.8	109.5
Imports of machinery, equipment & transport vehicles	109.5	127.8	137.3	139.2	140.1	160.6	264.0	151.8	146.6	143.3

Source: RF Ministry of Economic Development, RF Federal Customs Service.

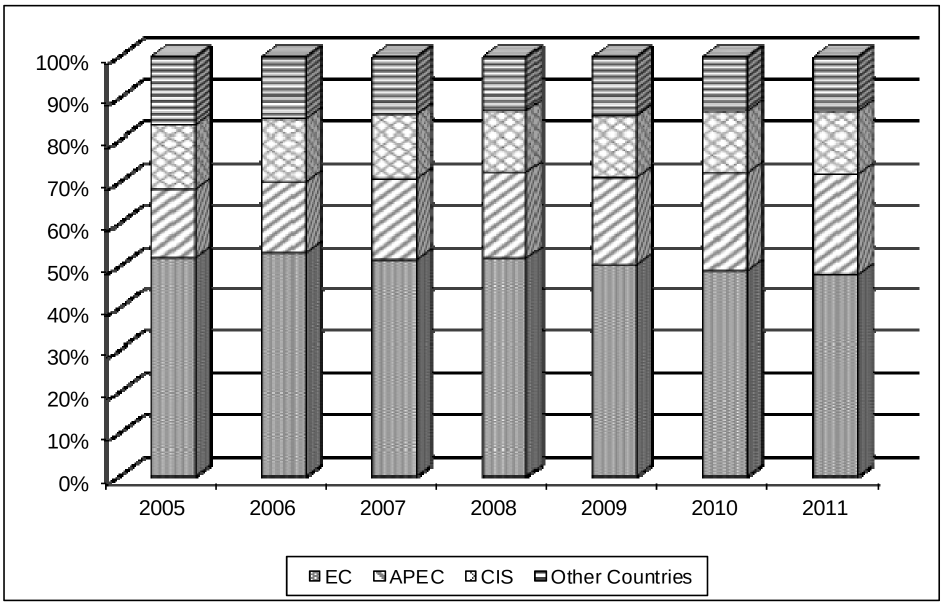
4.6.4. The Geographical Profile of Russia's Foreign Trade

In 2011, the European Union continued to be the main trading partner of the Russian Federation. Its share in Russia's foreign-trade turnover amounted to 48%, which represented a 1 p.p. drop on 2010 *(Fig. 72)*. The leader in European trade with Russia was Germany, whose share in Russia's foreign trade turnover increased from 8.4% in 2010 to 8.7% in 2011. The Netherlands, whose share dropped by 1 p.p. to 8.3%, ranked second. By the volume of trade with Russia, Italy remained in third place, while her share in Russia's foreign-trade turnover increased to 5.6%, which represented a 0.4 p.p. rise on 2010. On the whole, over the course of

2011, the EU countries increased their volume of trade with Russia by 28.3% on 2010. Russia's exports to the EU rose by 26%, while her imports from the European Union grew by 33.5%.

The share of OPEC (the Asia-Pacific Economic Cooperation Forum) member countries in Russia's foreign trade turnover climbed from 23.2% to 23.9%. Over the course of 2011, Russian exports to OPEC countries surged by 38.3% on 2010, while Russia's imports from them jumped by 32.7%. Russia's biggest trading partner belonging to the APEC was China, whose share in Russian foreign trade turnover increased by 0.7 p.p. to 10.2%. As before, second place in this group of countries went to the USA, whose share in Russian aggregate foreign trade turnover rose from 3.7% in 2010 to 3.8% in 2011. Over the course of 2011, Japan's share declined by 0.1 p.p. to 3.6%.

The share of CIS countries in Russian foreign trade turnover climbed from 14.6% in 2010 to 14.9% in 2011. Russia's top trading partners in the CIS were Ukraine and Belarus, whose shares in Russian foreign trade turnover amounted, in 2011, to 6.2% and 4.7% respectively. On the whole, Russia's foreign trade turnover with the CIS rose by 34.2% on 2010, with imports having increased by 39%.6%, and exports – by 31.3%.



Source: RF Federal Customs Service.

Fig. 72. The Geographical Pattern of Russia's Foreign Trade Turnover

The balance of Russia's foreign trade with all groups of countries (excepting the APEC) was positive. In 2011, Russia registered a trade deficit with 24 countries, whose share in Russian aggregate trade turnover amounted to 51% (in 2010, Russia ran a trade deficit with 22 countries, whose share amounted to 45%). The biggest contributors to Russia's trade deficit were China (-$ 13.0bn), Germany (-$ 3.5bn), Brazil 9-2.3bn), Canada (-$1.2bn) and Malaysia (-$ 1.1bn).

4.6.5. Regulation of Russian Foreign Trade

In 2011, the main legal documents regulating Russia's external economic activities were the RF Customs Code that came into force on 1 July 2010, and RF Federal Law of 27 November 2010, No. 311-FZ 'On Customs Regulation in the Russian Federation'.

The RF Customs Code envisages that:

– the period for customs clearance and the release of goods should be reduced from three days to one day;
– the number of required documents for export of non-primary goods should be reduced from 25 to 7;
– the amount of security payment should be reduced for a customs representative from Rb 50m to Rb 40m, or by 20%, and for a customs carrier – from Rb 20m to Rb 8m, or by 60%;
– the deadline for payment of customs duties should be extended from 15 days to 4 months.

The Federal Law 'On Customs Regulation in the Russian Federation' also contains a number of provisions simplifying the conduct of export-import transactions. Thus, the newly introduced Law:

– establishes the list of documents that external economic activity participants may be required to submit to customs authorities (previously such lists were to be established by departmental acts issued by the RF Federal Customs Service);
– reduces the number of documents for the release of non-primary goods from 14 to 7, and reduces the deadline for the release of goods from 20 to 4 hours;
– simplifies the procedure for importing and exporting scientific and commercial samples;
– establishes special procedure simplifications for the authorized economic operator;
– legislatively establishes the list of grounds for extending the deadline for the release of goods from 1 to 10 days.

The recent changes to Russian customs legislation feature prominently in *Doing Business 2012: Doing Business in a More Transparent World*[1], a joint report issued by the International Financial Corporation and the World Bank. The report assesses regulations that affect domestic firms in 183 economies, and ranks the economies in 10 areas of business regulation, including international trade.

The report notes that, over the past six years, 163 economies have made their regulatory environment more business-friendly. The Russian Federation is among the 30 economies that have improved the most over time.

In 2011, the Russian Federation improved its ranking in the *Trading Across Borders* indicator, coming in at 160th in 2011 (in 2010, Russia ranked 166th). This means that, although Russia's rating has slightly improved, Russian customs regulation continues to be unjustifiably restrictive both for exports and imports. Unfounded administrative pressure, non-transparent and cumbersome customs control, red tape and corruption are still making life difficult for external economic activity participants.

It takes at least 3 weeks for a cargo to be processed at the border in accordance with Russian legislative requirements (including the time spent whilst preparing all the necessary documents), while in the majority of countries this process takes three days at most. In Rus-

[1] http://www.doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport.pdf

sia, the time frame for customs processing of cargo at a border crossing point is legislatively set at 2 days, while in many countries this procedure usually takes only a few hours or even minutes. Thus, Russia's current approach to customs process organization is clearly counterproductive to the aims of innovation-driven development.

Doing Business 2012 emphasizes that international trade facilitation is becoming an ever more important factor of business development. The rules prescribing the submission of an excessive number of documents, burdensome customs procedures and red tape inevitably result in some additional costs and delays for exporters and importers alike, to the ultimate detriment of an economy's trade potential.

In 2011, in accordance with Article 3 of the RF Law 'On the Customs Tariff', the RF Government adopted 12 decrees establishing the rates of export customs duties on oil and petroleum products. The export customs duty on crude oil and petroleum products obtained from bituminous minerals exported from the territory of the Russian Federation beyond the borders of the member states of the agreements on the Customs Union was changed monthly on the basis of price monitoring for Urals crude from the 15th day of one calendar month to the 14th of the next month.

In response to the serious fuel shortages having erupted in a number of Russia's regions, RF Government Decree of 28 April 2011, No. 238 'On the Introduction of Alterations to Decree of the Government of the Russian Federation of 27 December 2010 No. 1155' adjusted the procedure for calculating the rates of export customs duties on commercial petrol. Previously, they were determined on the basis of the rate of the export customs duty on crude oil and the coefficient 0.67. The Decree of 28 April 2011 put an end to this practice. From 1 May 2011, the rate of the export customs duty on commercial petrol was increased from $ 283.9 per ton to $ 408.3 per ton.

Between 1 February 2011 and 1 October 2011, the rates of export customs duties on dark and light petroleum products were calculated in compliance with the methodology approved by RF Government Decree of 27 December 2010, No. 1155. In accordance with that document, export customs duties on dark petroleum products and light petroleum products were to be set at 46.7% and 67% respectively of the export customs duty on crude oil.

From 1 October 2011, Russia introduced a new procedure for calculating the rates of export duties on oil and petroleum products (*Table 55*) – the so-called '60-66' oil regime. The new regime envisages that the rate of the export customs duty on crude oil should be set at 60% of the difference between the average crude oil price revealed by monitoring and a crude oil price of $ 182.5 per ton, and not at 65%. At the same time, the rates of export customs duties on light and dark petroleum products should be equalized: in accordance with RF Government Decree of 27 December 2010, No. 1155 'On the Introduction of Alterations to Decree of the Government of the Russian Federation of 27 December 2010 No. 1155', during the period from 1 October through 31 December 2014, the rate of the export customs duty on any petroleum product except petrols should amount to 66% of the rate of export customs duty on crude oil. The new regime has introduced a prohibitive export duty on petrol in the amount of 90% of the export duty on crude oil. Thus, petrol exports become unprofitable, while fuel oil exports – less profitable. It is planned that, from 1 January onwards, the coefficient for dark petroleum products will be increased to 1.

RF Government Decree No. 840, of 17 October 2011, has introduced a new procedure for calculating the rate of the export customs duty on refined copper: the flat 10% export duty rate has been replaced by a progressive one. In accordance with the Decree, the rate of the export customs duty on refined copper should be determined on the basis of the average price of copper registered at the London Metal Exchange (LME) over a monitoring period. It should be calculated by different formulae depending on the average price. When the average price for a ton of copper is below $ 6,000, the rate should be zero. When the average price is $ 6,000 to 8,000, the rate should be calculated as follows: $ 800 + 30% of the difference between the current price and $ 8000.

Table 55

The Rates of Export Customs Duties on Crude Oil and Petroleum Products in 2011 (USD/ton)

	Crude Oil	Petroleum Products	
		light	dark
1 January	317.5	226.2	121.9
1 February	346.6	232.2	161.8
1 March	365.0	244.6	170.4
1 April	423.7	283.9	197.9
1 May	453.7	304.0	211.8
1 June	462.1	309.0	215.8
1 July	445.1	298.2	207.8
1 August	438.2	293.6	204.6
1 September	444.1	297.5	192.0
1 October	411.4	271.5	
1 November	393.0	259.3	
1 December	406.6	268.3	

Source: RF Government's decrees.

The monitoring of prices should be carried out by the RF Ministry of Economic Development. The length of the period of monitoring is equal to 1 quarter (3 months). No later than on the 20th day of the calendar month following the end of each period of monitoring, the RF Ministry of Economic Development should submit its proposals concerning the rate to the RF Government. The rate of the export customs duty on copper should come into effect from the fifth day of the third calendar month following the end of a monitoring period.

The progressive export customs rate on nickel set at $ 2,178 per ton has come into effect from 5 December 2011. The relevant decree of the RF Government (Decree No. 875) was signed on 1 November 2011. The previous export customs duty rate for nickel was set at 10% of the declared customs value.

The new method for calculating the export customs rate on nickel based on the quarterly monitoring of nickel prices on the London Metal Exchange (LME) came into effect on 28 May 2011. The cut-off price for determining the rate of export duty on nickel is $ 12,000 per ton. When this price is exceeded, calculation should be based on special formulae with coefficients ranging from 0.05 to 0.3. The length of the period of monitoring is equal to one calendar quarter (3 months).

The new export customs duties were to be introduced in mid-November of last year, but then their introduction was postponed until the fifth day of the third calendar month following the end of the accounting period.

Over the course of 2011, the Customs Union Commission adopted 25 decisions on the adjustment of import customs duties. Thus, the Commission reduced the rates of import duties on coking coal, heparin and its salts, some types of paper and cardboard, high resolution digital cinema projector systems, and ski-track-laying caterpillar tractors. Zero rates were temporarily introduced for import duties on some types of milled cereal products, some types of cereals (wheat and meslin, rye, barley, seed corn and oats), some types of vegetables (carrots, beets, onion), soy shrot, milled phosphates, some types of juice and mash concentrates for juice manufacturing, some kinds of apple puree, including compotes, and some kinds of concentrated apple juice.

There was an increase in the rates of Customs Union import duties on continuous-action elevators and conveyors, molded fabrics, drill machines for coal or rock mining to the depths of not less than 200 meters, and some types of agricultural machinery.

On having acceded to the World Trade Organization, the Russian Federation will not be able to efficiently protect its domestic market by merely increasing the rates of import duties, because Russia's import tariff is pegged to the level fixed in the process of the accession negations. The only efficient instrument for protecting the domestic market of a country acceded to the WTO is the special protective, anti-dumping and compensatory measures permitted thereby.

The list of the special protective and anti-dumping measures introduced in the customs territory of the Customs Union is posted on the official web site of the Customs Union Commission[1].

By the Commission's decisions, the following anti-dumping duties are established:

- until 13 May 2012 – in the amount of 21.8% of the customs value of Ukraine-made machine-building fasteners imported into the CU countries. These include bolts and nuts manufactured by the methods listed in the Commission's decision, with specified thread diameters;
- until 20 January 2013 – in the amount of 31.3% and 41.5% of the customs value of goods (specified depending on their manufacturers) on China-made ball bearings imported into the CU countries;
- until 16 June 2013 – in the amount of 19.4% of the customs value of China-made bearing tubes imported into the CU;
- until 24 September 2013 – in the amount of 11.6% of the customs value of Ukraine-made synthetic nylon threads with linear density of 29 to 250 tex imported into the CU;
- until 25 December 2013 on nickel-containing corrosion-resistant rolled steel (in sheets and coils) made in Brazil, China, Korea, and South Africa. The size of duty depends on a product's country of origin and may amount to 4.8–62.8% of its customs value;
- until 26 June 2014 – in the amount of 26% of the customs value of Ukraine-made forged steel rolls for rolling mills, imported into CU territory;
- until 18 November 2015 – on some types of Ukraine-made steel pipes imported into the CU. The size of duty depends on the pipe type and its manufacturer, and may amount to 18.9 – 37.8% of its customs value;

By the Commission's decisions, the following special duties are established:

- until 1 November 2012 – in the amount of 9.9% of the customs value (but no less than $ 1500 per ton) on corrosion-resistant steel pipes with outer diameter of up to 426 mm imported into the CU. That duty is not to be levied on corrosion-resistant steel pipes originating from developing countries, except Brazil and China;
- until 26 December 2012 – in the amounts of $ 1.4 per kg on corrosion-resistant steel cutlery imported into the CU, which are to be coded in accordance with the Commission's decision;

[1] http://www.tsouz.ru/db/spec_measures/Pages/Меры,действующиенаТТТС.aspx

- until 17 March 2014 – in the amounts of $ 282.4 per ton on some types of fasteners imported into the CU. This special duty is not to be levied on imported fasteners made in the developing countries applying the CU's Common System of Tariff Preferences. China is an exception;
- until 7 July 2014 – in the amounts of $ 294.1 per ton on caramel imported into the CU.

The Russian Federation's accession to the World Trade Organization

On 16 December 2011, the Ministerial Conference held by the World Trade Organization (WTO) in Geneva approved the package of documents concerning the accession of the Russian Federation. The Russian Federation will be obliged to ratify that package within the period prior to 15 June 2012. Thirty days after the WTO being notified of its ratification, the Russian Federation will become its fully-fledged member. As follows from the information posted to the WTO's official website[1], Russia has agreed to ensure a free trade regime and speed up its integration in the world economy, as well as to create transparent and predictable conditions for trade and foreign investments. The Russian Federation has undertaken the following commitments.

Access to Commodity Markets. Access Commitments Relating to Tariffs and Quotas

The ultimate legislatively consolidated rate of bound tariffs on all types of products will amount to 7.8% against the average weighted rate of 10% applied in 2011.

The average bound tariff rates on agricultural commodities will be set at 10.8% against the current average weighted tariff rate of 13.2%.

The average bound tariff on industrial commodities will be set at 7.3% against the current average weighted tariff of 9.5%.

Russia has agreed to lower her tariffs on a broad range of products. After this commitment is fully implemented, the tariff rates will be as follows:

- on dairy products – 14.9% (against the current tariff rate of 19.8%);
- on grain products – 10.0% (against the current tariff rate of 15.1%);
- on vegetable oils, fats and butter – 7.1% (against the current tariff rate of 9.0%);
- on chemical products – 5.2% (against the current tariff rate of 6.5%);
- on automobiles – 12.0% (against the current tariff rate of 15.5%);
- on electric equipment – 6.2% (against the current tariff rate of 8.4%);
- on timber and pulp-and-paper products – 8.0% (against the current tariff rate of 13.4%);
- on sugar – $ 223 per ton (against the current tariff rate of $ 243 per ton).

The bound tariff rates on cotton and information & communications products will be reduced to zero (the current tariff rate on information & communications products is 5.4%).

The finally established bound rates of customs tariffs will be applied, from the date of Russia's accession to the WTO, to more than one-third of the existing tariff items; the tariffs on another one-quarter of items will be reduced three years after the accession. The longest transition period (with maintaining the current tariff rates) is established for poultry and game meats – 8 years, followed by 7-year period for motor cars, helicopters and civil aircraft.

[1] http://www.wto.org/english/news_e/news11_e/acc_rus_10nov11_e.htm

Tariff quotas will be applied to beef, pork, poultry and game meats, and some whey milk products. Import duties on products within the limits of these quotas will be levied at lower rates than those levied on other imported goods.

The rates within the quotas are as follows (the corresponding rates outside the quotas are shown in brackets):

- beef – 15% (55%);
- pork – zero (65%). The tariff quotas on pork from 1 January 2020 will be replaced by a flat rate of 25%;
- on some poultry products – 25% (80%);
- on some whey milk products – 10% (15%).

Some of the aforesaid quotas are also subject to the norms established for certain members of the WTO.

Access to Services Markets

The Russian Federation assumed certain responsibilities with regard to 11 sectors and 116 subsectors in the services sphere.

Four years after Russia's accession to the WTO, the restriction on the participation of foreign capital in the sphere of telecommunications will be lifted (at present it is set at 49%). Besides, the Russian Federation agrees to implementing the terms and conditions stipulated in the WTO Basic Telecommunications Agreement. Nine years after the accession, foreign insurance companies will be allowed to establish their affiliations in this country.

Foreign banks will be allowed to open their affiliated structures. The restriction on foreign capital's participation in each individual banking entity will be lifted, but on the whole the share of foreign capital in the Russian Federation's banking system will be limited to 50%. (excluding foreign capital invested in potentially privatized banks).

In the sphere of transport services, the Russian Federation made certain commitments in regard of sea and road transport, including passenger and cargo carriage services.

In the distribution services sphere Russia, after her accession to the WTO, will allow companies with 100% foreign participation to operate in the wholesale, retail and franchising sectors.

Export duties

Export duties will be bound with regard to more than 700 tariff items, including some specific types of products in certain sectors, in particular fish and seafood products, fuel and lubricants, leather raw materials, timber and pulp-and-paper products, and base metals.

General Commitments Ensuring Access to Markets

Those quantitative restrictions with regard to commodity imports that cannot be justified under the existing WTO provisions, such as quotas, bans, import permissions, requirements that relevant permissions should be obtained prior to the start of supply, licensing requirements and/or other requirements or constraints imposed on commodity imports, are not to be renewed or are to be altogether abolished.

The fees for transit cargo shipments via railway transport from July 2013 onwards will be regulated by the WTO provisions. The Russian Federation will apply to product imports the same railway transport fees as those that are established with regard to domestic shipment of the same types of products. The regulated railway shipment tariffs are to be published prior to their actual introduction.

From the date of Russia's accession to the WTO, the importers of alcohol, pharmaceuticals and products manufactured with the use of cipher technologies will no longer be required to obtain import licenses with regard to these commodities.

After the accession to the WTO, the Russian Federation will apply the *Generalized System* of Preferences for the customs union of developing and underdeveloped countries which is currently applied by 152 states.

Within that system's framework, the import duties applied to those goods originating from developing countries that are subject to tariff preferences were at the level of 75% of the customs duties established for most favored nations, and 0% of the customs duties established for least developed countries.

In 2012, the Russian Federation will reform her national tariff regime for sugar imports, with its subsequent further liberalization.

By the date of Russia's accession to the WTO, any exemptions from the tariffs established for space products will be granted on the basis of most favored nation treatment.

No import licensing will be required for more than ten types of products based on cipher technologies (this list includes devices for developing electronic digital signatures, smart cards and wireless equipment). With regard to these types of products, all the currently existing restrictions on imports will be lifted, and no new constraints will be introduced, including expert's estimations, permissions and licenses. For those cipher-technology-based products that may be imported only on the basis of mandatory licenses, expert's estimations or permissions, these procedures will be applied on a one-time basis only.

Some products, including alcohol, timber products and meats, will become subject to measures that require customs declarations and/or entry through specially designated customs control points. As of the date of Russia's accession to the WTO, any measures that are contrary to the WTO Accession Agreement will have to be abolished. The Russian Federation will no longer apply the national customs procedures.

The Russian Federation is to apply all the relevant legislative, regulatory and other measures pertaining to the transit of commodities (including energy products) in accordance with GATT and WTO provisions. From the moment of her accession to the WTO, all the laws and regulatory norms applied to customs duties and other fees levied on transit of goods will have to be published.

The Russian Federation will revise the requirements in regard to access to markets that are applied to the affiliations of foreign banks and companies engaged in operations with securities, so as to make them acceptable in the context of the future negotiations on the Russian Federation's accession to the OECD or the next round of the WTO's multilateral trade negotiations.

When participating in preferential trade agreements, Russia will comply with the provisions stipulated in the WTO's Agreements, without making any distinctions between those agreements that will come into force after her accession to the WTO and those that will be adopted in the future.

Agreement on Government Procurement

The Russian Federation intends to join the WTO Agreement on Government Procurement, and so during her accession to the WTO will accordingly notify of that intention the WTO

Committee on Government Procurement. After the signing of that Agreement, Russia will acquire the status of observer, and within four years from the moment of accession to the WTO she will start negotiations concerning her joining that Agreement. After the accession to the WTO, the Russian government bodies will determine the winners in government procurement tenders in a transparent procedure.

Subsidies to Industrial and Agricultural Producers

Subsidizing of industrial producers

The Russian Federation will discontinue all the programs for subsidizing industrial producers or will modify those programs so as no subsidies be granted to exported goods or with the purpose of improving the competitive capacity of Russia-made goods as compared to imported goods. The Russian Federation will notify the WTO concerning the current subsidies and will not demand that any of the provisions stipulated in Articles 27 and 28 of the WTO Agreement on Subsidies and Countervailing Measures be applied in this connection.

Subsidizing of agricultural producers

The overall distorting effect on trade of the support granted to agricultural producers must not exceed $ 9bn in 2012; by 2018, its amount will have to be gradually reduced to the level of $ 4.4bn.

In order to avoid any excessive focusing of support on certain types of products, from the moment of this country's accession to the WTO and until 31 December 2017 the per annum volume of support provided to the producers of certain types of agricultural goods must not exceed 30% of the amount of support granted to other types of products.

All the export-related subsidies granted to agricultural producers will be bound at a zero level. After Russia's accession to the WTO, the exemption from VAT currently granted to some types of agricultural products will be abolished.

Pricing with Regard to Energy Carriers

The producers and distributors of natural gas in the Russian Federation will operate on the basis of normal commercial prices and the principles of payback and profitability. The Russian Federation will continue her practice of regulating the prices of energy carriers established for the population and non-profit consumers.

Sanitary and Phytosanitary Measures (SPM) and Technical Barriers to Trade (TBT)

All SPM and TBT in the Russian Federation and the Customs Union member states will be elaborated and implemented in accordance with the relevant WTO Agreements.

The Russian Federation will develop and implement international SPM srandards in the framework of her membership in *Codex Alimentarius* (the internationally recognized guidelines relating to food safety), the World Organization for Animal Health and the International Plant Protection Convention.

The reasons for suspension, recall or refusal of permission for importing products will be made compatible with the international standards and recommendations, as well as with the provisions stipulated in the WTO's SPM Agreement.

The Russian Federation will stage negotiations on veterinary export certificates that contain requirements which are different from the requirements established by the Customs Union in those cases when the relevant exporter country has submitted a substantiated request that such negotiations are to be conducted in the period until 1 January 2013.

The RF Federal Agency for Veterinary and Phytosanitary Supervision (*Rosselkhoznadzor*) will no longer suspend the supply of imported products by organizations on the basis of their on-site checks before providing the relevant exporter country with opportunities for suggesting adequate measures for correcting the situation, with the exception of cases fraught with some serious risks to human or animal health. *Rosselkhoznadzor* is to send a preliminary report to the exporter country's competent agencies in order to obtain the necessary explanations.

The Russian Federation will apply international standards to the development of technical regulation measures, provided that such measures do not turn out to be an inefficient or inadequate instrument for achieving the established goals.

Towards the end of the year 2015, the mandatory requirements to the telecommunication equipment applied in public telecommunication networks will be limited to the requirements stipulated in the technical regulation rules adopted under the agreements concluded by the Eurasian Economic Community and the Customs Union.

In accordance with the WTO's TBT Agreement, the Russian Federation will, on a continual basis, revise the lists of products to be subject to mandatory certification or declaration of conformity, as well as all the technical regulation measures applied in her territory (including the measures envisaged in the framework of the Customs Union and the Eurasian Economic Community, so as to confirm their necessity for achieving the Russian Federation's goals.

Within the period no later than 30 June 2012, the certified accreditation bodies will be replaced by a single national body in change of all accreditation issues. The body's name and other relevant information will be published on the websites of the RF Federal Agency for Technical Regulation and Metrology (*Rosstandart)* and the Customs Union's Commission.

Trade-Related Investment Measures

The Russian Federation will ensure compatibility of all the laws, regulatory norms and other relevant measures to be implemented under the WTO Trade-Related Investment Measures Agreement with the corresponding WTO provisions.

All the measures that are incompatible with WTO provisions, including preferential tariffs or exemptions from tariffs which are applied to investment programs (including investment programs implemented in the automobile industry) and any agreements concluded in their framework, must be abolished prior to 1 July 2018.

Trade-Related Aspects of Intellectual Property Rights Protection

The Russian Federation will implement in full the provisions stipulated in the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights, including the relevant law enforcement provisions, without any transition period.

The Russian government will continue to implement measures designed to prevent the functioning of those websites (whose servers are situated in the Russian Federation's territory) that unlawfully distribute content protected by authorship rights or intermediate rights.

The Russian Federation will initiate investigation and criminal proceedings against those companies that unlawfully distribute via the Internet objects protected by authorship rights or intermediate rights.

By the moment of her accession to the WTO, the Russian Federation will have been applying all the provisions established by the Berne Convention for the Protection of Literary and Artistic Work http://www.multitran.ru/c/m.exe?t=4330237_2_1.

Transparency

The provisions stipulated in the WTO Agreement will be applied uniformly across the entire territory of the Russian Federation, including the regions engaged in frontier trade, special economic zones and other territories where special regimes may be established with regard to tariffs, taxes and regulatory measures.

In accordance with the WTO's requirements, all legislation that can influence trade in commodities, services and intellectual property rights should be subject to immediate publication. The Russian Federation will be renewing, on a regular basis, the relevant official publications, including those posted to websites, and ensure access to these publications for WTO members, individuals and companies.

In order to improve the procedure of access to official publications, the Russian Federation will create an information service whose duty it will be to assist WTO members and all other related parties in gaining such access.

Thus, in particular, the Russian Federation will publish, prior to their enactment, the texts of all the legislative acts that can influence trade in commodities, services and intellectual property rights, and ensure that a reasonably lengthy period of time (no less than 30 days) be established for the WTO members to present their comments, excepting those acts that regulate issues pertaining to emergency situation, national security, monetary policy and other measures, the publication of which will encumber law enforcement procedures, be contrary to public interests or detrimental to the commercial interests of countries or private entrepreneurs. No legislative act that can influence trade in commodities, services and intellectual property rights may come into force prior to its publication.

The Russian Federation will send to WTO members her annual reports on the implementation of the current privatization program over the entire period of its implementation.

From the date of Russia's accession to the WTO, the lists of goods and services whose prices are subject to government control will be published in *Rossiiskaia gazeta* [The Russian Newspaper]. Russia will apply government control measures to pricing with regard of certain types of goods and services, including natural gas, rough diamonds, vodka, water supply services, natural gas transportation services, baby foods, medical products, public transport services and railway freight and passenger services. Price control measures are not to be applied in order to protect Russia-made products or services.

The Functioning of the Customs Union betweeny Russia, Kazakhstan and Belarus

The Customs Union between Belarus, Kazakhstan, and Russia came into existence as of January 1, 2010. From 1 July 2011, all customs borders between these three countries have been removed.

From 1 January 2012, the three states are to create a single economic space. The Russian Federation will publish all the legislative acts concerning the Customs Union prior to their adoption and ensure that a reasonably lengthy period of time be established for the WTO members and all the key related parties to prepare their comments and submit them to the Customs Union's empowered body.

Section 5. Social Sphere

5.1. Social standard of living

5.1.1. Incomes of the population

Growth rate of real per capita income of the population in 2001-2003 is by 2 or more times higher than the GDP growth rate in real terms, reaching the double rates (up to 14.6% in 2003), which was mainly due to the rapid growth of real wages and pensions.

In 2004-2007 the excess growth rate of real per capita income of the population over the of GDP growth rate was also typical, however, the gap in the values of indicators was reduced to 1.5-1.8 times. During that period, the growth rate of real volume of pensions lagged behind GDP growth, while real wages continued to grow rapidly.

The economic crisis of 2008-2009 has provoked a decrease in growth rate of real per capita income of the population. Nevertheless, the values of the indicator remained positive:

– in 2008 the growth rate was 3.8%,
– in 2009, it has dropped down to 0.9% (of GDP in that year declined by 7.8%).

Since the beginning of the post-crisis period, growth in real per capita income was almost equal to the increase in real GDP, having made 3.9% as compared to 2009 level.

Pensions in 2008 increased in real terms by 18% in 2009 - by 11%, and in 2010 - by 34.8% due to indexation, valorization, the introduction of additional payments to the social subsistence level. The high rate of growth of wages in this period was observed only in 2008. In 2009, real average monthly wages declined compared with 2008 by 3.5%. Since the beginning of real economic growth, average monthly wages began to grow, and the of its growth in 2010 made 5.2%.

In 2011, real per capita personal income exceeded the level of 2010 only by 0.8% with the GDP growth equal to 4.3%.

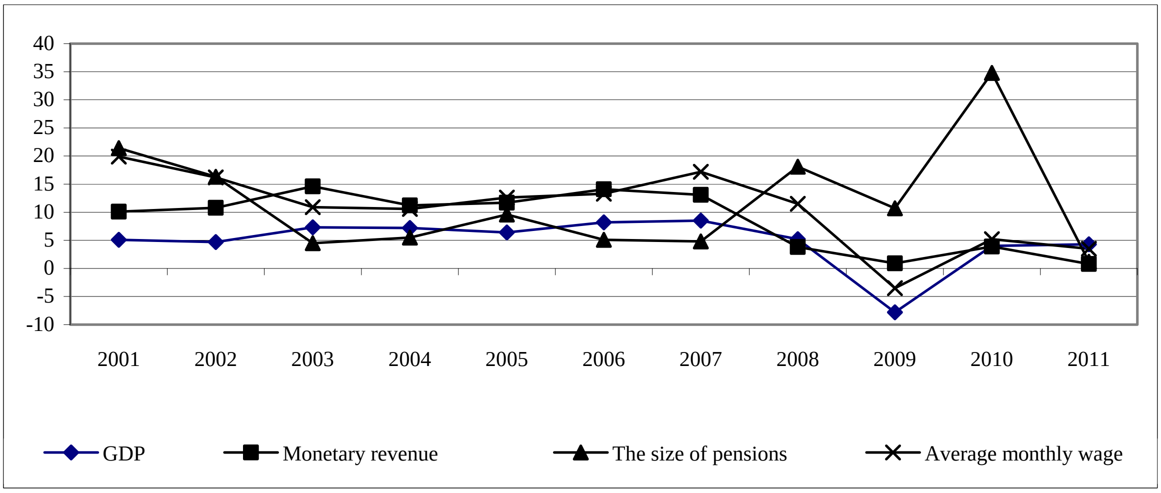


Fig. 1. GDP growth rate of per capita income, average monthly gross wages and the average size of pensions in 2001 to 2011

The growth rate of per capita income and average monthly wages for the period 2001-2011 were higher than the average rate of cost of living (except for 2005 and 2011). As a result, compared with 2001 in 2011 (in 2001 prices):

– real per capita personal income have grown by 2.4 times;
– the real average monthly wages increased by 2.6 times;
– the real size of pensions – by 2.8 times;
– the actual size of the subsistence level rose by the end of the first six months of 2011 was 1.5 times on average for the whole population and for the working population and children, and 1.6 times for retirees (*Table 1–3*).

Table 1

Average per capita real income and the subsistence minimum for an average of the total population in 2001-2011

	Per capita income, USD per month	A living wage for an average of the total population, Rb per month	Growth,% against previous year	
			Average per capita income	The average cost of living for all people
2001	3062	1500		
2002	3429	1571	12	5
2003	4616	1886	35	20
2004	5739	2127	24	13
2005	7315	2721	27	28
2006	9354	3139	28	15
2007	11262	3438	20	10
2008	13193	4054	17	18
2009	15633	4736	18	17
2010	17354	5228	11	10
2011 (9 months)	18633	6133	7	17

Source: estimated as per Rosstat data.

Table 2

Average real gross wage and the subsistence minimum of working population in 2001-2011

	Average monthly wages, Rb	A living wage for an average of the total population, Rb per month	Growth,% against previous year	
			Average monthly salary	Subsistence minimum of able-bodied population
2001	3240	1629		
2002	3788	1710	17	5
2003	4910	2057	30	20
2004	6034	2329	23	13
2005	7714	2935	28	26
2006	9756	3390	26	15
2007	12147	3717	25	10
2008	15260	4387	26	18
2009	17131	5121	12	17
2010	19384	5642	13	10
2011 (9 months)	21637	6487	12	15

Source: estimated as per Rosstat data.

Table 3

Average monthly pension and retiree cost of living, adjusted for consumer price index in 2001-2011

	Average size of pensions Rb per month	The subsistence minimum pensioner Rb per month	Growth,% against previous year	
			Average monthly pension	Subsistence minimum of a retiree
2001	1024	1144		
2002	1198	1198	17	5
2003	1462	1433	22	20
2004	1714	1612	17	13
2005	2132	2180	24	35
2006	2501	2506	17	15
2007	2784	2739	11	9
2008	3706	3216	33	17
2009	4771	3768	29	17
2010	6872	4155	44	10
2011 (6 months)	7809	4738	14	14

Source: estimated as per Rosstat data.

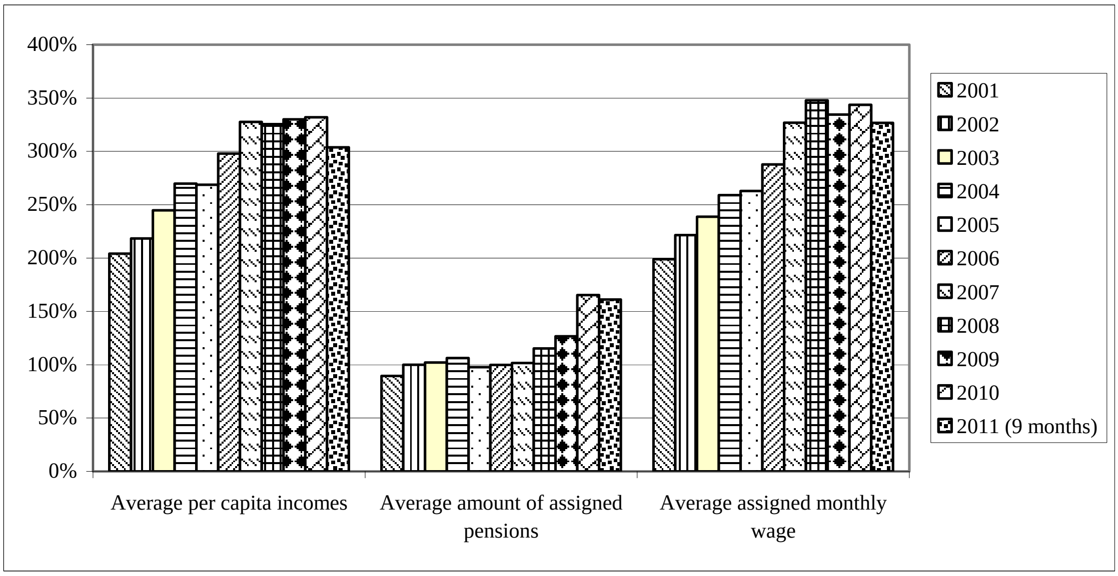
Higher growth rates of per capita income relative to cost of living have led to an increase in ratio of core indicators of incomes against the subsistence minimum:

– the ratio of per capita income to the average subsistence minimum of the total population has increased over the period under review by 1.6 times - from 204% in 2001 to 332% in 2010 (304% over 9 months of 2011)
– an increase in the average monthly wage to the subsistence minimum of working age population was 1.7 times. From 2001 to 2010 the value of this indicator has increased from 199% to 344% (334% for 9 months. In 2011)
– the ratio of monthly pensions to the subsistence level has increased over the years 2001-2011. 1.8-fold from 89% to 165%[1].

It should be noted that unlike the other major indicators of an increase in pension income was very irregular:

– in 2001, the average size of pensions amounted to 89% of the subsistence minimum for a pensioner,
– in 2002, the average size of pensions has reached 100% of the subsistence minimum for a pensioner,
– in 2003-2004 the growth of that indicator was noted from 102 to 106%, respectively,
– in 2005 the average pension again dropped below the subsistence level, however, the lag was only 2%,
– in 2006-2007 pensions again rose to the level of 100-102% of the subsistence minimum for pensioners,
– periodic increase in pensions in 2008 led to an increased ratio of pensions against the subsistence level to 115% in 2008, 127% in 2009, 165% in 2010 and 161% over 9 months of 2011.

[1] Estimates are based on data for January-November 2011. The data on the average amount of pensions in December 2011 and on average over 2011 have not published so far, but as in December 2011 there was no increase of pensions (the last indexation of pensions was carried out in April 2011), then with high probability we can assume that the average amount of pensions in 2011 will be almost the same as the value of this indicator for January-November 2011.



Source: estimated as per Rosstat data.

Fig. 2. The dynamics of population incomes against the subsistence minimum in 2001-2011

More dynamic growth of wages, as compared with an increase in the subsistence minimum in the period under review has changed the level of families welfare. For example, a family consisting of two adults and a child (under the assumption that the father is working and mother is looking after a child and if the father's salary is at average level in the Russian Federation), the wages provided: in 2001–68% of the family subsistence minimum, in 2002–2003–76–82%; in 2004–2005–90–91%; in 2006–100%; in 2007–113%; in 2008–121%; in 2009–2010–106–119%; over 9 months of 2011–113% of the family subsistence minimum.

5.1.2. Inequality and Poverty

In 2001-2010 inequality in the distribution of monetary income has grown:

– the share of the poorest quintile of the population accounted for:
  - in 2001–2003 – 5.5–5.7% of the total income of the population,
  - in 2004–2006 – 5.3–5.4%,
  - in 2007–2010 – 5.1%;
– the share of the richest fifth quintile of the population accounted for:
  - in 2001–2003 – 45.7–46.2% of the total income of the population,
  - in 2004–2006 – 46.7–47.3%,
  - in 2007–2010 – 47.8–47.9%;
– the share of the richest tenth decile accounted for:
  - in the early 2000s – 29.2% of the total income of the population,
  - in the middle of the period under review – 30.1–30.6% of the total income of the population,
  - in 2007–2010 – 31.0–31.1% of the total monetary income of population (See *Table 4*).

Markedly increased during the period under review:

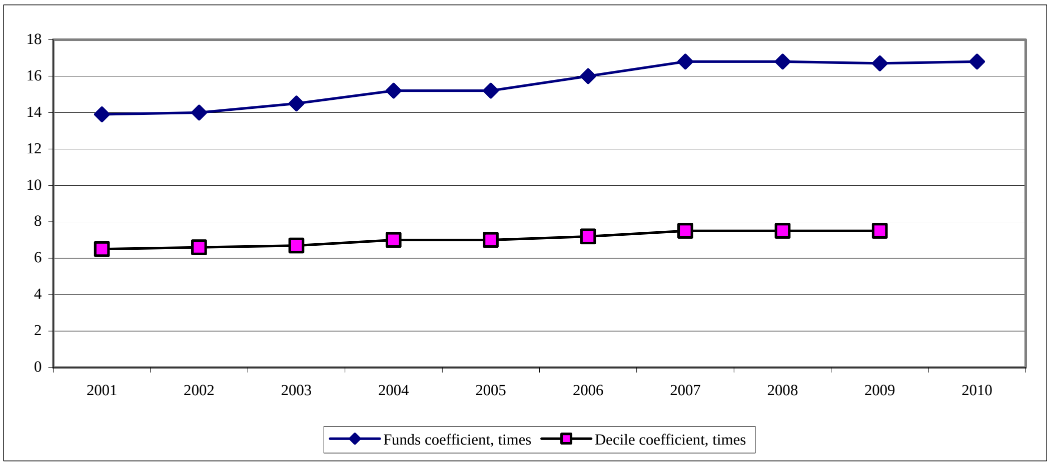
– Gini coefficient[1] - from 0.397 to 0.423,
– Funds coefficient[2] - from 13.9 times to 16.8 times,
– Decile coefficient - from 6.5 to 7.5 times (See *Table 4* and *Fig. 3*).

Table 4

Distribution of population by per capita income in 2001–2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Monetary income, total, %	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
including 20% of the population groups:										
first (lowest income)	5.7	5.7	5.5	5.4	5.4	5.3	5.1	5.1	5.1	5.1
second	10.4	10.4	10.3	10.1	10.1	9.9	9.7	9.8	9.8	9.7
third	15.4	15.4	15.3	15.1	15.1	14.9	14.8	14.8	14.8	14.8
fourth	22.8	22.7	22.7	22.7	22.7	22.6	22.5	22.5	22.5	22.5
fifth (highest income)	45.7	45.8	46.2	46.7	46.7	47.3	47.9	47.8	47.8	47.9
Among them 10% of the population with the highest income	29.2	29.3	29.7	30.1	30.1	30.6	31.1	31.1	31	31.1
Gini coefficient	0.397	0.397	0.403	0.409	0.409	0.416	0.423	0.422	0.422	0.423

Source: Rosstat data.



Source: Rosstat data.

Fig. 3. The dynamics of funds and decile coefficients in 2001-2010

During January-September 2011, as compared with their levels in the relevant period in 2010 a decrease in inequality was observed, which was reflected in a slight increase in the share of monetary income in total cash income of the first three quintiles of population with the lowest income (0.1–0.2 p.p. respectively) and the reduced share of the fifth quintile (with the highest income) from 47.2 to 46.8%.

Similar dynamics was observed among 10% of the population groups:

[1] Gini coefficient (an index of income concentration) characterizes the degree of deviation from the level of actual distribution of the total revenue from the level of equal distribution. The coefficient can range from 0 to 1, herewith, the higher is the value of the index, the more uneven is the distribution of income.

[2] Funds coefficient (coefficient of income inequality) demonstrates the degree of social stratification and is defined as the ratio between the average levels of cash income of 10% of the population (employees) against the highest income and 10% of population (employees) with the lowest income.

- the share of 10% of the population with the lowest income in the total monetary income of population has increased during the first 9 months of 2011 from 1.9% to 2.0% against the same period in 2010.
- however, the share of 10% of the richest population in total monetary incomes of population, which made in January-September of 2010 30.5%, decreased in the same period of 2011 to 30.2% (See *Table 5*).

The value of Gini coefficient (an index of income concentration) has also decreased from 0.414 to 0.41 and the funds coefficient from 15.8 times to 15.3 times.

Seasonal revenue growth in December 2011 (payment of the thirteenth salary, rewards and bonuses) will lead to an increase in the values of the socio-economic differentiation of the population. However, most likely the annual values of inequality in 2011 will be slightly lower than the values of that indicator for 2010.

Table 5

Distribution of population by per capita income over the nine months of 2010 and 2011

	2011 (9 months)	2010 (9 months)
Monetary income, total, %	100	100
including 20% of the population groups::		
first (lowest income)	5.4	5.3
second	10.1	9.9
third	15.1	15
fourth	22.6	22.6
fifth (highest income)	46.8	47.2
Among them 10% of the population with the highest income	30.2	30.5
Gini coefficient	0.41	0.414

Source: Rosstat data.

The number of people with incomes below the poverty level declined from 40m in 2001 to 25.2m in 2004–2005 and in the pre-crisis 2007 has reached the lowest value for the period of 2001-2007 (18.7m people) (See *Fig. 4*).

The crisis led to a very small - 0.2m people increase in the number of people with incomes below the poverty level in 2008. In 2009 - 2010. the number of the poor has declined to below pre-crisis level (18.5 and 18.1m people, respectively), which was largely due to the growth in incomes of the population, and especially pensions in the crisis period.

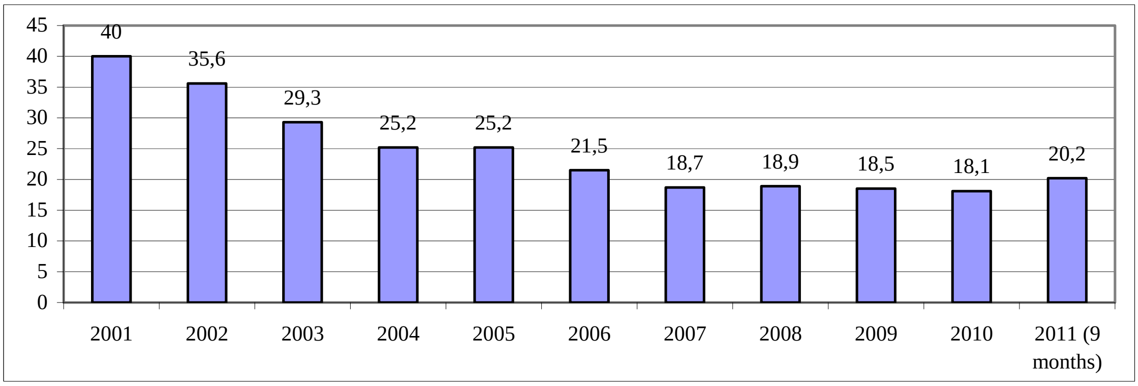
A similar dynamics was observed in the indicator "the share of population with incomes below the subsistence minimum as a percentage of the total population":

– in 2001 the share of people with incomes below the subsistence minimum was 27.5% of the total population;
– in 2004-2005 the poverty level has fell down to 17.6-17.7%;
– In 2007 the poverty rate has dropped to 13.3%.

In 2008 the poverty rate rose by 0.1 p.p. as compared with 2007 and then began to decline - to 13.2% and 12.8% respectively in 2009 and 2010.

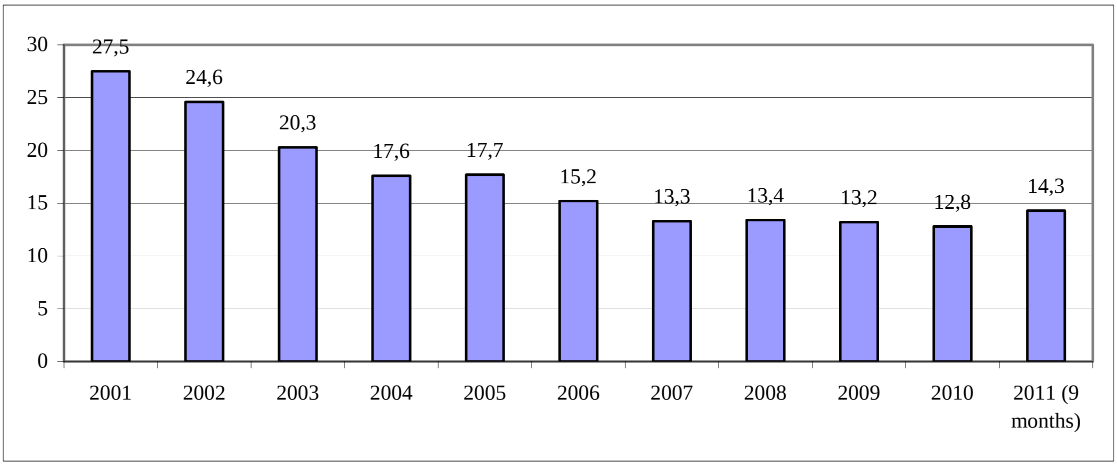
The slowdown in the growth of the population monetary income in 2011 was caused by the increased value of the "number of the poor" in Q1 and H1 of 2011, compared with the same periods in 2010, which was not fully offset by the reduced number of the poor in the Q3 2011. Thus, in Q1 2011 the number of the poor was 22.9m people. (in Q1 2010 - 20.6m people), in H1 2011 - 21.1m people. (in H1 2010 -19.1m people). The "poverty index" had the same trend: the poverty rate made 16.1% in Q1 and 14.9% in H1 2011, as compared with 14.5% and 13.5% over the same periods in 2010 in H3 the index fell down to 12.9%, while over the

9 months of 2011 – to 14.3% (in Q3 2010 the poverty rate made 13.1%, against 13.4% over 9 months of 2010).



Source: Rosstat data.

Fig. 4. The number of population with monetary income below the subsistence minimum in 2001-2011, m of people



Source: Rosstat data.

Fig. 5. The share of population with incomes below the subsistence minimum as a% of total population in 2001-2011,%

Trends in income progress in the Russian Federation were largely correlated with the dynamics of the indicators in OECD countries.

Virtually in all OECD countries over the period of the 2000s real per capita income has grown, but it should be noted that in countries with the highest rates of growth of that indicator is still significantly lagging behind against level in the Russian Federation:

- in most OECD countries the average per capita real income grew during the period from 2000 to 2008 by 1.1 - 1.25 times;
- in Australia and Poland - by 1.4-1.5 times (See *Table 6*);
- in the Russian Federation over the same period per capita income grew by 2.2 times.

Table 6

The dynamics of real per capita income of the population in OECD countries

	In national currency, 2000 rate			
	2000	**2005**	**2008**	**2008 vs. 2000 %**
Japan	3151263	2969538	2963009	94
Spain	17453	15995	16734	96
Germany	22222	22426	22080	99
Portugal	11256	11923	11521	102
Italy	17644	18200	18240	103
the Netherlands	23880	25146	24945	104
Belgium	22026	21781	23100	105
Denmark	196411	207408	211527	108
Luxembourg	36813	38926	40055	109
Israel	66930	67195	73350	110
France	21695	22850	24197	112
USA	35111	36473	39377	112
Switzerland	53223	53152	60058	113
Mexico	51019	53337	57963	114
Great Britain	16732	18243	19317	115
Ireland	24640	28426	28585	116
Canada	33822	36435	39492	117
Sweden	196356	206872	233820	119
New Zealand	33073	34432	40609	123
Hungary	1127847	1431086	1393410	124
Finland	20237	23012	25038	124
Austria	19817	23956	24530	124
Czechia	185154	198693	230367	124
Greece	12899	14642	16399	127
Norway	256510	284931	327423	128
Australia	32723	37113	47284	144
Poland	15907	17400	24114	152

Source: OECD data. http://stats.oecd.org/Index.aspx?DataSetCode=INEQUALITY.

The dynamics of socio-economic disparities in OECD countries in the period under review was volatile. In half of the countries over 2000-2008 Gini coefficient has declined. The maximum decline in the index value was observed in Greece, Belgium, Spain, Hungary and Mexico, where the value of the Gini coefficient was reduced by 6-11%. In nine countries. Reduction in the values of the Gini coefficient for the period was formed at the level of 1-4%. In a number of OECD countries over the period of 2000-2008 the differentiation of the population by income level has increased: in the Netherlands, Canada, France, Austria and Finland this indicator was formed at the level of 1-5%. In the US. Australia. Sweden. Israel, Switzerland. Czech Republic, Luxembourg - an increase made 6-10%. In Germany the growth of the Gini coefficient - 12% - was the highest in the OECD countries (See *Table 7*).

In the Russian Federation over the period of 2000-2008 Gini coefficient increased by 6%, which corresponds approximately to the change in the value of this indicator in countries with high differentiation, such as the USA and Australia.

Table 7

Gini coefficient in OECD countries

	2000	**2005**	**2008**	**2008 vs. 2000**
1	2	3	4	5
Australia	0.317	0.315	0.336	1.06
Austria	0.252	0.265	0.261	1.04
Belgium	0.289	0.271	0.259	0.90
Great Britain	0.351	0.331	0.345	0.98
Hungary	0.293	0.291	0.272	0.93
Germany	0.264	0.285	0.295	1.12

cont'd

1	2	3	4	5
Greece	0.345	0.321	0.307	0.89
Denmark	0.26	0.268	0.256	0.98
Israel	0.347	0.378	0.371	1.07
Ireland	0.304	0.314	0.293	0.96
Spain	0.342	0.319	0.317	0.93
Italy	0.343	0.352	0.337	0.98
Canada	0.318	0.317	0.324	1.02
Luxembourg	0.261	0.258	0.288	1.10
Mexico	0.507	0.474	0.476	0.94
Netherlands	0.292	0.284	0.294	1.01
New Zealand	0.339	0.335	0.33	0.97
Norway	0.261	0.276	0.25	0.96
Poland	0.316	0.349	0.305	0.97
Portugal	0.356	0.385	0.353	0.99
USA	0.357	0.38	0.378	1.06
Finland	0.247	0.254	0.259	1.05
France	0.287	0.288	0.293	1.02
Czechia	0.226	0.232	0.248	1.10
Switzerland	0.243	0.234	0.259	1.07
Sweden	0.279	0.276	0.303	1.09
Japan	0.337	0.321	0.329	0.98

Source: OECD data. http://stats.oecd.org/Index.aspx?DataSetCode=INEQUALITY.

5.2. Migration Processes

In 2011, just as it had been in the previous year, Russia's migration policy once again became the focus of the government's attention. This happened for a variety of reasons: the exit from the crisis and the 'special' measures undertaken on the labor market during that period; the pre-election year and the typical for such situations intensification of the 'migration discourse'; and finally, the census results that had turned out to be more positive than expected and the achievements in the demographic policy which, according to some officials, may serve as a proof that Russia does not need immigration.

In October 2010, the 11th All-Russian Census took place. Its final results were released one year later. In the most general terms, these results are as follows: Russia's population over the 8 years that had lapsed since the previous census (2002–2010) declined by 2.31 m (or 1.6%), thus amounting to 142.9 m. It should be reminded that, on the basis of current population statistics, the expected decline was to be greater by 980 thousand. However, the real situation is by no means as bright in all its aspects as it actually seems to be: the population decline as displayed by the last census – if we exclude the most 'problematic' RF subjects (from the point of view of quality of the 2010 'census campaign'), the city of Moscow and the North Caucasus republics constituting the North Caucasus Federal District,[1] – will nearly double

[1] The most obvious errors in counting the population occurred in the city of Moscow, in Dagestan, in the Republic of Karachaevo-Cherkessia, and probably also in those cities whose population 'hovers' around the 1 m mark. Besides, during the 2010 census it became nearly impossible to revise the errors of the 2002 census. In addition to the standard problems typical of any census, the reason for the inadequate counting of the population is the desire of regional and local authorities to increase the number of residents in the territories under their auspices in order to obtain some additional interbudgetary transfers. For more detailed information on that issue, see Mkrtchian N. V. *Migratsia kak komponent dinamiki naseleniia regionov Rossii: otsenka na osnove dannykh perepisi naseleniia 2010 goda*. [*Migration As a Component of the Population Movement in the Regions of Russia: An Estimation Based on the Data Provided by the 2010 Census*] // Vestnik RAN [The Herald of the RAS (Russian Academy of Sciences)]. *Geography* Series, 2011. No. 5. P. 28–41

(3.875 m, or 3.0%). The able-bodied cohorts shrunk by 959 thousand for Russia as a whole and by 1.950 m for Russia less the 'problematic regions'. Thus, the basic demographic characteristics of the Russian population are pointing to the existence of some problems (resulting from the demographic phenomena and events that happened much earlier) that are at present aggravating even further, threatening in the future with a historically unprecedented drop in the number of the able-bodied population [1]. These demographic parameters, in terms of tactics, make possible only two scenarios for further development: one, to learn to 'live by means' (that is, in a situation of a shrinking able-bodied population[2]); and the other, to compensate for the population depletion with an inflow of migrants.

Both these scenarios, in their turn, are fraught with some problems. The first one implies, first of all, the necessity to ensure a constant labor productivity growth (something that has never been successfully achieved before), and then to find solutions to the current issues of providing adequate financing to the Pension Fund and funding all the other social welfare expenditures. The second scenario – which is directly linked to the issues discussed here – will make it necessary to deal with the challenges and threats associated with mass immigration, as well as to take measures designed to increase the attractiveness of this country in the eyes of migrants in general, and in the eyes of migrants who possess certain (required) social and professional traits and qualifications in particular.

5.2.1. Permanent Migration

In terms of demographic indices, the year 2011 has brought in no news: this country is experiencing a natural population decline. The rate of that decline has dropped on the previous year, and it amounts, according to preliminary data, to 131 thousand. The migration-linked growth, as estimated on the basis of residence registration data (comparable with the data for 2010), amounted, according to 'operative' records, to slightly more than 100 thousand, and when estimated according to the newly introduced rules – to nearly 300 thousand. From 2011, the statistical records of long-term population migration (which is a component of 'replacement' of natural population decline) include those migrants who are registered at their place of residence, as well as those persons who are registered at the place of their stay for a period of 9 months or longer. In the preceding years, only migrants registered at their place of residence or those registered at the place of their stay records for periods of more than 12 months were entered in statistical records. The methodology-linked differences can probably be explained by the fact that migrants have the right to live without registration for a period of 90 days (or those 3 months that constitute the 'time lapse' to the one-year period), and as a result their stay will be extended to a full calendar year, which corresponds to the international recommendations for keeping records of long-term migrants. The alteration of the recording parameters could at least slightly increase the recorded migration-linked growth of Russia's population participating in compensation for natural population decline. On the

[1] Karachurina L. B. *Migratsionnye protsessy*. [Migration processes.] //*Rossiiskaia ekonomika v 2010 godu. Tendentsii i perspektivy*. [Russian Economy in 2010. Trends and Outlooks] (Issue 32). M.: IEP, 2011. Section 5.3. P. 343–361.

[2] In this connection it should be understood that the number of employees differs significantly from the number of the able-bodied population. Thus, for example, the number of people employed in Russia's economy in 2010 amounted to 69,804 thousand, or by 519 thousand more than 2009. At the same time, the number of able-bodied persons in 2010 (69,846 thousand) was by 124 thousand less than in 2009. /Source: *Trud i zaniatost' v Rossii, 2011*. [*Labor and Employment in Russia.*] 2011. *Rosstat,* 2011.

whole, migration-linked growth in Russia has become much greater than in 2009 (247.4 thousand), and even more so than in 2010 (158.1 thousand). It may be assumed that the current situation has resulted from the introduction of the aforesaid alterations in the procedure for keeping statistical records of migration. The annual volume of 300 thousand migrants evidently corresponds to the actual inflow of long-term migrants, which was previously significantly downplayed due to the exclusion of foreign students enrolled in Russian educational establishments and other categories of migrants. In this connection it is difficult to definitely state that the increasing rate of migration growth is associated with Russia's increasing migration attractiveness. In reality it is unlikely that it has significantly increased in the absence of any serious progress in reforming the migration processes, coupled with some very real economic and political problems. Migration-linked population growth in Russia (per 1,000 people, mean value for 2005–2009) is four times lower than in Norway, three times lower than in the Czech Republic and Sweden (*Fig. 6*), and twice as low as in the USA. Of course, some European countries make do with much lower, and in some years even negative, migration parameters. However, they are attempting to change the existing situation. For example, Latvia, which for many years has been experiencing an outflow of the native population, from 1 July 2010 introduced amendments to the Law 'On Immigration' whereby foreign citizens (Russians including) to legally obtain a permit for residence in Latvia, at the same enjoying the possibility to stay in the countries of the Shengen Area for an unlimited period of time. To achieve that status, a foreigner must acquire immovable property of a certain minimum value (no less than 100 thousand lats in Riga, the Riga region, or another big city, or from 50 thousand lats in other regions of Latvia[1]. By 1 October 2011 this right had been taken advantage of by approximately 1700 persons, who were in the main citizens of Russia or Kazakhstan. From March 2008, Poland introduced a *Pole's Card* as one of the components of a soft migration system[2].

In Russia, a similar idea was to certain degree reflected in the Government Program *Compatriots*[3]. However, it was never actually implemented due to numerous discrepancies in the corresponding law enforcement procedures, as well as its belated character and the excessive regulation that it implied[4]. Over the 5 years while it was in force, only 57.5 thousand persons were resettled in Russia (including 29.5 thousand persons in 2011 (with families)) instead of the 300 thousand that were planned just for the first three years of its implementation.

It should be reminded that the voluntary resettlement program was announced to be one of the two major directions of Russia's migration policy in the latter half of the 2000s (the second being liberalization of temporary labor migration). In accordance with the Program, depending on the socio-economic and demographic situation in a given recipient region (the regions were divided into three categories), the repatriates are to be granted a certain (differing

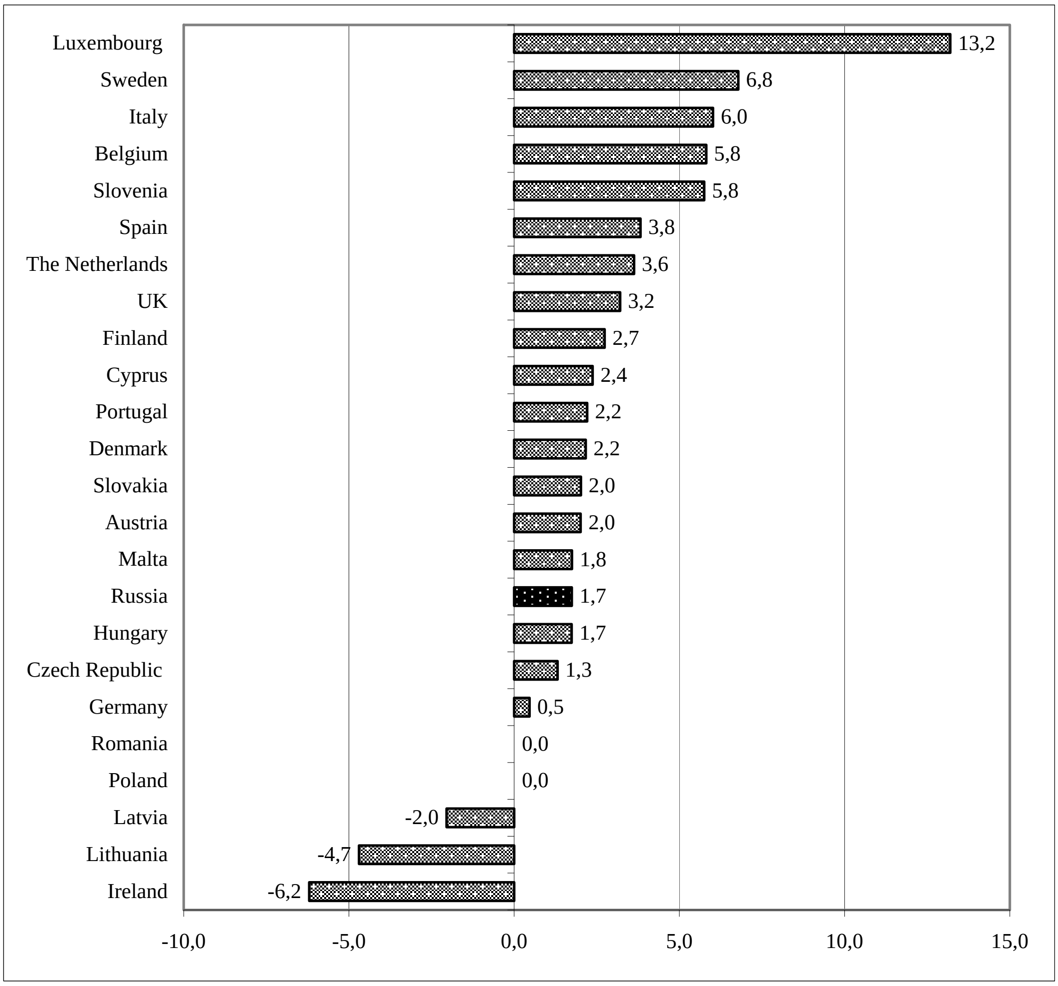
[1] http://www.latvio.ru/index.php?option=com_content&view=article&id=105:nedvizhimost-v-latvii-i-vid-na-zhitelstvo&catid=4:info&Itemid=98

[2] http://svoi.pl/web/index.php?option=com_content&view=article&id=78:polishcard&catid=3:legal&Itemid=55

[3] Edict of the RF President '*On Measures Designed to Assist in Voluntary Resettlement in the RF to Compatriots Residing Abroad*' of 22 June 2006, No. 637 (published as of 28 June 2006); '*The Government Program for Providing Assistance in Voluntary Resettlement in the RF to Compatriots Residing Abroad*'; and the "*Plan of Measures Designed to Implement 'The Government Program for Providing Assistance in Voluntary Resettlement in the RF to Compatriots Residing Abroad*' (approved by Edict of the RF President of 22 June 2006, No. 637).

[4] For more details concerning the issues involved in the implementation of the *Compatriots* program, see Karachurina L. B. *Migratsionnye protsessy*. [Migration processes.] //*Rossiiskaia ekonomika v 2009 godu. Tendentsii i perspektivy*. [Russian Economy in 2009. Trends and Outlooks] (Issue 31). M.: IEP, 2010. P. 376–392.

between regions) set of privileges (for example, the relocation allowance and the monthly allowance to compensate for the absence of income for the first six months), the compensation for their transportation costs connected with resettlement, the State duty for the preparation of the necessary documents, the compensation package for a participant in the Program (the services of pre-school, school and vocational training, social services, health care and the employment service) and the acquisition of Russian citizenship. The principal targets and 'donors' of the Program are the CIS countries, although the relevant documents are not limited only to those territories.



Source: Russia and the Member Countries of the European Union, 2011. *Rosstat*, 2011.

Fig. 6. Migration Growth Coefficients in Russia and Some Other European Countries (per 1,000 people), 2009

As the procedure for obtaining RF citizenship under a simplified regime was made much more complicated from October 2011, this circumstance may actually revive the Program[1]

[1] Previously, the procedure for obtaining RF citizenship was relatively liberal (within the framework of bilateral agreements or a simplified procedure for obtaining RF), and so little interest was observed with regard to obtain-

which will then serve as a means for a quick acquisition of Russian citizenship. In accordance with the RF President's Edict,[1] the citizens of Kyrgyzstan, Kazakhstan and Belarus – who until recently, under bilateral agreements, could get Russian citizenship in a simplified procedure within a very short period of time (three months) – from now on will have to apply for Russian citizenship in the same way as all other foreigners. The citizens of Belarus – via a residence permit (that is, they will have to wait for at least one additional year), those of Kazakhstan and Kyrgyzstan – after they obtain a temporary residence permit (which means a further delay for yet another year), then a residence permit, and only after that, if they are able to provide proper substantiation,[2] they may apply for citizenship. On the whole, this can still be regarded as a comparatively preferential procedure for granting RF citizenship, although a more lengthy and laborious than the one existing in the previous year. The reasons for toughening Russia's migration legislation are not easily understandable, and this refers to all its aspects – humanitarian, economic, political. It is a well-known fact that in a majority of cases those developed countries that experience demographic problems deliberately simplify the naturalization procedures for those applicants who have close relatives in the recipient country. As a rule, the 'family channel' is regarded as the most desirable source of immigration, and so it is encouraged.

It should be reminded that at an earlier point in time – in July 2010 – the simplified procedure of obtaining RF citizenship was abolished with regard to the citizens of those republics of the former USSR that had not signed any relevant bilateral agreements with Russia.

The toughening of the naturalization procedures was reflected by the sharp decline, in 2010–2011, of the number of immigrants who were granted Russian citizenship (*Fig. 7*). The expected result will be accumulation in this country's territory of people with unspecified status. In 2011, approximately 133 thousand persons lived in Russia on the basis of a residence permit; another 380 thousand persons had temporary residence permits (TRP). Thus, no more than 513 thousand people were actually able to confirm their legal migration status in Russia[3]. In 2010 that number declined still further – to approximately 390 thousand. In this connection, on the basis of surveys, it can be said that a considerable portion of temporary migrants (up to 25%[4]) do want to remain in Russia (for good, or for a long period of time), but they do not know how this goal can be achieved in a legal way.

The unregulated legal status of a considerable group of migrants is probably the most important reason why the quality of migration statistics is unsatisfactory. The perpetual attempts to somehow improve the statistical records of migration have so far failed to turn official data into a more or less reliable source of information on the basis of which that process could be

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ing Russian citizenship through participating in the Government Program *Compatriots*. Now the only way to obtain that status without waiting for a few years is that available to the participants in the Program.

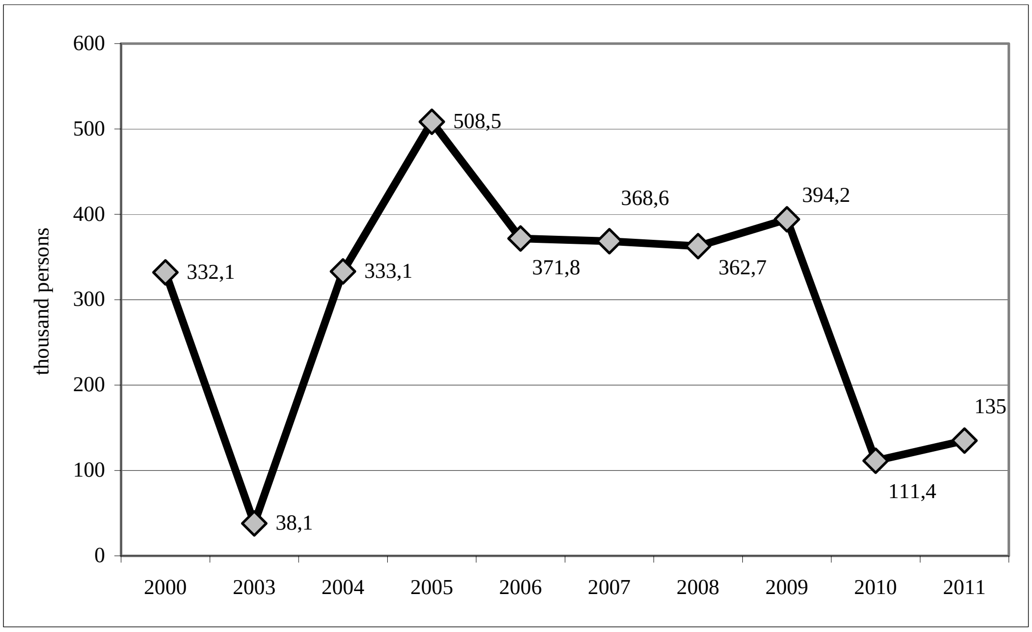
[1] Edict of the RF President of 19 October 2011, No. 1391, 'On Introducing Alterations in the Provision on the Procedure for Considering the Issues of the Citizenship of the Russian Federation', approved by Edict of the President of the Russian Federation of 14 November 2002, No. 1325'.

[2] The substantiation rules for applying for RF citizenship in a simplified procedure have not been altered: one must have a spouse or parent(s) who are RF citizens, or be born in the territory of the former RSFSR (Russian Soviet Federative Socialist Republic). If these facts cannot be substantiated, the general procedure is applied.

[3] Denisenko M. B. *Iz vystupleniia na zasedanii gruppy N 7 "Strategii – 2020"*. [From the Speech Deliveded at the Meeting of Group No. 7 of the 'Strategy 2020'.] *Migratsia: tendentsii i modernizatsiia politiki*. [Migration: Trends and Policy Modernization.] 5 March 2011. Data provided by the Federal Migration Service.

[4] Zaionchkovskaia Zh. A., Tiuriukanova Ye. V., Florinskaia Yu. F. *Trudivaia migratsiia v Rossiiu: kak dvigat'sia dal'she*. [Labor Migration into Russia: How to Move On.] M.: MAKS Press, 2011. P.25–26.

described, or its scale accurately determined. It must be properly understood that, as before, the migration indices in abstract terms may reveal only some basic trends.



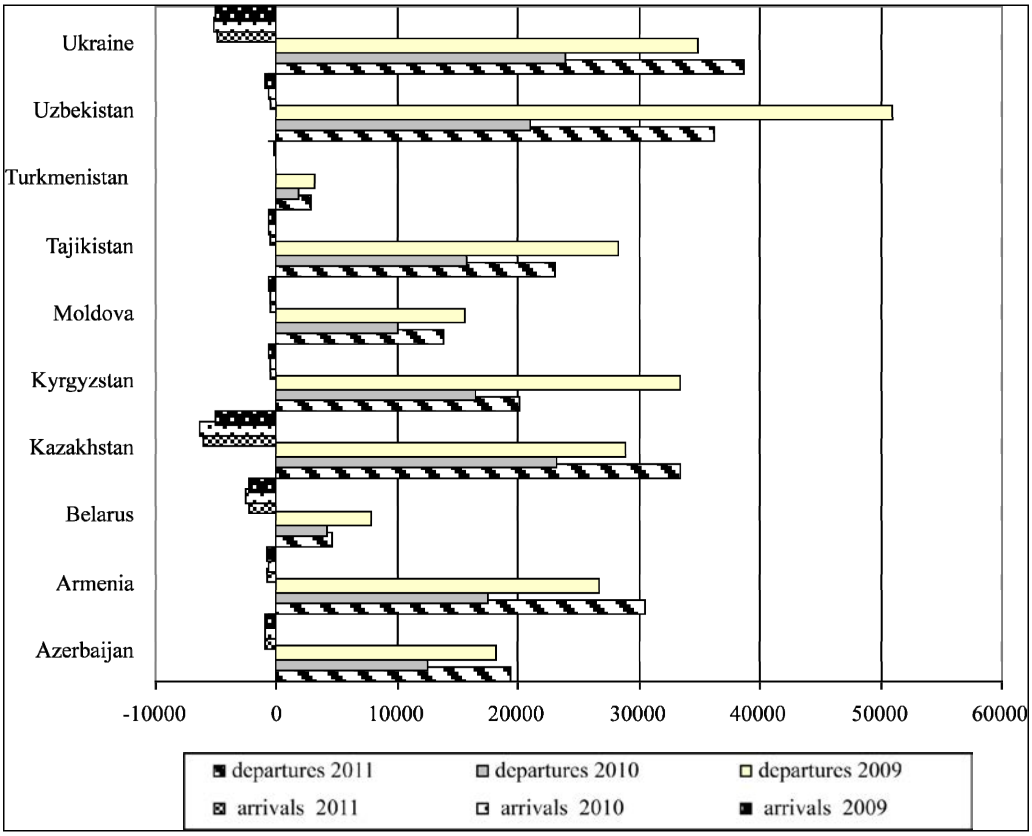
Source: Russia and the Member Countries of the European Union, 2011. *Rosstat*, 2011; Data for the year 2011 – Federal Migration Service of Russia.

Fig. 7. RF Citizenship Granted, 2000–2011, Thousand Persons

The phenomenon of Russia's migration growth continues to be dominated by migration flows from the former USSR republics. Thus, in the total number of arriving migrants, those from the CIS countries constitute no less than 90% (or 3–5% more than that in the cases of Georgia and the Baltic states), and their share in the total number of departing migrants is 58–63%. At the same time, as before, the migration inflow into Russia from the CIS countries is really incomparable in terms of its volume with the outflow, as the former is nearly ten times greater than the latter. If in 2011 the number of arrivals in Russia significantly rose in response to the altered record-keeping procedure and/or the crisis (as mentioned earlier), the number of departures stays at the same level (29 thousand persons over 10 months). However, it is even more difficult to estimate the real scale of departures from Russia than that of arrivals, because often it happens so that migrants, while actually living abroad for many years, maintain their residence registration in Russia and thus remain 'invisible' for statistical records and are considered to be permanent residents of Russia with full rights thereof (it is specifically this scheme that is currently applied most frequently both as a potential 'safety cushion' and a source of financial income from renting out the vacant dwellings). As estimated on the basis of data provided by sources in the principal countries that receive immigrants from Russia, over the period of 2002–2009 the outflow from this country by 2.7 times exceeded that recorded in the Russian Federal State Statistics Service's official data, thus amounting to more than 500 thousand persons[1].

[1] Denisenko M. B. *Esli smotret' s drugogo berega*. [If One Is to Look from Another Shore.] / *Migratsiia XXI vek* [Migration 20th century] No. 1 (4) 2011, P. 36–39.

Another trend that has emerged over the past few years is the constantly increasing Central Asian components not only in temporary labor migration, but also in permanent migration (*Fig. 8*). While in 2009–2010 the share of the four Central Asian republics constituted one-third of all arrivals, in 2011 it has already become more than 40%. Among the causes we should point both to the fact that Russia has become less attractive as a place of residence for the people from the 'western' republics of the former USSR who are reorienting towards the EU countries, and to the increasing mobility of the Central Asian peoples associated with the economically unfavorable situations and the 'demographic pressure' on the labor markets in their home countries. Evidently, the economic crisis had little impact on the evaluation, by migrants, of the ratio of opportunities in their home republics and Russia.



Source: Rosstat data.

Fig. 8. The Numbers of Arrivals to and Departures from Russia, January–October 2009–2011, persons

The new (post-Soviet) generations of migrants from Central Asia and Transcaucasia are characterized by a lower education level, poorer knowledge of the Russian language and lower level of professional qualification as compared to their predecessors. The results of various surveys of labor migrants demonstrate that approximately 15–20% of the contemporary migrants employed in Russia practically do not speak Russian at all[1]. Similar trends are also typical of the long-term migration flows.

[1] Zaionchkovskaia Zh. A., Tiuriukanova Ye. V., Florinskaia Yu. F. *Trudivaia migratsiia v Rossiiu: kak dvigat'sia dal'she*. [Labor Migration into Russia: How to Move On.] M.: MAKS Press, 2011. P. 8.

At the same time, migration is increasingly replenishing Russia's population with able-bodied individuals: the share of the able-bodied age groups among the migrants from the CIS countries is sometimes as high as 80%, and among migrants from other countries – as high as 75% (while the share of these groups in Russia's native population is 62.3%)[1]. This type of population structure demonstrates that even permanent (long-term) migration into Russia is largely labor-linked.

The year 2011 saw nearly a doubled number of arrivals and an intensified trend of net positive migration component growth in the migration exchange with Belarus. And, although the share of Belarus in the total number of officially registered arrivals in Russia is, as before, one of the lowest (2.8%), the financial crisis in that republic has certainly had some impact on its rate of out-migration.

There has occurred a considerable rise in the number of arrivals from Kyrgyzstan, which more than doubled by comparison with the same period of 2010 and had increased by nearly 1.7 times since 2009. A similar growth trend is displayed by Uzbekistan.

5.2.2. Temporary Labor Migration

The scale of labor migration has been on the rise throughout the entire pre-crisis decade. 2009 was, in fact, the first year that saw a slight decline in the number of legal foreign workers in Russia. In 2010, the volume of migration was already one-third below that in 2008, and the parameters of foreign workforce attraction became lower than in 2007 – that is, prior to the liberalization of migration legislation in the RF.

The shrinking presence of migrants on the labor market in the crisis years was a consequence of the decline, in objective terms, of the demand for labor, of the dramatic cuts in the quotas for legal labor recruitment and thus the ousting of foreign workers into the illegal labor market segment. The latter phenomenon was also contributed to by the financial problems experienced by employers and their economic interest in hiring workers without proper formalization. The liberal migration procedure was thus effectively abolished and replaced by the previously existing one. Now its components were as follows: low quotas explained by the need to protect the national labor market in order to make it advantageous for the local workforce; and linkage of migrant workers to their employers (a work permit could now be issued to an applicant allowing him or her to work only under a specified employer, after the said applicant's having submitted to the issuing authority a relevant labor contract concluded with that particular employer).

Quotas represent one of the most disputable regulation instruments applied in the framework of the existing procedure for attracting foreign workers. Similarly to some other spheres (for example, health care), quotas when applied to migration represent a mechanism that is formed in a non-transparent manner, is often sequestered on the basis of a strictly administrative but not economic logic, and most importantly – is prone to corruption. The RF Ministry of Health and Social Development – the author of that administrative mechanism – is actively campaigning for its preservation. In this connection, opinion polls conducted by Opora Russia have revealed that 70% of small businesses consider the procedure for formal recruitment of a foreign worker 'too laborious', while 40% of entrepreneurs do not know their actual need for

[1] Data for the year 2010. *Source: Chislennost' i migratsiia naseleniia Rossiiskoi Federatsii v 2010 godu*. [The Size of the Population of the Russian Federation in 2010 and Its Migration in the Course of that Year]. Rosstat, 2011.

workers for the next calendar year 8 months prior to its beginning (the timeline established by the currently existing labor quota mechanism[1]. The barriers thus established in the way of small businesses clearly go contrary to the government's declared plans to increase the share of small-sized businesses in the structure of GDP from 20% to 60%.

In 2011, the quotas for the issuance of work permits (1,745,584, including 523,675 as a reserve[2]) introduced in November 2010 were upwardly adjusted seven times (in March, May, July, August, September, October, and December), simultaneously with the quotas for the issuance to foreign citizens of invitations for entry into the Russian Federation (for those who needed a visa). Every time that procedure had to be substantiated, and the regions and federal center alike were required to prepare relevant document packages, coordinate many details and undergo numerous bureaucratic procedures, thus increasing the corruption component. Just as in the preceding years (beginning from 2008), migrants from visa-waiver countries may legally enter the territory of this country, but by no means may always legally be employed. This circumstance has urged some of the migrants to acquire the necessary documents; work permits thus traded are priced by the Moscow company specializing in that field from Rb 12,000 per work permit (without the official State duty in the amount of Rb 2,000).

In addition to the two aforesaid types of quantitative quotas, in 2011 the procedure envisaging the distribution of regional quotas for foreign workers by their profession, specialty and qualification, as well as the list of professions not to be included in quotas, was still in force.

The situation appears to be absurd. At the government level, orders are issued by the RF Ministry of Health and Social Development: 'On Introducing Alterations in the Annex to Order 'On Approving the List of Professions (or Specialties, or Posts) of Foreign Citizens – Qualified Specialists Recruited to Work According to Their Professions (or Specialties) to Which Quotas Are Not to Be Applied, for the Year 2011' (of 25 May 2011, No. 427n). Essentially, these Orders are about augmenting the already existing list of professions by items like 'circus actor', audio engineer', 'ringmaster'[3]. In the initial wording (Annex to Order of the RF Ministry of Health and Social Development of 24 January 2011, No. 22n), this list consisted of 32 items. These included 'general director', 'director', board chairperson (22 items), and 'engineer' of various specializations (10 items).

The regional quotas, sorted by profession, specialty and qualification of foreign workers, and determined in the Annex to a relevant Order of the RF Ministry of Health and Social Development [4], are in effect multiple-page lists of professions (in accordance with the All-Russian Classification of Occupations (OKZ)) with regard to which foreign workers are to be attracted to a given region. The number of such workers is estimated literally down to every single available vacancy. Thus, for example, in 2011 Belgorod Oblast requests two work permits for filling the jobs of 'sellers, merchandize demonstrators, art models and fashion models', and Kursk Oblast will be satisfied with only one work permit for 'general workers

[1] Nikolaeva D. *Vremennaiia migratsiia sebia ne opravdyvaet.* [Temporary Migration has not Lived Up to Expectations //*Kommersant*. 9 March 2011.

[2] Decree of the RF Government of 12 November 2010, No. 895 'On Determining the Need for Attracting into the Russian Federation Foreign Workers and Approving the Relevant Quotas for the Year 2011'.

[3] Official website of the RF Ministry of Health and Social Development http://www.minzdravsoc.ru/docs/mzsr/migration/23.

[4] Annex 2 to Order of the RF Ministry of Health and Social Development of 8 December 2010, No. 1080n, 'On the Distribution, Among Subjects of the Russian Federation, of the Quota for the Issuance of Work Permits to Foreign Citizens Approved by the RF Government for the Year 2011'.

for performing unskilled labor tasks similar in all sectors of the economy'. It is quite evident that, in a changing economic situation, the actual needs for the next calendar year with regard to workforce cannot be precisely specified in April of a current year (however, this is the timeline established for economic subjects to submit their requests for foreign workforce), and so this requirement is *a priori* unrealistic. If that list were to be actually implemented, Russian retail trade (especially in bigger cities) would have ceased to exist long ago. In Moscow, the number of requests actually filed under the 'seller' item for the year 2011 is 440, which is roughly 1.5 times less than the average staff number of one store in the *Auchan* chain[1]. This means that the smooth functioning of big retail outlets in Moscow almost entirely depends on applying various 'unofficial' personnel recruitment schemes.

The rigid linking of a foreign worker to his or her employer, which was abolished in 2007 for migrants from the visa-waiver countries of the CIS and then reintroduced in 2009 as an anti-crisis measure, effectively places migrant labor outside of the sphere of competition. Employers cannot freely select workers on the market because they are restricted by the quotas and are obliged to undergo the legalization procedure when recruiting each new worker. Migrant workers cannot change their employers without applying for a new work permit. Thus, there emerges a situation when informal relations are more competitive and economically efficient that formal ones[2].

The statistical data collected by the RF Federal Migration Service (RF FMS) concerning the attraction of temporary foreign workers in 2011 reveal a slight growth on the previous year. The number of work permits issued in 2011 is 1,219.8 thousand, which is higher than in 2010 by no more than 4%. Within that group, a slight increase occurred with regard to 'visa-waivers'. However, from that year onwards, within the framework of the newly created Customs Union, the citizens of Kazakhstan enjoy the same right to work in Russia without applying for work permits as has previously been granted to the citizens of Belarus. This was to give rise to a growing number of legally employed 'visa-waiver' workers, although Kazakhstan's share in labor migration into Russia had always been very modest (no more than 1%). However, 'net' growth of the number of work permits is negligible, and thus it is indicative of a continuation of the 'restrictive' course initiated in 2009–2010. Such policy is also fed by the numerous populist anti-migration and anti-migrants remarks which are made in anticipation of the forthcoming presidential election by various politicians willing to pander to the hostile feelings shared by part of society.

The predominance of the Central Asian component is even more visible in the labor migration flows than in 'permanent' migration. Its share amounts to approximately 55% of the official flow. At the same time, migration from Ukraine has been on the decline: from 30% per annum in 2000 to the present 10%. The specific features of migrants' countries of origin clearly reflect on the composition of Russia's migrant workforce: the share of the 18 to 29-year-olds is constantly increasing (38.6% in 2010). From the point of view of labor efficiency this is, no doubt, the most favorable factor, given the fact that the low-skilled jobs that are largely offered to the newcomers (the enclaves of the so-called 3D labor: dirty, dangerous, demeaning) require that they should be very strong and physically fit. At the same time, the prevalence of these

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[1] *Magaziny 'Ashan' v Moskve priostanovili torgovliu alkogolem*. [The *Auchan* Stores in Moscow Suspended Trade in Alcohol Products]. RIA Novosti, 20 May 2009. http://ria.ru/moscow/20090520/171736039.html

[2] *Naselenie Rossii 2009. Semnadtsatyi ezhegodnyi demograficheskii doklad*. [The Population of Russia 2009. The 17th Annual Demography Report. Ed. A.G. Vishnevsky. M.: ID VShE [Higher School of Economics' Publishing House], 2011. P. 273.

age groups implies automatically that knowledge of the Russian language will decline, because the school years of even the oldest representatives of these groups coincided with the collapse of the USSR. Of course, a similar decline can be observed – again by comparison with that of the 1990s – in the level of their professional qualification, because in the first years of independence the network of vocational schools created in the Soviet period went in disarray not only in Russia, but also throughout the territories of the former USSR republics.

The results of surveys indicate that labor migration is increasingly absorbing those people who have previously could not afford to migrate. There is a shift towards the poorer side of the social spectrum: 84% of migrants prior to migration describe themselves as poor (38%) and very poor (46%)[1].

The universally noted growth of the share of women in the worlde labor migration flows is difficult to precisely estimate in Russia. According to official data, their share changed little over the 2000s, and is fluctuating around 11–14%. However, when adjusted for the factor of the lower importance of official documentation for women (due to the specificity of their employment mostly in the services sector and in households they are far less visible for the law enforcement agencies), their share may actually become very significantly higher. The ILO's experts estimate the percentage of women among labor migrants in Russia as being on the average at the level of 25–30%[2].

All these structural parameters of external labor flows, as well as the high share of migrants on the Russian labor market – and consequently their general presence in Russian life – have for a long time[3] been posing for Russia some new tasks involving the country's social system's adaptation to that situation. The absurdity of it, however, is that while previously it was believed that labor migrants were mainly young males who had little need in basic social services (health care and education), while there actually existed legal opportunities for getting such services, now, in spite of the increasing female component in the migration flow and the need for relevant services, the innovations introduced in the Tax Code in 2010 have actually left no options for migrants to receive them (except emergency medical care). Another task is to find some way to bring the professional characteristics of migrants in conformity with the needs of the labor market through a system of short-term retraining courses at Russian vocational and technical schools and colleges. The attempts to achieve this goal by means of 'organized recruitment' of migrants with the required professional qualifications in their home countries have so far been very limited. In 2011 only 200 persons were recruited in that manner, a year earlier – significantly more (2108), but these numbers are low by comparison with the actual volume of migration flows.

The key zones where foreign labor is employed have remained relatively stable: construction, trade, the processing industries, services and agriculture absorb more than 85% of all employed migrants. The slight fluctuations in the employment levels in some sectors are probably associated with the periodically increasing and shrinking opportunities for migrant

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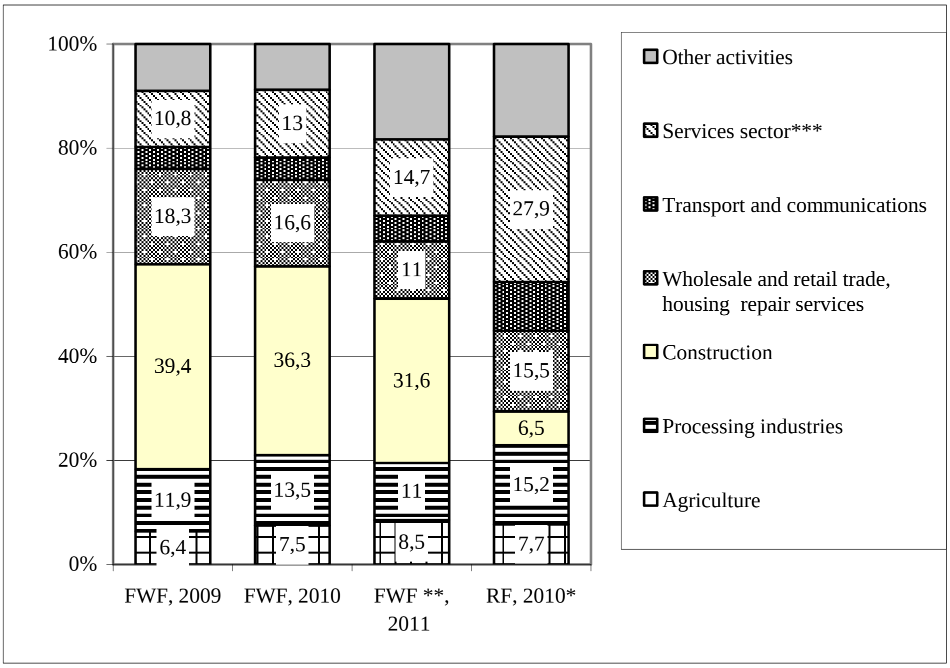
[1] *Naselenie Rossii 2009. Semnadtsatyi ezhegodnyi demograficheskii doklad*. [The Population of Russia 2009. The 17th Annual Demography Report. Ed. A.G. Vishnevsky. M.: ID VShE [Higher School of Economics' Publishing House], 2011. P. 266.

[2] *Otsenka nuzhd i potrebnostei zhenshchin – trudovykh migrantov. Tsentral'naiia Azia i Rossia*. [An Estimations of the Needs and Requirements of Women – Labor Migrants. Central Asia и Russia.]. UNIFEM - MOT. 2009. P. 23.

[3] Even according to the FMS' official data, in 2010 among the legal workers 78% were employed by legal entities, and 73.2% by individuals, and they stayed in Russia for a period between 6 and 12 months.

labor legalization. When the opportunities are more limited, as it happens to be at present, then the official indices demonstrate a downward employment trend in the construction sector where the possibilities for hiring illegal workers are traditionally greater than, say, in the processing industries (*Fig. 9*). The crisis has also had a certain impact on the by-sector distribution of foreign workers.

While for the Russian economy as a whole the share of legally employed foreign workforce in 2010 was only 2.4%, for some sectors and regions foreign workers have long ago become nearly indispensable. For example, in the construction sector the share of foreign workforce (FWF) is 11.8%. Given the presence of the illegal component in labor migration, that parameter in reality may at least double.



* Number of employed in the RF economy, less FWF (foreign workforce).
** Based on notifications submitted by employers concerning the attraction and use of foreigners in labor activity, arriving in the RF in a visa-waiver procedure.
*** Operations with immovable property, education, health care and social services, other types of social and personal services, and utilities.
Source: Trud i zaniatost' v Rossii 2011. [Labor and Employment in Russia 2011]. *Rosstat*, 2011. Federal Migration Service of Russia.

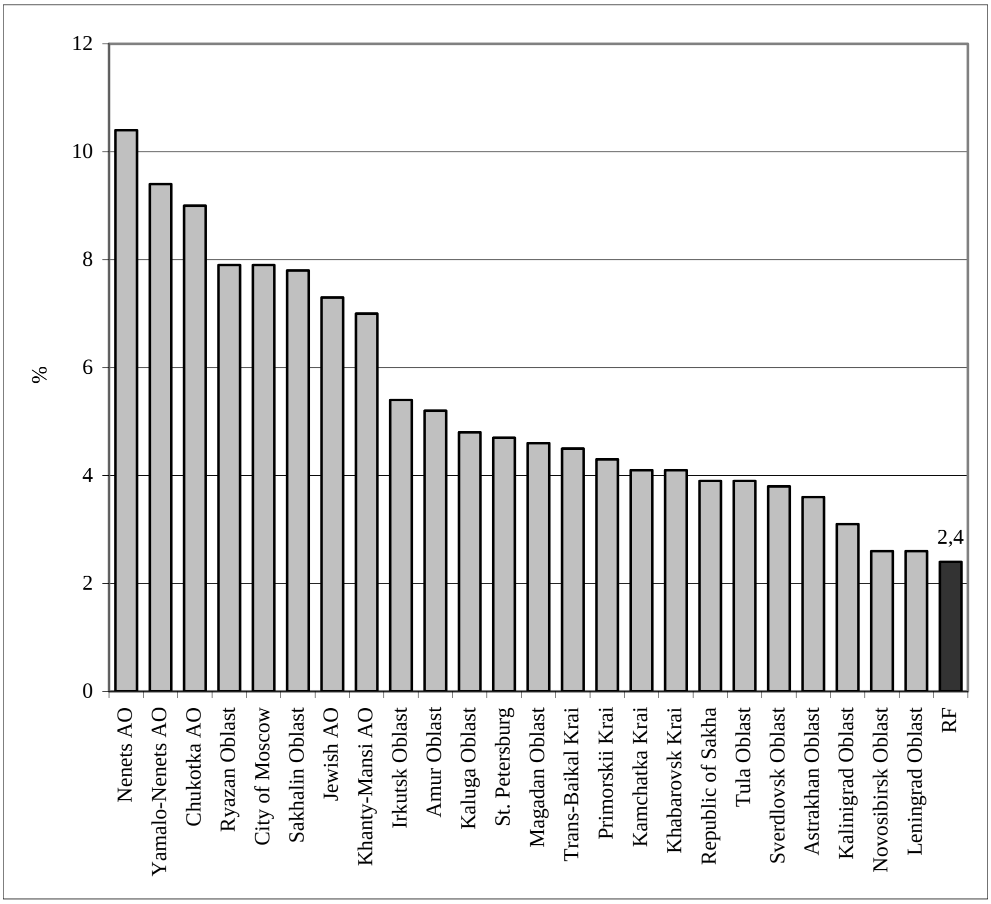
Fig. 9. The By-Sector Structure of Population Employment and Foreign Workforce in Russia, in Moscow, 2009–2011, as %

Surveys of employers[1] demonstrate that in Moscow and other big cities across Russia foreign worker have taken up a significant part of the labor market. According to official statistics, in 10 Russian regions the share of foreign workforce in the total number of employed in the economy is above 5% (2010), in another 13 regions – is somewhere between 3% and 5%.

