October 2007
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Russian Federation: 2007 Article IV Consultation—Staff Report; Staff Statement; 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 2007 Article IV consultation with the Russian Federation, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 25, 2007**,** 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 July 13, 2007. 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 statement of September 12, 2007 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 12, 2007 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation
with the Russian Federation

Approved by Michael Deppler and Michael Hadjimichael

July 13, 2007

EXECUTIVE SUMMARY

The authorities are considering a further fiscal relaxation that, together with the already approved 2007 budget, will increase the non-oil deficit by 2¼–3¼ percent of GDP through 2009. This implies that most of Russia's remaining terms-of-trade windfall will be spent, and that Russia's twin fiscal and current-account surpluses will disappear within 2–3 years—having amounted to 8½–10 percent only last year.

With private demand gaining strength and GDP growth close to potential, staff cautioned that the additional fiscal stimulus would accelerate real appreciation, and add to the nominal appreciation necessary for inflation to be kept on track. Noting the authorities' renewed focus on stabilizing the exchange rate, staff was concerned that the relaxation risked aggravating the inconsistency between inflation and exchange rate targets. While the authorities agreed that pressures would increase, they felt that they would remain manageable, and noted that cyclical considerations had to be weighed against the need to fund programs fostering long-term growth.

Staff argued that the planned fiscal relaxation would likely eliminate the remaining undervaluation of the ruble over the next few years, leaving little room for additional loss of competitiveness. This pointed to the risk of fiscally induced overshooting of the real exchange rate, especially if above-trend oil prices add to spending pressures over and above what was discussed with the mission.

The authorities noted that the new fiscal framework for saving oil revenues will entail large spending cuts in 2010-11, reflecting a continued determination to prevent a future drop in oil prices from forcing a procyclical tightening. Staff welcomed this, but questioned the back-loading, noting that it would be challenging to save up to 2 percent of GDP in the run-up to the 2011 elections, especially since efficiency-enhancing reforms have stalled and pressures for social transfers remain strong. The authorities agreed that progress with public-sector reforms would be key to expenditure control.

Staff argued that keeping inflation on target would require returning to a more flexible exchange rate. Record-high interventions, prompted by surging capital inflows, have led to a sharp acceleration in money growth in recent months that is inconsistent with the inflation target. Added exchange rate flexibility would also discourage speculative capital inflows. The authorities resisted calls for such flexibility, arguing that they would regain control over money growth through increased reserve requirements and that capital inflows would decline, having been boosted by large one-off inflows.

Financial-sector discussions were concerned with regulatory and legislative obstacles to further development. Discussions on long-term growth focused on the need to raise investment, as the scope for catch-up gains in productivity will eventually diminish.

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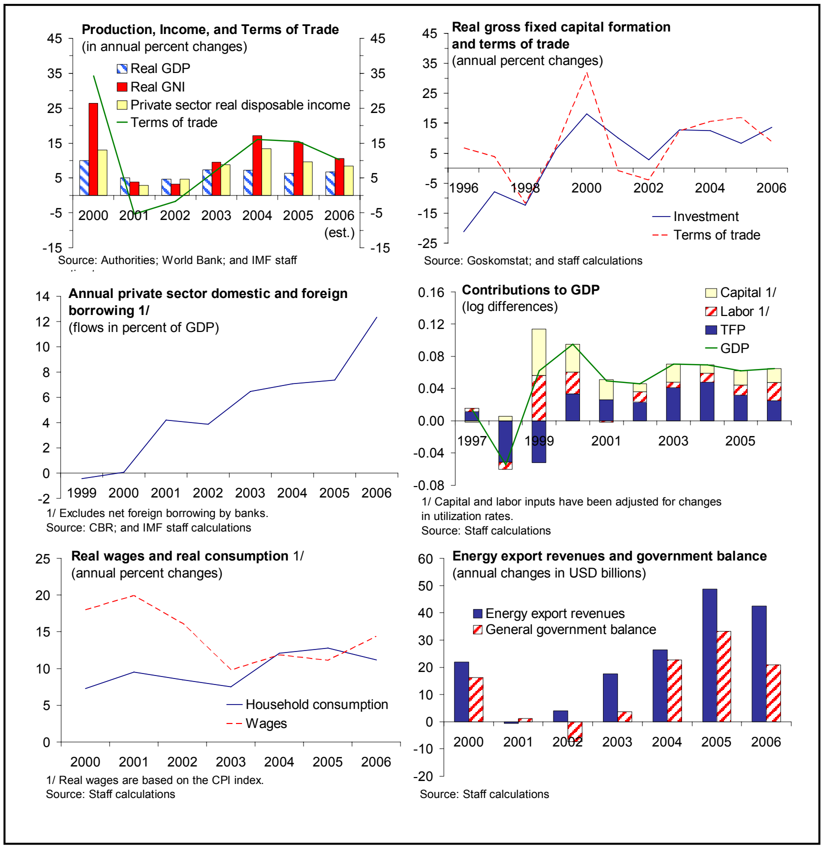
I. BACKGROUND

A. The Long-Term Perspective

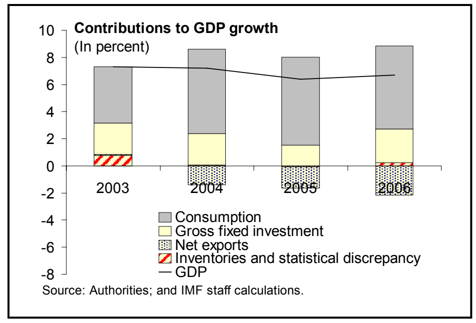
1. **High oil prices, a strong catch-up potential, and sound fiscal policy underlie Russia's long spell of robust growth.** Double-digit terms-of-trade gains annually since 2003, reinforced by rapidly developing financial markets and much-improved access to foreign borrowing, have underpinned strong investment growth, punctured only by a soft spot in late 2004 in the wake of turmoil in the oil and banking sectors. However, this growth notwithstanding, the level of investment has remained low, and capital and labor have accounted for less than half of the increase in GDP since 2003, with the balance due to higher total factor productivity. Robust growth has thus owed much to Russia's still considerable catch-up potential, as resources are reallocated to more dynamic sectors in the economy. The resulting nexus of strong productivity growth, rising real incomes, and higher consumption has been a key source of self-sustaining growth, especially in recent years as capacity constraints have slowed energy exports. With resource constraints becoming gradually more widespread—2006 was the seventh year of strong growth, despite comparatively low investment—the policy of taxing and saving Russia's oil revenues has limited overheating and prolonged the recovery. In 2006, the budget would have been balanced at an oil price $30 per barrel.



