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Investments as a Lever for Lifting the Economy out of Crisis

Abstract: This article has three objectives: first, to present the results of what has been done in Russia to create the institutional underpinnings for fixed investment; second, to explore investment profitability by type of business activity; and, third, to describe the role of foreign direct investment in the overall fixed investments in the Russian economy. Our analysis reveals that despite all the efforts, two problems remain with the Russian economy. Investments in fixed assets have not decreased income inequality both in industrial sectors and regional aspects, and these investments do not endeavor to change the structure of the Russian economy, leading to the predominance of natural resources extraction and the weakness of modern services and high-tech industries.

In 1998, I published an article with the same title as this one (Kossov 1998) that contained the well-known quotation by Archimedes: “Give me a fulcrum, and I will move the world.” The fulcrum I referred to was the institutional reforms that were strengthening private ownership, and the lever was specified in the title of the article as capital investment, which meant investment in fixed assets.

At that time, I worked as a deputy minister of the economy of the Russian Federation, and my area of responsibility included shaping government policy with regard to investment in real assets, including foreign investment. The most important priority seemed to be to create a complete legislative framework that would regulate the state’s relations with private investors and the legal framework for the activities of private investors in Russia. Two federal laws were prepared, introduced in the parliament, and finally accepted: one on capital investments in

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the Russian economy (1999, with subsequent revisions in 2000, 2004, and 2006) and one on foreign investments (1999).

Other elements of the legislative framework included the protection of private investments in leasing and agreements for the mutual protection of capital investments. A separate theme of the legislative activity was the agreements with various countries on mutual protection of capital investment, all of which should be approved by the parliament. Since that time a good deal of work has been done in rethinking the assessment of investment projects. In essence, a switch was made from an assessment of investment projects according to Soviet methodology, which was based on minimizing the annual equivalent of expenditures in constant prices, to a methodology based on capital budgeting principles. The purpose of this switch was to expand sharply the role of cash flow as the key evaluation characteristic of the investment project. To make this switch happen, the official procedural guidelines for the assessment of investment projects were issued and an appendix provided a beginning-to-end example that made it possible to test one's understanding of the text (Russian Federation, 2000). A major role in the preparation of the official publication was played by a group of scholars led by V. Livshits who has published the second edition of a fundamental work of 1,100 pages on this topic (Vilenskii and Livshits 2004). The procedure for drawing up business plans by companies was organized in the country at this time. Further interest in this new methodology was reinforced by linking the official procedural guidelines to the competitive bidding process between private investors' investment projects that were to receive state support. Notable assistance to this work has come from the "Teaching Economic and Business Disciplines in Secondary Schools and at Technical and Classical Universities" (TASIC) project, which has helped publish my book on business plans (Kossov 2000). Today there are dozens of books about business plans in Russian. This concept formed the fulcrum that the field of investment policy relied on. With this as a background, we can attempt to determine what really has been done over the past ten to fifteen years, which elements of investment activities already correspond to the same elements found in developed countries, and what are the remaining problems that mark the still unfinished transitional period of the Russian economy.

The role of investments in the aftermath of the Russian financial collapse of 1998 and in the follow-up of the world financial crisis of 2008

In this section, I analyze the validity of arguments I made in 1998 (in *italic*) about the problems of economic transition.¹ The first argument has been framed as follows: *The growing social inequality and the rise in the level of poverty is the major threat to economic development as the increase in the number of people in poverty fuels radical political tendencies. Fixed investment is a mean to prevent political radicalization.*

Economic theory considers economic growth and the distribution of families by income as largely separate phenomena. However, we will attempt to prove that the inequality of income, starting from a specific level, impedes economic growth because the state must allocate a part of the available resources to neutralize the negative consequences of rising inequality. Such a policy softens social tensions but cannot remove them completely. To ease social tensions, it is extremely important to increase the income level of the most deprived families. This may be partially achieved by the creation of new employment opportunities and the training of the potential labor force to help them obtain the necessary qualifications for productive and properly paid jobs. Assistance to individual entrepreneurs and to small companies is one of the most effective means to reach that solution, especially in regions affected by very high unemployment.

