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The review provides a detailed analysis of main trends in Russia's economy in 2012. 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. The socio-political context

1.1. Economic policy during 2012: Between modernization and stagnation¹

Russian economic development during 2012 was influenced to a significant degree by the world economic crisis. The global crisis has now entered a decisive phase in which the shape of the economic system of the future – the new equilibrium that the world economy has been seeking to achieve since the upheavals of 2008 – is becoming apparent. A new economic growth model has begun to emerge. Indeed, this is how global structural crises generally resolve themselves – the crises of the 1930s and the 1970s had a similar outcome. Creation of this new model will involve the formation of a new technological basis for society, an appropriate new system of regulation of socio-economic processes, the overcoming of macro-economic imbalances, the beginning of a new trajectory of growth and the adoption of a new system of reserve currencies². Periods of crisis are generally marked by economic and political instability – we should brace ourselves for a turbulent decade.

Analysis of the events of the last year will enable us to discern the emergence of the new technological and socio-economic system. As the new system takes shape, we shall be able to discern the “point of transition”, that is the point of emergence from the crisis. We should emphasise that a structural crisis, unlike a cyclical crisis, is accompanied by a recession: the start of a structural crisis should not be confused with the start of a recession but rather with the end of a recession – with a return to a trajectory of growth. A recession is only a particular episode (or several episodes) in the evolution of a structural crisis: it is not a system-forming or defining characteristic of the crisis.

1.1.1. Some global trends

Technological challenges. We are witnessing the appearance of new technologies that significantly increase the productivity of labour and reduce the cost of production. The proportion of labour expenditure on the production of new goods is falling relative to labour expenditure on design. Furthermore, in post-industrial society, technological development is in-

¹ The author wishes to thank A.Vedev, A.Moiseev, K.Rogov and K.Yudaeva for the valuable advice they provided during the preparation of this article.

² The structural crisis and methods for resolving it have been considered in more detail in the surveys of the Gaidar Institute for 2010 and 2011. See *The Russian Economy in 2010. Trends and Perspectives (Issue 32)* [Moscow, Gaidar Institute, 2011], pp.9-24; and *The Russian Economy in 2011. Trends and Perspectives (Issue 33)* [Moscow, Gaidar Institute 2012]. pp.9-28.

creasingly oriented towards the individualization of production: there is an increasing preoccupation with the needs of the individual consumer both in the production of goods and in the delivery of services. Finally, the increasing complexity of modern products frequently requires that design and production be located in close territorial proximity (this is probably one explanation of the economic and technological success of California).

Amongst these recent technological achievements we should include new methods of gas extraction. These are capable in future of fundamentally transforming the global system of energy supply and the consequences, political as well as economic, will be significant. Competition for access to fuel and energy resources will not diminish but will change direction. There will be a reappraisal of what is currently understood by the term “energy super-power”.

All of these circumstances, taken together, will make for a new location of productive forces whereby the high-tech functions of production which were in the past transferred to offshore “peripheries” will be repatriated to the countries of the developed “centre”. This trend will be accelerated by an increasing cost of labour in the developing countries, particularly in those that during the last two decades have succeeded in controlling high birth rates. In other words, labour costs in the new sectors will be relatively low and will diminish, and the individualization of production (orientation on the individual consumer) will require the direct participation of this consumer in the “assimilation” of the goods produced.

Of course, this does not mean a closing down of production in the “new industrial countries”. These countries also constitute important markets for finished goods, high-tech goods included. However, there are a number of important conclusions to be drawn for the post-crisis model of development.

Firstly, competition for investments and the location of production facilities, not only between developing countries but now also between these countries and the developed countries, will inevitably be stepped up. Decision-making as to where production should be located will come to involve a *greater* number of factors than whether to seek higher profits from countries with low-grade institutions or accept lower profits from countries where institutions are stable.

Secondly, the developing countries will not only have to create conditions favourable for production (cheap labour and viable institutions, which is to say an appropriate environment for investment and enterprise); they will also have to stimulate internal demand. Internal (or regional) demand will become an increasingly significant factor in the taking of investment decisions, especially for global corporations. This will make for significant changes in the economic policy that has been successfully implemented during the last thirty years (from Germany to China).

Thirdly, it is likely that there will be a “new industrialization” of the developed countries. At the very outset of the present crisis, this possibility was raised by a number of US politicians and economists and the Russian government has also spoken of this from time to time. This “re-industrialization” would consist not so much the revival of traditional industrial sectors but in the emergence of completely new sectors in which intellectual activity and production are closely intertwined. The territorial location of these processes according to input costs would make no sense. By the same token, under a “new industrialism” there would be no point in pitting the industrial sector against the financial sector, a policy that is increasingly being adopted by left-wing politicians in certain developed countries (during his electoral campaign, François Hollande declared a “war against the world of finance”).

This brings us to the fourth point, the consignment to the past of the distinction between backward and progressive branches of the economy. In the modern world, any branch of the economy can be simultaneously high-tech and underdeveloped. The branch structure of an economy will be no guide as to whether the technological base of that economy is backward or progressive¹. The same applies to the relationships between goods and services, in so far as the latter will more and more often become an extension of the former and the distinction between the two will disappear.

Fifthly, governments will have to stimulate economic growth and encourage the creation of high-tech jobs rather pursue the growth of production and security of employment at all costs. This will require a serious shift in the paradigm of economic policy. Every government, be it of a developed or developing country, would rather support existing enterprises than risky new ventures. Even when governments commit themselves to technological innovation, they tend to look backwards and select technological trends that have already become established. This greatly increases the likelihood of errors in the setting of budgetary priorities.

Institutional and structural reforms: During the last year or two we have witnessed the beginning of significant changes in the organization of socio-economic processes in the leading countries of the world – developed as well as developing. These structural shifts are part of the gradually emerging new model of regulation.

When the crisis began there was an outburst of left-wing criticism of the economic liberalism of the previous twenty years and calls for a renewal of direct state economic regulation. However, several months later, different voices were heard, warning against “Crass Keynesianism” and arguing that what was needed was, rather, a new model of regulation that took account of the globalization of economies and of the challenges posed by new technology. At present the new model of regulation is evolving along two lines:

On the one hand, national institutions are being consolidated within a context of regional integration. Understandably, these changes are being pursued most actively within the Euro-zone, where the problems of a single currency have demonstrated the vital importance of coordinating the regulation of financial institutions and fiscal systems. Processes for integration have also gained momentum in the post-Soviet territories – the formation of the *Customs Union* and of the *Eurasian Economic Community* (CAEU), although here the principal objective has been the creation of a large market, an objective achieved in Europe several decades ago.

Secondly, the need for systems capable of regulating financial institutions that operate on a global scale has become apparent. This has become a major topic in the agenda of the “Group of Twenty” (G-20). It has to be said that, so far, whilst the need for such systems has been acknowledged, a consensus as to what steps should be taken has not been reached.

The nature of the structural changes that will be needed in the socio-economic life of the developed countries was eloquently described as long ago as 2009 by Larry Summers, who

¹ This was the state of affairs before industrialization, at which time particular branches of the economy were not considered to be either backward or advanced. The most powerful states, economically and militarily, were then not states with developed urban industries and trade but agrarian monarchies. This is also the understanding of the technological base that one encounters in the thinking of the classical *laissez faire* liberals, who exhorted countries to exploit the advantages of free trade rather than force the development of particular branches of the economy. At the turn of the nineteenth to twentieth centuries the proponents of industrialization accused these thinkers of perpetuating economic backwardness, but they ignored the fact that for Adam Smith the indicator of progress was not the level of industrialization relative to agriculture, but the division of labour. For more detail on this topic, see V.Mau, ‘Post-industrial Russia in the post-industrial world: problems of “catching up development”’, *Voprosy ekonomiki*, 2002 No.7.

pointed to the importance of bringing socio-economic institutions into line with technological change. In his words, “the new American economy will be in different and better shape that it was before the bust, it will be more export-oriented and less consumption-oriented, more environmentally oriented and less energy-production-oriented, more bio- and software- and civil-engineering-oriented and less financial-engineering-oriented, and, finally, more middle-class-oriented and less oriented to income growth that is disproportionate towards a very small share of the population”¹. This agenda for change is of relevance to all of the world’s developed countries.

During the last year we have witness a number of positive structural changes in institutions of developed countries that suggest that we are beginning to emerge from the crisis and embrace the new economic paradigm. We should bear in mind however, that a recession as such is not an indicator of the beginning of the crisis or of emergence from a crisis.

In the Eurozone a number of institutional and structural reform were adopted aimed at overcoming the crisis. These were implemented at Community level and at the level of those countries that were suffering most severely from the crisis. The powers of the European Central Banks have been increased and it is close to becoming a “lender of last resort”. There are movements in the direction of a unified system of financial regulation and coordination of budgetary policies. Growing opposition in Great Britain to this further integration of the Eurozone will make a positive contribution to reform of the European Community in so far as the unity of the Eurozone is more important than the size of the common market. Of course, much still remains to be done, but the momentum in favour of consolidation will contribute to the institutional modernization of one of the largest markets in the world.

A number of cautious steps in the right direction were taken in the countries of southern Europe (“the European periphery”). Against a background of increasing social tension, these countries introduced deep-seated structural reforms that will the result in a reduction in costs and in increases competitiveness. These changes have already been implemented and have led to a stabilization (and in a number of cases an improvement) in the terms of borrowing for these “countries of the periphery”.

Essentially, what faces Greece and a number of other countries of southern Europe is the experience of Latvia, where the government refused to devalue (devaluation is, of course, not possible within the Eurozone) and went through a period of drastic structural adjustment, recession and high unemployment; however an improvement in competitiveness facilitated a return to economic growth.

Positive steps have been taken in the United States. The existence of a developed private sector and the limited role of the state make possible a more rapid adjustment of the economy to changing circumstances. Here, lessons were learned from past experience and this has facilitated the emergence of a new growth model. The pre-crisis model was based on consumer demand and on a demand for housing, financed by savings from abroad placed in under-capitalized American banks. Such imbalances cannot be corrected in the short term. Even so, the situation has begun to improve during the last three years: housing prices have fallen, banks, at the instigation of the regulators, have sanitized their balances by writing off debts and through measures for re-capitalization. Consumer debt has fallen from 133% to 114% of gross revenues

The weakening of the dollar has made for a growth of exports and this has made for a reduction in the trade deficit. Meanwhile, China has become the third most important market

¹ <http://www.ft.com/cms/s/2/6ac06592-6ce0-11de-af56-00144feabdc0.html>. (Financial Times. 2009. July 10).

(after Canada and Mexico) for American goods. American exports to China increased by 150%, notwithstanding a depreciation of the Chinese currency. American exports to the countries of Latin America also increased by 150% and to the OECD countries exports increased by 20%. The composition of American exports has also changed: in addition to such traditional exports as aircraft and computer software, there has been a significant increase in the volume of high-tech services (in architecture, engineering and finance) and in a range of IT products, for example 3D printing.

Finally, high energy prices have stimulated the introduction of energy saving technologies and the development of new methods of fuel production. As a result, in 2012, net import of oil in the USA was at its lowest since the 1900s, whilst America became a net exporter of gas. Meanwhile, also in 2012, the share of shale gas in US gas output increased from 1% in 2000 to 35%. It is worth noting that the implementation of new gas extraction technologies (hydraulic fracturing and horizontal drilling) came from private companies. The role of the state was confined to investment in research.

One feature of structural change is a lag in the recovery of the labour market relative to economic growth. Growth in productivity is reflected in the recruitment of more qualified, higher cost, workers but in fewer numbers. It is for this reason that modernization is often accompanied by a slower growth of employment relative to the growth of the economy. This is what modernization entails and it is precisely for this reason that modernization, especially in the early stages, is accompanied by an increase in unemployment and, it seems, by increased inequality. This creates a risk that states with strong socialist (or egalitarian) traditions will take steps strongly to resist the short term negative consequences of modernization. Such measures will undoubtedly impede the prospects for technological and institutional modernization.

Modernization of the welfare state: Another major difficulty of the present crisis consists in the need for a fundamental transformation of those branches of the economy responsible for the development of human capital. There will need to be a new model for the functioning of the welfare state.

The crisis of the welfare state in industrial society is one of the fundamental causes of the present global crisis. The imbalances of the developed countries are due to uninterrupted expansion of their budget expenditures to the advantage of particular population groups. Whereas, when the welfare state was created at the turn of the nineteenth-twentieth centuries, this redistribution was on a modest scale and benefited groups that were small in numbers, by the beginning of the twenty first century circumstances had altered dramatically. Now the overwhelming majority of the population benefits from education, health care and pensions and this provision is funded to a significant degree by a redistribution of resources from the state budget. Furthermore, the demographic development of many developed countries is such that the proportion of the population that provides the resources is shrinking, whilst the proportion of beneficiaries increasing.

If we analyse the geographical distribution of the crisis, we note that conditions are most severe in those countries where the burden of state social expenditure is particularly high (that is, in Europe) and amongst these countries there is greatest suffering where social expenditure has to be supported by the lowest productivity of labour (southern Europe). The crisis has had less of an impact in the USA, where the welfare state is less developed. Finally, the crisis has had least impact in the new industrial countries (we are referring not to a recession but to a

deceleration of growth rates) that have not yet had time to create systems of social support on a par with the standards of industrial society.

It is not only the redistributive model of the welfare state that has come under scrutiny during the global crisis: the instability of financial markets has created serious problems in the short and medium term for private savings invested in securities. It is now difficult to find financial instruments that combine reliability, liquidity and satisfactory yields. The decline in the yields of securities has cast doubt over the reliability of existing forms of social insurance and provided grounds for a reappraisal of the insurance model of the welfare state and a search for new ways of funding welfare.

All of the most developed countries are therefore faced with the problem of creating of a new kind of welfare state. And there is hardly anywhere they can turn for advice, for systems that are capable of dealing with the challenges of the present era do not exist in any country. Indeed, a country that succeeds in creating an effective model for the creation of human capital in present circumstances will obtain a powerful competitive advantage in the post-industrial era.

The welfare state in post-industrial society will differ significantly from that of the industrial period and a search for the principles upon which it should be founded is already under way. In all probability, the key features of a new system will include the following:

- continuing and life-long provision, whereby people study and obtain health-care throughout their entire lives;
- the individualization of services, that is the opportunity for individual to define their own educational needs and programmes for health care, choosing from a variety of available educational and medical services. In the sphere of pensions, this will imply a significant diversification of the forms of support available to older age groups;
- a globalization of service provision and international competition for clients, whereby educational and medical institutions compete not with neighbouring schools or hospitals and not even with comparable institutions in their own country but on a global scale;
- the privatization of social services accompanied by an increase in the role of private expenditure on the development of human capital – private payment or contributory payments can be said to be not only the natural but even the unavoidable consequence of the technological modernization of the institutions of human capital and precondition for the growth of wellbeing of the population;
- the creation of new technologies that radically alter the character of the services offered by these sectors¹.

The choices that will be made by the rapidly developing countries of Asia are of particular interest in this regard. Only now are these countries approaching the level of economic development that enabled welfare state systems based on redistribution to be established in the West and in Russia during the twentieth century. Will these countries look to the experience of the past and adopt the tried and tested model? Or will they attempt to construct a new model based on new principles? Singapore, which has not adopted the Western model, provides an interesting case study. However the experience of Singapore may not be widely applicable, given that it has a population of only 5 million.

Macroeconomic problems: The present crisis in global macroeconomic relations differs significantly from its two predecessors. In the 1930s the main problems were deflation, reces-

¹ For more detail, see V.Mau, 'Human capital. Challenges for Russia, *Voprosy ekonomiki* (2012) No.7.

sion and mass unemployment and the key problem during the crisis of the 1970s was stagflation, that is a combination of high rates of inflation, high unemployment and low (or zero) growth. In the current crisis, the main problem is the burden of debt on the economy, which is limiting the scope of the developed countries for budgetary flexibility and which has also demonstrated the ineffectiveness of exchange rate policy for the stimulation of economic growth. This last is a problem not only for the Eurozone, the members of which have been deprived of this instrument of regulation, but for a majority of other countries where such adjustments have had no positive impact whatsoever (with the exception, so some limited extent, of Switzerland and China).

Last year, the problems in macroeconomic policy that require solution if the present crisis is to be overcome, became clear. At this stage there are only questions and no answers. It seems likely that the search for answers will be a priority for economists and politicians in the coming months and, probably, years.

We need to be particularly aware of the medium and long-term consequences of monetary easing, a policy that is unprecedented in economic history and the theoretical implications of which need to be worked out. This will only be possible on the basis of practical experience of the policy in the years that lie ahead. This experiment will be an ordeal for the monetary authorities of the leading countries as they strive to prevent an upsurge in inflation.

During the last year discussion of the relationship between budgetary consolidation and economic growth reached a dead end. The discussion in many respects resembled polemics in Russia during the first half of the 1990s over the possibilities for monetary stimulation of growth in circumstances in which profound structural reforms were being envisaged that would inevitably result in the closure of enterprises. Certainly, Russia at that time was experiencing triple digit inflation. In the Eurozone, levels of inflation are not at high and the principal stimulus for growth is provided by budgetary policy, that is by preservation for an extended period of a high level of government debt. Here, no single outcome can be predicted. Everything will depend upon how far the markets will be willing to bear the risks of countries with high budget deficits and to refinance the debt of countries that have high levels of debt accompanied by a primary budget surplus.

For all its importance, the debate over “consolidation or growth” is a debate over tactics. In the long run, decisions will have to be taken to reduce government debt since the experience of the last few years had demonstrated that for an economy relying on debt (upon investors willing to purchase their sovereign debt) the transition from financial stability to financial catastrophe can be very sudden. The problem is particularly acute when the debt crisis cannot be eased by measures of currency regulation. Clearly, the journey of the Eurozone along the path of further budgetary and fiscal integration will require measures to limit the budget deficits of countries that belong to the single currency¹.

¹ In any reform of the budgetary and fiscal policy of the Eurozone there are lessons to be learned from the experience of the United States, where, following a number of defaults during the first half of the nineteenth century, the government adopted a policy of “no deficits”. This did not mean no borrowing; rather the government borrow not to cover budget deficits but to invest in particular projects. The cost of servicing and repayment of the debts figured as expenditure in the current budget. See K.R.Henning and M.Kessler, ‘Budgetary-fiscal federalism: lessons for the European Union from American experience’, *Ekonomicheskaya politika* 201, No.5.

1.1.2. Russia in search of economic stability

Against a background of global instability and by contrast with the developed market economies, the Russian economy in 2012 achieved positive results (See *Table 1*). The economy continued to grow, albeit at a modest rate – GDP grew by 3.4% and industry by 2.6%. One important feature of this economic growth was that it was achieved primarily thanks to internal demand (the incremental increase in investment in 2012 was 6.7% and in consumption 6.6%).

One significant development last year was a slowing down in the growth of imports, which increased by 3.6% relative to 2011 without any noticeable increase in the volume of exports. The reasons are not entirely clear, but three possible explanations have been put forward. Firstly, a floating exchange rate and a nominal depreciation of the rouble may have enabled output to become more competitive in catering for domestic demand. Secondly, a weakening of investment activity and a corresponding reduction in the import of investment goods (primarily of equipment) may have had an effect. Thirdly, the Customs Union may have enabled goods to be brought into Russia through partner countries without being recorded as imports. At present we do not know which of these three explanations is valid, but it is clear that only the first has positive implications for the country's economic development.

Although inflation increased somewhat during 2012, it was under control and there are indications that it will decline in 2013. Government debt remains low and the budget is in balance. A positive balance on current account has been maintained. Direct foreign investments are increasing, although there is also a significant outflow of capital.

Amongst new developments we should note the advent of positive real interest rates and the fact that borrowing by the population now exceeds the growth in deposits. This is indicative of a change in the attitude of domestic households towards savings and of a transition to a model of consumption based on credit.

To sum up, there have been no significant changes to the majority of macroeconomic indicators by comparison with 2011 but in conditions of global crisis this is no mean achievement. In the world economy, Russia can be seen as a country of stable growth based on internal demand, with a balanced budget, a low level of debt, significant currency reserves and positive real interest rates.

However, despite this favourable picture – and, if truth be told, in comparison with the majority of other countries, the strategic outlook does not provide grounds for complacency.

One macroeconomic development has been a slowing of economic growth towards the end of 2012. This was a cause of concern to some politicians and economists who take the view that a level of growth of at least 5% is essential to ensure stable socio-economic (and even political) development. In our opinion, it is not the rate of growth that is critical: for one thing, Russia cannot count upon high growth rates at a time when its principal foreign trade partner, the European Union (from which Russia obtains 50% of its trade turnover), has entered into recession; for another, the quality and structure of growth of the economy and the contribution of growth to modernization are more important than growth rates as such. A nervous response to a slowing down of growth rates that took the form of an artificial expansion of government demand, disturbing macroeconomic equilibrium, would be much more dangerous (we consider this problem in more detail below).

It is important to keep in mind *four long-term issues* in the socio-economic development of Russia. These in the final analysis, are associated with low and diminishing growth rates.

Firstly, there is the absence of in-built stimuli acting in favour of modernization. The recovery of the economy to pre-crisis levels was achieved at the cost of a regression of the branch structure of the economy: the extraction of raw materials exceeded pre-crisis levels by 5% and processed output exceeded pre-crisis levels by approximately 1% (See *Table 2*). The production of traditional Russian exports (coke and petroleum products, chemical goods, rubber and plastic goods) recovered, but the recovery of metallurgical output was slow, owing to weak demand for metal and a fall in world prices attributable to the lag in the emergence of the world economy from the crisis. There was a marked growth in the production of means of transportation (attributable for the most part to automobiles construction) but this has almost reached its limit.

By contrast, the decline in the production of investment related goods (construction materials, machinery, electrical equipment, electronic and optical equipment) has not been overcome. In 2012 output was approximately 14% below pre-crisis levels. The volume of construction projects continued to be 10% lower than before the crisis.

Secondly, the outflow of capital continues significantly to exceed the inflow. Of course, one can argue that given high prices for Russian export goods the country is generating more capital than it can “digest” – taking into account its limitations in material and human resources. However, in an open economy limited opportunities for the productive use of capital are also an indicator of the poor quality of the investment climate.

Thirdly, the low level of unemployment is unprecedented. Of course, in the current political climate, this makes an important contribution to stability. However, the low level of unemployment is also symptomatic of the absence of meaningful structural change. In conditions of modernization, the growth of employment would lag behind economic growth and for that reason the post-crisis recovery (we are referring to structural crisis and not to cyclical crisis) would be accompanied by continuing high levels of unemployment. This is precisely the phenomenon that we observe at the present time in the USA. The governments of post-socialist countries often find it difficult to accept that unemployment can be a consequence of modernization and often adopt measures designed artificially to support high levels of employment, regardless of the negative impact of such policies on the quality of the technological infrastructure.

Fourthly, there is a tendency on the part of many members of the educated strata (the “creative class”) to direct their attention abroad. We are referring here not to formal emigration. Rather, an increasing number of prosperous Russians are seeking medical care and education abroad, acquiring property abroad and sending their children to be educated abroad, eventually to reside abroad. According to recent polls, (*Valdai Club*, October 2012) approximately 70% of Russians of above average income would like their children to be educated and work abroad and over a third of them would like their children to reside abroad permanently. From a strategic point of view this trend is harmful, since it means that a qualitatively sustainable demand for education and health care is being directed beyond the frontiers of Russia. As we know, good universities and institutions of health care flourish primarily in places where there is a demand for their services.

It is becoming all the more easy for the élite to pursue this “exit strategy” as the transaction costs of departure continue to fall. The causes are globalization and the growing prosperity of Russia’s citizens. During the last 25 year there have been fundamental changes in the socio-political attitudes of the active citizenry: whereas in the past members of the creative class sought to improve their standard of living within the boundaries of Russia, they now find it

easier and cheaper to change their country of residence. This has been made all the more feasible by globalization: it is now possible to earn money in one country and enjoy the advantages of civilization (and create a sustainable demand for these advantages) in another.

There can be no quick remedy for this state of affairs. These are qualitative problems of the development of Russian society and they are indicative of the kinds of impediment that exist to modernization and not least of the difficulty of developing a market for innovation. Finding a solution will require not only time but also the political will to implement serious institutional reforms.

One can obtain some insight into the current problems of Russian socio-economic development and into the difficulties that might lie ahead from a comparison with the macro-economic conditions that obtained in the USSR at the turn of the 1970s and 1980s:

- at that time, as now, the Western world was experiencing a structural crisis. It was described by the Communist Party of the Soviet Union as “the third stage in the general crisis of capitalism”. Towards the end of the 1970s the crisis was coming to an end and a new paradigm for economic policy had emerged, involving deregulation. This policy was most consistently and successfully implemented by the administrations of Margaret Thatcher (from 1979) and Ronald Reagan (from 1981);
- in contrast with the countries of the West, the Soviet economy was at this time experiencing growth, albeit a moderate rates of 2-3% per annum;
- oil prices were very high, and, in constant prices, were at approximately at present day levels. The Soviet government actively encouraged the growth of energy exports;
- the budget was in balance, but all of the revenues from the export of hydrocarbons were used to cover budgetary expenditures;
- gas pipelines were constructed for the delivery of gas to Western Europe (the Urenga-Pomara-Uzhgorod pipeline) as part of a new economic model whereby “oil and gas” were exchanged from “food and machinery”;
- there was a low level of inflation, albeit with signs of a growing shortage of goods (where prices are fixed this is a form of inflation), a modest sovereign debt and full employment;
- the Soviet political system was extraordinarily rigid and incapable of reacting flexibly to new global challenges (whether technological, economic or political).

At that time it was thought that the Soviet economy was enjoying stable growth, in contrast with the crisis in the West. Only later did it become clear that the market-based democracies were going through a period of structural and technological modernization and that the foundations were being laid for a qualitative leap forward, whereas the Soviet Union was doing no more than conserving its existing economic structure and becoming a hostage to fluctuations in raw materials prices over which the government had no control.

Current circumstances are somewhat different. Russia has learned the lessons of the past and has accumulated significant financial reserves. Budgetary policy takes into account the risks of fluctuations in the international conjuncture even if, as a result of the crisis, the federal budget has begun almost completely to absorb revenues from the export of energy resources. Russia’s sovereign debt is much lower than was that of the USSR. The openness of the economy and the existence of private property are completely new factors. The political system, of course, is much more flexible than during the Soviet period. The government appreciates the need for a radical improvement in the investment climate and the importance of encouraging private enterprise. This has been reflected in the adoption of a target of being amongst the “top twenty” countries in the World Bank’s “Doing Business” rating.

However, there are also similarities with the circumstances of thirty years ago. The main problem is a resistance to innovation and, more broadly, to modernization. The availability of natural resources and of financial reserves are a serious impediment to institutional and technological renewal. The most obvious indicators of this are the deterioration in the branch structure of the economy during the last four years and an unprecedented low level of unemployment. As the Soviet experience showed, stability can very easily turn into stagnation and the path from economic stability to economic catastrophe can be very short.

A comparison with the late Soviet period is all the more relevant in that during 2012 the appraisal of political and economic options bore a close resemblance to debates of the 1980s. The draft prognosis of the socio-economic development of Russia to the year 2030 prepared by the Ministry for Economic Development considered three scenarios – one conservative, one based on innovation and a third that was “forced” or goal oriented.

The *conservative* scenario assumed stagnating growth at a decelerating growth rate of 2.7-3.1%. Growth would be based on the exploitation of competitive advantages in the raw materials sector and assumed a continuing lag in the high- and medium- tech sectors of the economy. Macroeconomic stability would be ensured by a conservative budgetary policy. Modernization would be achieved, for the most part, by the import of technology and equipment. Innovation would be achieved mainly in the energy and raw materials sectors.

The “*innovation*” scenario supplemented the *conservative* scenario by proposing a diversification of production and exports. This would require the modernization of institutions and of production. Of vital importance would be an improvement in the investment climate, the encouragement of entrepreneurship, and a marked improvement in the quality of public services and state administration. In the sphere of technology it was envisaged that there would be an active development of the transport infrastructure and development of a number of branches of technology in which Russia, traditionally, has been strong: the aviation and space industries, atomic technology, services linked with space and so forth. The government would radically modernize the social infrastructure with a view to bringing about a dynamic development of human capital. Budgetary policy would remain conservative. GDP under this scenario would grow by 4%.

The “*forced*” scenario implied a structural shift whereby the value of gross accumulation of basic capital would increase to 30-33% of GDP from the current 22%. This would be accompanied by a reduction in the share of household expenditure in consumption. There would be an active utilization of national savings and an increase in the inflow of foreign capital to a level of 65% of GDP. State expenditure on production and transport infrastructure would significantly increase. There would be a dramatic diversification of exports accompanied by a 10% increase in the export of machinery and equipment by 2030. However the volume of exports in GDP would fall from the present level of 27-30% to 19%. There would be a significant reduction of imports for consumption. This scenario envisaged an alteration in demographic trends: an increase in population including an increase in the numbers of those of working age. Clearly, this scenario is fraught with macroeconomic risks in so far as presupposed a stable budget deficit, an increase in government debt, and a deficit in the current account of the balance of payments. As the authors of this scenario themselves admit, it would increase the vulnerability of the economy to external shocks.

These three scenarios are familiar to those who have studied the economic policies of the 1980s. At that time they were known as the policies of “stagnation”, “perestroika” and “accelerated development”. “Stagnation” implied a continuation of economic development based on

a favourable external economic conjuncture, an expansion of imports of consumer goods and of the means of production. “Perestroika” gave priority to institutional reforms, the development of human capital (the anti-alcohol campaign, “glasnost”, granting more independence to enterprises and labour collectives, the encouragement of cooperative and individual entrepreneurship). “Accelerated development” meant a structural shift based on an increase in the share of accumulation in GDP and a reduction in the share of consumption, as the bases for the growth of investments and technological modernization. The last two scenarios were accompanied by massive external and internal borrowing, at first to promote the export of technology and later and to an even greater extent, of food.

The macroeconomic risks inherent in this policy were evident; and since the early implementation of structural and institutional reforms coincided with a sharp fall in the very energy prices that had, until that time, guaranteed the stability of the Soviet economy, it was not long before the consequences were felt.

1.1.3. Priorities in medium term economic policy

Irrespective of global instability and macroeconomic risks, it is indisputable that the principal objective of Russia socio-economic policy should be to provide *incentives for modernization*.

It is essential that, in working out policies for the modernization of Russia, the multifaceted nature of the task should be taken into account. The following objectives will have to be pursued at one and the same time:

Technological modernization. This will involve the creation of millions of highly qualified (hi-tech) jobs. (Vladimir Putin has set as an objective the creation of 25 million jobs of this kind). This objective is incompatible with a policy that takes the preservation of existing jobs and a low level of unemployment as criteria for evaluating the performance of regional administrations;

Economic modernization. This means a diversification of the economy and a overcoming of our dependence on the fluctuations of world energy prices. There will have to be a reduction of the non oil and gas deficit and a qualitative improvement in the investment climate;

Social modernization. This means that the middle class must become the dominant class in Russian society and that the performance of healthcare institutions and of the pension system must become much more efficient and more equitable;

Modernization of the military-industrial and security sectors. The work of these institutions must be directed towards the effective defence of the rights and freedoms of the citizen, whatever the citizen’s social origin;

Finally, *political modernization.* This means that access to and exercise of political and economic freedoms must be brought up to Western standards.

Experience of the last decade has revealed the existence of at least two major obstacles to modernization. These are of a systemic nature and will require special measures if they are to be overcome.

First amongst these is the absence of any demand for modernization. The fact that everyone agrees that modernization is necessary does not signify that there are powerful social groups within society who are willing to invest in the process. The attainment of socio-political stability and the availability of substantial financial reserves serve as disincentives to modernize, despite the fact that the advent of a structural crisis has provided conditions that

are optimal for this kind of change. What we have learned from the last decade is that the Stabilization Fund (whether it be call “Reserve Fund” or “Fund for Future Generations”) can serve not only as an instrument for macroeconomic stabilization, not only as a “buffer” in the event of a crisis, but also as an excuse for postponing essential reforms.

The government, of course (the top leadership) has a manifest political interest in modernization. Based as it is on the state corporations and other state institutions, the government attempts to nudge society along the path of modernization and innovation, but its efforts are doomed to failure, given a lack of support from economic actors. Nor are the policies of the political leadership always consistent: notably, a policy in favour of the creation of millions of new highly qualified jobs is accompanied by an insistence on maintaining high levels of employment. This is equivalent to a veto on the closure of unviable enterprises. Yet it is evident that in a country where the population is, at the very least, not increasing, and where there is no labour reserve in the rural areas, the creation of new jobs must entail a reduction in the number of old jobs.

The second obstacle is the “competitiveness trap” whereby high-cost labour exists alongside inefficient institutions. It is usual for investment activity to be high either in countries where labour is cheap (where high profits permit risk-taking) or in countries where, even if labour costs are high, institutions are effective. In Russia, labour costs are comparatively high (they are amongst the highest in countries with developing markets) but the quality of the institutional environment is relatively poor. This is reflected in Russia’s position in the World Bank rating “Doing Business” and in a number of other indicators of the quality of institutions. This is the background to the fact that the services sector and the raw materials sector (the extraction of raw materials) succeed in being competitive and in dominating Russian development.

There are two ways out of escaping from this trap: either institutions must be brought into line with the labour force or the labour force must be brought into line with the quality of our institutions. Most Russian economists, for understandable reasons, prefer to think in terms of the improvement of institutions. But the option of reducing labour costs should not be ruled out.

The priorities of the government with regard to modernization of the economy are well known and have hardly changed since we published a list in the Institute’s review of the year 2011¹. These priorities were enumerated in the first decrees of Vladimir Putin on the occasion of his appointment as President of the Russian Federation on 7 May 2012. Let us consider only those tasks that were given special attention in 2012.

Improvement in the climate for investment and entrepreneurship. During the past year Russia’s position in the “Doing Business” rating has improved somewhat, from 120th to 112th. This provides some grounds for satisfaction but it is completely inadequate when set alongside the objective of joining the “top twenty” by 2018. The improvement was predominantly due to the score under the heading “Paying taxes”. The score for other indicators taken together reported hardly any improvement (+15 points for improvement; -12 points for deterioration).

Besides, by four criteria Russia scores particularly badly – and these four criteria, which are out of line with other developmental parameters, account for the abnormally low position of Russia in the overall rating. They include “Dealing with construction permits” (178th posi-

¹ *The Russian Economy in 2011. Trends and Perspectives (Issue 33)* [Moscow, Gaidar Institute, 2012], pp.9-29].

tion amongst 185 countries); “Getting electricity” (184th position) and “Trading across borders” (162nd position). Unless there can be significant improvements under these headings it will be impossible for Russia to rise in the ratings.

At the moment, improvement in the investment climate is an important indicator in the performance assessment of Federal and regional institutions of government.

Of course, it would make sense, while striving for a dramatic improvement in Russia’s position in the “Doing Business” rating, to improve Russia’s position in other international ratings that more or less reflect entrepreneurial activity: in ratings of government efficiency, economic freedom and so on. All ratings have their drawbacks and limitations but this in itself is an argument in favour of measuring progress in Russia by to a range of international criteria rather by one set alone.

A responsible budgetary policy: Discussions of budgetary policy of late have revolved around the key question, whether the principal function of the budget in conditions of global crisis should be to guarantee the stability of the economy or facilitate structural transformation. Of course, both objectives are desirable but in practice it is a dilemma to know what risks can be taken with the budget even if these are justified by the goal of modernization. This is a difficult question. It cannot be answered theoretically, but only politically.

The lessons of the 1980s suggest that budgetary conservatism is advisable. But the experience of the past is not an infallible guide when dealing with problems that lie ahead.

One important achievement in 2012 was the adoption of a budgetary rule which introduced limits on the use of oil and gas revenues in the current budget and on the parameters of government debt. In a country that is reliant upon rent from raw materials this was a necessary measure and it will reduce our vulnerability to external shocks. At the same time, this measure severely restricts opportunities for assisting those sectors of the economy that have been prioritized for modernization.

Such support can be provided by management of expenditure, by reducing expenditures in some sectors and increasing them in others. However, politically, such decisions are always pointless, especially if the state disposes of substantial resources and has a low level of debt. The temptation of an expansionist budgetary policy is indulged at the cost of a weakening a conservative budgetary policy. Such choices are political and in 2013 observance of budgetary rules will be one of the principal responsibilities of the government. Worst of all would be a disregard of budgetary prudence that was not accompanied by a strict prohibition of any increase in government debt.

The management of a floating exchange rate has been one of the most important achievements of monetary policy. The increase in inflation during 2012 can most probably be attributed to temporary factors and in the year ahead inflation will fall. A new and very important development was the fact that interest rates on deposits became positive. In the medium term, monetary policy must aim to create conditions conducive to the adoption of the rouble as a regional reserve currency. This is all the more important given that the global crisis has drawn attention to the need for a reconfiguration of reserve currencies.

The modernization of the welfare state is another priority. It is essential that the welfare state should be reconstructed along lines that correspond to the needs of post-industrial society. This must be achieved while taking into account the imperatives of welfare, fiscal and investment policy.

In 2012 particular attention was given to the modernization of the pension system and especially to the fiscal and socio-political aspects of this question: how could the Pension Fund

be kept in balance and under what system (distribute or cumulative) could citizens who had entered retirement during the current political cycle be paid a large pension? In most respects, the government opted for a redistributive system. However, the problems associated with the pension system that we have outlined above, will not go away.

Discussion of the problems of the educational and health care systems got underway. In this sphere, the main objective is that these sectors should become internationally competitive.

The open economy: Joining the WTO and the development of a Eurasian economic space have made an important contribution to the openness of Russia's economic relations. The principal purpose of openness is to promote competitiveness as a critically important factor driving modernization. Here we are talking not only of the competitiveness of goods and services but also of the competitiveness of jurisdictions. This last, which is a relatively new consideration and a direct consequence of globalization, occasionally encounters resistance on the part of lawyers and politicians, though from an economic point of view competition amongst jurisdictions can serve as an important stimulus for the improvement of the entrepreneurial environment.

2012 was a turning point in the development of the Russian and of the world economy. No one had foreseen events of such importance. This was a year of accumulation of the resources (material resources and institutions) that will determine the shape of the world system that will emerge from the crisis. In this world there will be a new geo-political and a new geo-economic equilibrium. In two or three years time we shall have a clearer picture of what this world will look like. Critical decisions will soon have to be taken by the national élites of the leading countries and the place that their countries will occupy in the post-crisis scheme of things will depend upon the breadth of their vision and the boldness of their initiatives.

Table 1

**Economic development of Russia
2007-2012**

	2007	2008	2009	2010	2011	2012
1	2	3	4	5	6	7
Incremental increase of GDP over previous year %	8,5	5,2	-7,8	4,3	4,3	3,4
Industry: incremental increase over previous year %	6,8	0,6	-9,3	8,2	4,7	2,6
Agriculture: incremental increase over previous year %	3,3	10,8	1,4	-11,3	23,0	-4,7
Final consumption (domestic households): incremental increase over previous year %	14,3	10,6	-5,1	5,5	6,4	6,6
Investments in basic capital: incremental increase over previous year %	22,7	9,9	-15,7	6,0	8,3	6,7
Surplus («+») / Deficit («-») of the budget of extended government, % of GDP	6,0	4,9	-6,3	-3,5	1,6	0,4
Reserve Fund (from 2007 "Stabilization Fund") end of year, billion \$	156,81	137,09	60,52	25,44	25,21	62,08
National Welfare Fund, end of year, billion \$		87,97	91,56	88,44	86,79	88,59
Consumer Price Index December to December	11,9	13,3	8,8	8,8	6,1	6,6

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cont'd

1	2	3	4	5	6	7
Producer Price Index December to December	25,1	-7,0	13,9	16,7	12,0	5,1
Average interest rate on loans to enterprises in roubles	10,0	12,2	15,3	10,8	8,5	9,1
Average interest rate on deposit accounts of physical persons (excluding deposits on current accounts)	7,2	7,6	10,4	6,8	5,4	6,5
General level of unemployment (MOT methodology), end of period	6,1	7,8	8,2	7,2	6,1	5,3
Average monthly wages (thousand roubles)	13,6	17,3	18,6	21,0	23,4	26,7
Level of Savings as % of disposable income of domestic households	23,0	16,5	22,5	23,3	18,4	25,8
Balance of payments, billion \$:						
Current account	77,8	103,5	48,6	71,1	98,8	81,3
Trade turnover	130,9	179,7	111,6	152,0	198,2	195,4
Exports	354,4	471,6	303,4	400,6	522,0	530,8
Imports	-223,5	-291,9	-191,8	-248,6	-323,8	-335,4
Direct investments	9,2	19,4	-7,2	-9,2	-14,4	-4,4*
Federation	55,1	75,0	36,5	43,3	52,9	33,1
Abroad	-45,9	-55,6	-43,7	-52,5	-67,3	-37,5
Reserve assets («-» - growth)	-148,9	38,9	-3,4	-36,8	-12,6	-30,0

* Various sectors, excluding banking sector

Sources: Rosstat, Central Bank of the Russian Federation.

Table 2

**Results of adjusted growth: growth of industrial output
January-September 2012 / January-September 2008 %**

1	2
Total industrial output	2,7
Raw materials extraction	5,0
Processing industries	1,2
Production of consumer goods (food supplies and goods of national consumption (TNP))	6,6
Food products	9,3
Textiles and fabrics	-9,3
Leather, leather goods, footwear	9,9
Other goods	-0,3
Production of goods of intermediate demand	3,2
Coke and petroleum products	9,2
Goods of chemical industry	7,9
Rubber and plastic goods	23,3
Metals and finished metal goods	-3,5
Forestry, wood processing, cellulose & paper industry (LDTsB)	-7,1
Timber processing and output of goods in wood	-8,2
Cellulose and paper production: publishing and printing	-6,6
Production of goods of investment demand	-14,1
Building materials	-10,4
Machinery and equipment	-19,1

cont'd

1	2
Electrical equipment, electronic and optical equipment	-13,0
Production of means of transport and transport equipment	17,0
Production and distribution of electricity, gas and water	0,7
<i>Additionally:</i>	
Investments in basic capital	-6,9
Commercial transport turnover	-0,6
Construction	-10,7

Source: Rosstat.

Section 2. The Monetary and Budget Spheres

2.1. The Monetary Policy

In 2012, the RF Central Bank continued to bring down the scale of its interference in the foreign-exchange market's functioning: the volume of its currency interventions carried out over the course of that year hit a ten-year low. Besides, the monetary policy's key feature in 2012 was that the Bank of Russia completed its switchover to the practice of money supply formation through the issuance of loans to commercial banks. As seen by the year-end results, the amount of debt owed by banks to the RF Central Bank had exceeded the level of late 2008 – early 2009. However, in contrast to the crisis period, the bulk of debt growth was produced by repo operations (and not by unsecured loans), which means that the credit portfolio's quality had improved.

In accordance with the new monetary policy mode the main target indicator for the RF Central Bank is the inflation rate, which by the year's end had exceeded its 2011 level, thus getting beyond the target interval of 5–6% outlined in the main directions of the RF Central Bank's monetary policy for the period of 2012–2014. Most probably, a key role in speeding up the inflation rate was also played by some non-monetary factors, including the growth of food prices at a rate faster than that predicted by the Bank of Russia. However, the surge of inflation so far above its targeted value is a phenomenon that requires an in-depth analysis of the current policy, the instruments applied by the monetary regulation agencies in building their forecasts, and the mechanisms of response to negative price shocks.

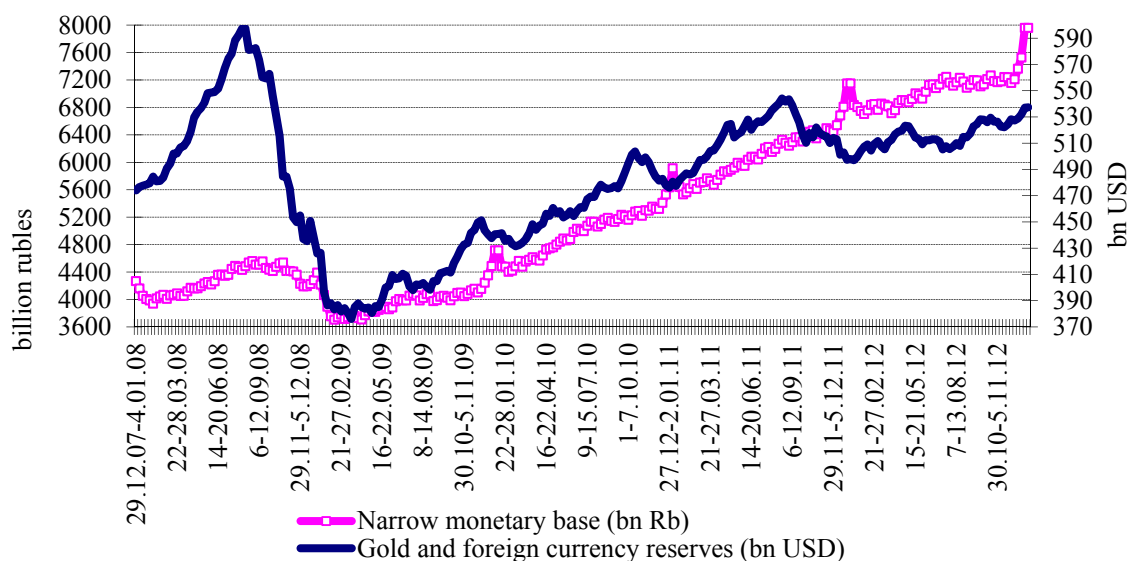
Below we discuss in more detail the processes that have been occurring in the monetary sphere as part of Russia's national economy.

2.1.1. The Money Market

In 2012, the volume of net purchases of foreign currency on the market by the RF Central Bank dropped to \$ 6.8bn from \$ 10.5bn in 2011. As a result, towards the year's end the volume of international assets held by the RF Central Bank as reserves had changed only slightly: from \$ 498.6bn as of 1 January 2012 to \$ 537.6bn as of 1 January 2013 (see *Fig. 1* and *2*).

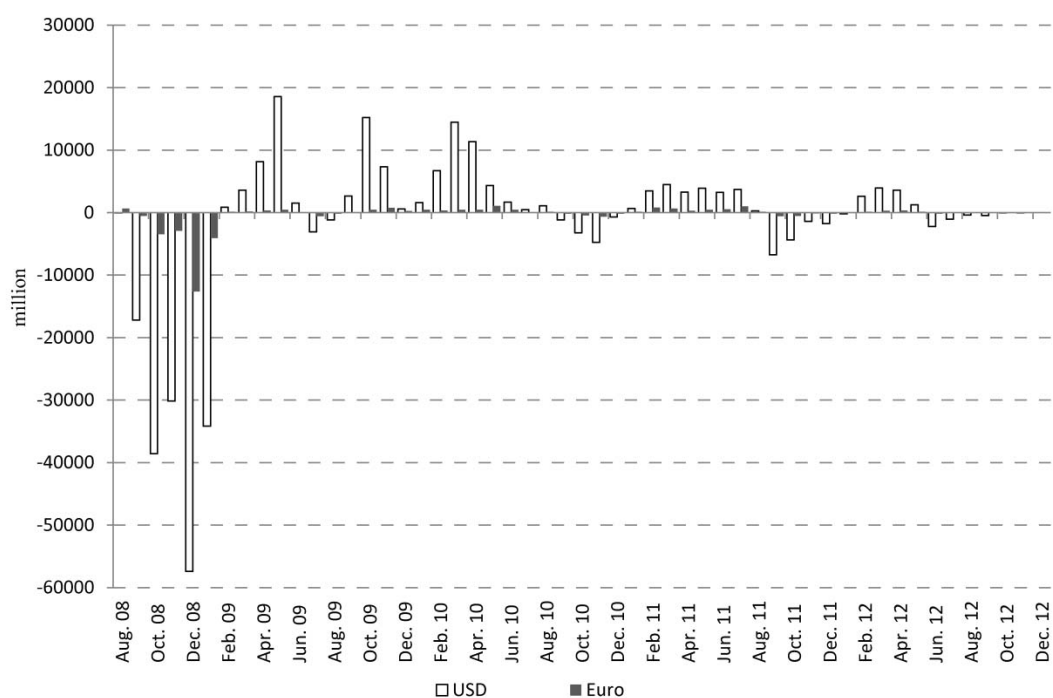
RUSSIAN ECONOMY IN 2012

trends and outlooks



Source: RF Central Bank.

Fig. 1. The Behavior of the Narrow Monetary Base¹ and the International Reserves Held by the RF Central Bank in 2008–2012

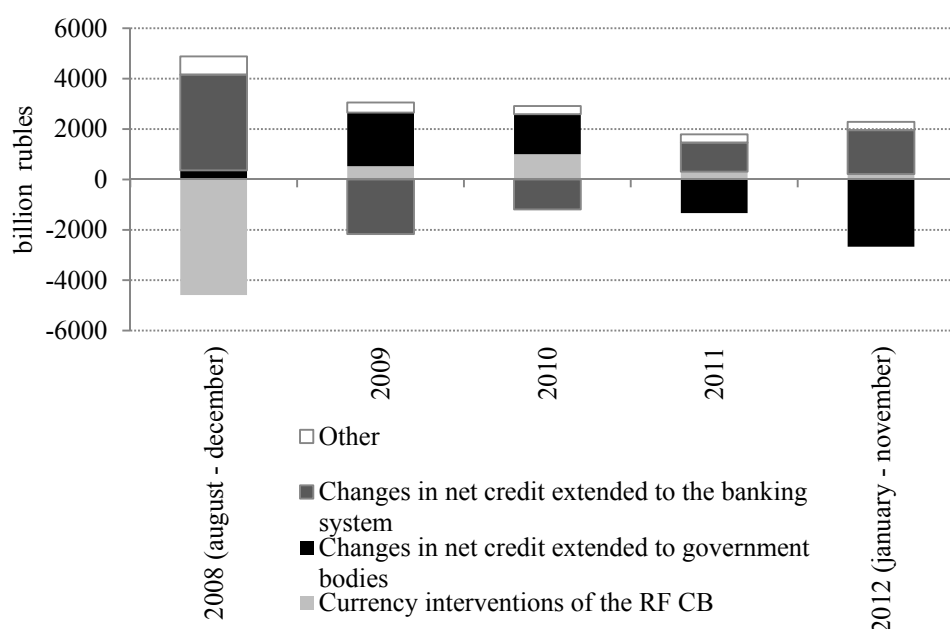


Source: RF Central Bank.

Fig. 2. The Bank of Russia's Currency Interventions (Net Currency Purchases) in 2008–2012

¹ The monetary base (narrow definition) consists of the currency issued by the Bank of Russia (including cash in vaults of credit institutions) and required reserves balances on ruble deposits with the Bank of Russia.

As a result, in 2012 – just as it had been a year earlier – the currency interventions undertaken by the RF Central Bank had practically no influence on the monetary base’s behavior (see *Fig. 3*). Nearly throughout the entire last year’s period, the broad monetary base¹ was on the decline: over January–November its value dropped by 4.5% to Rb 8.257bn. It should be noted that in the second half-year the monetary base was shrinking at a slower rate than it had done in the first half-year. In Q4, however, the broad monetary base began to increase in response to the traditional upsurge of government expenditure at a year’s end. The shrinkage in the monetary base was caused, on the one hand, by the markedly reduced volume of the regulator’s currency interventions in 2012 (the year’s highest level of currency interventions achieved in March (\$ 4.3bn) dropped 180-fold to \$ 23.6m in October, and on the other, by the accumulating budget surplus on the government’s accounts with the RF Central Bank (see *Table 1*). At the same time, the principal source of the monetary base’s growth, as before, were the resources of Bank of Russia – the latter having increased the volume of its credits issued to commercial banks.



Source: RF Central Bank; the IEP’s calculations.

*Fig. 3. The Principal Factors Influencing the Behavior of the Monetary Base (Broad Definition) in 2008–2012*²

¹ The broad monetary base describes the Bank of Russia’s monetary liabilities denominated in the national currency that determine money mass growth. The monetary base (broad definition) consists of the currency issued by the Bank of Russia (including cash in vaults of credit institutions), the balances in the required reserve accounts deposited by credit institutions with the Bank of Russia, the correspondent account balances (including averaged amount of the required reserves) and the balances on the deposit accounts of credit institutions with the Bank of Russia, the Bank of Russia bonds (OBRs) held by credit institutions, the balances on the required reserve accounts deposited by credit institutions with the Bank of Russia against their attracted funds in foreign currency, and other liabilities of the Bank of Russia against its operations with credit institutions in the currency of the Russian Federation.

² The period under consideration in 2008 and 2012 is determined by the availability, during the preparation of this overview, of data released by the RF Central Bank on its currency interventions and its balance sheets.

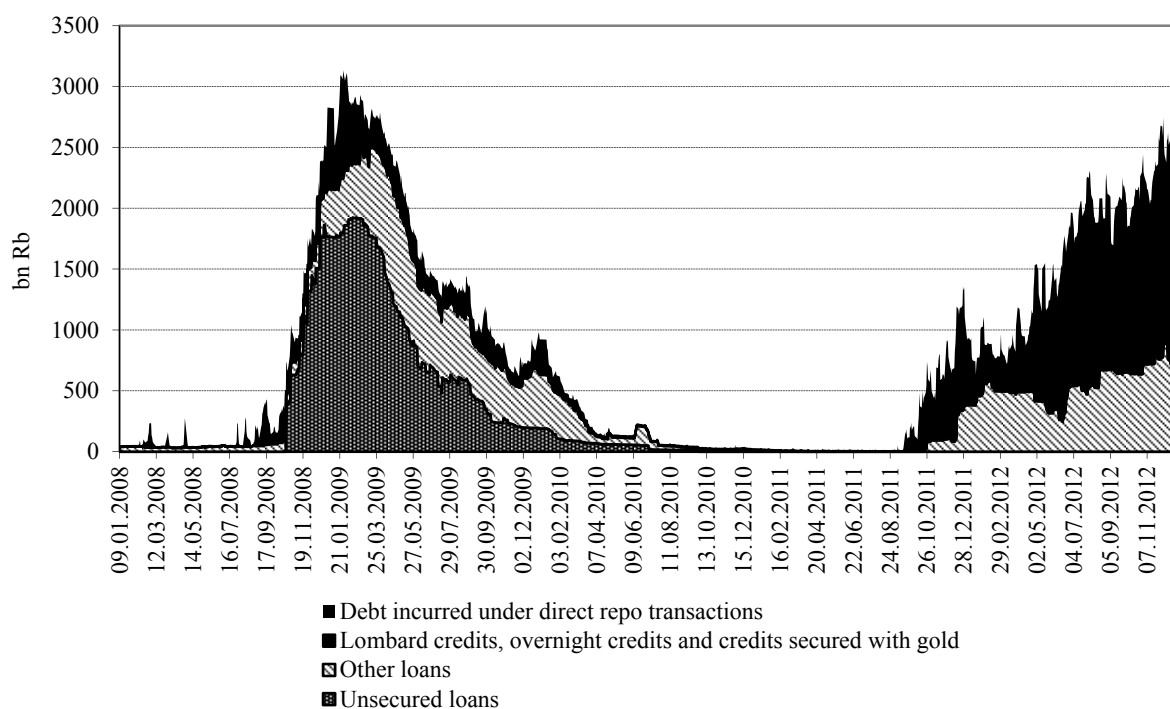
Table 1

**The Bank of Russia's Balance Sheet
in 2011–2012**

	1 January 2011		1 January 2012		1 November 2012	
	Bn Rb	% of as- sets/ liabilities	Bn Rb	% of as- sets/ liabilities	Bn Rb	% of as- sets/ liabilities
Funds placed with nonresidents and securities issued by nonresidents	13,272	85.5	14,245.3	76.7	14,575.7	68.7
Credits and deposits	514	3.3	1,663.3	9.0	3,404.6	16.0
Precious metals	1,201	7.7	1,527.5	8.2	1,720.8	8.1
Securities	441	2.8	426.2	2.3	453.6	2.1
Other assets	99	0.6	97.9	0.5	1,066.0	5.0
Total assets	15,526	100	18,562.7	100	21,220.7	100.0
Cash in circulation	5,792	37.3	6,896.1	37.2	6,872.0	32.4
Funds in accounts with the Bank of Russia	6,431	41.4	7,742.2	41.7	10,131.7	47.7
<i>Of which: Russian government funds</i>	3,270	21.1	4,443.5	23.9	6,196.7	29.2
<i>funds of resident credit institutions</i>	1,817	11.7	1,748.4	9.4	1,387.2	6.5
Float	7	0.0	36.2	0.2	22.3	0.1
Bank of Russia bonds	589	3.8	0	0	0.0	0.0
Liabilities to the IMF	-	-	472.3	2.5	458.2	2.2
Other liabilities	145	0.9	158.6	0.9	496.4	2.3
Capital	2,359	15.2	3,235.4	17.4	3,240.1	15.3
Profit of a fiscal year	204	1.3	21.9	0.1	0.0	0.0
Total liabilities	15,526	100	18,562.7	100	21,220.7	100.0

Source: RF Central Bank.

As seen from Fig. 4, the amount of debt owed by commercial banks to the RF Central Bank began to grow rapidly in late 2011. In 2012 its level practically reached its record high observed over the period of 2008–2009. Thus, at present it so happens that the monetary base is mainly formed by credits issued by the RF Central Bank. However, it should be noted that, in contrast to the situation typical of the crisis period, the size of debt is now increasing mainly as a result of the expansion of repo operations instead of unsecured credits, and thus the quality of the RF Central Bank's credit portfolio is improving. The high degree of dependence of commercial banks on the monies loaned by the RF Central Bank enables the latter to exert a stronger influence on market interest rates by regulating the interest rates on its loans through the application of liquidity provision and absorption instruments.



Source: RF Central Bank.

Fig. 4. Outstanding Debt of Credit Institutions against Loans Issued by the Bank of Russia in 2008–2012

Let us have a closer look at the structure of monetary base (broad definition) (see *Table 2*).

Table 2

Behavior of Monetary Base (Broad Definition) in 2012 (bn Rb)

	1 January 2012	1 April 2012	1 July 2012	1 October 2012	1 January 2013
Monetary base (broad definition)	8,644.1	7,787.8	8,129.3	8,082.8	9,852.8
- cash in circulation, including cash in vaults of credit institutions	6,895.8	6,450.8	6,809.7	6,826.8	7,667.7
- correspondent account balances of credit institutions with the Bank of Russia	981.6	812.5	790.7	753.7	1,356.3
- required reserves	378.4	385.2	393.1	411.5	425.6
- deposit account balances of credit institutions with the Bank of Russia	388.3	139.3	135.8	90.8	403.3
- Bank of Russia bonds (OBRs) held by credit institutions	0	0	0	0	0

Source: RF Central Bank.

Over the course of 2012, the cash in circulation volume increased by 11.2%, amounting as of the year's end to Rb 7,667.7bn. The amount of required reserves rose from Rb 378.4bn to Rb 425.6bn. The money market ran a ruble liquidity deficit practically throughout the whole year. From January through November 2012 were on the decline: the correspondent account balances of commercial banks with the Bank of Russia dropped by Rb 154.2bn, the deposit account balances of credit institutions with the RF Central Bank dwindled by Rb 250bn, while

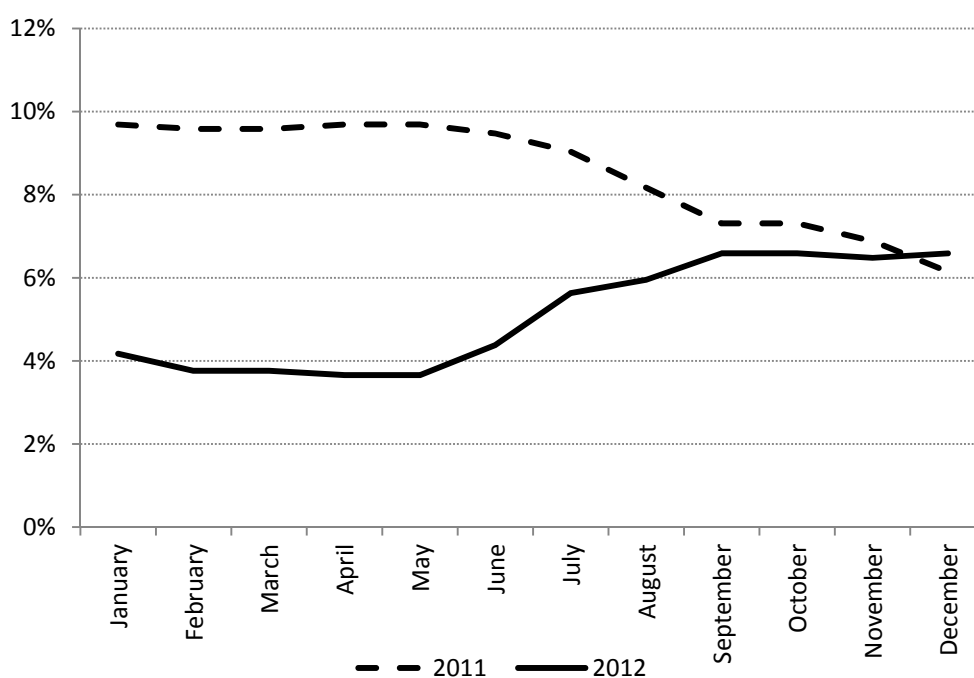
the amount of their investment in the Bank of Russia bonds remained at zero. However, the sharp rise in government expenditures in December resulted in a growth of excess reserves: on the whole, over the course of 2012, the correspondent accounts balances increased by 38.2%, to Rb 1.4 trillion, while the deposit account balances rose by 3.9%, to Rb 403.3bn.

While in Q1 2012 the annual growth rate of the M2 ruble money supply was relatively stable (approximately 21–22% in per annum terms), it continually decreased from Q2 2012 onwards, to 11.9% as of 1 January 2013. The decline in the growth rate of the money supply will apparently have a restraining effect on inflation in early 2013.

In 2012, the money multiplier’s value (ratio of M2 to monetary base) remained practically unchanged – at a level of 3. This value of a money multiplier represents a typical average for a developing economy, while in developed economies it is usually higher – somewhere in the 5 to 8 interval.

2.1.2. Inflation Processes

In 2012, the year-over-year growth rate of consumer prices was higher than in 2011, when it hit a record low for the entire post-Soviet period of Russian history (+6.1%) (see *Fig. 5*).



Source: Rosstat; the IEP’s calculations.

Fig. 5. The Growth Rates of Consumer Prices in the Russian Federation in 2011 and 2012 (in Annual Terms)

In the first half-year of 2012, the main factors behind the drop in inflation were the shifting of the regular date of the annual indexation of the state-regulated prices and tariffs for paid services provided to the population from 1 January to 1 July, and the decline in the growth rate of the money supply in 2011. Also, the decline in inflationary pressures was contributed to by the moderate growth in producer prices (in the first half-year of 2012, the Industrial Producer Price Index rose by 6.1% on the first half-year of 2011 vs. a 19% rise in the first

half-year of 2011 on the corresponding period of 2010), and by rather moderate global food prices¹.

However, in the summer of 2012, the growth rate of consumer prices began to steadily increase. It should be noted, that both the deceleration of inflation in the first half-year 2012 and its acceleration in the second half-year 2012 were largely caused by non-monetary factors. The rise in the growth rate of food prices, greatly contributed to by the poor cereal harvests in a number of Russian regions and around the world, was a major inflation factor. Food prices in Russia were also boosted by the worsening state of the global agricultural market. Furthermore, the rise in consumer prices in the second half-year of 2012 was caused by significant increases in administratively regulated tariffs.

Over the course of October–December 2012, inflation stabilized around 6.5% per year. This drop in inflation was caused by a combination of several factors, including the reduction in the negative impact of the failed harvest, the decline in base inflation, and the deceleration in economic activity.

As shown in *Table 3* below, over the course of 2012, the prices of food products were rising at a rate 1.7 times higher than that in 2011. Alcoholic beverages, whose prices rose by 12.1% owing to an increase in excise taxes, were among the main contributors to inflation. Adverse weather conditions pushed up the prices of fruit and vegetable products (+11%), bread and bakery products (+12%), and meat and poultry (+8,3%), whose prices usually grow after a rise in grain prices.

In 2012, the lowest increase in prices was registered for non-food products (+5,2%). Nevertheless, the prices of tobacco products rose by an unprecedented 22.6%, which represented the highest price increase recorded by any category of consumer goods and services. This sharp rise in the prices of tobacco products was caused, in the main, by a considerable increase in excise taxes. The growth rate of motor gasoline fell from 14.9% in 2011 to 6.8% in 2012. This drop resulted from the retail prices of fuel being frozen in January-March 2012 at 2011 levels.

In 2012, the prices of paid services provided to the population increased by 7.7% on 2011. It should be noted that the growth rate of prices for most categories of services registered a decline.

Table 3

The Annual Growth Rate of Prices for Individual Categories of Goods and Services in 2010-2012 (as a Percentage of December of the Previous Year)

	2010	2011	2012	2010–2012 ²
1	2	3	4	5
CPI	8.8	6.1	6.6	23.1
Food Products	12.9	3.9	7.5	26.1
Grains and Pulses	58.8	-8.0	-7.0	35.9
Butter	23.3	6.6	3.0	35.4
Sunflower Oil	27.6	4.6	3.4	38.0
Pasta	4.7	3.4	7.6	16.5
Milk and Dairy Products	16.7	6.3	4.4	29.5
Bread and Bakery Products	7.6	8.9	12.0	31.2
Meat and Poultry	5.3	9.2	8.3	24.5

¹ <http://www.fao.org/worldfoodsituation/wfs-home/foodpricesindex/ru/>

² The cumulative inflation rate over three years.

cont'd

1	2	3	4	5
Fish and Seafood Products	4.8	10.3	1.9	17.8
Fruit and Vegetable Products	45.6	-24.7	11.0	21.7
Alcoholic Beverages	8.3	8.4	12.1	31.6
Non-food Products	5.0	6.7	5.2	17.9
Building Materials	4.6	7.9	5.1	18.6
Motor Gasoline	6.5	14.9	6.8	30.7
Tobacco Products	19.5	21.1	22.6	77.4
Services	8.1	8.7	7.3	26.1
Housing and Utilities Services	13.0	11.7	9.4	38.1
Pre-school Education Services	7.7	11.3	6.4	27.5
Sanatorium and Health Recovery Services	5.4	9.0	5.9	21.7
Passenger Transport Services	8.7	9.1	6.9	26.8
Cultural Institutions' Services	8.6	11.3	8.8	31.5

Source: Rosstat.

In conclusion of this section of our paper, let us compare the growth rates of consumer prices in Russia and the other CIS countries (*Table 4*).

Table 4

**The Movement of Consumer Price Indices in the CIS Countries in 2010-2012,
% Per Annum**

	2010	2011	2012*	2010-2012* ¹
Azerbaijan	6	8	-2.7	11
Armenia	8	8	-1.5	15
Belarus	8	53	16.1	92
Kazakhstan	7	8	3.9	20
Kyrgyzstan	8	17	3.1	30
Moldova	7	8	2.4	18
<i>Russia</i> ²	7	8	5.2	22
Tajikistan	6	13	5.6	26
Ukraine	9	8	-0.3	17

*Data for January-September.

Source: Interstate Statistical Committee of the CIS (<http://www.cisstat.com/>).

By the end of the first three quarters of 2012 (see *Table 4*), Russia ranked 3rd place among the CIS countries, below Belarus and Tajikistan, in growth rate of consumer prices. It should be noted that a number of countries in that region faced deflation. Those countries were as follows: Azerbaijan (-2.7%), Armenia (-1.5%) and Ukraine (-0.3%). Thus, Russian inflation remained to be high not only in comparison with developed countries, but also with the other countries of that region.

In early 2013, inflation will be restrained by a number of factors, including the stabilization of food prices, which began in late 2012; the slow-down of economic activity; and the moderate growth of the money supply. As a result, it can be expected that by mid-year 2013 the rate of consumer inflation will drop to around 6%. At the same time, the further movement of inflation in Russia will be determined by both the situation in the global economy, including in

¹ The cumulative inflation rate for 2010 - September 2012.

² It should be noted that Russia's annual inflation rates presented in *Table 4* differ from official *Rosstat* data, which results from the peculiarities of the calculation methodology adopted by the Interstate Statistical Committee of the CIS. Nevertheless, we have decided to present here the Committee's data in order to make it possible to compare the annual inflation rates of different countries.

the global food market, and by Russia's domestic trends in the field of tariff regulation of housing and municipal utilities services as well as in her anti-monopoly and tax policies.

2.1.3. The Main Developments in the Field of Monetary Policy

Over the course of 2012, the RF Central Bank changed the refinancing rate only once, on 14 September, when it was increased by 0.25 pp., from 8 to 8.25% per annum. Simultaneously, the RF Central Bank increased by 0.25 pp. the interest rates on liquidity provision and absorption operations. In effect, this measure was the RF Central Bank's response to Russia's rising inflation. It should be mentioned that consumer inflation, after dropping in April and May 2012 to around 3.7% in annual terms, then started to creep up once again: in August Russia's CPI rose to an impressive 6% on a year-on-year basis, while the inflation target established by the Government for 2012 also amounted to 6%.

As we have already pointed out, the main causes of the rapid acceleration of inflation in the second half-year of 2012 were the growth in tariffs for consumer services and the rise in the global prices of food products, which resulted from the adverse weather conditions in a number of agricultural producing countries. Formally, these factors do not depend on the monetary policy of the RF Central Bank. However, base inflation was also on the rise, which set the stage for a rise in interest rates, given the situation created by the policy of inflation targeting declared by the Bank of Russia. We believe that this policy of the RF Central Bank was absolutely justified from the point of view of the current goals of Russia's monetary policy; in fact, it could be regarded as a signal to economic agents that the top priority goal of monetary policy should be to restrain inflation. At the same time, bearing in mind Russia's lackluster economic growth, and the largely exogenous character of Russian inflation, it should be admitted that the potential for a further significant rise in interest rates is rather limited.

Apart from changing the refinancing rate, the Bank of Russia undertook a number of measures designed to increase the effectiveness of its policy on interest rates. Thus, on 29 March 2012, the RF Central Bank announced that it would resume auction-based allocation of Lombard credits and direct repo auctions for a term of 12 months. It should be reminded that as the Russian economy recovered from the 2008-2009 economic crisis, the Bank of Russia gradually rolled back its anti-crisis measures aimed at propping up Russia's banking system. This bank bailout policy included the suspension, by the Bank of Russia, of direct repo auctions and Lombard credit auctions for a term of 12 months, put into effect in April 2010. However, the reduction in the RF Central Bank's interference in the functioning of the foreign-exchange market and the resulting decline in the Bank's foreign currency interventions caused a considerable shrinkage of its influence on the money base of the monetization channel of Russia's balance of payments. In due course, this development gave rise to the issue of bank refinancing extension, on the part of the RF Central Bank, for the purpose of maintaining the money supply at an adequate level. One of the methods for solving this issue is to increase the periods of the Bank of Russia's credits extended to banks. Thus, the RF Central Bank's decision can be considered justified. At the same time we cannot support the demand put forth by a number of Russia's biggest banks that the RF Central Bank should either provide long-term unsecured credits to commercial banks or considerably mitigate its collateral security requirements towards credits. In our view, in order to prevent the emergence of 'bubbles' and to exercise control over risks, the RF Central Bank should predominantly grant secured credits.

On 9 April 2012, the Bank of Russia introduced a new monetary policy instrument – a one-week deposit auction facility with a maximum interest rate of 4.75%. On Tuesdays, starting from 17 April, the Bank of Russia regularly held auctions for a term of one week either designed to provide funds to banks (a direct repo auction and a Lombard loan auction) or designed to absorb liquidity (deposit auctions introduced from 10 April 2012).

According to representatives of the RF Central Bank, the implementation of these decisions would contribute to the reduction of money market interest rates volatility and would enhance the effectiveness of the interest rate policy pursued by the Bank of Russia. In our view, the newly introduced measure conforms to the Bank of Russia's strategy aimed at increasing the role of the RF Central Bank's interest rates in Russian monetary policy. Under the adopted scenario, deposit auction interest rates are used as a tool to influence the setting of the minimum interest rate at the interbank loan market, while interest rates on liquidity-provision operations (direct repo and Lombard loans) – as a tool to influence the setting of the maximum interest rate at that market.

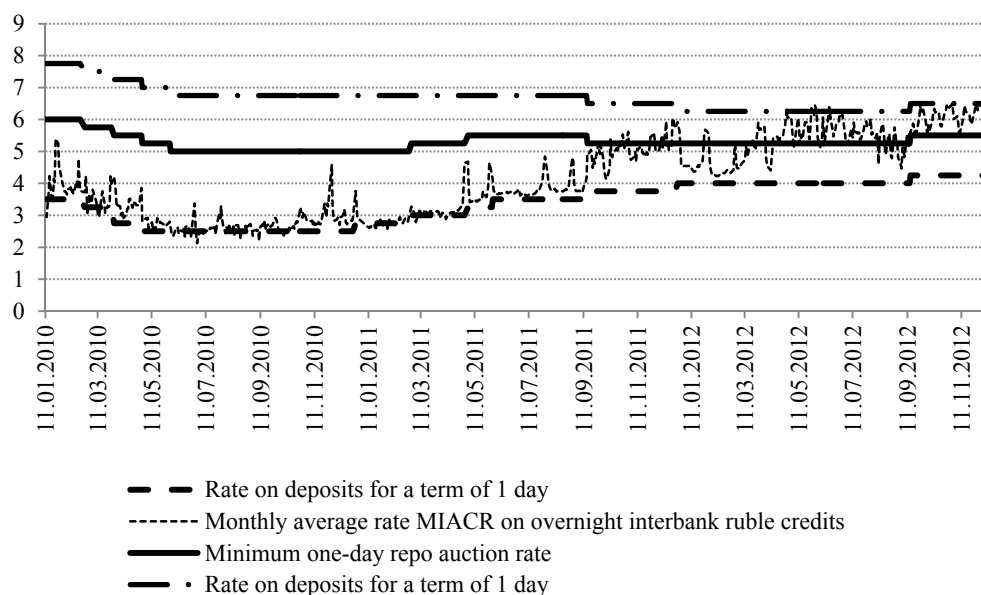
On 22 May 2012, the RF Central Bank announced its decision to resume direct repo operations with banks, collateralized by shares included in the Lombard list of the RF Central Bank. This step was taken to offset the liquidity concerns of Russia's banking system, which has become increasingly dependent on the provision of funds by monetary regulatory bodies. It should be reminded that in the post-crisis period the funds provided by the RF Central Bank to commercial banks became the main source of money supply formation in the Russian Federation. It was in response to this situation and the growing instability of global financial markets that the RF Central Bank made the decision to resume the extension of credits to banks against the security of shares. At the same time, it should be noted that the rapid growth in the RF Central Bank's credit lending to banks taking place against the background of a relatively slow growth of the deposit base sets the stage for future financial instability – if there happens to be a slowdown in such credit lending. Bearing this in mind, the RF Central Bank should take a more cautious approach to the issue of refinancing credit institutions and strictly control the risks faced by banks.

On 11 December 2012, the RF Central Bank once again narrowed the spread between the interest rates on some of its liquidity providing and absorbing operations. At the same time, the Bank of Russia reduced the interest rate on the ruble leg of its currency swap transactions from 6.75 to 6.5% per annum. Also, the RF Central Bank decided to raise - effective from 11 December 2012 - the interest rates on the Bank of Russia's fixed-term deposit operations by 0.25 percentage points, to 4.5% per annum.

It should be noted that, over the course of 2012, the Bank of Russia discontinued the use of some of its less effective and not popular instruments. The RF Central Bank suspended, from 17 April 2012, fixed-rate deposit operations conducted on standard conditions and Lombard loans for a term of one week. Also, the RF Central Bank suspended, from Q3 2012, deposit auctions for a term of one month – and replaced them with deposit operations at fixed interest rates.

Thus, as shown in *Fig. 6*, over the course of 2012 the Bank of Russia continued to narrow the spread between the interest rates on its liquidity providing and absorbing operations with banks. However, it should be noted that in 2012 interest rates in the interbank loan market systematically exceeded the upper limit of the interest rate corridor established by the RF Central Bank for auction-based operations. This trend reflects credit institutions' high demand for funds in a situation characterized by tight liquidity conditions in the money market and the

limited possibilities of attracting money from foreign sources. At the same time many banks are simply incapable of attracting funds from the RF Central Bank PΦ because of the insufficiency of their borrowing bases.



Source: RF Central Bank.

Fig. 6. The RF Central Bank’s Interest Rates on Liquidity Providing and Absorbing Operations, and the Rate on the Interbank Loan Market, in 2010 – December 2012

However, on the whole, this country’s money market is being strongly influenced by the Bank of Russia’s current interest rate policy – which represents an important condition for a successful switchover to the inflation targeting regime. Another aspect of that switchover is the foreign exchange policy of the RF Central Bank. In 2012, it continued to pursue the top-priority goal of that policy – to scale down its direct interference with setting the exchange rate on the domestic foreign-exchange market, thus making possible significant fluctuations of the ruble’s nominal exchange rate.

On 24 July 2012, the Bank of Russia widened from 6 to 7 rubles the bi-currency basket floating operational band and decreased the cumulative interventions threshold for shifting the boundaries of the operational band by 5 kopecks from \$ 500m to \$ 450m. It should be reminded that, from 27 December 2011, the bi-currency basket floating operational band had already been widened from 5 to 6 rubles, and the cumulative interventions threshold brought down from \$ 600m to \$ 500m.

The decision to decrease the cumulative interventions threshold influencing the bi-currency basket floating operational band is indicative of the increasing flexibility of the RF Central Bank’s exchange rate policy. The measures undertaken by the Bank of Russia point to a gradual abandonment of its policy of regulating the exchange rate and the beginning of a switchover to inflation targeting. During the period of instability on the foreign exchange market in the autumn of 2011 and the spring of 2012, the Bank of Russia demonstrated its preparedness to minimize its interference with the operation of the foreign exchange market and to allow some noticeable fluctuations in the ruble’s nominal exchange rate. Such a policy results in a

lower volume of speculations in the foreign exchange market, because the exchange rate's movement becomes less predictable.

In accordance with one of the priority goals of its monetary policy – *to promote information openness* – the Bank of Russia, from 7 August 2012 onwards, began to publish on its official website the information on the volume and structure of money supply M2 (national definition). From 1 January 2011, the data on money aggregates are to be broken down by level of liquidity (where M0, M1 and M2 are shown separately); another new feature is the by-sector distribution of deposits, where the funds of non-financial and financial institutions (with the exception of credit institutions) are presented separately from the population's funds.

From 4 December 2012, the Bank of Russia began to publish its forecast of factors underlying the formation of banking sector liquidity. The forecast highlights the following four key factors: changes in the volume of cash in circulation (outside the Bank of Russia); changes in balances of the general government's accounts with the Bank of Russia, and other operations; the Bank of Russia's regulation of the size of credit institutions' required reserves; and the balance of the Bank of Russia's liquidity providing and absorbing operations. On the whole, the appearance of such a forecast is a welcome development because, in addition to greater openness of the RF Central Bank's information sources, it will also conduce to a higher transparency of its monetary policy, and so increase the confidence of economic agents in the RF Central Bank's policies.

On 4 November, 2012 the Bank of Russia published on its official website the draft of *Guidelines for the Single State Monetary Policy in 2013 and for 2014 and 2015* (hereinafter referred to as *the Draft*). As stipulated in the Draft, by 2015 the RF Central Bank is planning to complete the switchover to inflation targeting. We believe that the Draft should be analyzed, in the main, from the point of view of that principal goal set by the Bank of Russia for its monetary policy in the medium-term perspective. Thus, this document has given rise to a number of serious questions.

Within the framework of the strategy of continual reduction in the growth rate of prices, it envisaged that, by 2014, the inflation rate must drop to 4–5% per annum. In this connection, the inflation target range for 2013 is set at 5–6%. It should be reminded that the inflation target range for 2012 was also set at 5–6%, but the Draft's authors admit that it might be possible for actual inflation indicators to move above the upper margin of that range. However, in the document it is simply stated that such a risk has indeed emerged as a result of rapid growth of food prices.

It must be noted in this connection that a detailed analysis of the ongoing inflation processes and the measures applied by the regulatory monetary authorities in order to keep the inflation rate within the established target range is a key component of an inflation targeting regime. The international experience in the sphere of inflation targeting by central banks point to the necessity to analyze very carefully the causes of the inflation rate slipping beyond the established target range. As noted earlier, the factors that have determined the surge of the inflation rate above the forecast level are largely beyond the RF Central Bank's control. Nevertheless, judging by the specific features of the current situation, it can be concluded that the RF Central Bank still failed to thoroughly analyze and take into account the existing inflation risks.

It is a noticeable fact that, in recent years, the rate of inflation has been declining in response to external factors rather than to the policies pursued by the RF Central Bank. Besides,

as the Bank of Russia has rarely achieved its proclaimed inflation targets, the trust of economic agents in its forecasts must evidently be rather low. In such a situation, it will be very important to accurately explain the meaning of the planned anti-inflation measures, as well as the reasons why the inflation rate is moving beyond the target range. However, judging by the Draft's content, the RF Central Bank holds a different opinion.

The main goal of its exchange rate policy is perceived by the Bank of Russia as that of reducing its direct interference with its level and creating appropriate conditions for a switch-over to a floating exchange rate mode (by 2015). The Draft puts forth the idea that, as such interference with the foreign exchange market on the part of the RF Central Bank becomes lesser, the policy aiming at the regulation of interest rates through liquidity provision and absorption operations will become a key component of the process of monetary regulation.

However, it must be borne in mind that the RF Central Bank's interest rates began to significantly influence the money market only after the 2008–2009 crisis, when the RF Central Bank's funds became an important component of commercial banks' liabilities. Indeed, in recent years the Bank of Russia has minimized its monetary interventions in the market, with the result that its refinancing operations are now the main channel for money supply growth. In the Draft it is assumed that if the average annual price of Urals increases to the level of \$ 121 per barrel, the growth of the RF Central Bank's international reserves in 2013 will exceed \$ 90bn. However, this will, in fact, mean a reversal to the pre-crisis monetary policy model, when the Bank of Russia suppressed the ruble's strengthening in nominal terms through foreign exchange purchases on the market. If such a policy is indeed resorted to, the monetary base will once again be formed in the main by monetary interventions undertaken by the RF Central Bank, and the role of interest rates will be waning. A considerable increase in net credit extended to banks is planned only in the event of a considerable worsening of the economic situation and a decline of prices for top Russian exports.

Besides, the Bank of Russia sets the following important medium-term goals:

- maintenance of financial stability (in order to achieve this goal the activity of the Bank of Russia will be based on international best practices in the field of risk-oriented supervision; maintenance of the transparency of credit institutions' activity; and differentiated supervision over financial institutions depending on their systemic importance). We believe that in order to achieve this goal, special emphasis should be placed on analyzing the banking system's resilience to shocks with taking into account their strong dependence on government-sponsored refinancing;
- development of the infrastructure of Russia's financial markets and the enhancement of their capacity. As the switchover to inflation targeting gathers pace, the derivatives market assumes special importance for hedging foreign exchange risks that will progressively increase due to the growing volatility of the exchange rate of the ruble;
- ensuring coordination between the monetary policy of the RF Central Bank and the budget and tax policies of the RF Government. The importance of such coordination in view of the considerable impact of government-regulated tariffs on inflation and the influence of fiscal policy on the money supply in the Russian Federation, the importance of such coordination is difficult to overestimate. It is absolutely clear that a balanced budgetary policy aimed at reducing the budget deficit and Russia's sovereign risk would be conducive to the achievement of the RF Central Bank's inflation target. However, it should be noted that the RF Central Bank's possibilities to influence the government's fiscal policy are extremely small;

- increasing the transparency of the Bank of Russia's policy in the field of monetary policy. In recent years, the RF Central Bank has achieved some progress in enhancing the transparency of its policy and almost reached international best practice standards. At the same time, the Bank still has plenty of room to improve the quality of its analytical output, including macroeconomic situation analysis, and to furnish economic agents with more-detailed explanations of the causes and consequences of its decisions.

On the whole, it can be said that so far the Draft has not been sufficiently adapted to the changing priorities of Russia's monetary policy. It seems that the principles of composing such documents have not been updated for many years for they do not take into account the latest shifts in the RF Central Bank's priorities and, first of all, the change of the monetary policy regime. This is deplorable, because if the RF Central Bank wants to increase economic agents' trust in its policy, it should offer them a thorough explanation thereof, which the Draft clearly fails to do. In its current form the Draft is simply not substantive enough and thus cannot be used as an independent tool for forming expectations.

2.1.4. The Balance of Payments¹ и and the Exchange Rate of the Ruble

In 2012, the Bank of Russia switched over to disseminating RF balance of payments data on the basis of the methodology set out in the 6th edition of the *Balance of Payments and Investment Position Manual* (BPM6). Conceptually, BPM6 maintains the overall framework of the methodology of the previous edition of the Manual (BPM5).

The main changes in the accounts of the balance of payments include the following: within *balance on trade in goods – goods for and after processing* are excluded and *net exports of goods under merchanting* are included; within *balance on trade in services – manufacturing services on physical imports owned by the others* and *financial intermediation services indirectly measured* are added; within *balance on income – rent* is included; within *capital account – migrants' transfers* are excluded; within *financial account – transactions of other sectors* are further broken down into *other financial institutions* and *nonfinancial enterprises, households and nonprofit organizations servicing households*. The *balance on income* and *balance on current transfers* accounts have been respectively renamed as the *primary income* and *secondary income* accounts.

According to the RF Central Bank², earlier balance of payments statistics compiled in accordance with BPM5 recommendations remain overall relevant for comparisons with the aggregates compiled under the new methodology. As the Bank of Russia has so far failed to publish the revised time series of all external sector statistics for the period from 1992 through 2011, recalculated under the new methodology, we will compare, in our overview, the data for 2012 (compiled under the new methodology) with data for previous years (compiled under the old methodology).

In 2012, the leading world economies continued to pursue soft monetary policies, which encouraged raw material prices to stay high. As a result, the balance on the current account of Russia's balance of payments remained solidly positive. As noted above, in 2012, the RF Central Bank practically abstained from interfering in the functioning of the foreign exchange market. Given the stability of the exchange rate of the ruble over the course of 2012, that

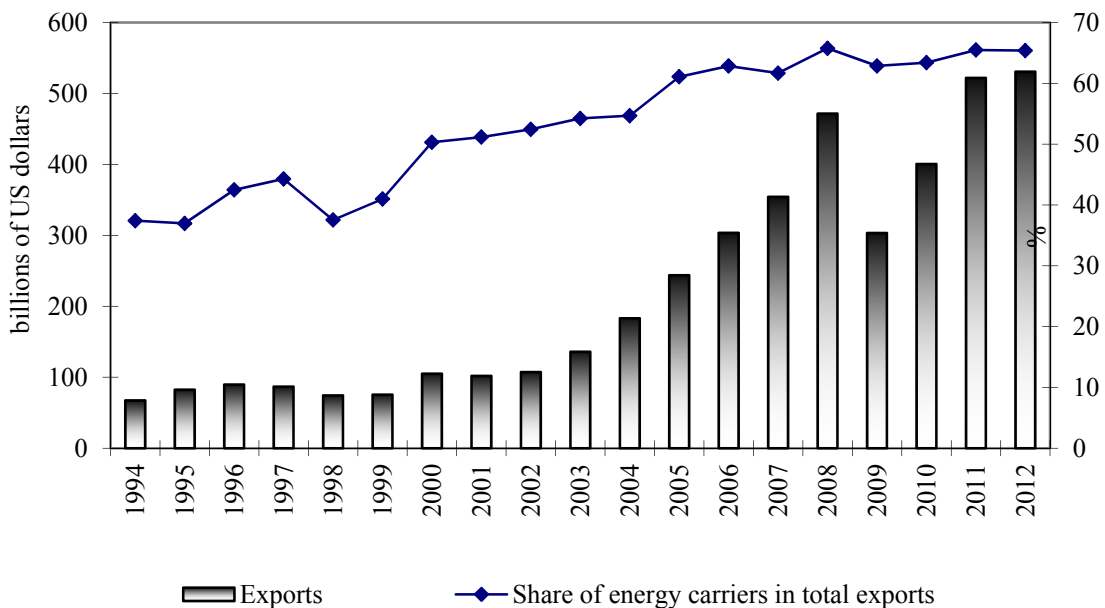
¹ The analysis of the balance of payments is based on preliminary data released by the RF Central Bank: http://cbr.ru/statistics/print.aspx?file=credit_statistics/bal_of_payments_est_new.htm&pid=svs&sid=itm_45297

² See http://cbr.ru/press/Plugins/Archive_get_blob.aspx?doc_id=120627_180506intern1.htm

meant that both the demand and supply of foreign currencies were well balanced. At the same time, net private capital outflow from Russia over the course of 2012 significantly exceeded its values predicted in the forecasts of the RF Government and the Bank of Russia, which once again emphasized the fact that investing in the Russian economy can be fraught with serious risks. As a result, although Russia's 2012 balance of payments looks healthy enough, it is clear that in the medium-term perspective the RF balance of payments will be vulnerable to changes that may occur in the international market situation.

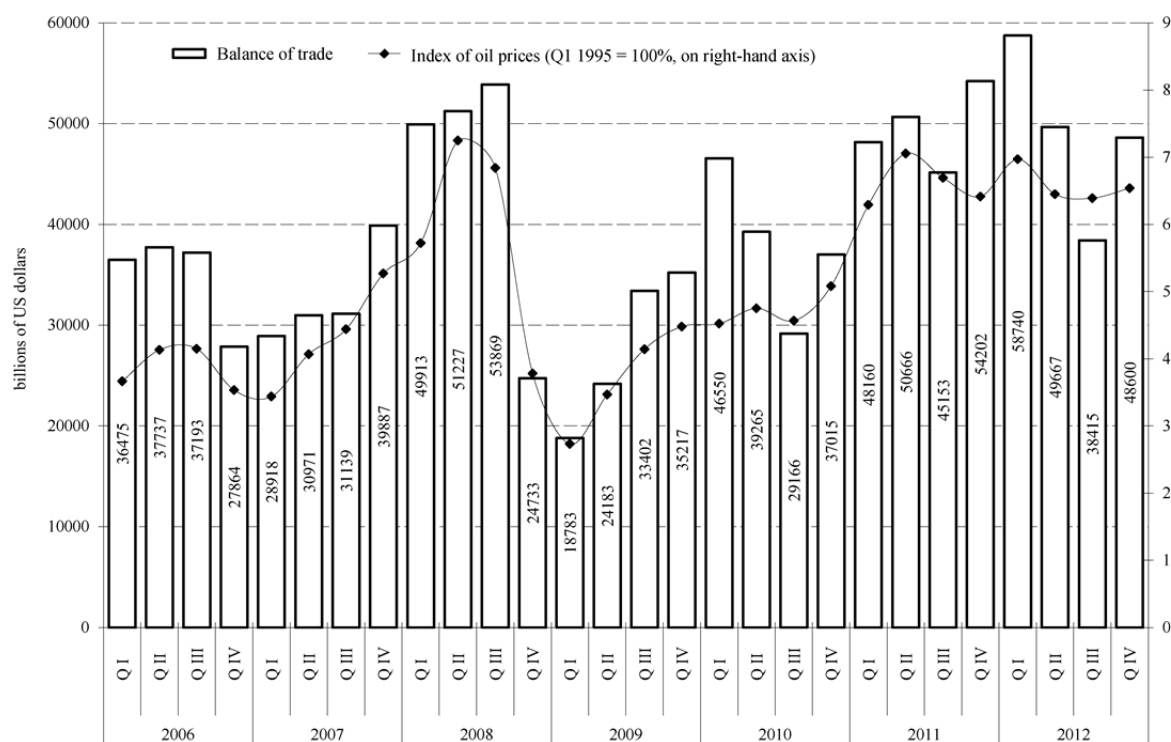
According to the Bank of Russia' preliminary estimate of the RF balance of payments for 2012, the current account surplus amounted to \$ 81.2bn, which represents a 17.8% drop on 2011 (*Table 4*). The balance of trade surplus dwindled by 1.4% (from \$ 198.2bn to \$ 195.4bn), while commodity exports increased by 1.7% (from \$ 522bn to \$ 530.8bn), and commodity imports rose by 3.6% (from \$ 323.8bn to \$ 335.4bn). The share of oil, petroleum products and natural gas in total exports amounted to 65.4%, which represents a 0.1 pp. drop on 2011 (*Fig. 7*). It should be noted that, in 2012, both exports and imports rose to post-Soviet record highs.

Thus, as in previous years, the main factor determining the size of Russia's current account surplus is the trade balance whose size largely depends on the price behavior of energy carriers and other top Russian exports on global markets. *Fig. 8* shows that the equilibrium relationship between global oil prices and the size of Russia's trade surplus observed in 2011–2011 was continuing over the course of 2012.



Source: RF Central Bank.

Fig. 7. The Movement of Commodity Exports and the Dynamics of the Share of Energy Carriers in Total Exports, 1994-2012



Source: RF Central Bank; EIA; the IEP's calculations.

Fig. 8. The RF Trade Balance and the World Crude Oil Price Index in 2006-2012

The deficit on the services account (reflecting the trade in services) rose to \$ 44.8bn, or by 24% in absolute terms compared with 2011. The export of services amounted to \$ 63.2bn, having increased by \$ 9.2bn (+ 16.9%) from the previous year. Over the course of 2012, the import of services rose by 19.9%, to \$ 107.9bn.

The balance on the compensation of employees account in 2012 increased in absolute terms, thus amounting to \$ -12/3bn (in 2011 it was \$ -9.5bn). The deficit demonstrated by the investment income balance in 2012 increased on 2011 by 5.1% and reached the level of \$ 53.3bn. Investment income receivable increased from \$ 38.5bn to \$ 41.8bn. The growth in the amount of investment income payable for 'other sectors' from \$ 75.4bn to \$ 78.8bn, and for banks – from \$ 11.7bn to \$ 14.1bn determined growth of total income payable from \$ 89.2bn to \$ 95.1bn.

The balance on the rent account¹ for 2012 amounted to \$ +1bn. (the data on this index is published from 2012).

The balance on the secondary income account (previously referred to as the balance on the current transfers account)² in 2012 amounted to \$ -4.7bn (in 2011 – to \$ -3.2bn), and the bal-

¹ Rent covers income receivable for putting natural resources at the disposal of another institutional unit. Examples of rent include amounts payable for the use of land, extraction of mineral resources and other subsoil assets, and for fishing, forestry and grazing rights.

² According to the RF Central Bank, current transfers, for instance, humanitarian aid in the form of consumer goods and services, increase the receiver's level of disposable income and consumption opportunities and decrease the disposable income and potential consumption opportunities of the donor. Current transfers are recorded in the current account. Transfers which are not current by definition are capital ones. If the donor and the recipient are residents of different countries a capital transfer results in a change in the level of national wealth of

ance on the capital account – to \$ –5.1bn (in 2011 – to \$ –0.1bn). The substantial deficit demonstrated by the capital account in 2012 is caused by the writing off of outstanding debt against the government loans issued by the former USSR.

Table 5

**The Main Items of the Balance of Payments and the Dynamics
of Russia's External Debt in 2010-2012 (bn USD)**

Index	2010					2011					2012				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4*	Year*
Balance from current and capital account	33.9	18.4	5.6	13.3	71.2	30.8	21.9	17.8	28.3	98.7	34.3	18.2	6.4	17.3	76.2
Financial account (excluding reserve assets)**	-11.8	9.1	-6.8	-16.6	-26.1	-16.0	-8.9	-20.2	-31.0	-76.1	-24.7	-1.4	-6.7	-3.0	-35.8
Change in reserve assets ('+' - decrease, '-' - increase)	-16.6	-26.1	-2.7	8.6	-36.8	-10.1	-12.9	1.8	8.6	-12.6	-4.6	-15.0	-1.5	-8.9	-30.0
Net errors and omissions	-5.5	-1.4	3.9	-5.3	-8.3	-4.7	-0.1	0.6	-5.8	-10.0	-5.0	-1.8	1.8	-5.4	-10.4
External debt of the Russian Federation ('+' - decrease, '-' - increase)	-3.8	-6.0	19.2	12.3	21.7	20.7	29.2	-11.1	17.4	56.2	19.2	11.0	23.9	29.3	83.4
RF government external debt	-2.4	3.8	-0.3	-0.5	0.6	1.3	0.0	-2.7	-0.8	-2.1	2.2	4.6	2.7	3.8	13.3
External debt of the RF private sector	-1.5	-9.8	19.5	12.8	21.1	19.4	29.2	-8.4	18.1	58.4	17.0	6.3	21.3	25.5	70.1

* – preliminary estimate; ** – foreign exchange reserves are not included.

Source: RF Central Bank.

Thus it can be concluded that, in 2012, the main factor that determined the continuing positive current account balance (at a substantial level) in the RF balance of payments were the high prices for top Russian exports – just as it happened in previous years. For example, the average per annum price of Brent crude oil remained practically unchanged, amounting to \$ 111.6 per barrel. It should be noted that the year 2012 also saw a continually increasing growth rate of the Russian private sector's external debt (see *Table 5*). If over the year 2010 the size of external debt owed by banks and the non-financial sector increased by \$ 21.1bn, in the next year (2011) the growth of that category of debt amounted to \$ 58.4bn, and in 2012 – to 70.1bn. As for RF government external debt, over last year it also increased by \$ 13.3bn. Owing to the favorable situation in the energy carriers market, it became possible, towards the year's end, to form a practically deficit-free state budget – and to increase the size of the RF Reserve Fund by approximately Rb 700bn. However, the government still resorted to borrowing on the external market. This measure was necessitated by the fact that government borrowing sets some target values that can be applied by the companies in the private sector in their own borrowing activity – which is carried out by them on a large scale. In the medium term one may expect the size of external debt to continue its growth – both in the private and public sectors of the national economy, which can be explained by the shortage – and the resulting high cost – of domestic financial resources, as well as by the possibility that foreign trade conjuncture may worsen because of the RF Government's ambitious plans to further increase budget expenditure.

the economies they represent. Examples of capital transfers are debt forgiveness and a free of charge transfer of the title of capital assets.

In 2012, the deficit of the financial account amounted to \$ 35.8bn. The size of liabilities of Russian economic agents to foreign economic agents increased over that year by \$ 80.4bn, which represents a 17.1% increase on the previous year (\$ 68.7bn).

Over the course of 2012, the size of the federal government's external liabilities increased by \$ 9.6bn. As far as RF subjects are concerned, their external debt shrank by \$ 0.4bn. In 2012, the size of liabilities of the monetary authorities increased by no more than \$ 2.9bn.

The banking sector's liabilities to non-residents over the course of 2012 increased by \$ 39.6bn, whereas in 2011 the growth of banks' liabilities did not exceed \$ 7.9bn. Given Russian banks' high demand for funds provided by the RF Central Bank, this movement pattern displayed by their liabilities may be indicative of the difficulties experienced by Russian banks in their attempts to attract funding from the domestic private sector.

The liabilities of 'other sectors' to non-residents over 2012 increased by \$ 28.9bn (against by \$ 62.2bn in 2011); the amount of direct investment in 'other sectors' was \$ 38.9bn (against \$ 47.3bn in 2011). There was an outflow of portfolio investment in the amount of \$ 8bn (against \$ 6.4bn one year earlier). The shrinkage of direct investment in Russia's non-financial sector points to its insufficient attractiveness in the eyes of investors from the point of view of the risk to yield ratio. However, the main reason for the slower capital inflow (by comparison with 2011) in the non-financial sector was the movement of liabilities to non-residents, the size of which in 2012 increased by only \$ 2.7bn vs. by \$ 21.4bn in 2011.

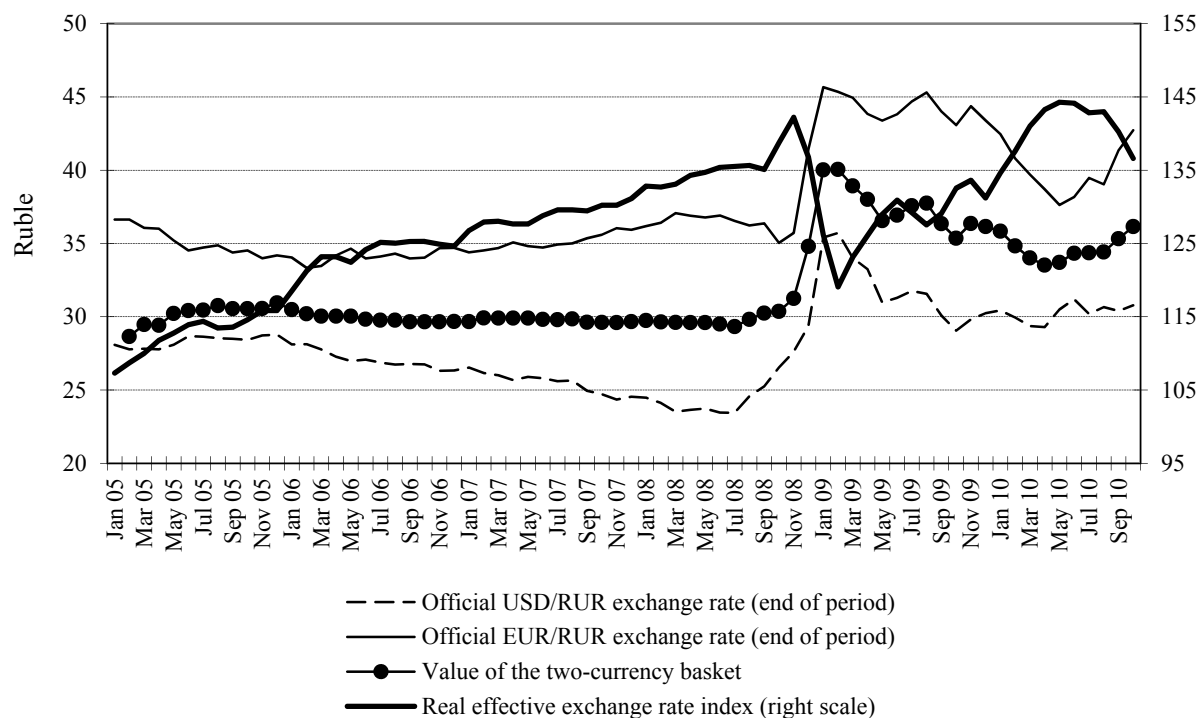
Thus, in spite of the increasing liabilities of RF residents to foreign economic agents, the structure of borrowed funds may be regarded as rather alarming because, in contrast to the situation in previous years, the size of borrowings made by banks has for the first time exceeded that made by the non-financial sector, while foreign liabilities of the latter have turned out to be much lower than in 2011.

The size of foreign assets held by residents (the liabilities of foreign economic agents to Russian economic agents) in 2012 increased by \$ 116.2bn (vs. by \$ 144.7bn in 2011). At the same time, the size of foreign assets held by the monetary authorities and federal government bodies remained practically unchanged.

The foreign assets held by the banking sector in 2012 increased by \$ 15.9bn (vs. by \$ 32bn in 2011). Capital outflows from 'other sectors' dropped on 2011 by 9%, and thus amounted to \$ 100.3bn. The share of direct and portfolio investment abroad amounted to \$ 45.4bn (\$ 26bn less than in 2011). The population and the non-financial sector increased their investment in foreign cash, and so its inflow amounted to \$ 2.5bn.

The situation on the RF foreign-exchange market in 2012 was determined by the inflow of foreign currency via the current account channel coupled with its outflow via the capital and financial account (reflecting operations with capital and financial instruments). As noted earlier, the RF Central Bank has markedly reduced its involvement in the foreign-exchange market's functioning, and so the ruble's exchanged rate was being determined in the main by market factors, while the regulator only smoothed over its most pronounced and consistent fluctuations. As a result, while the prices for top Russian exports stayed at a sufficiently high level, and the rate of inflation in the RF remained moderate, the ruble's real effective exchange rate over the period of January – December 2012 increased by 5.5% (over the course of 2011 – by +1.6%), but towards the year's end it still remained at a level lower than in mid-2011 (see *Fig. 9*). Over the course of 2012, the official USD-to-ruble exchange rate declined by Rb 1.83: by the end of December 2012, it was Rb 30.37 per USD against Rb 32.20 per USD as of 31 December 2011. At the same time, the ruble strengthened against the bi-

currency basket¹: over the period under consideration, the value of the bi-currency basket declined by Rb 1.65, from Rb 36.46 to Rb 36.81. As a result, the ruble-to-euro exchange rate as of the end of December 2012 amounted to Rb 40.23, having increased since the year's beginning by Rb 1.44.



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

Fig. 9. The Movement of the Ruble's Exchange Rate in January 2005 – December 2012

Thus, in 2012, the situation with the balance of payments was such that, by the year's end, the ruble's exchange rate slightly increased both in nominal and real terms – practically without any interference of the RF Central Bank in the foreign-exchange market. In other words, the market situation was developing rather favorably for the Bank of Russia, enabling it to switch over to the inflation targeting regime in absence of any fundamental changes in the ruble's exchange rate.

One of the major trends displayed by the balance of payments in 2012 was the behavior of net capital outflow from the non-financial sector, which by the year's end rose to \$ 56.8bn (in 2011 – \$ 80.5bn) (see Fig. 10). Capital outflow continued nearly throughout the entire year's period - with the exception of June, when the amount of net capital inflow in the private sector was \$ 4.3bn.

It should be reminded that, until August 2012, the annual capital outflow was forecast by the RF Ministry of Economic to be as low as \$ 15–25bn, with several subsequent upward adjustments. Interestingly, a similar situation has already been observed for a few years in a row, when at a year's beginning the authorities released their highly optimistic estimate of potential capital outflow. Meanwhile, it is evident that while the world economic situation

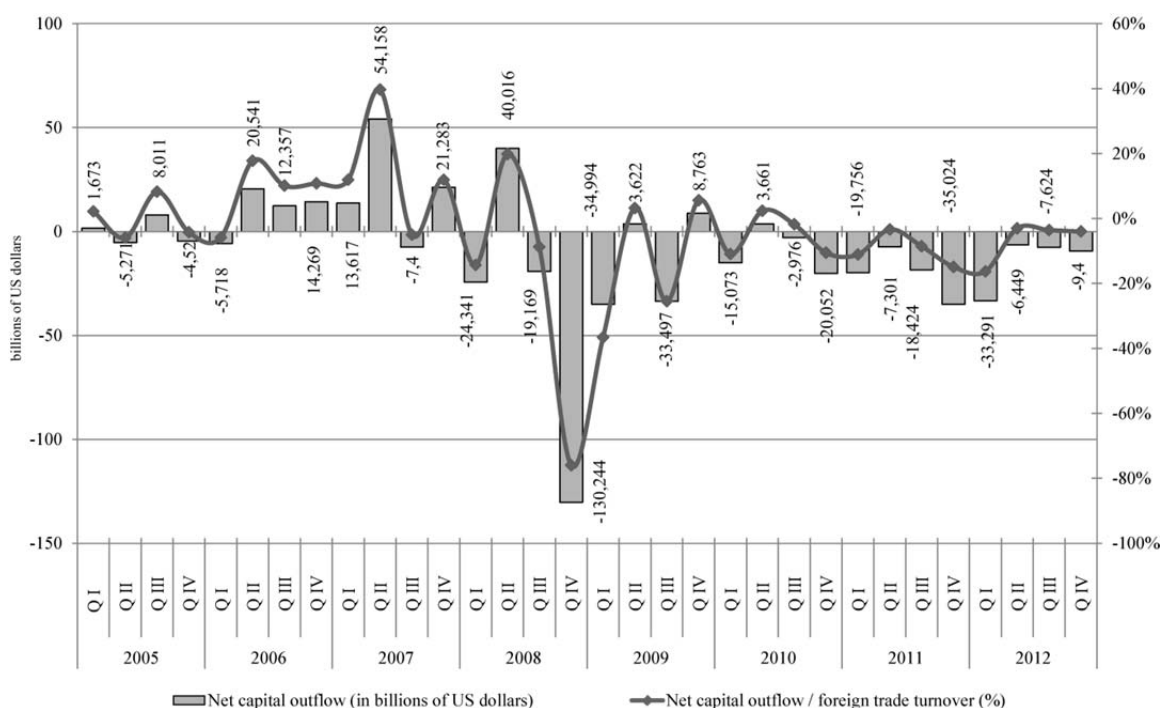
¹ The bi-currency basket serves as a target for the RF Central Bank in its monetary policy. At present, the share of euro in the basket is 45%, that of US dollar – 55%.

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remains unstable, Russia's economy heavily depends on the export of energy carriers, and the institutional environment's quality is poor, it will be very difficult to make nonresidents increase the amount of their investment in the RF - or to prevent residents from moving their assets abroad.

However, it should also be noted that an important factor that in recent years has been pushing up the level of capital outflow is the RF Central Bank's orientation towards minimizing its interference with the foreign-exchange market. In such a situation a positive balance on the current account of Russia's balance of payments is neutralized by a negative balance on the capital and financial account. Evidently, if the balance of international reserves is constant, capital outflow will correlate with foreign cash inflow as a result of foreign trade. In this connection, the relatively stable nominal exchange rate of the ruble points to an equilibrium of demand and supply on the foreign-exchange market.

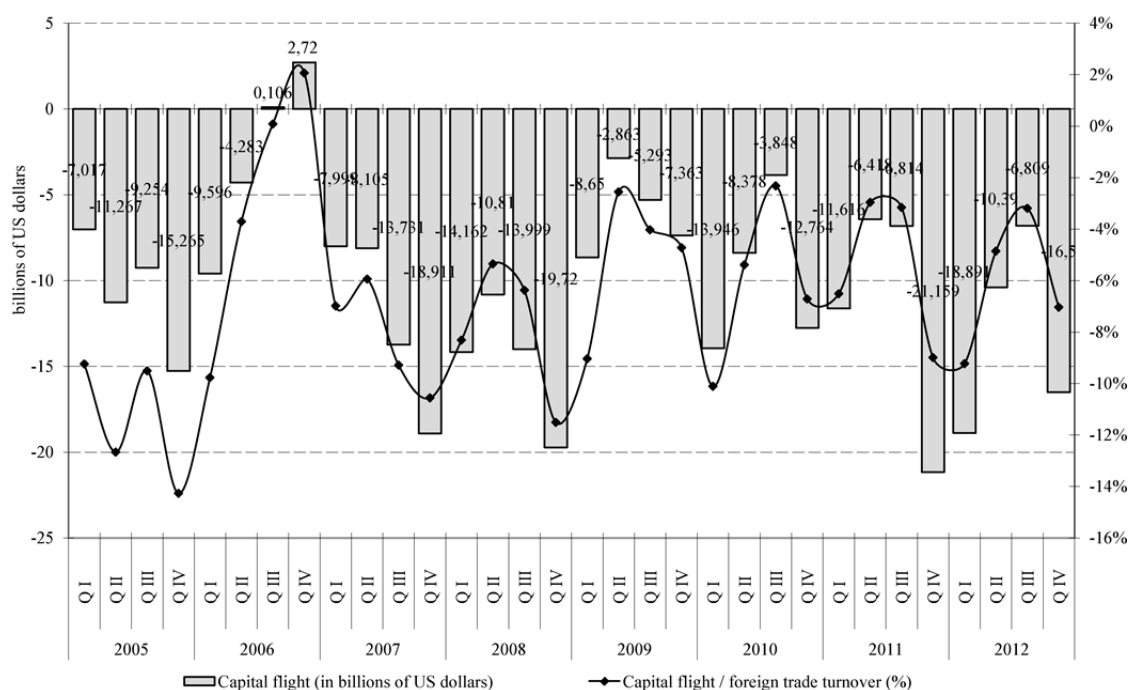


Source: RF Central Bank; the IEP's calculations.

Fig. 10. The Movement of Net Capital Outflow in 2005–2012

One more fact confirming the unfavorable situation with capital inflow is the increasing prominence, over the course of 2012, of the phenomenon termed *capital flight*¹. As of the end of 2012, according to our estimations, capital flight (Fig. 11) amounted to \$ 52.6bn, which is by \$ 6.6bn more than in 2011.

¹ We calculate capital flight in accordance with the IMF's methodology, where capital flight represents the sum of trade credits and advances, export proceeds in arrears and financial claims relating to the delivery of goods or services where payment has not taken place under import contracts, and net errors and omissions.



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

Fig. 11. The Dynamics of Capital Flight in 2005–2012

By way of summing up our analysis of Russia's balance of payments, we should like to note that the fact of it having only a small surplus is beneficial for the Russian economy because it increases the stability of the foreign-exchange market and conduces to sustainable development of the financial system. At the same time, due to the high dependence of the current account of the RF balance of payments on a limited number of top exports, the existing situation can hardly be estimated as being sustainable in the long run, as the movement of prices for energy carriers is unpredictable and, consequently, so is the situation in Russia's foreign trade. As for the balance on the account of operations with capital and financial instruments, it can be expected that capital flow in and from Russia will, most probably, remain sufficiently volatile – among other things, because of the uncertain prospects for further development of the world economy. However, all other conditions being equal (first of all, if prices of energy carriers should remain stable), if the RF Government makes no efforts to reduce the risks for foreign investment in the Russian Federation, Russia may hardly expect to receive any private capital inflows by the end of the year 2013.

2.2. State budget

In 2012 the Russian budget system, despite emergence of some risk factors, remained stable. In H2 of the year there were serious concerns of the second wave of crisis or a long-term recession in the global and domestic economy, as well as potential significant depreciation of the European currency and high volatility of the global oil prices, which required for the purpose of the stability of the Russian budget not only to adjust the macroeconomic parameters forecast, but also to develop new fiscal rules that define the limits of the federal budget and the amount of federal budget and its deficit¹.

¹ See "Prospects of Fiscal Policy" for details.

In the second half of the year, with some stabilization of the global economy and the rise in oil prices to the level that ensured a balanced budget system, the key internal risk factor, particularly for regional budgets, was a slowed growth rate of the Russian economy. In particular, as of the results of eight months in 2012, the consolidated budget of the Subjects of the Russian Federation has decreased by 0.5 p.p. of GDP against the eight months of 2011

As of the results of 2012, the extended government budget revenues have decreased to 37.7% of GDP, which is by 0.5 p.p. of GDP lower than the revenue of the budget system in 2011. Nevertheless, due to the tightening of control over the growth of expenditures in 2012, the extended government budget was executed with some surplus (0.4% of GDP).

However, defining the prospects of further fiscal policy, one should take into account the following:

- IMF¹ recommends to cut down expenditures at a moderate pace, and for countries with a balanced budget and enjoying lenders' trust, in the situation of economic growth deceleration, a policy of the budget deficit increasing should be pursued, rather than expenditures reduction;
- on average, budget expenditures expansion approximately by 3-4 p.p. was typical for the OECD countries in 2009-2010. approximately 3-4 p.p. of GDP due to the expansion of government support in the period of crisis, and then, in the framework of the policy of budget deficit and public debt reduction, the reduction and fixation of expenditures at a slightly higher level than before the crisis.

At the beginning of 2012 the position of Russia in comparison with other countries in terms of deficit and public debt indicators was estimated as favorable: budget deficit in Eurozone countries (in general 6.2% of GDP), in the USA (9.6% of GDP) and in Japan (10.3% of GDP) and of a huge public debt (more than 80% of GDP in the Eurozone, 69% of GDP in the USA and 208% of GDP in Japan), but in terms of GDP growth, in regard to the BRIC countries, Russia falls behind other countries as of 2012 results (Brazil - 4.0%, China - 7.5%, India - 4.5%, Russia - 3.4%). Thus, fiscal policy in the medium term should be built on the basis of a compromise between promoting economic growth and providing a framework of financial stability in the country.

2.2.1. General characteristics of the budget system of the Russian Federation

In 2012, the dynamics of revenue and expenditure of the extended government budget has changed against the trends of preceding two years. If in 2010 revenues increased by 0.5 p.p. of GDP and in 2011 a further by 2.7 p.p. of GDP against the previous year, in 2012 they were reduced to 37.7% of GDP, which is by 0.5 p.p. of GDP below the level of 2011 (See *Table 6*). At the same time, the extended government budget expenditures in 2012 have increased versus the preceding year by 0.7 p.p. of GDP after two years of decline.

In the context of the budgetary system revenue and expenditure dynamics is also volatile. If the federal budget revenues in 2012 continued to grow in absolute terms and in GDP percentage, the consolidated budget revenue of the Subjects of the Russian Federation in 2012 once again declined in terms of GDP share, which is a further evidence of the unbalanced distribution of taxes between the different levels of the budgetary system (the major taxes assigned to the federal budget). The centralization of revenues has been intensified by the year-

¹ www.elibrary.imf.org

end results: the share of federal budget in the extended government total revenues in 2012 has increased to 55.7%. (against 54.4% in 2011), while the share of intergovernmental transfers in the total income of consolidated regional budgets has declined from 21.4% in 2011 to 19.6% in 2012.

Table 6

**Revenue and Expenditures of Budgets
in 2008–2012**

	2012		2011		2010		2009		2008		Change, p.p. of GDP, 2012 vs. 2011
	Rb bn	GDP, %	Rb bn	GDP, %	Rb bn	GDP, %	Rb bn	GDP, %	Rb bn	GDP, %	
Federal Budget											
Revenue	12 853.7	21.0	11 366.0	20.8	8 305.4	18.4	7 337.7	18.9	9 275.9	22.5	0.2
Expenditures	12 890.7	21.1	10 935.2	20.0	10 117.5	22.4	9 660.9	24.9	7 570.8	18.3	1.1
Deficit (-)/ Surplus (+)	-37.0	-0.06	430.8	0.8	-1 812.1	-4.0	-2 322.3	-6.0	1705.0	+4.1	-0.9
Consolidated Budget of the RF Subjects											
Revenue	8 064.3	13.2	7 643.9	14.0	6 537.3	14.5	5 926.6	15.3	6 253.1	15.1	-0.8
Including intergovern- mental trans- fers	1 623.9	2.6	1 644.0	3.0	1 398.9	3.1	1 487.4	3.8	1 132.6	2.7	-0.4
Expenditures	8 342.7	13.6	7 679.3	14.0	6 636.9	14.7	6 255.7	16.1	6 253.5	15.1	-0.4
Deficit (-)/ Surplus (+)	-278.4	-0.45	-35.4	-0.06	-99.6	-0.2	-329.0	-0.8	-54.4	-0.1	-0.4
Budget of the extended government											
Revenue	23 088.7	37.7	20 853.7	38.2	16 031.9	35.5	13 599.7	35.0	16 169.0	39.2	-0.5
Expenditures	22 825.8	37.3	20 004.8	36.6	17 616.6	39.0	16 048.3	41.3	14 157.0	34.3	0.7
Deficit (-)/ Surplus (+)	262.9	0.4	848.9	1.6	-1 584.7	-3.5	-2 448.6	-6.3	+2 012.0	+4.9	-1.2

Source: Russian Statistical Service, RF Ministry of Finance.

Expenditures of the federal budget in 2012 have increased to 21.1 of % of GDP, which is by 1.1 p.p. of GDP higher than in 2011. At the same time, expenditures of consolidated regional budgets demonstrate a strong tendency to reduction from 14.7% of GDP in 2010 to 13.6% of GDP. In 2012 the share of expenditures of the federal budget in the total expenditures of the extended government has increased to 56.6% (against 54.6% in 2011).

As compared with the previous year, the situation with cash execution of the federal budget in 2012 has improved (See *Table 7*): the budget is executed in terms of expenditures for 98.9% (against 98.3% in 2011). However, the problem of regular budget execution is still remained: in the last months of 2012 there were spent 17.7% (Rb 2,255.9 bn)¹ of the annual budget allocations. The RF Subjects consolidated budget execution in cash terms has decreased from 91.4% in 2011 to 90.4% in 2012. In terms of budget expenditure lines, the most critical situation is with the execution of expenditures in 2012 under the section "Housing and Public Utilities" for 85.0%, "Physical Culture and Sports" for 85.7%, "National Economy" for 86.1%.

¹ For comparison, in December 2011 there were executed about 20% of the total federal budget expenditures.

Table 7

Cash Execution of the federal budget and the RF Subjects Consolidated Budget in 2011–2012

	Federal Budget				Consolidated Budget of the RF Subjects			
	2012		2011		2012		2011	
	Approved, Rb bn	Cash execution, %	Approved, Rb bn	Cash execution, %	Approved, Rb bn	Cash execution, %	Approved, Rb bn	Cash execution, %
Expenditures, total	13035.3	98.9	11126.0	98.3	9182.9	90.8	8400.7	91.4
<i>including</i>								
Federal issues	816.4	98.6	815.0	96.6	569.8	89.5	510.8	9170
National defense	1832.2	98.9	1524.4	99.5	4.1	97.6	3.6	94.4
National defense and law enforcement	1820.9	101.2	1258.1	100.0	104.7	90.3	291.3	96.9
National Economy	2051.9	95.9	1861.7	96.2	1864.6	86.1	1485.5	88.6
Housing and public utilities	239.8	95.4	282.9	98.9	1036.8	85.0	1135.8	85.2
Environmental protection	22.8	98.8	17.8	98.9	24.6	88.8	24.0	90.6
Education	608.9	99.2	556.0	99.5	2137.1	95.8	1791.3	96.4
Culture and cinematography	92.8	96.8	86.9	96.3	270.7	94.8	248.0	94.3
Healthcare	626.7	97.8	513.0	97.4	1479.0	91.8	1333.2	89.4
Social policy	3866.8	99.8	3185.9	98.2	1363.0	93.3	1273.8	93.5
Physical training and sports	46.0	99.3	45.0	98.2	182.4	85.7	168.5	85.8
Mass media	77.6	99.9	61.2	99.9	39.0	98.2	35.0	98.0

Source: Ministry of Finance.

As of the end of 2012 extended government budget was executed with a surplus of Rb 262.9bn (0.4% of GDP). Deficit of the federal budget amounted to Rb 37.0 bn, or 0.06 % of GDP. Deficit of the consolidated budget of the RF Subjects increased in 2012 by 0.4 p.p. of GDP from the previous year and amounted to Rb 278.4 bn; herewith, if in 2011 the budget deficit of was noted in 40 regions of the Russian Federation, in 2012 the consolidated budget expenditures have exceeded revenues in 68 regions. The deficit amount is on average 3.4% of revenues from the RF Subjects consolidated budget, but in some regions the level of deficit is greater. For example, in the Chukotka Autonomous Okrug the deficit made 28.7% of revenues in 2012, in the Yamal-Nenets Autonomous District – 16.2%, in the Krasnoyarsk Region – 13.0%, in the Republic of Udmurtia -11.3%, in the Amur Region - 11.4%.

According to the Ministry of Finance, the amount of external public debt over 2012 has increased by nearly \$15.0bn and made \$50.8bn, while the basic growth was due to the state guarantees of the Russian Federation denominated in foreign currency from \$1.0bn to \$11.4bn. Herewith, in the initial version of the law on the federal budget for 2012, the upper limit of the external public debt of the Russian Federation was set at \$ 48.4bn. Since the principal objective of providing state guarantees is the external support to the industrial exports of JSC "Roseximbank", involved, among other international financial institutions, in supporting the export of industrial goods (works, services), one can expect that this growth of government guarantees in foreign currency in the long term will lead to the growth of high-tech exports.

According to the Ministry of Finance, the amount of domestic government debt (including guarantees issued by the government) by the end of 2012 amounted to Rb 4,977.9 bn or 8.1% of GDP (in 2011 - Rb 4,003.3 bn or 7.3 % of GDP). in 2012 the share of government guarantees in the total domestic debt has increased: if by the results of 2011 the volume of state guarantees amounted to Rb 459.3 bn or 11.5% in the total domestic debt, in 2012 the volume

of government guarantees almost doubled Rb to 906.6 bn and reached 18.2% in the total volume of domestic government debt. Public debt of the RF Subjects in late 2012 has somewhat decreased to Rb 13.6 bn in comparison with the previous year, amounting to Rb 1,137.9 bn.

Despite the decline in the public debt of the Russian Federation Subjects in 2012, disparities in the level of fiscal capacity of regions is likely to be increasing. The Head of the Chamber of Accounts¹ has highlighted the problem of the substantial increase in the consolidated budgets deficit, including the additional liabilities on wages, back in the fall of 2012 and supported the initiative of the Federation Council, disapproved by the Ministry of Finance Russia, the debt write-off regions on budgetary credits provided earlier by the Ministry of Finance of Russia. According to the Ministry of Finance, on August 1, 2012 in the structure of the public debt of the RF Subjects there dominated the debts liabilities under budget loans - 37.1% (or Rb 412.6 bn). Privolzhsk Region is the leader in the debt liabilities under the budget loans (Rb 133 bn), followed by and the Central Federal Regions (Rb 114.1 bn).

Meanwhile, in the position of the Federation Council in reducing the debt burden on regional budgets, there prevailing a populist position, since the debt situation of regional budgets is not so critical. For the most regions the cost of servicing of the public debt makes less than 1% of the revenues of the RF Subjects. In 2012 the revenue of the RF Subjects in the consolidated budget made Rb 40.9bn from the allocated budget funds. In 2013 it is expected to increase the revenue of the RF Subjects consolidated budget in excise taxes in view of changed standard for the distribution of income between the budgets of the Russian budgetary system in the direction of increasing the share of income allocated to the budgets of the Subjects of the Russian Federation². Thus, it is recognized in the document, that the Ministry of Finance had enough valid arguments to reject proposals on writing-off the debts of the regions on budgetary loans.

However, some solutions on reducing deficit of the regional budgets, especially for the RF Subjects, which are incapable to increase their revenue or significantly reduce expenditures, should be developed at the federal level of the Ministry of Finance of Russia, involving both, the Deputies and the Accounting Chamber as independent experts. The problem of regional development disparities has been reflected in the Report of Fitch³ rating agency on the development of the institutional framework, presented in April 2012. It was reflected in the Report, that Russia's regional policy provides opportunities for the development only to the capital city and a few regions, selected by the government.

2.2.2. Analysis of the Basic Tax Revenues to the Budget System of the Russian Federation

In 2012, as compared with 2011, the tax burden was reduced by 0.6 p.p. of GDP and has grown by 1.8% in prices of 2012 (See *Table 8*), which is an evidence of the backlog of tax revenue growth from GDP growth.

It is clear from the above data, that there was a decline in the majority of taxes in terms of GDP revenue. Thus, revenues from income tax were lower than in 2011, revenue from the individual income tax remained at the level of the previous year and that from VAT and insurance contributions have reduced by 0.1 p.p. of GDP. The exceptions were revenues from

¹ <http://www.rbc.ru/digest/index.shtml?izvestia/2012>.

² At the ratio of 28% to the federal budget and 72% to the budgets of the RF Subjects.

³ www.fitchratings.com.

MET (4.0% of GDP in 2012 against 3.7% of GDP in 2011) and excise duties (1.3% of GDP in 2012 against 1.2 % of GDP in 2011).

Table 8

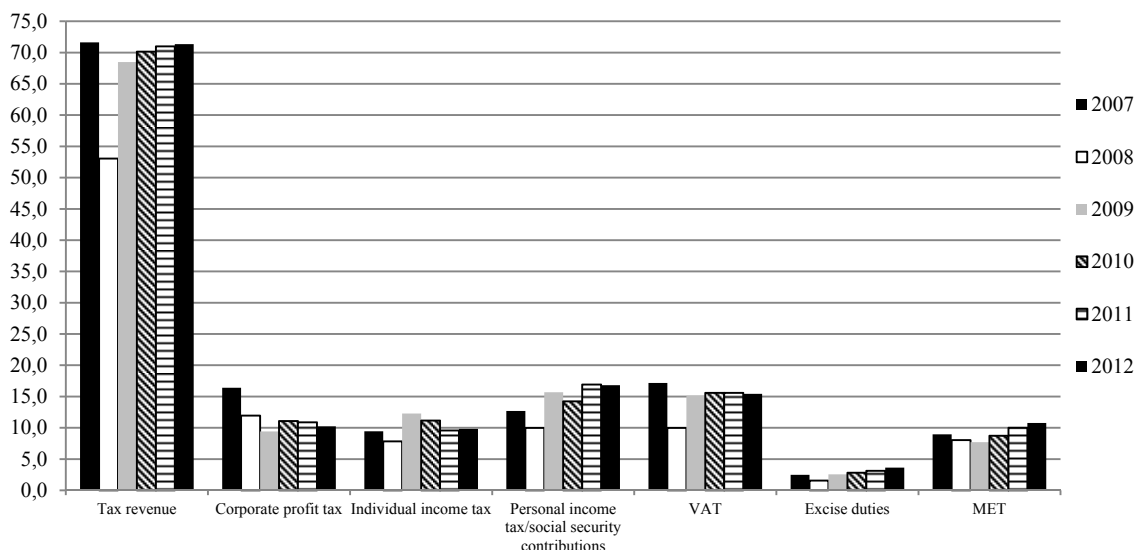
**Revenue from the Basic Taxes to the Budget of Extended Government
of the Russian Federation in 2007-2012, GDP, %**

	2007	2008	2009	2010	2011	2012	Change in 2012 against 2011	
							In % of GDP	In prices of 2012, %
Tax burden level	36.1	35.7	30.8	31.9	34.8	34.3	-0.5	1.8
Corporate profit tax	6.6	6.1	3.3	3.8	4.1	3.8	-0.3	-3.9
Individual income tax	3.8	4.0	4.3	4.0	3.6	3.6	0.0	4.9
Unified social tax /social security contributions *	5.1	5.1	5.5	5.0	6.3	6.2	-0.1	1.5
VAT	6.9	5.1	5.3	5.5	5.8	5.7	-0.1	1.0
Excise duties	1	0.8	0.9	1.0	1.2	1.3	+0.1	19.1
MET	3.6	4.1	2.7	3.1	3.7	4.0	+0.3	10.1
Customs duties and levies	7.3	8.6	6.8	7.0	8.3	8.0	-0.3	-0.9

* From 2010, there was a transfer from the unified social tax to the social insurance contributions, credited directly to the extra-budgetary funds.

Source: RF Ministry of Finance, Russian Statistical Service.

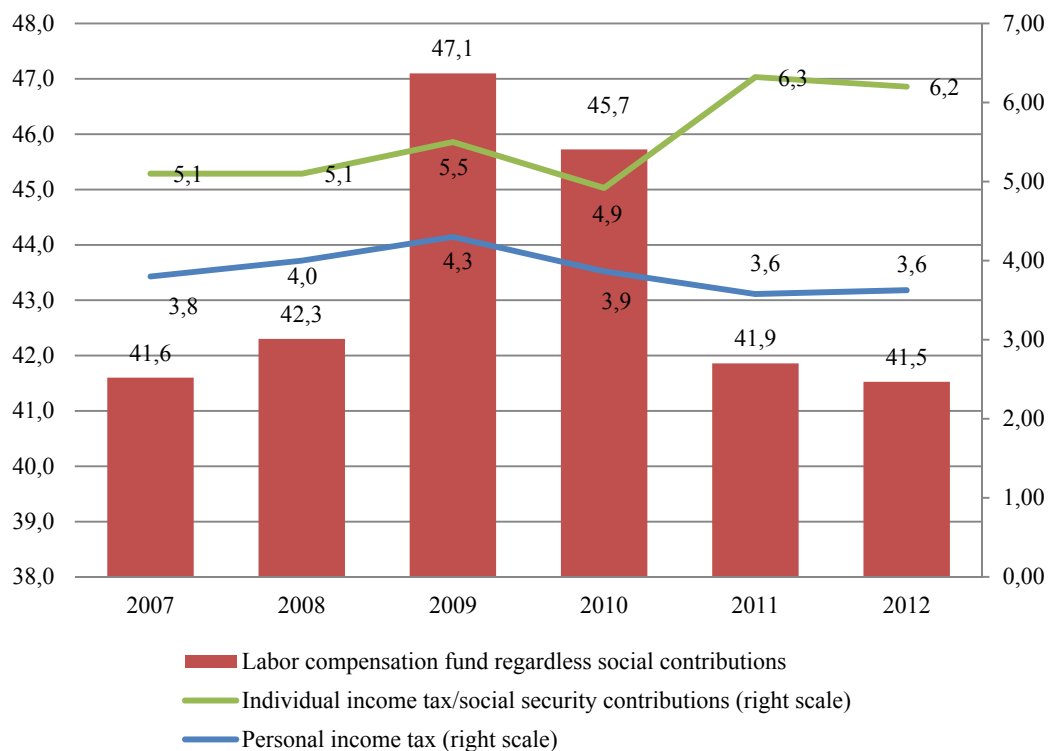
The structure of tax revenues of the extended government budget is shown in Fig. 12. One can note two trends developed over recent years in the restructuring of tax revenue to the budget of extended government. First, the increased revenues from excise duties, whereas the share of excise duties is relatively low in the structure of budget revenues. Second, the enhanced role of MET in the total tax revenue to the budget of extended government. In 2012, revenue from MET has reached 4% of GDP for the first time since 2008, which unfortunately, confirms the sustained or even somewhat increased significance of sectoral factors in the Russian budget.



Source: the RF Tax Service.

Fig. 12. The Share of Tax Revenues in the Total Budget Revenues of the Extended Government in 2007-2012, %

The main change in tax legislation of 2012 was the reduction the base rate¹ of insurance contribution from 34% to 30%. This measure was urged by the negative reaction of employers to the increase of the base rate in 2011 from 26% to 34%, which provoked, in particular, the rejection of the previously planned salary raises and the transition to the gray schemes of payment. As shown in *Fig. 13*, as a result, the share of the labor compensation fund regardless social contributions in GDP in 2011 has declined by almost 4 p.p. of GDP. Reduction of the base rate in 2012 was a kind of concession in connection with those negative trends. In the end, the base rate reduction did not lead to a serious reduction of insurance contributions to GDP (only by 0.1 p.p. of GDP), and in terms of 2012 prices, even to a rise by 1.5%. This result can be attributed to the partial rejection of gray schemes in salaries payment.



Source: RF Tax Service, Russian Statistical Service.

Fig. 13. A comparison of the Individual Income Tax/Social Security Contributions and Personal Income Tax Dynamics with the Dynamics of the Labor Compensation Fund regardless Social Contributions in 2007–2012, GDP, %

As for the oil and gas revenues, as compared to the 2011, the level in revenues has somewhat increased (See *Table 9*). In particular, the increase in tax revenue from MET by 0.3 p.p. of GDP was due in part to the increased production of energy resources (516.8 million tons of

¹ In 2012, the rate of wages did not exceed Rb 512,000.

oil, including gas condensate in 2012 against 509.4 in 2011). The second factor contributing to the higher revenues from MET was some reduction of ruble rate¹.

Table 9

**Revenues from Gas and MET
in 2008–2012**

	2008	2009	2010	2011	2012
Oil and gas revenue, % in GDP	10.6	7.7	8.3	10.1	10.5
MET, % in GDP	4.1	2.7	3.0	3.7	4.0
Oil production, including gas condensate, m tons	488	494	507.2	509.4	516.8
The annual average price level of Urals, for the year, \$/barrel	94.0	60.7	78.1	109.6	110.7
Annual average official exchange rate of the Central Bank, RB/\$ ² .	24.78	31.90	30.37	29.31	31.05

Source: Russian Statistical Service; RF Tax Service data; IEP estimates.

The level of proceeds from the second component of oil and gas revenues, i.e., export duties on energy resources, remained unchanged as compared with 2011 (about 6.5% of GD in 2011 and in 2012). The reason is that the natural values of exports of each category of energy resources in 2012 remained at the level of 2011. Thus, according to the Russian Statistical Service, oil exports volume in natural terms made 99.5% as compared with 2011, those of natural gas – 98.2%. Changes in the cost structure of exports of energy resources were also insignificant. A decline in revenues from oil exports duties were leveled by increased fees from exported oil (See *Table 10*). At the same time, the total reduction of import and export volumes in terms of GDP share in 2012 provided a negative impact on the amount of proceeds from customs duties and charges not related to energy resources.

Table 10

**Proceeds from customs duties
in 2008–2012, GDP, %**

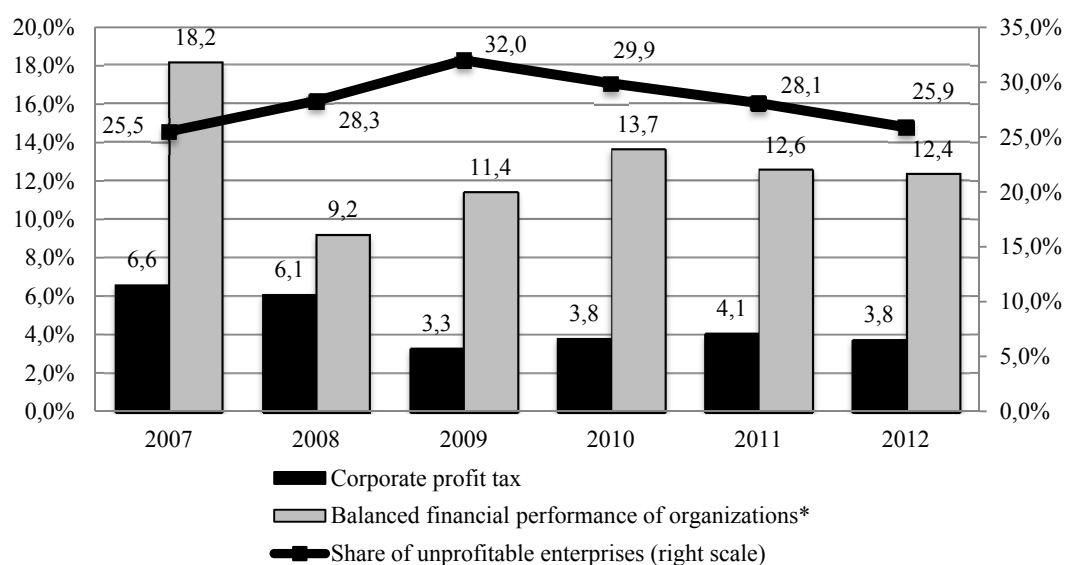
	2008	2009	2010	2011	2012
Export duties for:					
– crude oil	4.3	3.1	3.6	4.2	4.0
– natural gas	1.2	1.1	0.4	0.7	0.7
– oil products	1.3	1.0	1.3	1.7	1.8
Customs duties and charges, total	8.6	6.8	7.0	8.4	8.0

Source: Russian Statistical Service; Russian Federal Treasury data.

Revenues from income tax have returned back to the level of 2010 (See *Fig. 14*). Despite the drop in the share of unprofitable enterprises in the Russian economy, the net balanced financial performance of enterprises and organizations (except for small businesses) in terms of GDP share continued to decline in 2012, having reached 12.4% of GDP, which suggests maintaining the downward trend in business activity.

¹ The tax rate on MET includes a coefficient reflecting the dynamics of global oil prices, tailored to the average dollar exchange rate for the tax period.

² Estimated as the average chronological indicator of monthly data of the RF Central Bank.



* Tentative estimates of the Russian Statistical Service.

Source: Russian Federal Tax Service, Russian Statistical Service.

Fig. 14. Dynamics of corporate income tax revenue in the budget system of the Russian Federation, net financial performance of the organizations and the share of unprofitable enterprises in 2007–2012, GDP, %

The above-mentioned decline in imports in terms of the GDP share, however, did not affect the level of VAT revenues on imported goods (2.7% of GDP, as in 2011). The drop in revenues from VAT is entirely accounted to the VAT on goods sold in the territory of Russia (See *Table 11*). Such dynamics suggests that the quality of the VAT administration in Russia is higher in regard to the imported goods. In general, the rate of VAT collection¹ in 2012 got deteriorated by 5 p.p. as compared with 2011, which may be partly explained by the increased deductions on investment objects being implemented in Russia.

Table 11

Revenue from VAT to the RF Budget System in 2007–2012, GDP, %

	2007	2008	2009	2010	2011	2012
VAT	6.1	5.2	5.3	5.4	5.8	5.7
VAT on goods sold in the RF territory	3.5	2.4	3.0	2.9	3.1	3.0
VAT on goods imported to the RF territory	2.6	2.8	2.3	2.5	2.7	2.7
Rate of VAT collection, %	56.7	46.6	42.3	45.8	51.6	46.5
Imports*	15.3	16.1	13.7	15.0	16.1	15.6

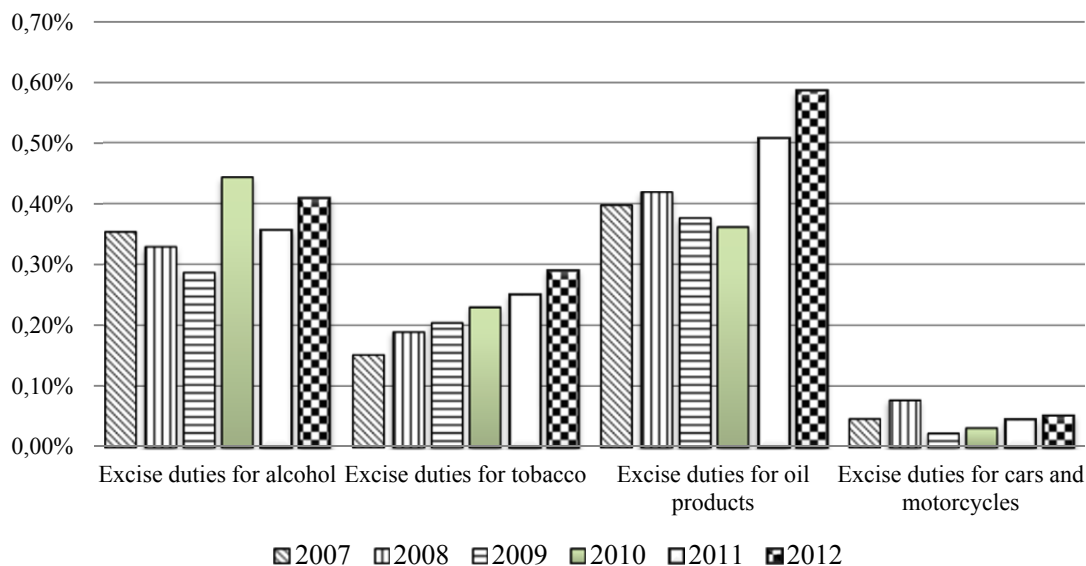
* The share of imports in the GDP share is estimated as the ratio of imports estimated on the Customs Statistics and GDP, denominated in dollars, based on the values of the average nominal exchange rate of the dollar against the ruble for the relevant year.

Source: Russian Statistical Service; Ministry of Finance of Russia.

In 2012 excise duties, along with the MET, have demonstrated an increase in revenue share of GDP. As seen in Fig. 4, the main drivers of growth were the excise duties on petroleum products (from 0.5% in 2011 to 0.6% of GDP in 2012). In 2012 there was a positive dynamics in charges for alcohol in relative terms (from 0.36% in 2011 to 0.4 % of GDP in 2012). Pro-

¹This indicator is estimated by the formula $\frac{\text{Revenue from VAT}}{\text{VAT rate} \times (\text{Final Consumption})}$.

ceeds from taxation of tobacco products have also increased (from 0.25% to 0.29 % of GDP) and from excise revenue from the sale of cars and motorcycles the tax burden has stabilized at 0.05 % of GDP.



Source: Russian Federal Tax Service.

Fig. 15. Excise Revenues over 2007-2012 by Groups of Excisable Goods, GDP, %

Revenue growth from the excise tax is the result of indexation of their rate above inflation rate, while maintaining a relatively low flexibility of demand for excisable goods in terms of the price. Thus, according to the Russian Statistical Service, the sales of gasoline has increased from 36.6 to 36.8 million tons, for diesel fuel it has decreased from 70.2 to 68.3 million tons in 2012, while the excise rates were increased, respectively, from Rb 5,995 to Rb 7,725 per ton of gasoline and from Rb 2,753 to Rb 4,098 per ton for diesel fuel.

The value of indexation of tobacco products rates ranged on average from 20% to 35%; for alcoholic beverages - from 10% to 20%. In 2012 the consumption of all types of alcoholic products changed slightly, while the consumption of tobacco products has decreased (See Table 12). The growth rate of excise duties for these products was compensated by the decline in consumption thereof.

Table 12

Consumption of Alcohol and Tobacco Products in Russia in 2007–2012

Products	2007	2008	2009	2010	2011	2012
Alcoholic products, m decaliters						
vodka and alcoholic beverages	184.6	177.2	166.1	157.8	159.0	159.8
grape and fruit wines	94.9	102.9	102.5	103.4	103.0	95.6
cognac	8.9	10.8	10.6	11.1	12.0	12.5
champagnes and sparkling wines	24.1	26.0	25.5	27.3	29.8	30.1
beer	1155.3	1138.2	1024.7	1004.0	1077.5	1055.7
Cigarettes and whitefish-portraits, billion units	398.2	393.6	394.3	370.6	366.1	361.0*

* Assessment.

Source: Russian Statistical Service.

2.2.3. Expenditures of the Budget System

With the total cost increase of the budget system in 2012 by 0.7 p.p. of GDP as compared with the previous year, the dynamics of expenditures by categories thereof was volatile. The growth of expenditures in 2012 against 2011 was observed in the most budget lines, including the sections "National Security and Law Enforcement" by 0.3 p.p. of GDP, "National Defense", "National Economy" and "Healthcare & Sports" by 0.2 p.p. of GDP each, for "Education" and "Social Policy" by 0,1 p.p. of GDP. At the same time, for two sections of the extended government budget in 2012 expenditures were reduced, namely for "Federal Issues» by 0.2 p.p. of GDP and for "Housing and Public Utilities" by 0.5 p.p. of GDP against the previous year (See *Table 13*).

Table 13

Expenditures of the Extended Government Budget in 2008–2012, GDP, %

	2012	2011	2010	2009	2008	Change in 2012 vs. 2011, p.p. of GDP
EXPENDITURES	37.3	36.6	39.0	41.3	34.3	0.7
Federal issues *	2.3	2.5	2.6	2.8	2.7	-0.2
National defense	3.0	2.8	2.8	3.0	2.5	0.2
National defense and law enforcement	3.1	2.8	3.0	3.2	2.6	0.3
National Economy	5.3	5.1	5.1	7.1	5.5	0.2
Housing and public utilities	1.7	2.2	2.4	2.6	2.8	-0.5
Environmental protection	0.1	0.1	0.1	0.1	0.1	0.0
Education	4.2	4.1	4.2	4.6	4.0	0.1
Culture, cinematography and mass media	0.7	0.7	0.8	0.8	0.7	0.0
Healthcare and sport	4.0	3.8	3.8	4.3	3.7	0.2
Social policy	12.1	12.0	13.7	12.1	9.1	0.1
Public debt servicing	0.6	0.6	0.6	0.6	0.5	0.0

* With the exception of public and municipal debt servicing.

Source: Ministry of Finance of Russia.

Expenditures under the budget lines "Environmental protection", "Culture, Cinematography and Mass Media" and "Public Debt Servicing» in 2012 in terms of GDP shares did not change as compared with 2011.

There were the following changes in the structure of extended government budget in 2009–2012:

- increased share of expenditures for national security and defense in total expenditures from 15.0% in 2009 to 16.3% in 2012;
- decreased share of expenditures for the national economy from 17.2% in 2009 to 13.1% in 2010 and a slight increase in the next 2 years to 14.2% of the total budget expenditures of the extended government in 2012;
- decline in the share of expenditures under the budget line "Housing and Public Utilities" from 6.3% in 2009 to 4.5% in 2012;
- increased share of expenditure under the budget line "Social Policy" from 29.3% in 2009 to 35.1% in 2010 and a decline to 32.4% in 2012.

There were insignificant changes in the other sections of the budget system expenditure structure in 2012 against previous years.

In terms of specific areas of the budget expenditures in 2012 against 2011, there is a trend of significant increase in the absolute value of expenditures under the budget line "National Defense", under "Implementation of International Liabilities in the Sphere of Military-Technical Cooperation" by 72.8% and "Other Issues in the Field of National Defense" by 31.7%. Expenditures are increased in absolute terms under the budget lines "Law Enforce-

ment Agencies" by 49.4% and "Internal Military Forces" of the section "National Security and Law Enforcement" by 61.7%.

Under the section "National Economy" the largest increase in expenditures in 2012 as compared with the previous year occurred in "Fuel-Energy Complex" by 2.4 times and the section "Exploration and Use of Outer Space" by 44.4% at the expense of the federal budget. Also noticeable growth of expenditures in absolute terms in this section was noted for "Water Systems" and "Road Facilities" by 38.8% and by 38.6%, accordingly.

With the total cost reduction of the extended government in 2012 under the budget line "Housing and Public Utilities" against the previous year by 10.0% in absolute terms, the volume of expenditures under "Housing Utilities" and "Public Utilities" in 2012 remained at the level of the previous year due to the increased expenses of regional budgets. At the same time, expenditures of the budgetary system in 2012 for the improvement and applied research in the field of public utilities have been significantly reduced.

In the section "Education" a significant increase in the expenses of regional budgets is noted for "Preschool Education" - by 18.9% in absolute terms in comparison with 2011 and the federal and the RF Subjects consolidated budget for "General Education" by 19.6%. At the same time, expenditures of the extended government budget for "Applied Research in Education" in 2012 have decreased by 32.5%.

Expenditures of the budget system in 2012 under the section "Healthcare" have been increased in absolute terms as compared with the previous year by 18.1%, including grown expenses for increases to inpatient and emergency care, and reduced allocations for "Healthcare in Day Patient Facilities of All Types" by 24.5% and "Applied Research in the Field of Healthcare" by 14.5%.

The data on the outcome of the extended government budget execution in regard to the sector of government management in 2012 demonstrates the increasing government involvement in the economy through the subsidies to organizations of commercial sector or contributions in the authorized capital. Expenditures of the budget system to increase the value of shares and other forms of participation in the capital in 2012 amounted to Rb 724.8bn (against Rb 583.7bn in 2011), including the funds of the federal budget in the amount of Rb 505.1 bn (vs. Rb 409.8bn in 2011). Expenditures of the budget system for granted for free transfers to organizations, except for those to the state and municipal agencies, were increased by Rb 92.8bn versus the previous year and accounted in 2012 for Rb 1,078.6bn, including the funds of the federal budget transfers granted for free, having grown from Rb 41.8bn to Rb 526.1bn. The problem of subsidizing such enterprises is usually associated with the lack of control over the proper use of the funds by a recipients¹ and cost effectiveness thereof, as the state is funding the activity, rather than the result, as in the case of public purchases.

Due to the changes in the procedure of government financing of the public and municipal institutions, there was noted a significant growth in expenditures of the RF Subjects consolidated budget under the section "Gratuitous Transfers to the Public and Municipal Institutions" from Rb 557.0bn in 2011 to Rb 2,764.8bn in 2012. Expenditures under the section "Remuneration of Labor and Charges on the Payment of Wages» in the budgets of the RF Subjects have been reduced from Rb 2,098.9bn in 2011 to Rb 861.3bn in 2012.

¹ Analysis of the activities of such companies has shown that most of the recipients of budget funds placed on deposit, will receive additional income not related to the core business. A number of businesses receiving subsidies do not publish financial statements.

In general, the structure and dynamics of the expenditure of the extended government budget in 2012 reflect the priorities of the national policy, with a strong focus on financing of social commitments and security.

2.2.4. Analysis of the RF Federal Budget Key Indicators in 2012 and for the Period of 2013–2015

The law on the budget implies to reduce revenue of the federal budget in the medium term (See *Table 14*) in 2013 by 0.7 p.p. of GDP, in 2014 by 0.3 p.p. of GDP and in 2015 by 0.2 p.p. of GDP from the previous year. A gradual decline of oil and gas revenues is planned from 10.5% of GDP in 2012 to 8.3% of GDP in 2015. The reduction of the forecast revenues from oil and gas sector in terms of GDP share in 2013-2015 against 2012 is due to the introduction of the new budget rules, as well as to the lower indicators of exchange rate of the ruble in regard to the GDP growth.

Table 14

Key indicators of the federal budget in 2008–2015, GDP, %

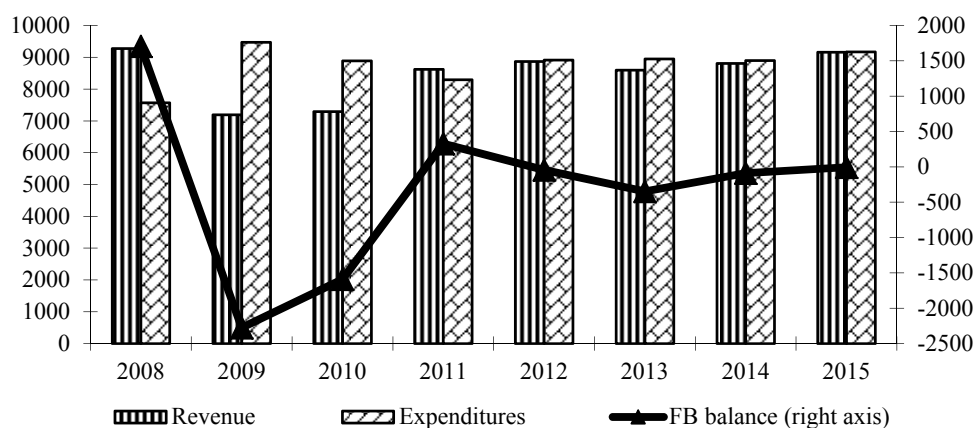
	Actual indicators					Budget law indicators		
	2008	2009	2010	2011	2012	2013	2014	2015
Revenue	22.5	18.9	18.4	20.8	21.0	19.3	19.0	18.8
<i>Including oil and gas</i>	10.6	7.7	8.5	10.2	10.5	8.9	8.5	8.3
Expenditures	18.3	24.9	22.4	20.0	21.1	20.1	19.2	18.8
Deficit (-) /Surplus (+)	+4.1	-6.0	-4.0	+0.8	-0.06	-0.8	-0.2	0.0
Non-oil deficit	-6.4	-13.7	-12.5	-9.4	-10.6	-9.7	-8.7	-8.3

Source: Ministry of Finance of Russia.

Expenditures of the federal budget are to be cut down in 2013 by 1.0 p.p. of GDP from the previous year to 20.1% of GDP, with further decline in 2015 to 18.8% of GDP, which is by 2.3 p.p. of GDP below the level of 2012. It should be noted that, when the main parameters of the federal budget were formed for 2013-2015, there was used a moderately conservative forecast of macroeconomic indicators, for instance, the pace of economic growth in 2013 by 3.7% of GDP, in 2014 - by 4.3%, in 2015 - by 4.5%.

There are insignificant changes from year to year in the income and expenditures of the federal budget for the next three years, estimated in the prices of 2008 (See *Fig. 16*).

As one can see in the Picture, revenues in the medium term remain at a rather high level, varying around the indicator of 2012, and reaching the pre-crisis level in 2015. Herewith, expenditures, planned for 2013-2015, remain virtually at the 2010 level, when funding of the anti-crisis measures, started in 2009 were still made from the budget, i.e., the 2010 budget had extremely high expenditure commitments. In other words, in the law on the federal budget under review, revenue is planned on the basis of expectations of the sustained favorable external economic situation at the current level, while expenditures have not been decreased after the anti-crisis pumping of the Russian economy with public finances made in 2009-2010. The budget balancing with relatively high prices for mineral resources challenges the sustainability of the state budget, bringing it in the sphere of exclusive effect of external factors on the national economy.



Source: Ministry of Finance of Russia, IEP estimates.

Fig. 16. Dynamics of Federal Budget Revenue, Expenditures and Deficit of the Federal Budget in Fixed Prices of 2008, Rb bn

The main sources of the federal budget in the medium term remain revenue from indirect taxes, customs duties and MET (See Table 15).

Table 15

Actual and Expected Revenue from Major Taxes to the Federal Budget of the Russian Federation in 2010-2015 (GDP, %)

	Actual indicators			Budget law indicators		
	2010	2011	2012	2013	2014	2015
Corporate income tax	0.6	0.6	0.6	0.6	0.6	0.6
VAT, total:	5.5	6.0	5.7	6.3	6.4	6.5
domestic production	2.9	3.2	3.0	3.2	3.2	3.2
imports	2.6	2.7	2.7	3.1	3.2	3.3
Excise duties, total:	0.6	0.5	0.6	0.7	0.9	1.0
domestic production	0.5	0.4	0.5	0.6	0.8	0.9
imports	0.1	0.1	0.1	0.1	0.1	0.1
MET	3.0	3.8	4.0	3.6	3.4	3.3
Customs duties, total:	6.8	8.2	8.0	7.4	6.8	6.7
Imports	1.2	1.4	1.4	1.4	1.4	1.4
Exports	5.6	6.8	6.6	6.0	5.4	5.3
The share of the above taxes and duties in the revenue of the federal budget, %	89.6	91.4	90.0	89.4	92.3	93.3

Source: RF Ministry of Finance.

In terms of foreign trade income, it is planned to reduce the weighted average rates of import customs duties in view of the accession of Russia to the WTO. However, in terms of GDP share, the revenue of the federal budget from the import customs duties remains at the three-year period indicator at the level of 1.4% of GDP.

The growth of non-oil revenues of the federal budget in terms of GDP volume in 2013-2015 is largely due to a projected increase in revenues from value-added tax in 2013 by 0.6 p.p. of GDP, in 2014 by 0.1 p.p. of GDP and in 2015 by 0.1 p.p. of GDP against the previous year, and from excise taxes in 2013 by 0.1 p.p. of GDP, in 2014 by 0.2 p.p. of GDP and in 2015 by 0.1 p.p. of GDP as compared with the previous year. In 2013-2015 there is planned an annual growth of excise duties by 0.1-0.2 p.p. of GDP against the previous year due to the indexation and redistribution of revenue from excise taxes between the federal and

regional budgets. The revenues from excise taxes on imported goods to the federal budget in 2013-2015 will remain at the level of previous years (0.1% of GDP).

Revenue from corporate income tax in GDP share is sustained at the level of 2012.

Forecast on revenues of the federal budget from the non-oil revenue for 2013 was made in mid-2012, when the trend of an economic slowdown was not demonstrated in full scope yet. Thus, the risks of reduction of the federal budget revenue from the import customs duties, VAT and corporate income tax are rather high in H1 2013.

The following revenues from the use of the state-owned property are expected in for 2013: revenue from placing funds of the federal budget in the amount of Rb 83.2bn, revenue from the management of the Reserve Fund in the amount of Rb 15.1bn and from management of the National Welfare Fund in the amount of Rb 47.9bn, and the revenue obtained in the form of interest earned from the provision of domestic loans from the federal budget is planned in 2013 in the amount of Rb 12.2bn.

The dynamics of the federal budget expenditures in 2010-2015 in terms of functional classification is presented in *Table 16*.

Table 16

Expenditure Liabilities of the Federal Budget in 2010–2015, GDP, %

Budget line	Actual indicators			Budget law indicators		
	2010	2011	2012	2013	2014	2015
TOTAL	22.4	20.0	21.1	20.1	19.2	18.8
Federal issues*	1.5	1.3	1.3	1.4	1.2	1.1
National defense	2.8	2.7	3.0	3.2	3.4	3.7
National defense and law enforcement	2.4	2.2	3.0	3.1	2.9	2.6
National Economy	2.7	3.2	3.2	2.6	2.4	2.1
Housing and public utilities	0.5	0.5	0.4	0.2	0.2	0.1
Environmental protection	0.0	0.03	0.03	0.04	0.04	0.03
Education	1.0	1.0	1.0	0.9	0.8	0.7
Culture, cinematography**	0.2	0.1	0.1	0.1	0.1	0.1
Healthcare ***	0.8	0.9	1.0	0.8	0.6	0.4
Social policy ****	0.8	5.6	6.3	6.0	5.6	5.5
Physical training and sports		0.08	0.07	0.1	0.04	0.04
Mass media		0.1	0.1	0.1	0.1	0.06
Public and municipal debt servicing	0.4	0.5	0.5	0.6	0.6	0.6
Intergovernmental transfers	9.2	1.2	1.0	1.0	0.8	0.7
<i>Tentatively approved</i>	-	-	-	-	0.5	0.9

* in 2010 regardless public debt servicing.

** in 2010 with regard expenditures for mass media.

*** in 2010 with regard to physical training and sports.

****In 2011 further on this budget lines includes targeted intergovernmental transfers, including those to extra-budgetary funds.

Source: Ministry of Finance of Russia.

Expenditures of the federal budget in the three-year period of fiscal planning have a strong tendency to decrease from 21.1% of GD in 2012 to 18.8% of GDP in 2015.

Increased expenditures in 2013 under the budget line "Federal Issues" is based on the increased budget allocations for wages versus to 2012 virtually to all the public authorities, which are funded in this sector. For example, it is planned to increase expenditures for the payment of the President's authorized representatives and his office staff in the federal districts by 77.8%, i.e., from Rb 0.9bn in 2012 to Rb 1.6bn in 2013, and in 2014-2015 expenditures for the payment to civil servants in general are maintained at the level of 2013.

There is noted a significant growth in budget allocations addressed to the international cooperation under the section "Federal Issues" in 2013 as compared with the previous year by

Rb 10.1bn to Rb 122.4bn, with further declining to Rb 108-109bn in 2014-2015. It is expected to increase spending under this section for the provision of financial assistance to socio-economic development of the Republic of South Ossetia from Rb 2.5bn, allocated in 2012, to Rb 2.8bn in 2013. Expenditures of the federal budget to provide financial assistance to the Republic of Abkhazia in 2013 in absolute terms remain at the level of 2012. In 2013 expenditures of the federal budget for the construction of facilities outside Russia are increased more than 2.5 times to Rb 5.1bn. In 2014-2015 expenditures for the assistance to Abkhazia and South Ossetia Republics, as well as to the construction of facilities abroad are planned in absolute terms at the level of 2013.

Under the budget line "National Defense" major growth of expenditures is planned in 2013 against the previous year in the section "Military Forces" by 17.3% to Rb 1.63 trillion and "Applied Research in the Field of National Defense" by 16.1% to Rb 198.3bn, which is about one third of total expenditures of the federal budget for research and development in the total public expenditures. In 2013 under the section "National Defense" about 25% are addressed to providing the service (labor) contracts.

It should be noted, that such a significant growth of expenditures for the national defense in terms of GDP, from 3.0% of GDP in 2012 to 3.7% of GDP in 2015 demonstrates the rapid growth in spending on military reform with respect to the GDP growth, while their share in the total expenditure of the federal budget is increasing. Without going in the criticism of the leaders of the country for the expenditures on defense, one should admit, that against this background we should recognize that the issue of control over the use of budget funds and state property turnover in not transparent agencies, as well as all levels of government authorities gets more actualized. In particular, during 2011-2012 there was discussed the issue of unsatisfactory state of the objects of property transferred by the Ministry of Defense¹, military settlements and social infrastructure to the management of regional and local authorities, and the inability thereof to carry out major repairs of those facilities without additional funding from of the federal budget. Already in the decision of the Federation Council² it was proposed to provide compensation for surplus expenditures for regions and municipalities, arising in connection with the transfer of ownership to them the military real estate, as well as the use of the Fund of Assistance to Reforming Housing and Communal Services for the funding for the resettlement of people from premises in apartment homes located in the territories of military settlements and recognized as emergency stock after January 1, 2012. The major increase in spending in 2013 by 0.1 p.p. of GDP versus 2012 under the section "National Security and Law Enforcement" pertains to the payments and social security for personnel. The increase in expenses is also associated with the implementation of the new program "Creation of the System for Calling Emergency Services by a Single Number 112", which relevance and importance for the Russian citizens arises no doubt.

Under the budget line "National Economy» in 2015 against 2012 expenditures in absolute terms will be increased by the sections: the Exploration and Use of Outer Space by 16.2%, the Reproduction of Mineral Resource Base by 18.8%, the Road Facilities (Road Funds) by 8.7 %. In absolute terms, the greatest reduction in expenditures of the federal budget will be

¹ In accordance with the Federal Law of December 8, 2011 No. 423-FZ "On the order of donation of military non-movable property in the possession of the Russian Federation - the municipal property of federal cities of Moscow and St. Petersburg and the amendments to some legislative acts of the Russian Federation".

² "On the proposals of the Council of Federation of the Federal Assembly of the Russian Federation on the implementation of the Federal Law "On the Federal Budget for 2013 and the planning period of 2014 and 2015".

made for the fuel and energy sector from Rb 46.3bn in 2012 to Rb 24.7bn in 2013 (by 46.6%), to Rb 4.9bn and Rb 4.3bn in 2014 and 2015 respectively mainly due to reduction of contributions to the authorized capital, the expenses for purchasing additional shares and property installments in the energy sector companies.

In the medium term there are planned increased budget allocations for the development of transport infrastructure:

- in the form of subsidies from the state company Rosavtodor from Rb12.8bn in 2012 to Rb 19.9 bn in 2014 (+58.4%) in the framework of the Federal Program "Development of the Transport System";
- for the implementation of measures of the subprogram "Automotive Systems" of the Federal Program "Development of Transport System" by 13.0% in 2015 as compared with 2012;
- for overhaul, repair and maintenance of roads in 2015 in comparison with 2012 almost twice to Rb 220.2bn.

Under the line of the federal budget "General Economic Issues" expenditures in 2013-2015 are volatile: in 2013 there will be a slight increase with respect to 2012 by 6.6%, and a reduction in 2014-2015 to 13.2% and 2.7% respectively against the preceding year.

In 2013-2015 a modest increase in expenditure of the federal budget for the support of the agricultural sector is noted. In the section "Agriculture and Fishing" expenditures are increased from Rb 149.5bn in 2012 to Rb 165.6bn in 2015 (+10.0%). At the same time, expenditures for the implementation of the State program of agricultural development and regulation of agricultural products, raw materials and food in 2013-2015 will be increased by 14.7% as compared with 2012 in connection with the implementation of new mechanisms of state support to agricultural producers in the use of fuel lubricants and fertilizers, credits, exports.

Significant reduction of budgetary allocations in the medium term is planned for the projects implemented in the framework of the Russian Investment Fund (IF), from Rb 65.5bn in 2012 to Rb 18.3bn in 2013 (by 72.3%) and to Rb 13.5bn in 2015 (by 80.0% as compared with 2012). It may be noted that Investment Fund did not become a real mechanism for implementation of large-scale projects based on public-private partnerships. As of October 1, 2012 in the register of IF projects included 49 projects (among which 2 projects meaningful were regarded as completed), that were approved before January 1, 2012. Most of the projects implemented by IF have the status of regional projects, while the projects of national significance, for which IP was created, account only for 12 units, which have been started back in 2006. Payment discipline of execution the obligations for those projects by private investors and the RF Subjects still remains a problem.

Subsidies to the state companies in 2013 remain at the 2012 level in the volume of about Rb 100bn. In 2014 budget allocations for subsidies were reduced by 20.2% as compared with the previous two years, including through the reduction of the cost of assets contributed to the state company Olympstroy twice as compared with 2013. In 2015 expenditures have been somewhat increased (by 6.4%) against the previous year due to the extended budgetary allocations from SC Rosatom.

In our opinion, expenditures of the budget for the national economy in the first place should provide the necessary institutional and infrastructural conditions for the restructuring of the real sector, rather than replace private financing of business. When providing direct budget support to the systemically and strategically important businesses, there occur the risks

of conservation for technological backwardness of production and preservation of inefficient management.

Expenditures reduction in 2013-2015 is planned for all social sections of the federal budget.

Under the budget line "Education" the greatest expenditures reduction in the absolute terms in 2013 are scheduled against the previous year for the section "Secondary Vocational Education" by 63.9%, and about half of them are addressed at ensuring the functions of government institutions of secondary vocational education, subordinated to the federal bodies of executive "force power" block, as well as under the Ministry of Labor in Russia, providing education to persons with disabilities. Thus, the Government has rejected to support the regions in the field of vocational education despite the aggravated problems of qualified personnel in blue-collar jobs. The lack of personnel deficiency was repeatedly raised at meetings of government representatives of the regions and businesses. The problem is not only in the fact that most regions have no their own funds for the development of vocational education, but also in the fact that well-trained personnel not always works in the region, but prefers to leave the region. In addition, we should realize that the development of modern education and training programs of teachers and trainers there also needed considerable expenditures, which might be funded from the federal budget. Expenditures under the section "Higher and Postgraduate Professional Education" remain virtually unchanged in absolute terms for the next three years.

With the total spending cuts under the budget line "Healthcare" related among other things to the redistribution of the budget for the project of modernization of the sector from the budget of the Ministry of Healthcare, addressed to the Fund of Mandatory Healthcare Insurance, we note an increase by 2.5 times in the expenditures in 2013 against the preceding year under the section "Applied Research in the Field of Healthcare" up to Rb 22.8bn, 96.4% of which is allocated from the system of public procurement and will be addressed in the form of subsidies to the federal budget, independent agencies and other nonprofit organizations, and the balance 4.6% are budgetary investments, not included in the Federal Special Purpose Program. This approach is somewhat contrary to the principles of budget funds efficiency, as the activities, rather than the results of subordinate institutions are funded.

In other functional areas of expenditure of the federal budget, the main factor affecting in the change in expenditures volume are budgetary allocations made for the implementation of the federal program and the non-program federal funding. The allocations of the federal budget for the implementation of the Federal Special Purpose Programs in 2015 has been decreased by 24.3% in real terms against 2012 for all groups of the Federal Special Purpose Program (See *Table 17*), while funding for the "Far East" program package in 2015 is being terminated.

The structure of the federal budget expenditures by the Federal Special Purpose Program sections in the medium term remained at the 2012 level: the largest share of expenditure (about 40%) in the next three years accounts for the section "Transport Infrastructure", in which only one federal program "Development of Transport" is implemented.

In 2013-2015 the share of expenditures is increased from 27.2% in 2012 to 33.7% for the section "High-tech Development» in the total cost of the Federal Program, which is consistent with the objectives set by the President of Russia to ensure rapid technological development. The expenditure for this section is increased by 12.6% in 2015 against 2012 in nominal terms mainly due to the increased budget allocations to the Federal Program "Maintenance, Development and Use of the GLONASS" by Rb 20.5bn in 2012 to Rb 50.3bn in 2015. In the

framework of the GLONASS program expenditures are increased for research and use of outer space by more than Rb 10bn in 2015 as compared with 2014.

Table 17

Dynamics of the Federal Budget Expenditures Planned for the Federal Special Purpose Program Implementation in 2012–2015, in Rb bn

	2012	2013	2014	2015	Change of 2015 vs. 2012, % in real terms
FSPF funding	1027,9	1 011,7	918,4	932,6	-24,3
Funding by FSPF sections					
1. High-tech development	279.3	324.7	301.0	314.1	-6.2
2. Housing facilities	58.6	41.9	40.9	41.1	-41.5
3. Transport infrastructure	353.5	353.2	362.6	366.5	-13.5
4. Far East	67.9	53.9	14.0	0	-100.0
5. Rural areas development	20.4	16.1	16.2	17.8	-27.2
6. Social infrastructure	112.1	93.8	57.1	66.7	-50.4
7. Security	99.9	105.2	84.4	83.4	-30.4
8. Regional development	40.1	21.9	13.4	12.1	-74.8
9. Public institutions development	4.3	4.1	4.1	4.4	-14.6

Source: Ministry of Finance, Ministry of Economic development, IEP estimates.

Expenditures of the federal budget are cut down for the program sections "Housing Facilities" by 29.4% in nominal terms, for the section "Rural Areas Development" by 12.8% and for the section "Social Infrastructure" by 41.1% in 2015 as compared with 2012. For the section "Housing facilities" expenditures are reduced for the federal program for:

- housing facilities for the young families from Rb 5.0bn in 2012 to Rb 3.5bn in 2015;
- housing programs of the RF Subjects promotion from Rb 2.4bn in 2012 to Rb 1.0bn in 2015;
- upgrading of municipal infrastructure objects from Rb 3.9bn in 2012 to Rb 2.7bn in 2015;
- measures to provide housing facilities for certain categories of citizens from Rb 11.5bn in 2012 to Rb 8.1bn in 2015.

Under the package of programs "Rural Areas Development" reduction of the federal budget expenditures is planned in connection with the termination of the program implementation term in 2012-2013 and the redistribution of funds of the federal budget for the implementation of new programs, such as "Sustainable Development of Rural Areas for 2014-2017 and for the Period up to 2020".

For the package of program "Social Infrastructure" one should note completion of the program "Prevention and Control of Socially Significant Diseases (2007-2012), the amount of funding for which in 2012 amounted to Rb 10.8bn in 2014-2015; budget financing of the "successor" of that program is not provided. At the same time, expenditures for the federal target program "Development of Education for 2011-2015" are increased from Rb 11.7bn in 2012 to Rb 17.7bn by increasing public investment in the state property objects in the federal public institutions of higher and postgraduate education and housing and utilities services.

The utmost reduction of the federal budget expenditures is planned under the package of programs "Far East" in view of termination of the federal program "Economic and Social Development of the Far East and Transbaikalian Region for the Period to 2013" in 2012. The amount of funding for this federal program was Rb 67.9bn, including expenditures on development of Vladivostok in the amount of Rb 12.9bn, and budgetary allocations for contributions in the authorized capital of share-holding companies in the amount of Rb 25.0bn. Although the validity term of the program is developed up to 2013, funding of the program in the

federal budget is planned in the amount of Rb 14.0bn in the form of subsidies for the financing of capital construction of the state-owned property in 2014.

Funding is reduced for the program package "Regional Development» in 2015 against 2012 by 70% in connection with the termination of the federal program "Socio-Economic Development of the Chechen Republic for 2008-2012", the amount of funding of which in 2012 amounted to Rb 12.2bn, and the federal program "South of Russia" (2008-2013) with the funding in 2012 of Rb 12.9bn. The budget is reduced for implementation of the measures of the federal program "Social and Economic Development of the Kuril Islands in 2007-2015" from Rb 4.0bn in 2012 to Rb 0.6bn in 2015.

Under the package of "Safety" measures, the budget allocation was reduced by 16.2% in 2015 against 2012 due to the end of a series of FTPs, in the first place "Fire safety in Russia up to 2012". Under a number of programs it is planned to increase funding, including the Federal Program "Development of the Penitentiary System" from Rb 5.6bn in 2012 to Rb 13.8bn in 2015.

In general, there should be noted a negative trend of reduction in expenditures for federal programs in the total expenditures of the federal budget in the next three years from 8.1% in 2012 to 7.6%, 6.5% and 6.0% in 2013-2015, respectively. Currently, before the introduction of the program budget, federal targeted programs are the most effective tools for the targeted budget management and the reduction of the share of expenditures allocated for the federal programs can be considered inappropriate in terms of increasing the efficiency of budget expenditures.

Expenditures for public debt servicing in 2013 as compared with the previous year will increase by 0.1 p.p. of GDP in 2015 and in percentage of GDP will remain at 0.6 of GDP. In 2012 the volume of balances in the Reserve Fund has increased from Rb 811.5bn to Rb 1,885.7bn, and in January 2013 there were allocated additional amount about Rb 704bn as per results of 2012. Thus, at this time the Reserve Fund makes about 3.9% of GDP. On the contrary, the amount of the National Welfare Fund over 2012 has decreased by Rb 103.8bn due to the exchange rate differences and on 01.01.2013 it makes Rb 2690.6 bn, which is equivalent to 4.4% of GDP. In 2013-2015 it is expected to maintain the growth of the Reserve Fund with oil and gas revenues. Herewith, the balance of the federal budget most likely will be either unchanged or reduced with regard to the decisions made on the pension reform.

Deficit of the federal budget in 2013-2015 will be covered, as before, by government borrowing and funds from the privatization of federal property. In 2013 the amount of involvement of government securities in the domestic market is planned to be in the amount of Rb 1,213.2bn, in 2014-2015 in the amount of Rb 842.2bn and Rb 1,114.8bn respectively. The amount of public external debt in foreign currency in 2013 will amount to \$7.27bn, in 2014-2015 - to \$7.19bn and \$717bn, respectively.

Dynamics of the main parameters of the federal budget in 2013-2015 gives grounds to say that the objective of the federal budget balancing is a priority.

2.2.5. Fiscal Policy Outlooks

There were two components of fiscal policy identified in the Guidelines of fiscal policy for 2012 and the planning period of 2013-2014:

- financial component, focused on reducing the deficit and increasing efficacy and transparency of public administration;

- economic component, which is to address the issues of sustainable post-crisis development, reduction of revenues depending on the current economic situation and creating conditions for the development and modernization of the economy, improving the level and quality of life.

Despite the fact that it is hardly possible to solve the problem of reducing the budget deficit with unconditional implementation of the commitments in the long term without the solution of the economic problems in the medium term, the objective of budget deficit reduction and capital accumulation was clearly dominating over objectives of priming of economy in fiscal policy in 2012.

Adjusted in 2012 fiscal rules include:

- addressing of a share of oil and gas revenues of the federal budget recognized as additional revenue, to the Reserve Fund up to the amount of the normative value in 7% of GDP;
- a new approach to the definition of the main parameters of the federal budget on the basis of the average price of oil. Revenue of the federal budget in 2013 is calculated on the basis of the average 5-year Urals crude oil prices with regard to increasing period of calculations every 1 year to 10 years. Total expenditures of the federal budget are limited to the amount of revenue of the federal budget without additional oil and gas revenue. With reaching the nominal value of the Reserve Fund the total expenditures of the federal budget can be increased up to 50% of additional oil and gas revenue, and addressing thereof to the financial security of infrastructure and other priority projects with a limited term of their implementation;
- limitation of the federal budget deficit at the level of 1% of GDP.

The new rules were declared by the government as a tool to reduce dependence of the federal budget from fluctuations in global prices for hydrocarbons and a "safety cushion» in the crisis situation.

At the same time, new approaches to the definition of the federal budget basic parameters can provoke reduction of the budget expenditure which is not always appropriate in terms of slowing economic growth. It should be noted that, despite the many years of experience of implementing the principles of performance-based management and budgeting by results, the formation of an effective and transparent system of public expenditure management is still far from being completed. The approaches to sequestering the budget basing on the priorities in the framework of a single section and by type of expenditure are still undeveloped. There is no break-down of expenditures by the mandate and discretionary ones, which results in subjectivism and protectionism in making decisions on increasing or reducing thereof. Priorities of investment activities of the state are undeveloped.

It may be admitted that the strategy of accumulating funds for the future is the most simple, not requiring any complicated calculations and skills, way manage finances, but not the most-effective way, since confiscated through taxes budgetary funds should be invested back in the economy and provide the required returns, the level of which may vary according to the basic terms and conditions of funding thereof.

It should also be recalled that the forecast of the budget funds needed for the financial system stabilization and the support the real sector of economy in case of occurrence of a new wave of crisis or a prolonged recession, is achieved as yet. Therefore, it is impossible to estimate the safety margin of "safety cushion" in the form of accumulated funds of stabilization funds. The Ministry of Finance has internal reserves to balance the budget by partial freezing

of budgetary allocations, such as Housing Utilities Fund (about Rb 100bn) and non-donation transfers to the regions.

Introduction of fiscal rules may place in doubt the possibility of realization of certain projects. For example, in late 2011 a proposal was expressed for the establishment of a special fund of regional investments from January 1, 2012. In anticipation of further reductions in income of consolidated regional budgets, the investment fund could compensate for the loss of revenue by increasing the tax potential of the regions. It was planned that the source of funds generated by the Federal Fund for Support of Investment (FFSR) will become unallocated revenues of the federal budget, but with the introduction of new fiscal rules creation of the Fund under such conditions is unlikely.

With the introduction of fiscal rules a part of oil and gas revenues will not be reflected in the budget, so the share of non-oil revenues in the structure of revenues of the federal budget will grow, and the value of non-oil deficit will decrease. With a moderate growth of oil prices up to 2020 (average annual oil price is about \$100 per barrel in 2011 prices), the non-oil deficit will decrease from 10.6 % of GDP to 7.8% of GDP. Such "positive" changes in the structure of budget revenues in the short term will be due solely to the calculation technique, rather than a result of systematic work on the restructuring of the economy.

Meanwhile, the adoption of the new fiscal rules and formation of reserves is a necessary condition for the stability of the budget of the Russian Federation, as for many other countries with undiversified economies and limited capacity for borrowing in the time of crisis. In addition, the creation of reserves for "future expenditure" will ensure the unconditional fulfillment of the Russian government commitment in funding of the Olympics - 2014, 2018 World Cup, as well as the development of the innovation center "Skolkovo".

Thus, it is difficult to give a clear assessment to the implications of the new fiscal rules; the 2013 is likely to add much clarity to the assessments.

It should also be said about the need for revision in management policy of state-government guarantees. In the last three years there has been a significant growth in the volume of state guarantees and their share in the total volume of domestic government debt. At the beginning of 2010 the volume of government guarantees amounted to Rb 251.4bn, and 12.0% in the total volume of domestic government debt, at the end of 2012 the volume of state guarantees rose to Rb 909.1bn and accounted to 18.2% of GDP. According to the normative and legal documents of different levels, government guarantees are provided to:

- backbone enterprises, included in the list¹ approved by the Government Commission² on Sustainable Development of the Russian economy in 2008 in the framework of anti-crisis measures of the government policy to ensure continuous monitoring of financial, economic and social situation;
- enterprises of the military-industrial complex (MIC);
- commercial investment projects.

It should be noted that most of the companies included in the list of backbone enterprises that receive government guarantees are the joint stock companies, in which the government is in the best case the minority shareholder, and other main shareholders may be offshore companies. In terms of such way to support the military-industrial companies, the government guarantees are not the major, but additional tool of support, along with budget subsidies and

¹ The initial list included 304 enterprises.

² Decree of the Russian Federation Government N 957 of December 15, 2008 "On the Government Commission on Sustainable Development of the Russian Economy".

contributions in the authorized capital, being less focused on improving the performance of these companies.

First of all, it is needed to review the list of the backbone enterprises, among other reasons, including the liquidation of the Committee, which approved the list, and the introduction of more stringent standards of the criteria for inclusion the enterprises in the backbone ones, for example, the inclusion of the requirement on the absence of the offshore companies among the founders. Second, we must implement individualized approach to provide guarantees to the backbone enterprises, MIC companies and investment projects, and, if possible, to change the instruments of support and replace them with such instruments as budgetary credits, interest rate subsidies, government purchase contracts.

The national debt policy needs to be improved as well. With the introduction of the new fiscal rules and with the growth of the Reserve Fund there raises a question of the relevance of continuing the practice of raising government borrowing, dictated solely by the current favorable conditions in the capital markets, especially in the situation when expenditures for servicing the funds raised exceed the proceeds of the placing thereof on deposits. Under these circumstances it seems reasonable to limit the amount of government borrowing only to the long-term targeted financing of investment projects of high socio-economic significance.

2.3. Intergovernmental Relations and Subnational Finance

2.3.1. Subnational budgets in 2012

Major trends in the relationships between different levels of government are reflected in the structure of the revenues and expenditures of the consolidated budget of the Russian Federation. *Table 17* presents data showing the share of tax revenues and expenses of the subjects of the Russian Federation in the relevant indices of the consolidated budget of Russia¹. It is obvious that the trend to reduce the share of subnational tax revenues, set in 2011 in the consolidated budget of Russia, continued in 2012. This trend is associated with a combination of high energy prices, determining the increased income of the federal budget and low economic growth rates which adversely affect the amount of income tax and personal income tax (the main revenue sources of subnational budgets).

Table 18

The share of particular indicators of subnational budgets in the consolidated budget of Russia between 1997–2012, in % terms

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Tax revenues	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	32.9
Tax revenues excluding resource payments and customs duties	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	55.7
Expenditures	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	49.3

Source: Federal Treasury, estimates of the Gaidar Institute for Economic Policy.

¹ The detailed analysis of the structure of some indicators of subnational budgets in the consolidated budget of Russia in 1996-2011 see in "The Russian economy in 2011. Trends and Prospects" (Issue 33) - Moscow: Gaidar Institute, 2012, pp. 71-73.

The decreased share of tax revenues in the subnational budgets is mainly determined by the very low income tax growth rate (as a result, there was even a decrease of 3.7% in real terms, see below) due to the deceleration of Russian economic growth (real GDP growth declined from 4.3% in 2011 to 3.4% in 2012). At the same time, the share of expenditures of subnational budgets in the consolidated budget expenditure of the Russian Federation continued to increase from 46.5% in 2011 to 49.3% in 2012, which was slightly higher than the corresponding pre-crisis indicator value (by 0.1 percentage point as compared to 2008). As a result, the vertical imbalance which had markedly declined in 2009 - 2010 was increasing during 2011 - 2012 with the simultaneous decrease of the oil and gas revenues of the federal budget and a rising scale of anti-recessionary expenditure at the federal level. Thus, we can say that by the end of 2012, the relations between the basic parameters of the federal and subnational budgets had returned to pre-crisis values. However, the sharp deceleration in the growth of income tax revenues in 2012 raises serious concerns and may lead to a continued fall in the share of tax revenues in the subnational budgets in the consolidated budget of Russia in the future.

Below we consider the situation for the income part of the subnational budgets in more detail. The performance of the main components of the consolidated revenues of the RF subjects is shown in *Table 19*.

Table 19

**Performance of the consolidated revenues of RF subjects
in 2008–2012**

	Revenues (in nominal terms), RUR billion					Real increase, %				
	2008	2009	2010	2011	2012	2009/ 2008	2010/ 2009	2011/ 2010	2012/ 2011	2012/ 2008
Total revenues	6,196	5,924	6,537	7,644	8,064	-12.1	1.4	10.2	-1.0	-2.8
Tax and non-tax revenues	4,912	4,243	4,980	5,827	6,385	-20.6	7.9	10.3	2.8	-2.9
Incl. tax revenues	4,384	3,792	4,520	5,273	5,800	-20.5	9.6	10.0	3.2	-1.2
Income tax	1,752	1,069	1,520	1,928	1,980	-43.9	30.6	19.6	-3.7	-15.6
Personal income tax	1,666	1,665	1,790	1,996	2,261	-8.1	-1.2	5.1	6.3	1.4
Lump sum taxes	161	152	179	215	272	-13.6	8.5	13.4	18.4	25.9
Property taxes	493	570	628	678	785	6.1	1.4	1.7	8.7	18.9
Excise taxes	189	246	327	372	442	19.2	22.5	7.1	11.4	74.2
Transfers	1,131	1,486	1,398	1,644	1,624	20.7	-13.5	10.8	-7.3	7.2
Other revenues	153	195	159	173	56	17.4	-25.1	2.5	-69.7	-72.7

Source: Federal Treasury, estimates of the Gaidar Institute for Economic Policy

In general, in 2012 revenues of the consolidated budgets of the subjects of the Russian Federation increased by 5.5% to the level of 2011 in nominal terms. However, if we consider the subnational budgetary income in real terms, the data in *Table 19* shows that in 2012 (for the first time since 2009) total revenues reduced by 1%, while the tax and non-tax revenues increased by 2.8%. The main reason for the reduction of total revenues was the reduced amount of federal transfers. Thus, while in 2011 the amount of allocated inter-budget transfers was RUR 1,644 billion, in 2012 it reduced by RUR 20 billion and amounted to RUR 1,624 billion. (see the *next section* for details).

Analysing the tax revenues separately, it should be noted that they grew by 3.2% in real terms (in 2012 as compared to 2011). However, the performance of the two main taxes - income tax and personal income tax (68.5% of tax revenues) has been mixed. While personal income tax revenues for the period in question increased by 6.3% in real terms, income tax, by contrast, decreased by 3.7%. Accordingly, there have been significant changes in the struc-

ture of the tax revenues of subnational budgets: in 2011 the share of personal income tax accounted for 37.8% of total tax revenues, while income tax accounted for 36.6%; in 2012, the amounts were 43.2% and 25.3%, respectively. It should be noted that only income tax revenues did not reach the pre-crisis level: the 2012 decline compared to 2008 was 15.6% in real terms (though the regions have additionally received 0.5 percentage points of the income tax rate since 2009). As a result, the significant reduction in income tax revenues did not allow the subnational budgetary tax revenues for 2012 to reach the 2008 pre-crisis level (a decrease of 1.2% in real terms). The performance of the other tax revenues of the subnational budgets has been more favourable. The highest increase in 2008 - 2012 was recorded in excise revenues – up by 74.2% in real terms, which was mainly associated with the rate indexation. Income taxes on total income and property taxes significantly increased (by 25.9% and 18.9%, respectively).

It is also interesting to consider the revenue pattern of the major types of income payable to the consolidated budget of the Russian regions in terms of GDP (see *Table 20*).

Table 20

**Major income revenues of the consolidated budget of Russian regions
in 2008 – 2012 (% of GDP)**

	2008	2009	2010	2011	2012
Tax revenues, total	10.62	9.77	9.76	9.45	9.30
Including:					
Corporate income tax	4.24	2.75	3.28	3.46	3.18
Personal income tax	4.04	4.29	3.87	3.58	3.63
Excise taxes on goods sold in Russia	0.46	0.63	0.71	0.67	0.71
Lump sum taxes	0.39	0.39	0.39	0.39	0.44
Property taxes	1.20	1.47	1.36	1.22	1.26
Taxes, fees and regular payments for the use of natural resources	0.25	0.19	0.07	0.07	0.07
Non-tax revenues	1.28	1.16	0.99	0.99	0.94
Non-repayable receipts	2.92	4.17	3.26	3.17	2.69
<i>For reference: GDP, RUR billion</i>	41,277	38,807	46,322	55,799	62,357

Source: Federal Treasury, estimates of the Gaidar Institute for Economic Policy.

Comparison of the data in *Tables 19* and *20* reveals the differences in performance of individual indicators in real terms and as a share of GDP in 2010 - 2012. Thus, while in real terms, there was an increase of tax revenues in 2010 - 2012 (though very low in 2012), their proportion of GDP showed a steady decline. It is also important to note that despite the increase in personal income revenues in real terms (in 2012 as compared to 2008), the corresponding indicator in terms of GDP is markedly below the pre-crisis value (3.63% and 4.04%). In general, the performance of income tax in terms of GDP corresponds to its performance in real terms, and further underscores the unfavourable situation with these tax revenues (4.24% of GDP in 2008 and 3.18% of GDP in 2012).

Above, we considered the performance of tax revenues at a subnational level in general. Next we shall consider the situation with tax revenues in the Russian regions. *Table 21* shows a grouping of the Russian regions on the basis of changes in tax revenues in general, as well as the income tax and personal income tax revenues in 2012 compared to 2011.

In 2012, sixty eight of the eighty two Russian regions recorded increased tax revenues in their consolidated regional budgets in real terms above the 2011 level. The leaders in terms of growth rates were the Kaluga region (18.8%), the Arkhangelsk region (16.4%), the Republic of Kalmykia (67.5%), the Astrakhan region (23.0%), the Magadan region (16.9%) and the Sakhalin region (19.4%). It should be noted that the particularly high growth rate of tax reve-

ness in the Republic of Kalmykia was provided by an increase in personal income tax (from RUR 1,347 billion in 2011 to RUR 3,775 billion). This significant growth was only determined by the tax payments of a major taxpayer amounting to RUR 2,229 billion. In 2012, the situation with the tax revenues of the subnational budgets in many Russian regions appears to be relatively benign. However, in a number of Russian regions the performance of tax revenues raises some concerns. Among them we should particularly note the Chukotka Autonomous District, where the fall amounted to 4.1% in nominal terms, which (along with the reduction of federal transfers) led to a reduction in total income of 15.7% (transfers and decreases in tax revenues contributed approximately equally to the reduction in total income).

Table 21

Grouping of Russian regions on the basis of changes in the consolidated budget revenues of the region

	The number of regions in which the change of tax revenues					
	Increased by more than 25%	Increased from 10 to 25%	Increased by less than 10%	Decreased by less than 10%	Decreased from 10 to 25%	Decreased by more than 25%
In nominal terms						
Total revenues	4	28	35	14	1	0
Tax revenues	4	54	18	5	1	0
Income tax	17	27	11	14	7	6
Personal income tax	5	69	8	0	0	0
In real terms						
Total revenues	2	5	39	27	9	0
Tax revenues	2	18	48	10	4	0
Income tax	6	21	23	12	11	9
Personal income tax	3	12	66	1	0	0

Note: Arkhangelsk Region and Nenets Autonomous District are shown in the calculations as a single entity.

Source: Federal Treasury.

Nominal decreases in tax revenues were also observed in the Krasnoyarsk Territory, Murmansk, Belgorod and Kemerovo Regions (within 6%). In all the above regions the share of tax revenue is 60% and it exceeds their total income, so the situation in the public sector in these regions is sensitive to the performance of tax revenues. In contrast, in the Republic of Ingushetia (despite a nominal decrease in tax revenues by 2.2%) it is in the range of 14-16% of the total income of the region making the republican budget dependent not on its own tax revenues, but on the changes in the amount of federal financial support.

In real terms, a fall of tax revenues in 2012 has been recorded in 14 regions already. In addition to the previously mentioned regions of the Russian Federation, this group also includes: the Lipetsk region (-0.7%), Moscow (-1.6%), the Republic of Karelia (-2.6%), St. Petersburg (-4.1%), the Tyumen region (-4.6%), the Khanty-Mansiysk Autonomous District (-2.4%), the Yamal-Nenets Autonomous District (-0.6%) and the Republic of Khakassia (-0.2%)¹. It should be noted that many of the aforementioned regions are ones with higher or average fiscal capacity.

Stable tax revenues are provided by personal income tax with increased related revenues in real terms in all regions, except in the Vladimir region (-0.9%, while the share of personal income tax in the total income of the region is high enough at about 28%). At the same time, income tax revenues for the period decreased in 21 regions in nominal terms, and in 32 regions of the Russian Federation in real terms. The largest nominal decreases in this tax were

¹ The lowest share of tax revenues in total revenues in this group was 57% in the Republic of Karelia (in 2011). In the Republic of Khakassia the indicator was 68.3%, and in other regions it exceeded 70%.

observed in the following regions where the share of income tax in their total income exceeds 25%: the Murmansk region (a decrease of 32.7%), the Kemerovo region (-31.6%), the Chukotka Autonomous District (-30.7 %), the Belgorod region (-25.0%), Krasnoyarsk Territory (-23.8%), St. Petersburg (-18.0%) and the Lipetsk region (-13.1%).

The performance of income tax revenues both in the whole of Russia and at a regional level, and the reduction of the tax revenues of a number of Russian regions in real terms, including regions with a relatively high fiscal capacity (due largely to the performance of income taxes) is quite worrying, revealing the instability of the recovery of growth in the Russian economy. It is also difficult to suppose the possibility of sustained growth of the revenue base of the regional budgets in the short to medium term. Furthermore, an important negative signal is the reduced income of subnational budgets in general. So, 36 regions out of 82 subjects of the Russian Federation recorded a reduced income in real terms and in 9 of them this reduction was between 10% - 25%.

Now let us consider the changes that have occurred in the expenditure component of the consolidated regional budgets of the Russian Federation (see *Table 22*). The total expenditure increased by 8.6% in nominal terms compared to the same period of 2011. However, in real terms, the increase was only 1.9%, and in GDP terms there was a decrease of 0.38 percentage points. The structure of the consolidated budget of the Russian Federation regions has undergone some changes.

Table 22

Expenditures of the consolidated budget of Russian regions in 2011-2012

	% of the total		% of GDP		2012/2011	
	2011	2012	2011	2012	Increase in nominal terms	Increase in real terms
					2011	2012
National Issues	6.1	6.1	0.84	0.82	8.9	2.1
National Security and Law Enforcement	3.7	1.1	0.51	0.15	-66.5	-68.5
National economy, incl.:	17.1	19.2	2.36	2.58	22.0	14.4
Agriculture and fisheries	3.0	2.9	0.41	0.39	4.0	-2.5
Transportation	2.8	3.5	0.38	0.47	39.0	30.4
Roads (road funds)	5.5	7.7	0.76	1.04	52.2	42.8
Other aspects of the national economy	3.6	2.9	0.50	0.39	-11.9	-17.3
Housing and utilities	12.6	10.6	1.74	1.41	-9.0	-14.7
Environmental protection	0.3	0.3	0.04	0.03	-0.3	-6.5
Education, incl.:	22.5	24.5	3.10	3.28	18.4	11.1
Pre-school education	5.1	5.6	0.70	0.74	19.0	11.6
General education	12.8	14.1	1.76	1.89	20.0	12.6
Vocational education	1.1	1.5	0.14	0.20	56.3	46.7
Other aspects of education	1.8	1.7	0.25	0.22	-0.1	-6.3
Culture and film-making	3.1	3.1	0.42	0.41	9.5	2.7
Public health	15.5	16.3	2.14	2.18	13.9	6.8
Social policy	15.5	15.3	2.14	2.04	6.9	0.3
Physical education and sports	1.9	1.9	0.26	0.25	8.0	1.3
Mass media	0.4	0.5	0.06	0.06	11.6	4.7
Servicing of the state and municipal debt	1.0	0.9	0.14	0.12	-1.5	-7.6
Total expenditure	100.0	100.0	13.76	13.38	8.6	1.9

Source: Federal Treasury.

By analysing the changes in regional budget expenditures in some areas, we can note the following. The greatest decrease in expenditures in 2012 was observed in the section "National Security and Law Enforcement" (-66.5%), which led to a decline in the share of expenditures on this section in the total expenditure from 3.7 to 1.1%. This performance is associated with the transfer of powers on the financial support of the police to Federation level in 2012. A nominal decline was also recorded in one of the major sections "Housing and Utilities"

(-9.0%) with its share reduced from 12.6% to 10.6%. It is also important to note a decrease in expenditure on servicing the state and municipal debt by 1.5% in nominal terms against the increase in borrowings in 2012. The lack of growth and even the decrease in expenditure on debt servicing is largely due to the fact that a sharp increase in the growth of borrowing was observed in December, which should result in increased expenditure to be considered in 2013 (for more details on the debt policy see below).

At the same time, a number of major sections showed an increase in expenditure: the "National Economy" (an increase of 14.4% in real terms), "Education" (11.1%) and "Public Health" (6.8%). In another major section, "Social Policy", the expenditure in real terms has not changed (it increased by only 0.3%).

Particular attention should be paid to the "National Economy" section. The share of expenditure in this area has increased from 17.1% to 19.2% (an increase from 2.36% to 2.58% in GDP terms). It is important to consider the performance not only of the entire section, but also of its separate subsections, as this area of expenditure is quite heterogeneous in contrast to most other areas. Thus, the expenditure on agriculture decreased by 2.5% in real terms, which resulted in some reduction in the share of this expenditure (from 3.0% to 2.9%) of the total expenditure. At the same time such major sub-sections as "Transport" and "Traffic Management" have shown significant growth in real terms, in 2012, these two sections were responsible for 58.6% of the total expenditure of the national economy.

In 2012, expenditures on the "Traffic management" subsection increased by 42.8% in real terms compared to 2011. As a result, the share of this section in the total expenditure increased from 5.5 to 7.7%. The increase in expenditure was associated with the road funds of the RF regions established back in 2011 and replenished primarily by the excise tax on oil products produced in the Russian Federation (increase by 43.5%) and transport tax (increase by 8.3%). As a result, the increased revenues allocated to the road funds of the regions of the Russian Federation led to an increase in maintenance expenditure (from RUR 143.1 billion to RUR 278.5 billion), and to expenditure on the construction of new roads (from RUR 217.3 billion to RUR 262.5 billion). It is also necessary to take into account the increase in federal subsidies for roads from RUR 57.6 billion in 2011 to RUR 98.2 billion in 2012 (for more details on federal transfers see *the next section*).

Expenditure under the "Transport" subsection in 2012 increased by 30.4% in real terms compared to 2011. The share of this section in the total expenditure increased from 2.8 to 3.5%. However, this increase is largely associated with an increase in Moscow expenditure. In 2012, the regional authorities' contributions to the authorised capitals of enterprises amounted to RUR 86.8 billion, accounting for 30.4% of the total expenditure on transport in the whole country. These contributions were made at early stages of the implementation of the Programme of infrastructure development for passenger traffic at the Moscow railway junction in 2012-2020¹.

Another significant part of subnational expenditure, "Education", increased by 11.1% in 2012 in nominal terms compared to the previous year. The proportion of expenditure in this area increased from 22.5% to 24.5% of the expenditure of the consolidated budget of the regions of the Russian Federation. This increase was primarily associated with an increase in

¹ In addition, in accordance with the Decree of the Government of the Russian Federation No. 2427-r dated 19.12.2012 (On the increase in the authorised capital of Russian Railways OJSC) the authorised capital of Russian Railways OJSC has been increased by RUR 25.9 billion at the expense of the federal budget in order to implement measures for the development of the transport infrastructure of the Moscow region.

expenditure on general and pre-school education (by 12.6% and 11.6%, respectively). However, we can hardly but note a significant increase in expenditure on the subsection "Vocational Education" - by 46.7% compared to 2011, which led to an increase in the share of this expenditure from 1.1% to 1.5% of the total regional expenditure. This performance was determined by the fact that, in accordance with the order of the Russian Government No. 2413-r dated 29 December 2011, the titles to 706 VE institutions located in 73 regions of Russia were transferred to the regions.

In general, in 2012, the consolidated regional budget was reconciled with a deficit of RUR 278 billion, which is RUR 243 billion greater than that for 2011. The total deficit was 3.34% of the total expenditure, which is less than the same indicator in 2009 (5.26%), but higher than in 2010 (1.51%) and 2011 (0.46%). The situation at a regional level is presented in *Table 23*.

Table 23

**The result of implementation (deficit/surplus) of consolidated budgets
for the regions of the Russian Federation in 2008-2012**

	The number of regions of the Russian Federation which implemented the budget with	
	Deficit	Surplus
2008	45	39
2009	62	21
2010	63	20
2011	57	26
2012	67	16

Source: Federal Treasury.

The data in *Table 23* suggest that the situation with the deficit of the consolidated budgets of the regions of the Russian Federation in 2012 was worse than in 2011. Whilst in 2011 only 57 subjects reconciled their budgets with deficits, in 2012 their number increased to 67 regions, even more than in 2009 - 2010. It should be noted that in 2012 twenty regions, which had been in surplus in 2011, reconciled their budgets with deficits. Ten of the twenty regions in question showed an increase in expenditure at a rate exceeding the national average (8.7% in nominal terms) due to increases in their total revenues at rates which also exceeded the national average (5.5%). In another 4 regions the expenditure growth rates sufficiently exceeded the national average against a slight increase or decrease in income. At the same time, in 2012 as opposed to 2011, nine regions, by contrast, have reconciled their budgets with a surplus. Thus, we can say that the substantial increase in the number of Russian Federation regions which implemented their budgets with deficits in 2012 is largely determined, not by a significant deterioration of the situation in subnational finance, but rather by a lack of sufficient budgetary discipline by the regional authorities in soft budget constraints specific to the Russian model of federalism.

Based on 2012 results, in ten regions of the RF the consolidated budget deficit exceeded 15% of the tax and non-tax revenues, with the highest value being observed in the Chukotka Autonomous District (46.8%). If we consider the regional budgets (only at a regional level), then the situation is as follows: In twenty of the eighty two regions the deficit exceeded 10% of their revenues, excluding reimbursable transfers. The highest values of this index were recorded in the following regions of Russia: Chukotka Autonomous District (45.7%), Amur Re-

gion (20.6%), Krasnodar Territory (18.6%), Pskov Region (18.7), Orel Region (16.5%) and the Yamal-Nenets Autonomous District (16.4%)¹.

The increase in the number of "deficient" regions and the increase the amounts of budget deficits have led to increased subnational debt borrowings in 2012. The data on the performance of the public debt of the RF regions and municipal debt in 2011 - 2012 are presented in *Table 24*.

Table 24

**The amount of state and municipal debt of subnational budgets
in 2011–2012**

	As at 01.01.11	As at 01.01.12		As at 01.01.13	
	RUR Billion	RUR Billion	Annual increase (%)	RUR Billion	Annual increase (%)
Total for regional budgets	1 096.0	1 171.8	6.9	1 355.0	15.6
Total for regional budgets (excluding Moscow and the Moscow Region)	649.9	831.6	28.0	1 068.7	28.5
Total for municipal budgets	169.8	215.5	26.9	245.3	13.8

Source: The Ministry of Finance of the Russian Federation.

The table shows that the situation with the amount of debt of the regional and municipal budgets for 2012 generally deteriorated. A significant increase in state and municipal debt was seen in December 2012. Thus, during just one month the national debt increased by 16.4% (by RUR 190.7 billion, from RUR 1,164.2 billion to RUR 1,355.0 billion), and the municipal debt increased by 14.8% (by RUR 31.7 billion, from RUR 213.2 billion to RUR 245.3 billion). During the same period, the amount of loans allocated from the federal budget to regions increased from RUR 88.3 billion to RUR 129.5 billion, while the balance of the budget loans granted to and repaid by the RF regions increased from RUR -12.4 billion only up to RUR +5.2 billion. Thus, the increasing amount of loans is not generally associated with the budgetary borrowings.

As a result, in 2012 the amount of the regional budgetary debt increased by 15.6% (in nominal terms), and, excluding the City of Moscow and the Moscow Region, by 28.5%. Moreover, whilst as at 1 January 2011 the amount of debt in these 2 regions was 40.7% of the total debt of the regional budgets, at 1 January 2012 it amounted to 29.0% and 21.1% at 1 January 2013. In 2012, the debt of Moscow and the Moscow Region decreased by 15.9%. We can say that in 2011 - 2012 the main reduction in public debt was accounted for by Moscow and the Moscow Region whilst the rest of the regions mostly built it up, except for certain periods of decreases in borrowings. Note, however, that the Moscow region, as well as many other regions, increased the amount of its public debt in December 2012 (21.1%), which put the region back from third to second place in terms of debt, trailing only Moscow.

The increase of the debt burdens of the regional budgets is also revealed in the data by regions (see *Table 25*).

¹ Prior to January 1, 2017 the budget deficit may exceed the RF regional limits set in Cl. 2, Art. 92.1 of the Budget Code of the Russian Federation (15% or 10% of revenues excluding non-repayable transfers - depending on the level of subsidisation of the region) within the difference between the received and repaid budget borrowings (Federal Law No. 58-FZ dated 09.04.2009 (as amended on 30.11.2011)).

Table 25

**The performance of the amount of public debt in the regional budgets
in 2008-2012**

	The performance of the amount of public debt in the regional budgets for corresponding periods (in nominal terms)						
	Increase of more than 50%	Increase from 10% to 50%	Increase of less than 10%	No changes	Decrease of more than 10%	Decrease from 10% to 50%	Decrease of more than 50%
	The number of regions in						
2008	21	26	4	0	5	13	9
2009	37	20	9	0	4	6	2
2010	29	28	4	2	7	9	0
2011	23	33	6	2	12	6	0
2012	18	36	9	0	6	12	1

Source: The Ministry of Finance of the Russian Federation.

In 2012, the amount of public debt amount in 63 of the 82 regions of the RF increased, with substantial increases in that amount (over 10%) observed in 54 regions. In 2011, the situation was similar, the public debt during this period increased in 62 regions, and in 56 of those it increased by more than 10%. It should be noted that in 2012 a rate of increase in public debt by more than 50% was observed in 18 regions: Republic of Ingushetia (by 15 times), Yamal-Nenets Autonomous District (by 566.7%), Republic of Tyva (238.1%), Saint Petersburg (149.8%), Murmansk Region (131.8%), Chukotka Autonomous District (111.1%), Kabardino-Balkar Republic (104.4%), in the remaining 11 of the 18 regions the public debt amount for the year increased by between 50% to 100%.

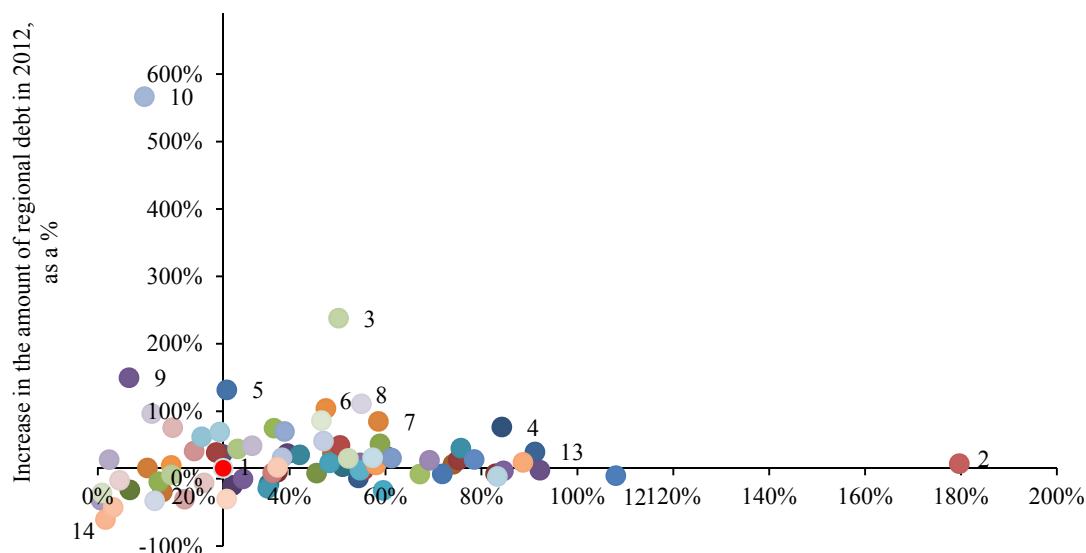
However, of particular concern are the regions of the Russian Federation, which not only significantly increased their amount of debt in 2012, but also significantly increased their debt burden, which is the ratio of the public debt and the level of tax and non-tax revenues of the region of the RF (see *Fig. 17*)¹. In 2012, the average debt burden of the Russian regions was 26.1%, which is 1% higher than in 2011.

