THE RUSSIAN ECONOMY

■ ANALYSIS
The Current State of the Russian Economy
By Philip Hanson, London

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Governance and Regional Resilience in Russia:
A Case Study of the Khanty-Mansiysk Autonomous Okrug
By Irina Nikolaevna Il’ina, Carol S. Leonard, and Evgenii Plisetskij, Moscow
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Abstract
Russian economic growth had slowed to a crawl before the Ukraine crisis. The reasons for this are assessed from both the demand side and the production capability side. Radical reforms to improve business confidence are needed but are unlikely to be undertaken. The Ukraine crisis and foreign sanctions make near-term prospects worse than they already were. In the medium term some restoration of growth is possible, but only to rates below the global average.

Introduction
In assessing the present state of the Russian economy, it is worth taking a step back from the question of sanctions and their impact. Why had Russia experienced a marked economic slowdown before the Ukraine crisis? What are the medium-term prospects? Answering the second of these questions has to involve some speculation about sanctions and their consequences. The first question however is important in its own right. If peace and goodwill were soon to break out over Ukraine—which, sadly, they will not—Russia would still face fundamental economic problems.

The Pattern of Russian Growth From 2000
Between the Russian financial crisis of 1998 and the global crisis a decade later, the Russian economy boomed. In 1999–2008 GDP growth averaged 6.9% per annum. This was made possible by a rapid growth in oil prices, fuelling a massive increase in household, state and corporate incomes and spending. Real incomes could and did grow even faster than production because the purchasing power of Russian exports over Russian imports was rising.

After a remarkably steep fall in 2008–09, Russian economic activity recovered in 2010–11, but without recapturing its former dynamism. It then slowed to a crawl in 2012–14: GDP rose 1.3% in 2013 and, on preliminary estimates, 0.8% year-on-year (yoy) in the first quarter of this year. Talk of stagnation became commonplace in the Russian media. There were fears of a new recession.

Figure 1 shows how this story looks in comparison with global GDP and that of the globe’s sick man: the Eurozone. During its inter-crisis boom, Russia comfortably outperforms the world as a whole, increasing its share of world output; it fares unusually badly in 2009; then approximates global-average rates of recovery in 2010–12, and drops below the global rate of growth in 2013. So far, it continues to do better than the Eurozone, though not as well as some individual European countries, such as Germany. The ‘extra slowdown’ from 2012 is something of a puzzle.

The figures for 2014–18 are IMF World Economic Outlook projections. Like other medium-term projections, they are not necessarily reliable guides to the future. Indeed, the IMF has already revised its Russia projection for this year down to 0.2%. However, a number of Russian forecasters, both official and independent, concur with the IMF in seeing Russian growth stuck for the foreseeable future below that of the global economy as a whole: no longer an emerging, but a submerging economy.

For a geopolitically ambitious leadership, this is bad news. For any country with a large productivity gap behind the developed world, it is profoundly disappointing (Russian GDP per employed person is around two-fifths of the German level). The IMF sees the Russian economy doing somewhat better than a feebly recovering Eurozone over the next few years, but not markedly better. Catching up with the West, that perennial Russian objective, looks to be postponed yet again.

Many commentators say that the ‘growth model’ of Russia’s boom years no longer works. But what does this mean? And, insofar as it is a helpful way of looking at the slowdown after 2009, can it account for what might be
The Slowdown: the Supply Side

Another way of looking at the slowdown is to ask what has been happening to those factors that determine the economy’s output capacity: its labour inputs, its capital inputs and the productivity of labour and capital combined. This ‘productivity’ measure is a residual—a black box containing all sorts of otherwise unaccounted-for influences. These include changes in the allocation of resources between different lines of production, as well as technological progress in the sense of the introduction of new production processes.