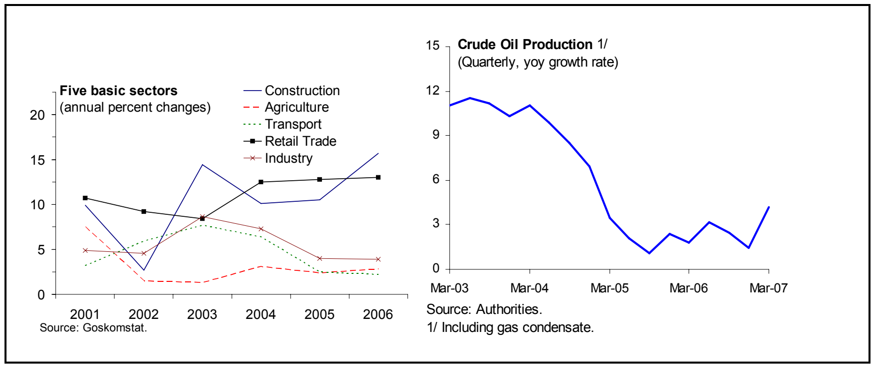
B. Recent Economic Developments

2. **GDP growth has strengthened and become better balanced** (Table 1). Growth accelerated to 7.9 percent (year-on-year) in the first quarter of 2007, and high-frequency indicators suggest undiminished momentum in the second quarter. The acceleration took place even as oil prices fell from mid-2006 highs; in part because of the strong automatic fiscal stabilizer embedded in the oil stabilization fund, which absorbs about 85 percent of the fluctuations in revenues when oil prices change. Recent output growth reflects a pickup in

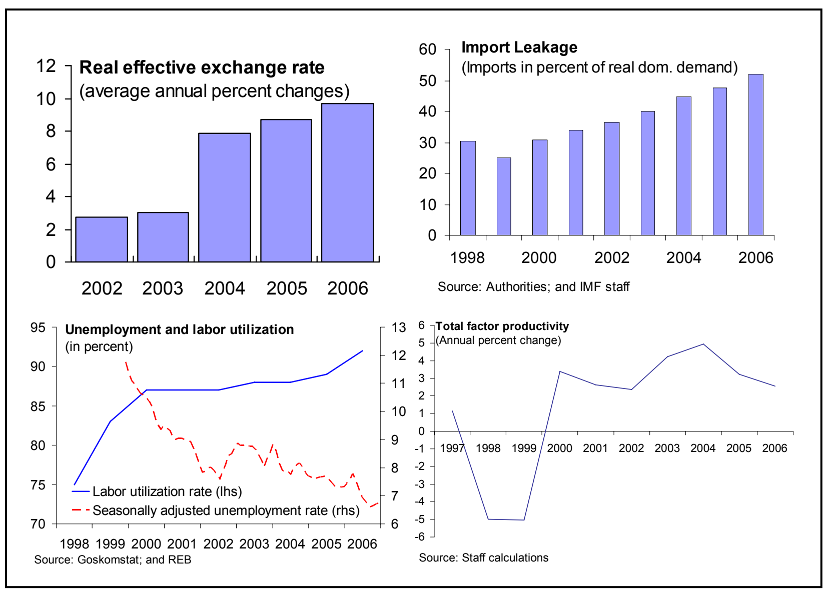
investment, suggesting that growth is becoming better balanced. Consumption remains, however, the main engine, spurred by annual increases in real incomes of more than 10 percent. Higher growth also reflects further fiscal relaxation.



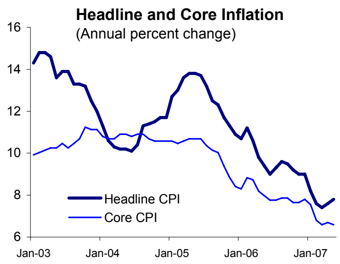
3. **The acceleration in growth is coming mainly from the nontradable sector.** Consistent with the relatively rapid real appreciation, growth in retail trade and construction continues to gain speed, running well above 10 percent (year-on-year), while growth in manufacturing is notably slower although still robust at 6–7 percent. Growth in oil production has not recovered from the precipitous decline in 2004–05, when it plummeted from 12 to 3 percent, reflecting mainly a lack of development of new fields and limited pipeline capacity.



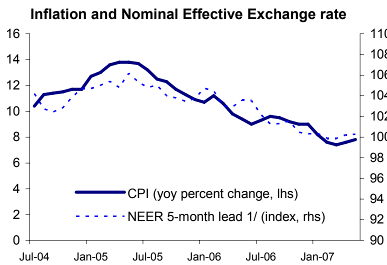
4. **While productivity growth remains high, resource constraints continue to tighten, not least in the labor market**. Production capacity is being expanded at a relatively fast pace, reflecting rising investment and continued high TFP growth as the economy is still realizing catch-up gains. Nevertheless, labor markets continue to tighten, with acute shortages in high-growth areas, high and increasing labor utilization rates, and high and accelerating growth in real wages, to 18.5 percent during the year through April 2007. Beyond the labor markets, the rapid real appreciation and the increase in the leakage of domestic demand to imports also point to tightening resource constraints. In line with this, standard output gap analysis—which is subject to notable conceptual and statistical problems in a structurally changing economy like Russia's—also suggests that GDP is close to potential.



5. **The decline in inflation has halted.** After having halved from almost 14 percent (year-on-year) in April 2005 to 7.4 percent in March 2007, inflation firmed in recent months, to 7.8 percent in May 2007. The decline reflected in part the impact of lower administered-price increases compared to previous years, an effect that accounted for about half of the decline in headline inflation in 2006. The slowdown was also a reflection of lower tradable-price inflation, as a change in exchange rate policy allowed a modest appreciation of the ruble in nominal effective terms—a notable break from the previous policy, which geared the CBR's foreign exchange interventions toward ensuring a steady depreciation of the ruble. The recent uptick in inflation has followed the return to a less flexible exchange rate policy since mid-2006.



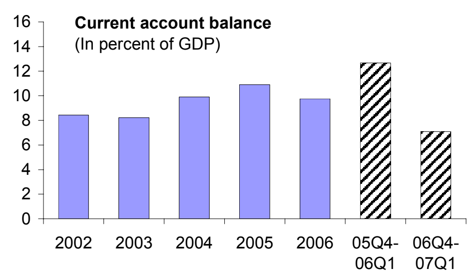
Source: Authorities; and IMF staff calculations.



Source: Authorities; and INS.
1/ Increase in index represents a depreciation of the ruble in nominal effective terms.

6. **The balance of payments has strengthened further as a lower current account surplus has been more than offset by sharply higher capital inflows (Table 2)**. Reserves increased by a record \$156 billion during the year through May 2007, to \$403 billion.

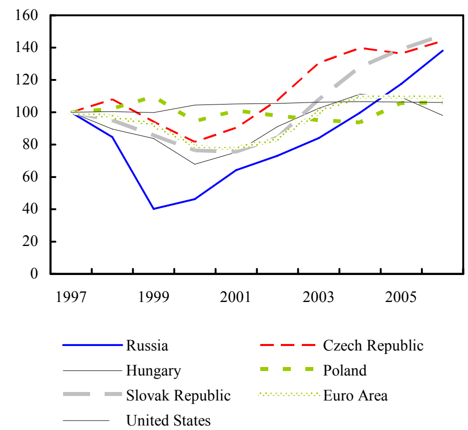
- **The current account surplus is declining as a result of continued strong import growth and a notable slowdown in energy export growth**. Propelled by robust domestic demand, import growth has accelerated, doubling to about 40 percent in January–April 2007 (year-on-year) compared to the same period last year. Moreover, whereas the increase in the non-energy deficit had until recently been more than offset by large increases in both oil prices and oil-export volumes, lower oil prices and the marked slowdown in oil-output growth are now causing a rapid decline in the overall current account surplus. The surplus relative to GDP in Q4 2006–Q1 2007 was only half that of a year earlier.



Source: CBR; and IMF staff calculations.

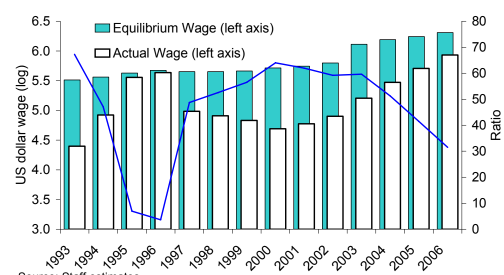
- **The ruble is still undervalued in real terms, but competitiveness is eroding.** Estimates using the Fund's standardized CGER approach suggest that the ruble is undervalued by 20 percent according to the external-sustainability approach and by 1 percent according to the macro-balance approach, implying a mid-point undervaluation of about 10 percent. This compares with the degree of undervaluation of 15 percent estimated last year. This weakening of competitiveness is confirmed by indices of relative unit-labor costs, which have increased steadily and are now estimated to be above the level just before the 1998 financial crisis. Nonetheless, staff estimates suggest that wages in Russia are still competitive internationally.[1] So, while profit margins are facing increasing pressure, competitiveness is not yet a major concern—non-primary commodity exporters have maintained their market share and annual growth in the manufacturing sector is robust at 5–7 percent.

