May 2003
IMF Country Report No. 03/144

Russian Federation: 2003 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Russian Federation, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **February 12, 2003,** with the officials of the Russian Federation on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 10, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **April 30, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 2, 2003 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Financial System Stability Assessment
Selected Issues Paper
Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2003 Article IV Consultation

Prepared by Staff Representatives for the 2003 Consultation
with the Russian Federation

Approved by John Odling-Smee and Leslie Lipschitz

April 10, 2003

- The 2003 Article IV consultation discussions were held in Moscow during January 30–February 12, 2003. The staff team met with Central Bank of Russia (CBR) Governor Ignatiev, First Deputy Finance Minister Ulyukaev, other senior officials, members of the Duma, the financial and business community, and academics.
- The staff team comprised Mr. Fajgenbaum (head), Ms. Banerji, Messrs. Lewis, Owen, and Stavrev (all EU2), Mr. Chua (FAD), Ms. Ilyina (ICM), and Mr. Mulder (PDR), and was assisted by the Fund's Moscow office. Mr. Petersen (MAE) joined the mission for the last two days to discuss the main conclusions and recommendations of the Financial Sector Assessment Program (FSAP). Mr. Mozhin, Executive Director, participated in the discussions.
- Russia has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement but maintains restrictions that are subject to Fund approval (Appendix I). Outstanding obligations to the Fund at end-February 2003 amounted to SDR 4,544 million (76.43 percent of quota).
- The authorities have agreed to the preparation of new data and fiscal transparency Reports on the Observance of Standards and Codes (ROSCs). ROSC modules on data dissemination, transparency in monetary and financial policies, and fiscal transparency were circulated to the Board as background to the 2000 Article IV consultation. Russia is preparing to subscribe to the special data dissemination standard (SDDS). Despite a number of concerns, data quality is sufficient for an assessment of current macroeconomic policy (Appendix III).

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EXECUTIVE SUMMARY

Recent developments. Macroeconomic outcomes remained generally strong in 2002, despite the global slowdown. Implementation of structural reforms slowed substantially.

- GDP growth was close to 4½ percent in 2002, although it slowed toward year end. Inflation declined to 15 percent, slightly exceeding the authorities' target range of 12–14 percent.
- Gross international reserves rose to six months of imports, driven by a strong external current account surplus and higher private capital inflows. Inflows have increased sharply in the first part of 2003.
- Fiscal policy was loosened in 2002, broadly in line with the budget.
- Monetary and exchange rate policies have continued to aim at slowing the pace of real ruble appreciation, while keeping inflation on a downward path.
- Performance of Russian financial markets was very strong.

Policy discussions. There was broad agreement on the outlook and risks. The discussions focused on the need to ensure that macroeconomic policies are both cautious and flexible, and that structural reforms are accelerated.

- Some change in the mix of monetary and fiscal policies will likely be needed if inflation is to be substantially reduced. Monetary policy needs to give higher priority to lowering inflation, and fiscal policy should assume a greater share of the burden in containing real exchange rate appreciation. Greater exchange rate flexibility would also be necessary.
- Medium-term fiscal policy should aim for a roughly balanced budget based on long-run average oil prices; measures that would loosen the fiscal stance should be resisted.
- Russia's medium-term outlook suggests sustainable debt dynamics, although a sustained sharp drop in the oil price—the main source of vulnerability in present circumstances—would require some fiscal and exchange rate adjustment. A continuation of high oil prices, possibly aggravated by greater capital inflows, would lead to a sharper conflict between the goals of limiting real exchange rate appreciation and lowering inflation.
- The FSAP concluded that the banking system remains fragile, although given the small size of the financial sector, the direct cost of financial sector distress would be limited. Recommendations highlighted the need for strengthened banking supervision and greater competition in the banking sector.
- Medium-term economic growth is projected to remain moderate, below potential, underlining the need to speed up structural reforms, notably in the financial sector, public administration and civil service, natural monopolies, and housing and communal services.

I. Background

1. In completing the last Article IV consultation on March 8, 2002, Executive Directors welcomed Russia's impressive macroeconomic performance, noting that the strong external and fiscal positions had created room for a prudent relaxation of the fiscal stance. They stressed that monetary policy should target a lasting reduction in inflation, but generally supported the authorities' policy of limiting real ruble appreciation to encourage diversified growth. Directors welcomed progress on structural reforms but noted that the agenda remained vast and that sustained implementation would be a challenge.

2. **Parliamentary elections are to take place in December 2003 and the presidential election in March 2004**. Most observers do not expect the elections to result in any major policy breaks, but consider that it will be difficult to push forward with reforms in the pre-election period. Indeed, the authorities' focus on structural reforms has shifted to preparing measures for implementation after the elections.

II. Recent Developments

A. Macroeconomic and Market Developments

3. **Macroeconomic outcomes remained generally strong in 2002, despite the global slowdown**. Russia recorded a fourth successive year of relatively strong GDP growth and large current account surplus, and a third successive year of fiscal surplus. The economy has continued to benefit from the impact of earlier reforms, although temporary factors—in particular, strong world energy prices and the post-crisis real depreciation of the ruble—have also played an important role in growth performance. Moreover, GDP growth has become increasingly dependent on rapid growth of consumption.

Key Macroeconomic Indicators, 2000-02

	2000	2001	2002 Est.
		(In percent)	
Real GDP growth	9.0	5.0	4.3
of which			
Private consumption	9.2	8.7	8.5
Private investment	13.1	11.6	2.5
Inflation (eop)	20.1	18.6	15.1
General government, commitment basis			
Primary balance (percent of GDP)	7.1	5.7	2.7
Overall balance (percent of GDP)	2.7	3.0	0.6
Current account (US$ bn)	44.6	32.4	30.4
(percent of GDP)	17.2	10.5	8.8
Gross official reserves (US$ bn)	27.9	34.5	47.8
(months of import cover)	4.6	5.1	6.3
(ratio of short-term debt)	89.0	118.0	154.0
World oil price (US$/barrel)	28.2	24.3	25.0

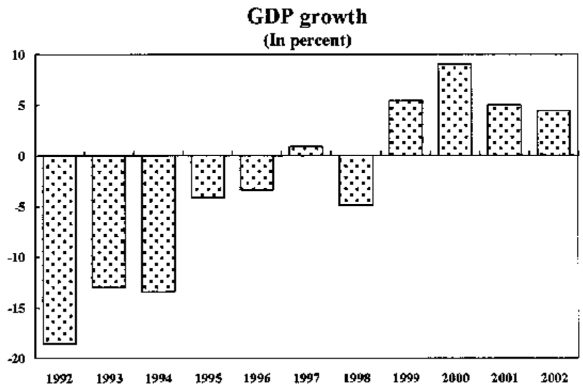
4. **Although real GDP grew by close to 4½ percent in 2002, growth slowed toward year end, and investment was weak**. The impetus to growth continued to come mainly from energy exports and consumption, reflecting a major rebound in real wages from depressed levels in the wake of the 1998 financial crisis and a rapid increase in real noninterest public expenditure. Real wages in the industrial sector increased more rapidly than productivity, dampening enterprise

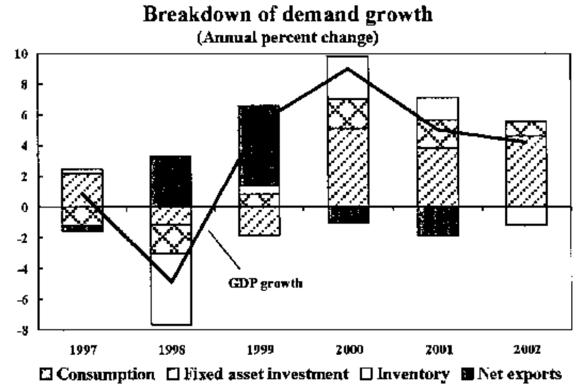
Labor Market Indicators
(In percent)

	2000	2001	2002	Cumult. since 1998
Change in total employment 1/	2.2	0.3	1.7	3.3
Unemployment, ILO methodology, 1/	9.8	8.9	8.6	-3.7
Real wage growth in industry 2/	20.2	20.5	16.5	29.8
Productivity growth in industry 2/	9.8	5.9	8.2	38.1

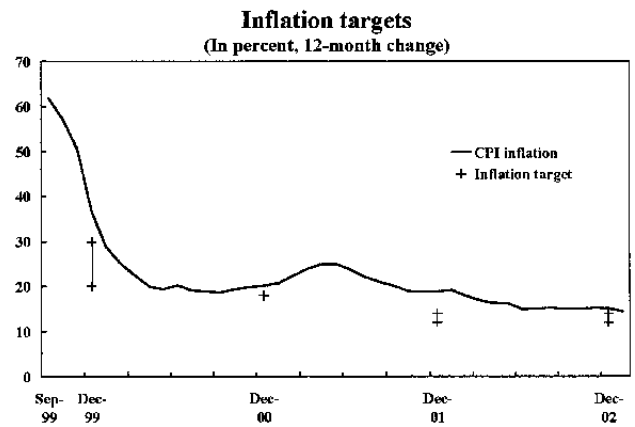
1/ End of period
2/ Annual average

profitability and investment, while growth in investment-intensive sectors such as commercial construction and machine building slowed.

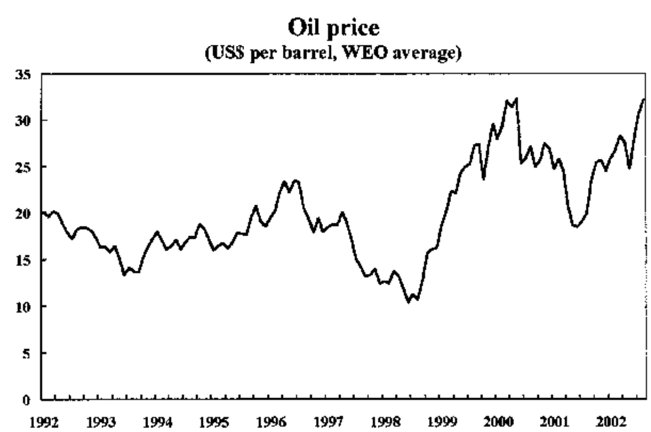




5. **Inflation declined to 15 percent in 2002, slightly exceeding the authorities' target range of 12–14 percent.** Core inflation (i.e., headline inflation minus the effect of increases in administered prices, gasoline, fruit, and vegetable prices) remained slightly above 10 percent. Cumulative inflation during January–February 2003 is running at about the rate for the same period a year ago, despite lower administrative price increases in 2003. This has raised some concerns about the feasibility of reducing inflation to the target range of 10–12 percent for 2003.



6. **The external current account surplus narrowed in 2002, but by less than expected, helped by continued strong world oil prices.** Imports continued to rise significantly, reflecting rapid domestic demand growth. Non-energy export growth was moderate, limited by weak external demand, while oil exports boomed. In real effective terms, the ruble depreciated about 2 percent during 2002—owing in part to the sharp appreciation of the euro against the dollar in the latter part of 2002—and remains about 20 percent below its pre-crisis level. Private capital inflows rose sharply, largely reflecting a marked improvement in corporate access to capital markets (Box 1). Direct investment inflows, however, remained low, at $2½ billion. The overall balance of payments strengthened



considerably, and gross international reserves rose to over 150 percent of short-term debt (six months of imports).

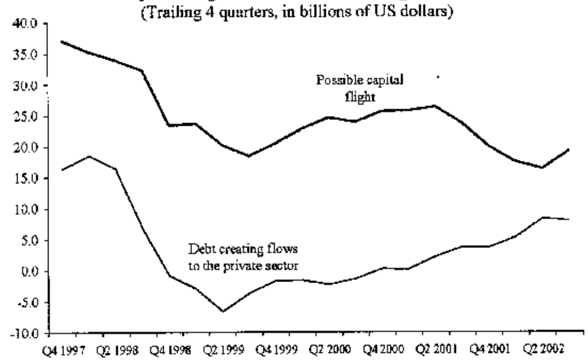
Box 1. Changing Capital Flows

The size and composition of capital flows to and from Russia have shifted significantly in recent years:

- Net private capital outflows more than halved, from about 10 percent of GDP in 2000 to an estimated 4 percent in 2002.[1] Capital flight[2] declined from about $25 billion in 2000 to about $20 billion in 2001 and 2002.
- Inflows, in the form of debt creating flows (net) to the private sector, recovered from negligible levels in 2000 to an estimated $7 billion in 2002, still only about half their peak pre-crisis level. The increase in private sector inflows reflects a recovery in corporate borrowing, in the wake of lower sovereign spreads and easier capital market access. Borrowing by the banking sector, in contrast, stagnated, possibly reflecting lack of confidence of lenders in the banking sector and ample bank liquidity.
- FDI has continued at relatively modest levels (under 1 percent of GDP) since 1997, but is expected to grow—e.g. British Petroleum announced in February an investment valued at $6.8 billion over 3 years (of which $3 billion will be paid in cash, most likely in 2003).

Russia's external debt stock has been declining since the 1998 crisis, with increasing repayments by the government more than offsetting increased debt of the private sector. This decline is expected to slow as government repayments taper off and debt flows to the private sector accelerate.

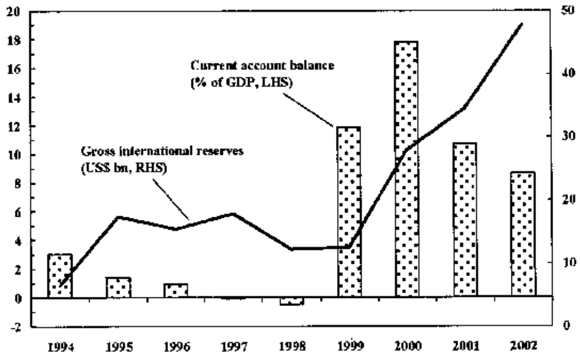
Capital flight and debt creating inflows
(Trailing 4 quarters, in billions of US dollars)



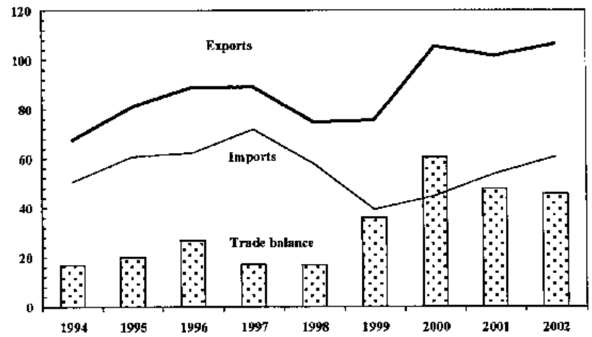
1/ Including errors and omissions.

2/ Defined as the sum of errors and omissions, changes in banks foreign assets, non-repatriated exports proceeds, non-delivery of goods and services against import advances and trade credit extended. A significant share of this category (e.g., the relatively stable errors and omissions) could constitute current account payments.

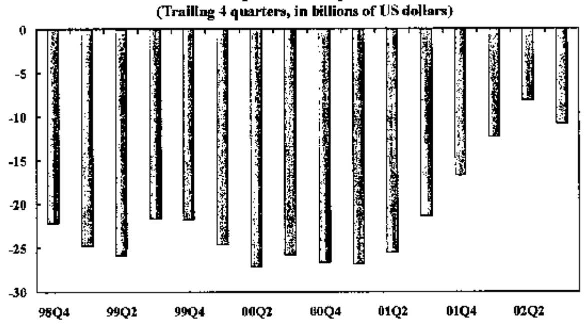
Current account and international reserves



Exports and imports
(US$ bn)

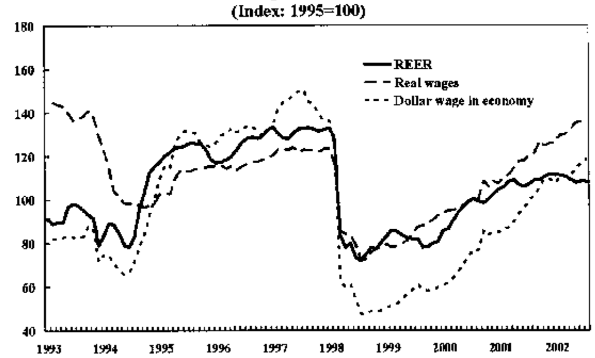


Total net private capital flows 1/
(Trailing 4 quarters, in billions of US dollars)



1/ Sum of all non-government items in the financial and capital accounts of the balance of payments, plus net errors and omissions.

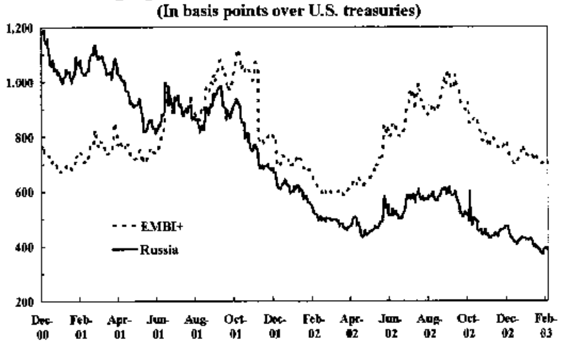
Real exchange rates and wages
(Index: 1995=100)



7. **At this stage, Russia's real exchange rate does not appear overvalued, although a significant further real appreciation without corresponding productivity gains could pose a problem for future competitiveness of the non-energy sector.** In recent years, growth in real wages has outpaced productivity gains, further narrowing the productivity-real wage gap, but this in part reflects a continued rebound from the sharp compression in real wages following the 1998 crisis. And while the rise in consumption was not accompanied by a significant pick up in output from some consumer goods sectors, some other industries—notably food production, and the chemical and related industries—registered robust growth. Thus, structural impediments in some import-competing industrial sectors, rather than competitiveness problems, may be the more important factor in restraining growth at this stage.

