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Directorate A - Economic and Scientific Policy
Policy Department A.: Economic and Scientific Policy and Quality of Life Unit

Russia

Economic Policy and Financial Services Brief

Briefing Note

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1. Executive Summary

The current report aims to provide a brief overview of the Russian economy, with a special focus on current events around the financial crisis, covering the macroeconomic causes and consequences as well as a general overview on financial services.

Political Brief[1]

The governing arrangement of a "tandem" between the president, Dmitry Medvedev, and the former president and now Prime Minister, Vladimir Putin, was subjected to a serious test during Russia's conflict with Georgia and its aftermath. Following some apparent initial indecision, both Mr Medvedev and Mr Putin put in strong performances during the crisis. Although Mr Putin showed again that he retains an important role, including in foreign policy, Mr Medvedev was not upstaged. Russia's military intervention and easy victory have been popular at home and have strengthened the general standing of both men. The further souring of relations with the West that ensued has also done the domestic popularity of the two leaders no harm.

Russian-Western relations have been poor for some time, and even before the recent Russian conflict with Georgia there was little prospect of improvement, given deep-seated differences over a range of issues. The Georgia crisis, which has now strained relations even further, marks a watershed in one sense. Russia has for years complained about disregard for its interests and about Western actions such as the two rounds of NATO expansion; alleged interference in the internal affairs of countries of the Commonwealth of Independent States (CIS); the bombing of Serbia in 1999; the abrogation of the Anti-Ballistic Missile Treaty (ABM Treaty) and the effort to build a missile shield; the invasion of Iraq; and backing of Kosovo's independence earlier in 2008. Although Russia's opposition has become more vocal in recent years, as Russia's growing economic strength has driven a desire to reclaim an important role on the world stage, this is the first time that it has acted on its grievances, and the first time since the end of the Cold War that Russian troops have engaged outside Russia's borders.

The following presents a map as well as the basic facts about the Russian political system.

Graph 1:Map of Russia

Source: CIA World Factbook

[1] Largely taken from Economist Intelligence Unit, Country Report Russia, September 2008.

Country snapshot

Political structure

Official name	The Russian Federation
Form of state	Federal state with republican form of government. A new constitution was adopted after a national vote on December 12th 1993
National legislature	Two-chamber legislature: the lower house, the State Duma, has 450 deputies; and the upper house, the Federation Council has 178 deputies, two from each of Russia's 89 republics and regions
Electoral system	Universal direct suffrage over the age of 18. As a result of changes to the electoral law, in the 2007 election all 450 seats in the Duma were elected from party lists in a single nationwide constituency on a proportional basis. The Federation Council is composed of representatives chosen by regional governors and legislative bodies
National elections	Most recent: December 2nd 2007 (parliamentary), March 2nd 2008 (presidential); next elections due December 2011 (parliamentary) and March 2012 (presidential)
Head of state	President, elected for a four-year term; Dmitry Medvedev, elected March 2nd 2008
National government	The government is appointed by the prime minister, who is appointed by the president
Main political parties	The most important parties are: United Russia; the Communist Party of the Russian Federation (CPRF); Just Russia and the Liberal Democratic Party of Russia (LDPR)

Leading members of the government	**Prime minister**	Vladimir Putin
	First deputy prime ministers	Viktor Zubkov
		Igor Shuvalov
	Deputy prime ministers	Aleksei Kudrin
		Aleksandr Zhukov
		Sergei Ivanov
		Igor Sechin
		Sergei Sobyanin
Key ministers	**Agriculture**	Aleksei Gordeyev
	Civil defence & emergency situations	Sergei Shoigu
	Culture	Aleksandr Avdeyev
	Defence	Anatoly Serdyukov
	Economic development	Elvira Nabiullina
	Education & science	Andrei Fursenko
	Energy	Sergei Shmatko
	Finance	Aleksei Kudrin
	Foreign affairs	Sergei Lavrov
	Industry & trade	Viktor Khristenko
	Internal affairs	Rashid Nurgaliyev
	Justice	Aleksandr Konovalov
	Natural resources	Yuri Trutnev
	Public health & social development	Tatyana Golikova
	Regional development	Dmitry Kozak
	Sports, tourism & youth	Vitaly Mutko
	Telecommunications	Igor Shchegolev
	Transport	Igor Levitin
Central Bank governor	Sergei Ignatiev	

Monthly Report September 2008 www.eiu.com

Source: Economist Intelligence Unit Country Report September

Economic Synopsis

- **Real GDP growth remains high** (and above long-term trend) at over 8% but is expected to slow in 2008-09 as a result of stagnating oil output, high inflation, monetary tightening and real currency appreciation.
- In recent years, Russians have enjoyed a strong increase in their real incomes and wages. P**rivate demand should support a solid rate of expansion** unless the adverse impact of the current financial crisis reaches too far into the real economy.
- Monetary policy is caught in a difficult balance between fighting inflation and managing competitiveness and liquidity. **Growth of monetary aggregates has been very high**.
- High oil prices, capital inflows and the effects of a fiscal relaxation are feeding **inflationary pressures**. A good harvest and a tightening of monetary policy should help to reduce inflationary pressures in the coming months.
- The **federal government balance remains comfortably in surplus** at 5.5% of GDP in 2007, largely thanks to the oil revenues.
- **Unemployment** is at its lowest levels since 1994 (6.1% in 2007), but could rise in 2008.
- The **current account** has been in surplus for the last 5 years, but may be on the reversal now depending on the extent of the capital flight.

