

Part 3.

STATE FINANCES

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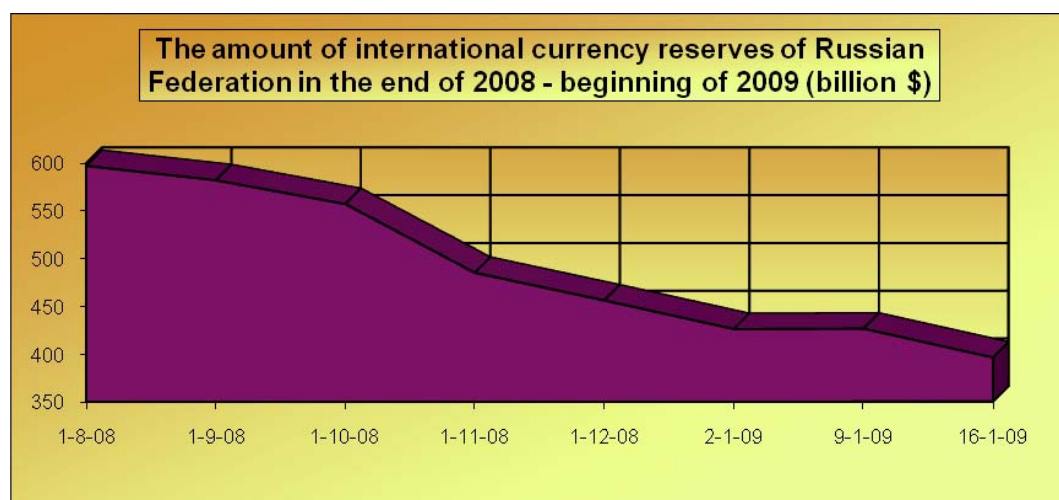
In the second half of 2008 and the beginning of 2009, the RF government had to reconsider the basic strategy of state financing. Economic crisis provoked the return of the budget deficit and weakened the rouble. As a consequence, the cabinet had to cut spending and introduce active measures of support for the financial system.

3.1. The state supports rouble's exchange rate, using reserves

In January 2009, the Central Bank of Russia delineated the corridor for the national currency exchange rate fluctuations. The Central Bank set the upper limit of the technical corridor for bi-currency basket equal to 41 roubles, which approximately corresponded to 37 roubles for one US dollar.

Thus, the Bank of Russia changed its strategy of national currency exchange rate regulation. After CB set the upper limit, it fixed the “fair” value of rouble compared to bi-currency basket.

Earlier, the Bank of Russia preferred alternative strategy, which was called “controlled devaluation”. Essentially, it was gradual (“smooth”) lowering of the exchange rate between national currency and bi-currency basket. This strategy helped to avoid social shock from dramatic rouble devaluation and to prepare industry for higher import prices. Yet, the “controlled devaluation” appeared to be quite capital-intensive. Consequently, a rapid reduction of the gold and foreign currency reserves of the Bank of Russia started.



Besides, “controlled devaluation” led to the significant growth of the import prices, threatening to provoke additional inflation. The rapid increase of the prices for socially important goods started in December of 2008.

Situation in Russia in that respect was similar to the situation in other countries. The weakening of the national currency is a quite painful event for the countries with a high amount of imported goods. “The devaluation parade” causes increase of inflation, meanwhile in euro and dollar zones the prices stop growing.

In December of 2008, the majority of foreign countries consumer goods prices decreased compared to the previous month. Yet, the consumer goods prices and services prices grew in Ukraine by 2.1% (compared to December of 2007 – by 22.3%), in Belarus – by 1.2% (respectively by 13.3%), in Germany – by 0.4% (by 1.1%), in Brazil, Kazakhstan, Malta and Romania – by 0.2 – 0.3% (respectively by 5.0 – 9.5%). In Russia the prices for consumer goods and services increased in a month by 0.7% and from the beginning of the year – by 13.3% (on average in EU countries consumer prices dropped in a month by 0,1% and increased compared to the beginning of the year only by 2.2%).

It should be mentioned that the market of agricultural products experienced the most dramatic influence of price growth. Consequently, food products prices inflation became the main driving force of the prices increase for various goods.

In comparison to December 2007, December 2008 witnessed the highest price increase was for bakery products and cereals; meat and meat foods; sugar, jam, honey, chocolate and sweets in the European Union. The highest consumer price increase for bakery products and cereals was recorded in Lithuania – by 15.0%, in Cyprus – by 12.3% and also in Latvia, Estonia, Malta and Finland – by 10.0 – 11.1%. The highest price increase for meat and meat products was recorded in Lithuania (22.1%), Bulgaria (16.7%) and Latvia (14.6%). The highest price increase for sugar, jam, honey, chocolate and sweets was recorded in Malta – by 12.0%, in Estonia – by 10%, in Austria, Latvia and Germany – by 6.9 – 7.0%. Since the beginning of 2008 in Russia, as in EU countries the highest price increase rate was recorded for bakery products and cereals – by 25.5% (in EU countries on average by 6.2%); for meat and meat products – by 23.0% (5.1% in EU). In 2008, the prices for sugar, jam, honey, chocolate and sweets increased in Russia by 17.8% (in EU by 4.7%), for fats and oil – by 16.9% (by 3.0% in EU), for fish and seafood – by 14.7% (in EU by 2.3%). The lowest price increase compared to December 2007 in Russia was recorded for vegetables – by 7.0% (in EU – 3.2%), and also for milk products, cheese and eggs – by 7.5% (in EU – 2.1%).

Agricultural products are traditionally considered to be the most significant “social goods”. Price increase in this segment negatively influences population’s buying power. To control inflation at the domestic market the Central Banks had to change radically its strategy of currency exchange rate management. Instead of “managed devaluation” strategy, the Bank of Russia introduced the strategy of the “strict upper limit of the corridor”.

The choice of timing for the change of the strategy was successful. In the end of January 2009, the banks accumulated rouble liquidity for their tax payments. It is worth mentioning that they needed liquidity also for their clients’ (companies and physical persons) payments. As a result the demand for Russian currency has significantly increased.

Taking into account that non-residents during the last six months were actively selling roubles, and CB was actively buying roubles, the Bank of Russia has accumulated big reserves of rouble liquidity. After Central Bank acquired a powerful lever for influencing currency market, it announced rising of the upper limit of the technical corridor for the bi-currency basket. In the situation of the high demand for roubles the speculators could not bear the market. Moreover, the Bank of Russia performed several “punishment operations” at the currency market against the speculators. As a result the players have started closing their long positions.