[1] The results of an all-Russian survey of enterprises and organizations conducted in April and May 2010 by the All-Russian Public Opinion Research Center (VTsIOM) (ordered by the autonomous non-profit organization *OPORA-Druzhba* (1,500 organizations in 47 regions of Russia).

In real terms this means that migrants have become a numerically important factor on the labor markets of a quarter of all Russian regions. It can be assumed that, when adjusted for the illegal component, the presence of foreign labor there is approximately the same as in some European countries – 8% or 9% (Italy, Germany).

Among the leaders in relative terms (the share of FWF in total employment levels) are Russia's West Siberian and North European regions rich in oil and natural gas deposits; the regions of the Far East that suffer from the out-migration of their own population; the rapidly developing Kaluga Oblast, Sverdlovsk Oblast, Kaliningrad Oblast, Moscow, and St. Petersburg (*Fig. 10*).



Note. All the 24 regions presented here are those where the share of FWF in the total number of employed in a region's economy is above the mean Russian level.
Source: Trud i zaniatost' v Rossii 2011. [Labor and Employment in Russia 2011]. Rosstat, 2011.

Fig. 10. Share of Foreign Workforce in the Total Number of Employed in Regional Economies across Russia, 2010, as %

The situation in Moscow is illustrative. The projects involving the city's territorial expansion into the surrounding regions and the substantial growth of its population (over the period between the two crises (2003–2010) it increased by 1.2 m) take place against the backdrop of the highest possible employment level (nearly all its economically active population is employed) coupled with a very low unemployment rate (1.7% in 2010). Other than migration, there exist no sources for filling that large and versatile labor market. At the same time, judging by the declarations of the former and current city mayors, foreign workforce – with the exception of highly qualified labor – are clearly unwelcome. The city's quotas for FWF decrease year on year. According to official data, in 2010 Moscow hosted 345.1 thousand foreign workers, thus coming eighth among 83 RF subjects by the share of foreigners in the total number of employed (5.8%). The structure of migrant employment in Moscow is also remarkable: more than 5% of migrants in that city are engaged in agriculture, forestry, hunting and mineral resources extraction – which sounds incredibly fantastic for a country's capital, and only 20.4% work in construction.

Besides Moscow, another champion in producing issues relating to the ratio between the legal and illegal components of foreign workforce is Krasnodar Krai, where large-scale construction projects are being implemented in preparation to the 2014 Olympic Games. As shown by statistical data, only 1.9% of all employed there are foreign worker. At the same time, 63% are employed in construction – and the information collected by experts indicates that it is the construction sector where the Krai Commission on Quotas most often grants to employers the requested number of foreign workers.

In the majority of the crisis-ridden old industrial regions of the European center of Russia, Northwest, the Volga region, and the backward and labor-redundant republics of North Caucasus the share of migrants in the total number of employed is under 1%.

Thus, the distribution of labor migrants is an illustrative example of a territorial mobility driven by the 'correct' economic self-regulation mechanisms of regional labor markets. These would have been even more visible if the authorities had not been so much inclined to impose restrictions through establishing federal quotas, which are then translated into regional quotas.

The relatively new external labor policy instruments applied in the sphere of migration are the issuance of patents to migrants employed by physical persons and the attraction of highly qualified specialists (HQS).

With regard to the former innovation it can be said that last year the number of actually issued patents surged, thus amounting to 810 thousand against 130 thousand in 2011. However, the specificity of the statistical records kept by the RF Federal Migration Service is such that it is impossible to know the true per annum number of foreign citizens working in Russia under that regime, because one migrant worker can be issued several patents over the course of one year.

The number of work permits issued in 2011 to HQS is 10,220. Out of that number, 92% of HQS arrived from the countries whose citizens are required to have visa to enter Russia. It is difficult to analyze the trends in the issuance of this category of work permits. Firstly, that mechanism in 2010 was in force only beginning from the second half-year; secondly, it was adjusted many times since its introduction. At present, highly qualified specialists are allowed to register with the migration service within a period of up to 90 days. However, this can be done only at the place of their residence, and not at the employer organization's juridical address. It is difficult to attract HQS not only because of the frequent introduction of alterations in the existing procedures, but also because there exists only one (for the entire country) federal migration service department where the relevant documents can be properly formalized (Moscow, the Center for Citizens' Applications on Passport and Visa Issues of the Federal Migration Service of Russia). In spite of the many declarations of Russia's top officials that this country is interested in attracting highly qualified foreign workforce for developing hi-tech products, as well as for the implementation of the *Skolkovo* project, so far this migration channel has been effectively inactive.

5.2.3. Domestic Migration

The domestic migration across Russia is increasingly becoming labor-oriented. This labor migration is taking the forms of shift-work, pendulum, seasonal and other types of migration. Recently, *Rosstat* has, for the first time, included in its population employment surveys a question concerning interregional labor migration across Russia, and in 2011 these data were published[1]. Their analysis has led to a number of conclusions with the regard to certain facts whose existence could previously only be assumed:

– the majority of regions are still insufficiently involved in the interregional exchange of labor. This circumstance makes it difficult to maneuver on labor markets whenever it becomes necessary – say, during a crisis. Besides, it serves as a natural obstacle to modernization of the economy and society as a whole. The volume of domestic interregional labor movements has amounted to approximately 1.7 m, which corresponds to 2.4% of the total number of employed in the Russian economy;

– the entire European part of Russia is influenced, to a varying degree, by the Moscow labor market. Some years ago, Russia's most eminent migration expert, Zh. A. Zaionchkovskaia, aptly called Moscow 'a vacuum cleaner that literally sucks in the surrounding population'[2]. In 2010, the number of people coming to Moscow in search of employment was 902 thousand, which amounts to 54% of all the officially requested labor movements across Russia. If the data for Moscow Oblast are added, the resulting figure will be 65%. Even the rapidly developing regions of Central Russia, which are attractive in terms of investments but are geographically relatively close to Moscow, cannot stop the outflow of their population to the capital. As far as the depressed areas of Central Russia are concerned, out-migration in search of temporary employment has long become a usual and widespread practice. Thus, for example, in Briansk Oblast, Smolensk Oblast or Ivanovo Oblast labor outflow is 60–100 times higher than the movement in the other direction;

– the balance of domestic labor migration in the 'Russian North' is positive, although it is low in absolute terms. In contrast to the overwhelming majority of Russian regions, more people arrive in Komi Republic, Archangelsk Oblast, Khabarovsk Krai, and Magadan Oblast, than leave those areas;

– in 8 Russian regions the number of domestic migrants is by more than 2% higher than the total number of employed. These are: the City of Moscow (15%), Yamalo-Nenets Autonomous Oblast (11,5%), Khanty-Mansi Autonomous Oblast (8,4%), Moscow Oblast (5,2%), St. Petersburg (4,5%), Nenets Autonomous Oblast (3,3%), the Republic of Sakha (2,5%), and Krasnodar Krai (2,2%). This list demonstrates that the zones that attract foreign and domestic labor migrants overlap. There actually exist few economically attractive regions in Russia, and so they draw migrants irrespective of their origin. In its turn, the labor market in these regions manifests its own needs for additional workforce from outside, while the actual unemployment levels there are very low.

Judging by the published data, domestic labor migration flows in 2005–2008 were demonstrating an intense growth amounting to about 20 to 30% per annum. The crisis produced a decline in 2009, followed by a new surge in 2010.

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[1] *Trud i zaniatost' v Rossii 2011*. [*Labor and Employment in Russia 2011*]. *Rosstat,* 2011.

[2] *V Moskvu ili iz Moskvy: gde luchshe zhit' v Rossii*. [To Moscow Or from Moscow: Where It Is Better to Live in Russia // *Echo of Moscow*. An interview with Zh. A. Zaionchkovskaia by M. Koroleva. 8 November 2008.

A very similar trend occurred in the sphere of 'permanent' domestic migration. All the inaccuracies of statistical records notwithstanding, the crisis manifested itself in a drop in the number of resettlements within Russia in 2009 (to its historic low) and its subsequent rise. In 2011, the number of resettlements, for the first time over a long period, surged above the 2 m mark. Moreover, it can be expected that by the end of 2011 this index will become as high as almost 3 m. This figure was last recorded in 1995. However, the statistical data in this sphere are not quite comparable. It should be reminded that statistical records include both those who register at the place of their residence (as it has actually been happening since 1995) and those who register at the place of their stay, and from the year 2011 they register for a period over 9 months. Thus, the surge in resettlements within Russia in 2011 has also been contributed to by the factor of statistical record-keeping. There were actually few objective causes for a sharp rise in the level of domestic migration - rural flight that had been the core of migration flows in the 1970s and 1980s is now far less significant. As for resettlements in the northern and eastern regions of Russia in search of higher earnings, that phenomenon has effectively disappeared. Long-term growth of domestic mobility may be induced by the recently observed rise in the number of those who seek higher education and the resulting upsurge of student migration. The ideology behind the implementation of the Unified State Exam (EGE) in Russia was in part aimed at providing young talents from 'the periphery' with access to this country's best higher educational establishments. This is what also happening now, to a certain extent.

At the same time, another instrument – resettlement of unemployed persons to other regions – did not gain popularity. After the 'official declaration' of the crisis in Russia, that measure was put forth as part of the struggle against unemployment. However, although the amount of money allotted for its implementation was small, it remained unspent. Unemployed people were very reluctant to move to other towns or regions. The surveys among the unemployed and job seekers, conducted in 2008 – 2009 by the Institute of Demography for the RF Federal Service for Labor and Employment (*Rostrud*), revealed their very low potential mobility level: only 4% of all respondents displayed any intention to move to another region[1]. So it seems unrealistic to attempt to revive that measure as a trigger of domestic migration with material incentives like lumpsum benefits and the reimbursement of one-way transportation cost, which are proposed in the draft law 'On the Support of Unemployed Citizens in Their Relocation and Resettlement in Another Area for Finding Employment'[2]. The draft law is now undergoing a second reading at the State Duma.

5.2.4. Legislative Innovations

The main initiatives that emerged over the past year were the discussion of the Migration Policy Concept and further elaboration of the law enforcement procedures for implementing some recently adopted legal provisions.

The revival of discussions concerning the existing migration legislation occurred in the framework of adjusting *Strategy 2020*. The preparation of the next wording of the Migration

[1] Denisenko M. B., Karachurina L. B., Mkrtchian N. V. *Gotovy li rossiiskie bezrabotnye ekhat' za rabotoi?* [*Are the Russian Unemployed Ready To Relocate for Work?*] // Demoskop Weekly. 2010. No. 445-446. http://demoscope.ru/weekly/2010/0445/index.php

[2] Kozlov V. *Pravitel'stvo obeshchaet oplatit' dorogu i vydat' 'pod"emnye' vnutrennim migrantam*. [The Government Promises to Cover Transportation Costs and Allot 'Relocation Money' to Internal Migrants] //Moskovskie novosti [The Moscow News]. 16 November 2011.

Policy Concept was under way for a whole year. However, the term 'the next wording' is correct only to a certain extent. In fact, the elaboration of the Concept's draft had been started back in 1998, when the Federal Migration Service was still a civilian establishment. That initial draft was then widely discussed, and some research and public organizations took an active part in composing it. The core idea of that first Concept had been repatriation migration (from the CIS countries into Russia). In the autumn of 2001, after the FMS was transferred under the auspices of the Ministry of Internal Affairs, the approaches to the Concept were changed: the core idea was now the struggle against illegal migration and regulation of temporary labor migration. On the basis of that logic the document was entitled 'The Concept of Regulating Migration Processes', and in that wording it was adopted in March 2003. However, instead of being approved by the President's Edict, it was approved by a Regulation of the RF Government, which somewhat diminished its status. Thus, notwithstanding the increasingly prominent role of migration processes in contemporary Russia's socio-economic life and the abundance of laws, by-laws and amendments to those laws that were adopted in that sphere in the 2000s, this country still has no proper concept of migration policy. The last migration reform in Russia (2006–2007) was oriented in the main towards regulation of temporary labor migration, and had little to do with migration for the purpose of permanent residence in this country. And even the actually implemented migration policy regulated by the relatively well-elaborated part of that legislation (temporary labor migration) gave rise to misunderstandings and criticism, the main target for which was the mechanism of quotas discussed earlier.

The currently discussed version of the Concept is based on the assumption that in a situation when it can be expected that the world's developed countries are going to compete for 'one of the main resources of economic development' (as migration was characterized by I. I. Shuvalov)[1], we need some efficient mechanisms and programs capable of ensuring a permanent and not only temporary migration. The goal of such measures will be not only to sustain the existing population of the country, but also to improve the quality of its human potential. It is speculated that temporary residence permits should be abolished; an applicant for a residence permit (and then the RF citizenship) will be able to obtain it by applying the so-called points based system which takes into account language fluency, education, professional skills and other individual features. The issue of abolishing the quotas for the issuance of work permits is being hotly debated, but no consensus has been reached so far.

It should be noted that the discussion of the Migration Policy Concept during the second half-year 2011 was influenced by the forthcoming presidential election and the typical prevalence of populist tendencies over actual economic needs[2].

The current alterations introduced in existing legislation address the category of highly qualified specialists, as said earlier.

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[1] From Igor Shuvalov's speech at a meeting of the RF Government Commission on Migration Policy. See L. Grafova, *Migratsionnyi razvorot* [A U-turn in Migration Affairs] // *Rossiiskaia Gazeta* [The Russian Gazette]. 3 March 2011.

[2] Similar 'high and low tides' in migration policies caused by the proximity of a presidential election were observed even in such a country of traditional immigration as the USA – for more details in this respect, see A. V. Korobkov, *SShA – strana immigrantov* [The USA is a country of immigrants] // Demoscope Weekly. 2008. No. 351-352. http://demoscope.ru/weekly/2008/0351/index.php

And finally, one more innovation introduced in legislation in 2011 is concerned with lowering the rate of personal income tax from 30% to 13% for the participants in the Government Program *Compatriots* and their families who have permanently resettled in Russia[1].

A large number of issues, and first of all the necessity to promote the adaptation and integration of migrants and their families into local communities, have remained outside of the focus of existing Russian legislation on migration.

5.3. Results of 2011 in the Educational System

5.3.1. Main Drivers of the Educational System's Advancement in 2011

The main drivers behind the advancement and functioning of Russia's educational system were as follows:

- like in recent years, the major factor was the demographic one;
- not yet implemented factor became the transition to three types of institutions: public, budget and autonomous ones. That said, the factor is expected to play a notable part in the sector's development in years to come;
- a sizeable fraction of the population continued to conceive of USE as a negative factor fuelling degradation of the complete secondary education and the tertiary one;
- transition to the level-based system of the tertiary education thus far has fallen short of manifesting itself and has not stepped into the limelight; it is most likely to be 2013-2014 when it would start playing a notable role, with Bachelors *en masse* entering the market. The Masters' coming to the market passed unnoticed, as their specific weight in the overall number of university graduates still was insignificant, albeit posted some increase: from 1.4% in 2009 up to 1.75% in 2011;
- the budget funding of the educational system continued to increase both in nominal and real terms (after a two year-long contraction in real expenditures on education). Thee factor generated a specific effect, that is, universities being increasingly focused on budget-sponsored students, rather than on those who pay for themselves, and the competition for the latter category intensified;
- yet another milestone development in the educational system became a proposal, in the frame of renewal of the Strategy-2020, on reforming the system of vocational education and school. Debates on these issues on numerous expert platforms stirred a fairly considerable public interest, which, however, is gradually dying, as no ideas emerged in this respect;
- the discussion of the bill "On education in Russian Federation" is under way, but as the document has been drafted for several consecutive years already, with no serious progress, the at-large public's reaction to new modifications therein was extremely amorphous;
- a federal act was adopted which engaged non-state universities in the process of assignment of the state order and, consequently, of budget allocations. The state universities opposed the Act adamantly, for given the demographic decline, it can affect their financialstanding. That said, it was clear to everyone that access to the budget pie would be granted to no more than 40 out of 452 state universities at best. The number of budget-sponsored students

[1] Corresponding amendments were introduced in the RF Tax Code and the RF Federal Law 'On the Legal Status of Foreign Citizens in the Russian Federation'.

at private universities should not exceed 4,500, ie. some 0.8% of the aggregate budget-sponsored admission.

5.3.2. Demographic Factor and Its Impact

As noted above, *the demographic factor* currently is atop of the list of factors affecting the educational system's advancement and functioning. In the pre-school sector, the number of children was on the rise, which entailed an increase in the unsatisfied demand for kindergartens, with more than 10,000 children on the waiting list in Moscow alone. The authorities have so far fallen short of solving the problem. What's worse, the problem of organization of the pre-school, primarily for children from the needy households, has not been solved as yet. It was assumed that pre-school institutions would ensure an equal starting point for first-graders, as they appear to have different social and cultural background, thus discriminating the first-graders with a poor one against those who have come from the families in possession of the said resources. It is the pre-school which was set to give much-needed initial knowledge and skills to children from low-income families, thus the shortage of kindergartens has the strongest adverse effect on this social group.

As far as school is concerned, the number of students in the primary school was on the upsurge, while the figures for the secondary one continued to plummet. Some deceleration of the pace of decrease of school-age cohorts along with the continuous fall in the number of teachers resulted in some rise in the pupils-per-teacher ratio from 10.1 in 2010 to 10.3 in 2011.

The cohorts in the primary and secondary vocational education continued to decline in 2011, and the pace of the process was accelerating, which can be explained by two causes: first, it is fueled by the demographic situation, as the number of the 15-17-aged and 15-19-aged cohorts, which are the main source of ‘supply” of students to the institutions in question, is plunging. The other cause is the recently noted stabilization of the proportion of teenagers who opt for the said institutions: it accounts for some 22.5% and 23.4% of each age group, respectively.

In the university education, the number of the respective cohorts was down for the third consecutive year, as the age cohort of 17-25 years which forms a major “source of supply” of university students has shrunk consistently. As a result, the university student cohort (both in public and municipal universities) has been nearly 5.9% down from its peak figures in 2008 (6.2mn). In parallel with that, the number of budget-sponsored student has been in decline, too – it has dwindled 4.3%.

Meanwhile, as the overall admission was tumbling at a pace greater than the budget-sponsored one, the 2011 share of the budget-sponsored admissions was up to 42.3% vis-à-vis the 2010 figure.

5.3.3. Financing of Education

In 2011, the budget spending on education continued rising both in nominal and real terms. (*Table 8, Fig. 11*). That proved a reverse trend, as in 2009-10 the expenditures were growing in nominal terms but were down in real terms, which apparently can be ascribed to the Duma election in 2011 and preparations for the presidential one due in 2012. Thanks to that and to a favorable situation in the foreign trade area, educational expenditures once again increased at a pace greater than the one of inflation, having added 22.1% by the end of the year. Meanwhile, the 2011 federal budget spending on education was up by 26.5% vs. its 2010 figures, while the one of consolidated budgets of the Subjects of the Federation was up by 20.8%.

Table 8

Budget Spending on Education in 2005–2011

	2005	2006	2007	2008	2009	2010	2011*
Consolidated budget for education, as Rb bn., including:	801.8	1033.3	1342.3	1664.2	1783.5	1893.9	2330.1
• Federal budget for education	162.1	201.6	278.5	354.9	418. 0	442.8	559.5
• Consolidated budgets of RF Subjects for education	628.6	831.7	1063.8	1309.3	1365.5	1450.9	1770.6
Consolidated budget's spending on education, as % of GDP, including:	3.7	3.9	4.1	4.1	4.6	4.4	4.3
• Federal budget for education	0.8	0.8	0.8	0.8	1.1	1.0	1.0
• Consolidated budgets of RF Subjects for education	2.9	3.1	3.3	3.3	3.5	3.5	3.3
Proportion of spending on education in Russia's consolidated budget, as %	11.8	12.3	11.9	11.8	11.1	11.2	12.1
Proportion of the federal budget expenditure on education in the spending from the federal consolidated budget, as %	2.4	2.4	2.5	2.5	2.6	2.6	2.9
Proportion of spending on education of the consolidated budgets of RF subjects in the spending from the federal consolidated budget, as %	9.4	9.9	9.4	9.3	8.5	8.6	9.2

* The aggregate budget breakdown with account of amendments therein as of 01.11.2010.
Source: the Federal Treasury.

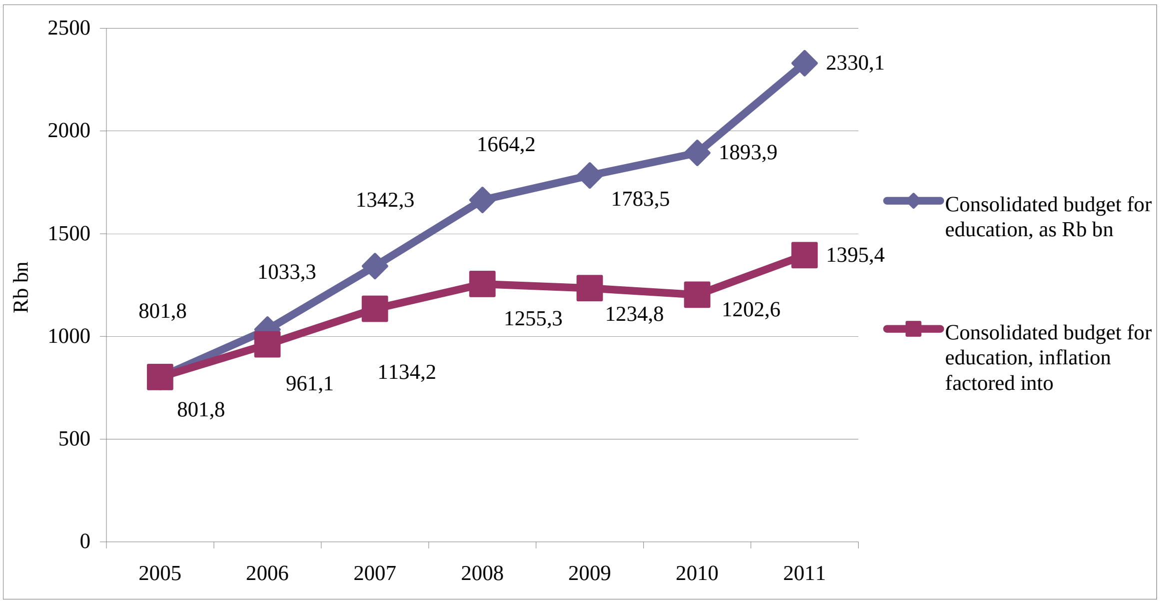


Fig. 11. Dynamic of Consolidated Budget Expenditures on Education in Nominal and Real Terms in 2005–2011

The 2011 budget expenditures on education in real terms were in excess of the 2008 figures (when with the start of the economic crisis in September, driven by inertia, the expenditures still were on a high level). While in 2010 the consolidated budget expenditures on education in real terms accounted for 95.8% of their 2008 level, in 2011 they proved at 11% over the 2008 benchmark. So, in 2011, the educational system basically found itself in a safe harbor, and it took it just two years to get out of the trouble.

As to the sphere of fee-based services, the educational system faces a situation worse than with the budget funding (*Fig. 12*). While residents' nominal education expenses kept rising, the real ones were in decline. This can be explained, first, by the fact that in 2011 the population's incomes were increasing at a far slower pace than in the pre-crisis period. Second, the bulk of fee-based educational services is formed by those in the tertiary education area, and the sector in question faced a certain fall in the fee-based cohorts, albeit not drastic yet. The volume of fee-based educational services in 2005-2001 is depicted in *Table 9.*

Table 9

Volume of Fee-Based Services in the Educational System in 2005–2011

	2005	2006	2007	2008	2009	2010	2011*
Volume of fee-based services in the educational system, as Rb bn	147.0	189.6	231.7	281.2	306.0	326.0	344.3
as % of GDP	0.7	0.7	0.7	0.7	0.8	0.76	0.65

*preliminary data.
Source: Rosstat, the RF Ministry of Finance.

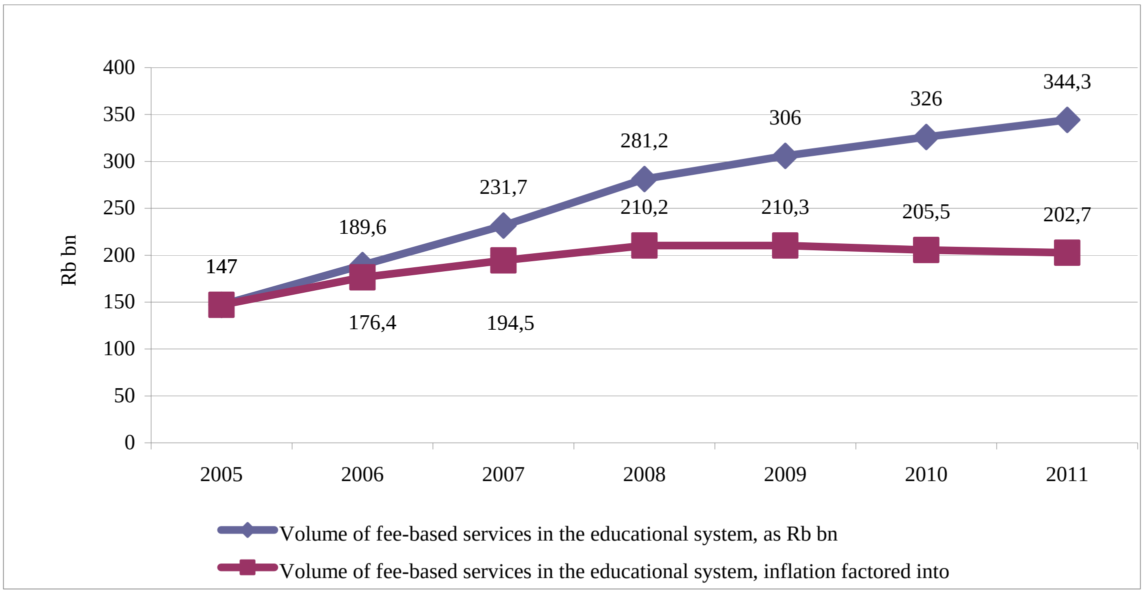


Fig. 12. Volume of Fee-Based Services in the Educational System in the Nominal and Real Terms in 2005–2010

Having dwindled by 3.6% vs. their peak value of 2009, the population's expenses in real terms were back roughly to their 2007 level (*Fig. 12*). At this point, it is also worth noting the inertia-driven processes in the fee-based educational services system: in the heyday of the crisis they kept rising, as residents were keen to honor their obligations to pay for education, and it was only in 2010 when they started tumbling.

Table 10

Volume and Structure of Budget Expenditures Across Tiers of the Educational System in 2005–2011

	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011***
1	2	3	4	5	6	7	8
Consolidated budget for Education, as Rb bn.	***801.8***	***1036.4***	***1342.3***	***1664.2***	***1783.5***	***1893.9***	***2330.1***
Preschool education (PE), as Rb bn	**113**	**145.3**	**189.7**	**254.5**	**287.5**	**321.3**	***410.0***
Share of spending on PE in the consolidated budget for education, as %	14.1	14	14.1	15.3	16.1	17	17.6
Share of expenditures on PE as % of GDP	0.52	0.54	0.57	0.61	0.74	0.75	0.77
Increase rate of budget spending on PE (year-on-year) as , %	123.2	128.6	130.6	134.2	113	111.8	127.6
General education (GE), as Rb bn	**356**	**475.9**	**599**	**737.1**	**795.7**	**827.4**	***1043.2***
Share of spending on GE in the consolidated budget for education, as %	44.4	45.9	44.6	44.3	44.6	44.5	44.8
Share of expenditures on GE as % of GDP	1.65	1.77	1.8	1.78	2.04	1.93	1.96
Increase rate of budget spending on GE (year-on-year) as , %	119.4	133.7	125.9	123.1	108	104	126.1
Primary vocational education (PVE), as Rb bn	**39.4**	**47.4**	**57.6**	**65.5**	**66.8**	**61.7**	***64.0***
Share of spending on PVE in the consolidated budget for education, as %	4.9	4.6	4.3	3.9	3.7	3.3	2.7
Share of expenditures on PVE as % of GDP	0.18	0.17	0.17	0.16	0.17	0.14	0.12
Increase rate of budget spending on PVE (year-on-year) as , %	110.7	120.3	121.5	113.7	102	92.4	103.7
Secondary vocational education (SVE), as Rb bn	**43.3**	**55.3**	**70.4**	**93.9**	**102.2**	**102.1**	***116.4***
Share of spending on SVE in the consolidated budget for education, as %	5.4	5.3	5.2	5.6	5.7	5.4	5.0
Share of expenditures on SVE as % of GDP	0.2	0.21	0.21	0.23	0.26	0.24	0.22
Increase rate of budget spending on SVE (year-on-year) as , %	142	127.7	127.3	133.4	108.8	99.9	114.0
Tertiary and postgraduate vocational training (TVT), as Rb bn.	**125.9**	**169.9**	**240.2**	**294.6**	**347.2**	**377.8**	***423.2***
Share of spending on TVT in the consolidated budget for education, as %	15.7	16.4	17.9	17.7	19.5	19.9	18.2
Share of expenditures on TVT as % of GDP	0.58	0.63	0.72	0.71	0.89	0.88	0.79
Increase rate of budget spending on TVT (year-on-year) as , %	163.7	134.9	141.4	122.6	117.9	108.8	112.0

* Aggregate budget breakdown with account of modifications therein, as of 01.11.2010.
Source: the Federal Treasury.

It was budget spending on preschool education which posted the highest year-on-year growth rate (by 27.6%) and general education (up by 26.1%), while the opposite pole was formed by budget expenditures on PVT (which added just 7.3% over the period in question, ie. continued to plunge in real terms) (*Fig. 13*). The structure of the consolidated budget for education also underwent substantial changes: the proportion of expenditures on tertiary education was down 1.5 p.p., on primary vocational training – by 0.6 p.p. and on secondary vocational training – by 0.4 p.p. By contrast, the proportion of expenditures on preschool education was up 0.6 p.p., while the one on general education – up by 0.3p.p. Overall, instructural terms, it was tertiary education which suffered at most.

As to the overall picture across all the tiers of the educational system (except for PVT), in 2011 all of them saw budget expenditures on education rise both in nominal and real terms (*Fig. 13 and 14*).

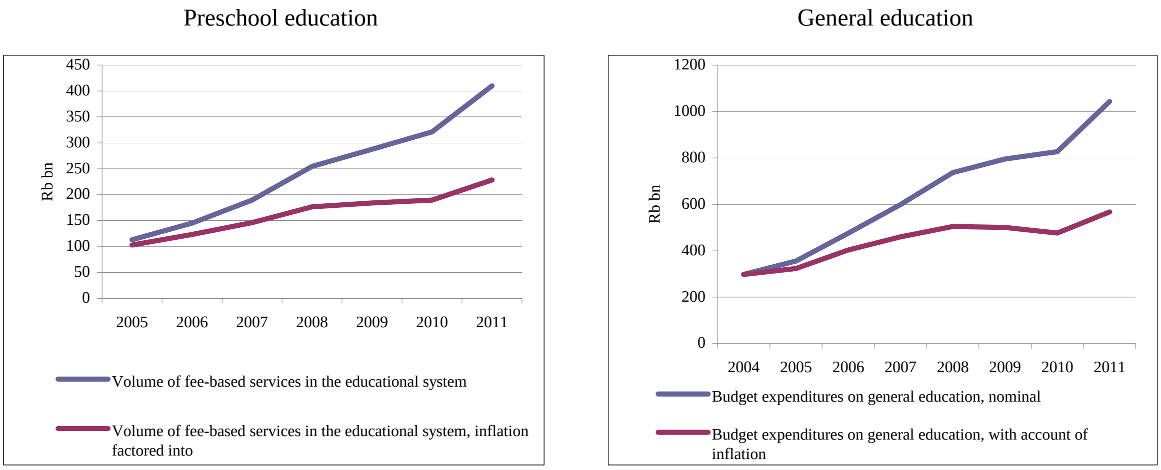


Fig. 13. Budget Expenditures on the Preschool and General (School) Education in Nominal and Real Terms in 2005–2011

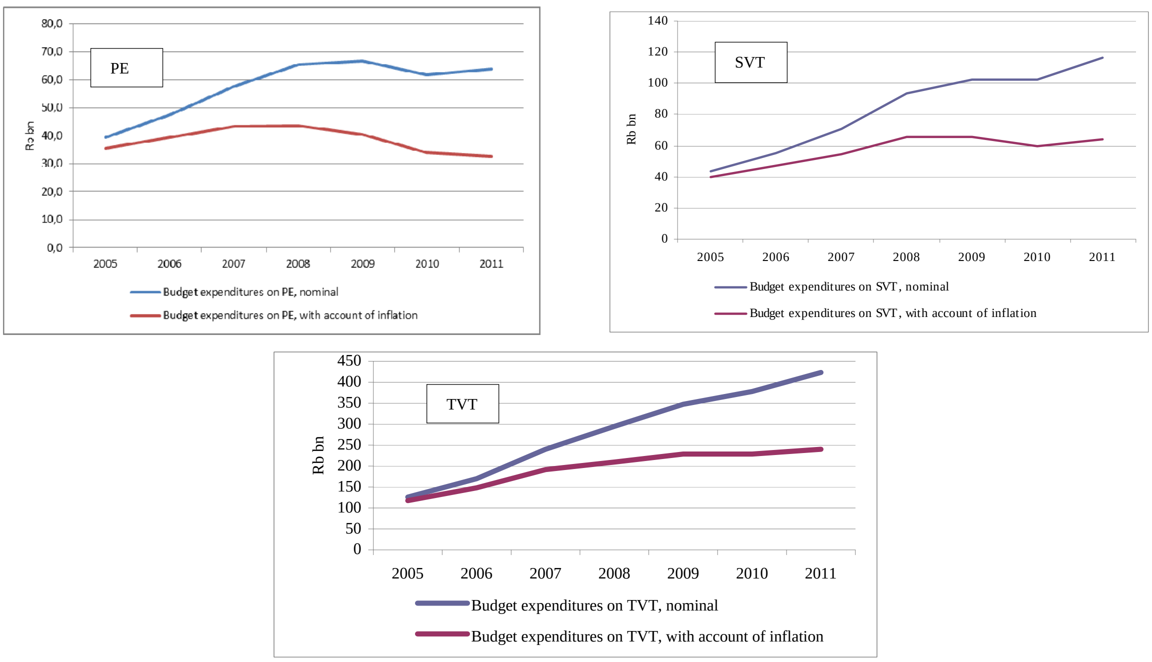


Fig. 14. Budget Spending on PE, SVT and TVT in nominal and real terms in 2005–2011

5.3.4. Uniform State Examination

After a long period of pilot tests (2001-2008), in 2009, the Uniform State Examination (USE) was in regular operation mode.

During the pilot phase, the squall of criticisms was stirred by contents of the examinations per se and procedures of the USE and assessment of its results. At this point, it should be noted that scared by the prospect to trigger parents, school leavers and the schoolteacher community’s negative reaction in the course of deploying USE in a fully operational mode, the RF Ministry of Education and Science and Rosobrnadzor crafted far more lenient requirements to school leavers' competencies in the compulsory subjects, namely the Russian language and mathematics (*Table 11*).

Table 11

Proportion of School Leavers Who Scored "2"by the Five-Grade Scale by Compulsory Subjects of USE in 2006–2010, as %[1]

Subject	«2» (by the five-grade scale)				
	2006	**2007**	**2008**	**2009**	**2010**
The Russian language	7,91	8,81	11,21	2,76	2,1
Mathematics	19,99	21,14	23,48	3,04	3,5

Source: Rosobrnadzor.

Table 11 displays a drastic fall in the number of "2-s" in mathematics and Russian in 2009 and 2010, when USE was already run in a routine mode. Meanwhile, as the data above show, the period of 2006-2008 was seeing an absolutely opposite trend, with the number of "2-s" rising steadily.

The fact of the matter is, during the pilot phase of 2001-08, there was a "+1 grade" rule in place. That is to say, having scored "2" at the USE, a school leaver would automatically earn "3" and, consequently, his high school diploma and eligibility for enrollment in university. In 2009, naturally, that rule was terminated, which meant that some 25-30% of school leavers were no longer entitled to the said diploma and the right to university enrollment. That could have resulted in a spike of social tension, the population's negative sentiments toward USE (as Russians are keen to have their children receive university education and the USE would have blocked their aspiration) and the teacher community's discontent, as infuriated parents would turn to schools first. Besides, universities would have lost quite a fraction of fresh students, which would have battered their financial standing. All the above led to what has already been noted, that is, requirements to USE were loosened up considerably.

In 2011, it became impossible to raise the "3" (C grade) threshold in mathematics and the Russian language (*Table. 12*), as it would have insulted both the population and schools which had already relaxed and come to appreciate the concept of USE, as they sensed it would not affect families' long-range plans and teachers' performance metrics. However, having discontinued to be a social stimulus, USE was no longer an objective arbiter to select those who could enroll in university and screening out those who could not.

Table 12 evidences that in 2009-2011 minimum test grades remained practically unchanged (with the ones for mathematics and literature being slightly up, while those for informatics, ICT and chemistry- a bit down). It was announced that the 2012 minimum test grades for the Russian language and mathematics were going to stay unchanged.

The drop in the "quality" of the USE grades resulted in popular demands to introduce "cut-off grades", meaning that should a university aspirant score lower than, for instance 60-65 in a given subject, he/she shall not be eligible for a budget sponsored tuition, but solely for the fee-based one.

In 2009-10, the NRU HSE ranked universities in terms of their enrollees' USE grades, which allowed identification of directions of training with relatively high and relatively low USE grades of students admitted for budget-sponsored tuition.

[1] Rosobrnadzor did not supply information about re-calculation of the USE grades into the traditional 5-grade scale.

Table 12

Minimal USE Grades in 2009-2011 across All the USE Subjects

Code	Subject	Tasks of bloc A	Tasks of bloc B	Tasks of bloc C	Max primary grade	Min grade in 2009	Min grade in 2010	Min grade in 2011
1	Russian	30	8	1	60	37	36	36
2	Mathematics	0	12	6	30	21	21	24
3	Physics	25	5	6	50	32	34	34*
4	Chemistry	30	10	5	66	33	33	32
5	Informatics and ICT	18	10	4	40	36	41	40
6	Biology	36	8	6	69	35	36	36
7	History	27	15	7	67	30	31	31*
8	Social science	24	6	9	59	39	39	39
9	Geography	28	14	7	61	34	35	35
10	English	28	16	2	80	20	20	20
11	German	28	16	2	80	20	20	20
12	French	28	16	2	80	20	20	20
13	Spanish	28	16	2	80	20	20	20
14	Literature	0	12	5	39	30	29	32

* stands for non-available, which is why the column for 2011 contains the 2010 scores.
Source: http://www1.ege.edu.ru/min-points, 2011 – Rosobrnadzor.

In the event of introduction of “cut-off grades” for budget-sponsored tuition at the level of 60-65, most students enrolling in engineering and agricultural specialties will have to pay for their tuition, while those admitted to socio-economic and humanitarian specialties will study at the expense of budget funds. As engineering and agricultural specialties prove far more “funding-intensive” vis-à-vis socio-economic and humanitarian ones, such a pattern of assignment of budget funds can hardly be labeled as an efficient one. Plus, the economy’s transition toward the innovation development requires highly qualified cadres of both engineering specialties and directions of training and not only socio-economic ones (though there is a significant need for enhancement of the quality of training of managerial, economic and legal cadres). Today, engineering specialists and directions of training appear critical for the state, and, accordingly, they cannot be assigned practically in full to the fee-based sector of education.

5.3.5. The Tier Level of the Tertiary Education System

The experiment on introduction in Russia of a two-tier cadres training system was launched in 1992. In 2003, Russia’s joining the Bologna Process gave a new impulse to the transition toward the two-tier, “Bachelor –Master”, system, instead of the 5-year training of specialists. In 2005, an Act was adopted on transition to the tier-based system of TVT (with training of specialists retained by some specialties). According to the Act, the transition was scheduled for 2009. A long transitional period was determined by the need to develop new tertiary education standards (the 3rd–generation ones) and transition to them, as well as the need for universities to devise new curricula.

In 2000–2009, the number of fresh BAs, specialists and MAs was as follows (see *Table 13*).

Table 13

Graduates from TVT Educational Institutions in 2000–2009[1], by Degree Awarded

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
1	2	3	4	5	6	7	8	9	10	11
	All educational institutions of tertiary professional education									
Specialists graduated, Thos.	**635.1**	**720.2**	**840.4**	**976.9**	**1076.6**	**1151.7**	**1255.0**	**1335.5**	**1358.5**	**1442.3**
With incomplete high vocational training	2.3	2.1	2.9	4.3	4.1	4.3	6.0	8.6	9.3	10.1
Growth rates in their number (y-o-y), as %		91.3	138.1	148.3	95.3	104.9	139.5	143.3	108.1	108.6
Their specific weight in the aggregate number of graduates, as %	0.4	0.3	0.3	0.4	0.4	0.4	0.5	0.6	0.7	0.7
Bachelors	71.0	68.8	76.8	80.3	77.9	84.6	87.5	98.9	98.5	124.0
Growth rates in their number (y-o-y), as %		96.9	111.6	104.6	97.0	108.6	103.4	113.0	99.6	125.9
Their specific weight in the aggregate number of graduates, as %	11.2	9.6	9.1	8.2	7.2	7.3	7.0	7.4	7.3	8.6
Specialists with high vocational training	553.4	639.9	751.4	882.7	983.9	1051.7	1149.1	1213.1	1233.8	1287.7
Growth rates in their number (y-o-y), as %		115.6	117.4	117.5	111.5	106.9	109.3	105.6	101.7	104.4
Their specific weight in the aggregate number of graduates, as %	87.1	88.9	89.4	90.4	91.4	91.3	91.6	90.8	90.8	89.3
Masters	8.4	9.4	9.3	9.6	10.7	11.1	12.5	14.9	16.8	20.5
Growth rates in their number (y-o-y), as %		111.9	98.9	103.2	111.5	103.7	112.6	119.2	112.8	122.0
Their specific weight in the aggregate number of graduates, as %	1.3	1.3	1.1	1.0	1.0	1.0	1.0	1.1	1.2	1.4
	Public and municipal institutions of high professional training									
Specialists graduated, Thos.	**578.9**	**647.8**	**753.1**	**860.2**	**930.4**	**978.4**	**1055.9**	**1108.9**	**1125.3**	**1166.9**
With incomplete high vocational training	0.7	1.3	2.5	3.0	3.1	3.5	5.0	6.6	7.7	7.7
Growth rates in classes of incomplete high vocational training (y-o-y), as %		185.7	192.3	120.0	103.3	112.9	142.9	132.0	116.7	100.0
Specific weight of individuals with incomplete high vocational training in the aggregate number of graduates, as %	0.1	0.2	0.3	0.3	0.3	0.4	0.5	0.6	0.7	0.7
Bachelors	48.8	45.4	50.8	52.6	51.3	53.3	55.8	57.5	56.9	63.3
Growth rates in their number (y-o-y), as %		93.0	111.9	103.5	97.5	103.9	104.7	103.0	99.0	111.2
Their specific weight in the aggregate number of graduates, as %	8.4	7.0	6.7	6.1	5.5	5.4	5.3	5.2	5.1	5.4
Specialists with high vocational training	521.2	591.9	690.6	795.0	865.5	910.6	982.8	1030.3	1044.3	1076.1
Growth rates in their number (y-o-y), as %		113.6	116.7	115.1	108.9	105.2	107.9	104.8	101.4	103.0
Their specific weight in the aggregate number of graduates, as %	90.0	91.4	91.7	92.4	93.0	93.1	93.1	92.9	92.8	92.2
Masters	8.2	9.2	9.2	9.6	10.5	11.0	12.4	14.6	16.4	19.8
Growth rates in their number (y-o-y), as %		112.2	100.0	104.3	109.4	104.8	112.7	117.7	112.3	120.7
Their specific weight in the aggregate number of graduates, as %	1.4	1.4	1.2	1.1	1.1	1.1	1.2	1.3	1.5	1.7
	Non-public institutions of high professional training									
Specialists graduated, Thos.	**56.2**	**72.4**	**87.3**	**116.7**	**146.2**	**173.3**	**199.1**	**226.6**	**233.2**	**275.5**
With incomplete high vocational training	1.6	0.8	0.4	1.3	1.0	0.8	1.0	2.0	1.6	2.4
Growth rates in their number (y-o-y), as %		50.0	50.0	325.0	76.9	80.0	125.0	200.0	80.0	150.0

[1] The most recent official data available.

cont'd

1	2	3	4	5	6	7	8	9	10	11
Their specific weight in the aggregate number of graduates, as %	2.8	1.1	0.5	1.1	0.7	0.5	0.5	0.9	0.7	0.9
Bachelors	22.2	23.4	26.0	27.7	26.6	31.3	31.7	41.5	41.7	60.7
Growth rates in their number (y-o-y), as %		105.4	111.1	106.5	96.0	117.7	101.3	130.9	100.5	145.6
Their specific weight in the aggregate number of graduates, as %	39.5	32.3	29.8	23.7	18.2	18.1	15.9	18.3	17.9	22.0
Specialists with high vocational training	32.2	48.0	60.8	87.7	118.4	141.1	166.3	182.8	189.5	211.6
Growth rates in their number (y-o-y), as %		149.1	126.7	144.2	135.0	119.2	117.9	109.9	103.7	111.7
Their specific weight in the aggregate number of graduates, as %	57.3	66.3	69.6	75.1	81.0	81.4	83.5	80.7	81.3	76.8
Masters	0.2	0.2	0.1	0.0	0.2	0.1	0.1	0.3	0.5	0.7
Growth rates in their number (y-o-y), as %		100.0	50.0	0.0	-	50.0	100.0	300.0	166.7	140.0
Their specific weight in the aggregate number of graduates, as %	0.4	0.3	0.1	0.0	0.1	0.1	0.1	0.1	0.2	0.3

Source: calculated by the 2010 Rosstat data.

According to the Rossstat's preliminary information, in 2010, the proportion of Masters accounted for 1.65 and in 2011–1.75%.

The data in *Table 13* show that the number of awarded BA and MA degrees in absolute terms was rising at public and non-public universities alike, though their proportion in the overall number of graduates has thus far remained insignificant.

Sociological surveys demonstrate that employers have not yet perceived of BAs as full-fledge employees. Rather, they think of them as "sophomores and half-baked specialists"[1].

Overall, as employers in Russia strive to accumulate a symbolic capital, they prefer MAs and even PhDs over specialists. We think this is yet another proof of employers still being pretty unsure of the quality of specialists training by domestic universities, which is why the number of years spent at the university and the degree awarded illustrate the prospective employee's industry, passion for studies, and ability to pass through filters set by the formal educational institutions.

That said, it should be noted that employers do not display the same degree of respect to advanced training or professional retraining certificates, except in the cases the employer himself has initiated the said kinds of training.

It appears that as long as BAs fall short of flooding the market, employers' would not change their mind. This is true for both academic and applied BAs, which is why the hopes associated with creation of the institution of applied BA presently seem overly exaggerated[2].

5.3.6. Strategy-2020 in Education

While updating Strategy-2020 in the educational sphere, there were two expert groups to tackle the issue, that is, Group No. 7 and Group No. 8. The former Group dealt with professional education, while the latter – with school education.

One of the Groups' key proposals was to ensure an effective contract for professors. The current version of the bill "On education in Russian Federation" contains a provision holding that the average salary of pedagogical staff may not be lower than the one across a given re-

[1] Studies by TSENO, 2004; ISEPN, 2007; ISEPN, 2011.
[2] See, for example, presentation by Y. Kuzminov at a workshop on the Strategy on 12.03.2011 or his address in Ekaterinburg on 23 April 2011.

gional economy. Presently, the average salary in the educational sector accounts for 65% of the one across the economy.

But the Expert Group on professional education believes that a university professor's wages (all his incomes combined) should make up 200% of the above benchmark (in 2011, according to Rosstat's preliminary data, it was 93.5%), the one of a general or polytechnic college professor – 150% (some 68%), and a schoolteacher's – 115% (some 62–64%).

It is suggested that in this case the faculty should abandon moonlighting and focus on research and tuition instead. It goes without saying the faculty's wages should be differentiated, with some making under the said 200% and others - more than that. Experts from Group No. 7 argue that the move should encourage the best faculty members to get the job, while the worst ones – to reside.

This Expert Group also nurtures the idea to introduce an applied Bachelor's program in Russia. It is proposed to incorporate this new form of education into a new version of the bill "On education in Russian Federation", as the present one does not bear any reference to it.

According to the Expert Group's report, once introduced, the applied Bachelor's program should help solve the problem of qualified employees, as the current primary and even secondary vocational training systems have recently lost their popularity with the youngsters. In 2010, nearly 20% of leavers from PVT institutions and over 70% of those who finished SVT ones enrolled in universities. The concept of the applied Bachelor's program should be as follows: having studied for two years by a regular, academic Bachelor's program, the student realizes that he is keen to promptly enter the labor market. He consequently signs up for a year-long vocational training, earns a diploma and gets a job. Meanwhile, he retains the possibility to return to the university, complete his budget-sponsored Bachelor's program and enroll in Master's program.

The expert group also accentuated another problem, that is, pseudo-education. Presently, a great number of universities deliver that at the expense of budget funds. More than a half of third-graders now work 22 and more hours a week, ie. *de facto* being full-timers, thus not being able to normally attend to classes. The experts believe that in this case it would be appropriate to have students sign up for an applied Bachelor's program, get to the labor market and, if he/she wishes so, return to the university to complete the academic training.

It seems that in addition to purely legal questions that may arise with respect to the status of a student and a graduate from an applied Bachelor's program, which, in principle, can be resolved, as the draft Act 'On education in Russian Federation" is still at the stage of discussion and, therefore, can be amended, if need be, there emerge equally serious challenges of economic and psychological nature.

As noted above, employers fresh Bachelors do not receive a warm welcome from prospective employers. Needless to say, it will be very hard for them to tell a "normal", academic Bachelor from an applied one, which is why they will project their negative sentiments onto the latter, too. Meanwhile, cashing in budget funds for tuition while their students are busy working a full day, universities will turn against the proposed measure, particularly in light of a fast contraction of student cohorts due to demographic reasons (for it is far less profitable to teach a student for three years than five years, and in the latter case - with no trouble whatsoever). Students who work and earn the record of service and professional experience required on the labor market and, at the same time, earn money and, ultimately, a university diploma demanded by employers, appear yet far less keen to change the status quo.

Plus, should, upon introduction of the applied Bachelor's program, the secondary vocational training system be retained (and the Expert Group proposes so), the mess on the labor market would reach its acme, for it seems to us the employer would still favor specialty graduates or Masters, or, at least, leavers from special secondary educational institutions.

The Expert Group believes there is a need in legislative modification of the budget-sponsored university admission procedures. Universities currently appear restricted solely by USE marks by liberal arts which evidence that the aspirant has mastered the school program. As a result, engineering universities admit students who have scored in mathematics just 33 out of 100. In view of that, it is proposed to introduce for aspirants to budget-sponsored tuition a minimum threshold of quality of knowledge across profile subjects, which should vary by year depending on the school leavers' performance, but cut off the least trained nonetheless.

We think this approach deprives the General Certificate of Education of any significance. Besides, it abuses school leavers' constitutional rights, as they prove to be rejected budget-sponsored tuition beforehand, prior to submission of an enrollment application to a specific university. It should also be taken into account that in compliance with the effective Act "On education" and the bill "On education in Russian Federation", no less than a certain number of students should study at public and municipal universities at the budget's expense. But the Expert Group argues that the minimum threshold of quality of knowledge constitutes an element of the enrollment competition that does not infringe the aspirants' constitutional rights.

That said, universities' performance should be put under control, including running an independent assessment of students' performance, universities' operational transparence, other kinds of monitoring to assess the quality of student cohorts, faculty, conditions of tuition.

The Expert Group also proposed to create conditions for competition between universities in the course of allocation of public order, namely, to replace the allocation of control figures in advance with allocation of budget funds by results of admission. As well, the Group galvanized an old proposal to have students with higher scores secure a greater budget funding for their universities than students with lower ones. It *de facto* means revisiting the concept of state personalized financial obligations (SPFO) in the form of SPFO-2, with just two categories of those (in the past, there were five categories of SPFO). That is to say, if an aspirant scores between 85 to 100 at USE, the university collects Rb.200,000 in budget allocations, 60 to 85 –Rb 100,000. Those aspirants who scored between 35 and 60 will have to pay for tuition, while the rest will not be entitled to admission at all. Whereas the best students today chiefly opt for socio-economic, humanitarian specialties and ICT, the respective universities will be eligible for a sizeable budget funding; by contrast, while, as noted above, "technical" universities are more "funding-intensive", they will receive smaller amounts of budget funds. Ultimately, there will arise the need to introduce a multiplying coefficient to ensure their normal functioning. In short, the concept of SPFO-2 so far seems poorly designed and, furthermore, it does not help solve the urgent task of the country's technological modernization, which will grow yet more urgent by 2020.

The Expert Group also proposes special allocations to the federal and national research universities, MSU and StPSU, and other high-profile universities, as they are set to climb to the international level of tuition and research activity. The Expert Group believes that the move would allow attraction therein foreign professors and ensure normal conditions of tuition for foreign students. Plus, a greater volume of spending on research and higher wages would fuel Russian researchers' eagerness to stick to home turf.

So, according to the Expert Group, graduates from the above universities will receive a world-class education, the influx of foreign students therein should rise, and the universities' research capacity will increase, too, which will justify (efficiency-wise) their higher standards of funding.

Overall, the above proposals by Expert Group No. 7 can be assessed as a holistic request to the government to allocate extra budget funding to public universities with no clear return on that. In the period between 2005 and 2011 alone, budget financing of the system of high education rose 3.4 times in nominal terms and doubled in real terms[1], while the quality of tertiary education did not increase but plummet. Singling out leading universities and their priority budget funding perhaps could make a difference, but for that particular segment of tertiary education only, while its other segments would continue degrading at an accelerated pace.

So, it can be concluded that while Strategy-2020 for the educational system has been formally prepared, but main challenges facing this sphere remained unsolved and demand adequate remedies.

5.4. State of Science and Innovation in 2011

The scientific sphere saw continuation of the measures initiated between 2009 and 2010. The Russian research complex displayed certain positive shifts, though they fell short of being of magnitude sufficient to be mirrored by statistics. There also were alarm bells: specifically, against the backdrop of increasing budget appropriations for civil science Russian researchers' publication activity continued to decline.

The Government implemented its innovation policy with much vigor: the i-city Skolkovo project advanced at a very high pace, new institutions of development emerged, and the project on formation of technological platforms was launched.

5.4.1. The R&D Funding

The budget financing of civil R&D in 2011 in current prices posted a robust 20.9%[2] increase and hit Rb 287bn. The figure accounted for 3.07% of the federal budget spending (in 2010 – 2.35%). Meanwhile, it is worth noting a parallel increase in extrabudgetary funding of science. That said, the budgetary to extrabudgetary R&D funding ratio remained at the 2009 level (65:35). So, budget sources still dominated the structure of R&D financing.

The policy with regard to allocation of budget funds was changing towards increase in the proportion of competition-based financing under public contracts, which posted a 37.3% increase. This is a positive development indeed, as competition suggests picking the best projects. Meanwhile, according to leading university presidents and research organizations executives, the basic financing, like before, proved short of covering the institutions' maintenance and research process costs. Accordingly, the stochaticity in the financing of science did not reduce, as the constant (outside the competition area) budget financing was insufficient to ensure implementation of long-term research projects.

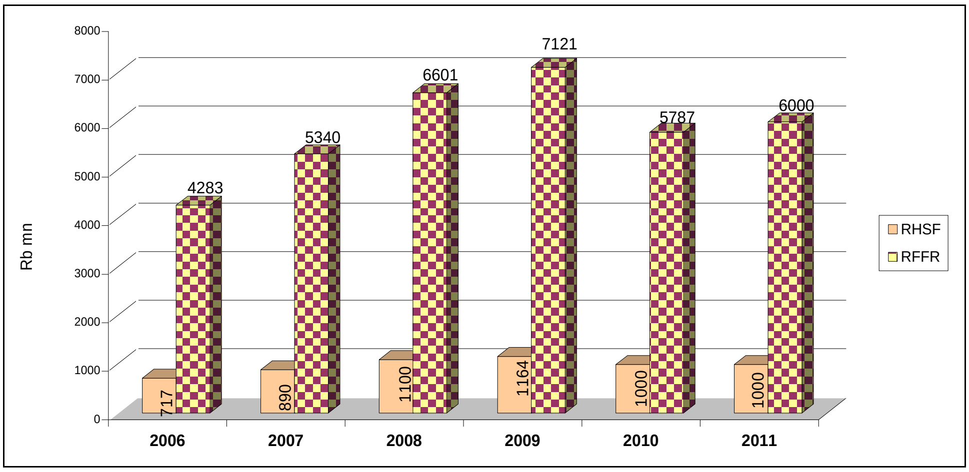
Another serious tendency became the shrinking role played by competition-based grant financing through the system of scientific foundations as a specific conduit. Despite all the official documents trumpeting the pivotal role of the Russian Foundation for Fundamental Re-

[1] See subsection "Financing of Education" above

[2] Data for 2011 are given in accordance with Federal Law of 13 December 2010 No. 357-FZ "On the federal budget for 2011 and the planned period 2012 and 2013"

search (RFFR) and the Russian Humanitarian Scientific Foundation (RHSF), their actual standing remained very complex. In 20011, their budgets were small, particularly in contrast with the amount of public funding of R&D under public agencies' lots in the framework of federal target programs (FTPs).

The Foundations' budgets were first axed back in 2010. (*Fig. 15*). Average amounts of their grants have not increased ever since and accounted for Rb 370,000 per a team of up to 10 persons at RFFR and 400,000 – at RHSF[1]. What is more, actual funds spent on research account for between 60 and 40% of the grant total, with the rest being various taxes and overheads.



Sources: http://www.ras.ru/news/news_release.aspx?ID=e251689c-6b6d-48b1-a819-ab2bbbae9531. The art of combining. An interview with Acad. V. Panchenko, Chairman of RHSF// Poisk, No. 17, 29 April 2011, p. 6. Report on the RHSF performance. The meeting of the Presidium of the Russian Academy of Sciences of 31 May 2011. http://www.ras.ru/news/news_release.aspx?ID=e251689c-6b6d-48b1-a819-ab2bbbae9531

Fig. 15. Dynamics of Budgets of the Public Foundations, RHSF,RFFR, in 2006–2011

Miserable budgets are not the only challenge facing grant-awarding research foundations. Their organizational-legal status still remained murky, which is why every year, when the annual federal budget is formed, they find themselves under the Damocles' sword of being crossed out of the list of main managers of budget funds. Federal Law No. 249-FZ[2] ,which became effective as of 1 October 2011 and which specifies the status of foundations for support of research, scientific and technical, and innovation activities, fell short of solving the problem. The Law in question introduces the concepts of public and non-government funds and specifies that the former may be established in the form of budget or autonomous institutions, while financing of research projects is exercised at the expense of grants. However, the Law fails to clarify peculiarities of funding of RFFR and RHSF. More specifically, there is no single reference therein to the Foundations being entitled to the status of main managers of budget funds or, as an alternative, being recognized as critical budget institutions.

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[1] Report on the RHSF performance. The meeting of the Presidium of the Russian Academy of Sciences of 31 May 2011. http://www.ras.ru/news/news_release.aspx?ID=e251689c-6b6d-48b1-a819-ab2bbbae9531. The art of combining. An interview with Acad. V. Panchenko, Chairman of RHSF// Poisk, No. 17, 29 April 2011, p. 6.

[2] Federal Law of July 2011 No. 249-FZ «On introducing amendments to the Federal Law "On science and the scientific-technical policy" and Art. 251 Part Two of the Tax Code of Russian Federation with respect to specifying the legal status of foundations for support of research, scientific-technical and innovation activity".

That said, regardless of all the drawbacks of their current mechanism of allocation of funds, foundations can be viewed as a more progressive and transparent vehicle to support science than the competition-based financing procedure in the frame of FTPs. When compared with tenders held by federal agencies, the undisputable pluses of the grant-based form of funding lie in the refusal to apply the criteria used in the course of public procurement to evaluation of scientific projects, as well as in the broadness with which such grants encompass individual researchers and research teams, which proves far greater than the one displayed by FTPs' projects. Besides, the Foundations strive to bolster transparency of their operations: more specifically, today, applicants for RFFR grants have access to reviews and comments to their applications[1], which is equally important both for researchers in the course of implementation of their projects and for increasing experts' responsibility for their conclusions.

The Foundations were de-facto required to "prove the operational efficiency", nonetheless, and by analogue to FTPs, to set up target indicators, in particular. The indicators the Foundations currently put forward may result in a biased, rather than more objective, assessment of their performance. Thus, it is planned to increase the proportion of applied projects, which is most likely to result in a greater support of such projects to the detriment of purely fundamental ones. As well, the share of projects whose results match or exceed the international level (with no clear ways of identification of the latter) is set for increase. Likewise, the share of PhDs and Drs in the age of up to 39 years among contributors to projects should grow.[2] It is common knowledge that when such an indicator becomes an imperative, it is not a big deal to give a statistical boost to the number of young researchers. Meanwhile, there is no explanation as to why the indicator of publication activity and citation, which proves the most adequate one, as far as assessment of outcomes and level of research under the Foundation's grants, was not included in the list of major indicators.

In addition, under the pressure from inspecting instances the Foundation were compelled to modify or even terminate some important and useful for researchers programs. More specifically, RFFR will no longer award grants to partake in scientific conferences, as the Accounting Chamber auditors considered that a "scientific tourism". That said, many research organizations lack funds to send their fellows to conferences, especially overseas. That gave rise to a déjà vu situation, when, like in 1990s, Russian scientists find themselves reliant on the hosts, who, unlike the then crisis time in Russian science, are now often reluctant to incur the costs in question.

The mechanism of financing through FTPs to a significant extent suffers from the need to abide by provisions of the law on state procurement[3], which, as far as the R&D sphere is concerned, does not always result in picking the strongest application, as it is the costs of implementation of works (until 2010 – costs of implementation of works and their timelines) that constitutes a principal criterion. That said, last year, the foundation was laid for positive changes.

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[1] Mysyakov D. Familiar signs // Poisk, No. 3, 20.01.2012, p. 5.
[2] Up-and-down traffic. Research foundations in search of common language with the authorities. // Poisk, No. 49, 9.12.2001, p. 4.
[3] Federal Law of 21.07.2005 No. 94-FZ "On placement of orders for delivery of goods, implementation of works, provision of services for the public and municipal needs".

New Federal Laws[1] enacted in April and in December introduced two important adjustments set to facilitate contract- and grant-based implementation of R&D projects: The first of them makes it possible to place orders without a tender, where an R&D project is implemented by a budget institution at the expense of grants (competition-based subsidies) awarded out of a respective budget of the budget system of Russian Federation as well as grants awarded by foreign foundations, unless otherwise established by grantors. The other novelty is that budget institutions are now allowed to attract, outside of the tender procedure[2], in the course of implementation of a public or municipal contract, or a contract under the civil law of Russian Federation, other entities to jointly implement an R&D project, as well as to deliver goods, provide services required for its implementation.

Yet another problem associated with the FTP-based mechanism of financing is the opaque project evaluation procedure. The project awarding statistics evidence monopolization of the "market for public contracts" by a closed circle of research institutes and universities. On the one hand, they indeed might be most qualified for the job, while, on the other hand, the concentration of funding by year in the same structures, with the evaluation procedure being opaque and with no publicity with regard to presentation of respective outcomes whatsoever can result in an increasingly lowering quality of implementation of projects. The RF Ministry of Education and Science planned to post such projects findings and outputs on the Internet, but that has not taken place as yet - both the customers and contractors do not seem to be keen on that.

Lastly, implementation of projects under FTPs' lots is a time-consuming exercise, with the respective paperwork taking far greater time than overseas. And if this is not enough, the paper squall is intensifying and gradually results in poorer performance. Thus, one of the increasingly frequently cited reasons behind young Russian researchers' emigration is bureaucratization of the scientific process, rather than low salaries or a primitive research infrastructure, as before[3].

The imperfection of financing mechanisms clearly leads to poorer performance. Despite a continuous increase of budget allocations for R&D, the number of Russian papers published in journals referenced and indexed in the Web of Science database is in decline and has presently sunk lower than the other BRIC nations' respective indicators. (*Table 14*).

Table 14

Dynamic of the Number of Papers for the BRIC Countries, 2007–2011, as Thos. Pcs

Country	2007	2008	2009	2010	2011 (estimated)
Russia	27.4	29.4	29.8	28.9	27.0
Brazil	27.8	32.2	34.4	35.8	37.0
India	36.3	42.3	43.5	46.2	48.0
China	100.0	114.7	132.2	146.2	160.0

Source: The Web of Science data. Published in: E.Onischenko. The fall in the number of Russian publications should account for some 10%. www.gazeta.ru/science/2011/11/17_a_3837722.shtml 17.11.2011.

[1] Federal law of 21.04.2011 No. 79-FZ "On introducing amendments to the Federal Law "On placement of orders for delivery of goods, implementation of works, provision of services for the public and municipal needs"; Federal Law of 07.12.2011 No. 418-FZ "On introducing amendments to Art. 31[1] (Art. 31 item 1) and 55 of the Federal Law "On placement of orders for delivery of goods, implementation of works, provision of services for the public and municipal needs".

[2] Sub-items 32 and33 item 2 Art. 55 of Federal Law No. 94-FZ, as reworded on 07.12.2011 No. 418-FZ.

[3] Volchkova N. One day application, another day report // Poisk, No. 5, 3.02.2012, p. 7.

Regretfully, the planned volumes and priorities of the budget financing of science for next three years cannot be assessed in a positive way. According to budget projections, the 2013 allocations to civil research will rise by 1.3% vs. 2012 and then fairly drastically plunge in 2014 (nearly by 15% to the prior year's level). That will be a serious cut with no sound rationale behind it. One of substantial changes is that the correlation between allocations for civil research and military one will be changing in favor of the latter. While in 2012 the planned expenditures on defense research are projected to be twice as low as those on civil one, the "civil research to defense research" ratio will have already been 1.2:1 by 2014. So the structure of the budget would become similar to the one characteristic of the first post-Soviet years. Notably, with the planned increase in spending on military research, it is planned to trim allocations for science in the frame of the state defense order which currently helps keep afloat research a a fairly wide array of technical universities.

The good news is that spending on fundamental research will be increased; however, both RFFR and RHSF will still remain underfinanced against the respective legislative standards. The research foundations are supposed to receive thrice as low the funding they would otherwise be entitled to.

As for applied research, the Government seems to be far more generous in this respect. The greatest volume of funding is provided for civil research under the item 'National economy": in 2012-13, this direction of research should receive more funding than the defense one; by 2014, the levels of spending on research under these two directions should be practically even. Such substantial expenditures on the item "National economy" should be ascribed to the fact that it comprises the most science-intensive programs, namely the 2006–2015 Federal Space Program (funding of R&D in 2012–2014 – Rb 66bn, 74.6bn and 71.8bn, respectively) and FTP "Development of the civil aircraft in Russia for 2002–2010 and for the period through 2015" (Rb 34bn, 37.7bn and 23.3bn, respectively). For reference: allocations for research in the frame of the basic FTP aiming at implementation of priority avenues of development of science and research – "Research and development in priority directions of development of the scientific-technological complex of Russia for 2007–2012" – will account for Rb 18.8bn in 2012 and 21.9bn in 2013. This also is in contrast to the funding of science by the item "Applied research in the health care area"– Rb 8bn in 2012–2013 and 10bn - in 2014. That spending on research in this area is planned to increase is a positive trend, but its level is too low. All that evidences that long-standing tendencies have not changed, with priority still given to the airspace sector.

So, the civil science should arrive by 2014 with the old system of priorities. That said, given sizeable allocations for defense research, the national scientific complex will most likely to keep focusing on the state as its major customer.

5.4.2. Changes in Organization of Academic Research: Research and Federal Universities

The reform of the public scientific sector which read that all the scientific organizations were to be split into three categories with respective managerial decisions tailored for each category[1], has not started in 2011. Changes were taking place only in the university sector of science, with the system of elite universities unfolding continuously. Last year, yet another

[1] For a greater detail, see: Russian economy in 2010. Trends and perspectives. Issue 32. – M.: the Gaidar Institute, 2011, p.381–382.

federal university was added to this category, namely the North-Caucasian one, thus making the total of 9 federal universities. The number of national research universities (NRU) remained unchanged, with development programs for some of them potentially set for some adjustment following results of their 2011 evaluation.

The evaluation of the NRU's progress in fulfillment of their development programs[1] started in the spring of 2011, with the emphasis put on the 14 pioneer universities which were granted the NRU status in 2009. The ultimate objective of the evaluation was to assess the universities' record of fulfillment of development programs they initially formed, to examine what objective and subjective challenges they faced, and how adequate to the goals of the evaluation in question the existing system of indicators was.

At the end of the day it was found that the NRU drafted their reports in such a manner that it was hard to judge qualitative results of their performance. That said, it became quite evident that most of them were still building on their past developments and know how. Furthermore, the expert evaluation of the federal and research universities' curricula revealed that only 14.7 and 13.7% of those, accordingly, proved to be of an adequate quality.[2]. The result is a consequence of both external reasons and the internal situation at the universities. As far as serious external causes, those are peculiarities and timelines of budget allocations for development programs. For example, in 2009, the funding was allocated with a significant delay to reach recipients in the fall of the year. In 2010, there arose a new problem: while in 2009 the financing was carried out following the budget estimate, in 2010 it was allocated in the frame of the FTP "Research and scientific-pedagogical cadres of the innovation Russia" for 2009-13, under the "Other directions" item. That resulted in extra costs for the universities, as those allocations were taxable. In 2011, a positive development was that it was already in July that the NRUs received all the federal budget funding due.

As the concept of research university *per se* suggests a vigorous development of research, it was critical to assess developments therein from the perspective of the faculty's increasing contribution to research. At some NURs, this indicator is higher than nationwide averages: e.g. at St. Petersburg State Mining University, up to 70% of faculty is engaged in research activities; the respective index at HSE is 45%, while the nationwide average is under 20. However, the objective is not just to boost the number of faculty engaged in research but also to change the volume and quality of the latter. In this respect, the number of papers indexed in Russian and foreign databases per one faculty member of the group of 14 universities has so far accounted for 0.7 (the median value for all the 29 universities was 0.58), ie. not even a single article per one faculty member. The best results in this regard were posted by MFTI and Tomsk State Polytechnic University whose faculty publish more than one article a year per one faculty member.

The other critical aspect of the NURs' operations which distinguishes them from other universities is international cooperation in education and research, attraction of cadres (both faculty and students) from overseas. The top 14 NRUs have not performed well enough in this respect and find themselves far below the commonly recognized international standards applicable to their peers overseas. According to the NRUs' reports, they believe success lies primarily in internships with foreign universities, academic exchange programs, contribution

[1] A special expert Commission was established to evaluate the NRUs' performance (Executive Order of the RF Ministry of Education and Science of 4 February 2011. No. 167 "On commission on evaluation of efficiency of implementation of programs of national research universities".

[2] http://www.best-edu.ru/directory-best.

to conferences, publication of research findings overseas, contribution to a string of projects, including, *inter alia*, the EU Framework Program, and - rarely enough – in conduct of joint research. The NRUs have no developed system of expansion of their international contacts, and only a tiny fraction of them has begun revising approaches to training in English. Prospects for bolstering the number of visiting foreign students from regions other than CIS appear fairly elusive, while just a handful of the universities can afford the luxury to attract a foreign specialist.

That said, the analysis of the NRU's performance shows there are no clear losers among them. Those universities that failed to report on a number of target indicators put forward quite logical explanations which do not evidence a given university's poor performance, which is why where the university fell short of attaining the planned value of the targeted indicator, it does not necessarily mean it failed on it. Furthermore, because of the original imperfection of the selected system of indicators, their absolutization is dangerous where a managerial decision is to be made. Plus, unification of indicators without regard to a given university's profile does not seem to be an unarguable decision. It is impossible to compare medical, technical and classical universities using one and the same metrics or one should thoroughly interpret quantitative data and be well aware of specificity of each given university's operations.

While addressing the issue of evaluation of universities' activities on implementation of development program, there arise problems as to how and by what parameters they should be gauged. The existing indicators exhibited a string of deficiencies, namely:

- they are not informative enough;
- there are many of them, but no cogent system is in place;
- integration between research and education is not assessed;
- universities employed different indicator calculation methodologies.

Plus, each NRU would set benchmarks on its own. Understandably, they proved too low, hence, easily attainable in some cases. From this perspective, one should have risen the standard primarily with regard to such indicators as the number of postgraduates from outside organizations, which reflects both the level of academic mobility as a whole and a concrete postgraduate course's attractiveness to prospective applicants from different universities, institutions and regions, the R&D volume per one faculty member, and publication activity.

The evaluation also exposed that at the stage of formation of programs, the university leadership had had no clear vision of both the Government's objectives and future moves to develop the national research universities system. Post-evaluation, the decision was made to modify methodologies of calculation of a string of NRU's performance indicators and introduce a few new ones to ensure a more comprehensive picture of the *status quo* at the universities. As well, some changes in the indicators were caused by new normative and legal documents which affect NRUs' operations. More specifically, in August 2011 NRUs were granted the right to send their faculty members and students to study overseas against the guarantee of their employment with Russian corporations, which resulted in a rise of the respective indicator.

In addition to the federal and research universities, the year of 2011 saw the rise of yet another group of "selected" ones, as 55 universities were awarded with up to Rb 100mn out of the federal budget for the term of up to 3 years (2012–2014) to fulfill their development programs. While selecting recipients, both a university's scientific and educational, as well as innovation capacity, and geopolitical importance were taken into account. That is why the support was granted to universities in the Caucasus and the south of Russia, among others.

In all, the volume of university funding was up 3.5-4-fold per one faculty member[1], but the university research fell behind that of scientific organizations, nonetheless. This is evidenced by the level of international cooperation expressed in the degree of engagement in it of staff of respective institutions. Thus, a survey on 3,450 PhDs and Drs at research institutions, universities and the corporate sector showed that 3.8% of university faculty is engaged in research at foreign organizations (for the term of up to 3 months) vs. 10.1% of staff at research institutions doing that too. As to joint publications with foreign authors, the respective rates are 10.5 vs. 22.1%, while judging such indicators as engagement in research projects and conferences overseas, universities' performance is twice as low as research institutions'[2]. A low efficacy of budget investment can be partly ascribed to the fact that the funding is channeled to universities which are bound to operate in accordance with strict and not yet changed rules (such as, for instance, a high tuition load rate, which hampers academic research), while expenditure items are too rigid. Hence, an insufficient efficiency of the system as a consequence of the rigidity of the system of its support.

5.4.3. Scientific-Educational Centers as a Form of Integration of Education and Research

In 2011, the Government continued to fund scientific-educational centers (SECs') operations. Established under universities and research institutions, over 1,300 SECs received support from the RF Ministry of Education and Science. Most of such centers operate under universities, while some ¼ - under RAS institutions.

In 2011, SECs supported by the Ministry in 2009-2010 underwent evaluation of their performance[3] .

According to the Ministry's documents, main objectives of allocation of the support were:

1) attainment of world-class scientific results across a broad spectrum of research;
2) shaping efficient and viable research teams wherein young scientists, postgraduates and students work hand by hand with the most effective researchers of older generations;
3) retention of research and scientific-educational cadres in the scientific sphere.

Indicators by which SECs report to the Ministry do not allow to judge whether the objectives of their support were attained, as the indicators in question are only quantitative ones, while the objectives were formulated in such a manner that evaluation of their attainment requires a quantitative analysis too. That is why there were objective limitations in the course of evaluation of the SEC's performance.

Attainment of world-class scientific results was evaluated chiefly by indicators of publication activity and the number of new educational programs. The respective scores proved very moderate, especially with respect to the indicator of publication activity overseas. There is a whole string of SECs without any scientific outputs. When compared with university SECs,

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[1] N. Volchkova. Two Quarters of Justice. Rectors are punished for small salaries // Poisk, No. 47, 25.11. 2011, p. 3.

[2] Shmatko N.A. Scientific capital as a driver of researchers' social mobility // Foresight, 2011, No. 3, p 18–32.

[3] The author ran the evaluation on the basis of data collected and processed by the National Foundation for Cadres Training. The scoring is based on information collected across two masses of SECs: 1) the ones that became victors in the 2009 competition (a total of 502 SECs) and 2) victors of the 2010 competition (809). The author analyzed the data as of late-2010.

academic ones performed far better. As for the university community, the situation varies by university, and the specific weight of SECs with no research output is greater than at the academic institutions. Interestingly, as evidenced by the specific weight of SECs which have had respective results, SECS are keen on research, rather than development of new educational programs.

Shaping efficient and viable research teams. Whether viable teams were formed is premature to assess right after financial support to SECs came to an end. However certain landmarks can be found by assessing the volume and composition of the attracted by SECs extrabudgetary financing, which can evidence the degree of their successfulness and potential of a sustained development. The analysis revealed that the SECs's extrabudgetary funds are formed largely by their own ones (it is universities where the specific weight of this particular source of funding is particularly high). The second critical source of finding is "Other" funds, including:

– agreements on delivery of services under the RF civil law;
– co-investors' funding;
– agreements on execution of works concluded between organizations;
– RFFR, RHSF's grants;
– target grants awarded under the EU 7th framework program.

Foreign funding constitutes a fairly meager part of financial support to SECs (under 5%); however, its "weight" at academic SECs is greater than at university ones. It should also be noted that the former SECs boast a greater variety of sources of financing than university SECs, which allows suggestion that the latter are less stable than academic Centers.

So, while assessing the SECs viability and sustainability from the perspective of composition of extrabudgetary funding sources, it can be ascertained that they rely largely on their own funds, which, on the one hand, evidences their future sustainability, while highlighting a small volume of extrabudgetary (including the Centers' own) financing, which is unlikely to increase in the future to a degree needed to ensure their substituting for the budget financing.

Retention of research and scientific-educational cadres in science and education

Attainment of this particular objective was assessed using specific weight of young staff employed specifically to complete a project under the aegis of a SEC. It turned out that the performance of the Centers supported since 2009 was in stark contrast with the one of the Centers supported since 2010. The average index of the proportion of young staffers employed for the said purpose made up 24% for SECs-2010 vs. 41% for SECs-2009.

In all, roughly a half of young researchers was hired to do the job, which proves a fairly high rate, given caps on payrolls at research institutions and universities. But it remained unclear for which term the young cadres accounted by the statistics were hired, as, according to the established procedure, the calculation is run only with regard to those who were "fixed" for the term of the project implementation, rather than given a full-time job at a research center or a university.

In addition to the evaluation of attainment by SECs of their goals, equally important is analysis of types of SECs which have currently emerged under Russian research organizations and universities, as well as examination of their strengths and which centers are missing. The research allowed identification of three basic types of SECs.

The first, most numerous, type of SECs includes those ones which demonstrate median-low performance in respect to major scientific-educational parameters. In such Centers, ex-students mostly stay on in the same organization where the Center belongs. Accordingly, no encouragement of mobility of cadres there, while research efficacy is poor, outputs and findings are not presented at conferences overseas, which is why the level of international relations is low. It can be asserted that such SECs operate in a slow mode. They ensure minimum results required for their support. This type of SECs can be tagged as centers of poorly efficient integration of research with education.

The second type boasts somewhat better results compared with the first one: such Centers are a bit more efficient with training of cadres, a greater number of their graduates find jobs at other universities, ie. diffusion of expertise and skills takes place there. That said, their scientific performance is poor too, and the emphasis is put mostly on education. Their international "visibility" rate is fairly low. To some extent it can be argued they may become resource centers for a short-term advanced training of cadres.

The third type incorporates the SECs with the highest indexes of R&D outputs. Such Centers are based mostly at RAS organizations, federal and research universities. They demonstrate a high degree of retention of young people in the scientific area. Such Centers are successfully engaged in the international research community (judging by the number of publications in foreign journals and presentations made at international conferences), and the proportion of foreign sources in their budgets is quite substantial. It is also possible to identify sub-clusters of SECs which are eligible for the title of international centers of research. There are just a handful of such SECs – some 10% of the aggregate number of examined Centers.

It should be noted that just 6% of SECs are engaged in commodization of their research outputs, which manifests itself in the average statistical structure of funding of SECs' operations: with 66% of the funding spent on research, another 23% is spent on education and only 10% - on commercialization, despite the fact that commercialization is the most resource-intensive exercise. SECs' business culture is still nascent. Traditionally, they practice patenting, but none of them has ever sold a single license. So, a Russian patent is still viewed as a means to secure the priority, rather than as a lever to engage results of intellectual activity into economic turnover.

5.4.4. Formation of a World-Class Scientific Base: Megagrants on Creation of University Laboratories

Megagrants on creation of laboratories at universities to be spearheaded by leading international experts[1] can be regarded as yet another vehicle to advance the university science, integrate research with education, and shape a world-class scientific base.

The peculiarity of the program lies primarily in the scope of its funding, which is in stark contrast with the one the RF Ministry of Education and Science typically awards to "routine" SECs without foreign leaders. The maximum volume of financing available for a "normal" SEC is Rb 15mn for the term of three years, while the said laboratories can apply for a Rb 150mn-worth grant for the same term. That said, requirements to their performance are even more lenient than those to SECs'.

In 2011, as many as 39 projects on creation of university laboratories were selected on the basis of the nationwide competition; thus, the number of the megagrant-supported laboratories totaled 79. During the competition, applications were reviewed by 1,299 experts of whom foreign ones accounted for 46.9% (609 persons). The contest rate was the same as a year ago,

[1] The program was launched in 20101. For a greater detail, see: Russian Economy in 2010. Trends and Perspectives. Issue 32.-M.: the Gaidar Institute, 2011, p. 376-379.

that is, 13 applications per project. The country-of-residence pattern of heads of laboratories (see *Table 15*) evidences that, like in 2010, preference was given to projects spearheaded by the diaspora representatives (more than a half of all the grants). The proportion of projects led by foreigners increased substantially, while just a sole Russian resident was awarded a grant (in 2010 – 5 ones). So, greater emphasis was put on attraction of foreign specialists per se to run laboratories, while megagrants appear particularly attractive to Russian-speaking specialists. For them, megagrants are not just extra funding enabling them to make another leap in their research field, but a possibility to frequent Russia and meet relatives and friends[1].

Table 15

Megagrants Allocation Pattern Depending on the Team leader's Residence

Team leaders' residence	Grants, 2010, as % to the total (N=40)	Grants, 2011, as % to the total (N=39)
Russian researcher	12.5	2.6
Foreign researcher	35.0	46.2
Foreign researcher – representative of the Russian-language diaspora	52.5	51.2

Source: calculated on the basis of the RF Ministry of Education and Science.

The year of 2011 saw intensification of the debate on two problems associated with attraction of foreign researchers: one of them concerned their age (whether it was mainly pensioners who came to Russia) and adequacy of assessment of qualification of attracted researchers using the h-index[2]. The data published at the closure of the competition for 2011 megagagrants showed that concerns about pensioners largely being interested in them were vain, as out of heads of 39 laboratories 41% aged 50 to 59 years and another 15.4% - 40-49 years. Meanwhile, the proportion of laboratory heads who aged 70 and above was 17.9%, which is not a small figure, albeit not a critical one.

As to the h-index, most experts reckon it does not allow assessment of an applicant's actual research qualification and should not be used as a selection criterion. According to Acad. G. Georgiev, "the Hirsch index is applicable to an active average Joe"[3].

Abstracting from precise metrics of foreign researchers' qualification, it should be noted that it was papers coauthored by Russian and foreign researchers that ensured the Russian science's higher level of citing of publications on the whole. As demonstrated by the data on citing of Russian papers published between 2003 and 2007, 93% of all the intensively cited papers was published in international co-authorship[4].

[1] Voropaev A. "Here I am back to my home town" // Science and Technologies in Russia. http://www.strf.ru/material.aspx?CatalogId=222&d_no=44701 18.01.2012.

[2] The h-index is an index that attempts to measure both the productivity and impact of the published work of a scientist or scholar. The index is based on the set of the scientist's most cited papers and the number of citations that they have received in other people's publications. The index can also be applied to the productivity and impact of a group of scientists, such as a department or university or country. The index was suggested by Jorge E. Hirsch, a physicist at UCSD, as a tool for determining researchers'' relative quality and is sometimes called the Hirsch index or Hirsch number. The index displays a proper accuracy only under comparison of researchers of the same field of science, as citation traditions differ across different branches of science. Like other bibliometric characteristics, the h-index is not strictly correlated with the researcher's profile and performance, because of string of parameters that bias its value, including for example time that has elapsed from the moment the article was published (this is why young authors cannot enjoy a very high h-index).

[3] G. Gergiev. The Hirsch Index should be crossed out from assessment of academia. http://www.strf.ru/material.aspx?CatalogId=221&d_no=43481 17.11. 2011.

[4] V. Pislyakov. High-class work//Poisk, No. 49, 9.12.2011, p.18.

So, like other kinds of international cooperation, megagrants should contribute to advancement of the national science. Besides, the initial megagrant outputs exposed a whole range of positive side-effects, namely: more attention is now paid to the English classes, research teams became more focused on a more efficient performance in the form of papers, and the culture of conduct of laboratory research started to change gradually. All these are steps towards the Western mentality which implies a constant proving of research credentials, rather than a lifetime resting on one's laurels upon winning certain positions and titles, as it happens in Russian science.

That said, the work under megagrants helped expose a number of challenges which need to be address to ensure a maximum efficacy of laboratories' performance. Those are, primarily, organizational and bureaucratic problems when it comes to procurement of equipment and reagents, customs procedures, invitation of foreign specialists for a short period of time (in that case they are not subject to the law on highly qualified specialists). As well, it was found out that a whole series of projects failed to regulate rights to created intellectual property objects.

Because of such challenges, heads of laboratories often were in a pensive mood. Here is a typical comment of one of victors in the megagrant competition: "*The efficiency of spending (vis-à-vis Western programs) is 10-15% at best*"[1].

The challenges, though, are not associated only with the situation where huge funding has been allocated while the operational environment is far less conducive than the one at Skolkovo. The approach implying creation of less than a hundred elite laboratories within universities where other research teams operate in a routine mode and on modest money may have a further adverse impact on the research environment in general. It should also be noted that stimulating measures on promotion of international cooperation so far have not centered on internationalization of Russian science, ie. on making sure international researchers work hand by hand with Russian colleagues at Russian laboratories. There appeared elite visitors in the national science, but no progress towards circulation of cadres has so far been in place. And if it were not enough, no internal circulation of cadres, such as, for instance, academic exchanges between different Russian universities, is encouraged, while such an initiative would be quite worth the federal budget support.

Presently, there is an ongoing debate on the possibility of spreading the megagrant program onto academic institutes under RAS. That would be a right move, provided the ultimate objective is to give a new look to the national science, rather than to "drag" university research to an acceptable level. The project aiming at ensuring a broader access to participation in the said program implies modifications of the size of funding available to laboratories: with a new format, it is planned to cut the federal budget allocations to Rb 60mn per laboratory.

5.4.5. Modifications in the Research Infrastructure of Science

The public scientific policy has increasingly centered on the "infrastructure" area, that is, supplies of equipment and apps for researchers' needs, including particularly complex and huge units, *aka* megascience. An important incentive in this process became the government's commitment to expansion of international cooperation in the research area, which suggests unique equipment and apps at hand.

[1]Sterligov I. New claims by owners of megagrants. http://www.strf.ru/material.aspx?CatalogId=221&d_no=42123 06.09.2011.

In Russia, one of popular forms of research infrastructure support is centers for collective use of equipment (CCUE). Originally, they were established to ensure research process in the conditions where every given research institute was unable to have much-needed equipment and apps. Plus, CCUEs became home to costly equipment that cannot be bought in mass quantities, while Centers made them available to a broad array of users. Presently, CCUEs also became a minor, albeit critical to research organizations source of extrabudgetary funding. Numerous initiatives sponsored by the RF Ministry of Education and Science suggest extrabudgetary financing. It is common knowledge that research organizations and universities are short of extrabudgetary funding, while the industrial sector is keen to sponsor corporate research only. That is why incomes from provision of services using the CCUEs' equipment forms one of very few genuinely extrabugetary sources of financing. According to the Ministry, assignments the CCUES network fulfills include, on average, at 77% academic research projects and at 23%- delivery of services.

CCUEs can form a pivot to a further advancement of the research infrastructure, should the approaches to their financing and monitoring be modified. That said, CCUEs have so far evolved only from the perspective of increase in allocations for equipment purchases, while to date there has been no comprehensive assessment of their performance and operational efficiency.

Indeed, while the RF Ministry of Education and Science annually collects a string of formalized metrics with regard to CCUEs' performance[1], there were no public assessments of their operational efficiency, including, *inter alia*, an assessment of unique apps installed therein.[2] What's worse, the precise number of up and running CCUEs remained unknown, for there is no clarity as to which organizations qualify for this status. Even the website of the RF Ministry of Education and Science displays controversies in this regard. More specifically, judging the list of CCUEs, which comprises resource centers, technoparks, among other centers, their ultimate headcount is 418[3]. Meanwhile, an interactive map of the country posted on the very same web-site displays less than a hundred of them, including unique apps. Some experts hold there currently are between 43[4] and 63 CCUEs in the country (apparently, those ones that received target funding from the Ministry), with 11 centers in possession of 30% of all the research equipment placed with CCUEs [5]. Lately, when the RF Government has begun allocating substantial funding for purchases of research equipment, numerous structures

[1] The Ministry requests the following kinds of CCUEs' performance indicators: the number of staff, including those holding a degree; equipment loading rate; costs of works; list of methodologies; the list and costs of works; the list of R&D projects, volumes of of their financing and conformity with priority avenues; the list of corporate users; the list of publications, research theses and patents produced with the use of the CCUEs' equipment. Source: http://ckp-rf.ru/news/science/Ezhegodnyj_monitoring_effektivnosti/

[2] In his paper «Methodological approaches to assessment of centers of collective use of research equipment» (published in almanac «Science. Innovation. Education», issue 9, 2010 PP. 189-202), A.B. Gusev suggests a methodology of assessment of CCUEs, including their operational effectiveness; however, the paper fails to cite results of such an assessment, even a selective one. Official presentations by the RF Ministry of Education and Science offer a general perspective on capacity of the supported by the Ministry CCUEs, but not on their efficiency.

[3] Most such CCUEs operate under universities, while in the corporate sector, there are just 11 CCUEs, including at 9 universities that have the status of public scientific center (PSC). Source: data of the RF Ministry of Education and Science.

[4] Centers of collective use of research equipment in the sector of modern research and development. http://www.fcpir.ru/doc.aspx?DocId=970

[5] On the basis of oasis. CCUEs quench the thirst for knowledge// Poisk, No. 10, 5 March 2010, p.7.

rushed to declare themselves centers for collective use and the competition for funds on support of the infrastructure has grown very fierce. That in turn potentially lowered chances for continuation of receipt of funding out of federal sources for the CCUEs for already several years in operation (though such funding has not ever been guaranteed for more than 1-2 years).

The question of the CCUEs' operational efficiency appears yet a more confusing one. That certain capacity enabling one to efficiently conduct research on the basis of CCUEs is there raises no question: according to the RF Ministry of Education and Science[1], the average age of CCUE equipment is 8 years, or twice as low as nationwide, while the technical capacity rate of researchers in such centers is nearly 8-fold greater. So, CCUEs form one of the most progressive kinds of research infrastructure in Russia. Meanwhile, expert estimates suggest that there are just a handful of efficient CCUEs in Russia, even without regard to differences in interpretation of their efficiency *per se*. According to a number of CCUE directors, such centers prove efficient only when their equipment loading rate reaches its absolute peak[2], which is not quite typical of all the centers. Another interpretation suggests that CCUEs are efficient at organizations that have built sound financial and operational models[3]. That said, many centers fell short of formalizing procedures of granting users with access to their equipment, nor there are normative and legal documents determining forms of organization of such centers and interaction with them[4]. As a result, CCUEs’ equipment is not used in an optimal way. Lastly, their operational efficiency depends on organizational peculiarities of their operations. CCUEs have so far been centers of provision of individual gauging services or the basis of implementation of individual fragments of research projects, rather than project research centers (the way they largely operate overseas)[5]. Plus, practically all the CCUEs face such systemic challenges, as lack of funds to compensate for equipment operators' labor costs and to procure spare parts and maintain equipment.

In the US, from where the concept of CCUEs was partially borrowed, the fundamentals of their financing, operations and assessment of operational efficiency offer stark contrast to the Russian practices. One of key agencies supporting the university-based research infrastructure, the National Science Foundation, sponsors establishment of a variety of centers for collective use which form the basis for interdisciplinary research. Presently the US federal budget allocates support to seven kinds of such centers: Centers for Analysis and Synthesis, Centers for Chemical Innovation, Engineering Research Centers, Material Science Centers, Nanotechnology Research Centers, Technology Research Centers, and Education Research Centers. Within each category, the number of centers varies strongly: from 29 Material Science Centers to 2 Centers for Chemical Innovation. In any case, they are not counted in hundreds, like in today's Russia. More than that, the number of government-backed CCUEs in US has recently slightly dwindled, as the Administration is keen to secure robust funding for the strongest centers with the most promising research projects.

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[1] Data for 2007-2010 гг. http://www.fcpir.ru/doc.aspx?DocId=970
[2] Bykova N. The sunshower for CCUEs. http://ckp-rf.ru/news/science/Ezhegodnyj_monitoring_effektivnosti/ 20.09.2011.
[3] Axenova L. Just a handful of efficient CCUEs. http://strf.ru/material.aspx?CatalogId=221&d_no=42105 05.09.2011.
[4] Golichenko O.G., Kleiner G.B., Samovoleva S.A. An analysis of implementation of main avenues of the public innovation policy in Russia (2002-2010). M.: TSEMI RAN, 2011. P.49.
[5] Gorbatova A. A non-for-profit effect. http://strf.ru/material.aspx?CatalogId=37188&d_no=42310 16.09.2011.

The NSF awards grants to each Center in the region between USD 2m and 5m a year, and such a support is provided over a long period of time (usually, in a span of two 5-year long cycles). The NSF encourages cooperation between different participants, Centers' delivery of business services, and creates incentives for their sustainable operations in future, which should be secured through diversification of sources of financing.

The structure of spending of the grant funding of the Centers' operations is worth a particular notice. While in Russia the bulk of funding is spent on equipment purchases, the US Centers spent on that an average 12% of the NSF grant, with the bulk of financing, some 60-65% of the grant, being spent on labor compensations to students, postgraduates, and postdocs[1] working at a Center and, partly, on university professors' salaries[2]. That equipment purchase costs appear relative small can be ascribed to the Centers being established, as a rule, on the basis of universities that already are in possession of a modern material base. Established at different times and with an emphasis on different areas, the Centers are currently linked to each other and even integrated into a single nationwide shared facilities network.

Equally important factor is that the NSF periodically monitors the Centers' performance, with contribution to advance discovery and broader impacts as major criteria. There are just a few quantitative indicators, while the major assessment is expert, informal one, with the quantitative indicators being interpreted in the context of the Center's specialization and other operational peculiarities. That is why support is extended to very versatile centers, be those monospecialized or diversified, large or small ones. This ensures the much-needed degree of flexibility of the system of material support of research.

The development of the apps base of research in Russian public sector, including, in particular through CCUEs, appears uncoordinated, and a systemic approach to its shaping and renewal is missing. This results in duplication of equipment and in the number of very expensive units not operating at full capacity. These problems were not tackled in 2011, nonetheless, with the Government shifting the focus of attention onto building megascience apps.

Indeed, significance of such centers for the country is hard to overestimate, for they enable one both to obtain fundamentally new research products and technologies, and breakthrough discoveries across a broad array of subjects. By bolstering international cooperation, arresting the brain-drain, and, potentially, forming the basis for the rise of innovation clusters, such centers engender an inflow of qualified cadres.

The Russian Government appears divided on the issue of the path dependency with respect to megascience apps. While some members of the Cabinet believe it is imperative to build supercenters similar to CERN and the likes, others propone the need to strengthen a number of existing infrastructure facilities so that they would be able to cope with the tasks complementing experiments run at the largest international centers. In all likelihood funds will be allocated to beef up the existing capacities to tackle individual problems for the sake of furthering studies into subjects performed using the largest overseas apps. The Government has already approved establishment of at least six facilities to complement international megas-

[1] Postdoc is an acronym for Postdoctoral Fellowship , which is a stipendium for a fresh PhD for a 1 to 3 year-long internship with an overseas university or a research center different from the one where his/her PhD was awarded. Accordingly, the successful applicant for Postdoctoral Fellowship is also called Postdoc (with the official title being Postdoctoral Fellow).

[2] The National Science Foundation's Material Research Science and Engineering Centers Program: Looking Back, Moving Forward. National Research Council of the National Academies. The National Academies Press, 2007.

cience ones, of which two facilities will be located at institutions under the auspices of the RRC Kurchatov Institute[1].

