

RUSSIAN ECONOMY: TRENDS AND PERSPECTIVES
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May of 2007: political and economic outcomes

The key events of the month took place in the sphere of foreign policy. The summit Russia – EU held in Samara on May 18 not only failed to bring any positive results for the Russian authorities, moreover, it resulted in an escalation of claims the European partners put forward with respect of Russia. Poland refused to remove its veto on the launch of negotiations concerning the new agreement on partnership and cooperation between Russia and the European Union, since Russia still has in place the ban on the import of Polish meat. An attempt to “sit European countries out” failed, similarly to the hopes that other EU member countries could somehow influence Poland, which did not come true. Moreover, Estonia and Lithuania declared that they were ready to join the veto put by Poland. As a result, V. Putin stated that he hoped to “depoliticize” the issue of Poland’s meat imports and instructed his subordinates to settle this problem at the level of ministries. There were also voiced concerns with respect to the export customs duties on unprocessed logs and maintenance of economic embargo against Georgia. As a result, in fact for the first time since the time the respective protocol was signed in 2004, hints were in the air that EU could revoke its agreement with Russia’s accession to the WTO (these rumors were made public by some Polish officials).

However, Russia encountered even more serious troubles in the sphere of its home policy. In fact, prior to the summit and at the summit officials from EU and EU member states (for instance, A. Merkel, the Chancellor of Germany, J. Barroso, the President of the European Commission and some others) openly spoke in defense of the Russian out-of-parliament opposition, what they had refrained from earlier. Yet prior to the summit, Germany had brought up the issue of permission to hold the “The Dissenters' March” in Samara on the same day as it was planned by the Other Russia coalition. As a result, such permission was granted. It should be noted that only several hundreds of people took part in the march and it could not have become an important event, but for that G. Kasparov, E. Limonov and a group of their supporters were held at the Sheremetyevo airport and their departure for Samara was blocked under the pretext that their air tickets were allegedly counterfeit. This incident was also criticized by A. Merkel and J. Barroso, whereas V. Putin had to give explanations at the press conference, also for the first time, and say that he was not against marches as a “marginal venues hold in all countries.” Therefore, the plans of initiators of this march came true as the Russian authorities demonstrated that they were not absolutely sovereign after all as they wished to position themselves.

Yet another bad news came from the United Kingdom, where the British prosecutor’s office brought charges against A. Lugovoi, a former FSB officer, who allegedly murdered by poisoning A. Litvinenko, a political emigrant, on the basis of evidence that A. Lugovoi had a meeting with A. Litvinenko and left a radioactive track at the places he visited. Although in formal terms this allegation does not concern the Russian authorities, it is apparent that these charges cast an imputation primarily not on A. Lugovoi as an individual (he could hardly get his hands on radioactive materials), but on the reputation of Russian leaders. This version was voiced, among others, by A. Litvinenko himself at the time after the poisoning.

However, it would be wrong to discuss exceptionally failures of the Russian authorities. In May, Gazprom and the Byelorussian Property Committee made a sale and purchase contract with respect to shares in the public joint stock company Beltransgaz. In accordance with the terms and conditions of this agreement, the public joint stock company Gazprom should purchase 50 per cent of shares in Beltransgaz for US \$ 2.5 billion. The purchased shares should be paid for in four equal installments over the period from 2007 till 2010. At each stage, Gazprom should acquire 12.5 per cent of shares in Beltransgaz. Until the transaction is completed, the shares in Beltransgaz due to be sold to Gazprom should not be sold, encumbered or pledged to any third party. Gazprom and the Byelorussian Government also signed a supplement to the protocol of December 31, 2006, concerning the issue of creation of a joint Byelorussian – Russian natural gas transportation organization and on delivery of natural gas, as well as the transit thereof via the territory of Byelorussia. The supplement to the protocol envisages, among other things, a time phased (in 2008 through 2010) raising of the level of the wholesale markup on the price of natural gas sold by the public joint stock company Beltransgaz to end customers in the Republic, as well as an obligation of the Byelorussian party not to introduce a special state right (golden share) with respect to the participation in the management of the public joint stock company Beltransgaz. Therefore, the Lukashenko regime, which is in the situation of international isolation and which depends on Russia more than Russia depends on it (only 20 per cent of the total exports of Russian natural gas are transported via the Byelorussian territory) showed white flag and accepted two conditions put forward by Russia: a time phased raise of natural gas prices and the acquisition of at least 50 per cent of shares in the natural gas transportation system of the Republic of Belarus.

In May, there were observed certain events related to the most popular topic of the modern Russian policies – the “succession” problem. As a result, the political weight of S. Ivanov increased. Mr. S. Ivanov, the first deputy Prime Minister, gave a large press conference in the course of which he answered questions of journalists for more than 2 hours. The conference was dedicated to the topic of “Industrial development of Russia.” However, the questions asked at the conference concerned a much more broad range of issues; in this respect, it was comparable with the annual speeches delivered by V. Putin, or the March press conference given by D. Medvedev. Among other interesting things said by S. Ivanov there should be specially mentioned the following: the praise of Russia’s accession to the WTO and his confidence that negotiations should be successfully completed soon, his words that Russia was de facto already integrated with the EU (“We are the third partner of the European Union after the USA and China in terms of the amount of trade turnover”), the insistence that there was the necessity of symmetric actions on the part of countries participating in the Treaty on Conventional Armed Forces in Europe (CEF) (i.e. the moratorium on the compliance with this treaty should be introduced until other countries ratify it), that Russia was not ready to cooperate with the USA in the sphere of the anti-ballistic missile defense program; however, according to S. Ivanov, “Russia is ready to develop its cooperation with partners of the US “in many spheres.” Mr. Ivanov also criticized the Organization for Security and Cooperation in Europe (OSCE) – according to S. Ivanov this organization focused on the monitoring of the situation with democracy in the CIS member countries (perhaps, monitoring should be carried out at some other places). As concerned the declared topic of the conference, S. Ivanov stated that he bears a heavy burden of responsibility for “very important spheres.” The first deputy Prime Minister reminded that “I supervise 26 federal target programs, on which 1 trillion 314 billion 33 million rubles are spent a year.” Among the priorities of Russia’s industrial development, S. Ivanov named aircraft and shipbuilding industries, construction of roads, scientific centers, and an increase in energy capacities. According to S. Ivanov, these problems could be settled via creation of “large holdings,” whereas the goal of a twofold raise in GDP could be “attained in 2011 if not yet in 2010.”

As concerns D. Medvedev, in May he practically disappeared from the state television channels and during one week of this month there were absolutely no news about his activities. However, this fact may be explained not only by the apparent decline in his political influence, but also the total disappearance of the issue of “national projects” from the ideological arsenal on the whole due to the apparent problems encountered in the course of their implementation and PR activity concerning these projects. In May, S. Chemezov, the head of the Rosoboronexport and a personal friend of V. Putin publicly stated that he lacked presidential ambitions and was not going to seek a place in the Russian leadership. Of course, this statement does not mean anything in itself; however, it reflects a certain trend.

In May, the idea and supporters of the third term in office for V. Putin suffered yet another blow. The consistent advocate of the third term idea, S. Mironov, the Chairman of the Federation Council and the Just Russia party, in fact disavowed his statements made two months and two weeks earlier saying that “...we will take no decisions concerning the third term. The President has said that this issue is out of question” (just some time earlier S. Mironov was sending letters to regional parliaments asking to approve his initiative and assured that support for this initiative was growing day by day). In fact, the head of the alternative party had publicly brought shame on himself by renouncing of his declared and in a certain sense electoral idea. Therefore, there is a risk that in the course of the election campaign he also might be guided not by the interests of his organization, but by commands from above. As concerns the third term itself, similarly to the situation with Mr. Chemezov these developments only indicate the respective trend. The arguments put forward by the ruling group in support of the third term in office for V. Putin are rather serious and it is highly probable that this theme will be reanimated in January or February of this year.

The RF State Duma has adopted the draft budget for years 2008 through 2010 in the first reading. The development of the draft of a three year federal budget should be welcomed, since it significantly increases the predictability and stability of the state policy fixed by the budget. The concept of the budget and its key parameters (revenues, expenditures and budget surplus) envisages that revenues should make Rub. 6.64 trillion and expenditures should amount to Rub. 6.57 trillion. It is planned that in 2009 and 2010 revenues and expenditures will be practically equal making Rub. 7.4 trillion and Rub. 8 trillion respectively (however, all Duma deputy groups require to raise social and infrastructure expenditures on the eve of the near parliamentary elections).

It is expected that in the situation of declining prices of hydrocarbons revenues of the federal budget will decrease from 23.2 per cent of GDP in 2006 and estimated 22.3 per cent of GDP in 2007 to 19.0 per cent in 2008, 18.8 per cent in 2009 and 18.1 per cent of GDP in 2010. However, whereas the decline in revenues of the budget should make 14.8 per cent (in terms of their share of GDP) expenditures borne by the budget will

not be reduced and even grow significantly – up to 18.8 per cent of GDP in 2008 and 18.1 per cent of GDP in 2010. In 2009 and 2010 the budget surplus is planned to be at zero.

The priorities of the budget for years 2008 through 2010 are as follows: expenditures for social policy (a growth by 74 per cent) and transfers to extra-budgetary funds, primarily, the RF Pension Fund (an increase by 73.6 per cent). These indicators apparently reflect the priority of the election campaign for the ruling group. Expenditures for defense and law enforcement agencies grew in proportion to the general increase in the budget expenditures; at the same time, expenditures for health care and education will grow much below the average level of increase. It is expected that “national projects” will be gradually returned to the budget. Given the election nature of the budget, it is surprising that the project most close to failure, “Affordable housing,” is planned for continuation.

It is estimated that the amount of the domestic debt should increase two times: up to Rub. 2.8 trillion in 2010.

Therefore, it may be stated that a conservative budget policy, of which the RF Government was justly proud of, was significantly fractured. In fact, the approved draft budget abandons the principle of maintaining of a budget surplus that leading to a growth in state expenditures simultaneously with an escalation of borrowings. An even more alarming signal to the supporters of the course pursued by the RF Government was sent in the May statement of V. Putin, who said that the financial resources of the RF Stabilization Fund should be spent for purchase of shares in Russian companies. Although the RF Government pretends not to hear this statement (and the Presidential Administration refrains from reminding about it), it demonstrates the level of “political correctness” of the Russia’s leadership.

The Russian Parliament has approved the constitutional law concerning the creation of an investigative committee under the office of the RF Prosecutor General. A Presidential Ambassador A. Kotenkov stated that this law was initiated personally by V. Putin in spite of protests voiced by officials of the RF Prosecutor General office. Investigation should be vested with a special separate body under the RF Prosecutor General office – the Investigative Committee. This Investigative Committee should be headed by a Chairperson with the status of the first deputy Prosecutor General; however, this official will not be subordinated to the Prosecutor General. The head of the Committee should be appointed by the RF Federation Council and nominated by the RF President, whereas deputy Chairpersons should be appointed by the RF President and nominated by the Chairperson of the Investigative Committee. The RF Prosecutor General will delegate to the head of the Committee the powers related to the initiation of criminal cases against persons having immunities (Prosecutor General, State Duma deputies, senators, judges, former Presidents, candidates running for the office of the President, members of the Central Election Commission, the Chairperson of the Audit Chamber). In fact, amendments create a “super Prosecutor General office within the Prosecutor General office” subordinated to V. Putin personally, what reflects his apprehensions that the present personal composition of the RF Prosecutor General office still may pursue interests of some other person than the President in spite of the last year purge. As a “consolation prize” there was introduced the amendment making it not necessary for officials of the Prosecutor General office to have a record of work at prosecutor offices of lower levels. The main thing required of the hierarchy of prosecutors is to follow right orders. It should be noted that this idea has nothing in common with the proposal put forward earlier by D. Kozak that investigation should be separated from and be independent of the prosecution; the prosecutor offices should have retained only supervision functions and the function of representation of prosecution in courts. However, the new law retains investigative committees under the Ministry of Interior, the Federal Security Service, and the Russian State Committee for Control over the Illegal Trafficking of Narcotics and Psychotropic Substances (Gosnarkontrol).

In May, M. Fradkov, the RF Prime Minister, appointed one of his key aids V. Milovidov, who had already had an experience of top administrative work at the former Federal Commission for Securities Markets (FCSM), at the post of the Chairman of the Federal Financial Markets Service (FFMS). According to the official report, the former head of the Commission, O. Vyugin, who was close to A. Kudrin, the RF Finance Minister, voluntary resigned in order to work in the private sector. Therefore, there should be noted a certain increase in the influence of the Prime Minister.

In May there were appointed two new heads of Russia’s regions. There was registered the first instance of resignation of a Governor appointed by the RF President due to the “loss of trust” on the part of V. Putin. It was L. Korotkov, the head of the Amur oblast, reappointed by the RF President at this office two years earlier. Mr. Korotkov could not withstand the consolidated pressure of the prosecutor office, the United Russia party (he was not a member of this organization), and, judging by the nomination of his successor, the forces interested in the office he had hold (the office of the Amur oblast Governor was taken by having nothing to do with this region N. Kolesov, a creature and former townsman from Tatarstan of K. Iskhakov, the RF

President's Ambassador in the Far East Federal Okrug). At the same time, A. Kuzmitsky, a resident of St. Petersburg, was appointed as the Governor of Kamchatka. Therefore, there becomes noticeable a trend from the earlier practices of reappointment of current Governors towards the distribution of this office in the feudal ownership of persons personally close to V. Putin or his entourage.

S. Zhavoronkov

Budgetary and Tax Policy

According to the tentative performance of the budget as of January-April 2007, the level of revenue of the RF federal budget made 21 per cent of GDP; the expenditures accounted to 15.1 per cent of GDP, budget surplus has come up to 5.9 per cent per cent of GDP. Within January - March of 2007 the RF consolidated budget revenues made 32.7 per cent of GDP, consolidated budget expenditures made 22.4 per cent of GDP, and consolidated budget surplus accounted to 10.3 per cent of GDP. As of May 1, 2007 the volume of financial reserves of the RF Stabilization Fund made RUR 2 290.5 billion, as compared with RUR 2 812.2 bln on April 1, what makes 10.6 per cent and 10.4 per cent of annual GDP accordingly.

The most noteworthy developments in the budget sphere at the end of April-May 2007 were a draft Law "On the federal budget for 2008 and for the period to 2010", presented to the State Duma, the letter of the RF President to the Federal Assembly of the Russian Federation and the amendments, introduced by the State Duma to the Law "On the federal budget for 2007" in regard to revenues generated from "NK YUKOS".

The State of the Federal Budget

The dynamics of basic parameters of the RF federal budget in 2005-2007 is presented in *Table 1*. According to the tentative estimates of the federal budget execution on cash basis, made by the RF Ministry of Finance, in January-April 2007 the federal budget was executed in terms of revenue in the amount of RUR 1 925,5 млрд. руб. (21 per cent of GDP), in terms of expenditures – in the amount of RUR 1 386.5 bln (15.1 per cent of GDP). The budget surplus made RUR 539.1 bln.(5.9 per cent of GDP). It should be noted that the amount of revenues and expenditures of the federal budget within the period under review in absolute terms were somewhat higher than the respective indicators of the relevant period of preceding year (revenues - RUR 1 875.6 billion, expenditures – 1 189.1 billion). Nevertheless, in regard to GDP the indicators have declined (25.4 per cent and 16.1 per cent of GDP accordingly). It should be noted, that the budget surplus has decreased in both, absolute terms and in regard to GDP share versus the indicators of preceding year (RUR 686.3 billion, i.e. 9.3 per cent of GDP).

Table 1.

Basic Parameters of the RF Federal Budget in 2005 – 2007 (% versus GDP)

	2005	April 2006	2006	April 2007
Revenues	23,7%	25,4%	23,5%	21,0%
Expenditures	16,2%	16,1%	16,2%	15,1%
Deficit (-)/ Surplus (+)	7,5%	9,3%	7,4%	5,9%

Source: RF Ministry of Finance, IET estimates

Table 2.

**Amount of Revenues to the RF Federal Budget in 2005-2007 гг.
(per cent of GDP in terms of cash basis execution)**

	2005	April 2006	2006	April 2007
Taxes and other payments administered by the Federal Tax Service	12,33%	12,90%	11,27%	10,19%
Taxes and other payments administered by the Federal Customs Service	9,73%	11,33%	10,76%	9,82%
Receipts administered by the Federal Agency for Management of Federal Property	0,27%	0,20%	0,26%	0,13%
Revenues of the federal budget administered by other federal structures	1,35%	0,96%	1,25%	0,88%
Total revenues	23,67%	25,39%	23,54%	21,02%

Source: RF Ministry of Finance, IET estimates

The structure of tax revenues to the federal budget for the period under review as broken by individual federal administrative bodies is presented in *Table 2*.

As one can see from the data, presented in the Table, in the first four months of 2007 the volume of tax and other revenues as broken down by individual administrative bodies has decreased in comparison with the data registered in the same period of preceding year. Tax revenues, administered by the RF Federal Customs Service, made 10.19 per cent of GDP, what is nearly 2.7 lower than relevant indicators of January-April of 2006. The share of revenues administered by the RF Federal Customs Service, accounted to 9.82 per cent of GDP, (11.33 per cent of GDP in 2006, i.e., the decline made over 1.5 per cent). The scope of revenues, administered by other Federal Agencies, as of the results of the first four months of 2007 also demonstrated some decrease (by 0.08 per cent of GDP) and made 0.88 per cent of GDP as compared with the relevant indicators of previous year and accounted to 0.88 per cent of GDP (0.96 per cent of GDP in 2006).

For more detailed analysis of the above mentioned tendencies there required the data, published by the RF Treasury. Though the data is available only for the first quarter (i.e., one month less than the data, published by the RF Ministry of Finance), the tendencies of preliminary data for the first quarter are much the same as observed in the first four months of 2007. (See *Table 3*) The utmost decline in terms of GDP share in the first quarter of 2007 was observed in the following revenue sources: import customs duties (-2,1 per cent of GDP), VAT for the goods, sold on the RF territory (-2 per cent), tax on profit of enterprises (-1,6 per cent). It should be noted, that those taxes totaled over 58 per cent of the gross revenues of the federal budget for January-March 2007. The highest growth in terms of GDP share was observed in the following budget lines: VAT on the goods, imported to the RF territory (+0.41 per cent) and import customs duties (+0.15 per cent). The share of those taxes in the total amount of federal budget revenues has reached somewhat less than 19 per cent as per budget execution results within the first three months of 2007. As concerns other budget lines, the changes were insignificant (within 0.1 per cent of GDP). The above changes in the budget revenues, broken down by the types of taxes and duties, have resulted in the decline of the federal budget revenues versus GDP level both, for the first quarter and for the first four months of 2007.

Table 3.

**Amounts of Revenues of the RF Federal Budget (by Basic Lines) within 2005-2007
(in per cent of GDP)**

	2005	March 2006	2006	March 2007
TOTAL BUDGET REVENUES	23,72%	26,62%	23,58%	20,95%
1. Enterprise Profit Tax	1,75%	1,86%	1,92%	1,76%
2. Unified Social Tax	1,24%	1,19%	1,19%	1,21%
3. Taxes for Goods and Services, imported to the RF Territory	5,16%	5,54%	3,82%	3,41%
3.1. VAT	4,75%	5,12%	3,47%	3,08%
3.2. Excises on taxable goods	0,41%	0,42%	0,35%	0,33%
4. Taxes for Goods and Services, imported to the RF Territory	2,15%	2,21%	2,27%	2,62%
4.1. VAT	2,07%	2,13%	2,20%	2,54%
4.2. Excises on taxable goods	0,08%	0,08%	0,06%	0,08%
5. Severance taxes	3,95%	4,85%	4,11%	3,27%
6. Import tax duties	1,25%	1,27%	1,28%	1,42%
7. Export tax duties	6,25%	7,98%	7,12%	5,86%

Source: RF Treasury, IET estimates.

The preliminary data, estimated by the RF Ministry of Finance on financing of Federal Budget expenditures in January-April of 2007 are presented in *Table 4*.

As one can see from Table 4, there was observed high volatility of total funding, depending on the period under review. Thus, as of the year results of 2006 the expenditures amounted to about 16.4 per cent of GDP, within January-April 2007, they increased to 23.7 per cent of GDP. However, there has been a decline of funded expenditures as compared with the relevant indicator of the preceding year (25.5 per cent of GDP as of the end of April 2006).

Comparison of the structure of expenditures as broken down by sectors within January-April of 2007 with the relevant indicators of preceding year, the changes were variable. The utmost downgrading (in terms of GDP share) was observed in the following budget lines: Interbudgetary transfers (-1.48 per cent), Federal issues (-0.38 per cent), National defense (-0.13 per cent) and Social policy (-0.13 per cent). The share of expenses for those budget lines made 67.9 per cent in the total expenses of the federal budget within the first four months of 2007. The utmost growth (in terms of GDP share) was observed in such budget lines as National Economy (+0.18 per cent), Education (+0.11 per cent) and Housing and public utilities (+0.10 per

cent). Expenditures under those three budget lines have accounted to 13.7 per cent of the total expenses on the federal budget. In other budget lines there were no significant changes (less than 0.1 per cent in GDP). The above changes in expenditures by sectors of the federal budget have reduced the share of total expenditures in the GDP for January-April 2007

Table 4.

Financing of the RF Federal Budget in 2005-2007 (in per cent of GDP)

	2005	April 2006	2006	April 2007
Federal issues	2,58%	3,29%	2,19%	2,91%
Including expenditures associated with the servicing of federal and municipal debt	1,06%	1,20%	0,65%	0,77%
National defense	2,71%	4,05%	2,57%	3,92%
National security and law enforcement	2,05%	3,21%	2,08%	3,28%
National Economy	1,17%	1,55%	1,31%	1,73%
Housing and public utilities	0,04%	0,22%	0,20%	0,32%
Environmental protection	0,02%	0,04%	0,03%	0,03%
Education	0,73%	1,09%	0,78%	1,20%
Culture, cinematography and mass media	0,22%	0,28%	0,21%	0,28%
Health care and sports	0,42%	0,83%	0,56%	0,76%
Social policy	0,88%	1,32%	0,81%	1,19%
Interbudgetary transfers	5,77%	9,58%	5,68%	8,10%
Total expenditures	16,58%	25,45%	16,40%	23,73%

Source: RF Ministry of Finance, IET estimates

The basic reason of reduction of the share of expenditures and revenues of the federal budget in GDP in January-April of 2007 versus the relevant period of 2006 is explained by accelerated growth of GDP. The GDP growth (as compared with the growth of GDP in January-April of 2006) is based on three factors. First, abnormally warm winter allowed to continue construction works. Secondly, in early 2007, there were observed increased investment and consumer activities. Third, the significant role played by the tax base effect (at the beginning of 2006 the rates of GDP growth were rather slow)¹.

There can be highlighted several reasons for the growth rates of the federal budget revenues were not as high as the rates of Russian economy in the first four months of 2007:

1) the federal budget revenues are highly dependant on proceeds from commodity economy (about a half of the federal budget proceeds were made by export duties and tax on extraction of mineral resources). The volume of industrial production in the first quarter of 2007 has exceeded the same indicator of the relevant period of 2006 (by 8.4 per cent). Apparently, the volume of mineral extraction could not grow at the same rates. The slower growth rates of commodity sector have resulted in decrease of the share of export customs duties and tax on mineral extraction tax in GDP.

2) it should be also mentioned that oil prices have been reduced in the first months of 2007 as compared with the relevant period of 2006 (See Table 5).

Table 5.

Oil Prices in the First Quarter of 2006 and 2007

Average prices for Urals oil, USD per barrel ²	2006	2007
January	59,18	49,79
February	56,37	53,73
March	57,53	58,69

¹ GDP in the first quarter of 2007 was by 7.9 % higher than in the first quarter of 2006, the corresponding indicator for the relevant period of 2006 made accordingly 4.6 % and 5 % in 2005.

² The above prices are used for tax purposes

3) One of the basic reasons for reduction of the share of VAT proceeds to the federal budget in terms of VAT for goods and services, provided on the RF territory. It could be explained to some extent by the transfer to the notification procedure of VAT refund to exporters, introduced from January 1, 2007. As a result, the procedure of VAT refund has been considerably accelerated. Under the former VAT refund procedure, in the first quarter of 2007 the refund would be provided to the taxpayers, who made export operations in 2006, and the majority of taxpayers, who exported their goods or services in the first quarter of 2007 (or even in 2006), would have obtained the refund later.. With the new VAT refund procedure the majority of taxpayers of both categories have been refunded in the first quarter of 2007, which resulted in a decrease of that tax proceeds.

In May the RF Treasury has published the information on the execution of the RF consolidated budget and non-budgetary public funds for the first quarter of 2007. As per results of January-March of 2007, the expenditures and revenues of the RF consolidated budget accounted to 32.7 per cent and 22.4 per cent of GDP accordingly. According to *Table 6*, one can see that those indicators are much lower than the relevant indicators of 2006 (37.9 per cent and 24.2 per cent of GDP accordingly). The surplus of the RF consolidated budget in January-March of 2007 made 10.3 per cent of GDP, what is also lower than the indicator of 2006 (13.6 per cent of GDP). According to the RF Treasury information on the budget execution of the extended RF government for the first quarter of 2007, the volume of revenues made 37.3 per cent of GDP, expenditures – 25.8 per cent of GDP, while the surplus accounted to 11.4 per cent of GDP.

As of May 1, 2007 the volume of assets of the RF Stabilization Fund made RUR 2,920.5 bln, as opposed to RUR 2,812.2 bln on April 1, 2007, what makes 10.6 per cent and 10.4 per cent of GDP in annual terms accordingly.

Table 6.

**Execution of the RF Consolidated Budget in 2006 - 2007
(in per cent of GDP)**

2006												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes*	36,2	34,4	37,9	37,1	37,2	36,8	36,6	35,4	35,4	35,1	34,8	35,5
Revenues	17,6	21,0	24,2	25,4	24,7	25,5	25,3	25,1	24,8	24,7	25,1	27,8
Deficit/ Surplus	18,7	13,4	13,6	11,7	12,5	11,3	11,3	11,4	10,6	10,4	10,7	7,7
2007												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes*	30,9	29,6	32,7									
Revenues	14,2	19,0	22,4									
Deficit/ Surplus	16,7	10,6	10,3									

Source: RF Ministry of Finance, IET estimates

Major developments in the budgetary sphere.

On April 2007 the RF Government has presented to the State Duma the Draft Law “On the Federal Budget for 2008 and for the period up to 2010”. It has to be highlighted, that the budget is planned for three years for the first time in the Russian practice. It should be noted, that with all the advantages of the three-year budget planning, it is connected with certain difficulties. On the one hand, this new approach increases the predictability of budget policy, makes more distinct the three-year period commitments in terms of budget expenditures, but on the other hand, it requires greater accuracy of estimates and increased responsibility for any mistakes in planning.

Basic parameters of the budget draft, as well as the data on Federal budget execution for 2000-2007. (for 2007 г. – IET) are presented in *Table 7*.

Analyzing the data on the actual execution of the RF federal budget in 2000-2006 (See *Table 7*), one can highlight several major trends: first, a steady growth of federal budget revenues, which have upgraded within this period more than 1.5 times. Second, stabilization of the share of expenditures in the past three years at the level of 16per cent of GDP. Third, the rapidly growing surplus of federal budget: from 2002 to 2006 the amount of surplus increased 5.3-fold, having reached 7.5per cent of GDP; fourth, the continuing high dependence of the budget revenues from energy sources, which results in steady deficit of other than oil and gas proceeds.

Based on the data presented at the Table. 7, one can come to conclusion, that in the period of 2007-2010 dramatic changes can be expected in the above trends. In the first place, due to the anticipated decline in world oil and gas prices, slower growth rates in the production and export of hydrocarbons, as well as in view of the strengthening of the RUR against USD, there expected more than two-fold decline of the share of the federal budget oil and gas proceeds in terms of GDP, i.e., from 10.9 per cent in 2006 to 5.2 per cent in 2010.

Table 7.

Basic Parameters of the Federal Budget in 2000-2010 (in % of GDP)

	Actual data							Esti- mates	Budget draft		
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenues	15,5	17,8	20,3	19,5	20,1	23,7	23,6	20,3	19,0	18,8	18,1
Other than oil and gas proceeds	11,7	13,1	15,1	14,1	13,5	13,6	12,7	12,2	12,2	12,9	12,8
oil and gas pro-ceeds	3,8	4,7	5,2	5,4	6,6	10,1	10,9	8,1	6,8	5,9	5,2
Expenditures	14,2	14,8	18,9	17,8	15,8	16,3	16,1	18,3	18,8	18,8	18,1
Including oil and gas transfer	2,4	1,9	2,9	3,7	2,0	2,3	2,9	4,9	6,1	5,3	4,5
Saving oil and gas revenues	1,4	2,8	2,3	1,7	4,6	7,8	8,0	3,2	0,7	0,6	0,7
Balance of the RF federal budget, % in GDP	1,4	3,0	1,4	1,7	4,3	7,4	7,5	2,0	0,2	0,0	0,0
Non-oil and gas deficit	2,5	1,7	3,8	3,7	2,3	2,7	3,4	6,1	6,6	5,9	5,3

Source: RF Ministry of Finance, IET estimates

This reduction of oil and gas proceeds will not be adequately compensated by structural revenue growth. As a result, the reduction of budget revenues by 5.5 p.p. versus GDP in 2010 is expected as compared with 2006. At the same time, an explicit increase in the aggregate federal budget revenues in 2007-2010. Significant reduction of budget revenues in the background of increasing expenditures should lead, according to the Ministry of Finance estimates, to a zero balance of the budget already in 2009.

It should be noted that the growth of expenditures in 2008-2010, as well as amendments to the effective budget for 2007 are directly related to the initiatives, expressed by RF President V.V. Putin in his annual message to the Federal Assembly of Russian Federation on April 26, 2007 g.

Among the "new challenges", set forth by the President, the following ones should be highlighted: allocation of budget assets for creation of a special fund the reform of housing and public utilities in the amount of RUR 250 billion; allocation in 2007 from the Stabilization Fund RUR 300 billion for capitalization of development institutions, first of all, the Bank Development, Investment Fund, Russian Venture Company (having estimated further funding for this purpose); allocation of RUR 100 billion for roads and road network development (in the cities); allocation of RUR 130 billion for a special Russian corporation for development of nanotechnologies.

Another notable development in the public sector was the Law "On amendments to article 6 of the Federal Law "On the federal budget for 2007 (in regard to revenues derived from OAO NK YUKOS)" adopted by the State Duma on May 18. The Law stipulates that the total amount of arrears to the budgets of the Subjects of the Russian Federation, local government budgets and non-budgetary funds, should be mainstreamed in the federal budget.

The amount of "NK Yukos" liabilities on tax and non-tax payments to be credited to the budget system of the Russian Federation (according to the RF Federal Tax Service, declared in the case on bankruptcy) exceed RUR 400 billion. Proposals on utilization of those funds will be presented to the State Duma by the RF government upon after the actual crediting of the assets to the federal budget. According to A. Kudrin, the RF Minister of Finance, the funds, credited to the budget from NK Yukos, "can be addressed at formation of the Russian Corporation for nanotechnology development and for the reform of housing and public utilities.