Table 1: Key Economic Indicators 2003-2008 (Source: Russian Statistics Agency, Central Bank of Russia, Ministry of Finance)

	2003	2004	2005	2006	2007	4M-2008
GDP growth, %	7.3	7.2	6.4	7.4	8.1	8.7*
Industrial production growth, year-on-year, %	8.9	8.0	5.1	6.3	6.3	6.9
Fixed capital investment growth, %, year-on-year	12.5	13.7	10.9	16.7	21.1	20.3
Federal government balance, % of GDP	1.7	4.3	7.5	7.4	5.5	9.0
Inflation (CPI), % change, end of period	12.0	11.7	10.9	9.0	11.9	6.3
Current account, USD billions	35.4	58.6	84.2	95.6	76.6	37.0*
Unemployment, %	8.6	8.2	7.6	7.2	6.1	6.6
Reserves (including gold), USD billions, end of period	76.9	124.5	182.2	303.7	476.4	534.4

* data for Q1, 2008.

Source: Rosstat, Minfin, CBR.

Financial Markets Synopsis

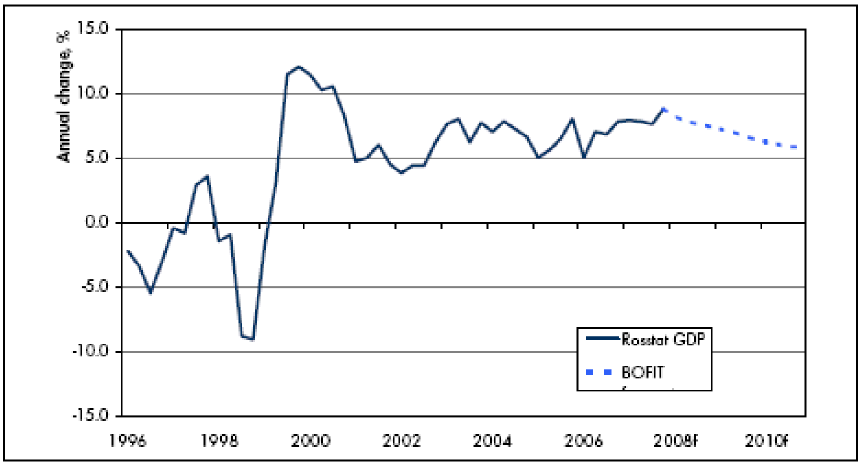
- **Russia has suffered from capital flight as foreign investors pull out**. This has an impact on the stock markets which has lost 45% since May this year.
- **The Russian banks have had massive liquidity injections from the Central Bank** (on 17 September, the Central bank pledged 78 billion USD and said it would cut reserve requirements by 4% effective as of 18 September).
- **In the Russian banking sector private credit to GDP ratio is low at 42%.** Up to the crisis, banks had been actively pursuing a growth strategy of around 45%. Retail loans had been growing at twice the rate reflecting Russia's macroeconomic performance.
- **The Russian banking sector is still dominated by state ownership.** Out of the 30 largest banks, 21 are 50% majority owned by the state.
- Following WTO negotiations, **most restrictions on foreign insurance groups have been removed.**
- **The Russian rouble bond market will suffer from massive redemptions in 2008**, which will in the present crisis further impact the market.

2. General Economic Situation

GDP growth has been strong and above its long term trend

Economic growth in Russia has remained high in the new millennium, strongly increasing real incomes. Around 1998, the financial crisis saw the economy plunge into a vast recession, which however did not last too long (see graph below). Apart from a short period of a few quarters around 2002, growth has been comfortably above 5% since, equalling about 8.1% for 2007. The growth prospects for the future show a dampening effect, and are very uncertain at this stage as the financial crisis is yet to show its full impact on the real economy.

Table 2: GDP Growth 1996-2008

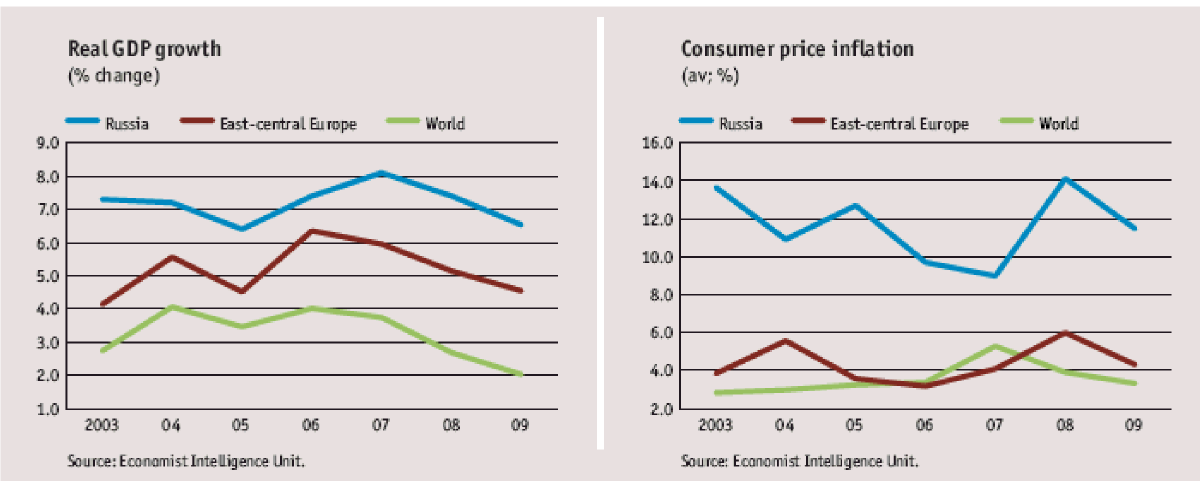


Source: BOFIT Forecast for Russia 2008–2010, p. 6; data for 1996–2007: Rosstat, for 2008–2010: BOFIT, http://www.bof.fi/NR/rdonlyres/258ED784-5359-4D4D-9566-B8187F8D99A5/0/brf108.pdf

Inflation has been persistent and signs of overheating remain

Inflation in Russia has been characterized by a considerable degree of persistence. After a decline from about 30 percent in 2000 to close to 10 percent in 2003, annual headline consumer price inflation became entrenched at 10–14 percent until early 2005. Since then, inflation has declined to about 9-10 percent, but it remains higher than in many other emerging market economies (Table 3 below). The inflation is driven by excess liquidity, fiscal relaxation and food price inflation.