It is important to make sure the funding of new apps is concomitant with solutions to the problem of approaches to, and mechanisms of, their operation. Continuation of the policy that provides for allocation of budget funds exclusively for the purpose of equipment purchases along with cutting costs of its further use and scaling back the maintenance staff and operators payroll will substantially lower the potential of use of new research infrastructure facilities.

5.4.6. Small-Sized Innovation Businesses

The year of 2011 saw no unambiguous assessment of the process of advancement of small-sized innovation businesses. With no uniform database on their performance, any assessments are based upon a set of more or less random evidence, which is why observations that claim such businesses are on the rise co-exist with those suggesting the opposite. Contraction in the number of SSIBs is typically explained by the continuous crisis and the consequent fall in small businesses' activity (as evidenced, in particular, by assessments made by EBRD and OPORa of Russia). Meanwhile, expansion of small businesses is often ascribed to the role played by institutions of development whose number, as well as the rainbow of programs they are implementing, is on the upsurge, and with a changing normative-legal environment for SSIBs' functioning, primarily for those of them which were founded in compliance with Federal Act No. 217-FZ[2].

According to the data on registration of SSIBs established in compliance with the above Act, their number continued to rise and stood at 1,250, of which research institutes became founders only in 39 such firms, while the others were established by universities[3]. Results of the monitoring run by the RF ministry of Education and Science suggest that roughly one-third of these firms are operational, rather than established for the sake of reporting to the Ministry[4]. The surging number of companies established exclusively for the said purpose remained a persisting challenge. Furthermore, in 2011, the size of the companies' authorized capital continued to shrink, which is most likely to suggest further increase in the share of "paper" companies.

Meanwhile, the normative-legal regulation of companies established under research institutes and universities kept on improving, and more favorable conditions of financing were established for them when compared with other small-sized firms. More specifically, the management of the Foundation for assistance to development of small form of enterprises in the scientific-technical sphere noted that support of the firms established in the frame of Fed-

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[1] Sterligov I. Megascience will cost the nation Rb 133bn. http://strf.ru/material.aspx?CatalogId=221&d_no=40914 06.07.2011. Sterligov I.V. The Russian Ministry of Education picked six megascience finalists. http://strf.ru/material.aspx?CatalogId=37188&d_no=40541 24.06.2011.

[2] Federal Act of Russian Federation of 2 August 2009 No. 127-FZ "on introducing amendments to individual legislative acts of Russian Federation on matters of creation by budget research and educational institutions of economic companies for the purpose of practical application (introduction) of results of intellectual activity"

[3] Gorbatova A. "Minors" always have the green light here. http://strf.ru/material. aspx? CatalogId=223&d_no=44139 20.12.2011.

[4] Sterligov I. One-third of small-sized companies under universities exists on paper only. http://www.strf.ru/material.aspx?CatalogId=223&d_no=41450 02.08.2011.

eral Act No. 127 forms a priority task for the Foundation. As of early 2011[1], financial support was granted to more than 100 of such companies, while by the end of the year more than 350 SSIBs had received funding from the Foundation[2] by winning respective competitions 3.5 times oftener than other small-sized firms.

The list of normative-legal novelties comprises the following ones:

1. Corporations established under Federal Act of 02.08.2009 No. 217-FZ are permitted to employ a simplified taxation system (per Federal Act of 27.11.2010 No. 310-FZ); in particular, they may pay corporate profit tax at the rate of 6%. Plus, in compliance with Federal Act of 16.10.2020 No. 272-FZ[3], they can enjoy benefits with regard to insurance premiums (in 2011-2017, the insurance premium tariff for such organizations will be 14%, in 2018 - 21%, and in 2019 - 28%).
2. In compliance with Federal Act of 08.05.2010 No. 83-FZ[4], budget institutions now have a possibility to contribute with cash, equipment and other assets with a value of up to Rb 500,000 to authorized capital of created economic companies.
3. Federal Act No. 22-FZ[5] grants to budget institutions the right to rent out to economic companies temporarily idle assets and facilities without holding a tender or an auction.

Meanwhile, according to the procedure of conclusion of the rental contract[6], while entering in such agreements with respect to federal assets (except for those of the state academies of sciences), the size and procedure of payment of rental charges are set following the conditions below:

a) year one into the agreement– 40% of the amount of the rental payment;
b) year two – 60% of the amount of the rental payment;
c) year three – 80% of the amount of the rental payment;
d) year four and thenceforward – 100%of the amount of the rental payment.

That said, it was just a handful of small firms that managed to take advantage of the benefits in question and switch to the simplified taxation regime in 2011, as the Acts had become effective right before the deadline for submission to tax authorities of the respective notification for the next year. That is why it is premature to judge how the tax novelties have affected the state of affairs in the area of small investment business.

Thanks to legislative novelties, the possibility to establish SIBs with participation of research institutions or universities as their founders became more appealing to large corpora-

[1] "Start" in a new manner. Interview with S.G. Polyakov, Director General of Foundation for assistance to development of small form of enterprises in the scientific-technical sphere //Innovation, 01.02.2011. http://fasie.ru/mass_media/Pressa_o_nas_stat_/press_stat_start-ponovomy.aspx

[2] Gorbatova A. "Minors" always have the green light here. http://strf.ru/material.aspx?CatalogId=223&d_no=44139 20.12.2011.

[3] Federal Act of 16.10.2020 No. 272-FZ "On introducing amendments to the Federal Act "On insurance premiums to the Pension Fund of RF, the Social Insurance Fund, the Federal Fund for compulsory medical insurance and territorial funds of compulsory medical insurance" and Article 33 of the Federal Act "On compulsory pension insurance in RF".

[4] Federal Act of 08.05.2010 No. 83-FZ "On introducing amendments to individual legislative acts of RF in connection with improvement of the legal status of public (municipal) institutions).

[5] Federal Act of 01.03.2011 No. 22-FZ "on introducing amendments to Article 5 of Federal Act "On science and the public scientific-technical policy" and article 171 of Federal Act "On protection of competition".

[6] Procedures of conclusion of leasing agreements with respect to public and municipal assets of public educational institutions of tertiary vocational education (including those established by state academies of sciences) or municipal institutions of tertiary vocational education (including those established by state academies of sciences). Approved by Resolution of the RF Government of 12.08.11 No. 677.

tions too. They de facto were given a new way to optimize their R&D-related taxes by incorporating their R&D into small-sized enterprises established jointly with a research institution or a university. On the one hand, this can be viewed as tax dodging, but, on the other hand, if an enterprise is established to develop products and technologies the corporation needs, such a partnership optimizes the R&D logistics and helps drive research and business closer to each other. Notably, such ties emerge on their own, without government's interference or special compulsive measures.

5.4.7. Large Corporations: Creation of the System of Incentives to Innovation

It was in 2011 that after a long period of negligence large corporations exhibited a growing interest in innovation activities, with the focus of their attention being on holding or commissioning R&D, rather than technology purchases. Apparently, their production renewal resources and borrowing overseas in the first place were about to exhaust, especially for corporations competing on international markets. Thus, according to a PriceWaterhouse Coopers's survey, 58% of Russian companies operating on the domestic market have innovation technologies in their portfolios, while for those operating both in Russia and overseas the respective index is 85%[1]. A series of interviews the NRU HSE's Institute of Management [2]ran on 22 large industrial corporations revealed that none of them scaled back on R&D spending. Rather, they displayed a "renaissance" of interest in the domestic sector-specific research.

That said, nationwide, the average statistical "interest" of the business sector in funding R&D has not been great, which can be evidenced by the dynamic of extrabudgetary funding of R&D with regard to projects implemented under the aegis of FTPs. The planned volume of the 2011 allocations for extrabudgetary financing of measures under the target programs dwindled vs. the respective figures for 2009 and 2010. Some decrease in the absolute volume of extrabudgetary financing on FTPs can be partially attributed to modification of the composition of respective works. More specifically, the specific weight of the component known as "generation of expertise", which does not require extrabudgetary financing, was on the rise.

It cannot be ruled out that exposed by surveys corporate sector's interest in remnants of the sector-specific research and outsourcing of R&D is dictated by new government measures aiming at sgrengthening ties between businesses and the public scientific sector (primarily, universities). In this respect it is possible to single out four major measures which appear to some extent intertwined:

- Investment development programs (IDP) (47 large companies);
- Collaboration with universities on conditions established by Resolution of the RF Government of 09.04.2010 No. 218[3];
- Contribution to technological platforms[1] (28 technical platforms to which 200 universities and 300 research institutions contribute)[2];

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[1] V. Saraev, D. Medovnikov, T. Oganesyan. What cannot be sold is developed//Expert No. 44, 7-13 November 2011, p.22.
[2] R&D management in Russian companies. The National Report.- M: Association of Managers, 2011, p. 30-31.
[3] Resolution of the RF Government of 9 April 2010 No. 218 "On measures of state support of development of cooperation between Russian Institutions of tertiary education and organizations implementing complex projects on creation of hi-tech production".

- Employment of measures of indirect regulation of innovation activity.

In Russia, according to interpretations by official representatives of the Ministry of Education and Science and the Ministry of Economic Development, the purpose of the cooperation is not just to expand connections in the research and production sphere but restoration, at least, across a range of directions, of sectoral science, which was lost in the post-Soviet time, including, *inter alia*, by means of its partial "transfer" to universities. Indeed, the progress in this direction is already visible: 67% of companies with annual earnings over Rb 1bn already interact with universities and corporations established under their auspices; meanwhile, their cooperation with sectoral and departmental research institutes was a bit less intense, with the respective figure accounting for 56%[3].

Indeed, according to the data on large corporations' innovation development programs (IDPs) (*Table 16*), volumes of financing they should allocate for universities will be constantly growing. It is envisaged that expansion of the outsourcing practice should help overcome the internal monopolism at corporate R&D divisions and bolster the efficiency of R&D spending in the corporate sector, while concurrently fueling university research.

Table 16

Corporate Innovation Development Programs: Increase in the R&D Outsourcing to Universities

	2010	2011	2012	2013	2014	2015
Volume of R&D financing by corporate innovation development programs, as Rb bn .	82.9	227.6	291.9	344.1	330.7	304.6
Volume of financing allocated to universities, as Rb bn	2.9	11.5	16.5	20.2	21.0	22.8
Proportion of R&D financing allocated to universities, as %	3.5	5.0	5.7	5.9	6.3	7.5

Source: data of the RF Ministry of Education and Science.

It should be noted that much attention was paid to public corporations' innovation development programs. The RF Government is going to make them catalysts of the business sector's activity in the research and innovation area. In this connection, Prime Minister V. Putin believes that it is imperative, "to tightly link the corporate executives and leading managers' compensations to attainment of key indicators of innovation development" , while, at the same time, extending the list of enterprises with government participation which shall devise innovation development programs.

Currently the corporate plans in question appear fairly tentative, as, objectively, the planning time-frame, as a rule, is limited by no more than three years. R&D financing projections are in many ways associated with the anticipation of budget support, which is particularly true as far as defense corporations are concerned. Indeed, some 60% of the R&D spending by the corporations that have developed IDPs is formed by budget funds . Lastly, IDPs have so far

[1] Out of 47 companies that developed IDPs 37 ones contribute to technological platforms and 9 are coordinators of technological platforms. Source: Meeting of the Government Commission on hi-tech and innovation. 30 January 2012. http://premier.gov.ru/events/news/17904/

[2] Problems of formation of technological platforms are discussed below (see sub-Section 5.5.9).

[3] According to a questionnaire survey on 100 large, small- and medium-sized corporations run by the Association of Managers. Source: R&D management in Russian companies. The National Report.- M: Association of Managers, 2011, p. 38.

appeared loosely coordinated with corporate strategic plans (where the latter exist), as well as with financial plans which are typically developed for just one year.

There also exist challenges to expansion of the cooperation between corporations and universities under IDPs. Those are: a low quality of the university R&D and its management, the external authors' unpreparedness for taking into account corporate requirements, etc. That was exposed by a survey on members of the Association of Managers and the one on companies and universities collaborating in the frame of Resolution of the RF Government of 09 April 2010 No. 218, which is running at the time of preparation of this paper. The search for a "perfect match" appears in many regards a random one, which is why corporations find it difficult to identify university contractors for their R&D even on the basis of competition. That said, 96% of the corporations that developed IDPs included universities in their R&D co-suppliers lists. The same proportion of corporations is going to cooperate with research institutions, which, however, is likely to be a form of the R&D outsourcing, rather than a genuine partnership, which is evidenced by the fact that it is only 17% of corporations that plan a joint use of research an experimental capacities at universities or at their own enterprises.

Innovation development programs suggest using a system of monitoring developed in 2011. Monitoring will be run on the basis of a set of indicators a part of which is to be reported on the quarterly basis. That said, every agency is keen to know different aspects of corporations' performance and prioritize different indexes: e.g., the Ministry of Education and Science seeks to promote cooperation between the corporate sector and research institutions and universities, while sectoral ministries emphasize the importance of getting the programs aligned with sectoral development ones, etc. Overall, like other numerous "performance assessment" methodologies, the monitoring in question is based upon assessment of costs, rather than outputs. Clearly, there are too many indicators in this case, which antagonizes companies. Indeed, the data collection and processing methodology appears so sophisticated that companies will be compelled to hire a group of professionals to ensure timely reporting. The quarterly reporting in turn does not match innovation introduction cycles, as it makes it hard to judge results of novelties. Hence, the danger of profanation, as the trustworthiness of data reported would be hard to examine. Perhaps it would make sense to cut the number of indicators to ensure a greater quality of the exercise.

The year of 2011 also saw the indirect regulation of innovation activities unfold, but it is premature to assess its effects. The situation with regard to instruments of indirect regulation is uneven: while tax benefits advance and are adjusted, the development of technical regulations finds itself at a stage close to stagnation. Accordingly, problems exacerbates. Thus, for example, technical regulation in the road construction sector has not been updated over the past 20-30-plus years[1], which means that any attempt to introduce anything innovative would be regarded as a violation of the regulation. This problem also popped up with the launch of the work on Resolution of the RF Government of 9 April 2010 No. 218, and similar comments were received in response to a survey the Association of Managers[2] ran on corporations. More specifically, the survey demonstrated that the standards comprised obsolete requirements and excessive detalization, while the use of State Standards of the 1970-80s *de facto* meant "the ban on the use and application of new technologies". Novelties in the technical regulation area have so far fell short of justifying themselves, as the possibility for appli-

[1] S. Kulikov. Novelties were let to drift in a paper sea//Nezavisimaya gazeta, 09.02.2011 p.4.
[2] R&D management in Russian companies. The National Report.- M: Association of Managers, 2011, p. 70–71.

cation of new measures has not been ensured. Thus, companies are not ready to use the recently introduced European standards and technical specifications, as the procedure of transition to them has not been specified both to them and certification authorities.

5.4.8. Development Institutions in the Concept of "Innovation Lift"

In 2011, the concept of "innovation lift"[1] became popular with the Government. According to the concept, at every stage of the idea's lifecycle – from fundamental and applied research to development, prototyping, commodization – there should be institutions and structures to back these stages, thus ensuring the accompaniment of a given project or idea.

In 2011, the "innovation lift" was complemented by another two development institutions, that is, the restored Russian Fund for Technological Development and the Agency of Strategic Initiatives. However the other institutions continued operating too. Those primarily were the Russian Venture Company, ROSNANO, the Fund for Assistance to Development of Small Forms of Enterprises (hereinafter referred to as the Foundation for Assistance), and Skolkovo Foundation. This comment is needed, because last year saw the rise of a trend to label any organization or even an instrument that affects the sphere of research and high-tech as "institution of development". Because of that, the tag was also put on research foundations and even FTPs, albeit the latter constitute a mechanism of financing, rather than an institution.

So far a grave problem was that like within the national innovation system on the whole, the "innovation lift" comprises numerous elements, but ties between them appear specific and inefficient. Institutions duplicate, rather than complement, each other, across a string of directions, which is why it is hard to arrange projects moving from one development institution to another. Thus, only very few of thousands of small-sized firms' projects supported by the Foundation for Assistance were granted a subsequent funding from ROSNANO[2] or via venture funds established by RVC[3]. Furthermore, in the venture financing sphere, the search for projects was gradually replaced by the quest for companies with promising technologies, for representatives of development institutions tend to believe that there was too little a number of worthwhile projects[4]. Thus, for example, the RVS's Fund for Seed Investment approved just 20 projects in 2011, or roughly the same number as a year before (19 projects)[5]. In other words, the magnitude of operations was small and did not expand.

That said, the cause for a loose succession may also lie in stringent conditions of financing offered by RVC and even more so – by ROSNANO. Until recently there had been yet another remora to advancement of the venture business, namely, the absence of adequate forms of its

[1] The concept of "innovation lift" was *de facto* used back yet in 2009 and the need for its formation was cited, for example, at meetings of the Commission on technological development and modernization of Russia. See, for example: http://kremlin.ru/transcripts/6108

[2] Thus, out of 83 projects approved by ROSNANO only 16 had been earlier approved by the Foundation for Assistance. Source: "Start" anew. Interview with S.G. Polyakov, Director General of the Foundation for Assistance//Innovations.01.02.2011. http://fasie.ru/mass_media/Pressa_o_nas_stat_/press_stat_start-ponovomy.aspx

[3] According to Yan Ryazantsev, Director of Department of Investment and Evaluation of JSC "Russian Venture Company", there are only a handful of recipients of federal and regional grants among projects awarded financing from venture funds with participation of RVC. Source: D. Mindich. Getting innovation into the region// Expert, No. 27, 11-17 July 2011, p. 58.

[4] See, for example, Gorbatova A. Venture projects under the Russian jurisdiction? http://www.strf.ru/ material.aspx?CatalogId=223&d_no=43796; D. Mindich. Getting innovation into the region// Expert, No. 27, 11–17 July 2011, p. 58.

[5] Data as of 17 December 2011. Source: the list of projects approved by the RVC's Fund for seed investment.

organization, which would have enabled one both to launch a business and drop it without sophisticated bureaucratic complexities. Some changes in this respect took place in late 2011, and they soon should have a positive effect on development of the national venture industry.

Between November and December 2011 two Federal Acts were passed – namely, "On investment partnerships" (of 28.11.2012, No. 335-FZ) and "On economic partnerships" (of 03.12.2011 No. 380- FZ). Both Acts should become effective as of 2012. Investment partnership is a well-known worldwide means of organization of collective investment without the formal incorporation, and its emergence should facilitate Russian entrepreneurs' development of investment business. By its form, economic partnership appears similar to a Western LLC, and this novel form expands prospective investment mechanisms, which should become more attractive and understandable to foreign investors.

It should also be noted that the development institutions' operations should not be narrowed down to a mere selection and financing of projects. Indeed, all of them are also engaged in complementary initiatives: from contributing to development of the technological infrastructure and holding various educational events to popularization of breakthroughs in research to support of business papers. That said, businesses have so far eyed development institutions *"as moneybags, extra sources of financing, rather than partners able to help promote innovation with their expertise, background, business contacts, and organizational capacity"*.[1]

Underpinning this conclusion is in part an insufficient degree of transparency of the development institutions' operations, despite a broad publicity of a range of their projects and initiatives. At the same time, it is hard to discern their funding priorities, decision-making principles and, accordingly, it is difficult to judge not even their performance, but, at least, the quality of resources at their possession. That said, they exhibited a visible progress in certain directions, including growing interest in support of the investment infrastructure, formation of divisions and structures under foreign jurisdictions which would help penetrate international markets, attempts to better coordinate their operations. With regard to coordination, experts believe[2] its effects so far have been two-fold: on the one hand, where executives of one development institutions sit on another one's board, this bolsters the level of their mutual understanding, while demotivating one to objectively assess the colleagues' performance, on the other.

Agency of Strategic Initiatives

"Agency of strategic initiatives on promotion of new projects" (ASI) was established pursuant to Prime Minister V. Putin's executive order[3]. The Agency focuses on implementation of strategic initiatives on support of societally significant projects for medium-sized businesses across a range of key directions, including two ones that directly center on fostering innovation, including the technological one. Those are "Support to medium-sized businesses"

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[1] R&D management in Russian companies. The National Report.- M: Association of Managers, 2011, p. 57.

[2] Cited by: Yu. Simachev. A presentation at the dispute club of ANTSEA "Economic policy knots" by the topic "Interim results of development institutions' progress".Moscow: MSU, 19.01.2012.

[3] Executive Orders of 17 May 2011 No. VP-P16-3168 (item 15) and of 27 May 2011 No. VP-P13-3511. The ASI's Charter and the composition of its Supervisory Board were established by Resolution of the RF Government of 11 August 2011 No. 1393-r.

(including the “Promotion of hi-tech medium-sized business on global markets” initiative) and “Young professional cadres” (the “System of support of leaders and talents” initiative)[1].

ASI kickstarted in the autumn of 2011, and it is not still clear how it is going to support projects. In all likelihood, funding is going to be mixed, that is, public-private one. Meanwhile, it is already known that the ASI’s Expert Council will consider only business projects worth minimum a total of Rb 300mn, with the applicant being bound to invest therein no less than 10% of funding of his own[2].

The groundbreaking initiative – training overseas of up to 10,000 specialists a year over the next 10 years – sparked the expert’s controversial reaction and once again compelled them to consider the degree of the overlap between different departmental initiatives.

Strikingly, the RF Ministry of Education and Science had been designing practically the same initiative before ACI was founded. In April 2011, the Ministry was gearing up for implementation of the President’s executive order to send for training overseas 10,000 students over the next decade[3]. The Ministry’s approach was to send those student who would subsequently be keen to return and work in the research or business sphere, which suggested, accordingly, co-sponsorship of such internships by universities and business. ASI modified the concept and produced a fairly simple, albeit large-scale, scheme, that is, to have up to 10,000 students a year earn Masters or PhD overseas over the next 10 years at the RF Government expense and somehow get them back home (no mechanisms of their return have been designed so far). This ambitious endeavor would demand USD 5bn in a span of 10 years, and this amount would be sufficient to implement far more imperative and less controversial projects, such as, for example, restoration and development of several engineering universities or world-class laboratories, etc. ACI did not care to provide a rationale for appropriateness of the project, nor did it make available a comparative efficiency of possible approaches to boost of the human capital quality.

Russian Fund for Technological Development

The year of 2011 saw the Russian Fund for Technological Development (RFTD) renew its operations for the first time since 2008. RFTD is to form yet another component of the innovation lift by funding final stages of R&D, creating and testing experimental models and prototypes. In the frame of this model, RFTD “captures” successful research projects and project companies which have grown from the start-up level to catapult them to the state of commercially viable firms capable to advance at the expense of their own capital or by attracting credits on the market.

According to the approved by the RF Government on 7 September 2011 “Strategy of innovation development of Russian Federation” (the Strategy), RFTD should stimulate the rise of non-governmental R&D which are understood as a gradual increase in “both non-governmental organizations and the share of funding coming from non-public sources, from the entrepreneurial sector’s funds in the first place”. More specifically, it is suggested that together with other structures RFTD will sponsor applied R&D, primarily corporate ones. That said, in the frame of its operations there will be secured:

1) disbursement of long-term (for 3-5 years) loans for R&D at a preferential rate;

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[1] http://www.asi.ru/agency
[2] http://www.izvestia.ru/news/504218
[3] Poisk, No. 16, 22.04.2011, p.4.

2) consulting and methodological accompaniment of the projects.

The Strategy holds that "RFTD will combine provision of financial support to corporations' innovation activities with delivery of services and formation of conditions necessary for boosting the efficacy of the corporate technological management, shaping up corporate R&D centers, corporate venture funds and other modern innovation management institutions". Lastly, RFTD was assigned to provide *institutional, organizational and consulting support to the functioning of the technological platforms* included in the list.

RFTD is currently launching operations along four major avenues:

- selection, on the basis of a respective evaluation procedure, and financing with its loans of corporate R&D projects, with the funding to be repaid within 5 years from the moment of its disbursement;
- provision of information and consulting assistance to projects under development;
- provision of institutional, organizational and consulting assistance to the technological platforms' functioning and funding of R&D projects presented by them;
- teaming up with the Agency of Strategic Initiatives in disbursing loans to medium-sized businesses, provided there is a large consumer of their innovation produce.

So, the RFTD's mandate is ample and versatile, while its financial capacity appears fairly limited, particularly vis-à-vis other development institutions (*Table 17*).

It is planned that amounts of RFTD's loans will vary from Rb 10mn to 300mn. Applications for funding are set to pass through 4 kinds of examination: science-technical, technological (technological audit), financial and economic, and legal examination. The evaluation system is built quite efficiently, as it allows completion of the project assessment within 4-5 months, ie. from the moment the applicant's registration at the RFTD website to disbursement of the loan. The key factors affecting the length of consideration of applications are the quality and adequacy of the borrower's business plan and Terms of Reference.

Table 17

Budgets of Development Institutions Implementing Programs of Support of Research, Technological and Innovation

Organization	The 2012 budget, as Rb bn
Fund for assistance to development of small forms of enterprises in the research and technical area	4,0
Funds established by Russian Venture Company	30 (the RVC's aggregate budget)
ROSNANO	22,2
Scolkovo Foundation	22,0
RFTD	1,3
MSP Bank	50,0 (бюджет Банка)
Vnesheconombank	383,1 (бюджет Банка)

Source: M. Rogachev. The role and place of RFTD in the system of state support of innovation development. Presentation of 29.11.2011.

Priority is given to technology development projects, even where there are going to be no breakthroughs. That is why the examination focuses on a product' usefulness for development of production (a new technical quality of the product and/or its lower production costs), rather than on its research novelty. Also important is the clause which holds that the right to the output of such R&D projects belong to their operators.

One of key directions of RFTD's operations is financial support to R&D projects developed in the frame of technological platforms. To exclude duplication in development institutions' operations RFTD picked 12 technological platforms to support (in such areas as medicine and bioindustry, photonics, energy, new materials, mineral production and processing, environment).

Given the structure of Russia's economy which is dominated by huge production enterprises whose activity in the area of technological innovation is low, albeit on the upsurge, RFTD is keen to support huge integration projects in the first place, including those with participation of small- and medium-sized businesses. It is implementation of large-scale R&D projects that corporations most often lack funding for. But, according to expert estimates, such projects come up with a price tag in the region of Rb 150-200mn, thus RFTD is doomed to momentarily run out of cash. So, RFTD will find it hard to follow its peers in generating a favorable environment for investment activity.

Skolkovo and the satellites of its concept

In 2011, the i-city of Skolkovo was developed at an unprecedentedly high pace and at high costs (Rb 22bn). While in mid-December 2010 there were 16 registered participants therein, by early 2012 they had outnumbered 300[1], with successful candidates having been selected from more than 1,500 aspirants. Plus, there started a grant-based financing of the projects, which were classified into 4 main groups by the stage of their commercial maturity[2]. By the end of the year, 40 companies had already been awarded grants to implement their projects. In parallel with that the project application evaluation system advanced: by late-2011, there was formed an expert panel of 368 experts, of whom 80% were Russian ones. However, the work is under way to attract foreign specialists so that their number would match the Russians'.

During the year, new amendments to the national legislation were adopted in order to create yet more favorable conditions for the Skolkovo residents to implement their projects.

Finally, a kind of defining moment was the signing on 26 October 2011 of a Cooperation Agreement between MIT and Skolkovo Foundation on creation of the Skolkovo Research and Technology Institute. The project is to be completed in a span of 3 years and should result in shaping up both a university and interdisciplinary research centers. That MIT finally decided to take part in the Skolkovo project – it took the MIT leadership quite a while to make up their mind – evidences that the project has proved credible and foreign professionals consider it possible to locally form a university of a new type.

The Skolkovo project is eyed with envy by many territories, especially those ones which have long made innovation development a priority. That is why the year of 2001 saw a more visible replication of Skolkovo by a number of regional administrations striving for creation of some "mini-Skolkovos", if not ideology-wise, then, at least, in terms of principles of development. The ingredients of the success are clear: huge funding, exclusive benefits, universities' contribution, and attraction of foreign specialists.

By the end of the year, there had emerged 2 regional leaders which managed to catch up with Skolkovo as close as possible. Those are: the city of Tomsk and its concept of "INO

[1] Svetina B. Matrix at the junction//Poisk, No. 5, 3.02.2012, p. 23.

[2] The stages are classified into the following ones: "0" (ideas); "1"(seed stage); "2" (early stage); and "3" (advanced stage. A half of all the 2011 investments was designated for the early stage (projects with the volume of financing of up to Rb 150mn, with extrabudgetary funds making up half of the funding). Source: Investment Committee of the Skolkovo Foundation agreed upon principles of financing of resident companies of the Innovation Center Skolkovo http://www.unova.ru/article/7997 16.05.2011.

Tomsk 2020", which ultimately came with the price tag of Rb 39.9bn[1] ,and the city of Belgorod (Aurora-Park, worth a total of Rb. 23.3bn)[2]. In Tomsk, it is planned to focus on two priorities of "technological breakthrough" out of five, namely, nuclear and biomedical research, as well as on development of infrastructure, including transportation one, and on pooling local universities and research organizations' efforts to deliver on the project[3].

So, while i-city Skolkovo has not yet been completed, there emerged the followers of its model. This should soon give an interesting material to compare which would prove more efficient – a city built from scratch or an attempt to shape up a cluster where already existed a certain research, educational and other capacity.

5.4.9. Technological Infrastructure of Innovation Activity

The traditional infrastructure of innovation activity, including technoparks, business incubators, technology transfer centers, continued to unfold in 2011. It can even be asserted that these infrastructure elements experience now a new cycle of development whose distinctive features became a regional authorities' more vigorous contribution thereto, programs of the RF Ministry of Education and Science on support of university infrastructure, and development institutions' initiatives. That said, the number of technoparks and incubators established, and all the more so - in operation, in Russia remains unknown. By some estimates, there are some 100 technoparks and 120 business incubators in the country. At the onset, many technoparks were created as real estate objects, which is why they used to face the dilemma: either to develop projects, or to make money by leasing out office space. Plus, there was no previous record of development of projects (which can be partly ascribed to the fact that technoparls initially were not tasked to do that). In 2011, the Association of Hi-Tech Technoparks initiated development of a statute on the *status* of technopark[4], which will be awarded basing on strictly defined notions, such as "innovation", "resident", and "technopark" *per se*. This should help identify genuine innovation infrastructure objects. Other lacunas are being filled in, too, including establishment of back offices at technoparks and incubators. Until recently, most operating incubators had not adhere to the classical rules which read that an incubator shall not be a permanent "hotel" for businesses; nor shall they be home to mature companies already selling their products; and local corporate residents should have various kinds of services at hand. Technoparks, too, faced similar challenges, and, in many instances, had loose ties with universities or research organizations, which encouraged their transformation into mere real estate objects.

Presently, new approaches to formation of technoparks have emerged. Thus, a technopark under construction at Novosibirsk Science Campus since August 2010 has thus far been the only one wherein construction of more than a half of objects is funded by private corporate investors which will subsequently reside there. That bolsters their eagerness to have robust logistics and operations on the spot. Inside the technopark, there is an incubator to host 30-35 firms for the term of up to three years. In summer, the technopark hosts summer schools, with mentors delivering tuition and training students and postgraduates in the art of going into in-

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[1] Authorities are set to establish a center of cluster development in the frame of "INO Tomsk 2020". http://ria.ru/nano_news/20111109/484586234.html 09.11.2011.
[2] A Skolkovo's clon: // Poisk, No. 6, 11.02.2011, p. 2.
[3] The consortium of Tomsk universities and research organizations "UniTomsk" was established on 16 November 2011. Source: O. Bulgakova. Precedent//Poisk, No. 47, 25.11.2011, p. 20.
[4] Kolesova O. What is the name?//Poisk, No. 5, 3.02.2012, p. 2.

novation business in particular. For businesses such events form a source of both prospective projects and cadres. Besides, such training sessions enable one to expose challenges facing the current university education system from the businesses' perspective, which, once agreed upon by the parties concerned, allows incorporation of more down-to-earth elements into the university curricula. The technopark thus contributes to shaping up a "classical" interplay between education, research and business.

Some business incubators can boast success stories. While their overwhelming majority was created as office centers with beneficial rental fees available to fresh entrepreneurs, rarely were companies provided with various kinds of backing, be those counseling or assistance with finding an investor . Hence a very low rate of new businesses survival and hatching and, consequently, development institutions' laments about the scarcity of innovation projects and companies. The analysis of successful projects highlights the importance of the regional administrations' stance on the issue and well thought-through operational conditions of infrastructure objects.

The above conclusion can be proved by the record of the Nizhny Novgorod Innovation Business Incubator (NIBI). Founded in 2007 with the federal and regional governments' support, it offers to its residents a whole lot of services, including, *inter alia*:

– fully equipped office space (office machines, furniture, telephone and access to the Internet) on easy terms;
– free training and consulting services in the area of management, marketing, law, accounting, and technical consulting;
– assistance with drafting the business plan;
– assistance with promoting the company's product or service;
– assistance with searching for investment;
– organization of a free participation in exhibitions and conferences at the national and international levels.

Since the business incubator's onset, out of 18 resident companies initially picked on the basis of competition 7 ones have already hit the commodization stage, while another 6 companies have left the incubator and successfully operates on the market. Most importantly, their products and services enjoy demand both at the regional and federal levels, and some foreign organizations got interested in their technologies[1].

So, the new forms of fostering entrepreneurship boast constantly increasing success stories and it is critical to ensure their diffusion and, where necessary, institutionalization. The proper vehicle for this is the Association of the Innovation Regions of Russia (AIRR), which was established in September 2011. The Association unites 8 Russian regions: Republics of Tatarstan and Mordovia, Tomsk, Novosibirsk, Irkutsk, Kaluga oblasts, and Krasnoyarsk and Perm krais. That Mr. I. Bortnik, the founder of the Fund for Assistance to Development of Small Forms of Enterprises in the Research and Technical Sphere was appointed the CEO of the Association adds much to its positioning.

The Charter of the Association reads that its mission lies in "pursuing an efficient public regional policy which helps promote socio-economic development of Subjects of Russian Federation and Russian Federation on the whole by means of inter-regional cooperation between Subjects of Russian Federation which hold membership in the Association".

[1] http://www.government-nnov.ru/?id=61209

The Association began to operate quite vehemently both in its capacity of an expert body, a lobbyist of regional interests, and as an important intermediary in various initiatives. Thus, the Association and Skolkovo Foundation signed a cooperative agreement, in accordance with which the Association promotes projects of the Fund for Assistance's grantees for their subsequent development at Skolkovo, thus attempting to translate the still eclectic concept of "innovation lift" to practice.

5.4.10. Technological Platforms as a new Mechanism of Creation of New Ties

The rise of technological platforms can be interpreted as a new phase of the advancement of the cluster policy under which clusters are shaped up following the territorial, rather than thematic, sign. At the same time, technological platforms form a new element aiming at fostering the ties between main stakeholders to the innovation process - academia, education and business in the first place The instrument was not concocted in Russia – it was borrowed from the European Union, but has already begun exhibiting Russia-specific features.

In compliance with the "Procedure of formation of the list of technological platforms"[1], technological platform "is understood as a communication lever aimed at bolstering efforts on creation of promising commercial technologies, new products (services), attraction of additional resources to conduct research and development on the multistakeholder basis (business, academia, government, the civil society), improvement f the normative-legal base in the area of scientific-technological, innovation development" (p. 2 of the "Procedure").

So, the ultimate objective of formation of technological platforms lies in generation of promising commercial technologies. Plus, technological platforms widen corporations participating in them by:

- granting access to new resources to carry out R&D;
- ensuring their contribution in development of priority avenues of industries' advancement;
- respective technical regulations and standards (lobbying of corporate interests);
- expanding the planning horizon and ensuring optimization of business planning, as it is both developers and producers of technologies, and their consumers that participate in the platforms;
- bolster efficiency of spending by expanding outsourcing;
- promoting international cooperation;
- addressing the cadres problem for research and business.

That said, the emphasis is put on the technological platform being a "communication lever". While correct *per se*, this concept appears somewhat misguiding to potential participants in the platforms, as the tradition of the Russian innovative policy implies that concomitant with the granting a certain status usually come extra budget infusions.

A typical European algorithm of shaping up technological platforms and their operational standards includes *three stages*. At the first stage, priorities are identified which de facto predefine the clusters' agenda. The second stage sees development of "roadmaps" for platforms. At the third stage, there begins projects implementation, including R&D, which are funded out of various sources.

[1] Approved by the decision of the Government Commission on Hi-Tech and Innovation of 3 August 2010.

When compared with the last year's processes in Russia, the present arrangement exhibits its "biases from the Western standards" already at its first stage. As of the moment of collection of proposals on formation of platforms, the nation saw the list of priority avenues and respective critical technologies be revised, with the said list having no relation whatsoever to the initiative on shaping up the platform. The list of 8 priority directions and 27 critical technologies was approved by the presidential Decree of 7 July 2011[1]. In parallel with that, there exists yet another priority list – namely, 5 "presidential" "technological breakthrough" avenues identified yet in 2009[2] , in accordance with which, for example, clusters in i-city Skolkovo were formed.

Subjects of the existing 28 technological platforms[3] are consistent with the "technological breakthrough" priorities (albeit cannot be reduced to those) and appear partially overlapping with the eight national priorities and a number of critical technologies identified in pursuance of them. Accordingly, technological platforms found themselves beyond main financing mechanisms of financing of priorities implemented via the federal target programs system and FTP "Research and development across priority avenues of development of the scientific-technological complex of Russia for 2007-2013" in the first place.

Meanwhile, as far as long-term development prospects are concerned, technological platforms draw much attention at the federal level, particularly in the most recent version of the "Strategy of innovation development of Russian Federation for the period of up to 2020" approved by the RF Government on 7 September 2011. The document identifies technological platforms as a key instrument of coordination of the emerging innovation system in the frame of which "science, government, business and consumers will be developing a common vision of prospects of technological advancement of a respective industry or a technological direction, shaping up and implementing a prospective research and development program". Technological platforms are set to play a special part in the system of fostering the public-private partnership, corporate research, etc.

The second stage, that is, design of "roadmaps" *à la Russe* is linked to innovation development programs of corporations with government participation[4]. Plus, a distinctive feature of Russian platforms is the obligingness of a universities' contribution thereto. A series of companies have thus far viewed the requirement as a tie in, while universities, on the contrary, are nearly enthused to contribute to shaping up technological platforms. Thus, a recent survey of 193 academics (laboratory, chair, university research center heads, executives of small-sized investment firms under universities) demonstrated[5] that such a kind of activity as creation of

[1] Decree of the President of RF of 07.07.2011 "On approval of priority directions of development of science, technologies and technics in Russian Federation and the list of critical technologies Of Russian Federation.

[2] Energy efficiency and energy saving, nuclear technologies, space technologies, medical technologies, strategic information technologies.

[3] Of a total of 203 applications 28 platforms were selected. As of December 2011, yet another 5 applications were considered for inclusion in the list of technological platforms, Source: data of the RF ministry of Economic Development.

[4] According to the Executive Order by the RF President by results of the work of the Commission under the RF President on modernization and technological development of Russia's economy. (No. PR-22 of 4 January 2010, item 5 "b"), corporations with government participation engaged in innovation development programs shall partake in shaping up technological platforms and their operation.

[5] Klimov A.A., Frumin I.D. An abridged report on studies into best practices in developing the management system by research and innovation activities in Russian tertiary education institutions. Russian Academy of Na-

technological platforms is third most popular one in the list of kinds of cooperation with Russian corporations, trailing behind just such kinds of joint activities as cooperative R&D and research commissioned by the corporate sector. Quite surprisingly, technical platforms proved more popular than training of cadres for corporate partners.

So, while judging the "innovation enforcement" measures from the perspective of the scale of outreach, they prove more effective than promotion of "non-coercive" communication, even in such traditional forms of the latter as training of cadres for corporations. Whether the "enforcement" proves efficient and is going to have a long-lasting effect on development of science and innovation, or the effects fade right once the "pressure" on subjects of innovation activity is over, is another story.

The first fruits of the cooperation between Russian universities and corporations implemented in the frame of the Resolution of the RF Government of 9 April 2010 demonstrate that corporate partners have gradually identified directions and forms of cooperation with universities which proved to have contributed to development of much-needed technologies. Cooperation is a hard thing to push ahead not only in Russia, but elsewhere: the record of promotion of the Advanced Technology Program in the US demonstrated that it took the corporate sector nearly a decade to grow pro-active as far as their collaboration with the university community is concerned.

The third stage is implementation of R&D projects put forward by technological platforms. This particular stage has not been activated as yet, as the process of shaping up of technological platforms exposed an array of still unresolved problems.

The first of them lies in the methodological backing to the process, which is secured by two agencies: the RF Ministry of Economic Development and the RF Ministry of Education and Science. But the technical platform coordinators lack clarity as to which agency is responsible for what and to where inquiries regarding *modus operandi* should be placed. Specifically, it is not clear yet who will be considering technical platforms' proposals on formation of the agenda of the future government program on development of science and technologies.

The other problem is the uncertainty with sources of financing of technological platforms projects. Presently, there are no strictly set procedures of financing of technological platforms. It is assumed that there would be a plethora of such sources, including federal target programs, ROSNANO, public corporations, RAS's fundamental research programs, allocations under the aegis of various initiatives by the RF Ministry of Education and Science on cooperation between corporations and universities, to name a few.

As of December 2011, the ministries in question were not ready to finance even the organizational and technical operations of a technical platform (including drafting a strategic development program and a roadmap). Furthermore, an argument against special allocations in that regard is that where businesses and other cash-rich organizations partake in the platforms, they would be fond of sponsoring their operational logistics.

In all likelihood, the future support of technological platforms projects will be provided on a common basis. Somewhat more favorable regime may emerge only because collective projects developed on their basis would prove more ready-to-implement, thus having the greatest chance for getting funding.

tional Economy and Civil Service under the President of Russian Federation, National Research University 'The Higher Scholl of Economics", Center for Sociological Research MITSAR. M.: 2011.

In general, two scenarios of development of support of technological platforms projects can be envisaged:

1) technological platform is a special status, which suggests a higher quality of projects. Besides, their subjects will be considered priority ones. In such circumstances technical platforms projects would find it easier to receive funding in the frame of the existing financial instruments;
2) technological platform is a combination of status and an additional budget funding to be allocated in the frame of an adjusted state program of development of science and technologies for 2013-2020. In such circumstances it is RFTD which may become the operator of allocation of respective funding.

The earlier selected platforms experienced a certain evolution in 2011: the composition of their participants became more balanced, thanks to some influx of business representatives, albeit 11 platforms have thus far displayed a low level of the corporate sector's contribution thereto. There emerged leaders among the platforms, that is, those ones which have outpaced the others in the advancement along the above stages of formation and deployment. In this regard the "Medicine of the future" platform is particularly noteworthy. It has become the informal leader among its peers since the very onset. Its structure and performance allows assumption of how far a most efficient structure could progress. The platform is a consortium of 160 organizations, of which a half is corporations, 25%- educational institutions and 20% - academic ones[1]. In the course of the project's evolution there unfolded 9 scientific-technical councils which cover more detailed directions of research in the frame of the platform's overarching agenda. Furthermore, there already is a 120 project-strong base, of which 35 projects have already earned support in the frame of FTP "Research and development across priority directions of development of the scientific -technological complex of Russia for 2007-2013" and "Farma-2020". Notably, the platform focuses on implementation of the cluster policy: specifically, task forces on development of innovation clusters were established in a number of regions, including Moscow, St. Petersburg, Samara, Ekaterinburg, among others.

*   *   *

The analysis of the development of science and innovation in 2011 allows the following conclusions:

1. Last year, innovation rhetoric and support of innovation on the government level proved very intense. The budget funding of R&D was on the upsurge, implementation of initiatives at Skolkovo was gaining momentum, the normative-legal environment for science and innovation activity was being modified, and new development institutions were unfolding. Importantly, the business sector's attention to sponsoring R&D was on the rise and that can partly be ascribed to Government's measures on promotion of the cooperation with the public research sector, primarily at universities.
2. By the end of the year, new legal acts had come in effect, which lifted a number of general economic barriers to advancement of innovation activities, including legal acts that concerned various forms of venture investment.

[1] All the data on the technological platform "Medicine of the Future" are cited by the presentation: V.I. Dovgy. "Russian technological platform "Medicine of the Future": development record and new opportunities" made at an international workshop "Russian and European technological platforms: boosting cooperation". Moscow, NRU HSE, 7 December 2011. http://issek.hse.ru/announcements/38687293.html

3. Meanwhile, the last year witness growing inequality in terms of assignment of budget funds, with main priorities being the university science and megaprojects, such as Skolkovo and megagrants on creation of laboratories led by prominent researchers from overseas. In the future, there may well emerge a string of other cash-intensive priorities, including cadres training overseas and creation of megascience units. Given that the public sector of science has remained unreformed, the innovation system may slip out of balance.
4. Measures on "forcing" business to get engaged in innovation have become increasingly widespread. Their efficiency appears ambiguous. The phenomenon of "forcing" corporations into innovation and collaboration with universities makes one recall recent plans to force young researchers to stay in the academic sector for several years in exchange for certain public benefits (such as the so called "departmental housing", or a paid-for internship overseas, etc.). At the time, the idea was present only in draft concepts and strategies and, fortunately, was not adopted. It was academics themselves who opposed the idea in the first place, as an unmotivated researcher is a threat to equipment, a cause for an inaccurate fulfillment of experiment, etc. That is to say, an incorrect "enforcement" can cause a considerable damage.
5. New initiatives (developments in Skolkovo, shaping up technological platforms) in many ways are based upon customization of foreign experiences. But once borrowed, the instruments in question undergo a certain transformation in the Russian economic environment, which often ends up quite unpredictably. Meanwhile, the country sees new domestic developments unfold, and they are worth examination and a wider spread.
6. The State has remained the principal controlling and regulating agent, with bottom-up initiatives (such as scientific funds) left with no chance for advancement. That results in loose ties in the innovation system, while the "innovation lift" has thus far existed only in the form of a segmental set of development institutions.
7. In all, the level of the State's involvement in development of the research and innovation activity has remained high and tended to further increase. Consequently, the innovation sphere focuses, primarily, on public financing, and such "uniqueness" of the economic structure blocks Russia's integration in the global innovation system.

Section 6. Institutional Issues

6.1. Public Sector Status and Privatization Process

6.1.1. Public Sector Share of the Russian Economy

The quantitative federal property data[1] from official sources (*Table 1*) proves with assurance that in 2011 the total number of property assets registered with the federal property register decreased by more than 12% against the peak (1.562 million items) in the beginning of 2011. As of the beginning of 2012, however, it outstripped the value reported two years ago.

Table 1

The number of organizations using federal property, and property assets registered with the federal property register in the period between 2008 and 2011 (units)

Date*	Federal State Unitary Enterprises (FSUEs)	Business entities (JSCs and LLCs) with federally held share (interest)		Total number of federal property assets registered with the registry	
		Total	special right ("golden share") without interest holding	on paper	in the Computerized Federal Property Accounting System (CFPAS)
as of January 1, 2008	5709	3801/3647**	127	…	…
as of January 1, 2009 (December 31, 2008)	3765	3503/3338**	136	701325	14096
as of January 1, 2010 (December 31, 2009)	3517	3066/2920**	117	1276572	1193121
as of January 1, 2011 (December 31, 2010)	…	3077	120	1562018	1552121
as of January 1, 2012 (December 31, 2011)	…	2930***	111	1371266	1367975

* – according to the quantity of federal property assets registered with the registry in the CFPAS as of December 31 of the relevant year;
** – only JSCs as denominator;
*** – as of December 28, 2011, including 2794 JSCs, 25 LLCs and 149 JSCs with the special right of the Russian Federation to participate in management ("golden share") (without a federally held interest in 111 of them), 2822 JSCs with state participation are managed through the Federal Agency for State Property Management.
Source: Forecast Plan (Program) for the Federal Property for 2009 and the Guidelines of Federal Property Privatization for 2010 and 2011, the Forecast Plan (Program) for the Federal Property for 2010 and the Guidelines of Federal Property Privatization for 2011 and 2012, the Forecast Plan (Program) for the Federal Property and the Guidelines of Federal Property Privatization for 2011–2013; the data of the Ministry of Economic Development and Trade of Russia on the basis of the federal property register, www.rosim.ru.

The aggregate quantity of business entities with state participation also decreased by 4.8% in 2011, however, it decreased by much more in 2008 and 2009, whereas a small growth was reported in 2010. As a result, the number decreased for the first time below 3,000 as of the

[1] In 2011, given the Forecast Plan (Program) for the Federal Property Privatization for 2011-2013 approved at the end of November 2010. No new annual privatization program was approved by the Russian Federation Government, as it did in the 2000s. In the meantime, it is these documents that traditionally contained the data on the quantity of federally held enterprises (FSUEs) and joint stock companies with a state-held interest as of the beginning of the calendar year. Therefore, there is no sufficient information that would allow an impartial judgment to be made as to the dynamics of these components of the public sector in 2011, however, the federal property registry's data allows evaluation of the trends in the movement of the total number of the registered companies and business companies with a state-held interest.

beginning of 2012[1]. The number of JSCs which are subject to a special right of state participation in management thereof ("golden share") (about 100 companies) was also minimum throughout the entire 2000s.

The turn back in the upward trend, which developed as early as the mid-2000s, towards share holding which allows the state to realize a comprehensive corporate governance at business entities, became a new phenomenon in the corporate sector with state participation in 2011 (*Table 2*).

Table 2

Dynamics and quantity structure of business entities with state capital participation (save for JSCs which are subject to a special right ("golden share") without interest holding) in 2008 – 2011

As of January 1	Business entities (JSCs and LLCs) with federally held share (interest)											
	Total quantity	interest, %	state-held interest									
			100%		50–100%		25–50%		2–25%		less than 2%	
			q.	%	q.	%	q.	%	q.	%	q.	%
2008	3674	100.0	1989	54.1	269	7.3	645	17.6	421	11.5	350	9.5
2009	3367	100.0	1850	54.9	202	6.0	503	14.9	305	9.1	507	15.1
2010	2949	100.0	1688	57.2	167	5.7	377	12.8	296	10.0	421	14.3
2011	2957	100.0	1840	62.2	136	4.6	336	11.35	265	9.0	380	12.85
2012*	2819	100.0	1617	57.4	112	4.0	272	9.6	254	9.0	564	20.0

* – as of December 28, 2011

Source: the data provided by the Ministry of Economic Development and Trade of Russia on the basis of the federal property register, IET's estimates.

As of 2011 year-end, the state could have a minority or majority controlling interest in more than 61.4% of all the entities (the level as of the beginning of 2008) against 67% in the preceding year.

Such a shift resulted from reduction in the total structure of federal share holding (interest holding), both full share holding (100% participatory interest) from 62.2% to 57.4% and majority share holding (more than 50%, but less than 100% of equity) from 4.6% to 4%. Blocking share holding (from 25 to 50% of equity) decreased much more (more than 1.5 percentage points (p. p.)), whereas minority share holding (up to 25% of equity) increased considerably (less than 22% to 29%) through the increase (less than 13% to 20%) in the smallest share holding (less than 2% of equity). A special emphasis should be placed on the doubled growth in the latter category of federal share holding (interest holding) vs. the pre-crisis period, while only full share holding (interest holding) saw a small increase of only 3.3 p.p. among other categories.

In the period between 2008 and 2011, the absolute number of majority, blocking share holding (interest holding) decreased by almost 60% as well as the share holding (interest holding) accounting for 2% to 25% of equity. Full share holding decreased by much less (less than 19%). The same trends were reported in 2011. However, the number of the smallest share holding (interest holding) increased 1.6 times vs. as of the beginning of 2008, 1.5 times in 2011, while their number was getting smaller in 2009 – 2010 after a rapid growth in 2008.

The upward trend for the minority share holding, especially the smallest share holding during and after the economic crisis is questionable. Its negative nature is quite obvious, because

[1] Considering only business entities with a state-held interest (exclusive of JSCs which are subject to the "golden share"), the given value was reached as early as the beginning of 2010.

the size of such share holding gives no opportunity to the state to either sell at best or provide sufficient control over business entities.

Regarding trends in the structure of the whole body of property assets registered with the federal property registry (according to the data provided by the CFPAS), they can be seen through the data provided in *Tables 3* and *4*.

Table 3

Dynamics and structure by type of the federal property assets registered with the federal property registry, in 2008 – 2011

As of December 31	Total quantity of immovable and movable property assets, total		by type					
			immovable property assets (save for land plots)		land plots		movable property assets	
	q.	%	q.	%	q.	%	q.	%
2008	14096	100.0	7538	53.5	1517	10.75	5041	35.75
2009	1193201	100.0	600842	50.35	116274	9.75	476085	39.9
2010	1552121	100.0	718114	46.3	165281	10.6	668726	43.1
2011	1367975	100.0	800143	58.5	192825	14.1	375007	27.4

Source: the data provided by the Ministry of Economic Development and Trade of Russia on the basis of the federal property register, IET's estimates.

It should be reminded that paper inventory of the federal property assets registered with the state federal property database as of the effective date of Russian Government Order No. 447, dd. July 16, 2007 was completed by the beginning of the summer of 2010. This hard work on converting the relevant data into e-format by entering thereof to the Computerized Federal Property Accounting System in 2010 – 2011 allowed the paper data to be covered almost in full with the relevant e-data (*Table 1*).

As of 2011 year-end, immovable property assets (58.5%) dominated in the structure of federal property, which was also typical of the previous periods (except as of the end of 2010). The category of movable property assets was ranked #2. These items decreased from 43.1% to 27.4% during the year, mostly because in April thru May 2011 movable property assets with a value of less than Rb 500,000[1] were withdrawn step by step from the CFPAS. Land plots account for a total of about 14% of federal property assets, but this has been the max. value over the recent few years. It should also be noted in this context that the area of federally owned land plots has increased more than 1.7 times to reach 1,007,938,198 ha over the recent eighteen months, as based on the data provided by the Federal Agency for State Property Management[2]. Such a growth could result from intensified delimitation of public ownership of land by level of public authority and state registration of the Russian Federation ownership of land plots.

A major part (more than 2/3 as of 2011 year-end) of the federal property assets are secured for titleholders on the basis of operational management basically applicable to government agencies. The process of reducing the number of unitary enterprises is also reflected in the structure of federal property, where a pronounced reduction trend in the property assets secured on the basis of economic management, however, in 2011 it remained almost at the level reported in the previous year (nearly 18% vs. more than 24% as of 2008 year-end). Further-

[1] The foregoing movable property assets were excluded because Order No. 47 issued by the Government of Russia on February 4, 2011 entered into force, under which the minimum initial value of movable property assets regarded as stand-alone property was to be increased from Rb 200,000 to Rb 500,000.
[2] www.rosim.ru.

more, a share of federal treasury items increased slightly (about 15% vs. 11 to 12% in 2009 – 2010) in the previous year.

Table 4

Dynamics and structure of the federal property assets registered with registry by category of titleholders, in the period between 2008 and 2011

As of December 31	Total quantity of Total quantity of immovable and movable property assets, total		By category of property right					
			secured for titleholders on the basis of economic management		secured for titleholders on the basis of operational management		constituting a state treasury of the Russian Federation *	
	q.	%	q.	%	q.	%	q.	%
2008	14096	100.0	3418	24.2	8202	58.2	2476	17.6
2009	1193201	100.0	226818	19.0	827234	69.3	139149	11.7
2010	1552121	100.0	279402	18.0	1096547	70.6	176172	11.4
2011	1367975	100.0	245060	17.9	921252	67.35	201663	14.75

* – net of business entities’ share holding (interest, deposits).
Source: the data provided by the Ministry of Economic Development and Trade of Russia on the basis of the federal property register, IET’s estimates.

According to the Rosstat’s public sector composition monitoring, the quantity dynamics of public sector economic agents in the period between the mid-2010 and mid-2011 can depicted as follows (*Table 5*).

Table 5

The number of public sector organizations registered with territorial offices of the Federal Agency for State Property Management and government bodies for management of state-owned property of the constituent territories of the Russian Federation in the period between 2009 and 2011

Date	Total*	SUEs, including state-run enterprises	Government agencies	Business entities with more than a 50%	
				state-held share (interest)	share (interest) held by public sector business entities
as of July 1, 2009*	77082**	8706	63019	4007	1350
as of January 1, 2010*	76658**	8122	63087	4089	1360
as of July 1, 2010*	74867**	7230	61493	3915	2229
as of January 1, 2011*	73498**	6761	60266	4051	2420
as of July 1, 2011*	72047**	6245	59483	3928	2391

* – federal property is subject to accounting pursuant to Russian Government Order No. 447, dd. July 16, 2007, “On the Enhancement of Federal Property Accounting”;
** – including organizations whose state registered articles of association registered contains no specific types, but excluding joint stock companies with more than 50% shares (interest) held on the basis of joint state and foreign ownership.
S*ource:* On the development of the public economic sector of the Russian Federation in H1 2009 (p. 7), in 2009 (p. 7), in the first half of 2010 (p. 7), in 2010 (p. 7), in the first half of 2011 (p. 7). M., Rosstat, 2009 – 2011, IET’s estimates.

As is seen from *Table 5*, the total number public sector organizations decreased 6.5% over the two years (from July 1, 2009 till July 1, 2011) (or more than 5,000) to amount to about 72,000 as of July 1, 2011.

The result was achieved basically through a decrease of 28.3% (or almost 2,500) in the number of unitary enterprises. Though the number of agencies deceased much less (5.6%), it was more impressive in absolute value (3,500). The number of business entities with more than 50% state-held interest decreased even less, only 2% (or about 80) July 1, 2011. In this respect, the number of business entities with more than 50% interest held by public sector business entities, increased more than 1.7 times. Their number grew up more than 1040 to reach almost 2,400 as of July 1, 2011, i.e. the historic maximum throughout the entire 2000s.

Within a period of one year, between the mid-2010 and mid-2011, the total number of public sector organizations decreased by 3.8% (or more than 2,800 entities) basically due to a reduction of 13.6% (or almost 1,000) in the number of unitary enterprises. Though the number of agencies deceased much less, only 3.3%, its absolute value was found to be twice as much as that of unitary enterprises (2,000).

At the same time, the number of business entities with more than 50% state-held interest remained almost at the previous level (3,900 entities). In this context, however, it should be emphasized that the number of business entities with more than 50% interest held by public sector business entities increased (up 7.3%). They grew up more than 160.

The crisis of 2008 – 2009 raised a question of how they effected the state as manufacturer of (works, services) in the economy. The Rosstat's monitoring only partially supports the view of growing state participation in different final figures of economic performance (*Table 6*).

Table 6

Public sector's share according to various indicators in the period between 2008 and 2011, %

Indicator	2008	2009	2010	H1 2011
Volume of shipped goods produced by the company, completed works and services w/o subcontracting :				
- mineral recourses production	13.5	11.5	9.8	17.0
- fuel and energy recourses production	13.2	11.1	9.0	17.0
- manufacturing sector	8.5	9.5	8.7	9.5
- production and distribution of electric power, gas, and water	13.0	14.0	17.8	22.5
Scope of construction works performed w\o subcontracting	3.6	3.8	4.1	4.1
Passenger turnover at transportation companies *	63.9	63.2	56.1	66.1
Volume of commercial transportation (dispatch) of cargos by transportation companies (net of companies involved in pipeline transportation)	71.1	76.6	78.4	78.5
Commercial cargo turnover performed by transportation companies (net of companies involved in pipeline transportation)	94.3	93.8	93.6	93.7
Communication services **	9.9	13.9	15.2	14.5
In-house research and development costs	72.6	74.4	73.4	73.5
Volume of paid services rendered to the general public	16.3	16.5	18.9	18.8
Capital investments from all sources of financing ***	21.5/ 15.9	22.8/ 17.1	24.5/ 17.8	26.0/ 19.9
Net proceeds from sales of goods, works, services (net of VAT, excise taxes and other similar mandatory payments)	9.8	10.6	18.9	11.7
Average staffing number	24.0	24.6	24.9	25.2

* – save for municipal electric passenger transport organizations;

** – net revenues from sale of goods, products, works, services (net of VAT, excises and other mandatory payments);

*** – in the numerator, net of small enterprises and volume of investments which can't be observed through direct statistical methods.

Source: On the development of the public economic sector of the Russian Federation in 2008 (c. 13, 43, 45-46,47, 53, 61-62, 63, 67-68, 88), in 2009 (c. 13, 45, 47-48, 49, 52, 60-61, 62, 66-67, 87), in 2010 (c. 13, 46, 48-49, 50, 53, 61-62, 63, 67-68, 88), in the first half of 2011 (c. 13, 33, 35-36, 37, 40, 43-44, 45, 49-50, 70). M., Goskomstat of Russia (Rosstat), 2009-2011, IET's estimates.

However, as it can be seen from *Table 6*, in 2010 and H1 2011, However, as it can be seen from *Table 3*, in 2009 and H1 2010, like throughout the entire period of 2000', that the public sector had an insignificant share in most indicators (no more than 10–15%), with a slightly bigger share in the field of investments (more than 15–25%) and employment (24–25%), whereas only cargo transportation (more than 60–90%, depending on an indicator) and internal research and development costs (more than 70%) remained significant exceptions.

However, official statistics reported a small decrease in 2010–2011 vs. 2008 in the public sector's participation share in the field of production and distribution of electric power, gas and water, communication services, capital investments, paid services to the general public, and such a generalized financial indicator as net proceeds from sales of goods, works, services (net of VAT, excises and other mandatory payments) [1].

A substantial increase of up to 17% in the first half of 2011 vs. 11 to 13% in the period between 2008 and 2009 in the public sector's participation share in mineral production (including fuel and power minerals) should be noted. The same is true with generation and distribution of electric power, gas and water, where at the end of H1 2011 the public sector reached 22.5% (against 13 to 14% in the period between 2008 and 2009), and passenger traffic of transportation organizations in which public sector's share increased again after a visible fall in 2010, thus exceeding 2/3 of the total volume vs. 63 to 64% in the period between 2008 and 2009.

A closer look at the situation reveals that at year-end 2010 the public sector was dominating in some of the industries, namely railway cargo shipment and passenger transportation, forest regeneration, production of sodium carbonate, externally powered broadcasting radio receivers, helicopters. In most other cases the public sector accounted for less than 20%, save for production of ethyl alcohol made of food raw material, wooden unimpregnated railway and tramway sleepers, cargo mainline cars, production of electric power at hydroelectric power stations, passenger automobile transportation service, all types of paid services, where the public sector accounted for less than a half anyway. An increase, up to 21.8% vs. 15.9% at 2010 year-end, in the public sector's participation share in oil production, including gas condensate, should be noted among the changes highlighted in the first half of 2011.

It should be noted, however, that the foregoing data should rather be regarded as minimal given the complexity of measuring the public sector's share for the following reasons: (1) limited reliability of the Rosstat's data amidst the multistage corporate control system employed at many state-owned enterprises, which excludes several levels (by analogy with private companies), (2) impossible impartial and reliable assessment of the state indirect effect on property relations based on the results of the anti-recessionary measures taken in 2008 – 2009 and (3) potential incompleteness of accounting by public agencies.

6.1.2. Privatization Policy

Since the privatization Program for the period of 2011–2013 approved by the Government of Russia in November 2010 was developed on the basis of the amendments which were made to the applicable law on privatization at the end of May 2010 and provided for a 3-year extension of the planning effective period of the Forecast Plan (Program) for the Federal Property, in 2011 the foregoing document was only amended and updated. A total of 13 relevant statutes and regulations were adopted by the Government of Russia through Enactment No. 2102-r, dd. November 27, 2010, since the approval of the Forecast Plan (Program) for Federal Property Privatization and the Guidelines of Federal Property Privatization for 2011–2013, two of

[1] With regard to the latter indicator, the data on the end of H1 2011, which saw a considerable growth (against the previous few years) in 2010, also tend to increase a bit as to the public sector's share for the other specified indicators, which needs refinement as to the year-end results in general.

which were issued as early as the very end of 2010 and in January 2012. Government of Russia Enactment No. 513-r, dd. March 24, 2011, contained a major part of the amendments.

The list of the property subject to privatization was expanded as to all types of assets (SUEs, JSCs, LLCs, other property). The list of the latter category which is basically represented by immovable property assets and land plots, was updated most. Whereas the originally approved version of the privatization Program for the period of 2011–2013 included 73 items of other property assets, it was updated to include 468 items, or up 6.4 times, as early as 2011 year-end.

In addition, the privatization program was complemented with special instructions providing for incorporation of a part of the FSUEs subject to privatization which are 100% owned by the federal government (shares (a part thereof) are subsequently to be contributed to the charter capital of a relevant integrated entity, or 100% shares are subsequently to be assigned as the state asset contribution to Russian Technologies state-owned corporation, as well as provide for the terms of privatization to be defined by the state with regard to specific blocks of shares[1].

Given the updates and amendments made, the Privatization Program for the period of 2011–2013 provides for privatization of a total of 1396 federally held shares of joint stock companies, 276 federal state unitary enterprises and other 468 property assets as part of the Russian Federation treasury.

A special emphasis should be placed on that the list of the 10 super large companies in which the government allowed state capital participation to be reduced in 2011 – 2013, remained unchanged, but were specified with regard to the Federal Hydropower Generating Company (RusHydro) and the United Grain Company (UGC).

The Ministry of Economic Development and Trade of Russia and the Ministry of Energy of Russia were assigned to see, jointly with the Federal Agency for State Property Management, that the federally held interest in OJSC Federal Hydrogenation Company (the city of Krasnoyarsk) is duly sold under a favorable market situation until July 1, 2012, to the extent that the state retains 50% plus one share in the said joint stock company. The same corporate governance threshold was determined for the United Grain Company (UGC).

A privatization transaction was closed with regard to the foregoing companies, which became the largest transaction throughout the entire period of 2000. In February 2011, OJSC VTB Bank floated a federally held interest of 10% among Russian and foreign investors during a secondary public offering (SPO) at $6.25 per global depository receipt (GDR). According to the data provided by the bank, a total of 1,046,054,133,732 shares of the Russian company were floated in the form of GDRs and common shares. A total of Rb 95.68bn proceeds were obtained.

LLC Merrill Lynch Securities was authorized to organize and close the transaction on behalf of the state under an agency contract. As early as the fall of 2010, LLC Merrill Lynch Securities Merrill Lynch Securities was assigned to be the sole contractor of the public contract on purchase and sale of the federally held ordinary registered shares of OJSC VTB Bank (up to 10% of charter capital) at least at a market price specified on the basis of the market value assessment report made by an independent appraiser.

[1] The originally approved version of the Privatization Program included an instruction for the to-be privatized shares of some of the OJSCs scheduled for contribution to the charter capital of the relevant integrated entity on the basis of the decisions made by the President and Government of Russia.

Gazprombank in the same manner under an agency contract closed a transaction on purchase and sale of the federally held interest in OJSC Prosvescheniye Publishing House, for a total of Rb 2.25bn.

Apart from the sale of OJSC VTB Bank and OJSC Prosvescheniye Publishing House, five investment banks to be engaged in purchase and sale of the federally held interest in six companies were determined in 2011 as part of the work performed by the Ministry of Economic Development and Trade of Russia.

In all other respects, the Privatization Program for 2011 started traditionally with the bid, which was announced as early as 2010, and summing up the results thereof.

In particular, at the end of December 2010, the Federal Agency for State Property Management announced a purchase and sale of the federally held interest in 16 JSCs (incl. OJSC Tolmachevo Airport) of the 26 investment-attractive joint stock companies (seaports, river ports and shipping lines, airports) included into the privatization program for 2010 for the purpose of subsequent sale under Russian Government Order No. 1321-p, dd. August 4, 2010, following the President's decision to shorten the list of strategic enterprises and JSCs (Order No. 762, dd. June 18, 2010). The results of the relevant auctions were summed up as early as 2011.

All in all, the shares (interest in charter capitals) of 359 joint stock companies were sold in 2011, including 38 JSCs whose purchase and sale was announced in accordance with the Forecast Plan (Program) for Federal Property Privatization for 2010, and decisions on the terms of privatization were made with regard to 143 federal state unitary enterprises.

Comparing the provided data with the results of the privatization programs implemented in the previous years (*Table 7*), it is obvious that the number of FSUEs doubled, for which the terms of privatization were made, and the number of sold shares increased 2.7 times vs. 2010. At the same time, more than 500 shares were sold annually in the mid-2000s, and the results achieved in 2011, 2000 and 2006 thru 2007 are the same. The results are less impressive as to privatization of unitary enterprises.

Furthermore, more important is their inclusion into the composition of vertically integrated entities. For example, almost 2/3 (92) out of the 143 FSUEs, for which the Federal Agency for State Property Management made decisions on the terms of privatization, were incorporated as part of the integration processes. The same picture also can be seen with regard to registered OJSCs (30 out of 42).

The issue of lack of bids from those companies who were supposed to be the bidders in the relevant procedures remained to be resolved in spite of a large scale of privatization in the previous year. For example, more than a half (375) of the shares of 730 JSCs which were offered for sale in 2011 (information announcements were published), were reoffered for bid.

In particular, the same was reported with regard to the shares of OJSC Cheboksary River Port and OJSC Northern River Shipping Lines, which were a part of the aforementioned group of 26 joint stock companies delisted from the list of strategically important enterprises and companies in 2010. Another 10 companies of the list were expected to be privatized in 2011 as part of the implementation of the Forecast Plan (Program) for Federal Property Privatization for 2011–2013 on the basis of the Government of Russia decisions on the terms of privatization of the federally held shares of Murmansk (25.5%) and Novorossiysk (20%) Commercial Seaports.

Table 7

Comparative data on the dynamics of privatization of federal state unitary enterprises and federally held shares in the period between 2000 and 2011

Period	The number of federally owned privatized enterprises (units) (according to the Federal Agency for State Property Management, and the Federal Agency for State Property Management of Russia until 2004)	
	privatized FSUEs[a], q.	JSC shares sold, q.
2000	2	320
2001	5	125[b]
2002	102	112[b]
2003	571[c]	630
2004	525	596[d]
2005	741	521
2006	…	356[e]
2007	377	377
2008	213	209[b]
2009	316+256[f]	52[b]
2010	62	134[b]
2011	143	359[b]

[a] – all preparatory arrangements have been completed and decisions on the terms of privatization made;
[b] – including blocks of shares which were announced for sale in the previous year;
[c] – net of the FSUEs whose assets were contributed to the charter capital of OJSC Russian Railways;
[d] – including 31 blocks of shares which were announced for sale in 2004, but the results thereof were summed up in 2005;
[e] – estimated value based on the data provided in the FPMA's Report "On Federal Property Privatization in 2007";
[f] – the number of FSUEs for which the decision on incorporation was made by the Ministry of Defense of Russia in addition to those when a similar decision was made by the Federal Agency for State Property Management.
Source: www.mgi.ru; The materials for the meeting of the Government of Russia which was held on March 17, 2005. "On Measures Aimed at Improving the Effectiveness of the Federal Property Management"; Federal Agency for State Property Management (FPMA) Report "On Federal Property Privatization in 2005". M., 2006; Federal Agency for State Property Management (FPMA) Report "On Federal Property Privatization in 2007". M., 2008; Federal Agency for State Property Management. Performance Report for 2008. M., 2009; the data provided by the Ministry of Economic Development and Trade of Russia, the Federal Agency for State Property Management.

Transport assets were sold more or less successfully throughout the entire year. Of most importance were the privatization transactions of the federally held interest in Tolmachevo Airport (the Novosibirsk Oblast, 51%, Rb 2.806m), Volga Shipping (Nizhny Novgorod, 25.5%, Rb 1,042.646m), Tuapse Seaport (25%, Rb 1,612.1m), North Western River Shipping Lines (25.5%, Rb 934m), Vostochny Port (Nakhodka, 20%, Rb 912m), Osetrovsk River Port (the Irkutsk Oblast, Rb 361,821m), Moscow River Shipping Lines (25.5%, Rb 302.994m), Vostok Aviation Company (the city of Khabarovsk, 51%, Rb 263.4m), Astrakhan Airport (51%, 216,875m Rb), Volgograd International Air port (about 38%, Rb 177m), South River Port (Moscow, Rb 134.881m), Volgograd River Port (25.5%, Rb 112,825m), Azov Seaport (25.5%, Rb 100.390m). The sale of blocking interest in Eisk and Taganrog Seaports, Rostov River Port generated less than 100m Rb each[1].

The sale price exceeded the initial price in some of the transactions closed, which is not typical of privatization in Russia: (4 times as much) for the federally held interest in Azov Seaport, (2.95 times as much) in Volgograd Airport and (more than 2.5 times) in Tolmachevo Airport, (1.74 times as much) in Volgograd River Port. At the same time, most of the other

[1] www.rosim.ru

specified federally held shares were sold when the sale price was equal to the initial price, save for Vostok Aviation Company, Vostochny Port, Eisk and Taganrog Seaports, Rostov River Port, where the sale price slightly outstripped the initial price.

The sale of 55% interest in Vaninsk Commercial Seaport should have been the largest privatization transaction in terms of absolute value (apart from the sale of 10% interest in VTB) (Rb 10,824,125m) and excess of the sale price over the initial price (11.6 times as much), however, the results thereof were cancelled, because the contractor refused to meet the payment commitments. Furthermore, the contractor was to pay a penalty of Rb 75.114m under the arbitration court order, though the Federal Agency for State Property Management demanded much more, Rb 300.46m.

Neither blocking interest auctions for Murmansk River Shipping Lines and Yenisei River Shipping Lines, Samara River Port and Tver River Port, Anapa Airport were held, nor the shares of the foregoing Cheboksary River Port and North Western River Shipping Lines were sold through public offering due to lack of bids.

Given the outdated data of the share market value assessment reports and availability of up-to-date financial figures, as well as the need to engage the maximum number of interested investors, the Federal Agency for State Property Management decided to cancel the sale of the shares of OJSC S7 Airlines and OJSC Murmansk Fishing Seaport which was scheduled for the end of September.

The federally held shares of joint stock companies of various economic sectors, including air transport and water transport (including seaports and river ports), were sold through more than 50 privatization transactions at a value of more than Rb 100m closed in the previous year by the Federal Agency for State Property Management and its territorial offices. It suffice to refer to transactions at a value of more than Rb 300m.

Among these were specialized installation entities (Specialized Building and Construction Works for Electrification of the Moscow Railway Junction (Rb 1065.41m) and Elekrotsentrmontazh (Moscow, Rb 330m), Moscow research institutes (NIITECHIM (Rb 554.615m), Vitamin Research Institute (100%, Rb 491,546m), MNIIRS (Rb 355.175m)), agricultural sector enterprises (OJSC Doskoye (Rb 476.49m) and the First Horse Cavalry Stud Farm (Rb 303m) (both are located in the Rostov Oblast)). Also Buryatia Hotel and Tourist Complex (Ulan-Ude, Rb 508.2m). The overwhelming majority of the foregoing cases included the sale of 100% participatory interest held by the state[1].

Therefore, it may be suggested that the emerged investment priorities mean the opportunity to have access to sought-after resources (land, immovable property in major cities) and large-scale cash flows, which in markets with high entry barriers created through capital-intensive and highly specialized equipment must generate the demand of natural monopolies with potential co-financing on the side of the state, rather than interest in the offer to run business in one or another sector of the economy.

An effort to launch a large-scale sale of other property assets as part of the treasury of Russia became another specific feature of privatization in 2011.

In 2010, decisions on the terms of privatization of such assets (only 10 property assets) were made and publication of information announcements of sale were published not until the very end of the year, while the results were summed up as early as the beginning of 2011: six of the eight property assets were sold for a total of Rb 196.91m

[1] www.rosim.ru

Of 132 property assets subject to sale under the Privatization Program for the period of 2011–2013[1], and 86 of those offered for sale, the results in 2011 were summed up only for 16 property assets, of which only three were sold at no more than Rb 5m, and no sale took place for 13. Eleven sales of other property assets for a total of Rb 84.3m have been recognized as completed since the beginning of 2012. Therefore, no success was achieved.

Nevertheless, the amount of the proceeds generated in 2011 from sale of the federal property subject to privatization totaled Rb 121.44bn, i.e. 2.5 times as much as the total amount of revenues generated from the this source in the previous four years (2007 thru 2010), as the Ministry of Economic Development and Trade of Russia and the Federal Agency for State Property Management reported. More details on the federal budget revenues from privatization and usage of state-owned property assets are provided in other sections herein based on the budget statistical data.

6.1.3. Updates to the Law on Privatization

The law on privatization was constantly improving during the previous year, like the year before that[2].

Four federal laws were issued a time in July 2011 to amend and update the Law "On Privatization of Public and Municipal Property" of December 21, 2001, (No. 178-FZ). The Federal Law of July 1, 2011, No. 201-FZ, was considered most important, as it intended to amend the applicable Law on Privatization, whereas the other three laws updated the same in the context of other legislative initiatives.

The following significant amendments and updates to the Law were made:

– it is accepted that disposal of 15 categories of property which are not covered by the law[3], can be regulated not only by other federal laws, but also other regulations (only regulations adopted under federal laws were mentioned previously);

[1] The main part (about 72%) of the treasury property assets included into the program was subject to be included into integrated entities.

[2] See Annual Review "Russian Economy in 2010. Trends and Outlooks (Issue 32)" issued by IET (P. 6.1.5. New Stage in the Implementation of National Policy on Privatization of State-Held Property: Key Priorities and Objectives, Actions and Risks, p. 426-459).

[3] It was in the original version of the law that relations arising out of transfer of property were not supposed to be within the scope thereof, namely transfer of (1) land, safe for transfer of land plots on which property assets are located, including property complexes; (2) natural resources; (3) public and municipal residential properties; (4) public and municipal property, (5) property assets located outside the territory of the Russian Federation; and in (6) the cased provided for by international agreements (accords) signed by the Russian Federation; (7) faith-based buildings and facilities, including the land plots which pertain thereto, and other faith-based property owned by the state and municipalities which are transfer on a compensation-free basis to faith-based organizations which will use thereof for the faith-based purposes; (8) public and municipal property to non-profit organizations and entities established as a result of transformation of public and municipal institutions; (9) the property assigned to state and municipal unitary enterprises, state and municipally institutions on the basis of economic management or control; (10) public and municipal property on the basis of a relevant court order; (11) shares (interest) in the cases when the Russian Federation, constituent territories of the Russian Federation and municipalities become legally entitled to demand from a joint stock company to purchase such shares (interest).
Later these were complemented with the following types of property: (1) publicly and municipally owned land plots on which buildings, facilities and structures owned by all-Russia societies of the disabled and organizations are located, and these societies are the sole founders of such property being transferred to them on a compensation-free basis (in 2005, this types of property was combined into a single category with faith-based property being transferred to faith-based organizations); (2) the stocks of a joint stock company (OJSC), including securities to be converted into such stocks, in case of retirement thereof pursuant to the procedure set forth in

– the composition of one of the foregoing category of property was extended through transfer of the title of public and municipal property to non-profit organizations (NPOs) established as a result of transformation of public and municipal unitary enterprises (the category previously included the property transferred to NPOs established as a result of transformation of public and municipal institutions, as well as the federal property transferred to public corporations as an asset contribution from the Russian Federation);
– there is a provision for the possibility to privatize unitary enterprises through incorporation thereof not only into open joint stock companies (OJSCs) (as previously) but also limited liability companies (LLCs), which, consequently, resulted in many updates to the text of the law, including the emergence of "business entities" category which within the meaning of it covers a wider population of business organizations;
– it is the size of the charter capital of a company established through privatization that serves as the criterion for bidding of one of the foregoing methods: if the size is smaller than the minimum charter capital requirement for OJSCs established by the Russian laws, a unitary enterprise shall be transformed into LLC, if its charter capital equals or beyond the requirement, it should be incorporated into a joint stock company, but if one of its performance figures (such as (1) average staff headcount, (2) proceeds from sale of goods (works, services) net of VAT in the period of three calendar years prior to the privatization, (3) the amount of residual value of its fixed assets and intangible assets as of the latest reporting date) is equal or less than the ceiling established for small business entities pursuant to Federal Law No. 209-FZ, dd. July 24, 2007 "On the Development of Small and Medium Size Enterprises in the Russian Federation", the unitary enterprise property complex also can be privatized through transformation thereof to LLC;
– LLCs like OJSCs may not buy their interest; the emergence of a special regulation, i.e. if the buyer of public or municipal property was not entitled to purchase thereof, the relevant transaction shall be deemed null and void. This regulation is of general nature though;
– an explicit rule was included into the law on that the size of the charter capital of a business entity established through transformation of unitary enterprise equals to the book value of the unitary enterprise's assets subject to privatization which includes the value of land plots;
– the text of the law was complimented with a provision on that to define the composition of the privatized property complex of a unitary enterprise, creditors' claims shall be duly considered without having to obtain the consent of creditors as to address their claims to a successor in title of the unitary enterprise;
– a list of the data to be included into a decision on federal property privatization was complemented with data on the size of charter capital of OJSCs' or LLCs' established through transformation of unitary enterprises, the number, category and par value of a share in OJSCs and interest in LLCs which is held by one or another level of public authority;

Article 84.8 of Federal Law No. 208-FZ dd. December 26, 1995, "On Joint stock Companies" which regulates the retirement of securities of joint stock companies as demanded by a person who holds at least 95% of interest in such OJSC (2006); (3) property to be transferred to public corporations (state-owned companies) (2007) and the Russian Housing Development Foundation as an asset contribution from the Russian Federation (2008); (4) property transferred to the RF Presidential Center for Historical Legacy which ceased to perform its duties (2008); (5) federal property pursuant to the decisions of the Government of Russia made for the purpose of creating conditions for the attraction of investments, stimulation of the stock market, as well as modernization and technical development of the national economy (2010).

– some amendments were made to the regulation on how buyers of privatized property should submit relevant documents: (1) instead of having to provide a written decision on the purchase of property made by a relevant governing body, legal entities must have a document which confirms the powers of the head of a legal entity to act on its behalf without a power of attorney or with a power of attorney authorizing him/her to act on behalf of an bidder[1]; (2) a requirement that the bidder or a representative thereof bind, enumerate, seal and sign (required for legal entities) all the pages of documents (or specific volumes thereof) submitted together with bids, attach (to a bid) two copies of the record statement thereof, one for the seller, another one for the bidder; (3) the bidder must observe the foregoing requirements, which means that bids and the documents to be attached thereto are submitted on behalf of the bidder[2];
– the same way one should consider a new explicit rule emerged in the law, which prohibits to impose other requirements on the documents to be attached to bids, as well as require other documents upon the abolishment of the previous rule requiring that the bidder prove that he is entitled to purchase public or municipal property;
– with regard to social guarantees to the workers employed in OJSCs and LLCs established through privatization, it was ascertained that a new collective agreement may be entered into or the previous agreement may be extended for a period of up to three years upon expiration of three months from the date of registration thereof (previously, the agreement in effect was allowed to be revised without having to specify its terms, in addition to a new one);
– in case of privatization through tenders, shares or a participatory interest in the charter capital of OJSCs or LLCs, accounting for more than 50% of their charter capital, may be sold, whereas previously the unitary enterprise property complex might be sold along with the sale of more than 50 per cents of OJSC's charter capital;
– a list of the terms and conditions of tenders was added to the change in assigning specific property assets used for scientific or/and research purposes;
– a procedure for reimbursement on invalid transactions on purchase and sale of public and municipal property: budgets at a relevant level became the only source of financing thereof, whereas previously budgetary funds could be used subject to shortage of the proceeds from sale of property to other buyers under other privatization transactions prior to allocation thereof;
– public and municipal title must be protected the same way, i.e. with relevant budgets, while the priority of the norms set forth in the Budget Code of Russia was established with the regard to the money received with regard to defaults on privatization transactions, like interest transaction for the amount equal to the provided installment payment for privatized property;
– given the possibility to transform unitary enterprises into LLCs fully owned by the state (municipality), it was established that the charter of such LLCs may not provide for the prerogative right to buy the interest sold by its holder, as well as they are not subject to the norms set forth in the Federal Law "On Limited Liability Companies" on joint and

[1] Where the power of attorney authorizing to act on behalf of the bidder is signed by a person authorized by the manager of a legal entity, the bid also must contain a document which certifies the powers of such person.
[2] Inappropriate meeting by the bidder of the requirement that all pages of documents attached to the bid must be enumerated is not considered a ground for denying the bid, though no sanctions are provided for in this respect.

several obligations of the members of such LLCs and an independent appraiser to bear subsidiary liability in case of shortage of LLCs' property if non-cash payment for a participatory interest in the charter capital under their obligation is made to the extent equal to an overvalued amount of the property paid for a participatory interest in the charter capital made within three years from the date of state registration of the company or making amendments to the charter thereof;

– the wording of the article on the specifics of legal status of OJSCs and LLCs whose shares, participatory interest in the charter capital are held by the Russian Federation, constituent territories of the Russian Federation or municipalities was rectified to refer to shares and participatory interest which are not assigned to state and municipal unitary enterprises and institutions;
– due to acceptance of engaging legal entities, apart from public authorities, in organizing sale of privatized property pursuant to the duly established procedure, an allowance is made for such sellers to sell in specific cases to exercise on behalf of the state some of the rights which the shareholders or members of LLCs are entitled to;
– with respect to OJSCs and LLCs with a 100% federal or municipal government ownership (100% participatory interest in the charter capital) are held by the state or a municipality it was ascertain that procedures for preparation and holding a general meeting of shareholders (members of a joint stock company) are not to be applicable, except for the provisions regarding the dates of an annual general meeting of shareholders, general meeting of the members of a joint stock company;
– the text of the law was supplemented with a provision on that OJSCs and LLCs established through privatization of unitary enterprises are to be entitled to conduct the types of activities provided for by their charters based on licenses and other permits issued to such unitary enterprises.

A series of amendments and updates were made in December 2011 to the applicable Federal Law "On Privatization" in the context of the development of the legislation on the protection of competition:

– the format of information support of privatization which after the amendments dated May 2010 must include, apart from having to be published in official printed publications, posting of relevant information on official websites, also supplemented with the official website of the Russian Federation for posting information on bidding as determined by the Government of Russia;
– the requirement for a period of acceptance of bids for auctions (at least 25 days) was supplemented with a rule specifying that such auctions must be held not less than 10 days from the date on which the bidders are accepted (the same rule is to be applicable to a special auction, tender, sale through public offering);
– second, (5 to 15 working days from the date of summing up the results of an auction) the term for concluding a purchase and sale agreement with the winner was extended (the same must be applicable to sale through public offering from the date of winner pronouncing notice);
– a duration applicable for auctions (tenders) was a bit shorter (10 to 15 working days);
– however, no agreement may be entered into on the basis of the results of auctions, sale through public offering, sale without specifying the price within less than 10 working

days from the date when a protocol containing the results of sale of privatized property is posted on websites;

– a new version of Article 22 of the applicable Federal Law "On Privatization" is to take effect next year (on January 1, 2013), which will regulate sale of OJSCs' shares through a securities market operator, in which this notion and notions derived from this notion were replaced with the 'exchange auction', etc. with relevant drafting amendments.

The following should be highlighted in assessing numerous updates to the Federal Law "On Privatization".

The duration of entering into a purchase and sale agreement with the winners of privatization procedures was extended; a regulation on the minimum time interval between the acknowledgement of bidders and the moment of conducting procedures themselves must raise the level of competition in the sale of privatized assets.

Improving information support of privatization by adding more channels of dissipation of relevant information through the official website of the Russian Federation together with the introduction of the minimum time interval between posting of a protocol of sale of public or municipal property on websites and conclusion of an agreement on the basis of such sale is intended to contribute to a more transparent privatization process as a whole thus counteracting corruption and organized crime.

The regulation on the right of OJSCs and LLCs which are established through privatization, to conduct activities on the basis of licenses and other permits issued to a relevant unitary enterprise is supposed to further strengthen the status of new owners and privatized enterprises themselves.

Changes in the procedure for reimbursing under invalid transactions of purchase and sale of public and municipal property, which prohibits the use for this purpose of the proceeds from sale of property to other buyers under other privatization transactions prior to allocation thereof, is likely to streamline the process of privatization.

The way of incorporation of unitary enterprises into LLCs seems to be ambiguous. On the one hand, many options of incorporation of business entities of this type can be made available by using this way together with the regulations set forth in the relevant special law[1,2].

The formerly used type of incorporation of almost all[3] unitary enterprises (including many small enterprises) into OJSCs with a 100% state-held interest was related to a formal necessity to incur expenses arising out of the requirements set forth in the laws on of joint stock companies and securities[4] with questionable prospects of attracting investments through enlisting in the stock market, but a substantial increase in subsequent public expenses on representation of its interests (the need to increase the number of its representatives in the gov-

[1] Federal Law No. 161-FZ, dd. November 14, 2001, "On Public and Municipal Unitary Enterprises" allows these to be transformed into public and municipal institutions and, based on the recent amendments, autonomous nonprofit organizations as well.

[2] The procedure for participation of public representatives in the top management body of autonomous nonprofit organizations and the Procedure for Corporate Governance of LLCs with a State-Held Interest Established Through Privatization were approved by RF Government Regulations No. 33 and No. 34, dd. January 27, 2012.

[3] Except for sale of the unitary enterprise property complex which was abolished on the basis of analysis of the amendments made to the Federal Law "On Privatization" in the summer of 2011.

[4] The obligation to annually publish profit & loss reports, balance sheets, disclose information on general meetings of shareholders, the need to engage a special registrar in maintaining a register, etc.

erning bodies of OJSCs while having to maintain their qualification at an adequate level and adequately using corporate governance arrangements[1]).

On the other hand, there arises a certain contradiction with the orientation – which was typical of the entire period of reforms of ownership relations in Russia as early as the 1990s – of property management agencies towards minimization of public participation in the economy in any legal form which differs from OJSC because the latter is more transparent. However, this perspective should be accepted as realistic due to that an interest held by the state (municipality) in a LLC may not be bought in full at a time in the course of privatization. Furthermore, the use of criteria applicable to small businesses which provide for the possibility itself of incorporation of a part of unitary enterprises into LLCs, is not mandatory and diverse.

Enlarging the list of terms and conditions for sale during tenders (auctions) by restricting changes regarding the purpose of specific property assets used for scientific and/or research activities may have an adverse effect due to the threat of formal approach towards privatization without considering sector-related specifics, and the notorious problem of following up the observation of the terms and conditions of tenders (auctions).

It also is worth noting that there was a continued trend towards enlarging the already exclusive prerogatives of the government in the world of privatization without actual external control over privatization, as evidenced by a newly appeared regulation on the transfer of property of 15 categories which are not covered by the law, other federal laws and also other norms and regulations.

The update issued in 2010 – it still remains to be adequately formalized – allows other legal entities besides government authorities[2] to be engaged in organizing sale of privatized property, was supplemented with the possibility in some cases for such legal entities to exercise on behalf of the state the specific rights to which LLC shareholders or interest holders are entitled, without defining any set of such rights and conditions under which they can be delegated.

Hence, summing up the results, one may say that the amendments and updates made to the Federal Law "On Privatization" in Russia in 2011 materialized the proposals of the Ministry of Economic Development and Trade of Russia and the Federal Agency for State Property Management which were prepared as early as 2005, on how to raise the level of effectiveness and enhance the mechanism of privatization process and optimize decisions on the management of state-owned property assets, followed the logic of the important updates included into the Law "On Privatization" in 2010.

However, the latter, being focused on a large-scale privatization of large aggregate of relatively small assets and expansion of the conditions, potential mechanisms of privatization of large and super large public companies, are imposed to a significant potential of risks related to poor transparency of sale of property to strategic investors, ill-defined reciprocal obligations of the state and buyers, unclear mechanisms of enforcement of such obligations. With regard to privatization of large companies, a special focus is placed on "individual" decisions, but even general frameworks of such decisions remain to be defined, while the powers of the

[1] The activity of the Board of Directors of OJSCs is a certain precondition for being subject to a strict control over management. However, lack of regular meetings and red tape cast some doubt on the effectiveness of incorporation of unitary enterprises.

[2] A relevant mechanism should be developed on a competitive basis, which is not mentioned in the law, to create conditions for making decisions on engaging private sellers in selling privatized federal property. A list of such organizations, 23 legal entities, including Sberbank and VTB, was approved as early as 2010.

Government of Russia in making such decisions were enhanced and their role made more important[1].

The circumstances require that further efforts be made to create objective preconditions for strengthening the structural trend of privatization which require a significant progress in developing institutional environment, long-term and transparent "game rules" for interaction between the state and business community.

Among the applied regulations which have an effect on the privatization process, a special emphasis should be placed on Russian Government Regulation No. 71, dd. 12 February 2011, which specifies – as part of the implementation of the amendments adopted in 2010 to the Federal Law "On Privatization" – the rules for sale through public offering, establishes the transition to setting the initial sale price through market-driven mechanisms on the basis of the report made by an independent appraiser, updates the rules for submission of documents for bidding at privatized property sale auctions.

Order No. 208 which was issued by the Ministry of Economic Development and Trade of Russia on May 11, 2011, approved the Procedure for Disclosure of Information by OJSCs whose shares are held by the state or municipalities, and public (municipal) unitary enterprises since the moment of enlisting into the Forecast Plan (Program) for Federal Property Privatization. These rules are applicable at the federal, regional and municipal levels, save for FSUEs subject to transformation – based on decisions of the President and the Government of the Russian Federation – into OJSCs with a 100% federal government ownership and to be contributed to the charter capital of OJSC or a public corporation as an asset contribution from the state, as well as OJSCs whose shares are to be contributed to the charter capital of other OJSC on the basis of decisions made by the President and the Government of the Russian Federation.

In addition, Russian Government Order No. 1094, dd. December 22, 2011, approved the amendments to the Rules for the Development of the Forecast Plan (Program) for Federal Property Privatization issued at the end of 2005. The amendments regulate, in particular the procedure for delisting federal property from the privatization program, establish the procedure and terms within which the Ministry of Finance of Russia and the Federal Antimonopoly Service of the Russian Federation are to approve the proposals on delisting federal property from the privatization program which federal government executive bodies submit to the Federal Agency for State Property Management, as well as the procedure and terms within which discrepancies on this issue are to be considered. The foregoing procedure provides for the following. Federal property can be delisted from the privatization program on the basis of consideration at a meeting held by the Government. Provisions on privatization of a state-held interest in LLCs were also included into the Rules for the Development of the Forecast Plan (Program) for Federal Property Privatization.

6.1.4. Enhancing corporate governance of business entities with state participation

A series of significant amendments were made during 2011 to the applicable regulations which regulate the corporate governance of business entities with state participation.

[1] See Annual Review "Russian Economy in 2010. Trends and Outlooks (Issue 32)" issued by IET (P. 6.1.5. New Stage in the Implementation of National Policy on Privatization of State-Held Property: Key Priorities and Objectives, Actions and Risks, p. 426-459).

The amendments were made on the basis of Russian Government Regulation No. 1214, dd. December 31, 2010, *applicable* to *federally owned JSCs,* and approved a pro-forma structure of the reports made by such JSCs, and some updates to the previously issued Russian Government regulations.

It was established that from March 1, 2011 federal executive bodies must cooperate on the issues regulated by the Provision on Management of Federally Held Shares of Joint stock Companies and the Use of the Special Right of Participation of the Russian Federation in Corporate Governance of Joint stock Companies ("Golden Share") approved by Russian Government Order No. 738, dd. December 3, 2004, through an Internet-based Special Interdepartmental Portal on State-owned property Management operated by the Federal Agency for State Property Management.

The first stage of the Interdepartmental Portal was put into pilot production in 2010 and the second stage was scheduled for 2011. The Federal Agency for State Property Management used the Portal to control the activity of joint stock companies, in particular allocation of net profit retained as of the end of the previous year, reduction of expenses and management cots, implementation of investment programs.

The Portal was designed to play an important role in the set of public management tools, because representatives of state interests in the governing bodies of federally owned joint stock companies undertook to submit quarterly progress reports to the board of directors (Steering Committee) of JSCs and annual financial reports by posting thereof on the Portal.

The Ministry of Economic Development and Trade of Russia was put in charge of approving a form of the report made by those who represent the interests of the Russian Federation in the governing bodies of joint stock companies with federally held shares, and a filling-out manual, which the Ministry did by issuing Order No. 164, dd. 12 April[1].

More details were specified as to the contents of the annual report on the management of federally held shares of JSCs and exercising the special right ("golden share") in the previous year which the Ministry of Economic Development and Trade of Russia is to submit to the Government of Russia. The report must include information on: (a) execution of the orders issued by the President and the Government of the Russian Federation, including information on target and actually achieved characteristics and indicators of the sector-based performance in the previous year, (b) measures aimed at enhancing the corporate governance system, (c) all decisions on payment of dividends (including the amount dividends paid), including by sector, including large dividend payers, as well as JSCs which made a decision to pay no dividends, (d) business performance results, the dynamics of net profit and debt load against the sector average, including retrospective dynamics and analysis of capital adequacy, (e) the results of general meetings of shareholders which were held in the reporting year.

Formalized were the requirements to persons whom the state offers as independent directors and their relatives[2], in nominating candidates for election to the board of directors of JSCs with state participation. Within the three recent years such persons must not:

[1] The former standard forms of the reports to be made by representatives of the public interests in the management bodies of JSCs and general managers of FSUEs ceased to be in force under Government of Russia Regulation No. 499, dd. June 20, 2011.