As the figure shows, 37 of the 82 regions of the Russian Federation were in the "troubled sector": the increase in their public debt and their general debt burden was higher than the Russian average. Thus, the public debt of the Belgorod Region during one year only increased by 76.7% providing an 84.2% debt burden. We can also select other regions based on these indicators: Tver Region (21.4% and 74.1%, respectively), Ryazan Region (39.8% and 91.1%), Kaliningrad Region (45.4% and 75.7%), Nizhny Novgorod Region (20.6% and 58.0%), Kemerovo Region (31.3% and 38.4%), Tomsk Region (49.1% and 32.2%), Omsk Region (30.3% and 52.2%). It should be noted that, based on the results of 2012, in two regions the level of debt burden exceeded the amount of tax and non-tax revenues. These are the Republic of North Ossetia-Alania (by 8%) and the Republic of Mordovia (by 79.7%). Whilst in North Ossetia the amount of additional debt granted was 4.6% higher, Mordovia showed a 22.4% increase, which is 6.7 percentage points higher than the national average (15.6%).

In general, we can say that the situation in the field of regional and municipal debts is worsening somewhat, but at the same time most of the regions which are actively increasing the amount of their borrowings are, as yet, far enough from critical values of debt burden. At

¹ Prior to January 1, 2017 the maximum amount of regional debt (municipal debt) may exceed the limit set in Cl. 2 and 3, Art. 107 of the Budget Code of the Russian Federation (100% of budget revenues, excluding non-repayable payments) within the scope of the regional public debt (municipal debt) in the form of budget borrowings (Federal Law No. 58-FZ dated 09.04.2009 (as amended on 30.11.2011)).

the same time, there are a few regions where the public debt situation is quite tense. To resolve the situation in a number of regions it will be necessary to reduce the debt. Thus, to limit the debt of five regions, the Russian Ministry of Finance has entered into special agreements, providing for debt reduction over the next three years¹.



The ratio of the regional debt to tax and non-tax revenues in 2012, as a %

Note: 1 - Russia (The intersection of the axes occurs at the point where the debt load and the increase in the amount of debt of the RF regions for 2012 represent the national average values (26.1% and 15.6%, respectively)), 2 - Republic of Mordovia, 3 - Tuva Republic, 4 – Belgorod Region, 5 – Murmansk Region, 6 - Kabardino-Balkar Republic, 7 – Krasnodar Territory, 8 – Chukotka Autonomous District, 10 - Yamal-Nenets Autonomous District, 11 - Republic of Ingushetia, 12 - Republic of North Ossetia – Alania, 13 - Ryazan Region, 14 - Khanty-Mansiysk Autonomous District.

Source: Federal Treasury, The Ministry of Finance of the Russian Federation, estimates of the Gaidar Institute for Economic Policy.

Fig. 17. Debt load and changes in the amount of regional public debt in 2012 (in %)

In general, summing up the results of the analysis of the main characteristics of the subnational budgets in 2012, the following should be noted. The situation in the field of regional and municipal finance has become more tense: the number of regions that have ended the fiscal year with a deficit has increased; at the end of the year the amount of the borrowings significantly increased. In part, these trends are related to the performance of tax revenues and mainly to the income tax revenues, which decreased in 2012 in real terms. However, as shown above, the regions that have become "unprofitable" in 2012 were the ones which adhered to quite irresponsible budgetary policies, increasing the amount of expenditure at a rate exceeding (and in some cases much higher than) the national average level.

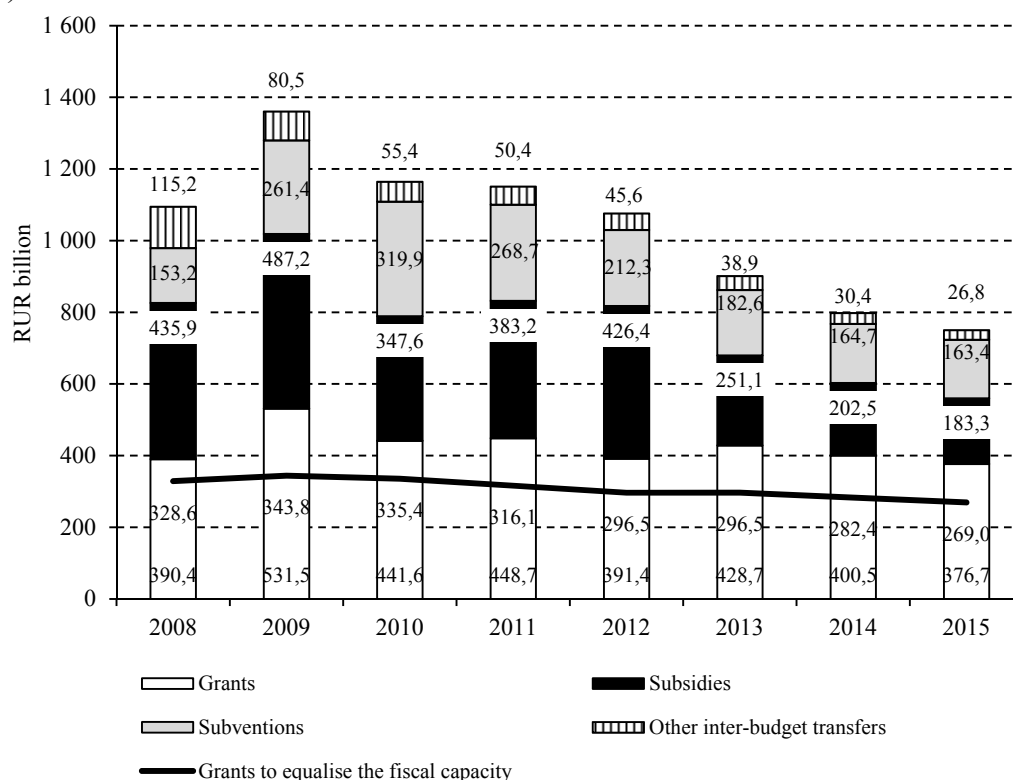
¹ <http://www.minfin.ru/ru/press/speech/index.php?pg56=32&id4=18253> – A.G. Siluanov's statement made during an interview for "Russia 24" on 29.12.2012

2.3.2. Financial aid from the federal budget

The total amount of funds allocated from the federal budget to subnational budgets in 2012 decreased by 0.4% in nominal terms. However, in real terms, the decrease was already 6.5%. It is possible to speak about a continuing downward trend in the amount of transfers in real terms. Thus, the decrease was 1.2% in 2011 as compared to 2010 and 14.4% in 2010 as compared to 2009. In terms of GDP, the performance was as follows: after a sharp increase in 2009 compared to 2008 (from 2.71% to 3.81% of GDP) during the next three years the total amount of transfers to the regions was gradually decreasing: in 2010 it was 3.0% of GDP, in 2011 it was 2.59% of GDP, in 2012 was 2.31% of GDP.

The surplus of granted and repaid budgetary loans decreased in 2012 to RUR 4.9 billion (from RUR 79.8 billion in 2011). It should be noted that the amount of the federal budget loans allocated in 2012 to the regions slightly increased by RUR 1.2 billion to RUR 129.5 billion. The dramatic decline in the balance was associated with a substantial increase in the amount of budget loans repaid by regions - from RUR 48.6 billion in 2011 to RUR 124.5 billion in 2012.

Let us consider the performance of certain types of federal transfers in more detail (see Fig. 18).



Source: Federal Treasury, Federal Law No. 216-FZ dated 3 December 2012 On the Federal Budget for 2013 and the planning period to 2014 and 2015", estimates of the Gaidar Institute for Economic Policy.

Fig. 18. Transfers to regions from the federal budget in 2008-2015 (in 2008 prices)

In real terms, the amount of subsidies, subventions and other inter-budget transfers (other IBT) decreased in 2012 as compared to 2011. Subventions were reduced the most - by 21.0%, the amount of subsidies decreased by 12.8% and other IBTs by 9.6%. However, if we com-

pare the amounts of these types of transfers in 2012 with their amounts in 2008 (the pre-crisis level), it can be noted that in real terms the subventions increased by 38.6%, subsidies – by 0.3% and other IBTs decreased by 60.4%. In 2012, subsidies increased by 11.3% as compared to 2011 (but the attained level is by 2.2% less than the corresponding value of 2008). It should be noted that in general the 2012 performance was similar to the previous performance in 2011, when there were also reduced subventions and other IBTs and increased subsidies, as compared to 2010. Analysing the Budget Law for 2013 and the planning period 2014-2015, it can be noted that the trend to decrease the amount of transfers will continue. As a result, in 2015 the amount of transfers should be reduced by 31.5% compared to 2008. The proposed amount of grants will be reduced by 3.5%, subsidies by 58%, other IBTs by 76.7%, while subventions will be increased by 6.7% (for more details see Section 2.3.4).

In analysing the process of the allocation of federal budget transfers to regions, it is important to consider the effect of federal aid on the differentiation of the income of the regions, i.e. to assess the levelling properties of financial aid from the federal budget (see *Table 26*).

Table 26

**The variation coefficient of revenues of consolidated regional budgets
(per capita based on the IBE*) in 2008 - 2012, %**

Year	Tax revenues	Tax revenues and grants to equalise the fiscal capacity	Tax revenues and the total amount of transfers from the federal budget
2008	90.6	80.4	68.2
2009	78.0	66.5	51.6
2010	74.2	63.9	53.6
2011	77.8	68.4	58.0
2012	72.7	64.3	55.5

* Index of budget expenditures used by the Russian Ministry of Finance upon the allocation of grants to equalise the fiscal capacity of regions.

Source: Federal Treasury, estimates of the Gaidar Institute for Economic Policy.

The data in *Table 26* show that, in 2012, the allocation of subsidies to equalise the fiscal capacity continued to affect the reduction of the inequality in subnational budget income. Note, however, that the extent of this effect has been gradually reducing since 2010. This has largely resulted from the decrease in the share of grants in the total transfers allocated from the federal budget for equalising the fiscal capacity. Whilst in 2008 the share of this type of grants was 30.1%, in 2011 - 2012 it was already 27.6%. One can also note a significant decrease in grants for equalising, from 0.86% in 2010 to 0.64% in 2012 in terms of GDP (0.80% in 2008). The amount of tax revenues in the consolidated budgets of the regions in GDP terms was also decreasing during this period, but at a much slower rate: from 9.76% to 9.30% of GDP (10.62 % in 2008). As a result, in 2012, the variation coefficient of regional revenues, after the allocation of equalising subsidies, decreased by only 8.4 percentage points, whilst in 2008 - 2010 this rate consistently exceeded 10 percentage points. While 27.6% of inter-budget transfers (equalising subsidies) provide exactly the same decrease of the variation coefficient considered as the remaining 72.4% of inter-budget transfers, this indicates the low progressivity of all inter-budget grants, except for the equalising subsidies. Thus, we can speak of the need to increase the share of equalising subsidies in the total alignment of inter-budget transfers.

The above performance of inter-budget transfers allocated from the federal budget has led to certain changes in the structure of transfers in 2008 - 2012 (see *Table 27*).

Table 27

Transfers to Russian regions from the federal budget in 2008 - 2012

	2008		2009		2010		2011		2012	
	RUR billion	% of the total	RUR billion	% of the total	RUR billion	% of the total	RUR billion	% of the total	RUR billion	% of the total
Transfers to regions, total	1 094.7	100.0	1 480.3	100.0	1 378.3	100.0	1 445.6	100.0	1 440.2	100.0
Subsidies	390.4	35.7	578.3	39.1	522.7	37.9	563.5	39.0	524.0	36.4
Including:										
Grants to equalise the fiscal capacity	328.6	30.0	374.0	25.3	397.0	28.8	397.0	27.5	397.0	27.6
Grants to support measures to balance the budgets	46	4.2	191.9	13.0	105.9	7.7	154.3	10.7	117.2	8.1
Subsidies	435.9	39.8	530.0	35.8	411.4	29.8	481.3	33.3	570.9	39.6
Including:										
Subsidies on roads	34.5	3.2	21.9	1.5	24.4	1.8	57.6	4.0	98.2	6.8
Agricultural subsidies	58.4	5.3	92.5	6.2	94.8	6.9	98.5	6.8	112.8	7.8
Subventions	153.2	14.0	284.4	19.2	378.6	27.5	337.5	23.3	284.2	19.7
Other inter-budget transfers	115.2	10.5	87.6	5.9	65.6	4.8	63.4	4.4	61.1	4.2

Source: Federal Treasury, estimates of the Gaidar Institute for Economic Policy.

As data Table 27 shows, the amount of *grants* in 2012 decreased as compared to 2011 primarily due to a decrease in the amount of grants to support measures to maintain the budget balance (from RUR 154.3 billion to RUR 117.2 billion). As a result, the share of equalising grants in the total amount of transfers decreased from 10.7% to 8.1%. The share of grants to equalise fiscal capacity has slightly changed (increased by 0.01 percentage points). The total amount of grants in 2012 was 36.4% of the total amount of inter-budget transfers, less than in 2011 by 2.6 percentage points. In general, these changes cannot be unambiguously assessed. On the one hand, the positive effect is the reduction of equalising grants (which are distributed according to the least transparent procedures and criteria), while on the other hand, the equalising grants remained the same during the three consecutive years - RUR 397 billion (the effects of this on performance of the equalising process are mentioned above).

The share of *subventions* in the total transfers decreased from 23.3% in 2011 to 19.7% in 2012. This decrease in subventions was largely associated with the reduction of subventions to exercise authority in the field of employment (reduced by RUR 29.3 billion), the reduction which appeared in 2009 (RUR 7.4 billion), in the subvention to provide housing to veterans of WWII, to commemorate the 65th anniversary of the Victory in the Great Patriotic War, as well as the reduction in the subvention for the purchase of housing by citizens discharged from military service or equivalent persons (reduced by RUR 15.7 billion). The reduction of subventions in the field of employment is associated with the improvement in this area against the continued (albeit slow) growth of the Russian economy. The reduction of two other types of subventions is explained by the gradual implementation of measures to provide housing for the population categories concerned.

By contrast, the share of *subsidies* in the total amount of transfers in 2012, increased by 6.3 percentage points compared to 2011 (from 33.3% to 39.6%). It should be noted that, in general, after the reduction of the share of subsidies in 2009 - 2010, there has been an increase since 2011. So, whilst in 2008 the share of subsidies in the total federal transfers amounted to

39.0%, in 2010 it was 29.8% and in 2012 there was an increase of 0.6 percentage points from the 2008 level to 39.6%.

The main areas of co-financing of the expenditures of subnational budgets in 2012 were:

- The construction and upgrading of roads (17.2% of the total subsidies)¹;
- Improvement of the regional general education programmes (10.6%);
- State programme for agricultural development and the regulation of agricultural products, raw materials and food markets (9.8%);
- Financial support for additional health care provided by district doctors and paediatricians and general practitioners (family doctors) (3.7%).

The share of *other IBTs* in the total federal transfers continues the downward trend established in 2008. Whilst in 2008 the share of this type of transfer was 10.5%, in 2009 it was 5.9%, in 2010, 4.8%, 2011, 4.4% and in 2012 it was 4.2%.

In general, speaking of the main features of the provision of financial aid to regions from the federal budget in 2012, we can note the following. With some reduction in the total amount of transfers (even in nominal terms), their structure has undergone negative changes. Subsidies came top in the share of the total, amounting to nearly 40%. It is necessary to consider that this type of transfer is still allocated as numerous disparate subsidies, and the process of consolidation is clearly inhibited (for details see *Section 2.3.4*). At the same time, the share of equalising grants (the most transparent and efficient type of transfer) does not change whilst their amount is maintained at the level of the previous year, resulting in a decrease in the scale of reduction of the of regional per capita income differentiation after the allocation of these grants. As a result of the above trends, the transparency of inter-budget relations is reduced and regional governments have less ability to forecast the amount of federal financial aid (as subsidies, along with equalising grants, are the most unpredictable types of transfer).

2.3.3. Performance assessment of the executive authorities of the Russian Federation

In 2012, the practice of allocating financial resources from the federal budget to the regions of the Russian Federation depending on their results in the field of economy and finance continued². As compared to previous years, it has undergone some changes.

In 2012, the Presidential Decree No. 825 dated June 28, 2007 (On the performance assessment of the executive authorities of the Russian Federation) was repealed. During the few years of its existence the assessment methodology itself had been amended several times. On the one hand, the purpose of regular amendments was to take into account all features of the assessment subject (actions of the public authorities) within one methodology, on the other hand, in practice, this led to an increased number of indicators being used, making it congested, confusing and opaque. In the last edition of this Decree 329 different indicators were in use. The granted amount depended on the size of the integrated assessment and ranged from RUR 70 million to RUR160 million. Only 10 regions with the best assessment results could qualify.

Replacing the old Presidential Decree, the new one, No. 1199, with the same name (On the performance assessment of the executive authorities of the Russian Federation) was adopted on 21 August 2012. In accordance with this Decree the Resolution of the Government of the

¹ The amounts of these subsidies includes the corresponding expenditures under all federal target programmes.

² For more details of the practice of the provision of financial resources depending on the region's results prior to 2012 see Russian Economy in 2011. Trends and prospects. (Issue 33) - Moscow: Gaidar Institute, 2012, pp. 84-88.

Russian Federation No. 1142 dated 3 November 2012 (On measures to implement the Decree of the President of the Russian Federation No. 1199 dated 21 August 2012) was also adopted. It sets the rules on the provision of grants and the executive authorities' assessment methodology. In accordance with the Resolution, a grant from the federal budget can be allocated to the 20 regions that have received the highest ranks under the adjusted comprehensive performance assessment of the executive bodies of the Russian Federation. The performance of regional officials acting in the field of economy, the investment attractiveness of the region, the state and municipal government, and health, education and housing will be assessed. Compared to the previous method in 2007, the new method has significantly reduced the number of indicators used (from 329 to 53)¹. The assessment will be conducted in two phases. In the first stage a comprehensive assessment is made, taking into account only 12 indicators: life expectancy at birth; population size; the amount of investment in fixed assets (excluding budgetary funds); sales of goods (services) produced by small enterprises, including micro-enterprises and individual entrepreneurs; the amount of tax and non-tax revenues of the consolidated budget of the Russian Federation region, the average annual unemployment rate; the real disposable incomes of the population, the proportion of the total housing floor area commissioned in relation to the total housing floor area; the proportion of graduates of public (municipal), educational institutions who did not pass the unified state exam out of the total number of graduates of public (municipal) educational institutions; mortality (excluding mortality from external causes); an assessment of the activities of the executive authorities of the Russian Federation region by its population; the proportion of children without parental care, including those transferred to non-relatives (to foster care, adoption, under guardianship (custody), foster homes and foster families), or living in any type of state (municipal) institution².

In the second stage the so-called individual performance indicators of the executive authorities of the Russian Federation regions are calculated, and these are used to adjust the estimates of the above 12 indicators. The result is the adjusted comprehensive performance assessment. It is important to note that not all the individual indicators (from the total of 41) are used in the calculations for each region. At this stage, an expert group consisting only of representatives of the federal departments and agencies selects 2 individual targets for each region, to reflect the existing particular problems of the region and the ability to solve them. In 2013, the amount of the grants to the regions (other than inter-budget transfers to promote the best values of the indicators of the performance of the executive authorities) is set at the 2012 level (RUR 1 billion).

In addition to the above changes, in 2012, the practice of financing the subnational budgets depending on their results was amended to change another incentive mechanism for the RF regions, which managed to achieve the best results in economic development fund-raising³.

Additional grants to regions which achieved the best results on increasing the regional tax capacity were first allocated in 2011: Twenty regions of the Russian Federation received grants in support of measures to balance their budgets, in the amount of RUR 10 billion. Each of the 20 regions has received between RUR 206.8 million to RUR 2 billion of additional un-

¹ In the original version the new method included 47 indicators. Later, the Physical Culture and Sports Section was added, which contains a number of new indicators.

² This indicator was introduced additionally under the RF Government Decree No. 168 dated 28.02.2013.

³ Government Decree No. 798 dated 27.09.2011 (as amended on 12.12.2012) "On the distribution of subsidies to support measures to balance the budgets to the Russian regions achieved the best results in the increase of the regional tax capacity".

designated transfers. In 2012, compared to 2011, there were 2 changes introduced in the incentive mechanism for regional authorities. Firstly, the list of grant-receiving regions was extended from 20 to 25. Secondly, changes were made to the assessment methodology by increasing the number of indicators. So, the six existing indicators were supplemented by two money income indicators calculated from the dynamics (growth rate for the last three years) and static (amount per capita). Thirdly, a standard was introduced, which stipulates that the grants to territories and provinces of the regions which include autonomous districts are calculated for the consolidated budget of the territory and the region, including the budgets of the autonomous districts, and credited to the budget of the respective territory or region.

In 2012, despite the increase in the number of regions to 5, there were no increases in the amount of funding. As in 2011, it amounted to RUR 10 billion. As a result, the regions received from RUR 233.6 million to RUR 794.3 million. It is important to note that in 2012 the list included 13 Russian regions, which were already receiving the incentive grants in 2011. For the second consecutive year, the list of regions that have achieved the best results in increasing their regional tax capacity includes: the Republic of Tatarstan (RUR 1,085.0 million as the total amount of grants for two years), Primorsky Territory (RUR 1,001.1 million), Voronezh Region (RUR 683.3 million), Kaluga Region (RUR 2,649.9 million), Leningrad Region (RUR 1,643.9 million), Moscow Region (RUR 627.9 million), Novgorod region (RUR 855.3 million) Omsk Region (RUR 528.3 million), Tula Region (RUR 573.7 million), Tyumen Region (RUR 2,562.9 million), Ulyanovsk Region (RUR 477.6 million), Yaroslavl Region (RUR 487.4 million) and the St. Petersburg (RUR 707.4 million). It should also be noted that in 2012 all those regions with the highest level of fiscal capacity in the country received this type of financial aid, namely the Tyumen Region (RUR 649.9 million), St. Petersburg (RUR 388.5 million) and Moscow (RUR 435.9 million). This seems to be rather a contested decision, especially considering that these amounts represent a small share of the budget of the mentioned regions (for example, in the Tyumen Region and its associated ADs it was 0.12% of the total consolidated budget revenues).

In addition to the mechanisms discussed above for allocating financial resources to regions from the federal budget, depending on their results, in 2012, the Presidential Decree No. 1276 dated 10 September 2012 (On the performance assessment of the heads of federal executive agencies and chief executives (heads of supreme state executive authorities) of the Russian Federation, intended to create a favourable business environment) was also issued. This Decree should be aimed at assessing the performance of the heads of the federal authorities and regions in the relevant field. It should be noted that the public authorities are also assessed under the Presidential Decree No. 579 dated 13 May 2010 (as amended on 14 October 2012) "On the performance assessment of the executive authorities of the Russian regions, city and municipal districts, local self-government authorities in the field of energy conservation and the improvement of energy efficiency" and Presidential Decree No. 607 dated 28 April 2008 (as amended on 14 October 2012) "On the performance assessment of local self-governing authorities of city and municipal districts".

It must be stressed that the mechanism for funding the regional authorities depending on their results, has a number of inherent disadvantages¹. *Firstly*, such estimates can not reflect the current state of regional economic policy, as either the results of resolutions adopted by the authorities are long-term (e.g., the results of on-going large investments can be seen only

¹ For more details see Russian Economy in 2011. Trends and prospects. (Issue 33) - Moscow: Gaidar Institute, 2012, pp. 87–88.

after a number of years) or the assessed economic indicators depend very little on the resolutions made by public authorities. *Secondly*, the promotion, through the mechanism, of the allocation of grants to the financially successful RF regions, can hardly be effective, given the small amount of funds allocated to the relatively large number of regions entitled to premiums. As a result, this mechanism cannot have a significant influence on the priorities of the regional authorities, and only leads to the dissipation of the budget funds. *Thirdly*, the federal government's commitment to improving the individual methodology will lead to constant changes to it, which will not allow the regions to correctly determine their long-term priorities.

In this sense, 2012 has shown that there is a regular extension of the system of indicators in order to obtain a more objective performance assessment of the government. Thus, already in 2012, the methodology for assessing the fiscal capacity had existed for only for one year before it was changed to increase the number of indicators (from 6 to 8). However, increasing the number of indicators by this method will also lead to a distortion of the real goal-setting system on the part of the regional authorities of the Russian Federation, replacing results-oriented work with index-oriented work. As a result, the regional authorities will seek to achieve current high indices (higher than in the previous period) without carrying out the actual work under the long-term strategic development plans. Expansion of the system of indicators makes the assessment complex and confusing, and, as a result, the regional leaders do not understand how they should organise their work to meet the federal government-proposed evaluation system and actually improve the socio-economic situation of their region. The result is the rejection of sophisticated methodologies for assessing all aspects of life in the region (as in the methodology proposed by the Ministry of Regional Development, based on 329 indicators) and the transition to a simpler mechanism, as has happened in 2012 (the decrease in indicators to 14 (12 core and 2 individual ones for each region)). It should be noted that originally (in 2007) the methodology of the Ministry of Regional Development also included dozens of indicators, but over a few years their list has increased by several times, and the methodology dated 3 November 2012 has been increased by six indicators. So, in the future, we can expect its increased complexity, which ultimately will lead, perhaps, to its abolition.

It is important to understand that the above effects are similar to those that result from attempts to introduce different systems of Performance Budgeting in the public sector at the level of government, in general and for individual departments and agencies¹. In order to reduce the likelihood of the problems described above, we must reject the funding of the RF regions depending on their results, but to improve the assessment systems. The assessment system is required to create a knowledge base for identifying the processes taking place in the region, based on various aspects of regional development. This will enable the identification of the spread and application of regional best practice in other regions of the Russian Federation. It is also important to note that the real renaissance of the institution of the direct election of governors and the possibility of early termination of their powers may be the best incentive and the best performance indicator of the regional authorities.

¹ For more details see, for example, H. de Bruijn. Management in the public sector. Moscow: Institute for Complex Strategic Studies, 2005.

2.3.4. Federal law of 3 December 2012 No. 216-FZ "On the Federal Budget for 2013 and the planning period to 2014 and 2015" for the allocation of intergovernmental transfers to other levels of the budgetary system

The Federal Law No. 216-FZ dated 3 December 2012 "On the Federal Budget for 2013 and the 2014 and 2015 planning period" implies a gradual reduction of the total amount of transfers allocated to regional budgets from the federal budget in nominal terms as compared to 2012. The overall decrease in the amount of transfers in nominal terms is expected to be 9.8%. First of all, the reduction of the total amount of transfers is related to a reduction of subsidies (by 32.8% in nominal terms in 2013 as compared to 2012).

The planned performance of certain types of inter-budget transfers differs substantially. The budget projections provide for a noticeable growth in **grants** allocated from the federal budget to regions, from RUR 524.0 billion in 2012 to RUR 602.9 billion in 2013 (increased by 15.1% in nominal terms and by 9.0% in real terms). Then, in 2014 - 2015, it is planned to reduce their volumes by 1.6 - 1.7% annually. Note, however, that the marked increase in the amount of grants is primarily achieved by increasing the amount of grants to support measures to balance the budgets of the Russian regions. The growth of this type of transfer is planned at a level of 45.7% in nominal terms and 38.0% in real terms in 2013.

The additional increase in financial aid to Russian regions, by RUR 100.0 billion annually, in the form of grants to support measures to balance their budgets in 2013 - 2015 is associated with the increased expenditure commitments of subnational budgets in the process of implementation of the Presidential Decrees dated 7 May 2012. In addition, the Law provides for the distribution of RUR 60 billion in grants for partial compensation of the additional costs of increasing the wages of public sector employees. It should be noted that the increase in expenditure commitments on wages of public sector employees at a rate exceeding the increased rate of tax and non-tax revenues of the regional budgets introduces risks for the balance of the budget system as a whole, in the face of the uncertainty in the global economy, given that such current expenditure commitments are extremely difficult to reduce. In the case of deterioration of the global conditions, the subnational budget deficits could increase substantially, and this would require a significantly greater amount of additional financial aid to the regions to be provided by the federal government (given that during the crisis market borrowing opportunity would be sharply reduced). It should be borne in mind that the current budget projections for 2013 already include an increase in the federal budget deficit from 0.06% of GDP in 2012 to 0.78% of GDP in 2013. Thus, we can say that the federal government resolutions have created additional expenditure commitments for subnational budgets which result both a deterioration of condition of the regional budgets in terms of their expenditures and total tax and non-tax revenue proportions, and to increases in the overall risk for the budget system of the Russian Federation.

Examples of opaque mechanisms for providing the equalising grants include the following amounts from the Law on the Federal Budget for 2013 - 2015 to be allocated to a number of regions, which are reflected as a separate line, in fact beyond any methodological framework of distribution of the remaining amounts of equalising grants:

- Grants to support measures to balance the budget of the Chechen Republic in 2013 amounting to RUR 23,555.2 million,
- The grant to the Omsk Region budget to balance the budget in the amount of RUR 1,000.0 million annually during 2013 - 2014,

- Grants to the budget of St. Petersburg to increase the authorised capital of Western High-Speed Diameter JSC, in the amount of RUR 20,000.0 million in 2013 and RUR 10,709.7 million in 2014.

The latter amount allocated to the budget of St. Petersburg raises additional questions. Based on the name of the transfer, it obviously has a special purpose, yet it has been granted in the form of a non-purpose transfer (grant).

The Law we are investigating also provides for some indexation of grants to equalise fiscal capacity (allocated from the Fund for Financial Support of the Regions (FFSR)) in 2013 - 2015 relative to the level of 2012. In 2011 - 2012, the FFSR amount remained at the 2010 level, so the proposed indexation of its amount can be positively evaluated. But the amount of this indexation is ambiguous. An increase in equalising grants is provided only for 2013, at 5.5%, i.e. at the projected rate of inflation. Then, in 2014 - 2015 the FFSR amount will be maintained at the 2013 level. As a result the FFSR amount in 2013 in real terms is 11.1% less when compared to 2010. In 2014 - 2015, if there is no further indexation, the decline in real terms will continue. In this case, the need for financial resources to equalise the fiscal capacity of the RF regions at least does not decrease. Perhaps, in 2013, under the new draft federal budget for 2014 - 2016 the new increased FFSR amount will be determined (again the same for all three years).

In general, the trend to increase the amount of grants and their share in the total amount of inter-budget transfers (it is planned to increase this share from 36.4% in 2012 to 50% in 2014 - 2015) should be appreciated, however, as noted above, this increase is achieved primarily through equalising grants. As a result, it does not lead to a significant increase in the level of transparency of intergovernmental fiscal relations between the federal centre and the regions and does not allow them significantly to improve their financial autonomy (as the distribution of balancing grants is much less transparent, predictable and methodologically sound than the distribution of grants to equalise the fiscal capacity). From this point of view, it would be logical to increase the FFSR by comparable amounts.

In 2013 - 2015 it is planned significantly to reduce the **subsidies**: by 32.8% in nominal terms in 2013 (as compared to the previous year), by 21.3% in 2014 and by 4.3% in 2015. As a result, their share in the total amount of inter-budget transfers should be reduced from 39.6% in 2012 to 24.6% in 2015. It is proposed to reduce the amount of subsidies from the federal budget in the following areas: housing and utilities (75.0%), public health (54.4%), physical education and sports (33.8%) and the national economy (29.7%). At the same time, it is planned to increase the subsidies for national security and law enforcement (81.1%), environmental protection (374.3%) and social policy (17.0%). Budget estimates provide for the reduction of subsidies from 104 in 2012 to 93 then 81 and 70 types for the years 2013 - 2015 respectively. In general, the trend to decrease the number of grants and their share in the total federal transfers should be assessed as positive. The current system of a large number of separate subsidies, where the total amount in some areas does not exceed (or is barely above) RUR 1 billion significantly reduces the efficiency and transparency of the Russian system of inter-budget relations, mainly in terms of excessive restrictions as regards free decision-making by regional authorities against the discrepancies of federal and regional priorities in some cases (i.e. the federation can not correctly identify what people really need in this or that region). However, the proposed reduction of subsidies is obviously insufficient.

It is important to note that the "Main targets of the budgetary policy for 2013 and the planning period of 2014 and 2015" is to propose "to consolidate the currently applicable subsidies

into single ones under the relevant state programmes for each chief administrator of the federal budget." The Order of the Federal Government No. 1950-r dated 11 November 2010 approves a list of 41 state programmes of the Russian Federation (as amended). In this case, each programme provides for one responsible person (federal ministry or agency) and collaborators (federal ministries or agencies). Comparing the number of government programmes and the expected number of subsidies allows us to draw the clear conclusion that more than one subsidy will be allocated under at least some state programmes, which seems to be unnecessary and to over-complicate the system of inter-budget transfers. It should also be borne in mind that not every programme provides for the co-financing of regional expenditures from the federal budget, just because the relevant authority is exclusively assigned to the federation. By this we mean such programmes as "Russia's space activities", "The development of the nuclear power industry," "Ensuring the defence capability, "Foreign policy activities", etc. Thus, we can say that the number of subsidies planned by 2015 exceeds more than 2 times the number of state programmes. It is important to note that the law on the federal budget for 2012 - 2014 provided for a reduction in the number of subsidies down to 70 in 2013 and 62 in 2014, i.e. the plans have been significantly adjusted to increase the number of subsidies. Thus, there is obviously a clear inhibition of the reforming process for the mechanism for allocation of subsidies from the federal budget, which may significantly affect the transparency and efficiency of inter-budgetary relations between the federation and the regions.

In 2013, it is also planned to decrease the amount of **subventions** (by 9.5% in 2013 as compared to 2012) and reduce **other IBTs** (by 9.2% in 2013 as compared to the previous year). Despite the decrease in the total of other IBTs, in 2013 it is planned to allocate significant funds to finance the purchase of diagnostic tools and antiviral drugs for the prevention, detection, monitoring and treatment of persons infected with the human immunodeficiency virus and hepatitis B and C, in the amount of RUR 14 billion (25.2% of the total amount of other inter-budget transfers), as well as other IBTs related to the implementation of activities on the preparation and holding of the 2018 World Cup in the Russian Federation (for the design and construction or renovation of stadia in the amount of RUR 4.9 billion). The latter amounts are lump sums and more related to solving the current economic and social problems, so after 2014 it is proposed to decrease other inter-budget transfers by 17.8% as compared to 2013. In addition, after 2014, the grants and inter-budget transfers for the development and support of the social and physical infrastructure allocated by the federation to the Closed Administrative-Territorial Entities will be consolidated into a single inter-budget transfer in the form of a grant. Thus, a part of the amount of other inter-budget transfers will be redistributed in favour of grants to Closed Administrative-Territorial Entities. As a result, in 2014 - 2015 it is planned to reduce the share of this type of transfer from 4.3% in 2013 to 3.6% in 2015. However, given the budget plan for 2012 and the actual amount of other IBTs for the year, we can forecast that this type of transfer can be significantly changed during the year. Thus, the amount of other IBTs allocated in 2012 was 67.3% higher than had been initially planned.

In general, it should be noted that the parameters of the Federal Law "On the Federal Budget for 2013 and the planning period of 2014 and 2015" raises a number of serious issues in terms of inter-budgetary relations with the Russian regions as regards the improvement of the efficiency of the Russian system of federalism. Firstly, insufficient indexation of balancing grants with a significant increase in the balancing grants themselves does not allow for enhancement of the transparency and predictability of the process of allocation of federal

transfers to the regions. Secondly, there is an apparent inhibition of reforming the mechanism of co-financing regional expenditures through the mechanism of allocating subsidies against the adjustment of plans, to reduce their number significantly. In this case, it is unclear how much subsidy will eventually be allocated in 2013 and whether there is a planned significant decrease in the amounts of these transfers.

Section 3. Financial Markets and Financial Institutions

3.1. The Post-Crisis Recovery of Russia's Financial Market

In 2012, Russia's stock market failed to recover its pre-crisis indices. After their decline in the previous year, in 2012 the RTS Index rose by 10.5%, the MICEX Index – by 5.2%. After that, there was no hope for a V-shaped recovery of the Russian stock market: the movement of its indicators rather strictly followed a W-shaped trajectory.

The crisis of 2008–2009 was milder than its predecessor in 1997–1998, both in terms of depth and longevity of the downfall of the market indexes (*Table 1*). In the late 1990s, the RTS Index dropped by 91.3%, the MICEX Index - by 73.0%; in 2008–2009, the two indexes dwindled by 78.2% and 68.2% respectively. In 1997–1998, the RTS Index was on the decline for 14 months, and the MICEX Index – for 13 months in a row; the length of decline of these two indexes in 2008–2009 was 8 and 7 months respectively.

Table 1

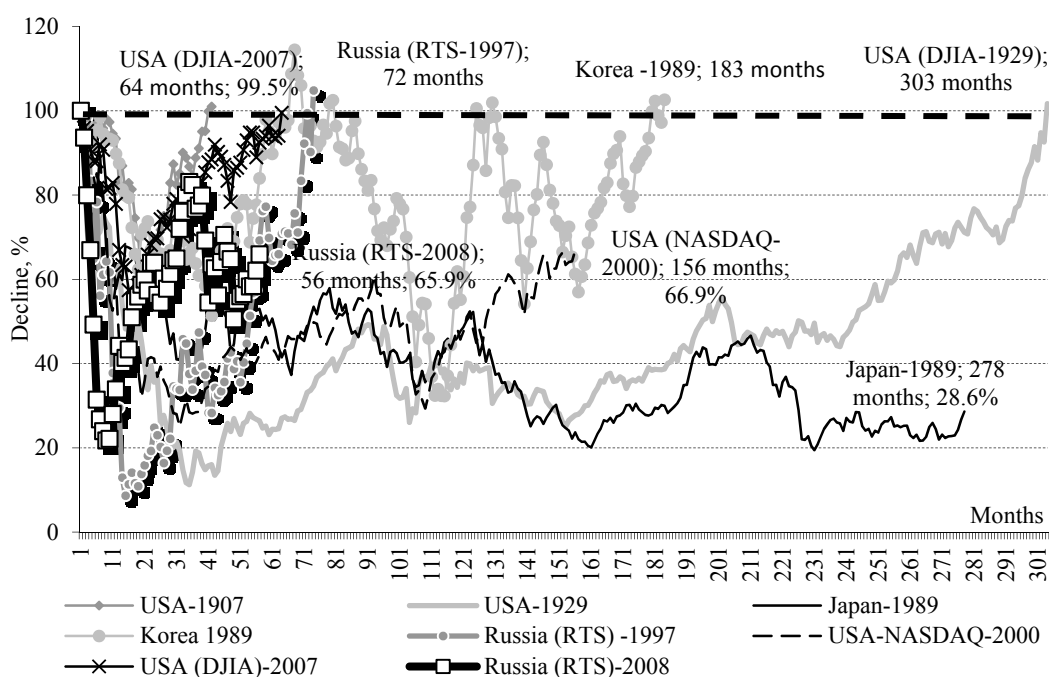
The Financial Crises of 1997/98 and 2008/09 in Russia and the Market's Subsequent Recovery (as of 31 January 2013)

	1997/98 crisis	2008/09 crisis
1. Decline, from peak		
1.1. Depth, %		
RTS Index	-91.3	-78.2
MICEX Index	-73.0	-68.2
1.2. Length, months		
RTS Index	14	8
MICEX Index	13	7
2. Recovery, months		
RTS Index	58	48
MICEX Index	8	49

Source: data released by the Moscow Exchange.

However, the recovery of stock prices after the last financial crisis is becoming a lengthy process. During the 1997–98 crisis, due to the 5-fold depreciation of the ruble, the ruble-denominated MICEX index returned to its pre-crisis record high within a period of only 8 months, while the recovery of the RTS Index denominated in foreign currencies lasted for 58 months. In 2008–2009, the value of the ruble dropped approximately by 50%, and in the course of its subsequent strengthening against major foreign currencies approximately one-half of its lost value was recovered. That is why both these indexes are now recovering at nearly the same rate – the RTS Index for 48, and the MICEX Index – for 49 successive months.

Against the backdrop of last century's biggest long-term financial crises (*Fig. 1*), the current financial crisis in Russia appears to be a short-term one. Its W-shaped trajectory resembles the development pattern of the Korean financial crisis of 1989, which lasted for 183 months – while Russia's current drop-recovery cycle has lasted for only 56-months. In the situation of the current lengthy recession of the global economy it would be useful to remember that, over the course of modernity, the stock indexes sometimes failed to return to their former historic highs. After its drop in 1989, the recovery of Japanese Nikkei-225 Index has been continuing for 278 months, and by January 2013 it has gained only 28.6% of its former peak value. If things remain the way they are, in twenty-five months the Nikkei-225's 'recovery' will be the slowest in history, surpassing the current record of 303 months set by the Dow Jones Industrial Average (DJIA) in the aftermath of the Great Depression of 1929–1933. The NASDAQ Composite Index (USA) in January in 2013, after a 156-month recovery period, had increased to only 66.9% of its 2000 record high. By its recovery schedule and its W-shaped trajectory, that index also resembles the recovery parameters of the Korean stock market after its collapse in 1989.

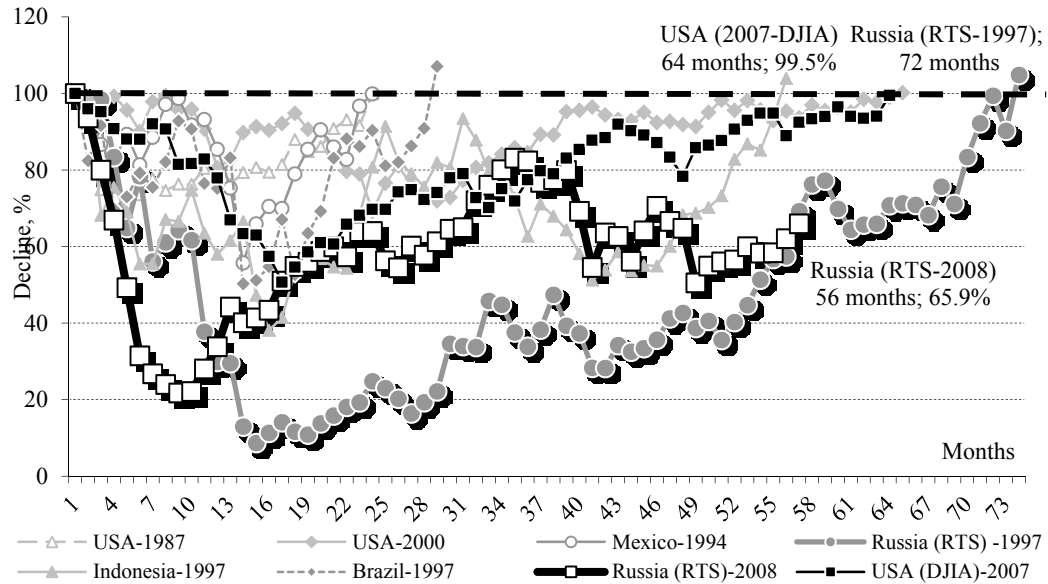


Source: data released by the Moscow Exchange; www.finance.yahoo.com.

Fig. 1. Depth and Length of Long-term Financial Crisis across the World, As of 31 January 2013 (Peak = 100%)

When set against the most famous short-term financial crises in the USA in 1987, 2000 and 2007; in Mexico in 1994; in Indonesia in 1997; and in Brazil in 1997, the Russian crisis of 2008/2009 appears to be remarkable by its depth and longer period of recovery (*Fig. 2*). These specific features can be explained not only by the protracted recession experienced by the world's leading economies, but also by the weakness of Russia's stock market caused by the declining rate of economic growth, continuing capital outflow and unresolved institutional problems. In January 2013, the DJIA in the US – in contrast to the indicators of Russia's stock market – managed to return exactly to its 2007 historic high. By that moment, Russia's

RTS Index had amounted to only 65.9% of its pre-crisis historic high of 2008. It is noteworthy that, as seen by the past 56 months, its current pattern and recovery level began to follow precisely the timeline and recovery level of the RTS Index after the 1997 crisis.



Source: data released by the Moscow Exchange; www.finance.yahoo.com.

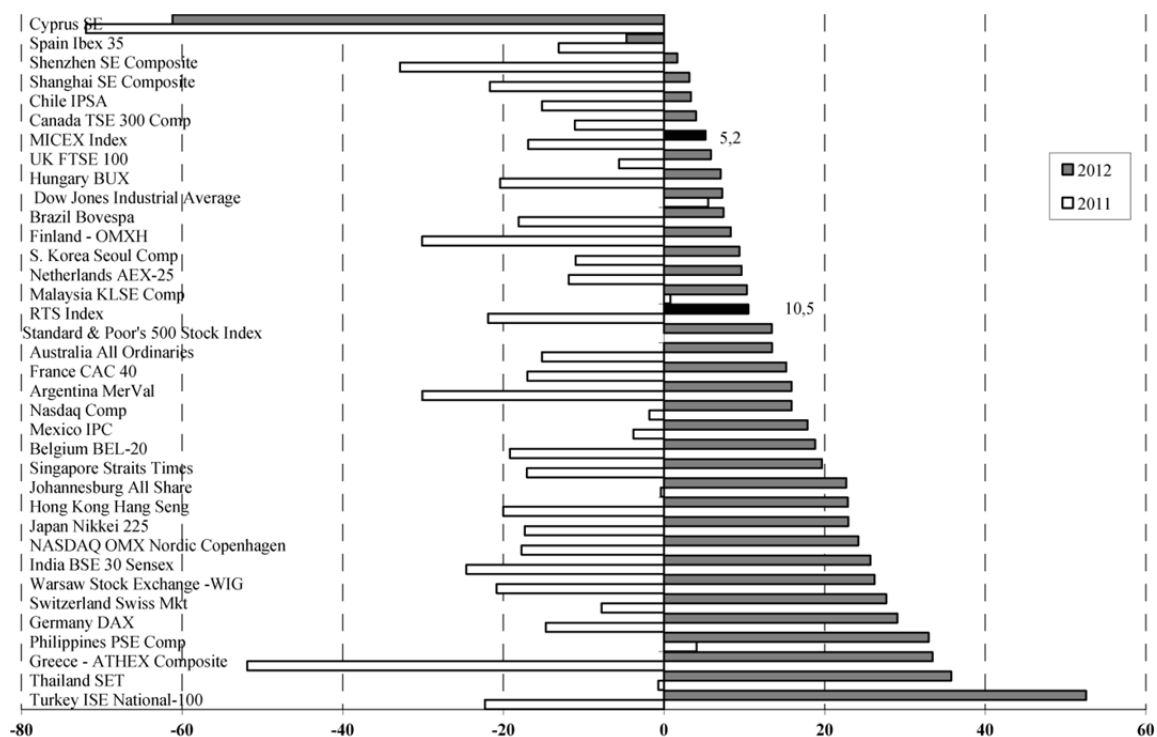
Fig. 2. Depth and Length of Short-term Financial Crisis across the World, As of 31 January 2013 (Peak = 100%)

When the movement of the RTS and MICEX indexes is compared with that of similar indicators of the stock markets in other countries, an interesting trend reveals itself that has already been visible for a second year in a row. The behavior of the Russian indexes can no longer be regarded as fitting an extreme pattern. This means that, in terms of yield, they used to be either leaders or outsiders among the indexes of all the other markets. However, now the Russian indexes, by their annual yield, fit somewhere in the middle of the list of other countries' indexes (Fig. 3). In 2011, this specificity could be seen against the backdrop of an across-the-board decline in stock indexes; in 2012 – in conditions of the moderate growth demonstrated by the world stock prices. This phenomenon has to do with the multi-vectored influence exerted on the Russian stock market by the increasingly complex variety of factors, and first of all the movement patterns of oil prices, portfolio assets of foreign investors, domestic liquidity, and some other factors.

One of the most important trends in the development of stock markets across the globe in 2012 was the continuing shrinkage of trade volumes on stock exchanges (Table 2). Over that period, the volume of trade in shares on US stock exchanges amounted to only 54.5% of its 2007 level; the value of that index for the London Stock Exchange, *Euronext* (Europe), and *Deutsche Börse* was 21.3%, 27.9%, and 37.9% respectively. This situation largely emerged due to investors' avoidance, on a mass scale, of risky investments during the period of protracted recession.

At the same time, one cannot rule out the effect of institutional investors' mistrust of the modern exchange trade mechanisms, caused by the accelerated growth rate of the number of participants resorting to high-frequency trading and other types of speculative strategies. This

fact is confirmed, in particular, by the published correspondence between the Investment Company Institute and the US Securities and Exchange Commission (SEC), which states the necessity of regulating the activity of market participants engaged in high-frequency trading. In the opinion of the organization uniting biggest US investment management companies, high-frequency trading – whose share in the US securities market is estimated to be 50–70%, is fraught with some significant risks for the industry of open-ended funds¹, because it uses confidential information on big bids, resorts to market manipulation through front-running, and induces unjustified liquidity turmoils on the securities market. The ICI fears that such activities may result in market disorganization and provide high-frequency traders with advantages over long-term investors². One of the manifestations of the risks associated with high-frequency trading was the collapse, in 2012, of Knight Capital Group Inc. - a broker company notorious for promoting such trading strategies and taken over by *Getco* LLC – a Chicago-based company³. On 1 August 2012, as a result of the incorrectly installed new software applied by *Knight Capital* in its transactions, the NYSE’s trading system was flooded by erroneous bids, which caused the broker company’s losses in the amount of \$ 440m.



Source: data released by the Moscow Exchange; www.finance.yahoo.com; World Federation of Exchanges (WFE).

Fig. 3. Yields on World Stock Indexes in 2011–2012, %

¹ The letter addressed by the Investment Company Institute (ICI) to SEC, as of 10 April 2010, concerning proposals relating to the securities market’s structure. See its full text on the ICI’s official website: <http://www.ici.org/pdf/24266.pdf>

² Patterson S. *Probe Sparks Split on Trades*. WSJ, 17 December 2012. Russian translation: *Neiutno na birzhe. Vedomosti*, 19 December 2012.

³ Strasburg J., Patterson S. *High-Speed Traders Race to Fend Off Regulators*. WSJ, December 27, 2012.

As estimated by Tabb Group, the share of off-floor trading systems functioning by the principle of dark pools on the US stock market increased from 3% in 2007 to 15% in 2012¹. A substantial part of such trading involves shares withdrawn from the exchange.

The situation with share market liquidity on the Moscow Exchange was rather controversial. The volume of (anonymous) market exchange transactions with shares in 2012 dropped to only 44.7% of its 2007 level, while only a year ago, when the RTS and the MICEX merged, it was as high as 151.9% - with the same base. On the contrary, the volume of transactions in shares carried on in all trade modes in 2012 rose by 25.7% on 2007. This happened because the main mode of trade in shares on the Moscow Exchange included the repo market, which is indirectly supported by the Bank of Russia².

Table 2

**Behavior of Market Transactions with Shares on Major Global Stock Exchanges
in 2007–2012, in Terms of Value (2007 = 100%)**

	2007	2008	2009	2010	2011	2012
USA (NYSE и NASDAQ)	100	150.2	109.7	71.5	72.2	54.5
China (two exchanges)	100	70.2	114.9	103.1	98.5	63.8
Japan (Tokyo and Osaka exchanges)	100	90.5	64.5	65.9	64.0	55.5
UK	100	62.8	33.0	29.1	28.8	21.3
Euronext	100	78.2	35.1	35.8	37.8	27.9
Germany	100	92.3	38.3	41.8	52.3	37.9
Hong Kong	100	177.4	162.5	174.2	169.2	120.6
Canada	100	107.6	75.3	83.0	92.4	82.5
Australia	100	76.9	57.6	92.4	94.2	70.8
Russia (MICEX – market transactions)	100	74.5	90.5	106.0	151.9	44.7
Russia (MICEX – all trade modes)	100	117.2	71.4	84.1	134.6	125.7
NASDAQ OMX Nordic Exchange	100	73.6	40.3	41.3	45.6	32.3

Source: calculations based on data published by the World Federation of Exchanges (WFE).

Table 3

Movement of Domestic Market Capitalization in 2007–2012 (2007 = 100%)

	2007	2008	2009	2010	2011	2012
USA (NYSE and NASDAQ)	100	58.3	76.7	87.9	79.5	94.9
China (Shanghai SE)	100	38.6	73.2	73.5	63.8	68.9
Japan (Tokyo Exchange)	100	71.9	76.3	88.4	76.8	80.3
UK	100	48.0	72.5	80.5	75.2	88.0
Euronext	100	49.8	68.0	69.4	57.9	67.1
Germany	100	52.8	61.4	67.9	56.3	70.6
Hong Kong	100	50.1	86.8	102.1	85.1	106.7
Canada (TMX Group)	100	47.3	76.7	99.3	87.4	94.2
Australia (Australian SE)	100	52.7	97.2	112.0	92.3	106.8
Russia*	100	26.4	57.3	91.7	72.9	71.8
NASDAQ OMX Nordic Exchange	100	45.3	65.8	83.9	67.8	80.1

* Based on data released by S&P for the period of 2007–2012.

Source: calculations based on data published by the World Federation of Exchanges (WFE).

The movement of market capitalization indices on the world exchanges appears to be more optimistic inducing than the situation with liquidity. In 2012, the capitalization of companies on US exchanges rose to 94.9% of its pre-crisis 2007 level. The same index for Japanese stock exchanges amounted to 80.3%, for UK – 88.0%, for Germany – 70.6%, for Hong

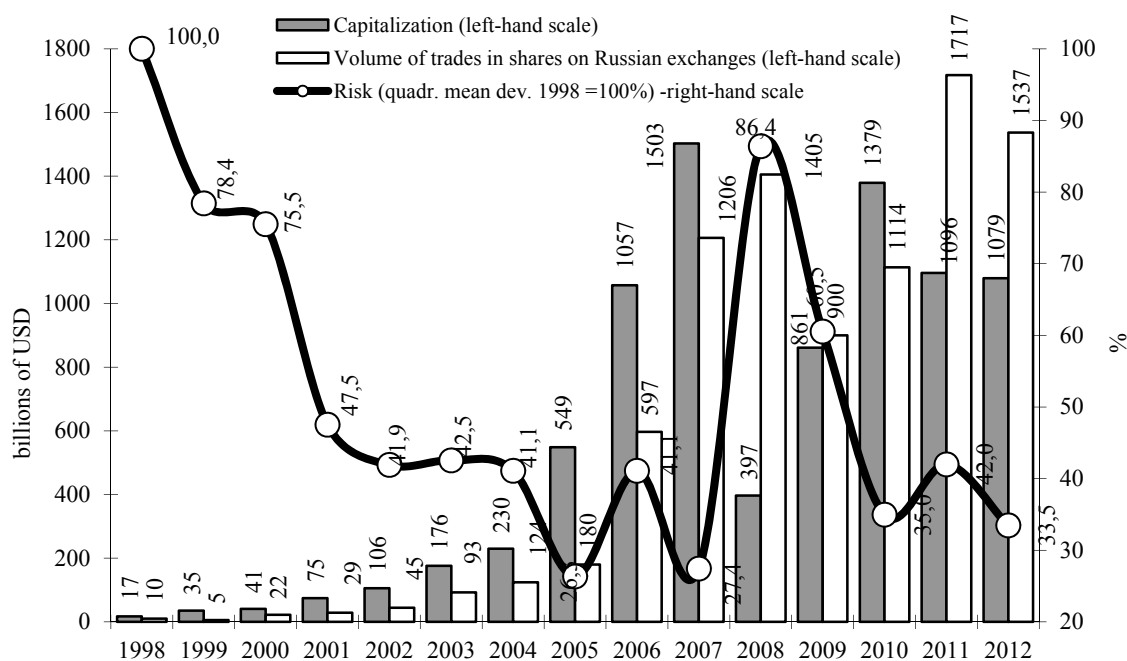
¹ See Patterson S. *Finra CEO Says It Is Expanding Oversight of Dark Pools*. WSJ, January 8, 2013.

² As a rule, the Bank of Russia conducts a limited number of repo operations on the stock exchange market. However, the high liquidity volume that it supplies to biggest banks via the bond repo market enables these banks to use part of their excessive liquidity for the issuance of loans to brokers and their clients on the share repo market.

Kong – 106.7%, for Canada – 94.2%, for Australia – 106.8%, and for *Euronext* – 67.1%. In 2012, even in face of the declining liquidity on the exchanges, capitalization indices began gradually to return to their pre-crisis level due to the rising prices of stocks traded on the world’s biggest stock exchanges.

The capitalization of Russian joint-stock companies in 2012 amounted to \$ 1.1 trillion, or 71.8% of its 2007 level, which generally corresponds to the rates of recovery displayed by that index on the world’s major trading floors. However, the specific feature of capitalization in Russia in 2012 is that, in contrast to the other countries included in our overview, and in spite of the rising values of the RTS and MICEX indexes, its rate, instead of increasing, dropped on its 2011 value (*Fig. 4*). This is the result of withdrawal of some Russian issuers into foreign jurisdictions, as well as the modest annual results reported by a number of big companies. Thus, for example, in 2012 the price of share in the state-owned OJSC *Gazprom* dropped from Rb 183.8 to Rb 143.7, or by 28.1%, while its profits shrank by 11% which, according to expert analysts, reflects the competitive capacity and dividend policy problems faced by this emitter. Thus, analysts from UBS believe that *Gazprom* is the most underestimated oil and natural gas producer in the world¹. This is a good illustration of how the insufficient effectiveness and low corporate governance level in a state-owned company may become a serious obstacle to its capitalization growth.

The aggregate volume of transactions in shares carried on in all trade modes on the Moscow Exchange decreased from \$ 1.7 trillion in 2011 to \$ 1.5 trillion in 2012, or by 10.8%. In 2012, the share market’s volatility (measured in terms of standard deviation of the RTS Index’s daily fluctuations) dropped on the previous year and amounted to 33.5% of its 1998 level.

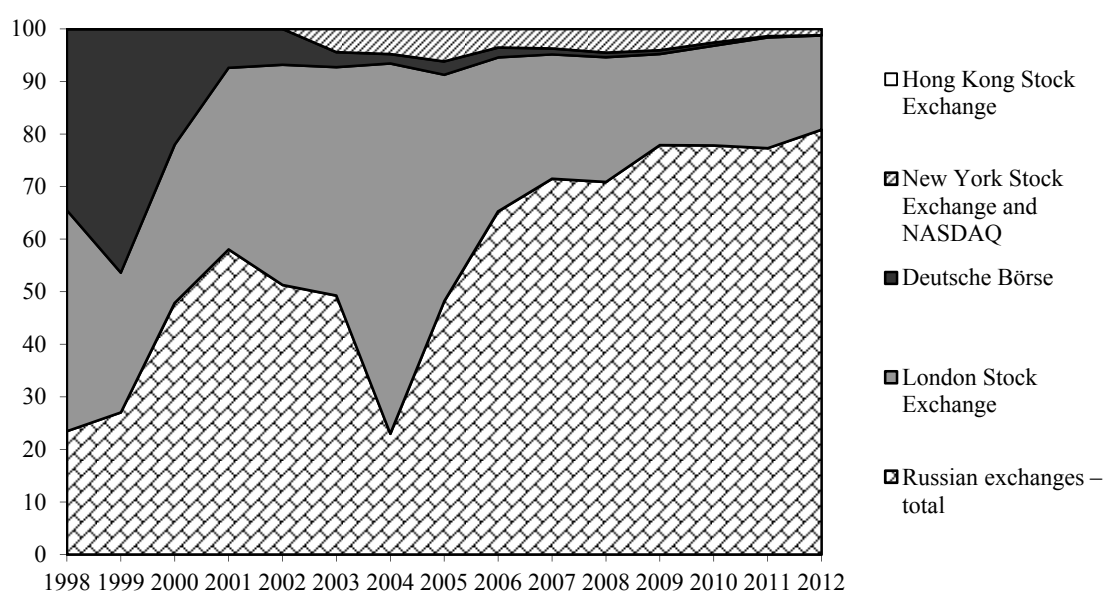


Source: estimates based on market capitalization data released by the Moscow Exchange and S&P.

Fig. 4. Capitalization, Liquidity and Volatility of the Russian Share Market

¹ Khodiakova E. *Novyi antirekord Gazproma*. [*Gazprom’s New Record*]. *Vedomosti*, 13 February 2013.

In terms of its aggregate volume of transactions in shares carried on in all trade modes, the Moscow Exchange in 2012 managed to maintain its status of major organizer of trade in this type of financial instruments (shares and depository notes) issued by Russian emitters (*Fig. 5* and *Table 4*). The participation of the Moscow Exchange in trade in shares and depository notes increased from 77.3% in 2011 to 80.8% in 2012. Meanwhile, the relative volumes of trade carried on by the London Stock Exchange, *Deutsche Börse* and the two major US exchanges shrank by a noticeable degree. However, this happened by no means because Russia's major exchange became more attractive for global investors, the simple reason being that the foreign exchanges – in contrast to Moscow's trading floor – could not rely on the central bank's liquidity support mechanism.



Source: estimates based on data released by Russian and foreign exchanges.

Fig. 5. Participation of Exchanges in the Trade in Shares Issued by Russian Joint-stock Companies

Table 4

Participation of Exchanges in the Trade in Shares Issued by Russian Joint-stock Companies

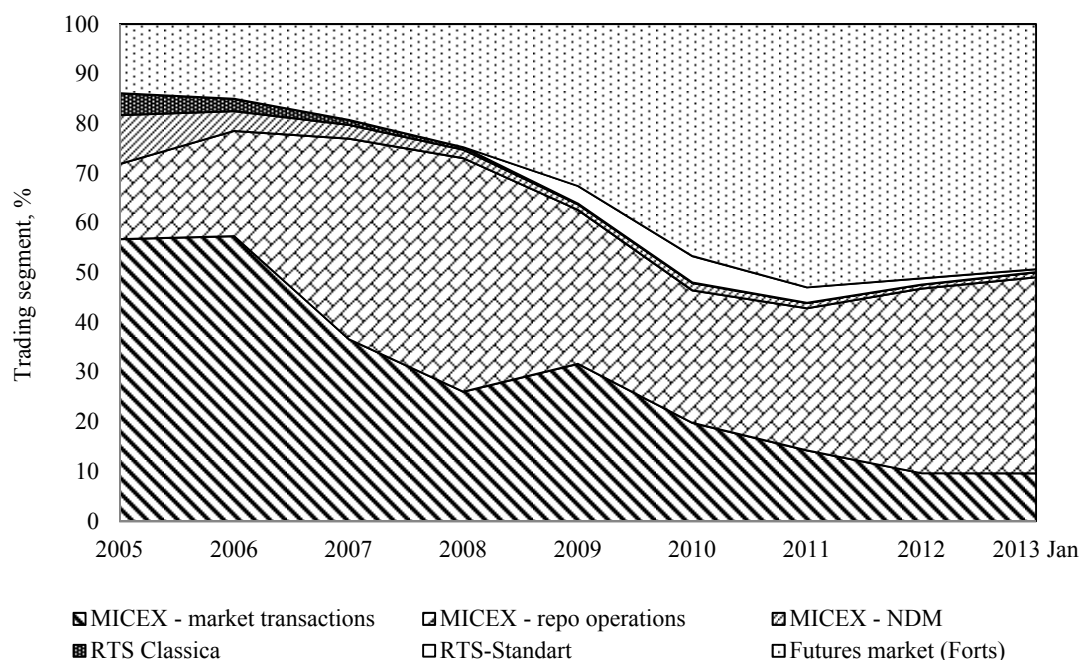
	2000	2005	2010	2011	2012
MICEX	36.0	38.1	69.9	72.1	78.7
RTS Classica	11.9	2.0	0.2	0.1	0.03
RTS T+0 Market		0.8	0.02	0.01	
Saint-Petersburg Exchange	0.003	7.3	0.001	0.001	0.0002
RTS Standard			7.7	5.1	2.1
Russian exchanges – total	47.9	48.2	77.8	77.3	80.8
London Stock Exchange	30.1	43.1	19.0	21.1	17.9
Deutsche Börse	22.0	2.6	0.6	0.3	0.05
NYSE and NASDAQ		6.2	2.6	1.4	1.2
Hong Kong Stock Exchange			0.031	0.009	0.005
Shares and depository notes – total	100.0	100.0	100.0	100.0	100.0

Source: calculations based on data released by Russian and foreign exchanges.

A serious defeat suffered by the Russian stock market in the fierce competition between exchanges – and one that may be fraught with far-reaching consequences, as it has created a

precedent for the national companies – is the switchover of such companies as *Polyus Gold*, *Polymetal*, and the holding company *Mail.ru* to offshore jurisdictions and onto the London Stock Exchange’s main market.

Fig. 6 and *Table 5* demonstrate changes in the structure of different trade modes on Russian exchanges, including operations carried on in the FORTS futures and options market. After the merger, in December 2011, of the two largest Moscow-based exchanges, this structure significantly altered. The share of market transactions dropped from 14.3% in 2011 to 9.7% in 2012, which became a strong negative factor because it is the volume of market (anonymous) transactions that truly reflects the effectiveness of a stock exchange as a pricing center and provides a base for all stock indexes. The futures market’s share over the same period shrank only slightly - from 53.0% to 51.1%. Market transactions on the spot and futures markets gave way to repo operations, whose relative volume over the year rose from 28/6% to 37.1%.



Source: calculations based on data released by Russian exchanges.

Fig. 6. The Market Structure of the Moscow Exchange, January 2005 through January 2013

Another important development after the merger of the two exchanges was the gradual disappearance of Standard - the market segment where the more sophisticated mechanisms of guarantees and settlements of exchange operations with shares were tested. This segment shrank from 3.1% in 2011 to 1.3% in 2012. In 2012, the Moscow Exchange significantly reduced its reward programs for market makers in the Standard segment which, as estimated by its own specialists, resulted in a sharp drop of the trade volume¹. However, there is some ground for believing that, in 2013, the Moscow Exchange will fully switch over to applying T+2, thus introducing an adequate replacement for Standard.

¹ Trifonov A. *Birzha nedoschitalas' 9 trln rub.* [The Exchange Lost Rb 9 Trillion] *Vedomosti*, 18 January 2013.

Table 5

**The Structure of the Moscow Exchange's Share Market from January 2005
through January 2013**

	2005	2006	2007	2008	2009	2010	2011	2012	Jan 2013
MICEX – market transactions	56.7	57.4	36.6	26.1	31.7	19.8	14.3	9.7	9.6
MICEX – repo operations	15.1	21.1	40.3	47.0	31.0	26.7	28.6	37.1	39.4
MICEX – Negotiated Transactions Mode	9.8	4.0	2.8	1.7	1.1	1.5	1.1	0.8	1.0
RTS Classica	4.4	2.5	1.0	0.5	0.2	0.1	0.0	0.0	0.0
RTS Standard					3.5	5.3	3.1	1.3	0.6
Futures market (Forts)	13.9	15.0	19.3	24.8	32.6	46.7	53.0	51.1	49.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: calculations based on data released by Russian exchanges.

The market IPO-SPO represents a weak component of the Russian exchange system, as the participation of the Moscow Exchange in the total volume of public placements of shares issued by Russian companies remains close to zero. According to *Dealogic*, in 2011 Russian companies undertook IPO-SPO to the total value of \$ 11.3bn but, as stated by NAUFOR (Russian National Association of Securities Market Participants), the Moscow Exchange launched only IPO in the amount of \$ 0.75bn¹. In 2012, out of the total of \$ 9.5bn of public placements, the value of shares placed by the Moscow Exchange amounted to \$ 0.15bn. Within the framework of the two biggest public placements by Russian companies, the volume of shares purchased through offering on the Moscow Exchange amounted to 2.9% (*Sberbank* [The Savings Bank of Russia]) and 2.3% (*MegaFon*)².

The events of early 2013 have given rise to some hopes that the problem posed by the reluctance of Russian issuers to place their shares via the Moscow Exchange may – at least in part – be resolved. At the general government meeting held on 25 January 2013, President Vladimir Putin said that privatization deals in the form of IPO should be carried out in such a way that would ensure the circulation of issued shares on Russian exchanges. This requirement will probably be reflected in some normative legal acts.

Besides, on 15 February 2013 the Moscow Stock Exchange successfully launched an IPO in the amount of Rb 15.0bn. Its specificity was that all the additionally issued shares were to be placed exclusively on Russian trading floors. This relatively successful IPO has proved that large-scale placements of securities may indeed be made on the domestic market and attract biggest international investors.

In addition to providing a solution to the problem of ensuring the participation of Russian companies in the public placement market, the Moscow Exchange will also have to reverse the negative trend towards de-listing the shares of big emitters which emerged in 2011–2012. As stated in the reports released by CJSC MICEX, the number of emitters of shares operating on the exchange had shrunk from 320 in 2011 to 275 in 2012, or by 14.1%; and the number of issues of shares – from 418 to 368, or by 12.0% respectively.

In 2012, more than 30 big joint-stock companies left the Moscow Exchange, including *Petersburg Energy Sales Company*, *Kurganenergo*, *SUEK-Krasnoyarsk* (Siberian Coal Energy Company), *Far-Eastern Bank*, *Vykxa Steel Works*, *Baskirenergo*, *Podolsk Machine-building*

¹ Sovershenstvovanie protsedury emissii tsennykh bumag [Improvement of the Procedure for the Issuance of Securities] (Report by NAUFOR). 13 December 2011. See NAUFOR's official website <http://naufor.ru/tree.asp?n=9411&hk=20111216>

² Kuznetsov I., Ladygin D. *Pervichnoe razmeshchenie pensii. Rynok IPO poluchil prezidentskoe poslanie*. [Primary pension placement. The IPO Market Received the President's Message.]. *Kommersant*, 28 January 2013.

Factory, Kemerovo OJSC Azot, JSC Moscow Heat Distribution Network, OGK-1, OGK-2, OGK-3, Taganrog Metallurgical Works, Seversk Pipe Plant, Sinar Pipe Works, Tulagorvodokanal, TGK-13, *Kola Energy Sales Company*, Kazan Helicopters (Russian Helicopters), Ulan-Ude Aviation Plant (UUAZ), SIBUR Holding, Kuibyshevnefteorgsintez, RTM Group, Hutrinvestholding, Polymetal, JSC The Seventh Continent, Baltika Breweries, LOMO, Phosagro, and Bashinformsviaz. They did so for a variety of reasons: reorganization, low sales of their shares on the exchange, or reluctance to disclose their information in accordance with the International Financial Reporting Standards.

One manifestation of the worsening position of the Moscow Exchange in the global competition between exchanges is Russia's low global competitive capacity rating by the World Economic Forum (WEF), which estimates the ability of domestic markets to attract financial resources for the development of national companies. By that criterion, Russia was rated 125th among 139 countries in 2010, 127th among 142 in 2011, and 130th among 144 in 2012. In that year, India, Brazil and China were rated 19th, 40th and 46th respectively.

3.2. The Market for Shares Issued by Russian Companies

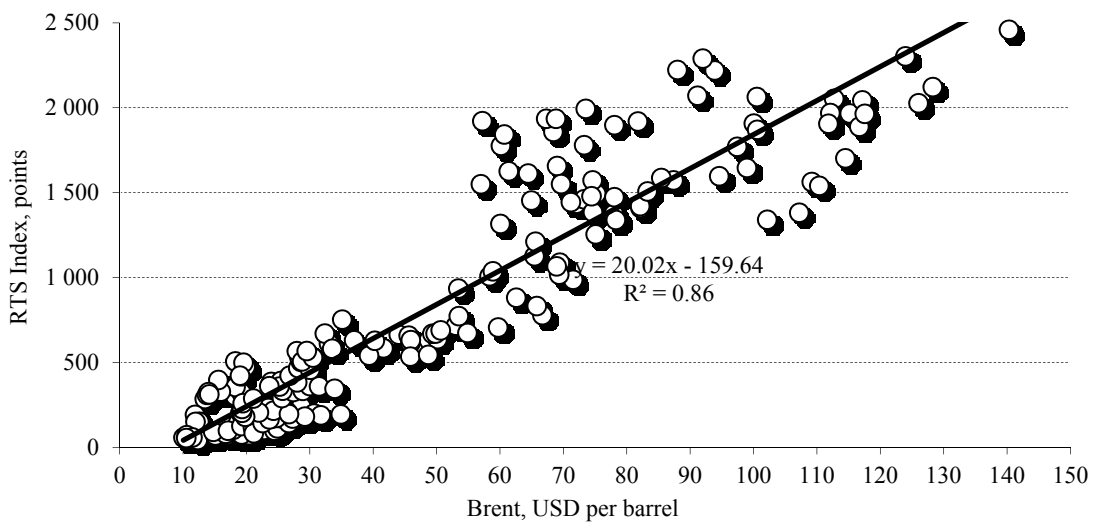
As in previous years, the main factors determining the movement of Russian stock prices were the global conjuncture of prices for raw materials, and primarily oil and gas prices; the behavior of foreign portfolio investors; the ruble's exchange rate against major foreign currencies; and instability of the world economy and financial system. The majority of these factors exist independently of the economic policy pursued by Russian authorities.

3.2.1. Dependence on the Global Conjuncture of Prices

The dependence of the market for the shares of Russian emitters on oil prices is a well-known fact. The coefficient of determination (R^2) between the absolute monthly values of the RTS Index and the price of Brent crude over the period from September 1995 through January 2013 is equal to 0.86 (see *Fig. 7*), which points to a very close interdependence of these two indicators.

According to the forecasts released by international financial organizations and the RF Ministry of Economic Development, no dramatic growth of oil prices can be expected in the next few years. The subdued outlook for oil prices stems from both by the moderate demand for oil in a situation of a slowdown in the global economy's growth rate coupled with the implementation of energy-saving technologies, and the emergence of technologies for the extraction of mineral resources, in particular shale oil and natural gas. As estimated by the RF Ministry of Economic Development, the availability of hydrocarbons from domestic sources in the USA will increase from 50% in 2010 to 66% in 2030; in terms of liquid fuel extraction, the USA remains the world's leader¹. Under such conditions, Russian energy carriers in the European and Asian markets will have to deal with growing competition from the countries of the Middle East and Central Asia, and probably from the USA as well.

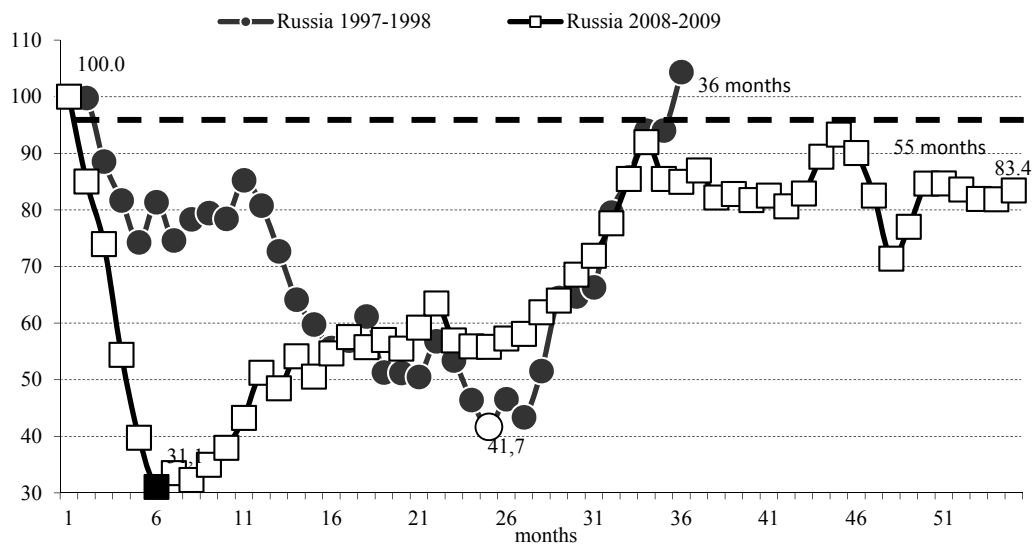
¹ Scenario Conditions of the Long-Term Forecast for the Socio-Economic Development of the Russian Federation until 2030 (Forecast-2030). January 2013, p. 32. See the RF Ministry of Economic Development's official website.



Source: calculations based on data released by IMF International Financial Statistics (IFS) and the Moscow Exchange.

Fig. 7. The Dependence of the RTS Index on the Price of Brent Crude, from September 1995 through January 2013

As a result, in accordance with the basic scenario for the development of Russia’s economy and the RF Ministry of Economic Development’s *Forecast-2030*, the price of Urals will rise to the level of \$ 127 per barrel (its pre-crisis record high of June 2008) only in the next decade, by 2023. As shown in Fig. 8, so far the correctness of such predictions has been confirmed by facts. In contrast to the 1997–1998 crisis period when oil prices returned to their previous level within 36 months, over the past 55 months they have climbed to a level of only 83.4% of their pre-crisis peak. Another feature of the present situation is that for 22 months in a row oil prices have remained relatively stable.

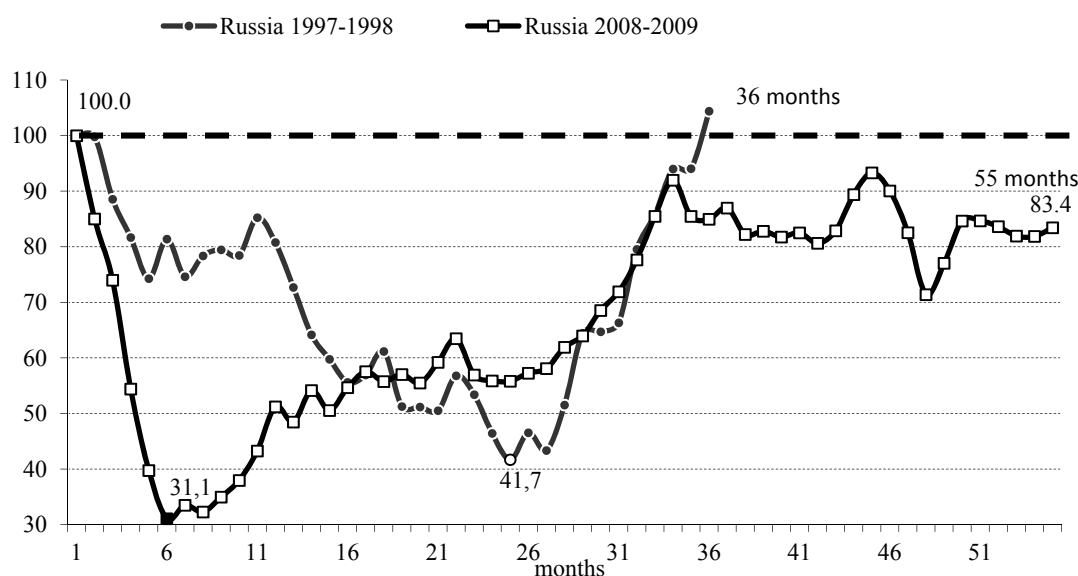


Source: data released by IMF IFS.

Fig. 8. Drops and Recoveries of the Price of Brent Crude During Financial Crises in Russia (Record High =100%), as of January 2013

A more accurate description of the interdependence between stock indexes and oil prices is based on the analysis of the relative changes in their values. *Fig. 9* demonstrates the results of changes in the coefficient of correlation between the monthly relative movements of the RTS Index and the price of Brent over a 12-month period. A specific feature of the sliding correlation curve is that it reflects the strengthening or weakening of the interrelation between the two indicators with a lag of one year.

The correlation curve describing the changing values of the RTS Index and the oil price has a cyclical nature. As the value of the Index approaches the pre-crisis peak, the coefficient of correlation declines and becomes negative. It means that the price of oil and the Index unexpectedly begin to change in two different directions. While the share market is plummeting, the positive correlation between the changes in the Index's value and the price of oil is reestablished. When the acute phase of the crisis is over, the correlation once again begins to move towards (-1).



Source: calculations based on data released by IFS IMF and MICEX-RTS.

Fig. 9. The Correlation between the Movements of the RTS Index and the Price of Brent Crude, from September 1995 through January 2013.

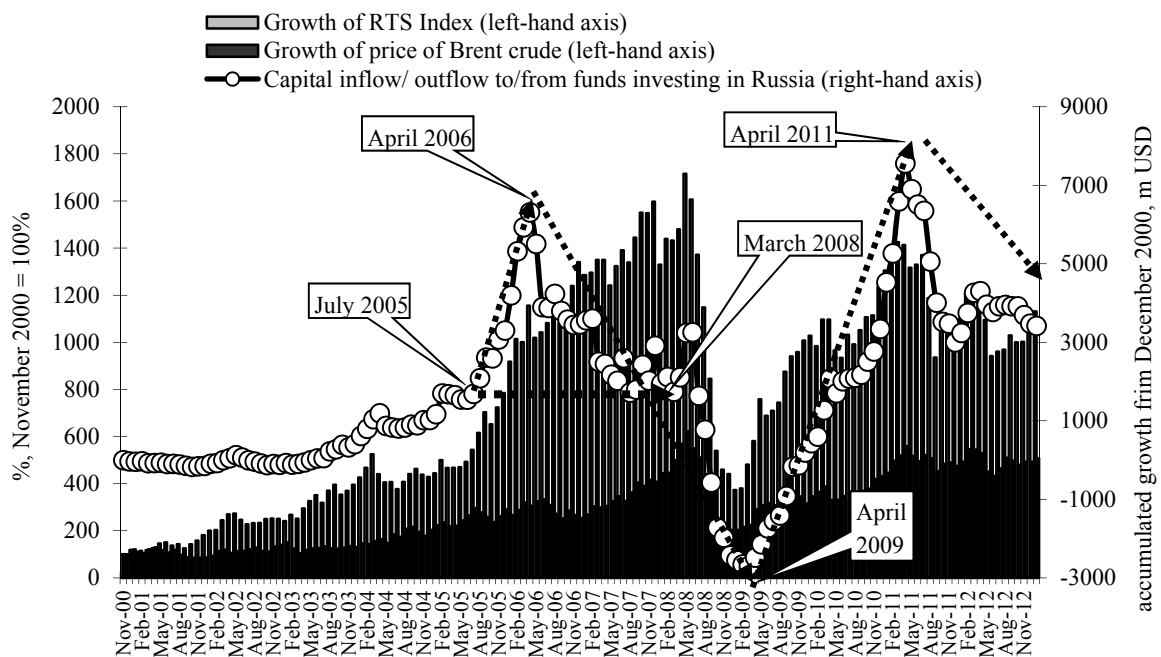
The correlation curve clearly displays five periods over the last decade:

- from the early 2000s through July 2005 the coefficient of determination increased from 0.2 to 0.5; oil prices and the RTS Index were moving upwards in one and the same direction;
- July 2005 – April 2008: the coefficient of determination declined from 0.5 to -0.5, oil prices and the RTS Index generally displayed an upward movement over that period, but in the second half of 2006 and the first half of 2007 there was a decline in oil quotations;
- April 2008 – April 2009: the coefficient of determination increased from -0.5 to 0.8, this was a period of plummeting oil prices and the prices of shares issued by joint-stock companies;
- April 2009–April 2011: the coefficient of determination declined from 0.8 to -0.2, the price of oil demonstrated a moderate growth, while the RTS Index displayed intensive recovery-related growth;

- in the period from May 2011 through January 2012, the coefficient of determination increased to 0.8 in April 2012, then slightly declined towards January 2013 to 0.6; over that period, prices of oil and the prices of shares issued by Russian joint-stock companies were generally on the decline.

3.2.2. Inflow/Outflow of Foreign Portfolio Investment

In terms of their influence on the prices of Russian shares, the outflow and inflow of funds provided by foreign portfolio investors and recorded by Emerging Portfolio Fund Research (EPFR)¹ represent a factor equal to the movement of oil prices, as shown in Fig. 10.



Source: calculations based on data released by IFS IMF, the Moscow Exchange and EPFR.

Fig. 10. Accumulated Growth of the RTS Index and the Price of Brent Crude, Capital Inflow (Outflow) into the Funds Specializing on Investment in Russia, from November 2000 through January 2013

As for the five periods during which the correlation of changes in the RTS Index and the movement of oil price was becoming distinctly different, an analysis of accumulated re-

¹ The data released by EPFR on capital inflow and outflow via the foreign funds specializing on investing in Russia may be treated as an indicator of the investment behavior of foreign big portfolio investors, including global and regional funds. According to our estimates, the portfolio held by specialized funds amount to approximately 50% of all investment in Russia made by regional and global investment funds. If, for example, investors withdraw their monies from a specialized fund, this should by no means be regarded as capital outflow from Russia. True capital outflow will occur only when a fund, in order to fulfill its obligations to investors, will begin to sell its shares in Russian joint-stock companies. If capital is withdrawn from global or regional funds, it is practically impossible to make a quantitative estimation of the influence of that operation on the actual shrinkage of amount of investment made by that fund in Russian shares which, as a rule, constitute only a negligible portion of their portfolios. Nevertheless, if there indeed occurs capital outflow from the foreign funds specializing on investing in Russia, it is likely that global and regional portfolio investors have also begun to withdraw their assets from Russia.

sources of foreign investment funds specializing on Russia has provided an explanation of the nature of that phenomenon.

The growth of the coefficient of correlation between the RTS Index and the prices of oil from the early 2000s through July 2005 occurred because, during that period, both factors influencing the movement of the share market – oil prices and the money inflow into the foreign funds specializing on investing in Russia – were moving in the same direction. Oil prices were rising, the flow of portfolio investment was directed into Russia, and the RTS Index was displaying a stable growth. As shown in *Table 6*, over the period from November 2000 through June 2005 the investment funds received \$ 1.5bn in investment.

The decline in the coefficient of correlation in July 2005 – April 2008 to –0.5 was caused by the differently directed movement of oil prices against the inflow of foreign portfolio investment. In the period from July 2005 through April 2006, in spite of the increasing volatility of oil prices, the foreign funds specializing in investing in Russia received a total of \$ 4.8bn of new investment (*Table 6* и *Fig. 10*). The surge in the short-term investment activity can be explained by Russia being assigned an investment rating by international rating agencies (*Fitch's* - on 17 November 2004; *S&P's* – on 31 January 2005). Besides, on 31 May 2005, the verdict in the first court case of Mikhail Khodorkovsky was announced, and many portfolio investors then believed the declarations of Russian authorities that this case was going to be exceptional. However, in the period between April 2006 and April 2008 there occurred a reversal in the preferences of foreign investors, and so, in spite of the stable growth of oil prices, the funds investing in Russia began to actively withdraw their capital (*Fig. 10*). As a result of portfolio investment outflow, the growth rate of the RTS Index demonstrated a significant slowdown against the rapidly rising oil prices.

During the period from April 2008 through April 2009, the coefficient of correlation increased to 0.8, while the share market sharply declined. At that time, plummeting oil prices resulted in rapid withdrawal of capital from the foreign funds investing in Russia. The RTS Index also displayed a rapid decline.

The downward movement of the coefficient of correlation between the RTS Index and the level of oil prices in the period from April 2009 through April 2011 (to –0.2) was once again caused by the fact that the accelerated growth of the RTS Index was mostly sustained by the capital inflow into the foreign funds, while the price of oil was increasing at a moderate rate. Over that period, the foreign funds received new investment in the amount of \$ 10.2bn.

The recovery of the former values of the coefficient of correlation between the RTS Index and the price of oil in the period from May 2011 through January 2013 occurred because the latter once again was moving in the same direction as the volume of foreign investment. In the second half of the year, oil prices were on the decline, and private investors were withdrawing their monies from the funds investing in Russian shares. Between May 2011 and January 2013, a total of \$ 4.1bn was withdrawn, and the RTS Index declined accordingly.

Table 6

Inflow/ Outflow of Foreign Funds Invested in Russian Shares, According to EPFR

	Investment inflow (+)/ outflow (-), million USD
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 – January 13	-4,140

Source: calculations based on data released by EPFR.

From the changes in the cumulative capital flows via the foreign funds specializing on investing in Russia shown in *Fig. 10* it become obvious that the key shifts in the behavior of foreign investors took place in May 2006 and May 2011. According to the data displayed in *Table 6*, capital outflow from foreign investment funds in the period from May 2006 through March 2009 amounted to \$ 9.0bn, and in the period from May 2011 through January 2013 – to \$ 4.1bn. Even if these figures are doubled by way of adjusting them to the potentially similar behavior of regional and global asset managers whose investment in Russia were likewise shrinking, it will still appear that the shock-generated fluctuations in the prices of shares on the Russian market may only result in a gradual withdrawal of capital in amounts equal to 1-to-2-day volume of trading in shares on the Moscow Exchange.

The explanation of the factors behind the negative changes in the behavior of global portfolio investors in the developing markets was offered by the IMF's experts in its Global Financial Stability Report published in September 2011¹. They based their calculations on data collected by EPFR Global for the period from January 2005 through May 2011 on the capital flows via the investment funds managing investment in shares across the world, in Asia, Latin America, Europe, the Middle East and the economically developed countries. Their conclusion was that the most important factors with statistical significance at the 1% level of confidence were as follows:

- the forecast real GDP growth rate² (+);
- volatility of the forecast GDP growth rate (–);
- volatility of the exchange rates of major world currencies (–);
- the volatility index of the share market (VIX) (–).

The level of interest rates and the toughness of currency regulation were the least significant factors.

These factors can be regarded as indicators of forthcoming financial crises, which are applied by the portfolio investment funds specializing on certain types of markets. According to the IMF Report, the strongest shock in the form of peak capital outflow in the amount of \$ 4.4bn from the funds specializing in investment into Europe, the Middle East and Africa occurred in June 2006. As seen from *Fig. 10*, it was in that month that the investors in shares issued by Russian joint-stock companies reversed their behavior. In such a situation, the downward trend in the rate of GDP growth in the leading developed and developing economies registered in the IMF's World Economic Outlook in April 2006³, as well as the disturbances in the movement of VIX that began from Q2 2005 onwards⁴, could serve as signals triggering the withdrawal of funds by portfolio investors. The volatility surges predicted in the forecasts of GDP growth and the prices of shares were a reflection of the concerns of the experts and the market about the disproportions in the national balances of trade, the aggravating crisis on the housing mortgage market in the USA, and some other factor that finally resulted in the 2008 recession.

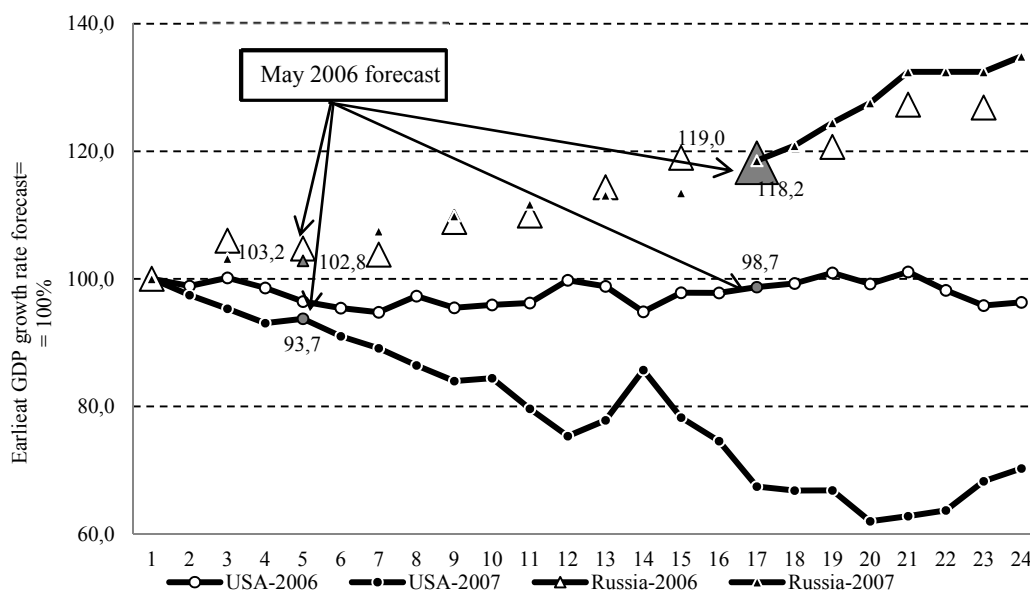
¹ IMF. Financial Stability Report. September 2011, pp. 11-18. See www.imf.org.

² The forecasts of GDP growth and its volatility are based on data released by Consensus Economics.

³ World Economic Outlook (WEO), April 2006, Fig. 1.8. See www.imf.org.

⁴ In his book *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, (Russian translation: Delo Publishers, Moscow, 2011. P. 272) R.Rajan noted that in the period from Q2 2005 through Q2 2007, the two-year implied volatility of S&P500 option price (an indicator that reflects markets expectations of stock price volatility) was by 30–40% above the short-term one-month volatility.

Fig. 11 displays changes in the predicted values of GDP growth in Russia and the USA in 2006 and 2007, plotted on the basis of the international surveys of economic forecasts conducted by *Consensus Economics*. The GDP growth data for 2006 were collected from January 2005 through December 2006, the forecasts for 2007 – from January 2006 through December 2007. The cumulative estimations of the forecasts for Russia over these periods were done, as a rule, once every two months.



Source: calculations based on data released by Consensus Economics.

**Fig. 11. Changes in the Forecasts of GDP Growth for 2006 and 2007
Based on International Surveys**

Among the factors shown in Fig. 11, in May 2006 the strongest influence on the growing concerns of the portfolio investors operating in Russia could be exerted primarily by pessimistic forecasts for US growth in 2007. Over the period from January through May 2006, economists cut their forecasts for US GDP growth in the USA in 2007 by 6.3% which, in its turn, pointed to the possibility of a decline in the demand for oil and the risk of the ruble’s depreciation. Later on, the fears of a slowdown in the US economy were transformed in a reality, as indicated by the behavior of the USA-2007 curve. At the same time, also in May 2006, the forecasts of US GDP growth in 2006 stayed practically at the same level, as well as the forecasts of Russia’s GDP growth in 2006 and 2007. In May 2006, the forecast growth in the Russian economy for 2006 amounted to 118.2% of its level forecast as of January 2005, and the forecast growth for 2007 – to 102.8% of its level as of January 2006. In other words, the analysts of the world’s biggest financial organizations in May 2006 were expecting a dramatic slowdown in the US economy in 2007, which so far had not transformed itself in a decline in the developing economies, and Russia in particular. This proved to be a sufficient signal for portfolio investors to begin fleeing from developing markets.

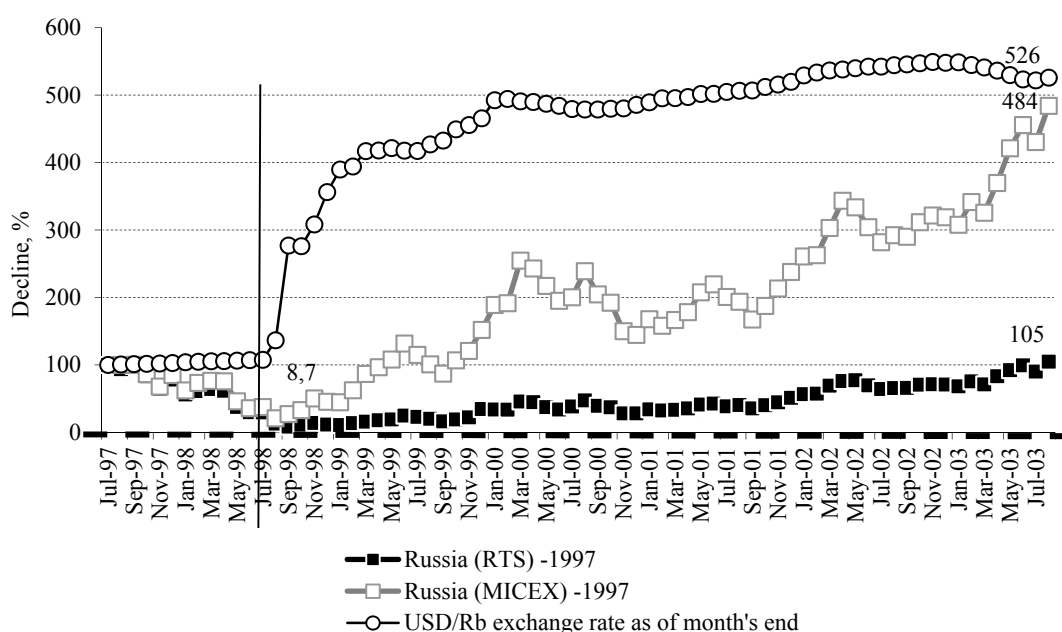
It is an interesting fact that, by withdrawing their assets in June 2006 from the funds investing in the shares issued by European companies, as well as in Russia, the Middle East and Africa, global portfolio investors displayed their amazing insight as they came far ahead of the most outspoken prophets of the future financial crisis. The famous declaration by Profes-

sor Nouriel Roubini that a housing mortgage crisis was looming came only as late as September 2006 at an IMF conference. At Davos, in February 2008, RF Minister of Finance Alexei Kudrin insisted that Russia will remain a ‘peaceful haven’ amidst the world financial crisis. Christine Lagarde, the current managing Director of the IMF, in her interview in the documentary film *Inside Job* (2010) admitted that it was only in February 2008, at a G7 summit, that she had realized that a crisis was indeed approaching – when she heard US Treasury Secretary Henry Pauson’s assurances that everything was ‘under control’.

However, as early as May 2006, foreign investors began to flee from Russia’s and other developing markets. Now we can better understand why foreign portfolio investors proved to be more shrewd and insightful than the most eminent stock market experts of monetary authorities. The movement of these indicators in 2012 will be discussed later, in the section on the stock market risks.

3.2.3. Currency Exchange Rates

The differences in the depth of the ruble’s depreciation observed during the 1997–1998 and 2008–2009 crises are reflected in the discrepancies in the recovery dynamics of the RTS and MICEX Indexes. The MICEX Index describes the value of shares in portfolios denominated in rubles, and the RTS Index – the value of those denominated in US dollars. So, after the more than 5-fold depreciation of the ruble¹ in 1998, the subsequent recovery of the MICEX Index proceeded at a faster rate than that of indexa the RTS Index (*Fig. 12*). The MICEX Index returned to its pre-crisis record high in May 1999 – only 8 months after it had hit ‘the bottom’. By contrast, the recovery of the RTS Index lasted for 58 months.

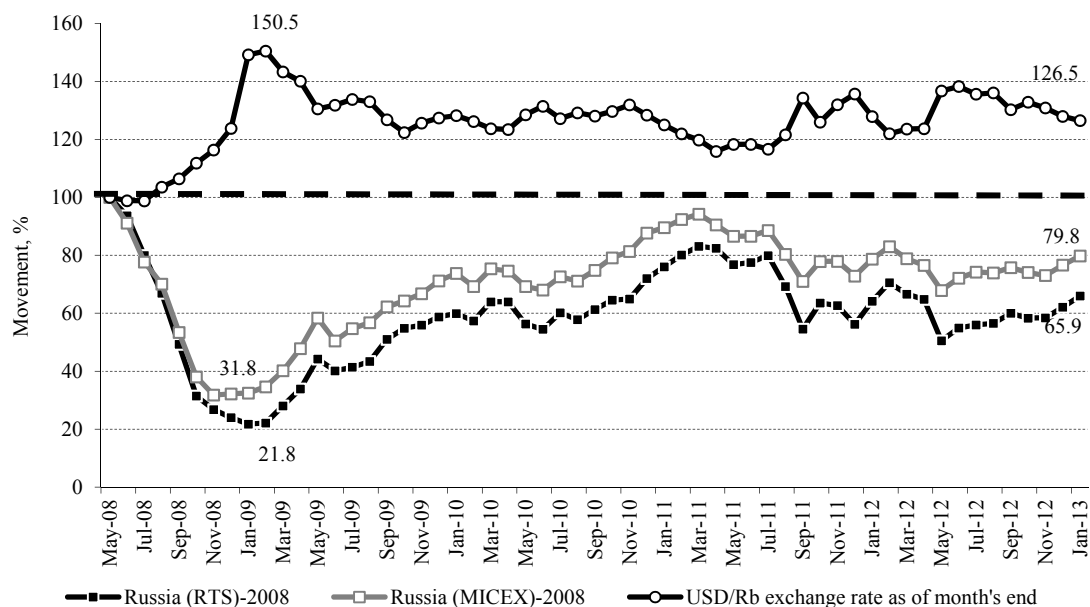


Source: data released by the Moscow Exchange and the Bank of Russia.

Fig. 12. The Dynamics of the US Dollar’s Exchange Rate and the RTS and MICEX Indexes during the Crisis Period 1997–98 (July 1997 = 100%)

¹ The period of 1998–2003.

During the crisis period of 2008–2009, the ruble’s depreciation hit the mark of 50% of its initial level (Fig. 13), and then its exchange rate against major foreign currencies began gradually to rise. For this reason, the recovery of the RTS and MICEX Indexes proceeded at almost identical rates, the rate displayed by the MICEX Index being only slightly higher. By January 2013, the RTS Index had gained 65/9%, and the MICEX Index – 79.8% of their record highs registered in May 2008.



Source: data released by the RTS, the MICEX, the Moscow Exchange and the Bank of Russia.

Fig. 13. The Dynamics of the US Dollar’s Exchange Rate and the RTS and MICEX Indexes during the Crisis Period from May 2008 through January 2013 (May 2008 = 100%)

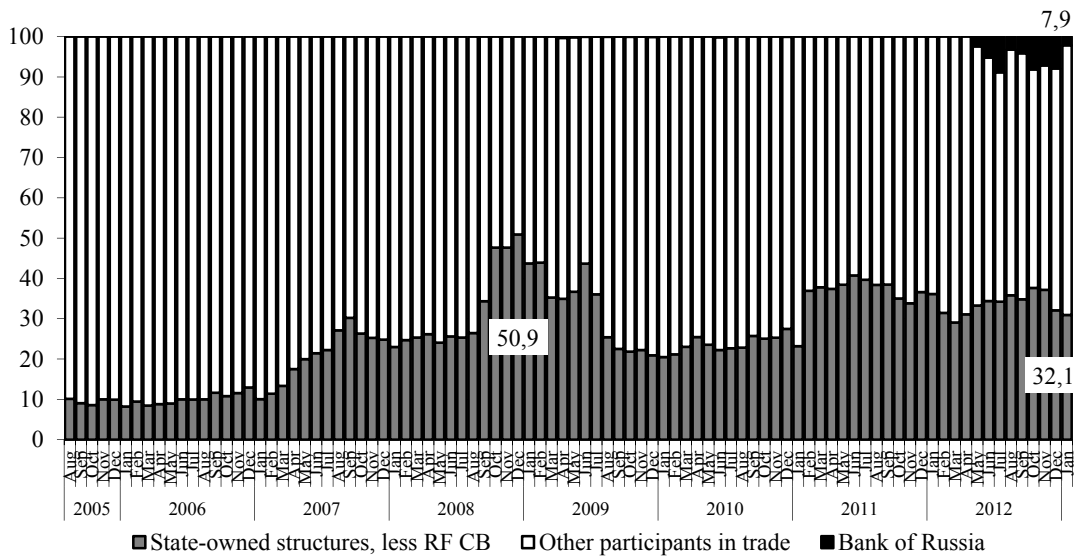
3.2.4. Competition on the Domestic Share Market

The year 2012 saw a considerable rise in the influence exerted by state-owned companies and government departments on the share market. This was manifest in the increasing participation of government financial organizations in the trading in shares on the exchanges, their increasingly prominent role in the management of the Moscow Exchange, and the expansion of power of government departments in the field of regulation, supervision and development of the financial market.

Fig. 14 demonstrates the results of the transactions with shares carried out in the Main Market of the Moscow Exchange by the Bank of Russia, state-owned banks and related structures¹. During the most acute phase of the crisis from September 2008 through July 2009 this segment of the market was characterized by a marked increase in the activity of the players representing the State. By December 2008, the participation of state-owned structures in the trading in shares on the exchange had increased to 50.9%. This may largely be explained by the fact that some big market participants (*Kit Finance*, *Sviaz Bank*) because of their financial problems were taken over by state-owned banks, as well as by the implementation, by *VEB*

¹ *VEB*, *VTB*, *VTB Capital*, *VTB24*, *Gazprombank*, *Sberbank*, *Kit Finance*, *Sviaz Bank*, *Bank of Moscow*, *TransCreditBank*, and from 2011 onward – the investment company *Troika Dialog*.

[Bank for Development and Foreign Economic Affairs], of the stock market support program funded by a Rb 175bn loan received by VEB from the National Welfare Fund. During the period of market recovery the participation of state-owned banks and their affiliations in the exchange trade in shares declined, but from February 2011 onwards it was once again on the rise, climbing to 36.1% in December 2011. This happened due to the acquisition, by *Sberbank*, of the investment company *Troika Dialog*. In 2012 the share of state-owned financial organizations did not increase. However, from May 2012 onwards the share market of the stock exchange was entered by the Bank of Russia, whose monthly participation in trading amounted to 2% to 8% of the total value of transactions. In December, private financial organizations accounted for 60.0%, state-owned financial organization – for 32.1%, and the Bank of Russia – for 7.9% of the total volume of transactions with shares on the Moscow Exchange respectively.



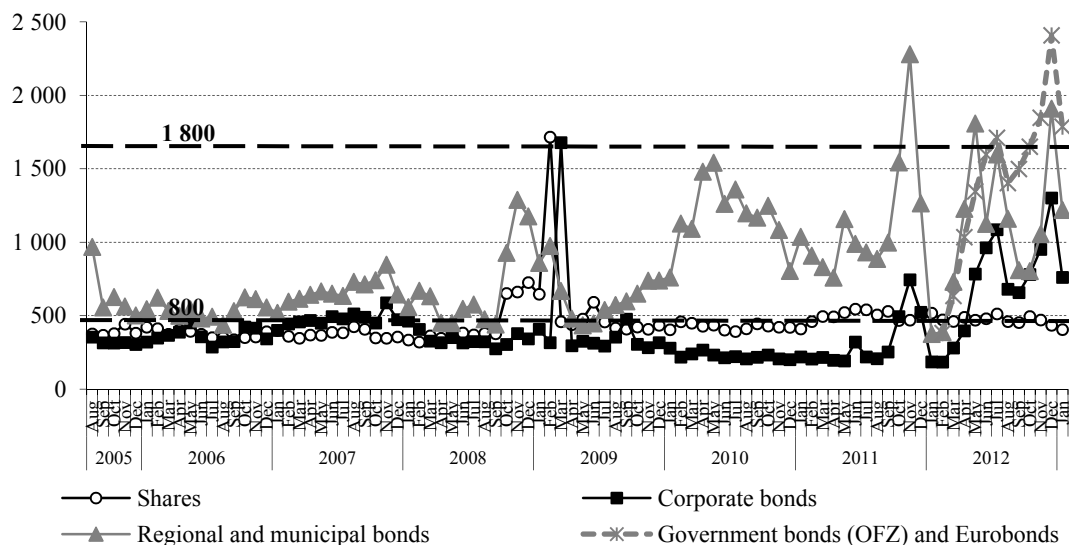
Source: calculations based on data released by the Moscow Exchange.

Fig. 14. The Participation of Private and State-owned Broker Companies in Trading in Shares on the Moscow Exchange, %

In 2012, the antimonopoly parameters of the majority of the Moscow Exchange’s market segments worsened – with the exception of trading in shares. This is indicated by the movement of the Herfindahl–Hirschman Index, or HHI,¹ on the Moscow Exchange, by market segment, in the period from January 2005 through January 2013 (see *Fig. 15*). As estimated by the Federal Antimonopoly Service of the Russian Federation, the market has a low concentration if HHI is below 800; moderate concentration if $800 < \text{HHI} < 1800$; and high concentration if HHI is above 1,800². Over the course of 2012, the HHI for the transactions on the Moscow Exchange’s main share market remained stable at a level of approximately 500, which means that this market segment was low-concentrated.

¹ The market concentration Herfindahl–Hirschman Index (HHI) is defined as the sum of squares of the volumes of participation of each participant in trading on an exchange: $\text{HHI} = (D_1)^2 + (D_2)^2 + \dots + (D_m)^2$, where D_i – is the per cent market share of i^{th} participant; $i = 1, 2, \dots, m$.

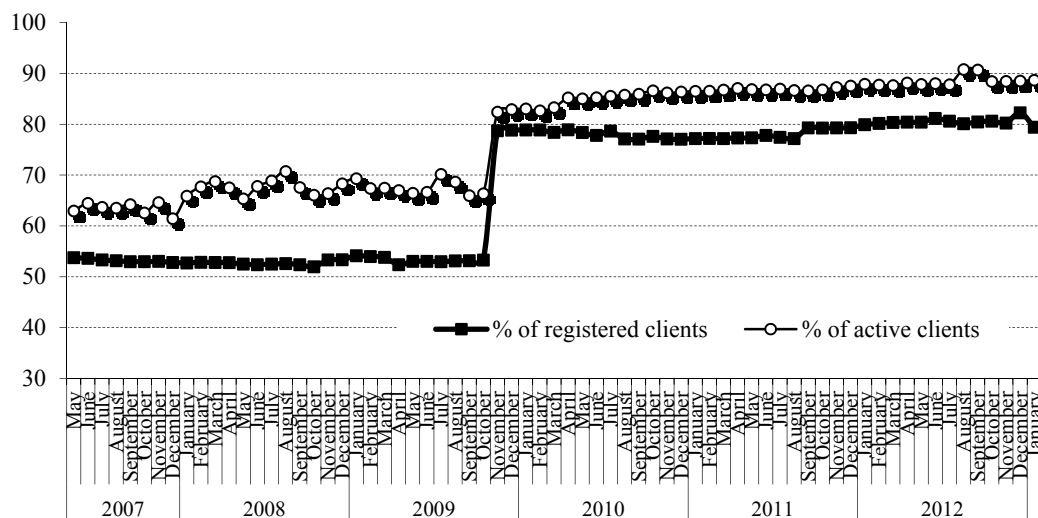
² See section 2.6.4 of the Methodological Recommendations for the Procedure of Analysis and Evaluation of the Competitive Environment on the Financial Services Market, approved by Order of the RF Ministry for Antimonopoly Policy of 31 March 2003, No. 86.



Source: calculations based on data released by the Moscow Exchange.

Fig. 15. The Herfindahl–Hirschman Index, Based on the Volume of Secondary Trading in the MICEX-RTS’s Main Market (All Trade Modes)

Fig. 16 shows the dynamics of the share of the seven biggest broker companies in the total number of registered and active clients¹ serviced by participants in the trading on the Moscow Exchange’s Main Market. Over the period of 2010–2012, the share of that category of companies in both indexes was steadily on the rise, reaching as of January 2013 the level of nearly 90% for all registered clients and 80% of active clients of broker companies.



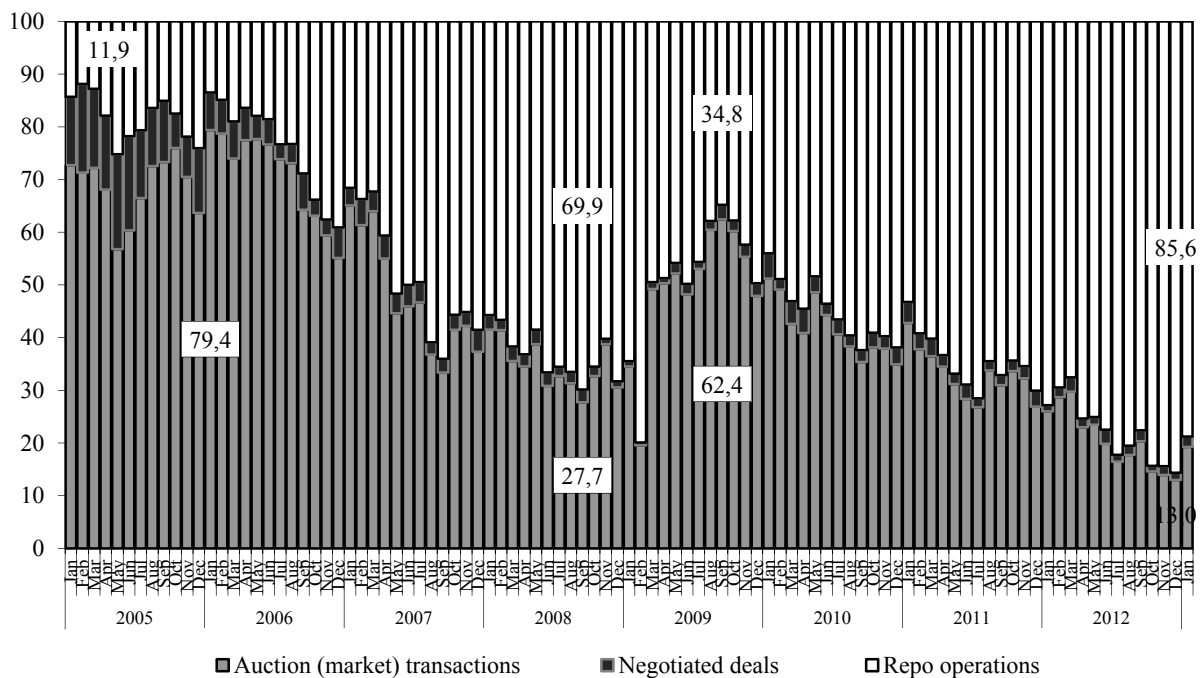
Source: calculations based on data released by the Moscow Exchange.

Fig. 16. The Share of Seven Biggest Brokers in the Total Number of Registered and Active Clients of Russian Brokers, %

¹ According to the Moscow Exchange’s rules, a client is to be recognized as ‘active’ if it carries out at least one transaction per month.

In 2012, the proportion of market (anonymous) transactions in shares on the Moscow Exchange hit its record low of 13.0% (Fig. 17), while that of repo operations, on the contrary, rose to 85.6%. By means of repo operations on the share market, brokers can implement some very risky strategies in order to attract short-term borrowed resources, which then enable them to provide their clients with marginal loans, as well as to carry out arbitration repo transactions with the same assets but with different contracting parties. According to media reports, arbitration on the market for repo operations with shares was one of the reasons why one of Russia's biggest investment banks – *Renaissance Bank* – in 2012 experienced problems that resulted in a change in its controlling interest¹.

The main causes of the decline in the volume of market transactions on the Moscow Exchange in 2012 were the continuing outflow of foreign portfolio investment, fewer opportunities for carrying on transactions after the merger of the MICEX and RTS², shortage of new attractive issues of shares on the exchange³, the flight of domestic private investors from risky assets⁴, and the indirect support coming from the Bank of Russia (first of all, for repo operations on the merged exchange).



Source: calculations based on data released by the Moscow Exchange.

Fig. 17. The Structure of Transactions with Shares on the Moscow Exchange's Main Market, %

¹ Tofaniuk E. *V Afriku guliat'*. [To Go for a Walk in Africa]. *Forbes*, No 1 (106), 2013, pp.100–101.

² Trifonov A. Brokery zhduet luchshikh vremen [Brokers Are Waiting for Better Times]. *Vedomosti*, 8 August 2012.

³ Trifonov A., Kamneva G. *Birzha sbavliaet oboroty* [The Exchange Slows Down Its Pace]. *Vedomosti*, 31 October 2012.

⁴ Rudenko P. *Bank Rossii vzial polbirzhi. V ob"eme togov snizhaetsia dolia chastnykh investorov* [The Bank of Russia Takes Over Half of the Exchange. The Share of Private Investors in the Trading Volume Is Shrinking]. *Kommersant*, 6 June 2012.

The introduction, from 3 September 2012, of an additional commission payment on hyperactive trading machines which imposed a counterproductive burden on the trading system delivered a strong impact on the exchange-related activity in the Moscow Exchange's stock and currency markets. Each broker client was granted the right to submit up to 30,000 bids per trading session free of charge. For each ruble of the exchange commission paid on a completed transaction, a market participant could submit another 20 bids. Each bid submitted in excess of that limit would cost 10 kopecks. Simultaneously with these measures, from 17 September 2012, the Moscow Exchange doubled the minimum price tick and tick value for the most popular types of futures contracts – another measure designed to protect the exchange infrastructure from any excessive activity of trading robots in response to minimum changes in contract prices.

According to the Bank of Russia's overview of the financial market, in 2011 high-frequency trading systems (trading robots) accounted for approximately one-half of the trading turnover on the futures market Forts and 15% of the trading in shares on the MICEX. According to former First Deputy Chairman of the Moscow Exchange Roman Goryunov, such estimates of the volume of robotic transactions are conservative, but the order of the number is correct¹. The information published by *Expert* (with reference to data released by the Moscow Exchange), in 2012 trading robots conducted approximately 40% of the total volume of transactions on the stock market and handled a total of 97% of the submitted bids².

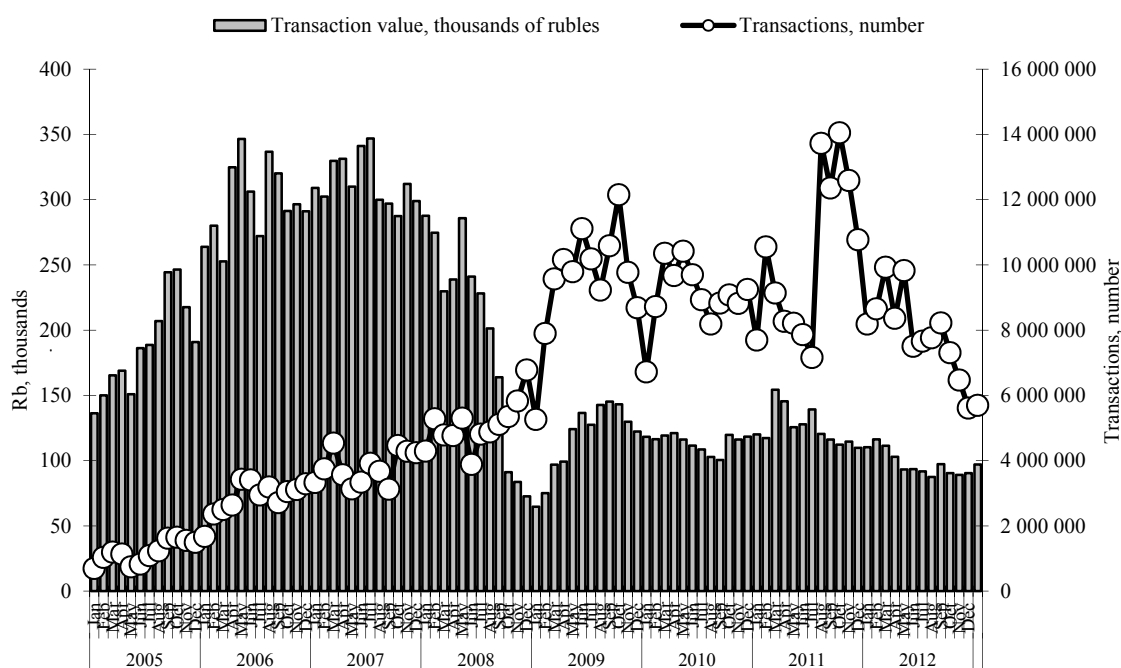
As stated by the Moscow Exchange's Managing Director of Securities Market Anna Kuznetsova, two months after restrictions were imposed on the number of bids submitted by hyperactive trading systems, it dropped fourfold – while the number of transactions did not decline³. Nevertheless, as shown in *Fig. 18*, in 2012 the volume of market transactions on the Moscow Exchange continued its downward movement; moreover, from September onwards the rate of this movement became much faster, which could indeed be the result of the measures introduced on the exchange in order to reduce the scale of robotic trading activity. The number of market transactions in December 2012 dropped by 47.9% on December 2011. At the same time, the value of one transaction over the same period shrank by 17.7%.

Nevertheless, the measures introduced in 2012 by way of regulating high-frequency trading on the exchange were of a limited nature. However, some other measures adopted in the same year were aimed at boosting the use of speculative strategies - for example, the launch of the so-called T+2 trade settlement system instead of the currently applied pre-settled trades mode T+0. The new settlement standard is more convenient for profiteers than for conservative investors because in practical terms it means that trade settlement occurs two days after the trade is enacted via the payment clearing and settlement system. Another booster of robotic activity is the annual contest Best Private Investor (BPI) held by the exchange, where winners get generous prizes – invariably snatched by the most active trading robots. Regrettably, the exchange offers no explanation of the risks associated with high-frequency trade.

¹ Trifonov A. *Birzha robotov*. [The Exchange of Robots]. *Vedomosti*, 26 March 2012.

² Obukhova E. *Birzha pobedila robotov*. [The Exchange Conquers Robots]. *Expert*, No 37, 17-23 September 2012.

³ Kamneva G. *Chistka v stakane*. [A Purge in a Glass]. *Vedomosti*, 19 November 2012.



Source: calculations based on data released by the Moscow Exchange.

Fig. 18. Market Transactions with Shares on the Moscow Exchange's Main Market

The shrinking volume of private investor activity on the exchange and the increasing prominence of state-owned structures on the financial market (which enjoy preferential treatment when obtaining financial resources from monetary authorities)¹ have given rise to concerns about the ability to continue doing business for many private companies – brokers and asset managers. In 2011, after the appointment of a new head of the RF Federal Financial Markets Service (FFMS), some positive changes occurred in its regulatory activity – for example, it no longer resorted to administrative measures in order to oust small-sized companies from the legal stock market. By its Order of 24 May 2011, No. 11-23/pz-n, the FFMS renounced its intention to raise, in a stagnating market, the equity capital sufficiency standards for brokers and dealers in securities from Rb 35m to Rb 50m, and for depositaries – from Rb 40m to 60m. By doing so, it prevented a large-scale flight of financial intermediaries into the 'grey area' of financial business.

However, a simple removal of excessive administrative pressure on the business activities of non-bank financial organizations proved to be insufficient. For four years in a row – in fact, since 2009 – the number of professional participants of the securities market has been on the decline (*Table 7*). In 2012, the number of brokers dropped from 1,084 to 958, or by 11.6%; and the number of dealers – from 1,085 to 959, or by 11.6%.

The current problems that non-bank financial institutions are faced with when attempting to expand their business activity have largely arisen because the state authorities actually fail

¹ As estimated by Fitch Rating, state-owned banks accounted for 84% of the total volume of funding received by banks from the Bank of Russia and the RF Ministry of Finance, while their share in the banking sector's aggregate assets is approximately 55%¹.

to exercise in full their powers relating to the development of the sphere of non-banking financial and investment services.

Table 7

The Number of Professional Participants of the Securities Market

	2007	2008	2009	2010	2011	2012
Number of holders of FFMS's license for:						
1. Broker activity	1,445	1,475	1,335	1,213	1,084	958*
Change on previous period, %		2.1	-9.5	-9.1	-10.6	-11.6
2. Dealer activity	1,422	1,470	1,337	1,198	1,085	959*
Change on previous period, %		3.4	-9.0	-10.4	-9.4	-11.6

* as stated in the FFMS's register as of 8 February 2012.

Source: data released by the RF Federal Financial Markets Service (FFMS).

The executive bodies of state authority have so far failed to fulfill the assignment envisaged in the *Strategy for the Development of the Financial Market in the Russian Federation*, approved by the RF Government's Regulation of 29 December 2008, No. 2043-r (hereinafter – *Development Strategy*), on submitting to the State Duma, in September 2009, of the drafts for alterations to be introduced in Federal Law 'On the Securities Market' and other legislative acts of the Russian Federation in the part regulating the activity of investment consultants, as well as the services rendered to retail investors. The requirements stipulated in Part 3 of Section 4 of the *Concept of Long-term Socio-Economic Development of the Russian Federation Until 2020*, approved by the RF Government as of 17 November 2008, No. 1662-r (hereinafter – KDR-2020), on the introduction of measures designed to create tax incentives for Russian and foreign investors to apply long-term financial instruments have never been complied with. The government departments did not fulfill the assignment stipulated in Item 19 of the plan for implementing measures designed to create an international financial center in Moscow, approved by Regulation of the RF Government as of 11 July 2009, No. 911-r, which envisaged the preparation of a draft federal law aimed at augmenting existing legislation by stipulations concerning the creation of special targeted accounts (pension accounts, education accounts, etc.) for investing individual savings.

One can hardly recognize as effective the practice that has emerged in the sphere of financial market regulation, when the government approves new strategies and programs for the securities market's development without any more or less detailed analysis of the results achieved in the course of implementing previous programs and documents that address the same issue. As a result, the mechanisms that ensure officials' responsibility for implementing the adopted decisions are destabilized, the financial market's development proceeds at a slower pace, and investors lose confidence in the government's efforts to improve the institutional environment.

In January 2012, the transaction whereby *Sberbank* acquired the investment company *Troika Dialog* was finalized. From 8 October, the company was transformed into *Sberbank's* corporate investment department named *Sberbank CIB*. This event had a symbolic significance for the Russian stock market because it demonstrated that private investment banks are giving way to big state-owned banks, which rely on their own resources and banking investment services in providing corporate financing to their clients. From 14 November 2012 on-

wards, *Renaissance Group* – second biggest private investment bank - by way of restructuring its debt replaced its controlling owner, but so far its solvency issues have not been resolved¹.

3.2.5. Preliminary Results of the Merger of the RTS and MICEX

The year 2011 saw a merger of Russia's two biggest exchanges - the MICEX and RTS. In June 2012, a general shareholder meeting approved the name of the new exchange - Open Joint Stock Company 'Moscow Exchange MICEX-RTS', or OJSC Moscow Exchange.

The merger of the two Russian exchanges had a strong positive influence on the development of Russia's stock market.

First of all, it now became possible to create, on the basis of the MICEX settlement chamber, the National Settlement Depository (NSD) and the Depository Clearing Company (DCC), a 'fully-fledged' central depository. In accordance with Order of the FFMS of 6 November 2012, No. 12-2761/PZ-I, this status was granted to non-bank credit institution Close-end Joint Stock Company National Settlement Depository (NSD). From 1 January 2013, the last provisions of Federal Law of 7 December 2011, No. 414-FZ 'On the Central Securities Depository' came into force, whereby it was envisaged that all the organizations operating on the stock market were to conform their activity to the requirements stipulated in that Law. In particular, the registers of holders of securities were from then on to include a new personal account – of the central depository's nominal holder. In due time, all registered securities kept on the personal accounts of nominal holders in the registers of other depositaries will have to be re-registered to that account.

The creation of a central depository will result in a qualitative improvement of the efficiency and reliability of the operations of re-registering the ownership right to securities and the trade settlements on the stock market². Besides, as the NSD is recognized by central legislation in conjunction with legislations of the leading developed countries, biggest foreign pension and investment funds will be able to raise the limits for their investment in the shares and bonds of Russian emitters. In 2012, the NSD's capital rose to \$ 180m – a level that, according to the *Thomas Murray* international agency which provides private and public ratings on the world's 120 biggest settlement depositories, appears to be adequate for a depository that has a restricted banking license to perform cash settlement services. The NSD also has at its disposal some additional resources in the form of reserves and insurance coverage with a responsibility limit of \$ 65m and the possibility to attract a daylight or overnight loan secured by the Bank of Russia. The value of securities kept at the NSD increased from Rb 8.1 trillion in 2011 to Rb 12.3 trillion in January 2013. According to the NSD's representatives, by 1 April 2013 they are going to open nominal holder accounts in the registers of Russia's 1,000 biggest emitters; the other joint-stock companies will join the system before 6 November 2013³.

The establishment of a central depository resulted in *Euroclear* and *Clearstream* opening their nominal holder accounts there, thus creating a competitive environment with adequate settlement technologies for attracting onto Russia's domestic market the resources of big foreign institutional investors, investment banks, brokers and hedge funds. So far, the only type

¹ Trifonov A. *Dzhennings ushel ot kreditorov*. [Jennings Escapes from the Creditors]. *Vedomosti*, 21 February 2013.

² This can be fraught with the risk of formal and informal follow-up of investment in Russian securities; one may hope that the State will attempt to minimize this risk by means of introducing some special procedures and rules.

³ Papanchenkova M., Trifonov A. *Velika Rossia, a pokupat' nekomu*. [Russia is Big, But There Are No Buyers in It]. *Vedomosti*, 4 February 2013.

of transactions settled via these accounts has been the purchase of OFZ by foreign investors, and later on – the purchase of corporate bonds. From 2014, foreign investors will be also able to invest in shares issued by Russian joint-stock companies.

As estimated by Executive Director of the *Euroclear* Bank Frédéric Hannequart, the possibility for European depositaries to open accounts with the the NSD may bring \$ 20bn of new investment¹. At the same time, many market participants have expressed their concerns that the existence of *Euroclear's* and *Clearstream's* accounts with the the NSD may also result in a liquidity outflow from the Russian stock market, because the fees for settling securities transactions inside European depositaries are significantly lower than those set for the transactions settled via the NSD. In particular, objections against *Euroclear* and *Clearstream* having their accounts at Russia's central depository were voiced by NAUFOR and the head of the task force set up by the stock market development council under the RF President. On the other hand, the Bank of Russia, the RF Ministry of Finance, the National Securities Market Association (NSMA) and the NSD supported this decision². By now, the FFMS has approved the list of 66 central depositaries across the world granted the permission to open nominal holder accounts with NSD as the central depository for the Russian stock market.

The merger of the RTS and the MICEX has significantly simplified for market participants the settlement of transactions on the securities and futures markets, because the participants in trading are now able to concentrate all their liquidity earmarked for settling their transactions with government and corporate securities, as well as on the futures and currency markets, on their trading accounts in a single settlement and trading system. The diversification of the combined exchange's activity in servicing transactions with different monetary and investment assets has improved its financial sustainability in a situation of a general global decline in the volume of exchange trading and investor flight from risky assets.

The merger of the two exchanges resulted in the creation of a well-motivated manager team, who initiated development projects that were unprecedented in the history of the Russian stock market. Besides, it became easier for government bodies to deal with a unified exchange, which manifested itself in the active support of its projects by the RF Government, the Bank of Russia, the RF Ministry of Finance, the FFMS, the interdepartmental task force for the development of multi-function centers, and the legislative branch of state authority. In 2012, the Moscow Exchange group implemented the following major projects:

- the switchover of operations with OFZ into the Main Market sector, and the introduction of a single procedure for depository registration and settlement of transactions with OFZ and corporate securities;
- the creation, in accordance with the requirements of G-20 for national financial markets, of the first Russian repository on the basis of the NSD for the registration of off-floor transactions with different financial instruments³;
- cross-listing of benchmark equity index derivatives on the stock exchanges of the five founding members of the BRICS Exchanges Alliance;
- the integration between the FORTS Derivatives market and MICEX Derivatives market;

¹ Department of finance. Euroclear. *Kommersant*, 7 February 2013.

² Rudenko P. *Evroklijr pustili v Rossii*. [Euroclear To be Let Into Russia]. *Kommersant*, 12 April 2012; Rudenko P. *Gosbumagam spriamili put' na zapad*. [Government Securities Are Given a Shortcut to the West]. *Kommersant*, 8 June 2012.

³ To be put in operation from 6 February 2013.

- the adoption of the *Moscow Exchange Group IT strategy Until 2015*, the launch of its new trading platform *Spectra* to power FORTS and Standard markets in order to upgrade the trading, clearing and post trade infrastructure;
- the centralization of the clearing activity for all market segments, including the futures market, on the basis of the unified Clearing House created with CJSC JSCB National Clearing Centre (NCC);
- the transfer to the unified list of constituents for the calculation of the *Moscow Exchange Group's* indexes;
- the introduction of direct client access (based on DMA) to the currency exchange market for all categories of participants as an alternative to the FOREX system that involves tens of thousands of private clients in risky off-floor deals;
- the introduction of trading in options on the EUR/RUB FX futures contracts, the launch of new long-term swaps;
- the creation, by the National Securities Market Association (NSMA) and the NDR, with the support by the Bank of Russia, of a pricing center for evaluating bonds with low liquidity.

The most difficult decision for the Moscow Exchange in 2012 was that of transferring from the procedure whereby trades are pre-settled [T+0], meaning that you need to put money up front in order to execute the trade, to the so-called T+2 trade settlement system, which means that the trade is settled two days after the trade date, the settlement being guaranteed by a clearing center¹. The problems involved in the transfer to T+2 are associated with some substantial additional costs for the market participants, because they need to install new software, implement new procedures for their internal record keeping and new systems of contractual relations with their clients. After switching over to T+2, small-sized broker companies may lose their former direct access to the exchange's clearing and settlement system, and so be forced to operate through the mediation of big clearing agents, mainly banks². The switchover to T+2 is associated with different benefits for different groups of market participants. It will be helpful for non-residents, exchange brokers and their clients interested in getting an additional leverage for settling their transactions. The asset managers of pension saving funds, reserve funds and open-ended investment funds, for which operations with borrowed funds are forbidden by legislation, the introduction of the new exchange trading mode will, most probably, be fraught only with additional costs and risks without any business benefits.

By deciding to transfer to T+2, the Moscow Exchange, in our opinion, has made an uneasy but – on the whole – correct choice. Foreign investment can be attracted onto the domestic market only by means of creating for the investors the settlement modes that they are used to, the modes that are recognized by international regulators and the international expert community³. This category of investors can enter a country's internal market only if the settlement procedure on the national exchange is compatible with the universal standards. The Moscow Exchange's choice was supported – either explicitly or passively – by the RF government rep-

¹ This transfer is to begin from March 2013.

² At present, the only condition of gaining access to the clearing system on the Moscow Exchange's securities market is that the participant must pay a contribution of Rb 2m to the guarantee fund; no additional requirements concerning the size of their own capital, loss-free operation, etc. have been introduced so far.

³ For more details on the requirements for and evolution of the settlement modes for exchange transactions on the global and national stock markets, see Thomas Murray. Capital Market Infrastructure (CMI) in Focus - Equities Settlement Cycles, 2 January, 2013. <http://www.thomasmurray.com/>

resented by the Bank of Russia, the RF Ministry of Finance and the RF Federal Financial Markets Service (FFMS).

However, such a decision meant a certain violation of the interests of domestic institutional investors on the exchange market. In this case, we believe that the adopted strategy for switching over to T+2 had a significant drawback, in that the reduced access to exchange transactions for domestic institutional investors entailed neither any changes in the regulation procedures nor appropriate infrastructural projects that could bring down the costs incurred by that category of market participants and open up for them some new opportunities for developing their businesses. Thus, for example, the Moscow Exchange did not accept the proposals put forth by the National League of Management Companies that a centralized system for settling the transactions with the stocks of open-ended investment funds should be created – a counterpart of *Fund/Serv* and *Vestima+* applied in the international settlement and clearing systems DTCC and *Clearstream*. In 2012, no decisions were made to allow pension savings be invested in shares issued by Russia's biggest joint-stock companies that are not listed in A category, or in open-ended funds. Many of the professional community's proposals aimed at improving the taxation regime for pension accounts and collective investment schemes were not considered. Unlike their position with regard to the exchange's project, the regulatory bodies remained passive towards the discussion of the development issues faced by the domestic institutional investors.

It can only be hoped that, in the future, the business development problems of the domestic institutional investors may be dealt with as promptly as were the development projects put forth by the Moscow Exchange. In this connection, a gradual improvement of the existing settlement standards and their switchover to the T+0 mode may help in leveling down the problems and risks faced by domestic portfolio investors in the framework of T+2.

At the same time, the year that has already passed since the exchange's merger did not relieve the market participants' fears as to how it may influence the competitive capacity of Russia's domestic financial market. The merger eliminated the competition between the MICEX and the RTS which for many years has been the main driving force of the stock market's development. This factor, shortly after the event took place, was emphasized by former Deputy RF Minister of Finance Alexey Savatyugin in his interview with *Rynok tsennykh bumag* [The Securities Market]¹. A year later, the market participants are still lamenting the disappearance of inter-exchange competition².

With due regard for the risk that domestic competition may indeed disappear, when the merger of the two exchanges was effectuated it was intended that this factor should be counterbalanced by the external competition between the combined exchange and foreign exchanges. The RF Federal Financial Markets Service (FFMS) promised that, when a central depository was created, the rules for the access of Russian joint-stock companies to public placement of their shares on foreign exchanges would be liberalized. For this end, on 4 August 2011, the FFMS sent to the RF Ministry of Justice an order whereby Russian emitters were allowed to put in circulation up to 100% of their shares on foreign exchanges in the

¹ *Ubezhden v pravil'nosti sushchestvuiushchei sistemy regulirovaniia marketa*. [I Am Convinced in the Correctness of the Existing Market Regulation System]. *Rynok tsennykh bumag* [The Securities Market], 2012, No. 1, p.19.

² According to Chairman of the Supervisory Board of Alor Group Anatoly Gavrilenko, the competition between the MICEX and the RTS 'was a real driver behind the exchange trade development in Russia'. After their merger, 'the drive was gone, and so was competition.' Obukhova E., Ogorodnikov E. *Bez Riazani ne budet Londona*. [Without Riazan There Will Be No London]. *Expert*, No. 43, 29 October – 4 November 2012, p. 46.

form of notes, instead of the formerly existing ceiling of 25%. It was intended that the order should come into force from the day of enactment of the federal law designed to regulate the conditions and procedure for the central depository's operation – that is, from 1 January 2013. However, this rule has never been adopted in actual practice. Moreover, in anticipation of the forthcoming IPO on the exchanges, a number of other fundamental decisions were adopted in order to impose restrictions on the placement of securities by Russian issuers on foreign trading floors. At the general government meeting on 25 January 2013, President of the Russian Federation Vladimir Putin said that the shares issued as a result of privatization deals in the form of IPO must be circulated on Russian exchanges. This requirement will probably be duly reflected in normative legal acts.

In the course of implementing the legislation on a central depository, the authorities have by no means always undertaken logically arranged measures – a fact that is fraught with increased legal risks for the foreign investors purchasing depository notes for Russian securities. Thus, for example, in Article 2 of Federal Law of 7 December 2011, No. 415-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in Connection with the Adoption of the Federal Law 'On the Central Securities Depository', it is stipulated that the information on the end holders of depository notes must be disclosed on a quarterly basis, and that failure to disclose that information should be punished by sanctions in the form of seizure of dividends. In some instances, it was impossible for global depositaries – the issuers of depository notes – to comply with such requirements, because some foreign investors refused to disclose the relevant information to Russian emitters. As a result, as late as the last workday of 2012, Federal Law of 29 December 2012, No. 282-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation and on the Recognition as Null and Void of Some Provisions of the Legislative Acts of the Russian Federation' was signed, whereby the mandatory quarterly disclosure on the holders of depository notes was abolished. At the same time, this requirement still applies to the instances of payment of income on issued securities and the lists of persons endowed with the right to participate in general shareholder meetings. Moreover, the alterations and amendments introduced by Federal Law No. 282 to Articles 214.6 and 232 of the RF Tax Cod have made it possible to interpret tax legislation as follows: if the holders of depository notes for basic securities fail to disclose their information, the tax on their income will be levied at a maximum rate of 30%. Such measures undermine the trust of foreign investors in Russian securities and create opportunities for arbitrary interpretation of the taxation rules by various state departments.

The creation of a merged exchange resulted in it being controlled by state-owned structures¹ (*Table 8*). Prior to the merger, the Russian market was operated by two exchanges: OJSC RTS was fully controlled by private shareholders, while the state-controlled stake in the charter capital of CJSC MICEX amounted to 61.1%. As a result of the merger, OJSC RTS exists no longer, while the stake held by state-owned structures in the combined exchange is 56.1%. After the IPO undertaken in the framework of privatization of the Moscow Exchange, partly in the form of placement of an additional issue of shares, the size of the state stake declined to 50.3%. It was reduced also as a result of the sale, on 21 December 2012, of part of

¹ The *Bank of Russia*, *Sberbank of Russia*, *VTB*, *VEB*, *Gazprombank* and the Russian Direct Investment Fund (RDIF). Part of shares in the merged exchanges is owned by its 100% daughter structure MICEX-Finance. In our calculations, the share held by state-owned entities in the structure of the exchange's property is not included in the state stake. However, it should be remembered that, as its capital is controlled by state-owned entities, the rights to the stake in MICEX-Finance are practically controlled by the state.

the stake held by *Gazprombank* to an officially unknown buyer; according to some media sources, this buyer could be a strategic investor from China¹. In fact, the state-owned stake in the Moscow Exchange's capital may be somewhat bigger because, at the moment of the IPO, approximately 2.69% of its shares were held by *Bank Saint Petersburg*, and 0.18% - by the *Bank of Moscow*, controlled by *VTB*.

Table 8

The Structure of Shareholders of the Russian Exchanges Before and After their Merger

	Prior to reorganization		After merger: OJSC MICEX-RTS as of 1 February 2012 ²	After the IPO: Moscow Exchange as of 15 February 2013 – estimated ³
	OJSC "RTS"	CJSC «MICEX»		
Bank of Russia		28.6	24.3	22.5
Sberbank of Russia		7.5	10.4	9.6
VTB		7.1	6.1	5.6
VEB		10.5	8.7	8.0
Gazprombank		6.2	5.4	
RDIF		1.3	1.3	4.6
State-owned structures	0	61.1	56.1	50.3
MICEX-Finance		2.8	2.8	5.5
Other shareholders	89.0	27.9	32.9	38.7
Total	100.0	100.0	100.0	100.0

Source: data released by the Bank of Russia; publications by *Vedomosti* and *Kommersant*.

In the recognized competitive capacity ratings of countries, the presence of state-owned structures in the management bodies of a stock exchange is estimated as a negative factor. Thus, for example, this is the main reason why, in the World Economic Forum's Global Competitiveness Report (GCR), Russia ranks near the bottom in terms of stock exchange regulation efficiency. The WEF's ranking released in September 2012 – that is, almost 9 months after the merger of the two Russian exchanges – effectively ignores this positive fact. By the level of stock exchange regulation efficiency, in 2011 Russia was ranked 116th among 142 countries, in 2012 – 114th among 144 countries. By contrast, Brazil, India and China in 2012 were ranked 8th, 28th and 58th respectively.

The domination of state-owned structures not only in the sphere of regulation and supervision, but also in the direct management of infrastructure results in a diminished role of private organizations in dealing with the key issues of financial development. According to Alexey Savatyugin, the then Deputy RF Minister of Finance, one of the major trends in the financial market in 2012 was 'the domination of government institutions (and the strengthening of that domination) in the most important sectors of the financial market', 'the transfer of the function of generating market development ideas to state-owned structures and in favor of state-owned structures'. He also believes that 'market factors play a minimum role in the elaboration of decisions – let alone the decision-making, unless they are connected – formally or informally – with the State'⁴. The key projects for the exchange in 2012 were the develop-

¹ Rudenko P. *Na Moskovskuiu birzhu vyshel tainstvenniy pokupatel*. [A Mysterious Buyer Enters the Moscow Exchange]. *Kommersant*, 25 December 2012.

² Mazunin A., Rudenko P., Khvostik E. *Birzhevoi kapital utek na zapad*. [The Exchange's Capital Has Flown to the West]. *Kommersant*, 13 March 2012.

³ According to data released by the Moscow Exchange as of 16 January 2013, as well as the information on the biggest stakeholders in the Moscow Exchange published in the statistics section of *Kommersant* on 18 February 2013.

⁴ *Itogi 2012 goda: mnenie uchastnikov rynka* [The Results of the Year 2012: The Opinion of Market Participants]. See <http://finparty.ru/section/news/17508/>

ment of direct repo operations, the opening of accounts for the international settlement and clearing systems at the central depository (primarily for servicing OFZ), the participation in IPO of *Sberbank of Russia*, and the development of the currency market.

The prevalence of state-owned structures in the running of an exchange is associated with two sets of risks. First, it is difficult to put an end to the expansion of state-owned structures on the market, because in the process of their expansion they can attract a lot of resources and receive high incomes; this also holds true for the Bank of Russia and the RF Ministry of Finance as the issuer of government securities. Secondly – and especially in view of the creation of a mega-regulator controlled by the Bank of Russia – the Russian market has practically been deprived of an independent mechanism whereby an excessive expansion of risky activity as part of the general functioning of the RF Ministry of Finance and the Bank of Russia can be prevented, for example in an event of the emergence of an unfavorable financial situation in Russia.

In this connection, it appears necessary that a clearly defined strategy should be developed in order to withdraw the Bank of Russia from participation in the capital of the Moscow Exchange and to restrict its participation in any organizations forming the stock market's infrastructure. At the first stage of the merger of the two exchanges it was planned that the Bank of Russia will give up its stake in 2011, but later on it announced that this act would be postponed until 2013–2015¹. According to *RBC*, on 15 February 2013 the RF President approved the plan of the Bank of Russia's withdrawal from the charter capital of the Moscow Exchange (RTS-MICEX). He reminded that, in accordance with the established plan, the final withdrawal of the Bank of Russia from the Moscow Exchange's capital would happen two years later. At the same time, the Bank of Russia signed the document whereby it assumed the obligation not to alienate its shares over a period of six months. As stated by Deputy Chairman of the Bank of Russia (and also Chairman of the Moscow Exchange Supervisory Board) at the press conference on 15 February 2013, any real actions aimed at withdrawing the Bank of Russia's assets from the exchange's capital will be undertaken only in six months.

The ownership structure remains non-transparent for the Moscow Exchange's clients and the public alike; the identity of only a few of its shareholders with stakes of 5% or more has been disclosed. Considering its position on the market, the preferences granted to it (justly) in the sphere of legislative initiatives and the availability of the administrative resource, this situation can hardly be considered as tolerable. The government itself admitted the importance of the choice of stakeholders for ensuring state security when, in the summer of 2010, the FFMS and the Federal Security Service vetoed the attempt to sell the stake in OJSC *FB RTS* owned by *Kit Finance* to a foreign bank – the EBRD. As a result of the FSS's interference, 11% of shares in the RTS were finally acquired by a structure belonging to the MICEX Group. The Bank of Russia also requires that banks disclose complete lists of their beneficiaries.

According to Alexander Afanasiev, Chairman of the Executive Board of the Moscow Exchange, 'the exchange must set an example for efficiency and openness for the whole finan-

¹ Ulyukaev A. *My ne dorabotali v chastii nadzora*. [We Are Less Than Perfect As Far As Supervision Is Concerned]. An interview with the newspaper *Vedomosti* of 6 June 2011; the Bank of Russia's presentation 'On the Merger of CJSC MICEX and OJSC RTS and the Procedure for the Bank of Russia's Withdrawal of Its Share in CJSC MICEX'.

cial market¹. Another factor conducive to the achievement of that goal can be the introduction of the rule whereby the Moscow Exchange should be obliged to disclose the information on its shareholders owning stakes of one or more percent.

At present, it is still not evident just how strong has been the synergic effect of the merger of the RTS and the MICEX on the market – and the exchange itself. Prior to the merger, in early 2011, the value of OJSC RTS was estimated to be \$ 1.15bn, or Rb 34.5bn; and the value of CJSC MICEX – \$ 3.45bn, or Rb 103.5bn. In other words, the value of the two exchanges put together was estimated to be \$ 4.6 bn. The complicated process of mutual settlements of the owners of the exchanges during their merger did not conduce to capitalization growth – although the latter is considered to be the most objective indicator of a transaction's success. According to our estimations, with due regard for all the paid dividends – including the shares in OJSC RTS, the total amount paid to the former shareholders from the exchange's assets was roughly equal to Rb 28.4 bn, or \$ 1bn².

Another sum of approximately Rb 35bn was to be paid by the Moscow Exchange to the former shareholders in the RTS in the event of no initial public offering being held by the combined exchange in the first half-year of 2013 – which, luckily, did not happen due to the relatively successful IPO undertaken by the Moscow Exchange in February 2013.

In January 2012, 7.54% of shares in the MICEX-RTS was bought by the European Bank for Reconstruction and Development and the RDIF. As estimated by the newspaper *Vedomosti*, the transaction's value amounted to Rb 8.5bn³, which means that the entire value of the combined exchange was estimated to be only \$ 3.75bn.

As was announced by First Deputy Chairman of the Bank of Russia Alexey Ulyukaev and the exchange's representatives in February 2012, in Q4 2012 the combined exchange was planning to achieve a capitalization level of \$ 6bn⁴. A similar figure was cited in March 2012 in the mass media by 'a source close to the exchange's board of directors', who confirmed that, by the moment of the IPO, its value would be estimated at \$ 6bn⁵.

Over the period from 4 through 15 February 2013, the Moscow Exchange launched an IPO of its own shares, with successfully placed shares to the value of Rb 15bn, or \$ 500m. While the announced offer price range was Rb 55–63 per share, the actual quote was set at its bottom margin, or Rb 55. Thus, the Moscow Exchange's capitalization amounted to \$ 4.2bn, which is 8.7% below the estimated value of the MICEX and the RTS on the eve of their merger, and 30.0% below the predicted value of the combined exchange announced in early 2012. The expected synergy effect of the joint business so far has not been justified, in the sense that the preliminary value of both exchanges was evidently overestimated.

At the same time, the IPO by the Moscow Exchange had a generally positive influence on the domestic stock market's development. It clearly demonstrated that it was indeed possible to launch big IPOs on the domestic market, and by doing so, attract large-scale foreign investors. According to reports in the mass media, the participants in the IPO were the state-owned

¹ Trifonov A. *Krov' ekonomiki ne dolzhns zastaivat'sia*. [The Economy's Blood Circulation System Must Not Get Clotted]. An interview with Chairman of the Executive Board of the Moscow Exchange A. Afanasiev. *Vedomosti*, 22 November 2012.

² *The Russian Economy in 2011. Trends and Outlooks* (Issue 33) – M.: Gaidar Institute, 2012. P. 120-121.

³ Pis'mennaia E., Trifonov A. *Fond Ulyukaeva* [Ulyukaev's Fund]. *Vedomosti*, 16 February 2012.

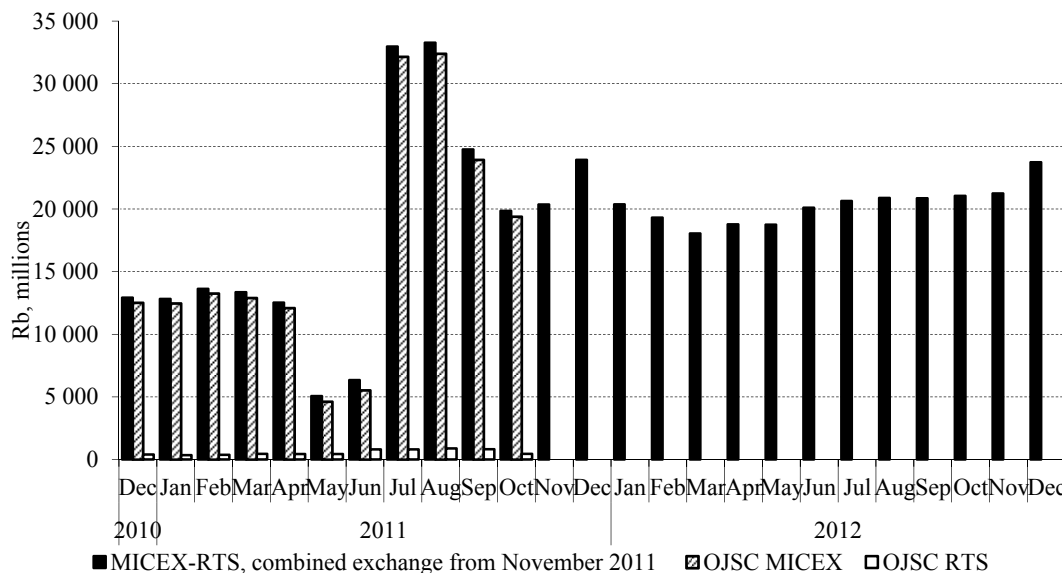
⁴ Rudenko P. *Birzha pereotsenila razmeshchenie*. [The Exchange Overestimates the Placement Size]. *Kommersant*, 13 February 2012.

⁵ Interfax-AFI. *Fondovaia birzha otsenila sebia k IPO* [The Stock Exchange Evaluated Itself for an IPO]. *Kommersant*, 26 March 2012.

Chinese Investment Company (CIC), *OppenheimerFunds*, *Blackrock* and many other foreign investment funds from Germany, Scandinavia, the UK, the USA, and Asia¹. In spite of the per share price being set at the bottom margin, it is still sufficiently high in terms of the price/earnings ratio (P/E) against the prices of shares circulated on the world's major stock exchanges. For the first 9 months of 2012, that index for the Moscow Exchange was 16 against 6 for the London Stock Exchange, 13.3 for the Warsaw Exchange, 13 for *Deutsche Börse*, and 17 for the New York Stock Exchange².

On the first trading day, 15 February 2013, the underestimation of the Moscow Exchange's shares against the placement price amounted to 0%. Usually, the low underestimation index on the first trading day of an IPO launched by a Russian joint-stock company points to an overestimated per share price as of the moment of the IPO launch. Later on, this often results in negative surplus earnings per share against the basis index, for many years³.

The movement of the Moscow Exchange's shareholder equity is demonstrated in *Fig. 19*. Its size was very volatile – a fact that may alarm its potential investors. Probably it will be necessary to supplement the official report by a note explaining the causes of such broad fluctuations of the recorded data.



Source: calculations based on data released by Russian exchanges on their own assets, published on their official websites.

Fig. 19. The RTS, the MICEX and the Combined Moscow Exchange's Shareholder Equity

The integration of the IT, trading and settlement systems is a slower process by comparison with the legal and administrative merger of the two exchanges. One manifestation of the

¹ Trifonov A., Papchenkova M., Kamneva G. Global'nye gosti stolitsy [The Capital's Global Guests]. *Vedomosti*, 15 February 2013; Shlygin I. Kitaiskoe IPO. [A Chinese IPO]. *RBC Daily*, 15 February 2013; Gaidav V., Kuznetsov I. Klubnoe IPO. [A Club-style IPO]. 15 February 2013.

² Rudenko P. *Moskovskaia birzha dlia IPO otsenena v \$4,4-5 mlrd.* [The Moscow Exchange is Evaluated for an IPO in the Amount of \$4.4-5 bn]. *Forbes*, 1 February 2013. Published at <http://m.forbes.ru/article.php?id=233700>

³ Abramov A.E. *Problemy IPO-SPO Rossiiskikh kompanii. Ekonomiko-politichaskaia situatsiia v Rossii.* [The Problems of IPO-SPO Faced by Russian Companies. The Economic and Political situation in Russia]. *Ye. T. Gaidar Institute for Economic Policy*, No. 10, 2012. pp. 58-54.

existence of such problems was the serious technical errors and technology glitches in the exchange's operation in 2011. On 9 August, the trades on the RTS futures market were suspended for 1.5 hours. On 17 August, the trades in securities on the MICEX were likewise suspended for 1.5 hours, and for the 15 minutes no information on the technology glitch was posted by the exchange¹. On 1 and 8 November 2011, the MICEX suspended its trades in securities for technical reasons. It was explained that the two-hour-long suspension of trading on 1 November happened because of the incorrect interaction of software components on a number of servers providing the access of participants to the trading system; and the more than one-hour-long suspension on 8 November – the incorrect transmission of information on the residuals available to the participants in trades². On 24 November 2011, OJSC RTS suspended its evening trading session on the futures and Standard market for half-an-hour: instead of 19:00, it started at 19:30. An unprecedented technology glitch occurred on the futures market on the day when the legal merger of the exchanges was finalized – 19 December 2011. After the clearing session based on the main session's results, unsanctioned transactions began to be recorded on the accounts of the participants in trading. Many private investors suffered losses³. In this connection, the exchange's management and many brokers through whom the bids had been placed declared that they were not obliged to compensate those investors for their losses⁴. The exchange's explanation was that, after the main session's results had been drawn up, some incorrect data on the trades and cash positions of the participants were downloaded into the trading system. Another technology glitch occurred on the exchange on 6 March 2012: for twenty minutes, the trade participants in FORTS and Standard markets failed to receive part of the information on their positions⁵.

According to the FFMS's head Dmitry Pankin, the MICEX and the RTS, being too busy dealing with the financial and legal aspects of their merger, failed to ensure smooth-running trades⁶. After considering the results of its audit of the exchange after the December 2011 technology glitch, the FFMS published a statement that 'the process of development, testing and exploitation of the technologies applied in conducting trades on the exchange is not compliant with the performance and reliability requirements that are presented, first of all, by the users of its services'⁷. However, no sanctions were imposed on the exchange, and the regulator only issued an instruction that mandatory audits of the technical devices were to be conducted by an independent organization. The exchange designated the PwC company to be that organization.

Technical problems continued to plague the trading sessions on the Moscow Exchange throughout 2012 and 2013. On 23 April 2012, the Moscow Exchange's securities market was halted for 4 hours, and the situation – for the first time in the exchange's history – was de-

¹ Mazunin A., Rudenko P. *MMVB prikryla Ameriku*. [The MICEX Un-discovers America]. *Kommersant*, 19 August 2011.

² Trifonov A. *Utro bez birzhi*. [A Morning without the Exchange]. *Vedomosti*, 9 November 2011.

³ Rudenko P., Mazunin A. *Fond-Mazhor* [Fund-majeure]. *Kommersant*, 20 December 2011.

⁴ Rudenko P., Mazunin A. *Klientov MMVB-RTS pustili v raskhod* [The Clients of the MICEX-RTS Have Been Bumped Off]. *Kommersant*, 21 December 2011.

⁵ Rudenko P. *Birzha pokrivila otrazheniem*. [The Exchange Distorts Its Reflection]. *Kommersant*, 7 March 2012.

⁶ Verzhbitskiy A. *Dmitrii Pankin nedovolen sboiami*. [Dmitry Pankin Is Displeased with the Technology Glitches]. *RBC daily*, 17 November 2011.

⁷ Rudenko P., Mazunin A. *FSFR sdelala sbivchivye vyvody*. [The FFMS Made Confused Conclusions]. *Kommersant*, 24 January 2012.

clared to be an emergency¹. In the FFMS statement of 24 April 2012 concerning that incident it was noted that, in spite of the instructions issued to the exchange and its reports on the correction of violations duly submitted to the FFMS, as well as the plans being developed by the exchange for the purpose of modernizing its information technologies complex, the exchange still had failed to pay sufficient attention to strategic development of IT issues, and in particular the reliability of its software and hardware. There followed no serious sanctions against the Moscow Exchange, the FFMS only imposed a fine in the amount of Rb 300,000. However, from May onwards, the exchange began to implement certain measures, which finally resulted in a complete replacement of its CEOs.

On 20 August 2012, the Moscow Exchange accepted no bids for its Main Market sector because of an operational error of one of its employees². On 14 November 2012, there was a major technology glitch in the Moscow Exchange's foreign exchange market, and trading was discontinued for nearly 3 hours³. On 21 February 2013, for technical reasons, trading in foreign currencies was suspended at the UTS.

The Moscow Exchange was also less than perfect in managing its staff. In the midst of preparations to the IPO, the old managerial team was replaced. In May 2012, the Moscow Exchange introduced two separate posts of Chairman of the Executive Board and President of the Exchange – both formerly occupied by Ruben Aganbegyan. Alexander Afanasiev became the new Chairman of the Executive Board of the Moscow Exchange. Senior Managing Director and First Deputy Chairman of the Moscow Exchange Roman Goryunov quit his job from 1 July 2012. From 25 September 2012, the Moscow Exchange was left by its President Aganbegyan.

3.2.6. A New Regulation Model in the Financial Market

In 2012, a number of decisions were made concerning the regulation model to be applied on the Russian financial market, which can be regarded as a landmark in its entire history. As a result of lengthy discussions, it was deemed necessary to create a mega-regulator of the financial market as part of the Bank of Russia's structure and to transfer to it certain regulatory and supervisory powers formerly exercised by other government departments.

The idea of creating a mega-regulator emerged largely due to those rather controversial changes that had occurred in the sphere of financial market regulation in 2011. In accordance with the RF President's Edict of 4 March 2011, No. 270 'On the Measures Designed to Improve Government Regulation in the Sphere of the Financial Market of the Russian Federation', the functions relating to stock market regulation were divided between the FFMS and the RF Ministry of Finance.

The task of elaborating and implementing the government policy and normative legal regulation in the sphere of financial markets was effectively reassigned from the FFMS to the RF Ministry of Finance. At the same time, in accordance with Item 5.2 of the Provision on the FFMS, the Service may only be allowed to take part in preparing the drafts of the main directions for the development of financial markets, draft federal laws and the normative legal acts to be issued by the President of the Russian Federation and the Government of the Russian Federation to address the fields that lie within the range of the Service's competence. So far,

¹ Trifonov A. *Birzha ob"iavila ChP*. [The Exchange Declares an Emergency]. *Vedomosti*, 24 August 2012.

² *Otdel finansov. Moskovskaia birzha*. [The Finance Department. Moscow Exchange]. *Kommersant*, 21 August 2012.

³ Papchenkova M., Kamneva G. *Valiutnaia pauza*. [A Foreign Exchange Pause]. *Vedomosti*, 15 November 2012.

the function relating to the stock market's development has been performed inadequately which, in particular, is demonstrated in Section 3.2.4. The regulatory bodies have been more interested in the issue of power distribution than that of developing the financial market.

By the RF Government's Decree of 29 August 2011, No. 717 'On Some Issues of Government Regulation in the Sphere of the Financial Market of the Russian Federation', the RF Ministry of Finance was granted the right to work out the main directions of the securities market's development and to coordinate the functions of the federal bodies of executive authority relating to the regulation of the securities market. The same decree established a unique procedure for adopting normative legal acts in the sphere of regulation of the financial market and institutional investors. Such acts are to be approved either by the RF Ministry of Finance in coordination with the FFMS or, vice versa by the FFMS in coordination with the RF Ministry of Finance. Thus, for example, under Item 5.3.17 of the Provision on the FFMS, approved by the RF Government's Decree No. 717, the FFMS is obliged to coordinate with the RF Ministry of Finance the following documents, standards, guidelines, requirements, etc.: standards for the issuance of securities, the prospectuses of securities to be issued by the emitters, the procedure for State registration of securities issues (or an additional issue), State registration of reports on the results of placement of a securities issue (or an additional issue); the mandatory requirements for the procedure of keeping the register of owners of inscribed securities, and the requirements for the procedure of keeping the register of owners of investment units; standards for accepting securities for public placement, circulation, quotation and listing; the procedure for granting access to the initial placement and circulation beyond the territory of the Russian Federation for the securities of emitters registered in the Russian Federation; the procedure and timelines for the disclosure of information by the emitters of securities; the procedure for issuing licenses for different types of professional activity on the securities market; and many other documents.

In its turn, the RF Ministry of Finance must coordinate with the FFMS the following normative legal acts on financial market issues: the requirements to the qualification and professional experience of persons acting as single executives of different institutional investors; the requirements to the qualification of professional securities market participants; the equity sufficiency norms for professional securities market participants, with the exception of credit institutions, and other requirements aimed at lowering the risks associated with professional activities on the securities market, including the procedure for calculating the size of equity for professional securities market participants, with the exception of credit institutions; the requirements to and the procedure for calculating the size of equity of an open-ended investment fund and the asset manager of an investment fund, open-ended investment fund or private pension fund; the procedure for calculating the size of equity of an applicant for a license for exchange trade organization, or an applicant for a license for mediation in transacting exchange-traded derivative contracts; the requirements to the asset structure of close-ended and open-ended investment fund; and many other types of documents.

Simply by going through the list of these powers one can easily understand just how unreasonable will be the practice of duplicating the functions of the two government agencies in the sphere of financial market regulation. The new power distribution pattern between the RF Ministry of Finance and the FFMS had a purely subjective foundation because it relied on the FFMS being *de facto* subordinated to the RF Ministry of Finance, and head of the Ministry, Alexey Kudrin, was simultaneously Russia's Vice Prime Minister. After he had left this post, that connection disappeared, and the mechanism of interaction based on personal communica-

tion between the heads of two government departments became dysfunctional. In the newspaper *Vedomosti*, an anonymous source from the RF Ministry of Finance commented the situation as follows: ‘... as a result, the coordination between the two departments was transformed into perpetual argument, all issues were submitted to the government for discussion, and the decisions were made there’¹.

The fact that the decisions relating to the redistribution of powers between the RF Ministry of Finance and the FFMS were subjective and lacked proper substantiation becomes especially noticeable in view of the decline of activity and the level of earnings of the market participants coupled with the complaints that the funding provided by the government for the purpose of market regulation and supervision is insufficient. Besides, this principle of distributing the responsibilities reduces personal responsibility of the officials involved in the process and results in excessive budget expenditure being allocated to the upkeep of the staff of the two government structures performing parallel functions. In the first half of the 1990s, the unreasonably arranged division of functions relating to market regulation and supervision between the RF Ministry of Finance, the Bank of Russia, *Goskomimushchestvo* (the State Committee for State Property Management of the Russian Federation), and some other departments was the reason why this was the time of flourishing financial pyramids and other types of unlicensed financial activities that resulted in large-scale violations of the rights of private investors.

The measures introduced in 2011 in order to restructure the system of regulation and supervision of the financial market did not provide adequate solutions to many of the existing law enforcement problems. Although the FFMS became the only agency responsible for control and supervision in the sphere of financial markets – including the control and supervision of insurance companies, credit cooperation, microfinance, commodity exchanges, exchange mediators and brokers, government control over compliance with legislation of the Russian Federation on the use of insider information and market manipulation, - its sphere of responsibility was not extended to banks, audit companies, many aspects of the activity of private pension funds and pension saving managers, the latter being regulated by the RF Ministry of Finance and the RF Ministry of Health Care and Social Development. The inadequacy of supervision over the non-banking sector on the financial market was largely associated with the shortage of highly qualified staff at the FFMS caused by insufficient financing. As admitted by deputy head of the FFMS Alexander Sinenko, an average salary size at the FFMS is Rb 32,000, whereas at the RF Ministry of Finance it amounts to Rb 93,000, and at the Bank of Russia – to Rb 110,000. At the same time, one FFMS official supervises approximately 10 subjects, and the norm for the Bank of Russia is 10 officials per supervised subject². Two years after the enactment of Federal Law of 27 July 2010, No. 224-FZ ‘On Counteracting the Unlawful Use of Insider Information and Market Manipulation’, and on Introducing Alterations in Some Legislative Acts of the Russian Federation’, this area, as of July 2012, was supervised by only three FFMS officials. The proposals of the FFMS to the effect that its staff should be increased in a proportion necessary for implementing that Law were not accepted

¹ Papchenkova M., Trifonov A., Rozhkov A. *Novye polnomochiia dlia TsB*. [New Powers for the CB]. *Vedomosti*, 24 September 2012.

² Materials of the round table discussion on the creation in Russia of a mega-regulator on the basis of the Bank of Russia, held by the Russian Union of Industrialists and Entrepreneurs (RSPP) on 12 September 2012. See the Finmarket agency’s website: http://www.finmarket.ru/z/bw/banks_aninf.asp?id=3056778&sec=1443&p=1

by the RF Government, and so its actual implementation, in fact, never happened¹. It is not a coincidence that, also two years later, First Deputy Prime Minister Igor Shuvalov said that the attempt to create a mega-regulator on the basis of the FFMS was ‘such an awkward compromise’².

Against the backdrop of all these problems typical of the Russian stock market in 2011 and early 2012, the RF Government-initiated decision to create a single mega-regulator for regulating the financial market appears to be quite logical. However, so far no official documents determining its powers, responsibilities and the organization process have been adopted. Judging by the available official documents and statements made by government officials at different levels it may be assumed that the mega-regulator will be created in the form of a subdivision (main executive office) of the Bank of Russia that will ‘take over’ the FFMS. The source of financing for the mega-regulator will be the Bank of Russia, without any participation on the part of the federal budget³. The mega-regulator’s powers will include the regulation and supervision of the bulk of financial institutions operating in Russia, as well the regulation and supervision of her financial markets. The exceptions will probably be the RF Pension Fund, the activity of insurance companies relating to medical insurance, the insurance of military servicemen, and other types of insurance services where insurers act as the government’s agents. It is still unclear if the mega-regulator will also perform the functions pertaining to the regulation and development of the financial market that are currently consolidated to the RF Ministry of Finance. It is not determined which body will be responsible for the supervision of insiders and insider trade on the financial and foreign exchange markets.

On the whole, the idea of creating a mega-regulator in Russia follows the course of recent global changes in the world financial markets. This measure can probably provide solutions to some of the key problems involved in the development of the domestic financial market, and will help foster investor confidence in its reliability. First of all, it may improve the level of qualification of the personnel responsible for the regulation, supervision and development of financial markets. The supervision of non-bank financial institutions will be more efficient if based on the principle of prudential supervision, when performance problems are identified as they emerge, and not *post factum*, after a crisis situation has already developed⁴. One important consideration, however, is that prudential supervision should be applied with caution, and its specific mechanisms designed for banks should not be automatically extended also to non-bank financial institutions and investment funds. And finally, the existence of a mega-regulator will eliminate the duplication of functions by government executive bodies, thus saving billions of rubles for Russia’s budget.

¹ Kamneva G. *FSFR ne khvataet insaidarov*. [The FFMS Lacks Insiders]. *Vedomosti*, 10 July 2012.

² Rudenko P., Kuznetsov I., Yakovleva M. *Megaregulirovshchik*. [Mega-regulator]. *Kommersant*, 27 December 2012.

³ Sapozhkov O., Grishina T. *Belyi dom ustupil TsB polnomochiia po regulirovaniu strakhovshchikov i NPF*. [The White House Cedes to the CB Its Powers to Regulate Insurers and PPF]. *Kommersant*, 20 February 2013.

⁴ In 2012, under order of the FFMS, NAUFOR conducted a study that provided a foundation for elaborating concrete proposals concerning the mechanism of organizing and exercising prudential supervision of non-bank financial institutions. On the basis of these proposals, special pilot zones will be created for testing the principles of prudential supervision in order to avoid a situation when the excessive requirements applicable to banking institutions may be automatically extended to non-bank financial institutions (Kamneva G. *Plan deistvii dlia FSFR*. [A Plan of Action for the FFMS]. *Vedomosti*, 21 November 2012).

At the same time, some positive aspects of international best practices of running a mega-regulator on a financial market have not been properly considered yet; there also remain some doubts as to whether this supervision will indeed be efficient.

Besides, Russia's non-bank financial institutions express their serious concerns about the risk of a conflict of interests, because the Bank of Russia is simultaneously the biggest market participant, a stakeholder in Russia's biggest stock exchange, the owner of the biggest bank, and the regulator may underestimate the importance of non-bank institutions if it created on the basis of the Bank of Russia¹. As seen from international practice, among the 115 full members of the International Organization of Securities Commissions (IOSCO), only in 13 countries – which, besides, by no means represent the world's biggest stock markets – the functions of a mega-regulator are executed by national (central) banks².

As far as the sources of funding for Russia's financial mega-regulator are concerned, the plan of its creation was not tested against the experience of the world's most important financial markets. According to the preliminary decisions, the mega-regulator will be funded from the Bank of Russia's budget. Given the fact that, at present, 75% of the Bank of Russia's profits is transferred to the federal budget, the cost of the mega-regulator's upkeep will be covered at the expense of reducing federal budget revenue by the same 75%. Many countries apply a mixed approach to arranging the financing sources. Bearing in mind that the principal beneficiaries of the financial market are by no means the entire population of a country, but, as a rule, only a relatively narrow circle of market participants and investors – part of the costs is covered by targeted contributions of the participants in the stock market. In the USA, the SEC is funded from the federal budget. Meanwhile, the regulatory body generates an income in the form of duties levied on the volume of trading operations, as well as the registration of issues of securities. In 2011, a duty of \$ 19.1 was levied on each million of dollars in the overall volume of exchange and off-exchange trading. The payer of this duty on exchange transactions is the exchange itself, and broker pay it on off-floor transactions. In Australia, the UK and Germany the mega-regulators are not funded from the state budget. Instead, all the costs are covered by market participants.

It can be hoped that many of the problems that are as yet unsolved will be provided with adequate solutions in the course of implementing the current approaches to organizing the mega-regulator's activity.

3.3. Financial Institutions in Search of New Ideas for Growth

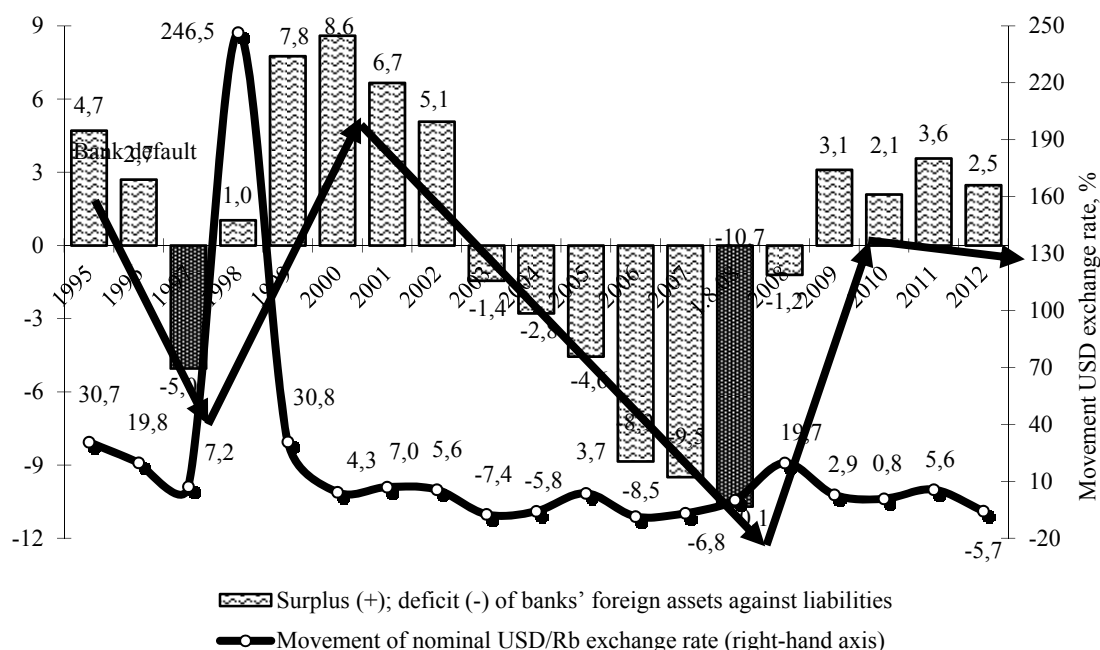
3.3.1. Restrictions on Carry Trading and Growth of Financial Leverage

In 2012, Russia's banking system was in search of an appropriate model for sustainable development in conditions of limited access to carry trading (CT) strategies. The constraints had arisen due to global financial markets now being closed to borrowers from the developing countries, as well as to capital outflow from Russia and to the Bank of Russia's foreign exchange and monetary policies. The scale of involvement of banks in CT can be estimated by

¹ As Chairman of NAUFOR's Board of Directors Alexey Timofeev noted during the round table discussion of the issues of creating a mega-regulator on the basis of the Bank of Russia, held by the Russian Union of Industrialists and Entrepreneurs (RSPP) on 12 September 2012. See http://www.finmarket.ru/z/bw/banks_anlinf.asp?id=3056778&sec=1443&p=1

² Danilov Yu. *Ostanovit' monstra!* [Stop the monster!] *Expert*, No. 46, 19-25 November 2012.

means of setting the index of deficit (–) or surplus (+) of the banks’ foreign assets against the value of non-residents’ claims to the banks, and then comparing it with the total value of bank assets (Fig. 20). In 2012, for a fourth year in a row, the value of the banks’ foreign currency assets was higher than the sum of their liabilities to non-residents, amounting to 2.5% of the total bank asset value.



Source: calculations based on data released by the Bank of Russia.

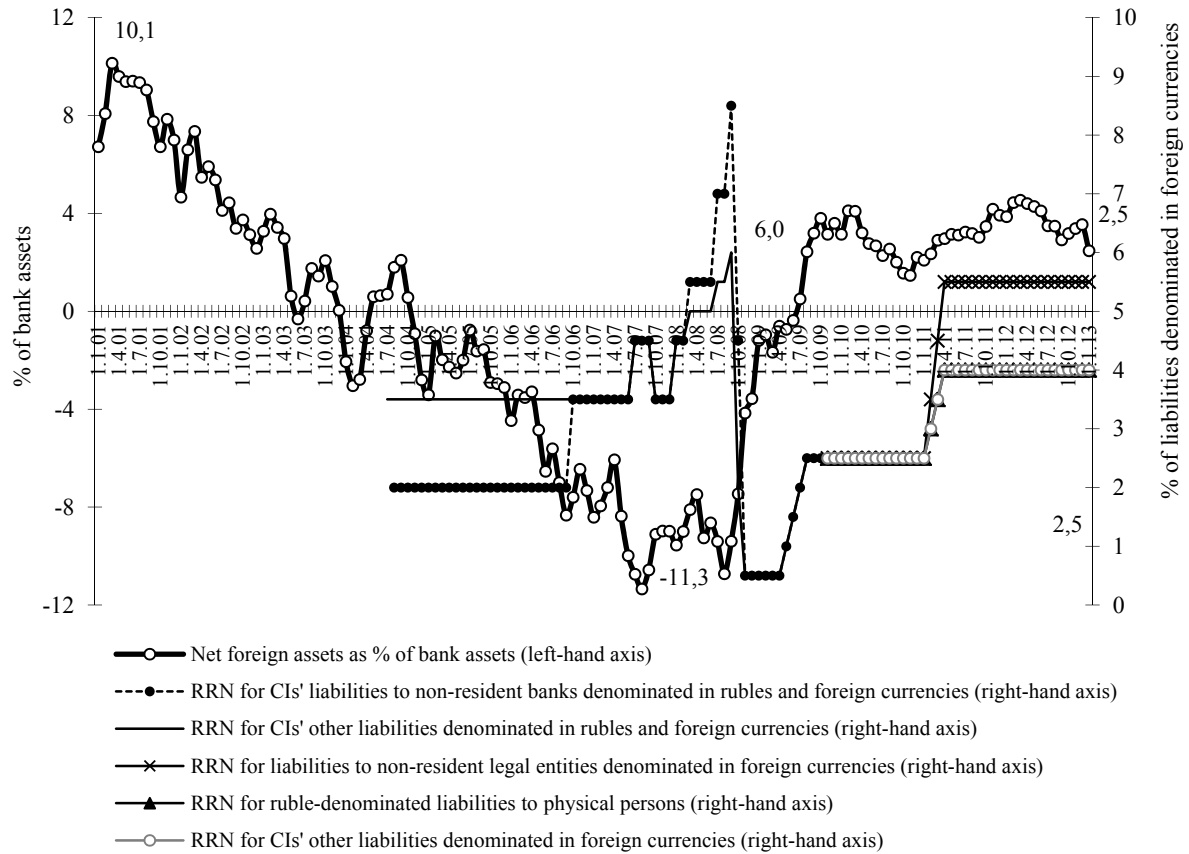
Fig. 20. Surplus (+) / Deficit (–) of Banks’ Foreign Assets Against Liabilities (% of the Value of Banks’ Assets (Liabilities) – Left-hand Scale)

From the first half-year of 2011 onwards, the Bank of Russia raised the required reserves norms (RRN) against liabilities to non-resident legal entities denominated in foreign currencies from 2.5% to 5.5% to the value of these liabilities, and for other liabilities denominated in foreign currencies – from 2.5% to 4.0% (Fig. 21). This move resulted in a noticeable increase in the surplus of foreign currency assets over liabilities. The Bank of Russia’s strategy of allowing broader fluctuations of the ruble’s exchange rate as part of its switchover to inflation targeting is also aimed at restricting carry trading. In December 2011, the RF Central Bank announced that it would expand the bi-currency basket corridor from Rb 5 to Rb 6.

However, from 1 March 2013, the Bank of Russia introduces a single required reserves norm of 4.25% for all liabilities, including liabilities to non-residents denominated in foreign currencies. The RRN for the liabilities to non-resident legal entities denominated in foreign currencies will be decreased from 5.5% to 4.25%. Although the Bank of Russia stated that this ‘does not mean a reversal of the monetary policy’, a number of experts regard this measure as a kind of signal to banks that they should borrow from abroad¹. We believe that the CT risks are also increasing for another reason: this decision comes into force simultaneously with the liberalization of access to Russia’s financial market for the settlement and clearing systems *Clearstream* and *Euroclear*, as a result of which the OFZ market will receive a total

¹ Plotonova O. *TsB otkryl granitsu*. [The CB Opens the Border]. *Vedomosti*, 13 February 2013.

of Rb 200–300bn of domestic investment in compensation for the losses that it may expect in 2013 due to the re-orientation of the pension saving portfolio towards investment in infrastructure bonds. Besides, the risk of pension savings withdrawal from OFZ is associated with the possibility of the funded pension system being abolished or reduced.

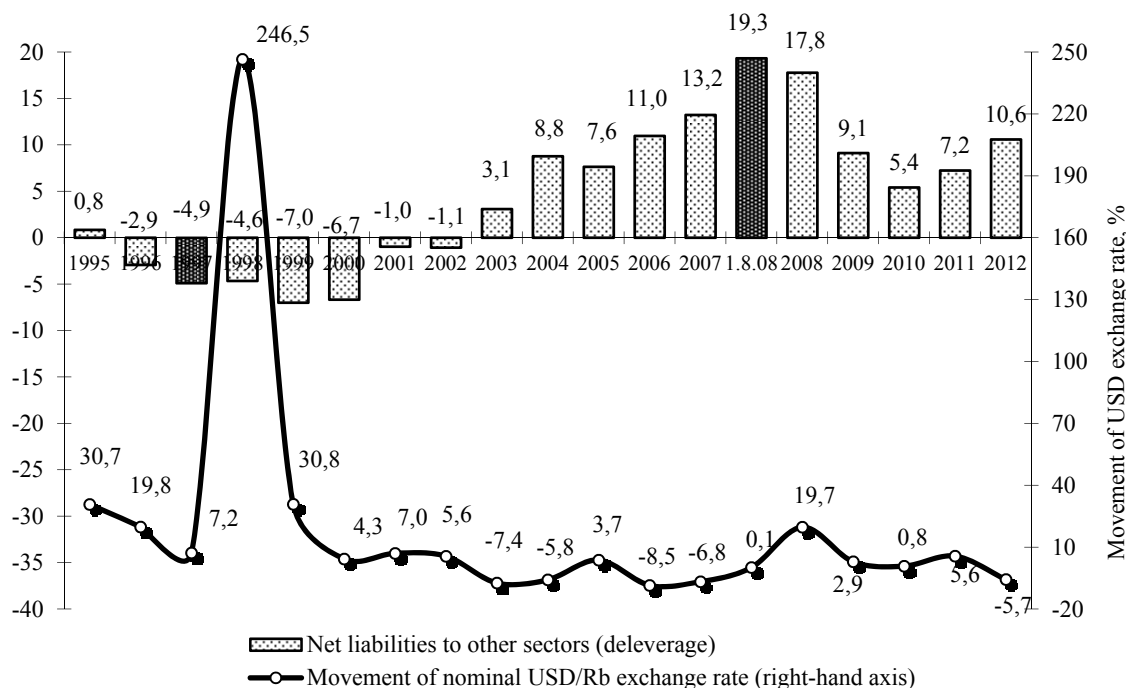


Source: calculations based on data released by the Bank of Russia.

Fig. 21. Carry Trading Regulation by the Bank of Russia, as of 1 January 2013

From 2011, the period of banking system deleveraging¹ was over (Fig. 22), which means that the credit portfolio was once again increasing at an accelerated rate by comparison with deposits. In 2012, the ratio of the credit portfolio value to bank assets exceeded that of deposits to bank assets by 10.6 percentage points. This roughly corresponds to the level of leveraging in 2006. However, while in 2006 the leverage was provided by CT, in 2012 it was sustained by short-term borrowings by the Bank of Russia.

¹ The index of net claims of banks to the population and businesses against aggregate bank assets



Source: data released by the Bank of Russia.

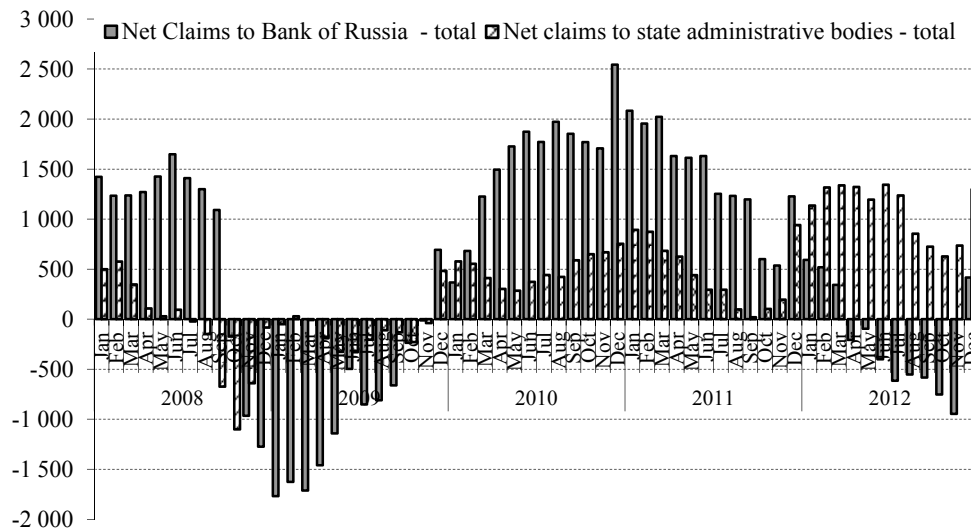
Fig. 22. Credit Surplus over Deposits (as % of Bank Asset Value – Left-hand Axis)

3.3.2. Liquidity and the Current Stability of the Banking System

Fig. 23 shows two trends typical of the banking system in 2012. On the one hand, over the period from April to December,¹ there occurred an unprecedented growth in the net debt of credit institutions to the Bank of Russia. By the scale of expansion, the support rendered to banks by means of loans in 2012 is comparable only with that observed in the acute phase of the financial crisis in September - December 2008. On the other hand, in 2012 the volume of net government borrowing from banks in the form of OFZ hit its all-time record high. So, judging by these facts, it can be assumed that the monetary authorities did everything in their power to sterilize the increasing cash inflow into the banking system from the central bank by means of selling federal bonds to banks.

The RF Ministry of Finance’s orientation towards the domestic debt market can be explained by its desire to replenish the Reserve Fund in conditions of declining revenues caused by a halt in the upward movement of prices for energy carriers on international markets. In accordance with the *Main Directions of Government Debt Policy in the Russian Federation for 2013–2015* (hereinafter – *Main Directions*), government borrowings on capital markets will become the principal source for covering budget deficit. All these factors put together will urge the monetary authorities to return to CT in 2012 – at least in part, so as to promote new purchases of federal securities. According to *Main Directions*, it is expected that in the medium-term perspective the share of non-residents in the OFZ market will go up from the current 5.5% to 10%, while in the long-term perspective it will increase to 25%.

¹ The December 2012 net borrowing situation favorable to the Bank of Russia was temporary and atypical. It was caused by the traditionally occurring anomalous and temporary growth of deposits with banks as a result of ‘de-freezing’ of budget funds.



Source: the Bank of Russia's overview of credit institutions

Fig. 23. Estimate of Net Claims of Credit Institutions on the Bank of Russia and State Administration Bodies, bn Rb

The data presented in Fig. 24 explain why the excessive support of banks by loans issued by the Bank of Russia did not result in a surge in the volume of banks' investment in government securities. This phenomenon occurred due to a sharp drop in the volume of deposits held by credit institutions with the Bank of Russia, which previously served as one of the sources for sterilizing the excess of liquidity in the banking system. Its average monthly level declined from its record high of Rb 937.3bn in February 2011 to Rb 132bn in December 2012. Now this function has been taken over by OFZ, whose yield is approximately by 2 p.p. higher than the interest rate on deposits with the Bank of Russia.

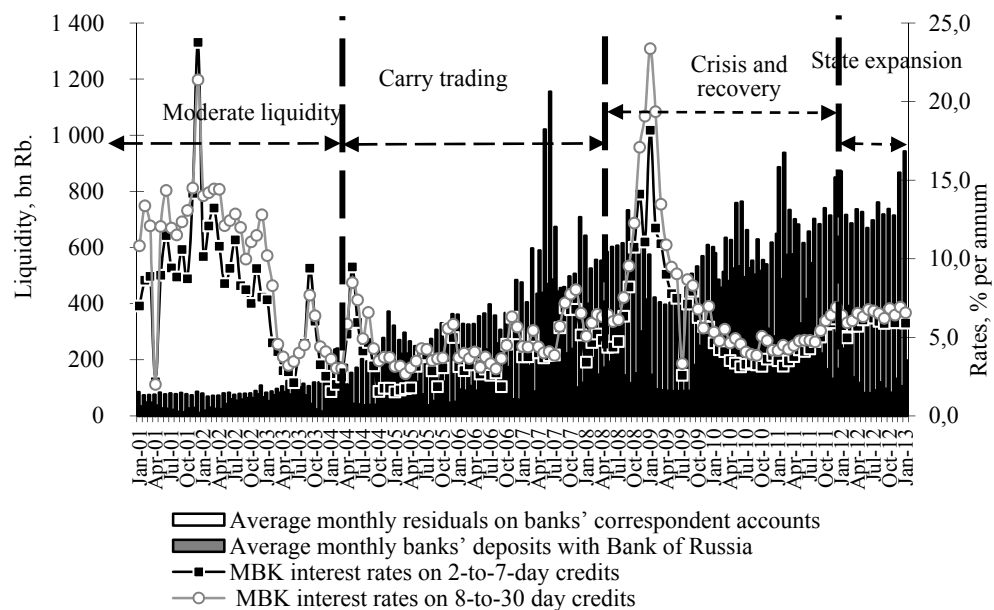
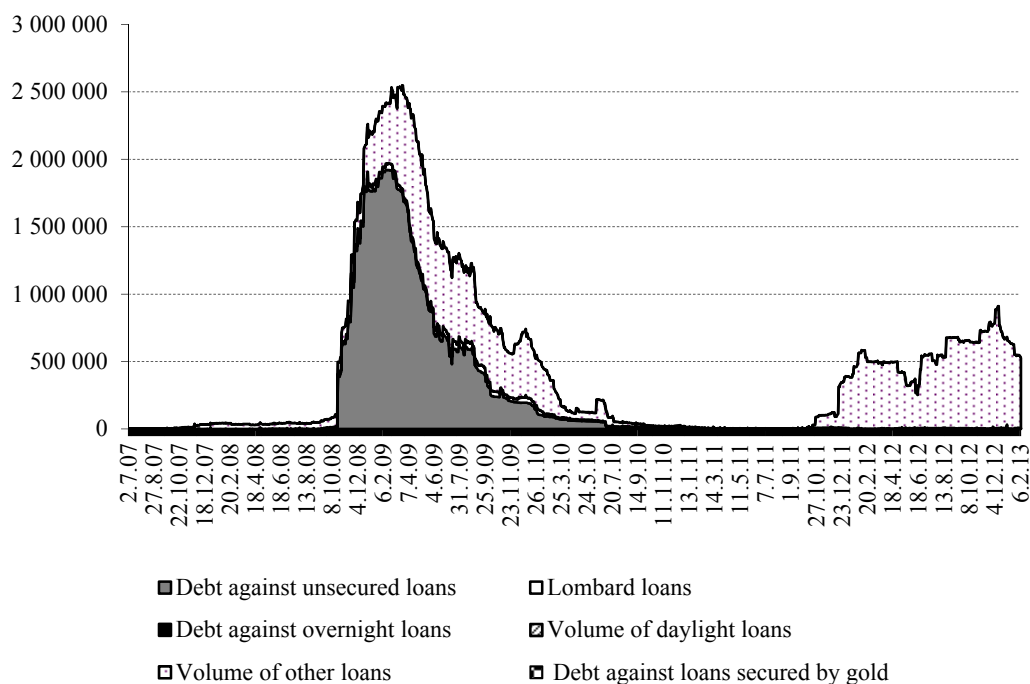


Fig. 24. Average Monthly Banking Liquidity Indices and the Interest Rates on the Interbank Credit Market in 2001 – January 2013

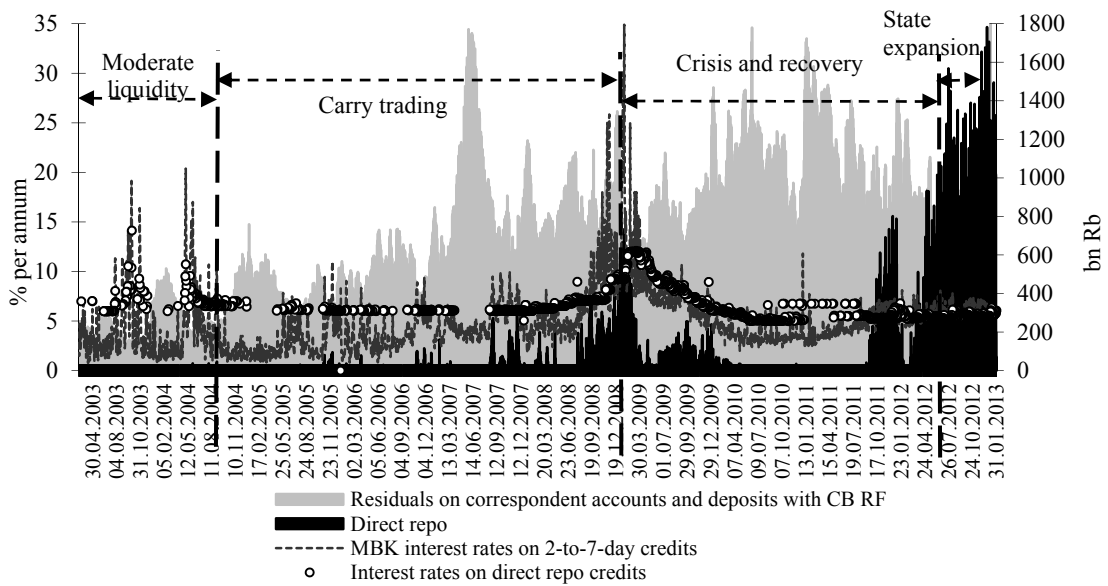
The main form of support rendered to the banking system by the Bank of Russia is the funding that banks receive via direct repo operations. This type of funding is designated in *Fig. 25* as debt against other credits. The level of banks' debt against repo operations in 2012 became significantly higher than the volume of these operations observed during the crisis period of 2008–2009. However, at the time of crisis the main form of crediting was the issuance of unsecured loans to banks.



Source: data released by the Bank of Russia.

Fig. 25. Credit Institutions' Outstanding Debt against Loans Received from the Bank of Russia, million Rb

Fig. 26 depicts different periods in the history of the Russian banking system's development, depending on the sources of bank liquidity support. The period from the second half-year of 2004 through July 2008 saw the peak of carry trading (CT). After Russia was included in the investment ratings of the leading international rating agencies, from late 2004 and until the onset of the financial crisis in 2008 banks could borrow cheap money on foreign markets. The period from August 2008 through March 2012 was a time of crisis and post-crisis recovery. During the acute phase of the crisis the government was actively resorting to various forms of loans to banks, including unsecured loans. In the period of recovery, it would periodically resort to direct repo operations in response to problems with bank liquidity. From April 2012 onwards, the Bank of Russia began to regularly apply direct repo operations as a mechanism of lending money to banks by way of supporting them. That period, with certain reservations, may be described as a time of growing government credit expansion in the banking system. The volume of loans increased in qualitative terms, and the periods of loans granted against the pledge of securities were lengthened. In some instances, the daily amount of credit on the direct repo market exceeded Rb 1.6 trillion.

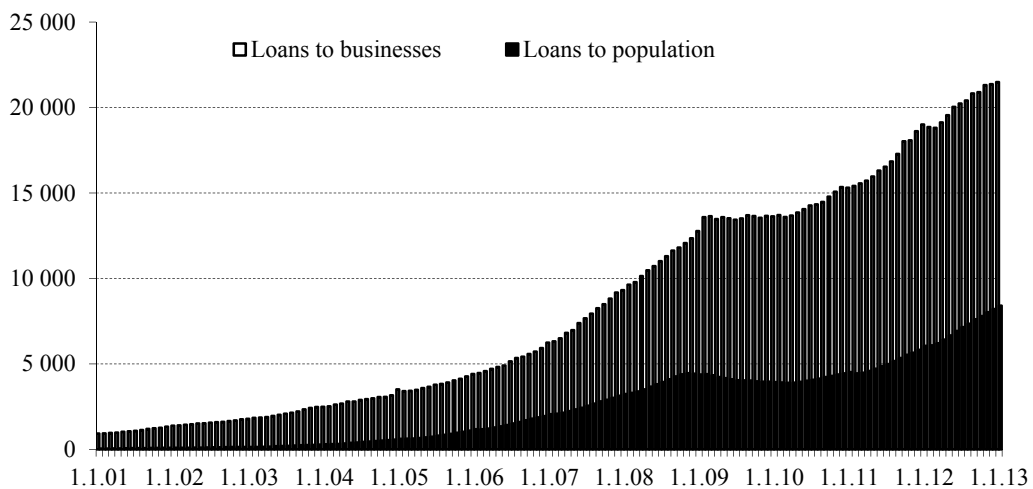


Source: data released by the Bank of Russia.

Fig. 26. Direct Repo Operations as a Mechanism of Bank Liquidity Regulation in 2003 – January 2013

3.3.3. Growth of Crediting

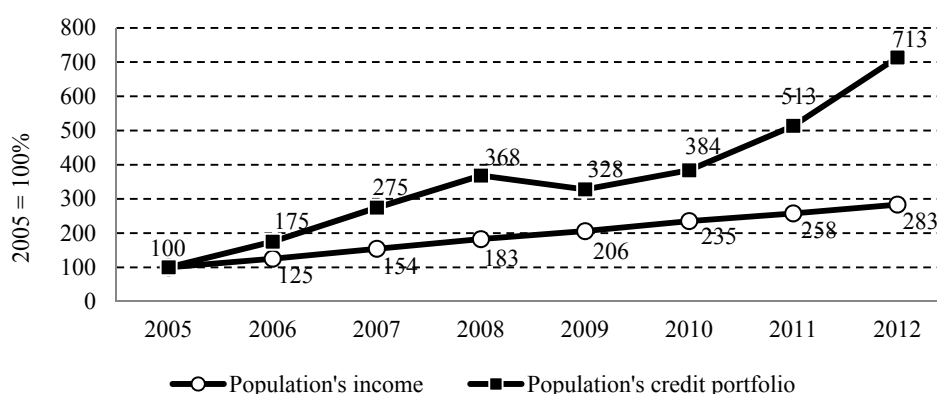
One positive consequence of the support rendered to the banking system by the Bank of Russia in 2012 (in contrast to the situation on many developed financial markets) was an accelerated growth of the volume of crediting granted to the population and businesses (Fig. 27). This was one of the most important measures aimed at promoting domestic demand growth and the volume of investment by non-financial businesses; as a result, economic growth in Russia was sustained at the level of 3.4%. In 2011, the share of loans to the non-financial sector in the bank’s credit portfolio increased by 24.0%, that of loans issued to the population – by 33.8%. In 2012, the amount of debt outstanding owed by these two categories of borrowers increased by 13.2% and 38.9% respectively.



Source: the Bank of Russia’s overview of credit institutions.

Fig. 27. Russia: the Volume of Loans Issued, bn Rb, as of 1 January 2013

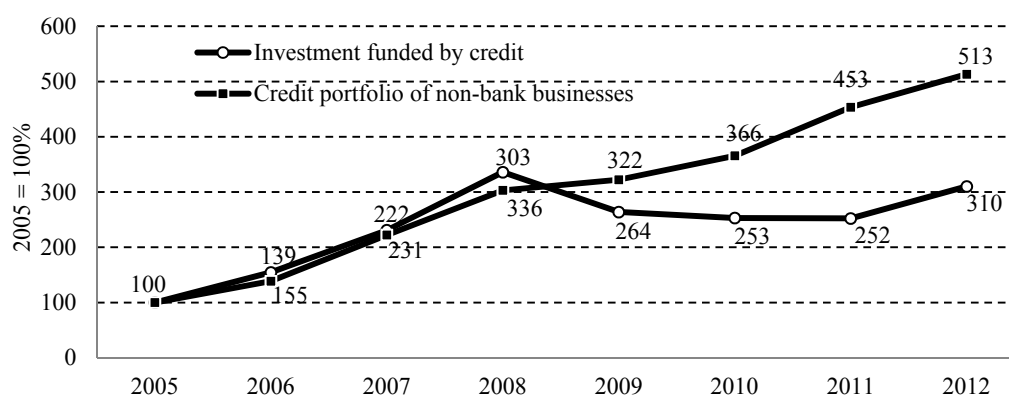
However, a rapid growth of banks' loans to the population is fraught with increasing risks of household insolvency. The data presented in *Fig. 28* are indicative of an increasing gap between the growth rate of the population's incomes and the volume of debt outstanding against bank loans. The volume of loans extended to the population rose 7.1 times on 2005, while the population's aggregate incomes over the same period increased only 2.8 times. In recent years, the Bank of Russia has been publishing a lot of analytical materials and statistical data on various aspects the financial market's functioning and the financial sustainability of its different sectors. However, the results of its surveys of banks, including the information concerning the share of loan redemption in the composition of incomes of different categories of banks' clients, are still unavailable to the general public.



Source: data released by Banka Russian and Rosstat.

Fig. 28. The Movement of the Population's Incomes and Loans, %

Some concerns have been raised by the information on the growth of the share of the non-financial sector in the banks' credit portfolio and the movement of the volume of investment made by businesses (less small-sized businesses) at the expense of bank credits (*Fig. 29*). The amount of loans issued to non-bank businesses rose 5.1 times on 2005, while the volume of investment funded by this type of loans increased only 3.1 times.



Source: data released by the Bank of Russia and Rosstat.

Fig. 29. The Dynamics of Credit-financed Investment¹ and the Movement of the Credit Portfolio of Non-financial Businesses, %

¹ The estimates for Q4 2012 are based on calculations.

3.4. The Market for Ruble-denominated Bonds

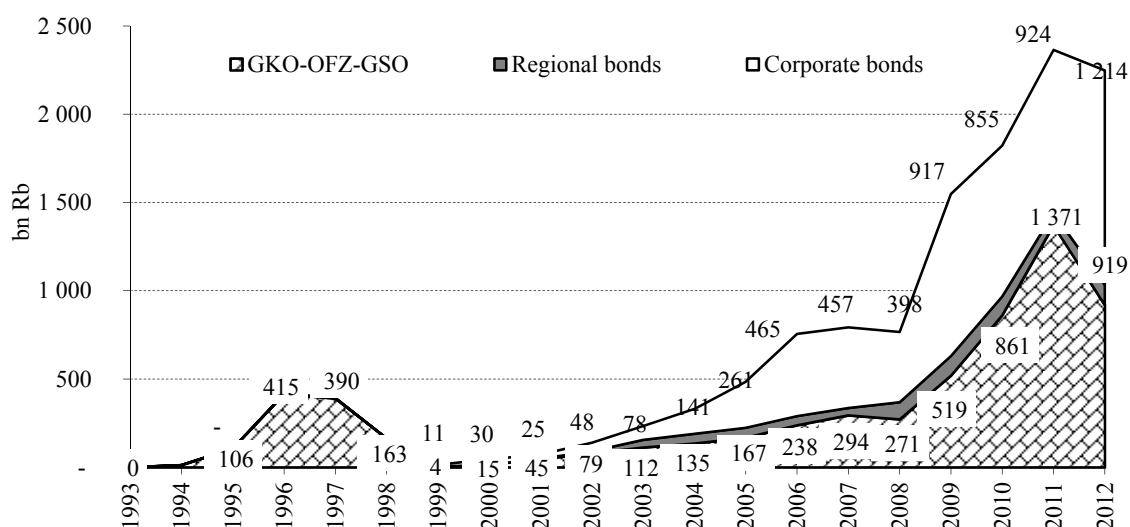
3.4.1. The Government Securities Market

In 2012, the market for ruble-denominated federal bonds was developing very successfully. This happened largely due to the measures implemented in order to achieve a unification, on the domestic market, of the rules for trades, settlements and depository record-keeping of OFZ and other types of securities, as well as to liberalize access to the OFZ market for non-residents (which primarily manifested itself in the opening of accounts with the NSD by *Euroclear* and *Clearstream*). From 13 February 2012, all the operations with OFZ were transferred onto the Moscow Exchange's Main Market. The Exchange estimated that the number of participants in trades in this category would increase from 304 to 640¹. The depository operations on the organized securities market were simplified and brought to a unified standard. Thus, in particular, the main depository for GKO-OFZ was no longer obliged to duplicate the data on the depo accounts of the holders of securities kept on the subdepositories' records, in the framework of the so-called SDTSC system (subdepository dealer technical support center). On the off-exchange market, from 1 January 2012 onwards, investors for the first time were allowed to trade in government securities by means of opening depo accounts for keeping records of the rights to government securities at the Russian depository, without mediators (subdepositories).

In accordance with the *Main Directions*, the OFZ market in 2012 was demonstrating the following changes: the liquidity of OFZ issues was on the rise (the average daily turnover of the secondary market of OFZ rose by 20%); the average size of a tradable OFZ issue doubled (from Rb 45bn to 87bn); the OFZ portfolio duration increased by 5.6% - from 3.6 to 3.8 years; and for the first time in the market's history an OFZ issue with a yield to maturity of 15 years was placed.

At the same time, in 2012 the trend towards accelerated growth of placement of government securities against that of corporate bonds was no longer visible (*Fig. 30*). Consequently, the fears that federal bonds may begin to oust from the market the bonds of corporate emitters proved to be unsubstantiated. In 2011, the volume of corporate bond placement amounted to Rb 924bn, and the value of new issues of government securities – to Rb 1,371bn. In 2012, the value of placed corporate securities increased to Rb 1,214bn, while the volume of placed federal bonds declined to Rb 919bn. Given the fact that in the *Main Directions* it is envisaged that the value of issued federal bonds should amount to Rb 1,213bn in 2013, Rb 842.2bn in 2014, and Rb 1,115bn in 2015, it is evident that, in the next few years, no accelerated growth in the volume of government securities placement against that of corporate bonds should reasonably be expected. It appears to be a more important goal for the government to replace the loss of the domestic pension system as the source of investment in government bonds by attracting a broad range of foreign investors – which can also be helpful in the event of a significant global market downturn.

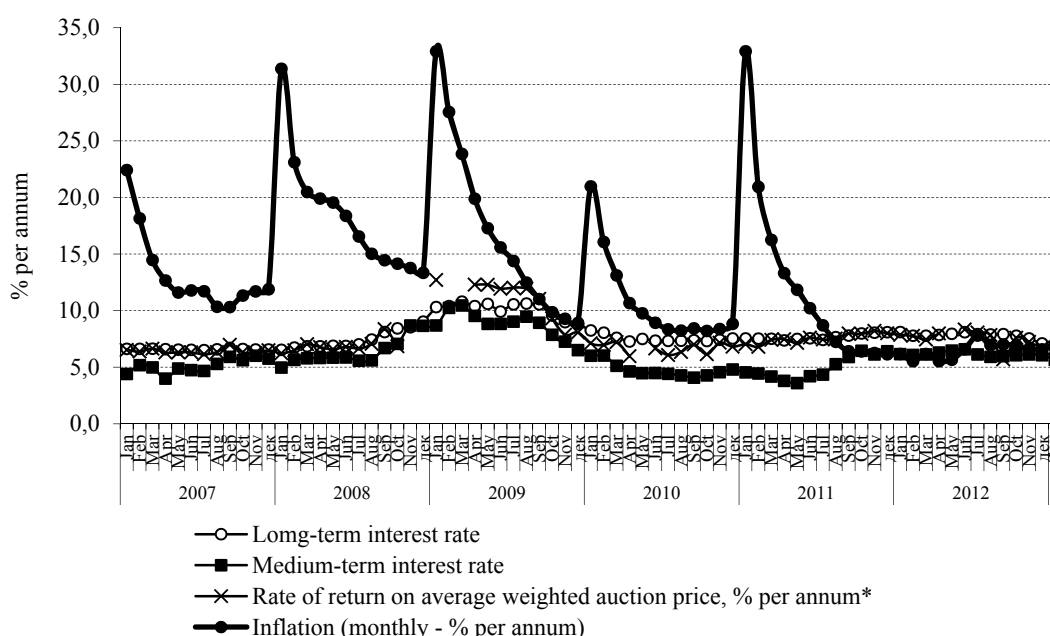
¹ Mazunin A. *Investory prishli za dlinnym rublem* [Investors are Chasing the Big Money]. *Kommersant*, 9 February 2012.



Source: data released by MICEX-RTS and the IMF.

Fig. 30. Placement of Ruble-denominated Bonds in 1993–2012

An additional factor conducive to successful placement of government securities in 2011–2012 was the relatively stable macroeconomic situation in Russia and the moderate inflation rate at the level of 6.1% in 2011 and 6.6% in 2012. Thus, it was possible to maintain the rate return on investment in OFZ for domestic investors at a level above the rate of inflation (Fig. 31). For example, in December 2012, the rate on long-term OFZ was 7.1% per annum, the average weighted auction price of OFZ was 6.72% per annum, and the inflation rate amounted to 6.59%.



* average monthly rate of return by the results of auctions, weighted for the bond placement volume.
Source: data released by Bank of Russia and Rosstat.

Fig. 31. Average Monthly Rates of Return on the OFZ Market and Inflation, % per annum

At the same time, any increase of the share of foreign investors in OFZ will inevitably reduce their yields. Although in the *Main Directions* the influence of this factor is estimated to be on the level of only 1 percent point, if the situation with inflation becomes unfavorable, this may once again push the real rate of return on OFZ into negative zone, thus making investment in OFZ unattractive in the eyes of domestic investors, who have to deal in the national currency.