In the beginning of the twentieth century, Russia experienced a series of revolutions that coincided with rapidly accelerating income inequality as a consequence of explosive industrial development. By my estimate, the Gini coefficient (the ratio between the income of the top 10 percent of the wealthiest family and the income of the lowest 10 percent of the poorest families) contracted during the period of 1918–2000 by a factor of 10, from 50 to 5, due to the mass expropriation of private property; the Gini coefficient then remained stable over the period of 1930–1980s. Starting with the privatization processes in the early 1990s, the Gini coefficient officially rose from 8 in 1992 to 16.8 in 2007 (Russian State Statistical Committee 2001, table 7.1; 2008, table 6.20).² The closeness of the coefficient to the level experienced in Russia at the beginning of the twentieth century shows the rising potential danger for a new revolution.

Besides the overall level of poverty, the regional differences are of even greater importance. In 2006, gross regional product per capita was \$29,716 in the richest Russian region (the oil-producing Tiumen oblast) and \$664 in the poorest region in Russia (Ingushetia) (Russian State Statistical Committee 2008, tables 11.20 and 22.42). To catch up with the national level, the underdeveloped regions will need to absorb a greater share of the total real investments. To accomplish this, both federal and regional authorities should create the necessary conditions for private investors, assuming that investors will create properly remunerated jobs. In reality, we have observed exactly the opposite. The Russian Federation consists of 81 regions, each of which has a legislative branch and a government. The nationwide level of investments in 2007 was merely 59.4 percent of the amount made in 1990, before the dissolution of the Soviet Union. Among all 83 regions, 63 regions are below the national average. For the 16 poorest regions, the level of investments in 2007 was less than 33 percent of the investment level in 1990 (Russian State Statistical Committee 2008, table 23.10). The main cause is that, with the exception of Moscow and St. Petersburg, the major flow of investment is oriented toward extraction industries and regions with rich natural resources. The policy of attracting investment in manufacturing regions has failed. If we consider the use of microcredits, as proclaimed by the Nobel Peace Prize winner Mohammed Yunis,

the necessary investment needed to start a microbusiness in Russia is approximately US\$1,500–3,000, and, indeed, in 2009 the Russian government launched a program to offer the sum of US\$2,000 to unemployed people to start a business. Unfortunately, a major problem was the very low level of entrepreneurial activity of the population. Only 3.9 percent of the Russian population are self-employed or have their own business (Bilibina 2009).

A statistical analysis reveals an interrelationship between the rate of fixed investment and the rate of the creation of small businesses; yet, this relationship is masked by the influence of other, far more powerful sources of investment. While omitting the details of the calculations, it is important to note that growth in the number of small businesses strongly affects the function of attracting investment. On average, the rate of investment inflow lags behind growth in the number of small businesses by roughly 50 percent. The importance of small businesses derives from its widespread dispersion in the economy, which leads to the fact that even small investments made in small settlements are important to local development.

In order to identify the factors impeding fixed investment in sectors other than natural resource exploitation, which is the only way the vast majority of Russia's regions can develop, a special study was undertaken at the State University—Higher School of Economics under my direction. It showed that campaigns aimed at attracting private investors have been organized by the authorities of every region, but in the vast majority of them, it was done in a perfunctory manner, the results of which are presented in my book (Kossov 2009). The book also examines the most typical deficiencies in innovative and investment projects in midsize and small businesses.

The second argument I proposed in 1999 dealt with structural changes in the national economy: Recovery from the crisis presupposes the creation of new industries and production lines that shape the face of a new economy. This again requires significant investments. If we look at the dynamics of investments (Figure 1), we may see that the dynamics of fixed capital investments falls below the growth in the gross domestic product (GDP). The proposition that huge investments in the Soviet military-industrial complex are unnecessary seems to be valid. However, the capital invested in the military complex has not been converted into investments into roads or housing. The low rate of investment in growing GDP becomes obvious when we look at the fact that only a very small number of modern industries have emerged over the last two decades. Exceptions are the extremely quick development of beer production, orchestrated by major international breweries that achieved an eightfold raise in per capita consumption of beer in Russia, the development of mobile telecommunication networks, the emergence of the modern retail formats under the auspices of IKEA, Metro AG, Auchan, and other major world players, and the construction of automotive assembly plants by Ford, GM, Volkswagen, Toyota, PSA, Renault-Nissan, and others, all of which were completed with the participation of foreign investors. The only genuine Russian sector that emerged in 1990s and