[2] Their family members (spouse, parents, children, adoptive parents, adopted persons), as well as blood and half-blood brothers and sisters, grandparents.

- hold management positions, be employed at an JSC or its subsidiaries and related companies, as well as hold management positions, be a member of the governing body or the manager of an JSC;
- be an affiliate with any JSC or its subsidiaries and related companies, save for being a member of the board of directors (steering committee) of a joint stock company;
- act as an auditor of an JSC (including an officer of an auditor), as well as be an affiliate with the auditor of the JSC;
- perform obligations or be an officer of a company which performs obligations under an agreement with an JSC, if a total amount of transactions closed for the purpose of executing the agreement accounts for at least 10% of the book value of the JSC's assets within a period of one year;
- represent the interests of persons or legal entities bound under an agreement with JSCs with whom a total amount of transactions accounts for at least 10% of the book value of the JSC's assets within a period of one year;
- receive from JSCs remunerations, compensations or any other types of payment whose value accounts for at least 10% of the total annual income of the foregoing persons, safe for payments relating to the activity as an independent director and closing of transactions in order to satisfy personal, household, family or other non-business needs, as well as participate in optional programs of the company.

In addition, a person whom the state as shareholder nominates as an independent director in the board of directors, must not:

- fill offices of state civil service or be a staff member of the Central Bank of Russia;
- be an elected member of the board of directors (steering committee) of a company within the recent five years;
- be in the capacity of manager or employed in any other JSC in which any member of the governing body of a company to which the person is nominated as independent director, is a member of the HR and remuneration committee under the board of directors of the company;
- be in the capacity of independent director of more than three joint stock companies.

In addition, formal revisions replacing the previously used notion 'open joint stock company' with 'joint stock company', meant that the foregoing regulations cover a wider population of business entities, because the state participates in the capital of some CJSCs besides OJSCs.

A new revision of a paragraph of the Provision on management of federally held shares of joint stock companies and exercise of the special right to participation of the Russian Federation in corporate governance of joint stock companies ("golden share") approved by Russian Government Order No. 738, dd. 3 December 2004, with regard to the status of those who represent state interests in boards of directors, became the most important amendment in 2011.

First of all, it should be noted that representatives of state interests and the persons whom the state nominated as independent directors were differentiated.

After that, the state was entitled to vote for the election of persons as representatives of state interests whom the state as shareholder didn't nominate for the board of directors, if such persons entered into an agreement on representation of state interests in the governing body of JSCs with federally held shares.

The provision issued in 2004 was also supplemented with regulations concerning professional agents, i.e. persons who act under the foregoing document and agreement and may represent the state interests together with persons filling public offices or offices of state civil service.

The agreement must stipulate that professional agents are entitled to initiate a discussion with relevant government authorities and invite other representatives of state interests in a joint stock company to discuss the issues brought up for meetings of the board of directors, and receive information which they need to exercise their powers and duties.

The agreement specifies the following powers to delegate to professional agents: (1) exercise in good faith and reasonable manner the delegated powers and duties within the scope of competence of board of directors, (2) notify promptly of their meetings whose agenda includes the issues which require directives to be issued, (3) vote in accordance with the issued directives (if issuance of directives is specified in the agenda of a meeting of the board of directors), (4) participate in the committees and commissions of the board of directors (if an agent is elected as a member of such committees and commissions), (5) convene a meeting of the board of directors and add to the agenda thereof the issues proposed by the Russian Federation as shareholder (if an agent is elected the chairman of the board of directors)[1].

Following the Ministry of Defense of Russia, the Department for Presidential Affairs of the Russian Federation was entitled to exercise on behalf of the state the rights of shareholder of joint stock companies established through privatization of subordinated federal state unitary enterprises with federally held shares.

With regard to FSUEs, the aforementioned Russian Government Order No. 1214, dd. December 31, 2010, established a threshold to the value of property on which various decisions must be made on the basis of decisions of the Government of Russia, the Chairperson of the Government of Russia or decisions made by Deputies Chairperson by Chairperson's order[2].

With regard to FSUEs which are not enlisted into the Forecast Plan (Program) for Federal Property Privatization, such a threshold was established to coordinate (1) transactions relating to management of a contribution (share of) to the charter (pooled) capital of business entities or partnerships, as well as shares held by a company, and (2) make decisions on participation of companies in business and non-profit organizations, as well as conclusion of a simple partnership agreement.

With regard to FSUEs which are enlisted in the Forecast Plan (Program) for Federal Property Privatization, such a threshold was established to coordinate (1) closing of large transactions as well as transactions relating to the extension of loans, issuance of sureties, banking guarantees, other encumbrances, assignment of claims, debt transfer, fundraising (2) transactions relating to the management of a contribution (shares of) to the charter capital of business entities or partnerships, as well as the shares held by an enterprise, (3) decisions on participa-

[1] Previously, the issues related to the activity of proxies were regulated by still applicable Government of Russia Regulation No. 625, dd. May 21, 1996, which approved the Standard Agreement on Representation of State Interests in the Governing bodies of Joint stock Companies (Business Partnerships) Whose Stocks (Interest, Contribution) are Partially Held by the Federal Government and the Procedure for conclusion and registration of such agreements. This aspect, however, was not adequately reflected in the legal framework in the 2000s, concerning the management of state held shares (special Provisions which were approved by following each other government regulations issued in 2000, 2003 and 2004).

[2] More than Rb 150m pursuant to the law on valuation activities. This threshold value and the specified procedure for coordination have been applied in different variations since 2003 for the purpose of regulating FSUEs' transactions with the federal immovable property located in Russia and assigned to them for economical management.

tion of companies in business and non-profit organizations, as well as conclusion of a simple partnership agreement[1].

Russian Government Order No. 499, dd. June 20, 2011, established that federal government executive bodies (FGEBs) should interact with regard to corporate governance of FSUEs which are basically governed by regulations concerning the functioning of entities of this type[2], the same way as with JSCs with state participation, namely through the interdepartmental portal dedicated to the management of state-owned property assets.

The Federal Agency for State Property Management was placed in charge of regulation of interaction of FGEBs with regard to corporate governance of enterprises through the portal, while government authorizes themselves must start to approve corporate development strategies for the period of three to five years. Relevant guidelines were approved by Order No. 683 issued on November 18, 2011 by the Ministry of Economic Development and Trade of Russia.

Important amendments were made to the Procedure for the Reporting of Managers of FSUEs[3] and other regulations in force which regulate their functioning.

For example, Russian Government Ordinance No. 228, dd. April 10, 2002, "On the Measures of Enhancing Effective Use of the Federal Property Secured to Federal State Unitary Enterprises for Economic Management" with regard to approval by FGEBs of development strategies of their subordinated entities, established that they should be based on the approved programs and decisions made by the President and the Government of the Russian Federation. Corporate development strategies must be duly approved by a government authority[4] by engaging (as may be appropriate) representatives of other federal government executive bodies, while FSUEs' activity programs must be based on their duly approved corporate strategy.

Russian Government Regulation No. 739, dd. December 3, 2004, "On the Powers of Federal Government Executive Bodies to Exercise the Title to the Property of Federal State Unitary Enterprises" was supplemented with a regulation on that FGEBs shall make decisions on coordination of (1) closing of large transactions as well as transactions relating to the extension of loans, issuance of sureties, banking guarantees, other encumbrances, assignment of claims, debt transfer, fundraising (2) closing of transactions in which the manager of an enterprise acts as stakeholder, (3) transactions relating to the management of a contribution (shares of) to the charter capital of business entities or partnerships, as well as the shares held by an enterprise, (4) decisions on participation of companies in business and non-profit organizations, as well as conclusion of a simple partnership agreement, provided that such deci-

[1] The scope of actions was also changed for this group of FSUEs. To do such actions, a decision of industry-specific authorities requires a motivated position of the Federal Agency for State Property Management, which is to be submitted in written within 10 working days from the date of receipt of relevant proposals from them.

[2] Russian Government Ordinance No. 228, dd. April 10, 2002 (together with the Rules for the Development and Approval of Operational Programs and Determination of a Profit of Federal State Unitary Enterprises which is Subject to Transfer to the Federal Budget, No. 333, dd. June 6, 2003 and No. 739, dd. December 3, 2004.

[3] Apart from the changes relating to the transition towards cooperation in managing FSUEs through the portal and approval of their development strategies, the procedure for reporting by their managers was changed by adding a provision on submission of information to the Federal Agency for State Property Management on participation of a company in the capitals of legal entities (this requirement was previously imposed on participation in the capital of foreign legal entities only).

[4] Except for the enterprises enlisted into the forecast plan (program) on federal property privatization, or the enterprises to be privatized on the basis of duly made decisions.

sions are in line with the measures provided for by their corporate development program, volumes and sources of financing, corporate budget items for the planning period.

Many amendments and updates were made to the currently applicable regulations which regulate the functioning of FSUEs.

In particular it was established that transactions on purchase and sale of property should be conducted by selling property at auction pursuant to the procedure established by the federal antimonopoly agency, whereas a reference to provisions set forth in the Law "On Privatization" which regulate sale of state-owned property assets and state-held shares of OJSCs at auction, was applied for this purpose in the previous periods.

In December 2011, the powers of the Federal Agency for State Property Management with regard to FSUEs, save for those FSUEs which are in the scope of competence of the Ministry of Defense of Russia and the Department for Presidential Affairs of the Russian Federation, with regard to coordination based on the proposals of a federal authority which is in charge of supervision over transactions with the immovable property assets secured to the enterprise on the basis of economic management, were supplemented with a qualifying regulation on leasing these property assets under agreements whose standard terms and conditions are approved by the Ministry of Economic Development and Trade of Russian, unless otherwise provided for by other norms and regulations adopted in accordance with the federal laws.

Special Russian Government Instruction No. 1060-r, dd. June 20, 2011 approved a list of 13 FSUEs to be subject to a special procedure for decision-making on specific issues concerning the activity of such enterprises, including appointment of the general manager thereof, conclusion, revision and termination of labor contracts therewith, approval of the development strategy and program, determination of a corporate profit to transfer to the federal budget, as well as approval of the estimate of income and expenses of federal state-run enterprises.

With regard to this group of enterprises, decisions on coordination of transactions relating to purchase, assignment or possibility of assignment, directly or indirectly, by enterprises owning property assets whose value exceeds 25% of book value of the corporate assets based on its accounting reports as of the latest reporting date, should be made by a FGEB on the basis of decisions of the Government of Russia, the Chairperson of the Government of Russia, or decisions made by Deputies Chairperson by Chairperson's order. The same procedure was established for reorganization of such FSUEs.

From the practical point of view, the update to corporate governance of federally owned joint stock companies can be characterized as follows (*Table 8*).

In the period since 2008 the number of JSCs whose governing bodies included elected professional directors, increased by 41 times, incl. 1,7 times in 2011, to reach 739 persons.

Hence, the percentage of JSCs with federally held shares, which engaged professional directors (net of JSCs which are subject to the special right "golden share", and LLCs), stood at more than 26% (against about 8% in 2009, 15.3% in 2010)[1].

[1] In analyzing this indicator, one should consider incomplete comparability of the give values, because in 2009 and 2010 they were obtained by comparing the number of JSCs which had professional directors in their governing bodies, with the total number of JSCs with federally held shares, as of the beginning of the year. Moreover, in 2011 the value was obtained by comparing it with a smaller group of JSCs with state participation at the year-end, which means that it was slightly overestimated. In addition, there is no knowing whether or not the membership of professional directors nominated by private shareholders apart from those nominated by the state was taken into account.

Table 8

Dynamics of engaging professional directors in the governing bodies of joint stock companies with state capital participation in the period of 2008–2011

Indicator	2008	2009	2010	2011
Number of professional directors, per., including	112	610	921	1568
- independent directors, per.	41	180	296	369
- professional agents, per.	71	430	625	1199
Number of JSCs in which they were elected as members of the governing body thereof	18	269	448	739

Source: G.S. Nikitin, E.Y. Litvina. Comprehensive Development of the Systems of Corporate Governance of Joint Stock Companies with State Participation. – B: "Joint stock Company: Corporate Governance" No. 12 (91), 2011, PP. 13-15, www.rosim.ru.

A total number of professional directors increased by 14 times, incl. by 1.7 times in 2011, in the foregoing JSCs. The number of professional agents increased almost by 17 times (1.9 times in 2011), independent directors by 9 times (about ¼ times in 2011). As a result, the latter accounted for 23.5% of the total number of professional directors in 2011, whereas this indicator the percentage was a bit higher in the previous periods (36.6% in 2008, 29.5% in 2009, 32.1% in 2010). Six hundred and two professional agents became Chairpersons of the Board of Directors (supervision boards) of companies with state participation, or half of the total number of those engaged.

Less success was achieved in other fields of corporate governance modernization. A total of 194 JSCs approved their mid-term strategic development program, 241 companies approved a system of key performance indicators. Different number of specialized committees (e.g., committee for strategic planning, HR and remuneration committee, audit committee, etc) were established under the board of directors of 261 JSCs, a position of corporate secretary was envisaged in 129 JSCs. The performance-based assessment of top manager remuneration, which is essential in crisis and post-crisis periods, was introduced through the use of key performance indicators in some joint stock companies: a provision of management remuneration was approved in 296 companies (of which 250 companies introduced remuneration on the basis of key performance indicators), but a provision on remuneration of the members of boards of directors was approved only in 122 companies[1].

Following are important events that took place within the property strategy framework at the federal level. The CEOs of various large companies with state capital participation (e.g., the United Aircraft Corporation) were replaced, but it was not the case with natural monopolies, and deputy prime-ministers, ministers, managers of other federal government executive bodies and members of the Presidential Office were replaced with independent directors and professional agents in the board of directors of joint stock companies with state participation.

This measure is intended among others to improve the investment environment and cover about 20 largest companies with state capital participation and was supposed to be implemented within the first half of the year, when meetings of shareholders in the foregoing companies were supposed to replace ministries and other heads of government authorities assigned to regulate some or other market segments, who often were in the capacity of chairperson the board of directors of such companies. Not every civil servant was supposed to

[1] G.S. Nikitin, E.Y. Litvina. Comprehensive Development of the Systems of Corporate Governance of Joint stock Companies with state participation. – B: "Joint stock Company: Corporate Governance" No. 12 (91), 2011, P. 10, www.rosim.ru

be replaced with an independent director, government authorities were placed in charge of instructing state representatives on most important issues to consider.

The effect of this measure seems to be mixed. On the one hand, it creates potential preconditions for improving corporate governance, which is a key objective of the new privatization program. On the other hand, given the shortage of independent directors who would meet the requirements arising out of the materiality of companies with state capital participation, the situation is very likely to become the same as that at the very beginning of the 2000s, when senior civil servicemen represented state interests in these companies. In any case, it is undesirable if the state loses its leverage on the managers of these companies due to weakened status of state representatives in boards of directors and possible requirements to independent director candidates, and the issue of looking for efficient corporate governance arrangements in companies with state participation which provide for adequate balance of strategic interests of the state and private shareholders, still remains to be topical.

6.1.5. State participation in the economy and structural policy

Ownership of assets doesn't mean that the state can influence the configuration of a specific industry and indirectly the structure of economy at large, including through stimulating or opposing to some or other changes in specific sectors. In this respect, the year of 2011 was characterized by a relatively small changes vs. the recent few years.

A list of strategic enterprises and joint stock companies was updated. From the quantitative point of view, the changes were smaller vs. a large-scale reduction that took place in the preceding year. Only one unitary enterprise and two OJSCs were enlisted, and seven unitary enterprises (of which two unitary enterprises were subject to conversion into state-funded institutions) and two OJSCs, including Oboronservice, an integrated entity established in 2008, were delisted. Two OJSCs underwent changes in the format of their presence in the foregoing list: the state-held interest decreased from 100% to 50% +1 share after Sherementyevo International Airport (SIA) and the United Grain Company (UGC) were allowed to increase their charter capital through additional offering.

The same size of state-held interest was established in the middle of the year for Federal Hydropower Generating Company (RusHydro), through a tentative contribution of federally owned shares of 12 OJSCs to its charter capital in addition to a large number of other property assets, of which most significant were Pavlodolsk HPP in North Ossetia (100%), Kamchatka Gazenergy Complex (96.58%), RAO Energy System of East (52.68%). A state-held interest in the three of the rest of companies was bigger than the blocking interest.

Apart from the electric-power industry, the plan for integrated entities includes decisions relating to the geological and agricultural sectors.

The existing OJSC Centrgeologiya will be renamed into Rosgeologiya with subsequent contribution in the form of payment of additional federally-held shares of 24 OJSCs (100% -1 share) and OJSCs established as a result of transformation of 13 FSUEs, to be floated by this joint stock company.

OJSC Rosspirtprom's property complex underwent significant changes. On the one hand, its charter capital was increased through a state contribution of a great number of immovable property assets[1] withdrawn from operating management of federal state-run enterprise (FSRE)

[1] This can explain in part a sharp increase in the number of property assets subject to privatization which fall under the category of "Other property" in the privatization program for the period of 2011-2013.

Rosspirtprom. On the other hand, the number of business entities whose shares and interest were contributed to the charter capital of OJSC Rosspirtprom, decreased from 58 to 39, whereas the possibility to delegate exclusive rights to intellectual activities which previously were to be included therein, ceased to be in force. FSUE Central Moscow Hippodrome was incorporated into a OJSC with a 100% federally held interest, consolidating hippodromes of the Russian Federation. This is why the property assets of 27 state stud farms (SSF) left after liquidation of federal state institutions (FSI) were contributed as a state contribution to its charter capital.

An OJSC, Strategic Points of Control, started to build up in the defense industry. Such entities as the Concern Sozvezdiye and Concern Morinformsystem – Agat were expected to enlarge.

In 2011, a total of 29 integrated entities (including the Russian Technologies State Corporation) (26 integrated entities in 2010) were formed on the basis of the decisions made by the President and the Government of the Russian Federation.

As part of this process the Federal Agency for State Property Management made decisions on the terms of privatization of 92 unitary enterprises (24 unitary enterprises in 2010), shares of 44 JSCs (46 JSCs in 2010) and another 12 JSCs established as a result of transformation of FSUEs eligible for the Privatization Program and subject to become a part of integrated entities (two integrated enterprises in 2010), as well as 336 other property assets to contribute to the capital of OJSC Federal Hydropower Generating Company (RusHydro) and OJSC Rosspirtprom. The shares of 10 JSCs established through privatization of unitary enterprises were transferred as a state contribution to the Russian Technologies State Corporation.

With regard to 11 integrated entities (OJSC Concern PVO Almaz-Antey, Precision Instrument-Making Systems Research and Production Corporation, Uralvagonzavod Research and Production Corporation, Center of Excellence of Live Stock Reproduction, Rosneftgaz, Moscow Thermotechincs Institute Corporation, INTER RAOUES, OJSC Federal Hydropower Generating Company (RusHydro) and such FSUEs as “MMPP “Salut”, Khrunichev State Research and Production Space Center, Rosoboronexport), the decisions of the President and the Government of the Russian Federation were implemented in 2011 (the data provided by the Ministry of Economic Development and Trade of Russia).

At the end of October, OJSC Russian Railways sold 75% -2 shares (Rb 125,5bn) to its subsidiary Pervaya Gruzovaya Kompaniya. A blocking interest to Transcontainer was considered to be sold in the same manner[1]. However, the rolling stock was transferred to Pervaya Gruzovaya Kompaniya and Vtoraya Gruzovaya Kompaniya, other subsidiaries and independent companies because it became impossible to provide cargo transportation serviced on the side of the largest all-Russian railway carrier, which raised a question of introducing a category of “outsourced cars” which the Russian Railways should lease from other operators, including subsidiaries, to provide to consignors at special prices[2].

Under such circumstances, apart from the structural policy aspects, it is the dividend policy of the state as shareholder of integrated entities that becomes important in terms of generating extra revenues from sale of assets in addition to operating income. The state may expect a certain amount of compensation for contributing free assets to these entities. In some cases, the

[1] http://www.1prime.ru, 28.10.2011, M. Kukushkin. The Case is in Container // Moscow News, No. 159 (159), November 11, 2011, p. 07.
[2] Direct investments, No. 1 (117), 2012, p. 66.

state may accept discounting of budget-related problems by integrated entities in implementing "big privatization", which requires a mandatory set of behavior requirements to such business entities with regard to pricing policy, participation in mergers and acquisitions, investments, etc.

6.1.6. Budget effect of the state property policy in the period between 2000 and 2011

The downturn the Russian economy has been facing since the fall of 2008, naturally resulted in reduction of budget revenues, including revenues from the implementation of the state property policy. In 2011, like in the preceding year, economic growth was followed by a visible growth in state-funded revenues relating somehow to state-owned property assets.

It should be reminded that all federal budget revenues from state-owned property assets can be divided into two groups in terms of nature and sources thereof. One group includes revenues from the use of state-owned property (renewable sources). The second group comprises revenues of single origin, which are non-renewable, because once they are sold the state assigns the title thereto to other legal entities and individuals, incl. as part of the privatization process (non-renewable sources).

Below (*Tables 9* and *10*) are the data on the revenues (save for the data on the preceding year) specified in the laws on the implementation of the federal budget for the period of 2000–2010, with regard to the use of state-owned property assets and sale thereof only in the form of tangible assets[1].

[1] Outside the investigation remained federal budget revenues from mineral tax payments (including aquatic biological resources, revenues from the use of forest resources and mineral resources), compensation for losses in agricultural productivity relating to forfeiture of agricultural lands as a result of financial operations (revenues from allocation of budget funds (revenues from balances of budget funds and allocation thereof, from 2006 also revenues from management of funds allocated in the Stabilization Fund of the Russian Federation (in 2009 – the Reserve Fund and the National Wealth Fund), revenues from allocation of money accumulated during state-held shares auctions), interest from domestic budget loans extended with federal budget funds, interest on sovereign loans (cash inflow from foreign governments and legal entities thereof as repayments for loans extended by the Russian Federation, revenues from enterprises and organizations as payments of interest and guarantees on loans issued to the Russian Federation by foreign governments and international financial organizations)), from the provision of paid services or compensation for government expenses, transfer of profit to the Central Bank of Russia, some types of payments from public and municipal enterprises and organizations (patent fees and registration dues payable for official registration of software, data banks and integrated circuit layouts and other revenues which prior to including 2004 formed an integral part of payments due by government organizations (apart from revenues from the Vietsovpetro Joint Venture since 2001 and allocation of a part of the profit of FSUEs since 2002)), revenues from exercise of product sharing agreements (PSA), revenues from disposal and sale of confiscated properties converted into the revenues received from the usage and sale of confiscated and other property returned to the state (including properties whose title was transferred to the state by way of inheritance or gift, or contributions), revenues from lotteries, other revenues from the use of state-owned properties and title (revenues from exercise of rights to intellectual activity (R&D and technological works) of military, special and double purposes, revenues from exercise of rights to the state-owned results of scientific and research activity, revenues from operation and use of motor road assets, motor road tolls payable for vehicles registered overseas, and other revenues from the use of state-owned property assets), as well as from permitted types of activity of organizations, federal budget revenues from sale of precious metals and stones as part of the national reserve of the same.

Table 9

Federal budget revenues from the use of state-owned property assets (renewable sources) in the period between 2000 and 2011, m Rb

Year	Total	Dividends on shares (2000–2011) and revenues from other forms of capital participation (2005–2011)	Rental payments for state-owned land	Revenues from leasing of state-owned property assets	Revenues from transfers of a part of after-tax profit and other mandatory payments payable by FSUEs	Vietsovinvest Joint Venture Revenues
2000	23244,5	5676,5	-	5880,7	-	11687,3[a]
2001	29241,9	6478,0	3916,7[b]	5015,7[c]	209,6[d]	13621,9
2002	36362,4	10402,3	3588,1	8073,2	910,0	13388,8
2003	41261,1	12395,8	10276,8[e]		2387,6	16200,9
2004	50249,9	17228,2	908,1[f]	12374,5[g]	2539,6	17199,5
2005	56103,2	19291,9	1769,2[h]	14521,2[i]	2445,9	18075,0
2006	69173,4	25181,8	3508,0[h]	16809,9[i]	2556,0	21117,7
2007	80331,85	43542,7	4841,4[h]	18195,2[i]	3231,7	10520,85
2008	76266,7	53155,9	6042,8[h]	114587,7[i]	2480,3	-
2009	31849,6	10114,2	6470,5[h]	113507,6[i]	1757,3	-
2010	69728,8	45163,8	7451,7[h]	12349,2[j]	4764,1	-
2011	104304,0	79441,0	8210,5[h]	111241,25	4637,85	773,4

[a] – according to the Federal Agency for State Property Management of Russia, the Law "On the Implementation of the Federal Budget for 2000" contained no separate line for these; the amount of payments from state-owned enterprises (Rb 9887,1m) was specified (no specific elements were shown);
[b] – amount of rental for (i) agricultural lands and (ii) lands of cities and settlements;
[c] – total revenues from leasing of the property assets secured to (i) research institutions, (ii) educational institutions, (iii) medical institutions, (iiii) public museums, public institutions of arts and humanities, (iiiii) archive institutions, (iiiiii) Ministry of Defense of Russia, (iiiiiii) organizations under the Traffic Ministry of Russia, (iiiiiiii) organizations providing services to public academies of science and (iiiiiiiii) other revenues from leasing of state-owned property assets;
[d] – according to the Federal Agency for State Property Management of Russia, the Law "On the Implementation of the Federal Budget for 2001" contained no separate line for these; the value coincided with the value of other revenues from payments due by public and municipal organizations;
[e] – total amount of revenues from lease of state-owned property assets (without specifying land rental);
[f] – amount of rental for (i) lands of cities and settlements and (ii) state-owned land after the delimitation of land ownership;
[g] – total revenues from leasing of the property assets secured to (i) research institutions, (ii) educational institutions, (iii) medical institutions, (iiii) public institutions of arts and humanities, (iiiii) public archive institutions, (iiiiii) federal postal agencies under the Federal Communications Agency, (iiiiiii) organizations providing services to public academies of science and (iiiiiiii) other revenues from leasing of federally owned property assets;
[h] – rental after the delimitation of land ownership and proceeds from sale of the right to conclude contacts on leasing of state-owned land (net of land plots owned by autonomous (2008–2011) and state-funded (2011) institutions);
[i] – revenues from leasing of property assets which are operatively managed by federal government bodies and the institutions established thereby and on the basis of economic management by FSUEs: transferred for the purpose of state-status operating management (i) scientific institutions, (ii) institutions providing scientific services under the Russian Academy of Science and industry-specific academies of science, (iii) educational institutions, (iiii) medical institutions, (iiiii) federal postal agencies under the Federal Communications Agency, (iiiiii) public institutions of arts and humanities, (iiiiiii) public archive institutions and (iiiiiiii) other revenues from leasing of property assets which are operatively managed by federal government bodies and the institutions established thereby and on the basis of economic management by FSUEs[1] (for 2006–2009 net of overseas reve-

[1] In 2008-2009, FSUEs, as a source of revenues from leasing of property assets being under economic management thereby, were not mentioned, and leasing of property assets being under operating management by federal government authorities and the institutions established thereby excludes property assets owned by federal autonomous institutions.

nues from permitted types of activity and the use of federal property assets located overseas, which were not shown in the previous years[1]);
[j] – revenues from leasing of property assets which are operatively managed by federal government bodies and the institutions established thereby (save for state-funded and autonomous institutions): transferred for the purpose of state-status operating management (i) scientific institutions, (ii) institutions providing scientific services under the Russian Academy of Science and industry-specific academies of science, (iii) educational institutions, (iiii) medical institutions, (iiiii) public institutions of arts and humanities, (iiiiii public archive institutions, (iiiiiii) on the basis of economic management by the Ministry of Defense of Russia and its subordinated bodies, (iiiiiiii) federally owned with functions of disposing thereof being assigned to the Department for Presidential Affairs of the Russian Federation (2010) and (iiiiiiiii) other revenues from leasing of property assets which are operatively managed by federal government bodies and the institutions established thereby (net of overseas revenues from permitted types of activity and the use of federal property assets located overseas).
Source: The laws on the implementation of the federal budget for the period of 2000–2010, the Report on the Implementation of the Federal Budget as of January 1, 2012, www.roskazna.ru; IET's estimates.

Proceeding to analysis of preliminary results of the budget effect of the state property policy in 2011 with regard to renewable sources, first of all it is worth noting that dividends were growing and their value visibly increased 76% vs. 2010. Transfers of a part of the profit of unitary enterprises decreased a bit (less than 3%). A similar picture was seen in budget revenues from leasing. Revenues from leasing of land kept growing (more than 10%) like they did in 2010 as revenues from leasing of federal property decreased by 9%.

Finally, the dividends which were accumulated in the budget (Rb 79,44bn)[2] and land rental (Rb 8,21bn) exceeded in terms of absolute value all of the previously reported indicators. Transfers of a part of the profit of FSUEs (Rb 4,64bn) were found to be maximum too throughout the entire 2000x, save for 2010. In the meantime, revenues from leasing of property assets were continuously dropping since 2008 to reach the level of 2004.

The structure of the federal budget revenues from renewable sources saw continued growth of dividends in percentage terms (more than 76% in 2011 vs. 64.8% in the preceding year). The percentage of other sources decreased vs. 2010: by 10.8% for revenues from leasing of property assets, 7.9% from leasing of land, 4.4% for the profit transferred by FSUEs.

Proceeding to analysis the federal budget revenues from privatization and sale of state-owned property (*Table 10*), it should be noted that since 1999 revenues from sale of a major part of such assets (shares, and also land plots in 2003–2007[3]) became classified as sources of financing of the federal budget deficit.

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[1] According to the Federal Agency for State Property Management, revenues from the use of federal property assets located overseas (net of revenues of the Russian participant in Vietsovpetro Joint Venture), totaled Rb 315m in 1999 and Rb 440m in 2000. Thereupon, Overseas Management Enterprise, a FSUE, began to play the key role in organizing commercial use of federally owned immovable property assets located overseas.

[2] This value also exceeds the aggregate value of federal budget revenues prior to the crisis in 2007 from domestic dividends on shares of Russian JSCs (Rb 43,5bn) and revenues from the Russian participant in the Vietsovpetro Joint Venture (about Rb 10,5bn). After completion of the development program for OJSC Zarubezhneft, during which a 50% interest held by the Russian participant in the Vietsovpetro Joint Venture was contributed to the Zarubezhneft charter capital in 2007 along with the shares of two joint stock companies as research institutes, this source of federal budget revenues ceased to exist and was not even recognized in the structure of revenues from renewable sources in 2008-2010. In 2011, Vietsovpetro Joint Venture's revenues (Rb 773,4m) were transferred to the federal budget in terms of settlements on revenues generated in the previous years.

[3] In 2003-2004, given the sale of leasehold right.

Table 10

Federal budget revenues from privatization and sale of property assets (non-renewable sources) in the period between 2000 and 2011, Rb m

Year	Total	Sale of federally held shares (2000–2011) and other forms of interest holding (2005–2011)[a]	Sale of land plots	Sale of various types of property
2000	27167,8	26983,5	-	184,3[b]
2001	10307,9	9583,9	119,6[c]	217,5+ 386,5+0,4 (IAs)[d]
2002	10448,9	8255,9[e]	1967,0[f]	226,0[g]
2003	94077,6	89758,6	3992,3[h]	316,2+10,5[i]
2004	70548,1	65726,9	3259,3[j]	197,3+1364,6+0,04 (IAs)[k]
2005	41254,2	34987,6	5285,7[l]	980,9[m]
2006	24726,4	17567,9	5874,2[l]	1284,3[n]
2007	25429,4	19274,3	959,6[o]	5195,5[p]
2008	12395,0	6665,2+29,6	1202,0[q]	4498,2+0,025 (IAs)[r]
2009	4544,1	1952,9	1152,5[q]	1438,7[r]
2010	18677,6	14914,4	1376,2[q]	2387,0+0,039 (IAs)[r]
2011	136660,2	126207,5	2425,2[q]	8027,5[r]

[a] – refer to sources of internal financing of the federal budget deficit, total amount of Rb 29,6m in 2008 (according to the data provided in the Report on the implementation of the federal budget as of January 1, 2009) was classified as federal budget revenues but not specified in the Federal Law "On the Implementation of the Federal Budget in 2008";

[b] – revenues from privatization of state-owned organizations classified as sources of internal financing of the federal budget deficit;

[c] – revenues from sale land plots and leasehold rights to state-owned land plots (specifying the land plots on which privatized enterprises are located) classified as federal budget revenues;

[d] – amount of proceeds from (1) sale of federally owned property classified as sources of internal financing of the federal budget deficit, (2) revenues (i) from sale of living quarters, (ii) from sale of public productive and nonproductive assets, means of transport, other equipment and other tangible assets, as well as (3) revenues from sale of intangible assets (IAs) classified as federal budget revenues;

[e] – including Rb 6m from sale of shares held by constituent territories of the Russian Federation;

[f] – revenues from sale of land and intangible assets, without specifying the amount of proceeds therefrom, classified as federal budget revenues;

[g] – proceeds from sale of state-owned property (including Rb 1,5m from sale of the property owned by constituent territories of the Russian Federation) classified as sources of internal financing of the federal budget deficit;

[h] – includes proceeds (1) from sale of land plots, which include immovable property assets owned by the federal government prior to transfer, to be allocated to the federal budget, (2) from sale of other land plots, as well as from sale of the right to conclude contracts on leasehold thereof, (3) from sale of land plots prior to the delimitation of land ownership, as well as from sale of the right to conclude contracts on leasehold thereof, to be allocated to the federal budget, classified as sources of internal financing of the federal budget deficit;

[i] – the amount (1) of proceeds from federally owned property classified as sources of internal financing of the federal budget deficit, and (2) revenues from sale of intangible assets classified as federal budget revenues;

[j] – includes proceeds (1) from sale of land plots prior to the delimitation of state ownership of land, which include immovable property assets owned by the federal government prior to transfer, to be allocated to the federal budget, (2) from sale of other land plots, as well as from sale of the right to conclude contracts on leasehold thereof, (3) from sale of land plots prior to the delimitation of land ownership, as well as from sale of the right to conclude contracts on leasehold thereof, to be allocated to the federal budget, classified as sources of internal financing of the federal budget deficit;

[k] – the amount (1) of proceeds from federally owned property classified as sources of internal financing of the federal budget deficit, (2) revenues (i) from sale of living quarters, (ii) from sale of equipment, means of transport and other tangible assets, to be allocated to the federal budget, (iii) from sale of ship utilization products, (iiii) from sale of the property owned by SUEs, institutions and military equipment, (iiiii) from disposal of military products, equipment and ammunition, (3) revenues from sale of intangible assets (IAs) classified as federal budget revenues;

[l] – includes proceeds (1) from sale of land plots prior to the delimitation of state ownership of land, which include immovable property assets owned by the federal government prior to transfer, (2) from sale of land plots prior to the delimitation of land ownership,, to be allocated to the federal budget, (3) from sale of other land plots which were owned by the state prior to the delimitation of state ownership of land and are not to be used for housing construction (the latter update is referred to 2006 only) and are classified as sources of financing of the federal budget deficit;
[m] – revenues from sale of tangible and intangible assets (net of federal budget revenues from disposal and sale of confiscated and other property converted into state income), include revenues (i) from sale of living quarters, (ii) from sale of the property of FSUEs, (iii) from sale of the property operatively managed by federal institutions, (iiii) from sale of military property, (iiiii) from disposal of military products, equipment and ammunition, (iiiiii) from sale of other federally owned property, (iiiiiii) from sale of intangible assets, classified as federal budget revenues;
[n] – revenues from sale of tangible and intangible assets (net of revenues which represent a public share in profit products in executing product sharing contracts (PSCs) and federal budget revenues from disposal and sale of vacant, confiscated and other property converted into state income), include revenues (i) from sale of living quarters, (ii) from sale of the property of FSUEs, (iii) from sale of the property operatively managed by federal institutions, (iiii) from sale of military property, (iiiii) from disposal of military products, equipment and ammunition, (iiiiii) revenues from sale of other federally owned property classified as federal budget revenues;
[o] – proceeds from sale of land plots prior to the delimitation of land ownership, which were owned by the federal government and are classified as sources of financing of the federal budget deficit;
[p] – revenues from sale of tangible and intangible assets (net of revenues which represent a public share in profit products in executing product sharing contracts (PSCs) and federal budget revenues from disposal and sale of vacant, confiscated and other property converted into public revenues, proceeds from sale of sequestered lumber), include revenues (i) from sale of living quarters, (ii) from sale of the property of FSUEs, (iii) from sale of the property operatively managed by federal institutions, (iiii) from sale of released movable and immovable military and other property available at federal government executive bodies in which military and equivalent to military services are envisaged, (iiiii) from sale of military products available in federal government executive bodies within the framework of military and technical cooperation, (iiiiii) revenues from sale of other federally owned property classified as federal budget revenues;
[q] – revenues from sale land plots owned by the state (save for land plots of federal autonomous and state-funded (2011) institutions), classified as federal budget revenues;
[r] – revenues from sale of tangible and intangible assets (net of revenues which represent a public share in profit products in executing product sharing contracts (PSCs) and federal budget revenues from disposal and sale of vacant, confiscated and other property converted into public revenues, proceeds from sale of sequestered lumber, revenues from sale of special raw materials and fertile materials), include revenues (i) from sale of living quarters, (ii) from sale of the property operatively managed by federal institutions (save for state-funded and autonomous institutions (2011), (iii) from sale of released movable and immovable military and other property available at federal government executive bodies in which military and equivalent to military services are envisaged , (iiii) from disposal of military products, equipment and ammunition, (iiiii) from sale of military products available at federal government executive bodies within the framework of military and technical cooperation (2008 and 2010–2011), (iiiiii) from disposal of military products, equipment as part of the federal special program on Industrial Utilization of Arms and Military Equipment for the period of 2005–2010, (iiiiiii) revenues from sale of other federally owned property, as well as revenues from sale of intangible assets (IAs) classified as federal budget revenues;
Source: The laws on the implementation of the federal budget for the period of 2000–2010, the Report on the Implementation of the Federal Budget as of January 1, 2012, www.roskazna.ru; IET's estimates.

A rapid, more than 7-fold growth in the federal budget property-related revenues from nonrenewable sources took place in 2011 against the preceding year, which is comparable with the results of 2003, when a 9-fold growth was reported.

Proceeds from sale of shares increased most (by 8.5 times) and exceeded by 40% in terms of absolute value (Rb 126,2bn) the best results since 2003. However, it should be understood that most of these revenues were generated from a single transaction with 10% shares of OJSC VTB Bank (Rb 95,68bn).

Revenues from sale of various types of property increased almost 3.4 times, revenues from sale of land plots increased by 76%. While the revenues from the former exceeded in terms of absolute value (more than Rb 8bn) the previous maximum (Rb 5,2bn) in 2007, federal budget revenues from sale of land plots were much less (more than Rb 2,4bn) than in 2003–2006, but exceeded by 2–2.5 times those in 2007–2010.

All in all, proceeds from sale of shares in 2011 accounted for more than 92% of total revenues from nonrenewable sources vs. almost 80% in 2010. Other sources of revenues were insignificant: revenues from sale of various types of property stood at 5.9% (13% in 2010), revenues from sale of land stood at mere 1.8% (7.4% in 2010).

Total federal budget revenues from privatization (sale) and the use of state-owned property assets (*Table 11*) in 2011 increased more than 2.7 times vs. 2010. The reached an absolute maximum of about Rb 241bn from the beginning of the 2000s.

Table 11

Structure of federal budget property-related revenues from various sources in the period between 2000 and 2011

Year	Total revenues from privatization (sale) and use of state-owned property assets		Revenues from privatization(nonrenewable sources)		Revenues from the use of state-owned property assets (renewable sources)	
	Rb m	% of total	Rb m	% of total	Rb m	% of total
2000	50412,3	100.0	27167,8	53.9	23244,5	46.1
2001	39549,8	100.0	10307,9	26.1	29241,9	73.9
2002	46811,3	100.0	10448,9	22.3	36362,4	77.7
2003	135338,7	100.0	94077,6	69.5	41261,1	30.5
2004	120798,0	100.0	70548,1	58.4	50249,9	41.6
2005	97357,4	100.0	41254,2	42.4	56103,2	57.6
2006	93899,8	100.0	24726,4	26.3	69173,4	73.7
2007	105761,25	100.0	25429,4	24.0	80331,85	76.0
2008	88661,7	100.0	12395,0	14.0	76266,7	86.0
2009	36393,7	100.0	4544,1	12.5	31849,6	87.5
2010	88406,4	100.0	18677,6	21.1	69728,8	78.9
2011	240964,2	100.0	136660,2	56.7	104304,0	43.3

Source: The laws on the implementation of the federal budget for the period of 2000–2010, the Report on the Implementation of the Federal Budget as of January 1, 2012, www.roskazna.ru; IET's estimates.

Nonrenewable sources in the structure of total revenues from privatization (sale) and the use of state-owned property assets in 2011 increased by more than 2.5 times (up to 56.7%) vs. the preceding year and doubled a half thereof for the first time over the last 7 years. The foregoing value is comparable with the results of 2000 and 2004, and a bit smaller than those in 2003 (69.5%). On the contrary, revenues from the use of state-owned property assets decreased from 79% in 2010 to 43.3% in 2011. In the meantime, the results of 2011 were maximum in terms of absolute value and outstripped by 30% the results 2007, while revenues from privatization (sale) of property outstripped by 45% the previous maximum (2003)

The results of privatization in 2011 allows one to assume that the “new privatization policy” which was under discussion in 2009–2011 and supported by a series of legal updates, has a chance, under otherwise equal conditions, to be implemented in full in the ensuing years.

6.2. "New Privatization Policy": Risks, Stakeholder Groups, Constraints, Potential Innovations

The worldwide downturn that hit economies at the end of the first decade of 21st century, has led to a series of socio-economic changes whose effect in terms of radicality requires quite a long time to comprehend[1]. Even today, however, it is quite obvious that both leading market institutions of the western world, namely the US institution based on the principles of free market competition, and the European institution governed by socially oriented principles, have failed to offer adequate countermeasures at the initial phase of the crisis, when the first signs thereof emerged. However, it is only the nations with more powerful influence on their economy that have managed to counteract the developments leading to financial and economic collapse. And Russia belongs to this nations, with some reservations though.

However, the effect of a large-scale government intervention in the economy, which is positive amid crisis, may often become adverse at the stage of stable, long-term economic growth.

6.2.1. "New privatization policy" background

More than 20 years of experience in Russia and other economies in transition proves that the process of denationalization is complex and time-consuming[2]. The dynamics of denationalization process in Russia was conditioned by two opposite trends in the 2000s.

On the one hand, the privatization process continued with different degrees of intensity. The Government of Russia approved annual comprehensive forecast plans (programs) of privatization of federally owned property, which include thousands of FSUEs and shares (interest) of business entities operating in various sectors. As is evident from the previous section, a total number of federal state unitary enterprises and joint stock companies with state participation decreased about 40% in the period between 2007 and 2010. This trend, however, is most typical of the federal level. The number of unitary enterprises changed in different ways at the regional and local levels. Even a formal decrease in the number of state-owned enterprises at the federal level depends largely on the formation of "integrated structures" and state-owned corporations.

The rate of privatization slowed down after 2005, as evidenced by the results achieved in 2006–2008. No positive dynamics was reported until 2010, as evidenced not only by quantity of property assets but also budget revenues. According to the Ministry of Economic Development and Trade of Russia, revenues from sale of privatized federally owned property assets in 2010 totaled Rb 22,67bn[3] and outstripped many times the federal budget revenues from

[1] Based on the materials provided by the Expert Group on Management of State-Owned Property and Privatization which was established in January 2011 as part of the updated Concept of Socio-Economic Development of the Russian Federation until 2020 ("Strategy 2020").

[2] More information on the initial stages of privatization in Russia is provided in the following publications: *A.D. Radygin*, Ownership Reform in Russia: From the Past to the Future. M., Respublika, 1994; *A.D. Radygin, P.M. Entov*, Institutional Issues of the Corporate Sector Development: Ownership, control, securities market. M.: IET, 1999; *Radygin A.* Privatization, Ownership Redistribution, and Formation of the Institutional Basis for Economic Reforms. - In: The Economics of Russian Transition. Ed. by Y. Gaidar. Foreword by S. Fischer. The MIT Press, Cambridge, Massachusetts, 2003. Chapter 14. P. 395 –459.

[3] However, according to the preliminary data provided in the Report on the Implementation of the Federal Budget as of January 1, 2011, www.roskazna.ru, federal budget revenues from privatization and sale of property assets (including land plots) totaled Rb 18,68bn.

privatization of state-owned property assets in 2008 (Rb 7,19bn) and 2009 (Rb 1,93bn), and outstripped the target figures, which was not the case in the recent successive years. In 2011 this trend became more evident, with some reservations though (Rb 121bn) (Rb 126bn, according to the Report on the Implementation of the Federal Budget as of January 1, 2012).

On the other hand, the state has strengthened its influence vs. the 1990s. In the period between 2000 and 2003 the state was focused mainly on optimizing its direct participation in the economy which was retained after the implementation of the programs on voucher (1992–1994) and cash (1995–1999) privatization. The next 5-year period (from 2004 to 2008) was characterized by a wider participation through acceleration of the activity of companies with state capital participation which tended to expand and diversify their business by engaging in mergers and acquisitions. The strategy of consolidation of the remainder of scattered state-owned assets into integrated entities was accelerated in the period of 2006–2007. The public ownership policy was distinguished by the establishment of state-owned corporations, some of which were industry-specific (aviation and nuclear power industries, shipbuilding industry), including manufacturing of civil products.

Enhanced state participation in the economy was reflected in the national policy documents as well. It is highlighted in the Concept of Long-Term Socio-Economic Development of the Russian Federation until 2020 (which was adopted in 2008) that public sector fits well into the Russian economy and acknowledges that state-owned enterprises play an important role. However, with regard to state-owned property management (of specific categories of property assets), this document provides for basically the same approaches envisaged in the previous government programs implemented in the 2000s. The requirement that the composition of state-owned property must comply with not only powers and functions of the state, but also structural changes in any given industry, can be considered an important feature.

The recession of 2008–2009 was not responsible for a large-scale growth in the public sector, because the anti-recessionary strategy was focused on minimizing direct participation of the state in the capital of distressed private companies and banks. Furthermore, according to the official data provided by the Rosstat (without consideration of pyramidal ownership in the mixed sector) testifies to the fact that the public sector continued to decrease its participation in the economy in the period between 2008 and 2010 as well. However, most of expert estimates show that the state increased its participation in the Russian economy due to both activities of mixed sector companies in corporate control market and indirect recession countermeasures taken by the state. In particular indirect influence of state-controlled banks and entities acting as its agents in taking recession countermeasures, increased.

According to the EBRD, by 2009 the public sector of the Russian economy increased from 30 to 35% of GDP. Though this data is very illustrative in terms of dynamics, it seems to be underestimated as applicable to the public sector scope. According to the available estimates (Troika Dialog, 2008), federal and regional authorities controlled about 40% of capitalization in the Russian stock market at the end of 2007 vs. 24% in 2004. According to the Expert-400 rating, by the beginning of 2008 “the depth of ownership concentrated” in the hands of the state stood at 40 to 45%, whereas in 2009 this indicator stood at within 50%, according to various expert assessments.

Active “structural” privatization policy was commenced at the end of 2009, when the Russian economy began to recover from acute recession phase. The following “standard” objectives of privatization were set in the period between 2006 and 2008: generate federal budget revenues, undertake privatization of the property assets which were not involved in government functions, undertake incorporation of unitary enterprises. Public statements of top officials of the Government of Russia in September-October 2009 made notes for the first time of a "structural" privatization aimed at reducing the scope of state direct participation in the Russian economy, enhancing competition in industries, generating investments in long-term corporate development, improving the effectiveness of large companies with state participation.

A new stage of privatization was started when the Government of Russia (November 30, 2009) approved another Forecast Plan of Privatization of Federally Owned Property for 2010 and the Guidelines of Privatization of Federally Owned Property for the Period of 2011–2012. The plan had some specific features, namely generation of extra budgetary investments in the development of privatized companies was set as a top-priority task; the list of sectors (industries) scheduled for privatization was expanded essentially; focus was placed on privatization of a series of the largest (budget revenue generating) companies. The foregoing allows one to say that a "new privatization" policy was launched in Russia at the beginning of 2010.

In general, *two groups of preconditions for the transition to "new privatization"* can be underlined. The first group included fundamental factors which are not linked directly to the recent worldwide downturn:

– the state has an ambiguous and controversial status (as lawmaker, regulator and direct participant in large companies);
– there is no appropriate environment in place to ensure fair competition and enhance investment activity through private businesses in industries with high level of direct state participation;
– large companies with state participation show active behavior in acquiring assets, including extension of non-core assets;
– there are objective limits which interfere with higher quality of corporate governance in public sector companies;
– there are many public sector entities which are not effectively managed and supervised by the state.

However, radical changes in the contents of state privatization policy in 2010, which were focused on the structural component thereof and denationalization of the largest companies, specific sectors, were, in our opinion, largely conditioned by awareness of the issues which became topical as a result of the recent downturn (second group of preconditions):

– the state is strengthening its participation (influence) in the economy amid crisis, and the level of direct state participation is too high;
– the risk of that in the post-crisis period the state would strengthen its participation in the economy due to uncertainty about what may happen with companies' shares pledged as collateral for state anti-recessionary support if such companies fail to discharge their loan obligations;
– poor competitiveness of a series of public sector large companies, the need to undertake restructuring and technological modernization thereof;
– the need to generate considerable extra budgetary investments, including the development of the key sectors within the infrastructure framework;

– there are stronger doubts about prospects of rapid post-crisis growth in the Russian economy; social budget expenditures have been extended, which may result in the need to impose stronger budget constraints (looking for more budget revenues).

In general, the issues of structural effect of privatization for the development of the Russian economy have been placed to the foreground of ‘state agenda’. In our opinion, the privatization policy’s structural approach is evidenced by both official statements and actions which have been undertook over the last two years to update regulation of privatization, reduce drastically the list of strategic enterprises, plan privatization of the largest public sector companies, improve corporate governance of companies with state participation.

First, a series of significant updates and amendments were made to the Federal Law “On Privatization”[1], in particular:

– the transfer to mid-term planning of privatization of federally owned property was undertaken, the Government of Russia was entitled to define possibilities to draft forecast plans (programs) of privatization for a period of 1 to 3 years (previously, forecast plans were drafted annually) and add new entities to privatization plans;
– the Government of Russia was entitled to make decisions on privatization of state-owned property of the scope of the ‘standard’ procedures established by the Federal Law “On Privatization” for the purpose of creating conditions for investments, promoting the development of the stock market, as well as modernization and technological development of the economy;
– the Government of Russia was entitled to delegate to legal entities the functions of seller of privatized federally owned property assets;
– the use of the principle of standard price of assets subject to privatization was abolished; standard price was defined pursuant to the procedure for minimum price at which such assets may be sold, established by the Government of Russia;
– conditions for privatization of small federally owned property assets were simplified, potential buyers were granted more assess to be able to participate in privatization (the possibility to sell state-owned property assets in electronic format was defined; the relevant procedure was refined through public offering – Dutch auction; the required amount of tender or auction guarantee was reduced);
– transparency requirements for privatization procedures were upgraded.

Second, drastic changes in the list of strategic enterprises and joint stock companies[2] should be mentioned in the context of extension of the privatization base: the number of eligible organizations was more than halved, down to 200 in 2010. Making industry-specific examination of the delisted organizations, it should be noted that a major part thereof (about 1/4) are somehow linked to the transport industry and the relevant infrastructure.

Third, plans on privatization of the shares of 10 largest Russian companies and banks (Rosneft, RusHydro, Federal Grid Company of United Energy System, Sovcomflot, Sberbank of Russia, VTB Bank, United Grain Company, Rosagroleasing, Russian Railways,

[1] Federal Law No. 106-FZ, dd. May 31, 2010, “On the Amendments to the Federal Law “On Privatization of State-Owned and Municipal Property””.

[2] Russian President Order No. 1009, dd. August 4, 2004, “On the Approval of the List of Strategic Enterprises and the List of Strategic Joint Stock Companies”. It should be noted that under the applicable Federal Law “On Privatization”, strategic enterprises and the shares of strategic joint stock companies may not be included into the forecast plan (program) of privatization of federally owned property unless they are excluded from the list of strategic enterprises and joint stock companies.

Rosselkhozbank)[1] leading in relevant industries were defined for 2011–2015. The shares of the foregoing companies are planned to privatize subject to relevant decisions of the President and the Government of Russia, i.e. on a case-by-case basis. It was established that state participation would be reduced both through sale of a part of state-held shares and second offering to generate investments for the benefit of companies.

Fourth, in addition to defining plans and preparations for sale of the shares of largest public sector companies and banks, it should be noted that the process of preparation and implementation of privatization of smaller public sector companies and enterprises was accelerated. For example, the Forecast Plan of Privatization of Federally Owned Property for 2010 was largely extended by enlisting about 500 enterprises, of which FSUEs totaled more than 200[2]. A special emphasis should be placed on that a series of large JSCs operating in the transport industry and transport infrastructure (sea and river shipping line companies and ports, airports), were added to the list.

It should be noted that high dynamics of actions within the framework of state privatization policy remained unchanged in 2011 (see the previous section herein). Both new political statements (about enhancing the privatization process) and applied innovations in the field of e-trading, development of FSUE strategies, withdrawal of top state officials from boards of directors, creating a greater variety of methods of transformation of unitary enterprises.

Hence drafting and implementation of the “new” privatization policy in 2009–2010 were definitely considered among the top priority objectives of the state. However, in spite of positive developments, this process is quite complex and requires constant maneuvering and temporal trade-offs. In our opinion, drafting and implementation of the state privatization policy are characterized by a special role of political decisions, a particular system of ‘presumptions’ with regard to this field, due to objectively limited possibilities of assessing a socio-economic effect, high diversity of the public sector and specifics of various state-owned assets. In the meantime, it goes without saying that political decisions can’t define all the complementary measures to be taken by the state, thus increasing the role of various stakeholder groups with a positive agenda in defining specific measures on the implementation of political decisions, whereas rivalry between these stakeholder groups defines ‘driftage’ of the privatization policy.

6.2.2. Stakeholder groups and principal risks

In our opinion, the development of “new privatization” ideology can be distinguished, with certain reservations, by three different but not mutually exclusive approaches which are somehow linked to different stakeholder groups in constructing the relevant public policy.

First – ‘budget’ – approach implies that privatization should firstly serve as a tool for generating more budget revenues and eventually ensuring current and mid-run macroeconomic stability. In doing so, however, revenues from renewable sources, including privatization, are

[1] Refer to, above all, the Forecast Plan (Program) of Privatization of Federally Owned Property and the Guidelines of Privatization of Federally Owned Property for the period of 2011–2013, as well as the information published by the Ministry of Economic Development and Trade of Russia on planned sale of the shares of large companies leading in relevant industries of the Russian economy, in 2011–2015 (http://www.economy.gov.ru/minec/activity/sections/investmentpolicy/doc20101123_08). This list was extended in July 2011.

[2] No unitary enterprises were originally listed in the Forecast Plan (Program) of Privatization of Federally Owned Property for 2010.

supposed to be made much less available to finance current budget expenditures. Shrinking of the public sector as a result of privatization is also considered a way to reduce the number of ‘recipients’ of state support.

Second – ‘structural’ – approach means that privatization should basically be used as a tool to improve competitive power of companies subject to privatization as well as the structure of selected industries and activities. Decisions on privatization of companies should be governed by expediency-based practice of engaging strategic private investors, investment inflow (including a secondary issue of shares to reduce a state capital participation), higher level of corporate governance, promotion of competitive and business environments, etc., rather than fiscal interests.

Third – ‘sectoral’ – approach is focused on ensuring social stability and control over the situation, triggering processes of modernization of specific industries through direct state participation. This may result in the need to maintain (increase, as appropriate) direct state influence on the development of industries and sectors ‘sensitive’ for the general public and the development of the economy at large. This approach is based on large and extra large state-owned companies. The principal tools are implementation of large investment projects and programs (innovative ones, whenever appropriate), establishment of state controlled (state-owned companies) integrated structures, etc.

Each of the approaches has both advantages and is exposed to certain issues and risks. This is why forecasts of expected revenues from privatization may differ largely in the level of declarativity of selected revenue base as well as the status of a regulatory document, and quite often are conventionally estimative (see *Table 12*).

Table 12

Forecast of revenues from privatization in the period between 2011 and 2014: assessment, Rb billion

	2011	2012	2013	2014
The Forecast Plan (Program) of Privatization of Federally Owned Property for the period of 2011–2013 (approved by Russian Government Order dd. November 27, 2010)*	6	5	5	-
Federal Law “On the Federal Budget for 2011 and Planning Period of 2012 and 2013” No. 357-FZ, dd. December 13, 2010, (as revised on June 1, 2011, No. 105-FZ)	-	-	-	-
Basic principles of the budget strategy for 2011 and planning period of 2012 and 2013; for 2012 and planning period of 2013 and 2014.	298	276,1	309,4	300,0
Budget quarterly breakdown for 2011, item “revenues from sale of shares and other forms of capital participation, federally owned property” (www.roskazna.ru)	297,954	-	-	-
The Office of the President of Russia (11.07.2011, Moscow News): at least	450	450	450	450
Government of Russia (17.06.2011, http://www.rg.ru/2011/06/17/privatizacia-site.html): about	500	-	-	-
the Ministry of Economic Development and Trade of Russia (25.07.2011, Vedomosti)	1000	1000	1000	1000

* It was assumed that “The forecast of revenues from sale of federally owned property can be updated if the Government of Russia makes relevant decisions on privatization of the shares of the largest companies which are highly attractive for investment, in which case revenues from sale of federally owned property in 2011–2013 may total (with consideration for a market situation) about Rb 1 trillion”. The forecast remained the same in spite of five amendments made in the period between December 2010 and July 2011.

Realistic assessment of available sources of financing of ambitious privatization plans is a special and extremely complicated problem as part of the ‘budget’ approach. Putting aside any options relating to active behavior of largest companies and banks with state participation (as buyers who have indirect, preferred access to state financial resources), the first thing that comes to mind is international financial markets, where, however, competition between national governments wishing to implement certain privatization projects resumed its intensity in the period between 2010 and 2011.

Furthermore, according to a severe assessment of A. Vedev, "when we talk about prospects of privatization of, say, state-owned corporations, state-owned banks, state-owned property assets, we must understand clearly that we have no internal resources for privatization". Referring to analysis of the structure of institutional cash flows of the Russian economy as of January 1, 2011, enterprises have been net borrowers over the last decade (net debt due by accounted for 15% of gross assets of the banking system, or accounted for about 10% of GDP)[1].

From this it is inferred that "the new privatization policy" can be implemented with success depending on a set of decisions relating to the system-wide development of the institutional and investment environments, and the financial system of Russia. First of all, it means constraints on foreign legal entities with regard to strategic industries, title guarantees and law enforcement in general, promotion of internal long-term sources of investment, also through modernization of the funded pension system, collective investment institutions and stock market technologies.

However, the 'budget' approach neither is focused on fundraising to develop privatized companies, nor requires any mandatory transfer of control over privatized companies from the state to private owners. These are advantages of the 'structural' approach which, however, is exposed to the risk of subsequent state intervention in the activity of privatized companies, ensures no efficient use of companies' borrowings and is not focused on the development of most "notable" business entities. Though the 'sectoral' approach can be used for aggressive, relatively rapid reconstruction of selected sectors in creating "national champions", it may result in unregulated overgrowth of the public sector, deterioration of the competitive environment and restriction of private initiatives (see *Table 13*).

Table 13

Principal advantages and risks relating to different approaches towards drafting of state policy as part of "new privatization"

Approach	Advantages	Problems and risks
"Budget" approach	Lower (or full absence of) barriers for buyers; reasonable presales preparation; focus on privatization of largest companies; general reduction of the number of SUEs and OJSCs with state participation	Value of privatized shares is not important; possible state control in large companies; focus on sales of "no-problem", liquid assets; focus on a relatively short-term perspective
"Structural" approach	Increasing investment trend in using revenues from privatization; Focus on attracting strategic investors; actual reduction of a public sector share in the economy	Ill-defined mutual obligations in the long-term outlook; Issues relating to the selection of efficient strategic investors; focus on the development of basically large and extra large companies; problems of inefficient usage of extra budgetary borrowings by companies
"Sectoral" approach	Development and advanced modernization of largest public sector companies; higher level of attractiveness of large state-owned companies for potential investors; provision of social stability	Poor incentives to develop sectoral regulation; retained (increased) direct state participation in the economy; risk of uncontrolled "overgrowth" of companies with state participation and deterioration of competitive environment; risks of "nontransparent exchange", "administrative bargaining"

[1] The records of the meeting of the Expert Group on Management of State-Owned Property and Privatization held on July 6, 2011, http://2020strategy.ru/g15/news/32746132.html

Competition for influence between the selected "stakeholder groups" leads to some investigations.

First effect – a certain frequency of increase (or decrease) in influence of "stakeholder groups" on decisions made in the world of privatization. Seniority of a specific approach depends largely on a situation (expectations) relating to budget balance, serious problems encountered in some of the "socio-sensitive" markets. For example, it was in the period (May thru June) of discussion of the draft budget parameters when a trend towards increase in the role of privatization in generating extra budget revenues became well-marked, when deficiencies in regulation of certain markets came into surface, the rationale increased for the need to maintain direct state participation in certain large companies as "compensation" for market failures.

Second effect – half-way nature of decisions made, incompleteness and inconsistency of implemented measures. Following are some of the recently (2010 – 2011) available examples:

– positive decision on widening the representation of independent directors in companies with state participation is not supported by measures aimed at increasing the role and liability of boards of directors, changing the procedure for appointment of senior managers therein;
– generation investments for corporate development in the course of privatization (denationalization, to be more precise) is possible for only a small number extra large companies on the basis of individual decisions, whereas no relevant tools and mechanisms (methods of privatization) are available for other companies;
– refusal to use state-owned corporations as a type of business entity is accompanied by setting a task on working out a new form of "public entity"[1];
– given a general focus on reduction of the use of the institute of unitary enterprises, no efforts are made to determine tools of transparent financing of solution of public objectives (functions) through companies, including the private sector.

Third effect – predominantly concealing nature of lobbing interests as part of privatization, more opportunities for making individual decision amid ill-defined legal framework, poor official rationale for decisions made. In our opinion, a certain "lack of focus" regarding the conditions of privatization, in particular of large companies, is, to a certain extent, reasonable costs conditioned by an effort to change in reasonable time the situation amid high administrative barriers as coordination of well-defined regulations and rules of privatization between 'stakeholder groups'. The same, however, boosts "competition" between different approaches towards privatization and leads to lesser predictability of its conditions at the level of every large company with state participation.

With respect to prospects of privatization, provision of the effective socio-economic development given the significance of a series of political decisions (provision of structural effect, restriction on direct representation of sector-specific ministries in the governance of companies, defining the possibility for the state to give up its controlling interest in a series of largest companies), the following *significant risks* are worth noting.

First risk – expansion of the public (quasi-public) sector amid privatization processes. In our opinion, the scales of denationalization, on the one hand, and consolidation of assets

[1] See the schedule of measures of transformation and liquidation of state-owned corporations and Avtodor state-owned company, approved by the Chairman of the Government of Russia on December 29, 2010, No. 6793p-P13.

within specific large companies (banks) with state participation, their "growth" in competitive activities, on the other hand, can be found to be comparable. This risk seems to be more important in the near term.

Second risk is more important in the mid- and long-term prospects: *lack of efforts for the development of sector-specific regulation of privatization of large companies will subsequently increase an informal effect on them from the state*. This can be explained by that given poor regulation in certain sectors, which previously was "offset" by direct state participation in the governance of certain large companies, if the state withdraws from such governance, it would need other tools for resolving publicly relevant objectives. The major problem here is represented by even more deteriorated transparency of public interests with regard to such companies, preconditions for replacement of public interests with parochial (both departmental and administrative) interests vs. the option of direct state participation in the capital. In addition, a positive structural effect of privatization may be limited significantly by the retarding nature of "external" measures aimed at improving the investment environment.

Third risk – ill-defined conditions and criteria of privatization of large companies with attracting investments for the development thereof; discrepancies which may arise between the state and the owners of such companies in perception of mutual obligations. This makes the parties put more pressure on each other, and provides politicians with more chances to appeal to a segment of the society which is traditionally focused on "injustice" and "cheapness" of privatization.

Fourth risk – the quality of state-owned property management tools available for the state (it means unitary enterprises and shareholding) *seems to have reached its objective ceiling*. The risk of conservation of the prevailing model of governance remains very high, which may result in palliative measures and reduce the effectiveness of any measures aimed at further denationalization.

6.2.3. "New dimension" of denationalization

The policy of state-owned property management and privatization must move to a "new dimension" in the near future. The *following important approaches* should be considered.

'Gradual' approach. The remaining scope and "quality" of most of public sector assets prevent from implementing an analogue of accelerated "large-scale" privatization. Denationalization should be based on the principle of "controlled steadiness" of privatization, which requires a whole package of preparatory measures and stepwise approach. Unnecessary radicalization of the approaches makes equal the expected advantages and losses.

'Multisector' approach. A big variety of public sector assets implies availability of differentiated models (planning) of privatization and governance.

'Strategic nucleus model'. There are no visible arguments against (temporal) retaining a series of largest companies in state ownership, but there are reasonable arguments in favor of gradual decrease in control thresholds, creating equal competitive conditions, transparency and modification (of quality) of corporate governance.

'Structural' approach. Economic effect of privatization (efficient owner) is unlikely to be achieved without having to implement modernization of the sector; the sector can't be modernized amid state domination/without widening the private sector; there is no point to widen the private sector without changing the quality of the institutional environment.

'Pragmatic' approach means identification of strategic nucleus of the economy (strategic, core enterprises), priority of "deep" privatization of large companies, getting rid of anachro-

nistic and palliative types of business entity and illiquid assets, modernization of the existing system of state-owned property management.

In our opinion, *the state long-term policy* of state-owned property management and privatization must be governed by the following general *principles*:

- make sure that privatization is "reasonable"; follow the principle under which all companies, save for a selected group of companies, with state participation, unitary enterprises, state-owned corporations and state-owned companies may be subject to privatization;
- make sure that participation of foreign investors in the capital of privatized companies, including large companies, is reasonable;
- maintain the existing social commitments and/or provide direct reduction of public sector functions;
- create alternatives to direct state participation in the capital of companies in terms of meeting public interests; constantly combine efforts of privatization and widening of institutional and economic preconditions for privatization;
- take any measures which directly or indirectly increase the state "weigh" in the economy, including through the mixed sector, must be exclusive, reasonably sufficient and well coordinated;
- state controlled companies must not operate in the sector with private entrepreneurial initiative, establish terms of competition, on the one hand, build up barriers to prevent new companies from entering markets within "their" scope, on the other hand;
- ensure high priority of structural effect of privatization on economic development;
- the principle of "reasonable aggression", succession and "gradualism", limitation of risks;
- ensure transparency of the processes of state-owned property management and rationale for decisions made; openness to various forms of public control and assessment;
- create an integral system of incentives for all players; inviting the society and business community to participate in a dialogue with the state on the policy of privatization and state-owned property management.

Two stages should be reasonably highlighted from the point of view of general top objectives of the state policy of state-owned property management and privatization: 2012–2015 and 2016–2020. These stages differ in objectives to achieve, the level of expected risks and the need to take a series of preparatory measures.

Ensure high priority of implementation of current plans, making minimum radical decisions, getting rid of illiquid assets, making a "site" ready for the second stage *at Stage 1*. The level of potential risks can be assessed as minimal. In particular the following should be reasonably foreseen as part of this stage:

- implement the target plans on reduction of a share of state participation in largest and large companies;
- impose constraints on companies with state participation (their subsidiaries and related entities) for purchase of privatized assets, receive financing from state-owned banks and state-owned companies, consolidation of assets within state-owned companies;
- increase the number of large companies with mixed ownership (privatization up to a level of 75% +1 share);
- enhance significantly the quality of corporate governance at companies with state participation (enhance the status of independent directors, incentives for managers and their reporting to boards of directors, etc.);

– reduce the number of state-owned entities through liquidation of a wide range of FSUEs which went out of business;
– undertake privatization of illiquid assets (small value minority shares);
– implement a package of measures aimed at widening the potential base for privatization at Stage 2;
– identify principles and special features of privatization at the regional and municipal levels;
– implement a 'small-scale action' strategy (ensure transparency of progress reports on privatization, changes in the public sector's socio-economic role, accounting and registration of all assets owned by unitary enterprises, state-owned corporations, integrated structures with state participation, etc.);
– create a single media space of sale of federal, regional and municipal property assets.

At Stage 2, provision should be made for drastic reduction of direct state participation in the economy, which may be exposed to a higher level of multidimensional risks. The following key measures can be implemented at this stage:

– undertake "deeper" privatization with regard to largest companies (or full privatization or privatization through holding a blocking interest);
– restrict state participation in state-owned institutions for development and special banks;
– restructure assets of large companies, identify and privatize sub-holdings of conglomerate integrated structures;
– reorganize state-owned corporations (a part thereof are to go out of business, another part thereof are to be incorporated into OJSCs and subject to a certain degree of privatization);
– applying the principle of multiplicity of options, transform unitary enterprises operating on the basis of economic management, depending on the nature and scope of the core activity, into OJSC (standard scheme); into state-run enterprises; into non-profit organizations; into public institutions;
– undertake privatization of most mid-sized and large companies with state participation (even a blocking interest, whenever appropriate).

The foregoing stages can be identified with two different (in terms of the degree of radicality) *scenarios of state policy* in the field of privatization and state-owned property management. With some degree of conventionality, the first (inertial) scenario suggests extrapolation of the first stage objectives in the period of 2012–2020. The second (radical) scenario implies full-fledged implementation of the key measures at the first and second stages in the period of 2012–2020.

This suggests development of the existing mechanisms and implementation of a wide range of measures which serve as the basis for six *most significant functional lines of state policy* in the field of state-owned property management and privatization.

1. Limit risks of "overgrowth" of the public sector in the economy, increase its "weight" in certain sectors, widen the range of state-owned entities.

2. Ensure sustainable and orderly reduction of direct state participation in the economy.

3. Achieve structural effect of privatization: "depth" of privatization of large companies; modernization of the sector and replacement of direct control with sector-specific regulation; improving the terms of participation in privatization of foreign investors; engaging efficient owners and developing a competitive environment.

4. Undertake institutional optimization of the public sector: reduce the number of state-owned entities, liquidate and reorganize inefficient enterprises of the public sector.

5. Enhance effectiveness of the "nucleus" of public sector, define its scope, and optimize levels of required direct state participation.

6. Enhance corporate governance in companies with state participation.

Each of above listed lines provides for a wide range of potential innovations and applied measures with the possibility to vary the degree of radicality. Without getting into a detailed analysis, let us provide just a few examples (see *Table 14*).

Table 14

New key points of the state policy of state-owned property management and privatization: potential innovations

Line	Available approach	Suggested approach
Determining the composition of state-owned property assets for privatization	Drafting privatization plans on the basis of proposals of federal executive bodies	"Declarative principle" – drafting privatization plans on the basis of business proposals, potential investors in combination with the "privatize or explain publicly" principle for federal executive bodies
Constraints on privatization	Regulatory restriction system	Replace a part of constraints with legally established encumbrances for owners
Privatization under conditions (under the Federal Law "On Privatization")	Investment tender; sale based on the results of as a result of trust management	A combination of investment tender and trust management
Generating investments to companies in the course of privatization	For extra large companies privatized on the basis of custom-made schemes	Define "investment mechanisms" under the Federal Law "On Privatization" for all large enterprises (e.g., with a net asset value of more that Rb 3m against the minimum monthly wage)
Unitary enterprises	The single possible option of transformation – into OJSC with a 100% state participation	Provide many options of transformation: – в OJSC with a 100% state-held interest, в LLC, into a public institution, non-profit organization
Privatization of unitary enterprises	Two separate procedures: incorporation, sale of shares	Provide a single procedure (incorporation with subsequent privatization of a part of the shares)
Interest in the development of companies with state participation	State interest maximization model (both short- and long-term), costs incurred on the majority model of corporate governance	Undertake transition of the "positive conflict" model (long-term state interests – short-term business interests) with delegation actual rights to boards of directors within the "influence – independence – awareness" reference system
The mechanism of representation of state interests	Directive institution	The institution of recommendations in combination with higher responsibility of the members of boards of directors and delegation of more rights to independent directors
The institution of independent directors	Not representatives of federal executive bodies	Impose restriction on "cross government" between companies with state participation
Appointing top managers in companies with state participation	Political decisions, nontransparent selection, limited role of boards of directors	Open tender, public recommendations of boards of directors to general meetings of shareholders
Assessing parameters of the public sector and privatization	Administrative approach – assessment of the number of state-owned entities, privatized entities (by type of enterprise, by state participation, by industry)	Economic approach – assessment of the socio-economic role of the public sector and effect of privatization on the development (contribution to GDP, GRP, export, market concentration, investment generation, etc.)

It still remains to be seen whether the "new dimension" of the privatization policy is feasible or not. State measures may both increase and mitigate the afore mentioned risks. However, a major lesson learned in the 1990–2000s is still of extreme importance: effect of privatization can be nothing but long-term, while the rate of achieving the effect depends on the quality and rate of implementation of the entire package of lines of socio-political and economic reforms (the "institutional environment" factor).

6.3. Russian Financial Development Institutions: Their Rise and Main Challenges on the Path toward Improvement of Their Performance[1]

It is already for roughly a decade and a half that the RF Government undertook various efforts to build and fine-tune the financial development institutions in the country. This direction of the national economic policy is congruent with the common international practice: there exist a string of tasks and fundamental reasons behind many nations' strive to shape up development institutions and support their operation[2].

In their general form, major drivers for governments to shape up and improve the development institutions' performance are associated with the need to compensate for market failures, lower risks facing private investors, secure substantial positive externalities, assist in overcoming various barriers and cutting down transaction costs, ensure "synchronization" of changes in the economic subjects' behavior. Hence it is not accidental that the most typical development institutions' operational areas include boosting expansion of small- and medium sized businesses, backing import-export operations, infrastructure development, bolstering regional development, support of individual sectors of an economy (agriculture as a model example).

As a marginal note, there is no any strict definition of the phenomenon of development institution. We believe that experts are keen to define it as some kind organization (forms of whose incorporation may vary) which exhibits a combination of at least some of the following signs:

- it was created on the government's initiative and with its participation;
- it centers on compensating for market failures and securing a demonstration effect;
- it is financed through one-time government contribution (in that case, such funding suggests it loss-free operation) or on the basis of regular budget appropriations;
- its operations pursues a long-term prospect, attainment of set for it strategic objectives;
- it operates on the basis of a specific legal base and special regulatory requirements;
- it focuses on employing private-public partnership mechanisms;
- as far as tactical decision making is concerned, it is autonomous from the government.

By various estimates there are a few hundreds of development institutions worldwide, and they fall under different classifications[3] (e.g., basing the nature of services they deliver); however, one singles out, as a rule, the group of financial development institutions, which operate in various forms, including, *inter alia*, development banks, funds and agencies[4].

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[1] The present Section was prepared in 2011 using findings of a project "Institutional analysis of problems of functioning of the financial development institutions system for the benefit of the support of innovation activity" completed by the Interdepartmental analytical center at the commission of the Russian Academy of National Economy and Civil Service under the President of Russian Federation.

[2] For more details about the concept and typology of development institutions, objectives, tasks and directions of their operations, see: O.G. Solntsev, M.Yu. Khromov, R.G. Volkov. Development institutions: an analysis and assessment of the international record. Problems of prognostication, 2009, No. 2.

[3] See, for example, a presentation by I.G. Sokolov, Research Fellow of the Gaidar Institute "Development Institutions and the budget: results and prospects" (July 2011 г.).

[4] For a more detailed classification and examples of public development institutions overseas, see presentation by Gref G.O., the RF Minister of Economic Development and Trade: "On creation of a public financial development institution (On the bill "On the Development Bank")" (December 2006).

While citing the need for a government's interference to compensate for market failures with regard to innovation development in particular[1], experts, at the same time, point at certain risks associated with such interference. As to the risks associated with the public development institutions, it is appropriate to single out the following ones:

– reallocation of support in favor of inefficient companies;
– "seizure" by the state of projects its supports;
– generation of sizeable biases into the market environment;
– substitution for private expenses.

In general it is believed that to lower such risks, nations need to employ more sophisticated systems of corporate governance and institutional organization.

6.3.1. Main Stages of the Rise of the Russian System of Financial Development Institutions

From our perspective, it is possible to provisionally identify *five main stages* in the process of the rise and advancement of development institutions in Russia since the late 1990s. (see *Table 15*). Our phasing to a significant degree is determined by changes in the state's resource capacity and a certain evolution, at the government level, of prevailing notions of the urgency and significance of support to innovation development "against the backdrop" of other directions of public policy.

Overall, until 2007 the mode of Russian development institutions' development had been an evolutionary one: the evolution suggested a gradual (and not that costly for the budget) fine-tuning of individual vehicles of support to investment and innovation projects, which were implemented largely in the frame of assistance to the small- and medium-sized entrepreneurship (hereinafter - SME). At the time, implementation of a policy implying the economy diversification and innovation policy went on the back burner as far as the government (as well as allocation of budget resources) was concerned and was reduced to individual experiments and random initiatives.

The switch to an intense shaping up of financial development institutions and fuelling a substantial expansion of their resource base occurred in 2007. Behind that was a political decision[2] to use a fraction of resources under management of the National Welfare Fund (some Rb 300bn) to capitalize several development institutions. In all likelihood there were numerous and heterogenic reasons behind the decision, but we assume a fundamental one was a strive for a certain compromise in the conditions where for one part the government was under a mounting pressure of advocates of a significant increase of public investment in the economy (enemies to a further accumulation of public financial reserves), while on the other hand, the government bent an ear to staunch champions of macroeconomic stability who had managed to organize a systemic resistance to an increase in the level of public spending. Investing a fraction of accumulated public financial resources in development institutions would "link" them to their future investment use, without giving a strong boost to public spending.

Meanwhile, the Russian leadership's view on the main role of the national financial institutions system underwent several changes over the past five years. Back in 2007, extension of the development institutions' mandate was linked primarily to the task of the economy diver-

[1] Igniting innovation: rethinking the role of government in emerging Europe and Central Asia / Itzhak Goldberg [et al.]. The World Bank, 2011.
[2] The Address by the RF President to the Federal Assembly of RF of 26 April 2007.

sification, advancement of its individual sectors, lifting infrastructure barriers. By contrast, in 2009-2010 the emphasis was already made on "fine-tuning" of the development institutions system[1] for the sake of implementation of the innovation policy, technological modernization, attraction of additional investments, with account, *inter alia*, of an insufficiently favorable investment climate.

Table 15

Main Stages of Emergence of the Development Institutions System

Period	External conditions	Key developments	Peculiarities
1999–2000	Tight budget constraints, encouragement of innovations is on the periphery of public policy	The Russian Development Bank * and the Venture Innovation Bank are created**	Emphasis on creation of relatively small self-financing institutions
2004–2006	Budgets constraints softened, a steady economic growth, greater attention to its "quality"	The Russian Development Bank launched the program of support of SME through regional partners; the Fund for Assistance to Development of Small Forms of Enterprises in the Research and Technical Sphere launched the "Start" program; the rise of regional venture funds; establishment of the Russian Venture Company (RVC); decision made to establish the Russian Investment Fund for ICT	Emphasis on the regional support of SME
2007–2008	A huge volume of budget revenues, encouragement of innovation as one of major public policy avenues, an attempt to link substantial resources to individual directions of development	Establishment of public corporations: the Bank of Development and Foreign Economic Acitivity (Vnesheconombank), the Russian Corporation for Nanotechnologies (Rosnanotech) ***	Launch of the biggest institutions
Late 2008 – 2009	The economic crisis, slashing of resources spent on encouragement of innovation along with a greater attention to the effectiveness of measures implemented	Most of resources temporarily withdrawn from Rosnanotech; the Fund for Assistance to Development of Small Forms of Enterprises in the Research and Technical Sphere launches the "Anti-crisis" program instead of a string of earlier implemented ones; the Seed Investment Fund is established under RVC	A vigorous use of the institutions and/or their resources to implement the anti-crisis policy; the beginning of the process of establishment of the "second-tier" institutions
since 2010	Improvement of the economic situation, attempts to learn lessons from the crisis, innovations form one of top priorities declared by the state	RVC and ROSNANO founded a range of new institutions, including those centering on infrastructure, and funds overseas; establishment of the Foundation for Development of the New Technologies Development and Commercialization Centre ("Skolkovo Foundation"); on the government's initiative Vnesheconombank founds the Russian Fund for Direct Investment (RFDI) and the Russian Agency for Export Credit and Investment Insurance (EXIAR); the Russian Development Bank begins implementing a program on support of modernization and innovation	A vigorous process of establishment of new institutions; expansion of international operations; a greater attention paid to improvement of the investment climate

* Currently JSC Russian Bank for Small and Medium Enterprises Support (JSC SME Bank).
** The first public development institution created by the "fund of funds" model in 2000 to support the venture industry. However, it began operating only in 2000 and at a fairly moderate scale, because of a relatively humble capital of Rb 100mn of which, as suggested by data available, only a half was financed, and due to a very strict cap (10%) on participation in venture funds' capital .
*** In March 2011was transformed into joint-stock company – JSC ROSNANO.

The record of the emergence of the Russian development institutions system to date (see *Fig. 1*) allows the following conclusions:

[1] See in particular: Minutes of the meeting of the Commission under the RF President on modernization and technological development of Russia's economy of 25 November 2009.

1) the period between late 1990s and 2008 saw a gradual shift toward shaping up institutions focused on support of projects at their later stages. In this respect a milestone development became the rise of the public corporations Vnsehseconombank and Rosnanotech. But since 2009 some of the then existing development institutions (RVC and ROSNANO) have expanded their operations to encompass earlier stages too. Plus, the newly created institutions ("Skolkovo" Foundation in particular) have become to a significant extent focused on support of projects at their early stages too;

2) there exists a steady trend to expansion of both the institutions and Funds' resources and the size of projects they support: while between late 1990s and early 2000s it was largely "low-cost" instruments (the Fund for Assistance to Development of Small Forms of Enterprises in the Research and Technical Sphere, the Venture Innovation Fund, the Russian Development Bank), a number of institutions (Vnesheconombank, Rosnanotech, RFSI), which were created later, boast a far greater resource capacity and use it to support fairly huge projects (worth a total of some Rb 1bn each);

3) the actual launch of the institutions in question suffered from substantial delays accounting from one to several years. That said, while in the case of RVC and ROSNANO the delay was basically a technical one (dictated by the need to shape up management bodies, craft their mandates, adopt of corporate regulations and statutes, organize of tenders, etc.), in the case of the Venture Investment Fund and the Russian Investment Fund for ICT[1] delays were caused by substantial deficiencies built in the respective rules and standards;

4) in a number of cases, while creating new institutions, the performance record (including the negative one) of earlier created instruments was taken into account: thus, created by the same model as the Venture Investment Fund (that is, a public "fund of funds"), RVC does not exhibit the latter's fundamental normative defects;

5) Roughly since late 2009 there started a large-scale process of "secondary" creation of development institutions. In the frame of the process, the existing structures found new ones, with the government initiating the process just in a handful of instances (RFSI, EXIAR). Meanwhile, in other cases those were the development institutions' initiatives, with RVC and ROSNANO being particular active in this regard;

6) The period between 2010 and 2011 saw the rise of the trend to a rapid expansion of the national development institutions' operations: not only has their circle been growing, but directions of their functional profiles and instruments employed expanded, and the volume of their resources and the number of innovation projects they support was on the rise.

The financial institutions established by today appear fairly versatile (see *Table 16*): they focus on support of both small-and medium-sized firms and large corporations' innovation activity; they orient to different phases of a company's development (from the seed and initial ones to maturity), and their mechanisms of support are associated with awarding grants, investment, disbursement of loans and guarantees. Let us note that different models of encouragement of innovation are realized under individual functional directions: thus, in addition to grant-based mechanism (the Fund of Assistance to Innovation), seed projects are supported through a seed investment vehicle (The Seed Investment Fund under RVC); support to venture investments is carried out via both the "fund-of-funds" model (RVC and, to a lesser ex-

[1] The institution was established back in 2007, but has not yet started investment activity due to a legislatively set strict requirement to reduce the government's participation in its capital to 51%.

tent, ROSNANO) and on the basis of a mechanism of a program-based support of creation of regional venture funds.

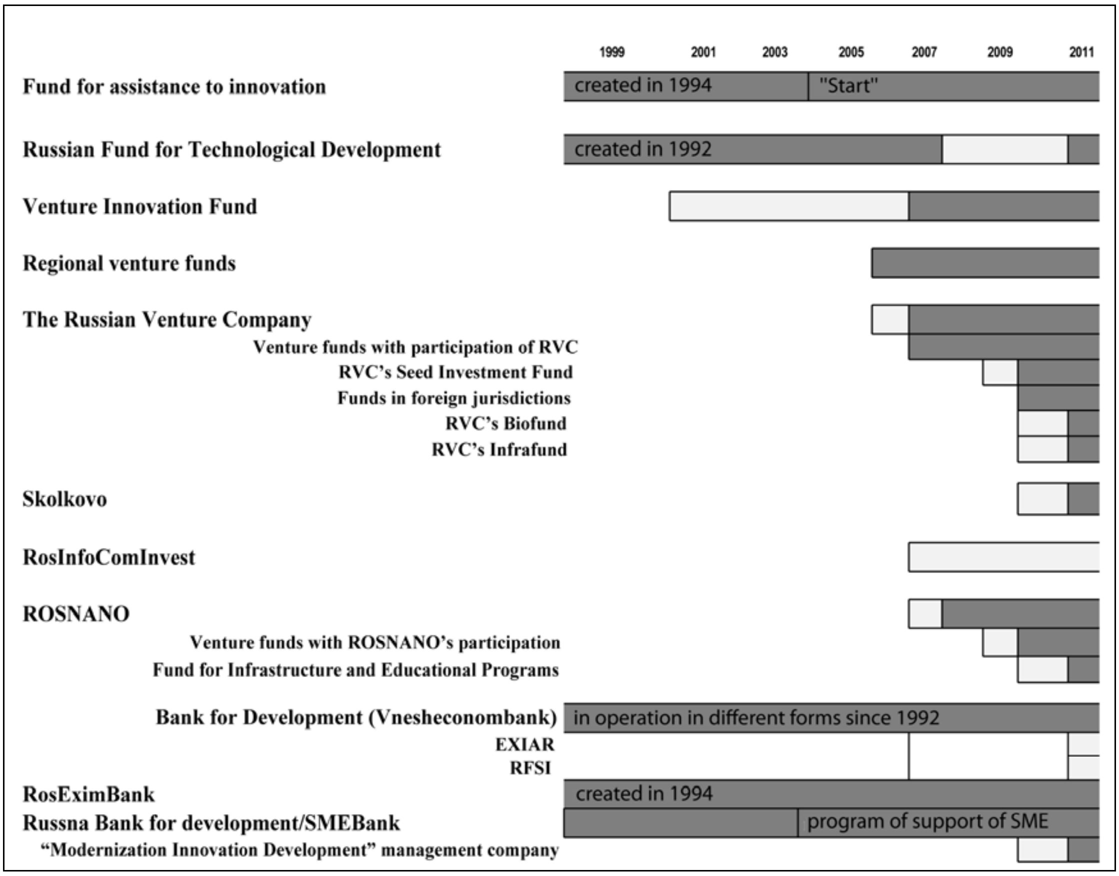


Fig. 1. Process of Creation of Russian Development Institutions

In general, the system of Russian financial development institutions has undergone a dramatic transformation and become far more exuberant vis-à-vis its nascent state in the early 2000s: it indeed became richer in the proper sense of the word, that is, in terms of aggregate volumes of resources under management, and in a figurative sense – in terms of variety of types of the institutions in question. Furthermore, over the past two years the government has been far more active in extending the development institutions system and, particularly, in implementing its earlier designed blueprints.

Table 16

Characteristics of Main Existing Financial Development Institutions

Development institution	Year of incorporation	Legal form	Participants	Modus operandi	Forms of support	Stages supported	Resources
1	2	3	4	5	6	7	8
Fund for assistance to development of small forms of entrepreneurship in the scientific-technical sphere (The Fund for assistance to innovation)	1994	Federal public budget institution	Russian Federation	Funding small innovation firms' R&D at the expense of public funds	Grants	Pre-seed, seed	Budget allocations in 2010 – Rb 3.4bn, 2011. – 4bn, 2012 – 4bn

cont'd

1	2	3	4	5	6	7	8
Russian Venture Company (RVC)	2006	Open-end joint-stock company	Russian Federation	The state fund of funds for seed, venture and direct investment	Investment	Seed Venture Later stages	As of late 2010, net assets worth a total of Rb 34.5bn
The seed Investment Fund under RVC	2009	LLC	RVC – 99%; Fund for assistance to innovation – 1%.	Investment fund for early stages	Investment	Seed	Authorized capital of Rb 2bn
Regional venture funds	2006–2009	Closed-end mutual investment funds for particularly risky (venture) investment	Regional funds for assistance to investment to small-sized enterprises in the research and technical sphere (funded in equal proportion out of the federal and regional budgets) – 50%; outsider investors– 50%	«Classical» venture funds	Investment	Venture	As of early 2012, the aggregate volume was Rb 9.2bn
Foundation for Development of the New Technologies Development and Commercialization Centre ("Skolkovo Foundation"	2010	Non-for-profit organization	Russian Academy of Sciences, Vnesheconombank, Fund for assistance to innovations, Bauman Technical University, ROSNANO, RVC	Funding of innovation projects of companies t participating in the innovation center	Grants	Pre-seed Seed Venture	Budget allocations in 2010 – Rb 10.3bn, 2011. – 15.5bn, 2012 – 27.1bn
The Russian Investment Fund for information and communication technologies (Rosinfocominvest)	2007	Open-end joint-stock company	Russian Federation	Sectoral direct investment fund	Investment	As a rule, late	Authorized capital – Rb 1.45 bn
Russian Fund for Technological Development (RFTD)	1992	Federal state autonomous institution	Russian Federation	Support of R&D on the reverse basis	Loans	As a rule, late	n/a

cont'd

1	2	3	4	5	6	7	8
ROSNANO	2007	Open-end joint-stock company	Russian Federation	Financing of innovation companies, venture and investment funds	Investment	Creation and development of production	Net assets as of June 2011- Rb 61.3bn; long-term borrowings (under state guarantees) – Rb 43bn; Russian Federation's contribution to the authorized capital in 2011 – Rb 47.2bn
Bank for Development and Foreign Economic Activity (Vnesheconombank)	2007*	Public corporation	Russian Federation	State development bank, including exercise of support of investment projects	Loans, investment, guarantees	As a rule, late	As of late 2010, assets were worth a total of Rb 1,782.8bn
The state specialized Russian export-import bank (Roseximbank)	1994	Closed-end joint-stock company	Vnesheconombank	Specialized bank for support of export	Loans, guarantees	As a rule, late	Assets as of October 2011 – Rb 9.1bn
Russian Bank for Small and Medium Enterprises Support (SME Bank)	1999	Open-end joint-stock company	Vnesheconombank	Support to SME through target financing of regional partners represented by banks and infrastructure organizations	Loans (incl. microfinancing), leasing, investment	As a rule, late	Operational assets as of early 2012 - Rb 103.9 bn
Russian Fund for Direct Investment (RFDI)	2011	Open-end joint-stock company	Vnesheconombank	Large investment in leading domestic corporations in a proportion equal to foreign institutional investors'	Investment	As a rule, late	Russian Federation's target contribution to Vnesheconombank's in 2011 – Rb 62.6bn.**
Russian Agency for Export Credit and Investment Insurance (EXIAR)	2011	Open-end joint-stock company	Vnesheconombank	Insuring Russian exporters and investors' business and ;political risks	Insurance	–	Authorized capital – Rb 30bn

* The year of creation of a public corporation by reorganization of the Bank for Foreign Economic Activity of the USSR, which had been operating in various forms since 1922.
** It is planned that within next 5 years the Government will form the Fund's capital in a volume of USD 10bn.
Sources: the development institutions' official web-pages, official reporting, federal acts on the federal budget.

6.3.2. The Development Institutions' Operational Objectives and Priorities, and Conditions of Projects Support

Whilst considering the totality of objectives developed for public financial development institutions (*Table 17*), it is worthwhile to note that most of them cite assistance to the public policy implementation in the respective area as a principal operational profile, while tasks and targets that complement it are likewise formulated very broadly. Notably, mission of some financial development institution stretches beyond the framework of delivery of solely financial services and outlines a broader sphere of their operations. This, the Fund for Assistant to Innovation is to help attract extrabudgetary investment in the area of small-sized innovation-based entrepreneurship, while RVC is tasked to deliver technological and consulting assistance to the innovation market agents and bolster the infrastructure supporting innovation clusters, as well as professionalism of participants in the innovation ecosystem and encouragement of demand for innovation corporations' produce.

Objectives of the two largest development institutions, Vnesheconombank and ROSNANO, are somewhat nonpareil ones and worth a particular notice. In case of Vnesheconombank, in addition to general objectives, targets and tasks for each of its major operational directions were set (including support of investment projects) in a very concrete form and with measures on their improvement. Meanwhile, ROSNANO's peculiarity lies in a fairly specific (at least, vis-à-vis other institutions) and very ambitious objective, namely, the being first strategy, as far as the global markets for nanotechnological projects are concerned.