Why the ‘Extra Slowdown’ From 2012? The Demand Side

On the demand side, one element stands out: for most of 2000–2008 the oil price was rising, the inflow of petrodollars was growing and delivering a rapid increase in prosperity. After oil prices recovered, they fluctuated around a historically high (nominal) level but did not resume an upward trend. Therefore income growth slowed after the immediate crisis of 2008–09—whether household income, government revenue or corporate profits. Consequently aggregate demand growth also slowed. That is enough to account, in very broad terms, for the slower rate of GDP growth, a bit above 4%, in 2010 and 2011. But why the further slowdown in 2012–14? It was not to do with any significant fall in the oil price.

Household consumption, at just over half of GDP and growing particularly fast during the boom, is a large part of the story. In 2000–13 average real wages grew more than four-fold and, in the first quarter of this year, the volume of retail sales was still rising, albeit at only 3.5% yoy. However, the rate of growth of household consumption in real terms has slowed sharply: it was an astronomic 11.5% a year between 2002 and 2008, 7.3% from 2010 to 2012, and 4.7% in 2013.

In addition, fixed investment growth slowed after the boom and in 2013 stalled; in fact it fell marginally. Government current spending was almost unchanged between 2012 and 2013. Net exports rose, but there was, as in the abrupt collapse of 2008–09, an especially large cut in inventories (stocks of both finished and unfinished goods).

The World Bank has described this whole deterioration (from mid-2012) as the result of a ‘crisis of confidence’. We shall consider just what this means after the next section.

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<tr>
<td>Capital inputs</td>
<td>6.9</td>
<td>2.3</td>
</tr>
<tr>
<td>of which, capacity utilization</td>
<td>2.1</td>
<td>2.5</td>
</tr>
<tr>
<td>Labour inputs*</td>
<td>1.4</td>
<td>1.0</td>
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<tr>
<td>Total factor productivity</td>
<td>3.7</td>
<td>0.9</td>
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Three things stand out: the extent to which the growth of the recent past was a recovery process; the importance in the boom period of ‘productivity’ growth, and the importance for the medium-term future of the decline in the labour force.

What we see throughout is a low growth of capital stock, with much of the increase in capital inputs during the boom coming from increased utilization of capacity rather than increases in that capacity. Similarly, part of the boom-period growth in employment corresponds to a reduction in unemployment. These recovery processes are interrupted by the 2008–09 crisis, but the further recovery from that experience is, it seems, soon completed. Entov and Lugovoy’s assumption that capacity utilization will continue to increase in future rests on producers continuing to scrap obsolete equipment.

Employment, even allowing for official measures of net immigration, is expected to fall at close to 1%
A Crisis of Confidence in 2012–14?

Last year’s decline, albeit marginal, in fixed investment was in part the result of some major state investment projects, including the Sochi Winter Olympics, having come to an end and not being followed up—in the name of fiscal prudence—by others. It was also in part the result of a dearth of private investment. To some extent, the latter may be dependent on the former. However, there was also evidence that a great many recent private-sector projects had not shown a return above their comparatively high financing costs. Businesspeople have been complaining of high labour costs and low profits, and therefore little incentive to invest. They also think, according to a survey sponsored by the Russian Union of Industrialists and Entrepreneurs, that the business environment has recently got worse.

The wider population, meanwhile, continues to take a dim view of the way the country is run. Asked in March whether ‘thefting and corruption in the leadership of the country’ was greater or less than 10–12 years ago, 33% of respondents to a Levada Center poll said ‘greater’ and only 10% said ‘less’ (48% opted for ‘about the same’ and the remaining 9% wisely found it hard to say).

So far as household consumption is concerned, growth has continued, but at a slower pace. Wages continue to rise, particularly in the public sector. Putin’s May 2012 pledges to raise public-sector pay have put regional budgets under acute pressure but have not been postponed. Despite the drastic weakening of economic performance, unemployment remains at a historically low level—in part because of reduced labour supply. Yet there have been downward pressures on consumption all the same. Household debt, including credit-card debt, is modest by British standards (debt service is about 20% of household income), but it is still worrying because unsecured borrowing has risen fast and non-performing loans with it. The banks are tightening borrowing requirements.