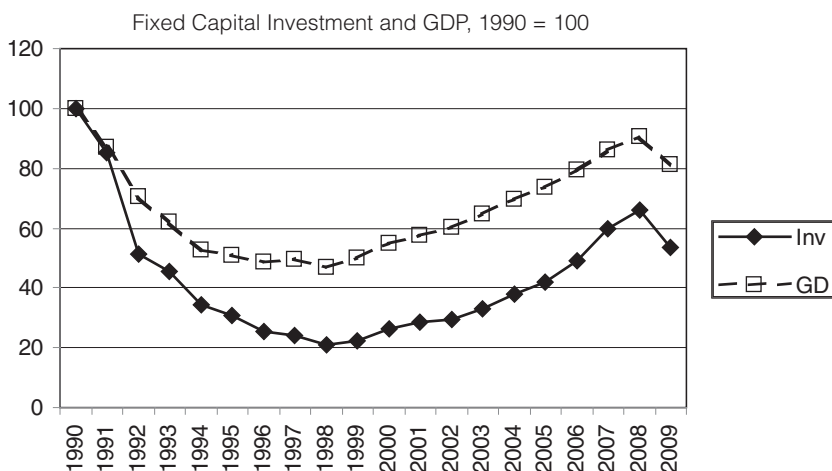


Figure 1. **The dynamics of fixed capital investment and the gross domestic product, 1990–2009**

especially in 2000s was suburban housing. Elegant cottages have mushroomed on the outskirts of dying villages and abandoned industrial cities!³

So far the two major problems that I outlined in 1999 are far from a satisfactory solution even today. Nevertheless, the investment process in Russia is going on, and we should outline the main elements of its structure.

The structure of investment processes in Russia

The structure of investment in fixed assets may be depicted as the accumulation of necessary funds from various sources, the use of such funds, and their attractiveness as evaluated by their efficiency. The crisis that started in the fall of 2008 affected the choice of the years analyzed, so the last year of analysis for investment is 2008 and for foreign investment is 2007. The principal change here was the emergence of bank loans as a source of funding that increased from 3.5 percent to 12 percent of the total. The second shift was the diversion of owners' investments into three types of capital flows: retained profits and depreciations of assets, transfers between the members of the same holding companies, and credits between de jure independent companies that belong to the same corporation or that are part of the ownership portfolio of the same owners (no data shown for the latter two types). In addition, the state provides about 20 percent of the sources of investments, and advanced methods of capital formation, such as bond and stock issues, are still in their infancy and occupy together less than 1 percent of the total source of funds for real investments.

We also should stress the role of foreign direct investment (FDI). The share of FDI is about 10 percent of total capital investment in Russia. We should add to this

Table 1

Structure of sources of financing for investment in fixed capital in Russia

Sources of investments	1997	2008	2009 (Jan.– June)	Remarks
Investments in fixed capital–total	100	100	100	
Owner's equity	60.8	39.5	40.1	
Retained profits	13.2	18.4	16.9	
Depreciation	n.a.	17.3	20	
Borrowed funds	39.2	60.5	59.9	
Bank loans:	2.5	11.8	12	Clear increase in borrowed funds
of which loans from foreign banks	0.9	3	3.7	
Borrowed funds from other entities	n.a.	6.2	8.2	Credits from other companies that belong to the same owners
Budgetary funds	20.7	20.9	16.7	Visible efforts of both federal and local governments to save money during the crisis
of which federal budget	10.1	8	6.5	
of which budget of regions of the Russian Federation	10.5	11.3	9.2	
Nonbudgetary funds	4.1	0.4	0.2	Before 2000 significant funds were allocated to the road fund
Other	28.5	21.2	22.8	
Funds from higher-level entities	20.1	13.8	17	This vague terms refers to the transfers from other companies under control of the same owners
Funds received from ownership stake in construction (entities and the public)	3.8	3.5	2.3	
Funds from the issue of corporate bonds		0.1	0.01	
Funds from stock issues	0.1	0.8	0.5	
Foreign direct investment	7.0	10.0	8.6	

figure loans from foreign banks. The total figure both underestimates and overestimates the role of foreign companies in capital formation. The overestimation stems from the fact that 30 percent of foreign investment come from offshore entities such as Cyprus, British Virgin Islands, and Luxembourg. This is merely Russian money exported and then repatriated to Russia. Underestimation stems from very poor accounting systems that exist for deals where entire companies were acquired. Gurkov and Settles, in this issue, mention how easily major multinational companies purchased market shares in Russian consumer markets by takeover or acquisition of a controlling share in major Russian players. Such deals are not counted here as foreign investments into fixed assets. Another source for underestimation is related to the activities of foreign banks in Russia. Because foreign banks are still prohibited to open branches in Russia, operations of major international banks such as BNP-Paribas, Citibank, RBS, and others are done through subsidiaries that, despite their 100 percent foreign ownership, are considered by official statistics to be *Russian* banks.