3.4.2. The Situation on the Corporate Bond Market

Fig. 32 shows the monthly data on the issue volumes and the turnover of the secondary market for ruble-denominated corporate bonds on the Moscow Exchange for the period from 2001 through January 2013. In addition, there are data on bank liquidity, represented by the average monthly residuals on banks' correspondent accounts and deposits with the Bank of Russia. In 2012, the secondary corporate bond market's volume increased to Rb 58.0 trillion against Rb 36.3 trillion in 2011 and Rb 23.0 trillion in 2010. For the first time in the contemporary history of Russian stock exchanges, in 2012 the volume of secondary trading in corporate bonds exceeded that of exchange trading in shares in all modes, amounting to Rb 47.8 trillion.

The liquidity of the corporate bond market is highly dependent on the level of liquidity in the banking system, so the same phases as in the movement of bank assets kept with the Bank of Russia can also be distinguished in the movement of exchange trades in these instruments (CT, crisis and recovery, expansion of state-owned structures) (see *Fig. 26*). In the pre-crisis years the turnover growth corporate bond market was sustained in the main by the carry trading strategy. In the period of crisis and post-crisis recovery it relied on the Bank of Russia's resources flowing into the banking system in the form of unsecured loans and other forms of crediting. From April 2012 onwards, the corporate bond market's liquidity is sustained by direct repo operations with the Bank of Russia.

Another distinctive feature of the corporate bond market is the constantly increasing importance of the secondary market against that of initial bond placement. The ratio of issue volume to secondary trades in corporate bonds declined from 3.7% in 2010 to 2.5% in 2011 and 2.1% in 2012. On the one hand, the accelerated growth of the secondary corporate bond market's liquidity has a positive effect on interest rates and the duration of loan periods. On the other, the attraction of short-term resources for funding long-term loans increases the risks of that market, including the issuers' capacity to refinance their loans in the future.

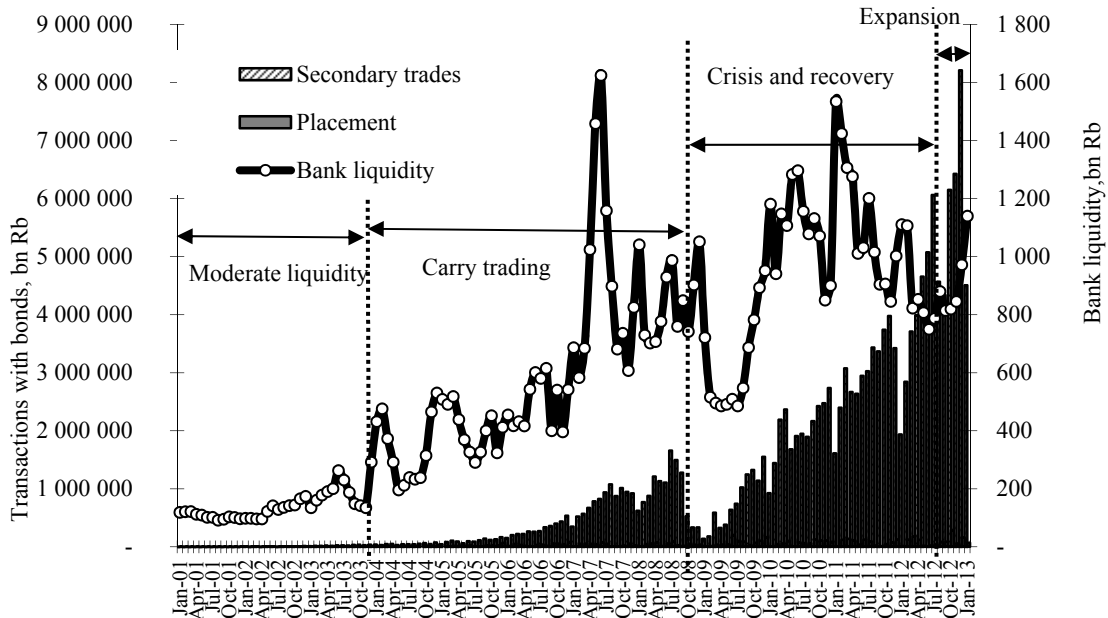
The most urgent problem for ruble-denominated bond markets, as before, is how to attract the resources of domestic investors. So far, banks serve as the principal source of money on that market, although their share in the structure of corporate bond holders had dropped from 42.7% in 2010 to 40.9% in 2011 and 30.6% in 2012. Supposedly, the declining share of Russian banks was counterbalanced by the increasing presence of non-residents. The share of pension saving in the compositing of bond value rose from 3.5% in 2010 to 4.9% in 2011 and 5.6% in the first 9 months of 2012. The share of open-ended investment funds in the structure of corporate bond holders amounted to only 0.5% in 2010, 0.6% in 2011 and 0.7% in 2012.

The fact that the corporate bond market is increasingly becoming an instrument for servicing interbank crediting operations – which, in fact, is contrary to the long-term nature of corporate bonds – can be seen from the structure of exchange transactions with corporate bonds on the Moscow Exchange (*Fig. 33*). In December 2012, the share of repo operations in the total value of exchange transactions with corporate bonds hit its absolute record high of

RUSSIAN ECONOMY IN 2012

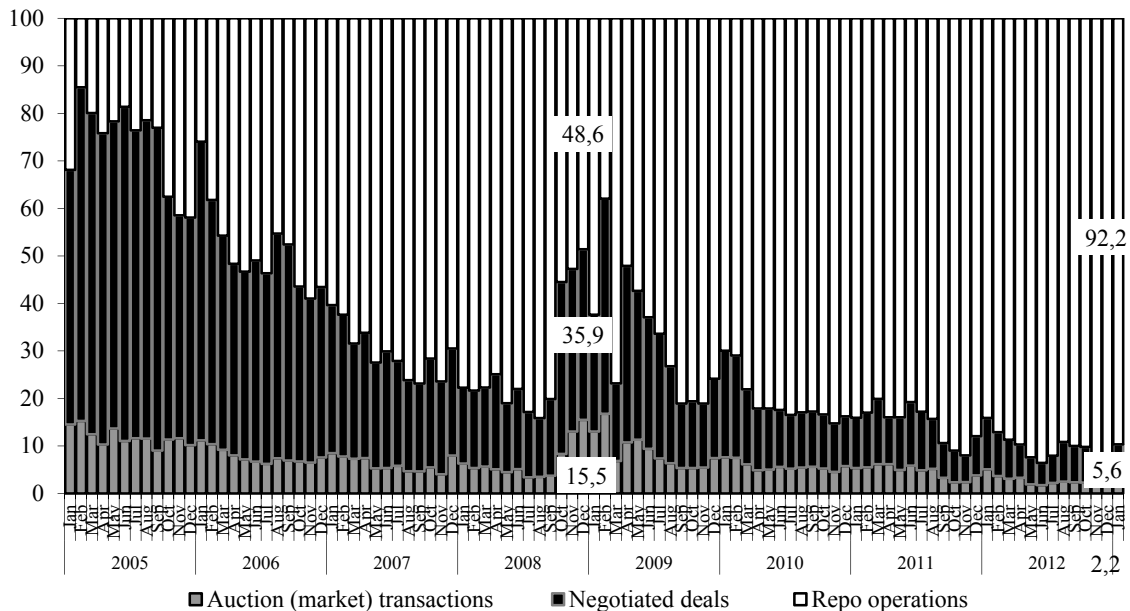
trends and outlooks

92.2%, getting beyond its level observed during the 2008 crisis. At the same time, only 2.2% of trades in corporate bonds are market transactions – that is, their real purpose is to create or restructure a portfolio. This sharp decline in the share of market transactions significantly increases the risks that the prices of corporate bonds may not be set on an objective basis in the course of trading on the Moscow Exchange.



Source: data released by the Bank of Russia and the Moscow Exchange.

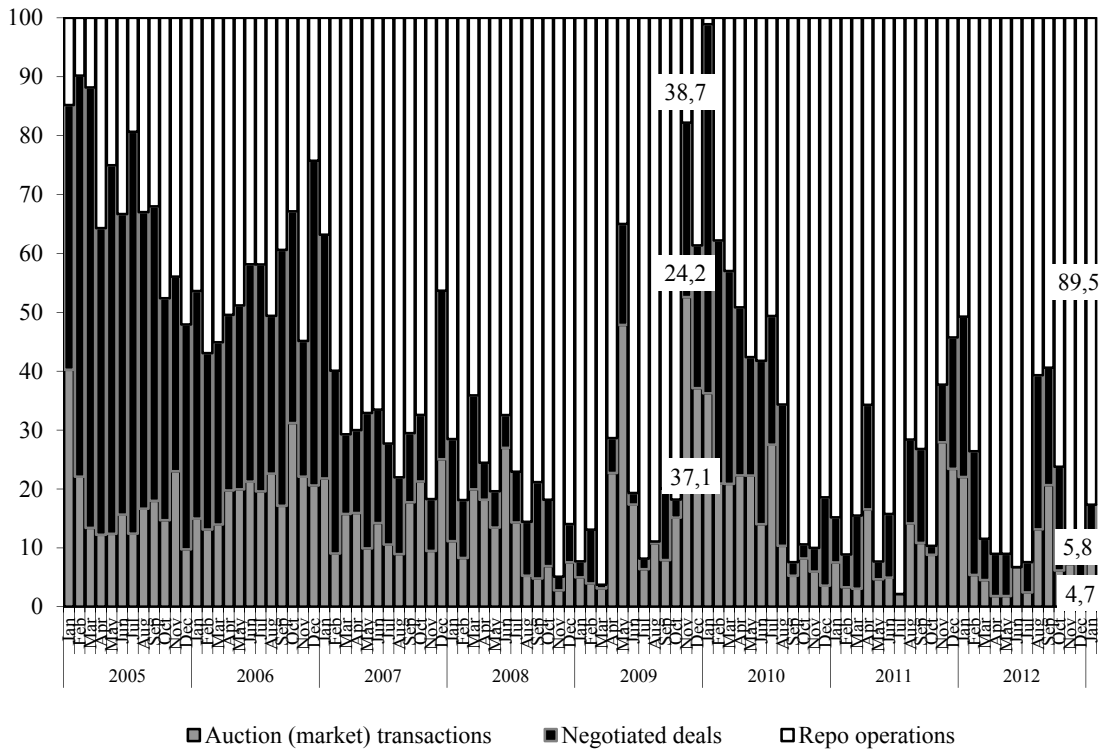
Fig. 32. Operations with Corporate Bonds and Bank Liquidity in the Period from January 2001 through January 2013



Source: calculations based on data released by the Moscow Exchange.

Fig. 33. The Structure of Transactions with Corporate Bonds on the Moscow Exchange, %

Similar problems, caused by the shrinking share of market transactions, are experienced by the exchange market for regional bonds (*Fig. 34*). In December 2012, the share of market transactions there declined to 4.7%, while the share of repo operations rose to 89.5%.



Source: calculations based on data released by the Moscow Exchange.

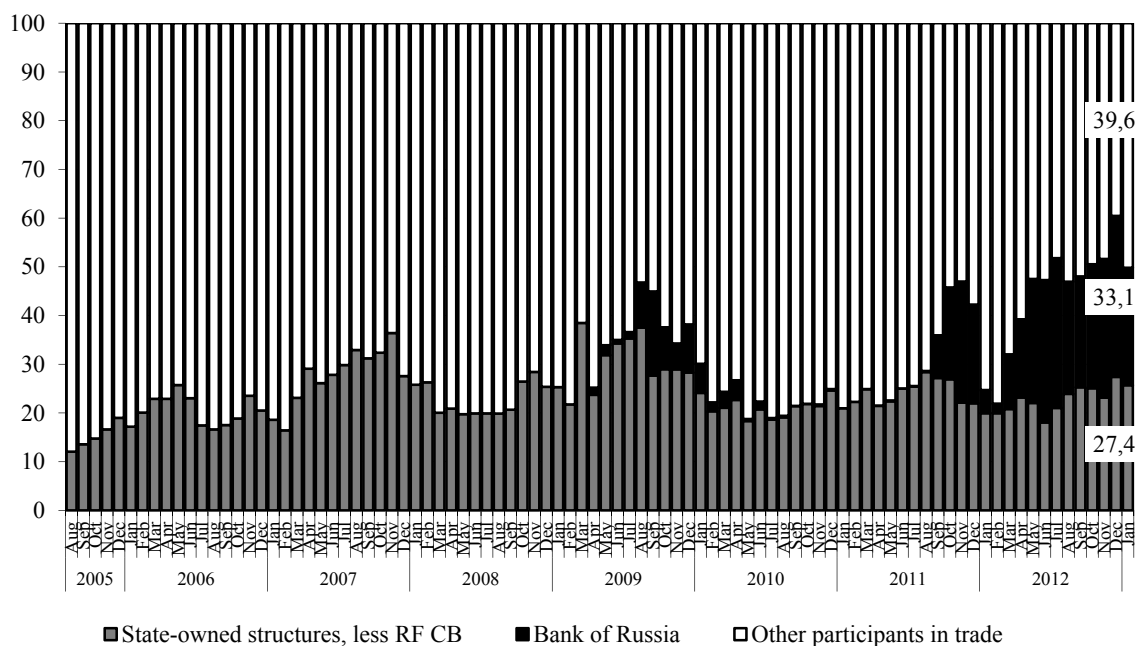
Fig. 34. The Structure of Transactions with Regional Bonds on the Moscow Exchange, %

3.4.3. Competition on the Corporate and Regional Bond Market

Fig. 35 shows an analysis of the shares of different groups of trade participants (private and state-owned companies¹, the Bank of Russia) in the overall volume of exchange trades in corporate bonds on the Moscow Exchange in all modes, including market transactions, negotiated deals and repo operations. In 2012, the participation of state-owned structures and the Bank of Russia in the volume of exchange trades in corporate bonds surged to 27.4% and 33.1% respectively in December of that year. This was associated with the corresponding surge in the volume of crediting provided to banks by the Bank of Russia on the repo market. The scale of the Bank of Russia’s participation in the operations on the corporate bond market was significantly higher than during the crisis of 2008–2009.

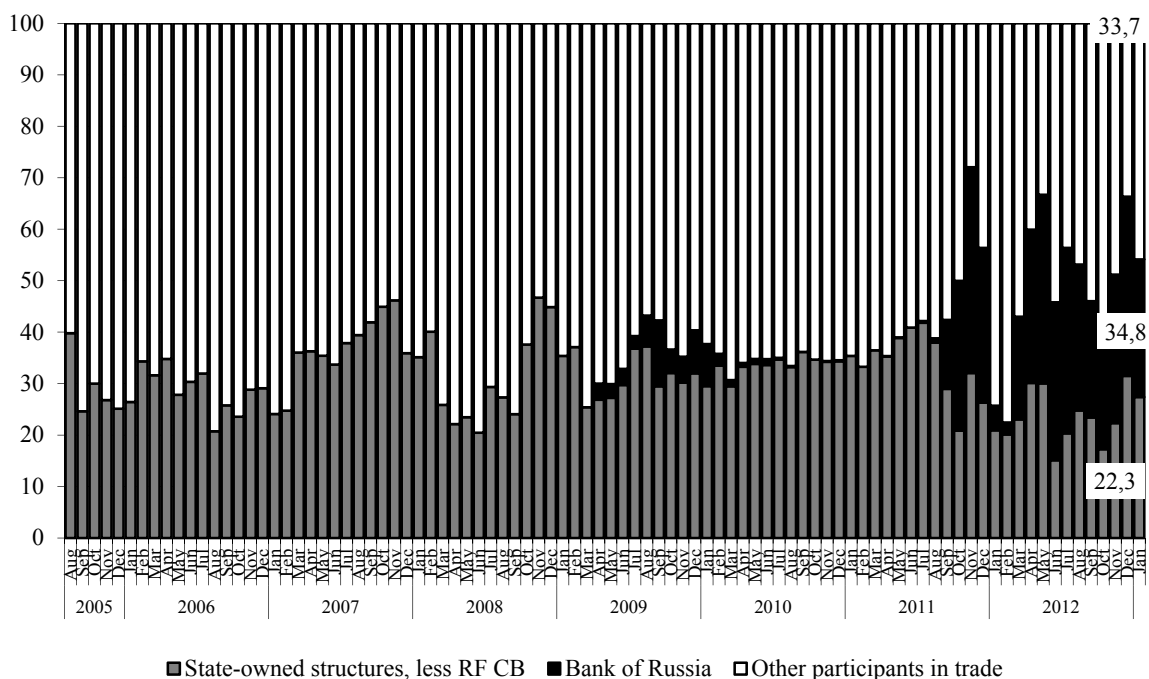
Fig. 36 depicts the share of state-owned structures and the Bank of Russia in the volume of exchange trades in regional bonds. In 2012, this index was even higher than its counterpart for the exchange corporate bond market. In December 2012, the share of state-owned structures and the Bank of Russia in transactions with regional bonds was 22.3% and 34.8% respectively.

¹ For the list of state-owned structure, see p. 108, note 1 to *Fig. 14*.



Source: calculations based on data released by the Moscow Exchange.

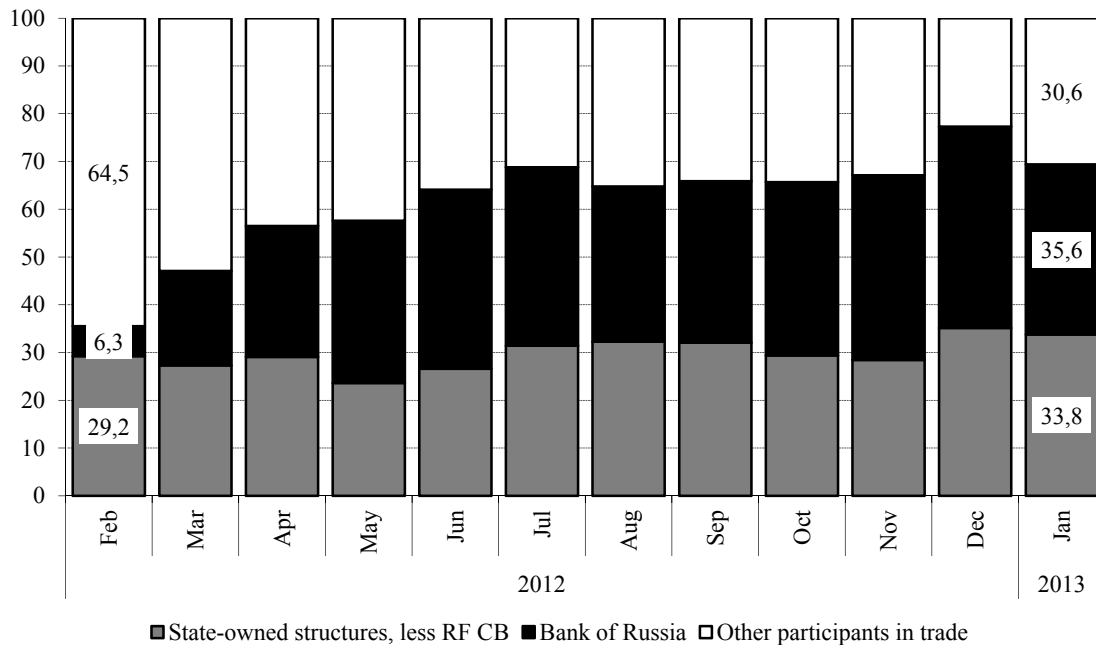
Fig. 35. The Shares of Private and State-owned Brokers in the Volume of Trades in Corporate Bonds on the Moscow Exchange, %



Source: calculations based on data released by the Moscow Exchange.

Fig. 36. The Shares of Private and State-owned Brokers in the Volume of Trades in Regional Bonds on the Moscow Exchange, %

Fig. 37 shows data on the share of state-owned structures and the Bank of Russia in the exchange market for federal bonds (the Moscow Exchange began to disclose such data from February 2012). Here, state-owned structures and the Bank of Russia accounted for 33.8% and 35.6% respectively of the total volume of exchange transactions with government securities in all trade modes.

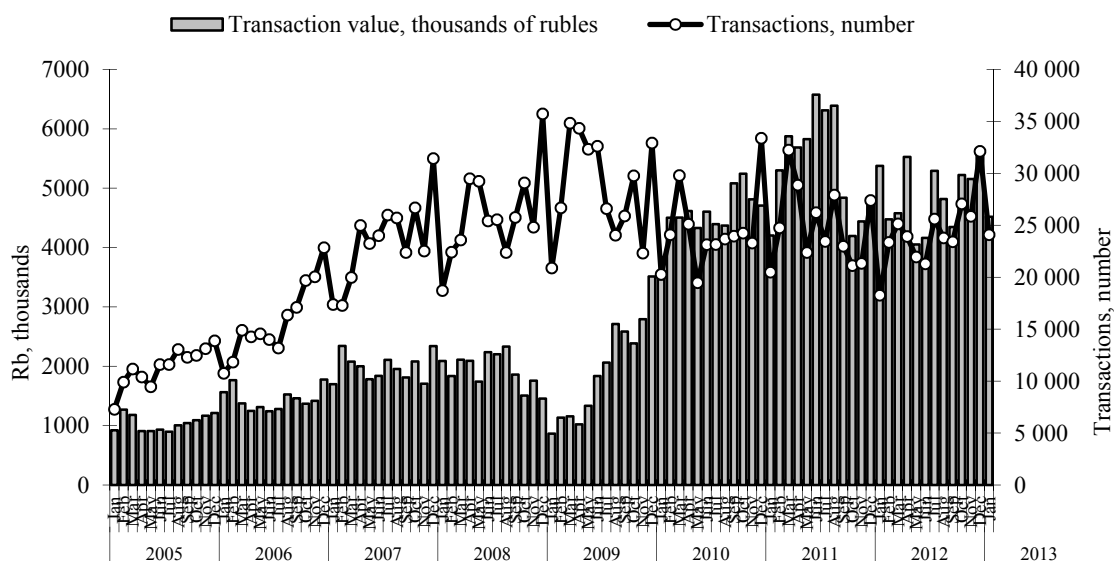


Source: calculations based on data released by the Moscow Exchange.

Fig. 37. The Shares of Private and State-owned Brokers in the Volume of Trades in Federal Loan Bonds (OFZ) and Eurobonds on the Moscow Exchange, %

The markets for corporate and regional bonds significantly differ by the levels of concentration measured by the Herfindahl–Hirschman Index (see *Fig. 15*). Prior to 2012, the corporate bond market had a low concentration level, its HHI was nearly twice as low as the HHI for the Moscow Exchange’s market for shares. However, as a result of the increased activity of the Bank of Russia on the repo market in 2012, the antimonopoly properties of the Moscow Exchange’s markets for bonds significantly deteriorated. Over the greater part of 2012, the markets for corporate, regional and federal bonds displayed features of moderately concentrated markets, their monthly HHI values being within the range of 800 - 1800. At the same time, the monthly HHI for the OFZ market was above 1800, which means that this market segment on the Moscow Exchange complied with the highly concentrated market criteria. In our opinion, a further course towards the accelerated growth of the volume of repo operations on the exchange must be backed by measures aimed at increasing the level of supervision over various segments of the exchange market by the antimonopoly regulation agency.

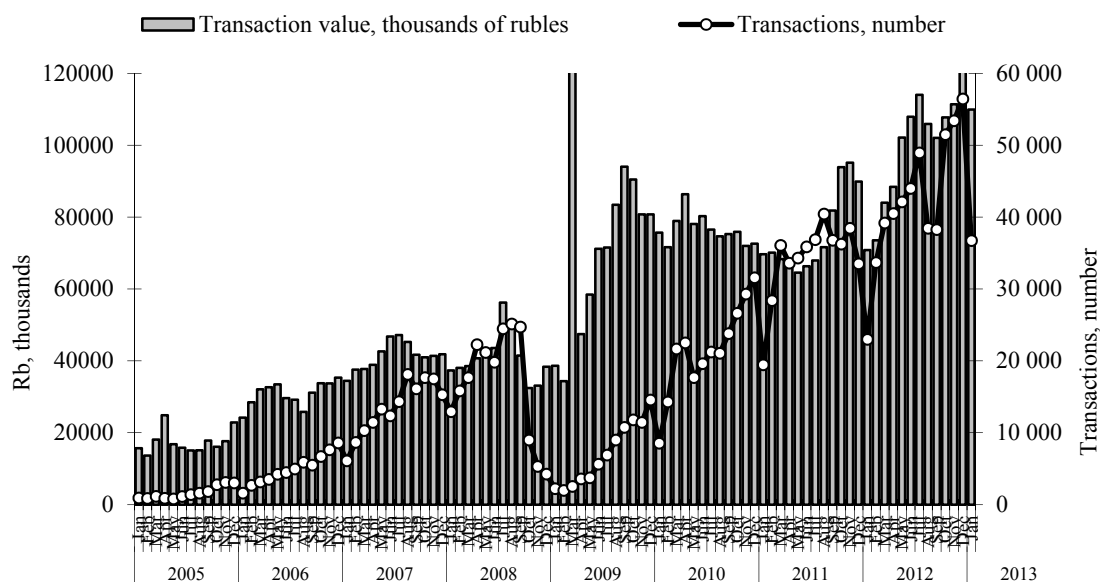
In *Fig. 38*, the data on the number of transactions and the average value per transaction with corporate bonds carried on in the anonymous trade mode on the MICEX-RTS. In contrast to the market segment where shares are traded (*Fig. 18*), here, in 2012, the number of market transactions with corporate bonds displayed an upward trend, while the mean transaction volume slightly declined.



Source: calculations based on data released by the Moscow Exchange.

Fig. 38. Market Transactions with Corporate Bonds on the Moscow Exchange

Fig. 39 illustrates the results of an analysis of the segment of repo operations with corporate bonds on the Moscow Exchange. In contrast to the market mode, the repo segment in 2012 showed a stable rise both in the number of transactions and the mean transaction volume. The value of an average repo operation is also approximately twice as high as that of a market transaction with corporate bonds, which is not surprising because the amount of money loaned by banks to financial companies cannot be small.



Source: calculations based on data released by the Moscow Exchange.

Fig. 39. Repo Operations with Corporate Bonds on the Moscow Exchange

In the post-crisis period, the leading role in the process of securities issuance is played by big – predominantly state-owned - companies. This is illustrated by the data in *Table 9*, which demonstrate that, in 2009, 24 biggest emitters accounted for 87.7% of the total value of corporate bond issues, and in 2010, 2011 and 2012 – for 60%, 59% and 57% respectively. In 2007, the share of these 24 emitters in the total volume of corporate bond placement to the value of Rb 476.7bn had amounted to only 42.1%.

The number of state-owned companies in the top ten emitters of corporate bonds was 6 in 2009 and 2010, 8 in 2011, and 7 in 2012.

Table 9

Biggest Emitters of Ruble-denominated Corporate Bonds in 2009–2012

	Emitters	2009		Emitters	2010		Emitters	2011		Emitters	2012	
		Billions of Rb	%		Billions of Rb	%		Billions of Rb	%		Billions of Rb	%
1	2	3	4	5	6	7	8	9	10	11	12	13
1	Russian Railways	145	15.8	FGC UES	50	5.8	Russian Agricultural Bank	Billions of Rb	5.7	VTB	60	5.0
2	Transneft	135	14.7	Russian Agricultural Bank	35	4.1	FGC UES	55	5.0	Gazprom bank	60	5.0
3	VEB	60	6.6	Rusnano	33	3.9	Uralkali	50	4.6	FGC UES	55	4.6
4	LUKoil	50	5.5	Evraz Holding	30	3.5	Rostelecom	39	3.5	AHML	54	4.5
5	Atomenergoprom	50	5.5	AHML	29	3.3	AHML	35	3.2	VEB	36	3.0
6	Bashoil	50	5.5	VEB	27	3.2	Rusnano	33	3.0	Vimpel-Com	35	2.9
7	AFK Sistema	39	4.3	Alrosa	26	3	VEB	30	2.8	Russian Agricultural Bank	35	2.9
8	MTS	30	3.3	MTS	25	2.9	Gazprom Neft	30	2.8	RTK	35	2.9
9	AHML	28	3.1	Mechel	25	2.9	RUSAL Bratsk	30	2.8	Transneft	34	2.8
10	VTB (VTB 24)	23	2.5	Wimm-Bill-Dann	24	2.8	VEB-leasing	25	2.3	Metalloinvest	25	2.1
11	SIBMETINVEST	20	2.2	VTB (VTB 24)	20	2.3	Mechel	25	2.3	NLMK	25	2.1
12	Gazprom Neft	18	2	Gazprom Neft	20	2.3	Oboronprom	21	1.9	Gazprom Neft	20	1.7
13	VTB-Leasing Finance	15	1.6	Vimpel-Com-Invest	20	2.3	Mortgage Agent of AHML	20	1.9	Mechel	20	1.7
14	Mechel	15	1.6	Russian Railways	15	1.8	Gazprom-bank	20	1.8	NovaTek	20	1.7
15	MMK	15	1.6	Severstal	15	1.8	NLMK	20	1.8	Promsvyaz bank	20	1.7
16	Gazprom	15	1.6	Globex Bank	15	1.8	RusHydro	20	1.8	Rusnano	20	1.7
17	NLMK	15	1.6	Norilsk Nickel	15	1.8	AFK Sistema	20	1.8	Rosneft	20	1.7
18	Severstal	15	1.6	UniCredit Bank	15	1.8	NK Alliance	17	1.6	UniCredit Bank	20	1.7
19	IA VTB	14	1.6	EBRR	14	1.6	Uranium One Inc.	17	1.5	IA VTB24	19	1.6

cont'd

1	2	3	4	5	6	7	8	9	10	11	12	13
20	Bank Petro-commerce	11	1.2	MMK	13	1.5	Gazprom-Capital	15	1.4	Bank ZENIT	16	1.3
21	MBRD	10	1.1	Bank Saint Petersburg	13	1.5	Evrax Holding	15	1.4	URALSIB Leasing Company	16	1.3
22	Rosbank	10	1.1	Aeroflot	12	1.4	Kuzbas-energo-Finance	15	1.4	Sviaz-Bank	15	1.3
23	Russian Agricultural Bank	10	1.1	Trans Credit-Bank	12	1.4	MMK	15	1.4	WHSD	15	1.3
24	VimpelCom-Invest	10	1.1	Atomenergoprom	10	1.2	Credit Bank of Moscow	13	1.2	Alfa-Bank	15	1.3
	Other emitters	113	12.3	Other emitters	342	40.0	Other emitters	448	41.2	Other emitters	509	42.5
	Total	917	100	Total	855	100	Total	1089	100	Total	1199	100

Source: data published at www.cBonds.ru, www.rusbonds.ru and released by the MICEX-RTS.

Every year the corporate bond market increasingly focuses on the provision of cash flow services to various state structures, which increases cash flows between them. State-owned companies borrow money from state structures. The secondary market is also kept afloat mainly by state structures and the Bank of Russia. Furthermore, state-owned investment banks act as underwriters and investment consultants with regard to any corporate bond placement (Table 10). In 2007, state-owned banks acted as underwriters for 36.3% of corporate bond issues (in value terms). In 2008, their share increased to 46.8%, in 2009 – to 62.4%. After a slight decline in 2010, it resumed growth in 2012, climbing up to 59.4%.

A similar situation has emerged with respect to investment banking services on the market for regional bonds. In 2008 and 2009, the share of state-owned banks in the total amount of money invested in bond issues increased from 14.2% in 2007 to 58.7% and 85.6% respectively. However, over the next two years - 2010 and 2011 – this index once again declined, first to 75.4%, and then to as low as 14.4%. The cause of this sharp drop of state investment in regional bonds in 2011 was the discontinuation of the activity of *Mosfinagentstvo* [Financial Agency of the City of Moscow] in accordance with the changed priorities of the Moscow Government's budget strategy; previously, *Mosfinagentstvo* had been a key player on the market for regional loans. In 2012, the share of state-owned structures in this market segment was once again on the rise, and increased to 51.8%.

Table 10

The Shares of State-owned and Private Financial Organizations in the Market for the Services of Domestic Bond Loan Organizers in Russia

	Bond issue organizers:					
	corporate bonds			regional bonds		
	State financial organizations	Private financial organizations	Total	State financial organizations	Private financial organizations	Total
1	2	3	4	5	6	7
2007						
Rb, million	169, 668	298, 302	467, 970	7, 551	45, 481	53, 032
Share, %	36.3	63.7	100.0	14.2	85.8	100.0
2008						
Rb, million	219, 892	249, 900	469, 792	42, 227	29, 716	71, 943
Share, %	46.8	53.2	100.0	58.7	41.3	100.0
2009						
Rb, million	620, 044	373, 978	994, 022	133, 325	22, 511	155, 836
Share, %	62.4	37.6	100.0	85.6	14.4	100.0

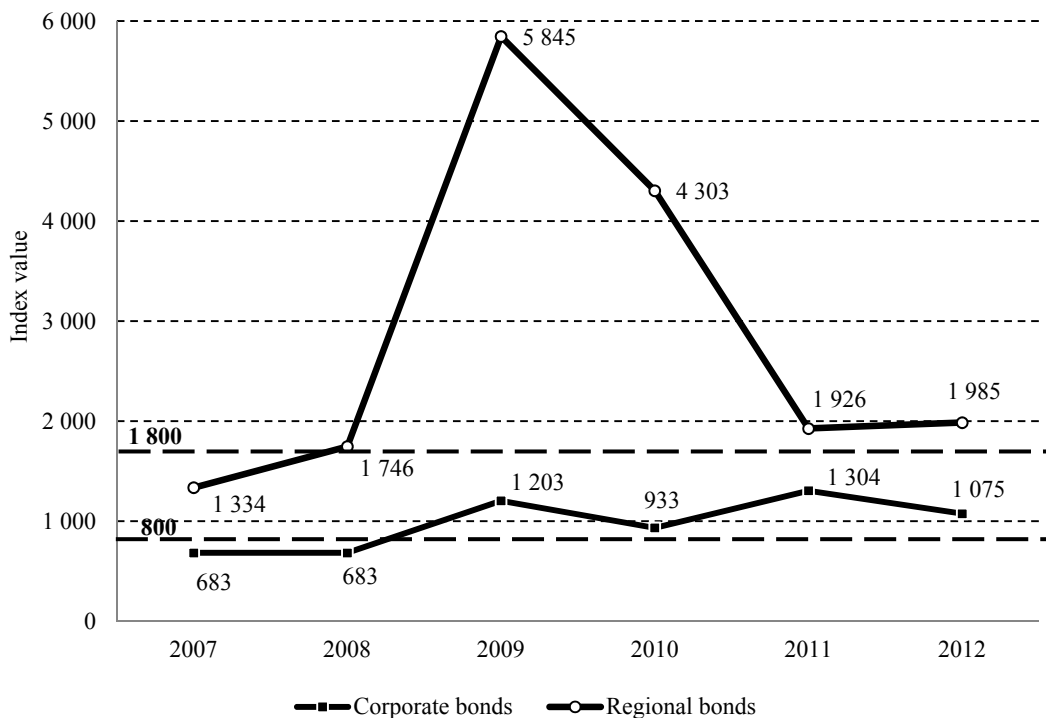
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1	2	3	4	5	6	7
2010						
Rb, million	393, 743	461, 292	855, 035	86, 613	28, 288	114, 901
Share, %	46.0	54.0	100.0	75.4	24.6	100.0
2011						
Rb, million	620, 698	374, 146	994, 844	7, 767	46, 177	53, 944
Share, %	62.4	37.6	100.0	14.4	85.6	100.0
2012						
Rb, million	734, 697	502, 831	1, 237, 528	61, 925	57, 637	119, 562
Share, %	59.4	40.6	100.0	51.8	48.2	100.0

Source: data on the ratings of organizers of bond issue placements; see www.cBonds.ru for 2007–2012.

That the conditions for competition with regard to bond placement on the market for investment banking services are far from perfect is demonstrated by the data on its concentration level measured by the Herfindahl–Hirschman Index (*Fig. 40*).

From 2009 onwards, the market for services rendered on the corporate bond market has been transforming from a highly competitive one into a moderately concentrated market, with monthly HHI values falling within the range between 800 and 1,800. The market for investment banking services, in its segment of regional bond issues, invariably displays high concentration levels. Its HHI is stable at a level above 1,800. All these circumstances point to the necessity to make the role of antimonopoly regulation on the securities market more prominent.



Source: data on the ratings of organizers of bond issue placements; see www.cBonds.ru for 2007 to 2012.

Fig. 40. The Herfindahl–Hirschman Index: Services Related to Organizing the Issuance of Ruble-denominated Corporate and Regional Bonds

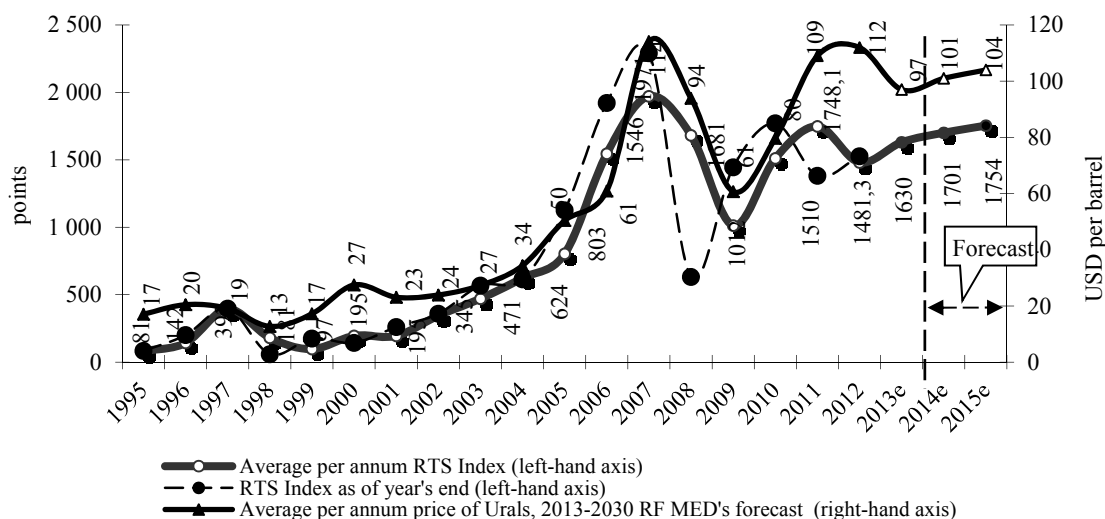
3.5. An Analysis of Financial Market Risks

The principal risks faced by the financial market are associated with the following factors: stagnation on the share market caused by a halt in the upward movement of prices for energy carriers; a significant outflow of foreign capital; a depreciation of the ruble; an accelerated growth of foreign loans made by banks and the non-financial sector; a revival of CT strategies; growth in the volumes of trades on the futures market coupled with insufficient backing for the transactions; increasing risks on the repo market; the low capacity of the financial services market as an obstacle to the growth of financial intermediaries.

3.5.1. The Halt in the Share Market Growth Caused by the Price Factor

As demonstrated in Section 3.2.1, the movement of the Russian stock market strongly depends on that of oil prices. The price of oil acts as an indicator of the situation in the global economy, as well as of the financial system's sustainability and liquidity. The current forecasts released by the RF Ministry of Economic Development and international financial organizations – while unanimously indicating that oil prices are not going to increase in the medium-term perspective – reflect their concerns with the slowdown in the rate of global economic growth and the existing risks for the world financial system's stability. A relatively new factor is the emergence of new technologies for the extraction of oil and natural gas, which will enable many countries to gradually switch over to providing their economies with their own oil and gas.

If the dependence equation shown in *Fig. 7* is applied to the RF Ministry of Economic Development's medium-term forecast of oil prices for the period of 2013–2015, we will see that the average per annum value of the RTS Index will indeed be increasing, but at a low rate. In 2013, it may reach the level of 1,630 points against 1,481 points in 2012 – that is, the per annum growth rate displayed by the Index will be 10.1%.



Source: calculations based on data released by the forecasta MED and MICEX-RTS.

Fig. 41. A Forecast of the Movement of the RTS Index until 2015, Based on the Forecast of Oil Prices Released by the RF Ministry of Economic Development

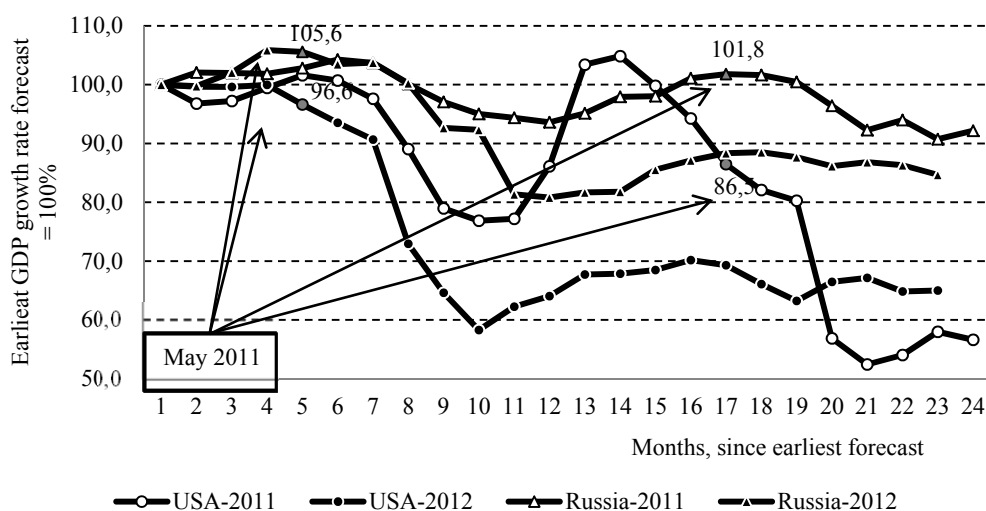
This method of predicting the average per annum growth rate of the stock index is by means ideal; this, however, may also be said about the other methods applied in the forecasts

of stock market indicators. According to the 2011 forecast for 2012, the average per annum value of the RTS Index was to rise from 1,748 to 1,842 points, or by 5.4%. But its actual value in 2012 amounted to 1,481 points – that is, noticeably lower than in 2011. The error in the forecast based on the historic ratios of oil prices and the RTS Index is caused by the negative effect of the investment outflow from Russia, which turned out to be stronger than its average value over the entire period of the RTS Index's history.

3.5.2. The Risks of Foreign Capital Outflow

In Section 3.2.2., we analyzed the dependence of the Russian share market on the movement of the assets of foreign investment funds invested in Russia. As indicated by the above-mentioned study carried out by the IMF, the investment decisions of portfolio investors rely on the dynamics and volatility of the forecasted GDP growth indices (for example, by international financial institutions), the volatility estimates of currency exchange rates, and the indices of the expected volatility of developed and developing markets.

As shown in *Fig. 10*, the year 2012 saw a continuation of the outflow trend among the foreign funds specializing in investment in Russia that had first manifested itself in May 2011. Further data presented in *Fig. 42* indicate that the onset of the cash outflow from the funds in May 2011 coincided with the emergence of another trend – that of dramatic worsening of the forecasts of economic growth in the USA for 2012, which confirms our hypothesis that the strongest influence on the behavior of foreign portfolio investors investing in Russia is exerted by the changes in the global economic growth forecast released by *Consensus Economics* and by the IMF's quarterly reports on the situation in the world economy. The IMF's forecasts for 2013 published in January 2013 once again pointed to a slight slowdown in the global economy's growth rate. The growth rates of GDP in Russia and the USA predicted for 2013 were reduced by 0.1 percentage point. This provides some grounds for assuming that, in the first half-year of 2013, the Russian market will be experiencing a small-scale outflow of portfolio investment, which may cease as soon as the economic growth forecasts for 2013–2014 display the beginning of an upward trend.



Source: calculations based on data released by *Consensus Economics*.

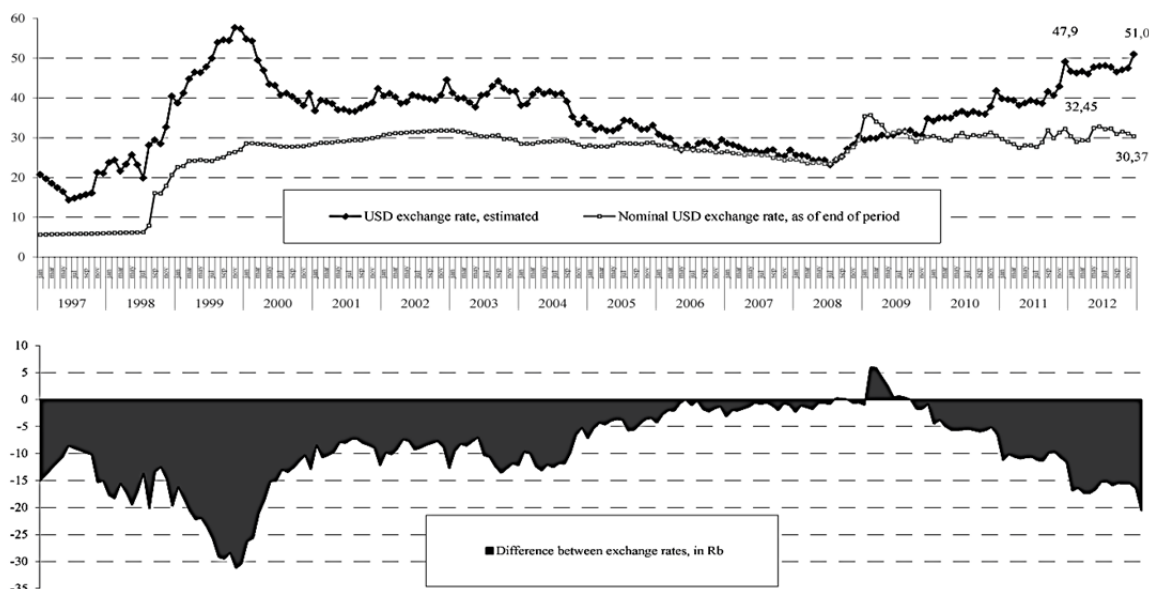
Fig. 42. The Movement of GDP Growth According to Consensus Economics's Forecasts for 2011 and 2012

3.5.3. The Risks of the Ruble's Depreciation in the Medium-term Perspective

The slower foreign currency inflow into Russia as a result of the stabilization of prices on global raw materials markets coupled with foreign investment outflows from that country, the switchover to a more liberal foreign exchange policy, the energetic support of the banking system's liquidity by the monetary authorities resulted in the movement of money supply becoming more independent of the foreign currency inflow. In the medium-term perspective, due to the RF Government's preparedness to pursue a more active economic policy and to orientate it towards accelerated economic growth, the gap between the value of gold and foreign-exchange reserves (G&FX reserves) and the ruble-denominated money mass will become wider.

All these circumstances are fraught with a higher risk of the national currency's dramatic depreciation, if the effect of the accelerated growth of the ruble-denominated money mass against that of foreign-exchange reserves is combined with shocks on the financial markets. In an event of a crisis on the global market or a panic on the domestic financial market, when the population and companies alike begin to display feverish demand for foreign currencies, the government and the central bank may experience a shortage of foreign-exchange reserves necessary for satisfying such a high level of demand, and so they will be forced to depreciate the national currency.

The depth of such depreciation is illustrated by the data presented in *Fig. 43*. It depicts the ratio between the official US-dollar-to-ruble exchange rate as of a month's end and the estimated US dollar's exchange rate determined by dividing money supply (M2) by the value of RF gold and foreign-exchange reserves. From late 2009 onwards, the official exchange rate of the ruble began to display an increasing deviation from its estimated values, and in December 2012 this difference hit a ten-year record high. The gap between the estimated and actual exchange rate of the ruble (see the lower graph) became as wide as in the crisis year 1998.



Source: calculations based on data released by the Bank of Russia and the RF Ministry of Finance.

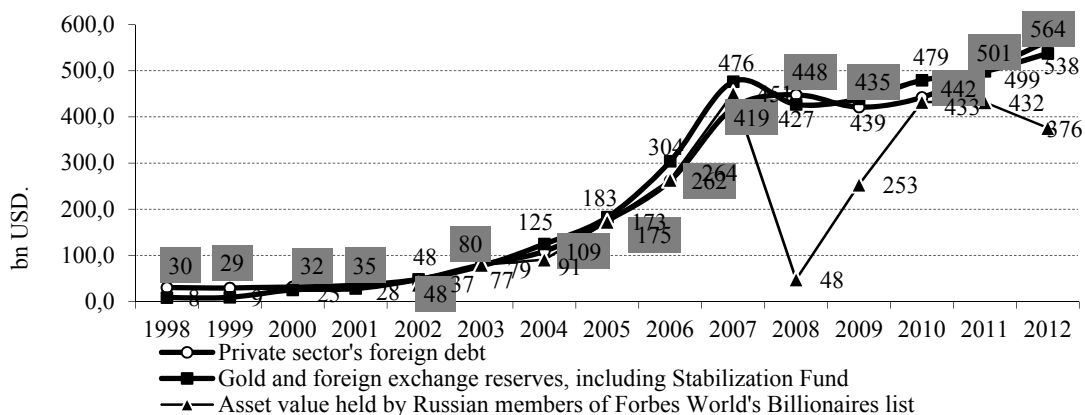
Fig. 43. The Dependence of the USD-to-Ruble Nominal Exchange Rate on its Estimated Value in January 1997 – December 2012.

For December 2012, the estimated exchange rate was 51.00 Rb/USD, while the actual official exchange rate as of the year's end amounted to 30.37 Rb/USD. In the present situation, given the difference between the ruble's official exchange rate and its real exchange rate against major foreign currencies, the monetary authorities or the market's 'invisible hand' will be gradually weakening the ruble's position in the medium-term perspective. This scenario would be more preferable from the point of view of the goals of economic (industrial) policy, because the gradual depreciation of a national currency represents an instrument for rendering support to national producers that can be both effective and compatible with the WTO's principles.

3.5.4. The Risks Presented by the Foreign Debt of Banks and Non-financial Businesses

The volume of foreign debt owed by Russian banks and non-financial companies in 2012 increased by \$ 61bn, or 12.6%, and for the first time since 2008 exceeded the value of the Russian Federation's gold and foreign-exchange reserves (*Fig. 44*). The volume of that debt was \$ 564bn, while Russia's G&FX reserves amounted to \$ 538bn. On the one hand, the accelerated growth of overseas borrowings made by businesses may be regarded as a positive trend indicative of an active inflow of resources necessary for economic growth and development. The centralization, in the form of G&FX reserves, of part of the value created by businesses increases the financial system's stability and imposes constraints on the ruble's excessive strengthening. On the other hand, in terms of the global economy, the withdrawal of these resources from businesses' incomes makes it difficult for entrepreneurs to sustain the process of expanded reproduction. In order to keep it at the same level, they are forced to compensate for part of their foreign exchange assets withdrawn by the State in order to generate its gold and foreign-exchange reserves by increasing the amount of their overseas borrowing.

At the same time, if the amount of foreign debt of businesses is maintained at a level significantly higher than that of national gold and foreign-exchange reserves, the State has fewer opportunities for rendering support to businesses in an event of a crisis and a decline in their asset value. Besides, the availability of cheaper money to be borrowed on foreign markets by comparison with the domestic market triggers a revival of CT strategies - which, in case the inflation rate goes up, can restrict the development potential of domestic institutional investors and their opportunities for investing their assets against a real interest rate.



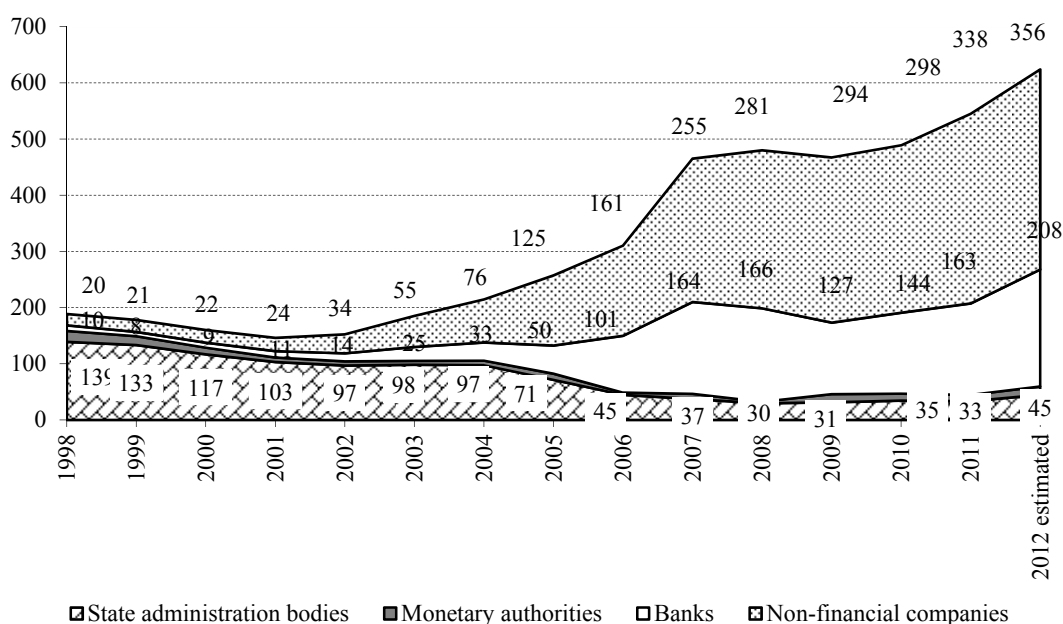
Source: Russia's balance of payments for a number of years.

Fig. 44. Growth of the Private Sector's Debt, the State's Gold and Foreign-exchange Reserves, and the Assets of the Russian Members of the Forbes World's Billionaires List

For a second year in row, an interesting trend has been displayed by the ratings of the Russian members of the Forbes World's Billionaires list. The total value of their personal assets dropped from \$ 433bn in 2010 to \$ 376bn in 2012, or by 13.2%. This may have happened due to the gradual dispersion of the initial owners' estates among their heirs, as well as due to unsuccessful investment. In terms of investment activity, this fact is indicative of a noticeable decline in Russia's wealthiest citizens' potential for investment in the Russian economy. To a certain extent, this can be interpreted as a sign of failure of the strategy of orienting Russia's economy towards relying on her national oligarchic capital's potential.

In Fig. 45, the data on foreign debt are shown separately for banks and non-bank companies. The foreign debt of banks increased from \$ 163bn in 2011 to \$ 208bn in 2012, or by 27.6%. The accelerated growth rate displayed by banks' foreign debt confirms our assumptions that CT is gradually reviving on the Russian financial market.

The amount of debt owed by non-bank companies rose from \$ 338bn in 2011 to \$ 356bn in 2012, or by 5.3%. As in the previous year, in 2012 the amount of the private sector's foreign debt increased in spite of the impressive net capital outflow from Russia in the amount of approximately \$ 57bn. There is no generally accepted explanation for the phenomenon of net investment outflow from Russia, which is indicative of the insufficiency of analytical research carried on at the Bank of Russia and the other government departments with access to the primary documentation on this type of operations. In our opinion, net capital outflow from Russia can be primarily explained by the fact that businesses and wealthy individuals alike do not believe in the prospects of profitable investment in Russia in the currently existing institutional environment and the uncertain prospects for growth in the Russian economy with its strong reliance on raw materials.



Source: Russia's balance of payments for a number of years.

Fig. 45. The Russian Federation's Foreign Debt in 1998–2012, bn USD

3.5.5. The Risks Associated with Carry Trading

In 2012 and early 2013, Russia's financial market displayed many signs of a revival of CT strategies, which had already resulted in two banking crises in 1998 and 2008. The accounts at the international settlement and clearing systems have created adequate technological conditions for the inflow of speculative foreign capital, and the rules whereby restrictions formerly imposed on banks' borrowings from non-residents have been amended. The amount of the banking sector's foreign debt is increasing at an accelerated rate, and it resorts with increasing frequency to the use of financial leverage in order to expand its credit portfolio.

Why is the carry trading strategy so dangerous, and what are its consequences? Let us point out the following three aspects: the growing risk of a liquidity crisis in the banking system; the threat of gold and foreign-exchange reserves being wasted by the State on the support of inefficient businesses; and the suppression of the population's stimuli to invest their savings in ruble-denominated bonds.

In the banking system that strategy maintains the misbalance between the amounts of banks' foreign-exchange assets and liabilities, with the significant excess of the former over the latter. This represents the main risk factor in terms of the possibility of a liquidity crisis in the banking system. The IMF experts believe that the involvement of banks from the developing countries in carry trading in order to raise funds for issuing loans to the population is one of the principal risks faced by their financial markets¹.

3.5.6. The Operational Risks in the Stock and Futures Markets

A typical feature displayed by the securities market over recent years has been the accelerated growth of trading volumes by comparison with the growth of assets held by market participants and their clients. High-frequency trading is becoming increasingly popular. The annual Best Private Investor contest held by the exchange, in effect, has been turned into indirect promotion of the high-frequency trading methods. The information on client operations occasionally appearing in the media has provided some grounds for assuming that the private clients of big broker companies completely renovate their portfolios, on the average, every two or three days². The Moscow Exchange itself, in its presentation of the development strategy for 2012–2015 published on 22 March 2012 on its website, admits that the 'distortion of the investor base and the trade volumes towards algo traders' is indeed one of its weaknesses.

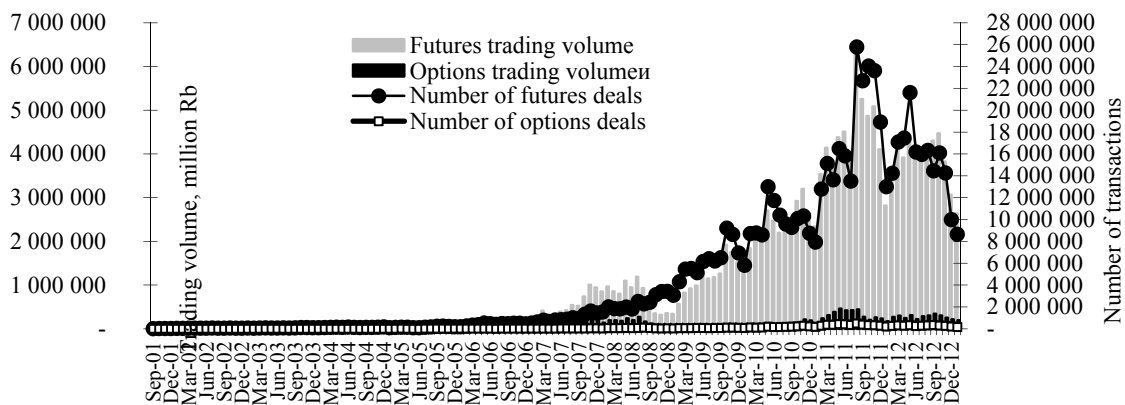
Hyperactive trading is often not only detrimental to the investment results achieved by the bulk of private investors, but is also fraught with increased operational risks for the trading systems. In Section 3.2.5 we discussed the issue of frequent technical glitches on the Russian exchange in 2010–2012. Every year, the exchange gets deeper and deeper involved in the competition for processing a constantly increasing flow of bids with approximately 700 other market participants, each of them possessing all the necessary resources for increasing their own operational activity. And it is by no means obvious that this competition has increased the capitalization of the emitters, attracted of new money, and improved the results of investment. Thus, in the next few years, we may expect the infrastructure to experience continuing operational problems, which may, in their turn, necessitate further measures aimed at regulating high-frequency trading.

¹ IMF. *Global Financial Stability Report. Financial Market Turbulence: Causes, Consequences, and Policies*. September 2007, pp.22–25.

² *BKS stroit plany*. [BKS [Broker Invest Company] Elaborates Its Plans]. *Vedomosti*, 22 June 2010.

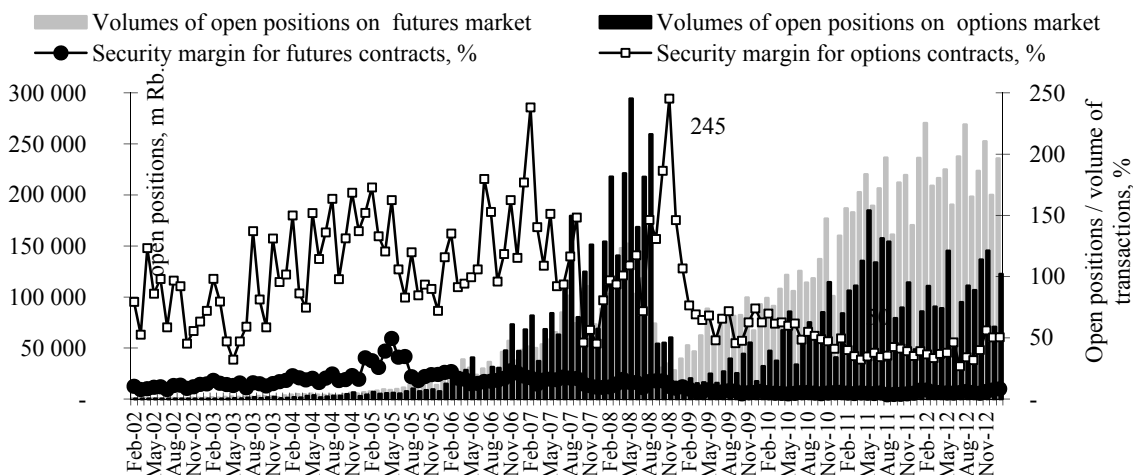
The futures market FORTS gives rise to similar concerns. The number of transactions and trading volume on that market are increasing at a fast rate (*Fig. 46*), the growth rate displayed by client assets is slower, and the information on the number of market participants and their operational activity is not transparent.

At the same time, by comparison with the early phase of the futures market's development in the mid-2000s, it displays a lower level of security margin for futures and options contracts, as confirmed by data, shown in *Fig. 47*, on the volumes of open positions on the futures and options market, as well as on the transaction margins for each segment of that market. The latter index was calculated by dividing the monthly volume of open positions by the volume of trading in each category of futures contracts. The growth of trading volumes on the futures and options markets over the period from March 2009 to early 2013 was associated with the reduction of the minimum margin requirements for futures and options. From 21 February 2013, the minimum basic margin requirements for futures contracts on stock indexes on the Moscow Exchange's futures market were decreased from 10% to 7.5%.



Source: calculations based on data released by the Moscow Exchange.

Fig. 46. The Trading Volume and the Number of Transactions on the Moscow Exchange's Futures Market over the Period from 1 September 2001 through 31 January 2013



Source: calculations based on data released by the Moscow Exchange.

Fig. 47. Open Positions and the Margins of Safety on the RTS Futures Market over the Period from 1 February 2002 through 31 January 2013

3.5.7. The Risks of Repo Operations

From Q2 2012 onwards, the repo market once again became the most important instrument applied by the Bank of Russia in its support of bank liquidity. Some important measures were implemented on the market in order to manage the risks in that particular segment: the National Securities Market Association (NSMA) adopted model repo operation contracts, and the mechanism of settling repo operations via a central contractor was put in operation.

We believe the main risks on the repo market to be those associated with the economic consequences of the large-scale and relatively short-term crediting of Russia's banking system by the monetary authorities. In terms of its influence on the banking system, the direct repo mechanism in many of its aspects strongly resembles CT. It enables banks to obtain relatively cheap short-term financial resources that can be used in high-margin operations like loans issued to individuals and organizations, or investment in risky bonds or other assets, including foreign investment. In this connection, banks can be tempted to invest short-term resources in projects with delayed return, as well as to ease their requirements as to the financial status of households seeking consumer loans. Once direct repo operations are transformed into a permanent refinancing mechanism, it will be difficult to reverse the spontaneous growth of credit expansion. The industrial and banking lobby will always have enough strength and argumentation for substantiating the necessity of continuing the crediting process, even in face of certain signs that the existing risks are excessive.

At a certain stage, it may even become difficult for the Bank of Russia to make the decision to discontinue refinancing, because its income, personnel number and personnel remuneration will be increasingly dependent on the Bank's activity on the domestic market.

These risks, however, can be avoided by a mega-regulator that will be truly independent of various market participants, including state structures.

3.5.8. The Problems Involved in Implementing the Financial Market Development Policy

A serious risk for the Russian financial market is posed by the absence of an effective development policy. Over the last few years, it has failed to implement adequate technologies and logistics for decision-making, elaboration and implementation of necessary measures, including the transfer of new information. There is no distinct definition of the rights and responsibilities of the various participants in the decision-making process in the sphere of financial market development, including government departments, self-regulatory organizations, universities and research institutes, market participants and the regions. The program documents addressing the issues of the financial market's development (the Concept of Long-term Socio-economic Development of the Russian Federation for the Period Until 2020 (*KDR-2020*), the *Development Strategy*, the roadmaps for the creation of multi-functional centers (MFC), the RF Ministry of Finance's *Program for the Development of Financial and Insurance Markets, Creation of an International Financial Center*) contain no references to any studies on financial market issues and the financial market's economy.

A positive development in 2012 and early 2013 was the elaboration, by the RF Ministry of Finance within the framework of target program budgeting, of the *Program for the Development of Financial and Insurance Markets, Creation of an International Financial Center*. However, so far it is too early to make any conclusive assessment of its effectiveness. The program has a rather fragmentary structure, as it overlooks some important market sectors like pension reserves and pension savings, collective investment, investment companies, tax in-

centives for domestic investors, and foreign expansion of Russian financial businesses. It is not quite clear who is going to implement the programs, as it has been written by one government agency (the RF Ministry of Finance) for another government agency (the FFMS or the mega-regulator). The set of quantitative indices included in the program is by no means exhaustive, and the procedure for their calculation is less than perfect.

In absence of any coordinated development policy, financial organizations – especially non-state ones – have to deal with some serious problems associated with their development prospects and the dramatic shrinkage of their income base. In 2009–2010, on the basis of detailed data on the economic status of non-bank financial organizations, we prepared a forecast of their capitalization growth in the period until 2020.¹ It was found that the aggregate value of all the investment banks, broker companies and asset managers operating in Russia might amount to \$ 22.7bn under an optimistic scenario, to \$ 20.5bn under a basic scenario, and to \$ 11.8bn under a moderate scenario. An analysis of the actual data for 2011–2012 has demonstrated that the development of the domestic market for financial services follows a trend that is much worse than our moderate scenario.

3.6. The Issues Involved in Attracting Conservative Institutional Investors

The attitude of big foreign institutional investors towards Russia's stock market has so far remained conservative. This conclusion can be drawn on the basis of the data on investments in the shares issued by Russian joint-stock companies made by a big US public pension fund – the California Public Employees' Retirement System (CalPERS), whose asset value in 2012 amounted to \$ 233bn (*Table 11*).

Table 11

CalPERS' Investment in Shares Issued by Russian Companies, Million USD

	2008*	2009*	2010*	2011*
Gazprom	144.7	46.0	55.1	154.4
LUKoil	189.1	93.5	80.6	78.7
Mechel	9.1	1.0	1.8	9.8
Norilsk Nickel	4.6	1.4	14.3	12.1
NovaTek		20.6	10.4	45.4
Novorossiysk Commercial Sea Port	10.3	8.4	7.7	6.3
Rosneft	11.4	31.4	15.7	59.7
Polyus Gold		5.5	2.3	5.8
Rostelecom		3.4	1.0	16.4
Sberbank of Russia	5.5	30.8	9.3	53.7
Severstal	7.0	4.7	7.0	9.4
AFK Systema (including MTS)	9.7	3.8	62.0	71.9
Surgutneftegas	4.5	20.5	18.9	23.5
Wimm-Bill-Dann		20.2	2.2	0
Magnit		7.3	15.5	37.5
MMK		6.1	2.0	2.8
VTB	31.6	6.9	14.3	22.8
LSR Group		2.9	4.4	4.5
Other OJSC			12.9	60.1
<i>Shares in Russian companies – total</i>	<i>427.4</i>	<i>314.4</i>	<i>337.4</i>	<i>674.8</i>
<i>Shares traded in foreign and domestic markets</i>	<i>122, 281.2</i>	<i>80, 728.6</i>	<i>91, 776.3</i>	<i>117, 640.8</i>
<i>Shares in Russian companies as a proportion of CalPERS' portfolio</i>	<i>0.35</i>	<i>0.39</i>	<i>0.37</i>	<i>0.57</i>
<i>Shares in Russian companies as a proportion of world market capitalization</i>	<i>1.21</i>	<i>1.85</i>	<i>1.91</i>	<i>2.43</i>

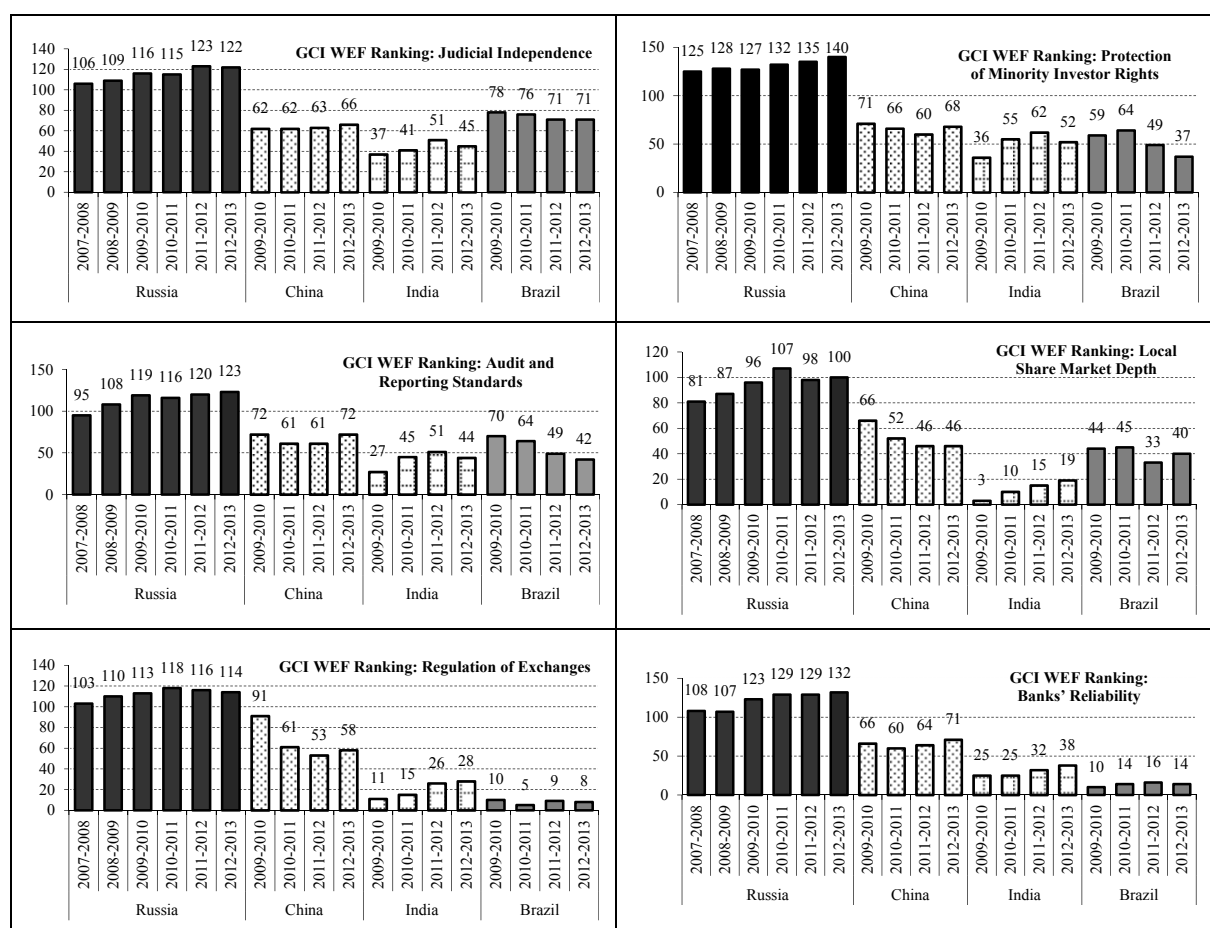
* a financial year ends in June; for detailed information on the portfolio's composition and structure, see CalPERS' website. CalPERS releases its data with a lag of approximately one year, probably because it does not want its portfolio strategy to be followed too closely.

Source: based on annual investment reports released by CalPERS.

¹ For more details concerning the results, see *Vestnik NAUFOR* No 3, March 2010.

The value of CalPERS's investment in Russian stocks is low. It rose from \$ 427m (or 0.35% of its total portfolio value) in 2008 to \$ 675m (or 0.57%) in 2011. For reference: the shares in Russian companies amounted to 1.21% of the world market capitalization index in 2008, and to 2.43% in 2011. In other words, the relative share of portfolio Russian stocks in that pension fund's portfolio is lower than the world's average – a fact indicative of CalPERS's cautious attitude towards them.

CalPERS began to invest in the depository notes issued by Russian joint-stock companies only from 2008 onwards. Until that year, CalPERS had been traditionally applying the methodology of rating the developing markets from the point of view of their investment potential, and for a long time Russia's rating was such that it was not considered to be eligible for investing in. In 2007, CalPERS abandoned that rule and allowed its portfolio asset managers operating in the developing markets to make independent decisions concerning the eligibility of some or other emitters for investing in their stocks. However, our analysis of their formerly applied methodology made it possible to identify those key factors that for many years had prevented CalPERS from investing in Russia. The factors, arranged in accordance with Countries' Ranking Based on the World Economic Forum's Global Competitiveness Index, are shown in *Fig. 48*.



Source: World Economic Forum's Global Competitiveness Index for a number of years.

Fig. 48. BRIC Members' Rankings in the World Economic Forum's Global Competitiveness Index with Regard to the Criteria Relevant for Conservative Portfolio Investors

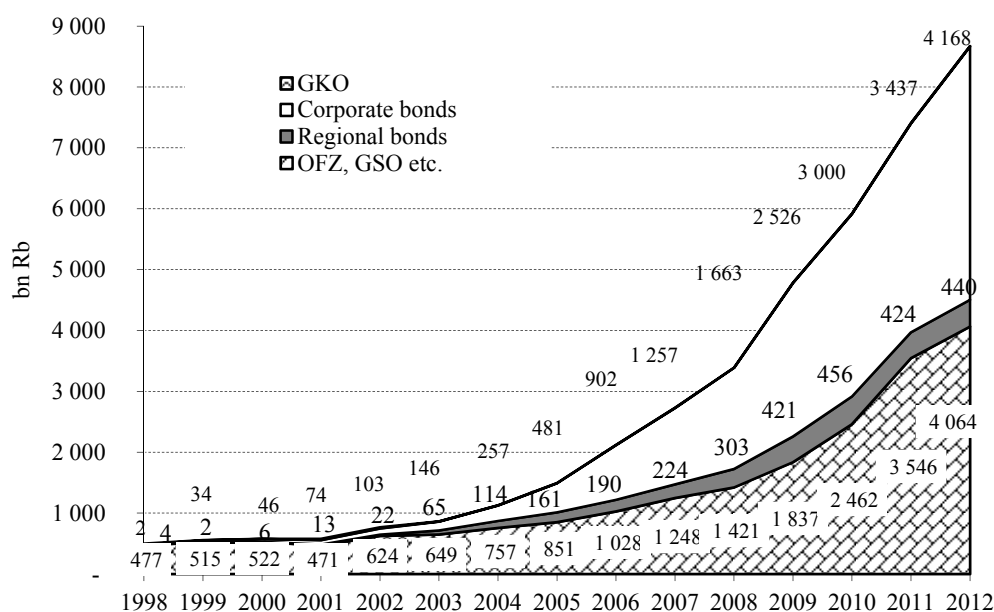
In terms of the most relevant issues – independence of the judicial system, the level of protection of minority investor rights, the audit and reporting standards, the depth of the share market, the proficiency of the regulation of exchanges and banks’ reliability, Russia’s market falls significantly behind the markets of the other BRIC members. Besides, in 2012, Russia’s ranking with regard to four out of the six parameters deteriorated, and with regard to the other two is only slightly improved – by one or two positions.

3.7. The Stock Market’s Role in the Modernization of the National Economy

The crisis revealed some deep problems and controversies underlying the Russian economy, its unpreparedness to adequately respond to the challenges posed by the globalization process. Russia’s society has announced its course towards economic modernization, where the financial market is assigned one of the key roles. But is Russia’s financial market really ready for coping with such comprehensive tasks?

3.7.1. The Contribution of the Corporate Bond Market to Real Capital Growth

An important financial phenomenon of the 2000s was the development of the market for ruble-denominated bonds (*Fig. 49*). The capitalization of the ruble-denominated bond market increased from Rb 0.6 trillion in 2000 to Rb 8.7 trillion in 2012, or 14.5 times. Among all the categories of ruble-denominated bonds, the most rapid growth rate was observed on the market for corporate bonds. Their aggregate capitalization increased from Rb 46bn in 2000 to Rb 4.2 trillion in 2012, or by 91.3 times.



Source: data released by the RF Ministry of Finance and Cbonds.ru.

Fig. 49. The Volume of Ruble-denominated Bonds in Circulation, Billions of Rubles.

Table 12 shows the parameters of the ruble-denominated corporate bond market in 2000-2012, expressed in US dollars. In spite of the rapidly increasing corporate bond placement volume - from \$ 1.1bn in 2000 to \$ 39.1bn in 2012, the volume of proceeds invested in fixed assets has so far remained low. While the total volume of bond placement in 2011 amounted

to \$ 31.5bn, only \$ 0.0003bn out of that amount (or 0.001% of the total bond placement volume) was spent on the acquisition of fixed assets. If we look at the entire period of 2000–2012, the share of the proceeds from the placement of corporate bonds that were spent on the acquisition of fixed assets hovered within the range from 0.00% to 3.0%. The data for January-September 2012 present no exception. Out of the total volume of corporate bond issues placed over that year to the value of \$ 39.1bn, in the first nine months of 2012 the emitters spent \$ 0.002bn, or 0.004%, on the acquisition of fixed assets.

Table 12

The Parameters of the Ruble-denominated Corporate Bond Market (bn USD)

	Capitalization	Secondary market, including REPO	Placement	Proceeds from bond placements, that were invested in fixed assets		
				Bn USD	The same, as % of capitalization	The same, as % of placement volume
2000	2	0.2	1.1			
2001	3	1	0.8			
2002	3	2	2	0.1	3.0	6.7
2003	5	8	3	0.1	2.1	3.8
2004	9	15	5	0.1	1.1	2.0
2005	17	44	9	0.3	1.8	3.3
2006	33	135	17	0.1	0.3	0.6
2007	49	371	18	0.2	0.4	1.1
2008	67	457	16	0.2	0.3	1.2
2009	80	293	29	0.1	0.1	0.3
2010	99	757	28	0.03	0.03	0.1
2011	117	1237	32	0.0003	0.0003	0.001
2012*	134	1866	39	0.002*	0.001	0.004

* for January-September 2012.

Source: calculations based on data released by the Moscow Exchange, *cBonds*, the Bank of Russia and *Rosstat*.

3.7.2. The Impact of IPOs on the Economy

As far as the attraction of money for fixed asset financing is concerned, the placement of shares in the form of IPO or SPO is by far a more effective instrument than the issuance of corporate bonds. The reason is that the proceeds from an IPO have a more long-term nature. *Table 13* shows the parameters of the market for shares issued by Russian companies. These demonstrate that the peak of IPO activity was observed in 2006 and 2007, when companies attracted a total of \$ 17.0bn and \$ 33.0bn respectively. Out of the total amount of money generated for companies by their IPO-SPO in 2006, 18.8% was spent on the acquisition of fixed assets; in 2007, this indicator dropped to 10.9%. In some years – for example, in 2008 – 110.5%, and in 2009 – 117.6% of the IPO volume was spent on fixed assets. This happened because part of the money to be invested in fixed assets was generated not through IPOs and SPOs, but by means of distribution of additional shares by limited subscription.

In 2011, out of the total value of IPOs in the amount of \$ 11.3bn, \$ 2.6bn was invested in fixed assets; in 2012, out of the total of \$ 9.5bn, - \$ 2.0bn. A substantial part of the resources attracted in the stock market was spent on buying out businesses from their former owners, refinancing of debt, and the servicing of merger and takeover deals, including the acquisition of big blocks of shares. So far, the volumes of IPOs and investment in fixed assets funded by the issuance of shares have been lagging rather far behind the volume of merger and takeover deals. In the period from 2000 through 2012, the total volume of IPO-SPO by Russian companies amounted to \$ 91.5bn, and that of merger and takeover deals – to \$ 778.8bn, which is 8.5 times more.

Table 13

The Parameters of the Market for Shares Issued by Russian Companies (bn USD)

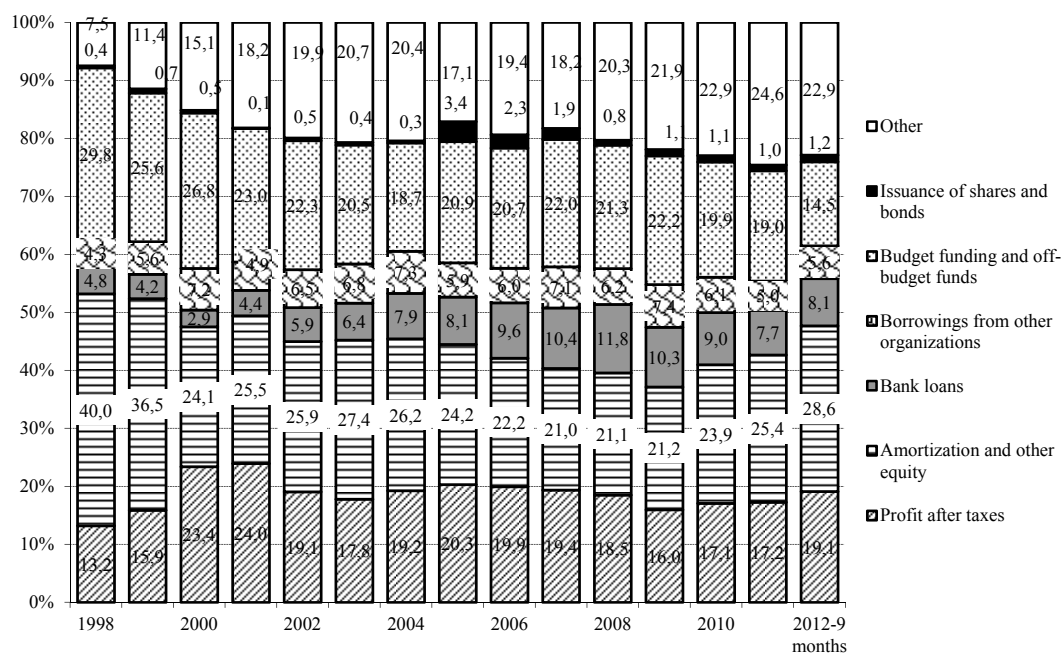
	Capitalization	Secondary market, including foreign exchanges	IPOs of shares	Proceeds from IPOs, that were invested in fixed assets			Volume of merger and takeover deals
				Billions of USD	The same, as % of capitalization	The same, as % of IPO volume	
2000	41	47	0.5	0.2	0.5	40.0	5
2001	75	49	0.2	0.1	0.1	50.0	12
2002	106	87	1.3	0.2	0.2	15.4	18
2003	176	188	0.6	0.2	0.1	33.3	32
2004	230	541	3	0.1	0.0	3.3	27
2005	549	374	5.2	3.2	0.6	61.5	60
2006	1057	914	17	3.2	0.3	18.8	62
2007	1503	1687	33	3.6	0.2	10.9	126
2008	397	1983	1.9	2.1	0.5	110.5*	110
2009	861	1156	1.7	2.0	0.2	117.6*	56
2010	1379	1431	6.3	2.4	0.2	37.9	56
2011	1096	2222	11.3	2.6	0.2	23.1	79
2012	1079	1901	9.5	2.0**	0.2	21.3	135

* the value is above 100% because part of the amount invested in fixed assets could be generated by private placement of shares;

** over the period of January-September 2012.

Source: calculations based on data released by the Moscow Exchange, cBonds, the Bank of Russia and Rosstat.

However, it is still too early to draw the conclusion that a considerable part of the proceeds from the placement of shares – let alone corporate bonds – is being spent on modernizing the national economy and promoting Russia’s economic growth. The amount of money attracted by companies through the placement of shares and corporate bonds and then invested in fixed assets constitutes only a small part of the financial resources allocated to the acquisition of fixed assets. This is illustrated in Fig. 50, where the sources of financing for investment in fixed assets are presented.



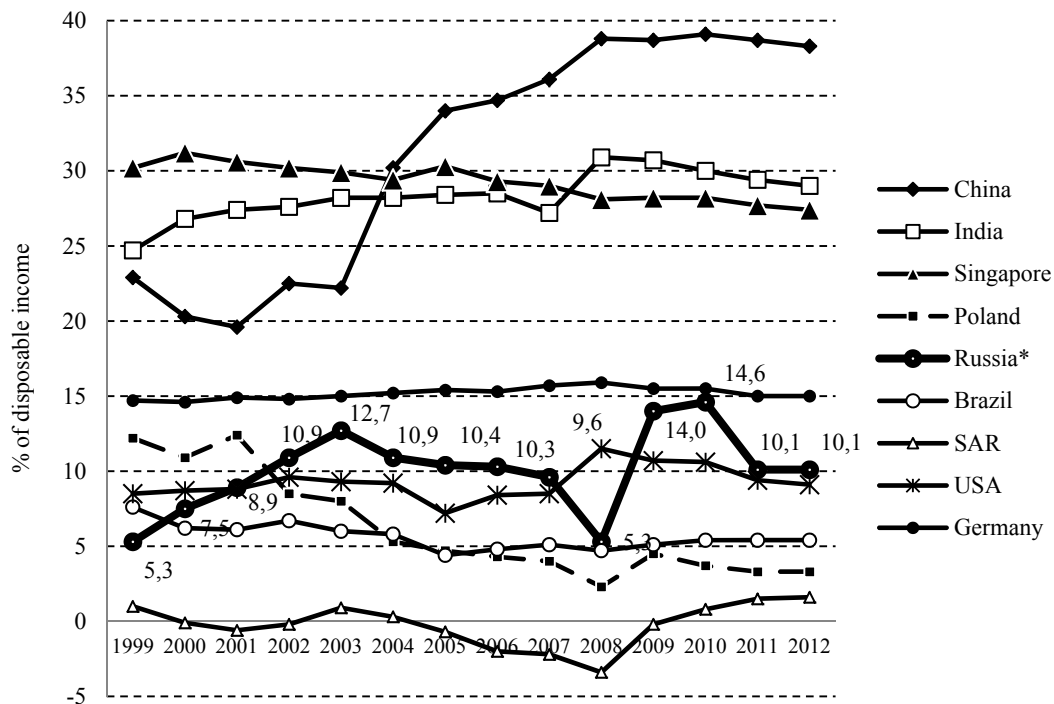
Source: calculations based on data released by Rosstat.

Fig. 50. The Structure of the Sources for Investment in Fixed Assets

Over the period from 2000 through 2012, the amount of resources obtained through the issuance of bonds and shares constituted only a very small fraction of financial resources earmarked for investment in fixed assets. Their share fluctuated between 0.1% in 2001 and 3.4% in 2005. In 2011, this index amounted to 1.0%, and in the first 9 months of 2012 – to 1.2%.

3.8. The Development of Russia's Domestic Savings System

In order to achieve a high rate of growth and modernization, Russia's economy must keep the norms for domestic saving at a high level. The amount of savings will grow if the household savings rate is on the rise. According to the official statistics released by *Rosstat*, Russian households save approximately 10% of their income (*Fig. 51*). In the countries whose economies are leaders in economic growth and modernization (China, India, Singapore, Hong Kong), the ratio of the household savings rate to disposable income is much higher. The social and demographic situations in these countries are certainly different from that in Russia, but it must be admitted that any large-scale modernization can only rely on domestic sources of financing. Besides, the currently high consumption rate in Russia in the present situation implies that domestic demand creates incentives mostly for foreign producers.



* *Rosstat's* data, less savings kept as deposits denominated in major foreign currencies and foreign currency cash.

Source: calculations based on data released by *Euromonitor International*.

Fig. 51. Household Savings Rate, as % of Disposable Income

In order to raise the population's savings rate and attract long-term resources, there must be institutional investors operating on a stable basis – just as in the case with government reserves. Their keeping a relatively low profile in Russia (*Table 14*) poses a major problem for the Russian financial market. The most important negative development of 2012 was the decision that the rate of compulsory deduction to the funded pension component should be de-

creased, in order to ensure the Russian pension system's gradual transition towards distribution-based pension funding. In the sphere of pension provision, Russia is increasingly resembling Argentina and Kazakhstan where, as a result of inconsistent government policies in the sphere of pension reform, private pension funds were nationalized.

Table 14

The Development Levels of Institutional Investors in Russia

Average index for 2001–2011	Number of countries in ICI ¹ and OECD samples	Russia's place in sample	Assets, % of GDP	
			Average for 2001–2011	2011
Assets of open-ended investment funds*	49	49	0.3	0.2
Savings and reserves of private pension funds**	67	53	2.1	4.5
Assets of insurance organizations***	41	40	1.4	1.7

* Russia – open-ended and interval pension investment funds;

** Russia – pension savings and reserves of private pension funds;

*** Russia – insurance reserves

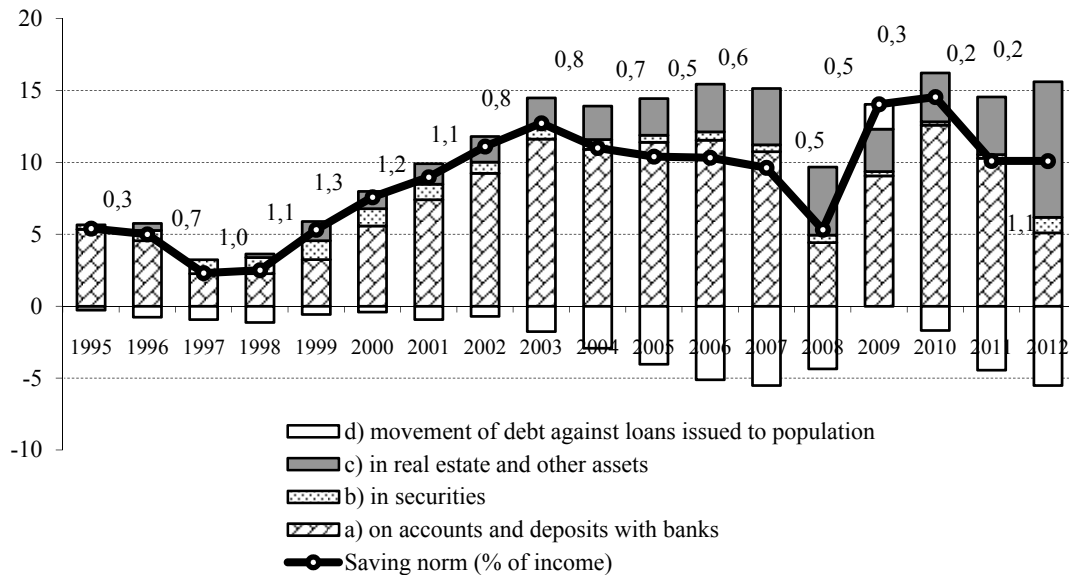
Source: calculations based on data released by the Investment Company Institute, stat.org OECD and IMF IFS.

Against the backdrop of all the other countries with domestic stock markets Russia is the world's only outsider in terms of the levels of development of all three forms of institutional investors. Thus, Russia ranks 49th (the lowest) among the 49 countries for which statistics on their open-ended investment funds' assets are available; ranks 53rd out of 67 by the relative level of private pension funds' development; and ranks 40th out of 41 by the size of insurance organizations' assets. In 2011, the assets of open-ended and interval pension investment funds accounted for 0.2% of Russia's GDP; pension savings and reserves of private pension funds – for 4.5% of GDP, and the assets of insurance organization – for approximately 1.7% of GDP. This is indicative of the almost complete absence in Russia of an effectively operating mechanism of savings mobilization via institutional investors. In contrast to all the other countries of the world, the principal savings methods applied by Russia's population are investment in housing and bank deposits (Fig. 52)

Fig. 53 presents data on the number of individual investors' brokerage accounts and the number of individual accounts on the registers of investment stakes kept by private pension funds. Regrettably, at present the National League of Management Companies (NLMC) does not release timely information on market stakeholders in pension investment funds. However, if we assume that the number of stakeholders in pension investment funds in 2009–2012 did not significantly decline on 2008, the resulting number of individual investors dealing in securities directly or via collective investment will be approximately one million. In this connection, the distinctive feature of the period of 2010–2012 was the newly emerged downward trend in the growth rate of the number of broker clients registered in the MICEX's trading system. Thus, in 2009 the number of registered clients increased by 112.2 thousand, in 2010 – by only 42.8 thousand, in 2011– by 66.5 thousand, and in 2012 – by 24.8 thousand. At the same time, the number of *active* broker clients dropped dramatically – from 114.1 thousand in 2009 to 70.3 thousand in 2012. This dynamics may point to the fact that the model formerly applied in attracting clients into the Russian stock market is no longer as effective as it used to be. Anyway, the number of people interested in speculation on the stock exchange is relatively limited in any country. The new growth model implies the presence on the market of long-term investors, and these cannot be attracted without creating an effectively operating pension savings system and restructuring the services rendered by financial institutions. However, the

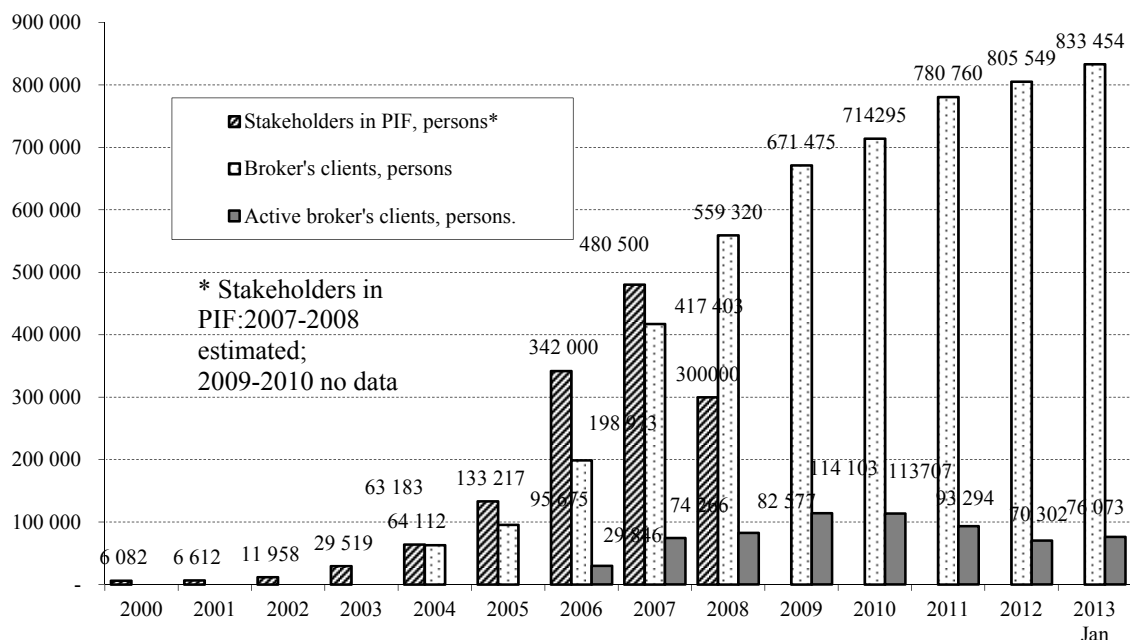
¹ Investment Company Institute.

government is evidently not very anxious to promptly create in Russia a new model for the operation of non-bank financial organizations oriented towards servicing long-term private investors.



Source: calculations based on the balances of population incomes and expenditures released by Rosstat.

Fig. 52. The Savings Structure in Russia (as % of the Population's Income)



Source: calculations based on data released by the Moscow Exchange and the National League of Management Companies (NLMC).

Fig. 53. The Number of Market Retail Clients of Asset Managers and Brokers

3.9. Market Failures and the State's Presence on the Financial Market

In 2012 it finally became clear that the State was going to play a key role on the financial market – not only in the sphere of its regulation and supervision, but also in elaborating its development strategies and directly managing the projects aimed at creating market infrastructure and the international financial center. On the one hand, this was a response to the challenges and threats that the domestic financial market had to deal with in the course of the protracted recession in the world economy coupled with the growing global competition in the financial sphere. On the other, this activity followed the current general trends in economic policy, when the government relied on its active involvement in the economy and the potential of government development institutions and big state-owned companies. The idea behind this policy was that such an approach would help in correcting ‘market failures’ and overcoming Russia’s inadequacy in global economic competition.

The state expansion on the financial market in 2011–2012 helped to sustain the banking system through short-term loans, to prevent the collapse of exchange liquidity that could result from global investor flight and the absence of domestic institutional investors in Russia, to relatively successfully carry out the public placements of the Moscow Exchange and *Sberbank of Russia*’s shares, to boost the population’s trust in the bank deposits guaranteed by the government, consolidate the exchange infrastructure, and to grant to foreign investors the access to the Russian debt market. The reliability of financial organizations and investor confidence in them may be increased by creating a mega-regulator of the financial market.

However, it also is becoming increasingly evident that by no means all the existing problems can be adequately solved by replacing the market forces by the government’s activity. Moreover, there are some signs that in place of the market’s failures we may now witness failures of the State – that is, the negative consequences visible on the market and in the behavior of market subjects as a result of excessive interference of the authorities in market relations and the constraints imposed on competition.

The interference of the State results in the development of paternalistic attitudes and in the lack of private initiative in dealing with the key issues of managing private finances. As demonstrated by the *Levada-Centre*’s survey of consumer behaviors conducted in February 2013, 60% of the respondents believe that it is the duty of the State to provide them with adequate earnings. According to the survey’s authors, this is the result of the State’s cultivation of a paternalist model. If the citizens feel that they are unable to influence the existing situation in any way, they become increasingly irresponsible – among other things, in the financial sphere. Family budget planning with a view towards ‘life in retirement’, illness or unemployment is the consideration that is most seldom mentioned by the respondents as one of the most relevant issues¹. All this poses a serious obstacle in the way of elaborating an efficiently functioning domestic savings system.

It becomes easier for the monetary authorities and exchanges alike to promote the formation of a financial system and exchange infrastructure by means of issuing preferential

¹ Surveys conducted by *Levada-Centre* by order of the *Sberbank of Russia*’s Centre for Macroeconomic Research. February 2013. See *Sberbank*’s website: http://www.sbrf.ru/common/img/uploaded/files/pdf/press_center/2013/Levada_potreblenie_doverie_i_otvetstvennost_.pdf

loans to banks via direct repo operations and by implementing infrastructure projects designed to attract investors onto the financial market (the issuance of federal bonds, the attraction of foreign portfolio investors – including the speculative CT strategy), than to create the conditions necessary for an accelerated development of domestic institutional investors (private pension funds, investment funds, life insurance companies). As a result, Russia is increasingly becoming an outsider on a global scale in terms of the level of development of her institutional investors, whose presence offers the only possibility for the population to build long-term savings. The government agencies brought pension reform to a complete failure. None of the issues relating to the granting of tax exemptions to private investors operating on the domestic market has been provided with an adequate solution.

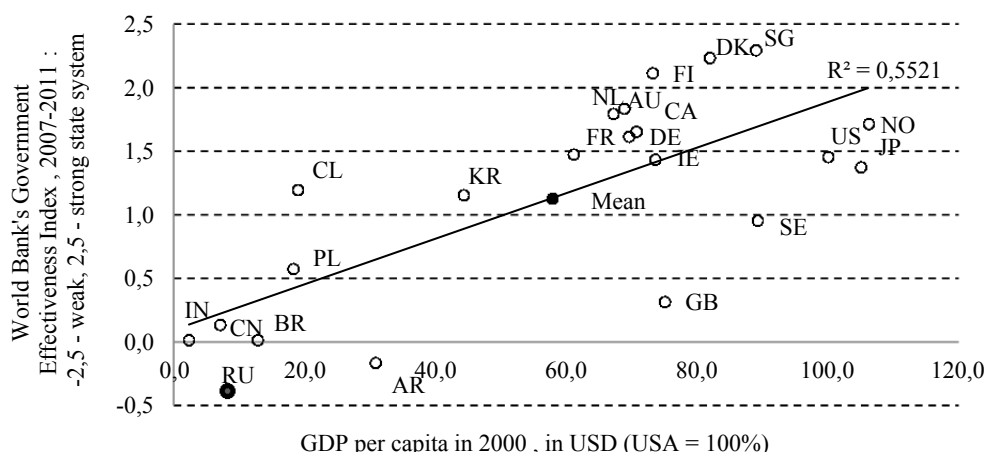
For many years, the dynamic development of the banking system has depended on an easy access to cheap money attracted via CT or preferential loans issued by the Bank of Russia. This eliminated any incentives for the banking system to attract capital in the form of foreign direct investment or public placement of shares on an exchange. Over the past two years, out of the entire banking system, only two state-owned banks resorted to trading on the open market. The IPO by *Nomos Bank* can hardly be called successful, because the bank was taken over by the Financial Corporation *Otkritie*.

The prevalence of the State in the capital of biggest commercial banks and the Moscow Exchange makes it impossible to create market conditions conducive to the private sector's successful development in the financial market. In 2012, various segments of the exchange trade demonstrated a significantly increased participation of state structures and the Bank of Russia. The exchange market and the market for investment banking services displayed a marked deterioration of the indicators describing the level of competition. Many serious initiatives put forth by self-regulated organizations with regard to investment consultants, individual investment accounts, the taxation of individual incomes, and collective investment were met with indifference by government bodies.

So far, the World Economic Forum's Global Competitiveness and Financial Development Indexes and the ratings by major international credit rating agencies have demonstrated no signs of any positive developments in Russia's institutional environment, business climate, performance levels and accessibility of services rendered by financial institutions, banks' reliability, and exchange regulation quality.

In our opinion, the optimal form of the State's response to market failures in Russia is yet to be found – both in terms of the financial market's functioning and the government policy at large. As shown in *Fig. 54*, Russia's government performance rating, as estimated by the World Bank, is very low - even by comparison with the major developing countries.

The government performance level is an inert indicator; few countries have ever succeeded in improving its value within a period of only two or three years. From this it follows that many of the decisions concerning the financial market's functioning must be geared for the low efficiency of the State in the sphere of economics. Another implication is that the State's expansion in the capacity of a participant in the financial market, its regulator and manager must be subject to certain constraints. As far as the sphere of the financial market's regulation, supervision and development is concerned, it is more feasible to rely on the self-regulation of market participants and on private initiatives.



Note. The GDP per capita index is based on average data for 2001–2011.

Source: World Development Indicators, the World Bank.

Fig. 54. Estimations of the State's Performance Level

3.10. Russia's banking sector in 2012

3.10.1. Key trends

The Russia's banking sector fully recovered after the economic crisis in 2012 and either caught up with some of the parameters of the preceding year, or its development even slowed down.

Total volume of bank assets grew up by 20.4% in 2012, whereas in 2011 they stood at 23.1% (Fig. 55). Nevertheless, the banking sector was growing faster in terms of volume than the economy, for the first time since 2009. Total bank assets to GDP increased from a level of 75–76%, which was stable over the last three years, to 79%. However, the volume of bank assets increased against the economy mostly in response to that growth rates in GDP nominal volume slowed down substantially, which almost halved in 2012 against the preceding year (from 20.5 to 11.8%).

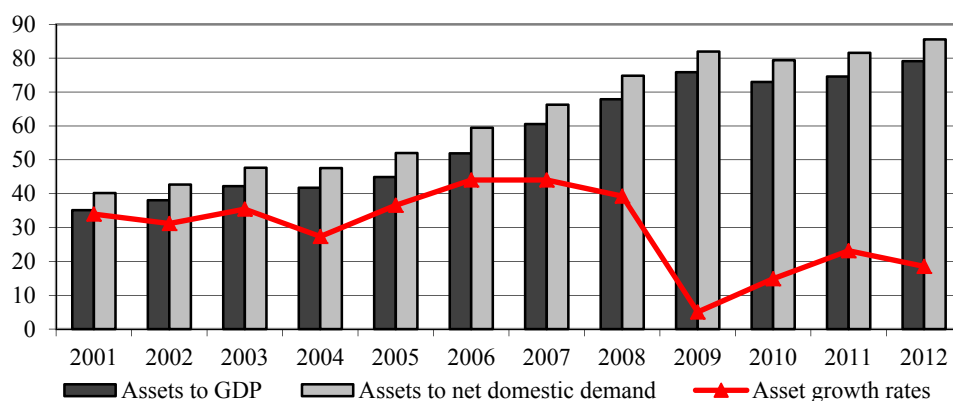


Fig. 55. Bank assets gain rates as percentage of the preceding year, and the ratio of bank asset volumes to GDP and net domestic demand¹, %

¹ Net domestic demand is calculated as GDP less net exports, and represents the estimation of domestic consumption in the economy.

In 2012, the Central Bank of Russia increased its participation in promoting growth of bank transactions. In 2011, refinancing stood at 2.5 p.p. of total asset growth, i.e. under otherwise equal conditions bank assets would grow less by 2.5 p.p. without loans from the Central Bank of Russia, whereas in 2012 regulator's loans reached 3.6 p.p.

The following changes took place in the resource build-up structure in the banking sector as compared to 2011 (Fig. 56). Borrowings from corporate customers decreased notably. Their share in the resource build-up structure of banks reduced from 30 to 14%, personal savings remained unchanged and stood at 28%, whereas the volume of bank deposits increased by 20% in nominal terms. At the same time, as noted above, the Central Bank of Russia increased its participation in and contribution to the build-up of bank resources from 13 to 18%. In addition, owners of banks increased their role. In 2012 their contribution stood at 12.5% against 9.2% in 2011. Nominal capital growth in the banking sector increased by more than 70%, almost by Rb 900bn in 2012 against a little bit more than Rb 500bn in 2011.

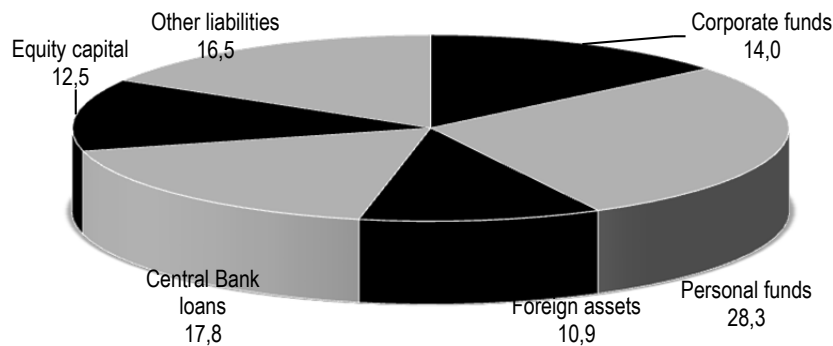


Fig. 56. Resource build-up structure in the banking sector (growth in liabilities and reduction in assets) in 2012, as percentage of total

The main outcome in the field of active bank transactions in 2012 became the replacement of corporate lending with retail loans. In 2012, banks allocated 37% of their built up resources to loans to enterprises and organizations as well as investments in corporate bonds against 46% in the preceding year, whereas retail lending received more resources than in 2011, 28% against 23% (Fig. 57).

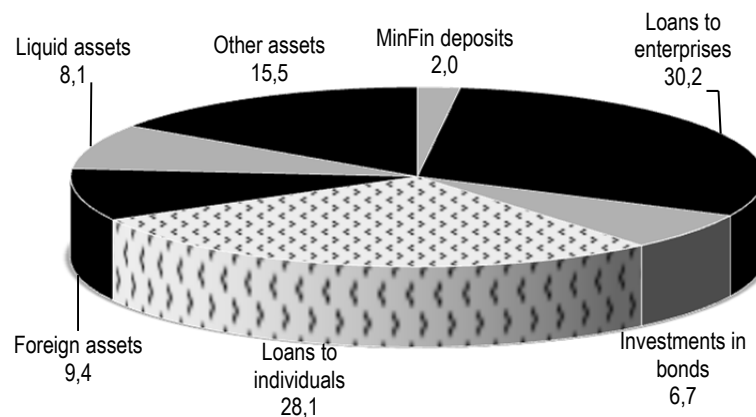


Fig. 57. Resource utilization structure in the banking sector (growth in assets and decrease in liabilities) in 2012, as percentage of total

3.10.2. Retail segment bank transactions in 2012

The year of 2012 featured the following trends in the relationship between banks and individual customers:

1. Household consumption level became more dependent from bank lending.
2. Household disposable incomes experienced a heavier load in servicing debts owed to banks.
3. Household savings rates reduced.

Higher dependence of individuals on loans

Growth rates in the retail segment of bank lending in 2012 reached maximum values in the post-crisis period. In the summer of 2012, annual (over 12 months) growth rates of individual (household) debts owed to banks reached 44%, whereas the growth slowed down to 39% at the end of the year. Debts under unsecured consumer loans increased most, by 57%, whereas debts under other types of loans grew moderately, by 35% for housing loans (incl. mortgage loans) and by 24% for car loans.

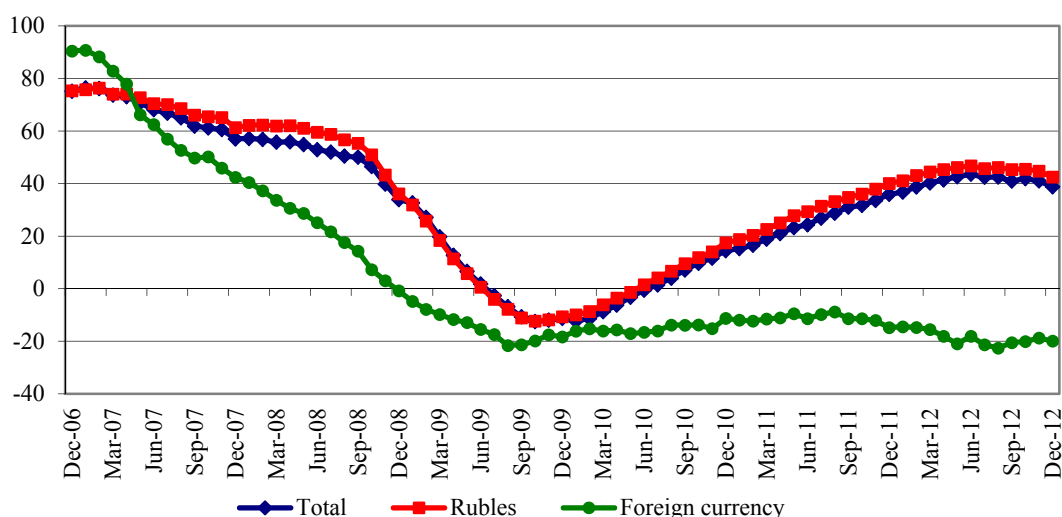


Fig. 58. Growth rates in retail loans over 12 months, %

Individual (household) debts owed to banks grew with volumes of new loans. In 2012, banks extended a total of Rb 7.2 trillion of retail loans, i.e. 33% more than in the preceding year. The ratio of new loans to households consumer spending (the sum of retail sales volume, expenses on food service, and paid services) exceeded the pre-crisis level (22% in 2007) to finally amount to 25.6% at year end. Furthermore, it used to reach 27% in Q2 2012. It means that one in four rubles which individuals spent for consumption in 2012 was borrowed from the banking sector.

It is the growth in debt burden on income and assets of households that gives rise to concern in terms of bad debt risks and, consequently, financial sustainability of banks, rather than credit portfolio growth rates – loans grew faster prior to the crisis. For instance, the ratio of total debts under bank loans to income of households already exceeded a maximum of 17.8% during the crisis in September 2008 to reach 21.5% at the 2012 year end.

In addition, the current debt service burden (the sum of mandatory principal payments plus interest payments) on household disposable income was growing. All in all, in 2012 this parameter reached 9.6%, being comparable with the same US parameter (10.6% at the end of Q3 2012). The Financial Stability Review published by the Bank of Russia in September provided different data on debt burden on household disposable income. According to the foregoing data, debt burden on households used to reach 20% in certain quarters during 2012. Our data differ from that of the Central Bank of Russia in the following. To estimate the amount of principal payments, we use the amount of retail loans matured in the period under review. It is this information that banks use to solvency of a particular borrower, whereas the Bank of Russia took into account total amount of repayments, including early repayment of loans. Thus, the parameter provided in the Financial Stability Review can be used to estimate actual debt load, whereas our estimates show the amount of scheduled debt load. It should be noted that such method is comparable with the estimates made by the US Federal Reserve System¹.

Reduction in household savings rate

In 2012, the relationships between banks and individuals (households) saw breaking changes. Retail bank deposits grew at a slower rate against retail loan debts owed to banks throughout the entire period of the year. Thus, the household sector, which traditionally was the principal source of resources for banks, turned into net borrower. Over a period of 11 months net household savings in banking system reduced almost by Rb 700bn. It was only the seasonal December growth in retail bank deposits that restored status quo. All in all, the inflow of retail bank deposits to the banking sector was equal to the growth in loan debts, both parameters showing a value of Rb 2.3 trillion at the year end.

It was only in the crisis-hit year of 2008 when the growth in bank retail loans grew much faster in nominal terms than bank deposits over 11 months (at that time this parameter exceeded Rb 800bn over 11 months). In 2008, however, it was caused by withdrawals of retail bank deposits in response to impending large-scale crisis in the banking system. In the period between September and October 2008 alone individuals withdrew more than Rb 540bn of deposits with banks. The year of 2008 still remains the only year when individuals played a role of net borrowers against the banking sector.

During 2012 the transition to net retail borrowing took place quietly without any signs of panic on the side of retail bank depositors, thereby speaking for changes in the savings behavior of households and transition to a loan-based consumption model which was more evident than in the period when retail lending was booming in 2006–2008.

Formally, the growth in retail bank deposits in 2012 was equal to that of loan debts, both parameters amounted to Rb 2.3 trillion. However, from the one hand, a major part of the growth in retail bank deposits was caused by interest accruals: in 2012 banks paid Rb 665bn of interest on retail accounts, accounting for about 30% of growth in the retail deposit base. On the other hand, a part of the extended retail loans were one way or the other discharged from banks' books. Overdue bad debts are often sold to collector agencies, a part of loans are subject to refinancing, e.g., mortgage loans through the instruments offered by the Agency for Housing Mortgage Lending (AHML).

In other words, actual inflow of household money to banks was notably less, whereas the increase in debts was more, than the observed growth. To that end, it is safe to say that in 2012 individuals ceased to be creditors to the banking sector by turning into net borrowers.

¹ DSR (debt service ratio) also includes scheduled loan repayments only.

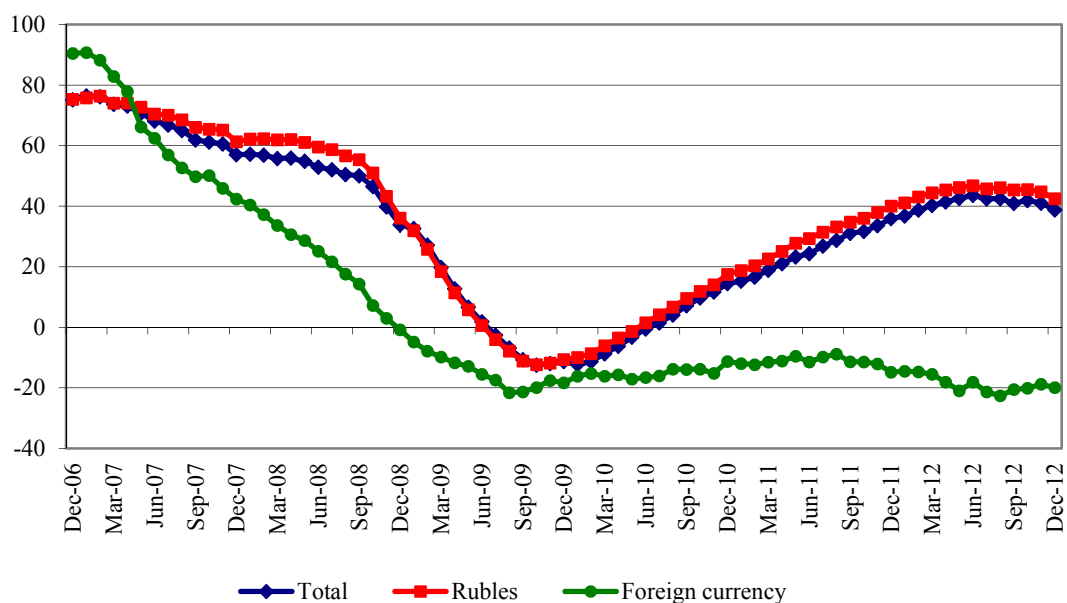


Fig. 59. Retail bank deposits growth rates over 12 months, %

However, growth rates in the deposit base remained stable, ranging between 19 and 21% over the last two years. The household savings rate in bank deposits and cash in decreased insignificantly from 8.4 to 8.2% in 2012 against 2011, however, a shift from cash to bank deposits was observed in the personal savings structure. Retail bank accounts and deposits accounted for 6.6% of disposable income in 2012 against merely 6.0% in the preceding year.

This was quite likely caused by growth in interest rates on retail bank deposits which almost throughout the entire year were stable, increasing by 1–2 p.p. the officially registered inflation level. In addition, retail bank deposits in foreign currencies increased in response to highly volatile ruble exchange rates. The growth rate in this type of savings was almost equal to the growth rate in ruble bank deposits at the year end.

3.10.3. Relationship between banks and corporate customers

The following trends were observed in the relationship between banks and corporate customers in 2012:

1. Slower growth rates in corporate lending.
2. Reduced growth rates in corporate account balances.
3. Increased nonperforming assets in the corporate sector.

Growth in corporate loan debts owed to banks slowed down in 2012. Growth rates of the corporate segment in the lending market dropped to 14% in 2012, after a 24% growth in corporate debts at the 2011 year end. Furthermore, the retail segment almost caught up with the corporate one in terms of nominal volume of growth in corporate debts in 2012: corporate debts increased by Rb 2.5 trillion, whereas individual debts by Rb 2.3 trillion.

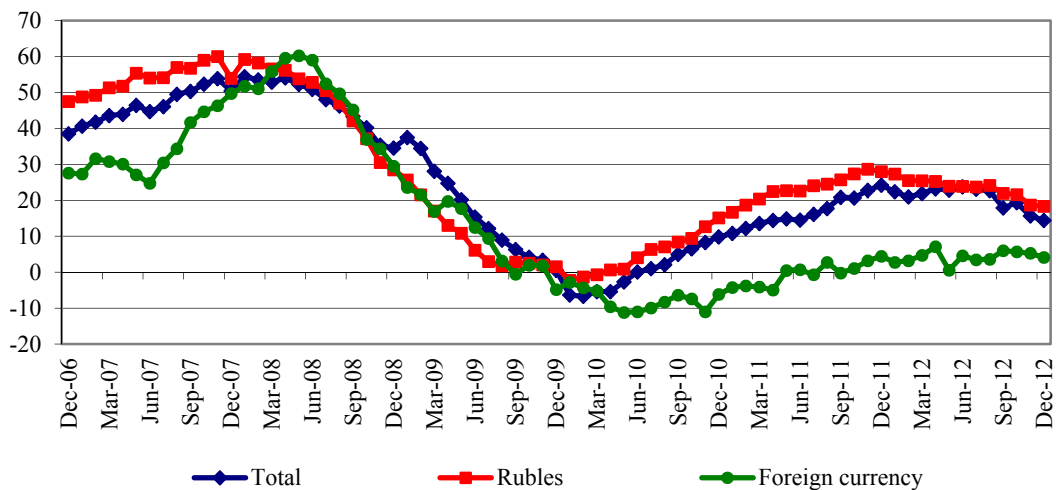


Fig. 60. Corporate loans growth rates over 12 months, %

The quality of corporate debts owed to banks improved gradually throughout the entire year. The volume of loan loss provisions increased merely by 3.5% while the amount of overdue debts by 9.9%. As a result, a share of overdue debts in total corporate debt reduced (from 4.8 to 4.6%), and the ratio of provisions to loan debts from 8.3 to 7.5%) during the year. However, these parameters still remain much worse than the minimum values observed prior to the crisis, when overdue debts accounted for less than 1% and the volume of provisions for about 3% of total lending volume.

Corporate funds growth in bank accounts saw significant changes during 2012. In 2011, balances on corporate accounts and deposits stood at 25%, whereas in 2012 they dropped below 10%. This process took place partly together with slowdown in lending. However, the presented data show that growth rates of bank account balances slowed down at a higher rate than loan debt volumes. In 2012, corporate borrowers left on the banking sector's accounts less than 50% of growth in loan debts against about 70% in 2011.

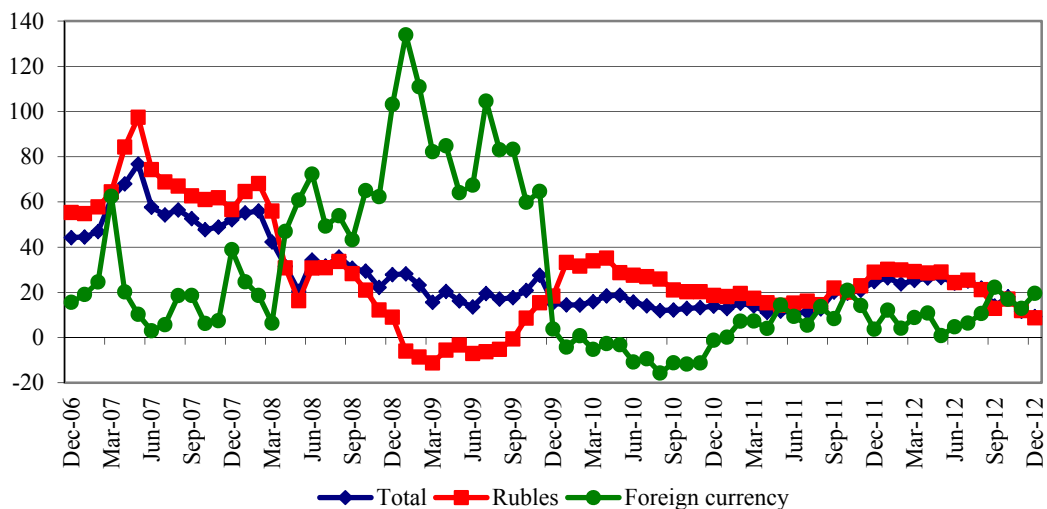


Fig. 61. Corporate funds growth rates in the banking sector over 12 months, %

It was bank term deposits representing nonperforming corporate assets withdrawn from the current economic turnover that began to account for most of the corporate funds available in the banking sector. They accounted for no more than 50% of total corporate customers' funds throughout the entire year. Moreover, most of corporate bank term deposits had a maturity of more than one year. Bank term deposits with a maturity of more than one year accounted for 42.4% of total deposits for nonfinancial organizations and 57.6% for financial institutions, which means that many enterprises and organizations preferred bank long-term deposits to investments in their production development, in spite of the fact that weighted average yield on bank deposits for corporate customers was fairly moderate in 2012. All in all, average value of a business entity's bank deposit stood at 5.8% p.a. during the year.

3.10.4. Foreign transactions in the banking sector

The balance of transactions with nonresidents in the banking sector kept changing in favor of net allocation of foreign assets at the 2012 year end. The volume of foreign liabilities increased by \$31bn and foreign assets by \$35bn¹ during the year. Thus, banks' net investments in foreign assets increased by \$4bn (from \$46bn to \$50bn) during the year, being much less than in the preceding year, when banks' net foreign assets amounted to \$24bn².

The growth in net foreign assets in 2012 was accompanied by shrinking of net foreign exchange position in the banking sector, i.e. foreign exchange assets exceeded foreign exchange liabilities. Net foreign exchange position decreased by \$12bn during the year.

Mixed dynamics of net foreign assets and foreign exchange position in the banking sector resulted from growth in domestic foreign exchange savings deposited in the banking sector. Russian customers' deposits in their foreign currency accounts exceeded by \$25bn foreign exchange loans they obtained from banks. Retail deposits accounted for most of it (about \$17bn). Thus, capital outflow from banks over the last few years was a response to higher demand for foreign exchange savings on the side of their customers, because foreign exchange loans inside the country have long lost demand in the required volume. This is the main difference between the current situation and that in the period between 2008 and 2010, when the dynamics of net foreign assets banks corresponded to the dynamics of foreign exchange position in the banking sector, because growth in investments in foreign assets was caused by the intention of some of the large banks to maintain a positive foreign exchange position.

Moreover, this situation stultifies to a large extent a potential recurring of the growth strategy in the banking sector which was widespread prior to the crisis: accelerating credit expansion inside the country by borrowing cheap (in foreign exchange values) resources from foreign financial markets. Today, when changes in the policy of the Bank of Russia gave rise to uncertainty in midterm dynamics of the ruble exchange rate against other foreign currencies, neither banks, nor their customers are ready any longer to assume foreign exchange risks in

¹ Hereinafter in the section the data on foreign assets and foreign exchange assets are presented as adjusted for FX swaps with the Bank of Russia. FX swaps are referred to as Bank of Russia's loan to a bank in exchange for foreign currency delivery. The transaction is performed at a pre-determined rate depending on a interest rate on the provided assets.

² It should be noted that due to methodological differences the dynamics of banks' foreign assets and liabilities in bankers' books not always correspond to statistics on balance of payments. For example, our analysis takes no account of Vnesheconombank transactions, which is not regarded as credit institution, but its transactions are recognized under "banks" item in the balance of payments. In addition, today banker's books make it impossible to quickly assess the volume of nonresident investments in the banking sector's capital.

the volumes typical of the period between 2005 and 2007, thereby bringing into focus the issue of sources for growth in the banking sector in the midterm perspective.

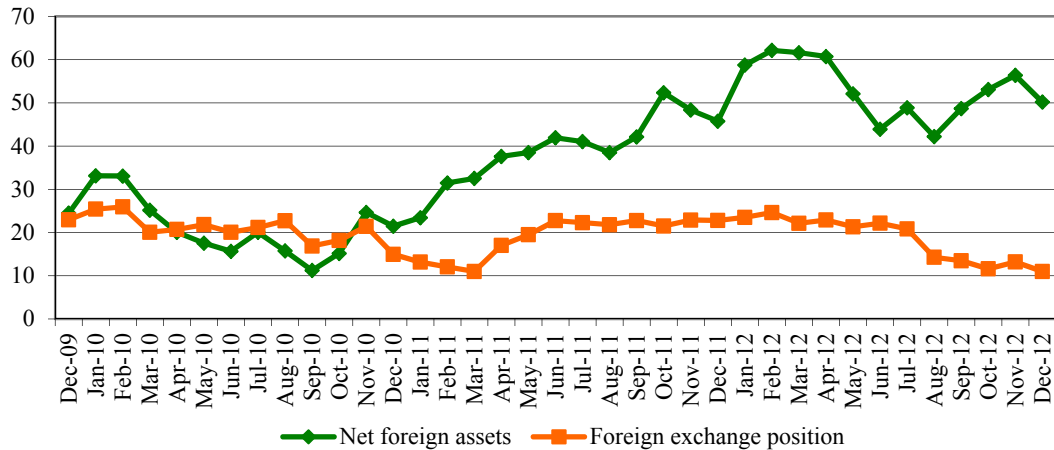


Fig. 62. Net foreign assets and foreign exchange position in the banking sector, billions of US dollars

3.10.5. Strengthening state influence on the banking sector

The banking sector's large dependence on the budgetary policy manifested itself again in 2012. For the second year in a row state finances created an artificial issue of bank liquidity. It means a combination of two processes, namely federal budget surplus accumulated in the Reserve Fund, and comparable in volumes operations on the placement of government securities in the domestic financial market.

Let us consider in detail the functioning of this mechanism. The dynamics of money supply is governed by three basic types of operations of the Bank of Russia: operations with reserve assets (in particular interventions in the domestic foreign exchange market), budget operations (mostly accumulation of budget balances on accounts with the Bank of Russia, including the Reserve Fund and the National Wealth Fund), and operations providing liquidity to commercial banks (banking system refinancing).

In 2012, the Bank of Russia conducted minimum foreign exchange interventions. A total of \$7.6bn of interventions were conducted during the year (\$12.4bn in 2011). In general, in 2012 interventions in the domestic foreign exchange market contributed Rb 229bn to the money supply (increase in M0 money stock), according to the Bank of Russia. In addition, the Bank of Russia's reserves increased by another \$22.5bn through other operations with reserve assets (except for interventions in the domestic foreign exchange market). This value includes the placement of government Eurobonds in foreign exchange (\$7bn), revenues from the sale of a share in Sberbank to non-residents (about \$5bn), foreign currency swaps with Russian banks (\$9bn).

Money supply reduced in response to accumulated surplus (non-spent) national revenues in accounts with the Bank of Russia. Though in 2012 federal budget was reduced to nil balance (budget deficit amounted to merely Rb 12bn, according to preliminary estimates), balances on government bank accounts increased considerably, including but not limited to additional borrowings in the domestic market and external markets. Balances on federal government authorities' accounts with the Bank of Russia increased by Rb 959bn during the year. Given the

funds of the constituent territories of the Russian Federation, government agencies resources in the Bank of Russia increased by Rb 1.1 trillion. This value represents a direct deduction from the money supply, because this money were withdrawn from the current economic turnover.

To compensate for cash outflow to state administrative bodies' accounts with the Bank of Russia, refinancing of the banking system should be accelerated. In 2012, the Bank of Russia's requirements to institutions increased by Rb 1.5 trillion.

In accordance with the Federal Law "On the Federal Budget for 2013–2015" (Annexes 43 and 44), the situation may recur, because domestic and foreign debts and the Reserve Fund will grow simultaneously time in 2013 and beyond.

Virtually, public borrowings in the domestic market act as an alternative for the financial sector to lending to the nonfinancial sector of economy, thereby preventing the real sector from increasing its resource base which in involved in both current economic turnover and capital investments. This makes banks reduce their resource base and have a need for more single-source refinancing.

It should be noted that scheduled borrowings will discount much less funds from lending within three years to come than in 2011. For example, if total corporate and retail lending grow by 17–18% annually, new government borrowings in the domestic market in 2013–2015 would account for 10–15% of credit portfolio growth against 25% in 2011.

3.10.6. Banking regulation

Bank of Russia's stricter requirements to risk assessment for selected categories of assets and the resulting reduction in capital adequacy of banks became a key issue for banks in 2012. Capital adequacy in the banking sector kept decreasing throughout the post-crisis period. As early as the 2011 year end, capital adequacy fell to reach the pre-crisis level (14.7% as of 01.01.2012 against 14.6% as of 30.09.2008) from maximum values of 20–21% reached late in 2009 in response to state support to banks amidst the crisis. By 01.01.2013 it fell to 13.7%, with the acceptable threshold being 10%.

On the one hand, reduction in capital adequacy reflects growth in bank lending and accelerated growth of working bank assets. During the crisis owners of banks accumulated a substantial safety bag thanks to state support, which can absorb different risks the banking sector is exposed to. Accumulation of banks' capital slowed down in response to the transition to recovery growth in the banking sector whose adequacy ratio began to decline against an increase in business loans and other active bank transactions.

However, banks' profitability remains far below the pre-crisis level. Return on investments accounts for 20% p.a. against 25–30% in the period between 2006 and 2007, thereby leading to a relatively poor attractiveness of banking business for investors and discouraging owners from recapitalizing credit institutions without dire need.

On the other hand, the Bank of Russia tightened gradually the bank capital regulation in an effort to encourage bank owners to increase their capital in order to strengthen financial sustainability of the banking sector and prevent lending from being accelerated too fast, above all, unsecured consumer loans and higher-risk segments of corporate borrowers.

As a result, in 2012, though growth rates in equity capital of banks increased by more than 1.5 times (from 11% in 2011 to 17% in 2012), capital adequacy kept declining in 2012. The amount of risk weighted assets increased by 25% during the year, according to the Bank of

Russia capital adequacy ratio calculation method, against a total growth rate in assets stood at about 20%.

Scale-up risk factors for borrowers who have no credit rating and fail to disclose their credit record, were introduced in the summer of 2012, which “cost” banks almost 0.5 p.p. of capital adequacy ratio. In 2013, the Bank of Russia plans to introduce higher risk ratios for tight unsecured retail loans, thereby making additional contribution to the reduction in capital adequacy, if banks can’t further increase their equity capital.

For example, beginning with July 1, 2013, retail loans at higher interest rates will be included with higher ratios into the capital adequacy ratio calculation formula. Interest rates of more than 25% p.a. will be regarded as higher interest rates for ruble loans. The multiplying ratio will be set to 1.1 (i.e. such loans will be regarded as being exposed to a risk which is 10% higher than that for “cheap” loans) for up to 35% p.a., 1.4 for 35 to 45% p.a., 1.7 for 45 to 60% p.a., and 2 for more than 60% p.a.. In other words, banks will have to double their capital adequacy in case of most tight loans. To fully assess the effect of such measure on the situation in the banking sector, a more extensive information on specific banks is needed against that provided by the Bank of Russia. Based on the available bank financial statements as of the end of Q3 2012, 43 banks had more than 25% p.a. of average yield on retail loans. In other words, these banks will certainly face either capital adequacy reduction, or have to revise their interest rate policy. In practice, since most banks have at least one tight loan, the foregoing measure will definitely have an effect on many banks which will have to either reduce their yield on retail loans, or seek extra sources to increase their capital.

3.10.7. Banking sector development prospects in 2013

In 2013, potential sources of growth in the banking sector will be concentrated within this country. External capital inflow to the Russia’s banking sector is unlikely for domestic reasons, rather than because unfavorable conditions in external markets. Gross external loan inflow, which is small though, kept going throughout the entire post-crisis period. The Russia’s banking sector should not count on the external world as a source of financing in the mid-term perspective, because of highly volatile ruble exchange rate, lack of efficient foreign exchange risk tools in the Russia’s financial market, and reluctance of banks and their customers to assume such risks.

Consequently, the mid-term development of the Russia’s banking sector will be based mostly on domestic sources of financing which basically comprise the two segments: 1) the state and the Bank of Russia as regulator in the banking market and, consequently, 2) the private sector.

Possible reliance on the private sector as potential source of financing for the banking sector implies higher effectiveness of Russian banks as financial mediators who are able to convert national savings into investments. However, the key risk here is growing erosion of money supply sources from the banking sector which has been observed over the last few years, thereby leading to deficit of resources required for further growth in lending. This issue resulted in liquidity deficit in the banking sector and growing dependence on short-term refinancing from the Bank of Russia.

This issue stems from outside the banking sector, after all, from bank customers’ decisions on allocation of their own financial assets, which are directly related to a degree of their confidence in the national banking system. Allocation of financial resources in accounts and de-

posits in the national banking system (or liabilities of Russia's banks) is an option for assets in the non-bank corporate sector and households. Alternative options are investments in liabilities of other sectors: the state (purchase of government securities), the Central Bank of Russia (accumulation of the national currency in cash) and the external world (purchase of any foreign assets, including foreign currencies in cash). As an alternative to banks, the process of converting savings into investments may pass through different forms of non-bank financial mediators. In addition, cash outflow from the national banking system may result from growth in current payments to the state (taxes) and the external world (payments for imported goods, and foreign debt service).

According to our estimates, the following situation would remain in 2013. Growth in loans to the non-bank sector (corporations and households) of the economy would be combined with stagnation in the demand for M2 money stock and, consequently, wider gap between bank loans to the economy and the deposit base of banks. In its turn, the financial sector would have a depressive effect on economic growth amidst a relatively low for Russia inflation and stagnating demand for money.

According to our estimates, in 2013 assets in the banking sector would grow within a range of 15 to 17%, loans to corporate borrowers 12 to 15%, whereas retail lending may increase by 25–30%. Growth in the deposit base would most likely be limited by nominal growth rates in gross output, which would not exceed 10–12% during the year amidst relatively stable oil prices and absence of external inflation shocks. Thus, monetary authorities would further increase their role in creating bank liabilities banks. In addition, Russia's Government intentions to promote economic growth through different types of stimulation programs would be able to strengthen state-owned banks position as most likely mediators in the transfer of public resources to target economic sectors.

3.11. Municipal and Sub-federal Loans Market

3.11.1. Market development dynamics

At the 2012 year end, consolidated regional budget and budgets of territorial state extrabudgetary funds ran a deficit of Rb 273.1bn (0.44% of GDP). Consolidated regional budget deficit increased by 14.7 times of GDP against 2011. For example, territorial budget deficit amounted to Rb 14.2bn (0.03% of GDP) in 2011.

In 2012, the constituent territories of the Russian Federation ran a budget deficit of Rb 251.1bn, urban districts ran a budget deficit of Rb 31.0bn, Moscow and St. Petersburg city municipalities ran a budget surplus of Rb 0.4bn, municipal districts ran a budget deficit of Rb 1.1bn, urban and rural settlements ran a budget surplus of Rb 4.3bn, territorial state extrabudgetary funds ran a budget surplus of Rb 5.4bn. In 2011, the constituent territories of the Russian Federation ran a budget deficit of Rb 20.4bn, urban districts ran a budget deficit of Rb 31.1bn, Moscow and St. Petersburg city municipalities ran a budget surplus of Rb 0.8bn, municipal districts ran a budget surplus of Rb 13.6bn, urban and rural settlements ran a budget surplus of Rb 1.8bn, territorial state extrabudgetary funds ran a budget surplus of Rb 20.9bn.

Table 15

Ratio of territorial budget surplus (deficit) to budget expenditures (%)

Year	Consolidated regional budget*	Regional budgets
2012	-3.0	-3.5
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

* inclusive of state extrabudgetary funds.

Source: estimates made by Gaidar IET based on the Federal Treasury data.

Table 16

Ratio of territorial budget surplus (deficit) to budget expenditures in 2007–2012 (%)

Year	Moscow and St. Petersburg municipal budgets	Urban districts' budgets	Municipal districts' budgets	Urban and rural settlements' budgets
2012	2.26	-2.01	-0.08	1.34
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: estimates made by Gaidar IET based on the Federal Treasury data.

As of January 1, 2013, 68 constituent territories of the Russian Federation (in 55 regions as of January 1, 2012) ran consolidated budget deficit (including state territorial extrabudgetary funds). The total deficit amounted to Rb 347.3bn, or 4.6% of their budget revenues (Rb 189.2bn, or 4.4% of their budget revenues in 2011).

Median value of budget deficit accounted for 4.6% of respective budget revenues. The highest ratio of budget deficit to budget revenues was observed in the Chukot Autonomous Region – 28.5%, Yamalo-Nenets Autonomous Region – 15.3%, Krasnodar Territory – 12.7%, Amur Region – 11.2%, Pskov Region – 11.0%, Udmurt Region – 10.9%, Tver Region – 10.2%. Moscow accounted for more than 13.5% of the total consolidated budget deficit, or Rb 47.0bn (*Table 18*).

In 2012, 15 constituent territories of the Russian Federation ran consolidated budget surplus (against 28 in 2011). These regions ran a budget surplus of Rb 74.2bn, or 6.1% of their budget revenues (Rb 175.0bn in 2011, or 4.7% of their budget revenues). Median value of budget surplus accounted for 2.2% of budget revenues.

The highest ratio of surplus to consolidated budget revenues was reached in the Republic of Kalmykia – 13.9%, Moscow Region – 11.7%, Republic of Tyva – 8.0%.

Two constituent territories of the Russian Federation accounted for a major part of (86.1%) the total consolidated regional budget surplus, namely the Moscow Region – 77.7%, or Rb 57.7bn and the Irkutsk Region – 8.4%, or Rb 6.2bn.

3.11.2. Changes in accumulated debt structure

According to the Ministry of Finance of Russiaa России, the amount of accumulated debt owed by the constituent territories of the Russian Federation in 2012 increased by Rb 183.2bn to reach Rb 1,355.0bn, the amount of accumulated debt owed by municipalities increased by Rb 29.9bn to reach Rb 245.3bn.

However, based on the Federal Treasury data, total volume of net borrowings regional consolidated budgets in 2011 составил Rb 205,246.5m, or 0.33% of GDP (*Table 17*). The volume of accumulated external borrowings of regional consolidated budgets reduced by Rb 3.2m, whereas the volume of net internal borrowings increased by Rb 205,249.7m.

Table 17

Net borrowings of regional and local budgets, as percentage of GDP

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Borrowing of sub-federal and local government authorities 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	0.33
Repayable loans from the budgets at 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	0.01
Sub-federal (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	0.06
other borrowings	0.01	-0.02	0.19	0.6	...	0.03	0.11	0.10	0.09	0.17	0.07	0.17	0.26

Source: estimates made by Gaidar IET based on the Federal Treasury data.

3.11.3. Structure of borrowings

In 2012, total volume of regional consolidated budget borrowings amounted to Rb 830994.2m, of which external borrowings amounted to Rb 765.1m. Like in the period between 2009 and 2011, it is the Republic of Bashkortostan that became the only region acting as external borrower.

Total volume of regional and municipal domestic borrowings amounted to 830229.2. Following are the regions who acted as the largest borrowers in the domestic market. Nizhni Novgorod Region – Rb 68.5bn, Moscow Region – Rb 58.5bn, Omsk Region – Rb 53.4bn, Krasnodar Territory – Rb 52.5bn, Novosibirsk Region – Rb 25.5bn, Republic of Tatarstan – Rb 25.2bn, Saratov Region – 24.8bn Rb, Smolensk Region – 23.7bn Rb, Krasnoyarsk Territory – Rb 23.6bn, Samara Region – Rb 22.2bn which accounted for a total of 42.5% of the borrowings. Against 2011, total domestic borrowings in nominal terms increased by Rb 226,306.0m, or 37.5%.

Securities issuance accounted for 14.4%, loans from upper-level budgets (budget loans) for 15.6%, other borrowings (borrowings from commercial banks and international credit institutions) for 70.0% of the total volume of consolidated regional budget domestic borrowings.

The reduction in a share of budget loans by increasing a share of securities issuance from 9.1 in 2011 to 14.4 was the most relevant change in the structure of borrowings in 2012.

Following are the regions which showed the highest ratio of net borrowings to budget revenues demonstrated. Ryazan Region – 11.7%, Chukot Autonomous Region – 11.3%, Republic of Mordovia –10.1% (*Table 18*).

Following are the regions which acted at the largest borrowers. Krasnodar Territory – Rb 36.0bn, Krasnoyarsk Territory – Rb 14.6bn, Nizhni Novgorod Region – Rb 9.4bn.

Following are the regions whose accumulated debt was reduced to the fullest extent by increased volume of repaid loans over new borrowings. Moscow – by Rb 39.8bn, Moscow Region – by Rb 7.4bn, Khanty-Mansiysk Autonomous Region – by Rb 2.7bn.

Table 18

**Implementation of consolidated budgets of the constituent territories
of the Russian Federation in 2012**

	Budget revenues (millions of rubles)	Budget deficit (surplus) (millions of rubles)	Deficit (surplus) to revenues ratio, %	Borrowings to revenues, %	Net borrowings to revenues, %	Borrowings repayment costs to revenues, %	Net borrowings to deficit (surplus), %
1	2	3	4	5	6	7	8
Central Federal District							
Belgorod Region	84381.7	4564.8	5.41	14.68	7.45	0.07	137.72
Bryansk Region	47502.0	1701.1	3.58	13.42	2.19	0.11	61.18
Vladimir Region	53785.9	2202.7	4.10	1.43	0.25	0.01	6.01
Voronezh Region	97515.6	1476.3	1.51	5.79	-0.02	0.06	-1.34
Ivanovo Region	39043.5	1488.8	3.81	12.44	3.45	0.09	90.44
Tver Region	58378.4	5979.4	10.24	22.12	6.73	0.15	65.66
Kaluga Region	54850.4	3139.6	5.72	9.90	1.59	0.08	27.71
Kostroma Region	27540.9	-172.5	-0.63	24.38	3.18	0.21	-507.75
Kursk Region	50165.8	620.4	1.24	2.42	1.28	0.01	103.54
Lipetsk Region	49178.1	2978.3	6.06	11.91	6.40	0.06	105.71
Moscow Region	492036.3	-57654.2	-11.72	11.90	-1.50	0.13	12.76
Oryol Region	32030.5	2728.4	8.52	10.63	6.04	0.05	70.92
Ryazan Region	51572.8	4332.9	8.40	29.90	11.74	0.18	139.78
Smolensk Region	43551.6	2596.6	5.96	54.37	8.28	0.46	138.82
Tambov Region	47006.5	-236.4	-0.50	12.93	3.32	0.10	-660.17
Tula Region	64944.1	2840.4	4.37	25.28	3.61	0.22	82.60
Yaroslavl Region	64924.4	5090.3	7.84	27.49	8.47	0.19	108.01
Moscow	1566455.6	46962.6	3.00	0.00	-2.54	0.03	-84.76
Financial Division, Baikonur city administration	3669.7	-198.9	-5.42	0.00	0.00	0.00	0.00
Total	2928534.0	30440.6	1.04	6.95	-0.27	0.07	-26.00
Northwestern Federal District							
Republic of Karelia	38222.4	2218.6	5.80	23.36	6.98	0.16	120.31
Republic of Komi	75500.5	929.3	1.23	5.95	4.32	0.02	350.60
Arkhangelsk Region	74722.8	4592.9	6.15	26.03	5.67	0.20	92.31
Vologda Region	60541.6	3150.2	5.20	18.68	7.51	0.11	144.31
Kaliningrad Region	54037.5	921.6	1.71	8.13	4.55	0.04	266.49
Leningrad Region	96653.1	606.7	0.63	2.44	1.09	0.01	173.82
Murmansk Region	60451.7	5296.6	8.76	10.98	8.28	0.03	94.53

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1	2	3	4	5	6	7	8
Novgorod Region	37578.2	-1671.6	-4.45	12.11	4.31	0.08	-96.97
Pskov Region	30346.1	3327.4	10.96	11.16	8.74	0.02	79.69
St. Petersburg	407775.6	2985.7	0.73	3.68	3.13	0.01	427.54
Nenets Autonomous Area	16050.9	-831.2	-5.18	0.00	-0.19	0.00	3.61
Total	951880.4	21526.4	2.26	8.46	4.23	0.04	186.93
Southern Federal District							
Republic of Kalmykia	91491.6	936.1	1.02	3.70	1.31	0.02	128.51
Krasnodar Territory	28060.4	367.1	1.31	12.12	6.71	0.05	513.18
Astrakhan Region	25094.6	-718.9	-2.87	15.54	2.00	0.14	-69.66
Volgograd Region	22200.9	94.3	0.42	4.01	3.75	0.00	881.97
Rostov Region	96997.6	5990.2	6.18	13.17	6.94	0.06	112.39
Republic of Adygeya (Adygeya)	22729.1	-325.5	-1.43	4.83	0.59	0.04	-41.49
Total	601961.9	41040.8	6.82	14.94	7.63	0.07	111.91
North Caucasian Federal District							
Republic of Dagestan	91491.6	936.1	1.02	3.70	1.31	0.02	128.51
Kabardino-Balkar Republic	28060.4	367.1	1.31	12.12	6.71	0.05	513.18
Republic of North Ossetia-Alania	25094.6	-718.9	-2.87	15.54	2.00	0.14	-69.66
Republic of Ingoshetia	22200.9	94.3	0.42	4.01	3.75	0.00	881.97
Stavropol Territory	96997.6	5990.2	6.18	13.17	6.94	0.06	112.39
Karachai-Cherkess Republic	22729.1	-325.5	-1.43	4.83	0.59	0.04	-41.49
Chechen Republic	83923.9	-510.9	-0.61	0.55	-0.99	0.02	163.11
Total	370498.1	5832.2	1.57	6.99	2.82	0.04	179.23
Volga Federal District							
Republic of Bashkortostan	166115.4	9751.2	5.87	4.81	1.98	0.03	33.66
Republic of Marii El	25408.5	1808.6	7.12	13.94	6.98	0.07	97.99
Republic of Mordovia	44462.1	2882.6	6.48	21.82	10.10	0.12	155.74
Republic of Tatarstan	226477.9	3372.1	1.49	11.12	2.35	0.09	157.68
Udmurt Republic	65493.7	7126.9	10.88	24.72	5.86	0.19	53.85
Chuvash Republic	45886.1	2061.6	4.49	13.73	3.59	0.10	79.92
Nizhni Novgorod Region	145543.1	13661.5	9.39	47.09	6.43	0.41	68.52
Kirov Region	54692.8	4702.3	8.60	21.58	6.97	0.15	81.08
Samara Region	162138.5	841.5	0.52	13.72	3.01	0.11	580.35
Orenburg Region	90552.9	2198.1	2.43	13.31	4.24	0.09	174.55
Penza Region	55236.8	2720.9	4.93	17.06	6.19	0.11	125.61
Perm Territory	130680.9	467.7	0.36	0.09	-0.24	0.00	-67.22
Saratov Region	90253.9	7421.1	8.22	27.44	9.02	0.18	109.71

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1	2	3	4	5	6	7	8
Ulyanov Region	47544.9	4546.8	9.56	11.51	8.65	0.03	90.49
Total	1350487.5	63562.9	4.71	16.53	4.27	0.12	90.62
Ural Federal District							
Kurgan Region	37615.0	1134.9	3.02	4.51	2.12	0.02	70.39
Sverdlov Region	228650.5	1188.8	0.52	2.80	0.87	0.02	166.98
Tyumen Region	185104.3	5215.7	2.82	0.00	-0.01	0.00	-0.42
Chelyabinsk Region	146974.7	398.6	0.27	3.77	1.33	0.02	489.23
Khanty-Mansiysk Autonomous Region	223177.1	8272.4	3.71	0.48	-1.23	0.02	-33.16
Yamalo-Nenets Autonomous Area	150577.7	23052.1	15.31	5.64	5.64	0.00	36.87
Total	972099.3	39262.3	4.04	2.39	1.08	0.01	26.66
Siberian Federal District							
Republic of Buryatia	53025.1	1074.2	2.03	2.65	-2.54	0.05	-125.42
Republic of Tyva	23894.9	-1918.0	-8.03	6.71	4.20	0.03	-52.32
Altai Territory	94609.6	5340.4	5.64	1.56	0.41	0.01	7.26
Krasnoyarsk Territory	198648.9	25795.2	12.99	11.88	7.32	0.05	56.41
Irkutsk Region	140490.6	-6196.0	-4.41	0.59	-1.33	0.02	30.07
Kemerovo Region	135914.1	9781.5	7.20	8.77	5.24	0.04	72.80
Novosibirsk Region	142989.6	4350.5	3.04	17.84	4.38	0.13	143.86
Omsk Region	86443.8	2867.0	3.32	61.79	6.38	0.55	192.24
Tomsk Region	59061.8	2062.1	3.49	24.63	6.57	0.18	188.15
Altai Republic	15326.9	-178.2	-1.16	8.26	0.84	0.07	-72.17
Republic of Khakassia	26629.7	266.4	1.00	15.04	2.50	0.13	249.79
Zabaikalye Territory	54814.7	3304.6	6.03	11.35	6.81	0.05	113.01
Total	1031849.9	46549.9	4.51	14.13	3.88	0.10	86.00
Far Eastern Federal District							
Republic of Sakha (Yakutia)	150609.4	3206.2	2.13	2.21	-0.53	0.03	-24.80
Primorsk Territory	109761.9	5172.7	4.71	3.46	0.57	0.03	12.09
Khabarovsk Territory	101692.3	5575.2	5.48	4.39	2.63	0.02	47.94
Amur Region	57660.8	6433.9	11.16	21.60	7.22	0.14	64.70
Kamchatka Territory	57162.9	238.9	0.42	3.06	-1.61	0.05	-385.87
Magadan Region	28329.2	329.8	1.16	4.87	-1.76	0.07	-151.34
Sakhalin Region	84051.9	-1158.9	-1.38	8.20	0.54	0.08	-39.36
Jewish Autonomous Region	10696.2	39.8	0.37	7.38	6.91	0.00	1855.03
Chukot Autonomous Region	17703.7	5053.0	28.54	22.09	11.30	0.11	39.58
Total	617668.6	24890.8	4.03	6.28	1.37	0.05	33.91
Total Russian Federation	8824979.8	273106.1	3.09	9.42	2.33	0.07	75.15

Source: estimates made by Gaidar IET based on the Federal Treasury data.

Domestic bond-based borrowings

In 2012, bond prospectuses were registered in 27 constituent territories of the Russian Federation and 4 municipalities (against 21 regional and 5 municipal bond issuers in 2011). Following are the regions whose prospectuses were registered with the Ministry of Finance of Russia in 2012: Republic of Karelia, Republic of Sakha (Yakutia), Chuvash Republic, Republic of Khakassia, Republic of Marii El, Udmurt Republic, Krasnoyarsk and Krasnodar Territories, Volgograd Region, Nizhni Novgorod Region, Tver Region, Tomsk Region, Yaroslavl Region, Sverdlov Region, Samara Region, Kaluga Region, Vologda Region, Ryazan Region, Irkutsk Region, Belgorod Region, Lipetsk Region, Voronezh Region, Tula Region, Orenburg Region, St. Petersburg, Volgograd, Novosibirsk, Krasnoyarsk, Tomsk.

In 2012, the volume of issued bonds amounted to Rb 119.2bn, a double growth against 2011 (Rb 55.1bn), and exceeded the volume of 2010 (Rb 111.1bn). Thus, the volume of sub-federal and municipal bonds issuance increased from 0.10 to 0.19% of GDP during the year (*Table 19*).

Table 19

Sub-federal and municipal securities issuance volume, as percentage of GDP

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Issue	0.19	0.17	0.27	0.46	0.47	0.37	0.28	0.26	0.43	0.41	0.25	0.10	0.19
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	0.13
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	0.06

Source: estimates made by Gaidar IET based on Ministry of Finance data.

The largest issuance of securities were observed at the Krasnoyarsk Territory – Rb 16.9bn, or 14.1% for the total volume of territorial securities issuance, Samara Region – Rb 10.0bn, or 8.3%, Nizhni Novgorod Region – Rb 8.0bn, or 6.7%, St. Petersburg – Rb 7.0bn, or 5.8%.

Thus, the four largest issuers accounted for 36.1% of the total volume of issued regional and municipal bonds (*Table 20*).

Table 20

Sub-federal and municipal securities issuance in 2012

Constituent entity of the Russian Federation	Issuance volume (millions of rubles)	Issuer's share in total issuance volume (%)	Issuance volume to internal borrowings ratio (%)
1	2	3	4
Central Federal District			
Belgorod Region	5000.0	4.2	40.4
Voronezh Region	225.0	0.2	4.0
Tver Region	3000.0	2.5	23.2
Kostroma Region	1873.8	1.6	27.9
Lipetsk Region	2500.0	2.1	42.7
Moscow Region	0.9	0.0	0.0
Ryazan Region	30.0	0.0	0.2
Tula Region	5000.0	4.2	30.4
Yaroslavl Region	4163.8	3.5	23.3
Northwestern Federal District			
Republic of Karelia	1500.0	1.3	16.8
Republic of Komi	945.2	0.8	21.1
Vologda Region	4600.0	3.8	40.7
St. Petersburg	7000.0	5.8	46.7
Southern Federal District			
Krasnodar Territory	12000.0	10.0	22.9
Volgograd Region	6000.0	5.0	32.9
North Caucasian Federal District			
Stavropol Territory	5 000.0	4.2	39.1

cont'd

1	2	3	4
Volga Federal District			
Republic of Bashkortostan	3000.0	2.5	41.5
Republic of Marii El	1500.0	1.3	42.4
Republic of Tatarstan (Tatarstan)	101.0	0.1	0.4
Udmurt Republic	2500.0	2.1	15.4
Chuvash Republic - Chuvashia	1509.9	1.3	24.0
Nizhni Novgorod Region	8000.0	6.7	11.7
Samara Region	10000.0	8.3	45.0
Orenburg Region	4 000.0	3.3	33.2
Ural Federal District			
Sverdlov Region	3 000.0	2.5	46.8
Siberian Federal District			
Krasnoyarsk Territory	16910.0	14.1	71.7
Novosibirsk Region	2000.0	1.7	7.8
Tomsk Region	3995.5	3.3	27.5
Republic of Khakassia	2000.0	1.7	49.9
Far Eastern Federal District			
Republic of Sakha (Yakutia)	2500.0	2.1	75.0
Russian Federation – total:	119 855.0	100.0	14.4

Source: estimates made by Gaidar IET based on the Federal Treasury data.

To date, high level of securitization has been observed mostly in major issuers, namely Republic of Sakha (Yakutia) – 75.0%, Krasnoyarsk Territory – 71.7%, Republic of Khakassia – 49.9%.

In 2012, net borrowings in the securities market amounted to Rb 38.2bn, whereas in 2011 the volume of regional and municipal repayable securities exceeded by Rb 58.2bn their issuance volume (*Table 21*).

Table 21

Net borrowings in the internal sub-federal and municipal securities market (millions of rubles)

	Consolidated regional budget	Regional budgets	Municipal budgets
1	2	3	4
2012			
Net borrowings	38175.9	36797.5	1378.5
Fundraising	119855.0	115953.2	3901.9
Principal loan repayment	81679.1	79155.7	2523.4
2011			
Net borrowings	–58202.6	–57113.1	–1089.5
Fundraising	55050.7	53366.2	1684.5
Principal loan repayment	113253.3	110479.3	2774.1
2010			
Net borrowings	29 774. 6	28 611. 9	1 162. 6
Fundraising	111 106. 3	105 854. 3	5 251. 9
Principal loan repayment	81 331. 7	77 242. 4	–4 089. 3
2009			
Net borrowings	95 457. 6	97 916. 5	–2 458. 9
Fundraising	158114.0	153992.5	4121.5
Principal loan repayment	62656.5	56076.1	6580.4
2008			
Net borrowings	68851.3	72984.9	–4133.7
Fundraising	178565.7	177324.4	1241.4
Principal loan repayment	109714.5	104339.4	5375.048.0
2007			
Net borrowings	25867.0	23691.970	2175.0
Fundraising	84159.2	79889.761	4269.4
Principal loan repayment	58292.2	56197.791	2094.4

Cont'd

1	2	3	4
2006			
Net borrowings	36489.7	35161.6	1328.1
Fundraising	73288.6	66524.8	6763.8
Principal loan repayment	36798.9	31363.2	5435.7
2005			
Net borrowings	20887.6	16939.9	3947.7
Fundraising	81220.5	75016.8	6203.8
Principal loan repayment	60332.9	58076.9	2256.1
2004			
Net borrowings	47880.3	44470.1	3410.2
Fundraising	79436.7	74995.9	4440.7
Principal loan repayment	31556.4	30525.8	1030.6
2003			
Net borrowings	41908.2	40043.5	1864.7
Fundraising	61712.6	59012.9	2699.7
Principal loan repayment	19804.4	18969.4	835.0
2002			
Net borrowings	17696.5	17153.8	542.8
Fundraising	29141.8	28169.2	972.6
Principal loan repayment	11445.2	11015.4	429.8
2001			
Net borrowings	6601.4	6667.6	-66.1
Fundraising	15123.7	14226.931	896.8
Principal loan repayment	8522.3	7559.3	962.9
2000			
Net borrowings	-1877.3	-2286.1	408.8
Fundraising	13042.2	10090.2	2952.0
Principal loan repayment	14919.5	12376.4	2543.2

Source: estimates made by Gaidar IET based on the Federal Treasury data.

Most of the regions who issue debt securities on a regular basis continued to do so in 2012. The Volgograd Region issues bonds on an annual basis since 1999, the Krasnoyarsk Territory since 2003, the Republic of Karelia and Nizhni Novgorod Region since 2004. The Republic of Marii El and Orenburg Region issued debt securities for the first time (Table 22).

Table 22

Registration of sub-federal and municipal securities prospectuses in 2007–2012

ЭМИТЕНТ	2007	2008	2009	2010	2011	2012
1	2	3	4	5	6	7
Constituent territories of the Russian Federation						
Volgograd Region	*	*	*	*	*	*
Krasnoyarsk Territory	*	*	*	*	*	*
Republic of Karelia	*	*	*	*	*	*
Nizhni Novgorod Region	*	*	*	*	*	*
Tver Region	*	*	*	*	*	*
St. Petersburg	*	*		*	*	*
Tomsk Region	*	*		*	*	*
Republic of Sakha (Yakutia)	*	*		*	*	*
Yaroslavl Region	*	*		*	*	*
Udmurt Republic	*	*		*	*	*
Sverdlov Region				*	*	*
Chuvash Republic	*	*	*		*	*
Samara Region	*	*	*		*	*
Kaluga Region	*	*			*	*
Stavropol Territory		*			*	*
Republic of Bashkortostan	*				*	*
Vologda Region					*	*
Krasnodar Territory	*			*		*
Republic of Khakassia				*		*

cont'd

1	2	3	4	5	6	7
Ryazan Region				*		*
Irkutsk Region	*	*	*			*
Belgorod Region		*				*
Lipetsk Region	*	*				*
Voronezh Region	*					*
Tula Region						*
Republic of Marii El						*
Orenburg Region						*
Republic of Komi		*		*	*	
Kostroma Region	*				*	
Ivanovo Region	*				*	
Republic of Buryatia					*	
Moscow		*	*	*		
Murmansk Region				*		
Khanty-Mansiysk Autonomous Region			*			
Penza Region	*	*				
Ulyanov Region	*	*				
Kurgan Region		*				
Moscow Region	*	*				
Novosibirsk Region	*					
Republic of Kalmykia	*					
Khabarovsk Territory						
Kabardino-Balkar Republic						
Leningrad Region						
Yamalo-Nenets Autonomous Area						
Bryansk Region.						
Republic of Mordovia						
Sakhalin Region						
Kursk Region						
Primorsk Territory						
Municipalities						
Volgograd		*	*	*	*	*
Novosibirsk				*	*	*
Krasnoyarsk	*	*	*	*	*	*
Tomsk	*	*		*		*
Kazan	*		*	*	*	
Krasnodar				*	*	
Ufa				*		
Electoral city, Moscow Region	*		*			
Smolensk			*			
Lipetsk	*	*				
Magadan	*	*				
Bratsk		*				
Novorossiysk		*				
Yekaterinburg	*					
Klin District, Moscow Region	*					
Noginsk District, Moscow Region	*					
Blagoveshchensk	*					
Cheboksary	*					
Balashikha city, Moscow Region	*					
Odintsovo District, Moscow Region						
Astrakhan						
Bryansk						
Voronezh						
Orekhovo-Zuyevo city, Moscow Region						
Yaroslavl						
Yuzhoskhalinsk						
Novocheboksarsk						
Angarsk						

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cont'd

1	2	3	4	5	6	7
Vurnar Region, Chuvash Republic						
Shumerlya city, Chuvash Republic						
Barnaul						
Perm						
Hizni Novgorod						
Kostroma						
Arkhangelsk						
Dzerzhinskiy						

Source: the Ministry of Finance of Russia (MinFin).

Section 4. The Real Sector of the Economy

4.1. Production Macrostructure

4.1.1. Post-crisis performance of the Russian economy

Analysis of the main performance indicators of the Russian economy in 2008 - 2012 allows us to identify the general and specific factors and conditions of the post-crisis recovery of the national economy. In 2012, as compared to pre-crisis 2007, the GDP had grown by 9.4%, including domestic demand (by 15.8%) and external demand (by 4.7%). However, economic development over the past five years has been extremely unstable and there have been significant qualitative differences during this period: (1) the acute phase of the financial crisis in QIV 2008 - QIV 2009 was followed by (2) the economic recovery in QI 2010 – Q II 2012, and (3) in QQIII - IV 2012 by a period of deceleration of development. But the effects of certain negative trends have been observed throughout the whole period.

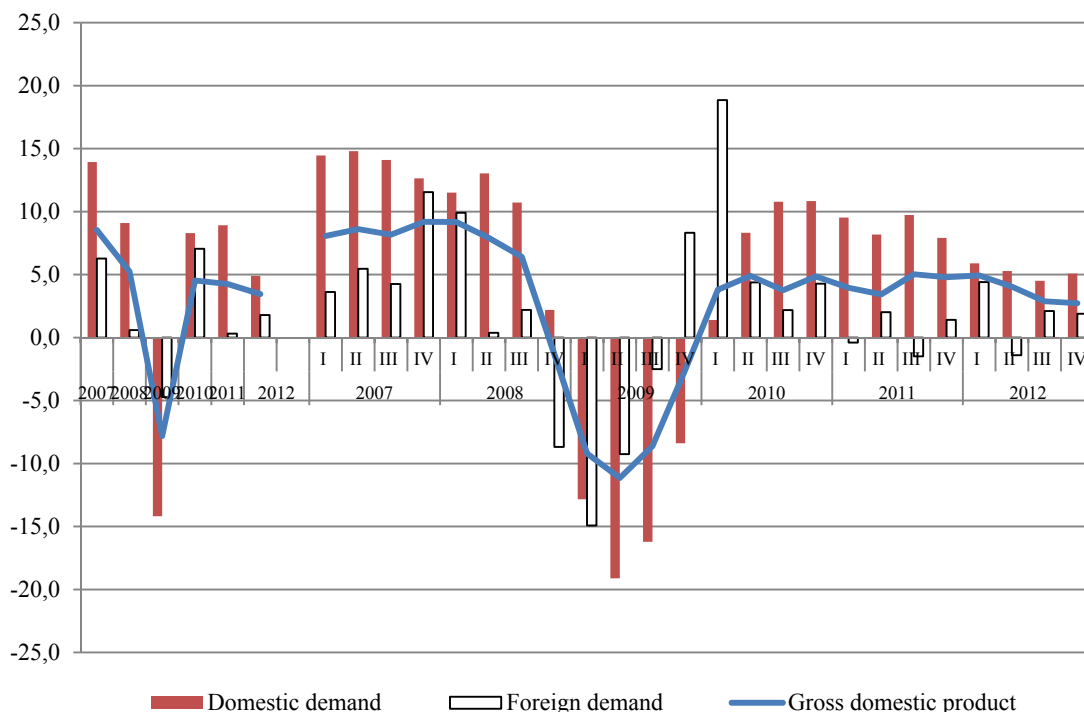
The first phase. QIV 2008 - QIV 2009. A simultaneous reduction of foreign and domestic demand. The sharp fall in world commodity prices from QIII 2008 due to restricted demand led to a decrease in Russian exports of goods, both in volume and value. Since the II half of 2009, with the gradual recovery of the global commodity markets and the anti-recessionary measures of the Russian government to support the financial institutions, there has been a gradual remission of the economic downturn. In general, GDP in 2009 was at 92.2%, with foreign demand at 95.3% and domestic demand at 85.8% as compared to the previous year. It should be noted that for the domestic market the biggest change was mostly a reduction of imports by 30.1% compared to 2008. The reduction of domestic production for the domestic market in 2009 was 9.1% compared to the previous year, which slightly reduced the tension in the real sector.

Since QIV 2009, the growth dynamics for external demand were restored, and from QII 2010 domestic production for the domestic market was restored.

The second phase. QI 2010 - QII 2012. In 2010 - 2011, the average annual GDP growth rate was 104.4%, including the domestic demand (108.6%) and foreign demand (103.6%). The ratio of demand factors was differentiated by year. In 2010, production was restored to the 2008 level in the mining sector, and this has determined the dominant influence of foreign demand, but the GDP was still 3.6% below the 2008 level.

The 2008 - 2009 crisis, in contrast to the 1998 crisis, was characterised by a deeper fall in the real sector and a longer recovery period to growth. The dynamics of domestic demand in 2011 developed under the influence of growth in domestic production and imports. Since

2010, there has been a trend towards faster growth of imports relative to domestic production. In 2011, the volume of manufacturing production had recovered to the 2008 level, and this was one of the factors in achieving the pre-crisis level of domestic demand and GDP.



Source: Rosstat.

Fig. 1. GDP by components of the domestic and foreign demand in 2007–2012, as a % of the corresponding period of the previous year

Rapid recovery of consumer demand was another distinctive feature of 2010 - 2011. Household consumption in 2011 exceeded the 2008 level by 6.1%. Unlike 1998 - 2001, when low consumer demand limited the rate of expansion of the domestic market, the increase in people’s real income, by 9.2% compared to 2008, led to a growth of retail sales in about the same proportion, and this was the dominant factor in the economic recovery. During the same period, an intensive growth of demand for consumer loans began, which in turn positively affected the financial sector.

The crisis in the investment sector was still a negative aspect of the economy in 2010–2011. The volume of capital investments in 2011 amounted to only 96.7% of the 2008 level.

Table 1

Key macroeconomic indicators in 2007 - 2012, as % of the previous year

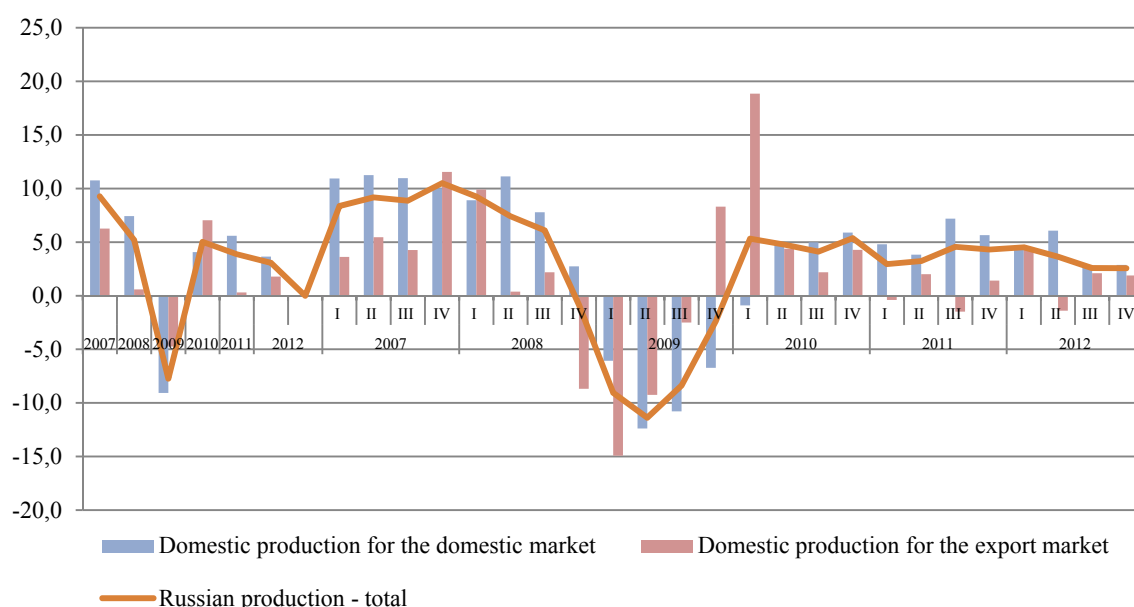
	2007	2008	2009	2010	2011	2012
1	2	3	4	5	6	7
Gross domestic product	108.5	105.2	92.2	104.5	104.3	103.4
Capital investments	122.7	109.9	84.3	106	108.3	106.6
Construction	118.2	112.8	86.8	103.5	105.1	102.4
Commissioning of housing floorspace	121.1	104.6	93.5	97.6	106.6	104.7
The volume of industrial production	106.8	100.6	90.7	108.2	104.7	102.6
Mining operations	103.3	100.4	99.4	103.6	101.9	101.1

cont'd

1	2	3	4	5	6	7
Manufacturing industry	110.5	100.5	84.8	111.8	106.5	104.1
Power, gas and water	99.4	100.6	96.1	104.1	100.1	101.2
Agricultural production	103.3	110.8	101.4	88.7	123	95.3
Freight turnover	102.4	100.7	89.9	106.9	103.4	101.7
Retail turnover	116.1	113.7	94.9	106.4	107	105.9
foodstuffs	112.6	111.7	98.1	105.1	103.2	103
non-food products	119.1	115.3	91.8	107.7	110.8	108.4
Retail services	107.7	104.3	97.5	101.5	103.2	103.5
Exports	105	96.8	97	106.9	101.6	100.4
Imports	127.1	113.5	63.3	134.8	122.2	105.5
Real disposable income	112.1	102.4	103.1	105.1	100.4	104.2
Real wages	117.2	111.5	96.5	105.2	102.8	107.8
The real size of pensions	104.8	118.1	110.7	134.8	101.2	104.9
The number employed in the economy	102.4	99.7	98.1	100.7	101,3	100.9
Number of unemployed	89.2	98.0	141.1	74.0	89.1	85.3
Number of registered unemployed	101.1	102.2	99.6	100.4	76.3	80.1
Consumer price index	111.9	113.3	108.8	108.8	106.1	105.1
Producer price index of industrial products	125.1	93.0	113.9	116.7	112.0	106.8

Source: Rosstat.

Third phase. QIII - IV 2012. In the second half of 2012 production for the domestic market dramatically slowed due to a reduction in agricultural production, instability of investment demand and a flat manufacturing production performance. Compared to the same period of the previous year, the growth rate of domestic production for the domestic market in the II half of 2012 fell to 102.8% from 105.4% in the I half of 2012. The associated restriction of demand for Russian products on the domestic market was not compensated by an acceleration of exports and imports in QIV 2012 as compared to the previous quarter, and eventually led to a slowdown in growth of domestic demand to 4.4% in the II half of 2012 compared to 8.8% a year earlier.



Source: Rosstat.

*Fig. 2. Domestic production by components used
in 2007 - 2012, as % of the previous year*

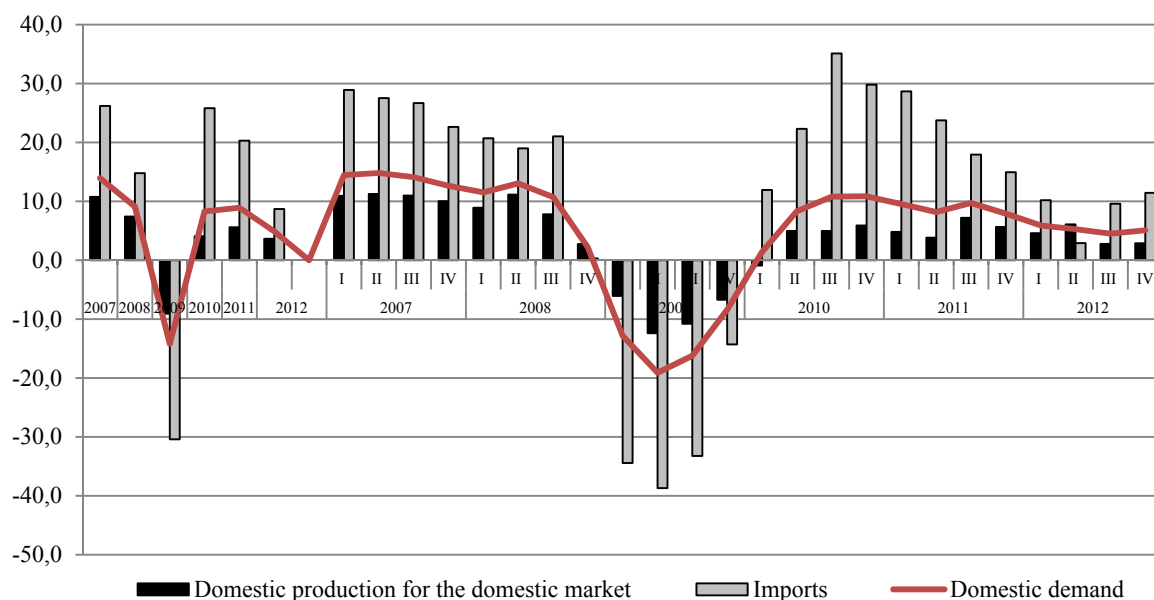
In general, the GDP growth rate in 2012 was 103.4% compared to the previous year, including domestic demand at 104.9% and foreign demand at 101.8%.

The performance of the domestic market was determined, on the one hand, by the growth of domestic production for both domestic consumption and for export markets, and on the other by the dynamics and structure of imports. The slowdown in growth of domestic production from 5.0% in 2010 to 3.9% in 2011 and 3.1% in 2012 resulted from the slowdown in both the export sector and in production for the domestic market.

The dynamics of domestic demand in 2012 were significantly affected by the weakening of the growth rate of investment and of the consumer markets. In 2012, the growth of capital investments was 6.7% against 8.3% a year earlier, retail trade was 5.9% against 7.0% and for the services sector 3.5% against 3.2%. The growth slowdown in 2012 compared to the previous year was also observed in the commodity sector: in the industry sector which was up to 102.6%, including the manufacturing industry (104.1%) and construction (102.4%). A fall in agricultural production by 4.7% compared to the previous year also negatively affected the economic performance in 2012 (*Table 1*).

Noting the importance of expanding the domestic market for post-crisis development, we should pay attention to the gap in the dynamics of domestic production compared with the growth of imports. In the Russian economy this trend has operated for a long time now.

Note that from the QIV 2010 a weakening in the growth of imports was recorded simultaneously with a slowdown in domestic demand. Domestic production for the domestic market is recovering very slowly, and in contrast to the 1998 crisis, when the reserve of competitive production capacity initiated a large-scale process of import substitution, this could no longer happen in 2009 - 2012: reserve capacity was not available. In 2012, the growth rate in imports amounted to 8.7% (2011 - 20.3%), domestic production for domestic consumption to 3.6% (5.6%) and domestic demand to 4.9% (8.9%).



Source: Rosstat.

Fig. 3. Dynamics of domestic demand by components in 2007-2012, as % of the previous year

In 2010 - 2012, the share of imports in the structure of the domestic market was increasing, and the proportion of investment and intermediate goods in the structure of imports was also increasing, whilst the proportion of imported consumer goods was declining. This kind of shift in the structure of imports was qualitatively new for the Russian economy and took place during the on-going crisis in the investment sector and in several industries for intermediate goods. The share of imports in the commodity resources of the retail trade in 2012 was 44%, including 34% for food products and 52% for non-food products.

Table 2

The structure of retail commodity resources in 2010 - 2012, %

	Commodity resources Retail	Including	
		domestic	imported
2007	100	53	47
2008	100	56	44
2009	100	59	41
2010	100	56	44
2011	100	57	43
2012	100	56	44

Source: Rosstat.

Analysis of the key macroeconomic trends suggests that although the Russian economy as a whole had overcome the consequences of the crisis by 2012, the unstable dynamics of key macroeconomic indicators and the slow recovery of the investment sector defined the development of a constraints system in the short term. The factors determining the economic dependence on the world commodity markets continued to dominate the economy. Overcoming the effects of the crisis of 2008 as part of the reproduction model formed in 2000–2007 allowed the economy to exceed the level of successful performance in 2007, though the sustainable and effective development of the Russian economy requires changes in the business and competitive environment, improvement of production capacity, strengthening of innovations and an improvement in the quality of human capital.



Source: Rosstat.

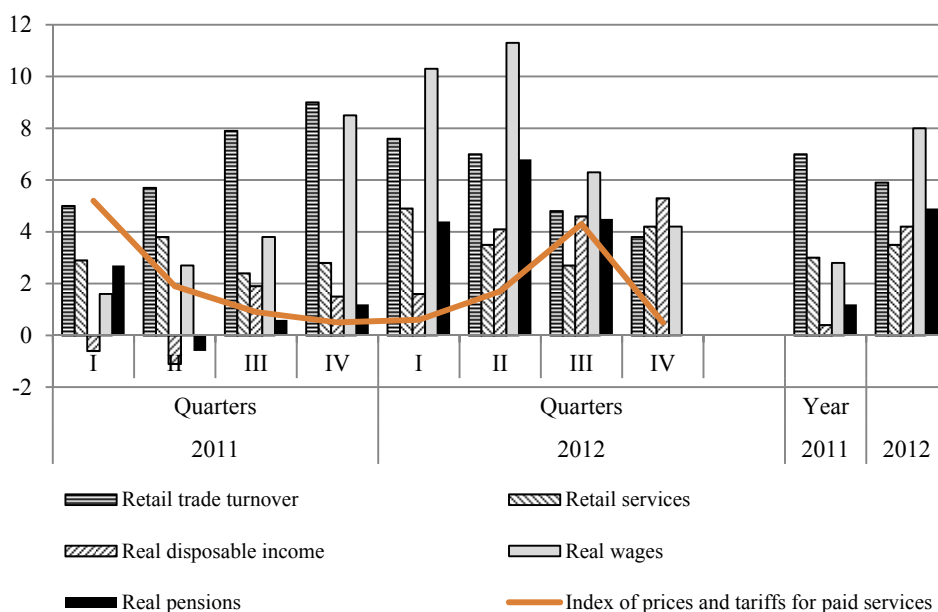
Fig. 4. The annual growth rate of main economic and social indicators in 1999 - 2007 and 2007–2012, %

4.1.2. The main characteristics of GDP utilisation

Throughout 2012 the growth in consumer demand remained one of the key factors in maintaining economic growth. The quarterly dynamics of retail trade turnover in 2012 showed that the slowdown in real income growth and real wage growth was accompanied by a gradual weakening of consumer demand, and that activity here was significantly affected by the rate of inflation, the risks associated with the indexation of regulated tariffs in the second half of the year and the change in exchange rate, with growing expectations of devaluation.

In the first half of 2012 growing consumer demand was associated with wage increases in the public sector and low inflation compared with the corresponding period of the previous year. The feature of consumer behaviour in this period was a sharp increase in demand for food products. While in the I half of 2011, growth in the food market turnover amounted to 1.0%, in the I half of 2012 it was 4.9% compared to the same period of the previous year. The growth rate of the non-food market, however, slowed down from 111.3% to 9.4%.

From the II half of 2012 the acceleration of inflation due to changes in prices and tariffs for paid services and to increasing food prices determined a slowdown in consumer demand both in the food and non-food markets. In general, the food price index in 2012 was 7.5% (2011 - 3.9%), the non-food price index was 5.2% (106.7%) and the services price index was 7.3% (8.7%). In the QIII 2012, the growth in retail trade slowed to 4.6% and to 4.5% in the QIV of the previous year against the 7.9% and 9.0% of a year earlier. As a result, the retail trade turnover in 2012 increased by 5.9%, including food products (by 3.1%) and non-food products (by 8.4%).



Source: Ministry of Economic Development of Russia, Rosstat.

Fig. 5. The dynamics of retail trade, paid services and real income turnover, as % of the corresponding period of the previous year

As in 2011, the growth of retail sales resulted from a reduction in the rate of savings and an increase in consumer lending. Loans to individuals, as at the end of December 2012, amounted to RUR 77,371 trillion and had increased by 1.39 times compared to the same period of

2011. The share of savings in personal incomes decreased by 0.3 percentage points compared to 2011, and amounted to 10.1%. Note that the proportion of income used for currency purchases by the public had increased by 4.9% in 2012 against 4.2% a year earlier.

Table 3

The structure of population income utilisation in 2011-2012., as % of the total

	Cash Revenues	Including those allocated to							
		Purchase of goods or payment for services	Including		Mandatory payments and contributions	Savings	Incl. Deposits and securities	Purchase of currency	Increase (+), decrease (-) in disposable cash
			Purchase of goods	Payment for services					
2011									
QI	100	77.3	58.1	17.6	9.7	+10.6	+2.8	3.8	-1.4
QII	100	72.4	55.0	16.1	10.3	10.9	+6.3	3.8	+2.6
QIII	100	76.0	58.7	15.6	10.4	+6.9	+2.3	4.8	+1.9
QIV	100	69.4	54.5	13.6	10.8	+12.7	+8.7	4.3	+2.8
Year	100	73.5	56.4	15.6	10.3	+10.4	+5.3	4.2	+1.6
2012									
QI	100	79.9	60.9	16.9	10.6	+7.3	+1.8	5.3	-3.1
QII	100	73.4	56.2	15.4	11.0	+9.9	+7.6	4.4	+1.3
QIII	100	75.9	58.4	15.3	11.2	+7.4	+3.2	5.9	-0.4
QIV	100	69.7	54.5	13.5	10.3	+14.4	+10.8	4.1	+1.5
Year	100	74.2	57.2	15.1	10.8	+10.1	+6.2	4.9	0.0

Source: Rosstat.

The model of post-crisis recovery has been focused primarily on the recovery in domestic demand by maintaining the standard of living of the population. Real personal income in 2009–2012 was positively stable, real wages, retail sales and household consumption in 2010 exceeded the pre-crisis levels of 2008. The full implementation of the State's social obligations which was related to the part of the population with a low level of accumulation led to a change in the GDP structure. The share of final consumption in GDP increased from 64.7% in 2007 to 70.2% in 2012, including household consumption (from 46.1% to 52.9%). By 2012, the gross accumulation had not been restored to pre-crisis levels.

Table 4

Utilised GDP structure in 2007-2012, as % of the total

	2007	2008	2009	2010	2011	2012
GDP	100	100	100	100	100	100
Including						
Final consumption expenditure	64.7	66.7	69.5	68.9	69.3	70.2
Including						
Household	46.1	48.4	49.8	50.3	51.3	52.9
Government	18.2	17.8	19.2	-18.1	17.6	17.0
Gross accumulation	24.3	25.5	16.3	20.1	23.6	24.0
Net exports	12.5	9.2	15.7	13.1	8.7	7.1
Statistical discrepancy	-1.5	-1.5	-1.6	-1.7	-1.8	-1.5

Source: Rosstat.

In 2012, capital investments increased by 6.7% as compared to the previous year and exceeded the 2008 rate by 3.3%. The share of gross savings and capital investments in GDP for 2010 - 2012 had not reached the pre-crisis level. The share of capital investments in GDP in 2012 is estimated at 21.1%, which corresponds to the 2003 index. Despite the fact that in 2010–2012 capital investments grew faster when compared to GDP, the deep recession in the investment sector in the acute phase of the crisis had been the binding constraint on economic development.

Table 5

**The share of gross savings, gross accumulation and investments
in fixed assets in GDP in 2007–2012, as % of the total**

	2007	2008	2009	2010	2011	2012
GDP	100	100	100	100	100	100
Gross savings	35.3	33.3	30.5	31.1	30.7	29.8
Gross accumulation	24.3	25.5	16.3	20.1	23.6	24.0
Including						
Gross fixed capital accumulation	21.2	22.3	20.7	21.0	22.2	22.7
Capital investments	20	21.3	19.5	19.7	20.5	21.1

Source: Rosstat.

4.1.3. Changes in the GDP structure
by source of income

The domestic market performance in 2009 - 2012 was based on the redistribution of income from enterprises to the public. The share of wages in GDP in 2012 increased to 50.4% compared to the average of 46.7% in 2007.

Table 6

**GDP structure by source of income in 2007 - 2012, as % of the total,
at current prices**

	2007	2008	2009	2010	2011	2012
Gross domestic product	100	100	100	100	100	100
Including						
Remuneration of employees, including hidden labour and mixed income	46.7	47.4	52.6	49.7	49.5	50.4
Net taxes on production and imports	19.2	20.0	16.6	17.7	19.5	19.4
Gross operating surplus and gross mixed income	34.1	-32.6	30.8	-32.6	31.0	30.2

Source: Rosstat.

In the structure of the employed population, only 8% are non-hired employees, i.e. employers engaging hired employees on a permanent basis for work at their enterprises, and the self-employed population. Accordingly, this has determined the peculiarities of the population income structure. Almost 66% of the population income in 2012 was comprised of the wages of hired employees with a reducing proportion of income being derived from business activity and property.

A characteristic feature of the Russian economy is the high degree of differentiation of the average wage by economic activity. In industry, the degree of wage differentiation is illustrated by the widening gap in the rate of wage growth in the mining and manufacturing industries. The accrued nominal wage in the mining sector in 2012 was 1.87 times higher than the average in the rest of the economy, including the 2.1 times increase in the fuel and energy production sector. In the manufacturing sector, the wages were 93% of the average for the economy and 45% of that in the extractive industries. A 2.3 time excess over the average monthly wage in the economy was recorded in sectors related to the production of oil products and the transportation of fuel and energy resources, as well as in the financial sector. In the education and public health sectors the average wage increased to 70 - 77% of the average level in the economy. The aspect of wages for work in different economic activities has had a significant influence on the structure of income and spending, consumer demand, the nature of employment and the distribution of labour in the economy.

The level and the share of wages of hired employees in the GDP structure has had the dominating influence on social variables, including the labour market. In 2012, the number of the employed population increased to 71.3 million against 70.7 million in 2011, which caused a decline in the overall unemployment rate to 5.8% from 6.8%.

The intensity ratio (number of unemployed people registered with the state employment services per 100 jobs) fell, in December 2012, from 117.4 to 91.3 compared to January of the same year.

Table 7

**Major indicators of the labour market
in 2010–2012**

	2010	2011	Quarters				2012	Quarters			
			I	II	III	IV		I	II	III	IV
The number of employed in the economy, mln.	69.8	70.7	69.4	70.7	71.9	70.9	71.3	69.9	71.7	72.3	71.4
The number of unemployed, mln.	5.6	5.0	5.6	5.0	4.8	4.7	4.3	4.9	4.2	4.0	4.0
Unemployment rate, as a % of the economically active population	7.5	6.6	7.5	6.6	6.2	6.3	5.7	6.5	5.5	5.3	5.3
The number of unemployed registered with the state employment services, mln.	2.2		1.6	1.5	1.3	1.2	1.1	1.3	1.2	1.1	1.0
The registered unemployment rate, as a % of the economically active population	2.5	1.4	2.2	2.0	1.7	1.9	1.5	1.8	1.6	1.4	1.4
The average nominal gross wages of employees of organisations, RUR	21.090	23.369	21.354	23.154	23.352	26.905	26.690	24.407	26.547	26.237	29.702
As a % of the corresponding period of the previous year											
The number of employed people in the economy	100.6	101.3	102.1	101.0	101.1	101.1	100.7	100.9	101.4	100.6	100.7
The number of unemployed	89.1	89.1	85.7	88.1	91.8	91.6	85.3	91.1	84.8	84.4	85.0
The number of unemployed registered with the state employment services	90.0	76.3	73.1	75.4	78.0	80.2	80.9	80.1	78.5	79.9	82.4
The average nominal gross wages of employees of organisations	112.4	111.5	111.2	112.5	112.2	115.7	113.3	114.6	115.5	113.3	111.0
Average gross monthly real wages	105.2	102.8	101.6	102.7	103.8	108.5	107.8	110.3	111.3	106.9	104.2

Source: Rosstat.

Note that in 2000–2012 the changes in demand for labour were determined by shifts of employment into the services sector. In recent years, almost all businesses in the industry have shown a decline in employment with the greatest decrease in jobs in the manufacturing sector. The annual growth rate of labour productivity in 2010 - 2012 was 103.1% and remained well below the pre-crisis levels.

The low efficiency of manufacturing is one of the main reasons for the reduced competitiveness of the Russian economy. The dramatic gap between the growth rates of labour productivity and of wages in the economy in favour of the latter, even during the crisis, negatively affected the quality economic indicators. However, the possibility of further increases in labour costs were fairly tightly confined by changes in the competitive market environments, due to the increased RUR exchange rate and the increasing pressure from imports.

The outpacing of wage growth relative to productivity increased the burden on the economy and affected its financial performance.

Table 8

Development of productivity in the Russian economy, in% to the previous year

	OKVED (All-Russia Classifier of Economic Activities)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total for the economy		107.0	106.5	105.5	107	107	104.8	95.9	103.0	103.8
Including										
Agriculture, hunting and forestry	A	105.6	102.9	101.8	104.3	105.0	110.0	104.6	90.0	119.9
Fishing, fish farming	B	102.1	104.3	96.5	101.6	103.2	95.4	106.3	76.4	112.5
Mining operations	C	109.2	107.3	106.3	103.3	103.1	100.9	108.5	100.6	101.2
Manufacturing industry	D	108.8	109.8	106.0	108.5	108.4	102.6	95.9	108.3	105.9
Production and distribution of power, gas and water	E	103.7	100.7	103.7	101.9	97.5	102.1	96.3	99.0	99.9
Construction	F	105.3	106.8	105.9	115.8	112.8	109.1	94.4	98.7	102.8
Wholesale and retail trade;	G	109.8	110.5	105.1	110.8	104.8	108.1	99.0	98.8	104.8
Hotels and restaurants	H	100.3	103.1	108.5	109.2	108.0	109.2	86.7	94.5	101.2
Transportation and Communication	I	107	108.7	102.1	110.7	107	106.4	95.4	102.4	102.6
Real estate, renting and services	K	102.5	101.3	112.4	106.2	117.1	107	97.5	99.4	101.2
For reference: real gross wages		110.9	110.6	112.6	113.3	117.2	111.5	96.5	105.2	102.8

Source: Rosstat.

In 2012, pre-crisis levels of profitability in the economy were not achieved. The profitability of sold goods, products and works in 2012 was 9.7%, i.e. 1.8 percentage points below the previous year. Mining activities remained the most profitable activity in 2012.

At current prices on the domestic and world energy markets, the enterprises engaged in mining showed a positive net balanced financial result, of RUR 1.503.9 trillion in 2012, representing 98.4% of the same index for the previous year. The financial status of manufacturing enterprises has slightly improved: in 2012 their balanced net financial result amounted to RUR 2,093.3 trillion and was 12.8% higher than the level of the previous year. With a general trend towards slower growth in industry, in 2012 the profitability of the mining industry decreased to 31.1% against 35.7% in the previous year, and for the manufacturing industries to 11.0% against 13.2%.

Table 9

Profitability of sold goods, products, works, services and assets of organisations by economic activities in 2007-2012, %

	2007	2008	2009	2010	2011	For the incomplete range of businesses and organisations	
						2011	2012
1	2	3	4	5	6	7	8
Profitability of sold goods, products, works, services							
Total for the economy	13.1	-13.0	10.8	10.0	9.6	11.5	9.7
Including:							
Agriculture, hunting and forestry	14.3	10.0	7.8	9.1	9.1	10.3	11.7
Fishing, fish farming	8.4	7.4	20.7	19.6	18.2	22.0	21.4
Mining operations	30.5	25.4	28.8	31.9	31.4	35.7	31.1
Fossil fuel extraction	30.1	22.6	28.2	29.2	27.5	32.1	28.8
Manufacturing	18.3	17.1	13.4	14.8	13.2	13.2	11.0
Production of vehicles and equipment	6.1	4.1	1.5	4.8	5.5	7.5	6.0
Production and distribution of power, gas and water	5.2	4.9	6.8	7.1	6.4	6.6	4.6

cont'd

1	2	3	4	5	6	7	8
Construction	5.8	5.6	5.0	4.5	4.3	6.8	3.7
Wholesale and retail trade	8.8	10.8	7.1	8.3	8.9	10.5	8.2
Transportation and Communication	15.7	14.2	13.4	13.5	11.4	12.8	12.2
Return on assets							
Total for the economy	10.4	5.4	5.5	6.7	6.5	7.0	6.8
Including:							
Agriculture, hunting and forestry	6.4	4.8	2.9	2.9	3.9	4.2	4.8
Fishing, fish farming	8.0	1.0	15.1	13.3	11.9	13.8	18.7
Mining operations	11.4	10.5	8.8	11.6		18.4	15.3
Fossil fuel extraction	11.0	10.3	9.1	10.9	13.2	17.9	15.2
Manufacturing	14.8	8.6	6.1	8.2	8.4	8.2	7.9
Production of vehicles and equipment	4.4	-2.0	-5.1	-0.3	2.1	2.9	2.2
Production and distribution of power, gas and water	3.5	2.3	2.2	4.6	1.1	1.4	2.2
Construction	4.6	3.1	2.6	2.0	2.1	2.6	2.7
Wholesale and retail trade	9.0	5.3	7.8	7.1	9.8	10.2	8.2
Transportation and Communication	8.0	5.4	4.4	5.3	4.9	4.7	5.4

Source: Rosstat.

4.1.4. Dynamics and pattern of production by economic activity

In 2012, there was a recorded slackening of the annual and quarterly performance of almost all economic activities. The physical quantum index for basic economic activities was 102.6% of the previous year, against 105.5% in 2011. The slowdown in industrial production determined the reduction of demand for the infrastructure market sectors. The freight turnover index amounted to 101.7% as compared to 2011. The decline in agricultural production in 2012, by 4.7% as compared to the previous year, negatively affected economic performance. During the second half of the year there was a significant slowdown in construction activities.

Table 10

Indices of main indicators of production in 2011-2012, as a % of the previous year

	2011					2012				
	Year	Quarter				Year	Quarter			
		I	II	III	IV		I	II	III	IV
GDP	104.3	104.0	103.4	105.0	104.8	103.4	104.9	103.9	102.9	102.6
Production of goods and services in basic economic activities	105.5	105.6	104.0	106.7	105.6	102.6	105.0	103.2	101.6	101.1
Agricultural sector										
Agricultural production	123.0	100.7	100.6	129.7	134.7	95.3	104.0	104.3	94.0	89.4
Industrial sector										
Industrial production	104.7	105.9	104.8	105.1	103.3	102.6	104.0	102.3	102.5	101.7
Mining operations	101.9	103.3	101.7	102.2	101.3	101.1	101.9	100.4	101.2	100.9
Manufacturing industry	106.5	110.6	105.8	105.7	104.6	104.1	104.4	104.7	104.5	102.8
Power, gas and water	100.1	99.0	101.9	101.4	98.5	101.2	102.6	100.8	100.0	100.5
Investment sector										
Construction	105.1	102.6	99.9	105.6	109.1	102.4	105.0	104.6	98.9	102.8
Commissioning of housing floorspace	106.6	97.6	95.2	114.3	111.8	104.7	105.7	98.7	104.2	107.1
Capital investments	108.3	99.2	105.0	108.2	113.6	106.7	116.6	110.2	107.3	101.3
Machinery and equipment	100.5	111.0	113.2	112.5	100.8	100.4	119.8	88.1	90.2	100.4
Production of construction materials	109.3	112.7	109.3	108.6	106.5	105.6	112.7	109.9	104.8	100.6
Market infrastructure										
Retail turnover	107.0	105.0	105.7	107.9	109.0	105.9	107.6	107.0	104.8	104.5
Freight turnover	103.4	103.9	105.2	102.4	102.3	101.7	103.8	99.8	102.8	100.6

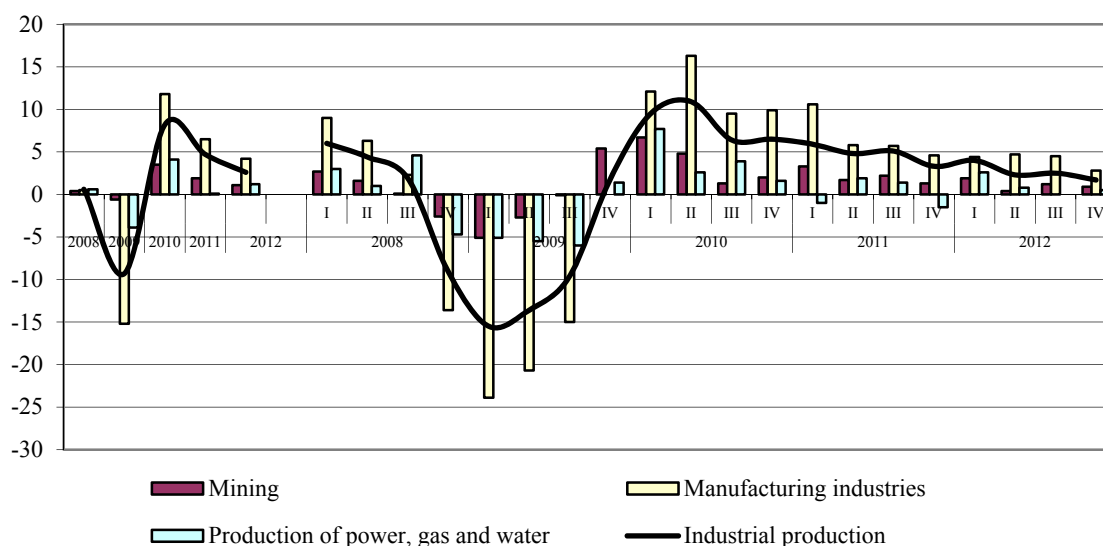
Source: Rosstat.

The greatest decline in industrial production was recorded in the first half of 2009, when the decline was 14.5% compared to the corresponding period of the previous year. This included a 22.3% decline in the manufacturing sector. Since the early second half of 2009, as a result of recovery in foreign demand and government anti-crisis actions, the situation began to improve, and industrial production for the year only decreased by 9% compared to the previous year.

With the recovery of the global and domestic demand for energy, the growth of mining operations in the QIV 2009 provided momentum for the development of the manufacturing industries. Industrial production in the first half of 2010 was 110.2%, including extractive industries (105.8%) and manufacturing industries (114.3%). Since QIII 2010 the economic growth has slowed down due to a decline in export growth rate. The index of industrial production in 2010 was 108.2%, including mining operations (103.5%) and manufacturing industries (111.8%). Note that mining output in 2010 exceeded the pre-crisis 2008 level by 2.3%.

Throughout 2011, industry recorded slow growth largely determined by the high base of the previous year. The industrial production index in 2011 was 104.7%, including 106.5% in the manufacturing industries. At the end of 2011 the manufacturing sector had reached the pre-crisis level, which, in addition to maintaining the growth of mining production, has determined industry recovery to pre-crisis levels.

Having reached pre-crisis levels, starting from the second half of 2012, the Russian economy began to show signs of growth slowdown, as the structure of the economy had not changed significantly, and the potential impact of the factors contributing to the growth was over. In 2012, the industry recorded weakening quarterly dynamics associated with a sharp slowdown in manufacturing industry. In the IV quarter of 2012, the index of processing production fell to 102.8% compared to the same period of the previous year, and the result for the year amounted to 104.1%. The simultaneous slowdown in mining production to 101.1%, and in the production and distribution of electricity, gas and water to 101.2%, compared to 2011 determined the reduction of the general industry index to 102.6%.



Source: Rosstat.

Fig. 6. Production growth by economic activity in industry in 2008 - 2012, as a % of the corresponding period of the previous year

The performance of the manufacturing industries is quite significantly differentiated by the types of economic activity, with the largest influence being the result of the ratio of the production rate of capital and consumer goods. Slow recovery in investment demand has determined the characteristics of the machine-building sector.

In the acute phase of the crisis in 2009, the volume of production in the machine-building sector was 2/3 of the 2008 level. The characteristics of the post-crisis machine-building sector were defined by the outstripping growth of production of vehicles and equipment, which was based on government support encouraging demand. In 2012, the production of vehicles and equipment exceeded the 2008 indicators by 16.6%. The dynamics of the production of machinery and equipment, as well as of electrical and optical equipment has been highly volatile during the past four years. Whilst in 2010 the high growth rates for these activities were determined by the low base of the previous year, the inhibited performance in 2011 - 2012 was determined by the weakening of domestic demand for capital goods. In 2012, the production of machinery and equipment remained at 15.5%, and the production of electrical and optical equipment was 8.7% lower than in 2008. Despite the rapid development in the production of vehicles, the machine-building industry has generally not reached pre-crisis levels. This was one of the factors causing the slow recovery of associated production. Metallurgy and finished metal production recovered to pre-crisis levels only in 2012. Low investment activity determined the continued crisis in the production of construction materials. Note that the negative impact of the sharp slowdown of capital investments in QIV 2012 sustained the trend to weakening of the performance of the full range of associated industries.

Table 11

Indices of main production indicators in 2011-2012, as a % of the previous year

	2011					2012				
	Year	Quarter				Year	Quarter			
		I	II	III	IV		I	II	III	IV
GDP	104.3	104.0	103.4	105.0	104.8	103.4	104.9	103.9	102.9	102.6
Production of goods and services in basic economic activities	105.5	105.6	104.0	106.7	105.6	102.6	105.0	103.2	101.6	101.1
Agricultural sector										
Agricultural production	123.0	100.7	100.6	129.7	134.7	95.3	104.0	104.3	94.0	89.4
Industrial sector	104.7	105.9	104.8	105.1	103.3	102.6	104.0	102.3	102.5	101.7
Mining operations	101.9	103.3	101.7	102.2	101.3	101.1	101.9	100.4	101.2	100.9
Manufacturing industry	106.5	110.6	105.8	105.7	104.6	104.1	104.4	104.7	104.5	102.8
Power, gas and water	100.1	99.0	101.9	101.4	98.5	101.2	102.6	100.8	100.0	100.5
Investment sector										
Construction	105.1	102.6	99.9	105.6	109.1	102.4	105.0	104.6	98.9	102.8
Commissioning of housing floorspace	106.6	97.6	95.2	114.3	111.8	104.7	105.7	98.7	104.2	107.1
Capital investments	108.3	99.2	105.0	108.2	113.6	106.7	116.6	110.2	107.3	101.3
Machinery and equipment	100.5	111.0	113.2	112.5	100.8	100.4	119.8	88.1	90.2	100.4
Production of construction materials	109.3	112.7	109.3	108.6	106.5	105.6	112.7	109.9	104.8	100.6
Market infrastructure										
Retail turnover	107.0	105.0	105.7	107.9	109.0	105.9	107.6	107.0	104.8	104.5
Freight turnover	103.4	103.9	105.2	102.4	102.3	101.7	103.8	99.8	102.8	100.6

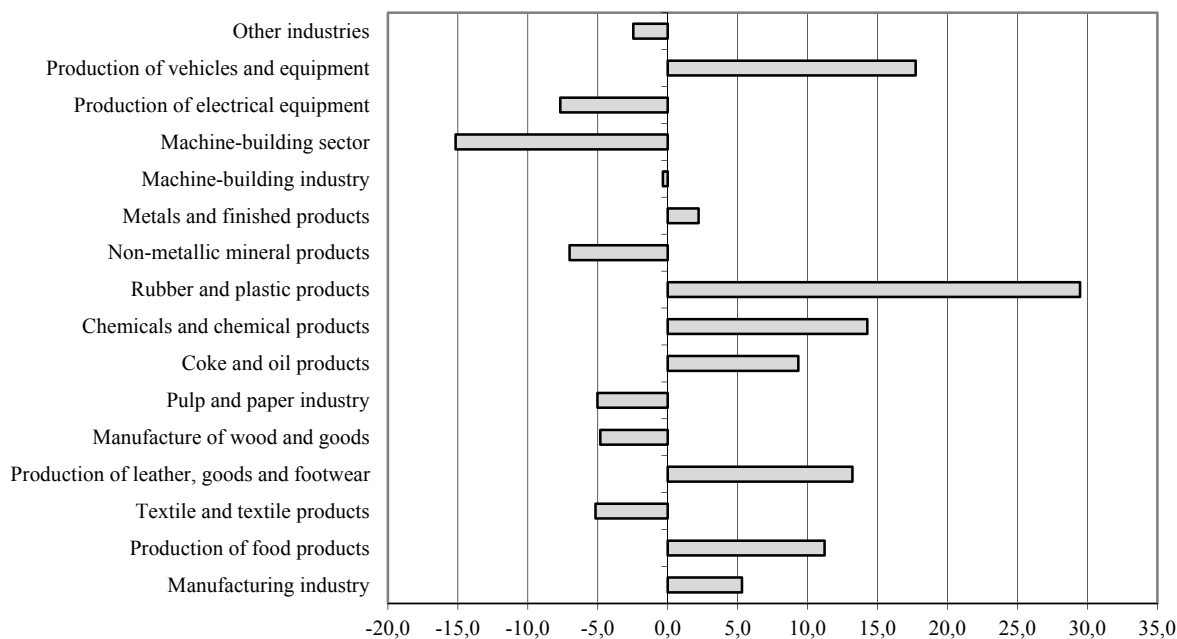
Source: Ministry of Economic Development of Russia, Rosstat.

In 2009 - 2012, production increased faster in the food processing industry relative to the pre-crisis period. In 2012, the results of the crisis were noted in the textile and clothing industries, as well as in the production of leather and shoes: the decline in production was 2.0% and 10.9% respectively, compared to the previous year.

Pre-crisis levels in the intermediate goods sector are being exceeded in the production of rubber and plastic products, chemical production and the production of coke and oil products.

This was defined by the simultaneous recovery of the supply of these products to the domestic and foreign markets.

In general, the structure of the post-crisis recovery of industry repeated the pattern of the 1998–2000 developments, when growth started in the production of food products, mining and the industries related to the processing of hydrocarbons and other mineral resources, and then spread to other economic activities in industry. However, in 2012, the unstable dynamics of the key macroeconomic indicators and the slow recovery of the investment and financial sectors determined the system of constraints on the Russian economy in the short term.



Source: Rosstat.

Fig. 7. The rate of growth of manufacturing industries by economic activity in 2012, as a % of values in 2008

4.2. Russian Industrial Enterprises (on the basis of the surveys)

The section has been prepared on the basis of business surveys (BS) of managers of industrial enterprises; the above surveys have been carried out by the Gaidar Institute for Economic Policy (IEP) in accordance with the European harmonized methods on a monthly basis since September 1992 and cover the entire territory of the Russian Federation. The size of the panel includes about 1,100 enterprises with workforce exceeding 15% of the workers employed in industry. The panel is shifted towards large enterprises by each sub-industry. The return of queries amounts to 70%–75%.

A BS questionnaire includes a small number of questions (maximum 15 to 20 questions). The questions are of a qualitative, rather than quantitative nature. The simple structure of questions and answers permits the respondents to fill in queries quickly and without any documentation. It is principally important that a respondent at each enterprise is a top level manager who has a comprehensive idea of the state of things at the enterprise and is directly engaged in management of the enterprise.

In analysis of business surveys, a specific derivative index – called the balance – is used. The balances are calculated as a difference between the percentage of those who answered “it increases” (or “above the norm”) and the percentage of those who answered “it decreases” (or “below the norm”). The obtained difference permits to present the distribution of the answers to each question by a single figure with the «+» sign or the «-» sign.

The balance is interpreted as the first derivative or the speed of the process. If the balance of the answers to the question about the expected change in prices has the «+» sign, it means that the average prices will soon grow (that is, the number enterprises which reported about the expected growth in their prices prevailed). For example, growth in the balance within a month from +10% to +17% means that prices in industry in general will grow at a higher rate because the number of enterprises which forecasted their growth increased. The negative balance means a decrease in average prices (that is, a larger number of enterprises intends to lower their prices). A change in the balance from -5% to -12% is interpreted as growth in the price reduction rate.