Unit labor costs in US dollars[1]
(Index, 1997=100)



Sources: Russian authorities; WEO; IFS; and IMF staff estimates.
[1] For manufacturing sector, except Russian ULC, which is for industries.

Russia: Equilibrium US-dollar wages and actual wages, 1993-2006
(Manufacturing sector)



Source: Staff estimates.

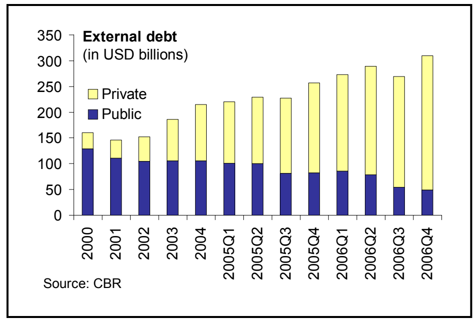
- **Net private capital inflows are surging across all major categories.** The underlying increase is even larger if loans related to ownership transfers in the energy sector are excluded. Russia has become a major FDI recipient among emerging market economies, with gross inflows of 3 percent of GDP. Net FDI and portfolio inflows have been boosted by increased merger and acquisition activity and greenfield investment, reflecting strong investor sentiment buoyed by Russia's growth potential and

Net private capital flows, excluding errors and omissions
(in billions of US$)

	2005	2006	Q1 2006	Q1 2007
FDI and portfolio investment /1	-4.1	21.6	4.2	3.4
FDI	-0.8	10.8	2.5	...
Portfolio investment	-3.3	10.8	1.7	...
Commercial banks /2	7.9	24.1	-2.2	-8.9
Corporate loans (received, net)	40.9	16.8	2.0	24.1
Other	-33.5	-21.8	-8.5	18.8
Net private capital	**11.3**	**40.7**	**-4.5**	**13.3**
Of which large one-off transactions	5.5	-12.5	...	18.0

1/ For Q1 2007, excludes FDI and portfolio investment in commercial banks.
2/ For Q1 2007, includes FDI and portfolio investment in commercial banks.

[1] Staff estimates of the international competitiveness of Russian wages are based on a cross-country panel framework, including 85 countries, which models manufacturing wages denominated in U.S. dollars. The equilibrium wage is estimated as a function of various measures of productivity and income, including per capita GDP, human capital, share of agriculture, and institutional indicators.

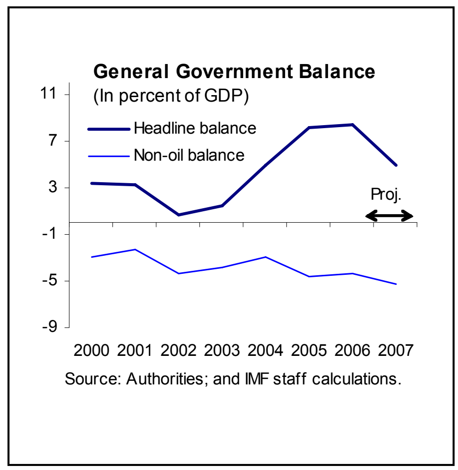


rapidly rising incomes. Another important development is the surge in overseas borrowing by banks to fund their domestic loan portfolios, reflecting an arbitrage opportunity created by high domestic lending rates and expectations of continued ruble strength. Large share issuances by two state-owned banks boosted capital inflows in the first quarter of 2007.

- **Russia's external vulnerability is low by most measures, but nongovernment indebtedness is rising rapidly**. From end-2004 to end-2006, the government's external indebtedness dropped from $106 billion to $49 billion, while that of the nongovernment sector rose from $109 billion to $261 billion. This reflects, in part, large-scale foreign borrowing by state-controlled firms (Tables 3 and 4).

C. Macroeconomic Policies

Fiscal policy



7. **Fiscal policy has become increasingly expansionary** (Tables 5 and 6). Since 2005, fiscal policy at the general government level has added a notable impulse, by allowing more of Russia's oil-revenue windfall to pass through to the economy (last line in accompanying table), contributing to a gradual increase in demand pressures as resource slack has been used up. This relaxation has been reflected in a deterioration in the general government's non-oil balance, even as higher oil revenues caused the headline surplus to increase through 2006. The non-oil balance is set to decline further under the 2007 budget, by 0.9 percent of GDP. (In addition to this discretionary relaxation, a further impulse is arising from the automatic stabilizers, to the extent that reduced public savings will absorb the bulk of the negative impact on the economy of somewhat lower oil prices.)

Fiscal Indicators of the General Government and Energy Exports

	2004	2005	2006	2007 Proj.
	(changes in percent of current year GDP 1/)			
Change in Overall Balance (A)	3.8	4.3	1.9	-2.4
Change in Oil Revenues	3.7	6.6	2.5	-1.0
Change in Non-Oil Balance	0.1	-2.3	-0.7	-1.4
Change in Energy Exports (B)	3.6	6.1	3.6	-1.3
Oil windfall net of absorption by the budget (B-A)	-0.1	1.9	1.8	1.1

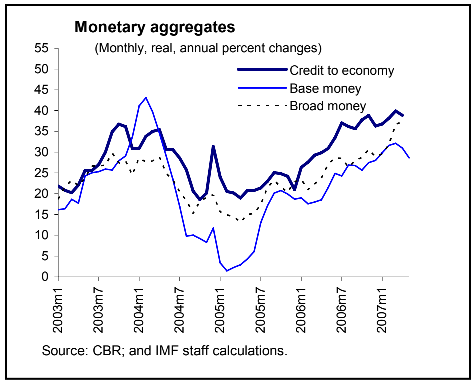
Sources: Russian authorities and Fund staff estimates.
1/ Calculated as $(X_t - X_{t-1})/GDP_t$

8. **The relaxation reflects higher recurrent expenditures and a decline in social contributions.** Federal primary spending increased by 2¾ percentage points of GDP during 2005–07, mostly because of higher recurrent expenditures in the social and security sectors. A substantial part of this increase was due to higher transfers to extrabudgetary social funds, notably to the pension fund, which saw a sharp deterioration in its financial position as a

large discretionary tax cut and continued compliance problems caused a decline in revenues by 4 percent of GDP. At the level of the consolidated general government, primary expenditures rose by 0.4 percentage points of GDP while non-oil revenues declined by 2.6 percentage points of GDP during 2005–07.

Monetary policy

9. **Monetary policy has become more accommodative with the CBR's resumption of a fixed nominal exchange rate policy.** Against a backdrop of rapid real appreciation and increasing political concerns about competitiveness, the CBR has been resisting further nominal appreciation of the ruble vis-à-vis a EUR-U.S. dollar basket since mid-2006. This represents a reversal of the policy introduced in early 2005, wherein the CBR had been allowing some, albeit limited, appreciation. The return to a fixed exchange rate has been associated with a surge in capital inflows, record-high interventions, and a sharp acceleration in base money growth, to 41 percent through April (year-on-year). Importantly, the perception that the CBR will eventually have to allow renewed appreciation, in order to keep control over inflation, is exacerbating capital inflows, not least through the banking system. In this regard, the CBR has found that its policy of refraining from active sterilization is resulting in much-faster base money growth, as the source of foreign exchange inflows is shifting from oil revenues, which are sterilized automatically through the stabilization fund, to the capital account.