Nevertheless, a foreign investor in Russia, especially an investor from a Western country, will run into business activity that is organized in a way they are not at all accustomed to. In Russia, unlike Western countries, practically all issues of regulation of investment activity are handled by state entities rather than by self-regulating ones. This means that success depends heavily on having good relations with representatives of the government, which is made easier by the fact that local authorities in most regions have promulgated policies with respect to desirable areas for investment. This is carried out through the appointment of overseers for projects from the responsible officials of the administration whose rank depends on the scale of the projects. Major projects are supervised by second-tier people in the administrative hierarchy such as vice-governors.

This framework applies to planned investments. A foreigner in Russia can obtain essential assistance from associations of his fellow countrymen working in Russia, the largest of which is the American Chamber of Commerce. The interests of foreign investors are discussed annually with the prime minister of Russia at meetings of the Advisory Council on Foreign Investment. The questions submitted to council meetings are prepared by joint working groups of representatives of the Russian government and foreign investors.

A particularly important issue related to foreign investment concerns enterprises classified as strategic, which is the subject of the new law "On the Procedure for Foreign Investment in Business Entities of Strategic Value in Supporting the Nation's Defense and State Security," passed by the State Duma, the Russian parliament, in November 2009. This law defines the concept of "strategic enterprise," under which foreign companies, in order to acquire 50 percent or higher ownership stake, must obtain special permission from an "authorized agency," which as of the writing of this article has not been established yet, and a commission headed by the prime minister. This restriction also extends to Russian companies with foreign capital, which must obtain such permission to purchase a 25 percent ownership stake.

Clearly, the heavy burden of dealing with central and regional bureaucracy frightens small and medium-size foreign investors. Only large multinationals, with positive experience of special deals in the various parts of the world, and with the strong backing from their home governments, may dare to enter Russia for greenfield investments. Thus, most foreign investments are concentrated in three areas: retail trade, oil extraction, and production of ferrous and nonferrous metals. These three areas account for two-thirds of foreign investment (see Table 2). The remaining one-third of investment includes two important sectors. The first is motor-vehicle assembly plants and the production of vehicular components. The second important area is investment in lumber processing. A decision was made in Russia to raise export duties on the exportation of unprocessed logs to control their export, but the implementation of these duties has been postponed due to the 2008 financial crisis. Since Russia accounts for half the world's reserves of coniferous timber and the regions where it is abundant such as Siberia have ample fresh water and cheap electricity from hydropower stations, these regions hold great promise in terms of advanced lumber processing.

At the same time, Russian practice shows that if investors, including foreign ones, are treated with consideration, things go well even in a crisis. A positive example is Rostov oblast (region), where the amount of investment tripled from 2005 to 2008. In Rostov oblast, for each investment project that meets the criterion of a total value of at least \$6 million or the creation of employment for 200 or more people, the authorities appoint two special overseers: a minister of the regional government and the head of the *raion* (county) where the project is to be implemented. These overseers defend the project from so-called raids and demands for bribes by other, nonappointed, bureaucrats. An example is a snack producing subdivision of PepsiCo that decided in 2009 to allocate \$6 million for microcredits to farmers who grow potatoes for snack production in that region in order to meet the employment criterion.

In general, the investment process in Russia is a game for the big boys, namely, large corporations with established government relations departments and long planning horizons that heavily rely on their own funds to cover the capital expenditures. Thus, we should evaluate the results of such a game, both in terms of the gains for individual investors and the overall impact of investments on the national economy.

FDI in the Russian economy mostly remains the domain of large multinational corporations whose partners are large Russian corporations. Foreign investors are concentrated in the largest cities or in close proximity to Moscow and St. Petersburg. However, a larger physical presence of foreign companies, especially in the service sector, is important for the dissemination of market culture, and this may be accomplished by the activities of small and medium-size foreign companies interested in operating in the Russian market.