Table 17

Operational Objectives, Tasks and Priorities of Development Instutions

Development institution	Objectives	Sectoral and/or subject-wise priorities
1	2	3
Fund for assistance to innovation	Mission: assistance to implementation of the state scientific-technical policy and bottom-up research projects, efficient employment of the scientific-technical capacity and engagement of scientific and technical achievements in the production sphere to bolster development of small forms of enterprises in the scientific-technical sphere, whose operations imply practical introduction (development) of intellectual deliverables, - small-sized innovation entrepreneurship agents, the innovation infrastructure, generation of job opportunities for an efficient building on the existing national scientific and technical potential . Tasks: – Implementation of the public policy on development and support of small-sized enterprises in the scientific-technical sphere; – Delivery of a direct financial, information and other support to small-sized innovation enterprises which implement projects on development of new kinds of science-intensive products and technologies on the basis of belonging to them intellectual property; – Creation and bolstering of the infrastructure of support of small-sized innovation-based entrepreneurship; – Assistance to generation of new job opportunities for an efficient building on the existing national scientific and technical potential; – Attraction of extrabudgetary investment in the sphere of small sized innovation-based entrepreneurship; – Cadres training (including engagement of the youth in innovation activities)	In the frame of the «Start» program: • 5 thematic directions: – IT; – Medicine of the future; – Modern materials and technologies of their development; – New devices and apps; – biotechnology; • 80 sub-directions. In the frame of the «Development» program: – Sub-program in the energy-saving sphere («Energo»); – Sub-program in the sphere of diagnostics, prevention and treatment of the most socially significant diseases («Frama»); – Sub-program in the IT sphere («Soft»)

cont'd

1	2	3
Russian Venture Company	<u>Mission:</u> ensuring an accelerated unfolding of an efficient and competitive on a global scale national innovation system by creating a self-developing venture industry in interaction with other development institutions with the help of engagement of private venture capital, bolstering innovation-based entrepreneurship and technological business expertise and mobilizing human capital in Russia. <u>Purpose:</u> assistance to implementation of the public policy in the sphere of development of Russian innovation industry and the innovation market's infrastructure, shaping up a system of Russia's own venture investment industry, creation of infrastructure for the innovation-venture ecosystem and encouragement of its expansion, giving a fillip to demand for innovation companies, and generation of profits from business operations. <u>Strategic objectives for the period through2020.:</u> ensuring an unfolding of an independently developing venture industry and innovation-technical entrepreneurship. <u>Tasks:</u> – Integration into global technological chains and support of export of innovation products; – Attraction of international investment resources in a "cash-and-expertise" form to fund Russian innovation industry; – Improvement of innovation Russian companies' investment attractiveness; assistance to increase in the number and enhancement of the quality of technological investors at all stages of the venture investing process; – Communication for the Russian market for innovation, technical and consulting assistance to innovation market agents particularly by organizing workshops, conferences, symposia and roundtables; – Bolstering the back-end infrastructure of innovation clusters, companies at early stages of venture financing and corporations rendering universal services to innovation firms; – Bolstering professionalism of the innovation ecosystem agents, encouragement of demand for innovation corporations' products; promotion of innovation-entrepreneurial, scientific-technical and invention, venture investment activities, in particular, by assisting to creation and advancement of professional contests and awards. <u>Main tasks for the period through 2020:</u> engagement of private venture capital in development of venture entrepreneurship and assistance in creation of the institutional and sectoral venture infrastructure	Venture funds with participation of RVC: • Current priority directions of development of science, technologies and technics of the Russian Federation: – Security and countering terrorism; – The nanosystem industry; – ICT systems; – Life sciences; – Promising kinds of arms, military and special equipment – Rational natural management; – Transportation and space systems; – Energy efficiency, energy saving, nuclear energy; • List of critical technologies of Russian Federation (27 titles therein). The RVC's biofund: biotechnological, pharmaceutical and medical industries
The RVC's seed fund	<u>Tasks</u>: – Boosting advancement of the national sector of seed investment under the venture financing industry; – Boosting a venture partner network for seed investment funds for the sake of a maximum engagement of professional managers, experts and business angels in the process of creation of new technological companies; – Generation of conditions for shaping up an continuous flow of transactions into venture funds, including those established with participation of the JSC RVC's funds; – A significant increase in the number and quality of small-sized technological businesses consequently claiming for receipt of venture investors and early-stage funds' investment	Priority directions of development of science, technologies and technics (see above); The list of critical technologies of Russian Federation
Skolkovo Fund	Shaping up a full cycle of innovation process, including education and research, development efforts and commodization of their deliverables	Priority directions of modernization and technological advancement of Russia's economy ("President's Priorities"): – Energy efficiency and energy saving; – Nuclear technologies; – Space technologies, telecommunications and navigation systems; – Medical technologies; – Strategic computer technologies and software

cont'd

1	2	3
Rosinfo-cominvest	Purposes: – Facilitation of access to financial resources for the most promising Hi-Tech and rapidly expanding companies of small and medium-sized capitalization in the ICT sphere; – Boosting attractiveness of ICT organizations in the eyes of potential investors through the Fund's participation in their authorized capital and management; – Attraction of domestic and foreign investment to secure production and technological cooperation between domestic and foreign enterprises of the ICT sector, development of mutually complementary and supplier/consumer production; – Assistance to bolstering Russian ICT companies' investment activity with respect to attraction of foreign investment in Hi-Tech sectors of Russia's economy. – Exclusive operational profile: investing assets in objects referenced to in the investment declaration (certain kinds and categories of securities, cash on bank accounts and deposits)	ICT
RFTD	Purpose: assistance to implementation of the public policy in the sphere of scientific, research and technical and innovation activity. Object of activity: securing provision of financial support to Russian organizations implementing scientific, scientific-technical and innovation projects, including those in the frame of international research and technical cooperation.	Technological platforms, including, primarily: – medicine of the future; – bioindustry and bioresources; – bioenergy production; – innovation laser, optical and opto-electronic technologies – photonics; – environmentally friendly high-efficiency thermal power; – cutting-edge renewable energy technologies; – small-sized distributed energy production; – metallurgy materials and technologies; – technological platform for solid minerals; – carbohydrates production and use; – intense processing of carbohydrate resources; – ocean development; – green growth technologies. Priority directions of research, technologies and technics (see above)
ROSNANO	Mission: assistance to implementation of the public policy aiming at having Russia joined the group of leading nations in the nanotechnology area. Purposes: – assistance to implementation of the public policy in the sphere of establishment and development of the nanoindustry and the respective innovation infrastructure; – financing investment nanotechnology production projects; – building technological chains securing the rise of new production units in the nanoindustry area in the territory of Russian Federation; – Generation of profit in the course of implementation of the above purposes. Main objective: Russia winning leading positions on global markets for nanotechnological products. Main purposes: securing commodization of the nanoindustry's R&D and coordination of innovation activities in the sohere of nanoindustry. Main vehicle: investment projects	Nanotechnologies

cont'd

1	2	3
Vnesheconombank	<u>Mission:</u> the national development bank, assisting to implementation of the public socio-economic policy, bolstering the national economy's competitiveness and its innovation-based modernization. <u>Purpose:</u> securing an increase in competitiveness of the Russian Federation's economy, its diversification, encouragement of investment activity by exercising investment, foreign economic, insurance, consulting and other provided for by law activities with regard to implementation of projects both in Russian Federation and overseas, including those with participation of foreign capital, aiming at bolstering infrastructure, innovation, special economic zones, environment protection, support of export of Russian products, works and services, and support of small-and medium-sized entrepreneurship. <u>Strategic objective for the period through 2015</u>: boosting the activity on securing a sustained innovation socio-economic development of Russian Federation on the basis of the national economy's modernization and increasing competitiveness. Implementation of this objective requires a considerable increase in the volume of financing of investment projects, expansion of support of export of Hi-Tech products and implementation of support programs for SME, as well as introduction of best practices with regard to project development and management. The Bank's contribution to solving the government's task of the national economy modernization requires an increase in its credit portfolio of the share of loans associated with the funding of investment projects. <u>Strategic objective in the area of contribution to implementation of investment projects</u>: boosting the volume of financing of investment projects across major avenues and sectoral priorities. To implement this objective the Bank will need to tackle the following <u>tasks</u>: – To ensure a greater efficiency of investment projects to implementation of which the Bank contributes, including improvement of internal documents with respect to project evaluation and selection; – To improve the system of control over implementation of investment projects (including, inter alia, with respect to financial monitoring, monitoring of progress in projects implementation and their efficiency); – To render assistance to organizations in preparation of project documentation in accordance with the Bank's requirements; – To create private equity funds and specialized sectoral investment funds to attract the domestic and foreign capital; – To expand the range of instruments of the Bank's contribution to implementation of investment projects by creating development corporations and funds	Sectoral priorities: – aircraft engineering and aerospace complex; – ship-building; – electronics industry; – nuclear sector, including nuclear energy; – transport, special and power machine building; – metallurgy (production of special kinds of steel); – wood-working industry; – defense-industrial complex; – agroindustrial complex; – strategic computing technologies and software; – ICT; – Medical technics and pharmaceutical sector. Priority directions of modernization and technological advancement of Russia's economy (the "Presidential priorities", see above)
Roseximbank	<u>Purpose:</u> implementation of the public policy of supporting and encouraging the national export, creation of import-substituting production and assistance in attraction of investment into Russia's economy. In its capacity of an agent of the RF Government with regard to extension of the state financial support to Russian exports the Bank is responsible for the following <u>tasks</u>: Pursuance of the state policy in the area of guarantee-based support of Russian exports oriented towards solidification of Russian exporters' standing competition-wise on traditional markets of developing and the CIS countries; Rendering assistance to Russian exporters with regard to marketing their industrial products; Granting Russian exporters access to long-term loans, including pre-export lending at minimal market rates. The Bank's operation as the RF Government's agent with regard to state support of exports <u>should help:</u> – Boost the number of national exporters and countries wherein their supply their products; – Promote Russian companies' competitiveness on the global market; – Create import-substituting production units, including innovation ones; – Attraction of investment in Russia's economy; - Generation job opportunities in the country	The manufacturing sector

cont'd

1	2	3
SME Bank	Strategic objective in the area of support of SME: expansion of the financial support of development of SME agents for the sake of diversification of the economy's structure, increase in employment, bolstering self-employment growth in GDP, boosting tax revenues, emergence of the middle class. Tasks in the area of support of SME: – Ensuring equal opportunities to small- and medium-sized businesses to medium- and long term financial resources throughout the territory of Russian Federation, including resource-scarce regions in the first place; – Organization of financial support to production corporations in the first place, as well as those implementing innovation and Hi-Tech projects, thus promoting changes in the sectoral structure of the lending; – Funding development of the support infrastructure for small-and medium-sized businesses (microlenders, business incubators, leasing companies, regional funds of support of MSE, technoparks, multifunctional business centers for MSEs, etc.)	Primarily production sector
RFDI	Mission, values: – Maximization of return on investment to secure a greater corporations' efficiency, generation of job opportunities and promotion of the economy's competitiveness; – Assistance in modernization of Russian economy; – Ensuring the foreign investment inflow; – Ensuring the inflow of the most advanced technologies and the best cadres into Russia; – Ensuring transparency of the corporate governance procedures	Fundamental sectors of modernization: – Advanced processing of mineral resources; – Technological development of critical deposits; – Agriculture and food retail; – House construction and construction materials; – Transport and logistics. Priority directions of modernization and technological development of Russia's economy («Presidential priorities», see above)
EXIAR	Objective: support of national exports and investment outside of Russia across the following directions: – Insuring of export loans from entrepreneurial (business) and political risks; – Insuring Russian investments to overseas from political risks. Tasks: – Marketing Russian export of equipment and technologies; – Monitoring and insurance support of national exporters on new and risky markets overseas; – Design and introduction of a modern system of financial support of export under the Agency's insurance coverage; – Increase in transparency of Russian export transactions and international investment	–

Sources: statutory and other title documents, including development institutions' internal documents, approved strategies and development programs, the development institutions' official homepages.

The development institutions' current operational priorities appear fairly versatile, having different nature and "origin" and, generally speaking, they raise some questions. More specifically, in accordance with the statute on investment policy of the Russian Venture Company, venture funds in which creation it participates and the Fund for Seed Investment should follow in their operations officially set priority directions of development of research, technologies and technics, and the list of critical technologies of Russian Federation; investments made by Skolkovo Foundation should be consistent the with priority directions of modernization and technological development set by the RF President; the "Start" program operated by the Fund for Assistance to Innovation provides for technological "framework" (a fairly big one, *apropos*) set by the Fund itself. That said, there are serious doubts about appropriateness of employment of any priorities and restrictions at the stage of seed – and even more so – pre-seed financing.

At this point, it is worth noting a fairly peculiar prioritization scheme devised by the Russian Fund for Technological Development. The Fund focuses on support of projects matching respective approved technological platforms and, primarily, those related to technologies of live systems, future energy engineering and rational environmental management. Vensheconombank centers on sectoral priorities which encompass practically all major manufacturing industries. Meanwhile, it is only one of them, namely, metallurgy for which a priority was identified, that is, a relatively narrow segment of special steel production, with no meticulously identified priorities for the other sectors. Lastly, a range of development institutions have a clear technological specialization (ROSNANO- nanoindustry, Rosinfocominvest – ICT, RVC's Biofund – bioindustry and pharmaceuticals), but it is not clear why other Hi-Tech sectors have thus far been neglected in this respect.

In all, the current system of development institutions' priorities cannot be viewed as a sufficiently consistent. Quite opposite, it appears even "spontaneous", with no general layout or ideology underpinning it.

While considering the current requirements to quantitative parameters of supported companies and projects (*Table 18*) it should be noted a drawback of the current development institutions system, as follows: it does not appear to a sufficient degree oriented toward supporting mid-size projects worth in the region between several hundred million and one billion Rubles. It is only ROSNANO which can afford to support such projects (provided they are directly associated with the nanotechnology sphere), and so can some of RVC's venture funds. As to other development institutions, they center on either bigger, or smaller projects. The SME Bank's operations nominally focus on small- and medium-sized businesses, but due to the effective caps on volume of funding (Rb 150mn for innovation and modernization projects and Rb 60mn – for all other projects), they largely center on support of small-sized businesses.

Table 18

Main Parameters of and Restrictions on the Development Institutions' Operations on Support of Innovation Companies and Projects[1]

Development institutions	Forms of support	Characteristics of supported companies			Characteristics of supported projects		
		«Age», as years[a]	Number of employees[a]	Volume of revenues (income) as Rb mn[a]	Volume of support, as Rb mn	Term of support, years	Co-financing, as %
1	2	3	4	5	6	7	8
Fund for assistance to innnovation ("Start" program)	Grants	Up to 2	No more than 100	Up to 0.3	Year I – up to 1; Year II – up to 2; Year III – up to 3	1–3	Year I – 0; Year II – no less than 50; Year III – no less than 50
RVC's Fund of Seed Investment	Investment	No more than 3		No more than 10	Up to 25	1–5	No less than 25
Skolkovo Foundation	Grants				1,5–300	Up to 10[b]	0–75
Regional venture funds	Investment		Up to 250	Up to 1000	Up to 36–120[c]	Up to 7[d]	25–75
RVC's Venture funds	Investment			No more than 75	Up to 300–1000	Up to 5–10	
RVC's biofund	Investment				No more than 100[e]		No less than 50

[1] In this case we do not consider support of infrastructure, educational, etc. projects

cont'd

1	2	3	4	5	6	7	8
Russian Fund for Technological Development	Credits				As a rule, no more than 300	Up to 5	
Rosinfocominvest	Investment				No more than 150	2–6	No less than 50
ROSNANO	Investment			No less than 250[f]	300–1300	No more than 10	No less than 25–50
	Loans		Up to 250	Up to 1,000	Up to 60; microfinancing – between 0.1 and 1 per contract (no more than 10 by all the contract with a given SME agent); funding for innovation and modernization – up to 150	From 0,5 Up to 5; Microfinancing – from 0,25 Up to 2; Financing of innovationas and modernization – from 1 Up to 5–7[g]	0 or no less than 15[g]
	Leasing	No less than 1	Up to 250	Up to 1,000	Between 0.15–60 up to 60–150[b]	Up to 5	No less than 15–30[g]
	Investment		Up to 250	Up to 1,000	Up to 60	5–7	No less than 15[h]
Vnesheconombank	Loans				No less than 1000 (the volume of the project – no less than 2,000)	As a rule, more than 3 (payback time - over 5)	No less than 20
Russian Fund for Direct Investment	Investment				1500–15,000[i]		No less than 50

Note.
[a] – as of the moment of the beginning of support;
[b] – the term of effect of the status of participant in the Innovation Center Skolkovo;
[c] – due to the volume of the Fund;
[d] – the term of trust of the funds;
[e] – during the first round of investment;
[f] – in 5 years after the start of the project;
[g] – due to conditions of a concrete direction of support (product);
[h] – from the total value of the project; investment – no more than 25% of the total value, credit support – no more than 60%;
[i] – 50–500 $ mn.

There exist some barriers to the "innovation lift" at early stages, particularly to the "capture" by the RVC's Seed Investment Fund of successful projects earlier supported by the Fund for Assistance to Innovation. This can be explained by the fact that the Seed Investment Fund grants support on a far greater (up to Rb 25mn) level, and the recipient company should be no more than 3-year old. By contrast, the Fund for Assistance to Innovation extends support to companies aged under 2 years and with the volume of proceeds at the onset of no more than Rb 0.3mn. So, objectively, companies' chances for managing to "grow up" to a level at which they can qualify for the Seed Investment Fund's support are limited.

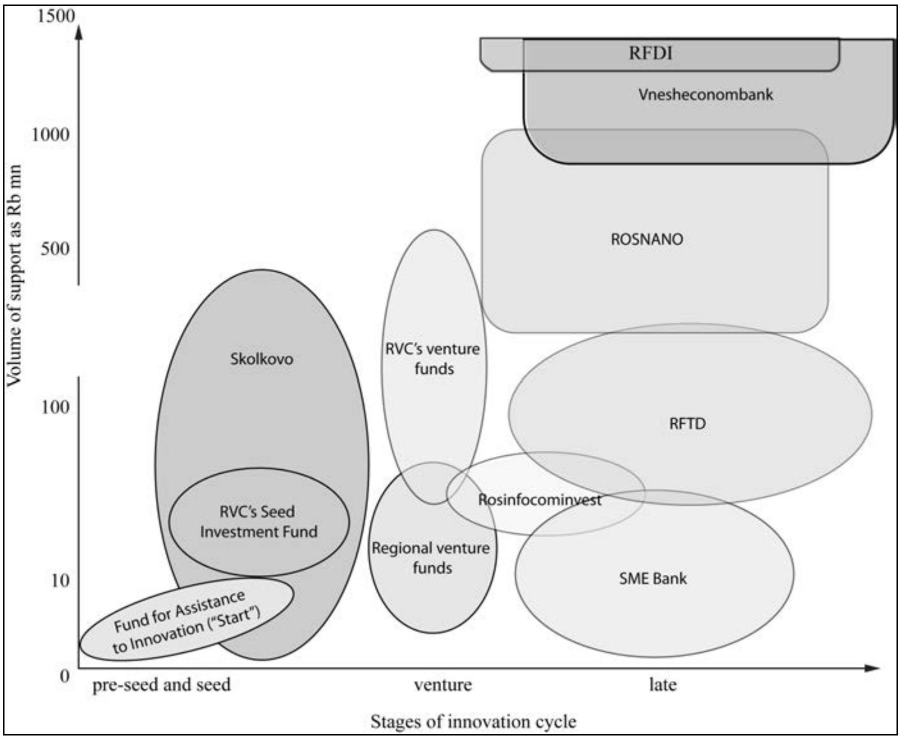


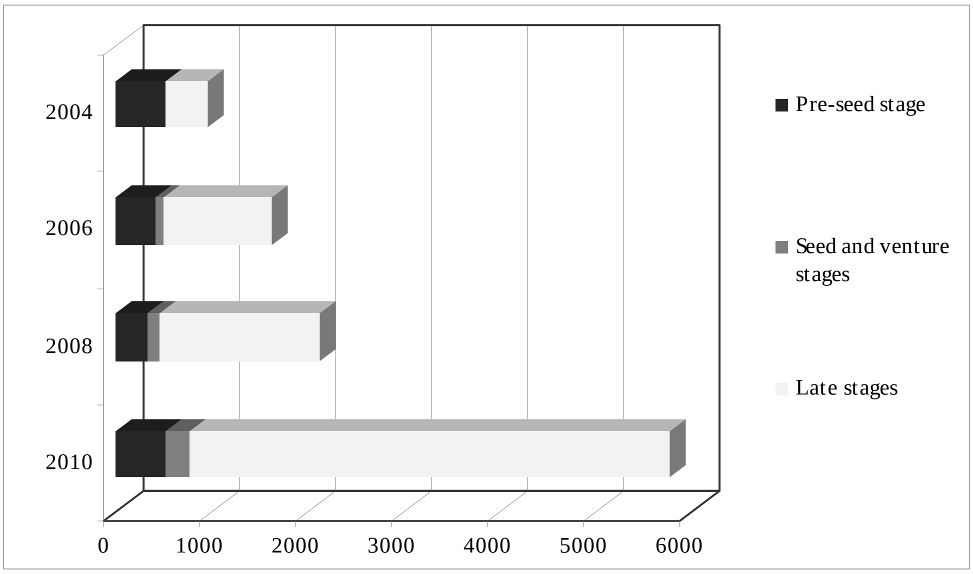
Fig. 2. "Positioning" of Financial Development Institutions by Stages of Projects and Volumes of Their Support

It should be noted that there has recently emerged a tendency to extension of the upper margin of support: thus, the Fund for Assistance to Innovation raised it by 1/3, SME Bank now is in a position to disburse loans of up to Rb 150mn to innovation and modernization projects (with another 60mn to be potentially invested in SME implementing such projects), while earlier the cap for the said categories of project was Rb 60mn. Plus, some of recently established institutions and funds allow far greater projects financing volumes than the existing institutions centering on the same stages of the innovation cycle (the most shining examples in this respect are Skolkovo and RFDI).

6.3.3. Assessment of the Scale and Outputs of the Development Institutions' Performance, Main Tendencies and Recent Critical Changes

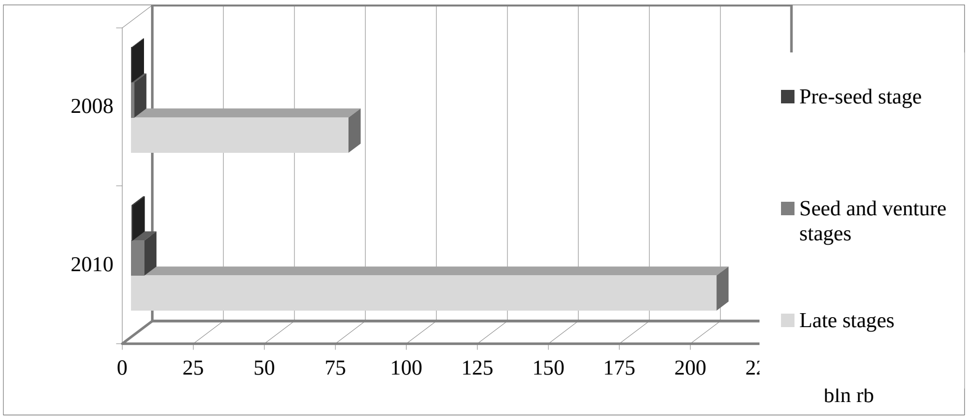
The number of supported projects recently has steadily been on the upsurge (*Fig. 3*), and in 2009 – 2010 it nearly tripled, which can be ascribed largely to a substantial expansion of SME Bank's operations. The rise was practically exclusively fueled by projects at late stages of the innovation cycle, which resulted in a very considerable "bias" towards those: while in 2004 the number of supported projects at early stages roughly equaled the one of late-stage projects, in 2010 the latter accounted for nearly 90%.

The prevalence of late-stage projects is yet more visible in the structure of financing (*Fig. 4*), which, however, is quite natural, as the size of support granted at early stages is more humble. As well, let us note that in the overwhelming majority of cases the size of support of projects implemented in 2010 was fairly small and accounted for up to Rb 50mn per project.



* Hereinafter without regard of the projects supported by SME Bank via the infrastructure organizations.
Source: estimates by the interdepartmental Analytical Center on the basis of materials of Russian development institutions and RVCI.

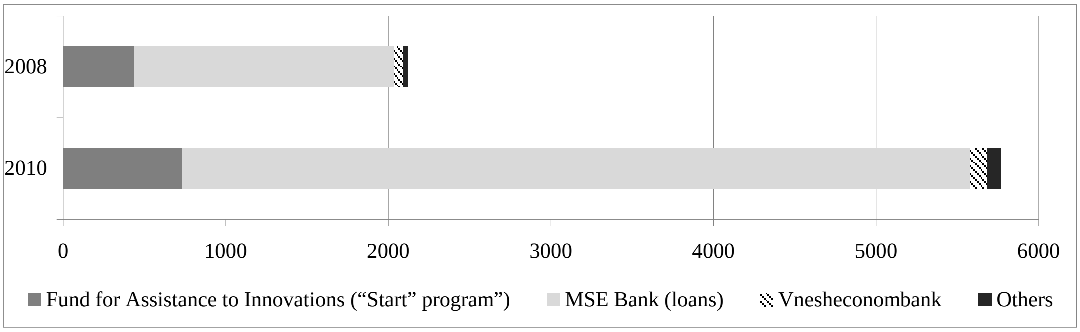
Fig. 3. Dynamic of the Number of Supported by Development Institutions Projects by Main Stages of Innovation Cycle*



Source: estimates by the interdepartmental Analytical Center on the basis of materials of Russian development institutions and RVCI.

Fig. 4. Volume of Financing of Supported during the Year Projects by Development Institutions by Main Stages of Innovation Cycle

It was the Fund for Assistance to Investment and SME Bank's performance which proved the most "mass-scale" one (*Fig. 5*): in the case of the former institution, there were hundreds of objects of support over the year, while in the latter case they were counted in thousands. Common for the institutions in question is their focus on support of relatively small projects: in the former case the grant typically does not exceed Rb 1mn, while loans disbursed in the latter case account for some Rb 4mn each. That said, the institutions' operations center on the "polar" stages of the innovation cycle: that is to say, the Fund supports projects at their early (mostly pre-seed) stages, while the Bank does the same for projects on late stages.



Source: estimates by the interdepartmental Analytical Center on the basis of materials of Russian development institutions and RVCI.

Fig. 5. The Number of Projects Supported by Development Institutions over the Year

When it comes to the performance of two particular development institutions, SME Bank and Vnesheconombank, which carry out fairly large-scale support programs (in the former case – in terms of the number of supported objects, while in the latter case – volume-wise), their common peculiarity lies in a relatively low proportion of the “investment component”: thus, the institutions themselves estimate the specific weight of innovation projects in the overall amount of support at the level of ¼ for SME Bank (as of 2009) and a meager 3% for Vnesheconombank (as of 2010). Meanwhile, SME Bank has recently launched a program “Financing of innovation and modernization” which should intensify its activity in the area of innovation; as to Vnesheconombank, we feel the above estimate appears lower than in reality, as some projects which the Bank did not label as innovation ones are directly associated with innovation, nevertheless. As well, it is worth noting that the Bank’s recently adopted strategy through 2015 provides for an increase of the proportion of investment projects in its credit portfolio up to 20%.

While comparing the magnitude of the development institutions’ operations in 2008 with the 2010–2011 one (*Table 19*), it is worthwhile to note their substantial expansion for most of the institutions and, sometimes, in tandem with diversification of their activities. In a number of cases that was determined by the fact that back in 2008 some institutions (like RVC or ROSNANO) basically kicked off into existence and were way below their “projected capacity”. However, in certain instances, it can be ascertained that already mature institutions (such as SME Bank) expanded their operations considerably. Against the general backdrop RFTD appears a notable looser, as not only did the Fund fail to expand its R&D financing operations, but de facto put them on halt. That said, as noted above, it was announced in 2011 that the Fund was going to renew its operations in the capacity of development institution.

Table 19

Magnitude and Performance of Development Institutions with Regard to Support of Innovation Projects

Development institutions	Magnitude and performance	
	2008	2010–2011
1	2	3
Fund for Assistance to Innovation	Between 2004 and 2008 in the frame of the “Start” program 8,700 applications were considered, over 2,000 projects were supported, including some 270 ones – at the second stage and around 50 – at the third stage	By late 2010 in the frame of the “Start” program over 12,000 applications had been received and some 3,000 projects were supported. As many as 82 small-sized innovation companies had completed a three-stage cycle of the program

cont'd

1	2	3
Russian Venture Company	As many as 7 venture funds with a total volume of a. Rb 19bn were formed. Three funds invested some Rb. 1.8bn in 15 companies	By late 2011 venture funds had selected 45 projects to be financed. The Seed Investment Fund was created (see below). Two Funds were created under foreign jurisdictions and USD 20mn was invested. The RVC's InfraFund was established , 9 projects were selected. The RVC's BioFund was established
RVC's Seed Investment Fund	–	By the end of 2011 41 projects were selected for financing
Regional venture funds	As many as 14 funds created in 12 Russian regions with a total capitalization of some Rb 5.5bn. A. 30 porjects were funded, and the aggregate amount of investment hit Rb 1.3bn	There are 22 funds in 20 regions with the aggregate capitalization of over Rb 9bn. By late 2010 they had approved a. 50 projects for financing, and the aggregate amount of investment was Rb. 3.3bn
Skolkovo Foundation	–	By late 2011 as many as 85 grants worth a total of Rb 5.8bn were approved and the volume of co-financing hit Rb 4bn. The grant recipients de facto received Rb 1.9bn
Russian Fund for Technological Development	Over 800 projects worth a total of Rb 7.4bn were financed*	
ROSNANO	By late 2008 a. 400 applications and proposals for financing were received for a total of Rb. 464bn, including 310bn out of the corporation's funds. ROSNANO approved 7 projects (6 investment and 1 educational one) worth a total of Rb. 10.3bn, including 5.5bn – out for the Corporation's funds. Another 2 projects were launched with the funding amounting to Rb 0.2bn	By late 2011 as many as 1,884 applications for project financing worth a total of Rb 4,064bn, including 1,764bn out of the Corporation's funds (in 2010 – 439 applications, Rb 1,867bn and 556bn, respectively). Of the said number 104 projects worth a total of Rb 347bn, including ROSNANO's co-funding in the amount of Rb 140bn, were approved (in 2010 – 44 projects, Rb 146bn and 47bn, respectively). The Corporation allocated Rb 64bn for 49 projects, including32bn – in 2010. ROSNANO fulfilled its investment obligations by 11 projects. ROSNANO's participation with Rb 30bn in creation of 8 venture funds worth a total of Rb 62bnwas approved. Of the said number 4 funds were financed (Skolkovo-Nanotech, Advanced Nanotechnologies, Nanomet, Rosnano Capital), of which 3 are up and running
Vnesheconombank	By late 2008 as a creditor contributed to financing of 54 investment projects, of which contributed to 5 projects as an investor, too, while to another two projects – as a guarantor. The volume of loans on implementation of investment projects accounted for Rb 129.9bn. In 2008, the Bank started financing 21 new investment projects in Russia	By late 2010 Vnesheconombank contributed to funding of 97 investment projects, of which to 94 – as a creditor. As well, the Bank provided guarantees to 2 investment projects. The volume of disbursed loans accounted for Rb 306bn, the balance-sheet value of stock the Bank acquired in the process of allocation of support to the project was Rb 27bn, and the volume of guarantees provided was a. Rb 11bn. In 2010 the Bank began financing 27 new investment projects and disbursed Rb 126bn in loans on projects implementation, including Rb 61bn- on new projects, and invested in corporate stock over Rb 20bn
Roseximbank	By late 2008, the Bank's credit portfolio accounted for Rb 4bn, including some 2.5bn extended in the form of pre-export funding. The volume of loans disbursed in 2008 was Rb. 29bn	By late 2010, the Bank's credit portfolio accounted for Rb. 5.1bn, including some 3bn extended in the form of pre-export and investment lending (aiming, as a rule, at modernization of equipment of manufacturing corporations seeking to reduce production costs of their exports). In the course of the year, Rb 3.7bn was disbursed (prolonged) in loans
SME Bank	In 2008, as many as 1,600 loans worth a a total of Rb. 7.8bn were disbursed to SMEs. In all, since 2004, the Bank extended nearly 6,500 loans to SMEs for a total of over Rb 23bn	In 2010, MSEs were granted some 5,000 loans for a total of over Rb 27bn. By the end of the year, the aggregate volume of the support to SMEs accounted for, on an accrual basis, some Rb 80bn. In the frame of the "Financing for innovation and modernization" program in 2010 alone the Bank disbursed 12 loans for a total of Rb. 0.8bn

* By 2008 RFTD had de facto terminated its project financing operations.
Sources: the official corporate reports, the development institutions' official homepages.

Importantly, a number of Russian development institutions *have lately substantially modified* operations (or, at least, modifications began to emerge therein), *and, as a rule, for the better:*

- As the most visible recent tendency it is worth noticing the aforementioned activation of efforts to complete building the system of development institutions, primarily in respect to creation of new ones both by the state (Skolkovo Foundation) and by the already existing institutions (RVC and ROSNANO's venture and infrastructure funds, among others – see *Fig. 6*);
- The processes of Russian development institutions' integration into the global innovation system have gained a notable momentum: at this point, it would be appropriate to cite a string of programs with Vnesheconombank's participation (co-funding of projects in the area of infrastructure, industrial production, energy efficiency and resource management with the World Bank; a joint program with EBRD on funding investment projects in the frame of the Russia-EU "Partnership for Modernization" initiative, and incorporation by RVC and ROSNANO of subsidiaries and foundations under foreign jurisdictions;
- An important operational direction for the institutions and funds in question has recently been support of development of various elements of the innovation operational (information, educational one, etc.) infrastructure. At this point, it should be noted that while creation by ROSNANO of the Fund for Infrastructure and Educational Programs allows to speak about incorporation of the respective operational direction in the individual legal entity format, creation, for instance, of the InfraFund and BioFund under RVC (in the focus of the latter are both innovation and service companies that deliver laboratory, information-analytical and consulting services) constitutes the every initiation of the respective operational directions under the aegis of Russian Venture Company;
- Meanwhile, the development institutions have substantially bolstered their cooperation with respect to support of innovation activities. The most visible manifestations of the process in question are the "Agreement of the Nine" aiming at securing a perpetual funding of innovation projects[1]; bilateral agreements between individual funds and institutions, such as creation of the RVC's Seed Investment Fund with participation of the Fund for Assistance to Innovation, the RVC running evaluation of projects that seek funding out of regional venture funds. Besides, it is worthwhile to note the recently started "mutual penetration" of managing structures of different development institutions, which is most visible at the level of their Boards (Advisory Councils);
- The search for optimal forms of organization of development institutions' operations, shaping up new directions and instruments of support, including in pursuit of strategic prospects, is under way. To cite particular moves or core initiatives in this area suffice it to refer to the incorporation of ROSNANO and the planned for a foreseeable future privatization of a fraction (up to 10%) of the newly established joint-stock company's stock; the transformation of RFTD from public institution into an autonomous one and renewal of its operations on supporting R&D with the emphasis on projects implemented in the frame of tech-

[1] In 2010, a number of public development institutions, including Vnesheconombank, ROSNANO, the RF Ministry of Education, Fund for Assistance to Innovation and RVC, as well as 2 non-profits (OPORA Rossii and the Russian Association fof Direct and Venture Investment), and MICEX, and the Federal Agency for Youth concluded a cooperation agreement which provides for organization of a prompt information exchange about projects in progress to arrange for their "transfer" from one institution to another.

nological platforms; the already repetitiously cited creation of RVC and ROSNANO's funds; initiation by the Russian Bank for Development of the "Financing for Innovation and Modernization" program. It is also worth noting a practically completed process of development of strategic guidelines (plans, programs, etc.) for core institutions for years to come[1];

- Development institutions have to some degree succeeded in solidifying trust in them through their leadership's professional reputation. In this regard the most shining example is the composition of the RVC's Board, with 3 out of its 7 members being independent directors and renowned business community representatives.

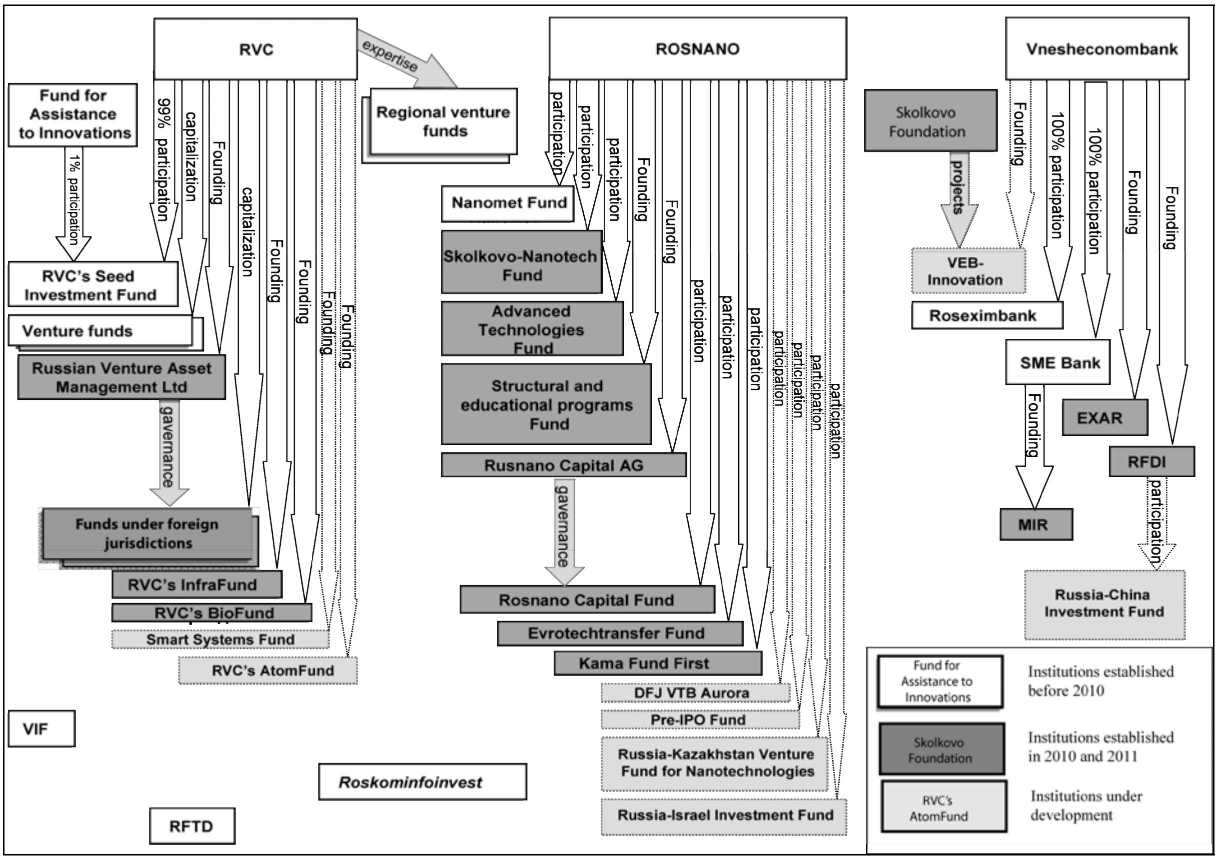


Fig. 6. The System of Existing Financial Development Institutions and the Ones under Development

While considering the balance of the development institutions' strengths and weaknesses (*Table 20*) it can be noticed that each of them is in possession of a substantial spare capacity to bolster operations on support of innovation: for example, the Fund for Assistance to Innovation could raise its caps on both the volume of support and the size of supported companies, as well as enhance its operational transparency and improve the overall performance; Vnesheconombank could bolster the innovation component; Rosinfocominvest could tackle nor-

[1] The only clear "lacuna" today is the absence of such a public document for the Fund of Assistance to Innovation; however, it has already crafted a draft medium-term action plan.

mative hurdles to the start of its investment operation; and practically all the institutions could expand the array of forms of support and intensify their efforts to attract private resources.

Table 20

Main Strengths and Weaknesses of Development Institutions with Respect to Support of Innovation

	Strengths	Weaknesses
1	2	3
Fund for Assistance to Innovation	Implements a grant-based scheme of support, no problems with "walking out" from the supported projects. A developed territorial structure in place, a broad "encompassing" of Russian regions, a well-developed evaluation system. Credibility, the possibility for a substantial scaling of "Start" and "SMART" programs without lowering the selection quality bar. Flexibility and creativity in shaping up new programs. Possibility for building a program of new directions of support, particularly with regard to small business – exporters	Financial resources are limited. A significant fraction of programs suspended during the crisis. The Fund's support may go only into funding R&D and works directly related to R&D implementation. A fairly low cap on support of a single project. Restrictions on subjects of supported projects (albeit not so stringent) appear excessive on the seed stage and on the pre-seed one in particular. Possibilities for purchasing special equipment are considerably restricted by the effective standards[1], ergo, problems with supporting start-ups where costly equipment is needed. No approved development strategy and public performance reports available
RVC	Possibilities for flexible participation in creation of various funds together with private businesses. RVC's lessen principle with regard to decisions on projects selection generate general framework for private initiative and risk allocation. In addition to "typical" venture funds, shaping up specialized ones (seed, infrastructure, sectoral (BioFund). High activity, regular putting forward new practical initiatives on creation of new funds, development of the innovation-venture ecosystem, etc.	Shift of the focus on creation of funds without co-sponsors. Due to the established prioritization (priority directions of development of research, technologies and technics, and the list of critical technologies of RF) there may exist a lack of attention to interdisciplinary projects, new, rapidly growing sectors that have failed to make it into the list of officially set priorities
RVC's Seed Investment Fund	With account of a substantially higher (compared with the 'Start" program) cap on support of a individual project –s the possibility for implementation of investment-intensive projects at the seed stage across a broad spectrum of thematic directions. No caps on kinds of financial costs associated with projects implementation, flexible conditions with regard to projects implementation timelines. Focus on capitalization of innovation firms. Possibility for creation in the future of a steady flow of transactions on "walkaway" from projects with the help of the system of venture partners	Overly strict capping on marginal earnings of a company potentially applying for support – in reality it is micro-companies, not even small-sized businesses which are subject to support. Due to the innovation pattern of the "seeding", the problem of "walkaway" from projects. Requirement to supported companies' operations to be in line with priority directions of development of research, technologies and technics, and the list of critical technologies of RF appears excessive
Regional venture funds	Attraction of RF Subjects' funds to develop the venture industry. A due account of the regional specificity of venture investment, possibility for flexible "walkaway" timelines. Decreasing small-sized innovation companies' costs of access to support Requirement for RVC to run evaluation of projects seeking the funds' investment can positively influence the quality of supported projects	Low level of investment activity: as of late 2010 the average transactions-to-fund ratio was just around 2 to 1. The need for an "intermediary link" – The need for «regional funds for assistance to venture investment in small-sized enterprises in the technical sphere most of which are used to create a sole venture fund. A broad representation of RVC on the funds' Boards in tuned, with evaluation of projects can result in an excessive concentration of real control powers in the hands of RVC. Negative record of interaction with private management companies (in Tyumen oblast, Stavropol krai). An insufficient level of the overall transparency of the system of created funds and their deliverables
Skolkovo Foundation	Considerable amount of support, grant-based operational pattern. Possibility to combine financial support with other mechanisms provided for residents of the Skolkovo Innovation Center: large-scale tax, customs and tariff benefits, a simplified procedure of employment of foreign workforce, softening administrative barriers to doing business with the use of an independent institutional regulation system	The priorities embrace just a fraction of promising directions of technological development. The current concept of the Foundation and the Innovation Center is better suited to accommodate large, well-established companies, rather than innovation startups

[1] Proportion of funds used to purchase special equipment may not exceed 15% of the value of the contract .

cont'd

1	2	3
Rosinfocominvest	Focus on a partial privatization, possibility to refine the scheme of attraction of private investment at the Fund's level which can prove effective in the ICT sector, along with implementation of a broad totality in respect of short-term projects	Ban on the Fund investing until the moment the government reduces participation in its capital to 51%, the absence of any progress in attraction of private shareholders and, as a consequence, the absence of the Fund's profile operations. The cap on investment in a given single project may prove insufficient, as the Fund has not right to invest in LLCs of which such a volume of investment is more typical than of JSCs
RFTD	A significant record of selection and support of applied research projects. A mature system of communication with research organizations and corporations. As the focus is on support of projects in the frame of technological platforms, the high demand for the projects' outputs is highly likely	Just a sole mechanism of support is permitted, that is, target loans, which is not always the best mechanism for innovation projects by companies and new and small-sized ones in particular. The selection of a fraction of technological platforms as top priority ones is not clear
ROSNANO	Holistic approach to operations (support of innovation projects, innovation infrastructure development, education, improvement of regulation. Sizeable financial resources at hands. Upon incorporation there emerges a possibility (and plans have been shaped up already) for attraction of private investors. Highly active, primarily in regard to investment projects rollout across a broad range of directions. A considerable number of initiatives associated with the innovation infrastructure development. A fairly high degree of transparency, including that of operational pillars and regulations; a well-developed public awareness and communications system.	Gradual drift to support of increasingly larger programs and projects. With no strictly established corporate development framework in place, the risk of an unjustified expansion of the scale and functions. The de-facto refusal to finance R&D (beyond the frame of innovation projects), while support of R&D was set as one of the company's major functions
Vnesheconombank	A sizeable resources volume, possibility to support huge long-term investment projects. Pre-crisis, a high efficacy with regard to organization of selection and support of implementation of huge investment projects. The resource and organizational capacity on hand to support projects that secure significant multiplying effects for advancement of the national economy and the rise of progressive technological shifts. Rainbow of forms of support: loans, investment, guarantees – and the possibility to combine them. Possibility to expand projects on support of regional innovation infrastructure	No strictly determined methodology of assessment and principles of support of investment projects on development of innovation as yet. A gradual expansion of the Bank's functions in its capacity of the RF Government's agent (which became particularly significant during the crisis) which reduces the Bank's capacity with regard to a consistent and systemic implementation of functions of development institution. There are signs of a certain trend to reallocation of resources in favor of infrastructure projects with resources on support of innovation projects being limited. No strictly determined requirements to the extrabudgetary project co-financing. The risk of using the Bank's resources as a "surrogate" of extrabudgetary funding in side-projects (including those implemented by other development institutions)
Roseximbank	Employment of various schemes, provision of support at different stages, including the pre-export one. Support of export as a major profile, a substantial record in this sphere	Relatively moderate magnitude of operations and humble resource capacity on hand. A certain inclination to supporting traditional industries. The support was not customized to meet small-sized companies' needs
SME Bank	Well-developed and fairly effective operational pattern of a mass provision of support to SMEs on the basis of agent agreements with banks and infrastructure organizations. Sizeable volume of resources to support SMEs. A very broad "encompassing" (in terms of the number of supported projects). Rainbow of forms of support: loans, including microfinancing), leasing, investment. Expansion of the scope and employment of new forms of support, in particular, in the innovation sphere	Because of the effective caps on loans, the Bank focuses largely on support of small-sized and micro-firms, rather than medium-sized businesses. A special program of support of innovation activity was launched just in 2010 and, funds-wise, has thus far been fairly modest
RFDI	Possibility to implement very large, backbone for an industry, region or the economy as a whole, projects Focus on attraction of foreign investors, including institutional ones. Intention to invest in rapidly expanding sectors and industry leaders	Taking into account prospective projects – relatively small capital of the fund. No publicly available documents to specify the procedure and conditions of investment activity. The risk of "megalomania" in the course of selection of projects to

6.3.4. Critical Challenges and Possible Ways of Improvement of the System of Public Financial Development Institutions with Regard to Support of Innovation Activity

So, there has recently emerged a tendency to a notable expansion of Russian financial development institutions' scope of operations: the volume of their investment is on the rise, as the number of investment projects they back is. Our estimates suggest that the aggregate volume of support of investment and innovation projects by development institutions increased from Rb 78bn in 2008 to 211bn in 2010, while the number of supported projects grew over the same period from 2,100 to 5,800. As noted above, it was expansion of the Russian Bank for Development's operations on support of MSEs that accounted for a critical contribution to the rise in the number of supported projects. Meanwhile, the growth in the overall volume of support was secured by expansion of the Vnesheconombank's operations on lending to investment projects and ROSNANO's funding production projects.

In its most general form, as far as the innovation sphere is concerned, the development institutions system should ensure addressing the following tasks:

1) Support of creation of new innovation companies, R&D commodization processes, and technology transfers;
2) Ensuring conditions of a rapid expansion of successful innovation firms, including by compensating for market failures and granting access to financing at different stages of the innovation cycle;
3) Ensuring a demonstration effect for the economy, boosting private resources in the innovation sphere.

The businesses' assessment[1] *of the development institutions' impact* allows the following conclusions: on the one hand, their influence on the corporate sector's innovation performance may appear fairly limited: only 4% of enterprises in the sample noted the presence of such an effect from VEB and ROSNANO's operations, while another 2% of respondents noted the same with regard to venture funds' operations. On the other hand, however, those are not small figures, given the narrow focus of the development institutions' operations and comparing them with the respective figure of the impact of financing of innovation projects in the frame of the FTP (8% of respondents).

More important is what category of enterprises noted a positive effect from development institutions' operations. Having run a regression analysis, we found out that it is corporations with government participation and those with a solid financial standing which more often cite a positive effect from Vnesheconombank and ROSNANO's operations. Meanwhile, it is medium-sized companies (with up to 250 employees), corporations with government participation and those with a solid financial standing which more often ascertained the same with regard to venture funds. As a positive fact, let us note that the positive effect in question was more often cited (given other conditions being equal) by companies with a higher level of spending on technological innovation, a positive dynamic of such costs and boasting cutting-edge innovation produce.

[1] On the basis of a survey on executives of 600 medium-sized and large industrial corporations run in October-November 2011 and individual interim findings of the project of the Interdepartmental analytical center on assessment of various instruments of encouragement of innovation implemented for the benefit of the RF Ministry of Education and Science.

It appears quite logical that the development institutions' operations generally prove more significant to robust companies, while venture funds' operations in particular – to smaller-sized companies. That said, interpretation of some shift of the "group of beneficiaries" towards companies with government participation is a tricky question. We assume there might be at least two explanatory hypotheses: (1) being controlled by the state, public development institutions' focus of operations is shifted toward support of companies with government participation; (2) where private corporations receive funding from public development institutions, they face the need to give up a fraction of corporate control in the course of implementation of an investment project, while companies with government participation are not particularly concerned about such anti-motivations.

An accelerated and multidirectional expansion of Russian development institutions, particularly coupled with an insufficiently developed independent audit of their performance, inevitably increases risks associated with the rise (intensification) of certain systemic imbalances in their operations. It is possible to identify the following tentative groups of such imbalances:

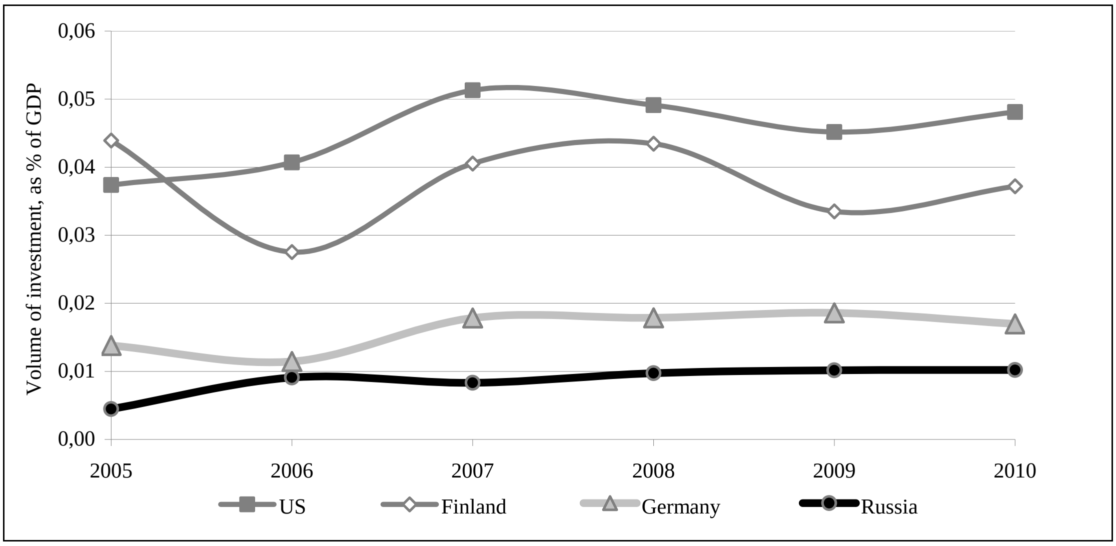
- «vertical» ones, which appear to be determined by an insufficient balance of support at different stages of innovation ;
- «horizontal», which are associated with thematic directions of development institutions' operations and peculiarities of their prioritization; and
- Institutional ones, determined by the normative framework of conditions of provision of support and a loose combination of instruments applied.

Let us first examine *general trends of development of the Russian market for investment at venture stages* vis-à-vis mature innovation economies. Between 2005 and 2010, Russia first posted some advanced growth of the level (vs. GDP) of investment at venture stages followed by its stabilization at the level of 0.1% of GGDP since 2008 (*Fig. 7*), with the indicator in question nationwide during the whole period being substantially lower than in countries with a mature venture industry, such as US and Finland and thus far having exhibited no trend to its *post-crisis growth.*

While analyzing *operations on the Russian market for venture and direct investment sector-wise,* it should be noted that thus far it has not undergone any substantial, sustained shifts in terms of "diversification" of thematic directions. According to RAVI[1], in 2007–2010, investment in three sectors – telecommunications, financial services and consumer market – accounted for 70-80% in the structure of private equity and venture funds' investments. Throughout the period in question, investments in the medicine and health care sector were being steadily on the rise. After the crisis 2009 tendencies to growth in investment renewed in such sectors and energy, industrial equipment, agriculture, while investment activity in such sectors as chemicals, biotechnology, light industry, and environmental management remained low.

The public institutions' operations at venture stages also gravitate more toward "traditional" thematic direction, though with some attention being paid to certain other sectors, such as medicine and energy engineering.

[1] Russian Association for Direct and Venture Investment. Direct and venture investment in Russia 2010. A preliminary market review. 2011

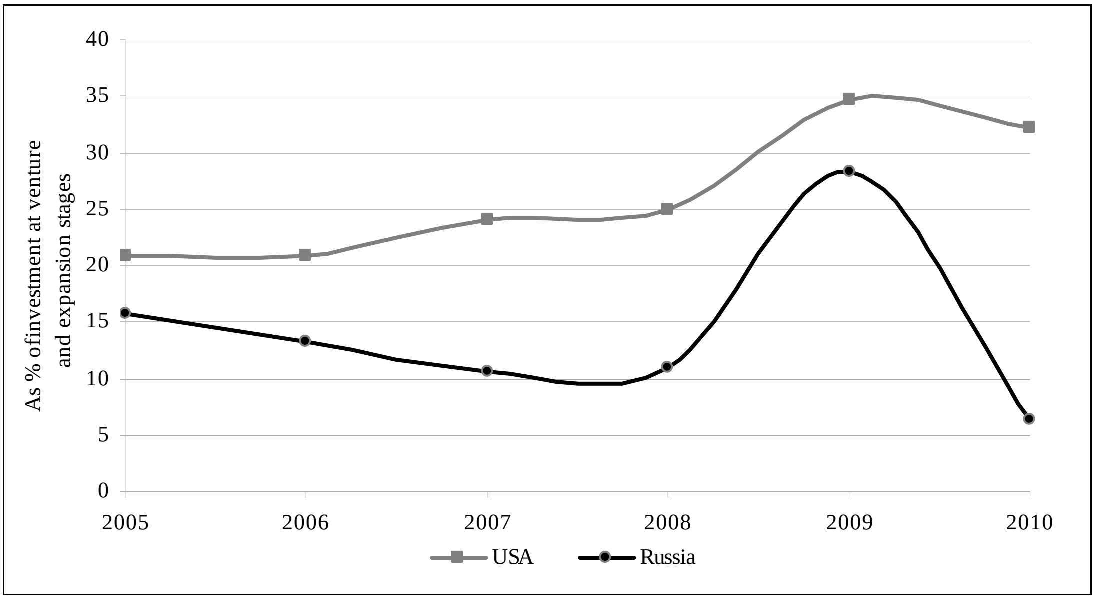


* Venture stages include the seed, initial and early stages (by the RAVI methodology) and analogous stages as classified overseas.
Source: assessments of the Interdepartmental analytical center on the basis of data of RAVI (Russia), NVCA (UD), EVCA (Germany).

Fig. 7. Dynamic of the level of Investment at Venture Stages * in Individual Countries, as % to GDP

As to the direct investment market, ROSNANO is particularly active there, but, of course, only in the frame of its core mission of development of nanoindustry. Meanwhile, as far as such a promising direction as bioindustry is concerned, the existing development institutions do not exert any significant influence on its advancement. In our view, due to the industry's huge capital intensiveness and dependence of its development prospects on improvement of regulation, it is imperative to establish a specialized PPP-based biotechnological direct investment fund. There might as well be a certain niche to form other funds (both venture and direct investment ones) to focus on such directions as fine chemistry, alternative energy, robotics.

Despite a certain progress, the Russian industry of venture capital and direct investment has still *remained unbalanced phase-wise:* between 2005-10 investment at the stage of expansion proved nearly 10-fold greater than investment at venture phases, while developed economies exhibit a greater level of investment at the latter stages. If in our consideration we cross out a "formal" increase in the share of investment at venture stages during the crisis period (determined by contraction of private businesses' investment activity at expansion stages), it can be noted that US demonstrated a tendency to increase in the share of investment at venture stages, while in Russia this share was down: in 2005, the proportion of investment at venture stages in the aggregate volume of investment at venture stages plus those at expansion stages was over 15.7%, in 2010 it dwindled to 6.3% (*Fig. 8*). We believe this effect was engendered by the strive for practical results from development institutions' operations in the short run and by the shift of operation of the whole system of development institutions toward later-, "commercial" stages with more visible direct deliverables.



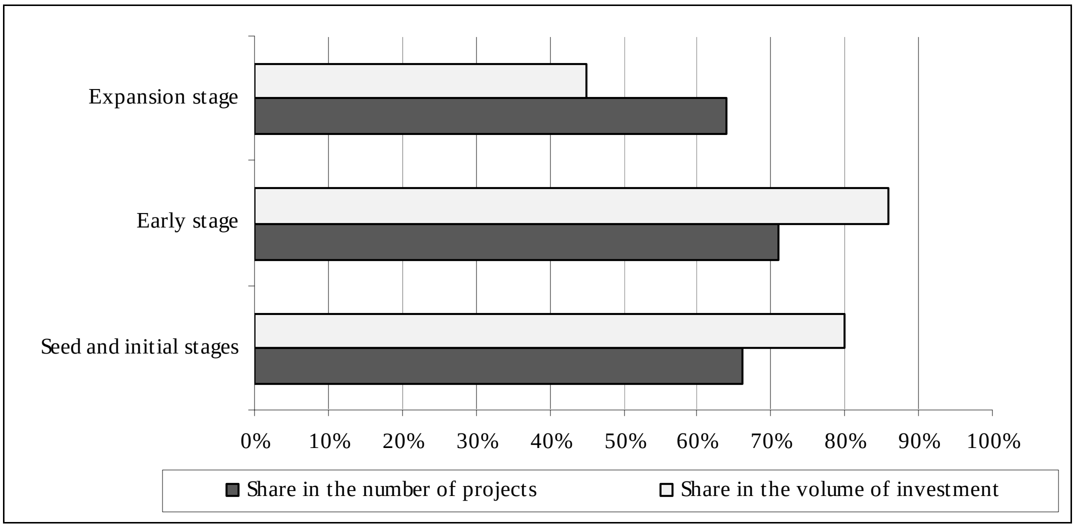
* The category of venture stages comprises seed, initial and early stages (by the RAVI methodology), and their analogues in foreign classifications.
Source: estimates by the Interdepartmental analytical center on the basis of RAVI (Russia) and NVCA (US) data.

Fig. 8. Dynamics of the Proportion of Investment at Venture * Stages in the Volume of Investment at Venture and Expansion Stages

It is common knowledge that it is early stages when the role of the state (and development institutions) with regard to support of innovation is critical, as at these stages private initiative is missing at most. But the Russian system of public development institutions appears insufficiently mature as far as the said stages are concerned.

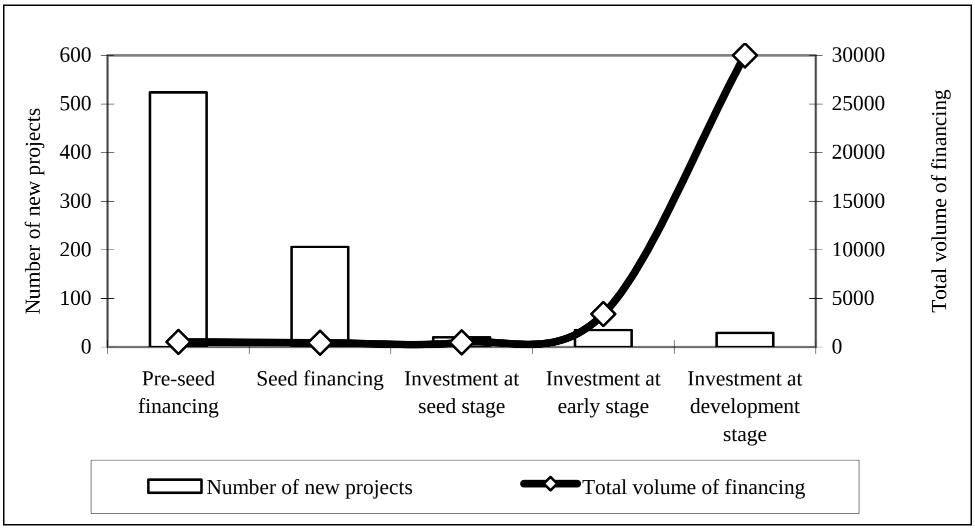
On the one hand, Russia's development institutions do play the greatest role at venture stages. Thus, we estimated that in 2010 alone, their and their daughter funds' direct contribution to the aggregate volume of investment in companies at venture stages accounted for 85% (RAVI estimates it at a level of 75%), and another 45% - in the total volume of investment in companies at expansion stage (*Fig. 9*). Let us note the critical role played by the Fund for Assistance to Development at the pre-seed stage.

On the other hand, the main "increase" in Russian development institutions' activity in 2010, both investment-wise and in terms of the number of supported projects, was associated with later-stage investment. While comparing the magnitude of public development institutions' operations in terms of different stages of the innovation cycle, an insufficient "broadness" of support (in terms of the number of projects) at venture stages in general (*Fig. 10*) and with regard to seed investment in particular (despite expansion of the RVC's Seed Investment Fund' operations) is particularly noticeable. This substantially constraints possibilities for private investment to embrace later-stage projects and blocs the rise of a steady "flow" of innovation projects.



* Assessments by RAVI are used as basic values with regard to aggregate volumes of direct and venture investment in Russia.
** The Seed Investment fund, venture funds founded with RVC's participation, regional venture funds, ROSNANO.
Source: estimates by the Interdepartmental analytical center with the use of RAVI's estimates of aggregate volumes of direct and venture investment in Russia.

Fig. 9. Assessment of Contribution* of Public Financial Development Institutions (and Funds Created with their Participation)** in Russian Market of Venture and Direct Investment in 2010

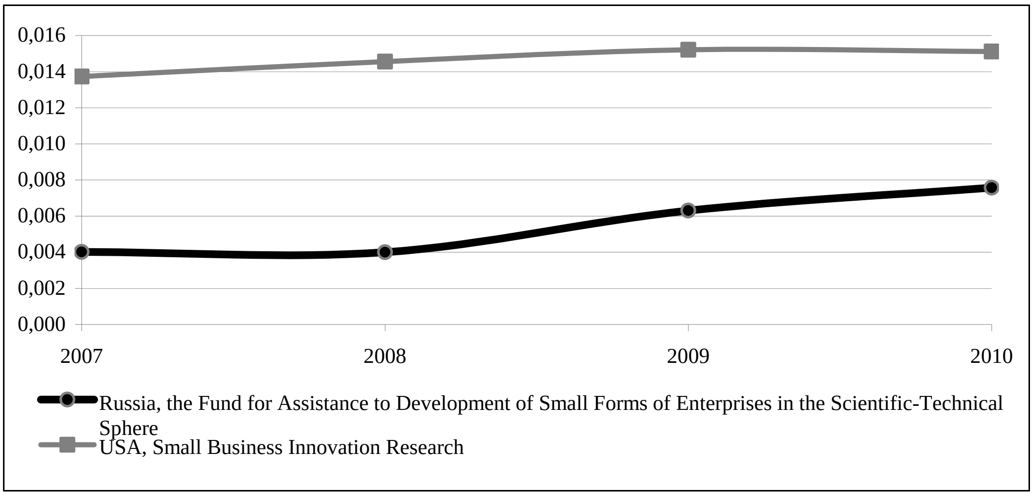


Source: estimates by the Interdepartmental analytical center

Fig. 10. Estimated Correlation between the Scale of Public Development Institutions' Operations on Support of Innovation Projects at Different Stages

An insufficient project "flow" at the pre-seed and seed stages appears a critical challenge to the task of ensuring a broad general economic effect from the development institutions' operation. Let us note the limited nature of grant-based support arrangements in the first *place* (this modus operandi is noted only for the Fund for Assistance to Innovation and Sklokovo Foundation).

In principle, the state-sponsored grant-based support of projects at the pre-seed stage is unfolding in Russia, but its magnitude has thus far been far smaller than in the US: the grant-based support to GDP ratio displayed by the Fund for Assistance to Development of Small Forms of Enterprises in the Scientific-Technical Sphere is nearly twice as little as the respective figure of its US vis-à-vis, the Small Business Innovative Research (*Fig. 11*).



Source: estimates by the Interdepartmental analytical center on the basis of public information about operation of the Fund for Assistance to Development of Small Forms of Enterprises in the Scientific-Technical Sphere (Russia) and about implementation of SBIR (USA)

Fig. 11. Level of State Support of projects at the Pre-seed Stage

But the challenge does not lie solely in the above: it is imperative to pay attention to a fairly low size of individual grants the Fund in question is authorized to award (even after the cap was raised up to Rb 1mn) vis-à-vis other nations' practice. Plus, while using such grants, there are stringent restrictions with regard to the volume of spending on equipment (which objectively is explained by the fact that the Fund's operation is financed out of the state budget in the frame of the R&D expenditure). This constraints possibilities for effective implementation of the pre-seed stage across a string of cash-intensive technological directions.

We believe that a limited demonstration effect in the innovation sphere from Russian development institutions' operations appears to a significant degree associated with external institutional constraints, as well as peculiarities of the authorities' "expectation overhang". So far there have been substantial institutional barriers in place to implementation of the "venture" model of innovation development basing on a high activity on creation of new innovation businesses and a rapid expansion of successful companies.

First, the inflow of new entrepreneurs is limited, due to an insufficiently conducive entrepreneurial environment and negative, rather than positive, public perception of entrepreneurship: more specifically, a recent monitoring of entrepreneurship[1] evidences that in 2010 only 4.3% of Russian residents were going to start their own business in 3 years to come, but,

[1] Verkhovskaya.O., Doronina M. National report "Global monitoring of entrepreneurship. Russia. 2010". High School of Management of the St. Petersburg State University, 2011

given that entrepreneurs accounted for a. one-third of them, the prospective inflow of entrepreneurs makes up a meager 2.6% (one of the lowest figures vis-à-vis other countries). The same research exposed such fundamental challenges to expansion of entrepreneurship in Russia (vs. other nations) as a weak cultural background, nascent competition, and a low level of availability of venture capital.

Second, the national policy on support of small-sized business has thus far been to a greater degree oriented towards its social mission, that is, a mechanism to generate new job opportunities and mitigate social problems, rather than a major driver of economic development and emergence of new sectors. There emerged a significant "tax lacuna" for small businesses, due to which (as well as because of risks of increase of the administrative burden and a limited array of instruments of support tailored for small businesses) their motivations to transition to (over time) the category of medium-sized ones prove substantially arrested.

Third, the pace of the process of formation of a civilized market for mergers and takeovers has been very slow, which can be ascribed primarily to problems with protection of property rights, including intellectual ones, and risks associated with raiders' operations. Because of this, on the one hand, owners' motivations to capitalize their companies are limited, while venture investors have problems with an efficient "walkaway" from corporate capital, on the other.

Fourth, there exist external constraints to a cardinal increase of the number of projects supported at the pre-seed and seed stages. There of course exists a potential positive short-range effect from measures on development of organizational infrastructure for formation of new innovation projects (e.g. a model with venture partners for search of projects and assistance in preparing high-quality business offers, which is implemented by the Seed Investment Fund). But we believe that the future will see an increasing exhaustion of scientific-technological capacity across a number of demanded by business thematic directions and an adverse impact of the insufficient effectiveness of instruments of assistance to commercialization of R&D outputs.

The government's underestimation of external constraints and its excessive expectations, in our view, lead to *a certain deformation of motivations behind, and assessment of, the development institutions' performance*.

The *first peculiarity* in this regard is the strive to demonstrate to a broad array of stakeholders notable successes in the innovation sphere already in the short run, at the expense of the development institutions' operation.

At the development institutions level, this results in stronger motivations to demonstration of their outputs, implementation of milestone, "worth-bragging-about" projects. That the development institutions have received sizeable resources is an additional factor fuelling the anticipation of significant and understandable to a broad audience deliverables. Conceptual opponents to the development institutions accentuate an insufficient efficiency of their contribution to economic development, while individual groups of champions of the government's proactive role in encouragement of innovation criticize them for a slow pace of spending.

An inseparable and fundamental component of development institutions' operation is *securing a demonstration effect for private businesses*, diffusion of best practices, improvement of regulation, the environment for innovation and, ultimately, a gradual overcoming of "market failures". That said, *principles of assessment of the development institutions' performance* *appear to a far greater degree oriented toward their direct performance metrics,* with the emphasis on employing formal indicators which characterize the use of resources.

Due to their profile, development institutions respond to expectations of the public administration system and various interest groups by boosting the scale of their projects, their uniqueness, spending, and by launching new initiatives.

Second, strive for ensuring dynamic structural shifts, scientific and technological breakthroughs through the development institutions.

We believe this sometimes results in *development institutions' operation in certain cases beginning to drift away from general market trends and investors' preferences*. This problem is further exacerbated by the view that capitalization of the development institution and expansion of their operational scale can help promptly compensate for drawbacks of the investment climate. *Having been oriented toward support of huge projects, development institutions become prone to a strong political pressure*, which gives rise to preconditions of their following the "agent – of - the government" model, rather than the "development institution" one.

Even with locally efficient operations and successful direct project outputs, such an approach arrests possibilities to attract private investment in development institutions' operation, fuels their hunger for additional public resources and encourages their shift from the PPP model to a public-quasipublic partnership one, concentration of the state banks and development institutions' resources on implementation of individual projects.

Third, the desire to increase direct return from their operation, no readiness for risk-taking (costs- wise), strive for localization of all the effects in the frame of the national economy.

The problem of bolstering the development institutions' efficiency is often viewed from the perspective of the need for their concentration solely on provision of financial support to projects implementation, without pursuing any organizational, educational and methodological goals. With very stringent criteria of assessment of success of projects they support and direct effectiveness of the development institutions' costs there arise *extra motivations to shifting main risks with regard to failures in innovation projects implementation onto recipients of the support*.

Focusing on early stages, development institutions appear objectively limited in delivering immediate results, as main positive effects from their operation become visible at later stages. In this regard more motives emerge to extend the development institutions' resources at the later stages which are capable to demonstrate the said results.

Despite the above problems with improvement of the development institutions system (which to a significant extent can be ascribed to costs of its rapid growth), basically, it can be ascertained that there has been made a substantial progress in the area concerned. More specifically, development institutions secured the following positive qualitative effects:

- demonstration to business of possible prospects with regard to obtaining support at different stages of development;
- cementing trust in development institutions on the part of the business community and the new, medium-sized business in the first place;
- working out various new, complex patterns of support of innovation and investment activity; laying ground for diffusion of respective qualifications and skills;
- design and promotion of proposals on improvement of market regulation and investment climate;

– identification of policy bottlenecks and critical challenges in the area of innovation development; a substantial public administration system's progress in appreciation of tasks and instruments of innovation policy.

In conclusion, let us single out the following possible *avenues of improvement of the Russian system of development institutions*:

1. It is imperative to expand the scope of their support of early-stage innovation, primarily at the pre-seed and seed stages. For a steady flow of projects to rise it is necessary to substantially broaden the "array" of the supported projects: up to several thousand – at the level of the Fund for Assistance to Development, and up to several hundred – at the level of the Seed Investment Fund.
2. It seems appropriate to expand the scale of grant-based support at early stages (where risks are maximum), namely, at the pre-seed one, as well as to spread this mechanism onto the seed stage of innovation. It is desirable, in the frame of measures on development of the university R&D, to consider a possibility for support of creation by research universities of special seed funds (capitalization of the existing ones).
3. With regard to development of grant-based innovation support patterns in Russia, it should be noted that a string of nations apply the "matching grants" mechanism to encourage innovation development. Good practices evidence that provision of such public grants to private businesses appears more effective than tax incentives for innovation[1]. When compared with "regular" grants, the mechanism in question is less exposed to the risk of "substitution" of private resources with public ones in the course of exercise of investment activity, and it to a greater extent helps attract businesses' extra resources into the innovation sphere.

In principle, in Russia, there is a similar mechanism associated with provision of subsidies on financing of innovation projects corporations implement together with universities[2]. However, an additional flexibility of this mechanism and prospects of its expansion could be ensured either by positioning it as a basic operational vehicle of one of public funds engaged in support of innovation activity, or by creating a special fund.

1. An important source of new innovation projects may become small innovation companies created under universities. This appears important from the perspective of expansion of the community of innovation-oriented entrepreneurs at the expense of university graduates: in the frame of the aforementioned monitoring, experts referenced to a substantial potential of the university environment in this regard: some 8.5% of students are ready to become entrepreneurs[3].

While noting a substantial progress in terms of reduction of normative barriers to creation of small-sized innovation firms under universities, it can be ascertained, nonetheless, there should be additional measures (mechanisms) in place to support integration of such companies into global value creation chains. The current emphasis on the number of newly founded companies and their focus mostly on local niches arrest potential to their dynamic growth.

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[1] See, for example: Maloney, William. 2005. "Global Patterns of Innovation". World Bank
[2] Resolution of the RF Government of 9 April 2010 No. 218 "On measures of state support to development of cooperation between Russian institutions of high education and organizations implementing complex projects on creation of highly technological production".
[3] Verkhovskaya.O., Doronina M. National report "Global monitoring of entrepreneurship. Russia. 2010". High School of Management of the St. Petersburg State University, 2011.

1. The task to broaden the circle of projects supported at the pre-seed and seed stages cannot be solved momentarily, as it requires improvement of conditions of formation of new innovation projects and companies. So, it is imperative to increase funding of applied R&D at the pre-commercial stage to ensure an accelerated rise of the scientific and technological capacity to get university students engaged in conduct of research and commercialization of research outputs.
2. Solution to the problem of bolstering the development institutions' operational efficacy appears in many ways associated with implementation of measures on attraction of foreign investors to participate in their capital. This allows counting on a fair assessment of the quality of governance and "value" of the respective structures, improvement of selection of projects to support, and mitigation of the risk of a "timeserving" influence of the state. So far it has been only ROSNANO which has developed plans to attract private investors; however, such medium-term tasks seem rational for the Russian Venture Company and – in a more remote future – for Vnesheconombank (upon separation from it the Bank for Development per se and its transformation into an adequate organizational and legal form), too.
3. It is imperative to promote efforts with regard to dissemination of development institutions' best operational practices, public demonstration of success stories associated with specific projects, and special educational programs. It is critical to ensure a substantial progress in monitoring and assessment of qualitative, indirect effects from development institutions' operations[1]; meanwhile, assessment of such external effects requires organization of regular independent audit.

6.4. Bankruptcies in 2009–2011: Post-crisis Dynamics; New Trends; Regulation

6.4.1. Dynamics of Bankruptcies (2009–2011)

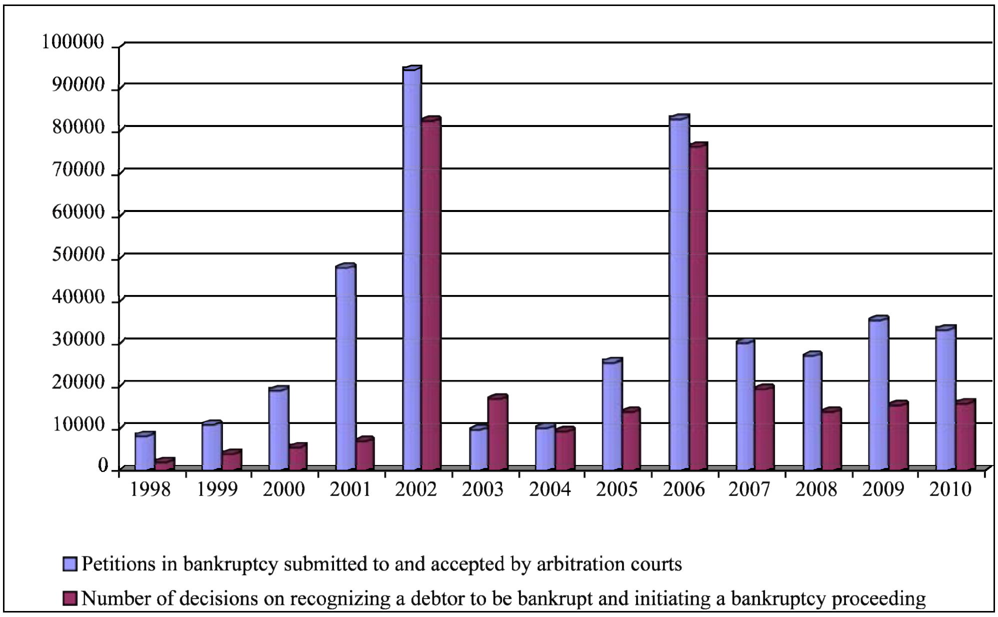
The overall situation in the field of bankruptcy over the period under consideration was shaped by the following four key trends.

1. First of all, it is necessary to *note the beginning, in first half-year 2011, of a decline in the number of bankruptcies and the number of petitions in bankruptcy submitted to court that followed the period of growth of these indices in 2009–2010.* Thus, over the period of 2009–2010, the number of court decisions concerning the recognition of a debtor to be bankrupt and the initiation of a proceeding in bankruptcy rose by more than 15% (in 2008 – 13.9 thousand; in 2009 – 15.5 thousand; in 2010 – 16 thousand cases[2]). In the first half-year 2011, there occurred a significant drop (by nearly 20%) in the number of petitions in bankruptcy filed with courts of justice (first half-year 2010 – 21,037; first half-year 2011 – 16,853); and a drop by 13.5%, on the same period of 2010, in the number of decisions issued to the effect that a relevant debtor should be deemed to be bankrupt (first half-year 2010 – 8,047; first half-year

[1] See, also: Simachev Yu., Kuzyk M. Institutions in Development.- Direct investment, 2010, No. 4.

[2] Out of 16,009 decisions on deeming a debtor to be bankrupt and initiating a proceeding in bankruptcy in 2010:
– 3.2% (or 508 cases) have to do with state and municipal unitary enterprises;
– 13.1% (or 4,882 cases) have to do with individual entrepreneurs;
– 5% (or 800 cases) have to do with agricultural producers;
– 1.4% (or 224 cases) have to do with financial institutions.

2011 – 6,955)[1]. The changes in these indices that occurred over the period of 1998–2010 are shown in *Fig. 12*.



Sources: Statements prepared by the Supreme Arbitration Court of the Russian Federation concerning the consideration, by the arbitration courts of subjects of the Russian Federation, of insolvency (bankruptcy) cases in the period of 1998–2010.

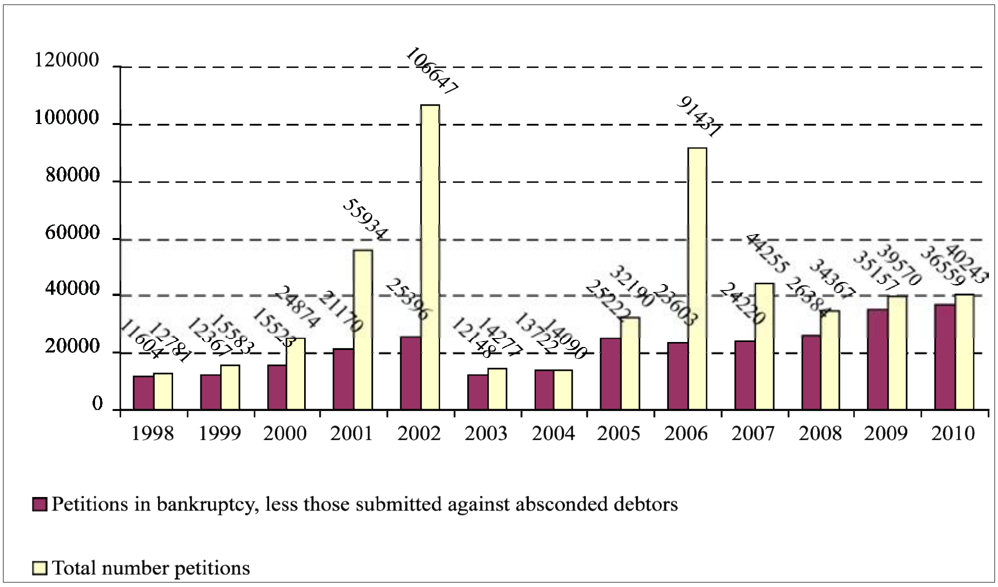
Fig. 12. Changes in the Number of Decisions on Bankruptcy Petitions over the Period of 1998–2010

The surges in the number of bankruptcy cases in 2002 and 2006 and its growth in 1998–2002 (analyzed previously elsewhere)[2] resulted from the government's activity in connection with the need to 'clear the field' of effectively abandoned enterprises through recognizing the absent debtors to be bankrupt and allocating the necessary budget funding to the achievement of that goal.

The years 2009–2010 saw a continuation of the growth (since 2008) of both the overall number of submitted petitions in bankruptcy (2008 – 34.4 thousand; 2009 – 39.6 thousand; 2010 – 40.2 thousand) and the number of petitions submitted with regard to substantive debtors[3] (in 2008 – 26.4 thousand; in 2009 – 35.2 thousand; in 2010 – 36.6 thousand). Thus, over the period of 2009–2010 *the number of petitions in bankruptcy filed against substantive debtors rose by 38.6%*, while the overall growth in the number of petitions in bankruptcy amounted to approximately 17.1%. The peak of growth was observed in 2009. The data on the bankruptcies of 'substantive' debtors for 2011 are not yet available, but it can be reasona-

[1] Statement on the consideration, by the arbitration courts of the Russian Federation, of insolvency (bankruptcy) cases in 2008–2010; in the first half-year 2011 – see www.arbitr.ru
[2] *Ekonomika perekhodnogo perioda. Ocherki ekonomicheskoi politiki postkommunisticheskoi Rossii 1998–2002*. [The Economy in Transition. Essays on the Economic Policy in Post-Communist Russia of 1998–2002.] M.: IET, 2003, p. 505; *Ekonomika perekhodnogo perioda. Ocherki ekonomicheskoi politiki postkommunisticheskoi Rossii* 2000–2007. [The Economy in Transition. Essays on the Economic Policy in Post-Communist Russia of 2000–2007.] M.: IET, 2008, p. 473.
[3] Substantive debtors are understood to be all the debtors less absconded ones.

bly assumed that this index is going to decline in accordance with the general downward trend displayed by the number of bankruptcy proceedings. The dynamics of the number of petitions to recognize 'substantive' debtors to be insolvent (or bankrupt) over the period between 1998 and 2010, set against that of the overall number of petitions in bankruptcy, can be seen in *Fig. 13.*



Sources: Statements concerning the consideration, by the arbitration courts of subjects of the Russian Federation, of insolvency (bankruptcy) cases over relevant periods; analytical notes to the statistical reports on the operation of the arbitration courts of the Russian Federation over relevant periods, prepared by the Supreme Arbitration Court of the Russian Federation.

Fig. 13. The Number of Petitions for Recognizing a Debtor to Be Bankrupt Submitted in 1998–2010

2. *A diminishing influence of government policy measures on the dynamics of bankruptcies,* including the regulatory activity of tax agencies relating to the recognition of debtors to be bankrupt[1]. Thus, while in 2008 more than 67% of petitions in bankruptcy were submitted by relevant empowered agencies (in the main tax agencies), in 2010 the share of indices belonging to that group dropped to 39.2%.

Against the backdrop of both general growth and the increasing frequency of the application of bankruptcy procedures in some segments, an opposite trend was displayed by the number of bankruptcies of agricultural producers, which declined by more than 5 times between 2006 and 2010 (in 2006 – approximately 4,000 bankruptcies; in 2007– 2,465; in 2008 – 1,614; in 2009 – 1,036; in 2010 – 800). This was the result of the government's agricultural support measures that involved broader crediting, restructuring of tax liabilities, and allocation of dotations to cover purchases of petrol, oil and lubricants, etc.

[1] On the impact of the activity of government agencies in the sphere of legal entity liquidation on the general trends in the bankruptcy sphere, see Apevalova E. A., Radygin A. D. *Bankrotstva v 2000-e gg.: ot instrumenta reiderov k politike "dvoinogo standarta"*. [Bankruptcies in the 2000s: from Raiders' Instrument to "Double Standard" Policy] – *Ekonomicheskaia politika* [Economic Policy], August 2009.

At the same time, bankruptcy indices were increasing elsewhere: thus, for example, the number of bankruptcies of individual entrepreneurs more than doubled over the period of *2007–2009 by comparison with the previous years:* in 2004–2006 there were 200–700 bankruptcies per annum; in 2007 – 2,478; in 2008 – 4,751; and in 2009 – 5,423). In 2010 there occurred a certain decline to a total of 4,882 bankruptcy cases (by 10% on 2009).

3. *A more noticeable activity of creditors, from the year 2009 onward, in the sphere of protection of their interests in the framework of bankruptcy procedures, and in 2010 – also in the initiation of bankruptcy proceedings*.

Thus, over the period of 2009–2010, the number of applications, disputes, complaints and petitions files in the framework of *bankruptcy* procedures effectively *doubled*: from 111,521 in 2008 to 232,845 in 2010; the rate of growth of opened and considered bankruptcy cases was noticeably lower. The main reason for that growth was the considerably increased number of petitions filed with courts in connection with failures to comply with and violation of contractual obligations; the general economic situation; as well as changes in bankruptcy legislation in the part of granting some new rights to the participants in bankruptcy proceedings. In particular, this had to do with the right to dispute the transactions carried out by a debtor; the right to bring the persons and entities controlling a debtor to subsidiary responsibility; the right to submit a petition concerning the intention to redeem claims relating to mandatory payments, etc.[1] In the first half-year 2011, this index became somewhat adjusted by dropping by 10.9% on 2010.

Besides, the year 2010 saw a rise of 31.7% on 2009 in the number of petitions submitted on behalf of creditors in bankruptcy, which in 2010 amounted to 39.1% of the total number of petitions. The share of petitions filed by debtors shrank from 23.1% in 2009 (9,145 petitions) to 21.7% in 2010 (8,727 petitions)[2].

4. *In the period of 2010–2011 there emerged an upward trend in the number of concluded amicable agreements, financial recoveries of enterprises and external management procedures.*

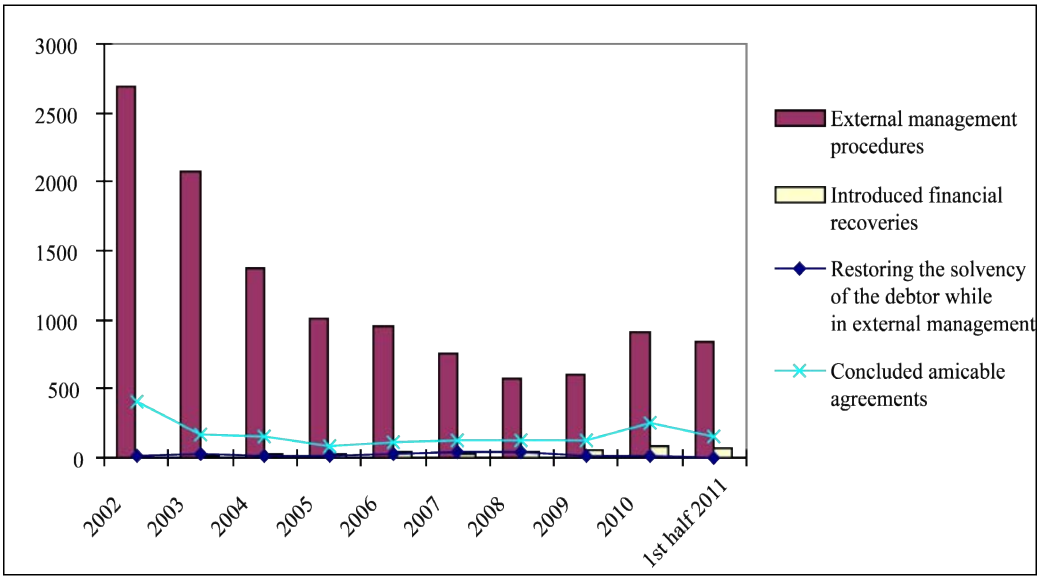
Thus, while the level of solvency recovery of enterprises as a result of the imposition of external management was traditionally low, the number of external management procedures actually effectuated in the first half-year 2011 rose by 30.9% on 2010 (839 in the first half-

[1] Out of 232.8 thousand of applications, disputes, complaints and petitions, 165 thousand (or 70.1%) is constituted by documents concerning the determining the amount of creditor claims. That index also significantly rose on 2008 (by 2.4 times: in 2008 – 67.6 thousand), while the number of petitions concerning the dismissal of an arbitration commissioner was no longer declining, and in 2010 it even slightly increased – to 13,416 (or to 5.8% of the total number of applications, disputes, complaints and petitions).
As follows from statistical data, the number of creditor complains concerning the violation of their rights and lawful interests considered in 2010 rose on 2009 by 73.5%. The number of petitions concerning the determining of the amount of creditor claims increased by 33.2%; and the number of petitions concerning prolongation of a bankruptcy proceeding increased by 27.5%.
The bulk (62.4% of the total number) of petitions, applications and complaints were considered by courts in the phase of a bankruptcy proceeding. In the phase of supervision, 33.4% of the petitions were considered. The number of petitions considered during external management procedures nearly tripled, increasing from 2,158 to 5,749.

[2] Here and throughout the text bankruptcy statistics are taken from *Analiticheskaia zapiska k statisticheskomu otchetu o rabote arbitrazhnykh sudov Rossiiskoi Federatsii v 2010* [Analytical Note to the Statistical Report on the Operation of the Arbitration Courts of the Russian Federation in 2010], pp.16–19.

year 2011 against 641 over the same period of 2010). The period of 2002–2008 had been characterized by a 5-fold drop in the number of external management procedures.

The dynamics of the number of external management procedures, financial recoveries and amicable agreements in 2002 and the first half-year 2011 is shown in *Fig. 14.*



Source: Statement on the consideration, by the arbitration courts of subjects of the Russian Federation, of insolvency (bankruptcy) cases in 2006–2010 and the first half-year 2011.

Fig. 14. The Dynamics of the Number of External Management Procedures, Financial Recoveries and Amicable Agreements over the Period of 2002 – First Half-year 2011

By all indications, the year 2011 saw a historic high of the number of concluded amicable agreements for the entire period of 2002–2011, which amounted to approximately 300. That year would have also seen a peak in the number of cases when financial recovery procedures were applied. In the first half-year 2011, 76 such cases were already registered, which is by 13.4% higher than the previous historic high of 67 cases achieved in the same period of 2010.

The ongoing (for two years in a row) growth in the number of concluded amicable agreements and actually introduced financial recovery and external management procedures was triggered, for the most part, by the tax innovations introduced in 2010; by the increased opportunities for applying installment plans and delays in redeeming the accumulated arrears of mandatory payments, and for writing off uncollectable payables; as well as by the innovations designed to prevent bankruptcies of financial institutions (including insurance organizations) and to regulate the special bankruptcy procedures established for independent (non-state) pension funds, professional participants of the securities market, and asset managers of investment funds and mutual investment funds.

6.4.2. Bankruptcy Legislation in 2009–2011

The global economic crisis acted as an external stimulus for the implementation of some long-due alterations and the abandonment of the formerly inertia-based policy of the Russian government in the field of bankruptcy. Another reasons for an upsurge in the lawmaking activity in that direction were the mounting payables owed by some of Russia's biggest banks, loans issued to some big companies against their assets and the deterioration of the financial indices of many of those companies, and the anticipated growth in the number of bankruptcies of enterprises in 2009–2010.

In order to correctly estimate the latest innovations introduced in the bankruptcy field with regard to certain specific sectors of the economy, it is important to understand the status of and the situation faced by the relevant objects of regulation.

According to a study undertaken by the All-Russian Public Opinion Research Center (*VTsIOM*) and the Deposit Insurance Agency, in 2010, 40% of Russians, or about 40 m persons, had a deposit or account with one or other bank. For more than 57% of citizens, the most important criterion when selecting a bank was whether or not it was state-owned[1]. In 2009 and 2010, the number of banks was falling due to the imposition, by the RF Central Bank, of more rigorous standards for credit institutions. As a result, in 2009, 44 banks had their licenses recalled, and in 2010, 28 more credit institutions were liquidated[2]. More than 50% of the banking system is directly or indirectly controlled by the State. Thus, on the one hand, the State has clearly embarked on a process of creating a fully-fledged banking system, while on the other hand, it is taking measures designed to protect depositors' interests.

In the last few years, the number of insurance organizations was decreasing by approximately 10 to 12% per year (as of the end of 2010, Russia had 618 insurance organizations registered in the *Unified State Register of Insurance Entities*; as of the end of 2009, their number was 702; and as of the end of 2008, it was 779)[3]. The introduction, in 2010, of more stringent equity capital requirements for insurance organizations, and the intensification of competition will be conducive to consolidation of the insurance market. According to some forecasts, between 200 and 250 insurance companies will be liquidated. Over the next five years, the share of Russia's top twenty companies in total premium volume will increase from 69 to 80-85%, while that of the top ten companies – from 55 to 65-70%[4]. At the same time, the compulsory motor-vehicle liability insurance *OSAGO* and the voluntary motor-vehicle insurance *KASKO* still represent the largest segments of the insurance market.

Russia's non-state pension funds (hereinafter NSPF) have rather successfully survived the acute phase of the crisis. Their 2010 results had more than compensated for their losses in 2008. However, according to the Expert RA rating agency, the gap between the yield on the placement of pension reserves and inflation, accumulated over the past 5 years, remains no less than 10 to 15 p.p. This means that the issue of assets' depreciation in real terms remains high on the agenda. The resolution of that issue can be brought about through upgrading the pension funds' investment policy[5].

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[1] Ye. Kukol. *Stavki katiatsia vniz.* [The Rates are Tumbling Down] // *Rossiskaia Gazeta* – Stolichnyi Vypusk [The Russian Gazette – Moscow Issue]. No 5166, 23 April 2010.

[2] On the liquidation of credit institutions (as of 1 January 2011) – www.cbr.ru

[3] *Igroki strakhovogo rynka i ikh kapitaly*. [Players of the Insurance Market and Their Finances] – www.allinsurance.ru, 14 February 2011.

[4] The Marillion company's forecast of the insurance market's development. www.allinsurance.ru, 20 December 2010.

[5] In Q4 2010, the NSPF's assets increased by a staggering $ 30-35bn. The key factor of that surge in assets was the considerable rise in the stock market (thus, in the course of the afore-said period the MICEX Index grew by 18%). According to the Expert RA rating agency, the volume of pension reserves and pension savings rose to Rb 790-800bn. By the end of 2011, the NSPF's aggregate assets are likely to rise to Rb 1.5-1.2 trillion, depend-

In 2009, the NSPFs managed to occupy the central niche in the trust management market, where they now accounted for up to 40% of operations carried out by asset management companies (AMC). It should be said that the market did not suffer even a single major bankruptcy, while the State totally refrained from giving any assistance to the system. Nevertheless, the NSPFs still have to deal with such issues as the wide-spread dishonesty of their agents, and the necessity to increase people's trust in the system, to create compensatory mechanisms, to establish a single concept of market development, etc.[1]

In the next three years a stable growth and consolidation of the market can be expected: 69% of participants in the opinion poll conducted by Expert RA Rating Agency are anticipating that, towards the end of 2012, the volume of the NSPF market will exceed Rb 1.5 trillion (which means that it will have more than doubled over 3 years). At the same time, 72% of the respondents believe that more than 90 funds will remain on the market (and 39% think that their number will be no more than 70). However, this does not mean that the potential for NSPF growth will be exhausted – 68% of participants in the survey expect that no more than 7m insured persons are going to transfer their pension savings into these funds[2].

Over the past decade, the securities market has been experiencing a rapid growth of quotations coupled with an increasing interest in that market displayed by private investors. As of 1 September 2006, 1,402 organizations were operating as professional securities market participants under broker licenses; 1,410 organizations held licenses of professional securities market participants authorized to operate as dealers; 1,048 organizations held licenses of professional securities market participants for the conduct of trust management; 9 organizations held licenses for the conduct of clearing activities on the securities market; 748 organizations operated under professional securities market participant licenses for depositary operations; 77 organizations operated under licenses to run registers; 5 organizations held licenses for organizing trade in the in the securities market; and 6 organizations held licenses to operate a stock exchange[3].

The number of companies – professional participants of the securities market and the collective investments market in recent years has been displaying a gradual downward trend, which is going to continue. First of all, the number of professional securities market participants will be declining in response to the coming in force, from 1 July 2010, of alterations introduced in the specifications of sufficiency of own funds for professional participants in the securities market and the asset managers of mutual investment funds and independent pension funds[4]. The tougher requirements established by the regulator will result in either

ing on the market situation. See *Itogi 2010 na rynke NPF: v poikakh effektivnosti* [2010 NSPF market results: a quest for efficiency] - www.raexpert.ru

[1] *Krizis proshol – riski ostalis'*. [The Crisis Is Over – The Risks Are Still There.] An Overview by the Expert RA Rating Agency of the NSPF Market Based on the Results of the Year 2009. – see www.raexpert.ru

[2] *Solidarnost' v detaliakh i voprosy po sushchestvu. Resul'taty oprosa reguliatorov finansovogo rynka, top-menedzherov negosudarstvennynkh pensionnykh fondov i upravliaiushchikh upravliaiushchukh kompanii na konferentsii 'Budushchee pensionnogo marketa'* [Solidarity in Details and Some Essential Issues. Results of Surveys of Financial Market Regulators, Top Managers of Non-State Pension Funds and CEOs of Asset Managers at the Conference *The Future of Russia's Pension Market*]. See www.raexpert.ru

[3] Sovershenstvovanie nadzora na finansovom rynke Rossii [Improving Russia's financial market supervision] – see www.raexpert.ru

[4] Thus, from 1 July 2010 onwards, the professional participants in the securities market engaged in dealer and (or) broker operations, as well as securities management, must possess a charter capital in the amount of no less than Rb 35m, and from 1 July 2011 onwards – Rb 50m.

these companies being ousted from the market and then liquidated, or in their merger with some other structures.

The years 2003–2007 saw a robust development of mutual investment funds (hereinafter MIF) against the backdrop of the then favorable macroeconomic situation. Thus, the volume of aggregate net assets over that period increased more than 35 times (Rb 11.7bn as of 1 January 2003, and up to Rb 420.5bn as of 1 January 2007). According to the National League of Management Companies, as of 29 August 2008 the number of functioning MIFs was 1,058; the number of MIFs being created was 19; the number of asset managers (AM) was 287; net asset value (NAV) of all Russian MIFs amounted to approximately Rb 507bn, of which that of close-end funds amounted to Rb 365bn; that of open-end funds amounted to Rb 104bn; and that of interval unit investment funds amounted to Rb 38bn. As for the situation in 2008–2010, we may describe it as follows:

– a stable decline in the net asset value of MIFs and asset managers from May 2008 through December 2009 by nearly 44.4% (from Rb 552.81bn to Rb 307.4bn respectively);
– growth in the number of MIFs, from 1 January 2009 through 1 January 2010, by more than 19% (from 1,050 to 1,252 respectively);
– considerable growth in the number of asset managers, from 1 January 2009 through 1 January 2010, by more than 4.8 times (from 68 to 328).