Table 3: Inflation performance in comparison



The exchange rate is one of main channels that affect inflation. Research by the IMF suggests that backward-looking behaviour is relatively important in determining inflation in Russia.[2] In comparison, inflation in industrial countries is mainly driven by forward-looking expectations which can be anchored by monetary policy. The results of the estimations show that exchange rate shocks have a larger impact on core inflation than interest rate shocks and that in the post-1998 crisis period core inflation has to a large extent been driven by exchange rate shocks and surprise inflation shocks.

Exchange Rates: continued appreciation of the rouble, which may now be reversed

The Russian Central Bank (RCB) has attempted to resist rouble appreciation with heavy monetary interventions at the cost of inflation (see above). Nevertheless, since the beginning of 2006 until about July 2008, the rouble had continued to appreciate in real effective terms because of high energy export earnings and capital inflows. However, the nominal exchange rate against the euro and the US dollar has weakened by around 10% since the outbreak of the conflict with Georgia, as a result of capital flight and tougher borrowing conditions abroad, now (22 September) equalling 25.2 Rb/USD and 36.8 Rb/EUR. The RCB intervened heavily to support the rouble in August.

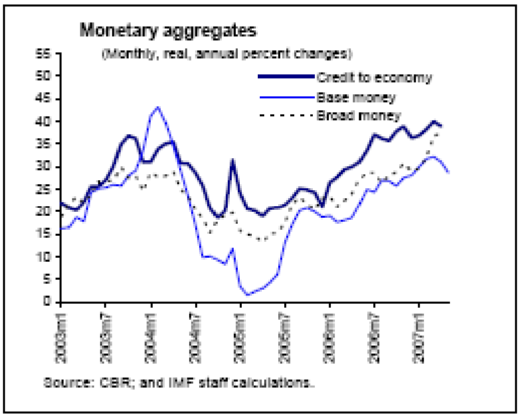
Table 4: Exchange Rate development rouble-USD (Source: Economist Intelligence Unit)

Monetary Policy: a difficult balance between fighting inflation and managing competitiveness and liquidity

The RCB will continue to try to balance the pursuit of the potentially contradictory goals of fighting inflation and maintaining or preventing the erosion of the competitiveness of Russian producers, as well as the need to ensure sufficient domestic liquidity. The relative priority accorded to these goals have been observed to change according to developments. In early 2008, following the onset of the global credit crunch, the RCB prioritised measures to boost domestic liquidity. It has subsequently done the opposite measure by raising its refinancing rate by a cumulative 100 basis points and raised reserve requirements three times in an effort to combat rising inflation. However, since July the RCB is likely again to have to switch priorities to supporting liquidity owing to weakened investor sentiment.

[2] See IMF Country Report No. 07/352 Russia, p. 3-4.

Table 5: Very strong growth of monetary aggregates (Source: IMF)

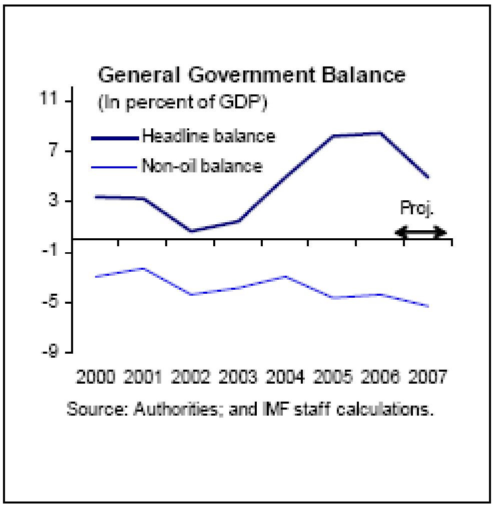


Growth in broad money and bank credits is accelerating sharply. Broad money growth (including foreign currency deposits) reached 48 percent by April 2008 (yoy) — and growth of rouble broad money was even faster at 57 percent, reflecting continued stagnation in foreign-currency denominated deposits.

Fiscal Policy is well in surplus but is becoming increasingly expansionary

Since 2005, fiscal policy at the general government level has added a notable impulse to the economy, by allowing more of Russia's oil revenue windfall to pass through to the economy. This relaxation has been reflected in a deterioration in the general government's non-oil balance, even as higher oil revenues caused the headline surplus to increase through 2006. The non-oil balance has further declined under the 2007 budget by 0.9 percent of GDP (see Table 6b below).

Tables 6a and 6b: General Government Balances (Source IMF staff calculations)



Russian Federation: Federal Government Budget, including preliminary supplementary 2007 budget

	2006	2007	2008	2009
	Actual	Staff projections		
	(in percent of GDP)			
Non-oil balance	-3.8	-4.3	-5.9	-7.0
Oil revenues	11.2	9.0	8.4	7.2
Overall balance	7.4	4.7	2.5	0.2
Memo item				
Oil price (Urals, USD bbl)	61.1	57.6	61.6	61.3

