MINISTRY OF FINANCE
OF THE RUSSIAN FEDERATION

PUBLIC DEBT MANAGEMENT POLICY OF THE RUSSIAN FEDERATION FOR 2012 – 2014

2011

Contents

Introduction

The high level of global energy commodity prices will result in a relatively high level of forecast federal budget revenues over the next few years. However, a faster growth in federal budget expenditures increases the likelihood of a steady federal budget deficit, thus preventing any substantial renewed accumulation in the size of the sovereign funds. Federal government borrowing in the capital markets will be the main source of financing the federal budget deficit in the medium-term. However this means that the volume of prospective issuance of federal government securities primarily in the domestic bond market is likely to be unprecedented for Russia, at up to two trillion roubles annually.

The realization of such ambitious plans is obviously not feasible with an unreformed domestic capital market which still bears the consequences of the transitional period. Without the implementation of urgent measures aimed at the fundamental modernization and liberalization of the domestic public debt market, the growth of the federal budget deficit funding requirements could lead to a negative investor reaction, a significant increase in government borrowing costs and negative consequences for the macroeconomic and financial stability of the country.

In this regard, reform of the domestic debt market is a vital priority for the public debt policy in the medium-term. Key tasks on this issue are an improvement in the infrastructure of the government securities market, an increase in its liquidity, a widening of the investor base, and the establishment of supportive and competitive conditions for market participants of all types.

The public debt policy in 2012 – 2014 will focus on securing the federal budget deficit financing by means of funding in the domestic and international capital markets on favorable conditions, ensuring an optimal balance between yields and duration of sovereign debt obligations, maintaining the sovereign credit ratings at a high level, and establishing favorable pricing benchmarks for Russian corporate borrowers. At the same time, the policy aims to enhance the monitoring of the corporate sector's external borrowings and to establish a strategy for addressing the borrowing policy of corporations and banks with state ownership.

1. Main factors defining the character and trends of the debt policy of the Russian Federation in 2012 – 2014

In the planned period, several factors will simultaneously influence the shape and scope of public borrowings.

Factor 1. Macroeconomic conditions of debt policy implementation.

According to the scenario conditions and main forecast parameters of the social and economic development of the Russian Federation in 2012 – 2014, the debt policy will be implemented amid an acceleration in national economic growth, a gradual decrease in inflation, a moderate growth of oil prices and the relative stability of the rouble exchange rate. (Table 1).

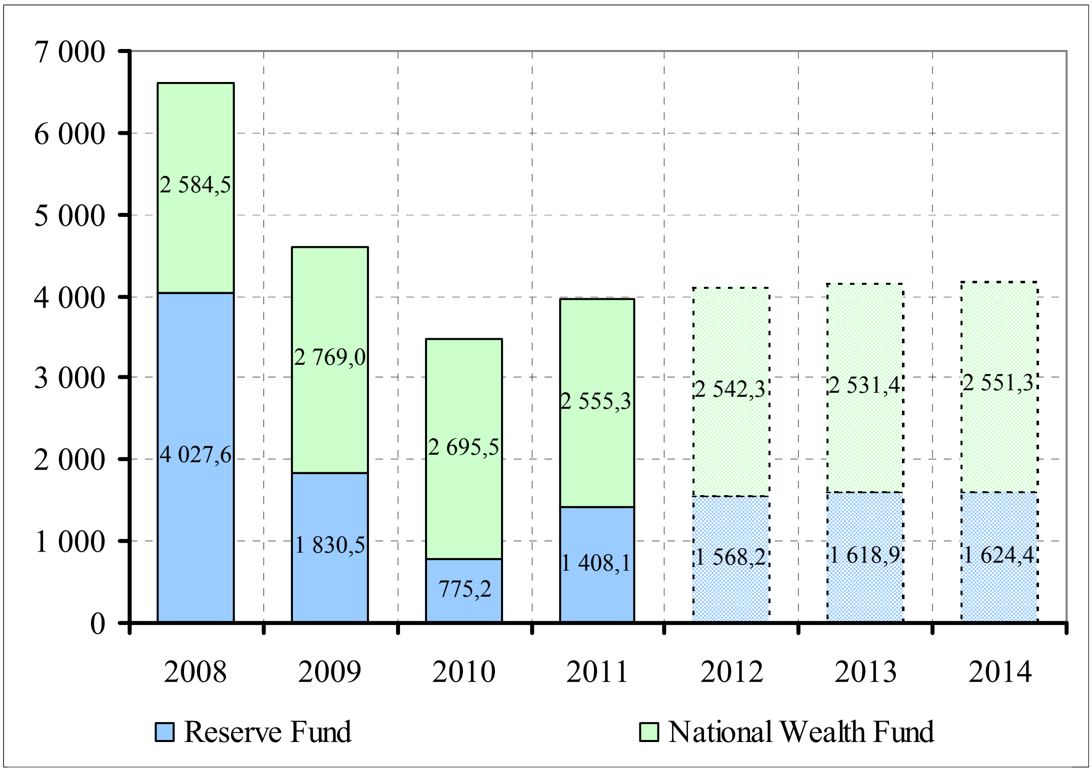
Table 1. The main macroeconomic indicators in 2012 - 2014[1]

Indicator	2012	2013	2014
GDP, billion roubles	57 532.0	63 436.0	70 409.0
GDP growth (% change, YoY)	+3.5	+4.2	+4.6
Oil price, US$ per barrel	93.0	95.0	97.0
Inflation, %	6.0	5.5	5.0
RUB/USD exchange rate	27.9	27.9	28.0

Most of the oil and gas budget revenues will cover budget expenditures and only an insignificant portion will be allocated to the Reserve Fund: 3.3 percent in 2012, 1.0 percent in 2013, and 0 percent in 2014. The replenishment of the National Wealth Fund is not planned in the 2012-2014 period. The projected size of the sovereign funds is detailed in graph 1.

[1] In this table and hereafter the data in tables and graphs is given as at the end of the period.

Graph 1. Volume of the Reserve Fund and the National Wealth Fund, billion roubles



Over the next three years the federal budget deficit will increase in nominal terms from 2012 to 2013 and then fall in 2014. In relative terms the deficit will amount to 2.7 percent of GDP in 2012 and 2013 and fall to 2.3 percent of GDP in 2014.

Borrowing will be the prime source of federal budget deficit financing in 2012-2014, most of it domestically (approximately 90 percent). Gross borrowings will amount to more than 2 trillion roubles annually (Table 2).

Table 2. Sources of federal budget deficit financing in 2012-2014, billion roubles

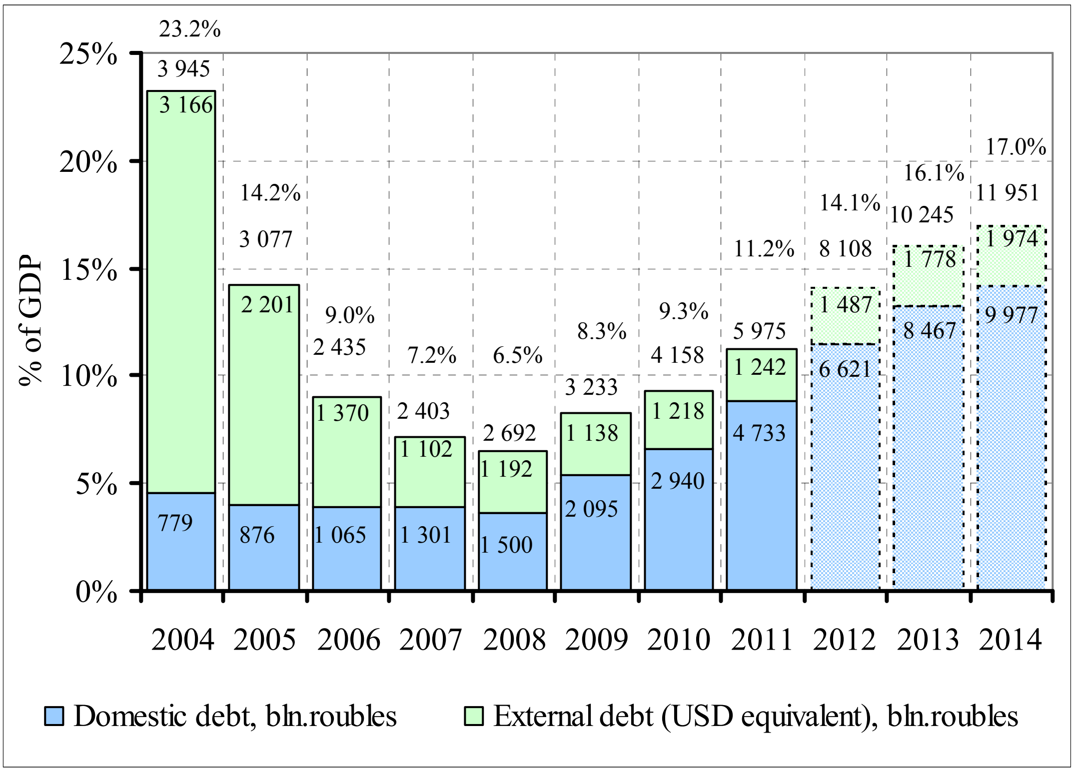
Indicator	2012	2013	2014
Federal budget deficit	1 570.5	1 744.3	1 648.4
Government borrowing	1 592.3	1 601.7	1 626.1
o/w: borrowing	2 181.7	2 284.0	2 474.1
repayment	-589.4	-682.3	-848.0
Government domestic borrowing	1 459.0	1 465.7	1 486.2

o/w: borrowing	1977.9	2082.2	2273.6
repayment	-518.9	-616.5	-787.4
Government external borrowing	133.3	136.0	139.9
o/w: borrowing	203.8	201.8	200.5
repayment	-70.5	-65.8	-60.6
Replenishment (Drawdown) from the Reserve Fund	-164.0	-51.4	0.0
Replenishment (Drawdown) from the NWF	7.5	10.0	10.0
Privatization receipts	276.1	309.4	300.0
Execution of state guarantees	-120.2	-85.8	-248.7

Factor 2. Low level of government debt

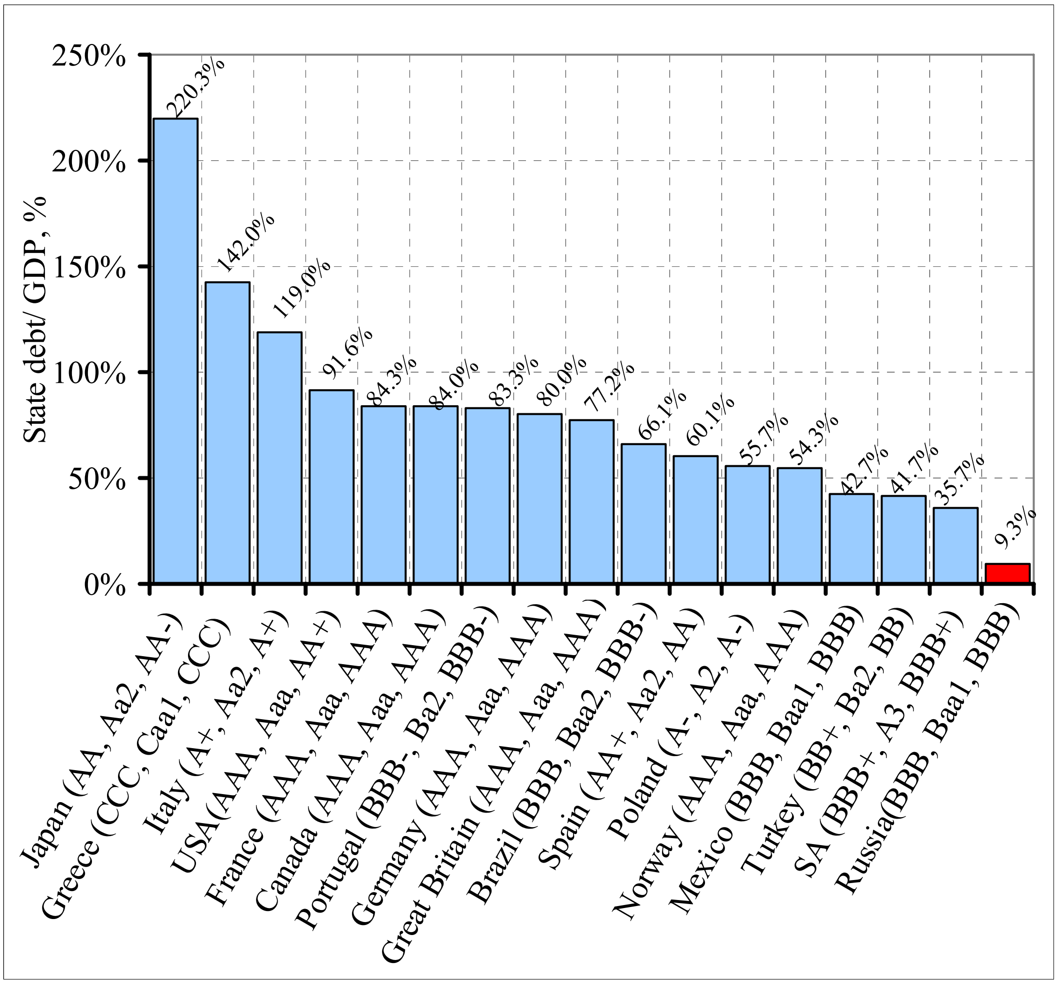
As of July 1, 2011 the volume of the government debt of the Russian Federation stands at 4.6 trillion roubles, including government domestic debt of 3.6 trillion roubles and government external debt of US$ 36.8 bln. (approximately1 trillion roubles). Over the period 2012 to 2014, the volume of government debt is forecast to rise each year to 12 trillion roubles or 17 percent of GDP by the end of 2014. External debt is forecast to nearly double to approximately 2 trillion roubles, and domestic debt is forecast to rise nearly 2.8 times to close to 10 trillion roubles (Graph 2).