O. Kirillov., A. Mamedov., V. Nazarov.

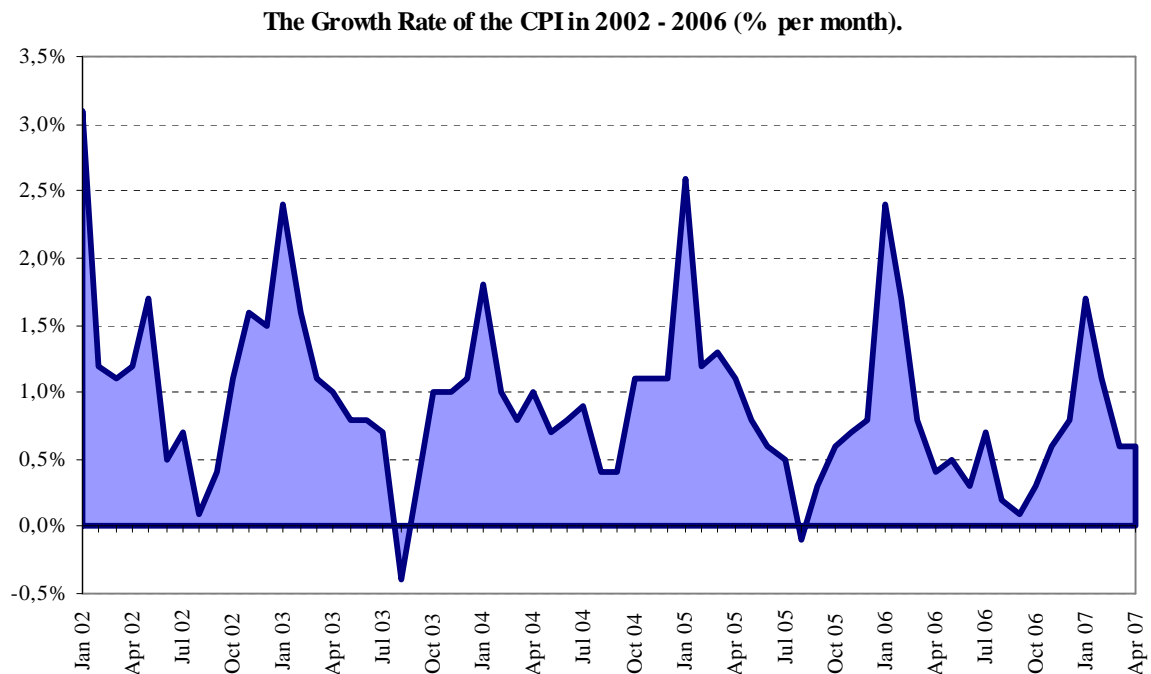
Monetary and Credit Policy

In April of the current year inflation in the RF (+ 0.6 per cent) was sustained as compared with both, March 2007 and the relevant period of preceding year (+ 0.4 per cent). There were observed the speedy growth of foreign currency and gold reserves in the country, which has reached the volume of USD 394.3 bln and +4.5 per cent in terms of monetary base. The RF Central Bank has responded to the rapid growth of monetary supply with the increased standards of mandatory reserves 0.5-1 p.p. depending on their commitments.

In April consumer price index has made 0.6 per cent (against 0.4 per cent in April 2006; see Fig. 1). Like in March, the utmost input in consumer prices growth in April was made by food stuffs. Their prices have been increased by 0.8 per cent on average country-wide (as opposed to + 0.3 per cent in April of 2006). It should be noted that the rate of food stuffs price growth in comparison with the previous year was based on the increased CPI in the current month, like in April 2006. The utmost growth of price was observed for vegetable and fruit products (+ 3.1 per cent against + 0.3 per cent in April of 2006), grits and beans (+ 0.1 per cent against + 2.1 per cent in April of 2006), fish and sea food (+ 0.6 per cent against + 0.4 per cent in April of 2006). Some decrease in April was observed in prices for granulated sugar (- 0.7 per cent against - 7.4 per cent in April of 2006).

Upgrading of commercial public services in April reached 0.5 per cent (+ 0.6 per cent in April of 2006). The utmost growth was observed in regard to public transport (by 1.8 per cent), culture organizations (+ 1.6 per cent), health-care and resort services (+ 1.6 per cent) and public services (+ 1.4 per cent). Besides, there was no decrease in prices for housing facilities (-0.1 per cent) and communication services (-0.1 per cent).

Fig. 1



Source: RF Statistical Service

Non-food products have also grown in price in April; they have been raised by 0.4 per cent on average (+ 0.3 per cent in April of 2006). The growth of non-food products prices were caused mainly by the growth of prices for construction materials (+ 1.3 per cent) and footwear (+ 0.7 per cent). It should be mentioned, that in March there was observed some decrease for audio-and video products(- 0.4 per cent).

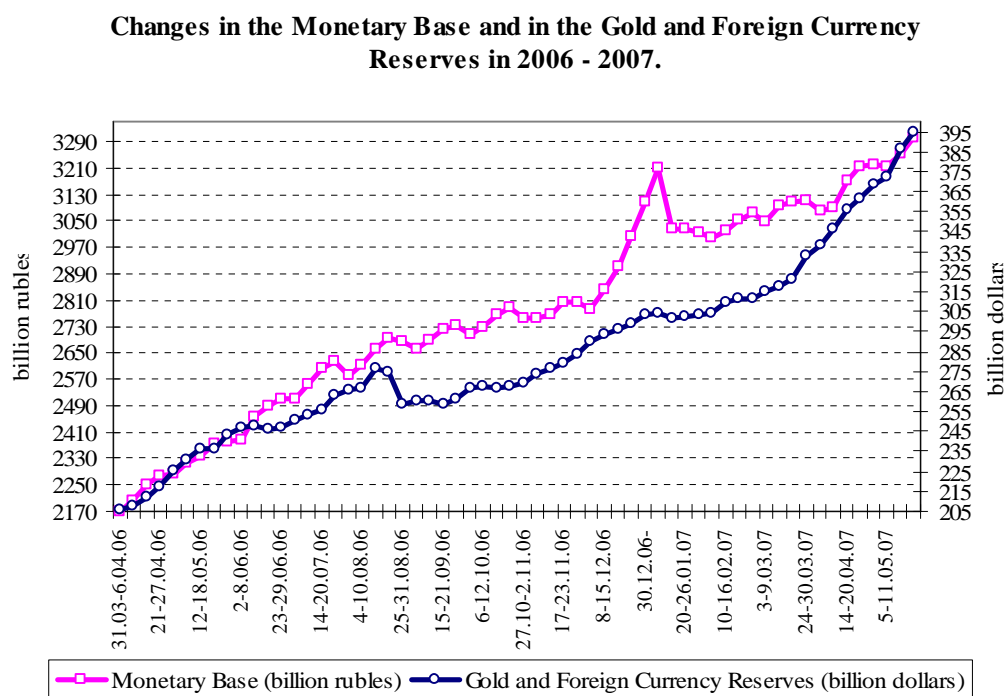
The basic consumer price index³ in April 2007 made 0.5 per cent (versus the relevant period of preceding year 0.4 per cent). According to the bulletin of approximation short-term estimates of the RF socio-economic indicators, published by IET, the CPI in May 2007 made 0.6 per cent.

The basic consumer price index growth⁴ in April 2007 made 0.5 per cent (versus the relevant period of preceding year 0.4 per cent). According to the bulletin of approximation short-term estimates of the RF socio-economic indicators, published by IET, the CPI in May 2007 made 0.6 per cent.

Within April 2007 the monetary base (in broad definition⁵) has been increased by RUR 385 bln, to RUR 4594,2 bln (plus 9.1 per cent). The volume of the monetary base in broad definition made RUR 4209.2 billion as of April 1, 2007. Let us consider the dynamics of the monetary base in broad definition by components.

The increased amount of cash in circulation in April of the current year (by 4.6 per cent) and mandatory reserve funds insignificant decrease (- 4.5 per cent) has led to the growth of monetary base in narrow definition (cash plus mandatory reserve funds)⁶ by 4.5 per cent (see Fig. 2). In this background gold and foreign exchange reserves of the RF Central Bank have grown by 7.7 per cent and made RUR 369.1 billion as of May 1. Within the first three weeks of May they have been further increased by 6.8 per cent and reached the amount of USD 394.3 billion. Such a rapid increase in reserves was primarily based on the large inflow of capital to the country as a result of IMF IPO. In such circumstances, the Bank of Russia, to avoid excessive RUR strengthening, purchases foreign currency, bought in the country thereby increasing the international reserve assets.

Fig.2.



Source: RF Central Bank

³ Basic index of consumer prices is an indicator of the inflation level without regard to seasonal price reduction (fruit and vegetable products) and to administrative measures (tariffs for government-regulated services, etc.). It is estimated by the RF Statistics Service

⁴ Basic index of consumer prices is an indicator of the inflation level without regard to seasonal price reduction (fruit and vegetable products) and to administrative measures (tariffs for government-regulated services, etc.). It is estimated by the RF Statistics Service

⁵ The RF monetary base in broad terms with no regard to the cash issued by the Bank of Russia and the balance of Compulsory Reserve Accounts on credit organizations in national currency, deposited in the Bank of Russia, taking into account the assets of correspondent accounts and bank deposits, allocated in the Bank of Russia.

⁶ We should remind, that the monetary basis in broad terms is not a monetary indicator, but an indicator of the Bank of Russia liabilities in national currency. The monetary base in narrow terms is a monetary indicator (one of the indicators of monetary supply), ultimately controlled by the Central Bank of Russia.

The major part of incoming liquidity has been accumulated in the RF Stabilization Fund, the volume of which has reached as of May 1 2007 RUR 2920.5 billion, or 20 per cent of GDP (plus 108.3 bln as compared with April 1, 2006). In comparison with the relevant period of the preceding year the volume of Stabilization Fund has grown by RUR 122.9 bln.

It should be noticed, that according to the IET RF published model short-term socio-economic forecasts, the volume of the accumulated of gold and foreign exchange reserves by the end of the year of 2007 should overcome the level of USD 370 billion.

According to the information of the Federal Treasury, payments under external debt in April of the current year have made USD 179.7 million. The amount of USD 145.6 million was addressed to repayment of the external debt and USD 34.1 million was paid for the services thereof. Herewith, USD 65.9 million was million was spent to cover the debt of Russia, USD 113.6 million for the World Bank and EBRD loans, USD 0.2 million for loans raised upon bonds

In late April, the RF Central Bank has published the second edition of a report on the structure and the results of gold and currency reserves management in the I-III quarters of 2006. According to the report for the first three quarters of 2006, the Bank's assets in Russia reserve currencies rose by USD 82.3 billion, including the interest income and revaluation of securities for 6.4 billion USD (8 per cent of total growth).

The Bank of Russia estimates the reserve foreign currency and operating and investment portfolios. The operating portfolio is designed to maintain a high level of liquidity reserve assets needed to accomplish the RF Central Bank functions for the monetary and exchange rate policies. The investment portfolio used to invest the money in less liquid, but higher risk assets. During the test period the operating assets portfolio grew by 35 per cent, and investment one -to 102.7 per cent. The investment portfolio has grown by was justified, because the volume of operating assets is corresponding to international standards.

Performance operating portfolios, as in the first half of 2006, was in all currencies lower income portfolio in the same currency. The report is based on the rise of interest rates in the first half of 2006, resulting in an investment portfolio, invested in long-term securities, which have demonstrated lower yields. However, we believe that this situation still shows some failures the management of in reserves.

Therefore, currently, under conditions of substantial inflow of foreign currency in the country, the interest rate is a negligible factor in the changes in the share of the gold and foreign currency reserves. However, in case of aggravation of the external economic environment and declined capital inflow to the country, the results of reserves management will definitely play a big role.

P. Trunin

Financial Markets ⁷

In May the situation in the Russian financial market was rather variable. On the one hand, the uncertainty in regard to further position of the USA IRS in terms of monetary and credit policy and further growth of the US economy has boosted up some growth of the US securities, which has stimulated some growth of the US securities, followed by the relevant dynamics of the Russian foreign currency bonds. However, extremely favorable situation with the liquidity in bank sphere was making for stabilization of the internal debt market and even some growth as of monthly results. The most problematic segment of the Russian financial markets was the securities market, where there was observed the withdrawal of assets within the whole month, resulted in considerable decrease of quotations. It is remarkable, that those developments were happening at the background of rather high oil prices and favorable dynamics of the leading stock indices.

Government securities market

As of May results, in the Russian foreign currency debt market there was observed some growth, largely due to the dynamics of the US debt market.

For example, earlier this month in the United States the information was published on some macroeconomic indicators, which did not adequately characterize the situation in the US economy. On the one hand, there were some problems in the real estate market, and on the other hand, the industrial sector proved the stability of economic growth. The US corporations also demonstrated rather high financial indicators. In this regard, at the meeting of the USA IRS, scheduled for May 9, the investors anticipated the sustained rate, so the fluctuations of quotations of the US debt have been limited, what has been reflected in the Russian Euro-

⁷ In the course of preparation of the survey, there were used analytical materials and surveys published by the Zenith Bank, investment company ATON, MICEX, and the materials presented at web sites of Russian issuing companies.

bonds segment. The investors' expectations have been reflected at the meetings of the US IRS, European and British Central Banks in the second week of May. In the United States and in Euro zone rates were left unchanged, while the British CB increased the rate by 0.25 p.p. These developments have not affected the dynamics of the US Treasury bonds and Russian Eurobonds, and their profitability staid within the achieved level.

Fig 1.

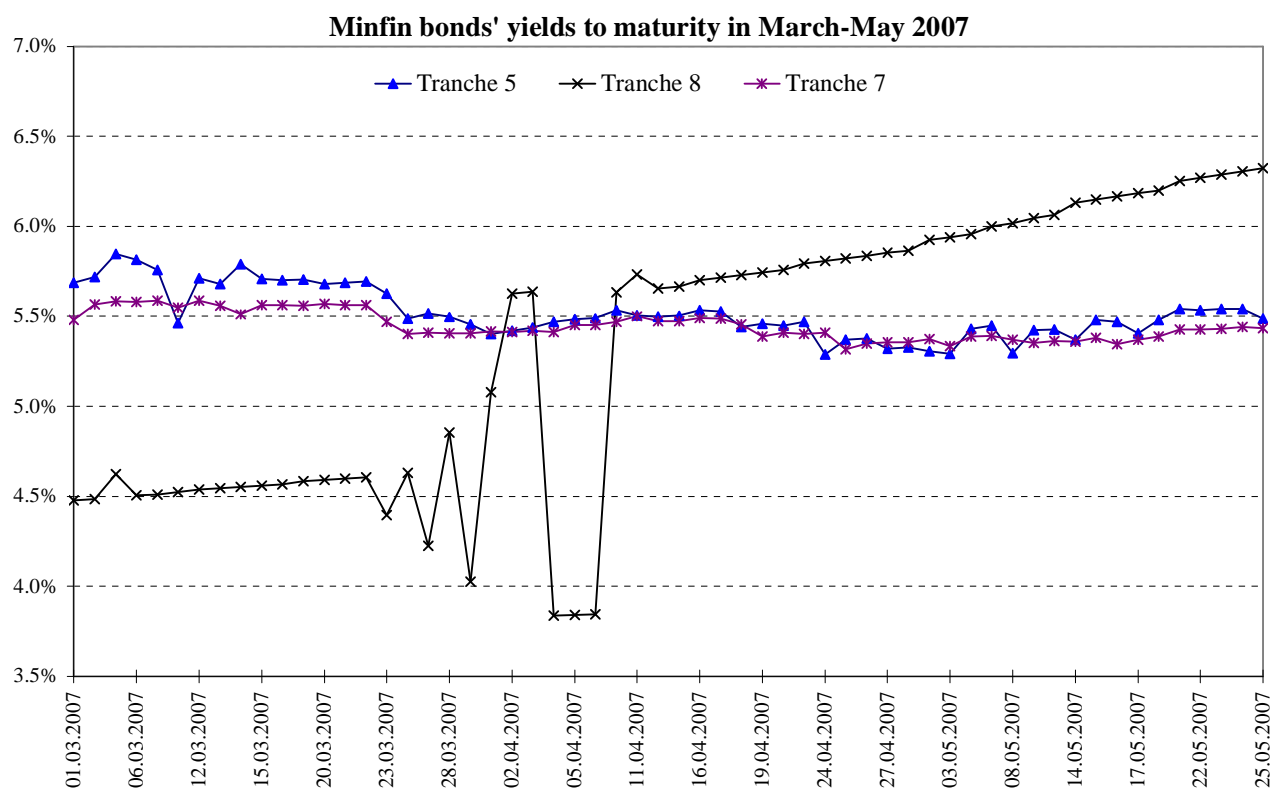
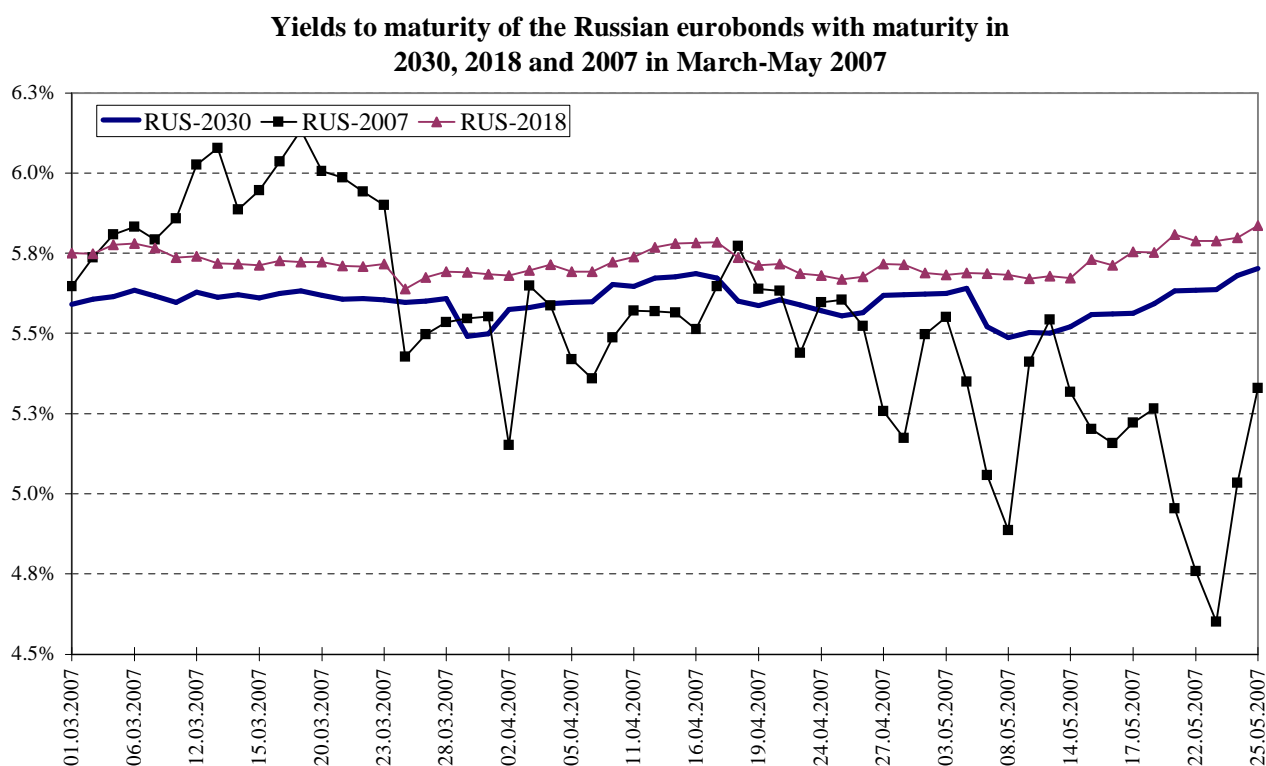


Fig 2.



The second half of the month was marked by the publication of a number of favorable macroeconomic indicators on real estate market and industrial sector, which resulted in some growth of the US bonds. The need for milder monetary policy in the United States has been reduced, and the investors reacted by an increase in the offers. Some adjustments occurred in the Russian Eurobonds, though they were less expressed than in the United States. By the end of May, an increase profitability of American bonds continued, as another block of positive macroeconomic statistics has been published in the United States. The Russian bonds downgrading was somewhat lower.

As of May 25, the Russian Eurobonds' RUS 30 yield to maturity made 5.7 per cent per annum, RUS-18 – 5.84 per cent per annum. As of the same date, the yield to redemption of the Russian Eurobonds made: for the eight tranche of external currency debt bonds – 6.32 per cent, seventh tranche bonds – 5.44 per cent, fifth tranche bonds – 5.49 per cent, RUS-07 – 5.33 per cent.

The situation in the government debt ruble market at the beginning of May remained fairly stable. There were observed no positive dynamics in the quotations, so the price increases were observed. On the other hand, the Russian ruble bonds were supported by favorable liquidity in the banking sector, which was on a rather high level. There were no expressed changes in the second week of the month. Federal bonds barely reacted neither to the dynamics of external market, nor to the increasing liquidity of the accounts of commercial banks in the Central Bank. Quotations of the majority of bonds reached the minimum values, so the investors refrained from further acquisitions.

Early in the second half of May, positive trends continued to dominate in the market, based on high level of liquidity in the banking sector. Several issues GKO-OFZ were in demand, which was partly caused by an inflow of funds from the primary market, where the demand for an additional OFZ placement has considerably exceeded the offer. But at the same time, a number of Russian officials expressed a concern about the inflow of financial resources to the country, that could provoke the growth of prices and thus reduce the effectiveness of counter-inflation policy of the government. To counteract that trend, the RF Central Bank can use interventions in foreign currency market to support the RUR bonds. The growth of quotations continued throughout the last week of May. In addition to traditional May factors (high liquidity, stability of the foreign currency market and external debt market), the growth of quotations of RUR instruments can be attributed to increased correction actions in the stock market: investors withdrew money from securities and in this situation, the bonds become quite an attractive investment instrument.

In the period of May 2 to 25 the total turnover in the secondary market of GKO-OFZ made about RUR 58.1 bln, with an average daily turnover at the level of RUR 3.4 bln.(as compared with RUR 53 bln with an average daily turnover at the level of RUR 93.4 bln. In April). Two auctions on OFZ placement were held during the month. Thus, on May 2 placement of OFZ-PD series 25062 with the issue volume of RUR 11 bln. was made. The issue volume was RUR 10.9 bln with an average weighted yield at the level of 6.12 per cent per annum. On May 16 placement of OFZ-AD series 46021 with the issue volume of RUR 15 bln. was made. The issue volume was RUR 14.97 bln with an average weighted yield at the level of 6.45 per cent per annum.

As of May 25, the GKO-OFZ market amounted to RUR 982.36 bln at face value and to RUR 991.44 bln at market value. The duration of the GKO-OFZ market portfolio was 2015.61 days.

Equity Market

Stock market situation.

In May there was observed a noticeable downgrading of the basic indices in the Russian stock market.

The decline of the stock market in early May happened due to both, technical and seasonal factors, caused by long holidays, as well as by a number of fundamental factors, oil prices reduction was the basic one among them. Even positive dynamics at the international stock market failed to provide adequate support to the quotations. As per results of the first week of May, positive dynamics was demonstrated by the bonds of “Sberbank of Russia”, based on publications of financial reporting, compiled in accordance with international accounting standards, as well as “Nornickel” bonds, due to expressed growth of nickel prices in the international market. However, during the next week negative trends grew stronger. At the same time, there was no expressed aggravation of internal and external factors. At the beginning of the second part of May the market has recovered to a certain extent. Herewith, the market value of a number of “blue chips” has grown within 1.5-5.5 per cent. That grown was based on increased oil prices in the international market, as well as quite favorable situation in the basic international stock markets. Certain impact on the market dynamics in general was made by upgrading of RAO “UES of Russia” bonds in the background to the increased investment program of the Holding, the decision on which was adopted at the Government meeting. Herewith, the oil and gas sector bonds either sustained at the same level, or even decreased in view of the expected downgrading of financial indicators of oil companies as or the current half-year results. Those ex-

Expectations came true at the end of the month, when analytics of JP Morgan investment bank have downgraded the rating of oil and gas companies to “negative” and reduced the general prospects of the Russian market for 2007. Moreover, the statement of A. Greenspan, former Head of the US IRS, who expressed a concern about overheated Chinese stock market and high probability of its further decline, served as a negative factor. The combination of these factors brought up further deterioration of the Russian market situation and downfall of indices to the level of the beginning of current year.

Fig. 3.

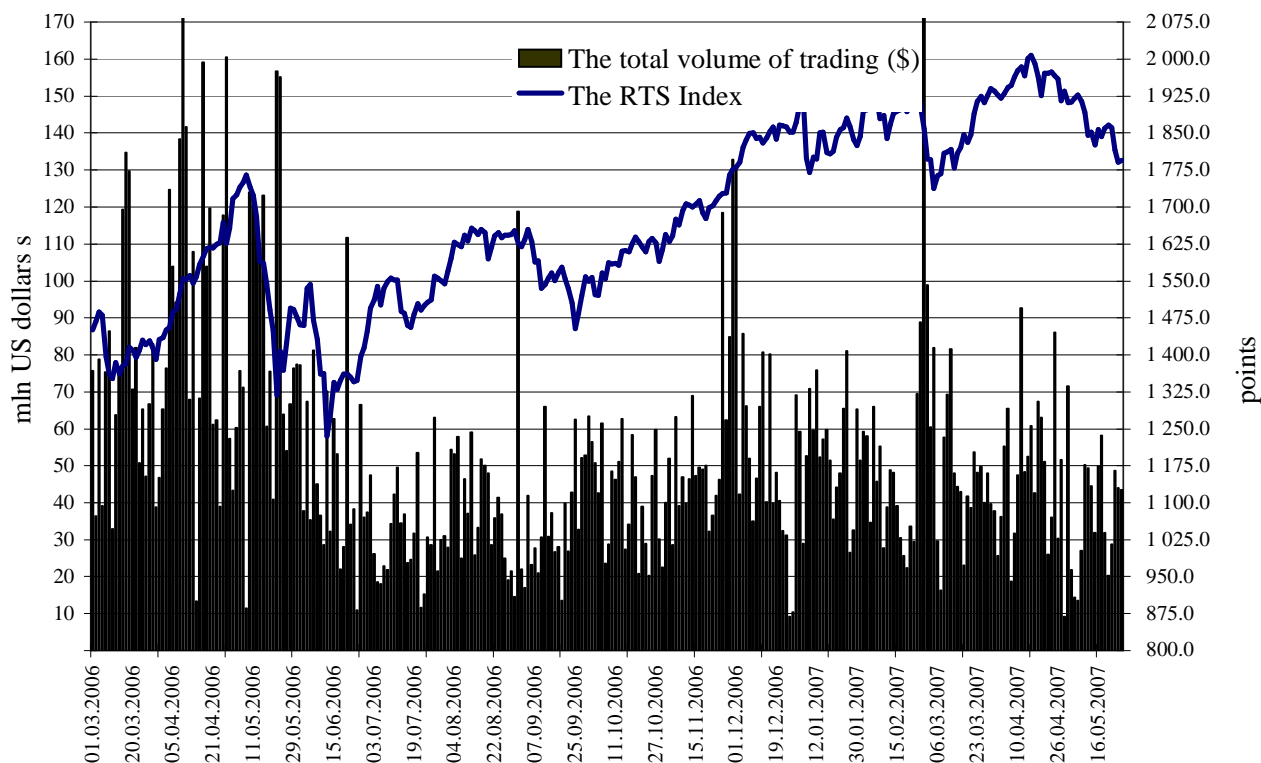
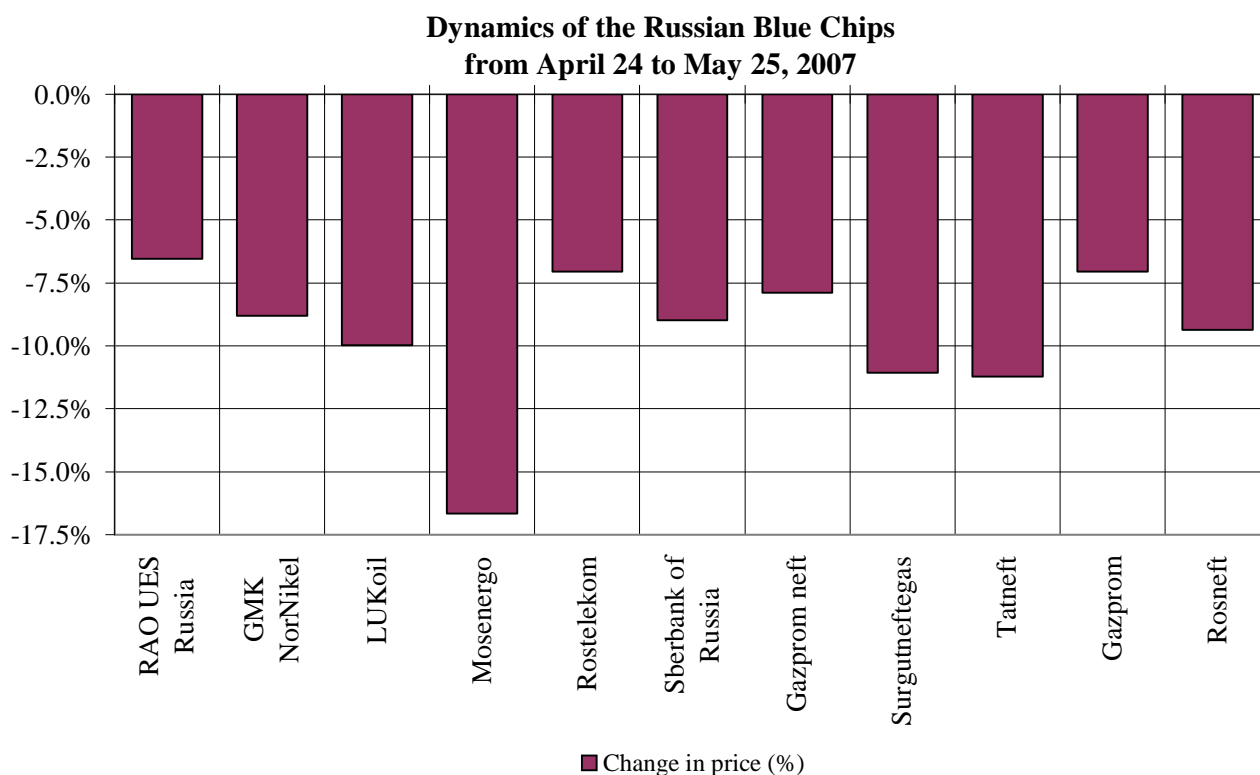


Fig. 4.



In general, within the period of May 2 to 25, the RTS index has decreased by 7.22 per cent in absolute terms and made 140.75 points. At the same time the period of turnover of sales on shares, included in the RTS index, made about USD 649.2 mln at the average daily turnover at the level of USD 50.36 mln (as compared with about USD 835.8 mln at the average daily turnover at the level of USD 38.2 mln in April). Therefore, the investors' activity in the stock market in May has been noticeably decreased as compared with the preceding month. The indicators of maximum and minimum turnover in the market trades in May made USD 71.5 mln (as May 11) and USD 18.63 mln (as of May 6), accordingly.

As of monthly results (from April 24 through May 25) the "blue chips" have shown a decline. Thus, utmost downgrading rates were demonstrated by "Mosenergo", "Tatneft", "Surgutneftegaz" (-16.67 per cent, -11.22 per cent and -11.08 per cent accordingly). Also considerable decline was observed about quotations of "LUKOIL" (-9.07 per cent), "Rosneft" (9.37 per cent), Sberbank of Russia (-8.98 per cent), Nor-nickel (-8.82 per cent), "Gazprom Neft" (-7.89 per cent), "Gazprom" and "Rostelecom", which have lost 7.04 within the month. RAO UES of Russia shares have demonstrated the minimum decrease (-6.54 per cent).

In May the RTS turnover leaders⁸ were: "RAO UES of Russia" (32.8 per cent), "Sberbank of Russia and "Norilsk Nickel" (9.9 per cent each), "Gazprom" (9.4 per cent), "LUKOIL" (8.0 per cent). and "Surgutneftegaz" (5.7 per cent). The total share of trades with the above companies has accounted to 75.7 per cent of the total RTS trading volume.

In terms of capitalization, as of May 25 the top five leaders of the domestic share market were⁹: "Gazprom" (USD 216.79 bln, "Rosneft" (USD 85.1 bln), "Sberbank of Russia" (USD 76.18 bln,) "LUKOIL" (USD 63.6 bln), RAO «UES of Russia» (USD 51.3 bln), , "Surgutneftegaz" (USD 41.3 bln).

Futures and options market

In May the investors' activity on the RTS futures and options market (FORTS) has decreased as compared with the preceding month. Thus, from May 2 to 25 the total turnover on the RTS futures and options market amounted to approximately RUR 300.6 bln (625.6 thousand of transactions, 7.65 mln of contracts) against RUR 332.4 bln (557.49 thousand of transactions; 7.525 mln of contracts in the relevant period of April).

The greatest demand, as before, was for futures: the volume of trading in futures in the period under review was RUR 262.82 bln (607.93 thousand of transactions, 6.5 mln of contracts). Options enjoyed a far lower demand, with the volume of trading at about RUR 37.82 bln (17.7 thousand of transactions and 1.15 mln of contracts). The highest level of trading in the futures market was RUR 22.72 bln (as of May 24), the lowest was RUR 10.0 bln (as of May 7).