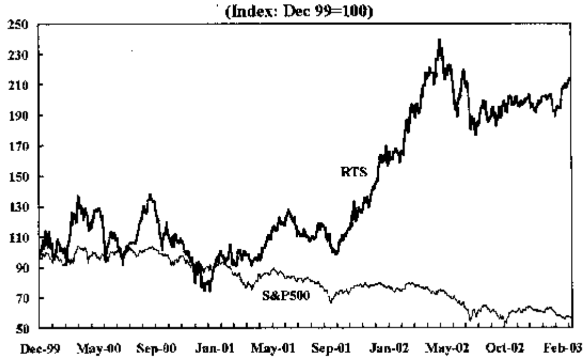
8. **In 2002, the Russian financial markets were, for a second consecutive year, among the best performing in the world.** Russian external debt trades at yields that are lower than those of other countries with similar credit ratings, although rating agencies provided a series of upgrades in 2002.[1] Corporate debt issuance (both ruble and foreign currency denominated) rose sharply in 2002, largely driven by companies' refinancing needs.

Emerging Market Bond Index (EMBI+) spreads
(In basis points over U.S. treasuries)



Source: JPMorgan

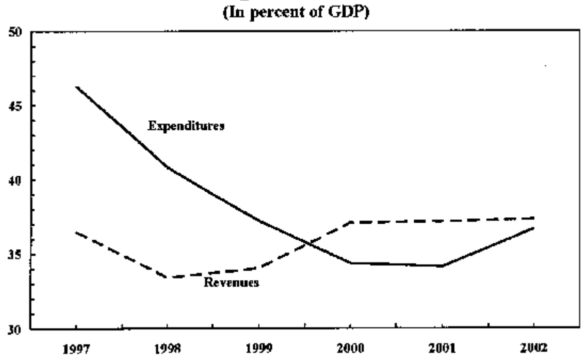
Russian stock market
(Index: Dec 99=100)



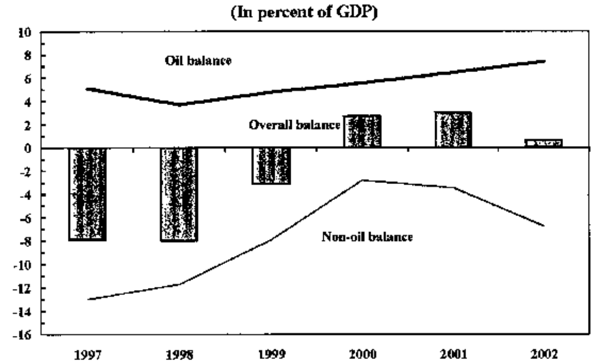
B. Fiscal and Monetary Policies

9. **Fiscal policy was loosened in 2002,** broadly in line with the budget. Preliminary data indicate that the general government fiscal surplus was about ⅔ percent of GDP, or close to 2½ percent of GDP lower than in 2001. Revenues increased by about ¼ percentage point of GDP, reflecting slightly higher oil prices and significant gains in personal income and social taxes, while expenditures rose by 2½ percentage points, continuing a strong upward trend in real non-interest expenditures. As a result, the deficit in the non-oil balance rose considerably. While the extrabudgetary funds were largely in balance, regional budgets, in aggregate, recorded a deficit in 2002 due to rapid spending increases in the latter part of the year.

General government finances
(In percent of GDP)

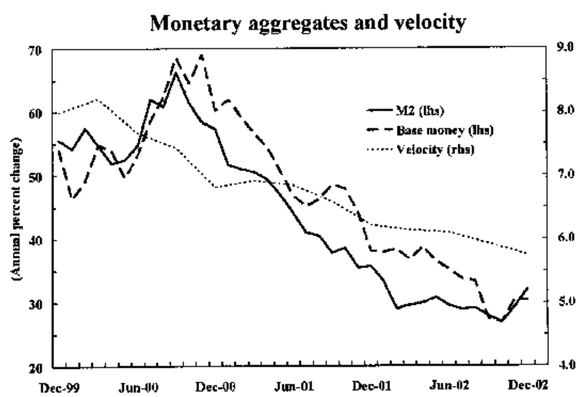


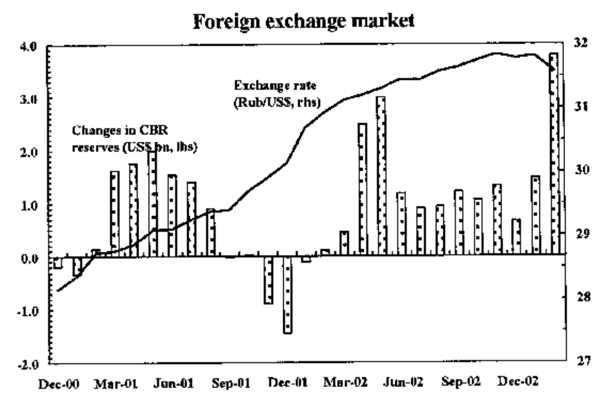
Overall and non-oil balances
(In percent of GDP)



[1] See Chapter VII in the Selected Issues paper on Russia's sovereign credit ratings and market access.

10. **Monetary and exchange rate policies have continued to aim at slowing the pace of real ruble appreciation, while keeping inflation on a downward path, despite the pressures generated by the strong balance of payments and the weaker fiscal stance.** The Central Bank of Russia (CBR) intervened to engineer a gradual nominal depreciation against the dollar through most of 2002, and, with the euro appreciating against the dollar, the ruble depreciated in real effective terms. The CBR's intervention was only partially sterilized by attracting deposits. Continued remonetization of the economy helped avoid a large deviation from the 2002 inflation target, notwithstanding ruble broad money growth exceeding its end-year target of 24–28 percent. In early 2003, faced with intense inflows associated with high oil prices, large corporate bond issues, and the privatization of Slavneft, the CBR has allowed a modest appreciation of the ruble against both the dollar and the euro. It has, nonetheless, continued to intervene heavily in the foreign exchange market, and reserves increased by close to US$8 billion in the first three months of the year, well ahead of projections.





C. Structural Reforms

11. **Implementation of structural reforms slowed substantially in 2002, due in part to the electoral calendar, but also to strengthening opposition from vested interests.**[2] Progress was achieved with the enactment of the agriculture land law and bankruptcy law in 2002, and firm-level surveys suggest deregulation efforts may have started to have some impact. However, electricity sector reform—while moving forward—was significantly diluted, and progress in other areas has slowed markedly, including other components of natural monopoly reform, deposit insurance, and efforts to strengthen public administration and the civil service. Corruption remains a major obstacle to private sector investment and activity.[3]

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[2] Chapter VIII in the Selected Issues paper examines progress on the government's reform agenda in 2002.

[3] Russia scores below the 40th percentile on all six of the World Bank's governance indicators, and significantly below its income category comparators for "regulatory quality," "rule of law" and "control of corruption."

Box 2. Regional Trends

A comparison of recent macroeconomic developments in the three largest CIS economies leads to two striking observations:

- **Russia has been markedly less successful than either Ukraine or Kazakhstan in reducing inflation.** Kazakhstan's performance is especially notable, as it has faced much the same oil-related balance of payments pressures as Russia and has pursued a similar exchange rate policy, with the tenge closely linked to the ruble.
- **GDP growth in Russia has been much slower than in Kazakhstan and, in the past three years, a little slower than in Ukraine**, which has not benefited from an oil boom.

There are no simple explanations for these differences, but possible factors are discussed below.

Factors affecting **inflation differentials** include:

- Greater **absorption of higher oil revenues** in Kazakhstan through imported investments within the expanding oil sector, profit remittances, and more effective sterilization of inflows, including via the oil fund. By contrast, Russia's more mature oil sector has absorbed less of the windfall, and oil revenues have instead helped fuel higher private and public sector wages, pensions, and consumption.
- Less supportive **fiscal policy** in Russia. Whereas the non-oil deficit in Russia has widened significantly since 2000, the fiscal stance has so far been steadily tightened in both Kazakhstan and in Ukraine.
- **Administered price increases** in Russia, which have been significantly above general inflation, compared with moderate relative declines in administered prices in Kazakhstan and no significant changes in Ukraine.
- **Exchange rate policy:** the Ukrainian hryvnia has been broadly stable against the dollar since end-1999, compared with a nominal ruble depreciation of nearly 20 percent over the same period, despite the pressure for appreciation coming from higher oil prices.

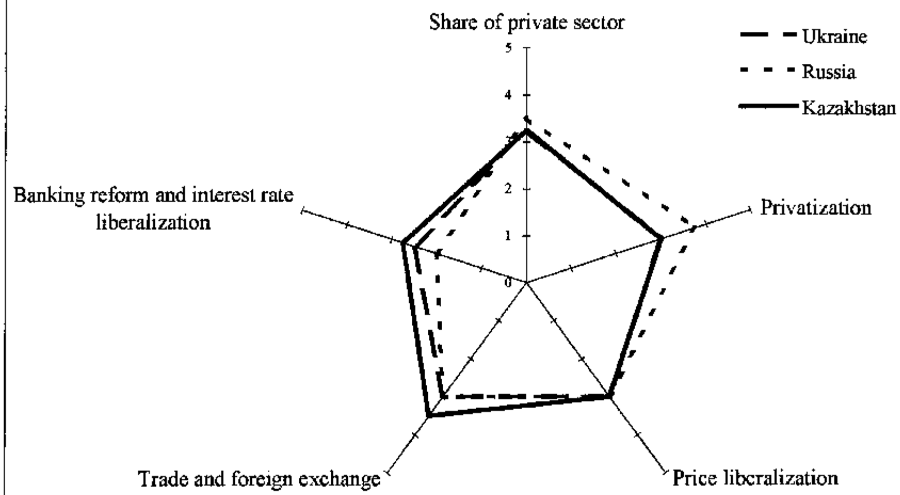
Regarding **output performance**:

- Rapidly increasing **oil production and investment** have boosted growth in Kazakhstan, while **strong harvests** were a factor in both Kazakhstan and Ukraine.
- Kazakhstan and Ukraine have recently been more successful than Russia in maintaining the **competitiveness gains** following the 1998 crisis, in part reflecting tighter fiscal policy and lower wage pressures. Notably, Ukraine achieved this despite its stronger nominal exchange rate, consistent with the view that real factors are the primary determinant of real exchange rates except in the short term.
- Overall progress on **structural reforms** is similar in the three countries, with common concerns about the recent slowdown. While this does not provide any clear explanation of growth differentials, some variations may be significant, with agricultural reforms in Ukraine and Kazakhstan playing an important role in the strong contribution of this sector to growth.
- Strong growth in all three countries, despite a slowing pace of structural reforms, suggests that **cumulative reforms** to date have at least been sufficient for producers to take advantage of the post-crisis competitiveness gains, still relatively low wages, and spare capacity.

Selected Macroeconomic Indicators
(In percent)

	1999	2000	2001	2002 Prel.
Russia				
Real GDP growth	5.4	9.0	5.0	4.3
Inflation, eop	36.6	20.1	18.6	15.1
Real effective exchange rate, average	-29.5	10.5	18.5	3.6
General government balance	-3.2	2.7	3.0	0.6
of which: non-oil balance	-10.3	-2.8	-3.5	-6.9
Kazakhstan				
Real GDP growth	2.7	9.8	13.5	9.5
Inflation, eop	18.1	9.8	6.4	6.6
Real effective exchange rate, average	-9.7	-10.1	-1.5	-2.8
General government balance	-5.0	-0.8	2.7	1.4
of which: non-oil balance	-5.9	-4.1	-4.0	-3.0
Ukraine				
Real GDP growth	-0.2	5.9	9.2	4.6
Inflation, eop	19.2	25.8	6.1	-0.6
Real effective exchange rate, average	-17.9	-4.6	5.9	-3.0
General government balance	-2.4	-1.3	-1.6	0.5

Reform Progress



Source: EBRD Transition Report 2002.
Note: Minimum score (little progress) is 1 and maximum score is 4.5 ("4+") except for the share of private sector, which is re-normalized between 0 and 5. The privatization indicator is an average of the small-scale and large-scale privatization scores.

III. Report on the Discussions

12. **The policy discussions took place against the background of generally positive economic outcomes and high oil prices, but also slowing growth, and uncertainty about prospects for private capital flows and the future path of money demand.** Since the financial crisis in 1998, macroeconomic policies have effectively responded to the challenges faced by Russia, with fiscal and external balances rapidly restored, and some success achieved in reducing inflation to moderate levels while restraining real exchange rate appreciation. At the same time, the pace of structural reforms markedly increased in 2000–01. Through most of this period, there has been broad agreement between the authorities and staff on the key issues and the appropriate policy response, although more recently the authorities have not been able to resist pressures—highlighted by the Executive Board in the 2001 consultation—to slow the pace of reforms. Looking forward, the challenges facing Russia have shifted and, in the short run, strong oil prices and the associated foreign exchange inflows may further test the authorities' ability to contain inflationary pressures and/or the real appreciation of the ruble. This task will be even more difficult if the recent strength of foreign exchange inflows continues or intensifies. Looking further ahead, there is considerable uncertainty related to the timing and magnitude of a future reversal in the current high oil prices. There is also a risk that money demand growth could be slower than anticipated. In this context, the discussions focused on the need to ensure that macroeconomic policies are both cautious and flexible in an uncertain environment. Key issues included:

- The mix of fiscal, monetary, and exchange rate policies needed to allow a substantial reduction in inflation in an environment of strong external inflows;
- The appropriate fiscal stance to support Russia's macroeconomic objectives, while ensuring that over the medium term potentially higher demands on the budget, or lower oil prices, can be accommodated;
- The key role of faster structural reforms in supporting medium-term growth.

13. **Most interlocutors broadly agreed with the staff's assessment of the outlook for 2003–04, based on the WEO projections.**[4] GDP growth is expected to slow somewhat in 2003, and could ease further in 2004, reflecting the impact of low investment in the non-oil sector in recent years and the absence of any new impetus from structural reforms. Net exports are projected to pick up in 2003, driven by high oil prices; however, this is expected to be offset by slowing domestic demand as the sharp growth in consumption eases due to slower growth in wages.

Key Macroeconomic Indicators, 2002-04

	2002 Est.	2003 Proj.	2004 Proj.
		(In percent)	
Real GDP growth	4.3	4.0	3.5
Inflation (eop)	15.1	12.0	8.0
Nominal GDP (Rub bn)	10,864	13,104	14,435
General government, commitment basis			
Primary balance (percent of GDP)	2.7	4.3	4.0
Overall balance (percent of GDP)	0.6	2.5	2.2
Current account (US$ bn)	30.4	42.4	29.3
(percent of GDP)	8.8	10.1	6.3
Gross official reserves (US$ bn)	47.8	67.6	85.9
(months of import cover)	6.3	8.0	9.4
(ratio of short-term debt)	154.0	237.0	263.0
World oil price (US$/barrel)	25.0	31.0	25.0

[4] These projections were subsequently revised on the basis of the latest WEO update.

14. **The external current account should strengthen considerably in the first part of 2003, but the surplus is projected to turn down as high oil prices recede toward the end of 2003 and in 2004**. Gross capital inflows are expected to continue to pick up, driven in part by higher borrowing by Russian corporations and stronger prospects for foreign direct investment. Capital outflows are likely to slow, but will nonetheless remain large. Through a series of buybacks and prepayments on external debt (including to the IMF), Russia has successfully smoothed what had been a hump in debt service due in 2003. Assuming continued intervention in the foreign exchange market to restrain nominal exchange rate appreciation, and government savings of the revenue windfall from higher oil prices (see below), Russia's gross international reserves are projected to rise by some US$20 billion in 2003, and US$18 billion in 2004.

A. Macroeconomic Policies

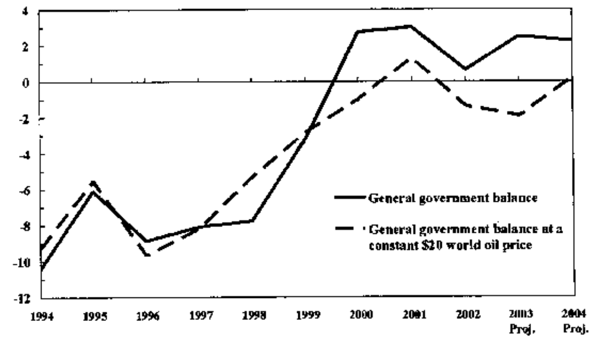
15. **The authorities underlined their concern, shared by staff, that a sharp appreciation of the real exchange rate could damage growth in the non-oil sector. However, they recognized the tension between their exchange rate and inflation objectives.** In this context, the staff stressed that this tension has become increasingly pronounced, and that some change in the mix of monetary and fiscal policies will likely be needed to reduce inflation substantially. Limiting real appreciation through monetary policy, by effecting a gradual nominal depreciation in the context of strong external inflows, leads to an inflationary bias and is not sustainable. The greater sterilization efforts that would be required by the central bank, particularly if money demand growth decelerates, would be costly. The objectives of restraining real appreciation and strengthening competitiveness are best achieved through strong fiscal policy and structural reforms, leaving monetary policy free to focus on the critical task of reducing inflation.

16. **The authorities agreed that fiscal policy will need to assume a greater share of the burden in resisting real ruble appreciation**. To avoid adding upward pressure on the real exchange rate, the staff recommended that the authorities save at least all additional revenues in 2003 associated with higher-than-budgeted oil prices. On this basis, the general government would show a surplus of 2½ percent of GDP and the federal government a surplus of 3 percent.[5] The authorities agreed that the oil windfall should be saved, but noted their concern that as oil prices strengthen, pressures to cut taxes and increase spending are increasing.

