Ministry of Finance of the Russian Federation

PUBLIC DEBT MANAGEMENT POLICY OF THE RUSSIAN FEDERATION FOR 2013 – 2015

2012

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Introduction

The rule of distribution of oil and gas revenues, which is being brought back into the budget planning process, seeks to reduce the state budget's susceptibility to volatile oil price fluctuations. The new elements of a more conservative financial policy, such as the legislatively imposed state expenditure limit and the "automatic" accumulation of a portion of oil and gas revenues in the sovereign funds, will allow in the medium term for an increased sustainability of the budget system, a moderate federal budget deficit in 2013 and 2014 and a balanced budget in 2015. Federal government borrowings in the capital markets will be the main source of financing the federal budget deficit. The volume of prospective issuance of public securities primarily in the domestic bond market may equal up to RUB 1.2 trillion per annum.

Raising debt capital in the markets on acceptable terms and conditions and in the required amount will be challenging. In this context, continuing to prioritise development of the domestic debt market is considered to be the most important goal of public debt policy in the medium term. It is necessary to complete the initiated reforms aimed at market liberalization and modernization of its infrastructure. The key objectives in this regard remain the expansion of the investor base and the development of user-friendly and competitive conditions for market participants.

The public debt policy in 2013-2015 will be focused on funding the federal budget deficit by means of issuance in the domestic and international capital markets on favorable terms, ensuring an optimal balance between yields and duration of sovereign debt obligations, maintaining Russia's credit ratings at a high level, and establishing adequate market benchmarks for Russian corporate borrowers. At the same time, the policy will look to enhance the system of monitoring the corporate sector's external borrowings and the mechanism of granting state guarantees.

1. Main factors determining the character and trends of the debt policy of the Russian Federation in 2013-2015.

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

Factor 1. Macroeconomic conditions of debt policy implementation

The upcoming period of the social and economic development of the Russian Federation is characterized by uncertainty of the speed of world economic recovery, aggravated by regional and inter-regional financial and economic misbalances. These conditions will reduce the demand for Russian exports, which however, will help create the conditions for the modernization of Russia’s economy.

According to the scenario conditions and main forecast parameters of the social and economic development of the Russian Federation in 2013-2015, the debt policy during the upcoming period will be implemented in conditions of a moderate acceleration in Russian economic growth, a stable inflation rate, maintenance of oil prices at USD 100 per barrel, and limited rouble depreciation. (Table 1).

Table 1. Main macroeconomic indicators in 2013-2015.[1]

Indicator	2013	2014	2015
GDP (RUB, billion)	66,515	73,993	82,937
GDP growth against previous year (%)	+3.7	+4.3	+4.5
Oil price (USD per barrel)	97.0	101.0	104.0
Inflation (%)	5.5	5.0	5.0
RUB / USD exchange rate	32.4	33.0	33.7

Source: Ministry of Economic Development of the Russian Federation

The unstable character of the world economic recovery as well as the unstable condition of public finances in a number of foreign countries, primarily european countries, creates a serious risk of a deterioration in the global economic situation and continued stress in the world financial markets in the medium term. The slowdown of economic growth in BRICS countries, and as a consequence, reduction of world demand for energy products could trigger a

[1] In this table and hereinafter in Tables and Diagrams the data are given as at the end of the period.

reduction in oil prices in the medium term to a level considerably lower than USD 100 per barrel, a new wave of global financial and economic crises and realization of pessimistic scenarios for the economic development of Russia.

The federal budget is forecast to be in deficit during the planned period; however, it will be relatively small (0.8% of GDP in 2013 and 0.2% of GDP in 2014) with a forecast zero budget deficit in 2015. Although the overall deficit is forecast to be moderate, the non-oil-and-gas deficit will remain elevated, albeit steadily falling: in 2013 – 10.1% of GDP, in 2014 – 8.9% of GDP, in 2015 – 8.6% of GDP.

The main source of financing the federal budget deficit will continue to be federal government borrowings totaling RUB 1.4 trillion, RUB 1.1 trillion and RUB 1.4 trillion in 2013-2015, respectively (Table 2).

In order to accumulate a portion of oil and gas revenues in the Reserve Fund and further develop the domestic debt market in the upcoming period, the government plans to continue the “borrow and save” strategy, borrowing funds on favorable terms in volumes that exceed the federal budget deficit.

Should crisis tendencies develop in the world economy, borrowing conditions in the debt markets will worsen considerably for the Russian Federation as well as for many other sovereign borrowers. In the worst-case scenario the debt markets can close temporarily, limiting the ability of the sovereign to raise funds in the required volumes on acceptable terms and conditions. In such a situation the funds accumulated in the Reserve Fund will guarantee execution of budget expenditure obligations.

Accumulation of oil and gas revenues in the sovereign funds directly impacts the appeal of Russian debt for foreign investors. In other words, the maintenance of the funds helps to ensure borrowing opportunities for the Russian Federation on favorable conditions in the future. In conditions of a relatively calm situation in the economy and in financial markets it is expedient to refrain from spending the Reserve Fund and instead borrow on favorable conditions in the market.

Table 2. Sources of federal budget deficit financing in 2012-2015, in billion roubles

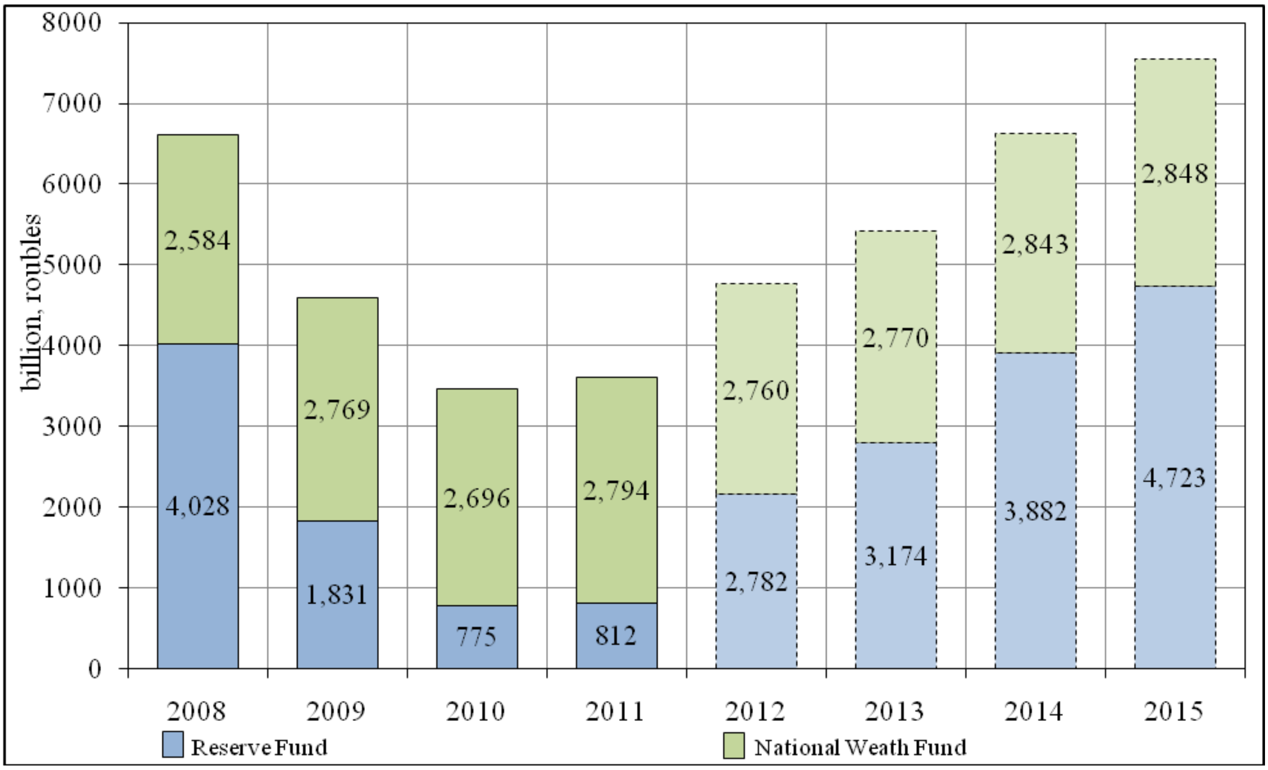
Indicator	2012	2013	2014	2015
Federal budget deficit	-68.1	-521.4	-143.6	-10.8
Public borrowing, including:	842.1	606.5	563.4	414.4
Borrowing	1,519.9	1,448.8	1,079.3	1,356.4
Repayment	-677.8	-842.3	-515.9	-942.0
Public domestic borrowing, including:	709.8	448.6	398.5	306.5
Borrowing	1,310.2	1,213.2	842.2	1,114.8
Repayment	-600.4	-764.6	-443.7	-808.3
Public external borrowing, including:	132.3	157.9	164.9	107.9
Borrowing	209.7	235.6	237.1	241.6
Repayment	-77.4	-77.7	-72.3	-133.7
Use of the Reserve Fund	-830.3	-373.4	-596.3	-818.6
Use of the National Wealth Fund	7.5	5.7	7.5	8.9
Privatization	300.0	427.7	330.8	595.1
Execution of state guarantees of the Russian Federation	-109.9	-58.3	-89.6	-160.0
Other	-141.3	-86.7	-72.1	-29.0

Source: Ministry of Finance of the Russian Federation

In this context, in 2013-2015 it is planned to continue to replenish the Reserve Fund on account of additional oil and gas revenues. It is assumed that at the end of 2013, the volume of the Reserve Fund will be 4.8% of GDP, while at the end 2014 and in 2015, 5.2% of GDP and 5.7% of GDP, respectively. However, such rates of Reserve Fund replenishment will not provide for a return to its pre-crisis level.

In the absence of replenishment and if the funds are only used for the purpose of co-financing citizens voluntary pension contributions in an amount of no more than RUB 9 billion annually, the size of the National Wealth Fund (NWF) in the planned period will not change significantly and at the end of 2013 it will be 4.2% of GDP, at the end of 2014 3.8% of GDP and in 2015 3.4% of GDP. The dynamics of the volumes of the sovereign funds are shown in Diagram 1.

Diagram 1. Volume of sovereign funds of the Russian Federation, in billion roubles



Source: Ministry of Finance of the Russian Federation

The Russian financial market is sufficiently integrated into the global market that if crisis tendencies develop in the world economy it will not escape the consequences. In these conditions, the possibility of borrowing on favorable terms both for the state and for Russian companies would likely decrease significantly in 2013-2015. Liquidity shrinkage will lead to increased competition for financial resources in the capital markets and a possible increase in the rate at which Russian companies can borrow.

The policy pursued by the Central Bank of the Russian Federation for the past few years, i.e. a transfer to inflation targeting, a shift from heavy regulation of the foreign currency exchange rate and an expansion of the currency corridor has helped to reduce inflation to the lowest levels in the history of modern Russia (3.7% per annum in July 2012). Continuing with this policy in the upcoming period will provide for real returns on public securities and encourage investor demand for these instruments.

In order to minimize the likely consequences of a drastic deterioration in the economic situation and in financial markets, the existing instruments of the state anti-crisis policy are being updated and new ones are being created, including those aimed at protecting the budget system from increased volatility in oil prices.

The most important measure for ensuring such protection is to introduce in the forecasted period the so-called "budget rule" – a legislatively established procedure of distribution of oil and gas revenues between current consumption and accumulation in the sovereign funds.

Factor 2. Introduction of the budget rule

One of the primary budget policy objectives defined by the President of the Russian Federation in the Budget Message for 2013-2015 is to ensure macroeconomic stability and federal budget sustainability.

In the past decade the dependence of the federal budget on oil prices increased significantly. The share of oil and gas revenues in total federal budget revenue more than doubled (from 20% in 2002 to 50% in 2012), while the non-oil-and-gas deficit increased more than five times (from 2% of GDP in 2002 to 10.5% in 2012). Given the increased instability of prices in the energy market, this poses considerable risks to the sustainability of the budget system.

The budget rule for distribution of oil and gas federal budget revenues, to be introduced in 2013, which rests on the long-term average oil price together with a simultaneous cap on the budget deficit, reduces the dependence of budget expenditure on current energy prices and, in a challenging environment, is a necessary step towards a more conservative fiscal policy.

An effective mechanism for the redistribution of surplus oil and gas revenue was put in place before. In accordance with the procedure introduced in 2004, oil and gas revenues resulting from an excess of the actual oil price over the established cut-off price were credited to the Stabilization Fund of the Russian Federation. From 2008 oil and gas revenue only in excess of the so-called oil and gas transfer value of 3.7% of GDP were credited to the Reserve Fund. Due to the sharp downfall of oil prices in 2009 the operation of this mechanism was suspended.

In accordance with the new rule a federal budget expenditure limit will be calculated based on federal budget revenue received at the basic oil price and increased by no more than 1% of GDP – the budget deficit cap. At the same time, the basic oil price will be determined based on historical data as the average value for the past 10 years. The transfer to the indicated period will be phased: for 2013 the average value for the past five years shall be used, while for every subsequent year it will be increased by one year until 10 years are achieved. Should the actual oil price exceed the basic price, additional oil and gas revenue will be credited to the Reserve Fund, and any shortage of oil and gas revenue will be covered from the Reserve Fund.

After the Reserve Fund reaches 7% of GDP no less than 50% of the remaining oil and gas revenue will be credited to the National Wealth Fund while the remaining 50% can be used to finance infrastructure and other priority projects for the Russian Federation.

The impact from the introduction of the budget rule on debt policy will be indirect. On one hand, the budget deficit which is normally financed from public borrowing will be capped at 1% of GDP. This will limit both the probability of a sharp increase in the need for debt financing and significant growth in the public debt. On the other hand, the budget rule does not limit public borrowing to the amount required to fund the the budget deficit, which allows for the possibility of borrowing more than 1% of GDP in periods of favorable market conditions.