Corporate bond market

Corporate debt market in May remained relatively stable, which enabled it to show some growth as of monthly results.

During the first week of May, the investors' activity remained relatively low due to the holidays. Moreover, the volume of placements in primary market was also fairly low. In general, the quotations were supported by favorable trends in foreign currency market, as well as high liquidity in the banking sector.

In the next two weeks the situation has been practically unchanged: volatility of prices in the corporate segment remained relatively limited. Only in primary market there was observed an upsurge in the activities of issuers after the holidays. By the end of May, the situation has not notably changed: the most liquid corporate bonds were slowly growing, and in the primary market auctions were quite successful, with large placements.

From May 2 through 25 the price index of corporate bonds traded on MICEX¹⁰ went up by 0.15 points (plus 0.14 per cent), while the index of the ten most liquid corporate bonds grew up by 0.37 points (plus 0.31 per cent). In the same period the total turnover on the MICEX corporate bond section amounted to RUR 45.1 bln, with an average daily turnover of RUR 2.65 bln (about RUR 48.88 bln with an average daily turnover in of RUR 2.87 bln in the relevant period of April). Therefore, the investors' activity has explicitly grown in April.

External factors behind Russian stock market dynamics

The situation in the international oil market was quite favorable in May, what contributed to the growth of the Russian stock market.

⁸ On the classical market.

⁹ According to RTS data.

¹⁰ The calculation was based on indices of corporate bonds traded on MICEX. The indices were produced by the Zenit bank.

Thus, Brent oil price grew in Europe within the month by 4.1 per cent, while Russian Urals has grown on average by 6.8 per cent. However, the stability of oil prices were unable to hold Russian securities from downgrading, observed within the greater part of the month. Therefore, a conclusion can be made that, despite relatively high dependence of Russian securities on oil prices, this dependence can get lower and investors can sell shares even in the situation of high oil prices.

Trends of the international stock markets were also positive in May (see Table 1). The dynamics of the US stock market was promoted by the data, published on macroeconomic statistics. In general, published statistical data confirmed the stability of economy at the background of still existing moderate inflation risks. As a result, further growth of the base interest rate, which could have negatively affected the stock market, is not expected. Meanwhile, the financial performance of the US corporations was so favorable, resulting in considerable upgrading of the basic stock market indicators.

Fig. 5

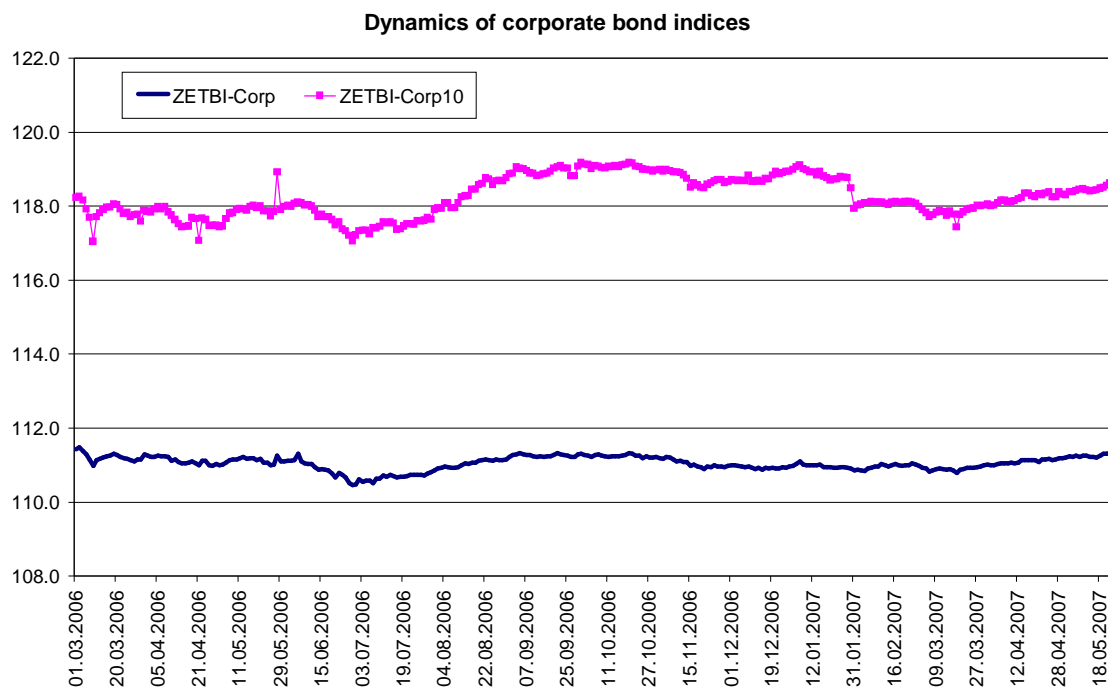


Fig. 6



Corporate News

OAO "LUKOIL"

Standard&Poor's rating agency has upgraded the long-term credit rating as an the issuer and the ratings of all securities of OAO "LUKOIL" from «BB+» to «BBB-», Outlook "Stable". Thus, currently the company has the highest investment rating among all three leading rating agencies: Moody's (Baa2), S&P (BBB-) and Fitch (BBB-). According to Standard&Poor's, the rating confirms the position of LUKOIL as the leading Russian vertically-integrated company with a high share of export proceeds, international diversification and stable financial indicators.

RAO «Gazprom»

OAO «Gazprom» and the State Committee on Property of the Belarus Republic have signed a purchase agreement on OAO "Beltransgas" shares. According to the contract terms, OAO «Gazprom» acquires 50 per cent of OAO "Beltransgas" shares for RUR \$2,5 bln. Payment will be made in four equal installments within 2007-2010.. For each installment OAO «Gazprom» will acquire 12,5 per cent of OAO "Beltransgas" shares. Prior to completions of the transaction, OAO "Beltransgas" shares should not be alienated, encumbered or pledged. Within 50 days upon the transfer to OAO Gazprom the ownership rights for the first part of OAO "Beltransgas" in the amount of 12.5per cent of the authorized capital, there should be arranged an extraordinary meeting of shareholders of OAO Beltransgas" for election of the new Supervisory Board of the Company

On December 31, 2006 OAO Gazprom and the government of Republic of Belarus have also signed a Supplement to the Protocol on the establishment of a joint organization and Belarus gas supply and transit of natural gas through Belarus. The Supplement foresees the gradual upsurge of a mark-up on the wholesale price of gas, sold by OAO "Beltransgas" to the end-users of the Republic (within 2008-2010), as well as the commitment of Belarus not to introduce a special right of the State ("golden share") for participation in OAO "Beltransgas" management.

OAO "Norilsk Nickel"

In early May, OAO GMK Norilsk Nickel announced its intention to make an offer to purchase all the issued ordinary shares of the Canadian company LionOre Mining International Ltd for CAD 21.50 one ordinary share in monetary assets of LionOre Mining International Ltd under condition that offer will include all ordinary shares. The total amount o the offer will make approximately CAD 5.3 bln.

The bonus for the purchase in monetary assets makes approximately 22.9 per cent of the price of CAD 17.49 per ordinary share of LionOre at Toronto Stock Exchange as of closing date on March 23, 2007, prior to the announcement of the intention Xstrata Canada Acquisition Corp. ("Xstrata"), a 100-per cent subsidiary company of Xstrata plc, to make an offer on acquisition of ordinary shares of LionOre. The proposal also includes a bonus of approximately 16.2per cent to the price of CAD 18.50 per ordinary share of LionOre proposed by Xstrata. Later, upon the offering price from Xstrata, of OAO Norilsk Nickel announced a higher price of its offer for all issued ordinary shares of LionOre Mining International Ltd. up to CAD 27.50 per ordinary share. Norilsk Nickel will provide the revised proposal package to LionOre shareholders tentatively by May 24, 2007. The proposal will be valid for acceptance until 20:00 on the Monday, June 18, 2007, by Toronto local time, unless extended or withdrawn. He new bidding cost exceeds the previous price of "Norilsk Nickel (CAD 21.50 per ordinary share) by CAD 6.00 per ordinary share and exceeds the last proposal of Xstrata plc ("Xstrata"), CAD 25.00 for one ordinary share by 10 per cent.

In case If all the ordinary shares will be proposed for sale, the upgraded offer of "Norilsk Nickel" will amount to about CAD 6.8 billion in monetary assets, which will allow LionOre shareholders to obtain about CAD 620 million more than proposed by Xstrata.

OAO «Rosneft»

On May q5, 2007, OAO «Rosneft» has published consolidated audited financial reporting for 12 months of 2006 through December 31, developed in accordance with US GAAP. The net profit .for 2006 has been increased by 38,7 per cent, to USD 33,099 bln, versus USD 23,863 bln in 2005. EBITDA indicator (Earnings before interest, taxation, depreciation, amortization) has grown by 3,5 per cent, up to USD 7,276 bln versus USD 7,029 bln of the relevant period of the preceding year. The net profit for the twelve months of 2006, excluding the share of other shareholders, adjusted for the proceeds from the sales of ZAO Sevmorneftegas, has increased by 0.3 per cent to USD 3.625 billion, against USD 3.615 billion within twelve months of 2005 The slowdown of net profit was mainly based on substantial increase of the tax burden; thus, the amount of taxes, except profit tax, have been raised by 31.2 per cent, while export duties increased by 77.8 per cent.

OAO «Rostelecom»

On May 3, 2007 OAO «Rostelecom» has disclosed non-audited financial results for the first quarter of 2007 in accordance with RAS (Russian Accounting Standard).

According to the results of the first quarter of 2007, the net profit of OAO «Rostelecom» has grown by 4.3 per cent as compared with the relevant period of preceding year and amounted to RUR 15 206,2 bln. Revenues from terminal and transit incoming telephone traffic increased by 19.6 per cent to RUR 1213.3 mln.. Revenues from other services for the first quarter of 2007 increased as compared with the same period of 2006 by 26.7 per cent up to RUR 3185.5, million.

The positive trend is based on the substantial growth of revenues from the leased communication channels, high-tech network services and support engineering services. Revenues from the leased lines increased by 13.9 per cent and made 1 973.5 mln as compared with the first quarter of 2006.

Expenditures on the Company's ordinary activities amounted to RUR 12 222, 2 million, having decreased by 0.5 per cent as opposed to the first quarter of 2006. The growth of depreciation costs by 20.5 per cent versus the first quarter of 2006, was based on the new equipment, introduced into service in 2006. Depreciation for the first three months of this year amounted to RUR 926.6 million. EBITDA indicator has grown by 27.4 per cent (accounting to RUR 3 910.6 mln) as compared with the first quarter of 2006. EBITDA profit margin made 25.7 per cent.

Sales profit in the first three months of 2007 amounted to RUR 2984, 0 million, what is 29.7 per cent higher than the relevant indicator in the relevant period of the last year. Other gains and losses for the first quarter of 2007 amounted to RUR 902.9 million as compared with RUR 395.5 million of preceding year..

The improvement of the above indicator as compared with the first quarter of 2006 is mainly based on revaluation of the market value of the Company's financial investments. The amount of financial instruments revaluation as of results of the first quarter of 2007 amounted to RUR 848.4 million, as opposed to RUR 368.1 million in the same period of preceding year. The net profit of Rostelecom within the first quarter of 2007 has grown by 41.1 per cent and amounted to RUR 2899.3 million, as compared with RUR 2055.4 million in the first three months of 2006.

Table 1.

Dynamics of international stock market indices

Data as of April 24	Value	Dynamics within the month(%)¹¹	Dynamics since the year beginning (%)
RTS (Russia)	1794,76	-9,08%	-0,22%
Dow Jones Industrial (USA)	13507,28	4,27%	8,38%
NASDAQ Composite (USA)	2557,19	1,29%	5,88%
S&P 500 (USA)	1515,73	2,39%	6,87%
FTSE 100 (UK)	6570,5	2,19%	5,62%
DAX-30 (Germany)	7739,2	6,45%	17,32%
CAC-40 (France)	6057,49	2,91%	9,31%
Swiss Market (Switzerland)	9381,34	-0,12%	6,78%
Nikkei-225 (Japan)	17481,21	0,17%	1,48%
Bovespa (Brazil)	51617,97	5,19%	16,06%
IPC (Mexico)	30700,01	3,91%	16,08%
IPSA (Chile)	3210,31	3,07%	19,20%
Straits Times (Singapore)	3486,63	3,32%	16,77%
Seoul Composite (South Korea)	1644,56	5,64%	14,65%
ISE National-100 (Turkey)	46194,27	-1,75%	18,09%
Morgan Stanley Emerging Markets Free Index	1 004,87	2,52%	10,09%

Foreign currency market

As of results of the month, from May 3 to 26 the USD official exchange rate against RUR has demonstrated a some increase as compared with the beginning of the month, having gained RUR 0.23 (0.89 per cent) and made RUR 25.92 to USD 1. The total volume of trading in USD on SELT in the same period amounted to about USD 77.52 bln at an average daily turnover of USD 4.6 bln (about USD 56.18 bln at an average daily turnover of USD 3.3 bln in the relevant period of April). Therefore, trading activity of foreign currency in May has remarkably grown as compared with the preceding month. The largest amount of trad-

¹¹ Versus index indicator valid on September 27, 2006.

ing in USD was noted on May 4, when it amounted to about USD 12.2 bln, the minimum level of USD 1.3 bln was observed on May 7.

In the banking sector ruble liquidity in May of the current year has been practically the same as April indicators: the average balance of credit agencies' correspondent accounts in the Bank of Russia in May was about RUR 437.1 bln, against April indicator of about RUR 434.6 bln.

Fig. 7.

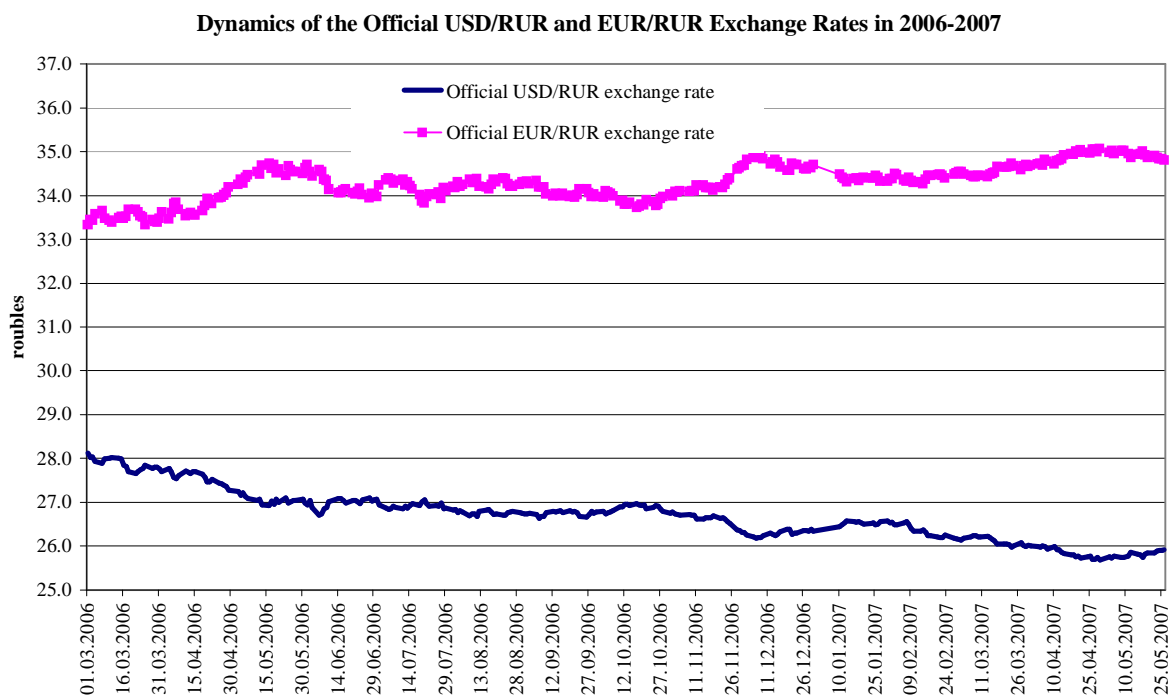
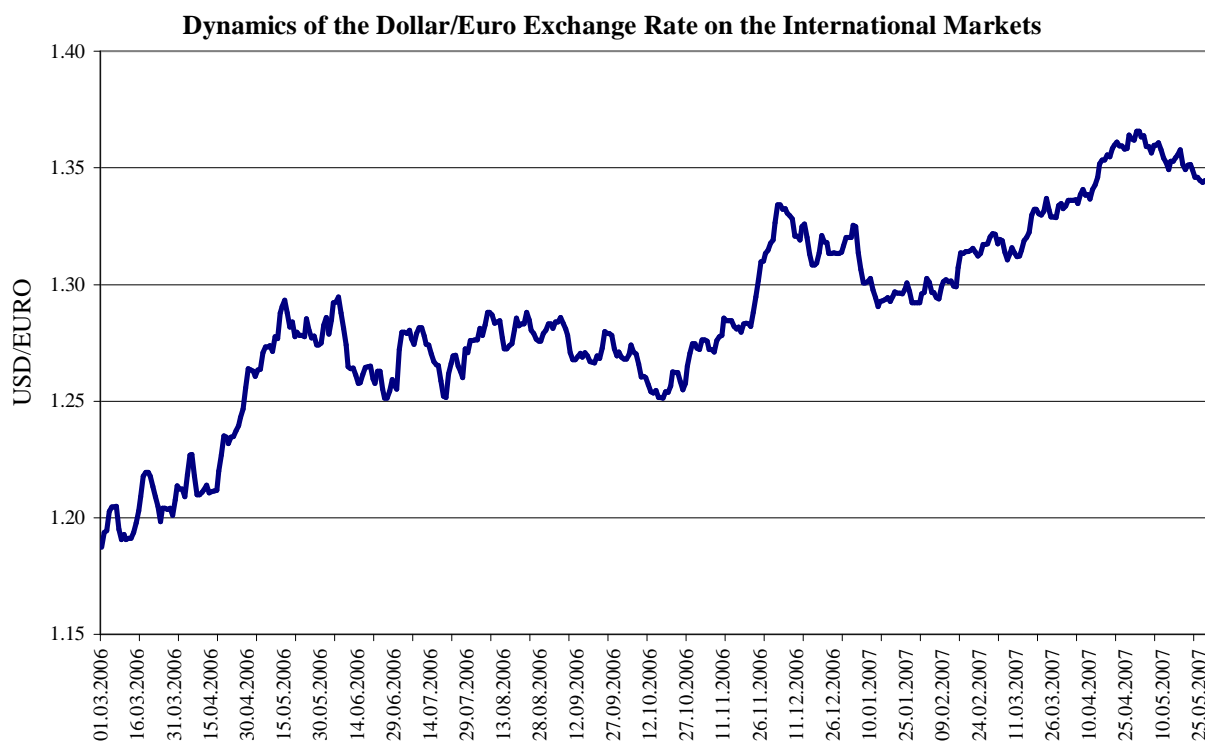


Fig. 8.



From May 1 to 28 Euro rate in the world market has decreased by USD 0,0213 (-1.56 per cent) to the level of USD 1,3445 for EURO 1. In this background some decline of EURO against RUR was observed. In

the period from May 3 to 26, EURO has downgraded by RUR 0.261. (-0.745 per cent), namely from RUR 35.065 to RUR 34.804 for EURO 1. The total volume of trading in EURO on SELT in the period from May 2 to 25 amounted to about EURO 940.67 mln at an average daily turnover of EURO 55.3 mln (about EURO 880.95 mln at an average daily turnover of EURO 51.82 mln in relevant period of April). Therefore, the trading activity of the European currency has been somewhat increased as compared with the preceding month. The largest amount of trading in EURO within the period under review was noticed on May 17 at the level of EURO 86.97 mln, the minimum level of EURO 40.2 mln was observed on May 16.

Table 2.

Financial market indicators/indices

Month	October	November	December	January	February*
Monthly inflation	0,3%	0,6%	0,8%	1,7%	1,3%
Estimated annual inflation given the current month trend	3,66%	7,44%	10,03%	22,42%	16,7% %
Russian Central Bank refinancing rate	11%	11%	11%	10,5%	10,5%
Average yield to maturity for all OFZ bond issues (% per annum)	6,00%	5,97%	5,93%	6,58%	6,1%
Monthly turnover on the GKO-OFZ market (RUR bln)	24,36	16,95	45,64	27,83	17,0
Minfin bond yield to maturity at end of month (% per annum):					
tranche 5	5,18%	5,38%	5,47%	5,69%	5,6%
tranche 7	5,50%	5,42%	5,41%	5,49%	5,5%
tranche 8	4,17%	5,30%	5,57%	5,63%	5,5%
Eurobond yield to maturity at the end of month (% per annum):					
2007	5,47%	5,28%	5,04%	5,45%	5,3%
2010	5,24%	5,43%	5,70%	5,71%	5,1%
2018	5,87%	5,69%	5,64%	5,90%	5,7%
2028	6,15%	6,03%	5,96%	6,18%	6,1%
2030	5,71%	5,52%	5,50%	5,76%	5,6%
Interbank credit-MIACR rate (% per annum at end of month) on 1-day loans	9,82%	7,21%	3,65%	5,24%	6,15%
Official RUR to USD exchange rate at the end of month (RUR/USD)	26,7477	26,3147	26,3311	26,5331	26,1599
Official RUR to Euro exchange rate at the end of month (RUR/EUR)	34,0284	34,6775	34,6965	34,3896	34,5180
Change in the official RUR/USD exchange rate in one month (%)	-0,12%	-1,62%	0,06%	0,77%	-1,41%
Change in the official RUR/Euro exchange rate in one month (%)	0,15%	1,91%	0,05%	-0,88%	0,37%
RTS stock market turnover in one month (in USD mln, for shares on the RTS index list)	907,19	1175,61	1094,42	929,19	993,46
RTS-1 index at the end of month	1613,57	1776,68	1921,92	1842,93	1858,14
Change in RTS-1 index in one month (%)	3,22%	10,11%	8,17%	-4,11%	0,83%

* Estimated data

D. Polevoy

Real Economy Sector: Trends and Factors

According to the preliminary data of the Ministry for Economic Development and Trade in 1 quarter 2007 the GDP increase was equal to 7.9% against 5.0% in the corresponding period of the previous year. The trend for slowdown of the industry production growth rates was overcome in 2007. In January-April 2007 the rise of industrial production was equal to 7.5% and exceeded by 4 p.p. the figure of the previous year. Over January-April 2007 the increase of the investments in the fixed assets was equal to 19.9%, workload in construction – to 23.7%, retail trade turnover – 13.6

Characteristic for the beginning of the year was the gap between the growth rates of the real wages and labor efficiency. While in January-March 2006 they were equal to, correspondingly, 8.5% and 6.1%, in January-March 2007 – to 15.5% and 7.8%.

According to the preliminary data of the Ministry for Economic Development and Trade in 1 quarter 2007 the GDP increase was equal to 7.9% against 5.0% in the corresponding period of the previous year. Acceleration of economic growth rates is observed in nearly all types of economic activities. In 2007 the trend for slowdown of the industry production growth rates, which outlined in the second half of 2006, was overcome. In January-April 2007 the rise of industrial production was equal to 7.5% and exceeded by 4 p.p. the figure of the previous year, despite the fact that in April the slowdown of industry rates as compared with April 2006 and March of the current year was observed. Output and service index for the basic kinds of economic activities was equal to 108.4% in January-April 2007 and exceeded by 3.2 p.p. the figure of the previous year.

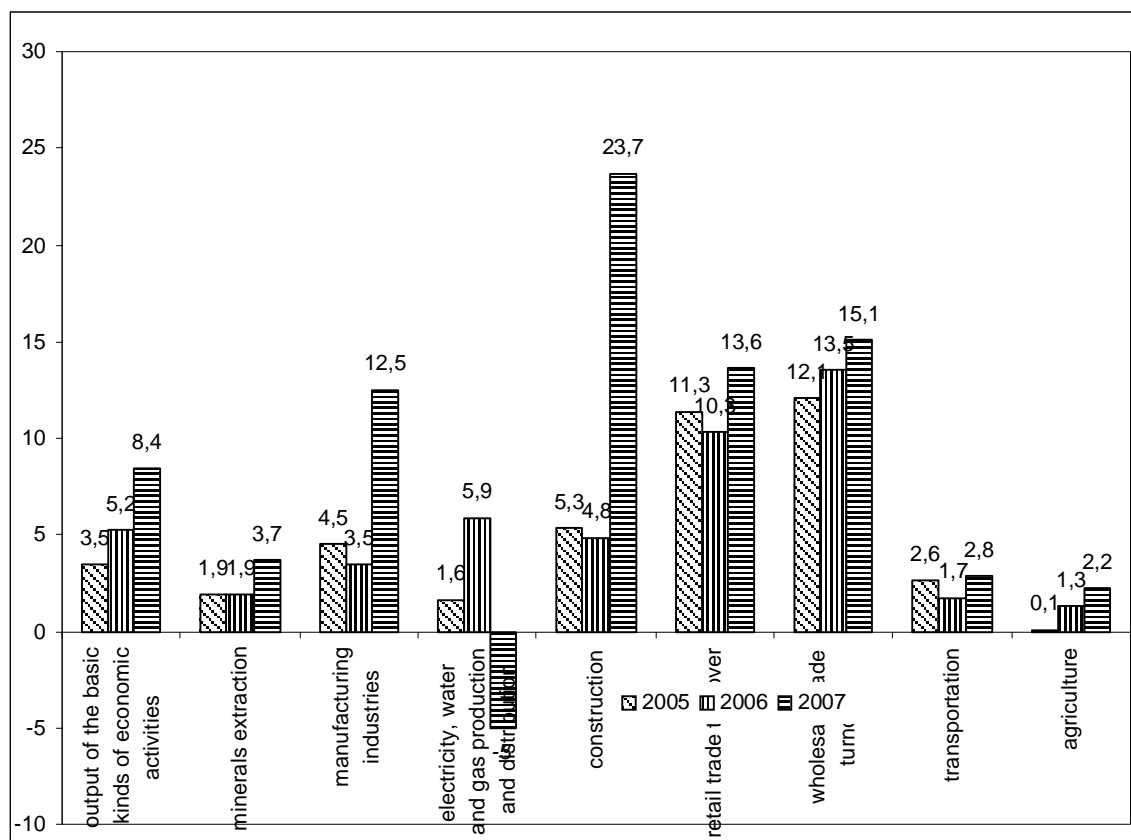


Fig. 1. Change of the Goods and Services Output for Basic Kinds of Economic Activities in 1 quarter 2007, as percentage to the previous year

Characteristic features of the current situation are defined by a big upsurge of business activity in construction and manufacturing industry, the dynamics of retail and wholesale trade turnover remaining high. On the whole in January-April 2007 the trend for the change of the industrial growth structure towards the increase of manufacturing industries share sustained. Increase in output of processing enterprises comprised 12.5% against 3.5% in January-April 2006, and for extractive enterprises 3.7% against 1.9%, correspondingly. Attention should be drawn to the slackening of the production and distribution of electricity, gas and water dynamics by 5 p.p. as compared with the previous year, which is due mainly to by unusual climatic factors, which accounted for the reduction of heat energy production by 8.3% as compared with January-April 2006 in the environment of the trend for stabilization of the energy production.

In 2007 the trend for acceleration construction work, which was formed in 2 quarter 2006 and supported by intensive growth of the investments in the fixed assets, persisted. In January-April 2007 the increase of workload in construction was equal to 23.7% against 4.8% in the corresponding period of the previous year. Exceedingly high rates are characteristic for commissioning of the total living space of the dwelling houses. Over January-April 2007 dwelling houses of the total floorspace of 12.4 sq m were put into commission, which exceeds the level of the previous year by 45.3%.

The stirring up of the activity in the construction and growing demand for investment goods and construction materials gave an additional incentive for the development of the extractive and manufacturing industries. In January-April 2007 the growth in the production of construction non-metallic materials (129.2% to January-April 2006), construction plastics, the goods from the reinforced concrete (121.5%) steel pipes (125.5%), finished metal goods (114.0%) was observed. At the same time the expansion of machinery and equipment production by 23.3% was recorded.

At the beginning of 2007 the trend for the increase of domestic demand factors persisted. The growth of the domestic demand, according to the preliminary estimation, increased by 11% in 1 quarter 2007 in the environment of the strengthening trend for the decrease of net export rates decrease: trade surplus dropped by 23% as compared with January-March 2006. As compared with 1 quarter 2006 goods export in terms of value increased by 6.0% and was by 2.4 p.p. lower than the industrial output index. According to the data of the Ministry for Economic Development and Trade the expansion of the domestic market demand by the majority of goods items of traditional Russian export is observed. At the same time it should be underlined that under existing domestic demand expansion rates and goods production dynamics and, especially, final demand the dependence of market filling on export is strengthening. In 1 quarter 2007 import increase was equal to 38.7% and exceeded by 18.1 p.p. the figure of the previous year. In 1 quarter 2007 in the monetary structure of the Russian import as compared with the corresponding period of the previous year the share of the machinery, equipment and transport vehicles increased from 43.3% to 47.5%, of textile, textile goods and footwear – from 4.5% to 4.7%, of metals and metal goods – from 7.6% to 8.6%. Investment demand remaining high and the share of the imported machinery and equipment in the range of 7-9% the solution of the practical problems of reconstruction, modernization and technological re-equipment of the economy under existing dynamics and structure of the domestic investment goods production depend on the nature of the foreign economic activity development.

Since 2 quarter 2006 anticipating growth of the investments in the fixed assets as compared with households' final consumption became one of the key factors of the structural shifts of the used GDP. Over January-April 2007 the increase in the investments in fixed assets was equal to 19.9% against 6.9% in the corresponding period of the previous year and retail trade turnover, correspondingly, by 13.6% against 11.4%. In the environment of the economic growth rates acceleration Russian economy is becoming more and more attractive for the foreign investors. In 1 quarter 2007 the trend for slowdown of the foreign investment in the Russian economy was overcome. The volume of the foreign investment supplied to the Russian economy increased by 2.8 times as compared with the corresponding period of 2006, including the growth of direct investments by 2.5 times. According to the preliminary results of 1 quarter 2007 net inward investment was equal to USD 13.0 bln, against capital export of USD 4.7 bln in the corresponding period of the previous year.

Expansion of the consumer's demand was supported by the positive dynamics of the population incomes growth. In January-April 2007 increase of the real population incomes was equal to 11.5% against 7.1% in the corresponding period of the previous year, real wages - to 18.5% against 10.42%. It was the structural specific features of the population's income formation that had considerable influence on consumption dynamics. It is to be noted that in the structure of the population incomes the share of incomes from entrepreneur's activity and property is observed to be decreasing by 3.2 p.p. In the environment of the trend for intensive growth of the nominal wages the share of labor remuneration in the population incomes increased up to 70.4% against 67.4% in 1 quarter 2006.

Structural shifts in population incomes formation were accompanied with the change of population distribution by the amount of average per capita incomes. In 1 quarter 2007 average per capita incomes increasing by 121.5% and nominal wages – by 127.6%, the share of the population with the average per capita incomes of more than RUR 12000 increased by 8.5 p.p., in the range of 12000-6000 - by 2.5 p.p., with the incomes below 6000 reduced by more than 10.5 p.p. However difference in the amount of average monthly incomes of the population remaining high the differentiation of the population according to the monetary incomes increases: fund coefficient in 1 quarter 2007 was equal to 15.1 times (in 2006- 14.6 times), Gini coefficient – 0.408 (0.404).

The specific character of incomes distribution also determined the distinctive features of the current expenses dynamics and the level of savings in the households sector. Increase of the purchasing capacity of the population incomes determined the sustention of high growth rates of the retail trade – 113.0% against January-April 2006. Over the last six years the change in the consumer spending was determined by the increase in the share of expenditures for non-food goods and services and reduction of the share of expenditures for foodstuffs. It is to be mentioned that under existing incomes level the statistic monitoring observed gradual shift of sales assortment structure of foodstuffs towards more expensive and of non-food goods towards the

imported goods of better quality. The change in the population demand and the increase in the share of non-food durable goods and house furnishing goods stirred up the development of consumer crediting. The volume of credits given to individuals increased by 1.67 times in comparison with April 2006. It is to be noted, that it was characteristic for the beginning of the current year that the share of savings in the form of deposits and stocks increased from 5.0% in 1 quarter 2006 to 6.9% in the similar period of the current year.