[5] The 2003 federal budget, based on a world oil price of about US$23/barrel, targets a balance of close to zero; staff projections are based on an oil price of US$31/barrel. A US$1 increase in the oil price is estimated to boost revenues by close to 0.4 percent of GDP. The world price cited here is the WEO's composite price.

17. To provide more support to the disinflation effort and help put downward pressure on the real exchange rate, **the staff recommended that medium-term fiscal policy should aim for a roughly balanced budget when world oil prices are at the long-run average** (about US$20 per barrel).[6] Accordingly, the 2004 budget should target a budget surplus of 2¼ percent of GDP on the basis of a projected oil price of $25/barrel, a tightening of underlying fiscal policy of 1½–2 percent of GDP compared to 2003. While tighter than needed to ensure debt sustainability, this fiscal stance would support Russia's macroeconomic objectives and ensure that the budget would be in a stronger position to absorb a sharp drop in oil prices. The staff also suggested that an underlying fiscal stance of budget balance at a baseline oil price could be formalized in a fiscal rule (Box 3). This could be useful in de-politicizing budget formulation and in guiding the medium-term budgetary framework.[7] The authorities noted that the underlying fiscal stance implied by this proposal closely matches the targets in their own medium-term budgeting exercise, and indicated that they would target a similar fiscal tightening in the 2004 budget.

General government fiscal balance
(In percent of GDP)



18. **The authorities have proposed establishing an oil stabilization fund**, which the mission considered a helpful fiscal management tool, either as a stand-alone fund or as a complement to a fiscal rule, provided that it is transparent, accountable, and fully integrated with the budget. Such a fund, which would also need a sound asset management strategy and clear rules on inflows and outflows, could serve to help smooth the impact of fluctuating oil receipts on the budget, accumulating assets during periods of higher-than-baseline oil prices and providing transfers to the budget when prices are low.[8] The authorities fully agreed with staff that in the event of a large and prolonged downturn in the oil price, it would be prudent to adopt fiscal measures to offset at least part of the oil revenue shortfall. The authorities also noted that the stabilization fund could help ensure the availability of resources in the context of their medium-term budgeting.

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[6] This figure represents the average over the past ten years. Setting an oil price baseline is difficult given the sharp price fluctuations and slow mean reversion; accordingly, any baseline oil price for medium-term fiscal budgeting would need to be revised periodically in light of oil market developments. The Ministry of Finance is using an average price of about US$20 per barrel.

[7] Chapter V in the Selected Issues paper discusses the medium-term fiscal stance, and design issues related to a fiscal rule and oil stabilization fund.

[8] The use of hedging instruments to smooth fluctuations in oil receipts is likely of limited use in the near term. Markets for these instruments are small relative to the size of the Russian petroleum sector, and the instruments are very costly. There is little the government can do to encourage their use, given that most Russian petroleum firms are private entities.

Box 3. Potential Role of a Fiscal Rule and Oil Stabilization Fund

The balanced budget fiscal rule proposed by staff could serve as a useful tool in lessening discretionary intervention in the economy and supporting implementation of countercyclical fiscal policy. Fiscal rules can have drawbacks: some discretion may be desirable at times, and alternatively, fiscal rules can often be circumvented. Nonetheless, for Russia, the key advantage of the fiscal rule is that it would serve a political economy objective of building greater support for public savings, and would buttress credibility in the pursuit of a prudent fiscal policy. The rule needs to be designed with enough flexibility to ensure that the baseline fiscal stance is not overly rigid in the event that circumstances shift. The proposed fiscal rule would target the overall general government balance, although other fiscal measures (e.g., primary balance, non-oil balance) could be used instead.

The fiscal policy underpinned by the staff proposal would aim to:

- Support the authorities' macroeconomic objective by sterilizing part of oil-related flows which have complicated the conduct of monetary and exchange rate policy. Similarly, the rule would neutralize the impact of fluctuating oil receipts on the budget, supporting more stable movements in the non-oil balance.
- Place the budget in a stronger position to withstand severe shocks, and ensure fiscal sustainability.
- Provide resources to cover the future costs of structural reform and potential public investment needs. The government's reform agenda includes a large number of structural reforms with potential sizable fiscal costs which cannot be absorbed solely through expenditure savings elsewhere in the budget.
- Serve as a useful counterpart to a monetary policy rule—inflation targeting—should Russia move in that direction.

The authorities are currently refining a proposal for an oil stabilization fund that would likely be introduced in 2004. They consider that the fund would be an effective instrument in resisting the political pressures for a more relaxed underlying fiscal stance which have emerged during periods of high oil prices. The fund would utilize a baseline oil price to serve as a trigger for determining contributions to, and transfers from, the fund. Although the authorities' proposal does not envision the fund being paired with a fiscal rule, it would in principle be a component of their medium-term budgeting exercise, and the parameters governing flows into the fund, including the baseline oil price, would be determined in this context. Given the scale of Russia's oil and gas resources and their relatively low rate of depletion, the authorities do not envision that the fund would also be a "savings" fund, steadily accumulating financial assets for future generations.

The authorities were receptive to staff views on the potential pitfalls of stabilization funds. Their proposal would ensure that asset and debt management would be integrated to prevent the situation, for example, whereby the treasury would have to borrow to finance the non-oil fiscal deficit, while at the same time making contributions to the fund. Mechanisms would be in place to ensure that the trigger price for the fund would be adjusted if it appeared to be diverging from trends in the market. The authorities and staff discussed the Norwegian oil fund, which provides potentially useful lessons on the design of stabilization funds.

19. **The authorities indicated that lowering inflation is a key macroeconomic objective.** However, they noted that more ambitious targets may be difficult to achieve, given the projected strong external inflows and their concern to avoid a sizable nominal exchange rate appreciation. The staff underlined that, with support from tighter fiscal policy to sterilize the impact of foreign inflows, the central bank would be able to give a higher priority than in the past to achieving a significant reduction in inflation. The staff recommended aiming for the bottom end of the authorities' 10–12 percent target range for headline inflation in 2003, corresponding to core inflation of about 7 percent, with a further reduction taking core inflation to less than 5 percent by end-2004. The mission pointed out that Russia had made only slow progress in reducing inflation in recent years; other transition countries have achieved much faster disinflation, with little sign of significant output costs. By not reducing core inflation more rapidly, Russia faces the continued efficiency costs of high inflation, and the risk that inflationary expectations could become entrenched, increasing the costs of future disinflationary efforts.[9] And by generating higher inflation, limiting nominal appreciation will not be successful in restraining real appreciation over the medium term. The staff argued that, in the event that inflation appears likely to exceed its target, the central bank would need to be prepared to cut back on intervention in the foreign exchange market and thus allow greater exchange rate flexibility, increase sterilization, and accelerate removal of existing controls on capital outflows. The mission stressed, however, that headline inflation should not be artificially suppressed by delaying further administrative price increases that are clearly justified, including in the natural monopolies sector and for housing and communal services.

20. **In recognizing the tensions in their approach, the authorities noted that targeting a nominal depreciation vis-à-vis the dollar last year had unintentionally resulted in a real effective depreciation** because of the sharp appreciation of the euro against the dollar in the latter part of the year. Thus far in 2003, the CBR has allowed a nominal appreciation of the ruble of more than 1½ percent against the dollar in response to strong inflows, possibly signaling a more flexible approach than in the past,[10] even though some senior CBR officials had stated that moderately higher inflation may be preferable to a significant nominal appreciation of the ruble. They pointed out that money demand had strengthened considerably, and expressed concern that gradual nominal appreciation could fuel capital inflows. In recent months, they had steered interest rates lower to discourage speculative inflows. The staff cautioned that lowering interest rates would discourage ruble-denominated financial savings, and thus risk fueling inflation, and urged the authorities to monitor balance of payments developments closely.

[9] Chapter I in the accompanying Selected Issues paper examines disinflation and output growth in central and eastern Europe, and potential lessons for Russia.

[10] This may also signal a growing recognition of the importance of the ruble/euro exchange rate.

21. **The staff recommended that the authorities consider moving toward the adoption of full-fledged inflation targeting over the medium term**, once the necessary preconditions are in place (Box 4).[11] The current monetary policy framework with multiple objectives is unlikely to be sustainable, while an inflation targeting framework would provide the economy with the necessary nominal anchor. The authorities expressed some interest in moving toward full-fledged inflation targeting, and agreed that an inflation targeting framework would need to be accompanied by the adoption of a medium-term fiscal framework based on the proposed fiscal rule in order to help offset the swings in the terms of trade experienced by Russia.[12]

B. Medium-Term Outlook and Vulnerabilities

22. **Russia's medium-term outlook suggests sustainable debt dynamics, due in part to the strong macroeconomic performance in recent years, which would enable Russia to withstand sizable shocks.** However, economic growth is projected to remain moderate, below potential,[13] in light of the slowing pace of investment and structural reform, and resulting subdued output growth in the non-oil sector. On the assumption that current policies are maintained and oil prices decline to around $20 per barrel, the baseline envisages real GDP growth of about 3½–4 percent per year, reflecting annual total factor productivity growth of around 1½–2 percent.

23. **Under this scenario, the external current account is expected to move toward balance, driven by lower oil prices and gradually increasing private investment**. The growth of oil export volumes is predicted to slow as export capacity (pipelines and ports) constraints become more binding. The capital account is projected to steadily improve, reflecting growth in foreign borrowing by Russian companies, moderately higher foreign direct investment, and a gradual shrinking of capital flight. Reserve cover is expected to flatten at about 10 months of imports at the end of this decade, well over 200 percent of short-term debt. The envisaged fiscal position should allow a reduction in public debt to below 20 percent of GDP by 2007, and leave some room to cover costly structural reforms and public investment.

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[11] Chapter IV in the Selected Issues paper discusses the preconditions for a move to inflation targeting.

[12] Russia has been subject to terms of trade shocks on the order of 10–20 percent of GDP.

[13] Potential growth is estimated at 5–6 percent; see SM/02/63 (02/21/02).

Box 4. Inflation Targeting

The existing monetary framework, which also focuses on a real exchange rate objective, would need to be modified to achieve sustained low inflation. Staff analysis concludes that:

The authorities should consider adopting a credible nominal anchor to guide inflationary expectations, which risk becoming quite entrenched after 5–6 years of double digit inflation and slow disinflation.

The exchange rate and the money supply are not suitable nominal anchors for Russia given the uncertainty about the scale and volatility of external flows and the pace of remonetization. The choice of inflation as the primary objective of monetary policy would help influence inflationary expectations by signaling that the CBR would be prepared to accept a nominal appreciation of the ruble if the conflict between its exchange rate and inflation objectives became binding.

The staff recommended that the authorities consider moving to full-fledged inflation targeting over the medium term, as this would allow the CBR to give precedence to inflation reduction, anchor inflationary expectations, reduce the scope for discretionary policy changes, and help achieve and sustain low inflation.

Many of the pre-conditions for inflation targeting could be established without much difficulty:

- A joint government-central bank commitment to the inflation target and, possibly, amendments to the CBR law would help ensure the necessary political support for inflation reduction. The CBR already has instrument independence and efforts must be made to ensure this continues to be the case.
- The CBR's accountability to the public should be further improved by providing: fuller explanations for changes in monetary policy, including an ex-post assessment of monetary policy performance; full disclosure of information about the inflation target and the underlying assumptions; regular publication of inflation forecasts; improved disclosure of monetary and financial policies; and the use of a broader set of disclosure channels.
- A clearer understanding of the analytical underpinnings of the inflation process in Russia, and the effectiveness of the transmission mechanism of monetary policy, is needed. The ability to make inflation forecasts using a broad range of available information also needs strengthening.
- To ensure that fiscal policy would be supportive of the inflation objective, a fiscal rule would be useful to insulate the budget from fluctuations in oil prices and political pressures to raise spending when oil revenues are high.

However, the development of effective tools to conduct monetary policy, greater financial sector deepening, and more capital account liberalization (to allow capital flows to offset terms of trade shocks) may require some time, and therefore, delay the possible introduction of inflation targeting.

Nevertheless, the CBR should already begin the process of transition to such a regime by placing greater emphasis on its inflation reduction objective. Key to this process would be the adoption of more supportive fiscal policies, and a willingness to make greater use of the interest rate tool and to allow more flexibility in the exchange rate regime.

24. **The main downside risk facing Russia is a sustained sharp drop in the oil price.**[14] Under a scenario in which the world oil price falls to US$12 per barrel for two years before settling at US$15 per barrel, real GDP growth could decline to close to zero before gradually recovering. In the absence of adjustment, the fiscal balance would move rapidly into deficit, and Russia could potentially face serious short-term liquidity constraints, with reserves declining to very low levels by 2006; this could entail high borrowing costs, or even a cut-off in access to capital markets, and thus threaten sustainability. To minimize the effects of the terms of trade shock and lower growth, under this scenario fiscal policy is assumed to tighten in response to the initial deterioration and there would need to be an early and sizable exchange rate adjustment. Accordingly, imports would contract, limiting the deterioration in the current account.

25. **The more immediate risk facing Russia is a prolongation of higher oil prices, possibly aggravated by greater capital inflows than assumed under the baseline scenario.** Were these circumstances to continue over the medium term, the authorities' current monetary policy dilemma would be deepened. Fiscal policy would need to sterilize the additional oil receipts. Inevitably, however, a larger appreciation of the ruble might be necessary to avoid an inflationary spike. Under this scenario, accelerated structural reforms would become even more crucial to strengthen productivity growth and maintain the competitiveness of Russia's non-oil sector.

26. Russia is expected to be able to meet its obligations to the Fund in a timely manner. Indeed, **the authorities indicated that they are considering making additional voluntary advance repurchases, although apparently not before 2005.**

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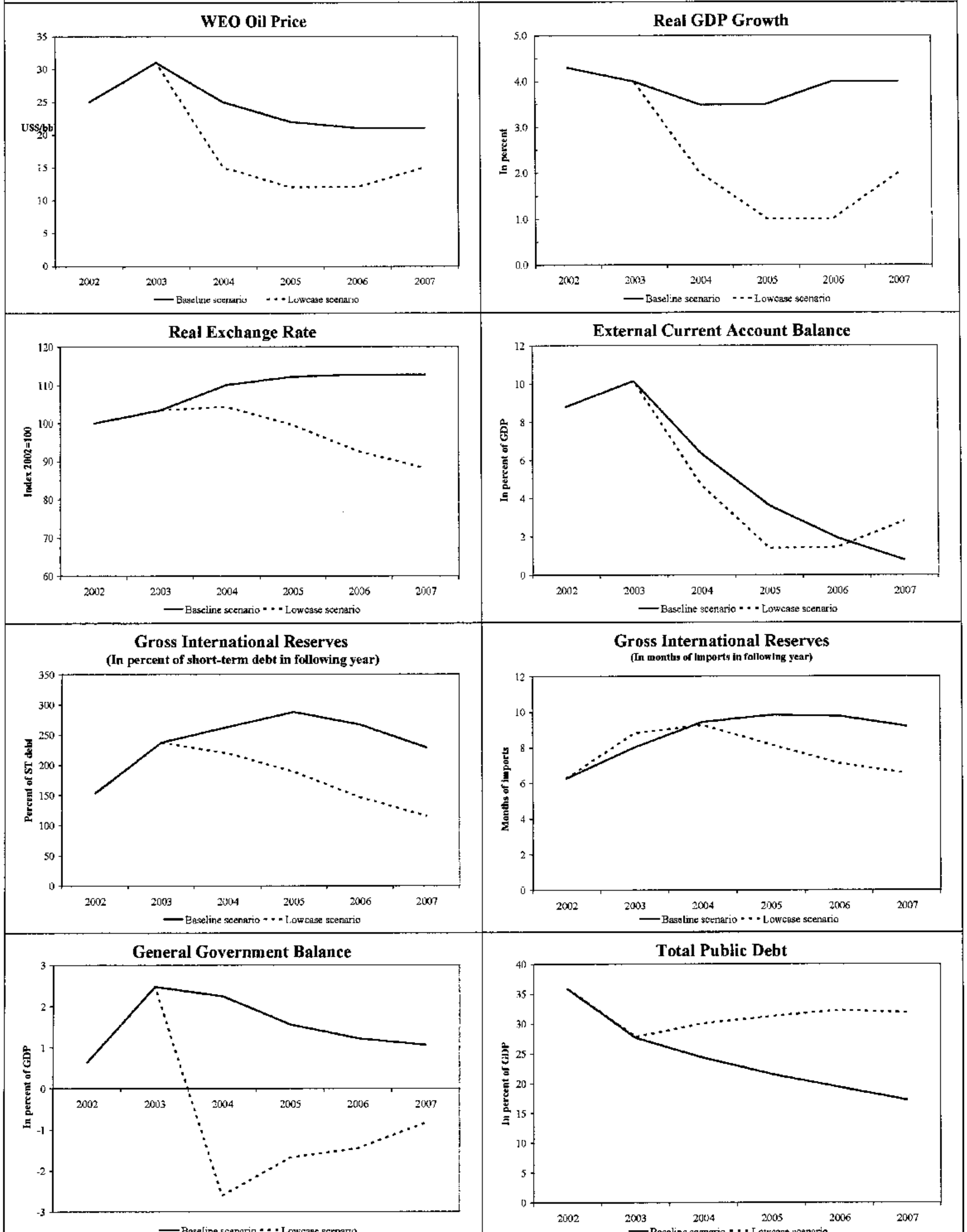
[14] Standard tables for assessing sustainability are attached (Tables 7 and 8). However, as the shocks are based on average outcomes over the past ten years, which were distorted by the post-transition output collapse and hyperinflation, as well as the 1998 financial crisis and subsequent rebound, they may be of limited use.