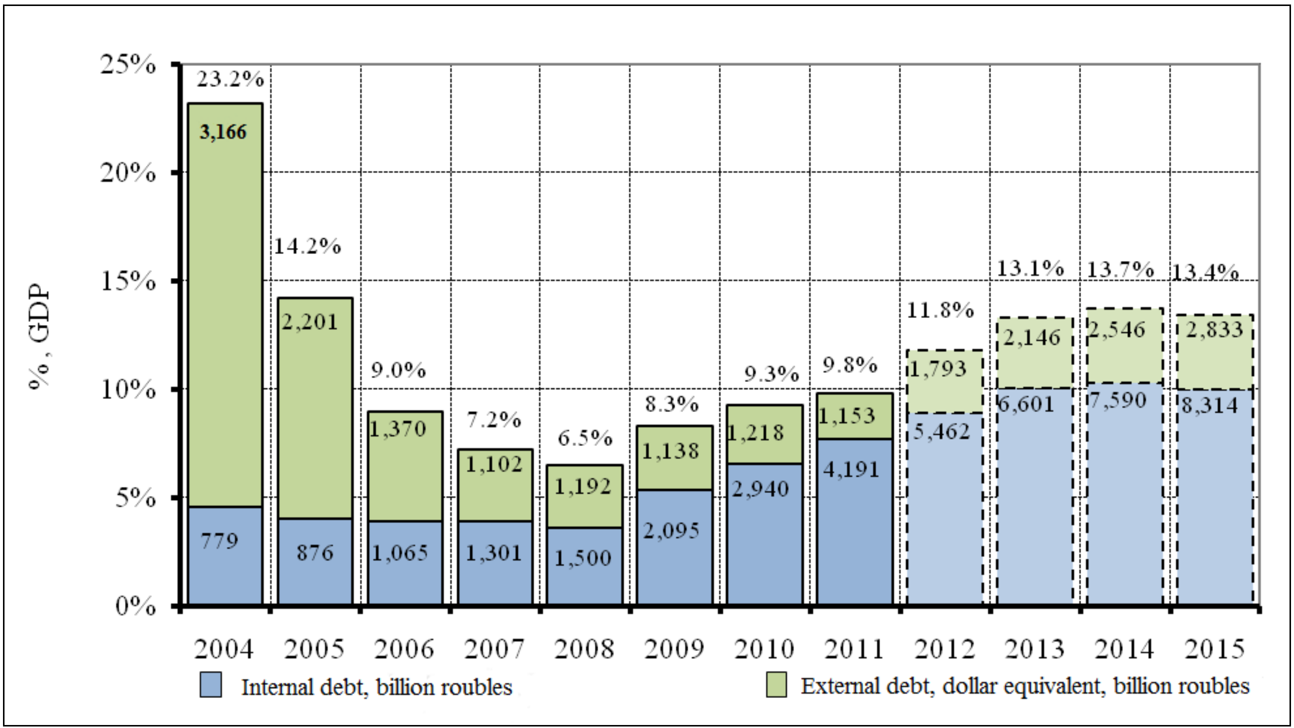
On the whole, from the perspective of debt policy implementation, securing the sustainability of the federal budget, through observance of the aforementioned budget rule and maintaining the sovereign funds, will support the Russian Federation's credit ratings and international investor perception of Russia as a responsible sovereign borrower, and provide for increased confidence in Russian state and corporate debt instruments.

Factor 3. Low level of the public debt

As of October 1, 2012 the volume of outstanding public debt of the Russian Federation stood at RUB 5.8 trillion, including public internal debt of RUB 4.5

trillion, and public external debt of USD 40.5 billion (equivalent of RUB 1.3 trillion). The structure of the public debt of the Russian Federation is detailed in the attached Schedule 1. In the upcoming period the volume of public debt is forecast to increase annually and reach RUB 11.1 trillion or 13.4% of GDP by the end of 2015 (Diagram 2). At the same time, the share of internal debt in the aggregate volume of public debt will not change significantly and will stand at 75%.

Diagram 2. Dynamics of the volume of the public debt of the Russian Federation

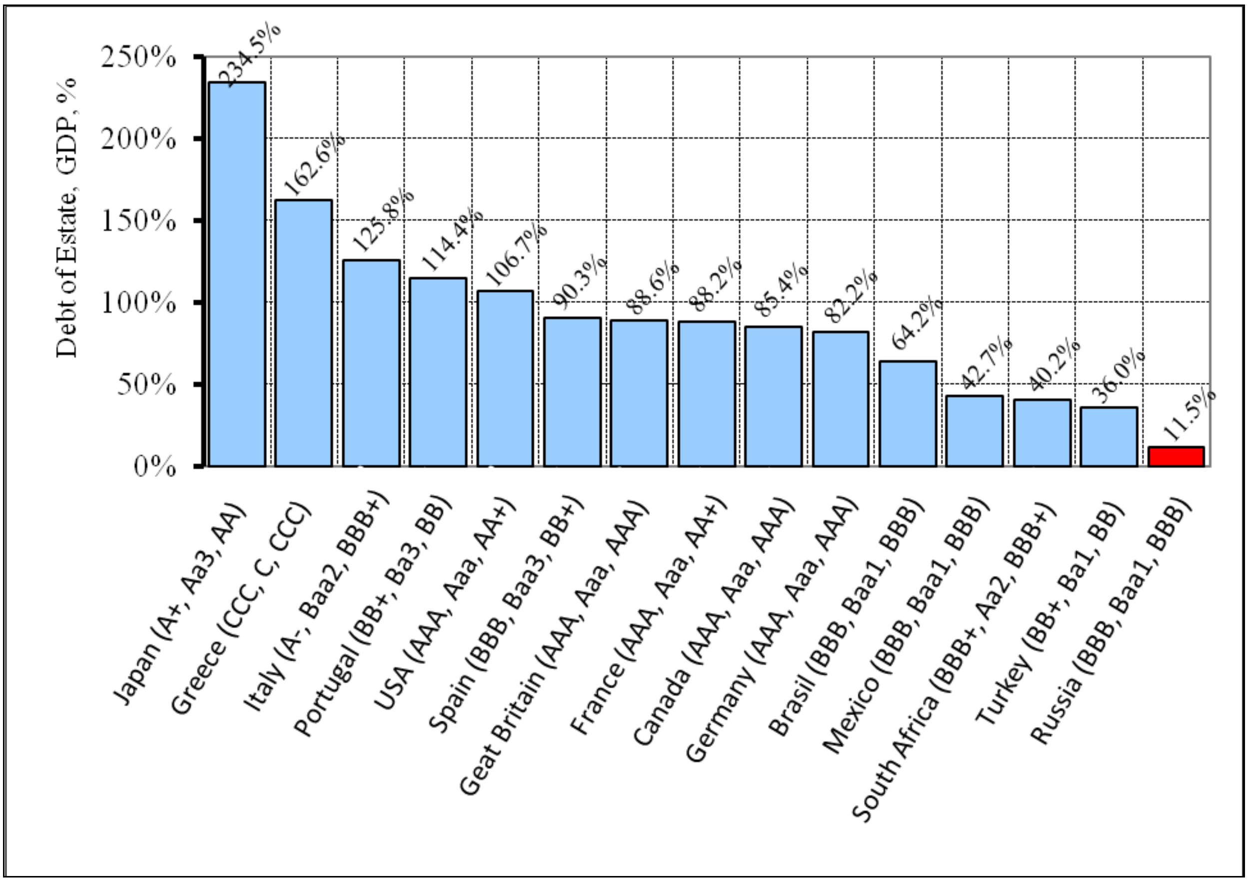


Source: Ministry of Finance of the Russian Federation

The low level of public debt positively distinguishes Russia from a significant majority of both developed countries and emerging markets (Diagram 3). Compared to the downward revision to credit ratings for many developed and developing countries in recent years, primarily as a result of the considerable deterioration of their debt sustainability indicators, the Russian Federation's credit ratings have remained relatively stable and investment grade.

On a number of macroeconomic indicators the economic situation in Russia is better than the economic situation in most BBB-rated countries, and in some cases it is better than the economic situation in the A-rated countries. The credit ratings assigned to Russia by the leading international rating agencies («BBB» with stable outlook by Fitch, «Baa1» with the stable outlook by Moody's and «BBB» with stable outlook by Standard&Poor's) are lower than might be expected given a comparative analysis of macroeconomic indicators.

Diagram 3. Debt to GDP ratio and credit ratings comparison[2]



Source: IMF

According to the parameters assumed in the forecast of the social and economic development of the Russian Federation in 2013-2015, and taking into account the projected borrowing levels, the debt sustainability indicators of the Russian Federation in the upcoming period will remain at levels substantially lower than those which would give cause for concern. (Table 3).

However, on certain measures the margin of safety for securing debt sustainability is not unbridgeable. First, despite a projected slowdown over the next few years the increase in public debt and, as a consequence, of debt service will be high (Diagram 4). In 2013 expenditure to service the debt of the Russian Federation will increase by RUB 85.5 billion.

[2] Credit ratings of the countries are given in the following sequence: by Fitch, Moody's and Standard&Poor's.

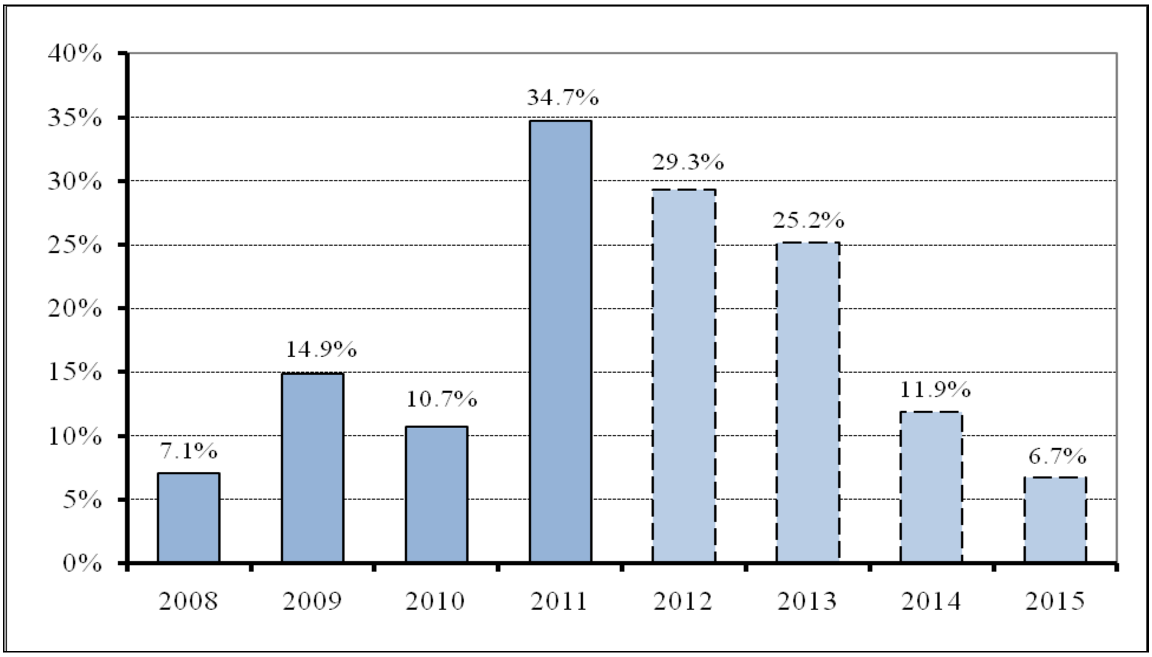
Table 3. Indicators of debt sustainability of the Russian Federation (budget position), %

№	Indicator	2012	2013	2014	2015	Threshold
1	Public debt of the Russian Federation to GDP	11.8	13.1	13.7	13.4	**25**
2	Russian Federation public debt service expenditure as a percentage of total federal budget expenditure	2.6	3.2	3.4	3.3	**10**
3	Payments on service and repayment of the public debt of the Russian Federation as a percentage of total federal budget revenue	7.9	9.9	7.1	9.3	**10**
4	Public debt of the Russian Federation as a percentage of federal budget revenue	56.2	68.0	72.1	71.4	**100**
5	Public external debt of the Russian Federation as a percentage of annual volume of export of goods and services	11.5	13.2	14.8	15.4	**220**
6	Expenditures on service of public external debt of the Russian Federation as a percentage of annual volume of export of goods and services	0.5	0.6	0.6	0.6	**25**

Source: Ministry of Finance of the Russian Federation

Second, there are risks of a deterioration in the macroeconomic situation which would correspondingly affect debt sustainability indicators. According to budget projections, GDP and budget revenue forecasts for 2013-2015 are calculated on the favorable basis which assumes a high level of oil prices and annual increases: USD 97 in 2013, USD 101 in 2014 and USD 104 in 2015. Given that oil prices are currently close to historical highs, the possibility of oil prices falling to levels considerably lower than the level used in the forecast of the Russian Federation social and economic development for the next few years should not be discounted.

Diagram 4. Dynamics of growth of expenditure on Russian Federation debt service, % against the previous year



Source: Ministry of Finance of the Russian Federation

A decline in oil prices by USD 10 per barrel would result in a federal budget revenue shortfall of around RUB 0.6 trillion, which would correspondingly result in an increase in the budget deficit of 0.9% of GDP in 2013 and 0.8% in 2014-2015. Under such a scenario debt sustainability indicators would worsen.

Third, the possibility of Russia losing one of the most important financial stabilizing factors over the planned period, the safety cushion of the Reserve Fund, should not be discounted. By January 1 2014 its forecast size will be RUB 3.2 trillion, assuming the oil price in 2012 does not fall below USD 97 per barrel and the Fund will be replenished with RUB 373.4 billion in 2013. However, under the worst-case macro-economic scenario in 2013 not only would the forecast size of the Reserve Fund be lower, but the Reserve Fund would be fully depleted in order to fund budget expenditures and we would be required to fund the budget from both debt financing in addition to drawing from the Reserve Fund. The absence of this safety cushion would make the Federal budget more vulnerable and would likely lead to increased borrowing costs and, as a consequence, increased debt service expenditure.

According to stress-tests of Russian debt indicators, if oil prices remain throughout the forthcoming period at levels lower than the forecasted level by USD 40 per barrel, the public debt to GDP ratio will exceed 20% in 2015. This will in fact take Russia back to the situation of 2004.

Fourth, according to our calculations, under a negative scenario of oil prices falling to USD 60 per barrel and remaining at this level for one year, the federal budget deficit would exceed 5.5% of GDP. This would require additional sources of funding. It is possible that a combination of drawdown from the NWF, privatization revenues and tax increases could provide this additional funding. However, a drawdown of NWF funds will deprive the Pension Fund of the Russian Federation of the safety cushion for addressing its chronic deficit, revenues from the sale of state-owned property depend on prevailing market conditions, and putting an additional tax burden on the economy would be very undesirable given the likely negative social effects.