Simultaneously RF CB provided necessary amount of rouble liquidity on auctions. So, already on 26th and 27th January 2009, the Bank of Russia conducted auctions at Moscow Interbank Currency Exchange (MICEX) for the credit organization, providing uncollateralized credits.

At the same time, on 26th January the Central Bank offered 200 billion roubles to banks for the period of six months with the minimal annual interest rate of 13.5%. Later, Russian credit organizations were offered additionally 80 billion roubles for the period of 5 weeks with interest rate of 13.25%. The starting date for credit provision was 28th January and for credit reimbursement 22nd March.

The transition to the strategy of “strict upper limit” together with the provision of rouble liquidity could help banks obtain additional resources and channel them into real economy. Earlier, financial organizations have actively speculated at currency market, and predominantly against rouble. Returns on dollar investments were about 200%. Now banks can switch to industrial crediting companies.

Nevertheless, the “strict upper limit” strategy could be successful only in the situation of relatively stable market conditions at raw materials markets. If the

price for a barrel of oil drops below \$20, the CB will be unable to support the currency corridor and the Bank of Russia will have to surrender its positions again.

3.2. The government helps financial system

Along with the stabilization of currency exchange rate, the RF government has decided to support some Russian companies. During the first few months of the crisis, the key problem for Russian business structures were their debts with foreign banks.

VEB started refinancing the foreign debts of Russian companies in autumn 2008. \$11 billion dollars were provided to some companies from fuel and energy industry as well as metallurgy, construction, transport and communications industries.

The total amount of VEB credits was planned to exceed \$50 billion. The minimal interest rate on these credits should not exceed LIBOR plus 5 points.

The information about refinancing plan appeared for the first time in autumn 2008, after Vladimir Putin had conducted a conference on the stabilization of financial system of RF. The draft legislation, which was discussed at the conference ***“On the additional measures for the support of financial system of Russian Federation”*** authorized the state corporation (VEB) to provide currency credits and loans to organizations (including banks) with the purpose to repay and to service their foreign debts.

Among the first who announced their willingness to get access to refinancing were the biggest oil companies. On September 24, 2008 “Gazprom”, “Rosneft”, “LUKOIL” and TNK-BP sent a letter to Vladimir Putin. These business structures asked the head of the Government to provide them with financing for repayment of their foreign debts. Vladimir Putin supported their initiative.

Later, ***on 11th October Igor Setshin conducted a meeting and informed the participants about the amount of refinancing for the major oil companies.*** In total, it was planned to provide them \$9 billion. The lion’s share of these funds (\$4.2 billion) was intended for “Rosneft” – the vice-premier is a chairman of the Board of Directors of this company. The rest of the credits were intended to: “LUKOIL” – \$2 billion and TNK-BP – \$1.8 billion and “Gazprom” – \$1 billion. Soon after, some private companies refused to get refinancing from VEB.

The second group, which actively lobbied refinancing of its foreign debt was the automobile industry. Their leader was “Avtovaz”. *The subsidiary of “Rostekhnologii” purposefully defended the interests of “profile” industry in the Government.* The Parent company actively helped it. *“Rostekhnologii” has representatives in the Ministry of Industry and Trade.* The most influential among them is Denis Manturov, which was “landed” there from another state corporation’s subsidiary – “Oboronprom”. These were the “Rostekhnologii” representatives, who at the meeting conducted by Igor Setshin on 15th October 2008, managed to make him promise to provide them with funds for refinancing through VEB.

In addition, metallurgical companies have started more actively advancing their interests. “Rusal”, “Evraz”, “Severstal” and some other business structures announced their refinancing plans. They also discussed their initiatives with Igor Setshin. Yet, later only “Rusal” received financing.

Construction companies, which suffered from the crisis more than others, negotiated with VEB with the assistance of Igor Shuvalov. The first vice-premier also served as a mediator for financial organizations and for the biggest one from among them – VTB headed by Andrei Kostin.

Refinancing was not the only kind of the state support. *In 2009, the RF government announced the next pull of measures for the support of Russian financial system.* Russian banks will receive the second package of support; nevertheless, the first package was used by financial organizations absolutely inefficiently.

The first package assumed the direct help of the state to banking system. The financing was provided either through the auctions, conducted by the Ministry of Finance of the Russian Federation, or through the subordinated credits provided by VEB.

The total amount of subordinated credits, which were provided to Russian banks, was 950 million roubles. “Sberbank” got 500 billion roubles from the reserves of Central Bank; the other 450 billion were received by VEB. VTB received 200 billion roubles from VEB, “Rosselkhozbank” got 25 billion roubles. It was planned that VEB would transfer the remaining 225 billion roubles to commercial banks as subordinated credits.

The RF Central bank suggested quite tough requirements for obtaining subordinated credits. Only those banks, which had international rating BBB- or BB+ according to Fitch classification, or Baa3b and Ba1 according to Moody’s classification, were entitled. Nevertheless, one more condition was the willingness

of bank's shareholders to increase bank's authorized capital from their own funds. As a result, the access to the state financing was granted only to 50 biggest Russian financial organizations, which also used the auctions conducted by the Ministry of Finance.

Moreover, the biggest banks preferred to buy dollars, instead of investing money into real economy. As a result, the funds of CB and the Ministry of Finance were used in bear speculations against the national currency. The RF government condemned such a practice, and the leader of the industry – "Sberbank" was the main culprit.

JSC "Sberbank Rossii" is the biggest bank in Russia and also in Central and Eastern Europe, and it owns about 30% of assets of Russian banking system and it is the main creditor of the national economy. The Central Bank of Russian Federation is the founder and the main shareholder of "Sberbank" (it owns more than 60% of voting shares of "Sberbank"). "Sberbank" has more than 200 thousand shareholders, both physical persons and legal entities. The bank has the biggest branch network in Russia: 17 territorial banks, more than 20 thousand of branches and departments, and also subsidiaries in Kazakhstan and Ukraine.

Despite multiple attempts of the bank's top-managers to refute accusations that "Sberbank" speculated on rouble's devaluation, the criticism continued.

Nonetheless, the situation in the private sector was even worse. In contrast to the state banks, which could be influenced by the government through its representatives in their boards of directors, the private financial organizations were outside the sphere of influence of the government.

As a result, CB and the Ministry of Finance of RF have decided to change the model for the provision of state financing to banks.

The new scheme for the support of the financial system was presented in 2009 at the conference devoted to the economic issues, in which the heads of the biggest state banks participated.