Baseline and Low Oil Price Scenarios, 2002–07 1/



1/ The low oil price scenario reflects a sizable fiscal and exchange rate adjustment.

C. Structural Policies

27. **The uncertain growth outlook and the need to diversify the economy highlight the importance of speeding up structural reforms** in order to raise productivity and thus foster faster growth and help the economy withstand external shocks. The reform agenda is extensive, and many reforms with long implementation schedules may not boost growth in the near term. Therefore, to provide support to growth over the next few years, it will be important to focus on full and effective implementation of reforms that have already been enacted or are well advanced. These include the deregulation reforms—which are essential to reduce corruption and stimulate the development of small and medium-sized enterprises, and where early results appear to be encouraging—as well as the financial sector reforms and WTO accession. Reform measures also need to aim at enhancing public sector and corporate governance.

Financial sector reforms

28. **The authorities agreed with the key recommendations of the FSAP (Box 5) to reform the financial sector, which were broadly in line with the CBR-Government joint strategy paper on financial sector reform formulated last year.**[15] The FSAP mission concluded that the banking system is fragile and vulnerable to a downturn in energy prices, and is characterized by a lack of transparency and weak—albeit improving—prudential supervision. However, given the small size of the financial sector, and the relatively low level of bank lending, the direct cost of financial sector distress would be limited. Stress tests indicate that a large shock to the banking system, in line with the 1998 financial crisis, would have an impact on banks' balance sheets of about 3–5 percent of GDP. Still, the capital of the system would be significantly impaired, which combined with a possible further loss of confidence, disruption to the payment system, and curtailment of working capital (especially for non-extractive industries), could have considerable negative implications for Russia's economic growth prospects.[16]

29. **Draft deposit insurance legislation was recently submitted to the Duma.** The authorities consider such insurance an important step toward boosting confidence in the banking system and reducing the advantages enjoyed by state-owned banks—especially Sberbank—in the form of an explicit government guarantee. The draft law envisages the introduction of guarantees on household deposits up to a certain threshold in participating banks. State-owned banks, which currently have a 100 percent state guarantee on their

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[15] The findings of the FSAP are presented in more detail in the accompanying Financial System Stability Assessment report.

[16] Recent surveys of the World Bank suggest that the limited ability of the financial sector to intermediate has served as a brake on economic activity, particularly for small and medium enterprises.

household deposits, will join the scheme in 2007. At that time, household deposits in these banks would have the same guarantee as those in other banks. The staff recommended that the establishment of deposit insurance be postponed until there has been sufficient improvement in the CBR's ability to effectively supervise banks, including through the introduction of International Accounting Standards (IAS). Regrettably, the timetable for introducing IAS has now slipped from 2004 to 2006 or 2007, which will seriously hamper the assessment of banks' suitability for participation in the proposed deposit insurance scheme.

Box 5. Recommendations of the FSAP

The FSAP focused on assessing the vulnerability of the banking sector as well as providing recommendations to address the weaknesses in the financial sector. These are part of a multifaceted approach to the development of the sector so that it can fully support the growth of the Russian economy. The recommendations include:

- Strengthening banking supervision to allow proactive and aggressive assessment of the operating condition and integrity of banks.
- Closing of non-viable banks that transgress supervisory norms (or prohibiting them from soliciting household deposits).
- Enhancing corporate governance and the protection of creditor rights.
- Introducing IAS accounting.
- Addressing the uneven playing field in part caused by the large size of Sberbank, which accounts for 70 percent of household deposits, and by the 100 percent guarantee of household deposits for state banks. The FSAP assessed the authorities' plans to use a deposit insurance scheme to level the playing field in the banking sector and as a way to withdraw licenses from unsound banks. It recommended that the authorities should only proceed with the proposed scheme if they are fully committed to taking the necessary but difficult decisions of withdrawing licenses.
- In the short term, holding Sberbank to the same standards as other banks (including all prudential ratios), ensuring that it operates on a fully commercial basis with a hard budget constraint, and considering other measures to limit risks in its lending activities.
- Developing medium-term options for Sberbank, ranging from privatization to transformation into a narrow bank, in the context of a comprehensive strategic review.
- Pressing ahead with the privatization of Vneshtorgbank (VTB).

30. **The authorities have made progress in developing instruments to enhance the effectiveness of monetary policy, in line with the recommendations of previous MAE technical assistance**. Biweekly deposit auctions with a 2-week maturity have been introduced, and are now the CBR's main intervention tool to manage ruble liquidity. The effectiveness of other instruments remains hampered by the limited supply of tradable government securities to serve as collateral.

31. **Russia has made significant progress in implementing an anti-money laundering (AML) and anti-terrorist financing regime since the AML law was enacted in February 2002**. As a result, in October 2002, the Financial Action Task Force (FATF)

removed Russia from its list of non-cooperative countries and territories. The major foundations of an AML framework are in place, but some issues relating to the legal framework and implementation remain, including the need for greater clarification of enforcement mechanisms.

Fiscal reforms

32. **The authorities and other observers noted that political pressures to spend the oil windfall would likely increase**. There is growing support in the broader political arena for tax cuts—ostensibly to stimulate flagging growth—including various types of tax incentives for investment. A widely-held view in Russia, often echoed by the authorities, is that the reduction in the personal income tax rate in 2001 paid for itself by enhancing collections, thus justifying rate cuts for other taxes. The staff advised against investment incentives, and cautioned against excessive optimism about Laffer-curve effects: while tax reforms have undoubtedly helped strengthen the business environment, they have almost certainly led to a revenue loss (Box 6). It is still too early to fully assess the impact of existing cuts, and the loss of revenue from the elimination of the regional sales tax, which the authorities have already decided to repeal in 2004, will need to be absorbed. The ministry of finance and the CBR agreed with staff that further tax cuts should go hand in hand with reductions in recurrent spending or tax-base broadening, to avoid loosening the fiscal stance.

33. **A recent FAD technical assistance mission recognized the considerable progress achieved in tax policy reform in recent years.** To support growth, it recommended that future reforms place a stronger emphasis on the taxation of consumption relative to capital and labor. In particular, the FAD mission suggested a broadening of the VAT base and increases of excises on alcohol and tobacco, while lowering the burden of social taxes paid by employers. **The authorities are considering shifting the tax burden from the non-energy sector to the energy sector.** The FAD mission acknowledged that the oil sector was relatively lightly taxed compared to other oil-producing countries, but it cautioned that if measures were taken to increase the relative tax burden on the energy sector, government revenue would become even more sensitive to changes in oil prices. The long-term revenue stability would need to be carefully considered in mapping out future tax reform.

34. **A high-level commission and associated working groups have been set up to examine public spending, and are expected to report shortly**. The aim is to lower and streamline outlays by clarifying areas of expenditure responsibility for federal and subnational governments and, in particular, to ensure adequate funding for all spending programs. A key task is to look carefully at local government unfunded mandates (in particular for veterans, and in housing and communal services). Budgetary units will be re-registered and the legal status of some units clarified. In support of public management reform, focus is also being placed on strengthening the tax and customs administration, with assistance from the World Bank, and improving expenditure management, where Fund technical assistance has centered on efforts to modernize the federal treasury.

35. **The authorities are considering a number of proposals related to intergovernmental fiscal relations,** which aim to promote fiscal decentralization and enhance self-sufficiency in regional budgets. The authorities generally agreed with the staff's recommendations that the ministry of finance maintain effective controls on borrowing by local and regional governments, and that treasury systems for local and regional governments are closely coordinated with the federal treasury system.

Box 6. Does Russia Provide Evidence of a Laffer-Curve Effect?

The authorities reduced rates on the personal income tax (PIT) and unified social tax (UST) in 2001, and on the corporate profits tax in 2002. While some conclusions can be drawn regarding the short-term impact of the rate reductions on the PIT and the UST, it is still too early to do so for the profits tax.

A single 13 percent rate replaced a progressive PIT schedule (with three rates of 12 percent, 20 percent, and 30 percent) and a UST of 35.6 percent replaced a combined payroll tax rate of 39.5 percent. Following the rate cut, the PIT performance has been impressive. As a percent of GDP, collections rose from 2.4 percent in 2000 to 2.8 percent in 2001, and 3.3 percent of GDP in 2002. The UST collection fell after the rate cut from 7.7 percent of GDP in 2000 to 7.2 percent in 2001, but rose to 7.7 percent in 2002.

There is no clear evidence that the PIT and UST performance was driven by the rate cut. While the rate cuts may have provided incentives for bringing some wages into the formal sector, a number of other factors are likely to have contributed to the better performance. First, the PIT and UST bases were broadened along with the tax cut. The base-widening measures included a new system of deductions; the elimination of income tax exemption; and a tightening of control over deposit and insurance schemes for tax purposes. The UST base was reformed to be more in line with the PIT base for wage income.

Second, administrative procedures to check tax evasion were strengthened. As the rates were cut, the authorities tightened control over income tax declaration (for example, by tightening audits and requiring a declaration of income and expenditure for real estate transactions) and strengthened enforcement procedures.

Third, the cut in the PIT rate was more apparent than real, as the average effective tax was reduced from 14 percent in 2000 to 13 percent in 2001–02; it is therefore difficult to argue that there had been a significant cut in the tax rate.

Fourth, the rebound in both the PIT and UST collections is likely to have been aided by the recovery in wages following the crisis. As a percent of GDP, wages rose from 29.1 percent of GDP in 2000 to 33.9 percent of GDP in 2001 and 36.1 percent in 2002.

Capital account liberalization, capital markets, and the trade system

36. **Legislation has been introduced in the Duma to liberalize foreign exchange transactions.** The staff generally welcomed this effort, but stressed that international experience suggests that further liberalization should be accompanied by a strengthening of the financial system and better enforcement of prudential regulations on market and credit risks. The legislation would also permit the imposition of "Chilean-style" zero-interest deposit

requirements, which the authorities would propose to activate if necessary to discourage excessive capital inflows or outflows. Several previously identified exchange restrictions subject to approval under Article VIII remain in place. The mission urged the authorities to remove the existing restrictions, and avoid the introduction of any new restrictions in the new foreign exchange law.

37. **The authorities attach considerable importance to speeding up the redevelopment of the government ruble bond market**, given the length of time it takes to develop a deep and liquid market.[17] The recent successful launch of a 15-year ruble bond is an encouraging step in this direction. The government ruble bond market is currently very small, about 2 percent of GDP. In addition, given that most of Russia's public debt is foreign currency denominated, increased ruble-denominated bond placements to retire external debt would also help to achieve a more balanced public debt structure. The staff noted that the development of the ruble government bond market would provide the CBR and the financial system with liquid local currency instruments for conducting open market operations.

38. **The authorities agreed that the rapidly increasing leverage and foreign exchange exposure in the corporate sector will need to be closely monitored.** At present, corporate leverage is still modest, and given the size of the ruble corporate bond market (less than $3 billion), the risks of any adverse systemic implications are very small. Moreover, the foreign exchange exposure of the corporate sector is limited and does not pose major risks in the short-term; external borrowing by Russian companies in 2002 was mostly by top-tier companies from the oil and gas sector with dollar revenues.

39. **The authorities stressed that they remain committed to WTO accession.** A tight schedule of meetings between the Working Party and the Russian authorities is in place for the coming months. Differences remain on a number of issues, including domestic energy pricing; foreigners' access to services markets; the ability to raise agricultural tariffs; and import duties, especially on cars and aircrafts. The authorities have resisted committing to obligations which they consider would go beyond those demanded of original WTO members, and noted that given the structure of its exports, Russia's economic benefits from accession may be limited.

40. **Following substantial trade reforms in 2000-01, there were no major trade liberalization measures in 2002.** Russia's trade system currently measures 5 ("Moderate") on the Fund's Trade Restrictiveness Index. A large number of tariff bands are in place, and export duties are applied to exports from the natural resources sectors. The Ministry of Finance indicated that the weighted average tariff has remained at about 12 percent.

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[17] Chapter VI in the Selected Issues paper discusses recent developments and prospects for Russia's domestic capital markets.

Other structural reforms

41. **The authorities highlighted a number of other priority areas in their medium-term reform program** that aim to reduce excessive government intervention in the economy, encourage the diversification of Russia's economy away from dependence on natural resources, and boost the development of human capital. These reforms are important for ensuring truly competitive markets, critical for the growth of small and medium-sized enterprises and for encouraging foreign direct investment. These areas include:

- **Natural monopoly reform.** For electricity, the aim is to move forward on the dismantling of the parastatal Unified Energy Systems (UES) and the gradual liberalization of the sector. The railways would be restructured by splitting up the ministry of railways into a joint-stock company absorbing all commercial activities and a sector regulator. Reforms to liberalize the gas sector are under discussion, but plans have not yet been finalized.

- **Reform of public administration and civil service.** Measures envisaged to improve the civil service include functional reviews to eliminate duplication and non-core activities; pay reform to retain qualified professional staff while reducing incentives for rent-seeking; and strengthened accountability. This effort is critical to raise the effectiveness of the deregulation reform.

- **Reform of housing and communal services.** Draft legislation would change the current system of subsidies to targeted means-tested assistance, with the long-range goal of full cost recovery. Efforts are also underway to increase private sector participation and competition in these services, with the aim of boosting efficiency, including energy efficiency.

IV. Staff Appraisal

42. **Russia's strong macroeconomic performance in recent years has been marked by continued GDP growth and rising incomes, a large increase in international reserves, and gradually declining inflation.** Sound macroeconomic policies combined with a positive external environment have strengthened Russia's financial position, and have reduced vulnerabilities considerably. This improvement is reflected in lower spreads faced by Russian borrowers, and signs of warming investor sentiment. The considerable strengthening in Russia's balance of payments, however, complicates macroeconomic management in the short run, and masks the challenges Russia faces in boosting growth over the medium term in areas outside the natural resources sector, reducing inflation considerably, and raising the living standards of the population. Cautious and flexible macroeconomic policies together with a reinvigorated structural reform program are needed to address these challenges.

43. **Continued high oil prices have deepened the policy dilemma faced by the authorities in trying to limit the real appreciation of the ruble while lowering inflation.** This problem could be exacerbated by stronger than anticipated capital inflows, as they would add further upward pressures to the real exchange rate, which could affect economic activity. The strong fiscal adjustment that followed the 1998 crisis, the productivity gains since then, and the major remonetization process of recent years muted this dilemma, as they reduced the inflationary bias built into a monetary policy that targeted the real exchange rate. The current setting of very large foreign exchange inflows, and the uncertainty as to whether money demand will continue to grow rapidly, suggest the need for a shift in the policy mix, with monetary policy giving a higher priority to disinflation and fiscal policy supporting that effort and containing upward pressures on the real exchange rate. An acceleration of the structural reform effort will buttress these policies by increasing productivity and competitiveness in the non-oil sectors and therefore promoting the diversification of the economy.

44. **Regarding risks from weaker oil prices**, Russia's strengthened financial position should allow it to withstand a significant drop in oil prices. However, in the event of a considerable and sustained drop, there would be a need for a sizable adjustment, both on the exchange rate and fiscal policy, and GDP growth could be substantially lower.

45. **There is a need to resist pressures to spend the windfall gains from high oil prices, and to tighten fiscal policy in 2004.** Budget surpluses contributed substantially to stemming the rise in the real exchange rate during 1999–2001. More recently, however, fiscal policy has been relaxed, and this has reduced the room for maneuver in the event that the external environment deteriorates or the need to sterilize central bank foreign exchange interventions increases; using part of the oil windfall to increase expenditures and cut taxes would further limit such room. Looking forward, more fiscal restraint would help to sterilize the foreign exchange inflows, reducing pressures for real appreciation. In addition, it would put the budget in a better position to withstand greater demands on public resources over the medium term, in particular to meet the future expense of costly but necessary structural reforms and public investment. For these reasons, further reductions in tax rates—which may be warranted, particularly in the case of the unified social tax—should only be implemented in conjunction with revenue base-broadening measures and/or offsetting expenditure reductions.

46. **The staff and the authorities largely agree on the appropriate medium-term fiscal stance, which should aim for a broadly balanced budget on the basis of a long-run average oil price**. Such a stance could usefully be formalized as a fiscal rule. An oil stabilization fund, either paired with this fiscal rule or established separately, would support the authorities' medium term fiscal and macroeconomic objectives. But it would be important that this fund be transparent, accountable, and fully integrated with the budget. Such a fund would prudently be designed asymmetrically so that underlying fiscal policy adjusts more rapidly to downturns in the oil price than to upswings.

47. **Monetary policy should give higher priority to achieving a substantial reduction in core inflation.** This will likely require more active central bank sterilization than in the past, supported by the fiscal policies described above, and greater exchange rate flexibility. The recent small nominal appreciation of the ruble is a welcome sign that the authorities are adopting a more flexible exchange rate policy. Recent cuts in short term interest rates, however, may limit the authorities' ability to conduct sterilization operations and may discourage ruble-denominated financial savings, and thus risk fueling inflation.