Under the unfavorable scenario, the prime source of funding the federal budget deficit will be debt financing. Given that the volume of public borrowings has been rather high in recent years, additional issuance requirements will add significant risk to the budget, 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, although public debt is currently low further borrowing requires constant monitoring. For the time being it allows the government to increase public borrowings without fear of a significant deterioration in the Russian Federation's debt sustainability. Assuming macroeconomic developments 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 low risk levels in the forthcoming period. At forecast borrowing levels the debt burden on the federal budget will remain within levels that allow for comfortable servicing of the public debt, and the preconditions for maintaining sovereign credit ratings at the investment grade level will be met.

Given the high dependence of both 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 Russia's most important competitive advantages. A prudent borrowing policy will create growth opportunities for the private sector and improve the investment case for the domestic economy in general.

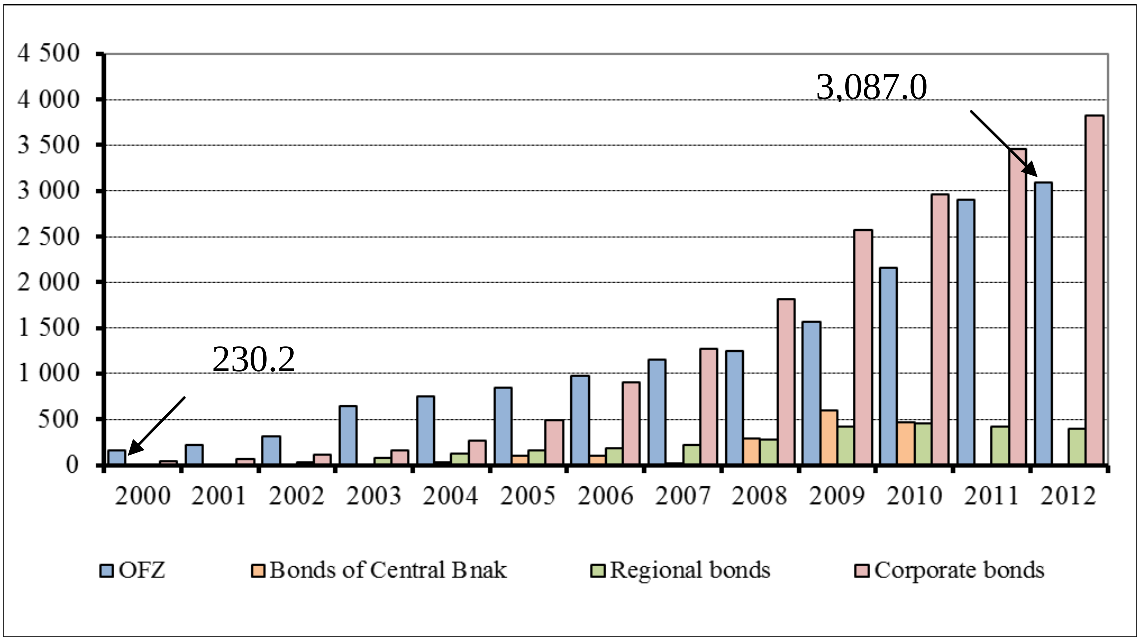
Factor 4. Domestic capital market conditions

In the medium term the domestic capital market will continue to be the prime source of financing the federal budget deficit, as has been the case since 2009.

Over the past 5 years the volume of domestic public securities has virtually tripled, having increased from RUB 1.1 trillion in 2007 to RUB 3.1 trillion as of October 1, 2012 (Diagram 5).

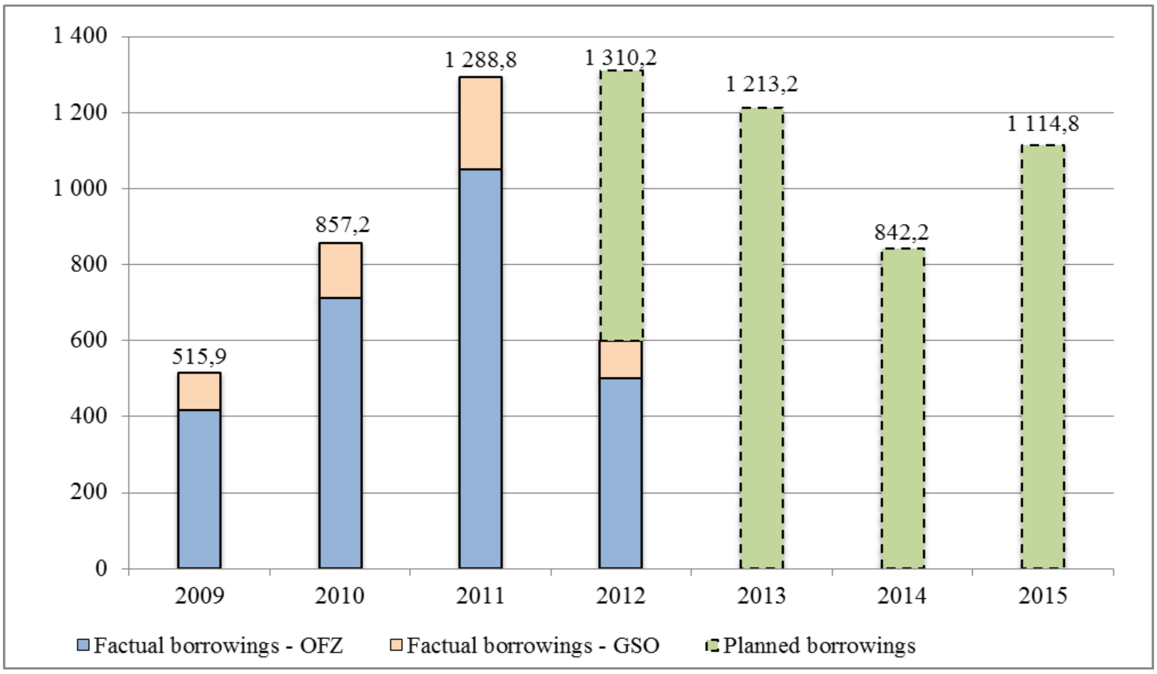
The volume of borrowings raised in the public domestic bond market in 2011 turned out to be almost equal to the joint volume of borrowings for the previous two years. It is planned that total borrowing in the domestic capital market in the coming three years will decrease and in 2015 will total RUB 1.1 trillion (Diagram 6).

Diagram 5. Capitalizatiun of the debt market of the Russian Federation, in billion roubles



Source: Ministry of Finance of the Russian Federation, cbonds.ru

Diagram 6. Volumes of actual and forecast borrowings through issue of public internal bonds, in billion roubles [3]



Source: Ministry of Finance of the Russian Federation

Currently public debt obligations represent a key segment of the domestic financial markets accounting for 43% of the entire Russian market of debt instruments (Diagram 7). For the past three years the public debt market was growing more rapidly than both the corporate debt market and municipal and regional debt. In 2012, the market of public debt obligations increased by 6,3% (since 2010 – by 96.7%), the market of corporate obligations increased by 10.6% (since 2010 – by 48.8%), the volume of the market of regional and municipal debt decreased by 6.0% only (since 2010 its volume fell by 5.3%).

The growth of the volume of public bonds in circulation and the tendency to place large offerings at certain maturities (3, 5, 7, 10 and 15 years) resulted in an increase in 2012 of the turnover of daily OFZ trades and, as a consequence, an increase in the liquidity of listed public securities. As a result, the OFZ yield curve became a fully-fledged benchmark for pricing corporate and municipal debt instruments.

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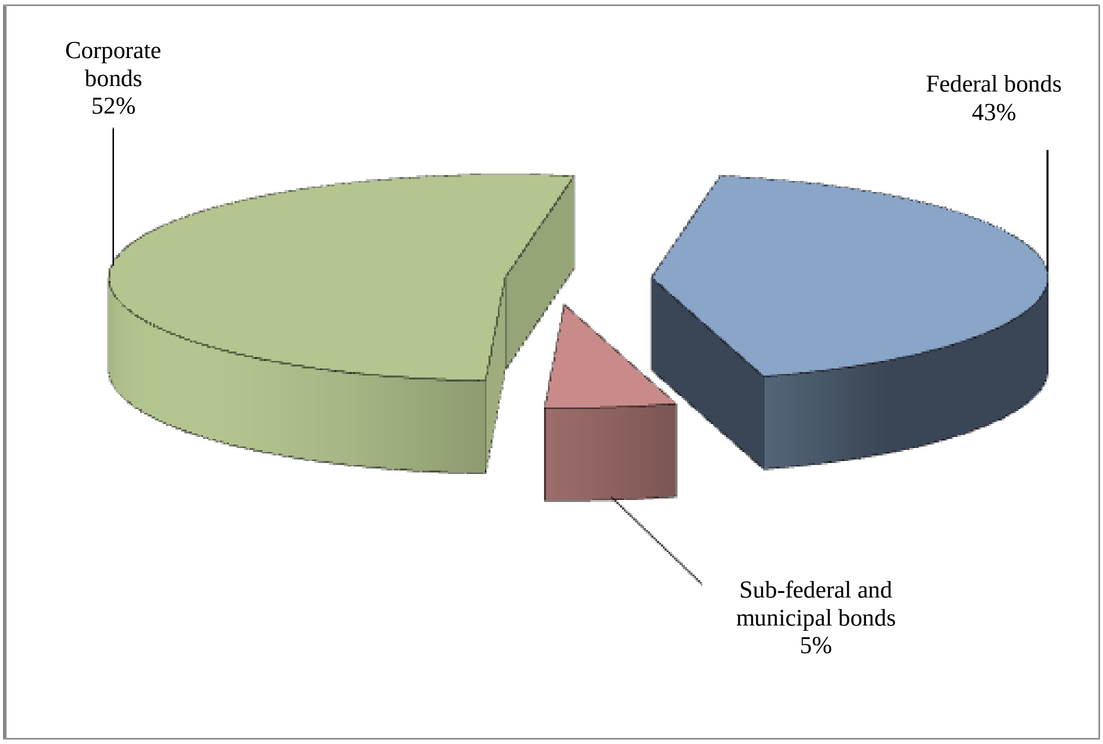
[3] As of October 1, 2012.

Diagram 7. Structure of the Russian Bond Market



Source: Ministry of Finance of the Russian Federation, cbonds.ru

However, the volume and liquidity of the OFZ secondary market is still inferior to that of the corporate bond secondary market (Table 4).

Table 4. Market of corporate and public bonds in 2012

	Outstanding volume, RUB billion	Average daily turnover, RUB billion
Corporate bonds	3,821.3	17.2
OFZ	3,087.0	15.0

Source: Ministry of Finance of the Russian Federation, MICEX, cbonds.ru

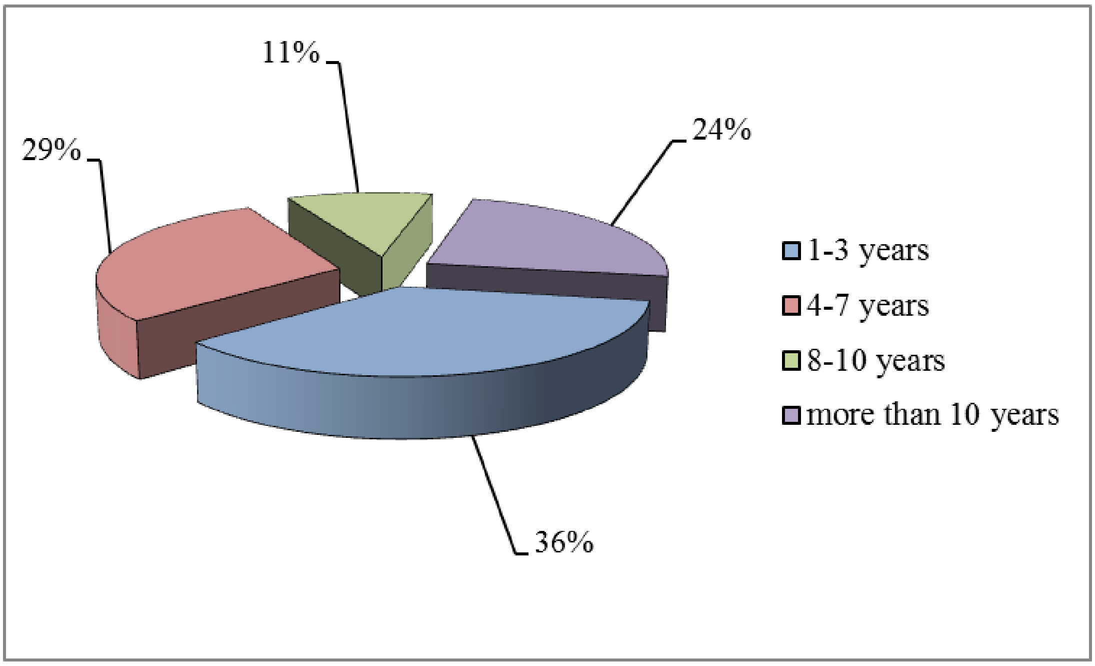
Compared to 2009, in 2011-2012 the average yield of public securities market portfolio had decreased by 350 basis points. Increased volatility in global financial markets and, as a consequence, in domestic financial markets over the past two years led to OFZ yields trading in a range of 110 basis points (Diagram 8).

Diagram 8. OFZ portfolio yield from 2009 to 2012

Source: Bank of Russia

In order to achieve the target duration for the OFZ portfolio of 5 years, public securities were predominantly placed with maturities of 5-15 years in 2012. The average duration for securities issued in the first 8 months of 2012 was 5,6 years which provided for an increase in the total duration of the OFZ portfolio to 3,8 years (from 3,6 years as of beginning of 2012). At the same time, the share of long-term securities in the outstanding OFZ portfolio remains quite low (Diagram 9).

Diagram 9. Maturity structure of OFZ market, as of October 1, 2012



Source: Ministry of Finance of the Russian Federation

In order to hedge the interest rate risks of investing in public debt obligations and in order to increase pricing efficiency in the OFZ market, OFZ basket futures with maturities of two, four and six years have been made available on MICEX since 2011. The volume of trading in these instruments in the first half of 2012 totaled RUB 106.4 billion (around 15% of secondary market OFZ turnover), having increased more than five times compared to the first half of 2011. The average daily turnover of OFZ basket futures in 2012 more than doubled, totaling RUB 590 million against RUB 250 million in 2011.