10. **Growth in broad money and bank credits is accelerating sharply.** Broad money growth (including foreign currency deposits) reached 48 percent by April (year-on-year)—and growth of ruble broad money was even faster at 57 percent, reflecting continued stagnation in foreign-currency denominated deposits. The rapid de-dollarization is also evident from further large cash sales of foreign exchange by households.

11. **Rapid credit growth is fueled by ample liquidity and structural changes in the financial sector.** Increased liquidity in the banking system has been reflected in real credit growth of close to 40 percent year-on-year—from a low base. Consumer lending is growing particularly fast, reflected in the rising share of household loans in newly extended credit, from 20 percent in 2003 to 33 percent in 2006. Rapid credit growth is also a result of ongoing structural changes in the financial sector, as discussed in Box 1.

12. **Banks' financial soundness indicators are strong, but weaknesses remain in the banking system and in supervision** (Table 8). Bank profits have surged, boosted by wide interest-rate margins and high credit growth; aggregate NPL ratios are low; and liquidity buffers remain relatively high. However, NPL and loan concentration ratios are believed to be underreported as the financial sector continues to be plagued by poor prudential data, limited transparency, and weak governance, as discussed below. In addition, concentration of ownership is high and connected lending is a concern.

II. THE NEAR-TERM OUTLOOK

13. **The backdrop to the near-term outlook is stable**. According to WEO projections, Russia is facing a small terms-of-trade loss in 2007—following four years of double-digit annual gains—but this loss will be largely absorbed through lower savings in the stabilization fund. The favorable outlook for emerging markets, and widely held expectations of policy continuity after the presidential elections, also suggest a relatively stable environment. It is noteworthy in this regard that investment growth accelerated and capital inflows surged last year; even as oil prices receded significantly from mid-2006 highs, President Putin confirmed his intention to leave office, and the government further expanded its control over the energy sector. This resilience in investment growth suggests that investor sentiments are relatively robust, and that downside risks to the near-term outlook, in particular from lower oil prices, are limited.

14. **Real GDP growth is expected to remain strong and resource constraints to tighten further** (Table 9). On the strength of buoyant investment growth, and with scope for further TFP gains, potential GDP growth is expected to continue at its recent pace. However, demand is likely to accelerate in 2007. This reflects in part a discretionary relaxation of the non-oil fiscal balance (see below), as well as the automatic stabilizer built into the stabilization fund, which will limit the direct impact of lower oil revenues to no more than 0.3 percent of GDP. In addition, staff expects the development of the financial sector, reinforced by sustained large capital inflows, to add further strength to private demand, not least because the rapidly expanding market for consumer credits provides households with a newfound ability to consume against expected future income gains. In view of this, staff projects GDP growth to continue at 7 percent, above the consensus forecast of 6.6 percent, and demand pressures to increase with an attendant tightening of resource constraints. As to 2008, growth is expected to remain robust on the assumption of additional fiscal stimulus and slightly higher oil prices. Accordingly, staff projects continued real appreciation and rapid import growth in 2007–08. The current account surplus is expected to decline from almost 10 percent of GDP in 2006 to near-balance in 2009. This reflects in part a steady fall in the non-energy balance because of rapid import growth and a low base for non-primary commodity exports. But it also reflects the decline in energy exports relative to GDP, as oil prices are assumed to remain largely unchanged while energy output is not expected to regain its previous buoyancy.

Russian Federation: Key Economic Indicators

	2006	2007	2008	2009
		projection		
	(in percent changes)			
Real GDP	6.7	7.0	6.8	6.6
Terms of trade	11.3	-5.1	2.0	-1.5
Inflation (e.o.p)	9.0	8.0	7.0	7.0
	(in percent of GDP)			
Current account	9.6	5.1	2.9	0.3
Energy exports	19.4	15.6	13.8	11.8
Non-energy current account	-9.8	-10.4	-10.9	-11.4

Source: Staff calculations.

15. **Inflationary pressures are set to remain strong.** Against a backdrop of robust demand growth and plans to gradually raise domestic energy prices starting next year, upward pressures on prices will remain strong. In staff's view, achieving even the relatively slow decline in inflation targeted by the authorities during the remainder of 2007 and 2008 will require a change in policies, including additional nominal appreciation.

III. Report on the Discussions

16. **Macroeconomic discussions focused on tensions in the policy mix arising from envisaged further relaxations of fiscal policy in the face of tightening resource constraints and the fixed exchange rate policy.** The discussions took place amid the preparation of a supplementary 2007 budget that foresee a further large fiscal relaxation and could entail small fiscal and current account deficits within 2–3 years, down from surpluses of 8½–10 percent of GDP only last year, even with broadly unchanged oil prices. The discussions addressed in particular conflicts between short-term cyclical considerations and the medium-term objective of using oil revenues to boost potential growth and ensure a more equitable income distribution. They also coincided with increased concerns within the CBR of the implications for monetary policy of surging capital inflows.

17. **The erosion of competitiveness is increasingly bearing on macroeconomic policies.** According to staff projections, the real exchange rate appreciation will—in the absence of further fiscal relaxation—slow gradually to 3–5 percent over the medium term, a pace that would be broadly in line with Balassa-Samuelson-type effects. However, the planned fiscal relaxation would mean that the appreciation would continue at a 7–9 percent rate. Thus, staff projections suggest that the further fiscal relaxation will mostly eliminate the remaining undervaluation of the ruble over the next few years, leaving the exchange rate around its equilibrium level by 2009. However, the pace at which the undervaluation is set to unwind and the possibility that the large catch-up gains in productivity might begin to wane faster than expected, even as demand pressures fuel fast appreciation and high wage growth, all point to increasing downside risks. This is especially the case for manufacturing, which although still growing at a satisfactory pace, is already underperforming the nontradable sector. In view of this, much of the discussion of medium-term issues focused on the risk that an even faster fiscal relaxation than discussed with the mission would cause overshooting of the real exchange rate.

A. Fiscal Policy

18. **The authorities are considering a fiscal relaxation over the next few years that—under the current outlook for oil prices—would allow most of the remainder of the oil revenue windfall to be passed through to the economy**. The approved annual federal 2007 and three-year budgets entail a relaxation of the non-oil deficit of 2½ percent of GDP by 2009, following a cumulative expansion of 1½ percent of GDP during 2005–06. A supplementary 2007 budget discussed with the staff will increase spending authorizations by an additional 2¼ percent of GDP, to be distributed over the next three to four years. With this, the planned expansion in the non-oil deficit over 2007–09 would reach 3.2 percent of GDP if the amounts authorized under the approved 2007 and three-year budgets are fully spent and the borrowing margin under the new fiscal framework is fully exploited. Ministry of Finance officials indicated that they were intending to limit borrowing

Russian Federation: Federal Government Budget, including preliminary supplementary 2007 budget

	2006	2007	2008	2009
	Actual	Staff projections		
	(in percent of GDP)			
Non-oil balance	-3.8	-4.3	-5.9	-7.0
Oil revenues	11.2	9.0	8.4	7.2
Overall balance	7.4	4.7	2.5	0.2
Memo item				
Oil price (Urals, USD bbl)	61.1	57.6	61.6	61.3

Source: Authorities; and staff projections and to resist pressures to spend the reserves, and thereby aiming to limit the increase in the non-oil deficit to 2¼ percent of GDP.[2] Other officials, however, suggested that the non-oil deficit would increase to the full extent of what is permitted within the newly approved framework. This appears realistic in the light of past and present pressures to increase spending. As regards the overall balance, the stabilization of oil prices and oil-sector output will cause oil revenues to decline by 4 percentage points relative to GDP, resulting in a decline in the headline surplus from 7½ percent of GDP in 2006 to near-balance in 2009. On staff estimates, the oil price at which the budget would be balanced is set to increase from less than $30 per barrel (Urals) in 2006 (when the actual price was $61 per barrel) to $55–62 per barrel by 2009 (when the price is projected to be $61 per barrel, according to the WEO).