According to a survey of 2,000 developers carried out by the Association of Russian Builders in 2009, two-thirds of Russia's building companies were either on the verge of bankruptcy or had already gone bankrupt. This circumstance was fraught with serious danger not only for one of Russia's most important industries, but also for the social and economic right of investors (individuals and organizations alike).

Thus, the State's innovations in the field of prevention and introduction of a special bankruptcy procedure clearly represent, on the one hand, instruments for regulating consolidation and liquidation processes in the corresponding markets, and a means for preventing the negative social consequences of these developments.

The further course of bankruptcy legislation development, centered on the idea of *creating favorable conditions for satisfaction of the creditors' interests and for improvement of their rights' protection*, was determined by two factors. The first factor was the State's decision to provide assistance to the banking sector, and to take measures designed to preserve the stability of that sector, including by creating conditions for keeping banks' bad loan levels low. The second factor was large-scale irregularities in repayments under loan agreements. The idea itself can be deemed to be both an anti-crisis decision (because 40% of Russian citizens have bank deposits) and a decision that satisfies the interests of the currently strong financial

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The companies operated under a license to provide depositary services unrelated to security settlements effectuated through organizers of trading in the securities market or through entities authorized to execute depositary operations on behalf of investment funds (MIFs and NSPFs) – Rb 60m, and from 1 July 2011 onwards – Rb 80m.

For market participants engaged in clearing activities and trading in the securities market – Rb 80m, and by 1 July 2011 – Rb 100m. The size of the charter capital of companies providing services of running registers of securities holders – Rb 100m, and from 1 July 2011 – Rb 150m; of stock exchanges – Rb 150m, and from 1 July 2011 – Rb 200m. The specifications of sufficiency of own funds for asset managers of investment funds, mutual investment funds and non-state pension funds established from 1 July 2010 envisage the floor of Rb 60m, and from 1 July 2011 – Rb 80m. – *Chislo professional'nykh uchastnikov rynka tsennykh bumag okruga snizhaetsia, I eta tendentsiia sokhranitsia*. [The Number of the District's Professional Securities Market Participants is Declining, and This Trend is Bound to Persist]. – http://www.verbacapital.ru, 21 September 2010.

lobby. Most likely, some combination of all these aspects was taken into account by the authorities before making the afore-said decision.

Within the framework of implementation of that idea, Russia adopted Federal Law, of 30 December 2008, No. 296-FZ, '*On the Introduction of Alterations in the Federal Law 'On Insolvency (Bankruptcy)*" and Federal Law, of 28 April 2009, No. 73-FZ '*On the Introduction of Alterations in Some Legislative Acts of the Russian Federation*'. Those alterations were designed to *increase the transparency of bankruptcy proceedings*, mainly by changing the rules regulating the activities of arbitration commissioners and their self-regulatory organizations (SROs); *by increasing their responsibility*; and by introducing a number of other innovations.

1. Arbitration Commissioners

Firstly, the new laws *have raised the level of responsibility* of arbitration commissioners. The non-performance or improper performance by an arbitration commissioner of his or her duties, including those envisaged by federal standards, now constitutes a ground for his or her being removed from the process of management, which is to be carried out by one or other arbitration court on demand of the persons taking part in the bankruptcy case. Also, the procedure for implementing the decision on an arbitration commissioner's disqualification is now specified in detail[1].

Secondly, the introduced alterations have changed the system of commission-fee payments to an arbitration commissioner and the persons invited thereby to render their services in the course of the bankruptcy process. The newly introduced mechanism of commission-fee payments is designed to stimulate an arbitration commissioner's activity on behalf of the creditors. It envisages that the commission fee of an arbitration commissioner should be fixed at 15 to 45 thousand rubles per month[2], depending on which stage of bankruptcy process management is conducted, and that an additional payment can be made to an arbitration commissioner on the creditors' initiative[3].

The amount of money that may be spent by an arbitration commissioner on the services of specialists invited by him or her is also subject to detailed regulation, and depending on the size of the balance sheet value of the debtor's assets it may be equal to 10% of the value of assets from Rb 200,000 to Rb 2,995,000; and to 0.01% of sums in excess of Rb 1bn, if asset value is above Rb 1bn[4]. Also, the size of payments for such services, as it is determined by

[1] Later on, in December 2010, it was established, by Federal Law No. 429-FZ, of 28 December 2010, *'On the Introduction of Alterations in the Federal Law 'On Insolvency (Bankruptcy) and on the Invalidation of Parts 18, 19 and 21, Article 4 of the Federal Law 'On the Introduction of Alterations in the Federal Law 'On Insolvency (Bankruptcy''*, that requirements to the property liability of arbitration commissioners for the non-performance or improper performance of their duties could be extended by the inclusion of federal standards professional activity standards and regulations. Data from the Register of Disqualified Arbitration Commissioners should be entered in the Unified Federal Register of Bankruptcy Information.

[2] This amount can be increased by a court decision on the petition filed by participants in a bankruptcy case.

[3] For more details, see Items 10-14, Article 20.6 of the Federal Law '*On Insolvency (Bankruptcy)*'.

[4] In July and December 2009, the size of interest payments due to arbitration commissioners and the size of payments for the services rendered by the persons invited by an arbitration commissioner were slightly changed. For more details, see Items 10 and 11, Article 20.6 and Item 3, Article 20.7 of the Federal Law *'On Insolvency (Bankruptcy)'* as amended by Federal Law of 17 December 2009, No. 323-FZ, '*On the Introduction of Alterations in Articles 20.6 and 20.7 of the Federal Law 'On Insolvency Bankruptcy)' and Article 4 of the Federal Law 'On the Introduction of Alterations in the Federal Law on Insolvency (Bankruptcy)'*.

the law, and the payments themselves can be recognized as unjustified on the basis of a petition filed by the persons taking part in the bankruptcy case, if such services are not related to the aims of the ongoing bankruptcy proceedings or to the duties imposed on the persons invited by the commissioner in bankruptcy, or if the size of payments for such services is '*clearly not proportionate to the expected result*'.

Thirdly, the new legislation has extended the duties of arbitration commissioners in the part of provision of information to participants in bankruptcy proceedings: to the creditors – with regard to the transactions and actions that will entail or can entail the civil liability of third parties, and with regard to the revealed indications of fraudulent bankruptcy; and to the corresponding government agencies – with regard to the revealed administrative violations and crimes.

Fourthly, the new laws *have introduced rigid requirements to the compulsory liability insurance contracts concluded by arbitration commissioners*. The law has defined the objects of compulsory insurance, the insurance event and the insurance risks under liability insurance contracts, and has defined the procedure for the effectuation of payments due under such contracts. In July 2009[1], the amounts of insurance payments to be due under the contracts concluded by arbitration commissioners were slightly reduced.

2. Self-Regulatory Organizations (SROs) of Arbitration Commissioners

Firstly, the new laws *have extended the powers and increased the responsibility of self-regulatory organizations (SROs) of arbitration commissioners*. Thus, starting in 2009, these SROs have been granted the right to issue accreditation to the insurance organizations, valuators, and professional securities market participants that are involved in the maintenance of a register, as well as to other persons invited by arbitration commissioners within the framework of implementation of their duties in the course of one or other bankruptcy case. Also, the SROs in question are obliged to develop standards and rules for arbitration commissioners' activities and to supervise their implementation, as well as to make sure that commissioners in bankruptcy duly observe all the requirements concerning compulsory liability insurance.

In December 2010[2], SROs of arbitration commissioners were also authorized to issue accreditation to electronic trading floor operators who organize bidding for the sale of debtors' property.

Secondly, the new legislation has established that *self-regulatory organizations of arbitration commissioners should be obliged to disclose data on their activities*, including the data concerning their compensation funds; asset managers; and all the instances of disciplinary measures being applied against arbitration commissioners.

Thirdly, *the new legislation has established the procedure for the use, by SROs of arbitration commissioners, of their compensation funds, from where payments to debtors are made*: the procedure for presenting claims with regard to compensatory payments; the timelines for making compensatory payments; the conditions for the placements of monies held in a compensation fund; the asset manager's responsibilities; the procedure for transfer of the monies

[1] For more details, see Item2, 2 Article 241 of the Federal Law '*On Insolvency (Bankruptcy)*' as amended by Federal Law of 19 July 2009, No. 195-FZ.
[2] By Federal Law of 28 December 2010, No. 429-FZ 'On the Introduction of Alterations in the Federal Law "On Insolvency (Bankruptcy)" and Recognizing as Null and Void Parts 18, 19 and 21 of Article 4 of the Federal Law "On the Introduction of Alterations in the Federal Law 'On Insolvency (Bankruptcy)".

held in a compensation fund to the national association of arbitration commissioners when the information on a self-regulatory organization is struck off the register.

Fourthly, *the government's control over the activity of SROs of arbitration commissioners has been* toughened. The control functions delegated to the Federal Service of State Registration, Cadastre and Cartography (*Rosreestr*, formerly *Rosregistration*) were strengthened through giving the Service some additional powers:

– the right to initiate proceedings against an arbitration commissioner, a self-regulatory organization of arbitration commissioners and (or) that organization's official in an event of their having committed an administrative violation, and to consider that case or to refer it for consideration to an arbitration court;
– the right to enter information on not-for-profit organizations in the Unified State Register of Self-Regulatory Organizations of Arbitration Commissioners and to take part in its maintenance;
– the right to establish the status of the association of self-regulatory organizations of arbitration commissioners as a national one;
– and some other powers.

In an event of a failure of a SRO of arbitration commissioners to comply with the instructions issued by the controlling (or supervisory) agencies with regard to correcting relevant violations committed in the process of elaborating standards and operative rules, or dealing with complaints submitted with regard to certain actions committed by that organization's members, representatives of the government agency are obliged to apply to an arbitration court with a petition that the relevant organization be struck off the *Unified State Register*.

3. Other Measures

1. The desire to achieve the maximum degree of satisfaction of creditors' claims was the reason for *the introduction of a number of mechanisms for disputing transactions aimed at withdrawal of a debtor's assets* – 'suspicious transactions' and 'deals that result in preference being given to one creditor at the expense of another'. In fact, that was the first time in five years when the State adopted some legislative measures designed to narrow the 'grey field' in the field of bankruptcy regulation.
2. Then, *responsibility of the debtor's owners is established.* For the first time, alongside the aforesaid persons, real owners – 'the persons controlling a debtor', understood to be those persons that have possessed, during a period of less than two years prior to the petition in bankruptcy being submitted against the relevant debtor to an arbitration court, the right to issue to that debtor instructions that had to be complied with, or in any other way determine the debtor's actions, – can be brought to subsidiary responsibility[1].

[1] A debtor's actions may be determined by a controlling person, including by means of coercing the director or members of the board of directors of a debtor organization, or by exerting a leading influence on the said director or members of the board of directors in another way (in particular, the persons that control a debtor may be the members of a liquidation commission; or a person authorized on the basis of a power of attorney, a normative legal act, or special authorization to conclude transactions on behalf of the debtor, or a person empowered to dispose of 50% or more of voting shares in a joint-stock company, or more than half of the charter capital of a limited liability company). Federal Law of 28 April 2009, No. 73-FZ '*On the Introduction of Alterations in Some Legislative Acts of the Russian Federation'*.

The possibility to actually bring such persons to responsibility is doubtful – given the fact that very often the real owners and beneficiaries of valuable Russian assets cannot be identified even in the course of criminal investigation.

The responsibilities of the directors and owners of credit institutions arising in an event of the situation of imminent bankruptcy are determined, as well as some new sanctions to be applied against them, including a 10-year ban forbidding such persons to acquire shares in credit institutions in an amount of more than 5%, and a three-year ban forbidding them to occupy the post of director of a credit institution.

3. *The possibility for a closed sale of debtor assets has been narrowed.* Elaborate legislative regulations have been introduced with regard to the procedure for the sale of an enterprise, these rules being also extended to the sale of a debtor's property or part of that property (Articles 110, 111 and 139 of the Federal Law 'On Insolvency (Bankruptcy)'). While the possibility of a closed sale of assets has been preserved, that sale now being termed 'bidding with sealed price proposals', numerous necessary technical innovations are introduced (the definition of the procedure for submitting an application for the participation in bidding and the requirements for such an application; the requirements to the conclusion of the contract of purchase and sale of an enterprise; the scope of open information concerning the process of sale of an enterprise has been increased, etc.).

The procedure for a formally open bidding has been proclaimed, but the practice of selling debtor's assets to 'VIP' buyers (even under a somewhat limited scenario) will continue, especially if one takes in consideration the increasing pressure exerted by the State on arbitration commissioners whose role, in fact, is to actually organize the bidding or to attract a third organization specifically to perform that function.

In addition to those procedures, a bankrupt enterprise may now be sold at an auction or through a tender – in those cases when the buyer must comply, in regard of a given enterprise, with the conditions set by a creditor committee or a creditor meeting.

As an improvement on the existing procedure one may regard the introduction of *an online bidding procedure with regard to a bankrupt enterprise*. By Order of the RF Ministry of Economic Development of 15 February 2010, No. 54 the following procedures and requirements are approved:

– the procedure for an online open bidding for a debtor's estate (or an enterprise) to be sold in the framework of a bankruptcy proceeding;
– the requirements to the online auction floors and operators of online auction floors relating to open online bidding for a debtor's estate (or an enterprise) to be sold in the framework of a bankruptcy proceeding;
– the procedure for confirming the compliance of online auction floors and operators of online auction floors with the established requirements.

Besides, the *Unified Federal Register of Bankruptcy Information* has been created that contains and makes public a broader spectrum of issues relating to the conduct of procedures applied in bankruptcy cases (concerning the initiation of each proceeding in bankruptcy; the conduct of bidding on the sale of property of debtors and the results of biddings; the suspension or dismissal of arbitration commissioners, etc.).

In December 2010, the Federal Law regulating the procedure for the creation and functioning of the Register was signed [1]. Thus, in particular, the creation and functioning of the Unified Federal Register of Bankruptcy Information is to be effectuated by the operator of the Unified Federal Register of Bankruptcy Information, that operator being a legal entity registered in the territory of the Russian Federation and in possession of appropriate technical appliances enabling the said operator to ensure the creation and keeping of the said Register in an electronic form, and also an entity selected specifically for the performance of the said functions by the regulatory agency.

The procedure for selecting the operator of the Unified Federal Register of Bankruptcy Information is to be confirmed by the regulatory agency and must ensure the possibility of participating in the selection procedure of all the entities that comply with the criteria established by the regulatory agency. Alongside the information that will have to be published under the Federal Law, the Unified Federal Register of Bankruptcy Information should also incorporate certain other types of information, the list of which is to be established by the regulatory agency.

The reliability of the information on a given debtor as of the moment of it being entered in the Unified Federal Register of Bankruptcy Information is to be checked by an operator of the Unified Federal Register of Bankruptcy Information by means of comparing it with the information contained in the Unified State Registere of Legal Entities and/or the Unified State Register of Individual Entrepreneurs.

The information to be published under the bankruptcy law is to be entered in the Unified Federal Register of Bankruptcy Information from 1 April 2011[2].

In July 2009[3], the status of creditors in the framework of proceedings in bankruptcy was further strengthened.

Firstly, *the distribution of responsibility and the powers with regard to the sale of enterprises were defined more precisely*: from now on, it has been consolidated in legislation that the functions of the organizer of bidding are to be performed by an external manager; the procedure and conditions for the conduct of bidding are not to be determined in advance by a creditors' committee, as it happened earlier, but are to be approved on the basis of an application submitted by an external manager. In this connection, the terms for the sale of a debtor's estate have been expanded and further specified, and in addition these terms have to be coordinated with the arbitration commissioner, or a creditor committee, or a creditor meeting. Among these terms are, for example, the composition of the estate; the form of bidding (an auction or a tender); the terms of the tender, the form of presenting the proposal of price (close or open); and the starting price of the estate; the mass media organs where the announcements of the bidding are to be published (Item 1 of Article 139 of the Federal Law '*On Insolvency (Bankruptcy)*').

Thereby, the level of debtor-creditor asset sale transparency was increased, while opportunities for abuse on the part of arbitration commissioners, including by restricting access to auctions by pooling (when assets are grouped into large auction lots); and by publishing up-

[1] Federal Law of 28 December 2010, No. 429-FZ '*On the Introduction of Alterations in Federal Law "On Insolvency (Bankruptcy)" and Recognizing as Null and Void Parts 18, 19 and 21 of Article of the Federal Law "On the Introduction of Alterations in the Federal Law 'On Insolvency (Bankruptcy)'"*.

[2] Item 2 of Article 4 of Federal Law of 28 December 2010, No. 429-FZ.

[3] Federal Law of 19 July 2009, No. 195-FZ '*On the Introduction of Alterations in Some Legislative Acts of the Russian Federation'*.

coming auction announcements in small-circulation newspapers and magazines and then buying out all the copies, etc.

Secondly, a number of *innovations relating to the satisfaction of creditor claims secured by a pledge* were adopted. This enables an arbitration court to determine both the process and conditions of sale of the subject of pledge, should any differences arise between the commissioner in bankruptcy and a creditor in bankruptcy with regard to the liabilities secured by the pledge. And this means that, in the event of a repeat auction being declared as having failed, such creditor is now endowed with the right to retain the subject of pledge, valuing it in an amount which must be 10% lower than its initial selling price at the repeat auction. Moreover, this means that the creditor is not to take advantage of the right to retain the subject of pledge, and the latter can be sold by way of public sale (Items 4, 4.1 of Article 138 of the Federal Law 'On Insolvency (Bankruptcy)').

The adopted legal norms represent a natural continuation of the previous innovations introduced in the field of civil law that made it possible for ownership of the subject of pledge to be transferred to the pledgeholder without resorting to judicial proceedings[1]. These innovations make it possible for pledgeholders, of which banks with high degree of state control constitute the majority, to provide solutions to that problem by applying lawful methods.

Thirdly, the *extension of tax norms to the regulation of relations pertaining to settlements with regard to mandatory payments* (paragraph 2 of Item 3 of Article 84; paragraph 2 of Item 2 of Article 194 (in regard of strategic enterprises) of the Federal Law 'On Insolvency (Bankruptcy)') was abolished. The abolition of that norm is conducive to a more frequent application of the instruments of amicable agreements and financial recovery of enterprises.

In Aprile 2010,[2] *large-scale innovations were introduced that were designed to prevent bankruptcies of financial institutions (including insurance companies), as well as to regulate the special procedure for the conduct of bankruptcy proceedings against non-state pension funds, professional securities market participants and the asset managers of investment and mutual investment funds*.

On the whole, these innovations were based on the model of financial recovery and interim management regulation initially stipulated in Federal Law of 25 February 1999, No. 40-FZ 'On the Insolvency (Bankruptcy) *of Credit Institutions'*, which was now substantially expanded to encompass a broader range of issues to be regulated and the categories of persons to which these new legal norms were to be applied.

The range of persons that were to be subject to the new special bankruptcy norms was expanded to include asset managers of investment funds, mutual investment funds, and non-state pension funds, which under the new law were placed in the category of financial institutions.

The range of issues to be regulated encompasses measures designed to prevent bankruptcies of financial institutions similar to the measures for financial recovery of credit institu-

[1] Federal Law of 30 December 2008, No. 306-FZ '*On the Introduction of Alterations in Some Legislative Acts of the Russian Federation in Connection with Improving the Procedure for Levying Execution on Pledged Property'*.

[2] Federal Law of 22 April 2010, No. 65-FZ "*On the Introduction of Alterations in the Law of the Russian Federation 'On the Organization of Insurance Business in the Russian Federation' and Some Legislative Acts of the Russian Federation"*.

tions[1]: the provision of financial aid to an organization by its founders; alterations introduced in the organization's structure of assets and liabilities; reorganization and other measures that are not forbidden by legislation (Article 183.1 of the Federal Law 'On Insolvency (Bankruptcy)').

In an event when proper grounds arise for applying the measures designed to prevent bankruptcy of a financial institution, the said institution is obliged to approve and submit to the controlling agency – the RF Central Bank – a plan for restoring its solvency, including an analysis of its financial situation, a list of measures to be implemented in order to prevent its bankruptcy, and the timelines for their implementation that should not exceed a period of 6 months.

The grounds for implementing the measures designed to prevent bankruptcy of a financial institution are as follows (Article 183.2 of the Federal Law 'On Insolvency (Bankruptcy)'):

1) multiple refusals, within the period of one month, to satisfy the claims of creditors in regard of financial liabilities;
2) failure to fulfill obligations in regard of mandatory payments within the period of more than 10 working days from the date established for the execution of those payments;
3) insufficiency of available cash for timely fulfillment of financial liabilities and (or) obligations in regard of mandatory payments, if the fulfillment of such liabilities and (or) responsibility is already due.

In each of the aforesaid cases the financial institution is obliged to submit to the controlling agency, within 15 days, a notification with an attached plan for restoring its solvency (if any indicia of bankruptcy in this connection are absent).

Within 30 working days, the controlling agency must make the relevant decision concerning the introduction of interim management of the financial institution, or lack of feasibility of introducing interim management.

Interim management is introduced in the following instances:

1) the controlling agency reveals the instance of multiple refusals, within the period of one month, to satisfy creditors' claims in regard of financial liabilities; or failure to fulfill obligations in regard of mandatory payments within the period of more than 10 working days from the established date for their execution, if in each of these instances the financial institution failed to notify the controlling agency of the presence of those circumstances;
2) the controlling agency made the decision that interim management should be introduced on the basis of the results of its on-site audit or its analysis of the submitted plan for restoring the financial institution's solvency;
3) the financial institution fails to fulfill or improperly fulfills the plan for restoring its solvency (Item 1 of Article 183.5 of the Federal Law 'On Insolvency (Bankruptcy)').

The controlling agency's decision to introduce interim management must be published and posted on the website of the controlling agency. The purpose of interim management introduction is to restore the solvency of a financial institution and/or to guarantee the safety of property.

The aims of interim managers are as follows:

[1] Article 7 of Federal Law of 25 February 1999, No. 40-FZ 'On the Insolvency (Bankruptcy) of Credit Institutions'.

– to adopt measures designed to prevent bankruptcies and/or to control the application of such measures;
– to eliminate the existing grounds for suspension or limitation of the license of a financial institution.

The composition of an interim management team, as well as the procedure and the grounds for changing its composition, should be approved by the controlling agency. The person appointed head of an interim management team should be an arbitration commissioner who has passed an additional examination which is to entitle him or her to exercise relevant managerial functions in the afore-listed institutions. The head and members of an interim management team should be selected by the controlling agency in the procedure established by the regulatory agency. On his or her appointment, the head of the interim management team should conclude a liability insurance contract.

The controlling agency has the right to send its representatives to a financial institution for the purpose of exercising control over the activities of that financial institution and its interim managers.

The Law sufficiently thoroughly regulates the functions of interim managers, the consequences of their appointment, their duties, and the consequences of limitation and suspension of the powers of the executive bodies of a financial institution (Articles 183.7–183.11 of the Federal Law 'On Insolvency (Bankruptcy)').

The term in office of interim managers is between three and six months, with the possibility of an extension of up to three months.

Interim managers should carry out an analysis of the financial situation of the financial institution in their charge, and no later than 45 days after the date of their appointment should submit, to the controlling agency, a conclusion on the financial situation of that financial institution. In the event the conclusion suggests the possibility of restoring the solvency of the financial institution, the interim managers should submit, to the controlling agency, a plan for solvency restoration. In the event of the impossibility thereof, the interim managers should recommend that a petition for bankruptcy be filed.

On conclusion of their term in office, interim managers should submit a report on the results of their activities.

The new law has introduced *a new definition of the indicators of bankruptcy of a financial institution*. While previously a petition for bankruptcy of a credit institution was primarily associated with a license recall and a court ruling confirming the existence of monetary obligations, the new procedure envisages the following indicators of bankruptcy:

1) the amount of claims against a debtor, constituting its monetary obligations and/or mandatory payments, is no less than 100 thousand rubles, and the debtor has failed to satisfy those claims over the course of 14 days;
2) a debtor has failed to implement, within 14 days from the entry into force of the court decisions on the recovery of the debt; in such cases, the debtor should be deemed as bankrupt irrespective of the amount of claims against it;
3) the value of a debtor's property is insufficient to cover its money obligations to the creditors and its mandatory payment liabilities;
4) the solvency of a financial institution has not been restored in the period of its interim management team's activity.

It should be emphasized that a financial institution should be deemed to be incapable of meeting the demands of its creditors and/or fulfilling obligations in regard of mandatory payments even in the presence of only one of the above-listed indicators of bankruptcy.

As far as the peculiarities of insurance organization bankruptcy prevention are concerned, special attention should be paid to the additional grounds for the application of bankruptcy prevention measures to an insurance organization. These grounds are as follows:

- multiple violations, within one year after the discovery of the first violation, of the standard ratio between the amount of the entity's own financial resources as established by the existing norms, and the amount of its assumed liabilities or the requirements to the composition and structure of its assets necessary for covering its insurance reserves and own funds;
- recall or suspension of the license for effectuating the established types of compulsory insurance, as well as limitation of that license.

In these cases, interim management should be appointed by the Federal Insurance Supervision Service (Rosstrakhnadzor). The right to file with an arbitration court a petition in bankruptcy, in addition to some other entities, is granted to a professional association which is recognized to be endowed with the right to present claims to a debtor – insurance organization – within the limits equal to the amount of entrance fees, membership fees, special-purpose contributions and other payments transferred to the professional association, as well as compensatory payments and other related expenses.

Legal regulation was introduced with regard to the transfer (or sale) of the insurance portfolio during the implementation of the measures designed to prevent bankruptcy, as well as in the course of a proceeding in bankruptcy. The sale of the insurance portfolio may be effectuated upon its coordination with the Federal Insurance Supervision Service's agencies. The transfer of the insurance portfolio (Article 184.9 of the Federal Law 'On Insolvency (Bankruptcy)') implies its transfer to another insurance organization(s) or to its management company.

In this connection, the insurance portfolio being transferred must include:

a) outstanding liabilities under insurance policies as of the date of the decision concerning the transfer of the insurance portfolio (or insurance reserve);

b) assets received in order to cover the insurance reserves created by the insurer.

The procedure for the transfer of the insurance portfolio, including the procedure for fulfilling the obligations assumed under insurance policies, and the procedure for fulfilling the obligations of the management company are established by the Federal Insurance Supervision Service. In an event of insufficiency or lack of assets at the disposal of that insurance organization, the outstanding liabilities under insurance policies may be covered by the professional association with the monies earmarked for covering compensatory payment.

The notification concerning the transfer of an insurance portfolio must be published. Within the period of one month from the date of its publication, insurers and insurance policy holders have the right to present to the insurance organization a request that the insurance policy the rights and liabilities under which are to be transferred should be annulled.

Besides, *the order of priority with regard to claims of third-priority creditors has been altered* (Article 184.10 of the Federal Law 'On Insolvency (Bankruptcy)').

Highest priority will now go to claims under compulsory insurance policies. Previously this category included only compulsory individual insurance, while all the other types of compulsory insurance were given second priority. In addition, the Federal Law's articles have been augmented by those regulating the claims concerning refunds of compensatory payments and insurers' claims.

Second priority will go to the claims under life insurance policies and other types of personal insurance. The range of claimants has also been expanded by including therein insurers.

Third priority, instead of claims under individual insurance policies, will now be granted to claims under civil responsibility insurance policies presented for causing damage (harm) to the life or health.

Fourth priority, instead of 'claims of other creditors', will go to claims presented under civil responsibility insurance policies for causing damage property of third parties and under property insurance policies.

Fifth priority will be granted to claims presented by other creditors.

The specific feature of an amicable agreement concluded with an insurance organization is the necessity to redeem the outstanding claims of first- and second-priority creditors, the claims of insured persons, beneficiaries, insurers under compulsory insurance policies, as well as the claims pertaining to refunds of compensatory payments and related expenses.

It should be noted, among the specific features of bankruptcy of professional securities market participants [1], asset managers of mutual investment funds, investment funds and non-state pension funds, that the primary goal of the interim management team after its appointment is to ensure safety of the monies and securities owned by their clients. Besides, interim managers must establish the sufficiency of monies and securities owned by the clients and kept on a special broker account, depo account, or a separate bank account for the satisfaction, in full, of the clients' claims with regard to restitution in regard of their monies and securities (Article 185.2 of the Federal Law 'On Insolvency (Bankruptcy)').

On the whole, the relations arising in connection with bankruptcy of the aforesaid organizations are to be regulated by the same norms as the bankruptcies of financial institutions (which has been discussed earlier), with a few specific variations.

Thus, in order to satisfy the clients' claims in the course of supervision or a proceeding in bankruptcy, the arbitration commissioner or register keeper keeps a register of the clients of a relevant professional securities market participant or asset manager. The participation of the register keeper is mandatory if the number of clients exceeds 100. The contract with the register keeper may be concluded only in an event of the latter having insurance liability coverage with regard to inflicting losses on the clients.

The claims of the clients of a professional securities market participant or asset manager are satisfied in full if the amount of the clients' funds kept on their accounts is sufficient for satisfying their claims. If the amount of the clients' funds pooled in one account is insufficient to satisfy their claims in full, these funds should be transferred to the clients in amounts proportional to their claims. The unsatisfied claims of the clients are to be entered in the creditor register and given a third order of priority.

Besides, there exist a number of specific features of the actual conduct of the procedures of supervision and a proceeding in bankruptcy. Thus, for example, the clients' funds are not included in the bankrupt estate of a professional securities market participant, asset manager or clearing institution, if these are kept on a special broker account, depository account, transit

[1] In accordance with Federal Law of 22 April 1996, No. 39-FZ '*On the Securities Market*', professional securities market participants are to be understood as persons carrying on broker, dealer, depositary activity, management of securities, keeping of securities registers, organization of trade on the securities market. From 1 January 2013, clearing will also be recognized as a type of professional activity on the securities market.

account, depo account, individual account of a securities holder, or a separate bank account opened for carrying on settlements against transactions relating to trust management. This also applies to the funds transferred for trust management to an asset manager or credited as investment units.

The securities owned by a professional securities market participant or asset manager and circulating on an organized market must be sold through an organizer of trading on the securities market. The securities that cannot be traded in that way must be sold in the procedure determined in Article 111 of the Federal Law 'On Insolvency (Bankruptcy)'.

Some specific bankruptcy features are also consolidated with regard to <u>non-state pension funds.</u>

1. Apart from the general grounds, the new legislation has established the following additional grounds for the imposition of bankruptcy prevention measures:
   – the standard size of pension reserves for fixed-parameter pension schemes has dropped, by the end of a relevant quarter, below the level envisaged by the controlling agency;
   – the actuarial deficit, as reflected in the latest annual actuarial assessment of a non-state pension fund, has increased on the previous year.
2. Liabilities under contracts on non-governmental pension provision and the composition of the list of creditors whose claims are due to be satisfied at the expense of pension reserves and pension savings, as well as the amount of payables, should be determined and entered in the register of creditors' claims by the interim manager.
3. Within 6 months from the date of an arbitration court's ruling that a non-state fund should be deemed to be bankrupt and bankruptcy proceedings should be initiated, the commissioner in bankruptcy should ensure:
   – the transfer of pension savings to the RF Pension Fund and the conclusion of proper settlements with the creditors of the pension investment fund;
   – the payment or transfer to other funds of the redemption sums or their transfer as an insurance premium payment under the pension insurance contracts concluded with insurance organizations;
   – the transfer of the fund's duty with regard to the payment of non-governmental lifetime pensions, and its pension reserves to another non-state pension fund.
4. A bankrupt pension fund's pension savings and pension reserves should not become part of the bankrupt's assets, and are to be used only for the afore-said purposes. The procedure for satisfying the creditors' claims at the expense of pension reserves and pension savings is been regulated by Article 186.7, 186.8 of the Federal Law 'On Insolvency (Bankruptcy)'.
5. When bankruptcy-prevention measures are being applied or bankruptcy proceedings are being implemented, the duties with regard to payment of non-governmental lifetime pensions and pension reserves can be transferred, with the concurrence of the controlling agency, to another non-state pension fund.
6. All transactions for the sale of non-state pension funds' properties in which pension reserves and pension savings are invested should be registered by a specialized depositary. The procedure for such accounting operations should be set by the controlling agency.
7. The sale of the enterprise and the replacement of any assets of a non-state pension fund are not permitted.

Thus, the State increases the levels of protection of the various types of pension savings, insurance contributions, share deposits and investments. On the macroeconomic and political levels, the positive social effect of such innovations is clear and evident. On the negative side, the implementation of these legal norms might end up with the State regulating the number of monetary asset management funds and companies and their mergers and takeovers, as well as redistribution of the corresponding markets in favor of influential big players with good political connections.

In February 2011[1], the bankruptcy law was extended to include the specific features of bankruptcy of clearing institutions, concerning, among other things, the determination of the size of the monetary obligations arising from financial contracts. Monetary obligations arising as a result of contracts concluded under a general agreement (or a joint contract) which corresponds to the model contractual terms (envisaged by Article 51.5 of the Federal Law 'On the Securities Market'), and (or) the rules of the staged auction, and (or) clearing rules and regulations, should be terminated in the procedure envisaged by the afore-said general agreement (or joint contract), and (or) the rules of the staged auction, and (or) clearing rules and regulations. The afore-said termination inevitably results in a monetary obligation, whose size should be determined in the procedure envisaged by the general agreement, and (or) the rules of the staged auction, and (or) clearing rules and regulations.

An interim manager has the right to refuse to implement only those financial contracts concluded between the creditor and the debtor that belong to the afore-said contract types. Creditors whose claims relate to net obligations are deemed to be third-priority creditors.

The afore-said legal innovations have been in force since 11 August 2011.

Since 11 February 2011, 'transactions handled at public auctions on the basis of even a single bid addressed to an unlimited range of auction participants, as well as actions aimed at implementing the obligations and duties arising from such transactions, cannot legally be challenged' as suspicious and resulting in preference being given to one creditor at the expense of another.

The most important innovations of that period are as follows:

1) the abolition of judges' *exclusive* right to determine whether or not supervision should be introduced, to consider petitions, applications and complaints in bankruptcy cases; disputes concerning the amount of the creditors' claims; the creditors' claims whose validity has been contested; the creditors' claims in the bankruptcy cases of failed financial institutions and absentee debtors;
2) the extension of grounds for recognizing a transaction as null and void in the event of an 'interrelated contract' that should be understood as 'a contract concluded with the central contracting party on the basis of an offer, including the bid, submitted at an auction, on whose basis the now invalid contract with the central contracting party was concluded' (Item 5, Article 61.6 of the Federal Law 'On Insolvency (Bankruptcy)'). Interrelated contracts that entail losses eligible for recovery can be concluded in the course of suspicious transactions or the debtor's transactions resulting in preference being given to one creditor at the expense of another.

[1] Federal Law of 7 February 2011, No. 8-FZ '*On the Introduction of Alterations in Some Legislative Acts of the Russian Federation in Connection with the Adoption of the Federal Law 'On Clearing and Clearing Activities'*.

In July 2011, Russia adopted a new bankruptcy regulation[1] specifically targeting developers[2]. Item 6, Article 201.1 of the Federal Law, of 12 July 2011, No. 210-FZ contains an extensive list of grounds for deeming a person to be a creditor of a developer, reflecting the various forms of consolidation of legal relationships introduced into practice in the field of construction.

As of the date of introduction of supervision upon an indebted developer, the debtor has the right to conclude contracts envisaging transfer of residential property and agreements altering or dissolving those contracts only after having been granted an express written permission of the interim manager. The same holds true for any other real estate transactions, including transactions in land.

The court decision on the imposition of supervision upon a developer should be forwarded by the arbitration court to the agencies carrying out the state registration of real property rights and real estate transactions, at the place of location of the developer's land plots.

The decision of the creditors' meeting that an amicable agreement should be concluded in a debtor's bankruptcy case, should be taken by a majority vote of all creditors in bankruptcy and the authorized state agencies, in accordance with the register of the creditors' claims. This decision will be deemed to be adopted if it has been voted for by all the creditors whose claims related to the debtor's obligations are secured by pledge, and by no less than three-quarters of participants a given construction project.

Unlike in all the other categories of bankruptcy cases, the bankruptcy case of a developer is participated in by the participants in a construction project who have claims for residential property transfer, and the authorized executive agency of a RF subject, exercising control and supervision over the participatory share construction of blocks of flats and (or) other real estate objects in the area where the said construction project is being implemented.

In response to a petition filed by the applicant or some other person-participant in the bankruptcy case of a developer, the application court has the right to take measures designed to satisfy the creditors' claims and the debtor's interests (measures ensuring the performance of obligations) in the form of *a ban on the lessor concluding a contract on the lease of the land plot with any other person but the developer*, and *a ban on the lessor disposing of that plot in any other way*.

As of the date of introduction, by the arbitration court, of supervision upon an indebted developer, any claims against the developer for the transfer of residential properties and (or) any monetary claims except those regarding current payments should be filed against the developer only within the framework of the developer's bankruptcy case throughout the whole period of supervision and the duration of all the subsequent procedures applied in the developer's bankruptcy case, in accordance with the established procedure for filing a claim against a developer.

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[1] Federal Law of 12 July 2011, No. 210-FZ, 'On the Introduction of Alterations in the Federal Law 'On Insolvency (Bankruptcy) and Articles 17 and 223 of the Code of Arbitration Procedure of the Russian Federation with Regard to the Determination of the Particulars of the Bankruptcy of Developers Having Attracted Monetary Resources of Participants of Construction'.

[2] Developer is a legal entity irrespective of its organizational-and-legal form, including a housing construction cooperative society or an individual entrepreneur, to which claims are presented for the transfer of residential property, or monetary claims. The special bankruptcy rules should be applied irrespective of whether or not the developer has any ownership, rental or sublease rights to the land plot, and also irrespective of whether or not the developer has ownership rights or any other property rights to the construction object.

As of the date of introduction of supervision upon an indebted developer, the implementation of the documents of execution concerning the claims filed by participants in a construction project, should be suspended for the whole period of supervision and all subsequent procedures applied in the developer's bankruptcy case. As of the date of opening of bankruptcy proceedings, the implementation of the said documents of execution should be discontinued.

Within 5 days from the date of confirmation of supervision and bankruptcy proceedings, the interim manager and the commissioner in bankruptcy should inform all the participants in the construction project known to them, of the introduction of supervision or the opening of bankruptcy proceedings. They should also inform these participants in the construction project that they are now eligible to file claims for the transfer of residential properties and (or) monetary claims, and that a participant in the construction project is now eligible to unilaterally refuse to implement a contract envisaging the transfer of a residential property.

The opening of bankruptcy proceedings against a developer constitute a ground for a participant in the relevant construction project to unilaterally refuse to implement a contract envisaging the transfer of a residential property. This refusal can be stated, within the framework of the developer's bankruptcy case, in the process of determining the amount of the monetary claim of that participant in the construction project.

When determining the amount of the monetary claim of a participant in a construction project, the court should take into account the amount of his or her losses in the form of the actual damage caused by violation of the developer's obligations relating to the transfer of the residential property. The amount of that damage represents the difference between the cost of the residential property (determined as of the date of dissolution of the contract envisaging the transfer of the residential property) that should be transferred to the participant in the relevant construction project, and the amount of the monetary resources paid prior to the dissolution of that contract, and (or) the cost of the property (determined by the contract envisaging the transfer of the residential property) transferred to the developer.

When the validity of claims for the transfer of residential properties is being considered by the arbitration court, it is required that evidence confirming the fact that a participant in the relevant construction project has indeed made a full or part partial payment in pursuance of his or her duties towards the developer should be submitted thereto.

The claim for the transfer of a residential property, declared to be valid by an arbitration court should be entered in the register of claims for the transfer of residential properties.

The rules for maintaining a register of claims for the transfer of residential properties, including the content of information required to be entered in that register and the procedure for release of information from the register of claims for the transfer of residential properties should be in conformity with the established federal standards.

As of the date of introduction, by an arbitration court, of supervision over an indebted developer, the following claims against the developer on the part of other persons or against other persons on the part of the developer should be submitted and considered throughout the whole period of supervision and all subsequent procedures applied in the developer's bankruptcy case only within the framework of the developer's bankruptcy case:

1) claims for the recognition of the existence or non-existence of a property right or any other right or encumberment with regard to real estate, including uncompleted construction objects;

2) claims for the recovery of real estate, including uncompleted construction objects, from the unlawful possession of another person;

3) claims for the demolition of an unauthorized structure;

4) claims for the declaration of a real estate transaction to be invalid or non-concluded, and for the application of the consequences of the invalidity of that void transaction;

5) claims for the transfer of real estate for the purposes of performing an obligation by a debtor to transfer that real estate in ownership, economic jurisdiction or operative management, or to transfer that real estate for use to the claimant;

6) claims for the State registration of the transfer of title to real estate (Article 201.8 of the Federal Law 'On Insolvency (Bankruptcy)').

In the course of bankruptcy proceedings against a developer, the creditors' claims, except the creditors' claims relating to current payments, should be satisfied in the following order of priority:

1) first priority should be given to the claims for the compensation for damage (harm) caused by the debtor to the life or health of citizens; their settlement involves the capitalization of the corresponding time payments and the payment of compensation for the inflicted moral damage;

2) second priority should be given to the claims for severance benefits, for the payment of labor of persons working or having worked under labor contracts, and for the remuneration payable to the authors of intellectual activity results;

3) third priority should be given to the monetary claims of citizens-participants of construction;

4) forth priority should be given to the claims filed by other creditors.

In the process of financial recovery, external management and bankruptcy proceedings, in the event that a debtor developer has an uncompleted construction object, the arbitration commissioner should put forward for consideration at a meeting of participants of construction, no earlier than 1 month and no later than 2 months after the date of his or her appointment, the issue of addressing the arbitration court with an appeal that the claims filed against the developer by participants of construction be settled by way of transferring the developer's rights to the uncompleted construction object and the land plot to a housing cooperative or to a specialized consumer cooperative of another type.

The transfer of an uncompleted construction object to participants in the relevant construction project may be carried out if the following conditions are simultaneously met:

1) the value of the debtor's rights to the uncompleted construction object and the land plot does not exceed by more than 5% the aggregate amount of the participants of construction's claims entered in the register of the creditors' claims and the register of claims for the transfer of residential properties; or the decision that the uncompleted construction object should be transferred to participants of construction has been approved by the affirmative vote of three-quarters of the forth-priority participants of construction; or the necessary amount of money has been paid into the deposit account of the arbitration court in accordance with Item 4, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy)';

2) the value of the property remaining in possession of the debtor after the transfer of the uncompleted construction object is sufficient for covering the current payments and for settling the claims filed by the first-priority and second-priority creditors; or the necessary amount of money has been paid into the deposit account of the arbitration court in accordance with Item 5, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy)';

3) the register of the creditors' claims does not contain any claims filed by the creditors who are not participants in the relevant construction project with regard to the obligations se-

cured by a pledge of the developer's rights to the uncompleted construction object and the land plot; or the afore-said creditors have given their assent to the transfer of the uncompleted construction object; or the necessary amount of money has been paid into the deposit account of the arbitration court in accordance with Item 6, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy)';

4) on completion of construction of the uncompleted construction object, it contains a number of residential properties sufficient to satisfy the claims filed by all participants in the construction project with regard to that particular construction object, entered in the register of the creditors' claims and the register of claims for the transfer of residential properties, in accordance with the terms of the contracts envisaging the transfer of residential properties (and there are no instances when one and the same residential property in the block of flats is simultaneously claimed by two or more participants in the construction project, except for the instances envisaged by Item 7, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy'). With the consent of a participant in the construction project, he or she may be allotted a residential property whose layout design, floor space and location will differ from those stipulated in his or her contract envisaging the transfer of residential property;

5) the uncompleted construction object belongs to the developer by right of ownership;

6) the land plot where the uncompleted construction object is situated belongs to the developer by right of ownership or any other property right;

7) participants in the relevant construction project have adopted a decision that a housing cooperative or a specialized consumer cooperative of another type, corresponding to the provisions of Item 8, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy), should be established.

In the event that a debtor developer has a block of flats whose construction has been completed, the arbitration commissioner should put forward for consideration at a meeting of participants in the construction project, no earlier than 1 month and no later than 2 months after his or her appointment (if the object's construction is completed within the period of bankruptcy proceedings, no later than 2 months after the date of its completion), the issue of addressing the arbitration court with an appeal that the claims filed against the developer by participants in the construction project should be settled by transferring ownership of residential properties in that block of flats to participants in the construction project.

The transfer of residential properties to participants in a construction project may be carried out if the following conditions are simultaneously met:

1) a completed block of flats has been issued an official completion certificate authorizing its commissioning;

2) the developer and participants in a construction project have not signed the deeds of real estate or any other documents concerning the transfer of residential properties to participants in the construction project;

3) the value of the residential properties to be transferred does not exceed by more than 5% the aggregate amount of the claims filed by participants in the construction project, entered in the register of the creditors' claims and the register of claims for the transfer of residential properties; or the decision that residential properties be transferred to participants in the construction project has been approved by the affirmative vote of three-quarters of the forth-priority participants in the construction project, with the exception of the juridical persons-participants in the construction project; or the necessary amount of money has been paid into

the deposit account of the arbitration court in accordance with Item 4, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy)';

4) the value of the property remaining in possession of the debtor after the transfer of residential properties to participants in a construction project is sufficient for covering the current payments and for settling the claims filed by the first-priority and second-priority creditors; or the necessary amount of money has been paid into the deposit account of the arbitration court in accordance with Item 5, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy)';

5) the register of the creditors' claims does not contain any claims filed by the creditors who are not participants in construction with regard to the obligations secured by a pledge of the developer's rights to the completed block of flats, the land plot and the residential properties to be transferred; or the afore-said creditors have given their assent to the transfer of residential properties to participants in the construction project; or the necessary amount of money has been paid into the deposit account of the arbitration court in accordance with Item 6, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy)';

6) all participants in a construction project are allotted residential properties in accordance with the provisions of their contracts envisioning the transfer of residential property, and the number and the size of the residential properties being transferred is sufficient to satisfy the claims filed by all participants in the construction project with regard to that particular construction object, entered in the register of the creditors' claims and the register of claims for the transfer of residential properties, in accordance with the terms of the contracts envisaging the transfer of residential properties (and there are no instances when one and the same residential property in the block of flats is simultaneously claimed by two or more participants in the construction project, except for the instances envisaged by Item 7, Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy'). With the consent of a participant in the construction project, he or she can be allotted a residential property whose layout design, floor space and location will differ from those stipulated in his or her contract envisaging the transfer of residential property.

* * *

On the whole, as far as the situation in the field of bankruptcy in 2009-2011 is concerned, it was the first time since 2004 that we saw a systemic development of Russia's bankruptcy legislation. The impetus for those changes came from outside the legislative domain – it was provided by the crisis phenomena in the global and Russian economy that resulted in a more than 15% rise in Russia over the period of 2009-2010.

The fact that the State made use of the key ideas for exiting the crisis – supported the banking sector and protected financial institutions in their role of creditors by reducing the level of bad debts – determined the adoption of a number of urgently needed legislative measures primarily designed to strengthen the creditor's position and to improve the overall transparency of the bankruptcy process.

However, the motives behind the recent legislative initiatives have inevitably narrowed the State's focus and thus have left a number of most important issues on the waiting list. Some of those issues are as follows:

– the issue of participation of the tax agencies in bankruptcy procedures (for the purpose of eliminating the conflict of interests between their major task of collecting taxes and the necessity of liquidation of potentially lucrative enterprises, and for the purposes of pre-

venting the Federal Tax Service's bodies from hampering the application of financial recovery mechanisms and the conclusion of amicable agreements);
– issues relating to the development of bankruptcy prevention mechanisms (bankruptcy hindrance mechanism, mechanism for the conclusion of amicable agreements, financial recovery mechanism), and to the restoration of the solvency of enterprises and their preservation (especially those whose output is export-oriented and competitive) in the instances when this approach is economically and/or socially feasible;
– the issue of supervision over the activities of SROs of commissioners in bankruptcy and SROs of valuators still failing to efficiently perform their functions and to provide high levels of service;
– the issue of monitoring and analyzing the practical implementation of legislation, of detecting problems in the areas of application of the new legal norms (adopted over the period December 2008 through January 2011) concerning the activities of commissioners in bankruptcy and their SROs (including the legal norms on the application of liability measures, by a SRO, to arbitration commissioners, and by the controlling agencies – to a SRO and the legal norms regulating the accreditation, by a SRO, of organizations of valuators and organizations maintaining registers of securities); the issue of the practical effectiveness of the legal norms establishing the liability of person exercising control over companies, and the issue of the practical effectiveness of the legal norms for contesting 'suspicious transactions' and 'transactions resulting in preference being given to one creditor at the expense of another'.

6.5. Self-Regulated Organizations – the Evolution of the Law (2007–2011)

The development of the Laws on Self-Regulated Organizations [1] (hereinafter – SRO) can be conventionally divided into two stages:
- I – April 1994 – July 2007;
- II – August 2007 – till now.

Let us review their main features.

At the 1st stage that began in April 1994 by the establishment of "self-regulated associations" as a SRO prototype for professional participants of the security market and ended in July 2007, self-regulated organizations were created spontaneously and on a limited basis. During this period, the SRO establishment was regulated by certain types of professional businesses limited to isolated areas, outside industries and major markets such as evaluation/appraisal business, investment foundations managers, bankruptcy commissioners, etc.

The key elements and tools of regulating SROs during this period were:
1) definition of the notion of a self-regulated organization as an entity established for coordination of its activities, representation of its members and for the purpose other than profit generation;
2) identification of state authorities that would control the self-regulated organizations;
3) the right and procedure for development of SRO performance standards and control over activity of the SRO members by the SRO.

[1] As of November 1, 2010, 634 self-regulated organizations have been registered in Russia. Out-of-court settlement of disputes in SRO – Bankruptcy Commissioner, 2010, No. 6.

During this period, SROs were not in majority: for 13 years they were set up in three areas only: valuation/appraisal (in May 1998), bankruptcy commissioners (October 2002) and audit boards of agricultural cooperatives (November 2006).

Starting 2001, the process of establishment of self-regulated agencies has intensified – each year new legal norms regarding SRO were established in Federal Laws such as: “On investment foundations” (2011), “On insolvency (bankruptcy) (2002), “On communications” (2003), “On housing and construction cooperatives” (2004), “On organization of insurance” (2005), “On advertisement” and “On agricultural cooperatives” (2006).

With the enforcement of Federal Law of 01.12.2007 No. 315-FZ “On self-regulated organizations” in July 2007, the *2nd stage* of the development of the Laws on self-regulation began. Efforts to introduce the self-regulation intensified, and the share of organizations with mandatory self-regulation increased considerably.

The SRO Laws developed in two directions: by enforcing and amending the general Federal Law and by enforcing special Laws in all the areas where self-regulation was adopted.

6.5.1. Federal Law of 01.12.2007 No. 315-FZ «On self-regulated organizations”

According to the new Law, a self-regulated organization shall be a non-commercial organization based on the membership that unites the subjects of entrepreneurship by one of the following attributes:

– a unity of the sector of production of goods (works, services), e.g. construction. communications;
– a unity of the market of produced goods (works, services), the e.g. market of real estate/ appraisal services/cadaster services;
– unification of subjects of professional business of a certain type, e.g. mediators, patent attorneys, auditors.

Such division, however, seems very conventional since the subjects of a certain professional activity can render their services on one market and can satisfy two attributes simultaneously, e.g. support to the commercial infrastructure of electric energy wholesale market - the Market Council.

The content of “self-supported and initiative” activity of such associations includes:

– development and establishment of SRO standards and rules;
– control over compliance with these standards and rules.

According to Federal Law “On self-regulated organizations” (Federal Law “On SRO”) (jointly with special norms about SRO), all self-regulated organizations were divided into *3 categories:*

1) SRO to which the general legal norms are not applied and which are governed by special norms (see section 6.5.3 for details);

This category includes mainly SROs[1] established before 2001 that had sufficiently developed legal framework of regulation and practices of application of the legal norms; these relate to a financial market segment. Among these SRO are professional participants of the securities market, share investment funds, non-state pension funds, etc. [2];

[1] SRO of housing funded cooperatives enforced in 2004 are an exception.
[2] See item 3, Article 1 of Federal Law “On self-regulated organizations” for details.

2) SRO that are governed by special norms on a number of issues defined by the general law; however these SRO are subject to general norms of the Federal law "On SRO";

3) SRO that are not governed by special norms but are regulated by FZ "On SRO" exclusively; however special norms can be enforced also.

Two categories of entities can become SRO members:

1) subjects of entrepreneurship are individual entrepreneurs and legal entities engaged in entrepreneurship. To set a SRO, at least 25 such entities are required if the applicable federal laws do not provide otherwise;

2) subjects of professional activity are individuals (physical persons) engaged in professional business. To set a SRO, at least 100 such subjects of a certain type are required.

An organization is considered a self-regulated one if it meets the attributes of a non-commercial organization as set forth in the RF Civil Code and has the above mentioned number of members, if standards and rules of entrepreneurial or professional activity of a certain type are available (if the applicable federal laws do not provide otherwise) and if each SRO member will have additional property liability before consumers of produced goods (performed works and/or rendered services) and other persons [1].

The SRO membership is voluntary according to the general rule. However, the federal laws can provide also for mandatory membership in SRO.

A SRO develops SRO *standards and rules* that are requirements to be obligatory complied with by all SRO members; these requirements relate to entrepreneurship or professional activities. The SRO standards and rules can contain requirements that are additional to those established by the law.

Disciplinary sanctions are provided for breaches of the SRO standards and rules.

The SRO standards and rules shall:

– comply with the business ethics rules;
– remove or mitigate a conflict of interests of the self-regulated organization members, their employees and members of a collegial governance body of the SRO.

The SRO standards and rules shall prohibit SRO members to perform any actions that could damage other subjects of entrepreneurship or professional activity; they also shall protect from:

– unfair competition;
– actions causing moral or other damage to the consumers of goods (works, services) and other persons;
– actions damaging the SRO business image or that of a SRO member.

The SRO shall ensure release of the information about activities of the SRO members that may affect the rights and lawful interests of any person.

The functions of a SRO are similar to those of a non-commercial entity: to develop and establish the membership; to take disciplinary sanctions against their members, etc. The SRO has very large authorities in the area of *control over activities of their members*.

The SRO reviews the activities of their members using reports and other documents approved by the general meeting and provided to the SRO. Besides, the SRO:

1) complaints against actions of the SRO members and incidents of breaching the SRO standards and rules and the membership terms by SRO members;

[1] See, Article 13 of Federal Law "On self-regulated organizations" for details.

2) conducts scheduled and off-scheduled audits of activities of the SRO members. (The controls entrepreneurship and professional activities of their members relating to compliance of the SRO standards and rules and the SRO membership terms;
3) reviews scheduled audit is held at least once every three years while an off-schedule audit is held in response to a claim of standards and rules breaching, and in some other cases).

Two key mechanisms of responsibility of the SRO members are established by the law:
1) disciplinary;
2) property-related.

Disciplinary sanctions can be taken against a SRO member based on the review results of complaints on the actions of the SRO member related to non-compliance with the SRO standards and rules and the SRO membership terms.

The following disciplinary actions can be taken against a SRO member:
1) an order to remove identified breaches by the set deadline;
2) a note of warning;
3) a fine;
4) a recommendation to exclude the member from the SRO; this recommendation is reviewed by the SRO standing collegial governance body.

Any decision on expulsion from the SRO members likewise any abuse of the rights and lawful interests of the SRO members by actions/no actions of the SRO and its employees and/or governance bodies can be contested in court. The SRO member concerned is entitled to demand from the SRO compensation for caused harm.

Property liability of the SRO members to the consumers of goods, works and services manufactured/performed/rendered by the SRO members and other persons can be insured by using the compensation fund and the system of individual and/or collective insurance.

The compensation fund is initially formed by SRO members fees in the amount at least Rb 3,000 from each member. The minimal insured sum under a contract of liability insurance of each SRO member shall be at least Rb 30,000 per year.

Federal Law “On self-regulated organizations” regulates thoroughly the issues of placing cash funds of the compensation fund (Article 13). The Law also provides for broad opportunities in certain sectors/markets and type of business for SRO to define independently, by using the Federal Law and in some cases – the SRO internal documents – other terms including the procedure of building up the compensation fund, placement of its money, the minimal size and the procedure of insuring liability of the SRO members.

According to general rule, the SRO shall be liable for obligations of any SRO member (up to the compensation fund amount) that have arisen as a result of causing damage by defects of goods (works, services) manufactured by the SRO member. The SRO obligations may not be recovered from the assets of the compensation fund.

The Federal Law “On self-regulated organizations” sets a rather high level of requirements to information transparency about the SRO activities (Article 7, FZ “ On SRO”).

The enhanced control functions of the SRO require a specific procedure *of interaction of the SRO with the authorized bodies of executive power*. Thus, the SRO shall:
1) forward to the authorized body the SRO standards and rules, the membership terms and changes inserted in these documents;
2) data on the scheduled and conducted audits by the SRO of the activities of the SRO members and the audit findings.

The authorized body shall:

1) send to the SRO information about the findings of the conducted audits or entrepreneurial and professional activities of the SRO members;
2) appeal to court to delete the data on the non-commercial organization from the SRO State Registry; if the claim is met, the self-regulated organization loses its status (item 6 Article 3, FZ "On SRO").

The SRO governance bodies are:

1) general Meeting of the SRO members – a supreme body convened at least once a year; the body deals with such issues as approval of the Charter, making changes therein, election of a standing collegial governance body, approval of the procedure for applying disciplinary sanctions, etc[1];
2) standing collegial governance body – is made of the SRO members and independent members who do not have employment relations with the SRO and its members. Independent members shall make at least 1/3 in the standing collegial body of the SRO. If the Federal Law does not stipulate otherwise, the SRO standing collegial governance body's Terms of Reference include approval of SRO standards and rules, decisions on joining and withdrawal from the SRO membership, setting specialized bodies of the SRO, etc.[2] The functions of this body can be exercised by the General Meeting of the SRO members;
3) SRO executive body resolves issues of SRO economic and other activities that do not fall within the scope of competencies of the two bodies mentioned above.

Federal Service for State Registration, Cadaster and Mapping (RosReestr) maintains the SRO Federal Registry if no federal body is set up with control and supervision functions in a certain business area. The Registry data are deemed open and public. When a non-commercial entity is entered in the SRO Registry, this entity shall acquire the SRO status; when an entity is excluded from the SRO Registry, its status is lost. The State Registry Maintenance Procedure is set by Ministry of Economic Development of the Russian Federation[3].

Distribution of supervision and control functions over self-regulated organizations between different state authorities (*Table 21*).

Table 21

Distribution of supervision and control functions over self-regulated organizations between different state authorities

State control/supervisory authority	Sector or type of activity of a SRO
1	2
RF Ministry of Finance	- SRO of auditors; - SRO of credit cooperatives; - SRO ina micro-finance sector
Federal Service for Financial Markets (FSFM of Russia)	- SRO on the securities market; - SRO in the area of investment funds managing companies; - SRO in the area of housing funded cooperatives;
Federal Service for State Registration, Cadaster and Mapping (RosReestr)	- SRO of appraisers (in part); - SRO of bankruptcy commissioners (in part)
Federal Service for Insurance Supervision (Rosstrakhnadzor)	- SRO of insurers
RF Ministry of Agriculture	SRO of auditing councils of agricultural cooperatives
RF Ministry of Energy	Activity in support of functions of the commercial infrastructure of the electric energy wholesale market (Market Council)

[1] See item 3, Article 16 of FZ "On self-regulated organizations" for details.
[2] See item7, Article 17 of FZ "On self-regulated organizations" for details.
[3] Article 5.2.28.19 of Regulation of the RF Government of 05.06.08 No. 437 (version of 24.03.11with amendments of 06.04.2011) "On Ministry of Economic Development of the Russian Federation".

cont'd

1	2
RF Ministry for Economic Development	- SRO of appraisers (in part); - SRO of bankruptcy commissioners (in part)
RF Ministry of Communications (Mincomsvyaz of Russia)	- SRO in communications
RF Ministry of Regional Development	- SRO in the construction sector (in part)
Federal Service for Ecological, Technological and Nuclear Supervision	- SRO in the construction sector (in part)

Where there is no control/supervisory body it means the Law does not specify it.

Coming back to general provisions on the SRO, note that the rights of the SRO, its officials and employees are limited by a number of terms. Thus, the SRO shall not:

1) execute entrepreneurial activity;
2) incorporate economic partnerships and companies engaged in entrepreneurship which is the subject of self-regulation for the particular SRO and become a member of such partnerships and companies:
3) exercise a number of actions and deals (if the federal laws do not specify otherwise) such as:
   - pledge the SRO property or make the property a surety against obligations of other persons;
   - grant surety for persons that are not SRO employees;
   - act as a mediator in selling goods (works, services) manufactured by the SRO members;
   - etc.

There is also a number of restrictions for the sole executive body of the SRO[1].

6.5.2. Development of the SRO general laws in 2008–2011

During 2007–2011, the right to establish self-regulated organizations was fixed in the above mentioned Federal Law and in other 8 Federal Laws. In 5 cases out of 8, the establishment of a SRO in this or that form is mandatory and the segments to which such norms apply are critical segments of the economy in terms of their social importance like construction, electric energy wholesale market, design and engineering, etc.

For the reviewed 4-year period considerable changes in the Federal Law 'On self-regulation" occurred only once – *in July 2008 No. 148-FZ of 22.07.08* (hereinafter – Federal Law "On SRO" - new version). Exceptions are the right of using compensation fund assets not only to secure the property liability of the SRP members and the right of return of contributions of the SRO members as per the applicable federal laws; these rights were enforced in July 2010 (No. 240-FZ of 27.07.10). Such innovations have been typical for legal regulation starting from the mid of the 2000'es. They have been actively used, e.g. in the bankruptcy law[2]. On one hand, such clauses ensure flexibility of the application of laws while on the other hand – they establish unjustified "specific" conditions for separate market players thus disrupting competition. Thus, a SRO engaged in construction and design, and engineering

[1] See items 4 and 5 of Article 14 of FZ No. 315-FZ dated 01.12.2007 "On self-regulated organizations" for details.
[2] E. A. Apevalova, A. D. Radygin. Bankruptcies in the 2000's: from a raider instrument to the "double standard" policy– "Economic Policy" August, 2009.

surveys is allowed, e.g. to invest the assets of the SRO compensation fund in order to increase its size. Such SRO has also the right of return of the SRO members' contributions [1].

The new version of the Federal Law 'On SRO" was not an exception as it also contains "specific" new clauses regulating particular cases:

1) possible establishment of a SRO not only for self-regulation but for other purposes that will be specified in "other federal laws";
2) possibility not to establish control bodies that supervise the compliance of the standards and rules by the SRO members, if this possibility is established" by a federal law";
3) non-obligatory key requirements to the SRO activity (sub-items 1-3, Federal Law "On SRO", new version) in the instances "established by federal laws":
   – availability of standards and rules of entrepreneurship/professional activity mandatory for compliance by the members;
   – securing additional property liability of the SRO members to consumers of works and services by insurance and establishing compensation funds;
4) no obligation to disclose information to the majority of consumers of the manufactured goods and services and to shareholders, investors, creditors in the instances "established by a federal law" (p. 4, Article 7, Federal Law "On SRO", new version).
5) possibility to use the compensation fund assets to keep, increase and invest the assets not by managing companies, if this is "specified by a federal law" (P. 5, Article 13, Federal Law "On SRO", new version). The reduced control over placing and investment of funds is usually used to derive unlawful profits, to misuse funds, to abuse authorities, etc. Eventually all these reduce the performance efficiency.

While in some instances we talk about the necessity to have a flexible regulation with account for sector and regional specifics, in the above mentioned cases a specific institutional environment will be created for a narrow group of people, thus the legal environment will be diluted and the effect of the legal regulation will be reduced.

As for systematic innovations, we'd like to focus on the following:

1. *Enhanced risk of reduction of protection of the consumers' rights* as a result of establishment by the federal laws of a different procedure for the formation of the compensation fund, its minimal size, investment of the fund assets and insurance of the liability of the SRO members (p. 4, Article 13, Federal Law "On SRO", new version). Earlier, the federal laws could specify only *additional requirements* to the size of the compensation fund and insurance.

2. *Expansion of the area that would be regulated by special federal laws* by incorporating issues relating to the SRO legal status; the procedure of enrolling members and the rules of the SRO membership, control over the SRO members activity (part 2, Article 1, Federal Law "On SRO", new version).

3. *Additional authorities granted to the SRO*:

– review of complaints on the SRO members' actions and cases of abuse of the standards and rules and membership terms by the SRO members. This function corresponds to introduction of administrative responsibility for abuses in this area (see below);
– other authorities provided by the federal laws.

[1] For details see: 4-5, Art. 3.2 of Federal Law dated 29.12.04 No. 191-FZ "On Enforcement of the Town Planning Code of the Russian Federation".

4. *Application of the Law on SRO to organizations registered outside the Russian Federation – now these organizations can become SRO members* (p. 3, Article 2, Federal Law "On SRO", new version).

5. *Imposition on the SRO of the obligation to assure transparency of information* that affects rights and lawful interests of any person (p. 5, Art. 4, Federal Law "On SRO", new version).

6. Fixing the general rule – the approval of the Procedure for regular and one-off payments by the SRO members at the General Meeting of the SRO members. However, a federal law or a SRO Charter can provide otherwise.

7. *Possibility to redistribute the authorities from the standing collegial body to the General Meeting of the SRO members* on the issues of approval of SRO standards and rules (and amendments thereof), setting SRO special bodies, approval of the regulations on such special bodies and rules on their activity.

8. *Extension of the list of grounds for refusal to enter the data on SRO in the State Registry (*e.g. where there are no standards and rules for entrepreneurial and professional activities, or additional property liability of the SRO members is unsecured, etc.). In such cases we can talk about the improved level of requirements to the SRO responsibilities and performance.

9. *Extension of the list of grounds for expulsion of a non-commercial organization from the State Registry* due to incompliance with the legal requirements (e.g. the number of the SRO members, the size of the compensation fund).

10. *Extension of the list of grounds for expulsion of a non-commercial organization from the State Registry in response to the request of the federal authorized body.* This actually means the termination of the SRO activities. If, e.g. more than two requirements of the Federal Law "On SRO" are abused by the SRO within one year (in addition to the requirements set forth in part 3, Article 3); or if other federal laws are breached and these breaches are not corrected or cannot be corrected.

11. Establishment of periodicity of the General Meeting of the SRO members – at least once a year.

12. An open list of rights that can be delegated by the members of a SRO association (union) to an association (union).

13. Fixing the SRO membership right in other (except Chambers of Commerce and Industry) non-commercial entities.

6.5.3. SRO legal regulation by special laws and its development in 2008–2011.

The Federal Law "On SRO" is the main law regulating the relations that emerge with the acquisition and termination of the SRO status and the SRO activity. However, other federal laws can also regulate specific relations associated with the SRO (p. 2 Art. 1, Federal Law "On SRO"). There are 20 such laws altogether, and each of them highlights this issue differently (see *Table 22*).

Table 22

SRO legal regulation by special laws

			SRO						SRO members vs SRO		Means of securing property liability of the SRO members						
			Notion	Type of association		Procedure of acquisition and termination of the SRO status	Number of members	Functions, rights and obligations	Rights and obligations	requirements to membership	Compensation fund				Insurance		
				Mandatory	Voluntary						Envisaged	Size of SRO members' contributions	Terms and procedure of investing the fund assets, restrictions	Compensatory payments	Envisaged	Type of insurance	
																Obligatory	Voluntary
1			2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
The Federal Law "On SRO" applies to	**Law "On the organization of insurance in the RF** of 27.11.1992 No. 4015-1		–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
	FZ "On agricultural cooperation" of 08.12.1995 No. 193-FZ		+	+	–	+	+	+	+	+	+	–[1]	–	+	–	–	–
	FZ "On valuation activity in the RF" of 29.07.1998 No. 135-FZ	SRO	+	+	–	+	+	+	+	+	+	+	+	+	+	+	-
		National Council on Valuation Activity	+	–	+	+	+	+	–	–	+	–	+[2]	+[3]	–	–	-
	FZ "On insolvency (bankruptcy)" of 26.10.2002 No. 127-FZ	SRO	+	+	–	+	+	+	–[4]	+	+	+	+	+	+	+	-
		National Association of the SRO of bankruptcy commissioners	+	–	+	+	+	+	–	+	+	–	+	+[5]	–	–	-
	FZ "On electric energy" of 26.03.2003 No. 35-FZ		+	+	–	–	–	+	–	+	–	–	–	–	–	–	–
	FZ "On communications" of 07.07.2003 No. 126-FZ		–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
	"City Planning Code of the RF" of 29.12.2004, No. 190-FZ	SRO (of respective tupes[6])	+	+	–	+	+	+	–	+	+	+	+	–	+	–	+
		SRO National Associations (of respective types)	+	+	–	+	–[7]	+	–	+	+	–[8]	+[9]	–	–	–	-
	FZ "On advertisement" of 13.03.2006 No. 38-FZ		+	–	–	–	–	+	–	–	–	–	–	–	–	–	–
	FZ "On the State Real Estate Cadaster" of 24.07.2007 No. 221-FZ		+	–	+	–	–	+	–	–	–	–	–	–	–	–	–
	FZ "On patent attorneys" of 30.12.2008 No. 316-FZ		–	–	+	–	–	–	–	–	–	–	–	–	–	–	–
	FZ "On auditing activity" of 30.12.2008 No. 307-FZ		+	+	–	+	+	+	–	+	+[10]	–	–	–	–[11]	–	–
	FZ "On credit cooperation" of 18.07.2009 No. 190-FZ		–	+[12]	–	+	+	+	–	+	+	+	+	+	+	–	+
	FZ " On energy saving and improvement of energy efficiency" of 23.11.2009 No. 261-FZ		–	+	–	+	+	+	+	+	+	–	–	–	–	–	–
	FZ "On micro-financial activity and micro-financial organizations" of 02.07.2010 No. 151-FZ		–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
	FZ "On the mediation procedure" of 27.07.2010 No. 193-FZ		–	–	+	+	+	+	–	–	–	–	–	–	–	–	–
	FZ " On heat supply" of 27.07.2010, No. 190-FZ		–	+	–	+	+	+	–	+	+	+	–	–	+	–	+

cont’d

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	1
The Federal law “On SRO” shall not apply to	**FZ “On the securities market”** of 22.04.1996 No. 39-FZ	+	–	+	+	+	+	–	–	–	–	–	–	–	–	–
	FZ “On non-state pension funds” of 07.05.1998 No. 75-FZ	+	–	+	–	–	+	–	–	–	–	–	–	–	–	–
	FZ “On investment funds” of 29.11.2001 No. 156-FZ	+	–	–	+	–	+	–	–	–	–	–	–	–	–	–
	FZ “On funded housing cooperatives” of 30.12.2004 No. 215-FZ	–	–	+	–	–	+	–	–	–	–	–	–	–	–	–

[1] The minimal size of the fund is established (part 4, Article 33.1, part 12 Article. 33.1).
[2] If a SRO is liquidated and/or the data on this SRO are deleted from the Unified State Register of the SRO of Appraisers, the assets that make up the SRO compensation fund shall be transferred to National Council on Valuation Activity. The requirements to the procedure of investment of the transferred assets are similar to the requirements to the procedure of investment of assets of the SRO compensation fund. The assets of the SRP compensation fund that have been transferred to the National Council shall be returned, after 4 years, in cash form to the persons that were the members of the said SRO. (Art. 24.8).
[3] A request t to receive a compensatory payment from the compensation fund can be submitted, also to the National Council on Valuation Activity, if the assets of the compensation fund of the SRO of appraisers have been transferred thereto (Art. 24.8).
[4] A small number.
[5] To the procedure of investment of the SRO compensation fund assets that are transferred to a National Association of the SRO and to the procedure of compensatory payments from its funds, are similar to the requirements to the procedure of investment of assets from the SRO compensation fund and the procedure of compensatory payments from the fund assets (item. 23 Art. 25.1).
[6] SRO based on the membership of persons engaged in engineering surveys, preparation of design documents and construction (Art. 55.3).
[7] All SRO.
[8] Within thirty days from the date of entry of the SRO data into the SRO State Registry the SRO shall pay an affiliation fee to the National Association of the SRO and make other payments for the needs of the National Association of the SRO of the respective type according to the procedure in the amounts set forth by the All-Russia Congress of the SRO, this is a specific feature of self-regulation in this area (part. 5.1 Art 55.20).
[9] After the data about a SRO are excluded from the SRO State Registry, the assets of the compensation fund shall be credited to the account of the National Association of the SRO of the respective type and can be used for payments only associated with SRO subsidiary liability for the obligations of the members of such organization. The National Association of the SRO shall invest the assets of the said compensation fund according to part 4, Art. 55.16 (p. 8 Art. 55.16).
[10] The establishment of the compensation fund and investment of its assets shall be made according to the procedure set forth in Art. 13, FZ “On SRO”(i. 14 Art. 17).
[11] An auditing company /individual auditor during the audit have the right to insure liability against breaches of the contract on auditing services and/or liability for damaging property of other persons as a result of the audit (Art 13). However, this is not related to the SRO membership.
[12] Except credit cooperatives of the second tier (item. 3 Art. 35).

The following Federal Laws do not have a clause on the SRO: “Organization of the insurance in the RF”, “On communications”, “On micro-financial activity and micro-financial organizations. They only refer to a possibility of a SRO being established.

The *Federal Law “On patent attorneys”* neither regulates the SRO activities. However this Law provides for several norms related to the SRO (Art. 5, part. 2 Art. 6, part. 2 Art. 9).

The Federal law “On advertisement” includes Chapter 4 that has two clauses only: the one deals with the SRO notion (Article 31) while the other – with the SRO rights (Art. 32).

The Federal Law “On the State Real Estate Register” also establishes the SRO rights only (Art. 34).

The Federal Law "On the mediation procedure" regulates the procedure of acquiring the SRO status and the SRO functions (Art. 18, 19).

Regardless of the importance to self-regulate the commercial infrastructure of the wholesale market, *the Federal Law "On electric energy"* has only one article on the SRO purpose, functions (Market Council) and requirements to the membership of a Market Supervisory Board and its competences (Art. 33).

Only organization of the wholesale market of electric energy and capacity is based on self-regulation of its participants (part 2, Art. 31), and there is no SRO for retail markets. The membership in the SRO (Market Council) for the wholesale market participants and those of wholesale electric energy is compulsory (Art. 35).

The following group of the Federal Laws regulates the SRO activities in more details.

The Federal Law "On agricultural cooperation" contains provisions regulating the activity of the SRO of the auditing boards of agricultural cooperatives, and such provisions can be found in a number of articles (Art. 1, 31 & 32). Their main part, however, is summed up in Article 33.1 which regulates the SRO activities in full.

This SRO has specific membership: a cooperative or a board of cooperatives must compulsory become a member of an auditing board (p. 3 Art. 31) while the auditing board must be a member of one of the SROs (part. 7 Art. 31).

Many articles of the *Federal Law "On valuation activity"* deal with SRO. In addition, Chapter III "Regulation of valuation activity" including 22 Articles regulates the SRO activity.

The National Council on Valuation Activity is a special feature of self-regulation in this area (Art. 24.10) likewise the compulsory way of securing property liability of the SRO members (Art. 24.6).

The Federal Law "On insolvency (bankruptcy)" (Art. 21–26.1) describes self-regulation in a similar way.

Chapter 6.1 "Self-regulation in the area of engineering surveys, architectural and construction design, construction, reconstruction and capital repair of capital construction facilities (Art. 55.1 – 55.23) of the *RF City Planning Code* contains the main provisions about the SRO.

The self-regulation rules can set requirements to insurance of civil responsibility by the SRO members (part. 12 Art. 55.5). Such requirements, however, can be compulsory if the SRO sets forth the size of contribution to the compensation fund which is lower than the legally established minimal size (with no requirement to insurance) (Art. 55.4, 55.5, 55.16).

The SRO membership issue is resolved ambiguously.

The types of works that affect the safety of capital construction facilities must be performed only by individual entrepreneurs or legal entities that have work permits issued by the SRO. Other types of work can be performed by any individual person or a legal entity (Art. 47, 48, 52). In other words, the membership is compulsory for those individual entrepreneurs or legal entities only that intend to execute a certain type or types of work that can affect the safety of capital construction facilities.

The SRO can expel from the SRO members an individual entrepreneur or a legal entity if the individual entrepreneur or the legal entity has no permit certificate for at least one type of work that may affect the safety of capital construction facilities (p. 2 Art. 55.7).

However, Article 55.15 on disciplinary sanctions imposed by the SRO against SRO members sets forth the following actions:

- termination of the term of the work permit certificate for the works that may affect the safety of capital construction facilities in relation to a certain type or types of work (item 4 part 2 Article. 55.15);
- Expulsion from the SRO membership (item 5 part 2 Art. 55.15).

According to this Article, the termination of the work permit does not mean the expulsion from the SRO members as these are two different sanctions. This runs contrary to the above mentioned Article 55.7, which says that the absence of the work permit certificate for *at least one type of work* that may affect the safety of capital construction facilities leads to a decision of expulsion from the SRO members.

Many provisions of the *Federal Law "On auditing activity"* deal with self-regulation, but there are also special articles about the SRO of auditors (Art. 17–22).

This Federal Law sets very strict requirements to the SRO membership (Art. 18).

Auditing Activity Board is worth mentioning (Art. 16). Unlike the mentioned above SRO National Associations this Board is established as an authorized federal body. Among its members are so many representatives from the SRO of auditors that makes the Board critical for self-regulation purposes.

In terms of regulation of the SRO activity*, the Federal Law "On credit cooperation"* is equal to such laws as the Federal Law "On valuation activity in the RF", the Federal Law "On insolvency (bankruptcy", the RF City Planning Code and/or the Federal Law "On auditing activity (Art. 35–41).

The Federal Law "On energy saving and improvement of energy efficiency" describes in detail the procedure of self-regulation. However, it does not contain provisions on securing property liability of the SRO members.

The Federal Law "On heat supply" is rather new. Probably because of this, the self-regulation of this area has a lot of questions.

Thus, a non-commercial organization can become a SRO in the area of heat supply provided this organization secures additional property liability of each member before the consumers by using the following (Art. 24):

a) the compensation fund of at least RUR50,000 for each member of the non-commercial organization if the organization established a requirement to insure the civil liability by its members; inception of the insurance cover may occur in case of damage caused by defective works and services in heat supply – in the amount of at least RUR15,000 per each member of the non-commercial organization;

b) the system of individual and/or collective insurance of the liability.

The text of the Article assumes that in order to acquire a SRO status, the property liability must be secured by both ways. However, looking at item "a" we see that the compensation fund size depends on the requirement to its members to insure the civil liability.

The liability insurance requirements to the SRO members are compulsory if the compensation fund is at least RUR50,000 per one member (part 1 Art. 24).

The Federal Law does not keep any direct reference to the nature of association in SRO. Thus, a number of issues may arise.

1. A non-commercial organization can receive a SRO status in the area of heat supply if its members are legal entities supplying heat and/or they are heat network companies, and/or individual entrepreneurs (part 1 Art. 24).

A heat supplying company is a company that sells to consumers and/or heat supplying companies generated or purchased heat energy (capacity), a heat carrier and that owns, by the property right or on any other lawful ground. the sources of heat energy and/or heat networks in the heat supply system by which the consumers receive heat energy.

A heat network company is a company rendering services in transferring heat energy.

These provisions apply to regulation of similar relations with involvement of individual entrepreneurs (Art. 2).

The membership in the SRO is not specified as a compulsory condition for performing these types of activity.

2. SRO in the area of heat supply must develop and approve the requirements to issuance *of a work permit certificate in relation to works that affect the safety of the heat supply facilities* (part 3 Art. 24). In this case, the membership in the SRO will be compulsory only for the individual entrepreneurs or the legal entities that intend performing works affecting the safety of the heat supply facilities.

Further in the Law the legislator gives the following definition of the permit certificate: "*a permit certificate to execute certain types of work or types of work in the area of heat supply*" (e.g. part 1 Art. 25 and others), this seems to be a more general notion. Thus the range of entities for which the membership in SRO is compulsory expands.

3. A person/entity in relation to whom the permit certificate is refused to be issued, must, jointly with the local government authorities of a settlement or a city district where this person/entity supplies heat, prepare a plan of actions for securing reliable heat supply under no permit certificate conditions. If certain types of work are performed by a person with no permit certificate, the SRO in the area of heat supply this person is a member of shall not be liable for this person action (no action) with the assets of the compensation fund (part 8 Art. 27).

To become a member of a SRO in the area of heat supply, an individual entrepreneur or a legal entity files an application for this SRO membership by stating certain type or types of work in the area of heat supply for which they intend to receive work permit certificates (item 1 part 2 Art. 26).

The person/entity who becomes a SRO member and meets the permit certificate requirements , is issued such certificate no later than within three business days after the date when the respective decision is made, the membership fee is paid and the contribution is made to the compensation fund of this SRO (part 5 Art. 26).

Incompliance with the permit certificate requirements for certain types of works/activities in the area of hear supply can be a basis for refusal to admit an individual entrepreneur or a legal entity as a member of the SRO (part 4 Art. 26).

It means that the refusal to issue the certificate is equal to the refusal in SRO membership. Thus, a person/entity *who has been denied a permit certificate cannot become a SRO member in the heat supply business,* and this contradicts the provisions of part 8, Art. 25. The Federal Law does not have the provisions that would state that an individual entrepreneur or a legal entity being a SRO member may *not be refused* a certificate.

4. The following disciplinary sanctions are imposed on the SRO members (part 6 Art. 27):

a) suspension of the permit certificate term of action;

b) termination of the permit certificate term of action;

c) expulsion of a faulty person/entity from the SRO membership.

In the first instance, a SRO member continues to be its member regardless of the absence of the right to carry out business in the hear supply area. Two other sanctions demonstrate that the termination of the permit certificate term would not automatically lead to the expulsion from the SRO membership. These are two different actions.

Thus one can talk about a mandatory membership for those individual entrepreneurs or legal entities who intend to do works that may affect the safety of the heat supply facilities.

The action of the Federal Law “On SRO” does not apply to the SROs of professional participants of the securities market, joint-stock investment funds, managing companies and specialized depositaries of investment funds, shared investment funds, funded housing cooperatives, non-state pension funds, credit agencies, credit history agencies (item 3, Art. 1 of the FZ “On SRO”).

The Law establishes that the relations arising in connection with the acquisition or cessation of the status of such SRO and their activities shall be defined by federal laws regulating the respective type of activity. However, by now, the following federal laws have been enforced: regulating activities of the professional participants of the securities market (Federal Law “On the securities market”), activities of non-state pension funds (Federal Law “On non-state pension funds”), activities of the managing companies of investment funds (Federal Law “On investment funds”), activities of the funded housing cooperatives (Federal Law “On funded housing cooperatives”). However, there are not many provisions on the self-regulation in the said laws.

Federal Law “On funded housing cooperatives” specifies that the SRO of the funded housing cooperatives is regulated by the Federal Law and therefore refers to the special Federal Law on the SRO of the funded housing cooperatives. However, such law has not been adopted yet. Joining a SRO is voluntary. Three Federal Laws state this implicitly (Federal Law “On the securities market”, Federal Law “On non-state pension funds” and Federal Law “On funded housing cooperatives”).

The SRO functions, rights and obligations in the above mentioned laws correspond to the main functions, rights and obligations provided for in the Federal law “On SRO”.

According to part 5, Art. 3, Federal Law “On SRO”, the obligatory requirement on securing by the SRO of additional property liability of each SRO member before the consumers of the manufactured goods (works and services) and other persons as per Art. 13 of Federal Law “On SRO” (the creation of a system of individual and/or collective insurance; setting up a compensation fund) shall be mandatory if the Federal Law does not provide otherwise. If the Law specifies a means of securing the property liability that differs from the compensation fund or insurance, these will not run contrary to the Federal Law “On SRO”.

Thus, the means of securing the liability specified by the laws that are not covered by the Federal Law ‘On SRO” will not contradict the norms of the Federal Law “On SRO”.

Though *the Federal Law “On the Securities market”* does not specify any means of securing the property liability of the SRO members, one should apply Art. 17 of the Federal Law of 05.03.1999, No. 46-FZ (the version dated 04.10.2010) ”On the protection of rights and lawful interests of investors on the securities market” that states that the SRO shall establish a compensation and other funds to reimburse for damage incurred by investors who are physical persons as a result of activities of the professional participants who are members of the SRO.

The Federal Law “On non-state pension funds” establishes that the SRO shall secure a warranty fund or a mutual insurance society to finance the liability to indemnify losses caused by the SRO members in performing their activities (part 5, Art. 36.26).

According to the *Federal law “On investment funds”*, before a federal law is enforced that sets forth the terms and the procedure of compensatory payments to individuals for damage caused as a result of non-performance or improper performance by the joint-stock investment funds, managing companies, specialized depositaries and the persons maintaining registries of the owners of investment units imposed on them by the relevant law or the agreement on obligations, the procedure of protection of property rights of individuals shall apply according to which the losses in the form of actual damage caused by the individuals who are shareholders of joint-stock investment funds, individuals who are owners of investment units shall be compensated from the assets of the federal compensation funds set up as per the RF Law "On the protection of rights and lawful interests of investors on the securities market" (art. 63)[1]. This fund, however, is not related to self-regulation.

The Federal Law "On funded housing cooperatives" provides for creation of a reserve fund which assets can be used to secure contingent expenses only and to cover cooperative losses. Such assets may be contributed to a unified reserve fund set up by the SRO of funded housing cooperatives if a cooperative is a member of the SRO. The aims of the formation of the reserve fund, however, do not correspond to the main aims of setting up the compensation fund.

All the laws may be divided into ***three groups*** in terms of changes in the SRO special legislation.

The ***1st group*** includes the laws enforced before the Federal Law "On SRO". These laws are: "On the organization of insurance activity in the RF", Federal Laws "On agricultural cooperation", "On the valuation activity in the RF", "On insolvency (bankruptcy)", "On electric energy", "On communications", "On advertisement" and "On the State Real Estate Cadaster", the RF City Planning Code.

The Federal Laws "On communications", "On advertisement" and "On the State Real Estate Cadaster" initially included the provisions on the SRO. Such provisions were also incorporated in the Law *"On the organization of insurance activity in the RF"* on March 7, 2005, and in the *Federal Law "On agricultural cooperation"* – on March 11, 2006. In both cases no substantial changes on the SRO activities were made.

The Federal Law "On electric energy" had the notion of self-regulation at the start. On 04.11.2007, however, the provision was modified, and the Trade System Administrator of the wholesale market was replaced for Market Council. A direct reference was also made that the SRO is the Market Council.

The first version of the *Federal Law "On the valuation activity in the RF"* dated 29.07.1998 contained the SRO provisions. Self-regulation was considered as an addition to the state regulation (Art. 22, 24).

Since 27.07.2006, the SRO membership has been a mandatory condition for performance of valuation. The following changes have been made:

1. The following requirements become mandatory for appraisers: insurance of liability (Art. 4, 24.6, 24.7), compliance with the standards, valuation rules and the rules of business and professional ethics; also the requirement to pay contributions (Art. 15).

2. Now the valuation activity is regulated not only at the government level. National Board on Valuation Activity develops federal standards for valuation. The SRO of appraisers develops and approves the standards and rules of valuation (Art. 18, 20).

[1] Art. 19, Federal law of 05.03.1999 , No 46-FZ (the version dated 04.10.2010) "On the protection of rights and lawful interests of investors on the securities market".

3. The number of Articles regulating SRO has increased from one to sixteen (Art. 22, 22.1-22.3, 23, 24.1-24.10). They include, among others:

a) the notion of the SRO (Art. 22);

b) the procedure of entry of a non-commercial organization in the Unified State Registry (hereinafter – the USR) of the SRO of appraisers and the grounds thereof (including the requirement of the minimal number of members and availability of a compensation fund) (Art. 22, 23, 24.2, 24.6, 24.8, 24.9);

c) a larger list of the SRO functions, rights and obligations and the requirements to the SRO membership (Art. 22.1, 22.2, 22.3, 24, 24.1);

d) the procedure for SRO control over valuations and the procedure of application of disciplinary sanctions to the SRO members (Art. 24.3, 24.4);

e) the provisions/norms regulating activities of National Board on Valuation Activity and other associations of the SRO of appraisers (Art. 24.10).

The norms regarding the SRO Expert Council appeared in the version dated 24.07.2007 (Art. 24.2).

Since 27.12.2009, a state duty has been established for the entry of a non-commercial organization in the USR of the SRO of appraisers (Art. 23).

On 22.07.2010, (with the introduction of Chapter III “State Cadaster Value”) Art. 24.16 on the expert review of the report on definition of the cadaster value by the SRO was included in the Federal Law.

On 01.07.2011, the list of documents required for inclusion of non-commercial organizations into the USR of the SRO of appraisers was extended (Art. 23).

Significant amendments were made in the Federal Law on 11.07.2011 including:

1) norms on the single qualification test: if a member of the SRO of appraisers passes this test, this member can become a member of the SRO Expert Council; and on the qualification certificate issued in confirmation of passing the single qualification test (Art. 16.2, 21.1, 21.2, 24.2);
2) the SRO of appraisers which expert has prepared and got approved a positive expert opinion shall bear a joint liability for losses caused to the customer who concluded a valuation contract or for property damage caused to third parties by the action (no action) of an appraiser, as a result of identified violations of the federal standards on valuation and the valuation standards and rules (Art. 24.6).

The Federal Law “On insolvency (bankruptcy”) in its first version of 26.10.2002 required compulsory membership in the SRO.

Material changes were made in the version of 30.12.2008, e.g.:

1. Norms on the SRO National Associations were added (Art. 2, 26.1).

2. The compulsory terms of the SRO membership were changed.

The minimal service record on a leading position was reduced from 2 years to one year. At least two years of probation were included for an assistant to the bankruptcy commissioner as an equal alternative to the requirement for the leader’s service record and the period of at least 6 months for probation as an assistant to the bankruptcy commissioner (part 2 Art. 20).

The requirement of no record of convictions for economic crimes and crimes of moderate severity, grave and exceedingly grave crimes was substituted for the requirement of no penalty/punishment in the form of disqualification for administrative offences or in the form of termination of right to hold certain positions or to perform certain types of activity as a result of the court sentence, and also the requirement to have no record of convictions for deliberate crime (part 2 Art. 20).

The registration as an individual entrepreneur was excluded from the list of compulsory terms.

New requirements have been developed: a SRO member shall have a contract of compulsory insurance of the liability; a SRO member shall pay contributions as stated by the SRO, including contributions to the SRO compensation fund (part 3 Art. 20).

The SRO is entitled to set other requirements to competences, integrity and independence of the bankruptcy commissioner as the membership conditions (part 4 Art. 20).

3. The activities of the STO governance bodies and the specialized bodies are now regulated by a separate article – 21.1.

4. The compensation fund provisions were incorporated into a separate article 25.1.

5. The scope of the SRO rights and obligations has expended (Art. 22). The SRO now has the right to certify insurance companies, appraisers, professional participants of the securities market who maintain the registry of the securities owners and other entities that a bankruptcy commissioner may engage to secure commissioner's obligations from the debtor's funds.

The following articles dealing with the SRO activities are considered new: 22.1, 22.2, 23.1, 24.1, 25.1 и 26.1.

The later versions regarding self-regulation have not changed considerably.

Since 27.12.2009, a state duty has been imposed on the entry of a non-commercial organization in the USR of the SRO of bankruptcy commissioners (part 1 Art. 21).

From 22.04.2010, the SRO functions have been extended due to changes in §4 dealing with the bankruptcy of financial organizations.

On 28.12.2010 it was established that the federal standards, the standards and rules of professional activity can set forth additional requirements to securing property liability of the bankruptcy commissioner for non-performance or improper performance by the commissioner of his/her obligations relating to bankruptcy (part 5 Art. 20.4).

Though the *RF City Planning Code* was enforced back in 2004, the norms regulating the SRO activity (including separate Chapter 6.1 (Art. 55.1–55.23)) appeared only on 22.07.2008. On the same date the second version of the Federal Law "On SRO" was passed; this version had the greatest number of changes for the entire term of action of this Law.

On 27.07.2010, the following major amendments were introduced in the Code:

1) where the works on preparation of design documents (part 5.1 Art. 48), organization of construction, reconstruction and major overhaul (part 3.1 Art. 52) of a capital construction facility are included in the list of works that may affect the safety of capital construction facilities, the person/entity who prepares the design documents or the construction of such facility must have a permit certificate issued by the SRO allowing for doing works in preparation of design documents or organization of construction;
2) article 60 that sets forth the procedure for indemnification of damage caused as a result of defective works was supplemented with the following provisions:
   - whenever the data on a SRO that issued the permit certificate for works that affect the safety of the capital construction facilities are removed from the SRO State Registry, the National Association of SRO of the respective types shall have the joint liability up to the assets of the compensation fund of the said SRO credited to the account of this National Association (part 3.1 Art. 60, part 8, Art. 55.16);

– part 5 defines persons/entities, SRO among them, who can bear joint liability for damage caused by defective works (e.g. the Russian Federation, an RF subject. etc.) (part 5, Art. 60);

3) to receive a permit certificate, the set of requirements has been supplemented by the notion of “certification” (sub-item б, item 1, part 6, Art. 55.5, item 3, part. 8, Art. 55.5);
4) minimal requirements have been established to the issuance of the work permit certificate for preparation of design documents (part 8.1, Art. 55.5) and organization of construction (part 8.2, Art. 55.5);
5) it is established that an individual entrepreneur or a legal entity who have the permit certificate are entitled to perform the said works provided the cost of their preparation under one contract does not exceed the estimated cost of work execution based on which the respective SRO member paid its contribution to the compensation fund. The number of contracts that the SRO member can conclude is not limited (part 1.1 Art. 55.8);
6) the permit certificate is issued to a SRO member only after the SRO member has paid a contribution to the SRO compensation fund to increase the total size of the contribution of this member up to the contribution size set forth by the SRO for the members who have received the permit certificate for the said types of works but not lower than the minimal size of the contribution to the SRO compensation fund. (part 10.1, Art. 55.8);
7) the provision according to which the same person cannot be a leader of the standing collegial governance body of the SRO for two terms in succession was excluded (part 4 Art. 55.11);
8) the SRO rights on control over activities of the SRO members have been expanded (part 1, Art. 55.13);
9) if earlier the cash assets of the SRO compensation fund could be invested in the assets only for the purpose of the fund maintenance and increase, now the cash assets of the compensation fund can be invested in deposits and/or deposit certificates in Russian credit agencies (part 4, Art. 55.16);
10) the minimal size of the contribution to the SRO compensation fund for one SRO member was established (part 6, Art. 55.16, part 7, Art. 55.16);
11) it is established that only one National Association of the SRO of the respective type can be created (part 2.1, Art. 55.20);
12) the functions of All-Russia SRO Congress have been supplemented. The Congress elects President of the National Association of the SRO for 2 years and determines its authorities. The same person cannot hold the position of the President of the National Association of the SRO for two terms in succession (item 2.1, part 3 Art. 55.21);
13) an Article on state control of the National Associations of the SRO has been introduced (Art. 55.23);
14) a SRO shall be a member of the National Association of the SRO of the respective type since the date of entry of the respective data thereof in the SRO State Registry. This SRO must pay a membership fee to the National Association of the SRO of the respective type within 30 days as well as other contributions for the needs of the National Association of the SRO of the respective type according to the procedure and in the amount established by the All-Russia SRO Congress (part 5.1 Art. 55.20).

The ***2nd group*** comprises the Federal Laws passed after the Federal Law “On SRO”. These include: *“On patent attorneys”, “On audit activity”, “On credit cooperation”, “On energy* *saving and improvement of energy efficiency", "On micro-financial activity and micro-financial organizations", "On the mediation procedure", "On heat supply".*

Their common feature is that the SRO provisions were adopted together with these laws. There were no changes in the legal provisions, and in cases changes have been made they have been minor. Thus, *the Federal Law "On auditing activity"* was amended on 01.07.2010 as follows:

- each SRO of auditors shall adopt the rules of independence of the auditors and audit companies endorsed by the Audit Board. The SRO of auditors is entitled to include in these rules additional requirements (item 2.1 Art. 8);
- requirements to the membership for an individual auditor in the SRO are to comply with the internal control rules over work quality (sum-items 5, item 3, Art. 18, sub-items 4.1 item 6, Art. 18).

The amendments of 28.12.2010 clarify that the SRO of auditors issues to an auditor a qualification certificate (item 1 Art. 11).The SRO of auditors shall not place any demands or conditions while issuing the auditor's qualification certificate. The SRO of auditors has the right to charge a fee for the issuance of the auditor's qualification certificate in the amount not exceeding the certificate manufacturing and shipment costs. The issuance date of such certificate shall be the date when the SRO of auditors makes a decision to issue the qualification certificate to the auditor (item 7 Art. 11).

The ***3^rd^ group*** includes the federal laws that are not covered by the Federal Law "On SRO".

In the federal laws such as *Federal Law "On the securities market", "On investment funds" and "On funded housing cooperatives*" the SRO provisions were specified since the date of enforcement of these laws. The SRO provisions in the last two laws have not been amended considerably while the *Federal Law "On the securities market*" was amended on 15.04.2006 by adding training of individuals in the area of professional activity on the securities market and also if a SRO is an agency accredited by the relevant federal executive authority for the securities market; grading qualification examinations and issuing qualification (Art. 49).