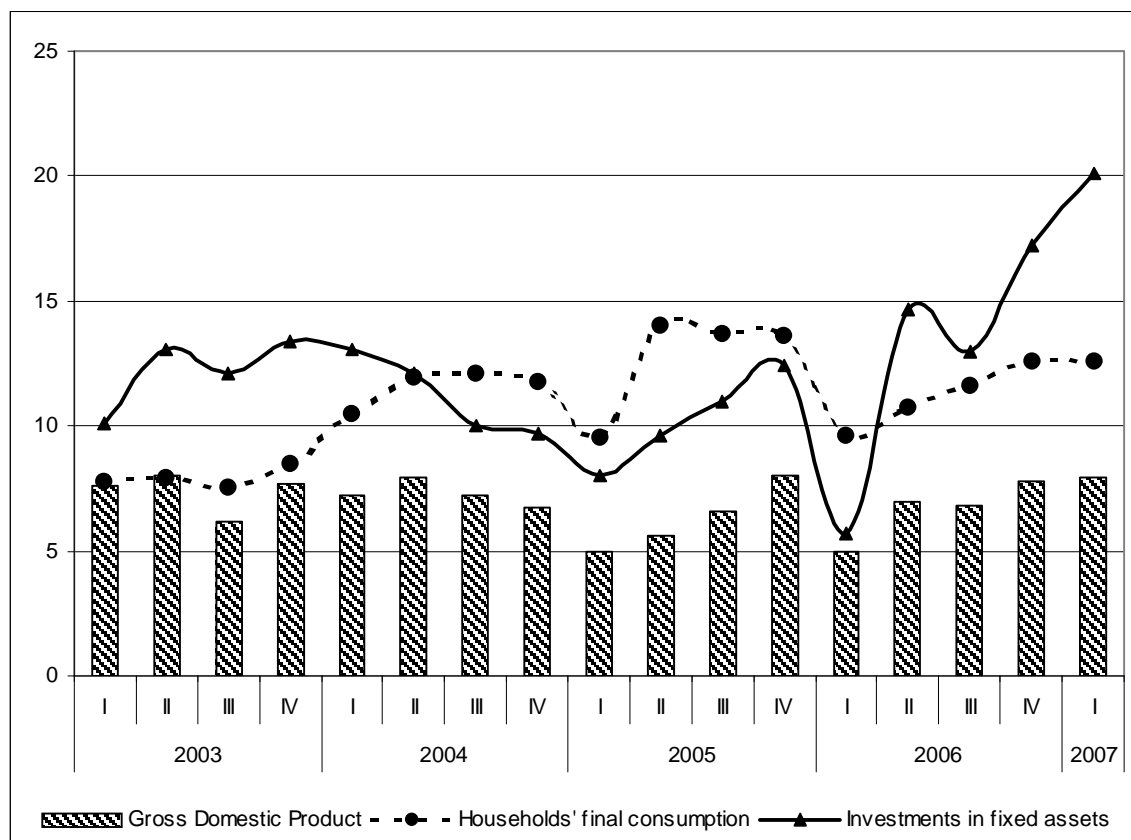


Fig. 2 Change of the Dynamics of the Used GDP by the Components throughout 2003- 2007, to the corresponding quarter of the preceding year

Wages earners labor remuneration is the main source of income for the vast majority of the population and the differentiation of the average monthly wages being high in different kinds of activity it has a considerable effect on the labor force flow. Whereas in March 2007 average monthly accrued wages in minerals extraction was 2.1 times higher than all-Russian level of average wages and in financial activity – 2.9 times, in manufacturing industry this figure was equal to 96%, in education – to 67%, in health care – to 76% of the all-Russian level. Labor resources redistribution towards economic activities with high profit favors the evolution of the specialists and skilled workers shortage in the majority of manufacturing industries and kinds of activities which render services. In prospect such situation can cause limitations for further economic growth and processes intensification, economic structure diversification and increase in its efficiency. On the whole the growth of the gap between the growth rates of wages and labor efficiency was characteristic for the economy at the beginning of the current year. While in January-March 2006 they were equal to, correspondingly, 8.5% and 6.1%, in January-March 2007 – to 15.5% and 7.8%.

In April 2007 the number of the employed in the economy increased by 1.3 mln of people as compared with the corresponding period of the previous year and was equal to 69.5 mln of people. The number of unemployed according to the methodology of the International Labor Organization was equal to 5.2 mln of people in April 2007 or 7% of the economically active population and decreased by 426 thou of people as compared with April 2006. In April of the current year the tension coefficient (number of unemployed citizens registered in placement service institutions as calculated for one vacant position) was equal to 1.6 against 2.2 at the beginning of the year. The demand for labor force, declared to the placement service by the organizations, increased in March 2007 and was equal to 1000 thou of people.

O. Izryadnova

Oil and Gas Sector

The growth of oil, oil products and gas production sustained in the oil and gas sector, the prices for oil remaining exceedingly high at the world market. Though the oil production growth rates slightly increased, they remain relatively low. The strengthening of the state-owned companies in oil sector continued. Rosneft, as a result of acquisition of the rest of the YUKOS assets, became the biggest oil company in the country, the share of state-owned companies at the oil market expanded.

In 2007 exceedingly high level of the world prices for oil sustains, which is due to high growth rates of the world economy, the USA and China economies in particular, low level of idle production capacities for oil production and shift of OPEC's price marks. In fact, OPEC refused to sustain world prices for oil in the previously established by this organization range from 22 to 28 USD per barrel and demonstrated its aspiration to sustain oil price at the level above USD 50 per barrel. Beyond OPEC it was the decrease of oil production growth rates in Russia that had a substantial influence on the oil production dynamics. The preservation of high geopolitical risks, problems connected with Iran and Iraq in particular, which favor the maintenance of high world prices for oil is also to be noted.

At the beginning of 2007 a considerable decrease in the world prices for oil was observed, which was partially accounted for by unusually warm winter in the Northern hemisphere. In following months under the influence of further oil production reduction by OPEC countries, which was undertaken since 1 February 2007 and relatively cold weather in Europe the prices for oil went up again (table 1). At the 144th OPEC conference, which took place in March 2007, the decision to leave the level of oil production, established from 1 February 2007, unchanged was made.

Table 1

World Prices for Oil in 2005-2007, as USD per barrel

	2005	2006	2007 January	2007 February	2007 March	2007 April
Price for oil grade Brent, the UK	54.38	65.16	53.68	57.43	62.15	67.51
Price for oil grade Urals, Russia	50.75	61.24	50.12	53.81	58.84	63.81
Price for oil basket of OPEC member countries	50.64	61.08	50.73	54.45	58.47	63.39

Source: OECD/IEA, OPEC.

In 2007 the development of the oil and gas sector in Russia is characterized by the sustention of the trend for increase in oil, oil products and gas production, which was formed in recent years. Oil production, gas condensate included, increased by 3.6% in January-April 2007 as compared with the corresponding period of the previous year. The causes of considerable growth of the oil production in recent years were the extension of the export possibilities, thanks to the creation of Baltic pipeline system in particular and the use of railway transportation, as well as the increase in the domestic demand. At the same time the oil production growth rates remain at considerably lower level than in 2002-2004, when the increase of oil production reached 8.9-11% a year. It is the indicator of the exhaustion of reserves for the rapid growth of oil production owing to the intensification of oil fields in operation development and is the evidence of necessity to act quite actively, developing new oil fields (in the Eastern part of the country, for example).

In January-April 2007 the volume of primary oil processing increased by 3.9% as compared with the corresponding period of the previous year, and the extent of oil processing increased up to 70.7%, this index being equal to 70.2% in January-April 2006. The growth of natural gas production, which started in 2002, continued, though slowly, and was equal to 0.7% over the first four months

The increase in the state-owned companies influence in the oil sector was characteristic trend over the recent years. The positions of the state-owned companies strengthened considerably due to the purchase of private-owned companies assets: in 2004 Rosneft purchased Yuganskneftegas, apportioned from YUKOS, in 2005 Gazprom purchased company Sibneft, and at the end of 2006 Gazprom purchased controlling stock in "Sakhalin-2" project, which is being fulfilled by foreign investors.

In May 2007 the sale of the rest YUKOS assets, the company that was declared bankrupt last year, finished. All main oil producing and oil processing YUKOS assets were purchased by the state-owned company Rosneft. As a result, the share of Rosneft in all-Russian oil production increased from 17% up to 21.5%, and the share of the state-owned companies on the whole (Rosneft and Gazprom, including Gazprom

neft) increased from 26.6% to 31.1% (Table 3). As a result of YUKOS assets acquisition Rosneft became the biggest oil company in Russia, LUKOIL being the biggest oil company before that.

Table 2

**Oil, Oil Products and Natural Gas Production in 2000-2007,
as percentage to the previous year**

	2000	2001	2002	2003	2004	2005	2006	2007 Janu- ary- April
Oil, including gas condensate	106.0	107.7	109.0	111.0	108.9	102.2	102.1	103.6
Primary oil processing	102.7	103.2	103.3	102.7	102.6	106.2	105.7	103.9
Motor petrol	103.6	100.6	104.9	101.2	103.8	104.8	107.4	107.7
Diesel oil	104.9	102.0	104.7	102.0	102.7	108.5	107.0	104.9
Furnace fuel oil	98.3	104.2	107.1	100.3	97.8	105.8	104.5	102.1
Natural gas, bln cu m	98.5	99.2	101.9	103.4	101.6	100.5	102.4	100.7

Source: Federal State Statistics Service

Table 3

The Influence of YUKOS Assets Sale on Oil Production Structure in Russia

	Oil production structure in 2006, %*	Oil production structure after YUKOS assets sale **, %*
Rosneft	17.0	21.5
LUKOIL	18.8	18.8
TNK-BP	15.1	15.1
Surgutneftegas	13.7	13.7
Gazprom (including Gazprom neft)	9.6	9.6
Tatneft	5.3	5.3
Slavneft	4.8	4.8
Yukos	4.5	-
Russneft	3.1	3.1
Bashneft	2.4	2.4
Other producers	5.7	5.7
State-owned companies, total	26.6	31.1

*As percentage to the all-Russian oil production, gas condensate included

** According to the data on oil production in 2006

Source: calculated on the basis of the Ministry for Industry and Power of the Russian Federation data

As a result of assets redistribution taking place the concentration of the production has considerably increased in the oil sector. Currently the share of five biggest companies of the sector (Rosneft, LUKOIL, TNK-BP, Surgutneftegas and Gasprom) is equal to 79% of the oil production in the country. Eight oil companies, which either are or can be considered as vertically-integrated, control more than 91% of oil production. In the gas sector one company (Gazprom) produces 84% of the gas. At the same time Gazprom controls the system of the main gas pipelines and gas export.

In January –September 2006 a considerable growth in prices for oil and oil products at the domestic market was observed due to the growth of the world prices. In September 2006 the average internal price for oil (producers' price) in dollar terms reached USD 232.1 per ton, which is the maximum value for oil and car petrol prices over the whole post-reform period. At the end of 2006 and in January-February 2007 the prices at the domestic market decreased considerably under the influence of world prices for oil fall. In March-April along with the increase in the world prices domestic prices also went up, remaining, though, below the level of last September (Table 4).

As it is demonstrated by the oil and oil products export data analysis (table 5), net total export of the oil and oil products in 2006 the total net export of oil and oil products reached unprecedented level of 349.4 mln tons, which is by 19.8% more than pre-reform maximum, reached in 1988 (291.6 mln. tons). At the same time the increase in oil products share in oil export was observed, their share rising from 18.2% in 1990 to 29.6% in 2006. In the environment of the sharp reduction in domestic oil consumption (according to our calculations it decreased from 269.9 mln. tons in 1990 to 130.6 mln. tons in 2006, that is more than by half) the share of oil and oil products net export in oil production increased over this period from 47.7% to 72.8%.

Table 4

**Domestic prices for Oil, Oil products, and Natural Gas in 2005-2007 as USD
(average producer's prices, as USD per ton)**

	2005 r. December	2006 June	2006 September	2006 December	2007 January	2007 February	2007 March	2007 April
Oil	167.2	207.3	232.1	168.4	173.5	156.9	150.9	174.8
Motor petrol	318.2	400.7	478.7	416.5	392.1	365.9	385.6	441.9
Diesel oil	417.0	455.9	471.2	426.1	420.1	422.9	425.5	449.8
Furnace fuel oil	142.7	191.9	194.9	148.8	138.3	120.5	133.6	164.4
Natural gas, as USD per thou. cu. m	11.5	14.0	16.1	14.4	12.2	15.4	15.5	16.0

Source: calculated on the basis of the Federal State Statistics Service data.

Table 5

The Ratio of Oil and Oil Products Production, Consumption and Export in 2000–2006

	2000	2001	2002	2003	2004	2005	2006
Oil, mln tons							
Production	323.2	348.1	379.6	421.4	458.8	470.0	480.0
Export, total	144.5	159.7	187.5	223.5	257.4	252.5	248.4
Export to non-CIS countries	127.6	137.1	154.8	186.4	217.3	214.4	211.2
Export to CIS countries	16.9	22.7	32.7	37.1	40.1	38.0	37.3
Net export	138.7	154.7	181.3	213.4	253.2	250.1	246.1
Domestic consumption	123.0	122.9	123.5	129.8	124.2	123.1	130.6
Net export, as percentage to the production	42.9	44.4	47.8	50.6	55.2	53.2	51.3
Oil products, mln tons							
Export, total	61.9	70.8	75.0	78.4	82.1	97.0	103.5
Export to non-CIS countries	58.4	68.3	72.5	74.9	78.0	93.1	97.7
Export to CIS countries	3.5	2.5	2.6	3.5	4.1	3.9	5.8
Net export	61.5	70.5	74.8	78.2	81.4	96.8	103.3
Oil and oil products, mln. tons							
Oil and oil products net export	200.2	225.2	256.1	291.6	334.6	346.9	349.4
Oil and oil products net export, as percentage of oil production	61.9	64.7	67.5	69.2	72.9	73.8	72.8

Source: Federal State Statistics Service, Ministry for the Industry and Power, Federal Customs Service, authors' calculations.

The share of oil products export having increased to some extent, the crude oil export, being 70% of the total export volume, still prevailed in the structure of oil export. It was the furnace fuel oil, which is used as a primary product in Europe for further processing, and diesel oil that comprised the main part of the oil products export. The main part of the energy supplies (85% of oil, 94% of oil products) was exported beyond CIS.

The given data testifies that the export orientation of oil sector in comparison with the pre-reform period has reinforced. It should be, however, taken into account that it is connected not only with the increase of the absolute export volumes, but also with a considerable decrease in the domestic oil consumption as a result of Russian economy market transformation.

High level of the world prices for oil determined considerable incomes growth in the oil sector of the economy. In 2006 total earnings from oil and main kinds of oil products export (car petrol, diesel oil and furnace fuel oil) reached USD 140.0 bln., which is a record level over the whole post-reform period (table 6). For reference it can be noted that the minimum level of oil export earnings was observed in the environment of world oil prices fall in 1998, when the export profit was only USD 14 bln

Table 6

Oil and Oil Products Export Earnings in 2000-2006, as USD bln

	2000	2001	2002	2003	2004	2005	2006
Oil and main kinds of oil products export earnings	34.9	33.4	38.7	51.1	74.6	112.4	140.0

Source: calculated on the basis of the Federal State Statistics Service.

In 2006 the share of power and energy commodities in Russian export was equal to 65.2%. The proportion of oil and main kinds of oil products (car petrol, diesel oil and furnace fuel oil) in Russian export in 2006 was equal to 46.4%, including that of crude oil of 33.9%. In the 1 quarter 2007 oil export in natural terms increased by 3.0% as compared with the corresponding period of the previous year (table 7). Oil export proportion in the total volume of the Russian export was equal to 33.0% in 1 quarter 2007.

Table 7

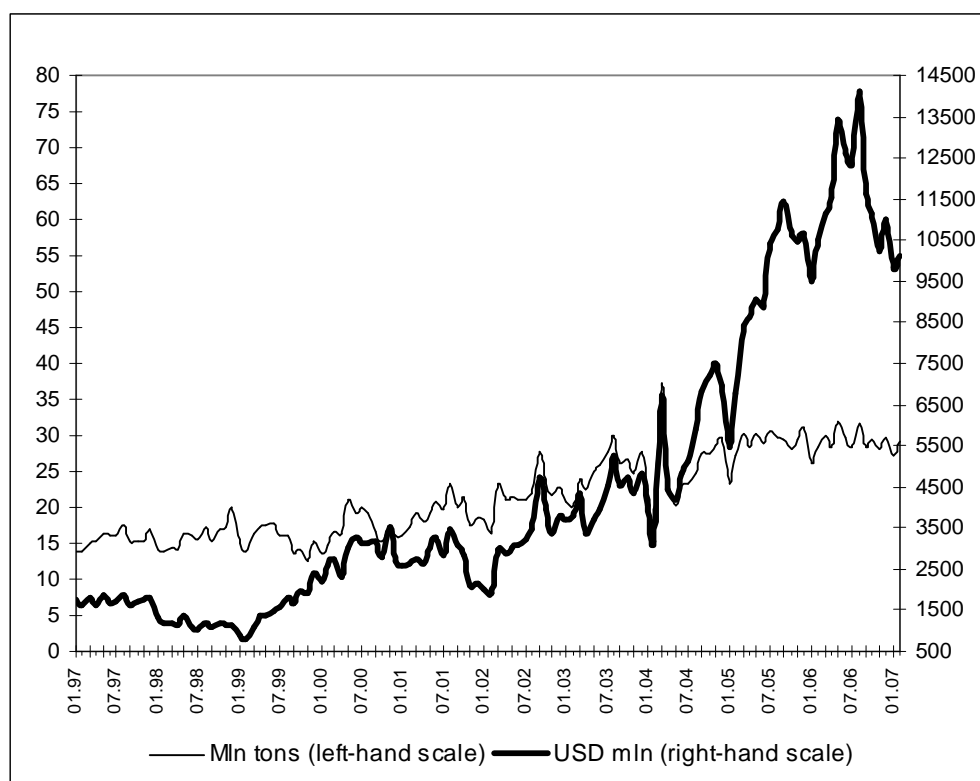
Oil Export from Russia in 2002-2007, as percentage to the previous year

	2002	2003	2004	2005	2006	2007 1 quarter*
Oil export, total	113.9	117.8	115.0	98.4	98.0	103.0

* As percentage to 1 quarter 2006

Source: Federal State Statistics Service

Oil and oil products export dynamics in natural and value terms is shown in figure 1.



Source: calculated on the basis of the Federal State Statistics Service data.

Fig.1. Oil and oil products export dynamics in natural and value terms in 1997-2007, mln tons, USD mln

In near prospect the situation at the world oil market allows to expect the sustention of high world prices for oil and favorable external conditions for the formation of the state budget's earnings, stabilization fund replenishment and development of the oil and gas sector. According to the IET forecast, price for oil grade Brent will be around USD 60 per barrel¹² in the coming months, which will correspond to the price of the Russian oil grade Urals about USD 56.5 per barrel.

Yu. Bobylev

¹² See Bulletin of model calculations for short-term forecasts of the social and economic indicators of the Russian Federation, Moscow, IET, 2007.

Business Survey in May 2007

First data on the state of affairs in Russian industry in May make quite an optimistic picture of the main business indicators dynamics. The increase in output growth rates is based on the continuing rise of effective demand growth rates and the necessity to replenish the stocks of finished goods. It was for the first time that the main obstacle for the output growth was the shortage of qualified staff.

According to the data of the Federal State Statistics Service, in April the growth of industrial production slowed down considerably. After a business upsurge in 1 quarter in April the production growth index was equal to 4.6% as compared with the corresponding period of the previous year (or 6.0% according to the Center for Macroeconomic Analysis and Short-Term Forecasting calculations) against 8.4% in 1 quarter (the Center for Macroeconomic Analysis and Short-Term Forecasting – 7.2%). In April manufacturing industries growth rates as compared with the previous month, seasonal and calendar factors excluded, was equal to 0.5% against 0.7% in March.

Live data of surveys present a more optimistic picture of the main business indicators dynamics in Russian industry over the last months.

First, the decrease in output growth rates is demonstrated only by unprocessed data, before exclusion of the seasonal and occasional fluctuations. Exclusion of seasonal factor demonstrates a gradual increase in production growth rates. As a result a new absolute record value of 36 balance points against 34 balance points in April was reached in May.

Second, intensive industrial growth is based on the continuing effective demand growth rates. In May the sales growth rates after exclusion of seasonality were equal to 22 b.p., which exceeds the results of April by 4 b.p. and is also an absolute record over the whole period of monitoring. Initial data, however, as it was in case of output, demonstrated the slow-down of demand growth rates from 36 balance points in March to 22 in May. The satisfaction with the volume of sales continues to grow nevertheless. At the moment 72% of enterprises consider the demand for their products as normal, the growth over the last 12 months being 17 points. This is also an absolute record.

Third, the dynamics of industrial production is also sustained by the necessity to replenish final goods stocks. From August 2006 to March 2007 the balances of stock estimations were in the range of +2 .. +5 balance points, which is an extremely low value after +10 ..+15 b.p. over the last 12 months. In May this indicator increased up to +9.

The forecasts of demand change before exclusion of seasonality did not change and remained at the level of 33 b.p., absolute record being 39 b.p. was registered in March 2007. Exclusion of seasonal factor demonstrated the sustenance of the record March values during April and May. The situation with the output forecasts was similar. Initial data demonstrated expected output growth rates decrease from 51 b.p. in April down to 44 b.p. in May. Exclusion of seasonality demonstrated the sustention of the record values during the last three months, and exclusion of occasional fluctuations improved the previous record by 1 point.

Enterprises' surveys regularly demonstrate that quite a considerable part of Russian industry does not have competitive import at its markets. According to the estimations of the very producers (excluding power and fuel industry enterprises), approximately one third of them do not face the import (see table).

Structure of Competitive Russian Goods as to Import, %

Industry (according to OKONH- Russian Classification of Economy Industries)	There is no competitive import at markets	«On equal terms»	Noncompetitive goods		Total
			Imported	Domestic	
All manufacturing	33	35	10	22	100
Metallurgy	57	29	7	8	100
Chemistry and petrochemistry	44	32	1	23	100
Machine-building	23	36	15	26	100
Timber industry	37	41	7	15	100
Construction	74	17	6	3	100
Light industry	34	29	6	31	100
Foodstuffs industry	21	54	17	8	100

Source: Calculations based on the results of IET survey, April 2007

The share of noncompetitive with the imported markets varies through the industries from 74% for the construction to 21% for the foodstuffs production and is quite close, at least in the range, to the intuitive

ideas. Thus, a considerable share of the Russian enterprises due to the features of the goods produced by them, import quality and structure still does not compete with the latter at their markets.

When domestic producers have to compete with import price and quality of Russian goods can either excel or yield to the price and quality of imported.

Approximately a half (53%) of Russian enterprises which faced the import (100% accounts for the markets where there is competitive import) consider its quality as practically equal to the quality of their goods. The greatest amount of goods of equal quality is produced in the foodstuffs industry (87%), metallurgy (64%) and machine-building (52%). Only 9% of Russian enterprises regard the quality of their goods as better than of the imported ones. The maximum of such estimations was received in construction materials production (19%), minimum – in machine-building (5%). The latter number seems more than just worrying. 38% of Russian enterprises acknowledge the superiority of import as regard to the quality. The most pessimistic attitudes towards quality were observed in chemistry and petrochemistry, where the import of better quality dominates at 57% of the markets, in timber industry (48%) and machine-building (42%).

As for prices, on the whole over the markets competitive with the import there exists a near parity: at 37% of the markets import prices are higher and at 35% of the markets they are lower than the Russian goods prices. 28% of domestic enterprises consider their prices to be nearly equal to the prices of the competitive import. There are only two industries that have utter price problems – metallurgy and light industry, in which the majority of the Russian enterprises believe that the prices of competitive import are lower than their own. In other manufacturing sectors the markets where import is more expensive prevail. And it is only in foodstuffs industry where 66% of the enterprises have the prices, approximately equal to the import.

The ratio of quality and price of the Russian production and import that compete with it, however, demonstrates that the position of domestic producers at the markets, which are competitive with the import, i.e. where the import does confront the Russian enterprises of manufacturing industries, are not as weak as they can seem due to the sharp increase of import supplies volumes, ruble appreciation and constant appeals to protect domestic producers. The ratio of price and quality estimations for domestic goods and import, received from the enterprises themselves favor such a conclusion.

First, on the whole throughout the industry import is noncompetitive due to the fact that its prices are equal to or higher than the domestic goods prices while the quality is the same or below the domestic goods. The biggest number of such markets is in foodstuffs industry (17%) and machine-building (15%). The smallest number of such highly-favorable in respect to competitiveness markets is in light industry (5%), chemistry and petrochemistry (1%). The main part of import at these markets is more expensive than domestic products the quality of goods being approximately equal.

Second, a large part of the markets (35% in total throughout the manufacturing industry) has correct (adequate) price to quality ratio of domestically produced goods and import. That is better quality of import comes along with higher price, equal quality – with equal price, lower quality – with lower price as compared with Russian goods. At such markets domestically produced goods compete by the ratio of price to quality with the import on equal terms. Leaving other industries far behind foodstuffs industry leads in respect to this index (54% of the markets). In other words, this industry, having the biggest proportion of the markets, which competes with the import, has to defend its positions in the environment of equal and therefore, perhaps, the most violent, competition with the import. Machine-building, which has the second biggest proportion of competitive markets, competes with the import as an equal in 36% of cases. Light industry succeeds in equal competition still less often (29%).

The competition being equal, import oftener has better quality and higher prices, especially at the chemistry and petrochemistry, machine-building and light industry markets. And acuteness of competition at the foodstuffs industry is underlined by the fact that equal competition prevails there, prices and quality being approximately equal.

Third, only 22% of Russian manufacturing industry enterprises considered their production as noncompetitive. The leader of this “anti-rating” was, as it should be expected, light industry. In this industry 31% of the enterprises admitted without any pressure that the goods they produce is of equal or lower quality as compared to import and is sold at equal or higher prices than import prices. The number of such markets in machine-building (26%) and in chemistry and petrochemistry (23%) a bit smaller. High competitiveness of foodstuffs industry is confirmed by the number of such markets where domestically produced goods yields to the import in price-to-quality ratio of only 8%. The same proportion in metallurgy and lower proportion in construction are not so informative owing to better protection of these industries market against the import.

Thus, Russian manufacturing enterprises believe that around 78% of their production is competitive in respect to import. These 78% include markets, where there is no import at all, where import is non-competitive

as regard to price-to-quality ratio and where there is equal competition with import. The proportion of such markets varies from 97% in construction to 69% in light industry by the industries.

It is not surprising under such conditions that competitive import is not considered as the main obstacle to output growth. In 2 quarter 2007 competitive import holds only 5th place according to the frequency of citation. The first place, which happened never before, is occupied by the shortage of qualified staff, which seems normal in the environment of demand and output high growth rates. This factor forced once two most severe problems of Russian industry: shortage of liquid capital and low demand. The shortage of production facilities is in the 4th place. In 2 quarter 2007 the shortage of equipment hinders the growth of already one-fourth of the enterprises, which is an absolute record value over 1993-2007.

S. V. Tsuchlo

Foreign Trade

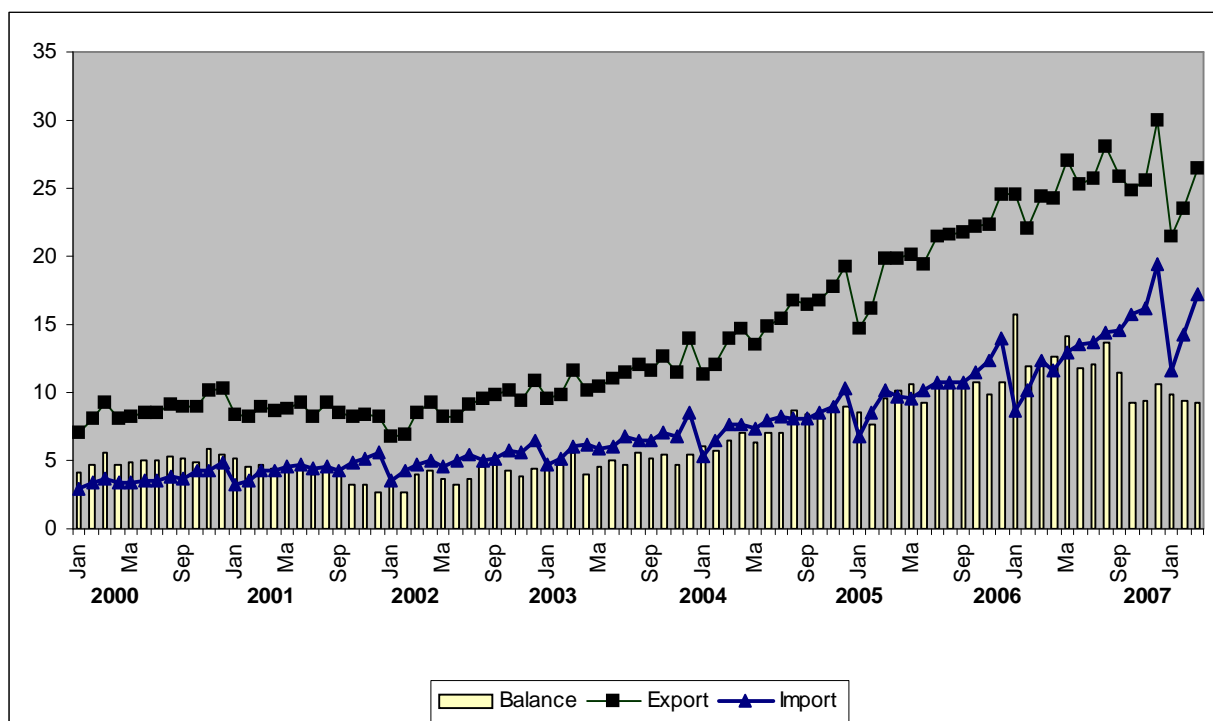
In March 2007 the development of the Russian foreign trade proceeded in the environment of sustention of the favorable external economic situation, ruble appreciation and increase in effective domestic demand. Nevertheless, the trend for anticipating import growth is reinforcing, which leads to the reduction of trade surplus.

The Government of the Russian Federation pursuits the policy for import duties nullification for the technological equipment whose analogues are not produced in Russia.

In March 2007 Russian foreign trade turnover, calculated by the balance-of-payments methodology was equal to USD 43.6 bln, which exceeds by 18.3% the volume of the foreign trade turnover in March 2006. Export from the Russian Federation grew only by 8.1% and was equal to USD 26.4 bln, while import – by 38.3% up to USD 17.2 bln. In March 2007 foreign trade surplus decreased by 23.2% as compared with the corresponding period of 2006 down to USD 9.2 bln.

Figure

Main Indices of the Russian Foreign Trade (as USD bln.)



Source: Central Bank of the Russian Federation

The volume of Russian export in 1 quarter 2007 was equal to USD 71.4 bln, which is by 6% higher than in the corresponding period of the previous year. In 1 quarter 2007 export from Russia to non-CIS countries went up by 5.5% - up to USD 60.96 bln, to CIS countries – by 9.1% - up to USD 10.4 bln. Thus, in 1 quarter 2007 Russian export growth rates were at the lowest level since 2002.

This can be accounted for by the decrease in growth rates of world prices for mineral resources used as sources of power as well as by the slowdown of the physical volumes of export. So, export physical volume

index in 1 quarter 2007 was equal to only 100.8% (in 1 quarter 2006 – 106.8%), price index – to 105% (in 1 quarter 2006 – 124.9%).

Nevertheless, the situation at the world market remained quite favorable for the Russian exporters. Despite the slow-down of the world prices for mineral resources used as sources of power growth, in March 2007 the state of the affairs at the world goods market for the Russian exporters was better than that in March 2006.

The world prices for oil having decreased in January 2007 by 14% as compared with the level of December 2006 (down to USD 50 per barrel), in February the price went up by 7.8% as compared with the level of January. In March the prices for oil continued to grow and reached their maximum over 6 months of over than USD 66 per barrel. The causes of the prices growth was apprehension, connected with the UN introduction of new sanctions against Iran, which did not agree to stop uranium enrichment program.