19. **Staff cautioned that the planned increase in the non-oil deficit would increase upward pressures on prices and the ruble**. Noting that inflationary pressures were already strong, as the economy is growing at close to potential and private demand is strengthening, staff argued that additional fiscal stimulus would likely increase pressures for nominal appreciation if inflation is to be kept on a downward path. It would also increase pressure for real appreciation, as increased demand drives up prices for nontradable goods. In this regard, staff noted that concern about competitiveness appeared to have been the foremost reason for the return to a policy of resisting appreciation, and that this policy change was leading to a rate of growth in money supply that is incompatible with the inflation target. Further fiscal relaxation, therefore, would exacerbate existing tensions in the macroeconomic policy mix and aggravate the inconsistency between inflation and exchange rate targets. With the risk that large capital inflows might significantly exacerbate such pressures, staff felt that a more cautious fiscal approach was warranted. It recommended that the authorities delay increasing spending until the economy could absorb this spending without undue pressure on prices. Under the current outlook, this suggests that there should be no increase in the non-oil deficit in the remainder of 2007 and in 2008, beyond that envisaged in the approved 2007 budget.

20. **Ministry of Finance officials felt that the macroeconomic pressures would be manageable, and noted that the government needed to strike a trade-off between cyclical considerations and the need to fund programs fostering long-term growth.** They shared staff's view that the planned additional fiscal stimulus would likely require accelerated ruble appreciation if inflation is to be kept within target. They also stressed, however, that the supplementary 2007 budget would target investments and projects expected to boost long-term growth. They pointed to various infrastructure and housing projects, research programs, and investments in aluminum, petrochemical, nuclear power, and other priority sectors. Responding to concerns that some of these activities lie outside the normal purview of government, and to broader concerns about the efficiency of such spending considering that public sector reforms are not well advanced, the authorities noted that

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[2] The staff's estimate assumes that the unallocated reserve appropriation equal to 5 percent of total spending is actually spent and that the government makes full use of the annual borrowing of up to 1 percent of GDP permitted under the new fiscal framework (see Box 2). The Ministry assumes that not all of the reserve allocation would be spent and that no additional spending would be approved that would require borrowing above the currently envisaged 0.6 percent of GDP.

spending efficiency in several areas would be strengthened through extensive use of Public Private Partnerships. While they had advocated a somewhat slower pace of fiscal relaxation, Ministry of Finance officials felt that the compromise embodied in the supplementary budget reflected an acceptable balance between short-term costs and medium-term benefits.

21. **Ministry of Finance officials also noted that the government remained committed to increase saving of oil revenues over the medium term as set out in their new budgetary framework.** The increase in spending under the planned supplementary budget was meant to be temporary; spending would subsequently have to be lowered by about 2 percent of GDP in order to stay within the deficit ceilings for 2010–11, set out by the new framework for saving of oil revenues. Thus, while the swelling of the stabilization fund meant that there was no longer political support for continuing to save current oil revenues on the same scale as before, the approval of this framework was evidence of a continued political determination to prevent spending from increasing to a level where Russia could be forced into a procyclical tightening in the case of a drop in oil prices.

22. **Staff welcomed these intentions, but questioned the feasibility of the medium-term spending plans.** The depositing of all future oil and gas revenues with a new fund separated from the budget, the fixed annual transfer to the budget, and the cap on the budget's non-oil deficit would strengthen demand management and allow intergenerational considerations to bear on spending decisions. However, implementation of the new framework was to be back loaded to 2010–11, and spending would be allowed to increase above the level implied by the new framework during the interim period. In this regard, staff found that the assumed spending cut of 2 percent of GDP was ambitious, considering that the federal government's non-interest expenditures amount to only about 16 percent of GDP. Staff also noted that much of the savings would have to come from socially difficult cuts in education, health, and other social sectors in the run-up to the 2011 elections—and that efficiency-enhancing reforms in these sectors had stalled. Indeed, staff was concerned that the government would find it difficult to resist pressures for spending increases, considering that important groups, notably pensioners, were not sharing in the rapid growth in incomes. For instance, annual transfers to the pension fund would have to be gradually increased to 2-3 percent of GDP merely to stabilize the replacement rate at the already low level. In view of these considerations, staff doubted that the assumed expenditure cuts underlying the new framework could be achieved, unless the new government gave priority to reinvigorating stalled efficiency-enhancing social sector reforms. Similarly, staff stressed that, without strong public-sector and administrative reform, the efficacy of the authorities' planned public investment would be much reduced. Such reform would also be essential to ensure the full benefits of public-private partnerships.

23. **Staff cautioned that, looking forward, failure to contain spending created risks of procyclical tightening over the medium term.** While it agreed that there was little risk at this juncture, the speed with which the twin surpluses were set to unwind, in combination with the continued rapid real appreciation, pointed to the risk of a fiscally induced overshooting of the current account and real exchange rate unless the government is able to resist continued expenditure increases. In this regard, while the ruble was still somewhat undervalued, staff projections implied that the proposed fiscal relaxation would mostly eliminate the remaining undervaluation, suggesting that any further relaxation in the face of

continued strong growth in private demand could take a serious toll on GDP growth and export diversification. Staff also noted that the virtual stagnation of the oil sector was heightening the risk of such overshooting, as this sector's contributions to both taxes and foreign exchange earnings are declining fast.

B. Monetary and Exchange Rate Policy

24. **CBR officials were confident that they could keep inflation on a downward course.** Despite the recent uptick, year-on-year inflation was still running below the 2007 end-year target of 8 percent. The acceleration in money growth in recent months, resulting from surging capital inflows and record-high foreign exchange interventions, was a matter of concern, and this had prompted the increase in reserve requirements. The CBR would consider increasing such requirements further if necessary to reduce money growth. Moreover, it expected capital inflows to decline as the recent surge largely reflected a series of one-off transactions relating to mergers in the energy sector and to share issuances by the two large state-owned banks.

25. **The nominal exchange rate was expected to remain broadly unchanged.** CBR officials explained that, while the rapid real appreciation had prompted increasing political concerns about competitiveness, their decision last fall to return to a stable ruble had been brought about by the finding that appreciation, by fueling expectations of continued appreciation, was exacerbating capital inflows. Under the current outlook, they expected to be able to keep the currency steady during the remainder of the year.

26. **Staff argued that keeping inflation on the targeted path would require returning to a more flexible exchange rate policy.** Noting that demand pressures were set to increase, in light of the procyclical relaxation of fiscal policy, staff warned that stabilizing the exchange rate would likely prevent the CBR from adopting an appropriately restrictive monetary stance. Indeed, in staff's view, the rapid growth in liquidity resulting from interventions would, if unchecked, lead to an overshooting of the authorities' inflation target, suggesting that monetary policy was already overly accommodating. The staff urged the CBR to swiftly reverse the upturn in inflation, pointing to the added cost of doing so once inflationary expectations begin to rise. It saw no alternative means for reining in money growth other than scaling back interventions and allowing the ruble to appreciate. In this regard, staff argued that successive increases in reserve requirements would not be an effective substitute for a more flexible exchange rate policy, if only because the consequent increased spread between deposit and lending rates would encourage disintermediation. In this context, staff agreed with the CBR on the need to further develop the bank's market-based instruments, and to deepen the domestic money market. Looking forward, this would strengthen the relative effectiveness of the interest-rate channel and increase the flexibility of lending rates.