High volatility is currently one of the distinctive features of the OFZ market which is highly sensitive to price fluctuations in currency and commodity markets. Despite the availability of and improved turnover in OFZ basket futures noted above, the lack of risk hedging instruments in sufficient volume discourages investor participation in the market at times of volatility in external markets or a deterioration in domestic market conditions. As a result, investor requirements increase in terms of yield (premiums at auctions). At other times high levels of liquidity and low short-term interest rates in the Russian money market create arbitrage opportunities that attract speculative capital, including from external investors. This fuels price volatility and increases the risks for local investors.

The share of non-speculative institutional investors allocating funds for the long-term and considered as the core investor base for domestic capital markets is extremely low among OFZ market participants. In the OFZ market today, only Vnesheconombank as pension funds manager and, to a less extent, the Russian Federation Pension Fund might be considered as traditional institutional investors.

Vnesheconombank manages around RUB 1.4 trillion of assets, of which RUB 410.0 billion is invested in the OFZ market (around 13% of OFZ market); the Russian Federation Pension Fund's OFZ portfolio is less than RUB 4.0 billion. The Bank of Russia accumulated its OFZ portfolio in the years prior to 2008 and has maintained the portfolio at the same level ever since.

Reform of the Russian pension system may incorporate a reduction in non-state contributions. The implementation of such a scenario will result in substantially reduced demand for OFZs from this source. This would significantly complicate implementation of the public domestic borrowing programme, would increase the volatility of the Russian market and, most importantly, would likely significantly decrease its attractiveness for foreign investors as they look to a substantial local presence in the domestic market, including local pension funds, as an important element in providing stability.

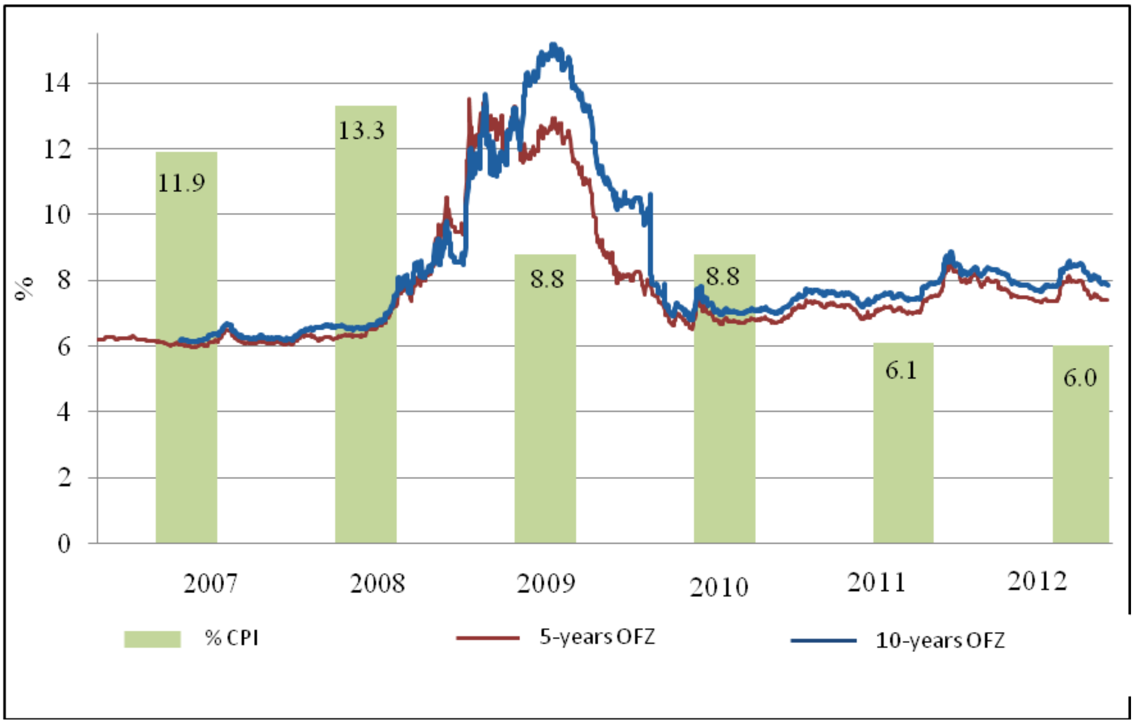
Russian banks invest in OFZ primarily for reasons of liquidity management and implementation of short-term investment strategies. Non-state pension funds managing significant money (more than RUB 1 trillion) currently make virtually no investments in the OFZ market. Funds owned by oil, gas and raw material exporters similarly do not invest in the market. A significant expansion of the investor base through non-speculative Russian participants is unlikely in the near future.

The existing investor base for the OFZ market contributes to the problems of insufficient capacity and liquidity. Until very recently it would be reasonable to assume that market liquidity was divided between domestic and foreign platforms based on the principle “long-term investors are international and the speculators are domestic”. The measures taken in 2012 to facilitate access for international investors to the OFZ market and the corporate bond market,through accounts in Euroclear and Clearstream, contributed to the possible change in non-residents’ preferences. It is illustrative that today local investors generally prefer purchasing bonds with a maturity up to 5 years while non-residents are more likely to invest in the longer end of the curve. The regular issuance of a 15-year OFZ became possible thanks to the surge in non-residents’ interest following the news on liberalization of the Russian market in 2012.

The inflation targeting policy pursued by the Bank of Russia facilitates the maintenance of sustainable demand for OFZs, through ensuring a positive real yield on public debt obligations, at least since 2011 (Diagram 10).

Along with other factors, maintenance of this trend is vital from the perspective of continued interest of non-residents in the Russian debt market: regardless of the volume of funds directed to the local market, stable foreign demand will be formed only if the OFZ yield in the medium and longer end points of the curve provide for a real return.

Diagram 10. Dynamics of yield of 5 and 10 years OFZ and inflation



Source: Ministry of Finance of the Russian Federation, Rosstat

An additional source of liquidity in the banking system, and as a consequence, a potential source of demand for OFZs is temporary surplus funds of the federal budget deposited by the Federal Treasury in credit organizations. In 2012 the volumes of these transactions were relatively low: the amount of deposited funds did not exceed RUB 550 billion with the average balance of non-deposited funds kept in a single federal budget cash account of RUB 1.5 trillion. In order to decrease the credit risk of budget funds placement and significantly increase of the number of eligible counterparties, it is planned to place temporary surplus budget funds under a REPO mechanism secured by public securities. REPO transactions with OFZs which may begin by the end of 2012 will assist in the placement of surplus federal budget funds and support additional demand for public domestic debt.

In 2011-2012 some important measures were undertaken to liberalize access to the Russian securities market for foreign investors including: adoption of the law on a central depositary, adoption of the list of foreign organizations to which the central depositary opens nominee accounts, including the leading international Euroclear and Clearstream depositary clearing systems, and a repeal of a ban on off-market trading of OFZs.

By the end of 2012, the central depositary will be accredited by the Federal Financial Markets Service of Russia and, after the short-term technical adjustment of accounting systems, foreign investors will get direct access to the OFZ market through accounts opened in one of the international depositary clearing centers.

The expected liberalization of the OFZ market along with the repeal of a ban on off-market trading of OFZs has already provided for an increase in the share of non-resident OFZ holdings from 3% at the beginning of 2012 to 5,4%.[4] According to expert estimations, and including "indirect" non-resident OFZ holdings, this percentage is actually 6,5%. It is expected that in the medium term the share of non-resident holdings will increase to 10%, while in the long-term it will increase to 25%. Due to this expected additional demand from non-residents, OFZ yields are expected to fall by 1% on average. These estimates are supported by the fact that the average share of non-resident holdings in domestic debt markets is 20%,.

A long-standing discussion on the expediency of providing for direct access through Euroclear/Clearstream to the Russian debt market has now concluded. On the whole, the market community has positively accepted the federal law "On Central Depositary". The emergence of this institute in Russia has a number of incontestable advantages both for investors and issuers: reduced costs, faster settlement, cheaper borrowings, and an improved transaction process. Creation of the central depositary is a step forward towards increased competitiveness and attractiveness of the Russian market. For non-residents the existence of this institute brings Russia into line with its international peers.

As for the risk of reduced liquidity in the Russian market due to the opening of the nominee accounts in the central depositary, such fears are primarily of a theoretical nature. Most European central depositaries have nominee accounts and manage to maintain domestic capital markets. The benefits from direct and

[4] According to the estimates of the Bank of Russia, as of January 1, 2012.

technologically efficient access for foreign investors to the Russian market through such accounts are much more significant. The opening of the market to greater foreign participation increases competitiveness which will create additional incentives for further development.

Generally, the Ministry of Finance of the Russian Federation and the Bank of Russia think that the any negative effect from opening the market will be insignificant and, most importantly, of a temporary nature. Any negative effect will be more than compensated for by the expansion of the investor base, growth of the market, improved market efficiency and a lower cost of borrowing.

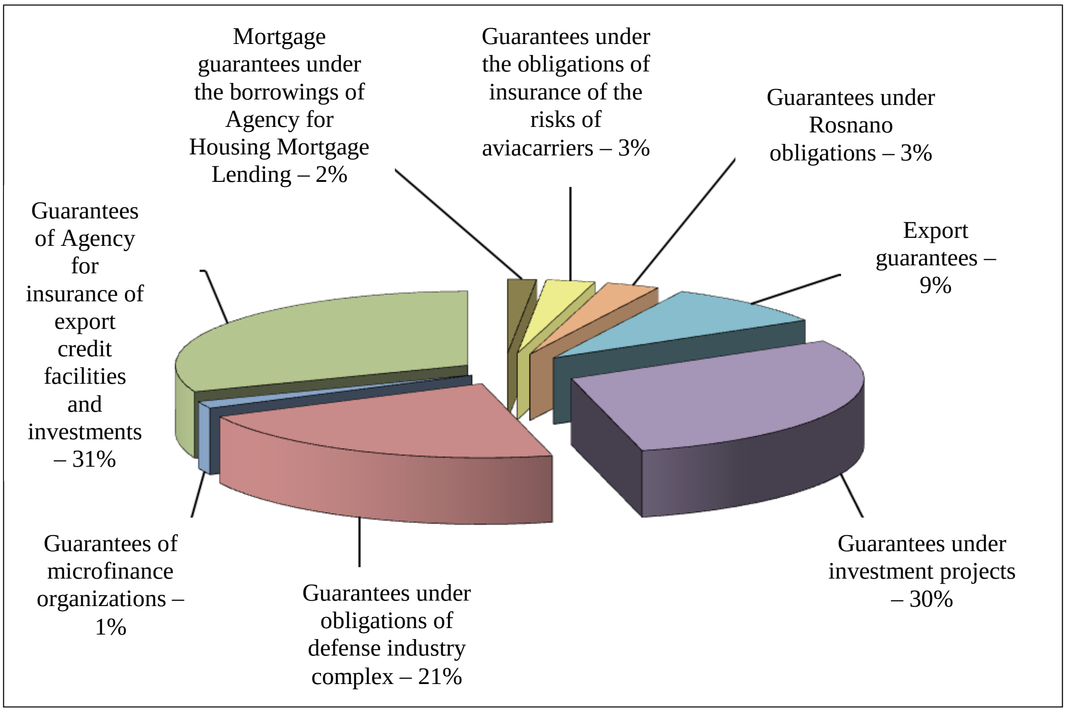
A core problem of the Russian debt market is the lack of opportunity to enter into transactions under «T+n» regime in the stock exchange market. The execution of transactions with public debt obligations in this regime and further improvement of stock exchange technologies will facilitate further attraction of foreign participants to OFZ market.

Completion of the initiated reforms in the forthcoming period aimed at liberalization of the Russian debt market and modernization of its infrastructure will noticeably improve its investment attractiveness and significantly increase its capacity and liquidity.

Factor 5. State guarantees of the Russian Federation

State guarantees play an increasingly significant role in the Russian economy today, acting as an important instrument of economic policy. In recent years many (if not most) policy documents (industry strategies, federal special-purpose programmes, “road maps” etc.) contain references to state guarantees of the Russian Federation as a key condition for capital raising to finance projects related to modernization of the economy, infrastructure, state-private partnership and support of national high-tech production exports. The effective use of this instrument will help to achieve the objectives of social and economic development of the country such as modernization of the economy, development of the state - private partnership, implementation of large investment projects, and support of national high-tech production exports. The structure of the program of state guarantees of the Russian Federation for 2012, shown in Diagram 11, reflects the current specifics of using this instrument of federal government support – high share of “investment” guarantees (including for implementation of investments projects in the North Caucasian Federal District), guarantees on obligations of the integrated industry corporations, on insurance of export credits and investments.

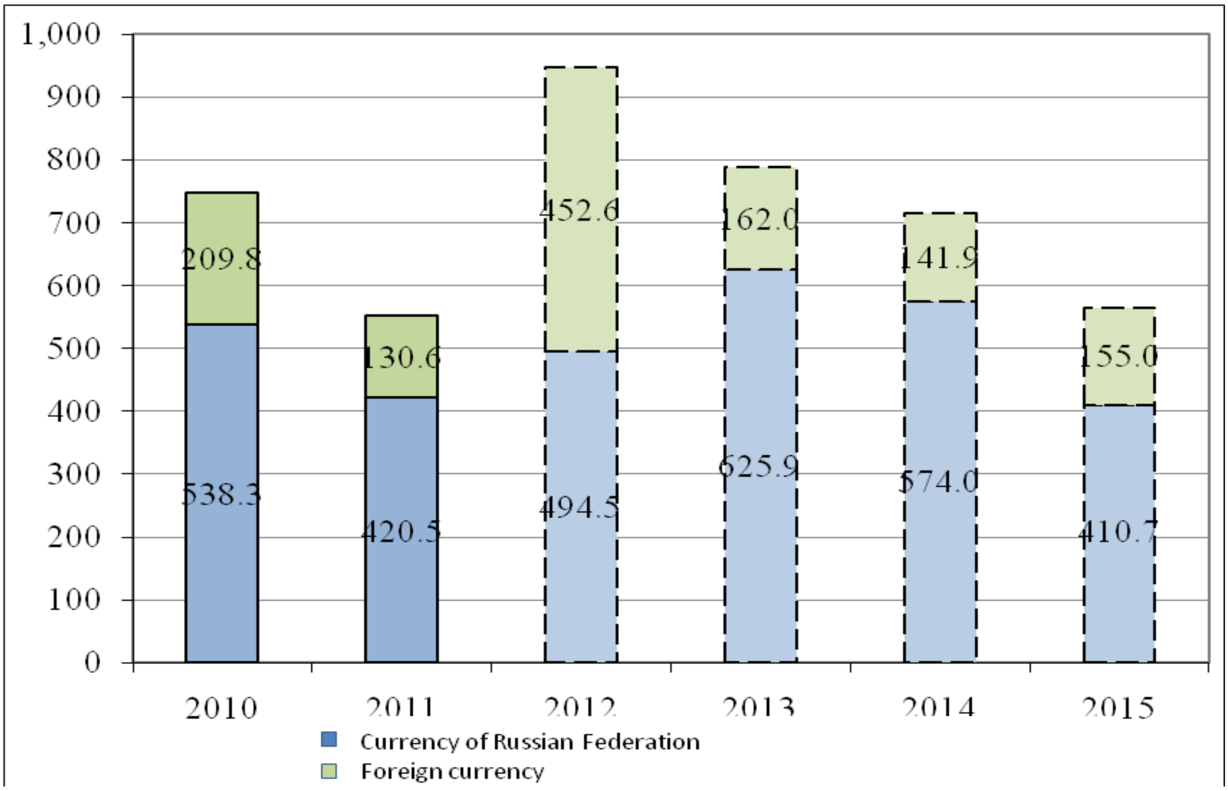
Diagram 11. Planned provision of state guarantees in 2012



Source: Ministry of Finance of the Russian Federation

In addition the instrument of state guarantees of the Russian Federation aims to become a flexible “anti-crisis” mechanism helping to effectively raise capital by organizations in conditions of a deteriorated situation in financial markets. The volume of state guarantees of the Russian Federation to be provided in 2012 exceeds RUB 0.95 trillion (Diagram 12). It is two times more than the volume of the guarantees planned in the last year budget.