Following the results of the conference, it was announced that Russian financial structures could receive no less than \$40 billion roubles (or about 1.4 trillion of roubles). It was planned that "Sberbank", VTB and VEB would receive respectively 500 billion roubles, 200 billion roubles and 100 billion roubles into their core (tier 1) capital.

The remaining 600 billion roubles would be assigned for the state investments into private banks' capital through purchases of their additional share issues. As a result, the RF government will receive blocking shareholding

packages (25 – 30%) in the majority of private financial organizations. The only exception will be the banks with partial foreign ownership – about 20% of private banks.

Thus, the state will be able to promote its representatives into banks' boards of directors and to control the distribution of state financing.

Afterwards, the Bank for Foreign Economic Activity (VEB) would be able to allocate additional 225 billion roubles as subordinated credits for commercial banks on the condition of co-financing by private shareholders. In the beginning of February 2009, VEB received 38 applications for subordinated credits on amount 70 billion roubles. Yet, only three banks' applications were approved for the total amount 17.1 billion roubles.

The support for financial organizations proved to be timely. At the breakthrough of 2008/2009, the share of bad loans was rapidly growing. The growth of the amount of "bad debts" in Russian banks "freezes" liquidity and causes sizeable write-offs.

Currently, the total proportion of corporate loans overdue for all banks is 40% (7 trillion roubles), for credits granted to physical persons it is 50% (8.2 trillion roubles), the capital before bad loans write-offs – 4.4 trillion roubles, and after write-offs – only 2.3 trillion roubles.

It is interesting that only in three months (November – January) the amount of credits overdue increased several times. According the most recent CB official statistical data the total amount of debts of all organizations in the end of November 2008 was 28.015 trillion roubles, including *overdue debt 1.112 trillion roubles or 4% of the total amount of debt* (in the end of November 2007 it was 4.4%, in the end of October 2008 – 3.8%).

The total indebtedness under credits for Russia in the end of November was 13.646 trillion roubles, including credits overdue – *1.049 trillion roubles, or 7.7% of total credit indebtedness* (in the end of November 2007 – 8.2%, in the end of October 2008 – 7.2%).

Thus, *during the last few months the amount of credits overdue increased several times*. The growth of "bad credits" forces Russian banks to create reserves for possible credit defaults.

Even the leaders of the market – state banks became overcautious, although they have direct access to state financing and subordinate credits. So, according to "Sberbank" report, in January this organization demonstrated fast growth of reserves for problem loans. During the first month they increased to 39% of total bank's expenses or to 4.7% of its total credit portfolio.

In the same month the credit portfolio of the bank increased by only 147 billion roubles and amounted to 5.7 trillion roubles, and the share of corporate credit portfolio increased to 72%. This sharp increase is explained by the unprecedented decrease of retail credits.

Thus, ***“Sberbank” is not just increasing its reserves, but it is also tightening credit conditions:*** instead of retail crediting the state company places its stake on support in big companies. If the leader of the market is behaving overcautiously, then small financial organization will go even further in that direction.

Yet, ***even these measures cannot protect Russian banks from losses.*** So, the number of credit organizations in Russia, which reported net losses for the first 10 months of 2008 compared to 2007 increased 10 times – from 11 to 113.

With the purpose to improve the financial performance of the banking sector and to decrease (at least nominally) the amount of “bad” debts, ***Central bank undertook some measures.***

In the end of the last year, ***CB temporarily softened its requirements with respect to the reserves.*** Pursuant to the Central Bank’s Directive No. 2156-U (“On the Peculiarities of the Evaluation of Credit Risk for Loans, Loan and Similar Indebtedness”), banks can more liberally estimate loans quality and use softer criteria for mandatory reserves. The criteria for the quality of servicing of loans were also relaxed: quality of servicing will be considered “good” for loans overdue up to 30 days for companies and up to 60 days for physical persons (it used to be 5 and 30 days respectively). The periods for “medium” and “bad” servicing classification were also expanded by 30 days. Furthermore, the loan restructuring entails changes in its quality rating.

Also, ***in December 2008, the regulator authorized banks to reclassify securities.*** As a result, banks were allowed not to disclosed in their balance sheets approximately 40.4 billion roubles of losses from revaluation (the total losses amounted to nearly 177 billion roubles).

Only nominal measures appeared to be insufficient for resolving the problem of “bad” credits, and ***Central Bank along with the Ministry of Finance has started preparing the next tranche of direct state financing.*** The funds will be provided as investments into authorized capital and as subordinated credits.

The new programme for subordinated loans provides for allocation from the federal budget in 2009 extra amount of 300 billion roubles for the capitalization of banking system, including 200 billion roubles for capitalization of VTB and 100 billion roubles for capitalization of VEB. It is planned to allocate this year 255 billion roubles from the funds of the Federal Wealth Fund (FWF) for

subordinated credits to private banks. As it was mentioned above, in 2008 it was planned to spend 225 billion roubles from FWF for subordinated credits for private banks, but it did not happen. In fact banks has started spending these funds only in January 2009 that is why they were transferred into the current year expenses. The amount, which FWF plans to spend this year, was increased by 30 billion roubles in addition to earlier authorized amount, which in total provides necessary 255 billion roubles.

Traditionally, the state financial support is provided to the state banks and big private bank, but as the result ***small regional and mortgage financial organizations might have to withdraw from the market*** because of bad loans.

Speaking about small and medium regional banks, their businesses profitability is already under threat, because of mass write-offs of bad corporate loans. The banks, which do not belong to the top-200 list, will probably, recover only 50 billion roubles from the 482 billion roubles amount of bad loans.

The same pessimistic outlook is in the mortgage industry.

According to data of CB RD the amount of debts overdue on mortgage loans in roubles increased 13.4 times – to 5.8 billion roubles, and for currency loans – 17 times, to 6.3 billion roubles. In the fourth quarter of 2008 roubles mortgage credits accounted for more than a half (3.1 billion roubles out of 5.4 billion roubles) of the annual increase of debts overdue, and currency mortgage credits – about 70% (4.1 billion roubles out of 5.9 billion roubles). As the result the share of debts overdue for currency credits in the total amount of debts for that year increased from 45.4% to 51.7%. In 2008, physical persons received mortgaged credits in amount of 633.8 billion roubles – it was 14% increase compared to 2007 (556.8 billion roubles). The amount of credits in roubles was 539.5 billion roubles (18% increase compare to 2007 – 438.2 billion roubles respectively), and the amount of currency credits – 94.3 billion roubles (decreased by 20% compared to 118.3 billion roubles in 2007).