The investment process is not a black box. Any private business expects proper return on its investments and tries to predict the return on its particular invest-

Table 2

Investments by foreign investors by subtype of business activity

	2000		2007		Notes
	billions of US\$	%	billions of US\$	%	
Total investment	29.7	100	120.9	100	
Extraction of mineral resources	5.7	19.3	17.4	14.4	
Extraction of fuel and energy resources	5.1	17.3	15.9	13.1	
Manufacturing	6.5	22	31.9	26.4	
Production of food products, including beverages, and tobacco	1.0	3.4	2.9	2.4	
Lumber processing and production of items from wood	0.3	1.1	0.5	0.4	Low duties on log exports
Pulp-and-paper production, publishing and printing activities	0.2	0.8	0.9	0.8	
Production of coke and petroleum products	0.2	0.6	4.4	3.6	
Chemical production of plastic items	0.4	1.2	1.6	1.4	
Iron and steel production and metal products	3.1	10.3	15.2	12.6	
Production of means of transportation and transport equipment	0.2	0.7	3.0	2.5	Vehicle assembly
Construction	0.1	0.3	2.9	2.4	
Wholesale and retail trade; repair of motor vehicles, motorcycles, household items and personal products	10.5	35.5	47.3	39.1	
Transportation and communications	1.1	3.8	6.7	5.5	
Communications	0.7	2.3	3.3	2.7	Mobile phones
Financial activities	0.8	2.6	4.5	3.7	
Real estate transactions, leasing and services	4.6	15.4	8.4	8.5	

ments. Data reflecting the potential attractiveness of investment in Russia's real economy is presented in Table 3. The first two rows of Table 3 show the return on investment, while the other rows outline the investment conditions. As expected, the most profitable business in Russia is the extraction of minerals. The second-most profitable type of business is the manufacturing industry. Transportation and communication rank third in profitability. The average data for the type of business disguises the indisputable preponderance of investment in communications, where return on sales (ROS) was 33.75 percent in 2008 and 35.5 percent for the first six months of 2009. The average return on assets (ROA) for that type of business was 13.1 percent in 2008.

A surprising result is the virtually equal returns on two such different types of businesses: agriculture and trade. A more detailed analysis shows that this is a consequence of the specific characteristics of a very favorable year for agriculture. In more typical years, ROS and ROA in trade are usually 50 percent higher than in agriculture. This defines the advantages of trade over agriculture from the standpoint of return on investment. Fishing and fish farming rank last in return on investment, which was a hard year for that industry. ROS for fishing was 30.4 percent and the ROA was 10.5 percent in the first six months of 2009.

Valuations of fixed assets are given using the prices entered on the companies' balance sheets. This complicates the measurement of trends in fixed assets, but it is not of fundamental importance in analyzing the differences among types of economic activity. The largest shares of fixed assets are concentrated in transportation and communications, followed by the extraction industry, which is to be expected in Russia. What is important for understanding the specific characteristics of the economy is the substantial amount of assets in the manufacturing industry.

An assessment of the qualitative changes in the makeup of fixed assets after the breakup of the Soviet Union was conducted by Voskoboinikov (2004), who separated out from the overall mass of fixed assets those that were in reserve, that is, those that could be used at the enterprise in question to manufacture products if there was a demand for them, and those that were effective, that is, those that were in fact put into operation. According to his calculations, the amount of reserve fixed assets in 2002 was about 70 percent of the amount available at the end of 1990, while the figure for the effective fixed assets was slightly more than one-third. This data demonstrate how the Russian economy has contracted in twelve years. The same period was the period of active reallocation of fixed assets between enterprises. Almost 75 percent of effective assets were not inherited from Soviet times but, rather, were acquired in the market. Such an acquisition processes assisted in correcting the inefficiency of the initial privatization schemes, which gave control over the assets to individuals and entities that were unable to use them effectively.

The qualitative difference between the crisis of 1991–98 and the one that began in the fall of 2008 is that, first, the economy had a significant reserve of unused capacity that contributed to a fast restart of the economy later. There proved to be far less unused capacity in 2009 as a result of the adaptation of former Soviet en-

Table 3
Investment attractiveness of principal types of business activity in 2008

	Agriculture, hunting and forestry	Fishing, fish farming	Mining and quarrying	Mfg.	Electricity, gas, and water supply	Construction	Wholesale and retail trade	Trans. and comm.
Return on sales, %	10.0	7.4	25.4	17.1	4.9	5.6	10.8	14.2
Return on assets, %	4.8	1.0	10.5	8.6	2.3	3.1	5.3	5.4
Available fixed assets, at beginning of year, billions of dollars	79	3	219	209	176	41	67	819
Renewal coefficient of fixed assets, in percent	4.8	1.7	7.0	7.1	3.6	4.4	9.6	3.8
Disposal coefficient of fixed assets, in percent	3.2	1.9	1.1	1.5	0.3	1.2	1.0	0.3
The share of totally depreciated assets (percent)	45	61	53	46	51	46	33	54
Average monthly wage paid to employees of entities, in US dollars	288	664	1,130	546	649	632	508	707
Proportion of loss- making companies, in percent	23.8	37.0	37.6	29.2	46.4	24.1	23.6	34.0

terprises to the market economy. That is the fundamental difference in the status of Russia's industrial complex between the beginning of 1999 and the end of 2009.