Diagram 12. Volume of issued state guarantees of the Russian Federation, in billion roubles



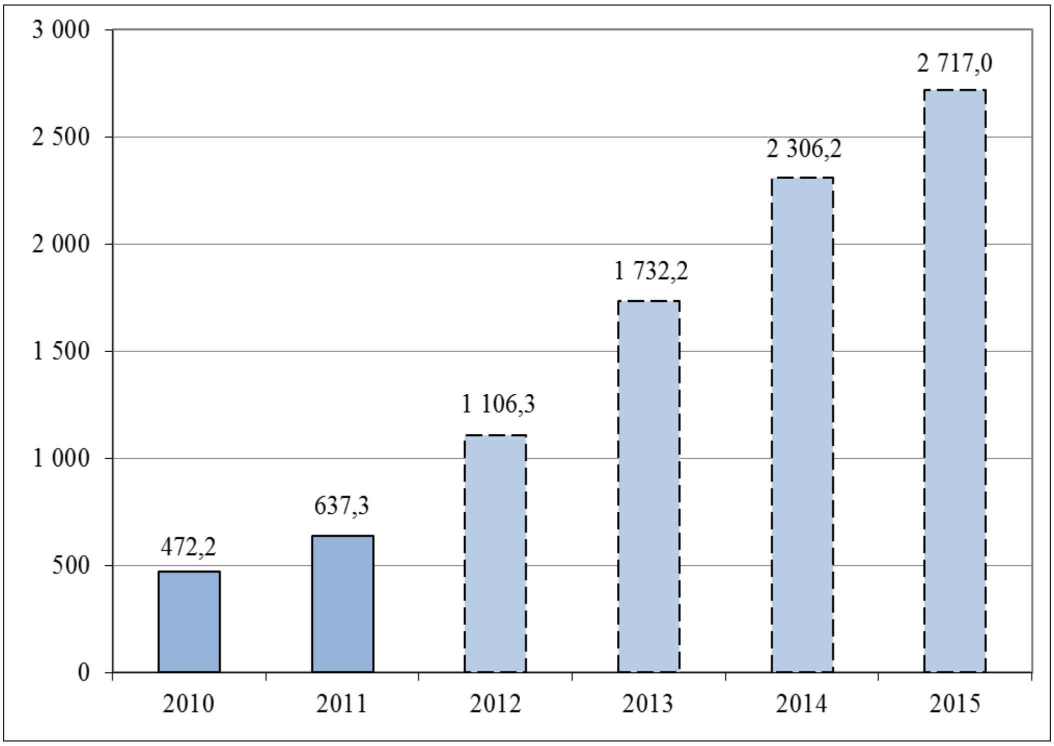
Source: Ministry of Finance of the Russian Federation

The acceptance of state guarantee obligations significantly impacts the main federal budget parameters. The volume of issued guarantees forms contingent obligations of the state and is included in the total public debt of the Russian Federation. Thus, the increasing volume of guarantee obligations directly influences the growth of the public debt, budget expenditure and sources of deficit funding.

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 outstanding stock of state guarantees has been increasing at a steady rate (Diagram 13). Notably, the increase has substantially outpaced the increase of the public debt through market borrowings.

Diagram 13. Stock of Russian Federation state domestic guarantees, in billion roubles



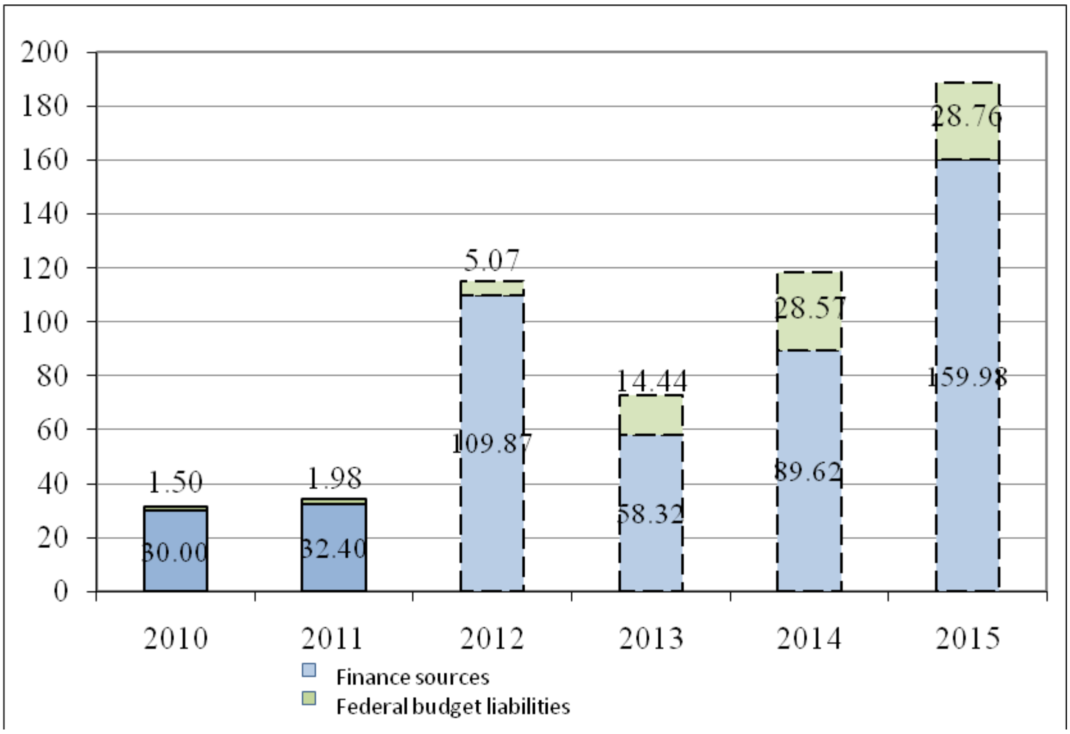
Source: Ministry of Finance of the Russian Federation

As a consequence, the volume of funds incorporated in the federal budget for possible execution of state guarantees of the Russian Federation increase rapidly as well (Diagram 14). At the same time, given the long-term nature of obligations secured by state guarantees (up to 30 years), the main burden falls on future budgets.

It is crucial to note that even in the event that state guarantees are not called, the need to allocate budget funds for their execution reduces potential budget appropriations for other priorities (social security, health service, education).

In other words, the replacement of direct budget funding of certain “projects” by contingent state obligations (state guarantees) leads to deferred federal budget expenditure or a “freezing” of budget appropriations for other purposes.

Diagram 14. Volume of budget appropriations planned for the execution of state guarantees of the Russian Federation, in billion roubles.



Source: Ministry of Finance of the Russian Federation

The growing volume of state guarantees will inevitably result in a significant increase in federal budget costs (agency remuneration, guarantee provision related administrative costs and, most importantly, further maintenance of each state guarantee). At the same time, labor costs associated with the provision of state guarantees do not depend on their term or amount, therefore, it is particularly important to establish a minimum size for state guarantees and provide federal guarantee support to large projects only.

Considering the points noted above, public debt policy in the planned period must incorporate an improved approach to the provision of state guarantees, aiming at a modernization of the management of federal budget contingent obligations.

<u>Factor 6. Corporate Borrowing in the International Capital Markets</u>

The corporate sector, in particular, state-owned companies and banks are active borrowers both in the domestic and international capital markets. Furthermore, a deficit of long-term money in the Russian financial market and the relative cheapness of foreign borrowings encourage Russian banks and enterprises to use the international debt markets as a source of funding their activities.

In 2012 Eurobonds were placed in the external markets by such regular participants as Vnesheconombank, OJSC Sberbank of Russia, OJSC Russian Railways, OJSC Rosselkhozbank, OJSC Bank VTB, OJSC Gazprom, OJSC Gazprombank and a number of other Russian corporate borrowers.

Russia, as a sovereign borrower, is interested in establishing “benchmarks” to create favorable conditions for borrowings by domestic economic entities, and, taking into account that the investor base is the same, to ensure a coordination of the growing activities of Russian issuers in the international capital markets. The ongoing presence of the Russian Federation in the international debt markets must be encouraged.

In 2013-2015, public debt policy will be implemented on the basis of the necessity, on the one hand, to maintain the ability of Russian borrowers to attract financing in the capital markets on the most favorable terms, and on the other hand, to efficiently monitor the debt sustainability of Russian corporate and bank issuance.

2. Priorities and Instruments of Debt Policy

The debt policy of the Russian Federation in 2013-2015 will be implemented in accordance with the following objectives:

- Maintenance of a low debt burden as a crucial competitive advantage for Russia;
- Transformation of the domestic capital market into a stable source for funding budgetary needs;
- Maintenance of high-level investment grade credit ratings for Russia, and fulfillment of the necessary requirments for upgrading up to a single A rating;
- Ensuring domestic and external markets remain open to the Russian Federation and Russian corporate borrowers on reasonable terms, and minimizing the cost of such borrowings;

- Enhancing the existing management system of the public debt of the Russian Federation, and expanding the practical work of the Russian State Financial Agency;
- Supporting the Russian corporate sector through encouraging the adoption of a prudent foreign debt strategy.

2.1. Domestic Debt policy

Improving liquidity in the domestic market and ensuring a broadening and deepending of the investor base will require the implementation of a further package of measures aimed at enhancing the attractiveness of the domestic securities market. During the period 2011-2012, a number of previously planned fundamental transformations were carried out in the market:

1) Direct access of non-residents to the Russian government securities market has been secured, including through accounts in the international depositary clearing systems (the Law on Central Depositary and relavent amendments to the Law on the Securities Market were adopted and a list of foreign organizations with which the Central Depositary is allowed to open nominee accounts was approved);

2) OFZs have been admitted to trading on the stock exchange: secondary market trading of OFZs was shifted from a separate government securities section of the exchange to the capital market section which facilitates the expansion of secondary market trading participants, reducing their transaction costs and increasing the turnover of government securities on the stock exchange;

3) over-the-counter trading of OFZs became possible, i.e. bypassing broker intermediaries which simplified access of investors to the OFZ market and reduced their costs;

4) as a result of the establishment of the Central Depositary, the major measures on the introduction of an institution for centralized recording of titles to securities in Russia has been implemented;

In the wake of the implemented measures for 2012, the following positive changes took place in the OFZ market:

- liquidity of traded issuances has increased (the average daily turnover of secondary trading of OFZs grew by 20%, from 12.5 to 15.0 billion roubles);
- the average size of OFZ outstanding has doubled: from 45 to 87 billion roubles;
- the duration of the OFZ portfolio increased by 5.6%, from 3.6 to 3.8 years;
- the issuance of OFZs with a 15-year maturity for the first time.

One of the priority guidelines in the planning period is the issuance of medium and long-term government securities. The issue of short-term instruments (up to 1 year) is considered an exceptional measure, the use of which can be justified only in extremely poor market conditions in the absence of an ability to issue medium and long-term government securities at reasonable cost. Such an approach will keep refinancing risk low and optimize the maturity structure of the government's domestic debt.

It is expected that OFZs with a fixed rate coupon will be issued. Currently, it is not a priority of debt policy to issue OFZs with a variable rate coupon determined by consumer price index dynamics or key money market indicators.

The policy of focusing on benchmark issuances of large size and redemption at standard maturities on the yield curve will be continued, i.e. 3, 5, 10, 15, and 30 years. The issuance of bonds with these maturities are in high demand with investors since they allow for hedging against interest rate and currency risks. The high liquidity of benchmark OFZ issuances will be supported by offering new benchmark issuance of bonds to the market on a regular basis.

For the purpose of creating a meaningful and mutually beneficial dialogue between the state as an issuer and investors on investment preferences, demand levels and expectations relative to the volumes of government bond issuance and interest rate dynamics, investor communication will be enhanced, including through the following measures:

1) Undertake regular interaction with key participants of the government securities market, including meetings and telephone conferences with investors;

2) post on the official website of the Ministry of Finance of the Russian Federation basic relevant data on public debt and macroeconomic conditions in the country, public borrowing plans, principal guidelines of the government's debt policy and quarterly schedules of auctions for the placement of OFZs;

3) provide greater clarity on the decisions to be made in the area of government debt management.

OFZ issuance yields will be influenced primarily by budget needs (supply) and the market situation (demand for bonds), subject to the strategic goal of achieving and maintaining an average duration of 5 years for the OFZ portfolio.

The practice of placing public savings bonds (GSOs) will remain in place in order to meet the demand of Russian institutional investors, primarily those engaged in the placement of pension savings.

In addition to completing measures already taken to develop the government securities market, the following problems are expected to be addressed:

<u>1) to integrate the initial offering and secondary trading of OFZs in a unified exchange trading marketplace</u>

This will facilitate an increase in the number of investors participating in domestic debt market auctions, an improvement in pricing efficiency and a reduction in transaction costs for participants;

<u>2) to meet the requirements for entering into transactions on the exchange market in "T+n" mode</u>

The possibility of settling OFZ transactions not at the transaction date (T+0) but with an internationally standard delay (T+2 or T+3) involving a central counterparty will enable investors to better manage their cashflows, thereby contributing to a reduction of transaction costs.