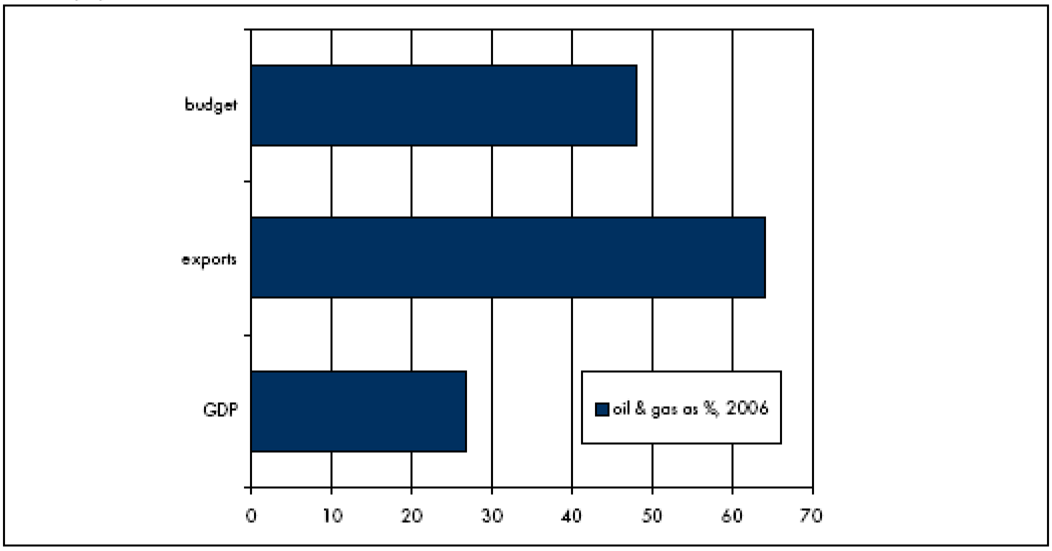
Source: Authorities; and staff projections

The authorities are considering a fiscal relaxation over the next few years that would allow most of the remainder of the oil revenue windfall to be passed through to the economy. With this, the planned expansion in the non-oil deficit over the coming years reaches considerable higher levels, with around 6% of GDP estimated for 2008.

Oil and gas provide major windfall gains in the Russian economy

Russia holds the world's largest natural gas reserves and the eighth largest oil reserves, being the world's largest exporter of natural gas, and the second largest oil exporter. Russia's economy is heavily dependent on oil and natural gas exports. The oil and gas sector generates more than 60% of Russia's export revenues (64% in 2007), and accounts for 30% of all foreign direct investment (FDI) in the country (see Table 7 below).

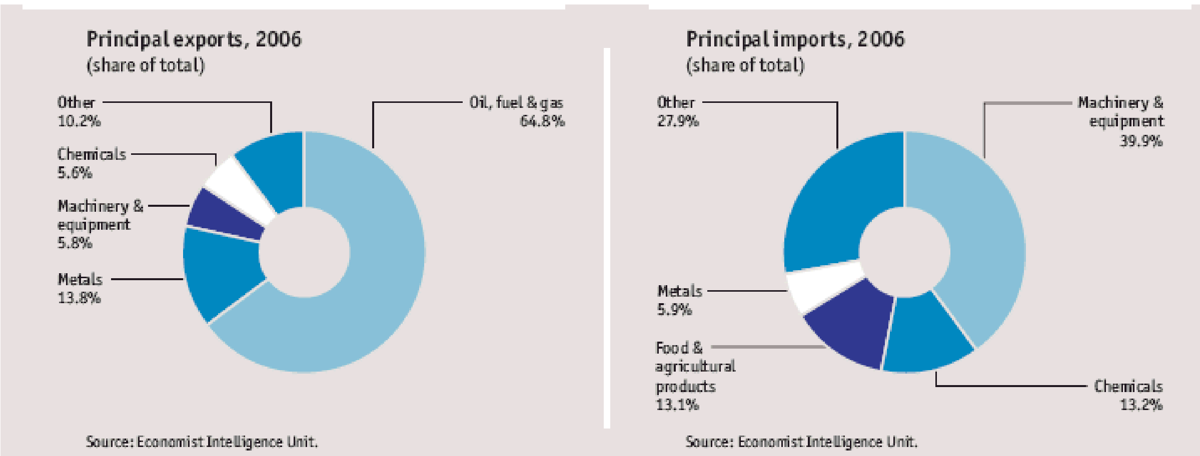
Table 7: The oil and gas sectors share in Russian federal budget, exports and GDP (Source: Central Bank of Russia)



Sources: Central Bank of Rusia; Aleksei Kudrin lecture at Higher School of Economics, 21 February 2007 (GDP share, presumably value added share of GDP in current prices).
Note: The Economist of 1 March 2008 quotes an estimate of 31.6 percent for the oil and gas share of GDP in 2007, from Andrei Illarionov.

Russia's GDP and investments remain concentrated in a few sectors, mainly the extractive industries, reflecting limited diversification of the economy. This is also reflected in the aggregate share in exports for fossil energy and metals, making up almost 80% together (see Table 8 below).

Table 8: Imports and Exports (Source: Economist Intelligence Unit)



The current account in Russia has been comfortably in surplus for many years, owing mainly to high oil and gas exports. However, excluding oil and gas, the current account is strongly in deficit.

In 2007, Russia registered record net capital inflows into banking and non-banking sectors, further boosting liquidity and keeping the capital account strongly in surplus. This could however be reversed in the remaining months of 2008 due to ongoing problems on the financial markets.

Doing Business in Russia remains difficult

Doing business in Russia continues to be a difficult endeavour. The following presents Russia's ranking in two standard indices to measure the ease of doing business, the Index of Economic Freedom and the Corruption Perception Index. Russia's global ranking among countries in both indices remains clearly below average.