The banks, which actively credited housing purchases, are in trouble now. In contrast to ordinary consumer credits, ***mortgage credits are more difficult to recover***. The procedure of ejectment of mortgaged real estate in case of default on credit is complicated and time-consuming.

And the situation will be getting even worse. ***The court proceedings in case of insolvency of debtor could last for months*** and the major share of bad loan cases will surface in the late spring of 2009, when the debtors, who lost their jobs, will default on their debts.

3.3 State budget deficit appears

State support for Russian economy and falling revenues of Russian companies influenced Russian budget-2009. At first the Ministry for Economic Development had to adjust its forecast for long-term perspective.

The adjusted forecast was presented at the meeting of the Presidium of the Government in the beginning of this year. As the result the forecast of Russia's development in 2009 was also adjusted. The Ministry for Economic Development announced that the scenario of economic development should be adjusted the previous autumn.

The necessity of correction of the forecast became obvious in November, when the problems in RF economy were revealed. The core factor was the decline of industrial production in autumn 2008.

Compared to November 2007 it declined by 8.7%, instead of increasing by 5.3%, like it was in 2007 compared to 2006. In October 2008 the industrial production increased only by 0.6% compared to the same month in 2007. The growth of industrial production in RF in January-October 2008 compared to January-October 2007 was 4.9%, in October 2008 compared to October 2007 – 0.6%, and compared to September 2008 – 2.8%. According to “Rosstat” (Federal Statistics Service) data the biggest production decline was recorded in November 2008 in the processing industries – by 10.3% compared to November 2007 (compared to October 2008 – by 15.3%). The industrial production in extracting industries in November 2008 compared to November 2007 declined by 1.6% (compared to October 2008 – by 5.8%), and in production and distribution of power, gas and water (compared to October 2008 it increased by 8.1%). The industrial production in extracting industries increased in January-November 2008 by 0.4 compared to the same period in 2007, in processing industries – by 5.4%, and in power, gas and water production and distribution – by 2.4%.

In December 2008, the ministry suggested four scenarios: two inertial (average annual oil price \$50 or \$60 per barrel), the third was “basic” scenario – oil price \$50 with government's support measures for economy taken into account. Also Elvira Nabiullina's office analyzed the unfavourable scenario (oil prices \$35 – 40 per barrel), but this scenario was not presented.

The important difference of basic and inertial scenarios related to the pace of GDP growth.

According to the basic scenario, RF GDP in 2009 will increase by 2.4%, investments in core capital will increase by 1.4%, but investments in industrial production will decrease by 3.2%. Inertial variant with oil price of \$50 per barrel forecasts that RF GDP in 2009 will decrease by 0.5% because of investments and industrial production decline by 9.5% and 4.7% respectively.

Furthermore, according to the basic scenario, the minor economic growth should be accompanied by the growth of the real income by 2.5% in 2009. In 2008, the real income of population increased on average by 4%. The share of population with income below subsistence line according to the ministry's forecast would decrease to 12.8% of the real income of population in 2009 compared to 13.1% in 2008.

Yet, along with the growth of real income of population, gas and railroad rates would increase. If it is still possible that gas rates do not increase (in case of adverse market conditions), rail road rates will definitely increase.

The smoother quarterly increase of the rates for various categories of consumers was established. In the first quarter, the rates for “blue fuel” will increase by 5%, in the second – by 7%, in the third – by 7%, in the fourth – by 6.2%.

Furthermore, considering the results of 2008, the government had to abandon the basic scenario and to accept the pessimistic scenario prepared by the Ministry for Economic Development, but not published before. This pessimistic scenario was discussed at the Presidium of the Government in January 2009. This scenario is based on low oil prices, which leads to sequestering of budget expenses.

The revision of forecast made revision of budget inevitable measure. Immediately after Russian main financial document was signed last year, the Ministry of Finance of RF announced the procedure of its revision. Alexei Kudrin's office began the revision of economic forecasts for 2009, which are used in the budget for the years 2010 – 2012. The fact was that prognostic indicators for the main financial document of the country were determined in summer, when RF economy did not experience yet the consequences of financial crisis. As a result, these indicators for the three-year budget still reflected optimistic expectations of summer 2008.

It was assumed earlier that the approved budget for 2009-2011 will not be adjusted with respect to either the expected incomes or the expected expenses. The Ministry of Finance of RF was expected to be capable of performing the budget “optimization” by means of moderate small-scale corrections. So, the State Duma in November 2008 emergently approved amendments to the Budget Code,

allowing Kudrin's office to use the Reserve Fund in 2009. Moreover, other corrections for 2009-2011 provided that the Joint Commission of the State Duma and the Council of Federation is authorized to approve transferring of funds to another recipient or the another year. Yet, these measures appeared to be insufficient, and the Ministry of Finance of RF started a radical revision of the main financial document of the country.

The new budget was submitted in the end of February 2009. As it was mentioned before, this document, approved in 2008, proved to be overoptimistic. So, it was expected that Russia would get record revenues – 10.9 trillion roubles and that expenses would be 9 trillion roubles, and that inflation will not exceed 8.5%.

It was already obvious in the end of the last year that Russia's budget would be driven into deficit in 2009 – at that time the Council of Federation was still reviewing the proposed budget. In spite of that, the ***Ministry of Finance of RF decided to adjust the financial plan only after the results of 2008 would become known.*** In addition, the Ministry for Economic Development has not prepared yet the adjusted forecast for the economic development in the long-term perspective.

The statistical data for the last year and for January of this year demonstrated the severity of recession both at domestic and global markets. As a result, the Ministry for Economic Development determined the most probable scenario for the future events, which did not promise anything good for the Russian economy. According to the most recent forecast of the Ministry for Economic Development (so-called “pessimistic” scenario), this year the outflow of capital from Russia is expected to be over \$100 billion, while Russia will have foreign deficit and inflation about 13-14%.

All this will have negative consequence for Russian companies and GNP. Accordingly, the economic growth could be negative, varying from 9 to -2.3%, for the first time during the last eleven years (since 1998).