Graph 2. Russian sovereign debt



The low level of government debt positively distinguishes Russia from most developed countries as well as many emerging markets (Graph 3). However, the credit ratings assigned to Russia by the leading international rating agencies (BBB with positive outlook by Fitch, Baa1 with stable outlook by Moody's, and BBB with stable outlook by Standard&Poor's) suggest that Russia is clearly underrated.

Graph 3. Debt to GDP ratio and credit ratings[2] of some countries



According to the parameters assumed in the forecast of the social and economic development of the Russian Federation in 2012 – 2014, and taking into account the planned volume of borrowings, the government debt of the Russian Federation in the forthcoming period will still be markedly lower than levels considered unsafe. (Table 3).

However, on certain measures the Russian Federation's government debt sustainability should not be considered as inviolable. First, the projected rate of increase in government debt and government debt service expenditures are very high (Graph 4). Therefore, in comparison to 2008, government debt service expenditures in 2011 will have risen in absolute terms by 2.3 times, or by 1.4 times relative to federal budget expenditures.

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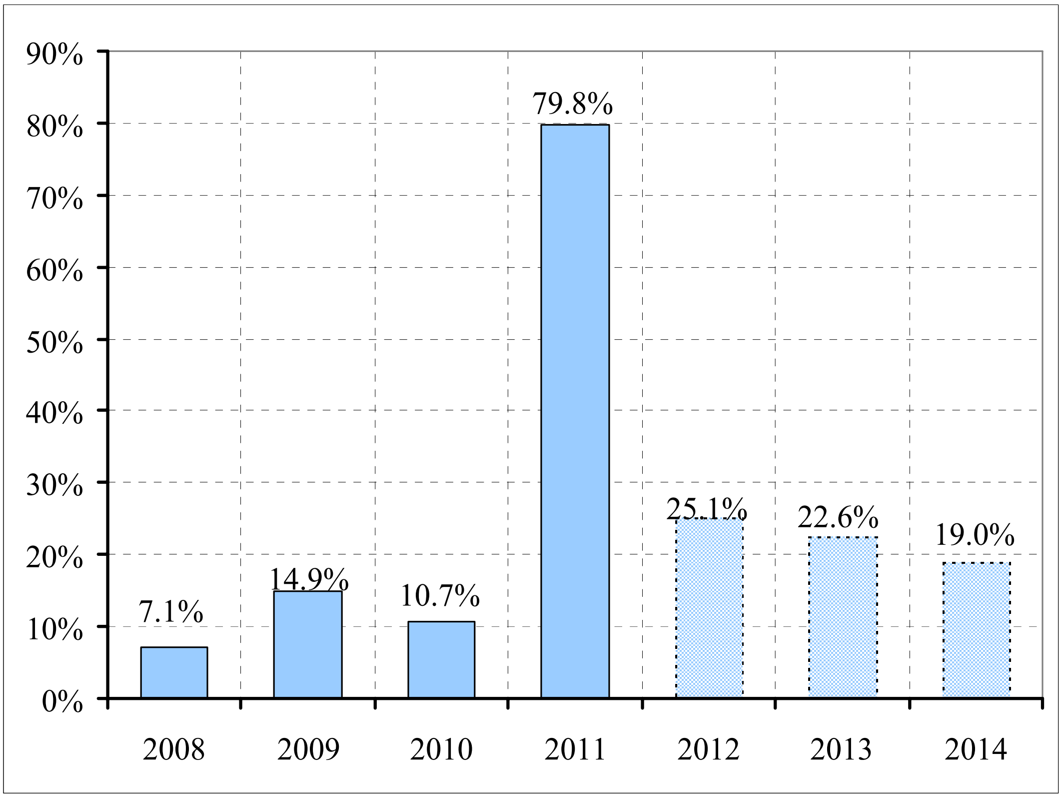
[2] Fitch, Moody's and Standard&Poor's, respectively

Table 3. Indicators of debt sustainability of the Russian Federation (based on budget planning)

№	Indicator	2011	2012	2013	2014	Threshold
1	Sovereign debt to GDP, percent	11.2	14.1	16.1	17.0	**25**
2	Sovereign debt service expenditure as a percentage of total federal budget expenditure	3.2	3.6	4.0	4.5	**10**
3	Sovereign debt service and repayment expenditure as a percentage of federal budget revenue	8.2	9.7	10.4	11.8	**10**
4	Sovereign debt as a percentage of federal budget revenues	58.0	76.3	87.7	94.5	**100**
5	Sovereign debt as a percentage of exports of goods and services	8.7	10.9	12.5	13.2	**220**
6	Sovereign debt service expenditures as a percentage of exports of goods and services	0.6	0.6	0.6	0.7	**25**

Second, there are risks of a deterioration in the macroeconomic situation, which upon occurrence, would impact debt sustainability. According to the budget projections, GDP and budget revenues forecasts for 2012 – 2014 are calculated based on the favorable scenario which assumes not only a continuing high level of average oil prices but also a gradual increase: US$93 per barrel in 2012, US$95 per barrel in 2013 and US$97 per barrel in 2014. Given that oil prices are currently at elevated levels compared with the last few years, the possibility of oil prices falling to levels considerably lower than the level used in the forecast of the social and economic development of the Russian Federation for the forthcoming period cannot be excluded. A decrease in the oil price of US$10 per barrel results in approximately 0.5 trillion roubles less government budgetary revenue and, therefore, an increase in the federal budget deficit of around 1 percent of GDP. All debt sustainability indicators would similarly deteriorate under the same adverse scenario of materially lower oil prices.

Graph 4. Growth in sovereign debt service, yoy



Third, the scenario of Russia losing one of the most important financial stability factors over the planned period, the "safety cushion" of the Reserve Fund, is quite probable. By January 1, 2013 its forecast size will be 1.6 trillion roubles assuming the average oil price in 2012 does not fall below US$93 per barrel and the Fund is replenished with 164.0 billion roubles. However, the worst-case scenario of the macroeconomic situation in 2012 presumes that not only would the forecast size of the Reserve Fund be lower, but moreover, the Reserve Fund in 2013 would be fully depleted in order to fund budget expenditures and we would be forced to use both net proceeds from borrowing and considerable amounts from the Reserve Fund. The absence of this "safety cushion" would make the state budget much more vulnerable and would likely lead to increased borrowing costs and sovereign debt service expenditures.

According to stress-test results of the Russian debt indicators, if oil prices fall by US$50 per barrel compared with the official forecasts and remain there throughout the forthcoming period, the sovereign debt to GDP ratio would exceed 20-21 percent in 2013 - 2014. This would be the same debt to GDP ratio as in 2004 when the country did not have an investment-grade sovereign credit ratings assigned by all three leading international rating agencies.

Fourth, according to calculations, under a negative scenario of oil prices falling to US$60 per barrel and remaining at this level for one year, the federal budget deficit would exceed 5 percent of GDP, which would require additional funding. It is possible that a combination of a drawdown of the NWF, privatization revenues and tax increases could provide this additional funding. However, a drawdown of NWF funds would reduce the ‘safety cushion’ available to finance the chronic deficit of the Pension Fund of the Russian Federation, revenues from the sale of state-owned property depend on current conditions, and putting an additional tax burden on the economy is undesirable due to the likely negative social effects.

Under the negative scenario, the prime source of the federal budget deficit financing would be government borrowings. Given that projected annual issuance levels are already at an unprecedented high, additional issuance requirements would add significant risks, including at the very least a worsening of borrowing terms for the Russian Federation as a sovereign borrower in the capital markets, a steep increase in the debt burden, and in the worst case, an inability to borrow in the required amounts on acceptable terms.

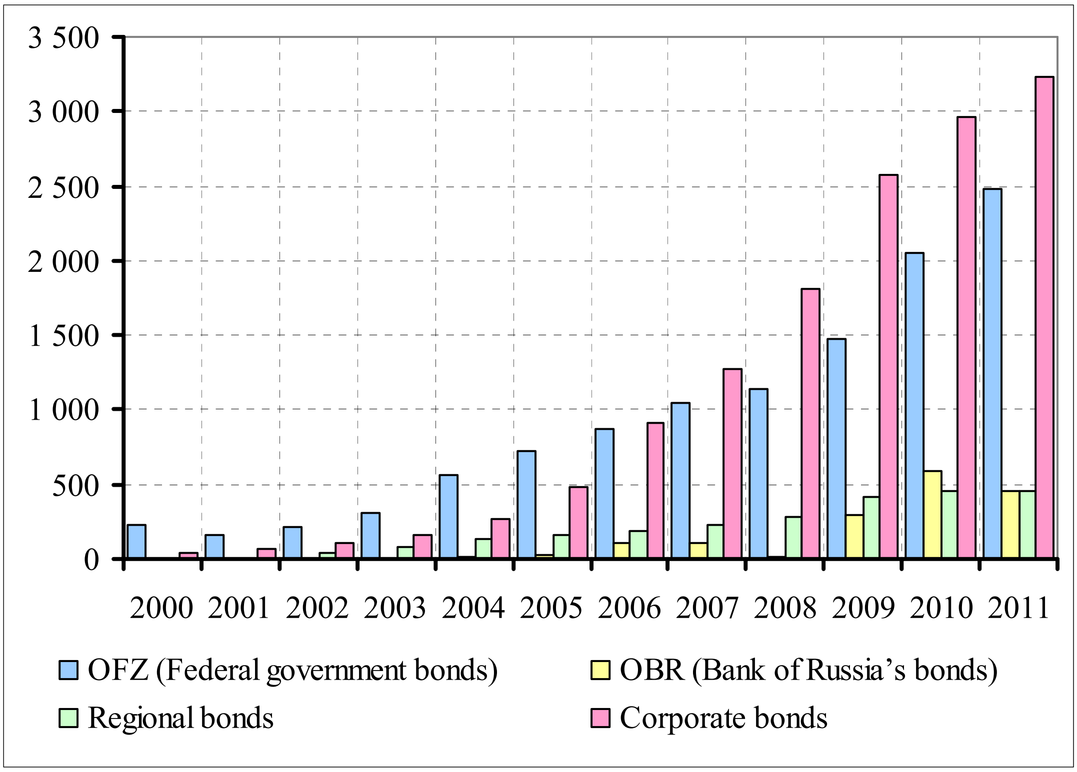
Therefore, the current low level of sovereign debt requires constant vigilance. For the time being it allows the government to implement a policy of increased government borrowings without any real risk of a drastic deterioration in the Russian Federation’s debt sustainability. Assuming a macroeconomic development similar to the scenarios under the approved social and economic development forecasts for the country, the Russian Federation’s debt sustainability will remain at relatively non-hazardous levels in the forthcoming period. Current projected issuance levels will keep the debt burden within the official forecast range, allow for servicing of the sovereign debt without undue concern and should maintain the sovereign credit ratings at the investment grade level.