As a result of monitoring over March-April, average price for oil grade Urals was equal to USD 61.13 per barrel. Hence from 1 June 2007 export customs duty for crude oil will be increased from USD 156.4 per ton up to USD 200.6. From 1 June export duty for light oil products will go up from USD 117.7 per ton to USD 147.5, for dark oil products – from USD 63.4 to USD 79.4.

The dynamics of prices for oil products followed the pattern of the oil prices dynamics. The drop of prices in January gave place to their growth in February and March. In March 2007 average monthly prices for oil were as the following: for furnace fuel oil – USD 271 per ton (increase by 18.7% as compared with January 2007), for diesel oil – USD 545 per ton (increase by 13%), for premium car petrol – USD 613.4 per ton (increase by 27.2%).

The dynamics of the price for natural gas retraced the dynamics of the prices at the world markets of oil and oil products with a certain time lag. In March average price went down by 4.7% as compared with the level of February 2007, but increased by 18.4% as compared with March 2006.

At the world market of non-ferrous metals the trend for world prices increase was observed. During March, despite the lowering pressure, the price for aluminum remained at a quite high level. It was the increasing stock reserves and growing metal production that had weakening effect on aluminum market. Throughout the month stock exchange prices for aluminum lasted in the good range of USD 2700- 2800 per ton.

Price situation for copper producers was favorable in March 2007. World supplies decreased, stocks at licensed storage facilities also reduced. Another important factor having supported copper prices was growing demand from China. The price for the metal at London Metal Exchange was increasing nearly all the time. The price for copper did not go below USD 6000 per ton and by the end of the month the price had reached the level of USD 6750 per ton.

Nickel stocks have decreased by 90% over the last 12 months, while demand for nickel continues to grow, which is especially true for stainless steel producers. As a result considerable price growth is observed: while in March 2006 nickel price was USD 12879 per ton, on 19 March 2007 the price reached USD 50345 per ton.

Table 1

Average Monthly World Prices in March of the respective year

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Oil (Brent), USD/bbl	19.1	19.2	13.0	13.7	26.9	25.5	24.1	29.1	33.6	53.7	60.9	62.05
Natural gas, USD /1 mln BTU		1.870	2.170	2.120	2.828	5.200	2.996	5.757	5.267	7.234	6.123	7.25
Petroleum, USD /gallon	0.603	0.645	0.467	0.527	0.934	0.890	0.783	1.005	1.12	1.581	1.7	1.91
Copper, USD/ton	2584.7	2424.8	1772	1477.1	1779.1	1780.3	1605	1681.6	3018.0	3254.4	5103	6452.5
Aluminum, USD/ton	1600.8	1635.5	1441.3	1251.1	1584.2	1511.2	1403.2	1393.1	1660.0	1988.6	2429	2761.7
Nickel, USD/ton	7955.7	7929.5	5380	4934.5	10270	6140.3	6503.3	8402.4	13730	16190	14897	46324.8

Source: calculated on the basis of London Metal Exchange, International Petroleum Exchange (London) data

In January-March 2007 the monetary value of export of fuel and energy commodities decreased by 3.4% as compared with the similar period of 2006, and the share in the total volume of export decreased by 5.9 percentage points. Monetary value of the main commodity – crude oil, which makes up 52% of this group, - increased by 21%. Monetary value of oil products export went up by 3.6%. This index for natural gas, which comprises 22.3% of the whole group of fuel and energy commodities, decreased by nearly 20%. Such a decrease of gas supplies was caused by the decrease in demand because of warmer weather conditions.

Export of metals, gems and goods thereof in terms of value increased by 39.9%, and their share went up by 4.3 percentage points from 12.1% to 16.1%.

The share of chemistry industry production increased from 5.8% to 6.3% as a result of the rise of prices and physical volumes by 8.4% and 5.6%, correspondingly. The share of timber, pulp and paper goods export increased owing to considerable price rise (25.7%), decrease in physical volumes being slight (0.4%).

The first quarter of 2007 was record one by the indices of import, which went up by 38.7% as compared with the corresponding figure of 2006. It was the continuing appreciation of the real ruble and increase of real incomes of the population in the environment of insufficient competitive ability of domestic goods that favored import volumes increase. In January-March 2007 the dynamics of real disposable monetary incomes remained at a high level – increase was equal to 13.0% as compared with the corresponding period of the previous year.

The rise in import monetary volumes in the first quarter 2007 is connected primarily with the increase of physical volumes. Physical volumes index of import supplies was equal to 143.9%, price index m- to 105%.

Considerable rise of import supplies is observed throughout all items of goods. It is the share of capital goods, and first of all machine-building production, that is increasing especially fast. Machinery and equipment import increased by 67.8%. The role of increase in car import is, however, quite significant at that, in physical terms they were imported by 63.7%, in terms of value – by 81% more than in the first quarter of the previous year.

In comparison with March 2006, in March 2007 it was observed that purchase of textile and footwear goods increased by 50.4%, foodstuffs – by 31.6%, chemistry industry goods – by 18.6%.

In 1 quarter 2007 as a result of anticipating import growth foreign trade surplus decreased by 23% as compared with the first quarter 2006 and was equal to USD 27.9 bln.

The coefficient of imbalance in trade turnover dropped from 37% in 1 quarter 2006 to 24.8% in 1 quarter 2007 (with non-CIS countries decreased from 37.8% to 25.3%, with CIS countries – from 32.2% to 22%). Import cover by export with non-CIS countries decreased from 221.5% in 1 quarter 2006 to 167.8% in 1 quarter 2007, with CIS countries – from 195.1% to 156.4%.

In 1 quarter 2007 the share of countries which are the main Russia's business partners in the total trade turnover grew by 2 percentage points in comparison with the 1 quarter 2006 and was equal to 52.4%. The share of Germany and the Netherlands in the total trade turnover over the period mentioned decreased as compared with the corresponding period of 2006 by 0.7 and 1.1 points, respectively. This is connected with the reduction of fuel and energy commodities supplies from Russia. In the total volume of the trade turnover the share of China increased by 1.2, of the republic of Korea – by 0.6, of Japan – by 0.9, of Turkey – by 0.7 percentage points as compared with the corresponding period of the previous year.

On 29 April 2006 the resolution of the Government of the Russian Federation No 168, which envisages nullification of import duty rates for technological equipment not produced in Russia for the period of 9 months. On 23 May 2007 the Ministry for Economic Development and Trade suggested to the Government the project on introduction of zero duty rates for technological equipment on the permanent basis.

To develop domestic industry and increase its competitiveness as well as in connection with the preparing Russia's accession to the WTO, the Ministry for the Economic Development and Trade continues the work on further decrease and abolition of the import duties for technological equipment. Interdepartmental committee on protective measures for foreign trade and customs and tariffs policy adopted the decision on exemption from the import duty of 98 more types of machinery, equipment and apparatuses on 18 July 2006.

It took nearly a year to adjust the list. In the prepared project of the resolution it is suggested to abolish import duties (which are 5-10%) for 63 out of 87 items of commodities group 84 of Commodities Classification for foreign economic activities – “nuclear reactors, boilers, mechanical devices and parts of them”, for 3 out of 48 items of commodities group 48 – “electric machinery and equipment, sound recording and sound transmitting devices, devices to record and reproduce video pictures and sounds” and for all 32 items of commodities group 90 – “optical, photographic, cinematographic, measuring, control, medial or surgical tools and devices”. Besides the equipment the duties are abolished for cameras and camcorders, liquid crystals indicators.

Liberalization of the customs tariff in 2006 concerned approximately 5% of equipment import. Given the list of resolution project, directed to the Government by the Ministry for Economic Development and Trade, from June 2007 more than half of the range of technological equipment import will be duty-free, which will comprise about 6% of the total equipment import.

According to the estimations of the Ministry for Economic Development and Trade, the losses to the budget were about USD 500 mln (according to the customs statistics for 2005). Duties nullification for 98

items will cost the budget USD 106 mln (given the data of the Federal Customs Service on import in 2006). Lost incomes should be compensated for by the improvement of customs administration.

The number of export duties of purely fiscal nature should be reduced, transferring from the situation when the main function of the customs is to fill the budget, to the situation when the duties become the tool to stimulate the economic growth. It is not improbable that if the production of the equipment analogues will start in Russia, the duties can be again introduced.

N. Volovik

An analysis of key characteristics of the federal budget for year 2008 and the period until 2010

In April of 2007, the RF Government presented the draft law “On the federal budget of the Russian Federation for year 2008 and the period until 2010.” It should be noted that for the first time in the Russian practice of budget planning the federal budget was drawn up for a three year period, what, on the one hand, should no doubt improve the understanding of the medium term fiscal policy pursued by the RF Government on the part of the public and the clearness of financial security of adopted expenditure obligations for the three year perspective; however, on the other hand, this development enhances the requirements with respect to the quality of the budget and enhances responsibility for mistakes made in the course of budget planning.

Below there are presented some comments on the state of the revenue and expenditure sides of the federal budget for years 2008 through 2010, as well as sources of financing of the deficit of the federal budget. Basing on the presented comments there will be made some inferences on the draft federal budget for years 2008 through 2010.

1. An analysis of key characteristics of the RF federal budget

Basing on the data on the actual execution of the RF federal budget in the period from 2000 till 2006 (see Table 1), there can be noted several general trends: first, it is a trend towards a stable growth in the revenues of the federal budget; over this period revenues increased more than 1.5 times; second, the stabilization of the share of expenditures at the level of 16 per cent over the recent years; third, it is a rapidly growing budget surplus: in the period from 2002 till 2006 the amount of the budget surplus increased 5.3 times making 7.5 per cent of GDP; fourth, the persistent high dependability of budget revenues on the export of energy resources is manifested by the persistent deficit of the budget without its oil and natural gas based components, over the period under observation this figure fluctuated in the range from 1.7 per cent to 3.8 per cent of GDP.

Table 5

An analysis of the actual and expected execution of revenues and expenditures of the federal budget in the period from 2000 till 2010 (in per cent of GDP)

	Actual values							Es- tima- tes	Draft budget		
	2000	2001	2002	2003	2004	2005	2006		2007	2008	2009
Revenues	15,5	17,8	20,3	19,5	20,1	23,7	23,6	20,3	19,0	18,8	18,1
including revenues not related to oil and natural gas	11,7	13,1	15,1	14,1	13,5	13,6	12,7	12,2	12,2	12,9	12,8
revenues related to oil and natural gas	3,8	4,7	5,2	5,4	6,6	10,1	10,9	8,1	6,8	5,9	5,2
Expenditures	14,2	14,8	18,9	17,8	15,8	16,3	16,1	18,3	18,8	18,8	18,1
Including oil and natural gas transfer	2,4	1,9	2,9	3,7	2,0	2,3	2,9	4,9	6,1	5,3	4,5
Saving of oil and natural gas related revenues	1,4	2,8	2,3	1,7	4,6	7,8	8,0	3,2	0,7	0,6	0,7
RF federal budget balance, in % of GDP	1,4	3,0	1,4	1,7	4,3	7,4	7,5	2,0	0,2	0,0	0,0
Budget deficit without oil and natural gas generated revenues	2,5	1,7	3,8	3,7	2,3	2,7	3,4	6,1	6,6	5,9	5,3

Source: RF Finance Ministry, IET calculations.

As it is seen in Table 1, the RF Finance Ministry expects that significant changes will take place in all the trends described above since the adoption of the federal budget for year 2007 and in budgets for years 2008 through 2010. First of all, it is expected that due to the forecasted decline in the world oil and natural gas prices, a slower rate of growth in the extraction and export of hydrocarbon resources and the Ruble appreciation against the US dollar the ratio between the oil and natural gas generated revenues of the federal budget and GDP should decline almost two times: from 10.9 per cent in 2006 to 5.2 per cent of GDP in 2010. This decrease of oil and natural gas generated revenues is not expected to be sufficiently compensated by a growth in structural revenues. As a result, it is estimated that the reduction of the total amount of all budget revenues should make 5.5 percentage points of GDP in 2010 as compared with the figures registered in 2006.

At the same time, the budget expenditures significantly grow, what is to a great extent related to both the implementation of the already existing federal target programs and priority national projects and the necessity to attain the “new” objectives formulated in the Presidential Address to the Federal Assembly of the Russian Federation in 2007: to include in the federal budget financial resources for creation of a special fund, which should ensure efficient work on the reforming of the housing maintenance and public utilities, amounting to Rub. 250 billion; Rub. 300 billion for the capitalization of development institutions, primarily, of the Development Bank, Investment Fund, Russian Venture Company and so on; Rub. 100 billion for the development of the street and road networks, i.e. for urban redevelopment in Russian towns and cities; Rub. 130 billion should be managed by a specially established Russian Corporation of Nanotechnologies, etc.

A significant reduction of budget revenues coupled with an increase in its expenditures should result in the zero budget balance yet by 2009. However, from our viewpoint, taking into account the 7 years long dynamics of growth in the budget surplus and other objective data on the declining rates of increase in exports of hydrocarbon resources and appreciation of the Ruble observed in 2006, the reduction of the budget surplus from 7.5 per cent of GDP in 2006 to 0.2 per cent of GDP in 2008 seems, nevertheless, to be unlikely. Apparently, the dynamics of the budget revenues are open to question; however, in this case one may doubt the reliability of the forecast on the indicators of social and economic development of the Russian Federation worked out by the RF Ministry of Economic Development and Trade.

No doubt, a rather significant dependence of the Russian budgetary system on the export of energy resources and, therefore, the business situation on the world markets is evidence of substantial risks related to a possible destabilization of the state balance. In this connection, taking into account the important role played by oil and natural gas generated revenues in the formation of the state budget due to the importance of the raw materials sector of the economy, the urgency of structuring of such revenues and their further utilization in the Russian economy is apparent. An attempt to use oil and natural gas generated budget resources on condition of maintenance of long term macroeconomic stability will be made in 2008 by the way of transformation of the RF Stabilization Fund into the Reserve Fund to be used for the compensation of budget revenues declining in the case of a decrease in oil prices and the Future Generations Fund, which should be used to ensure the long term budget equilibrium. As a result, in the period from 2008 till 2010 the utilization of oil and natural gas generated revenues should increase from 2.9 per cent of GDP in 2006 to 5.3 per cent of GDP in 2008 through 2010 on the average; at the same time, the savings of oil and natural gas generated revenues over this period should be at or below 0.7 per cent of GDP as compared with 8.0 per cent of GDP observed in 2006.

2. An analysis of the revenues as set in the draft federal budget of the Russian Federation

The observed in 2008 through 2010 decline in the share of budget revenues in GDP in comparison with the figures registered in 2006 may be primarily explained by the reduction of the share of the oil and natural gas sector in the national economy – from 20.7 per cent in 2006 to 14.9 per cent in 2010, and, as a result, a decline in the revenues generated by the mineral extraction tax and export customs duties, as well as the changes in the RF tax legislation, which, according to the RF Finance Ministry estimates, should result in a 0.68 per cent of GDP decline in the revenues in 2008. However, in the course of calculation of budget revenues, from our point of view, not all possible consequences of changes in the tax legislation were taken into account. For instance, no attention was paid to such possible changes in the legislative framework as the introduction of special registration procedures with respect to persons, who should pay VAT, to be introduced on January 1, 2008, as well as the reduction of the list of operations eligible for VAT relief to be introduced on January 1, 2009, and the annual, since January 1, 2008, indexation of the rate of the mineral extraction tax on natural gas with the use of a coefficient significantly exceeding the estimated inflation rates proposed by the RF Finance Ministry.

The fact that at the background of a significant decline in the budget revenues generated by the mineral extraction tax and export customs duties, which should take place in the period from 2008 till 2010, also gives rise to doubts, since the share of key taxes in budget revenues will remain at the practically same level, and only the structure of tax related revenues should change, as it is presented in Table 6.

Table 6

The dynamics of the structure of tax generated revenues of the federal budget in the period from 2004 till 2010 (in % of GDP)

Taxes	Actual execution			Estimate 2007	Draft budget		
	2004	2005	2006		2008	2009	2010
Corporate profit tax	1,2	1,8	1,9	1,9	1,5	1,5	1,4
VAT	6,3	6,2*	5,7	5,8	6,2	7,0	7,2
Excise duties	0,7	0,5	0,4	0,4	0,4	0,4	0,4
Revenues generated by customs duties (revenues from external economic activities)	5,0	7,8	8,6	6,7	5,9	5,3	4,8
Mineral extraction tax	2,5	3,9	4,1	2,9	2,5	2,1	1,9
Share of the above taxes in the revenues of the federal budget, %	78,1	87,6*	87,7	87,2	86,8	86,7	86,7

* without revenues related to YUKOS

Proceeding from the data presented in Table 6, it may be concluded that across all key taxes with the exception of the value added tax there is forecasted either a decline in revenues (in per cent of GDP), or stabilization thereof. It should be noted that, as it has already been indicated above, the estimates of tax revenues directly related to the business situation on the markets primarily depend on the accuracy of the forecast of the dynamics of world prices of hydrocarbon resources and indirectly on the rates of extraction of energy resources and the Ruble exchange rate levels; however, the amounts of structural revenues (i.e. those not related to oil and natural gas) should be determined by objective changes in the domestic economy. In this connection, the substantiation of the forecasts concerning a growth in VAT generated revenues seems especially doubtful.

It is apparent that in 2004 through 2006 the dynamics of budget revenues generated by the value added tax demonstrated a stable trend towards decline, what was primarily determined not only by macroeconomic factors, but, mainly, by the changes introduced in the tax legislation over these years (the reduction of VAT base rate from 20 per cent to 18 per cent in 2004; the introduction of the list of operations concerning real estate and plots of land not subject to this tax in 2006; and, the most significant factor, the switching to the accrual method and the adoption of new procedures governing the compensation of VAT paid in relation to capital construction operations in 2006). It should be noted that the indicators of VAT generated revenues registered over 4 months of 2007, the effect of these factors persist and is not of short, but of long term nature. Alongside these factors, the decline in the VAT generated revenues was also facilitated by the switching to the declaration based procedures concerning the compensation of VAT paid by exporters with respect to material resources since January 1, 2007, what should result in a streamlining of procedures governing the payment of such compensations and, therefore, a reduction of the balances of amounts not yet returned to exporters. Moreover, the estimates of VAT generated budget revenues do not take into account the consequences of the switching to the special registration procedures with respect to legal persons and individual entrepreneurs as VAT payers.

Basing on the facts discussed above, it may be concluded that, from our viewpoint, the estimates of VAT generated budget revenues in 2008 through 2010 are apparently overstated and poorly substantiated, it should be noted that the error may make up to 1.5 per cent of GDP.

Yet another controversial issue in the draft budget as concerns tax generated revenues is the decline in the revenues related to the corporate profit tax, which, on the contrary, demonstrated a trend towards growth over the recent months. Besides, at the background of the expected reduction of the share of the extractive sector of the economy the growth in the volumes of output of manufacturing industries and the sphere of services, as well as an increase in producer prices and the net balanced financial results of the operations carried out by enterprises in the Russian Federation (over the first 10 months of 2006 the net balanced financial result increased by 26 per cent) permit to expect that the revenues generated by the corporate profit tax in 2006 will be at least maintained at the same level.

On the whole, in the medium term outlook in the situation of implementation of structural reforms and economic growth the risks to face problems in functioning of individual taxes may be structured as follows:

1. A significant dependence of tax revenues generated by oil and natural gas prices, as well as the risk of a sharp decline in such revenues in the case the external business situation deteriorates, require planning and implementation of measures aimed at the reduction of the dependence of tax generated revenues of the budgetary system on the world oil prices. In the present situation, taking into account the persistent trend towards a decline in the structural component of revenues of the budgetary system (i.e. the component, evaluation of which does not depend on world oil prices), it requires at least the upholding of the quality of administration of the base and rates of taxes, which depend less on the world oil prices (value added tax, excise duties).

At the same time, the reduction of the value added tax rates, the replacement of VAT with the sales tax, refraining from the indexation of excise duties rates, on the contrary, sharply raise the risks of a decrease in tax generated revenues in the case of decline in the world oil prices. In the case it becomes necessary to implement decisions concerning a further reduction of the tax burden, it would be feasible, all other things being equal, to reduce taxes significantly depending on oil prices, such as the mineral extraction tax or the corporate profit tax, whereas the rates and base of the value added tax and excise duties rates in real terms should be maintained at the same level.

2. Yet another group of potential risks related to the significant dependence of the Russian tax system and its economy at large on the oil sector is the potential decline in revenues in this sector caused by the decreasing rate or returns and growing costs of development of deposits of natural resources. Taking into account the fact that the enterprises operating in the oil and natural gas sector provide more than one third of the total amount of tax generated revenues of the budgetary system, the fact that resources exhaust and their prices increase should be taken into account in the course of making long term forecasts of budget revenues. It should be kept in mind that over time the share of revenues generated by these activities will gradually diminish.

One of the key problems pertaining to the functioning of the mineral extraction tax is the evaluation of its feasibility and possible switching to the differentiation of its rates. In the present situation of high oil prices, the differentiation of rates may create the danger of making of unsubstantiated discretionary decisions concerning the reduction of tax rates for certain oil companies; however, in the long term outlook, as the tax administration and control over the conditions of extraction are enhanced, the differentiation of tax rates will, it seems, be introduced, but on condition that the problem of substantiation and examination of the differences among deposits is solved.

3. In the medium term outlook, the trends of development of the Russian economy will, as it seems, include a relatively slower rates of development of the manufacturing sector and a faster growth in the sectors of construction and services. These developments should result in the increase of the shares in the economy of the sectors most difficult for tax administration. In addition, it should be noted that the implementation of the transformations in the sphere of development of financial instruments will, as it appears, result in an enhancement of the role played by the financial sector in the economy; in this case, alongside with the complication of tax administration, the risks of functioning of the tax system will also include the necessity to adopt special provisions concerning the taxation of earnings and operations in the financial sector.

The risks indicated above require a more thorough examination and quantitative evaluation in the course of planning of tax revenues in order to increase the quality of drafting federal budgets for the medium term outlook.

3. An analysis of the expenditures as set in the draft federal budget of the Russian Federation

In 2008 through 2010, the changes in the share of expenditures of the federal budget in per cent of GDP follows the dynamics of growth set in the budget for year 2007 yet. At the same time, as it is shown in Table 3, the aggregate growth of the expenditures borne by the budget was determined only by the increase in the expenditures not related to the payment of interest, which should make 18 per cent of GDP on the average in 2008 through 2010 as compared with 16.0 per cent registered in 2005 through 2007.

One of the key factors behind such a significant growth in the non-interest expenditures of the federal budget in 2008 through 2010 was the Address of the RF President to the RF Federal Assembly, where there was set a number of priority objectives of the state policy to be pursued over the period under observation. In particular, the priorities included the work towards a solution of a number of problems in the sphere of social policy and raising of the standard of living of employees in the public sector, federal public servants, servicepersons and persons granted an equal status, as well as pensioners and other citizens, with respect to whom there exist financial obligations at the federal level. Yet another priority was the elimination of transport and energy related limits on development of the national economy, and the creation of incentives for

growth in the nano-industry and aircraft industry. Also in the composition of expenditures of the federal budget for 2008 through 2010 there were allocated financial resources necessary for the implementation of the provisions of the Presidential Address concerning the demographic situation in Russia.

Now, let us review the structure of expenditures of the RF federal budget and compare it with the structure of expenditures observed in the preceding years (see Table 8).

Table 7

Parameters of expenditures borne by the federal budget in 2005 through 2010, in Rub. billion

	2005		2006		2007		2008		2009		2010	
	Rub. billion	% of GDP	Rub. billion	% of GDP	Rub. billion	% of GDP	Rub. billion	% of GDP	Rub. billion	% of GDP	Rub. billion	% of GDP
Expenditures, total:	3514,3	16,3	4281,3	15,9	5615,5	18,3	6570,3	18,8	7451,2	18,8	8089,9	18,1
Including expenditures not related to the payment of interest	3306,0	15,3	4112,3	15,3	5458,7	17,8	6382,4	18,2	7238,6	18,2	7842,8	17,5
Interest expenditures	208,3	1,0	169,1	0,6	156,8	0,5	187,9	0,5	212,6	0,5	247,1	0,6
Memorandum: GDP	21620		26871		30690		35000		39690		44800	

Source: RF Finance Ministry, IET calculations

Table 8

The dynamics of changes in the structure of expenditures of the federal budget in the period from 2005 till 2010

	Actual figures		Law for 2007	Draft budget		
	2005	2006		2008	2009	2010
Expenditures, total:	16,3	15,9	17,8	18,8	18,8	18,1
Including:						
Federal issues	2,4	1,9	2,6	2,5	2,4	2,4
<i>Of which</i> servicing of the public debt	1,0	0,6	0,5	0,5	0,5	0,6
National defense	2,7	2,5	2,7	2,7	2,7	2,7
National security and law enforcement	2,1	2,0	2,2	2,2	2,3	2,2
National economy	1,2	1,3	1,6	2,1	2,0	1,2
Expenditures for social policy and social sphere	2,1	2,0	2,5	2,5	2,5	2,6
Interbudgetary transfers	5,8	5,6	6,1	6,5	6,1	6,1

Source: RF Finance Ministry, IET calculations

At the backdrop of the general growth in expenditures, the most noticeable changes in comparison with the budget for year 2007 and two preceding years are related to the increase in the financing of measures undertaken in the social sphere (on the average, by 0.4 percentage points of GDP as compared with the figures registered in 2005 through 2007), as well as the fluctuations in the share of expenditures for the national economy in GDP: in 2008 it reached the maximum (2.1 per cent of GDP in the period from 2005 till 2010), and later declines making 1.2 per cent of GDP by 2010, what is primarily related to the completion of a number of the federal target programs. It should be stressed that the programs nearing completion are directly aimed at the development of infrastructure and aircraft industry – “Motor roads,” “Modernization of the Russia’s transport system,” “Civil aircraft,” “Sea transport,” “Internal waterways,” and “Development of export of Russia’s transport services.”

It should be also specially noted that expenditures for federal issues declined (without taking into account the expenditures for the servicing of the public debt) from 2.1 per cent of GDP in 2007 to 1.8 per cent of GDP in 2010, whereas the amount of interbudgetary transfers should increase in 2008 (by 0.4 percentage points of GDP) at the expense of a growth of contributions to extra-budgetary funds.

In 2008 through 2010, the shares of other expenditures of the federal budget in GDP will either insignificantly change (within the range of $\pm 0,1$ percentage points of GDP), or remain at the same levels.

Similarly to the situation observed a year ago, significant amounts of financing were traditionally allocated for sections “Interbudgetary transfers,” “Federal issues,” “National defense,” “National security and law enforcement,” “National economy,” and the package of social expenditures.

In 2008 through 2010, the situation with budgetary expenditures seems to be rather ambiguous. On the one hand, formation of expenditures of the federal budget took into account the benchmarks of financing indicated by the RF President in his Address to the RF Federal Assembly. On the other hand, such a significant increase in the budgetary expenditures (almost 3 percentage points of GDP in comparison with the figures registered in 2006) may entail negative consequences for the Russian economy, since in the situation of excessive inflation pressure this growth in expenditures creates additional problems deteriorating the efficiency of anti-inflation measures taken by the RF Government. In spite of the fact that by the end of 2006 the RF Government was able to contain inflation rates at the planned level, any further increase in the non-interest expenditures in terms of their share in GDP may hinder the measures the RF Government takes in order to further decrease the rates of growth in consumer prices in the short term and medium term outlook.

Moreover, the draft budget includes a significant amount (hundreds of billions of Rubles) of obligations concerning the financing of measures implemented either in the framework of priority national projects, or through the channels of the RF Investment Fund, Development Bank, and other development institutions; these obligations are assumed without the due analysis of long term financial consequences of such funding for the expenditures borne by the federal budget and the national budgetary system on the whole. As a result, possible additional expenditures, which may arise in the process of implementation of these projects and programs, remain unaccounted for. Therefore, in the course of the planning of new expenditure obligations it is necessary to ensure that all possible financial consequences of implementation of individual measures in the framework of these projects are thoroughly monitored and, respectively, reflected in the budget.

4. An analysis of the debt policy of the RF federal budget

The aggregate balance across the sources of financing of the federal budget deficit will increase in comparison with the figures registered in 2007 by Rub 121.2 billion and will make Rub. 174.0 billion in 2008, Rub. 234.1 billion in 2009, and Rub. 332.3 billion in 2010. In the case there is reviewed the structure of the budget across the sources of financing, the balance of domestic sources will make Rub 328.5 billion, Rub. 333.1 billion, and Rub. 439.6 billion respectively in 2008 through 2010, whereas the negative balance across external sources of financing is expected to make Rub. 154.5 billion, Rub. 99 billion and Rub. 107.3 billion respectively in 2008 through 2010. Therefore, at the federal level there will be continued the policy aimed at the replacement of external sources of borrowings with domestic ones. This process is illustrated by the data presented in Table 9.

Table 9

The dynamics of the structure of the public debt of the Russian Federation, in % of GDP

	2006	2007	2008	2009	2010
Public debt, total:	9,0	8,5	8,4	8,7	9,1
Internal debt	3,9	4,6	5,2	5,7	6,4
External debt	5,1	3,9	3,2	2,9	2,8

Source: RF Finance Ministry, IET calculations

As the Table demonstrates, the share of domestic sources of borrowings in the total amount of the RF public debt should increase up to 70 per cent by 2010 as compared with 43 per cent registered in 2006. Such a ratio between the domestic and foreign sources of borrowings is a result of the implementation of the policy aimed at the complete abandon of attraction of new credits of governments of foreign countries and on the international markets of capital, as well as the acceleration of implementation of the majority of the current projects with participation of international financial organizations in order to complete repayment of the earlier debts and minimization of amounts of new borrowings from the international financial organizations. As a result, the draft budget envisages the use of only target “tied” credits extended by the international financial organization. The amount of such credits should make Rub. 18.6 billion in 2008, and Rub. 13.4 billion and Rub. 11.1 billion in 2009 and 2010 respectively.

Over the period under observation, the main source of financing of repayment of the state debt obligations should be financial resources attracted via the placement of securities on the domestic market. Thus, in 2008 the placement of state securities on the domestic market is estimated to attract Rub. 463.3 billion, Rub. 496.7 billion in 2009, and Rub. 671.4 billion in 2010. However, from our point of view, the more than twofold increase in the amounts of domestic borrowing in comparison with the figures registered in 2007 and the fact that these financial resources are attracted for medium and long terms (their share should make about 98 per

cent of the total planned amount of borrowings) will not result in the squeezing out or growth in the prices of investments necessary to ensure growth of the national economy.

Conclusions

Basing on these comments on the law on the federal budget for year 2008 and the period until 2010 concerning the revenues and expenditures of the budget, as well as the sources of financing of the federal budget deficit, there may be drawn the following conclusions.

1. The level of reduction of all budget revenues by 5.5 percentage points of GDP by 2010 in comparison with the respective level registered in 2006, and, as a result, the reduction of the budget surplus from 7.5 per cent of GDP in 2006 to 0.2 per cent of GDP in 2008 seems to be rather controversial; however, the reliability of the indicators of the forecast of social and economic development of the Russian Federation elaborated by the RF Ministry of Economic Development and Trade, on the basis of which there was drawn the revenue side of the federal budget, is open to question.

At the same time, from our point of view in the course of calculation of the revenues of the federal budget there were taken into account not all possible consequences of changes in the tax legislation; as a result, the justification of the forecasts concerning the growth in the amount of VAT generated budget revenues seems to be doubtful. No proper assessment was made with respect to the consequences of switching to the accrual method and the adoption of new procedures governing the compensation of VAT paid in relation to capital construction operations, as well as the switching to the declaration based procedures concerning the compensation of VAT paid by exporters with respect to material resources since January 1, 2007, what should result in a streamlining of procedures governing the payment of such compensations and, therefore, a reduction of the balances of amounts not yet returned to exporters. Moreover, the estimates of VAT generated budget revenues do not take into account the consequences of the switching to the special registration procedures with respect to legal persons and individual entrepreneurs as VAT payers since January 1, 2008, and the reduction of the list of operations eligible for VAT relief to be introduced on January 1, 2009, as proposed by the RF Finance Ministry.

Yet another controversial moment in the draft composition of tax generated budget revenues is the decline in the revenues related to the corporate profit tax, which has demonstrated a stable trend towards growth over recent years.