In the version dated 11.07.2011, Article 51.5 "Approximate terms of agreements and general agreement (the uniform contract) on the financial market" was added that specifies some of the SRO rules.

SRO provisions were included in the *Federal law "On non-state pension funds"* only on 10.01.2003. The version of 06.12.2007 clarified that now the SRO shall be the SRO of funds *and* organizations that keep pension accounts under respective agreements with the funds (Art. 36.26).

6.5.4. Development prospects of the SRO legislation

It is obvious that the process of implementation of the general policy on reducing the role of the government in the economy will trigger an intensive process of partial transfer of the control and supervision functions over SRO various activities, sectors and markets.

Thus the RF State Duma of the Federation Council during 2010–2011 reviewed in the first reading the draft laws envisaging the establishment of SRO in the following sectors

1) health care;
2) protection of animals;
3) water supply and sewerage;

4) fire safety;
5) actuarial activity.

There are also proposals to introduce self-regulation for cadaster engineering, patent attorneys, expert reviews of industrial safety, real estate management. A draft law on setting a SRO for housing and public utilities is also reviewed.

Besides, a possibility is reviewed to set requirements to compulsory membership in the SRO for some professional participants of the securities market (brokers and the persons/entities who manage securities and render services to those who are not qualified investors). All SROs support the idea of compulsory membership of professional participants and managing companies, however, those who are not SRO members have a different opinion. Mid-size and small companies consider the compulsory membership as an additional financial load, and their concerns are justified and confirmed by the SRO with compulsory membership. While making a decision on this issue, the interests of investors should be also taken into account as the level of their protection can be improved considerably at the expense of compensation funds which will be used as a source of compensatory payments for losses incurred.

There are also sectors where the proposals on the SRO initiated in 2011 were not adopted as legal provisions including SRO of managing companies of multifamily houses (though the ruling party was very active in their promotion); SRO of the compulsory inspection centers for transportation vehicles.

The degree of preparedness of the market/sectors for self-regulation is a critical issue that must become a corner stone. However, the implementation of the government objectives to reduce the degree of state regulation, to reduce budget costs etc. is not enough to make SRO activity effective. Before a SRO is established the following is required:

– to analyze the market/sector to see whether they are prepared for “independent and initiative actions”, effective control by the SRO bodies of the activities of the SRO members, and implications of introducing a SRO on the market/in the sector;
– to develop measures of state control and supervision during a transition period and further to compensate for inefficient implementation of the self-regulation functions by non-commercial companies.

As practices show, in such sectors as valuation the control and supervisory functions are ineffective; unfair players and poor professionals are not “washed out” even by bringing them to responsibility; thus the applicable legislation must be corrected and the functions of the control and supervisory bodies must be modified in this sector.

Establishing SROs in the sector of heat supply and possibly in water supply and sewerage sectors would be extremely negative in the country where 42% of rural residential houses only are equipped with water pipes, 32% - with sewerage, 20% - with hot water pipes. The scale of the task (required capex) has been beyond the government capacity; and it would be an urban utopia to rely on the SRO effectiveness.

In February 2011, the draft law “On amendments in the Federal law “On the securities market” and other legal acts of the Russian Federation” No. 469229-5 was passed in the first reading. However the law was not enforced by the end of 2011. This new draft envisages the following provisions:

1. Obligation to be members of the SRO of professional participants engaged in brokerage and management of securities if they provide services to non-qualified investors.

2. Obligation to be members of the SRO of managing companies which rules of the trust management include the issue of equity shares to non-qualified investors.

3. Obligation of the SRO of brokers and/or managing companies, the managing companies of shared investment funds to set up compensation funds to compensate individuals who are not qualified investors for losses caused as a result of insolvency (bankruptcy) of the said professional participants of the securities market and managing companies.

4. Requirements to the content of standards (rules) of the SRO of brokers, managers and dealers.

The proposed actions are deemed to be justified and they could improve effectiveness of the SRO activities and protection of the interests of the qualified investors on the securities market.

There is also a number of ideas which discussion and implementation could be quite successful:

1. Proposals from the professional community of bankruptcy commissioners regarding higher level of responsibility of the bankruptcy commissioners to ensure the effective instrument of compensation for losses incurred in the course of the bankruptcy procedure are quite fair. Thus, some of the community representatives propose increasing the minimal size of the compensation fund up to RUR20 mln. If so, the compensatory payments for one case could reach RUR5 mln.
2. The concept of passing regulatory acts on the development of mechanisms of out-of-court settlement of disputes and arbitrations that was not incorporated in the legislation seems to be quite constructive; this concept have been implemented practically in a number of SRO at the level of the National Association of the SRO of bankruptcy commissioners.
3. At the moment, the National Association of the SRO of bankruptcy commissioners does not have the functions of control and supervision over the SRO of bankruptcy commissioners; these functions are proposed to be introduced with the regulatory function being the main one.
4. The right to develop standards and rules in construction must be replaced by the respective duty fixed by law, with the requirements to the content of such documents and responsibility for performance. Given the complexity of the SRO structure, diversity of the SRO members and types of works, this duty possibly will be established at the level of NOSTROY[1].
5. In the area of the construction SRO, Rostekhnadzor supervisory functions should be enhanced; today they are poorly implemented, and there is a significant number of offenses committed by SRO.
6. To introduce a common responsibility instead of a special administrative responsibility in each sector for offenses committed by the SRO and their leaders is proposed; this will considerably enlarge the area of application also in relation to the SRO types regulated by the law.
7. The list of works affecting safety at the capital construction facilities should be reduced as the list contains works that do not affect the safety of the facilities; also there is certain duplication of works in the general and special (for hazardous and technically complicated facilities) lists.
8. Uncertainty in the authorities of the SRO and the federal government should be resolved in connection with the right to issue a work permit certificate with regards to works that af-

[1] NOSTROY – National Association of builders is a non-state non-commercial organization based on the obligatory membership of self-regulated organizations in the construction sector.

fect safety of the capital construction facilities (the uncertainty emerged after the Russia's Ministry of Regional Development issued Order No 624 on December 30, 2009).

9. To improve transparency of the SRO activity on the financial market is required by publishing a SRO annual report at the SRO web-sites and the web-sites of the Federal Service for Financial Markets. Besides, to assess self-regulation efficiency, the RF Ministry of Economic Development suggests stepping-up demands to the SRO on information disclosure by the member-companies including publishing of all member companies' reports at the SRO site.
10. As the legislation does not regulate administrative responsibility of persons/entities engaged in professional activities and the officials of the SRO of appraisers (as a result of this, corruption is facilitated, the number of unfair appraisers grows, and the officials of the SRO of appraisers often demonstrate arbitrary behavior towards their members), to make changes in the RF legislation is necessary to establish responsibility of the persons who carry out professional activities and of the SRO officials.
11. In general we can speak about the absence of a special responsibility of self-regulated organizations for abusing the SRO members in their internal activities and of a more specialized responsibility in some of the sectors like valuation[1] of agricultural and financial cooperatives, etc.

6.6. Russian Market for Real Estate

Like other sectors of the national economy, the state of the market for real estate in 2011 was driven by controversial dynamics of macroeconomic and financial indicators.

On the one hand, most last year's indicators of the nation's socio-economic development (GDP, industrial output, investment in capital assets) posted a positive dynamic.

Affected by developments in the Middle East, the trend to increase in international oil prices which had emerged yet in H2 2010 continued in Q1 2011. After hitting their record highs in April, the oil prices were then slightly down. That affected the dynamic of the Rb exchange rate: in early 2011 Rb was on the rise against USD, but in Q4 2011 it depreciated and bounced back to the values noted a year ago and finally slightly outran them by the end of the year.

On the other hand, like in the past three years, the country saw a continuous capital outflow whose value ultimately proved greater than in 2009-10. The capital outflow continued through the whole year, with its quarterly dynamic increasing since H2.

Negative dynamic of the population's real disposable incomes had a yet more significant impact on the real estate market. According to Rosstat, their average nationwide increase in 2011 was a meager 0.8% (vs. 5.1% in 2010 and 2.3% in 2009).

[1] The RF Ministry of Economic Development, e.g. identifies the following gaps in the legal regulation of the SRO on valuation that must be corrected:
1) no legal provision that would fix the obligation of the SRO of appraisers to submit to the authorized body documents and information as per the Law on valuation activity;
2) no legal provision that would fix the notion and types of the expert review of reports on valuation, and requirements to the experts of the SRO of appraisers;
3) no approved procedure for supervision of the activities of the SRO of appraisers, neither there is a list of legal grounds for RosReestr to perform off-scheduled audits;
4) no legal provision that would fix the authorities to develop and approve the procedure for monitoring the SRO of appraisers' activities and for monitoring of this SRO by the relevant executive authorities.

That said, in H1 of 2011, real incomes did not post any increase nationwide, while in Moscow, they tumbled by 7.3% and climbed up by 1% in Moscow oblast. In H2, the electoral campaign fueled the rise in population incomes. According to data for the 11 months of 2011, the increase rate in the population's real disposable income in Moscow oblast was 4%, St. Petersburg – under 2%, while in the city of Moscow the said incomes slid by 2.5%[1].

Despite insignificant increase rates of the population's incomes, in the conditions of stable major macroeconomic and financial indexes, the earlier delayed effective demand began to unfold in 2010, which had a positive effect on the real estate market. In 2011, the effect of the factor of delayed demand proved mostly exhausted, and the 2010 recovery of the market proved insignificant in the conditions of falling rates of the population's income growth.

6.6.1. The Land Market

According to Rosreestr, the land area owned by residents tends to shrink and as of 1 January 2011 accounted for 121.4m hectares, or 7.1% of Russia's land vs. 124.3m hectares (7.3%) in 2009 (*Table 23).* By contrast, the land in corporate ownership expands and accounts for 12.1m hectares, or 0.7% of Russian land, up 02 p.p. vs. 2009 and 01 p.p. vs. 2010.

Table 23

Classification of Land in Russian Federation by Types of Ownership

Property form	As of01.01.2009		As of 01.01.2010		As of 01.01.2011	
	M hectares	% to result	M hectares	% to result	M hectares	% to result
Public and municipal	1576.9	92.2	1576.3	92.2	1576.4	92.2
Residents', including	124.3	7.3	123.2	7.2	121.4	7.1
Residents' land shares	107.4	6.4	104.3	6.1	100.8	5.9
Corporate	8.6	0.5	10.3	0.6	12.1	0.7
Private	132.9	7.8	133.5	7.8	133.4	7.8
Total	1709.8	100.0	1709.8	100.0	1709.8	100.0

Source: by data of Rosreestr.

By results of privatization, as of 1 January 2011, most land falls under the joint share property, including unclaimed shares (*Table 24*).

Table 24

Classification of Privatized Land by Forms of Property and Proprietors as of 1 January 2011

	Thos. of hectares	%
Joint share property (land shares owned by residents)	76 131.3	57.1
Residents' property (farming, agricultural, personal subsidiary farming, individual housing, gardening, summer housing, etc.)	20 546.5	15.4
Joint collective property	698.7	0.5
Land owned by corporations	12 064.1	9.0
Unclaimed land shares and land shares owned by residents	24 005.5	18.0
Total	133 446.1	100.0

Source: by data of Rosreestr.

According to Rosstat, as of 1 January 2011, out of land owned by residents (20, 546.5 Thos. hectares), 2.1% or 434.100 hectares, was allocated under individual housing (*Table 25*), while the respective figure as of 1 January 2010 was 439,300 hectares.

[1] Socio-economic situation in Russia in 2011, www.gks.ru

Table 25

Land Owned by Residents

	As of 01.01.2011	
	Thos. of hectares	**%**
Owners of land lots	8 374.5	40.80
Personal subsidiary farming	5 414.6	26.30
Peasants' (farmer) economy	4 809.1	23.40
gardening	797.9	3.90
Individual housing	434.1	2.10
Self-employed in agricutlure	532.8	2.60
Other purposes	183.5	0.90
Total	20 546.5	100.0

Source: by data of Rosreestr.

The greatest area in residents' ownership per 1,000 residents in 2010 was reported in Nenetsky Autonomous okrug – 20.7 hectares per capita (*Table 26*). The leading position in this regard among federal super-regions (okrugs) is held by Siberian Federal Okrug (0.85 hectares per capita), while at the bottom of the list was North-Western Okrug (0.32 hectares per resident).

Table 26

Classification of Land of Russian Federation by Property Forms across Subjects of Russian Federation and Federal Okrugs, as Hectares per 1,000 Residents (as of January 2011)

	Total area, Thos. hectares	**Land in residents' ownership, Thos. hectares per 1,000 residents**	**Land in residents' ownership, as % of the total area**	**Land in corporations' ownership, as % of the total area**	**Ranking in terms of the land area in residents' ownership per 1,000 residents**
1	2	3	4	5	6
Russian Federation	**12048.3**	**855.3**	**7.10**	**0.71**	
Nenetsky Autonomous Okrug	341727.9	20696.1	6.06	0.59	1
Republic of Kalmykia	26391.2	4603.7	17.44	0.05	2
Trans-Baikal krai	38666.3	3805.9	9.84	0.17	3
Orenburg oblast	5854.6	3453.7	58.99	2.26	4
Kurgan oblast	7544.4	3253.4	43.12	2.59	5
Altay Republic	44087.3	2917.5	6.62	1.44	6
Altay krai	6744.9	2572.6	38.14	1.36	7
Novgorod oblast	8647.8	2425.2	28.04	1.15	8
Volgograd oblast	4358.4	2418.6	55.49	2.83	9
Omsk oblast	7014.6	2278.3	32.48	3.66	10
Saratov oblast	3947.2	2178.0	55.18	6.93	11
Novosibirsk oblast	6708.1	2074.9	30.93	0.63	12
Khanty-Mansy Autonomous Okrug	5753.8	1940.9	33.73	1.28	13
Orel oblast	3034.0	1698.0	55.97	4.70	14
Tambov oblast.	3166.2	1692.6	53.46	8.74	15
Republic of Khakassia	11419.6	1633.3	14.30	0.11	16
Stavropol krai	2440.2	1479.5	60.63	5.39	18
Rostov oblast	2387.2	1461.6	61.23	4.11	19
Republic of Buryatiya	36464.7	1448.9	3.97	0.17	20
Kirov oblast.	8653.4	1438.6	16.62	3.53	21
Kursk oblast	2611.6	1428.9	54.71	8.59	22
Ryazan oblast	3439.6	1390.0	40.41	6.11	23
Amur oblast	42048.8	1382.3	3.29	0.10	24
Moscow oblast	678.2	112.2	16.54	11.13	71
Siberian federal okrug	26302.0	1559.2	5.93	0.28	17
Southern federal okrug	3069.1	1313.5	42.80	2.94	25

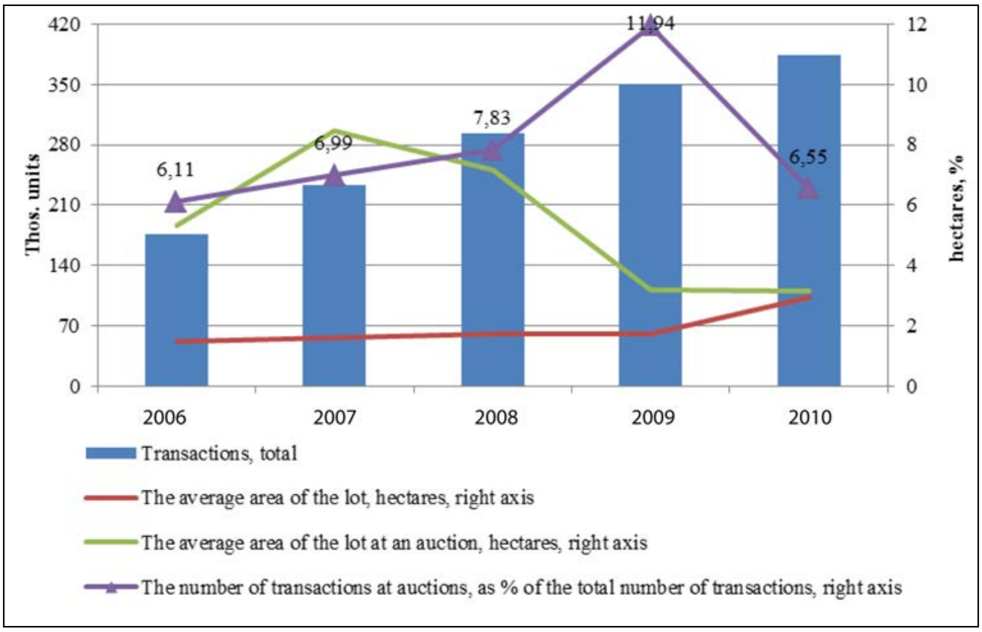
cont'd

1	2	3	4	5	6
Volga federal okrug	3444.0	1062.0	30.84	3.73	33
Ural federal okrug	14808.5	757.1	5.11	0.32	42
Central federal okrug	1751.7	558.5	31.88	5.93	55
North-Caucasian federal okrug	1841.6	463.1	25.15	2.15	63
Far-East federal okrug	95791.3	345.3	0.36	0.03	69
North-Western federal okrug	12554.6	324.3	2.58	0.31	70

Source: The state (national) report "On the state and use of land in Russian Federation in 2010" национальный)

The number of cases of sale of public and municipal land was rising steadily, and in 2010 alone, there were 384,600 transactions involving land plots of total area of 1,124.680 hectares, with the average area of a land plot expanding up to 2.92 hectares (*Fig. 15*). When compared with the 2009 figures, the number of land plots sold increased by 33,894 and their area grew by 513,940 hectares.

The number of transactions of auctioned land plots nationwide in 2010 slid to 25,185 from 41,868 transactions reported in 2009. Area-wise, the 2010 total area of sold at an auction land plots was 79,044.77 hectares vis-à-vis 133,028.2 hectares a year before. The number of transactions made at auctions hit its peak in 2009 (11.94% of all the land transactions) and dwindled to 6.55% in 2010. The average area of land plots sold at an auction, on the contrary, is down; thus, the gap between it and the average area of public and municipal land lots sold is narrowing (*Fig. 15*). As many as 14.369 land lots of the average area of 7,204.52 hectares were sold at an auction for individual housing and summer housing, while 5,864 land lots with the average area of 1,139.08 hectares were sold for personal subsidiary farming, gardening, vegeculture, cattle breeding. In the overwhelming majority of cases the cost of auctioned land was higher than the price at which it was redeemed from the public and municipal property.



Source: The state (national) report "On the state and use of land in Russian Federation in 2010".

Fig. 15. Dynamic of Sales of Public and Municipal Land

According the 2010 State (national) report, Russian residents bought 268,736 land lots of total area of 4,921.000 hectares for individual and summer housing, personal subsidiary farming, vegeculture, gardening and cattle breeding. That was at 25,736 lots more than in 2009, with the average area of such lots having changed from 0.66 to 0.18 hectare

When compared with 2009, the national average price of land lots in settlements designated for individual and summer housing remained unchanged, with the fall accounting for a meager 0.09%. Federal Okrug-wise, price differences are substantial: in the Central Okrug prices were up 140%, while in the Ural one – down 62%. (*Table 27*). Prices for land lots designated for the said purposes but located outside settlements were down 54.62%. The average national prices of land lots for industrial construction were likewise in decline, but prices for land lots designated for agrarian production were on the upsurge (*Table 27*).

Table 27

Average Prices of Public and Municipal Land Lots Sold to Private Individual and Corporations in 2010 (as Rb/M²)

Federal okrugs	Citizens and their associations:				Legal entities for industrial and other special use		Peasant (farmer)households, other agrarian organizations	
	Individual and summer housing		Personal subsidiary farming, vegeculture, gardening and cattle breeding					
	In settlements	Outside settlements	In settlements	Outside settlements	In settlements	Outside settlements	In settlements	Outside settlements
Russian Federation	58.05	2.9	14.14	6.09	74.78	12.18	11.03	4.76
Change over the year, as %	-0.09	-54.62	-58.59	31.82	-54.00	-9.64	181.38	230.56
Central	94.56	0	20.27	15.08	255.57	17.53	74.82	1.2
Change over the year, as %	140.30	n/a	-64.36	129.53	-73.48	28.33	1262.84	-4.76
North-Western	21.53	8.43	7.91	9.68	38.31	22.6	0.85	1.61
Change over the year, as %	-82.79	2.68	-83.44	137.25	153.54	-23.70	-14.14	71.28
Southern	26.5	0.55	12.27	1.28	41	10.29	2.96	1.18
Change over the year, as %	0.04	25.00	-26.35	-50.58	152.62	17.20	218.28	-83.81
North-Caucasian	101.58	0	18.93	0.14	138.85	10.62	0.8	1.28
Change over the year, as %	-7.04	n/a	-81.93	-17.65	-3.90	477.17	-40.30	265.71
Volga	28.43	8.92	12.19	6.71	30.58	18.09	2.02	11.85
Change over the year, as %	24.97	-52.45	27.91	-29.52	-7.14	-54.83	81.98	2135.85
Ural	19.66	0.41	4.33	2.62	46.82	9.66	5.53	2.6
Change over the year, as %	-62.39	-79.90	-19.07	12.45	5.90	74.68	276.19	1633.33
Siberian	43.92	3.59	5.79	8.04	23.69	6.94	1.27	6.9
Change over the year, as %	15.18	-79.74	-5.24	53.14	-38.96	15.28	111.67	702.33
Fra-East	128.23	1.33	31.46	5.15	23.39	1.7	0.02	11.48
Change over the year, as %	149.23	n/a	20.63	-19.91	-48.02	-28.27	-99.90	6652.94

Source: The state (national) report “On the state and use of land in Russian Federation in 2010”.

The specific weight of lease of public and municipal land in the overall volume of the land market in terms of the number of transactions accounts for 64.0%, and area-wise – 87.1%. In 2010 to 2009, the number of various effective lease agreements plunged from 3,514.600 units (113, 081.800 hectares) to 3,403.600 units (138, 576.700 hectares). The average rental payment for public and municipal lots for (summer) housing in settlements in 2010 was up 28.6%

compared to 2009 and accounted Rb 17.27/m², while that outside settlements dropped 32.3%, down to Rb 0.86/m² (*Table 28*).

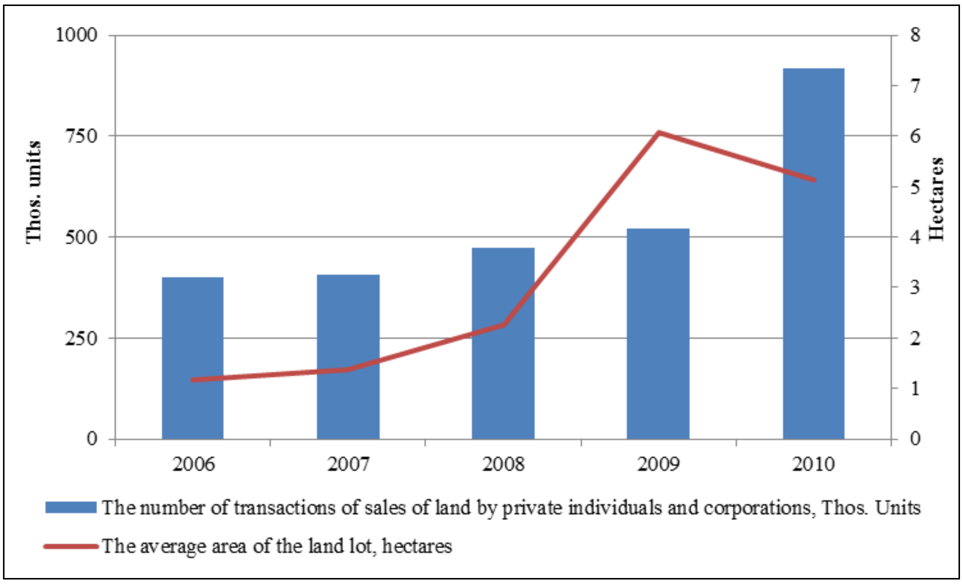
Table 28

The Average Size of Rental Fee for the Use of Public and Municipal Land in Russian Federation (as Rb/M²)

Tenants	2007		2008		2009		2010	
	In settlements	Outside settlements	In settlements	Outside settlements	In settlements	Outside settlements	In settlements	Outside settlements
1.Corporations, organizations, institutions: from the industrial sector								
Transport, communications, construction	20.59	3.45	19.62	10.36	29.48	40.40	58.81	4.75
Trade, public catering, household and consumer services	74.19	9.69	719.2	22.08	200.52	14.85	131.20	24.73
Agricultural corporations	0.33	0.03	3.76	0.22	2.76	2.23	10.42	0.8
2. Residents, their associations, using land lots for construction of housing and summer housing								
construction of housing and summer housing	3.68	1.03	7.47	5.95	13.43	1.27	17.27	0.86
Personal subsidiary farming, vegeculture, gardening	0.36	0.15	0.66	0.07	1.49	0.17	2.02	1.07

Source: The state (national) report "On the state and use of land in Russian Federation in 2010".

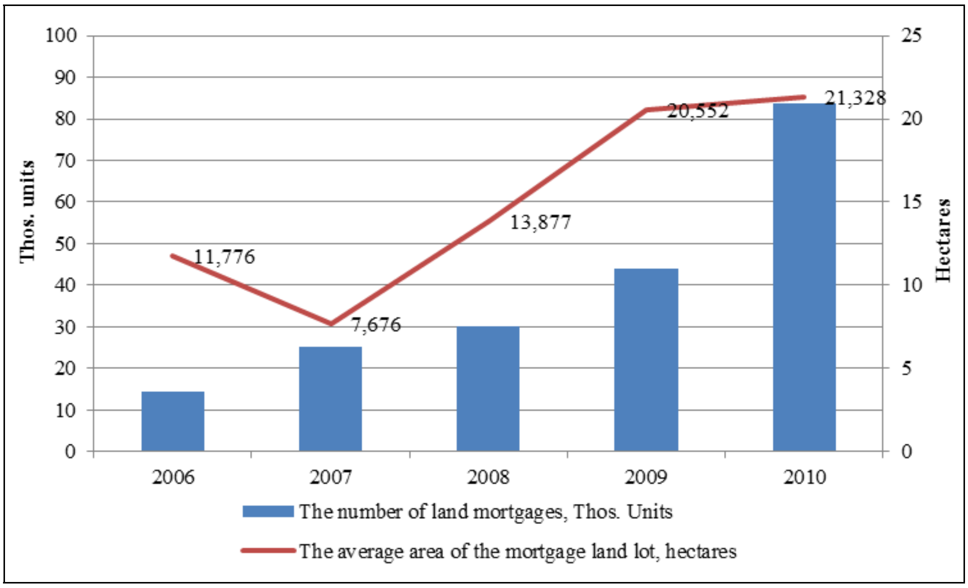
The 2010 turnover of private land lots accounted for 917,354 transactions (*Fig. 16*) of the total area of 4,706.821 hectares, or up 76.3% transaction-wise and 49.0% - area-wise vs. the 2009 figures. The average area of a land lot per transaction in 2010 was 5.13 hectares vs. 6.07 hectares in 2009.



Source: The state (national) report "On the state and use of land in Russian Federation in 2010".

Fig. 16. Dynamics of Sales by Private Individuals and Corporations of Privately Owned Land Lots

The number of mortgage transactions involving land lots in 2010 was 1.9 times greater than in 2009 (*Fig. 17*), with the total mortgage area accounting for 1,786.079 hectares. The average area of the mortgaged land lot in in 2010 was 21.3 hectares, or slightly over the 2009 figure.



Source: The state (national) report "On the state and use of land in Russian Federation in 2010".

Fig. 17. Dynamic of Mortgaging of Land Lots by Private Individuals and Legal Entities

The share of the area of privately owned (by private individuals and corporations combined) mortgaged land lots in the total area of a federal okrug varies from 0.24% in far-East Federal Okrug to 2.44% in the Central one. The 2010 average national figure was 1.33%, or nearly twice as high as in 2009 (*Table 29*). The share of mortgaged agricultural land in the total area of mortgaged land was down to 79.54% from 86.88% in 2009.

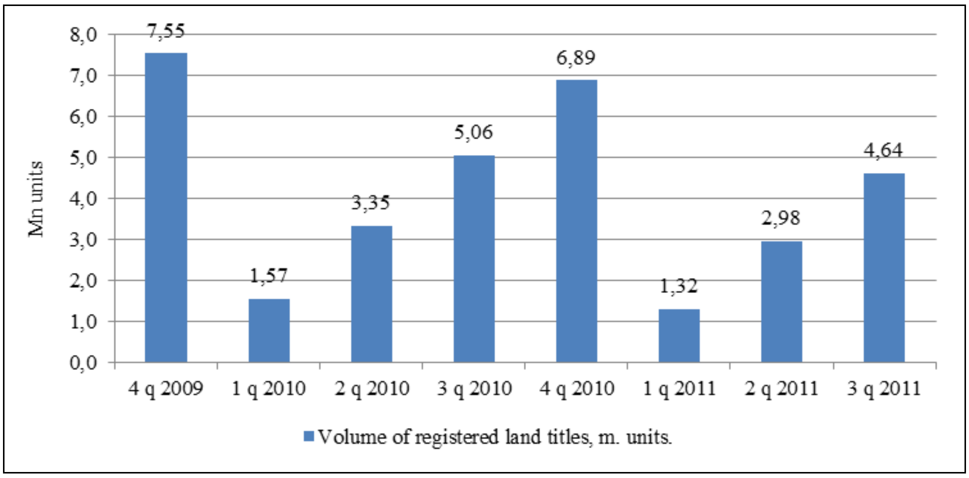
Table 29

Characteristic of Mortgaged Land in Russian Federation in 2010

Federal okrugs	Land owned by private individuals and corporations	Of which mortgaged		Including agricultural land	
	(by state accounting), Thos. hectares	hectares	%	hectares	%
Russian Federation	**133446.1**	**1 786 079.51**	**1.33**	**1 420 645.88**	**79.54**
Central	24582.2	598 936.52	2.44	577 217.34	96.37
North-Western	4873.8	30 892.23	0.63	16 500.46	53.41
Southern	19249.5	76 375.36	0.40	45 668.32	59.79
North-Caucasian	4652.3	25 207.41	0.54	22 196.90	88.06
Volga	35847.8	554 631.38	1.55	531 866.40	95.90
Ural	9874.5	204 812.89	2.07	37 661.23	18.39
Siberian	31959.6	289 376.52	0.91	185 963.30	64.26
Far-East	2406.4	5 847.23	0.24	3 571.94	61.09

Source: The state (national) report "On the state and use of land in Russian Federation in 2010".

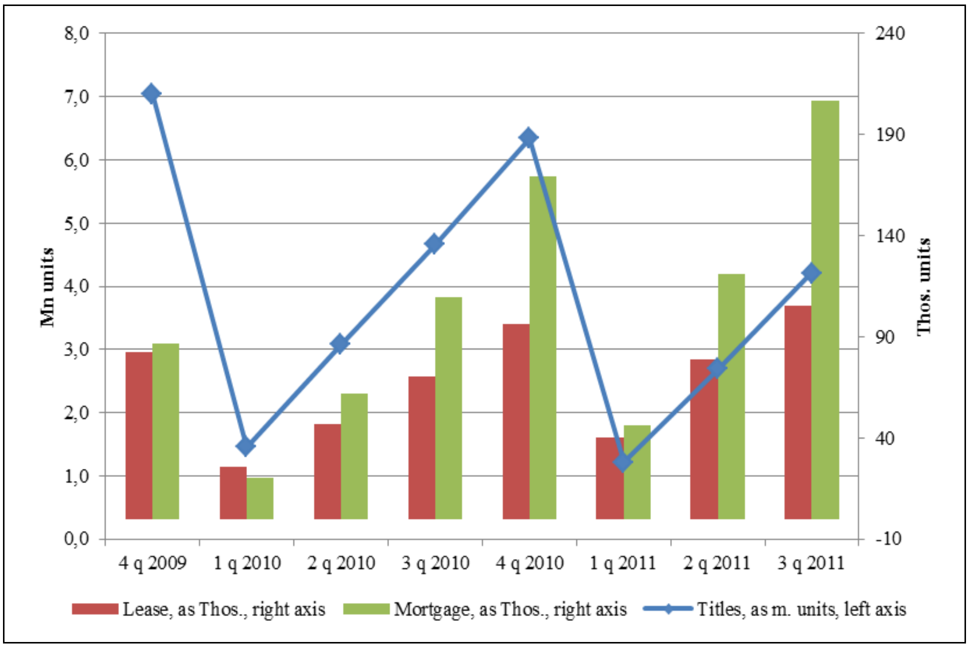
According to Rosreestr, the 2011volume of registered land titles was down vs. respective periods of 2010 (*Fig. 18*), which may evidence a decline of the turnover of land lots. More specifically, the fall in Q1 2011 vs. Q1 2010 was 15.8%, H1 2011 vs. H1 2010 – 11.1%, and over the first three quarters 2011 vs. the same period of 2010 – 8.4%.



Source: data of Rosreestr.

Fig. 18. Volume of Registered Land Titles

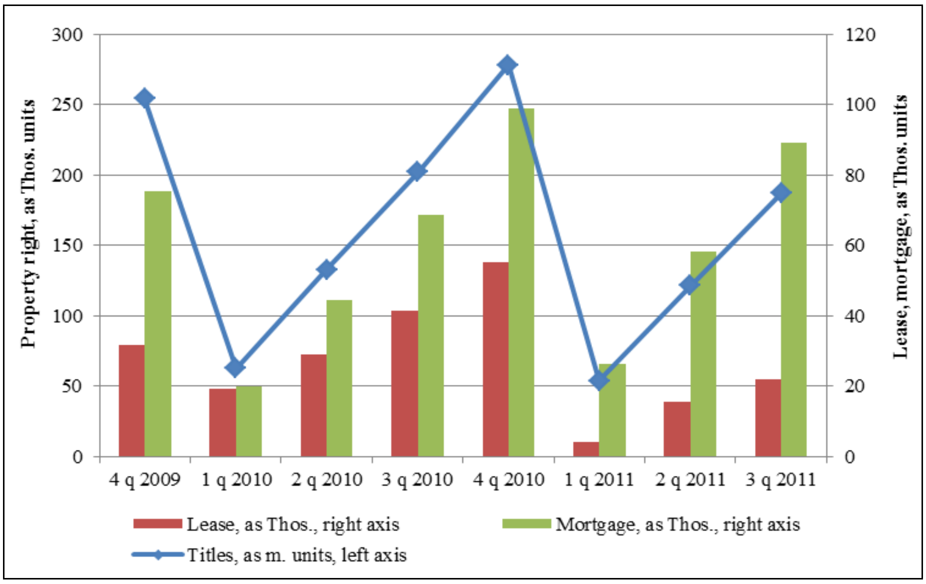
While the volume of state registration of private individuals' land titles over the three quarters 2011 was down 9.7% vs. the same period of 2010, volumes of registration of land lease and mortgage contracts by private individuals over the period in question rose by 49.5% and 88.5%, respectively (*Fig. 19*).



Source: data of Rosreestr.

Fig. 19. Dynamic of Registration of Private Individuals' Rights to Land Lots

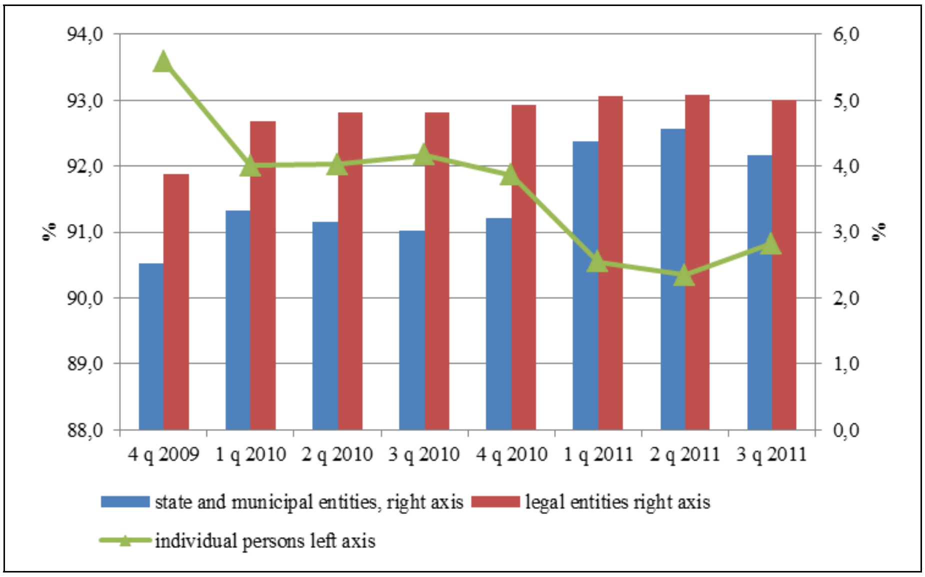
According to Rosreestr, as of 1 October 2011, volumes of state registration of property rights to, and lease of land lots by legal entities were down 7.4% and 47.1%, respectively, on a year-on-year basis, while the volume of registration of mortgaged land lots over the period in question rose by 29.7% (*Fig. 20*).



Source: data of Rosreestr.

Fig. 20. Dynamic of Registration of Corporate Rights to Land Lots

The distribution pattern of volume of state registration of land titles (*Fig. 21*) shows that in terms of the number of registrations 90% of the land lots turnover falls on private individuals. As of 1 October 2011, the share of registrations of land titles by private individuals was down by 1.35 p.p. compared with 1 October 2010 and accounted for 90.82%, while shares of corporations and public and municipal entities were up 0.2 p.p. and 1.15 p.p., respectively.



Source: data of Rosreestr.

Fig. 21. Dynamic of Distribution of Registered Land Titles between Private Individuals, Corporations and Public and Municipal Entities

On 1 February 2011, Rosreestr submitted to territorial bodies of the Federal Tax Service data on all the land lots subject to taxation. The tax base to calculate the land tax I formed by the cadaster value of a land lot, with the land tax rate calculated as percentage thereof and the actual amount of the tax is set accordingly. Specifically, the 2006 weighted average national cadaster value of 1 hectare of agrarian land was up by Rb 8,067 vs. the 2003 figure. The increase in the specific indicator of cadaster value was particularly notable in the Central, North-Caucasia and Southern federal okrugs where the average value of 1 hectare of agrarian lands rose more than 1.8 times; in the North-Western and Volga federal okrugs, the respective figure was 1.7 times up. By results of cadaster valuation works, the most valuable agrarian lands whose cadaster value stand at Rb 8.39/m² are located in Krasnodar krai.

Most municipal legislatures (a. 60% of them) rule to establish maximum cadaster value-based land tax rates within their jurisdictions. In compliance with the Tax Code of Russian Federation, the maximum land tax rate on land lots falling under the categories of agrarian land, as well as land lots designated for housing and engineering infrastructure, personal subsidiary farming, vegeculture, gardening or cattle breeding, as well as summer housing, accounts for 0.3% of the cadaster value of the lands. Meanwhile, as to other lands not exempt from the land tax, the maximum tax rate on them is 1.5% of their cadaster value.

According to FTS, in 2010, as much as Rb 109,414bn was collected from cadaster-based land tax payments, or 18% up vs. the respective period of 2009 (Rb 92.44bn).

Since 1 January 2012, while registering property rights to land plots under industrial enterprises, the effect of the beneficial redemption rate of 2.5% of the cadaster value was terminated and replaced with market prices. The RF Ministry of Economic Development estimates the share of enterprises having passed the re-registration procedure at the level of no more than 70%.

6.6.2. Price Situation on the Housing Market[1]

In 2009, the price downfall on the housing market was ubiquitous. In 2010, the city of Moscow saw the beginning of a gradual price rise (up by 10%), while most cities in the sample were experiencing an oscillating price stability. Price increases in nominal terms were noted everywhere, except for Nizhny Novgorod, Stavropol and Shakhty; however, in real terms they were down practically everywhere, except Moscow and Novosibirsk.

In 2011, the dynamic of nominal housing prices across the sample of 20 cities and Moscow oblast was as follows (*Table 30*):

[1] All calculations were made on the basis of monthly data on the average specific housing offer price in Russian cities provided by certified by RGR real estate market analysts Sternik S.G. (Sternik′s Consulting Ltd.), Beketov A.G (all from Moscow and Moscow oblast), Bobashev S.B., Bent M.A., GK «Real Estate Bulletin» (St. Petersburg), Khorkov M.A. Antasyuk A.A., Tukhashvili G.T. (all from RITS UPN, Ekaterinburg), Sosnitsky E.G., Titul (Rostov-on-Don), Chemodanov A.L., "Indicators of Nizhny Novgorod Real Estate" (Nizhny Novgorod), Ermolaeva E.A., Salmina K.A., RID Analitics (Novosibirsk, Kemerovo, Barnaul, Krasnoyarsk), Molodkina C., ALCO Association (Tyumen), Epishina E.D., Epishina Yu.V., GK "Kama Valley" (Perm), Khairullina N.A., "United Regions (Ufa), Zyranova G.N., «KuzbassInvest Stroy» (Kemerovo), Moskalev A.A., «InvestOtsenka» (Voronezh), Kovalchuk N.I., RK «Sluzhba nedvizhimosti» (Chelyabinsk), Savina M.Yu., «Agentstvo pechati i informatsii», Kazakov R., «Ryazan Real Estate» newspaper (all from Ryazan), A.M. Cheremnykh, UK «ASSO-Stroy» (Izhevsk), Trofimov A.S., "Ilecta" center (Stavropol), E.R. Gamova., «Real Estate» Center (Ulyanovsk), Trushnikov A.V., «B.I.N.-Expert» (Sterlitamak), Eydlin G.Yu., «Realty» (Shakhty).

Table 30

Dynamic of the Average Specific Apartment Offer Price on the Secondary Housing Market

City (region)	Тыс. руб./кв. м			Index relative to Moscow		Increase to 2010, %	
	December 2009	December 2010	December 2011	December 2010	December 2011	Nominal	Real
Moscow	153.0	168.5	185.5	1	1	10.1	3.8
St. Petersburg	81.1	82.3	88.3	0.488	0.476	7.3	1.1
Moscow oblast	71.5	73.0	80.0	0.433	0.431	9.6	3.3
Ekaterinburg	53.0	55.5	63.8	0.329	0.344	15.0	8.3
Rostov-on-Don	48.4	50.5	55.8	0.300	0.300	10.5	4.1
Nizhny Novgorod	46.4	45.8	49.58	0.272	0.267	8.3	2.0
Novosibirsk	45.5	49.7	50.8	0.295	0.274	2.2	–3.7
Tyumen	43.1	45.4	53.0	0.269	0.286	16.7	10.0
Perm	42.4	44.1	48.4	0.262	0.261	9.8	3.4
Krasnoyarsk	40.3	43.5	48.8	0.258	0.263	12.2	5.7
Ufa	41.0	43.9	49.2	0.261	0.265	12.1	5.6
Kemerovo	40.3	40.6	44.4	0.241	0.239	9.4	3.1
Voronezh	Н/д	35.8	41.3	0.212	0.223	15.4	8.7
Chelyabinsk	36.8	37.2	39.9	0.221	0.215	7.3	1.1
Ryazan	35.4	37.7	40.8	0.224	0.220	8.2	2.0
Barnaul	34.4	35.1	40.2	0.208	0.217	14.5	7.9
Izhevsk	33.3	34.9	39.6	0.207	0.213	13.5	6.9
Stavropol	32.1	30.5	31.6	0.181	0.170	3.6	–2.4
Ulyanovsk	31.0	31.8	34.2	0.188	0.184	7.5	1.4
Shakhty (Rostov oblast)	27.0	26.3	27.6	0.156	0.149	4.9	–1.1
Sterlitamak (Bash-kortostan)	22.9	23.7	28.5	0.141	0.154	20.3	13.3

In 2011, nominal prices were on the rise in all the cities of the sample, with the range of the increase being a broad one: from 2.2% in Novosibirsk to more than 20% in Sterlitamak. In Moscow, the price rise accounted roughly for 10%, like a year ago. It mostly was Ural and Siberian cities (Tyumen, Ekaterinburg, Barnaul, Izhevsk, Krasnoyarsk, Ufa), as well as Voronezh and Rostov-on-Don, where the price increases were greater than in Moscow.

By contrast, the group of cities where price increases were lower than in Moscow is located largely in the European part of Russia (Moscow oblast, Nizhny Novgorod, Ryazan, Ulyanovsk, St. Petersburg, Shakhty, Stavropol), as well as Perm, Kemerovo and Chelyabinsk. Quite notably, like Moscow oblast, Perm and Kemerovo’s price increases were just slightly below Moscow’s.

The Russian capital remained an absolute leader in terms of the price level for housing. In more than a half of the cities of the sample housing prices were at a level of 20 to 30% of Moscow’s. The gap was somewhat narrower in Ekaterinburg (0.344), Moscow oblast (0.431) and St. Petersburg (0.476) prices. Meanwhile, at the bottom of the list (15-20% of Moscow’s price level) were Ulyanovsk, Stavropol, Sterlitamak, and Shakhty.

In most cities of the sample the December 2011 price level vis-à-vis Moscow’s one was less than in December 2010, except for a few cities in the Urals and Siberia (Ekaterinburg, Ufa, Izhevsk, Sterlitamak, Krasnoyarsk, Barnaul), and Voronezh, albeit all those changes were quite negligible.

Unlike the prior year, the 2011 the housing prices in real terms (less the 6.1% annualized inflation on the consumer market) (the IGS index)[1] were on the upsurge in most of the cities in question, except for Novosibirsk, Stavropol and Shakhty, where real prices were down (1–4%). Atop the leading group in terms of increase in real housing prices were Sterlitamak (13.3%), Tyumen (10%), Voronezh, Ekaterinburg, Barnaul, Izhevsk, Krasnoyarsk, Ufa (between 5 and 9%).

As to the correlation between prices on the primary and secondary markets, it is worthwhile to note Moscow, with the specific price on the secondary market being lower than that on the primary one (in 2011 – at 12–17%) (*Fig. 22*).

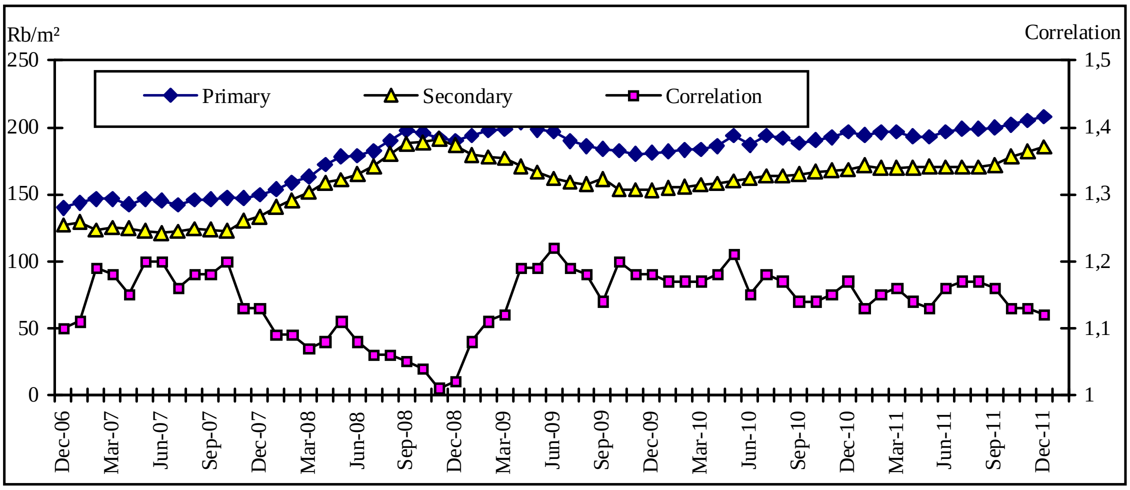


Fig. 22. Price Correlation between the Primary and Secondary Markets in Moscow

By contrast, prices in most other cities, as a rule, were higher on the secondary market: the gap was: in Izhevsk – 2–7%, Ryazan – 5–15%, St. Petersburg – 13–16,3%, Stavropol – 16,5–20%, Perm – 13–21%, Moscow oblast – 15–20%, Novosibirsk – 17–25.5%, Tyumen – 22–27%.

In this context, mavericks became Chelyabinsk and Ufa, where the gap proved pretty narrow, and Nizhny Novgorod where through most of 2011 prices on the secondary market have been following the trend noted in other cities, but by the fall they had caught up with or exceeded those on the secondary market.

The main driver of such differences is the differentiation of the quantitative-qualitative structure of housing on the markets concerned. In Moscow, roughly a half of the offer on the primary market is formed by residential property of advanced quality (business and elite class housing). By contrast, in the other cities, the absolute bulk of offer concentrates in the economy-class and middle-class segment. Plus, the quality of newly built housing differs across the cities with regard to the presence/absence of interior works and their quality, and stages of construction (and, accordingly, the cost) as of the moment of payment of the co-investment contract. The price correlation also changes in time, due both to changes in the quality of housing under construction and the state of the market determined by developers' price differences in response to change in demand during the crisis.

[1] The IGS index is calculated using the following formula: IGS=Ipr/Icp, where Ipr is the housing price index in Rb. equivalent, Icp – consumer price index.

6.6.3. Revitalization on the Real Estate Market

Revitalization of the real estate market started yet in late 2009. In 2010, with the deferred demand back to the market, it bounced back to the pre-crisis level. The distinctive feature of the 2011 housing market became its expansion, which was fueled both by the deferred demand and deferred offer ("investment" apartments, collaterized housing, etc.), which resulted in a considerable increase of offer and secured a lack of shortages on the housing market.

Data on Moscow serves a perfect illustration of the trend. Back in 2009, the number of apartment sales accounted for 55,680 deals, thus being at its record lows over the whole post-Soviet history of the market. By contrast, in 2010 the volume of deals added 54% and hit 85,700, thus having caught up with the all-time pick of 2003. In 2011, the number of deals cleared a new height by having added another 6.4% and accounting for 91,200 deals (*Fig. 23*).

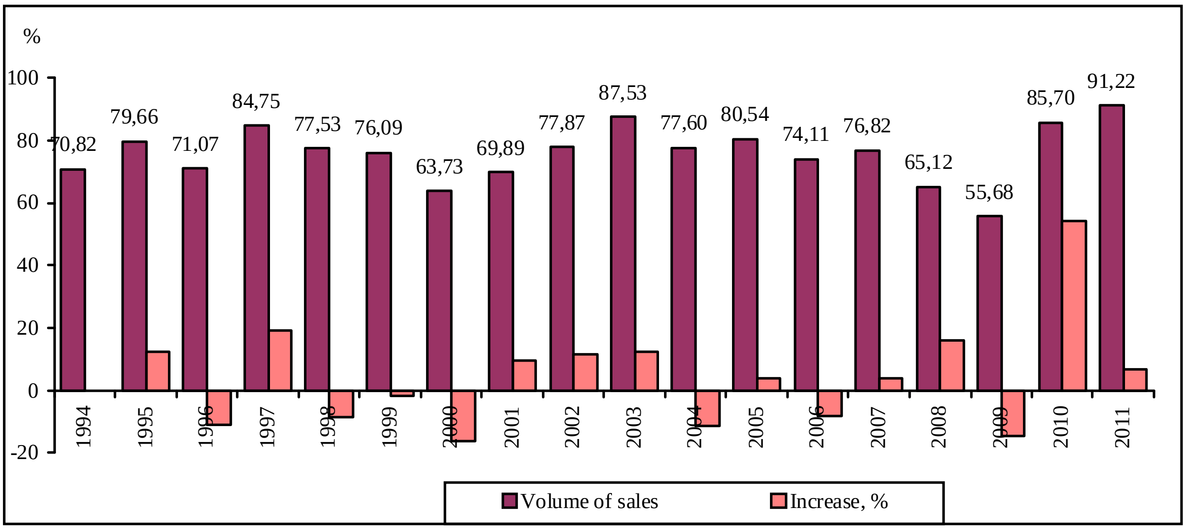


Fig. 23. Annual Volume of Apartment Sales on Moscow's Secondary Market

Such a combination of dynamics of the market indicators (moderate price rise rates under a rally on the market) shows that the market has found itself in the phase of revitalization with a tendency to transition to the phase of growth: with demand having renewed, offer now matches demand and, should the population's incomes continue growing, the price rise rates may accelerate.

In 2011, Moscow saw continuation of the rise in the volume of mortgages – they accounted for 24,000 vs. 20,000 a year before. The increase (roughly by 20%) of course is no match to a nearly 4-fold one in 2010, but at the time, we noted a post-crisis bounce back of the mortgage mechanism from a very low 2010 benchmark.

Increase in the proportion of mortgage deals in the aggregate number of housing deals slowed down in 2010–2011 at the level of 23–26% (26–29% in individual months of 2011), which roughly corresponds to the share of direct apartment purchases (with the rest of the deals being alternative ones, which are financed at the expense of sales of the existing apartments).

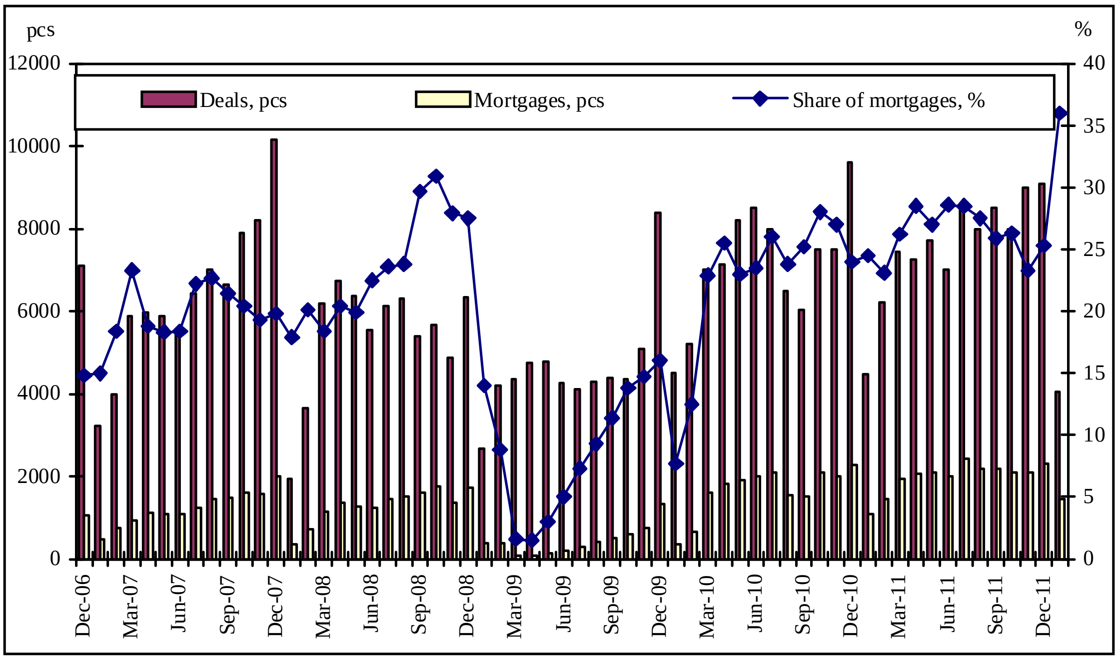


Fig. 24. Dynamics of Turnover of Housing and Mortgage Markets in Moscow

6.6.4. Dynamic of Placement of new Housing in Operation and Prospects for Institutional Development of Housing Provision Mechanisms

In 2011, volumes of placement of new housing in operation have posted growth for the first time since the start of the financial crisis (by 6.6% on a year-on-year basis). The volume of such housing accounted for 788,200 apartments with the total area of 62.3m m² (*Table 31*), with the increase being noticed only since H2.

Table 31

Placement of Housing in Operation in Russia in 1999–2011

Year	M m² of total area	Increase rates, %	
		to the prior year	to 2000.
1999	32.0	104.2	105.6
2000	30.3	94.7	100.0
2001	31.7	104.6	104.6
2002	33.8	106.6	111.5
2003	36.4	107.7	120.1
2004	41.0	112.6	135.3
2005	43.6	106.3	143.9
2006	50.6	116.0	167.0
2007	61.2	120.9	202.0
2008	64.1	104.7	211.5
2009	59.9	93.4	197.7
2010	58.4	97.5	192.7
2011	62.3	106.6	205.6

Sources: Russian Statistical Yearbook. 2007: Stat. collection./ Rosstat, M., 2007, p. 507; Russian Statistical Yearbook. 2011: Stat. collection/ Rosstat, M., 2011, p. 461; On housing in 2011, www.gks.ru, the authors' calculations.

So, the year 2011 saw the record-breaking figures of placement of new housing in operation, well in excess of the pre-crisis 2007 figures, which in turn were twice as big as the 2000 ones. This creates good preconditions for hitting the historic peak for the 2000s already reported once in 2008 (despite the rise of a sharp phase of crisis in the fall of the year, effects from the investment collapse echoed in the house-building sector only in 2009).

The proportion of individual house construction in the aggregate area of housing completed in 2011 accounted across Russia for 42.9%. In terms of the rate of placement of housing in operation (4.6%) individual house construction roughly corresponded to the 2009 figures, while in terms of its specific weight –the 2008 figures. Individual house construction prevailed in a number of regions (Altay Republic, Bashkortostan, Ingushetia, Dagestan, Tyva, Kabardino-Balkaria, Karachaevo-Cherkessia, Chechnya, Astrakhan and Belgorod oblasts) and accounted for between 73.3 and 94.5% of the total area of completed housing construction projects.

Positive dynamics of housing construction was noted in the overwhelming majority of Russian regions, including those where the aggregate volumes of placement of housing in operation exceeded 1m m^2 (*Table 32*).

Table 32

Dynamics of Placement of Housing in Operation in Russian Regions in 2011 (Adjusted by Housing Placement Rates)

Region	Housing Placement Rates, as % to 2010.
Samara oblast	127.8
Chelyabinsk oblast	122.6
Tatarstan	118.2
Stavropol krai	115.1
Tyumen oblast	113.9
Kemerovo oblast	108.0
Dagestan	107.7
Krasnoyarsk krai	106.3
Bashkortostan	105.1
Belgorod oblast	104.3
Rostov oblast	104.0
Moscow oblast	103.5
Leningrad oblast	103.0
Sverdlovsk oblast	102.7
Krasnodar krai	102.3
Moscow	102.1
Saratov oblast	102.1
St Petersburg	101.9
Nizhny Novgorod oblast	101.4

Source: On housing construction in 2011, www.gks.ru.

As evidenced by *Table 32*, Samara. Chelyabinsk, Tyumen (including Khanty-Mansy and Yamal-Nenetsky autonomous okrugs[1]), Tatarstan and Stavropol krai reported the dynamics of placement of new housing in operation be in excess of the average national figures (over 10%). Meanwhile, the increase in volumes of housing construction in the city of Moscow and St. Petersburg roughly made up a meager 2%. Moscow oblast posted a higher increase rate (3.5%), which was nearly twice as low as the national averages nonetheless.

That said, it should be remembered that since 2004 Moscow oblast has been the leading region nationwide in terms of absolute figures of placement of new housing in operation,

[1] That said, Yamal-Nenetsky Autonomous Okrug proved one of 13 regions where volumes of placement of new housing in operations were in decline.

while the city of Moscow started sinking along the respective ranking in the course of the last crisis and has plunged below a whole range of regions, including – for the second straight year – St. Petersburg. The specific weight of the capital region in the aggregate volume of the nationwide housing construction accounted just for 16.1% (16.4% in 2010), of which the lion's share (13.2%) fell on Moscow oblast's, while the share of the city of Moscow was 2.9%[1].

Such a situation seems quite logical. Throughout the whole 2011, the newly appointed City Hall has been busy reviewing earlier concluded 1,000-plus investment development contracts, including those in the housing construction sector. As a result, as many as 200 out of some 600 contracts were terminated. The canceled contracts mostly concerned downtown and infill development. The fact of the revision of the contracts of course has affected construction expansion rates in the city[2].

A mighty tool to clear the capital's urban space to give room to implementation of new approaches to the local development policy will be provisions of Federal Act of 12.12.2011 No. 427-FZ "On introducing amendments to Art 2 and 3 of the Federal Act "On implementation of the Land Code of Russian Federation" and individual legislative acts of Russian Federation" which provide for the following critical amendments.

A contract of lease of a public or municipal land lot located within the limits the of city of Moscow or St. Petersburg and concluded prior to 1 January 2011 for the sake of construction, reconstruction of real estate objects may become subject to early termination unilaterally by a respective public agency or local self-government body[3], where there has occurred a substantial breach of terms and conditions of the agreement of lease of such a land lot and or a substantial change of circumstances from which the parties to the agreement proceeded while entering into it.

The list of cases of the substantial breaches which may form the reason for a unilateral termination of such contracts by a public agency or local self-government body, include the following ones: (1) failure to honor obligations with respect to construction, reconstruction of the real estate object within the timelines provided for by the agreement, or (2) where there are no such timelines stipulated in the said agreement, for the term of which the permit on construction, reconstruction of the said object was granted, in the event the degree of the construction completion of the real estate object as of the last day of such a term is under 40% of the overall volume of its construction, reconstruction provided for by design documentation approved following the procedure established by the RF law; (3) an absence, upon expiration of 5 years from the date of conclusion of the said contract of permit for construction, reconstruction of the real estate object, construction of which is provided for by the said contract, in

[1] At this point, it should be noted that the Rosstat data also evidence that in 2011 in the territory of the city of Moscow, including the area of Lubertsy Fields, as much as 2,107.300 m² of total area of housing was placed in operation (106.9% to the 2010 figures), or roughly 300,000 m² more than in the aggregate table across all Russia's regions (1,805.200 ²m). No earlier published data on the aggregate placement of housing in operation over a number of years, including the housing built under the Moscow Government's program beyond the city's territory, were available.

[2] Boykova M. The epoch of construction minimalism.-In: Direct Investment, No. 12 (116), 2011, p.99.

[3] The contract of lease of such a land lot is considered terminated upon one month from the date of dispatch by the government agency or local self-government body of the contract termination notification. Prior to expiration of the said timeline, the party to the contract may forward the said agency/body its objections in writing with regard to the termination of the contract. In that case, the contract is deemed terminated since the date of dispatch of the notification of confirmation of the earlier made decision.

the event the contract in question does not provide for a date of completion of construction, reconstruction of the said object.

A material change of circumstances, from which the parties to the contract proceeded while entering into a contract of lease of the land site, under which the government agency or local self-government body is permitted to unilaterally terminate the contract, is termination of another agreement between the said agency/body and a public or municipal institution or unitary enterprise which provides for construction, reconstruction of a real estate object on such a land site leased per the said contract.

Provisions introduced with respect to investment contracts appear analogous to the above, except for a slightly reworded formulation of the material change of circumstances from which the parties thereto proceeded while entering into the contract and which allows its unilateral termination by the state. The material change of circumstances is the impossibility to fulfill obligations with regard to completion of construction, reconstruction of real estate objects due to the impossibility to allocate a land plot s per the law, as well as due to existence of a real burden or encumbrance with respect to titles held by third parties which prevent its construction, reconstruction.

Approved in September 2011, the city of Moscow's state program "Housing" for the medium term (2012-16) provides for construction over the period in question of 12.7m m² of housing at the expense of all sources of financing, including 3.8m m²-at the expense of budget funds. So, average annual figures should make up some 2.5m m² and 0.8m m², respectively, or less than those reported in the crisis 2009, to say nothing of the pre-crisis H2 2010.

Together with continuation of already existing programs of improvement of housing conditions (free allocation of housing, social mortgage, installment sale, resettlement of slum, rundown and morally obsolete housing and the one subject to demolition), the new accent in the City Hall's policy should become expansion of the housing fund for lease (construction of commercial and unsubsidized residential property) and major overhaul of the existing housing in a volume nearly twice in excess of the one of newly constructed housing (23.5m m²). The City Hall should also fulfill obligations with regard to provision of housing (with account of various payments) before 88,000 families (208,000 people)[1].

Prospects of expansion of housing construction in the capital region will be in many ways driven by effects from the decision to expand Moscow to South-West made on the federal level in the summer of 2011.

The ambitious plans to develop the so called 'New Moscow" suggest building in new territories some 60m m² of housing and 45m m² of office space (particularly to accommodate to-be-relocated plethora of government agencies and a financial center). The holistic approach to development of newly acquired city territories provides for creation of more than 1m highly qualified job opportunities and provision of housing to 2m Muscovites, and construction of office space and social, cultural and household objects. At the same time, the density rate in the newly developed areas is envisaged to be lower than within the Moscow Ring Road, particularly thanks to low-rise housing constructed with the use of modern technologies. It is planned to allocate huge funding out of the federal budget for the project implementation.

The factor of Moscow's expansion has already strongly affected the state of the real estate market in the capital region. Once announced, the future change of the metro's limits immedi-

[1] Resolution of the Government of Moscow of 27 September 2011 No. 454-PP.

ately caused a spike of previously unseen activity on the real estate market, with mass media fanning the boom.

Despite the summer holidays and traditional tranquility in all the business sectors, July and August 2011 broke long-standing record in terms of demand for apartments on the primary market. Between the late summer and early autumn 2011, developers' front offices were overstretched, and the pressure concerned both projects located in the new Moscow's territory other areas in Moscow oblast, too. Between the summer and early autumn 2011, demand for apartments on the market for newly built housing in the areas adjacent to the city of Moscow increased 2.5 times, while the number of deals with newly built housing in the territories to be added to Moscow was momentarily up 4-fold and remained on a fairly high level through October 2011. Presently, the level of activity is lower than last summer, but remains fairly high nonetheless. Some decline in the boom of demand is noticed on the market for newly built housing both in New Moscow and other areas near the city of Moscow.

Because of the change of the city of Moscow's limits by including therein a sizeable area south-west of the city and the subsequent record-breaking increase in demand, initially, prevailing sentiments on the local metro market were:

(1) anticipation of a rapid speculative price rise for real estate on the primary and secondary markets in the areas in question to make a fortune on rumors of inclusion of certain territories in the city of Moscow;

(2) anticipation of a mass increase in the number of new investment and development projects in the new Moscow's territory and their entering the market any time soon;

(3) anticipation of some price adjustments on the Moscow city real estate market, particularly in the territories adjacent to the future Moscow areas.

That said, by results of the period in question, no drastic price rise for housing in the above territories was noted. For instance, some complex residential development projects saw average prices having added just 5 to 7% over the 3-4 month-long period. At this point, it should be noted that similar price rise rates were noted across all the projects located in the same region, except for a few projects where prices were raised by 20-30%. Those, however, were unique cases and out of the mainstream trend.

It is prospects of the project's further development which will largely affect the atmosphere on the real estate market, the degree of consumer trust and demand. Disappointment of those who, spurred by discussions on Moscow's expansion, have already invested in real estate in the new territories may emerge as a significant factor fueling a collapse of the market and the rise of mass claims to return private investments, which would mean sizeable losses for developers operating in New Moscow.

As to the general situation across Russia, in 2011, the nation's leadership vowed to bolster availability of mortgage for some groups of residents by cutting the interest rate and the amount of the initial installment. Meanwhile, alternative to mortgage approaches to the housing problem, such as cooperative housing societies (CHS) and housing savings societies (HSS), and building-and-loan-associations (BLA), started drawing an increasingly greater attention.

One of the first steps in that direction became enactment of amendments to Federal Act of 24.07.2008 No. 161-FZ "On assistance to expansion of housing construction".

Presently, employees at regional and municipal educational, healthcare institutions were added to the list of groups of residents[1] who, while establishing a HSS, have the right to apply to the Federal Fund for Assistance to Development of the House Construction (FFADHS) for a free land plot for a cooperative housing construction project. Such an arrangement generates certain preconditions for cutting down construction project costs, as the FFADHS's principal vehicle nonetheless are auctions on land plots, which implies the market interaction between demand and offer, which clearly falls short of securing a greater availability of housing. Plus, HSS enjoy some tax benefits, while their members potentially have possibilities to influence progress in a construction project implementation (by electing the project management, having access to documentation, etc.).

While assessing this novelty, it is worthwhile to note first that an evident hurdle to the spread of the mechanisms in question remains the problem of a low level (relative to costs of housing) of labor compensations in the economy in general and in the public sector in particular. The challenge will inevitably arise under any organizational and legal arrangement (whether a share-based contribution while joining an HSS, or the amount of the initial installment while obtaining a mortgage).

That said, the alternative mechanisms bear certain risks. More specifically, by contrast with participation in a shared construction project, membership with a housing association does not necessitate a compulsory project declaration, obtaining a construction permit and registration of all transactions. HSS members may face expulsion, the need to bear subsidiary responsibility for the association's obligations within the limits of a non-invested fraction of an additional contribution of each HSS member and cover possible losses by collecting additional contributions under the threat of liquidation of the HSS pursuant to its creditors' claims[2].

It is quite likely that the alternative vehicles have a long and winding road to travel, as far as the problem of improvement of their operational mechanisms is concerned, thus following the dependency path of shared construction projects back in the mid-'2000s. The proportion of housing put in operation by HSSs in the overall volume of housing placed in operation in 2008-10 thus far has fallen short of exceeding even 1% (2000 – 2.4%, 2005 – 1.4%)[3].

As well, problems of administrative barriers and monopoly in the housing construction sector have remained persistent, though the crisis has given rise to an ongoing process of shaping up of a new configuration of the construction market. Thus, in the early autumn of 2011, a co-owner of BIN-bank in tandem with "Sberbank Investment Ltd", a Sberbank's subsidiary, acquired JSC Inteco, Paritet and all their affiliated structures (though the Sberbank Investment's stake is a symbolic 5%). The assets, which were not limited to construction and development, were acquired for as much as USD 1.2bn[4].

6.6.5. The Home Loan Sector

According to the CBR, over 11 months 2011, as many as 656 credit institutions disbursed 449,210 mortgage loans (ML) for a total of Rb 613,355bn, or up 1.95 times vs. the respective figure as of 1 December 2010. The number of ML as of 1 November 2011 evidenced the out-

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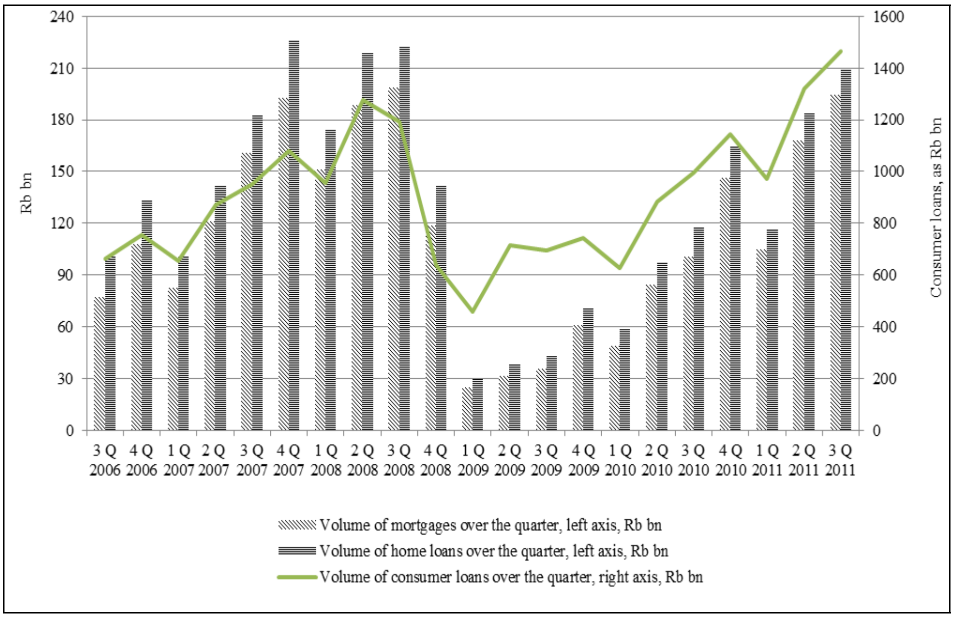
[1] The right in question was earlier granted solely to the federal-level public servants (including the military), staff of federal public enterprises and unitary enterprises, educational and academic research institutions.
[2] Sanzhiev D. Associations may challenge mortgage //Economics and Life, No. 01 (9417) 13 January 2012, p. 19.
[3] Russian statistical yearbook. 2011: Stat. comp./Rosstat, M., 2011, p. 461.
[4] Inteco sold - In: Direct investment, No. 10 (114)б 2010, p. 72.

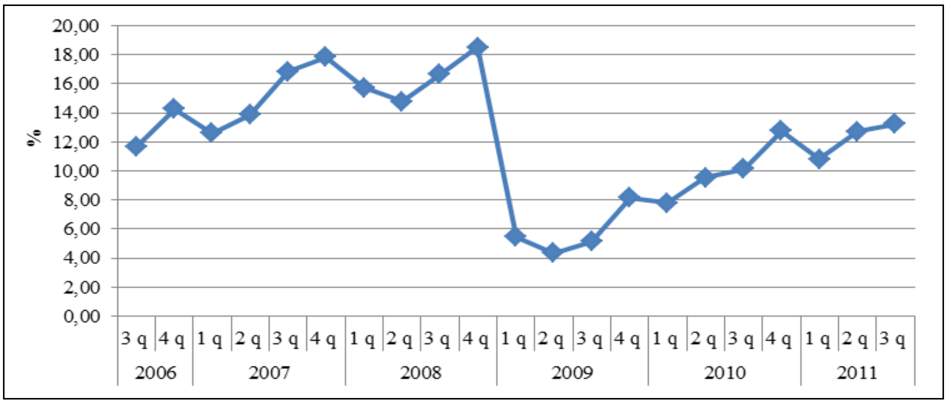
running of 2008 when 602 credit institutions extended, throughout the year, 349,502 ML worth a total of Rb 655.8bn; by volume of extended ML Q3 2011 practically caught up with Q3 2008 (!*Fig. 25*).



Source: data of CBR.

Fig. 25. Quarterly Dynamic of Loans Extended to Private Individuals

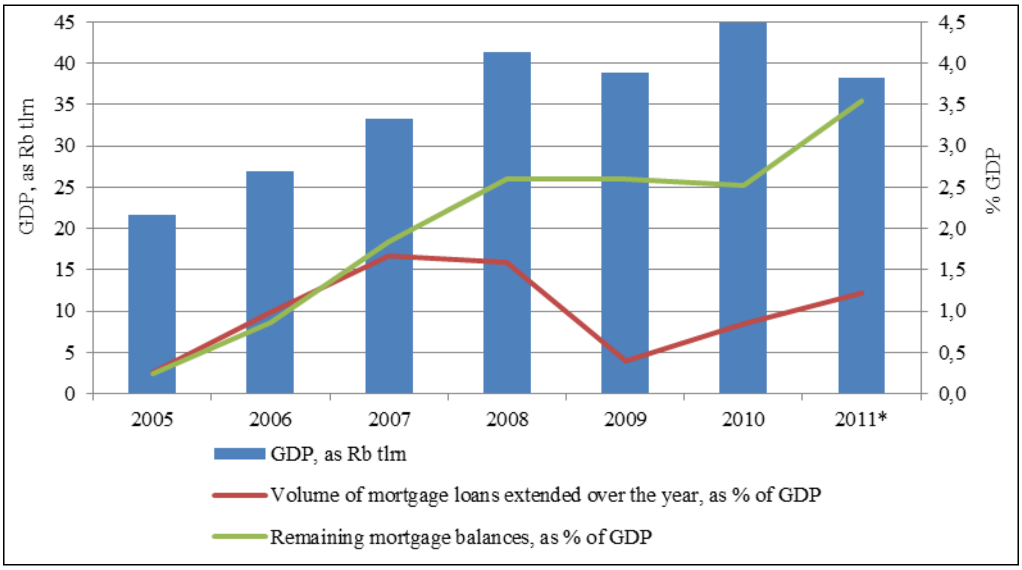
In Q3 2011, the share of ML in the volume of consumer lending added 3.13 p.p. vs. Q3 2010 and hit 13.25% (*Fig. 26*). The volume of consumer lending in Q3 2011 accounted for Rb 1,466.78bn (the proportion of ML therein making up 13.25%), thus having outrun the pre-crisis peak of Rb 1,275.46bn. (the share of ML – 14.77%) reported in Q2 2008 (*Fig. 26*). The increase rate of the respective share of ML trails behind the increase in the volume of consumer lending. The pre-crisis peak values of shares of ML and HL in the volume of consumer lending (Q408: 18,5% and 22.24%, accordingly) were not attained either.



Source: the CBR data.

Fig. 26. Dynamic of the Proportion of ML Extended to Private Individuals over the Quarter in the Volume of Consumer Lending, as %

The volume of ML extended as of 1 October 2011 accounted for 1.22% of the respective GDP vs. 0.85% in 2010 and the 2007 peak pre-crisis value of 1.67%. (*Fig. 27*). The arrears by ML as of 1 October 2011 accounted for 3.54% of GDP, or 1.3% higher than in 2010 and 0.93 p.p. higher than the peak pre-crisis value in 2008.

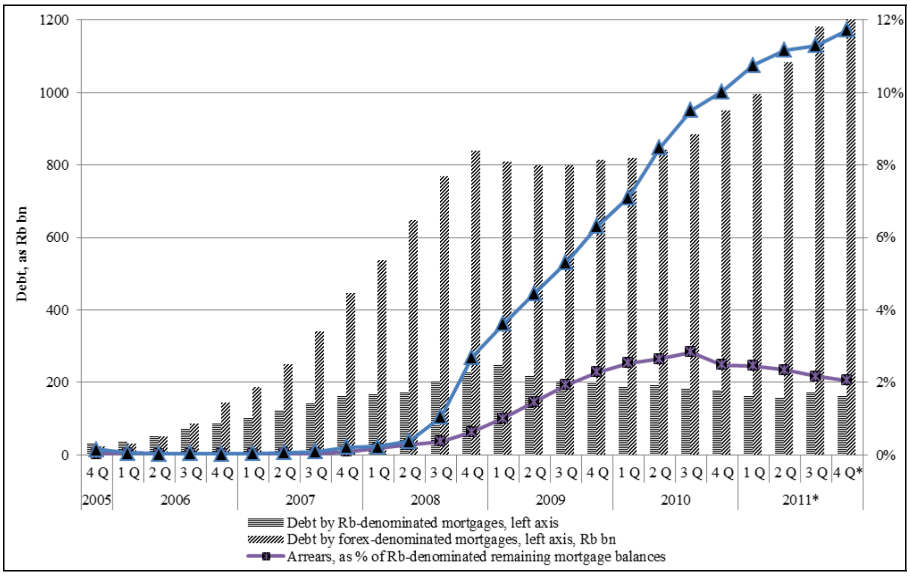


Source: the CBR data.

Fig. 27. Dynamic of Mortgage Lending, as shares of GDP, %

The year of 2011 saw continuation of the increase in the remaining Rb-denominated mortgage balances and decline in the share of outstanding payables in the remaining debt balances (*Fig. 28*). As of 1 December 2011, the Rb-denominated mortgage arrears rose by 37.3% vs. 1 December 20101 and accounted for Rb 1,261.878bn. The volume of arrears was down 0.78 p.p. vis-à-vis 1 December 2010 and accounted for 2.06% of the outstanding payables. During the period in question, the volume of forex-denominated remaining mortgage balances tumbled by 12.4% and made up Rb 163,357bn, while outstanding debt was up 1.74 p.p. and hit the level of 11.72%. As of 1 December 2011, the Rb-denominated remaining mortgage balances in cash equivalent increased up to Rb 26,006bn, while the forex-denominated ones climbed up to Rb 19,152bn.

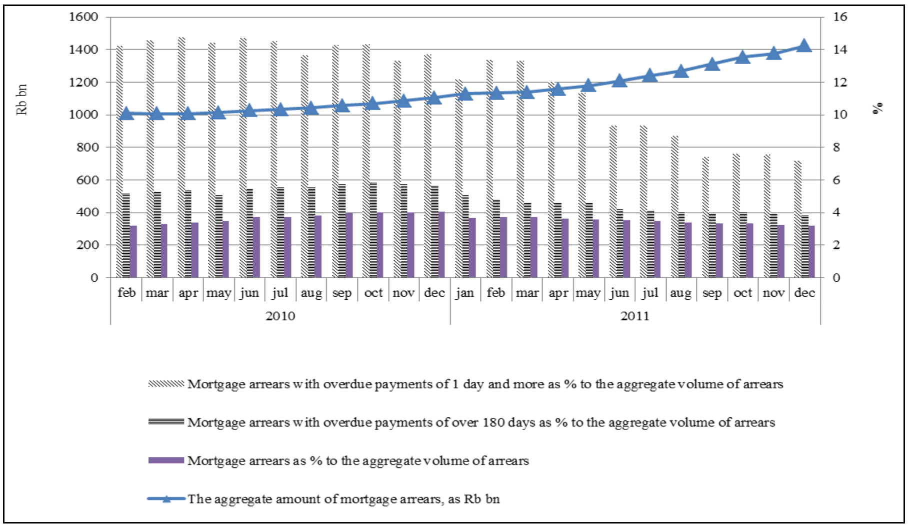
According to data of the Federal Service for State Registration, Cadaster and Cartography, as of 1 October 2011, private individuals had registered as many as 683,032 cases of mortgage lien with the United State Titles Registry Database.



Source: the CBR data.

Fig. 28. Dynamic of Remaining Mortgage Balances and Mortgage Arrears

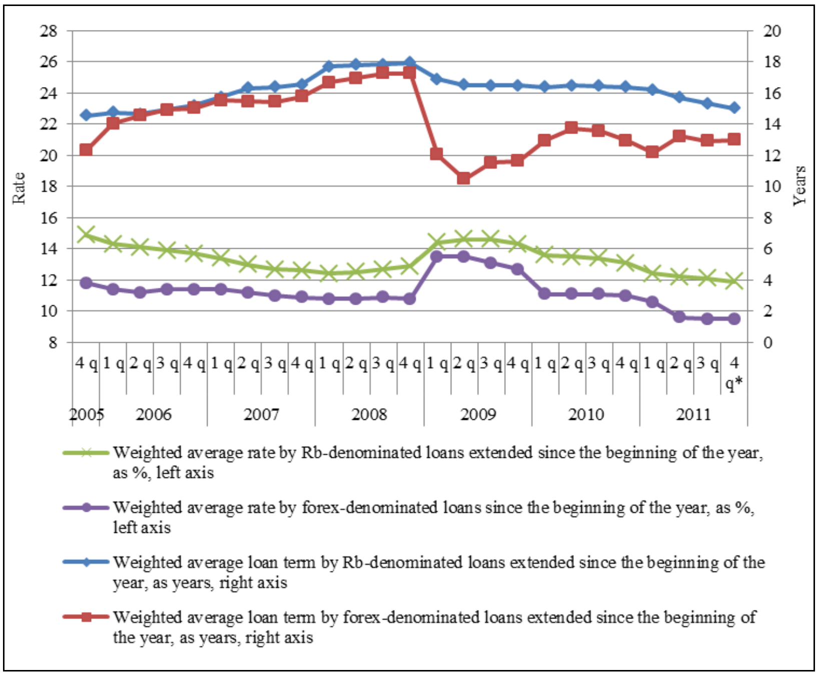
The year of 2011 saw increase both in remaining mortgage balances without outstanding payments and their proportion in the overall amount of the debt (*Fig. 29*). As 1 December 2011, the proportion of such arrears (Rb 1,324.185bn) in the total amount of the debt accounted for 92.91%, or down 5.08 p.p. vs. 1 January 2011. The proportion of mortgage arrears with overdue payments over 180 days (default loan arrears) in the overall amount of arrears as of 1 December 2011 was also down by 1.27 p.p. vs. 1 January 2011. In 2011, there was noticed a trend both to fall in the proportion of mortgage arrears with overdue payments over 180 days and decline in proportion of mortgage arrears in the overall debt.



Source: the CBR data.

Fig. 29. Dynamic of Mortgage Arrears and Overdue Payments in Terms of Payment Delays

In 2011, the weighted average rate by Rb-denominated mortgages disbursed since the beginning of the year slid from 13.1% as of 1 January 2011 down to 11.9% as of 1 December 2011 (*Fig. 30*). The weighted average rate by forex-denominated mortgages was also down since the beginning of the year from 11.0% to 9.5%.

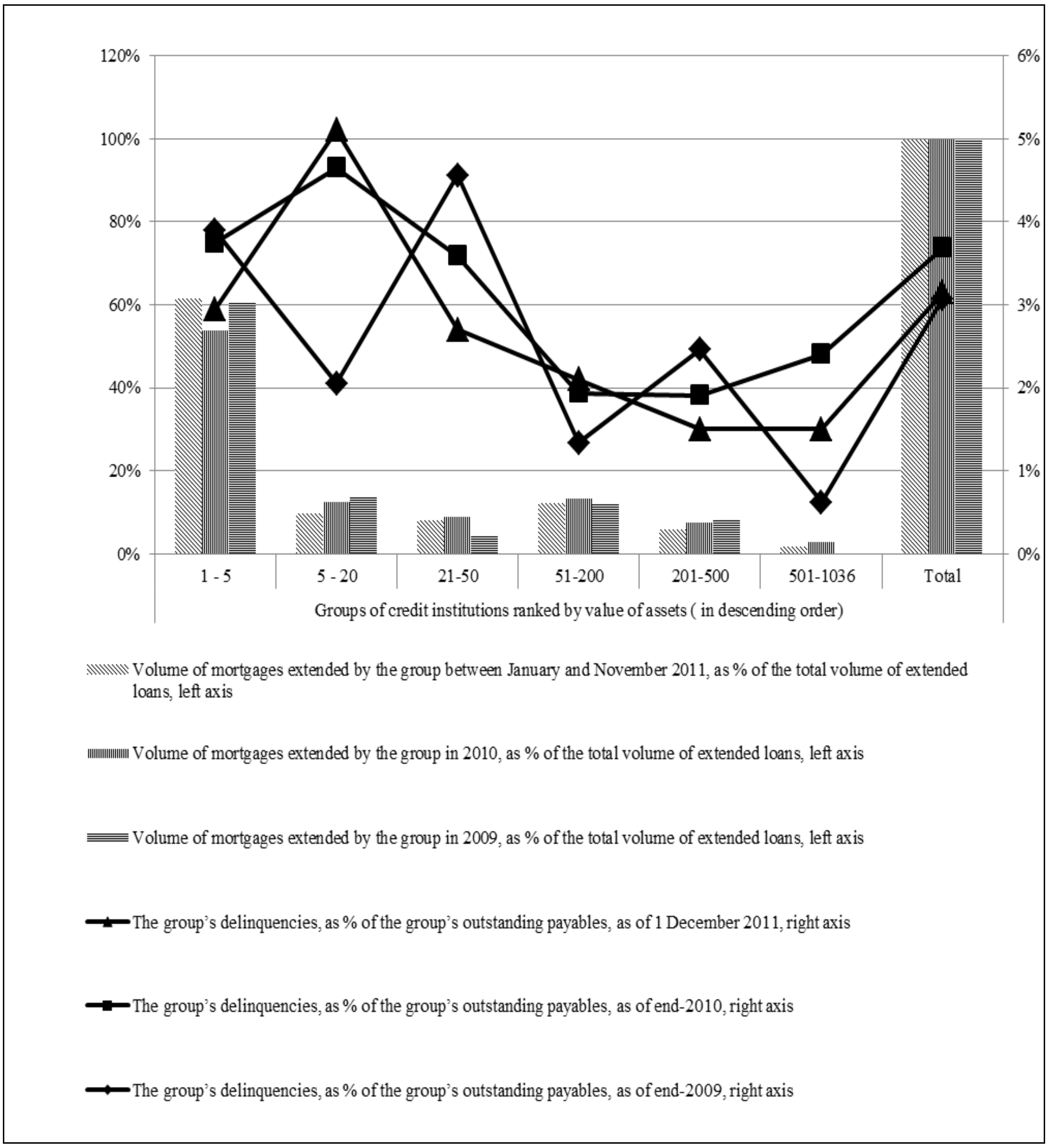


Source: the CBR data.

Fig. 30. Weighted Average Interest Rates and Loan Term by Disbursed since the Beginning of the Year Rb- and Forex-Denominated Mortgages

The weighted average loan term with regard to Rb-denominated mortgages extended since the beginning of the year was down from 16.36 years as of 1 January 2011 to 15.02 years as of 1 December 2011, while the weighted average loan term by forex-denominated mortgages made up 12.98 years as of 1 December 2011. (*Fig 30*).

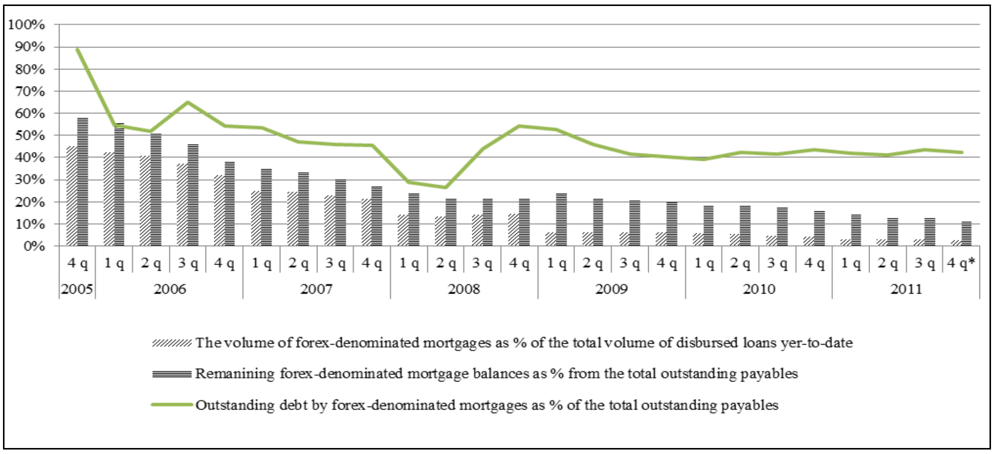
The fall to 54.02% in 2010 in the share of the Top-Five assets-wise credit institutions in the overall volume of ML extended throughout the year was replaced between January and November 2011 with its rise up to 61.88% and redistribution of volumes between other groups (*Fig. 31*). In 2009, it was the third group which exhibited the greatest share of arrears (4.56%), while in 2010-2011 it was the second group whose mortgage portfolio proved the most risky one (4.65% в 2010 and 5.12% in 2011). The second and third groups proved close to each other when it comes to volume of lending; however the third group's mortgage portfolio (2.80% of arrears) proved less risky than the second one's (5.1%).



Source: the CBR data.

Fig. 31. Quantitative and Qualitative Expansion of ML across groups of Credit Institutions Ranked by Value of Assets

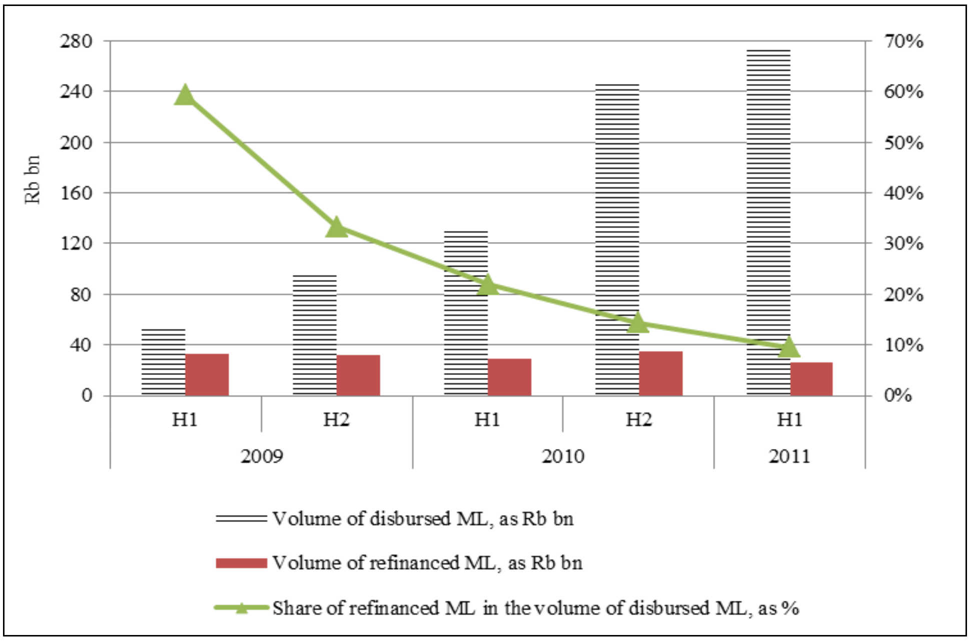
When compared with Q211, the proportion of forex-denominated ML in the total volume of ML surged 0.35 p.p. and accounted for 3.2%, while the proportion of forex-denominated remaining ML balances in the overall debt soared 0.02 p.p., up to 12.79%. The proportion of arrears by forex-denominated mortgages between 2010 and 2011 varies between 39.06% and 43.4%, and as of 1 November 2011 accounted for 43.36% (*Fig. 32*).



*as of 1 December 2011.
Source: the CBR data.

Fig. 32. Correlation between Rb-Denominated and Forex-Denominated Mortgages

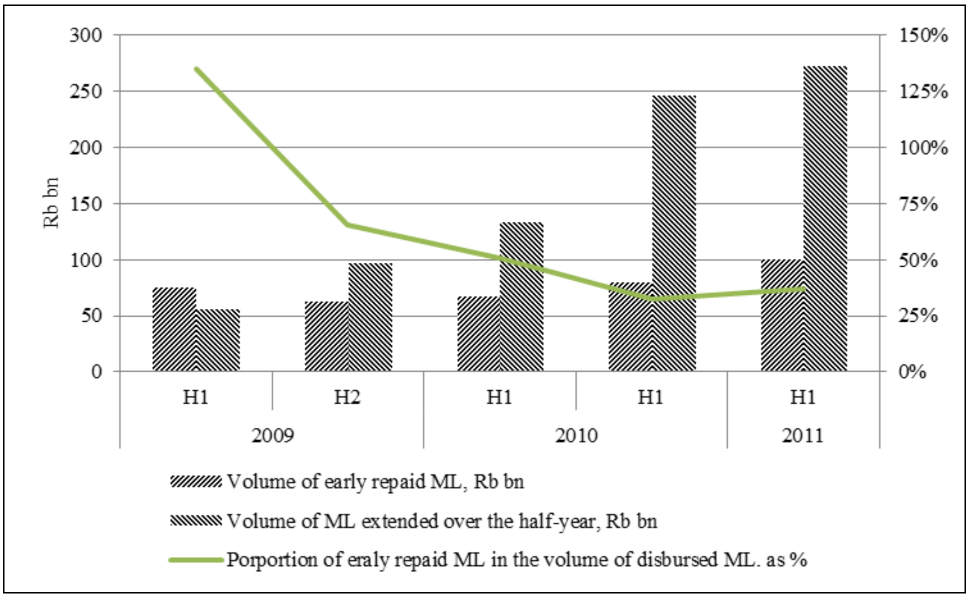
According to CBR, in H1 2011, as many as 131 organizations, including 19 credit ones, refinanced ML with the sale of the pool (rights of claim with regard to mortgage loans) worth a total of Rb 25.9bn (*Fig. 33*), or 9.5% of the volume of mortgage loans disbursed over the first half-year. The proportion of 102 specialized resident organizations accounted for 86.4% of the volume of refinancing, with no refinancing carried out by non-resident organizations.



Source: the CBR data.

Fig. 33. Dynamic of Refinancing of ML (Rights of Claim)

As of 1 July 2011, the amount of early repaid ML accounted for Rb 100.3bn, or 36.75% of the volume of loans extended in the first half-year, with borrowers having repaid Rb 80.401bn with their own moneys. In the first half 2010, as much as Rb. 67.6bn was repaid, or 50.67% of the volume of disbursed ML (*Fig. 34*).



Source: the CBR data.

Fig. 34. Dynamic of Early Repayment of ML

In 2011, JSC AHML refinanced 40,255 mortgages for a total of Rb 51.3bn (*Table 33*).

Table 33

Redemption by JSC AHML of Mortgages in 2011

	Across all products	Standard product	Military mortgage	Maternity capital	Newly built housing	Others
Mortgages redeemed, pcs	40 225	22 719	9 829	3 053	4 437	162
Mortgages redeemed, Rb m	51 255	23 827	18 575	3 632	5 005	185
Average value of mortgage, Thos. rb	1 274,2	1 048,8	1 889,8	1 189,7	1 128,2	1 147,2

Source: data of JSC AHML.

6.6.6. Outlook for the Housing Market

Forecasting the pricing dynamic on the Russian housing market in the previous years[1] was built on the premise of the 2010 price stabilization and anticipation of the beginning of a price rally in 2011-2012; that said, the price rise was anticipated to be more moderate than in 2000-01 (with the trend taking the **L-form**).

The outlook for 2011 and beyond followed the methodology built upon the use of a mathematical model of correlation between price rise rates and the pace of increase of average per capita incomes for different types of markets[2].