Nevertheless, given the high dependence of the Russian economy and the federal budget on global commodity market conditions, maintaining the debt burden at moderate levels is a strategic goal. Achieving this goal means sustaining one of the most important competitive advantages of our country. A moderate borrowing policy will create growth opportunities for the private sector and support the case for investing in the national economy.

Factor 3. Domestic capital market conditions

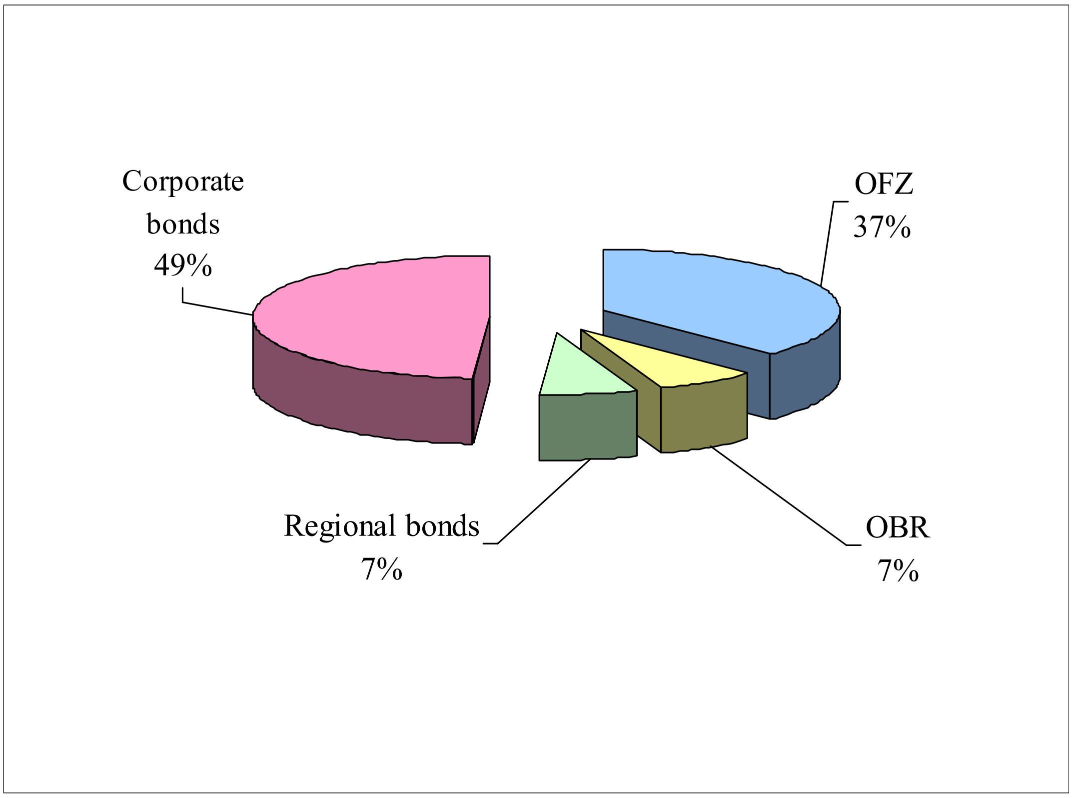
Before the 2008 global economic crisis, when the federal budget was in surplus, annual government domestic debt issuance was a relatively small figure at 170 – 250 billion roubles annually. Federal government bonds (OFZ) were being issued for technical reasons (maintaining the functioning of the market, building-up the government yield curve etc.), rather than financial considerations. The situation has changed drastically since 2009 when the domestic market started to be considered as the main source of budget deficit financing.

Graph 5. The Russian Federation debt market capitalization, billion roubles



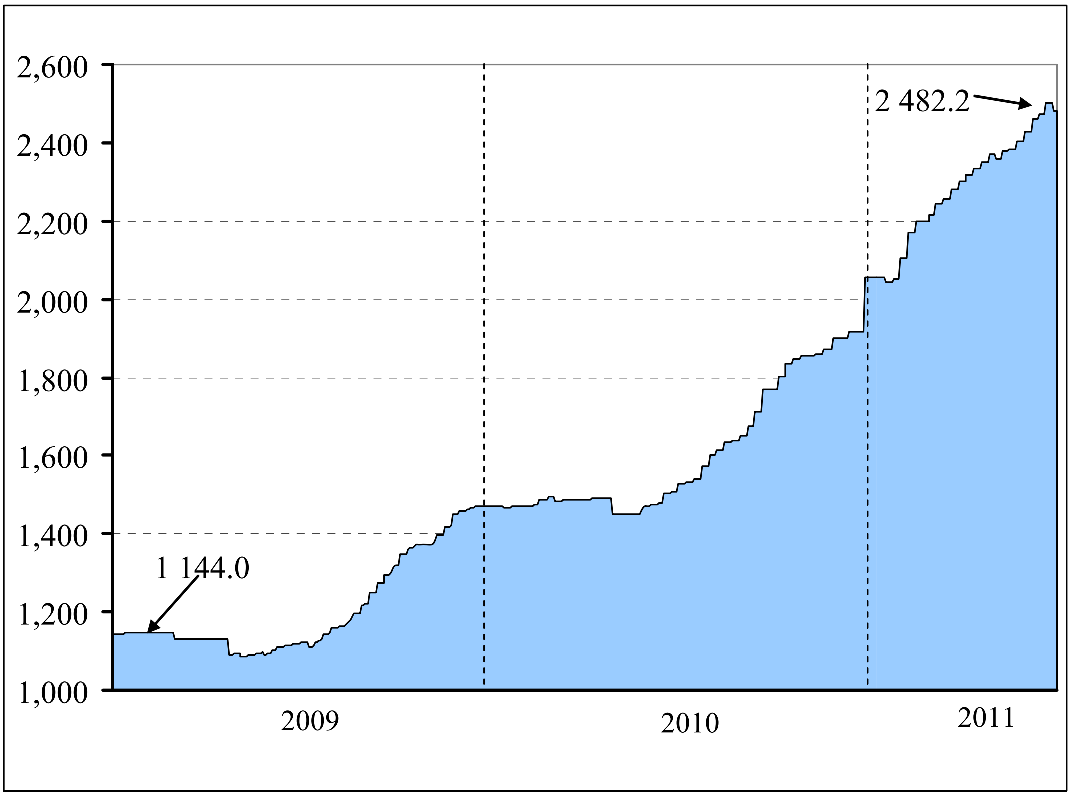
For the last 10 years the government domestic securities market grew at a stable rate, becoming a key part of the country's financial sector: the OFZ share of the total domestic Russian bond market is quite high at 37 percent (Graphs 5 and 6). At the same time, in only the last 2.5 years the OFZ market has more than doubled, increasing from 1.1 to 2.5 trillion roubles (Graph 7).

Graph 6. The Russian bond market structure



Pricing conditions (for the borrower) have improved significantly. The government securities market portfolio yield fell during the years 2009 to 2011 from 11.6 percent to less than 7.2 percent, while the average maturity of outstanding OFZs stands at 3.5 years (Graph 8). The OFZ market is more liquid for maturities of 2 to 7 years and less liquid at the short and long ends (Graph 9).

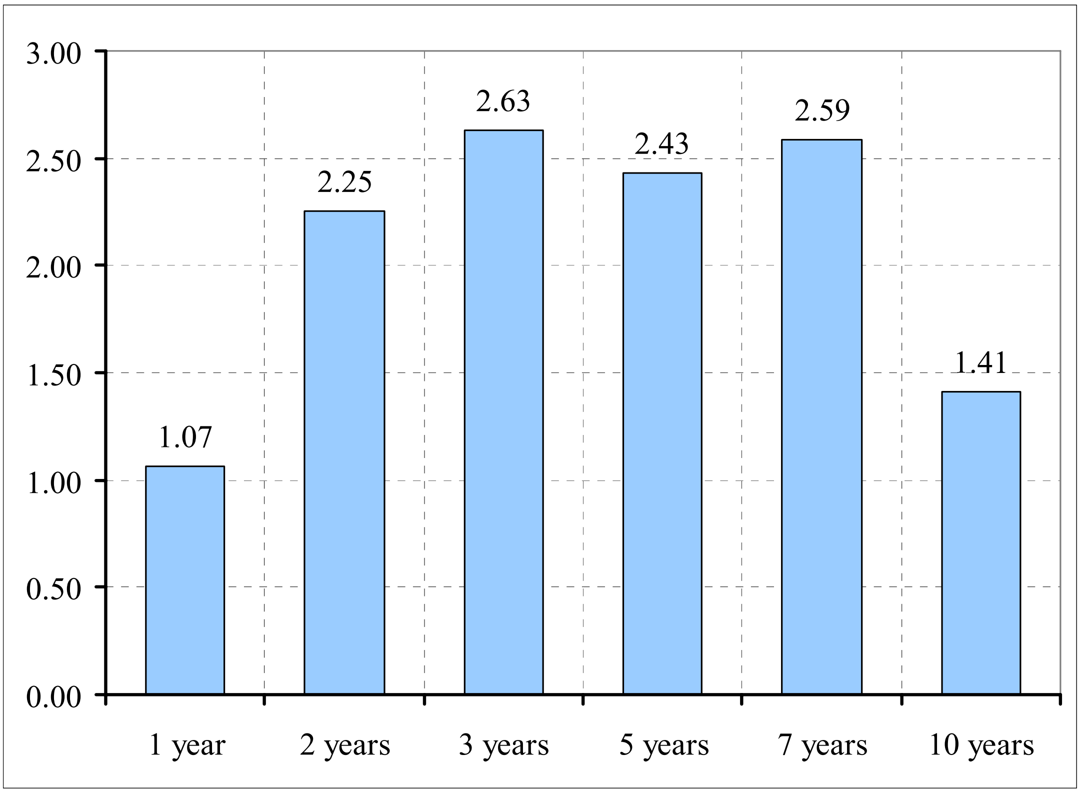
Graph 7. OFZ market volume 2009-2011, billion roubles



Graph 8. OFZ yield curve in 2009-2011

Market participants generally view OFZs to be of benchmark status, providing pricing guidance to the rest of the domestic debt market. The OFZ yield curve is the benchmark for all investors in rouble-denominated instruments (the attractiveness of any corporate or municipal security is evaluated via spreads to OFZ yields).

Graph 9. Trading volume in the secondary market in 2011, billion roubles



Market participants are now able to undertake futures trading on government bonds: in February 2011 and March 2011, respectively, RTS (Russian Trading System, Moscow-based exchange) and MICEX (Moscow Interbank Currency Exchange), respectively, launched the trading of futures contracts on OFZs, allowing investors to hedge the interest rate risks of investing in government securities. Although the volume of futures trading is currently insignificant (less than 1 percent of the total OFZ secondary market), the volume of open positions grows steadily. In July 2011 the volume exceeded 1.7 billion roubles.

A distinctive feature of the domestic debt market is its high volatility. For the last 3 years the average yield of a 10-year Russian government bond was 8.53

percent with a standard deviation of 1.37 percent. For the same period the average yield of the US Treasury bonds was 3.23 percent and the standard deviation 0.40 percent which is 3 times less than the range for Russian government bonds. Such volatility is not characteristic of investment grade assets, has a negative impact on the investment attractiveness of the government domestic bond market and considerably limits investors' ability to plan their cash-flows. The main factors behind this level of volatility in the Russian market are greater susceptibility to fundamental factors, including external factors, for example global financial and commodity market conditions. The forecast rouble exchange rate, expected and actual liquidity of the credit and monetary system in general, and the interest rate policy of the Bank of Russia etc., also have an important role. All these factors directly influence demand for Russian Federation government securities and price levels.

High volatility is one of the characteristics of the OFZ market's underdevelopment. The lack of ability to hedge generally tempers investor appetite for government securities during deteriorating market conditions. As a result, creditors' requirements increase in terms of the yield level of issues offered (premiums at auctions). Additionally, available liquidity and low interest rates in the money market creates arbitrage opportunities that attract speculative capital, including from external investors. This fuels price volatility and increases the risks for local investors further.