The budget and inflation continue to trouble policymakers. By Western standards, Russian public debt and fiscal balances look very healthy: debt at around 12% of GDP and the consolidated budget (national plus regional plus local budgets) running a deficit last year of only 1.3% of GDP. However, the budget depends heavily (about half of federal budget revenue in recent years) on oil and gas, so uncertainties about both the future oil price and Russia’s current ability to borrow make a strong case for continuing prudence, just when fear of recession prompts talk of a new stimulus package. Meanwhile the policy of passing spending obligations down to sub-national budgets that lack the revenue to support them can only end in the federal budget having to bail out the regions.

In late April consumer price inflation was at an annual rate of 7%, well above the target for the year of 5–6%. If the spending lobby gets its way and the National Prosperity Fund is raided to prop up public spending, that inflation rate is unlikely to come down. In sum, both households and businesspeople have recently had every reason to lack confidence.

Reforms, and Why They Don’t Happen

The conventional wisdom among Russian liberal economists is that a radical improvement in the business environment is needed. This, in most versions, would include a strengthening of the independence of courts and hence of the protection of property rights, as well as a reduced economic role for the state. Stronger property rights would encourage more investment and innovation, contributing to the growth of both capital inputs and factor productivity. If the state could no longer be corruptly used by incumbent firms to support asset-grabbing and the suppression of market entrants, competition would be strengthened, bringing further gains.

The political elite, many of whom understand the case for such reforms, are unlikely to implement them because their own material privileges could, in a more open society, be threatened. Now, in May 2014, they are less likely to implement radical reforms at a time when, at odds with the West, the leadership is disposed to ramp up social controls.
Even before the Ukraine crisis, however, policy on the judiciary seemed if anything to be going in an illiberal direction. The merging of the High Commercial Court with the general-jurisdiction Supreme Court is widely seen as a step backwards from transparency and judicial effectiveness.

**Ukraine, Sanctions and Prospects**

The economy, then, was in poor shape before Putin’s response to the ousting of Yanukovich. The rouble was already depreciating, initially in line with the currencies of other emerging economies. Rouble depreciation helps towards balancing the federal budget, as export dollars generate more rouble tax revenue. But it worsens inflation and, according to the Centre for Macroeconomic Analysis and Short-term Forecasting (TsMAKP), does more harm than good to the business sector: rouble gains from export revenues, TsMAKP estimates, are outweighed by the higher rouble cost of imported components and equipment and of foreign debt service.

The net outflow of private capital was over $50bn in the first quarter of this year alone. That threatens an annual outflow—absent an improbably rapid resolution of international tension—of over 5% of GDP, and correspondingly depressed domestic investment.

Already, Western sanctions, though officially limited in scope, have tended to deter banks from lending to Russian banks and non-bank companies. They have probably contributed to Standard & Poor’s late-April downgrade of its rating of Russian sovereign foreign-currency debt to BBB-, or one notch above junk-bond status. There is brave talk by Russian officials of making the country financially self-sufficient, but this is not promising. The limitations of Russia’s domestic financial markets are considerable. The reduced availability of foreign credit is already damaging Russian economic prospects.

The World Bank’s ‘high risk scenario’ for this year has Russian investment falling by a tenth and GDP by 1.8%. That now looks entirely possible. Later on some recovery towards the IMF’s projected 2.5% annual GDP growth rate is plausible.

However, to get back to that rate of improvement two things have to happen. First, there has to be at least some return to a working commercial relationship with the outside world. Second, the ‘crisis of confidence’ within Russia, pre-dating the Ukraine events and already slowing the economy to a crawl, has to be resolved. Both could take time. Radical reform could stimulate investment and innovation. It might in time restore Russian growth beyond 2.5% to world-average levels or above. Right now, however, radical reform looks to be a remote prospect. Meanwhile a sharp recession in the near term cannot be ruled out.