27. **Staff noted that conflicting inflation and exchange-rate targets had exacerbated capital inflows.** Discussions with market participants showed that the surge in medium-term capital inflows, in particular through the banking system, was in large part due to expectations that a strong balance-of-payments position implied further appreciation over the medium term. Thus, while the mission agreed that the slow-but-steady appreciation during

2005–06 had presented markets with a predictable exchange rate path, encouraging speculators to make one-way bets, the current rigidity was likely to exacerbate arbitrage-related inflows, as the inconsistency between inflation and exchange-rate objectives became more apparent. By signaling that monetary policy would remain firmly focused on inflation reduction, with the exchange rate allowed to appreciate as needed to keep inflation on the targeted path, the CBR would eliminate the apparent tension between these two goals, and so reduce the scope for such inflows. Staff reiterated, however, that this tension would persist if, at the same time as the ruble is allowed to appreciate, the planned fiscal relaxation necessitated a tightening of monetary conditions so as not to accommodate attendant inflationary pressures.

28. **There was agreement that the CBR is likely to face a gradually more challenging environment in the coming years.** This reflects, in part, the pressures associated with the planned fiscal relaxation for 2007–09. Moreover, even if a more-flexible exchange rate policy succeeds in reducing arbitrage-related flows, capital inflows would likely remain substantial, not least through the equity market. For instance, the privatization of the electricity sector and the anticipated consolidation of the banking system are both expected to attract considerable foreign interest. In this regard, capital inflows pose a more difficult challenge for monetary policy than oil-related current account inflows, as the latter are for the most part automatically sterilized via the stabilization fund. Finally, whereas underlying inflation has been masked by slower increases in administered prices over the past two years, the government's commitment to raise domestic energy prices over 2008–11 suggests that administered prices will add to pressures on headline inflation. The estimated impact on annual inflation ranged from ½ to 1½ percentage points.

C. Financial Sector

29. **The rapid development of the financial sector is expected to continue.** CBR officials noted that the deepening of financial markets and the introduction of new financial products had improved the efficiency of financial intermediation and spurred economic growth. They believed that the financial sector would continue to expand rapidly and that current institutions, laws, and regulations governing the operation of the sector did not pose major obstacles in this regard. Market participants, however, raised some concerns that inconsistencies among different laws and different regulatory institutions were hampering development in some areas, e.g., in offering hedging instruments, including derivatives. But they agreed that these obstacles would not prevent a continued rapid expansion of the sector.

30. **Although CBR officials found the regulatory framework for prudential supervision to be broadly complete, they saw scope for strengthening the effectiveness of supervision.** Regulators were confident that banks had generally updated their risk-management systems to keep pace with the expansion of credit, but they felt the loan review practices could be strengthened further. Moreover, they were working to improve the evaluation of capital adequacy and obtain more accurate assessments of the financial soundness of individual banks. They were also exploring steps to clarify the responsibilities of the various agencies charged with overseeing the financial sector, and enhance the skills of banking supervisors to improve the capacity of prudential supervision.

31. **Despite some notable risks, CBR officials considered the likelihood of a systemic crisis to be low.** According to CBR stress testing, credit risk is significant and remains the most important risk to the system. Under the bank's less-severe scenario, combining effects of credit, market, and liquidity shocks, capital in the banking system would drop by 38.7 percent or 2.5 percent of GDP, while under the most severe scenario the capital reduction will be equal to 63.1 percent or 4.0 percent of GDP. Even under the more benign scenario, a large number of institutions will lose over 50 percent of their capital, suggesting substantial vulnerabilities in the financial system. However, the authorities stressed that neither scenario is likely to materialize in the near future because of the overall positive macroeconomic conditions. For a more-likely range of shocks, CBR officials found that banks are generally well capitalized and sufficiently provisioned. As profitability in the banking sector has also remained high, they considered the risk of a systemic crisis to be low, although periods of turmoil as in 2004 could not be ruled out.

32. **Staff welcomed the rapid development of the financial sector, but warned that the favorable external environment may be masking underlying vulnerabilities.** Noting that the rapid credit expansion by the banking system has resulted in declining capital-adequacy ratios and an increase in overdue loans in 2006, especially household loans, staff recommended close monitoring of banks with fast-growing or large household loan portfolios. It also cautioned that potentially significant vulnerabilities arise from the rapid increase in open positions, as banks have increasingly funded their ruble lending through borrowing in foreign currency, as well as from the large increase in banks' holdings of ruble-denominated corporate bonds. Staff noted that these vulnerabilities are heightened by the lack of access of many banks to either the interbank market or foreign funding, and by weaknesses in Russia's prudential framework and regulatory practices. While agreeing that there appears to be no major systemic risk, staff stressed that a more in-depth review of vulnerabilities should be a priority. The Financial Sector Assessment Program (FSAP) update that is now underway would provide an early opportunity for such a review.

D. Investment Climate, and Long-Term Growth Prospects

33. **There was agreement that the prospect of diminishing catch-up gains in productivity, and of a declining labor force, made the long-term growth potential particularly dependent on raising the low level of investment.** The authorities concurred with staff analysis showing that productivity gains have been the key engine of growth, with the combined contribution from labor force growth and capital accumulation accounting for less than half of GDP growth in recent years. It was also agreed that while there was scope for continued high catch-up gains in productivity going forward, as the reform agenda promises to further improve the allocation of existing factors of production, such gains would eventually wane as Russia's transition process matures. The authorities also noted that relatively adverse demographic factors, notably the comparatively low life expectancy and low birth rate, have caused the labor force to contract since 2006, further weighing on the long-term growth potential. In view of these considerations, there was agreement on the urgency of increasing Russia's still low level of investment, and on the need for economic policies to reinforce and strengthen the investment climate.

34. **The authorities were confident that recent changes in economic policy would boost investments and raise long-term growth.** In particular, the increase in government interventions in the economy over the next few years, in the context of the supplementary 2007 budget, would help overcome infrastructure bottlenecks and increase investments through public-private partnerships. Moreover, the funding of the long-dormant development bank and the introduction of the venture capital fund, special economic zones, and an institute for nanotechnology research would further promote economic diversification, not least by encouraging growth in areas where Russia had a potentially strong comparative advantage. The expanded role of government in this regard was needed because important market structures were still relatively weak, including the ability of financial markets to provide competitive, large-scale, long-term financing. In addition to these new initiatives, the government would continue to push ahead with structural reforms across a broad front. In particular, electricity sector reforms—involving separation of generation and transmission, and privatization—are now gaining significant momentum.

35. **Staff welcomed the emphasis on raising investments but stressed the importance of complementary reforms.** It noted that many important reforms were running behind schedule, and it urged a general reinvigoration of reforms after the forthcoming elections. It also noted that Russia scores low on cross-country comparisons of the business climate, with corruption and bureaucratic meddling the predominant complaint. This suggested that the authorities should give priority to long-delayed reforms of the public administration and the civil service. While acknowledging that investments have continued to increase, staff was concerned that the increased state control over the energy sector could reduce investors' willingness to undertake large-scale projects with a long gestation period. Noting that the poor performance of the state-controlled portion of the energy sector stands in stark contrast to the long-term performance of the privately controlled part, staff questioned whether the state was the best steward of this important sector. While agreeing that the long-term goal should clearly be to diversify the economy away from natural resources, staff argued that this sector provides Russia with a strong comparative advantage and that its resources can help spur growth if harnessed through the right policies.

36. **The authorities hope to complete WTO accession by early next year.** However, they explained that Russia has concluded most bilateral negotiations, but that a number of bilateral issues still remained to be resolved before multilateral discussions on accession can commence. Moreover, such discussions would have to cover issues like the level of agricultural support and enforcement of intellectual property rights. Staff urged early conclusion of the discussions, noting that Russia's increased integration into the global economy would spur further enterprise restructuring.

IV. Staff Appraisal

37. **Russia's macroeconomic performance continues to impress.** Much is owed to high oil prices and large capital inflows, but also to good economic management. Most important in view of the dependence on oil prices, the stabilization fund is providing a notable measure of stability, helping self-sustaining growth in the form of rising investments and a positive nexus of high growth in productivity, real wages, and consumption to take hold. The

acceleration in investments, even with receding oil prices and uncertainty relating to political transition, points to the robustness of investor sentiments at this time.