4.2.1. Is the Russian Industry Getting Involved in the Second Wave of the Crisis?

In 2012, the prevailing unclarity and narrowness of the official industrial statistics remained a major problem for its consumers and gave rise to heated disputes on the issue whether the Russian industry was getting involved in the second wave of the crisis or switched over to the state of a “new normality” which was principally different from the dynamic development of the first decade of the 21st century. The above circumstances preserved the relevancy of assessment of the general state of the Russian industry on the basis of the IEP Industrial Optimism Index (IEP IOI)¹.

In a situation of the economic crisis, the above index permits to solve a few important tasks. First, it permits to receive almost on-line (as compared to frequency and efficiency of the official statistics) the idea about the state of the domestic industry. Second, enterprises which take part in the IEP’s surveys are the “middle class” of the Russian industry. They are situated all over the country and related primarily to manufacturing industries. The information on the state of such enterprises is not always available on time and in the required volume to the authorities and analysts. Third, the Index is calculated on the basis of indices which have no equivalent in the state statistics system, but specify the important aspects of the actual situation in the Russian industry (the demand, reserves and output plans). They characterize accurately and comprehensively the situation of enterprises which fact is confirmed by the 20-year experience in carrying out and analyzing of over 240 business surveys. Long-

¹ The index is based on the arithmetic average of balances (the difference of answers) of four questions of the IEP BS queries:

1. The actual change in demand, balance = % growth – % reduction;
2. Assessment of demand, difference of evaluations = % above the norm + % norm – % below the norm;
3. Assessment of the stocks of finished products, balance = % above the norm – % below the norm, the opposite sign;
4. Plans of change in output plans, balance = % growth – % reduction.

Balances of the 1st question and the 4th question are cleared of the seasonal and calendar factors.

The Index may assume the value from -100 to +100. The positive values of the index mean that positive assessments prevail. The negative values of the index mean that the negative assessments of the situation prevail. A decrease in the value of the index means a deterioration of the situation. Growth in the value of the index means improvement of the situation.

term, personified and informal relations with respondents (90% of the respondents are managers of enterprises) create conditions for receipt of the most objective data on the Russian industry. As a result, the IEP IOI gives an idea about the real state of things in the Russian industry.

As seen from calculations, the end of 2011 was highly unsuccessful to the Russian industry. Within the last quarter of 2011, the index fell to the year and a half minimum, though in the middle of 2011 it almost rose to the post-crisis record high level. In January 2012, negative trends consolidated: the index fell to the zero. The first few months of 2012 showed that the industry tried to keep back from the dangerous line beyond which it could get involved into the second wave of the crisis. However, in February-April growth in the index amounted to 3 points and was determined mainly by growth in satisfaction with the current sales volumes due to the effect of insignificant slowdown of the decline rates of demand. However, other components of the Index did not permit it to go up to the previous positive values registered in 2011.

In the 2nd quarter of 2012, sentiments in the industry started to decline again: first to the zero level in May and then to the 28-month minimum. In May-June, the Index lost 7 points and, as a result, the remaining optimism which kept it in the positive zone in the first few months of 2012 vanished. The assessment of the demand was subjected to the most serious adjustment. The industry was becoming less and less prepared to be satisfied with decreasing sales volumes and it seemed to be getting involved in the 2nd wave of the crisis.

There was not much hope in the industry that it would manage to get out of that situation. From the beginning of 2012, the index of forecasts lost 11 points and in July fell to the level of the 34-month minimum. The output plans were the worst hit. In the 2nd quarter, the demand forecasts decreased by 9 points and ceased to be the positive for the first time in 35 months. The hiring plans were explicitly negative as they amounted to -8 points after being cleared of the seasonal factor; from the beginning of 2012 they lost 11 points.

However, in the 3rd quarter the situation in Russian industry started to improve. First, the optimism index recovered from its dip in June thanks to sudden improvement of industrial forecasts and assessments of stocks of finished products. However, demand kept declining at a growing rate. But most enterprises regarded that dynamics as a normal one and that assessment did not change since June when the decline was less intense. It seems the industry expected a more dramatic drop in sales, so, a small worsening (not a recessionary one) of the index was sooner assessed positively, rather than negatively.

Optimism in industry kept growing until the end of the 3rd quarter. In that period, the IEP index rose steadily by 6 points after a steady decrease in the 2nd quarter, while by the end of the 3rd quarter it attained one of the best values in 2012 due to growth in its three out of four components. Stocks of finished products accounted for the largest positive contribution. In September their balance was zero which fact was evidence of the most cautious behavior of manufacturers and their unwillingness to take risks when producing against probable growth in demand in future. However, that factor improved output plans. The industry was prepared to switch over from zero growth rates to the positive output dynamics. According to enterprises, the 4th quarter of 2012 could become the beginning of the exit from the protracted stagnation. All the industry's plans and forecasts for the last months of 2012 underwent positive changes. The IEP composite index of forecasts showed enterprises' readiness to draw the Russian economy out of stagnation late in 2012.

However, at the beginning of the 4th quarter the optimism index underwent dramatic negative changes caused by worsening of its three out of four components. Formal preservation of the fourth component – assessment of stocks of finished products – at “the best” levels in the past year and a half points sooner to the minimal hopes for growth in sales, rather than infeasibility to meet the demand and utilize of warehouse stocks for those purposes. Calculation of the November value of the IEP optimism index showed further worsening of the situation in the Russian industry. The value of the index became explicitly negative and fell to the three-year minimum. The demand kept depressing the sentiments in the Russian industry. It was only the output forecasts that kept the index from falling even further.

The Russian industry completed the year 2012 in a highly pessimistic mood (see *Fig. 8*). The optimism index fell to the three-year minimum and consolidated its position in the negative zone, while hopes for revival of industrial growth (the industry forecasts index) are too weak in 2013. The main factor behind a drop in the optimism index was the continued reduction of satisfaction with the current sales volumes.

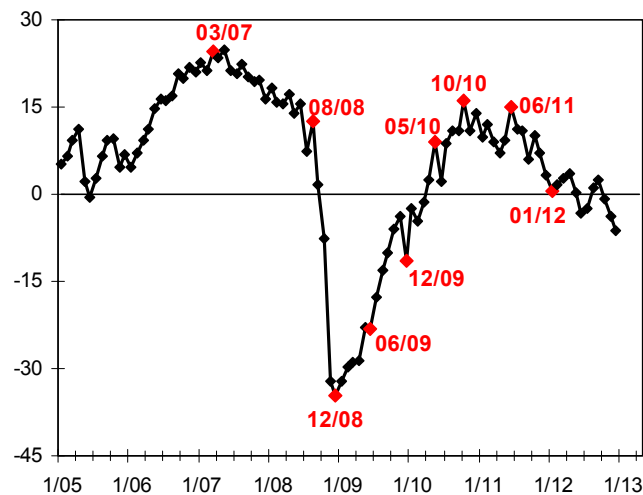


Fig. 8. The IEP Industrial Optimism Index in the 2005–2012 period

So, in 2012 the dynamics of the main indices of the Russian industry demonstrated the explicit worsening of the situation as compared to 2011. Within a year, the optimism index slightly exceeded the zero level, but fell down to significant negative values.

4.2.2. Dynamics of the Main Indices of the Russian Industry

The beginning of 2012 was problematic to the Russian industry. An explicit drop in demand made enterprises slow down (practically to a complete halt) the output growth rates, lay off workers and exceedingly cautiously raise prices. However, sudden growth in optimism of forecasts showed that the industry hoped for the exit from the protracted crisis.

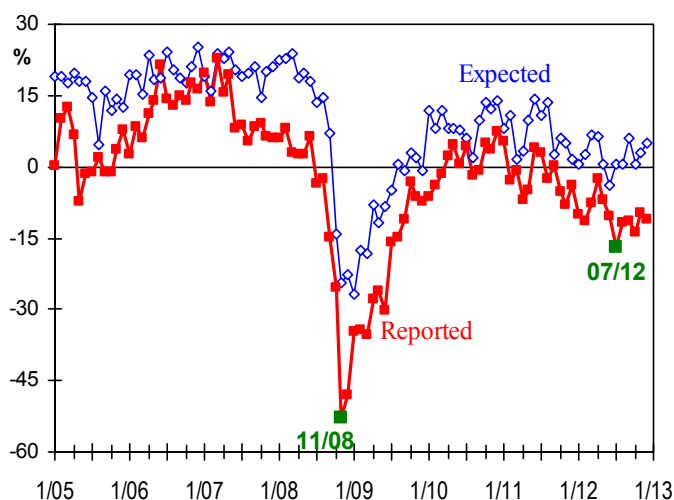
In the beginning of the year, as usual in the period of national holidays a sudden drop in demand on industrial products took place. However, the January drop in sales became a continuation of negative trends in the dynamics of the demand which was formed as early as September 2011 when sales of products ceased to grow, then started to go down with a growing intensity (rate) and attained in January 2012 such a high rate of drop which was never registered after the 1998 default in any January, except for the recessionary January 2009. Clearing

of the seasonal factor helped improve that result of the beginning of the year, but only to the worst growth rates since September 2009.

Despite the weak demand, in January the balance of assessments of stocks of finished products did not undergo principal changes and remained within the limits of the index since the beginning of the 2nd quarter of 2011. In January 2012, a resolute and negative adjustment of the output in accordance with the predicted dynamics of demand permitted enterprises to bring the coincidence of actual changes in those two indices to 72% which situation has not been observed in the industry since November 2008 - January 2009 when enterprises were left with no other option, but to follow the rapidly declining demand.

In January, on the contrary, enterprises' prices showed growth which is as typical of the beginning of the year as a drop in demand or output. However, disturbances in the dynamics of that index were observed, too. First, growth in prices was registered for the first time in the past 12 months. Throughout the entire 2011, growth rates of prices declined all the time making short stops and within a year lost 55 points. It is to be noted that in December 2011 the most intense drop in that index in the past two and a half years was registered. Second, early in 2012 the growth rates of prices were much lower than those which rose dramatically early in 2011 (it can be explained both by natural calamities of the hot summer 2010 and man-made factors). But growth in prices in January 2012 is lower than price surges in any January of the entire 1999–2008 pre-crisis period. Third, throughout 2011 enterprises were well aware of the fact that there was a lack of prospect in switching over to more intense growth in prices and revised constantly downwards their price growth forecasts till October.

Recovery of the normal economic dynamics after the January national holidays was quite uncertain. Demand kept falling and its forecasts remained weak. Hiring of the personnel which just started was weak, too, and had little chances to continue in the following months.



*Fig. 9. Changes in the solvent demand cleared of the seasonal factor
(balance = % growth – % decrease)*

In February, the demand dynamics underwent principal – but traditionally positive – changes and small changes as compared to January (a holiday season) and the 4th quarter of 2011, respectively. (see *Fig. 9*). However, recovery of sales in February turned out to be weak: balance (the rate of change) rose after January 2012 – which can be regarded as a fail-

ure by the standards of both the mid-crisis 1999–2008 period and the 2009-2011 post-crisis period - to the values which were somewhat better than in the last quarter of 2011. But the most disappointing thing is that it was still in the negative zone. It means that demand in industrial produce kept shrinking. But the balance of assessments of stocks of finished products did not undergo serious changes in February and remained in industry as a whole at the level of a small surplus which situation already became quite an ordinary one. The industry was solving successfully in that mode the problem related to stocks of finished products; it sought to prevent both overstocking and depletion of its warehouses. The latter permitted enterprises to show positive dynamics of output: the initial growth rate improved after the failure in January by 61 points straight, while the one cleared of the seasonal factor, by 9 points.

The 1st quarter of 2012 showed weak results. According to enterprises' forecasts, growth in demand which emerged only at the end of the period and disappeared with the seasonal factor cleared had little chances to continue. That factor resulted in growth in excessive stocks of finished products, a drop in output growth rates and negative adjustment of production plans for the next quarter.

Though in March the dynamics of demand in industrial produce showed positive changes again, nevertheless, with the seasonal factor cleared the balance of the index still remained in the negative zone with meager growth registered, that is, there was only a slowdown of the rate of drop in demand. It is to be noted that further improvement in the sales dynamics appeared quite doubtful. However, even those changes in the sales dynamics were rated highly by enterprises. In February-March 2012, the difference between assessments of satisfaction with the demand improved by 21 points and turned around the industrial optimism index at a dangerous line to which it was descending to throughout the second half of 2011.

In March, the data on the dynamics of output (prior to clearing of the seasonal factor) showed at the first sight that growth rates increased by 10 points. However, the obtained result turned out to be worse than that of any March in the past ten years (except, certainly, for March 2009). Clearing of the seasonal factor showed that in March 2012 the output growth rates after a surge in February returned to the previous low values which were hardly discernable by the Rosstat. The industry was quite unprepared to increase output in a situation of weak growth in demand and low optimism of its forecasts.

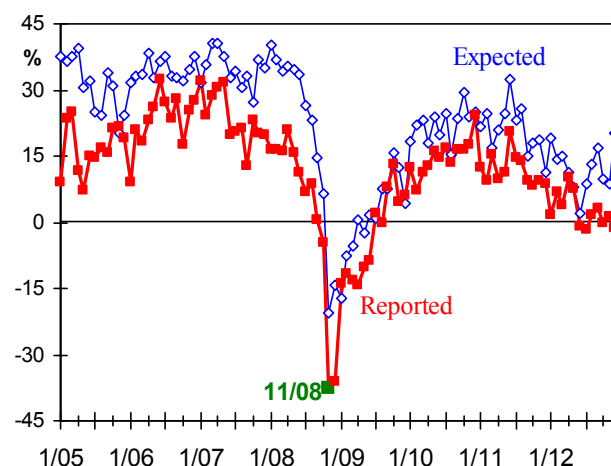


Fig. 10. Changes in output volumes cleared of a seasonal factor
(balance = % growth – % decrease)

Enterprises' production plans confirmed that conclusion (see. *Fig. 10*). Such sluggish growth (as yet) the industry did not plan since the beginning of 2010. It is to be noted that the March survey showed principal changes in formation of enterprises' production plans. Early in the 1st quarter of 2012, enterprises showed high growth in optimism of output plans which were 26% (more properly, in 26% of cases) ahead of their own forecasts of the demand. Such a significant advance of the forecasts of demand over the output plans was not registered in the industry for four years. However, at the end of the quarter the industry switched over to intense slowdown of its output plans as compared to its own forecasts of the demand: the share of enterprises which planned a lag of changes in production from those in demand rose to 10%. Such a high (that is, pessimistic) value of that index was not registered for more than a year and a half.

Moderate positive changes in the dynamics of the demand and output early in the 2nd quarter, as well as the certainty that followed after the elections were over did not add optimism to the industry. Insufficient demand, growth in excessive stocks of finished products, decrease in the optimism of the output and hiring plans, growth in excessive capacities and disappearance of personnel shortages – such were assessments of the situation by Russian industrial enterprises.

In April, growth rates of change in demand showed growth in sales at the previous positive rate (as in March) on the basis of the initial data. However, with a seasonal factor cleared the index fell to –2 points which situation can be interpreted as a lack of changes. But as compared to the results of the first months of the year when the rate of a drop in demand amounted to –9 –7 points, the value of –2 points appears quite positive. In March-April, the demand forecasts rose to +8 points after a surprising stability at the level of +4 points in September 2011-February 2012, while satisfaction with sales stabilized at the level of 53%.

In April, dynamics of industrial production showed some positive changes. The initial data showed that growth rates remained at the March level, while those cleared of the seasonal factor pointed to improvement to the 11-month maximum.

However, enterprises' plans did not suggest that the achieved output growth rates would be preserved in May-June. Another “drawback” of the output plans was the fact that they lagged behind the forecast of the demand. If earlier, on average, only 6% of enterprises had output plans that lagged behind the forecasts of the demand, in March-April 2012 a lag was registered with 12% of enterprises.

In the 2nd quarter of 2012, principal changes occurred in the system of factors of disturbance which hindered output growth (according to the version of managers of industrial enterprises).

The most significant changes took place as regards the disturbance factor: “the unclear current economic situation and its prospects” (see. *Fig. 11*). Within a quarter (to be precise, from January 2012), the mention of that factor fell from 39% to 23% and returned to the average level of 2010 and early 2011. Sharp growth in that factor (from 23% to 36%) was registered in October 2011. January 2012 added another 3 p.p. So, a drop in uncertainty in April was sooner related to completion of the hectic period of the State Duma and presidential elections, as well as formation in the society of a perception of distribution of power both in the government and the economy.

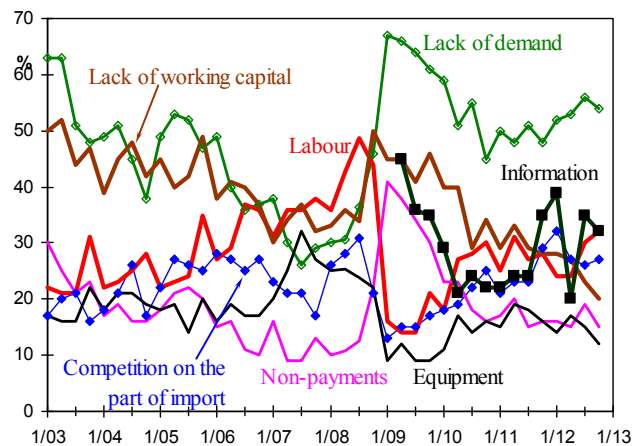


Fig. 11. Disturbances to growth in production, 2003–2012

A positive return to the previous level of certainty in the economy was flattened by the fact that enterprises did not have a good idea about the details of that certainty. First, the industry did not see, nor expected revival of the demand in its output. In April 2012, low demand accounted for 55% of the restraining influence in the real sector. Both sustained growth in excessive stocks of finished products and negative adjustment of output plans supported that thesis.

Second, the industry managed to get rid of personnel shortages, which means sooner that it gave up the illusions of a return to the previous output growth rates and the need to hire more workers.

Third, the restraining influence of the working capital shortages went down to the historic minimum of 26% in the entire 20-year history of monitoring. The pre-crisis minimum of that index amounted to 30%, while the historic maximum, to 83%. It appears that the erstwhile most deficit resource (until the end of 2008 as regards the rate of occurrence it used to compete with the insufficient demand) restrained output growth only with 25% of industrial enterprises, while the demand, with more than a half of enterprises. Enterprises had fewer resource limitations hindering the output growth, but more demand limitations. In addition to the above, a shortage of loans had virtually no effect on industrial growth. For five quarters running, only 3% (three!) of industrial enterprises stated that that factor was hindering growth.

Fourth, in industry excessive capacities increased. In April 2012, 21% of enterprises believed that they had “more than enough” machines and equipment due to the expected changes in demand against 5% of enterprises which thought that they lacked them. The above factor had a negative effect on enterprises’ investment plans. In April, they decreased by 8 points to the 12-month minimum (if a dip in December 2011 is not taken into account).

In May 2012, the dynamics of demand, output and employment was sooner negative, rather than positive. Assessments of the demand and stocks of finished products pointed to the fact that the mood in industry was getting worse, while forecasts and plans of enterprises did not suggest any improvement of the situation in the months to come.

In May, actual changes in demand failed to retain the positive dynamics as regards both the initial data and that cleared of a seasonal factor. As a result, a small positive surge in March-April gave way to stagnation in sales. The initial forecasts of the demand after a surge of 43 points in the 1st quarter kept losing optimism. Though they decreased by 13 points and still

remained in the positive zone (+9 points), but with a seasonal factor cleared they fell to +2 points, which value became the 12-month minimum. The negative dynamics of actual sales and a drop in the optimism of forecasts of the demand provoked further growth in excessive stocks of finished products.

In June, the dynamics of the main indices (demand, output, employment and prices) preserved negative trends and definitely brought the Russian industry closer to the second wave of the crisis. Enterprises' plans and forecasts did not promise any improvement of the situation in the following months. The initial dynamics of the demand in industrial produce underwent at first glance "positive" changes: a drop in demand was followed by stagnation in sales. However, with a seasonal factor cleared the June data lost that positive specifics: the demand kept decreasing and the rate of a drop increased by another two points. Such dynamics of sales was adequately assessed by manufacturers. Within a month, the balance of assessments of the demand got worse by 9 balance points and amounted only to +4 points, though in October 2011 its value amounted to +31. The industry was less prepared to be satisfied with declining sales volumes. Enterprises' forecasts did not promise any improvement of the situation with sales.

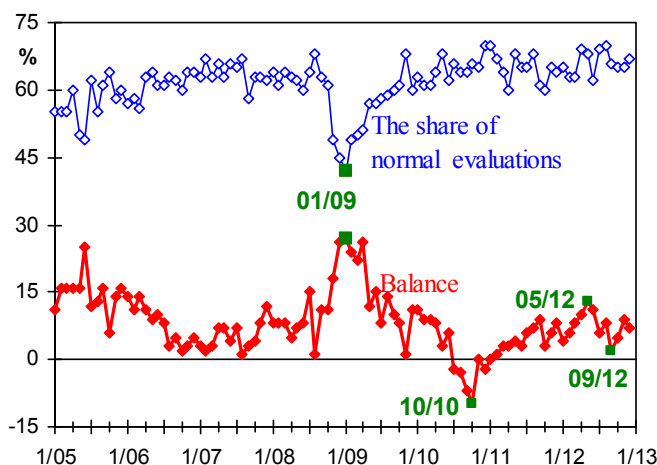


Fig. 12. Balance of evaluations of stocks of finished products
(balance = % above – % below)

In the meantime, in June the balance of evaluations of stocks of finished products decreased for the first time in the past five months (that is, improved). In May, the index reached the 33-month maximum which meant that the largest excessive (for that situation!) warehouse reserves were formed since August 2009 (see Fig. 12). Further growth in excessive stocks of finished products in a situation of weak demand and diminishing hopes for its revival was regarded by industry as pointless and clearing of warehouses began.

In June, the initial output growth rates lost another 7 points, while the total losses of that index amounted to 24 points in the 2nd quarter. As a result, at the end of the second half-year enterprises estimated the production growth rates at +3 points, while in June 2011 and June 2010, at +25 points and +19 points, respectively. Clearing of the seasonal factor diminished the value of losses of industrial growth within a quarter, but worsened the final result: the balance became equal to +1 point which means that output growth came to a halt in June.

In July, changes in demand continued the trend of the past three months, that is, growing slowdown of sales. However, that situation was assessed by most enterprises (54%) as normal

and even somewhat better than in June (then, the normal demand was recognized by 52% of enterprises), when the decline was less intense. It seems the industry expected a more dramatic drop in sales, so, a modest worsening (not a recessionary one) of that index was assessed sooner positively, rather than negatively. Probably, that factor was behind a dramatic revision by the industry of its sales forecasts. After four months and three months of worsening of the initial data and the one cleared of the seasonal factor, respectively, in June expectations improved by 5 points and 9 points as regards the initial data and the one cleared of a seasonal factor, respectively.

In July, the dynamics of industrial production did not undergo principal changes as compared to June: output growth stopped, while a recessionary slump (and the one similar to that of late 2008) did not begin. It is to be noted that output plans like forecasts of demand changed the trend: after five-month growth in negative expectations that resulted in June in the three-year minimum, the data in July demonstrated a surge of positive forecasts by 9 points straight. Matching of the expected changes in demand and output was registered with 75% of enterprises and only 8% of enterprises believed that changes in output should be ahead of the dynamics of demand. At the first glance, the industry was carefully preparing its production plans in accordance with the forecasts of demand which were fairly positive in that period of time. However, enterprises were not certain that they would manage to realize them.

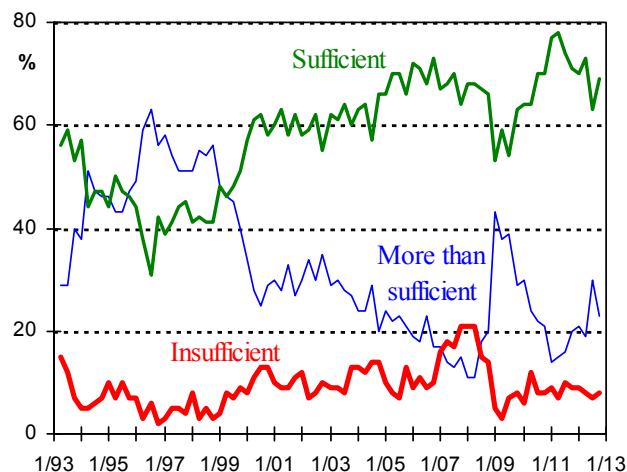


Fig. 13. The share of enterprises with excessive, sufficient and insufficient capacities

The above was pointed to by assessments of sufficiency of capacities due to the expected changes in the demand (see *Fig. 13*). In July 2012, the balance of those assessments rose sharply by 9 points and became the 9-quarter maximum. So, a quarter (26%) of industrial enterprises regarded their capacities as excessive against only 11% of enterprises early in 2011.

In August, the state of things in the Russian industry sooner improved, rather than got worse. Slowdown of the demand permitted enterprises to carry on without reducing the output, introduce positive adjustments in output plans and reduce the rate of lay-offs with stocks of finished products put under complete control. However, uncertainty about the future made enterprises minimize investment plans and go ahead with lay-offs.

In August, the dynamics of demand in industrial produce underwent relative positive changes. The initial data and that cleared of a seasonal factor showed growth of 6 points in the index though it still remained in the negative zone, which factor points to slowdown of a drop

in sales. In other words, a decrease in demand in August continues, but not at that rate as in July. The second wave of the crisis which analysts predicted and the government started to get ready for beforehand did not materialize in summer 2012.

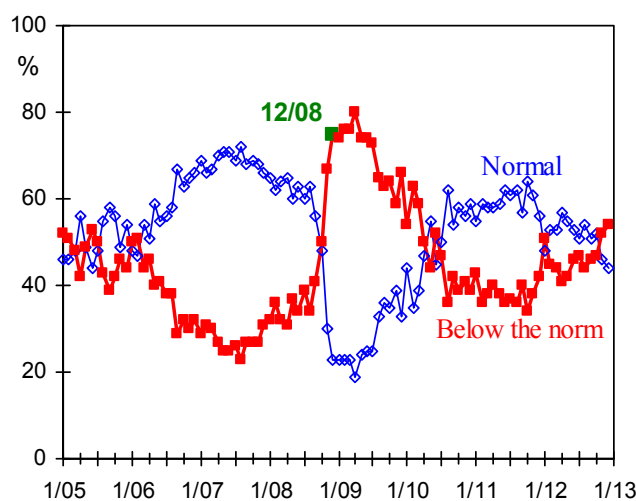


Fig. 14. Dynamics of the main assessments of the solvent demand

The above situation permitted the industry “to take breath” and improved satisfaction with the current sales volumes (see Fig. 14). Within a month, the difference of assessments of the demand increased by 8 points and “won back” all the loses of June and July. Only 42% of enterprises were unsatisfied with sales of their products. The above value became the 9-month minimum, that is, the best index value.

In a situation of the continued decline of the demand and uncertainty about changes in it, the industry minimized risks related to accumulation and maintenance of a reasonable surplus of stocks of finished products. Within summer, the balance of assessments lost 8 points after attaining in May the 33-month maximum. In August 2012, the share of the “normal” answers reached the historic maximum of all 243 surveys which had been carried out by that time – as never before the industry was so careful in its policy of management of stocks of finished products.

Following the dynamics of demand, in August the output dynamics underwent positive changes. As a result, the surveys showed that in summer months growth in industrial production stopped (the growth rates were in the range of from –2 points to +2 points, that is, a nil). The fact that the expected recessionary drop in output (or the one close to it) did not materialize added optimism to that data. However, the pessimism of the June-August data cleared of the seasonal factor consisted in absence of any evidence of growth. That evidence could be seen only in enterprises’ plans. In the 3rd quarter, their optimism increased by 11 points after a dip in June to the 3-year minimum. Absence of a recessionary slump in output instilled hope to enterprises for revival of production.

However, in October a slowdown of the main indices of demand, output and prices started in industry again. The employment rate was falling, too, but, probably, for another reason: due to low wages and salaries workers started to quit enterprises and, as a result, the latter were no longer confident that with the remaining personnel they would manage to ensure even the stagnating output volumes.

The initial data on the dynamics of demand showed that it fell at a higher rate to –19 points. However, the data cleared of the seasonal factor smoothed the sharp drop and showed a decrease only to –15 points. Lack of positive changes in the dynamics of the demand increased dissatisfaction with its volumes again: 49% of “below the norm” assessments was received; the year’s best result (41%) was registered in April. The dynamics of forecasts of the demand did not suggest optimism, either. The initial data got worse by 11 points, while that cleared of a seasonal factor, by 7 points and became negative again. In industry (according to all the data), expectations of a drop in sales prevailed over forecasts of their growth.

Following the demand, the dynamics of output dipped in October, too. The initial rate of a change in the index fell to –7 points. In the past three years, a more intense rate of decrease was registered only in January 2010, January 2011 and January 2012. Clearing of a seasonal factor made the rate of decrease in output in October comparable with the results of June-July 2012 when the worst values of the index were received from the mid-2009.

Output plans underwent explicit negative changes, too: the initial data lost 17 points and became negative, while that cleared of a seasonal factor, 10 points, but remained in the positive zone. As a result, explosive growth in optimism in the 3rd quarter (then, the balance of plans rose by 15 points) was replaced by pessimism which was untypically low for October.

In November, the situation of enterprises kept getting worse. The demand was decreasing and its forecasts did not suggest any optimism. The prevailing stagnation of production resulted in a situation where the dynamics of output was more often in advance of that of sales. That situation contributed to accumulation of risks of failure of production and made enterprises subject their output plans to a serious negative adjustment and use a price reduction for promotion of demand.

The negative dynamics of demand and absence of hopes for its revival (particularly, before the national holidays in January) sent sharply downwards the level of satisfaction with current sales. Within a month, the index got worse by 18 points and hit the 32-month minimum.

In November, output growth rates did not change and remained at a zero level. Such situation was registered by surveys since June 2012 and was confirmed later by the official statistics data. Clearing of a seasonal factor did not introduce any particular changes into the initial data and demonstrated preservation of output growth rates for six months running in the range of from –2 points to +2 points. The stagnation of output in Russian industry continued. Unfortunately, that stagnation was fraught with more serious consequences which were difficult to spot on the basis of the official statistical data.

They included advanced growth in output changes as compared to the dynamics of demand in it. In November, the share of enterprises where changes in output were ahead of changes in demand amounted to 31%, though in 2012 that index was in the range of 12% to 29%. Thus, the apparent stagnation of output contributed to accumulation of risks of future failure of production when enterprises were required to bring their output in harmony with demand in their products.

The first evidence of such harmonization could be found in output plans in November. Within a month, the initial plans fell by 15 points straight and appeared to be the worst ones in the 2010–2012 period; they surpassed even traditionally bad forecasts of December. Clearing of a seasonal factor showed a decrease of only 4 points, but to the worst values since the mid-2009 (if a dip of June 2012 is not taken into account). As a result, in November 2012 correlation between output plans and forecasts of demand amounted to 80%, which is the record

in the 2009–2012 period. In November 2008, that index rose to 83%, while in December, to 88%.

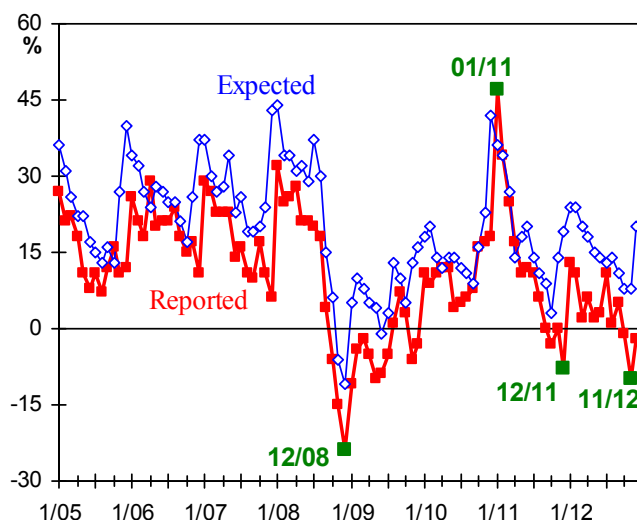


Fig. 15. Changes in selling prices (balance = % growth – % decrease)

Another measure which was aimed at ensuring the balanced demand and output was enterprises' prices. In November, the industry switched over from the minimal price rises (normally, in the range of from +2 points to +6 points) to a radical price reduction (see *Fig. 15*). Within a month, the balance fell to –10 points and hit the absolute minimum in the 2009–2012 period, that is, there was no such a dramatic drop in selling prices from December 2008 when the industry was in the midst of the current crisis.

The year 2012 ended up quite unsuccessfully for the industry. Weakening of the demand made enterprises review assessments of it and switch over to explicit reduction of output and prices, but retain control over stocks of finished products. However, workers kept quitting the industry due to low wages and salaries, while investment plans were getting worse.

The dynamics of demand on industrial produce remained negative till the end of 2012. The initial data showed that the rates of drop in sales in December 2012 attained the four-year maximum for that month. Clearing of a seasonal factor (as in July 2012) brought the value of the balance to the 42-month maximum (that is, the worst value in that case). According to all the data, the situation in the Russian industry as regards sales was getting worse. The above conclusion was confirmed by enterprises' assessments of current volumes of the demand. In December, the share of normal assessments fell to 40% and turned out to be the 33-month minimum. In the Russian industry, in November-December losses of satisfaction with sales amounted to 12 p.p.

As a consequence, in December the industry reported a dramatic drop in the rates of change in the output. The initial balance lost 15 points straight, fell to –18 points and became the worst value of the month in the 2009–2012 period. Clearing of a seasonal factor showed a decrease in the balance from the symbolic -2 points to the explicit -9 points. So, after remaining at the stagnation level (–2 .. +2) in June-November, the rate of change in output showed a tangible drop in December. However, slowdown of the dynamics of output permitted the industry to retain under control the stocks of finished products and improve the balance of their assessments by 4 points by means of reduction of the share of the “above the norm” answers.

In a situation of weak demand, the industry had to slow down not only output growth, but switch over to price reduction. For two months running, the absolute and most dramatic price reduction for the end of the year in the 2009-2012 period was registered by surveys.

In December 2012, the balance of investment plans dropped by 10 points and hit the 3-year minimum. A similar drop in investment plans (by the value) was registered late in 2011, however, the balance was restored as early as January 2012. Recovery from the latest drop of last December is unlikely to be as fast as a year ago.

4.2.3. Lending to Russian Industry 2012

According to assessments of enterprises, in 2012 bank lending to the Russian industry underwent small negative changes. Though availability of loans to industry changed within narrow limits (from 68% to 72%), the average annual value of the index amounted to 69% as compared to 72% in 2011. The average minimum rate offered by banks increased in industry as a whole from 12.0% per annum in January to 12.8% and 12.9% in October 2012 and January 2013, respectively. Growth in interest rates was registered by all the industries, except for the light industry, and all the size groups of enterprises. However, lack of loans restrained output growth with only 3% (three!) of enterprises and was second to last in the rating of industrial growth limitations. It is to be noted that that the restraining effect of that factor on the industrial production was the minimum one from the 2nd quarter of 2011.

Early in 2012, the conditions of lending to industry were characterized by conflicting trends. On one side, reduction of the average minimum interest rate offered by banks on ruble loans definitely stopped. After amounting to 11.8% in October 2011, that index demonstrated symbolic growth having increased to 12.1% in the next three months. On the other side, general assessments by enterprises of lending conditions showed some easing in January. The aggregate assessment of availability (normal + above the norm) rose by 5 points to the 7-month maximum.

In February-April, conditions of lending to industry did not undergo any particular changes. The aggregate availability of loans (“above the norm” + “normal”) remained at the level of 72% with the average minimum rate offered by banks being in the range of 12.1% to 12.3%. With the normal availability of loans, the rate amounted to 11.6%, while in October 2011 it was estimated by enterprises at 11.0%.

In the beginning of the year, enterprises’ lending plans did not undergo any principal changes, either. The industry reported about plans of moderate growth in borrowings. In 1st quarter of 2012, the balance of that index amounted to +14 points and did not change as compared to both the 4th quarter of 2011 and the 1st quarter of 2011.

Generally, in the 1st quarter of 2012 banks stopped tightening lending conditions which enterprises reported about in the 2nd quarter of 2011. In that period, after attaining of the post-crisis maximum of satisfaction (78%) in the 2nd quarter of 2011 the index fell to 70%, while the lowest level was registered in December and amounted to 68%. In the 1st quarter of 2012, the most reasonable lending terms were offered to the iron and steel industry (77% of satisfaction). Almost the same level of satisfaction (75%) was observed in engineering.

In the 2nd quarter of 2012, the conditions of lending to the Russian industry did not undergo principal changes as compared to the previous three quarters (see *Fig. 16*). In that period, the aggregate availability of loans (“above the norm” + “the norm”) was in the range of 70% to 72%. The most comfort terms of lending were offered to the food industry where the ag-

aggregate availability of loans returned to the level of 80%. The average minimum rate offered by banks in that industry amounted to 12% per annum.

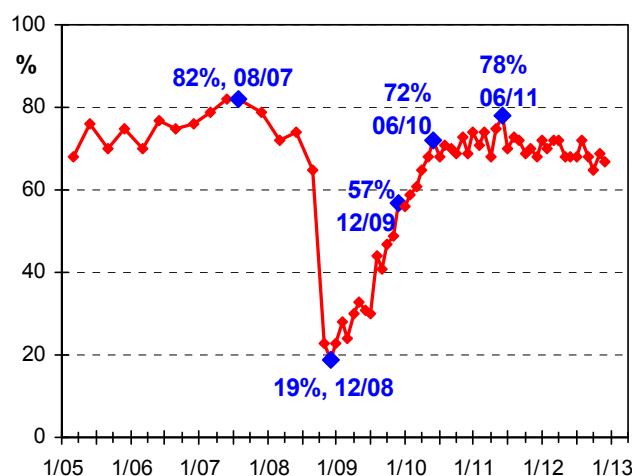


Fig. 16. The share of enterprises with the “above the norm” and ‘norm availability of loans

The opposite situation was observed in the iron and steel industry. From the beginning of 2012, banks toughened conditions of lending to that industry by 18 points: if in the 4th quarter 2011, the aggregate availability of loans amounted to 83%, in the 2nd quarter of 2012 it fell to 65%. Within the previous four quarters, the rate in that industry rose from 9.0% to 10.3%. As a result, the iron and steel industry was rated the third as regards availability of loans, though from the mid 2009 till the end of 2011 it enjoyed banks’ utmost confidence. Availability of loans to the light industry was the worst one; only 30% to 40% of enterprises had normal accessibility of borrowed funds in the previous seven quarters. However, in the 2nd quarter of 2012 banks made lending easier to that industry by reducing the average minimum rate to 13.4% after it was in the range of 13.9% to 14.2% in the previous five quarters.

However, availability of loans in that industry in general correlated well with the level of ability to service loans in the industry: in the light industry that index amounted to 35%. However, detailed calculations showed that in light industry availability of loans correlated with ability to service them only with 68% of enterprises, while 11% of enterprises believed that they had a reduced accessibility of borrowed funds as compared to the ability to service them. On the contrary, 21% of enterprises of the light industry assessed banks’ policy as a risky one as the latter provided access to loans to such an extent that it exceeded enterprises’ ability to pay for them.

Precision of banks’ lending policy was the highest in the food industry, chemical industry, wood industry and nonferrous industry where it corresponded 80% or more to enterprises’ ability to repay loans. The lowest correlation between the availability of loans and ability to service them was registered in the 2nd quarter in building industry (53%). In that industry, banks more often (in 38% of instances) reduced availability of loans as compared to enterprises’ actual creditworthiness.

In the 3rd quarter of 2012, it was expected that the Russian industry’s need in loans would decrease. In the 2nd quarter of 2012, the balance of forecasts of that index amounted to +9 points after remaining in the range of +12 points to +14 points in the previous five quarters. The strongest demand in loans was possible in the nonferrous industry and building industry

where the balance of forecasts amounted to +20 points. In other industries it amounted to +8 points to +9 points.

In the 3rd quarter, availability of loans to the Russian industry was getting worse. First, average availability of loans was preserved at the level of the 2nd quarter (69%), but only thanks to upturn of the index in August, otherwise, it would have lost 2 points. Second, the average minimum rate offered by banks rose to 12.5% points after 12.3% in the 2nd quarter. In September, loans were extended at the rate of 12.6% per annum in rubles. Third, growth in interest rates on loans took place for all the industries. (see Fig. 17). For the second quarter running, the highest rates on loans were offered to the building materials industry (14.2% and 14.3% per annum). As regards that index, the light industry moved to the second place (13.8%). Banks were prepared to provide loans to the food industry and engineering at the interest rate of 12.6% and 12.2%, respectively. Fourth, a similar situation was observed in respect of enterprises of different sizes, too. A decrease in interest rates was registered in none of the groups; only large enterprises (251,000–500,000 workers) reported about stabilization of a loan supply at the level of 13.1%. Interest rates set for small and mid-sized enterprises rose to 15.0%, while those for very large enterprises (501–1000 workers) and the largest enterprises (over 1,000 workers), to 12.1% and 10.6%, respectively. Thus, banks' priorities in lending to enterprises of different sizes did not change.

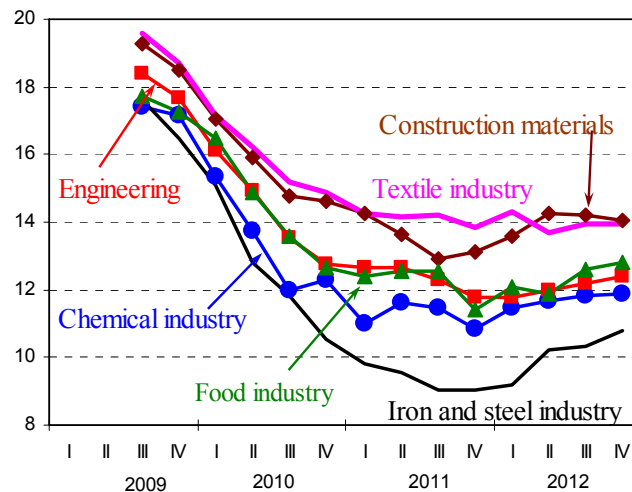


Fig. 17. Average minimum rate offered on loans in rubles in different sectors, quarterly average, % per annum

Early in the 4th quarter, the aggregate availability of loans decreased by 3 points and hit, as a result, the 30-month minimum. However, in November banks' confidence in industry returned to the level of 69% which is typical of the second half-year. In November, the average minimum interest rate offered to industry was equal to 12.6% and preserved the sectorial specifics which is typical of the Russian industry in general.

In the 4th quarter of 2012, the ability of enterprises to repay outstanding loans did not change and amounted to 87%. Within a year, that index demonstrated a surprising stability by remaining in the range of 86% to 88%. At the beginning of monitoring of that index in 2009, only 61% of enterprises believed they were able to service the outstanding loans, while during that year the share of such assessments rose from 52% to 68%.

4.2.4. Personnel Problems of the Russian Industry in 2012

In 2012, the Russian industry had to face new problems on the labor market. Early in 2012, hiring of personnel was short-lived and was less intense as compared to the same period of 2011, while the rate of lay-offs which continued throughout the second half-year surpassed the index of the previous post-crisis years. However, slowdown of industrial growth reduced the severity of personnel shortages to the zero balance. The main reason for which workers quitted enterprises was low wages and salaries.

The year 2012 traditionally began with continued reduction of the number of workers engaged in industry. The balance (rate) of changes in the number of personnel lost within a month another 8 points and fell to the two-year minimum. It is to be noted that explicit reductions began in industry from October 2011 and reached their peak level only in January. However, it was in accordance with enterprises' plans which showed as early as September the intention of enterprises to switch over from hiring of workers to reduction of their number. In December 2011, those plans were the most resolute ones and only 5 points short of the post-default record registered in January 2009. However in January 2012, hiring plans traditionally rose and the balance increased straight by 31 points which is the record change in that index in the entire period of monitoring from 1993.

However, hiring plans could encounter the assessments of personnel redundancy/shortages due to the expected changes in the demand. In January 2012, those assessments underwent serious changes. If within the previous six quarters the "less than sufficient" evaluations prevailed in industry, by the beginning of 2012 the share of those evaluations became equal to that of the "more than sufficient" ones and the balance of evaluations became zero, that is, by the beginning of 2012 enterprises got rid of personnel shortages. As those developments took place in a situation where the number of workers was reduced, it can be supposed that liquidation of the problem of personnel shortages was related not to a change in the number of workers, but revision (a negative one) of the prospects of exit from the phase of a sluggish crisis.

In February, the industry switched over from large-scale lay-offs of personnel to hiring of workers (see *Fig. 18*). However, the rate of hiring was rather low (the total +3 points) after (-11 points and -17 points in December 2011 and January 2012, respectively), but the very fact of a turning point in that negative trend which was formed in the second half of 2011 was important. In addition to the above, it was also important that lay-offs stopped and hiring of personnel began in a situation where enterprises were getting rid of the problem of personnel shortages which had prevailed for a year and a half.

In March-April, enterprises increased somewhat the rate of hiring of personnel. It is to be noted that expansion of hiring in industry took place in a situation where labor shortages disappeared. For two quarters running, the balance of assessments of personnel due to the expected changes in demand was zero (the share of "more than sufficient" answers was balanced by that of "less than sufficient" answers) with the share "sufficient" answers being equal to 75%, that is, the industry in general was quite supplied with personnel to meet the expected growth in demand and supply. For that reason, preservation of the rate of hiring of personnel attained in the first few months of the year appeared highly unlikely to enterprises: hiring plans started to lose optimism and in May they were successfully realized.

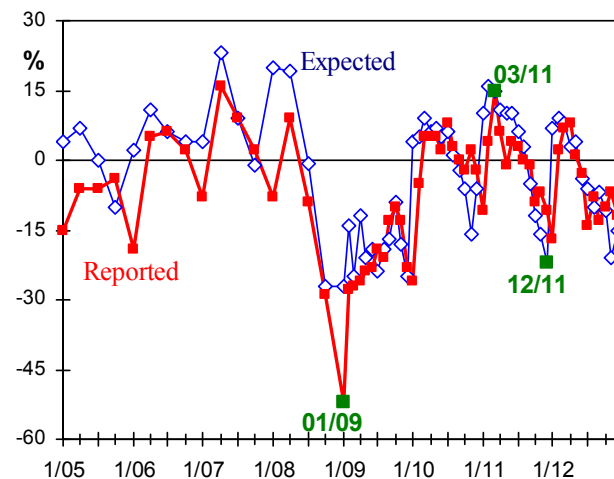


Fig. 18. Changes in employment (balance = % growth – % decrease)

In June, the industry as a whole almost maintained the approximate parity between hiring and lay-offs of workers. But the situation differed by sectors. Hiring at an intense rate took place only in building materials industry which fact can be explained by a seasonal revival of production, while other sectors laid off personnel at different rates (from –3 points to –15 points). Hiring plans in June lost small optimism of the first months of the 2nd quarter and pointed to enterprises' willingness to preserve the existing number of workers in the next few months.

However, in July the industry switched over to large-scale lay-offs. Within a month, the rate of lay-offs (the balance) increased by another 12 points and amounted to the values which were comparable to the worst values which are normally registered in January. Clearing of the seasonal factor showed that the rate of lay-offs in June 2012 was the highest one in the past three years. However, the number of workers thus achieved suited enterprises well; 78% of enterprises believed it was adequate to the expected volume of demand in output. Hiring plans did not suggest principal changes in enterprises' HR policy: enterprises had to go ahead with lay-offs.

In August, the industry actually kept losing workers but at a smaller rate than in July. It is to be noted that as before enterprises' plans did not suggest changes in the HR policy of the industry. In August, the initial balance of forecasts fell by another 6 points, while that cleared of the seasonal factor, by 4 points. Enterprises expected that reduction of the number of workers would continue and, more probably, at a higher rate.

The end of the 3rd quarter was characterized by growth in the rate of reduction of workers in industry. The growth rates increased by 3 points as compared to August and pointed to the fact that large-scale lay-offs in industry continued; according to the surveys they lasted during the entire 3rd quarter of 2012. However, it was exactly the situation which was forecasted by enterprises. In October, the Russian industry kept losing personnel, while the forecasts of changes in employment in October attained the level of November in the 2009–2011 period. Industrial enterprises believed that they would lose workers at the end of the year, as well.

Such a situation ceased to be acceptable to enterprises. First, in the second half of 2012 labor shortages became the factor behind slow-down of output with 30% of enterprises. Second, late in 2012 enterprises became less supplied with workers. In industry, the number of enter-

prises with labor shortage explicitly increased as compared to those with redundant workforce (see Fig. 19).

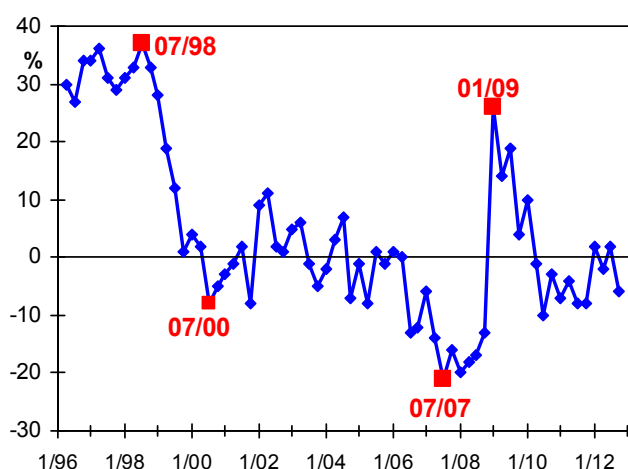


Fig. 19. Balance of assessments of personnel (balance = more than sufficient – less than sufficient)

The main factor is sooner related to raising of wages and salaries in other sectors of the economy, primarily, in the public sector. As a result, the level of remuneration in industry (with working conditions taken into account) ceased to be attractive to potential workers. In October 2012, managers of enterprises started to understand that: for the first time since April 2009 the share of unsatisfactory assessments of the level of remuneration of both workers and experts increased. Earlier, that index fell from 59% to 26%. In October, the share of the “below the norm” answers amounted to 33%.

In November, the industry managed to slow down reduction of the number of workers, but at the level which was critical even for stagnation. Forecasts in October showed that enterprises were less able to correct imbalances between employment and demand. The forecasts in November got worse by another 9 points. The industry did not expect principal changes in solution of their personnel-related problems.

In December, the situation with personnel in industry did not change, either. Reduction of employment continued at a stable rate from July 2012. During the second half-year, the balance of changes in the number of workers (the rate of change) was in the range of –13 points –8 points, while a year ago in the same period it decreased from +3 points to –17 points. In the 4th quarter of 2012, the highest rate of reduction of workforce took place in wood industry (the balance of –17 points), iron and steel industry (–15), light industry (–13) and engineering (–11). Hiring of personnel was registered only in power industry.

The main factor behind lay-offs in industry was low wages and salaries due to which workers had to quit enterprises on their own initiative. Such was the opinion of 46% of managers of enterprises. The second most important factor (39%) is lay-offs on the initiative of workers due to a pensionable age. It is to be noted that only in 7% of cases workers of pensionable age were laid off on the initiative of enterprises. The above factor is rated the last in the rating of the main reasons for lay-offs. Enterprises more often (in 23% of cases) fired workers who breached labor and production discipline, while redundant workers were laid off only by 15% of enterprises.

4.2.5. Consequences of Labor Shortages in the Russian Industry

In the 4th quarter of 2012, industrial enterprises surveyed by the IEP reported that they lacked workers due to expectations of changes in demand. For the first time in the past year, the balance of assessments became a negative one, that is, the number of the “less than sufficient” answers happened to be 10 p.p. higher than that of the “more than sufficient” answers. A similar situation took place in industry in the second half of 2010 and during 2011. At that time, within seven quarters the balance of assessments was in the range of –10 points –4 points, while in the 2007–2008 period the balance fell to –20 points...–17 points, which fact is the evidence of the largest labor shortages in industry in the past 17 years. At the first glance, the value of the index of the end of 2012 is not beyond the limits of the range which is typical of the post-crisis years. However, if the dynamics of demand and output is taken into account evaluation of the situation starts to change. Late in 2010 and early in 2011, the industry reported about the highest post-crisis growth rates of demand and output; the IEP optimism index amounted to the post-crisis maximum. It seemed that the eventual exit from the crisis was not far away. Late in 2012, the situation was quite the opposite: demand and output either stopped growing or decreased and the optimism index was close to the post-crisis minimum. Forecasts of change in indices were sooner pessimistic, rather than optimistic. The industry was definitely losing workers and confidence that it would be able to have sufficient workforce to ensure even stagnating volumes of output.

So, the Russian industry encountered again and in a new situation the problem of labor shortages, and due to the above it is worthwhile to make a comprehensive assessment of the consequences of a similar situation.

Our analysis will be based on the outputs of the IEP surveys of enterprises. Such surveys create conditions for receipt of first-hand and trustworthy evaluations of labor shortages as informal and long-standing relations between the IEP and respondents permit the former to ask them direct questions proceeding, primarily, from the common sense, while enterprises can answer those questions without reserve because they do not have to fear that they may provoke the authorities’ discontent or cause damage to their business reputation with potential investors. The whole situation with the latest labor shortages in 2012 is supplemented with comparable results received in summer 2008 (that is, the industry’s pre-crisis peak level) and summer 2011 (when expectations of a final exit from the 2008-2009 crisis were strong in the industry). The analysis is made comparable due to the fact that the questions asked in 2008, 2011 and 2012 were absolutely identical.

In 2012, the most large-scale consequence of labor shortages in the Russian industry was reduction of output quality: 42% of enterprises reported about that (see *Fig. 20*). In 2008, such consequences were more dramatic (46%), which situation can be explained, primarily, by the fact that the industry experienced severe labor shortages (the 2008 balance of assessments fell to –20 points against only –10 points in 2012), while the most moderate negative effect on the quality of the output was produced by labor shortages in 2011. But even then a third of industrial enterprises had to sacrifice the quality; due to that factor the above consequence of labor shortages remained on the top of the list.

Due to labor shortages, the quality of the domestic produce of the engineering industry declined more often and steadily. In 2012, 49% of enterprises in that industry reported about that against 54% in 2008, while in 2011 such consequences were specified by 43% of enterprises, thus yielding formally the first place in the industry to another consequence caused by labor shortages, that is, infeasibility to increase the output even with orders being available (45% of

mentions). The aggregate result of the three-year monitoring showed that the quality of engineering products suffered more often than that of products of other industries: 49% (half of the industry!) against 31%–37% (one-third!) in other sectors. So, the industry which is to be the flagship of the real sector in an effort to “break with the oil needle” and promote Russian competitive products on the global market admits the fact of weakening of its positions for reasons which are mainly within the competence of the government (demographic policy and proprieties in the sphere of higher and specialized secondary education). In other sectors, reduction of the quality of output due to a lack of skilled workers was less dramatic and/or stable.

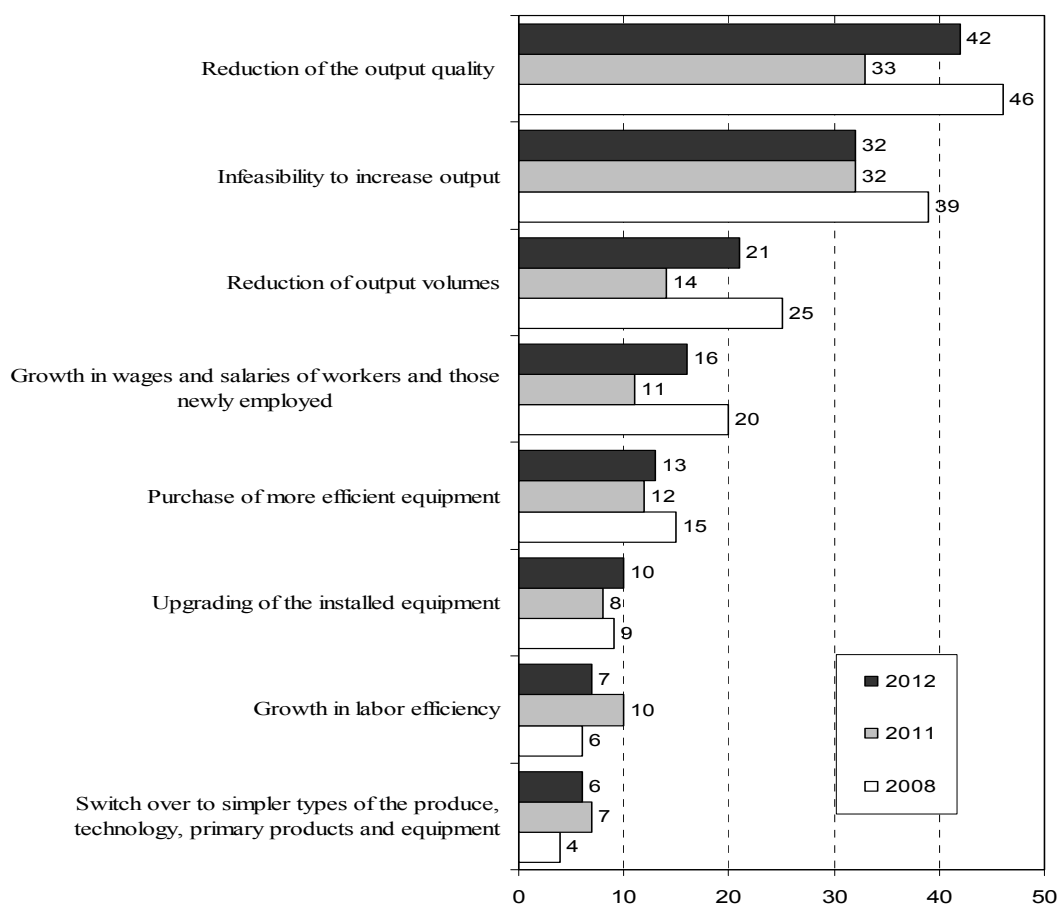


Fig. 20. Consequences of labor shortages in the Russian industry in 2008, 2011 and 2012, %

The intense dynamics of the effect of labor shortages on the quality of output was observed by the forms of ownership. During the monitoring, state-run enterprises managed to reduce the negative consequences of that factor: if in 2008 and 2011 reduction of the quality was mentioned by 55% and 48% of enterprises, respectively, in 2012 it was stated by only 9% of plants of that sector. Within a year, a fivefold reduction in the impact of labor shortages on the quality of products took place! During the past year, on the contrary, enterprises of other forms of ownership had to use more extensively the quality-reduction practice due to labor shortages: open joint-stock companies – an increase of 10 points in the above practice (to

43%), closed joint-stock companies – an increase of 5 points (to 37%) and limited liability companies – an increase of 24 points (up to 57%).

The second place in the general rating (and in each year of monitoring) of consequences of labor shortages in the industry was occupied by the factor of infeasibility to increase output even with availability of orders. The above consequence was widespread in the engineering and light industries where it was mentioned by over 50% and about 40% of enterprises in 2008 and 2012, respectively. Growth in output was hindered in other sectors less often due to the above factor: maximum 38% of enterprises in iron and steel industry in 2008 and 24% of plants in the building industry in 2012. Throughout the entire period, the most moderate effect of labor shortages on output was observed in food industry where it was mentioned by only 15% to 19% of enterprises.

More serious consequences of labor shortages for the output dynamics – not only slowdown of growth, but decline of production in absolute terms – were also widespread in the Russian industry. In the past three years, that effect of labor shortages was stated on average by 20% of enterprises, while in 2008 and 2012, by 25% and 21% of plants, respectively. Within the entire period of monitoring, the absolute leader as regards that factor was the light industry where half of enterprises in 2008 and 2012 and one-third of enterprises in 2011 reported about output reduction due to labor shortages. In other sectors, a similar reaction amounted at most to one-third of enterprises in 2008, while in 2012, on average, to only 19% (with the light industry not taken into account). Thus, in addition to the existing problems in the light industry a decline of output is a factor which is extremely widespread there due to labor shortages.

State-run enterprises had more rarely than others to reduce the output due to the above factor: in 2008 there was 15% of such reports, while in 2011 and 2012, there were 16% and 12%, respectively. In summer 2008, enterprises of other forms of ownership resorted to output reduction in absolute terms in 20%–25% of instances, reduced the pressure of labor shortages on output to 13%–18% in 2011 and reported about that factor's growth to 17%-50% in 2012.

Growth in labor remuneration as a consequence of labor shortages (and a measure to get rid of them) was rated the fourth by industrial enterprises despite the fact that such measures by employers are considered a widespread reaction to labor shortages.

A direct survey of managers of enterprises showed that in the Russian industry wages and salaries were increased only by 20% and 11% of enterprises before the 2008 crisis and at the stage of the exit from the crisis in the mid-2011, respectively, as well as by 16% of enterprises in the period of slowdown of the exit in conditions of new labor shortages that prevented to ensure even the stagnating output. Thus, the "remuneration" reaction to the labor shortages took place 2.3 times to 3 times more rarely in the Russian industry than the most popular and far less pleasant one – reduction of the quality of the output.

In an effort to liquidate labor shortages, the remuneration factor was utilized more often in the food industry; 28%, 14% and 36% of enterprises reported about that in 2008, 2011 and 2012, respectively. In 2012, over 30% of enterprises of the building materials industry and the iron and steel industry were prepared to utilize the factor of remuneration growth, as well.

Measures aimed at raising of labor efficiency were rated, on average, the fifth during the monitoring and actually ended up the list of measures which domestic manufacturers were prepared to take in order to cope with labor shortages. The most popular (widespread) measure in that area consisted in purchasing of more efficient equipment; 15%, 12% and 13% of enterprises reported about that in 2008, 2011 and 2012, respectively. The leader as regards

that reaction to labor shortages was the engineering industry (19% of enterprises which buy on average such equipment) and the light industry (over 17%). On the contrary, only 6% and 7% of enterprises were prepared to incur such expenses in the chemical industry and wood industry, respectively.

It is to be stated that only one-tenth of the industry dealt with upgrading of the installed equipment as a response to labor shortages. Almost in all the sectors, the level of that reaction in 2008, 2011 and 2012 was on average the same and within the range of 9% to 12%; only in the chemical industry and light industry it amounted to 4% and 7%, respectively.

But, in the final analysis, the number of Russian industrial enterprises which rely on growth in labor efficiency is even smaller: the average level of that reaction in the industry amounted only to 8% and rose maximum to 10% in 2011. The highest expectations of growth in labor efficiency as a response to labor shortages were registered in the iron and steel industry and light industry, but mainly in 2011 and 2012.

The outputs of the IEP surveys showed that in the Russian industry there was always a fairly large segment of enterprises which were able to cope with labor shortages without resorting to reduction of quality and output volumes and raising of wages and salaries. During the monitoring period, only one-third of enterprises assessed their abilities as such.

In 2008, the number of such enterprises was the smallest one (22%) which fact can be logically explained by overheating of the Russian economy and, as a consequence, acute labor shortages. Early at the stage of the exit from the crisis the industry rated above all its ability to meet the demand in additional workforce at the expense of its own reserves and on the labor market – the number of such enterprises amounted to 38% in 2011. In 2012, slowdown of the economy and industry reduced enterprises' readiness to solve its personnel-related problems to 29%.

Enterprises' ability to solve personnel issues is determined sooner by the level of remuneration and the potential to use that factor to attract new workers on the market. Industries which demonstrate the highest ability to use the remuneration factor in solution of their personnel issues showed that they were able to solve those problems by means of their own reserves or through attraction of workers from the market. In 2012, 35% of enterprises in the food industry, 25% of enterprises in the building industry and 24% of enterprises in iron and steel industry reported about that. However, the need to increase remuneration does not exist in all the sectors. So, in the chemical industry 53% of enterprises declared that they had sufficient workforce or were able to find more workers. In such a situation, the need to increase wages and salaries for solution of their personnel issues is the minimum one (11%) in that industry. It is to be noted that a similar situation (a high level of provision with the personnel and low intentions to increase wages and salaries) took place in the industry throughout all the years of monitoring.

Engineering demonstrates the rather modest potential (intensions) to use a pay rise factor in solution of personnel issues. In 2008, with a 10% ability to solve their personnel issues only 20% of engineering plants increased wages and salaries. In 2011, labor self-sufficiency rose to 26%, while the need to use the remuneration factor fell to 14%. In 2012, the situation got worse: only 21% of enterprises were sufficiently provided with personnel (or were able to find workers), while only 13% of plants were prepared to increase wages and salaries. As a result, as it was stated above, the engineering industry had to reduce the quality of its produce.

A unique dynamics of solution of personnel issues without harm to output (in quantitative and qualitative terms) and the need of investment was demonstrated by state-run enterprises.

If in 2008 only 9% of plants of the state industrial sector had own personnel reserves or was able to hire new workers, in 2011 there was 32% of such enterprises which situation appears quite normal as compared to enterprises of other forms of ownership which assessed their potential in the range of 24% to 45% in 2011. However, the result of 2012 turned out to be absolutely unique: the potential to meet its requirements in personnel rose in the state sector to 73%! The need in additional (potential) utilization of the remuneration factor decreased from 23% in 2008 to 13% and 6% in 2011 and 2012, respectively. With wages and salaries in the state industrial sector becoming so high as compared to neighbor-enterprises and a work load being stable thanks to budget financing, personnel issues in that sector are solved better than anywhere else and require the minimum effort to maintain the status quo.

Thus, the long-term monitoring of personnel issues in the Russian industry shows that the most widespread reaction of enterprises to labor shortages is reduction of the quality of output, rather than growth in wages and salaries. It is to be noted that the quality reduction factor is the most widespread and stable one in domestic engineering – an industry whose degradation means the degradation of this country. Decrease in output volumes (or slowdown of its growth) turned out to be a fairly widespread reaction of the domestic industry to labor shortages. Particularly unpleasant is the fact that those developments took place in 2012 when the industry failed to get out of stagnation. Growth in wages and salaries which was much spoken about in connection with labor shortages took place at best at 20% of enterprises and was rated the fourth by the Russian industry in the rating of consequences of labor shortages, while growth in labor efficiency virtually ended up that gloomy rating.

However, there is a sector in the Russian industry which managed by the year 2012 to bring virtually to naught reduction of output quality due to labor shortages, reduce output volumes more seldom than others, do without upgrading of the equipment under the pressure of labor shortages, refrain from raising workers' wages and salaries and at the same time have a unique potential to solve its personnel-related problems. That sector is state-run enterprises which together with the state-financed sector deprive the rest of the industry of personnel and, thus prevent it from prospering.

Such a reaction of industrial enterprises to labor shortages makes one be cautious in approaching the data on reduction of the number of the unemployed in Russia and should contribute to adjustment of the government policy in the sphere of the higher and specialized secondary education so that correct priorities in training of personnel for the needs of the economy could be set.

4.2.6. Assessment of the Government Anti-Crisis Measures

The prevailing threat of the second wave of the crisis and the governments' efforts to prepare for it permitted in 2012 to evaluate thoroughly (not in a hasty way as it was done late in 2008) the efficiency of the government's anti-crisis package and, particularly, do it in terms of the Russian industry which the government supported in the first wave of the crisis and would not definitely let down if the second one occurred. For that purpose, in July 2012 the IEP asked managers of industrial enterprises to specify the most efficient measures of support of their enterprises. The survey in July became the fourth stage of monitoring of efficiency of the government's anti-crisis measures. The first similar survey was carried out late in 2009, the second one – late in 2010, while the third one – in September 2011 when fears of the second wave of the crisis became too high. As a result, a unique (as regards duration), reliable and,

probably, useful to the authorities array of evaluations of efficiency of the government's measures and plans during the crisis which began in 2008 was accumulated.

It is to be noted that the 2012 survey differs fundamentally from the 2009 and 2010 stages of monitoring by the fact that it precedes the potential application (development) of the government's anti-crisis measures and, as a result, permits to take into account preferences of "the rescued" themselves as early as at the stage of development of those measures. Another important specifics of that survey (as well as all the previous surveys) consisted in the fact that it took into account opinions of hundreds of managers of enterprises of different sizes from all the sectors and locations and was not limited to the opinions of those who had an opportunity to uphold their interests at corridors of power. The IEP's respondents evaluated the state of things in the industry not by the Rosstat's bulletins, but more profoundly (at least at their enterprise and sector). It was those managers, their deputies and heads of business divisions who experienced as early as November 2008 the power of the first strike of the crisis, witnessed how slowly and at the same time hastily the government was trying to smooth its consequences and as early as 2009 understood that the exit from the crisis – not aggravation of it – began. In 2012, in industry expectations of the second wave of the crisis arose again which situation definitely contributed to development of the plan of anti-crisis measures. So, coordination of actions by the government and enterprises may help them both to overcome the second wave of the crisis if it occurs.

According to the survey of 2012, the most welcome measure for the industry will be reduction of a tax burden (see *Fig. 21*). The above measure is expected by 73% of enterprises which figure is the absolute record: in the past four years none of the measures has been so popular in the industry. It is to be noted that in 2011 the preference of a tax reduction amounted only to 44%! Moreover, fiscal anti-crisis measures turned out to be the only ones whose popularity within the incomplete year of expectations and preparations rose. In the above period, all other possible government measures were regarded as less desirable by the industry.

What did happen to enterprises' approach to taxes which the government collects from the industry and uses at its own discretion? As no principal changes in taxation of the industry took place between the two surveys and enterprises were sooner adapting to the existing system of taxes, such a surge can be determined more likely by assessment by taxpayers of the lines and efficiency of the government's budget spendings. Actually, if before the second wave of the crisis the government set as priority a reduction of costs and, particularly, at the expense of labor remuneration, in the period from September 2011 to July 2012 the authorities actively increased budget expenditures for obvious reasons – it was an elections period – on pay rises for law-enforcement officers and other public sector employees. More anger could have been provoked by ambitious state projects (building of bridges and stadiums, reconstruction of theatres and other) whose cost estimates steadily increased several times over in a situation of an ongoing public discussion of the percentage of kick-backs. It is to be noted that there were no hopes for real reduction of the tax burden and the authorities explicitly stated that at the end of 2011. So, the industry's overwhelming voting for adjustment of the fiscal policy should be sooner regarded as a call to the authorities to moderate their appetites, rather than a hope to see real steps in that area.

In 2012, limitation of growth in regulated tariffs on railway carriage, gas and heating was rated second by the industry; 60% of enterprises looked forward to see such measures (68% and the first place in 2011). During the first wave of the crisis, the efficiency of those measures was rated positively by 43% and 24% of enterprises in 2009 and 2010, respectively.

Higher popularity of the antitrust component of the anti-crisis package was probably related to unwillingness of natural monopolies to deal with the crisis and adjust their ambitions.



Fig. 21. Preference of the government's anti-crisis measures to the Russian industry in case of the second wave of the crisis, %

In 2012, demand motivation measures received almost the same support from the industry (55%). During the first wave of the crisis, evaluation of such government measures was more moderate: in 2009 and in 2010 those measures helped 19% and 17% of enterprises, respectively. A sudden (threefold!) surge of expediency to motivate demand at the expense of budget funds was related to a stable negative dynamics of industrial produce sales in 2012 and absence of actual hopes for their revival at the expense of private demand. In such a situation, the government could use more efficiently budget funds on support of at least individual sectors of industry.

According to enterprises, other possible government measures will be less efficient in case of the second wave of the crisis.

Only one-third of the industry would like to receive subsidizing of a portion of expenses related to payment of interests on loans (41% in 2011). As compared to the actual efficiency of that measure in the 2009–2010 period at the level of 20%, 1.5- 2 fold growth can be explained by a hope for priority utilization by the government of that particular method of support of lending to the industry and not by simple pumping of cash to the banking sector with calls not to scale down lending to the real sector. In 2012, the latter measure was supported only by 7% of enterprises (the second to last in the rating). However, in 2009 the government support to banks was rated by the industry as the second to last. At present, 14% of enterpris-

es expect state guarantees for loans which situation is comparable with the level of positive assessment of that measure in 2009 (11%).

In 2012, government measures related to support of employment were rated the fifth by the industry. In case of the second wave of the crisis they may be required by a quarter of enterprises. Though as early as 2011 the popularity of such measures amounted to 43%, the positive assessment of application of them gained 49% and 41% in 2009 and 2010, respectively. A two-fold decrease in demand in government anti-crisis measures in the labor market can be explained by a number of reasons. First, during the second wave of the crisis a possible drop in demand and output will sooner be of a smoother nature and require no large-scale lay-offs. Second, the continued stagnation of demand permits enterprises smoothly and less painfully to solve even now the employment issues and get better prepared for the second wave of the crisis. Third, achievement of the optimal number (in the current situation) of the employed at enterprises is ensured partially not by administrative measures, but through a natural way.

Protection of the domestic market with customs import duties may turn out to be advantageous only to 20% of enterprises and the above assessment coincides with evaluation of efficiency of the measure in question during the first wave of the crisis. It is to be noted that in 2012 import hindered output growth with 26% of enterprises. Another well-known measure of protection of domestic manufacturers – the devaluation of the ruble – is actually far less popular with the industry. In 2012, only 10% of enterprises believed that smooth depreciation of the ruble could help them go through the second wave of the crisis. The number of supporters of dramatic (as in 1998) devaluation is even smaller (only 3%). Within a year, the views on devaluation did not virtually change in the industry. But in 2009, the efficiency of the above measure was recognized by 20% of enterprises.

Reduction of pressure from corrupt practices in operations with supervising and tax authorities, as well as in state procurements will be more advantageous to the industry than devaluation of the currency. Such is the opinion of 18% of enterprises. In 2009, the government's anticorruption measures (but, probably, to a greater extent – reduction of flows of bribes and kickbacks due to dramatic slowdown of business activities in the most bribe-intense spheres of the economy) were positively rated by 9% of enterprises.

The favorite creation of the authorities – formation of the list of strategic enterprises – is supported by only 14% of enterprises. In 2009, similar target measures were approved by 11% of manufacturers.

Summing up the results of the four-year monitoring of the efficiency of anti-crisis measures of the Russian government, the following can be stated. First, the industry is in no way indifferent to the government's measures. If the most required measures at present are supported by 73% of enterprises, the most unpopular ones, by 3% to 7%. It would be highly unwise to ignore such a dispersion of values. Second, priorities and, consequently, expenses related to support of the industry during the first wave of the crisis need adjustment. There is no point to "get ready for the past war" as only bad generals do. Third, a long period of expectations of the second wave of the crisis permitted the industry to work out and even partially implement its own anti-crisis plan of actions which situation could not but effect evaluation of the expected government actions.

4.2.7. The Anti-Crisis Package of Russian Industrial Enterprises

Anti-Crisis Measures of the Russian Industry in Case of a New Wave of the Crisis

Expectation of the second wave of the crisis definitely rose in spring and summer 2012. Aggravation of the problems of the euro area and public statements by members of the government on development of the package of anti-crisis measures made the Russian industry get ready for a new wave of the crisis. The expected reaction of enterprises to declining demand in the mid-2012 was revealed by the regular stage of the crisis monitoring – carried out by the Gaidar Institute for Economic Policy – of the sentiments in the industry.

The survey in June 2012 became the seventh stage of the crisis monitoring carried out by the IEP. The first survey took place as early as December 2008 when questions were included in the December questionnaire and dispatched after the IEP industrial optimism index registered a collapse of the Russian industry on November 18, 2008. Later, questions about the actual reaction and expectations were asked in the 2nd, 3rd, and 4th quarters of 2009 and the 1st quarter of 2010. Explicit positive trends of the second half of 2010 and the beginning of 2011 made continuation of that monitoring irrelevant. However, aggravation of the economic situation in August 2011 triggered higher concerns over the second wave of the crisis and the question about the possible reaction of enterprises to crisis phenomena was included for the sixth time in the IEP questionnaire. As a result, at present a unique array of the data – as regards the content and the time period – on the expected and actual reaction of enterprises to the crisis which began in 2008 and is not over yet has been accumulated.

The main (the most large-scale) reaction of enterprises to the second wave of the crisis will be reduced wages and salaries and incomplete work week. In summer 2012, 63% of enterprises reported about that against 68% in autumn 2011 (other anti-crisis measures explicitly yielded in popularity to enterprises' possible economy on the workforce). It seems the industry evidently has an opportunity to carry out that strategy. According to the data of the IEP surveys, in mid-2012 two-thirds of enterprises paid their workers a "normal" – as believed by the management – remuneration. The above result exceeds by 30 p.p. the crisis minimum of the value registered in the 2nd quarter of 2009. The dramatic cuts in wages and salaries will take place in engineering (75% and 78% of enterprises in that industry reported about that in summer 2012 and autumn 2011, respectively). According to the outputs of the two surveys, the building materials industry is rated the second (62% and 86%, respectively); early in summer the above industry experienced revival and for that reason it adjusted its plans in that sphere due to the seasonal factor. The chemical industry is rated the third; in 2011 67% of enterprises in that industry planned cuts in wages and salaries and a switch-over to incomplete work week, against 62% in 2012. The chemical industry is followed by iron and steel industry and light industry with the average level of such plans at 61%–62%. If the second wave of the crisis occurs, cuts in wages in salaries will be the least widespread in the wood industry (such plans were declared by 46% and 44% of enterprises, respectively) and food industry (48% and 39%, respectively). Generally, cuts in wages and salaries and incomplete work week will be the most popular reaction in most sectors of the Russian industry. Only in iron and steel industry and food industry the above measures yield the first place to output reduction and costs reduction, respectively.

Other measures of (anti)crisis policy in the sphere of employment are planned more rarely by enterprises.

According to the data of the survey in 2012, only one-fourth of industrial enterprises plan lay-offs. In the composite rating of anti-crisis measures, the above measure is rated the fifth

and the sixth in the plans of 2012 and 2011, respectively. It seems fears of labor shortages still prevail in the Russian industry.

Such measure as sending of workers to unpaid leaves is possible at about one-fourth of industrial enterprises (in autumn 2011 nearly one-third of enterprises planned to use that measure). The above measure will be the most widespread in the light industry, where it is included at present in the anti-crisis package by 34% of enterprises as compared to 36% in autumn 2011. In most sectors, such unpaid leaves will be practiced at 21% to 27% of enterprises and only in the food industry and wood industry they will be used in 15% to 11% of cases.

The cost-reduction measure is rated the second in the composite rating of anti-crisis measures. In 2012, 51% of enterprises was prepared to resort to the above measure, against 46% in autumn 2011. It is to be noted that that measure turned out to be the only one whose mention was insignificant, but it increased in 2012 as compared to 2011. In iron and steel industry (69% of mentions), chemical industry (64%), food industry (54%) and wood industry (51%), the cost-reduction measure is rated the first on the basis of the outputs of the 2012 survey.

The output-reduction measure was rated the third by the Russian industry; it is the extent of reduction of output by which the government and experts judge about unfolding of the crisis. Only 43% of enterprises are ready to resort to that measure, though in autumn 2011 similar plans were approved by 54% of plants which situation ensured the second place for that anti-crisis measure. The most dramatic output reduction will take place in the iron and steel industry (56% and 89% of enterprises of that industry reported about that now and in autumn 2011, respectively), building industry (55% and 69%), chemical industry (51% and 56%) and engineering (47% and 63%).

More active marketing and search for new buyers and sales markets will be the fourth most popular measure in the industry. In 2012, 39% of enterprises were prepared to resort to that measure, against 44% in autumn 2011. The above 'classical' steps are likely to meet tough resistance on the part of other manufacturers whose markets become endangered as a result of such an intrusion. According to our latest survey of the sentiments and limitations in that sphere, such an impediment for access to new sales markets is expected by 45% of enterprises.

The pricing factor is rated the fifth – with 27% of mentions – in the composite rating of anti-crisis measures in 2012. The same share of enterprises planned to resort to a price reduction in 2011, however, at that time the result in question could ensure the eighth place only. But as (according to evaluations of enterprises) the importance of a larger part of anti-crisis measures diminished during the past few months, the pricing factor moved three positions upward.

Only 23% of enterprises in the industry in general are prepared to agree on delayed receipt of payments from buyers of the produce. In 2011, such delays in payments were approved by 28% of plants, but work in conditions of tough demand limitations permitted enterprises to keep only reliable customers which factor probably reduced the likelihood of non-payments in case of new aggravation of the crisis.

Non-cash forms of settlements (whose renewal was so much feared about in 2008) have small chances to emerge in the Russian industry: only 10% of enterprises in 2012 (12% in 2011) approved them in case of the second wave of the crisis. The building materials industry may become the absolute leader with at least 20% of enterprises prepared to approve such measures in order to support output.

Anti-Crisis Measures of the Russian Industry during the First Wave of the Crisis

For the sake of comparison, it is worthwhile to consider the plan of anti-crisis measures of the Russian industry during the first wave of the crisis. As was stated above, the analysis of those plans was prepared by the Institute for Economic Policy as early as November 2008 when the country was in the dark and the government only cautiously looked out of its “safe haven” on the storm of the global crisis. The above analysis permitted to receive the first-hand and trustworthy information on the initial (2008) anti-crisis package of the Russian industry.

In the beginning of the crisis, nearly all the enterprises (84%) planned to reduce the cost of production (see *Fig. 22*). Late in 2008, that measure was absolutely justified as in the pre-crisis period the most intense growth in costs was registered from 1999. Only 9% of enterprises declared that they were unlikely to resort to the above measure.

In 2008, the output reduction measure was rated the second both in the industry in general and all the sectors (except for the food industry), in particular. The widespread willingness in the industry to reduce output deserves positive assessment as it means that enterprises are ready to follow the recessionary decline of the solvent demand, rather than work for a warehouse or resort to non-cash forms of settlements. Only 21% of enterprises declared at that time about their open unwillingness to reduce the output even in a situation of the declining demand.

Utilization of survival measures typical of the 90s was planned rather rarely in the Russian industry in 2008. Non-cash forms of settlements were the last in the rating of the industry’s anti-crisis measures. Only 38% of enterprises were ready to resort to them, while 56% answered straightforwardly that they would try to avoid them. The latter value turned out to be the maximum one in assessment of the unacceptability of anti-crisis measures. Work for a warehouse and accumulation of stocks of finished products from which the Russian industry suffered much in the 90s turned out to be an unpopular anti-crisis measure in 2008; only 42% of enterprises were prepared to resort to that measure with 54% of enterprises explicitly against it.

Search for new markets and buyers – which measure 69% of enterprises were ready to approve – was sooner a tribute to a book tradition, rather than a real anti-crisis measure in Russian conditions because the extent of a drop in the industrial production along with high protection of markets by traditional manufacturers did not contribute at all to accessibility of those markets by new manufacturers. However, active market position of the Russian industry does impress.

Reduction of wages and salaries, underemployment and unpaid leaves were rated the fourth most popular measure in December 2008 with 62% of enterprises being ready to resort to it. Lay-offs yielded much to other anti-crisis measures which were not related to reduction of personnel. Only 46% of enterprises were ready to use that measure. Large-scale labor shortages which the Russian industry encountered with in 2006 and degradation of the system of the vocational and technical education definitely prevented enterprises from planning more large-scale lay-offs. The industry preferred to maintain redundant personnel in order to have an opportunity to promptly increase output soon after the crisis was over, rather than search for new workers.

The pricing factor was expected to be used in overcoming of the crisis by nearly a half of enterprises in the industry as a whole. However, in the iron and steel industry which encountered with the crisis earlier than other sectors 93% of enterprises were ready to resort to that measure (if only they did not actually start to use it then) and only 7% of enterprises declared

that they would try to avoid that. Quite the opposite plans were in the iron and steel industry where only 30% of plants were prepared to reduce prices, against 70% which planned to avoid that.

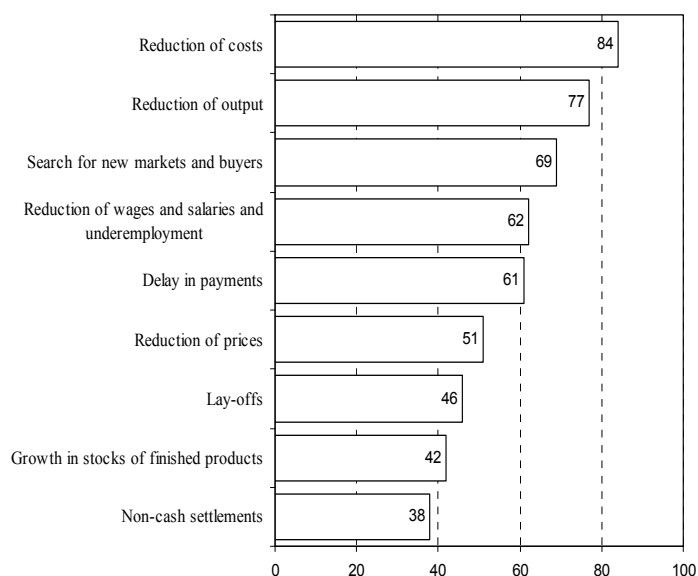


Fig. 22. The reaction planned in December 2008 to the crisis of the Russian industry, % enterprises

During the crisis of 2009–2010, enterprises' anti-crisis plans were subjected to adjustment; it is to be noted that all the measures lost their popularity, but to a different extent. Reduction of the extent of anti-crisis measures can be explained in our view by the specifics of the unfolding crisis. The main blow of the crisis fell into the end of 2008, while as early as the 1st quarter of 2009 the industry started its exit from the crisis. Such dynamics was explicit both in analysis and utilization of the outputs of the surveys which were received by the respondents. The latter factor permitted them not only to develop effectively anti-crisis plans, but also adjust them.

Output-reduction plans (that is the measures whose monitoring continued in the 2009–2010 period) were subjected to the most serious adjustment. By the 2nd quarter of 2009, the popularity of the above measure in plans of the Russian industry decreased by nearly a half (from 77% to 40%), by the 3rd quarter 31% of enterprises was prepared to further reduce output volumes and by the end of 2009 and early in 2010 such plans remained with 25% of plants. So, according to enterprises' estimates by the end of monitoring of the first wave of the crisis the need to reduce output decreased by 66.7 % in the Russian industry.

Reduction of wages and salaries, incomplete work week and unpaid leaves became the second most popular measure which was monitored all the time. Popularity of that measure declined considerably in the 2008–2010 period, too. As early as the 2nd quarter of 2009, the above measure lost 20 p.p. and remained in the plans of only 42% of enterprises, while early in 2010 it was planned to be used by 28% of enterprises. However, even with that value the anti-crisis measure in question was rated the second most popular one in 2010.

Popularity of lay-off plans in response to a recessionary drop in demand underwent principal changes by the 2nd quarter of 2009 and stabilized after that in the range of 27%–32% until the end of the first wave of the crisis. There were two factors which could predetermine such

a cautious utilization of that classical anti-crisis measure in the Russian industry. First, the abovementioned shortages in skilled workers in the pre-crisis period when a lack of personnel hindered growth in output with a half of industrial enterprises were replaced by a recessionary redundancy just for three quarters of 2009 to be followed by growth in the share of the “insufficient” answers in the industry in evaluation of the number of workers, which share exceeded by the mid-2010 the share of the “more than sufficient” answers. Second, the government’s anti-crisis policy in that area restrained the rate of lay-offs at enterprises, too.

In the 2008-2010 period, popularity of a delay in payments as an anti-crisis measure decreased only by half, that is, from 61% to 32%. Utilization of non-cash forms of settlements as a means of support of output in a situation of a dramatic drop in demand was rated the fifth most popular measure by the Russian industry during the first wave of the crisis and could be accepted at 25% of enterprises. It is to be noted that in 2009-2010 period acceptability of such a measure fluctuated within a very narrow range which factor points to a stable attitude of the industry to that popular anti-crisis measure of the 90s, while the absolute values can serve as evidence of extremely low intentions of enterprises to use non-cash settlements. The only exception was the building materials industry where 36% of enterprises approved such settlements.

In the 2009–2010 period, in the anti-crisis plans of the industry reduction of prices was rated the sixth most popular measure and was planned by 20%–28% of enterprises in the industry in general.

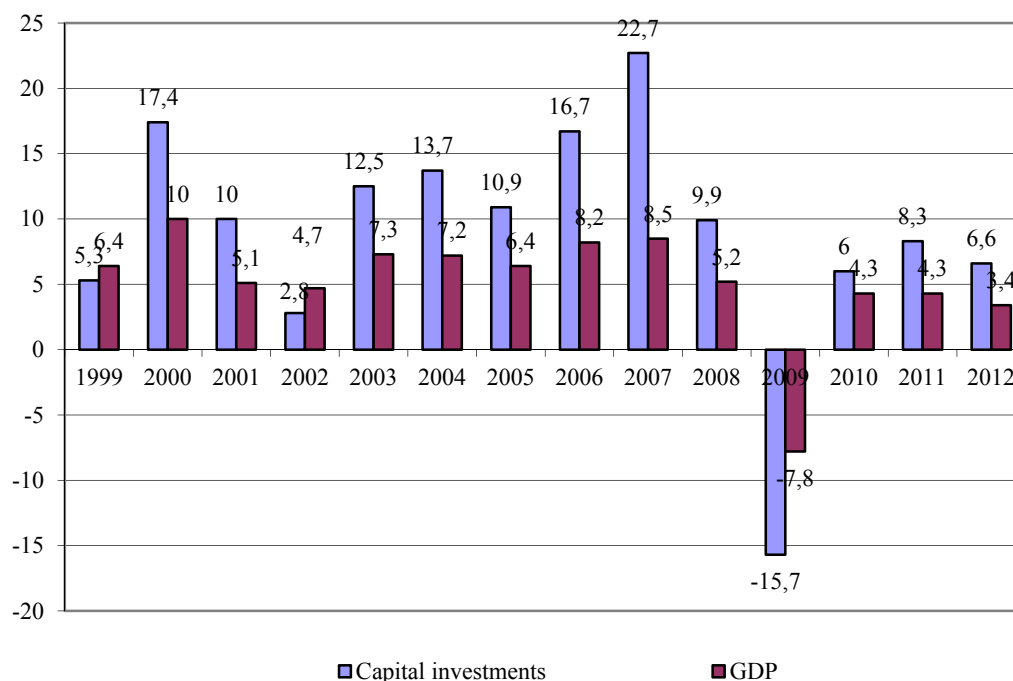
The experience related to overcoming of the crisis phenomena in the 2008–2009 period permitted the Russian industry to select a new system of priorities in solution of the problems related to a possible outbreak of the second wave of the crisis. First, a smoother nature of the new spiral of the crisis and a long preparatory period (and, probably, a partial implementation of measures) reduced the rate of the expected application of most anti-crisis measures. Only such measures as reduction of wages and salaries and underemployment will be utilized by enterprises more often than in 2009–2010 period and at the beginning of the first wave of the crisis. It seems that due to the fact that the problems related to training of personnel remained unsolved the above measure was rated the first in 2012. The situation is supplemented by the most moderate lay-offs plans in the entire period of monitoring. Second, a number of the most unpleasant measures (developments) may not be used (take place) at all during the second wave of the crisis. It concerns changes in the ownership structure, non-cash settlements and suspension of enterprises’ operations. Though delays in payments are expected by enterprises, the extent of that measure is the most moderate in the entire period of monitoring. Third, according to the plans of enterprises a recessionary drop in output will not be as large-scale as late in 2008 which situation, probably, makes it easier for the industry to go through the second wave of the crisis, but at the same time it will be difficult to identify it on the basis of the official statistics data and due to that factor the government’s anti-crisis measure may not be used timely. If in 2008 the official statistics failed to be timely, at present it may lack clarity.

4.3. Investment activities

4.3.1. Domestic capital investments

In 2010–2011, business activities in the investment sector were characterised by a faster rate in growth than that of the GDP. However, the effects of the deep investment crisis in 2008 - 2009 were overcome only in 2012. In 2012, capital investments were 3.2% higher than

in 2008. In 2012, with the GDP growth at a level of 103.4% compared to the previous year and with capital investments of 106.6%, the share of capital investments in GDP had almost reached the level of 2007 and amounted to 20.2%.



Source: Rosstat.

Fig. 23. Capital investments and GDP in 1999 - 2012, as % of the previous year

The different behaviour of institutional business entities significantly affected how the crisis developed. In the acute crisis phase, when compared to small businesses, the large and medium-sized businesses were forced to pursue a more assertive policy to reduce investment costs. Despite the slowdown in investment activity in 2011, the volume of investments in the small businesses sector for that year almost reached the pre-crisis level of 2008, and then significantly exceeded it in 2012.

The dynamics of capital investments of large and medium-sized businesses in the post-crisis period were quite unstable, and in 2012 this sector recorded a sharp slowdown in investment activity. As a result the capital investments of large and medium-sized businesses amounted to 96.4% of the 2008 pre-crisis level.

It should be noted that the changes in the performance of large and small businesses and organisations was of an opportunistic nature and did not reflect the fundamental changes in the investment climate. Another fundamental point was the change in the structure of the financing of capital investments in 2009–2012. The slow recovery rate of the domestic market, and of income, determined the stronger emphasis on the use of businesses’ own funds to finance investment programmes. In late 2012, the share of businesses’ own funds in the structure of capital investments increased to 45.4% and exceeded the level of the previous year by 3.5 percentage points.

Table 12

Growth in the volume of capital investments, as a % of the previous year

	2008	2009	2010	2011	2012
Capital investments (across the full range of organisations, including adjustments for investments not observed through direct statistical methods)	109.9	84.3	106.0	108.3	106.6
Large and medium-sized businesses (capital investments, excluding small businesses and investments not observed through direct statistical methods)	105.6	82.5	105.1	110.4	100.7

Source: Rosstat.

Table 13

Investments in fixed capital by sources of funding (excluding small businesses and investments not observed through statistical methods), as a % of the total

	2007	2008	2009	2010	2011	2012
Capital investments - total	100	100	100	100	100	100
Including by sources of funding:						
Own funds	40.4	39.5	37.1	41.0	41.9	45.4
Profit disposable by the business (accumulation fund)	19.4	18.5	16.0	17.1	17.9	NA
Borrowed funds	59.6	60.5	62.9	59.0	58.1	54.6
Including:						
Bank loans	10.4	11.8	10.3	9.0	8.6	7.9
Including loans from foreign banks	1.7	3.0	3.2	2.3	1.8	1.2
Borrowed funds of other organisations	7.1	6.2	7.4	6.1	5.8	5.4
Budgetary funds	21.5	20.9	21.9	19.5	19.2	17.9
Including:						
Federal funds	8.3	8.0	11.5	10.0	10.1	9.6
Budgetary funds of the subjects of the Russian Federation	11.7	11.3	9.2	8.2	7.9	7.1
Extra-budgetary funds	0.4	0.3	0.3	0.2	0.2	0.2
Other	20.1	21.2	23.0	24.1	24.3	23.1
Including:						
Funds of superior organisations	11.3	13.8	15.9	18.0	19.0	17.8
Funds from the equity in the construction (businesses and individuals)	3.7	3.5	2.6	1.9	2.0	2.0
Including funds derived from the public	1.5	1.9	1.3	1.1	1.3	1.3
Funds from the issuance of corporate bonds	0.1	0.1	0.1	0.01		
Funds from the issue of shares	1.8	0.8	1.0	1.4	1.0	1.0
Foreign investments in the total investments in fixed capital	5.4	4.3	4.3	3.8	3.1	2.7

Source: Rosstat.

Although in 2012 the main sources of financing of capital investments were borrowed funds, which accounted for 54.6% of the total investments in the economy, their structure was changed. The share of the budget in such sources decreased from 19.2% in 2011 to 17.9% in 2012. The share of budget funds used for capital investments in GDP was 2.52% of GDP in 2012 against 3.41% of GDP in 2009, including federal budget funds (1.35% against 1.78%, respectively).

The public demand for the products and services of Russian companies was supported through the implementation of planned investment projects in transportation, telecommunications, etc. implemented under FTP and FTIP. According to the federal targeted investment programme, approved by the Russian Ministry of Economic Development, a provision of RUR 755.3 billion was made in 2012 (with updates as at 1 January, 2013), including federal budget funds of RUR 719.0 billion. In 2012, RUR 492.4 billion from the federal budget and RUR 29.4 billion from the budgets of the subjects of the Russian Federation and other sources were allocated under the annual limit. In 2012, there were plans to commission 1,430 projects. Of these 562 projects were commissioned at full capacity and 64 projects were partially commissioned. On 1 January 2013, the technical readiness of 710 sites (with no facilities, as

the design and survey works for future construction are still in progress) ranged from 51.0% to 99.9%.

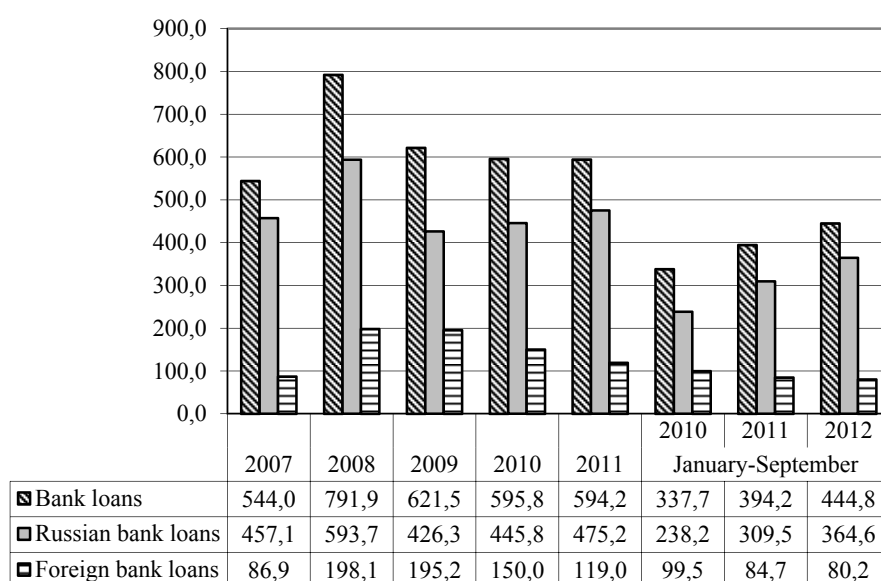
Table 14

Facilities provided in the targeted investment programme, and the amount of state capital investment for 2012 (excluding construction projects and facilities included in the state defence order)

	Number of sites		Commissioned		State capital investment limit		Financed from the federal budget	Investment utilised from all sources
	Total	Including those with commissioning dates in 2012	At full capacity	Partially	Total	Including from the federal budget		
	Units				Bn. RUR			
Total	3,777	1,430	562	64	755.3	719.0	492.4	468.7
Including:	132	58	39	6	5.1	5.1	5.0	5.0
Agriculture, hunting and forestry								
Fishing and fish farming	21	5	-	-	2.1	2.1	NA	1.3
Processing industry	51	11	1	-	8.3	7.0	NA	2.6
Production and distribution of power, gas and water	39	14	-	-	44.5	42.5	30.5	40.7
Construction	105	49	14	4	18.0	15.2		13.7
Transportation and Communication	608	279	124	15	310.5	299.0	241.7	234.9
Real estate, rent and services	1307	136	22	5	149.4	142.9	NA	32.1
Public administration and defence;	695	515	294	14	55.3	54.4	40.9	35.1
Education	207	110	24	12	40.6	38.3	32.0	29.3
Public health and social services	187	93	26	6	60.3	57.0	44.2	38.4
Other utility, social and personal services	414	158	18	2	59.0	53.4	NA	33.7
Other activities	11	2	-	-	2.2	2.2	NA	1.9

Source: Rosstat.

Before the crisis in 2008 the restructuring of the financing of capital investments was associated with increased activity in the banking sector, increasing public investments in residential housing and a heavy influx of foreign capital. Since 2009, the share of borrowed funds to finance capital investments has shown a strong trend towards a narrowing of the participation of banking and debt capital. Moreover, we note that the very slow recovery of the credit activity of domestic banks did not overlap the decline in loans from foreign banks. In 2011, the share of loans in borrowed funds was 13.4% and had decreased by 4.1 percentage points compared to 2007. In 2012, the share of bank capital in borrowed funds remained at about the level of 2011, and the ratio of loans had changed to increase the share of the domestic banks.



Source: Rosstat.

Fig. 24. Bank loans to finance capital investments in 2007–2012, Bn. RUR

The crisis of 2008 was characterised by steeper rates of decline in foreign loans and of investments in the Russian economy relative to the domestic capital. In 2011, direct foreign investment in the Russian economy amounted to 66.2% as compared to 2007 with an increase in domestic investment of 6.3%. In 2012, the overstripping growth of internal investments (106.6% of the previous year) continued with respect to direct foreign investment (101.4% of the previous year). As a result, the share of foreign investment in total capital investment in 2012 decreased to 2.7% from 3.1% in 2011. The discreet participation of Russian and foreign private capital to finance investments was defined by the disinvestment trends existing in 2008. In 2012, the net outflow of capital amounted to USD 56.8 billion. In contrast to the previous year, an absolute reduction of capital outflow was associated with the inflow of capital through the banking sector. The outflow of capital to other sectors of the economy in 2012 had increased and reached 80.4 billion dollars.

Table 15

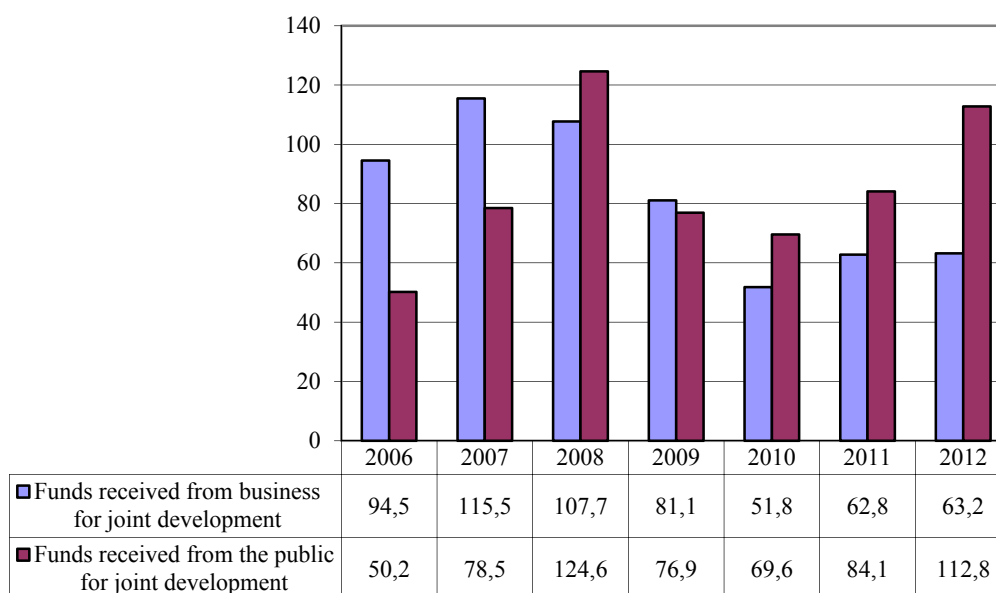
Net inflow/outflow of capital from the private sector according to the balance of payments, Bn. USD

	Net inflow/outflow of capital from the private sector, Total	Net inflow/outflow of capital from banks	Net inflow/outflow of capital from other sectors
2007	81.7	45.8	35.9
2008	-133.7	-56.9	-76.8
2009	-56.1	-30.4	-25.8
2010	-33.4	15.9	-50.3
2011	-80.5	-24.2	-56.4
2012	-56.8	23.6	-80.4
QI	-33.3	-9.7	-23.5
QII	-6.4	11.6	-18.0
QIII	-7.6	7.6	-15.2
QIV (estimate)	-9.4	14.2	-23.6

Source: Central Bank of the Russian Federation.

In analysing the changes in the financing of capital investments, it is necessary to note the features of the financing of housing construction. In 2009, there was a reversal in housing construction trends. Following the steady increase in housing construction during 2001 - 2008, the level of commissioning of residential buildings in 2011 fell by 2.8% compared to the pre-crisis level in 2008.

In 2011, the absolute reduction of investment in housing construction suspended (including small businesses and adjustments). In 2012, the growth of population funds for joint development was RUR 28.7 bn. compared to the previous year. Increasing investments by members of the public was supported by an increasing demand for loans. The volume of residential loans in 2012 amounted to RUR 1,053.6 billion against RUR 746.0 billion in the same period in 2011.

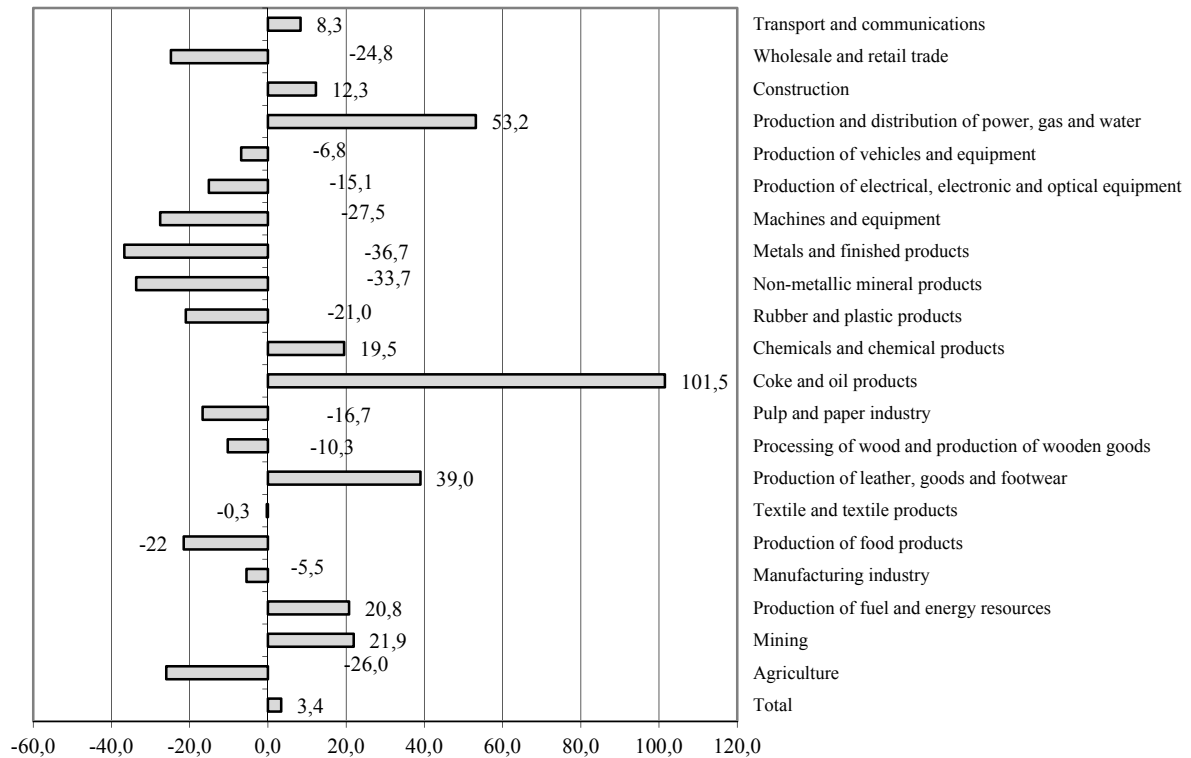


Source: Rosstat.

Fig. 25. Funds received for joint development in 2007 - 2012, bn. RUR

Analysis of capital investments in 2009 - 2012 allows the identification of common and specific features of the change in investment demand by different types of activity. In 2009 - 2012, the structural changes in capital investments were determined by the increased share of industry in total capital investment (excluding small businesses). In 2012, industry accounted for 5.3% of capital investment in the economy compared to an average of 44.5% in 2011–2010. In 2012, investment in industry increased by 7.2% compared to the previous year. There was quite a significant differentiation of rates by economic activity. The recovery was defined both by the higher rate of growth of the fuel and energy sector and of the mining industry, together with higher growth rates of investment demand. Investments in the fixed capital of mining industries production in 2012 compared to 2008 increased by 21.9%; in the production and distribution of power, gas and water by 53.2%, meanwhile in the manufacturing industries overall investment only amounted to 94.5% of the pre-crisis level. The highest rates of growth in investment in manufacturing industry in 2009 - 2012 were observed in the production of coke and oil products, in chemical production and in the production of leather goods and shoes. Investment activity in the production of machin-

ery, equipment and vehicles remained below the pre-crisis levels of 2008. Regarding other economic activities, the rapid growth of investment in pipeline construction should be noted.



Source: Rosstat.

Fig. 26. Capital investments in 2012, as a % of 2008

An analysis of the performance and structure of investments indicates that the recovery of investment activity in the machine-building industry is much slower compared to other economic activities.

According to a sample survey of investment activity conducted by Rosstat, the main purpose of capital investments, as in previous years, has been to replace worn-out equipment and machinery. The structure of capital investments in 2009 shows a steady increase in expenditure for the purchase of machinery, equipment, vehicles, and an increasing shift towards domestic equipment. We must not overestimate the importance of these changes, given the poor development trends and status of production facilities in the Russian machine-building sector.

The existing structure of capital investment related to the type of economic activity with a high proportion going towards the fuel and energy industries and their associated vehicles, has apparently exhausted itself. There is a growing imbalance between investment performance and the production of capital goods. The replacement of fixed assets is slowing down. There are no significant changes in favour of innovative production in manufacturing industry or of improvements in the quality of the labour force. The rapid growth of investments, increasing of the share of investment in GDP at the pre-crisis level with a slowdown in the growth of GDP, is leading to an increased capital intensity for production but this not supported by increased labour productivity.

Table 16

Capital investments by type of fixed assets in 2007–2012 (excluding small businesses and parameters of the informal economy)

	2007	2008	2009	2010	2011	2012
In bn. RUR, for each year						
Capital investments	4,908.2	6,272.1	5,769.8	6,413.7	7,701.2	8,764.7
Including:						
Houses	371.8	467.2	343.5	372.3	361.8	418.4
Buildings (excluding residential) and other construction	2,436	3,286.8	3,221.2	3,495.8	4,172.5	4,574.1
Machinery, equipment, vehicles	1,736	2,071.3	1,798.2	2,109.6	2,644.3	3,175.7
Including:						
Purchase of domestic machinery, equipment and vehicles	1,427.5	1,656.9	1,426.4	1,729.8	2,152	2,661.2
Purchase of imported machinery, equipment and vehicles	308.5	414.4	371.8	379.8	492.3	514.3
Other	364.4	446.8	406.9	436	522.6	600.4
Share, as a % of total						
Capital investments	100	100	100	100	100	100
Including:						
Buildings (excluding residential) and other construction	7.6	7.4	6.0	5.8	4.7	4.8
Machinery, equipment, vehicles	49.6	52.4	55.8	54.5	54.2	52.7
Including:	35.4	33.0	31.2	32.9	34.3	36.2
Purchase of domestic machinery, equipment and vehicles						
Purchase of imported machinery, equipment and vehicles	29.1	26.4	24.7	27.0	27.9	30.3
Buildings (excluding residential) and other construction	6.3	6.6	6.4	5.9	6.4	5.9
Other	7.4	7.1	7.1	6.8	6.8	6.8
For reference:						
The share of purchased imported machinery, equipment and vehicles in the total investment in machinery, equipment and vehicles	17.8	20.0	20.7	18.0	18.6	16.2

Source: Rosstat.

4.3.2. Foreign investments

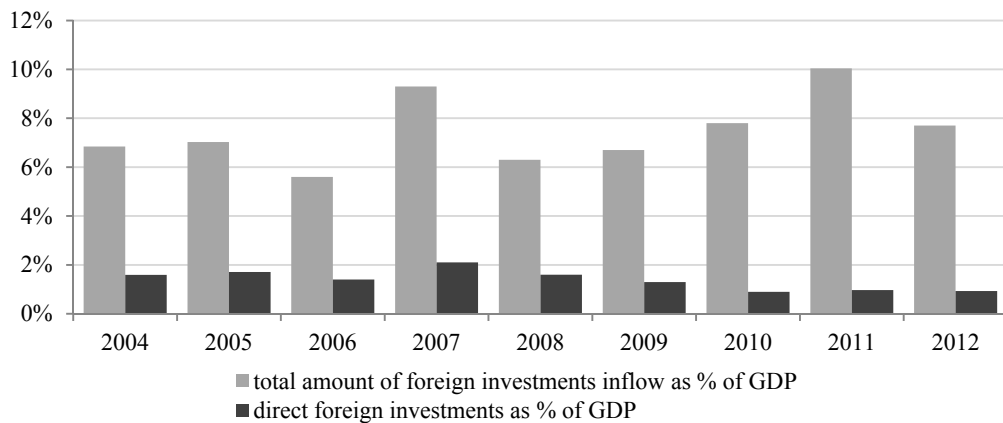
The year of 2012 was characterized by lower interest of foreign investors in the economy of Russia. Foreign investments in the Russian Federation decreased by 18.9% to \$154.6bn in 2012 against 2011. In 2012, a total of \$136.6bn or 88.3% of foreign investment inflow at that period (against 86.6% in 2011) was withdrawn as returns on foreign investments transferred from Russia to other countries, as well as payments of loan interests and repayment of loans. Capital outflow by the foregoing items decreased by 17.3% against 2011. In 2012, Russian investments in other countries reached \$149.9bn, a decrease of 1.2% against 2011, and accounted for 97.0% of total investments in the economy of Russia (against 79.6% in 2011).

Inflow of foreign investments in the economy of Russia as percentage of GDP decreased from 10.0% in 2011 to 7.7% in 2012

In spite of the decrease, foreign investments inflow in the economy of Russia in 2012 remained higher than that prior to the crisis.

Aggregate values decreased in response to a \$37.3bn decrease in other investments.

Direct investments increased by \$251m. Contributions to charter capital, and loans from foreign joint owners of companies accounted for most of direct investments. The former increased by 1.9% to reach \$9.2bn in 2012. Loans obtained from foreign joint owners of companies increased by 2.3% to reach \$7.7bn. Thus, loans from foreign joint owners of companies saw an increase from 40.7% in 2011 to 41.1% in 2012, whereas contributions to charter capital remained at the preceding year level and stood at 49.5% (against 49.3% in 2011) in the structure of direct foreign investments in the Russian Federation.



Source: Federal State Statistics Service of Russia.

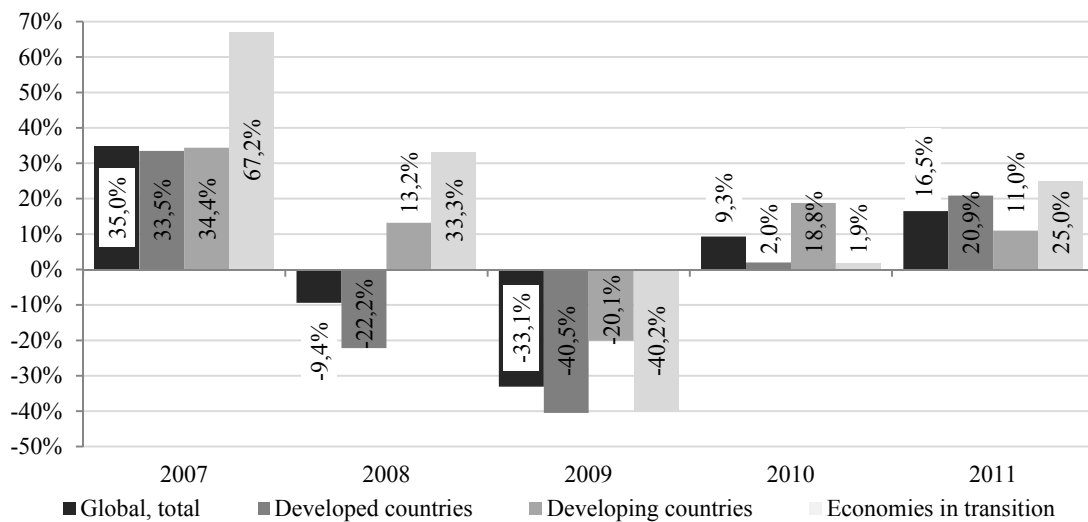
Fig. 27. Foreign investments inflow in the economy of Russia in 2004–2012 (as % of GDP)

Table 17

Structure of foreign investments in the economy of Russia¹

	millions of US dollars				As % of the previous year			
	Total	Direct investments	Portfolio investments	Other investments	Total	Direct investments	Portfolio investments	Other investments
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
2012	154,570	18,666	1,816	134,088	81.1	101.4	in 2.3 times	78.2

Source: Federal State Statistics Service of Russia.



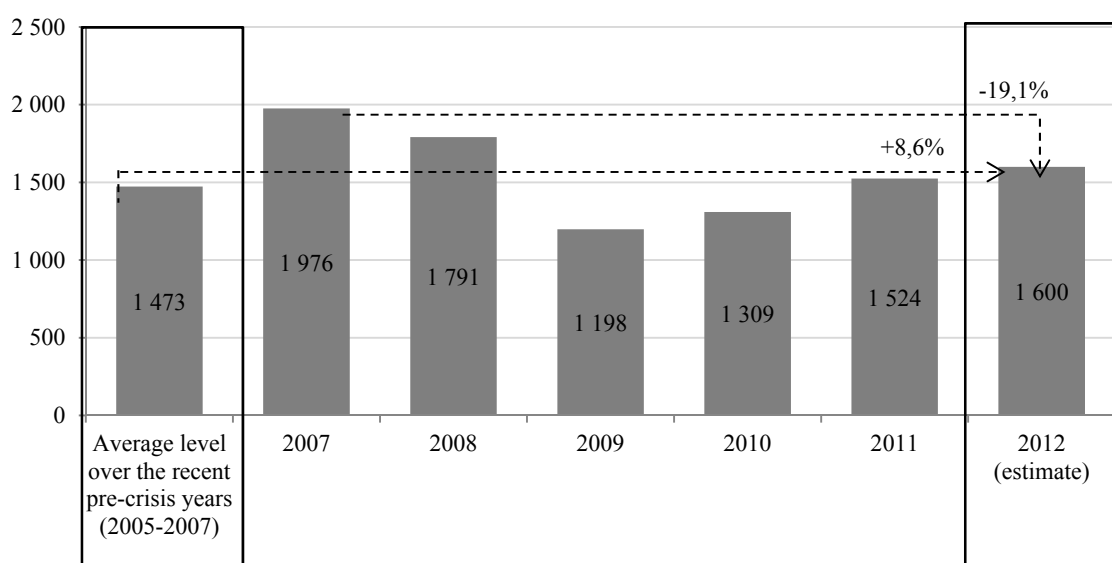
Source: UNCTAD, World Investment Report 2012, 05.07.2012.

Fig. 28. Changes in direct foreign investments inflow worldwide in 2007–2011

¹ Direct investments – investments in real assets, acquisition of a control interest or a corporate governance interest; portfolio investments – investments in securities for the purpose of generating returns on investments only; other investments – revolving investments (loans from international credit institutions, trade loans, etc.).

According to the UN Conference on Trade & Development (UNCTAD, World Investment Report 2012) report on investments which was published in July 2012, по объему привлеченных direct foreign investments in 2011 the Russian Federation was ranked 8 in the world (according to refined data, it was ranked 8 in 2010 and 6 in 2009 thru 2008). According to the foregoing report, in 2011 Russia accounted for 3.5% of direct foreign investments worldwide (3.3% in 2010, 3.0% in 2009, 4.2% in 2008) and 6.8% of direct foreign investments in developing countries, and economies in transition (6.3% in 2010, 6.3% in 2009, 9.7% in 2008).

According to the UNCTAD report, in 2011 total direct foreign investments worldwide remained lower than the peak level of 2007. According to preliminary estimates, in 2012 total direct foreign investments may amount to \$1.5 to \$1.7 trillion, in 2013 it is expected to grow up to \$1.6 to 1.9 trillion, in 2014 up to \$1.7 to 2.1 trillion. Such a scenario may be realized as long as no serious problems are faced by the global economy.



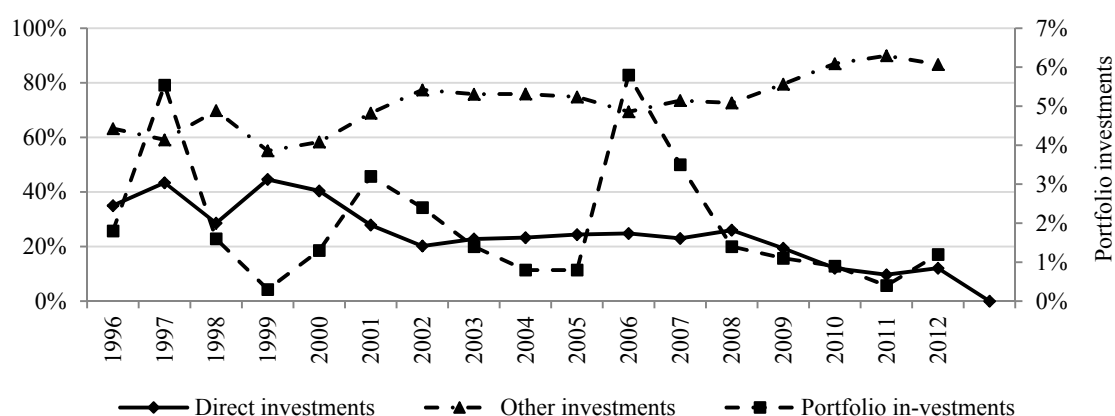
Source: UNCTAD, World Investment Report 2012, 05.07.2012.

Fig. 29. Direct foreign investments inflow worldwide, billions of US dollars

With regard to the portfolio investments inflow in the economy of Russia, a growth of 2.3 times was reported in 2012 against 2011. Furthermore, investments in stocks and units increased by 2.7 times in the structure of portfolio investments, thereby increasing its share from 71.7% in 2011 to 84.4% in 2012

Trade-related loans increased from 16.2% in 2011 to 20.9% in 2012 in the structure other investments. With regard to term of loans, loans with a maturity of more than 6 months increased in 2012 to 39.5% against 28.3% in 2011, whereas loans with a maturity of less than 6 months decreased to 33.2% (against 53.4% in 2011).

In 2012, the structure of foreign investments in the economy of Russia saw changes against the preceding year.



Source: Federal State Statistics Service of Russia.

Fig. 30. Structure of foreign investments in the economy of Russia in 1996–2012

In 2012, concentration of foreign investments remained in the financial sector, financial business, industrial production sector, and trade industry. На данные сферы of the economy in Russia in 2012 accounted for 89.3% of total foreign investments inflow (against 90.5% in 2011) in the Russian Federation. Investors heightened their interest in the industrial production sector, trade industry, and real estate business as investments in transport and communications continued to decline, and investments in financial business decreased.

Distribution of foreign investments by key sector of the economy in Russia is presented in Table 18.

Table 18

**Sectoral structure of foreign investments in the economy of Russia
in 2010–2012**

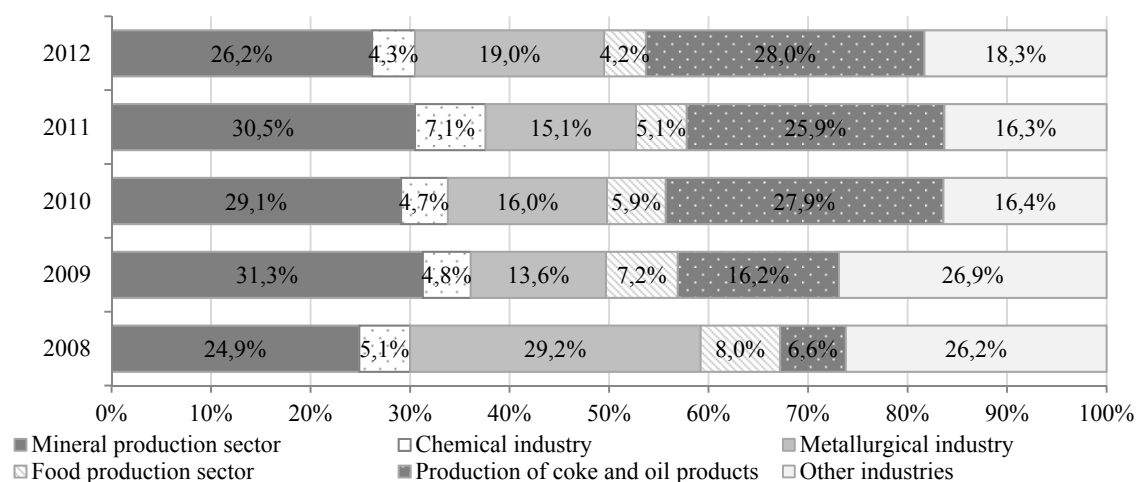
	millions of US dollars			Changes as % of the previous year			as % of total		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
Production sector	47,558	61,145	69,201	144.2	128.6	113.2	41.4	32.1	44.8
Transport and communications	6,576	5,943	4,622	47.8	90.4	77.8	5.7	3.1	3.0
Wholesale and retail trade; repair of motor vehicles, motor bikes, household items and personal articles	13,334	24,456	25,379	58.5	183.4	103.8	11.6	12.8	16.4
Real estate business, leasehold, and provision of services	7,341	9,237	10,035	92.5	125.8	108.6	6.4	4.8	6.5
Financial business	37,913	86,885	43,395	1426.3	229.2	49.9	33.0	45.6	28.1
Other industries	2,024	2,977	1,938	111.8	148.1	65.1	1.8	1.6	1.2

Source: Federal State Statistics Service of Russia.

The secondary industry was leading in terms of growth within the structure of foreign investments in the industrial production sector in 2012. Investments in secondary industry sectors increased by 19.8% against 2011 (a growth of 23.9% in 2011). Foreign investments in the mineral production sector decreased by 2.6% (a growth of 34.5% in 2011).

In the secondary industry, investments in the production of coke and oil products increased by 22.4% and in the metallurgical industry by 42.2%, reaching \$19.4bn and \$13.1bn, respectively (in 2011, investments in production of coke and oil products increased by 19.4% and in the metallurgical industry by 21.1%). In 2012, foreign investments in chemical and food manufacturing industries decreased by 31.8% and 6.6%, to \$3.0bn and \$2.9bn, respectively,

against 2011 (in 2011, foreign investments in these sectors doubled and increased by 10.6%, respectively).



Source: Federal State Statistics Service of Russia.

Fig. 31. Structure of foreign investments in the industrial production sector in 2008–2012

Portfolio and other investments in the industrial production sector increased by 2.2 times and 14.3% in 2012 against 2011 (in 2011, portfolio investments in the industrial production sector increased by 39.9%, other investments grew up by 26.4%). Direct investments in the industrial production sector increased slightly by 1.0% (2011 saw a growth of 40.6%). Thus, other investments in the industrial production sector increased from 83.5% in 2011 to 84.3% in 2012, portfolio investments increased from 0.9% to 1.8%, whereas direct investments decreased from 15.7% to 14.0%, respectively, at that period.

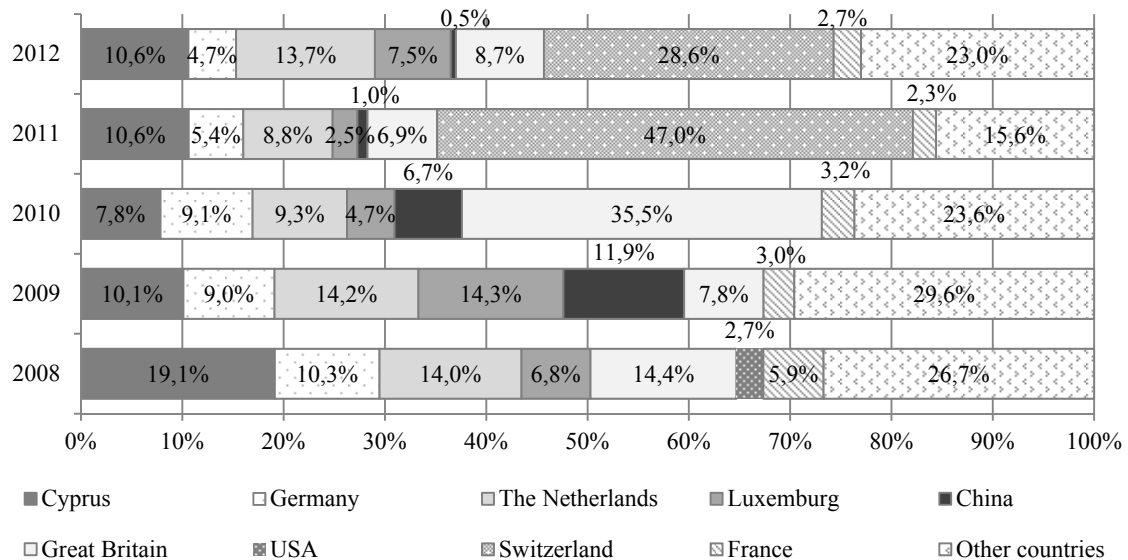
Changes were noted in the structure of foreign investments by type of economic activity in the industrial production sector of economy. In 2012, direct investments in the mineral production sector reduced by 23.7% to \$3.5bn, thereby shrinking their share to 19.4% in total investments in this industry (against 24.8% in 2011). Other investments in the mineral production sector, which increased by 4.9% to amount to \$14.6bn in 2012, increased to 80.2% (against 74.4% in 2011).

Other investments dominated in the secondary industry in 2012. They were increased by 17.1% against 2011 to finally account for 86.3% of investments in the secondary industry (against 88.3% in 2011). Direct foreign investments in secondary industry sectors increased by 21.7%. In 2012, direct investments accounted for 11.6% of the secondary industry (against 11.4% in 2011). Portfolio investments increased by 8.7 times, their share grew up to 2.1% in secondary industry sectors (against 0.3% in 2011).

Changes in the list of countries as large suppliers of capital to the Russian Federation come under notice in the geographic structure of foreign investments in the economy of Russia in 2012. The biggest inflow of investments in the Russian Federation, more than \$44bn, came from Switzerland, \$21.1bn from the Netherlands in 2012. At the year-end (2012), the list of top-3 leading suppliers of capital in the Russian Federation also included Cyprus who invested \$16.5bn in the economy of Russia.

In 2012, investments from Luxemburg showed the highest growth, 2.5 times against 2011, investments from the Netherlands increased by 25.6%, investments from Great Britain grew

up by 2.9%. Investments from China decreased by 60.8%, investments from Cyprus, Germany, and France declined by 18.8%, 29.8%, and 3.7%, respectively. The difference in dynamics of investments resulted in changes in the geographic structure of foreign investments in the economy of Russia.



Source: Federal State Statistics Service of Russia. Data on investments from the United States in 2009 thru 2012, from China in 2008, from Switzerland in 2008 thru 2010 are included into other investments.

Fig. 32. Geographic structure of foreign investments in the economy of Russia in 2008–2012

As of the year-end (2012), accumulated foreign capital, net of monetary authorities, commercial and saving banks, including ruble investments converted into US dollars, amounted to \$362.4bn, thereby showing a growth of 4.4% against the beginning of 2012. Direct accumulated investments reduced by 2.3%, whereas other investments increased by 9.8% from the beginning of the year.

As of the year-end (2012), Cyprus, the Netherlands, Luxemburg, China, and Great Britain were leaders accounting for 65.0% of total accumulated foreign investments (against 63.5% in 2011). The top-5 countries as investors accounted for 69.1% of other investments (against 63.2% in 2011), 58.9% of the structure of direct investments, and 59.5% of the structure of portfolio investments (against 66.9% and 22.1%, respectively, in 2011).

Other investments prevailed in the structure of accumulated foreign investments at the year-end (2012), accounting for 60.1% of the same (against 57.1% in 2011). Direct foreign investments accounted for 37.5% of the structure of accumulated foreign investments (against 40.1% in 2011).

4.4. The oil and gas sector

The oil and gas industry remains the primary sector of the Russian economy playing a leading part in shaping state budget revenues and the trade balance of the country. By 2012, the continued high levels of world oil and gas prices had had a positive effect on the development of the oil and gas sectors of the Russian economy. This has ensured high revenues for Russian oil and gas companies and considerable state budgetary income. Oil production in

Russia had reached its maximum level for a period since 1990. At the same time, there had been an observed deterioration in the conditions for oil extraction as well as a decline in oil production from “old” oil fields and considerably higher costs relating to the development of new ones, especially in regions with no infrastructure. In these circumstances additional measures have been taken on tax incentives for the development of new oil fields. At the same time, the tax burden on the gas sector has been raised.

4.4.1. The dynamics of world prices for oil and gas

The situation in the world oil market in 2012 was characterised by the persistence of high world oil prices. The average price for Brent crude oil in 2012 was 112.0 USD/bbl while the price for Russian Urals oil on the world (European) market was 110.3 USD/bbl which was higher than the previous year (*Table 19, Fig. 32*). The main factors explaining the high prices are the increase in oil demand (*Table 20*) due to growth in the world economy, primarily, the economies of China, India and other Asian countries, sufficiently restrained OPEC policy with regard to increase of oil production by member states, the low growth rates of oil production outside of OPEC and geopolitical risks. In 2012 the aggregate oil production quota for OPEC members was 30 million barrels per day, including Iraq which had not been subject to such limitations before, and to Lebanon (this quota actually corresponded to the level of oil production reached by OPEC in 2011). Despite some overproduction by OPEC countries above the official quota, the world oil market was generally balanced and the average oil production by OPEC countries in 2012 (31.4 million barrels per day) was lower than the 2008 level (31.6 million barrels per day). At the end of 2012 oil production by OPEC countries was close to the official quota and in December reached 30.4 million barrels per day.

Table 19

**World oil prices in 2000-2012,
USD/bbl**

	2000	2005	2006	2007	2008	2009	2010
Brent oil price, UK	28.5	54.4	65.2	72.5	97.7	61.9	79.6
Urals oil price, Russia	26.6	50.8	61.2	69.4	94.5	61.0	78.3

cont'd

	2011	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2012
Brent oil price, UK	111.0	118.5	108.9	110.0	110.4	112.0
Urals oil price, Russia	109.1	116.9	106.5	109.0	108.8	110.3

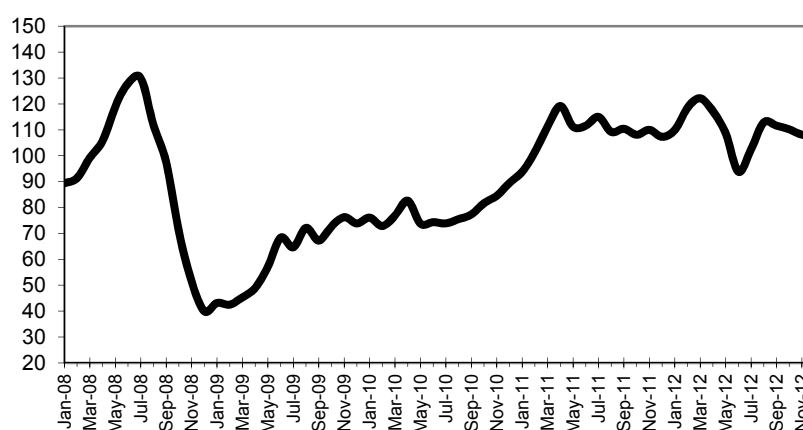
Source: IMF, OECD/IEA.

Table 20

World oil prices in 2000-2012, % change compared with relevant year

	2008	2009	2010	2011	2012
World, total	-0.6	-1.2	3.1	0.9	1.1
OECD countries, including:	-3.6	-4.2	1.3	-0.8	-0.9
North America	-5.2	-3.7	2.0	-0.3	-1.0
Europe	-0.6	-4.7	-0.3	-2.3	-3.6
Asian and Pacific region	-4.0	-4.6	1.8	0.4	4.2
Non-members of OECD, including:	3.3	2.5	5.2	3.0	3.3
Asia (excluding Middle East countries and former USSR countries)	1.7	4.4	7.9	3.2	3.3

Source: OECD/IEA.



Source: Ministry of Economic Development in Russia.

Fig. 33. Prices for Urals oil 2008-2012, USD/bbl

The prices for Russian natural gas on the European market were also quite high, exceeding the level of the preceding year. Prices for natural gas supplied under long-term contracts are determined on the basis of the prices for energy sources which are alternatives to natural gas (mainly, gasoil/diesel fuel and residual oil), and these depend on world oil prices. As a result, world gas prices follow, with a certain lag, world oil prices. The price for Russian natural gas on the European market reached its peak in 2008 while the price minimum occurred in 2010. In 2011-2012, under the conditions of increasing world oil prices, the price for Russian gas on the European market increased considerably (*Table 21*). At the same time, the changing circumstances in the European gas market had a reducing effect on Russian gas prices. In particular this was the increased gas supply from other gas producing countries (especially due to the considerable growth of supply of compressed natural gas) and the lower level of spot-prices for gas, compared to the prices under Gazprom's long-term contracts (*Table 22*). This forced Gazprom to reduce its gas prices on the European market.

Table 21

World prices for oil and natural gas in 2002-2012

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Average world oil price, USD/bbl	24.95	28.89	37.76	53.4	64.3	71.1	97.0	61.8	79.0	104.0	105.0
Price for Russian natural gas on the European market, USD/thousand cubic metres	96.0	125.5	135.2	212.9	295.7	293.1	473.0	318.8	296.0	381.5	431.3

Source: IMF.

Table 22

Price for Russian natural gas on the European market in 2011-2012, USD/thousand cubic metres

	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4
Price for Russian natural gas on the European market	329.4	360.6	401.0	434.9	444.7	452.4	409.9	418.2
Spot-price for Russian natural gas on the European market, Austria	333.6	357.5	344.5	334.2	355.1	350.0	333.7	361.0

Source: IMF, CEGH.

4.4.2. The dynamics and structure of production in the oil and gas industry

The fast growth of oil production in Russia in the first half of 2000 (in 2002-2004 the oil production growth rate reached 8.9-11% per year) was associated with the expansion of oil export opportunities (in particular, due to the creation of the Baltic Pipeline System), intensification of development of existing deposits (in particular, due to the application of the foreign technologies of horizontal drilling and hydraulic fracturing treatment) and expansion of the investment capabilities of oil companies due to the growth in world prices. In later years, oil production growth rates slowed substantially, while in 2008 a shrinkage was observed (Tables 23, 24). This was an indication of the exhaustion of the capacity to increase the country's oil production due to the intensification of development of existing deposits which evidenced the necessity for more proactive development of new oil fields.

In 2012, against a background of high world prices, oil production in Russia reached 518 million tons, which was the maximum level since 1990. The dynamics of oil production were influenced positively by the start-up, in recent years, of several new large deposits in Eastern Siberia (the Vankorskoe, Talkanskoe and Verkhnechonskoe deposits) and in the north of the European part of the country (the Yuzhno-Khylchuyusskoe deposit), as well as by changes in the taxation system, aimed at reducing the tax burden on the oil sector, stimulating further development of existing deposits and the development of new extraction fields.

The reduction in the growth rate of oil production, which has been observed recently, can be explained, primarily, by the objective worsening of the conditions of its extraction. A considerable part of the existing deposits have entered a declining production phase and new deposits are mostly characterised by poorer mining, geological and geographical parameters. Their development requires higher capital, operational and transportation costs.

Table 23

Oil production and refining in the Russian Federation in 2000-2012

	2000	2005	2006	2007	2008	2009	2010	2011	2012
Oil production, including gas condensate, million tons	323.2	470.0	480.5	491.3	488.5	494.2	505.1	511.4	518.0
Primary oil processing, million tons	173.0	208.0	220.0	229.0	236.3	236.0	249.3	258.0	270.0
Oil refining to oil production ratio, %	53.5	44.3	45.8	46.6	48.4	47.8	49.4	50.4	52.1
Depth of crude oil refining, %	71.0	71.6	71.9	71.7	72.0	71.9	71.1	70.8	71.5

Source: Rosstat (Russian Statistics Agency), Ministry of Energy of the RF.

At the same time, in 2012 the growth rates for oil refining remained higher than those for oil production, mainly due to the higher growth rates in exports of oil products, stimulated by lower export duties compared to those on crude oil. In 2005-2012 the growth rates for primary crude oil processing were 3.2-6.2% per year (except for 2009) while oil production growth rates were only 0.8-2.2% per year (excluding 2008). As a result, the oil refining to oil production ratio increased from 42.5% in 2004 to 52.1% in 2012. However, oil refining depth showed practically no increase during this period and was only 71.5% in 2012 (which closely corresponds to the 2005 level).

If we consider a longer period, it can be stated that despite the programme goal set by the government of increasing the oil refining depth, at the moment this figure actually remains close to the pre-reform level (in 1990 the oil refining depth in Russia was 67%) and it is still considerably lower than in developed countries, where the depth of oil refining reaches 90-

95%. The quality of refined oil products produced in Russia is also substantially lower than elsewhere in the world. Modernisation of the oil refining industry is one of the most relevant objectives in the development of the oil sector of the Russian economy.

Table 24

**Production of crude oil, oil products and natural gas in 2000-2012,
% to the preceding year**

	2000	2005	2006	2007	2008	2009	2010	2011	2012
Crude oil, including gas condensate	106.0	102.2	102.1	102.1	99.3	101.2	102.1	100.8	101.3
Primary crude oil refining	102.7	106.2	105.7	103.8	103.2	99.6	105.5	103.3	104.9
Petrol	103.6	104.8	107.4	102.1	101.8	100.5	100.5	102.0	104.3
Diesel fuel	104.9	108.5	107.0	103.4	104.1	97.7	104.2	100.3	98.7
Residual oil	98.3	105.8	104.5	105.2	101.9	100.8	108.5	104.6	101.6
Natural gas	98.5	100.5	102.4	99.2	101.7	87.9	111.4	102.9	97.7

Source: Rosstat (Russian Statistics Agency), Ministry of Energy of the RF.

The largest oil volumes in 2012 were produced by the following oil companies: Rosneft, LUKOIL, TNK-BP, Surgutneftegaz and Gazprom. The share of these five companies was 73.8% of the country's total oil production. The share of medium-sized companies (Tatneft, Slavneft, Bashneft and RussNeft) was 14.3% of the total oil production. Operators of Production-Sharing Contracts produced 2.7% of Russian oil in 2012. The share of other producers, which includes over 100 small oil producing companies, accounted for 8.5% (*Table 25*).

In October 2012 the state oil company Rosneft announced its acquisition of the TNK-BP oil company, which was previously owned by a Russian consortium, AAP and the British company, BP. The total amount of the transaction, which is to be completed in the first half of 2013, is USD 61 billion. Upon completion of the transaction, in addition to its monetary consideration, BP is supposed to obtain 18.5% of Rosneft shares. As a result, BP's share in the Rosneft share capital will be 19.75% (taking into account the 1.25% of Rosneft shares already owned by BP).

The acquisition of TNK-BP by Rosneft is the largest transaction in the oil and gas sector. Before that, the biggest transaction was the 2005 acquisition by Gazprom of 75.7% of Sibneft shares, for USD 13.1 billion (after the takeover by Gazprom, Sibneft was renamed Gazprom Neft).

Table 25

Oil production structure in 2008-2012

	Oil production in 2008, million tons	Share in total production, %	Oil production in 2010, million tons	Share in total production, %	Oil production in 2011, million tons	Share in total production, %	Oil production in 2012, million tons	Share in total production, %
1	2	3	4	5	6	7	8	9
Russia, total	488.5	100.0	505.1	100.0	511.4	100.0	518.0	100.0
Rosneft	113.8	23.3	112.4	22.3	114.5	22.4	117.5	22.7
LUKOIL	90.2	18.5	90.1	17.8	85.3	16.7	84.6	16.3
TNK-BP	68.8	14.1	71.7	14.2	72.6	14.2	72.5	14.0
Surgutneftegaz	61.7	12.6	59.5	11.8	60.8	11.9	61.4	11.9
Gazprom + Gazprom Neft	43.4	8.9	43.3	8.6	44.8	8.8	46.1	8.9
including: Gazprom	12.7	2.6	13.5	2.7	14.5	2.8	14.5	2.8
Gazprom Neft	30.7	6.3	29.8	5.9	30.3	5.9	31.6	6.1
Tatneft	26.1	5.3	26.1	5.2	26.2	5.1	26.3	5.1
Slavneft	19.6	4.0	18.4	3.6	18.2	3.6	17.9	3.5
Bashneft	11.7	2.4	14.1	2.8	15.1	3.0	15.4	3.0

cont'd

1	2	3	4	5	6	7	8	9
RussNeft	14.2	2.9	13.0	2.6	13.6	2.7	13.9	2.7
NOVATEK	2.7	0.6	3.8	0.8	4.1	0.8	4.2	0.8
Operators of Production-Sharing Contracts	12.0	2.5	14.4	2.9	15.1	3.0	14.1	2.7
Other producers	24.1	4.9	38.2	7.6	41.1	8.0	44.1	8.5

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

As a result of the acquisition of TNK-BP, which (including its share in Slavneft) accounts for 15.7% of the total oil production in Russia, Roseft will have considerably strengthened its positions in the Russian oil sector and it will have become one of the largest oil companies in the world. The company's oil production (taking into account its share in other companies' production) will account for about 200 million tons per year, or 38.7% of Russia's total oil production.

The state sector will be considerably expanded. In general, after Rosneft's acquisition of TNK-BP the share of state companies in Russia's overall oil production will increase to 48.1% (Table 26). Note that in 2003, i.e. before Rosneft and Gazprom acquired the assets of the private oil companies YUKOS and Sibneft, and before Gazprom entered into the Sakhalin-2 project, the share of state companies in overall Russian oil production had been only 7.3%.

Table 26

Share of state companies in Russia's oil production, including Rosneft's acquisition of TNK-BP, 2012

	Oil production, million tons	Share of total oil production, %
Rosneft, including TNK-BP	190.0	36.7
Share of Rosneft and TNK-BP in oil production of other companies (Slavneft, Sakhalin-1)	10.4	2.0
Rosneft, including TNK-BP and the share of Rosneft and TNK-BP in oil production of other companies	200.4	38.7
Gazprom, including Gazprom Neft	46.1	8.9
Share of Gazprom in oil production of other companies (Sakhalin-2)	2.8	0.5
Gazprom, including Gazprom Neft and the share of Gazprom in oil production of other companies	48.9	9.4
State companies, total	249.3	48.1

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

Table 27

Gas production structure in 2008-2012

	Gas production in 2008, billion cubic metres	Share of total gas production, %	Gas production in 2010, billion cubic metres	Share of total gas production, %	Gas production in 2011, billion cubic metres	Share of total gas production, %	Gas production in 2012, billion cubic metres	Share of total gas production, %
Russia, total	664.9	100.0	665.5	100.0	687.5	100.0	671.5	100.0
Gazprom + Gazprom Neft	553.1	83.2	513.9	77.2	519.0	75.5	489.4	72.9
including: Gazprom	550.9	82.9	509.0	76.5	510.1	74.2	478.5	71.3
Oil companies	54.8	8.2	66.6	10.0	69.1	10.1	71.1	10.6
NOVATEK	30.8	4.6	37.8	5.7	53.5	7.8	51.3	7.6
Operators of Production-Sharing Contracts	8.5	1.3	23.3	3.5	25.2	3.7	26.8	4.0
Other producers	17.6	2.6	23.9	3.6	20.7	3.0	32.9	4.9

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

As for gas production, Gazprom has traditionally remained the leader. However, its share in overall gas production in Russia has considerably declined over recent years: from 83.2% in 2008 to 72.9% in 2012 (*Table 27*) while the ratio of other producers (the oil companies, NOVATEK, operators of Production-Sharing Contracts and other producers) in total gas production has increased. The share of state companies in overall Russian gas production in 2012 was 75.9%. After Rosneft's acquisition of TNK-BP, the share of state companies will increase to 79.6% of total Russian gas production (*Table 28*).

Table 28

**Share of state companies in gas production in Russia, including
Rosneft's acquisition of TNK-BP, 2012**

	Gas production, billion cubic metres	Share of total gas production, %
Gazprom, including Gazprom Neft	489.4	72.9
Rosneft, including TNK-BP	35.9	5.3
Share of Gazprom and Rosneft in production of other companies (Slavneft, Sakhalin-1, Sakhalin-2)	9.3	1.4
State companies, total	534.6	79.6

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

4.4.3. The dynamics and structure of oil and gas exports

Along with growth in oil production a significant increase in oil exports has been observed: according to preliminary estimates the net export of crude oil and oil products in 2012 increased to 375.7 million tons and the ratio of the net export of crude oil and oil products to oil production was 72.5% (*Table 29, 30*). The growth in oil exports was achieved due to the increased export of oil products (up by 4.4% compared to 2011) while crude oil exports declined (by 1.8%). The proportion of produced crude oil which was exported in 2012 decreased to 46.3%. At the same time, the share in exports of residual oil products in 2012 was 91.0% and for diesel fuel it was 59.4%. Under the influence of restrictive export duty, petrol exports declined in 2012 by 16.5% and the proportion of product petrol which was exported decreased to 8.4% (for comparison: the share of exports in production of petrol was 7.2% in 1999, 18.5% in 2005, 8.2% in 2010, and 10.6% in 2011). Meanwhile, 2012 saw a substantial reduction in imports of oil products (by 63.3% compared to 2011) and a reduction of the proportion of imports to supply domestic demand. Along with a considerable increase in domestic production, the proportion of petrol imported decreased from 2.6% in 2011 to 0.5% in 2012 (for comparison: the proportion of petrol imported was 8.7% in the first half of 1998, 0.7% in 2008 and 1.4% in 2010). The proportion of imported diesel fuel decreased from 1.1% in 2011 to 0.3% in 2012.

Table 29

**Export of crude oil, oil products and natural gas from Russia in 2002-2012,
% of the preceding year**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Crude oil, total	113.9	117.8	115.0	98.4	98.0	104.0	94.0	101.8	101.2	97.6	98.2
including: to non-CIS members	109.9	118.9	116.3	99.1	98.0	104.8	92.6	102.9	106.1	95.7	98.7
Oil products, total	118.5	103.6	105.5	117.9	106.3	108.0	105.0	105.3	106.2	98.5	104.4
including: to non-CIS members	119.1	102.6	104.9	119.1	104.5	107.6	102.0	107.1	109.6	94.6	100.8
Gas, total	102.4	102.0	105.5	103.7	97.6	94.6	101.8	86.2	105.6	104.0	96.6

Source: Rosstat (Russian Statistics Agency).

Exports of natural gas in 2012 declined by 3.4% compared to the preceding year. The main reason for the decrease in gas exports in recent years has been the reduction of supplies to Europe, where the share of supply from other gas producing countries has significantly increased. As a result, in 2012, compared to 2006 when the maximum supply volume of Russian gas to Europe was reached, exports of Russian gas to non-CIS countries declined by 30.4%. At the same time, the ratio of net exports compared to gas production decreased from 31.4% in 2005 to 26.0% in 2012.

Table 30

Correlation of oil and natural gas production, consumption and export in 2000-2012

	2000	2005	2006	2007	2008	2009	2010	2011	2012
Oil, million tons									
Production	323.2	470.0	480.5	491.3	488.5	494.2	505.1	511.4	518.0
Export, total	144.5	252.5	248.4	258.4	243.1	247.4	250.4	244.6	239.9
Export to non-CIS countries	127.6	214.4	211.2	221.3	204.9	210.9	223.9	214.4	211.6
Export to CIS-countries	16.9	38.0	37.3	37.1	38.2	36.5	26.5	30.2	28.4
Net export	138.7	250.1	246.1	255.7	240.6	245.6	249.3	243.5	238.9
Domestic consumption	123.0	123.1	131.2	124.1	130.4	125.3	125.9	140.7	142.3
Net export as a % of production	42.9	53.2	51.2	52.0	49.3	49.7	49.4	47.6	46.1
Oil products, million tons									
Export, total	61.9	97.0	103.5	111.8	117.9	124.4	132.2	130.6	138.0
Export to non-CIS countries	58.4	93.1	97.7	105.1	107.6	115.4	126.6	120.0	121.0
Export to CIS-countries	3.5	3.9	5.8	6.7	10.3	9.0	5.6	10.6	17.0
Net export	61.5	96.8	103.2	111.5	117.5	123.3	129.9	127.2	136.8
Oil and oil products, million tons									
Net export of oil and oil products	200.2	346.9	349.3	367.2	358.1	368.9	379.2	370.7	375.7
Net export of oil and oil products as a % of oil production	61.9	73.8	72.7	74.7	73.3	74.6	75.1	72.5	72.5
Natural gas, billion cubic metres									
Production	584.2	636.0	656.2	654.1	664.9	596.4	665.5	687.5	671.5
Export, total	193.8	207.3	202.8	191.9	195.4	168.4	177.8	184.9	178.7
Export to non-CIS countries	133.8	159.8	161.8	154.4	158.4	120.5	107.4	117.0	112.6
Export to CIS-countries	60.0	47.5	41.0	37.5	37.0	47.9	70.4	67.9	66.0
Net export	189.7	199.6	195.3	184.5	187.5	160.1	173.5	180.6	174.4
Domestic consumption	394.5	436.4	460.9	469.6	477.4	436.3	492.0	506.9	497.1
Net export as a % of production	32.5	31.4	29.8	28.2	28.2	26.8	26.1	26.3	26.0

Source: Rosstat (Russian Statistics Agency), Ministry of Energy of the RF, Federal Customs Service, IEP calculations.

Crude oil export was still dominant in the oil export structure, accounting for 63.6% of the total crude oil and oil product exports in 2012. The major part of the export of oil products was comprised of residual oil and diesel fuel. The major part of energy resources (88% of crude oil and oil products and 63% of gas) was exported outside the CIS.

Analysis of the trends in Russian oil exports over a long period shows a strengthening of the export orientation of the oil sector, compared to the pre-reform period. The ratio of net exports of crude oil and oil products to oil production increased from 47.7% in 1990 to 72.5% in 2012. However, we should take into account that this is connected not only with an increase in absolute export volume but also with a substantial reduction of domestic oil consumption due to the market transformation of the Russian economy and the substitution of residual oil by natural gas. At the same time an increase in the share of oil products in oil exports can be noted: it increased from 18.2% in 1990 to 36.4% in 2012 (*Table 31*). However, due to the low depth of oil refining the major part of Russian oil product exports is represented by residual oil, which is used in Europe as a raw material for further refining and the pro-

duction of light petroleum products. In 2012 the share of residual oil in the total export of oil products was 55.1%.

Table 31

**Net export of oil products
in 2002-2012**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Net export of oil products, million tons	74.8	78.2	81.4	96.8	103.2	111.5	117.5	123.3	129.9	127.2	136.8
Share of oil products in net export of crude oil and oil products, %	29.2	26.8	24.3	27.9	29.5	30.4	32.8	33.4	34.3	34.3	36.4

Source: Rosstat (Russian Statistics Agency), Federal Customs Service, IEP calculations.

An increase in world oil prices and the growth of exports growth has resulted in an increase in revenues in the oil sector of the economy (*Fig. 34, 35*). The aggregate revenues from the export of crude oil and primary oil products (petrol, diesel fuel and residual oil) reached USD 269.1 billion in 2012, which is a record for the entire reforming period (*Table 32*). For comparison, it should be noted that the minimum level of income from oil exports was in 1998, when world oil prices were falling, and the revenues from crude oil and oil product exports was only USD 14 billion.

Table 32

**Revenues from crude oil and oil products export
in 2000-2012, billion USD**

	2000	2005	2006	2007	2008	2009	2010	2011	2012
Revenue from export of crude oil and main types of oil products	34.9	112.4	140.0	164.9	228.9	141.2	193.9	259.5	269.1

Source: calculated based on data of Rosstat (Russian Statistics Agency).

As a result of the growth of world oil and gas prices, and the increase in the physical volumes of export of oil products and coal, the share of fuel and energy products in Russian exports reached 70.4% in 2012, with the share of crude oil being 34.5%, and of natural gas, 12.0% (*Table 33*).

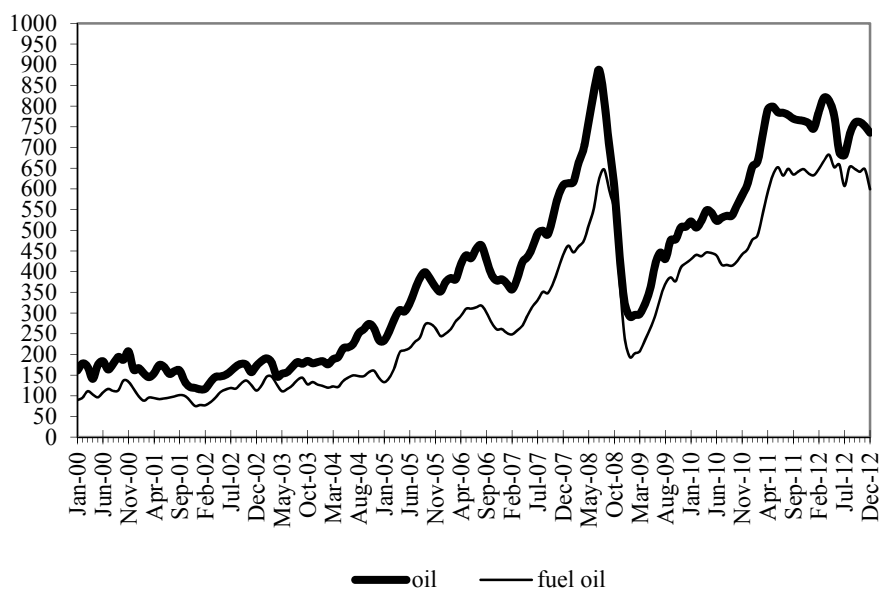
Table 33

**Amount and ratios of exports of fuel and energy products
in 2005-2012**

	2005		2010		2011		2012	
	billion USD	%*	billion USD	%*	billion USD	%*	billion USD	%*
Fuel and energy goods, total:	154.7	64.1	267.7	67.5	357.2	69.2	369.4	70.4
including:								
oil	83.8	34.7	134.6	34.0	179.1	34.7	180.9	34.5
natural gas	31.4	13.0	47.6	12.0	63.8	12.4	63.0	12.0

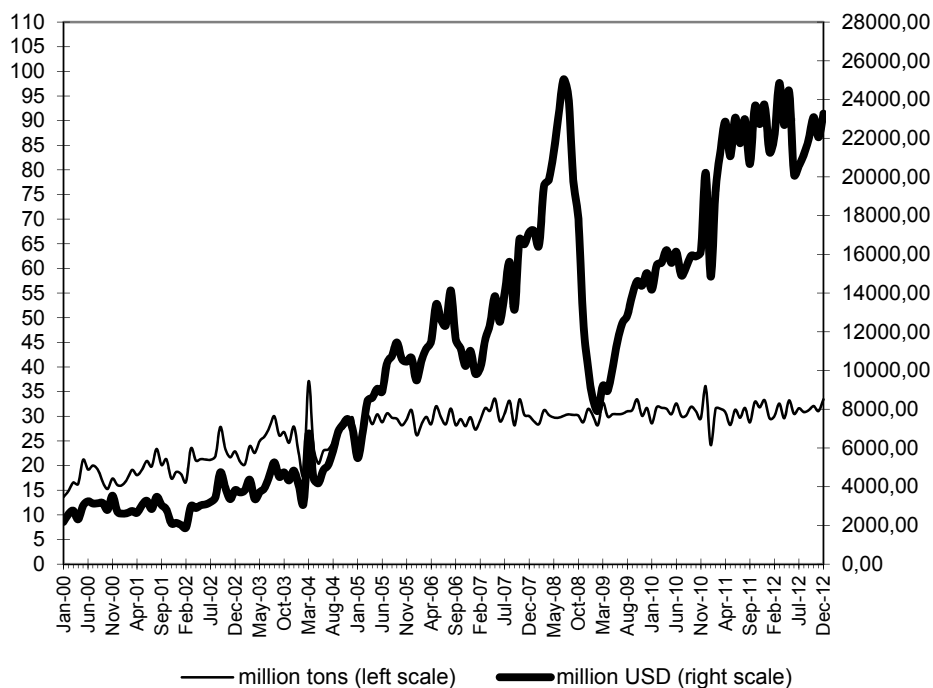
* As a % of the total volume of Russian exports.

Source: Rosstat (Russian Statistics Agency).



Source: calculated based on data of Rosstat (Russian Statistics Agency).

Fig. 34. Average export prices for oil and residual oil in 2000-2012, USD/ton



Source: calculated based on data of Rosstat (Russian Statistics Agency).

Fig. 35. Export of crude oil and oil products in physical and monetary terms in 2000-2012

4.4.4. Trends in the prices for energy goods on the internal market

Prices for oil and oil products in the Russian domestic market are based on world prices for these goods, reflecting the equal profitability of supplies to the external and internal markets, i.e. as the net back price is equal to the world price, less export customs duty and export transportation costs. Since the export duty rate has increased to a lesser extent than the world price (for example, the maximum growth of the export duty rate is only 65% of the growth in the price of Urals oil), an increase in world prices inevitably leads to increases in internal prices. The same was observed in 2012, when, under the influence of world prices, the prices for oil and light petroleum products on the domestic market grew as well. However, these prices remain below the maximum values reached in July 2008 when the average domestic oil price (producers' price) reached USD 410.2 USD per ton and the average price for petrol reached USD 810.3 per ton. At the end of 2008 and at the beginning of 2009, with declining world oil prices, a considerable reduction of the domestic prices for crude oil and oil products (in USD) was observed, however, thereafter due to the growth of world prices the domestic prices for crude oil and oil products grew substantially (*Table 34, Fig. 36, 37*).

Table 34

**Domestic prices for crude oil, oil products and natural gas in USD in 2000-2012
(average producers' prices, USD/ton)**

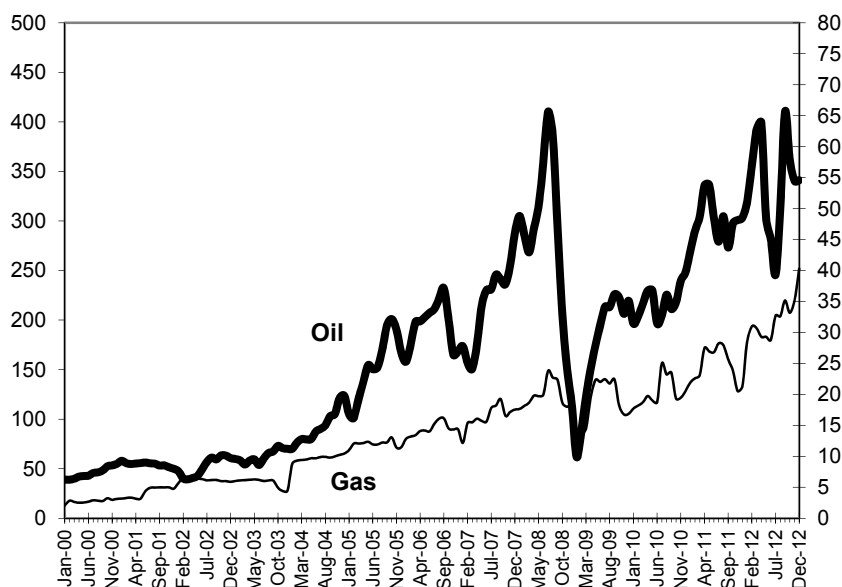
	December 2000	December 2005	December 2006	December 2007	December 2008	December 2009
Crude oil	54.9	167.2	168.4	288.2	114.9	219.3
Petrol	199.3	318.2	416.5	581.2	305.1	457.4
Diesel fuel	185.0	417.0	426.1	692.5	346.5	394.8
Residual oil	79.7	142.7	148.8	276.5	125.0	250.8
Gas, USD/thousand cubic metres	3.1	11.5	14.4	17.6	18.1	16.9

cont'd

	December 2010	June 2011	December 2011	June 2012	December 2012
Crude oil	248.2	302.7	303.3	281.8	341.1
Petrol	547.9	647.7	576.9	542.3	628.7
Diesel fuel	536.1	605.2	644.9	597.1	774.2
Residual oil	246.3	308.8	274.6	276.8	275.3
Gas, USD/thousand cubic metres	20.5	26.8	21.3	28.8	40.3

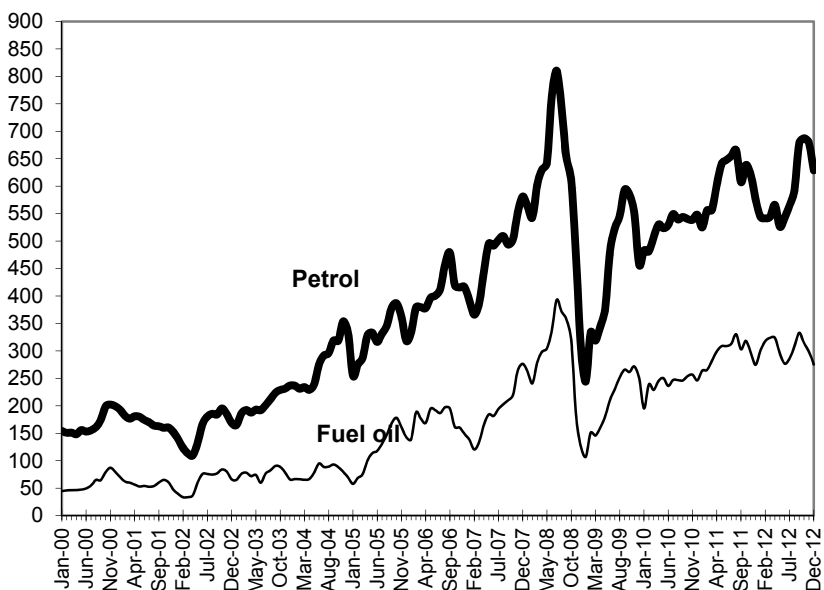
Source: calculated based on data of Rosstat (Russian Statistics Agency).

Meanwhile, domestic oil prices in Russia still remained lower than world prices. For instance, in 2012 the internal oil price (producers' price) was, on average, only 46.4 USD/bbl, or 42.1% of the world price (Urals oil price on the European market). The gap in the levels of world and domestic prices is the result of the existence of export customs duty and the additional transportation costs relating to exports. Domestic prices for gas remain under state regulation. In order to ensure competitiveness of the national economy the government supports a considerably lower level of domestic gas prices compared to the rest of the world. In the IV quarter of 2012 the internal gas price (the purchase price for industrial consumers without indirect taxes) was only about 26% of the Russian gas price on the European market.



Source: calculated based on data of Rosstat (Russian Statistics Agency).

Fig. 36. Average producers' prices for oil and gas in USD in 2000-2012, USD/ton, USD/thousand cubic metres



Source: calculated based on data of Rosstat (Russian Statistics Agency).

Fig. 37. Average producers' prices for petrol and residual oil in USD in 2000-2012, USD/ton

4.4.5. Tax regulation of the oil and gas sector

Changes in the taxation system, aimed at reducing the tax burden and encouraging further development of existing deposits and the development of new oil fields, have had a positive

impact on the oil industry. Since 2009 a non-taxable price minimum used in the formula for calculation of the coefficient C_p , which reflects the dynamics of world oil prices and applies to the basic MET (Mineral Extraction Tax) rate for oil production, was raised from 9 USD/bbl to 15 USD/bbl (*Table 35*), which led to a considerable reduction of the MET rate applied to oil production. Furthermore, the requirement for the use of a direct accounting method for oil extracted from specific deposits in order for them to be eligible for the application of a reduced coefficient for the MET rate (C_w) was abolished for deposits with a high degree of resource depletion. This enabled all depleted deposits to benefit from the exemption, which, in turn, stimulated the extension of operation periods and additional oil production.

Table 35

MET rates applied to oil production in 2005-2013

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Basic MET rate in oil production, rub/ton	419	419	419	419	419	419	419	446	470
Coefficient reflecting the dynamics of world oil prices (C_p)	$(P-9) \times R/261$				$(P-15) \times R/261$				
Coefficient reflecting the degree of deposit depletion (C_w)	-		$3.8 - 3.5 \times N/V$						
Coefficient reflecting the deposit's reserves (C_r)	-							$0.125 \times V_3 + 0.375$	

Symbols: P – the average Urals oil price level in USD per barrel over the tax period; R – the average USD/RUR exchange rate set by the Central Bank of the RF over the tax period; N – cumulative amount of oil extracted from the deposit; V – initially extractable oil reserves of categories A, B, C1 and C2 in the deposit; V_3 – initially extractable oil reserves of the deposit, million tons.

Source: Tax Code of the RF (revision 2005-2012), Federal Law No.158-FZ dated 22.07.2008, Federal Law No.151-FZ dated 27.07.2006, Federal Law No.33-FZ dated 07.05.2004.

In order to stimulate development of the oil fields located in underdeveloped regions with no infrastructure MET tax holidays were introduced. The mechanism of MET tax holidays is the application of a zero tax rate for the period until a certain cumulative oil production volume is reached, or for a specified period from the date of state registration of the licence for the use of subsurface resources. This speeds up the return on capital investments and ensures the required yield on investments in the development of new oil fields.

The first region where the tax holiday mechanism was applied was the Eastern Siberian oil and gas province in the Sakha (Yakutia) Republic, Irkutsk oblast and Krasnoyarsk krai where, since 2007 a zero MET rate has been set for the period until the cumulative oil production volume reaches 25 million tons, provided that the development of the reserves does not exceed 10 years; or for periods from the date of state licence registration of 10 years, for a licence for the development of subsurface resources, and 15 years for a licence for the use of subsurface resources both for geological studies (exploration and development) and production.

For the purpose of further stimulation of development of fields in the Eastern Siberian oil and gas province the Government of the RF has set zero export duty rates for oil fields located in this regions since 1 December 2009. These rates were applied until 1 July 2010. Thereafter the Government started applying reduced export duty rates to oil extracted in this region.

Starting from 2009, MET tax holidays were also introduced for new oil deposits located in the Nenets Autonomous Okrug and on the Yamal Peninsula, on the continental shelf to the north of the Arctic Circle as well as in the Caspian and Azov Seas. From December 2010 reduced export duty rates also began to apply to deposits located in the Caspian Sea.

Since the beginning of 2012 a number of changes in the taxation of the oil and gas sector have come into force. In order to promote the development of small oil fields a special-purpose reduction coefficient reflecting the size of the reserves in the relevant deposit (Cr) was introduced for the MET rate for oil production in 2012. This coefficient is calculated using a specific formula (see *Table 35*) and is applied to deposits with initially recoverable oil reserves of up to 5 million tons and a reserve depletion of up to 0.05. Prior to this, the procedure for calculating MET on oil production had not provided for tax differentiation depending on the size of the oil reserves in the deposit and, as a result, the development of small oil fields usually turned out to be uneconomic due to the high capital and operational costs. The application of the special decreasing coefficient, Cr, to the MET rate should create conditions for the development of new small deposits which would be unprofitable under the general system of taxation.

Within the framework of implementation of the policy for encouraging the development of new production regions the MET tax holiday regime was extended to new oil fields located in the Yamal-Nenets Autonomous Okrug, to the north of the 65th parallel north. For subsurface sites located in this region, with the exception of those located on the Yamal Peninsula, the same parameters of tax holidays as for the Vostochny region were set. Since 2012 the MET tax holiday regime has also been applied to oil fields located in the Black Sea and the Sea of Okhotsk. These decisions should create the necessary economic conditions for the development of the deposits of the Yamal-Nenets Autonomous Okrug, the Black Sea and the Sea of Okhotsk, which are uneconomic under the common system of taxation due to the necessity for large volumes of capital investment needed for the creation of the infrastructure and the special conditions relating to the development of deposits located in these regions.

In 2012 the mechanism of application of reduced export duty rates to new deposits in Eastern Siberia, the Yamal-Netets Autonomous Okrug and the Nenets Autonomous Okrug was legally approved. Such an approach had already been applied in practice: reduced export duty rates were envisaged for deposits in Eastern Siberia, the Caspian Sea, and the Pirazlomnoe field on the Arctic shelf, for high-viscosity oil, although the mechanism for setting such rates was not legally approved.

Considerable undeveloped reserves of oil and gas are located on the continental shelf of the Russian Federation. However, the development of offshore deposits requires extremely high capital and operational costs and under the common system of taxation these would not provide a return on the investments required, so this has impeded the development of these fields. In 2012 the Ministry of Energy of the RF developed a concept for the taxation of hydrocarbon extraction from the Russian continental shelf which provides for special preferential tax treatment for the development of subsea fields. It was proposed to base this tax regime on a reduced ad valorem MET rate, differentiated on the basis of the shelf zone and the standard tax rate. It has been suggested that export duty should not be charged on export products within the offshore project framework.

Within the framework of an effective tax system, a differential reduction of MET rates and of export duty rates for certain regions characterised by high development costs is, in principle, justified because this enables investors gain the necessary return on investments in the development of new fields. At the same time, the tax holidays and reduced rate mechanisms applied for these purposes, which are simple from the point of view of tax administration, are far from perfect. For all fields within a certain region (the shelf zone) a unified, averaged approach is applied where no account is taken of the considerable differences in costs relating to

development of specific fields in the region. As a result, for deposits having the highest costs, an “average” tax burden turns out to be extremely high and these deposits are not being developed.

A better form of taxation for oil production, as applied in developed countries, is the taxation of additional (net) income. This approach ensures automatic differentiation of the tax burden depending on the specific conditions of oil extraction. Such an approach takes into account, not only the gross income gained by the producer (as in the application of MET or export duty) but also the costs relating to oil extraction from particular deposits. The application of such a tax regime would allow for the creation of the conditions necessary for the development of new deposits where there are high capital, operational and transportation costs.

2012 has also become the first year of operation of the new scheme of taxation for crude oil and exported oil products (the so called 60-66-90 scheme). At the end of 2011 the general export duty rate was decreased by applying a coefficient of 0.60 (instead of 0.65) in the formula for the calculation of the export duty rate (*Table 36*). This has reduced the tax burden on the oil production industry and should have a positive effect on oil production.

Table 36

Maximum rates of oil export duty

World price for Urals oil	Rate, USD/ton
Up to 15 USD/bbl	0
From 15 to 20 USD/bbl	$0.35 \times (P-15) \times 7.3$
From 20 to 25 USD/bbl	$12.78 + 0.45 \times (P-20) \times 7.3$
Over 25 USD/bbl	$29.2 + 0.65 \times (P-25) \times 7.3$

Symbols: *P* – Urals oil price, USD/bbl

Source: Law of the RF No.409-FZ on Customs Tariff.

The export duties on petroleum products are set at a lower level compared to the export duties on crude oil. In 2006-2010 the export duty on light petroleum products was about 0.72 of the duty on crude oil exports, and the rate of export duty on dark petroleum products was about 0.39 of the crude oil export duty. This stimulated the growth of oil refining within the country and an increase in the export of oil products. Whilst oil production grew by 7.5% during the period of 2006-2010, primary oil processing increased by 19.9% and the export of oil products grew by 36.3%. The oil refining growth of 85% observed during this period was facilitated by the growth in oil product exports.

At the same time, such differentiation of export duties did not stimulate an increase in the depth of oil refining. In 2011 the oil refining depth in Russia was only 71%, i.e. for the period from 2000 it has shown practically no increase. The growth of Russian exports of petroleum products observed in recent years has mainly been due to the increase in exports of residual oil, which is used in Europe as a raw material for further refining and the production of light petroleum products.

In these circumstances, in order to stimulate modernisation of the Russian oil refining sector and to increase the depth of oil refining, a number of decisions were made in 2010-2011 for a stage-by-stage increase of export duty on residual oil to the level of 66% of the rate of crude oil export duty (*Table 37*). At the same time, in 2011, under the conditions of the so called “petrol crisis” and market saturation, an increased (limiting) export duty on petrol was introduced at the rate of 90% of the rate of crude oil export duty.

The results for 2012 show that the increase of the export duty on residual oil, up to 66% of the crude oil export duty, did not have any effect on the situation: production of residual oil and its export continued to grow and the depth of oil refining showed practically no increase.

At the same time, the forthcoming increase (to be introduced in 2015) in export duty on residual oil, up to that for crude oil, has provided an incentive for oil companies to begin the modernisation of their oil refining facilities. At the moment oil companies are implementing special programmes for the modernisation of oil refining facilities approved by federal governmental authorities. Implementation of these programmes should considerably increase the technological level of the oil refining sector and improve the depth of oil refining in Russia.

Table 37

**Export duty rates on petroleum products in 2011-2015
(as a ratio to the rate of crude oil export duty)**

	From 1 January to 30 April 2011	From 1 May to 30 September 2011	From 1 October 2011 to 31 December 2014	From 1 January 2015
Commercial petrol, directly distilled petrol	0.67	0.90	0.90	0.90
Light distillates, medium distillates, diesel fuel	0.67	0.67	0.66	0.66
Residual oil, lubricating oils, etc.	0.467	0.467	0.66	1

Source: Resolutions of the RF Government dated 27.12.2010 No.1155, dated 26.08.2011 No.716.

An important aspect of tax regulation in 2012 was the considerable increase in the tax burden on the gas sector. In 2011-2012 the MET rate on natural gas was raised significantly. For the period of 2006-2010 this rate had remained unchanged whilst wholesale prices for gas on the domestic market had increased more than two-fold. As a result, the MET rate for natural gas during these years decreased both in absolute and relative terms (as a percentage of the price). In 2011 this tax rate was indexed at 1.61 times which actually corresponded to the cumulative inflation for the period 2007-2010.

However, the high profitability of the production, transportation and sale of natural gas evidenced a considerably lower level of tax burden in the Russian gas sector compared to the oil sector and the possibility of a further substantial increase of the MET rate. As shown by calculations based on the annual financial statement data of companies acting in the industry, in 2011, the after-tax income calculated as a percentage of net profit to gross income for the oil sector was 14.6%, whilst for the gas sector it was 33.9%.

As a result, in 2012, the MET rate for natural gas was increased to 509 rubles/thousand cubic metres, or by 2.15 times compared to 2011. For 2013-2015 there are additional increases in this tax rate (Table 38). These should bring the tax burden on the gas sector to that of the oil sector and withdraw a major part of the additional (essentially rental) income from the proposed increase in domestic gas prices for the benefit of the state.

Table 38

MET rate for natural gas production in 2010-2015

	2010	2011	2012	2013 I half	2013 II half	2014	2015
MET rate, rubles/thousand cubic metres	147	237	509	582	622	700	788

Source: Tax Code of the RF (revision of 2010-2012), Federal Law dated 29.11.2012 No.204-FZ.

The decisions made have considerably increased the tax burden on OAO Gazprom, which, as the owner of the Unified Gas Supply System, receives relevant income from the transportation and export of natural gas. For all organisations other than owners of the Unified Gas Supply System facilities and organizations in which owners of the Unified Gas Supply System facilities hold over 50% of the shares a reduced coefficient is applied to the established rate (in 2012 this coefficient was 0.493).

The increase of the MET rate on natural gas will provide for a more complete withdrawal of gas rent and increase state budget revenues. In the future it is expedient to set the MET rate for natural gas on the basis of a special formula which takes into account the main rent forming factors, above all, the price of gas. At the same time it would be expedient to ensure differentiation of the MET rate for gas, depending on the actual conditions of its extraction. For new gas deposits, the development of which requires higher capital and operational costs (for example, deposits on the continental shelf), it would be expedient to apply reduced MET rates.

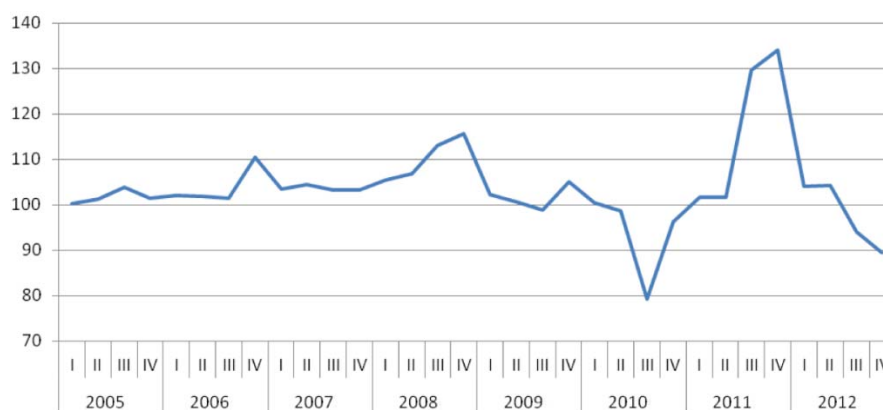
In prospect, it is reasonable to introduce a level of tax on additional income from new gas fields which will allow for an automatic differentiation of the tax burden, depending on the conditions relating to the development of the relevant deposits.

4.5. Russian Agriculture and Agricultural Policies in 2012

4.5.1. General Outline of Agricultural Performance

At present about 4% of Russia's GDP is generated in agriculture; however, the sector still accounts for 9.7% of the total number of employed in domestic economy with 26% of the country's population living in rural areas. The latter indicator has remained actually unchanged throughout the 10 recent years.

From 2006 to 2011 agriculture displayed high development indicators¹: annual output increased at the average rate of 4.4%, production of meat livestock and poultry over these 6 years grew by 53%. In the first and the second quarters of 2012 the increment of output against the respective periods of 2011 also exceeded 4% (*Fig. 38*). However, the spring and summer droughts resulted in a sharp drop of production in the third and the beginning of the fourth quarter of 2012. The most affected was the gross output of grain that in 2012 fell by nearly one fourth as compared with 2011 – down to 70.7m tons. Decrease was also observed in the production of sunflower seeds that reduced by 18% (down to 7.96m tons), sugar beets – less by 9% (down to 43.4m tons), potatoes and vegetables – less by 11% and 2%, respectively (down to 29.1 and 14.4m tons). However, the overall reduction of agricultural output in 2012 versus 2011 was less than 5%.



Source: Rosstat.

Fig. 38. Agricultural Output as % of the Respective Period of Previous Year

¹ Hereinafter – the data of Rosstat.

Nevertheless, 2013 has all chances to be more successful – farm producers have managed to sow winter crops at actually the same areas as in 2011 (the decrease being as low as 0.8%).

The drop of crop production was partially offset by the increase of livestock production. In 2012 the number of pigs in farms of all types continued growing (by 7.7% up to 19.3m heads) as well as that of sheep and goats (by 6.4% up to 25.1m heads). Cattle inventories did not reduce as compared with 2011 (20.4m heads) and the number of cows even somewhat increased (by 0.5% up to 8.9m heads). As of December 2012 smallholder farms accounted for 45.9% of cattle population, 25.4% of pig population and 47.6% of that of sheep and goats with the respective shares falling over time (in 2011 they reached 46.9, 31.5 and 50.1% accordingly). 2011 was the first year since early 1990s when an increase (albeit small – less than 1%) was observed in the cattle herd. It's notable that this modest increase was ensured by a sizable growth of cattle population in individual private (peasant) farms where it was up by 15%. The increase of livestock inventories in this type of farms is a new phenomenon resulting from the introduction of a new tool of state support to agriculture – the subsidizing of expenditures on the creation of family dairy farms.

The output of meat and eggs continues growing – in 2012 its increase versus 2011 in all categories of farms amounted to 6% and 2.2%, respectively. It was provided by the growth of production in corporate and individual private farms where the overall output of slaughter livestock and poultry was up 11.7% and 3.8%, respectively. Corporate farms increased output of not only pork (up by 13.4%) and poultry meat (up by 13.4%) but also that of beef and veal (up by 3.2%). Individual private farms expanded production of poultry (by 25.8%) and slaughter cattle (by 10.9%). The increment of eggs production (by 2.2%) was also due to their larger output in corporate farms (up by 2.8%) and individual private farms (up by 6.7%). Low aggregate growth rates of milk production in 2012 (0.9%) resulted from the combination of its increase in corporate farms (by 2.5%) and individual private farms (by 12.8%) and decrease in smallholder farms (by 1.8%). The sector of household farms is losing its positions as compared with 2011: it produced not only less milk but also less meat and eggs. In 2012 the share of smallholder farms in the output of livestock products totaled 45.5% while the share of individual private farms – 4.4%. For the first time since 1995 the share of corporate farms exceeded 50%. The structure of meat production continues changing: the share of poultry meat has approached 58%, the share of pork – 29%.

The production of grain, sugar beets and sunflower seeds is largely concentrated in corporate farms but the share of individual private farms therein is growing year after year. In 2012 they already produced 22.3% of grain and 27.2% of sunflower seeds grown in the country. Potatoes, vegetables, fruit and berries are produced mainly by smallholder farms although in recent years the share of individual private farms is expanding at rather high rates.

The production of basic agricultural products is not growing all over the country. Agriculture has ceased to be a sector developed in any region; at present it is rather an activity specific for certain areas. In the post-Soviet period the principles of locating agricultural production have changed. Instead of being targeted at ensuring regions' self-sufficiency (which was the goal of the Soviet agrarian policies and was regarded as an important component of planned and proportional development of all regions of the country), its current location is shaping taking into account economic expediency considerations. The scale of production is less and less tied to the number of population; it's rather being shifted to regions with the highest profitability. These processes are characteristic for those agricultural products the most part of which is produced in corporate farms. For smallholder producers the profit-generation capaci-

ty of a specific production is less decisive; instead, other priorities can be of greater importance, such as the need to produce healthy food for the family or the possibility for self-employment in case there are no job opportunities in local corporate farms and individual private enterprises.

The drop of agricultural production after the start of market-oriented reforms in the country was catastrophic. It reached its maximum in 1998 when the output of corporate farms fell down to 35% of the 1990 indicator. However, the output of smallholder farms during this period was growing and helped to mitigate the overall drop curbing it at the level of 55%. Live-stock production suffered the greatest damage: it was falling not only in corporate but also in smallholder farms.

By 1995 only 19 regions managed to preserve their production at the level of 80-100% of the 1990 reference point (*Table 39*). The revival of the sector began in the period from 2000 to 2005 when the number of such regions started growing. By early 2012 the scale of production in 16 regions was already above the 1990 level and in 23 regions it ranged from 80 to 100% thereof.

Table 39

Distribution of Regions by the Percent Ratio of Annual Farm Output to the 1990 Reference Point

Intervals, %	1995	2000	2005	2010	As of 1.01.2012
160 and more				1 (Belgorod oblast)	2 (Belgorod oblast, Dagestan)
140 and up to 160				1 (Dagestan)	3 (Lipetsk oblast, Kabardino-Balkaria, Tatarstan)
120 and up to 140			1 (Dagestan)	1 (Kabardino-Balkaria)	3 (Tambov and Voronezh regions, North Ossetia-Alania)
100 and up to 120			1 (Tatarstan)	2 (North Ossetia, Astrakhan oblast)	8 (Astrakhan, Penza, Kursk, Tyumen oblasts, Udmurtia, Bashkortostan, Mordovia, Krasnodar krai)
80 and up to 100	19	4	9	11	23
60 and up to 80	35	35	31	28	24
40 and up to 60	20	31	28	23	8
20 and up to 40		4	4 (Arkhangelsk, Kamchatka, Sakhalin and Murmansk oblasts)	7	3 (Murmansk and Sakhalin oblasts, Kamchatka region)
less than 20	2	2	2 (Magadan oblast and Chukotka autonomous district)	2 (Magadan oblast and Chukotka autonomous district)	2 (Magadan oblast and Chukotka autonomous district)
Total	76	76	76	76	76

Source: Rosstat.

Agriculture is slowly restoring in some regions of the country. However, for a long time there have remained regions where no signs of restoration after a more than 60%-drop are observed. It's quite explicable if one looks at the list of such territories: Magadan, Murmansk and Sakhalin oblasts, Chukotka autonomous district, Kamchatka region. On the whole, the growth of production has so far failed to offset the overall decline of agricultural sector (in 2012 farm output reached about 92% of the 1990 level).

Agricultural production is concentrating in progressively diminishing number of regions – constituent members of the Russian Federation. While in 1990 the 15 largest regions-producers accounted for 40% of the total country's output, by 2012 their share increased up to 50%. The list of such producers was changing but the leader remained the same – Krasnodar krai (in 1990 it accounted for 4.5% of the total domestic output and as of January 1, 2012 – for already 7% thereof). By the beginning of 2012 Moscow oblast ranked 7th after being 2nd in

1990. Nijny Novgorod, Leningrad, Novosibirsk and Sverdlovsk oblasts and Krasnoyarsk krai have left the ranks of the 15 largest regions-producers. By early 2012 their positions were occupied by Belgorod, Voronezh, Chelyabinsk, Omsk and Tyumen oblasts.

The analysis of labour use dynamics in agriculture leads to the conclusion that the sector's adjustment to market conditions has prompted the improvement of labour productivity coupled with the reduction of the number of employed. In corporate farms the latter fell almost 6 fold during the reform years while the productivity of labour by the end of 2011 was more than 4 fold higher than in 1990. The official statistics estimates labour productivity in both family and corporate farms enabling to see cardinal changes that have taken place. For instance, in 1990 gross output per average annual employee in family farms was 3.7 fold higher than that in corporate farms while by the beginning of 2012 – 3.3 fold lower. It implies qualitative changes in the productivity pattern: corporate farms with better mechanization of labour started to employ far less workers than households using predominantly manual labour.

The data on corporate farms allows to evaluate the changes in labour productivity for some sectors of agricultural production: by the beginning of 2012 direct labour inputs for producing slaughter pigs and sugar beets dropped 8-10 fold as compared with 1990, those for producing potatoes, vegetables and poultry meat – 3.3-4.5 fold, for producing milk, grain, sunflower seeds and eggs – 1.6-2 fold.

At the same time the decrease of employment and the rise of labour productivity in agriculture were not accompanied by state programs aimed at adaptation of rural population – such as retraining, fostering of investments in the development of non-agricultural business in rural areas, encouragement of entrepreneurial self-employment of population. It produced a devastating effect on the rural community. At present advanced corporate farms face the problem of skilled labour shortage despite quite a stable share of rural population over the recent decade: the most qualified and active workers were forced to migrate from rural areas. Such developments have not been duly regarded by the state support policy which is traditionally aimed at the supporting of farm production versus development of rural areas thus aggravating the degradation of depopulated territories.

Up till 1998 the efficiency of farmland use in all categories of farms was falling but in later years it switched to growing. However, the trends for corporate and smallholder farms were different. In corporate farms the shrinking of farmlands was accompanied by the growth of gross output resulting in higher efficiency indicators of their use. The efficiency of land use by family farms in the first years of reforms was rapidly decreasing as their areas expanded. The per hectare output of these farms stabilized only in recent years.

Despite the difference in efficiency trends, small businesses use land much more efficiently than corporate farms. Each hectare used by them generates twice larger gross agricultural output as compared with that of corporate farms.

Yields were falling from the beginning of 1990s. In 1998 they were below the 1990 level for all crops. But in 2011 they already surpassed the 1990 indicators: for fruit and berries – 1,8 fold, for sugar beets – 1.6 fold, for soybeans, potatoes and vegetables – 1.3-1.4 fold, for grains – 1.2 fold¹. Even in 2012 with its unfavourable weather conditions not all crops demonstrated a drop of yields against the 2011 level and this drop was not dramatic: for grains it amounted to 17%, for sunflower seeds – to 3.6%. Meantime, the yield of sugar beets exceeded the 2011 indicator by 1.6%. Yields are relatively stable despite the sharply decreasing use of mineral and organic fertilizers (*Fig. 39–41*).

¹ Wheat yields reached their maximum in 2008 – 24.5 centners per hectare.

The yields of grains and sugar beets were growing along with the shrinking of areas sown in them. Production was falling mostly in those areas where yields were the lowest. One more factor of higher total grain yields was the increasing share of winter crops that are generally more productive than spring ones. The rise of sugar beet yields was due to the progressive spreading of up-to-date technologies of their production¹. The trend for sunflower seeds was an exception with areas sown expanding 2.8 fold as compared with 1990. Production of this crop has shifted to new cultivation areas with less favourable conditions.

The issue of potential growth of farm output is traditionally tied to the need to involve abandoned lands in agricultural production. However, the comparison of yields in Russia with those in developed countries of the world evidences that there is a potential for increasing the output employing only the currently cultivated areas.

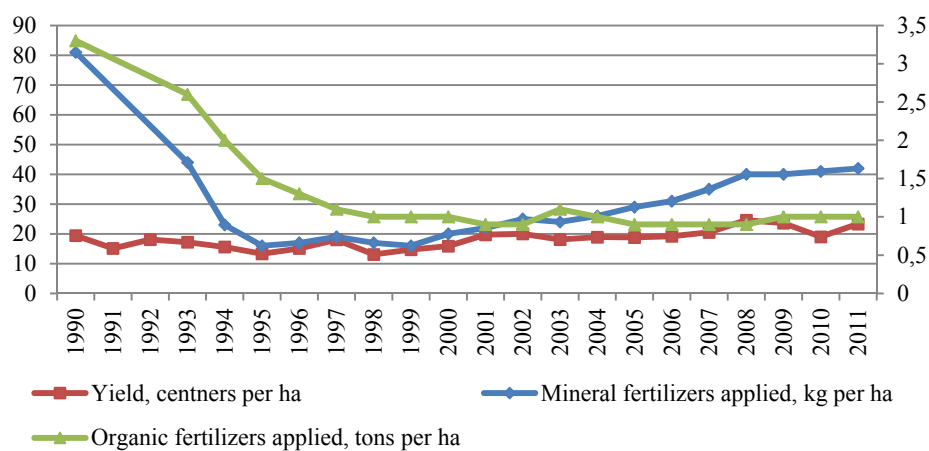


Fig. 39. Grain Yields and Application of Fertilizers in Corporate Farms

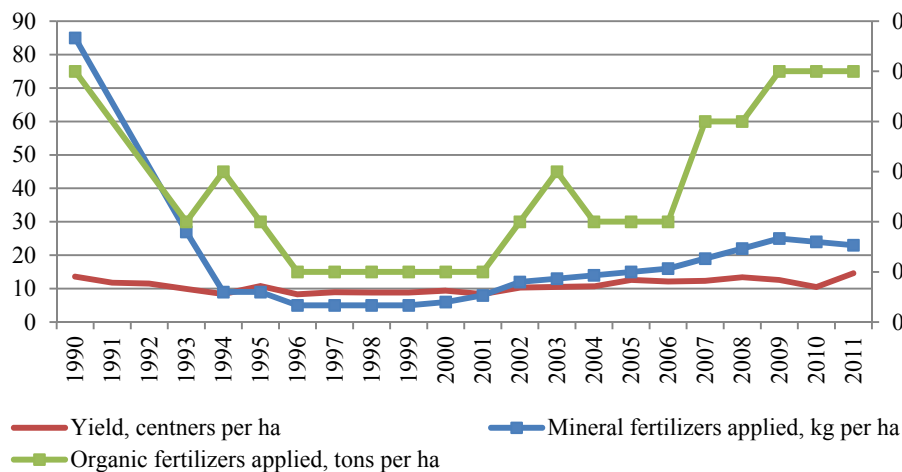


Fig. 40. Sunflower Seed Yields and Application of Fertilizers in Corporate Farms

¹ The yield was maximal in 2008 – 366 centners per hectare which was twice above the 2000 indicator. But it still remains below the level of developed countries of the world. For instance, in Canada it reached 603 centners per ha in the best years, in the US – 646 centners per ha.

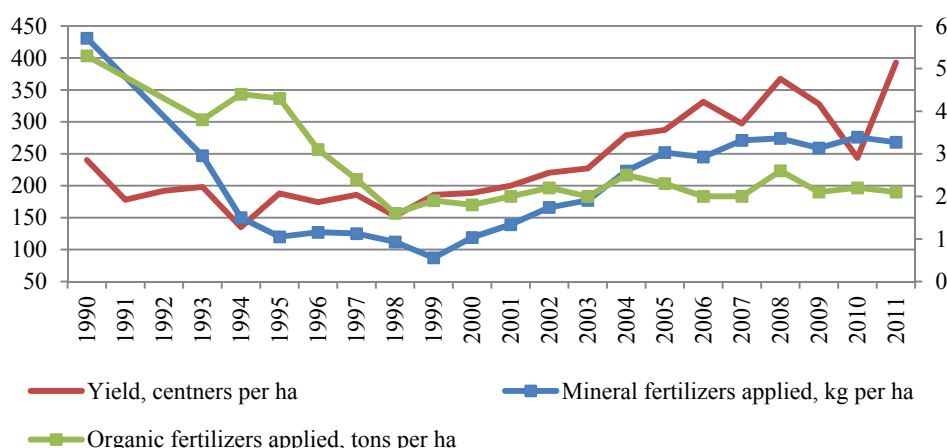


Fig. 41. Sugar Beet Yields and Application of Fertilizers in Corporate Farms

The growth of productivity was observed in all sectors of livestock and poultry production. Uncontestable leaders by this parameter were poultry and pig breeding: as compared with 1990 daily weight gain for broilers was up almost 2.5 fold, for pigs – 1.53 fold. Production of milk per cow grew by 38.3%, production of eggs per laying hen – by 30.9%. In January-October 2012 the per head production of milk reached 4 243 kg which is 6% above the respective indicator for 2011¹.

A clear evidence of the improving efficiency of livestock production is the reduction of per unit feed inputs: while in 1990 830 kg of feed units were needed to produce 100 kg of pork, at present this rate is almost twice lower – 420 kg. Required feed inputs per 1 kg of milk fell by nearly 31%. In beef production high level of feed consumption that formed back in the Soviet times has failed to reduce so far due to the use of high-input technologies of cattle raising in livestock complexes. Lower feed input requirements are attained in case farms use technologies of loose pasture keeping of calves together with meat cows with further fattening in feedlots. It's noteworthy that in regions traditionally practicing grazing livestock management (Altai, Dagestan and Kalmykia republics) the number of meat cattle has been growing for already several years.

The productivity of inputs has been steadily improving while their consumption has been falling. Beginning from 1992 prices for inputs have been rising at much higher rates than those for agricultural products². In these conditions only farms that succeeded in resource saving and efficient utilization have managed to remain profitable. Electric energy consumption dropped in both absolute terms (almost 5 fold) and per Rb 100 of gross output (in 2011 it was three times lower than in 1990). The total application of fertilizers over these years fell almost 5 fold and their use per Rb 100 of gross output – 3.3 fold.

Despite certain annual fluctuations, in 2000-2010 the nominal indicators of aggregate farm support in Russia grew 10 fold in ruble terms and 9 fold – in dollar terms³. The ratio of aggregate farm support to the gross value added in agriculture over this period rose from 11.8% in 2000 to 33.8%.

¹ The total for 11 months exceeds the annual output in 1990.

² Such a trend was observed in all countries but in Russia the disparity between the growth of prices for farm inputs and those for farm products was most dramatic. OECD, 1998.

³ The data on aggregate farm support in 2011 and 2012 are not available.

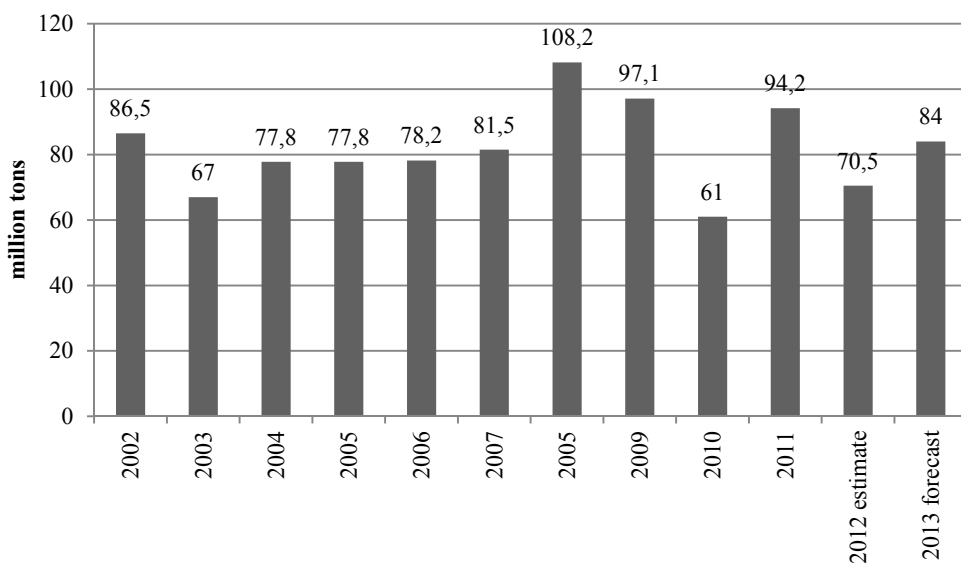
The prevailing component of support structure are consumer transfers to producers (about 70%) implying that in Russia support is mostly rendered at the expense of consumers of farm products rather than at the expense of the state budget¹. Estimates show that the growth of support is accompanied by the lowering of its efficiency: in 2000 the gross output per Rb 1 of state support reached Rb 7.4 but later it fell down to Rb 2-2.6.

In 2012 some changes took place in Russia’s agricultural policies. They were fostered by two events. The first of them was the country’s accession to the WTO implying the need to adjust the measures of national agrarian policies to WTO requirements. The second was the termination of State program for agricultural development and regulation of agricultural, input and food markets for the period of 2008-2012. A new program may envisage new measures of agricultural policies that meet both the requirements of WTO and the new realities of situation in agriculture and development of rural areas.

4.5.2. Situation on Selected Agricultural and Food Markets

Grain Market

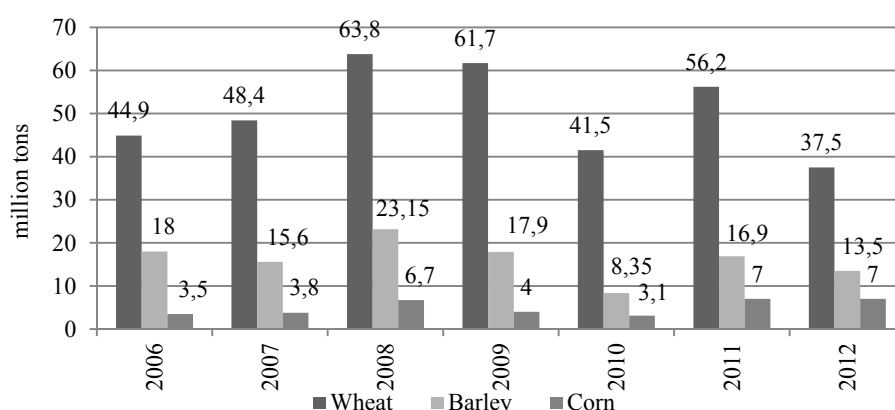
Cold winter and hot summer brought about disappointing results of 2012 harvesting campaign. Grain output was below the average indicators for 2000s (*Fig. 42 and 43*). The crop of barley also fell relative to the previous year level – down to 13.9m tons. The output of corn grew up to 8.0m tons but since the conditions of harvesting were difficult due to rains, it couldn’t fail to affect the quality of grain – the percentage of moisture was rather high.



Source: “SovEcon” Center.

Fig. 42. Russia: Gross Output of Grains in 2002-2012 and Forecast for 2013

¹Assessments were made on the basis of OECD data for 2010 since later estimates are not available.



Source: "SovEcon" Center.

Fig. 43. Russia: Gross Output of Wheat, Barley and Corn in 2002–2012 and Forecast for 2013

The main factor contributing to the decrease of gross output of grains is the lowering of yield which fell down to 18.3 centners per hectare of harvested area (the level of the poor crop 2010). The yield of wheat dropped to 17.7 centners per hectare which is below the 2010 level and is the lowest indicator since 2003.

In July 2011 restrictions on export of grain conditioned by 2010 drought were lifted. In 2012 grain export continued without restrictions. As a result in 2011/2012 MY (June-July) Russia exported 28.1m tons of grain (including flour in grain equivalent) of which wheat accounted for 21.6m tons. This is more than in the rich crop 2009/2010 MY (*Table 40*).

Given the modest crop and active export supplies, by the beginning of October 2012 the inventories of grains and especially wheat in farms, stock and processing enterprises in actually all major producing regions were noticeably below those of not only the previous year but even the poor crop 2010. For instance, as of November 1, 2012 they amounted to 32.9m tons while as of the same date in 2011 they reached 46m tons, in 2010 – 40m tons. The stringent grain balance fostered the growth of market prices.

Table 40

**Supply and Demand Balance for Grains in 2009/10–2011/12 MY (June-July),
million tons**

	2009/10	2010/11	2011/12
Supply (resources)			
Beginning stocks	24.6	28.2	18.6
including intervention stocks	8.25	9.6	6.7
market stocks	18.35	20.6	11.9
Production	97.1	61.0	94.2
Imports*	0.4	1.8	1.7
Total	122.1	91.0	113.8
Consumption			
Domestic consumption	72.0	68.0	70.0
Exports*	21.9	4.4	28.1
Total	93.9	72.4	98.1
Intervention purchases	1.75	-	0.4
Ending stocks	28.2	18.6	15.7
including intervention stocks	9.6	6.7	4.7
market stocks	18.6	11.9	11.0

*including flour in grain equivalent.

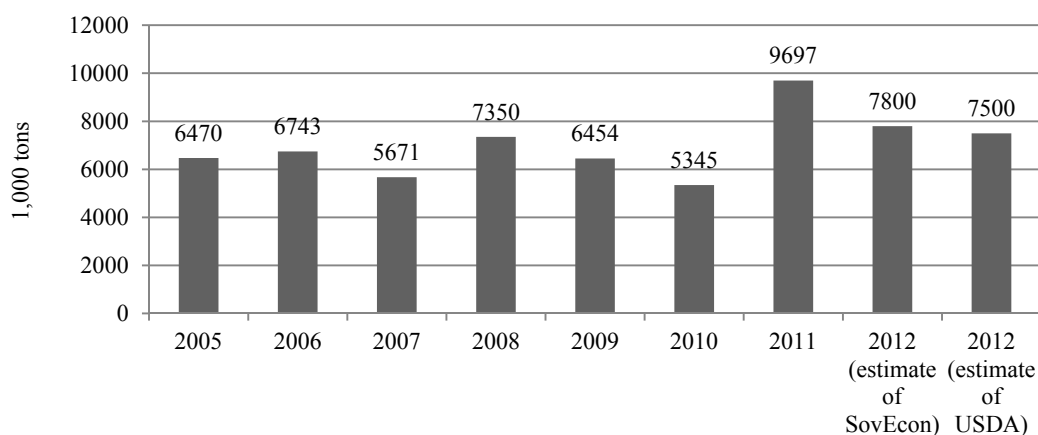
Source: "SovEcon" Center.

With weather conditions being close to the long-term annual average, the Russia's output of grain in 2013 is unlikely to reach the record of 2008 and 2009, i.e. 100m tons. According to the forecast of "SovEcon" it will be about 84-85m tons. However, even despite the expected growth of production the situation on the domestic market in 2013 will remain tight due to the stable export demand for grain in the southern regions and a notable decrease of carry-over stocks. The market will be adjusting to the tightening balance through further growth of domestic prices. Opportunities for regulating domestic market by means of commodity interventions seem to be very limited since the most part of intervention stocks will have been sold by the end of 2012-the beginning of 2013. On the one hand, higher prices will lead to a further decrease of domestic grain consumption (first of all in smallholder farms) which can result in the slaughter of livestock and poultry. On the other hand, the situation may develop so that the accelerated growth of domestic prices will make import of grain more efficient for some regions than its purchase on the domestic market. It concerns not only regions bordering on Kazakhstan but probably also north-western regions of Russia and regions in its center wherein supply of corn from the Ukraine is convenient from the logistical point of view.

Market of Oilseeds and Vegetable Oils

From the beginning of 2000s the market of oilseeds demonstrates a clear trend towards slower growth of sunflower seeds output as compared with that of other oilseeds – rapeseeds, soybeans and oil flax. This is an evidence of both the diversification of oilseeds production and the expansion of their cultivation area in Russia. 2011 set a record in the output of basic oilseed crops: sunflower seeds, rapeseeds, soybeans and oil flax. The dynamic and stable growth of oilseeds production was intermitted only in 2007 and 2010 due to the extreme weather conditions.

According to preliminary estimates the output of sunflower seeds in 2012 will amount to 7.5-7.8m tons. This is below the previous year record but stands second over the whole history of observations (*Fig. 44*). The outputs of rapeseeds and soybeans are estimated to be somewhat above the record indicators of 2011 – 1.0-1.1m tons and 1.8m tons, respectively (*Fig. 45*).

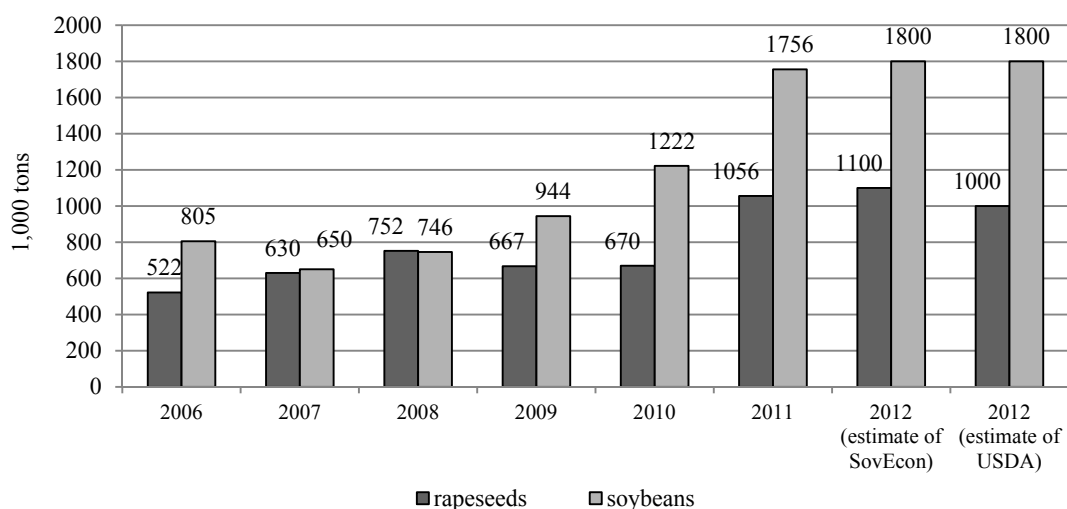


Source: "SovEcon" Center.