In comparison to the corporate bond market, the liquidity of the OFZ secondary market is small (Table 4). Despite comparable issuance volumes, trading of government securities is of an order of magnitude smaller than the trading level of corporate bonds.

Another key OFZ market disadvantage is the lack of a large diversified institutional investor base with significant capital. The main demand for OFZs comes from the major state-owned Russian banks[3] and commercial banks with

[3] Russian banks form the most substantial group of investors in all sectors of the rouble bond market, holding 60% of outstanding OFZs, 40% of outstanding corporate bonds and 60% of municipal bonds.

foreign capital. Foreign investors generally buy OFZs in order to execute short-term and speculative strategies and for liquidity management purposes, often considering such investments as an alternative to bank lending.

Table 4. Corporate and government bonds market

	Outstanding volume, billion roubles	Average daily turnover of secondary market, billion roubles
Corporate bonds	3 285.2	24.7
OFZ	2 526.9	13.1

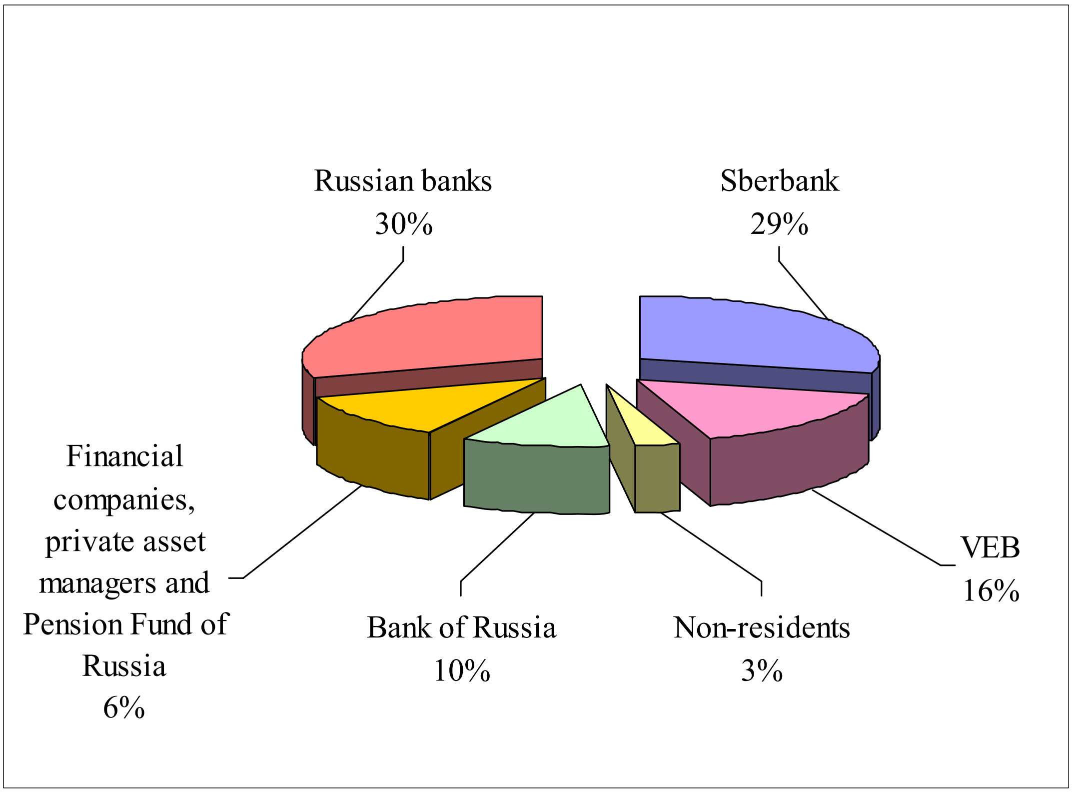
The OFZ market lacks non-speculative institutional investors allocating funds for the long-term, the anchor investor base for most government domestic securities markets. In the OFZ market today, only Vnesheconombank as pension funds manager and, on a generous interpretation, the Russian Federation Pension Fund might be considered as traditional institutional investors. The Bank of Russia accumulated its OFZ portfolio in the years prior to 2008 and has maintained the portfolio at broadly the same level ever since. Private pension funds which manage significant funds (more than 1 trillion roubles) do not invest in the OFZs market currently. Neither are the proceeds of oil, gas and raw materials exports invested into OFZs today.

OFZ portfolios held by non-residents are currently insignificant at approximately 64 billion roubles, i.e. nearly 3 percent of the marketable debt. Most of this amount represents short-term investments made by hedge funds and private investors.

The current investor breakdown of OFZ holdings aggravates the problems of insufficient depth and low liquidity. The market suffers not simply because the investors’ money is divided between international markets and Russia, but rather because long-terms investors are ‘there’ (on the international markets) and speculators are ‘here’ (in Russia). OFZ holdings by investor type are detailed in Graph 10.

It is necessary to develop our domestic debt strategy on the assumption that in the near term the investor base is unlikely to diversify through the emergence of a significant number of conservative Russian market participants. Increased non-resident investment in the OFZ market will contribute to higher liquidity of the domestic market and improve pricing transparency.

Graph 10. Composition of OFZ holders



A fundamental issue for foreign investors who want to access the Russian domestic debt market is the fact that OFZ transactions cannot be settled in the international depositary and clearing systems. This is considered to be the most significant infrastructural impediment to non-residents actively working in the Russian debt market. OFZs are traded on the MICEX exchange, and only Russian participants with a depositary license have direct access to the MICEX exchange. Foreign investors and other Russian investors have to apply through Russian intermediaries. Over the counter OFZ trading is prohibited, unlike that of corporate and municipal bonds.

In Russia, only the National Settlements Depositary (NSD) is authorized to render depositary service and settlement of OFZs, which is not a concern for most Russian investors. However, for foreign investors the common practice is to settle transactions in different local markets in a single account open at one of the international depositary and clearing centers (the principle of "one depositary (deposit account), many brokers (broker accounts)". When it comes to buying OFZs, the foreign investor is forced to open a deposit account in the NSD and to enter into an agreement with a Russian broker.

This process requires additional time and financial costs for a foreign investor, as well as incurring both legal and operational risks related to the Russian market. At the same time the ability to directly own and trade OFZs is a key issue for many "quality" (conservative) investors representing foreign pension funds and asset management companies.

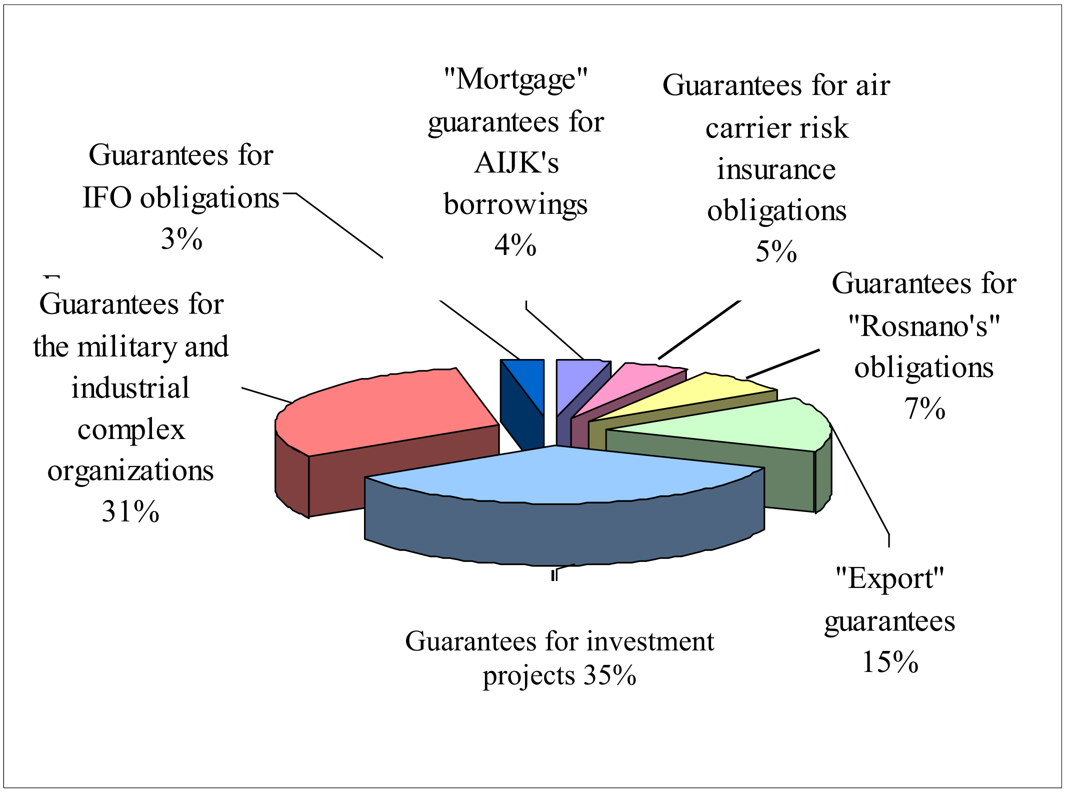
At present more than 40 companies certify securities ownership in Russia. Such practice is not common place for most developed countries or emerging market countries. Usually there is one central depositary in these countries, exclusively authorized to certify securities ownership. The absence of a central depositary in Russia is a substantial disincentive for many foreign private and government investment funds, which under their regulatory requirements are not allowed to invest in markets with no centralized record of securities ownership.

Therefore the transition of the domestic debt market into a properly-functioning and deep funding source for the federal budget deficit is possible only with a substantial modernization and liberalization of this market.

Factor 4. State guarantees

State guarantees play an increasingly significant role in the Russian economy today, acting as an important instrument of post-crisis economic policy. In recent years many (if not most) policy documents (industry strategies, federal special-purpose programmes, “route maps” etc.) contain references to state guarantees as a key part of capital raising to finance projects related to modernization of the economy, infrastructure, private and state partnership and support of national high-tech production exports.

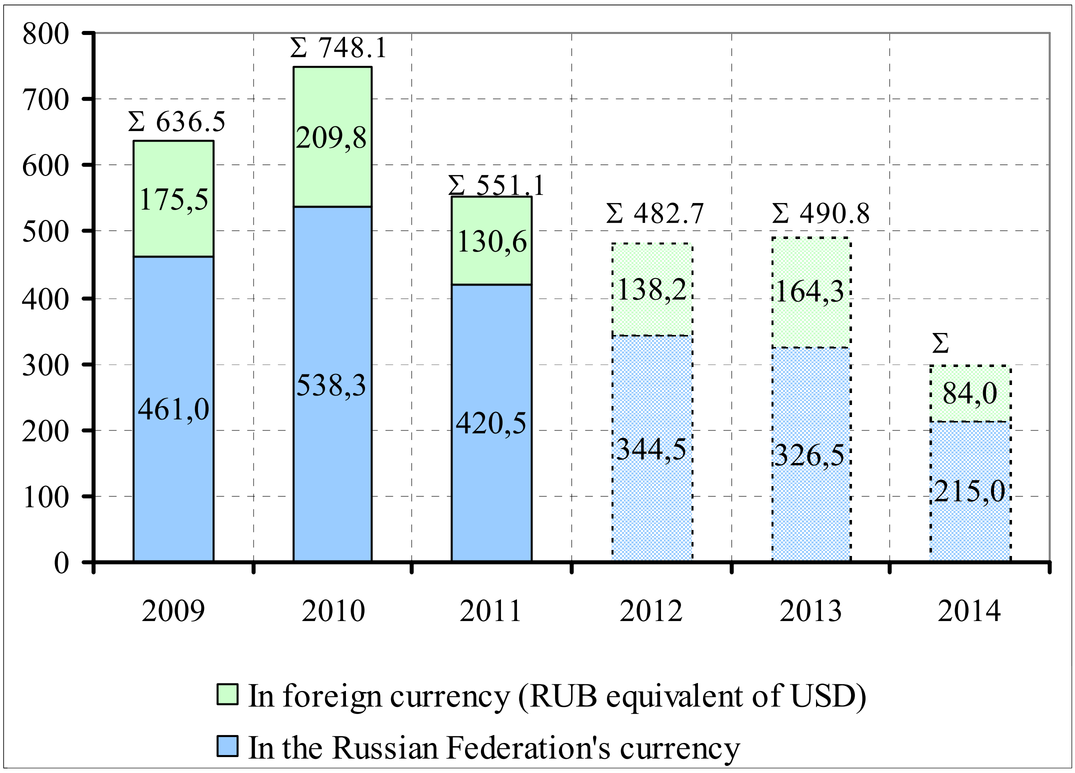
Graph 11. Breakdown of state guarantees to be provided in 2011



The breakdown of state guarantees to be provided in 2011, detailed in Graph 11, reflects the current specifics of using this instrument of federal government support: a big share of guarantees for various investment projects (including investment projects in the North Caucasian Federal District, including the Chechen Republic), the appearance of new types of guarantees provided to carry out state defense orders, and a considerable share of guarantees for liabilities of large state companies (“ROSNANO”, “AIJK”).