38. **Private demand is gathering additional momentum.** Restructuring, consolidation and privatization are gaining pace, powering a further acceleration in investment growth. This process is getting significant added impetus from the rapid development of the financial sector and the strong foreign appetite for Russian assets. Private consumption is also set to strengthen going forward, as the rapid development of markets for consumer credits and mortgages now provides households a newfound ability to consume against future income gains. With such a buoyancy in private demand, resource constraints are set to become more binding even with robust investment growth and impressive catch-up gains in productivity.

39. **Against this background, the planned fiscal relaxation risks causing overheating.** Raising the non-oil deficit by up to 3.2 percent of GDP in the next few years will provide an unhelpful fiscal stimulus considering that private demand is gaining further strength and that the economy is already growing at potential. This will increase inflationary pressures, entailing rapid, possibly excessive, nominal appreciation. In staff's view, increased spending of oil revenues should be delayed until demand pressures ease. Under the current outlook, this means that the non-oil deficit should not increase further during the remainder of 2007 and in 2008.

40. **The planned fiscal relaxation will also entail continued rapid real appreciation.** Faster real appreciation is the means through which buoyant private demand, not least investments in the tradable sector, will be forced to make room for the public sector's larger claim on scarce resources, if the government goes ahead with the plan to pass-through most of the remaining terms-of-trade gains in the form of higher government spending. Such a dampening of the private sector recovery would run counter to the objective of boosting growth that underlies the case for interventions in the economy.

41. **Margins of competitiveness are set to narrow further**. As yet, competitiveness is not a major concern, as the ruble is still undervalued and Russia enjoys a notable if narrowing degree of competitiveness. However, the authorities' fiscal plans, in combination with strong private demand, will largely eliminate the remaining undervaluation of the ruble. Downside risks in this regard arise from the possibility that catch-up gains in productivity—which have so far limited the loss of competitiveness in tradable sectors as surging demand for labor by nontradable sectors have pushed up wages—will begin to wane as demand-induced pressures continue to fuel appreciation and rapid wage growth. This points to the urgency of reinvigorating structural reforms in order to unlock further productivity gains. It also suggests that demand pressures over and above what is currently projected could begin to take a considerable toll on manufacturing growth and export diversification.

42. **In the context of narrowing freedom of action, additional fiscal relaxation would significantly increase risks of procyclical tightening and of the real exchange rate overshooting its long-term path.** There is little risk of a procyclical tightening now—large reserves and low indebtedness leave considerable scope for deficit financing. However, the rise in the balanced-budget oil price, from about \$30 per barrel last year to \$55–60 per barrel by 2009, illustrates the speed at which margins for maneuver are narrowing. The very fast

unwinding of the twin surpluses that is in store points to the risk of fiscally induced overshooting of the real exchange rate if above-trend oil prices make it difficult for the government to resist pressures for further relaxation over and above what was discussed with the mission.

43. **This points to the urgency of controlling expenditures.** The new framework for spending oil revenues is close to best practice for management of natural resource wealth. But its credibility is undermined by the large back-loaded spending cuts it assumes, not least considering that large transfers to the pension fund are needed to avoid a socially unacceptable drop in the replacement rate. In view of this, realizing significant expenditure savings in socially sensitive areas in 2010–11, the run-up to elections, will be difficult without a reinvigoration of efficiency-enhancing social sector reforms.

44. **Besides the risks of overheating, the planned interventions in the economy also raise questions about the efficiency of spending**. In some areas, the interventions go outside the normal purview of government. More generally, the limited progress with regard to public-administration and civil-service reforms, and Russia's low score in international comparisons of corruption and rent seeking, raise questions about the efficiency of large interventions. While there certainly is a case for government support of infrastructure and basic research, and while the authorities are seeking safeguards against waste, a more cautious approach to interventions in the economy has served Russia well in the past. The increasing dynamism of the private sector suggests that priority should be given to unlocking this sector's full potential by reducing government interference in the economy. Any scope for higher spending should primarily be directed toward improving infrastructure, overcoming problems in providing basic public services, and alleviating social problems associated with rapid economic transformation.

45. **Turning to monetary policy, the renewed policy of maintaining a stable exchange rate threatens to undo gains in reducing inflation.** The sharp increase in money growth in recent months as a result of record-high foreign exchange intervention is inconsistent with keeping inflation on track. Staff believes that the CBR should return to a policy of giving priority to inflation reduction, standing ready to allow appreciation as needed to keep inflation on target. In this regard, frequent changes in reserve requirements are not an effective substitute for a flexible exchange rate policy, as it tends to encourage disintermediation and discourage savings. To avoid entrenching inflation expectations, adopting a more flexible exchange rate policy is a matter of some urgency.

46. **Inconsistent exchange rate and inflation targets are fueling capital inflows.** Markets expect that the policy of resisting appreciation will eventually have to give way in order to keep control of inflation. This exacerbates capital inflows, further undermining control over money growth and inflation. By signaling that it will give priority to inflation reduction and allow appreciation if needed, the CBR would discourage speculative capital flows. However, much of the capital inflows are strategic in nature and so are relatively insensitive to monetary conditions. These flows are likely to increase in the coming years. To the extent that such inflows add to demand pressures, they are best offset through fiscal policy.

47. **The rapid development of the financial sector is much welcomed, but financial sector vulnerabilities are rising.** Competitive forces unleashed by access to international capital markets and entrance of foreign players are causing rapid deepening and broadening of financial markets. But the associated pace of credit growth will place a premium on effective supervision and prudential regulation. The rapid increase in banks' consumer lending, holding of ruble-denominated corporate bonds, and open foreign exchange positions should be kept under close review. Vulnerabilities continue to be heightened by the lack of access of many banks to the interbank market, and add urgency to the need to further strengthen Russia's prudential framework and regulatory practices. The Financial Sector Assessment Program update now underway with a joint Fund-Bank expert team will provide an opportunity for an early in-depth review of vulnerabilities and regulatory practices.

48. **Improving the investment climate is the main long-term challenge.** Despite the increases in recent years, the level of investments remains relatively low. Moreover, Russia scores poorly in international comparisons of the investment climate. The limited progress with regard to important reforms—not least, civil service, public administration, and legal reforms—has been of limited consequence so far because high oil prices and the still strong catch-up potential have entailed robust growth. To maintain such growth as the scope for catch-up gains begins to wane, it should be a priority for the new government coming into the office after the elections to reinvigorate such reforms.

49. **It is recommended that the next Article IV consultation take place on the standard 12-month cycle.**

Box 1. The Increasing Role of Financial Markets in Economic Growth

Russia's financial sector is expanding at a rapid clip. Measured by assets, the sector as a whole has increased to more than 150 percent of GDP as of end 2006.

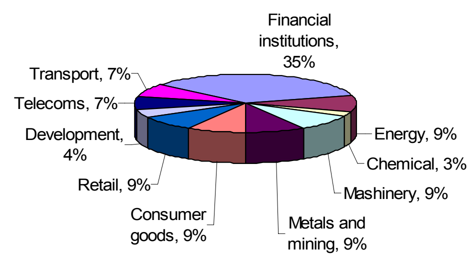
Russian Financial Markets 1/ (in percent of GDP, unless noted otherwise)	**2003**	**2004**	**2005**	**2006**
Banks				
Assets	42	42	45	52
Private credit	14	16	25	30
Household credit 1/	3	6	9	12
Stock market capitalization	38	33	53	102
Coporate bond market capitalization	1	2	3	4

Source: CBR, Finam, MICEX, RTS
1/ In percent of household income

The growing economic importance of the sector is reflected in the rising share of investment that is being financed with debt.