Fig. 44. Russia: Gross Output of Sunflower Seeds in 2005-2012

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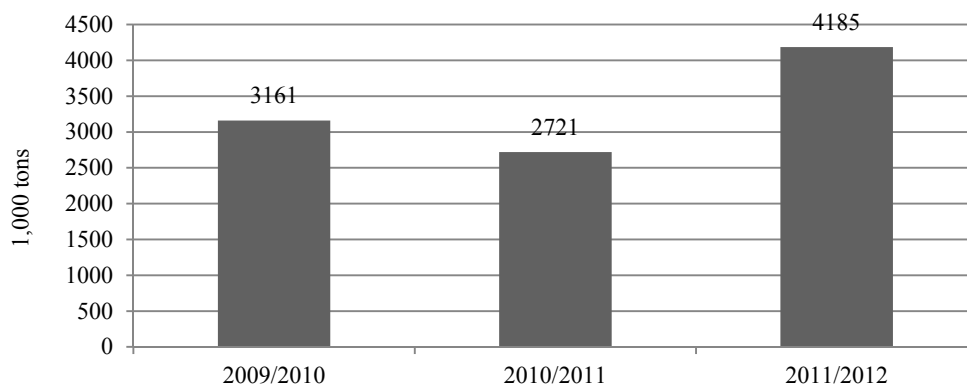
Source: "SovEcon" Center.

Fig. 45. Russia: Gross Output of Rapeseeds and Soybeans in 2006-2012

From the beginning of 2000s the gross output of soybeans in Russia demonstrates an upward trend. In the five recent years it grew almost 3 fold and amounted to 1.8m tons in 2012. The record crop of soybeans was harvested owing to the combination of such factors as the expansion of areas sown (that in 2012 reached nearly 1.3m hectares) and favourable weather conditions. The major regions cultivating soybeans in Russia are the Far East (60% of the domestic output), and the Southern and Central regions of the country.

The domestic consumption of soybeans grew in line with their production – over the period concerned it increased 3 fold up to 2.84m tons. Soybeans are largely used by feedstuffs industry and in the production of meat, dairy, bakery products and confectionary. The promising sector attracted many farm investors and a lot of projects for the construction of soybean plants are being elaborated and implemented in Russia.

Conditioned by the abundant 2011 crop, the output of vegetable oils in 2011/2012 MY (October-September) was record (Fig. 46) as well as exports of products of oilseeds processing (Table 41). At the same time imports of palm oil and soybean meal continue growing.



Source: "SovEcon" Center.

Fig. 46. Russia: Output of Vegetable Oils in 2009/2010–2011/2012 MY (October-September)

Table 41

**Exports and Imports of Oilseeds and Products of Their Processing
in 2009/2010-2011/2012 MY (October-September), 1,000 tons**

	2009/2010	2010/2011	2011/2012
Exports			
Sunflower oil:	505.5	193.6	1426.6
raw	350.1	71.9	1223.3
refined	155.4	121.7	203.3
Rapeseed oil	98.0	116.1	186.4
Soybean oil	158.0	129.3	145.0
Sunflower seeds	17.0	10.8	336.1
Rapeseeds	81.0	15.7	48.4
Flax seeds	n.a.	n.a.	390.8
Sunflower meal	699.3	573.1	1711.3
Imports			
Soybean oil	17.2	20.8	8.5
Palm oil	487.2	611.0	507.5
Sunflower oil	7.6	9.7	17.6
Soybean meal	381.6	469.9	512.2

Source: "SovEcon" Center.

In 2011 – first half of 2012 high world prices for vegetable oils prevented the plummeting of prices on the domestic market (due to large output) and ensured a good margin. But by the end of 2012 prices for soybean and sunflower oils on the European markets switched to falling. So, foreign markets were too sluggish to stimulate a dynamic export outflow of vegetable oils from the domestic market. In these conditions the saturation of the latter by the end of 2012 started to increase.

The domestic market of oilseeds faces a permanent price confrontation between processors and farm producers. In 2011/2012 MY the margin received by sunflower processing industry grew owing to the low cost of raw input. But beginning from August 2012 prices for sunflower seeds were rising while prices for sunflower oil remained constant. As a result the margin received by sunflower processors reduced and fell below the indicators of previous years.

Market of Meat

According to preliminary data the output of meat in 2012 demonstrated positive dynamics. The total production of slaughter livestock and poultry in all types of farms reached 11.6m tons (live weight) which is 6.1% above the respective previous year indicator. The biggest increase is observed in the production of poultry – up 12.0%, pigs – up 3.5% and cattle – up 1.3% (*Table 42*). Meantime imports of meat to the country (except those of poultry meat) have somewhat shrank (*Table 43*).

Table 42

**Production of Slaughter Livestock and Poultry in Farms of All Types,
1,000 tons live weight**

	2005	2006	2007	2008	2009	2010	2011	2012	2012 as % of 2011
Cattle	3 204.7	3 055.0	3 020.0	3 114.6	3 070.3	3 053.1	2 888.1	2925.9	101.3
Poultry	1 970.0	2 267.1	2 650.1	3 022.3	3 475.2	3 866.4	4 325.3	4842.3	112.0

Source: Rosstat.

The growth in pig breeding is conditioned by the continuing full-scale modernization and restoration of the sector under government support. Over the period from 2006 to 2012 more than Rb 8bn were invested in the sector, about 750 pig-raising facilities were put in operation

and reconstructed (according to data of the National union of pig breeders). As a result the increase of pork output (slaughter weight) over these years amounted to 58%.

Table 43

Imports of Meat to Russia, 1,000 tons

	2008	2009	2010	2011	2012	2012 as % of 2011
Poultry meat, fresh-frozen	1 223.9	985.8	688.1	493.0	527.5	107.0
Meat, fresh-frozen	1 710.8	1 437.7	1 441.8	1 428.8	1399.2	97.9

Source: Rosstat, RF Federal Customs Service.

The profitability of highly efficient pig-raising farms reaches 25%, they produce almost one half of the total pork output in the country (*Table 44*).

Table 44

Profitability of Pig-Raising Farms in Russia

Types of farms by level of efficiency	Average profitability		Share of farms of the type in the total output
	Excluding investment component	Including investment component	
Highly efficient farms	25%	3%	48%
Efficient farms	10%	3%	42%
Non-efficient farms	-4%	-4%	10%

Source: National union of pig breeders.

As different from domestic pig breeding, Russian poultry production has already gone through the active investment stage. Therefore, poultry breeders can afford working with minimal profitability that is due to high domestic competition. As a result the gap between prices for poultry meat and pork in Russia is bigger than in other countries: according to data of the National union of pig breeders the ratio between them in slaughter weight equals 0.5 while in China it averages 0.7, in the US and Brazil – 0.9, in the European Union – 1.1. By 2020 when the supply of domestic pork in Russia will grow owing to the completion of investment projects and the credit burden on domestic pig breeders will decline, the gap is expected to become comparable with that in other countries.

According to estimates of the National union of pig breeders the prospective structure of meat consumption in Russia is likely to change. By 2020 the share of pork will grow from the current 33% to 38%, the share of poultry meat – from 38% to 42%, the share of mutton – from 2% to 3%. Meantime, the percentage of beef in the total structure of meat consumption will fall from 26% to 17%.

Taking into account the announced investment projects in the sector and the level of customs and tariff restrictions effective in 2012, the production of pork might increase from 2.428m tons in 2011 (slaughter weight) to 3.923m tons in 2020 and become approximately equal to the projected level of pork consumption in the country – 4.070m tons¹. But due to the Russia's commitments to alleviate meat import restrictions upon accession to the WTO, the pig breeding sector may be the most affected. Larger pork imports and lower prices may result in the decline of pig producers' profitability down to 10-12%. If the worst scenario comes true, the output of pork in the country will drop to 2.207m tons and the share of imports in the total consumption may amount to 46%.

¹ According to estimates of the National union of pig breeders.

4.5.3. Changes in Priorities of Agricultural Policies in 2012 and for the Period of 2013–2020

State Program for Agricultural Development and Regulation of Agricultural, Input and Food Markets

In 2006 following the adoption of Law “On agricultural development” (FZ No. 264 of December 29, 2006) the procedure of allocating funds to the development of agrarian sector changed. From then on budget support to farm producers could be rendered only in case it had been envisaged in the State program for agricultural development and regulation of agricultural, input and food markets (henceforth the State program). This practice has its undeniable merits since all the operators of agricultural market now can – theoretically – plan their activities for a 5-year period knowing in advance the basic rules of the game: the targets of agricultural policies, clearly defined measures of state support and amounts of subsidies they can apply for.

The first State program for agricultural development in 2008-2012 was generally abided by albeit with notable adjustments due to the emergency conditions following the 2009-2010 drought. The next State program was elaborated and came into force beginning from 2013. The draft program for 2013-2020 that had been long discussed by key departments (partially due to the Russia’s accession to the WTO) was finally accepted on July 10, 2012.

The government presumes that the problems of agricultural development are as follows:

- Russia’s lagging behind developed countries of the world by the technical and technological level of agriculture due to the insufficiency of incomes received by farm producers for carrying out modernization as well as to the stagnation in building of machinery for farm production and food industry;
- limited access of farm producers to the market due to drawbacks in its infrastructure and the increasing monopolization of trade networks;
- slow rates of rural areas’ social development conditioning the deterioration of social and demographic situation therein, the outflow of able-bodied population especially of younger age and the shrinkage of rural settlement network.

Indeed, wages in agriculture are as low as 51% of the average wages in economy at large. Many rural areas are depopulating and degrading. Expenditures on food in the structure of households’ final consumption average 30% and in the poorest decile group – over 50%.

What are the basic differences of the new State program from the previous one?

First, the amount of financing has notably increased. While the State program for 2008-2012 envisaged allocation of Rb 551bn of budget funds to the development of domestic agri-food sector (i.e. on the average Rb 110.2bn per annum), the implementation of the State program for 2013-2020 will cost Rb 1509bn (Rb 188.7bn per annum). The structure of support by directions (sub-programs) changed and their number increased to 8 – up from 5 in the previous State program (*Fig. 47¹*).

The priority of agricultural policy goals has changed as well: while in the previous State program the development of rural areas ranked (or at least was declared to rank) first, now it is next to last. At present the main declared goal is the ensuring of food supply in compliance

¹ Directions of financing under the State program for 2008-2012 were split up into blocks corresponding to the sub-programs envisaged in the draft of the new State program for 2013-2020 in order to facilitate comparisons; the sub-program for development of meat cattle breeding was included in the general expenditures on livestock production.

with parameters set by the country's doctrine of food security. In terms of management the increase of the number of goals reduces the probability of their achievement.

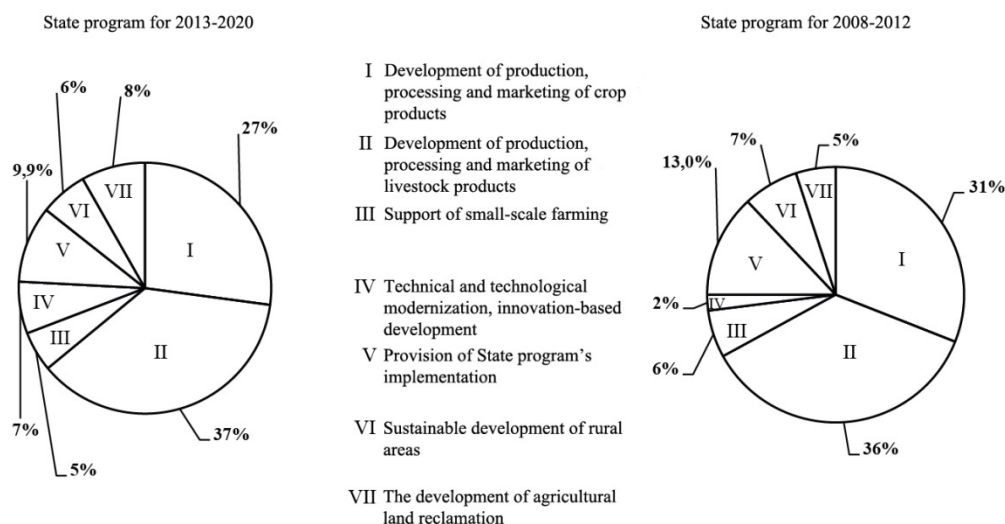


Fig. 47. Structure of Financing by Basic Directions of the State Program

The State program envisages complex development of all sectors, sub-sectors and agri-business activities taking into account Russia's accession to the WTO. Along with that two levels of priorities are distinguished – for the first time ever.

Priorities of the first level include:

- *in the production sphere* – cattle breeding (production of milk and meat) as a system-forming sub-sector using competitive advantages of the country, first of all the availability of extensive agricultural land areas;
- *in the economic sphere* – raising of farm producers' incomes;
- *in the social sphere* – sustainable development of rural areas as a necessary condition for preserving labour force, territorial integrity of the country and ensuring of economic and physical availability of foodstuffs for vulnerable strata of population according to the rational rates of consumption of selected food items;
- *in the sphere of developing production potential* – melioration of agricultural lands, employing of idle pasture and other categories of farmlands;
- *in the institutional sphere* – development of integration links in the agro-industrial complex and shaping of product sub-sectors and territorial clusters;
- *scientific and educational support* – as a vital condition for the forming of innovative agro-industrial complex.

Priorities of the second level include such elements as:

- development of import-substituting sub-sectors of agriculture including vegetable and fruit production;
- ecological safety of agricultural and food products;
- expansion of exports of agricultural, input and food products in line with saturation of domestic market;
- minimization of logistical costs and optimization of other factors that determine the competitiveness of domestic produce following Russia's accession to the WTO, in particular

rational location and specialization of agricultural production and food industry by country zones and regions.

Despite the declared goals, tasks and priorities, the actual priority of state policies is the increase of agricultural output (*Table 45*). According to estimates of the Ministry of agriculture, the implementation of new State program should ensure its average annual growth at the rate 2.5% and more. By 2020 basic indicators envisaged in the country's doctrine of food security should be attained.

The core of the two basic support directions – the development of priority agricultural sub-sectors (in the new State program – sub-programs for the development of crop and livestock production) and the sustainable development of rural areas - was preserved. Measures for regulation of agricultural, input and food markets (the former State program envisaged only the carrying out of purchase and commodity interventions on the grain market), granting of subsidies for compensation of interest rate on received credits and loans and insurance of farm output were transferred into the corresponding sub-programs according to sector profile. On the contrary, melioration of farmlands, technical and technological modernization of agriculture and support of small-scale farming were detached as separate sub-programs.

A new feature is the emergence of tasks targeted at the development of market infrastructure, the ensuring of efficient work of state government bodies administering agricultural development and the development of biotechnologies. More attention – evidently following the accession to WTO – is focused on tasks related to ecology, security and quarantine, preservation and improvement of farmlands' quality.

Table 45

Provisions for Financing of the State Program in 2013–2020

Sub-program	Billion rubles
Development of crop production, processing and marketing sub-sector	466.5
Development of livestock production, processing and marketing sub-sector	499.3
Development of meat cattle breeding	65.4
Support of small-scale farming	83.6
Technical and technological modernization, innovation-based development	23.7
Provision of the State program's implementation	202.5
Social development of rural areas till 2013 (federal target program)	9.0
Sustainable development of rural areas in 2014-2017 and for the period till 2020 ¹ (federal target program - draft)	90.4
Preservation and restoration of soil fertility of farmlands and of agricultural landscapes as a national endowment of Russia in 2006-2010 and for the period till 2013 (federal target program)	7.4
Development of melioration of Russia's farmlands in 2014–2020 ² (federal target program - draft)	62.0

The emergence of sub-program “**Development of meat cattle breeding**” emphasizes new priorities of agricultural policies – the drop of beef production during the reform years was most dramatic and thus the restoration of cattle population became one of the main targets of the State program. Accordingly, new investment credits will be subsidized only for meat cattle producers while subsidizing of those for construction, reconstruction and modernization of poultry and pig breeding facilities will discontinue beginning from January 1, 2015 and January 1, 2017, respectively.

¹ The financing provisions will be adjusted after the adoption of federal target program (draft) “Sustainable development of rural areas in 2014-2017 and for the period till 2020”.

² The financing provisions will be adjusted after the adoption of federal target program (draft) “Development of melioration of Russia's farmlands in 2014–2020”.

Sub-programs for the development of crop and livestock production are designed according to a scheme including four blocks of basic measures: production of farm output of corresponding types; its processing; development of infrastructure and regulation of markets; crediting and insurance.

The Minister of agriculture Nickolay Fyodorov stressed that the government “gradually moves away from the former forms of direct subsidizing to the support of farm producers’ rates of return”¹. Indeed, 207 out of Rb 467bn of state support will be allocated for subsidies to budgets of regions-subjects of the Russian Federation for granting non-bound support to crop producers. However, non-bound measures have so far been envisaged only for crop production and it’s not yet quite clear how will this support be provided.

The measure “Creation of logistical centers” in the form of “wholesale distribution centers for marketing of output” is specified rather vaguely and the declaration of “forming of market price and excluding of numerous middlemen in the chain from farm producers to consumers” as one of the targets of agricultural policies seems to be no more than a pretentious declamation. It’s not clear who will actually receive these subsidies. Among other beneficiaries the State program names farm producers who by the profile of their operation will hardly engage in the construction of either logistical centers or ports for exporting Russia’s agricultural output.

The sub-program “Support of small-scale farming” implies the continuation and extension of government efforts in the following fields:

- development of small-scale entrepreneurship in rural areas including support of beginner farms;
- development of family livestock farms on the basis of peasant (individual private) farms;
- subsidizing of interest rate on received credits;
- assistance to peasant (individual private) farms in registering titles to land plots.

The latter measure leaves perplexed: first, why only peasant farms are eligible for subsidizing of land registration? Second, the area of lands the registration of which one supposes to subsidize is only 960,000 hectares, or less than 0.5% of the total farmland area in Russia, i.e. it won’t have any effect except for being a bonus for a small number of farmers. Third and most important, the problem of registering titles to land plots is not a financial one - it’s rather a problem of corruption of registering officials at the district level and poor involvement of available remote sensing data obtained at the cost of budget funds in the process of cadastral recording of earlier formed land plots. The development of land market in agriculture can be fostered primarily by the simplification of rules of registering new or certification of earlier obtained titles to agricultural land plots as well as by making the procedure of demarcating boundaries of land plots less expensive.

Regrettably, the measures for supporting the system of agricultural cooperation found no understanding in the RF Ministry for Economic Development. Meantime, such measures as granting of long-term budget loans for the replenishment of rural credit cooperatives’ working capital could help to tackle the problem of providing access to credits for small rural entrepreneurs that still produce one half of agricultural output in the country.

Till 2013 the sub-program “**Sustainable development of rural areas**” will be administered via the federal target program (FTP) “Social development of rural communities till 2013” and afterwards – via the FTP “Sustainable development of rural areas in 2014-2017

¹ Rossijskaya gazeta No. 160, July 16, 2012.

and in the period till 2020". Measures under the sub-program are divided in the following groups:

- provision of housing for rural residents;
- education;
- health care;
- culture;
- trade and consumer services;
- information and consultation services for rural residents;
- electrification;
- gasification;
- water supply;
- telecommunication;
- complex compact housing development;
- road construction.

The program does not specify what exactly will be financed and on what terms. The previous program defined the measures more clearly:

- encouragement of non-agricultural activities in rural areas;
- amelioration of housing conditions for people living in rural areas including young families and young specialists;
- development of social and engineering infrastructure in rural areas;
- support of complex compact housing development and improvement of living environment in rural settlements in the framework of pilot projects;
- grant support of rural communities' initiatives on the amelioration of living conditions.

However, their financing was cut due to the 2010 drought and the implementation of other priority support measures.

The proportion between amounts of funds allocated to financial support of two sub-programs – “Technical and technological modernization, innovation-based development” (1.8%) and “Provision of State program's implementation” (15.1% of the total projected expenditures under the State program less federal target programs “Social development of rural areas” and “Melioration”) – is astonishing. The almost 9-fold overbalance of allocations to the sub-program associated with functioning of federal government bodies gives rise to the suggestion that this way the latter, and first of all the RF Ministry of Agriculture, attempt to secure their financial “self-sufficiency”.

Along with that the number of reporting forms to be submitted to the RF Ministry of Agriculture increases year after year, they become more detailed and more frequent, sizable funds are allocated to the maintaining of this system. For instance, beginning from 2016 expenditures on the “Forming of state informational resources in the spheres of ensuring food security and administration of Russia's agro-industrial complex” will exceed Rb 1bn per year. At the same time departmental information gets increasingly classified, first of all for scientific community. Starting from 2010 depersonalized data on farm producers became unavailable and starting from 2012 the access to consolidated reports by regions and for the Russian Federation at large was denied as well.

The general impression about the State program is that it was prepared in haste. Not in all cases one can observe a clear and logical inter-connection between targets, tasks and indicators of sub-programs, the measures under which often overlap and duplicate each other. The

degree of elaborating details differs greatly by sub-programs and it's not always clear what this or that measure implies. For instance, it is mentioned in the sub-program for melioration of farmlands that the essentials of financing and the procedure of granting subsidies for application of mineral fertilizers will be specified in other sub-programs but we have failed to find them. The situation is similar with such a new support direction as the improvement of farm producers' rates of return. One can suggest that these will be such subsidies that will be granted to agricultural producers per hectare of arable land but it's not clear from the text of the State program.

One more bottleneck of the program that can be mentioned is the disregard of regional specifics of rural economies in regions-subjects of the Russian Federation. In 30% of them corporate agriculture with large agro-firms and agro-holdings is the prevailing form of farming. In approximately the same number of regions family farming is the primarily developed pattern and in 40% of them the structure is mixed¹. However, a unified set of measures is envisaged in the text of the new State program. For instance, most types of subsidies are fit only for regions with intensive agriculture and favourable social conditions for the development of rural areas. Meantime in regions with unfavourable conditions for farming producers have no chances to get subsidies for reimbursement of interest rates on investment credits due to low profitability of their production. A special program of social development measures needs to be elaborated for disadvantaged regions suffering from depopulation and for poorly developed areas with adverse natural conditions. In such regions the amount of subsidies actually granted for the development of agriculture is traditionally below the projected sums, budget funds remain under-used.

It has to be admitted that some measures envisaged in the new State program are the most distorting for the market. The spiral of paying subsidies for the compensation of expenditures on servicing long-term bank credits is still progressing. One can avoid this in case the policies of providing state support are revised: subsidies for the purchase of machinery and equipment should be granted directly to producers² instead of subsidizing interest rate; funds should be invested in the support of science, education, the system of information and consulting, construction of roads and other forms of improving rural infrastructure, development of agricultural cooperation; subsidies should be granted on a per-hectare or per-head basis instead of supporting selected products and inputs.

The following hazards associated with accession to the WTO were identified when elaborating the State program for the period till 2020:

- lowering of investment prospects and profitability of enterprises;
- failure to achieve target indicators of the food security doctrine;
- bankruptcy of small and medium-sized enterprises due to their low competitiveness;
- diminishing of job opportunities, lowering of incomes and living standards in rural areas.

The RF Ministry of Agriculture has worked out and adopted an intra-departmental plan of measures for the implementation of Plan of actions of the Government of the Russian Federation targeted at the adaptation of selected sectors of agricultural economy to the terms of RF membership in the WTO.

¹ See Uzun V.Ya., Saraykin V.A., Gataulina E.A. *Klassifikatsiya sel'skokhozyaystvennykh proizvoditeley na osnove dannykh Vserossiyskoy Sel'skokhozyaystvennoy Perepisi 2006 goda*. [Classification of farm producers on the basis of data of All-Russian Agricultural Census of 2006.] Moscow, VIAPI named after A.A. Nikonov, 2010, p. 229.

² Without binding these purchases to the production of a selected product.

A “roadmap” for customs tariff and non-tariff regulation of agricultural import following Russia’s accession to the WTO has been adopted. It was elaborated by the structural departments of the Ministry in collaboration with producer associations and integrates the basic directions of support to farm sub-sectors facing hazards due to the accession to WTO.

The national standard for and the system of assessing the quality of cattle meat are being worked out.

The following measures are envisaged to overcome possible negative effects:

- extension of some tax concessions for agricultural producers including profit tax concessions till 2020; exemption of farm producers from the obligation to pay VAT when importing pedigree livestock, embryos and semen till 2020;
- adoption of federal law “On veterinary” aimed to improve the legal regulation in this field and to harmonize domestic legislation with requirements of international organizations;
- preparation of the list of agricultural and food products the purchase of which for state and municipal needs is forbidden in countries other than countries of the Common Economic Space;
- tightening of customs regulation of agricultural products’ import (especially that of beef) by the Federal Customs Service;
- introduction of amendments to Law “On agriculture” in order to specify criteria of regions with unfavourable conditions for farming. The support of such regions will be regarded as a “green box” measure and accordingly payments to farm producers won’t be subject to restrictions;
- encouragement of demand for agricultural and food products through food aid to low income population strata, supported nutrition of selected social groups (e.g. school meal), reforming of the system of food purchases for state needs (e.g. purchase of domestic food products by the Ministry of Defense, purchases for food reserve, etc.).

The new State program also specifies the mechanism of co-financing of its measures by regions-subjects of the Russian Federation. It implies that in case regional budgets do not provide funds for financing measures under the State program, federal funds won’t be used for these purposes as well. The reasoning is clear: an incentive is being created for regions to support agriculture. But the challenges of such reasoning are also high. The first of them has already been mentioned: the set of measures envisaged in the State program is universal and aimed primarily at the support of production. This universal set disregards regional specifics. As a result, depopulated areas with spotty agriculture that require an approach emphasizing development of rural areas, will be supposed to implement a universal package of measures aimed at the development of farm production unless they have their own funds for carrying out special programs. Second, in case regional budgets do not have enough money or regional authorities do not find it proper to accept federal ideology of support, federal funds won’t be used for the envisaged directions either. Third, the division of responsibilities between the Federation and its subjects is such that the function of supporting agriculture is assigned to the latter. The channeling of financing through regional budgets implies the transfer of funds from the federal budget which reduces the transparency of support and complicates the estimation of its total amount. Fourth, the division of responsibilities complicates control over amber box measures¹. Russia has assumed obligation to diminish them but separate regions

¹ According to the WTO terminology all types of support are divided into three “boxes” depending on the degree of consequent market distortion: the green box (non-distorting), the amber box (the most distorting) and the blue box (an intermediate one).

can – within capacities of their own budgets – finance any efforts outside the State program including those that the Russian Federation should cut in compliance with its international commitments.

State Policies Regarding Farmlands

At present there are no grounds to believe that any policy regarding farmlands exists in the country if under this term one understands a voiced public concern over such lands the responding to which is the goal of the respective policy; there are no formulated tasks and implementation mechanisms either. The failure to voice public concern disorients not only various departments engaged in the organization of land transfer but also the society at large. Measures influencing the transfer of farmlands are often contradictory and their implementation implies high transaction costs and conflicts. For lack of goal there simultaneously exist institutional backgrounds for concentration of farmlands in property of a single owner, on the one hand, and hardly efficient but legislatively formalized restrictions on concentration – on the other; the ban on ownership of land by foreign companies and the legal ways of circumventing this ban; the introduction of new register of land titles and the reluctance of state to automatically transfer there the information on previously granted land titles; problems with compiling the new register of land titles and extremely high costs to be born by title owners due to the technical requirements to documents and plot boundaries that are needed for registering; the inability of state to prepare state-owned lands for purchase or lease and the setting of tight time limits for such purchase or lease to be effected by tenants of state lands under the title of permanent (indefinite) use; the inability of state to reduce the cost of boundary demarcation, to organize the work of respective agencies, to impose legal restrictions on transactions (e.g. mortgage) with plots the titles to which are not inserted in the new registers of titles (the procedure being usually conditioned by boundary demarcation); declared inadmissibility of wasting farmlands and their haphazard withdrawal for real estate development regardless of the quality of lands. This list of contradictory interests and actions can be continued.

In 1992 a special body – the Committee on Land Reform and Land Resources under the RF Government (Roskomzem) – was established whose functions included the state administration of land use, the carrying out of land policies and the implementation of land reform in the Russian Federation. This body was working out the strategy and tactics of land reforms taking into account the needs of all sectors. After 1992 it was repeatedly restructured, changed departmental subordination, some of its functions were detached. Beginning from 2004 there is no agency in the country whose statute reads that it is in charge of land resources. Having come a full circle of transformations – from a single body concentrating functions of land policy making and implementation along with administration of land resources to a set of agencies assigned with specific technical functions and then back to a single body – Rosreestr (2009) – the system has lost strategic functions and retained only a mixture of technical ones. The performing of merely technical functions without binding them to strategic goals cannot be successful. However, instead of leading to the re-establishment of a body in charge with land resources, this discontent resulted in nothing more than the dismissal of Rostreestr's head (September 2012). Meantime, without a strategy for the management of land resources it's impossible even to work out the form of the register since it's not clear what information it should include taking into account the emerging new challenges.

Due to the unsatisfactory state of affairs in the organization of land transfer¹ in agriculture, in 2008 the RF Ministry of Agriculture managed to secure the transfer under its jurisdiction of the functions of land policy making and implementation as well as of legal regulation of land relations in the part pertaining to lands of agricultural destination. However, the transfer to a branch department of the functions concerning resource that can be used for different purposes hinders its management for the benefit of various groups of stakeholders and agencies. Besides, the branch department is short of personnel capable to elaborate the management strategy and does not have the proper physical and information basis for carrying out these functions.

At present two trends in respect of farmlands have taken shape. The first of them is lobbied by the RF Ministry of Agriculture. It envisages the tightening of measures aimed at the preservation of farmlands' quality and their use for agricultural production. Two Government Resolutions in execution of Federal Law No. 101-FZ of July 24, 2002 "On the transfer of lands of agricultural destination" were adopted:

- RF Government Resolution No. 612 of July 22, 2011 "On the adoption of criteria of critical diminishing of soil fertility of lands of agricultural destination";
- RF Government Resolution No. 369 of April 23, 2012 "On indications of land plots' non-use taking into account specifics of farm production or other related activities in the subjects of Russian Federation".

Besides, the State program for agricultural development envisages the financing of works for monitoring the condition of lands of agricultural destination. However, the implementation of the first Resolution requires regular large-scale examinations of agro-chemical quality of soils while the funds envisaged for that in the State program are very scarce. For instance, only Rb 61.8m were spent for this purpose in 2011 and the projected federal budget allocations for 2012 are as small as Rb 65m. Meantime, only examination of arable lands used by corporate farms and individual private (peasant) farms requires at least Rb 8bn². It implies that the Ministry's determination is rather a declaration than a real intention.

On the grounds of revealed indications of land non-use (as listed in the second Resolution) one plans to initiate judiciary withdrawal of idle farmlands. In theory this could improve the mobility of land resources. But these indications are so poorly defined that in case a negligent land user has a lawyer it will be very difficult to withdraw his land. The implementation mechanism has a built-in corruption component enabling a bureaucrat to take any decision due to the vagueness of indications. For instance, the Resolution specifies that one of the indications is that "no livestock is grazed on the pastures"³. It's not clear to what conclusion an inspector should come if there is a single goat on a pasture measuring dozens of hectares: does the grazing take place or not? Besides, federal legislation has left no maneuver for regional authorities: they should withdraw non-used lands even in case there is no demand for them from other farm producers. This can result in mass withdrawal of farmlands in territories where their use is still inefficient and the growth of land areas in state ownership. If the non-use is caused by economic factors, the withdrawal of land can't help to reduce the share of idle lands.

¹ In foreign literature another term is used – land market.

² Calculations are based on the costs of examining arable land in selected pilot farms and the total area of arable land in corporate and individual private farms.

³ RF Government Resolution No. 369 of April 23, 2012 "On indications of land plots' non-use taking into account specifics of farm production or other related activities in the subjects of Russian Federation".

Rural families could parcel out plots equivalent to their land shares in large land areas privatized in the course of restructuring collective and state farms for which there is no demand from corporate and individual private farms. However, taken together the amendments made in 2010 to Federal Law “On transfer of lands of agricultural destination”, the inability of state to curb prices on works for boundary demarcation, the requirements to normative documents to be submitted when forming a plot make the process very time- and money-consuming. For instance, after the enactment of 2010 amendments the process of parceling out plots in exchange for one land share has actually halted since an owner of such a share has to certify the demarcation layout of not only his plot (usually averaging 4-7 hectares) but also that of the remaining plot with area ranging from hundreds to thousands of hectares. Before the introduction of these amendments each owner could order works for the forming of only his own plot and parcel it out with far less efforts. Due to all these problems in 2009-2010 the RF Ministry of Agriculture started the work on improving land legislation. But in line with the pattern that has become traditional, the introduction of amendments initiated by the RF Ministry of Economic Development and deputies from the Duma’s committees on construction and land relations only increased the costs of parceling out plots for rural families instead of making the procedure easier. In the situation when rural residents cannot form their own plots, it does not seem to be fair to qualify lands as non-used and to withdraw them.

At the same time farmlands face growing pressure from developers. The latter have financial capabilities to create formal and informal mechanisms for involving agricultural lands in real estate development irrespective of their value as a non-replenishable natural resource¹. The examination of legislative acts shows that in recent years the state attempted to regularize the haphazard withdrawal of land. For instance, by January 1, 2013 the rules of land use and construction in all settlements and city districts should have been adopted. Otherwise, the ban on allotment of land plots for construction from state or municipally owned lands as well as on the issue of permissions for construction or changing of land plots’ allowed use category should have come into force. But due to the lack of money and – obviously – of the willingness of officials to regularize the use of land for real estate development such work has not been done in most settlements. Besides, developers need new plots for “dachas” outside residential settlements. In Russia it’s customary to create garden and dacha communities – recreation villages for rural residents – on agricultural lands. Only a resolution of local authorities is needed for that. There is no transparent procedure protecting these valuable lands. The practice is highly corruptive.

In June 2012 a draft of the new law “On introducing amendments in the Land Code of the Russian Federation and selected legislative acts of the Russian Federation pertaining to the abolition of land categories and annulling of Federal Law “On transfer of lands or land plots from one category to another”” was introduced to the RF State Duma. According to this draft the currently existing – albeit not very reliable but still protective – mechanisms of managing farmlands are lifted. Taking into account the great lobbying potential of developers the law is very likely to be passed. It predetermines high mobility of agricultural land plots (that will be transferred to developers rather than farm producers) in densely populated areas and their loss for agricultural production. In case the law is adopted – at present it’s being discussed – there will emerge additional demand for farmlands from developers, prices will grow and respective plots will become unavailable for agricultural producers.

¹ Shagayda N.I. *Zashchita zemel’ ot iz’yatiya iz sfery sel’skokhozyaystvennogo proizvodstva*. [Protection of lands against withdrawal from agricultural production.] EKO. - 2008. – No. 5 (407). - Pp. 139-147.

Besides, conflicts are currently aggravating in connection with the withdrawal of land for real estate development by the Foundation for Development of Housing Construction¹. The Foundation was created in 2008 in compliance with the President's decision in order to facilitate transfer of federally owned lands that were not used at all or were used for purposes other than their envisaged destination with the aim to encourage construction of residential dwellings and respective infrastructure². That is, the rationale behind creation of the Foundation was the transfer of non-used lands thereto. However, these provisions – i.e. the withdrawal of non-used or misused lands – have not been enshrined in law. Article 15 of Federal Law No. 161-FZ of July 24, 2008 “On facilitation of housing construction” reads that “in case federally-owned land plots are granted to entities on the title of permanent (indefinite) use, this title is terminated without consent of these entities and regardless of the grounds envisaged in Paragraph 2 of Article 45 of the Land Code of the Russian Federation”. Article 45 of the Land Code envisages termination of title to permanent (indefinite) land use in two cases: first, different types of violations (littering, non-use, etc.); second, necessity to use the plot for state needs in case of natural and other calamities for some time or forever. Meantime, the provision of Federal Law “On facilitation of housing construction” introduces a broader list of grounds and allows to terminate the title to land without consent of a bona fide user regardless of the fact that the plot is not littered and is rationally used. In fact, the withdrawal of plots and non-replenishable loss of farmlands could be acceptable in some cases, for instance, when a city needs extension of its area. But in this case one mustn't use a punitive mechanism in respect of properly used farmlands; rather, the mechanism of land withdrawal for state and municipal needs should be applied with granting of compensation or an equivalent plot. At present the legislation regulates neither this question nor the question of compensating corporate farms' losses due to the need to purchase additional feeds (that they fail to produce because of the withdrawal of land) and their expenditures associated with non-completed production cycle on this land. Besides, in practice farmlands are by no means always withdrawn for the purposes of facilitating housing construction³.

Beginning from 2011 one of the directions of state support to agriculture is associated with farmlands: the partial subsidizing of expenditures of individual private (peasant) farms (including individual entrepreneurs) on registering of titles to farmland plots used by them. In 2012 the financing of this measure continued. However, the subsidy terms do not contain any limitations as to the amount to be granted per one farm or per hectare. Given budget constraints the result will be the use of these subsidies by only a limited number of farmers having close ties with decision-taking officials as well as the over-pricing of works by cadastral engineers.

4.5.4. Assessment of Outcomes of Russia's Accession to the WTO

Accession to the WTO will require a considerable amendment of Russia's agricultural policies. The meeting of basic WTO requirements will result in the diminishing of import duties and respective budget revenues and in smaller transfers from consumers to producers.

In 2008-2010 the aggregate support to Russian agriculture amounted to Rb 621.8bn including Rb 481.8bn received from consumers of agricultural products and Rb 140bn allocated

¹ <http://www.permoboz.ru/txt.php?n=9591>

² <http://www.socpolitika.ru/rus/news/document8062.shtml>

³ http://www.fondrgs.ru/press/news_detail.php?ID=16949

from the budget (Rb 328.4bn of budget expenditures minus Rb 188.5bn of budget revenues owing to the support measures).

The main direction of Russian agricultural policies' adjustment following the accession to WTO should be the revision of sources of farm support: the reduction of consumer transfers and the growth of allotments from the budget.

Assuming that the amounts of support to domestic agriculture after the accession to WTO remain the same and the country approaches the EU by the structure of sources of support, the allocations from the budget should be increased almost 3 fold (from Rb 140bn to Rb 497bn).

In order to preserve the existing level of support to farm producers (that before joining the WTO was primarily provided at the expense of consumers of farm products), its financing from the budget should grow by approximately \$12bn. Without such increment domestic producers will find themselves in unequal competitive conditions and can lose their positions on foreign and home markets. Meantime, it's impossible to increase support by means of amber box measures that are traditionally used in Russia since according to the WTO accession terms they should not exceed \$4.4bn. State support is to be provided primarily through green and blue box measures that do not distort the market or distort it to a lesser extent. A mere changing of measures won't help to achieve the desired results. It's obvious that an assessment should be made as to the efficiency of amber box measures, their adjustment to the WTO requirements or substitution by green box measures.

Further follows the assessment of outcomes of Russia's accession to the WTO for selected sectors of agriculture.

1. Pig breeding. In 2010 the domestic purchase price per 1 kg of pork amounted to Rb 107.9 while the respective import price was as low as Rb 62.8, the output of pork totaled 1.993m tons while its consumption – 3.249m tons. Given these prices and volumes, consumer transfers to producers amounted to Rb 89.9bn. Besides, consumer transfers to the state and other agencies owing to imports equaled Rb 56.6bn.

In case the ratio between domestic and world prices – nominal protection rate – falls down to 1 (which is the case in the US and the EU), this will result in the drop of domestic purchase price, the cut of production down to 1.2m tons, the increase of consumption up to 3.7m tons and the expansion of imports from 1.3 to 2.5m tons.

In order to preserve production at the achieved level additional Rb 89.9bn should be allotted to pig breeders from the budget (the compensation for non-received consumer transfers). For output to reach the existing consumption level, allocations from the budget should amount to Rb 146.5bn and complete import substitution is attainable in case of Rb 167.6bn budget spending.

The estimated amounts are well above the total budget provisions for pig producers under the previous and the new State program and even exceed the maximum support to agriculture by means of amber box measures to be achieved by 2018 (as set by Russia's agreement with the WTO). Other measures considered to belong to green box should be elaborated. Besides, it's necessary to modernize the sector, to cut costs and to improve competitiveness of domestic producers on the foreign and home markets without sizable transfers from the budget and consumers.

2. Milk cattle breeding. In compliance with WTO requirements the rate of milk producers' nominal protection will be gradually reducing and the transfers from milk consumers to milk producers will be diminishing as well. In 2010 they amounted to Rb 94.8bn (with output totaling 31.9m tons and the difference between purchase and import prices being Rb 2.9 per kg).

The revenues received by the budget and other organizations owing to consumer transfers per 7.9m tons of imported products will drop by Rb 23.5bn.

In case domestic purchase prices reduce from Rb 12.3 to Rb 9.4 per 1 kg of milk, its production in the country may fall down to 24.2m tons while consumption may rise up to 42.3m tons. To satisfy such demand imports need to be increased up to 18.1m tons implying that their share will grow from 24.8% to 43%.

In order to fulfill the doctrine of food security and meet not less than 90% of demand for milk by domestic production, the latter should amount to 38m tons. It's necessary to allocate Rb 113bn from the budget for compensation of consumer transfers that won't be received by milk producers. It's quite obvious that such a sum cannot be paid under amber box measures. To support milk producers one needs to design measures complying with the requirements of green box, on the one hand, and to work out tools for the reduction of costs and improvement of domestic producers' competitiveness – on the other.

3. Production of beef. The doctrine of food security sets the task to achieve 85% level of self-sufficiency in meat. Its fulfillment is most complicated for beef production. In 2010 about 50% of beef was imported. Crisis in the sector has not been overcome and cattle population continues falling. If following accession to the WTO domestic purchase price (Rb 122.6 per kg) falls down to the level of import price (Rb 100.8 per kg), production will decline even more while consumption will grow and imports will exceed home production almost 1.5 fold.

The 85% level of self-sufficiency will be attained in case domestic production is as large as 2.318m tons. Beef producers should receive Rb 50.7bn from the budget to compensate missing transfers from consumers. However, the problems of meat cattle breeding cannot be solved exclusively by channeling budget funds to the non-competitive sector. Its modernization is required. Meantime, the type of modernization that was used in poultry and pig breeding, i.e. large-scale production concentration is not acceptable for cattle meat breeding. To develop the sector one should start with creating 150,000—200,000 individual private farms that will keep 15-20m meat cows and raise calves up to the weight of 120-200 kg. Basing on this ground echelon it will be possible to develop large-scale businesses – feedlots for fattening cattle, meat processing plants, trade networks.

To launch such a scheme of sector development, one needs respective policies, incentives on the part of government and organizational efforts on the part of large business, the latter's investments not only in feedlots and meat processing but also in contracting farmers engaged in raising of feeder livestock.

4. Broiler poultry production. In the recent decade broiler production has been the most speedily growing sub-sector of agriculture with an annual increment of 10-15%. In the coming 2-3 years Russia can fully satisfy domestic demand for poultry meat and proceed to the exporting of this item. The accession to WTO and the expected lowering of producer protection rate can result in the slowing down of this growth and even in the reduction of output. In 2010 the domestic purchase price amounted to Rb 74.3 per kg of poultry meat while the respective import price equaled Rb 43.6. In case domestic prices drop, the output will fall from 2.7 to 1.6m tons and the consumption will grow from 3.3 to 3.8m tons with imports increasing from 0.6 to 2.2m tons. In order to preserve the achieved level of production Rb 84.3bn need to be transferred from the budget. To secure the achieved rate of satisfying domestic consumption by domestic output Rb 102.3bn need to be allocated and complete import substitution is attainable in case of allocating Rb 117bn.

Such large funds cannot be allotted through amber box measures. Therefore, one needs to elaborate measures complying with green box requirements. Besides, it's necessary to modernize the sub-sector and to switch to production patterns customary for developed countries, i.e. based on collaboration of large companies with smaller broiler farms. Thanks to this collaboration large companies benefit from lower expenditures on investments, electricity, water, protection of environment, resources and output, while farmers receive higher incomes owing to concentration of production, up-to-date technologies, guaranteed marketing, repulsion of encroachments on property and incomes by bandits, raiders, bureaucrats, etc.

5. Production of grain and sunflower seeds. The accession to WTO is likely to produce quite an opposite effect on producers of grain and sunflower seeds. As different from the above examined livestock sectors that will require sizable budget allotments just to preserve the attained levels, membership in the WTO will stimulate domestic production and export of grain and sunflower seeds. Producer transfers to consumers will decrease but this reduction won't affect consumption seriously as the demand for bread, bakery products and vegetable oils is non-elastic.

The accession to WTO and the consequent growth of wheat producers' nominal protection rate up to 1 is expected to have the following effects (estimations based on annual averages for 2008-2010): growth of domestic purchase prices up to the level of export ones (from Rb 4.43 per kg to Rb 4.91 per kg), additional producer revenues amounting to Rb 30bn, increase of output (from 55.7 to 62.3m tons) and exports (from 14.7 to 22.3m tons).

4.5.5. Recommendations for Economic Policies

Russia's accession to the WTO necessitates adjustment of domestic agricultural policies to new requirements. The main directions of cardinal revising of the country's farm support policies following this accession are:

- reduction of consumer transfers to producers and to the budget due to the lowering of import customs duties;
- sizable increase of budget support in order to compensate non-received consumer transfers to producers;
- improvement of support structure: reduction of the share of direct support to producers and the growth of expenditures on general support measures;
- revision of support mechanisms: reduction of product-specific subsidies depending on the volume of production of specific products and distorting the market; reduction of input-specific subsidies depending on the volumes of specific inputs' use and also distorting the market; the increasing of subsidies that do not distort the market and belong to green box measures according to the WTO classification;
- ensuring of producers' competitiveness on domestic and foreign markets of all basic farm products primarily by means of modernization and creation of favourable conditions for business. Russia's accession to the WTO implies its consent to the functioning of the whole economy and agriculture in particular in the competitive environment.

State policies should pay more regard to specific conditions of each region: for instance, envisage wider support to rural development instead of prioritizing support to farm production in areas showing signs of its degradation.

In the part pertaining to the improvement of farmland policies it seems rational to develop the concept of state policy envisaging the need to elaborate tools for protecting land use and property rights of bona fide farm producers; to monitor the re-distribution of lands; to curb

concentration of farmlands in property of selected individuals; to classify lands with determining plots of valuable land the involvement of which in real estate development should be limited; to estimate the costs of land transfer and to change procedures entailing high expenditures; to make the spontaneous process of involving farmlands in real estate development more controllable through the adoption of plans for territories' development and agricultural zoning, including the sale of development permits at auctions; to allocate funds to the preparation of state-owned plots for lease or sale; to elaborate standard rules of agricultural zoning with establishing requirements to the density of construction, types of buildings and use of plots; to work out mechanisms of preparing plots for and their transfer to long-term lease by foreign residents while securing the priority of Russian residents and entities in getting titles to these plots; to switch from the procedures of state control over the use of farmland plots to the control by physical and legal bodies interested in the acquiring of non-used plots; to introduce mechanisms forcing owners to use or lease out idle farmland plots; to prioritize the preservation of open spaces on non-used farmlands in order to enable their quick involvement in agricultural production if necessary, etc.

Russia's accession to the WTO necessitates adjustment of domestic farm support measures to the requirements of this organization. Russia traditionally applies measures that are classified as amber box. Adoption of the new State program for the period till 2020 (i.e. to be implemented in compliance with WTO rules) requires estimation of efficiency of amber box measures used under the previous State program that ended in 2012. Before 2009 the collection of initial information from farm producers was assigned to Rosstat and this information was available for calculations and assessment of support measures by independent scientific community. Beginning from 2009 the function of gathering information was transferred from Rosstat to the RF Ministry of Agriculture that abruptly curbed access to this data. For instance, as of December 20, 2012 the information portal EMISS – Common Inter-Departmental Information and Statistical System – contained only 2 documents in the section “Ministry of Agriculture”: “daily output of milk” and “average daily milk yield”. In addition to the fact that local bodies in charge of agriculture each day are engaged in gathering such data from farms, districts and regions irrespective of its questionable usefulness for management of the sector, one can but say that this information is able to satisfy the requests of a very limited set of people. At the same time at present it's impossible to estimate the effect of support measures and to give sound recommendations as to their reduction or expansion basing on calculations. Due to that in order to improve the quality of recommendations it's reasonable to prepare and adopt a government resolution on the rules of getting access to information collected by the Ministry of Agriculture at the expense of Russian taxpayers.

Analysis of the system of state support to agriculture brings to the conclusion that although the principle of co-financing of support measures by the federal and regional authorities has a certain stimulating potential, it needs to be revised in respect to some programs. In order to attain the federal policy goals it's rational to elaborate measures for supporting farm production (including the ones classified as amber box) to be financed from the federal budget irrespective of the capabilities of regional budgets. Meantime it's reasonable to transfer to regions a part of federal funds allocated to the development of rural areas and belonging to green box measures on co-financing terms. This will require re-distribution of authorities between the Federation and regions since at present these are regions that are assigned with this function regardless of the fact that 50% of support of the kind is executed from the federal budget via inter-budgetary transfers. Two federal laws have to be amended in order to revise the distribu-

tion of authorities and the system of channeling budget funds. Since according to the WTO requirements the Russian Federation has to exercise control over expenditures on amber box measures, it's also advisable to work out the mechanisms of controlling such expenditures from the regional budgets. They can include regional quotas for such support established by the federal budget and the possibility to re-distribute them between regions bypassing the Federation – via purchase and sale of quotas between regions. This will also require amendments in the existing legislation as regards the distribution of authorities between the Federation and its subjects and the transfer of control functions to the Federation in case they are associated with the RF international commitments.

In order to preserve the dynamics of growth in some sectors of agriculture after the country's accession to the WTO, additional support should be rendered thereto. This support used to be provided by population that paid higher prices for commodities. The accession to WTO will allow cheaper import products to enter the Russian market and population will stop paying for higher costs of domestic producers due to various reasons. Given that a dramatic increase of budget support will be necessary to compensate funds earlier paid by population. The Russian budget is hardly ready for such an increase. For instance, only producers of pork will need additional Rb 89.9bn to be allocated from the budget (for compensation of non-received consumer transfers) in order to preserve the current level of aggregate support. To increase the output to the existing level of consumption the budget should spend additional Rb 146.5bn and to attain complete import substitution – Rb 167.6bn. These sums are well above the total annual budget expenditures on agriculture under the current and the new State program; they also exceed the maximum amount of funds for amber box measures by 2018 that is established by Russia's agreement with the WTO. One should elaborate other support measures belonging to the green box and to cut transaction costs of pork producers. Besides, the sector needs modernization and diminishing of production costs. Otherwise, it's impossible to secure competitiveness of domestic producers on the home and foreign markets.

In order to fulfill the doctrine of food security as regards milk, i.e. to cover not less 90% of consumption by domestic output, it's necessary to produce 38m tons of milk. Following the accession to WTO consumer transfers to producers (per this quantity of milk) will drop by approximately Rb 113bn. It's quite obvious, that such a sum cannot be paid from the budget. The support to milk producers will require the elaboration of support measures complying with the requirements of green box, on the one hand, and the creation of institutional framework for cutting of farm producers' costs, on the other. The latter goal can be achieved through such steps as, for instance, the lowering of costs charged for connection to utility networks; the transfer to paying for actually consumed electric power versus its preliminarily ordered quantities; the lowering of expenditures on registration of land titles; the encouragement of modernization; improvement of business security; execution of control over milk processors with the view to prevent preferential use of imported dry milk to the detriment of domestic producers of fresh milk, etc.

Following accession to the WTO consumer transfers to producers will drop (due to lower prices). In order to preserve the existing level of support, Rb 50.7bn should be allocated from the budget to producers of beef. However, the problems of meat cattle breeding cannot be solved exclusively by channeling budget funds to the non-competitive sector. Its modernization is required. Meantime, the type of modernization that was used in poultry and pig breeding, i.e. large-scale production concentration is not acceptable for cattle meat breeding. To develop the sector one should start with creating 150,000-200,000 individual private farms

that will keep 15-20m meat cows and raise calves up to the weight of 120-200 kg. Basing on this ground echelon it will be possible to develop large-scale businesses – feedlots for fattening cattle, meat processing plants, trade networks.

To launch such a scheme of sector development, one needs respective policies, incentives on the part of government and organizational efforts on the part of large business, the latter's investments not only in feedlots and meat processing but also in contracting farmers engaged in raising of feeder livestock.

In order to preserve the achieved level of broiler production Rb 84.3bn need to be transferred from the budget. To secure the achieved rate of satisfying domestic consumption by domestic output Rb 102.3bn need to be allocated and complete import substitution is attainable in case of allocating Rb 117bn.

Such large funds cannot be allotted through amber box measures. Therefore, one needs to elaborate measures complying with green box requirements. Besides, it's necessary to modernize the sub-sector and to switch to production patterns customary for developed countries, i.e. based on collaboration of large companies with smaller broiler farms. Thanks to this collaboration large companies benefit from lower expenditures on investments, electricity, water, protection of environment, resources and output, while farmers receive higher incomes owing to concentration of production, up-to-date technologies, guaranteed marketing, repulsion of encroachments on property and incomes by bandits, raiders, bureaucrats, etc.

4.6. Foreign Trade

4.6.1. The State of Global Economy

In 2012 the global economy was developing in the situation of high uncertainty. Although the economic recovery after the global financial crisis continued, its growth rate has slowed down: if in 2010 the global GDP has grown by 5.1%, in 2011 - by 3.8% and in 2012 - by 3.2%.

The major threat to the economy came mainly from the Eurozone, which failed to cope with the sovereign debt crisis. Although most governments in European countries have taken a ply to reducing the budget deficit, significant progress in the fight against the debt crisis could not be reached. According to the second tentative estimates of Eurostat¹, the GDP of 27 countries of the European Union (EU-27) in 2012 as compared with the previous year has decreased by 0.3% and GDP of 17 Eurozone countries – by 0.6%. Herewith, in the Eurozone countries the GDP decrease was observed throughout the year. Thus, in Q1 as compared with the same period of 2011, the Eurozone GDP has decreased by 0.1%, and in the Q2 - by 0.5%, in the Q3 - by 0.6%, in the Q4 – by 0.9%. According to the forecast of the European Central Bank (ECB), the countries of Europe, experiencing the economic crisis can start recovery by the middle of 2013. However, the transition to worldwide economic growth in the region will be visible only by the beginning of 2014.

Throughout 2012 the leading economy of the world - the United States was able to maintain growth, and in Q3 even significantly accelerate its rate. Thus, having slowed down in the Q2 from 2.0 to 1.3% of GDP, the growth rate in annual terms has accelerated in Q3 to 3.1% (according to the US Bureau of Economic Analysis²). However, in Q4 the GDP has declined

¹ http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-06032013-AP/EN/2-06032013-AP-EN.PDF

² <http://www.bea.gov/national/index.htm#gdp>

by 0.1% for the first time since 2009, when the global economy was in a recession. Nevertheless, as per results of 2012, the US economy has demonstrated growth in the amount of 2.2%. Such growth cannot resolve all economic problems, but it represents a further step on the path to sustainable growth and reduction of unemployment, which is an encouraging indicator for the global economy.

Downturn in the Eurozone, the risks associated with the sovereign debts' crisis, forecasts on cooling the global economy and fluctuations of financial markets have provided a significant impact on the economies of developing countries. Throughout the year there was a slowdown of the Chinese economy growth. As a result, over the year the national GDP has grown by 7.8%¹, which is the lowest level in the latest 12 years.

The growth rate of the Brazilian economy continues to decrease. The growth rate slowing was started at the beginning of Q1 2010, when Brazil economy has grown by 9.3%. Then, the GDP growth rates were declining steadily from quarter to quarter. In 2012 the economic growth rates have fallen sharply: quarterly growth has never exceeded 1%. Thus, in Q2 2012, the GDP growth rate in annual terms has decreased from 0.8% to 0.5%, in Q3 there was a slight acceleration to 0.9%. Overall, in 2012 Brazilian GDP has increased as compared with 2011 by 1.3% (whereas in 2011 the growth made 2.7%, in 2010 - 7.5%)².

In the economy of India in 2012 there were noted the slowest rates in three years. Thus, in Q1 2012, the GDP has grown by 5.3% in Q2 - by 5.5%, and in Q3 it has again slowed down to 5.3% against the relevant period of the previous year. In general, the Indian economy has grown by 5.4%³, which is the weakest indicator in the last decade.

International economic organizations during 2012 were repeatedly reducing their forecasts for further development of the global economy. Thus, in October Bulletin Prospects and Outlooks for the Growth of the Global Economy, the International Monetary Fund has cut down its outlook for global growth in 2012 to 3.3% in 2013 to 3.6% in 2013. In the July issue of the Prospects and Outlooks for the Growth of the Global Economy for 2012, the relevant forecast was presented at the level of 3.5 and 3.9%. And even earlier, in the April 2012 Prospects and Outlooks for the Growth of the Global Economy, the outlook for growth in the world economy has been higher than in July. Herewith, the forecasts for both, the countries with advanced economies and for those of emerging market and developing countries. In the January 2013 issue of the Bulletin the forecasts for nearly all countries were downgraded again (See *Table 46*).

In November 2012, the Organization for Economic Cooperation and Development (OECD)⁴ has also decreased its forecast for the global economy development, having warned that the greatest threat to global economic growth remains the indebtedness crisis in the Eurozone. The OECD report "Economic Perspectives" has forecasted the global GDP growth in 2012 by 2.9% and by 3.4% in 2013. Thus, there was also a significant adjustment of the forecast given in May 2012. Then the organization was assuming that in 2012, the global economy would grow by 3.4% and in 2013 - by 4.2%. The GDP growth in OECD countries is expected to reach 1.4% in 2013, accelerated in 2014 to 2.3%.

¹ <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html>

² <https://www.cia.gov/library/publications/the-world-factbook/geos/br.html>

³ <https://www.cia.gov/library/publications/the-world-factbook/geos/in.html>

⁴ http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-outlook-volume-2012-issue-2_eco_outlook-v2012-2-en

Table 46

**Dynamics of the Global GDP and Global Trade Growth Rate in% against
the Preceding Year**

	2010	2011	2012	IMF estimates		Difference between the forecasts made in October 2012 and in January 2013	
				2013	2014	2013	2014
Global GDP	5.1	3.9	3.2	3.5	4.1	-0.1	-0.1
Countries with advanced economy	3.0	1.6	1.3	1.4	2.2	-0.1	-0.3
USA	2.4	1.8	2.3	2.0	3.0	-0.1	0.1
Eurozone	2.0	1.4	-0.4	-0.2	1.0	-0.3	-0.1
Germany	4.0	3.1	0.9	0.6	1.4	-0.3	0.1
France	1.7	1.7	0.2	0.3	0.9	-0.1	-0.2
Italy	1.8	0.4	-2.1	-1.0	0.5	-0.3	-0.0
Spain	-0.3	0.4	-1.4	-1.5	0.8	-0.1	-0.2
Japan	4.5	-0.6	2.0	1.2	0.7	0.0	-0.4
Great Britain	1.8	0.9	-0.2	1.0	1.9	-0.1	-0.3
Canada	3.2	2.6	2.0	1.8	2.3	-0.2	-0.1
Other countries with advanced economy	5.9	3.3	1.9	2.7	3.3	-0.3	-0.1
Newly industrialized Asian economies	8.5	4.0	1.8	3.2	3.9	-0.4	-0.2
Emerging markets and developing countries	7.4	6.3	5.1	5.5	5.9	-0.1	0.0
Central and Eastern Europe	4.6	5.3	1.8	2.4	3.1	-0.1	0.0
CIS	4.8	4.9	3.6	3.8	4.1	-0.3	-0.1
Russia	4.3	4.3	3.6	3.7	3.8	-0.2	-0.1
Outside Russia	6.0	6.2	3.9	4.3	4.7	-0.5	-0.1
Developing Asia	9.5	8.0	6.6	7.1	7.5	-0.1	0.0
China	10.4	9.3	7.8	8.2	8.5	0.0	0.0
India	10.1	7.9	4.5	5.9	6.4	-0.1	0.0
Latin America and the Caribbean	6.2	4.5	3.0	3.6	3.9	-0.3	-0.1
Brasilia	7.5	2.7	1.0	3.5	4.0	-0.4	-0.2
Mexico	5.6	3.9	3.8	3.5	3.5	0.0	0.0
World trade in goods and services	12.6	5.9	2.8	3.8	5.5	-0.7	-0.3
Imports							
Advanced economies	11.4	4.6	1.2	2.2	4.1	-1.1	-0.4
Emerging markets and developing countries	14.9	8.4	6.1	6.5	7.8	-0.1	-0.1
Exports							
Advanced economies	12.0	5.6	2.1	2.8	4.5	-0.8	-0.4
Emerging markets and developing countries	13.7	6.6	3.6	5.5	6.9	-0.2	-0.2

Source: <http://www.imf.org/external/russian/pubs/ft/weo/2013/update/01/pdf/0113r.pdf>

The US economy will grow in 2013 only by 2.0%, while in May the OECD was forecasting the growth at 2.6%. The most serious internal risk to the favorable growth of the U.S. economy is the possibility of a sharper-than-planned budget reduction, if the U.S. politicians fail to reach an agreement on the prevention of substantial automatic tax rates growth and the schedule of costs reduction in early 2013. In the worst-case scenario, the amount of the budget adjustment can reach more than 4% of GDP. Financial adjustment in 2013 will have an impact on the economy of the U.S. and its major trading partners, as well as on the export of raw materials (due to lower cost of raw materials).

In October 2012 the World Trade Organization (WTO) has published the annual package of documents, presenting the detailed statistics on the volume of trade flows and on tariff rates in 2011¹, according to which the growth of trade in goods in 2011 was 5% under the global GDP growth by 2.5%. In 2010 those indicators were 13.8% and 3.8%, respectively. In the pre-crisis period of 1990-2008 the average indicators of the annual growth rates of trade in goods were at the level of 6%.

¹ http://www.wto.org/english/news_e/news12_e/stat_23oct12_e.htm

In 2011 the largest exporter of goods in the world (in value terms) was China, the exports of which had increased by 20% to \$1.898bn. The share of China's share in the global exports made 10.4%. The USA takes the 2nd place with the exports of \$1.48bn, and Germany is at the 3rd place, which has exported goods worth \$1.472bn. Russian Federation with exports of \$522bn has come up to the 9th place from the 12th, which it held in 2010.

In terms of the volume of imports in 2011 at the 1st place was the United States, which has purchased abroad the goods for \$2.266bn. The 2nd place is held by China, imports of which amounted to \$1,743bn; the third place is held by Germany, which imported goods for the amount of \$1.254bn. The Russian Federations rose from 18th place, which was occupied in 2010, to the 17th place, having bought abroad goods for the amount of \$324bn.

In 2012 the foreign trade turnover of the U.S. made \$3.82 trillion¹, China - \$3.87 trillion². Therefore, as of 2012 results, China became the leader of the global trade in goods, having overcome the United States, which was the leader in this regard since 1945.

WTO has reduced the forecast for growth of the global trade for 2012 to 2.5% from 3.7%, which was given by the organization in the previous forecast, made in April 2012.

For 2012, the growth of exports from developed countries was projected by 1.5%, and from developing countries by 3.5%. Import of the first group of countries will increase by 0.4%, i.e., it will be almost stagnant, and of the second group by 5.4%. The forecast for April 2012 was more optimistic: there is expected growth by 1.9 and 6.2%, accordingly. Relevant indicators are lowered also for 2013: WTO finds that the global trade will grow by 4.5% instead of 5.6%. Herewith, further adjustment can take place in case of continued uncertainty in the European financial system.

The need to revise the WTO forecast in April is largely due to the decline in trade within the EU and the EU trade with the outside world.

4.6.2. Terms of the Russian Foreign Trade: Market Prices for the Major Exported and Imported Goods

In addition to the global slowdown in economy, commodity markets in 2012 were influenced by other factors. The major event in the global energy market was the development of shale oil and gas fields in the U.S. Shale gas production has led to a significant decline in prices in the domestic market. Right now they are lower than in Europe or Asia. Meanwhile, the growth of oil production affects the world market through the reduction in demand from the U.S., which slows down the growth of prices.

The tense situation in the North Africa and the Middle East, as well as the introduction of the EU and U.S. sanctions against Iran have prevented from the sharp fall in the price of energy sources. In 2012 the EU has joined the U.S. stringent sanctions regime in regard to Iran with the purpose to influence the nuclear program of that country. Many traditional buyers have drastically reduced or restrained from purchases energy sources from Iran. In general, tightening of the U.S. and the EU sanctions has led to reduction of oil exports from Iran. Increased supply from Saudi Arabia, Iraq and other countries - OPEC members helped to smooth the effect of the reduction in the supply of Iranian oil to the global market.

One of the most anticipated events of the year was the launch of quantitative easing program (QE3) by the U.S. Federal Reserve. With the expectations of new injections of liquidity by the U.S. Federal Reserve and the rise in the global economy activity commodity quotes

¹ <http://www.trade.gov/press/press-releases/2013/export-factsheet-february2013-020813.pdf>

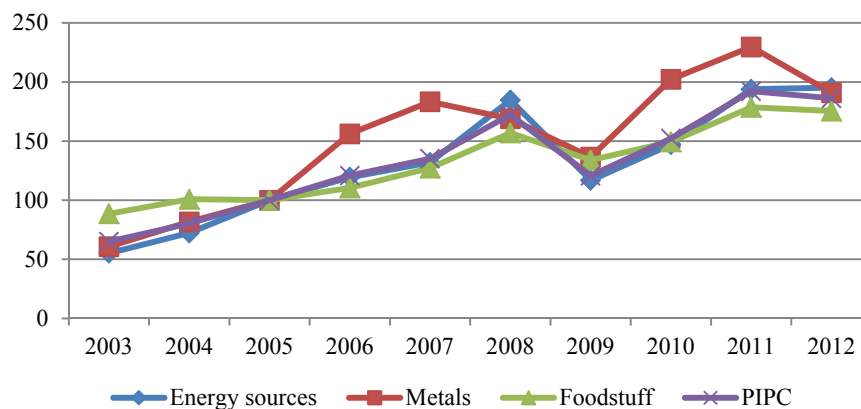
² <http://english.customs.gov.cn/tabid/47819/Default.aspx>

after a serious correction in the H1 2012 began to rise in the H2 of the year. However, due to the sustained poor dynamics in both, the developed and the developing countries the launching of a new program of asset purchases by the U.S. Federal Reserve was not enough. After a short-term growth, quotations of many primary assets quickly returned to the previous levels achieved before the launch of QE3.

In some regions of the world in 2012 there were noted abnormally hot and dry weather conditions, which affected crop areas of Russia, Australia, Brazil, India. The most serious damage was caused to the agricultural sector of the United States, where by a number of assessments the drought has been the most significant in the last fifty years. Badly damaged were the harvests of soybean, grain, and a number of forage crops. Against this background, food prices began to grow.

However, in general, in 2012 the average FAO Food Price Index¹ made 212 points, which is by 7% lower than in 2011. The most significant was the decline in sugar prices index (17.1%), dairy products (14.5%) and vegetable oils (10.7%), to a lesser extent were reduced prices for cereals (2.4%) and meat (1.1%).

The price index of primary commodities (PIPC)² calculated by the IMF, in 2012 was also lower than in 2011 - 186.2% against 192.2%. A significant reduction was observed in the group of metals, the price index of which has decreased from 229.7% in 2011 to 191% in 2012. In the group of energy sources there was a slight increase from 193.8% in 2011 to 195.2% in 2012.



Source: IMF.

Fig. 48. IMF price index of primary commodities (PIPC) (2005 = 100)

As a result of the "shale revolution" in the United States, the global energy market got split into two mutually independent parts - the Eurasian market, where high oil and gas prices are retained, and the U.S. market, where a decrease in the prices of these commodities is observed. The U.S. market is almost entirely dependent on the state of the U.S. economy, the continuing tensions in the Middle East are not affecting energy prices in the region. Elsewhere in the world market prices of oil are driven by the demand in Europe and Asia, tensions in the Middle East, as well as the problem of Iran.

¹ FAO Food Price Index (Food and Agriculture Organization) is a measure of the change in a basket of international prices of food commodities over the last month.

² PIPC is a weighted average price index of 51 types of primary commodities, grouped into three main groups – energy sources, industrial resources (mainly base metals) and foodstuff.

As a result, the price dynamics in the global oil market in 2012 was different depending on the brand. Thus, the price of Brent crude oil on average for the year increased by 0.9% to \$111.97/bbl, while crude oil WTI price, by contrast, fell down by 0.7% to \$94.1/bbl.

Throughout the 2012 difference between the prices of European Brent crude oil and American brand WTI increased by cheaper WTI. In November 2012 Brent price was by \$23 more than WTI, despite the fact that until the mid-2009 the U.S. WTI crude oil cost was by \$2-3 more expensive than Brent.

Global market prices for Brent crude in 2012 did not demonstrate nether any downfalls, no sharp upsurges. They have reached the maximum level on March 17, having risen to \$126.16/bbl. One of the main factors affecting the price dynamics of the oil market in this period was intensified conflict between Iran and the EU: the rise in prices in Q1 was due to the decision taken by the EU on sanctions against Iran and termination of oil imports from this country from July 1. Due to the fears of possible shortages of raw materials the oil price has grown up to the maximum level of the first year above \$120/bbl. Brent oil price was sustained from mid-February to mid-April.

In mid-April prices have begun to decline. On June 1 Brent crude fell to \$98.53/bbl. and for 1.5 months was kept below \$100/bbl. During this period, once again debt problems in Greece were aggravated. The Euro rate against dollar fell down to a two-year minimum. Besides Iran, after eighteen-month pause has resumed negotiations on its nuclear program with the mediators (Russia, Britain, China, the U.S., France and Germany). There was hope that the opposition of the parties could be settled without a conflict. As a result, the price of Brent oil on June 21 has reached an annual minimum - \$89.48/bbl.

In Q3 price growth has resumed, and its main cause was the entry into force of the embargo on imports of Iranian oil. Although Saudi Arabia and other OPEC countries increased production and prevented oil shortage, the major role was played by psychological factor. In addition, the market situation was affected in this period Euro strengthening against dollar.

In Q4 of the price dynamics was more regular: the price of Brent crude oil was fluctuating around the value of \$110/bbl. The average price of Brent in 2012 has grown by 0.92% as compared with 2011 to \$111.97/bbl.

Following the dynamics of the world market, the price of Urals oil in early 2012 began to rise dramatically, and in March its monthly average price exceeded the level of \$123/bbl, maximum since 2008. However, in Q2 it began to decline. In June the price was \$93.3/bbl, which is the lowest level since December 2010. In Q3 and Q4 the price dynamics got improved. As a result, throughout 2012, the average price of Urals oil surpassed that of 2011 by 1% and reached \$110.41/bbl. Recall that in 2011 the Urals oil price increased by 40% as compared with 2010.

The global market for natural gas in 2012 was also rather volatile. In the U.S., because of the large supply of gas produced in shale deposits, its market price for the H1 was below the level of \$2.68/ 1 million BTU. Herewith, in April the price in the U.S. has dropped down to \$1.95 / 1 million BTU, and in October it has grown up to \$3.32 / 1 million BTU. But still the U.S. gas remains the cheapest in the world.

In Southeast Asia the situation was different. Because of the strong earthquake that occurred in 2011, the demand for liquefied natural gas was sharply increased in Japan. The price of gas in this region is the highest in the world. In Europe gas prices are also much higher than in the U.S. However, Qatar, which until recently was supplying large volumes of lique-

fied natural gas to the U.S. market, was forced refocus on Europe, and as a result, prices there have gone down: under the spot contracts the gas sold for \$320 per 1000 m³.

The global market of non-ferrous metals began to deteriorate from the end of 2011, which is due to the overall macroeconomic problems – European debt crisis and its impact on the global economic growth and on the slowdown of economic activity in the U.S. and China. A short-term growth rates in the first two months of 2012 was replaced with their downgrading, which lasted until the H2 of August. At the end of Q3 2012, the market has been recovered due to the Euro growth against the dollar, as well as because of promoting measures announced by the U.S. and China to support their economies.

However, according to the London Metal Exchange, in 2012, prices for aluminum were lower than in 2011 by 15.8%, for copper – by 9.8%. The worst of all was the price situation in the nickel market, which has fallen down by 23.4%. Further price decline will be likely restrained by the reduction of metal production and higher production costs.

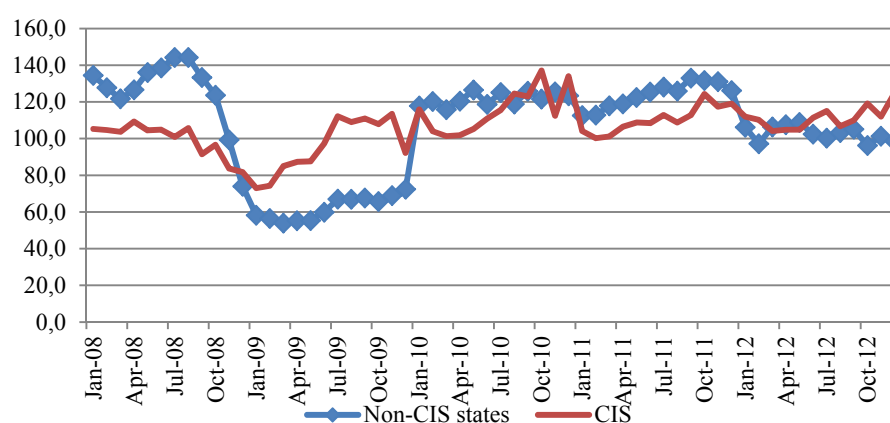
Under the current trends of the global market, the terms of trade in 2012 in Russia, although remained favorable, have significantly deteriorated as compared with 2011. If in 2011 the terms of trade (the ratio of export price index versus the import price index) was 125.3 points, in 2012 it made only 104.4 points.

Table 47

Average Annual Global Prices

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Oil (Brent), \$/bbl	25.02	28.83	37.4	54.38	65.15	72.32	97.64	61.86	79.64	110.9	111.97
Oil WTI, \$/bbl	26.09	31.11	41.44	56.44	66.04	72.28	99.56	61.65	79.43	95.05	94.16
Natural gas(USA), \$/1m BTU	3.36	5.49	5.89	8.92	6.72	6.98	8.86	3.95	4.39	4.00	2.75
Natural gas, European market, \$/1m BTU	3.05	3.91	4.28	6.33	8.47	8.56	13.41	8.71	8.29	10.52	11.47
Natural gas(Japan), \$/1m BTU	4.28	4.73	5.13	5.99	7.08	7.68	12.55	8.94	10.85	14.66	16.67
Copper, \$./ton	1559	1779	2866	3679	6722	7118	6956	5149	7534	8828	7962.4
Aluminum, \$./ton	1350	1431	1715	1898	2570	2638	2573	1665	2173	2401	2023.3
Nickel, \$./ton	6772	9629	13823	14744	24254	37230	21111	14655	21809	22910	175476

Source: estimated by the data of the London Metal Exchange (UK, London) and the World Bank



Source: Ministry of Economic Development of Russia.

Fig. 49. Terms of Foreign Trade Index

4.6.3. Key Indicators of the Russian Foreign Trade

In 2012 the national foreign trade turnover, computed by the balance-of-payments methodology amounted to \$864.7bn, which is by 2.2% higher than the relevant indicator of the last

RUSSIAN ECONOMY IN 2012

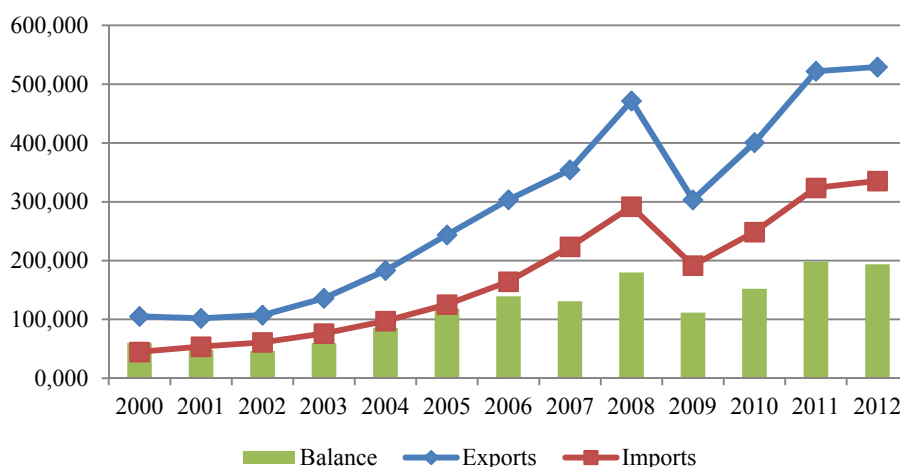
trends and outlooks

year, while with non-CIS countries it rose by 3.1% to \$735.5bn, and with the CIS countries it has decreased by 2.4% to \$ 129.2bn.

Foreign trade quota in 2012 decreased as compared to 2011 from 44.5% to 42.9%, though the share of foreign trade in GDP OS remained significant.

It is worth noting that in January 2012 the foreign trade turnover has grown by 28.8% (with respect to January 2011). Imports began the year with the growth by 22.7% and exports - by 31.7%. Then, at the background of the expansion of the debt crisis in the Eurozone and the slowdown in the Russian economy, the dynamics of international trade began to weaken. While in 2011 the average monthly exports growth made up 30.3% and imports - 32.2%, in 2012 they made 2.4% and 4.3%, respectively.

The average monthly growth of Russian exports to the non-CIS countries was reduced from 29.7% in 2011 to 3.2% in 2012 and to the CIS countries from 35.7 to 1%. Average monthly growth of imports to Russia from foreign countries in 2011 was 31%, in 2012 - 5.7%. After an average monthly growth of 39.3% in 2011, in 2012 imports from the CIS countries was falling down monthly by 2.9% on average.



Source: RF Central Bank.

Fig. 50. Key Indicators of the Russian Foreign Trade, \$bn

Sustainability positive dynamics of Russian exports throughout the year was mainly due to the price factor. Import growth was based on the increase in its volumes accompanied with lower average prices.

Table 48

Russian Foreign Trade in % vs. Preceding Year

	2010		2011		2012	
	Measured by volume	Measured by average prices	Measured by volume	Measured by average prices	Measured by volume	Measured by average prices
Exports	110.0	119.8	97.8	132.9	99.9	101.6
Imports	135.4	101.6	122.2	109.1	105.1	97.3

Source: Federal Tax Service of Russia.

The trade balance in 2012 was positive - \$193.8bn, which is by 2.2% less than in 2011.

The coverage ratio of exports to imports has dropped from 161.2% in 2011 to 157.8% in 2012.

The imbalance of foreign trade ratio (the ratio of surplus to the trade turnover) has also decreased from 23.4% in 2011 to 22.4% in 2012.

Exports Structure Dynamics

External demand for the goods produced in Russia remained weak in 2012. The volume of Russian exports exceeded that of the previous year by 1.4%, having grown to \$ 529.3bn. The growth was due to an increase by 2% of export to foreign countries, where the Russian goods were exported at the amount of \$446.8bn. To the CIS countries there were sold goods worth of \$ 82.5bn, which is by 1.6% less than in 2011. The total share of the non-CIS countries in exports has increased from 83.9 to 84.4%.

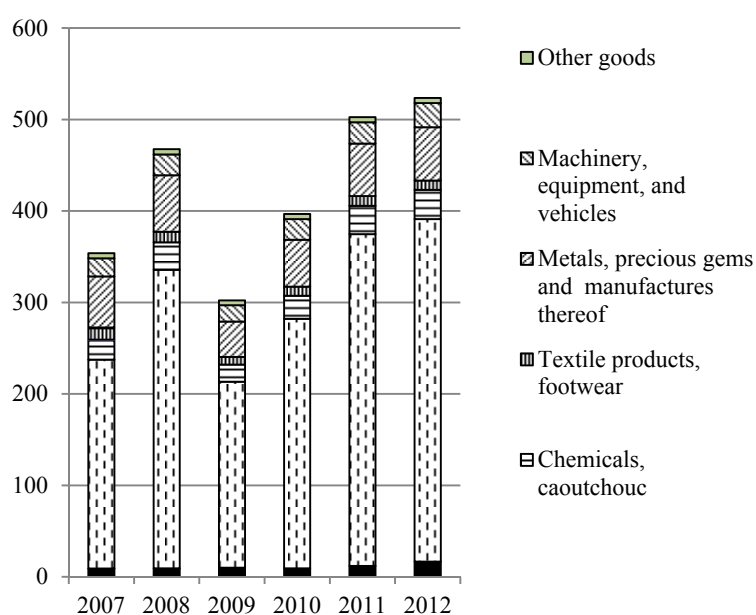
Table 49

Russian Exports Dynamics, \$bn

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Exports, \$bn	101.9	107.3	135.9	183.2	243.8	303.6	354.4	471.6	303.4	400.6	522.0	529.3
Including												
Non-CIS countries	86.6	90.9	114.6	153.0	210.2	260.2	300.6	400.5	255.3	338.0	438.2	446.8
Growth rates in % vs. preceding year												
Volume index	104.2	115.0	109.5	110.7	104.7	105.8	105.0	96.8	97.0	110.0	97.8	99.9
Price index	93.8	86.0	113.4	122.7	126.9	119.7	110.9	137.4	76.4	119.8	132.9	101.6

Source: the Bank of Russia, Ministry of Economic Development of Russia.

The share of energy products in the Russian exports remains excessively high, and the share of machinery, equipment and vehicles is rather insignificant. As of the end of 2012, the share of exports of mineral products made 71.4% (including fuel and energy products in the amount of 70.4%), the share of machinery, equipment and vehicles - only 5%, like in 2011.



Source: Federal Tax Service of Russia.

Fig. 51. Russian Export Commodity Structure, \$bn

In 2012 exports of fuel and energy products increased by 2% as compared with 2011, mainly due to the price component.

According to the Ministry of Energy, the volume of Russian oil exports in 2012 has decreased by 1% as compared with 2011 - up to 239.64m tons. Oil supplies to the non-CIS countries have decreased by 0.34% - up to 211.48m tons, to the CIS countries - by 5.7% to 28.17m tons.

In 2012 the sales of Russian gas abroad have been decreased by 8.7% against 2011 – to 186.1bn m³. The decline in demand for it on the international market was due to the increased competition from other suppliers and the reduction of gas consumption in Eurozone. The Russian gas supplies were decreased to both, CIS and non-CIS countries.

OAOGazprom in its report for Q3 2012 also provides data on the decline in sales abroad. As compared with 2011, the sales decreased by 10.8%. Basically this result is due to a sharp decline in exports to Ukraine. However, as can be seen from *Table 50*, in 2012 almost all countries have reduced the purchase of Russian gas.

Table 50

Natural Gas Imports of OAOGazprom in 2012

Country	m ³ bn	In % vs. 2011
Germany	33.16	97.4
Italy		
Italy	15.08	88.3
Turkey	27.02	103.9
France	8.04	84.4
Finland	3.75	89.5
Austria	5.22	96.1
Greece	2.5	86.5
Netherlands	2.31	52.9
Switzerland	0.3	97.4
UK	8.11	99.4
Hungary	5.29	84.6
Poland	9.94	96.7
Slovakia	4.19	71.1
Czechia	7.28	95.9
Rumania	2.17	76.7
Bulgaria	2.53	90.4
Serbia and Montenegro	0.74	53.2
Slovenia	0.5	94.3
Bosnia and Herzegovina	0.26	92.9
Macedonia	0.08	60.4
Ukraine	32.87	82.2
Belorussia	20.26	101.3
Moldavia	3.08	99.3
Lithuania	3.32	97.4
Latvia	1.12	94.5
Estonia	0.62	93.1
Kazakhstan	0.93	99.1
South Ossetia	0.03	115.4
Armenia	1.94	120.5
Georgia	0.25	133.7
Total	202.89	91.8

Source: <http://www.gazprom.ru/f/posts/21/499896/qr0412.pdf>

According to the International Monetary Fund (IMF), average contract prices for Russian natural gas on the border of Germany have increased over the year on average by 13.8% to \$431.3/1000 m³, but in Q4 2012 they have decreased as compared with the same period in 2011 by 3.7% to \$418.2/1000 m³. According to the Ministry of Economic Development of Russia, due to increased production of gas from shale deposits in the U.S. and the increased share of spot contracts, OAOGazprom will no longer be able to maintain high prices for its

long-term contracts. Russian gas price in the markets outside the CIS is forecasted as follows: in 2013 - at the level of \$362/1000 m³, in 2014 - \$352/1000 m³, in 2015 - \$366/1000 m³.

The volume of oil products supply to the non-CIS countries increased by the results of 2012 by 0.9% to 121.0m tons. Herewith, there was almost a nearly twice decrease in exports of gasoline (from 2.4m to 1.4m tons), which is not only due to the increased export duty. Also during this period, there was a 0.1% reduction in the export of diesel fuel - up to 33m tons, however, exports of liquid fuels (heating oil) rose by 3.5% - to 72.9m tons. As a result, the share of heating oil in the total exports of petroleum products to the non-CIS countries has grown, and as of 2012 it amounted to 51.5% against 48.9% in 2011. The growth occurred despite the introduction in 2011 of a new formula for calculating the export duty ("60-66"), which led to a substantial increase of taxes on heavy oil products.

Exports of metals and products therefrom have decreased in 2012 as compared to 2011 by 6.5% (from \$47.5bn to \$44.5bn). The share of this product group in the total Russian export has decreased to 8.5% against 9.2% in 2011.

Throughout 2012 there was observed a significant increase in the volume of exports of non-ferrous metals: copper export and its products in physical terms has increased by 36.9%, aluminum and its products - by 3.9%, nickel and its products - by 11.9%. Growth of the physical volume of exports of non-ferrous metals to some extent has compensated the loss of revenue of the Russian companies from falling global prices for base metals. Nevertheless, in price terms, exports of aluminum in 2012 have decreased by 4.6% to \$ 6.5bn, nickel - by 17.3% to \$ 3.7bn, copper exports rose by 18.4% to \$1.9 bn. Virtually all exports of copper and nickel were carried out to non-CIS countries. To the CIS countries there were supplied only 8.900 tons of copper and 0.500 tons of nickel.

Exports of chemical products in 2012 amounted in price terms to \$32bn, which is lower than the same period of 2011 by 2%. Its share in the total exports of major commodities in 2012 has decreased to 6.1% against 6.3% in 2011. The leading position in this product group occupy fertilizers (2.1% of the total exports of essential goods), inorganic chemistry products (1.4%) and synthetic caoutchouc (0.5%).

In 2012, there was a significant reduction in the export of timber and pulp-and-paper products. While in 2011 the goods of this group were sold abroad in the amount of \$11.3bn, in 2012 they were sold only for \$10.1bn, i.e., by 10.2% less. This decrease was due to both, lower contract prices, and to reducing the physical volumes. The physical volumes of exports of raw timber have decreased by 16.8%, of timber - by 3.4%, of newsprint - by 6.5%. Physical export volume of pulp has been increased by 12.4%.

In the consolidated list of commodity items the only commodity group, which experienced strong growth in exports in 2012 became the group "foodstuffs and raw materials for production thereof". Cost volume of supply of these products has increased by 24.5% to \$16.6bn, and physical volume - by 25.3%. The share of this group has been increased to 3.2% from 2.6% in 2011 due to the high growth dynamics of exports in H1 of the year, during which it increased nearly twice. However, the crop failure prevented from maintaining a high rate of growth in the supply of foodstuffs.

Physical volume of exports of food products were increased primarily due to the export of crops. In addition, the volume of exports of sunflower seed and oil has been significantly increased.

Exports of wheat and meslin increased by 22.9% to \$4.5bn mainly due to an increase in contract prices (by 16.6%). In physical terms, this indicator amounted to 16.6m tons, which is

by 5.4% more than last year. The main part of the grain – 15.49m tons (\$4.36bn) was exported to the non-CIS countries.

At the same time, the rate of the Russian grain exports from the beginning of the agricultural season (started from July 1, 2012) is lower than in the past. According to the RF Ministry of Agriculture, grain exports from July 1, 2012 to January 30, 2013 amounted to 13.5m tons, as compared to 19.4m tons a year earlier. This is based on the reduced crop harvest due to the drought: in 2012 in the Russian Federation there was harvested 70.7m tons of grain against 94.2m tons in 2011.

As of the of 2012 results, the Russian exports of rice has reached its historical maximum of 334,000 tons, which is more than twice higher than in 2011, and by 1.7 times higher than the previous record in 2010. According to the RF Ministry of Agriculture, rice harvest in Russia in 2012 amounted to about 1.5m tons, which almost completely satisfied domestic demand and supply the excess to the world market. 169,000 tons of paddy and 165,000 tons of rice grains were sold abroad. The largest buyers were Libya, which acquired 30% of Russian rice, and Turkey, which has purchased 25% of Russian exports of rice. The overwhelming share of purchases of both countries is paddy. Rice grains are traditionally exported to the former Soviet Union countries: Turkmenistan, Tajikistan, Azerbaijan and Kyrgyzstan.

According to the Russian Union of Sugar Producers, in 2012 there were exported 1.4m tons of sugar of the beet production complex, which is the absolute maximum for the entire post-Soviet period. This happened due to the increased investments in the upgrading of basic production assets and increase of the capacity of the recycling of beet pulp in sugar mills, which were previously considered as waste product.

Exports of machinery, equipment and vehicles increased in 2012 as compared to the previous year by 1.8%. According to the Federal Tax Service of Russia, compared to the 2011, the supply of railway equipment increased by 20.1%, of mechanical equipment - by 11.8%, of optical instruments and apparatus - by 6.3%, of electrical equipment - 2.0%. The cost volume of supply of land transport (except railway equipment) increased by 10.4%.

Imports Structure and Dynamics

Russian imports in 2012 have increased as compared to 2011 by 3.6% to \$335.4bn. Imports growth was due to increasing imports from the non-CIS countries, from where the imported goods made \$288.7bn, which is by 4.9% exceeds the relevant indicator of 2011. Imports from the CIS countries have decreased by 3.7% to \$ 46.8bn. The share of non-CIS countries in the total imports has increased from 85.0% to 86.1%.

Table 51

Russian Imports Dynamics, \$bn

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Imports, \$ bn, Including:	53.8	61.0	76.1	97.4	125.4	164.3	223.5	291.9	191.8	248.6	323.8	335.4
Non-CIS countries	40.7	48.8	61.0	77.5	103.5	140.2	191.7	252.9	167.7	213.3	275.3	288.7
Growth rates in % vs. preceding year												
Physical volume index	129.1	117.6	119.2	124.2	122.4	130.1	127.1	113.5	63.3	135.4	122.2	105.1
Price index	94.3	93.4	98.7	106.1	106.5	105.5	107.6	117.8	99.1	101.6	109.1	97.3

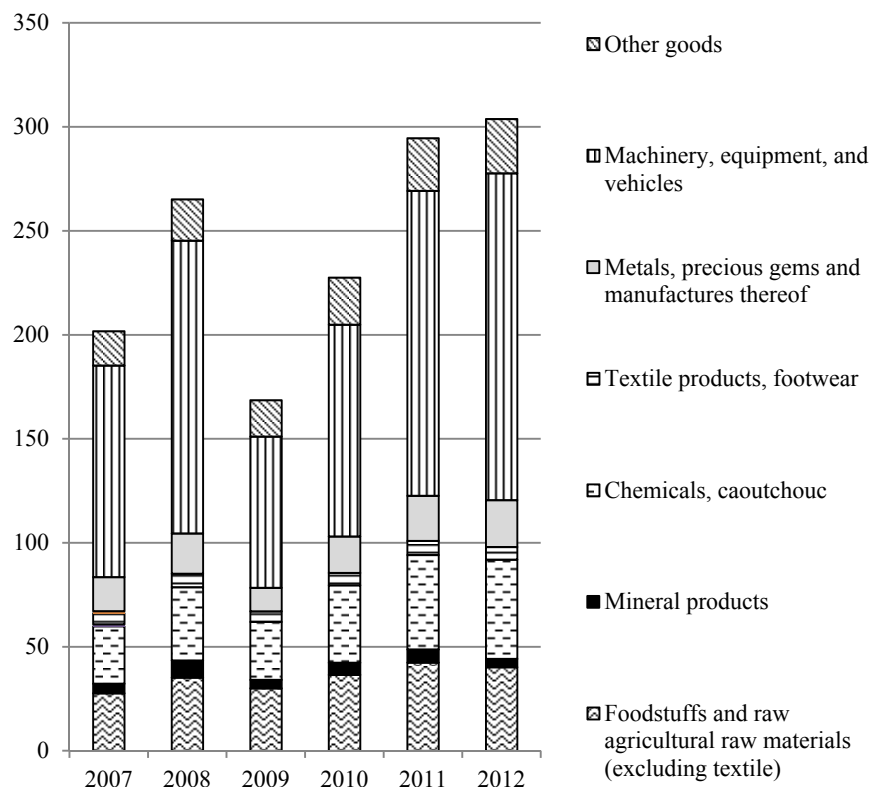
Source: Bank of Russia, Ministry of Economic Development of Russia.

The major trend in 2012 was the slowdown of imports, which has occurred in all major product groups. Imports supplies of food products, metals, products thereof and mineral prod-

ucts were decreased. Imports of machinery, equipment and vehicles, textiles, textiles footwear, chemicals have slightly increased.

Slower growth rates in imports are due to the deterioration of the dynamics of domestic demand at the background of slowing economic growth in Russia. The deterioration of the industrial production dynamics has led to a decline in investment demand. Consumer demand in Russia in 2012 was growing not so much due to increasing incomes, but rather due to the increasing consumer lending and reduction of savings rate. In view of the above, it was difficult to maintain stability of the active consumer demand. Already in July, consumer crediting in the country started to slow down, and against the background of rising interest rates the disposition of population to savings started to increase.

Imports structure in terms of commodities in has not changed much in 2012. The share of the foodstuffs and agricultural raw materials has decreased compared to 2011 by 1 p.p. and amounted to 12.9%. The share of machinery, equipment and vehicles has increased by 1.9 p.p. to 50.5%.



Source: RF Federal Tax Service.

Fig. 52. Russian Imports Commodity Structure, \$bn

In 2012 in the Russian Federation there were imported foodstuffs and agricultural raw materials for \$40.2bn, which is by 5.5% less than in 2011. The physical volume of deliveries of foodstuffs as compared to 2011 has been decreased by 12.3%.

As a result of the growth of sugar self-sufficiency of Russia, imports of raw sugar in 2012 for the first time in recent history have decreased to 0.5m tons. For comparison, in 2011 there were imported 2.3m tons, and in 1999 – 6.1m tons of sugar.

For some items, a growth of average contract prices is recorded. The utmost growth in the contract prices is noted in fresh meat and ice cream (by 6.9%), poultry (by 3.9%) and tea (by 3.6%).

Table 52

Foodstuffs Imports

	2010		2011		2012	
	Tons, thou.	% vs. 2009	Tons, thou.	% vs. 2010	Tons, thou.	% vs. 2011
Fresh and frozen beef	1442	100.3	1429	99.1	1399	97.9
Fresh and frozen pork	681	102.1	717	105.3	735	102.4
Fresh and frozen poultry	688	69.8	493	71.7	527	107.0
Fresh and frozen fish	792	99.6	705	89.0	736	103.7
Milk and dairy products	677	144.1	383	56.6	367	95.8
Butter	109	106.5	104	96.5	101	96.8
Cheese and curd	421	119.3	421	99.9	393	93.2
Potatoes, fresh or chilled	710	178.9	1511	by 2.1 times more	460	30.4
Raw sugar	2086	166.7	2332	111.8	520	22.3

Source: Russian Statistical Service.

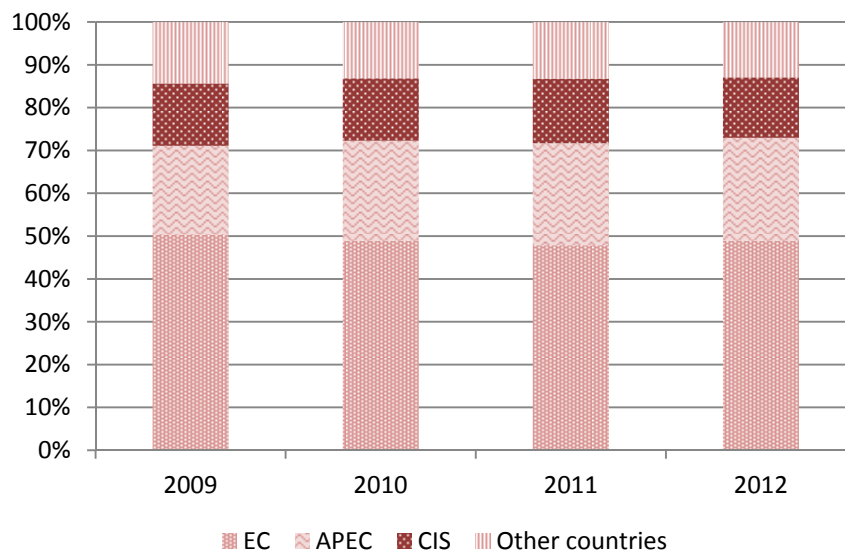
Imports of metals and products thereof decreased by 2.3%. In general, this was mainly due to decrease in the supply of ferrous metal pipes, which in 2012 were decreased by 47.7% as compared to 2011, and according to Russian Statistical Service, production of steel pipes in 2012 decreased against 2011 by 3.3%. The main reason for the drop in production and imports reduction is the completion of the implementation of major pipeline projects. The share of imported pipes in the domestic market in 2012 made 9.4%, which is below the annual average indicator for 2011 by 16.2%, for 2010 by 15.3% and for 2009 by 10.8%.

Import of the chemical complex products in 2012 in the cost terms has reached \$47.7bn, having increased against the relevant period of 2011 by 3.6%. The share of imports of chemical products in the total volume of the Russian imports during this period has increased as compared to the same period of the last year from 15.1 to 15.3%, among which pharmaceutical products made 4.1%, plastics and articles thereof - 3.7%, hygienic items - 1.1%, rubber and products thereof - 1.6% and dyes - 0.9%.

The main items of the Russian imports are still machinery, equipment and vehicles. Import of goods under this article has increased in 2012 in comparison with 2011 by 6.1% to \$157.1bn. The share of machinery, equipment and vehicles in the total volume of Russian imports increased to 50.3% from 48.4% in 2011.

4.6.4. Russian Foreign Trade in Terms of Geography

The major international trading partner of the Russian Federation is still the European Union. In 2012 the share of the EU in the geographical structure of Russian foreign trade turnover has increased as compared to 2011 by 1.1 p.p. to 49%, while the top trading partner in this group of countries were the Netherlands, the share of which has increased by 1.6 p.p. and amounted to 9.9%. The second place belongs to Germany, with its share in the Russian foreign trade turnover has increased from 8.7% in 2011 to 8.8% in 2012. Italy in 2012 was the third in terms of foreign trade with Russia among the EU countries; its share made 5.5%, having decreased by 0.1 p.p. as compared to 2011. In general, the EU countries in 2012 have increased the volume of foreign trade with Russia in comparison with 2011 by 4.1%, including the volume of the Russian exports grown by 4.2% and imports by 3.8%.



Source: RF Federal Tax Service.

Fig. 53. Russian Foreign Trade in Terms of Geography, %

The share of the Asia-Pacific Economic Cooperation (APEC) countries in the Russian foreign trade has increased from 23.8% in 2011 to 24.0% in 2012. The main trade partner of Russia in this group of countries is China, its share in the foreign trade turnover has increased by 0.4 p.p., having reached 10.5%. The second place in this group holds Japan, the share of which has increased from 3.6 to 3.7%. The share of the United States, by contrast, has decreased from 3.8 to 3.4%, bringing the U.S. from the second to the third place in this group of countries. The volume of Russia's trade with APEC countries in 2012 has increased as compared to 2011 by 2.4%. Foreign trade turnover growth with these countries was due to the increase in the Russian imports by 5.6%, while Russian exports to these countries have declined by 1.2%.

The share of CIS countries in the Russian foreign trade has declined in 2012 as compared to 2011 from 15.1 to 14.1%. Major trading partners in the group are Ukraine and Belorussia, which share in 2012 accounted for 5.4% and 4.3%, respectively. Overall, Russia's trade turnover with the countries of this group in 2012 against 2011 has decreased by 5.3%, Russian imports - by 10.1%, Russian exports - by 2.5%.

The trade balance in 2012 was positive for all groups of countries, with the exception of APEC countries (-17,9 \$ bn).

In 2012 Russia had a negative balance of trade with 27 countries, whose share in the total turnover of Russia was 35.6%. The most significant contribution to the formation of negative balance of trade in Russia have made China (-\$16.1bn), France (-\$3.2bn), USA (-\$2.4bn), Germany (-\$2.7bn), Canada (-\$2.1bn), Austria (-\$1.9bn).

4.6.5. Russian Foreign Trade Regulation

In 2012 there were developed and adopted 16 resolutions of the Government of the Russian Federation on amendments to the customs duties on the goods exported from the territory of the Russian Federation outside to the member-states of the Customs Union, including 12 resolutions "On Approval of Export Duties on Crude Oil and Certain Categories of Goods

Produced from Oil" 2 regulations "On Establishing the Export Customs Duty on Unalloyed Nickel, "one regulation "On the Approval of the Export Duty on Soybeans".

Since October 1, 2011 there were harmonized export duties on oil and oil products. Earlier, the export duty for light petroleum products was calculated by a factor of 0.7 of the export duty on oil, for black oil products - by a factor of 0.4. Currently, all ratios for oil products are 0.66.

As a result of the new formula, the export duty on heavy oil products has increased significantly in 2012 as compared with the last year. On average, over the year it has grown over the same period of 2011 by 28.9%. The duty on light oil products has decreased on average by 2.6%. Herewith, the automobile and straight-run petrol are excluded from the list of light oil products, duty on which from mid-2011 makes 90% of the duty on crude oil.

It was assumed that the new formula will make exports of dark oil products less profitable and the export of light petroleum products more profitable and therefore will encourage oil companies to invest more in the more enhanced refinery. As demonstrated by the current results, this goal is not achieved yet: the share of heavy oil in the total exports of refined products exports has decreased.

Table 53

Export Duties on Oil and Oil Products in 2011-2012, \$/t

	Oil	Oil products	
		light	heavy
2011			
January 1	317.5	226.2	121.9
February 1	346.6	232.2	161.8
March 1	365.0	244.6	170.4
April 1	423.7	283.9	197.9
May 1	453.7	304.0	211.8
June 1	462.1	309.0	215.8
July 1	445.1	298.2	207.8
August 1	438.2	293.6	204.6
September 1	444.1	297.5	192.0
October 1	411.4	271.5	
November 1	393.0	259.3	
December 1	406.6	268.3	
2012			
January 1	397.5	262.3	
February 1	393.7	259.8	
March 1	411.2	271.4	
April 1	460.7	304.0	
May 1	448.6	296.0	
June 1	419.8	277.0	
July 1	369.3	243.7	
August 1	336.6	222.1	
September 1	393.8	259.9	
October 1	418.9	276.4	
November 1	404.5	267.0	
December 1	396.5	261.7	

Source: RF government regulations.

Since May 28, 2011 the export duty on nickel is determined based on its average price at the London Metal Exchange for the previous quarter. In accordance with this, from March 5, 2012 the export duty on unalloyed nickel exported outside the Customs Union, was reduced from \$2117.8 to \$1245.5/ton, and from June 5, 2012 it was increased from \$1245.5 to \$1447.6/ton.

At the end of 2011 there was introduced a progressive rate of export duty on refined copper, which should also be based on the average world prices at the London Metal Exchange for the previous quarter. From June 5, 2012 the rate of export duty on refined copper (cath-

odes and sections, semiproducts for the manufacture of wire and rolling, etc.) amounted to \$893 per 1 ton. Previously it was 10% of the customs value.

By the Government Decree No. 408 of May 2, 2012 "On the approval of becoming the export duty rate on soybeans exported outside the member-states of the Customs Union", the rate of export duty on soybeans exported outside the Customs Union is reduced to 5% of the customs value, but not less than Euro 8.5 per 1 ton (previously - 20% of the cost, but not less than Euro 35 per 1 ton).

EurAsEC Customs Union Commission by the Decision No. 913 of January 25, 2012 has established, that from May 1 to July 31, 2012 the seasonal customs duty on import of raw sugar will not be reduced to \$50/ton, but remain at \$140/ton. The adoption of such measure is due to the record harvest of sugar beet in 2011 in the amount of 46.3m tons, out of which there was produced 5m tons of beet sugar. Carryover stock of sugar made 2m tons. These resources are sufficient to meet domestic needs and the saturation of the market before the next harvest season.

Earlier there were two scales of customs duties on raw sugar in the Customs Union. From August to May, sugar mills secured the market with its own raw materials, so the support of the domestic sugar market was intensified: in this period the duties on imported raw sugar (cane sugar) were kept at \$140-270/ton (depending on the global prices). From May to August, when the plants have no own raw materials, the duty were be reduced to the minimum of \$50/ton, which made it possible to process cane sugar.

On August 22, 2012 the protocol of accession of the Russian Federation to the Marrakesh Agreement on Establishing the World Trade Organization (WTO) came into effect, and thus Russia became the 156th member of the organization.

In the course of negotiations the Russian part managed to defend the most of its priority positions, including:

- maintaining cars' industrial assembly regime up to July 2018;
- establishing the permitted volume of agricultural support at a different level (decrease from \$9bn to \$4bn by 2018);
- maintaining the tariff quota regime in imports of pork (to the end of 2019), beef and poultry (for indefinite term);
- ban on opening of branches of foreign banks;
- a nine-year moratorium on the opening of branches of foreign insurance companies;
- preservation of the current regime of benefits for SEZ in Kaliningrad and Magadan regions up to April 2016.

On August 23, 2012 there came into force a new version of the Single Commodity Nomenclature of Foreign Trade of the Customs Union (CU FT SCN) and the Single Customs Tariff of the Customs Union (CU HS code), designed to meet the obligations of the Russian Federation to the WTO and approved by the Board of the Eurasian Economic Commission (EEC) on July 16, 2012.

CU SCT includes 11,271 commodity items. The new tariff, like the previous one, mainly consists of ad valorem rates of customs import duties, which are set as a percentage of the customs value of the goods. They account for 84% of the tariff - 9473 items. The lowest ad valorem rate, different from zero, is set at 2% and is applied to the cathodes made of copper and blades for chainsaws. The highest ad valorem rate in the amount of 65% is set on imports of pork exceeding the tariff quotas.

The number of specific rates that are charged in the specified amount per unit of taxable goods includes 235 items (among them 142 in Euro and 93 in dollars). Specific rates in the U.S. dollars are applied only to raw sugar (HS code 1701), because the amount of the import duty is calculated based on the average price on the New York Commodity Exchange.

The lowest specific rate of Euro 0.04 per 1 kg is established on maleic anhydride. The highest specific rate of Euro 22 per 1000 pcs is set on the jars of up to 1 liter for canning beverages.

Combined rates, in which the specific duty and ad valorem duties are summed up, include 1563 items. The lowest combined rate of 5%, but not less than Euro 0.02 per 1 kg is established on some citrus fruit and bananas. The highest combined rate of 100%, but not less than Euro 2 per 1 liter, is set on ethanol.

For 1606 commodity items, which is 14.3% of total import duty rates, a zero duty rate is established.

According to the ad valorem component, the most secure are such groups of the Single Commodity Nomenclature of Foreign Trade of the Customs Union as meat and meat by-products (an average ad valorem rate of 37%), carpets and floor coating (20%), weapons and ammunition (19%), alcoholic and non-alcoholic beverages (19%), textile articles (18%), natural pearls (average ad valorem rate 18%).

The new tariff provides for reduction on about 1,000 commodity items. First of all, of import duties that were increase during the crisis in 2008-2009 are returned to their previous level.

The most notable changes occurred in tariffs for foodstuffs and other consumer goods. Thus, the duty on pork imports within the quota is reduced from 15 to 0%, and for pork imports beyond the quota - from 75 to 65%. Import duty on finished meat products is reduced from 25%, but not less than Euro 0.4 per kg to 20%, but not less than Euro 0.4 per kg.

New duty on the import of butter is 15%, but not less than Euro 0.29 per kg against the previous 15%, but not less than Euro 0.4. The import duties for many cheeses are changed. In particular, the import duty for young cheese with a fat content of more than 40% is reduced to 15%, but not less than Euro 0.25 per kg; earlier this specific component made Euro 0.3 per kg. For example, a specific component of the duty on imports of cheeses such as camembert and brie is reduced by 2 times.

In the segment of fruit import duties are reduced on apples, as well as lemons and limes, among vegetables for tomatoes and cucumbers. For example, the import duty on the import on cucumbers is set at 15%, but not less than Euro 0.08 per kg - this rate will be in effect for the entire year. Earlier in the period from May 16 to October 31 the duty was 15%, but not less than Euro 0.12 per kg, and only from November 1 to May 15 the specific component was decreased to Euro 0.08 per kg.

According to the commitments to the WTO, Russia has left unchanged the prohibitive import duty on alcohol, but within three years it will reduce import duty on most of the strong liquors from Euro 2 per 1 liter to Euro 1.5. Also duties on mineral water, beer, wine, champagne, vermouth are significantly reduced.

Duties on finished fish products are reduced slightly - from 15 to 12.5-12% between for the period of 1-3 years. As for the raw fish, many of the types of fees will drop from 10 to 8.6%, in some cases up to 3-5%.

According to the agreement with the WTO, a gradual reduction of duties on most of the textile products, including clothing is foreseen.

According to the commitments of the Russian party, since the date of accession to the WTO duties on household and electronic appliances are sustained, but in future for some items will gradually decline, starting from 2013.

By 2014-2015, some reduction of duties on pharmaceutical products is foreseen on some items from August 23, 2012. For several years, duty on perfumes, cosmetics and hygiene products will be gradually reduced.

Customs duties on new imported cars are decreased from 30 to 25%, and then within seven years they will be reduced to 15%. The rate of customs duty on second-hand cars up to 7 years is reduced from 35 to 25%, and by 2018 it will make 20% of the cost. The rules for import of cars and SUVs over seven years, regardless of their type remained the same - from Euro 2.3 to 2.8 per 1 cm³ of engine.

To compensate for the loss of this position since September 1, 2012 a salvage fee is introduced in Russia. According to the RF government Regulation "On the salvage fee", individuals importing cars for personal use, shall pay the salvage fee in the amount of 0.1% of the base rate, which makes Rb 20,000 for new cars and 0.15% for the cars older 3 years.

Costs of legal entities are higher: thus, for the full weight trucks over 3.5 tons, which are designed for off-road driving, salvage fee make 37-fold new basic rate in the amount of Rb 150,000 for the new cars and 40-fold basic rate for the old ones. For the vehicles up to 2.5 tons legal entities must pay 0.5-times rate of Rb 150,000 for the new vehicles and of 0.8 of the rate for those over 3 years.

Export duty rates are brought in line with the obligations of the RF Government Decree No. 756 of 21.07.2012. Export duties remain largely at the same level. In particular, in the case of most types of frozen fish the rate is kept at 5% of the customs value, for crabs – at 10%, natural gas – at 30%, unrefined copper – at 10%, raw hides – at Euro 500 per 1 ton. The minimum fee for wet tanned cattle skin is reduced from Euro 250 to Euro 90 per 1 ton.

Duty rates are revised on certain timber materials. Thus, the combined rate of export duty is established on raw timber from oak to 20%, but not less than Euro 30 per 1 m³ (previously - Euro 100 per 1 m³). A prohibitive duty is foreseen on raw timber from European pine in the amount of 80%, but not less than Euro 55.2 per 1 m³. For these timber materials exported within tariff quotas, the rate is 13-15%.

Export duty is increased on soybeans from 5% (but not less than Euro 8.5 per 1 ton) to 20% (but not less than Euro 35 per 1 ton).

Ad valorem rates are set for refined copper (10%) and non-alloy nickel (5%).

Export duty is reduced on the second-hand axes and wheels of railway locomotives or trams rolling stock (5% instead of 15%, but not less than Euro 15 per 1 ton).

In the framework of the Russian Federation accession to the WTO, the most important element of regulation of foreign trade of the Customs Union became the use of measures of protection the domestic market from the negative impact of foreign competition, such as special protective, antidumping and compensating measures. In the international trade practice these tools are used for effective protection of the industry against dumping, subsidized or increased imports from foreign countries.

Since May 2012 the authority for the protection of antidumping and special safety investigations by national authorities of the countries of the Customs Union is transferred to the Department of the domestic market protection of the Eurasian Economic Commission. Earlier this function was in the authority of the Russian Ministry of Industry and Trade.

On May 24, 2012 the Eurasian Economic Commission Board took the decision to impose since July 1, 2012 an antidumping fee for a period of 5 years on the flat cold-rolled steel of a thickness exceeding 0.2 mm but not exceeding 2 mm, coated, originating from China Republic¹. The Commission's decision was made based on the results of antidumping investigation conducted by the Ministry of Industry and Trade of Russia. This is the first such investigation conducted in accordance with the legislation of the Customs Union.

The investigation was started on February 11, 2011 at the request of Russian producers of coated rolled products OAO "Severstal", OAO "Novolipetsk Steel Works" (hereinafter - OAO "NLMK") and OAO "Magnitogorsk Steel Works" (hereinafter - OAO "MMK"). The investigation established the fact of the dumped imports of polymer-coated rolled metal products from the PRC, which cause significant damage to economic sectors of the CU, that under WTO rules is the basis for the imposition of antidumping measures.

Within 2008-2010 import volumes of polymer-coated rolled metal products from the PRC to the CU countries have increased significantly - to 257,700 tons, or nearly twice. The highest growth in imports of those products from China was in H1 2010: as compared with the H1 2009, the volume of imports from China increased by 9.7 times. Within 2008-2010 the share of polymer-coated rolled metal products from China in total imports of goods into the customs territory of the Customs Union has increased from 52.6% in 2008 to 74.7% in 2010. The amount of antidumping fee is 22.6% of the customs value of goods. Herewith, for the three companies - manufacturers of polymer-coated rolled metal products special duties are established, namely for Angang Steel Co., Ltd – 12.9%, for Dalian POSCO Co., Ltd. - 11.4%, for Shandong Guanzhou Co., Ltd. - 8.1%.

According to Eurasian Economic Commission forecasts², after administration duties and within 1.5 years import polymer-coated rolled metal products from China can be decreased by 200.000-250.000 tons per year³, while the resulting demand almost fully will be satisfied by steel producers of the Customs Union.

According to the Ministry of Economic Development of Russia, 18 countries⁴ impose protective measures in regard to the Russian goods as of January 1, 2013.

71 measures are in effect in regard to the Russian goods, including 39 measures of anti-dumping duty, 2 measures of special safeguard duty, 15 measures of non-tariff, 5 measures of technical barriers, 3 measure of quota restrictions, 2 measure of additional tax, 3 measures of the excise tax on a discriminatory basis, one on restriction on the approved list and one the ban on imports.

At the same time, five investigations are conducted, including 3 antidumping and 2 investigations on of special safeguard measures, and seven revisions of antidumping measures and one revision of a safeguard measure.

In 2012 fifteen measures that impede access of Russian goods to foreign markets came out of effect. According to the tentative expert estimates, the amount of avoided damage made approximately \$ 70m.

¹ http://www.tsouz.ru/db/spec_measures/Pages/def_measures.aspx

² http://www.tsouz.ru/db/spec_measures/Pages/def_measures.aspx

³ http://www.tsouz.ru/db/spec_measures/Pages/def_measures.aspx

⁴ Those countries are Australia, Azerbaijan, Armenia, Belarus, Brazil, India, Indonesia, China, South Korea, Mexico, Moldova, the United States, Thailand, Turkey, Turkmenistan, Uzbekistan, Ukraine, and the EU as a single customs territory.

Section 5. Social Sphere

5.1. Living Standards

5.1.1. Personal real income: poverty and extreme poverty in Russia measured by national poverty method

Rapid economic growth early in the 2000s was accompanied by high growth rates in personal income. Personal real income grew up by 2.5 times as inequality increased insignificantly (Gini coefficient¹ was 0.42 in 20112 against 0.4 in 2000). In the first decade of the 21st century, the subsistence minimum increased mainly in response to its indexation to the consumer price index growth rate, thereby increasing the real personal income to subsistence minimum ratio (from 1.89 times in 2000 to 3.32 times in 2010). As a result, population with a substandard per capita money income and poverty level reduced by 2.3-2.4 times from the period between 2000 and 2010:

- poor population reduced from 42.3 million to 17.9 million persons,
- poverty level reduced from 29 to 12.6%.

Personal money income deficit reduced from 5% to 1.2% of total money income over the same period.

It should be noted that extreme poverty³ figures saw a more substantial reduction than poverty figures in Russia in the period between 2000 and 2010: about 8.2 million persons, or 5.7% of total population in 2000, against about 1 million persons, or 0.7% of total population⁴, in 2010.

Even amidst the financial and economic crisis poverty level kept decreasing in Russia, including, but not limited to a rapid, by 2.8 times, increase in pension benefits and other social transfers (e.g., nursing benefit payable for infants at the age of up to 1.5), introduction of

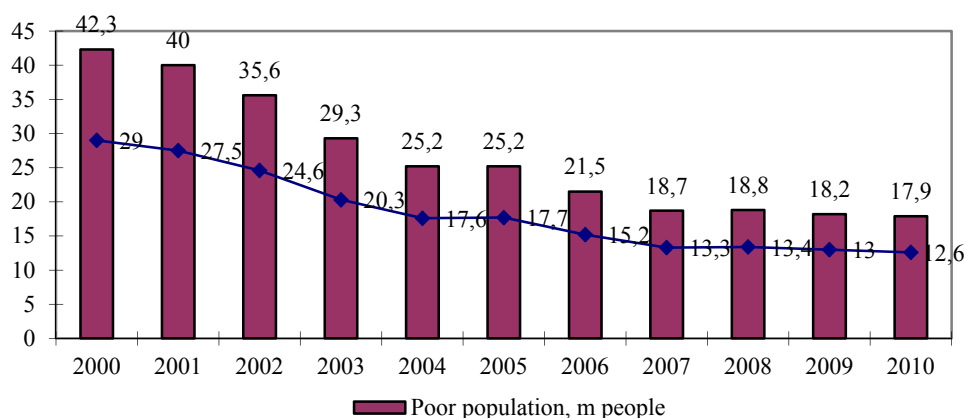
¹ Gini coefficient (income concentration index) describes deviation of total income actual distribution line from their equal distribution line. The value of the coefficient may vary from 0 to 1. The higher is the value, the more equally is income distribution.

² Most of statistics on living standards in the Russian Federation is generated through collection and aggregation of the data of the Household Budget Survey which is conducted by Federal State Statistics Service of Russia (Rosstat) on a quarterly basis, and some data, e.g., data on the availability of durable consumer items are collected on an annual basis. Since data processing takes time, principal data on living standards in the Russian Federation are published with quite a lag.

³ In Russia, individuals who have personal income less than 50% of the subsistence minimum are classified as extremely poor.

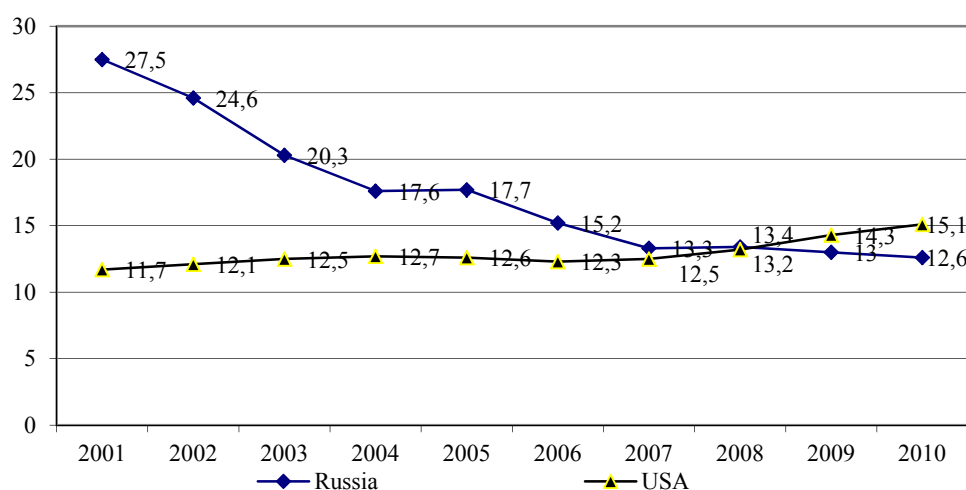
⁴ The authors' estimates are based on the Rosstat's data on personal money income distribution and average annual subsistence minimum.

employment programs for unemployed, rapid growth in salaries of government employees. The foregoing distinguished the dynamics of poverty figures in Russia from such figures in developed countries, e.g., the United States¹.



Source: Federal State Statistics Service of Russia.

Fig. 1. Dynamics of poverty figures in Russia in 2000–2010



Source: Federal State Statistics Service of Russia and U.S. Census Bureau (Current Population Survey), <http://www.census.gov/>.

Fig. 2. Dynamics of poor population (as measured through national methods) in the United States and Russia, as % of total population, in 2001–2010

¹ In Russia, poverty level is measured on the basis of absolute national poverty line. A similar method is employed in the United States, whereas in EC countries poverty is measured on the basis of a relative approach towards changes in poverty.

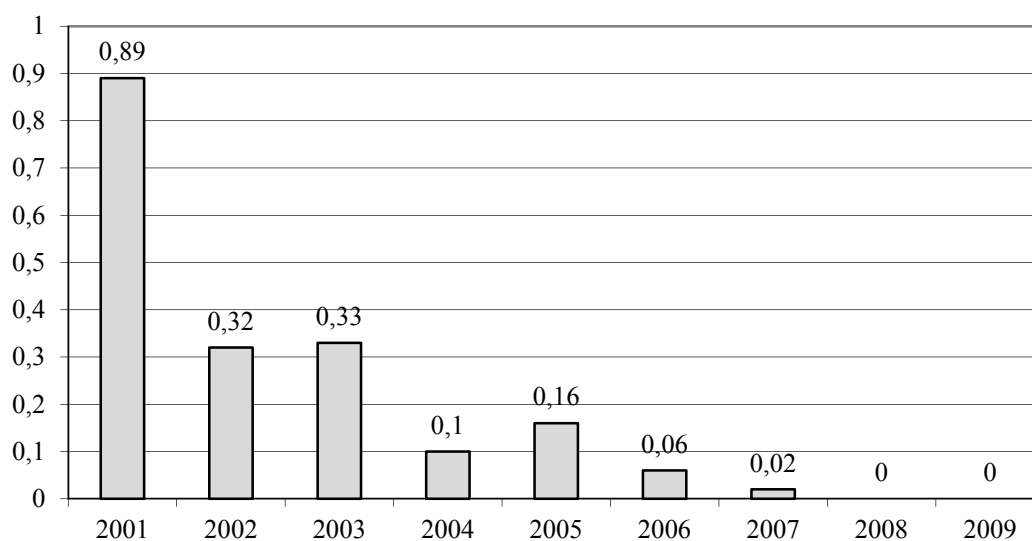
In the United States, individuals who have personal income less than poverty threshold are classified as poor. Poverty thresholds are established with due regard to family size and the number of children in a family. In 2010, for example, single nationals whose annual income was less than \$11,000 were classified as poor in the United States. A poverty threshold of \$22,000 per year was set for a family of four members without children. A poverty threshold of \$23,000 per year was established for a family of four members including one child at the age of below 18. A poverty threshold of \$22,000 per year was fixed for a family of four members with 2–3 children. See U.S. Census Bureau. www.census.gov.

5.1.2. Poverty level in Russia measured by international comparative methods applied to developing countries

Two poverty indicators are commonly used for international comparisons applied to developing countries:

- \$1.25 per day according to purchasing power parity (PPP) – to measure extreme poverty level in most poor countries; this is an average value of national poverty lines in the 15 poorest countries of the world¹;
- \$2.15 per day according to PPP – to measure poverty level in all developing countries; this is a median of national poverty lines in developing countries².

The data presented in *Fig. 3* and *Table 1* show that Russia has a very few individuals who live on less than \$1.25 or \$2.15 per day according to PPP. Thus, international comparative methods applied to developing countries show that Russia has a very low level of poverty and extreme poverty if measured by methods applied to developing countries. Furthermore, the available data show that poverty level in Russia reduced at a higher rate than in other countries in the beginning of the 2000s. No such methods are used to measure poverty in OECD member countries. The use of these methods in Russia will lose its point by the end of the first decade of the 21st century.



Source: World Bank's data. www.worldbank.org

Fig. 3. Russia's population who live on less than \$1.25 per day (in international prices of 2005), as % of total population

¹ See Ravallion M., Chen Sh. and Sangraula P., 2008, "Dollar a Day Revisited," Policy Research Working Paper 4620, Washington DC, World Bank.

² See Chen Sh. and Ravallion M. The Developing World Is Poorer Than We Thought, But No Less Successful In The Fight Against Poverty. Policy Research Working Paper 4703, World Bank, 2010.

Table 1

**Population who live on less than \$2.15 per day (in international prices of 2005),
as % of total population**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Russia	n/a	5.97	3.67	2.95	1.84	1.49	1.22	0.29	0.08	0.05
Croatia	0.14	0.15	n/a	n/a	0.09	n/a	n/a	n/a	0.09	n/a
Ukraine	n/a	n/a	3.41	1.46	1.25	0.48	0.58	0.21	0.13	0.17
Slovakia	n/a	n/a	n/a	n/a	0.43	0.43	0.14	0.19	0.17	0.12
Belarus	1.89	1.52	2.5	n/a	0.64	0.49	0.25	0.25	0.19	n/a
Poland	0.57	0.57	0.58	n/a	0.41	0.57	0.31	0.29	0.25	0.2
Latvia	n/a	n/a	0	1.44	1.04	n/a	n/a	0.47	0.37	n/a
Lithuania	1.28	1.9	1.83	n/a	1.55	n/a	n/a	n/a	0.44	n/a

Source: World Bank's data. www.worldbank.org

5.1.3. Poverty level in Russia measured by international comparative methods applied to developed countries

If Russia is measured by using poverty criteria which are applied to developed countries, in particular the United States, a reduction in the poverty level in Russia early in the 2000s would be substantial, by 2.1 times, from 64.4 to 30.6%¹ in the period between 1999 and 2010. A poverty threshold was about \$15.5 per day in 2010, as measured by applying the US poverty criteria. To compare: a subsistence minimum denominated in US dollars according to PPP was about \$9.4 per day in Russia. The data presented in *Table 2* show poverty level in Russia according to the US criteria.

Table 2

Population distribution by amount of per capita money income in Russia in 2010

Rubles per month	US dollars according to PPP per day*		A share of population, %
	from	to	
0–3,500.0	0	5.8	3.9
3,500.1–5,000.0	5.8	8.3	5.6
5,000.1–7,000.0	8.3	11.6	9.4
7,000.1–10,000.0	11.6	16.5	14.7
10,000.1–15,000.0	16.5	24.8	20.2
15,000.1–25,000.0	24.8	41.3	23.5
25,000.1–35,000.0	41.3	57.8	10.8
Beyond 35,000.0	57.8	and beyond	11.9

* – PPP in 2010 based on IMF data. www.imf.org.

Source: Social situation and living standards in Russia. 2011: Stat.sb./ Rosstat – M., 2011; the author's estimates based on the data provided by the Rosstat and IMF.

¹ The author's estimates based on the data from Rosstat, US Census Bureau, IMF. Since in the United States absolute poverty line is measured by using an equivalence scale which is rarely used in developing countries, M. Ravallion uses the poverty line for a family of four members, divided by 4 (see Chen Sh. and Ravallion M. The Developing World Is Poorer Than We Thought, But No Less Successful In The Fight Against Poverty. Policy Research Working Paper 4703, World Bank, 2010). In 2010, a poverty line was about \$15.5 per day, as measured by the same method. In the mid-1990s, the UN Development Program applied such approach to measure absolute poverty level in developed countries, by using the US poverty line for a family of 3 members, divided by 3 (see Human development report. 2003.UNDP. www.undp.org). An average of poverty thresholds for households comprising 3 and 4 members is used as poverty threshold in the measurement. This measurement ignores the effect of the equivalence scale: it underestimates poverty of households with 1 to 2 members (in particular single member households) and overestimates poverty of large households. However, the effect of this factor seems to be insignificant, because households of 3 to 4 members account for a major part of poor households in the Russian Federation (56.9%), whereas single person households account for less than 5% of total poor households.

5.1.4. Population consumption dynamics

Over the first decade of the 21st century, consumption of poor population improved substantially in Russia. According to Rosstat, over the foregoing period a gap in consumption of food products between non-poor and poor population narrowed notably for all basic groups of food products, a caloric intake of poor population increased 1.4 times to reach 2,100 kcal a daily¹ in 2010, being in line with the basic requirements of the World Health Organization (WHO). Protein consumption of poor population increased to reach the WHO and FAO² standards.

According to the data obtained during a survey conducted as part of the traditional World Barometer project under the auspices of the world largest association of independent research agencies ROMIR/Gallup International/WIN, those who ran short of food accounted for 31% (10% of these persons claimed that they often ran short of food) of the population in Russia in 2005, whereas this figure declined to 8% by 2012 (1% of these persons claimed that they often ran short of food)³. These data correlate with the results of a Rosstat household survey in which households who ran short of money to buy food accounted for 5.8% of poor households (an average of 1.5% of all households) in 2011.

Table 3

Consumption of staple food products, kg per consumer on average annually

	2000		2010		Gap between poor and non-poor households, times	
	Poor households	Non-poor households	Poor households	Non-poor households	2000	2010
Vegetables and gourds	45	97	64	104	2.1	1.6
Fruits and berries	10	35	36	78	3.4	2.2
Meat and meat products	24	60	53	85	2.5	1.6
Milk and dairy products	113	235	182	282	2.1	1.6
Eggs	130	232	169	234	1.8	1.4
Fish and fish products	8	16	14	23	2.1	1.6
Caloric value, kcal daily	1,525	2,762	2,096	2,786	1.8	1.3
Daily protein consumption, g	38	72	58	81	1.9	1.4

Source: Federal State Statistics Service of Russia.

Comparison of poor with non-poor households for availability of durable consumer goods shows no visible gap was between them (except for motorcars and personal computers) as early as 2010. However, it should be taken into account that a minimum set of non-food products, which are included into the subsistence minimum of an average family⁴, comprises a refrigerator, a washing machine, and a TV set. It is seen from *Table 4* that poor households have the foregoing goods plus non-essentials which are not included into the subsistence

¹ Socio-economic indicators of poverty in 2007–2010. Stat.sb. / Rosstat – M., 2011.

² Food and Agriculture Organization of the United Nations. See Energy and protein requirements. Report of a Joint FAO/WHO/UNU Expert Consultation. World Health Organization Technical Report Series 724. World Health Organization. 1985.

³ The index is calculated as a share of respondents from a representative sample of those who gave answers like ‘often’ and ‘sometimes’ to the following question: “Did you or your family happen to run short of food over the last twelve months?”. ROMIR. Issledovaniya. “Bogatyye tozhe golodauyt”. http://romir.ru/studies/405_1352750400/ 13.11.2012 (ROMIR. Studies. ‘The rich starve too’. http://romir.ru/studies/405_1352750400/ 13.11.2012).

⁴ The Russia’s Government Order dd. February 17, 1999, No.192 “On the Approval of Methodological Recommendations Consumer Goods Basket for Principal Socio-Demographic Groups of Population in the Russian Federation and Constituent Territories of the Russian Federation” (as amended and restated on March 16, 2000, August 12, 2005, June 4, 2007).

minimum (cellular phones, vacuum cleaners, videotape recorders, etc.). More than half of poor households have audio systems, two fifths of households have personal computers, one third of households have motorcars.

Table 4

**Availability of durable consumer items in low-income households in 2010,
as per 100 households on average, items**

	Poor households	Non-poor households
TV set	140	167
Videotape recorder, video player, DVD player	81	91
Refrigerator, freezer	112	122
Washing machine	96	100
Vacuum cleaner	81	93
Cellular phone	244	225
Audio system, audio tape recorder, audio player	57	68
Personal computer	41	59
Motorcar	32	50

Source: Federal State Statistics Service of Russia.

High degree of supply of durable consumer goods to the population, including poor population, depends on lending: according to the data provided by Rosstat, about 20% of poor households and about 30% non-poor households had an outstanding loan balance in 2011.

There is no big difference between poor and non-poor households in housing conditions (*Table 5*), except for dwelling space per dweller¹.

Table 5

Characteristics of household housing conditions

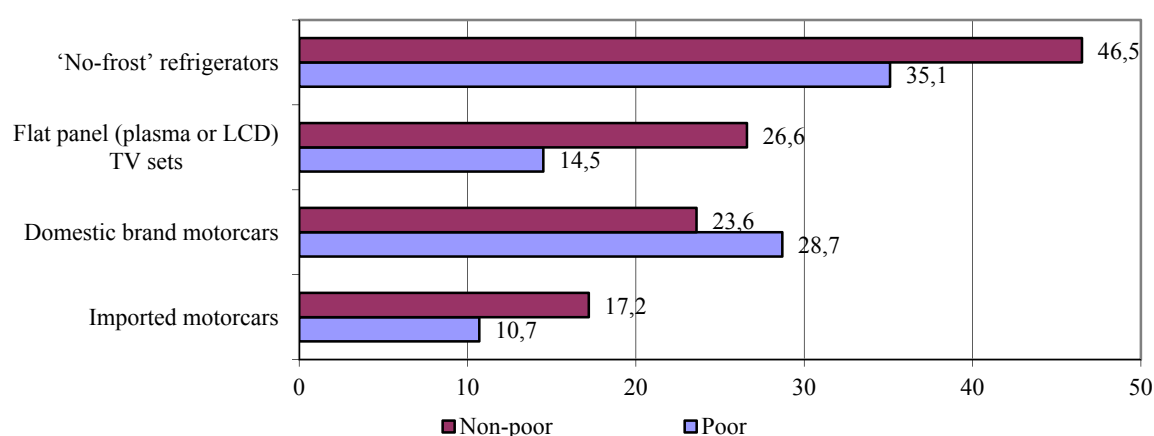
	Poor households	Non-poor households
Households living in a self-contained apartment, house, part of a house, %	97.7	98.7
Number of rooms per household	2.58	2.44
including separate rooms	1.92	1.99
Dwelling space per dweller on average, m ²	15.7	22.1
including living space	11	14.8

Source: Federal State Statistics Service of Russia.

Aggregation of the data provided by the 19th round of the Russian Economic and Public Health Monitoring in the Russian Federation, which was conducted in the period between Q4 2010 and Q1 2011, showed that such non-essential goods as no-frost refrigerators, flat panel (plasma or LCD) TV sets, domestic motorcars, imported motorcars are increasingly bought not only by representatives of non-poor, but also poor population in accordance with the Russian household criteria (see *Fig. 2*).

In 2011, poor population in Russia increased to 18.1 million persons (17.9 million persons in 2010), poverty level increased to 12.8% (against 12.6% in 2010). The situation in 2011 was indicative of stabilized living standards and poverty rather than a turning point in positive dynamics. Quarterly and semiannual data, as well as 9-month data on poverty in 2012 are lower than in 2011, and, more importantly, lower than in 2010 which saw the lowest poverty in Russia, thereby holding out a hope of further downward trend for poverty in Russia which seems to slowdown though.

¹ To some extent, a small gap in the figures relates to expensive housing in Russia.



Source: authors' estimates based on the data provided by the 19th round of the Russian Economic and Public Health Monitoring in the Russian Federation (Q4 2010 – Q1 2011).

Fig. 4. Households which have non-essential assets, %

Table 6

**Population with substandard per capita money income
in 2010–2012**

	2010			2011				2012		
	Q1	H1	year	Q1	H1	9 months	year	Q1	H1	9 months
Population with money income less than subsistence minimum, million persons	20.6	19.1	17.9	22.9	21.1	20.2	18.1	19.1	17.7	17.2
As % of total population	14.5	13.5	12.6	16.1	14.9	14.3	12.8	13.5	12.5	12.1

Source: Federal State Statistics Service of Russia.

5.2. Migration Processes

5.2.1. Legislative Initiatives

The State Migration Policy Concept of the Russian Federation through to 2025 was adopted in Russia in 2012 after an extended discussion. The Concept is the second one in the Russian modern history. The first one – The Migration Process Regulation Concept of the Russian Federation – was issued in 2003 but failed to be implemented both due to the fact that “the rigor of the laws is commonly mitigated by non-compliance therewith in Russia” and some of the provisions of the above document were rendered *a priori* impossible and its analytical quality was found to be hit-or-miss.

The substantive part (Conditions for the Formation and Implementation of Russia’s State Migration Policy) of the new Concept contains a self-critical list of all the issues which are currently being faced in the modern migration processes in Russia, including poor attractiveness of this country among foreigners in terms of permanent migration (except for the citizens of CIS member countries), and acknowledges that the informal sector of the Russian economy gains profit from illegal labor migration involving 3 to 5m persons. Acknowledged in the text is the experience of the countries with active migration policy in

place, and it is admitted that migration processes accelerate social and economic development and promote growth in the material well-being of the population. The very fact that the official governmental document acknowledges all these facts makes one consider that the document is more or less realistic and initially based on reliable data.

In its main part, however, (Goals, Principles, Objectives and Key Areas of the State Migration Policy of the Russian Federation) the Concept looks not so well-defined, which can be explained by a months-long struggle involving the Federal Migration Service of Russia and the Ministry of Health and Social Development during the lead time. In particular, these governmental departments hold different interests as to the proposal to abolish labor migration quotas and discontinue sojourn permits in 2015. As a result, these proposals of the Federal Migration Service failed to be implemented and become a part of the Concept. The following novations were approved: develop differentiated mechanisms of engaging, selecting and employing migrants, which also includes implementation of special programs of short- and long-term labor migration; create a score-based system in selecting migrants; simplify the entrance and departure procedures for special categories of migrants, for example, those who are involved in investment and business activities, etc. It is, however, the most corruption-driven mechanisms of quoting and issuing sojourn permits (SP) that are proposed to be “upgraded” and “modernized” (quoting system). Many of the proposals and stated goals which are related to the internal migration management seem to be unclear and elusive. Internal migration regulation – providing that Russian citizens enjoy the constitutional rights to freedom of movement within the country – is extremely difficult and lacks effectiveness in terms of scale¹. In addition, it is obvious that all of the proposals and measures relating to internal migration management are outside the scope of migration and completely determined by economic regulators/changes, it is the regional economic policy’s area of responsibility. The Concept proposes to fulfill various tasks such as “build up funds to enable implementation of measures encouraging labor migration to other regions including the far eastern area of the country; ensure attractiveness of investments in the Far East, Siberia, border areas and strategically important territories and regions for the purpose of creating a social and transport infrastructure required for migration, as well as reduce transport-related remoteness from the Central Russia’s regions” or “provide support to the regions and territories which are taking active measures aimed at attracting domestic migrants, also as part of the federal programs”, “develop inexpensive rental market segments”.

However, there are issues related to the adoption of the Concept due to the fact that some of the wording is quite ill-defined. Bureaucracy-related “mechanisms” and poor law enforcement are capable of destroying any kind of document, even best defined and most efficient. The President of the Russian Federation signed the State Migration Policy Concept in June 2012. Two months later a plan of measures aimed at implementing the Concept was considered, which provides a period of 2013 to 2014 for the submission of new migration

¹ It is to be recalled that it was not long ago, in 2010 – 2011, when the government resorted to the introduction of internal migration regulation mechanisms in the country as part of the efforts to counteract unemployment growth amidst the economic and financial downturn. Provision of unemployed persons with incentives for migration to other regions by offering migration-related compensations was one of the four tools which the Federal Labor and Employment Service (Rostrud) introduced in order to counteract unemployment growth. However, both unemployed persons and job seekers showed reluctance to take advantage of such an opportunity. More than a half of the small amount of funds allocated for this purpose by the government was left unspent. It is absolutely obvious that all of the proposals made and measures taken in an effort to transform internal migration are outside the scope of migration and completely determined by economic regulators/changes.

laws for the purpose of the Concept. It should be noted that the plan of measures contains only the period of submission of draft laws for the purpose of the Concept to the Federal Government and the State Duma, but it failed to be approved. Taking into account that the State Duma may keep such documents for years and Russian lawmakers' propensity to make urgent amendments to law enforcement (e.g., amidst crisis or in "response" to an international event, as was the case with the detention of Russian pilots in Tajikistan), the implementation of the Concept may be suspended for an uncertain period of time or never take place.

Another migration-related conceptual document – The Strategy of State National Policy of the Russian Federation through to 2025 – was adopted in December 2012. Both documents were brought into line with each other in terms of wording. Like in the State Migration Policy Concept, the developers of this document succeeded most in the substantive part (The Status of Cross-National (Interethnic) Relations in the Russian Federation) in which poor regulation of migration processes, the issues of social and cultural integration and adaptation of migrants, illegal migration, etc. are named among the factors which have an adverse effect on the development of cross-national and interethnic relations in the country. It is the first time that the government's position regarding "measures to prevent formation of closed ethnic enclaves of migrants" was made clear. In general, however, the tasks are depicted mostly as vain wishes, like in the State Migration Policy Concept, for example, "improve the system of measures to ensure that migrants respect the culture and traditions of the host country; provide through the public-private partnership that public associations and religious organizations participate in the activity of multifunctional cultural and educational centers in which migrants are provided with legal and personal services, learn the Russian language, get acquainted with the Russian culture, history and the basics of the legislation of the Russian Federation", etc. There is still work to be done with regard to elaboration of an Action Plan for the Strategy, even as much unclear one as that for the implementation of the State Migration Policy Concept.

Migration subject-matters were also mentioned in V. Putin's pre-election article "Russia: The National Issue"¹. To resolve pending issues he proposed to adopt four amendments to the applicable legislation. First, increase the responsibility for the admission of illegal migrants from other countries; second, apply punitive articles of the Criminal Code to employers for the employment of illegal migrants; third, introduce a mandatory examination in Russian for migrants; fourth, increase the responsibility of the owners of so-called "rubber apartments" for paid registration of migrants in such apartments. It is the task that was most talked about throughout the entire H2 2012 and resulted in the submission of a draft law to the State Duma early in 2013, which increased the administrative responsibility and introduced the criminal responsibility for non-observance of the registration and migration rules. In doing so, the draft law provides no measures aimed at simplifying the registration procedure which can be difficult not only because of lack of real address, but also in terms of time. For example, it may take a foreigner up to six months to obtain a sojourn permit in Russia. V. Alperovich, an expert of the Sova Center for Information and Analysis, believes that "unilateral tightening of control procedures in this sector instead of having an impact on illegal migration may force more people to avoid legal registration procedures in Russia. A. Makarkin, Deputy Director of the Center for Political Technologies, believes that there is a public demand for opening criminal cases against major facilitators involved in illegal migration, but if retired persons

¹ Nezavisimaya Gazeta. January 23, 2012. http://www.ng.ru/politics/2012-01-23/1_national.html

(pensioners) who decide to make a pretty penny in this sector are indicted under the new law, the government authorities may face a negative public response”¹.

5.2.2. Permanent Migration Scale and Dynamics

Regular changes in the migration registration procedure is an example of the Russian authorities' motivated thirst for constant novations. The motivation is growth or at least population stabilization in the country which have recently been claimed as a key objective to be fulfilled by the government. Population growth involves two components, namely the natural and migration gain/decline. In respect to the natural gain, the Federal State Statistics Service (Rosstat) reported a total of 4,600 persons over eleven months in 2012. A total of 129,700 persons were reported as part of the natural decline in the population for the same period in 2011. The shift itself from minus to plus as a result multiple factors deserves special attention. However, the migration component's contribution to the gross population gain was much more bigger, 98.3% (276,200 persons). Nevertheless, it is impossible to estimate for certain the country's population migration gain, let alone make any comparison with the previous periods which were formally less positive in terms of population dynamics. The procedure for statistical registration of migrants in Russia was changed again in 2011. Under the new procedure, with regard to the long-term migration registration (which is included into the estimation of gross population gain), persons registered at the place of sojourn for a period of nine months and longer (under the old registration procedure, statistical data covered migrants registered at the place of residence as well as at the place of sojourn for a period beyond 12 months²) are added to migrants registered at the place of residence. Methodologically, the difference seem to be in that during 90 days (i.e. the very three months “left” before the year ends) migrants may stay in a living quarters without the need to obtain registration at the place of sojourn³, and finally they stay for a year, which is in line with the international recommendations on the long-term migration registration. On the one hand, the logics of these changes is opportunistic: a mechanism has finally been found which shows that there is no decline in the Russia's population or it is even growing. On the other hand, statistically supported migration growth brings it someway closer to the real figures estimated by researchers.

Fig. 5 shows the impact of the changes in migration registration on parameters of migration flows covered with the statistical data.

First, almost all of the indicators grew rapidly when the migration registration procedure was changed in 2011, and the upward trend continued in 2012. This is especially evident through the scale of Russia's internal migration and inflow from non-CIS countries. It supports the idea that migration without changing the official place of residence is really important for the people in Russia. Russia's internal migration growth doubled over the comparative periods of 2010 and 2012. It was the first time since 1992 that the parameters of

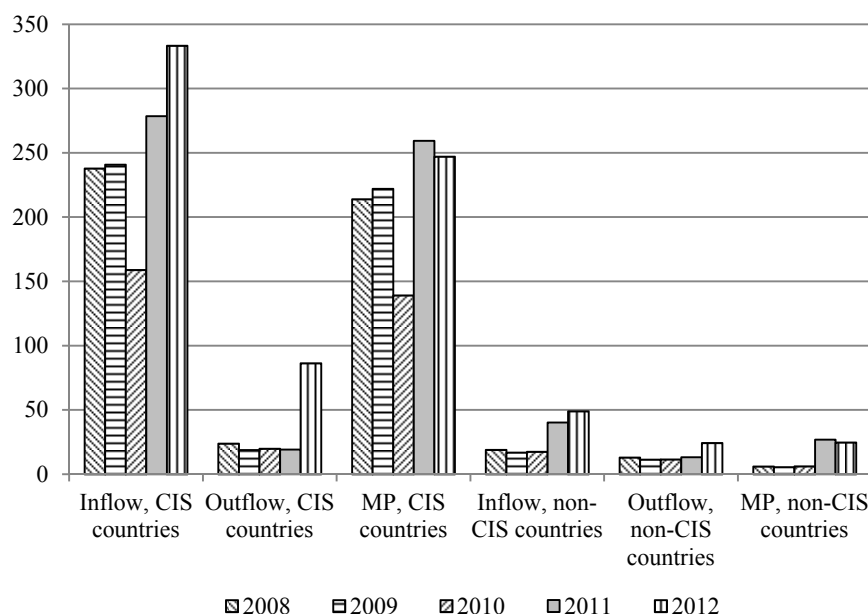
¹ Litoi A. The Law against “rubber apartments” is to be disputed in the Constitutional Court. RBK daily. 10.01.2013.

<http://subscribe.rbc.ru/2013/01/10/society/562949985473594>

² Even earlier only those persons who were registered at the place of residence were regarded as migrants who form the migration gain in Russia, whereas those registered at the place of sojourn – for any period of time – were not covered in the migration gain.

³ Though no changes were provided for by Federal Law No. 109-FZ “On Migration Registration of Foreign Citizens and Stateless Persons”.

registered Russia's internal migration exceeded and even broke through and went far beyond 3m persons in 2012. It is wrong to make a direct comparison of the data obtained in 1992 and 2012. In 1992, 3,2m persons moved without changing their place of sojourn, but those who had a temporary residential registration (this term is no longer applicable) were subject to registration. Today almost 3.5m Russia's internal migrants include persons who change both their place of residence and sojourn. According to Rosstat's data on the period between January and November 2011 one can see that migrants registered at the permanent place of residence accounted for 67%. If this data (no such data is currently available in the official statistics) is extrapolated on 2012, then Russia's internal migrants would total 2.3m to 2.4m rather than 3.5m persons, therefore the "Soviet" parameters of Russia's internal migration still remain unreached.



Note. Under the Rosstat methodology Georgia and Baltic countries fall under non-CIS countries in addition to the traditionally classified non-CIS countries.

Source: Social and economic situation in Russia. Rosstat's statistical bulletins for 2008 – 2012. Rosstat, 2008, 2009, 2010, 2011, 2012.

Fig. 5. General parameters of migration flows in Russia with CIS member countries and non-CIS countries (NCISC), January thru November 2008–2012, thousand persons.

Incomplete migration registration is open to misreading of the data on population size in the running records and the population censuses in 2002 and 2010¹ which discovered a shortage in the population against the running records in several Siberian and far eastern regions. Quite the opposite results were obtained in the central regions of Russia².

Second, the new changes had no significant impact on the migration gain which was the key target of the changes in the migration registration rules. The migration gain increased

¹ Population censuses are also known for incorrect calculation of the population, there may be found overcalculation or undercalculation with regard to specific categories of the population.

² For more details please refer to Mkrchan N.V. Migration as a component of regional population dynamics in Russia: estimation on the basis of the population census in 2010 //Izvestiya RAN. Geographic series, 2011. No. 5. PP. 28—41

considerably in 2012 against 2010, when migration volumes decreased due to the abolishment of simplified admittance to Russian citizenship for many categories of migrants from CIS member countries, whereas an increase against 2007–2009 was insignificant. The new method of registration seems to constitute a response to migration decline in 2010.

The changes in the registration procedure also resulted in a rapid growth in migrant outflow from Russia. It also refers to outflows to non-CIS countries but much more to outflows to CIS member countries. In the previous years, when only data on truly “permanent” migration was used for processing, the number of outflows from Russia to other countries was insignificant. The changes in migration at “the place of sojourn” triggered a 4.5 times rise y-o-y in outflows to CIS member countries in 2012. The foregoing testifies to the fact that the current migration gain in Russia actually contains a substantial share of “quasi-temporal” component, when after nine months of sojourn a person must obtain a new registration without possibly leaving the country, but migration statistics interprets this as a new migration. Some persons must be regarded as the resident population of Russia, others don’t. There is also illegitimate migration which only can be estimated (the Concept provides an estimate of 3 to 5m persons), and according to some surveys¹, migrants who have a long-term sojourn in Russia and intend to live in the country for good account for 20–25%. A small part of such persons but, of course, not all of them would seem to be included into the Rosstat registered migration.

5.2.3. Migration with CIS Member Countries

Migration with CIS member countries still determines the general background of migration processes in Russia. It refers to both “permanent” and labor migration.

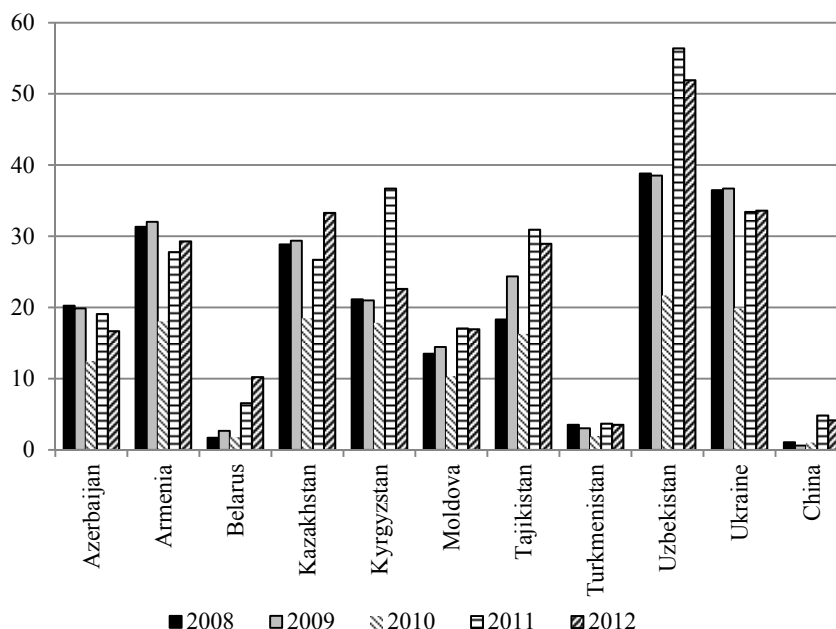
The migrant inflow from CIS member countries increased almost by 20% in 2012. However, as noted above, the migrant outflow was much bigger. Regardless of the well-known problems faced by migration statistics on the entire post-Soviet territory, both statistical data of CIS member countries and Russia show that Russia remains the key host country for the most of them, with a shift in emphasis though.

Uzbekistan continues to be the unbeatable leader in terms of migrant inflow to Russia which increased almost by 40% over the year. One in four migrants to Russia in 2012 was from Uzbekistan. The inflow from Belarus and Kazakhstan visibly increased. Kazakhstan was again, like in the 1990s, ranked #3 being slightly behind Ukraine in migrant inflow to Russia (*Fig. 6*). Regardless of reportedly growing significance of Kazakhstan and Ukraine as migration partners of Russia in 2012, a total share of migrants to Russia from these countries decreased from 56% in 2000 to 38% in 2012.

According to the All-Russian Population Census conducted in 2010, the population of Uzbek, Kyrgyz and Tajik nationals in Russia increased by 1.8, 1.5 and 1.4 times respectively against the data obtained during the population census conducted in 2002. The share of nationals from other CIS member countries decreased, including Ukraine and Moldova. However, it should be understood that growth in the number of Central Asian countries’ nationals is observed against a relatively small number of the nationals from these countries

¹ The Center for Migration Research conducted some surveys as part of the following projects: Migration management amidst demographic crisis (2007–2010, MacArthur Foundation grant, headed by Z.A. Zaionchkovskaya), “Strategic partnership to promote rights and broaden the opportunities of female labor migrants in Russia” (2010–2011, a grant from the Foundation in support of gender equality UN-women, headed by E.V. Tuyruykanova).

reported by the previous population census conducted in 2002, which totals less than 500,000 persons¹. However, there is an obvious general trend for the replacement of Ukraine-Moldova inflow with the Central Asian migrants, including both labor and “permanent” migration.



Source: Social and economic situation in Russia. Rosstat’s statistical bulletins for 2008 – 2012. Rosstat, 2008, 2009, 2010, 2011, 2012

Fig. 6. Migration gain of Russia with CIS member countries and China, January thru November 2008–2012, thousand persons.

The cessation in 2012 of the simplified procedure mechanism for the admission to Russian citizenship in accordance with the international agreements concluded with Kazakhstan, Kyrgyzstan and Belarus² became an important factor having an effect on the specifics of migration exchange between Russia and CIS member countries. As a result, the number of persons admitted to Russian citizenship according to the international agreements decreased by 92% in the period between January and November 2012, which resulted in a decline by almost one third in the total number of persons admitted to Russian citizenship. According to the Federal Migration Service of Russia, a total of 83,600 persons were admitted to Russian citizenship in the period between January and November 2012. This year Russia is going to fail to catch up with the lowest to date level of 2010 when only 111,400 persons were admitted to Russian citizenship.

The lack of opportunities to be admitted to Russian citizenship through a “simplified procedure” stimulated migrants’ interest in the State Program on Assisting the Voluntary Resettlement to the Russian Federation of Compatriots Living Abroad which failed to make

¹ For more details please refer to Denisenko M., Chudinovskikh O. Migration between the CIS member countries //Demoscop Weekly. 2012. No. 533-534. No. <http://www.demoscope.ru/weekly/2012/0533/analit04.php>

² For more details please refer to – Karachurina L.B. Migration processes //Russian Economics in 2011. Trends and Outlooks (Issue 33). M.: Gaidar IET, 2012. Section 5.2. p. 347.

any visible progress since its adoption in 2006. The participants of the State Program and their family members may be admitted to Russian citizenship according to a special procedure. Under the State Program, 300,000 compatriots were expected to receive assistance in the resettlement to Russia in the period between 2007 and 2010. However, the real number of the participants was found to be far more less: about 58,000 persons (jointly with their family members) joined the State Program as of January 1, 2012.¹ The situation saw a drastic change in 2012. Almost 47,000 persons (including their family members) joined the State Program over eleven months, a 1.7 times increase y-o-y.² Hence after six years since its inception the State Program managed to only approach the starting level of 50,000 persons which was declared as early as 2007. The State Program was reanimated only in part even after reducing the opportunities for compatriots to be admitted to Russian citizenship through a simplified procedure without the need to participate in the Program. It appears that migrants are not satisfied with the conditions offered by the State Program: resettlement is only allowed to the selected regions most of which are unattractive in terms of migration. Resettlement inside such regions is mostly allowed to remote, generally rural areas. Compatriots were expected to be employed to specific jobs, conclude labor contracts with employers, but this mechanism has been working “with moans and groans”. Being of humanitarian nature, the State Program was mistakenly positioned as a tool designed to resolve workforce-related issues faced by some of the Russian regions.

A new version of the State Program was reapproved and became unlimited in time in 2012³. The most controversial positions of the Program were abolished. The term “resettlement territory” was edited upon a years-long critics by the expert community. From now on compatriots can be resettled not only to the selected areas within a constituent territory of the Russian Federation participating in the implementation of the State Program, but also on the entire territory. Resettled may be not only compatriots who plan to fill specific job vacancies, but also those who plan to continue their education, start a business, work in the agricultural sector, run a private subsidiary farm.

Though one may expect the new version of the State Program to manage to draw foreign compatriots’ attention, it is insufficient to fully unlock the migration potential of compatriots. It appears that it is the treatment of compatriots as a “resource” which can be reallocated as required by the state that should be changed, and public servants should not be relied upon as to where the persons invited to live in Russia should be resettled. Given that migration inflows have gradually becoming more and more alien ethnically and culturally to the host Russian social medium, compatriots must be invited to the country first of all as a valuable ethnical and cultural component, and the more valuable such a component is, the less efforts the host country and social medium make to integrate such compatriots. According to Mukomel V.I., repatriate compatriots who are fluent in Russian, know the Russian culture need less secondary socialization as compared with other groups of migrants⁴.

¹ Population size and migration in the Russian Federation in 2011. Rosstat, 2012.

² Data from 1-RD Statistical form developed by the Federal Migration Service (FMS) of Russia

³ The Decree dated 14.09.2012, No. 1289, of the President of the Russian Federation “On the Implementation of the State Program on Assisting the Voluntary Resettlement to the Russian Federation of Compatriots Living Abroad”.

⁴ Mukomel V.I. Migrant integration: challenges, policies, social practices //Mir Rossii. 2011. No. 1. P. 34-50

5.2.4. Labor Migration

Labor migration has gradually replacing permanent migration over the last few years. Today we see that they are interconnected not only in that one of them is generally unceasing to the other, or in that permanent migration has not only structurally but also statistically become labor rather than family, with children and elder parents¹: labor migrants account for a significant share of those registered at the place of sojourn for a period of nine months and beyond (and included into the migration gain). However, one may only assume the size of this “significance”.

The Federal Migration Service’s data on labor migration in Russia must not be seen in absolute terms because of a significant incidence of illegal employment of foreign workers. The data only can be considered as a basic starting point. The data testifies to the fact that in 2012 no serious changes took place in the scale, geography of the countries from which foreign workers arrive, their employment industry-specific structure, distribution by region in Russia.

The Federal Migration Service of Russia issued 1,404,000 work permits in 2012, a 13% growth against the previous year. However, it is the acquisition of work patents that became a much more widespread channel than in 2011 for legalization of foreign workers’ labor. Under the applicable law, foreign workers obtain work patents for the purpose of being employed by resident legal entities. As of the end of 2012 the number of good and valid work patents accounted for about 970,000. Since some migrants file work patents for a period much shorter than 12 months, the number of work patents issued by the Federal Migration Service (1,229,000) is slightly bigger than that of legally effective work patents. Other migrants extend their work patents (1,914,000 patents). One way or the other, it implies from the above figures that about 1m foreigners were employed on the basis of work patents in 2012. This legalization channel became a fully legitimate “partner” for the employment based on work permits.

Another more than 40,000 persons were legally employed under work permits issued for highly qualified workforce (HQWF) in Russia, almost 5,000 were employed through organizational recruitment.

Hence a total of about 2.5mn labor migrants were legally employed in 2012.

Like over the last few years, the overwhelming majority of labor migrants (85%) among those who obtained a work permit arrived from visa-free CIS member countries. However, it is only the workers from visa-free countries who may obtain work patents under the applicable law. The statistical data on the work patents issued by the Federal Migration Service which allow foreign workers to work for physical persons shows that nationals from the three Central Asian countries obtained 81% of these work patents. Uzbekistan is the leader followed by Tajikistan and Kyrgyzstan². Indeed, the Central Asian component prevails in labor migration, but it seems to be less visible because Central Asian nationals need to obtain more documents (work permit or patent) as compared to migrants from the western republics of the former Soviet Union. According to the data on home countries of foreign workers, in

¹ In 2003, for example, children at the age below 16 and persons beyond the working age accounted for 15.4% and 17.5% respectively of the persons who arrived from the CIS member countries. By 2010 a share of young and old people decreased to 10.4% and 9.5% respectively. As a result of all this, a share of working-age persons increased by 20% over eight years, which is standing at 81% for the time being.

² No monthly data is published on the home countries of migrants who obtained work permits

2011 workers from Central Asian countries account for about 70% of all work permits obtained¹.

Industry-specific distribution of visa-free migrants with work permits is shown in *Fig. 7*. It resembles almost in full the situation observed in 2011. As before, almost one third of legally employed nationals from CIS member countries are employed in the Russian construction sector. Employment in the wholesale and retail sectors has annually decreased from 30% in 2005 and now is beyond a level of 10%. However, both the data obtained from surveys and expert evidence show no real decrease in the migrant module in the retail sector, above all in major cities of the country. It is to be recalled that after the events that took place in Kondopoga in the summer of 2006 the Government of Russia imposed in April 2007 the so-called “zero” employment quota for foreign workers employed in the retail sector of alcoholic beverages, pharmaceutical goods, vending kiosks and food markets and non-store retailing. The ban instead of preventing such an employment resulted in a drastic decline in official employment figures in this sector and fostered a new round of non-disclosures: foreign workers working at food stores are enrolled on the staff of companies which provide good-unloading and room-cleaning services, rather than on the staff of the food stores². According to some data, however, in the summer of 2011 the Federal Migration Service extended the zero quota requirements on the employment in the retail sector as well as part-time workers enrolled on third-party organizations’ staff, e.g., a clearing company. The figures provided by the directors of the largest retail networks show that foreign nationals working for outsourcing companies will cost about 15–20% less for their employers after being enrolled on the stores’ staff. Finally, in October 2012, for the first time in six years of “zero quota” the government committee for the competition and development of small and medium entrepreneurship of the Ministry of Labor of Russia took a decision to prepare a government’s draft decree on the abolishment of the zero quota for foreign workers employed in the retail sector in order to stabilize the situation in supermarkets and other retail organizations and prevent growth of prices due to wage increase for commercial workers. The corresponding Decree of the Russian Government dated December 1, 2012, No. 1243 “On the Establishment for 2013 of the Acceptable Share of Foreign Workers Employed by Economic Agents Involved in the Retail Sector and in the Field of Sports on the Territory of the Russian Federation” replaced the zero quota with a complex quota on the employment in the retail sector for 2013: a 25% quota for foreign workers employed in the retail sector of alcoholic beverages, including beer; a zero quota for other retail activities: pharmaceutical goods, vending kiosks and food markets and non-store retailing.

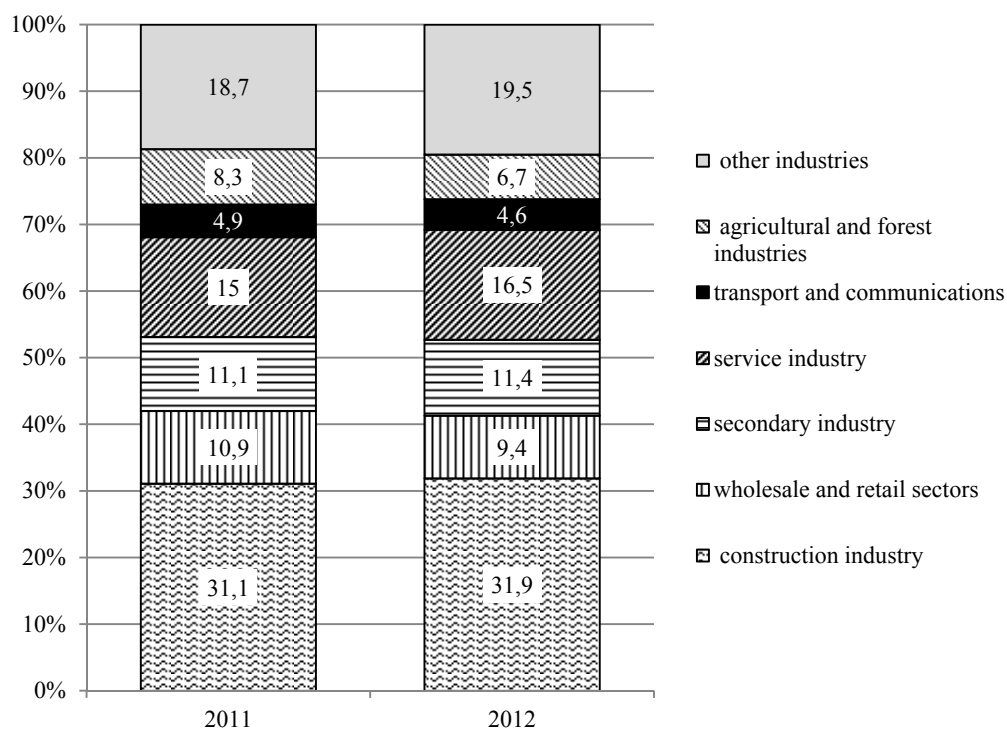
A new employment regulation procedure for a selected categories of workers³ – workers employed by physical bodies (they must obtain work patents) and highly qualified workforce (HQWF) – has been in force since July 1, 2010 in Russia. In effect, employment of foreign

¹ The results achieved by the FMS of Russia in 2011. The source book on the extended session of the board of the Federal Migration Service. Under the general editorship of K.O. Romadanovsky. Moscow.: FMS of Russia, 2012. p. 114.

² “Today, one fourth of the personnel working at stores – in general, cleaning, loading and packing staff – are enrolled on the staff of and provided by outsourcing companies. The retail sector in large cities is running extremely short of workforce” said M. Susov, a representative of X5 Retail Group. Refer to Kreknina A., Gribtsova Y., Malykhin M. Migrant workers will be allowed to work officially at stores //Vedomosti. October 17, 2012.

³ Federal Law dated 19.05.2010, No. 86-FZ “On the Amendments to the Federal Law “On the Legal Status of Foreign Nationals in the Russian Federation” and Other Normative Acts of the Russian Federation”.

workers on the basis of work patents and, in most cases, work permits is intended to provide service to a lower, wide, job-intensive part of the country's labor pyramid, whereas workers employed on the basis of HQWF work permits must occupy the top, narrow part of the pyramid.



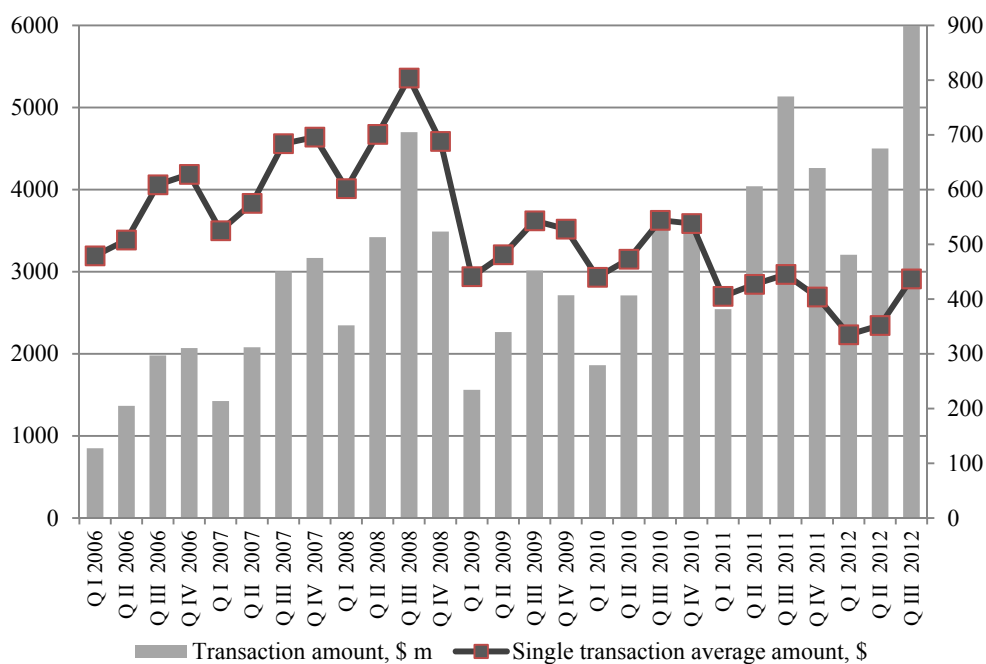
Source: the data provided by the Federal Migration Service Russia (1-RD statistical form)

Fig. 7. Employment industry-specific structure of visa-free foreign workers in Russia (based on notifications on concluded labor or civil law contracts), 2011–2012, %

The developed countries had to resort to labor migration of unskilled workforce in the face of a slower gain or decline in the working age population. However, migration of highly qualified workforce, in particular circular migration which also allows for temporary types of employment, has long become vital and relevant for the developed countries. The first time when Russia became interested in such migration was after the adoption of the amendments to the Federal Law dated July 25, 2002, No. 115-FZ “On the Legal Status of Foreign Nationals in the Russian Federation” which classify HQWF as a special group. The group comprises three categories to be identified by different quantitative criteria of income generation: specialists in the capacity of researchers or professors in case they are invited to give relevant classes (at least Rb 1m annual salary); other foreign workers (at least Rb 2m annual salary) and – exclusive of salary requirements – foreigners engaged in the implementation of the Skolkovo Project. Though the HQWF category was legally specified in the mid- 2010, work permits for HQWFs were first issued in 2011. However, no visible dynamics has been available to date, as is the case with issuance of work patents. A total of 10412 persons, of which visa nationals accounted for more than 90%, obtained HQWF work permits in 2012, a 2% growth against 2011. Hence this channel is only important for Moscow (59% of all the

work permits issued for HQWF in 2011¹) until it starts working properly, and the overwhelming share of the employed HQWFs work in the capacity of real estate and retail managers rather than scientific and research workers and intellectual elite.

The amount of migrants' cross-border cash remittances from Russia to CIS member countries keeps growing. It reached almost \$6m in Q3 2012 thus showing a 17% growth y-o-y and also exceeded by one third the parameters recorded in Q2 2012 (*Fig. 8*). In general, however, "power relation" between cash remittances to non-CIS countries and CIS member countries keeps growing constantly in favor of the former. The amount of cash remittances from Russia to non-CIS countries exceeded 1.6 times that to CIS member countries in 2006, 1.4 times in 2010, 2.3 times in 2012. Obviously, it would be much more easier to see a "migrant trace" in cash remittances to China than in cash flows to Switzerland, Hong Kong or Cyprus. Regardless of the differences in the amounts of cash remittances to CIS member countries and non-CIS countries, the balance of cross-border transactions in both channels is almost the same, because cash remittances from CIS member countries in favor of physical bodies in Russia are extremely insignificant.



Source: the data provided by the Central Bank of Russia <http://www.cbr.ru/statistics/?Prtid=svs>

Fig. 8. Cash remittances from Russia to CIS member countries based on the statistics on retail cross-border transactions, in Q1 2006 – Q3 2012

The smallest since 2006 average amount of a single transaction was reported in 2012. It can be explained by the fact that cash remittances from Russia to CIS member countries became more accessible for migrants (better infrastructure, lower cost of cash remittance services) and there is no need in cooperation for cash remittances, and a narrower gap

¹ The results achieved by the FMS of Russia in 2011. The source book on the extended session of the board of the Federal Migration Service. Under the general editorship of K.O. Romadanovsky. Moscow.: FMS of Russia, 2012. pp. 116-117.

between the salary and expenses (rental, food, transport) which migrants have to pay in Russia.

Country-specific amounts of cash remittances correlate with the intensity of migration flows: Uzbekistan is ranked #1, Tajikistan #2, followed by Ukraine, Kyrgyzstan. However, there is no such prevalence of the Central Asian component in the cash remittance statistics as, for example, is the case with issued work patents (see above). The amounts of cash remittances also depend largely on industrial “niches” and jobs occupied by migrants from specific countries and, consequently, remuneration. It is well-known that, for example, Ukrainian and Moldovan construction and maintenance workers are paid higher salaries than Tajik workers who are normally contracted to perform hard and dirty works.

5.2.5. Russia’s Internal Migration

It becomes more difficult to make analysis of Russia’s internal migration for the following two reasons: the above described changes in the migration registration procedure and high incidence of temporal internal migration which is poorly recorded in the statistics.

The changes in the migration registration procedure resulted in a record number of entrances (3.77m persons) inside Russia in 2012. The Central Federal District accounted for 1/4 of these persons and the Volga Region for another 20%.

Forty six percent of all Russia’s internal migration was intraregional, while interregional migration accounted for the rest. As in the previous years, a share of interregional migration in Russia’s internal migration is bigger in the north and far eastern regions (e.g., Kamchatka Territory, Murmansk or Magadan Regions, Chukotka, where all movements are made towards the “mainland” rather than from/to settlements of the regions) and most attractive economically developed regions of the European part of the country and gas and oil producing zones.

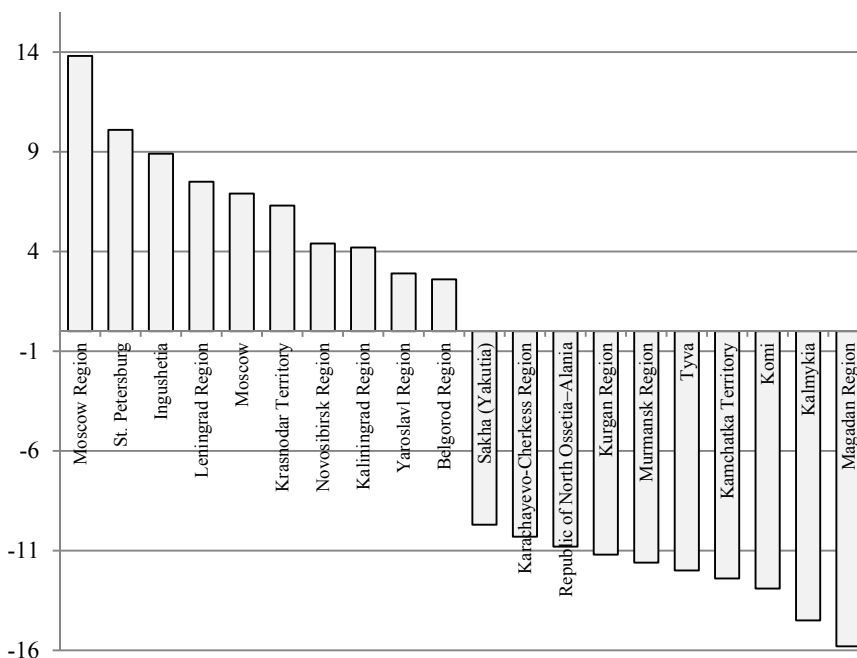
A positive migration gain in the interregional migration in 2012 was reported only in 18 Russia’s regions, six of which were among the leaders: Moscow and the Moscow Region, St. Petersburg and the Leningrad Region, the Krasnodar Territory and Ingushetia¹ (Fig. 9). Indeed, the four near-Moscow regions account for about 75% of the positive interregional net migration. Thanks to active housing construction and real estate prices the Moscow Region outstripped Moscow as it did in 2011. By contrast to this, St. Petersburg attracted, as it did in the previous years, much more domestic migrants than the Leningrad Region.

The Moscow Region is currently the ultimate leader in internal migration in Russia, in 2011–2012 it attracted about 100,000 persons via this channel. According to TDN Zhilichny Kapital, citizens of the other regions of Russia accounted for 48% of the total buyers of apartments in the Moscow Region in 2012². In addition, temporary labor migration which is only partially represented in this statistics and pendulum migration which is not represented in the statistics, play a visible role in the Region. The Moscow labor market capacity in combination with better prices of apartments than in Moscow and small volumes of new state-funded housing construction in Moscow has become the key factor of attractiveness of the Moscow Region. The near- Moscow cities and areas of the Moscow Region have long been playing the role of “bedroom districts” for Moscow. Regional citizens pretend to more than

¹ The data on Ingushetia seems to be quite disputable due to the serious issues in the civil registration which were revealed during the All-Russia Population Census in 2010, and negative plus high values of the migration gain ratio of the Russia’s internal migration recorded in the other North Caucasus Republics.

² Citizens of the Regions of Russia move to the Moscow Region. <http://realty.rambler.ru/news/living/1916583/>

50% of all the job vacancies available in the data base of Imperia Kadrov, a Moscow agency, and up to 70% of low-level job positions which require 1-2 years of employment history¹.



Source: the data provided by Rosstat.

Fig. 9. Migration gain ratio in Russia's internal migration, regions with maximum and minimum values of this indicator, 2012, %

The changes in the registration procedure recognize the sprawl of Moscow and the Moscow Region which was previously camouflaged by migration statistics but evident through the housing construction statistics².

In addition, comparison of the data on cities and administrative districts of the constituent territories of the Russian Federation which was collected under the “old” and “new” migration registration procedure showed with reference to specific regions of the Central Federal District that the new registration method results in polarization of the migration situation inside the regions: regional centers foster migration gain, while outflow from remote areas, rural areas and small towns has increased.

It appears that migration statistics now can “see” a significant part of educational migration. Previously, many students registered with dormitories for a period of less than 1 year were not covered.

¹ Karimova A., Lvov Y. Movement and punishment //Kommersant Dengi. January 30, 2012.

² Housing commissioning in the Moscow Region has been far ahead of that in Moscow since 2006, and since 2002 in per capita figures.

5.3. Key trends in the education system: results of 2012

We can identify a number of key events in the Russian education system in 2012 that will shape its development in the coming years:

- 1) The public tender for the distribution of university admission quotas for the 2012/2013 academic year and the use of standard costs per discipline (field of study) which are being used as the basis for funding the implementation of state-financed places in this academic year (April 2012);
- 2) On 7 May 2012 the President of the Russian Federation, V.V. Putin, signed a series of Decrees which directly define a number of areas of state education policy;
- 3) Adoption of the “State Programme for the Development of Education” for 2013-2020;
- 4) Adoption of the law “On Education in the Russian Federation”;
- 5) Adoption of the Federal Budget, significantly changing the priorities of federal government policy on the financing of education;
- 6) The Russian Ministry of Education monitored the activities of the federal state universities and their subsidiaries, identifying universities "with signs of inefficiency" (ineffective universities);
- 7) The Russian Ministry of Education monitored the activities of the accredited private universities and their subsidiaries, identifying ineffective universities;
- 8) The Russian Ministry of Education monitored teaching staff salaries in universities.

These events have resulted in wide public debate on the future development of the education system and have revealed many new challenges which this area has already faced, or will face in the near future.

1. The public tender for the distribution of university admission quotas for the 2012/2013 academic year and the setting of standard costs per discipline (fields of study, as the basis for funding the allocation of state-financed places in this academic year (April 2012).

This event is very important, as it represents the first time that private universities have been allowed to tender for the distribution of admission quotas (state-financed places). Thus, this law adopted in November 2011¹, allows accredited private universities to participate on a competitive basis in the implementation of the State staff-training programme, and to receive budget subsidies "paying" for its implementation.

When the Law was adopted, it was indicated (in the accompanying Notes) that no more than 40 of the 450 existing private universities could actually participate in the State programme. This showed that the informal quality assessment of higher education in the private sector was very low.

The results of the tender were that all 313 state universities, acting under the jurisdiction of the Ministry of Education of Russia, and 54 private universities obtained grants related to state-financed places, i.e. the limit set out by the legislator was exceeded, although, among universities receiving the budget funds for student education, the overall proportion of these private higher education institutions has remained very low. For all state students admitted to undergraduate courses we still cannot estimate the proportion of students who began studying at private universities in the 2012/2013 academic year using state-financed places (i.e. using the budget account). According to the aforementioned Notes, it was believed that the private

¹ Federal Law No. 318-FZ dated November 16, 2011 (On Amendments to Certain Legislative Acts of the Russian Federation with regard to the establishment of admission quotas for citizens to study at the expense of the respective budgets of the federal budget of the Russian Federation for state-accredited educational institutions of vocational and higher education).

universities would admit no more than 4,500 out of about 510,000 state-financed students (0.88%). It should be noted that the only regional university that allowed itself to take part in the tender for admission quotas was not successful in the bid. This has revealed a very significant problem: under Art. 69 of the Civil Code for Russian private higher education institutions in that these are entitled to receive state subsidies for the provision of state-financed places, whilst Russian Federation public or municipal universities may not. Moreover, there is no mechanism for federal state universities under the jurisdiction of federal executive authorities other than the Russian Ministry of Education, to participate in this tender. Currently the Russian Ministry of Education is developing solutions to provide ways of centralising the federal budget funds allocated for the training of state-financed students in order to ensure that all federal state universities can participate in the tender for the distribution of admission quotas.

However, the public tender aimed at the current and future distribution of admission quotas is completely incomprehensible, as all universities participating in it have state accreditation (this is a legal requirement!), i.e. the quality of their education is formally considered to be consistent with the federal state educational standards. In other words, they are all equal before the tender; so, from a legal point of view it would be wrong to separate the best and worst amongst them. There are some universities that are "more equal than others" - St. Petersburg State University and Moscow State University, the federal and national research universities, and the higher educational institutions, which according to the Decree of the President of the Russian Federation, are entitled to set their own standards. However, the standards of these universities exceed federal standards.

In these circumstances, an algorithm for the distribution of admission quotas amongst universities could be fairly simple: first, the quota is granted to the high-status universities, providing higher quality education (exceeding the standard) in such proportions as they may consider most appropriate; and then to the remaining universities, according to established proportions as there is no formal basis to change this. The only problem is that the distribution of students applying to the different universities, based on the results of the Unified State Exam, is not quite identical to the status granted by the State¹ to these higher educational institutions. It is no less important that this is determined, not only by these statutes, but also by a series of factors (family income, health status, benefits, availability of dormitories and military departments, location of the university, set of disciplines (training areas) in a particular university, etc.).

It should be noted that the public tender for the distribution of admission quotas amongst universities, held in April 2012, and the inefficiency monitoring of higher educational institutions, held in October, are in conflict - a number of universities found to be ineffective actually received admission quotas, i.e. won the tender. It turns out that the criteria of the tender for the distribution of admission quotas and the criteria for assessing ineffective universities are different; the two procedures do not correspond to each other. In this regard, it appears that the public cannot trust either the results of the tender or the results of the monitoring.

2. On May 7, 2012 the President of the Russian Federation, V.V. Putin, signed a series of Decrees which directly define a number of areas of state education policy.

Presidential Decree No. 599 dated 7 May 2012, "On Measures for the Implementation of State Education and Science Policy", directly affects the education system. It sets objectives in the field of education, most of which should be implemented in 2012, in particular:

- Introduction to the State Duma of the draft law “On Education in the Russian Federation” in July 2012 (it was introduced at the end of July 2012, the State Duma adopted it at the third reading on 21 December 2012);
- Development and implementation of measures to improve the efficiency of the Unified State Exam (in fact this is done every year);
- Monitoring the effectiveness of educational institutions (as already noted, this monitoring was carried out and universities showing signs of inefficiency were identified). Amongst these schools, 70 institutions of higher education are recognised as special universities not subject to optimisation, primarily the Moscow Institute of Architecture, the Institute of Literature and St. Petersburg State University of Cinema and Television. It is, however, recognised that 49 universities and more than 100 subsidiaries thereof, require optimisation, i.e. improvement of curricula, changes to their specialisations, with a requirement to make better use of educational and laboratory space, to purchase new equipment and possibly to make substantial changes to their faculty staff. More than 260 universities and their subsidiaries, including three in Moscow and four in St. Petersburg, are subject to closure or merging with large universities. Finally, for a large group of schools (118), including the State Humanitarian University, the Chechen State University, and the Far Eastern Medical University, decisions are still pending¹.
- Development of a set of measures to identify and support gifted children;
- Approval of the standards for secondary education and for general education (approved);
- Increasing scholarships to the level of a living wage for students with "good" or "excellent" marks and for some others (scholarship have now been increased).

In 2013, the Mathematical Education Concept should be developed.

All other orders are expressed as results indicators:

- Ensure the availability of pre-school education for all children (100%) between the ages of three to seven (currently this is 71.5% and it will be impossible to bring it up to 100% in the remaining three years before 2016, as there is a rising demographic trend in these age groups – the number of children is increasing, and so, despite all the efforts, the waiting lists for nurseries have not been reduced in recent years, and as of January 2012 it stood at more than 2 million children. Estimates show that it would be possible to achieve the desired result only by introducing of over 500,000 new places in kindergartens (whether public or private) in each of the remaining years, and that is impractical);
- By 2020, to provide the entry of at least five Russian universities into the top one hundred of the world's leading universities as defined by the world university rating system (unfortunately, the exact world university rating criteria are not specified, as they are based on various different indicators, but, apparently, the greatest attention is paid to an increased number of papers published in leading magazines, increases in the index of quoted Russian authors (professors), increased numbers of foreign students in Russian universities, etc. It is unlikely that the problem will be solved within 8 years, especially as there has been a precisely opposite trend in recent years. But if such a trend is at least reversed, then this will be a great achievement. However, there is a significant risk that focus and resources will be allocated to supporting potential favorites in this race whilst the other universities will stagnate);

¹ See <http://минобрнауки.рф/%D0%BF%D1%80%D0%B5%D1%81%D1%81-%D1%86%D0%B5%D0%BD%D1%82%D1%80/2845>

- By 2015, to have increased to 37% the proportion of the population aged 25 to 65 and employed in the economic sector, who have attained or are studying in postgraduate education (according to the Federal State Statistics Service, in 2010, 15.8% of the total population employed in the economic sector and 18.6% of people aged 25-65 had completed programmes of Continuing Professional Education (CPE). It appears that it will be impossible to double this value by 2015 - the entire CPE system does not have enough capacity, even if we include appropriate programmes in vocational educational institutions, corporate training centres, universities, etc;
- By 2020, to increase to 70-75% the proportion of children aged 5 to 18 enrolled in vocational educational programmes, and that 50% of these are trained through the federal budget (in the last 10 years, the vocational educational rate for children aged 5-18 increased to 58% but this was because of a reduction in their total number. However, in absolute terms, attendance at various vocational education institutions remained practically unchanged for the entire period in question. It appears that it is impossible radically to change this situation. In addition, children aged 5-18 should be divided into teenagers aged 12-14 and youth aged 15-18 who require special attention and special programmes - which are sorely lacking in the Russian system of vocational education);
- By 2020, to increase the proportion of institutions of secondary vocational education (SVE) and higher professional education (HPE), having buildings which are adapted for disabled people, from 3% to 25% (this is a worthy goal, but the solution will require the coordinated efforts of the federal and regional educational authorities and of the management of these educational institutions).

In addition to Decree No. 599, education is greatly affected by the Presidential Decree No. 597 dated 7 May 2012 “On Measures for the Implementation of State Social Policy”. Under this Decree the Russian government will provide:

- By 2018, an increase in real wages by 1.4 - 1.5 times;
- In 2012, an increase in the average salary of teachers in general educational institutions up to the average wage of the relevant region;
- By 2013, an increase in the average salary of teachers in preschool educational institutions up to the average wage for public education in the relevant region;
- By 2018 an increase in the average salary of teachers and trainers in primary and secondary educational institutions of and of the employees of cultural institutions up to the average wage in the relevant region;
- By 2018, an increase in the average salary of doctors, teachers in educational institutions and HPE researchers up to 200% of the average wage in the relevant region»¹.

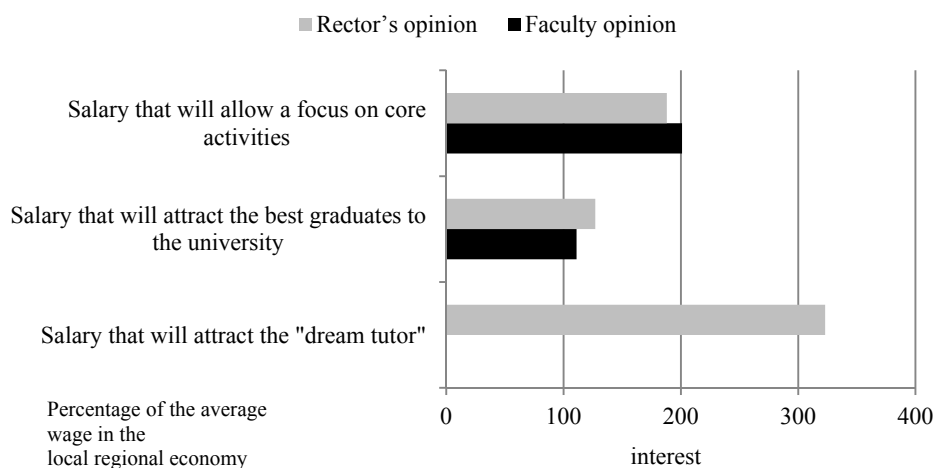
In fact, Decree No. 597 sets out the transfer of social workers to a so-called "effective contract," which a) should enhance the motivation to work, ensure long-term employment in state and municipal educational, public health and cultural institutions, and b) bring young professionals into the social-work field.

By signing the "effective contract," a teacher or tutor is committed to work in a single, rather than in multiple educational institutions (of course, the teaching can, and in high schools should, be combined with scientific activities). The teaching staff of schools, whose wages will rise by up to 200% of the average wage for the region, will be able, it is believed,

¹ See the website of the President of the Russian Federation V.V. Putin <http://putin.kremlin.ru/>.

to focus fully on academic work, improve their skills, devote a lot of time to communicating with students (including advisory work) and to conduct research work.

From the results of monitoring the educational economy in universities it appears that the “effective contract” will be achieved at the following ratios of average faculty salary and average wage in the local regional economy (*Fig. 10*).



Source: monitoring of the educational economy.

Fig. 10. Ratios of average faculty salary and average wage in the local regional economy, required to achieve the "effective contract" in universities

As shown in *Fig. 10*, according to rectors and professors, the salary that will allow the faculty to focus on their core activities is about 200% of the average wage for the economy of the region, and this is the figure recorded in the Presidential Decree.

Without questioning the sincerity of the respondents, we note only that the wage level deemed sufficient by the faculty and rectors in conditions when the average faculty wage does not exceed the average wage in the regional economy (or is below this value) may seem unsatisfactory when it approaches 200%. Recalling that in Presidential Decree No. 1, issued by B.N. Yeltsin, this faculty wage level (2 times higher than the average wage in the economy of the appropriate region) was established in 1991 (21 years ago) without any research or the introduction of an "effective contract", yet this will be reached (if reached at all) only in 2018, i.e. after more than a quarter of a century.

We should also mention another important fact. The adopted decision on the level of wages of education workers (kindergarten, school teachers, teaching staff at primary and secondary educational institutions, trainers and university teaching staff) actually cancels all prior studies on the definition of state financing standards in the education system. This model - a model of standard per capita funding - should be completely revised in the light of the decision to increase the salaries of kindergarten teachers, school teachers and the teaching staff of SVE and HPE institutions.

Indeed, it is impossible simultaneously to set, for example, the standard costs per discipline (field of study) for economic and management institutions located in Moscow at Rb 60,000

per student¹ {as these disciplines (fields of study) do not require laboratory equipment} and to require that the average faculty salaries in these institutions should be Rb 90,000.²

If we fix the average teaching staff salary in the region and the standard cost per discipline (field of study) per student, we can only determine the amount of the state-set task for each university (the number of state-financed students) which would allow it to pay the desired salary to its professors. We can almost certainly say that in the current conditions, and in 2018, there will be no solution to this issue in the education system in general (although some universities, in principle, could solve it). Furthermore, in this case it is necessary to adjust not only the state-financed student flows, but also fee-paying students flows, and this would be a further area causing administrative and economic problems: under these circumstances we would simply not be able to hold a tender for the distribution of admission quotas.

3. *Adoption of the State Programme for the Development of Education for 2013-2020.*

The State Programme for the Development of Education (SPDE) adopted in 2012 is the basis for the implementation of the state educational policy. However, the Programme itself states that its activities cover only about a third of the education system.

It seems that formally the SPDE is no worse than other state programmes. However, it should be noted that the core objectives stated therein:

- Providing a high quality of Russian education to meet the changing demands of the population and the future tasks of Russian economic and social development (hereinafter referred to as *Goal 1*);
- Improving the implementation of the youth policy for innovation and socially-focused development (hereinafter referred to as *Goal 2*) cannot be verified, so we cannot properly assess whether this programme is implemented and to what extent.

The Federal Educational Programme (2000-2005) and the Federal Target Programme for the Development of Education (2006-2011), which should have been the basis of the state education policy before SPDE, did not provide for public debriefing and assessment. The amount of budget funds spent was essentially the only measure of their effectiveness. Scientific support for these programmes has been low, and attempted developments in this field have frequently been made by different organisations but without any progress on the implementation of their results. In this regard, the SPDE is little different from its predecessors.

The goals of the Programme have little to do with its objectives and targets, which are a copy of the indicators set in Presidential Decree No. 599. In view of this, it is unlikely that the implementation of the SPDE will bring Russian education up to the next level and increase its competitiveness in the global education market (especially in the higher education market).

4. *The new law “On Education in the Russian Federation”.*

This Law has been in development since 2010 and was adopted by the State Duma at its third reading on 21 December 2012. Its first version contained more than 900 pages and was a combined jumble of legal documents regulating activities at various levels of education. This version was subjected to harsh criticism by all stakeholders, significantly revised, and then the

¹ See. <http://минобрнауки.рф/%D0%B4%D0%BE%D0%BA%D1%83%D0%BC%D0%B5%D0%BD%D1%82%D1%8B/2347>

² The standard costs per full-time student ('standard budget funding' or 'average financial support for the provision of a state-financed place'- these terms are used interchangeably), and the average salary in Moscow in 2018, of course, will be different, but, according to the federal budget expenditure trends for HPE, their relative values in 2012 and 2018 are unlikely to be very different.

result was put to a referendum. As a result, the content of the Law has become much more focused. But the new Law has a number of ideological drawbacks as compared to the law "On Education 1992". The old Law indicated a course of development of the education system in the direction of greater freedom for educational institutions, both in terms of educational and economic activities. We can assume that its purpose was to ensure increased diversity in the education system: development of the private sector, variety of educational institutions, variety of educational programmes, multiple founders (co-founders) of educational institutions, variety of funding sources, increased public participation in the management of education and its increased transparency.

The new Law is a law declaring the development of democracy and freedom, though all its elements are fairly subordinate to the regulatory effects of the State.

The old Law was a law of development, the new Law largely reinforces the *status quo*.

In addition, the new Law is largely descriptive and due to its pretentiousness it is not very suitable for the settlement of real educational conflicts (which is the main role of any law).

5. Adoption of the Federal Budget, significantly changing the priorities of the federal government policy on financing education.

The educational expenditure of the Federal Budget (hereinafter referred to as the FB) in 2013 and for the planning period, 2014-2015 are set as follows (*Table 7*):

Table 7

Federal expenditure on education in 2013 and for the planning period, 2014–2015 according to the draft FB and adopted FB (billion Rb)

	2013 Draft FB	2013 FB	2014 Draft FB	2014 FB	2015 Draft FB	2015 FB
Education	605.7	607.2	547.7	548.5	572.6	572.5
Preschool Education	7.6	7.7	6.0	6.3	5.7	5.8
General Education	67.4	67.7	19.3	19.9	19.0	19.6
Primary Vocational Education	4.3	4.3	4.5	4.5	4.5	4.5
Secondary Vocational Education	3.6	4.1	3.6	3.7	3.8	3.8
Professional training, retraining and advanced training	6.4	6.4	6.4	6.4	6.5	6.5
Higher and Postgraduate Professional Education	477.2	477.7	484.1	484.0	513.5	512.7
Youth Policy and Improvement of Children's Health	5.3	5.4	5.3	5.3	1.0	1.0
Applied Educational Research	12.5	12.5	9.4	9.4	9.8	9.8
Other educational issues	21.3	21.3	9.0	9.0	8.7	8.7

Source: the Ministry of Finance of the Russian Federation.

As can be seen from *Table 7*, the cost of education to the federal budget is different, but only slightly, from the planned expenditure on education in the draft FB: it is slightly higher in 2013 and 2014, and slightly lower in 2015.

In comparison with the draft FB the costs of preschool education are higher for all three years covered by the budget; in 2013 the expenditure on state education is higher by Rb 0.3 billion, on secondary and higher vocational education - by Rb 0.5 million and on youth policy and the improvement of children's health - by Rb 0.1 million.

In 2014 and 2015, the expenditure on general education is higher by Rb 0.6 billion compared with the draft FB, in 2014 expenditure on SVE is greater by Rb 0.1 billion while expenditure on HPE is lower by the same amount, in 2015, the expenditure on HPE is even lower - by Rb 0.8 billion. No significant changes occurred for any other items¹.

¹ Small changes do occur, but they are within the rounding error.

Federal expenditure on education will account for 0.91% of GDP in 2013, 0.74% of GDP in 2014 and 0.69% of GDP in 2015. Evidently, a substantial decrease is planned in the proportion of FB expenditure on education compared with GDP throughout the planning period (by almost a quarter).

The share of FB expenditure on education is also reduced in relation to the total expenditures of the federal budget: from 4.5% in 2013 to 3.7% in 2015 (in 2014 - 4.2%), but it should be considered that in nominal terms the FB costs are significantly reduced in 2014 and significantly increased in 2015 (in 2013 – Rb 13.4 trillion, 2014 – Rb 13.2 trillion, 2015 – Rb 15.6 trillion). Over the period 2013-2015, it is planned significantly to change the structure of FB expenditure on education (*Table 8*).

Table 8

The structure of FB costs on education in 2013–2015 (%)

	2013	2014	2015
Education	100.0	100.0	100.0
Preschool Education	1.3	1.1	1.0
General Education	11.1	3.6	3.4
Primary Vocational Education	0.7	0.8	0.8
Secondary Vocational Education	0.7	0.7	0.7
Professional training, retraining and advanced training	1.1	1.2	1.1
Higher and Postgraduate Professional Education	78.7	88.2	89.6
Youth Policy and Improvement of Children's Health	0.9	1.0	0.2
Applied Educational Research	2.1	1.7	1.7
Other educational issues	3.5	1.6	1.5

Source: the Ministry of Finance of the Russian Federation.

As *Table 8* shows, the structure of FB expenditure on education in 2013–2015 undergoes the following major changes:

- The proportion of expenditure on general education compared with total FB education expenditure is sharply reduced (by more than 3fold) - from 11.1% to 3.4%;
- The proportion of expenditure on the youth policy is further reduced – by 4.5 times;
- The proportion of expenditure on general vocational education is slightly increased - by 0.1 percentage points;
- The proportion of expenditure on preschool education is slightly reduced - from 1.3 to 1.0%;
- The proportion of expenditure on professional training, retraining and advanced training is practically unchanged;
- The proportion of expenditure on applied research and on other issues in the field of education is significantly reduced - by 19% and more than 2 times, respectively;
- Higher and postgraduate education is the main beneficiary of the FB expenditure on education with the proportion increased from 78.7% to 89.6% (10.9 percentage points).

It should be noted that, in absolute terms, the FB expenditure on general education is to be reduced from Rb 67.7 billion in 2013 to Rb 19.9 billion in 2014, and to Rb 19.6 billion in 2015. General education is funded at a municipal level, with regional budgets providing the municipal ones with subventions for teachers' salaries and training costs, so the reduction of FB expenditure on general education places an increased burden on the budgets of the subjects of the Russian Federation, albeit slight: a little more than 2% relative to the total consolidated regional budgets on education, but this change may be greater in some regions.

The FB expenditure on youth policy and children's health improvement is drastically reduced - from Rb 5.4 billion in 2014 to Rb 1.0 billion in 2015. Thus, youth policy does not appear to be a priority of the federal centre any more.

It should also be noted that even in the case of higher and postgraduate education the increase of FB expenditure on HPE in 2014 is below the target level of inflation (a nominal increase in expenditure of 1.3%, while the inflation rate is 5.5%), in 2015 the increase in expenditure on higher and postgraduate education is slightly ahead of inflation – an increase in expenditure by 5.9%, whilst the inflation rate is 5%. For other items the costs are either reduced or their growth is below the target rate of inflation.

6. *The Russian Ministry of Education monitored the activities of the accredited state universities, the private universities and their subsidiaries, and the teaching staff salaries in universities.* We have already discussed some issues related to the monitoring of accredited state and private universities, intended to identify inefficient universities.

We can only add that the monitoring was carried out on the basis of a range of indicators, with the five main ones being: the average USE score of students, the amount of research per faculty, the number of foreign students and the volume of financial activities and educational facilities per student. It seems, however, that the monitoring should be carried out based on licence and accreditation indicators or at least on both the two sets of indicators. Otherwise, it turns out that if a university meets the state requirements, this in principle allows it to act as an educational institution and to receive state accreditation, i.e. it is considered that it complies with the federal state educational standards, yet it is not effective and it should be reorganised. However, in our opinion, the results of the monitoring ultimately show the ineffectiveness of the licensing services and of the established structure of the state accreditation system (this is not to say that Russia has no weak universities requiring reorganisation). Therefore, firstly, it will be necessary openly to change the licensing and accreditation requirements, and then to carry out a universal re-accreditation of universities and their subsidiaries rather than just to monitor their activities.

In addition, in the case of non-compliance of the university infrastructure with the licensing requirements, its licence would have to be withdrawn, as the educational and laboratory infrastructure of the university is the basis for the calculation of the enrolment limit, which, *inter alia*, regulates the admission of fee-paying students to the university, and this affects the financial aspects of its activities. The withdrawal of the university's licence or state accreditation would undoubtedly raise the question of how this or that school obtained them in the first place. Currently, both these issues are only in the background.

Monitoring of the teaching staff *salaries* in universities largely confirms our earlier conclusion that it is impossible to establish the budgetary financing standards per discipline (field of study) due to the diverse socio-economic statuses of the regions where the universities are located.

Thus, according to the monitoring results¹, the average teaching staff salary at the Altai State Medical University was Rb 25,600 in October 2012 or 156.2% of the average wage in the region, and in the Russian National Research Medical University – Rb 24,100 or 51.5% of the average wage in Moscow whilst the two universities have almost identical sets of disciplines.

To achieve the desired results requested in Presidential Decree No. 597 (to increase the faculty salary in universities to 200% of the average wage for the local regional economies in

¹ See <http://минобрнауки.рф/%D0%BD%D0%BE%D0%B2%D0%BE%D1%81%D1%82%D0%B8/2849>.

2012), it would be necessary to increase the faculty salary of the Altai State Medical University by an average of Rb 7,200. To solve a similar problem in the Russian National Research Medical University the value of staff salaries would have to be increased by as much as Rb 69,500. Thus, introducing a teaching staff salary equal to 200% of the average wage in the economy of the surrounding area would have different effects in these regions of Russia.

For example, according to the Federal State Statistics Service¹, in 2012, the average wage in the economy of these subjects of the Russian Federation differed by 3.27 times, the cost of 1 sq.m in the primary housing market – by more than 4.1 times, in the secondary market - by 4.6 times², etc. However, if in 2012 the average teaching staff wages in these universities accounted for 200% of the average wage in the economy of the region, they would have differed by only a factor of 2.85. And these examples of salaries and universities are quite typical.

Despite these arbitrary monitoring criteria, restructuring of the network of universities has been initiated on the basis of their results (we can assume that it was on their formal grounds). These activities include:

- Liquidation of inefficient universities (subsidiaries of universities);
- Change in the management of inefficient universities;
- Accession of ineffective (weak) universities to effective (strong) universities.

Upon the liquidation of a state (municipal) university its state-financed students must be transferred to other universities (the fate of fee-paying students is less well understood). If the university was weak and the quality of education was poor, the fate of its students is unenviable: with rare exceptions, they will not be able to fulfill the requirements of the stronger university and would have to be expelled. If the alternative is to save them, the strong university will either have to reduce its requirements of students significantly (through a reduced quality of education) or serious efforts will be required to bring the weak students to the necessary level (which is unlikely without additional resources). In any case, effective universities will suffer along with the weak universities, and their reputation could be significantly affected.

Neither will changing the management of inefficient universities also allow for quick resolution of the issue of increasing the quality of education in them. Since these universities have been publicly recognised as weak, they will not attract strong enrolment in the foreseeable future. Consequently, the new management will have to "pull" the inefficient university in extremely adverse conditions. If the state-financed allocation is distributed on a competitive basis, a weak university with new management will not receive any, or will receive only a very small amount of it. This would mean that the university will have almost no budget funds, and if it has a poor reputation it will not be able to obtain higher fees from the weak fee-paying enrolment. Therefore, this university will slowly die even with new management in place. Alternatively, the state would have to take administrative measures to support it for a long time, by allocating additional budget subsidies (and giving some of the state-financed allocation to it despite the competitive criteria) in order to improve the quality of teaching, and by conducting public relations campaigns in order to remove its label of being an "ineffective university".

¹ http://www.gks.ru/bgd/regl/b11_44/IssWWW.exe/Stg/d01/04-15.htm

² http://www.gks.ru/bgd/regl/b11_44/IssWWW.exe/Stg/d02/09-22.htm

Joining a weak university (or universities) to a strong one, in contrast to a simple liquidation of the inefficient university, will provide a bonus to the strong university in the form of the property of the integrated university. But it is hard to say if this bonus will outweigh the negative effects (the need to teach the weak enrolment, to sort out the weak teaching staff, who cannot be immediately dismissed, and to repair the neglected buildings). Most probably, the strong university will just wait for a few years until the "heritage" of the weak one gradually dissipates whilst making great efforts to preserve its own reputation (since weak graduates will receive diplomas from the strong university).

Does this mean that it is not necessary to reorganise the higher education system? No, it does not. But we need clearly to understand the impact of the interventions and to minimise their negative effects.

* * *

2012 was eventful in the field of education, but as the analysis has shown this still has not led to significant positive shifts in the evaluation by Russian society of the quality of education or of the ongoing reforms in this area.

The objectives set in the Presidential Decree are unlikely to be resolved in a timely manner, as the "battle" for "effective contracts" will probably overshadow everything, since it enables the tracking of specific results. However, the "effective contract" or a significant increase in the salaries of teachers in pre-school educational institutions, of the teaching staff in SVE and HPE institutions, as well those in universities, will bury the model of standard per capita funding in its existing form.

The implementation of the state Development of Education programme for 2013-2020 will be difficult, since its goals do not effectively correspond to the objectives of the programme and its indicators. Therefore, this programme is unlikely to be successfully implemented in its existing form.

The adopted Federal Budget for 2013 and for the planning period of 2014-2015 clearly shows a decrease of FB expenditure on education, not only in relative, but also in absolute terms. In addition, the growth rate of expenditure on HPE education (in fact, being the only beneficiary of changes in the educational FB) will be below the rate of inflation, or, in other words, even these costs will be reduced in real terms.

Monitoring of accredited universities, conducted by the Russian Ministry of Education, has shown that the work of the licensing system, and in particular, the national university accreditation system, is ineffective in the first place. Without its improvement neither open public tenders for the distribution of the state-set admission quotas among the universities, nor the attempt to identify the underperforming universities, will be understood in Russian society or in the university community.

5.4. State of Science and Innovation in 2012

5.4.1. From Innovation to Science

The past year was marked by the alteration of former trends and priorities following the change of the President and the Government. State policies for supporting science came to the fore while the encouragement of innovative activities and technological development lost in

the frequency of its mentioning in the official documents. The switching of priorities was also reflected in the way consultative bodies were restructured.

In June the President signed Decree No. 878 of June 18, 2012 “On the Council under the President of the Russian Federation on economic modernization and innovation-based development of Russia” by which he eliminated the Commission under the President of the Russian Federation on modernization and technological development of Russian economy. A bit later – in August – the Government Commission on high technologies and innovations was eliminated as well¹. The declared rationale for cutting the number of institutions dealing with innovation-based development was the need to avoid overlapping of their activities; however, it also implied the fading of attention to this sphere.

Indeed, the word “innovations” has never been mentioned either in the Budget Message of the President on the budget policies in 2013–2015² or in the President’s Address to the Federal Assembly³ while the issues of development of science got fairly close attention. As soon as in August the Ministry of Economic Development (MED) declared that in the coming two years the state would cut expenditures on innovations⁴.

At the same time a new Department on scientific and educational policies under the President was established in June⁵, the general administration of which was entrusted to the President’s assistant – former Minister of education and science A.Fursenko. As different from the new Council on modernization of economy and innovation-based development of Russia under the President of the Russian Federation, the tasks of this Department were formulated rather explicitly. Among them was not only the participation in determining the guidelines for state scientific and educational policies but also the issues of funding scientific research including broader use of grant-based form of financing, programs for development of scientific-educational centers, scientific and educational institutions. Besides, the Department was charged with backing up the work of the Council on science, technologies and education under the RF President which in July was reorganized into the Council on science and education under the President of the Russian Federation⁶. So, the issue of “technologies” was also withheld from the area of priority concern. The new Council is an advisory institution and as different from the former one which concentrated largely on granting various kinds of State and Presidential awards, also has a range of clear-cut tasks for the implementation of which inter-departmental teams in four areas have been created. These are: “priority and interdisciplinary research”, “research infrastructure”, “mechanisms for supporting scientific and educational sphere”, “scientific and educational provision of engineering activities”. They can be regarded as the current priorities of the President’s policies in the field of science and education.