Table 9a: Index of Economic Freedom

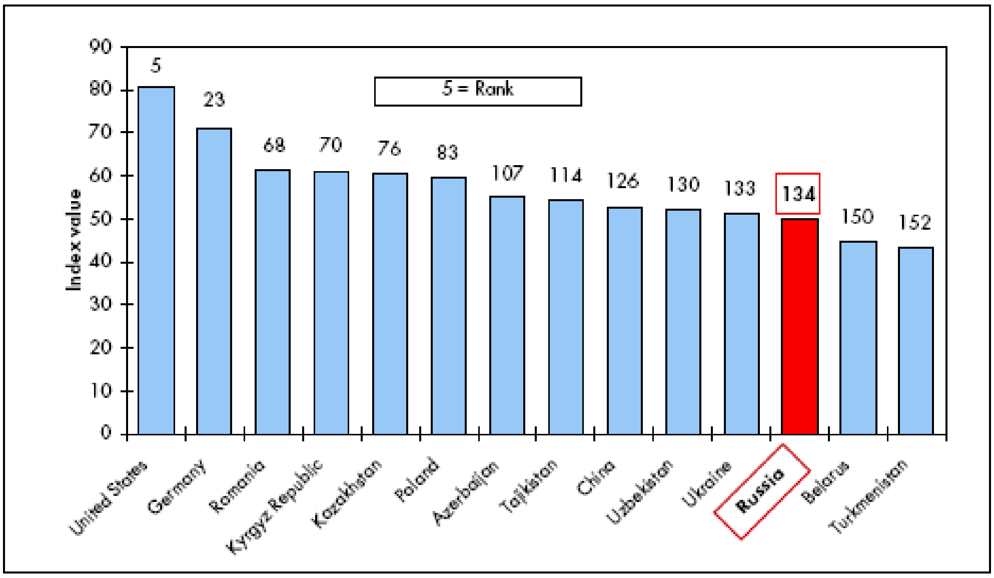
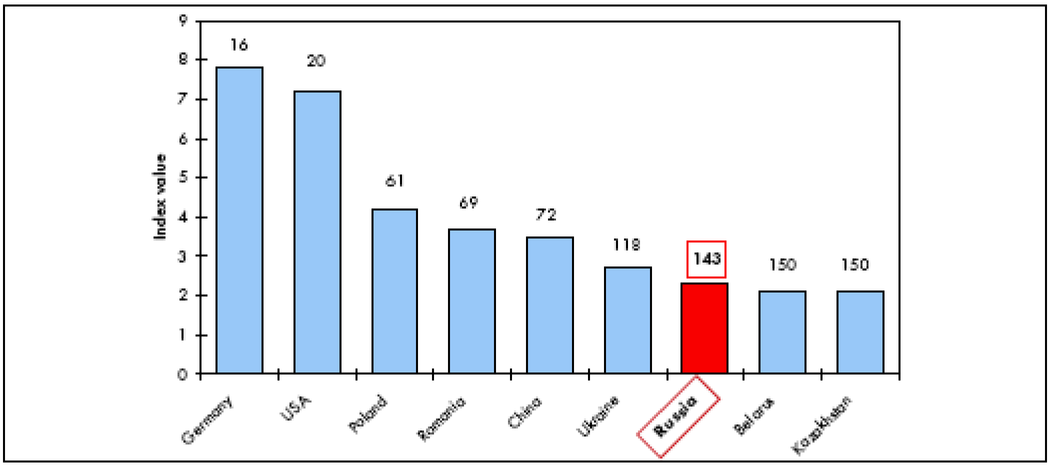


Table 9b: Corruption Perception Index 2008



3. Financial Services in Russia

On the Crisis

The Russian financial markets have been growing fast but not deep enough to sustain the current financial crisis that is hitting Russia as both the war with Georgia and increasingly nervous investors on the global front seek flight to quality have affected it. The rapid expansion on the economic front needs to be followed by the financial system as capital allocation would improve investment rates **(only 17% of investments are funded by the financial markets[3])**; especially as Russia's corporates suffer from decaying capital stock which needs large scale investments. **Also Russian infrastructure is seriously out of date, with ex president and now Prime Minister Putin estimating the investments needed at 1 trillion USD[4].** Financial deepening would also help to develop the SME sector and allow a diversification in the Russian economy away from the energy sector. **So far, the rating agencies have not downgraded Russia's Baa1 local and foreign currency bond ratings although they are keeping a close watch[5].**

What may yet change the situation even more are the problems that are starting to show in **Russia's overheated property market.** Already since early this summer warning signs have been seen. However now, rating agencies are putting large property companies such as OJSC PIK Group on rating 'watch negative' as concerns grow over their refinancing positions, which are overly reliant on the short term banking markets[6]. Russian property developers raised cash aggressively by going to the stock markets or through borrowing as banks saw that this sector was offering excellent returns, however property prices have gone up so much that now research agency IRN is predicting a **20 to 30% fall for Moscow properties in the next 12 months[7].**

Following the crisis with Georgia, Russia has suffered from capital flight as foreign investors pull out. **Before the crisis, foreign investment had risen to 221 billion USD (out of which 120 billion arrived in 2007 alone[8]); since the crisis with Georgia alone 30 billion USD has been pulled out.** Investors are increasingly concerned about the attractiveness of Russia as an investment destination. President Medvedev has sought to simplify regulations and laws, promising to cancel restrictions on foreign capital in the near future. However, the current financial crisis may impact this.

Putin's last act was however to sign a law limiting foreign investment to 42 key sectors. Also, the recent investigations into the coal and steel corporates Mechel and Evraz and the raiding by the police of BP's headquarters in Moscow have fuelled foreign concerns about the soundness of the system. The exodus of foreign capital is forcing Russian banks to slash lending as the crisis is starting to affect the real economy. Bankers are saying that Russia is facing the worst crisis since the 1998 default.