48. **Real GDP growth has been easing, due in part to weaker investment in the context of stagnating structural reforms, and the rapid rise in public and private sector real wages that has driven consumption growth is not sustainable.** In the short run, the current high oil prices provide some boost to economic activity and corporate profitability. But Russia's long run growth prospects will be closely tied to progress on structural reforms that are essential to boosting productivity, investment, and diversification of the economy. Progress on reform of the financial sector, public administration and civil service, natural monopolies, and housing and communal services—including the means-testing of subsidies—are all central to broader efforts to remove distortions in the economy, improve public and private sector governance, and boost human capital. Trade reform, in the context of the WTO, will also be an important element in boosting productivity. Despite pressures against many of these reforms from vested interests, it will be important for the authorities to demonstrate strong commitment to the reforms and speed them up. Success in these areas would make a significant contribution to reducing corruption, which continues to undercut private sector activity.

49. **The staff welcomes Russia's participation in the FSAP, and encourages the authorities to move ahead in implementing the recommendations.** Sounder financial institutions and stronger financial intermediation will be an important component of creating a climate more conducive to private sector activity, investment, and reducing vulnerabilities. The delay in moving forward on the introduction of full IAS is regrettable. Partly for this reason, the authorities' decision to proceed with the implementation of deposit insurance may prove counterproductive if unsound banks are allowed to participate and the CBR is unwilling or unable to withdraw licenses from such banks. The authorities should initiate in the near future a strategic review of Sberbank, to develop options that would address the problem of its dominance of the banking sector.

50. **The staff generally supports the proposals to liberalize foreign exchange transactions. However, the authorities should move carefully in this area**, as further liberalization needs to be accompanied by a strengthening of the financial system and better enforcement of prudential norms. In the current setting of sizable inflows, the authorities should avoid introducing deposit requirements or other restrictions on outflows. In addition, **the authorities need to monitor closely the growing debt exposure of the private sector**, which could become a source of vulnerability over the medium term if capital inflows strengthen while growth turns down. **Further progress in reviving the domestic market for**

government securities would not only benefit the conduct of monetary policy, but also facilitate a further reduction in exchange rate exposure.

51. **The commission to examine public spending could be an important step in boosting the efficiency of public expenditure, a reform that would benefit Russia greatly**. Addressing the problem of unfunded mandates would go a long way to helping local government budgets secure a sounder footing, and it will be critical for the authorities to continue to maintain effective control of subnational government borrowings. Over the longer term, Russia will need to proceed with its pension reform program to address imbalances in the pension fund.

52. **The authorities' decision to proceed with new data and fiscal transparency ROSCs is an encouraging development**. The staff urges the authorities to move ahead rapidly in resolving the outstanding issues regarding Russia's subscription to the SDDS.

53. Given the strength of the balance of payments and foreign reserves position, **the staff encourages the authorities to make voluntary advance repurchases in the near future.**

54. It is proposed that the next Article IV consultation for Russia be conducted on the standard 12-month cycle.

Table 1. Russian Federation: Balance of Payments Projections, 2000-07
(In billions of U.S. dollars, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007
			Est.			Projections		
Current Account	44.6	32.4	30.4	42.4	29.3	17.9	10.3	4.4
Trade Balance	60.2	47.9	45.4	58.6	45.7	34.7	27.7	23.0
Exports	105.0	101.6	106.3	126.8	122.1	117.5	116.6	118.8
Non-energy	52.2	49.9	50.8	53.4	55.6	57.6	59.3	61.0
Energy	52.8	51.7	55.5	73.4	66.5	59.9	57.4	57.9
Oil	36.2	34.0	39.6	52.6	45.2	41.5	41.0	42.1
Gas	16.6	17.8	15.9	20.9	21.2	18.4	16.4	15.8
Imports	-44.9	-53.8	-60.9	-68.2	-76.4	-82.8	-88.9	-95.8
Services (net)	-15.6	-14.7	-14.5	-15.7	-16.0	-16.3	-16.8	-18.1
Nonfactor services	-6.7	-8.3	-8.6	-9.8	-11.1	-12.0	-13.1	-14.3
Factor services	-8.9	-6.4	-5.9	-5.9	-4.9	-4.2	-3.7	-3.8
Public sector interest	-8.4	-7.5	-5.7	-5.7	-5.2	-5.1	-4.7	-4.6
Other factor services	-0.5	1.1	-0.1	-0.2	0.3	0.9	1.0	0.9
Current transfers	0.1	-0.8	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6
Capital and financial and account	-21.8	-13.0	-9.4	-11.9	-0.7	2.0	5.8	6.3
Capital transfers	-0.3	-9.4	-7.0	-0.3	-0.3	-0.3	-0.3	-0.3
Federal capital	-4.3	3.0	2.3	-7.1	-3.8	-4.9	-4.0	-5.1
Budgetary	-5.4	-8.8	-12.2	-7.1	-3.8	-4.9	-4.0	-5.1
Disbursements	1.1	0.6	0.8	0.7	0.7	2.2	2.3	2.4
Amortization	-6.6	-9.4	-13.0	-7.8	-4.5	-7.1	-6.3	-7.5
Non-budgetary	1.1	11.8	14.5	0.0	0.0	0.0	0.0	0.0
Local Governments	-0.8	-0.2	-0.5	-0.2	-0.2	-0.2	-0.2	-0.2
Private sector capital	-16.3	-6.4	-4.1	-4.3	3.6	7.4	10.3	11.9
Direct investment	-0.4	-0.2	0.1	3.5	3.9	4.2	5.1	5.5
Portfolio investment	-0.2	0.6	1.3	1.3	1.4	1.5	1.5	1.6
Commercial banks	-2.1	1.0	0.5	-1.4	-1.5	-1.6	-1.7	-1.8
Corporations	-1.0	0.4	5.9	8.3	9.3	9.8	10.5	11.1
Other private capital	-12.7	-8.2	-12.0	-16.0	-9.4	-6.4	-5.0	-4.5
Errors and omissions, net	-9.2	-10.1	-7.9	-8.7	-8.7	-8.7	-8.7	-8.7
Overall balance	13.7	9.3	13.0	21.8	19.9	11.2	7.4	2.0
Financing	-13.7	-9.3	-13.0	-21.8	-19.9	-11.2	-7.4	-2.0
Net international reserves	-18.7	-10.7	-14.0	-21.8	-19.9	-11.2	-7.4	-2.0
Gross reserves (- increase)	-15.8	-8.8	-12.6	-19.8	-18.3	-10.1	-6.3	-1.3
Net Fund liabilities	-2.9	-3.8	-1.5	-2.0	-1.5	-1.2	-1.1	-0.6
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-2.9	-3.8	-1.5	-2.0	-1.5	-1.2	-1.1	-0.6
Other liabilities	-0.1	1.9	0.1	0.0	0.0	0.0	0.0	0.0
Valuation adjustment	-0.2	0.7	-0.1	0.0	0.0	0.0	0.0	0.0
Arrears and rescheduling	5.2	0.7	1.1	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Current account (in percent of GDP)	17.2	10.5	8.8	10.1	6.3	3.6	1.9	0.8
Gross reserves 1/	27.9	34.5	47.8	67.6	85.9	96.0	102.3	103.6
(in months of imports of GNFS)	4.6	5.1	6.3	8.0	9.4	9.8	9.8	9.2
(as a percent of short-term debt) 2/	89	118	154	237	263	288	267	229
(as a percent of public debt service)	132	180	311	606	648	807	811	699
Net private capital outflows (in percent of trade)	17.0	10.7	7.2	6.7	2.5	0.6	-0.8	-1.5
World oil price ($barrel)	28.2	24.3	25.0	31.0	25.0	22.0	21.0	21.0
Terms of trade (percent)	35.2	-2.8	-4.2	10.9	-7.4	-7.0	-4.0	-1.1
Public external debt service payments 3/	14.9	21.1	19.2	15.4	11.2	13.2	11.9	12.6
(percent of exports of goods and services)	13.0	18.8	16.1	11.0	8.2	10.0	9.0	9.4
Public external debt	126.0	111.8	98.1	89.0	83.6	77.6	72.6	66.8
(percent of GDP)	48.5	36.1	28.4	21.3	18.1	15.7	13.7	11.7
Private external debt (incl local gov't)	32.3	38.6	43.6	49.4	56.0	42.2	49.8	63.9
Total external debt	158.3	150.4	141.7	138.4	139.7	119.8	122.3	130.8
(percent of GDP)	60.9	48.6	41.1	33.1	30.3	24.2	23.0	22.9

Source: Central Bank of Russia; and Fund staff estimates.

1/ Excluding repos with non-residents to avoid double counting of reserves.
2/ Excludes arrears.
3/ Net of rescheduling.

Table 2. Russian Federation: General Government Operations, 2000-07 1/

	2000	2001	2002	2003	2004	2005	2006	2007
			Est.	Projections				
				(In percent of GDP)				
Total revenue	37.1	37.1	37.3	39.3	36.7	34.6	34.2	34.2
Tax revenue	35.3	34.9	34.9	37.0	34.5	32.4	32.0	31.9
Corporate profit tax	5.5	5.7	4.3	4.9	4.6	4.6	4.6	4.6
Personal income tax	2.4	2.8	3.3	3.3	3.3	3.3	3.3	3.3
VAT	6.3	7.1	6.9	7.0	7.0	7.2	7.1	7.2
Excises	2.3	2.7	2.4	2.5	2.7	2.5	2.3	2.3
Customs tariffs	3.1	3.6	2.9	3.5	2.7	2.2	2.1	2.0
Resource extraction tax	1.1	1.4	2.2	3.0	2.1	1.7	1.6	1.6
Social security taxes	7.9	7.4	7.7	8.0	8.0	8.0	8.0	8.0
Other	6.8	4.1	5.1	4.8	4.1	3.0	3.0	3.0
Nontax revenue	1.8	2.2	2.4	2.2	2.2	2.2	2.3	2.3
Total Expenditure	34.4	34.1	36.7	36.8	34.5	33.1	33.0	33.1
Interest	4.3	2.7	2.1	1.8	1.8	1.5	1.3	1.1
Non-interest	30.0	31.5	34.6	35.0	32.7	31.6	31.7	32.0
of which								
Education	2.9	3.2	3.5	3.5	3.3	3.2	3.2	3.2
Health	3.2	3.2	3.5	3.5	3.3	3.2	3.2	3.2
Social spending	7.6	9.0	9.9	10.0	9.4	9.1	9.1	9.2
Primary balance	7.1	5.7	2.7	4.3	4.0	3.1	2.5	2.2
Overall balance	2.7	3.0	0.6	2.5	2.2	1.6	1.2	1.1
Financing	-2.7	-3.0	-0.6	-2.5	-2.2	-1.6	-1.2	-1.1
Foreign	-1.6	-2.3	-3.7	-1.7	-0.9	-1.0	-0.8	-0.9
Domestic	-2.1	-0.8	3.1	-0.7	-1.4	-0.5	-0.4	-0.1
Monetary Authority	-3.3	-0.9	-0.6	-1.7	-2.7	-1.3	-1.1	-0.8
Commerical Banks	0.6	0.1	1.0	0.0	0.0	0.0	0.0	0.0
Other	0.6	-0.1	2.6	0.9	1.3	0.7	0.7	0.7
Arrears/Rescheduling	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
				(In billions of rubles)				
Total revenue	2,708	3.358	4,055	5,147	5,298	5,514	6,004	6,518
Tax revenue	2,577	3,157	3,792	4,853	4,975	5,156	5,607	6,086
Corporate profit tax	400	515	470	643	669	735	808	876
Personal income tax	174	256	359	430	473	522	575	625
VAT	457	641	750	923	1,011	1,139	1,249	1,372
Excises	166	243	259	333	386	394	408	429
Trade taxes	229	329	320	454	388	352	362	388
Resource extraction tax	78	129	237	394	301	264	275	299
Social security taxes	575	671	841	1,045	1,151	1,269	1,399	1,520
Other	498	373	556	632	596	481	530	576
Nontax revenue	131	202	263	293	323	358	397	432
Total Expenditure	2,509	3,086	3,986	4,823	4,973	5.267	5,790	6,317
Interest	317	242	227	236	254	243	227	215
Non-interest	2,192	2.844	3,759	4,587	4,719	5,023	5,563	6,102
of which								
Education	214	285	377	460	473	503	558	611
Health	233	288	381	464	478	509	563	618
Social spending	554	816	1,078	1,316	1,354	1,441	1,596	1,751
Primary balance	517	514	296	560	579	490	440	416
Overall balance	200	272	69	324	324	247	214	201
Financing	-200	-272	-69	-324	-324	-247	-214	-201
Foreign	-113	-207	-401	-227	-126	-164	-138	-177
Disbursement	9	15	8	16	16	64	69	73
Amortization	122	222	409	243	142	228	207	251
Domestic	-156	-69	332	-96	-198	-83	-76	-24
Monetary Authority	-242	-77	-64	-219	-392	-199	-201	-158
Commerical Banks	43	13	109	-1	0	0	0	0
Other	43	-5	287	123	194	116	126	134
Arrears/Rescheduling	70	4	0	0	0	0	0	0
Memorandum								
Non-oil primary balance (in percent of GDP)	1.5	-0.8	-4.8	-4.9	-3.5	-3.3	-3.5	-3.8
Non-oil overall balance (in percent of GDP)	-2.8	-3.5	-6.9	-6.7	-5.3	-4.9	-4.8	-4.9

Sources: Russian authorities, and Fund staff estimates.

1/ Presented on a commitment basis.

Table 3. Russian Federation: Federal Budget Operations 2000-03

	2000	2001	2002		2003	
			Budget	Est.	Budget	Staff Proj.
	(In percent of GDP)					
Revenue	15.4	17.6	16.8	17.1	15.7	17.7
VAT	5.1	7.1	7.1	6.9	7.2	7.0
Excises	1.8	2.2	2.0	2.0	1.7	1.8
Profit tax	2.8	2.4	1.9	1.6	1.3	1.5
Trade taxes	3.1	3.7	3.0	3.0	2.6	3.5
Other	2.6	2.2	2.9	3.7	2.9	4.0
Expenditure (cash)	13.6	14.9	15.2	15.7	15.2	14.8
Interest	2.5	2.7	2.6	2.1	2.1	1.8
Noninterest	11.1	12.2	12.6	13.6	13.0	13.0
Primary balance (cash)	4.3	5.4	4.2	3.5	2.7	4.7
Overall balance (cash)	1.8	2.7	1.6	1.4	0.6	2.9
Primary balance (commitments)	5.2	5.5	4.2	3.4	2.7	4.7
Overall balance (commitments)	0.8	2.8	1.6	1.3	0.6	2.9
Memorandum items:						
GDP (billions of rubles)	7,302	9,041	10,950	10,864	13,050	13,104
World oil price ($ / barrel)	28.2	24.3	...	25.0	...	31.0
Russian oil price ($ / barrel, cif)	26.5	22.9	23.5	23.7	21.5	29.7
Oil / non-oil balances (% of GDP):						
Oil revenue	5.5	6.5	...	7.0	...	8.0
Non-oil revenue	9.9	11.1	...	10.1	...	9.7
Non-oil primary balance (commitments)	-0.3	-1.0	...	-3.7	...	-3.3
Non-oil overall balance (commitments)	-4.7	-3.7	...	-5.8	...	-5.1
	(In billions of rubles)					
Revenue	1,128	1,591	1,845	1,861	2,052	2,325
VAT	372	639	775	753	943	923
Excises	131	203	224	215	227	231
Profit tax	206	218	208	173	172	197
Trade taxes	229	331	324	323	333	454
Other	190	199	314	397	377	520
Expenditure	994	1,344	1,666	1,706	1,980	1,939
Interest	182	242	285	227	278	236
Domestic interest	71	57	53	37	58	58
External interest	111	184	232	190	220	178
Noninterest	812	1,103	1,381	1,479	1,703	1,703
Primary balance (cash)	316	488	464	382	350	622
Overall balance (cash)	134	246	179	155	72	386
Financing (cash)	-134	-246	-179	-155	-72	-386
Foreign	-61	-131	-82	-383	-346	-221
Disbursements	40	21	91	25	23	22
Repayments	101	152	173	408	369	243
Domestic	-73	-115	-96	228	278	-165
Bank financing	-44	53	-127	-74	177	-264
Monetary authorities	-118	47	-153	-153	203	-263
CBR credit (incl. VEB)	-34	96	-110	-67	268	-206
Use of NIR	-84	-50	-43	-86	-65	-57
Commercial banks	74	6	26	78	-26	-1
Nonbank financing	-28	-168	31	302	101	99
Privatization & precious metals	75	24	47	24	73	71
Securities held by nonbank	-103	-61	-16	5	28	28
New securities for arrears clearance	0	0	0	0	0	0
Other	0	-132	0	273	0	0
Memorandum items:						
Resched. interest/arrears/expenditure float	72	-9	0	15	0	0
Noninterest expenditure (commitments)	749	1,094	1,381	1,494	1,703	1,703
Primary balance (commitments)	379	497	464	367	350	622
Overall balance (commitments)	62	255	179	140	72	386

Sources: Russian authorities; and Fund staff estimates.