¹ RF Government Resolution No.839 of August 16, 2012 “On the elimination of Government commission on high technologies and innovations”.

² Budget message of the President of the Russian Federation on budget policies in 2013-2015 of June 28, 2012 <http://kremlin.ru/acts/15786>

³ Address of the President to the Federal Assembly of December 12, 2012 <http://www.kremlin.ru/news/17118>

⁴ According to O.Fomichev, the Deputy Minister of economic development of the Russian Federation. *Source: Rossiya planiruet sokratit' raskhody na innovatsii*. [Russia plans to cut expenditures on innovations]. *RIA Novosti, RBC TV*. 28.08.2012. http://rbctv.rbc.ru/archive/main_news/text/562949984609693.shtml

⁵ Decree of the RF President No.882 of July 28, 2012 “On the Department on scientific and educational policies under the President of the Russian Federation”.

⁶ Decree of the RF President No.1059 of July 28, 2012 “On the Council on science and education under the President of the Russian Federation” <http://www.kremlin.ru/news/16087>

The creation of the Department instigated the debate as to whether the new institution would be a sort of competitor to the RF Ministry of Education and Science with the consequent overlapping of functions and fight for influence and leadership. Competent experts expressed an opinion that such fears had no grounds and the President's assistant A.Fursenko stressed that each institution would find its own field of work and, moreover, the Ministry and the Department would generate additional opportunities for each other¹. Since the Department and the Council on science and education under the President of the Russian Federation have just begun to operate, it's still difficult to assess whether the executive body and the quite influential advisory institution that work in the same field will manage to co-exist peacefully.

Summing up the essentials of the basic Addresses and Decrees of the newly elected President of the Russian Federation, the priorities of the scientific policies from now on are:

- development of the system of grant-based financing of science including the increase of budget financing of public scientific foundations by 2018;
- growth of financing of R&D carried out in higher education institutions;
- increase of research workers' salaries (within the framework of raising incomes of social sphere workers – school teachers, university professors, cultural workers, etc.);
- improvement of quality of scientific research which should be reflected in higher share of Russian researchers' publications in the world scientific journals indexed in the database Web of Science;
- involvement of scientific community into the modernization of defense complex and creation of a special “Foundation for advanced research” to work with defense technologies. The latter was set up in October 2012². It will deal with R&D having respect to the country's defense and security, modernization of the armed forces and creation of innovative technologies and facilities for the production of military, special and paramilitary produce. The rise of attention to defense research that has been the case for some time now is not infrequently regarded as a stimulus to the development of science at large. However, the recent world trends evidence that civil science is increasingly feeding the military one and not the other way round as was formerly the case.

Last year not all of the above mentioned priorities started to be actively implemented – i.e. not to a noticeable extent. But preparatory works got really going in several directions including the elaboration of staff support measures and development of science in higher education institutions, the coordination and approval of the RF State program “Development of science and technologies” in 2013–2020. The operation of development institutions continued; at the beginning of the year new measures in the domain of innovation were initiated – first of all, the carrying out of competition-based selection of innovative clusters eligible for further state support. Finally, the change of policies towards foreign grant-awarding institutions should not go unnoticed; formally it was not relevant to the domain of

¹ Granik I., Nagornych I., Chernych A. *Andrey Fursenko poluchaet vtoroye obrazovaniye. V administratsii prezidenta sozdaiyotsya novoye profil'noye upravleniye.* [Andrey Fursenko gets second education. A new specialized department is being created in the President's administration.] // Kommersant, No.115, 27.06.2012. http://www.kommersant.ru/doc/1967938#_methods=onPlusOne%2C_ready%2C_close%2C_open%2C_resizeMe%2C_renderstart%2Concircled&id=10_1355756199031&parent=http%3A%2F%2Fwww.kommersant.ru;

A.Fursenko ob'yasnily zadachi Upravleniya po obrazovatel'noy politike. [A.Fursenko explained the tasks of the Department on educational policies.] 28.06.2012. http://www.strf.ru/material.aspx?CatalogId=221&d_no=47400

² RF Federal Law No.174 of October 16, 2012 “On the Foundation for advanced research”. <http://www.consultant.ru/law/hotdocs/21403.html#.UNAzI8V3pEs>

science but actually had a great impact on the atmosphere around foreign scientific foundations.

5.4.2. State Program for the Development of Science and Technologies

Within 2012 several draft projects of the RF State program “Development of science and technologies” in 2013-2020 were worked out but public debates focused mostly on the sub-section pertaining to the support of fundamental research.

The original intent of elaborating a new program for fundamental research was to make it “integrated”, uniting major performers of fundamental research in the country and eliminating over-lapping of their activities. Besides, the role of competition-based financing should have grown. Respectively, the procedures for establishing the structure of coordination, management and interaction with state agencies as well as the set of performance indicators were being elaborated. In its initial version the program for fundamental scientific research in state academies of sciences constituted a separate block of the sub-program “Fundamental research and development of academy sector of science” of the draft RF State program “Development of science and technologies” in 2013-2020. In March 2012 the Russian Academy of Sciences (RAS) coordinated this draft with the then executives of the Ministry of Education and Science but on June 19, 2012 the fresh leadership of the Ministry placed on its website an updated version after the examination of which the administration of RAS countermanded its endorsing signature¹. The provision about the pivotal role of RAS in the implementation of the consolidated program disappeared from the new version while the role of the Ministry of Education and Science respectively grew. In its coordinated version the program was a sum of independent sub-programs implemented by major stakeholders – RAS, leading higher education institutions, the Russian Foundation for Basic Research, the Russian Humanitarian Scientific Foundation, etc. However, the forming of agenda and execution of fundamental research was supposed to be based on the integrated system of priorities that should be determined through the consideration of program participants’ suggestions (taking into account the Plan of RAS fundamental research till 2025) and approved by the Coordinating Council of the program. It was also essential that the Coordinating Council should be headed by the President of RAS. In the new version the Coordinating Council was renamed into the Council of Integrated Program, its functions as well as the subordination of participants were defined rather vaguely and RAS became a coequal partner.

The system of performance criteria also changed a lot. There were many of them in the coordinated version: beginning from financial, infrastructural (the number of large scientific installations) and staff indicators to the frequency of citation. In particular, indicators of integration between different institutions engaged in fundamental research were proposed – for instance, the number of new basic chairs, educational and scientific centers, task academic laboratories created in higher education institutions – which was important for the integrated program. Only indicators of publication activity and frequency of citation remained in the new version. But it’s not quite correct to use the data of exclusively bibliometric analysis for the current assessment of research results since they are adequate for longer periods and should be supplemented with other indicators.

¹ Volchkova N. *Mozhno bep syurprizov?* [May there be no more surprise?] // *Poisk* [Search] No.38, 21.09.2012, p.3.

After the active criticism from RAS a revision of the draft project began and several more versions appeared since then.

At the meeting of the Open Government expert council in October 2012¹ the parties concerned (representatives of RAS, state scientific centers, higher education institutions) noted that their remarks on the draft State program had not been taken into account. In its turn the RF Ministry of Education and Science insisted that the document had a framework nature and therefore all the details would be amended a lot of times and finally defined later.

At the RF Government meeting in November a consensus was reached at last: the program of fundamental research in state academies of sciences for 2013-2020 was included in the RF Integrated program for basic scientific research as a separate section, and RAS became one of the major coordinators thereof². In December the Prime Minister signed the Directive (No. 2433-p of December 20, 2012) enacting the state program “Development of science and technologies”. According to its final version the RF Minister of education and science D.Livanov and the President of RAS Yu.Osipov were appointed co-chairmen of the Board of RF program for fundamental research.

It’s indicative that the discussion around the place and role of RAS distracted attention from more serious questions including the scenario according to which the R&D sphere should develop. In the adopted version of the program the least favourable scenario was chosen – the one based on budget rather than modernization.

The set of indicators to be used for assessing the achievement of the program goals is also noteworthy. Among them there are both hard-to-attain targets (pertaining mainly to the increase of publication activity)³ and easy-to-reach figures. In particular, by 2020 one plans to enlarge the share of researchers aged under 39 up to 35% and to provide for the lowering of researchers’ average age down to 43. By the first indicator the plan has been already over-fulfilled: the latest available data show that in 2011 the share of researchers under 39 years old reached 37.5%⁴. As to the average age of researchers, in recent years it stuck at the level of 48 years: although the inflow of young people to science became more active, they later leave this sphere. Meantime, elderly researchers do not retire and so the statistical average is not changing. But soon the share of elderly personnel will start to drop owing to the natural decline (so far the percentage of scientists above 70 years old has been growing) and by 2020 the required value of the “average age” indicator will be attained even in case nothing changes in HR policies. If the budget-based scenario remains the principal one, the results are not thus difficult to predict – the parameters of “scientific potential” will improve while the efficiency of science - will not.

¹ Volchkova N. *Consensus v tseitnote. Chem i kogda zakonchatsya spory o novoy gosprogramme?* [Consensus in time-trouble. How and when will the debates on the new state program end?] // *Poisk* [Search], No. 42, 19.10.2012 <http://www.poisknews.ru/theme/science-politic/4325/>

² Aleksandrova N. *Tseny na scenariii* [Prices of scenarios] // *Poisk* [Search] No.45-46, 16.11.2012, p.3.

³ According to estimates of experts of the National foundation for personnel training in order to achieve the set indicators of publication activity the corpus of Russian publications indexed in the international databases should increase by no less than 57% as compared with 2011. If one takes into consideration only articles (without reviews and “letters”), their number should grow by no less than 27% which is also hardly attainable. *Source*: Belyaeva S. *Scenarnye plany. Podnyat’ publikatsionnyuyu aktivnost’ mozjno raznymi sposobami*. [Scenario plans. Publication activity can be enhanced in different ways] // *Poisk* [Search], No. 1–2, 2013 <http://www.poisknews.ru/theme/science/5015/>

⁴ *Nauka, tekhnologii i innovatsii Rossii: 2012. Kratkiy statisticheskiy sbornik*. [Science, technology and innovation in Russia: 2012. Brief data book]. Moscow, *IPRAN RAN* [Institute for the Study of Science of RAS (ISS RAS)], 2012, p. 21.

5.4.3. Monitoring of RAS Institutions' Efficiency

Notwithstanding active discussions about the forthcoming direct or indirect reforming of RAS that set off after the new government (and especially the new Minister of education and science D.Livanov who had always been an opponent of RAS) came into office, in the past year the Academy at least preserved its positions. First, in compliance with the adopted plans for the development of fundamental research, within 8 years the annual budgeting of RAS will grow from Rb 55bn to Rb 75bn¹. Although the increase is not impressive, it's essential that the financing is not being cut. Second, the President signed Federal Law No. 240-FZ of December 3, 2012 "On the introduction of amendments to Article 6 of the Federal Law "On science and state scientific and technological policies" and selected legislative acts of the Russian Federation" in compliance with which state academies of sciences retrieved their powers of establishers of the subordinate state unitary enterprises and public institutions including scientific organizations. From now on the state academies will have the right to take decisions on creation, restructuring and liquidation of such institutions. Therefore, the independence of RAS has consolidated.

Finally, RAS estimated the performance of its institutions using the methodology that comprised 130 criteria including the involvement in international cooperation, effectiveness of work, commercial potential of R&D, resource availability, research area prospects. The results of this estimation stirred up animated discussion as they showed that 290 of 297 institutions proved to be efficient². Indeed, against the backdrop of continuous discussions about the inefficiency of RAS which have certain grounds such a result can be interpreted as an evidence of inapplicability of either solely quantitative criteria for the evaluation of research results or the chosen criteria for an objective analysis of performance. In particular, the productivity of RAS institutions is below the level that could be attained given such a great number of researchers and institutions. The more so, as it is the system of state academies of sciences where the most part of fundamental research is still being carried out – academic institutions account for more than 60% of the country's domestic expenditures on basic research. At the same time in Russia the share of publications with a high rate of citation in the total number of publications included in the Essential Science Indicators database is lower than even in other countries of BRICS to say nothing of the OECD countries³. Besides, according to outcomes of the tender for conducting joint studies with companies for the purpose of establishing hi-tech operations⁴ and judging from the number of applications submitted for participation in the tender for setting up laboratories under the direction of leading scientists (megagrants)⁵ to which the institutions of RAS were admitted in 2012, the

¹ Volchkova N. *S Instrumentom! Gosakademii sumeli otstoyat' svoyu programmu*. [Felicitation upon the instrument! State academies have managed to defend their program]. // *Poisk* [Search], No. 50, 14.12.2012, p.3.

² Bykova N. *RAN otsenila effektivnost' svoikh institutov*. [RAS has estimated the efficiency of its institutions]. http://www.strf.ru/material.aspx?CatalogId=221&d_no=51562 18.01.2013.

³ *Nauka, tekhnologii i innovatsii Rossii: 2012. Kratkiy statisticheskiy sbornik*. [Science, technology and innovation in Russia: 2012. Brief data book]. Moscow, *IPRAN RAN* [Institute for the Study of Science of RAS (ISS RAS)], 2012, p.84.

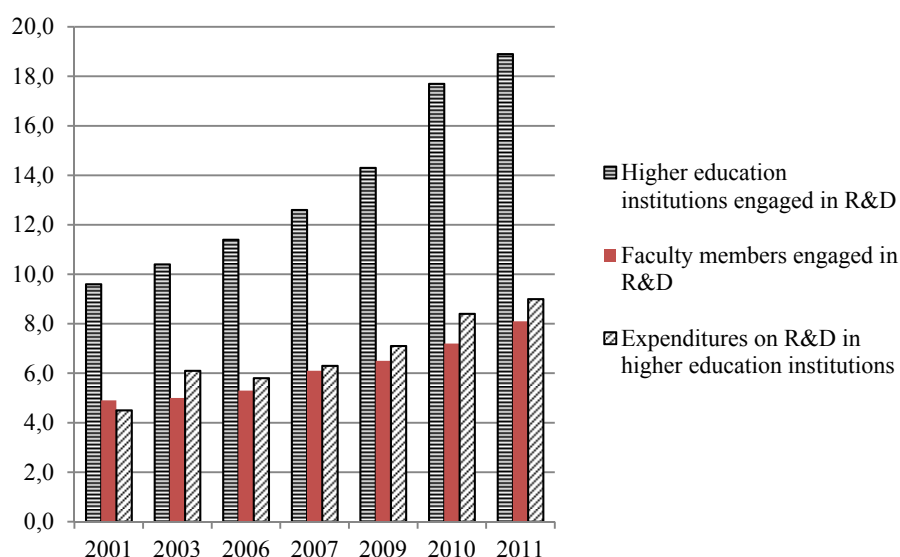
⁴ RF Government Resolution No. 1040 of October 12, 2012 "On introducing amendments to RF Government Resolution No. 218 of April 9, 2010" ("On measures of state support to the development of cooperation between Russian higher economic institutions and institutions carrying out comprehensive projects aimed at establishing hi-tech operations").

⁵ RF Government Resolution No. 531 of May 30, 2012 "On introducing amendments to RF Government Resolution No. 220 of April 9, 2010" ("On measures for inviting leading scientists to the Russian educational institutions of higher professional training").

activity of academic organizations was low. The projects for creating hi-tech operations will be implemented by 67 companies in cooperation with 53 Russian higher education institutions and only 3 state scientific institutions¹, and the share of institutions of state academies of sciences and scientific centers in the total number on applications for megagrants is only 20%².

5.4.4. State Support of Science in Higher Education Institutions

The financing of science in higher education institutions continued growing. While in 2001-2009 its share in the domestic expenditures on R&D was stable ranging from 5 to 7% (Fig. 11), by 2011 it reached 8.7%³ and the government plans to raise this indicator up to 15% by 2020. So, the government policies aimed at supporting higher education institutions that had been implemented for quite a long period of time (actually beginning from 2006 when the national project “Innovative curricula of higher education institutions” was launched) started to bring statistically measurable results. But the increase of funding does not automatically imply higher quality of research as evidenced by the current state of affairs.



Sources: *Nauka Rossii v tsyfrakh: 2008. Stat. sbornik*. [Russia’s science in figures: 2008. Statistical book]. – Moscow: CSRS (Centre for science research and statistics), 2008, pp. 16, 51, 89; *Nauka, tekhnologii i innovatsii Rossii: 2011. Kratkiy statisticheskiy sbornik*. [Science, technology and innovation in Russia: 2011. Brief data book]. Moscow, IPAN RAN [Institute for the Study of Science of RAS (ISS RAS)], 2011, pp. 10, 14, 30, 46.

Fig. 11. Higher Education Institutions as a Part of Russia’s Scientific Complex: Basic Indicators as % of the Country’s Total

In federal and national research universities (NRUs) which enjoy the most lavish financing (including funds for R&D) the progress has been very slow. The monitoring of scientific potential of the leading Russian higher education institutions carried out by the National

¹ <http://p218.ru/catalog.aspx?CatalogId=1228>

² <http://минобрнауки.рф/новости/3043> [News of the RF Ministry of Education and Science].

³ *Nauka, tekhnologii i innovatsii Rossii: 2012. Kratkiy statisticheskiy sbornik*. [Science, technology and innovation in Russia: 2012. Brief data book]. Moscow, IPAN RAN [Institute for the Study of Science of RAS (ISS RAS)], 2012, pp. 29, 44.

foundation for personnel training¹ revealed that although the publication activity of NRUs and federal universities was growing, the higher education institutions lagged far behind academic organizations by such parameters as the number of publications per one researcher and the Hirsch index². It is no coincidence that the number of published articles is the biggest in the Novosibirsk State University³ where 70% of faculty members are dual jobholders working simultaneously in the Academy of Sciences. If one compares the performance of NRUs and federal universities with that of leading foreign universities, their indicators are utterly incommensurable even regardless of the institutions' size. For instance, in a relatively small MIT the number of publications is 1.5-fold bigger than in the whole Moscow State University (MSU) named after M.V.Lomonosov. By the number of selected most highly cited publications the gap between MSU and MIT is even greater – already 12-fold⁴.

It should, however, be noted that the gathering and comparison of quantitative data do not allow to identify development problems of a particular university. For instance, the percentage of faculty members with scientific degrees (i.e. formally having high scientific qualification) in all federal universities is approximately the same, but their scientific output measured by the number of articles and their citing rate differs greatly. Moreover, this output does not correlate neither with the level of qualification nor with the amount of R&D funding⁵.

Finally, a paradoxical situation is being observed – despite the surge of budget financing Russian universities are sliding down in international ratings (Shanghai ranking, QS) mostly due to poor scientific results. The rating of Times HE published in October was a sort of exception: according to it MSU somewhat improved its positions but failed to enter the list of the Top-200 universities; meanwhile the Moscow Engineering and Physics Institute (MEPhI) unexpectedly appeared among universities ranking from 226 to 250. First it was reckoned to be a methodological mistake since the expert estimate of R&D level in MEPhI was low but then it emerged that the university had climbed to such a high position owing to one article

¹ Arzhanova I. *Dinamika razvitiya nauchnogo potentsiala vedushchikh vuzov*. [Scientific potential of the leading higher education institutions: dynamics of development]. Presentation at the VI Baltic educational forum. Kaliningrad, 20.10.2012. <http://balticeducationforum.ru/presentation/02.pdf>

² The Hirsch index (h-index) is a scientometrical indicator suggested in 2005 by the US physicist Jorge E. Hirsch from UCSD, California. The index was designed to improve upon simpler measures of a scientist's productivity such as the total number of citations or publications. The h-index is a quantitative parameter of productivity of a particular scientist based on the set of his most cited papers and the number of citations that they have received in other publications. Like other bibliometric characteristics, the h-index is not strictly correlated with the researcher's profile and performance, because of a string of parameters that bias its value, e.g. the time that has passed since the moment the article was published (this is why young authors cannot enjoy a very high h-index).

³ According to data of the Web of Science, over the 10 recent years (2001–2011) the leader among NRUs was the Novosibirsk State University with 4253 articles, then followed the Saint-Petersburg Polytechnical University (4101 articles) and the Nizhny Novgorod State University (2870 articles). Source: M. Murav'yova. *Vedushchie vuzy: den'gi, nauka, stat'i*. [Leading higher education institutions: money, science, articles]. 24.10.2012. http://strf.ru/material.aspx?d_no=49734&CatalogId=221&print=1

⁴ Within 2001–2011 MIT issued 2147 most highly cited publications while MSU – only 181. Source: Essential Science Indicators, Arzhanova I. *Dinamika razvitiya nauchnogo potentsiala vedushchikh vuzov*. [Scientific potential of the leading higher education institutions: dynamics of development]. Presentation at the VI Baltic educational forum. Kaliningrad, 20.10.2012. <http://balticeducationforum.ru/presentation/02.pdf>

⁵ Calculated using data of appraisal of federal universities. Source: M. Murav'yova. *Kakoy vuz federal'nee?* [Which higher education institution is more federal?] 27.09.2012. http://www.strf.ru/material.aspx?CatalogId=221&d_no=49157

with very high index of citation – the elementary particles handbook written by a large team of international authors which included one collaborator from MEPH¹.

This is a spectacular example evidencing untrustworthiness of such a parameter as international university ranking. Ratings are interesting and useful but cannot be a goal in itself. Meantime, the past year showed that they had become such a goal and, moreover, - one of the strategic targets of state policies in the sphere of education and science. At the extended meeting of the State Council in April 2012 President Dmitry Medvedev expressed an opinion that no less than five Russian universities should join the ranks of the Top-100 universities according to the major world ratings. Later this opinion has become a guideline for action for the fresh leadership of the RF Ministry of Education and Science which plans to select 10-15 universities that will get sizable budget subsidies for attaining the level of international standards and joining the Top-100 list of some international rating. In 2013 Rb 9bn are reserved for these purposes, in 2014-2015 – already Rb 21bn and Rb 24bn, respectively² although so far funds have been provided only for 2013. Nevertheless, the Ministry of Education and Science has prepared a draft Resolution “On measures of state support to the leading universities with a view to improve their competitiveness among the top research and educational centers of the world”³ that suggests granting competition-based subsidies to universities with the primary objective to encourage their penetration to the international educational space, to enhance mobility and improve postgraduate and doctorate training. The higher education institutions selected on the basis of competition will be obliged to work out roadmaps the implementation of which will be assessed annually by a specially set Board.

Such a decision is not beyond question not only from the point of view of benefits and costs but also because of the actual draining of budgets of other universities and research institutions. The world practice shows that there should be 4-5 strong universities per each world-class university which implies that the support to higher education institutions should not be so narrowly channeled. Besides, it’s difficult to fulfill the set task in principle since in order to transform Russian universities into internationally recognized ones too much is to be changed in the system of their management. So far, the number of foreign students in Russian higher education institutions is falling and is even smaller than it used to be in the times of the “shut-in” Soviet Union. At present more than 39% of them come from the CIS countries, 35% - from the Asian countries⁴. The main causes thereof are that the language of teaching is Russian and there are very few faculty members who can teach in English thus narrowing the range of potential students. The number of foreign professors is insufficient as well and despite the introduction of status of highly-skilled professional which facilitates recruitment of foreign professors and scientists, the contract system has not been duly revised. The terms offered in Russian contracts are unacceptable for many foreign researchers which seriously limits their inflow to Russia. In fact, the easiest way by now is to invite pensioners from abroad but it has its limitations.

¹ Rostovtsev A. *Reitingi nuzhno ponimat'* [Ratings should be understood]. // *Troitsky variant* [Troitsk version], No. 115, 23.10.2012, p.6.

² Panov P. *Vuzam razdadut 55 mlrd. rub. dlya vkhozheniya v mirovuyu elitu*. [Rb 55bn will be allocated to higher education institutions to facilitate their entering the world elite] 06.12.2012. <http://izvestia.ru/news/540974>

³ <http://минобрнауки.рф/документы/3045> [Documents of the RF Ministry of Education and Science].

⁴ S.Belyaeva. *Smotrite, kto edet. Kak privlech v Rossiyu luchshikh studentov?* [Look who is coming. How to attract the best students to Russia?] // *Poisk* [Search], No. 50, 14.12.2012, p.22.

In addition to allocating funds to universities as a whole, the government supported their research at the level of particular departments, including the creation of scientific laboratories under the direction of leading world scientists (the so-called *megagrants*) and the financing of projects carried out by scientific-educational centers (SECs).

The creation of scientific-educational centers started back in the mid-90's and in some cases it implied attempts to support or revive cooperation between higher education and scientific institutions that existed in the USSR in the form of basic chairs. SECs got occasional support through different programs and measures but systematic funding of their projects began only in 2009 in the framework of the federal target program (FTP) "Scientific and scientific-educational cadres of the innovative Russia" for 2009-2013 (hereinafter – FTP "Cadres").

The financing of SECs' operation is rather modest. The maximum amount of funds that their projects were eligible for was Rb 15m for three years but taking into account the legislation on state purchases (where one of the basic criteria for selection on a competitive basis was the price of a project), the actual budgeting of selected SECs' projects was far smaller – less than Rb 10m for three years. One should note the specifics of financing SECs – the support is provided to R&D projects carried out by the SECs' staff.

No model was set for the creation and functioning of scientific-educational institutions except for the need to comply with some simple requirements (for SECs) such as the necessary number of students, postgraduates and young scientists that should participate in their work, and some other. As a result most Centers at the moment are ad-hoc teams gathered for carrying out a particular project. There are very few established and sustainably operating centers included in the international scientific cooperation.

A promising development pattern could be the creation of joint SECs on the basis of cooperation between scientific and higher education institutions with the involvement of scientists demonstrating high performance in research and teaching in Russia and abroad. This will give an impetus to progress in two directions – (1) stronger ties between scientific and higher education institutions (2) closer integration of education and research inside higher education institutions.

Last year first estimates of the performance under megagrants – the projects for creating laboratories directed by leading scientists¹ - were made. By then the laboratories had been working for 1-2 years but the Resolution in compliance with which they had been formed did not define the terms for their further operation thus creating an atmosphere of uncertainty. In May 2012 the situation cleared up after the RF Government Resolution specified the terms for extending megagrants and announced the requirements of a new competition for the creation of laboratories². It became known that the current grants could be extended for two years on condition that in the second year the laboratory was able to raise extra-budgetary funds to the amount not less than the amount of grant in the first year of extension. It has greatly improved the position of laboratories inside higher education institutions since in the overwhelming majority of cases the required extra-budgetary funds can be provided by universities after a re-distribution of their resources. On the one hand, a laboratory that used to be a sizable

¹ For more details about megagrants see: *Rossiyskaya ekonomika v 2011 godu. Tendentsii i perspektivy. Vypusk 33*. [Russian Economy in 2011: Trends and Outlooks. Issue 33]. – Moscow, Gaidar Institute Publishers, 2012, pp. 385-388.

² "On introducing amendments to RF Government Resolution No. 220 of April 9, 2010". RF Government Resolution No. 531 of May 30, 2012.

source of funds, becomes more dependent on the administration of university where it was created. On the other hand, such a rigorous approach has its merits since university administrations will support only those laboratories that have proved to be really efficient.

But for many invited heads of laboratories the co-financing requirement turned out to be not only unachievable but also unacceptable since, first, not enough time had passed for the laboratories to be able to earn extra-budgetary funds and, second, when taking the decision to come, the scientists did not expect that they would have to be not only researchers but also “efficient managers”¹. If one examines the text of Government Resolution No. 220 in compliance with which the laboratories were created, it’s really difficult to find there any counterarguments to complaints of laboratory heads since the objectives of this effort are formulated very vaguely. According to the document grants are extended “with the aim to enhance state support to the development of science and innovation in tertiary institutions and to improve the quality of higher education”. Now, when the new requirements to laboratories have been specified the objective becomes more clear – the getting of practical output from science and the encouragement of inflow of extra-budgetary (better said - private) funds to science. The assessment of performance of the first 40 laboratories that were set up in 2010 showed that all the higher education institutions concerned were ready to provide co-financing for the continuation of their operation; however, only 24 laboratories will get budget support².

The terms for the to-be-created laboratories (that will be chosen in April 2013 summarizing the results of the contest announced at the beginning of December)³, have somewhat changed as well. They will be set up on account of more modest but still quite sizable budget funds – Rb 90m per three years. But now the applicants for megagrants will have to prove their ability to secure 25% extra-budget co-financing at the very start. Accordingly, projects of applied research have better chances to get support. 719 applications have been submitted to the contest⁴, of which 47% – by foreign researchers. This implies a noticeable boost of foreign participation as compared with the first contest held in 2010 (*Table 9*).

To some extent this result is logical: the program was most heavily criticized by grant receivers from among Russian-speaking scientific diaspora while foreign researchers who had got grants, estimated it positively.

¹ “The point is that we were invited to Russia not as efficient managers that would lift science to such a level where it would start bringing money. We were invited to change the image of Russian science, to raise its weight in the eyes of the world community, to integrate it in the global scientific process”, - Alexey Vinogradov, head of the laboratory for physics of strength and intellectual diagnostic systems created under megagrant in the Tol’yatti State University. *Source*: Murav’yova M. *Vedushchie uchyonye s protyanutoy rukoy*. [Leading scientists with hat in hand]. 11.10.2012. http://www.strf.ru/material.aspx?CatalogId=221&d_no=49480

² Murav’yova M. *Minobrnauki prodlit 24 proekta pervoy volny megagrantov*. [The Ministry of Education and Science will extend 24 projects of the first wave of megagrants]. http://www.strf.ru/material.aspx?CatalogId=221&d_no=51017 24.12.2012.

³ Announcement of the holding of an open contest for receiving grants of the RF Government for state support of scientific research carried out under the direction of leading scientists in Russian educational institutions of higher professional training, research institutions of the state academies of sciences and state scientific centers of the Russian Federation. 3.12.2012. <http://минобрнауки.рф/новости/2885> [News of the RF Ministry of Education and Science].

⁴ <http://минобрнауки.рф/новости/3043> [News of the RF Ministry of Education and Science].

Table 9

**Distribution of Applications for Megagrants Depending on the Residence /
Origin of the Project Head, 2010 and 2012**

Residence / country of origin of the project head	2010, number of applications as % of the total (N=507)	2012, number of applications as % of the total (N=719)
Russian researcher	43%	29%
Foreign researcher	35%	47%
Foreign researcher – representative of the Russian-speaking diaspora	22%	24%

Source: *Rossiyskaya ekonomika v 2010 godu. Tendentsii i perspektivy. Vypusk 32*. [Russian Economy in 2010: Trends and Outlooks. Issue 32]. – Moscow, Gaidar Institute Publishers, 2011, p. 379; 2012 – calculated using data of the RF Ministry of Education and Science. <http://минобрнауки.рф/новости/3043> [News of the RF Ministry of Education and Science].

5.4.5. Research Cadres as the Core Element of Institutional Reforms

The reshuffled Ministry of Education and Science of the Russian Federation quite promptly embarked on efforts that taken together evidence the launching of works on the elaboration of institutional reforms in the sphere of science. One of the first tasks that was formulated and brought up for public discussion was the charting of a “Map of Russian Science”. It turned out that throughout almost 20 years of post-Soviet development the administering body had not known what object it actually administered despite all the contests held, measures taken and sizable investments made in the informational and analytical provision of the Ministry’s operation. The Map of Russian Science should elucidate the situation and show in what institutions and regions the work of research teams and individual researchers is either efficient or non-efficient. The task is difficult and ambitious since the Russian scientific complex remains very large by the number of personnel, and the mobility of researchers is growing with many of them combining work in scientific and higher education institutions. Thus it’s not easy to clearly identify efficient teams and so much the more to assign them to a particular institution which is a technically sophisticated task as it is. The idea is to create a nation-wide informational and analytical system which will allow to “see vigorous, competitive scientists”¹. Then it will be maintained and updated on a regular basis. Such a “map” will be created by means of aggregating quantitative data (such as publication activity, received grants, patents, participation in R&D under contracts); however, it’s commonly known that even taken together the latter fail to reflect the true state of affairs and provide just an approximate assessment of situation. The set of indicators is still being formed, *inter alia* taking into account suggestions of the scientific community and will differ by fields of research (humanitarian sciences cannot be estimated in the same way as the natural ones). One plans to finish this work quite soon – already by March-April 2013 the site is to be ready containing the so called “dashboards” for the scientists included “into the Map” where they will be able to see the data relating to them, to adjust and complement it. It’s worth noting that in order to prevent the ignoring of this work by researchers, one plans to apply to them the policies of “soft compulsion”² implying that if a scientist wants to get a

¹ Murav’yova M. *Na karte otmetyat liderov*. [Leaders will be mapped]. Interview with the RF Deputy Minister of Education and Science I. Fedyukin. 14.12.2012. http://www.strf.ru/material.aspx?CatalogId=221&d_no=50789

² *Minobrnauki rasskazalo o kontseptsii Karty rossiyskoy nauki*. [The Ministry of Education and Science came out with the concept of Map of Russian science]. 13.12.2012. http://www.polit.ru/news/2012/12/13/map_of_science/

grant or any other scientific or organizational support from the state, it will be essential for him to have a full and precise record of his scientific performance in the new data base.

Three questions arise in connection with this initiative: 1) what for such an effort-consuming work is to be done, 2) is it possible to make an adequate estimate of the research teams' and collectives' expertise in a formalized way and, 3) whether the following managerial decisions based on this formalization are likely to do any harm to science as such? There are grounds for the latter concern as it was in 2012 that precedents with formalized estimate of the performance of both higher education and academic institutions took place demonstrating the inconsistency of a unified approach. It's not that difficult to identify and settle the arising discrepancies at the level of institutions. However, when they occur and later accumulate at the level of laboratories and individual scientists, the potential damage can be much greater.

But the purpose of creating the Map of Science remains the priority issue. According to the official standpoint it is needed in order:

1) to alleviate the bureaucratic burden in science – one won't have to duplicate the data already included in the Map when filing applications for contracts and grants¹;

2) to carry out monitoring measures, e.g. the certification of dissertation boards after the review of their status based on the expertise of board members;

3) to ascertain which teams are competitive at the world level and which fields of research are lagging behind; then taking into account the obtained information to reward the leaders in the form of “priority support by state, scientific foundations and sponsors”².

The latter intention causes the greatest concern as it is a common practice to determine leaders by holding various kinds of contests. It definitely requires a developed system of expertise that should be maximally objective and whenever possible international. At the same time, a question arises what will be done with the revealed low-performance teams, especially in case the latter belong to institutions that are not subordinate to the Ministry of Education and Science.

In general, if the Map helps to make at least some progress in solving the task of de-bureaucratization of state administration of science, the price paid for its working out – and it's not limited to Rb 90m that the consulting company PricewaterhouseCoopers Russia B.V. has got for the project management and visualization of the Map – can be deemed justified.

Alongside with discussion of the project for charting the Map of Russian Science, two more measures have been examined aimed not only at the improvement of situation in science but also at its gradual institutional restructuring. The first of them is the establishment of postdocs positions after the Western pattern, the second – the step-by-step creation of one thousand new laboratories within 2014-2020 that will work in compliance with standards accepted in developed countries of the world.

The “postdoc grant” involves a three-year sponsorship of young researchers who have recently passed Ph.D. defense. This is the time when they can obtain experience sufficient for further heading and management of projects. It is expected that similar to the Western

¹ Murav'yova M. *Na karte otmetyat liderov*. [Leaders will be mapped]. Interview with the RF Deputy Minister of Education and Science I. Fedyukin. 14.12.2012. http://www.strf.ru/material.aspx?CatalogId=221&d_no=50789

² *Uchyot uchyonykh* [Registering of scientists] // *Vedomosti*, 14.12.2012, p.1. http://www.vedomosti.ru/newspaper/article/363581/uchet_uchenyh

countries' case the postdoc grant will encourage academic mobility¹ – i.e. a postdoc will work not in the same institution where he wrote his thesis. This is a long overdue and useful measure. In the short run it solves the problem of young researchers' employment in the scientific sphere. In the long run it may allow to eliminate permanent positions of junior research fellows thus facilitating advancement of the new system of research organization.

At the same time the new measures will succeed only in case the terms of budgeting change. The effect from shifting to the grant and postdoc system will be less sizable if funds continue to be allocated with serious delays. The past year was indicative from this point of view – the grant funds that were usually transferred to researchers only in summer, that time were received by institutions and scientists even later. Some contests for young researchers were scheduled for summer since then the funding of scientific foundations was to be increased; but only in November one started to pay grants² that could not be postponed till the next calendar year. This means that the work, if any, was actually done without remuneration which is possible in some fields of humanitarian and social research (where personnel just has to wait long for the salaries to be paid) but is non-admittable in natural and technical sciences where one has to buy equipment, aids and appliances for experiments. It prompts the outflow of young scientists overseas despite all the programs, measures and grants that if summed up enable them to raise even larger funds for financing research than their senior colleagues can do.

In this financial situation being far from rosy one more promising initiative may be launched – the creation of 1,000 scientific laboratories working in compliance with the Western standards of research process organization³.

“The project for creating 1,000 laboratories” was initiated jointly by the RF Ministry of Education and Science and the SkolTech – the Skolkovo Institute of Science and Technology, the project name being suggested by the Institute. Indeed, if the state is building a new university designed to train world-class specialists, there should be new competitive workplaces available for graduates⁴. Otherwise, the outflow of young cadres will only intensify. SkolTech examined the world experience and attempted to adjust it to the Russian environment. As a result a draft program was prepared specifying potential parameters of such laboratories' operation⁵. It has turned out that the number of aspects requiring discretionary decisions is much bigger than it initially seemed. There are actually no “absolutely explicit” parameters, with international experience offering a whole palette of possible solutions to the same question.

The purpose of creating new laboratories is to make work there attractive for the leading scientists and to involve (retain) researchers who are competitive in the world science. They should facilitate the shaping of the new organizational structure of Russian science that will

¹ Igor' Fedyukin: “*Postdocovskiy grant dolzhen dlit'sya do tryokh let*” [“The postdoc grant should last up to three years”]. 27.08.2012. http://www.strf.ru/material.aspx?CatalogId=16080&d_no=48457

² Volchkova N. *Po edinomu biletu. RFFI otkryl molodyozhi dorogu v bolchuyu nauku*. [By travel card. The Russian Foundation for Basic Research opened the gateway to Big Science for young people] // *Poisk* [Search], No. 48, 30.11.2012, p.9; Turkov V. *Stimulom po karmanu*. [The stimulus that hits in the pocket] // *Poisk* [Search], No. 50, 14.12.2012, p.18.

³ Shatalova N. *Doschitat' do tysyachi* [Count up to one thousand] // *Poisk* [Search], No. 49, 7.12.2012, p.10.

⁴ *Nachinaetsya s lyudey* [It starts from people] // *Poisk* [Search], No. 29-30, 27.07.2012, p.12.

⁵ Next follow the suggestions of SkolTech worked out by the author in cooperation with Vice-President of SkolTech A.Ponomaryov that take into account the results of consultations with representatives of Russian-speaking scientific diaspora and some leading Russian scientists held in autumn 2012.

ensure the emergence of “growth points”. So, the primary objective is to provide gradual institutional shifts in the Russian science leading to the replacement of old practices with the new ones. As different from megagrants headed mostly by representatives of Russian-speaking diaspora and foreign scientists, grants for the creation of 1,000 laboratories are intended primarily for domestic researchers living and working in Russia.

The specifics of this initiative are that the amount of support will be smaller than that enjoyed by laboratories set up under megagrants, but its term will be longer – 5 years. The contests for creating laboratories will be held by stages so that to choose up to 200 winners a year. In the first years of holding the contests the number of selected laboratories will be smaller than in the years to follow since the mechanism of evaluation needs to be elaborated.

The grant will be awarded to the scientist who undertakes to form a team and choose the institution where he wants to work. The application for creating a laboratory should contain substantiation of the choice of institution with which a preliminary agreement on housing the laboratory has been reached. The institution assumes some commitments to service the research process at the expense of overhead costs from the awarded grant, the size of which is also subject to discussion, namely: the renovation of premises for the laboratory (in compliance with the international standards), the access to R&D infrastructure (available equipment and facilities), the providing of administrative support. The whole system is supposed to be flexible and dynamic – for instance, one can change the housing institution in case there arise problems with administration. So, double incentive is envisaged for institutions to motivate them to house laboratories: the financial benefit and the prestige gain since only the presence of new type laboratories is the evidence of not only up-to-date research but also of its adequate management.

In its turn, the head of a laboratory should devote not less than 75% of his working time to its development, i.e. if the grant is awarded to a foreign scientist (which is allowable), he should be ready to spend much time in Russia in contrast to 2-4 months which is the case with current programs involving foreign participation. On behalf of the laboratory its head can take part in both Russian and foreign contests and grant programs. However, the principle of spending additionally raised funds should be the same as is customary abroad – i.e. not for paying bonuses to key laboratory employees (their wages are ensured by the laboratory’s base budget) but for the expansion of the laboratory, recruitment of postdocs and postgraduates, purchase of aids and appliances, participation in conferences and internships. Accordingly, the staff of laboratories will change depending on the purport and scale of research tasks which is the habitual practice for countries with advanced science. The permanent staff of a laboratory should include its head and 2-3 researchers while other experts should be hired for carrying out specific projects. The positions of laboratory assistants should also be permanent – skilled technicians are carriers of methodological and technological knowledge and can teach laboratory methods to new employees and postgraduates.

It’s important for the laboratory head to be engaged not only in scientific work but also in teaching and tutoring of postgraduates since only in this case new competitive researchers will be trained that later will be able to create their own laboratories of the new type.

Grant applicants should meet a certain set of requirements that is still being worked out. Among them is the scientific degree, number, quality and citation of publications, experience in managing projects and contracts, organization and holding of scientific conferences.

A critical issue is the procedure and criteria of selecting applications. The former experience shows that failures not infrequently occur at this particular stage of project

examination even in case international experts are involved. Therefore, an important issue is not only who makes the examination but also how it is organized and who takes the final decision. One of the suggestions is to use the practice of the US grant agencies when after an anonymous expertise is carried out and applications are selected at the sections of expert panels, the final decision is taken by officials of the department that initiated the contest. It somewhat reduces the scale of lobbying and levels down the conflict of interests which always emerges in case the final decision is taken by some “supreme council”.

After laboratories start to operate, it's important to work out the procedure of their monitoring. The method of assessing results, both interim (annual) and ultimate (5-year total), is disputable but foreign experience evidences that the gathering of formal indicators should be coupled with the expert estimate of works. The results of assessment should be made public and lead to the following possible actions:

- 1) extension of the laboratory's operation;
- 2) replacement of the laboratory's head;
- 3) change of the housing institution;
- 4) pre-schedule closure of the project (discontinuation of its financing).

It should be noted that the mechanism of forming 1,000 laboratories that is being carefully elaborated at the moment faces a lot of challenges including those associated with factors that cannot be foreseen or predicted in advance. For instance, among them is the pattern by which the collaboration between new laboratories and older structures of the housing institutions will develop; how soon will the system of postdoc grants be introduced enabling to recruit young researchers into the laboratories' staff; how and whether at all the system of grant foundations will be expanded. There are some optimistic outlooks in this regard – according to the list of assignments given by the President in November following the meeting of the Presidential Council on science and education, the system of state and non-state foundations financing not only medium-term (3-5 years) but also long-term (10 years) research will develop¹.

5.4.6. Foreign Scientific Foundations and International Scientific Cooperation in the Context of Changes in Legislation

Along with favourable financial and organizational conditions, there should be propitious atmosphere for the development of international collaboration, the inflow of foreign researchers to the country and the expansion of scientific cooperation. However, the changes that took place in 2012 are rather a hindrance to such development.

Amendments and supplements to legislation have been adopted that concern both the work of non-commercial organizations sponsored from abroad and the issues of divulgence of state secrets, espionage and high treason. The changes do not affect the sphere of science and innovation directly but there is surely an indirect impact including the closure of and suspicious attitude towards foreign institutions that among other programs are sponsoring scientific and educational projects.

¹ *Utverzhdyon perechen' porucheniy po itogam zasedaniya Soveta po nauke i obrazovaniyu.* [The list of assignments following the meeting of the Council on science and education has been adopted]. 16.11.2012. <http://www.kremlin.ru/assignments/16840>

In July amendments were introduced to legislation regulating the work of non-commercial institutions receiving funds from foreign sources¹ – they acquired the status of organizations “performing the functions of a foreign agent”. The Law stipulates that this provision pertains only to organizations engaged in political activities, the latter not including “activities in the sphere of science, culture, art, public health service, disease prevention and health care, public social support and security, maternity and child welfare service, social support to invalids, promotion of healthy lifestyle, physical culture and sports, wildlife protection, welfare work as well as activities contributing to charity and volunteering”. It’s indicative that education is not mentioned in the exhaustive list and thus educational non-commercial organizations can be regarded as foreign agents.

The Law envisages frequent and detailed reporting for such organizations encompassing both their activities and sources of financing. Besides, in case they publish some materials, the latter should contain a notice reading that they have been prepared and disseminated by a non-commercial organization performing the functions of a foreign agent.

As cited above, the sphere of science was not considered to be politically-driven; however, there appeared concerns, *inter alios* felt by institutions receiving funds for their research from foreign organizations and foundations. They turned out to be not groundless since in September the Government took the decision to close the Russian office of US Agency for International Development² which among other projects supported some scientific and educational programs. The Agency was accused of attempts to influence political processes (including elections at different levels) and civil society via distribution of grants. Accordingly, Russia renounced its status of recipient of such aid. In November a scandal burst out around the US Russia Foundation for Economic Advancement and the Rule of Law (USRF) that was unexpectedly called the successor of closed USAID³. As different from USAID, USRF is more widely known in the scientific and educational community as it implements the pilot program “EURECA” – “Enhancing University Research and Entrepreneurial Capacity”⁴ coordinated with the RF Ministry of Education and Science. The pilot stage of the program was held in 2010-2012 and was targeted at creating a model for technology commercialization in two Russian research universities in cooperation with three US universities; later on the model could be extended to other universities. The final results were presented to the public including representatives of the RF Ministry of Education and Science and the RF Ministry of Economic Development. The Foundation explained that among its recipients there were no organizations that could be considered to be foreign agents, all the activity was transparent and information about recipients of grants was publicly

¹ Federal Law No. 121-FZ of 20.07.2012 “On introducing amendments to selected legislative acts of the Russian Federation pertaining to regulation of activities of non-commercial organizations performing the functions of a foreign agent”.

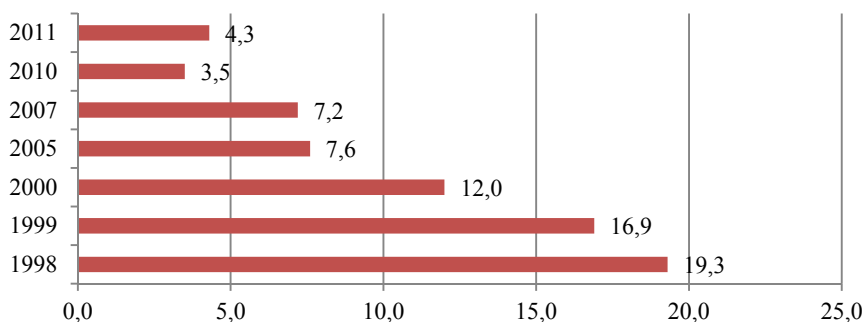
² See, for instance: *MID: predstavitel'stvo USAID dolzhno byt' zakryto v svyazi s popytkami vliyat' na vnutrenniye protsessy v Rossii*. [The Ministry of Foreign Affairs: the office of USAID should be closed due to the attempts to influence internal processes in Russia]. 19.09.2012; http://www.dp.ru/a/2012/09/19/MID_potreboval_u_SSHA_zakr/; *USAID pokidaet Rossiyu*. [USAID is leaving Russia]. 18.09.2012. <http://www.interfax.ru/politics/txt.asp?id=266330>

³ *USRF ne sobiraetsya zamenyat' USAID v Rossii*. [USRF is not going to succeed USAID in Russia]. The interview of Interfax with the President of USRF Mark Pomar. November 27, 2012. <http://www.interfax.ru/txt.asp?id=277881&sec=1483>

⁴ <http://www.eureca-usrf.org/>

available. But the atmosphere did not improve and scientific foundations having funds from the US Department of State in their budgets started to look suspicious.

Actually alongside with these developments (also in November) the law was adopted that introduced amendments to the articles of the RF Criminal Code pertaining to high treason, espionage and divulgence of state secrets¹. It enacted a broader interpretation of the term “high treason”. Now it’s not only the divulgence of state secrets but also any assistance to a foreign country, international or foreign organization if it is regarded as endangering the country’s security. Even an official employment under contract with a foreign civil organization can be considered as an act of crime in case the investigation proves that the respective institution works against the Russian state. Finally, the list of persons liable to criminal proceeding for the divulgence of state secrets was supplemented to include not only the ones who got to know secret information in the course of work but also those who learned it in the process of studying or “in other cases”. The vagueness of interpretations and implicitness of some terms causes concern and may be considered even dangerous since if desired actually any scientific and innovative cooperation with foreign organizations can be regarded as espionage and holds a possibility to be interpreted as high treason. Especially endangered are the applied projects that can result in dual purpose R&D. It’s impossible to preclude such a possibility, e.g. in the process of expanding international scientific cooperation in the framework of SkolTech research centers. Some experts examining the development of Skolkovo i-city project already voice their concern. Actually the fears may be exaggerated but the changes that have taken place are sure to discourage the inflow of foreign investments in science and innovation. In 2011 the share of foreign financing of R&D was as low as 4.3% (Fig. 12) and its further decrease is most likely to occur unless financing by business falls at an even greater pace.



Source: *Nauka Rossii v tsyfrakh: 2004. Statistichesky sbornik*. [Russia’s science in figures: 2004. Statistical book]. – Moscow: CSRS (Centre for science research and statistics), 2004, p.75; *Nauka Rossii v tsyfrakh: 2005. Statistichesky sbornik*. [Russia’s science in figures: 2005. Statistical book]. – Moscow: CSRS (Centre for science research and statistics), 2005, p.75; *Nauka Rossii v tsyfrakh: 2008. Statistichesky sbornik*. [Russia’s science in figures: 2008. Statistical book]. – Moscow: CSRS (Centre for science research and statistics), 2008, p.87; *Nauka Rossii v tsyfrakh: 2011. Statistichesky sbornik*. [Russia’s science in figures: 2011. Statistical book]. – Moscow: CSRS (Centre for science research and statistics), 2011, p. 74; *Nauka, tekhnologii i innovatsii Rossii: 2012. Kratkiy statisticheskiy sbornik*. [Science, technology and innovation in Russia: 2012. Brief data book]. Moscow, IPRAN RAN [Institute for the Study of Science of RAS (ISS RAS)], 2012, p. 30.

Fig. 12. Foreign Sources of Financing R&D as % of the Aggregate Domestic Expenditures Thereon

¹ Federal Law of the Russian Federation No. 190-FZ of 12.11.2012 “On introducing amendments to the Criminal Code of the Russian Federation and Article 151 of the Criminal Procedure Code of the Russian Federation.

5.4.7. Support and Encouragement of Technological Innovation

In 2012 one continued to carry out measures for the support and encouragement of technological innovation, *inter alia* using the tools aimed at strengthening ties between science and business. The following measures should be emphasized:

1. Implementation of innovation development programs (IDPs) of state corporations and companies partially owned by state launched back in 2010 and now scheduled to undergo the assessment of interim results;
2. Continuation of technological platforms' operation and holding of competition to select innovative clusters;
3. Operation of development institutions such as the Foundation for assistance to small innovative enterprises (FASIE), Russian Venture Company (RVC), ROSNANO, Russian Fund for Technological Development and Skolkovo Foundation. In 2012 a peer review of these institutions' performance with participation of international experts was held but its final results have not been published yet.

Innovation Development Programs

In June the “Expert RA” rating agency presented the results of assessing innovation development programs of those companies that agreed to participate in the study¹. 16 out of 48 companies having IDPs submitted their data for the rating. The results of the assessment are far from the most optimistic: only 10 companies have development strategies, there are few breakthrough projects, the ties with external institutions are loose, i.e. the R&D outsourcing is not developed, marketing projects are often passed off as innovative. Meantime, from the financial point of view the situation looks favorable – by 2020 the 48 companies will have spent Rb 4.2 trillion on IDPs, of which Rb 3.7 trillion will be allocated by two companies – “Russian Railways” and “Gazprom” – and funded on the account of their planned investments. The least efficient IDPs are those implemented by public companies focusing on the execution of state orders. Indeed, their incentives to innovation are minimal.

Nevertheless, thanks to the “forcing” of companies to get engaged in innovation and in particular to cooperate with state research and higher education institutions, the latter can enjoy greater demand for R&D to be performed under contracts. It should be noted that the attempts made by many companies to develop contacts with sectoral research and educational institutions supervised by respective agencies turned out to be far from successful and induced them to broaden the field of search for R&D executors. In particular, a good solution was found by OJSC “Russian Railways” that held a contest in cooperation with the Russian Foundation for Basic Research (RFBR). Research topics suggested in the contest terms were formulated so that to correspond to the respective projects included in the program of “Russian Railways” innovation-based development. 38 applications won, the number of contestants per one project being 4.5 – above the average for RFBR. The financing is parity-based, i.e. “Russian Railways” and RFBR will on the average invest in a 2-year project about Rb 1m per annum each, the annual amount per project ranging from Rb 0.8m to Rb 3m². Representatives of the company say that even in case only one third of the financed projects

¹ Rating of innovation development programs of state corporations and companies partially owned by state. Analytical materials. Forum of Russian innovations. Expert-RA, Skolkovo Foundation. – Moscow, 27 June 2012. http://www.raexpert.ru/researches/pir_2012/pir_2012.pdf

² Volchkova N. *Magistral' za gorizont*. [Highway beyond the horizon]. // *Poisk* [Search] No. 23, 08.06.2012, p.9.

bring the desired result, their investments will be fully recovered. Actually, it's a non-expensive way to achieve the needed results by means of extensive mobilization of research and educational institutions of the country. This approach is quite promising and was also applied by other companies, in particular the ones that together with higher education institutions took part in efforts for establishing hi-tech operations¹.

Technological Platforms and Innovative Clusters

The development of ties between companies and research institutions is to be fostered by technological platforms (TPs) launched in 2011. In 2012 a contest was held for the forming of innovative clusters that are also based on networking. TPs and clusters as tools for promoting contacts are very pertinent for Russia. International comparisons show that these are the parameters of innovative system's integrity by which Russia lags behind to the greatest extent (*Table 10*). In particular, the country still experiences shortage of technological brokers² – companies-intermediaries between generators and buyers of innovative products.

Table 10

Indicators of Innovative System's Development (scoring from 1 to 7 as estimated by the Knowledge Economy Index, 2010 data)

Indicator / Country	US	Great Britain	Germany	France	Japan	China	Russia
Private sector spending on R&D	5.4	4.6	5.7	4.7	5.9	4.1	3.2
University-company research collaboration	5.8	5.6	5.2	4.0	4.9	4.6	3.7
Intellectual property protection	5.1	5.3	5.7	5.9	5.2	4.0	3.0
Availability of venture capital	3.8	3.0	2.8	3.2	2.8	3.3	2.3
Value chain presence	5.1	5.5	6.3	5.7	6.3	4.0	2.6

Source: http://info.worldbank.org/etools/kam2/KAM_page3.asp

Technological platforms and clusters are potentially able to enhance the integrity of innovative system but for the time being they still remain disconnected tools without a specified standing towards each other.

In 2012 the platforms' progress slowed down as no funds were allocated for their start-up efforts including the working out of roadmaps. While the issue was being discussed (at least throughout 2012), some platforms managed to find funds for the organization and launching of works; however, the problem of allotting budget funds to their organizational support remains pending. The RF Ministry of Finance gave its principal consent to the allocation of Rb 300m but to the selection and coordination of topics for research, development and technological works (R&D&T) to be later incorporated in the effective federal target programs on behalf of a platform rather than to the organizational works that had been completed at many platforms.

¹ In compliance with RF Government Resolution No. 218 of April 9, 2010 "On measures of state support to the development of cooperation between Russian higher education institutions and institutions carrying out integrated projects aimed at establishing hi-tech operations". For more details see: *Rossiyskaya ekonomika v 2011 godu. Tendentsii i perspektivy. Vypusk 33*. [Russian Economy in 2011: Trends and Outlooks. Issue 33]. – Moscow, Gaidar Institute Publishers, 2012, p. 396.

² Kaz'min D. *Sut' dela: Neponyatnyy rynek*. [The core of the matter: uncomprehended market]. // *Vedomosti*, 27.12.2012 http://www.vedomosti.ru/newspaper/article/371221/neponyatnyj_rynok

The experience of both the Ministry of Economic Development and the Ministry of Education and Science showed that platforms turned out to be rather weak at generating new R&D projects. In September 2012 both Ministries announced the invitation of proposals from technological platforms with the aim to specify guidelines for the federal target programs wherein these agencies acted as commissioners. The Ministry of Education and Science offered TPs to take part in the shaping of research agenda for 2013 under the federal target program “Research and development in the priority areas of Russia’s scientific and technological complex development for 2007-2013” so that to announce open contests for signing state R&D&T contracts by December 1. In its turn, the Ministry of Economic Development issued Circular No.18970-OF of September 7, 2012 “On submitting proposals as regards the linking of state programs with technological platforms / RF President Decree No. 596 of May 7, 2012, Clause 2, Sub-clause “d”, Paragraph 2”. The documents submitted by technological platforms appeared to be of low quality, poorly elaborated and non-coordinated by time limits and results¹. That’s why the issue of getting funds from the Ministry of Finance for the development of platforms’ suggestions linkable to the federal target programs has remained pending.

It was only the Russian Fund for Technological Development that provided focused support to the platforms’ projects. But due to the budget constraints it selected 13 TPs out of 33, first of all establishing cooperation with those platforms that were not affiliated with financially powerful organizations (such as, for instance, ROSNANO supervising a number of platforms).

The in-depth case study of three technological platforms carried out by the author in autumn 2012 allowed to clear up the current state of affairs therein:

- the principal incentives for organizations to join platforms are first all the hope to get access to budget funds for R&D&T and the opportunity to lobby interests of particular groups (those of organizations-members rather than of platforms at large). But since the platforms haven’t got any sizable government support and paternalistic sentiments in associated organizations, especially in research and educational institutions that dominate in the platforms, are very strong, the development of TPs has got somewhat retarded;
- all the studied platforms were to a greater or lesser degree loaded with commissions and requests from agencies and participated in expert works despite the lack of budget funds for organizational procedures. Due to that a great burden was born by organizations-coordinators of the platforms;
- no criteria has been elaborated so far for the TPs’ performance self-assessment. Major emphasis is made on two parameters – the implementation of joint projects and the amount of invited external funds. These are the most obvious indicators as at the same time they represent the tasks for coping with which the platforms have been created.

The platforms are at the initial stages of their development and it’s too early to regard them as a consolidated tool and the more so – as a communication tool.

There is still no answer to the question whether technological platforms will continue to operate. Three basic sources of support to projects generated by TPs have been identified at the government level.

¹ S.Krymova. *Do vstrechi na platforme?* [See you at the platform?] // *Poisk* [Search] No. 41, 12.10.2012, p.10.

The first of them is the incorporation of projects suggested by TPs into the agenda of the federal target programs – the preparation for this process has already been launched by the request of Ministries to TPs to formulate the subject matters of lots.

The second one is the cooperation with large companies owned or co-owned by state that are implementing innovation development programs. This alliance can be mutually beneficial – on the one hand, TPs can identify topics that may become a part of such programs. On the other hand, state companies can participate in the working out of strategic research programs of relevant TPs. Both variants are possible and such partnership is quite logical: state corporations and companies co-owned by state act as coordinators of more than 1/3 of TPs.

The third source is budget subsidies for the elaboration of R&D agenda.

One more state initiative appeared to supplement TPs – the support of innovative clusters. The cluster policy is implemented in many countries of the world and involves the growing role of the state. At the same time clusters are considered to be a rather risky tool as cluster initiatives are time- and money-consuming and in case the choice of the object to be supported is wrong, the entailed losses will be significant. Besides, actually in all cluster initiatives state funds account for over a half of their budgets and in most cases the transfer of clusters to self-repayment is problematic. Therefore it's believed that on the whole it's more efficient to identify and support the already existing clusters than to create new ones. Nevertheless, the first approach has been chosen in Russia – that of supporting projects that claim to be cluster.

The selection of innovative clusters was held in two stages and in principle corresponded to the existing foreign practices. However, the term given for initial expertise was too short – only a month – affecting the quality of experts' work. Almost 100 applications had been submitted to the contest, of which 37 projects were selected. They were further examined for two months at the meetings of the Working group set up for choosing innovative clusters. Eventually 25 projects of developing territorial clusters were approved of which 14 were entitled to state subsidies.

In addition to short time-limits for preparing applications and assessment of projects, a few more parameters can be identified by which the Russian initiative of forming clusters seriously differs from its foreign analogues (first of all the European ones):

1. Goals of supporting clusters – in the Russian version the main idea is innovation-based development and consequently an active involvement of organizations engaged in R&D – higher education and academic institutions – in the work of clusters. The foreign experience demonstrates a whole palette of possible goals including the restructuring of hi-tech industries, raising of competitiveness in selected areas, etc., but in any case the list of goals and problems to be solved is more pin-pointed and clear-cut than that in the initiative for the development of Russian clusters;
2. Emphasis – in the Russian program it is made on solving the problems of large enterprises while small business is involved poorly and takes actually no part in managing clusters; meantime, in foreign clusters special attention is paid to small- and medium-sized entities;
3. Duration of the support – in foreign countries it lasts for 7–8 years while in Russia one can provisionally speak about a 5-year period of support; however, the first year has been actually wasted for choosing clusters and their support has actually failed to start despite the initial plans to make first allocations in 2012.

The process of selecting clusters revealed several patterns characterizing the current state of cluster projects¹:

- 1) in applications for creating innovative clusters one could distinguish the wish of as many as possible organizations to “sign up” for the cluster, sometimes disregarding industrial and regional aspects and the more so the fact of existence/non-existence of ties between major stakeholders;
- 2) the goals and tasks of some cluster projects actually reflected the interests of several large companies;
- 3) the level of participants’ interconnection was rather low – i.e. there were either no or very few joint projects in their cooperation record.

So, one can assert that applications for the contest were submitted not by clusters but in most cases by groups interested in the forming of a cluster (projects for forming clusters).

Those 14 clusters that are eligible for subsidies are focusing on investments in R&D; however, expenditures on infrastructure prevail in their outlay projections. The suggestions of 14 clusters regarding the structure of spending funds are presented in *Table 11*. The total amount of the requested subsidies is Rb 58.4bn.

Judging from the planned structure of expenditures under the subsidy, the most emergent task is the improvement of both innovation and transport infrastructures – over one half of the aggregate amount of subsidy is projected for these purposes (24.6% and 27.1% of the total funding, respectively). The following below items in the list of priorities are the support of R&D, the improvement of personnel skills and the development of engineering infrastructure. The least fund-demanding item is the upgrading of physical infrastructure of culture and sports.

Table 11

Suggestions of 14 Innovative Territorial Clusters as Regards the Channeling of Subsidy Funds in 2013-2017

Types of infrastructure	Requested by 14 clusters, as % of the total amount of subsidy
Innovation infrastructure	24.6
Transport infrastructure	21.7
R&D, training of personnel, innovative activities	18.5
Engineering infrastructure	13.7
Educational infrastructure	9.3
Housing infrastructure	7.0
Energy infrastructure	3.5
Physical infrastructure of culture and sports	1.7
Total	100%

Source: calculated using data of the Ministry of Economic Development, see “On the draft list of pilot programs for developing innovative territorial clusters”. Circular No. 13575-AK/D19ch of 05.07.2012.

One can state that measures for supporting technological platforms and clusters have got intertwined to some extent since the government suggests actually identical approaches thereto from the point of view of financing patterns. Similar to TPs, clusters should cooperate with development institutions and work with state companies implementing innovation development programs. The Ministry of Economic Development has recommended to start such interactions that are not dependent on the process of allocating budget funds. For the time being one can speak of creating mechanisms for the exchange of information in order to

¹ Based on observations of the author who took part in the expert assessment of applications for the creation of clusters.

estimate opportunities for cooperation¹. The need to address the same sources has potential for fostering synergy of TPs and clusters.

With the view to make their cooperation closer, one can initiate coordination of R&D&T agenda suggested by TPs with clusters. There is also a good reason to consider the issue of forming a common expert community, including the working out of a standard mechanism for using the expert potential of TPs and clusters.

Assessment of Development Institutions’ Performance

One of the tasks pursued by innovative policies is to secure complementarity of various tools that in particular can be achieved by the agency of development institutions. In 2012 such development institutions as RVC, ROSNANO, Skolkovo Foundation and the Foundation for assistance to small innovative enterprises (FASIE) were expanding and diversifying their activities but it’s not that easy to assess the productivity of development routes chosen by them. For instance, only Skolkovo Foundation submits detailed data on the achievement of key efficiency indicators while the performance indicators of other development institutions do not allow to form a clear view of their effectiveness.

Table 12 displays the monthly updated data on basic results of Skolkovo Foundation’s performance (see the respective site) reflecting its progress in achieving key efficiency indicators. The specific feature of Skolkovo is the focus on small- and medium-sized business and supporting it by means of various kinds of grants, both requiring and non-requiring co-financing. The composition of reported indicators evidences the concern of Skolkovo about the number of companies-members in clusters, the development of science-intensive products (reflected in such indicator as registration of intellectual property rights), the amount of invited co-financing. All these indicators grow at priority rates.

Table 12

Selected Results of Skolkovo Foundation’s Performance as of December 31, 2012

Key efficiency indicator	Target value	Actual value	Rate of achievement
Total number of members beginning from 2010	500	793	159%
Number of approved grant allocations in 2012	120	102	85%
Amount of approved grant allocations in 2012, million rubles	6300	3393.15	54%
Total amount of grants transferred by the Foundation in 2012, million rubles	4921	2935.5	60%
Average share of projects’ co-financing in 2012, %	40	43	107.5%
Number of submitted applications for registration of property rights in 2012	100	137	137%
Number of created centers for collective use of equipment (CCUE)	3	3	100%
Capacity utilization ratio of CCUE equipment put into operation	50%	30%	60%
Number of R&D centers to be housed under signed agreements	20	24	120%

Source: <http://community.sk.ru/press/b/results/archive/2013/01/28/rezultaty-raboty-za-dekabr-2012-goda.aspx>

There is a risk that the Foundation will plunge into grant-based financing which is a disputable measure for fostering innovative activities. The opponents of such approach find that grants “corrupt” business orienting it to the receipt of budget funds. These concerns are

¹ Online discussion “Territories of innovation - regional clusters”. http://www.strf.ru/material.aspx?CatalogId=223&d_no=49784 26.10.2012.

voiced not only in respect to Skolkovo Foundation but as regards any grant scheme for small business beginning from the Russia's Foundation for assistance to small innovative enterprises (FASIE) to the US SBIR (Small Business Innovative Research) – the program for supporting innovative research of small entities. The grant-based form of support is mostly justified for the startup stages of business development – the pre-seed and seed ones. But in case of Skolkovo Foundation there is a possibility of switching to grant support of “pure” R&D very loosely connected with innovations and carried out by individual researchers rather than research teams. In particular, there already exists a pilot program of grants for individual scientists that has been adopted by the Scientific Advisory Council¹.

Due to the fact that many experts viewed the construction of i-city Skolkovo as a political project, the shift of the country's leadership has prompted an opinion that the initiative will not survive for long². However, alarms are expressed even in respect of the Skolkovo's prototype – the American Silicon Valley which is predicted to die soon because of the proliferation of virtual networks and communities that will make the concentration of startup businesses and venture entrepreneurs in one physical spot unnecessary³. So, the growing number of investors and experts say that Internet is principally changing the pattern of innovative activities' organization and from this point of view the Skolkovo project was launched too late when the approach to cluster type of innovation development in the world started to transform.

Still, there are grounds to see some political context under the project since the times of prompt adoption of legislation to provide privileged conditions for Skolkovo Foundation are over. For instance, the President rejected the Federal Law “On introducing amendments to Federal Law “On Skolkovo Innovative Center”” adopted by the State Duma on November 23, 2012 and passed by the Federation Council on November 28, 2012. The Law was adjusting the rules of educational activities on the territory of the Center by envisaging the possibility to set up higher and postgraduate education institutions thereon. It was also suggested to postpone by a year (till January 1, 2015) the date of settling Skolkovo residents on the Center's territory due to the delays in construction of necessary premises. Several serious reasons for rejecting the Law were named including the absence of criteria for estimating the efficiency of performance in economic, scientific and social spheres and the illegitimate entitlement of the Skolkovo i-city's managing company with the right to adopt the town planning and design regulations⁴.

Although such criticism regarding efficiency indicators is quite justified, the same if not graver claims can be laid against other development institutions that at best list performance indicators in their annual reports (appearing in the middle of the next year) without providing

¹ So far only 12 such grants have been allocated and discussions are revolving around the expediency of continuing this initiative. See N.Shatalova, A.Shatalova. *Zhazhda skorosti*. [The thirst for speed]. // *Poisk* [Search] No. 50, 14.12.2012, p.12.

² An example of the typical viewpoint is the article of A.Vasil'ev. *Konets silikonovoy maliny*. [The end of silicon primrose path] // *Kommersant Den'gi* [Kommersant Money] No. 35, 03.09.2012. <http://kommersant.ru/doc/2013581?isSearch=True>

³ *Silikonovuyu Dolinu zhdyot krakh? Odin iz samykh populyarnykh segodnya IT-menedgerov v SSHA prorochit krakh Silikonovoy doline* [Collapse in store for the Silicon Valley? One the most popular for the day IT-managers in the US predicts the collapse of the Silicon Valley] // *Expert Online*, 23.08.2012. <http://expert.ru/2012/08/23/silikonovuyu-dolinu-zhdet-krah/>

⁴ *Prezident otklonil Federalny zakon o vnesenii izmeneniy v zakon ob innovatsionnom tsentre “Skolkovo”* [The President has rejected the Federal Law on introducing amendments to the Law on Skolkovo Innovative Center]. 12.12.2012. <http://www.kremlin.ru/news/17120>

either their numerical values or the rates of achieving target indicators. It is known that RVC sponsored 131 projects through the system of its foundations, and last year the growth of invited venture investments was higher than ever before¹. ROSNANO financed 107 projects with the total budget of Rb 488.1bn of which ROSNANO funds accounted for Rb 207.2bn². In the total 35 plants have been put into operation, the output has grown, but the target indicator – to raise the sales of products produced by companies in collaboration with ROSNANO up to Rb 300bn by 2015 – will hardly be achieved as by the end of 2012 the respective output was as low as Rb 23-24bn³. The Chairman of the Board A.Chubais has actually admitted that the key problem is the poor management of ROSNANO; some projects have been announced to close and the restructuring of the company to be launched. By spring-summer 2013 ROSNANO plans to complete its work as a development institution and to be transformed into an investment fund by selling 10% of shares to institutional investors. For this purpose throughout the year it was carrying out an audit of the supported projects. The company's staff was cut by 20%⁴ thus reducing the administrative costs down to 2.5% of the assets' volume. But by this indicator ROSNANO is still uncompetitive on the world market where the said costs in venture investment funds are as low as 1-1.5% of the total assets.

An important direction of ROSNANO's development was also the investment of funds in projects abroad, e.g. in the US biotech companies. At the end of October it announced the launching of a joint investment fund with Virgin Green Fund, Virgin Group (specializing on energy saving technologies) that was named VGF Emerging Market Growth I. L. P. The respective financial commitments amount to \$200m⁵.

A common trend for the development institutions was the diversification of activities, the growing attention to educational efforts and more active search for projects abroad. For instance, RVC was actively engaged in various educational projects including those to support startups as well as in popularization and promotion of innovative entrepreneurship. In particular, within three years it held about one hundred regional sessions of practical consulting that were free for their participants⁶.

Development institutions enhanced coordination of their work and jointly identified the key problems hindering innovative activities. The following challenges were named⁷:

¹ *Predvaritelnye itogi deyatelnosti RVK v 2012 godu*. [Preliminary results of RVC performance in 2012]. <http://www.rusventure.ru/ru/press-service/news/detail.php?ID=12084>

² *"Rosnano" ishchet pokupateley*. [ROSNANO is looking for buyers]. http://www.vedomosti.ru/newspaper/article/371141/rosnano_ishchet_pokupatelej 27.12.2012.

³ Chubais A. *Rosnano dolzhno nauchit'sya konkurirovat' na mirovom rynke kapitala, chtoby ne idti k gosudarstvu s protyanutoy rukoi*. [ROSNANO should learn to compete on the world capital market in order not to go to the government with hat in hand]. <http://www.finmarket.ru/z/nws/hotnews.asp?id=3207948> 30.01.2013.

⁴ Krasavina A. *Bol'she ne nano*. [No longer nano] // *Kompaniya* [Company] No. 3, 28.01.2013. <http://ko.ru/articles/24668>

⁵ *Virgin i ROSNANO ob'yavlyayut ob osnovanii sovместnogo investitsionnogo fonda*. [Virgin and ROSNANO announce the creation of a joint investment fund]. 31.10.2012. <http://www.rusnano.com/about/press-centre/news/20121031-virgin-rosnano-sovmestny-investitsionny-fond>

⁶ *Chto zhdyot startup v RVK: interv'yu s Igorem Agamirzyanom*. [What awaits a startup in RVC: interview with Igor Agamirzyan]. 28.08.2012. <http://www.nanonewsnet.ru/articles/2012/chto-zhdet-startapy-v-rvk-intervyu-s-igorem-agamirzyanom>

⁷ *A.Gorbatov. Chto meshaet innovatsionnomu liftu*. [What hinders the innovation lift]. 15.10.2012. http://www.strf.ru/material.aspx?CatalogId=223&d_no=49539; *Vse v odnov lifte* [All in one lift]. // *Poisk* [Search] No.42, 19.10.2012, p.12.

- low expertise of the ones who attempt to deal with innovations, poor understanding of specifics of innovative projects' implementation including the creation of startups;
- absence of “breakthrough” projects partially reflecting the weakness of scientific potential;
- shortage of funds allocated at the pre-seed and seed stages of project development and the resulting shortage of projects that could later proceed to the following development stages;
- wary attitude of private business to state initiatives, low demand for innovations, lack of belief in sustainability of state innovative policy measures. Indeed, there are all grounds for the latter concern as state policy is pinpointed at achieving quick results and remains case-specific in many aspects.

As to the supporting of pre-seed and seed stages, the major player continued to be the Foundation for assistance to small innovative enterprises (FASIE) with its relatively modest budget of Rb 4bn. A positive development is that the Foundation has got the right to award grants rather than finance small companies under the state order as was formerly the case – it generally reduces the bureaucratic burden on both the Foundation and small businesses¹. Finally, there is some continuity in support of the projects: about 30% of projects sponsored by the RVC's Fund for seed investments were earlier supported by FASIE. Besides, in November the RVC's Fund for seed investments announced the launching of a new program “Business-angel” envisaging co-investment of projects being at an early seed stage in which business-angels would invest their funds².

However, in 2012 the general trend for venture investments was the shifting of focus from the projects at seed stage to the ones at more mature stages. In particular, the number of seed transactions fell from 46 in 9 months 2011 down to 30 for the same period of 2012. At the same time the number of transactions involving projects at early growth and extension stages was up 2.5-fold – from 12 to 30³. But in general venture investments in hi-tech sector were growing at high rates lifting Russia to the fourth place in Europe by this indicator right after Great Britain, France and Germany⁴.

From the point of view of legal and regulatory framework, the conditions for venture business have not changed much. The introduction from January 1, 2012 of a new form of investment partnership similar to the international Limited partnership has so far produced no effect. The new form should have facilitated the creation of venture funds in Russia that used to be established predominantly as closed-end mutual investment funds subject to over-tightened regulation and difficult to manage. However, over the last year not a single company was instituted in the new form. At first experts saw the reason thereof in the lack of

¹ Podorvanyuk N. *Vazhno, chtoby nauka i biznes dogovarivalis' sami*. [It's important that science and business make arrangements on their own]. Interview with I.Bortnik, Chairman of the Supervisory Board of the Foundation for assistance to small innovative enterprises. 21.11.2012. http://m.gazeta.ru/science/2012/11/21_a_4861593.shtml

² Agamirzyan I. *V Rossii est' ogromny spros na innovatsii so storony naseleniya*. [There is great demand for innovations from population in Russia]. <http://www.rg.ru/2012/12/20/tehnologii.html> 20.12.2012.

³ *PwC i RVK: obzor venchurnykh sdelok za tri kvartala 2012 goda*. [PwC and RVC: review of venture transactions over 9 months 2012]. Press-service of PwC company. 29.11.2012. <http://www.crn.ru/news/detail.php?ID=73226>

⁴ Rooney B. U.K. Leads European Venture-Capital Funding, but Russia Is Fastest Growing. <http://blogs.wsj.com/tech-europe/2013/01/29/u-k-leads-european-venture-capital-funding-but-russia-is-fastest-growing/>

law application practice¹ but later poor elaboration of institutionalization regulations was declared to be the main hindrance². As a result companies still prefer to register abroad.

In 2012 an international review of Russian development institutions' performance was carried out. The co-executors of the study were the New Economic School and the international research team chaired by Professor of Harvard Business School, a reputed expert in the field of direct investments and venture financing Josh Lerner. The expert team was to prepare a package of recommendations for improving the performance of Russian development institutions by the end of the year. Presentation of the interim results of the study took place at the Moscow International Forum "Open innovations" on November 2, 2012. So far, the principal conclusions of the study are disappointing as they represent a set of rather general reasonings about the need to focus on the development of framework versus a mere distribution of funds, about the importance of coordination between venture investment agencies while understanding the difference of their missions and about the necessity of constant monitoring of results. It's noted that the carrying out of assessment is a difficult task since in Russia both the availability of information on venture capital and the transparency of regulations are worse than in other countries. So, the experts' attempt to involve and take into account global factors resulted in the shifting of accents towards the estimation of Russia's innovative system on the whole and thus largely in the replication of provisions of the Strategy of innovation-based development and some other Russian regulations of general nature. However, one should not rule out the possibility that in their finalized version the recommendations will be more case-specific.

* * *

Last year witnessed the shift of priorities from innovation to science and interconnection of the latter with education. The innovative rhetoric faded as well as the discussion of plans for economic modernization of the country. All through the past few years one has been saying that there are enough funds in the innovative sphere including those allocated from the budget via various development institutions but worthy projects are lacking, the former scientific potential has been exhausted, science experiences personnel crisis affecting the innovative potential of economy at large. It is possible that the 2012 shift towards support of science and the downscaling of priority given to state financing of innovations are due to the intention to resume the suspended reformation of scientific sphere.

The new government proceeded to the elaboration of measures of indirect institutional restructuring of science involving the creation of "parallel structures" – new laboratories complying with up-to-date standards of research work organization, new forms of staff support and motivation. Here lies the difference between the approaches being worked out and the attempts of reformation and restructuring made in the previous years: the influence on scientific sphere should be indirect rather than exerted through reorganization or closure /

¹ *Venchurny fond v Rossii: kakuyu yurisdiktsiyu vybrat'?* [Venture fund in Russia: which jurisdiction to choose?]. Press release of RVC of 23.10.2012. <http://www.rusventure.ru/ru/press-service/news/detail.php?ID=11473>

² Petlevoy V. *Instituty razvitiya namereny izmenit' zakon ob investitsionnom tovarishchestve*. [Development institutions intend to change the legislation on investment partnership]. // RBC daily, 29.11.2012. <http://www.rbcdaily.ru/2012/11/29/media/562949985227509>

opening of new institutions. According to the concept, later on the new forms are to replace the old ones - in conformity with the known effect of so-called “inside-out reforms”.

University science remained a priority with its financing steadily growing. However, even by formal indicators of research productivity Russian higher education institutions continue to lag far behind the leading foreign universities which is one more proof of the need to reform the entire system of scientific research organization.

However, even the most promising measures won't be efficient in case external factors affecting the performance of scientific sphere remain unremedied – arrears in allocation of budget funds, especially those under grants, difficulties in the organization of scientific process, discouragement of the inflow of foreign investments in Russian science, etc. From this point of view the past year was marked by further aggravation of the existing problems and the emergence of new ones.

Support to the development of technological innovations was still being provided but not so intensely as in the previous years. Innovation development programs of companies owned or co-owned by state as well as projects of technological platforms were progressing sluggishly. The innovative clusters selected in the first half of the year failed to get any financial support. The latter was postponed till 2013.

Development institutions stated the shortage of funds for projects at pre-seed and seed stages and started to diversify their activities increasing the focus on creation of “framework” (including educational projects). Still, in general the quality of performance data made available by development institutions is such that it's rather difficult to estimate their efficiency.

Section 6. Institutional Issues

6.1. Public Sector and Privatization

6.1.1. Public sector dynamics in the Russian economy

The Russia's Government has adopted no other privatization programs over the last two years, as it did in the 2000s, since the Forecast Plan (Program) for the Federal Property and the Guidelines of Federal Property Privatization for 2011–2013 was adopted in November 2010. However, it is these documents that contained numerical data on federal state unitary enterprises (FSUEs) and joint stock companies (JSCs) in which the Russian Federation had a participating interest as of the beginning of a calendar year. Therefore, there is no sufficient information for making an impartial assessment of the dynamics of the foregoing components in the public sector in 2012. Nevertheless, it is possible to assess some basic trends on the basis of the information provided by the heads of federal government authorities and the Federal Agency for State Property Management (*Table 1*).

Table 1

The number of organizations using federal property, and property units registered with the federal property register in the period between 2012 and 2013 (units)

Date	FSUEs	partially state-owned JSCs	FSEs	State-run assets	Land plots	
					units	ha
as of January 1, 2012	...	2933	...	1369446*	...	1007930198
as of mid-October 2012	1927	2587	21127	86630	314490	...
as of February 1, 2013	1795	2325	20246	87382/ about 250,000**	314490/ 238420***	1.2bn / 554m***

* – total property units registered with the federal property register;

** – in the numerator – based on the materials of the Ministry of Economic Development and Trade of Russia on “Federal Property Management” to the State Program on Federal Property Management through to 2018, in the denominator – based on the report made by the Minister of Economic Development, A. R. Belousov at the Russia's Government's meeting held on February 7, 2013;

*** – in the numerator – total including non-registered lands, in the denominator – only registered lands.

Source: www.rosim.ru; www.economy.gov.ru, Deputy Minister of Economic Development, head of the Federal Agency for State Property Management O.K. Dergunov's report on “The Enhancement of State Property Management Quality” made at the Collegium of the Ministry of Economic Development and Trade of Russia on November 30, 2012; the Federal Agency for State Property Management's materials on “Federal Property Management”, 2013; the report made by the Minister of Economic Development, A. R. Belousov at the Russia's Government's meeting held on February 7, 2013.

The number of partially state-owned JSCs decreased by more than 1/5 (approx. by 600 units) over 13 months (since early in 2012 to February 1, 2013), including the period between mid-October 2012 and early in February 2013 – approx. by 260 units. The number of FSUEs reduced approx. by 130 units, state-run enterprises increased by more than 750 units for a fraction of 4 months. Total area of the federally owned lands increased by 19% (or just short of 200m ha) over 13 months (in the period between 2012 and February 1, 2013).

Thus, as of February 1, 2013, 1795 FSUEs, 2325 partially state-owned JSCs, 20246 federal state establishments (FSE) were the key property units of the federal property management system.

Most (77%) of the unitary enterprises were governed by owners represented by federal executive authorities jointly with the Federal Agency for State Property Management, 15% of FSUEs were owned by state academies of sciences (Russian Academy of Sciences (RAS) and sectoral academies of sciences), 4% by the Ministry of Defense of Russia, another 2% of enterprises were governed through different state corporations (SCs) and the Presidential Property Management Department.

Fully state-owned JSCs governed by the Federal Agency for State Property Management accounted for 52% of 2325 JSCs, whereas JSCs with less than 2% of state-held interest accounted for 25% of these.

With regard to the management of partially state-owned JSCs, Minister of Economic Development A. R. Belousov pointed out in his report at the Russia's Government Meeting on February 7, 2013 that public sector employees accounted for 65% of the management of state corporations (inclusive of audit committees). In 2011, 1,500 professional directors, including 362 independent directors and 1143 professional agents, were appointed to the management body of about 700 partially state-owned JSCs.

However, the materials of the Ministry of Economic Development and Trade to the State Program on Federal Property Management through to 2018 contain information about 1512 professional agents and 601 independent directors. These figures are most likely to belong to 2012, because the figures for 2011 provided by the head of the Ministry of Economic Development and Trade of Russia are more or less correspond to those published in the previous review of the Russia's economy. However, the issue of professional directors in federally owned JSCs remains to be unclear. One may assume that a share of JSCs with professional directors increased notably in the last year in response to a decrease in the number of partially state-owned JSCs rather than growth in the number of professional directors.

Sixty six (or 2.8%) of such economic agents (a total of 2325 units) are included into a special list, and decisions on the key management issues of such economic agents are subject to Russia's Government decrees. However, most of such companies have no key performance indicators linked to approved provisions on senior management remuneration. Only 20 JSCs of the special list 66 JSCs have provisions on remuneration and 18 have approved key performance indicators which are linked to approved provisions on labor remuneration.

According to the Ministry of Economic Development and Trade, as part of the development of Russia's Government draft orders on the nomination of candidates to boards of directors (supervisory committees) of the JSCs included into the special list, the number of independent directors in the board of directors of such companies will be much (by 45%) bigger in the 2012–2013 corporate year (from 85 persons in the 2011–2012 corporate year to 123 persons in 2012–2013). However, the number of professional agents and state employees will be

slightly smaller (from 222 persons in 2011–2012 to 212 persons in 2012–2013) and (from 165 persons in 2011–2012 to 164 persons in 2012–2013)¹ respectively.

However, according to mass media², the Ministry of Economic Development and Trade of Russia suggested to increase from 140 to 163 government employees in the board of directors of the OJSCs included into the special list, which was approved by the Russia's Government Order No. 91-p. It is the new 6 companies (e.g., Russian Hippodromes and Avtomatika Concern) included in the list that were partially responsible for the increase.

However, this process has an effect on the companies which were included into the list long time ago. For example, only 6 of 16 leading companies (Gazprom, Russian Railways, Alrosa, Rostelecom, etc.) had 19 public sector employees in the board of directors in 2012 with 45 nominees for 2013, thereby the number of public sector employees is expected to increase almost in all of these companies (except for State JSC Oboronkomplex). All in all, the number of companies, in which the number of public sector employees is going to increase (17 units), is of a little bigger than that of the companies (11 units) in which the number of public sector employees is declining (e.g., OJSC Prioksky Non-Ferrous Metals Plant, the State Research Center of the Russian Federation Concern CSRI Elektropribor, JSC, and the Center for Shipbuilding and Maintenance Technologies).

The number of independent directors was suggested to change almost the same way, i.e. increase their number in 19 companies, decrease in 11 (including Vneshtorgbank, Russian Agricultural Bank, Zarubezhneft, Channel One Russia, Russian Space Systems), while the total number of independent directors was scheduled for increase by 1.2 times (from 90 to 108 persons).

The real estate portfolio owned by federal government bodies includes more than 430,000 buildings and facilities located on 72,000 land plots with a total area of 32m ha. Buildings, facilities and premises account for 93%, movable property for about 5%, aircrafts and sea ships for another 1% of the state-run enterprises (87382 units).

The aggregate nominal value of all of the foregoing assets registered with the federal property register amounts to nearly Rb 12 trillion. However, the Head of the Ministry of Economic Development and Trade of Russia stated that this value is a lot bigger and their real market value is more than Rb 100 trillion. It was the first time since Such figures were officially announced for the first time ever.

It is to be recalled that in March 2010 the Federal Agency for State Property Management published information on that the state property register had been completed for the first time since 1991. Systematic work on the register preparation began upon the approval of the Provision on Federal Property Accounting and the Federal Property Register Maintenance in the Russia's Government Decree dd. July 3, 1998, No. 696. The currently existing Provision on Federal Property Accounting was adopted nine years ago in response to the Russia's Government Decree dd. July 16, 2007, No. 447 "On the Enhancement of Federal Property Accounting", when the previous provision ceased to be in force.

Thus, the state property register was prepared over a period of about 12 years, i.e. throughout the entire decade of the 2000s, whilst such information was needed badly as early as the first half of the 90s, at least upon the completion of the voucher privatization in the mid-1994 when the privatization process remained intensive enough. The foregoing is a good illustra-

¹ www.economy.gov.ru, December 5, 2012.

² Ushakova D., Public sector employees again will be assigned to watch businesses, www.izvestia.ru, December 17, 2012.

tion of the quality of state economic policy administration, in particular of how the state performed its functions.

This is why the dispersion of state property appraisals is by no means surprising. Its total nominal value depends directly on the registry data completeness in terms of its quantitative and qualitative characteristics¹. With regard to the fair market value, it depends largely on the category of assets and appraisal methods. The blocks of shares in joint stock companies which were established long time can be valued against stock market quotations, whereas such assets as unitary enterprises, public establishments, lands, and real estate are hard to appraise.

For example, the principal real-estate appraisal methods are based on the comparative approach (available data on recent similar transactions), cost-based approach (based on full reproduction net of depreciation) and income-based approach (based on estimates of future incomes generated from the use of assets). It is obvious that the foregoing parameters can hardly be relied upon even for the appraisal of real estate itself, let alone the assets owned by unitary enterprises and establishments, because of the lack of similar transactions or the non-recurrent nature thereof. Well-known are the problems of taxation of physical bodies' property which occur because of the difference in the appraisal of apartments performed by the Bureau of Technical Inventory (BTI) and the appraisal based on residential property market prices, as well as when cadastral value of a land is determined. In addition, a big share of state property is used in non-profit activities (e.g., education, healthcare) and during performance of public functions (e.g., national defense, security), and the income generated from these activities and functions is an indirect result of its functioning.

This is why the provided market value assessment of state-owned assets is rather a potential value.

A circumstantial evidence of this is the market value assessment of an interest in the companies included into the MICEX index and directly owned by the Federal Agency for State Property Management (Rb 2.3 trillion)², and relatively moderate values of the budget revenues in the 2000s (much higher than in 2011–2012 though).

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-2012 can be depicted as follows (*Table 2*).

As is seen from *Table 2*, the total number public sector organizations decreased by 7.5% over the two years (between July 1, 2010 and July 1, 2012) (or by more than 5,600 units), to amount to about 69,2,000 units as of July 1, 2012.

It was the 27.0% decrease (or by almost 1950 units) in the number of unitary enterprises that was mainly responsible for the foregoing. Though being relatively less bigger, the reduction (by 5.6%) in the number of public establishments was more significant in absolute magnitude (by more than 3,400 units). By July 1, 2012 the number of business entities with more than 50% of state-held interest reduced most, by 8.2% (or approx. by 320 units). However, the number of business entities in which more than 50% interest is held by public sector business entities increased by 4.4%, a gain of about 100 units. As a result, as of the beginning of 2011,

¹ In his report at the Russia's Government meeting on February 7, 2013 the Head of the Ministry of Economic Development and Trade of Russia said that federal property inventory was scheduled to be completed this year.

² The amount would increase up to Rb 6.1 trillion if a state interest in the most expensive companies with indirect state control (e.g., Gazprom, Rosneft, Sberbank, Rostelecom) is taken into account Russia has evaluated its own property for the first time ever/ *Vedomosti*, 08.02.2013, www.finance.rambler.ru

the number of these economic agents exceeded 2,400 units to reach its maximum since they were included into the public sector of the economy at the very end of 2002.

Table 2

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 2010 and 2012

Date	Total*	SUEs, including state-run enterprises	Government agencies	Partially state-owned business entities	
				over 50% of state-held interest (interest)	over 50% interest is held by public sector business entities
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
as of January 1, 2012*	69689**	5805	57839	3733	2312
as of July 1, 2012*	69251**	5282	58049	3593	2327

* – federal property accounting is subject to the Russian Government Order dd. July 16, 2007, No. 447, “On the Enhancement of Federal Property Accounting”;

** – including organizations whose state registered articles of association contains no specific types, and excluding joint stock companies in which more than 50% interest is held on the basis of joint state and foreign ownership.

Source: On the development of the public economic sector in the Russian Federation in H1 2010 (pp. 7–11), in 2010 (pp. 7–11), in H1 2011 (pp. 7–11), in 2011 (pp. 7–11), in H1 2012 (pp. 7–11). M., Rosstat, 2010–2012.

Over a year from mid-2011 till mid-2012 total number of public sector companies reduced by 3.9% (or by almost 2,800 units).

It was a reduction of 15.4% (or by almost 1,000 units) in the number of unitary enterprises that was mainly responsible for the foregoing. The reduction in the number of public agencies was far smaller, only 2.4%, its absolute value was found to be bigger vs. unitary enterprises (more than 1,400 units), while public government agencies saw an increase in absolute number in H1 2012. At the same time, the number of business entities with more than 50% state-held interest decreased by 8.5% (or more than 330 units). The number of business entities in which more than 50% interest is held by public sector business entities reduced by 2.7% (more than 60 units), whereas their number increased a bit in H1 2012, like in the case with public agencies.

The latest crisis raised a question of its effect on 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 3*).

Table 3

Public sector’s share by basic economic indicator in the period between 2009 and 2012, %

Indicator	2009	2010	2011	H1 2012
1	2	3	4	5
Volume of shipped goods produced by the company, completed works and services w/o subcontracting :				
- mineral resources production	11.5	9.8	16.5	16.6
- fuel and energy resources production	11.1	9.0	16.7	16.5
- manufacturing sector	9.5	8.7	9.9	9.3
- production and distribution of electric power, gas, and water	14.0	17.8	24.0	25.8
Scope of construction works performed w/o subcontracting	3.8	4.1	4.0	3.9

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1	2	3	4	5
Passenger turnover at transportation companies *	63.2	56.1	65.3	61.7
Volume of commercial transportation (dispatch) of cargos by transportation companies (net of companies involved in pipeline transportation)	76.6	78.4	38.1	79.1
Commercial cargo turnover performed by transportation companies (net of companies involved in pipeline transportation)	93.8	93.6	36.4	94.3
Communication services **	13.9	15.2	13.4	13.8
In-house research and development costs	74.4	73.4	73.8	72.5
Volume of paid services rendered to the general public	16.5	18.9	18.8	18.6
Capital investments from all sources of financing ***	22.8/ 17.1	24.5/ 17.8	28.8/ 21.3	26.0/ 19.7
Net proceeds from sales of goods, works, services (net of VAT, excise taxes and other similar mandatory payments)	10.6	18.9	11.6	11.4
Average staffing number	24.6	24.9	24.9	25.7

* – 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 in the Russian Federation in 2009 (pp. 13, 45, 47–48, 49, 52, 60–61, 62, 66–67, 87), in 2010 (pp. 13, 46, 48–49, 50, 53, 61–62, 63, 67–68, 88), in 2011 (pp. 13, 35, 37–38, 39, 42, 50–51, 52, 56–57, 77), in H1 2012 (pp. 13, 33, 35–36, 37, 40, 42–43, 44, 48–49, 69). M., Rosstat, 2010–2012.

However, as it can be seen from *Table 3*, in 2011 and H1 2012, like throughout the entire period of the 2000s, that the public sector had an insignificant share in most indicators (not more than 15–20%) with a slightly bigger share in the field of investments (20–30%) and employment (about 25%).

However, official statistics reported an increase in 2011–2012 vs. 2009 in the public sector's participation share in mineral production (including fuel and power), в 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)

The public sector had most substantial share in the production and distribution of electric power, gas and water, approaching 26% (against 14% in 2009) at the end of H1 2012. It should not be left unnoticed that the public sector's share increased substantially to 16.5% in the mineral production (including fuel and power) in H1 2012 against 10 to 11% in 2009 – 2010.

A special emphasis should be placed on cargo transportation. On the one hand, the 2011 statistics showed a drastic decline in the public sector's share in cargo transportation and cargo turnover figures (up to 36–38%), whereas in H1 2012 their values resumed the level of 2009–2010 (more than 76–78% and 93% respectively). On the other hand, in H1 2012 a share of the public sector in the passenger turnover of transport companies was found to be far less than in 2008–2009¹ after a notable increase in 2011 (more than 65%).

A more sophisticated analysis of the situation reveals that the public sector was dominating (railway cargo shipment and passenger transportation, forest regeneration, production of sodium carbonate, domestic R&D costs) only in a few types of activity at the end of 2011 and in H1 2012.

¹ The foregoing trends need to be adjusted as to the results shown in 2012 in general for the figures describing the cargo transportation sector.

In most other cases the share was less than 20%, save for oil production, including gas condensate (in H1 2012 the public sector accounted for 21.4% against 20.9% in 2011), cargo and passenger air transportation, as well as vehicular traffic (net of small businesses), in all statistically recognized types of paid services¹ in which the public sector accounted for less than a half anyway. In addition, the public sector accounted for more than 20% in the inland water transport industry in H1 2012.

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 2011–2013 adopted by the Russia's Government in November 2010 covered a three-year period at the moment of its approval, it was subsequently amended and restated, more intensively in 2012 than in the preceding year. A total of 36 respective legal acts and regulations have been adopted by the Russia's Government Order dd. November 27, 2010, No. 2102-p since the adoption of the Forecast Plan (Program) of Federal Property Privatization and the Guidelines of Federal Property Privatization for 2011–2013, of which 24 were adopted in 2012 against 11 ones in 2011 (another one was adopted as early as the very end of 2010).

The amendments made in 2012 are distinguished mostly by a serious radicalization of privatization plans with regard to the largest companies in which a state-held interest was allowed to be reduced by extending a list of assets proposed for privatization.

It is to be recalled that the original version of the existing privatization program included 10 such companies, whereas in 2011 it was only a decrease in a state interest in the Federal Hydrogeneration Company (RusHydro) and United Grain Company (UGC) that was specified, retaining a 50% control interest plus one share.

All in all, the process of privatization of the largest JSCs in 2012–2013 was specified by the Russia's Government Order dd. June 20, 2012, No. 1035-p.

The United Grain Company (the state ceased to participate in the charter capital of the company), Sovcomflot (50% less one share), Rosagroleasing (49.9% less one share), VTB Bank (25.5% less one share), Russian Railways (25% less one share), Sberbank (7.58% less one share)) were referred to as the largest companies, in which (except for Sberbank and Russian Railways) the state is going to discontinue its participation by 2016. The same was announced with regard to many other companies, namely Zarubezhneft, RusHydro, INTER RAO UES, Sheremetievo International Airport, Aeroflot, Rosselkhozbank and ALROSA). A state-held interest is subject to reduction in some of the companies such as Transneft, FGC UES, UralVagonZavod (up to 75% plus one share), the United Shipbuilding and Aircraft Building Corporation (up to 50% plus one share)).

In addition, in 2012 it was suggested to reduce by 90% a state-held interest in OJSC ROSNANO by issuing and selling additional shares; beginning with 2013, to sell Ros-

¹ In this context, it is the transport, medical, convalescence, and educational services that can be highlighted in statistical reports.

neftegaz's interest and discontinue its participation in Rosneft by 2016 (provided that OJSC Rosneftegaz is allowed to act as investor during privatization of fuel-and-energy companies before the beginning of 2015 and submits a program of financing of such transactions, providing for the use of dividends from the companies' shares held by the said joint-stock company).

In the meantime, in 2012 Rosneft itself closed the largest transaction in the history of the Russian market for corporate. In the fall of 2012 Rosneft was reported to have bought TNK-BP.

Different documents were already signed with the both of the previous shareholders (British Petroleum and AAR Consortium comprising Alfa Group, Access Industries and Renova Group of Companies) which provide for selling of the shareholders' equal interest (50% each) in TNK-BP. The AAR Consortium's interest was valued \$28bn, whereas the BP's only \$17.1bn, but the latter also must receive the Rosneft's treasury shares (12.84%) being on the BP's books. In addition, BP entered into an agreement on the purchase of an extra block of NK Rosneft shares (5.66%) from OJSC Rosneftegaz which holds more than 75% of Rosneft shares. Once these transactions have been closed, BP would hold 19.75% of Rosneft shares, including a 1.25% interest which BP already holds. The transactions are expected to be closed in H1 2013 as soon as they are approved by regulating authorities.

The foregoing will definitely strengthen Rosneft's position both in the Russian fuel and energy industry and the world market. However, the need for a substantial amount of financial resources (inclusive of fundraising) to close the transactions might minimize a possible effect of optimization of assets and production performance, increased capitalization, and improved image of the company, which in turn may have an impact on privatization perspectives in the future.

Though the privatization program for 2011–2013 has been extended substantially, no changes have been made in the estimated amount of federal budget revenues. In this respect it is worth recalling that the forecast plan includes a maximum of about Rb 1 trillion of privatization revenues to be generated within the period between 2011 and 2013, given the market conditions and in case the Russia's Government makes specific decisions on privatization of the largest companies' shares which are highly attractive in terms of investment. Without considering the foregoing aspects, only Rb 6bn of revenues from privatization was estimated for 2011, and Rb 5bn for 2012 and 2013 each.

It should be taken into account within the context of analysis of the federal budget revenues from privatization and sale of state property that as early as 1999 the revenues from the principal part of such assets (shares, and also land plots in 2003–2007) began to be referred to as sources of budget deficit financing. Revenues from sale of other assets (different types of property and land plots) were included into the revenue side of the budget.

Neither the main part, nor the annexes of the Federal Law dd. December 3, 2012, No. 216-FZ, "On the Federal Budget for 2013 and for the Planning Period for 2014 and 2015" contain information on any specific amount of revenues from privatization. The annexes thereto relating to sources of budget deficit financing contain only a summary of other types of sources without any specific reference.

The same is true with a project which the Russia's Government submitted to the State Duma for consideration. It is only an explanatory note attached thereto that specified revenues from federal property privatization as a stand-alone source of federal budget financing, in addition to public borrowing.

It was announced that privatization of blocks of shares in large Russian companies which may attract investments would continue. Almost all of such companies were included into the list provided in the privatization program for 2011–2013 (as amended and restated). Such privatization will be based on the Russia’s Government’s decisions in setting specific dates and methods of privatization, and with due consideration of the market situation as well as recommendations of the leading investment advisors. Such measures would allow the federal budget to generate revenues of Rb 427.7bn in 2013, Rb 330.8bn in 2014, Rb 595.1bn in 2015.

Comparing the foregoing data with the estimates of the Ministry of Finance of Russia, one may see a notable increase in forecast revenues from state property privatization vs. the data that were available two years ago in the core documents of the Ministry¹, let alone the figures provided by the privatization program for 2011–2013 (*Table 4*).

Table 4

**Analysis of federal budget revenues from privatization in the period between
2011 and 2015, billions of rubles**

Source	2010	2011	2012	2013	2014	2015
The Forecast Plan (Program) for Federal Property Privatization for 2011–2013		6.0	5.0	5.0		
Fiscal Policy Guidelines for 2011 and the Planning Period for 2012 and 2013		298.0	276.1	309.4		
Fiscal Policy Guidelines for 2012 and Planning Period for 2013 and 2014		298.0	276.1	309.4	300.0	
Fiscal Policy Guidelines for 2013 and Planning Period for 2014 and 2015				380.0	475.0	385.0
Draft of the federal budget for 2013 and the Planning Period for 2014 and 2015 (explanatory note)				427.7	330.8	595.1

Though in the relatively recent Fiscal Policy Guidelines (FPG) for 2013 and the Planning Period for 2014 and 2015 dated July 18, 2012 revenues from privatization were forecasted to increase by 12.6% (against Rb 380bn) in 2013, they are expected to decline by 30% (against Rb 475bn) in 2014. Thus, the forecast of privatization revenues was considerably higher for 2015, by more than 1/5 times (against Rb 385bn).

It is hard to say whether such goals are attainable or not, given the specific amount of federal budget revenues from privatization, because it depends both on the list and value of assets to be privatized, which depend on evaluation methods and market conditions.

In general, commitment to market conditions and recommendations of the leading investment advisors having the required resources, experience and business record, given the government exclusive right in the privatization sector and actual lack of external control over privatization make it possible to obtain a decent compensation for privatized assets. The existing mechanism of budgeting process, when the text of adopted budget law contains no instructions for privatization in the context of budget revenues, leaves a wide and unlimited space for making any decisions in respect to the list, terms, and sale-format of privatized assets.

For example, the amendments and modifications relating to ROSNANO and Rosneft, which were made in June 2012 to the privatization program for 2011–2013, have no direct relationship with the generation of federal budget revenues, and the allowance for allocation of revenues from privatization of JSC ALROSA (with coordination of sale of shares held by regions and municipalities) to the infrastructural development of the Republic of Sakha (Ya-

¹ The Fiscal Policy Guidelines for 2011 and the Planning Period for 2012 and 2013, the Fiscal Policy Guidelines for 2012 and Planning Period for 2013 and 2014.

kutia) is likely to encourage a reduction in budget revenues, all the more so, because no scale and proportion of such usage of privatization revenues are specified whatsoever.

Furthermore, it was specified in the explanatory note to the federal draft law “On the Federal Budget for 2013 and the Planning Period for 2014 and 2015” that the formation of the Reserve Fund and the National Wealth Fund allows for a part of oil and gas extra revenues to be used as a substitution for federal budget financing sources subject to a decision by the Russia’s Government¹.

A similar possibility of financial maneuvering was allowed for by the amendments to the previous federal budgets: for 2011 and the Planning Period for 2012 and 2013² and for 2012 and the Planning Period for 2013 and 2014³, when oil and gas revenues which were generated during the implementation of the foregoing budgets were allowed to be used for the substitution of Russia’s borrowings and/or revenues from sale of state-held interest and other forms of state-held interest in the charter capital of companies, or for other legally supported goals⁴.

In addition, a subordinate role of privatization revenues in financing the federal budget deficit is worth noting, because these revenues are much smaller (by more than three times in 2013–2014, by more than two times in 2015) than the amounts of the expected public borrowings.

However, in addition to a possible adverse effect on the implementation of the privatization program due to a severe aggravation of the macroeconomic situation (e.g., a second round of crisis or global recession), there are visible risks relating to poor transparency of privatization processes, lack of transparency required for plans and methods of privatization of large companies, and the state gives no reasons (arguments) for decisions it makes. Given always an acute and controversial public response to privatization of large companies, the latter remains most important so that the ‘rules of the game’, mutual obligations of the state and buyers are clear for the general public. Also, there is a serious drawback in making no analysis of potential effects of privatization, practicability, alternative costs, potential risks, and impact on the development of specific markets, industries, regions, and the national economy at large.

So far the announced abrupt turn in the course of privatization away from public control in more than 10 largest nationally important companies has not been accompanied by any balancing measures, except for the possibility for the Russian Federation to exercise a special right (‘golden share’) in the management of less than a half of joint-stock companies (United Grain Company, Zarubezhneft, RusHydro, Aeroflot and ALROSA).

Regardless of many statements on the need to make the privatization process more transparent by the beginning of March 2012, to date, government authorities have provided no generalized data on the privatization process progress in 2012. No such data, except for information on the amount of budget revenues, was provided in the report of the Head of the

¹ Though no information about it can be found in text of the Federal Law dd. December 3, 2012, No. 216-FZ “On the Federal Budget for 2013 and the Planning Period for 2014 and 2015”.

² Under the Federal Law dd. December 13, 2010, No. 357-FZ “On the Federal Budget for 2011 and the Planning Period for 2012 and 2013” (as amended and restated by the Federal Law of June 1, 2011, No. 105-FZ).

³ Under the Federal Law dd. November 30, 2011, No. 371-FZ “On the Federal Budget for 2012 and the Planning Period for 2013 and 2014” (as amended and restated by the Federal Law of June 5, 2012, No. 48-FZ, which raised the threshold value. If the amount of oil and gas revenues exceeds this value, they may be used as described above).

⁴ The latter refers to the preceding year budget only – amendments made by the Federal Law dd. July 28, 2012, No. 127-FZ.

Ministry of Economic Development and Trade at the Russia's Government meeting on February 7, 2013.

Indirect signs, the data provided in the foregoing report on that a total of 284 unitary enterprises have been included into the privatization program over the last three years, of which 70% have already gone public, and the data on privatization of FSUEs in 2010–2011 (a total of 205 units)¹ may lead to a conservative conclusion of privatization of about 100–140 enterprises in 2012.

With regard to privatization of blocks of shares, mass media previously reported with reference to the press office of the Federal Agency for State Property Management that 273 blocks of shares in joint stock companies² were sold in 2012 as part of the privatization program, which is approx. one fourth less than in the preceding 2011. This figure exceeds the figure of the pre-crisis period of 2008–2010, whereas it is less than that reported in 2006–2007.

A total of six privatization transactions, each being valued more than Rb 1bn, were closed or nearly closed in 2012.

The largest of the six transactions was closed in September, when a 58% interest in Sberbank held by the Central Bank of Russia was sold at Rb 159.3bn. The transaction features a seller special public status which differed from the normal role of government authorities when it comes to property management, and gave rise to special amendments to the budget to allow budget revenues to be generated from this source. It was established in the beginning of December 2012 that a part of the revenues generated by the Central Bank of Russia from the sale of the Sberbank shares, whose amount was calculated as the difference between the amount of revenues from the sale of the said shares and their book value, net of sale costs of the said shares, were to be transferred to the federal budget by reducing accordingly a part of the revenues generated by the Central Bank of Russia in 2012³, which is payable to the federal budget.

A second largest transaction took place late in September 2012, when a 100% interest in SG-Trans OJSC was sold at Rb 22.77bn. SG-Trans is the largest railway carrier in Russia, which is involved in transportation, storage and sale of liquefied petroleum gas, and has a big stock of special railway tankers. Sistema JSFC⁴ won the tender in which four bidders participated. Renaissance Capital acted as bidding process organizer.

In addition, in the beginning of the fall of the preceding year, BNP PARIBAS BANK CJSC which in compliance with the Russia's Government Order dd. November 3, 2011, No. 1920-r acted as bidding process organizer of a federally held interest in Apatite OJSC, 26.67% of a state-held interest in this company was sold, accounting for about 20% of the charter capital thereof. The best bid (Rb 11.1bn) was offered by FosAgro OJSC (the agent re-

¹ However, this value reflects the number of FSUEs on which decisions on terms and conditions of privatization were made, but they haven't gone public yet. For example, in 2011 only a total of 42 JSCs were registered at 143 enterprises which were subject to privatization according to relevant decisions.

² Russia will generate about Rb 3 trillion from privatization in four years, 07.02.2013. RBK provided this information with reference to the Federal Agency for State Property Management in January 16, 2013, though no such information is available in the Federal Agency for State Property Management's website.

³ Under the Federal Law dd. December 3, 2012, No. 247-FZ, "On the Federal Budget for 2012 and the Planning Period for 2013 and 2014".

⁴ SG-Trans will pay 22.77bn Rb to buy Sistema JSFC), www.OilCapital.ru, September 28, 2012.

ceived an offer from two bidders, whereas a total of six bids were received from Russian and foreign legal entities, of which only three submitted their bids)¹.

A state-held interest (55% of the charter capital or 73.33% common shares) in the Vanino Commercial Seaport (the Khabarovsk Territory) was sold at Rb 15.5bn to MECHEL-Trans LLC, and VTB Capital was appointed as the sole executor of the state order to sell on behalf of the state an interest in the foregoing OJSC as early as February 2012.

A far less amount (Rb 2.2bn) was generated from a blocking shareholding (25.5%) in the Murmansk Commercial Seaport, which was sold to two buyers (SUEK OJSC and Alfa Capital Holdings (Cyprus) Limited). The transaction was arranged by Raiffeisen Investment LLC².

Another large transaction in 2012 was the acquisition by Summa Group of an interest (50% less one share) in the United Grain Company by private subscription. A total of Rb 5.951bn was generated. The transaction was arranged by Troika Dialog, a subsidiary of Sberbank, which selected the winner.

There were smaller privatization transactions, namely sale of an interest in the OPKH Stud Farm Leninsky Put OJSC (the Krasnodar Territory, 100%, Rb 1869.969m) and the Ob-Irtysh River Shipping Line (Khanty-Mansyisk, 25.5%, Rb 474.589m).

The Russia's Government Decree dd. August 27, 2012, No. 860, on "The Provision on Organization and Sale of State or Municipal Property in Electronic Form" which was long awaited after the amendments to the law on privatization in May 2010, became an important event from the privatization process point of view.

It was a negative background, which occurred for the first time over the last few years, that became the key difference between the privatization process of 2012 and in the preceding year.

The negative background was triggered by the notorious events relating to Oboronservis JSCo in the fall of 2012. Furthermore, the sale of assets which were considered investment-attractive was also responsible for it.

The Federal Anti-Monopoly Service (FAS Russia) revealed signs of violation during the sale, by private subscription, of an interest in the United Grain Company (UGC) in May 2012, namely by 'preventing economic agents from buying additional shares issued by UGC thereby reducing the number of potential investors'. In this respect, the FAS Russia forwarded a letter to the Russia's Government in which it suggested to sell the UGC shares through public offering.

There were 6 bidders, including Louis Dreyfus, one of the world's largest grain traders. It was only Basic Element, whose interests were represented by Kuban Agricultural Holding Company, that expressed its discontent about the form of placement of UGC additional shares. In the mid-May Basic Element announced that 'the qualified investor selection criteria are nontransparent' and 'the placement of additional shares in the form of private offering fails to comply with the principles of free competition'³. Though shortly after that announcement a case was filed against UGC OJSC and Troika Dialog CJSC to the FAS Russia, but it was finally dismissed for absence of violations of the competition act by the foregoing economic agents.

Published facts of misuse and withdrawal of assets from the recently (in the fall of 2008) established Oboronservis JSCo reveal clearly the totality of the problems being faced in the

¹ www.rosim.ru, 07.09.2012.

² www.rosim.ru, 25.12.2012.

³ Lanin D., FAS Russia is ready to dispute the UGC privatization, www.bfm.ru/news, June 15, 2012.

field of state property management and privatization, namely (1) lack of well-defined criteria of the need for privatization, in particular with respect to different types of activity in the military and national defense sector, (2) controversial advantages of corporatization in terms of retaining assets and serving the interests of the state, (3) the issue of manageability by and accountability to the state of integrated entities established at the initiative of the state, (4) it impossible for the state to get a compensation for previously contributed assets if their sale has been initiated by a holding company, while being exposed to the risk of a situation when a 'shell' of the parent company, which have sold its most valuable production or financial assets, becomes an entity for corporate governance or subsequent privatization, (5) a wide space for corruption becomes available in evaluating assets to be sold only subject to the provisions of the Federal Law "On Valuation Activity in the Russian Federation" in case of refusal to apply a price established by government authorities as the lowest price threshold in selling certain facilities.

It is to be recalled that Oboronservis JSCo is a large integrated entity comprising 9 sub-holdings, a 100% interest (less one share) of each was contributed to its charter capital. The same mechanism of asset control was provided for unitary enterprises and JSCs when the sub-holdings' capital was built up. Total number of enterprises which were scheduled for integration into the sub-holdings is impressive, even after some adjustments in 2011: Oboronstroj (58 units), Remvooryzheniye (56 units), Spetsremont (45 units), Aviaremont (39 units), Voentorg (34 units), Agroprom (30 units), Kransyaya Zvezda (20 units), Oboronenergo (11 units), Slavyanka (4 units). It is worth noting that Oboronservis JSCo itself, whose 100% interest is held by the state, was in the list of strategically important enterprises only for a year and a half (from the end of 2009 till April 2011) regardless of an obvious strategic importance of its affiliates.

The decision of the military entity's new management to suspend the sale of military assets and conduct inventory of the previously closed transactions was one of the short-term effects of the Oboronservis JSCo case.

A wider look at the situation from the perspective of the public sector at large would actualize an issue of the need and conditions for selling non-core assets of partially state-owned companies (JSCs in the first place) whose diversified nature may have both an adverse and a positive effect on the evaluation of an offered state-held interest.

In this respect, the Ministry of Economic Development and Trade and the Federal Agency for State Property Management suggest that the companies included into the forecast plan of privatization for 2011–2013 should not sell their non-core assets, because preliminary sale of such assets may deteriorate their investment attractiveness and result in less budget revenues. Thus, making a list of privatization for companies which are going to be released from the obligation to sell their non-core assets, inevitably becomes the subject matter to be agreed upon between different groups of interests, including those companies which generally prefer to retain such assets for many reasons (established relationships, the possibility for the personnel to receive benefits in kind, social responsibility, prestige, etc.). The scale of the asset disposal process would become quite limited without non-core assets of most structurally diversified large companies¹.

The Sale of a 100% interest in SG-Trans was disputed by Rosneft whose subsidiary RN-Trans filed a lawsuit against the bidding process organizer, LLC Renaissance Broker, to

¹ Kiseleva M., Privatization will help state-owned companies retain their non-core assets www.izvestia.ru, November 22, 2012.

invalidate the restrictions on participation in the privatization process. Initially, the court took the side of RN-Trans by prohibiting Renaissance Broker to further proceed with the sale of the federally-held shares. Later, however, the court lifted the injunction, and Rosneft renounced its claims and dropped the case. According to unofficial information, it happened after Sistema JSFC, a new owner of SG-Trans, provided Rosneft with a guarantee to enter with Rosneft into a long-term contract on transportation of liquefied petroleum gas¹.

Given the FAS Russia's refusal to allow Gazpromtrans to participate in the transaction, one may see a trend for prohibiting the largest partially state-owned companies from participation in privatization. Even earlier, late in 2011, Gazprom Energoholding withdrew its claim to buy IES Holding, the largest private energy company. Initially, Gazprom entities were expected to hold a 75% interest in the new entity.

A resale, as reported in January 2013, of a state-held interest in the Vanino Commercial Seaport which was purchased by MECHHEL a month and a half prior to the resale, raised the question of not only valuation of privatized assets, but also a real motivation of Russian businesses in the course of a new wave of privatization.

On the one hand, the MECHHEL management explained this transaction by the need to look for a base to sale the coal from the Elginsk minefield in Yakutia. The management looked into the option of constructing a new coal terminal as an alternative to the purchase of the port. Six bidders other than MECHHEL participated in the tender for the state-held interest. Finally, the state-held interest was sold at Rb 15.5bn, with an asked price of Rb 1.5bn, though MECHHEL had the strongest debt burden among all of the Russian mining companies. On the other hand, its subsidiary MECHHEL-Trans LLC reported that new 'investors are not interested in cargo transshipment through the Vanino Commercial Seaport'. Neither the composition of new owners, nor the amount of the resale transaction was specified.

Finally, MECHHEL retained only a 1.5% of the port capital, another 73.3% of common shares (55% of the charter capital) was transferred to the new owners, 28.1% was held by En+Group, an affiliate with Basic Element business group. MECHHEL representatives reported that the group acted as the leader of a consortium of investors with whom it concluded an agreement on non-debt funding if MECHHEL gains control of the port. Shortly after the resale, South Korean companies were mentioned among new owners, including Pohang Iron and Steel Company (Posco) which had an agreement on cooperation with the Russian company. Later, it was reported that three Cypriote companies (Open Trade Limited, Segmino Investments Limited and Travine Trading Limited) became new owners.

It is quite obvious that this fact contradicts the announcements made by the top political leaders about focusing on higher transparency and 'deoffshorization' of the economy. However, according to the statement made by the Head of the Ministry of Economic Development and Trade at a briefing which was held after the Russia's Government meeting on February 7, 2013, this news is not considered as triggering a deep concern².

Finally, one may add that the sale transaction of the state-held interest in the Vanino Commercial Seaport was not the first one. In 2011, the results of the previous sale of the in-

¹ The results of SG-Trans privatization were recognized by a government order, www.rupec.complexdoc.ru, November 22, 2012.

² Lanin D., MECHHEL sailed through Vanino, <http://www.bfm.ru/articles>, January 19, 2013; the Ministry of Economic Development and Trade of Russia sees no 'threat' in that three offshore company have obtained control of the Vanino port, 07.02.2013, ITAR-TASS. Delovye Novosti.

terest were cancelled after the buyer refused to discharge its payment obligations¹ and was charged by arbitration court to pay Rb 75.114m

Thus, the second year of the first in the Russian history 3-year privatization program (2011–2013) was marked by numerous scandals based on a set of issues which are typical of the Russian privatization (providing rationale for a fair price of privatized assets, real motivation for participants, defining buyer selection criteria, ensuring transparency, regulators' claims). Obviously, the foregoing provide no support to build up a positive image of the new wave of privatization.

In the mid-December 2012, a collegium of the Accounts Chamber of the Russian Federation (AC) analyzed the results of the preparation and implementation of privatization plans for 2011–2014. The collegium revealed that no regulatory and methodological documents regulating the content of expenditure commitments required for privatization were in place. It was revealed during the audit that the Ministry of Economic Development and Trade failed to ensure transparency of the procedures for making decisions on the terms and conditions of privatization of certain companies².

However, a series of sales of an interest in the most important Russian companies is expected to take place this year.

For example, as early as the summer 2012, UBS Bank LLC and Deutsche Bank LLC were selected as sellers (organizers of the sale) of a federally held interest in the Novorossiysk commercial seaport and Sovcomflot³.

In February 2013, agents were selected to sell a 7% interest in ALROSA. A branch of Goldman Sachs (Russia) LLC provided the best bid with the lowest commission charged for the organization and sale of the interest, which would be recommended as agent to the Russia's Government. The foregoing bank was recommended to include at least one Russian bank into a consortium of banks which is to be established to execute the transaction, given the objectives to develop the stock market and establish an international financial center⁴.

The Moscow Stock Exchange, an integral part of the process of creation of the International Financial Center in Moscow, is expected to become a floor for privatization of Alrosa OJSC and placement of additional shares of VTB Bank OJSC. According to Dergunov O., the Head of the Federal Agency for State Property Management, with reference to the Ministry of Economic Development and Trade, Alrosa together with Transneft and Russian Railways can be viewed as locomotives for raising Russian pension accruals and savings.

However, the latter of the aforementioned companies is currently subject to legal restriction on privatization. This is why the Ministry of Economic Development and Trade of Russia in conjunction with the concerned government authorities have been working on relevant amendments to the legislation in order to create conditions for the privatization of Russian Railways' shares, in particular amendments to the Federal Law dd. January 10, 2003, No. 17-FZ "On the Railway Transport in the Russian Federation". As soon as the amendments are made to the relevant legislation, a work would be performed jointly with the company and advisors on detailed structuring of the transaction which the Ministry of Economic

¹ The amount of that transaction (Rb 10.8bn) was 40% less than the sale price of 2012 (Rb 15.5bn), although the sale price was found to be a bit over the asked price (by 11.6 times against 10.3 times).

² Lanin D., The state sold Rb 200bn of assets, www.bfm.ru/articles, December 29, 2012.

³ www.economy.gov.ru, July 19 and August 1, 2012.

⁴ www.rosim.ru, 21.02.2013.

Development and Trade of Russia in conjunction with the Federal Agency for State Property Management plan to launch in 2013¹

6.1.3. State participation in the economy and structural policy

2012 was marked by more notable vs. the preceding year changes in the list of strategically important enterprises and joint stock companies. Sixteen OJSCs were included into and 6 unitary enterprises and 2 OJSCs excluded from the list.

The most significant entry in the list of strategically important enterprises was made in May 2012, a 100% interest in Systemic Operator of United Energy System and a majority shareholding in three other systemically important companies of the electric power industry (Federal Grid Company of United Energy System (FGC UES), Interregional Distribution Grid Companies Holding JSC (Holding IGDC) and Federal Hydropower Generating Company (RusHydro). A micro interest (less than 0.01%) in Rosneft² was included into the list of strategically important JSCs under same presidential order.

One more federal unitary enterprise and three OJSCs (FGC UES, Holding IGDC and RusHydro) saw changes in the format of their presence in the foregoing list. The FSUE, an aircraft navigation scientific and research institute, was affiliated with the State Civil Aviation Research and Development Institute, an enterprise with similar core activity, with the latter having been included into the list of strategically important enterprises. The three OJSCs experienced more serious changes, i.e. the entire state participation in a very important electric power industry was reformatted.

It is to be recalled that after the completion of a long-lasting restructuring in the electric power industry, including the wind-up of RAO UES of Russia in the summer of 2008, the state acquired a majority shareholding in two infrastructural companies, namely FGC UES (79.55% of federally held interest) and Holding IGDC (54.52% of federally held interest).

Decisions which were made in the second half of November 2012, provide for renaming the latter as Russian Grids OJSC and contributing almost the entire federally held interest in FGC UES to its charter capital as payment for the placement of additional shares by Russian Grids OJSC in response to an increase in its charter capital while the state direct participation in FGC UES was retained by holding at least one share.

The charter capital of Federal Hydropower Generating Company OJSC (RusHydro) is also expected to be increased, with a federally held interest being at least 60.5%. The state plans to contribute an interest in 4 OJSCs (2 minority and 2 blocking interest) and cash in the amount of Rb 50bn or less from the federal budget allocation for 2012.

The foregoing amounts of a federally held interest in Russian Grids JSC (54.52%), FGC UES (less than 0.01%) and RusHydro (60.5%) were registered for these companies in the list of strategically important JSCs. Such decisions contradict to a certain extent not only the supplements to the privatization program for 2011–2013 which were adopted in June, but also the last-year establishment of a lower threshold of state corporate control for RusHydro, 50% plus one share. It is to be recalled that previous (in December 2010 and July 2011) amendments to the existing privatization program provided for contributing a federally held interest in 12 OJSCs (in addition to other assets) to the company's charter capital. It should be

¹ www.economy.gov.ru, February 21 and 27, 2013.

² More specifically, it is not quite clear why such an asset was included into the federal property, because late in 2004 a President's order provided for contributing a 100% interest in Rosneft to the charter capital of Rosneftgaz which was included into the list of strategically important enterprises at the same time.

noted that two of them (RAO Energy Systems of East and Sakhalin Energy Company) were mentioned again in the Presidential decree on RusHydro in November, but with a new amount interest to be contributed. However, the contribution of almost the entire federally held interest in FGC UES to the charter capital of Russian Grids JSC¹ differs largely from that announced in the supplements to the existing privatization program, a fairly moderate reduction in state-held interest (up to 75% plus one share).

Unlike the bulk of similar decisions on the establishment of integrated entities, which were typical of the entire period of market reforms, the recent decisions relating to the electric power industry provide for the introduction of new tools of state control influence on partially state-owned companies.

With regard to the new Russian Grids OJSC (former Holding IGDC), the Russia's Government must support the preparation of a draft shareholder agreement between the Russian Federation and the company, which would regulate participation of Russian Grids' representatives in the management of FGC UES for the purpose of retaining state control of the company, and the development strategy of Russian Grids itself.

Furthermore, an agreement is to be concluded between federal authorities (the Ministry of Economic Development and Trade and the Ministry of Energy) and RusHydro, which would regulate flow of cash contributed to its charter capital to finance construction of certain facilities of the electric power industry at the Far East (two central heating and power plants and two hydroelectric power stations). Under the agreement the said ministries must conduct preliminary evaluation of utilization efficiency of the cash contributed for capital investments, and ensure proper cash spending for each of the construction facilities.

The need for such control tools is evident in response to a wide spread practice of recapitalization of different companies with federal budget funds. RusHydro, in which afterwards, at the end of 2012, a decision on the placement of additional shares resulted in a conflict of interests in the board of directors in which no federal government officials participated, and in 2013 the company came to the attention of law enforcement agencies as a result of severe criticism by the President of Russia, is a good example for raising a question of having additional tools for state control of budget-funded companies².

In general, the President of Russia and the federal government were focused on improving transparency of partially state-owned companies in the preceding year.

In particular, a group of 21 companies was selected as early as December 2011, whose top managers (together with their relatives) must disclose their income to the government, including all beneficiaries of all counterparties of the companies. As of the end of March 2012, the managers in 18 of the 21 companies failed to accomplish this instruction in full, some of them failed to provide such information or provided incomplete information. More than 200 cases of concealment of important information by managers were reported.

New instructions were therefore issued to ensure the provision of full data. In addition, an obligation to report to the government and employer about conflicts of interests will be entered in the list of duties of managers at partially state-owned companies as part of their labor contracts. Agreements with counterparties must disclose a full chain owners in full, otherwise

¹ Changes in the amount of a state held interest registered with the list of strategically important enterprises were insignificant for Russian Grids JSC.

² After the events relating to RusHydro, the Accounts Chamber of the Russian Federation raised a question of the need to conduct audit in all state-owned companies and state corporations (SCs).

such an agreement may be cancelled. Tax residents must provide a full information on foreign assets they hold and transactions therewith¹.

Transparency of partially state-owned companies is still a problem, above all, it terms of completeness of information about ultimate beneficiaries².

It should be noted that the issues of improving transparency were relevant for state corporations (SC) as well, regardless of a special law adopted as early as the end of 2010. Under the law, every state corporation is to establish a board of directors or supervisory board being in charge of adopting a long-term program of activities, a labor remuneration system for its personnel, and a profit allocation procedure. State corporations are subject to mandatory audit of their annual financial statements. They also must publish their strategy and annual reports in the Internet.

Getting back to the upcoming changes in the configuration of state participation in the electric power industry, it should be noted that amendments to the applicable legislation on regulation of the industry are expected to be drafted, which, among other things, would allow the Russian Federation to control the governance of the unified national (all-Russia) electric power grid through direct or indirect interest (at least 50% plus one share) in the charter capital of the grid. If this provision is adopted, it would remind to a certain extent the law on the specifics of disposal of shares in RAO UES of Russia of 1998, in a state interest was 51%, though at that time the all-Russia energomonopoly also included power generating assets which are currently not included into Russian Grids JSC. With regard to a possibility for the state to hold indirectly a 100% interest, it should be noted that the currently applicable law on gas supply of 1999 established a threshold in the charter capital of the owner of the Unified Gas-Supply System, which must be at least 50% plus one share for a total state-held interest and the assets owned by joint stock companies in which the Russian Federation holds more than 50% interest (a regulation on exclusive direct state-held interest of at least 35% was in force until the end of 2005).

Besides the electric power industry, the structural policy plan has decisions relating to the geodesy and agricultural sectors.

The existing Moscow Aero-geodesic Predpriyatiy FSUE is to be restructured into Roscartography OJSC, with subsequent contribution to its charter capital a federally held interest (100% less one share) in OJSCs which are to be established through corporatization of 32 FSUEs. A controlling interest in Roscartography (51%) is already in the list of strategically important enterprises. About 230 real estate units are scheduled for contribution to the charter capital of the existing Rosspirtprom OJSC, and 83 real estate units³ to the charter capital of Russian Hippodromes OJSC which is to be established.

Regarding the military defense industry, the following entities are to be expanded. Tactical Missiles Corporation JSC (through contribution of stakes in 12 JSCs, including 6 minority stakes, 3 blocking stakes, 3 controlling stakes, and a 100% stake less one share), Concern Granit-Electron OJSC (contribution of a 100% interest less one share in a OJSC which is to be established through corporatization of a FSUE), Concern Morskoye Podvodnoye Oruzhiye – Gidropribor OJSC (through contribution of stakes in 4 JSCs, including 2 controlling and 2 blocking stakes), "Shipbuilding & Shiprepair Technology Center" Joint stock corporation

¹ Top managers of state-owned companies failed to disclose their income, www.finmarket.ru, 20.03.2012.

² Putin: State-owned companies still remain to be transparent, www.bfm.ru/news, 13 February 2013.

³ This explains a sharp increase in the number of units subject to privatization which fall under the 'Other units' category in the privatization program for 2011-2013.

(through contribution of a controlling stake in a OJSC), Concern Oceanpribor (through contribution of stakes in 8 JSCs, including a 100% interest less one share, one controlling stake, the rest are blocking stakes), UralVagonZavod Scientific & Research Corporation (through contribution of stakes in 7 JSCs, including a 100% interest less one share, 2 blocking stakes, the rest are minority stakes). In addition, it is worth noting the establishment of Federal State Unitary Enterprise "State Research and Production Space Rocket Center "TsSKB-Progress" on the basis of the similarly-named FSUE, by contributing a 100% interest (less one share) in 2 other OJSCs to its charter capital.

State-owned assets in the defense industry have been consolidating in a different manner.

For example, in the summer of 2012, the Federal Agency for State Property Management represented by CAMELOT LLC, a specialized entity, held a mortgage asset auction. The auction was opened by the composition of bidders and the form of bidding. A stake in Baltiysky Zavod OJSC was tendered at an asked price of about Rb 222m. Zapadny Shipbuilding Center OJSC (a subsidiary of the United Shipbuilding Corporation) offered the highest bid of Rb 224,3m¹ and won the auction.

The Russian Federation regained its control of Klimovsky Specialized Ammunition Plant (JSC "KSPZ") (Moscow Region) by having been awarded a stake in the plant, after a legal claim of the Federal Agency for State Property Management was satisfied in court².

Some of the state corporations continued growing.

For example, the Russian Federation is to contribute to Rostekhnologi a 100% interest in MMPP "SALUT" to be established on the basis of the similar-named federal state unitary enterprise, by contributing to its charter capital a 100% interest in other OJSC, a scientific and research institute, as well as federally held minority stake in another 2 OJSCs. All these assets are subsequently to be contributed to the charter capital OBORONPROM OJSC United Industrial Corporation. Another 6 FSUEs are subject to corporatization and contribution of ROSATOM assets to their charter capital.

Vnesheconombank SC was included into a future scheme of indirect state corporate control of Rostelecom OJSC which is expected to be reorganized by taking over Investitsionnaya Kompania Svyazy OJSC (better known as Svyazinvest) and excluding the former from the list of strategically important enterprises, provided that the Russian Federation jointly with Vnesheconombank have a control of more than 50% of common shares in Rostelecom.

Reorganization of the state segment in the telecommunication sector is currently at the stage of floating additional shares of Svyazinvest, as part of which the state is going to transfer core assets to the holding (including stakes in Central Telegraph OJSC, Bashinformsvyaz and other companies). To retain its stake in Svyazinvest (25% plus one share, the rest is held by the state), Rostelecom must contribute cash to be able to take part in the floating of additional shares. In its turn, Svyazinvest must use the cash to reacquire 6.55% common shares of Rostelecom from its subsidiary Mobitel LLC. Svyazinvest must obtain an even smaller stake (approx. 1.91% common shares) in Rostelecom in exchange for a 50% stake in Skylink CJSC.

¹ However, a similar auction of encumbered stakes in Severnaya Verf OJSC was cancelled due to the lack of bids. www.rosim.ru, 06.07.2012, 08.08.2012.

² Previously, in executing the RF President's and Russia's Government's instructions on the contribution of a state-held interest of 26% in Klimovsky Specialized Ammunition Plant JSC to Rostekhnologi, in 2009 the Federal Agency for State Property Management found out that a stake of 25% in the plant was withdrawn from the federal ownership by having been debited from the federal account in compliance with a court order.

However, an interest held by Svyazinvest as the principal shareholder of Rostelecom is still smaller, even after an increase, than a controlling interest (41.84% of the capital and 45.29% common shares). The state, represented by the Federal Agency for State Property Management and Vnesheconombank, owns 7.43% of common shares (6.86% of the capital) and 2.45% of voting shares Rostelecom (2.26% of the capital) respectively¹.

The foregoing interest was transferred to the Federal Agency for State Property Management early in 2012 by another state corporation, the State Agency for Deposit Insurance (DEA), which acquired it in the summer of 2009 from KIT Finance bank as part of the financial rehabilitation of the latter, and then more than once asked the government to get rid of the interest.

It was at that time when Vnesheconombank acquired a 10% interest in and became a shareholder of Rostelecom. Later, however, Vnesheconombank's interest shrank as Rostelecom was reorganized by taking over eight companies owned by Svyazinvest in the spring of 2011², and conviction of shares. Svyazinvest intended to acquire the interest under the agreement concluded with Vnesheconombank in the summer of 2010. However, the agreement was terminated last year when the price of Rostelecom shares dropped below the 2009 value specified in the agreement, i.e. against the price which Vnesheconombank paid for the shares in 2009.

The floating additional shares of Rostelecom should be followed by taking over Svyazinvest which is to cease to exist. The state jointly with Vnesheconombank are going to remain the controlling shareholders of the united telecommunication company. However, the current process of Rostelecom reorganization by taking over Svyazinvest is slower than the timeframe (by March 2013) specified by the government³.

Vnesheconombank plays an important role as creditor of enterprises in the real sector of economy.

For example, in 2012 Vnesheconombank considered a question of replacing the management team at Machinery & Industrial Group N.V., a large machine building business group involved in the production of agricultural, road-building machinery, train cars, and special-purpose products. It is to be recalled that in 2010 the concern obtained a loan of Rb 15bn from Vnesheconombank in exchange for a 100% interest in the parent company, provided that the existing management should be retained, and there should be a buy-back option in seven years. However, Vnesheconombank considered not only an option of replacing the management team at Machinery & Industrial Group N.V., but also selling the assets in which Ural-VagonZavod, Russian Machines corporation, and IST Group were interested. The role of Vnesheconombank in assessing the prospects of Machinery & Industrial Group N.V. is getting more important, because this year the concern is to redeem a syndicated loan of a group of banks, including Sberbank⁴.

A decision to transfer a series of federally owned air transport assets to the regional level is an example of another recently forgotten line of state ownership policy.

¹ In addition, Rostelecom's subsidiary Mobitel and Gazprombank (5.24% and 9.66% respectively) remain Rostelecom shareholders.

² These companies include seven interregional communication companies, namely Volgatelecom, Dalsvyaz, Severo-Zapadny Telecom, Sibirtelecom, Uralsvyazinform, Central Telecommunications Company (Centrtelecom), Southern Telecommunications Company (STC), plus Dagsvyazinform.

³ Chernovanova A. Svyazinvest fails to comply with the presidential timeframe, *www.gazeta.ru*, 12.12.2012.

⁴ Popov E. Vnesheconombank restarts Machinery & Industrial Group N.V., *Kommersant*, No. 129 (4914), 17.07.2012; Machinery & Industrial Group N.V. may sell Promtractor Vagon, *www.iguru.ru*, 25.02.2013.

For example, the Yamal-Nenets Autonomous District became the holder of a 100% interest in Novy Urengoy United Air Group OJSC and Salekhard Airport. In the period till 2015 the Yamal-Nenets authorities intend to generate investments as part of public private partnership for comprehensive reconstruction, construction and upgrade of the air transport infrastructure of the airports at Novy Urengoy and Salekhard, at least Rb 4880.3m and at least Rb 2471.3m, respectively. The Rostov Region became the holder of a federally held interest (more than 38%) in Rostov on Don Airport OJSC¹. The regional government authorities intend to generate at least Rb 800m of investments as part of public private partnership for reconstruction of the airport airfield infrastructure facilities and at least Rb 15bn for construction of a new airport facility (Uyzhny) (exclusive of the airfield and facilities of the unified air-traffic management system) in Rostov on Don.

Besides the aforementioned transaction which was initiated by Rosneft, there were more examples of activity of partially state-owned companies in the market of corporate control that are worth noting. For example, Sberbank paid \$60m to acquire a 75% interest in the charter capital of Yandex Money. However, the amount seems to be miserable as compared to TNK-BP².

The regulations of the Russia's Government Decree dd. November 1, 2012, No. 1127 are intended to play an important role for regulation of public sector companies' activity in the market of corporate control.

Pursuant to the document federal executive bodies must till October 1, 2013 make amendments to the charters of open joint stock companies in which the state holds more than a 50% interest (save for credit institutions), which entitle the board of directors (supervisory board) of such OJSCs to determine the position of such OJSCs or their representatives when the management body of their subsidiaries or affiliated business entities considers the purchase of share holdings (participating interests in charter capital) in other business entities, also during their foundation, provided that the price of such transaction is at least 15% of the book value of the assets of a subsidiary or affiliated company as specified in the accounting records as of the latest accounting date. A similar regulation was also introduced with regard to business entities in which federal state unitary enterprises hold more than 50% of shares (participating interests in charter capital), where decisions to acquire an interest (participating interests in charter capital) in other business entities, also during their foundation, are subject to the approval of the board of directors (supervisory board) of such business entities.

Respective amendments were made to the Russia's Government Decree approved on December 3, 2004, No. 738, the 'Provision on the Management of Federally Held Interest in Joint Stock Companies and the Exercise of the Special Right (Golden Share) of the Russian Federation to Participate in the Governance of Joint Stock Companies', and the Russia's Government Decree dd. December 3, 2004, No. 739 "On the Authority of Federal Executive Bodies to Exercise the Ownership Right to the Assets of a Federal State Unitary Enterprise".

Furthermore, it was established that federal executive bodies' proposals as part of the drafting of instructions for state representatives in the board of directors (supervisory boards) of OJSCs with a state-held interest more than 50%, on the subject of acquisition by their subsidi-

¹ Furthermore, the region became the owner of the units and facilities at the Rostov on Don airfield (exclusive of the airfield and facilities of the unified air-traffic management system). The units and facilities of such airports as Bolshoye Savino (the Perm Territory), Novy Urengoy and Salekhard (Yamal-Nenets Autonomous District) were transferred to the region in the same manner.

² Kozlova N., Sberbank has found the "Money". – B: Profil, 01/2013, pp. 38-40.

aries or affiliated business entities of an interest (participating interests in the charter capital) in other business entities, also during their foundation, in the case when the Articles of a company reads that it shall be within the scope of the board of directors (supervisory board) of a joint-stock company to determine the position of the company or its representatives (when the management of subsidiaries or affiliated business entities considers the agenda of a general meeting of shareholders and a meeting of the boards of directors), must be presented with an explanatory note describing the reasons, as well as the materials required for decision-making in accordance with the established procedure.

6.1.4. Budget effect of the state property policy in the period between 2000 and 2012

Budget revenues relating to state-own assets continued to grow substantially in 2012, like in the preceding year. However, not all sources saw growth vs. 2010–2011.

It should be reminded that all federal budget revenues from state-owned property units 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).

Presented below (*Table 5 and 6*) 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 – 2012, with regard to the use of state-owned property units and sale thereof only in the form of tangible assets¹.

¹ No consideration was given to 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, 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 and other property converted into state income (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. Also see the notes to Tables 5 and 6 on the relevant periods.

Table 5

**Federal budget revenues from the use of state-owned property units
(renewable sources) in the period between 2000 and 2012, m Rb**

Year	Total	Dividends on shares (2000–2012) and revenues from other forms of capital participation (2005–2012)	Rental payments for state-owned land	Revenues from leasing of state-owned property units	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 ^c	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	14587.7 ⁱ	2480.3	–
2009	31849.6	10114.2	6470.5 ^h	13507.6 ⁱ	1757.3	–
2010	69728.8	45163.8	7451.7 ^h	12349.2 ⁱ	4764.1	–
2011	104304.0	79441.0	8210.5 ^h	11241.25 ⁱ	4637.85	773.4
2012	228964.5	212571.5	7660.7 ^k	3730.3 ^l	5002.0	–

^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 units secured to (i) research institutions, (ii) educational institutions, (iii) medical institutions, (iiii) public museums, public institutions of arts and humanities, (iiiii) archive institutions, (iiiii) Ministry of Defense of Russia, (iiiii) organizations under the Traffic Ministry of Russia, (iiiii) organizations providing services to public academies of science and (iiiii) other revenues from leasing of state-owned property units;

^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 units (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 units secured to (i) research institutions, (ii) educational institutions, (iii) medical institutions, (iiii) public institutions of arts and humanities, (iiiii) public archive institutions, (iiiii) federal postal agencies under the Federal Communications Agency, (iiiii) organizations providing services to public academies of science and (iiiii) other revenues from leasing of federally owned property units;

^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 units 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, (iiiii) public institutions of arts and humanities, (iiiii) public archive institutions and (iiiii) other revenues from leasing of property units which are operatively managed by federal government bodies and the institutions established thereby and on the basis of economic management by FSUEs¹ (for 2006–2009 net of overseas revenues from

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.

permitted types of activity and the use of federal property units located overseas, which were not shown in the previous years¹);

^j – revenues from leasing of property units 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, (iiiii) public archive institutions, (iiiii) on the basis of economic management by the Ministry of Defense of Russia and its subordinated bodies (2010), (iiiii) federally owned with functions of disposing thereof being assigned to the Department for Presidential Affairs of the Russian Federation (2010) and (iiiii) other revenues from leasing of property units 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 units located overseas).

^k – 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 and state-funded institutions), as well as (i) rental for land plots located right-of-way federal motor roads for general use, which are owned by the federal government, and (ii) payment from the implementation of agreements on easements concerning land plots located right-of-way federal motor roads for general use for the purpose of construction (reconstruction), over-haul and operation of road service units, laying, reallocation, rebuilding, and operation of engineering networks, installation and operation of advertisement constructions;

^l – revenues from leasing of property units 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) educational institutions, (iii) medical institutions, (iiii) public institutions of arts and humanities, (iiiii) public archive institutions, (iiiii) other revenues from leasing of property units which are operatively managed by federal state-run enterprises, (iiiii) federal government bodies, Bank of Russia, and agencies for public extrabudgetary funds management (net of revenues from the use of federal property located outside the Russian Federation, overseas revenues).

Source: The laws on the implementation of the federal budget for the period of 2000–2011, the Report on the Implementation of the Federal Budget as of January 1, 2013, www.roskazna.ru; the authors' estimates.

Proceeding to analysis of preliminary results of the budget effect of the state property policy in 2012 with regard to renewable sources, first of all, a drastic growth in dividends by 2.7 times against 2011 is worth noting, it was the biggest growth throughout the entire 2000s, except for a spike (by 4.5 times) in 2010 which was caused mostly by the low base effect in the preceding pre-crisis year (2009). Furthermore, in 2012, a growth of 7.9% in transfer of a portion of profits of unitary enterprises was the highest throughout the entire 2000s, whereas budget revenues from leasing of federal property units reduced by about 3 times and revenues from land lease reduced by 6.7%.

Revenues from property lease (Rb 3.73bn) were minimal against the record-breaking since 2000 values of dividends (Rb 212.6bn)² and transfer of a portion of profits of unitary enterprises (Rb 5bn), though land rent (Rb 7.67bn) was lower against the preceding year (2011)³ only.

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 Initially, government authorities were surprised by this value, because they expected something around Rb 150bn.

³ This value of land rent also includes the following items which were recognized in the budgetary reporting for the first time: (1) rental for land plots located right-of-way general-purpose federal motor roads which are owned by the federal government, and (2) payment from the implementation of agreements on easements concerning land plots located right-of-way general-purpose federal motor roads for the purpose of construction (reconstruc-

As a result, dividends accounted for the overwhelming part of federal budget revenues from renewable sources (about 93% against 76% in the preceding year), whereas other sources revenues accounted for rather token amount: land lease – 3.3%, profit transferred by FSUEs – 2.2%, leasing of federal property units – 1.6%.

Proceeding to the analysis of the federal budget revenues from privatization and sale of state-owned property (*Table 6*), it should be noted that since 1999 revenues from sale of a major part of such assets (shares, and also land plots in 2003–2007¹) became classified as sources of financing of the federal budget deficit.

Table 6

**Federal budget revenues from privatization and sale of property units
(non-renewable sources) in the period between 2000 and 2012, m Rb**

Year	Total	Sale of federally held shares (2000–2012) and other forms of interest holding (2005–2012) ^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 (HMA) ^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 (HMA) ^k
2005	41254.2	34987.6	5285.7 ^l	980.9 ^m
2006	24726.4	17567.9	5874.2 ⁿ	1284.3 ^o
2007	25429.4	19274.3	959.6 ^o	5195.5 ^p
2008	12395.0	6665.2+29.6	1202.0 ^e	4498.2+0.025 (HMA) ^r
2009	4544.1	1952.9	1152.5 ^q	1438.7 ^r
2010	18677.6	14914.4	1376.2 ^q	2387.0+0.039 (HMA) ^r
2011	136660.1	126207.5	2425.2 ^q	8027.4 ^r
2012	80911.3	43862.9	16443.8 ^q	20604.3+0.338 (HMA) ^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 units 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

tion), over-haul and operation of road service units, laying, reallocation, rebuilding, and operation of engineering networks, installation and operation of advertisement constructions.

Recognizing these items as land rent seems to be reasonable, because their source is land plots, whereas the previously recognized revenues from the use of motor road facilities, road toll payable by motor vehicles registered on the territory of other countries are classified as other revenues from the use of property and rights owned by the state.

However, as opposed to 2011, the structure of revenues from renewable sources of the federal budget has no revenues generated by Vietsovpetro in terms of calculation of revenues of prior years.

¹ In 2003-2004, given the sale of leasehold right.

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 units 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 units 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, (iiiii) from sale of other federally owned property, (iiiii) 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, (iiiii) 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, (iiiii) revenues from sale of other federally owned property classified as federal budget revenues;

^q – revenues from sale of 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 availa-

ble 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 2000–2011, the Report on the Implementation of the Federal Budget as of January 1, 2013, www.roskazna.ru; the authors' estimates.

In 2012, property-related federal budget revenues from non-renewable sources contracted by half to correspond approx. the value of 2004. First of all, revenues from sale of shares reduced drastically (2.9 times) and (Rb 43.9bn) were below, in absolute magnitude, not only the highest value of the preceding year (2011), but also the values of 2003–2004. According to the Federal Treasury's data on the implementation of the federal budget, budget allocations concerning this item were fulfilled by approx. 3/4.

Furthermore, revenues from sale of land plots increased a lot (6.8 times) to triple, in absolute magnitude, (more than Rb 16.4bn) the previous record values of 2005–2006. Revenues from sale of different types of property increased by 2.6 times (up to Rb 20.6bn) to overtop the previous maximum value of the preceding year (2011).

As a result, revenues from sale of shares accounted for more than 54% of total revenues from non-renewable sources in 2012 against more than 92% in 2011, whereas revenues from sale of land plots began to play a much more important role. The former accounted for more than 20% (against 1.8% in 2011), the latter – 25% (against 5.9% in 2011).

Total volume of the federal budget revenues from privatization (sale) and use of state-owned property units (*Table 7*) increased by 1.3 times in 2012 against 2011. Their value (about Rb 310bn) hit the absolute maximum since the beginning of the 2000s.

A share of non-renewable sources in total revenues from privatization (sale) and use of state-owned property units decreased by 2.2 times (to 26.1%) in 2011 against the preceding year, being similar to the value of 2006 and higher than in 2007–2010.

A share of revenues from the use of state-owned property units increased from 43.3% in 2011 to almost 74% in 2012. This value is maximum in absolute magnitude, exceeding by 2.2 times the total value in 2011, whereas revenues from privatization (sale) of property units decreased by approx. 40% against 2011, having reached its maximum throughout the entire 2000s.

However, according to the data provided by the Head of the Ministry of Economic Development and Trade in his report at the Russia's Government meeting on February 7, 2013, total revenues from property management amounted to Rb 433.6bn in 2012, of which revenues from privatization amounted to Rb 201.5bn.

One may assume that the latter represents the amount of revenues from sale of shares (Rb 43.9bn) classified as budget deficit sources of financing, and the revenues the Central Bank of Russia generated from sale of Sberbank shares, whose amount was calculated as the difference between the amount of revenues from the sale of the said shares (Rb 159.3bn) and their book value, net of sale costs of the said shares, were to be transferred to the federal budget by reducing accordingly a part of the revenues generated by the Central Bank of Russia at 2012 year end¹. The difference together with the data shown in *Tables 5, 6 and 7* also

¹ In this respect it should be reminded that a part of the revenues generated by the Central Bank of Russia, which is to be transferred to the federal budget, is registered on the revenue side of the budget, in the property management item. According to the Federal Treasury data on the implementation of the Federal Budget as of Janu-

may result from accounting budget revenues from a bigger spectrum of sources with regard to the use of state-owned property.

Table 7

**Structure of federal budget property-related revenues from various sources
in the period between 2000 and 2012**

Year	Total revenues from privatization (sale) and use of state-owned property units		Revenues from privatization (non-renewable sources)		Revenues from the use of state-owned property units (renewable sources)	
	millions of rubles	% of total	millions of rubles	% of total	millions of rubles	% 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	240964.1	100.0	136660.1	56.7	104304.0	43.3
2012	309875.8/ 469175.8*	100.0	80911.3/ 240211.3*	26.1/ 51.2*	228964.5	73.9/ 48.8*

* – inclusive of the revenues the Central Bank of Russia generated from sale of an interest in Sberbank (Rb 159.3bn), which together with a total share of non-renewable sources is probably slightly overestimated, because it was transferred to the budget net of books value and total sale costs. Therefore, a share of renewable sources is probably underestimated.

Source: The laws on the implementation of the federal budget for the period of 2000–2011; the Report on the Implementation of the Federal Budget as of January 1, 2013, www.roskazna.ru; the authors' estimates.

However, given the revenues generated from the sale of an interest in Sberbank through the Central Bank of Russia, a share of non-renewable sources in total revenues from privatization (sale) and the use of state-owned property units, which accounted for about 51% in 2012, is smaller than that in 2011 (56.7%).

6.1.5. A New State-Owned Property Management Program

A national program of the Russian Federation adopted by the Russia's Government Order of February 16, 2013, No. 191-r, "Federal Property Management", was the most important event having an impact on the entire spectrum of ownership relations in the country.

According to the Head of the Ministry of Economic Development and Trade who made a presentation of the draft program at the Russia's Government meeting on February 7, 2013, this document offers a new federal property management concept as a replacement for the existing Concept of State-Owned Property Management and Privatization of 1999, the system of actions and measures, including respective key performance indicators and budget of the program, as well as sub-programs on state-owned tangible assets reserve management, provided for by the Concept of 1999.

The publication procedure for this document is worth noting from the technical legal point of view. Unlike the Concept of 1999 whose text was published in full in the Consultant Plus system, the Russia's Government Order dd. February 16, 2013, No. 191-r instructed the Min-

ary 1, 2013, revenues from the transfer of a part of the revenues generated by the Central Bank of Russia amounted to about Rb 166bn against Rb 153.1bn in 2011.

istry of Economic Development and Trade to post only those parts of the said program which contain neither information constituting State secrets, nor classified inside information on its official website and the Internet portal for public programs.

The version of the new national program posted by the Ministry of Economic Development and Trade has some references to the Concept of 1999, but provides no information about the new concept of federal property management¹.

Two subprograms are to be implemented to accomplish the set goals and tasks as part of the national program:

1. Enhance the effectiveness of federal property management and privatization;
2. Ensure the management of the state-owned tangible assets reserve.

The latter is more related to information constituting State secrets and classified inside information, thereby classifying the information substantiating financial resource volumes concerning the management of the stat-owned tangible assets reserve.

The national policy concerning the management of federal property, which was developed on the basis of this national program, is intended to accomplish the following objectives:

- ensure an unambiguous definition and formation of a complete composition of federal property required for federal government bodies and subordinate federal agencies to perform their public functions;
- create an efficient federal property management system to ensure, in accordance with the functions of federal government bodies, the development of tools to assess the demand and need for managing certain property units, as well as procedures for including and excluding them from the list of units subject to management;
- provide an effective assignment (disposal) procedure for marketable federal property for commercialization;
- create an efficient accounting and monitoring system for federal property within the unified federal property management system.

With regard to the content of the new national federal property management program, it proceeds, like almost all of the previous property-related government programs did, from the need to reduce as much as possible state participation in the economy.

However, unlike most of the previous documents, the program provides the following reasons for that. The state is overloaded with surplus assets; corruption; budget overrun, with budget funds being spent to maintain useless property units, rather than the time-worn thesis, which was delicately put aside, about ineffectiveness of the state as economic agent.

That being stated, two principal lines in the enhancement of federal property management were highlighted: asset assignment (disposal) management (improve the effectiveness of the state as seller of assets) and the management of property units retained in state ownership. A great advantage of the national program is that it provides for a stand-alone line of management of potential risks that may occur during the implementation of the national program, as well as upgrade to a new technological level in terms of accounting and monitoring.

Let us focus on the key indicators of the new national program, rather than get into details.

First of all, a target function will be assigned to every federal property unit, and disposal of assets will take place if such function is not determined.

It must be completed with regard to all FSUEs by 2018 at the latest (given the allocation of extra funds in 2015), with regard to state-owned business entities by 2018 at the latest, with

¹ In any case, the Concept of 1999 has not ceased to be in force to date.

regard to 15% of FSEs by 2018 (given the allocation of extra funds in the same year, but to the full extent), with regard to 30% of state-run enterprises by 2018 (given the allocation of extra funds in the same year, but 90%). Application of management goals to each of the aforementioned entities also provides for their recognition in the unified system of federal property accounting and management.

This is supported by quantitatively fixed plans on annual reduction in the number of state-owned JSCs and FSUEs, as well as the area occupied by state-run land plots (except for land plots withdrawn from economic turnover and of limited transferability) which are not involved in economic turnover, and other state-run property units (exclusive of property units to be transferred to the public purse as a result of privatization of FSUEs in the period between 2013 and 2018) to these indicators in 2012. The four indicators are going to be included into the Federal Statistical Efforts Plan.

The following must be accomplished by 2018. Unitary enterprises operating under full economic jurisdiction will cease to exist, the number of state-owned JSCs will be reduced by a decade (more than 10 times)¹, the number of state-run property units (save for land plots) will be reduced by 90%, the area of state-run land plots not involved in economic turnover will be reduced by 35% (subject to allocation of extra resources and financing of land marking and cadastral registration of land plots under the items of expenses provided for the maintenance of the Russian State Register).

Eighty percent of all federal property units (a share of registered property units in the total number of identified and subject to registration property units) must be registered beginning with 2014.

In addition, the following must be qualified as key indicator:

- by 2018, an increase in and stage-wise doubling of an interest in partially state-owned companies which are publicly traded in the Russian securities market (increase in the number of state controlled open joint stock companies listed in the Russian securities market);
- ensure competitiveness, investment potential, and publicity of partially state-owned companies by 2018 (ensure that the specified companies achieve key performance indicators comparable with the world benchmark companies);
- achieve budget performance indicators on revenues from the use and sale of federal property.

Beginning with 2013, at least four purchase and sale transactions with large investment-attractive property units are expected though public offering (of such property units envisaged for sale in the decisions of the President of Russia and/or the Government of the Russian Federation in the current year) (stock market transactions and strategic sales). Performance indicators are expected to be achieved through budget appropriations to pay for investment and financial advisors' services provided for pre sale preparation and sale of joint stock companies' share in 2013–2015, a total of Rb 5bn annually (in accordance with the Federal Law dated December 3, 2012, No. 216-FZ "On the Federal Budget for 2013 and for the Planning Period of 2014 and 2015")².

¹ However, judging by the estimates provided in the attachments to the program, such a scenario can be realized only through additional financing, otherwise the number of unitary enterprises and State-owned JSCs would reduce 57% and 52%, respectively, by 2018.

² The foregoing budgetary appropriations are assigned to the Ministry of Finance of Russia, and under the consideration protocol of the list of unagreed subject matters concerning allocation of maximum amounts of budget-

The planned amount of revenues from privatization for 2012–2016 totals about Rb 3 trillion and exceeds the revenues from privatization generated over the last 18 years.

From the organizational and technical point of view, enhancement of the effectiveness of state-owned property management means the following. (1) Ensure an IT-based end-to-end accounting and control of all management processes and procedures at any stage and level, including territorial agencies; (2) ensure information transparency of the work performed by the Federal Agency for State Property Management through public access to the data on registered federal property units based on their inventory as the basis for generating complete and reliable information on managed property units; (3) define and assign areas of responsibility to every employee of the Federal Agency for State Property Management; (4) establish a special internal audit unit within the Federal Agency for State Property Management to ensure the implementation of compliance controls of approved regulations, processes, and procedures.

A key indicator of the national program with the regard to the foregoing is full transition to electronic information flows by 2018: all public services must be provided electronically, while legally valid e-document flow between the Federal Agency for State Property Management and its territorial branches with government agencies must account for 99%. This will allow the required level of transparency and controllability of all processes.

Legal support to the program provides for the adoption of more than 25 legal acts within five years to come, including amendments to the federal laws on privatization of state municipal property, on state registration of the rights to real property and transactions therewith, on unitary enterprises. The Ministry of Economic Development and Trade plans to perform additional work on accounting and management of intangible assets in the Russian Agency for Patents and Trademarks.

Though the new conceptual document is quite ambitious, it has the following major issues which may be encountered during its implementation.

First, property units whose target functions are not determined will be automatically included into the privatization program after January 1, 2015. Therefore, federal executive bodies would have to assign such functions for the assets they manage prior to the foregoing date.

On the one hand, this approach may encourage public authorities to retain as many property units as possible, and create an additional motivation for the management of subordinate enterprises and agencies to withdraw assets and gain private benefits from control in view of uncertainty about their positions.

However, public authorities may acquire a far more negative behavior, when the primacy of using the departmental approach in determining a target function of state-owned property would be based on a plane interest in exclusively socio-cultural and household-purpose units which are involved in servicing the management of specific public authorities and their personnel, rather than the interests of the state and national economy at large.

A big problem is to adequately determine a target function for each of the units in the state-owned property portfolio. The multipurpose nature of a series of state-owned assets must be taken into account.

ary appropriations for 2013 and the Planning Period for 2014 and 2015 on the Ministry of Economic Development and Trade of Russia (SPB 68) of August 16, 2012, the question of payment for the services of investment advisors will be considered by the Ministry of Finance of Russia according to the established procedure subject to a decision of the President of Russia or the Russia's Government.

On the other hand, the proposed approach may increase the volume of property units which may be potentially privatized in 2–3 years. Unavoidably, it raises the question of setting concrete dates and options of privatization, given the market conditions and demand for assets possessing a lot of specific features. Appearance of a great deal of extra property in the market would lower prices of assets for sale, being critical against the priority of budget approach towards privatization.

Extremely advisable is elaboration of potential effects of privatization based on its expedience, comparative economic and allocative efficiency of the public and private sectors, opportunity costs, potential risks and impact on the development of specific markets, industries, regions, and the national economy at large.

Second, though the new national program proclaims transformation of privatization for being used as a tool for fundraising to develop and upgrade state-owned enterprises and create new jobs, develop competition and markets by reducing state participation in the economy, involving property in economic turnover, it lacks any indicators for the achievement of these goals.

In the light of these facts, a lot of raised eyebrows is caused by mentioning in the assessment the planned effectiveness of the program as expected final results and socio-economic effects contribution to modernization of the Russian economy, creation of conditions for the mass emergence of new innovative companies in all economic sectors, structural diversification of the economy based on the innovative technological development. The same is the case for the quality of corporate governance.

Mentioning post-privatization monitoring and follow-up of the results of the development of property units which became private has no reference to any legal and organizational arrangements of such actions. In spite of all the negative aspects revealed during investment tenders in the course of privatization in the 1990s, no question has been risen of control enforcement and adequate sanctions against mala fide purchasers of state-owned assets. A federal special follow-up monitoring makes sense only to the extent that the state has adequate possibilities to influence new owners. So far, one can see lack of monitoring of the development even those enterprises and JSCs which were previously in the list of strategically important enterprises, i.e. there were officially recognized as important ones¹.

However, this aspect of privatization raises a more fundamental question about a degree of priority of the ownership right itself against other provisions, in particular when there is a lot of talking about the state putting a pressure on businesses, an ideal model of relationship between the state and the business comes down to timely tax payment and compliance of sanitary, environmental, and some other similar legal requirements by the latter.

Third, the provided therein rates of reduction in the number of state-owned JSCs and FSUEs are not substantiated whatsoever either from the perspective of final assessment of the number of such economic agents which would allow public functions to be performed and the state to play an adequate role in the economy, or from the point of view of engagement of any concrete mechanisms of state asset management (different types of unitary enterprises, an interest of any value in the charter capital of business entities (JSCs and LLCs), entitlement to a special right (golden share), forms of incorporation which are formally related to non-profit

¹ Left aside was the issue relating to the effect of the previous privatization on most of industries and production entities with an overwhelming share held by private owners, but being far behind other countries in terms of effectiveness or failed to recover from the effect of transformation-related recession (these are mostly secondary industry and research sector enterprises).

entities (public corporations and partially state-owned companies, stand-alone agencies and non-profit organizations)).

The focus on non-existence of unitary enterprises operating under full economic jurisdiction by 2018 (while ignoring this form of incorporation in general) would unavoidably result in retaining state-run enterprises whose obligations fall under subsidiary liability of the state. Neither is considered the aspect of comparative performance of transformation of unitary enterprises to other forms of incorporation in accordance with the selected type of legal entity (limited liability companies, stand-alone non-profit organizations, stand-alone agencies). A series of examples (e.g., Oboronservis JSCo) show that the OJSC status itself neither guarantees a better safety of property units, nor ensures in full government interests vs. a unitary enterprise.

Fourth, it is provided thereby to reduce to 30% a share of public sector employees in management and control bodies at partially state-owned JSCs beginning with 2014¹, as well as their concentration in audit committees being the weakest and mostly token corporate departments in the Russian practice. The participation of public sector employees has a very weak effect against the refusal to use directives as a control tool for the state as shareholder. However, it is the audit committees where specialists with specific knowledge and solid experience in auditing, accounting, etc. are in high demand.

Being regarded as an alternative, the institution of professional directors which are suggested to be engaged in management bodies of subsidiaries and affiliated entities of vertically integrated holdings and enterprises in the military defense sector (in addition to the existing practice) is not a plaster for all scores in performing corporate governance procedures.

Furthermore, reasoning from the formal primacy of financial considerations, a public sector employee representing the state interests is more independent, because he/she is not entitled to be paid directly by a company. In spite of all negative aspects relating to representation of state interests by public sector employees, it is quite clear what spectrum of sanctions they may be subject to (disciplinary penalties, deprivation of incentive payments to a basic salary, dismissal from work, disqualification with prohibition to certain occupations), whereas in case with independent directors there is an unavoidable question of adequacy of their reputational responsibility, and a possibility of making them subject to statutory provisions on asset and income disclosure on a mandatory basis.

Furthermore, according to deputy prime-minister Dvorkovich A., withdrawal of public sector employees – senior managers – from boards of directors would create a clean vacuum in the interaction between companies and government agencies, giving rise to the need to arrange an alternative mechanism to align positions, because on-going interaction, regular meetings, consultancies on elaboration of positions are vital for effective governance of partially state-owned companies.²

Fifth, according to the data provided by the Head of the Ministry of Economic Development and Trade, the current scale of state-owned assets at the federal level is much smaller than in 1999 by all categories of legal entities: more than 2,300 joint stock companies against about 3,900 (a reduction of 40%), about 1,800 state unitary enterprises against almost 13,800 (a reduction of 7.7 times), 20,200 agencies against 23,100 (a reduction of 12%), respectively. Thus, the trend towards quantitative reduction in volumes of state-owned property was devel-

¹ Except for those operating in the military industrial sector or relating to the national defense.

² Public officials withdrawal from state-own companies requires a new type of interaction, 07.02.2013, RIA-Novosti – Ekonomika.

oping anyway without taking a goal-oriented approach towards assets. However, a question of the quality and effect of privatization in the 2000s was left aside. However, no critical analysis of this subject matter is available in the new national program.

This is not to say that the volume of financial resources envisaged for the implementation of the national program looks very impressive: a total of Rb 33.4bn of federal budget funds for 2013–2018¹, while a total of Rb 19bn as additional financing is provided for by the national program if new additional opportunities emerge in the federal budget. The amounts of extra financing in 2013–2018 of liquidation (Rb 6bn) and maintenance (Rb 6.9bn)² of most hazardous state-run enterprises looks fairly small thereby contradicting one the basic concepts of the new national program, about the state encumbrance on surplus assets and substantial budget overruns.

The foregoing amount of budget allocations is comparable with the decade-old total federal budget revenues from privatization (sale) and the use of state-owned property (2000–2002) or in the crisis-hit 2009, let alone the government revenues in the previous year or the government expenditures on the implementation of prestige projects (APEC summit, Olympic Games in 2014, etc.).

6.2. Antimonopoly policy in Russia in 2011–2012: after the ‘Big Four’ case³

Both antimonopoly policy and competition protection have steadily been making the top-list of economic policies over the last five years, as is evident from a series of rounds of antimonopoly investigations against the largest oil companies; rapid growth in application of legal regulations against parties to agreements classified as collusion; emergence of billion-ruble penalties; widespread application of regulated sales practices for the largest companies as a condition for approving M&A deals and rectifying detected violations of the antimonopoly legislation.

Lively discussion of a report on competition made by the Federal Antimonopoly Service of the Russian Federation (the FAS Russia) in 2012 is an evidence of how important antimonopoly policy and competition protection are. The report was given much more attention than any of

¹ A total of Rb 103bn of financing till 2018 was provided for by the draft national program which was published late in January 2013. However, this amount seems to be very moderate.

According to the Head of the Federal Agency for State Property Management, the difference can be explained by the availability of a second subprogram on public tangible reserve in the structure of the national program, whereas the amounts of expenditures presented at the Russia’s Government meeting on February 7, 2013 are related exclusively to the activity of the Federal Agency for State Property Management.

² In addition, about Rb 0.9bn of the total additional financing may be allocated to complete the paperwork concerning technical inventory, registration of proprietary rights, and cadastral registration of land plots as part of the corporatization of unitary enterprises.

³ In the fall of 2008, the FAS Russia instituted legal proceedings against the Big Four oil companies (Gazprom Neft, LUKOIL, Rosneft, TNK-BP), in which new legislative concepts (collective domination concept and high monopolistic price determination), and new turnover-based fines were introduced. Under the foregoing cases the FAS Russia imposed fines of Rb 5.4bn on the Big Four, and fines of Rb 20.7bn under other cases which were further initiated in 2009. Afterwards, the FAS Russia’s rulings were disputed at different courts. However, the scales were weighted in favor of the FAS Russia by a ruling of the Supreme Arbitration Court on the TNK-BP case (in May 2010). A ruling to develop an amicable agreement (in September 2010) proved that the FAS Russia gained weight among government authorities, being able to employ the antimonopoly legislation tools to fulfill current tasks of the economic policy. See C. Avdasheva S., Kryuchkova P. For absence of evidence. Expert. February 14, 2011.

the previously issued documents; years-lasting heated discussions of the application of the law on government procurement; definitely landmark discussion and adoption of the law on trade.

In addition, a Commission for the Promotion of Competition and Small- and Medium-Sized Enterprises was established under the auspices of the Russia's Government, the Competition promotion Program (2009–2012) was given an intensive discussion, and the Competition Promotion Road Map and the Strategy for the Development of Antimonopoly Policy in Russia, whose development was initiated by the FAS Russia, were developed and adopted.

This review will focus on the events that took place over the last few years (above all, in the period between 2011 and 2012). This period was characterized by that a general scheme of counteracting monopoly practices (first of all, abuse of dominance) employed by the largest oil companies was defined. Furthermore, new material amendments were made to the antimonopoly legislation, and evidences for conclusions on the evolution of the Russian anti-trust emerged.

6.2.1. General Characteristics of antimonopoly legislation application

Scope of enforcement rules

The court rulings on the Big Four cases triggered an increase in the number of antimonopoly law enforcements, as can be evidenced in the statistics on three articles of the Federal Law “On the Protection of Competition”¹ (Table 8). Total number of cases initiated against companies under three types of cases, namely abuse of dominance; competition restraining agreements and concerted actions; unfair competition almost doubled in the period between 2008 and 2011. Furthermore, a share of cases which ended up with court rulings on violation of the antimonopoly legislation increased too.

The number of cases initiated by the FAS Russia together with its territorial offices is bigger than that of cases initiated by any other government agency involved in the competition policy in other countries. In 2001², the FAS Russia's headcount totaled 3079 persons. To compare: the headcount of two US government agencies, Federal Trade Commission and Antitrust Division, Department of Justice, was 1744 persons. The headcount of the Australian competitive policy agency, which is well-known by wide terms of reference and high activity, totaled 915 persons. The European Committee for the Application of Antimonopoly Legislation comprised 749 employees.

Table 8

Number of initiated cases and court rulings on violation of antimonopoly legislation by article of the Federal Law “On the Protection of Competition”, 2008–2011

	Number of initiated cases				Court rulings on violation			
	2008	2009	2010	2011	2008	2009	2010	2011
Abuse of dominance (Article 10)	1639	2411	2736	3199	862	1439	1539	2310
Agreements and concerted actions (Article 11)	359	488	607	482	183	293	376	315
Unfair competition (Article 14)	517	687	927	1065	303	476	754	828

Source: FAS Russia's data.

¹ The Federal Law dd. 26.07.2006, No. 135-FZ “On the Protection of Competition”. A comprehensive analysis of the antimonopoly legislation enforcement practice also must reflect the application of other articles of the Federal Law “On the Protection of Competition”, as well as antimonopoly regulations provided for by many other laws, including sectoral laws.

² Rating Enforcement 2012. Global Competition Review, 2012.

However, most impressive is the number of initiated and closed cases against abuse of dominance. In 2011, the FAS Russia initiated 3197 and completed 3199 investigations, whereas competitive policy agencies in other countries initiated a maximum of 106 such cases (Ireland). To compare, the European Committee initiated 54 such cases, the Australian competitive policy agency initiated 21 cases. Thus, every employee of the FAS Russia had more than one case under Article 10 of the Federal Law “On the Protection of Competition”, being 15 times less than in the EC and 45 times (*not percents!*) less than in Australia.

Observation of the antimonopoly legislation became more important for Russian companies after the fixed fines were replaced with turnover-based fines in 2007. The Big Four cases showed, among other things, not only potential possibility, but also real capability to collect substantial fines and issue instructions to restrict substantially business decisions. To date, however, an average amount of fines imposed by the FAS Russia remains low. The amount of imposed fine was reduced from Rb 16.5m in 2009 to Rb 2.3m in 2010, and Rb 4.5m in 2011 as per ruling on violation under Articles 10 and 11 of the Federal Law “On the Protection of Competition”. Virtually, it reflects rise and fall of (first, second, and third) ‘waves’ of oil cases. Amounts of fines are normally not so hard outside the Big Four. However, inflow of cases disputing antimonopoly authorities’ decisions in arbitration courts has been increasing (*Table 9*). Looking at the ratio of FAS Russia’s decisions on violation to claims against non-regulatory acts (i.e. rulings on specific cases), as well as decisions on imposition of administrative sanctions, one may infer that companies dispute an overwhelming number of antimonopoly authorities’ decisions¹. High level of competitiveness of arguments of parties to court cases is represented by the number of cases filed to courts of appeal and cassation. First instance arbitration courts have dismissed about two of five antimonopoly authorities’ decisions over the laws few years (*Table 9*). Half of first instance arbitration court rulings refer to appeals; disputes on one in three decisions are admitted in court of cassation. Arbitration courts’ rulings play an important role in the development of standards for the application of the Federal Law “On the Protection of Competition”.

Table 9

Decisions on violations and claims against antimonopoly authorities’ decisions, 2009–2011

	Decisions on violations of Articles 10 and 11		Claims against antimonopoly authorities’ decisions in first instance arbitration courts of the Russian Federation			
	Amount of imposed fines, billions of rubles	Number of decisions	Claims against non-regulatory acts	Including satisfied claims	Claims against decisions on administrative sanctions	Including satisfied claims
2009	28.5	1731	2657	1057	1624	848
2010	4.6	1969	3770	1390	2185	1039
2011	11.7	2625	4334	1709	2511	1049

Source: FAS Russia and Supreme Arbitration Court of the Russian Federation.

The scale of application of regulations under other provisions of competition legislation is growing. Counteracting competition restraints imposed by government agencies (Article 15 of the Federal Law “On the Protection of Competition”) remains the most important. In 2011,

¹ Obviously, direct comparison of the number of decisions on violation under the provisions relating to economic agents with the number of claims against antimonopoly authority’s decision should be interpreted carefully. Not only decisions against companies are disputable; however, in our opinion, it is corporate claims that account for an overwhelming part of disputes considered in arbitration courts.

5,800 cases were initiated against government authorities against about 3,000 in 2008. A share of detected violations in these cases increased from 68 to 87%. The number of government procurement checks has steadily been increasing (*Fig. 1*).

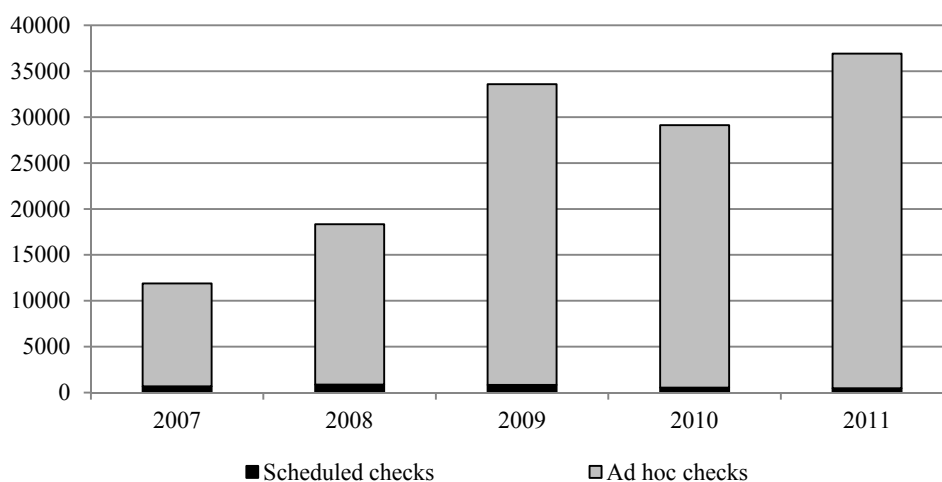


Fig. 1. Number of checks performed in the course of monitoring of compliance with the law on government procurement, 2007–2011

The number of cases on violations of the Federal Law “On the Framework of State Regulation of Trade in the Russian Federation” retail food store chains”¹ has been growing at the same rates as the number of cases on violations of antimonopoly legislation. About one fourth of all retail food store chains operating in the country underwent such checks in the year when the Law was adopted.

Developing antimonopoly prohibition standards in court rulings

Antimonopoly policy comprises, among other things, various antimonopoly authorities’ decisions and court rulings which have as much effect on companies as legislative innovations. It is hard analyze, let alone generalize, such decisions and rulings. First, key decisions are sector-specific, e.g., exporters are less concerned than retail networks about outcomes of discrimination cases, whereas the latter pay less attention to issues relating to monopolistically high prices. Second, court rulings on the same subject matter may differ largely. They may support the position of antimonopoly authorities in some cases, whereas contradict it in others. Furthermore, even single-type cases may be subject to decisions relying on polar concepts. Following are a few examples.

Abuse of dominance: domestic market and exports. In 2011 thru 2012, a few important court rulings were issued on cases where large sellers-exporters were accused of abuse of dominance by setting monopolistically high prices in the domestic market or discriminating (by setting different prices in the domestic and external markets) domestic consumers. Basically, it began from charges against the ‘four oil companies’ collectively dominating in the market. The conclusion about monopolistic oil prices in the period between 2007 and 2008

¹ Radayev V. Who gained from trade law adoption. *State and Municipal Governance Issues*, 2012, No. 2, pp. 33-59

was based on the two arguments, namely wholesale prices grew at a faster rate (or fell at a slower rate) than manufacturers' costs (according to their book records); wholesale prices grew at a faster rate than global oil prices in the period of growth and fell at a slower rate in the period of decline.

Thus, the FAS Russia addressed the issue being faced in the market where large corporate exporters operate. Considering exports as priority and encountering a more intensive competition in export markets, companies often set lower prices for foreign buyers than for domestic ones. It is difficult to tell to what extent such price-related decisions can be treated as violation of the antimonopoly legislation. Recognition of such a combination of prices as discrimination (in the language of the Federal Law "On the Protection of Competition" – 'creation of unequal conditions') relies indirectly upon the buyer identity approach, which is wrong in general. Recognition of higher prices in the domestic market as monopolistically high prices, because they are higher than foreign markets' prices, is also a disputable conclusion, because markets can hardly be so comparable as to allow prices to be compared directly.

Arbitration courts' rulings on these issues may differ drastically. In October 2012, the Supreme Arbitration Court of the Russian Federation (SAC) dismissed by way of supervision a review of the case on a claim filed by Rapsdsky Ugol LLC, which was closed in the preceding year. The Moscow Arbitration Court stated in the analytical part of the case that since different prices of soldering coal in Russia and abroad are governed by the specifics of such markets, they can't be regarded as a sign of discrimination. However, in the summer of 2012, under the claim of Novolipetsk Steel OJSC and VIZ-STEEL LLC the same court confirmed the validity of the FAS Russia's conclusion on that excess prices of transformer steel for domestic buyers vs. export prices is indicative of monopolistically high prices in the domestic market¹.

In the long run, the issue of legality of domestic prices exceeding prices of export contracts remains to be discussed. The antimonopoly authority believes that solution can be found by developing methodological recommendations on fair (or substantiated) prices directly linking the acceptable level of prices in the Russian market to prices in foreign markets. Without going into details about numerous methodological issues relating to the application of such approach, it should be noted that any form of price regulation including, but not limited to pegging domestic market prices to a benchmark is exposed to risks. In this case, one of such risks – weaker incentives for exporters to participate in competition of supply prices. If it is assumed, directly or indirectly, (e.g., like as part of an ordinance developed by the FAS Russia for URALCALI OJSC) that prices for Russia's buyers must be higher than the lowest export price, active price competition in exports would be less advantageous for the buyer. The stronger is this effect, the higher is a share of domestic supplies in exporter's output.

Concerted actions: parallel pricing and similar structure of agreements. In 2012, courts of different instances kept considering so called 'buckwheat cases'. Courts in Kazan and St. Petersburg dismissed (Tander, Perekryostok, Agrotorg, Pik in the case of the former; Perekryostok, Agrotorg, Dixi, Real, O'K in the case of the latter) the claims filed by retail food store chains to reverse decisions recognizing them as parties being involved in concerted actions of simultaneous rise of prices of buckwheat in the summer of 2010. Superior authorities dismissed the claims and upheld the foregoing decisions: the SAC rejected by way of supervision the St. Petersburg case, court of cassation remanded the Kazan case to the first instance court which upheld the decision on concerted actions as early as the beginning of

¹ However, in March 2013, the cassation authority remanded the Novolipetsk Steel and VIZ-STEEL case.

2013. These decisions proved low standards of evidences of tacit collusion¹. One-way changes in prices are regarded as a sufficient evidence of committed violation. No question of the mechanism of maintaining relationship between sellers' decisions was brought up, thereby allowing both large and small sellers to be accused of applying the 'price umbrella' model. The foregoing decisions contradict the concept of the amendments and restatements made to the Federal Law "On the Protection of Competition" on December 2011, which tightened the standards of proof of concerted actions.

Nevertheless, not all of the charges of concerted actions against sellers were upheld in court. In the summer of 2012, the Kazan Arbitration Court dismissed FAS Russia's decision on violation of the antimonopoly legislation by retail household appliances and electronics chains Media Markt, Ashan, Eldorado, Beringov Proliv for having used a similar standard structure and terms and conditions for agreements with suppliers, thereby leading to retail price maintenance. At least two aspects of this court ruling are important for the development of standards for different cases: the court ruling provides the assessment of relationship and interaction of the policy pursued by the selected group of market participants and takes account of alternative explanations concerning the non-infringement data provided by the FAS Russia.

Discriminative terms and conditions in agreements concluded between retail chains and suppliers. In 2011–2012, court rulings concerning cases on discriminative terms and conditions in agreements concluded between suppliers and retail food store chains (pursuant to Article 13 of the Federal Law "On the Framework of State Regulation of Trade in the Russian Federation") were issued mostly in favor of retail chains. First instance arbitration courts dismissed several dozens of decisions made by territorial offices of the FAS Russia, which recognized different mark-ups, different payment dates, different bonus schemes for volumes in agreements with different suppliers as discriminative. However, different legal motives for the differences in contractual terms and conditions were provided²:

- different suppliers or their products are recognized as nonequivalent;
- a provision on the need to compare a set of contractual terms and conditions rather than specific components thereof (if one supplier offers a higher wholesale price vs. other supplier, 'net' prices may be found equal);
- assessment of potential effects of the nondiscrimination standard (competition depression – market participants would look for a supplier who accepts the same terms and conditions accepted by the others, rather than for the best supplier.).

Decisions on a series of discrimination cases were upheld in judicial instances, including the Supreme Arbitration Court of Russia who dismissed a standard case by way of supervision in the summer of 2012. However, discrimination cases relating to different terms and conditions in agreements with different counterparties keep being initiated not only against retail food store chains, but also suppliers. The most odious of such cases seems to be a case against Penza Dairy Factory for the discrimination of Ashan and Perekryostok by offering them a resale discount which was less than that for regional retail food store chains.

¹ For details about the issue of tacit collusion and application of antimonopoly prohibition of tacit collusion see: Avdasheva S. Tacit collusion illegality in Russia's antimonopoly legislation: Can economists help develop legal rules? *Voprosy ekonomiki* 2011, No 5, p. 89–102.

² See for details: Avdasheva S., Novikov V. Fox and crane: Paradoxes of discrimination. *Konkurentsia i pravo*, 2012, No. 1, pp. 22-27.

However, a discussion about the definition of discriminative terms and conditions in agreements and discrimination proof standards may take up a lot of time. Uncertainty in this issue creates more legal risks for companies who intend to develop ‘sales practices’ as rules for interaction with counterparties.

Combating negotiation leverage misuse: from retail chains to national car distributors. Cases which are intended to settle contractual practice in specific industries account for a substantial part in the activity of the FAS Russia. The Federal Antimonopoly Service of Russia keeps using recommendations firstly as a tool to combat negotiation leverage misuse. In the fall of 2012, recommendations for carmakers and national distributors were developed. FAS Russia’s proposals whose observation is logically should be considered as the condition for a business practice to be recognized as legal, include setting standard terms of dealer agreements of at least five years with a view to ensuring return on dealer’s investments, making it possible to open different types of dealer centers (including, but not limited to those who only seller or only provide maintenance service), refusing to set a minimum resale price.

Carmakers and national distributors were recommended to develop a document describing unified requirements to counterparties, and prevent discrimination in agreements with different types of dealers and maintenance centers. It is hard to assess subsequent developments in the industry. One only may acknowledge that the foregoing recommendations do create more constraints for carmakers’ business. Whether these are going to be tight or not, also depends on how the foregoing nondiscrimination principle would be interpreted on a case by case basis.

6.2.2. “Third antimonopoly laws package”¹: before and after

A package of amendments to the antimonopoly legislation was adopted late in 2011, which covered a wide spectrum of relations regulated by the Federal Law “On the Protection of Competition”, as well as a series of other regulatory legal acts. Making no pretence to describe all of these amendments to the Russia’s antimonopoly legislation, let us highlight a series of new aspects including a substantial restatement of the previously applicable regulations as follows:

- additional conditions under which a price can’t be recognized as monopolistically high price;
- changes in the wording and a set of concerted action signs;
- criteria for identifying a group of persons and the monitoring concept;
- introduction of the ‘cartel’ term as a legal term, reduction of the list of cartel signs against the signs of competition restraining agreements;
- consecutive distinguishing between collusions and concerted actions (introduction of different law provisions, such as Articles 11 and 11.1, prohibiting agreements and concerted actions, respectively);
- acceptance of horizontal agreements on cooperation;
- introduction of an exception for agreements relating to the use of intellectual property;
- adjustment to regulation of vertical agreements;

¹ The adoption of the Federal Law dd. 06.12.2011, No. 401 “On the Amendments to the Federal Law “On the Protection of Competition” and Certain Legislative Acts of the Russian Federation and the Federal Law dd. 06.12.2011, No. 404-FZ “On the Amendments to the Administrative Offences Code of the Russian Federation” (the so-called ‘third antimonopoly package’) intended to enhance the antimonopoly regulation, became a significant event in 2011.

- trading requirements, quotation requests, and auctions;
- introduction of caution and warning institutions;
- further modernization of monitoring of economic concentration transactions.

Monopolistically high price

An attempt was made in the ‘third antimonopoly package’ to create a ‘safe harbor’ for market dominating entities, which may be accused of setting monopolistically high prices, through amendments to Article 6 of the Federal Law “On the Protection of Competition”. The price at which an economic agent sells goods through over-the-counter trading must not exceed the price indicator. A option of such indicator is the stock trading price of certain goods. However, trading itself must meet certain conditions so that the stock trading price may be recognized as an acceptable indicator. It means not only requirements to participants’ sales volumes and the number of trading participants, but also frequency and efficiency of distribution of volumes among trading sessions, minimum size lots, initial pricing specifics approved by antimonopoly authorities.

One of the reasons for the introduction of this regulation is that antimonopoly authorities had to rely on an single criterion – economically feasible costs and profit required for production – to qualify the actions of entities dominating in respective commodities market as abuse in the form of monopolistically high price. Furthermore, costs and profits were assessed on the basis of a book-keeping approach which prevailed over the economic approach, as the latter not only underestimates a total level of cost included into the price of goods, but also creates unequal conditions for entities who employ different models of business organization (first of all, with regard to a strategy of selection between creation and utilization of owned non-consumable assets or leasing such assets). The second sign of monopolistically high price – higher price in a respective market vs. the price in a comparable competitive market – was found to be rarely useful, because of excessively tight comparability criteria¹. At best, this principle could be used for retrospective research of competition in the market.

There is a question: who may gain or lose from the introduction of this regulation. No changes to non-exchange commodity markets, with the exception of an outside possibility of attempts to create regulated market mechanisms, in spite of external constraints. Markets, whose commodities can be regarded as exchange commodities due their characteristics and applicable agreements, are very likely to experience more certainty, provided that a set of issues relating to well-defined algorithms of setting (1) frequency, (2) efficiency, (3) initial price, taking into account such aspect as temporal restrictions on making decisions, is defined. Solution of the foregoing issues suggests many criteria and designing of indicators which would allow for the assessment of compliance of exchange trading practice and participation of certain economic agents in such trading with certain threshold values. One may hypothesize that the efficient distribution of volumes would be assessed by a Gini coefficient substitute, whereas frequency of monitoring points should be determined first to assess frequency. Daily, weekly or monthly?

Indeed, an attempt to make post factum decisions increases considerably corruptogenic potential of market indicators, thereby raising manipulation risks. The application of this regula-

¹ See the following publication for details on the issues of market comparability: Shastitko A. E. ‘Comparable markets’ as a tool of antimonopoly policy. *Voprosy ekonomiki*, 2010, No. 5, pp. 96–109.

tion is likely to result in high administrative costs which is typical of sophisticated and transaction management specialized mechanisms¹.

The Order issued by the FAS Russia and the RF Ministry of Energy on January 31, 2013, No. 41/13/37 “On the Establishment of Minimum Value of Exchange-Traded Oil Products Produced and/or Sold by an Economic Agent Dominating in Respective Commodities Markets, and on the Approval of Requirements to Exchange Trading in Which Transactions are Made with Oil Products by Economic Agent Dominating in Respective Commodities Markets” answered in part to the raised questions, in particular the questions about initial price, approaches to the assessment of frequency (month). However, are these answers full and complete? If not, then what are the extents of regulator’s discretion? ...

Study of the new document entitles one to believe that administration of antimonopoly control in this type of exchange trading may be very surprising.

Concerted actions

Well-defined signs of concerted actions are described in the wording of Article 8 of the Federal Law “On the Protection of Competition” adopted in the ‘third antimonopoly package’. Given the previous definitions, to recognize actions as concerted, it must be defined that:

- (1) the result of such actions meets the interests of each of the economic agents in question;
- (2) actions are foreknown by each of the economic agents involved in such actions due to a public statement about such actions made by one of the economic agents;
- (3) actions of each of the economic agents have been caused by actions of the other economic agents involved in the concerted actions, and have not arisen from circumstances which have an equal effect on all economic agents in respective commodities market.

Most important are changes concerning the answer to the question about how participants of concerted actions foreknow actions of the others. It may be public statements. However, criteria to define what may or may not be regarded as public statement seem to be based on the experience gained through the application of this regulation. In other words, this is a subject of judicial discretion. Indeed, if a company promises through mass media that it is going to increase by 15% its prices in a month, it would be difficult to dispute an assumption that the promise is a public statement. What if a specialized agency for monitoring and forecasting certain commodities markets’ conditions makes a forecast of prices which would be publicly available, even on a paid basis? If such forecasts would be available only for buyers, there is no guarantee that the forecasts will be completed unavailable to at least a single competitor? How antimonopoly risks can be distributed in this such case?

Changes in regulated tariffs; changes in prices of raw materials used for the production of goods; changes in prices of goods in global markets; substantial changes in demand for goods within at least a year or during the life of a particular commodities market, provided that it is less than a year, are listed among the objective factors that cause parallel behavior which, however, is not going to be recognized as concerted actions. However, no one would expect the above listed factors to have an *equal* effect on all economic agents in the particular commodities market. The question is which way these factors would influence.

However, an attempt to distinguish between ‘natural’ and ‘conscious’ parallelism in behavior is definitely a step forward towards reflection in legal regulations the most significant aspects of the model of tacit collusion as economic correlate in legal conception of concerted

¹ For more details on comparative analysis of transaction management mechanism see: Shastitko A. E. New institutional economic theory. M: Teis, 4TH Issue, 2010, pp. 491-515.

actions. Thus, public statements is the most serious issue relating to the application of this regulation. The efficiency of application of this regulation will depend on whether the issue of so-called ‘strict liability’ is resolved or not.

Group of persons and control

The new version of Article 11 of the Federal Law “On the Protection of Competition” answers the question about who is going to be the target for antimonopoly prohibitions and what categories of persons may be exempted from antimonopoly law enforcement when certain relationships develop between them. There is a principle under which group of persons (as opposed to affiliated or related persons in other branches of law) is regarded as a single economic agent in terms of being subject to the same prohibitions as economic agents are. In particular, abuse of dominance may be considered with regard to both a single economic agent and a group of persons in *ex ante* (e.g., as a result of the economic concentration deal approval) or *ad hoc* composition.

If, however, actions of a single economic agent are of no concern to antimonopoly authorities in terms of application of the prohibitions set forth in the law, this principle is not to be applied to a group of persons even if the group of persons is regarded as economic agent. In other words, it turns out that both concerted actions and collusions being subject to antimonopoly prohibitions may be detected within a group of persons.

The ‘third antimonopoly package’ contains not only a smaller number of signs of group of persons (merely 9 instead of 15), but also a framework which allows a group of persons to be identified generally and properly. Generally, a group of persons is identified on the basis of the signs set forth in Article 9, whereas, properly, it is identified on the basis of direct or indirect control (Clause 7 Article 11).

Two signs of control remained after a long-lasting discussion of this amendment:

- control over more than 50% of total voting shares comprising the charter (contributed) capital of a legal entity;
- legal entity’s executive body functions performance.

If at least one of the foregoing signs is detected, then control relations may be deemed to have been detected. This concept is applied to limit the scope of antimonopoly control to agreements (Article 11), concerted actions (Article 11¹), and economic concentration deals (Article 32).

The third sign, whose ‘traces’ remained in the wordings of the articles dedicated to the procedure of antimonopoly control of economic concentration deals, refers to identification of conditions for business activity (e.g., Clause 9, Article 28). It was removed from the amendments to Article 11 at the final stage of discussion. It should be noted that unlike the first two signs, this sign broadens considerably the limits for discretionary decisions both in administrative cases and as part of legal proceedings. Theoretically, many situations may occur when this sign, not falling under many signs of group of persons, nevertheless could be considered in terms of the control concept, thereby having an adverse effect on legal certainty in applying the concepts of group of persons and control in daily practice of antimonopoly control.

The introduction of the control concept is an important step towards recognizing that there are differences between the firm as legal entity or a combination of legal entities and physical bodies, on the one hand, and the economic firm which is characterized basically by a very specific allocation of powers to make decisions on recourse, on the other hand. It still remains to be seen what are the effects of reforming the concept of group of persons in the Rus-

sian antimonopoly legislation. However, even today one may say that new issues keep arising as to how the foregoing changes may influence the application of, for example, sanctions for non-compliance with the requirements set forth in the antimonopoly legislation. For example, offences committed within a group of persons (Article 4.3 thereof) are listed among aggravating circumstances in the Administrative Offences Code of the Russian Federation. It means, however, that economic agents turn out to be less exposed to antimonopoly risks being outside than within a group of persons with control. In its turn, this aspect may have an adverse effect on the build-up of mechanisms of control themselves, especially taking into account that such qualifications may be applied in criminal proceedings too.

Cartel

An amendment was made at the final state of discussion of the ‘third antimonopoly package’, which shortly conveys the meaning of the amendments made to Article 11 of the Federal Law “On the Protection of Competition”.

First, it was suggested to modify the Russian antimonopoly legislation towards more consistent differentiation and development of regulatory tools for horizontal and vertical agreements. In fact, it was legally stated *de jure* that *cartels are always horizontal agreements*, which has always been true for economists vs. other categories of specialists.

Second, it was recognized that not all horizontal agreements are so dangerous as to be prohibited as such, regardless of their effects. A new approach, according to the letter of the law, prohibits only those horizontal agreements which result or may result in (1) set and maintained prices (tariffs), discounts, surcharges (extra payments) and/or mark-ups; (2) increased, decreased or maintained bids; (3) that commodities market is divided by territory, sales or purchase volume of goods, assortment of goods for sale, or composition of sellers or buyers (customers); (4) reduced or discontinued production of goods; (5) refusal to enter into agreements with specific sellers or buyers (customers). In its turn, so-called exploitative practices were moved to categories of less serious offences.

Third, an attempt was made to distinguish more precisely between horizontal agreements and concerted actions. In particular, Article 11 is dedicated exclusively to agreements, whereas Article 11¹ especially to concerted actions, though elements of offence are similar in both cases.

Exemptions for intellectual property

The ‘third antimonopoly package’ provides for the introduction of an exemption for intellectual property with regard to regulations prohibiting competition restraining agreements (Part 9, Article 11 of the Federal Law “On the Protection of Competition”). This amendment complements a series of important exemptions provided for by the Federal Law “On the Protection of Competition” for stimulating innovations and protecting rightholders, and depend largely on intellectual property (Part 4, Article 10, Article 13 thereof).

This amendment became a most disputable one, because at different stages it was more than once either included into or removed from the draft law. The situation with this amendment reflects a very complicated issue in the antimonopoly legislation: interaction between antimonopoly policy tools and protection of intellectual property rights provided for by Part IV of the Civil Code of Russia (CCR) which was adopted in 2008.

The CCR provides for both the principle of contractual freedom (Article 421) and exemptions from this principle (Article 10) restricting the freedom to exercise civil rights: they are not allowed to be exercised to restrain competition. It is this aspect that provides no reasons to

believe that the CCR prevails over the Federal Law “On the Protection of Competition”, thereby giving rise to make exemptions from exemptions, such as the use of intellectual property in economic turnover.

A series of unsettled issues were revealed during a discussion of antimonopoly legislation in terms of ensuring a balance with the intellectual property protection policy, which may be presented as negative reflection of the following key policymaking principles in this area.

First, the situation with creation, protection, and availability of access to intellectual property should be evaluated for Russia, which supposes evaluation of the mode of usage and creation of types of intellectual property (based on the list provided in Article 1225 of the CCR) in certain industries with a view to providing a full picture required for (a) evaluating the scope/structure of the issue, (b) concerned groups of interests, (c) identifying options of solution, (d) selecting the best of the identified options of solution, (e) designing an effective mechanism of monitoring of the performance of the selected option (feedback mechanism element).

Second, a typology of competition restraining issues in creating and using intellectual property as applicable to the Russian market-specific relationships and promotion of Russian companies in foreign markets, should be made. To this end, a generalized perception of the competition restraining issues relating to exercise of rights to intellectual property in USA and EC¹ can be used, where they consider such blocks of issues as cartelization through intellectual property, exclusive agreements, refusal to enter into an agreement or prevention from entering a market, as well as setting of secretal standards.

Third, description of a specific situation or a set of situations (e.g., like in the case with layout designs of integrated circuits, marked reinforced concrete slab, access to digital content) constitutes sufficient grounds to infer existent/nonexistent problems and their possible content due to exemptions from antimonopoly prohibitions, rather than (1) the size of an issue, (2) sufficient explanation of the root of a problem, let alone (3) ways of modification and methods of application of antimonopoly prohibitions.

Fourth, the principle of non-expediency of increasing the number of prohibitions and making legal regulations more sophisticated should be adhered to, if any competition restraining issues can be solved through already existing regulations (e.g., as part of regulations which set acceptable limits for vertical agreements). An illustration of intellectual property is a tool such as compulsory licensing provided for by the CCR (Article 1239). To date, however, no evaluations have been made which are required to see if the regulation is being in demand or sufficient as a tool to counteract abuse of intellectual property rights.

Vertical agreements

The ‘third antimonopoly package’ also covered vertical agreements, probably a most confusing area in the antimonopoly legislation, which closely relates to the issue of relationships concerning intellectual property (with regard to means of personalization of manufacturers and their products, and other items of industrial property).

The first thing to begin with concerns regulation of vertical restraining contracts – a far narrower array than relationships between buyers and sellers, which more logically can be viewed as vertical agreements. Though under Clause 19, Article 4 of a new version of the

¹ An option of systematization of the issue is described in: Komakova A., Kudrin A. Antimonopoly policy’s specific features in terms of intellectual property items in USA and EC. Competitive policy bulletin. Laboratory for competition-related issues and competition policy. 2012, October, Issue No.9.

Federal Law, vertical agreement is defined as agreement between economic agents, one of which buys and the other provides (sells) goods. It is the uncertain location of ‘safe harbors’ and excessively repressive legislation, because of inconsistently distinguished horizontal and vertical agreements, that put at risk a much bigger number of companies than it was expected based on the developments in the modern economic theory. And the risks were quite tangible¹.

A supplement, which constituted another step towards distinguishing between horizontal and vertical agreements, was issued as part of the explanations provided by the FAS Russia after the amendments to the Federal Law “On the Protection of Competition” was adopted. It is well known that uncertain situation is created when the manufacturer not only sells its goods to the distributor, but also acts as distributor: how the relationships between the distributor and the manufacturer are to be interpreted, Vertical? Horizontal? Vertical and horizontal? Each of these qualifications provides both opportunities and risks for parties to such agreements. Following is the proposed solution. If the distributor is not the manufacturer of goods which are sold in the same market, the relationships are regarded as vertical, regardless of that both the manufacturer and the distributor sell goods in the same market.

Warnings and cautions

Article 26⁷ of the Federal Law “On the Protection of Competition” allows for providing the executive officer of an economic agent with a notice of caution on the inadmissibility of violation of the antimonopoly legislation. This regulation is intended to alleviate the issue of ‘standards’ in the antimonopoly legislation, which suggest the use of complex technologies to qualify actions as compliant or non-compliant with the rules in effect (including economic analysis tools). Caution is a method of restrain in addition to sanctions for violation of the antimonopoly legislation.

Unlike caution which relates to executive officer’s public statements about future actions, warning provided for by Article 39¹ of the same law is issued to entities whose actions already bear signs of violations. A warning is issued before a case is opened against a violator, thereby avoiding administrative and legal costs incurred both by the antimonopoly authority and the entity.

The presented innovations are intended to alleviate the issues which are most dangerous for maintain effective (for counterparties too) cooperation between market participants. However, perspectives of application of warnings and cautions depend largely on how corruption risks, which application of this provisions is exposed to, can be avoided.

Widening the scope of regulated procurement

The Federal Law “On the Procurement of Goods, Works, Services by Certain Types of Legal Entities” adopted in July 2011, took effect in 2012. The law provides for regulation of procurement by companies which are directly or indirectly owned by the state, state and municipal unitary enterprises, stand-alone establishments, as well as companies being subject to tariff regulation. According to different estimates, a procurement of about Rb 7bn (Rb 10bn, according to more optimistic estimates) is subject to regulation.

The law is based on the endeavor to reduce costs and restrain corruption, thereby increasing the effectiveness of this group of companies. The key method is to improve procurement

¹ Dzagurova N. Vertical relationship regulation practice: vertical restraints in terms of coordination of concerted actions. *Voprosy ekonomiki*. 2011, pp. 103-113.

transparency and ensure compliance of regulated procedures. It is provided for by the law that every regulated entity must develop its Procurement Procedure with description of procurement procedures and supplier selection criteria. It is the compliance with the Procedure that becomes the target of control and subject-matter of legal actions of suppliers excluded from a tender or wrongfully rejected.

Positive effects of the law can hardly be evaluated at the moment, as they are going to manifest themselves within a long period of time and be statistically imponderable during the first year, whereas the its drawbacks can become visible shortly since its introduction and foreshadow its assessment by companies and experts¹.

Indeed, total costs of the introduction of the law are heavy. Conservative estimation of extra costs incurred by all entities covered by regulation is Rb 225bn, thereby exceeding an optimistic estimation of money saved from tender procedures. Key sources of ineffectiveness are both lack of lower volumes of regulated procurement and application of the law to companies which either have in-house stimulus to reduce costs, which are not going to be enhanced by the application of the law, or lack of real possibilities for saving.

There can be no doubt that the law will have a substantial effect on the procurement of regulated entities. However, there is a risk that law enforcement may reproduce the well-known drawbacks of the enforcement of the previous law on government procurement No. 94-FZ, and more drastic consequences for business activity can't be ruled out. Practice shows that arbitrary content of the Procurement Procedure with a wide range of procurement was not upheld in court rulings. Moscow Arbitration Court's ruling can be considered as the test case for the time being, which stated that rules for such a procurement procedure as request for offers (which may allow for more freedom in decision-making than those regulated by the Federal Law No. 94-FZ), must be assessed according to Article 18.1 the Federal Law "On the Protection of Competition" ("The procedure for consideration by antimonopoly authorities of complaints about violation of tender procedure and procedure for the conclusion of contracts"). In other words, the Federal Law dd. 18.07.2011, No. 223-FZ "On the Purchase of Goods, Works, Services by Certain Types of Legal Entities" allows companies to develop and apply Procurement Provisions, including alternative procedures. In any case, however, legality of decisions will be assessed on the basis of very strict rules.

Widening the scope of instructions instead of prohibitions

Changes in the antimonopoly policy aimed at reducing the possibility or burden of wrongful accusations have become more relevant over the last few years. First of all, it is the business community that requests such changes in an effort to avoid antimonopoly proceedings and sanctions. Antimonopoly authorities respond to some extent to the request in an effort to increase its influence on pricing and contractual relations at the preliminary stage. Different forms are being used: recommendations on contractual relations in specific industries (both for manufacturers and national car distributors) and methodological recommendations on the application of legislation requirements (as in the case with the Federal Law "On Trade") are developed, terms and conditions of instructions issued to violators of the antimonopoly legislation become more specific and restrictive.

¹ Details on comparison of costs and expected gains from the introduction of the law can be found in the materials of a project of the Institute for Industrial and Market Studies under the Higher School of Economics National Research University (<http://iims.hse.ru/news/64491423.html>; <http://www.forbes.ru/sobytiya-column/kompanii/220584-225-milliardov-na-veter-pochemu-neeftiven-novy-zakon-o-goszakupk>; <http://opec.ru/1448591.html>)

Two tools should be worth emphasizing, namely fair (or reasonable) pricing standards and sales practices (or policies). Fair pricing issues get prominent coverage in the FAS Russia in sectoral expert committees. Requirements to the content of sales practices were included into the 'fourth antimonopoly draft package'.

Proposed fair pricing standards employ the method of calculation based on the principle of equal returns on sales in different markets. This method was borrowed from the concept of reorganization of oil and gas prices in Russia. The fair price model applies this principle to prices of imported goods too, in which case a fair price is a price which is not worse than foreign market price, given mechanical deductions plus transport costs and taxes (tariffs). In some options the fair price project goes even further by linking fair practices for closed markets directly with manufacturing costs.

The sales practices model is even more heterogeneous. Some sales practices were developed by antimonopoly authorities as a part of instructions aimed at remedying violations, whereas others were developed within the framework of global agreements between antimonopoly authorities and companies. And, finally, companies developed and keep developing sales practices on a self-imposed compulsory basis in an effort to substantiate specific features of their business model for an antimonopoly authority. Some of sales practices are focused on pricing principles. A bigger group of sales practices regulate procedures for the selection and conclusion of agreements with counterparties which may be distributors, suppliers or buyers. However, this group is heterogeneous: it is the selection criteria, procedures for the conclusion and performance of agreements with counterparties based on the principles of different contractual terms and conditions that may be focused. A rejected proposal on compulsory content requirements for sales practices suggested that all of the foregoing components should be included into the requirements.

Both tools meet at least mixed reaction of businesses, let alone experts. In the short-term perspective many companies and their managers are even satisfied with an opportunity to mitigate risks of antimonopoly cases. Observance of 'reasonable' prices rules out a monopolistically high price, while observance of the sales practice terms and conditions approved by the FAS Russia prevents entities from being accused of the creation of discriminative conditions. However, there are many arguments against intensive application of both fair price principles and sales practices. The simplest argument is that development of any rules costs money, even if such rules are intended to solve major issues. It is not only drafting a document by companies, regulating the pricing principle or contractual terms and conditions, though such documents require financing too. Furthermore, neither is free to adapt the entire corporate system of decision-making to developed rules. Developed procedures should be observed by all personnel, and the system of internal motivation and governance must be adjusted to new rules.

Much higher costs both for companies and the society may result from additional restrictions imposed on businesses by both types of rules. Our knowledge of the market, counterparties, trends in demand and behavior of competitors is always imperfect. Rules which seem to be a reasonable compromise between observance of the requirements of counterparties and antimonopoly authorities which protect them, on the one hand, and of companies, on the other hand, may turn out to be unreasonable and have nothing to do with compromise. Drastic movements in demand may turn a respective adjustment of wholesale prices into the most reasonable business solution, in which case terms and conditions may differ drastically in agreements with the same contract period but different contract dates. A potential counterparty may emerge, an agreement with whom is completely undesirable for business, simply

because a company never before dealt with such counterparty, rather than for reasons not specified in the sales practice. This is manifestation of a typical issue in decision-making assessment. Rules may be set *ex post*, whose observance would ensure the best result amidst existing constraints. However, it may become impossible *ex ante*, while respective attempts may cause substantial losses as any other limited possibilities.