<u>3) to unify tax rates on Russian Federation government securities and corporate bonds</u>

Interest income from Russian Federation government securities coupons are taxed at 15% and capital gains at 20%. All income on corporate bonds is taxed at 20%. As a result it is difficult to compare the net yield on corporate and government bonds and the accounting of investment in securities is complicated because investors can not financially offset transactions in government and corporate securities without additional accounting. Potential investors might consider the current situation as a further impediment to investing in Russian Federation government securities. It is reasonable to unify the tax treatment of government and corporate bonds. It will enable a simplification of the settlement system for investors, by treating all income uniformally, eliminating differences in the pricing of instruments in the domestic debt market and ensuring yields are directly comparable.

4) to shift to active debt management

As a result of the involvement of the Russian State Financial Agency in transactions involving public debt obligations, it is expected that the applicable procedure for the placement of government securities will be modernized in the planned period, interaction with foreign and Russian investors will be improved, and a more pro-active liability management strategy will be implemented, including through the exchange of the off-the-run government bonds onto new on-the-run bonds.

A consistent implementation of the above mentioned measures for development of the OFZ market will help to improve conditions for public borrowing and increase demand for government securities. A successful implementation of the proposed measures will facilitate an improvement of the investment climate in Russia more generally, enhance the reserve status of the rouble and will be an important part of the strategy for developing Moscow as an international financial centre.

2.2. Debt policy on international capital markets

Despite recent volatility in global financial markets, the international debt capital markets were generally open for issuance in 2011-2012 and the amounts issued by both developed and emerging market economies increased marginally. At the same time, the uncertainty of the situation in the Eurozone and macroeconomic difficulties in other developed countries have contributed to a rise in demand for emerging country debt, including Russia.

In 2012, the Russian Federation successfully issued a USD 7 billion 3-tranche Eurobond, meeting its full Annual Program for Public External Borrowings in one transaction. Investor demand totaled more than USD 24 billion, exceeding the amount placed by more than three times.

This transaction became the largest Eurobond issue by an emerging market sovereign after the Quatar USD 7 billion issue in 2009. The USD 3 billion 30-year tranche was the first such long term issue by Russia, confirming the confidence of foreign investors in the status and long-term prospects of the Russian economy.

As compared to the previous USD issuance by Russia in the external markets in 2010, the 2012 issue has a significantly lower yield and a better quality of investor thanks to a significant allocation to institutional (conservative) holders.

Eurobond issuance has met the following goals:

– the strategic objective of expanding and ultimately improving the investor base for Russian Federation securities;

– new and more favorable yield benchmarks have been established for Russian corporate borrowers facilitating a reduction of their debt financing costs in the international capital markets;

– a reduction in the average yield on Russian Federation eurobonds.

For the purpose of retaining Russia's presence as a sovereign borrower in the international debt capital markets and maintaining ongoing access to this funding source during the period 2013-2015, it is planned:

– to continue placing Russian Federation Eurobonds in limited quantities and subject to investor demand;

– to develop a benchmark yield curve for Russian Federation issues in different currencies, first of all in US dollars and Euro;

– to put in place the conditions necessary for attracting long-term investors diversified by type and geography;

– to continue a regular dialogue with a wide range of global investors.

2.3. State guarantee support

A number of conclusions can be drawn from the recent experience of using Russian Federation state guarantees as a means to supporting Russian business entities adversely impacted by the global financial crisis, which are important in the context of assessing the expediency of a further extension or curtailment of state guarantee support for domestic enterprises.

As of October 1 2012, 200 state guarantees of borrowing by Russian enterprises had been granted in the amount of 619.6 billion roubles. This form of anti-crisis state support was provided to 128 principals (borrowers) who received commercial loans from 10 banks in the Russian Federation. From 2011 to October 2012, 74 state guarantees in the amount of 145.3 billion roubles or 37% of outstanding guarantee obligations ceased to be effective. Thus 126 state guarantees in the amount of 474.3 billion roubles remained in place.

State guarantees issued on loans received by chemical and petrochemical companies had a clear positive impact as 97% of such guarantees were not called State guarantees issued to metallurgy and metal working enterprises were also successful with 76% of such guarantees not called. This confirms that these companies faced temporary problems caused by a lack of liquidity which they managed to promptly address as business conditions improved. As to other sectors of the economy (the automotive industry, agriculture, construction etc.), the share of non-called guarantees does not exceed 25%. This suggests that these enterprises faced a solvency crisis rather than a problem of liquidity, requiring restructuring and turnaround measures, including the replacement of owners and executives, rather than state guarantee support.

As to the risks of state guarantees being called on outstanding debt, none of the 67 entities with a current status of effective currently have a low probability of this occuring. For 31 enterprises with state guarantees in an amount of 61.2 billion roubles there is a high probability of federal budget expenditure being required, and for the remaining 36 enterprises (101.1 billion roubles) the risk is classified as “average”.

Signs of insolvency (accounts payable were overdue for more than 3 months) are evident for 35 of the relevant enterprises, and bankruptcy procedures have been initiated against two of them. Payments from the federal budget in favor of the relevant creditors might amount to 71 billion roubles.

For the period from 2011 to 2012 (for the first time since the adoption in 2000 of the Budget Code of the Russian Federation which set forth, *inter alia*, the procedure and principles for the provision of state guarantee support) 15 state guarantees were called with a maximum budgetary liability of 5.3 billion roubles.

An analysis of the financial terms on which state guaranteed loans were granted to companies shows that, despite the reduced risk for creditor banks, from April 2010 to December 2011 average weighted interest rates were significantly higher than the average weighted rate on non-state guaranteed rouble-denominated loans to non-financial organizations as independently calculated by the Bank of Russia and according to bank records. For example, in December 2010, the former exceeded 11.5%, while the latter was at a level of 9.7% per annum. The financial burden on enterprises obtaining state guarantees exceeded the average across the economy generally.

Data compiled over the last few years suggests that the consequences of a large-scale use of state guarantees can be burdensome for the federal budget and inefficient from the perspective of facilitating economic growth. As regards the risks for the federal budget, it is not insignificant that state guarantees have been called irrespective of the operational results of the projects in support of which the guarantees were provided. Recipients of state guarantees are under no obligation or responsibility for the implementation of the underlying projects supported by the state.

State guarantees are an efficient means for dealing with any liquidity problems faced by enterprises, but they cannot solve problems relating to the efficiency of business administration or increase the sales of goods (services). There is no reason to expect a drastic rehabilitation of insolvent companies as a result of state guarantee support.

For the purposes of improving the efficiency of state guarantees and managing the budget risks associated with the provision of such guarantees, particularly given a possible deterioration in both the economic environment and financial markets when providing state guarantees, it is reasonable to rely on the following basic principles:

1) A unified approach for the provision of state guarantees with common “characteristics” (economic industry, region, market etc.), irrespective of the recipient of state support and a move away from the practice of granting unique, non-standard guarantees.

2) A requirement for the selection of projects to receive state guarantees to be based on an analysis of the market for the goods or services produced by each enterprise, and as provided by the relevant enterprise. Cashflows must be sufficient to service the principal and interest payments on the loan extended under a state guarantee and accrue a sector average profit margin.

3) If the safeguarding of national interests is not at issue, then the provision of state guarantee support to loss-making projects and financially inefficient enterprises is not possible since it compromises this instrument of state economic policy.

4) Ensure an appropriate sharing of risks between the state and parties to a transaction (project) to which the guarantee support is provided.

5) Provision of guarantee support to be subject to the satisfactory financial position of the underlying obligor (except in certain cases such as, for example, by the rules for the provision of guarantees on investment projects and guarantees for implementation of state defence orders).

6) The availability of security ensuring the repayment of funds when a state guarantee is called (e.g., no recourse claims of the Russian Federation against the principal in relation to the guarantees under investment projects are foreseen).

7) The recipients of state support shall comply with certain restrictions during the term of state guarantees (for example no premium and bonus payments to senior management), as well as allocating responsibility for failure to execute projects supported by the state.

With regard to planning the budget appropriations for when state guarantees are called, a more flexible approach is to be adopted:

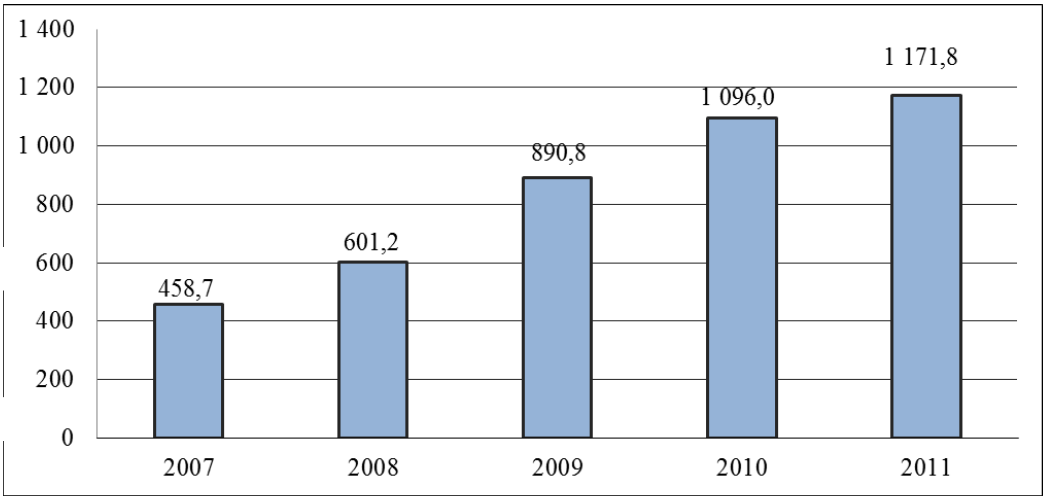
–in respect of actually issued state guarantees – to provide up to 100% of the amount of possible performance;

–in respect of planned state guarantees a substantially smaller amount with a subsequent prompt amendment (if necessary) of the Federal Budget Law providing for an increase in the budget appropriations up to 100% of the amount of possible guarantee performance.

3. Borrowing Policy of Russian Federation sub-sovereigns

Over the last 5 years, Russian Federation sub-sovereign debt has consistently increased and exceeded 1 trillion roubles by early 2011 (Diagram 15). At the same time, most of this increase was in the crisis year of 2009 (such debt grew by 48% that year), and this debt grew by only 7% in 2011.

Diagram 15. Russian Federation sub-sovereign debt, in billion roubles

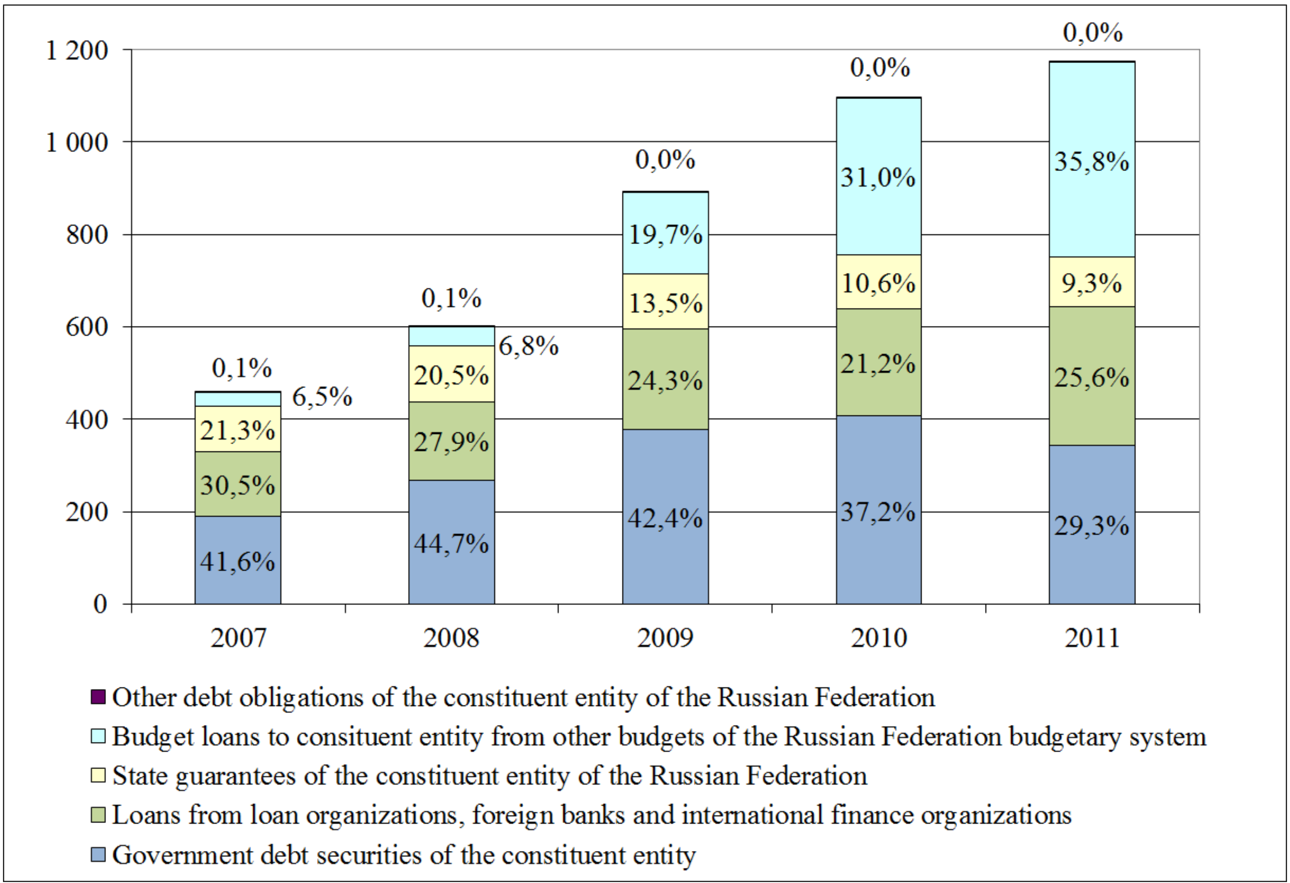


Source: Ministry of Finance of the Russian Federation

As of January 1 2012, Russian Federation sub-sovereign debt amounted to RUB 1.2 trillion or 2.2% of GDP, of which external debt amounted to only RUB 17.8 billion or 0.03% of GDP.