The guarantees provided for in the federal budget for 2011 total approximately 551.1 billion roubles (Graph 12).

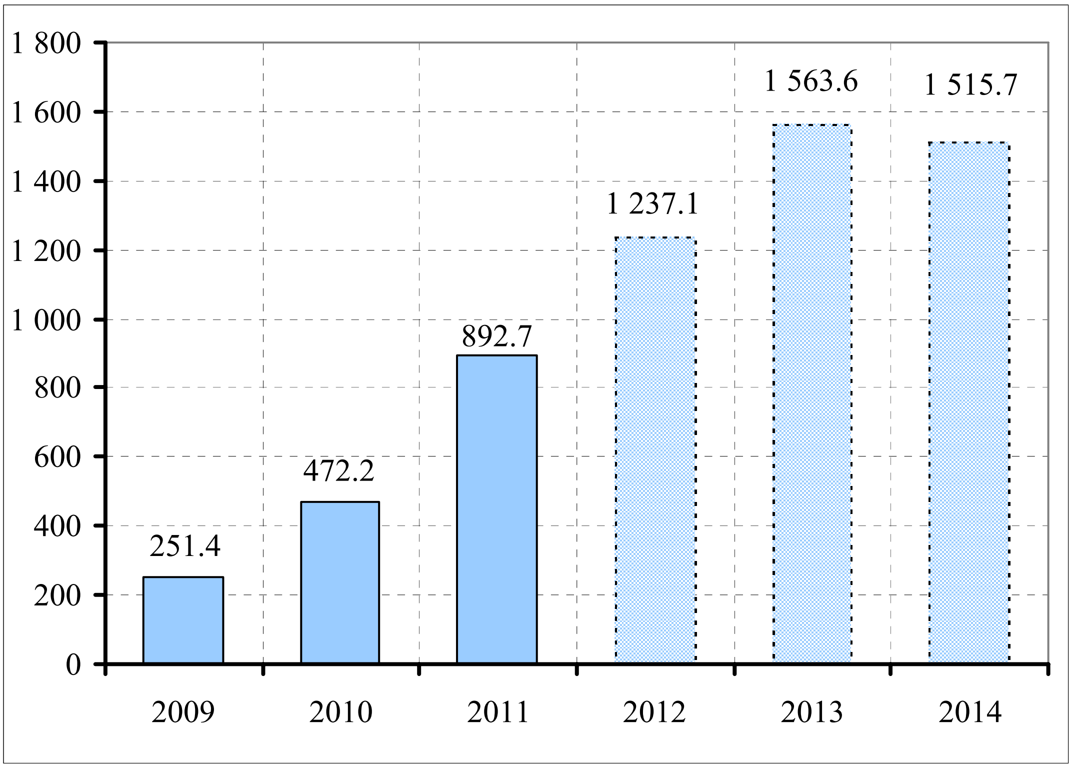
Graph 12. State guarantees, billion roubles



The provision of state guarantees and the associated contingent liabilities exert a significant influence on the main federal budget parameters. These guarantees, as contingent liabilities of the government, are included in the Russian sovereign debt. Increased guarantees directly impact the growth of government debt, budget expenditures and budget deficit financing requirements. Furthermore, at the time of preparing budget projections (planning of guarantees to be provided) it is difficult to accurately forecast the likely budget appropriations for such contingent liabilities as the terms of such projects are uncertain. This considerably complicates the budget planning process over both the short and long term.

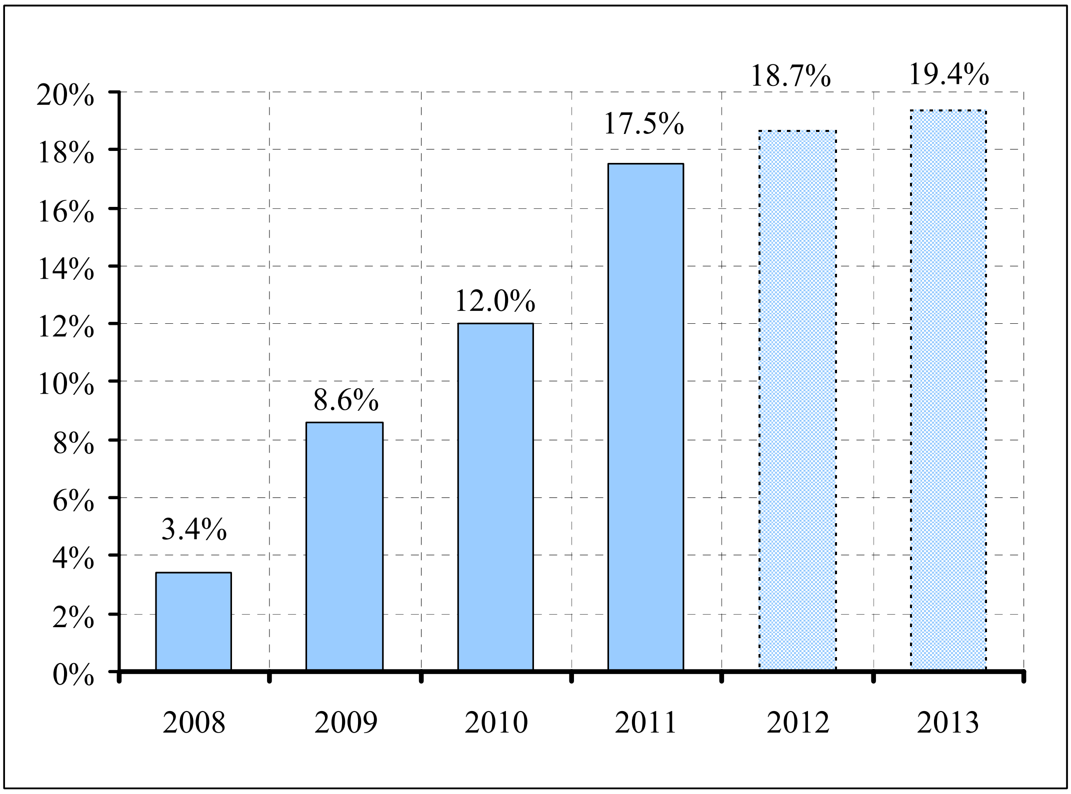
The federal government debt in the form of state guarantees has been increasing at a steady rate (Graph 13). Notably, the increase has substantially outpaced the increase of government debt in the form of OFZs. In 2009 the share of state guarantees in total federal government debt was about 8.6 percent (Graph 14), in 2011 it stands at 17.5 percent and is forecast to increase further in the next few years. As a consequence, the size of funds allocated in the federal budget for when these guarantees are called has been and is forecast to continue to increase rapidly (Graph 15).

Graph 13. Federal government domestic debt in the form of state guarantees, billion roubles



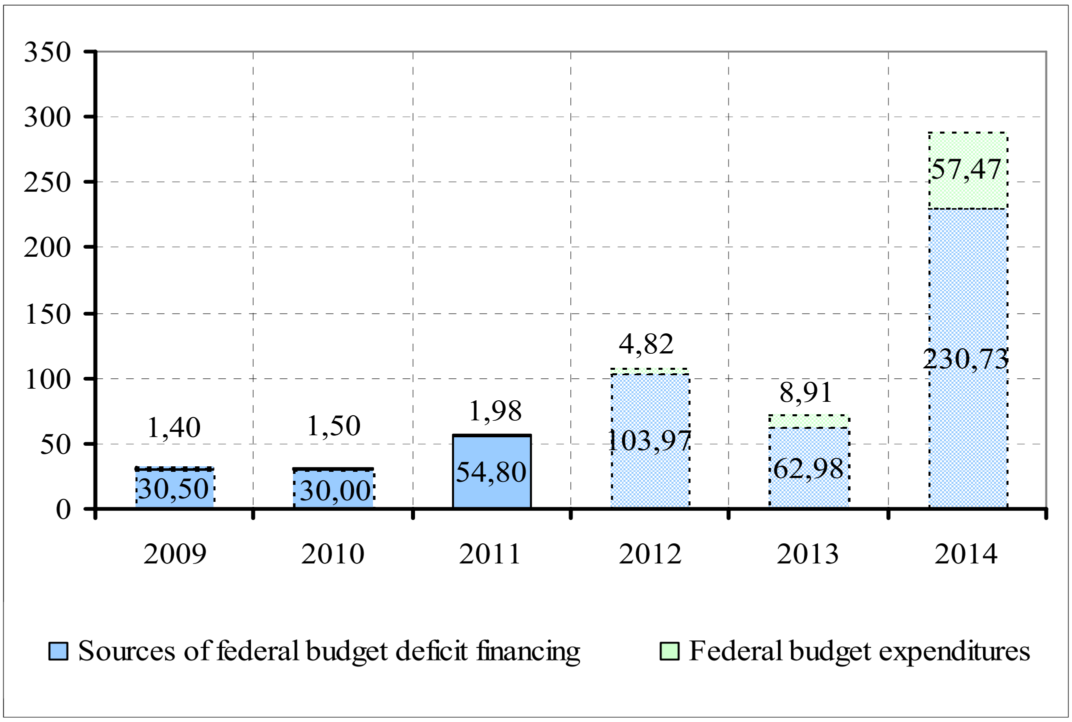
As early as 2014 projected federal budget direct expenditures for the execution of state guarantees (i.e. expenditures that are non-reimbursable thereafter due to the fact that the right to claim receivables in these cases is not provided for the federal government) could reach 57.5 billion roubles.

Graph 14. State guarantees as a share of sovereign debt



Considering the points noted above, we believe that debt policy over the period 2012 to 2014 should be developed and implemented on the basis that, state guarantees should not be used as much as in the last few years, and also that the debt accumulated under these guarantees requires a more considered strategy, particularly in the context of pro-active management of the federal budget's contingent liabilities.

Graph 15. Execution of state guarantees, billion roubles



<u>Factor 5. Sustained need of the private sector to borrow abroad</u>

During 2012-2014 the factors that induce Russian banks and companies to tap external debt markets as a funding source are likely to remain in place. Key factors include the lack of long-term funding available in the domestic market, the relatively low cost of external borrowing and its ready availability for large entities, especially those with state ownership. Therefore Russia, as a sovereign borrower, is interested in establishing benchmarks to facilitate external funding for Russian non-sovereign borrowers. We intend to keep a presence in the most demanded segments of the international capital markets. At the same time, measures intended to discourage the inflow of “hot” money, in the form of short-term loans and credits to the national economy, are to be taken.

Accordingly, in 2012-2014 the state debt policy will be developed based on the need, on one hand, to support the ability of non-sovereign Russian borrowers to raise funds in the international and domestic markets on the most favorable conditions and, on the other hand, to monitor carefully the corporate sector’s debt.

2. The Priorities and instruments of the debt policy

In 2012-2014 the Russian Federation debt policy will be implemented to fulfill the following objectives:

• ensure a balanced federal budget, subject to preserving the strong debt sustainability achieved in the last few years;

• maintain Russia's investment grade credit ratings with the target of creating the conditions for raising them to the single "A" category;

• further develop the domestic government debt market;

• ensure the permanent access of the Russian Federation and Russian non-sovereign entities to domestic and external borrowing sources on acceptable terms, and minimize borrowing costs;

• preserve the sound external debt trend of the Russian corporate sector through policy measures including the limitation of speculative capital ("hot" money) inflow.