Antimonopoly prohibitions and punishments are applied *ex post* to a practice which can hardly be judged in advance as to whether it might be recognized as law violation or not, and if 'yes', then what a degree of such violation might be. Legal uncertainty of this type is aggravated in Russia by intensive application of regulations aimed at preventing individual damage (which 'operate' but not restrain competition). A company against which a case on violation of the antimonopoly legislation is initiated, may regret it lacks sales practice. In this case, however, there is no certainty that development and observance of sales practice would neutralize the risk of antimonopoly prosecution. According to the experience gained by retail food store chains, the existence of formalized rules for the conclusion and performance of agreements encourages some counterparties to find reasons for accusing of non-observance of such rules. Non-observance of previously developed rules may result in unexpected shocks. However, non-observance of sales practice rules makes it much easier to prove suspected discrimination or monopolistically high price, because these rules are implicitly intended to prevent the foregoing.

There is another aspect of the issue which may manifest itself most intensively when regulated sales are applied in markets dominated collectively by more than one entity, in which case mitigation of risks of accusations of restraining competition through abuse of dominance is likely to increase competition restraining risks through agreements or concerted actions¹.

The trend for replacing antimonopoly law enforcement with regulation tools keeps gaining ground. Antimonopoly policy tends to become more a policy of instructions and regulations instead of policy of prohibitions.

Changes in the mode of application with regard to intellectual property is one of the extensively discussed amendments to the antimonopoly legislation – changes in the mode of application of the Federal Law “On the Protection of Competition” in so far as they relate to intellectual property. At present, the articles of law which regulate the application of prohibitions on competition restraining agreements and abuse of dominance, contain exemptions with regard to actions and agreements concerning the exercise of intellectual property rights and means of personalization. Such exemptions reflect an extremely important in economic policy compromise between protection of competition and promotion of innovations. Innovators must be given an opportunity and conditions to make profit generated from its developments, otherwise they would have no incentives to work for development projects. In the short-term perspective, viewing competition as a dynamic presses, no is no contradiction occurs between competition and protection of right to innovations, whereas in the short-term interval innovators' power is monopolistic and leads to losses on the consumer side. Given both short- and long-term gains, temporal monopoly is an optimal solution. Issuance of patents is based on this reasoning.

¹ It stands to reason that foreign practice prefers corporate antimonopoly compliance polices based on company-specific risk management to regulated corporate sales practices. For details on the ratio of regulated trade practice to antimonopoly compliance polices see Shastitko A. E. Corporate trade practice as antimonopoly compliance policy // *Korporativny yourist. Prilozhenie*. October 2012, pp. 46-49.

However, protection of developments as a technique to provide a profit inflow sufficient to stimulate development projects may employ all kinds of methods including those which are formally not related to the intellectual property protection methods provided for by the regulations set forth in Part 4 of the CCR. Setting a minimum resale price (e.g., for manufacturers of fully packaged IT-products), which may be suspicious in terms of the antimonopoly legislation regulations, plays an important role as one of such methods in some markets. An illustration is the case which was initiated by the FAS Russia Chelyabinsk Office in 2009 against Kaspersky Laboratory for the withdrawal of a dealer who set a lower than recommended price from the authorized partners. Since a fully packaged IT-product can be copied at zero cost, the lack of minimum price regulation would mean that price competition would prevent the manufacturer from generating profit, thereby providing no incentives for product development. This is why intellectual property was excluded from antimonopoly prohibitions.

However, like any other exemptions, they provide additional opportunities, such as for those who want to evade the law. An illustration is revocation of the FAS Russia's decision on a manufacturer of reinforced concrete slabs, because their production is licensed. Such examples also explain the reasoning for the revocation of exemptions for intellectual property, together with considerations about gains for end users (short-term as we know). At the moment, revocation of exemptions for intellectual property from respective articles of the Federal Law "On the Protection of Competition" and reduction in intellectual property protection are being discussed basically relying on such private arguments, without any integral estimation of gains and losses from amendments to the legislation.

* * *

The 'third antimonopoly package' differs from the previous changes in the antimonopoly legislation not only in the number of new changes, but also how the discussion was arranged.

In terms of intensity, public discussions of the amendments to this package can be compared with the 'first antimonopoly package' which caused significant changes in the Russian antitrust: when (in 2006) a new law was adopted instead of two laws, and a bit later (in 2007) turnover-based fines were introduced, thereby increasing enormously the amount of sanctions.

However, it is unstable publicity of the discussion itself that became the key feature of the discussion of the 'third antimonopoly package': although it is hard to document this feature, there are some signs which can prove that.

Within a period of more than year (beginning with February 2010) amendments were discussed not only by executive bodies (first of all, in the FAS Russia and the Ministry of Economic Development and Trade of Russia), but also by business associations (in particular, the Russian Union of Industrialists and Entrepreneurs (RSPP)), and expert institutions such as Competition Promotion Nonprofit Partnership, Corporate Lawyers Association.

Unfortunately, no statistics are available which could show how many amendments were analyzed, how many instructive comments and proposals were formulated by antimonopoly authority's partners and considered, and what is the percentage of substantiated (motivated and documented) consents or refusals to consider comments and proposals, let alone the quality of such argumentation. However, even application of the simplest option – participant

observation¹ – shows that information exchange increased. Does it mean transformation of quantity into quality?

Here come the doubts about no motivated and documented antimonopoly authority's refusals to take account of some or other proposals as part of the 'third antimonopoly package' discussion. Personal participation in the discussions of a new package of amendments was the only way to understand (not always though) the motives. A period between the first and second readings of the draft law in the State Duma in the fall of 2011 became most important. It turned out that a draft law was submitted to a second reading, which contained a great deal of conceptual amendments which, even though they were previously discussed, the discussion had nothing to do with their submission to the list of amendments to the antimonopoly legislation. Though the law which passed in second and third readings had minimum differences from the law which passed in a first reading, a question still remains: what made it possible to make a great deal of amendments after a 1.5-year period of public discussions.

The discussion of the 'third antimonopoly package' featured the following. No possibilities were offered to provide transparency, mitigation of risks of duplicate discussions ('going around in a circle'); amendments were adopted according to the letter of the law as per the form, whereas 'by ear' per se. In its turn, it is these specific features of the draft law discussion process that are most exposed to legislative error risks, generally and properly².

The foregoing possibilities can be offered by regulatory control assessment procedure³, regardless of that other statutes and regulations underwent no such a procedure (no matter how imperfect it was). This is what makes the 'third antimonopoly package' akin to the first, the second packages, and the existing traditions of discussion of draft legal acts.

It begs the question of whether a fourth package is to be issued after the discussion and adoption of the 'third antimonopoly package'.

The question seems to be reasonable, not only because the FAS Russia made statements about future plans on amendments to the antimonopoly legislation, but also almost all of the amendments proposed for the second reading were rejected by the Russia's Government. Finally, with the first, second, and third packages being in place, what may bar a fourth one from being issued.

There is another good reason – 'correction of errors'. Indeed, a part of the amendments to the 'third antimonopoly package' is referred to correction of errors. It is not only Article 178 of the Criminal Code of Russia in so far as it relates to the exclusion of concerted actions, but also introduction of amendments to Article 6 on the detection criteria of monopolistically high price (stock exchange trading).

¹ The authors participated in many discussions of the 'third (and all the previous) antimonopoly package' from February 2010 to November 2011 in the FAS Russia, the Ministry of Economic Development and Trade, the Russia's Government, as well as Competition Promotion Nonprofit Partnership and RSPP.

² Properly, legislative effort means an error which results from imperfect legal drafting methodology, whereas generally, errors also include regulations which, in spite of more or less good quality of legal drafting methodology, may cause the so-called type I and II errors. For details see: Shastitko A. E. Type I and II errors in economic exchange with the participation of a third-party guarantor // *Zhurnal novoi ekonomicheskoi assotsiatsii*. 2011, No. 10, pp. 125-148.

³ For details about regulatory control assessment see Kokorev R.A., Shastitko A. E. (edit.). Using regulatory control assessments to improve corporate legislation. Economic Analysis Bureau. M. Teis, 2006); Kruchkova P.V. (edit.) Principles and procedures for the assessment of state regulation measures expediency. M. Teis, 2005.

If one error leads to another one due to the amendment drafting and discussion process itself, then this process may become endless. Therefore, one may expect a fourth, fifth, sixth package to be issued.

Is it reasonable? Any amendment, even a well-intentioned one, to the legislation (maybe except for clearly visible drawbacks which can't be remedied by legal practice, as well as conflicts of laws) is exposed to risks and extra costs for businesses. The principal matter in question is adaptation costs. Since the key provisions of legislation are evaluative, they require a sophisticated application infrastructure both on the side of antimonopoly authority and companies. However, the more frequent and significant are changes, the bigger are adaptation costs.

A moratorium on amending provisions of the antimonopoly legislation after a long period of drafting, discussion, and adoption of amendments (2004 thru 2012) could have been a good sign for businesses, if it were not for two hitches.

First, it is obvious that such moratorium can't be endless. A period of moratorium should be set at least.

Second, until the practice of consideration of draft laws and their performance measurement on the basis of effective criteria becomes a routine, it is hard to assess conditions under which moratorium can be suspended in order to – again, in good faith – correct previously committed blunders.

6.2.3. Competition promotion initiatives: interception attempts

The period under review was characterized not only by on-going discussions and amendments to antimonopoly legislation as a tool of competition promotion. In addition, development trends were broadened, and interaction between them were getting more complex. In fact, the competition policy infrastructure was adjusted at least in form.

It also refers to the Competition Promotion Program in the Russian Federation, as well as at the level of constituent territories of the Russian Federation, and the FAS Russia's reports on competition. Furthermore, relationship between the Competition Promotion Road Map and the work load of the Government Commission for the Promotion of Competition and Small- and Medium-Sized Enterprises. Finally, it was FAS Russia's initiative to develop and implement Antimonopoly Policy Development Strategy in Russia. Activity in this field cannot help but relate to the existence and collision of different perceptions about development trends, including different interests. We will try to assess the situation in the context of such differences in general, without describing in detail groups of interests, their composition and motivation.

Competition Promotion Program implementation results, FAS Russia's report on competition

The Competition Promotion Program in the Russian Federation was adopted by the Russia's Government Order dd. 19.05.2009, No. 691. Though the program was developed and discussed as many other similar programs and strategies, it had a special feature which reflected specifics of the target issue: competition promotion neither can be regarded as an exclusively sectoral objective nor reduced to a narrow set of protection measures, especially in an emerging market country.

In general, comprehension of the specifics was reflected in the program: protection measures were specified, which first of all were intended to develop antimonopoly policy tools. Furthermore, the program provided for the application of active competition policy

tools too. Measures, which amounted to about 80 after amendments were made in 2010, were to be completed late in 2012. In addition, it should be noted that the program acquired a regional dimension, when the constituent territories of the Russian Federation and even municipalities began to develop similar programs after amendments were made to the list of measures.

However, as early as mid-2012, the program failure was announced in the course of discussion of competition issues and competition policy. Therefore, a few important questions arose from a practical point of view.

First, was any program progress monitoring in place at the federal and regional levels? If ‘yes’, what method was used, and what were its performance measurement results? If neither monitoring, nor performance measurement took place, then what information and performance measurement results were used for the development of next generation documents (in this case, the Competition Promotion Road Map)? Or the competition promotion program was ‘reincarnated’ into one of the first versions of the Road Map¹?

Second, the Competition Promotion Program included items which could be assessed in terms of both short-term and final results. In this respect, let’s make a list of questions which are closely related to learning lessons from the experience gained in the implementation of other programs.

(1) If the program items were fulfilled, but the program failed to fulfill its objectives, it means that the measures were irrelevant to the program’s content? Or the program itself was irrelevant to the problem? Or this is simply the result of incorrect performance measurement as such?

(2) If some of the program items failed to be fulfilled, what items, and why? Are they insignificant? Unrealizable? Or they are realizable, but there was a lack of performance discipline?

Third, what are the details of performance results of those program items which were considered as fulfilled, and, consequently, what are the effects of their subsequent realization?

Another remarkable event took place in June 2012 – the situation around the FAS Russia’s report on competition in the Russian Federation became hot. The antimonopoly authority makes such report on an annual basis and submits it to the Russia’s Government for consideration. It was the sixth report. All of the previous reports didn’t give rise to any serious discussions. At that time, however, both the sixth report and its principal developer FAS Russia became the focus of interest. The report was said to be of low quality, while the antimonopoly authority was said to work hard but lack effectiveness².

In its turn, it was stated in the report that the measures aimed at conducting structural economic reform with a view to promoting competition, which were proposed by the FAS Russia in 2009–2011 and reflected in the competition promotion program, failed to be realized, while the program itself ended in a fiasco according the head of the antimonopoly authority³, thereby implying that the FAS Russia admits to unbalance in active and protection measures of the competition policy, but is unable to solve the issue of competition promotion within its terms of reference which cover mainly protection measures. This is the keynote of the answer to its opponents who hold the antimonopoly authority liable for the lack of results.

¹ It should be noted that the Road Map underwent a few changes ‘beyond recognition’ after six months of discussion.

² <http://ria.ru/economy/20120613/672429743.html>; <http://v-novikov.livejournal.com/648429.html>

³ http://www.dp.ru/a/2012/06/14/Pravitelstvo_RF_obsudilo/

If the report changes its status of formalistic document into a real policy document, it gives rise to a few questions as follows.

(1) Who and how develop this report? The FAS Russia works hard on analyzing the situation with competition in Russia, but whether is possible conduct a comprehensive discussion of competition when there is no systemic alternative point of view? Who is going to point out restraining competition risks in the actions of the antimonopoly authority, including within the framework of the principal articles of the Federal Law “On the Protection of Competition”?

(2) What is the structure of the report, what is it comprised of, and what are the requirements to the algorithm of the issues described in the report? These questions are important for comparing assessments of the previous and subsequent reports, as well as more extensive discussion of problem issues in competition protection with the use of alternative results.

(3) Whether a government entity must develop a report with an alternative point of view about the situation in competition protection? Or the alternative report must be developed by a non-government entity?

Since competition can be protected through two groups of tools which regulate protection and active competition policy¹, the report should have at least more well-defined objectives of the competition protection policy; which tools are used for this; how to solve this issue if the report is drafted by an agency responsible for, above all, protection measures.

As noted above, the FAS Russia as executive body is mostly focused on protection measures of the competition policy, and the content of its report would be biased toward protection measures. However, the issue of balance between protection and active measures of the competition policy is especially acute for emerging market economies like Russia than developed economies. The report reflects the issues relating to counteraction of excessive entry barriers. It is well-known, however, that economic theory provides no clear understanding of entry barriers as socially unacceptable and adverse. In its turn, the report contains no clear idea about which and how barriers are recognized as excessive, and other active competition policy methods which can fulfill competition policy targets in general.

Competition promotion road map

The development of a Competition Promotion Road Map, which was intended to replace the program, began against the discussion of the Competition Promotion Program performance results and the FAS Russia’s report on competition. One may assume that the measures provided for by the Road Map were designed as alternative to actions of the Federal Antimonopoly Service.

Originally, the Road Map concept was to offer more effective competition promotion methods than the application of antimonopoly legislation. However, the Road Map eventually fell victim to the lack of both strong interest in competition promotion and understanding of problems relating competition promotion in specific sectors. The Road Map from the very beginning was and remained until its adoption a set of ‘cubes’ prepared at different level of insight into the subject. An overwhelming majority of reasonable, substantiated and efficient change proposals on regulation in the natural monopoly sectors were combined with inefficient and unreasonable proposals, namely a proposal to penalize the personnel of antimonopoly authorities for judicially overturned decisions. Had this proposal been implemented, it

¹ For details on active and protection methods of competition policy see: Avdasheva S.B., Shastitko A. E. Competition policy: composition, structure, system // *Sovremennaya konkurentsia*, 2010, No. 1, pp. 5-20.

would have left no hopes for positive effects of the antimonopoly policy; a proposal to reduce a share of oil companies in regional markets; and, finally, a proposal to vertically divide Russian oil companies. Such proposals were rejected as a result of more than six months of extensive discussion of the Road Map. However, positive results of expert discussion exhausted their potential at that. Finally, proposals of the personnel of those executive bodies for whom the Road Map was regarded as alternative accounted for most part of the Road Map, namely the Federal Antimonopoly Service of Russia and the Federal Tariffs Service.

Government Committee for Competition Promotion

In the mid-2012, Government Commission for the Promotion of Competition and Small- and Medium-Sized Enterprises was established on the basis of a committee set up by the Russia's Government Order dd. 17.03.2008 No. 178¹. It is not only the title that shows a shift of focus towards competition problems, because competition was a target, but also in defined terms of reference supplemented with functionality as the development of a system of competitive environment indicators and monitoring; analysis of practical application of the Russian legislation for the development and promotion of competition; development of proposals on amendments to the Russian legislation with a view to introducing best competition practices; consideration of reports on competition protection and promotion made by constituent territories of the Russian Federation and federal executive bodies.

The content of the Commission agenda is a potential indicator of not only prioritization, but also understanding of issues being faced in the field of competition protection and promotion in Russia.

6.2.4. Challenges in the development and application of competition legislation in Russia

After the termination of the Big Four cases, neither businesses, nor the Russia's Government, nor experts had any doubts that the antimonopoly policy have a serious effect on market development. This is an explanation for a greater attention and requirements to the FAS Russia facing serious issues in its work. In our opinion, the key strategic threat to the effectiveness of antimonopoly policy is the need for an extremely large-scale law enforcement with very limited (vs. the number of objectives) resources. This threat makes the FAS Russia search for decision-making cost reduction methods including, but not limited to broadening of powers and, to some extent, tailoring the regulatory framework to current needs. However, such a scale of law enforcement may result in errors in the FAS Russia's activity, thereby making business representatives to look for a method enabling them to change the legislation in order to cut the likelihood of antimonopoly prosecution. Mutual risk management in many cases leads to compromise changes in legislation and the Russian antimonopoly authority's activity, which in many cases ignore the key goal – prevent competition restraints. The struggle for FAS Russia powers forces competition promotion tasks to be put aside to some extent.

Among other factors which may have a potential effect on the application of antimonopoly legislation in Russia is a supranational authority within the framework of the Customs Union of the Ministry of Competition and Antimonopoly Regulation. The content of supranational

¹ The Commission was established according to the proposals made by Artemiev I.Y., the Head of the FAS Russia, in so far as they relate to acceleration of Government's work on competition, including the engagement of sectoral ministries which, according to the FAS Russia, not only do nothing to promote competition, but also restrain it.

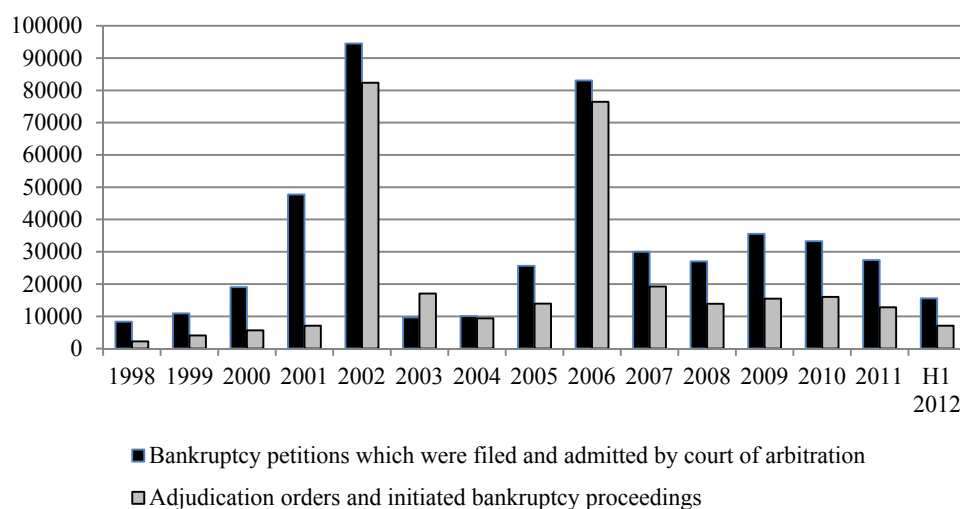
legislation still remains to be defined, but provisions thereof are not expected to correspond exactly with the rules provided for by the Russian antimonopoly law. The definition of illegal practice will be more different as a result of court rulings on disputed decisions made by the supranational antimonopoly policy authority. Delegation of powers among supranational and national authorities will be a question of principle. Finally, it should be noted that the discussion of a model competition law which is intended to harmonize the national antimonopoly legislation of the Customs Union countries. The question is whether this discussion is going to be a source of new errors or a good reason for correcting committed errors?

6.3. Bankruptcies in 2011–2012: less bankruptcies, new regulation, draft law on debt reorganization

6.3.1. Dynamics of bankruptcies (2011–2012)

The following key trends governed an overall picture of bankruptcies in the period under review (see *Fig. 2*).

First, it should be noted that the number of filed bankruptcy petitions reduced substantially in 2011, a growth by 17% against the previous year (33,385 petitions were filed in 2011; 40,243 – in 2010). In addition, the number of admitted bankruptcy petitions kept declining since 2010. For example, in 2010 – 2011 the decline was 22.8% (35,545 in 2009; 33,270 in 2010; 27,422 in 2011). However, in H1 2012 the number increased considerably by 13.7% year on year. Moreover, the number of adjudication orders and warrants in bankruptcy began to decline from 2009 (approx. by 1/5 against the previous year) (16,009 in 2010; 12,794 in 2011).



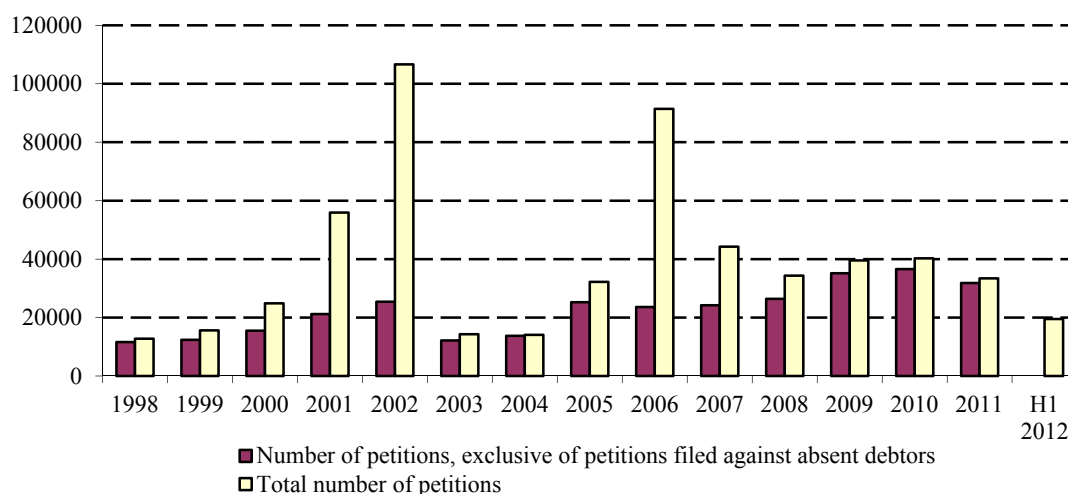
Source: arbitration courts’ notices on hearing of insolvency (bankruptcy) cases at the constituent territories of the Russian Federation, the Supreme Arbitration Court of the Russian Federation, in the period between 1998 and 2012.

Fig. 2. Dynamics of adjudication orders in the period between 1998 and 2012

In 2011, the number of petitions filed against relatively ‘appropriate’ debtors¹ reduced, for the first time since 2008, by 13% against 2010 (26,400 in 2008; 35,200 in 2009; 36,600 in

¹ ‘Appropriate’ debtors are referred to as all debtors exclusive of absent debtors.

2010; 31,800 in 2011). In the period between 2009 and 2010 the number of appropriate debtor bankruptcy petitions increased by 38.6% against a total growth of approx. 17.1% in the number of petitions. 2009 saw the maximum growth. Fig. 3 shows dynamics of bankruptcy (insolvency) petitions in the period between 1998 and 2012.



Source: arbitration courts' notices on hearing of insolvency (bankruptcy) cases at the constituent territories of the Russian Federation for the respective periods; analytical attachments to statistical reports on the performance of arbitrations courts of the Russian Federation over the respective periods, the Supreme Arbitration Court of the Russian Federation.

Fig. 3. Number of debtor bankruptcy (insolvency) petitions filed in 1998–2012

Second, it should be noted that state policy measures keep having a strong impact on the dynamics of bankruptcies. The foregoing together with regulation of tax authorities in terms of recognizing debtors as bankrupts, and measures aimed at supporting specific market entities.

For example, the number of bankruptcies grew in general together with a growth in the number of bankruptcy proceedings in other segments till 2010, whereas the dynamics of bankruptcies of agricultural manufacturers saw an opposite trend: the number of bankruptcies decreased by more than 5 times in the period between 2006 and 2010 (about 4,000 bankruptcies in 2006; 2,465 in 2007; 1,614 in 2008; 1,036 in 2009; 800 in 2010) and to 534 in 2011 in response to active government measures aimed at supporting the agricultural sector through increasing volumes of government loans, restructuring tax liabilities, subsidies on fuels and lubricants, etc.

In addition, the level of bankruptcies of financial and credit institutions reduced by 4 times in 2011 against 2010 (from 229 in 2010 to 58 in 2011) in response to both measures aimed at providing financial aid and improving market conditions, and a legal support provided in order to prevent bankruptcies in this category.

With regard to initiation of bankruptcy proceedings by tax authorities, it should be noted that such cases became less intensive. For example, more than 67% of bankruptcy petitions were filed in 2008 by authorized bodies, mostly tax authorities, whereas a share of indicators in this group reduced to 39.2 % in 2010 and to 31% in 2011.

Third, petitions, disputes, complaints and claims as part of the bankruptcy cases initiated in 2008 thru 2010 decreased by 12.1% after a substantial growth (from 111,521 in 2008 to

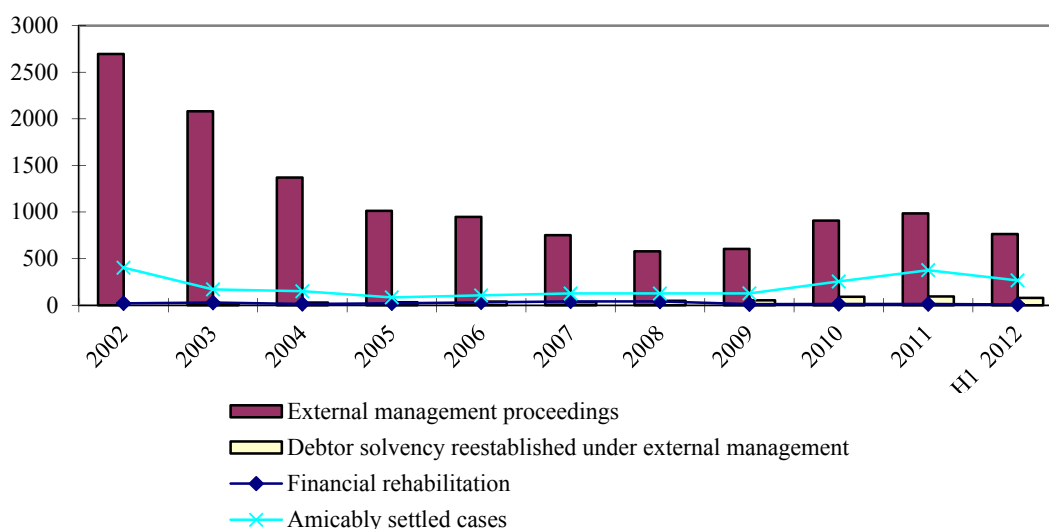
232,845 in 2010) в 2011 against 2010. The growth in the period between 2009 and 2010 was mainly caused by a considerable increase in the number of lawsuits relating to incompletion/breach of contractual obligations, economic situation, as well as amendments to the law on bankruptcy which granted new rights to bankruptcy proceeding parties (e.g., they were entitled to challenge debtor’s transactions; debtor’s supervisors could be held liable in terms of subsidiary liability; the right to submit a declaration of intention to satisfy claims on mandatory payments, etc.) The latter also had an effect on the statistics in 2012.

In H1 2012, the number of petitions, disputes, complaints, and claims resumed its growth, by 16.6% year on year (121,916 in H1 2012 against 104,543 in H1 2011).

For example, 3579 petitions on challenging debtor’s transactions (a gain of 41.4% against H1 2011), 72095 petitions on setting the amount of claims of creditors, on excluding the claims from the register (a gain of 15.9%), 3.796 petitions on recovering bankruptcy case expenses (gain), 839 petitions on dismissing the arbitration manager (a gain of 9.1%) were considered in H1 2012.

Fourth, the number of amicable settlements, external management and financial rehabilitation proceedings kept growing. For example, in 2008–2011 the number of amicably settled cases almost tripled (from 126 to 376). In 2011, the number of amicably settled cases reached its maximum, beginning with 2003. The number of cases with external management proceedings increased by 1.7 times (from 579 in 2008 to 986 in 2011) in the period between 2008 and 2011. In H1 2012, the number of cases with external management began to decline, by 9.1%, whereas other indicators kept growing.

Fig. 4 presents the dynamics of external management proceedings, financial rehabilitation, amicably settled cases in the period between 2002 and 2012.



Source: an arbitration courts’ notice on hearing of insolvency (bankruptcy) cases at the constituent territories of the Russian Federation in 2006 – 2010, 2008– 2011, 2009–2011, H1 2012

Fig. 4. Dynamics of external management proceedings, financial rehabilitation and amicably settled cases in 2002 thru H1 2012

The number of amicably settled cases, financial rehabilitation and external management procedures increased not least because of the novations that took place in the taxation system

in 2010, which expanded the range of application of deferred payment with regard to mandatory payments, and uncollectable accounts payable write-off, as well as novations aimed at preventing bankruptcy of financial (including insurance companies) institutions and regulating a special bankruptcy procedure for non-government pensions funds, securities market professional participants, managers of investment companies and unit funds. However, only a few individual cases, in which the debtor solvency was reestablished under external management and debt was recovered in response to financial rehabilitation, have been reported to date.

Fifth, the period between 2008 and 2011 saw a downward trend in the number of bankruptcies among state and municipal unitary enterprises. For example, the number of bankruptcies among state unitary enterprises reduced by 2.1 times in that period (from 176 in 2008 to 83 in 2011), the number of bankruptcies among municipal unitary enterprises reduced by 2.2 times (from 676 in 2008 to 302 in 2011). The trend began to change in H1 2012: the number of bankruptcies among state and municipal unitary enterprises increased 118.7% and 105.3% year on year, respectively.

6.3.2. Bankruptcy legislation in 2011–2012

Similar to 2010¹, the lawmaking process which is intended to settle bankruptcy proceedings for specific groups of persons, namely clearing organizations, real estate developers, credit cooperatives, kept developing in the period between 2011 and 2012.

In February 2011², the Federal Law “On Solvency (Bankruptcy)” was supplemented with the provisions which specify the characteristics of bankruptcy clearing organizations and are intended among other things to measure the size of financial obligations originating from financial agreements. Commitments under agreements concluded under the terms and conditions stipulated in the master agreement which is in line with provisional terms and conditions of the agreements provided for by Article 51.5 of the Federal Law “On the Securities Market”, and/or exchange trading rules, and/or clearing rules, have ceased to be in force under the procedure specified in the master agreement, and/or regulated trading rules, and/or clearing rules. The foregoing termination of obligations gives rise to a financial obligation whose size is to be measured subject to the procedure provided for by the master agreement, and/or regulated trading rules, and/or clearing rules.

The external manager only may refuse to comply with all of the aforementioned financial agreements existing between the creditor and the debtor. Creditors are treated as third priority creditors with regard to net obligations.

Beginning with February 11, 2011, “stock exchange transactions which are closed under at least a single order being addressed to an unlimited number of trading participants, as well as actions aimed at discharging obligations and liabilities arising under such transactions, may not be disputed” as suspicious and invoking a fraudulent preference.

The following novations of that period are worth noting.

1. A *single judge sitting* was abolished: a ruling on the commencement of a supervision procedure; statements, motions, complaints in a bankruptcy case; disputes relating to the size of claims of creditors; claims of creditors with counterclaims; filing creditors’ claims in

¹ For details please see: Apevalova E.A., Bankruptcies in 2010-2011: Post crisis dynamics, new trends and regulation//Russian economy in 2011. Trends and Outlooks. Is. 33 – M. IET 2012.

² The Federal Law dated 07.02.2011 No. 8-FZ “On the Amendments to Certain Legal Acts of the Russian Federation due to the Adoption of the Federal Law “On Clearing and Clearing Activities”.

bankruptcy cases against financial institutions, as well as bankruptcy cases involving absent debtors.

2. More grounds were provided to hold a transaction invalid in case of a ‘related agreement’ is concluded, a related agreement is referred to as “an agreement entered into with the central counterparty on the basis of an offer, including a stock market bid whose terms and conditions were in line with the offer, including a stock market bid under which the invalid agreement with the central counterparty was concluded” (Clause 5, Article 61.6 of the Federal Law “On Insolvency (Bankruptcy)”). Related agreements which may be subject to recovery of losses may be concluded in performing suspicious transactions and debtor’s transactions resulting in fraudulent preference.

In addition, in July 2011¹ a special regulation was introduced to govern bankruptcies of real estate developers². Clause 6, Article 201.1 thereof includes an extend list of legal grounds under which a person may be recognized as the creditor of a real estate developer, which is reasonable due to multiple forms of legal relationship which are practically applicable in the construction sector.

Beginning with the commencement date of a supervision procedure against the real estate developer the debtor may enter into agreements under which living quarters may be assigned, and agreements on amendments to or termination of such agreements, as well as perform other transactions with immovable property, including land plots, exclusively with the written consent of the temporary manager.

The ruling on the commencement of a supervision procedure against the real estate developer is to be submitted by court of arbitration to the authorities in charge of state registration of title to immovable property and transactions therewith, at the area where the real estate developer’s land plots are located.

The meeting of creditors’ resolution on amicable settlement of the real estate developer bankruptcy case is to be taken by a majority of vote of creditors in insolvency proceedings and authorized bodies according to the creditor claims register and shall be deemed to have been approved if voted for by all creditors on the liabilities secured by the debtor’s property, as well as voted for by at least one third of the construction participants.

Unlike in other categories of cases, the real estate developer bankruptcy case includes construction participants who claim to transfer the title to the living quarters, as well as authorized body of a constituent territory of the Russian Federation is charge of monitoring and supervision in the field of condominium construction and/or other immovable property on the territory of a particular construction site.

Based on the petition filed by an applicant or other participant of the real estate developer bankruptcy case, court of arbitration is entitled to take relevant measures (injunctive measures) with a view to supporting creditors’ claims and debtor’s interests by prohibiting the lessor to enter into a leasehold agreement on the land plot with any other person but the real

¹ The Federal Law dated 12.07.2011, No. 210-FZ “On the Amendments to the Federal Law “On Insolvency (Bankruptcy)” and Articles 17 and 223 of the Arbitration Procedure Code of the Russian Federation bankruptcy of real estate developers borrowing from construction participants”.

² Real estate developer is referred to as a legal entity irrespective of the form of business ownership, including housing cooperative, or self-employed entrepreneur, against whom living quarters assignment or payment claims have been filed. Special bankruptcy rules are applicable irrespective of whether the developer owns, leases or subleases the land plot, as well as irrespective of whether the developer enjoys the title or any other ownership right to the object of construction.

estate developer, and by imposing a ban on state registration of such a leasehold agreement, as well as prohibiting the lessor to otherwise dispose of the land plot.

Beginning with the date on which the court of arbitration issues a ruling on the commencement of a supervision procedure against the real estate developer, in the course of monitoring and all other subsequent proceedings applicable to the real estate developer bankruptcy case the living quarters assignment claims and/or payment claims raised by construction participants, save for current payment claims, may be raised against the real estate developer as part of the real estate developer bankruptcy case only, subject to the legally established procedure for claims against the real estate developer.

Beginning with the commencement date of a supervision procedure against the real estate developer, in the course of monitoring and other subsequent proceedings applicable a part of the real estate developer bankruptcy case, writs of execution shall be suspended for execution demanded by construction participants. The foregoing writs of execution shall cease to be executed from the date of initiation of bankruptcy proceedings.

From the date of their approval, the temporary manager, bankruptcy supervisor shall notify within 5 days all known to them construction participants of the commencement of a supervision procedure or initiation of bankruptcy proceedings and that the construction participants may file living quarters assignment and/or cash payment claims, as well as a construction participant may unilaterally refuse to execute the agreement which provides for the assignment of a living quarters.

Initiated bankruptcy proceeding against the real estate developer shall mean that a construction participant may unilaterally refuse to execute the agreement which provides for the assignment of a living quarters. Such a refusal may be announced as part of the real estate developer bankruptcy case, when the size of the construction participant's payment claims is determined.

When the size of the construction participant's payment claims is determined, the size of real losses caused by the real estate developer's non-compliance with the obligation to assign the living quarters, which are equal to the difference between the price of the living quarters (determined as of the date of termination of the agreement which provides for the assignment of the living quarters) which must be assigned to the construction participant and the amount cash paid prior to the termination of the agreement, and/or the price of the assigned real estate developer's property (as specified by the agreement which provides for the assignment of the living quarters).

In considering the relevance of the living quarters assignment claims, a court of arbitration must be provided with the evidence supporting that the construction participant has effected in full or in part the payment in fulfillment of his obligations to the real estate developer under the agreement which provides for the assignment of the living quarters.

The living quarters assignment claims which have been recognized as relevant by the court of arbitration, shall be included by the arbitration manager into the register of living quarters assignment claims.

The living quarters assignment claims, including the content of the information which shall be included into the foregoing register, and the procedure for the provision of information from the register of the living quarters assignment claims shall be approved by the federal standard.

Beginning with the date on which the court of arbitration issues a ruling on the commencement of a supervision procedure against the real estate developer, in the course of

monitoring and other subsequent proceedings applicable a part of the real estate developer bankruptcy case, the following claims of other persons against the real estate developer or the real estate developer's claims against other persons shall be subject to filing and consideration:

- 1) claims to recognize or not the title to, or any other right or any encumbrance on the real estate, including facilities under construction;
- 2) claims to reclaim the real estate, including facilities under construction, from unlawful possession by other persons;
- 3) claims to demolish the building(s) erected without proper legal authorization;
- 4) claims to hold the real estate transaction invalid or void, enforce the implications of the invalidated transaction to the real estate;
- 5) claims to transfer the title of, obtain operating control of, place under economic management, deliver possession of the real estate in order to discharge the obligation;
- 6) claims on state registration of the title to the real estate (Article 201.8. of the Federal Law "On Insolvency (Bankruptcy)").

Following is the priority order in which claims of creditors, save for current payment claims of creditors, shall be satisfied in the course of the bankruptcy proceedings as part of a real estate developer bankruptcy case:

- 1) first priority claims include settlements on the claims of individuals to whom the debtor has been held liable for causing harm to their life or health, by capitalizing respective payments due over time, paying a compensation for moral harm;
- 2) second priority claims includes settlements on severance payments and labor remuneration due to the persons who are or were employed under a labor contract, and remuneration payment due to owners of intellectual property;
- 3) third priority claims include settlements on individuals' payment claims – construction participants;
- 4) fourth priority claims include settlements with other creditors.

Where the real estate developer has a facility under construction in the course of financial rehabilitation, external management, bankruptcy proceedings, the arbitration manager no sooner than in a month and not later than in two months from the date of its approval shall be obliged to place before a construction participants' meeting the question of appealing to a court of arbitration for discharging the construction participants' claims by transferring to them the title to the real estate developer's title to the facility under construction and the land plot to the construction cooperative established by the construction participants or any other specialized consumer cooperative.

The title to the facility under construction may be transferred to the construction participants if all of the following terms and conditions are met.

- 1) provided that the value of the real estate developer's title to the facility under construction and the land plot accounts for not more than 5% of the total amount of the construction participants' claims included into the creditor claims register and the living quarters assignment claims register, or a resolution has been taken by three thirds of votes of the fourth-priority creditors, save for legal entities – construction participants, to agree to transfer the title to the facility under construction, or money has been credited to the court of arbitration's depository account.
- 2) provided that the property which the debtor retains after the assignment of the facility under construction is sufficient to effect current payments, discharge the first- and second pri-

ority creditors' claims or money has been credited to the court of arbitration's depository account;

3) provided that the creditor claims register contains no claims of creditors, who are not construction participants, under obligations secured by the real estate developer's title to the facility under construction and the land plot, or the foregoing creditors have agreed to assign the facility under construction, or money has been credited to the court of arbitration's depository account;

4) provided that upon the completion of the construction of a specific facility under construction, the living quarters of this facility are sufficient to satisfy all of the construction participants' claims against a particular construction facility included into the creditor claims register and the living quarters assignment claims register, given the terms and conditions of the agreements which provide for the living quarters assignment (also, there are no claims by some of the construction participants as to the assignment of the same living quarters in the block of flats, save for the cases provided for by Clause 7, Article 201.10.). Where a construction participant gives his consent, he may be entitled to a living quarters which differs in space, layout, location from the living quarters which meets the terms and conditions stipulated by the agreement which provides for the living quarters assignment;

5) the facility under construction is legally owned by the real estate developer;

6) the land plot on which the facility under construction is located is legally owned by real estate developer or under any other right of ownership;

7) construction participants have decided to establish a housing cooperative or any other specialized consumer cooperative which meets the requirements specified in Clause 8, Article 201.10 of the Federal Law "On Insolvency (Bankruptcy)".

In the event that the real estate developer has a block of flats whose construction is completed, the arbitration manager not sooner than one month and not later than two months from the date of its approval (if the construction is completed in the course of bankruptcy proceedings not later than two months from the date of its completion) shall be obliged to place before a construction participants' meeting the question of appealing to a court of arbitration for discharging the construction participants' claims by transferring to them the title to the living quarters in this block of flats.

The title to living quarters may be assigned to the construction participants if all of the following terms and conditions are met:

1) provided that a commissioning certificate has duly been issued for the block of flats whose construction has been completed;

2) provided that the real estate developer and the construction participants have failed to sign acceptance certificates or any other documents concerning the assignment of the living quarters;

3) provided that the value of the living quarters to be assigned is not more than 5% of the total amount of the construction participants' claims included into the creditor claims register and the living quarters assignment claims register, or a resolution has been taken by three thirds of votes of the fourth-priority creditors, save for legal entities – construction participants, to agree to transfer the title to the living quarters to the construction participants, or money has been credited to the court of arbitration's account in compliance with Clause 4, Article 201.10 of the Federal Law;

4) provided that the property which the debtor retains after the assignment of the title to the living quarters to the construction participants is sufficient to effect current payments, dis-

charge the first- and second priority creditors' claims or money has been credited to the court of arbitration's account in compliance with Clause 5 Article 201.10 of the Federal Law;

5) provided that the creditor claims register contains no claims of creditors, who are not construction participants, under obligations secured by the real estate developer's title to the block of flats whose construction has been completed, the land plot, the living quarters to be assigned, or the foregoing creditors have agreed to transfer the title to the living quarters to the construction participants, or money has been credited to the court of arbitration's account in compliance with Clause 6, Article 201.10 of the Federal Law;

6) all construction participants are entitled to the living quarters under the terms and conditions specified in the agreements which provide for the living quarters assignment, and the number of the living quarters to be assigned is sufficient to satisfy all of the construction participants' claims included into the creditor claims register and the living quarters assignment claims register (also, there are no claims by some of the construction participants as to the assignment of the same living quarters in the block of flats, save for the cases provided for by Clause 7, Article 201.10 of the Federal Law). Where a construction participant gives his consent, he may be entitled to a living quarters which differs in space, layout, location from the living quarters which meets the terms and conditions stipulated by the agreement which provides for the living quarters assignment.

From July 1, 2013 regulations are to take force to regulate the recovery of compensation in addition to compensation for the harm provided for by the Urban Planning Code of the Russian Federation, caused by decay of, damage to a capital construction facility, violation of the safety requirements during construction works, as well as the building safety operation requirements¹. These are included into cash payment claims. In addition, the recovery of compensation in addition to the compensation for the harm shall not be discontinued after the introduction of financial rehabilitation, external management. Creditors' claims on compensation in addition to the compensation for the harm shall be satisfied on first priority basis.

The information which is subject to disclosure under the Federal Law "On Insolvency (Bankruptcy)" shall be entered into the Unified Federal Register of Bankruptcy Information from April 1, 2011². A law was adopted³ in December 2011 which binds a regulator to approve before June 1, 2012 a procedure and criteria for the selection of an operator of the Unified Federal Register of Bankruptcy Information, select such operator before January 1, 2013 and put him in charge of forming and maintaining the register. Until then an entity assigned by the regulator is to perform such function.

In December 2011, a law (No. 390-FZ dated 03.12.11⁴) was adopted in support of credit cooperatives whose bankruptcy procedure shall be the same as for the bankruptcy of financial institutions, with certain specific features though.

¹ The Federal Law dated 28.11.11, No. 337-FZ "On the Amendments to the Urban Planning Code of the Russian Federation and Certain Legal Acts of the Russian Federation".

² Clause 2, Article 4 of the Federal Law dated 28.12.2010, No. 429-FZ.

³ The Federal Law dated 03.12.11, No. 390-FZ "On the Amendments to the Federal Law "On Insolvency (Bankruptcy)" and Article 3 of the Federal Law "On the Amendments to the Federal Law "On Insolvency (Bankruptcy)" and Invalidation of Clauses 18, 19, 21 and Article 4 of the Federal Law «On the Amendments to the Federal Law "On Insolvency (Bankruptcy)»".

⁴ The Federal Law dated 03.12.11, No. 390-FZ "On the Amendments to the Federal Law "On Insolvency (Bankruptcy)" and Article 3 of the Federal Law "On the Amendments to the Federal Law "On Insolvency (Bankruptcy)" and Invalidation of Clauses 18, 19, 21 and Article 4 of the Federal Law "On the Amendments to the Federal Law "On Insolvency (Bankruptcy)»".

For example, two extra grounds for taking bankruptcy preventive measures towards credit cooperatives are in place:

1) repeated violation of the financial requirements, set forth by the law on credit cooperation, within 12 months from the date of first violation;

2) a supervising body has issued an ordinance prohibiting a credit cooperative to borrow money, accept new members, and issue loans.

When grounds arise to take bankruptcy preventive measures, a credit cooperative shall submit its solvency recovery plan to the supervising body¹ or a self-regulating entity in which it is a member.

The temporary administration of a credit cooperative include representatives of the self-regulating entity of credit cooperatives in which it is a member. A decision to introduce temporary administration shall be made by the supervising body, if it is in charge of direct supervision over the cooperative activities, on the basis of an audit conducted within a month to the date when the decision to introduce temporary administration is made. Such a decision also may be taken in the course of supervising body's audit, provided that grounds for mandatory introduction of temporary administration have been found. The self-regulating entity may apply for the introduction of temporary administration if the legal grounds have been found, namely

A) repeated refusals within a month to satisfy of creditors payment claims. Such a refusal is referred to as non-performance or inappropriate satisfaction of creditors payment claims within 10 working days from the date when the obligation to satisfy such claims arises, unless otherwise provided for by the Federal Law.

B) repeated violation of the financial requirements, set forth by the law on credit cooperation, within 12 months from the date of first violation.

In the event when executive bodies of a cooperative are restricted in power, they are entitled to make decisions to accept new members and borrow money from the members subject to the consent of its temporary administration.

With regard to specific features of satisfying creditors' claims against the credit cooperative, it should be noted that claims of credit cooperative members – physical bodies as creditors – are subject to satisfaction on a first priority basis, thereby protecting their rights to the maximum. However, there are constraining factors, namely the amount of such protection is limited to Rb 700,000, and it only can be provided subject to an agreement on personal savings transfer. In practice, however, different types of agreements are often concluded, thereby making it difficult to protect the rights of physical bodies as creditors. Unsatisfied claims of physical bodies as creditors are subject to satisfaction on a third priority basis. At lower priority are claims of legal entities as credit cooperative members which may be satisfied on the basis of credit agreements. Finally – non-member claims. There are more specific features which are provided for by Clause 4, Article 189.5 of the Federal Law “On Insolvency (Bankruptcy)”.

Where a credit cooperative has no sufficient funds to repay the debt to its creditors, members of the cooperative as well as persons who not later than six months from the date of bankruptcy petition have ceased to be members of the credit cooperative shall be held subsidiary liable for the amount of additional contribution unpaid by each of the members of the cooperative. Members of the Board, auditing department or a single executive body are held

¹ If the supervising body is in charge of supervising the credit cooperative activities in compliance with Article 5 of the Federal Law dated 18.07.09, No. 190-FZ “On Credit Cooperation”.

jointly and subsidiary liable within the amount of units subject to repayment or repaid during termination of membership, provided that the cooperative's bankruptcy signs have resulted from faulty actions or culpable omissions by the specified persons. The foregoing persons may be found guilty if their decisions or actions having resulted in the bankruptcy signs, failed to meet the principles of good faith and prudence established by the civil legislation, the cooperative's charter, good business practices. Subsidiary liability of the self-regulating entity of credit cooperatives arises if no application to appoint a legally provided temporary administration has been submitted.

In general, in assessing the situation with bankruptcies in 2011–2012, we can say that the systemic innovations of 2009 triggered by external events such as crisis developments in the global and Russian economies, were replaced since 2010 with the protection of specific socially important groups of entities and (financial, insurance, construction, etc.) markets.

A series of key issues still remain outside the scope of national interests, namely:

1. Development of a system of regulations providing recovery of solvency and/or rehabilitation of enterprises manufacturing marketable export products.
2. A possibility to retain and recover solvency of companies which account for a big share in the total employment level. (Such level must be measured by the Government of Russia or at regions, depending on the situation with in the regional labor market).

6.3.3. Likely innovations in 2013: draft law on Russia's nationals' debt restructuring

Draft law No. 105976-6 "On the Amendments to the Federal Law "On Insolvency (Bankruptcy)" and Certain Legal Acts of the Russian Federation in terms of Regulation of Rehabilitation Proceedings Applicable to Nationals in Debt" was passed in a first reading in November 2012.

According to different sources of information, at the date when the draft law was adopted the overdue debt owed by individuals under bank loans ranged between Rb 304bn to Rb 317bn¹, and according to the Federal Bailiff Service, already 44 million of Russia's nationals (i.e. one in three Russia's citizens) are in debt to banks. In addition. Given the debt owed to the housing and community amenities (ZHKKH), other organizations, including micro financing ones, total debt owed by individuals may amount to trillions of rubles².

The draft law proposed to *introduce a series of measures aimed at preventing bankruptcy of Russia's nationals through debt restructuring*. For example, in particular, it was proposed to introduce debt restructuring for a citizen if creditors' claims amount to at least Rb 50,000 and fail to be satisfied within 3 months. Moreover, no court ruling (including court of arbitration) is required to confirm the debt, which *makes it much easier and accelerates the initiation of bankruptcy proceedings by creditors in bankruptcy*, which doesn't rule out the use of bankruptcy as a tool to seize the physical body's property.

In addition, a Russia's national, including a self-employed entrepreneur, is obliged to file a bankruptcy petition to the court of arbitration if satisfying one or more creditors' claims makes it impossible for the national to discharge in full his mandatory payment obligations and/or cash commitments as well as other obligations. With regard to self-employed entrepreneurs, it makes it difficult or impossible for them to run their business.

¹ The State Duma will consider one of the most controversial draft laws on bankruptcy of physical bodies - www.newsru.com, 1.10.12; www.aktualno.ru, 15.11.12.

² Rossiyskaya Gazeta, No. 5936, 15.11.12.

The bankruptcy case against a Russia's national must be considered within four months from the date when a relevant bankruptcy petition is received (previously it must be done within seven months).

A debt restructuring plan may be approved in the course of a national's debt restructuring. The plan shall be submitted by the national in debt and must be approved by a meeting of creditors and a court of arbitration. The debt restructuring plan may be provided by a national who meets a series of the following requirements:

- regular income generation;
- the national has no unexpunged or outstanding conviction for intentional crimes in the economic sector, and no administrative sanctions for theft, intended destruction of or damage to property, intended or fraudulent bankruptcy;
- the national was not declared bankrupt during five years preceding the submission of a debt restructuring plan;
- no debt restructuring plan was approved for the national during eight preceding years.

The requirements to Russia's nationals in debt seem to be minimum, thus allowing debt restructuring proceedings to be employed on a larger scale. However, a question arises: Are these requirements sufficient to recover debts? Perhaps, the amount of annual income of such nationals must be less than a share of the overdue debt in percentage terms.

A restructuring plan must contain provisions on the procedure for and terms during which the claims of all creditors in bankruptcy and authorized bodies, which the national in debt knows at the moment of preparation of the restructuring plan, must be satisfied. The debt restructuring plan may not be implemented within a period longer than five years.

A court of arbitration may approve the debt restructuring plan only after the current payment claims have been satisfied and the debt to the first and second priority creditors included into the creditor claims register has been paid off.

The amount of claims of the creditor in bankruptcy, authorized body included into the debt restructuring plan approved by the court of arbitration is subject an interest rate accounting for ½ of the Bank of Russia refinancing rate, unless otherwise provided for by the law.

A series of transactions may be performed during the implantation of a restructuring plan subject to the preliminary consent of the financial manager, and, if the financial manager has not been appointed, the preliminary consent of a meeting of creditors. Such transactions include transactions relating to acquisition, seizure or possible seizure of the national's property to the amount of more than Rb 50,000, and transactions relating to borrowing and lending, issuing of sureties and guaranties, assignment of claims, debt transfer, as well as establishment of trust administration of the national's property.

The restructuring plan may be changed at the initiative of the national and meeting of creditors (if the national's property status has been improved). Such a decision may be made the same way the restructuring plan was approved.

Based on the results obtained during the implementation of the restructuring plan, debts and creditors' complaints, the court of arbitration shall issue a ruling either to terminate the proceedings on the bankruptcy case if the debt has been paid off and the creditors' complaints have been found out to be unreasonable, or cancel the debt restructuring plan and the adjudication order.

Proceedings on the bankruptcy case and debt restructuring may be recommenced based on a court of arbitration ruling if the national has been found out to have concealed his property or illegally transferred the property to third parties. Such a recommencement may be initiated

by the creditors in bankruptcy or authorized bodies whose claims failed to be satisfied in the course of debt restructuring.

The draft law provides for the *introduction in nationals' bankruptcy cases of the same proceedings which are applied to bankruptcy of enterprises*, namely convening of a creditors meeting in order to approve the debt restructuring plan and some other issues; approve a financial manager; publish the information on the bankruptcy from the Unified Federal Register.

In addition to the previously specified effects of the national's bankruptcy, the draft law reads that within five years from the date of his bankruptcy petition the national may not assume liabilities under credit agreements and(or) credit agreements without notifying of the bankruptcy.

In addition to the amendments to the Federal Law "On Insolvency (Bankruptcy)", the draft law suggests to *make amendments to the Administrative Offences Code of the Russian Federation and the Criminal Code of the Russian Federation with regard to regulation of nationals' liability in case of their bankruptcy*. In particular, the draft law suggests to impose administrative liability of Rb 4,000 to Rb 5,000 (Article 14.12 – 14.13 of the Administrative Offences Code of the Russian Federation) on Russia's nationals for fraudulent, intended bankruptcy and illegal actions during bankruptcy. Furthermore, from now on Russia's nationals also may be held criminally liable for actions performed as part of their bankruptcy proceedings (Article 195 – 197 of the Criminal Code of the Russian Federation). They may be held liable to a fine of Rb 100,000 to Rb 500,000 or an amount equal to their wages or other income for those to be imprisoned for a period between 1 and 3 years, and they may be subject to imprisonment for a period of up to 2 years, compulsory labor for up to 3 years, as well as imprisonment for a period of up to 3 years with a fine of up to Rb 200,000 or an amount equal to their wages or other income for those to be imprisoned for a period of up to 18 months or not. (Part 1, Article 195 of the Criminal Code of the Russian Federation).

In general, we may say that bankruptcy proceedings have become more complicated for nationals, and the rights of individuals in debt have become more protected not only by enabling them to gradually repay their debts within a long-term period, but also by imposing minimum requirements for the submission of a debt restructuring plan by such persons. In addition, the proposed (in the draft law) measures will have an effect on credit organizations by allowing them to write off accounts receivable and reduce debt recovery costs.

The following provisions of the law looks controversial:

- restructuring plan terms (which are too long, according to some experts);
- the amount of debt owed by a national which may trigger the initiation of bankruptcy proceedings (according to some representatives of the collector community, a debt of Rb 50000 which triggers debtor's bankruptcy is too small and might have an adverse effect on both financial performance of banks and put extra load on courts. Therefore, it must be increased to an amount being equal to at least Rb 300,000 – Rb 500,000)¹.
- individuals have to pay high expenses for restructuring in which a financial manager is involved, which may total more than the minimum amount of debt required for the initiation of bankruptcy proceedings.

The banking sector representatives express their concern that the adoption of the draft law may trigger more violations by persons not in good faith. They forecast events when persons

¹ Hereinafter "The Law on bankruptcy of physical bodies: protection for persons in debt, the issue for banks?"-www.finam.ru, 05.07.12.

after raising a certain amount of funds may intentionally file a bankruptcy petition after having disposed of their assets. Another issue that banks may face is debtors with fraudulently “other” accounts payable which would make debts even harder to recover as part of bankruptcy proceedings.

In addition, the discussion of the draft law resulted in some comments and suggestions regarding goods in common, the effect of debtor’s death on a bankruptcy case, the possibility to postpone the introduction of criminal liability, definition of non-saleable property, the possibility to prohibit nationals in debt to leave Russia, etc.¹, as well as protect the debtor from a creditor seeking to deliberately drive the debtor to bankruptcy in order to take possession of the debtor’s property.

It is the foregoing provisions that may be modified / amended during the preparation of draft law for consideration in the second reading scheduled in April 2013. The discussion of the draft law on nationals’ debt restructuring gives rise to a discussion of the need to adopt a law on collector activities which would allow the nationals’ interests to be protected in recovering overdue debts.

6.4. Russia's Innovation Promotion Policies: Their Evolution, Achievements, Problems and Lessons

6.4.1. Introduction: A General Framework for Elaborating and Estimating an Innovation Policy

Innovations, science and technology, and innovation policies represent the limited range of fields where, as believed by a majority of eminent contemporary economists and analysts, it can be possible and even reasonable for the government to interfere. The only arguable aspects are, in the main, the scale, forms and limits of government interference and the experts also discuss and explore the world's best practices and the principles underlying each specific policy². The necessity of government interference in order to promote innovations is proclaimed (explicitly or implicitly) by two basic concepts of economic development – the neo-classical and evolution theories.

*The neoclassical economic theory*³ explains the need for public funding to be allocated to research and development by the phenomenon of market failures, when public benefits from investing in science and technologies turn out to be greater than the rate of return received from similar investment by private investors⁴. It is a well-known fact that the companies experiencing financial difficulties are forced to reject some potentially profitable innovation projects because of the existence of information asymmetry and the risk that the cost of credit

¹ The State Duma plans to consider the draft law on bankruptcy in the second reading in April to come - biz-tass.ru, 15.01.13.

² See, for example, Goldberg, I., Gobbard, G., Racin, J. Igniting innovation: rethinking the role of government in emerging Europe and Central Asia. World Bank, Washington DC.

³ Nelson, R. (1959). The Simple Economics of Basic Scientific Research. *Journal of Political Economy*, 67 (3), 297-306; Arrow, K. (1962). Economic Welfare and the Allocation of Resources for Invention. In R. Nelson (Ed), *The Rate and Direction of Inventive Activity* (pp. 164-181). Princeton University Press.

⁴ It is noteworthy that Arrow (see the previous note), when speaking of the necessity for the government to implement certain measures to compensate for market failures, also points out the following two fundamental issues: (1) how to guarantee that the investment is cost-effective, and (2) how to identify such market failures?

may increase¹. Along with these problems, some constraints are also associated with the attraction of venture capital in order to bridge the financial gap typical of R&D^{2,3}.

In the early 1990s, some proponents of the neoclassical growth theory, while studying endogenous technological changes⁴, demonstrated that the government's subsidizing of R&D activities urges companies to spend more on this particular field of research, thus creating a positive effect in terms of economic growth. Later on, a number of theoretical models were created⁵, which assessed the effects of subsidies allocated to R&D and their influence on long-term economic development.

Evolutionary economics⁶ regards innovations as a complex phenomenon fraught with high risks and requiring a broader access to knowledge, while the most important definitive feature of the innovation processes becomes the interaction between their participants. So, one of the most important factors that sustain the performance of an innovation system is the support provided by the State to the development of interactions, connections, and networks. It can be recalled that the success achieved in introducing and implementing R&D on a broad scale in the newly industrialized countries was based on intensive multi-disciplinary personnel training, in large groups, and the positive effects of this educational activity tend to accumulate with time⁷. It is the neutral and mass-scale support of R&D activities in the early phase of their development that later on makes it possible to identify genuine market failures whenever they occur, with due regard for their sectoral specificity, and thus to elaborate a more selective policy for promoting innovations.

Within the framework of the evolutionary approach, failures are usually perceived to occur in the field of education – 'learning failures'⁸, which can be interpreted as constraints imposed on the learning potential and its use – both at the level of each individual agent and at the level of group agents. In this connection, there arise such issues as lack of proper coordination be-

¹ Hall, B. H. (2002). The Financing of Research and Development. *Oxford Review of Economic Policy*, 18 (1), 35-51.

² Hall, B. H., Lerner, J. The Financing of R&D and Innovation. In Hall, B. H. and N. Rosenberg (Eds) *Handbook of the Economics of Innovation*, Elsevier-North Holland.

³ It is noted that more than half of the money allocated to R&D is spent on the remuneration of researchers, whose work generates intangible knowledge (that, more often than not, cannot be codified). As a result, the principal gains for the companies are associated with the development of their human resources, but the investors are faced with an increased risk of losses if the personnel involved leave (or change) their place of employment.

⁴ See, for example, Romer, P. (1990). Endogenous Technological Change. *Journal of Political Economy*, 98, S71-S102; Segerstrom, P., Anant, T., Dinopoulos, E. (1990). A Schumpeterian Model of the Product Life Cycle. *American Economic Review*, 80, 1077-1092; Grossman, G., Helpman, E. (1991). Quality Ladders in the Theory of Growth. *Review of Economic Studies*, 58, 43-61; Aghion, P., Howitt, P. (1992). A Model of Growth Through Creative Destruction. *Econometrica*, 60, 323-351.

⁵ See, for example, Howitt, P. (1999). Steady Endogenous Growth with Population and R&D Inputs Growing. *Journal of Political Economy*, 107, 715-730; Segerstrom, P. (2000). The Long-Run Growth Effects of R&D Subsidies. *Journal of Economic Growth*, 5, 277-305.

⁶ Metcalfe, J. S. (1994). Evolutionary economics and public policy. *Economic Journal*, 104 (425), 931-944; Edquist, C. (1997). System of innovation approaches - their emergence and characteristics. In Edquist (ed), *System of Innovation. Technologies, institutions and organizations*, London.

⁷ Teubal, M. (1996). R&D and technology policy in NICs as learning processes. *World Development*, 24 (3), 449-460; Teubal, M. (2002). What is the systems perspective to Innovation and Technology Policy (ITP) and how can we apply it to developing and newly industrialized economies? *Journal of Evolutionary Economics*, 12 (1), 233-257.

⁸ Bach, L., Mats, M. (2005). From economic foundations to S&T policy tools: a comparative analysis of the dominant paradigms. In M. Matt & P. Llerena (eds), *Innovation Policy in a Knowledge-Based Economy: Theory and Practice*. Springer Verlag.

tween agents, underdeveloped institutions for coordinated knowledge generation and distribution, their inadequate adjustment to and lack of timing with the ongoing technological changes, the difficulties of codification (lack of standards and platforms), barriers in knowledge perception, etc.

As both these approaches have been strongly influencing the process of elaborating economic policies in many countries, at present there exists a sort of a *framework consensus with regard to the innovation promotion mechanisms: they are viewed, on the one hand, as devices that help to lower the risks and to spread more evenly the innovation costs; and on the other – as stimuli for developing interaction networks, training methodologies and the generation of new collective knowledge*. Both these approaches to elaborating an innovation policy (see Table 10) are mutually supportive, with an increasing trend towards focusing on the evolutionary model of economic growth.

Table 10

A Tentative Framework for Innovation Policy

Innovation policy's specific features	Neoclassical growth model	Evolutionary growth model
1. Key problems	Market failures – problems with redistribution of resources	Learning failures – problems involved in knowledge generation and distribution
2. Main object	Science, technologies, innovations (STI)	Skills, use, interaction (DUI)
3. Policy character	Mission-oriented policy – orientation strictly to final results, to direct influence; assessments of needs and replenishment of lacking resources	Diffusion-oriented policy) – orientation to spreading changes, practical examples; learning as part of policy implementation
4. Estimation of results	Numerical effects, direct effects, changes in resource management	Qualitative effects, behavioral effects, learning effect

Hypothetically, an innovation policy can be mission-oriented or diffusion-oriented; the former is more compatible with the neoclassical model, and the later fits the evolutionary approach¹. However, when taken in practical terms, a policy is usually based on a compromise between the two models, with a certain degree of balance achieved in both dimensions – (1) horizontal or vertical; (2) mission-oriented or diffusion-oriented.

Over recent decades, the conditions for implementing innovations have changed dramatically – both in the developed countries and in the transition economies. Among the alterations that occurred in the sphere of *innovations on a global scale in the past few decades, the following ones can be pointed out:*

(1) global competition results in a shorter product life cycle and imposes tough constraints on the timelines for new product development;

(2) the global nature of the innovation activity and the inevitable specialization and international partnership make it impossible to keep all added value in one given country;

(3) the increasing complexity of new production technologies makes it difficult, even for biggest companies, to maintain their leadership on world markets - thus giving rise to new motives for specialization;

(4) interdisciplinary studies are becoming an important factor of a successful implementation of innovations, while the rising costs of research and development and the need for different specialization results in an increasing cooperation on all levels – corporate, inter-country, and in the emergence of technological alliances;

¹ Bach, L., Mats, M. (2005). From economic foundations to S&T policy tools: a comparative analysis of the dominant paradigms. In M. Matt & P. Llerena (eds), *Innovation Policy in a Knowledge-Based Economy: Theory and Practice*. Springer Verlag.

(5) the channels for transmitting new knowledge and technologies are broadening, thus creating opportunities for accelerating the process of spreading technologies across economies by means of better regulation;

(6) the transmission and perception (or acquisition) of knowledge on an individual level becomes a very relevant component in the process of spreading innovations, and so the requirements to human resources are significantly upgraded;

(7) the role of innovations in dealing with contemporary social challenges is also becoming increasingly prominent, and the innovation fields like ecology, health, nutrition are viewed as priorities for sustainable social development.

Against the backdrop of all these fundamental shift, inevitably, *the attitudes of many national governments to the task of supporting innovations have undergone a certain transformation* – in view of the increasing globalization and international competition the formerly neutral approach gave way to a more active direct involvement of government agencies in promoting the innovation processes, with a more accurate 'tuning' of the relevant instrument to the specificities of each sector, market, or technological shifts. In the innovation policies of different countries, the following common directions of the ongoing transformation can be identified:

- (1) a generally enhancing role of the government in promoting and supporting innovations; a switchover to an integration policy in the fields of science, technology, education and innovation; an increasing focus on the development of necessary networks and the promotion of interaction between the different participants in the innovation processes;
- (2) a shift from the model based on supporting the supply of innovations towards the one based on promoting a demand for innovations; an increasing number of governments applying a broad range of mechanisms for innovation promotion; a departure from the principle of neutrality in elaborating an innovation policy, and a diffusion of boundaries between the innovation and industrial policies;
- (3) an increasing inter-country distribution of best practices of innovation support, an increasing scale of inter-country transfers of the 'sets of instruments' for promoting innovations, with an emphasis on learning and deriving lessons from experimenting in the framework of an innovation policy;
- (4) the imposition of tougher budget constraints and, consequently, an increasing role of regular evaluation of the performance of various instruments innovation-promoting instruments.

A predominant trend in the current approaches to the task of stimulating innovations is to view them as a fundamental factor of sustainable economic development; in this connection, *the focus of the ongoing discussion has shifted onto the issue of how to select the most effective and appropriate instruments to be applied in government innovation policies.*

In principle, there exist a broad variety of instruments for the support of innovations that have already been tested in many different countries. These are tax exemptions, targeted loans, government subsidies, and a multitude of other things. Nevertheless, both the new industrial countries (for example, in Latin America) and those with developed market economies (such as EU members) *are still continuing an active quest for and discussion of new instruments for promoting innovations*¹ - the instruments that could yield most effective results with only minimum distortions in the existing market environment.

¹ DEMAND. (2002). STI Report: tax incentives for research and development – trends and issues. Paris: DEMAND; DEMAND. (2006). Government R&D Funding and Company Behavior. Measuring Behavioral Ad-

On the basis of an analysis of the practices of implementing different innovation promotion mechanisms, the following specific features can be pointed out¹:

- the advantages of *tax instruments* in promoting innovations is that they may be applied to a broad range of economic agents (without any special constraints), their neutrality, and no need for any special procedures of expert's estimation;
- the attractiveness of *financial instruments* applied in the support of innovations (credits, subsidies, grants) consists in their ability to concentrate the available resources within the framework of the most promising projects, the projects of the highest significance from the point of view of benefits to society; besides, they allow better opportunities for measuring the projects' cost-effectiveness and for exercising proper control over the expenditures allocated to innovations.

On the basis of available data for the EU countries it was demonstrated that, by comparison with tax exemptions, government co-financing of companies' expenditures on R&D produced a more long-term effect². The advantages of subsidies towards R&D activities are also associated with their potential to 'compensate', for companies, the market uncertainties that they are faced with in their business activity³. Thus, while tax exemptions are better from the point of view of expanding the ongoing innovation projects, subsidies conduce to the launch of new, more long-term projects. Besides, the companies - recipients of grants more often act as innovators on an international level and are more successful in commercializing their products than the companies that are encouraged only by means of tax exemptions⁴.

On the whole, *tax exemptions and subsidies, in terms of their effectiveness in prompting innovations, each have their own specific advantages and drawbacks*. It is not by chance that the group of independent experts participating in the preparation of the European Commission's Report⁵ recommended that different 'instrument packages' should be applied in promoting the innovation activity.

The cost-effectiveness and feasibility of different instruments for innovation support represent one of the key issues underlying the government innovation policies in many countries, especially under the conditions of toughening budget constraints. It is noteworthy that one of the directions in which the countries reacted to the changed conditions for the implementation of innovations in the post-crisis period has been a shift in the principles applied in the estimations of an innovation policy's results.

A policy implemented in the field of science and technologies usually aims at achieving certain goals set on a rational basis within a certain framework. From this it follows that, on the one hand, some of the ongoing changes may depart from the policy's established goals, while on the other, such 'unexpected' changes may either be compatible or incompatible with

ditionality. Paris: DEMAND; DEMAND. (2012). DEMAND Science, Technology and Industry Outlook 2012. DEMAND Publishing.

¹ DEMAND. (2002). STI Report: tax incentives for research and development – trends and issues. Paris: DEMAND.

² Guellec, D., y Van Pottlesberghe, B. (2003). The impact of public R&D expenditure on business R&D. *Economics of Innovation and New Technologies*, 12 (3), 225-244.

³ Czarnitzki, D., Toole, A. A. (2007). Business R&D and the interplay of R&D subsidies and product market uncertainty. *Review of Industrial Organization* 31(3), 169–181.

⁴ Berube, C., Mohnen, M. (2007). Are Firms That Received R&D Subsidies More Innovative? CIRANO Working Paper 2007s-13, CIRANO.

⁵ ECR. (2003). Raising EU R&D Intensity – Improving the Effectiveness of the Mix of Public Support Mechanisms for Private Sector Research and Development. Report to the European Commission by an Independent Expert Group.

the model framework applied in determining those goals¹. Therefore, there emerges *the task of a regular identification and estimation of the 'incompatible' changes and the continual re-definition of the model framework itself*.

An increasing attention has been focused on estimating an innovation policy as a learning instrument, and on finding the best ways for its implementation. In fact, something that has been good for one country may become counter-productive in terms of innovations on another, and so the identification of problem areas must go hand-in-hand with certain experimenting aimed at providing solutions to the existing problems, as well as with an expansion of learning processes².

By now, the world has already accumulated vast experience in estimating the effects of different innovation-promoting instruments on the performance of companies. Some progress has been observed in the development of general methodologies of estimating the effects of policies implemented in the field of science, technologies and innovations³. However, such issues as the time shifts of the effects of various applied mechanisms, the composition of the potential externalia, the heterogeneity of influence, and the multiple character of influences still retain their importance.

A basic factor in the estimation of innovation policies has become the concept of additionality, which implies identification and analysis of those effects that would have been non-existence in absence of the instruments of government support. A practice has already been developed⁴ for making such an estimation on the basis of four types of effects existing at a company's level: (1) changes in resources, (2) direct results of innovations, (3) changes in a company's competitive capacity, (4) behavioral changes.

In the framework of the first group of effects, among other things, the changes in the volume of corporate expenditures allocated to R&D are considered. The second group of effects includes the increment in the number of patents taken by companies, the output of new products and the resulting growth in sales. The third group incorporates indicator like productivity growth, the scale of business activity and market share.

The effects belonging to the fourth group (the so-called behavioral additionality⁵) stand somewhat apart from the others. These effects are much closely linked to the intrinsic factors

¹ Bach, L., Mats, M. (2005). From economic foundations to S&T policy tools: a comparative analysis of the dominant paradigms. In M. Matt & P. Llerena (eds), *Innovation Policy in a Knowledge-Based Economy: Theory and Practice*. Springer Verlag.

² Rodrik, D. (2008). *The New Development Economics: We Shall Experiment, but How Shall We Learn?* Working Paper Series rwp08-055, Harvard University, John F. Kennedy School of Government; Chaminade, C., Lundvall, B., Vang, J., Joseph, K. (2009). Designing innovation policies for development: towards a systemic experimentation-based approach. In Lundvall, B. et al. (eds.) *Handbook of Innovation Systems and Developing Countries*. pp. 360-379.

³ See, for example, Crespi, G., Maffioli A., Mohnen, P., Vazquez, G. (2011). *Evaluating the Impact of Science, Technology and Innovation Programs: a Methodological Toolkit*. SPD Working Papers 1104, Inter-American Development Bank, Office of Strategic Planning and Development Effectiveness.

⁴ See, for example, Hall, B. H., Maffioli A. (2008). *Evaluating the Impact of Technology Development Funds in Emerging Economies: Evidence from Latin America*. NBER Working Paper 13835, National Bureau of Economic Research, Inc.

⁵ The concept of behavioral additionality was first formulated in 1995. It was then noted that the additionality concept is an important instrument capable of boosting up the results of government support in the sphere of research and development, but that it must be geared not only to direct effects, but also to the behavioral ones. Thus, in particular, when applied to big companies, behavioral additionality may be linked to changes in the principles of composing the portfolios of research projects and corporate technological strategies. Behavioral

that have to do with the specificity of a company's organizational structure, the interests and motivations of different related parties, the individual standpoints of a company's owners, a company's potential for acquiring new knowledge and learning new technologies, etc. - that is, something that cannot be easily formalized. In the framework of the fourth group of effects, the changes in the attitudes of a company's owners to innovations, the transformation of companies' innovation strategies, the re-estimations of the importance of external interactions and partnerships with other organizations in the course of implementing innovations are usually analyzed.

It is due to the existence of the behavioral factors that the links between the first and second groups of effects are non-linear and versatile. The importance of the estimation of behavioral changes is also associated with the fact that the logic behind the government's interference in the form of an organized innovation policy implies a necessity to compensate not only for market and systemic failures (the market ones – support of research; the systemic ones – support of cooperation and networks), but also for failures in companies' receptability¹ - that is, support of changes in their behavior.

The estimation of behavioral additionality is increasingly becoming a typical component of the overall estimation of the performance of different instruments applied in promoting innovations. So, the following characteristic features of the practice of estimating the innovation instruments can be noted:

(1) regularity of estimations, inter-country comparison of the results is a well-developed practice in the EU countries; the practice of estimating the influence of new innovation promotion mechanisms in Latin American countries, in the new industrial countries;

(2) long periods of observation (more than 10 years), availability and maintenance of detailed official statistics in the relevant fields, openness of the official assessment procedures applied in the records of new effects;

(3) complexity and heterogeneity of the estimations (for example, the replacement effect), the existence of considerable time lags in the emergence of final effects (4 – 6 years), marked heterogeneity of the influences of different promotion mechanisms; the existence of significant econometric problems; preparation and presentation of methodological recommendations concerning the principles of estimation and the associated problems;

(4) openness, public access to the results of estimations; practical use of the results of estimations in the decision-making at the government level – distribution of best practices, learning the lessons; decision-making with regard to discontinuation, adjustment, or expansion of various programs and mechanisms applied in the promotion of innovations.

6.4.2. The Main Instruments and Development Phases of the Government Innovation Promotion Policy in the 2000s

The government policy aimed at promoting innovations that was implemented in Russia in the 2000s was by no means uniform. It involved many different instruments and measures, abounded in various initiatives that often appeared to be poorly substantiated and sometimes even downright eccentric. At the same time, it must be admitted that, over that period, the innovation policy became significantly better elaborated - even if its progress was by no means

changes determine the external (from the point of view of a given company) positive effects based on the distribution of best practices among other companies.

¹ Gok, A., Edler J. (2011). The Use of Behavioral Additionality in Innovation Policy-Making. MBS/MIoIR Working Paper 627, The University of Manchester.

always smooth and based on the choice of best decisions and practices. In our opinion, with some reservations, we may distinguish five main phases in the development of that policy, which were largely determined by the availability of government resources, as well as by the varying views of the ruling elites as to the most important goals of economic development during different periods and the necessity of innovations for providing adequate economic solutions:

2000 – 2002: the phase of 'small deeds' against the backdrop of limited resources;

2003 – 2005: the phase of activization and diversification against the backdrop of stable economic growth;

2006 – second half of 2008: the phase of big decisions and initiatives;

late 2008 – 2009: the phase when the anti-crisis agenda was predominant;

from 2010 onwards: the phase of a quest for 'new quality'.

2000 – 2002

Approximately until 2003, *in conditions of relatively tough budget constraints, the issues relating to innovations remained 'in the periphery' of the government's policy. Due to the low innovation activity of businesses, the demand for any relevant government measures was insignificant.* The government policy instruments that emerged during that period were, as a rule, relatively inexpensive, and their effectiveness was low. A typical example is the creation of the Venture Innovation Fund¹ – the government's 'fund of funds' designed to promote the development of a system of venture financing in Russia. The amount of government contribution in the fund's capital was limited to Rb 100m (of which, according to available data, only Rb 50m was actually transferred), while its investment activity began only a few years later. Besides, over the period under consideration, a new basic law was enacted in the field of standardization, certification and technical regulation². However, the process of elaborating, on its basis, the necessary technical regulations began much later – the first relevant document was issued in late 2005³, and that activity became more or less regular only in 2008.

However, alongside the aforesaid steps undertaken by the government (not very successful – at least initially), we cannot overlook another development – namely, that in 2002 the Russian Bank for Development (*RosBR*)⁴ (which had previously been specializing mainly on issuing loans to industrial companies in accordance with the priorities set by the RF Government) began to implement the *и* program of financial support to small and medium – sized and enterprises (SME). It was organized as a two-tier structure: first, the bank issued the money to its regional partners, which then issued loans to SME – to cover, among other things, the cost of renewal of their fixed assets. Soon – and it is still true today – the implementation of that program became not only the bank's core activity, but also the main instrument of rendering government financial support to SME.

It must also be noted that, over the period under consideration (which, however, is also true of the previous and later years), one important instrument for channeling government financing allocated to applied R&D projects were federal target programs, among which there were some specialized programs in the field of science and technologies: the Federal Research and

¹ The RF Government's Regulation of 10 March 2000, No. 362-r.

² Federal Law of 27 December 2002, No. 184-FZ 'On Technical Regulation'.

³ The RF Government's Decree of 12 October 2005, No. 609 'On Approving the Technical Regulation "On The Requirements As to the Emission of Pollutants by the Motor Vehicles Put in Operation in the Territory of the Russian Federation" '.

⁴ At present the Russian Bank for Small and Medium Enterprises Support (SME Bank).

Technology Target Program for the years 1996–2000 'Research and Development in the Priority Directions of Development of Science and Technologies for Civil Purposes'¹, the Federal Research and Technology Target Program 'Research and Development in the Priority Directions of Development of Science and Technologies' for 2002–2006², the Federal Target Programs 'National Technological Base' for 1997–2000³ and 2002–2006⁴), and also some sectoral programs. However, these programs did not envisage any financing to be allocated to the implementation in industry of the results of completed R&D projects.

2002–2005

Stable economic growth, followed by softening of budget constraints, created the necessary preconditions for further development of the government policy, which now could address those directions and sphere that previously were de facto considered to be of secondary importance. In combination with the government's increasing attention to the 'quality' of growth, this was transformed in a strong impetus to innovation activities and an expansion of the available set of relevant instruments.

The first real sign of the government's changed attitude to innovations was the launch, in 2003, of a number of government-level innovation projects, or *mega-projects*, which was at that time a step forward in the field of innovations that was unprecedented over the entire period of Russia's post-Soviet history. The key features of the mega-projects, which set them apart from all the other instruments previously applied in government innovation policy, were as follows:

- very impressive costs – up to several billions of rubles, of which government funding covered approximately half, on a non-refundable basis;
- long periods established for implementing the projects – 3–5 years, and so the framework of one project could encompass all the different phases of the innovation cycle – from the development of new products and technologies to putting them in operation;
- the mandatory requirement that the product's sale should be launched within the project's framework, and the sale volume was to be fivefold the amount of the aggregate budget financing allocated to the project.

Because of these specificities, the implementation of the mega-projects took place on a 'singular' basis – over the decade whilst that instrument was being applied, only about 30 projects were launched, half of which covered the period of 2003–2005.

In 2004, a number of significant alterations were made to the already mentioned Federal Research and Technology Target Program 'Research and Development in the Priority Directions of Development of Science and Technologies'⁵, which envisaged, among other things, support of the activity aimed at 'commercializing' the results of completed R&D. The new version of the programs mapped some measures designed to ensure the funding of the mega-

¹ Approved by the RF Government's Decree of 23 November 1996, No. 1414.

² Approved by the RF Government's Decree of 21 August 2001, No. 605.

³ Approved by the RF Government's Decree of 13 August 1996, No. 986.

⁴ Approved by the RF Government's Decree of 8 November 2001, No. 779.

⁵ The RF Government's Decree of 12 October 2004, No. 540 'On Introducing Alterations in the Federal Research and Technology Target Program 'Research and Development in the Priority Directions of Development of Science and Technologies' for 2002–2006, and Recognizing as Null and Void Some Acts of the Government of the Russian Federation'.

projects implemented 'under the auspices' of the RF Ministry of Education and Science¹, as well as some large-scale venture projects.

In 2004, the Foundation for Assistance to Small Innovative Enterprises in Science and Technology began to implement the program 'Start', which envisaged the allocation of grants in order to finance R&D carried out in the framework of innovation projects implemented by newly created small enterprises over a period from 1 to 3 years. As it happened in the case of the Russian Bank for Development's support of SME, this program soon became the Foundation's core activity - and at the same time the main instrument for allocating government financial support to small innovation companies.

In 2005, the legal foundation for the creation and operation in Russia of special economic zones was adopted², one of their types being that of a technology implementation zone, and a number of rather significant tax exemptions for their residents, including the free customs zone regime, the guarantees that the current tax regime was not to be worsened, the possibility to apply a reduced rate of profit tax, a preferential procedure for writing off the expenditures on R&D, the possibility for accelerated depreciation of fixed assets, temporary exemption from property and land taxes, etc. In late 2005, the RF Government formalized its decisions concerning the creation of four technology implementation zones: in Tomsk, St. Petersburg, Moscow (at Zelenograd), and Moscow Oblast (at Dubna).

The year 2005 saw the onset of the process of creating regional venture funds as part of measures designed to support small-scale entrepreneurship, to be implemented by RF subjects and co-financed from the federal budget³. At present there exist 23 funds in 21 RF subjects.

And finally, in 2005 the legal foundation was laid for the mechanism of subsidizing, by Russian exporters, of part of the interest paid on the loans attracted in order to develop exports of highly processed products⁴.

2006 – second half of 2008

The period of 2006–2008 was marked by *high government activity in the field of innovation support, and – as a result – regular implementation of new measures and instruments, which often required substantial resources (including in the form of lost budget revenue)*. In this connection, two directions of that government policy are especially noteworthy: the launch of a number of tax instruments for innovation promotion, as well as the creation and capitalization of some big financial development institutions:

- in 2006, the Open-ended Joint-stock Russian Venture Company (RVC)⁵ was established with the purpose of promoting the creation, in Russia, of a national venture investment industry modeled after a 'fund of funds. RVC's capital was fully formed by the government and amounted to Rb 30bn. It should be noted that this particular development institution

¹ Initially, the mega-projects were supervised by the RF Ministry of Industry and Science; after its abolition in 2004, this direction of government support was taken over by the RF Ministry of Education and Science and the RF Ministry of Industry and Energy.

² Federal Law of 22 July 2005, No. 116-FZ 'On Special Economic Zones in the Russian Federation' and No. 117-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in Connection with the Adoption of the Federal Law 'On Special Economic Zones in the Russian Federation'

³ The relevant rules were established by the RF Government's Decree of 22 April 2005, No. 249 'On the Conditions and Procedure for the Allocation of Federal Budget Funding Earmarked for the Government Support of Small Entrepreneurship, Including Peasant (or Farmer) Economies'.

⁴ The RF Government's 6 June 2005, No. 357 'On the Approval of the Rules for Compensation from the Federal Budget to Russian Exporters of Industrial Products of Part of their Expenditures on the Payment of Interest on Credits Received in 2005 from Russian Credit Institutions'.

⁵ The RF Government's Regulation of 7 June 2006, No. 838-r.

- was evidently created with due regard for the experience gained during the previous attempt at launching a government 'fund of funds' – the Venture Innovation Fund. In 2007 and 2008, with the participation of the RVC, 7 venture funds were created;
- from 2006, a depreciation premium was introduced, whereby enterprises were granted the right, when calculating the amount of tax on profit, to write off up to 10% of their capital investment in new fixed assets and the technological upgrading and modernization of fixed assets¹;
 - the period for writing off the expenditures on R&D whose results are applied in production processes was shortened first from 3 years to 2 years (from 2006)², and then to 1 year (from 2007)³;
 - from 2006, it was envisaged that the expenditures on R&D that had yielded no positive result could be written off in full⁴ (previously – 70%); from 2007, the period for writing off such expenditures was shortened to 1 year⁵ (previously – 3 years);
 - in 2007, the USSR Bank for Foreign Trade was reorganized into the State Corporation 'Bank for Development and Foreign Economic Affairs'⁶; simultaneously, the capital of the newly created entity was augmented by an additional contribution of Rb 180bn, as well as shares issued by two specialized banks – *RosBR* [Russian Bank for Development] and *Eximbank Russia*. It was established that one of the main directions of the State Corporation's investment activity was to be the implementation of innovation-oriented investment projects⁷. It should be noted that the reorganization resulted in some significant changes in *Vneshekonombank's* activity, and first of all in terms of quality of the development institutions. Thus, over the period of 2007 - 2008, the volume of investment credits increased more than 4-fold;
 - in 2007, the Russian nanotechnologies corporation (State Corporation *Rusnanotech*) was established with the purpose of developing the innovation infrastructure and implementing promising projects in the fields of nanotechnologies and nanoindustry⁸. The government's contribution to the corporation's capital was money in the amount of Rb 160bn. The financing of projects by the newly created state corporation was started in 2008;
 - from 2008 onwards, the enterprises were granted the right of accelerated depreciation (with a coefficient of up to 3) of their fixed assets used strictly for their activity in the field of science and technology⁹;
 - from 2008 onwards, the following types of activity were made exempt from VAT: the performance, by organizations, of research and development involving the creation of improvement of products or technologies, if this activity results in the development of an en-

¹ Federal Law of 6 June 2005, No. 58-FZ 'On the Introduction of Alterations to Part Two of the Tax Code of the Russian Federation and to Some Other Acts of the Russian Federation's Legislation on Taxes and Levies'.

² Federal Law of 6 June 2005, No. 58-FZ.

³ Federal Law of 27 July 2006, No. 137-FZ 'On the Introduction of Alterations to Part One and Part Two of the Tax Code of the Russian Federation and to Some Legislative Acts of the Russian Federation in Connection with the Implementation of Measures Designed to Improve Tax Administration'.

⁴ Federal Law of 6 June 2005, No. 58-FZ.

⁵ Federal Law of 27 July 2006, No. 137-FZ.

⁶ Federal Law of 17 May 2007, No. 82-FZ 'On the Bank for Development'.

⁷ the RF Government's Regulation of 27 July 2007, No. 1007-p.

⁸ Federal Law of 19 July 2007, No. 139-FZ 'On the Russian Nanotechnologies Corporation'.

⁹ Federal Law of 19 July 2007, No 195-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in the Part of Creating Favorable Tax Conditions for the Financing of Innovation Activity'.

gineering structure or technical system, new technologies, sample models of machines, equipment, or materials;

- the transfer of exclusive rights to inventions, useful models, industrial samples, software, databases, integral microcircuit topologies and know-how, as well as the rights to the practical application of the aforesaid results of intellectual activity on the basis of a licensing agreement¹;
- from 2008, the costs taken into account under the simplified system of taxation were to include:
 - the cost of acquisition of exclusive rights to the aforesaid results of intellectual activity, as well as the rights to their practical application on the basis of a licensing agreement;
 - the cost of patenting and/or the price of the legal services associated with legal protection of the results of intellectual activity;
 - the cost of R&D².

In addition to all these directions of innovation policies, a number of other measures, in some or other way associated with innovation promotion, were introduced during the period under consideration:

- within the framework of the priority national project 'Education', over the period of 2006–2008, innovation-oriented higher educational establishments received support as part of special innovative educational programs that envisaged fundamental and applied studies and students' participation in the implementation of real projects in various sectors of the national economy. The recipients of that support were 57 higher educational establishments across Russia;
- The Federal Target Program for the Development of Education in 2006–2010 envisaged, in particular, the financing of measures designed to create networks of innovation-oriented higher educational establishments, as well as to form a segment of the national innovation system on the basis of higher educational establishments³;
- in 2006, it was decided to establish the Open-ended Joint-stock Company 'Russian Investment Fund for Information and Communications Technologies' (*Rosinfokominvest*)⁴ for the purpose of making investment in promising innovation projects carried out by companies specializing in information and communications technologies (ICT); in 2007, the fund's creation was effectively completed. It differed from the other government financial development institutions created over the period under consideration (RVC, *Vneshekonombank* in the form of a state corporation, *Rusnanotech*) in that its capital was relatively small – Rb 1.45bn. Its another distinctive feature was that, by early 2012, it had not yet began to work towards its main goal - investing in companies⁵;

¹ Federal Law of 19 July 2007, No. 195-FZ.

² Federal Law of 19 July 2007, No. 195-FZ.

³ Approved by the RF Government's Decree of 23 December 2005, No. 803.

⁴ Decree of the Government of the Russian Federation of 9 August 2006, No. 476 'On the Establishment of the Open-ended Joint-stock Company "Russian Investment Fund for Information and Communications Technologies'.

⁵ It should be noted that in the aforesaid Decree of the RF Government it is envisaged that the fund's charter must contain a provision whereby the fund has no right to allocate financing to projects until the moment when the Russian Federation's stake in its capital is decreased to 51% (at present, 100% of the fund's stock is in federal ownership), but in the current wording of the fund's charter (approved by Order of the RF Ministry of Communications and Mass Media of 4 May 2010, No. 69) there is no such provision.

- in 2006, the Program 'Creation in the Russian Federation of Technoparks in the Hi-tech Sphere' was adopted¹ in accordance with which, from 2007 onwards, a number of RF subjects began to receive annual subsidies earmarked for the implementation of that specific goal². Initially, that program was geared for a five-year period – from 2006 through 2010, and envisaged the foundation of technoparks in Moscow Oblast, Novosibirsk Oblast, Nizhnii-Novgorod Oblast, Kaluga Oblast, Tyumen Oblast, the Republic of Tatarstan, and St. Petersburg; at present, the period of its implementation is prolonged until 2014, and the list of regions where technoparks are to be created has been extended - it now includes the Republic of Mordovia³, as well as Kemerovo Oblast⁴, Penza Oblast, Samara Oblast and Tambov Oblast⁵;
- an undertaking of fundamental importance was the launch, in 2007, of the presidential initiative 'Strategy of the Development of Nanoindustry', personally initiated by the RF President. It should be acknowledged that initially the Strategy attracted rather little attention⁶. In fact, the document adopted in this connection, in addition to outlining the main principles of the government policy in that sphere (which in itself was significant), also determined all the key activities of the RF Government related to the development of nanoindustry: the establishment of the Russian Corporation of Nanotechnologies, the implementation of the Federal Target Program 'Development of the Nanoindustry Infrastructure in the Russian Federation in 2008–2010'⁷, and the organization of a national research center in that field (to be discussed in more detailed later in the text);
- in 2007, the implementation of the Federal Target Program 'Research and Development in the Priority Directions of Developing Russia's Scientific-technological Complex in 2007–2012'⁸, was started, to replace the completed Federal Research and Technology Target Program 'Research and Development in the Priority Directions of Developing Science and Technologies', which had been implemented in 2002–2006. The new program continued the support of mega-projects via the RF Ministry of Education and Science. Besides, in its framework, a fundamentally new (for Russia) innovation policy instrument was applied in the co-financing of the innovation projects implemented in the interests of the business community. The key feature of that instrument that distinguished it from all the previously applied ones was that the themes of the R&D projects to be financed by the government were determined directly by the related businesses on the basis of their own interests and needs, while the government confined its role to determining, on the basis of contests, the entities to be changed with the task of the performing the relevant work (with due regard for the opinion of the beneficiary company, which participated in the expert estimation of the submitted applications). However, in spite of the strong interest demonstrated by the business community, that instrument was applied on a limited scale and for

¹ The RF Government's Regulation of 10 March 2006, No. 328-r.

² The RF Government's Decree of 20 December 2007, No. 904 'On the Procedure for Allocating Funding from the Federal Budget Earmarked for the Creation of Hi-tech Technoparks'.

³ The RF Government's Regulation of 12 September 2008, No. 1326-r

⁴ The RF Government's Regulation of 25 December 2007, No. 1912-r

⁵ The RF Government's Regulation of 27 December 2010, No. 2393-r

⁶ The RF President's Assignment of 24 April 2007, No. Pr-668.

⁷ Approved by the RF Government's Decree of 2 August 2007, No. 498.

⁸ Approved by the RF Government's Decree of 17 October 2006, No. 613; at present, the period of the program's implementation is extended to 2013 (by the RF Government's Decree of 6 April 2011, No. 253).

- a rather short period of time: in 2007–2010, the government granted support to only about ten project of this type, and since 2011 they have been allocated no financing whatsoever¹;
- in 2008, a pilot project was launched whose aim was the organization, on the basis of the Russian Research Center 'The Kurchatov Institute', of a fundamentally new entity (at least, its idea was new for Russia) – the national research center (NRC) 'The Kurchatov Institute'. The NRC's task is to ensure speedy implementation of newly developed scientific innovations, carry out complete R&D cycles, including the creation of industrial samples, in two priority directions of research in the field of science, technologies and technical equipment in the Russian Federation: the industry of nanosystems and nanomaterials, on the one hand, and power engineering and energy saving, on the other; besides, the NRC is delegated the functions of a coordinator of research within the framework of the presidential initiative 'Strategy of the Development of Nanoindustry';
 - and finally, in 2008 (5 years after the adoption of the Law 'On Technical Regulation'), the process of elaborating technical regulations was launched on a broader scale – over that year, a total of 6 documents were adopted².

Late 2008 – 2009

In the second half of 2008, when the onset of the *financial crisis urged the RF Government to launch a large-scale anti-crisis program, the innovation policy – as could well be expected – became a secondary priority, and so a considerable portion of the resources previously earmarked for these purposes was spent elsewhere*. At the same time, however, it would be incorrect to state that during that period the government was totally disregarding the innovation promotion instruments; on the contrary, in some of their aspects these instruments became even more strongly the focus of attention, and not only from the point of view of the ratio between the volume of investment and the results achieved, but also in terms of their orientation to true innovation.

Here are a few rather typical examples of the acts and measures undertaken in late 2008 and 2009:

- large-scale cuts in the amount of budget expenditures earmarked for the fields of science, technologies and innovation within the framework of several federal target programs (in particular, the Federal Target Program 'Research and Development ...');
- temporary withdrawal, from the State Corporation *Rusnanotekh*, of a considerable portion of previously allocated resources (Rb 66.4bn);
- the introduction of several new mechanisms for subsidizing, for the Russian enterprises operating in different sectors, in particular the motor-car manufacturing and transport engineering, the cost of interest on loans granted to them for their technological upgrading³;

¹ Decree the RF Government's of 6 April 2011, No. 253.

² Technical Regulation 'On the Requirements to Motor and Aircraft Petrol, Diesel and Vessel Fuel, Fuel for Jet Engines, and Fuel Oil' (approved by the RF Government's Decree of 27 February 2008, No. 118); Federal Law of 12 June 2008, N.o 88-FZ 'Technical Regulation on Milk and Dairy Products'; 'Technical Regulation on Oil and Fat Products', of 24 June 2008, No. 90-FZ; 'Technical Regulation on Fire Safety Requirements' of 22 July 2008, No. 123-FZ; 'Technical Regulation on Fruit and Vegetable Juice Products' of 27 October 2008, No. 178-FZ; 'Technical Regulation on Tobacco Products' of 22 December 2008, No. 268-FZ.

³ The RF Government's Decree of 30 March 2009, No. 262 'On Approving the Rules for Allocating Subsidies from the Federal Budget to Russian Automobile and Transport Engineering Organizations to Compensate for Part of the Interest Paid on the Loans received in 2008–2009 from Russian Credit Institutions, as Well as from the International Financial Institutions Created Under the International Treaties Signed by the Russian Federation and Aimed at Technological Upgrading'.

for the military-industrial complex - the cost of implementation of hi-tech innovation and investment projects¹, etc.;

- the launch of the Program 'Anti-crisis' by the Fund for the Support of Small-sized Entrepreneurship in Science and Technology;
- large-scale involvement of *Vneshekonombank* in implementing anti-crisis measures simultaneously in several directions: refinancing of foreign loans taken by Russian borrowers – companies and banks, and secured by strategic assets; the issuance of unsecured long-term subordinated loans to Russian credit institutions²; the functions of the RF Government's agent in dealing with the issues related to the granting of government guarantees to the strategic enterprises operating in the framework of the military-industrial complex and the companies included in the special list³; and acquisition of problem-ridden financial and credit institutions for the purpose of their recovery.

It should be noted that *Vneshekonombank* was performing its crediting and financial functions within the framework of anti-crisis measures almost exclusively at the expense of the additionally allocated government resources. For that reason, over the period under consideration, the scale of its 'core' activity as a state corporation acting in the capacity of a bank for development, instead of showing any signs of decline, increased even further – thus, over the course of the year 2009, the volume of investment loans was increased from Rb 130bn to Rb 230bn. Besides, in 2009, *Vneshekonombank* made an additional contribution to its affiliation Russian Bank for Development's charter capital in the amount of Rb 10bn, and also issued to the Russian Bank for Development loans in the amount of Rb 30bn earmarked for the implementation of a program for the support of small and medium-sized enterprises (SME), and so in 2009 the RBD's credit portfolio increased threefold.

Against the backdrop of the active implementation of the RF Government's anti-crisis program and the resulting redistribution of budget expenditure, the government innovation policy's emphasis shifted towards those measures and instrument that required no additional budget expenditures. In this context, we can mention the following ones:

- the adoption of a number of new technical regulations;
- the drawing-up of the list of main directions for the fundamental and applied studies to be carried out by the NRC 'The Kurchatov Institute'⁴, and the involvement of three other research institutes in the creation of the NRC⁵;

¹ The RF Government's Decree of 30 March 2009, No. 265 'On Approving the Rules for Allocating Subsidies, in 2009–2011, from the Federal Budget to the Organizations of the Military-industrial Complex to Compensate for Part of the Interest Paid on the Loans received from Russian Credit Institutions for the Implementation of Innovation and Investment Hi-tech Production Projects'.

² Federal Law of 13 October 2008, No. 173-FZ 'On Additional Measures Designed to Support the Financial System of the Russian Federation'.

³ The RF Government's Decrees of 14 February 2009, No. 103 'On Granting, in 2009, of the Government Guarantees of the Russian Federation against the Loans Taken by the Organizations Selected in the Procedure Established by the Government of the Russian Federation for Carrying Out their Core Production Activity and Capital Investment', and No. 104 'On Granting, in 2009–2010, of the Government Guarantees of the Russian Federation against the Loans Attracted by the Strategic Organizations of the Military-industrial Complex'.

⁴ The RF Government's Regulation of 27 October 2008, No. 1561-r.

⁵ The RF President's Edict of 30 September 2009, No. 1084 'On the Additional Measures Designed to Implement the Pilot Project of Creating the National Research Center 'The Kurchatov Institute'.

- legislative formalization of the procedure for transferring the government's rights to uniform civil, military, special or dual technologies, with the purpose of their practical application¹;
- softening, in principle, of the legislative norms designed to regulate the creation, by budget-funded research institutions and educational establishments, of economic societies (or implementation companies), the transfer to them of the results of intellectual activity for subsequent practical application².

This does not mean, however, that the government over that period was avoiding any new spending obligations with regard to innovations. Thus, in late 2008, it launched a pilot project aimed at creating two national research universities (NRU): the National Research Nuclear University (MEPhi) on the basis of the Moscow Engineering Physics Institute (State University), and the National University of Science and Technology MISiS on the basis of the State Technological University *Moscow Steel Institute*³. In 2009, the programs for the development of these two NRUs were approved⁴, whereby it was envisaged, among other things, that the university should be allocated additional budget resources (Rb 200m each in 2009).

Almost simultaneously with this pilot project, the procedures for elaborating the 'general' legal norms designed to regulate the national research universities were initiated. In early 2009, some alterations were introduced in legislation on education whereby the specific category of a 'national research university' (NRU) was defined⁵. In mid-year, the procedure for a contest-based selection of the development programs submitted by the universities applying for the NRU category was defined, as well as the procedure and terms for the financing of the relevant programs⁶. In 2009, by the results of a contest (i.e., outside of the framework of the pilot project), 12 universities were placed in the NRU category, and for each of them a corresponding development program was approved. In this connection, it must be specifically emphasized that, within the framework of that direction of the government policy, some of the experience accumulated previously in the course of implementing the support measures intended for the innovation programs approved for higher educational establishments was used.

Strange as it may seem, the 'economical' approach practiced by the government with regard to both the already assumed and the potential new obligations to allocate budget expenditures to the support of innovations had very little effect on the scale of applying the mechanisms like tax incentives designed to decrease the size of budget revenue. Since early 2009, the government introduced three rather significant (as demonstrated by the subsequent practice) tax exemptions:

¹ Federal Law of 25 December 2008, No. 284-FZ 'On The Transfer of Rights to Uniform Technologies'.

² Federal Law of 2 August 2009, No. 217-FZ 'On Introducing Alterations in Some Legislative Acts of the Russian Federation with Regard to Issues Relating to the Creation, by Budget-funded Research Institutions and Educational Establishments of Economic Societies for the Purpose of Practical Application (or Implementation) of the Results of Intellectual Activity'.

³ The RF President's Edict of 7 October 2008, No. 1448 'On Implementing the Pilot Project of Creating National Research Universities'.

⁴ The RF Government's Regulations of 13 July 2009, No. 915-r, and 30 July 2009, No. 1073-r.

⁵ Federal Law of 10 February 2009, No. 18-FZ 'On Introducing Alterations in Some Legislative Acts of the Russian Federation Issues Relating to the Activity of Federal Universities'.

⁶ The RF Government's Decree of 13 July 2009, No. 550.

- for the R&D projects (including those that yielded no positive results) included in the special list approved by the RF Government¹, a special procedure for writing off some of the costs incurred during the period of their actual implementation was introduced, with an upward coefficient of 1.5²;
- the exports into the territory of the Russian Federation of technological equipment that had no domestically manufactured analogues (again in accordance with the special list approved by the RF Government³ were made exempt from VAT⁴;
- for capital investment in fixed assets with a useful life of more than 3 years, but no more than 20 years, a depreciation premium of 30%⁵ was introduced (in addition to the previously existing 10% premium applicable to all fixed assets).

It is noteworthy that only the first of these tax exemptions had been formalized as a legislative norm before the crisis progressed into its acute phase. The other two exemptions were introduced in the context of the anti-crisis policy.

And finally, another important point is that, over the period under consideration, the creation of financial development institutions and funds was managed at the level of the relevant institutions, without any direct participation on the part of the government:

- the Russian venture company, with the minority participation of the Fund for the Support of Small-sized Entrepreneurship in Science and Technology, established the RVC *Seed-Fund*⁶, with the purpose of supporting innovation projects in the early phases of their implementation;
- the management of the State Corporation *Rusnanotekh* decided that it must take part in the creation of a number of specialized venture funds:
- the Skolkovo-Nanotech Fund supervised by the Skolkovo Moscow School of Management, for investing in small-scale venture projects launched in the field of nanotechnologies⁷;
- the nanotechnologies and innovations fund, with the participation of *VTB Group* (as a co-investor) and *Draper Fisher Jurvetson* (as a managing partner) for investing in promising

¹ The RF Government's Decree of 24 December 2008, No. 988 'On Approving the List of Scientific Research and R&D Projects, the Taxpayer Expenditures on Which, in Accordance with Item 2 of Article 262 of Part Two of the Tax Code of the Russian Federation Are to Be Recorded as Part of Other Expenditures, in the Amount of Actually Incurred Costs, with a Coefficient of 1.5'.

² Federal Law of 22 July 2008, No. 158-FZ 'On Introducing Alterations in Chapters 21, 23, 24, 25 and 26 of Part Two of the Tax Code of the Russian Federation, and Some Other Acts of the Russian Federation's Legislation on Taxes and Levies'.

³ The RF Government's Decree of 30 April 2009, No. 372 'On Approving the List of Technological Equipment (Including the Wear and Spare Parts Thereto), the Analogues of Which Are Not Manufactured in the Russian Federation, the Exports of Which into the Territory of the Russian Federation Is not to Be levied by Value Added Tax'.

⁴ Federal Law of 26 November 2008, No. 224-FZ 'On Introducing Alterations in Part One and Part Two of the Tax Code of the Russian Federation and Some Legislative Acts of the Russian Federation'. In fact, this norm came into force only from Q3 2009, because the government decree necessary for its enforcement (see previous note) was adopted only in Q2.

⁵ Federal Law of 26 November 2008, No. 224-FZ.

⁶ The stakes held by the RVC and the Fund for the Support of Small-sized Entrepreneurship in Science and Technology in the capital of the newly created entity are 99% and 1% respectively.

⁷ To avoid misunderstanding, it should be noted that the participant in that project (in the capacity of a managing partner) is not the innovation center 'Skolkovo', but Moscow School of Management with the same name (Skolkovo).

nanotechnological projects in Russia and abroad and for attracting international and Russian investors;

- the Russia-Kazakhstan nanotechnologies venture fund for promoting the development of nanotechnologies in the national economies of both countries;
- a sectoral fund for implementing nanotechnologies in metallurgy (*NanoMet*);
- a fund for low-budget projects in the field of nanotechnologies;
- an international fund (in a foreign jurisdiction) for attracting big international institutional investors into the Russian nanoindustry, as well as gaining access to state-of-the-art foreign nanotechnologies.

From 2010 onwards

As the signs of post-crisis growth were becoming more visible, the issues of sustainable development and modernization of the national economy began to play an increasingly prominent role on the government level (in response to the evidently negative impact of the world financial crisis on the Russian economy due to its low degree of diversification and the low competitive capacity of the processing industries). In late 2009 – early 2010, this phenomenon manifested itself in the active revival of government innovation policy - this time with an emphasis on the need to expand the range of active participants in the innovation process, including through the involvement in it of higher educational establishments, as well as the development of cooperation and network interaction in the innovation sphere. In this connection, one cannot overlook the consecutive character of many of the implemented measures and the directions along which innovations were being promoted.

In the context of the current phase of government anti-crisis policy, we must first of all mention the set of measures designed to promote the research and innovation activity of Russian higher educational establishments:

- in 2010, the mechanism of support for joint projects involving the creation of new industrial entities between Russian companies and higher educational establishments was launched and began to function effectively¹. It became the first domestic counterpart of *matching grants* - the instrument that has already become widespread in the developed and new industrial countries, and gained a good reputation. This mechanism had certain similarities with the one that had first been applied three years earlier within the framework of the Federal Target Program 'Research and Development ...', whose aim it was to render support to R&D projects launched in the interests of businesses (which was quite logical because the new mechanism incorporated some of the experiences and features of the old one). However, the mechanism for supporting joint projects had some individual specificities, which largely determined its 'new quality': first, in contrast to the instrument of 'business projects', which implied the selection of project participants by the government (although with due regard for the opinions of the beneficiary companies), the higher educational establishments to be nominated for the participation in the joint project were from the very start selected by the initiator company; secondly, the government financing for R&D was not channeled directly to the higher educational establishments, but indirectly - through the company. So far, this mechanism has been applied in rendering support to approximately a hundred projects. It should also be noted that, in late 2012 and early 2013, two new contests for the selection of joint projects were announced. This time, the

¹ The RF Government's Decree of 9 April 2010, No. 218 'On the Measures of Government Support of the Development of Cooperation between Russian Higher Educational Establishments and the Organizations Implementing Comprehensive Projects Aimed at Creating Hi-tech Industries'.

R&D may be carried out not only by higher educational establishments, but also by state research institutions;

- in 2010–2012, the government was rendering support to programs that envisaged the development of innovation infrastructure at higher educational establishments¹. These envisaged, in particular, the creation of a broad range of infrastructure objects (business incubators, technoparks, technopark zones, innovation technology centers, engineering centers, certification centers, technology transfer centers, collective use centers, scientific and technical information centers, innovation consulting centers, etc.), and their provision with state-of-the-art equipment and software; the evaluation and legal protection of the results of intellectual activity, the exclusive rights to which were held by higher educational establishments; consulting services of foreign and Russian experts in the sphere of transfer of technologies, creation and development of small-sized innovation companies, including the involvement of their faculty in elaborating the norms, methodologies and practice necessary for the creation of such companies. Within the framework of this direction of activity, support was provided to approximately 80 programs;
- the process of selecting and rendering support to national research universities across Russia was continued: in 2010, this category incorporated another 15 higher educational establishments; by late 2011, their development programs had been approved.

A significant impetus was given to the process of creating a legislative environment for the establishment of technology implementation companies by research institutions and higher educational establishments:

- from 2011, the property regulation opportunities for budget-funded institutions were expanded, including the right to transfer their property to their newly or previously established companies: now, budget-funded institutions were allowed to independently dispose of all their property, with the exception of immovable property and especially valuable movables, as well as large-scale deals or deals with related interest²;
- in 2011, a procedure was established for budget-funded institutions to lease out their property to the technology implementation companies created by them without a tender, on condition that the latter should be forbidden to sublease that property, or in any other way transfer their rights to that property to third parties³;
- from 2011, the technology implementation companies established by budget-funded institutions were granted the right to apply the simplified system of taxation, in spite of the presence in their capital of stakes held by other organizations in amounts in excess of 25% (of course, on condition that the technology implementation companies conform to all the other criteria established by the law – in terms of the amount of their proceeds, number of personnel, etc.)⁴;

¹ The RF Government's Decree of 9 April 2010, No. 219 'On Government Support of the Development of the Innovation Infrastructure at Federal Establishments for Higher Professional Education'.

² Federal Law of 8 May 2010, No. 83-FZ 'On Introducing Alterations in Some Legislative Acts of the Russian Federation In Connection with Improving the Legal Status of State (or Municipal) Institutions'.

³ Federal Law of 1 March 2011, No. 22-FZ 'On Introducing Alterations in Article 5 Federal Law 'On Science and Government Science-and-Technology Policy' and in Article 17.1 of the Federal Law 'On the Protection of Competition'.

⁴ Federal Law of 27 November 2010 r. No. 310-FZ 'On Introducing Alterations in Article 346.12 of Part Two of the Tax Code of the Russian Federation'.

- for the period from 2011 through 2019, reduced rates of the insurance contributions to government off-budget funds were introduced for the technology implementation companies established by budget-funded institutions¹.

Over the period under consideration, some significant developments and changes occurred in the system of government financial institutions and funds. In particular, the process of creating 'second-tier' institutions was continued on a noticeable scale. Thus, in 2011, *Vneshekonombank* founded four new affiliations, and at least in two of these cases the initiative to create these affiliations came from the government:

- on the RF President's initiative, the Russian Direct Investment Fund (RDIF) was established, whose goal it was to attract, on the basis of co-financing, foreign investors for the participation in projects aimed at developing and modernizing the existing ones and at creating new production capacities in the key industries of Russia's national economy;
- by decision of the RF Government², after introducing necessary alterations in the legislation on *Vneshekonombank* and some other acts³, the Russian Agency for Export Credit and Investment Insurance (EXIAR) was founded in order to provide insurance support to exports of Russian goods and services, Russian investment abroad, as well as to support exports-oriented small and medium-sized businesses (SME);
- the specialized Fund for the Development of the Far East and Baikal Regions was established, whose goal it was to participate in the elaboration and implementation of regional and urban development projects, and to increase the investment attractiveness of the Far East and the Trans-Baikal region;
- the VEB-Innovations Fund was created for issuing loans and making investments in the hi-tech projects launched by the Skolkovo Fund (for more details on the latter, see below).

The Russian Venture Company established 4 new funds in the period under consideration period:

- The RVC Biopharmaceutical Investment Fund (*RVC Biofund*), oriented to investment in biopharmaceutical innovation companies, as well as the companies rendering laboratory, information-analytical and consulting services to companies operating in the biotechnological, pharmaceutical and medical industries;
- The RVC Infrastructure Investment Fund (*RVC Infrafund*), for making investment in the infrastructure companies rendering consulting, expert, analytical and services to innovation companies;
- two funds in foreign jurisdiction for cooperation with international venture investors.

The State Corporation *Rusnanotekh* (from 2011 – Open-ended Joint-stock Company RUSNANO) continued the process of organizing and co-financing venture funds; it was decided to establish the following funds:

¹ Federal Law of 16 October 2010, No. 272-FZ 'On Introducing Alterations in the Federal Law 'On Insurance Contributions to the Pension Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, the Federal Fund of Compulsory Medical Insurance of the Russian Federation and Territorial Funds of Compulsory Medical Insurance' and in Article 33 of the Federal Law 'On Compulsory Pension Insurance in the Russian Federation'.

² See, for example, 'The Main Directions of the Anti-Crisis Acts of the Government of the Russian Federation for 2010 (approved at the RF Government's meeting as of 30 December 2009, Protocol No. 42).

³ Federal Law of 18 July 2011, No. 236-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation for the Purpose of Improving the Mechanism of Insurance of Exports Credits and Investment Against Entrepreneurial and Political Risks'.

- Kama Fund One – a regional fund for the development of innovation projects in Perm Krai;
- a pre-IPO fund for investing in rapidly growing innovation companies planning to launch IPOs or attract strategic investors;
- four funds with foreign participation and/or in foreign jurisdiction, to ensure the transfer of new technologies into Russia.

By early 2010, five venture funds created with the participation of the State Corporation Rusnanotekh / Open-ended Joint-stock Company RUSNANO had begun their investment activity.

Besides, it is important to note the following changes in the operation of that development institution:

- the creation of a number of specialized affiliated companies, including affiliations in foreign jurisdictions (the Metrological Center RUSNANO; RUSNANO-Inform; the *Rusnanotekh* Forum Fund; RUSNANO Capital AG; RUSNANO USA, Inc.; RUSNANO Israel Ltd.);
- the launch of projects aimed at creating nanotechnological centers, as well as the project envisaging the establishment of a Technologies Transfer Center jointly with the Russian Academy of Sciences;
- the transformation of the state corporation into a joint-stock company, the separation of its activities aimed at supporting educational projects and projects in the sphere of infrastructure into a separate juridical person – the Fund for Infrastructure and Educational Programs¹;
- the allocation of additional government financing, as well as commercial credits - but with active government participation: in 2010–2011, the State Corporation *Rusnanotekh*/ Open-ended Joint-stock Company RUSNANO received from the government more than Rb 50bn, in the form of property contribution, as payment to cover an additional issue of shares, as well as subsidies; another sum of approximately Rb 67bn was attracted in the form of bond loans and loans issued against government guarantees.

In 2010, the Russian Bank for Development began the implementation of a new program oriented to the support of innovation and modernization projects launched by small and medium-sized businesses. The distinctive features of that program, in addition to its declared orientation towards innovations, were, firstly, somewhat higher ceilings for the amount of support, and secondly, the possibility to apply, alongside the mechanisms of loans against projects, also the mechanism of investment in the capital of small and medium-sized and enterprises (the latter being implemented by the Bank's affiliated asset manager 'Modernization Innovation Development', created in 2010).

In 2010, a number of development institutions – *Vneshekonombank*, *Rusnanotekh*, the Russian Venture Company, the Russian Bank for Development and the Fund for the Promotion of the Development of Small Forms of Enterprises in the Scientific and Technical Sphere – signed an agreement on cooperation² whereby they intended to organize a efficient exchange of information on the projects in progress in order to 'transfer' prospective projects between institutions.

¹ Federal Law of 27 July 2010, No. 211-FZ 'On the Reorganization of the Russian Nanotechnologies Corporation'.

² The other parties to that agreement were OPORA RUSSIA, the Russian Venture Capital Association, the Moscow Interbank Currency Exchange, and the Federal Agency for Youth Affairs.

The year 2011 saw a 'revival' of the Russian Foundation for Technological Development¹ as an effectively operating innovation policy instrument: the Foundation announced that it was going to compile a portfolio of R&D projects for providing them with financial support (in the form of targeted loans). In this connection, priority was granted to applied research and development carried out within the framework of technological platforms (see later in our overview), or carried out as part of the modernization projects being implemented by industrial enterprises, the construction of new enterprises or the manufacture of new products by the already existing enterprises.

In the sphere of tax incentives for the innovation activity, in addition to a number of 'narrow specialization' measures (which include the already described instruments of tax support applied to the technology implementation companies established by budget-funded institutions, as well as the tax exemptions granted to residents of the Innovation Center *Skolkovo*, which will be discussed later on), the following alterations are noteworthy:

- from 2010, the possibility of accelerated depreciation (with a coefficient up to 2) is envisaged with regard to fixed assets belonging to a high energy efficiency class, or those included in the list of high energy efficient objects approved by the RF Government²;
- from 2012, in the form of a law, the list of expenditures on R&D to be taken into account for the purpose of taxation is established, with the possibility of writing them off in a one-time procedure. Besides, organizations are granted the right to make reserves against their future expenditures on R&D, and a ceiling is established for this type of deductions³;
- from 2012, the new equipment being put in operation, if it belongs to a high energy efficiency class or included in the aforesaid special list of high energy efficiency objects, is made exempt from tax on property for a period of three years since its registration⁴.

By way of summing up the discussion of the 'traditional' directions and measures of government policy, it should be noted that, over the period under consideration, the pilot project aimed at creating the NRC 'The Kurchatov Institute' was in progress, new technical regulations and standards were introduced, and so on.

In addition to all these developments, in recent years, a number of new instruments and areas of development have been introduced in Russia's innovation policy.

Firstly, in 2010, on the RF President's initiative, a very ambitious project (at least ambitious in its idea) was launched, aimed at creating in Russia a fundamentally new and unique piece of innovation infrastructure – the Innovation Center *Skolkovo*⁵. In its initial phase, it was officially declared to be Russia's analogue of the Silicone Valley. To illustrate the scale of this project, it is sufficient to mention the unprecedented tax exemptions granted to the partici-

¹ The off-budget fund created in 1992 for the support of applied R&D (the RF President's Edict of 27 April 1992, No. 426 'On the Urgent Measures Designed to Safeguard the Scientific and Technical Potential of the Russian Federation'). By 2008, the Fund became effectively dysfunctional due to the inadequacy of the norms determining its status.

² Federal Law of 23 November 2009, No. 261-FZ 'On Energy Saving and Energy Efficiency Upgrading, and on the Introduction of Alterations to Some Legislative Acts of the Russian Federation'; the RF Government's Decree of 16 April 2012, No. 308 'On the Approval of the List of Objects with High Energy Efficiency, for Which no Energy Efficiency Classes Are Envisaged'.

³ Federal Law of 7 June 2011, No. 132-FZ 'On the Introduction of Alterations to Article 95 of Part One, to Part Two of the Tax Code of the Russian Federation in the Part of Creating Favorable Tax Conditions for Innovation Activity, and to Article 5 of the Federal Law 'On the Introduction of Alterations to Part Two of the Tax Code of the Russian Federation and to Some Legislative Acts of the Russian Federation'.

⁴ Federal Law of 7 June 2011, No. 132-FZ.

⁵ Federal Law of 28 September 2010, No. 244-FZ 'On the Innovation Center Skolkovo.

pants in the Innovation Center, which were very significant and versatile in their nature - in fact, much higher than the exemptions established for the residents of special economic zones. Thus, for the period of ten years since the date whereon a company acquires the status of a participant of the Innovation Center, or until its annual proceeds exceed the threshold of Rb 1bn, and the subsequently accumulated profit exceeds the threshold of Rb 300m, the company is to be exempt from the payment of VAT, tax on profit, tax on property, and the insurance contributions the RF Social Insurance Fund and the RF Compulsory Medical Insurance Fund; to the rate of its contributions to the RF Pension Fund, a downward coefficient is to be applied¹. It should also be noted that the Innovation Center's asset manager was to allocate financing to innovation projects in the form of grants.

Secondly, in 2010, Russian's innovation policy was augmented by a new instrument that, for a long time, has already been successfully applied in the EU, – technological platforms. In this connection, on the basis of foreign best practices, the technological platforms for Russia are defined as a communications instrument designed to intensify the efforts aimed at the creation of promising commercial technologies, new products (or services), at the attraction of additional resources for funding research and development with the participation of all related parties (businesses, scientists, government agencies, civil society), and the improvement of the normative legal base in the field of science, technology and innovations².

Technological platforms are expected to provide solutions to a broad range of problems:

- to boost the influence of the business community and society's demand for innovative technologies on the choice of directions for scientific and technological development and the speed of their progress/";
- to identify new opportunities for scientific and technological modernization of the existing sectors and the creation of new sectors in Russia's national economy;
- to determine the basic directions for improving sectoral regulation, for more rapid distribution of promising technologies;
- to promote innovations, support research in the field of science and technologies and boost the processes of companies' modernization, with due regard for the specificities and individual variants of development in different industries and sectors of the national economy;
- to expand scientific and industrial cooperation, and to establish new partnerships in the innovation field;
- to improve normative legal regulation in the sphere of scientific research, innovation and technological development.

Each technological platform must have its own coordinator – an organization responsible for the organizational and informational backing of the interaction between the platform's participants.

The sphere of activity of the technological platforms should include:

- the development of a strategic research program that will set medium- and long-term priorities for research and development and build the mechanism of cooperation in the fields of science and industry;

¹ Federal Law of 28 September 2010, No. 243-FZ 'On Introducing Alterations in Some Legislative Acts of the Russian Federation in Connection with the Adoption of the Federal Law 'On the Innovation Center Skolkovo.

² The Procedure for Drawing-up the List of Technological Platforms (approved by decision of the Government Commission on High Technology and Innovations as of 3 August 2010, Protocol No. 4).

- the elaboration of learning programs, the directions and principles for developing standards and certification systems, and the implementation of measures designed to set up an innovation infrastructure;
- the development of a program for practical implementation and distribution of advanced technologies in the relevant sectors of the Russian economy, which will determine different mechanisms and sources of financings, as well as the responsibilities of different participants in a technological platform;
- the creation of an organizational structure necessary for smooth interaction between enterprises, research institutions and educational establishments.

In order to ensure efficient communication between technological platforms and the government, the latter must elaborate a list of technological platforms. The federal bodies of executive authority must provide the technological platforms included in that list with adequate institutional, organizational and consultative support.

Within the framework of technological platforms, proposals must be prepared for improving the regulation procedures in the sphere of science, technologies and innovations. The results achieved by a technological platform must be taken into account when planning and implementing the measures of government support designed to promote socio-economic development and activities related to science, technologies and innovations.

Towards the end of 2012, the list approved by the government consisted of 30 technological platforms.

Thirdly, in 2010, 47 biggest companies operating in the public sector were assigned the task of elaborating and approving programs for innovation-oriented development in the medium-term period (5–7 years). The recommendations for the elaboration of such programs¹, among other things, contained the following requirements:

- the programs were to envisage a set of measures designed to boost the development and implementation of new technologies, innovation products and services at the world state-of-the-art level;
- the programs were to be integrated in companies' business development strategies, be conducive to their modernization and technological progress on the basis of a significant improvement of the main productivity parameters, including a significant (more than 10%) reduction in the level of production costs without any deterioration of the product's useful or ecological properties; significant economy of energy resources involved in the production process – no less than 5% per annum, until the average level was achieved typical of foreign companies operating in the same industry; a significant improvement of the consumer characteristics of the products; a significant boost in the level of labor productivity – no less than 5% per annum, again until the average level was achieved typical of foreign companies operating in the same industry; and an improvement in the production, waste recycling and waste disposal processes from the point of view of environment protection;
- the programs were to envisage some measures designed to ensure an efficient interaction between the relevant companies and leading higher educational establishments, namely: the choice of 'core' higher educational establishments and the specific areas (in science of technologies) and scope of joint research (or development, or implementation); the elabo-

¹ Recommendations for the elaboration of innovation-oriented development programs for joint-stock companies with state stakes, state corporations and federal state unitary enterprises (approved by decision of the RF Government's Commission on High Technology and Innovations as of 3 August 2010, Protocol No. 4).

ration, in cooperation with higher educational establishments, of research programs envisaging, among other things, the mechanisms for exchanging scientific, technical and marketing information, joint research in the field of scientific and technological forecasts, the creation of a system for research (or development, or implementation) management at a relevant higher educational establishment with due regard for the forecasted needs of companies or entire industries; the implementation of programs, in coordination with higher educational establishments, for improving the quality of professional education and personnel training in hi-tech industries, with the participation of companies in the process of upgrading curricula and plans, the participation of their staff in training programs, the development of a system of on-site and field practice for graduate and postgraduate students and faculty members of higher educational establishments, as well as continual training systems for the staff of commercial companies; and the creation of organizational mechanisms for interaction with higher educational establishments;

- the programs were to set priority directions for the cooperation of companies with research institutions, elaboration of joint plans of studies in the field of science and technology, and scientific research aimed at creating priority technologies and products that would be competitive on the world market, as well as measures designed to ensure fruitful interaction with innovation-oriented small and medium-sized and enterprises;
- participation of companies in the creation and operation of technological platforms was to be ensured.

By late 2011, the process of elaborating the programs for innovation-oriented development of biggest state companies was in the main completed.

Fourthly, in 2012, on the RF President's initiative¹, the government innovation policy was extended to yet another target for support – regional innovation clusters. In some of their features (an association of different participant, primarily research institutions, educational establishments and industrial enterprises; functioning under a coordinator organization; elaboration of strategic development programs), clusters are similar to technological platforms; they differ, in the main, in their focus on developing territories, and not technological fields.

In mid-2012, on the basis of a contest, the list of 25 territorial innovation clusters was approved². In this connection, the distinctive feature of this direction of government policy - by comparison with the majority of previously initiated measures - was that no specific form of support had been determined prior to the selection of clusters to be supported; only some proposals had been put forth, but their scale was impressive:

- to support the implementation of measures envisaged under the cluster development programs within the framework of federal target programs and government programs of the Russian Federation;
- to involve government development institutions in the implementation of the cluster development programs;
- to encourage big companies with state stakes to participate in rendering support to the clusters implementing innovation-oriented development programs;
- to introduce in the territories where clusters are based the same tax exemptions as established by legislation for the Skolkovo project.

¹ Assignment issued by RF President on the basis of the results of the State Council of the Russian Federation's Presidium's meeting held on 11 November 2011 (Protocol No. Pr-3484GS of 22 November 2011)

² Assignment issued by the Chairman of RF Government as of 28 August 2012, No. DM-II8-5060.

Table 11

Main Phases in the Development of Government Innovation Policy in the 2000s

Period	External conditions	Key instruments and measures	Policies' specificities
1	2	3	4
2000 – 2002	Hard budget constraints, the task of innovation promotion is in the periphery of government policy	<ul style="list-style-type: none"> • Creation of the Venture Innovation Fund • Adoption of the Law 'On Technical Regulation' • The Russian Bank for Development launched its programs of supporting SMEs via its regional partners 	Emphasis on relatively low-cost and/or self-financing institutions
2003 – 2005	Softening budget constraints, stable economic growth, increased attention to its 'quality'	<ul style="list-style-type: none"> • Launch of key innovation projects of nationwide importance • The Fund for the Promotion of the Development of Small Forms of Enterprises in the Scientific and Technical Sphere launched its <i>Start</i> program • Initiation of the process of creating regional venture funds • Adoption of the Law 'On Special Economic Zones in the Russian Federation'; adoption of the decisions on creating 4 technology implementation SEZ • Creation of a mechanism for compensating Russian exporters for the interest paid on the loans attracted for exports development 	Intensification of the government's activity, application of different instruments, including those requiring significant expenditures
2006 – 2008	High budget revenue, innovation promotion – among the main directions of government policy, an attempt to 'peg' relevant resources to each key direction of development	<ul style="list-style-type: none"> • a 10% depreciation premium is introduced with regard to new fixed assets put in operation and the technological upgrading and modernization of fixed assets • Shortened the period for writing off the expenditures on R&D • The possibility of accelerated depreciation of the equipment applied in scientific and technological research • The R&D aimed at creation and improvement of new products and technologies and the transfer of rights to the results of intellectual activity are made exempt from VAT • The price of acquisition and practical application rights to the results of intellectual activity, the cost of patenting and the legal services associated with legal protection of the results of intellectual activity are to be included in costs under the simplified system of taxation • The Russian Venture Company is created • <i>Vneshekonombank</i> is transformed into a state corporation, with additional capitalization • The State Corporation <i>Rusnanotekh</i> is created • The Russian Investment Fund for Information and Communication Technologies (<i>RIFICT</i>) is created • As part of the National Project 'Education', support is provided to innovation educational programs launched by higher educational establishments • Onset of support of R&D in the interests of businesses • Launch of the program for the support of hi-tech technoparks • The presidential initiative 'Strategy of the Development of Nanoindustry'; the launch of the pilot project for organizing the NRC 'The Kurchatov Institute' • Onset of active elaboration of technical regulations 	Focus on long-term development, creation and capitalization of big government financial development institutions, tax incentives, onset of active support of research and innovation activity conducted by higher educational establishments
late 2008 – 2009	Economic crisis, shrinkage of the resources allocated to innovation promotion, increasing attention to the results of implemented measures	<ul style="list-style-type: none"> • Budget expenditure cuts in the field of science, technologies and innovation in the framework of a number of FTPs • Part of resources is temporarily withdrawn from the State Corporation <i>Rusnanotekh</i> • <i>Vneshekonombank</i> is involved in implementing the set of anti-crisis measures • <i>RosBR</i> receives additional resources for its support of small and medium-sized businesses • Alterations are introduced in legislation, whereby the establishment of technology implementation companies by research institutions and educational establishments and the transfer to them the results of intellectual activity are made easier • Start of the process of selection and support of national research universities • A preferential procedure for writing off expenditures on R&D in accordance with the list approved by the RF Government is introduced (with a coefficient of 1.5) • Exemption from VAT of imports, into the territory of Russia, of 	Applying innovation policy instruments/ resources as part of anti-crisis measures; focus on the use of instruments requiring no additional budget expenditures; flow' of the process of creating new development institutions and funds onto the level of these functioning institutions

cont'd

1	2	3	4
		technological equipment that has no Russian analogues, in accordance with a special list approved by the RF Government <ul style="list-style-type: none"> • a 30% depreciation premium is introduced for capital investment in fixed assets with useful life of more than 3 years, but no more than 20 years • The RVC <i>SeedFund</i> is established by the RVC Decisions on the participation of the State Corporation <i>Rusnanotekh</i> in the foundation of a number of venture funds	
2010 – 2012	Improving situation in the economy, attempts to draw lessons from the crisis, innovation is one of the government's declared priorities	<ul style="list-style-type: none"> • Onset of support of joint projects launched by companies and higher educational establishments and aimed at creating new production sites ('matching grants') • Onset of support of the innovation infrastructure development programs launched by higher educational establishments • <i>Vneshekonombank</i>, on the RF Government's initiative established the Russian Direct Investment Fund and the Russian Export Credit and Investment Insurance Agency • The Russian Venture Company established several specialized funds • The State Corporation <i>Rusnanotekh</i> is transformed into the Open-ended Joint-stock Company <i>RUSNANO</i>; the Fund of Infrastructural and Educational Programs is created • The Russian Bank for Development (<i>RosBR</i>) began to implement the program of support of modernization and innovation • Resumption of the activity of the Russian Foundation for Technological Development (RFTD) • The technology implementation companies created by budget-funded institutions are allowed to apply the simplified system of taxation, • The opportunities for institutions to allot property are expanded • The possibility of accelerated depreciation of energy-efficient equipment is determined, a three-year period of exemption from tax on property is granted to it • Introduction of one-time procedure for writing off expenditures on R&D • Onset of the creation of the Innovation Center <i>Skolkovo</i>, unprecedented tax exemptions are introduced for its participants • Technological platforms are created • Big state-owned companies elaborated and approved their innovation development programs 	Emphasis on expanding the range of active participants in the innovation processes, promotion of the innovation-oriented research activity of higher educational establishments, development of cooperation and interaction networks in the innovation sphere; increasing attention to the improvement of the investment climate

By way of summing up our 'progressive' overview of the government innovation policy of the 2000s, we should like to make the following statements:

- on the whole, over the period under consideration the government was practicing a proactive approach to shaping up and implementing its innovation policy, which consisted in continual initiation of new measures and instruments, while the pattern of problems and imbalances that were to be removed by means of those measures remained practically unchanged from year to year. At the same time, many of these instruments rather distinctly reflected the interests of different government and business entities, the 'centers of influence' for which these instruments were means to expand the range of resources and powers available to them, increase their importance, and so on, while the 'innovation agenda' per se was becoming only a secondary priority;
- in the course of mapping and implementing the measures that shaped the government innovation policy, little consideration was given to the achievements and general experience (including negative experience) accumulated whilst implementing the already existing innovation promotion mechanisms; the few examples of the practical use of such experience described above (the RVC, national research universities, joint projects launched by higher educational establishments and commercial companies) were singular events, rare and

far between. As a consequence, within the innovation policy's framework, there occurred little distribution of best practices - instead, previous mistakes were reproduced with impressive regularity. And the innovation policy's consecutive character in recent years that we have noted is by no means an indicator of the government's altered approach to its elaboration. Rather, is the evidence of the fact that the government has run out of any new ideas, and is unable to suggest anything that is not based on its previous experiences;

- the improvement and 'fine tuning' of the already operating innovation promotion instruments was outside of the area of the government's immediate focus, and so any activity there was carried on, as a rule, as a 'last priority' - that is, irregularly and with considerable delays;
- over the period under consideration, the government adopted a number of programs and conceptual documents that either directly addressed the innovation development issue, or were aimed at developing some related fields. Among the most significant and fundamentally elaborated documents of that type, we should point out the Strategy for the Development of Science and Innovation in the Russian Federation in the Period Until 2015¹, the Concept of Long-term Socio-economic Development of the Russian Federation in the Period Until 2020,² and the Strategy for the Innovation Development of the Russian Federation in the Period Until 2020.³ Each of these documents determined some basic goals, directions and phases of innovation development in the framework of the specified time-limits, and the two Strategies mapped some specific planned acts and measures. However, in spite of the indisputable importance of each document, their well-substantiated content and official status, none of them could enrich the government innovation policy with any new properties - first of all, in terms of a comprehensive and consecutive approach to its implementation. Perhaps the only exception was the presidential initiative 'Strategy of the Development of Nanoindustry', because the provisions stipulated therein - when set against the general background - were implemented on a relatively full scale and a comprehensive basis. However, its specificity was that, firstly, addressed only one sphere of technological development - however broad, and secondly, the bulk of the measures envisaged by that strategy and implemented in the main later on, had been planned prior to its adoption;
- in spite of the comprehensive nature of the government innovation policy and its detailed elaboration in the 2000s, it still lacks one feature of key importance that could ensure its success: a mechanism for estimating, on a regular basis, the results achieved in the course of its implementation, from the point of view not only of its direct, but also indirect effects. It is currently being estimated and assessed only from the point of view of the instruments involved. Moreover, each instrument is viewed separately and, as a rule, in terms of the direct results of its implementation.

¹ Approved by the Interdepartmental Commission on Scientific and Innovation Policy as of 15 February 2006, Protocol No. 1.

² Approved by the RF Government's Regulation of 17 November 2008, No. 1662-g.

³ Approved by the RF Government's Regulation of 8 December 2011, No. 2227-r.

6.4.3. Specific Features of the Instruments Applied in the RF Government's Innovation Promotion Policies, and Their Influence on the Enterprises Operating in the Real Sector

The distinctive features of the innovation policy currently implemented in Russia are the huge number (in fact, many dozens) and the wide range of the applied measures, which include almost the entire variety of instruments available to the government – from 'simple' co-financing of projects to the organization of interaction platforms for all the parties involved in the process. As it would be evidently unrealistic to attempt a detailed examination of every individual measure of government innovation policy, for our empirical analysis¹ we have selected a sample of approximately twenty 'typical examples' reflecting all the major directions of government support for innovations (tax incentives, co-financing of projects, development institutions, etc.). In this connection, the important factors that determined the selection of government measures for our sample were, firstly, the degree of attention that they attract at the government level (the fact of their being regularly mentioned in official documents, public speeches and comments of high-rank officials) and among the expert community, and secondly, their relatively recent introduction in the current practices.

Most often, enterprises take advantage of the tax instruments applied in promoting innovations, among which, in its turn, the most popular instrument is the depreciation premium (*Fig. 5*). Among non-tax measures, the most widespread are the subsidies covering part of the interest to be paid on the loans attracted in order to ensure the technological upgrading of production processes or the development of exports, budget funding allocated to innovation projects within the framework of FTPs or other government programs, and the funding allocated via government financial development institutions. If we look at the cost-effectiveness of these measures – the ratio of companies positively influenced by some or other instrument to the total number of its 'users', the leaders will be the joint projects launched by companies and higher educational establishments in accordance with Decree No 218, the possibility to write off, with an upward 1.5 coefficient, the expenditures on R&D entered in the government's list; and the exemption from VAT of the exports into Russia's territory of technological equipment that has no domestically manufactured analogues. On the other 'pole', among the least effective instruments, there will be the exemption from tax on profit established for the monies transferred by organizations to the funds for the support of science, technological research and innovation activity; the acquisition of rights to civil, special or dual-purpose technologies; technological platforms; and the financing of innovation projects via venture funds created with the government's support.

More often than others, the following companies are allocated government support: those in a good financial situation; those with a sufficiently high level of technologies; and relatively new companies. The companies that are usually overlooked by the government innovation policy are as follows: 'technological outsiders'; financially troubled enterprises; companies that do not export their products; and companies with state stakes.

The usage of government innovation promotion instruments generally does not depend on companies' sectoral distribution, or on their size. At the same time, a positive effect of government policy measures on innovation activity is more typically displayed by big companies.

¹ The analysis is based on data provided by two surveys of the directors of more than 60 Russian industrial enterprises conducted in 2011 and 2012, by order of the Interdepartmental Analytical Center, by the Center for Market Research of the HSE Institute for Statistical Studies and Economics of Knowledge (ISSEK).

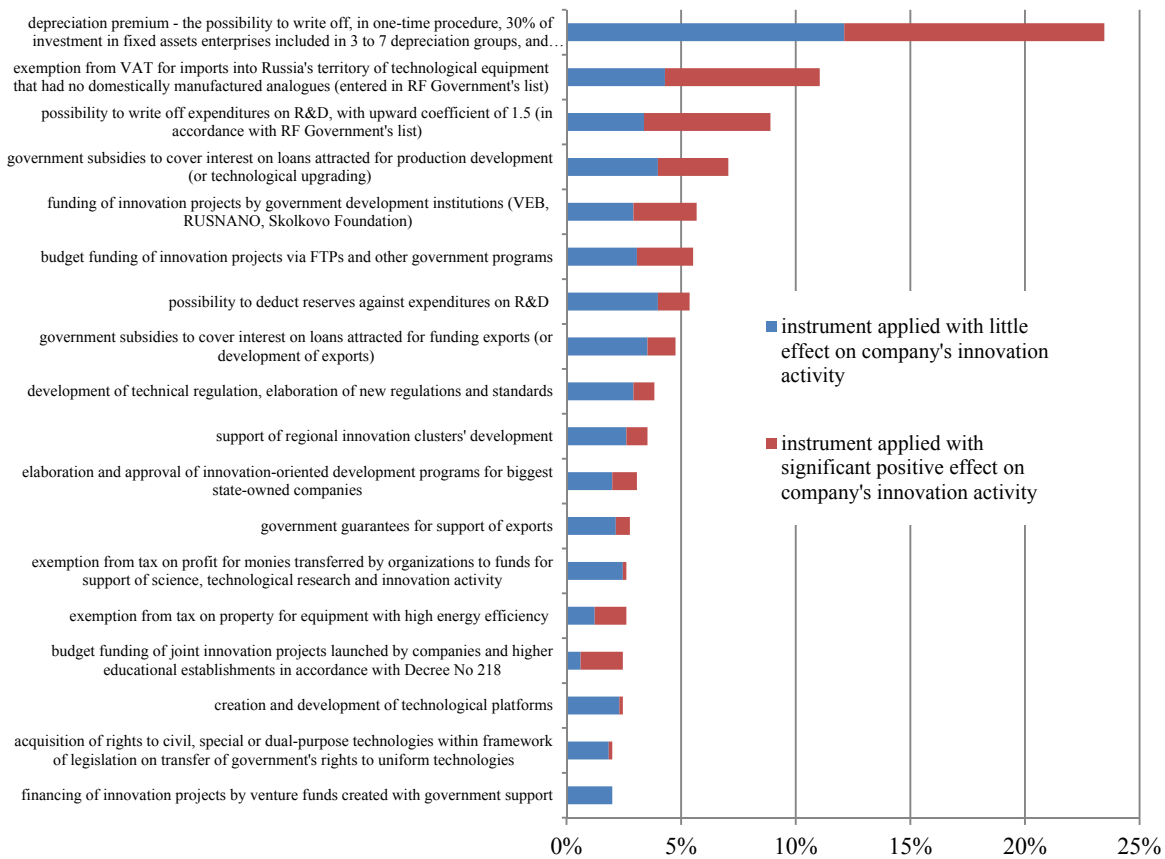


Fig. 5. Application, by Companies, of Different Innovation Promotion Instruments, and Their Influence on the Innovation Activity; as % of the Sample's Total

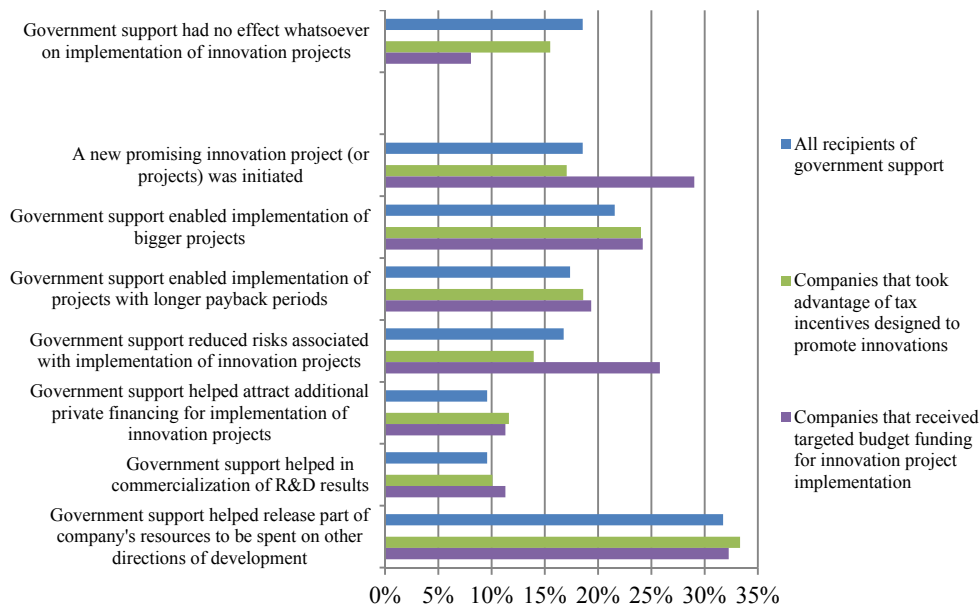


Fig. 6. Effect of Government Instruments for Promoting Companies' Innovation Activity

As for the effect of government innovation promotion measures on companies' innovation activity (*Fig. 6*), it should be noted that, most often, the fact of allocation of government sup-

port releases part of companies' resources, which may then be spent on other directions of development. Among the effects of government support, the least frequent are the attraction of additional private financing and the commercialization of the results of R&D. In the situation when budget funding is allocated to enterprises, this results in private resources (including an enterprise's equity) being ousted by government resources (the 'crowding out' phenomenon).

Direct budget funding - more often than tax incentives - results in the initiation of new projects, as well as lowers the risks associated with the innovation activity.

As far as the effects of government innovation policy at the level of individual companies are concerned (*Fig. 7*), it can be concluded that government support most often results in increased investment in new equipment, and most seldom - in the development of cooperation between the fields of research and production. In this connection it is important to note, with regard to specific support instruments, that the strengthening and further development of that type of cooperation was boosted, first of all, by the 1.5 upward coefficient established for writing off the expenditures on R&D in accordance with the RF Government's list, while no such effect was noted when the 'routine' cooperation promotion mechanism was applied, namely the support of joint projects launched by commercial companies and higher educational establishments. Another noteworthy fact is that the overall level of companies' competitive capacity is significantly boosted by only one of the instruments under consideration – budget funding allocated to innovation projects within the framework of FTPs and other programs.

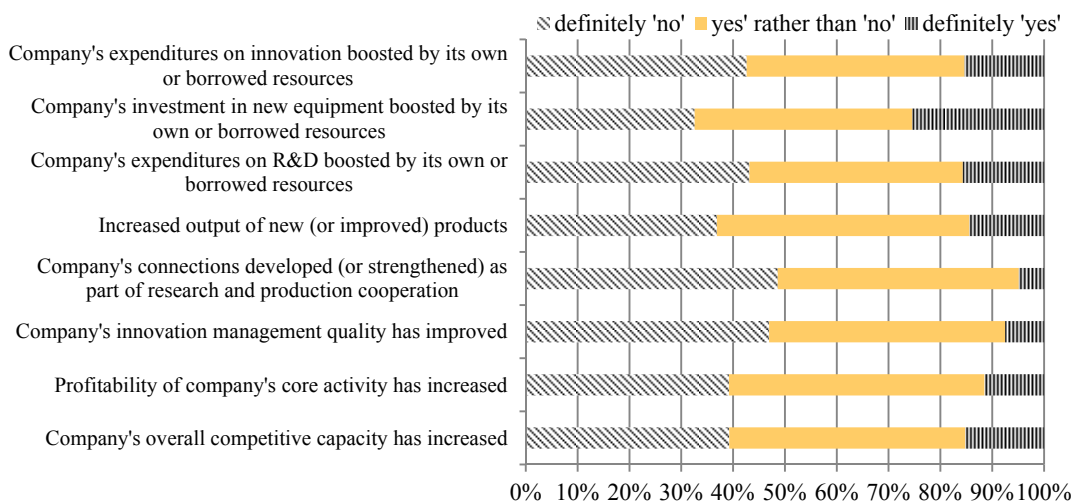


Fig. 7. Major Effects of Government Support at the Level of Companies

On the whole, the effect of the government policy instruments discussed here is much more frequently associated with a positive dynamics of the upfront features of business activity – the output volume, exports, and rising rate of return - rather than with improving labor productivity and increasing the share of innovation products in the total output volume.

The main drawback of the government innovation policy, according to heads of enterprises, is that the latter continue to bear all the risks associated with the implementation of innovation projects - even when provided with government support. In this connection, however, it is important to note that the scale of this problem is, in fact, grossly overestimated by those who in recent years have not had the experience of using government support.

The most serious problems associated with the application of innovation promotion tax mechanisms are the vagueness of the existing regulations and the inadequate parameters of the existing tax exemptions (their size etc.); those associated with the instruments based on budget funding allocated to innovation projects consist in the complexity of procedures of applying for support, including the necessity to prepare voluminous documentation and the excessively tough requirements for the recipients of government support, the composition of their expenditures, and so on; and those associated with the financial support allocated via development institutions include both of the drawbacks of budget allocations coupled with an insufficiently fair procedure of selecting the recipients of support.

By way of summing up the material discussed in this subsection, we should like to enumerate briefly the main features of the most frequently applied instruments of government innovation policy, dividing them (with a certain degree of arbitrariness) into positive and negative ones:

innovation promotion instruments based on tax incentives:

on the plus side:

- ensure the broadest possible involvement of innovation companies;
- offer a totally objective approach to selecting the recipients of support;
- constitute no significant barriers, easily accessible;
- imply a reasonable level of administrative costs;
- generally neutral.

on the minus side:

- difficulties in application, due to vagueness of the existing regulations;
- due to the formal criteria and base for application (which is inevitable), these measures may be applied to companies that in reality have nothing to do with innovation activity;
- risks of disputes with tax agencies, additional audits;
- more oriented to the expansion of the projects already under way than to the initiation of new projects;
- have little relation to the end results of innovation implementation;
- difficult to estimate the final effect of the application of these instruments.

targeted budget funding allocated to innovation projects:

on the plus side:

- conduces to the launch of new innovation projects, reduces the risks involved;
- makes possible the support of projects that are less profitable in terms of commerce, but more promising from the point of view of long-term development or social importance;
- makes possible the execution of control over the ways of spending the allocated support;
- oriented to the end results of innovation implementation;
- ensures a broad spectrum of positive effects for the recipients of support, including their increasing competitive capacity;

on the minus side:

- is fraught with high costs of the selection of recipients of support;
- does not rule out a subjective approach to selecting the recipients of support, gives rise to corruption risks;
- is associated with high entry barriers, excessive requirements to the recipients of support;
- excessive bureaucracy;

the activity of government development institutions:

on the plus side:

- distinctly project-oriented;
- most effective from the point of view of the external co-financing of projects;
- allows support of more important and promising, although less commercially profitable projects;

on the minus side:

- the highest degree of subjective attitude to the selection of recipients of support;
- is associated with high entry barriers - both in terms of complexity of the procedures involved and the excessive requirements to the recipients of support;
- in actual practice, there is a tendency to allocate support to more commercially attractive projects, to the detriment of their other prospects.

6.4.4. General Assessment of Russia's Innovation Policy

Over the last five years, evident progress has been achieved in the development of Russia's innovation policy. Its signs have been visible in several areas.

Firstly, some significant positive changes in the general understanding of the idea of innovation policy and its comprehensive character occurred at the government level. During the post-crisis phase, new strategic documents¹ were adopted with regard to innovation development, which rather adequately reflected the whole scope of changes to be introduced, as well as their complexity and in-depth nature.

Secondly, the range of available innovation policy instruments had been radically expanded, some new instruments for boosting demand for innovations have emerged, while at the same time, over recent years, the quality of the procedures of practical application of some of the innovation promotion mechanisms - in particular tax mechanisms - has dramatically improved. The system of government development institutions has been demonstrating a dynamic evolution. Thus, Russia's innovation policy today incorporates dozens of different mechanisms - nearly the entire arsenal of instruments known from the experience of other countries.

Thirdly, the openness of government agencies to the ideas of improving the innovation policy, has become much greater, while the period of 'digesting' new ideas prior to their implementation in actual practice has considerably shortened – to between six months and a year. A number of initiatives have been launched in order to create networks for identifying and supporting new partnerships, which can result in consolidating new interest groups.

Fourthly, the access for different interest groups to the process of shaping and estimating innovation policies has been made easier, and it has acquired certain features of institutionalization in the form of relevant commissions and task forces. The government is expanding its interaction with medium-sized businesses and new sectoral associations, and is making active attempts to improve the quality of regulation, and involve the business community in that process.

In spite of the significant achievements in the general development of Russia's innovation policy, and especially its instruments, so far there have occurred no more or less visible and sustainable positive shifts in the innovation sphere at the macrolevel (Table 12). The share of

¹ See, in particular: *Strategy for the Innovation Development of the Russian Federation in the Period Until 2020* (approved by Regulation of the RF Government as of 8 December 2011, No. 2227-r).

organizations implementing technological innovations is still low, and the fluctuation of that indicator over the period of 2006–2011 remained within the range of 9.3 to 9.6%; the role of non-governmental sector in financing research is very limited - moreover, between 2007 and 2010 the share of the entrepreneurial sector in domestic expenditures on research and development declined from 29.4% to 25.5%, and only in 2011 it somewhat increased - to 27.7%; and finally, the share of innovation products in total output demonstrated bi-directional movement (in different years) in the range of 5.5 to 6.1%.

Table 12

**Some Innovation Activity Indicators in Russia
at the Macrolevel**

Indicators	2006	2007	2008	2009	2010	2011
Domestic expenditures on research and development, % of GDP	1.07	1.12	1.04	1.25	1.16	1.12
Federal budget allocations to civil science, % of GDP	0.36	0.40	0.39	0.56	0.53	0.58
Share of government funding in domestic expenditures on research and development, %	61.1	62.6	64.7	66.5	70.3	67.1
Share of the entrepreneurial sector in domestic expenditures on research and development, %	28.8	29.4	28.7	26.6	25.5	27.7
Share of organizations implementing technological innovations, % of total number of organizations*	9.4	9.4	9.6	9.4	9.3	9.6
Share of innovation goods, work, or services, % of total volume of goods, work, and services delivered *	5.5	5.5	5.1	4.6	4.9	6.1
Share of expenditures on technological innovations, % of total volume of goods, work, and services delivered *	1.4	1.2	1.4	1.9	1.5	1.5

*) The extracting and processing industries, the production and distribution of electric energy, gas and water.

Sources: SU-HSE (2012). Nauka. Innovatsii. Informatsionnoe obshchestvo: 2012. Kratkii statisticheskii sbornik. [Science. Innovations. Information Society: 2012. Brief Statistics Collection], Moscow; SU-HSE. (2012). Indikatory nauki: 2012. Statisticheskii sbornik. [Science Indicators: 2012. Statistics Collection] Moscow; SU-HSE. (2012). Indikatory innovatsionnoi aktivnosti: 2012. Statisticheskii sbornik. [Innovation Activity Indicators: 2012. Statistics Collection]. Moscow.

To a certain extent, this can be explained by the inadequacy of the set of indices applied in official innovation statistics, the inertia of those statistics, and the inevitable limitations in the reflection of ongoing qualitative changes. However, microeconomic research so far has not revealed any stable upward trend in the level of innovation activity across the national economy, if a comparison is to be drawn between the period before the crisis, immediate pre-crisis and post-crisis periods. In principle, it can be noted that the share of companies investing in new equipment has evidently increased, but at the same time no significant positive changes were observed in companies' demand for the results of research and development projects (see *Table 13*).

The share of companies acting as strategic innovators demonstrated little changes over the past 7 years, while the 'depth' of companies' innovation activity (estimated by the level of expenditures on technological innovations and research and development projects) remains very low.

Of course, there did occur some positive changes and qualitative shifts, their presence can be gleaned from data yielded by formalized questionnaires and in-depth interviews conducted at the level of individual companies, market segments and sub-industries.

Table 13

Some Innovation Activity Indicators in Russia at the Microlevel¹

Some parameters of enterprises' innovation activity (based on microeconomic studies) *	2005	2007	2011
Share of enterprises continually involved in innovation activity, as part of their strategy aimed at boosting their competitive capacity, % of sample	35	39	38
Share of enterprises investing in new equipment, % of sample	63	74	78
Level of investment in new equipment, % of proceeds (median value for the group of enterprises within the sample investing in new equipment)	5	4	3
Share of enterprises allocating financing to R&D, % of sample	45	39	42
Share of enterprises allocating financing to R&D at a level above 5% of proceeds, % of sample	10	7	1.5
Share of enterprises whose output contains new, upgraded products, % of sample	.	60	53
Share of new, upgraded products, % of proceeds (median value for the of group of enterprises within the sample issuing such products)	.	10	3

*) The table is based on the analysis prepared by the Interdepartmental Analytical Center on the basis of results of surveys of the directors of medium-sized and big enterprises operating in processing industries, conducted in 2005, 2008, 2011 (more than 500 respondents in each survey).

Among the most important changes in the innovation behavior of Russian companies that occurred over the post-crisis period, the following ones can be pointed out:

- the increasing 'polarization' of companies in terms of their innovation activity and level of technologies, *emergence of noticeable groups of companies competitive on a global scale* (high heterogeneity of companies - including those operating inside one industry); considerable divergence of companies by the level of their innovation activity, increasing heterogeneity of economic forms in a number of sectors;
- *the presence, in some sectors (in particular, machine-building) of rather numerous groups of companies equipped with state-of-the-art technologies; most frequently, these compa-*

¹ Hereinafter, when references are made at microeconomic studies, these are understood as the results of research projects carried out by the Interdepartmental Analytical Center with the purpose of studying the specific features of the innovation behavior of Russian companies. The information base for these studies were the data yielded by the questionnaires answered by approximately 500 directors of enterprises operating in the processing industries, in the course of surveys that took place in 2005, 2008, 2009, 2011 and 2012. The results of these projects are reported in several publications, in particular in Kuznetsov, B., Kuzyk, M., Simachev, Yu., Tsukhlo, S., Chulok, A. (2006). Osobennosti sprosna na tekhnologicheskie innovatsii i otsenka potentsial'noi reaktsii rossiiskikh promyshlennykh predpriatii na vozmozhnye mekhanizmy stimulirovaniia innovatsionnoi aktivnosti. [Specific Features of Demand for Technological Innovations, and Estimation of the Potential Reaction of Russian Industrial Enterprises to Possible Mechanisms Designed to Foster Innovation Activity]. Modernizatsia ekonomiki i gosudarstvo. [Modernization of the Economy and the State] Ed. by E G. Yasin, 1. SU-HSE; Zasimova L. S., Kuznetsov B. V., Kuzyk M. G., Simachev Yu. V., Chulok A. A. (2008). Problemy perekhoda promyshlennosti na put' innovatsionnogo razvitiia: mikroekonomicheskii analiz. [Issues of Industry's Switchover to the Path of Innovation Development: Microeconomic Analysis. / Series Nauchnye doklady: nezavisimi ekonomocheskii analiz. [Scientific Reports: Independent Economic Analysis, No. 201. M.: Moscow Public Science Foundation (MPSF); Simachev, Yu. (2009). Ili naidi dorogu, ili prolozhi ee sam [Either Find the Road, Or Build It Yourself]. Priamye investitsii [Direct Investment], 11. P. 18-22; Kuznetsov, B., Simachev, Yu. (2009). Konets sveta otkladyvaetsia. [The Doomsday Is Postponed]. Expert, (049–050). P. 58-61; Simachev, Yu., Kuzyk, M., & Kuznetsov, B. (2010). Otsenka vozdeistviia razlichnykh antikrizisnykh mer na predpriatii obrabatyvaiushchei promyshlennosti [Estimation of the Effect of Different Anticrisis Measures on Enterprises in the Processing Industry]. Ekonomicheskaiia politika, 1. P. 122–134; Ivanov, D. S., Kuzyk, M. G., Simachev, Yu. V. (2012). Stimulirovanie innovatsionnoi deiatel'nosti rossiiskikh promyshlennykh predpriatii: vozmozhnosti i ogranicheniia. [Promotion of the Innovation Activity of Russian Industrial Companies: Possibilities and Limitations]. Foresight, V. 6, No. 2. P. 18–42; Simachev, Y., Kuzyk, M., Ivanov, D. (2012). Fostering innovation in Russian companies in the post-crisis period: Opportunities and constraints. MPRA Paper No. 41284, University Library of Munich, Germany; Kuznetsov, B., Simachev, Y. (2010). Impact of economic crisis on innovation behaviour of industrial firms in Russia. MPRA Paper No. 43675, University Library of Munich, Germany.

nies have the following features: (1) participation of foreign investors in their capital; (2) a rather short business history ('aged' less than 10 years);

- innovation-active companies are characterized by a *positive dynamics of expenditures on technological innovations*;
- an increasing demand for new products across the economy, the population being the main driving force behind that demand, while the government, within the framework of government purchases, so far has created no significant incentives for the production of innovation goods (or services);
- an increasing demand among companies for research and development, including the demand for new product development, with the increasing globalization of that demand.

Moreover, there exist some preconditions for the increasing interest of companies in research and development, which are as follows:

- the potential for improving the traditional products is shrinking, the implementation of technologies for manufacturing new types of products is becoming increasingly important;
- the consumer market is displaying an increasing demand for products with new properties;
- enterprises have already in the main solved their most urgent problems associated with the renewal of depreciated fixed assets;
- there exist some signs that the access of successfully operating big Russian companies to advanced technologies is diminishing (the range of tradable technologies is becoming narrower);
- the supply of innovation technologies by a number of universities has emerged, including engineering services based on the use of their qualitatively new equipment and test sites;
- the broadening views of companies' directorates as to the areas of research and development necessary for increasing the competitive capacity of their businesses.

Nevertheless, in spite of some real positive changes occurring on the microlevel, so far there have been no significant shifts on the macrolevel. Probably the reasons for this situation are the lack of a sufficient number of positive examples set by innovation businesses, the institutional environment unfavorable for rapid growth, and the increasing scope of innovation companies in the Russian economy.

On the one hand, the motivation for introducing innovation at the level of companies is evidently insufficient: since 2005, the number of companies with no obstacles for implementing innovations has been clearly multiplying – 6%, 15% and 21% in 2005, 2008 and 2011 respectively, but approximately half of those of them that had no obstacles in 2011 were not engaged in any innovation activity.

On the other hand, the government, whilst improving its innovation policy practices, at the same time implements certain measures in the framework of other policies (also associated with rational tasks), which sometimes impose significant restrictions on the distribution of innovations across the economy. In the OECD's review of Russia's innovation policy¹ it is noted, in particular, that a low level of competition leads to technological backwardness in many sectors and broadens the gap between profitability and productivity; meanwhile, government expenditure allocations to science and technologies continue to exert little influence on the amount of money invested in innovation technologies by businesses. On the whole, the influence of the existing different exemptions and preferences, as well as government protectionist measures on the situation in the business community is negative.

¹ DEMAND. (2011). DEMAND Reviews of Innovation Policy: Russian Federation 2011. DEMAND Publishing.

On the basis of microeconomic and institutional studies, the (rather arbitrary) balance of achievements and constraints in the innovation sphere over the last 5 years may be presented as follows (*Table 14*).

Table 14

Comparison of Major Achievements and Problems in the Implementation of the Innovation Policy in 2007–2012

Advantages and specific features of the government's innovation policy	Conditions, constraints and motivations for innovation at the level of companies
1. Pre-crisis period: 2007 – 2008	
vast budget potential; innovation is an important direction of government policy; increasing investment activity of the government; adoption of long-term strategies, target programs in the field of science and technologies; growing budget allocations to innovation; tax incentives for innovation; creation of big development institutions, venture funds	stable conditions for economic activity, a reduction in the tax load on businesses; limited areas of competition with foreign companies; risks of property takeovers and negative motivation for expanding the scale of business activity; predominantly the adaptive innovation model, without significant allocations to R&D; narrow circle of genuinely innovation-active companies
<i>Major constraints: large-scale application, by the government, of rough direct mechanisms in the support of innovations, introduction of strong distortions in the market environment</i>	
2. Crisis phase: 2009–2010	
dramatic shrinkage of budget potential; compensatory orientation of the anti-crisis measures; temporary protective measures, promotion of domestic demand; selective support of big and superbig companies; innovation at the top of the declared policy's agenda; establishment of commissions on modernization, technologic development; setting modernization priorities; launch of big innovation projects in a 'manual' mode	hard financial constraints for companies; dramatic lowering of the predictability of conditions for economic activity; concentration of innovation activity in the sphere of big businesses orientation of the innovation activity of businesses towards bringing down costs
<i>Major constraints: 'confiscation' of potential advantages from innovation-active companies (expansion of market shares as a result of departure of inefficient competitors, potential for attracting additional qualified workforce) due to the government policy's focus on social stability to the detriment of economic performance</i>	
3. Post-crisis phase: 2011 – 2012	
considerable budget constraints, welfare-oriented budget; innovation is one of government policy's priorities; significant alterations to regulation; new innovation promotion instruments, but weak institutional development of the business environment multiple 'experiments with no consequences' and learning projects	uncertainty, low predictability of government policy; multiple 'innovation signals' from the government; businesses wait and focus on completing their current projects; imitation of innovation activity by some enterprises; orientation of some companies to receiving rent in the innovation sphere; increasing importance, for businesses, of the task of mastering new products (services)
<i>Major constraints: uncertainty of the conditions for economic activity; postponement of a number of key economic decisions by the government; considerable slowdown in the institutional development of the business environment</i>	

The period prior to the crisis saw the emergence of a significant group of companies with a highly dynamic innovation activity, which laid the foundation for the expectations of the appearance of the 'second echelon' in economic development as a result of growth of medium-sized hi-tech companies. However, in the *pre-crisis period* when considerable resources were available, the government began to actively promote the demand for innovations, while at the same time evidently paying too much attention to direct promotion mechanisms in the form of FTP. As a result, significant part of the resources was from the very start orientated towards relatively big companies operating in the traditional industries. Besides, the amount of government investment in the economy was increased alongside the development of infrastructure; however, the increasing government purchases had little to do with applying higher requirements to the quality of the products or services being purchased. As a consequence, companies began to seek more attractive and less risky directions (outside of the innovation field) for expanding their activity. On the whole, over that period, while government direct expenditures on economic development were increasing, in the business community the motivation for looking for ways of generating rent was inevitable on the rise.

During the *crisis* period, the budget constraints imposed on innovation companies quickly became much harder, which resulted in a decline of innovation activity - first of all with regard to investment in new equipment. At the peak of the crisis, budget expenditures and some innovation policy instruments were partly reoriented to compensate some of the businesses for the losses resulting from the crisis. The government, whose main priority was now to maintain social stability, significantly restricted the flow of resources to innovation-active competitive companies, and reallocated resources instead to the support, on a large scale, of big companies, many of which had been performing badly even before the crisis¹. The informal requirements that were now applied by the government to the behavior of big companies became a significant obstacle to the ongoing restructurization processes in the business sector. The business environment generally became worse due to the active implementation of all kinds of quotas and preferences designed to support domestic producers, as well as protective measures on the domestic market².

However, that period also saw a re-evaluation of the role of innovations in boosting the competitive potential of Russia's national economy, and so a number of 'new wave' innovation measures had already been proposed and discussed by 2009.

The *post-crisis* period was characterized by some very controversial trends both in the government policy and in the behavior of businesses. The government had drawn several diametrically different lessons from the crisis situation: on the one hand, the 'manual management' practice was estimated to be positive, while on the other, it was considered to be necessary to reduce the government's direct participation in the functioning of the economy, and to improve both the investment climate and the interaction with businesses.

The distinctive feature of Russia's innovation policy in the post-crisis period became the initiation of comprehensive mechanisms for the support of cooperation between the different participants in the innovation processes, the creation of networks and partnerships in the innovation sphere, and the promotion of research at universities³. However, the activation of innovation policy in the post-crisis period has been too versatile and multi-vectored; big businesses, with their habit of responding to the signals displayed by the government, are faced with certain difficulties when mapping their strategic plans. The decision-making with regard to some fundamentally important directions of government policy has been started only recently, and in some areas the final decisions have not yet been elaborated (tax policy, pension reform).

The results of microeconomic studies also point to the negative influence on innovation growth of the lack of stability in companies' economic environment and the low predictability of government economic policy. Thus, at present, the most relevant factors that hinder the innovation activity of companies are, on the one hand, the unstable conditions for economic activity, which increase risks and reduce the planning horizon; and on the other, the internal bu-

¹ See, in particular, Simachev Yu. V., Ivanov D. S., Korotkoe M. Yu., Kuznetsov B. V., Kuzyk M. G. (2012). Gosudarstvennaia antikrizisnaia podderzhka krupnykh i sistemo-obrazuiushchikh kompanii: napravleniia, osobennosti i uroki rossiiskoi praktiki [Government Anti-crisis Support of Big and System-forming Companies: Directions, Specificities and Lessons of Russia's Practice. Ed. A. D. Radygin. Delo Publishers, RANEPa.

² Simachev, Yu. V., Kuzyk, M. G. (2012). Gosudarstvennaia antikrizisnaia podderzhka rossiiskikh kompanii: pomoshch i orranicheniia [Government Anti-crisis Support of Russian Companies: Aid and Restrictions]. Journal of the New Economic Association. No 1. P. 100-125.

³ Dezhina, I., Simachev, Y. (2012). Partnering universities and companies in Russia: effects of new government initiative. MPRA Paper No. 43622, University Library of Munich, Germany.

reaucratization of the business processes inside companies, which makes them less open and receptive to innovations¹.

Alongside the basic institutional factors that work against the process of innovation development in the Russian economy, *there also exist a number of sectoral-level constraints* (it should be noted that the removal of those constraints is a task that usually belongs to domains beyond the framework of 'standard' innovation policy):

(1) *the sector of superbig companies with substantial innovation potential and - with a high level of direct government participation in some companies.*

Due to the political and social importance of some of these companies, the government follows a policy of direct influence on their behavior. They are asked to behave in compliance with the socially acceptable norms, but the companies, in their turn, fight for certain exemptions and preferences. On the whole, the situation is characterized by low transparency and predictability, which results in a lower motivation for these companies, their owners and managers, to implement innovations,;

(2) *the traditional hi-tech sectors with a relatively high level of innovation activity.*

The factors that restricts the effect of innovations and their rapid distribution across these sectors are their traditionally vertical structure coupled with very insufficient unification and standardization. When applied to this sector, the general competition promotion measures can work only on a very limited scale;

(3) *new, relatively rapidly developing sectors with horizontal organization and predominantly small and medium-sized businesses.*

The development of these sectors is very sensitive to the entrepreneurial climate and the quality of administration (for example, customs or tax administration). The companies operating in these sectors are highly mobile, and so in view of an unfavorable situation may relatively easily move their business activity to other countries. The specificity of these sectors and their development potential are not easily understandable for the government.

On the whole, in recent years Russia has been witnessing an intensive *cooperation between innovation and industrial policies*, while at the same time there have been some reverse trends, when the innovation policy loses neutrality and becomes more oriented to the specificities of different sectors and markets, and the industrial policy becomes more horizontal and shifts towards dealing with technological development issues. Among the positive changes that occurred with regard to the elaboration and adjustment of Russia's innovation policy, the following ones can be noted:

- broadening access of different interest groups to the elaboration of the innovation policy and relevant proposals, the development of a system of consultative and coordinating bodies under the RF President and the RF Government to deal with the innovation and industrial policy issues;
- large-scale expansion of the representation and general strengthening of the influence of the interest groups linked to development institutions, educational establishments and research organizations;
- creation and development of instruments designed to encourage the search for new 'players' in the innovation sphere and the formation of partnerships (technological platforms, innovation clusters, tied grants).

¹ Simachev, Y., Kuzyk, M., Ivanov, D. (2012). Fostering innovation in Russian companies in the post-crisis period: Opportunities and constraints. MPRA Paper No. 41284, University Library of Munich, Germany.

However, there still remain the following attributes of a classical vertical policy (with its specifically high costs and risks in conditions of underdeveloped institutions):

- orientation to the interests of biggest players, even when their composition is made more complex by involving other entities from the sphere of science, education and technological development;
- weak competition between government institutions, in some cases there are the signs of monopolistic approaches and estimations;
- limited attention to the effect of demonstrations and sharing of best practices, focus on the use of government (or quasi-governmental) resources;
- relative openness to proposals, but closeness (non-transparency) of the processes of decision-making and estimation of achieved results.

6.4.5. Conclusions and Lessons for the Future

1. In recent decades, innovations have been increasingly referred to as a very important factor that determines economic development and adequate solutions to social problems. As inter-country competition is getting more intense, the requirements to the quality of innovation policies implemented by national governments are becoming tougher. These processes trigger the elaboration of new innovation promotion instruments and the methods of estimating the influences of different mechanisms applied in supporting the innovation activity. The international exchange of best practices of innovation support is growing in scale, and the role of inter-country transfer of innovation promotion instruments is becoming more prominent.

In many countries over the past few years, the general view of the government's role in promoting innovations, of the directions and forms of support of innovation activity have undergone a fundamental change. At the same time, in conditions of shortage of budget resources, governments are focusing their efforts on the regular assessment of the influences of various innovation promotion instruments on economic development and the identification of their long-term effects. This serves as a basis for continual improvement and adjustment of the mechanisms of incentives for implementing innovations.

All these phenomena determine the current serious challenges that Russia will need to adequately respond to by elaborating a reliable innovation policy, capable of boosting the competitive potential of domestic businesses and ensuring sustainable long-term socio-economic development.

2. Russia's current innovation policy represents an active process of elaborating new innovation promotion instruments. However, the impressive scale of experimenting within the innovation policy's framework has so far been inadequately followed by formulating the achieved results and using them as lessons for the future. It can be noted in this connection that, due to the limited number of estimated effects we often tend to overlook not only failures, but also the good examples of successful development. The process of adjusting successful instruments to the scale and level of their implementation is limited, and the adaptation of the functioning mechanisms to a changing environment occurs even less frequently.

The process of decision-making with regard to the innovation policy mechanisms and the argumentation it is based upon are not very transparent, and so there appears to be little sense in such experimenting, while its unpredictability is indeed high.

It should be admitted that the issue of the outcomes of Russian innovation policy, of the efficiency of the rather broad variety of currently applied promotion mechanisms, in the post-crisis period has been raised at the government level with sufficient clarity, but no adequate

answers have been provided so far, while the results of independent estimations may turn out to be dubious and disappointing for certain ministries. This imposes significant restrictions on any real progress in the organization of independent expert's estimations of the innovation promotion measures being implemented in Russia.

3. To reveal the existing best practices, it is important to determine the approaches to estimating the mechanisms applied in promoting innovations. In this connection, we may point out two major drawbacks of Russia's innovation policy: (1) excessive emphasis on monitoring the numerical indicators of allocated resources, and (2) expectation of short-term positive effects.

At present, the targets for innovation policy implementation are based in the main on the expected changes in resource management (for example, increased allocation of companies' money on R&D), while much less attention is paid to the end results of innovation activity (productivity growth, broader segments of world market taken over by hi-tech products, etc.). At present, many potential effects are overlooked by the applied estimation methods, and so the existing possibilities for identifying and distributing best practices in the framework of Russia's innovation policy are limited. The direct resource-based numerical targets in some cases produce a situation when a company implements its innovation activity only formally, which results in imitation of progress in the innovation sphere. What is usually being overlooked in the existing estimations is the spectrum of behavioral effects associated with different promotion mechanisms. However, it is these effects that are most sustainable and contagious in the entrepreneurial environment.

As for the expectations of the influences of different mechanisms on the end results of companies' activity, such changes take place with a significant lag, and so any early conclusions (made after 1–2 years after their implementation) of the functioning of new instruments and their comparison in order to select the best approach on their basis are by no means always reasonable and appropriate. Patience is necessary, and support must be provided on a stable basis for a relatively long period of time, so that the better performing companies could perceive lower future risks and reflect this circumstance in their plans, which will then be oriented to further expansion of their innovation activity.

4. There has been a significant progress in the expansion of the arsenal of innovation promotion instruments. However, in addition to all these achievements, it is also necessary to broaden, in practical terms, the notion of an innovation policy. So far it has mostly been associated with the classical linear model – science, technologies, innovation. But in the framework of innovation-oriented development – especially in its current phase – the central role is being increasingly taken over by policies based on accumulation and absorption of knowledge, network interactions and transfer of skills, and development of search networks, and so the importance of measures aimed at human capital development is increasing manifold.

At present, the range of companies in some or other way influenced by the government's innovation promotion measures is rather broad – thus, the positive influence of such measures was noted by the majority of directors of innovation-active companies included in the analyzed sample. Contrary to the widespread beliefs, the measures implemented by the government are mostly oriented to the support of successful companies rather than the 'outsider' businesses.

However, among the currently applied innovation promotion instruments, only a few are designed to boost the rate of companies' development. Besides, these measures are not, on the

whole, orientated towards supporting new businesses. A considerable number of the existing instruments (backed by sufficient resources) are intended mostly for the traditional sectors. The actual results of the use of innovation promotion instruments could indeed be better but for the low quality of their administration.

The ongoing changes in the outlooks of the business community with regard to the ways of technological modernization (and we believe that this process will be sped up even further) determine the need for elaborating some new, 'clever' innovation promotion mechanisms that could be adjusted to or even anticipate the ever-increasing demand of companies for new technologies.

5. When comparing the advantages and problems associated with the use of the major groups of innovation promotion instruments in Russia, we should like to stress the following points:

(1) Tax incentives have no significant barriers for access, and are generally neutral. However, they are predominantly associated with the resource component of innovations, and so do not create strong stimuli for development.

(2) Budgetary mechanisms are more closely linked to the end results of innovation activities than tax mechanisms. At the same time, companies can gain only limited access to budgetary mechanisms due to the complexity of the selection procedures and the voluminous reporting documentation required from them. For the dynamically developing medium-sized companies the bureaucratic costs are too high, and for big companies the amount of support is too modest to be of any real significance.

(3) Quasi-budgetary innovation promotion instruments (first of all, the government development institutions) have at least one important advantage – they are project-oriented, sometimes to a degree of boosting the rate of companies' development. These instruments are subject to somewhat less regulation than budgetary mechanisms, but at the same time they usually shift the bulk of the risks involved onto the recipients of support.

(4) Regulatory and communication-based innovation promotion mechanisms (in particular, improvement of technical regulation, promotion of the development of networks and partnerships) so far belong to the group of least developed mechanisms, although in recent years some improvement has been noted in that sphere. A significant potential for their development is created by the rising demand for advanced technologies and by the evident need to coordinate the behavior of innovation companies in certain sectors, as well as by the emerging new links between science and industry. However, the risks associated with failures to fulfill the proclaimed technical regulation development plans are also high.

On the whole, it can be noted that there still exist some significant risks of a 'takeover' of the new instruments by the traditional interest groups and the strengthening of direct government influence within the framework of innovation promotion mechanisms, on the one hand, and lack of adequate selection mechanisms, on the other.

6. There exist no 'universally useful' innovation promotion mechanisms. A serious problem associated with the estimation of mechanisms applied in fostering innovations is the heterogeneity of their effects, which strongly depend on companies' sectoral specificity, size, property structures, business history, etc. Thus, in particular, the investment in the research and development studies carried on in the hi-tech sectors yields higher more return than that in the low-tech sectors. At the same time, the priority for the low-tech sectors is to create favorable conditions for attracting investment needed for the modernization of their production base.

When a new innovation promotion instrument is being introduced, it is highly probable that its influences will be heterogeneous, and so it must first be applied neutrally and on a sufficiently broad scale; this will help to identify its sectoral specificity and possible market failures, thus providing a basis for its specialization later on.

7. It would be incorrect to believe that a low level of innovation activity is associated exclusively with lack or shortage of resources or improper adjustment of the innovation promotion mechanisms. On the basis of the available results of studies it can be argued that there is insufficient motivation for innovation at the level of companies.

The most serious barriers in the way of innovation development are unstable conditions for economic activity and low predictability of government policy. Thus, one of the most important priorities is to ensure regulation stability, because even positive alterations in the regulation procedures usually give rise to uncertainty and increase risks, especially in case of long-term innovation projects. On those markets where the need for changes is strongest, their potential positive influence reveals itself in the framework of procedures designed to assess the effects of regulation. In fact, the process of planning and introducing adjustments in regulation must be transparent for the business community.

8. The pressure exerted on big companies by the government for the good cause of encouraging their innovation activity may, in fact, result only in their formal imitation of innovation activity. The most negative outcome in this case seems to be the tuning of companies' internal innovation systems to the government's preferences (which can be especially true of companies with state stakes). By doing so, they will become less capable of interacting with other (generally speaking – more important) participants in the innovation processes – individual inventors, research centers, universities, small-sized hi-tech companies, etc.

9. A considerable (if not the principal) part of the barriers in the way of innovation development in the Russian economy are not linked directly to innovation policies. Instead, they have emerged due to the inadequate quality of the institutional business environment: distortions in the competitive environment caused by the existence of different quotas and preferences; the government's support of poorly performing companies; constraints on the growth of small and medium-sized companies; the possibility for some companies to take advantage of the fact of their social welfare orientation. It is necessary to note that, both at the time of crisis and in face of newly emerged 'mobilization' strategies, the government cannot resist the temptation to resort to some protective measures, introduce the mechanism of direct support for some selective industries and sectors, markets, or technologies, initially declaring them to be only temporary and of relatively short duration. However, as a rule, it eventually turns out that these 'temporary' measures later on display an amazing viability and adaptability to various new situations, and a lot of political effort is required to finally abolish them.

Any distortions in the institutional business environment significantly reduce the demonstration effects of the operation of successful innovation companies, as well as the attractiveness and, consequently, distribution of the relevant business behavior models across the economy. In principle, any acts aimed at improving the general environment may go hand in hand with support of individual projects, thus making it possible to better perceive the existence of real regulation-related problems. However, such support must from the very start be oriented to the achievement of demonstration effects, encouragement of new or relatively young companies in need of distribution of their risks, as well overall systemic improvement of the business environment.

10. It is not really a productive approach to directly counterbalance the problems existing in a less than perfect business environment by boosting the stimuli for innovation, because the availability of additional resources does not reduce the existing risks. On the contrary, such measures can only further increase companies' motivation for seeking sources of rent in the innovation sphere and imitate the innovation behavior model.

The mechanisms of support must not create excessively beneficial conditions for the support recipients. Rather, it is necessary to develop an innovation-friendly regulation, and the government must truly share the innovation risks with businesses and be ready sometimes to lose some of its resources allocated for the support of innovations - that is, to really assume responsibility for some of the risks borne by businesses.

The granting of support must be combined with sufficiently serious responsibilities assumed by its recipients, which must be subject to qualitative control. It is fundamentally important to shift the emphasis from the selection of the best candidates for the allocation of support (a task that would be very difficult for the government to accomplish) to the procedures of monitoring the process of implementation of the relevant projects, with a subsequent selection, in a regular basis, of those who have achieved the best results.

11. An excessively vigilant search for 'market failures' and the ways to compensate for them may result in inevitable 'government failures' in the actual practice of this activity. This kind of risk becomes even more significant in absence of adequate independent assessment of the influences of different measures, or if the government's potential for administering complex mechanisms is limited, or if the government has limited ability to abolish unreasonable initiatives, especially in face of powerful lobbying by the traditional interest groups. In this situation, it is necessary to impose some reasonable constraints on the number of large-scale big initiatives launched by the government in the innovation sphere, make more versatile the composition of major innovation policy 'actors' (regions, development institutions, business associations), introduce special procedures for regular monitoring of the applied instrument, as well as their regular adjustment on the basis of independent estimations.

12. The process of elaborating and implementing an innovation policy in Russia is itself in need of in-depth modernization; in this connection, the following aspects can be pointed out:

(1) a search for new instruments, measures and initiatives must always be supplemented by clearing off any old, outdated or obsolete measures and mechanisms, with the abolition of any wasteful areas and inefficient support mechanisms. This approach will also be useful if applied to the estimation of target budget-funded programs in the field of science and technology, the activity of development institutions, and the use of different tax incentives for promoting innovations;

(2) to adequately implement a state-of-the-art innovation policy, it is necessary to develop some 'clever' instruments, while at the same time looking for highly reputed individuals and organization capable of implementing such instruments in actual practice. The effects of such instruments cannot be based on direct numerical indicators alone - it is also very important to pay attention to the indirect qualitative effects. It is necessary to create appropriate conditions for conducting studies in several 'sessions', implement pilot projects to test the new instruments and adjust their 'design', and later on, at the time of assessment, to determine the steps necessary for adjusting these instruments;

(3) it is imperative to develop appropriate ways for communicating with the business community prior to the actual elaboration and use of new instruments. The classical problem is that a succession of new instruments is put forth, but support is sought (and received) al-

ways by the same few organizations. It is important to work with businesses and with different segments of the business community, so that they could really believe in the possibility of partnering with the government. It quite often happens so that those businesses that have never had any experience with government support instruments perceive much more negatively the potential risks and problems associated with their use. It is necessary to identify and publicize the available positive examples, which will conduce to better and more significant positive behavioral effects;

(4) in order to ensure progress in creating the motives for the spread of best practices, it is feasible to further broaden the spectrum of innovation promotion institutions and mechanisms, encourage competition between the institutions, and conduct regular assessment of the achieved results on the basis of external independent estimates. The latter appears to be especially important for two reasons. Firstly, any attempts to redistribute resources and to shift accents in the innovation policy are likely to be met with increased resistance on the part of the traditional interest groups; and secondly, consideration must be given to the existing mistrust in society of any new innovation promotion initiatives put forth by the government. This can result in lesser 'flexibility' of the innovation promotion instruments, as the desire to make them more attractive in the eyes of the public will inevitably result in 'roughening' of the practiced approaches.

6.5. Russia's Real Estate Market

6.5.1. The Land Plots Market

According to the RF Federal Service for State Registration, Cadastre and Cartography (*Rosreestr*), the land area in the ownership of RF individuals continues to decrease. As of 1 January 2012, it amounted to 119.6 million hectares (m ha) (7% of the total land surface) vs. 121.4 m ha (7.1%) in 2011 (*Table 15*). By contrast, the land area in state or municipal ownership and in the ownership of legal entities is on the rise. Over the course of last year, the area of land plots in the ownership of legal entities increased by 1.5 m ha, to 13.5 m ha, or to 0.8% of the total land surface, which represented a 0.3 pp. increase on 2009. In the main, these changes resulted from transfers of the ownership of participatory shares in the right of common ownership to land plots of agricultural designation.

Table 15

The Structure of the Russian Federation's Land Area by Form of Ownership

Form of ownership	1 January 2009		1 January 2010		1 January 2011		1 January 2012	
	m ha	%	m ha	%	m ha	%	m ha	%
In state and municipal ownership	1,576.9	92.2	1,576.3	92.2	1,576.4	92.2	1,576.7	92.2
In the ownership of individuals, including:	124.3	7.3	123.2	7.2	121.4	7.1	119.6	7.0
Land shares of individuals	107.4	6.4	104.3	6.1	100.8	5.9	97.6	5.7
In the ownership of legal entities	8.6	0.5	10.3	0.6	12.1	0.7	13.5	0.8
In private ownership	132.9	7.8	133.5	7.8	133.4	7.8	133.1	7.8

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

As of 1 January 2012, most of Russia's privatized land remained in common share ownership, including 72.8%, or 96.873.3 thousand ha in unclaimed land shares (*Table 16*), vs 75.04%, or 100,136.8 thousand ha as of 1 January 2011.

Table 16

The Distribution of Russia's Privatized Land by Form of Ownership and Owner

	1 January 2011		1 January 2012	
	thousands of ha	%	thousands of ha	%
Total share ownership (land shares in the ownership of individuals)	76,131.3	57.05	75,077.4	56.42
Land in the ownership of individuals (peasant (farmer) households, personal subsidiary plots, individual housing construction, gardening, <i>dacha</i> construction, etc.).	20,546.5	15.40	21,994.4	16.53
Total joint ownership	698.7	0.52	681.6	0.51
Land in the ownership of legal entities	12,064.1	9.04	13,526.6	10.16
Unclaimed land shares in the ownership of individuals	24,005.5	17.99	21,795.7	16.38
Total	133,446.1	100.00	133,075.7	100.00

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

According to the State (National) Report 'On the State and Use of Land in the Russian Federation in 2011', one of the tasks of the ongoing land reform is privatization, by individuals owning land plots by right of permanent (or infinite) use or by right of inheritable possession for life, of these land plots, with the right of ownership thereto being formalized in accordance with existing legislation.

Apart from privatizing land plots free of charge, individuals also buy land plots on the land market. According to available incomplete data, ownership rights have been formalized with regard to 12 million land plots with the total area of 44.5 m ha. Out of that amount, 24.3 m ha have been registered as participatory shares in the right of common ownership to land plots of agricultural designation.

According to *Rosstat* (the RF Federal State Statistics Service), as of 1 January 2012, out of the total land area owned by individuals (21,994.4 thousand ha), 463.6 thousand, or 2.11%, had been granted to them for individual housing construction (*Table 17*), which is more than the figure recorded one year earlier (434.1 thousand ha).

Table 17

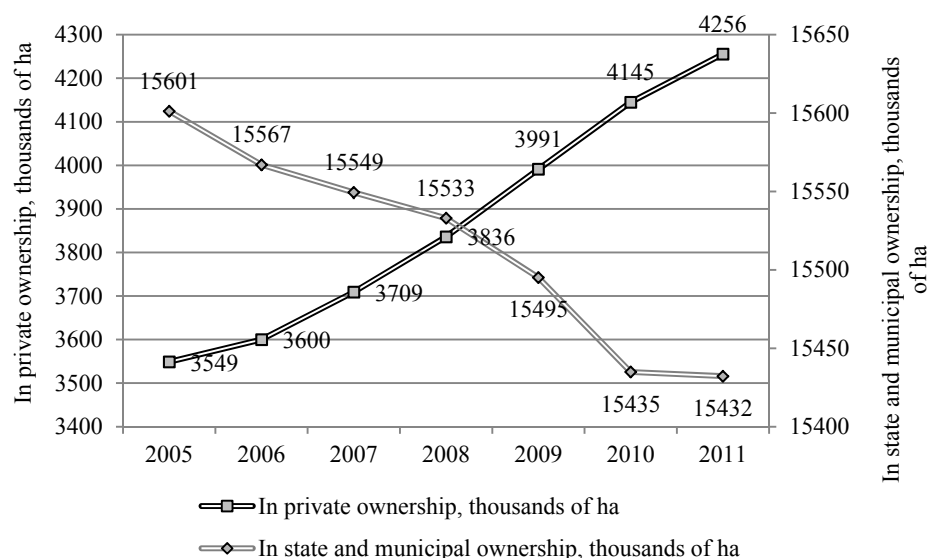
The Distribution of Russia's Land Owned by Individuals

	1 January 2012		1 January 2011	
	thousands of ha	%	thousands of ha	%
Owners of land plots	9,407.6	42.77	8,374.5	40.80
Personal subsidiary plots	5,534.7	25.16	5,414.6	26.30
Peasant (farmer) households	4,942.6	22.47	4,809.1	23.40
Gardening	807.7	3.67	797.9	3.90
Individual housing construction	463.6	2.11	434.1	2.10
Individual entrepreneurs engaged in agricultural production	642.8	2.92	532.8	2.60
For other purposes	195.4	0.89	183.5	0.90
Total	21994.4	100.00	20546.5	100.00

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

Privately owned land in inhabited localities steadily increases both quantitatively and as a percentage of the total land area of inhabited localities. As of 1 January 2012, it amounted to 4,256 thousand ha, or 21.62% of the total land area of inhabited localities (*Fig. 8*).

In 2011, the largest amount of land owned by individuals per 1,000 people was recorded in the Republic of Kalmykia (4.8 ha per person), where the share of privately owned land in the total land area amounted to 18.25% (*Table 18*). As regards the federal districts, first place in this index is held by the Siberian Federal District with 1.6 ha per person, while the North-Western Federal District with 0.31 ha per person is in the last place.



Source: The State (National) Report *On the State and Use of Lands in the Russian Federation in 2011*.

Fig. 8. The Dynamics of the Distribution of the Land Area of Inhabited Localities in the Russian Federation, by Form of Ownership, 2005-2011

Table 18

The Distribution of Land, by Form of Ownership, by RF Federal District, HA per 1,000 People (as of 1 January 2012)

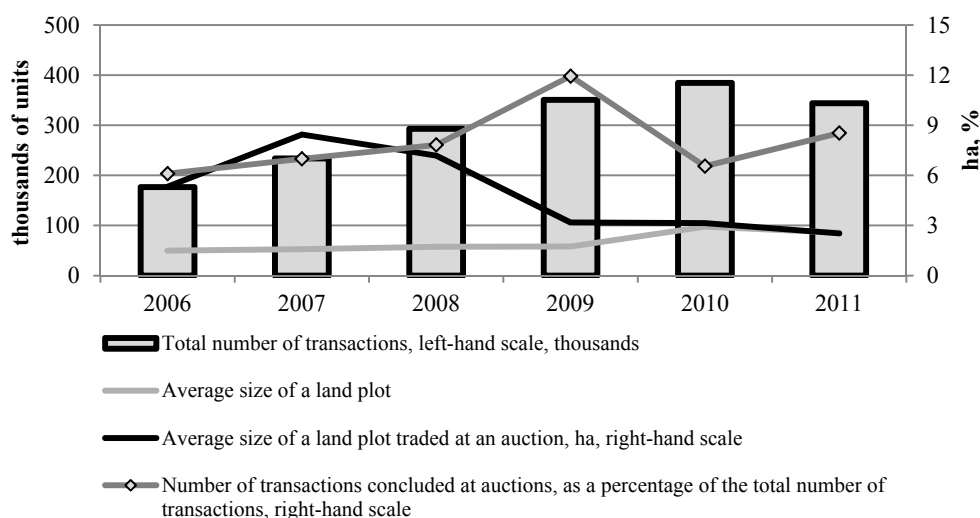
RF subjects and RF federal districts	Total land area, ha per 1,000 people	Land owned by individuals, ha per 1,000 people	Land owned by people, as percentage of total land area	Land owned by legal entities, as percentage of total land area	Place with regard to amount of land owned by individuals per 1,000 people and to total area in ha per 1,000 people
1	2	3	4	5	6
Republic of Kalmykia	26,066.92	4,756.72	18.25	0.05	1; 22
Trans-Baikal Krai	39,284.48	3,859.94	9.83	0.17	2; 14
Kurgan Oblast	7,976.22	3,408.37	42.73	2.92	3; 37
Republic of Altai	44,573.83	2,918.56	6.55	1.56	4; 12
Altai Krai	6,978.81	2,643.20	37.87	1.55	5; 39
Volgograd Oblast	4,350.08	2,447.26	56.26	2.90	6; 48
Omsk Oblast	7,146.98	2,305.12	32.25	3.77	7; 38
Pskov Oblast	8,306.64	2,259.48	27.20	1.99	8; 36
Nizhny Novgorod Oblast	3,752.02	2,203.58	58.73	2.30	9; 50
Saratov Oblast	4,035.47	2,200.97	54.54	7.59	10; 49
Novosibirsk Oblast	6,615.74	2,042.16	30.87	0.72	11; 40
Orel Oblast	3,155.33	1,733.31	54.93	5.87	12; 58
Tambov Oblast	3,183.42	1,663.21	52.25	10.37	13; 56
Republic of Khakassia	11,570.18	1,628.16	14.07	0.12	14; 32
Siberian Federal District	26,711.85	1,557.68	5.83	0.31	15; 21
Kirov Oblast	5,770.25	1,473.36	25.53	5.19	16; 42
Rostov Oblast	2,369.76	1,447.46	61.08	4.61	17; 69
Republic of Buryatia	36,168.13	1,440.51	3.98	0.17	18; 15
Stavropol Krai	2,373.85	1,426.86	60.11	5.93	19; 68
Kursk Oblast	2,674.57	1,419.18	53.06	10.38	20; 66
Southern Federal District	3,031.36	1,302.60	42.97	3.21	24; 59
Volga Federal District	3,478.44	1,055.32	30.34	4.13	30; 53
Russian Federation	11,952.10	835.68	6.99	0.79	37; 29
Urals Federal District	14,975.14	749.17	5.00	0.37	44; 26
Central Federal District	1,687.20	523.78	31.04	6.78	57; 80
North Caucasian Federal District	1,795.43	448.62	24.99	2.37	64; 75

cont'd

1	2	3	4	5	6
Far Eastern Federal District	98,459.84	345.62	0.35	0.04	68; 07
North Western Federal District	12,349.60	314.32	2.55	0.35	69; 27
Moscow Oblast	636.21	103.59	16.28	11.55	74; 90
City of St. Petersburg	28.33	1.39	4.92	13.33	90; 91
City of Moscow	9.39	0.04	0.46	1.83	92; 92

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

In 2011, the number of sales of state and municipal lands dropped by 10.6% on 2010 - to 343.81 thousand, while the land area sold dwindled by 21.53% (to 882.52 thousand ha), and the average size of a sold lot – by 12.23% (to 2.57 ha) (Fig. 9). In Russia as a whole, the number of transactions involving land sales at auctions increased on 2010 by 16.51% - from 25,185 to 29,343 land plots, while the amount of sold land dropped by 6.17% (from 79,044.77 ha to 74,166.91 ha), which resulted in the average area of a land lot sold at an auction shrinking by 19.46% (to 2.57 ha). As a result, the average size of sold state and municipal land plots became practically equal to that of land plots sold at auctions (Fig. 9).

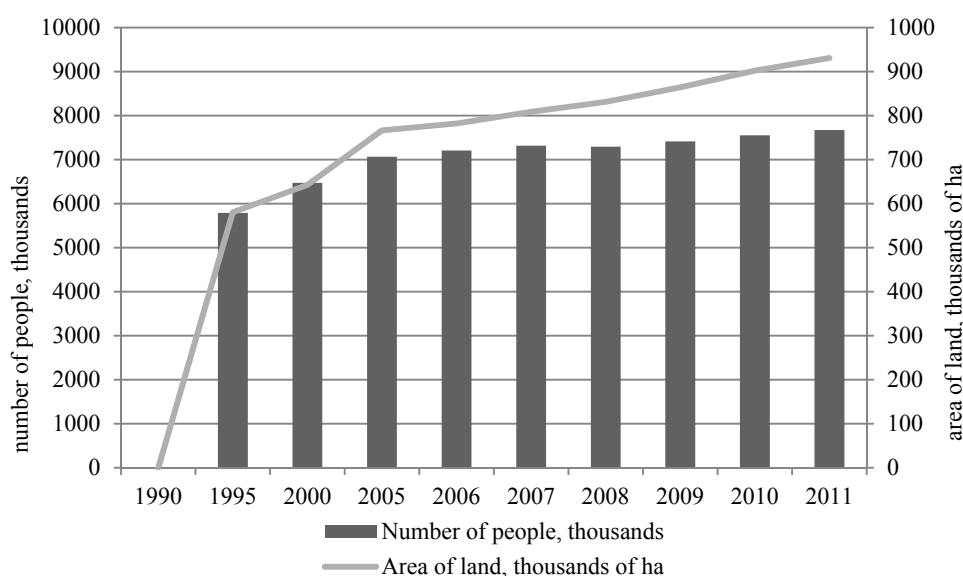


Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

Fig. 9. The Dynamics of Sales of State and Municipal Lands, 2006-2011

According to the State (National) Report ‘On the State and Use of Land in the Russian Federation in 2011’, Russia’s individuals bought 227,928 land plots with the total area of 64.96 thousand ha, to be used by them for individual housing and *dacha* construction, gardening, vegetable gardening and animal husbandry or for conducting personal subsidiary economy. 214,498 land plots with the total area of 60.63 thousand ha were bought in inhabited localities. The number of land plots sold in 2011 was 40,808 less than in 2010, while the average size of a sold land plot rose from 0.18 ha to 0.29 ha.

By the beginning of 2012, the number of persons who owned land plots for individual housing construction had increased to 7,671.5 thousand, while the total land area allotted to them for that purpose had risen to 930.8 thousand ha. On the whole, both these indices were steadily on the rise: over the course of 2011, more than 120 thousand persons acquired land plots for individual housing construction, with the total area of 28.6 thousand ha (Fig. 10).



Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

Fig. 10. Changes in the Number of Persons Who Owned Land Plots for Individual Housing Construction and in Total Land Area Granted to Them for That Purpose, 1990-2011

Out of the total amount of land plots granted for individual housing construction, 55.3% are in individual ownership; 44.7% are in the ownership of state, and are held by individuals by right of inheritable possession for life, by right of permanent (or infinite) use, by right of lease and right of temporary use (Table 19).

Table 19

The Structure of the Ownership of Lands Granted for Individual Housing Construction, 2011

Lands granted for individual housing construction	Thousands of ha	%
In private ownership	514.3	55.3
In state and municipal ownership, including:		
in permanent (or infinite) use	206.2	22.2
under lease	110.8	11.9
in free-of-charge temporary use (or temporary use)	2.2	0.2
in inheritable possession for life	56.2	6
without right to land being formalized	41.1	4.4

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

In 64 RF subjects alone, land plots for *dacha* construction, with the total area of 75.1 thousand ha, were granted to 189.8 thousand families. According to the RF Federal Service for State Registration, Cadastre and Cartography, the highest number of newly-granted ‘*dacha* plots’ was registered in Moscow Oblast, Novgorod Oblast, Rostov Oblast, Irkutsk Oblast, Leningrad Oblast, Yaroslavl Oblast, and the republics of Sakha and Buryatia. In 2011, the number of families engaged in *dacha* construction increased by 17.4 thousand, while the total area of *dacha* plots rose by 11.3 thousand ha.

In 2011, the average price of land plots in inhabited localities, designated for individual housing or *dacha* construction, dropped by 5.34% on 2010, while that of land plots outside of inhabited localities rose 1.5 times (Table 20). In this respect, differences among federal districts are considerable: in the North Western Federal District, the prices of land plots in inhab-

ited localities rose by 210.9%, while in the Southern Federal District they dwindled by 59.4% (Table 20).

Table 20

The Average Per Square Meter Prices, in Rubles, of State and Municipal Land Plots Sold to Individuals and Legal Entities in the Russian Federation in 2011, and Their Change on 2010, %

	To individuals and their associations, for the purposes of:				To legal entities, in order to be used for industrial or other special purposes		To peasant (or farmer) households and agricultural organizations	
	individual housing or dacha construction		conducting personal subsidiary economy, gardening, vegetable gardening, and animal husbandry					
	in inhabited localities	outside of inhabited localities	in inhabited localities	outside of inhabited localities	in inhabited localities	outside of inhabited localities	in inhabited localities	outside of inhabited localities
Russian Federation	54.95	4.31	12.15	8.17	126.02	65.1	19.15	3.74
<i>percent change</i>	-5.34	48.62	-14.07	34.15	68.52	434.48	73.62	-21.43
Central	82.04	2.11	20.9	15.7	192.89	172.56	73.17	2.56
<i>percent change</i>	-13.24	–	3.11	4.11	-24.53	884.37	-2.21	113.33
North Western	66.93	9.48	16.57	12.84	99.37	31.27	2.78	0.61
<i>percent change</i>	210.87	12.46	109.48	32.64	159.38	38.36	227.06	-62.11
Southern	10.77	0	5.98	0.9	82.83	67.77	3.00	1.05
<i>percent change</i>	-59.36	100.0	-51.26	-29.69	102.02	558.60	1.35	-11.02
North Caucasian	93.72	0.22	2.48	0.29	72.57	25.26	1.82	1.06
<i>percent change</i>	-7.74	–	-86.90	107.14	-47.73	137.85	127.50	-17.19
Volga	46.29	18.95	12.18	8.81	171.71	77.13	2.72	1.96
<i>percent change</i>	62.82	112.4	-0.08	31.30	461.51	326.37	34.65	-83.46
Urals	23.95	2.38	15.12	4.32	191.5	75.09	0.51	0.61
<i>percent change</i>	21.82	480.5	249.19	64.89	309.01	677.33	-90.78	-76.54
Siberian	48.35	1.36	7.84	10.28	142.08	41.49	46.01	21.45
<i>percent change</i>	10.09	62.12	35.41	27.86	499.75	497.84	3522.83	210.87
Far Eastern	67.53	0.01	16.12	12.25	55.22	30.2	23.2	0.64
<i>percent change</i>	-47.34	99.25	-48.76	137.86	136.08	1676.47	116000	-94.43

Sources: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011 and The State (National) Report On the State and Use of Lands in the Russian Federation in 2010.

According to the RF Federal Service for State Registration, Cadastre and Cartography, as of 1 January 2012, the total leased land area amounted to 159,420.52 thousand ha, including 20,526.43 thousand ha leased out in 2011. Over the course of that year, the authorities sold leases on 5,938.50 thousand ha of land in state and municipal ownership. Leases on state and municipal land account for 62.0% of transactions concluded on Russia's land market and for 82.7% of the land area covered by those transactions.

In 2011, the average lease payment for state and municipal land plots for housing and dacha construction, situated in inhabited localities, dropped by 22.18% on 2010, to Rb 13.44 per square meter. At the same time, the average lease payment for such land plots situated outside of inhabited localities declined by 11.63%, to Rb 0.76 per square meter (Table 21).

In the main, lease payments are determined on the basis of the cadastral value of relevant land plots, multiplied by a number of coefficients, depending on the economic importance of one or other territory, the targeted use of land, and the category of lease-holder.

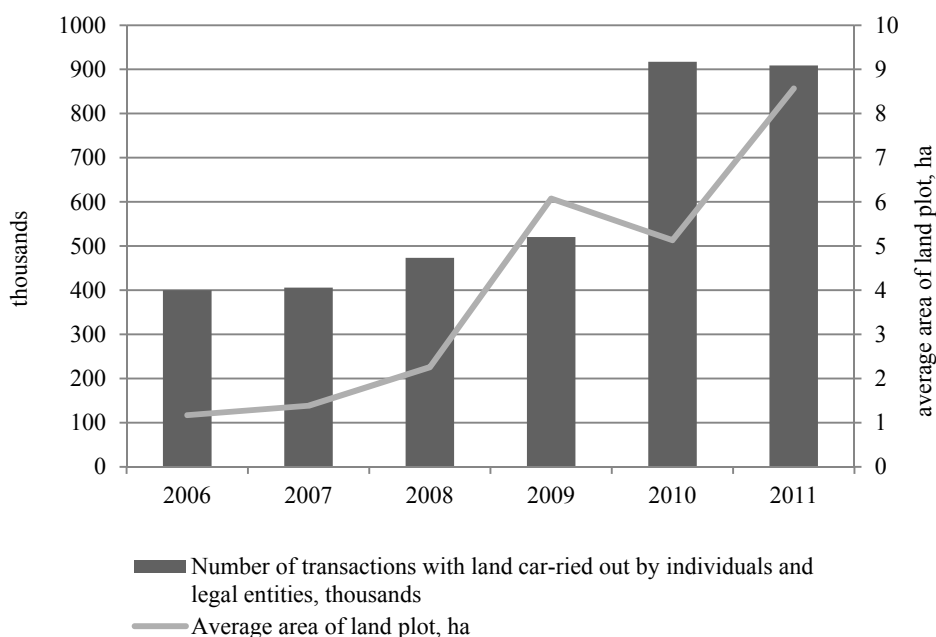
Table 21

**The Average Per Square Meter Lease Payments, In Rubles,
for the Use of State and Municipal Lands
in the Russian Federation in 2011**

Individual leasers and their associations using leased land plots for the purposes of:	2008		2009		2010		2011	
	in inhabited localities	outside of inhabited localities	in inhabited localities	outside of inhabited localities	in inhabited localities	outside of inhabited localities	in inhabited localities	outside of inhabited localities
housing and <i>dacha</i> construction	7.47	5.95	13.43	1.27	17.27	0.86	13.44	0.76
conducting personal subsidiary economy, gardening, and vegetable gardening	0.66	0.07	1.49	0.17	2.02	1.07	2.26	1.04

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

In 2011, the turnover of privately owned lands amounted to 908,867 transactions (*Fig. 11*), while the total area of land subject to those transactions was 7,787,561 ha. By comparison with 2010, the number of transaction slightly decreased - by 0.93%, while the total area of land subject to those transactions rose by 65.45%. The average area of a land plot grew by 67.0%, to 8.57 ha (*Fig. 11*).



Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

Fig. 11. The Dynamics of Sale and Purchase Transactions with Privately Owned Land Plots Concluded by Individuals and Legal Entities, 2006-2011

Land mortgages accounted for 6.74% of the 1,617,090 transactions with privately owned land plots concluded in 2011, which represented a 1.18 pp. rise on 2010 (*Table 22*).