Table 4. Russian Federation: Monetary Accounts, 1999-2003
(In billions of rubles, unless otherwise indicated)

	1999	2000	2001	2002	2003 Proj.
Monetary authorities					
Base money	324	520	717	935	1184
Currency issued	289	447	624	814	1009
Required reserves on ruble deposits	36	73	94	121	176
NIR 1/	-76	458	817	1313	2005
In billions of US$	*-2.8*	*16.3*	*27.1*	*41.3*	*63.1*
NDA	401	62	-100	-378	-821
Net credit to enlarged government	309	119	55	34	-186
Net credit to federal government 2/ 3/	333	268	212	102	-161
CBR net ruble credit to the federal government 2/	206	173	149	76	-129
Ruble counterpart 3/	-11	-94	-145	-231	-288
CBR net credit to local government and extrabudgetary funds	-24	-148	-156	-68	-25
Net credit to banks	-46	-128	-127	-196	-353
Gross credit to banks	27	23	21	22	18
Gross liabilities to banks and deposits	-73	-151	-148	-217	-370
Other items (net)	137	70	-28	-217	-282
Monetary survey					
Broad money	995	1564	2123	2841	3528
Ruble broad money	705	1144	1603	2120	2708
Currency in circulation	267	419	584	763	950
Ruble deposits	438	725	1018	1356	1758
Foreign currency deposits 1/	290	420	520	722	820
Net foreign assets 1/	71	686	1041	1512	2258
NIR of monetary authorities	-76	458	817	1313	2005
NFA of commercial banks	148	228	224	199	253
NDA	923	879	1081	1330	1270
Domestic credit	1132	1369	1869	2493	2488
Net credit to general government	551	413	378	466	245
Net credit to federal government 4/	575	592	575	544	280
Net credit to local government and extrabudgetary funds	-24	-179	-197	-78	-36
Net credit from monetary authorities	-24	-148	-156	-68	-25
Net credit from commercial banks	0	-31	-40	-10	-10
Credit to the economy	582	956	1491	2027	2243
Other items (net)	-209	-490	-788	-1164	-1217
Memorandum items:					
Seasonally adjusted ruble broad money velocity	7.8	6.7	6.2	5.8	5.3
Real ruble broad money (rel. to CPI, 12 month change)	11.8	39.1	20.2	14.9	14.0
Nominal ruble broad money (12 month change)	57.2	62.4	40.1	32.3	27.8
Base money (12 month change)	54.1	60.2	38.1	30.4	26.6
Ruble broad money multiplier	2.17	2.20	2.23	2.27	2.29

Sources: Russian authorities; and Fund staff estimates.

1/ 1999-01 at end of period exchange rates. 2002-03 calculated at accounting exchange rates of Rub30.1/US$ and US$1.26/SDR and Rub31.8/US$ and US$1.26/SDR respectively.

2/ Beginning December 1999 includes government securities held by the CBR's pension fund.

3/ Represents the government's use of NIR resources and calculated in flow ruble terms.

4/ Inclusive of valuation gains and losses on holdings of government securities.

Table 5. Russian Federation: Macroeconomic Framework, 2000-07

	2000	2001	2002	2003	2004	2005	2006	2007
			Est.		Projections			
	(In percent of GDP, unless otherwise indicated)							
I. Savings-Investment Balances								
General Government								
Consumption	13.8	13.9	15.3	15.5	14.5	14.0	14.0	14.2
Gross investment	3.3	4.5	4.9	5.0	4.6	4.5	4.5	4.5
Net income from abroad	-3.2	-2.3	-1.6	-1.3	-1.1	-1.0	-0.9	-0.8
National savings	6.0	7.4	5.5	7.4	6.9	6.0	5.7	5.6
National savings - investment	2.7	3.0	0.6	2.5	2.2	1.6	1.2	1.1
Private Sector								
Consumption	47.0	51.2	53.3	53.7	54.1	54.6	54.8	55.0
Gross investment	15.3	17.6	17.4	17.6	18.0	18.5	18.8	19.2
Net income from abroad	-0.2	0.0	-0.2	-0.2	-0.1	0.0	0.1	0.0
National savings	29.8	25.1	25.5	25.3	22.1	20.5	19.5	18.9
National savings - investment	14.5	7.5	8.1	7.7	4.1	2.1	0.7	-0.3
Overall Economy								
Consumption	60.8	65.2	68.6	69.2	68.6	68.6	68.8	69.1
Gross investment	18.6	22.1	22.3	22.6	22.7	22.9	23.3	23.7
Net income from abroad	-3.4	-2.3	-1.8	-1.5	-1.2	-1.0	-0.8	-0.7
National savings	35.8	32.5	31.1	32.7	29.0	26.6	25.2	24.5
National savings - investment (current account)	17.2	10.5	8.8	10.1	6.3	3.6	1.9	0.8
	(In percent of GDP, unless otherwise indicated)							
II. Federal government accounts and debt indicators								
Revenues	15.4	17.6	17.1	17.7	16.2	15.1	14.7	14.7
Primary balance, commitments	5.2	5.5	3.4	4.7	4.3	3.1	2.5	2.2
Overall balance, commitments	0.8	2.8	1.3	2.9	2.5	1.6	1.2	1.1
Foreign financing 1/	-0.8	-1.4	-3.5	-1.7	-0.8	-1.0	-0.7	-0.9
Domestic financing 1/	-1.0	-1.3	2.1	-1.3	-1.7	-0.6	-0.5	-0.2
Total public debt	56.2	44.0	35.6	27.0	24.1	21.5	19.2	17.2
External federal govt debt service / revenues (%)	26.2	23.2	34.5	20.9	15.6	17.9	15.4	15.2
External federal govt debt service / expenditures (%)	29.7	27.4	37.6	25.0	18.5	19.9	16.8	16.4
	(In billions of U.S. dollars, unless otherwise indicated)							
III. Balance of payments and external debt								
External current account	44.6	32.4	30.4	42.4	29.3	17.9	10.3	4.4
Change in external terms of trade (in percent)	35.2	-2.8	-4.2	10.9	-7.4	-7.0	-4.0	-1.1
Change in Russian crude oil price (in percent)	66.7	-15.5	1.1	24.0	-27.8	-4.5	0.0	0.0
Official reserves	27.9	34.5	47.8	67.6	85.9	96.0	102.3	103.6
in months of imports	4.6	5.1	6.3	8.0	9.4	9.8	9.8	9.2
Public external debt service (in percent of exports of goods and servi	13.0	18.8	16.1	11.0	8.2	10.0	9.0	9.4
	(In percent, unless otherwise indicated)							
IV. Growth and prices								
Real GDP growth	9.0	5.0	4.3	4.0	3.5	3.5	4.0	4.0
TFP Growth	7.0	1.8	1.5	1.6	1.4	1.5	1.9	1.9
CPI Inflation, end of period	20.1	18.6	15.1	12.0	8.0	7.0	5.0	4.0
Real effective exchange rate, period average, change	10.5	18.5	3.6	3.5	6.4	1.9	0.5	0.0
Real effective exchange rate, end of period, change	20.9	9.9	-1.7	10.7	3.0	1.0	0.0	0.0
Nominal GDP (in billions of rubles)	7,302	9,041	10,864	13,104	14,435	15,916	17,546	19,069

Source: Staff estimates and projections based on official data.

1/ Net Fund financing is included in domestic financing, as a component of MA credit; foreign financing therefore excludes the Fund.

Table 6. Russian Federation: Indicators of Fund Credit, 2000-07

	2000	2001	2002	2003	2004	2005	2006	2007
	Outstanding Fund Credit (in percent of)							
Quota	149.9	99.5	80.6	56.3	37.5	23.2	10.2	2.5
Exports	10.7	7.2	5.5	3.3	2.3	1.4	0.6	0.2
Gross reserves	43.9	23.5	13.8	6.8	3.6	2.0	0.8	0.2
Total external debt	7.7	5.4	4.6	3.3	2.2	1.6	0.7	0.2
Total official external debt	9.7	7.3	6.7	5.2	3.7	2.4	1.1	0.3
	Fund charges and repurchases (in percent of)							
Quota	45.6	57.1	22.9	26.4	20.2	15.5	13.7	8.0
Exports	3.1	3.8	1.5	1.5	1.2	1.0	0.9	0.5
Gross reserves	12.9	12.5	3.7	3.2	1.9	1.3	1.1	0.6
	In billions of U.S. dollars							
Total liabilities to the Fund	12.2	8.1	6.6	4.6	3.1	1.9	0.8	0.2
Fund purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fund repurchases	2.9	3.8	1.5	2.0	1.5	1.2	1.1	0.6
Fund charges	0.7	0.5	0.3	0.2	0.1	0.1	0.1	0.0
Memorandum item:								
Quota (SDR billion)	5.945	5.945	5.945	5.945	5.945	5.945	5.945	5.945
U.S. dollar/SDR exchange rate (period average)	1.319	1.273	1.295	1.378	1.377	1.378	1.379	1.380

Sources: Russian authorities; and Fund staff estimates and projections.

Table 7. Russian Federation: External Debt Sustainability Framework, 1997-2007

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
			Actual			Prel.			Projections		
						I. Baseline Medium-Term Projections					
External debt	39.1	57.9	92.2	60.9	48.6	41.1	**33.1**	**30.3**	**24.2**	**23.0**	**22.9**
Change in external debt	4.3	18.8	34.3	-31.3	-12.3	-7.5	-7.9	-2.8	-6.1	-1.1	-0.2
Identified external debt-creating flows (4+8+11)	-0.8	20.9	14.2	-40.5	-20.5	-14.3	-18.3	-10.6	-6.9	-4.8	-3.6
Current account deficit, excluding interest payments	-2.3	-4.1	-17.3	-21.3	-13.6	-11.1	-12.0	-8.0	-5.2	-3.4	-2.2
Deficit in balance of goods and services	-2.1	-3.8	-16.5	-20.6	-12.8	-10.6	-11.7	-7.5	-4.6	-2.7	-1.5
Exports (g&s)	23.6	27.1	44.1	44.1	36.3	34.4	33.5	29.5	26.6	24.8	23.5
Imports (g&s)	21.5	23.2	27.5	23.5	23.5	23.8	21.8	21.9	22.1	22.1	22.0
Net non-debt creating capital inflows (negative)	-0.7	-0.6	-0.2	0.2	-0.1	-0.4	-1.2	-1.1	-1.1	-1.2	-1.2
Net foreign direct investment, equity	0.4	0.4	0.3	-0.1	-0.1	0.0	0.8	0.8	0.8	1.0	1.0
Net portfolio investment,equity	0.3	0.3	-0.1	-0.1	0.2	0.4	0.3	0.3	0.3	0.3	0.3
Automatic debt dynamics 1/	2.1	25.6	31.8	-19.4	-6.9	-2.9	-5.1	-1.5	-0.5	-0.1	-0.2
Contribution from nominal interest rate	2.9	5.4	5.0	4.2	3.1	2.3	1.9	1.7	1.6	1.5	1.5
Contribution from real GDP growth	-0.6	2.9	-4.6	-6.2	-2.6	-1.9	-1.4	-1.0	-1.0	-0.9	-0.9
Contribution from price and exchange rate changes 2/	-0.2	17.3	31.3	-17.4	-7.4	-3.3	-5.6	-2.1	-1.1	-0.7	-0.8
Residual, incl. change in gross foreign assets (2-3)	5.2	-2.1	20.1	9.2	8.2	6.8	10.3	7.8	0.7	3.7	3.5
External debt-to-exports ratio (in percent)	165.8	213.9	209.3	138.1	133.9	119.3	98.9	102.8	90.8	92.9	97.2
Gross external financing need (in billions of US dollars) 3/	11.2	14.5	-4.4	-20.2	-1.7	4.4	-12.3	-2.3	13.5	22.0	33.2
in percent of GDP	2.6	4.5	-2.3	-7.8	-0.5	1.3	-2.9	-0.5	2.7	4.1	5.8
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	1.8	-4.9	5.4	9.0	5.0	4.3	4.0	3.5	3.5	4.0	4.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-11.5	-40.4	-60.6	-12.5	-3.6	-7.0	...	...	...	...	...
GDP deflator in US dollars (change in percent)	0.5	-30.7	-35.1	23.2	13.7	7.2	15.8	6.7	3.8	3.1	3.5
Nominal external interest rate (in percent)	8.5	9.1	6.0	6.1	6.0	5.2	5.6	5.5	5.7	6.7	6.9
Growth of exports (US dollar terms, in percent)	-1.9	-14.0	-2.5	35.4	-2.0	5.8	17.8	-2.9	-2.9	-0.2	2.2
Growth of imports (US dollar terms, in percent)	6.1	-19.1	-29.0	15.5	19.1	12.8	11.2	10.9	7.9	7.2	7.4
						II. Stress Tests for External Debt Ratio					
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2007							**36.0**	**29.2**	**16.5**	**8.7**	**1.9**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004							**34.4**	**32.6**	**26.5**	**25.4**	**25.2**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							**45.0**	**55.5**	**49.0**	**47.8**	**47.4**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004 4/							...	...	...	...	...
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004							**50.4**	**60.1**	**53.5**	**52.2**	**51.8**
6. Combination of 2-5 using one standard deviation shocks							**148.3**	**513.1**	**499.3**	**495.9**	**492.2**
7. One time 30 percent nominal depreciation in 2003							**48.5**	**45.0**	**38.6**	**37.4**	**37.1**

Historical Statistics for Key Variables (1992-2001)	Historical Average	Standard Deviation	Average 2002-07
Current account deficit, excluding interest payments	-8.6	6.9	-7.0
Net non-debt creating capital inflows	0.3	0.4	1.1
Nominal external interest rate (in percent)	6.3	1.5	5.9
Real GDP growth (in percent)	-3.4	9.2	3.9
GDP deflator in US dollars (change in percent)	30.9	94.9	6.7

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ High standard deviation of deflator gives aberrant results.

Table 8. Russian Federation: Public Sector Debt Sustainability Framework, 1997-2007

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
			Actual			Prel.			Projections		
					I. Baseline Medium-Term Projections						
Public sector debt 1/	32.4	119.2	87.7	56.2	44.0	**35.6**	**27.0**	**24.1**	**21.5**	**19.2**	**17.2**
o/w foreign-currency denominated	20.1	102.9	77.5	53.9	42.5	32.7	23.6	19.9	16.9	14.4	12.2
Change in public sector debt	-2.9	86.8	-31.4	-31.5	-12.3	-8.3	-8.6	-3.0	-2.6	-2.3	-2.0
Identified debt-creating flows (4−7+12)	4.7	70.3	-28.2	-30.8	-10.6	-6.1	-9.2	-4.3	-3.2	-2.8	-2.3
Primary deficit	3.3	3.4	-2.9	-7.0	-5.7	-2.7	-4.3	-4.0	-3.1	-2.5	-2.2
Revenue and grants	37.1	32.9	34.0	37.0	37.1	37.3	39.3	36.7	34.6	34.2	34.2
Primary (noninterest) expenditure	40.4	36.3	31.2	30.0	31.5	34.6	35.0	32.7	31.6	31.7	32.0
Automatic debt dynamics 2/	1.4	66.9	-25.3	-23.8	-4.9	-3.4	-4.9	-0.3	-0.1	-0.3	-0.1
Contribution from interest rate/growth differential 3/	0.0	1.4	-44.5	-26.2	-8.1	-5.3	-4.3	-0.7	-0.7	-0.7	-0.4
Of which contribution from real interest rate	0.6	-0.1	-40.8	-21.1	-5.9	-3.7	-3.1	0.1	0.1	0.1	0.3
Of which contribution from real GDP growth	-0.6	1.4	-3.7	-5.2	-2.3	-1.6	-1.2	-0.9	-0.8	-0.8	-0.7
Contribution from exchange rate depreciation 4/	1.4	65.5	19.2	2.5	3.2	1.9	-0.6	0.4	0.6	0.4	0.3
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	-7.6	16.5	-3.2	-0.7	-1.7	-2.2	0.6	1.4	0.6	0.6	0.3
Public sector debt-to-revenue ratio 1/	87.2	362.7	257.8	151.8	118.5	95.4	68.8	65.6	61.9	56.1	50.3
Gross financing need 5/	8.0	7.9	3.2	2.7	1.3	3.1	3.9	2.6	3.3	3.0	3.0
in billions of U.S. dollars	34.4	22.2	6.1	7.0	4.1	10.6	16.4	11.9	16.3	16.0	17.1
Key Macroeconomic and Fiscal Assumptions											
Nominal GDP (local currency)	2,479	2,741	4,757	7,302	9,041	10,864	13,104	14,435	15,916	17,546	19,069
Real GDP growth (in percent)	1.8	-4.9	5.4	9.0	5.0	4.3	4.0	3.5	3.5	4.0	4.0
Average nominal interest rate on public debt (in percent) 6/	15.6	15.3	8.8	7.6	5.9	5.7	6.1	7.2	7.0	6.6	6.4
Average nominal interest rate on forex debt (in percent) 6/	3.1	5.2	2.7	5.7	4.8	4.0	4.0	3.8	3.7	3.9	3.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.1	-1.0	-55.9	-33.2	-12.0	-9.5	-9.9	0.7	0.5	0.6	1.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.7	-71.1	-23.5	-4.1	-6.6	-5.2	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	13.5	16.3	64.7	40.8	17.9	15.2	16.0	6.4	6.5	6.0	4.5
Growth of real primary spending (deflated by GDP deflator, in percent)	12.7	-14.6	-9.4	5.0	10.0	14.7	5.2	-3.3	-0.1	4.5	5.0
						II. Stress Tests for Public Debt Ratio					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007							**39.9**	**46.5**	**53.2**	**60.0**	**66.7**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004							**49.6**	**77.2**	**74.4**	**71.3**	**68.9**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							**35.7**	**41.0**	**36.0**	**31.6**	**27.8**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004							**48.5**	**66.5**	**63.7**	**60.8**	**58.4**
5. Combination of 2-4 using one standard deviation shocks							**55.6**	**85.0**	**67.9**	**50.9**	**34.7**
6. One time 30 percent real depreciation in 2003 7/							**50.5**	**47.2**	**44.5**	**41.9**	**39.7**
7. 10 percent of GDP increase in other debt-creating flows in 2003							**37.0**	**33.9**	**31.3**	**28.9**	**26.8**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Primary deficit	2.8	7.2	-3.1
Real GDP growth (in percent)	-3.4	9.2	3.9
Nominal interest rate (in percent) 6/	12.4	5.4	6.5
Real interest rate (in percent)	-38.6	53.4	-2.6
Inflation rate (GDP deflator, in percent)	317.5	523.4	9.1
Revenue to GDP ratio	35.6	2.2	36.1