2.1 The debt policy in the domestic capital market

The task of maintaining a high level of liquidity in the government domestic debt market with a diversified investor base and of providing incentives for investment demand requires a speedy implementation of the measures intended to increase the appeal of the government securities market.

During 2010-2011 the Ministry has taken several steps in this direction:

1) The regular release of quarterly schedules for OFZ auctions as well as notifying market participants on the day before an auction of the expected yields of the security (securities) to be auctioned;

2) consultations from time to time with major market participants in order to elicit feedback on the problems restraining the development of the market and to understand market participants' preferences regarding tenor and the other terms of offered OFZs;

3) elimination of advance deposit requirement at auctions;

4) establishment of benchmark bonds at standard maturities and in volumes sufficient to enhance liquidity;

5) adoption of amendments to the “Securities Market” Federal Law and Tax Code of the Russian Federation aimed at simplifying the payments procedure for securities with the mandatory centralized depositary (endorsing the Russian depositaries’ exclusive right to make aforementioned payments to holders of securities and execute tax agent functions).

As a result of the measures mentioned above the following positive changes have taken place in the OFZ market:

- liquidity of outstanding issues has improved (average daily turnover of OFZs on the secondary market has increased to 3 billion roubles, a fourfold increase in comparison with 0.7 billion roubles in 2009);
- average issuance volume has grown from 45 to 83 billion roubles;
- average volume of placement at auctions has increased fourfold to 20 billion roubles;
- the number of participants in OFZ auctions has increased.

In the forthcoming period, the maturities of OFZs offered to investors will be diversified. The issue of medium and long-term securities will be the policy's primary focus. The issue of short-term instruments (up to 1 year) will be exceptional, justified only under very unfavorable market conditions when the issue of medium and long-term securities would not be feasible. Such an approach reduces refinancing risk, as well as optimizing the maturity structure of the federal government domestic debt. We favor maintaining the average duration of the stock of outstanding OFZs at 5 years.

We plan to issue OFZs with fixed coupons. At the current time, issuance of OFZs with variable coupon rates pegged to the consumer prices index or key indicators of the money market is not considered a debt policy priority.

The policy of issuing benchmark bonds in volumes sufficient to enhance liquidity and at standard maturities, i.e. 3, 5, 10, 15 and 30 years, will continue. Such securities enjoy the highest demand, as they allow for interest rate and currency risks to be hedged. The liquidity of benchmark OFZs is to be maintained by means of a regular exchange of bonds with near-term maturities for new benchmarks.

The regular release of quarterly schedules for OFZ auctions will be continued. Regular dialogue with key OFZ market participants will be maintained in order to understand investor preferences, demand and expectations regarding issue volumes and interest rate dynamics. Based on the feedback from this dialogue, adjustments aimed at maintaining the stability of the market will be made in auction schedules when investor expectations and market conditions have changed considerably.

The yield on any auctioned OFZ issue will be set taking into account the current needs of the budget in the first place (offer price), and market conditions (bid price) in view of the strategic goal of reaching and maintaining the average duration of the OFZ portfolio at 5 years.

The practice of auctioning state saving bonds (GSO) predominantly to meet demand from institutional investors allocating pension savings shall continue.

Further measures of domestic market development will be focused on improving market infrastructure and increasing the liquidity of outstanding government securities. In this regard the debt policy guidelines are the following:

1) Analysis of the feasibility of settling OFZ transactions using international depositary and clearing systems.

This task requires amendments to the “Securities Market” Federal Law in order to ease access to the OFZ market for foreign participants (depositaries). An easing of legal restrictions to open nominee accounts for foreign depositaries in a Russian depositary might be expected to encourage a partial outflow of the OFZ settlement process to overseas markets. However, if such a decision is supported and enacted, it will provide incentives for competition between Russian and foreign depositaries. This will presumably have a positive influence on the quality of services rendered. As for any possible negative effect, this should be insignificant and temporary. The arrival of new foreign investors in the Russian securities market will also provide some compensation.

2) Introducing a new mechanism for exchange-traded government securities

Currently OFZs are traded on the federal government securities section (FGS) of MICEX, separately from corporate securities. As a result, market participants have to use different accounts for transactions with OFZs and corporate securities. This limits their capacity to work with different types of financial assets. Furthermore, trading on FGS requires an advance deposit of funds (money and securities) in a trade account in FGS, unlike trading in other sections of the exchange. This requirement restrains the flexibility of market participants to manage their trading positions.

From 1 January 2012, under amendments adopted in the “Securities Market” Federal Law, the above-mentioned restriction will be removed and OFZs will be traded alongside corporate securities. The initial placement of OFZs will continue to be carried out in the FGS section until the Ministry enters into an agreement with MICEX to execute OFZ auctions in the common section of the exchange.

We expect that these changes will help to boost OFZ trading and expand the investor base. Trading on one platform will remove the need to separate liquidity and will simplify investors’ access to assets without time delays and additional costs.

It would also be reasonable to provide an option to settle transactions in the secondary market according to common worldwide practice (T+2 or T+3).

3) Over the counter OFZ trading

In compliance with the Bank of Russia’s Regulation “Service and Circulation of federal government securities” Ref. 219-P dated March 25, 2003, OFZs may be traded exclusively on the MICEX exchange. However, over the counter trading of government securities is common practice worldwide. For example, the secondary Eurobond market exists as exclusively an over the counter market. The lack of ability to trade OFZs over the counter leads to a rise in trading costs due to the stock exchange's commission, narrows access to the OFZ market for Russian participants and inhibits an expansion of the investor base.

4) Introduction of centralized registration of securities ownership rights in the Russian Federation

Establishing a central depositary is intended to increase the effectiveness and competitiveness of the registration and payment infrastructure of the Russian securities market, to strengthen ownership rights protection and thus help increase foreign investments in both OFZs and corporate securities. The implementation of the task is provided for by the Order of the President of the Russian Federation Ref. Pr-1822 dated June 27, 2011 as a follow-up to the St-Petersburg International Economic Forum.

5) Unification of tax rates on OFZs and corporate bonds

The taxation rate on OFZ coupon payments is 15 percent, compared to a 20 percent rate for the income received on capital appreciation. All income on corporate bonds are taxed at the rate of 20 percent. This complicates any comparison of the yield on corporate and federal government bonds and the accounting of investments in securities becomes more difficult since investors cannot offset a financial result on operations made with federal government and corporate securities without additional calculations and settlements.

Potential investors may consider the current situation as an additional hurdle for the allocation of funds into OFZs.

It would be reasonable to unify the taxation of federal government and corporate bonds. As a result the settlement system would be simpler, the tax base for profit tax would be common for all income, pricing of bonds in the domestic market would be comparable, and their yields will also be comparable.

We expect that consistent implementation of the above-mentioned measures would improve the conditions for federal government borrowings and increase demand for federal government securities. Successful realization of the proposed measures will help to improve the investment climate in Russia as a whole and strengthen the reserve status of the rouble. It will become an important part of building a world financial centre in this country.

2.2. Debt policy in external capital markets

2010-2011 can be viewed as a gradual recovery in the world economy and a restoration of investors' confidence after the financial and economic crisis. As a consequence, the volume of Eurobonds issued both by developed and emerging markets has risen. At the same time, uncertainty in the European Union and macroeconomic problems in some developed countries have contributed to a higher demand for emerging market debt, including Russia’s. As a result we have managed to successfully place three issues of Eurobonds of the Russian Federation in the above-mentioned period:

- two Eurobond issues maturing in 2015 and 2020 for the total amount of US$5.5 billion;

- for the first time in its modern history, Russia issued, and subsequently tapped, a 7 year local currency Eurobond (in amounts of 40 and 50 billion roubles, respectively) with a yield to maturity of 7.85 percent and 7.00 percent, respectively. In March 2011 a new type of government security, rouble-denominated Eurobonds, therefore appeared in the international capital market, with a yield to maturity 70 basis points lower than the yield of an OFZ with a similar maturity.

This issue has become the largest (equivalent to more than US$3 billion) local currency denominated Eurobond issued in the emerging markets universe.

The strategic objective of issuing rouble-denominated sovereign Eurobonds was to expand the investor base for government securities denominated in roubles and to strengthen the role of the rouble as a regional reserve currency. Furthermore, borrowing in local currency in the external markets, common practice for developed countries, contributed to a lower average yield on federal government bonds in the domestic market and reduced currency risks for the federal budget.

In order to maintain Russia's presence as a sovereign borrower in the international capital markets and keep permanent access to them in 2012-2014 we plan:

- to issue Eurobonds of the Russian Federation in small volumes, taking into consideration prevailing demand;
- to build representative yield curves in different currencies, first of all in US dollars and euros;
- to limit the issue of rouble-denominated Eurobonds in the international capital markets;
- to create the conditions necessary for the attraction of long-term investors, diversified by type and geography;
- to maintain a permanent dialogue with a wide circle of global investors.

2.3. State guarantee support

Terms of state guarantees provided in the period of 2009-2011 are such that a payback of the federal budget funds used in the event of their being called is difficult to predict. There is a probability that these expenditures may not be reimbursed. The fact that state guarantees are provided without regard for the results of implementation of the underlying projects for which the guarantees were granted is rather important from the point of view of risks related to the federal budget. The beneficiaries of the guarantees have neither an obligation, nor liability with regard to the implementation or ineffective implementation of projects supported by the state.

In order to increase the efficiency of state guarantees as well as to manage the associated budget risks, state guarantees will in future be granted based on the following basic principles:

1) establishment of common approaches for granting state guarantees with "generic characteristics" (i.e. industry, region, market, etc.) regardless of the

receiver of federal government support; departure from the practice of granting unique, non-standard guarantees;

2) allocation of risks to the federal government and participants of the project benefiting from the guarantee;

3) provision of guarantee support will be subject to the satisfactory financial condition of the entities receiving the guarantees (for example, the practice of granting guarantees to investment projects or projects related to state defence orders do not provide for adherence of such condition);

4) securing the repayment of funds used when state guarantees are called (for example, guarantees on investment projects do not provide for the state's right of recourse claim to the entity);

5) beneficiaries of guarantee to adhere to specific restrictions for the period of the guarantee (for example, cancellation of bonus payments to top management[4]) as well as the introduction of an entity's liability for a failure to implement projects supported by the state.

Similar measures are planned to be applied to budget appropriations for possible calling of state guarantees. In particular, the following appropriations are proposed to be provided for in the Federal Law on the Federal Budget for the corresponding year:

- on actually granted state guarantees - up to 100 percent of the amount of a possible execution;
- on state guarantees to be granted – in a considerably lower amount with subsequent prompt amendments to the Federal Law on the Federal Budget (if required) providing for an increase of budget appropriations up to 100 percent of the amount of a possible execution.