The Russian stock market had plummeted more than 25% since May this year up to 9 September and then fell another 20 % in two days of trading in the week beginning 15 September[9]. The Russian government has until now helped to shore up liquidity by placing up to 12.75 billion USD of development funds in short term deposits in the banking system and by holding regular cash auctions. Even large state banks such as Sberbank could face difficulties raising capital abroad (currently Sberbank is trying to raise 1 billion USD in the international syndicated loan markets).

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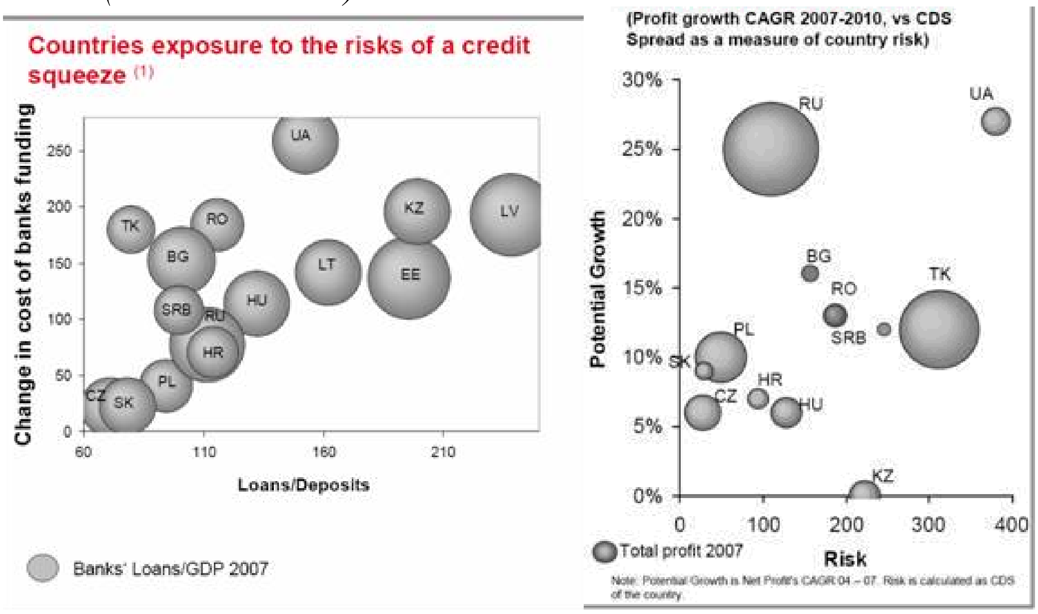
[3] Deutsche Bank Research, August 2007.
[4] REUTERS, 22 September 2008.
[5] Russia and CIS General Newswire, 19 September 2008.
[6] SKRIN newswire, 22 September 2008.
[7] REUTERS, 19 September 2008.
[8] Oxford Analytica, September 2008.
[9] Financial Times, September 9 2008.

As stronger measures were needed, the Russian authorities unveiled on 17 September their plans to address the current liquidity crisis and pledged almost 78 billion USD. The RCB said it would cut reserve requirements for banks by 4 % effective as of 18 September. The RCB will also loosen collateral requirements for fixed rate repo operations and increase lending limits for commercial banks. The government also announced it would provide Sberbank, VTB and Gazprombank with over 44 billion USD in 3 month deposits in order to solve the ongoing crisis.[10] The 'big three' will use the money to help smaller banks on the interbank market (which are seeing almost no lending and if some occurs then it is at rates of 20% to 40%).State intervention has not stopped the massive sell off on the Russian stock exchanges which in two days alone lost 20%; The Federal Financial Markets Service (FFMS) Russia's supervisor of the financial markets) has ordered a halt to trading until further notification and also banned short selling and margin trading indefinitely.

Table 10a and 10b: Indicators for financial solidity in 2007, reflecting potential to withstand a crisis (Source: Unicredit)



Banking Sector

Up to the crisis, Russia's banking sector had been catching up even though the **ratio of private credit to GDP is still low at 42%[11].** Annual growth of loans and deposits was between 35% to 45%. The share of foreign currency denominated loans had decreased following increased confidence in the Russian rouble, especially for deposits which in 2000 accounted for only 40% and were standing in 2007 at 75%[12]

Retail loans had been growing at more than twice the rate of corporate loans reflecting Russia's macroeconomic performance. However the retail market is still in its infancy with very little activity in mortgages and credit card loans although these two products are expected to be the main drivers until 2015 growing to 400 billion USD and 225 billion USD respectively. The banking market is also growing in sophistication, through the increased use of derivatives and securitisation since 2005.

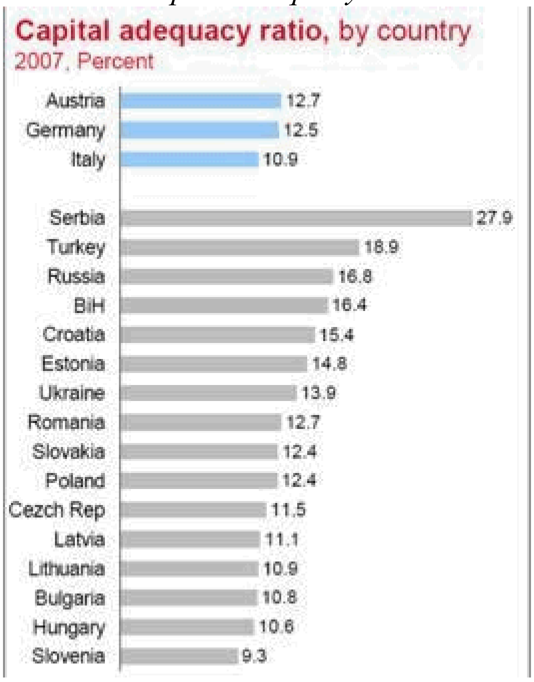
[10] Unicredit -Russian & CIS daily 18 September 2008
[11] CIS Banks Analyzer 15 September 2008
[12] Russia's Financial Sector -Deutsche Bank Research September 2007