1/ Gross debt of the general government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 9. Russian Federation: Indicators of External Vulnerability, 1999-2002
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002 Prel.	Date
Financial indicators					
Public sector debt 1/	87.7	56.2	44.0	35.6	
Broad money (percent change, 12-month basis)	57.0	62.0	40.0	32.0	end-year
Private sector credit (percent change, 12 month basis)	37.3	64.3	56.0	36.0	end-year
90 day GKOs yield 2/	...	12.8	14.7	12.7	end-year
90 day GKOs yield (real, deflated by actual CPI inflation) 2/	...	-7.3	-3.9	-2.4	
External Indicators					
Exports (percent change in US$)	1.5	39.0	-3.3	4.6	
Imports (percent change in US$)	-31.9	13.5	19.8	13.2	
Terms of Trade (percent change, 12 month basis)	4.1	35.2	-2.8	-4.2	
Current account balance (billions of US$)	22.2	44.6	32.4	30.4	Q3 based
Capital and financial account balance (billions of US$)	-14.6	-21.8	-13.0	-9.4	Q3 based
Gross official reserves (in billions of US$)	12.4	27.9	34.5	47.8	
Liabilities to the Fund (in billions of US$)	16.2	12.2	8.1	6.6	
Short term foreign assets of the financial sector (in billions of US$)	10.0	12.2	12.8	13.0	end-year
Short term foreign liabilities of the financial sector (in billions of US$)	4.3	4.8	4.7	5.0	end-year
Foreign currency exposure of the financial sector (in billions of US$)	5.7	7.4	8.1	8.0	end-year
Official reserves in months of imports GS	2.4	4.6	5.1	6.3	
Ruble broad money to reserves	2.1	1.5	1.5	1.4	end-year
Reserves to short term external debt	52.4	89.4	118.3	153.8	Q3 based
Total external debt (in billions of US$)	177.1	158.3	150.4	141.7	Q3 based
o/w: Public sector debt (in billions of US$)	145.8	126.0	111.8	98.1	Q3 based
Total external debt to exports GS (in percent)	209.3	138.1	133.9	119.3	Q3 based
External interest payments to exports GS	13.1	9.4	8.5	6.6	Q3 based
External amortization payments to exports GS	n.a.	20.7	27.8	24.6	Q3 based
Exchange rate (per US$, period average)	24.6	28.1	29.2	31.3	
REER depreciation (-) (12 month basis)	-29.5	10.5	18.5	3.6	
Financial Market Indicators					
Stock market index 3/	175.3	143.3	260.1	359.1	
Foreign currency debt rating 4/	Default	B-/Stable	B+/Stable	BB/Stable	
Spread of benchmark bonds (basis points, end of period) 5/	1418.7	1173.7	568.1	375.8	

1/ External and domestic debt.

2/ For 1998 end-August data.

3/ RTS index, end of period.

4/ S&P long-term foreign currency debt rating, eop.

5/ 2007, 10-year Eurobond in US$, spreads over treasuries, eop.

RUSSIAN FEDERATION: FUND RELATIONS
As of February 28, 2003

I. **Membership Status**: Joined 06/01/1992; Article VIII.

II. **General Resources Account**:	**SDR Million**	**Percent of Quota**
Quota	5,945.40	100.00
Fund holdings of currency	10,488.47	176.41
Reserve Tranche position	1.18	0.02

III. **SDR Department**:	**SDR Million**	**Percent of Allocation**
Holdings	0.08	n.a.

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**Percent of Quota**
Stand-By Arrangements	353.57	5.95
Extended Arrangements	3,831.23	64.44
Systemic Transformation	359.43	6.05

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	07/28/1999	12/27/2000	3,300.00	471.43
EFF	03/26/1996	03/26/1999	13,206.57	5,779.71
of which: SRF	07/20/1998	03/26/1999	3,992.47	675.02
Stand-by	04/11/1995	03/26/1996	4,313.10	4,313.10

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming			
	2003	2004	2005	2006
Principal	1,133.03	1,117.42	850.78	772.91
Charges/Interest	74.72	71.97	48.27	27.83
Total	1,207.75	1,189.40	899.05	800.74

VII. **Exchange Arrangements**: Managed float. The exchange rate of the ruble is determined in the interbank foreign exchange market, which was unified on June 29, 1999. The interbank market electronically links exchanges across the country. The official rate of the ruble is set equal to the previous day's weighted average rate in the interbank market.

The Russian Federation accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement with effect from June 1, 1996. The Russian authorities, however, presently impose a number of exchange measures that are subject to approval under Article VIII, Sections 2 and 3. Many of these were imposed in August 1998 in order to stem capital flight and stabilize the exchange rate. The Executive Board did not grant or extend approval of these measures at the time of the last Article IV consultation on March 8, 2002. Since then, the exchange restriction arising from the restrictions on certain advance payments to Latvian residents has been removed. Russia's remaining exchange restrictions subject to Article VIII are as follows:

- **Conversion Operations through non-residents' S accounts** (exchange restriction and multiple currency practice). These are special accounts for non-residents used for GKO-OFZ-related transactions. Before balances arising from such transactions can be repatriated, fund have to be transferred to a noninterest bearing transit account for a fixed period. As a result, the repatriation of interest earnings and other current proceeds from GKO/OFZ investments would be made with delay and at unfavorable terms.

- **Repatriation restrictions on ruble balances of nonresidents not participating in the GKO/OFZ novation** (exchange restriction and multiple currency practice). The rules governing the repatriation of ruble balances are similar to those described above with respect to the S-accounts. They apply to ruble balances arising from GKO/OFZ investments which matured before December 31, 1998.

- **Restrictions on advance import payments** (exchange restriction). The authorities do not freely permit the making of all advance payments that are required under valid import contracts.

- **Restrictions on nonresidents' N-accounts** (exchange restriction). These are nonresident bank accounts used for trade and some bond-related transactions. Existing restrictions limit the ability of nonresidents to effect moderate amounts of amortization from the proceeds of bond transactions.

- **Use of a more depreciated exchange rate for repatriation of S-account balances** (exchange restriction and multiple currency practices). Non-residents who participated in the GKO/OFZ novation are allowed to repatriate part of the proceeds by purchasing foreign currency in special auctions arranged by the CBR at a depreciated exchange rate.

Staff is also currently reviewing government resolutions on Vneshekonombank (successor to the Bank of the USSR for Foreign Economic Affairs) to assess their potential jurisdictional implications.

VIII. **Article IV Consultation**: Russia is on the standard 12-month consultation cycle. The last consultation was concluded on March 8, 2002.

IX. FSAP Participation and ROSCs

Russia participated in the Financial Sector Assessment Program during 2002, and the FSSA report will be discussed at the time of the 2003 Article IV discussion.

The following ROSC modules—issued to the Executive Board in 2000—will be updated:
-- Data Dissemination, SM/00/209 (9/13/2000).
-- Fiscal Transparency, SM/00/209 (9/13/2000).
-- Transparency in Monetary and Financial Policies, SM/00/209 (9/13/2000).

X. Resident Representatives:

Mr. Poul Thomsen, Senior Resident Representative, since January 20, 2001.
Mr. Goohoon Kwon, Resident Representative, since September 14, 2001.
Mr. Timo Välilä, Resident Representative since October 2, 2000.

Russian Federation: Relations with the World Bank Group

IBRD

1. As of March 1, 2003, IBRD commitments (net of cancellations) were $9.9 billion in 56 operations, 32 of which were active projects, including two GEF Grants and Special Initiative, and two Guarantees. Of this, $8.3 billion has been disbursed, including $5.1 billion in the form of fast disbursing adjustment loan proceeds.

2. The current Country Assistance Strategy was approved by the Bank's Board in June 2002. Overall, the strategy envisages continued emphasis on Bank support to deepen structural reforms. In particular, the current CAS emphasizes the need to (i) improve the business environment in order to encourage new firm growth (including financial sector reform, improvements in the licensing and regulatory environment and continued efforts at lowering the incentives for corruption), (ii) strengthen public sector management (including civil service reform, intergovernmental finance reform and support of judicial reforms), and (iii) safeguard against the social and environmental risks of transition (including improving health care systems and education, and developing appropriate instruments to mitigate environmental hazards). The Bank is also working with the government on monitoring the implementation of the structural reform program, in particular those elements designed to improve the business and investment climate.

3. The current CAS also emphasizes the need to re-engage in in-depth analytical work. The Bank is actively engaged in analytical work on the financial sector, SME growth, macroeconomic vulnerability, agriculture, public investments, budgetary management, education reform and the economic costs of contagious diseases (TB and HIV). The Bank has also adopted a Programmatic CEM approach, which addresses a different theme every year, rather than aiming at a single report that covers the economy comprehensively. The proposed topics are in line with the priority themes outlined in the last CAS. For this fiscal year (with the final report to be delivered in the Fall of 2003), the CEM would focus on Russia's economic structure and the diversification of its economy.

RUSSIAN FEDERATION: STATISTICAL ISSUES

1. Russia has a reasonably comprehensive and timely statistical database, but difficulties remain in terms of the data accuracy. State and private enterprise activities are measured through forms sent to firms included in enterprise registers, with sample surveys increasingly replacing full-count collections. The authorities are generally cooperative in reporting data to the Fund, mainly through the resident representative office, and during missions. Data are provided on a timely basis, albeit with a few exceptions. Russia produces a wide range of regular, timely publications on financial and economic statistics. The authorities report data for the Fund's *International Financial Statistics, Government Finance Statistics Yearbook, the Direction of Trade Statistics, and the Balance of Payments Statistics Yearbook.*

2. A draft ROSC module on data dissemination practices was prepared in 1999–2000, but never published. A new ROSC, including the data quality module, is being proposed for 2003.

National Accounts

3. The State Statistics Committee (Goskomstat) compiles and publishes discrete quarterly and annual national accounts data on a regular, timely basis, based on the *1993 System of National Accounts*. Source data are obtained from surveys of businesses and households, supplemented by reports from other agencies. There has been much effort to improve coverage. The official estimates of gross domestic product (GDP) use several methods to measure GDP. Data collection sources improved and include input and output tables, employment surveys of households, and fiscal and financial surveys of businesses, but further progress is needed in coverage of small and medium enterprises. The production-based estimates of GDP are considered more reliable than those derived from the expenditure and income approaches. The statistical discrepancy between the production and expenditure approaches is generally no more than 2 percent. More effort would be desirable in the presentation of the time series and in highlighting data revisions. Publication of financial accounts by institutional sector is also needed. The delay in finalizing a modern statistics law—requiring firms to provide data and with realistic penalties for noncompliance, together with a guarantee of confidentiality—is an impediment to further improvement of national accounts data.

4. In addition, the quarterly volume measures follow a non-standard approach. They are compiled and presented at the prices of the same quarter of the previous year and, typically, with a year-on-year growth rate, rendering time series analysis difficult. In addition, the authorities do not publish separately data on export and import volumes. Moreover, revisions to the data are not flagged in their publications, nor in the data posted on their web site. As a result, it is difficult for users, including the Fund, to maintain any form of consistent time series. However, the authorities intend to start publishing quarterly data measured at the average prices of the previous year.

Prices

5. Goskomstat compiles a good quality national consumer price index (CPI), developed with Fund technical assistance. Since January 2003, as a result of achieving moderate inflation in the recent years, Goskomstat has stopped the weekly publication of headline inflation and continued only with monthly reports; in addition, Goskomstat has started the publication of monthly core inflation data. Further improvements could be made on the basis of a new household budget survey, which has been under consideration for some time, including current efforts to improve the treatment of seasonal items in the index and to standardize specifications of items. World Bank and TACIS assistance is available in these areas. Goskomstat also publishes a producer price index. The State Customs Committee has initiated the development of foreign trade indexes, but export and import price deflators are still not available.

6. CPI data, as well as the producer price index, are not published in a time series format. The main focus is on a set of derived measures of change, presented for each month as a percentage of a previous month (the previous month and the same month in the previous year). This presentation differs from the standard practice of presenting index levels and derived percentage changes and complicates time series analysis. In addition, data on the basic components of the CPI are not readily available in time series format, rendering time series analysis of the CPI basket difficult.

Government Finance Statistics Data

7. The staff is provided with monthly information on revenues, expenditures, and financing of the federal and local governments and quarterly information on revenues, expenditures, and financing of extrabudgetary funds. The published functional classification of expenditure differs slightly from international standards. Expenditure data, classified by economic type, need improvement. Presently, they are compiled with a long delay on an annual basis, with a publication lag of one year. Data on domestic and external federal debt are compiled monthly, but are made public only in summary form on an annual basis; in addition, there is no unified debt monitoring and reporting system. In 1999, the statistical capabilities of the Ministry of Finance were greatly improved by the formation of a government finance statistics (GFS) unit in the Federal Treasury. The GFS unit commenced reporting fiscal data for publication in the *GFS Yearbook*. In the context of a work program for statistical improvement agreed with STA, there have been recent improvements in the coverage and quality of GFS data, although expenditure data remain poor. The latest detailed data reported for publication in the *GFS Yearbook* are for 2001. The Treasury has been reporting aggregate government finance data for publication in *IFS* since April 1996.

Monetary Statistics

8. Monetary data are reasonably comprehensive and generally in accordance with international standards. The new plans of accounts that were introduced in the beginning of 1998 for the central bank and commercial banks are fairly adequate for the compilation of analytically sound monetary statistics directly from accounting records. The September 2000 money and banking statistics mission made recommendations on several important methodological issues that were not properly addressed in the compilation of monetary data, such as the appropriate treatment of: (i) repurchase agreement operations with nonresidents; (ii) accounts of insolvent banks with revoked licenses; and (iii) foreign-owned banks operating in the Russian Federation and branches of Russian commercial banks that are officially licensed abroad and carry out regular banking activities. Most recommendations have been implemented, although data quality in the financial sector remains weak. Analytical accounts for the monetary authorities and commercial banks are reported for publication in IFS with a lag of one month. Timely interest rate data are available.

External Sector Statistics

9. The balance of payments is compiled on a Balance of Payments Manual (Fifth Edition) basis. In cooperation with the Fund, significant progress has been made with regard to balance of payments statistics. More detailed data have been published and new data sources have been developed. Though significant improvements have been made to enhance the quality of balance of payments statistics, there is further scope to improve the coverage of certain components of the current and the capital and financial account. There is especially also scope to improve the detail of data available to the public especially on the capital account to analyze the relatively complex flows.

10. Customs needs to substantially improve the coverage and valuation of exports and imports. Merchandise imports data published by the State Customs Service (SCS) are subject to large adjustments for under recording, especially for "shuttle trade" by individuals, smuggling, and under-valuation. Large, persistent differences between partner country and customs data on imports remain, although statistical agencies are seeking to reconcile the data with those of partner countries. The CBR has developed a methodology for calculating components of export and import transactions unrecorded by the customs authorities. Goskomstat needs to improve the coverage and quality of surveys on direct investment, and trade in services including travel.

11. Data on international reserves are not yet reported on the template on international reserves and foreign currency liquidity. Moreover, published historic series on reserves have not been corrected for changes in definitions. Headline data on reserves are reported to the Fund and the markets on a weekly basis with a four-business day lag. The Fund receives additional detail on reserves and reserve liabilities through the central bank balance sheet, but this is not as comprehensive as the reserve template.

12. Quarterly external debt data are now published by sector, maturity and currency. The timeliness is still less than the quarterly prescribed by the SDDS. Moreover, while a number of improvements have been made, there are a number of gaps in data, notably the lack of a debt service schedule. Underlying balance of payments data also lack information on gross payments, for example, for the banking system, which is necessary to monitor liquidity risk. There is also a need to monitor corporate sector off-balance sheet obligations and more generally information on interest and exchange rate exposure of the sector.

13. The Central Bank of Russia (CBR) has commenced publishing an annual international investment position for all sectors with data starting in 2001. The international investment position for the banking sector is now available on a quarterly basis.

Special Data Dissemination Standard

14. The authorities have indicated that they would like to subscribe to the Fund's Special Data Dissemination Standard. Data on a number of categories are now available e.g. on the CBR's website.

Appendix Table 10. Russian Federation: Core Statistical Indicators
(as of March 18, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt / Debt Service
Date of Latest Observation	3/18/03	3/12/03	3/12/03	3/12/03	2/1/03	3/18/03	02/03	9/02	9/02	9/30/02	Q3/02	9/02
Date Received	3/18/03	3/17/03	3/17/03	3/17/03	2/6/03	3/18/03	3/6/03	12/2/02	12/02	12/15/02	11/20/02	12/02
Frequency of Data	D	W	W	W	M	D	M	M	Q	M	Q	Biannual
Frequency of Reporting	D	W	W	W	M	D	M	M	Q	M	Q	Biannual
Source of Data	MAR	F, C	C	C	C	MAR	GKS	C	C	F	GKS	C
Mode of Reporting	E	E	E	E	E	E	E	E	E	V	E	F
Confidentiality	U	Gross-U Net-C	C	U	U	U	U	U	U	U	U	C
Frequency of Publication	D	W	n.a.	W	M	D	M	Q	M	M	Q	n.a.