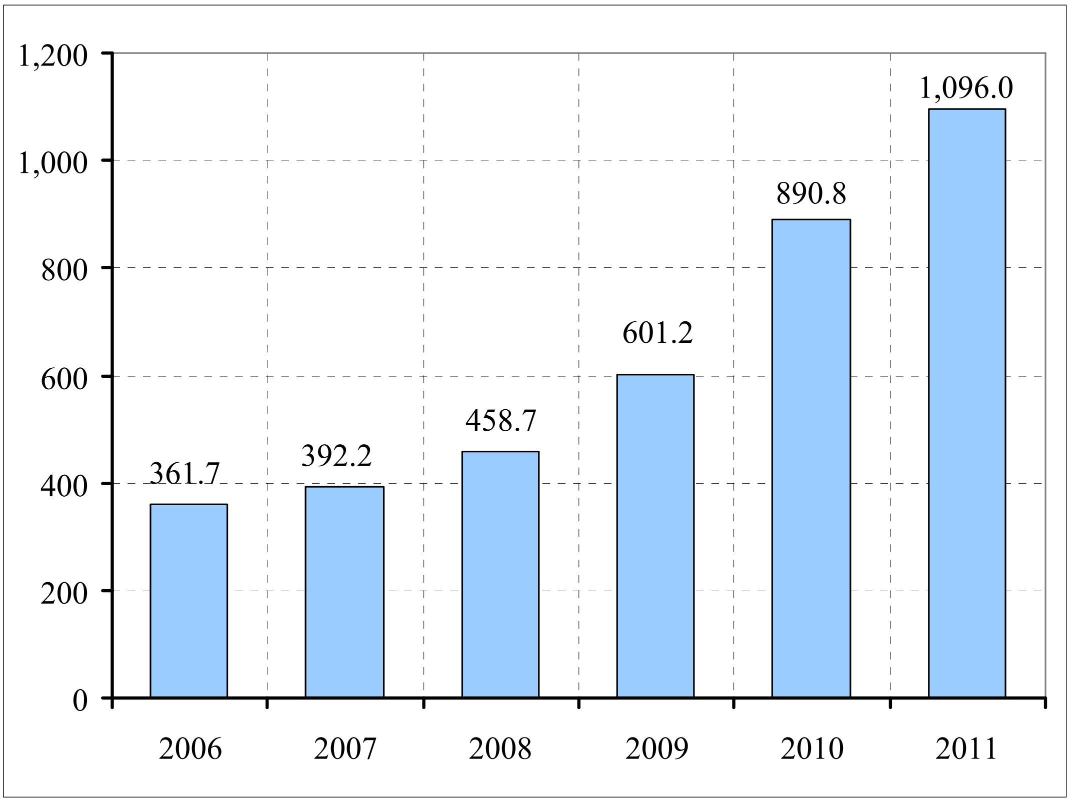
[4] This restriction, which has shown an extraordinary effectiveness, is provided for only under anti-crisis state guarantees

2.4. Policy related to the borrowings of the Russian Federation regions

In the last five years Russian regions' public debt grew steadily, on average by 25 percent per annum. At the start of 2011 the total amount had exceeded 1 trillion roubles (Graph 16) with the highest annual growth (more than 48 percent) in the crisis year of 2009.

As of January 1, 2011 public debt of the regions totalled 1,096.0 billion roubles, or 2.4 percent of GDP, including external debt in an amount of 32 billion roubles (US$1.1 billion), or less than 0.1 percent of GDP.

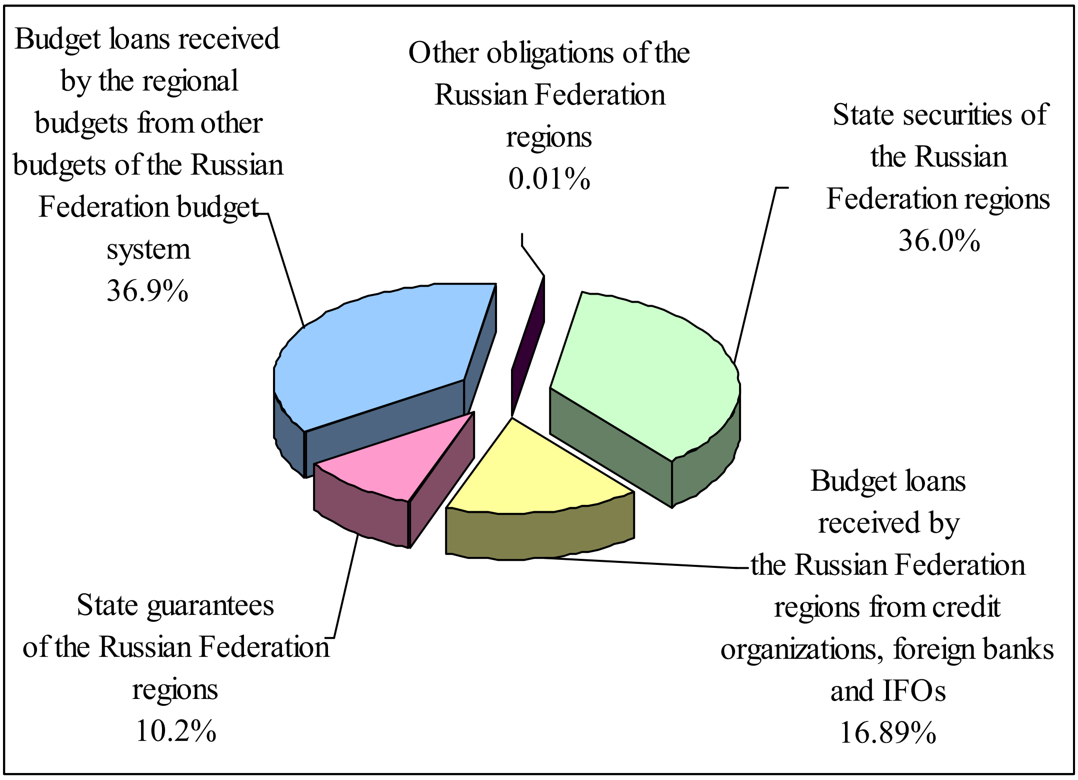
Graph 16. Public debt of the Russian Federation regions, billion roubles



During the last couple of years the structure of the regions' public debt has changed considerably. The share of budget credits received from other parts of the Russian Federation budgetary system has increased and the share of marketable debt has decreased. As of June 1, 2011 the share of budget credits reached almost

37 percent (Graph 17), having increased more than 5 times in comparison to the start of 2009, and have replaced liabilities on securities (fallen by 8.7 percent), bank credits (fallen by 11 percent) and state guarantees of regions (fallen by 10.3 percent).

Graph 17. The public debt structure of the Russian Federation regions



The aforementioned changes were the result of a deliberate government anti-crisis policy with respect to inter-budget relations: under conditions of contracting revenues of regions and restrained access to market funding, the accumulation of credits provided from the federal budget at preferential rates was justified and allowed to stabilize regional budgets.

The inter-budget relations policy will see drastic changes in the forthcoming period. The scope of credits provided from the federal budget to regional budgets will be substantially reduced with the prospect of regions receiving budget credits exclusively in emergency situations. In particular, it is planned to reduce the scope of budget credits to regions by more than 6 times: from 128.6 billion roubles in 2011 to 20 billion roubles in 2014. Starting from 2012 no budget credits are planned to be provided to construction, reconstruction, overhaul works, repair and maintenance of public roads.

As a result, in the forthcoming period the regions' need for market funding will obviously increase. On the one hand this situation imposes larger requirements to maintain sound solvency ratios. On the other hand it enhances competition for funding in the domestic debt market. This factor will become an extra incentive underscoring the necessity to extend the capacity and liquidity of the market as soon as possible.

Provisions of the Budget Code of the Russian Federation granting regions the right to resume foreign borrowings for the purpose of budget deficit financing and external debt repayments came into force on January 1, 2011. However this will not affect the regions whose estimated share of inter-budgetary transfers from the federal budget (excluding subventions) during two of the three last accounting years exceeded 5 percent of their own consolidated budget revenues and which have the right to borrow abroad only for the purpose of external debt repayment. Another restriction is that regions have the right to issue bonds in foreign currency provided that they obtain ratings from at least two leading international credit rating agencies.

In view of the aforementioned restrictions provided for by the Budget Code, only 6 regions may potentially tap the international capital market this year. However, only five of them (Moscow, Saint Petersburg, Tyumen region, Khanty-Mansy Autonomous Area – Yugra and Yamalo-Nenets Autonomous Area) may borrow to finance their budget deficit and repay accumulated debt obligations and one (the Republic of Bashkortostan) – to refinance external debt. In this case the potential volume of the regions' external borrowings will not exceed 198 billion roubles.

In general, the public debt of the Russian Federation regions will require strong vigilance in the forthcoming period.

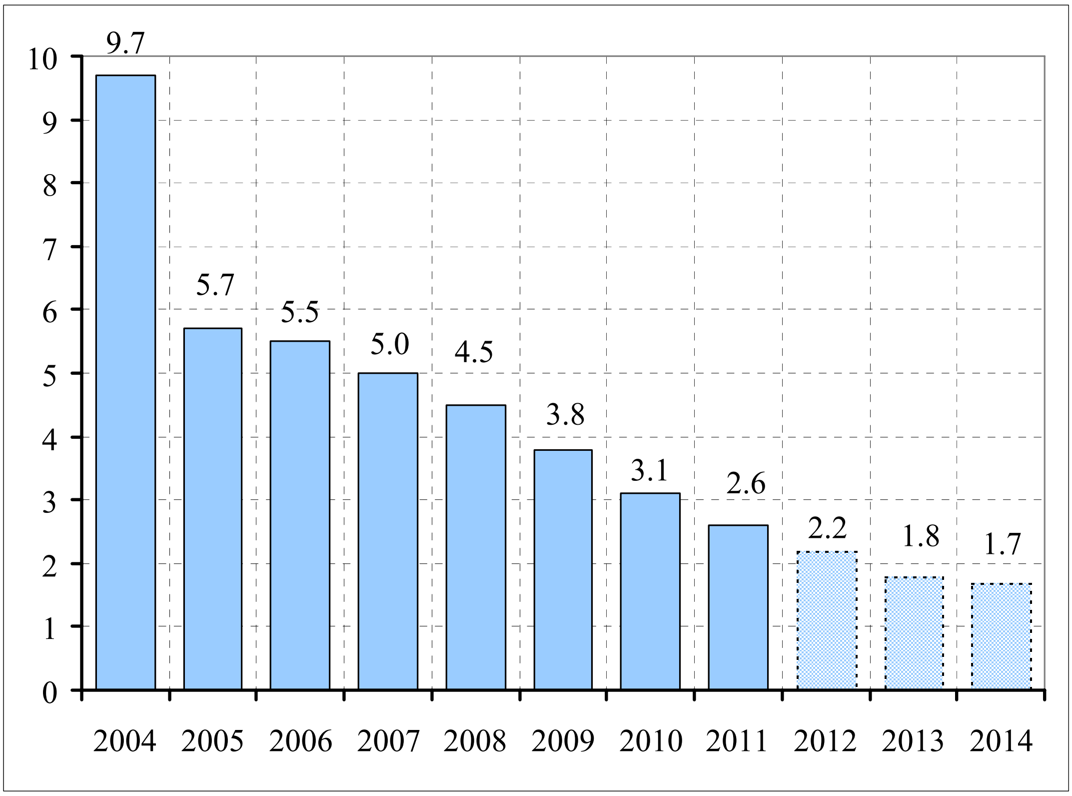
2.5. Cooperation with international development banks

Starting from 2002 the Russian Federation declined to obtain financial (budget replacing) loans from the international financial organizations (IFO) having concentrated on joint implementation of projects in priority areas and industries of the Russian economy, in cooperation with international development banks (IDB). Cooperation is based on investment loans with a substantial share of Russian co-financing.

In the intervening period, the share of liabilities on IFO credits in the structure of the Russian Federation's state debt was gradually decreasing and represented 1.8 percent (80.4 billion roubles, or US$2.6 billion) as of June 1, 2011 (Graph 18). IFO credits do not exceed 0.4 percent of all Russian Federation borrowings. During 2012-2014 the volume of such borrowings will remain at insignificant levels, not exceeding an average of US$300 million per year.

In addition to reducing the volume of borrowings from the IDBs, a particular feature of the current interaction of the Russian Federation with these institutions is the significant rise of Russian co-financing in joint projects. During 2005 - 2011 the scope of originally agreed budgetary co-financing was revised upwards by 50 percent on average. In some cases Russian co-financing grew between two and six times.

Graph 18. Russian state debt on credits (loans) from international development banks, US$ bln



Twelve projects for the total amount of US$2.3 billion are now being implemented within the framework of loan contracts with the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD) and the Nordic Investment Bank (NIB). The projects include enhancement of the Russian Federation's treasury system, information system of customs authorities, technical re-equipment of "Roshydromet" (the Russian Hydrometeorological service) institutions and organizations, reforming of housing and public utilities of Kaliningrad city, development of state registration of real estate ownership rights and system of state statistics, judicial reform support, Saint-Petersburg's economic development, Russian cultural heritage preservation, etc. In addition, Russia presented within the G8 an international initiative promoting financial literacy of the population and financial education development. In support of this initiative Russia signed an agreement with the IBRD worth US$113 million to aid these programmes in the Russian Federation.

Only two of the aforementioned projects (representing less than 10 percent of funds received from the IDBs) are granted to domestic borrowers as interest bearing sub-loans on conditions of repayment. The remainder of the credits are received by federal executive authorities. During 2012-2014 Russia's overall borrowings from the IDBs may total US$900 million, although in 2014 funds borrowed from the IDBs are not envisaged to be granted in the form of budget credits.