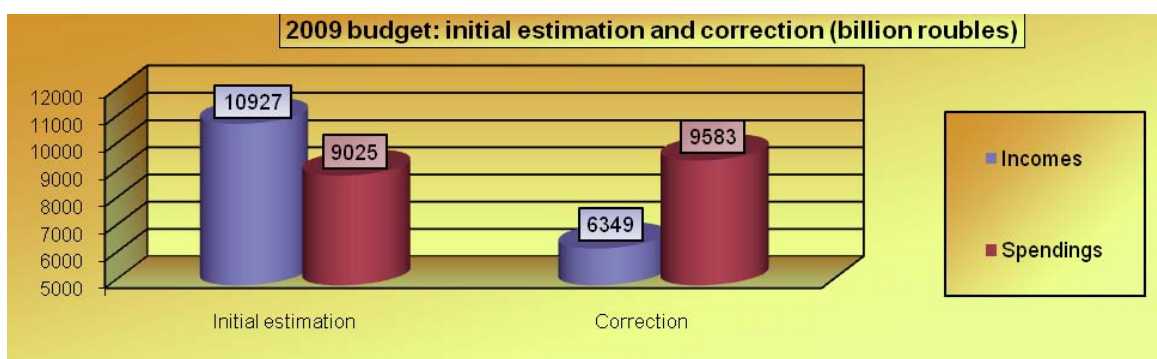
In January 2009 Russian GDP already declined by 8.8% compared to January 2008. Compared to December 2008 the same indicator declined only by 2.4%. For the fourth quarter of 2008 the GDP growth slowed down to 1.1% and in the year 2008 Russian economy grew by 5.6%. On 17th February 2009, the Ministry for Economic Development published the adjusted forecast for Russian GDP. Russia's economy this year will decrease not by 0.2% as it was expected earlier, but by 2.2%. The expected decline of industrial production for this year is 7.4%. Earlier, the Minister of Finance Alexei Kudrin also declared that the growth of Russian GDP in 2009 would be close to zero. The nominal volume of RF GDP in

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2008 was about 41.54 trillion roubles and increased by 5.6% compared to 2007. Russian economy in 2008 demonstrated the growth since 2002, when GDP increased by 4.7%. In 2007, Russian economy increased by 8.1%.

The decline of GDP and declining demand and prices at foreign market made inevitable adjusting of both income and expenses items of the budget-2009.

As it was forecasted budget expenses slightly increased, and revenue dramatically decreased.



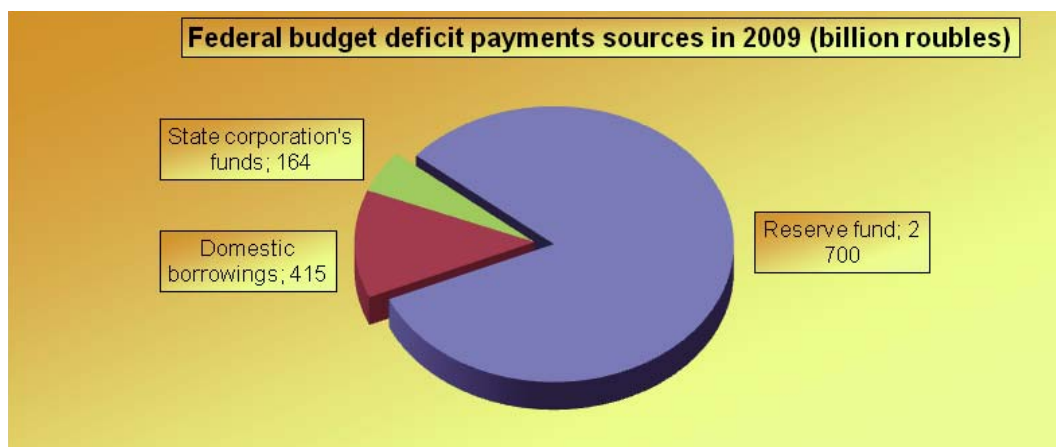
According to the new variant, the revenues of the RF federal budget will decrease by 42% in 2009, compared to the budget planned for the current year, and expenses will increase approximately by 500 million roubles and will amount to 9.5 trillion roubles, the deficit will be 8% of GNP. Budget revenues will be 6,349 trillion roubles, expenses – 9.3 trillion roubles, and the deficit – 7.4% of GNP. The head of the Ministry of Finance of RF explained that taking into account the funds of the Federal Wealth Fund (FWF) the expenses will be 255 billion roubles higher and the deficit will increase to 8% of GNP. The Reserve Fund will provide 2.7 trillion roubles to cover Federal budget deficit equal to 6.5% of GNP, and 1% will be compensated by net borrowing in domestic market in 2009. The Federal budget will also receive temporary 164 billion roubles from state corporations funds, the donors will be the state corporation “Rosnano” and “Fund for the assistance for housing and communal services reform”.

Thus nominal deficit amounts to 2.9 trillion roubles. Yet taking into account spending of the Federal Wealth Fund (FWF) ***the real deficit was close to predicted amount of 3.2 trillion roubles.*** It was planned that the deficit will be even higher. Yet, by means of federal budget sequestering by 12.5% on average the Ministry of Finance managed to stay within 3.2 trillion roubles limit. It appeared in the process of federal ministries’ expenses reduction that they have many “protected” budget items (social transfers, “Sochi 2014, APEC), so, the

reductions were limited to the expenses on personnel, infrastructural projects and long-term projects.

Staff reduction affected all levels of government and in 2009 – even the Presidential Administration. On February 17, the president Dmitri Medvedev ordered his head of administration Sergey Naryshkin to prepare the package of suggestions for the apparatus expenses reductions. As the result on February 24 Sergey Naryshkin published two instructions concerning reduction of expenses and also reduction of the personnel of the Presidential administration and the personnel of Presidential plenipotentiary envoys offices. According to this instruction before May 1 they have to prepare their suggestions for the reduction of at least 100 employees in the Presidential Administration.

For the compensation of budget deficit in 2009 it was decided to use the Reserve Fund.



Next year FWF will help to plug the gap in Federal budget. In total on February 1, 2009 the amount of the Reserve Fund of RF was 4.9 trillion roubles (\$137 billion), and FWF – 2.9 trillion roubles (\$84 billion). Note that from FWF 255 billion roubles will be spent for the anti-crisis measures. Thus, the real amount of oil and gas funds will be about 7.5 trillion roubles instead of 7.8 trillion roubles. This reserve, if skilfully used, can be sufficient for 2 – 2.5 years.

If the relative stability of the Federal budget is more or less ensured, the **problem of regional budgets is very acute.**

The legal entities of RF have started submitting their proposals on expenses sequestering last year. Yet, the aggravation of the situation in January forced them to intensify this process. The problem was that economic crisis had a negative impact on the most vulnerable and important for regional taxes: income tax and

property tax. According to the Ministry of Finance forecast *in one third of the legal entities of federation the revenue from income tax in 2009 will decrease by 60%*, and they will need federal assistance for that matter.