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**About the Author**

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Governance and Regional Resilience in Russia: A Case Study of the Khanty-Mansiysk Autonomous Okrug

By Irina Nikolaevna Il’ina, Carol S. Leonard, and Evgenii Plisetskij, Moscow

Abstract
Persistently among the leading regions of the country since the 1990s, Khanty-Mansiysk Autonomous Okrug, like most of Russia’s resource abundant regions, was resilient in the aftermath of the global financial crisis, despite its exposure to international capital flows. In such resource abundant regions, long-run efficient and cooperative budget planning and performance largely account for their dynamic resilience.

Economic Growth and Mineral Resource Abundant Regions
During the first decade of the century, the Russian economy rapidly improved. Between 2005 and 2011, GDP per capita rose annually by 4%, with one-quarter of Russia’s then 83 regions growing by over 5% per annum, with some even reaching to 10 and 11%. Although poverty diminished and there was regional convergence, the rise in per capita income left some regions well behind: northern regions lacking in minerals, southern regions overwhelmed by civil strife, and regions in the Urals overwhelmed by rural poverty and severe unemployment. Overall, 8% of all regions experienced between 0 and 1% growth per annum.

Taking the lead since the 1990s, along with Moscow and St Petersburg, the resource-rich regions of Russia experienced a growth rate in 1992 that exceeded that of the slowest growing regions by 2.5 times, and in 2000 by 3.2 times. They now enjoy an enviable standard of living (see Figure 1 on p. 9).

All of these regions have a substantially larger than average per capita income. For the Khanty-Mansi Autonomous Okrug (KhMAO), for example, living standards reach those in Moscow city, as Table 1 on p. 10 demonstrates.

Governance, 2000–2014
Resource regions retain their lead despite public sector reforms that have stripped them of much of their revenue. Most importantly, a 2001 law centralized the mineral resource extraction tax (MET) for the energy sector, and the regional share dropped to zero by 2010. For oil and gas revenues, most economists consider centralization to be the best practice, since only the federal government has the capacity to stabilize the economy under conditions of price volatility.

All regions depend now for their revenue base on the one quarter of the corporate profit tax and the personal income tax that they receive according to Russia’s budget federalism. The result, to be sure, is some centralization. But, by means of transfers and sharing, regions formally enjoy a substantial share of Russia’s consolidated revenue. In 2011, they received 46.8% of Russia’s overall revenue. Russia’s regions’ share of revenue is on a par with other federations: 34% in the US and 44% in Canada. The property tax in 2011 was 9%, or 1.9% of Gross Regional Product (GRP), close to the OECD regional average. Total regional tax revenues in Russia amount to roughly 11% of Gross Domestic Product (GDP) (Canada, 12.1%, Australia, 4%; Germany, 7.9%; and the US, 5%).

Budget reform was part of Russia’s large-scale administrative reform throughout the 1990s and 2000s. Centralization was the priority objective, which gave the federal government not only all the revenue from the mineral extraction tax (MET), but also 100% of the value-added tax (VAT); allowing for the creation of a stabilization fund in 2004. The government also ended some perverse institutional effects from the Soviet era, including legacies from the past that subverted small business growth, tax collection, and social public spending in some regions. Since 2003, policies suppressing competition have largely been removed at the regional level. Conflict between federal and regional laws was eliminated, federal funding was tied to long run strategic development plans and modernization of public services across Russia, including improvements in the information infrastructure. Federal directives include a focus on small enterprise development in the regions, the bal-

1 The research leading to these results has received funding from the HSE Basic Research Program under grant agreement No. TZ-430/95674.
2 The data are based on official government statistics by RosSTAT, chiefly Rossiiskii Statisticheskii Ezhegodnik (2000–2013), provided by Eastview for the University of Oxford online subscription service and by the National Research University-Higher School of Economics online resources.