Table 22

**The Number of Transactions with Privately Owned Land Plots Concluded
in the Russian Federation in 2011**

RF Federal Districts	Land sale	Gift	Inheritance	Pledge	Total number of transactions	Pledge transactions, as a percentage of the total number of transactions, %	
						2011	2010
Russian Federation	908,867	189,043	410,125	109,055	1617,090	6.74	5.56
Central	283,423	63,291	148,223	25,959	520,896	4.98	3.54
North Western	57,345	16,386	39,879	6,628	120,238	5.51	6.08
Southern	86,760	8,349	15,690	7,160	117,959	6.07	3.64
North Caucasian	41,602	8,272	17,687	8,249	75,810	10.88	2.29
Volga	206,271	50,662	116,624	33,541	407,098	8.24	7.68
Urals	113,235	14,055	33,759	4,320	165,369	2.61	4.60
Siberian	96,721	23,580	27,110	21,222	168,633	12.58	12.31
Far Eastern	23,510	4,448	11,153	1,976	41,087	4.81	5.64

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

The ratio between the total area of pledged land plots and the total area of land in the ownership of individuals and organizations fluctuated from 0.26% in the North Caucasian Federal District to 10.01% in the Central Federal District. In 2011, this index for the Russian Federation as a whole amounted to 2.67%, which represented a two-fold rise on 2010 (Table 23). Most of the pledged land plots were land plots designated for agricultural use. In 2011, the proportion of mortgaged land designated for agricultural use to the total area of pledged land decreased by 33.44 pp. - to 46.1%.

Table 23

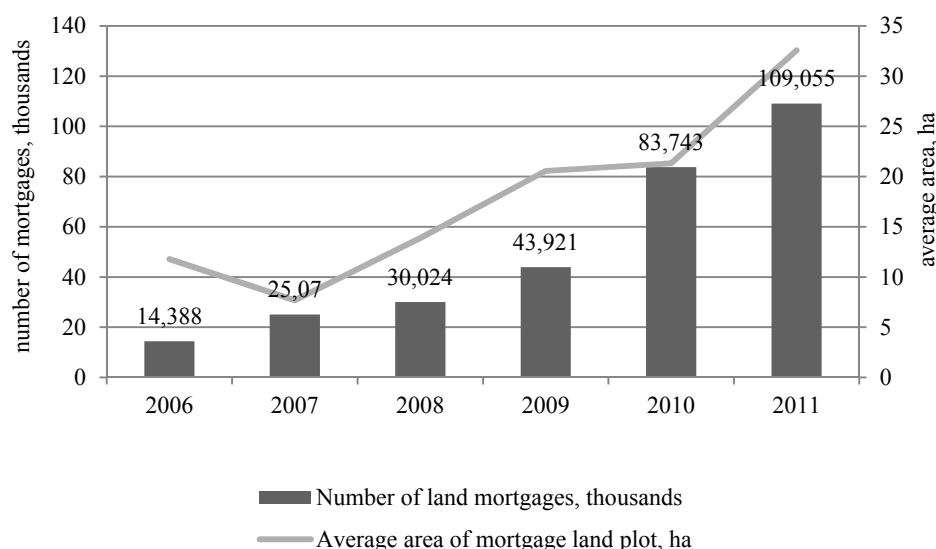
A General Characteristic of Pledges of Land in the Russian Federation

RF Federal Districts	In private ownership, thousands of ha	Of which in the state of being pledged, %		Including mortgages of land designated for agricultural use, %	
		2011	2010	2011	2010
Russian Federation	133,075.7	2.67	1.33	46.10	79.54
Central	24,593.0	10.01	2.44	30.22	96.37
North Western	4,883.4	0.77	0.63	63.36	53.41
Southern	19,435.6	0.43	0.40	95.67	59.79
North Caucasian	4,662.0	0.26	0.54	57.10	88.06
Volga	35,745.0	1.66	1.55	93.93	95.90
Urals	9,775.6	0.83	2.07	92.20	18.39
Siberian	31,589.2	0.84	0.91	51.06	64.26
Far Eastern	2,391.9	0.77	0.24	85.50	61.09

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

The year 2011 saw 109,055 pledge transactions with land plots (or mortgages), which represented a 30.23% rise on 2010 (Fig. 12). At the same time, the total area of pledged land rose to 3,553,568 ha, which was twice as much as in 2010. In 2011, the average area of a pledged land plot amounted to 32.59 ha, which represented a 52.78% rise on 2010 (Fig. 12).

On 1 February 2012, in accordance with the joint Order of the RF Federal Tax Service and the RF Federal Service for State Property Management (*Rosnedvizhimost*), of 13 September 2007, No. P/0235/MM-3-13/529, and Order of the RF Ministry of Finance, of 20 June 2005, No. 75n, the territorial bodies of the RF Federal Service for State Registration, Cadastre and Cartography (*Rosreestr*) prepared electronic data on all land plots subject to taxation and transferred them to the territorial bodies of the RF Federal Tax Service. The actual amount of land tax due should be established as a percentage of the tax base (cadastral value), which must not exceed the upper limit stipulated in the RF Tax Code, by the corresponding normative legal acts of the representative bodies of a municipal formation.



Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2011.

Fig. 12. The Dynamics of Pledges of Land Plots by Individuals and Legal Entities in 2006-2011

Most of the representative bodies of municipal formations have decided that the maximum possible land tax rates based on the cadastral value of land plots should be introduced within their respective territorial jurisdictions. However, according to *Rosreestr*, the representative bodies of municipal formations in a number of RF subjects have used their right to take decisions more favorable to taxpayers. For example, the land tax rate

- for the land plots occupied by residential buildings is set at 0.01% of the cadastral value of a land plot in the municipal formations of Sverdlovsk Oblast; at 0.03% of the cadastral value of a land plot in the municipal formations of Stavropol Krai; and at 0.06% of the cadastral value of a land plot in the municipal formations of Tyumen Oblast;
- for the land plots occupied by garages is set at 0.023% of the cadastral value of a land plot in the municipal formations of Smolensk Oblast;
- for the land plots granted to individuals for conducting personal subsidiary economy is set at 0.026% of the cadastral value of a land plot in the municipal formations of Tyumen Oblast, and at 0.08% of the cadastral value of a land plot in the municipal formations of Perm Krai;
- for the land plots occupied by trade outlets is set at 0.037% of the cadastral value of a land plot in the municipal formations of Smolensk Oblast.

According to RF Federal Tax Service data for 2011, land tax levied on the basis of the cadastral value of land plots yielded Rb 122.193bn, which represents an 11.7% rise on 2010 (Rb 109.414bn).

6.5.2. The Dynamics of Residential Housing Commissioning

The year 2012 was a second post-crisis year in a row that saw an increase in the residential housing commissioning volume (by 4.7% on 2011).

Over the course of 2012, 826.6 thousand apartments with the total floor area of 65.2 million square meters were commissioned (*Table 24*) – most of them in the second half of 2012.

Table 24

The Commissioning of Residential Housing in Russia in 1999-2012

Year	Total floor area in millions of square meters	The rate of growth, %	
		on the previous year	on 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
2012	65.2	104.7	215.2

Sources: *Rossiiskii statisticheskii ezhegodnik. 2007* [Russia: Statistical Yearbook 2007]: *Stat. Sb.* [Statistics Collection]: *Rosstat*. Moscow, 2011. P. 461; *O zhilishchnom stroitel'stve v 2012* [On Housing Construction in 2012], www.gks.ru, Authors' calculations.

Thus, in 2012, the volume of newly commissioned residential space surpassed its previous historic high achieved in the 2000s.

In 2012, the share of individual housing construction in the total area of completed residential housing units in Russia as a whole amounted to 43.2%. In this respect, individual housing construction in 2012 was at approximately the same level as in 2010, although the completion rate of individual housing construction hit its 5-year (2008-2012) high (5.2%). Moreover, in a number of regions (Dagestan, Tyva, Kabardino-Balkaria, Chechnya, Astrakhan Oblast and Belgorod Oblast) individual housing construction was clearly predominant: it accounted for more than 80% of newly commissioned residential space.

The positive dynamics of housing construction was observed in the majority of Russia's regions, including almost all regions where the volume of newly commissioned residential space exceeded 1 million square meters (*Table 25*).

As suggested in *Table 25*, a dynamics of housing commissioning considerably above the RF average (more than 8%) was recorded in Chelyabinsk Oblast, Tyumen Oblast (including the Khanty-Mansi [Yugra]¹ and Yamalo-Nenets autonomous okrugs), Samara Oblast, Bashkortostan and Moscow. At the same time, the volumes of residential housing construction in Kemerovo Oblast and Tatarstan grew by less than 0.5%, while in Stavropol Krai, St. Petersburg and Moscow Oblast housing construction volumes dropped. A very significant drop in the volume of housing construction, by more than 10%, was registered in the area around Moscow.

Despite this setback, Moscow Oblast retained its first-place position among Russian regions, in terms of the absolute volume of housing commissioning. Moreover, Moscow, where the growth rate of this index amounted to 8.7%, practically caught up with St. Petersburg in this respect. At the same time, the share of the Moscow region (Moscow Oblast and the city of Moscow) in Russia's aggregate residential housing construction volume contracted to 14.5% (vs. 16.1% in 2011). Most of that percentage was accounted for by Moscow Oblast (10.6% vs. 16.1 in 2011), while the rest of it – by Moscow proper (3.9% vs. 2.9% in 2011).

¹ At the same time, in Khanty-Mansi Autonomous Okrug alone the residential housing commissioning volume exceeded 1 million square meters.

Table 25

**The Dynamics of Housing Commissioning In Russia's Regions
in 2012 (Ranked by Housing Commissioning Rate)**

Region	Hosing commissioning rate, as a percentage of 2011
Chelyabinsk Oblast	127.3
Tyumen Oblast	119.1
Krasnodar Krai	116.8
Dagestan	116.0
Voronezh Oblast	112.2
Samara Oblast	111.5
Bashkortostan	109.9
Moscow	108.7
Leningrad Oblast	105.9
Belgorod Oblast	105.8
Rostov Oblast	105.5
Sverdlovsk Oblast	104.4
Novosibirsk Oblast	103.0
Nizhny Novgorod Oblast	102.2
Krasnoyarsk Krai	101.8
Kemerovo Oblast	100.3
Tatarstan	100.1
Stavropol Krai	96.2
Saint Petersburg	95.2
Moscow Oblast	89.6

Source: *O zhilishchnom stroitel'stve v 2012* [On Housing Construction in 2012], www.gks.ru.

However, judging by a number of statements made by Moscow's authorities, one should admit that the prospects for residential construction in the capital of Russia look very modest.

Based upon the 2012 volume of residential construction in Moscow, officially stated by *Rosstat* (approximately 2.6 million of square meters)¹, it can be expected that some 9 million square meters of residential units will be built in the territory of 'Old' and New Moscow in the next three years. According to Moscow Deputy Mayor for Urban Development and Building Construction Marat Khusnullin, these numbers are precisely those that have been borne in mind by the city authorities when they were composing Moscow's targeted investment program with regard to municipal engineering infrastructure objects. Moscow's three-year targeted investment program for 2013-2015 envisages that Rb 145bn should be allocated for residential construction.²

To a certain extent, the real estate market of the Moscow region was influenced by the recent expansion of Moscow's borders.

The announcement of the plans that a number of areas around Moscow should be annexed thereto became a strong growth driver for the housing market. The level of consumer activity was considerably increased by expectations of changes in the status of the newly annexed areas, which gave the market a major impetus to raise housing prices. As a result, in 2011, the annual growth rate of asking prices at the market of newly built homes in 'New' Moscow amounted to 27.4%, four to five times higher than in Moscow proper (5.7%) and Moscow Oblast (7.2%). However, by December 2011, the influence exerted by that news on the market had largely disappeared.

¹ It should be noted that *Rosstat* has pointed out that its data on Moscow, a city of federal subject significance, and Moscow Oblast relate to their new boundaries established on 1 July 2012 in accordance with Decree of the Federation Council of the RF Federal Assembly, of 27 December 2011, No 560 SF. For the sake of comparability, relative indicators were calculated with due regard for the latest change to the boundary between the city of Moscow and Moscow Oblast.

² <http://realty.rambler.ru>, 27 February 2013.

Over the course of 2012, the volume weighted average asking price on the primary housing market of 'New' Moscow rose by 13%, which was considerably higher than the price rise in the area around Moscow, but only slightly differed from that in the city of Moscow (10.9%). At the same time, the supply volume significantly increased, pushed up by continued stable demand and by new real-estate objects being put on sale. The areas newly annexed to Moscow also account for much of the 6% rise in the number of purchase-and-sale transactions with apartments, recorded in 2012¹.

Overall, the above data indicate that the 2009-2010 collapse in residential construction investment has been largely overcome by now, and that the volumes of residential housing commissioning both in Russia as a whole and in the majority of her regions have been on the rise for two years in a row. This general trend is apparent – but for a few exceptions (for example, Moscow and Moscow Oblast - in connection with the reorganization of their territories; Stavropol Krai - because of the growing local tensions reducing its attractiveness to investors) which, as the saying goes, confirm the rule.

A number of problems besetting the mechanism of share participation in housing construction have not been resolved. According to the data presented by RF Prosecutor General Yuri Chaika at a collegium session of the Prosecutor General's Office of the Russian Federation in December 2012, as of the end of 2012 in Russia there were 750 so-called *problem objects* with unclear prospects, where construction investment affected the interests of 75.6 thousand people. More than 40% of the *problem objects* were situated in 5 regions: Moscow Oblast (109), Samara Oblast (64), Novosibirsk Oblast (57), Moscow (52), and Perm Krai (42).

In order to improve the residential construction situation, a package of amendments has been recently introduced to the well-known law 'On Participation in the Shared Construction of Multi-Unit Apartment Buildings and Other Real Estate Objects, and on the Introduction of Alterations to Some Legislative Acts of the Russian Federation', No. FZ-214, dating back to the end of 2004. It should be noted that the Law had already been repeatedly amended, most radically in 2010, when construction companies became obliged to use only one method of attracting investment from individuals – the participatory share construction agreement subject to mandatory state registration.

Without a doubt, the most important of recent legal innovations (including the changes introduced to the laws associated with Law No. FZ-214) has been the adoption of yet another method to guarantee the fulfillment of contractual obligations by property developers (alongside the pledge and the bank guarantee). The new legislation introduces civil liability insurance for property developers, effectuated by way of an insurance contract to be concluded by the property developer, or by the property developer's membership in a mutual insurance company of developers (MIC). Also, the new legislation establishes requirements with regard to the minimum amount of insurance, the determination of an insured event, the procedure for payments, etc.

Bearing in mind that insurance companies are currently not interested in insuring developers and the mechanism of functioning of the MIC, and also that the role of the State in this connection remain unclear, it is doubtful whether the proposed measures will actually be ef-

¹ *Novaia Moskva prinesla stolitse record po prodazhe kvartir* [New Moscow Pushes Apartment Sales in the Capital City to a Record High], <http://news.rambler.ru>, 14 January 2013.

fective. Moreover, there is a strong risk that developers will pass on the insurance costs to investors, which would most certainly result in a price-rise in the primary housing market¹.

Subjects of the housing markets are also rather pessimistic with regard to the possible de-regulatory actions of the authorities.

Thus, according to Moscow Deputy Mayor for Economic Policy Andrei Sharonov, the 42 currently existing procedures for obtaining a permit for construction will be replaced by only 14 procedures, and so the applicant will spend fewer days getting a permit for construction. He also noted in this respect that, during the previous 2012 World Bank support mission, it had been noted that the number of days necessary for getting a permit for construction had dropped from 423 to 344.

When asked for comment on that statement, Aleksey Balykin, director of the project management department of the TEKTA GROUP development company, noted that in order to have any impact on the market, all those innovative ideas should first make their way into law; besides, he noted that the so-called ‘administrative component’ was simply not calculated as part of the overall cost in the majority of construction projects, and in reality the cost of housing was much stronger influenced by the ‘infrastructure component’ represented by the price of land and communications².

6.5.3. Housing Prices

The Price Situation in the Secondary Housing Market in 2007-2012, and the Regularities of Its Post-Crisis Development

Before turning to an analysis of the price situation in Russia’s secondary housing market in the past few years, it should be reminded that, over the course of the growth phase (from mid-2000 to Autumn 2008 – the second long-term cycle of the housing market’s development), ask prices on the housing market of Russian cities and towns increased five- to sevenfold. Overall, the duration of that cycle, with the time limits being set at the two lowest points (June 2000 and December 2009), amounted to about 10 years, precisely as in the case of the first cycle of the Russian housing market’s development (from June 1990 through June 2000)³.

Table 26 contains data on the dynamics of prices in the secondary housing market of almost 30 Russian cities (all towns of Moscow Oblast are presented as a single urban unit) in the period from December 2006 through December 2010. The collection and processing of data were carried out on a single methodological basis by real estate analysts certified by the Russian Guild of Realtors (RGR)⁴.

¹ *Dol’shchikov podstrakhuiut* [Stake Holders will be Insured] // *Ekonomika i zhizn'* [Economy and Life]. No. 01 (9467). 11 January 2013. P. 06; *Chuvstvo bezopasnosti* [A Sense of Security] // *Profil'* [The Profile]. January 2013. P. 36.

² Kuznetsova, Anna, RealEstate.ru.

³ *Rossiiskii rynek zhil'ia* [Russia’s Housing Market] // *Ekonomika perekhodnogo perioda. Ocherki ekonomicheskoi politiki postkommunisticheskoi Rossii. Ekonomicheskii rost 2000-2007* [The Economy of the Transition Period. Essays on the History of the Economic Policy of Post-communist Russia. Economic Growth in 2000-2007]. Moscow: Delo, ANKh [Academy of National Economy], 2008. P. 620-646 (Section 16.3); Sternik G.M., Sternik S.G. *Analiz rynka nedvishimosti dlia professionalov* [An Analysis of the Real Estate Market Intended for a Professional Audience]. Moscow: Ekonomika, 2009.

⁴ All calculations were performed by the authors on the basis of the monthly data on the median price asked for housing units in Russian towns, submitted by the RGR-certified real estate analysts S. G. Sternik (OJSC

Table 26

The Dynamics of Nominal Housing Prices in Russian Cities in 2006-2012, Including Some Typical Points (Ranked by the Level of Prices in December 2012)

City	Median unit price, thousands of rubles per square meter										
	Dec 2006	Dec 2007	maximum		Dec 2008	minimum		Dec 2009	Dec 2010	Dec 2011	Dec 2012
			date	price		date	price				
Moscow	126.9	133.4	11.2008	191.5	186.8	12.2009	153.0	153.0	168.5	185.5	203.0
St. Petersburg	68.2	78.6	10.2008	107.7	101.3	12.2009	81.1	81.1	82.3	88.3	95.0
Moscow Oblast	66.3	62.3	11.2008	93.2	91.0	02.2010	71.3	71.5	73.0	78.1	84.3
Yekaterinburg	63.5	64.1	06.2007	67.3	61.7	05.2010	52.9	53.0	55.5	63.8	70.1
Rostov-on-Don	41.1	52.0	09.2008	64.1	55.7	06.2010	48.3	48.4	50.5	55.8	62.8
Nizhny Novgorod	43.4	49.0	11.2008	61.4	59.9	08.2010	45.3	46.4	45.8	47.0	61.3
Kazan	40.0	40.7	09.2008	42.5	42.5	10.2009	37.8	38.0	43.0	51.5	n. d.
Tyumen	42.1	53.7	09.2008	52.9	51.5	12.2009	42.7	43.1	45.4	53.0	59.4
Novosibirsk	43.6	59.0	08.2008	65.2	56.6	12.2009	45.5	45.5	49.7	50.8	59.1
Tver	36.0	44.9	07.2008	69.0	62.0	08.2009	45.6	46.1	49.5	52.5	57.8
Yaroslavl	46.2	46.9	08.2008	54.6	51.6	08.2010	40.4	41.1	42.8	50.5	57.6
Irkutsk	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	46.0	48.7	50.2	57.2
Krasnoyarsk	30.2	54.3	02.2008	63.7	52.6	09.2009	40.0	40.3	43.5	48.8	56.2
Perm	38.1	56.8	09.2008	61.4	58.2	10.2009	41.5	42.4	44.1	48.4	53.4
Vladimir	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	41.6	42.5	46.7	51.3
Kemerovo	35.5	45.8	04.2008	54.0	52.5	10.2010	39.9	40.3	40.6	44.4	50.2
Novgorod	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	40.2	39.9	42.7	n. d.
Ufa	48.3	45.8	02.2009	55.5	50.2	08.2010	41.8	41.0	43.9	49.2	n. d.
Barnaul	n. d.	n. d.	06.2008	43.3	39.4	09.2009	31.5	34.4	35.1	40.2	48.1
Cheboksary	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	32.0	33.8	39.1	48.1
Izhevsk	48.5	45.4	03.2007	51.8	42.1	11.2009	33.0	33.3	34.9	39.6	46.4
Ryazan	30.0	36.9	08.2008	42.0	40.0	12.2009	35.4	35.4	37.7	40.8	46.2
Omsk	27.8	44.2	05.2008	45.6	43.3	06.2010	32.5	33.4	35.5	38.2	44.7
Chelyabinsk	n. d.	n. d.	12.2008	51.7	51.7	11.2009	36.8	37.2	37.2	39.9	44.4
Togliatti	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	37.9	43.5
Sterlitamak (Bashkortostan)	22.8	26.3	10.2008	29.1	27.9	06.2010	23.0	22.9	23.7	28.5	40.3
Ulyanovsk	22.6	30.5	02.2009	36.9	34.2	03.2010	30.8	31.0	31.8	34.2	39.9
Stavropol	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	n. d.	33.1	30.5	31.6	34.9
Shakhty (Rostov Oblast)	12.6	22.1	01.2009	31.2	31.1	08.2010	25.8	27.0	26.3	27.6	30.3

As shown by Table 26, as a rule, prices hit their historic highs in 2008, mainly in the second half-year, although some cities (Kemerovo, Krasnoyarsk, Barnaul and Omsk) had had their all-time price peak in the first half-year of 2008, while Yekaterinburg and Izhevsk – as early as 2007. For the three cities with the highest housing prices (including Moscow Oblast), the price peak was most clearly associated with the financial and economic crisis in October and November of 2008; as soon as that period was over, prices began to decline. The latest to

Sternik's Consulting), A. I. Rzhavskii, A. N. Sever'yanov (the *Azbuka Zhil'ia* [ABC about Housing] real estate agency) and A. G. Beketov (all of whom are Moscow - or Moscow Oblast-based), S. V. Bobashev, M. A. Bent (the *Biulleten' Nedvizhimosti* [Real Estate Bulletin] group of companies, St. Petersburg and Novgorod), M. A. Khor'kov, A. A. Antasiuk, G. T. Tukhashvili (all of whom are from the Realtor Information Center of the Urals Real Estate Chamber, Yekaterinburg), Ye. G. Sosnitskii, S. V. Fomina (the *Titul* [Title] real estate agency, Rostov-on-Don), A. A. Chumakov (Rostov-on-Don), A. L. Chemodanov (the *Indikator Nizhegorodskoi Nedvizhimosti* [Indicators of the Nizhny-Novgorod Real Estate Market] analytical center, Nizhny Novgorod), Ye. A. Yermolaeva (RID Analytics, Novosibirsk, Kemerovo, Barnaul, Krasnoyarsk), S. G. Molodkina (Association ALKO, Tyumen), E. D. Episheva, Yu. V. Selivestrova (*GK Kamskaia Dolina* [the Kama Valley group of companies], Perm), V. N. Kaminskii (the *Titan* real estate agency, Tver), A. V. Gollai (OJSC Metro-Otsenka [Metro-Valuation], Yaroslavl), M. Yu. Savina (*Agenstvo Pechati i Informatsii* [Information and Press Agency], Ryazan), R. M. Kazakov (Publishing House *Yarmarka* [The Fair], Ryazan), A. M. Cheremnykh (the ASSO-Stroi asset management company, Izhevsk), N. V. Koval'chuk (the *Sluzhba Nedvizhimosti* [Real Estate Services] real estate company, Chelyabinsk), A. S. Trofimov (Stavropol), Ye. R. Gamova, T. N. Kuklova (*Tsentr Nedvizhimosti* [Real Estate Center], Ulyanovsk), M. A. Repin (OMEKS, Omsk), A. V. Trushnikov (B.I.N.-Expert, Sterlitamak), G. Yu. Eidlina (Realty, Shakhty), S. V. Esikov (Vladimir, Irkutsk, Togliatti, Cheboksary).

hit their peak housing prices were Ufa, Ulyanovsk and Shakhty, which achieved this only in early of 2009.

As a result, despite the onset of the acute phase of the crisis in the autumn of 2008, a year-on-year drop in housing prices (in comparison with December 2007) took place only in a relatively small segment of the sample, which included most of Ural and Siberian cities (Krasnoyarsk, Yekaterinburg, Novosibirsk, Tyumen and Izhevsk). However, the following year, in 2009, the housing prices tumbled across the whole of Russia (*Table 27*).

Table 27

**The Dynamics of Housing Prices in Russian Cities in 2007-2012,
as a Year-over-Year Percent Change from December
of the Previous Year to December
of the Current Year**

City	from Dec 2008 to Dec 2007, %	from Dec 2009 to Dec 2008, %	from Dec 2010 to Dec 2009, %	from Dec 2011 to Dec 2010, %	from Dec 2012 to Dec 2011, %
Moscow	140.0	81.9	110.1	110.1	109.4
St. Petersburg	128.9	80.1	101.5	107.3	107.6
Moscow Oblast	146.1	78.6	102.1	107.0	107.9
Yekaterinburg	096.3	85.9	104.7	115.0	109.9
Rostov-on Don	107.1	86.9	104.3	110.5	112.5
Nizhny Novgorod	122.2	77.5	98.7	102.6	130.4
Kazan	104.4	89.4	113.2	119.8	-
Tyumen	095.9	83.7	105.3	116.7	112.1
Novosibirsk	095.9	80.4	109.2	102.2	116.3
Tver	138.0	74.4	107.4	106.1	110.1
Yaroslavl	110.0	79.7	104.1	118.0	114.1
Irkutsk	-	-	105.9	103.1	113.9
Krasnoyarsk	096.9	76.6	107.9	112.2	115.2
Perm	102.5	72.9	104.0	109.8	110.3
Vladimir	-	-	102.2	109.9	109.9
Kemerovo	114.6	76.8	100.7	109.4	113.1
Novgorod	-	-	99.3	107.0	-
Ufa	109.6	81.7	107.1	112.1	-
Barnaul	-	87.3	102.0	114.5	119.7
Cheboksary	-	-	105.6	115.7	123.0
Izhevsk	092.7	79.1	104.8	113.5	117.2
Ryazan	108.4	88.5	106.5	108.2	113.2
Omsk	098.0	77.1	106.3	107.6	117.0
Chelyabinsk	-	71.9	100.0	107.3	111.3
Togliatti	-	-	-	-	114.8
Sterlitamak (Bashkortostan)	106.1	82.1	103.5	120.3	141.4
Ulyanovsk	112.1	90.6	102.6	107.5	116.7
Stavropol	-	-	92.1	103.6	110.4
Shakhty (Rostov Oblast)	140.7	86.8	97.4	104.9	109.8

As far as the moment of hitting the price floor is concerned (*Table 26*), it can be seen that it differs considerably across the cities represented in the sample – just as it was in the case of achieving the price ceiling.

First of all, there is a group of cities (Moscow, St. Petersburg, Novosibirsk, Tyumen, Izhevsk, Chelyabinsk and Ryazan) where the housing price floor was hit in November-December 2009.

In some cities (Tver, Krasnoyarsk, Barnaul and Perm) this happened a bit earlier; while in other cities – much later, only in 2010, and not exclusively in its first half-year (Moscow Ob-

last, Ulyanovsk, Yekaterinburg, Rostov-on-Don, Omsk and Sterlitamak), but also in the second half-year (Nizhny Novgorod, Yaroslavl, Ufa, Kemerovo and Shakhty).

The results of calculations (*Table 28*) indicate that the crisis effect calculated using the ratio of the lowest (minimum) price (registered during the crisis period) to the preceding peak price, manifested itself through an 11 to 37% drop in prices on the secondary market. The cities where prices dropped by more than 30% were Krasnoyarsk, Izhevsk, Tver, Perm and Novosibirsk. The other pole of the spectrum was represented by the cities where prices dropped by no more than 20% – Kazan, Shakhty, Ryazan, Ulyanovsk and Tyumen.

Table 28

**The Dynamics of Housing Prices in Russian Cities in 2007–2012
in Relation to Typical Points**

City	Dec 2007, thousands of rubles per sq m	maximum, thousands of rubles per sq m	minimum		December 2009			December 2012			
			thousands of rubles per sq m	relative to maximum	thousands of rubles per sq m	relative to December 2007	relative to maximum	thousands of rubles per sq m	relative to minimum	relative to maximum	relative to December 2007
Moscow	133.4	191.5	153.0	0.799	153.0	1.147	0.799	203.0	1.327	1.060	1.522
St. Petersburg	78.6	107.7	81.1	0.753	81.1	1.032	0.753	95.0	1.171	0.882	1.209
Moscow Oblast	62.3	93.2	71.3	0.765	71.5	1.148	0.767	84.3	1.182	0.905	1.353
Yekaterinburg	64.1	67.3	52.9	0.786	53.0	0.827	0.788	70.1	1.325	1.042	1.094
Rostov-on Don	52.0	64.1	48.3	0.754	48.4	0.931	0.755	62.8	1.300	0.980	1.208
Nizhny Novgorod	49.0	61.4	45.3	0.738	46.4	0.947	0.756	61.3	1.353	0.998	1.251
Kazan	40.7	42.5	37.8	0.889	38.0	0.934	0.894	n. d.	-	-	-
Tyumen	53.7	52.9	42.7	0.807	43.1	0.803	0.815	59.4	1.391	1.123	1.106
Novosibirsk	59.0	65.2	45.5	0.698	45.5	0.771	0.698	59.1	1.299	0.906	1.002
Tver	44.9	69.0	45.6	0.661	46.1	1.027	0.668	57.8	1.268	0.838	1.287
Yaroslavl	46.9	54.6	40.4	0.740	41.1	0.876	0.753	57.6	1.426	1.055	1.228
Irkutsk	n. d.	n. d.	n. d.	-	46.0	-	-	57.2	-	-	-
Krasnoyarsk	54.3	63.7	40.0	0.628	40.3	0.742	0.633	56.2	1.405	0.882	1.035
Perm	56.8	61.4	41.5	0.676	42.4	0.746	0.691	53.4	1.287	0.870	0.940
Vladimir	n. d.	n. d.	n. d.	-	41.6	-	-	51.3	-	-	-
Kemerovo	45.8	54.0	39.9	0.739	40.3	0.880	0.746	50.2	1.258	0.930	1.096
Novgorod	n. d.	n. d.	n. d.	-	40.2	-	-	n. d.	-	-	-
Ufa	45.8	55.5	41.8	0.753	41.0	0.895	0.739	n. d.	-	-	-
Barnaul	n. d.	43.3	31.5	0.727	34.4	-	0.794	48.1	1.527	1.111	-
Cheboksary	n. d.	n. d.	n. d.	-	32.0	-	-	48.1	-	-	-
Izhevsk	45.4	51.8	33.0	0.637	33.3	0.733	0.643	46.4	1.406	0.896	1.022
Ryazan	36.9	42.0	35.4	0.843	35.4	0.959	0.843	46.2	1.305	1.100	1.252
Omsk	44.2	45.6	32.5	0.713	33.4	0.756	0.732	44.7	1.375	0.980	1.011
Chelyabinsk	n. d.	51.7	36.8	0.712	37.2	-	0.719	44.4	1.207	0.859	-
Togliatti	n. d.	n. d.	n. d.	-	n. d.	-	-	43.5	-	-	-
Sterlitamak (Bashkortostan)	26.3	29.1	23.0	0.790	22.9	0.871	0.787	40.3	1.752	1.385	1.532
Ulyanovsk	30.5	36.9	30.8	0.835	31.0	1.016	0.840	39.9	1.295	1.081	1.308
Stavropol	n. d.	n. d.	n. d.	-	33.1	-	-	34.9	-	-	-
Shakhty (Rostov Oblast)	22.1	31.2	25.8	0.827	27.0	1.222	0.865	30.3	1.174	0.971	1.371

If the chosen typical points are December 2007 (when clear signs of crisis were absent) and December 2009 (the end of a calendar year characterized by an across-the board drop in prices, that would be followed, in most of the cities, by a transition to oscillating stability), Moscow Oblast, St. Petersburg, Tver, Ulyanovsk and Shakhty clearly stand out as being most

robust, for even at the beginning of 2010 housing prices in these cities were higher than in December 2007, which means that despite a significant fall their growth potential had not been exhausted during the months directly before the crisis. It was precisely this circumstance that had predetermined the relative insignificance (by no more than 17-18%) of the drop in the real value of housing (not adjusted for consumer price inflation - which amounted to 23% over the period 2008-2009 (13.1% in 2008 and 8.8% in 2009)) traded in the consumer market (the IGS Index)¹ in those cities over the course of 2 years (2008-2009), while in the majority of Ural and Siberian cities (Yekaterinburg, Tyumen, Novosibirsk, Omsk, Perm, Krasnoyarsk and Izhevsk) that drop amounted to about 33 to 40% (*Table 29*).

In 2010, Moscow saw the beginning of a smooth rise in housing prices (which grew by more than 10%), while most of the other cities included in the sample demonstrated an oscillating stability of that indicator. In nominal terms, the price rise that took place in most of the cities did not exceed the rate of inflation. Therefore a real rise in housing prices took place, beside Moscow, only in Kazan and Novosibirsk. In four cities (Nizhny Novgorod, Novgorod, Stavropol and Shakhty) nominal prices continued to shrink, while in Chelyabinsk they remained at the same level as one year earlier.

In 2011, nominal housing prices went up in all towns (without exception) included in the sample. The price rise amounted to 2 to 20%, and in the absolute majority of those cities its rate was high enough to indicate that housing prices were increasing with inflation being taken into account. In this respect, the only exceptions to the rule were the five cities (Nizhny Novgorod, Novosibirsk, Irkutsk, Stavropol and Shakhty) where housing prices increased to a smaller extent than the rate of inflation, and Tver, where the rate of increase in housing prices was approximately equal to the rate of inflation.

In 2012, housing prices continued to grow across the board, and it should be noted that, unlike 2011, the rate of their rise exceeded the rate of inflation in all cities without exception. In most of the cities included in the sample, the rise in nominal housing prices amounted to more than 10%. Especially noteworthy in this regard were Sterlitamak (more than 41%), Nizhny Novgorod (more than 30%), and Cheboksary (23%). The group of cities with the most moderate increase in nominal housing prices (from 7.5% to 10%) included Yekaterinburg, Vladimir, Shakhty, Moscow, Moscow Oblast, and St. Petersburg. It should be noted that in Q4 2012, nominal housing prices breached the Rb 200 thousand per sq m mark.

In most of the cities included in the sample, prices grew to a larger extent than in 2011. The only exceptions were Moscow, Yekaterinburg, Tyumen and Yaroslavl, where the growth rate of prices decreased, and Vladimir, where it remained at the same level as one year earlier. As far as 2012 housing prices in real terms are concerned (that is, not adjusted for annual consumer price inflation which amounted to 6%) (the IGS Index), the only locality where a slowdown in the nominal growth of prices occurred (beside the above-mentioned cities, including Vladimir, which experienced a decline in the nominal growth of prices) was St. Petersburg (*Tables 27, 29*).

¹ The IGS Index is calculated by the formula: $IGS = RPI / CPI$, where RPI is the housing price index in rubles, and CPI is the consumer price index.

Table 29

**The Dynamics of Housing Prices in Russian Cities in 2007-2012, Including
the Indices of Nominal and Real Prices**

City	Dec 2007, thousands of rubles/sq m	thousands of rubles/sq m	December 2009.		thousands of rubles/sq m	December 2011		thousands of rubles/sq m	December 2012			
			price index as compared to Dec 2007			price index as compared to Dec 2010			price index as compared to Dec 2011		price index as compared to Dec 2007	
			nominal	real		nominal	real		nominal	real	nominal	real
Moscow	133.4	153.0	1.147	0.930	185.5	1.101	1.038	203.0	1.094	1.026	1.522	1.003
St. Petersburg	78.6	81.1	1.032	0.837	88.3	1.073	1.011	95.0	1.076	1.009	1.209	0.797
Moscow Oblast	62.3	71.5	1.148	0.931	78.1	1.070	1.008	84.3	1.079	1.012	1.353	0.892
Yekaterinburg	64.1	53.0	0.827	0.671	63.8	1.150	1.084	70.1	1.099	1.031	1.094	0.721
Rostov-on Don	52.0	48.4	0.931	0.755	55.8	1.105	1.041	62.8	1.125	1.055	1.208	0.796
Nizhny Novgorod	49.0	46.4	0.947	0.768	47.0	1.026	0.967	61.3	1.304	1.223	1.251	0.825
Kazan	40.7	38.0	0.934	0.757	51.5	1.198	1.129	n. d.	-	-	-	-
Tyumen	53.7	43.1	0.803	0.651	53.0	1.167	1.100	59.4	1.121	1.052	1.106	0.729
Novosibirsk	59.0	45.5	0.771	0.625	50.8	1.022	0.963	59.1	1.163	1.091	1.002	0.661
Tver	44.9	46.1	1.027	0.833	52.5	1.061	1.000	57.8	1.101	1.033	1.287	0.848
Yaroslavl	46.9	41.1	0.876	0.711	50.5	1.180	1.112	57.6	1.141	1.070	1.228	0.809
Irkutsk	n. d.	46.0	-	-	50.2	1.031	0.972	57.2	1.139	1.068	-	-
Krasnoyarsk	54.3	40.3	0.742	0.602	48.8	1.122	1.057	56.2	1.152	1.081	1.035	0.682
Perm	56.8	42.4	0.746	0.605	48.4	1.098	1.035	53.4	1.103	1.035	0.940	0.620
Vladimir	n. d.	41.6	-	-	46.7	1.099	1.036	51.3	1.099	1.031	-	-
Kemerovo	45.8	40.3	0.880	0.714	44.4	1.094	1.031	50.2	1.131	1.061	1.096	0.722
Novgorod	n. d.	40.2	-	-	42.7	1.070	1.008	n. d.	-	-	-	-
Ufa	45.8	41.0	0.895	0.726	49.2	1.121	1.057	n. d.	-	-	-	-
Barnaul	n. d.	34.4	-	-	40.2	1.145	1.079	48.1	1.197	1.123	-	-
Cheboksary	n. d.	32.0	-	-	39.1	1.157	1.090	48.1	1.230	1.154	-	-
Izhevsk	45.4	33.3	0.733	0.595	39.6	1.135	1.067	46.4	1.172	1.099	1.022	0.674
Ryazan	36.9	35.4	0.959	0.778	40.8	1.082	1.020	46.2	1.132	1.062	1.252	0.825
Omsk	44.2	33.4	0.756	0.613	38.2	1.076	1.014	44.7	1.170	1.098	1.011	0.667
Chelyabinsk	n. d.	37.2	-	-	39.9	1.073	1.011	44.4	1.113	1.044	-	-
Togliatti	n. d.	n. d.	-	-	37.9	-	-	43.5	1.148	1.077	-	-
Sterlitamak (Bashkortostan)	26.3	22.9	0.871	0.706	28.5	1.203	1.134	40.3	1.414	1.326	1.532	1.001
Ulyanovsk	30.5	31.0	1.016	0.824	34.2	1.075	1.013	39.9	1.167	1.095	1.308	0.862
Stavropol	n. d.	33.1	-	-	31.6	1.036	0.976	34.9	1.104	1.036	-	-
Shakhty (Rostov Oblast)	22.1	27.0	1.222	0.990	27.6	1.049	0.989	30.3	1.098	1.030	1.371	0.904

It is pertinent to ask to what extent the effects of the crisis have been overcome by now.

In December 2012, prices in all cities included in the sample were higher than their minimum values recorded in the period 2007-2010. The most considerable rebounds in prices were observed in Sterlitamak (by more than 75%), Barnaul (by around 53%), Yaroslavl (by around 43%), Krasnoyarsk and Izhevsk (by around 41%). The most moderate price rebounds took place in Moscow Oblast, St. Petersburg and Shakhty (by 17 to 18%).

However, prices climbed above their pre-crisis highs only in less than half of the cities represented in the sample, including Sterlitamak (by more than 8%), Tyumen and Barnaul (by around 12%), Ryazan (by 10%), Ulyanovsk (by more than 8%), Moscow (by 6%), Yaroslavl (by 5.5%), and Yekaterinburg (by more than 4%). At the same time, the December 2007 level of prices was surpassed in all cities except for Perm. The largest rises in prices were observed in Moscow, Sterlitamak (by more than 52% and 53% respectively), Shakhty (by more than 37%), Moscow Oblast (by more than 35%), and Ulyanovsk (by around 31%).

We believe that one of the most interesting results of the housing market's development during and after the crisis was the relative drop in inflation-adjusted housing prices in the secondary housing market. Over the course of 5 years (2008-2012), housing prices in real terms (not adjusted for consumer inflation which amounted to 51.7% over the course of that period

(2008 – 1.131; 2009 – 1.088; 2010 – 1.088; 2011 – 1.061; 2012 – 1.066)) dropped in almost all cities except for Moscow and Sterlitamak. The largest (by more than 30%) drops in prices were observed in Perm, Omsk, Izhevsk and Krasnoyarsk.

Thus, it could be noted that, by December 2012, prices in 9 cities (Nizhny Novgorod, Yekaterinburg, Yaroslavl, Moscow, Ulyanovsk, Barnaul, Ryazan, Tyumen and Sterlitamak) out of the 21 cities¹ included in the sample, had regained and surpassed their peak levels. Three cities (Rostov-on-Don, Omsk and Shakhty) were extremely close to their previous highs. In 9 cities prices lagged behind their peak levels by 7 to 16% (*Fig. 13*).

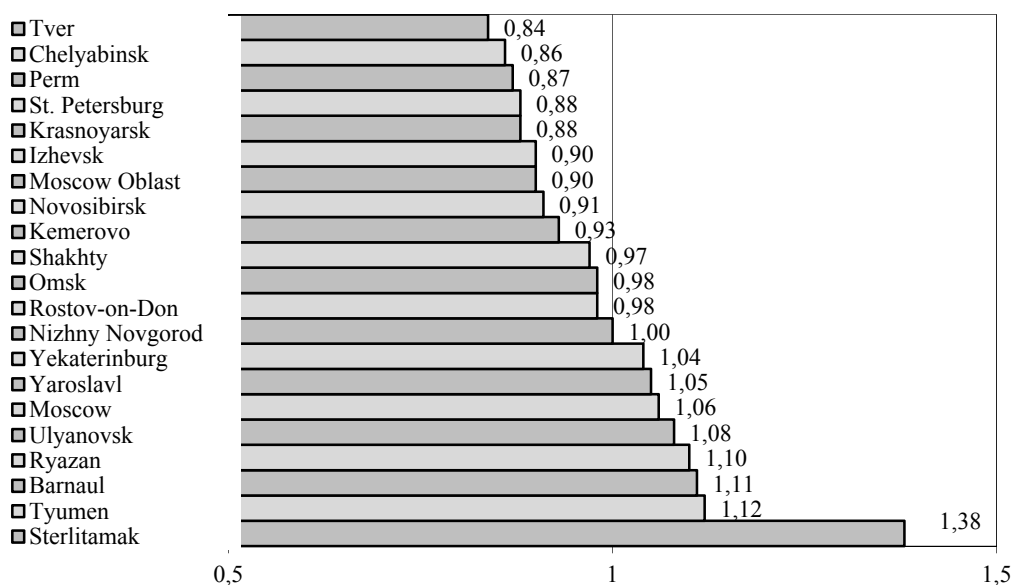


Fig. 13. Price Indices in the Secondary Housing Market in December 2012, Relative to their Peak Levels

Our analysis of the regularities of post-crisis recovery of prices suggests that, on average, prices rebounded faster in the cities where their drop had been small or moderate.

Nevertheless, the scatter in price recovery rates was relatively significant, which resulted from both the objective differences in the socio-economic situations from one region to another and the specific factors influencing the housing market of one or other region.

Some of these local specificities are as follows. In Sterlitamak, analysts note a rise in the number of speculative investment transactions, which clearly boosts prices. In Kazan, the current unprecedented growth of prices is associated with the activities celebrating the city's 1000th anniversary and with Kazan's preparation for the 2013 World University Summer Games. In St. Petersburg, the supply of affordable housing for sale dwindled. The decline in the growth rate of personal incomes has resulted in a shrinkage of demand for mortgage loans, and, consequently, in a fall of the growth rate of prices.

By contrast, in Moscow, where the supply of affordable housing for sale is on the rise, and that of prestigious housing is on the decline, the number of mortgage transactions has sharply increased (because of the greater availability of small mortgage loans), surpassing the pre-crisis peak levels. As a result, housing prices have gone up, and continue to grow. Over the

¹ The whole sample represented in *Tables 25-28*, comprises around 30 cities. However, many of these cities lack sufficient data to make statistically reliable comparisons.

course of 2012, the number of mortgage transactions increased by 29%, and it should be noted that one in three apartments purchased in Moscow last year was bought on credit (almost 32 thousand out of 96.7 thousand transactions)¹. Also, according to *Rosreestr*, the total number of purchase-and-sale transactions carried out on the Moscow housing market in 2012 grew by 6% vs. by 6.5% in 2011, and by 53.9% in 2010².

The Dynamics of Prices in the Primary Housing Market

A comparison of prices in the secondary and primary housing markets indicates that, on the whole, the dynamics of prices in the primary market was close to that in the secondary market. However, after the crisis had spread to Moscow, property developers were in no hurry to cut prices, in spite of a catastrophic decline in demand. In other cities their pricing policies were more reasonable, which helped the housing market to maintain its turnover.

As a result, after the Moscow housing market had returned to its growth trajectory, in the autumn of 2011 prices in the capital city's primary housing market breached the Rb 200,000 per sq m mark and surpassed their previous peak. They persistently remained above that level throughout 2012 (e.g. by more than 13% in December). In Tyumen, prices surpassed their previous peak in the first months of 2012; by the end of that year, the excess over the previous peak had risen to more than 11%. In Moscow Oblast, Nizhny Novgorod and Novosibirsk, prices regained their previous highs only as late as Q4 2012. In St. Petersburg, Ryazan, Perm and Izhevsk, the ratio between primary market prices and their previous peak was in the range from 0.86 to 0.93.

As one year earlier, in most of the cities included in the sample, prices in the secondary housing market were higher than primary housing market prices. The only exception to this trend was Moscow, where the median unit price in the secondary housing market in 2012 was by 12 to 16% lower than that in the primary market. In Chelyabinsk, these indices were relatively close.

In the rest of the cities, in 2012, the median unit price in the secondary housing market was higher than that in the primary market. It widely fluctuated over the course of the year: by 4 to 8% in Nizhny Novgorod; by 7 to 13% in Izhevsk; by 7 to 20% in Perm; by 18 to 27% in Moscow Oblast; by 19 to 21% in Tyumen; by 16 to 24% in Novosibirsk; and by 16 to 33% in Ryazan.

The main factor determining such a ratio between the median unit prices in the secondary and primary housing markets was the quantitative and qualitative differences in the structure of housing traded in these markets.

Thus, in Moscow, nearly half of the supply volume in the primary housing market consists of apartments in high-standard residential houses (of business and elite classes), situated, as a rule, in the central district or other prestigious areas of the city. In other cities, the supply volume in the primary housing market predominantly consists of affordable residential houses (of economy and comfort classes). With better lay-outs than those of older residential houses, they are situated, as a rule, far from the city center, in the areas with underdeveloped or non-existent transport and social infrastructure.

Another factor pushing down the ratio between prices for apartments residential houses under construction and prices for apartments in completed residential houses is the discounts (from 20 to 40% of the presumed value of the apartments after the commissioning of the rele-

¹ According to the Agency for Housing Mortgage Lending (AHML), in Russia as a whole, the proportion of housing mortgage transactions amounted to around 20% (in 2011 – to 17.6%).

² *Zhit' v kredit ne zapretish* [It cannot be Forbid to Live on Tick]. RBK daily. 14 January 2013.

vant projects) provided by property developers to apartment purchasers at early stages of housing construction in the form of share participation agreements. Naturally, there have been examples to the contrary: thus, in Yekaterinburg, the *Renova-Stroi* property development company has begun selling its apartments in Akademicheskii District only on their completion. The same approach to sales has been taken by the *Zhilstroj-9* company in Chelyabinsk. However, such practices are only exceptions to the general rule.

Naturally, the ratio between prices in the primary housing market and prices in the secondary housing market changes over time, and depends not only on the quality of residential houses being built but also on the state of the housing market: during the crisis, property developers in different regions adopted different pricing policies in response to changes in demand.

The home acquisition schemes used in the primary housing market of Moscow differ in many interesting respects from those used in the primary housing market of Moscow Oblast.

In 2012, the predominant home acquisition scheme in Moscow Oblast was the mechanism of share participation in accordance with the well-known Federal Law No. FZ-214 (89% of housing market transactions), while in Moscow, share participation in housing construction accounted for less than one half of housing market transactions (46%); although, according to the Moscow branch of *Rosreestr*, the number of such transactions registered in 2012 (12,107) was 2.7 times higher than in 2011. While share participation in housing construction was relatively unpopular in Moscow, the contrary can be said of such methods as the purchase of target housing under a preliminary agreement (approximately one-third of all transactions vs. a symbolic 1% in Moscow Oblast). Also, house-building cooperation is much more widespread in Moscow than in Moscow Oblast (20% and 8% respectively). Both in Moscow and Moscow Oblast, purchases of housing under simple purchase and sale agreements (widely used in the secondary housing market) account for a tiny percentage of the primary housing market (1% in Moscow and 2% in Moscow Oblast)¹.

The aforesaid differences existing within the Moscow region perfectly illustrate the relationship between the quantitative differences in the structure of the new dwelling stock being commissioned on the one hand, and the most popular home acquisition schemes, on the other. The lesser use of the share participation scheme in Moscow, as compared to Moscow Oblast, can be explained by the fact that elite-class and business-class houses account for a far greater proportion of the new dwelling stock (buyers of such dwellings do not need share participation agreements). In Moscow Oblast, where economy-class houses account for a predominant proportion of the new dwelling stock, buyers usually insist on such agreements being concluded. Moscow property developments have so far been reluctant to comply with such requests - unless stimulated in this respect by buyers of expensive homes.

By comparison with the mechanism of share participation in residential housing construction, which envisages special norms designed to safeguard the rights of shared construction participants², the purchase of a dwelling under a preliminary agreement poses more risks to the

¹ Grekova, O. *Chrezvychainye metry* [Extraordinary Meters] // *Moskovskii Komsomolets*. 15-21 February 2013. No. 33(87). P. 16; *Novaia Moskva prinesla stolitse rekord po prodazhe kvartir* [Thanks to New Moscow, Apartment Sales in the Capital Hit a Record High], <http://news.rambler.ru>, 14 January 2013.

² The property developer is legally required to register its ownership or leasing rights to the land plot, to obtain permission for construction and for publishing the project declaration, to register the share construction agreements with the RF Federal Service for State Registration, Cadastre and Cartography (*Rosreestr*), and to pay a fixed penalty in the event of the developer failing to meet its obligations. The buyer has the right to demand that all defects of construction be rectified free of charge, and to claim compensation for repairs or for the apartment's loss in value.

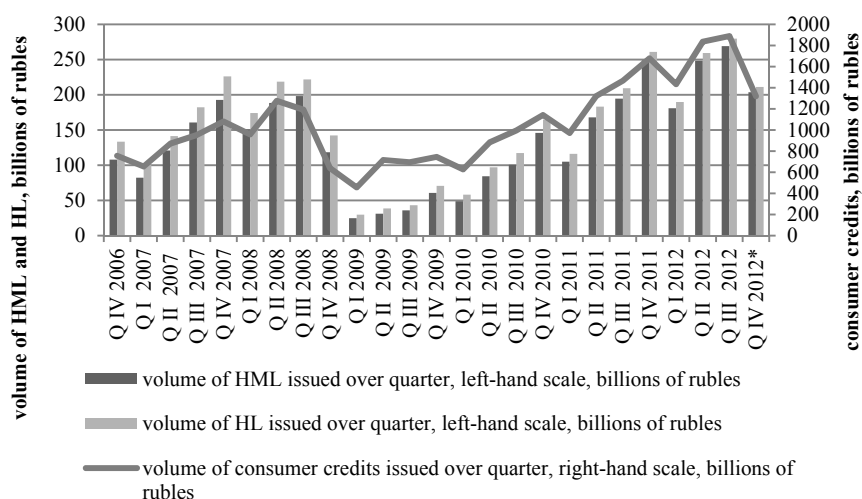
buyer because the object of such a transaction is only the *intention* of the parties. Moreover, under the existing law, such transaction can be deemed legal only in the event when the property developer has been granted permission to commission the object of construction. While the possibility of the seller going bankrupt and the risk of multiple sales always exist in share participation agreements, that is also true of housing purchases under preliminary agreements.

The main advantage of share participation in residential housing construction is the possibility, for a participant, to pay his or her contribution through installments over a long period of time. However, this scheme implies that participants can assume ownership of the property in question only on its completion, and that they must pay participant contributions. Moreover, this scheme makes its participants dependent on the decisions adopted by a general meeting of participants, which involves the risk of being expelled, without an explanation of the reasons, from the ranks of participants. And finally, it implies the possibility of the price of an apartment being increased, because house-building cooperatives do not take on the responsibility to keep the prices of apartments unchanged and to rectify the defects of construction.

Apart from the afore-noted schemes, the use of two more schemes – housing savings cooperatives and the investment agreement - is potentially possible. However, these two tools are almost nonexistent in the primary housing market for the following obvious reasons: the mechanism of housing savings cooperatives is extremely complicated, while investment agreements can be concluded only with legal entities¹.

6.5.4. Housing Mortgage Lending

According to the RF Central Bank, as of 1 December 2012, 664 credit institutions had issued, since the beginning of 2012, 611,487 housing mortgage loans (HML) in the amount of Rb 904.56bn, which represents a 47.3% rise on the amount of HML issued as of 1 December 2011, and a 37.93% rise on the amount of HML issued throughout the pre-crisis year 2008. In Q3 2012, the HML issued by credit institutions amounted to Rb 203.6bn, which represents a 35.76% rise on Q3 2008 (*Fig. 14*).

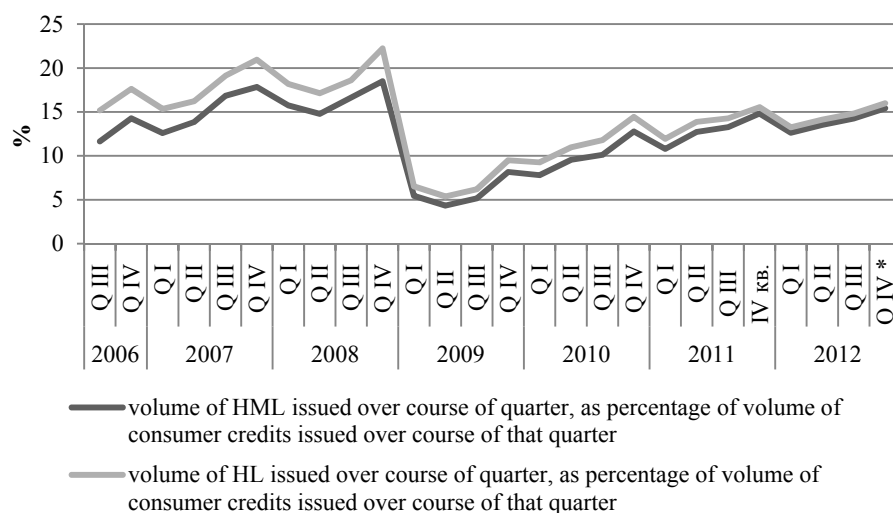


* October–November.
Source: RF CB data.

Fig. 14. The Dynamics of Loans Issued to Individuals over the Course of a Quarter, 2006-2012

¹ Before Law No. FZ-214 was amended, investment agreements could also be concluded by individuals.

In Q3 2012, the share of HML in the volume of consumer lending grew by 0.98 p.p. on Q3 2011 - to 14.25% (Fig. 15). The volume of consumer lending in Q3 2012 (Rb 1,889.5bn) rose by 48.14% on its pre-crisis record high registered in Q2 2008.



*) – October–November 2012.

Source: RF CB data.

Fig. 15. The Dynamics of the Volume of HML Issued to Individuals over the Course of a Quarter, as a Percentage of the Volume of Consumer Credits Issued Over the Course of that Quarter, 2006–2012

According to *Rosreestr*, the share of mortgaged real estate objects in the total number of real estate objects registered in housing transactions has been on the rise since 2009. In 2012, one in five housing transactions was a residential mortgage transaction (Table 30).

Table 30

The Share of Mortgaged Real Property Objects in the Total Number of Real Property Objects Registered in Housing Transactions, %

2005	2006	2007	2008	2009	2010	2011	January –November 2012
4.2	9.5	15.6	16.9	11.9	14.6	17.6	20.5

Source: OJSC Agency for Housing Mortgage Lending, on the basis of *Rosreestr* data.

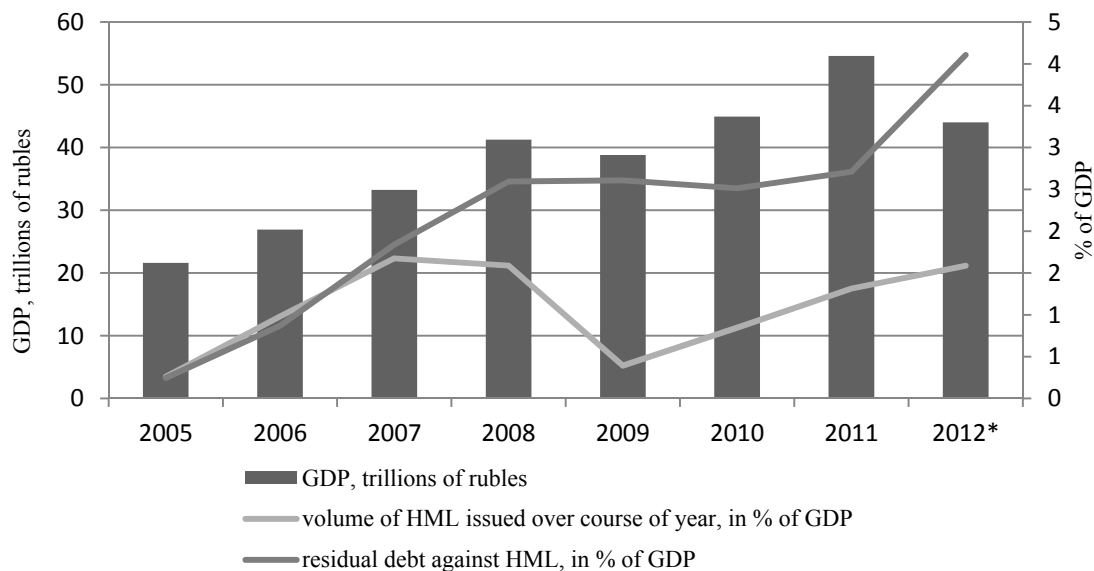
As of 1 October 2012, the volume of issued HML as a share of GDP amounted to 1.59% vs. 1.31% as of the end of 2011. Expressed as a percentage of GDP, this index rose to its record high in 2007 (1.67% of GDP) (Fig. 16). As of 1 October 2012, the amount of debt outstanding against HML, expressed as a percentage of GDP, was 4.11%, which represented a 1.4 p.p. rise on that index as of the end of 2011 and a 1.51 p.p. rise on its pre-crisis record high registered in 2008 (Fig. 16).

The year 2012 saw a continuation of the rise in the amount of residual debt against ruble-denominated HML, and also a continuation of the drop in the ratio of the amount of stale debt against ruble-denominated HML to the amount of residual debt (Fig. 17). As of 1 December 2012, the amount of debt against ruble-denominated HML rose by 42.41% on 1 December 2011 - to Rb 1,797.73bn, while the amount of stale debt dropped by 4.65%, to Rb 24.8bn, or 1.38% of the amount of residual debt. At the same time, the amount of residual debt against HML denominated in foreign currencies shrank by 23.22% - to Rb 125.73bn, while the

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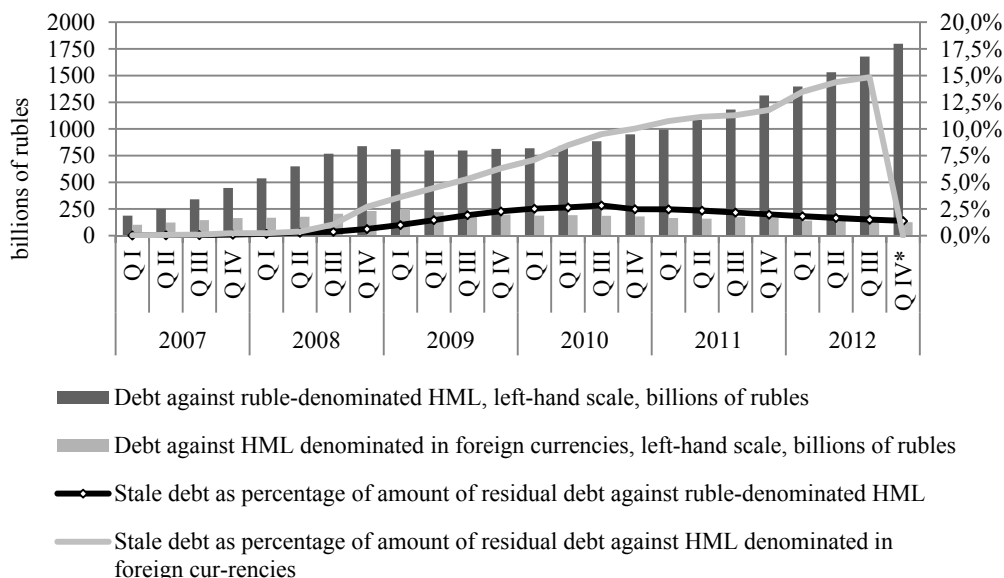
amount of stale debt against such HML grew by 0.75% - to Rb 19.3bn, or 15.35% of the amount of residual debt (Fig. 17). The share of effective stale debt in effective residual debt declined to 2.29% as of 1 December 2012 (Fig. 17).



*) – January–September 2012.

Source: RF CB data.

Fig. 16. The Dynamics of Housing Mortgage Lending as a Percentage of GDP, 2005-2012

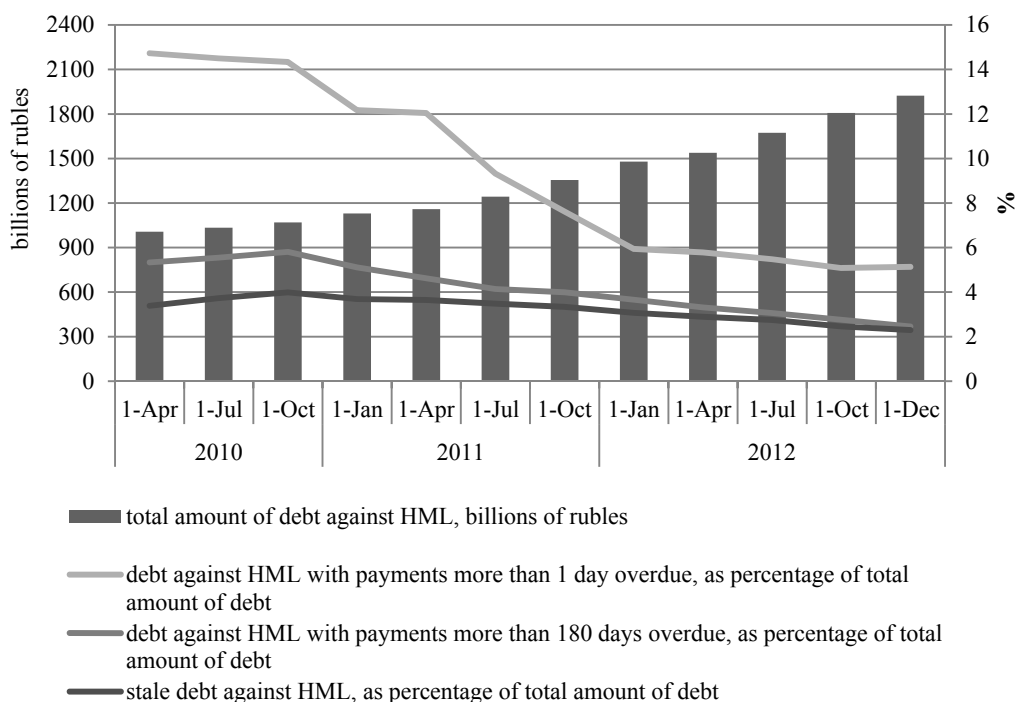


*) – as of 1 December 2012.

Source: RF CB data.

Fig. 17. The Dynamics of Residual and Stale Debt against Housing Mortgage Loans, 2007-2012

The year 2012 saw a continuation of the rise in the amount of residual debt against HML with no overdue payments and of the rise of its share in the total amount of debt (*Fig. 18*). As of 1 December 2012, residual debt against such HML amounted to Rb 1,824.8bn, while its share in the total amount of debt rose by 0.81 p.p. on 1 January 2012, to 94.87%. As of 1 December 2012, the share of debt against HML with payments more than 180 days overdue (debt against defaulted loans) in the total amount of debt dropped by 1.2 p.p. on 1 January 2012.

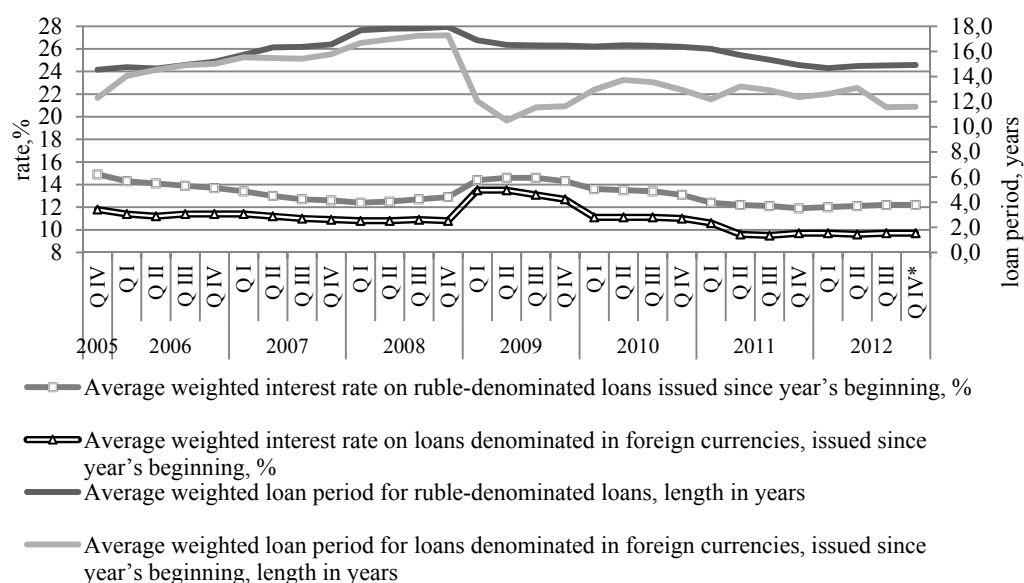


Source: RF CB data.

Fig. 18. The Dynamics of Debt against Housing Mortgage Loans and Stale Debt against Housing Mortgage Loans with Overdue Payments, 2010-2012

In 2012, the steady fall in the average weighted interest rate on ruble-denominated HML issued since the year's beginning, which had been taking place throughout 2010 and 2011, was replaced by its rising, from 11.9% as of 1 January 2012, to 12.2% as of 1 December 2012 (*Fig. 19*). The average weighted interest rate on HML denominated in foreign currencies, issued since the year's beginning, increased from 9.4% as of 1 March 2012 to 9.7% as of 1 December 2012. As of 1 December 2012, the average weighted loan period for ruble-denominated HML issued since the year's beginning amounted to 14.91 years, while that for HML denominated in foreign currencies amounted to 11.59 years (*Fig. 19*).

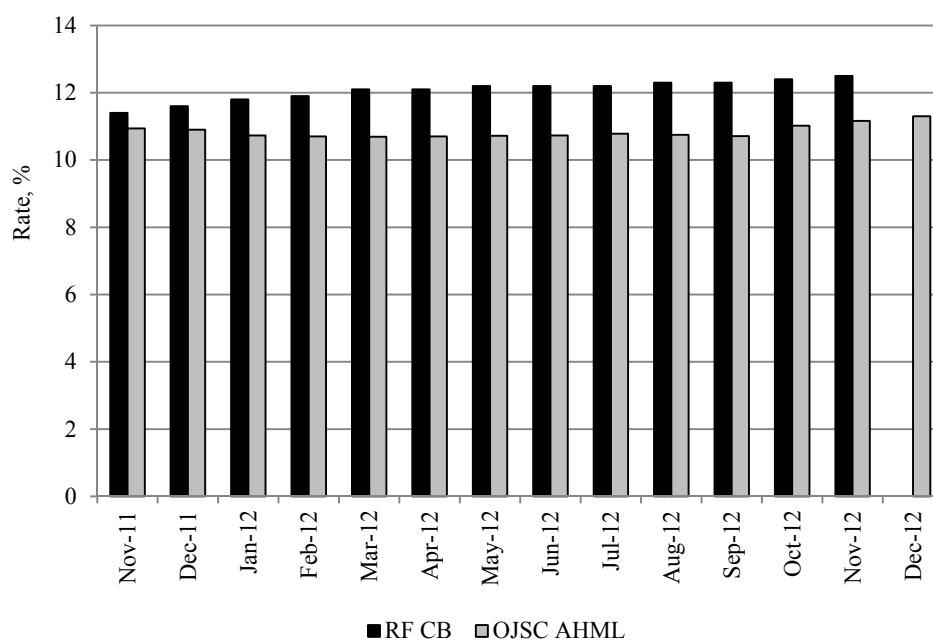
According to RF CB data, the average weighted interest rate on ruble-denominated HML issued since the year's beginning across the Russian Federation increased from 11.4% in November 2011 to 12.5% in November 2012 (*Fig. 20*). According to the Agency for Housing Mortgage Lending's data, the average weighted interest rate on ruble-denominated HML refinanced over the course of a month began to increase later than the aforesaid interest rate. It grew from 10.7% in April 2012 to 11.3% in December 2012 (*Fig. 20*).



*) – as of 1 December 2012.

Source: RF CB data.

Fig. 19. Average Weighted Data on HML Denominated in Rubles and Foreign Currencies, Issued Since the Year's Beginning, 2004-2012

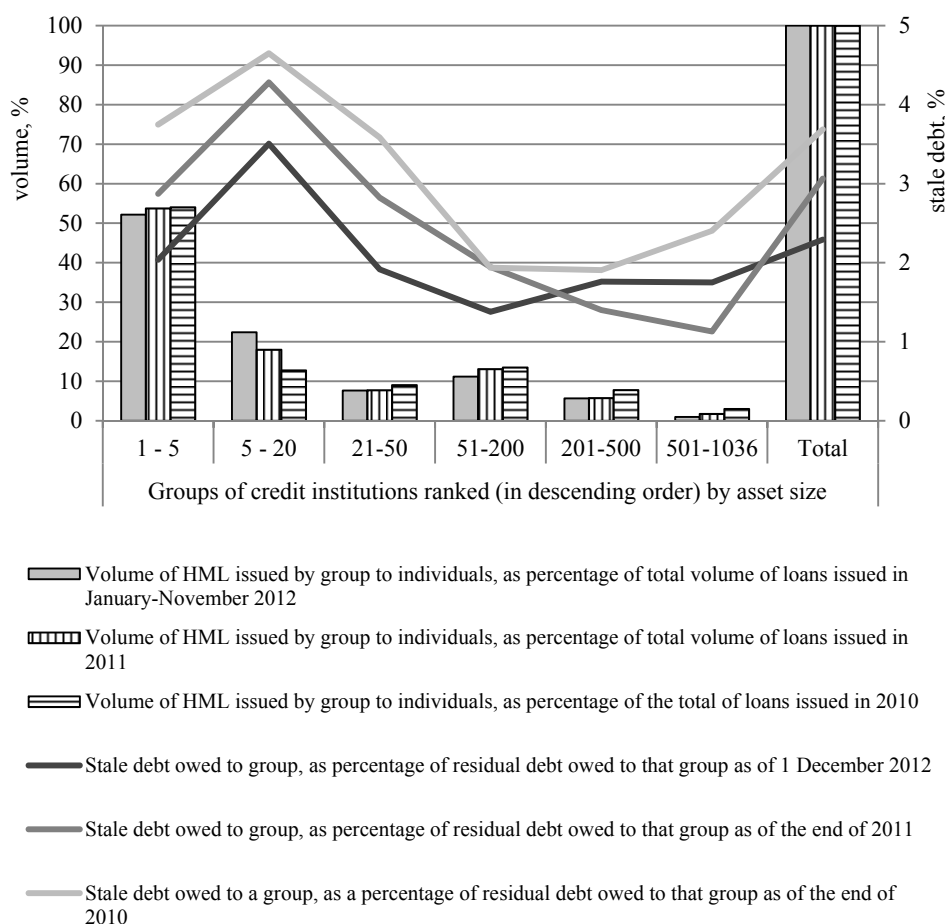


Source: data provided by the RF CB and the Agency for Housing Mortgage Lending (AHML).

Fig. 20. The Dynamics of the Average Weighted Interest Rate on Ruble-Denominated HML Issued Over the Course of a Month, November 2011 – December 2012

The share of the topmost group of credit institutions with the largest assets, comprising 5 such entities, in the total volume of HML issued over the course of a year dropped to 52.18% as of 1 November 2012 vs. 53.76% in 2011, and 54.2% in 2010 (*Fig. 21*). The share of the second group, comprising 15 credit institutions, rose to 22.39% as of 1 November 2012. Giv-

en the existing general trend towards a decline in the share of stale debt in total debt across Russia, as of 1 December 2012 the second group of credit institution continued to keep the largest share of stale debt (3.5%), which means that its HML portfolio was the most risky one. As of 1 December 2012, the first two groups of credit institutions account for three quarters of the HML market (74.58%).



Source: RF CB data.

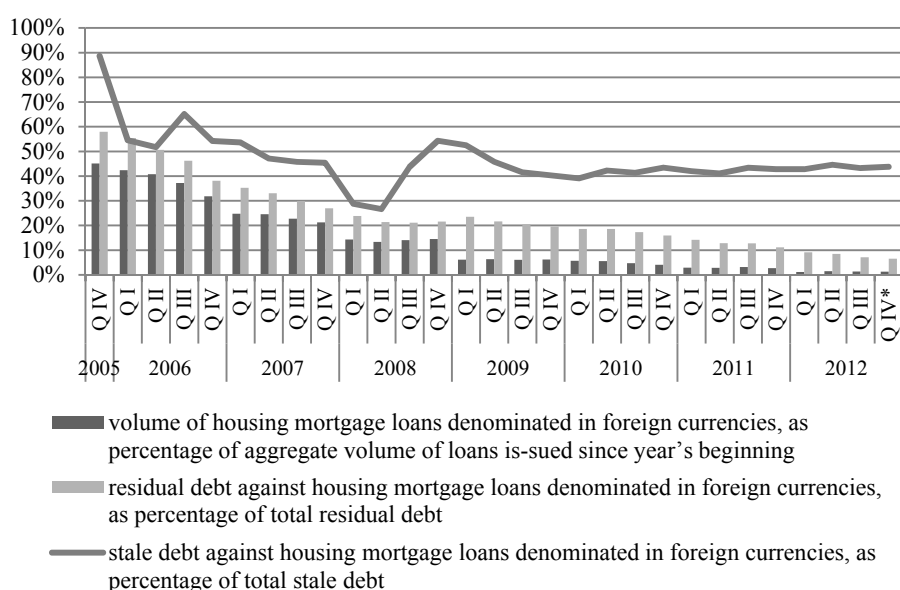
Fig. 21. The Dynamics of the Volumes of Issued HML and Stale Debt, by Group of Credit Institutions Ranked by Asst Size, 2010-2012

As of 1 December 2012, the share of the volume of HML denominated in foreign currencies, issued since the year's beginning, in the total volume of HML dropped to 1.33%, while the share of debt against HML denominated in foreign currencies in total debt declined to 6.54%. At the same time, the share of stale debt against HML denominated in foreign currencies in total stale debt hovered around 44% (Fig. 22).

According to the expert estimation carried out by OJSC AHML, the share of mortgage lending in the primary housing market is steadily on the rise. In January-November 2012, it amounted to 20.0% of the total volume of HML, having risen by 5.0 p.p. on 2011 (Table 31).

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*) – January–November 2012.

Source: RF CB data.

Fig. 22. The Ruble / Foreign Currencies Relationship with Regard to Housing Mortgage Loans, 2005-2012

Table 31

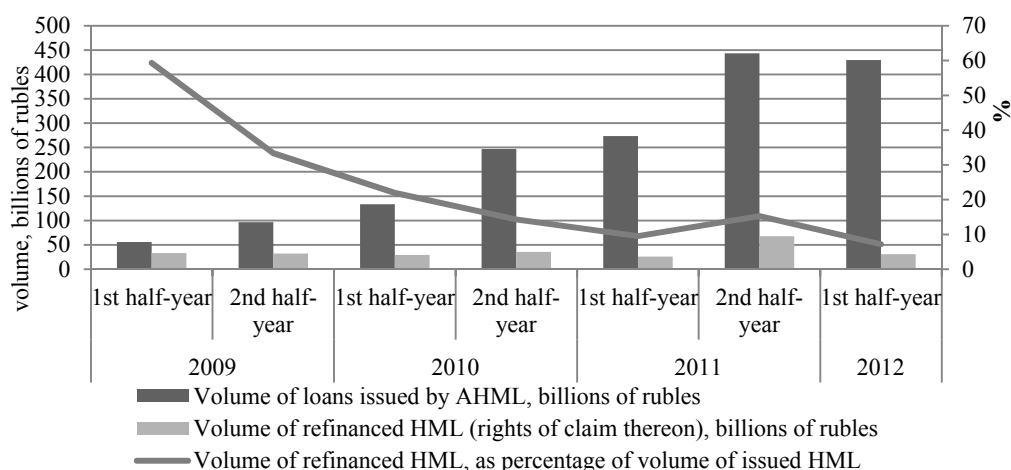
The Dynamics of HML in the Primary and Secondary Housing Markets

	2008	2009	2010	2011	January – November 2012	Forecast: 2013
Mortgage loans for housing acquisition at the secondary market						
Aggregate amount of loans, billions of rubles	534.9	136.9	340.1	609.4	723.6	760–920
Number of loans, thousands	285.1	116.7	270.2	445	489.2	507–613
Floor area, millions of sq m	13.5	3.7	8.1	16.3	18.8	21–24.3
Mortgage loans for housing acquisition at the primary market						
Aggregate amount of loans, billions of rubles	120.9	15.6	38.8	107.5	180.9	190–230
Number of loans, thousands	64.4	13.3	30.8	78.5	122.3	127–153
Floor area, millions of sq m	3.3	0.5	1.2	3.2	5.4	5.9–6.8
The volume of the HML primary market, as a percentage of the total volume of issued HML						
Aggregate amount of loans	18.4	10.2	10.2	15.0	20.0	20.0
Number of loans	18.4	10.2	10.2	15.0	20.0	20.0
Floor area	19.6	11.9	12.9	16.4	22.3	21.9

Source: the expert estimation carried out by OJSC AHML.

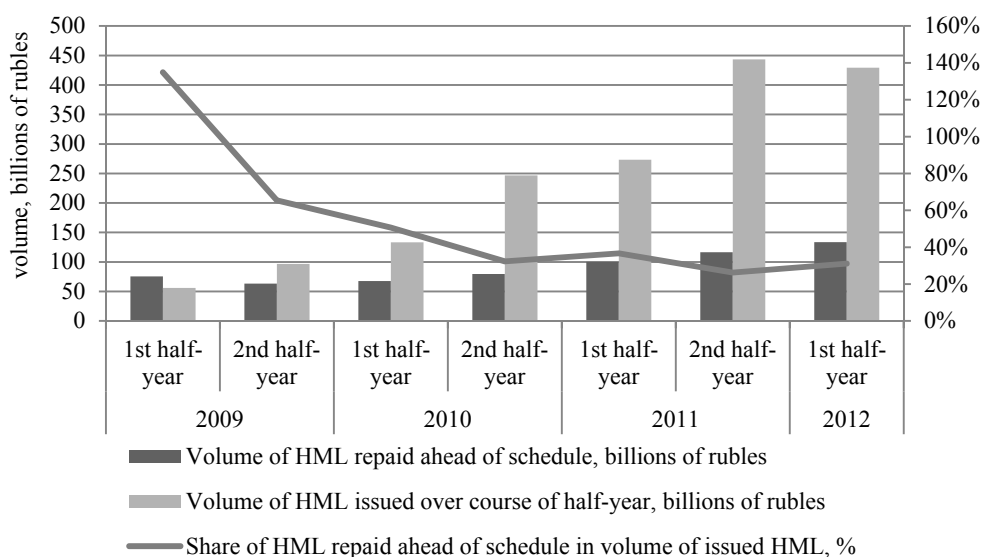
According to RF CB data, in the first half-year of 2012, 131 institutions (including 30 credit institutions) refinanced housing mortgage loans with the sale of the pool of those loans (the rights of claim thereon) in the amount of Rb 30.71bn (Fig. 23), which accounted for 7.15% of the volume of HML issued over the course of the first half-year of 2012. Credit institutions accounted for 29.56% of the refinancing volume, while 92 specialized institutions accounted for 65.5% of the refinancing volume.

As of 1 July 2012, housing mortgage loans in the amount of Rb 108.65bn had been repaid ahead of schedule, which represented a 35.13% rise on 1 July 2011. This amount accounted for 25% of the volume of loans issued in the first half-year of 2012. The amount of HML repaid before schedule by the money raised through the sale of mortgaged properties was Rb 2.05bn (Fig. 24).



Source: RF CB data.

Fig. 23. The Dynamics of HML (the Right of Claim Thereon) Refinancing, 2009-2012



Source: RF CB data.

Fig. 24. The Dynamics of HML Repaid Ahead of Schedule, 2009-2012

In 2012, OJSC AHML refinanced 45,489 ruble-denominated mortgage loans in the amount of Rb 61.39bn (Table 32), which was by Rb 10.14bn more than in 2011. In January - November 2012, the mortgage redemption rate set by the Agency for Housing Mortgage Lending amounted to 10.63% (for the following standard products: ‘Standard’, ‘House Under Construction’, ‘Young Teachers – Standard’, ‘Young Scholars’ and ‘Military Mortgage’), which was by 1.57 p.p. lower than Russia’s average weighted rate for that period, based on RF CB data.

According to data released by OJSC AHML, over the period from 1 October 2009 through 1 December 2012, it assumed obligations under the *Stimul* [Stimulus] project in the amount of Rb 79.93bn, of which a total of Rb 17.08bn has already been invested in the project's implementation. Out of the total sum of Rb 54.26bn issued by banks to legal entities to be invested

in housing construction under the *Stimul* [Stimulus] project at an average interest rate of 12,75%, the Agency refinanced a total of Rb 33.39bn at the rate of 7.71%.

Table 32

The Redemption of Mortgages by OJSC AHML in 2012 (as of 1 January 2013)

	For all prod- ucts	Standard product	Military mortgage	Mother capi- tal	House under construction	Other
Redemption of mortgag- es, number	45,489	27,587	8,313	4,279	5,223	87
Redemption of mortgag- es, thousands of rubles	61,390,454	32,505,840	16,593,420	5,913,840	6,113,801	263,553
Average value of mort- gage, thousands of rubles	1,350	1,178	1,996	1,382	1,171	3,029

Source: OJSC AHML data.

As evident from data released by OJSC AHML, housing mortgage loans to young school teachers under the program put forth by the Agency in September 2012 are currently issued only in 12% of the regions. In accordance with the program's conditions, if the first contribution in the amount of 10% is paid, the borrowers may be granted joint subsidies (from the Federal Treasury and regional budgets) against their loans, while the interest rate is relatively low - 8.5%. The main obstacle to the realization of this plan, in addition to teachers' low salaries, is the difficulty associated with the actual allocation of money from regional budgets.

6.5.5. The Prospects for the Housing Market's Development

The forecasts of the pricing trends on Russia's housing market made over the previous years were based on the assumption that the prices stabilization in 2010 would be followed by their growth in 2011–2012. The growth rate was expected to be slower than in 2000–2001 (an L-shaped trend).

The forecast for 2011 and later years was already based on a new methodology, which relied on the assumption that the growth rate of prices depended on the growth rates of per capita incomes adjusted for different types of markets^{1,2}.

The same methodology was applied in plotting the forecasts for 2012 and 2013.

The data on the growth rate of the population's real income and expected inflation rate were taken from the *Medium-term Forecast of the Socio-economic Development of the Russian Federation for 2011 and 2012–2013*³ and the corresponding regional forecasts, all of which demonstrated movement patterns of their main socio-economic indicators that differed little from Russia's average pattern, the only exception being that of Perm Krai⁴. The market types for 2012 were established as follows: for Moscow – developing market; for St. Peters-

¹ Sternik G. M., Sternik S. G. *Tipologia rynkov nedvizhimosti po sklonnosti k obrazovaniu tsenovykh puzyrei* [The Typology of Housing Markets Based on Their Propensity for the Emergence of Price Bubbles]. - *Imushchestvennye otnoshebiia v RF* [Property Relations in the RF] (Journal). No. 8 (95) 2009, pp. 18–28.

² Sternik G. M. *Metodika prognozirovaniia tsen na zhil'e v zavisimosti ot tipa rynka* [The Methodology for Forecasting Housing Prices depending on the Type of market]. – *Imushchestvennye otnoshebiia v RF* [Property Relations in the RF] (Journal) 2011, No. 1, pp. 43-47.

³ *Forecast of the Socio-economic Development of the Russian Federation for 2011 and the Planning Period 2012–2013* - http://www.economy.gov.ru/minec/activity/sections/macro/prognoz/doc20100923_07. Indicators of the Adjusted Forecast of the Socio-economic Development of the Russian Federation for 2011-2013 - http://www.economy.gov.ru/minec/activity/sections/macro/prognoz/doc20101217_03.

⁴ The initial conditions for plotting the development scenarios for Perm Krai's economy in the period until 2012 (basic scenario conditions) – <http://www.gorodperm.ru>. The document envisages a decelerated growth rate of the population's income (2%) and a higher inflation rate at the regional level (12.5%).

burg and Moscow Oblast – stable market in the first half-year, and developing market in the second half-year; and for Perm (considering its lower than average growth rate of real income, and higher than average inflation rate) – stable market over the entire year's course.

Our comparison of the actual data with the forecasts for 2012 confirms that the forecasts were in the main correct. The actual data for Moscow, St. Petersburg and Moscow Oblast demonstrated slight downward deviations from the forecasts due to the lower actual growth of personal incomes against the government's forecast.

The forecast for 2013 is based on the same methodology and applies the initial data on the growth rate of personal incomes plotted in the RF Government's *Medium-term Program*. It is presented in Fig. 25.

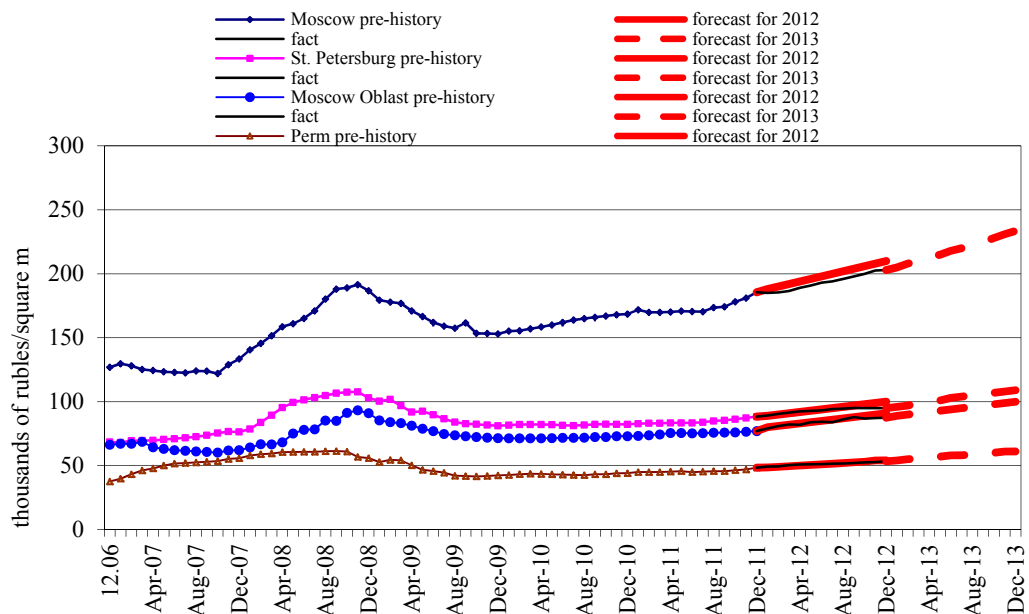


Fig. 25. A Forecast of Supply Prices in the Secondary Housing Market

Given the current macroeconomic situation in Russia (relatively high oil prices; the strengthening ruble; the decline in capital outflows; and the drop, however slight, in the rate of inflation), it can be expected that, in 2013, personal incomes - the main factor underlining the dynamics of housing prices - will marginally go up. The growth rates of housing prices can definitely increase provided that personal incomes continue to grow. If the dynamics of that index remains as it was in 2012, it can be expected that housing prices in Moscow and other cities will rise by 8 to 14%.

Thus, on the whole, the Russian housing market experienced in 2012 a slow but steady rebound in housing prices and housing commissioning volumes.

As far as the analyzed sample is concerned, prices in the secondary housing markets of more than 40% of the Russian cities where corresponding data were available have regained and surpassed their previous peaks. It is highly probable that, in 2013-2014, the same result will be achieved in the rest of the cities as well. It can be expected that housing prices in Shakhty, Omsk and Kemerovo will return to their pre-crisis levels in early 2013; prices in Novosibirsk, Moscow Oblast and Izhevsk – in late 2013; while prices in Krasnoyarsk, St. Petersburg, Perm, Chelyabinsk and Chita – in the first half-year of 2014.

6.6. The military economy and military reform in Russia

In early 2012 the Armed Forces (AF) were overshadowed by the accident with the fleet ballistic missile submarine (FBMS) K-84 "Yekaterinburg" and its grave consequences. The fire occurred three days before the New Year, during welding works as part of unscheduled repairs of the FBMS and where, in breach of safety requirements, the ballistic missiles and torpedoes had not been first unloaded. This compromised not only the crew and workers at shipyard No. 82 in Roslyakovo, but also the whole region and other nearby countries¹. Following this, and six weeks before the transfer of authority of the Supreme Commander, D. Medvedev had said: "the reform of the Armed Forces is almost complete." However, the sensation planned on the top level has not happened - public opinion has been almost unanimously set with on continuing the military reforms. New areas of reform which had previously been ignored were put on the agenda as a result of corruption revealed within the senior management of the Defence Ministry, which led to its sudden replacement in November, and this was probably the main news in Russia in 2012.

6.6.1. Military staffing and social policy

The military HR policy applied in Russia in 2012 was significantly different from the guidelines set by the country's government in late 2008. It was found that the AF management's feasibility studies of appropriate designs had been of low quality and were not based on demographic and economic considerations. As a result, newly organised brigades were only partly combat ready by the spring 2012 because of low staffing.

On the whole, the military draft situation has not worsened, provided we ignore the fact that only half the numbers specified by the former Chief of Staff as necessary to create the new "image of the AF" were actually called-up. Out of a total of 155 570 individuals called-up during the spring of 2012, 35,600 (22.9%) had studied in higher education and this undoubtedly contributed to the improvement of combat training and law enforcement in the AF.

Despite a decline in military recruitment numbers the problem of evasion of conscription remained unsolved. In the spring of 2012 more than 166,000 people evaded military service by various means. The total number wanted for evading military service was reduced by 3,900 (27%) as compared to the beginning of the previous year².

The same situation was observed in the autumn of 2012, when it had been planned to call-up 140,140 personnel. In reality, 295,710 people were called-up and sent to the Armed Forces and other troops during the year. As a result, according to a representative of the Audit Chamber of the Russian Federation, the AF staffing level stood at 77% by late 2012³.

A well known feature of the staffing of the AF is that "... the transition to a 1 year term of military service means that, after their training, junior specialists who have acquired the skills necessary to operate the new generation of military equipment will then leave at the expiry of their legal compulsory military service, i.e. although personnel will always be in training there will be no fully trained junior specialists⁴." The only real way out of this situation is a transition to contract staffing.

¹ M. Lukin, I. Safronov Jr. Fake boat // Kommersant Vlast. 2012. No. 6.

² A. Tikhonov The number of draft-dodgers has decreased // Red Star. February 4, 2012.

³ The staffing level is 77% // Military-Industrial Courier. March 13-19, 2013 (No. 10).

⁴ The concept of the new programme for the transition to contractual staffing was approved by the Prime Minister Vladimir Putin on 15 July 2008.

Therefore, immediately after taking office, President Vladimir Putin told the Russian government to provide "an increase in the number of contracted troops of not less than 50,000 people annually over five years¹."

However, the President's absolute social policy priority is solving the housing problem in relation to the AF. The first paragraphs of the decree quoted above require "the provision, in 2013, of housing for Armed Forces servicemen, other troops, military formations and bodies, in full, and in accordance with the legislation of the Russian Federation" and "the creation of a service housing fund by 2014."

The housing situation in the army is still very far from good. Thus, according to the Audit Chamber it follows that the triumphant reports of the former Defence Minister, on the mass resettlement of officer families, were significantly different from the reality². The criminally low quality of planning has led to 59,600 apartments being unoccupied due to general and infrastructure deficiencies. Thus, in 2012 the total amount of construction in progress for the Ministry of Defence exceeded RUR 317 billion, yet, at the end of the year, 100,000 servicemen were without housing.

In 2012, the main achievement of AF-related social policy was a significant increase in the size of the allowance for servicemen and for military pensions. Not only did the amount increase, but the payment system for the cash allowance has also been modernised through the use of bank cards. Unfortunately, however, the new centralised allowance accrual system has been "in fever" for nearly half of the year due to various faults. Fraudsters did not fail to take advantage of the situation – employees at the unified computing centre of the Ministry of Defence, who had introduced "dead souls" into the system, were detained. It is interesting that in the spring of 2012 significant errors and delays also occurred in the Centralised Allowance Computing System of the French AF, which, as it turned out, was the model for the new Russian system.

After the change of management at the Defence Ministry, some saw an opportunity to review military HR policy. In particular, the chairman of the Defence Committee of the State Duma, Vladimir Komoyedov, proposed the extension of the compulsory military service term to one and a half years³. This caused a negative reaction from society, so the Komoyedov's proposal was left hanging. In general, the change in management at the Defence Ministry has not added clarity to the policy on Russian military personnel.

6.6.2. Military-technical policy

Throughout 2012 the state armament programme (SAP), state defence procurement and the military-industrial complex (MIC) were the particular areas of focus of the Russian military and political management.

At the beginning of the year, on 20 February at a meeting in Komsomolsk-on-Amur President Putin, addressing members of the Government, said: "We need more than just developing these financial resources, these billions, millions and trillions - results are needed here. In

¹ Decree No. 604 dated 7 May 2012 "On further improvement of military service in the Russian Federation".

² *Yu. Gavrilov*. Apartment calculations // *Rossiyskaya Gazeta*. 4 December 2012.

³ Vladimir Komoyedov: "The conscription term should be 1.5 years and the conscription age should be 19 years" / *Izvestiya*. 23 November 2012.

the end, we need weapons, so we don't need to report the number of assimilated billions, but the number of equipment units, the latest technology delivered to the army and navy"¹.

Remember that 2012 was the second year of implementation of the regular armament programme. Plans for the first year were not met, the debt, including that in aeronautical engineering, was carried forward to 2012, which in turn began with difficulties in placing defence procurement (contracting). In addition, the Federal Target Programme "The Development of the MIC for the period up to 2020" was approved only at the beginning of March, after more than a year's delay.

Transcripts, published in the summer, of meetings between the President and the commanders of the AF on the implementation of the relevant sections of the SAP for 2011 - 2020, and media reports have refined its performance with regard to the Russian Defence Ministry (*Table 33*).

Table 33

The main indicators of the state armament programme of the Russian Defence Ministry for 2011-2020

Programme, subprogramme	Key objectives and indicators	Funding, RUR trillion
1	2	3
SAP, total, including:	The share for modern weapons and military equipment supplied to the armed forces should be 30% in 2016 and 70% in 2020	19.0
- Strategic nuclear forces	The share of modern weapons of 75-80% in 2020, more than 400 land-based and sea-based intercontinental ballistic missiles, 8 missile strategic submarine cruisers	1.0
- Military space forces and Aerospace Defence (ASD)	The share of modern weapons in the ASD in 2020 shall be at least 70%, about 100 spacecraft and 28 S-400 regimental units	4.0
- Air Force	More than 600 aircraft and more than 1,000 helicopters	4.7
- General purpose Navy forces	51 surface warships, 16 attack submarines and 90 support vessels	4.4
- Ground troops and airborne troops	10 Iskander-M regimental units, 9 S-300V4 regimental units, 2,300 tanks, about 2,000 self-propelled guns and more than 30,000 vehicles	2.6
- Main Departments of the Ministry of Defence	The share of modern rear and special equipment shall be at least 65% in 2020	2.3

Note: 1. The funding is 30% up to 2015 and 70% in 2016-2020.

2. More than 70% of the funding is allocated to purchase new equipment.

3. The amount of funding of the Main Departments of the Ministry of Defence is a balancing value.

The formal parameters of the Russian MIC are impressive: 1,353 enterprises and organisations located in 64 regions of Russia and employing approximately 2 million people (1,300 million according to other sources). But the annual results of the system for the Russian Federation are insignificant, except for the increase in sales of military products abroad.

Efforts to preserve the strategic deterrence forces are characterised not only by the "development" of the budget, as noted previously, but also by real perceptible results: with proper care and improvement the old systems are still an effective means of nuclear deterrence whilst they are being replaced with new complexes. Their share of the Strategic Missile Forces (SMF) now accounts for approximately 25-30% and production is established. The main achievement of the year should be considered to be the start of equipping the SMF with the RS-24 "Yars" multicharged complexes. Other new offensive weapons are currently being developed. Given the fact that the strategic missile forces are not only the most effective, but also the most expensive deterrent at current costs, the priority of their development is established correctly.

¹ Meeting on the implementation of the state MIC development policy for the period up to 2020 and beyond. Transcript. Komsomolsk-on-Amur, 20 February 2012. URL: <http://www.government.gov.ru/docs/18194/> (visited on 21 February 2012).

As regards aerospace defence troops, a new radar is being built in Armavir and will be placed on alert at the beginning of 2013. It will control the airspace and outer space in the southern strategic direction.

Shortfalls in defence procurement related to the Navy are the most frustrating - and in 2012 procurement actually failed, and this failure is not the first. In 2012, the Navy were to get three FBMSs (the "Yury Dolgoruky" and the "Alexander Nevsky" (both of Project 955 "Borey" class) and the "Severodvinsk" (a Project 885 "Yasen" class) and three surface ships – the corvettes "Boykiy" and "Stoykiy" and a leading frigate the "Admiral Gorshkov". But in the end, only the first submarine of the new project the "Yury Dolgoruky" was handed over to the Navy in early 2013, and even then without the standard "Bulava-30" missiles¹. However, throughout 2012 the departmental press had reported on the successful transfer of harbour tugs and other offshore support vessels to the Navy.

As regards the Air Force, in 2012, three aircraft and eight helicopter squadrons were refurbished. However, nobody knows so far whether the Ministry of Defence collected all the debts related to the 2011 procurement, and to the 58 aircraft and 124 helicopters planned under the 2012 procurement.

Ground forces have not received the 200 BTR-82 armoured personnel carriers - a full set for one infantry brigade - from the Arzamas Engineering Plant, which elected to sell them to a foreign customer. This disrupted about 60% of the state defence procurement for 2011–2012 related to those vehicles². Nevertheless, the Armed Forces fleet received 3,600 new multipurpose vehicles.

An outside observer cannot accurately assess the results of state defence procurement in 2012, because they are carefully sidestepped by all Russian officials. However, even the failure of the naval defence procurement on its own evidences serious problems with the implementation of the state armament programme for 2011 - 2020. It must be assumed that, given the disruption of supply to the Navy and ground forces already made known by the time of the review, the defence procurement for 2012, even with the April reductions (by around RUR 677.4 billion³) was basically not more than 90% complete.

6.6.3. Reforms of the financial security of the Russian AF

The transition to the outsourcing of maintenance for the AF and the disposal by the Defence Ministry of surplus property, using the proceeds to address pressing issues related to the agency and to servicemen were considered amongst the main achievements of the military reform.

But the red flags started to appear at the beginning of 2012. It turned out that Slavyanka JSC, which, two years ago and without any competition, received all the boilers, infrastructure and property at the Defence Ministry's military camps had not promptly booked and maintained many facilities, resulting in numerous accidents with boilers during the heating season. In this case, as evidenced by human rights organisations, in 2012, the practice of the illegal

¹ In 2012 the Russian Navy did not get five combat ships // RIA "Novosti". 21 February 2013.

² A. Mikhailov Arzamas Plant disrupted the delivery of BTR-82 // Izvestiya. 6 February 2013.

³ O.Vladykin. State defence procurement is cut by RUR 25 billion // Independent Military Review. 27 April – 17 May 2012 (No. 14).

involvement of conscripts in forced labour had expanded¹. And by November, the Investigative Committee of the Russian Federation revealed systemic culture of theft in Oboronservice JSC, which included the aforementioned Slavyanka.

Problems with the military camps received much attention at the government meeting at the end of June, 2012 chaired by the Prime Minister, Dmitry Medvedev². The urgency of the problem is determined by the fact that during the last 20 years Armed Forces staffing has decreased by a factor of three and their deployment system has also very significantly changed, yet the military camps themselves and their procurement infrastructure has remained virtually unchanged.

The procedure for changing property titles from one type to another is complex and includes many conciliation procedures and the preparation of numerous documents. As a result, military camps, which have ceased to be used for their intended purpose have been funded only residually. As confirmed by the Minister of Defence at the meeting, the Ministry of Defence is in charge of approximately 7,500 military camps, although about 1,644 of them are not used for their intended purpose, i.e. only 5,856 military camps are currently being used for the needs of the Ministry of Defence. The cash deficit is about RUR 70 billion and this amount is carried forward from year to year as the deficit for the next year. The scale of the property management problem in the Defence Ministry is characterised by the fact that, as of 1 July 2012, 494,279 facilities were reflected on the books, 15,352 of these being land plots, while 157,103 are buildings and 321 824 are apartments.

The change of management at the Ministry of Defence in November 2012 allowed for a sober evaluation of the excesses of the previous stage of the reform and the return of the maintenance and medical support units to the organisational and staffing structure of the combined arm brigades, which had been excluded by a strange misunderstanding.

6.6.4. Military and financial policy

In May, at the conclusion of the presidential election campaign, in the discussions around budget plans for 2013 and the 2014-2015 planning period by the Government, the Russian Ministry of Finance proposed to maintain macroeconomic stability through a reduction of expenditure on defence and law enforcement by RUR 4.3 trillion as compared to that previously planned for the period from 2014 to 2020³. A month later the detailed position of the financial authority came to be known - in order to achieve this objective it was also proposed to reduce the number of servicemen and equivalent personnel by 20% within three years⁴. And while plans to reduce staffing are still on paper only, the expenditure under Section 0200 on "National Defence" in the draft federal budget for 2013 has been reduced by RUR 198.2 billion (or 8.5%) in October compared to the amount planned one year ago under federal law No. 371-FZ dated 30 November 2011. According to this, the policy of the Ministry of Finance has found sufficient support within the Government.

¹ *L. Vakhnina*. Excess soldiers: Forced Labour in the Russian Army / Independent report. Moscow: Excess Soldier Group of NGOs, 2012, 77 p. URL: http://www.hro.org/files/lishniy_soldat_2012.pdf (visited on 25 February 2012).

² Meeting on the transfer of unused Ministry of Defence facilities to regions and municipalities, as well as the preparation of military camps for the heating season. Transcript. Petrovskoye, June 26, 2012. URL: <http://government.ru/docs/19465/> (visited on June 27, 2012).

³ *S. Kulikov*. The Ministry of Finance hunkered down // *Nezavisimaya Gazeta*. 29 May 2012.

⁴ The number of persons equated to servicemen can be reduced by 20% // *RIA Novosti*. 28 June 2012.

Implementation of the current federal budget for 2012 has not differed from the 2011 calendar - two significant annual adjustments of the initial release¹ in June² and at the end of the year³, and a formal adjustment⁴ in July, with mainly editorial amendments caused by the change of the official name of the legal entities receiving federal budget funds.

As a result of these changes federal budget expenditure under the "National Defence" Section had increased by 1.0% from RUR 1,846,585 million to RUR 1,864,822 million by the end of the fiscal year, with a growth in total budget expenditure by 2.4%. As compared to 2011, the allocations under the "National Defence" Section increased by 11.2% in real terms (the nominal increase was 21.3%) with a 3.0% increase in their amount in terms of GDP.

As in the previous six years, the above indicators of military expenditure are not included in the published budget law, so we again had to resort to the use of secondary data: an explanatory note to the government's draft of the federal budget, a Federal Treasury monthly report on the implementation of the federal budget in January 2013 and materials related to the Defence Committee of the State Duma from October⁵. This period is also the first time that the November materials of the Federal Assembly⁶, relating to the final version of this year's budget, do not contain the full amount for defence allocation, but show only its redistribution. The marked deterioration of the situation as regards the transparency of Russian military expenditure occurred after the public statement, made at the beginning of the year, on the intention of V. Komoyedov, the newly elected President of the Defence Committee of the 6th convocation of the State Duma, to take "a fresh look at the problem of the relationship between the public and private items of the military budget"⁷.

The confidentiality level of federal budget expenditure in 2012 has not changed compared to the previous year (see *Table 34*), which, with its secret allocations reached RUR 1,520,277 million.

¹ Federal Law No. 371-FZ dated 30 November 2011 "On the Federal Budget for 2012 and the planning period of 2013 and 2014".

² Federal Law No. 48-FZ dated 5 June 2012 "On Amending the Federal Law on the Federal Budget for 2012 and the planning period of 2013 and 2014".

³ Federal Law No. 247-FZ dated 3 December 2012 "On Amending the Federal Law on the Federal Budget for 2012 and the planning period of 2013 and 2014".

⁴ Federal Law No. 127-FZ dated 28 July 2012 "On Amending the Budget Code of the Russian Federation, Article 6 of the Federal Law on Amending the Budget Code of the Russian Federation and other legislative acts of the Russian Federation" and the Federal Law "On the Federal Budget for 2012 and the planning period of 2013 and 2014".

⁵ Resolution of the State Duma Committee on consideration of federal budget expenditures to support national defence, national security and law enforcement in the draft Federal Law No. 143344-6 "On the Federal Budget for 2013 and the planning period of 2014 and 2015." Moscow, 9 October 2012.

⁶ Resolution of the State Duma Committee on consideration of federal budget expenditure to support national defence, national security and law enforcement in the draft Federal Law "On Amending the Federal Law on the Federal Budget for 2012 and the planning period of 2013 and 2014" of the Federal Assembly of the Russian Federation. Moscow, 7 November 2012; Report No. 3.3-04/1846 of the Federation Council Committee on Defence and Security on the Federal Law "On Amending the Federal Law on the Federal Budget for 2012 and the planning period of 2013 and 2014". Moscow, 27 November 2012.

⁷ *Krasnaya Zvezda*. 13 January 2012.

Table 34

**The share of secret allocations in federal budgets
for 2004-2012, in % terms**

Code and name of the section (subsection) containing the secret expenditures	2004	2005	2006	2007	2008	2009	2010	2011	2012
1	2	3	4	5	6	7	8	9	10
Total federal budget expenditure	9.83	11.33	11.80	10.33	11.92	10.01	10.46	11.82	11.73
0100 NATIONAL ISSUES	N/A ¹	3.67	6.28	5.52	8.66	5.05	4.75	8.56	10.17
0108 International relations and international cooperation	18.04	–	0.01	< 0.01	3.66	–	–	–	–
0109 State financial reserve	93.33	82.86	89.23	92.18	90.17	85.01	85.08	88.15	85.71
0110 Fundamental research	–	2.13	1.22	1.12	0.97	0.78	0.32	0.66	2.89
0114 Other national issues	N/A	0.05	0.72	0.28	4.42	1.56	1.05	0.27	1.11
0200 NATIONAL DEFENCE	38.40	42.06	42.77	45.33	46.14	48.09	46.42	47.56	48.60
0201 Armed Forces of the Russian Federation	36.11	33.07	35.59	37.11	39.04	40.21	39.03	41.41	42.97
0204 Economic preparedness activities	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0205 Preparation and participation in collective security activities and peacekeeping	–	100.0	100.0	100.0	–	–	–	–	–
0206 Nuclear weapons complex	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0207 Implementation of international obligations in the sphere of military and technical cooperation	41.05	45.22	46.90	50.65	100.0	100.0	100.0	100.0	100.0
0208 Applied research in the area of national defence	N/A	98.37	93.94	93.69	93.20	92.85	91.32	91.94	94.64
0209 Other issues pertaining to national defence	N/A	2.49	8.79	24.38	29.21	34.64	42.03	36.41	44.03
0300 NATIONAL SECURITY AND LAW ENFORCEMENT	20.79	28.52	31.64	31.07	31.84	30.82	32.12	32.54	24.86
0302 Authorities of the Interior	3.01	4.76	6.31	5.16	4.97	3.70	4.30	6.56	3.42
0303 Internal troops	11.10	11.76	10.31	9.80	10.25	8.19	8.28	7.89	4.77
0306 Security agencies	98.91	97.80	95.49	97.31	99.05	99.61	97.05	99.87	99.56
0307 Border guard agencies	22.88	100.00	98.97	97.62	100.00	99.47	98.61	99.11	99.09
0309 Protection of population and territories from natural and man-made disasters, civil defence	41.74	59.02	62.39	50.65	51.39	51.00	51.28	47.35	42.81
0313 Applied research in the field of national security and law enforcement	N/A	73.95	66.41	64.43	75.49	79.35	92.09	87.07	84.50
0314 Other issues pertaining to national security and law enforcement	N/A	8.26	50.71	39.95	56.32	68.37	67.94	78.29	30.41
0400 NATIONAL ECONOMY	N/A	0.05	0.02	0.44	0.64	0.55	1.56	1.94	2.70
0411 Applied research in the field of national economy	N/A	–	–	5.23	5.84	4.49	5.61	12.07	15.24
0412 Other aspects of the national economy	N/A	0.12	0.06	< 0.01	0.31	0.72	4.47	2.22	2.69
0500 HOUSING AND UTILITIES	N/A	–	3.42	0.85	6.96	10.09	19.26	19.75	11.22
0501 Housing	N/A	–	4.22	5.69	15.97	12.91	20.79	25.04	15.02
0700 EDUCATION	–	2.76	2.69	2.39	2.55	3.06	3.59	4.30	3.21
0701 Pre-school education	–	2.03	2.17	2.44	2.48	2.45	3.91	5.00	3.58
0702 General education	–	1.51	1.91	2.14	2.00	2.75	3.45	0.59	0.20
0704 Vocational education	–	1.06	1.03	1.02	0.86	0.99	–	–	–
0705 Training, retraining and continuing education	–	16.85	15.78	17.22	1.80	2.54	9.40	18.50	8.27
0706 Graduate and post-graduate professional education	–	3.15	2.93	2.53	3.08	3.64	4.08	5.32	4.18
0709 Other educational issues	–	0.30	0.33	0.28	0.29	0.48	0.61	0.26	0.26
0800 CULTURE, FILM-MAKING, MEDIA	–	0.17	0.17	0.21	0.17	0.18	0.17	–	–
0800 CULTURE AND FILM-MAKING	–	–	–	–	–	–	–	0.12	0.12
0801 Culture	–	0.14	0.10	0.16	0.10	0.14	0.09	0.14	0.14
0804 Periodical Printing & Publishing	–	13.46	7.45	2.57	2.62	3.14	3.59	–	–
0806 Other issues in the field of culture, film-making and mass media	–	0.02	0.15	–	–	–	–	–	–

¹ Not applicable due to changes in the structure of the budget classification.

cont'd

1	2	3	4	5	6	7	8	9	10
0900 PUBLIC HEALTH, PHYSICAL EDUCATION AND SPORTS	–	4.30	3.99	2.57	4.14	3.54	3.01	–	–
0900 PUBLIC HEALTH	–	–	–	–	–	–	–	2.60	2.39
0901 Inpatient care	–	5.61	4.66	2.94	3.24	2.77	2.41	2.32	2.01
0902 Outpatient care	N/A	N/A	N/A	N/A	13.94	4.34	3.75	2.70	2.90
0905 Health improvement care	N/A	N/A	N/A	N/A	14.07	15.88	10.73	11.67	10.99
0907 Sanitary and epidemiological welfare	N/A	N/A	N/A	N/A	2.09	0.63	0.64	0.70	1.04
0908 Physical education and sports	–	0.28	0.26	0.24	0.42	0.32	0.62	–	–
0910 Other issues in the areas of public health, physical education and sports	–	–	–	–	1.74	1.07	1.01	–	–
0910 Other public health issues	–	–	–	–	–	–	–	0.43	0.30
1000 SOCIAL POLICY	–	–	–	–	0.01	0.01	–	–	0.06
1003 Social welfare of the population	–	–	–	–	0.02	0.02	–	–	0.24
1100 PHYSICAL EDUCATION AND SPORTS	–	–	–	–	–	–	–	0.26	0.29
1101 Physical education	–	–	–	–	–	–	–	53.51	41.53
1200 MASS MEDIA	–	–	–	–	–	–	–	0.27	0.27
1202 Periodical Printing & Publishing	–	–	–	–	–	–	–	3.38	3.15
1400 INTER-BUDGET TRANSFERS TO BUDGETS OF THE RUSSIAN REGIONS AND GENERAL-PURPOSE MUNICIPAL ENTITIES	–	–	–	0.16	–	–	–	–	–
1401 Subsidies to equalise the fiscal capacity of the Russian regions and municipal entities	–	–	–	0.50	–	–	–	–	–

Source: Federal budgets for 2004–2011, 2012 – the draft dated 30.09.2011 and Federal Law No. 247-FZ dated 3.12.2012. Data for 2004-2010 are normalised to the relevant sections and subsections of the budget classification effected in 2011. The italicised data represent the data of the previously applied budget classification and estimates subject to confirmation.

The absolute and relative values of the main components of the direct military expenditure of the Russian Federation within the federal budget and their changes relative to 2011 are shown in *Table 35*. Due to the fact that in the final December version of the federal budget law for 2012 and that the reports of the committees and commissions of the Federal Assembly contain no data on federal budget expenditure in the context of the sections and subsections of the expenditure classification, as noted above, the relevant data pertaining to Federal Law No. 371-FZ dated 30 November 2011 are used for 2011, which certainly affected the comparability with the data of previous years. Recalculation of the 2011 prices has been made using the first Rosstat deflator of GDP for 2012 (108.0%).

Table 35

Direct military expenditure of the federal budget under the National Defence Section

Name of the section and subsection	2012, RUR million / the same in 2011 prices	Changes in 2012 as compared to 2011, RUR million / increase, %	The share of allocations, % / changes relative to 2011, pp	
			In the 2012 federal budget	In the GDP
1	2	3	4	5
NATIONAL DEFENCE	1,846,585 1,709,801	172,357 11.21	14.25 0.43	2.96 0.21
Armed Forces of the Russian Federation	1,423,968 1,318,489,661	177,574 15.56	10.99 0.73	2.28 0.24
Preparedness and non-military training	7,316 6,774	74 1.10	0.06 –	0.01 –
Economic preparedness activities	4,895 4,533	–363 –7.41	0.04 –0.01	0.01 –
Preparation and participation in collective security activities and peace-keeping	411 380	–41 –9.65	<0.01 –	<0.01 –

cont'd

1	2	3	4	5
Nuclear weapons complex	27,475 25,440	-1,528 -5.67	0.21 -0.03	0.04 -
Implementation of international obligations in the sphere of military and technical cooperation	4,494 4,161	-286 -6.43	0.03 -0.01	0.01 -
Applied research in the area of national defence	163,080 151,000	-10,346 -6.41	1.26 -0.19	0.26 -0.03
Other issues pertaining to national defence	214,946 199,024	7,272 3.79	1.66 -0.07	0.34 -

Source: Estimates of the Gaidar Institute for Economic Policy.

Military allocations under other sections of the federal budget are shown in *Table 36* (estimated amounts of secret allocations made on the basis of the draft law on the federal budget are italicised).

Table 36

Direct and indirect military allocations under other sections of the federal budget

Name of the section or nature of the allocation	2012, RUR million / the same in 2011 prices	Changes in 2012 as compared to 2011, RUR million / increase, %	The share of allocations, % / changes relative to 2011, pp	
			In the 2012 federal budget	In the GDP
1	2	3	4	5
In the National Security and Law Enforcement Section				
Internal troops	118,858 110,053	36,828 50.29	0.92 0.26	0.19 0.06
Border guard agencies	84,527 78,266	-3,887 -4.73	0.65 -0.09	0.14 -0.01
<i>MOE forces and civil defence</i>	53,846 49,857	-1,161 -2.28	0.42 -0.04	0.09 -0.01
In the National Economy Section				
Organisation of alternative civil service	6 6	= -7.41	<0.01 -	<0.01 -
<i>Presidential programme "Destruction of chemical weapons stockpiles in the Russian Federation"</i>	740 685	-84 -10.88	0.01 -	<0.01 -
Subsidies to transport organisations acquiring the vehicles to replenish the rolling stock of military ground convoys.	55 51	-4 -7.41	<0.01 -	<0.01 -
Subsidies to the operation of the NATO-Russia Council.	49 45	13 39.11	<0.01 -	<0.01 -
Construction of special and military facilities.	11,767 10,895	-538 -4.70	0.09 -0.01	0.02 -
<i>FTP "Industrial disposal of weapons and military equipment (2011-2015)"</i>	101 93	2 2.71	<0.01 -	<0.01 -
<i>Contributions to authorised capitals and subsidies to organisations in the military-industrial complex.</i>	54,404 48,522	17,195 54.89	0.40 0.12	0.08 0.03
Scholarships to young employees of the military-industrial complex organisations	240 225	-9 -3.89	<0.01 -	<0.01 -
<i>Secret expenditure</i>	48,389 44,804	10,807 31.79	0.37 0.07	0.08 0.02
In the Housing and Utilities Sections				
<i>Presidential programme "Destruction of chemical weapons stockpiles in the Russian Federation".</i>	566 524	-135 -20.47	<0.01 -	<0.01 -
<i>Service and permanent housing for servicemen</i>	60,013 55,568	-70,776 -56.02	0.46 -0.67	0.10 -0.13

cont'd

1	2	3	4	5
<i>Secret expenditure</i>	<u>15,250</u> 14,120	<u>-28,628</u> -66.97	<u>0.12</u> -0.27	<u>0.02</u> -0.05
In the Education Section				
<i>Expenditure of the Defence Ministry</i>	<u>58,229</u> 53,916	<u>6,118</u> 12.80	<u>0.45</u> 0.02	<u>0.09</u> 0.01
<i>Secret expenditure</i>	<u>19,378</u> 17,943	<u>-4,523</u> -29.13	<u>0.15</u> -0.05	<u>0.03</u> -0.01
In the Culture and Film-making Section				
<i>Expenditure of the Defence Ministry</i>	<u>1,913</u> 1,772	<u>-719</u> -28.87	<u>0.01</u> -0.01	<u><0.01</u> -
<i>Secret expenditure</i>	<u>102</u> 95	<u>-113</u> -54.44	<u><0.01</u> -	<u><0.01</u> -
In the Public Health Section				
<i>Expenditure of the Defence Ministry</i>	<u>39,587</u> 36,655	<u>-2,285</u> -5.87	<u>0.31</u> -0.04	<u>0.06</u> -0.01
<i>Secret expenditure</i>	<u>40,148</u> 37,174	<u>-3,819</u> -9.32	<u>0.31</u> -0.06	<u>0.06</u> -0.01
In the Social Policy Section				
<i>Pensions for the Defence Ministry</i>	<u>251,991</u> 236,390	<u>86,791</u> 58.02	<u>1.94</u> 0.60	<u>0.40</u> 0.14
<i>Pensions for the border guard, internal troops of the MOI, and MOE troops</i>	<u>28,398</u> 26,640	<u>-1,503</u> -5.34	<u>0.22</u> -0.03	<u>0.05</u> -
Financial security for specialists in the nuclear weapons complex of the Russian Federation	<u>5,745</u> 5,389	<u>295</u> 5.79	<u>0.04</u> -	<u>0.01</u> -
<i>Housing for retired and discharged servicemen</i>	<u>20,724</u> 19,189	<u>-581</u> -2.94	<u>0.16</u> -0.02	<u>0.03</u> -
Additional monthly financial support for those disabled as a result of war injuries.	<u>625</u> 586	<u>-454</u> -43.66	<u><0.01</u> -	<u><0.01</u> -
Repairs to individual houses belonging to families who have suffered the military loss-of-bread-winner.	<u>607</u> 562	<u>255</u> 83.18	<u><0.01</u> -	<u><0.01</u> -
Compensation to families of deceased servicemen	<u>1,403</u> 1,316	<u>70</u> 5.65	<u>0.01</u> -	<u><0.01</u> -
Benefits and compensation for military personnel, persons equivalent to them and retired	<u>8,799</u> 8,236	<u>-409</u> -4.73	<u>0.07</u> -0.01	<u>0.01</u> -
Lump sum benefits for pregnant wives of conscripted servicemen and a monthly allowance for the children of conscripted servicemen	<u>2,372</u> 2,226	<u>-13</u> -0.56	<u>0.02</u> -	<u><0.01</u> -
In the Physical Education and Sports Section				
<i>Expenditure of the Defence Ministry</i>	<u>98</u> 90	<u>90</u> -	<u><0.01</u> -	<u><0.01</u> -
<i>Secret expenditure</i>	<u>117</u> 108	<u>-1</u> -0.99	<u><0.01</u> -	<u><0.01</u> -
In the Mass Media Section				
<i>Expenditure of the Defence Ministry</i>	<u>1500</u> 1389	<u>-111</u> -7.41	<u>0.01</u> -	<u><0.01</u> -
<i>Secret expenditure</i>	<u>177</u> 164	<u>-4</u> -2.67	<u><0.01</u> -	<u><0.01</u> -
In the Inter-budget transfers to the budgets of Russian regions and general-purpose municipal entities Section				
Grants to the Closed Administrative-Territorial Entity budgets	<u>8,876</u> 8,219	<u>-657</u> -7.41	<u>0.07</u> -0.01	<u>0.01</u> -
Development and support of the social and physical infrastructure of the Closed Administrative-Territorial Entities	<u>2,690</u> 2,491	<u>-199</u> -7.41	<u>0.02</u> -	<u><0.01</u> -
Resettlement of citizens from the Closed Administrative-Territorial Entities	<u>527</u> 488	<u>-39</u> -7.41	<u><0.01</u> -	<u><0.01</u> -

Source: Estimates of the Gaidar Institute for Economic Policy. Pensions, benefits, compensation and scholarships deflated by CPI.

As a result, the direct military allocations (see *Table 37*) of the Russian federal budget, calculated in accordance with the UN military expenditure standard in 2012, are estimated at 4.0% of GDP, and total military allocations based on the costs associated with past military activities (military pensions, destruction of chemical weapons, etc.) at 4.5% of GDP.

Table 37

The totals of military and related allocations from the federal budget

Allocation	Allocation amount, RUR million	The share of allocations, % / changes relative to 2011, pp	
		In the 2012 federal budget	In the GDP
General direct military allocations	2,464,803	19.02 -0.37	3.95 0.09
Total direct and indirect military allocations related to current and past military activities	2,787,381	21.51 0.15	4.47 0.21
Total allocations under the National Defence, National Security and Law Enforcement Sections	3,672,973	28.35 3.35	5.89 0.91

Source: Estimates of the Gaidar Institute for Economic Policy.

A peculiarity of federal budget implementation in 2012 as compared to the previous year was the surge in expenditure under Section 02s00 "National Defence" at the beginning of the year, and the February expenditures were comparable to the December ones (RUR 330 billion and RUR 357 billion, respectively). Under the consolidated federal budget breakdown the greatest excess of the expenditure limit over the allocations under the law on the budget for this Section was only RUR 3 billion in June, and by the year-end our estimated breakdown value was even lower than the statutory RUR 33 billion, revealing problems related not only to budget planning.

In general, the expenditures under Section 0200 "National Defence" were implemented using the savings of RUR 52,487 million (2.8%) relative to the allocations set in the June version of the law on the federal budget and RUR 19,900 million (1.1%) with respect to the consolidated budget plan.

The savings from the federal budget under Subsection 0201, "Armed Forces of the Russian Federation" (which finances the major part of the state defence procurement of the Russian Defence Ministry) relative to the allocations under the initial version of the law on the federal budget dated 30 November 2011 were RUR 73,985 million (5.2%) and RUR 5,179 million (0.4%) with respect to the limit under the consolidated budget plan. In this case, the Ministry of Defence saved RUR 19.48 million (5.4%) on military pay, and pay rises, which is quite remarkable in connection with the declared three-times wage increase in 2012, as the increase was only 28% (20% in real terms based on CPI) as compared to the previous year.

The actual cost of housing construction in 2012 by the Ministry of Defence under the heading of "National Defence" decreased by 52% to RUR 7,295 million as compared to the previous year, while the section "Housing and Utilities" increased by 18% (up to RUR 117,900 million). What has raised hackles is that the additional allocation of RUR 67,319 million for the construction of housing for servicemen during the last federal budget adjustments was made under federal law No. 247-FZ dated 3 December 2012, i.e. less than a month before the end of the year. Federal expenditure on the savings and mortgage system of housing for Defence Ministry servicemen increased by 49% to RUR 44,272 million compared to the previous year.

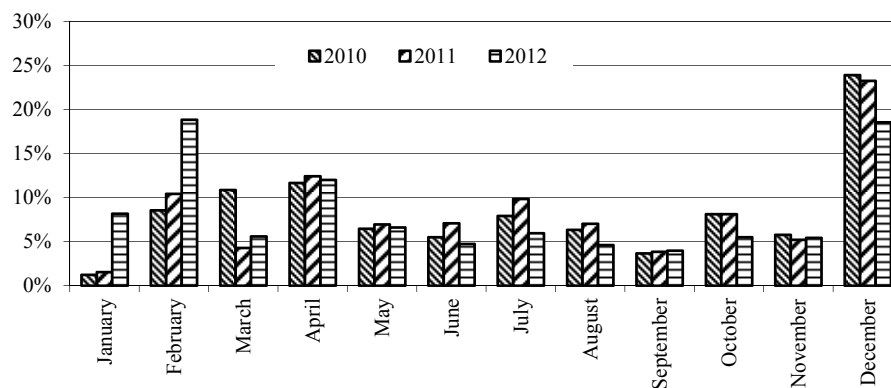
The expenditure of the Defence Ministry on fuel and lubricants (F&L) in 2012 increased by 12.5% to RUR 57,999 million with savings of RUR 1 billion (or 1.8%) relative to the amount allocated under the original version of the budget law. In this case, the Ministry of

Defence could not completely place its orders in the market, and the Government had to resort to compulsory quotas to facilitate the purchase of 42% of the annual demand for F&L products, which actually remained at the level of the previous year.

Federal budget expenditure on food procurement by the Ministry of Defence in 2012 decreased by 14% to RUR 43,035 million and the expenditure on clothing increased by 29% to RUR 16,241 million. Budget savings under these two expenditure items amounted to RUR 4,880 million compared to the original version of the budget law.

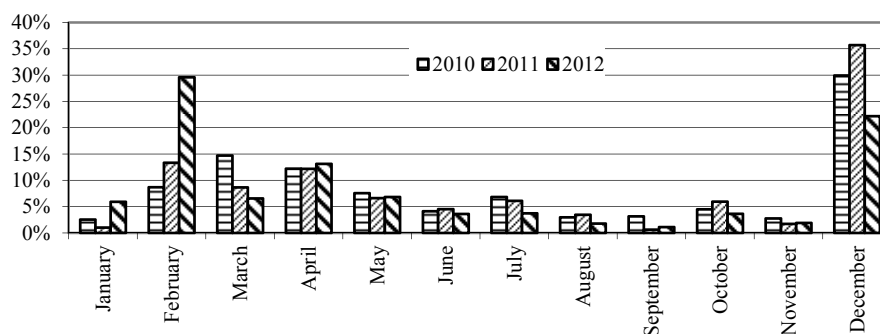
As regards Section 0200 "National Defence", most attention has been paid to the expenditures under Subsection 0209 "Other aspects of national defence" due to their rapid growth - the increase amounted to 32% (up to RUR 253,345 million) compared to the previous year. The excess of budget expenditure relative to the original version of the budget law was RUR 38,399 million, or 18%. The part of the Ministry of Finance reserves funded by this Subsection (TF 2026700) increased by a factor of five, from RUR 6,600 million to RUR 32,536 million over the period between the first and the latest version of the budget law. Incidentally, the December 2012 report of the Federal Treasury regarding the purpose of the budget for this item refers only to RUR 3,392 million, and it remained unused.

The performance of the monthly implementation of expenditure under the major subsections of Section 0200 "National defence" of the federal budget in 2010-2012 is shown in *Fig. 26-28*.



Source: Estimates of the Gaidar Institute for Economic Policy based on Federal Treasury data.

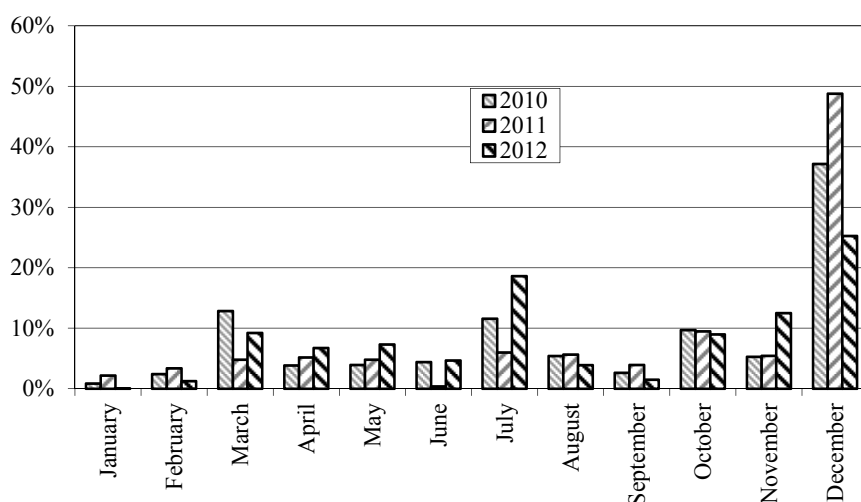
Fig. 26. Implementation of federal budget expenditure under the Subsection "Armed Forces of the Russian Federation" in 2010-2012



Source: Estimates of the Gaidar Institute for Economic Policy based on Federal Treasury data.

Fig. 27. Implementation of federal budget expenditure under the Subsection "Applied research in the area of national defence" in 2010-2012

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Source: Estimates of the Gaidar Institute for Economic Policy based on Federal Treasury data.

Fig. 28. Implementation of federal budget expenditure under the Subsection "Other aspects of national defence" in 2010-2012

Table 38 show the military expenditures of those government entities of the regions of the Russian Federation which maintain long-term trends.

Table 38

Military expenditures of the consolidated budgets of the Russian regions in 2004-2012, RUR million*

Subdivision of the expenditure classification	2004	2005	2006	2007	2008	2009	2010	2011	2012
Armed Forces of the Russian Federation	–	–	$\frac{3.5}{0.1}$	$\frac{0.5}{0.3}$	$\frac{0.3}{0.3}$	–	–	–	–
Improvement of the Russian armed forces and military units	–	–	–	–	$\frac{1.0}{0.5}$	–	–	–	–
Preparedness and non-military training	–	$\frac{65.6}{65.6}$	$\frac{899.3}{808.6}$	$\frac{1,351.9}{1,245.6}$	$\frac{1,797.9}{1,702.2}$	$\frac{2,116.0}{2,021.6}$	$\frac{2,003.7}{1,958.4}$	$\frac{2,250.0}{2,187.3}$	$\frac{2,366.7}{2,316.4}$
Economic preparedness activities**	$\frac{532.4}{500.6}$	$\frac{485.4}{468.6}$	$\frac{708.3}{692.8}$	$\frac{861.2}{840.9}$	$\frac{1,137.2}{1,063.9}$	$\frac{1,045.4}{989.7}$	$\frac{1,298.4}{1,247.8}$	$\frac{1,351.2}{1,266.3}$	$\frac{1,781.0}{1,689.1}$
Other issues pertaining to national defence	–	$\frac{109.6}{97.5}$	$\frac{32.8}{32.1}$	$\frac{5.5}{5.7}$	$\frac{0.7}{0.5}$	$\frac{4.4}{4.4}$	$\frac{<0.1}{<0.1}$	$\frac{2.7}{2.7}$	$\frac{3.2}{3.0}$
Internal troops	$\frac{12.4}{12.2}$	$\frac{9.9}{9.9}$	$\frac{3.5}{1.4}$	$\frac{1.0}{1.0}$	$\frac{0.3}{0.3}$	–	–	–	–
Security agencies	$\frac{6.7}{6.5}$	$\frac{0.3}{0.3}$	$\frac{16.5}{16.5}$	$\frac{0.1}{0.1}$	$\frac{0.0}{0.0}$	$\frac{60.0}{60.0}$	$\frac{<0.1}{<0.1}$	$\frac{14.5}{14.4}$	–
Border guard agencies	–	$\frac{0.1}{0.1}$	–	–	–	–	–	–	–
Protection of the population and territories from natural and man-made disasters, civil defence	$\frac{7,968.2}{7,281.3}$	$\frac{11,184.6}{10,958.9}$	$\frac{15,636.4}{14,367.0}$	$\frac{19,118.4}{18,292.6}$	$\frac{23,895.8}{21,456.7}$	$\frac{23,865.0}{21,712.6}$	$\frac{27,218.0}{25,527.4}$	$\frac{34,678.1}{32,122.9}$	$\frac{40,372.2}{37,373.5}$

* Numerator – allocated; denominator – actually implemented.

** Until 2005, this subsection was not included in the National Defence Section.

Source: Federal Treasury.

Table 39 shows Russian military expenditure for 1999–2012, excluding the expenditures of the consolidated regional budgets of the Russian Federation shown in *Table 38*, in order to avoid double estimates.

Table 39

Key indicators of military expenditure of the Russian Federation in 1999–2012

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1. In nominal terms (current prices), RUR billion														
Implementation of the FB expenditure under the heading of "National Defence" 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	1,812.3
FB allocations under the heading of "National Defence": in the current budget classification but transferred to other budget classification sections ^b	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	1,864.8
in the 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	2,101.9
Military expenditure based on 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	–	–
General 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	2,464.8
Total direct and indirect military allocations related to current and previous military actions ^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	2,787.4
2. In real terms (in 2012 prices)^f, RUR billion														
Implementation of the FB expenditure under the heading of "National Defence" in the current budget classification.	1,301.9	1,391.4	1,350.6	1,369.5	1,352.8	1,395.4	1,529.5	1,454.2	1,523.0	1,553.0	1,610.2	1,621.3	1,702.4	1,812.3
FB allocations under the heading of "National Defence": in the current budget classification but transferred to other budget classification sections	1,055.4	1,520.0	1,170.5	1,317.4	1,349.8	1,386.9	1,522.2	1,463.5	1,536.2	1,539.2	1,616.6	1,623.2	1,726.5	1,864.8
in the comparable budget classification.	1,055.4	1,520.0	1,170.5	1,317.4	1,349.8	1,386.9	1,638.7	1,629.2	1,703.4	1,727.9	1,890.9	1,967.1	2,090.9	2,101.9
Military expenditure based on UN data	–	1,470.6	1,605.3	1,511.1	1,700.2	1,619.2	1,750.2	1,753.4	1,556.6	1,681.8	1,594.3	1,497.8	1,611.5	–
General direct military allocations	1,361.1	1,858.4	1,429.6	1,489.8	1,553.2	1,593.1	1,821.5	1,919.0	1,987.2	2,024.0	2,239.8	2,310.5	2,422.4	2,464.8
Total direct and indirect military allocations related to current and previous military actions	1,548.7	2,135.8	1,708.8	1,989.6	2,115.6	1,903.5	2,074.5	2,133.0	2,312.9	2,241.7	2,469.6	2,548.7	2,667.4	2,787.4
3. In real terms (in 1999 prices), RUR billion														
Implementation of the FB expenditure under the heading of "National Defence" 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	143.0	144.0	151.2	160.9
FB allocations under the heading of "National Defence": in the current budget classification but transferred to other budget classification sections	93.7	135.0	103.9	117.0	119.8	123.1	135.2	129.9	136.4	136.7	143.5	144.1	153.3	165.6
in the comparable budget classification.	93.7	135.0	103.9	117.0	119.8	123.1	145.5	144.7	151.2	153.4	167.9	174.7	185.6	186.6
Military expenditure based on UN data	–	130.6	142.5	134.2	151.0	143.8	155.4	155.7	138.2	149.3	141.9	133.0	143.1	–
General direct military allocations	120.9	165.0	126.9	132.3	137.9	141.4	161.7	170.4	176.4	179.7	198.9	205.1	215.1	218.8
Total direct and indirect military allocations related to current and previous military actions	137.5	189.6	151.7	176.6	187.8	169.0	184.2	189.4	205.4	199.0	219.3	226.3	236.8	247.5
4. Military burden on the economy, % of GDP														
Implementation of the FB expenditure under the heading of "National Defence" 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	2.76	2.72	2.91
FB allocations under the heading of "National Defence": in the current budget classification but transferred to other budget classification sections	1.94	2.87	2.40	2.63	2.69	2.51	2.68	2.55	2.52	2.50	3.07	2.76	2.76	2.99
in the 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	3.34	3.34	3.37
Military expenditure based on UN data	–	2.77	3.29	3.01	3.38	2.93	3.08	3.05	2.56	2.73	3.03	2.55	2.57	–
General 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	3.93	3.87	3.95
Total direct and indirect military allocations related to current and previous military actions	2.85	4.03	3.50	3.97	4.21	3.44	3.65	3.72	3.80	3.64	4.70	4.33	4.26	4.47
5. Based on the purchasing power parity (in current prices), USD billion														
Implementation of the FB expenditure under the heading of "National Defence" 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	82.1	80.0	83.8	99.3
FB allocations under the heading of "National Defence": in the current budget classification but transferred to other budget classification sections	17.7	29.3	26.2	30.7	34.1	35.9	45.4	54.3	60.1	71.9	82.4	80.1	84.9	102.1
in the comparable budget classification.	–	–	–	–	–	–	3.5	6.2	6.5	8.8	14.0	17.0	17.9	13.0

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1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
in the comparable budget classification.	17.7	29.3	26.2	30.7	34.1	35.9	48.9	60.5	66.6	80.8	96.4	97.0	102.9	115.1
Military expenditure based on UN data	—	28.3	35.9	35.2	42.9	42.0	52.2	65.1	60.9	78.6	81.3	79.3	79.3	—
General direct military allocations	22.8	35.8	32.0	34.7	39.2	41.3	54.3	71.2	77.7	94.6	114.2	114.0	119.2	135.0
Total direct and indirect military allocations related to current and previous military actions	26.0	41.2	38.3	46.3	53.4	49.3	61.9	79.2	90.4	104.8	125.9	125.7	131.2	152.6
For reference														
Deflator of GDP,% YoY	172.5	137.6	116.5	115.5	113.8	120.3	119.3	115.2	113.8	118.0	102.0	114.2	115.5	108.0
Deflator of final consumption expenditure of government managed public services ^g , % YoY	140.1	155.2	133.1	117.6	121.9	117.2	123.3	123.4	116.5	122.7	110.1	106.7	113.1	112.3
Purchasing power parity ^h , RUR/USD	5.29	7.15	8.19	9.27	10.41	11.89	12.74	12.63	13.97	14.34	14.47	15.96	18.10	18.26

^a For 2012 – Preliminary data on the federal budget implementation of the Federal Treasury.

^b Total expenditure of the Defence Ministry and secret expenditures under sections 05-09 and 11 of the federal budgets for 2005-2011., for 2012 - in addition to section 12.

^c For 2012 – to be provided by the Government of the Russian Federation to the United Nations in 2013, including the expenditure on the procurement of interior troops, border guards and civil defence.

^d Including for the procurement of internal troops, border guards and civil defence troops.

^e Including military pensions.

^f Deflated by the deflator for final consumption expenditure for government managed public services.

^{g, h} For 2012 – IEP estimates.

Source: Federal laws on the federal budget for 2000-2012 and on federal budget implementation 2000-2011, National Accounts of Russia for 1997-2011: Statistical Abstract / Rosstat. Moscow, 2005-2012; Objective information on military matters, including the transparency of military expenditure. UN Secretary General reports, 2001-2012; Rosstat; Federal Treasury.

* * *

The military economy of Russia, which was intended to ensure the completion of a radical military reform and to create a fundamentally new image of our armed forces, by bringing them up to the standard of the five best armies in the world, was mishandled in 2012. The statement made by Dmitry Medvedev before the return to Vladimir Putin of the authority of Supreme Commander: that the planned military reform was successfully completed and that the tasks started by him and put to the Ministry of Defence were largely resolved - was hasty.

At a meeting with his authorised representatives on 10 December 2012 Vladimir Putin said of the military reforms: "based on the fundamental, basic conditions developed in 2005-2006, the reform must continue." And he repeated the requirement, stated several times before, that "the army should be compact, it must meet a number of parameters: it should certainly ensure the safety of the country and should be appropriate for our economy"¹.

However, substantially to reform the army, these general guidelines are not enough.

If we look at it in general terms, the main reason for the failures of the military reform implemented before late 2012, was that it was closed to public scrutiny and lacked control over the actions of senior officials in the Defence Ministry, as well as their subordinates. Many of them were not aware of the specifics of military organisation and did not consider them carefully. The quantity of money and goods allocated to them was enormous, and provided the temptation for embezzlement. In these conditions, the low morality of a number of officials led them to a series of abuses and crimes.

¹ Meeting with authorised representatives. Transcript. Moscow, 10 December 2012. URL: <http://www.kremlin.ru/news/17108> (visited on 11 December 2012).

The most important military, economic and legal lesson is that the availability of the budget of the Ministry of Defence, and the Defence Ministry estimate, separately approved by the Minister, plus the simultaneous existence of budgetary and extra-budgetary funds available to Ministry of Defence officials for virtually unchecked disposal, inevitably led to economic crimes. Another contributing factor was the wrongful classification of these assets as a result of incorrect interpretation of the law.

Returning to the effects of the fire on the FBMS "Yekaterinburg", we should note that other factors were also involved there too, instead of the allocation of all the resources to the early recovery of the affected missile carrier as would normally have been expected. In 2012, only RUR 6 million was allocated to conduct an inspection of the affected FBMS. The estimated cost of repairs (about RUR 1 billion) is to be carried forward. It is promised that only by 2014 will the submarine be ready to return to the Northern Fleet.

6.7. North Caucasus in 2012: results and risks

6.7.1. Investment projects and the interests of local communities

In December 2012, the Russian government adopted the "Programme for the Development of the North Caucasus Federal District (NCFD) up to 2025" (hereinafter referred to as the Programme). The total funding up to 2020 was approved at a level of 2.55 trillion RUR, and it was determined that the state budget would provide 10% of the funds, while 90% should be made up from investor funds. Note that this proportion is roughly consistent with the principle of distribution of budgetary and non-budgetary finance adopted earlier for some of the projects implemented under the Programme. Thus, of the total costs of holiday resort construction projects in the North Caucasus, 60 billion rubles out of 510 billion rubles will be financed from the budget (through the project operator: Resorts of the North Caucasus JSC (with a 98% stake owned by the Government of the Russian Federation). The State has systematically demonstrated its goal to ensure the economic development of the North Caucasus mostly through investors. They are granted tax benefits, if they register in the new special economic zones (SEZ) created in the North Caucasus, as well as government guarantees on loans granted on an individual competitive basis.

However, particular steps taken in 2012 for the implementation of investment projects in the regions of the North Caucasus Federal District (NCFD) show that a key challenge for the creation of new businesses in the North Caucasus is not the search for investors, but the social implications of the future project development. In some cases, new enterprises acquire land which was previously, in one form or another, controlled by the local communities. Moreover, the launch of new businesses will significantly change the economic traditions of the areas where they are created. Below, we consider the impact of a number of investment projects implemented in the North Caucasus Federal District on the economic situation for the local population with particular examples, and then describe the political risks arising from these impacts.

In principle, the major new projects implemented in the North Caucasus, can have both positive and negative consequences for the local people. The positive effects may include the creation of new jobs for residents of the North Caucasus republics and the creation of a market for the services that local business will provide to the new businesses. Negative effects may occur if new companies invade the established local market, depriving its members of

certain economic opportunities, or that the land formerly used by local people for their own purposes (or at least considered as their "own") is acquired by new projects.

We are not aware of any examples of completed or projected enterprises, which would be developed through an appropriate strategy of economic interaction with the local population. All the examples rather suggest that at this time there is no such strategy in for this.

One example is the construction project for the AgroDagItaliya agricultural industrial park in the Babayurt Region of Dagestan, where the shareholders of the company are structures affiliated with certain Dagestani businessmen (the total cost of the project is about 14 billion RUR)¹. This industrial park is to combine several types of production, including arable, cattle and poultry businesses. In general, the industrial park is expected to create about 16,000 jobs. 46,642 people live in the municipalities of the Babayurt Region (1 January 2011). The Region is characterised by active labour migration to the "oil" regions of Western Siberia (general statistics on the level of this migration are not available, but in the individual villages local residents estimate the proportion of men aged between 20 and 40 working in Siberia as 30-40%). Since the Tyumen Region, the Yamal-Nenets Autonomous District and Ugra are amongst the regions leading the Russian Federation in terms of wages, it is difficult to believe that a large number of residents working "in the North" are ready to change jobs to become farms workers in Dagestan, one of the outsiders in the "Salary ratings" of the Russian regions. This means that it will be impossible to provide the necessary number of employees for the newly created industrial park from residents of the Babayurt Region. The "Labour Reserves" may include people from the so-called transhumance lands, i.e. the land which in Soviet times was provided for farming on the mountain plateaux and where the current status is regulated by a special republican law². At least thirty villages are located within the boundaries of the Babayurt Region, being the municipal communities of the Dagestan mountains and others without any municipal status. According to the National Population Census 2010, the total population of these villages in the Babayurt Region is estimated at 25,579 people. Labour mi-

¹ Osnovately "Summy" Vozvrashayutsia v Dagestan // Ekspert-Yug, (Summa founders return to Dagestan // Expert South, No. 44-45(234), November 5, 2012) (<http://expert.ru/south/2012/45/osnovateli-summyi-vozvrashayutsya-v-dagestan/>).

² For additional information on the transhumance lands see: K. Kazenin. Elementy Kavkaza: zemlia, vlast I ideologia v severokavkazskikh respublikakh. M.: REGNUM. 2012. P. 28–33. O protsesse pereseleniya gortsev na dagestanskuyu ravninu see: Yu.Yu. Karpov. Pereselenie gortsev Dagestana na ravninu: k istorii razvitiya prostessa I sotsiokulturnym ego posledstviyam // Yu.Yu. Karpov. Traditsii narodov Kavkaza d meniyuschemsia mire. СПб.: Peterburgskoe vostokovedenie. 2010. P. 402–447; M.-P.A. Ibragimov. Etnodemograficheskaya situatsiya v Dagestane v posledney treti XX – nachale XXI veka // Vestnik Dagestanskogo nauchnogo tsentra RAN. № 34. 2009. P. 48–56; A.I. Osmanov. Agrarnye preobrazovania v Dagestane I pereselenie gortsev na ravninu (20–70-e gody XX veka). Makhachkala. 2000; Yu.Yu. Karpov, E.L. Kapustina. Gortsy posle gor. Migratsionnye protsessy v Dagestane v XX – nachale XXI vekov.: ikh sotsialnie I kulturnie posledstvia I perspektivy. Sankt-Peterburg: Peterburgskoe vostokovedenie. 2011. (K. Kazenin. The elements of the Caucasus: land, power and ideology in the North Caucasus Republics. M.: REGNUM. 2012. P. 28-33. On the process of resettlement of highlanders to the Dagestani plains see: Yu.Yu. Karpov (ed.). Resettlement of Dagestani highlanders to the plain: the history of the process development and its social and cultural implications // Yu.Yu. Karpov (ed.). Traditions of the Caucasian peoples in a Changing World. S.-Pb.: Petersburg Orientalism. 2010. P. 402-447, M.- R.A. Ibragimov. Ethnic and demographic situation in Dagestan in the last third of the XXth - early XXI century // Bulletin of the Dagestan Scientific Center, Russian Academy of Sciences. No. 34. 2009. P. 48-56; A.I. Osmanov. Agrarian reforms and resettlement of Dagestani highlanders to the plain (20-70-ies of the XXth century). Makhachkala. 2000; Yu.Yu. Karpov, E.L. Kapustina. Highlanders after the mountains. Migration processes in Dagestan in the XX - early XXI century: Their social and ethno-cultural implications and prospects. St. Petersburg: Petersburg Orientalism. 2011.)

gration from these villages to regions with high wages is low: according to the local administration of Tsadakh village in the Babayurt Region (part of the mountainous Charodinsky District) with a total population of about 750, only 20-30 people work in Western Siberia (generally in Dagestan, it is the Nogai, Kumyks and Lezgins who migrate actively to Western Siberia, while the Avars and Laks who comprise the majority in the area within the boundaries of the Babayurt Region transhumance lands are less involved in the process). Thus, a massive changeover to employment in the new enterprise by the transhumance land dwellers is more likely than such a change for the residents of the Babayurt Region. However, if the situation does not change, the launch of the agricultural industrial park may exacerbate the existing conflicts in the plains of Dagestan.

As will be shown below, it is the dispute about the transhumance land and the status of villages in this area that has become one of the central themes of life in Dagestan in recent years. The positions on these issues of activists acting on behalf of the indigenous plainsmen and activists acting on behalf of the mountain people, partly moved to the plain in Soviet times, differ significantly. If a significant part of the land in the Babayurt Region is acquired for the project, and mountain residents make up the majority of the people working there, it may intensify the debates between ethnic NGOs.

Another problematic aspect of the project is that it may hinder the economic development of poultry businesses currently existing in Dagestan. According to the project design, the poultry farm, which is intended to be one of the fundamental parts of the industrial park, will produce 50 tons of meat and 650 million eggs a year. Poultry farms which have been operating in Dagestan since Soviet times (particularly in the Buinaksk and Karabudakhkent Regions) have less capacity. Currently, their activities are complicated by conflicts over property rights, but the populations of the villages where the poultry farms are located are showing interest in resolving the disputes and resuming production at the poultry farms, where it has been stopped. Obviously, the launch of a larger poultry project in the neighbourhood may call the very possibility of such a resumption into question. In practice, this will depend on the target market of the new poultry factory - Dagestan (which the "old" poultry farms serve) or an external market. In any case, it is important that the community leaders, acting on behalf of the residents of villages where the poultry farms are located, have assessed the project negatively. For example, during the general meeting of the Cohesion Union of Public Associations (specialises in protecting the interests of the indigenous inhabitants of the Dagestan plains) held in Makhachkala on 31 October 2012 one of the speakers said¹: "I believe that there is no need to build this factory. It would be cheaper, for the Dagestan government to have considered updating the existing poultry farms. The construction of this farm is a source of dissatisfaction for the employees of the existing, non-operational poultry farms which are in need of a certain small amount of investment, as they may lose their jobs and livelihoods."

Thus, despite its attractiveness in terms of scale and the creation of jobs, the industrial park project in the Babayurt Region does not currently seem to have been thought through in respect of its interaction with the local communities and the protection of their interests. Similar problems are characteristic of an even more ambitious investment project implemented in the North Caucasus – the construction of resorts.

This can be illustrated by the Arkhyz resort which is under construction. Commenting on the development in December 2012, the President of the Karachay-Cherkess Republic (KCR) Rashid Temrezov stated that this was supposed to be all-year resort, as the many leisure op-

¹ Minutes of the Meeting courtesy of the author.

tions in the Arkhyz Gorge (rafting, pony-trekking, therapeutic recreation, etc.) may provide for holidays beyond the ski season. The total number of hotel rooms in the the future resort is 24,000. The main question regarding the implications of the resort for the population of the region is related to the prospects of saving the tourist business which already exists in the mountains of the Karachay-Cherkess Republic. Currently, Arkhyz without any operable skiing infrastructure is able simultaneously to accommodate about 1,000 tourists; the main accommodation locations being health resorts left over from the Soviet era (partially owned by companies located outside of the region) and private mini-hotels. The Dombay Ski resort located in the adjacent valley can accommodate up to 5,000 tourists, mostly in private hotels with 10-15 to 300 rooms¹. Given the instability in the North Caucasus, entrepreneurs operating in the KCR tourist industry do not predict a significant increase in the total number of tourists coming to the region. This means that the businesses now engaged in the tourism sector will have to compete for tourists with a new infrastructurally more developed resort. And, to our knowledge, there are no proposed options for the development of the local tourist industry in cooperation with the new resort.

There are also no schemes for local participation in the food supply chain for the future resort. The level of meat production in the KCR is such that it easily covers the needs of the existing resorts. For example, the annual demand for mutton at the Dombay resort, estimated at about 5,000 animals, corresponds to the current volume of production in only in the Teberdinsky Valley adjacent to the resort. However, if the Arkhyz resort operates throughout the year, regional producers are unlikely to be able to meet its needs. This is the result of the existing animal husbandry arrangements in the KCR.

The fact is, that the local pastures with special herbal content, which affects the quality of the meat, are suitable for grazing for only about five months of the year due to the climatic conditions. The rest of the cattle are stall-fed. According to our field data, the animal housing facilities available to local farmers, as a rule, allow each to take no more than 100-150 animals for fattening. However, a large resort business, as compared, for example, to the small and mid-range Dombay hotels, will obviously be more interested in working with wholesale suppliers who can provide a regular supply with consistent quality. And according to national agricultural entrepreneurs, to provide an uninterrupted monthly supply of at least 500 sheep, a farmer requires a fairly large feeding complex - not yet available in the region. If by the launch of the resort this facility has not been created, then it is likely that Arkhyz managers will give preference to suppliers from other regions.

So, the two large enterprise projects created in the North Caucasus which we have considered, in fact do not offer any form of local community cooperation, and one of these projects could also exacerbate the existing difficulties over cooperation in the land sector. This state of affairs with the administrative support provided to the projects is unlikely to be a barrier to their implementation, but it will have negative political consequences, since the local population will not develop a conscious loyalty to these initiatives of the federal government in the North Caucasus.

¹ For information on the Dombay resort economy see: I.V.Starodubrovskaya, N.V.Zubarevich, D.V.Sokolov, T.P.Intigrinova, N.I.Mironova, H.G.Mahomedov. *Severniy Kavkaz: modernizatsionniy vyzov*. M.: Izdatelskiy dom «Delo» (RANKHiGS). 2011. P.196–234 (I.V. Starodubrovskaya, N.V. Zubarevich, D.V. Sokolov, T.P. Intigrinova, N.I. Mironova, Kh.G. Magomedov. *North Caucasus: the modernization challenge*. Moscow: Delo Publishing House (Russian Presidential Academy of National Economy and Public Administration). 2011. P.196-234).

6.7.2. Renaissance of the national movement in the North Caucasus

In 2012, in some regions of the North Caucasus, especially in Dagestan a noticeable strengthening of national social movements has been observed compared to previous years. Their involvement in local politics is not as important at the moment as in the first years after the collapse of the Soviet Union, but it is much more active than in the mid-2000s.

Formal and informal social movements, positioning themselves as defenders of the interests of a particular ethnic group, first loudly declared themselves in the North Caucasus in the late 1980s - 1990s. Their goals and rhetoric were substantially different from region to region. For example, in the North-West Caucasus (primarily in Kabardino-Balkaria and Karachay-Cherkessia) the national movements raised the question of changing the boundaries between ethnic subjects (in particular, the separation of Balkaria and Karachay) and on the ethnic principles of forming the government¹. In Dagestan the leaders of national movements also paid much attention to the problem of ethnic representation "at the top", but were more interested in the distribution of the disputed land on the plain.

By the mid-2000s, the activity of the national movements had obviously declined in all regions of the North Caucasus. This can partly be explained by the aging of the "agenda" of these movements. The question of changing the boundaries of the regions have not been discussed recently (the last "surge" of discussions took place during the very contentious elections of the President of the KCR in 1999). Ethnic representation of the North Caucasus republics in the government had, in general, stabilised by the middle of the second post-Soviet decade, as a result of specific informal agreements.

A subsequent revival of national movements in the North-West Caucasus occurred in the second half of the 2000s and as a result of specific reasons for each region. So, in the KCR the ethnic community leaders were involved in lobbying for the interests of certain parties in opposition to the regional elite. In the Kabardino-Balkaria Republic (KBR), the resurgence of national movements was connected with the problems which had occurred in the region due to the implementation of the "Federal Law On Local Administration", while the relationship of the national movements to the part of the local elite opposed to the Republican government was also quickly revealed.

The ethnic community structures which asserted themselves in the political life of Dagestan in 2012 are quite clearly divided into *two groups*.

The first group consists of structures desirous of a partnership dialogue with the federal and regional authorities, and of attracting the attention of the federal media. One result of such activities is the acquisition of prominent publicity for the national organisations and the legalisation of the national movements in the eyes of the authorities (the latter may occur without the unconditional support of the national movements by the authorities). Organisations in this group pay less attention to the struggle for power and property at a municipal level, land conflicts, etc.

The second group includes ethnic organisations and movements, which, to the contrary, are focused on protecting the interests of their ethnic groups in the most "local" fields, such as

¹ See I.L.Babich. Sootnoshenie politicheskoy, religioznoy i etnicheskoy identichnosti v sovremennom kabardino-balkarskom obshestve // M.Olkott, A.Malashenko (sost.). Faktor etnokonfessionalnoy samobitnosti v postsovetском obshestve. M.:Karnegi Tsent. 1998. P. 140–165 (I.L. Babich. The ratio of the political, religious and ethnic identity in the modern Kabardino-Balkar society // M. Alcott, A. Malashenko (ed.). Factor of ethnic and religious identity in the post-Soviet society. M.: Carnegie Center. 1998. P. 140-165).

land tenure, local government, etc. These organisations are usually tough opposition for the Republican authorities but have no appreciable access to the federal media.

In 2012, the most prominent organisation of the first group was the *Federal Lezgin National and Cultural Autonomy (FLNCA)*¹. Last year, this organisation put forward some objectives which go beyond the Dagestani interior problems. The FLNCA has paid most attention to the status of Lezgins as a divided nation, after the collapse of the USSR², partly living in the territory of Russia (mainly in areas of southern Dagestan) and partly in the northern part of Azerbaijan. The problems of the Azerbaijani Lezgins, particularly those enclaves in Azerbaijan where Lezgins live, who are Russian citizens (Kharkh-Uba and Uryan-Uba), were the main point of discussion at the recent IV FLNCA Congress held on 9 November 2012 in Moscow³. Criticising the Republican government for the unsatisfactory economic situation in the Lezgin regions of Dagestan, and the federal authorities for the poor protection of the interests of Lezgins in Azerbaijan, the FLNCA nevertheless demonstrated its desire to cooperate both with the Kremlin and the official Makhachkala. For example, in response to a call made by the Presidential Administration, during the November Congress, FLNCA leaders expressed their willingness to intensify their work with the Lezghin diaspora across Russia.

*The Avar National and Cultural Autonomy (NCA)*⁴ also showed certain activity in the federal public arena in 2012. Unlike the FLNCA with the Lezgin, where the community leaders and entrepreneurs living in Moscow constitute its backbone, the Avar NCA is mainly constituted of Avar intellectuals living in Dagestan. In part they moved in the "fairway" of the FLNCA in 2012. For example, in May 2012 the two organisations held a joint conference in Moscow⁵ on the problem of the division of the Caucasian peoples (Avars live in the northern part of Azerbaijan along with the Lezgins). The activities of the Avar NCA cannot but reflect the fact that there are influential municipal Avar administrators in Dagestan, having political ambitions at a Republican level and not always finding a common language with the regional government. In this regard, there was the situation with the failed "Congress of Lezgin and Avar Peoples" planned for October 2012 in the Dagestani town of Khasavyurt, with its head, Saidpasha Umakhanov, being the most prominent representative of the "Avar Club" of municipal heads. He has repeatedly criticised the current government of the region, and at least since the mid-2000s has been considered a potential candidate for the highest office in Dagestan. Information on the preparation of the Congress appeared in the federal media on 24 September 2012 but two days later was denied by the Khasavyurt Mayor's Office⁶. According to our information, the Congress was actually prepared by activists of the Avar NCA, but it has been delayed due to disagreements between the organisers. Whether Umakhanov's team was

¹ Incorporated in 1999 by the National and Cultural Autonomies of Siberian Lezgins, in 2007–2008 it merged with the Dagestani, Moscow and several other National and Cultural Autonomies of Lezgins.

² For additional information see: M.E.Alekseev, K.I.Kazenin, M.Suleimanov. Dagestanskije narody Azerbaidzhana: politika, istoriya, kultura. M.:Evropa. 2006 (M.E. Alekseyev, K.I. Kazenin, M. Suleymanov. Dagestani peoples of Azerbaijan: politics, history, culture. M.: Europe. 2006).

³ Uchastniki syezda FLNKA raskritikovali dogovor Rossii i Azerbaidzhana o gosgranitse // Kavkazskiy uzel, 11 noyabrya 2012 (Members of the FLNCA Congress criticized the treaty on the state border between Russia and Azerbaijan // Caucasian Node, November 11, 2012) (<http://www.kavkaz-uzel.ru/articles/215543/>).

⁴ Registered at local level, it is currently being registered at the federal level.

⁵ V Moskve obsudili problem dagestantsev, prozhivaiushih v Azerbaidzhane (The problems of Dagestan people living in Azerbaijan were discussed in Moscow) // IA REGNUM, May 18, 2012 (<http://regnum.ru/news/1542825.html>).

⁶ Syezd lezgin i avartsev ne budet prokhorit v Khasavyurte (Congress of Lezgin and Avar Peoples will be held in Khasavyurt) // IA REX, September 26, 2012. (<http://www.iarex.ru/news/29496.html>).

involved or not, this situation confirms that the logic of development of the Avar national movement inevitably raises the question of its interaction with the Avar political "heavy-weights".

The *second group* of ethnic organisations primarily serve on land issues. Their work is mainly focused on the support of local communities who have land claims. In 2012, increased activity in this field in Dagestan showed, in particular, the Cohesion Union of Public Associations protecting the interests of the peoples of the plains (primarily Kumyks and Nogai). The ideology of this organisation is based primarily on their criticism of the current status of the transhumance land (on this status, see Section 6.7.1). The Activists of Cohesion argue that the land, with a total area close to 1 million hectares in the Dagestani plain was unfairly taken from the plain regions and the majority of it is not used for its legitimate agricultural purposes, being the source of rent for small groups of officials from the mountainous regions of Dagestan. Opponents of Cohesion, mainly represented in public by the heads of several villages located in the transhumance lands, indicate that the mountain peoples of Dagestan had put a lot of work into the development of these lands during the last Soviet decades, and therefore have no less rights than the plain "autochthons". Along with Cohesion, the public interests of the latter group are protected by ethnic NGOs - Nogai Birlik and Kumyk Tenglik¹.

In 2012, there were at least two notable actions on land issues by the Dagestani plain peoples. Interestingly, in both cases, the transhumance land was not the immediate object of the conflict. In the spring of 2012 residents of three Kumyk settlements in the suburbs of Makhachkala (Alburikent, Kyakhulay and Tarki) started a protest action. They camped on the land to the north of Makhachkala, which, until 1944, had belonged to these villages but has now been sold to private individuals for development². In 1944, the residents of these three villages were resettled on the land left vacant after the deportation of the Chechens; upon the return of the Chechens in 1957, the residents of the villages returned to their homes, but the land to the north of Makhachkala has not been returned to the villages. In the vicinity of the disputed land there is also the territory, which in early 1990 was allocated for the resettlement of residents of the Novolaksk region of Dagestan, where the Chechens claimed their right to the land near the Dagestan-Chechen border.

The camp created in spring 2012 lasted for 2 months, and residents of the settlements later conducted several meetings in the same area. The immediate issue in this case was about 200 hectares of land, which is not going to be used for agricultural purposes either by the current owners or by the villagers. However, representatives of the NGOs, denouncing the existing system of land relations in the Dagestan plain, in general supported the protests and participated in the negotiations between the organisers and the Republican authorities (as of the end of 2012, these negotiations had seen no particular results).

A kind of response to the Kumyk actions was the Congress of Lak people held in Makhachkala on 28 September 2012. This Congress, attended mainly by opposition community leaders, demanded the unconditional implementation of the decision to grant the land to the immigrants (people of the Novolaksk Region) and harshly criticised the regional authorities

¹ For additional information on debates on the transhumance lands see: K.Kazenin. *Elementi Kavkaza: zemlya, vlast i ideologiya v severokavkazskikh respublikah*. M.: REGNUM. 2011. P. 47–50. (K. Kazenin. *The elements of the Caucasus: land, power and ideology in the North Caucasus Republics*. M.: REGNUM. 2011. P. 47–50).

² V Makhachkale trebuyut kompensatsii za stalinskie pereseleniya (Makhachkala seeks compensation for the resettlement in the Stalin era) // IA REGNUM, May 5, 2012. (<http://regnum.ru/news/1526698.html>).

for the delay in this matter¹. Due to the proximity of the relevant land, the claims of Lak and Kumyk community members are inevitably interdependent and conflictual to some degree.

Another example of the mass action of plainmen on land issues took place in the Kizlyar Region where, in the summer of 2012, the Nogai people living in Novokrestyanovskoye village came into conflict with a company which had taken on the lease of part of the land adjacent to the village. On 21 June the residents came to a ploughed field on the outskirts of the village and stopped the working machinery owned by LLC Dag.agrokomplex². The reason for this protest action was the illegal (in their view) decision of the district administration to assign, by way of tender, the right to lease the land around the village to the external investor, while there was already a lack of land appropriate for the needs of the villagers. Note that according to our observations, in legal terms the situation in Novokrestyanovskoye, is typical of lowland Dagestan and may be repeated many times during the allocation of land for major agricultural projects: on the basis of the documents issued in 1990 residents of the village consider themselves to be the owners of shares in the former collective or state farm land, but due no survey having been carried out and ownership not being properly registered, the residents can not substantiate their claims to the land. A Kizlyar district administration official explains the problems as follows: "When these certificates were issued, it was assumed that the recipients of the certificates would organise farm holdings, be farming on a professional basis and paying taxes to the district budget. But almost none of the villagers registered their rights to the land, established farm holdings or paid land taxes".

The Novokrestyanovskoye conflict was partially resolved by direct negotiations between representatives of the villagers and the agricultural firm. Republican NGOs did not participate in it. However, it is important to consider that the Nogai NGOs showed their ability to become actively involved in land conflicts in 2011, when, with their support, residents of the Nogaisky district forced the investors to terminate construction of a sugar beet plant linked to proposed cultivation on the major part of the croplands³.

In 2012, also, the KBR public activity related to land issues was mainly manifested at a municipal level, but regional ethnic organisations also participated in it. This activity was mainly related to the allocation of land for future resort construction. In January 2012, residents of three villages in the Cherek District of the KBR formed a working group of 12 people for public control over the implementation of a tourist cluster project. As previously reported, Resorts of the North Caucasus JSC (RNC JSC) planned to build a resort in this area with 170 kilometres of ski slopes⁴ and capable of simultaneously accommodating 15,000 tourists. According to the company, some resort facilities will be located in the area of the Khulam-Bezengi Gorge. A part of the land in the valley is owned by the agricultural FSUE, but Bezengi villagers say that the land originally belonged to them and insist that any agreement on the allocation of land for the tourist cluster must be entered into with the village, and that the village representatives must control the project at all stages of its implementation.

¹ V Dagestane obsuzhdayut situatsiyu vokrug Novolakskogo rayona (Dagestan discusses the situation with the Novolaksky district) // IA REGNUM, October 2, 2012. (<http://regnum.ru/news/1576855.html>).

² Aslanbek Adiev. Poluchat li «nemestnie» dustup k zemle na Severnom Kavkaze? (Aslanbek Adiev. Will the "non-locals" have access to land in the North Caucasus?) // IA REGNUM, July 27, 2012 (<http://regnum.ru/news/1554910.html>).

³ V Tarumovskom rayone Dagestana realizuetsya proekt vozvedeniya sakharnogo zavoda // Kavkazskiy uzel (The construction project of a sugar factory is implemented in Tarumovsky district of Dagestan // Caucasian Node), January 20, 2012 (<http://www.kavkaz-uzel.ru/articles/199601/>).

⁴ Nezavisimaya gazeta (Nezavisimaya Gazeta), No.174, 29.08.2012.

Later, in November-December 2012, land disputes came to the surface in the Zolsky District of the KBR. On 22 November the Government of the Republic announced the completion of the procedure for defining a special economic zone in the region (SEZs are established in all districts of the KBR where actual or planned resort construction projects are implemented). Almost simultaneously, a number of deputies of rural settlements in the Zolsky District reported to the media that village deputy meetings had "vetoed" the activity of RNC JSC in the district, as the question of which land would be transferred to the tourist cluster had not been resolved. In response, the heads of the same villages said that the residents of the villages were not against the construction of resorts, and that the land issues had not been resolved since RNC JSC had provided no solutions in this regard¹.

The land issues which have caused public reaction in the KBR are currently unresolved. Further discussion will apparently take place against the background of land reform proposed by the President, Arsen Kanokov. Kanokov formulated the essence of the reform at the end of 2012 as follows: "The land is allocated and legally registered to the private ownership of particular groups of villagers, where the management practices are diverse, agricultural land cannot be split up into parcels of less than 10 ha, meaning that effective large and medium businesses will be preserved"².

In whatever format the land reform is discussed, we might expect that it will be actively influenced by regional NGOs, primarily the Balkar, as the areas for future resort construction are dominated by Balkars. They also support protests "on the ground". In particular, according to the media, Balkar activists of the public organisation the "Council of Elders of the Balkar People", together with the former head of Bezengi village, Muradin Rakhayev (in 2010 they pursued the "Hunger strike of the Balkar elders" outside the walls of the Kremlin), have played a significant role in the actions of the inhabitants of the Cherek District. Thus, forces which can transform a local protest in an aspect of regional policy are also present in the KBR. The peculiarity of this Republic is that ethnic community leaders are usually actively involved in political projects aimed against the regional authorities. In addition, according to past experience, the activities of NGOs acting on behalf of the various peoples of the KBR, can lead to a confrontation between them. The region has developed a whole tradition of controversy between the social activists acting on behalf of the Balkars and the social activists acting on behalf of the Kabardins. The former insist on the full transfer of the mountain lands to the Balkar villages whilst the latter recall the controversy of "ethnic borders" in the mountains, and that of the Soviet era and where previous inhabitants of the neighbouring valley could enjoy the mountain land in the vicinity of Elbrus³. These contradictions are of direct relevance to the land proposed for construction of the new resort.

¹ Deputati Zolskogo rayona ne zapreshali stroitelstva turklastera (Deputies of the Zolsky District did not prohibit the construction of the tourist cluster) // IA REGNUM, December 4, 2012. (<http://regnum.ru/news/1600606.html>).

² Zemlua dolzhna stat rynochnym instrumentom – glava KBR (The land should be a market instrument - the head of the KBR) // Interfax, October 24, 2012 (<http://www.interfax-russia.ru/South/main.asp?id=355348>); for the background of the land reform in KBR see: K.Kazenin. «Tikhie» konflikty na Severnom Kavkaze: Adygeia, Kabardino-Balkariya, Karachaevo-Cherkessia (K.Kazenin. "Quiet" conflicts in the North Caucasus: Adygea, Kabardino-Balkaria, Karachay-Cherkessia.). M.: REGNUM. 2009. C. 81–110.

³ For additional information see: K.I.Kazenin. Kabardino-Balkarskaya Respublika // I.G.Kossikov (sost.). Respubliki Severnogo Kavkaza: etnopoliticheskaya situatsiya i otnosheniya s federalnim tsentrom. M.: Makspress 2012. (K.I. Kazenin. Kabardino-Balkar Republic // I.G. Kosikov (ed.). Republics of the North Caucasus: ethno-political situation and relations with the federal center. M. Max Press. 2012.). P. 183–212.

Thus, major land allocation for new projects in the Dagestan plains and mountains of the KBR are causing protests amongst the local population and can be catalysts for political upheaval on a larger scale. Republican NGOs speaking from an ethnic point of view have been directly involved in a number of the conflicts mentioned herein. Some of these organisations have victories to their credit in land battles at a municipal level. Thus, the implementation of large investment projects in the North Caucasus is increasing the role of ethnicity in local politics, which, could obviously lead to an overall increase in conflicts in the region.

In addition to supporting the protests of local people on land issues, some of these organisations have participated in the opposition's political projects. For example, representatives of the Solidarity movement were present at the "Congress of Dagestani Peoples" held in Moscow in October 2012¹, organised by a number of ex-officials of Dagestan and critical of the republican authorities. In addition to organisations claiming to be the defenders of entire ethnic groups the Congress also invited the representatives of many public structures (mostly without official registration) engaged in anti-corruption activities, or protecting the interests of residents in conflict with officials and businessmen. An example is the "Anti-Corruption Committee of the Tabasaran District" who presented at the Congress. Such social activist unions are not directly ethnic, but as a rule, they act on behalf of mono-ethnic groups.

Thus, ethnic social structures have formed a kind of a "division of labour": some are actively opposed to the authorities and protect the interests of communities, whilst others legitimise a new high level of national movements in the public arena. Currently, these two processes are almost independent of each other, as there is no visible evidence of cooperation between these structures. But if they begin to interact with each other, this will lead to the formation of ethnic social structures that will combine publicity experience at a federal level and the support of local communities. The opportunities for such structures will inevitably be wider and the "elements" that are required to create them² already exist.

6.7.3. Dagestan: the dynamics of intra-confessional relations in Islam

In terms of attempts to decrease the level of conflict in the North Caucasus region, the most visible and dramatic events took place in the Republic of Dagestan. Given the crisis of the forms of settlement³ used previously, which manifested itself in the reduction of the insti-

¹ Dagestanskaya oppositsiya otpravilas v Moskvu razroznennimi gruppami (Dagestani opposition went to Moscow in separate groups) // IA REGNUM, October 24, 2012 (<http://regnum.ru/news/1585835.html>).

² For additional information on the ethnic factors of contemporary conflicts in the North Caucasus see: I.V. Starodubrovskaya, D.V. Sokolov. *Istoki konfliktov na Severnom Kavkaze*. M.: Izdatelskiy dom «Delo» (RANKHiGS) (I.V. Starodubrovskaya, D.V. Sokolov. *The origin of conflict in the North Caucasus*. M.: Delo Publishing House (Russian Presidential Academy of National Economy and Public Administration)). 2013. P.78–128.

³ In November 2010, the President of RD created the Commission to support of persons who have decided to stop their terrorist and extremist activities in the Republic of Dagestan in adapting to civilian life in the territory of the Republic of Dagestan." The Commission was headed by Deputy Prime Minister of the Republic of Dagestan, Rizvan Kurbanov (now the Deputy of the State Duma of the Russian Federation). The Commission includes the heads of the security forces of the region, a number of ministers, representatives of the civil society and the religious community of Dagestan. 37 persons applied to the Commission during the 1.5 years, 32 claims were satisfied. It reviewed more than 100 claims of citizens related the violation of their rights by the law enforcement agencies, all applicants received legal support (see: Yulia Rybina. *V Dagestane boevikov adaptiruyut k miru* (Julia Rybina. *Dagestani militants are adapting to the peace life*). 20.04.2012 07:29. <http://kavpolit.com/v-dagestane-boevikov-adaptiruyut-k-miru/>). The Commission's activities have received some

tutional role of the Commission in assisting previous terrorists, who have given up their extremist activities in the Republic of Dagestan, to adapt to civilian life, and the public discrepancy in the views of its members on the principles and strategy of this authority, a completely different settlement process began to develop.

One of the principal lines of division in Dagestani society, and in the North Caucasus in general, is the intra-confessional conflict of the Sufi¹ and Salafi (the more common, though incorrect name is the Wahhabi) movements of Islam. The Salafi movement was mainly a form of youth social protest in the region. Its confrontation with the Sufis seems to be one of the greatest sources of the continuing violence in the region. Not so long ago representatives of the "official Islam" in Dagestan said that any person who killed a Wahhabi would go to heaven. Even the external signs of belonging to the Salafi movement (particular form of beard, or short trousers) could be and often were the basis for repression by the security forces. At the same time the most frequent targets of terrorist attacks were, not only representatives of the law enforcement agencies, but also the most prominent Sufi religious leaders (sheikhs).

Against this background, the meeting and joint Friday prayers of moderate (legal) Salafis and the Spiritual Administration of Muslims of Dagestan (DUMD) held on 29 April 2012 at the Central Mosque in Makhachkala seemed a breakthrough in the settlement of the intra-confessional division. The meeting was chaired by Magamedrasul Saaduev, Imam of the Central Mosque. Moderate Salafis were represented by the Ahl-Sunnah Association of Scientists. Ahl-Sunnah combines dozens of religious Salafi leaders who do not accept violence in the struggle for the victory of Islam, and are focused on the dissemination of their ideas about the true faith through peaceful preaching. Representatives of both movements spoke at the meeting, as well as the Mufti of Dagestan. The resolution adopted by the meeting included, as important practical requirements, a ban on Muslims reproaching each other, tracing and informing on Muslims, as well as the prohibition of Dagestanis from travelling abroad to study in Islamic universities.

Following the meeting in the Central Mosque in Makhachkala similar events aimed at intra-confessional consent were held throughout Dagestan. On 11 June 2012, in the Tsumandin Region several events were held involving the Mufti of Dagestan, district activists and local Salafis. Resolutions adopted on the basis of these events were, in general, made in the spirit of the Makhachkala resolution from 29 April, not repeating it but adding several new aspects to the possible ways of settlement, including:

- To consider establishing a fund to assist families affected during intra-confessional conflicts;
- To consider a joint request to the Ministry of Justice for the abolition of the "Law on Wahhabism";
- To discontinue the practice of prosecuting Muslims for the possession of religious literature, as this should not be a justification for prosecuting a person for extremist activity.

These new trends in intra-confessional relations were discussed in the monthly report by E.T. Gaidar's IEP entitled "The Economic and Political Situation in Russia in June 2012". In answer to the question as to whether we can assume that the steps taken for the settlement of the intra-confessional conflict could fundamentally change the situation in the Republic and

public recognition, there have been cases when militia men put down their arms and surrendered to the authorities under the guarantee of Rizvan Kurbanov, Chairman of the Commission.

¹ Sufism is a mystical branch of Islam, which implies unquestioning obedience of believers (murides) to Sheikhs having the mystical knowledge. It has developed within the Sufi orders (Tariquas).

put an end to the armed confrontation, the Report stated that "it is too early to draw such conclusions," and suggested that the most likely scenario is the "strengthening of an open division between the Salafis and Sufis regarding the issue of termination of the confrontation"¹. Unfortunately, life has completely justified this quite pessimistic forecast.

An increase in violence in the country occurred simultaneously with the unfolding of the intra-confessional settlement process. In August 2012 a number of law enforcement officials and religious leaders were killed. On 18 August there was an attack on a Shiite mosque in Khasavyurt, leaving one person dead and several injured. However, the most resonant crime was committed on 28 August - Sheikh Saeed Chirkeisky was killed. He was the most ambitious figure of the contemporary Sufi movement in Dagestan. According to different estimates, he had from a few dozen to several hundred thousand followers (murids), including the DUMD management and some members of the Republican government. He was seen as the centre and symbol of the shadow power structure². The Sheikh died at his home in Chirkei village, bombed by a female suicide bomber (an ethnic Russian) who came to his house in the guise of a pilgrim. The blast killed six other people, and several victims had to be taken to hospital. The Sheikh's funeral gathered more than 100,000 people.

This crime has caused shock in Dagestani society, and not only amongst the religious community. The predictions were particularly disappointing. The local press emphasised that a few days after the tragedy there was not a single expert commentator on the murder who would not have predicted a sharp aggravation of the situation in Dagestan³. Journalist Yulia Latynina compared the crime with the hypothetical situation of the murder of the Pope in the middle of a war between Catholics and Protestants, and noted that the consequences of this event greatly increased the chance of catastrophic scenarios for the coming autumn⁴. The catastrophic scenarios failed to materialise. Yet the crime revealed many hidden processes in Dagestani society in general, especially in the religious community, and had a major influence on the future development of the situation.

First of all, mass violence on religious grounds between the murids of Saeed Chirkeisky and the Salafis was avoided, which, in fact, could have instigated an escalation of violence in society in general. In the days following the tragedy both sides showed an enviable wisdom and restraint. A few hours after the death of the Sheikh almost all prominent Muslim leaders in the Republic harshly condemned the murder, regardless of their confessional affiliation⁵.

¹ Starodubrovskaya I.V. Dagestan: neprosotoy vopros uregulirovaniya //Ezhemesyachnyi obzor Instituta ekonomicheskoy politiki imeni E.T.Gaidara «Ekonomiko-politicheskaya situatsiya v Rossii v iyune 2012» (I.V. Starodubrovskaya. Dagestan: complex settlement issue / Monthly Bulletin of the Economic Policy Institute named after E.T. Gaidar. Economic and political situation in Russia in June 2012). P.60. http://www.iep.ru/files/text/trends/Russian_economy_trends_and_perspectives_in_June2012.pdf

² Akhmedova M. Zhertva primireniya. Za chto ubili samogo uvazhaemogo cheloveka na Severnom Kavkaze // «Russkiy reporter» №35 (264) 06 sen 2012 (M. Akhmedova. The victim of reconciliation. What killed the most respected man in the North Caucasus? // Russian Reporter, No. 35 (264) September 6, 2012) http://expert.ru/russian_reporter/2012/35/zhertva-primireniya/

³ Agaev M., Magomedov R. Nachalo kontsa?!//Chernovik (M. Agayev, R. Magomedov. Is it the Beginning of the End? // Draft). 31.08.2012. <http://old.chernovik.net/news/507/REPUBLIC/2012/08/31/14040>

⁴ Latynina Yu. Vtoraya faza dzhikhada. Ubiystvo sheikh Saida Afandi –nachalo novogo nastupleniya islamskich radikalov // Novaya Gazeta (J. Latynina. The second phase of Jihad. The assassination of Sheikh Said Afandi - the beginning of a new offensive of Islamic radicals // Novaya Gazeta). 29.08.2012. <http://www.novayagazeta.ru/society/54194.html>.

⁵ See: Nerealnaya realnost... //Redakciya «Chernovik» (Unreal reality ... // Draft Editorial). 23.08.2012. <http://old.chernovik.net/news/506/News/2012/08/23/14012>

The Ahl Sunnah Association expressed its condolences to the relatives and friends of the victims and adopted a Statement which, *inter alia*, said: "Despite the fact that we had a number of disagreements with the dead, we have never supported such methods of solving disagreements, and we stated this during the joint meeting with DUMD. All disputes must be settled by scientific debate, we have called for and encouraged it. This is our principled position. The murder did not happen by chance at the time when the dialogue between the different groups of Dagestani Muslims was developing. ... At the same time, the proponents of force against the growing influence of Islam have found their place in a number of authorities. They are trying to derail the peace process in different ways. In this regard, the Ahl Sunnah Scientific Association in Dagestan declares that the murder should not affect the dialogue process developing in the country. We look forward to the continuation and development of this process¹". The Imam of the Central Mosque in Makhachkala, M. Saaduev, acting on behalf of the Sufis called on them to take a balanced position: "I appeal to the youth. Be tolerant, be wise, do not lose your heads. ... The peace process in Dagestan among believers will not be disrupted in any case. We will not allow this. We have come a long and hard way to the dialogue. We, the Sufis, know that among the Salafis there are moderate people, good people, and there those who are sick, as in any movement, in any religion, of any nationality. One group must not be punished for the actions of others. Any "retaliation" is barred and unacceptable... Do not play us off!"². Even the underground movement offered not to jump to conclusions about the person who committed the crime³.

The belief that this crime was particularly advantageous to those who were trying to disrupt the intra-confessional dialogue was dominant. The security forces and the "forest" were most frequently accused (although there were also more unusual versions of what had happened: the redistribution of the hajj market, a plot by "third forces"). Let us consider some examples of typical statements by experts and the community leaders of the Republic made in the first days after the tragedy: "This killing may involve Salafi followers from the small group arguing against the convergence of Islam, which took place in Dagestan early this year. The security forces may also be involved, as they would like to destabilise the situation in the Republic. It is possible that this is yet another provocation"; "People who are not benefitting from the association of different Islamic movements in Dagestan may stand behind the murder," "I think that the "forest" stands behind it. They killed the spiritual leader of the opposing side. The killing of enemy leaders is one of the goals in any war. This is another act of the hidden war in Dagestan;" "This is a political murder, a great provocation. ... If not directly,

¹ Mirnyj process dolzhen prodolzhat'sya. Zayavlenie Associatsii uchenykh Akhlyu-Sunna v Dagestane v svyazi s ubiystvom Saida Chirkeysogo i ego posledovateley // Kavkazskaya politika (The peace process must continue. Dagestani Ahl-Sunnah Association of Scientists' statement in connection with the murder of Saeed Chirkeisky and his followers // Caucasus Policy). 29.08.2012. <http://kavpolit.com/mirnyj-process-dolzhen-prodolzhat'sya/>

² Magomedov A. Luchshe khudo-bedniy mir, chem voyna! // Chernovik (A. Magomedov. The poor peace is better than war! // Draft). 7.09.2012. <http://old.chernovik.net/news/508/POLITICS/2012/09/07/14057>. Note how Abbas Kebedov's words (Salafi representative) resonate with this call: "I call all Dagestani people for restraint and responsibility, do not let brothers kill each other! We vented to each other for somebody's own purposes". (Tambiyeva M. Podryv tarikata: Kavkazskie eksperty prognoziryuyut obostrenie situatsii v Dagestane posle ubiystva sheikh Saida-afandi Chirkeysogo // Kavkazskaya politika (M. Tambiyeva. Undermining Tariqa: Caucasian experts predict worsening of the situation in Dagestan after the assassination of Sheikh Saeed Afandi Chirkeisky // Caucasus Policy). 29.08.2012. <http://kavpolit.com/podryv-tarikata/>)

³ See: Magomedov A. Luchshe khudo-bedniy mir, chem voyna! // Chernovik (A. Magomedov. The poor peace is better than war! // Draft). 7.09.2012. <http://old.chernovik.net/news/508/POLITICS/2012/09/07/14057>.

then indirectly, the state is responsible for the possible consequences. ... Why did it happen now, when Sufis and Salafis were coming to an understanding, to constructive dialogue?"¹.

The idea of the provocative nature of the crime was extremely widespread. And the statement of one radical Islamist group which appeared, finally claiming responsibility for the killing of the Sheikh, did not convince many people: "both Sufis and Salafis commonly say that this was a provocation that sought to prevent the dialogue amongst Muslims. In the Facebook "Dialogue Venue Group" created by the DUMD representatives, its members, in discussing the news that the rebels have claimed responsibility for the killing of the Sheikh, were in little doubt that it was part of a provocation"². However, following the announcement, the situation began to change rapidly. The subsequent period was characterised by three main processes.

First: Dagestan's official Islamic structures began to shift the responsibility for the death of Saeed Chirkeisky to their recent negotiating partners. The campaign was launched through an article by Patimat Gamzatova (the spouse of the Mufti of Dagestan and CEO of the media holding of the Spiritual Administration of Muslims of Dagestan) entitled the Hudaybiyyah "Peace" Treaty and published on 2 September 2012³. The publication caused shock in the Republic's public arena as is shown by several key features.

First, the article provides almost no distinction between the moderate and radical Salafis, the thesis that there is no connection of the moderates with the "forest" was declared a hypocrisy. And everybody is called Wahhabis as in the "best" times. The author writes with random characterisation of her opponents: "Hypocrites, whose hands are stained with blood! Those who do not have the balls to kill are happy just to be part of a movement which includes those who are capable of killing Muslims, of bringing harm to Islam, of splitting the Ummah! And they do not have enough brains even to hide their vulgar fun." The article is full of accusations and insults to moderate Salafis.

Secondly, it is argued that Sheikh Saeed Chirkeisky initially supported the negotiations, and that the DUMD management participated in peacekeeping activities as directed by him. However, two days before his death, he changed his mind and condemned the steps taken to expand the access to the media of his opponents, claiming that the Wahhabis would never change their nature.

Third and finally, the author came to a clear conclusion on the refusal of further negotiations and the termination of the settlement process as being the fault of the opposite party. Describing the position of Saeed Chirkeisky, the author states: "Even coming close to death, he tried to give a chance to the Wahhabis, to hold out the hand of peace. ... But they did not use it! They buried it with the Islamic scholar, Sheikh Saeed-Afandi, in Chirkeisk cemetery".

¹ See: Tambieva M. Podryv tarikata: Kavkazskie eksperty prognoziryuyut obostrenie situatsii v Dagestane posle ubiystva sheikh Saida-afandi Chirkeyskego // Kavkazskaya politika (M. Tambieva. Undermining Tariqa: Caucasian experts predict worsening of the situation in Dagestan after the assassination of Sheikh Saeed Afandi Chirkeisky // Caucasus Policy), 29.08.2012. <http://kavpolit.com/podryv-tarikata/>.

² Magomedov A. Khudeybiyskiy dogovor ili Verbluzhya bitva? // Chernovik (A. Magomedov. Hudaybiyyah Treaty or Camel fight? / Draft). 7.09.2012. <http://old.chernovik.net/print.php?new=14068>. Note that the proof of the militants' involvement in the crime was its inclusion in the general warfare summary of Mujahideen in the Caucasus Emirate for Dagestan Wilayah.

³ Gamzatova P. «Khudaybiyskiy» «mirmiy» dogovor (P. Gamzatova. "Hudaybiyyah" "Peace" Treaty) // Islam.ru. 2.09.2012. <http://www.islam.ru/content/analitics/5140>. Note that a few days before Novaya Gazeta had published the article by Julia Latynina, "The second phase of Jihad", with the same line: "The murder of Saeed Afandi is a logical consequence of the capitulation to the Salafis by the current management of Dagestan".

The article resulted in many negative reviews in the press, representatives of the Ahl-Sunnah Association refused to comment on it and attempted to downplay its significance. But it is clear that the religious settlement process in the Republic was irreparably damaged.

Second, such a serious difference in the positions of the representatives of the Spiritual Administration on negotiations with the Salafis revealed clear differences and conflicts in the official Muslim structures in Dagestan. The ins and outs of this process became more evident after the publication of the Murid Statement¹ on social networks, which contained harsh accusations against the Imam of the Central Mosque in Makhachkala, Magamedrasul Saaduev. The Imam was accused of incompetence ("It was said that he could not even prepare his own preaching"), of leaning towards the Wahhabis ("he is considered the Wahhabi imam among Wahhabis, and somebody else among the Sufis") and on his reluctance to terminate the dialogue with them, which, according to the authors of the statement, meant hypocritical grief at the death of Saeed Chirkeisky ("a heartbroken imam, without sorrow on his face, when expressing his condolences at the Jamaat mosque, said that: "we will not fight despite everything"). But the essence of the statement becomes clear when the murids come to the main accusations: "The reason that our patience is exhausted is the news that is known to all residents of Makhachkala. Government officials made a secret plan, jointly with the Wahhabis, proposing the removal of the acting mufti from his position and the appointment of Saaduev, who knew about it, agreed and hid that information".

The next day after the murid statement Gamzatova, the author of the sensationalist article, interviewed Saaduev². In this interview Saaduev denied his desire to become the Mufti: "A few months ago a thought crossed my mind - that I would like to become a mufti, etc. This was so irrelevant and pointless that I immediately put a stop to it at its root. ... For myself, I already have enough burden on my shoulders, let Allah give me strength to cope with the work of being the Imam of this mosque with a large number of parishioners". He also had to admit the failure of attempts to negotiate with the Salafis, "But you know how this attempt ended. Only Allah knows what's next" (earlier in the interview it was mentioned that Saaduev had previously tried to engage with his religious opponents).

Obviously, the murder of Saeed Chirkeisky intensified the power struggle between the different factions within the Spiritual Administration and has been used to hinder any kind of competition with the management of the Mufti Administration³. Once, it was reported that DUMD supporters were willing to admit the Mufti as the successor of Saeed Chirkeisky with the status of a Sheikh.

Third: the death of Said Chirkeisky further increased the tensions in the Salafi camp. The expressions of condolence by a number of prominent members of the moderate Salafi on the death of the Sheikh, their willingness to participate in his funeral and statements on their complete rejection of the methods of terror⁴ thoroughly exacerbated the relationship between

¹ Murid Statement. Published on facebook.com (<http://www.facebook.com/profile.php?id=100004415792614>) and livejournal.com (<http://baikonur113.livejournal.com/122280.html>).

² See: Gamzatova P. Vse tochki nad «i» (P. Gamzatova. All the "i"s). Ac-sunna.rf – Islamic education site.20/09/2012/ <http://as-sunna.ru/index.php/stati/221--lir>

³ It should be noted that in the course of the study various Islamic wings positively assessed Saaduev arguing that he was a prominent religious leader of the different movements and could significantly advance the intra-confessional dialogue in the country.

⁴ Thus, in response to Patimat Gamzatova's characteristic of the suicide bomber - "inhuman parishioner of the Kotrov mosque"- Imam of the Salafi Mosque in Kotrov Street in Makhachkala said only that he had not seen a girl accused of murdering the Sheikh in the mosque, but also that "criminals have no religion" (Fatullaev: dialog

the moderate and radical parts of the movement. The statement of the radical group, which claimed responsibility for the killing of the Sheikh, also contained an appeal to the moderate Salafis, who, according to the radicals, "openly transgressed the borders": "We separately want to appeal to the so-called Ahl-Sunnah wal Jamaa Association of Scientists. We do it openly because they have also made these statements in public. You are ignorant! How can you judge? Mushrik, who seduced hundreds of thousands of Dagestani, is a brother Muslim to you and his murder is a provocation through the intrigues of our enemies"¹. After Gamzatova's article was published, comments and threats against her appeared on the website of the radical Salafis, together with even more severe charges against the moderate wing of the movement. Stressing that the radicals did not have any regard for the intra-confessional dialogue ("spontaneous actions of these people") and categorically stood against its further development (which is regarded as a betrayal of Jihad by the radicals), the authors actually sided with the hypocrisy accusations of the moderate wing: "In this appeal we also want Muslims to open their eyes to the behaviour of the so-called Ahl-Sunnah Association of Scientists. Many of them are unscrupulous people occasionally showing signs of hypocrisy, and Patimat was not the only one who noticed it in them. Besides the fact that some of them openly expressed their grief over the killing of this Mushrik in their statement, they decided to go to Chirkey, to offer their condolences. The only thing that will stop them is a ban of the host"². This was followed by a list of eight names who wanted to bid their final farewells to the Sheikh.

Such aggravation of the confrontation revealed the instability of the positions of a number of moderate Salafis, who began to deny their previously defended position, and said that views and actions they did not commit were falsely attributed to them and they recanted them. The Ahl-Sunnah Association of Scientists prepared one of the most influential religious leaders of the Salafi movement - Abu Umar, who had been harshly criticised by the "forest"³. According to the available information, the crisis led to the withdrawal of a significant part of the educational activities of the peaceful Salafis.

Thus, our analysis shows that the killing of Saeed Chirkeisky has exacerbated the already existing problems and has created new contradictions in the religious environment of the Republic of Dagestan. The result is that the "balance of power" has undergone significant changes, the crisis has affected all the major inter-confessional trends: both of the official Islamic structures and of the opposition flank. In these conditions we have to be extremely careful with predictions: there is little chance of a simple return to the old "linear" confrontation, as the changes which have occurred in both "camps" during the last year are far too serious. At the same time, an active renewal of the dialogue cannot be expected.

It is likely that quite a serious transformation could occur within the Salafi movement. On the one hand, it has distanced itself from active participation in political activities (the Ahl-Sunnah Association), although the grassroots clearly need to express their social protest in some way. On the other hand, the strong commitment to preserve the results of the intra-confessional dialogue and its continuation, stated immediately after the death of the Sheikh,

mezhdru sufiyami i salafitami v Dagestane neizbezhen // Kavkazskiy uzel (Fatullayev: The dialogue between Sufis and Salafis in Dagestan is inevitable // Caucasian Node). 12/09/2012, <http://www.kavkaz-uzel.ru/articles/212501/?print=true>.

¹Website www.guraba.info, 01/09/2012.

²Na voine kak na voine... Mudzhakhedi Dagestanskogo fronta (Business is Business ... Mujahideen of the Dagestan Front). 10.09.2012. <http://guraba.info/component/content/article/1402-2012-09-10-18-22-12.html>

³Note that this is not the first time that a leading member has left the Association. Abbas Kebedov left it earlier due to disagreements on the issue of participation in political advocacy activities.

failed; a number of leaders in this matter fell for the blackmails of the "forest." The most negative scenario would provide for an increased attractiveness of armed methods of struggle for the youth in an environment where the legal wing of the movement does not protest and is not able to defend a consolidated categorical rejection of terrorist methods. Another alternative is the emergence of new "players" within the religious movements, who could fill the vacuum that arose after the murder of Saeed Chirkeisky (the re-commencement of Hizb ut-Tahrir activities in these conditions seems quite likely). Finally, there is a possibility that the religious opposition movement may diminish, and the believing youth, disappointed with the existing leaders will turn towards a "quiet life".

6.8. Changes in the Legislation on the Activities of Non-Profit Organizations 2012¹

In the sphere of activities of non-profit organizations (NPO), a new institute of legal regulation was established, and a new term – "foreign agent" introduced into the legislation by Federal Law No. 121-FZ of July 20, 2012 on Amendment of Individual Statutory Acts of the Russian Federation as Regards Regulation of Activities of Non-Profit Organization which Fulfills Functions of a Foreign Agent (hereinafter – the Law) – started to be used with reference to the above institute². The status of a "foreign agent" is assigned to Russian NPO which are involved in political activities and have foreign sources of financing.

In the above Federal law, deemed as NPO performing the functions of a foreign agent are Russian NPO which receive *funds and other property from foreign states and their state authorities, international and foreign organizations, foreign nationals, stateless persons or persons appointed by them and (or) Russian legal entities which receive funds and other property from the above sources*³ (except for open-end joint-stock companies with state participation and their subsidiaries) and participate in political activities, including those in the interests of foreign sources carried out in the territory of the Russian Federation⁴.

¹ The review was prepared with assistance of the KonsultantPlus legal system.

² A foreign agent (a foreign representative, as well) is a person (an individual or legal entity) which represents the interests of the trustor abroad. In legislations of a number of countries, identified as foreign agents are persons and entities engaging in internal political activities on instructions of a foreign state (such instructions are normally defined as funding from abroad); limitations are imposed on activities of such foreign agents. The above term covers a wide range of meanings, however, due to the fact that a foreign agent means also a spy the above word-combination has rather negative connotation both in Russian and English. The word combination – foreign representative – does not have such a connotation. See Wikipedia – a free encyclopedia, http://ru.wikipedia.org/wiki/%C8%ED%EE%F1%F2%F0%E0%ED%ED%FB%E9_%E0%E3%E5%ED%F2

³ It is to be noted that in accordance with the Law on Non-Profit Organizations (Article 26 (1)) the sources of formation of property of NPO in monetary and other forms are the following: regular and non-recurrent payments from founders (participants and members); voluntary property contributions and donations; proceeds from sale of goods and fulfillment of jobs and services; dividends (income and interest) received on equities, bonds, other securities and deposits; income received from property of NPO and other payments permitted by the law.

⁴ As it can be seen, it is a rather broad definition. Unlike the US Foreign Agents Registration Act, FARA – which was taken as the basis – where deemed as a foreign agent is a person which is "fully or to a great extent operated, controlled, financed and subsidized from abroad, the Russian law lacks a key requirement to the effect that an entity participating in political activities (primarily, by means of lobbying) *on instructions, at request or under supervision* of a foreign entity can be considered as a foreign agent. It is to be specified that from the point of view of the Russian civil legislation the agent is a person which acts (for remuneration) on behalf of another person, that is, there is no difference between NPO operating on (direct or indirect) instructions of foreign entities

The following two qualifying characteristics stem from the definition of a foreign agent: they are acceptance of funds (property) from foreign sources (directly or indirectly via other persons) and participation in political activities (as it is established by the Law). So, to recognize an entity as a foreign agent both the characteristics need be in place.

Interestingly, the definition deals with acceptance of funds and other property and does not include, in all probability, jobs, services and intangible assets (for example, assignment of copyrights and provision of software products) which under the Civil Code and the Tax Code of the Russian Federation are of a different legal nature.

A NPO, except for a political party¹, is recognized as participating in political activities in the territory of the Russian Federation if irrespectively of the goals and purposes specified in its founding documents it *participates (including by way of financing) in organization and holding of political actions* in order to have an impact on decision-making by state authorities to secure a change in the state policy and *form the public opinion* for the specified purposes.

According to the above Law, political activities do not include activities in the sphere of science, culture, art, healthcare, preventive measures and health protection of people, social support and protection of people, maternity and childhood protection, social support of the disabled persons, promotion of healthy life style, physical culture and sports, protection of flora and fauna, charitable activities, as well as activities which facilitate charitable cause and voluntary work.

The above definitions and criteria are ambiguous in general and lack any detailed regulation which factor is a serious disadvantage for all the participants in the process:

- A vague definition of “political activities” results in any interpretation of the term, for example, a NPO carrying out activities related to legal support and aid may fall within the scope of the Law² as, in essence, participation in a meeting, picket or other action can be interpreted as participation in political activities or exercising of influence on the public opinion³;
- Inclusion in the scope of the entities of the Law not only NPO registered by legal entities and receiving foreign funding, but also newly established NPO which are just planning their activities and, consequently, have already to plan their participation or nonparticipation in political activities and receipt of foreign grants or other funding.

NPO participating in political activities and receiving monetary assistance and (or) other property from foreign sources (“foreign agents”) will be under special supervision.

and NPO receiving funding from foreign entities for implementation of their own charter purposes without any instructions from foreign entities.

¹ The Law is not applied to political parties, state corporations and state-owned companies, including other NPO established by them, state and municipal entities, including state-financed and religious organizations, employers associations and chambers of commerce and industry. It is to be noted that profit-making organizations and individual entrepreneurs participating in political activities and receiving property from foreign sources are not subject to regulation under the above Law.

² Taking into account the fact that the term – “political activities” – is a broad definition and in it such language as “impact on formation of the public opinion” is used, many experts and public figures believe that a situation may arise where any protest against illegal decision made by the authorities, for example, in case of violation of human rights will be interpreted as a political activity. Or a charity NPO which receives a shipment of medicines from the Red Cross to help the homeless and then participates in the meeting in support of a candidate who promised to support the homeless may be recognized as a foreign agent, as well.

³ In particular, Article 3 (1) of Federal Law No. 38-FZ of March 13, 2006 on Advertisement reads that the impact on the public opinion is an action which arouses the public interest and forms a definite perception.

NPO performing functions of a foreign agent will be obligated, in particular:

- Submit applications for being entered into the register¹ of NPO which perform functions of a foreign agent;
- See to it that materials they publish and promulgate via the mass media or the Internet have the reference to the fact that they were published and promulgated by NPO which performs the functions of a foreign agent;
- Submit on an annual basis the audited financial statements to the relevant authority, once in six months – a report on their activities and the personnel of the governing bodies and once every three months – the documents on the goals for which the funds and other property were utilized;
- Place in the Internet once in six months the information on its activities.

For evasion of fulfillment of obligations imposed on a NPO which carries out functions of a foreign agent, administrative and criminal responsibility is provided for. For example, the relevant authority in charge of supervision over activities of foreign agents-NPO is in a position to suspend that NPO's activities for the period of up to six months if the NPO has violated the Law's requirements, including that to be registered in a special register². It is worth mentioning the most serious sanction for a criminal offence³ – an imprisonment for the term of up to two years.

Operations related to receipt by NPO of cash funds and (or) other property from foreign sources are subject to mandatory control if the sum of the transaction is equal or exceeds Rb 200,000 or the foreign currency equivalent of Rb 200,000. Such an amendment was introduced in Federal Law No. 115-FZ of August 7, 2001 on Prevention of Legalization (Money Laundering) of Incomes Received by Criminal Means and by Way of Financing of Terrorism as regards establishment of mandatory control over some operations of non-profit organizations⁴.

¹ It is to be noted that exit from that register has not been provided for by the legislation. The register is approved by Order No.223 of November 30, 2012 of the Ministry of Justice of the Russian Federation on the Procedure for Keeping the Register on Non-Profit Organizations Carrying Out Functions of a Foreign Agent. According to the Law and the above Order, in statutory acts there is no such option as refusal to NPO to be entered into the register, while the application itself is of notifying nature. It can be supposed that taking into account the submission procedure the documents can be returned to the NPO if they were executed incorrectly, otherwise, the Ministry of Justice of the Russian Federation is obligated to consider them.

² Logically, if NPO does not submit an application for being entered in the register of NPO which carry out functions of a foreign agent, it means that the NPO in question does not regard itself as such and, consequently, a disputable situation can be resolved only in a court of law.

³ Article 239 of the Criminal Code of the Russian Federation:

«2. Establishment of a non-profit organization (including a non-profit organization which carries out functions of a foreign agent) or a structural unit of a foreign non-profit nongovernment organization whose activities are related to prompting people to give up their civic duties and commit wrongful acts or other illegal acts, likewise management of such an organization or structural unit is punishable by a penalty in the amount of up to Rb 200,000 or the wage amount or other income of the convict for the period of up to 18 months or custodial restraint for the term of up to three years or compulsory labor for up to three years or imprisonment for the same term.

3. Participation in activities of a non-profit organization specified in part 2 of the Article in question, likewise promulgation of actions stated above are punishable by a fine in the amount of up to Rb 120,000 or the wage amount or other income of the convict for the period of a year, or custodial restraint for the term of up to two years or compulsory labor for up to two years or imprisonment for the same term».

⁴ Likewise such an obligation is imposed on banks which render services to NPO whose accounts cash funds from foreign nationals and foreign legal entities are credited to. If the amount of each operation in foreign cur-

So, NPO receiving funds from any foreign legal entity or individual, for example, donations, membership fees and payments for services¹ can be regarded as recipients of property from foreign sources. It is to be noted that the approved Law (Law No. 121-FZ) can be applied both to representatives of the countries of the former USSR and stateless persons, and it does not matter whether individuals reside in Russia or not.

The issue of receipt of anonymous donations will be particularly acute. It is to be noted that donations of the donor – a Russian legal entity which receives funds from foreign sources - are also considered the funds (property) received from foreign sources and, consequently, are subject to the norms of the Law. At the same time, the donor is not obligated to provide the beneficiary of funds with the information about its sources of funding.

There is a situation where for the purpose of application of the norms of the Law in question NPO is obligated to determine the citizenship of an individual (which cannot be done in reality when anonymous donations are received) and inquire into the procedure for formation of the property of Russian individuals and legal entities.

Due to novelty of the legislation, it is premature to speak about advantages of some or other norms. Meanwhile, it can be stated that the novations are going to enlarge considerably supervising authorities of the state and there is a concern that the Law increases an administrative burden on NPO as it requires keeping of an additional record (already in the existing separate bookkeeping) of foreign financing separately from the Russian one; carrying out of the annual audit and more frequent submission of the information and reports on their activities and utilization of property and funds. More importantly, as the forms of new reporting² have not been approved so far, it is not yet clear how complex and burdensome they are going to be. The possibility of unscheduled checks of such NPO may exceed the limit of the established norm of checks, that is, once in three years.

rency exceeds the equivalent of Rb 200,000, starting from November 21, 2012 the bank has to notify the Rosfinmonitoring of each such operation within three business days from the day such an operation was transacted.

¹ It is not yet clear how the Government of the Russian Federation is going to interpret the term - “cash funds and other property” – in application of the norms of the Law in question; probably services will be withdrawn from the above term. On the contrary, for example, establishments of higher education which receive fees from foreign students may fall within that status if recognized as ones engaging in political activities.

² In all appearances, in 2013 NPO will report as per the former regime – until April 15 in accordance with the approved forms. Approved by Order No. 72 of the Ministry of Justice of the Russian Federation are new forms of reports on activities of NPO, personnel of its governing bodies as well as spending of funds and utilization of other property, including that which was received from international foreign organizations, foreign nationals and stateless persons, as well as a new form of reporting on the volumes of cash funds and other property received by a public association from international and foreign organizations, foreign nationals and stateless persons, goals and purposes for which those funds are going to be spent and utilized and the actual spending and utilization of funds and property.

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Trends and Outlooks

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