So, *Moscow's and Saint Petersburg's budgets were sequestered*. Moscow's 2009 budget revenues are 1.387 trillion roubles, and expenses – about 1.462 trillion roubles (compared to initial estimation, 1.5 and 1.6 trillion roubles accordingly). In the “North Capital's” budget the revenues was sequestered by one third (by 108.6 billion roubles), and expenses – by one fourth (by 90.4 billion roubles). As the result budget deficit in 2009 increased almost twice – by 18.2 billion roubles and will amount to 38.3 billion roubles. The deficit budget of Krasnoyarsk Territory preliminary will be decreased by 10 billion roubles. The estimated revenue of the Tomsk region budget – 32 billion roubles, probably, will be downsized to 15 – 20 billion roubles; the Novosibirsk region council of deputies sequestered 2009 budget's revenues and expenses by more than 240 million roubles and also reserved more than 11 billion roubles. In May of this year it is expected that the Sverdlovsk Region's budget will be sequestered one more time for more than 20 billion roubles.

With the purpose to support regions the Ministry of Finance will provide them additional financing in year 2009. Federal budget in total will help 30% of all legal entities of RF. Thus, it is proposed to provide regions additional credits in amount 290-300 billion roubles, the half of this sum will be provided as budget credits for three years.

Subsidized regions will receive the significant share of funds, but this practice cannot last for a long time. As the result legal entities of RF will have to continue sequestering budgets and personnel. Following the Ministry of Finance budget cuts, long-term investment programmes and special-purpose programmes will be sequestered, speaking about special-purpose programme, their financing will be delayed for the future years.

Simultaneously, along the reduction of government spending, the increase of the government defence orders for 2009 was announced. Governmental purchases of defence technology this year will increase by 28%. From one side it will increase defence capability of the country and from the other – will support defence industry in the situation of economic crisis. In the next three years the armed forces will get 70 long-range missiles, 30 “Iskander” missiles, 48 warplanes, 60 helicopters, 14 battleships, 300 tanks and more than 2000 vehicles.

The RF government places its stake on long-range missiles (Topol M) and theatre missile systems (Iskander M).

The programme for supplying the armed forces with “Topol-M” systems was launched in 2006. It was planned that by 2010, 300 – 400 “Topol M” missiles should be manufactured.

The perspectives of “Topol M” purchases have become the topic of hot discussions after Dmitri Medvedev announced that the system will be deployed in the exclave of Kaliningrad.

The main producers of “Topol” and “Iskander” missiles will gain from the increase of governmental purchases. First of all, it will be Votkinsk Machine Building Plant, which besides “Iskander” and “Topol” also makes “Bulava” missiles. It should be highlighted that this enterprise was already included in the list of “backbone organizations” in contrast to another producer of “Iskander” missiles – “Kolomna KB of Engineering”.

While increasing governmental orders, the Government is simultaneously planning to reduce expenses on military personnel. So, in 2009 early retirement from military services is planned for 117.5 thousands officers. Among them 60.3 thousands have served in the army for 20 years and longer, which means that they have earned their pensions and in the case of early retirement they will be paid compensation equal to 20 monthly salaries. ***The rest of the officers will not get military pensions, but still will be paid aforementioned compensation.***

Accordingly, the Ministry of Defence will release resources which are necessary for the increase of military officers’ salaries.

Besides the expenses of federal agencies, in adjusted budget “InvestFund”’s programmes were also sequestered. So, ***in 2008 the Government announced that it was going to revise major investment projects.*** VEB was commissioned to analyze and to monitor these projects.

Now “InvestFund” supports 21 project of national significance for total amount 1.265 trillion roubles. It was planned that 363 billion roubles would be provided from budget funds. So, “InvestFund” is financing 14 national projects: 1) Construction of the “Western High-Speed Diameter” highway in St. Petersburg; 2) Construction of “Orlovsky Tunnel” under Neva river in St. Petersburg as an element of Neva and Baltic water transport system; 3) Construction of the new exit from Federal Motorway M-1 “Belarus” Moscow – Minsk to Moscow Belt Highway; 4) Construction of the segment of Moscow – St. Petersburg High-Speed Highway from 15th to 58th km; 5) Integrated development of Lower Angara region; 6) Construction of the transport infrastructure for the development of mineral resources in the South of the Chita region; 7) Construction of the complex of oil refineries and petrochemical plants in

Nizhnekamsk; 8) Construction of the railroad Kyzyl – Kuragino integrated with the development of mineral resources in Tuva Republic; 9) Construction and operation of the multi-purpose terminal “Yug – 2” in Ust-Luga commercial seaport; 10) Organization of production of integrated circuits on 300 mm plates with a design standard of 65-45 nm; 11) Development of the industrial complex in Novomoskovsk, Tula region; 12) Organization of high-speed passenger train operation St. Petersburg – Helsinki; 13) Reconstruction of the stretch between Oune – Vysokogornaya and the construction of the new Kuznetsky Tunnel on the stretch between Komsomolsk-on-Amur and Sovetskaya Gavan; 14) Integrated programme of construction and reconstruction of water supply and water disposal objects in Rostov-on-Don and in the south-east of Rostov region.

It was then minister of Economic Development German Gref who actively lobbied the creation of InvestFund for financing strategic infrastructural project. ***Initially there was a fierce competition for the state co-financing of different projects.*** The most powerful RF pressure groups actively lobbied their large-scale projects in the Ministry for Economic Development. As the result by the year 2007 “InvestFund” became the second biggest channel for the state financing of infrastructural projects after federal special purpose programmes (FSPP).

In autumn 2007, the political environment changed. The Ministry for Regional Development gained control over InvestFund.

Moreover, ***since June 2008 regional projects were also authorized to apply for state co-financing.*** As the result the Ministry for Regional Development received 49 applications from 32 regions. Their total amount was more than 200 billion roubles. 27 billion roubles were requested from InvestFund and regional governments planned to spend on the projects more than 13 billion roubles from regional budgets.

According to the Ministry for Regional Development, standard regional investment projects should correspond to the purposes of social and economic development of the legal entity of RF, at whose territory the project will be implemented, while the cost thereof should be at least 500 million roubles. The minimal required share of the private capital is 50% ***and local budgets are required to participate in the structure of financing of regional investment project.*** The amount of co-financing is determined by the Ministry for Regional Development depending on the fiscal capacity of the regional budget.