During the period 2009-2010 the portion of sub-sovereign debt in the form of intra-government debt increased and the portion of market debt fell (Diagram 16). These changes resulted from a responsible anti-crisis policy pursued by the state in the area of intergovernmental fiscal relations which enabled the regional budget situation to stabilize in an environment of limited access of sub-sovereigns to market funding.

Diagram 16. Structure of Russian Federation sub-sovereign debt in 2007-2011

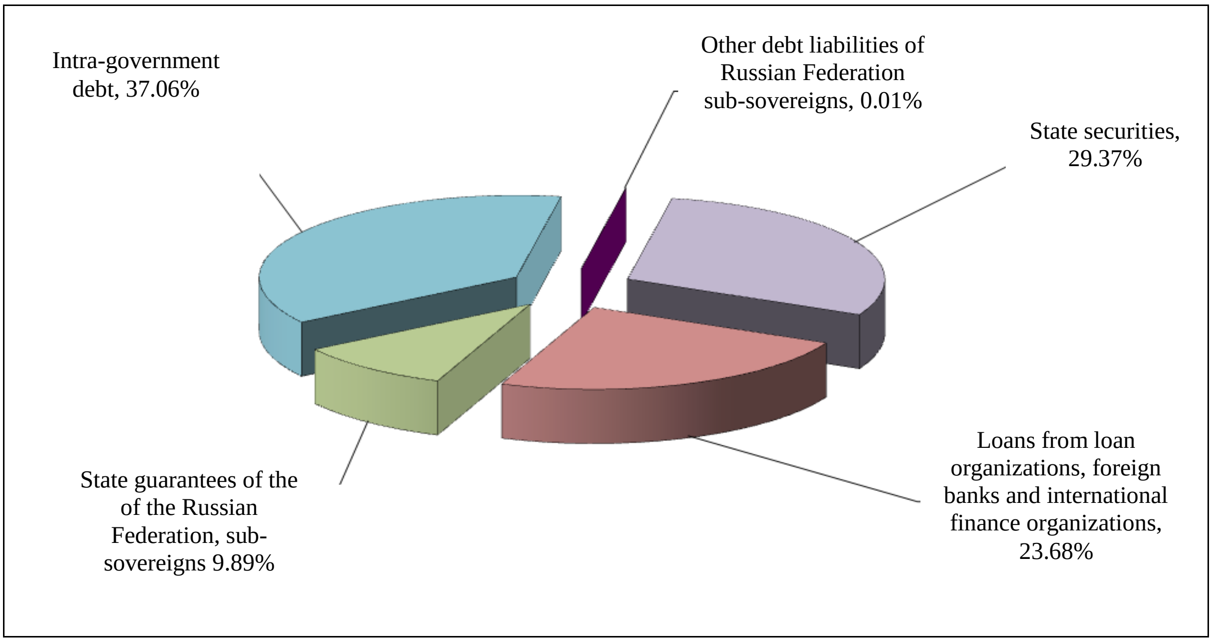


Source: Ministry of Finance of the Russian Federation

As at September 1 2012 (Diagram 17), intra-government debt exceeded 37% of all sub-sovereign debt, securities issuance accounted for almost 30%, bank and other loans accounted for 24% and state guarantees for almost 10%.

It is planned to reduce the volumes of state budget loans to the regions in the planned period (though not so fast as expected earlier), from RUB 125 billion in 2012 to RUB 70.0 billion in 2015. This is connected with the need for sub-sovereigns to implement in the years to come some key priority measures in social policy, health care and science, housing construction etc.

Diagram 17. Structure of Russian sub-sovereign debt at September 1, 2012



Source: Ministry of Finance of the Russian Federation

In accordance with the Budget Code of the Russian Federation, the ceiling for a sub-sovereign’s debt shall not exceed the approved overall sub-sovereign’s annual budgetary revenue without regard to the approved volume of grants from the federal budget.

For sub-sovereigns, where the share of inter-budget transfers from the federal budget (save for subventions, as well as subsidies provided to the constituent entities from the Investment Fund of the Russian Federation) within the two in last three fiscal years under review exceeded 60% of the sub-sovereigns own revenues the debt ceiling is reduced to 50% of the mentioned revenues.

From January 1 2017 a rule allowing sub-sovereigns to exceed the above limits up to the outstanding amount under state budget loans comes into place.

An analysis of compliance by sub-sovereigns with the restrictions on the maximum level of debt, including obligations under budget loans, - shows that four sub-sovereigns have accumulated debt above the statutory thresholds, while the total indebtedness of a further five is approaching the statutory threshold. The share of obligations of these nine indebted borrowers accounts for over 17% of the total debt of sub-sovereigns , with high levels of intra-government debt.

Data from monitoring of sub-sovereign debt confirms that greater attention should be paid to the issue of Russian regional debt burdens, which relate to the active use by some regions of loans from the federal budget. When the Russian Federation Ministry of Finance registers the terms and conditions for the issue and circulation of sub-sovereign bonds, it must take into account any failures by such sub-sovereigns to comply with their obligations under federal budget loans.

Of the 36 sub-sovereigns whose share of intra-government debt in their debt structure exceeds 50%, only four have market borrowings.

Currently only two sub-sovereigns (the City of Moscow and the Republic of Bashkortostan) have debt obligations denominated in foreign currency and owed to non-Russian banks.

In order to minimize the exposure of sub-sovereign budgets to foreign exchange risk a provision is intended to be put in place which will require that for a sub-sovereign to be allowed to raise external debt it will need credit ratings from at least two leading international credit rating agencies at or above the level of the Russian Federation’s international credit ratings. This will ensure only the financially strongest sub-sovereigns access the international capital markets.

Of six sub-sovereigns currently eligible under the Budget Code to access international finance (the City of Moscow, the City of Saint Petersburg, Tyumen Region, Khanty-Mansi Autonomous Okrug-Yugra, Yamalo-Nenets Autonomous Okrug and the Republic of Bashkortostan), four of them have credit ratings from at least two leading international credit rating agencies.

In addition, proposed changes in the budget law will allow the most responsible sub-sovereigns to place Rouble-denominated securities in the international capital markets.

In line with the main regional budgets parameters, the majority of Russian Federation sub-sovereigns are projecting budget deficits in the near term. Consequently, their borrowing needs will increase. This situation on the one hand imposes stringent requirements on sub-sovereigns' compliance with solvency ratios, while on the other hand, it creates conditions for competition on the domestic debt market for borrowed funds.

In general sub-sovereign debt will need to be monitored closely over the next few years.

4. Cooperation with Multilateral Development Banks

From 2002 the Russian Federation elected not to finance the budget deficit with loans from the international finance institutions (IFIs), focusing instead on a joint implementation of projects in priority areas and industries of the Russian economy with multilateral development banks (MDB).

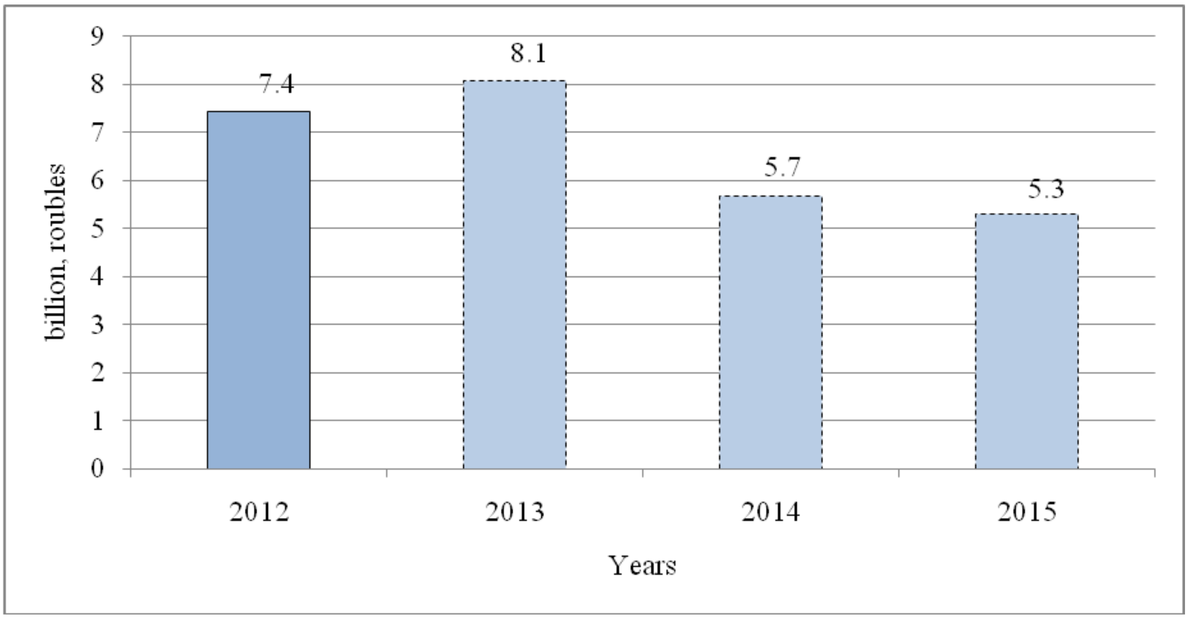
Since this date the share of the Russian Federation's total liabilities outstanding under loans from IFIs has steadily decreased and was 5.4% (USD 2.26 billion) on June 1 2012.

In 2013-2015 total Russian borrowings from MDBs will remain minimal, at less than USD 266 million (RUB 8.1 billion) per year on the basis of currently agreed projects (Diagram 18). However, if a decision is taken to implement additional projects with MDB involvement, the amount of such borrowings might rise to USD 1 billion per year over this period.

In addition to reducing loans from MDBs, current Russian cooperation with these institutions involves a significant increase in co-financing by Russia of joint projects. In some cases Russian co-financing has grown two- to six-fold compared with the last few years.

Currently, 22 projects for a total amount of about USD 1.6 billion are being drawn up and implemented in cooperation with the IFIs, including the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD) and the Nordic Investment Bank (NIB).

Diagram 18. Projected Credits/loans from IFIs in 2012-2015.

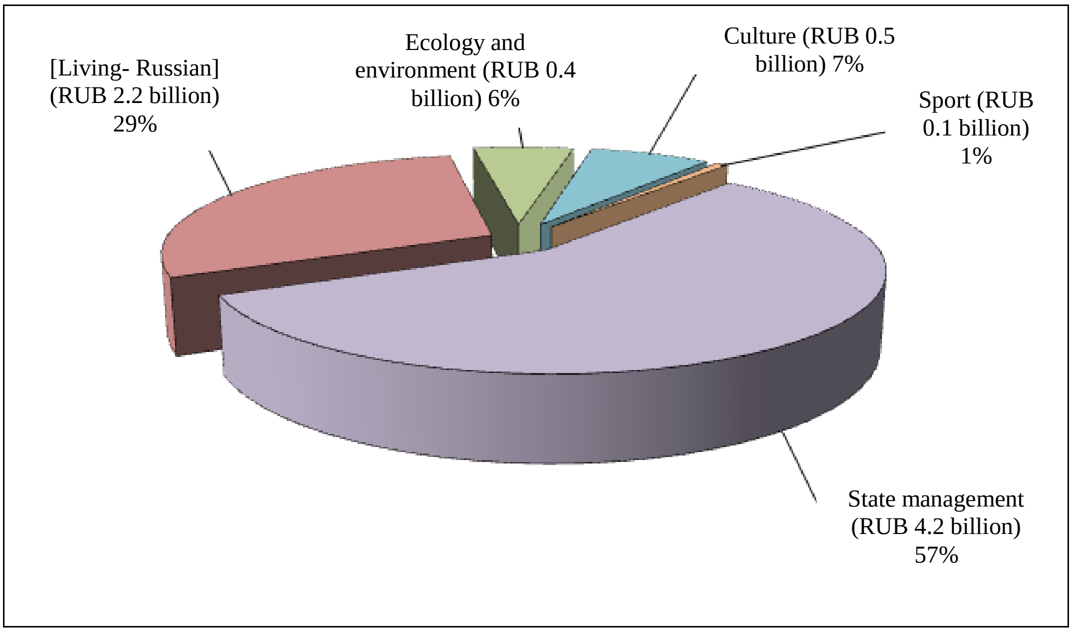


Source: Ministry of Finance of the Russian Federation

These projects include improving the information system of the customs authorities, developing the treasury system, enhancing and re-equipping Roshydromet institutions and organizations, reforming the housing and state utilities sector, developing systems for state registration of property rights and state statistics, supporting judicial reform, resolving problems in ecology and environmental protection, preserving and making use of Russia's cultural heritage and promoting financial literacy levels in Russia (Diagram 19).

Only in the case of two current projects are domestic borrowers obtaining funds as term, paid and repayable subloans (about 2.2% of financing granted by MDB). The recipients of the funds under the remaining loans are federal executive authorities.

Diagram 19. Multilateral development bank credit/loan structure by industry, 2012.



Source: Ministry of Finance of the Russian Federation

Planned borrowing by Russia from MDBs is considered beneficial for the following reasons :

– it is possible to engage leading specialists to provide expert analysis in support of reforming the state management system and implementation of major infrastructure and other projects of national significance;

– it ensures international approval of projects: MDB participation confirms compliance of the projects with international standards;

– it provides transparency of rules and implementation procedures, which contributes to inmproved confidence in the private sector and encourages private investments;

– it is possible to obtain additional financing, including grants, through participation in MDB endowment programs;

– it is possible to apply flexible financing mechanisms allowing for optimization of the level of financial resources borrowed from MDBs; [5]

[5] A flexible project financing mechanism allows for a change in the amount and terms of funds raised, depending on changes in market conditions.

– low cost of MDB loans.