Moreover, the existing risks that certain problems can arise in the functioning of some taxes were not reflected either in the draft budget for years 2008 through 2010, or in the respective supplementary documents, what also negatively affects the quality of the drawing of the budget and its reliability.

2. In spite of the fact that the total growth in the expenditures of the budget is primarily related to the allocation of financial resources for the implementation of priority measures in the social sphere indicated by the RF President in his Address to the Federal Assembly, the urgency of the problem of the fast elimination of infrastructural limitations on economic growth still persists. In this connection, it gives rise to concerns that expenditures for national economy are reduced from 1.6 per cent of GDP in 2007 to 1.2 per cent of GDP in 2010, as well as the completion of a number of federal target programs, which are directly aimed at the development of infrastructure and aircraft industry – “Motor roads,” “Modernization of the Russia’s transport system,” “Civil aircraft,” “Sea transport,” “Internal waterways,” and “Development of export of Russia’s transport services.”

In 2008 through 2010, the situation with budgetary expenditures seems to be rather ambiguous. On the one hand, formation of expenditures of the federal budget took into account the benchmarks of financing indicated by the RF President in his Address to the RF Federal Assembly. On the other hand, such a significant increase in the non-interest component of expenditures may entail certain risks that the task to contain inflationary processes in the economy may be not fulfilled. In this situation, it seems feasible to estimate inflationary consequences of execution of this draft federal budget.

Moreover, the draft budget includes a significant amount (hundreds of billions of Rubles) of obligations concerning the financing of measures implemented either in the framework of priority national projects, or through the channels of the RF Investment Fund, Development Bank, and other development institutions; these obligations are assumed without the due analysis of long term financial consequences of such funding for the expenditures borne by the federal budget and the national budgetary system on the whole. As a result, possible additional expenditures, which may arise in the process of implementation of these projects and programs, remain unaccounted for. Therefore, in the course of the planning of new expenditure obligations it is necessary to ensure that all possible financial consequences of implementation of individual measures in the framework of these projects are thoroughly monitored and, respectively, reflected in the budget.

3. In the sphere of management of the RF public debt at the federal level, the continuation of implementation of the policy aimed at the replacement of external sources of borrowings with domestic ones may be evaluated as positive dynamics. As a result, the share of domestic sources of borrowings in the total amount of the RF public debt should increase up to 70 per cent by 2010 as compared with 43 per cent registered in 2006.

At the same time, from our point of view the more than twofold increase in the amounts of domestic borrowing in comparison with the figures registered in 2007 and the fact that these financial resources are attracted for medium and long terms (their share should make about 98 per cent of the total planned amount of borrowings) will not result in the squeezing out or growth in the prices of investments necessary to ensure growth of the national economy.

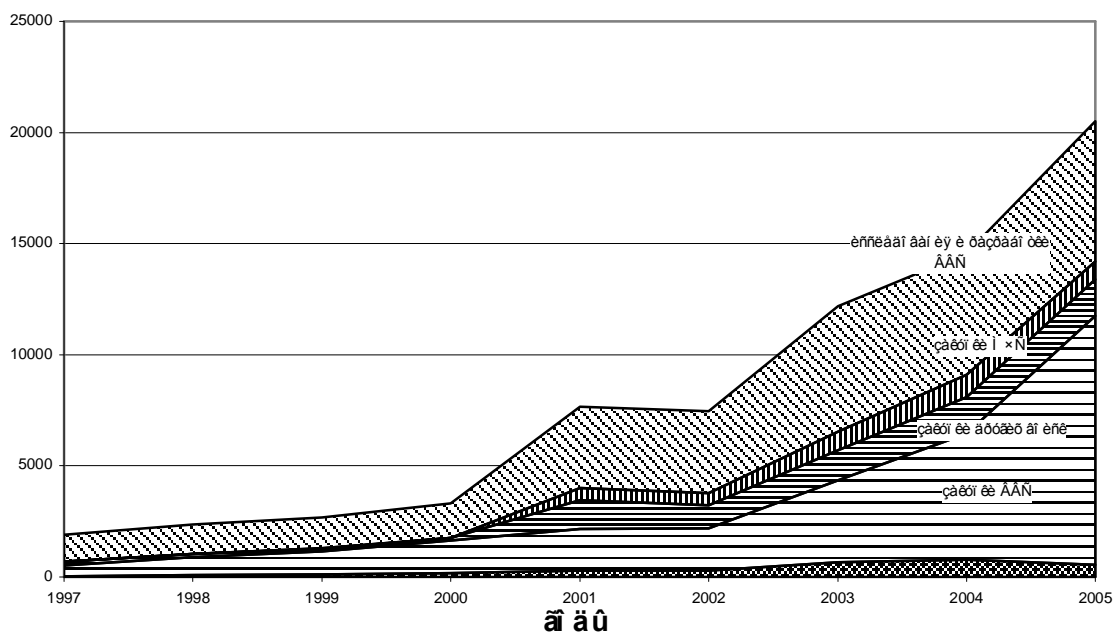
I. Sokolov

Economic aspects of development of the RF aircraft industry: social implications

This section deals with economic aspects of coordinated development of military and civil aircraft in Russia. Proceeding from an analysis of the data on the financing of the RF military aircraft industry, as well as the prospects of development of the RF civil aircraft, it follows that the needs of civil aircraft industry should be set as a priority. In order to answer the question on the rational share of production of civil aircraft aimed for export and for the domestic market there has been developed a method defined as “the evaluation of implicit optimization.” Basing on this method, there have been revealed possible “discrepancies” in the plans concerning the production and use of our civil aircraft.

A number of innovative projects taking into account the specifics of the present situation raise certain hopes that the RF aircraft industry could overcome the crisis in the grip of which it is now.

Let us begin with the military aircraft industry. At the moment, the Russian Federation has no completed principally new designs of piloted military flying vehicles (FV), although large sums have been spent for R & D in this sphere. These financial resources are shown in the upper “layer” of the total amount of the expenditures the Russian Federation allocates for military aircraft and are based on the data contained in reports the Russian Federation presented to the United Nations.



- Note: Ministry of the Russian Federation for Civil Defense, Emergency Management and Natural Disasters Response

Fig. 1. Expenditures for the development of the RF military aircraft borne by the RF, Rub. billion

On the whole, the dynamics of all these expenditures, if compared with the results achieved, provide evidence that the allocated financial resources have been spent inefficiently. The Air Force received just a few new military flying vehicles.

At the same time, the USA has already put out the first pieces of a new tactical aircraft of the so called fifth generation and a principally new multipurpose aircraft V – 22 driven by propellers mounted on its wings. Some other countries, for instance, Sweden, have also proven that they have sufficient competitive power with respect to the USA in the field of development of combat piloted flying vehicles due to an optimal ratio between the quality and prices of their planes. At the same time, many other countries successfully compete the United States in the area of creation of combat drone flying vehicles.

Judging by the publications in foreign mass media and studies of Russian military analysts¹³, in the USA numbers of combat airplanes and helicopters procured annually make hundreds vehicles. In comparison with these figures, the output of combat airplanes and helicopters manufactured by the piece in Russia for its own Armed Forces remains insufficient not only to meet the needs of the RF military organization, but (even taking into account the production of flying vehicles for export) to make production profitable. The backwardness of Russia is especially felt in the sphere of radio and electronic equipment “stuffed” in airplanes, i.e. avionics. There is a little chance of successful competition. Therefore, foreign procurement of Russian made piloted military flying vehicles may decline soon, moreover, taking into account the fact that since recently the Russian Federation has been selling not only completed flying vehicles, but also licenses for manufacturing thereof. It should be also noted that over recent years, both India and China, for instance, have already been installing equipment of their own production or purchased in third countries in the flying vehicles they buy in Russia.

It should be also noted that the RF Government totally abandoned the financing of development of the civil aircraft in the country yet in the early 1990s, immediately after privatization of the former civil air fleet (CAF) of the USSR. Numerous air carriers of Russia refrained from contracting new civil aircraft not to mention R & D. The leasing of Russian airplanes supported by the state has also failed to come up to expectations. In 2004, aircraft factories in the Russian Federation manufactured only 13 passenger planes, whereas the respective figure for 2005 made 8 pieces. Over the same period, European consortium Airbus and American Boeing produced 378 airplanes and 290 airplanes respectively.

In 2006, there was observed no significant improvement of the situation of the Russian aircraft industry. Over the recent years, at the enterprises of the RF aircraft industry there has not been carried out any renovation of the machine pool and technologies. Personnel aged both in the sphere of production and in the sphere of operation and maintenance of aircraft. Whereas in 1990 more than 600 pilots of the civil air fleet graduated from the national flying schools, at present this figure makes 70 to 80 graduates. In 1990, the average age of pilots made from 28 to 29; however, at present this figure is over 40. Breakdown rate increased and was record high in 2006.

Therefore, it became inevitable that in this sphere Russia returned to the industrial policy tested yet in the USSR and at present pursued by some developed countries, which envisaged the compulsory integration of state development strategies with respect to both military and civil piloted flying vehicles. As concerns technologies, there was also necessary to carry out unification of respective components. However, using the term “return” it should be noted that there exists a principal difference between the old and new situations. At that time, the priority was the development of military aviation, whereas at present the **priority has to be set on civil piloted flying vehicles.**

Therefore, the creation of a united aircraft industry corporation (UAC) in 2006 was both forced and strategically right measure. UAC sets focus on the development of civil production at all enterprises of the aircraft industry, including even the Sukhoi experimental design bureau, which has been earlier involved primarily in military aircraft. There was launched the project of manufacturing of regional and short range airplanes belonging to the Russian Regional Jet (RRJ) family. In the framework of this project there were introduced many features, which were new for the Russian aircraft industry: the development based on characteristics exceeding the respective features of products manufactured by all known competitors and meeting (on the safe side) the requirements set by all international standards; as well as cooperation with 15 foreign firms supplying component parts under the guidance of a Russian experimental design office.

Moreover, practically at the same time the project was launched there were signed contracts for purchase of the “competing” in this class airplane An – 148, the development of which was well ahead of RRJ. The competitive power of An – 148 is apparent. Its cost makes approximately US \$ 18 million. This figure is by

¹³ V. Korotchenko. *Proyekt voyennogo byudzheta SShA na 2008 finansovyi god* [Draft US military budget for financial year 2008]. *Zarubezhnoye voyennoye obozreniye* No. 4, 2007, p. p. 21 – 26.

25 per cent to 30 per cent below the costs of similar foreign products and below the expected costs of similar aircraft of the RRJ family. Does it mean that it was a mistake to set the course for development of RRJ and at the same time to support An – 148 project? Of course not. Answering this question one should not think only of RRJ as a potentially higher end product. Support of the An – 148 project means that at the same time there can be used yet another rational principle of state policy: not only to develop new, but also **maintain earlier, profitable schemes of international cooperation.**

Thus, a new idea was started up: to divide the spheres of use of these two flying vehicles. For instance¹⁴, An – 148 could be used by domestic and CIS airlines, whereas RJJ should fly to Europe and America. It is expected that these orders will be able to make busy Russian and Ukrainian factories, whereas new planes will replace the obsolete Tu – 134, which, it should be noted, is used both in the civil aviation and by the RF Air Force in the Russian Federation, taking into account the expected enormous demand for medium range airplanes, which can exceed 1.5 thousand aircraft in the nearest future.

Therefore, the RF Government officials assert that the concentration of resources of the aircraft industry in the framework of the UAC will permit Russia to increase the amount of its aircraft market up to US \$ 16 billion by year 2015. At the same time, it was stated that the percentage based relationship between the military and civil products manufactured by the holding should make 50 – 50, although this statement seems questionable.

At last, there is the news that there is to be expected the appearance of a new large air carrier, a competitor of the Aeroflot, in Russia soon. It is a Russian company AirUnion, which comprises of five regional air carriers and created, as it was stated, “in order to improve the quality of servicing of passengers.” The respective decree of the RF President was signed on May 2 of 2007. It is expected that practically all financial resources of this company will be allocated for the purchase of airplanes from the Sukhoi holding and that it will be oriented primarily not towards domestic Russian market, but to the international operations.

Therefore, the circle, in the center of which is the Sukhoi experimental design bureau, has been completed. The state has made its organizational steps. Financing of civil aircraft is envisaged by the budget. It should be also noted that at the same time there is expected no decline in the financing of military R & D in comparison with the figures registered in the preceding years (see Fig. 1). The only thing remains: to ensure the efficiency of the respective expenditures.

Table 1.

Information on the production strategies of the UAC

Mass media source	Information
<i>Rossiyskaya Gazeta</i> of January 7, 2007	It is expected that the price of RRJ should be in the range of US \$ 30 to 35 million. The total output of RRJ should make about 700 airplanes. The RF share should make about 7 per cent . About 93 per cent of aircraft should be exported. 35 per cent – USA; 25 per cent – Europe; 10 per cent – Latin American countries; 7 per cent - China.
<i>VPK</i> of February 28 – March 6, 2007	There was approved the range of civil airplanes to be manufactured by the UAC: 16 Il – 96 - 300/400 + 78 Tu - 204/214 or Tu - 334-100 + 74 An - 148 + 150 An - 140 and An - 38 – mostly, for domestic airlines; some of the aircraft should be exported; RRJ – mostly for export.
<i>Izvestiya</i> of March 12, 2007	A statement by the President of the closed joint stock company Sukhoi Civil Aircraft: From the very launch of the project, we have planned to sell our products on the international market. The share of the Russian market should make about 30 per cent of the total planned amount of sales.

It would seem that the creation of the UAC and the new operator of its future civil products should be welcomed. However, there are observed some alerting facts. Such facts include, first, the traditional segregation of the functional component “military aircraft” within the UAC. It is closed both for foreigners and for

¹⁴ I. Kedrov. Vzaimodopolnyayushchiye proyekty [Complimentary projects]. VPK No. 10 of March 15, 2006.

public control on the part of the RF citizens, what can be used by corrupt officials. Second, the creation of a separate closed joint stock company Sukhoi Civil Aircraft within the UAC, which, it should be noted, is also closed for the citizens of the country, although it manufactures only civil products.

Therefore, the issue of the share of the most modern airplanes to be used by Russian citizens of the total amount of the planned output of such planes is very urgent at the moment.

Information on the strategy of development of the RF civil aviation is very contradictory. On the one hand, there are repeated well known statements that it would be rational if aircraft manufacturers produced about 70 per cent of airplanes to meet the needs of the domestic market and 30 per cent of their products should be exported. On the other hand, there are heard other statements, partially summarized in the Table 1 below.

It is not surprising that in reaction to such statements and expected prices of the airplanes of the RRJ family, in April of this year Russian airlines already signed contracts for purchase of used (about 10 years) foreign aircraft priced in the range from US \$ 25 to US \$ 30 million per a 200 seats airplane.

How should the society react to all these developments? In order to answer this question we have analyzed conventional **relationships of normalized in the range from 0 to 1 interest indicators** K_j of major subjects being in the composition of the system of making and implementation of managerial decisions (SMIMD) in the RF and the share of airplanes x , which should be transferred to Russian airlines. The respective dependences of individual indicators are presented in Fig. 2. Three major subjects of SMIMD were assumed to be:

1) the society – the “subject” interested that the major share of the most comfortable and safe passenger airplanes would be received by citizens of Russia; in contradistinction to other subjects, the RF society is not organized and its influence on the making and implementation of managerial decisions is weak;

2) the RF military organization is most of all interested in 50 – 50 proportion, which provides the military an opportunity to influence the output of not only military, but also civil aircraft: partially – to meet their own transportation needs and partially to use the planes in the framework of the so called offset transactions in the course of sales of military aircraft abroad;

3) closed joint stock companies (CJSC) – producers of civil super aircraft and air companies intending to operate on international airlines. Their interests are determined by profits to be derived from the sales of flying vehicles and related services; therefore, they are interested in foreign air carriers and air passengers, who can pay a higher price for improved comfort and safety.

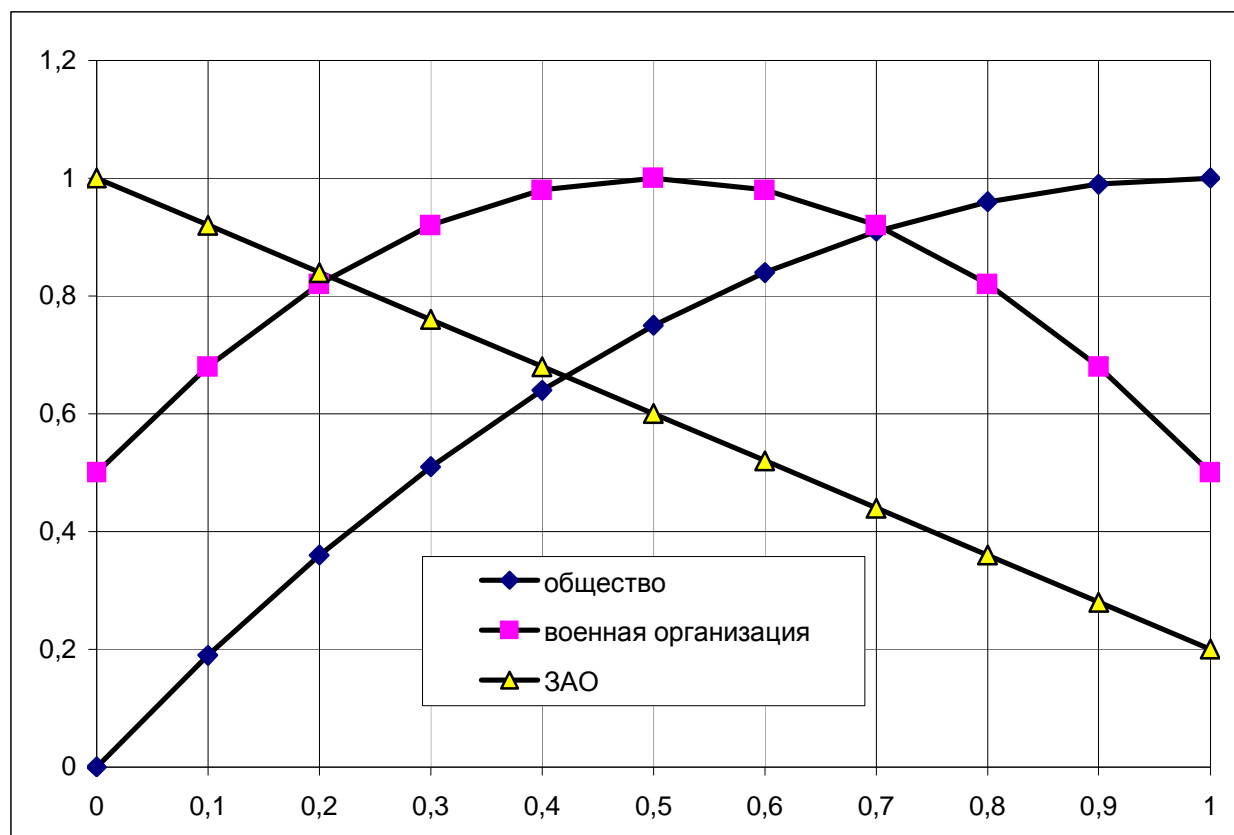


Fig. 2. Dependencies of individual indicators of SMIMD subjects on x .

We view the aggregate indicator of SMIMD actions as a result of summing individual indicators K_j , which reflect interests of subjects, with weights r_j (index $j = 1, 2, 3$ corresponds to the list of SMIMD subjects indicated above) and assume that $r_1 = 1$, the result is the effectiveness function $K_{123}(x) = K_1(x) + r_2 * K_2(x) + r_3 * K_3(x)$.

In order to analyze this function we applied the method of evaluation of implicit optimization of managerial decisions made by the SMIMD. The essence of this method is the solving of the reverse optimization problem¹⁵. We search for and find weights, with which the managerial decision presented to us as “optimal” actually meets the requirements of optimality. The results of such an analysis of pair-wise comparison of interests “society – military organization” and “society – closed joint stock companies” are illustrated in Fig. 3 and provide evidence of the following:

- in the case the value of $x = 0.6 - 0.7$ is declared to be optimal, there is present the balance of interests of the society (on the one hand) and the military organization together with the closed joint stock companies (on the other hand); at the same time, the interests of neither the military organization, nor the closed joint stock companies taken separately are infringed upon; for instance, representatives of interests of closed joint stock companies will be right to evaluate the weight of their interests to be close to 0.8, i.e. will be not much below the weight of the society’s interests (1);

- however, in the case the value of x in the range from 0.1 to 0.3 is declared to be optimal, what is the case today, such an “optimality” is possible only if the weights of the closed joint stock companies are significantly (approximately two times) above the interests of the society.

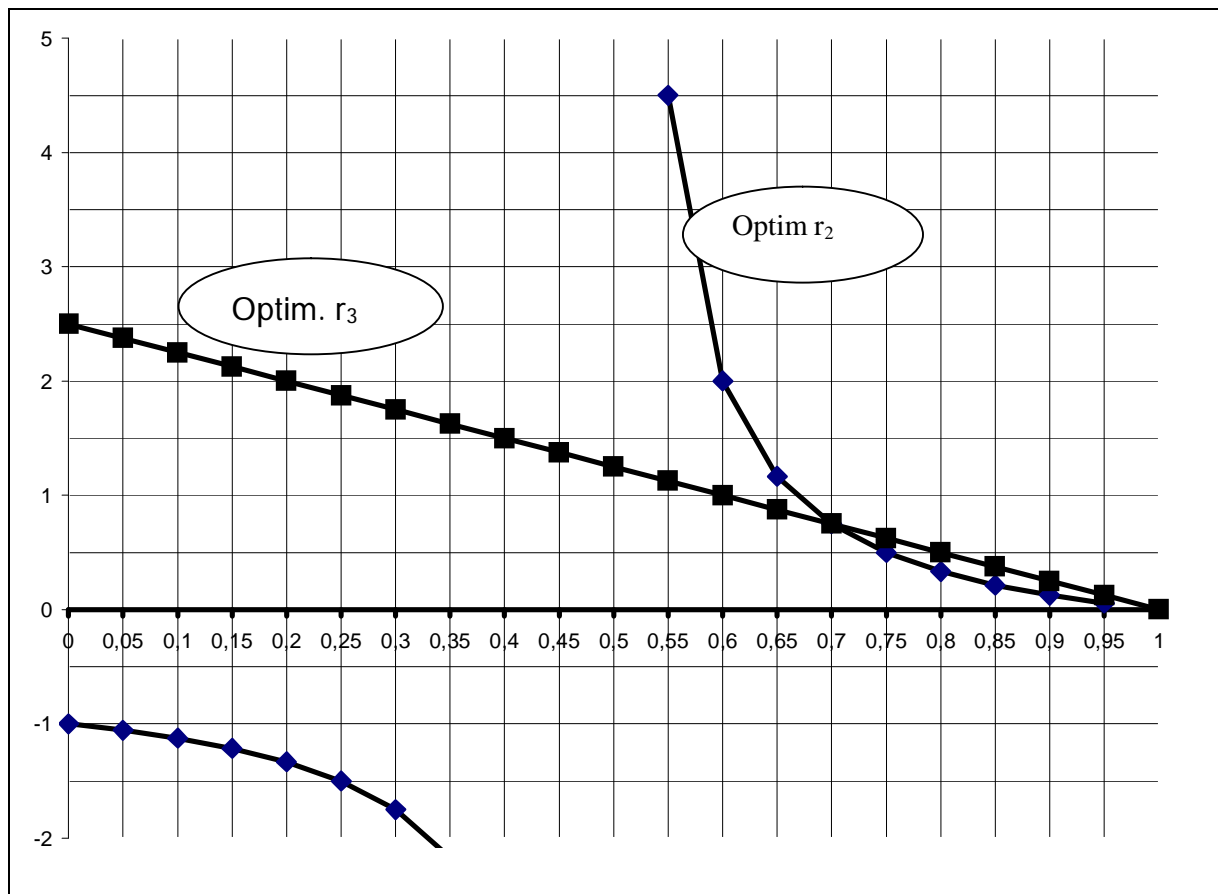


Fig. 3. Values of weight coefficients given to the interests of military organization (r_2) and CJSC to optimize parameter x .

¹⁵ V. Tsymbal. Metodicheskiye vozmozhnosti proyavleniya zayavlyaemoy optimalnosti strategiy i planov razvitiya [Methodological opportunities to evaluate the declared optimality of strategies and development plans] // In: Collected volume Strategicheskoye planirovaniye i razvitiye predpriyatiy [Strategic planning and development of enterprises]. Section 2. / Materialy Vosmogo vserossiyskogo simpoziuma [Materials of the Eighth All-Russian Symposium]. Moscow, April 10 – 11, 2007. – M.: TsEMI RAN, 2007, p. p, 193 – 194.

In the case all three subjects are analyzed collectively, the solution turns out to be ambiguous; however, its essence remains the same.

Not less illustrious is the direct analysis of the values of the normalized indicator of interest of each of the SMIMD subject in the cases, where the value of parameter x is changed, for instance, from 70 per cent to 10 per cent (see Table 2).

Table 2.

**Changes of individual indicators depending on the switching from
 $x = 70$ per cent to $x = 10$ per cent**

SMIMD subject	Change of the individual indicator
$j = 1$ – Russian society and air companies	Loss 72 %
$j = 2$ – military organization of the state	Loss 32 %
$j = 3$ – CJSC	Gain 48 %

The results of the analysis may be interpreted in the following way. As it turns out, the society is offered to use the financial resources provided by citizens to the state to modernize the aircraft industry of the country, set up the production of the most advanced and safe passenger airplanes in order to sell these aircraft mostly to foreign air companies and share the profits among shareholders of the closed joint stock companies.

As concerns passengers, in the case these plans of the management of the UAC come true, foreigners will fly the super advanced planes of Russian manufacture, whereas the majority of Russian citizens will have to use less comfortable and safe aircraft, either obsolete air liners of domestic production, or used foreign airplanes.

The issue of the rightfulness of such disposition of the financial resources belonging to Russian citizens is outside the framework of our economic analysis.

V. I. Tsybal

The Changes in Health Care Financing in the Subjects of the Russian Federation

In 2006 the trend for unification of the mechanisms used for medical institutions financing developed under the influence of the policy of the federal center. In a number of regions initiative innovations took place. On the whole, however, institutional changes taking place do not still have substantial influence on the stimuli of the medical institutions to increase the resource utilizations.

In 2006 the changes in the health care financing and management took place in all the regions of the Russian Federation. The majority of them was accounted for by the fulfillment of the requirements of the federal legislation of the authority demarcation and implementation of the national project “Health” as well as under the pressure of the federal power on the fulfillment of law on medical insurance regulations.

In 2006 restructuring of the health care institutions according to the requirement of the new legislation on power demarcation between the levels of authorities took place in 53 out of 76 regions on which the information was obtained¹⁶. All in all 493 health care institutions and more than 700 structural divisions of diversified health care institutions were passed from one level of subordination to another (in 2005 - 547 health care institutions and 377 structural divisions).

In 2006 in all the regions of the Russian Federations new kinds of additional payments were introduced in state and municipal health care institutions and the mechanism of child birth certificates was implemented according to the resolutions of the Government of the Russian Federation for priority national project “Health” undertakings fulfillment. In 23 regions coordination councils on realization of priority national projects were created in 2006.

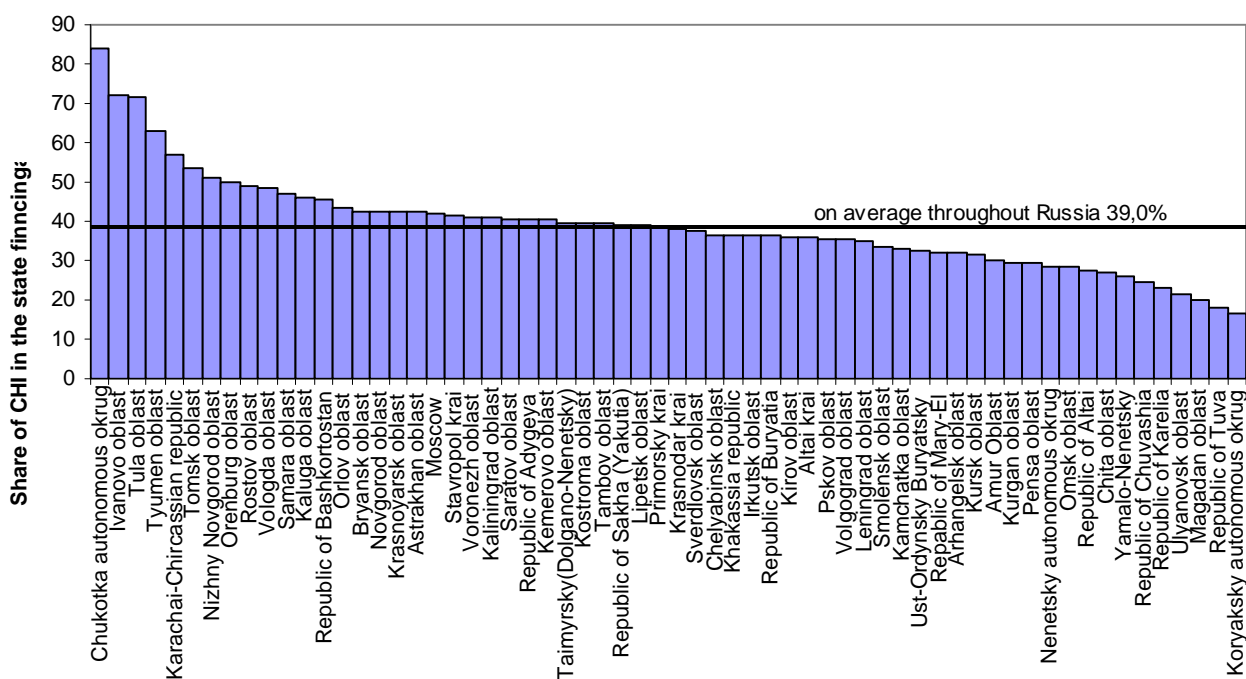
Over the last three years the trend for a slight decrease of the share of funds of the compulsory health insurance (CHI) while financing state guaranteed territorial programs was observed: in 2004 it was equal to 48%, in 2005 – to 47%, and in 2006 r. – 46%. The value of this index for different regions of the Russian Federation varies from 17% (Koryaksky autonomous okrug) to 84% (Chukotka autonomous okrug) (see fig. 1). At the same time in a number of regions the measures to the transfer to one-source system of health care

¹⁶ The source of information here and further – data from the subjects of the Russian Federation, collected in the framework of the WHO /CIDA program “Health care policy and Management in Russia” (see <http://www.healthreform.ru>; <http://zdrav.socpol.ru>).

financing, envisaged by territorial CHI programs were undertaken. This means the concentration of the biggest amount of the public funds in the system of CHI, which creates prerequisites for their more efficient distribution among the health care institutions. Whereas in March 2005 the leader in the progress to one-source financing system was Tyumen oblast (the share of CHI funds in the state health care financing was equal 77% then), last year its figures diminished slightly - to 63%, and Chukotka autonomous okrug (84%), Ivanovo and Tula oblasts (72%) outstripped it by this figure. Samara oblast, which was the leader of CHI implementation in 90ies and concentrated more than 90% of the public funds in the system of health care, in 2006 was in the second ten by the value of this figure (47%).

Figure 1.

The Share of CHI Funds in Health Care State Financing in Subjects of the Russian Federation in 2005 as percentage



Source: data from 62 regions of the Russian Federation

In 2006 the changes in the organization structure of the CHI proceeded due to the coercive elimination of administrative barriers for health insurance organizations operation by the federal centre and expanse of mainly Moscow insurance companies into the regions. The share of the regions where in the CHI systems the insurers were only health insurance organizations as it was envisaged by the law on health insurance, which was less than the half in 2004, now exceeds three quarters (see table).

Table.

Distribution of the Territorial CHI Models, Different by the Role of Health Insurance Organizations

Organizations actins as insurers in the CHI system in the subject of the Russian Federation in 2006	The share of the regions, having such a model, %		
	2004	2005	2006
CHI territorial fund and its branches	24	10	9
Branches of the CHI territorial Fund and Health Insurance organizations	27	36	14
Only health insurance organisations	49	53	77

Source: 2004 – data from 89 RF subjects, 2005 - data from 89 RF subjects, 2006 - data from 78 RF subjects.