4 0.5 to 1.5% of GDP, <http://stats.oecd.org/Index.aspx?DataSetCode=REV>
of the regional budget and funds for unemployment relief and retraining of labor. In 2012, President Putin’s “May 7 decrees” required improved standards of services, including a pay raise for government staff.\(^5\)

In summary, reform resulted in a loss of regional political autonomy, but a gain of clarity and control in budget making. The clarified relations between levels of government increased the federal power to enforce the law, creating greater accountability through closer monitoring and more transparency thanks to uniform audit rules. The tax regime, to be sure, also reflects lobbying and cooperation among business, and federal and regional authorities. For example, a 2012 amendment to the Tax Code favored the oil sector by allowing unified tax assessments of voluntary consolidated taxpayer groups (CTG), intended in part to reduce overlapping payments of the profit tax to federal and regional levels. Regarding the performance of the public sector in the regions, current surveys reflect a mixed assessment: only 35% of the general public is satisfied with administrative effectiveness in the de facto privatized health care sector, but 63% of the populace is satisfied with administrative activity in the sphere of education. Among public sector reforms, the budget transformation was arguably the most impressive in strengthening the state to accomplish this goal.

Impact of the Global Financial Recession

In 2009, public administration reform in Russia was severely tested by the global financial crisis. The government introduced new measures to help regions withstand the impact of global recession, but by 2011, it was evident that most regions, due to their relative lack of exposure to global finance, avoided a devastating impact. So, regional budgets were continually tightened afterwards. For example, in 2013, even though the corporate income tax fell by 20%, transfers were 7% lower than in the previous year.\(^6\) Regional reform encourages them to rely on credit to cover deficits. The federal level is reducing transfers to weak regions to end their dependency on federal subsidies. It encourages regions to take greater initiative in attracting investment resources, to compete with other regions, and carry out efficiency measures.

As a result, many regions have borrowed heavily, but the results are probably not as extreme as sometimes portrayed. For example, in 2013, Natalia Zubarevich, a regional expert at Moscow State University warned that “…regional budgets are buckling. Revenues in the first half of 2013 decreased due to a 20% decline in profit tax revenue and a 15% cut in federal budget transfers. Meanwhile, spending grew 5% to fulfill the president’s promises to increase public sector wages. Budgets are running deficits in two thirds of all regions, and aggregate regional and municipal debt has surpassed 25% of (tax and non-tax) revenue. The regions are reducing investment spending, but it’s not enough….the decline in public sector employment is accelerating. …Laid off workers have difficulty finding another job.”\(^7\)

Total public debt of sub-national entities increased by 15.6% in 2012 (RIA Rating, 12 March 2013). However, the wealthiest regions have most of the outstanding regional bonds: Moscow, Krasnoyarsk, Nizhny Novgorod, Samara and Moscow oblasts (64%), and these are regions that can easily cover their obligations. Also, the term structure of obligations and debt service matter.\(^8\) Russia’s debt service is high, about 10% of revenues; but debt ceilings as a percent of GRP are about the same as for states in the US, 5%.\(^9\)

Khanty-Mansi Autonomous Okrug: Recession and Recovery

KhMAO is one of only seven regions (including Moscow and St Petersburg) that maintains an investment-grade rating by two rating agencies, permitting it to obtain funds in international capital markets, where interest rates are considerably lower (8–10%) and repayment extends over a longer period (3–5 years) than those available in the rest of Russia.

The global recession had a severe impact on the economy of the resource regions. Profit and income tax fell in Chelyabinsk and Kemerovo by 90%. After the worst of the crisis, however, the liquidity of banks in resource regions, such as KhMAO, quickly recovered and oil and gas firms’ profits rose once again. Debt remained low in KhMAO, with regional and municipal debt amounting to 0.8% of GRP in 2013.

The rapid recovery is one sign of financial resilience, defined as the ability of a region to minimize aggre-
gate investment and program losses. Dynamic resilience describes a region that succeeds in rapid reconstruction afterwards, enabling it to retain its leading position independent of the severity of a one-time loss. The region adjusts the distribution of losses, protects vulnerable households’ pre-crisis income and smooths shocks over time with savings, borrowing, and insurance, and the social protection system.