In view of the above, cooperation with MDBs will continue in the forthcoming period on the basis of the following approach:

1) implementation of new projects relating to state management, environmental protection, enhancement of energy efficiency, development of the financial market and the microfinance services market, improvement of the national hydrometeorology system, physical training and sports for vulnerable parts of the population, development of forestry and development of urban state transportation systems;

2) selection of a specific mode of cooperation and application of flexible mechanisms of cooperation with MDBs;

3) expansion of participation of the Russian Federation in various initiatives of MDBs, including technical assistance funds and other modes of cooperation;

5) fostering an increase in 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), the Eurasian Development Bank (EDB), the European Investment Bank (EIB), the Nordic Investment Bank (NIB), the International Bank for Economic Cooperation (IBEC), and the International Investment Bank (IIB) in the Russian Federation without financial obligations being assumed by the Russian Federation;

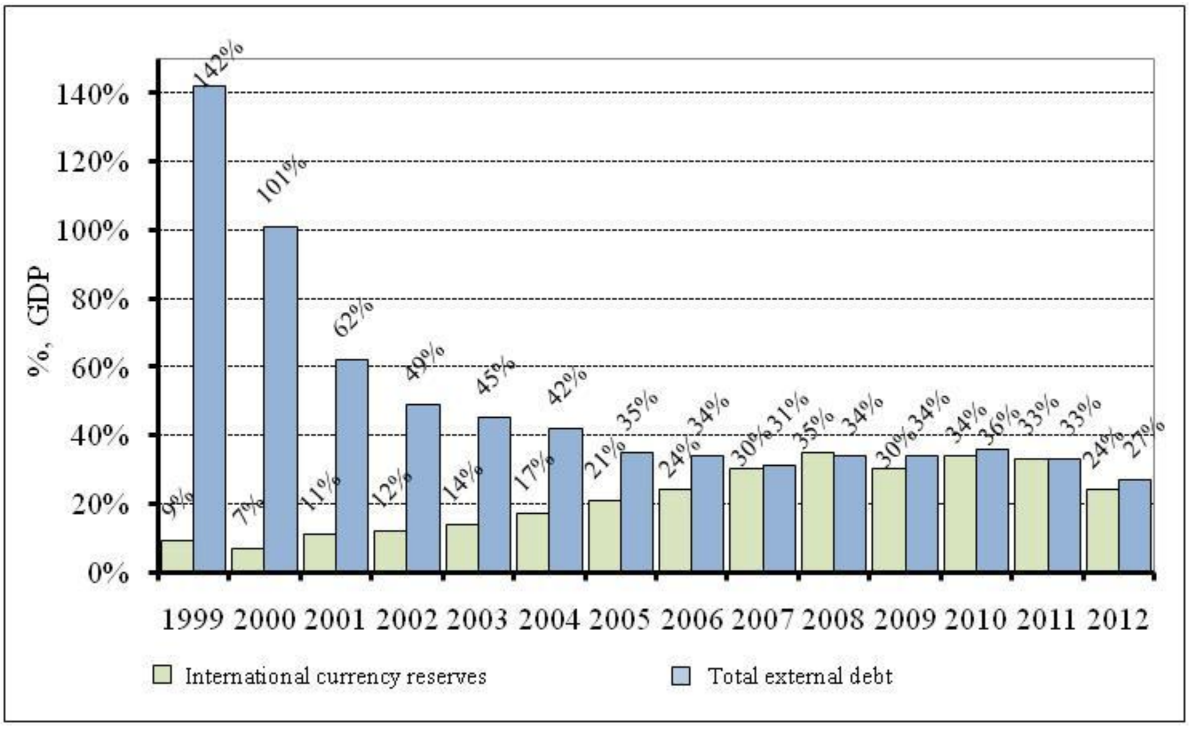
6) active participation of the Russian Federation as a shareholder in MDB activities aimed at ensuring effective use of the potential of international financial institutions for the benefit of the Russian Federation;

7) participation in development of initiatives to create new multilateral development banks on the basis of the appropriate inter-governmental agreements and entry of the Russian Federation into existing multilateral development banks.

5. Monitoring of Non-Government External Debt Obligations

From 2010 Russia’s external non-government debt has started to grow again. As of July 1 2012, Russia’s total (public and corporate) external debt amounted to USD 572.7 billion or 29.2% of GDP. In addition, Russia’s international currency reserves (USD 514.4 billion) no longer fully cover the amount of such debt (Diagram 20).

Diagram 20. International currency reserves and external debt of the Russian Federation, in % of GDP



Source: Bank of Russia

One of the general principles of the Russian Federation’s debt policy is that government borrowings must not undermine the ability of other Russian borrowers to raise finance in the international and domestic markets. Moreover, the government seeks to create favourable conditions for borrowing by the country's banks and corporations, including through the establishment of a Russian Federation benchmark yield curve, thus creating conditions for the efficient pricing of debt instruments for all Russian borrowers.

However, the rising level of the Russian non-government debt burden suggests that the financial authorities should pay close attention to corporate and bank borrowing. In 2013-2015 the monitoring system for bank and corporate external debt will continue to be enhanced, including the creation of a mechanism for timely and efficient influence on their borrowing policy, in particular that of state-owned enterprises. One of the proposed measures is the approval of a Russian Federation Government Decree setting forth an agreed procedure for state-owned enterprises ("SOEs") to take decisions on foreign currency borrowing.

It is intended that SOE supervisory boards/Board of Directors will approve maximum levels for certain debt sustainability indicators. Such indicators must be developed and approved at the company level, since it is unreasonable to define universal indicators for business entities in diverse industries or sectors of the economy.

General mandatory principles will also be introduced for SOEs to comply with to ensure debt policy remains responsible. Such principles may include: ongoing maintainance of moderate debt and debt service levels, regular assessment of the SOE's debt sustainability indicators and conformity of the relevant SOE's debt management policy with international best practice.

In order to ensure efficient monitoring of SOE debt levels and to increase business transparency, it is proposed that information on SOE foreign currency borrowings will be both provided to the Russian Federation Ministry of Finance and disclosed on the relevant SOE website with regular updates.

6. Creation of the Russian Financial Agency and Transition to Active Public Debt Management

Over the period 2013-2015 the Russian Financial Agency (Rosfinagentstvo) which is a new specialized financial institution responsible for the implementation of state policy on management of public debt and sovereign funds of Russia in the financial markets will commence operations.

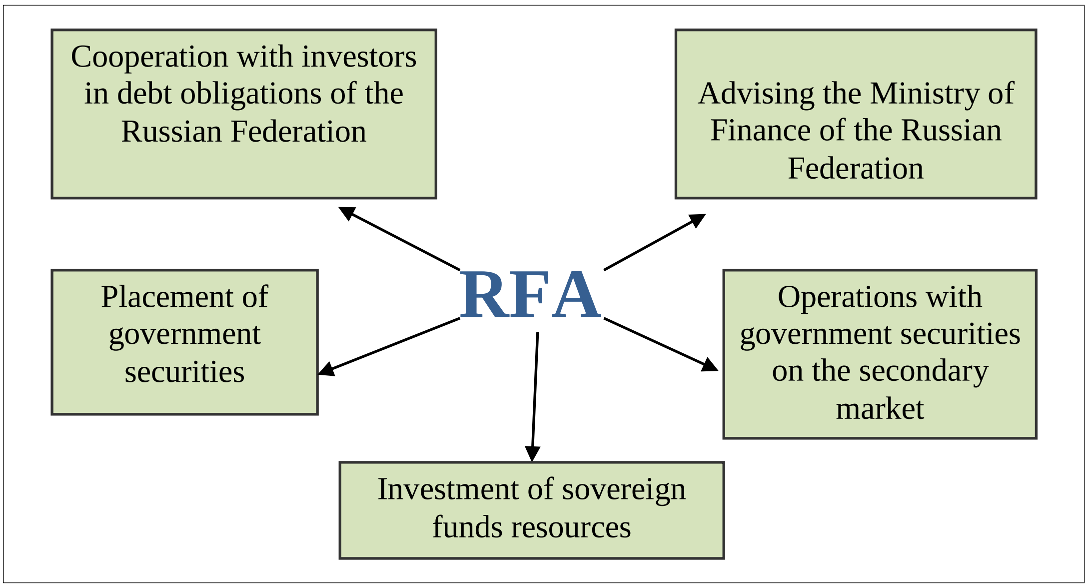
A number of steps related to the commencement of operations of this institution are expected to be taken shortly. Such steps include formation of

Rosfinagentstvo's charter capital, state registration of Rosfinagentstvo as a legal entity, approval of its investment strategy (a list of permitted financial assets for for the sovereign funds) and satisfaction of the pre-conditions for agreements to be entered into between the Russian Federation Ministry of Finance and Rosfinagentstvo relating to performance by the latter of its role as the manager of sovereign funds' assets and agent of public debt.

Together with these steps, a number of organizational and staffing matters need to be addressed in Rosfinagentstvo's internal documents, including the required software and data support, cooperation of Rosfinagentstvo with the Ministry of Finance, the Federal Treasury and the Bank of Russia, receipt of a license as a professional participant on the financial markets, recruitment and placement of staff, etc.

Rosfinagentstvo is to become the main entity for the Russian public debt management focused on reducing the costs of public borrowing and servicing of government obligations, managing budgetary interest and exchange rate risks, and maintaining an effective dialogue with the international investment community (Diagram 21).

Diagram 21. Functions of the Russian Financial Agency



Source: Ministry of Finance of the Russian Federation

With the appropriate infrastructure and human resources and the objective of matching best international practice, Rosfinagentstvo should be able to efficiently safeguard the interests of the Russian Federation as a sovereign borrower through the placement of government securities, pro-active liability management, ongoing communications with the international credit rating agencies, and foreign and domestic investors in order to ensure a proper understanding of Russia's credit risk. Rosfinagentstvo should be able to respond more effectively and promptly to constantly changing market conditions, with the objective of ensuring access to sources of borrowed capital on favourable terms and ultimately reducing federal budget expenditure on debt service.

Rosfinagentstvo will perform its activities under the strict control of the state within defined powers conferred by the Government of the Russian Federation and in close and direct cooperation with the Ministry of Finance of the Russian Federation.

7. Compensatory Payments on "Pre-Reform" Savings of Citizens

A separate issue under the current debt policy is ensuring that compensatory payments on the "pre-reform" savings of citizens of the Russian Federation in existence before the collapse of the Soviet Union, are financed through the federal budget by means of government domestic borrowings.

Federal Law No. 73-FZ dated May 10, 1995 "On Recovery and Protection of Savings of Citizens of the Russian Federation" and certain other federal laws enacted in subsequent years provide for these savings to be restored taking into account the purchasing power of the Soviet rouble in 1991. However, these laws do not establish the sources of financing for the related budget expenditures.

The "pre-reform" savings consist of (i) citizens' savings in state savings banks and state insurance institutions of the USSR (bank and insurance savings) and (ii) domestic lottery bonds issued in or after 1982 (1982 bonds). Compensation of bank and insurance savings accounts for the greatest portion of potential government spending on compensatory payments. The federal budget annually includes allocations for these payments in an amount consistent with the capacity of the budget. During the period from 1996 to 2011, the federal budget appropriations for these payments totaled 454 billion roubles. The Ministry of Finance proposes to allocate 50 billion roubles annually for these purposes in the period from 2012 to 2015.

The compensation payable to holders of 1982 bonds accounts for less than 1% of the total amount of potential government spending on compensatory payments.

These bonds were bearer securities placed within the territory of the former USSR. However, Federal Law No. 73-FZ dated May 10, 1995 recognized the liability of the Russian Federation only for those bonds placed within the territory of the Russian Soviet Federative Socialist Republic (RSFSR) prior to January 1, 1992 held by citizens of the Russian Federation.

In 1992-1993, the Russian Federation redeemed or exchanged the 1982 bonds for bonds issued by the Russian Federation without regard to whether the bonds were placed in the RSFSR or other former Soviet Republics. Due to the inflow of these bonds from other CIS countries, the Russian Federation incurred substantial costs in excess of the share that was properly allocable to it.

In the forthcoming period the Ministry of Finance expects the Government to complete the drafting of a procedure for making compensatory payments to holders of 1982 bonds based on the key provisions of prior laws which, as noted above, recognized the liability of the Russian Federation only for those bonds placed within the territory of the RSFSR prior to January 1, 1992 held by citizens of the Russian Federation.

As for resolving the issue of "pre-reform" savings in general, it is obvious that compensation should be made only to the extent it is within the capacity of the federal budget and within appropriate limits on the growth of public debt.

Conclusion

Irrespective of macroeconomic scenarios and capital market conditions, in the forthcoming year(s) public debt policy will be focused on ensuring the ability of the

Russian Federation to raise funds in the amounts required to perform designated social and economic tasks, and on terms and conditions acceptable to our country as a reliable sovereign borrower. This will be facilitated by regular Russian Federation issuance in the capital markets, a transparent and consistent auction policy, regular dialogue with the investment community, and a gradual broadening of the investor base for Russian Federation debt..

The actual levels of public borrowing will depend on the execution of the federal budget and on domestic and external market conditions. Aggregate domestic and external debt levels will remain moderate and sustainable. Debt policy will also be aimed at upgrading Russia’s credit ratings and ensuring its unconditional solvency.

Schedule 1

Structure of the Russian Federation's public debt, in billions roubles*

Debt category	2011	2012** (estimate)	2013 (forecast)	2014 (forecast)	2015 (forecast)
1. Russian Federation internal public debt:	3,553.30	4,355.80	4,868.30	5,284.00	5,596.70
Russian Federation government securities in roubles:	3,546.5	4,348.8	4,868.3	5,284.0	5 596,7
Federal Bonds (*OFZ*)	2,903.3	3,575.2	3,917.8	4,176.6	4,411.8
Public Savings Bonds (*GSO*)	553.2	683.6	860.5	1,017.4	1,094.9
domestic bonds placed in the international capital market	90.0	90.0	90.0	90.0	90,0
other	6.9	7.0	0.0	0.0	0.0
2. Sovereign guarantees of the Russian Federation in roubles	637.3	1,106.3	1,732.2	2,306.3	2,717.0
Russian Federation internal public debt including sovereign guarantees of the Russian Federation	4,190.6	5,462.1	6,600.5	7,590.3	8,313.7
3. Russian Federation external public debt:	1,120.20	1,264.40	1,449.40	1,678.50	1,805.40
government securities of the Russian Federation in foreign currency:	940.4	1,117.3	1,316.8	1,558.0	1 693.3
external bonds	939.6	1,117.1	1,316.6	1,557.8	1 693.1
sovereign bonds (*OVGVZ*)	0.8	0.2	0.2	0.2	0,2
foreign government loans	96.5	79.3	72.7	67.5	62,8
indebtedness to international financial institutions	81.5	67.2	59.3	52.3	48,6
other	1.8	0.6	0.6	0.7	0.7
4. Sovereign guarantees of the Russian Federation in foreign currency	32.5	528.1	696.7	867.0	1,027.6
Russian Federation external public debt including sovereign guarantees of the Russian Federation in foreign currency	1,152.7	1,792.5	2,146.1	2,545.5	2,833.0
Russian Federation public debt	5,343.30	7,254.60	8,746.60	10,135.80	11,146.70

* - data at the end of the period, ** - estimates are made on October 1st, 2012