The new head of the Ministry for Regional Development Victor Basargin also promotes regional projects. The minister is Eduard Rossel’s protégé. The Governor of Sverdlovsk Region actively promoted Basargin, who worked in the

office of the plenipotentiary president's envoy in the Ural Federal District (UFD).

Basargin also became the Chairman of the Cupervisory Board in JSC of the corporation "Ural Industrial – Ural Polar". This business structure is responsible for the implementation of a regional project under the same name and Eduard Rossel was among its main initiators.

It is interesting that for some time the main competitor of the project "Ural Industrial – Ural Polar" was allegedly "Belkomur" project, lobbied by Oganeg Ogaryan, the senator from Perm Region and the Ministry of Transport.

Both projects competed for financing from "InvestFund". Yet, Levitin's and Ogaryan's initiative was not supported by the Ministry for Economic Development. It was the very opposition of this ministry and "United Russia", which explained the delay in preparation of the application for "Belkomur" project.

After VEB's revision of infrastructural projects, it will be the regional projects (7 projects in total), not federal projects (14 projects in total), which will be sequestered in the first turn.

"InvestFund" participation in regional projects is limited only by elaboration of the design documentation and the state provides 90% of financing for this work. ***Following reduction of state financing, the process of design documents preparation will become much longer.*** It applies to practically all regional projects, the only exception will be the project "Ural Industrial – Ural Polar"

3.4. Tax burden will not be reconsidered

The economic crisis has terminated the programmes of the large-scale reduction of tax burden. The exceptions were only the reduction of income tax and small preferences for fuel companies.

Yet, recently intense discussions about the perspectives of tax increases have started. ***So, in 2009 the Ministry of Health of RF mailed to governmental agencies the draft law proposing to substitute consolidated social tax (CST) by insurance contributions since 2010.***

The intention to reform ***CST during the autumn last year*** was announced. At that time, the Ministry of Finance of RF and the Ministry of Health of RF proposed to substitute since 2010 consolidated social tax by insurance contributions and to change the intervals of the scale: from wages less than 1.1 million roubles – 26%, up to 2.3 million – 10%, more than 2,3 million roubles – 2%.

As a result of the change of the scheme of CST administration, proceeds from this tax should significantly increase, as the 26% rate will apply to 97% of wages. Moreover, since the year 2020 the 26% rate will be increased to 29%.

Ministry of Finance of RF is also going to change the system of distribution of CST proceeds. As a result, the federal budget will lose 6% of CST from 26%, and the share of contributions to RF Pension Fund will increase from 14% to 20%. This means that all social tax will be transferred to the funds of the Ministry of Health of the Russian Federation.

These decisions were intended to compensate the deficit of the Pension Fund of RF.

The task of the Pension Fund of Russia (PFR) is the state management of pension savings of citizens, ensured in this fund. The 2008 revenues of the budget funds are estimated to amount to 2.55 trillion roubles (in comparison: this amount exceeds the federal budget revenues for three months). The PFR obtains the major part of these funds directly from the budget (1.4 trillion roubles), and the rest – from enterprises and organizations as contributions for retirement insurance of their employees (the part of consolidated social tax). PFR, despite financing from the budget has a status of independent state non-budgetary fund. PFR pays pensions to 38.2 million of Russian pensioners. Besides, PFR database monitors personified information on 62 million Russian employed citizens, whose employers make contributions into PRF for their sake.

Until the autumn of 2008, the contributions to PFR were increasing. Yet, ***already in the fourth quarter of 2008 this growth began subsiding.*** Consequently, its dynamics in the last year appeared to be quite moderate: 23.3% increase in comparison with the 2007 data. The other non-budget funds have demonstrated similar moderate growth.

It s worth reminding that budgetary system of RF received 10 trillion 32 billion roubles of revenues in total, managed by Federal Tax Service (FTS), which is 16.1% more compared to the year 2007. This is the official FTS information. The budget revenues from taxes and duties into consolidated budget, including consolidated social tax (CST) amounted to 8 trillion 455.7 billion roubles and increased by 14.9%. The revenues of state non-budgetary funds increased by 22.9% and totalled 1 trillion 557.1 billion roubles. RF Pension Fund in 2009 received 1 trillion 251.4 billion roubles of insurance contributions, which is by 23.3% more than in 2007. Social Insurance Fund received 74 billion roubles (+15.5%), Federal Obligatory Health Insurance Fund collected 89.3 billion

roubles (+24.4%), and territorial obligatory health insurance funds received 162.4 billion roubles (+22.6%).

Payments from RF PF in 2009 will increase. Specifically, in the current year the basic part of pension in Russia will be increased twice: since March 1 – to 1950 roubles, and since December 1 – to 2460 roubles. It will allow increasing minimal pension to the level of subsistence line, which was 3191 roubles in 2008, for pensioners. In December pensions might be increased not by 29.5%, as it was planned before, but by 30%.

Moreover, the insurance part of pension is planned to be increased since 1st April 2009 by 17.5% instead of 15.6% as it was planned before. However, if consumer prices increase in the second half of the year by more than 6% (and this is already inevitable), then since August 1 unplanned indexation of the insurance part of pension will be conducted.

The managing companies do not inspire optimism either. Business structures, ***investing pension savings of Russians, suffer losses, which budget will have to compensate.*** So, in 2008 they had average annual profitability minus 25.5% — this is the worst result for all period of observation. According to reports of 55 companies, only one among them had positive profitability.

The tendency, which was revealed after the analysis of results of the first 11 companies, was confirmed. For the majority of them the negative results of pension savings management in 2008 consumed the positive profitability of the previous years. Only 17 companies reported positive profitability for the last three years.

Despite obvious problems of the pension system, the reaction of business associations to the proposal of the Ministry of Finance of RF and the Ministry of Health of RF to substitute CST by insurance contributions was quite negative. According to the opinion of Russian Union of Industrialists and Entrepreneurs the proposal of the Ministry of Finance to reform CST will increase employers expenses by 1.1 trillion roubles (by 40%) compared to current rates. Because of the financial crisis, these initiatives will be delayed and will not be introduced in 2010.

The significant reduction of tax burden for some industries is not expected either. The exception will be made only for oil companies. The contributions of oil and gas companies make up the lion's share of RF budget revenues. Moreover, tax proceeds from this industry are the major source of non-budgetary funds of RF. Recently, the Russian budget revenues from oil and gas started to decline rapidly. As a result, the budget deficit in 2009 might amount to 4 trillion roubles.