The data on the pace of increase of the population's real incomes and anticipated inflation was borrowed from the Medium-Term Forecast of Socio-Economic Development of RF for 2011 and 2012-13[3] and corresponding regional forecasts, with dynamics of main socio-

[1] See the IET 2009 and 2010 annual reviews of the state of Russia's economy.
[2] Sternik G.M., Sternik S.G. Typology of real estate markets by propensity to generate price bubbles. – Journal "Property relations in RF" No. 8 (95) 2009, p. 18–28.
[3] Sternik G.M. Methodology of forecasting housing prices due to the type of market. – Journal "Property relations in RF" 2011, No. 1, pp. 43–47.

economic indicators therein being closer to average national figures, except for Perm krai[1]. The type of the market assumed for 2011 was: for Moscow- an expanding one, for St. Petersburg, Moscow oblast – stable in the first half of the year and expanding in the 2nd half-year, and for Perm (with account of a lower increase in real incomes and a higher inflation rate) – stable throughout the year.

The comparison between the actual data and the outlook for 2011 shows that the latter proved true only partially.

In Moscow, the actual figures biased downward from the forecast, which should be ascribed to a smaller increase in the population's incomes vis-à-vis the government's forecast. By contrast, real prices on the secondary housing market in Perm, Moscow oblast and St. Petersburg slightly outpaced the forecast ones, which can be attributed to the actual increase of the local residents' incomes slightly outpacing the forecast value.

The outlook for 2012 was calculated following the same methodology and using the original data on the rate of increase in the population's incomes, as stipulated in the said Medium-term program (*Fig. 35*).

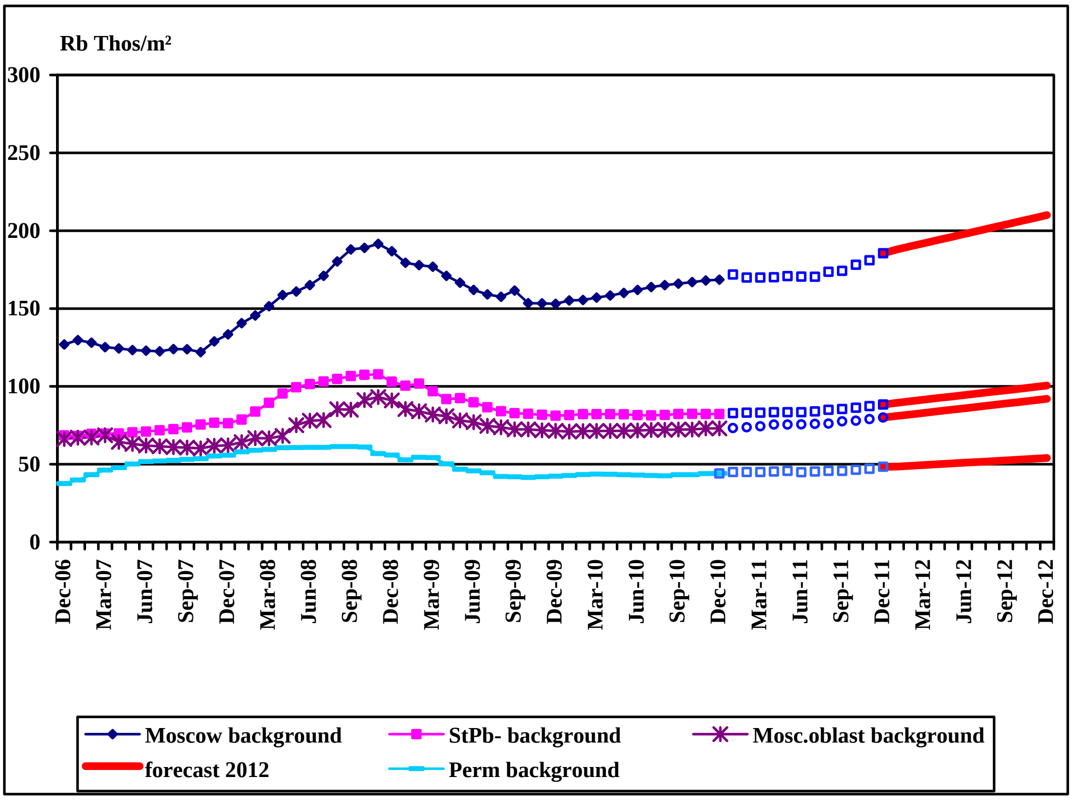


Fig. 35. Offer Price Outlook for the Secondary Housing Market

Given the instability and the impact of the ongoing socio-political and macroeconomic situation (relatively high oil prices, an appreciating Rb, and slightly decelerating inflation), the year of 2012 may see a slight increase in the population's incomes, which is the major

[1] Basic data for the development of scenarios of economic development of the Perm Krai through 2012 (main scenario factors). – http://www.gorodperm.ru. They envisage slow growth of the real income of the population (2%) and greater regional inflation (12,5%).

factor affecting the price dynamic on the housing market. Price rise rates can accelerate, should the population's incomes keep soaring. According to the outlook, the price rise rates in Moscow and across the other cities should make up between 11 and 14%.

6.7. Military economy and the military reform in Russia

The transition to "a new image" of the Armed Forces of the Russian Federation that started back in 2008 and continued through 2011 was clearly planned, as the Russian top military leaders affirmed. In practice, however, these plans proved to be "unbaked" and required on-line corrections and removal of deficiencies.

Likewise was the financial and economic support to the military construction. The encouraging statement made by Finance Minister A. Kudrin on the eve of 2011 that "the ministries and departments will receive 98% of the budget expenditures for their full disposal[1] " have come to nothing. A new government arms program (GAP) for 2011 – 2020 signed by President D. Medvedev on the last day of 2010, was not aligned, as appears, with a regular federal target program for upgrading the military-industrial complex that had not been adopted in 2011. It is obvious that these events could not but affect negatively the quality of planning and execution of the state defense order (SDO) for 2011.

The 2011 results in the military economy and the military reform demonstrate that there are more than enough grounds to talk about serious problems and contradictions at the new stage of the military reform in the RF in addressing five key tasks set by President D. Medvedev more than three years ago[2].

6.7.1. Structural transformations of the Armed Forces

Even a recap of the organizational and structural transformations in the RF Armed Forces that took place during the last three years makes a great impression. Late 2008, a new military administrative division of the RF was established: four military districts were set up instead of six and accordingly four united strategic commands (USC) were established to control all military forces based on the territory of such districts except strategic forces. At the top levels of the military hierarchy, a tree-tier command and control system was set up: the district USC - operative command (armies) – brigades and other military units. In 2009, the structure of the Armed Forces changed from the division-regiment based to the brigade-based one (except the Airborne Landing Forces and Strategic Missile Forces)[3].

As a result of functioning of the Armed Forces in their new structure in 2010, a number of issues was identified including maintenance of the AF combat readiness at a high level and having a mixed compulsory and voluntary system of enlisted and junior command personnel.

The establishment of Aerospace Troops (AST) as an independent unit is a major structural innovation of 2011. To some extent this may be considered as a restoration of the ex-USSR Armed Forces type called national Air Defense Forces.

The division of the command and control functions into two "branches" during the last three years was another important structural innovation: the first branch was in charge for comprehensive support (Russia's Ministry of Defense and the Armed Forces) while the second branch – in charge of the Armed Forces buildup, planning of troops employment and

[1] V. Petrov. In a week-s time.// Rossijskaya Gazeta.2010. December 2 (No. 272).
[2] Russian Economy in 2009, Trends and Prospects (Ed. 31) M., Gaidar's Institute. 2010. p.637–638.
[3] Russian Economy in 2009, Trends and Prospects (Ed. 31) M., Gaidar's Institute. 2010. p.640.

their combat training. The first branch is staffed mainly with civilian specialists (according to the practices of the civilized states) while the second – with military persons. Note that the move to this structure that was selected back in May 1992 as the most reasonable for Russia took almost 20 years. At that time it was announced at a Joint Staff conference as a target set by the then President of Russia Boris Eltsin by the top military leaders: Minister of Defense P. Grachev and his First Deputy A. Kokoshkin. The Russian Generals apparently did not support the proposed restructuring and tried to impede the process striving to keep the key financial and economic levers in their hands together with the associated capabilities. A lot of efforts and time was wasted.

Now the first command and control branch acquired two major tasks – financial and economic support to all the activities of the Ministry of Defense and the Armed Forces and interaction with the defense-industrial complex to ensure supplies of military equipment and hardware.

The newly created procurement services of the RF AF united in the second branch structure the rear services support and the technical services support; that was also in line with the best practices of the advanced countries. The reduced scope of tasks led to reduction of the administrative military staff by four times while the remaining administrators were reoriented to military objectives. Many purely economic activities were withdrawn from the RF Ministry of Defense and included into the scope of services of OJSC Oboronservice namely: maintenance of arms/hardware and military equipment, modernization, repairs, liquidation of surplus stocks, utilization of arms and limitary equipment, maintenance of all real property facilities, production and supply of agricultural products and goods, trade and daily services, catering, printing products, hotel services, etc. As for other procurement functions, some of them were outsourced (wholly or partially) to third parties and covered such types of procurement as food supplies, bath and laundry service – for the military people; aerodrome maintenance, truck shipments, fuelling, technical maintenance and service – for troops and military equipment and arms. As a rule, OJSC Oboronservice has acted as a general agent of the Ministry of Defense using the bidding system for contractors.

The Ministry of Defense and the Armed Forces have never gone through such radical changes before. Their functioning in 2011 revealed both pluses and minuses. Among the pluses, there have been quite valuable results, in particular regarding troops disposition. It is worth noting that the number of guarded military settlements reduced from 22,000 down to 4,000 with the prospects to continue reduction to a less than a thousand of such settlements. Only 7,000 people will be employed to guard them. The Air Force airfield network that used to have 356 airfields has been reduced down to 7 air bases with a more powerful infrastructure; this ensures better quality of airfields maintenance and operation. The released settlements and other facilities have been passed over to the local governments.

6.7.2. The RF military policy and its implementation

Early autumn 2011 it appeared that the Ministry of Defense could not approve the contracts for construction of two nuclear submarines of “Borey” type and one multipurpose nuclear submarine of “Yasen” type with OJSC OSK (United Shipbuilding Corporation). As A. Serdyukov, Defense Minister, announced, OSK refused to disclose the price structure on its products as the customer demanded (the last portion of Rb 20bln out of Rb 581bn as a total value of the state order for 2011 were involved).

Though this scandal did not directly affect the combat potential of the Russian sea-based nuclear forces (there were no missiles for new submarines), still it was very disturbing since the government officials made a lot of promises to settle the situation in the second half of the summer. It is clear now that the attempts of Russia's President and the Federal Government Chairman to get involved helped to save their faces only. Both officials made very important statements with regards to the military expenses and the national military and technical policy.

Thus President D. Medvedev addressing the members of the strategic exercise "Center-2011" on September 27, 2011, in the Chelyabinsk region[1] announced that "spending on defense, new arms, money allowances for the servicemen, their household activities and their apartments will remain the highest priority of the government. There are no two ways about it." Having evaluated this statement as an ethic prescription ("… this is imperative") he reaffirmed that "we (though the budget may regret this) will always have large expenses to support the defense and the security as this is our mission in relation to our citizens and our neighbors" and linked this to such factors as the territory of Russia and its membership in the UN Security Council and availability of nuclear arms.

Unfortunately this statement of Russia's President not only creates doubts as to his logics (regarding the mission of Russia with regards to the neighbors) bur contradicts Articles 23 and 112 of the RF National Security Strategy for the period ending 2020 approved by President (SNB-2020)[2], that do not include military expenses as one of the national security priorities or any aspect of the national security. Moreover, this document does not give the definition of the notion of "a supreme priority" (unlike the notion of "the strategic national priority"). Misunderstanding or ignoring the optimal balance concept expressed in SNB-2020 means that the "great power' status and not the growth of national welfare is given preference, that the investment resources will be frozen and rates of economic growth decline in a long-term perspective.

V. Putin. Chairman of the Federal Government, in his introduction to the meeting dedicated to the issues of the defense and industrial complex on October 7, 2011[3] declared that "there is a great large-scope task in front of us: to re-equip fully our army and Navy in the near 10 years". Though earlier D. Medvedev stated that the aim of our state arms program for the period 2011 – 2020 was a 70% re-equipment (30% by 2016) and not a 100%.

The challenge of a 100% or 70% re-equipment during 10 years seems to ignore the native and/or foreign experience and demonstrates that the program developers have not been aware of the balance principle and unable to look beyond the 10-year horizon.

The rationale of the 2020 state arms program and the opportunity for its implementation looks doubtful with account of the statements made by V. Putilin, the then First Deputy of the Chairman of the Military-Industrial Commission at the RF Government that the Ministry of Defense had no reasonable justification of the program; the former Deputy to Defense Minis-

[1] Meeting with unit commanders involved in combat exercise "Center 2011" (short-hand notes) September 27, 2011. http://news.kremlin.ru/transcripts/12836.

[2] National security Strategy of the Russian Federation up to 2020. Approved by RF President Decree of May 12, 2009 No. 537.

[3] V. Putin's introduction at the meeting on the issues of development of the defense and industrial complex (short-hand notes) October 7, 2011. http://premier.gov.ru/events/news/16656/.

try V. Popovkin also made it clear in March last year [1] that in Russia "the share of state-of-art arms in the military equipment fleet is 20% for strategic nuclear forces and under 10% for general-purpose forces. For comparison: in the armies of the leading foreign states such share is 30% to 50%."

If these data about the situation in the Armed Forces of the leading works countries are true, it means that Russia must reach these indicators as early as 2016 and surpass this level by 2020. It looks that the developer of the Russian arms program for 2011-2020 has never asked himself why the share of new arms and equipment in the world leading countries does not exceed 50%? The announced 70% re-equipment plans by 2020 are unreachable due to the poor potential of the national economy, and the first year of the program delivery has proved this. What the plants of the defense and industrial complex will do if after 2020 the Army and the Navy are fully re-equipped: will they have to re-orient themselves to foreign markets since the arms samples have a service life of 25 to 30 years.

It is impossible to make a correct assessment of the Russian military and technical policy in 2011 without the account for the events occurred in 1H. May 2011 was extremely important in this respect since on May 10, President D. Medvedev held in the Gorky a meeting[2] dedicated to the development of the Russia' military and industrial complex where he informed that for the state arms program adopted late 2010 budget allocations would be four times larger than for the previous program.

On March 21, 2011, Prime Minister Vladimir Putin addressing the meeting in Votkinsk on the implementation results of the state arms program[3], and on April 20, in the report of the RF Government on the results of his activity for 2010 in the State Duma affirmed that for the new arms program the government intends to allocate funds by approximately three times more vs the previous program[4]. It is obvious that if we compare the arms programs (for all power ministries) the President's assessment of May 10 is more correct than the government assessment given the declared growth of allocations from Rb 4.9 trillion up to Rb 21.5 trillion. It is worth noting that the said growth for the arms program of the Ministry of Defense was actually five times higher (more accurately by 4.9 times: from Rb 4 trillion to Rb 19.5 trillion).

It is hard to understand why the federal government has been disseminating false information for such a long time. Possibly,t our government is used to ignore such "trifles" and/or this is a simple arithmetic error. But it is quite probable that the use of such " not fresh" information determined, to a certain extent, the successful, in terms of the Russian military-industrial complex, approval of the state arms program by President since in terms of the budget almost triple growth of the budget allocations is not so "frightening" than the fivefold.

The approval of the state arms program for 2011-2020 by President Dmitry Medvedev is a case study. This fact became known only late February 2011 when Deputy Defense Minister Vladimir Popovkin announced at the meeting with journalists that the program was approved by President back on December 31, 2010, and this information was unexpected for the major-

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[1] We cannot afford buying poor arms// Military Industrial Courier. 2011. 2–8 March (No. 8); D. Litovkin "Triumph" and "Circon" march off to troops// The News. 2011. 11 March; National Defense. 2011. March.
[2] Meeting on the issues of development of the Russia's state arms program (Short-hand notes) 10 May 2011. http://www.kremlin.ru/transcripts/11206.
[3] Introduction by V. V. Putin at the meeting on the implementation of the state arms program for 2011–2020 . (Short-hand notes). Votkinsk, 21 March, 2011. http://premier.gov.ru/events/news/14545.
[4] Short-hand notes of the RF State Duma meeting of April 20, 2011. http://transcript.duma.gov.ru/node/3423/?full.

ity of the attendees since the Defense Ministry liable sources asserted otherwise through January.

What made the Russian government conceal the approval of the state arms program worth over Rb 20 trillion for more than two months is difficult to say. The reference to the secrecy of the Decree does not sound convincing as there is an official practice of publication of extracts, statements and information about the signing of classified documents. It may be possible that the program was signed in the first days of January 2011 retroactively in order not to repeat mistakes made in signing two previous programs when unexplainable intervals between their approvals reached 10-12 months.

The previous practice with the state arms programs has shown that the attempts to delay their signing in order to improve the quality are not successful since the last minute finalized programs have not been duly implemented. The Russian state arms programs are unachievable in principle.

This fact escapes the interested community, possibly, due to the unique combination of ten-year (horizon) planning with the five-year plan adopted for our programs in the ex-USSR. It is often believed that the new state arms program is passed because the previous program failed – this is not true since the new program is adopted because time has come to do it: in Russia there is an established practice to adopt such programs once every five years. As the development of the next program starts several years before the first part of the previous program is finished the developers indeed have no possibility to review the results of the program implementation. However, the implementation results can be seen with a naked eye regardless of the traditional screen of the state secret. It is quite possible that the government authorities did not want to make a focus on the actual approval of the state arms program because of this. The implementation results of the state military order in the first year of the program confirm our skepticism.

Thus, instead of the growth of the military production by 14% expected by the RF Ministry of Industry and Trade[1] in shipbuilding, this production fell down by 15.7[2] while commissioning of "Borey" strategic ballistic missile submarines that, according to some optimistic declarations[3] are almost ready for combat alert duty, is 6 to 12 months behind the schedule and expected at best by the end of 2012.

In 2010 and 2011, the shipbuilding production under the state military order was worth Rb 126 bn and Rb106bn and 765m accordingly, and these enable spending of Rb4,7 trillion of the state program for re-equipment of the Russian Navy[4] only under the condition of annual growth of military shipbuilding production by 30.6% during the remaining 9 years. In 2020, the shipbuilding production under the state military order will exceed the 2011 production tenfold.

In a more realistic assessment of the production surplus by 10% at best, the required allocations for the shipbuilding part of the state military program do not exceed Rb1.7 trillion, in other words, the budget spend for the Navy equipment can be reduced by 64% (almost by three times). Thus a logical step (not in terms of budget saving but in terms of spending the

[1] Report of the RF Ministry of Industry and Trade: 2004–2011.
[2] Shipwrights will not corrode, Red Star, 2012, February 4 (No. 19).
[3] E.g. see "To be strong: the guarantees of national security for Russia// Russian Gazette. 2012. February 20.
[4] Buildup of the force// Vzglyad (A View)// 20122, February 6.

allocated budget) is to procure foreign warships like "Mistral" in France. However the need to include the four procured warships in the Pacific Fleet looks doubtful [1].

The forecast of delivery of the 2012 state order by the shipbuilders is not very optimistic: when allocations for the 2012 draft federal budget were prepared in July-August 2011, there was no information on the prices for the sector products. The 2011 contracts under the state military order for nuclear submarines that were to be built and tested in the White Sea were signed by the Defense Ministry and USC on November 9, 2011 in the presence of Prime Minister Vladimir Putin: actually two weeks before the established date of the product delivery. After the contracts were signed, USC continued to resist disclosing the information on the price structure for their products, which may be understandable in the context of price fluctuations in the shipbuilding sector reflected in Russian statistics of the national accounts in the previous years.

On the other hand, the efforts of the Ministry of Defense in 2011 aimed to implement the resolutions of the RF President of November 25, 2010, Order No. Pr-3443, proved to be successful by the year-end. According to Joint Staff Commander, General of the Army N. Makarov[2] the contract prices on diesel submarines were reduced by 34%, on corvettes – by 15% and on frigates – by 26%.

The behavior of certain military and fleet commanders considerably aggregates the situation with the implementation of the military and technical policy and the state arms program. For example, the Navy Chief Commander Admiral V. Vysotsky, obviously violating the line of authority and contradicting the statements of the state first persons not to build aircraft carriers[3], continues advocating the plan of their building starting from 2015[4] . Note that the full protection of information about the state arms program allows such behavior.

Unfortunately, a similar situation with the equipment is observed in the Air Force:

- SU-34, a bomber aircraft, bought back in 2008, was officially passed into service by the state commission in September 2011;
- a fighter aircraft SU-35M that was bought earlier still undergoes testing;
- a surface-to-air missile system C-400 "Triumph" was made operational in 2007, but up to now it has not been equipped with 400 km distance missiles though it was given the index 400 according to this type of missile; the development of the missile is to be completed this year, though federal funds for construction of two plants for the C-400 serial production have been released since 2010.

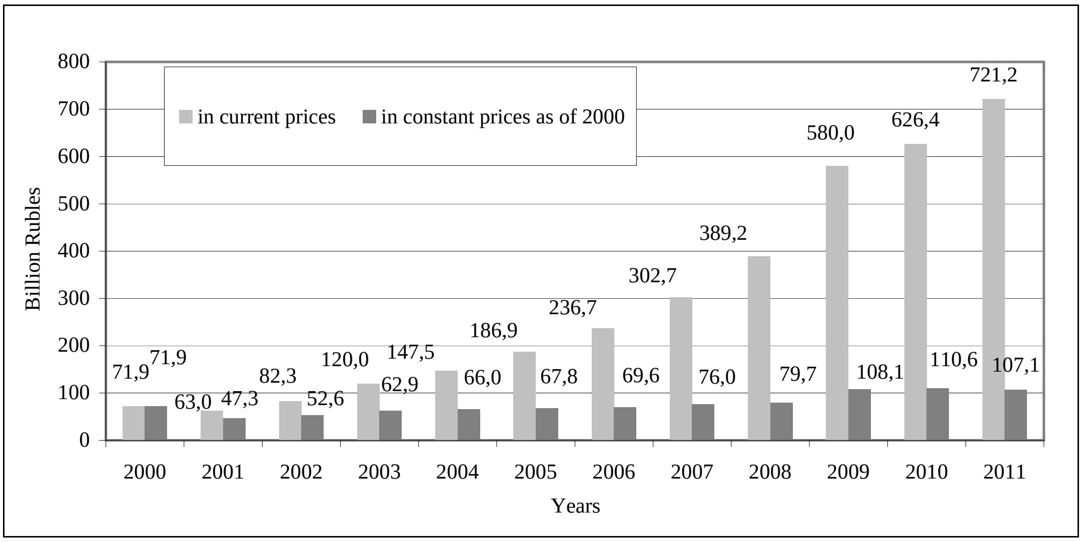
In 2011, the Air Force did not receive a new bomber aircraft Su-34, a fighter aircraft SU-35M, three Su-27SM, two helicopters "Ansat-U". Besides, a strategic bomber aircraft TU-95MS and an airborne interceptor MiG-31B remained under repair.

Given the absence of advance models ready for manufacturing, the Leaders of the Ground Forces and the Airborne Forces almost stopped procurements of armored vehicles and focused on modernization. The purchases of missile and artillery materials have been insignificant due to the same reason. On the whole, for 2011, the Russian defense industry did not ful-

[1] The Fleet: priorities and prospects // Red Star. 2012. February 15–21 (No. 26).
[2] The military reform as it is. Speech by N. Makarov, Russian Joint Staff Commander, at the Public Chamber. M. November 17, 2011. http://www.oprf.ru/files/Prezentaciya_mioboroni.ppt.
[3] e.g..: So far we do not have this in our plans" (V. Putin). // Short-hand notes of the meeting in Sarov on February 24, 2012 at http://premier.gov.ru/events/news/18248/.
[4] The Fleet: priorities and prospects//Red Starr. 2012. February 15–21 (No. 26).

fill the state order under 84 contracts for Rb 42bn[1], i.e. the 2011 state military order was delivered at under 94%.

The results of the multi-year policy of building up budget spend for the state military order by the Ministry of Defense in the situation of full secrecy is shown on *Fig 36* (an expenditure deflator for the final consumption of the state services is used).



Source: Rosstat.

Fig. 36. State Military order of the Russia's Ministry of Defense in 2000–2011

The confidence of the Russia's leadership in that the state guarantees a minimal productivity at 20% in the industrial and defense sector which will ensure the transition to its innovatory development and the required output[2] actually has no basis and is a result of promotion efforts by the Russian military-industrial lobby who is interested in re-distribution of the oil rent income. According to PwC (former PriceWaterhouseCoopers)[3], the average profitability in 100 leading western airspace and defense companies was 7.8% and 9.0% in 2010 and 2011 respectively, and such indicators enabled their development based on innovations, to step up their production and pay out dividends to their shareholders.

6.7.3. Improvement of the legal and regulatory framework of the Armed Forces operation

This stage of transformations of the RF Armed Forces required the improvement of the legal and regulatory framework. First, to review the set of program and regulation documents was required that regulated the procedures and the rules of modern military actions with account of their types and administration of troops and forces. Secondly, a lot of efforts were taken to revise the documents regulating the functions of the Armed Forces in peaceful times,

[1] V. Litovkin. Bottleneck in the state military order // Independent Military Review. 2012. February 3–10 (No. 3).
[2] "We assume that the profitability of the enterprises should be at least 13–15%, even let it be 20%" (V. Putin) // Short-hand notes of the meeting at Komsomolsk-on-Amur, February 20, 2012 http://premier.gov.ru/events/news/18194/.
[3] Aerospace & Defence 2010 year in review and 2011 forecast. PwC, 2011. http://www.pwc.com/aerospaceanddefence/.

including the regulations/manuals (Internal Service Regulations, Combat Manual, Disciplinary regulations) and various instructions. The participation of the Defense Ministry specialists in the development of draft laws on money allowances (MA) for servicemen and on retirement pays became a most important area of activity. The IEP experts also took part in this effort[1].

The main comments to the MA draft law developed by the Ministry of Finance and Ministry of Defense were as follows: the new MA system will deepen the gap between military and civil officers, and between the military officers who serve in different departments inside the power block. The MA is not linked to the average national wage and to the budget process, if done, this could align the MA indexation. Corruption-biased wordings are used in certain law provisions. The key thing is that for lower ranks of the servicemen the MA level is inappropriate, and this would make the army recruitment even more difficult.

There are numerous comments to the provisions setting retirement pays. These provisions are very unfair in treating the old age pensioners, and may cause a lot of complaints immediately after the new pensions are paid.

Unfortunately, the justified comments caused no reaction, and the drawbacks in the draft laws have been incorporated in the laws.

6.7.4. Changes in the military staffing policy

Early 2011, the first theoretical and practical conference of the Ministry of Defense was arranged on the topic “The formation of the innovative educational environment in the system of educational institutions of the RF Ministry of Defense”. As per the established tradition, that meant training of the officers only with simultaneous reduction of the number of academies and colleges, and this approach caused strong dissatisfaction among the servicemen. Nevertheless, the changes have been implemented as planned. Now in the RF Armed Forces there are three scientific and training centers, 11 military academies under the Joint Chief Academy, and two universities (Military University and Military Aviation Engineering University). The Academies train staff for such troops as missile strategic forces, army signals, army troops, NBC defense troops, engineering troops, artillery troops, battlefield air defense troops, military space troops, combined service forces. The focus was also made on the training of troops in advanced combat training centers where in addition to individual training, units will be trained.

However, the attention to training of ranks and files and junior command personnel was not appropriate. The major part of the military personnel continues to be conscripted. The Armed Forces Commanders, namely the Commanders of the ground troops acknowledged that the current practice of a five-month training of the called-up specialists does not meet the modern requirements. Note that the reduction of the service term to one year was provided in the federal Government Regulations adopted back in 2003, and the respective amendments were made in the legal framework in 2007. However, “the tests of the new training program

[1] See, e.g. V. Tsymbal, A. Privetkin. A failure of the strategy for social development at the financial front // Independent Military Review. 2011. June 3–9 (No. 20); V. Tsymbal, A. Privetkin. The servicemen are promised a worthy pension in a quarter of a century. Independent Military Review 2011. June 10–16 (No. 21); E. Trofimova Certain achievements and issues of the social development of the RF Armed Forces//Economic and political situation in Russia, 2011. No. 2; A. Privetkin, E. Trofimova. On the fund of money allowance of the RF servicemen// Economic and political situation in Russia, 2011. No. 7.

for junior specialists" designed for 3 months "in connection with the transition to one year of service" began in 2011 only[1].

The need to refuse from the call-up principle was hushed up (in autumn 2010, the Joint Staff Commander announced 700,000 positions for conscript servicemen) early this year though full enlisting was clearly impossible. The Border Guards and the Federal Penal Service abandoned the call-up principle long before. Recently, the Interior Ministry Troops being aware of the conscription difficulties have decided to contract the staff and tried to improve the attractiveness of such service[2].

By March 2011, the Ministry of Defense had matured to be aware of the true situation with enlisting. The report at the meeting in the RF Academy of Military Sciences can give some evidence to that[3]. It was said that the number of the conscripted servicemen should be reduced by 10–15% of the total membership. And the report also focused on the attractiveness of the contract enlisting. Some NATO country-members, Poland, in particular, were mentioned as an example. It appeared that by 2017 the number of rank and files and junior command officers serving under the contract should be 425,000 instead of current 184,000.

Activities on "humanization" of the military service have been carried out in the troops: a new plan of the day (with an after-lunch rest) and a five-day service week with possible week-end leaves was introduced; to use rank and files in fatigue duties was limited or even forbidden; the food ration and quality were improved; mobile phones were allowed. The principle of "service close to home" was implemented where possible. Nevertheless, there is still no contest for the military service, and there are many draft evaders.

The institutions of priests and military police have been promised recently for implementation. However, in 2011, the promises remained unfinished.

The necessity to abandon the call-up enlisting seems obvious, but the top commanders hesitate to acknowledge this though President Dmitry Medvedev did recognize this necessity but for a faraway perspective. There is no political will yet to do this.

6.7.5. Social support to the servicemen and their family members

Housing is an obvious example of how the Armed Forces deal with social and economic issues. There is a tremendous burden of such issues in this sector since the national leaders used to put off them for a number of years. Once there was an attempt to re-shift this burden from the federal to the regional authorities. Eventually, the military and political leaders of Russia elected to stop pushing aside this problem. After all the housing needs were registered in 2009 it became clear that 175,600 servicemen and military retirees had to be provided with housing.

Early 2011, the Ministry of Defense while talking about the house provision plans announced their ambitious target "to do away with the waiting list of the servicemen in need of housing by 2012"[4]. This announcement was very challenging since in that year there was no properly functioning Unified Register of the Servicemen in need of housing accessible via Internet, i.e. the system of recording and control was still in the process of development.

[1] A. Gerasimov. Special courses for junior specialists//Red Star, 2011 February 3, (No. 17).
[2] Interior troops invite//Red Star 2011.February 4 February (No. 18).
[3] N. Makarov. Up to date//Red Star. 2011. March 29 (No. 51).
[4] D. Semenov, V. Mokhov. No waiting lists should remain // Red Star. 2011. January 14 (No. 2).

However, by October 2011, the list reduced down to 63,800 families and by the year end further to 41,600, according to the report of the Joint Staff Commander to the Public Chamber.

Nevertheless, the problems are still there: there are corrupt officials and bribetakers involved, the files of the servicemen on the demand list was lost, the computerized recording and control system does not function properly, apartments are provided in locations where people do not want to reside.

The second important area of solving social issues is the increase of the money allowance from January 2012. Let us talk about the MA amounts. The main MA components, namely the basic salary for the service position (SSP) and for the military rank (SMR) are given in *Table 34*.

Table 34

Comparison of the military ranks, positions and money allowances of the RF AF servicemen after January 1, 2012

Grade	Proposed position*	Proposed SSP*	Approv. SSP**	Standard military position (Regulation 922)**	Proposed military ranks	proposed SMR*	Appr. SMR**
1	2	3	4	5	6	7	8
50	First Deputy Minister	45000	45000	First Deputy, RF Minster of Defense	Army General		27000
49	Deputy Minister	44000	44000	Deputy, RF Minster of Defense	Army General		27000
48		42000	42000	Commander-in-Chief, AF type	General-Colonel	20000	↑25000
47	Military District (MD) Commander	40000	40000	Director-General, Central Office (CO) Department Director, Commander-in-Chief , Corps; MD Commander-in-Chief	General-Colonel	20000	↑25000
46		38000			General-Lieutenant	17000	↑22000
45	Deputy, MD Commander	37500			General-Lieutenant	17000	↑22000
44	Army Commander	37000	37000	Deputy to: CO Director-General, Department Director Army Commander-in-Chief	General-Lieutenant	17000	↑22000
43		36500			General-Lieutenant	17000	↑22000
42		36000	36000	Director-General: CO, MoD Department :	General-Lieutenant	17000	↑22000
41		35500			General-Lieutenant	17000	↑22000
40		35000			General-Lieutenant	17000	↑22000
39		34500			General-Lieutenant	17000	↑22000
38		34000	34000	Deputy Director-General: CO, Department :	General-Lieutenant	17000	↑22000
37	Deputy Army Commander	33500			General-Lieutenant	17000	↑22000
36		33000			General-Lieutenant	17000	↑22000
35	Corps Commander	32500	32500	Commander, motorized rifle corps, Director-General, Department in USC, MD	General-Lieutenant	17000	↑22000
34		32000			General-Major		20000
33		31500			General-Major		20000
32	Deputy Corps Commander	31500	31500	Section Head: CO, Department	General-Major		20000

cont'd

1	2	3	4	5	6	7	8
31	Division Commander	30500	30500	Commander, motorized rifle (tank) division	General-Major		20000
30		30000	30000	Deputy Section Head: CO, Department	Colonel	13000	13000
29	Deputy Division Commander	29500	29500	Section H in USC /MD Department	Colonel	13000	13000
28	Brigade Commander	29000	29000	Commander, motorized rifle (tank) brigade, Section Head, Army	Colonel	13000	13000
27		28500	29000	Group Head in Central Office/Department Section, MoD of Russia	Colonel	13000	13000
26		28000	28000	Senior Officer (CO Section, Department)	Colonel	13000	13000
25	Deputy Brigade Commander	27500			Colonel	13000	13000
24		27000	26500	Officer (CO Section, Department)	Colonel	13000	13000
23	Regiment Commander	26500	26500	Commander, motorized rifle (tank) regiment	Colonel	13000	13000
22		26000	26000	Senior Officer, USC Department. MD	Sub-colonel		12000
21		25500	25500	Senior Officer, All-arms army administration	Sub-colonel		12000
20	Deputy Regiment Commander	25000	25000	Officer, USC Department, MD	Sub-colonel		12000
19		24500	24500	Officer, all arms army administration	Sub-colonel		12000
18	Battalion Commanding Officer	24000	24000	Commander: motorized rifle (tank) battalion, missile/artillery division	Major	11500	11500
17		23500			Major	11500	11500
16	Deputy Battalion Commanding Officer	23000			Major	11500	11500
15		22500			Captain		11000
14	Squadron Commander	22000	22000	Commander: motorized rifle (tank) squadron, anti-air missile battery	Captain		11000
13		21500			Senior lieutenant		10500
12	Deputy Squadron Commander	21000			Senior lieutenant		10500
11		20500			Lieutenant		10000
10	Platoon Commander	20000	20000	Commander, motorized rifle (tank) platoon	Lieutenant***	10000	10000
9		17000			Senior Warrant Officer		8500
8		16500			Senior Warrant Officer		8500
7	Deputy Platoon Commander	16000			Warrant officer		8000
6		15000			Sergeant		7500
5	Squad Commander	14500	↑15000	Commander, motorized rifle (tank) squad	Senior Sergeant		7000
4		12500			Sergeant	6500	6500
3		11500			Junior Sergeant		6000
2		10500			Private First Class		5500
1	Rifleman	10000	10000	Rank and file positions of soldiers and seamen under contracts	Soldier	5000	5000

* The military ranks, position grades and salaries related to ranks and positions: see "the State defined the price of the military service// Military and industrial courier. 2011. April 13 (No. 14).

** RF Government Resolution of December 5, 2011 No 992 "On the establishment of base salaries of the cash allowance of the servicemen who serve under the contract".
*** There is no "junior lieutenant" rank in the table since it is very rare and assigned only in exceptional cases(e.g. to sergeants who graduated from short-term qualification courses or to lieutenants who are reduced to a lower rank).

Let us do the following comment to the data in *Table 34*. MA for high-ranking military officials and commanders was increased even above the level that had been discussed when the MA draft laws were reviewed. But the lower ranks of the military hierarchy "lost the game". The gap between the rank-related salaries of the Colonel and General Major was Rb 7,000; this is actually the amount that makes the difference between the rank-related salaries of the Junior Sergeant and the Colonel - how's that?

The situation with promises given to contracted soldiers is even worse. In 2012, at the start of the service, the soldier will get not the promised Rb 28,000 but less: Rb 15,00 – Rb 20,000 per month. The soldier will have to wait for two to three years to get the promised allowance, and this will depend on the attitude of his commanding officer. For reference: by the end of 2011, in Russia the average wage went up to Rb 22,000. Thus the voluntary military service has not become attractive on the employment market.

So far the Russian military leaders feel optimistic by declaring the contracting plans (and the contest selection) up to 50,000 people annually (in reality with account of the replacement of those who retire this figure must go up to 70,000) but they hardly take into account the situation on the employment market and the current demographic trends.

6.7.6. Military and financial policy

Through 2011, the Ministry of Finance was an ongoing supporter of reduction of the military expense. In May, at the meeting in the RF Government with the agenda on the RF budget for 2012-2014, Minister of Finance made proposals[1] to cut down the key additional expenses related to the pre-election obligations of the Kremlin and the White House regarding budget military costs. The key proposal was not to step up the number of officers and contractors of the Ministry of Defense with the consequent saving about Rb 160bn annually up to 2014 inclusively. The Ministry of Finance also proposed not to increase the army but to reduce it further by 15% over next three years and to cut down the budget costs for the state military order during this period by Rb100bn per year. There was another proposal not to increase the financial provision of the saving-and-mortgage system for the servicemen thus saving up to Rb78.2bn in 2012. Besides the Ministry of Finance suggested to cut down costs for the Ministry of Internal Affairs: by Rb 97 bn in 2012 and by Rb 99.1 bn in each of the following two years.

However, the MinFin initiatives were not accepted by the military and political leadership of the country.

As for the federal budget that has been adopted by that time the practice of its execution in 2011 turned back to the pre-crisis scheme with two annual corrections of the initial version[2] – in summer[3] and in autumn[1], but with an additional correction in July[2] when mainly secret and

[1] P. Netreba. The budget gets rid of expenditure units// Commersant, 2011 May 25 (No. 92).
[2] Federal Law of December 13, 2010 No. 357-FZ "On the federal budget for 2011 and the planning period of 2012 and 2013".
[3] Federal law of June 1, 2011 No. 105-FZ On amendments in the Federal Law "On the federal budget for 2011 and the planning period of 2012 and 2013".

top-secret applications related to the state military order were changed with no modification of the overall federal budget expenditures. The July correction may be viewed as another demonstration of the unusual boom in the Russia military and technical policy during 2011.

As a result of all the said changes, by the year end the federal budget allocations for "National Defense" increased by 1.3% from Rb1 trillion 517bn 91mn to Rb 1 trillion 537bn 444mn in 2011 with the total growth of budget expenditures by 4.3%. In real terms, these allocations increased by 4.2% (nominal growth – 20.3%) vs 2010, while their size remained at 2.8% of the GDP.

The above mentioned figures of military expenditures cannot be drawn from the published Budget Law given that after 2007 the non-transparency of the Russian federal budget has sharply increased, and the analysis of the Budget Law should be supplemented with additional sources; thus in preparation of the review we used the materials of the government version of the federal budget, the monthly report of the Federal Treasury on the execution of the budget in January 2011 and the documents of the State Duma[3]. Such an indirect approach cannot but influence the accuracy of the evaluations.

In 2011, the degree of secrecy of federal budget expenditures increased by 1.4 vs 2010 (*Table 35*), and its secret allocations reached Rb1 trillion 302 bn 839mn. Secret/classified allocations were returned to subsection "Intermediate vocational education" and to section on inter-budgetary transfers. The secrecy level remained in such sections as "Physical culture and sports" and "Mass media" (these have been independent sections since 2011), and the share of secret expenditures in the overall expenditures for physical culture was more than half (53.31%, according to our estimates) surpassing the section "National defense" and getting closer to the level of secrecy traditional for the security authorities. Also secret are some allocations for "Preschool education" and "Culture", by tradition. The share of secret allocations to "National economics" is reaching 2%, and to sub-section "Housing" goes above 25.03%.

Table 35

The share (%) of secret allocations in the federal budget expenditures in 2005–2011

Code and the title of section (sub-section) with secret expenditures	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
1	2	3	4	5	6	7	8
Overall federal budget expenditures	11,33	11,80	10,33	11,92	10,01	10,46	11,82
0100 GENERAL GOVERNMENT ISSUES	3,67	6,28	5,52	8,66	5,05	4,75	*8,56*
0108 International relations and international cooperation	–	0,01	< 0,01	3,66	–	–	–
0109 State material reserve	82,86	89,23	92,18	90,17	85,01	85,08	*88,15*
0110 Fundamental research	2,13	1,22	1,12	0,97	0,78	0,32	*0,66*
0114 Other general government issues	0,05	0,72	0,28	4,42	1,56	1,05	*0,27*
0200 NATIONAL DEFENSE	42,06	42,77	45,33	46,14	48,09	46,42	47,56
0201 Armed Forces of the Russian Federation	33,07	35,59	37,11	39,04	40,21	39,03	41,41
0204 Mobilization of the economy	100,0	100,0	100,0	100,0	100,0	100,0	100,0
0205 Preparation for and participation in assurance of collective security and peace-making efforts	100,0	100,0	100,0	–	–	–	–

[1] Federal Law of November 6, 2011 No. 302-FZ On amendments in the Federal Law "On the federal budget for 2011 and the planning period of 2012 and 2013".
[2] Federal Law of July 20, 2011 No. 251-FZ On amendments in the Federal Law "On the federal budget for 2011 and the planning period of 2012 and 2013".
[3] Decision of the State Duma Commission on the review of the federal budget expenditures to support defense and state security of the Russian Federation, in draft federal law No. 607158-5 "On the federal budget for 2011 and the planning period of 2012 and 2013", M., October 19, 2011.

cont'd

1	2	3	4	5	6	7	8
0206 Nuclear arms	100,0	100,0	100,0	100,0	100,0	100,0	100,0
0207 Implementation of international obligations in the area of military and technical cooperation	45,22	46,90	50,65	100,0	100,0	100,0	100,0
0208 Applied research in the area of national defense	98,37	93,94	93,69	93,20	92,85	91,32	92,47
0209 Other issues of national defense	2,49	8,79	24,38	29,21	34,64	42,03	37,64
0300 NATIONAL SECURITY AND LAW-ENFORCEMENT	28,52	31,64	31,07	31,84	30,82	32,12	31,91
0302 Internal Affairs agencies	4,76	6,31	5,16	4,97	3,70	4,30	3,39
0303 Internal troops	11,76	10,31	9,80	10,25	8,19	8,28	5,58
0306 Security agencies	97,80	95,49	97,31	99,05	99,61	97,05	99,57
0307 Border service agencies	100,00	98,97	97,62	100,00	99,47	98,61	99,15
0309 Protection of the population and territories in emergencies of natural and technogenic nature, civil defense	59,02	62,39	50,65	51,39	51,00	51,28	49,08
0313 Applied research in the area of national security and law-enforcement efforts	73,95	66,41	64,43	75,49	79,35	92,09	87,20
0314 Other issues in the area of national security and law-enforcement efforts	8,26	50,71	39,95	56,32	68,37	67,94	88,40
0400 NATIONAL ECONOMY	0,05	0,02	0,44	0,64	0,55	1,56	*1,96*
0411 Applied research in the area of national economy	–	–	5,23	5,84	4,49	5,61	*12,07*
0412 Other issues in the area of national economy	0,12	0,06	< 0,01	0,31	0,72	4,47	*2,18*
0500 HOUSING AND UTILITIES	–	3,42	0,85	6,96	10,09	19,26	*17,87*
0501 Housing	–	4,22	5,69	15,97	12,91	20,79	*25,03*
0700 EDUCATION	2,76	2,69	2,39	2,55	3,06	3,59	*4,33*
0701 Pre-school education	2,03	2,17	2,44	2,48	2,45	3,91	*5,34*
0702 general education	1,51	1,91	2,14	2,00	2,75	3,45	*0,70*
0704 Intermediate vocational education	1,06	1,03	1,02	0,86	0,99	–	*0,01*
0705 Professional training, re-training and qualifications improvement	16,85	15,78	17,22	1,80	2,54	9,40	*18,16*
0706 Higher and post-higher education	3,15	2,93	2,53	3,08	3,64	4,08	*5,34*
0709 Other issues of education	0,30	0,33	0,28	0,29	0,48	0,61	*0,27*
0800 CULTURE, CINEMATOGRAPPHY, MASS MEDIA	0,17	0,17	0,21	0,17	0,18	0,17	–
0800 CULTURE AND CINEMATOGRAPHY	–	–	–	–	–	–	*0,12*
0801 Culture	0,14	0,10	0,16	0,10	0,14	0,09	*0,14*
0804 Periodic press and publications	13,46	7,45	2,57	2,62	3,14	3,59	–
0806 Other issues of culture, cinematography and mass media	0,02	0,15	–	–	–	–	–
0900 HEALTHCARE, PHYSICAL CULTURE AND SPORTS	4,30	3,99	2,57	4,14	3,54	3,01	–
0900 HEALTHCARE	–	–	–	–	–	–	*8,29*
0901 Stationary medical help	5,61	4,66	2,94	3,24	2,77	2,41	*2,71*
0902 Outpatient care	n/a[1]	n/a	n/a	13,94	4,34	3,75	*21,38*
0905 Health-building care	n/a	n/a	n/a	14,07	15,88	10,73	*11,98*
0907 Sanitary and epidemiological health	n/a	n/a	n/a	2,09	0,63	0,64	*0,73*
0908 Physical culture and sports	0,28	0,26	0,24	0,42	0,32	0,62	–
0910 Other issues of healthcare, physical culture and sports	–	–	–	1,74	1,07	1,01	–
0910 Other issues of healthcare	–	–	–	–	–	–	*0,43*
1000 SOCIAL POLICY	–	–	–	0,01	0,01	–	–
1003 Social security	–	–	–	0,02	0,02	–	–
1100 PHYSICAL CULTURE AND SPORTS	–	–	–	–	–	–	*0,26*
1101 Physical culture	–	–	–	–	–	–	*53,31*
1200 MASS MEDIA	–	–	–	–	–	–	*0,27*
1202 periodical press and publications	–	–	–	–	–	–	*3,38*
1400 INTER-BUDGET TRANSFERS TO THE BUDGETS OF THE RF SUBJECTS AND MUNICIPAL ESTABLISHMENTS OF GENERAL NATURE	–	–	0,16	–	–	–	*0,14*
1401 Subsidies to align budget cover of the RF subjects and municipal establishments	–	–	0,50	–	–	–	–
1403 Other inter-budget transfers to the budgets of the RF subjects and municipal establishments of general nature	–	–	–	–	–	–	*1,74*

Source: the IEP estimates based on the federal budgets data for 2005–2011 (2003–2007 data linked to the respective sections and sub-sections of the budget classification effected since January 2008.) The classification that has been out of the effect since 2011 and preliminary estimates are shown in italics.

[1] Non-applicable due to the changes in the budget classification.

Absolute and relative values of the main components of direct military allocations in the federal budget and their changes vs 2010 according to the final, November version of the Federal Budget Law for 2011 are shown in *Table 36.* The 2010 prices have been recalculated by using the first estimate[1] of the GDP index-deflator for 2011 (115.4%) used by Rosstat.

Table 36

Direct military allocations of the federal budget under section "National defense"

Section/subsection title	2011 in Rb mn / same in prices of 2010	Changes in 2011 vs 2010, Rb mn / growth, %	Allocation share % / change vs 2010 in points	
			2011 federal budget	GDP
1	2	3	4	5
NATIONAL DEFENSE	1 537 444 1 332 274	54 247 4,24	13,82 1,36	2,83 –
Armed Forces, Russian Federation	1 140 915 988 661	29 098 3,03	10,26 0,90	2,10 –0,03
Mobilization and paramilitary training	6 700 5 806	3 199 122,73	0,06 0,03	0,01 0,01
Mobilization preparation of the economy	4 895 4 242	–653 –13,34	0,04 –	0,01 –
Preparation for and participation in collective security and peace-making efforts	421 365	–10 722 –96,71	<0,01 –0,10	<0,01 –0,02
Nuclear arms	29 968 23 369	4 614 24,60	0,24 0,06	0,05 0,01
Implementation of international obligations on military and technical cooperation	4 447 3 854	–357 –8,47	0,04 –	0,01 –
Applied research in the area of national defense	161 346 139 815	–8 866 –5,96	1,45 –	0,30 –0,03
Other issues of national defense	191 752 166 163	37 934 29,58	1,72 0,47	0,35 0,07

Source: the IEP estimates.

Military allocations from other sections of the federal budget are given in *Table 37* (by italics, secret allocations are shown on the basis of the draft law on the federal budget). Note that to improve comparability of the data of the Russian military expenditures according to the international practice, since 2011 expenditures on security agencies have not been accounted for as military, and the respective amendments have been made in our published perennial dynamic rows.

Table 37

Direct and indirect military allocations under other sections of the federal budget

Section title or *allocations for*	2011 in Rb mn / same in prices of 2010.	Changes in 2011 vs 2010, Rb mn / growth, %	Allocation share % / change vs 2010 in points	
			2011 federal budget	GDP
1	2	3	4	5
in section "National security and law-enforcement efforts"				
Internal troops	73 225 63 454	–2 980 –4,49	0,66 0,01	0,13 –0,01
Border service	82 153 71 190	–6 237 –8,06	0,74 –0,02	0,15 –0,02
EMERCOM troops and civil defense	51 018 44 210	–1 930 –4,18	0,46 0,01	0,09 –0,01

[1] On the production and use of GDP for 2011 M.: Rosstat, February 21, 2011 See.: http://www.gks.ru/bgd/free/b04_03/Isswww.exe/Stg/d03/20vvp31.htm.

cont'd

1	2	3	4	5
In section "National economy"				
Alternative civil service	6 5	–1 –13,34	<0,01 –	<0,01 –
President Program "Destruction of chemical weapons in the RF"	768 666	–404 –37,74	0,01 –	<0,01 –
Subsidies to transportation companies that purchase motor vehicles for military convoys	55 48	–7 –13,34	<0,01 –	<0,01 –
Subsidies to functioning of Russia-NATO Center	33 28	7 34,85	<0,01 –	<0,01 –
Construction of special and military facilities	11 433 9 907	–5 224 –34,53	0,10 –0,04	0,02 –0,01
Federal target program "Industrial utilization of weapons and military equipment (2005–2010)"	91 79	42 116,91	<0,01 –	<0,01 –
Contributions to charter capitals and subsidies to organizations of defense-industrial complex	31 328 27 147	3 962 17,09	0,28 0,06	0,06 0,01
Stipends to young employees of the defense-industrial complex	234 221	– –	– –	– –
Secret/classified expenditures	*33 998* *29 461*	*7 179* *32,22*	*0,31* *0,09*	*0,06* *0,01*
In section "Housing and utilities"				
President Program "Destruction of chemical weapons in the RF"	659 571	–847 –59,70	0,01 –0,01	– –
Provision of office and permanent housing accommodations too servicemen	126 344 109 483	–16 433 –13,05	1,14 –0,09	0,23 –0,05
Secret/classified expenditures	*42 749* *37 044*	*1 335* *3,74*	*0,38* *0,04*	*0,08* –
In section "Education"				
MoD expenditures	47 798 41 419	–3 092 –6,95	0,43 –	0,09 –0,01
Secret/classified expenditures	*22 465* *19 468*	*4 891* *33,56*	*0,20* *0,06*	*0,04* *0,01*
In section "Culture and cinematography"				
MoD expenditures	2 491 2 158	–1 535 –41,56	0,02 –0,01	<0,01 –
Secret/classified expenditures	*208* *189*	*–28* *–13,34*	*<0,01* –	*<0,01* –
In section "Healthcare"				
MoD expenditures	38 940 33 744	922 2,81	0,35 0,03	0,07 –
Secret/classified expenditures	*40 993* *35 523*	*25 337* *248,74*	*0,37* *0,27*	*0,08* *0,05*
In section "Social policy"				
MoD pension provision	149 598 140 998	15 090 11,98	1,35 0,12	0,28 –
Pension provision to Border troops, Internal troops and EMERCOM troops	*28 143* *26 525*	*3 861* *17,03*	*0,25* *0,03*	*0,05* –
Material security to specialists of the RF nuclear weapons complex	5 095 4 802	637 15,29	0,05 0,01	0,01 –
Acquisition of housing for retired servicemen	19 770 17 132	–916 –5,08	0,18 –	0,04 –
Additional monthly material security to disabled after a service-related trauma	1 041 981	336 52,04	0,01 –	<0,01 –
Repairs of individual housing units owned by servicemen family members who lost their bred-winner	307 266	–135 –33,72	<0,01 –	<0,01 –

cont'd

1	2	3	4	5
Compensatory payments to the family members of the deceased servicemen	1 245 1 174	198 20,35	0,01 –	<0,01 –
Allowances and compensatory payments to servicemen, persons equivalent to servicemen, and retired servicemen	8 644 8 147	–3 079 –27,43	0,08 –0,03	0,02 –0,01
On-off allowance to a pregnant wife of a convicted serviceman under call-up liability, and a monthly allowance for the called-up serviceman's child	2 238 2 109	133 6,72	0,02 –	<0,01 –
In section "Mass media"				
MoD expenditures	1 500 1 300	100 8,32	0,01 –	<0,01 –
Secret/classified expenditures	*168* *146*	– –	– –	– –
In section "Inter-budget transfers to the budgets of the RF subjects and municipal establishments of general nature"				
Transfers to the budgets of Closed Administrative territorial Units (ZATO)	8 876 7 692	–1 185 –13,34	0,08 –0,01	0,02 –
Development and support to ZATO social and engineering infrastructure	2 690 2 331	–359 –13,34	0,02 –	>0,01 –
Migration from ZATO	527 457	–70 –13,34	>0,01 –	<0,01 –
Secret/classified expenditures	*820* *711*	– –	– –	– –

Source: the IEP estimates. Pensions, allowances, compensations and stipends are deflated for CPI.

Let us analyze the dynamic trend of the federal budget and its corrections in the course of the year.

In 2011, the allocations for MoD housing construction in the section "National defense" (Rb 17bn 639 mn) increased vs the previous year by 140 % (in real terms) also as a result of re-allocation of Rb 12bn in the budget year from the target item expenditures "Construction of military and special facilities", while in section "housing and utilities" (Rb 95bn 82mn) the allocations fell down by 23%. The federal budget allocations for the savings and mortgage system of housing provision to the MoD servicemen went up by 21% (in real terms) reaching Rb 29bn 740mn.

In 2011, allocations to motor fuels/lubs reduced by 10% (in real terms) down to Rb 51bn 57mn vs 2010 as a result of considerable carry-overs of the motor fuels. Thus, according to the Accounts Chamber[1], the cost of the surplus stock of motor fuels was evaluated at Rb 13bn 287mn as of June 1, 2011; during the last three years 15% up to 20% of the motor fuels (vs the established annual limits) have not been used. The shortage of motor fuels is no more a cause of low combat training since the actual average flying hours in the military aviation was about 90 hours against the 100 planned hours in 2011[2].

The federal budget allocations to MoD subsistence support continued growing by 27% in real terms vs 2010. Unlike the previous year, in 2011, allocations to MoD material support grew up by 12.4% in real terms. The MoD healthcare allocations demonstrated an interesting trend having reduced by Rb 2bn 901mn in June and increased again in November by Rb2bn 991mn (about 7.7% of their total).

In 2011, the MoD allocations to MA and additional incentives reduced in real terms by 12.5% vs 2010 down to Rb 262bn 578mn in spite of the actual increase of the money allow-

[1] Conclusive statement of the Accounts Chamber regarding draft federal law "On the federal budget for 2012 and the planning period 2013 and 2014". No. ZAM-23/1. M., October 7, 2011. P. 129–130.
[2] Independent Military Review. 2012. 16–23 March (No 8).

ances by 6.5% since April 1st. Simultaneously, the military personnel allocations to the MoD healthcare system reduced by 58% in nominal value during the year.

In 2011, allocations to MoD pension provision went up by 12% vs 2010 (in real terms) thus ensuring the 6.5% increase of the military pensions since April 1st, and pension provision to newly retired servicemen.

As a result, in 2011, direct military allocations from the Russian federal budget (*Table 38*) calculated according to the UN standard for military expenditures amounted to 4% of GDP while general military allocations with account of costs related to previous military functions (retirement pensions, destruction of chemical weapons, etc.) made 4.4% of GDP.

Table 38

Total military and military-related allocations from the federal budget

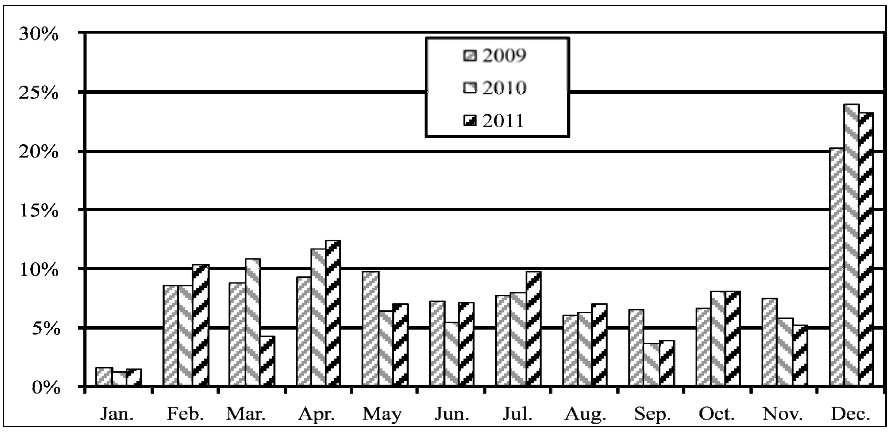
Allocation items	Allocation amount, in Rb mn,	Allocation share in % /its change vs 2010	
		in 2011 federal budget.	in GDP
Total direct military allocations	2 157 078	19,40 1,70	3,97 –0,05
Cumulative direct & indirect military allocations related to the previous and current military activities	2 375 205	21,36 1,82	4,37 –0,07
Total allocations for sections “National defense” and “national security and law-enforcement efforts”	2 779 552	24,99 1,92	5,11 –0,13

Source: the IEP estimates.

The 2011 federal budget implementation with regards to the military spend was more uniform than in 2010. According to our estimates, the excess over the limit of expenditure under “National defense” item reached its maximum of Rb5bn 866mn in July but did not exceed the limit of Rb 7bn 58mn established by part 7 Article 24 of the Law on federal budget for 2011, for the growth of military allocations at the expense of above plan budget revenues according to the consolidated budget plan.

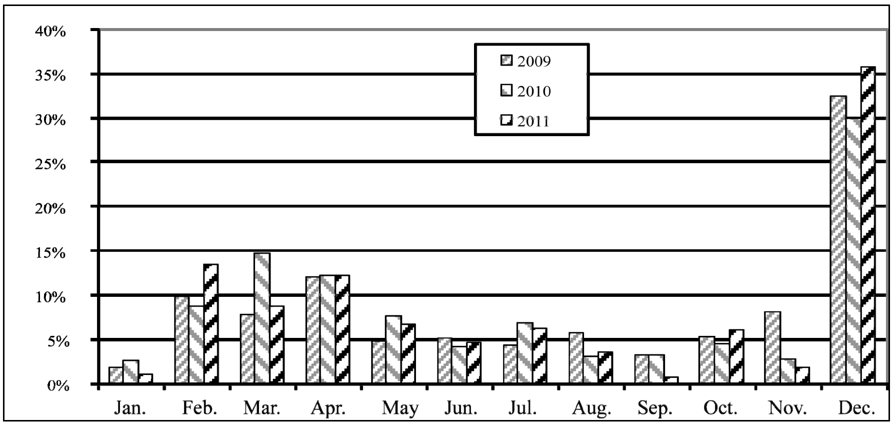
After this the said excess went to zero in November, and by the year end the consolidated plan envisaged Rb13bn of savings in section “National defense” as compared to the allocation amount sated in the budget law.

The dynamic trend of monthly execution of expenditures for major subsections of section “National Defense” in 2009-2011 is shown on *Fig. 37–39*. The expenditures of subsection “Armed Forces of the Russian Federation” that are used to fund the greater part of the MoD state military order failed to meet the two-month standard in 2011 while the December budget “tent” decreased but slightly (*Fig. 37*). The situation with expenditures in two other sections (*Fig 38*, *39*) probed to be even worse and quite considerably in the last case.



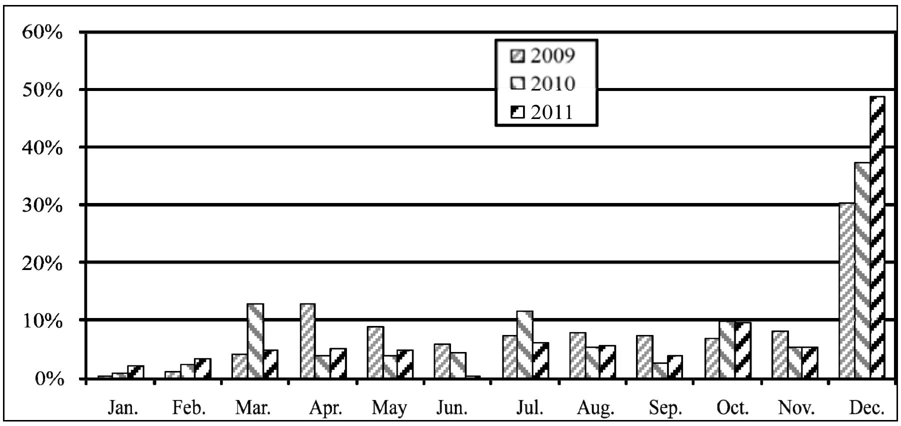
Source: the IEP estimates based on the Federal Treasury data.

Fig. 37. Implementation of federal budget expenditures under subsection "Armed Forces of the Russian Federation" in 2009–2011



Source: the IEP estimates based on the Federal Treasury data.

Fig. 38. Implementation of federal budget expenditures under subsection "Applied research in the area of national defense" in 2009–2011



Source: the IEP estimates based on the Federal Treasury data.

Fig 39. Implementation of federal budget expenditures under subsection "Other issues of the national defense" in 2009–2011

Table 39 shows military expenditures of the governments of the RF subjects that maintain long-term trends.

Table 39

Military expenditures of the consolidated budgets of the RF subjects in 2004–2011, in Rb mn*

Subsection of expenditure classification	2004	2005	2006	2007	2008	2009	2010	2011
Armed Forces of the Russian Federation	–	–	3,5 / 0,1	0,5 / 0,3	0,3 / 0,3	–	–	–
Modernization of the Armed Forces of the Russian Federation and military units	–	–	–	–	1,0 / 0,5	–	–	–
Mobilization and paramilitary training	–	65,6 / 65,6	899,3 / 808,6	1 351,9 / 1 245,6	1 797,9 / 1 702,2	2 116,0 / 2 021,6	2 003,7 / 1 958,4	2 250,0 / 2 187,3
Mobilization preparation of the economy **	532,4 / 500,6	485,4 / 468,6	708,3 / 692,8	861,2 / 840,9	1 137,2 / 1 063,9	1 045,4 / 989,7	1 298,4 / 1 247,8	1 351,2 / 1 266,3
Other issues of the national defense	–	109,6 / 97,5	32,8 / 32,1	5,5 / 5,7	0,7 / 0,5	4,4 / 4,4	<0,1 / <0,1	2,7 / 2,7
Internal troops	12,4 / 12,2	9,9 / 9,9	3,5 / 1,4	1,0 / 1,0	0,3 / 0,3	–	–	–
Security units	6,7 / 6,5	0,3 / 0,3	16,5 / 16,5	0,1 / 0,1	0,0 / 0,0	60,0 / 60,0	<0,1 / <0,1	14,5 / 14,4
Border service units	–	0,1 / 0,1	–	–	–	–	–	–
Protection of population and territory from emergencies of natural and technogenic nature, civil defense	7 968,2 / 7 281,3	11 184,6 / 10 958,9	15 636,4 / 14 367,0	19 118,4 / 18 292,6	23 895,8 / 21 456,7	23 865,0 / 21 712,6	27 218,0 / 25 527,4	34 678,1 / 32 122,9

*Numerator – allocated, denominator – actually spent.
** Before 2005, the subsection was not included in “National defense”.
Source: Federal Treasury.

Table 40 presents Russian military expenditures in the period 1999–2011 that do not include (to avoid duplication) military expenditures of the consolidated budgets of the RF subjects shown in *Table 39*.

Table 40

Main parameters of the Russian Federation military expenditures in 1999–2011

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
1	2	3	4	5	6	7	8	9	10	11	12	13	14
1. In nominal terms (current prices) Rb bn													
Implementation of FB expenditures under section “National defense” in the current budget classification [a]	115,6	191,7	247,7	295,4	355,7	430,0	581,1	681,8	831,9	1 040,8	1 188,2	1 276,5	1 516,0
FB allocations to “National defense”: current budget classification	93,7	209,4	214,7	284,2	354,9	427,4	578,4	686,1	839,1	1 031,6	1 192,9	1 278,0	1 537,4
moved to other sections of the budget classification [b]	–	–	–	–	–	–	44,3	77,7	91,3	126,5	202,4	270,8	324,4
in comparable budget classification	93,7	209,4	214,7	284,2	354,9	427,4	622,6	763,9	930,4	1 158,1	1 395,3	1 548,8	1 861,9
Military expenditures, UN data[c]	–	202,6	294,4	325,9	447,0	499,0	665,0	822,1	850,2	1 127,2	1 176,4	1 179,3	–
Total direct military allocations[d]	120,9	256,1	262,2	321,3	408,4	490,9	692,1	899,7	1 085,4	1 356,5	1 652,7	1 819,1	2 157,1
Cumulative direct and indirect military allocations related to current and previous military activities[e]	137,5	294,3	313,4	429,1	556,2	586,6	788,2	1 000,1	1 263,3	1 502,4	1 822,3	2 006,7	2 375,2
2. In real terms (in 2011 prices)[f], Rb bn													
Implementation of FB expenditures under section “National defense” in the current budget classification	1 202,9	1 285,6	1 247,9	1 265,4	1 250,0	1 289,3	1 413,2	1 343,6	1 407,2	1 434,9	1 491,9	1 517,8	1 516,0
FB allocations to “National defense”: current budget classification	975,1	1 404,4	1 081,5	1 217,3	1 247,3	1 281,5	1 406,5	1 352,2	1 419,4	1 422,1	1 497,7	1 519,6	1 537,4
moved to other sections of the budget classification	–	–	–	–	–	–	107,6	153,2	154,5	174,4	254,1	321,9	324,4

cont'd

1	2	3	4	5	6	7	8	9	10	11	12	13	14
in comparable budget classification	975,1	1 404,4	1 081,5	1 217,3	1 247,3	1 281,5	1 514,1	1 505,4	1 573,9	1 596,5	1 751,9	1 841,5	1 861,9
Military expenditures, UN data	–	1 358,8	1 483,3	1 396,2	1 570,9	1 496,1	1 617,1	1 620,1	1 438,2	1 554,0	1 477,1	1 402,1	–
Total direct military allocations	1 257,6	1 717,0	1 320,9	1 376,5	1 435,1	1 471,9	1 683,0	1 773,1	1 836,1	1 870,1	2 075,1	2 162,9	2 157,1
Cumulative direct and indirect military allocations related to current and previous military activities	1 431,0	1 973,4	1 578,9	1 838,3	1 954,7	1 758,8	1 916,7	1 970,8	2 137,0	2 071,3	2 288,0	2 385,9	2 375,2
3. In real terms (in 1999 prices), Rb bn													
Implementation of FB expenditures under section "National defense" in the current budget classification	115,6	123,5	119,9	121,6	120,1	123,9	135,8	129,1	135,2	137,9	143,4	145,8	145,7
FB allocations to "National defense": current budget classification	93,7	135,0	103,9	117,0	119,8	123,1	135,2	129,9	136,4	136,7	143,9	146,0	147,7
moved to other sections of the budget classification	–	–	–	–	–	–	10,3	14,7	14,8	16,8	24,4	30,9	31,2
in comparable budget classification	93,7	135,0	103,9	117,0	119,8	123,1	145,5	144,7	151,2	153,4	168,3	177,0	178,9
Military expenditures, UN data	–	130,6	142,5	134,2	151,0	143,8	155,4	155,7	138,2	149,3	141,9	134,7	–
Total direct military allocations	120,9	165,0	126,9	132,3	137,9	141,4	161,7	170,4	176,4	179,7	199,4	207,8	207,3
Cumulative direct and indirect military allocations related to current and previous military activities	137,5	189,6	151,7	176,6	187,8	169,0	184,2	189,4	205,4	199,0	219,9	229,3	228,2
4. Military burden on the economy, % of GDP													
Implementation of FB expenditures under section "National defense" in the current budget classification	2,40	2,62	2,77	2,73	2,69	2,53	2,69	2,53	2,50	2,52	3,06	2,87	2,79
FB allocations to "National defense": current budget classification	1,94	2,87	2,40	2,63	2,69	2,51	2,68	2,55	2,52	2, 50	3,06	2,83	2,79
moved to other sections of the budget classification	–	–	–	–	–	–	0,20	0,29	0,27	0,31	0,52	0,60	0,60
in comparable budget classification	1,94	2,87	2,40	2,63	2,69	2,51	2,88	2,84	2,80	2,81	3,60	3,43	3,42
Military expenditures, UN data	–	2,77	3,29	3,01	3,38	2,93	3,08	3,05	2,56	2,73	3,03	2,61	–
Total direct military allocations	2,51	3,51	2,93	2,97	3,09	2,88	3,20	3,34	3,26	3,29	4,26	4,03	3,97
Cumulative direct and indirect military allocations related to current and previous military activities	2,85	4,03	3,50	3,97	4,21	3,44	3,65	3,72	3,80	3,64	4,70	4,44	4,37
5. Purchasing power parity (in current prices), Rb bn													
Implementation of FB expenditures under section "National defense" in the current budget classification	21,9	26,8	30,2	31,9	34,2	36,2	45,6	54,0	59,5	72,6	82,0	79,9	93,3
FB allocations to "National defense": current budget classification	17,7	29,3	26,2	30,7	34,1	35,9	45,4	54,3	60,1	71,9	82,3	80,0	94,7
moved to other sections of the budget classification	–	–	–	–	–	–	3,5	6,2	6,5	8,8	14,0	16,9	20,0
in comparable budget classification	17,7	29,3	26,2	30,7	34,1	35,9	48,9	60,5	66,6	80,8	96,3	96,9	114,6
Military expenditures, UN data	–	28,3	35,9	35,2	42,9	42,0	52,2	65,1	60,9	78,6	81,2	73,8	–
Total direct military allocations	22,8	35,8	32,0	34,7	39,2	41,3	54,3	71,2	77,7	94,6	114,1	113,8	132,8
Cumulative direct and indirect military allocations related to current and previous military activities	26,0	41,2	38,3	46,3	53,4	49,3	61,9	79,2	90,4	104,8	125,8	125,6	146,3
For reference													
GDP deflator, % to the previous year	172,5	137,6	116,5	115,5	113,8	120,3	119,3	115,2	113,8	118,0	101,9	111,4	115,4
Expenditures deflator on end consumption of collective services of public administration[g], % to the previous year	140,1	155,2	133,1	117,6	121,9	117,2	123,3	123,4	116,5	122,7	109,8	105,6	*118,9*
Purchasing power parity[h], Rb/$	5,29	7,15	8,19	9,27	10,41	11,89	12,74	12,63	13,97	14,34	14,49	15,98	*16,24*

[a] For 2011. – preliminary data on federal budget implementation of Federal Treasury.
[b] Total expenditures of MoD and secret/classified expenditures under sections 05–09 and 11 of 2005–2011 federal budgets for 2011 – additionally for section 12.
[c] For 2011 – RF government will provide the data to UN in 2012; these will include expenditures for maintenance of the internal, border troops and civil defense
[d] Including maintenance of the internal, border troops and civil defense troops.
[e] With servicemen retirement pays.
[f] Deflated by the deflator of expenditures on end consumption of collective services of public administration.
[g, h] For 2011 – the IEP estimates.

Source: Federal laws on the federal budgets of 1999–2011 and on the implementation of the federal budgets of 2000–2010.; Russia's national accounts in 1997–2010 Statistical collection/Rosstat M., 2005–2011; Objective information on the military issues including transparency of the military expenditures. UN General Secretary reports of 2001–2011.; Rosstat; Federal Treasury.

* * *

The objectives of the 2011–2020 state arms program to raise the share of state-of-the art arms in the current force up to 70% by 2020 and in the strategic nuclear force – up to 100% are non-realistic and counterproductive since, firstly, these objectives are unreachable given the potential of the national industry, and this has been confirmed by the results of the first year implementation of the said program, and secondly, they doom the national industry to a more than two-fold reduction of the strategic nuclear weapons production after 2020, and of the conventional weapons for the national Armed Forces, after 2025. If these reductions take place, one should not rely on a considerable compensation of the reduced weapons at the expense of growing weapon exports, specifically with respect to the strategic nuclear weapons.

According to the Russia's Ministry of Defense data[1], the share of state-of-the art weapons in the armies of the leading foreign countries makes 30% to 50%; this apparently sets up a necessary pace for development of their defense industries that supply products to the domestic markets.

Therefore, assuming that the optimal value of the said target indicator would be in the same range for Russia as for other countries with sufficiently developed military production and following the declared value of the state arms program worth Rb 20 trillion for 2011-2020, we can estimate possible saving of the budget at the expense of the arms program till 2020 inclusively within the range Rb5.3 trillion – Rb14.8 trillion (with account of the attained, by early 2012, target indicator of the arms program at 25% and 16% for strategic and conventional weapons, respectively).

To overcome the current bureaucratic stupor caused by the fight between the Ministry of Defense and the Russian defense and industrial complex may be possible only if the military and technical policy returns to the route pointed out by V. Putin back in 2004 in his President message to the Federal Council in the form of a statement on "the transparent military economy" as an absolutely necessary condition of the successful reform. This for sure will require abandoning the latest practice of thoughtless pumping of budget funds into the defense and industrial complex, improving discipline at all the tiers of the public administration and doing away with the administration irresponsibility. The directive and financial methods of managing the defense and industrial complex in the existing context of the vertical power model proved to be ineffective and inefficient both in a short-term and long-term perspective; and the 12-year long experience is a good evidence of this.

Indeed it is impossible to improve the efficiency of expenditures including the military expenditures unless accurate statistics is published, federal budget gets transparent, a policy of openness (glasnost) on the issues of defense is carried out and corruption is fought with effectively. *Table 35* gives you an idea of what a long way Russia will have to go.

The irrational institution of the program-based planning of weapons that is outdated in terms of the format and the content still remains the only tool of blackmailing politicians and

[1] Interview of V. Popovkin, Deputy Minister of Defense//National Defense, 2011, March.

the community forcing them to satisfy, every five years, the ever growing appetite of the Russian defense and industrial complex with no responsibility for the outcomes. This may create a *dangerous* effect that feeds up not only the ongoing growth of military expenditures but also leads to militarization of the community backed up with the statement about increasing defenselessness of Russia.

The modern Armed Forces of Russia have not been among the top five world leading armies, and so far there is no opportunity for them to reach this target set by the MoD leadership. Among the G8 states, Russia remains the only country with the army which by over one half is formed involuntary, by the call-up principle. Given the established total numerical force of one million, the efforts to staff all the military units at 100% failed due to erroneous notions about the number of conscripts and low attractiveness of the military service. The ongoing "humanization" of the call-up military service is useful, no doubt, but it is not going to resolve the problems of the service effectiveness.

The program of transition of the constant readiness military units to the contract enlisting during 2004–2007 failed for the sake of keeping the conscription and the "feeding trough" for corrupt officials engaged in conscription. Up to now, the persons at fault have not been punished, no lessons have been drawn from the situation and the intentions to increase the number of enlisted by contract continue running into old corruption factors and the absence of understanding by the government officials of the needs of the servicemen and their family members, and the real difficulties of the military service. As a result of this policy, the initial money allowance of the soldiers (rank and files) is going to be lower than the average wage across the country even after the latest increase of this allowance, though the Strategy of social development approved by the RF MoD fixed the 25% excess of MA over the average wage. It may be expected that the competitiveness of the army at the employment market would remain low. The attempt to equip the army with volunteers from the CIS countries who wish to become citizens of Russia seems to be totally inefficient.

Economic incentives are needed to support the declared annual increase of the numerical force of the army by 50,000 of the enlisted by contract, these incentives could ensure manning of new positions and replacement of the retired, and this would set the annual enlisting requirement up to 70,000. To reach this level would be hard if the initial amount of the rank-and file money allowance is not increased in the near future.

The announced by the Joint Staff Commander proposals for implementation of the system of continuous military training of the servicemen that so far covers officership only, should also include soldiers and the junior command personnel.

6.8. Strategy of Socio-Economic Development of the North-Caucasian Federal Okrug: the First Steps

Strategy of the socio-economic development of the North-Caucasian Federal Okrug through 2025 was approved more than a year ago, and its implementation has already kick-started. But already at the onset there arose risks which experts had long forewarned of: specifically, the Strategy implementation mechanisms may exacerbate typical of the North-Caucasian regions problems and fuel new ones. Hence an integral component of the NCFO Strategy should become a policy comprising strictly defined rules and procedures and aiming at prevention of conflicts.

Strategy in a Nutshell

Strategy of the socio-economic development of the North-Caucasian Federal Okrug through 2025 was approved by Resolution of the RF Government No 1485-p of 6 September 2010. The mission of the strategy is "to ensure conditions for advanced development of the real sector of the regions in the Okrug, generation of job opportunities, raising the residents' living standards". In the frame of an optimal scenario of development of NCFO by 2025 it is planned to:

- create no less than 400,000 jobs and bring unemployment from 16% down to 5%;
- reduce the proportion of the population with incomes under the subsistence level from 16.5% to 9.2%;
- raise average salaries and wages from Rb 9,600 to 23,800;
- ensure the annual GRP increase rate at a level of 7.7% (with its cumulative growth over the period in question accounting for 2.7 times) and the annual increase rate in the industrial sector at a level of 10.1%;
- quadruple consolidated regional budget revenues per capita.

It is envisaged to ensure such a breakthrough by encouraging advancement of the real sector, including the agro-industrial complex, tourist-recreational one, energy, mining and processing industries, and transit functions. It is also envisaged to bolster innovation-educational activities and establish a federal university.

During most of the period of 2010-2011, the Strategy was largely "appended" with necessary paraphernalia, such as the normative base, organizational structure, etc. There began functioning the Commission of the RF Government for the North Caucasus led by PM V. Putin as its Chair. To implement the Strategy, there were established JSC "the North Caucasus Development Corporation", a subsidiary to Vensheconombank, with the authorized capital of Rb 500mn, and JSC "Resorts of the North Caucasus", a subsidiary to JSC 'Special Economic Zones" with participation of Vnesheconombank and Sberbank of Russia, with the authorized capital of Rb 5,35bn. The RF Ministry of Regional Development, regional agencies in charge of economic development became engaged in projects selection. A range of public advisory bodies were created: the Council under the Envoy, the Public Council of the Okrug, The Anti-Corruption Council, the Council of Elders, the Council for Youth Policy, the Council of Alims, the Okrug Commission for Cossack Affairs, the Expert Council, to name a few.

That said, not all the problems were solved even on the organizational level. Specifically, the widely publicized federal target program "Development of the North-Caucasian Federal Okrug through 2025" was not adopted. In accordance with the FTP, it was planned to allocate Rb 3.9 trillion, including 2.6 trillion out of the federal budget, for development of the North Caucasus. Devised in July 2011 by the RF Ministry of Regional Development, the FTP consists of 10 sub-programs and over 8,300 measures. It is envisaged that three currently implemented federal target programs which concern the NCFO regions, namely, "The Socio-Economic Development of the Republic of Ingushetia for 2010-2016", "The Socio-Economic Development of the Republic of Chechnya for 2008-2013", "South of Russia (2008-2013)" (with regard to RF Subjects within NCFO), should form structural components of the Program. It is planned to allocate, on the annual basis, some Rb 400 bn to implement this program in years to come.

However, the program has not been adopted as yet, particularly because of significant controversies with the RF Ministry of Economy and Ministry of Finance with respect to its funding. The program is to be approved by May 2012, but it is not clear how to combine a gargantuan increase in the federal spending on the North Caucasus with the task to ensure a sustained balancing of the budget and ensuring a budget maneuver in favor of sectors of the social sphere which the nation faces today in connection with the imperative of attaining its strategic development objectives on the whole.

Prospects and Risks Facing the Tourist Cluster

It was the work on shaping the tourist cluster that proved particularly active. With its Resolution No. 833 of 14 October 2010 "On creation of the tourist cluster in the North-Caucasian Federal Okrug, Krasnodar krai and Republic of Adygeya", the RF Government ruled to establish 5 tourist-recreational special mountain skiing economic zones, of which 4 ones – in the North-Caucasian federal okrug (Matlas in Dagestan, Elbrus-Bezengi – in Kabardino-Balkaria, Arkhyz – in Karachaevo-Cherkessia and Mamison – in North Ossetia – Alania). It was envisaged that the Government would invest, through JSC "RNC", Rb 60 bn in the transport and communal infrastructure of these projects, with the private businesses financing construction of resort infrastructure objects against the RF Government's guarantee to return up to 70% of their investment in the event of force majeure and vows to grant tax and customs benefits. More specifically, tax benefits include exemption from the federal component of the corporate profit tax (2%) coupled with a possible slashing to 0% of the current 18% regional component thereof, and exemption for the term of up to 10 years from land and property, and transport taxes.

The year of 2011 saw vigorous efforts to attract foreign investment into the project. The Russia-France summit in Dauville in May 2011 resulted in a joint declaration on inclusion of the project of development of a tourist cluster in the North Caucasus in the list of priority directions under the aegis of the nations' strategic partnership. At the St. Petersburg Economic Forum, JSC "RNC" signed a memorandum of intention with the French state-owned holding Caisse des Dépôts et Consignation with regard to a joint venture to contribute to the tourist cluster development project. In late 2011, a joint Russian-French venture "The International Development of the Caucasus" was incorporated, which is to commence its operation in February 2012. In compliance with the Incorporation Agreement signed by the parties thereto, the newly established joint venture plans to attract up to Euro 1 bn in investments in the project.

The work on building a mountain skiing cluster has just kicked off (construction *de facto* is in progress only in Arkhyz), but with its Resolution of 29 December 2011 No. 1195 "On special economic zones in the North-Caucasian Federal Okrug", the RF Government has already doubled in size the territory of the North-Caucasian tourist-recreational complex. More specifically, special economic zones of tourist-recreational type are established in the Republic of Ingushetia (in the territory of Jeirakh and Sunzhen districts), along the Caspian shore in the Republic of Dagestan and in a number of other territories. At this point, it should be noted that peaceful environment, the absence of ethnic and confessional conflicts and acts of terror are not typical of all those territories. There also exist plans to have the company's operations spread across other territories, including those beyond the North Caucasus. In parallel there intensify demands for public funding to build the infrastructure. It has been announced recently that it is imperative to build four new airports and reconstruct two existing ones in the region.

The envisaged deliverables indeed pursue the goal of a substantial transformation of the economic basis to bolster the region's advancement and include creation of over 1,000 km of pists, over 200 cable tramways, erection of hotels, apart-hotels and private cabins of different categories with the overall capacity of some 85,000 beds. It is envisaged that the project implementation will generate over 330,000 jobs in the region. It is planned to have local resorts in the North Caucasus and along the Caspian shore be able to accommodate up to 250,000 tourists a day. In accordance with the publicly voiced estimates, once the project gets into top gear, the tourist inflow in the region will account for 10 mn people. The peak of construction works will fall on 2013-17 and the program is scheduled for completion in 2019.

Meanwhile, a series of fundamental questions raised a year ago regarding development of the tourist cluster in the region still remain unanswered. Let us cite three of them.

First, the *occupancy rate.* At the existing resorts in the North Caucasus, the high-season occupancy is 10-15,000 alpine skiers a day. The season lasts for 100-120 days. Besides, even prior to the 2011 developments which battered the local ski industry (see below), the number of tourists there had been dwindling[1]. There has been no in-depth examination of demand for services of those tourist giants which are supposed to be created in the region or, at least, respective findings were not made public.

Second, *what is going to happen to the existing tourist centers?* There are at least two large ski centers in the region: at the vicinity of Mt. Elbrus (Kabardino-Balkaria) and Dombai (Karachaevo-Cherkessia). Given development of the tourist cluster, their prospects remain murky. They will obviously prove undesirable rivals to the ski cluster under construction which lower their chances for survival. That said, it is worth noting they both are holders of a real brand, with the Elbrus one boasting an internationally recognized brand of both ski and mountaineering center. They secure quite a number of job opportunities for both locals and seasonal staff and it is not guaranteed they would be able to find their niche in the frame of the new tourist industry with its greater, and somewhat different, requirements. It is not at all granted, either, that residents of once long-standing tourist industry leaders which subsequently fell prey to the state would necessarily welcome new privileged rivals. It is more likely that such a development would fuel new intense conflicts in the region and no one is insured against such conflicts growing violent.

This compels posing the third and, perhaps, the most thorny – at the moment – question*: how can development a tourist cluster* receiving 250,000 visitors a day, including women and children (as it is also planned to develop family tourism), *combine with the threat of acts of terror*? The act of terror in Kabardino-Balkaria on 18 February 2011, which left three tourists dead and another three wounded[2], is a perfect demonstration of the gravity of the threat in question. The fact that the first act of terror against tourists took place after making public the gargantuan plans to develop a tourist complex in the region, thus increasing the political and economic significance[3] of security issues, cannot help but compel contemplating the urgency

[1] See: North Caucasus –Modernization challenge.-M.: Delo Publishers, 2011, p. 222-223.

[2] Actually, the killing of the tourists on 18 February was just the first link the in the chain of terrorist attacks in the territory which aim at derailing the local tourist business. The next night, a pillar of a local cable tramway was blown, and a mine-strewn car was found at a local alpine place popular with tourists.

[3] Experts differ on the issue. Thus, Islam Tekushev, Director of medium Orient news agency suggests that behind the acts of terror were forces striving to topple Arsen Kanokov, the incumbent President of Republic of Kabardino-Balkaria: "It is not known when clans and local thugs represented by the Kabardino-Balkar underground began to systematically work on destabilization of the situation for the sake of their common objective,

of creation of efficient anti-terrorist mechanisms. This problem is a genuine life-and-death one for the future tourist cluster. That said, while discussing respective plans in this sphere, these problems have not even been made public.

In practice, it is the forceful option that still remains predominant in this regard, with the sole response to the rise of terrorism in the Republic being a counterterrorist operation regime (CTO) since 20 February 2011. In Elbrus district and in a part of Baksan district the CTO regime was canceled only on 5 November 2011, thus having lasted for over 8 months. From the perspective of forceful action, its results were positive and the militant underground suffered a serious blow. According to the local Ministry of Interior, 95 illegal militants were killed and another 97 detained during the CTO period. That said, a longer-range success of such a policy does not seem that granted.

First, like many other actions of this sort, the one in question was accompanied with abuses of human rights, including killing innocent individuals who were taken for militants and inflicting damage on non-combatants' property. Specifically, once again the crackdown on the regular "mosque-goers" was on the upswing. During the CTO, mosques stayed empty in Elbrus district as local residents were afraid of dropping by. NGO "Memorial" cites an example of the local authorities' failure to engage militants' families to get their children out of the "woods". A month and half after airing their mothers' video with an appeal to put an end to the civil war there was broadcast another one which evidenced that sons of two women who had recorded the video in the summer were killed literally in their presence during a "special operation" in the town of Baksan[1]. It is this kind of situation that gives rise to the "vicious cycle of violence" when suffering and deaths of the innocent, often relatives, friends and mates, in the course of combat against terrorism bolsters the desire to revenge and result in augmentation, rather than fading, of the armed struggle.

Second, the territories concerned saw the local economic activity in ruins. The influx of tourists in the locality has fully discontinued since the moment of imposition of the anti-terrorist operation regime there. Hoteliers and other operators and owners of the local tourist infrastructure objects faced a grave challenge, as they had already taken loans in the hope to expand their businesses. Employees, too, found themselves on the verge of hunger, and so did small-sized businesses, including, in particular, craftsmen and artisans (there even was a probability of not sending children to school on 1 September, as there was nothing to wear). Unknown structures were vehemently buying land at giveaway prices[2]. While the CTO regime was canceled in early November 2011, it goes without saying it will be fairly hard to avoid its long-term adverse effects.

For one part, the residents' growing discontent is centered both on militants and the authorities, which manifested itself even on the official level. While meeting with residents of

that is, toppling Kanokov… Customers realized very well that killing tourists within the zone of a federal ski resort popular with mountaineers, rock-climbers and skiers throughout Russia and European states does not fit in the framework of permissible risks set by Russian elites in the Caucasus" (Islam in the North Caucasus: history and modernity. Prague, Medium Orient, 2011, p. 178-179). In the Republic, a widespread opinion is that the spike of violence is directly associated with the struggle for control over the tourist business.

[1] Bulletin of the Memorial human rights watchdog. Situation in the zone of conflict in the North Caucasus: the human rights activists' assessment. The summer of 2011. Source: the human rights advocacy center "Memorial"//"Caucasian knot". http://www.kavkaz-uzel.ru/articles/194174. 18 October 2011.

[2] We visited this locality during the ATO period. Even on the surface the picture was terrifying: packs of hungry dogs, rags of billboards flying in the wind, and not a single human being around.

settlement Elbrus, President A.Kanokov of Kabardino-Balkaria enunciated that, “Nobody was going to impinge upon the local residents’ interests, despite the dearth of talks about that”. However, in private conversations the local residents cited a comment made by a high-ranked federal bureaucrat: “You are going to starve till the last Wahhabi!” Such an automatic labeling of local residents as terrorists’ accomplices does not help ensure a social harmony in the Republic, either, and contributes to the said “vicious circle of violence”.

On the other hand, development prospects for tourism in the region and, perhaps, throughout the North Caucasus have been jeopardized. While it is yet premature to assess prospective losses, some short-term results have become already known. Since mid-December the local resort’s occupancy rate has been just 15%, while during the high season (New Year holidays) it received twice as little tourists than a year before. According to information available, local businesses’ economic losses are further exacerbated by the need to invest in security and no possibility for even an inflation-adjusted price rise. Meanwhile, compensations payable to local residents for damages inflicted by ACT are preposterous: according to information available, the Elbrus district residents are entitled for a total of Rb. 1.5mn in compensations, while the neediest households received a Rb. 15,000-worth compensation each.

Apart from ACT, the official reason for a meager tourist inflow in the region is the snowless winter. Future will show which factor plays a greater role; however, it is already clear that restoration of the Elbrus district and the North Caucasus on the whole as an appealing ski resort can take a lot of time and costs.

At this juncture it is evident that a successful development of the local tourist cluster is up in the air without fundamentally new approaches to security challenges in the region. Most North-Caucasian Republics already rejected the credibility of the purely forceful solution.

Some efforts were made, albeit with a different level of consistency and success, in Dagestan, Ingushetia and Kabardino-Balkaria to mitigate the standoff and return former militants to peaceful life, but federal structures did not contribute to the process, thus drastically lowering its efficiency. Should such a policy be pursued further on, it may seriously torpedo the Strategy implementation.

Project Financing

The possibility to obtain guarantees or other forms of backing to investment projects aroused much interest in the region, primarily with the medium-sized business community. Practically all its representatives we interviewed last year were preparing projects to apply for the support. Meanwhile, those entrepreneurs who have already faced the selection procedure sounded ambiguous. Thus, it was noted that structures engaged in the selection process are keen to pick large, rather than small, projects and explicitly encourage the entrepreneurs to extend their projects and increase volume of investment. But the process is at its onset, and it is too early to assess its efficacy. Thus, Rb 50bn allocated in the 2011 budget for provision of state guarantees against loans attracted by legal entities to implement investment projects in the North Caucasus was carried forward to the 2012 budget (accordingly, the latter now provides for Rb 100bn in allocations for the said purpose).

Main technical problems exposed by now were quite predictable. Those were: an insufficiently high quality of projects and a low level of their development. This factor might become one of the reasons behind the decision to transfer implementation of most projects to Stavropol krai, with its lower risks and a relatively higher culture of project implementation, as evidenced by Mr. A. Khloponin, the presidential Envoy in NCFO: “For next year

Rb. 6.6bn from the Investment Fund was planned in the budget, and all the allocations are for projects in NCFO, infrastructure development. But it is only Stavropol krai which is ready and already in receipt of Rb 3bn. The rest of the money has not been assigned as yet, as there are no concrete projects and documentation in accordance with which the projects need to be funded"[1].

Meanwhile, conflicts engendered by implementation of state-sponsored investment projects were not long in coming. A particularly explosive situation emerged in Nogaysky district of Dagestan, where it was planned to build a sugar-processing plant.

The fuel for the future conflict had been there even before the respective decision was made and it was the land. The district in question is a territory where most lands (over 60%) fall under the category of the so called distant-pasture cattle rearing ones and as such are used by settlers from mountainous regions (the Dargin and Avar peoples), rather than the local Nogays. Ex-highlanders have also staked out most pastures in the district that did not fall under the above category, thus de-facto leaving the Nogays with a meager fraction of arable land in their hands. It is most of these lands (some 100,000 hectares) claimed by the sugar-processing plant development project. The locals conceived of the project as a threat from different perspectives.

First, in the absence of formal land titles, the disputable lands *de facto* prove to have been fixed with the locals. Informal property rights are widespread in Dagestan and the residents therein regard them as legitimate ones. Thus, the investor's arrival was *de facto* perceived of as a way to strip the residents off their last land plots. Besides, the Nogay *vox populi* is that sugar beet cannot be cultivated in the local climatic conditions.

Second, the construction of the prospective plant was perceived of as a means to ensure the highlanders' further migration into the territory of the district. Such conclusions were made basing on the fact that the project provided for 15,000 new jobs. But the local residents cannot supply workforce in such quantities. Besides, there practically is no qualified staff among them, as the Nogays have never been engaged in planting sugar beet. The need to attract extra workforce into the region was voiced by the Republic's leadership too.

More fat into the fire was added by the fact that the project was initiated by an Avar from Khasavyurt district of Dagestan.

The local residents' protests were ultimately a success and the project was transferred to a neighboring district. But a fragile equilibrium in the district was broken, the residents grown politically mobilized and the conflict started living its own life which was independent of the investment project which had triggered it. At the congress of the Nogay people[2] held in the capital of Nogay district, the settlement of Terekli-Meleb, in late May 2011, in addition to the problem of the sugar-processing plant, the residents raised more general political issues: the need to unite all the Nogays in the frame of an administrative-territorial entity, transition to direct elections of the district Head, etc. Even after the decision was made to relocate the construction project in question, the Nogays' activity did not subside, the conflict with the district authorities escalated and the range of political demands was expanding (the opposition now is

[1] Yuri Goverdovsky. The North Caucasus have a Development Strategy// The Parliament Gazette, No. 48 (2464). http://www.pnp.ru/newspaper/20101001/4614.html. 1 October 2010.

[2] Main territories of the Nogays's compact residence; Dagestan, Chechnya, Karachaevo-Cherkessia and Stavropol krai, and Astrakhan oblast. There are Nogay national districts in Dagestan and Karachaevo-Cherkessia.

against election of the local legislature on party ticket). According to mass media, "the region itself is growing into a full-fledged zone of conflict"[1].

The risks emerged already at the onset of the Strategy implementation, which proved associated with escalation of the conflict potential in the North-Caucasian regions, require an additional development, in the frame of the NCFO Strategy, of a policy aiming at prevention of the rise of additional conflicts. This can be at least partly ensured through devising a set of rules and procedures which would secure a sound awareness campaign, taking into account the residents' opinion and refusal of projects that may have an adverse effect on social stability in the region.

The latter is in need for a more detailed explanation. The previous record of launching investment programs in the North Caucasus exposed an extreme danger of implementation of projects that provided for withdrawal from the economic turnover of sizeable arable land sites (eg., as a result of their impounding). By destroying traditional livelihoods without offering a credible alternative, such projects can provoke the rise of extremism in the territories concerned. It seems appropriate either to shelve such projects at all, or to secure a maximum possible account of the popular opinion and get the projects implemented only upon mobilization of a broad public consensus. As in the conditions of the North Caucasus monitoring of genuineness of such a consensus may pose certain problems and be associated with sizeable costs, the former option (a ban on projects associated with a large-scale land withdrawal) may prove the most sound one.

The policy in question should also encompass anti-terrorist activity and provide for abandonment of a purely forceful solution to the problem and engagement of mechanisms securing public consent with participation of the federal center which should become a guarantor behind agreements reached and coordinator of law enforcement agencies and other "*siloviki*"'s contribution to the process in question.

[1] Ivan Sukhov. The Nogay Riot. The biggest district in Dagestan demands for non-party elections. Moscow news. http://mn.ru/blog_caucasus/20110905/304671811.html. 5 September 2011. 17:12.

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Trends and Outlooks

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