Borrowing the planned amounts from the IDBs is considered to be reasonable, subject to the following comparative advantages inherent in the funding source:

- ability to involve leading specialists experienced in the reforms of the public management system, execution of large infrastructural and other nationwide projects;

- providing international certification of projects: IDB participation evidences compliance of the projects with international standards;

- transparency of codes and implementation procedures, which contributes to the growth of the private sector's confidence and stimulates private investments;

- ability to obtain additional financing, including grants, through participation in IDB endowment programs;

- flexibility in determining the proportion of funds borrowed from IDB and Russian co-financing;

- low cost of IDB loans.

Taking into consideration the above, cooperation with the IDBs will continue in the forthcoming period, including small scale borrowings based on the following approaches:

1) priority funding for joint IDB projects from the federal budget with corresponding reduction in the proportion of debt financing; minimal borrowings from IDBs exclusively when it is a required and mandatory condition of IDB participation in projects due to the provisions of the IDB's founding charter terms, and project implementation is recognized as reasonable;

2) implementation of new projects related to public management, environment protection, enhancement of energy efficiency, development of financial market and microfinance services sector, aiding regional initiatives, modernisation of national hydrometeorology system, development of special economic areas, physical training and sports intended for people with low social protection, and forestry development. The choice of the form of cooperation with the IDB as well as determination of the share of Russian co-financing shall be carried out on a case-by-case basis;

3) use of state guarantees for projects carried out jointly with IDBs;

4) expansion of Russia's participation in various IDB initiatives, including technical assistance funds, private equity funds and other forms of cooperation;

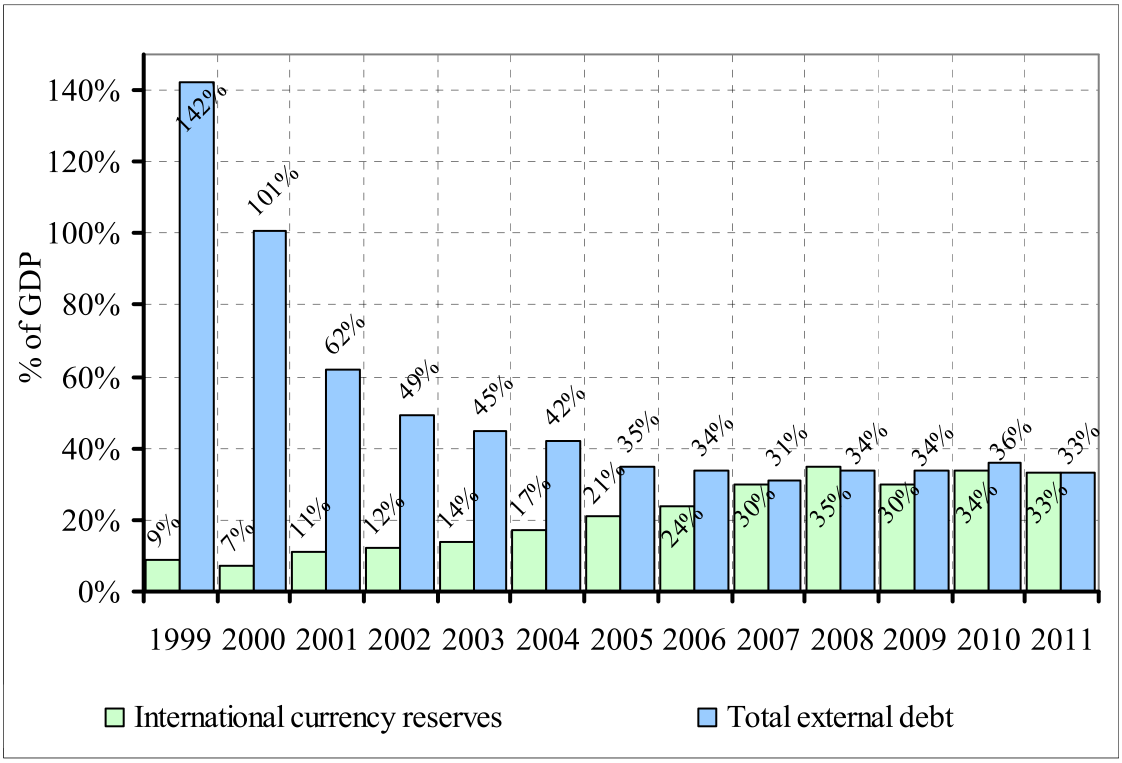
5) help increase the portfolio of projects implemented by the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), the European Bank for Reconstruction and Development (EBRD), the Black Sea Trade and Development Bank (BSTDB) and the Eurasian Development Bank (EDB) in the Russian Federation without financial liabilities assumed by the Russian Federation;

6) as a shareholder, active participation of the Russian Federation in IDB's activities aimed to effectively exploit the capabilities of the international financial institutions in Russia's interests.

2.6. Monitoring of corporate sector's external debt

In 2009-2010 Russian external corporate debt decreased by US$5.8 billion (1.3 percent) and by the middle of 2011 totalled US$485.6 billion which is equivalent to 25 percent of Russian GDP. As of July 1, 2011 total (public and corporate) external debt of the country totalled US$532.2 billion or 28 percent of GDP. Russian international reserves (US$524.5 billion) provided 98 percent coverage of this debt (Graph 19).

Graph 19. International reserves and total external debt of the Russian Federation



One of the general principles of the Russian Federation debt policy is that public borrowings must not undermine the ability of other Russian borrowers to raise capital in the domestic and external markets. Moreover, in recent years the government has sought to create favourable conditions for national banks and corporations, in particular by building up representative sovereign yield curves and thus forming an environment where Russian borrowers' debt instruments could be priced accordingly.

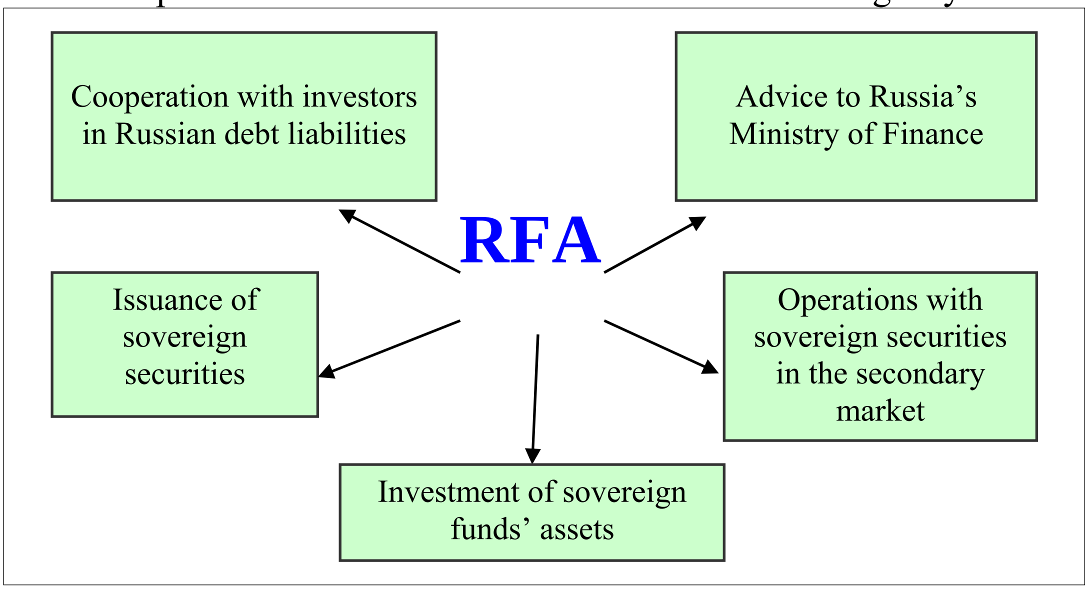
At the same time, corporate borrowings and their debt burden requires vigilance of the financial authorities. In 2012-2014 policies intended to enhance the monitoring of corporate external borrowings and to establish a strategy for a timely response on the borrowing policy of corporations and banks with state ownership will be continued. In compliance with regulations of Federal Law "Non-Profit Institutions" Ref. 7-FL dated January 12, 1996 (as amended on December 29, 2010) Decree of the Government of the Russian Federation establishing procedures of foreign currency borrowings by state corporations is planned to be enacted, adding to monitoring policy tools.

2.7. Transition to active public debt management

The task aimed at effectively minimizing growing expenditures related to debt repayment and debt service, as well as risk management costs, imposes the necessity of a transition to active public debt management. It presumes a deliberate influence on the debt structure (maturities, currencies, instruments, interest rates, etc.).

Experience in a number of foreign countries illustrates the importance in the establishment of a duly authorized specialised market institution that has the necessary set of powers and human resources. With respect to our country, reference is made to OJSC "Russian Financial Agency" (RFA), the creation of which was made by a political decision in 2008. On the one hand this institution will act as a "front office" responsible for cooperation with investors and other financial markets participants. Its activities will be aimed at shaping and maintaining an adequate perception of Russia's credit risk by the investment community. On the other hand in the long run, the RFA will assume the functions of primary consultant to the Russian Finance Ministry on issues related to the minimization of debt repayment and service expenditures, as well as interest rate and currency risks for the federal budget.

Graph 20. The functions of the Russian Financial Agency



The RFA on behalf of the Russian Federation will be issuing government bonds in domestic and external markets and manage the government's marketable debt portfolio via operations in the secondary market. As the necessary framework is established, the RFA will also be investing a part of the Russian sovereign funds' assets (Graph 20).

In case the draft law prepared by the Ministry of Finance is enacted in the forthcoming period, the RFA will be established by the Government of the Russian Federation and will commence its activities.

2.8. Compensation of "pre-reform" savings of citizens

Compensatory payments on "pre-reform" savings of citizens is a separate issue of the current debt policy. In particular, ensuring that these payments are financed through the federal budget via government domestic borrowings. Over the last decade funds allocated for this purposes have grown more than nine times: from 12 billion roubles in 2001 up to 115 billion roubles in 2010. 50 billion roubles are planned to be allocated annually for compensatory payments in 2011 and in the forthcoming period.

The current regulatory framework provides for complete compensation of all depositors' losses, i.e. recovery of the purchasing power of their savings up to the level corresponding to the purchasing power of money in 1990-1991. Yet the regulatory framework that was formed in the mid 1990s does not define the funding sources of such budget expenditures. Meanwhile, the Federal Law dated May 10, 1995 Ref. 73 "Recovery and Protection of Savings of the Russian Federation Citizens" proposes to transform pre-reform savings into debt liabilities possessing the status of government securities and issued to cover the overall savings volume. Additional government domestic debt emerging in this case would result in an estimated 25 (!) trillion roubles as of the beginning of 2011.

Obviously, the actual realization of this concept imposes exorbitant liabilities on the federal budget. If this happens then the government would be unable to finance its remaining expenditures for a long period of time. Clearly an issue of federal government securities in the financial markets in such a scale is impossible for other reasons as well.

In accordance with the Decree of State Duma of Federal Council of the Russian Federation dated January 27, 2010 Ref. 3125-5 GD, a working committee on the enhancement of savings recovery and protection legislation was established. The committee involves representatives of the executive and legislative authorities as well as several professional organisations. However, even before completion of its work, it is important to determine at a legislative level a conceptual approach to a solution to the pre-reform deposit compensation problem. Obviously, the appropriate compensation should be exercised with due consideration to the federal budget's capability as well as limiting the growth of state debt.

Conclusion

Regardless of the macroeconomic scenarios and capital markets conditions, the state debt policy in the forthcoming period will seek to ensure the Russian Federation's ability to raise capital in volumes required to accomplish the established social and economic tasks, and on conditions acceptable for our country as a reliable sovereign borrower. Regular presence of Russia in the capital markets, transparent and consistent auction policy, permanent and effective communications with the investment community, and a gradual expansion of investors interested in placing funds in Russian government securities will contribute to this goal.

The actual scope of government borrowings will depend on the results of the federal budget execution and conditions of domestic and external markets. The accumulated volume of debt liabilities to national and foreign creditors will be within the limits excluding considerable worsening of the Russian Federation's debt sustainability. The debt policy will aim to upgrade the credit ratings of our country and to secure unconditional solvency.