Migration data for KhMAO show that oil, price, and production shocks have not affected outmigration of highly mobile unemployed labor from the region, as shown below in Figure 2 on p. 10.

Conclusion
Among resource regions, KhMAO is a leader in economic growth. The profit tax from the oil and gas sector in 2012 made up some 95% of KhMAO’s operating income, and revenues from the majors comprised 52.1% of total revenue.\(^\text{10}\) Falling extraction at major fields and a dip in the share of oil in GRP to less than half (43.6%) has not dented that leadership.

By 2030, according to the region’s Energy Strategy to 2030, annual production of oil will fall, at a minimum, from 260 to 222 million tons, and more likely, to 196 mt. Fracking will help to increase production, but costs of extraction will rise at the same time due to flooding and technological challenges.\(^\text{11}\) Although fracking technologies are freely available, hydraulic fracturing, horizontal drilling, three-dimensional seismic modeling are especially costly in the initial stages.

The KhMAO budget for the post-crisis years is an example of how a severe crisis can be rapidly overcome in one of Russia’s resource rich regions. KhMAO reestablished its surplus without going deep into debt and while also covering the new 2012 requirements for increased salaries and other obligations announced in President Putin’s “May decrees.”

Ultimately, the resilience of KhMAO, and other resource regions, results from a number of factors: avoidance of dependence on budgetary subsidies from the federal government; geopolitical factors, including the region’s ability to attract large energy and industrial companies; the development of new clusters other than in the oil sector; a social protection program; and a high level of administrative skills. There is also evidence of within-region cooperation of public and private sectors and inter-regional coordination to secure flexibility on tax allocations and spending requirements.

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Figure 1: Resource Regions of the Russian Federation by Production Share in GDP (%)
Table 1: Standard of Living Indicators: Khanty-Mansiysk Autonomous Okrug, Moscow city, Russian Federation average (2011)

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<tr>
<th></th>
<th>Average Expenditure per household member, rubles per Month</th>
<th>% Households on Internet</th>
<th>Average Income per Household Member, Rubles per Month</th>
<th>Minimum Sustainable Monthly Income Set by Region</th>
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<tr>
<td></td>
<td>Disposable Income</td>
<td>Consumption</td>
<td>Expenditure on Food</td>
<td>Expenditure on Non-Food items</td>
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<td>Average, Russian Federation</td>
<td>15,816</td>
<td>10,460</td>
<td>3,250</td>
<td>4,178</td>
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<tr>
<td>City of Moscow</td>
<td>25,629</td>
<td>21,145</td>
<td>4,720</td>
<td>8,220</td>
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<tr>
<td>Khanty-Mansiysk AO</td>
<td>27,061</td>
<td>15,278</td>
<td>3,240</td>
<td>7,112</td>
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Source: Rosstat.

Figure 2: Oil Extraction and Population, KhMAO, 1959–2012
The Russian Analytical Digest is a bi-weekly internet publication jointly produced by the Research Centre for East European Studies (Forschungsstelle Osteuropa) at the University of Bremen (<www.forschungsstelle.uni-bremen.de>), the Center for Security Studies (CSS) at the Swiss Federal Institute of Technology Zurich (ETH Zurich), the Resource Security Institute, the Institute of History at the University of Zurich (<http://www.hist.uzh.ch/>), the Institute for European, Russian and Eurasian Studies at The George Washington University, and the German Association for East European Studies (DGEO). The Digest draws on contributions to the German-language Russland-Analysen (<www.laender-analysen.de/russland->), the CSS analytical network on Russia and Eurasia (<www.css.ethz.ch/rad>), and the Russian Regional Report. The Russian Analytical Digest covers political, economic, and social developments in Russia and its regions, and looks at Russia's role in international relations.

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