The renewal coefficient of fixed assets (row 4 in Table 3) reflects the proportion of fixed assets put into operation in the current year and is defined as the ratio between the annual increase of the cost of the fixed assets and the total cost of fixed assets of a firm. The lull in capital investment that characterized the first half of the 1990s exacerbated the perception of the age of the production complexes. The average rate of depreciation for all types of business exceeds 50 percent. The rate was only 33 percent for trade because of the large investments in that type of business as a result of the transition to the market economy. Because the renewal coefficient of fixed assets is dependent on the fixed assets put into operation, this measure is a good indicator so long as the fixed assets undergo normal maintenance, which, unfortunately, is one of the sore points for Russia today since routine maintenance is usually delayed.

Conclusion

I have tried to interweave here strands of analysis relating to, at times, conflicting private and public policies related to investment in fixed assets. Indeed, there are several arguments that hardly correspond. The level of capital investment in Russia's economy is inadequate for rapid qualitative economic and societal transformations, which have been proclaimed and financially supported by the authorities under the banner of modernization.

The federal government is still persuaded that abundant natural resources and significant local demand for consumer goods can create significant high levels of investment, and, despite the generally good legal framework for investments created in the 1990s, the government continues to impose stricter rules on foreign investment and more obstacles for local investors. Contrary to the attitudes at the federal level, the Russian regional authorities understand the role of both local and foreign investors in the creation of jobs and prosperity in their regions and, hence, compete to attract investors. The elements of this competition are regional development programs with priorities in capital-investment sectors and the assignment of senior representatives to supervise investment projects. Despite all the objective and subjective obstacles to investments, the return on capital investment in Russia is fairly high; most of the implemented investments are recuperated merely in four years. Russia should be experiencing a boom in fixed investment, but institutional limitations and difficulties in doing business in Russia limits the level of investment.

The unique combination of economic factors in Russia means that the life of a Russian investment manager is anything but dull and monotonous. The transition period redistributed Soviet-era fixed assets followed by rapid economic growth in the post-1998 crisis period that has created a wide range of investment possibilities in the Russian market. The rapid shift from Soviet-era investment analysis to

modern project analysis techniques has radically changed the process of investment decision making. Companies, operating in Russia, local and foreign alike, are keen to implement all the advanced techniques in capital budgeting, risk management, and activities scheduling in order to counterbalance the turbulence of the external environment.

The analysis in this article reveals that despite all the Russian government's efforts two problems remain in the Russian economy. Investments in fixed assets have not decreased income inequality both across industrial sectors and regional areas, and these investments do not endeavor to change the structure of the Russian economy, leading to the predominance of the natural resources extraction industry and the weakness of modern services and high-tech industries. Long-run economic growth and reducing the level of income inequality in the Russian economy is tied to proper investments in fixed assets. Barriers to entry into the market through strategic industry limitations have reduced competition within certain industries, resulting in less effective investment plans and use of resources. The weak institutional framework to protect investments in fixed assets and innovation has also contributed to the unbalanced pattern of investment in natural resource production instead of high-tech and service industries. Investment in effective and productive real assets has the proclivity of leveraging Russia out of its natural resource rut.

Notes

1. Data presented in this article, unless otherwise stated in the text, have been taken from the Web site of the Russian State Statistical Committee, which is also available in English: www.gks.ru/wps/portal/english/.

2. Official data are based on a censored sample that trims the sample to remove the highest and lowest income earners. Experts have estimated the Gini coefficient in Russia, based on more complete sample, at from 17 to 35.

3. Another disturbing observation is the overall fall in the savings rate in Russia. Even in 2006, one of the most prosperous years in the past two decades, the savings rate in Russia was merely 18 percent of GDP, compared with 43.3 percent in China, 37.1 percent in India, and 19.6 percent in the United States, which is notable for its low savings rate.

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