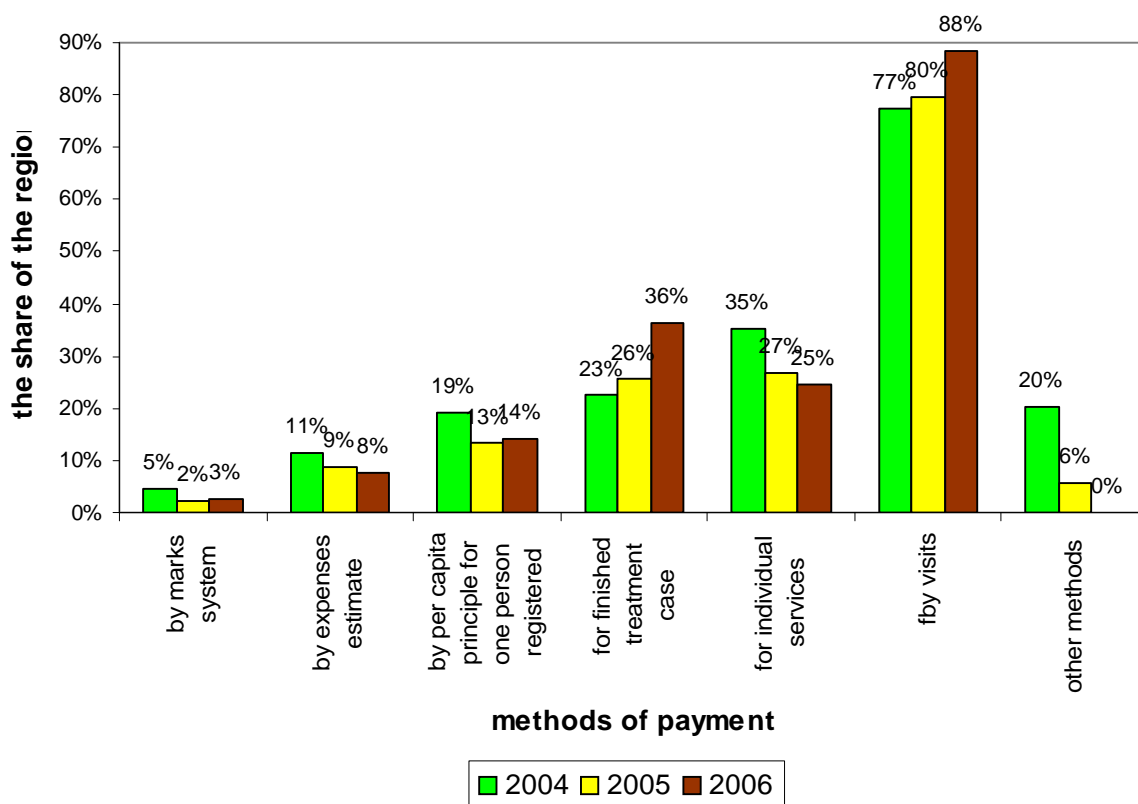
There are 6 main methods of payment for out-patient health care (by expenditure estimate, by visits, by marks system, for individual services, for finished medical case, by per capita principle for one person registered) and 5 main methods of payment for in-patient care (by expenses estimate, by the real number of days spent by the patients in clinic, by the average cost of one patient treatment in specialised department, for

finished hospital treatment, for the adjusted volume of medical care) used. In a number of regions several methods are used simultaneously to pay for out-patient and in-patient aid.

In 2004-2006 the trends for the reduction of the regional differences by the methods of payment used were clearly seen. In last three years among the methods of payment (see fig. 2) the application of payment for visits expanded. In 2006 this method was used by 88% of the regions. The regions were encouraged to transfer to this method of payment in 2003-2005 by Pension Fund (this was a prerequisite to join into the experiment on co-financing of the health care rendered to pensioners, conducted I 2003-2005 and involved 36 regions), and then by the authorities of the Ministry for Health Care and Social Development of the Russian Federation. In the meantime, the payment for outpatient care by the number of visits encourages the growth of calls to the doctors and does not stimulate the work on illness prevention. Another method of payment, which does not have such disadvantages and is widely used in other countries, - by per capita principle for one person registered – was used only in 14% of the regions in 2006 (in 2004 – in 19%). Among the changes, which took place in 2006, it should be noted that the share of the regions which apply the method for finished treatment cases payment grew a bit – up to 36% (in 2004 - 23%, in 2005 – 26%).

Figure 2.

The Distribution of the Outpatient Care Payment Methods in the System of CHI in the Subjects of the Russian Federation in 2004-2006, as percentage*

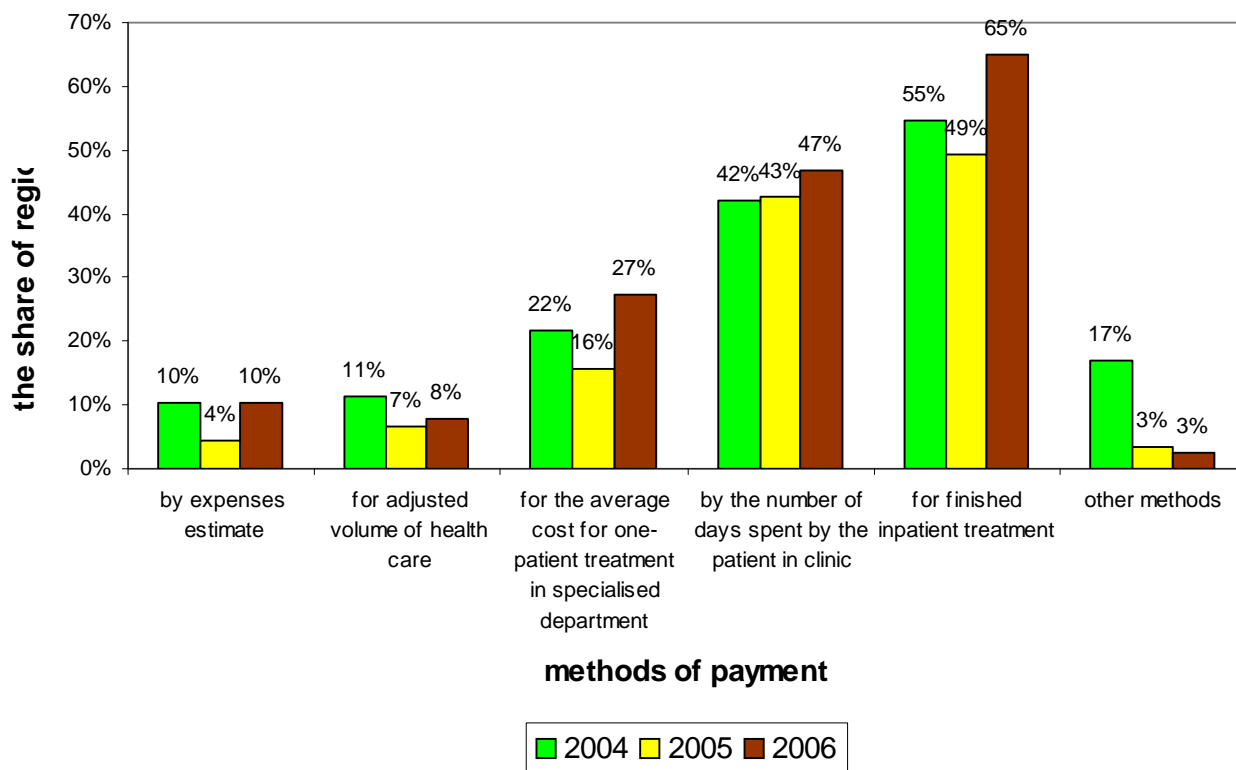


* In a subject of Russian Federation several methods of payment can be used simultaneously
 Source: 2004 – data from 89 RF subjects, 2005 - data from 89 RF subjects, 2006 - data from 78 RF subjects.

Among the methods of payment for in-patient care (see fig. 3) the implementation of the payment for finished treatment case increased considerably in 2006 (65% of the regions). The method of payment for the adjusted volume of the health care allows to take into account the complexity of the care provided more exactly and create incentives for increase of resources use efficiency in hospitals, but it is used only in 8% of the regions (in Kemerovo, Kostroma, Samara, Tula oblasts, the Republic of Chuvashia). It is notable that the number of regions, which use the method of payment by the number of the real days the patient spent in bed increased over the last three years (from 42% in 2004 to 47% in 2006). It encourages the inpatients clinics to maintain the maximum amount of the beds, increase the number of hospitalization cases and the duration of the treatment.

Figure 3.

The Distribution of the Methods of Payment for Inpatient Care in the CHI System in the Subjects of the Russian Federation in 2004-2006, as percentage*



* In a subject of Russian Federation several methods of payment can be used simultaneously
 Source: 2004 – data from 89 RF subjects, 2005 - data from 89 RF subjects, 2006 - data from 75 RF subjects.

It should be also noted that 8% of the subjects of the Russian Federation use CHI funds to pay for outpatients care by the method of financing health care institution by the expense estimate and 10% of the subjects use this method to pay for in-patient care. Thus CHI system has not yet substituted its expense estimate financing of the health care institutions, which encourages them for expense-oriented type of management, for the payment for work according to the results figures.

The efficiency of the methods of payment application in the CHI system depends on the extent of regulatory and methodology base development, which controls the amount of rendered health care. In 2006 there was the approach of medical and economic standards development for health care provision, allotment of clinic statistic groups of the illnesses and application of this tool to calculate the tariffs in CHI system that developed considerably. The number of the subjects of the Russian Federation, which use this methodology, reached 34 in 2006 (27 in 2004).

In March 2006 the President of the Russian Federation commissioned the Government to start the experiment on the financing of the in-patient health care institutions, orienting on the final results, and on transition to one-source financing in 2006. The preparation of the experiment took the whole year. 19 regions were chosen to participate in the experiment by the Ministry of the Health Care and Social Development. By the Resolution No 296 from 19 May 2007 the Government of the Russian Federation established the rules of expenses financing for 2007 of the fulfillment of the pioneer project, directed towards the increase of the service quality in the field of health care and adopted the list of regions, which participate in the project. Among them there are: Astrakhan, Belgorod, Vladimir, Vologds, Kaliningrad, Kaluga oblasts, Krasnodarsk krai, Leningrad oblast, Republic of Chuvashia, Tver, Tomsk oblasts, Republic of Tatarstan, Rostov oblast, Perm krai, Samara, Sverdlovsk, Tyumen oblasts, Khabarovsk krai, Khanty-Mansi autonomous okrug.

The experiment will test:

- Step-by-step transition of the health care institutions to mainly one-source financing in the system of CHI;

- Guaranteeing of the financing of in-patient care according to the regulations of the financial expenses, calculated on the basis of health care standards, taking into account the quality of health care provided;
- Implementation of partial funds accumulation at the level of outpatients clinics, envisaged to pay for medical aid on the basis of per capita standard financing (partial fund holding), and creation of the system of intra- and interdepartmental mutual settlements;
- Reformation of medical staff labor remuneration depending on the final result of their work;
- Guaranteeing the registration of the health care provided and estimation of its quality.

In 2007 the conduction of the experiment will be financed at RUR 5.4 bln from the federal budget and Federal Funds CHI means, as well as co-financed by the budgets of the Russian Federation subjects.

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Non-state pension funds in 2006

The total amount of pension reserves of non-state pension funds (NSPF) made Rub. 405 billion (US \$ 15.4 billion in the terms of the current exchange rate as in the beginning of the year) by the end of 2006. As it is demonstrated by the data in Figures 1 and 2, the NSPF pension reserves grew rapidly over a several years period and in 7 years, from 2000 till 2006, the total amount of such reserves increased approximately 38.5 time in Ruble terms (39.5 times in US \$ terms).

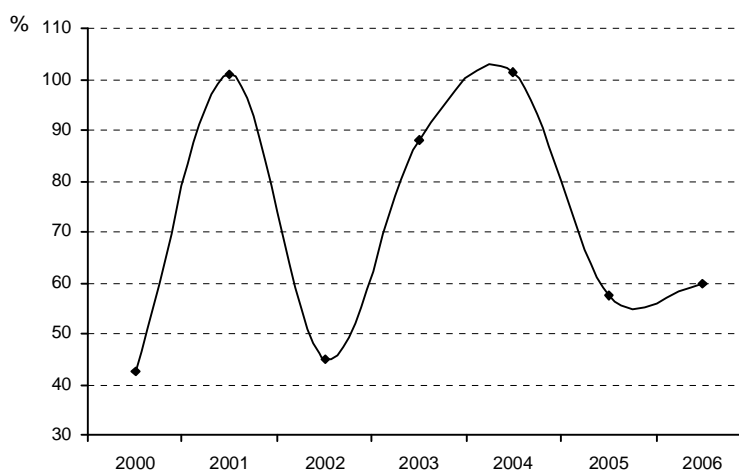
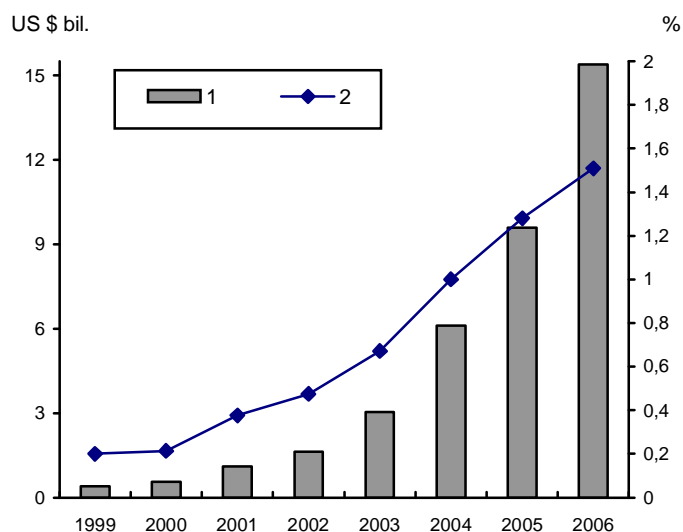


Fig. 1. Growth in pension reserves and investments of NSPF (in US \$ terms)

Calculated basing on the data presented by the Inspection of Non-State Pension Funds (INSPF).

In spite of the fact that the reserves demonstrated very impressive dynamics (for Russia), the total amount of assets still remains extremely insignificant (1.5 per cent). Even taking into account the compulsory funded component of the pension system the significance of pension funds in the economy remains several times below the respective indicator registered in the majority of the OECD member countries (see Fig. 3) and is at a level close to that demonstrated by East European countries and the countries of the former USSR (see Fig. 4).



- 1 - Pension reserves as at the end of the year (left axis)
- 2 - Pension reserves in per cent of GDP (right axis)

Fig. 2. Pension reserves of NSPF.

Calculated basing on the data presented by the Inspection of Non-State Pension Funds (INSPF), FSFR, Rosstat.

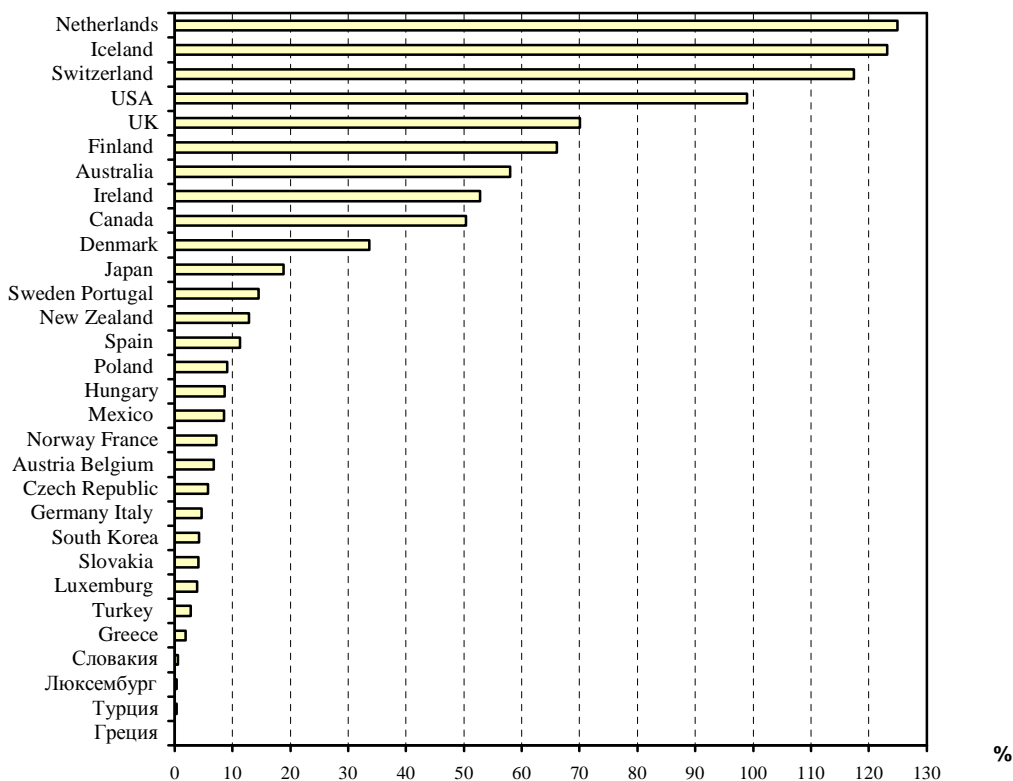


Fig. 3. Assets of pension funds in OECD member countries in per cent of GDP as in 2005

Notes:

- (1) The data do not include mutual trusts, preliminary data.
- (2) The data include mutual funds.
- (3) Preliminary data
- (4) Preliminary estimates

Source: OECD. Pension markets in focus, October 2006, # 3

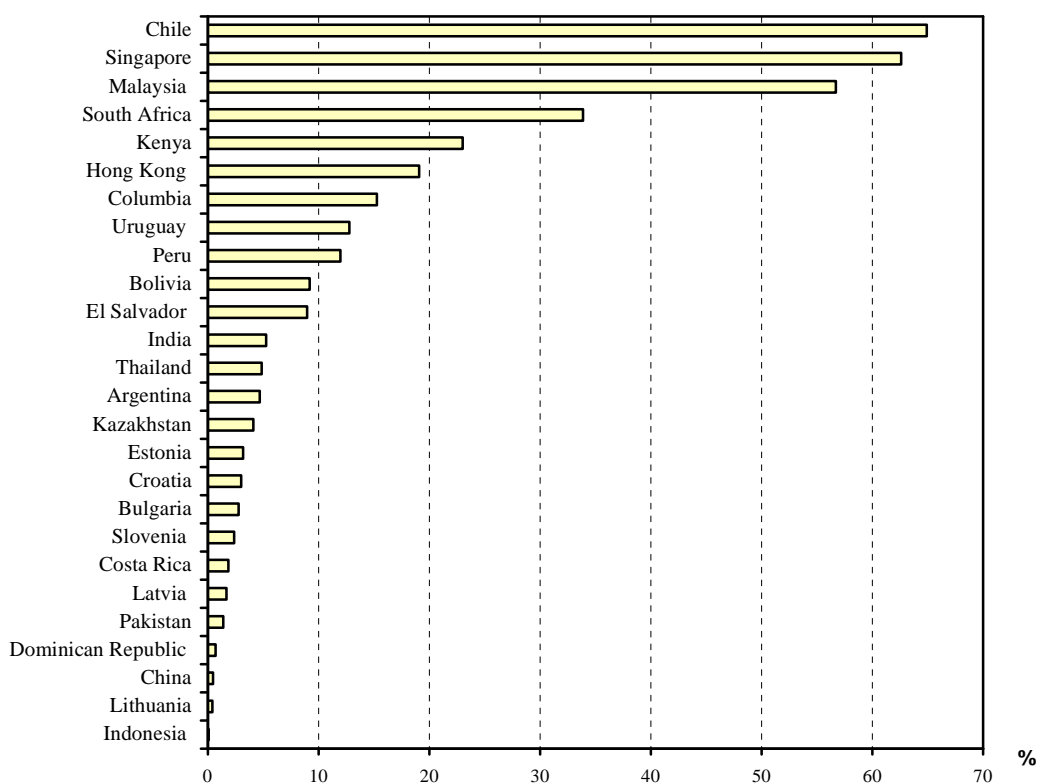


Fig. 4. Assets of pension funds across countries outside OECD in per cent of GDP as in 2005

Source: OECD. Pension markets in focus, October 2006, # 3

The average amount of pension reserves of the non-state pension fund made Rub. 1.6 billion as at the end of 2006. As concerns this criteria, funds differ from zero to Rub. 245 billion.

Given the small amount of financial reserves at the disposal of the average NSPF, the structure of the branch market is characterized by a very high level of concentration. As at the end of 2006, the share of the largest NSPF made about 60 per cent of the total amount of pension reserves. The next four funds made other 20 per cent of the total amount, therefore, 5 largest NSPF concentrated 80 per cent of the total amount of voluntary pension contributions¹⁷. At the same time, the largest NSPF in terms of pension reserves (Gazfond) was more than five times above the respective indicator of the second largest fund.

Pension savings have not yet made a noticeable component in the pension related obligations of NSPF. As at the end of 2006, these resources made Rub. 10 billion (2 per cent of own assets). Seventy three funds took leading positions on the market of compulsory pension insurance. In terms of attraction of financial resources, NSPF “LUKoil – Garant” was the leader of the market, its respective financial resources made Rub. 2.4 billion.

The level of concentration in this segment is not as high, as in the segment of pension reserves: the share of the leader made 24.5 per cent, whereas the share of the five largest funds made 60 per cent.

In connection to the specifics of the terms of transfer of pension savings from the PFR to NSPF the most illustrative of the activities of NSPF is yet not the end of a year, but the end of the first quarter of the year, when PFR transfers pension savings to NSPF in accordance with the applications submitted by insured persons. As concerns the results of the 1st quarter of 2007, the pension savings in NSPF almost doubled and made Rub. 19.8 billion. In terms of attraction of financial resources, NSPF “Blagosostoyaniye” was the leader of the market. In this fund, pension savings grew more than 2 times over the quarter. The market share of the leader makes at the moment 27.8 per cent. At the same time, about 20 new operators appeared on the market, including NSPF of the Sberegatelyn Bank. This bank could attract 18.8 thousand insured

¹⁷ For comparison, in 2003 this indicator was at 70 per cent.

persons; however, in terms of the amount of pension savings – Rub. 351 million - it was able to become 9th on the list of the leaders.

Besides, in order to correctly assess the real positions non-state pension funds have on the financial markets it is necessary to take into account the fact that a considerable part of the financial resources they dispose of are not pension reserves or pension savings; these assets are properties aimed to ensure carrying out their activities as defined by their respective bylaws.

On the average, the indicator of assets allocated to ensure the carrying out the activities defined by NSPF bylaws makes 18 per cent across the funds, whereas without NSPF Gazfond it makes 25 per cent. However, the rates of growth in these assets lag somewhat behind the rates of increase in pension reserves and its share in the own assets of currently operating NSPF declined by 7 percentage points, while without Gazfond the value of this indicator decreased by 11 percentage points. At the same time, the amount of assets aimed to ensure carrying out the activities defined by NSPF bylaws of 100 funds having submitted their financial statements to the FSFR as on January 1, 2007, was below the minimum amount of Rub. 30 million set forth by the federal law “On non-state pension funds.”

In contradistinction to the dynamics of financial indicators of NSPF, the involvement of the population in voluntary pension programs is growing at slower rates. Over three years, from the end of 2003 till the end of 2006, the number of NSPF participants grew by only 23 per cent and made 6.4 million (9 per cent of the total amount of employed), whereas payments are made to less than 0.9 million persons. In 2006, the amount of pension paid by NSPF made Rub. 993 a month that making 36 per cent of the average pension paid by the Pension Fund of the Russian Federation.

L. I. Sycheva, L. V. Mikhailov

Issues, Discussed at the Meetings of the Government of the Russian Federation held on 10 and 24 May 2007

The following most significant issues were discussed at the meetings of the Government of the Russian Federation in May 2007: draft of the Federal Law on making amendments to a number of laws in the field of licensing and the report of the Ministry of Finance of the Russian Federation On the insurance legislation development in the Russian Federation.

On **May, 10** at the meeting of the Government of the Russian Federation the draft of the Federal Law “On making amendments to some legislative acts of the Russian Federation and recognition of some legislative acts as invalid on the licensing issues of certain kinds of activity”. The law is aimed at regulating of the system of licensing in the territory of the Russian Federation, exclusion of the possibility to apply a large number of principles of the law, which regulate the licensing procedure. According to the ideas of its authors, the adoption of the law will enable to pursuit the unified state policy in the field of individual kinds of activity licensing.

The law envisages making amendments to 13 legislative acts of the Russian Federation, which contain the statements on licensing. These amendments concern the specification of the denomination of the kinds of activities which are subject to licensing as well as the exclusion of requirement to license the kinds of activities not envisaged by the Federal Law.

Thus, in the Air Law of the Russian Federation, the Law of the Russian Federation “On social protection of the citizens, exposed to radiation as a result of the catastrophe at the Chernobyl Atomic Power Plant” the norms that envisage the licensing of activity connected with the goods produced in the suffered territory as well as activity in the field of air transportation, licensing of which is not envisaged by the Federal Law are excluded.

In article 6 of the Federal Law “On state support of the small business in the Russian Federation” the norm of simplified procedure for licensing of the entities of small business is excluded, for the list of kinds of activities to which a simplified procedure of licensing can be applied is established by the Federal Law and the activity of small business entities is not mentioned in it.

Federal Law “On Government control over the effect of the carriages by roads and the responsibility for the violation of the order of the procedure” is put into accordance with the international treaties of the Russian Federation on international motor traffic, which does not envisage licensing of the type of activity mentioned.

In accordance with the amendments, being made to the article 333 of the Tax Code of the Russian Federation, its statements, concerning the peculiarities of state duty payment while conducting notarial acts in the field of assessing activity in connection with the abolition of this type of activity licensing are excluded.

Reference rule, according to which the licensing of some types of activities in the inland water transportation is realized in compliance with the legislation of the Russian Federation, is introduced in the Inland Water Transportation Code of the Russian Federation

The bill also regards as invalid 7 Federal Laws, which established the requirements for licensing of the kinds of activities, which are not subject to licensing or licensing of which was ceased in accordance with the Federal Law (on issue of the certificates of digital signatures keys, assessing activity, arbitral management, pedigree cattle breeding, and breeding production sales, tobacco goods production, best seeds production and grain storage.

On 17 May at the meeting of the Government of the Russian Federation the report of the Ministry of the Finance “On the measures to improve insurance legislation in the Russian Federation” was heard. The aims and tasks of the government policy in the field of insurance were described in the report.

The aim of the government policy in the field of insurance is the formation of the national insurance system which will be able to protect effectively property interests of the citizens, legal entities and the state in case of insured accidents happening.

The main directions of the state policy in the field of insurance business are stated in “The main directions of the development of the national insurance system in the Russian Federation in 1998-2000” as well as in the corresponding legislation acts of the Russian Federation. The biggest attention is paid to the following issues:

- Formation and improvement of the legal base in the field of insurance;
- Increase of the control over the business of insurance companies; increase of reliability and stability of insurance organizations operation, increase of their capitalization;
- Compensation guaranteeing of losses (damages), caused as a result of insured accidents, including natural phenomena, anthropogenic accidents and catastrophes and other accidents, decreasing the budget loading;
- Development of voluntary and compulsory kinds of insurance;
- Use of insurance as one of the sources for investments.

It is established in the report that the regulations of the “Main directions of insurance development” and “Development concept” were on the whole fulfilled.

The following directions were outlined as the main for financial policy for further development of insurance legislation:

- Development of the basic statutory act – the Law on insurance (“On the organization of insurance business in Russian Federation”);
- Development of legal basis of compulsory insurance as well as implementation of control over its conduction;
- Development of the clauses of individual statutory and other regulatory legal acts, which concern insurance issues;
- Development of the project “Insurance industry development strategy for 2008-2012” etc.

The main problems that need to be solved by making amendments to the Law of the Russian Federation dated 27 November 1992 No 4015-1 «On organization of insurance business in the Russian Federation”:

- specification of insurance terminology, introduction of new notions, reflection of characteristic features of insurance types, establishment of the forms and kinds of the reinsurance.
- definition of functions, rights and obligations of the professional participants of the insurance market and their responsibility for qualitative fulfillment of the obligations.
- regulation of licensing procedure for the entities of insurance business.
- bringing of the Russian insurance legislation in compliance with international standards, norms and rules, international treaties with the participation of the Russian Federation.
- protection of the insurance services consumers rights, creation of the system of adjudication by the participants of the insurance business, insurance payments guaranteeing.
- regulation of the legal relationships on interaction of insurance supervision body and participants of the insurance business, insurer unions during licensing and control over the insurance business.
- further development of the integral territorial system of the insurance supervision taking into account the specific features of the regions, number of insurance organizations, the volume of the services, provided by them in the territory of specific Federal okrug etc.
- continuation of the work on the development of the system of sanctions, applied to the entities of insurance business by the body of insurance supervision, taking into account the nature of infringements, in-

roduction of fines system for the entities of insurance business, imposed by the body of insurance supervision to the Federal budget earnings.

Development of the basics of the compulsory insurance is supposed to be implemented in the following spheres:

- regulating of the introduction of the new kinds of compulsory insurance;
- development of the statements of the legislative acts in effect as well as implementation of the control over the conduction of the compulsory types of insurance, including the application of the Federal Budget funds;
- bringing of the rules on compulsory insurance, contained in different industry laws, in compliance with the requirements of the Civil Code of the Russian Federation, Law on Insurance, elimination of the existing legal collisions, which do not correspond to the requirements of the Russian Federation insurance legislation.

It is stated in the report that the priority orientation for the state policy in the field of compulsory insurance is the development of the basics of compulsory automobile owners' liability insurance in connection with which a number of amendments are proposed to the Federal Law "On compulsory automobile owners' liability insurance".

Goldin M. P.

Overview of the Economic Legislation over May 2007

The following changes to the existing legislation were made in May: excise rates for excisable goods for 2008-2010 were approved; income tax rates for natural persons as regard to the incomes in the form of dividends from share-holding in Russian organizations were established, which are obtained both by tax residents and non-residents of the Russian Federation, the list of goods (works, services), placement of orders for whose supply (fulfillment, provision) of which is to be conducted by holding an auction; the data, applied for the calculation of tax for minerals extraction in regard to the oil for March 2007 were provided.

I. FEDERAL LAWS of the Russian Federation

1. "ON MAKING AMENDMENTS TO CHAPTER 22 OF THE RUSSIAN FEDERATION TAX CODE PART 2" dated 16.05.2007 No 75-Ф3

Comes into effect after one month from the date of the official promulgation and no sooner than on the first day of the next taxation period, excluding issue 4 of paragraph 1, which comes into effect on 1 January 2008.

The Law establishes the rates of excises for excisable goods for 2008-2010. For instance, the excise rates for oil products, tobacco and cigars remain at the same level, while for cigarettes and cigarettes with a card-board holder the increase by 0.5 percentage point per year of ad valorem component of the excise rate is envisaged. The procedure of definition of the imputed value of one kind of tobacco goods, imported into the territory of the Russian Federation with different maximum retail prices, mentioned at the unit of consumer package.

2. "ON MAKING AMENDMENTS TO ARTICLES 224, 275 AND 284 OF THE RUSSIAN FEDERATION TAX CODE PART 2" dated 16.05.2007 No 76-Ф3

Comes into effect on 1 January 2008 but no sooner than after one month from the date of the official promulgation and no sooner than on the first day of the next taxation period for the income tax for natural persons and profit tax for organizations.

The Law makes amendments to chapter 23 "Natural Persons Income Taxation", 25 "Organizations Profit Taxation" of the Tax Code of the Russian Federation Part 2.

As regard to the dividends from the share holding in the Russian organizations activities, obtained by the natural persons who are not the tax residents of the Russian Federation, the income tax rate for natural persons at the level of 15%, and for natural persons who are tax residents of the Russian Federation the tax rate is established at the level of 9%.

The formula to calculate tax base for organization profit tax, which is subjected to deduction by tax agent from the incomes of a tax payer, who gets dividends from share holding in other organizations. The tax rate of 0% for the organizations profit tax as regard to the incomes, obtained by Russian organizations in the form of dividends if a number of conditions is observed. For instance, by the day of making resolution on dividends payment the organization, which obtains dividends should own by the rights of property no less than 50% investment in authorized capital for no less than 365 days in the organization that pays the dividends.