At present Russia seems over-banked and a consolidation seems likely, especially in the aftermath of the financial crisis. **As of March 2007 there were 1,178 credit institutions in Russia. However the market is dominated by the 30 largest banks which together control 70% of all assets**[13] . The sector is still dominated by state ownership as out of the 30 largest banks, 21 are majority owned by the state. No private bank controls more than 5% of total assets. The 4 largest state controlled banks hold almost 50% of total deposits and loans. In contrast to other Central and Eastern European countries (CEE), there are still few foreign owned banks which limits the benefits of the transfer of knowledge on issues such as risk management and managerial know how which was so useful in CEE.

Most Russian banks in 2008 now operate on a very low capital base; about 60% of Russian banks have less than 5 million Euro in operating capital[14].The capital adequacy ratio had until the crisis remained above the minimum of 10% as set by the RCB. AS shown in table 11, Russia in 2007 even was among the top 3 in CEE with regards to capital adequacy, this picture is now changing as the impact of the liquidity crisis hits**.** However this will be an issue as due to their underdeveloped risk management systems, Russian banks could well suffer problems in times such as these.

Profits remain a major source of capitalisation (50 %) followed by subordinated loans (34%) and paid up authorised capital (23%). The reforms in banking regulations should have an impact on banks' access to capital; foreign banks have been allowed to buy up to 20% stakes in any bank without permission of the central bank (effective since January 2007) and a law was also enacted in 2007 permitting issuance of hybrid capital instruments, useful for boosting tier II capital.

Table 11: Capital adequacy in CEE in 2007 before the liquidity crisis (Source: Unicredit)



Looking forward to post 2008 the sector is still expected to expand at 30% p.a. over the 2008-2011 period driven by strong GDP growth and rising financial intermediation (estimate of rise of loans/GDP from 38% end 2008 to 46% by 2010[15]**.**

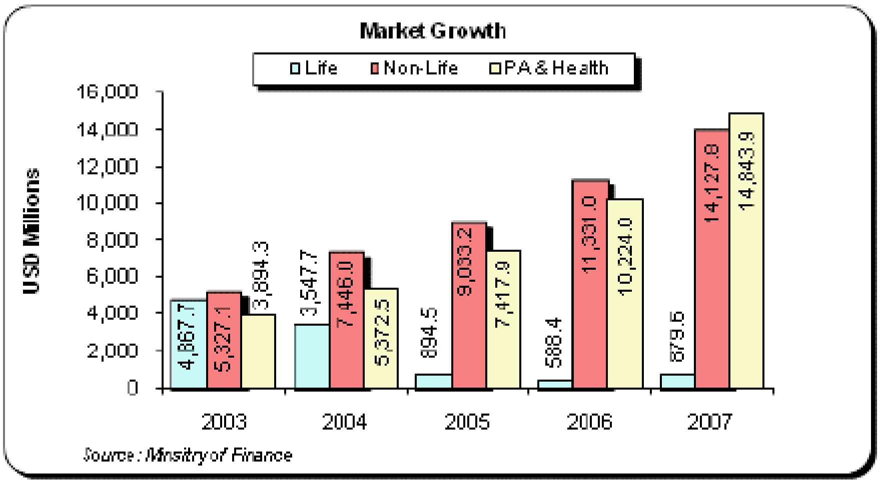
[13] Central Bank of Russia
[14] Central Bank of Russia
[15] Banking/Finance CIS Banks Analyzer, 15 September 2008.

Insurance

The Russian financial crisis of 1998 did affect not insurers as much as the rest of the financial sector as they were able to continue paying claims and no insurer became insolvent. In 2004, amendments to the 1992 insurance law were implemented (following the WTO negotiations) introducing higher capital requirements, split insurers into life and non-life operations and removing most restrictions on foreign insurers effectively opening the market fully. **From 1 July 2007, life and non-life insurance was split into separately capitalised and licence entities.** In 2008, it was announced that accession into the WTO had been achieved by reaching the quota of 25% of foreign capital in Russian insurance companies which was then raised to 50%. From 1 January 2008, changes in personal income taxation will encourage group and individual pension schemes as well as the development of employee benefits.

Premium income reached 20 billion Euros in 2007 representing a 27% yoy growth[16]. As of the end of 2007, Russia had 857 insurance licenses. Russia's top 5 insurance companies generate less than 25% of the total premium income. Rosgosstrakh, Russia's top insurer has roots in Soviet times and is still 25% state owned.

Table 12: Market growth for the Insurance sector



Life

The Russian economy's decade of high growth has raised disposable incomes especially in Moscow and surrounding regions. As wealth is restricted to the area of Moscow and surroundings, the development of the life insurance and pension schemes is also restricted to those areas. **Not more than 1% of the population has life insurance.**

An increasing number of foreign life insurers are being established in Russia and it is estimated that they will seek 20billion USD of the life market by 2012[17]**. Life market growth is seen at 40% p.a. until 2016[18].** Group life is majority dominated by the life insurer Sogaz-Zhizn (owned by Gazprom) which has a 47% market share. The Russian life market features predominantly captive life companies which provide employee benefits to related companies (this makes up for about 7 of the top 10 insurerers).