Explanations of abbreviations:

Frequency of data, reporting of publications: D-daily, W-weekly, M-monthly, Q-quarterly
Source of data: MAR-Market, F-Ministry of Finance, C-CBR, GKS-Goskomstat
Mode of reporting: E-electronic, V-variable, F-cable/fax
Confidentiality: U-unrestricted, C-for use by Fund staff and the Executive Board

INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2003 Article IV Consultation—Supplementary Information

Prepared by European II Department

(In consultation with the Policy Development and Review Department)

Approved by José Fajgenbaum and Leslie Lipschitz

April 30, 2003

1. Since the issuance of the staff report, world oil prices have fallen sharply, with significant implications for the macroeconomic projections presented in the staff report, as discussed below. In addition, some further information has become available on macroeconomic developments in Russia during the first quarter of 2003 and on the authorities' plans for fiscal policy in 2004 and beyond. These developments do not change the thrust of the staff appraisal, although they underscore staff concerns about the direction of fiscal policy.

2. **Economic activity and inflationary pressures in the first quarter were stronger than expected.** Preliminary estimates suggest that real GDP was about 6½ percent higher than a year earlier, with strong growth recorded in all main sectors except agriculture. Growth continued to be driven by consumption, with retail sales up 8½ percent, while investment rose faster than envisaged. Cumulative inflation during the first three months of the year was 5.2 percent (not seasonally adjusted), compared with 5.5 percent in the same period in 2002, and annual inflation dipped only slightly, to 14.8 percent in March.

3. **The balance of payments has been exceptionally strong so far this year**, reflecting high oil prices and increasing confidence in Russian financial assets. The current account surplus in the first quarter of 2003 is estimated at $10 billion, compared with $5 billion a year earlier. Exports rose 38 percent year-on-year (with non-energy exports up 13 percent), while imports rose 24 percent. Capital inflows, primarily in the form of borrowing by the Russian corporate sector, were strong. Gross international reserves increased by nearly $10 billion (34 percent of end-2002 base money) between end-December 2002 and mid-April 2003, well ahead of projections in the staff report which show an accumulation of $20 billion for 2003 as a whole. The ruble has continued to appreciate slowly against the U.S. dollar, by about 2 percent so far in 2003.

4. **Monetary conditions have loosened in the early months of 2003.** Year-on-year growth of base money rose to 36 percent in March, the Central Bank of Russia (CBR) has continued to steer short-term interest rates downward, and active sterilization has been insufficient to absorb excess liquidity. The surge in liquidity took place notwithstanding substantial passive sterilization facilitated by a federal government surplus, on a cash basis, of 3¼ percent of GDP in the first quarter, reflecting buoyant oil revenues and delays in spending by budgetary institutions. Moreover, as budgetary allocations are spent, base money will likely expand rapidly if the CBR continues to intervene in the foreign exchange market and shuns more active sterilization efforts.

5. **World oil prices have fallen from an average of $31 a barrel in the first quarter of 2003 to around $25 a barrel in the last few weeks**. As a result, the WEO projections for the world oil price have been revised down, compared with those used in the staff report, from $31 a barrel to $26.5 a barrel in 2003, and from $25 a barrel to $23.5 a barrel in 2004. In view of the unexpected strength of activity in the first quarter, the staff considers that its forecast of 4 percent real GDP growth in 2003 remains appropriate, despite some dampening effect of lower oil prices. Moreover, at this stage the staff has not adjusted its end-2003 forecast of 12 percent inflation, even though lower oil prices may help to ease current monetary policy tensions and associated inflationary pressures. Recent inflation outturns have reinforced the concerns expressed in the staff report that the authorities' target of 10–12 percent for end-2003 could be hard to achieve; the authorities are encouraged to make every effort to bring inflation down to within this range—albeit not at the expense of limiting administrative price adjustments.

6. **Lower oil prices will, other things being equal, lead to lower balance of payments and fiscal surpluses than projected in the staff report**. The revised projections shown in the table below take account of the direct impact of the lower WEO oil price projections on oil exports and budgetary oil revenues, as well as developments in the first quarter. With lower oil exports only partially offset by the higher capital inflows already recorded, reserves accumulation for 2003 as a whole is revised down to $17 billion (58 percent of end-2002 base money). Based on the authorities' intention—communicated to staff during the discussions—to save the budgetary oil windfall this year, and to aim for a balanced budget for 2004 at a world oil price of $20 a barrel, projected general government surpluses would be reduced by 1½ percent of GDP this year and ¾ percent next. This reflects lower oil revenues—a $1 reduction in the oil price per barrel is estimated to reduce revenues by about 0.4 percent of GDP—partly offset by somewhat lower local government expenditures in response to the fall in their oil revenues.

7. **Recent government decisions, however, reinforce concerns noted in the staff report that high oil prices will increase pressures to cut taxes and loosen underlying fiscal policy**. On April 23, the government approved proposals for wide-ranging tax cuts for 2004 and beyond, including a reduction in the VAT rate from 20 percent to 18 percent in 2004, without offsetting reductions in exemptions or elimination of lower rates for some products. The unified social tax would be cut in 2005, and a further reduction and unification of the VAT rate is planned for 2006. These reductions would be partially offset by some increases in energy sector taxation. Nonetheless, the tax cut proposals, together with other tax policy changes already adopted (e.g., the cancellation of the sales tax), would reduce revenues by 1¾ percent of GDP in 2004 —some 1 percentage point more than allowed for in the staff's projections. Recent indications from the government suggest that there is little prospect of this reduction in revenue being offset fully by lower expenditures, and that the tax cuts will largely be financed using the oil windfall. The underlying fiscal position for 2004 (after adjusting for oil price changes) would, therefore, be considerably looser than envisaged by the authorities at the time of the mission.

8. **The staff considers that its advice on macroeconomic policy set out in the staff report remains valid**. In particular, regarding 2003, while lower oil prices may reduce inflationary pressures somewhat, under present circumstances there is still a need for more active sterilization and greater exchange rate flexibility in order to meet the inflation target this year. And, while it is appropriate that targeted fiscal surpluses should adjust in response to oil windfall changes, the prospect of a lower windfall underlines the importance of resisting pressures to cut tax rates without offsetting revenue measures or expenditure cuts. If the recently announced plans for the 2004 budget are implemented, fiscal policy would remain weaker than implied by the balanced-budget rule recommended by staff, making it even more difficult to achieve a substantial reduction in core inflation while limiting the real appreciation of the ruble.

Russian Federation: Revised Projections

	2002	2003		2004	
		SM/03/129	Revised	SM/03/129	Revised
	(In percent of GDP, unless otherwise indicated)				
Real GDP growth (in percent)	4.3	4.0	4.0	3.5	3.5
CPI inflation (e.o.p., in percent)	15.1	12.0	12.0	8.0	8.0
General government balance	0.6	2.5	1.0	2.2	1.4
Revenues	37.3	39.3	37.2	36.7	35.0
Expenditures	36.7	36.8	36.2	34.5	33.6
Federal government balance	1.3	2.9	1.5	...	...
External current account	8.8	10.1	8.0	6.3	5.1
In billions of U.S. dollars	30.4	42.4	33.6	29.3	23.4
Gross international reserves					
In billions of U.S. dollars	47.8	67.6	65.0	85.9	80.1
In months of GNFS	6.3	8.0	7.7	9.4	8.8
World oil price ($/barrel)	25.0	31.0	26.5	25.0	23.5

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/59
FOR IMMEDIATE RELEASE
May 9, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with the Russian Federation

On May 2, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Russian Federation.[1]

Background

Macroeconomic developments remained generally strong, with a third consecutive year of considerable GDP growth, fiscal surplus, and large current account surplus. The economy continues to benefit from the earlier reforms and the post-crisis real depreciation of the ruble, as well as strong world energy prices. For a second consecutive year Russian financial markets were among the best performing in the world, and rating agencies provided a series of upgrades in 2002.

Real GDP grew by about 4½ percent in 2002 although it slowed toward year-end. The impetus to growth continued to come mainly from energy exports and consumption, reflecting a major rebound in real wages from post-crisis low levels and a rapid increase in real noninterest public expenditure. However, investment slowed as real wages in the industrial sector increased more rapidly than productivity, dampening enterprise profitability.

Inflation declined to 15 percent, slightly exceeding the authorities' target range of 12–14 percent in 2002. Inflation during January–April 2003 has remained high despite lower administrative prices increases this year.

Due to continued strong world oil prices, the external current account surplus in 2002 narrowed less than expected. Booming energy exports largely offset a significant domestic

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the Executive Board discussion based on the staff report.

demand-induced growth of imports, while non-energy exports grew moderately, reflecting weak external demand. The overall balance of payments also strengthened considerably as a result of a large increase in private capital inflows, largely reflecting greater corporate access to capital markets abroad. Gross international reserves rose to over six months of imports by end-year.

Fiscal policy was loosened in 2002, broadly in line with the budget. Preliminary data indicate that the general government fiscal surplus was some ⅔ percent of GDP, a deterioration of 2½ percent of GDP compared to 2001. The bulk of this deterioration reflected an increase in expenditures—particularly at the regional level in the latter part of the year, which continued a strong upward trend in real non-interest expenditures. Revenues increased by about ¼ percentage point of GDP due to higher oil prices and significant gains in personal income and social taxes. As a result, the deficit in the non-oil balance rose markedly.

Monetary and exchange rate policies continued to aim at slowing the pace of real ruble appreciation, while bringing inflation down, despite the pressures generated by the strong balance of payments and the weaker fiscal stance. The Central Bank of Russia (CBR) intervened to gradually depreciate the ruble against the dollar, only partially sterilizing these interventions by attracting deposits. Continued remonetization of the economy helped avoid a large deviation from the 2002 inflation target, notwithstanding ruble broad money growth exceeding its targeted rate. In early 2003, faced with a surge in inflows due to high oil prices, corporate bond issues, and privatization receipts, the CBR has allowed a modest appreciation of the ruble against the dollar and the euro. The CBR's continued intervention in the foreign exchange market raised reserves by US$10 billion between end-December 2002 and mid-April 2003.

Structural reforms slowed due to the electoral calendar and strengthening opposition from vested interests. The agricultural land law and bankruptcy law were enacted. However, electricity sector reform—while moving forward—was significantly diluted, and progress in other areas has slowed substantially, including other components of natural monopoly reform, deposit insurance, and efforts to strengthen public administration and the civil service. Corruption remains a major obstacle to private sector investment and activity.

Executive Board Assessment

Executive Directors commended the authorities for Russia's macroeconomic performance, which has been marked by strong GDP growth, a large increase in international reserves, and a further improvement in public debt ratios. While high world energy prices have contributed to these results, sound macroeconomic policies have also been critical in bringing about the improved economic and financial position, which is also reflected in a narrowing of sovereign bond spreads and signs of warming investor sentiment.

Directors discussed the challenges facing Russia's economic policy makers against the background of a continued strong balance of payments position. They agreed that cautious and flexible macroeconomic policies will be needed to manage the tension between exchange rate and inflation objectives. In addition, even if energy prices were to remain high, structural reform efforts will need to be reinvigorated and will be essential for sustained, broad-based economic growth that is less dependent on the energy sector.

Directors observed that the authorities' task of containing the real appreciation of the ruble while at the same time lowering inflation has become more challenging. They noted that, although the substantial fiscal adjustment, productivity gains, and remonetization of recent years have thus far limited the inflationary consequences of a monetary policy targeted at the real exchange rate, progress in reducing inflation has been relatively slow. In the current setting of large foreign exchange inflows and uncertainty about the future path of money demand and capital flows, this calls for a change in the mix of monetary and fiscal policies. Specifically, Directors recommended that monetary policy should give higher priority to combating inflation, while fiscal policy should be geared toward containing upward pressures on the real exchange rate.

Directors urged the authorities to resist calls to spend the windfall gains from high oil prices and called for a tightening of fiscal policy in 2004. By helping to sterilize the foreign exchange inflows and lower pressures on prices of non-traded goods and services, this policy stance would slow the real appreciation of the ruble. A tighter fiscal policy would also put the budget in a better position to help meet demands on public resources that will arise from planned structural reforms. Directors underlined that the further reduction in tax rates for 2004 and beyond decided by the authorities recently would loosen the fiscal stance unduly, even if it improves future growth prospects by lowering the tax burden. Accordingly, they encouraged the authorities to ensure that the tax reductions are offset by measures to broaden the revenue base and/or reduce expenditure.

Directors endorsed the view that medium-term fiscal policy should aim for a roughly balanced budget based on a conservative oil price benchmark, as this fiscal stance would best support the authorities' macroeconomic objectives. They accordingly urged the authorities to work toward adopting a fiscal rule to formalize the balanced budget constraint. Directors considered the establishment of an oil stabilization fund as proposed by the authorities as a helpful tool in support of a disciplined fiscal stance. They stressed that such a fund should be managed in a transparent and accountable way, and be fully integrated in a coherent medium-term budgetary framework. Directors also welcomed the establishment of a high-level commission to examine public spending. In particular, they encouraged the authorities to improve the efficiency of public expenditure and to address the problem of unfunded mandates, which has undermined the financial position of local governments.

Directors generally agreed that, to achieve the authorities' macroeconomic objectives, monetary policy will need to give higher priority to reducing core inflation in order to avoid the risk of entrenching inflationary expectations. This will entail preparedness to increase sterilization—along with the development of additional money market tools to do so—as well as acceptance of greater exchange rate flexibility. Directors were encouraged by recent signs of the authorities' willingness to move in this direction. A few Directors nevertheless saw a continuing need for efforts to slow the pace of real ruble appreciation. While acknowledging the authorities' concern about large capital inflows, a few other Directors were concerned that the recent cuts in short term interest rates could risk fueling inflation. Directors welcomed the authorities' interest in starting to prepare for the adoption of inflation targeting when the conditions for making this transition—including financial market conditions and a medium-term fiscal framework—are in place.

Directors expressed disappointment at the recent slowdown in the pace of structural reforms and urged the authorities to reinvigorate the process in order to boost Russia's long-term growth and employment prospects by improving the investment climate, diversifying the economy, raising productivity, and sustaining real wage increases. Key areas of reform include the public administration, the civil service, the judiciary, natural monopolies, and housing and communal services. These, along with trade reforms in the context of World Trade Organization accession, should result in a significant strengthening of governance and the rule of law and a reduction of distortions in the economy.

Directors underscored that sounder financial institutions and stronger financial intermediation will be key to improving the climate for private sector activity, particularly for small and medium-sized enterprises. They welcomed Russia's participation in the Financial Sector Assessment Program, and encouraged the authorities to press ahead with implementing its recommendations. Directors underscored the importance of strengthening the CBR's ability to effectively supervise banks and, in this context, regretted the delay in introducing full International Accounting Standards. In particular, they cautioned that the planned introduction of deposit insurance may prove counterproductive if unsound banks are allowed to participate. Directors called for further steps to reduce the role of the state in the banking sector and, in this context, encouraged the authorities to initiate a strategic review of Sberbank that would address the problems associated with its dominance in the banking sector. Directors commended the significant progress made by Russia in implementing an effective anti-money laundering and anti-terrorist financing regime, and looked forward to further efforts in the period ahead.

Directors supported the authorities' plans to speed up the redevelopment of the government ruble bond market, and encouraged further efforts to develop domestic capital markets to help reduce reliance of the corporate sector on foreign currency borrowing. Directors welcomed the legislative proposals to liberalize foreign exchange transactions, and urged the authorities to ensure that a strengthening of the financial system and better enforcement of prudential norms go hand in hand with liberalization. They encouraged the authorities to remove the remaining exchange restrictions under Article VIII, and considered that, in the current environment of sizable capital inflows, the authorities should avoid introducing new controls.

Directors welcomed the authorities' decision to proceed with new data and fiscal transparency Reports on the Observance of Standards and Codes, and encouraged them to resolve the outstanding issues related to subscription to the Special Data Dissemination Standard.

Directors noted that with its strong balance of payments and foreign reserves position Russia is well placed to make voluntary advance repurchases on its outstanding obligations to the Fund, and a number of Directors encouraged the authorities to do so at an early opportunity.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Russian Federation: Selected Economic Indicators, 2000–03

	2000	2001	2002 Est.	2003 Proj.
	(Annual percentage changes)			
Production and prices				
Real GDP	9.0	5.0	4.3	4.0
Consumer prices				
Annual average	20.8	21.5	16.0	13.4
End of period	20.1	18.6	15.1	12.0
GDP deflator (annual average)	40.8	17.9	15.2	16.0
	(In percent of GDP)			
Public sector				
Enlarged government overall balance	2.7	3.0	0.6	1.0
Federal government				
Overall balance (commitment basis)	0.8	2.8	1.3	1.5
Primary balance (commitment basis)	5.2	5.5	3.4	3.3
Revenue	15.4	17.6	17.1	16.2
Expenditure (cash basis)	13.6	14.9	15.7	14.8
Interest	2.5	2.7	2.1	1.8
Noninterest	11.1	12.2	13.6	13.0
	(In billions of U.S. dollars unless otherwise indicated)			
External sector				
Total exports	105	102	106	118
Total imports	45	54	61	68
External current account (deficit –)	45	32	30	34
Stock of public external debt	126	112	98	89
Gross reserves coverage (months of imports of GNFS)	4.6	5.1	6.3	7.7
Memorandum items:				
Nominal GDP (billions of rubles)	7,302	9,041	10,864	13,104
Exchange rate (rubles per U.S. dollar, period average)	28.1	29.2	31.3	. . .
Russian oil price, ($/barrel, c.i.f.)	26.5	22.9	23.7	25.2

Sources: Russian authorities, and IMF staff estimates and projections.