3. "ON MAKING AMENDMENTS TO ARTICLE 372 OF THE TAX CODE OF THE RUSSIAN FEDERATION PART 1" dated 16.05.2007 No 77-Ф3

Comes into effect after one month from the date of the official promulgation and no sooner than on the first day of the subsequent taxation period for the organization assets tax

The Law obviates the contradiction between the statements of the Tax Code of the Russian Federation Part 1, which state that the forms of tax declarations and the procedure of their filling are established by the Ministry of Finance and point 2 article 372 of RF Tax Code in respect to the norms which indicate that legislative (representative) bodies of the regions of the Russian Federation besides tax rate, procedure and dates of tax payments definition also determine also the reporting form for the organization assets tax. From 1 January 2008 according to amendments made legislative (representative) bodies of the Subjects of the Russian Federation forfeit the right to establish the reporting form for organization assets tax.

II. RESOLUTIONS of the Government of the Russian Federation

1. "ON the list of goods (works, services), placement OF orders for WHOSE SUPPLY (fulfillment, provision) of which is to be conducted by holding an auction" dated 15.05.2007 No 609-p

According to the Federal Law dated 21.07.2005 No 94-Ф3 " On placing the orders for goods supply, work execution, service provision for state and municipal needs" the list of goods (works, services), placement of orders for whose supply (fulfillment, provision) of which is to be conducted by holding an auction was approved. The list is quite a long one and includes: plant cultivation, cattle breeding, forestry and timber production, coal, peat, crude oil and natural gas, ferrous, non-ferrous and noble metals, tobacco goods, textile goods, fur and fur goods, leather and leather goods, footwear, paint, varnishes and similar coatings, pharmaceuticals, perfumes and cosmetics, tools, household appliances, various equipment and so on as well as some kinds of services.

III. ORDERS, LETTERS

1. Letter of the Federal Tax Service of the Russian Federation "ON DATA, NECESSARY TO CALCULATE SEVERANCE RATE IN REGARD TO OIL FOR APRIL 2007" dated 17.05.2007, No CK-6-11/400@

The data, applied to calculation of the severance tax in regard to oil calculation for March 2007, are prepared for application:

- average level of prices for oil grade Urals – USD 63.88 per barrel;
- average US dollar exchange rate against ruble of the Russian Federation over all the days of tax period – 25.8423;

Cp coefficient value – 5.4338.

Tolmacheva I. V.

A review of regulatory documents concerning taxation issues, which were made public in April and May of 2007

1. Letter of the Federal Tax Service No. ShT-6-03/360@ of April 28, 2007, and letter of the RF Finance Ministry No. 03-07-15/47 of April 4, 2007, explain the issues pertaining to the procedures governing the imposition of VAT on services, which relate to the leasing of property.

In accordance with article 163 of the RF Tax Code, a calendar month is established as the tax period for VAT payers. As concerns taxpayers, whose monthly earnings (without VAT) make less than Rub. 2 million, the tax period should be defined as a quarter of the year.

VAT related obligations of lessors originate on the earlier date from: the date of payment (partial payment) for services to be provided in the future, or the last day of the tax period, in which services were provided, notwithstanding the future terms of payment of the rent.

The lessees should be eligible for the deduction (offset) of VAT in the case of submission of commercial invoices and source accounting documents (including the handover statements concerning leased property) notwithstanding the date on which the said services were provided.

2. Letter of the RF Finance Ministry and the Federal Tax Service No. ShT-6-07/385@ of May 10, 2007, explain the issues pertaining to the regulation of gambling businesses on the basis of federal law No. 244 FZ of December 29, 2006. The letter explains that in accordance with sections 7 and 8 of article 16 of this federal law, since July 1, 2007, the authorities of subjects of the Russian Federation have the right to take decisions on the prohibition of activities related to the organization and conduct of gambling (including the ac-

tivities of certain types of gambling establishments) in their respective territories (with the exception of gambling zones).

3. Order of the RF Finance Ministry and the Federal Tax Service No. MM-3-06/281@ of May 7, 2007 approves the recommended forms of documents used by the tax authorities in the course of implementing their powers (Decision of the conduct of on site tax inspection according to the supplement, Decision on the prolongation of the on site tax inspection, Decision on the prolongation of examination of materials of the tax inspection).

4. Letter of the Federal Tax Service No. ShS-6-14/386@ of May 10, 2007, and letter of the RF Finance Ministry No. 03-02-07/2-78 of April 25, 2007, explain the issues pertaining to the uniform (simplified) tax declaration.

In accordance with sub-item 4 of article 23 of the RF Tax Code, taxpayers should submit their tax declarations (estimates) in the case such responsibility on their part is envisaged by the legislation concerning taxes and fees.

In the case the taxpayer has no sufficient amount of financial resources to pay the charged amount of taxes at the end of the respective tax period, this fact does not relieve such a taxpayer from the responsibility to submit the tax declaration concerning the respective tax period.

5. Letter of the Federal Tax Service No. GI-6-04/388@ of May 11, 2007, and letter of the RF Finance Ministry No. 03-04-07-01/48 of April 6, 2007, explain the issues pertaining to the procedures governing the taxation of earnings of individuals resulting from gifting.

In connection to the abolishment of the tax on properties transferred under the procedures of inheritance or gifting since January 1, 2006, in the cases envisaged by item 18.1 of article 217 of the RF Tax Code, the properties transferred to an individual under the procedure of gifting should be subject to taxation in accordance with the stipulations of article 23 of the RF Tax Code.

In the case it proves impossible to collect the calculated amount of tax from the taxpayer, the tax agent should, in accordance with item 5 of article 226 of the RF Tax Code, inform in writing about this fact the respective registering tax authority within the established period of time and indicate the amount of indebtedness on the part of the taxpayer. Individuals being donors should not be recognized as tax agents.

6. Letter of the Federal Tax Service No. ShS-6-14/389@ of May 11, 2007, explains the issues pertaining to the procedures governing the taxation of properties owned by the RF Defense Ministry with respect to the transport tax.

In accordance with the explanations presented by the RF Finance ministry (No. 01-02-01/03-1625 of August 5, 2004, and No. 03-06-01-02/09 of March 3, 2006), the institutions and unitary (operationally managing public property) enterprises being separate legal entities under the jurisdiction of the RF Defense Ministry are not federal executive authorities and therefore should pay the corporate property tax and transport tax with respect to property belonging to them due to the right of economic authority over such property and vehicles or the right of operational management of such property and vehicles. At the same time, in the regions there have formed ambiguous law enforcement practices (since the taxes are received by regional budgets). In this connection, the RF Finance Ministry has granted to the tax authorities the right not to turn to courts in the cases, where the respective tax authority has no grounds to expect that the court rulings will be in favor of such a tax authority.

7. Determination of the RF Supreme Court No. KAS07-140 of May 3, 2007, pertaining to the issue of return of confiscated properties abolished the provision of Instruction of the RF Federal Tax Service, which set a 6 month limitation on the term of submission of an application for return of the confiscated properties.

The court explained that it was inadmissible to refuse to return the properties earlier confiscated on the basis of court rulings due to the expiration of the 6 month period.

In accordance with articles 195 and 196 of the RF Tax Code, the limitation of action is defined as a period, within which the infringed rights of a person submitting the respective claim to the court should be protected.

The general period of limitations should be three years.

8. Federal law No. 83 FZ of May 17, 2007, introduced amendments to the RF Tax Code in connection to the adoption of the federal law "On the Development Bank." Any revenues and expenditures of the Bank should be completely exempted from the profit tax. It is the first precedent of such kind, when revenues and expenditures are exempted from taxation just due to the fact that these revenues and expenditures relate to the operations conducted by a certain organization.

9. Letter of the Federal Tax Service No. GI-6-04/342@ of April 23, 2007, and letter of the RF Finance Ministry No. 03-04-07-01/46 of April 2, 2007, explain the issues pertaining to the procedures governing the taxation of earnings of individuals relating to the sales of securities.

Prior to January 1, 2007, in accordance with item 3 of article 214.1 of the RF Tax Code it was envisaged that the earnings derived from sales and purchases of securities subject to taxation should be defined as the difference between the amounts of earnings derived from the sale of securities and documented expenditures. Since expenditures for purchase of securities are borne by taxpayers not only in the cases they purchase securities in the framework of sale and purchase contracts, but also in the framework of barter contracts, including exchanges for vouchers, and in these cases such expenditures are equal to the value of properties transferred in the framework of barter contracts, such taxpayers could be granted tax deductions.

Such cases should be distinguished from the cases where securities were acquired without bearing expenditures related to such acquisitions, for instance, under the procedures of inheritance or gifting. No tax deductions were granted with respect to such operations.

Since January 1 of 2007, the tax base has been calculated without the application of property tax deductions. At the same time, the tax base may be diminished by the amount of documented expenditures borne in relation to the purchase, sales and keeping of securities.

10. Federal law No. 76 FZ of May 16, 2007, introduced amendments to articles 224, 275, and 284 of the RF Tax Code.

Dividends were excluded from the composition of earnings of non-resident individuals subject to taxation at the rate of 30 per cent (the rate of taxation of dividends was reduced to 15 per cent).

With respect to other individuals receiving dividends there was introduced a formula in accordance with which tax agents calculate the amount of tax due to be withhold and paid on the amount of dividends.

As concerns the proceeds of organizations derived in the form of dividends, such proceeds are subject to taxation at the rate of 0 per cent in the cases, where the organization owned less than 50 per cent of shares in the organization paying dividends within the whole tax period, on the condition that the cost of purchase and (or) other type of acquisition being in compliance with the legislation of the Russian Federation of the ownership rights with respect to the contribution (share) in the authorized (share) capital (fund) of the organization paying dividends or depositary receipts of this organization granting the right to receive dividends was above Rub. 500 million.

In all other cases the rate of tax on dividends was retained at 9 per cent for Russian organizations and 15 per cent for the dividends received by foreign organizations from Russian organizations.

The said changes in the RF Tax Code have no serious economic substantiation and are political measures aimed at the protection of interests of big businesses. As concerns the relief of the tax burden on nonresidents, these decisions bring no significant consequences, since the taxation of earnings of nonresidents is based on the double taxation conventions.

11. Letter of the Federal Tax Service No. ShT-6-03/361@ of April 28, 2007, and letter of the RF Finance Ministry No. 03-07-15/44 of April 2, 2007, explain the issues pertaining to the procedures governing the taxation of provision of completed (rendered) in 2004 and 2005 works (services) related to the processing of goods carried out in the framework of the customs treatment of goods processed within the customs territory with VAT. As a matter of fact, the RF Tax Code distinguishes between the operations relating to the export of goods (when goods are sold from the territory of the RF to other countries) and the customs treatment of goods processed within the customs territory (in this case products provided by a foreign supplier are not transferred to the territory of the Russian Federation but processed in the customs zone and returned to the customer). In both cases such operations are subject to the zero rate of VAT; however, there are in place two different mechanisms of the application of such a VAT rate.

The operations relating to the processing of goods within the customs territory are subject to taxation with the value added tax at the rate of 0 per cent only on the condition that the respective tax authorities receive the documents listed in article 165 of the RF Tax Code.

In accordance with article 173 of the RF Tax Code, since January 1, 2004, the customs treatment of goods processed within the customs territory should be stopped at the moment the processed products are transferred from the customs territory of the Russian Federation, what is not defined as exports.

However, the court practices concerning the transfer of products from the Russian Federation in the framework of customs treatment of goods processed within the customs territory view this operation as the export of goods, since the processed goods should not be returned to Russia. Taking into account this situation, the RF Finance Ministry agreed that in order to substantiate the appropriateness of the taxation of such goods at the zero rate VAT in the period from January 1, 2004 till December 31, 2005, the taxpayer should have the right to submit customs freight declarations defining the transfer of such goods abroad both either as exports or as the movement of goods treated by customs as goods being processed within the customs territory, i.e. any customs freight declarations confirming the fact of transfer of the products of processing from the customs territory of the Russian Federation.

12. Letter of the Federal Tax Service No. ChD-6-25/353@ of April 26, 2007, provides recommendations concerning the procedures governing the filling in the form “Information on the average number of employees in the preceding calendar year.”

The information on the average number of employees should be submitted in accordance with the form “Information on the average number of employees in the preceding calendar year” (the Classification of Tax Documentation (CTD) form code 1180011) as approved by Order of the RF Federal Tax Service No. MM-3-25/174 of March 29, 2007).

13. Letter of the RF Finance Ministry No. 05-04-05/203636 of April 25, 2007, explains the issues pertaining to the procedures governing the taxation of operations related to the replacement of insurers.

As a matter of fact, the transfer of the insurance portfolio involves the simultaneous transfer of assets amounting to the insurance reserves corresponding to the transferred insurance obligations. Assets may be transferred in the form of a portfolio of securities, cash or real estate.

In the course of transfer of assets being in the form of securities there should be determined the tax base for the purposes of taxation of the profits derived by organizations by the date of withdrawal of such securities (i.e. by the date of transfer of the respective insurance portfolio).

As concerns the transfer of real estate, in accordance with item 1 of article 249 of the RF Tax Code, proceeds are defined as earnings derived from the sales of own or earlier acquired goods (works, services) and earnings from the exercise of ownership rights. The amount of the respective proceeds may be reduced by the balance cost of the transferred amortizable assets determined in accordance with the provisions of item 1 of article 257 of the RF Tax Code.

As concerns the VAT, in accordance with sub-item 1 of item 1 of article 146 of the RF Tax Code, operations related to the sales (transfer) of goods (works, services, property rights) are included in the number of objects subject to taxation. Therefore, with respect to the operations involving the transfer of assets accepted in order to cover insurance reserves, the value added tax should be applied under the general procedures depending on the type of assets accepted for the coverage of insurance reserves.

14. Letter of the RF Finance Ministry No. 07-05-10/27 of April 24, 2007, explains the issues pertaining to the procedures governing the formation of expenditures related to the remuneration of work of the managers of unitary enterprises, which should consist of the salary and bonuses for the financial and operating results of activities of the respective enterprise. These expenditures are expenditures borne in the course of carrying out of usual types of activities.

This letter of the RF Finance Ministry explains that the amount of bonuses granted to the managers of such enterprises in connection to the financial and operating results should be included in the composition of expenditures borne by the taxpayers in relation with remuneration of labor for the profit taxation purposes only in the case such bonuses are envisaged in the collective and (or) labor contracts.

15. Letter of the Federal Tax Service No. ShT-6-03/340@ of April 23, 2007, and letter of the RF Finance Ministry No. 03-04-15/52 of April 3, 2007, explain the issues pertaining to the procedures governing the taxation of financial resources transferred by the lessor to the lessee as a compensation for the expenditures borne by the lessee in relation to the payment for communal services, communication services, as well as services related to the security and cleaning of the premises in the framework of contracts, which do not include the costs of the provision of such services in the composition of costs related to the rent of premises with VAT.

This letter explains that lessors do not make out commercial invoices for lessees concerning the provision of communal services, communication services, as well as services related to the security and cleaning of the premises in the framework of the said contracts, since lessors do not provide such services to lessees. Accordingly, no object of taxation with the value added tax originates after the transfer of the financial resources as the payment for such services.

At the same time, the letter explains that due to the absence of the respective commercial invoices, the amounts of the value added tax charged in relation with payments for the provision of said services should not be deducted as concerns lessees.

L. Anisimova

A brief analysis of changes in the budget legislation introduced in the 1st quarter of 2007

This survey focuses on the most important systemic changes in the budget legislative framework adopted at the end of April of 2007. The changes under review were primarily aimed at the creation of a legal framework for approval of the medium term budget at the federal level, change of the status of financial reserves accumulated in the RF Stabilization Fund, as well as the enhancement of fiscal independence of regions and municipal entities.

In this quarter (at the end of April of 2007) there was approved and enacted federal law No. 63 FZ of April 26, 2007, “On the introduction of amendments to the RF Budget Code as concerns the regulation of the budgetary process and bringing of certain legislative acts of the RF into line with the budget legislation of the RF.” The law introduced a number of significant changes and additions to the budget legislation. The format of this survey does not permit to cover all the changes introduced to the RF Budget Code by this law, therefore, let us more thoroughly analyze some of them.

A part of amendments came into force immediately after the promulgation of the law, some of them should enter into force in 2008, 2009 and 2011. It should be noted that the amendments introduced by the law have principally changed the existing system of the budgetary process thus creating the basis for switching to the three year performance oriented budget.

The new law has substantially detailed article 6 of the RF Budget Code, which sets the definitions of terms used in the budget legislation. In particular, the law provided more precise definitions of the domestic and foreign debt, now it becomes possible to include regional and municipal borrowings in the composition of the domestic debt¹⁸ and impossible to include such debts in the composition of the foreign debt¹⁹. At the same time, the law set the status of regional and municipal debt obligations to the Russian Federation arising in the course of utilization of target foreign credits; the law more precisely defined the system of budget obligations and provided definitions of such types of obligations as expenditure obligations, budgetary obligations, public obligations, public normative obligations, and cash obligations; there was given the definition of of the state (municipal) services rendered to individuals and legal entities, as well as a number of other definitions and terms.

Besides, the law provided significantly more detailed stipulations of articles 18 – 27 of the RF Budget Code concerning the issues related to the budget classification. In particular, the law directly introduced classification of budget revenues into the text of the RF Budget Code. It also introduced the new “classification of operations carried out by the sector of state administration.” The law also enhanced the rights of regions and local governments concerning the more detailed presentation of the budget classification. For instance, article 20 of the RF Budget Code sets forth the groups and subgroups of revenues “uniform for all budgets of the budgetary system of the Russian Federation.” At the same time, this article of the law stipulates that financial authorities of regions and municipal entities of the Federation should approve the lists of codes of subtypes across the types of revenues, the chief administrators of which are the authorities of the respective tiers of the budgetary system. These authorities were also granted the right to approve the lists of target items and types of expenditures in accordance with the expenditure obligations, which should be met at the expense of the financial resources of the respective budgets, by approving laws (decisions) on the budgets.

At the same time, article 38.1 of the RF Budget Code fixes the principle of jurisdiction as concerns budget expenditures, which means that recipients of budget financial resources should have the right to obtain budget financial resources and budget obligations within certain quotas *only* from the chief administrator of budgetary financial resources, in whose jurisdiction such resources were transferred.

¹⁸ Domestic debt is the obligations denominated in the RF national exchange, as well as obligations of RF subjects and municipal entities to the Russian Federation denominated in foreign exchange, which were assumed in the framework of utilization of target foreign credits (borrowings)

¹⁹ Foreign debt is the obligations denominated in foreign exchange, with the exception of the obligations of RF subjects and municipal entities to the Russian Federation denominated in foreign exchange, which were assumed in the framework of utilization of target foreign credits (borrowings)

The law more clearly delineates expenditure obligations and sources of revenues. Thus, for instance, this stipulation concerns fines and other compulsory payments; from now on the revenues generated by such payments are more clearly detailed in article 46 of the RF Budget Code.

Therefore, the new version of the RF Budget Code is even more oriented towards the ensuring of enhanced independency of budgets of lower tiers and delimitation of powers among the different tiers of the budgetary system.

Articles 69, 69.1 and 69.2 of the RF Budget Code detail definitions of budget allocations and budget targets, as well as list the types of budget allocations for provision of state (municipal) services, what permits to make the planning of budget expenditures more transparent, as well as establish relationships with a new organizational form of the public sector – autonomous institutions. Thus, the budget allocations for provision of state (municipal) services should include allocations for:

- Provision of subsidies to autonomous institutions, including subsidies for the compensation of normative costs borne by such institutions with respect to the provision of state (municipal) services to individuals and (or) legal entities;
- Provision of subsidies to not-for-profit organizations not having the status of budget financed and autonomous institutions, including those providing state (municipal) services to individuals and (or) legal entities on the basis of contracts (agreements);

Procurement of goods, works and services to meet state (municipal) needs (with the exception of budget allocations aimed at the ensuring of performance of the functions of budget financed institutions), including the following objectives:

- provision of state (municipal) services to individuals and (or) legal entities;
- making budget investment in objects being in the state (municipal) ownership (with the exception of state (municipal) unitary enterprises);
- R & D, procurement and repairs of armaments, military and special equipment and machinery, products to be used for production and technological purposes and properties in the framework of the state defense order;
- Purchase of goods for the state material reserve.

Besides, article 74.1 of the RF Budget Code separately defines the types of budget allocations for social security purposes. In particular, the article stipulates that such allocations should be determined separately for each type of obligations, such as pensions, compensations and other social payments, as well as implementation of social support measures.

Yet another innovation introduced by the law is the setting of the procedures governing the provision of subsidies to legal entities (see article 78 of the RF Budget Code) and not-for-profit organizations, not being budget financed institutions (see article 78.1 of the RF Budget Code). It should be noted that such organizations retained the right to receive the full amounts of respective subsidies.

After the adoption of the law, the RF Budget Code substantially details the procedures governing budget investments in objects being in the state and municipal ownership (see article 79 of the RF Budget Code). In particular, this article stipulates that budget allocations for budget investments in the objects of capital construction in the form of capital investments in the fixed assets of state (municipal) institutions and state (municipal) unitary enterprises should be envisaged by long term target programs, as well as legal and regulatory acts of, respectively, the RF Government, the supreme state executive authority of the RF subject, or the local administration, or by decisions of chief administrators of budgetary financial resources of the respective budgets taken in accordance with the procedures established by the said authorities. The decisions on the preparation and making of budget investments in the objects of capital construction being in ownership of the Russian Federation exceeding Rub. 600 million and not included in long term target programs should be made by the RF Government and reflected in the composition of the consolidated federal budget revenues and expenditures separately for each investment project and the corresponding type of expenditures.

Budget allocations for budget investments in the objects of capital construction being in the ownership of the Russian Federation in the framework of projects, the estimated costs of which amount to less than Rub. 100 million and included in the federal target investment program should be reflected in the composition of the consolidated federal budget revenues and expenditures separately for each investment project and the corresponding type of expenditures. The new version of article 79 of the RF Budget Code introduces a stronger ban on direct investments in the objects being in ownership of other tiers of the budgetary system. Co-financing is carried out at the expense of interbudgetary subsidies, the financial resources provided from the higher budget should be approved by the law (decision) on the budget of the lower tier of the budgetary system in the composition of the departmental structure of expenditures separately for each investment project and the corresponding type of expenditures.

Unfortunately, an earlier problem was retained in the new version of the RF Budget Code: articles 79 and 80 of the RF Budget Code fail to provide a clear definition of “investments.” Besides, investments transferred to state unitary enterprises (SUEs) and municipal unitary enterprises (MUEs) are often seen only the investment in their capitals, although the budget legislation also envisages other forms of transfer of financial resources to such organizations. At the same time, the transferred financial resources may in certain cases be used by SUEs and MUEs for purchase of fixed assets. Therefore, investment related expenditures are still insufficiently clear singled out of the general mass of budget expenditures.

One of the most significant amendments introduced in the RF Budget Code by the law under review is the division of the RF Stabilization Fund in two parts. This topic will be more thoroughly examined in other surveys; however, in the framework of this study we shall only briefly touch upon this issue. The law introduced into the RF Budget Code article 13.2 «Utilization of oil and natural gas generated revenues of the federal budget,” which stipulates that oil generated revenues should be utilized in order to ensure the so called oil and natural gas transfer²⁰, as well as the formation of the Reserve Fund, which is in many aspects similar to the Stabilization Fund as concerns its utilization, and the Future Generations Fund. The financial resources accumulated in the Reserve Fund may be invested in foreign currencies and the following types of financial assets denominated in foreign exchange:

- Debt liability instruments of foreign states and state agencies;
- Debt liability instruments of international financial organizations in the form of securities;
- Deposits with foreign banks and crediting organizations.

Among the most significant innovations in the text of the RF Budget Code there should be also indicated the introduction of more detailed procedures governing the granting of state guarantees and budget credits, more precise definition of the system of participants of the budgetary process. However, perhaps the most significant change in the sphere of the budgetary process is the switching to the drawing and approval of the federal budget for a 3 year period (see item 3 of article 169 of the RF Budget Code). At the same time, regions were granted the right either also switch to the drawing of their budgets on the 3 financial year basis, or to retain the system based on the approval of one year budget and three year medium term financial plan, the structure of which is regulated by article 174 of the RF Budget Code.

Besides, articles 174.1 and 174.2 were added to the RF Budget Code. The former new article contains the provisions regulating the forecasts of budget revenues, whereas the latter sets the procedures governing the planning of budget allocations. In particular, to this article there were transferred regulations, earlier set by subordinate legislation concerning separate planning of budget allocations for the meeting of current and newly assumed obligations. The system of planning of budget expenditures was changed by the introduction of the new version of article 179 in the RF Budget Code. This article regulates general issues pertaining to the approval of long term target programs, as well as financing and monitoring thereof. In particular, the new version of the article clarified that these programs should be approved by a resolution of the supreme executive authority of the respective tier of the budgetary system, and not in the form of a law. Article 179.3 of the RF Budget Code mentions departmental target programs the development of which has been earlier regulated exceptionally at the level of subordinated legislation. Besides, yet another article was introduced in the RF Budget Code, which specifically deals with the issues pertaining to target investment programs (see article 179.1 of the RF Budget Code). Unfortunately, this article, as well as article 179.3 of the RF Budget Code retained very general (reference) nature and does not contain sufficient number of regulatory provisions. In this connection, its usefulness may be evaluated as insufficient.

Simultaneously with the switching to the new system of budget planning, legislators reduced the number of readings, in which the draft federal budget should be passed by the RF State Duma – from 4 to 3, respectively, the subject of each reading was defined more precisely. It should be also noted that section VIII.1 was added to the RF Budget Code. This section set the procedures governing the carrying out of external inspections, discussion and approval of budget reporting.

When assessing these amendments on the whole, the following should be noted. Powers in the sphere of revenues, expenditures and planning of different target programs were divided among the tiers of the national budgetary system more precisely. The regional and local tiers were granted broader powers in the sphere of selection of mechanisms of budget planning, formation of budget classifications, and so on. On the

²⁰ Deficit of the federal budget without its oil and natural gas based components is a difference between the amount of revenues of the federal budget without the revenues generated by oil and natural gas and the revenues derived from the management of the financial resources of the Reserve Fund and the Future Generations Fund, and the total amount of expenditures borne by the federal budget in the respective year.

one hand, these developments enhance the flexibility of fiscal policies pursued at the regional and local levels. However, on the other hand, it appears that under certain circumstances the changes introduced in the RF Budget Code by the law under observation may render the budgetary system less transparent, since the “reading” of regional and local budgets may become a more complicated task. By approving these amendments, legislators made yet another attempt to move closer to the formation of the budget policies oriented towards the implementation medium term programs and plans.

A. V. Kireyeva

A review of budget legislation introduced in May of 2007

In May of 2007, the following significant changes were registered in the sphere of budget legislation: there were introduced numerous amendments to the federal law “On the placement of orders for procurement of goods, conduct of works and rendering of services for state and municipal needs” and the federal law “On the state budget for year 2007” was amended to the effect that some powers in the sphere of forestry policy and forestry were delegated from the Russian Federation to regions. Orders issued by the RF Finance Ministry have regulated some accounting rules to be observed by non-state pension funds and approved the procedures governing the granting of subsidies and subventions from the federal budget to budget funded institutions.

Federal legislation

Federal law No. 53 FZ of April 4, 2007, (on the introduction of amendments to article 1. “General provisions” and article 2. “Placement of orders via organization of tenders” of the federal law “On the placement of orders for procurement of goods, conduct of works and rendering of services for state and municipal needs” in the RF Civil Code and the RF Budget Code)

Federal law No. 53 FZ of April 4, 2007, (hereinafter referred to as the law) has significantly amended federal law No. 94 FZ of July 21, 2005, (hereinafter referred to as the law on procurement) as well as some other legislative acts regulating the procedures, which should govern the placement of orders for procurement of goods, conduct of works and rendering of services for state and municipal needs. Besides, the law changed the provisions regulating certain methods of order placement (with the exception of the stipulations regulating the placement of orders at commodity exchanges).

In fact, the law has abolished an earlier criterion of its application. Earlier the provision of goods, conduct of works and rendering of services for state or municipal needs being below the caps on the amounts of cash payments between legal entities (Rub. 60 thousand) could be carried out outside the procedures set forth by the law.

The law established that legal relations regulated by the law on procurement should not include the cases of provision of aid on the part of international financial organizations created in accordance with the international agreements, in which the Russian Federation is a participant, as well as the international financial organization, with which the Russian Federation entered into international agreements; the list of such organization should be approved by the RF Government. Therefore, the law should not be applied with respect to such services provided by international financial organizations.

The new law also bridged the gap in the provisions of the law on procurement defining the list of eligible state or municipal ordering customers. The law established that budget funded institutions may be state and municipal ordering customers.

The law introduced that state or municipal ordering customers should refrain from making contracts with the winners of tenders and auctions or requests for quotations in the cases, where it was established that such winners were subject to the procedures of liquidation or bankruptcy, suspension of the operations of such a winner under the administrative procedures, as well as in the cases where such winners submitted false information about themselves in the course of selection of contractors, or certain parts of their assets were under arrest imposed by court decisions (sub-item “a” of item 8 of article 1). In accordance with the previous version of the law on procurement, in such cases a state or municipal ordering customer could refrain from concluding a contract at the customer’s discretion, what provoked infringements on this stipulation of the law.

Some other significant changes were also introduced in the law on procurement.

Federal law No. 74 FZ of May 15, 2007, “On the introduction of amendments to the federal law “On the federal budget for year 2007”

This law has brought federal law No. 238 FZ of December 19, 2006, “On the federal budget for year 2007” in compliance with the RF Forestry Code No. 200 FZ of December 4, 2006, which entered into force on January 1, 2007 and envisages delegation of certain powers of the Russian Federation in the sphere of forestry relations to the executive authorities of subjects of the Russian Federation in the framework of decentralization of forestry policy and forestry.

Resolutions of the Government of the Russian Federation

Resolution of the RF Government No. 293 of May 15, 2007, “On the invalidation of certain acts of the Government of the Russian Federation”

The resolution invalidated Resolution of the RF Government No. 844 of December 4, 2001, “On the approval of the rules governing the write down of debts of organizations to the federal budget, which, according to the legislation of the Russian Federation should be recognized as repaid, with respect to financial resources provided in the form of repayment financing, interest on the use thereof and relevant penalties and fines,” as well as the amendments to this Resolution introduced by Resolution of the RF Government No. 95 of February 24, 2005, “On the introduction of amendments to certain resolutions of the RF Government.”

Orders of the RF Finance Ministry

Order of the RF Finance Ministry No. 3n of January 10, 2007, “On the specifics of accounting procedures for non-state pension funds.” Registered by the RF Ministry of Justice, No. 9379 of May 2, 2007.

In particular, the order established that the annual financial statements of non-state pension funds should consist of the balance sheet of the non-state pension fund (form No. 1 – NPF), the profit and loss statement of the non-state pension fund (form No. 2 – NPF), respective supplements and the explanatory notes.

It is recommended that non-state pension funds should use model forms supplemented to the document under observation in the course of development of their financial statements.

Besides, the order defines the Specifics of formation of financial statements of non-state pension funds (Annex No. 2), including: the specifics of formation of the indicators entered into the balance sheet, the profit and loss statement, the cash flow statement with respect to financial resources pertaining to target financing, pension reserves and pension savings of non-state pension funds.

Order of the RF Finance Ministry No. 28n of March 29, 2007, “On the procedures governing the granting of subsidies and subventions from the federal budget to budget funded institutions.” Registered by the RF Ministry of Justice, No. 9485 of May 17, 2007.

The procedures established by this order were developed in compliance with item 40 of the Resolution of the RF Government “On the measures aimed at the implementation of the federal law “On the federal budget for year 2007” envisage, in particular, that subsidies should be granted on the basis of an agreement made by a budget funded institution with the chief administrator of financial resources of the federal budget or recipients of financial resources of the federal budget being in the jurisdiction of the chief administrator of the federal budget financial resources.

Besides, the order stipulates that the subsidies should be granted to a budget funded institution in accordance with the consolidated budget revenues and expenditures within the balances of the quotas of budget obligations and the amounts of financing of expenditures registered in the customer account of the recipient of financial resources of the federal budget opened with the territorial office of the RF Treasury by the authorized recipient.

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