[16] BOFIT weekly, June 2008.
[17] AXCO insurance report on Russia September 2008.
[18] ibid

Pensions

The Russian pension system has been the subject of major reform over the past few years as the old state system cannot sustain the level of payments for the future. Voluntary pension provision was allowed back in 1992. Under current legislation, pillar II provisions are funded by mandatory contributions, divided into two parts; one going into the State Pension fund of Russia to provide funding for the social pension and a second part for an individual pension account. Since the beginning of 2004, employees can transfer the management of the individual accounts to independent asset managers. Further changes have been passed to pension legislation in April 2008, whereby the state co- finances additional contributions to the cumulative part of the occupational pensions.

For pillar III, in January 2008 some tax benefits were allowed for pension contributions.

Mutual Funds

The mutual fund industry is very recent in Russia and has only been in existence for 5 years. Annual returns from the funds have been very high but fears about corporate governance and risk management remain. Supervision is provided by the FFMS and in December 2007, improving measures were taken to increase the control of investment funds, asset management companies (especially non-state pension funds). **Current changes to legislation being considered are regarding an increase in the percentage of foreign securities in fund portfolios (which is limited to 20%) or even to permit funds only invested in foreign securities**. Total assets under management at 31 March 2008 were estimated at 33.89 billion USD[19].

Securities

Russia's belongs to the BRIC group of countries with the highest GDP rates of growth and that has also given an expansionary stock market until the recent crisis. Russian stock markets have become integrated in the global market effectively since the 1998 crisis. **Foreign investors have increasingly taken part in this process and the period 2006 to 2006 witnessed an eightfold growth which is a record high for emerging markets.**

There are two exchanges, the MICEX and the RTS exchanges. By overall trading volume MICEX is the largest exchange in Russia, the CIS and CEE. The National depositary Centre (NDC) is a central depositary to service government securities traded on MICEX. In 2008, NDC is recognized as a joint stock company, with major Russian banks and investment companies taking up the bulk of the share capital. Each shareholder having a minor interest. RTS is the second stock exchange which, although much smaller in volume, has a larger spread of securities. The Depositary Clearing Company (CJSC) is the clearing agent for RTS. The two clearers can transfer securities from one depositary to the other.

Foreign participants in the stock exchanges establish subsidiaries with 100% foreign capital and thus obtain a licence to act as a professional participant. Foreign issuers can place securities both directly and indirectly through Russian depositary receipts.

Traded instruments are corporate shares and bonds, government bonds and promissory notes of Russian banks and companies. There are two types of government bonds: federal loan bonds (OFZs) denominated in Russian Roubles and foreign currency denominated domestic bonds in USD (MinFin bonds). OFZs are traded on the stock exchange only. Their volume is around 41 billion USD.

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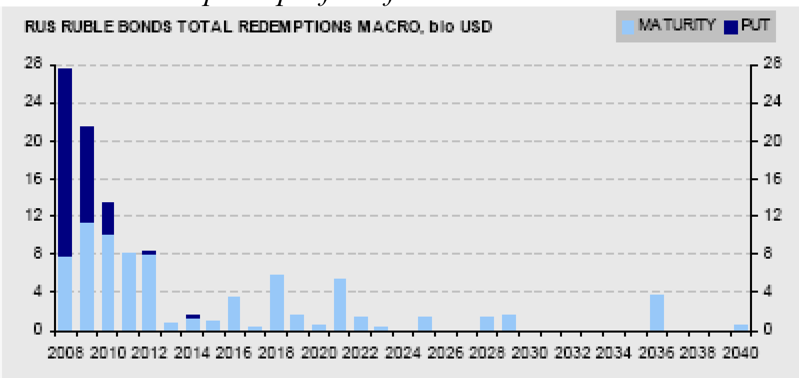
[19] Investfunds

The MinFin bonds are traded OTC representing around 4.5 billion USD. The highest capitalization issuer is without any surprise Gazprom which is the largest by far with 336 billion USD, its next in line only achieving 93 billion USD (at the start of 2008 the total capitalization of the Russian Stock market was 1328 billion USD)[20].

Since the onset of the financial crisis demand for bonds is currently limited and this causes problems as 2008 has been the year of massive redemptions and put options which further affect the liquidity of the bond market[21].

Table 13: Redemption profile of Russian Rouble bonds



Source: Credit Europe Treasury Research, Bloomberg, MICEX, CBONDS.

Legal Framework

The federal law 'On the Securities Market' dating from 2004 is the basis for market regulation. According to this law, issuance of shares is only allowed in non-documentary form which reduces risks in circulation of the securities and speeds up turnover. Institutions engaged in both depositary and trading are obliged to have separate bookkeeping of assets deposited by their clients under the depositary agreements. Clients' securities are not included in case of the bankruptcy of an institution. The law furthermore forbids foreign depositaries from opening nominee holders' accounts with Russian depositaries, thereby restricting the flight of liquidity to foreign markets.

The FFMS is a federal executive body (established in 2004) which controls and supervises activity in the financial markets, including that of the exchanges, and issues regulations; It also regulates the investment of pension savings. The key objective of the FFMS is to maintain stability in the financial markets, increase market transparency. The FFMS took on both the controlling and supervising functions. The Russian government has control of the FFMS and is responsible for appointing its head and deputy heads;

There are also a number of self-regulating bodies that work on providing standards.

Draft Laws are currently being analysed in the Duma regarding (i) the simplification of the issuing of securities, (ii) regulation of the Russian depositary Receipts, (iii) acquisition regulations and -(iv) securities management regulations.. A further law is being considered regarding the amendment of the Mortgage law and the Mortgage Securities Law. It is aimed at improving the safety in the securitization of mortgage loans. The new law will favour the conditions for the effective creation and transfer of mortgage collateral; this will thus decrease the risks and enhance reliability[22].

[20] VNESHECONOMBANK review of the Russian Securities market, 2008.
[21] Credit Europe Bank, the Russian economy and Banking system 2008
[22] BBH- Legal Newsletter on Financial and Capital Markets Developments in Russia, March 2008