To support Russian oil companies, the government traditionally uses tax regulations to considerable extent. The competition for tax concessions for oil companies started last autumn in rather complicated situation.

Recall that Russian budget get oil and gas money contributions predominantly from two sources: NDPI (mineral extraction tax) and export duties for oil. Because of the crisis some problems with the latter began. *The declining prices for the energy resources caused negative effect – so called “Kudrin’s scissors* (delayed revisions of high oil export duties following sharp reductions in oil prices). Consequently, many Russian companies exporting oil suffered losses. Small oil companies suffered the most severe negative impact, as they operate the hardest oil deposits with low level of profitability. Yet, “Kudrin’s scissors” also had negative consequences for major Russian oil companies.

With the aim in mind to set oil export duties adequate to the conjuncture at the market, *oil companies lobbied for shorter periods of monitoring*. Until autumn, monitoring was conducted once in two month, and oil companies insisted on conducting monitoring once a month or once in two weeks. The project was lobbied by Igor Setshin.

The main opponent of oil companies’ initiative is Alexei Kudrin, supervising budget policy in the Government. The head of the Ministry of Finance perceives Setshin’s initiative as a threat for budget revenues.

Igor Setshin won two vice-premier’s contest. His victory became evident after the so-called “Anti-crisis Plan of the Government” was presented in November last year. The plan contained provisions for the change of oil prices monitoring periods’ duration.

Yet, oil lobbyists have continued their activity. In the beginning of 2009, Russian oil companies suggested supporting their industry with additional tax concessions. A week before the governmental conference on the issues of the oil industry development, the head of “LUKOIL” Vagit Alekperov declared in his interview for the Wall Street Journal that the industry needed at least \$10 billion in tax breaks this year to reverse the declining production.

Moreover, the top manager said that “LUKOIL” had to delay modernization of two oil refineries – in Perm and Volgograd and also the development of gas field in the Caspian region.

“LUKOIL” is the biggest private oil company in Russia. Its core business is: exploration and extraction of oil and gas, production and sales of oil products. LUKOIL is the second company in the world according to its drilled proved reserves of hydrocarbons. The share of LUKOIL in global oil reserves is about

1.3%, and in global oil production – 2.3%. The company plays a key role in the Russian energy sector: its share of oil production is 18.6%, and in oil processing – 18.1%. LUKOIL owns big oil refineries both in Russia and abroad.

With the purpose to decrease tax burden on the industry Vagit Alekperov proposed to substitute NDPI for oil by the “excess profit tax” (if oil company profit decreases, the tax significantly decreases too). Zeroing of custom duties was also proposed. Since January 1, 2009 the export duty for crude oil was \$119.1 per ton, for light oil products – \$92.6, for black – \$49.9. Since February 1 it was decreased to \$100.9. Yet, taking into account the fact that the average price per barrel for the period from January 15 to February 1 was \$43.103 – oil export duty was increased for the first time since October of the previous year. According to preliminary monitoring data, it was over \$114 per ton.

Alekperov’s initiatives were supported by other oil companies and were actively propagated in friendly mass media.

Despite information pressure, the government supported oil companies’ proposals only partially. Specifically, the Cabinet of Minister recommended advancing the proposal to substitute NDPI by “excess profit tax”.

Two initiatives among the approved are worth mentioning.

The first one is to introduce NDPI tax holidays for the development of oil and gas deposits in Eastern Siberia, Caspian region, Arctic shelf, Yamal and the Nenets Autonomous District.

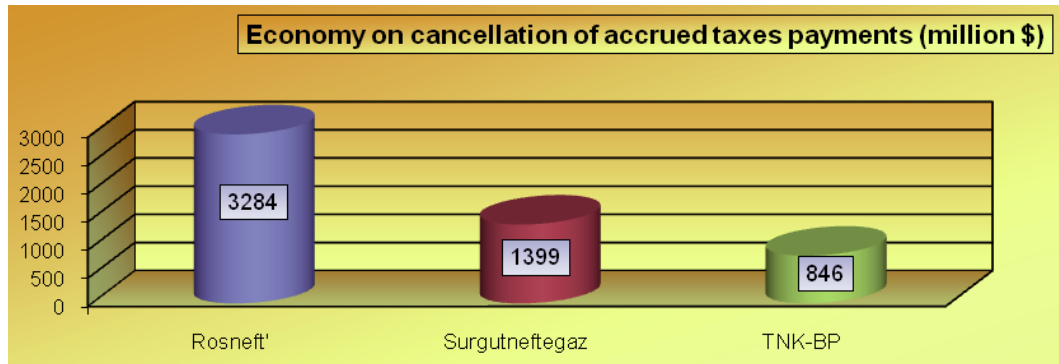
The second was the decision to zero custom duties for Eastern Siberian deposits. Formally this decision will be beneficial in the first place for “SurgutNefteGaz” and TNK-BP. Yet, it will also help “Rosneft”, which is developing in Eastern Siberia Vankor deposit and also owns licenses for deposits in the Urubchen-Tokhomo Zone and has 26% share of Verkhnechonskoye field.

This RF Government’s decision will also support “SurgutNefteGaz”, which is developing Talakan deposit and some additional licensed parcels in Yakutia.

The JSC “SurgutNefteGaz” is also one of the biggest Russian oil companies. Its activities comprise exploration, development and operation of oil and gas deposits, production and sales of oil and gas, production and sales of oil products and petrochemicals. It conducts geological prospecting and extraction of oil and gas in the Khanty-Mansisk and the Yamal-Nenets autonomous areas. According to an independent expertise on international standards, oil and gas productive capacity of JSC “SurgutNefteGaz” is about 2.5 billion tons of oil equivalent. The company’s share in Russian oil industry increased from 11% to 13% during the last several years.

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According to preliminary data, zeroing of custom duties will help “Rosneft” to save \$3.3 billion after tax in 2010-2013, “SurgutNefteGaz” will save \$1.4 billion and TNK-BP — \$0.8 estimated assuming that Urals oil price will be \$60 per barrel.



Yet this savings are only nominal, as “Rosneft” and “SurgutNefteGaz” do not plan serious investment in Eastern Siberia in the situation of the economic crisis.

Additionally, the return on investment into Eastern mineral deposits will appear only in 2-3 years, especially in the case of the favourable change of conjuncture at raw materials market.

Some advantage could be obtained from alignment of the duties for light- and dark-oil products. The companies with higher rate of oil refining will profit from this decision. Yet, the majority of oil companies are freezing the construction of new and reconstruction of the existing oil refineries, the only exception is “Rosneft”.