- The share of ***bank loans*** in investment grew steadily from 5 percent in 2003 to almost 9 percent in 2006, although the bulk of bank lending remains short-term (less than three years).
- The ***corporate bond market*** is expanding rapidly and financed 6–9 percent of investments in 2006, up from virtually nil in 2003. The supply of funds in the corporate bond market is driven by ample liquidity in the banking system, an expanding base of domestic institutional investors, and increasing foreign participation after the removal of all remaining capital controls in July 2006 and the acceptance of the ruble as a full settlement currency by the two major clearing and settlement systems. Demand is driven by competitive financing conditions. High-rated companies can generally issue bonds at interest rates and maturities that are more favorable than on commercial bank loans, while for lower rated companies that do not have access to bank financing the bond market is often their only source of external financing. The success of the corporate bond market is also reflected in the diversity of issuers, with retail trade, power generation, and metals and mining as the fastest growing sectors at present.

Corporate bonds by sector, 2007



Rapidly-growing household credit has supported the consumption boom.

- ***Household credit*** grew at an average rate of more than 100 percent a year, during the past three years, as banks rapidly increased their exposure to retail lending. Consumer credit expanded especially fast, reaching almost 12 percent of household income (16 percent of consumption) in 2006. Although growth in consumer credit has moderated somewhat recently, it is still growing at 75 percent year-on-year. Besides saturation in some market segments, the slowdown reflects in part that concerns about loan quality have caused a tightening of lending standards.
- ***The mortgage market*** remains small, financing only about 5 percent of all real estate transactions, and is mostly serving relatively high-income households. Nevertheless, the market is expanding steadily, supported by increasing competition among banks and recently introduced refinancing instruments.

Box 2. The Budget Framework—Issues and Recent Developments

The new budget framework entails the creation of a second oil fund, the introduction of three-year budgets, and steps towards performance budgeting. From 2008, the existing oil stabilization fund (OSF) will be capped at 10 percent of GDP. It will continue to be invested in highly liquid securities and serve as a buffer for the budget against a drop in the oil price. Once the OSF reaches 10 percent of GDP, additional oil revenues will be accumulated in a new National Welfare Fund which will invest in higher-yielding securities. The institutional arrangements for the management of these funds are currently being discussed. Another important innovation is the introduction of three-year rolling budgets for the federal government and the federal extrabudgetary funds, the first of which have already been adopted for 2008–10. Moreover, in a gradual move towards performance budgeting, the government has started to include performance indicators in the federal budget covering 70 percent of expenditure.

The changes could substantially improve demand management. A key innovation in this regard is the introduction of the concept of the non-oil balance, which will be capped at a deficit of 4.7 percent of GDP starting in 2011. Of this deficit, up to 3.7 percent of GDP may be financed from oil and gas revenues, which under the new framework will also encompass the extraction and export taxes on natural gas and oil products, while the cutoff price will be abolished. A remaining deficiency in the new framework is that the corporate income tax and dividend revenues from oil, as well as the extraction tax revenues accruing to the regional governments, will remain excluded from the stabilization fund mechanism and accrue to the budget as non-oil revenue. The envisaged transfer of oil revenue of 3.7 percent of GDP to the budget is consistent with the calculations of the optimal level of spending of oil and gas revenues based on an intergenerational framework discussed in Chapter I of the 2006 Selected Issues Paper.

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2003–08

	2003	2004	2005	2006	2007	2008
	Actual				Proj.	
	(Annual percent change)					
Production and prices						
Real GDP	7.3	7.2	6.4	6.7	7.0	6.8
Consumer prices						
Period average	13.7	10.9	12.7	9.7	7.7	7.5
End of period	12.0	11.7	10.9	9.0	8.0	7.0
GDP deflator	14.0	20.1	19.2	16.1	7.0	9.6
	(In percent of GDP)					
Public sector						
General government						
Overall balance	1.4	4.9	8.2	8.4	4.9	2.8
Revenue	36.3	36.6	39.7	39.7	36.5	34.6
Expenditures	34.8	31.7	31.6	31.3	31.5	31.8
Primary balance	3.1	6.1	9.1	9.2	5.5	3.3
Nonoil balance (in percent of GDP)	-3.9	-2.9	-4.6	-4.4	-5.3	-6.6
Federal government overall balance	1.7	4.3	7.5	7.4	4.7	2.5
	(Annual percent change)					
Money						
Base money	49.6	24.9	31.7	39.6	36.1	30.2
Ruble broad money	51.6	35.8	38.6	48.8	49.4	32.2
	(Annual percent change)					
External sector						
Export volumes	12.4	10.5	4.7	5.8	4.7	5.0
Oil	17.2	11.3	3.2	0.3	3.5	2.9
Gas	2.0	5.5	3.7	-2.5	-0.8	3.8
Non-energy	12.1	11.2	6.9	18.2	8.1	8.1
Import volumes	24.4	21.3	18.3	24.0	22.4	20.3
	(In billions of U.S. dollars; unless otherwise indicated)					
External sector						
Total merchandise exports, fob	135.9	183.2	243.8	303.9	315.2	332.6
Total merchandise imports, fob	-76.1	-97.4	-125.4	-164.7	-210.3	-249.2
External current account	35.4	59.0	83.8	94.5	61.7	42.8
External current account (in percent of GDP)	8.2	10.0	11.0	9.6	5.1	2.9
Gross international reserves						
In billions of U.S. dollars	76.9	124.5	182.2	303.7	431.8	524.4
In months of imports 1/	8.9	11.4	13.3	17.4	19.8	20.6
In percent of short-term debt	128	198	161	348	434	517
Memorandum items:						
Nominal GDP (in billions of U.S. dollars)	431	592	764	985	1,201	1,452
Exchange rate (rubles per U.S. dollar, period average)	30.7	28.8	28.3	27.2	...	...
World oil price (U.S. dollars per barrel, WEO)	28.9	37.8	53.4	64.3	60.8	64.8
Real effective exchange rate (average percent change)	3.0	7.8	8.7	9.5	9.9	8.1

Source: Russian authorities; and IMF staff estimates.

1/ In months of imports of goods and non-factor services.

Table 2. Russian Federation: Balance of Payments, 2003-08
(In billions of U.S. dollars, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008
					Proj.	
Current Account	35.4	59.0	83.8	94.5	61.7	42.8
Trade Balance	59.9	85.8	118.4	139.2	104.9	83.4
Exports	135.9	183.2	243.8	303.9	315.2	332.6
Non-energy	62.2	83.0	94.9	113.2	128.3	132.1
Energy	73.7	100.2	148.9	190.8	186.9	200.6
Oil	53.7	78.3	117.2	147.0	143.5	157.9
Gas	20.0	21.9	31.7	43.8	43.3	42.7
Imports	-76.1	-97.4	-125.4	-164.7	-210.3	-249.2
Services	-10.9	-13.4	-14.8	-14.9	-16.4	-14.3
Income	-13.2	-12.8	-18.8	-28.5	-24.4	-22.7
Public sector interest (net)	-2.7	-2.2	0.5	7.8	13.0	19.4
Other	-10.5	-10.6	-19.3	-36.3	-37.4	-42.1
Current transfers	-0.4	-0.7	-0.8	-1.3	-2.4	-3.6
Capital and financial account	2.1	-5.6	-10.7	13.1	66.4	49.8
Capital transfers	-1.0	-1.6	-12.8	0.2	0.2	0.2
Federal Government	-4.9	-2.4	-9.0	-28.0	-6.1	-8.3
Portfolio investment	-1.6	2.8	-1.6	-1.0	-4.7	-7.0
Loans	-1.8	-3.4	-18.3	-29.8	-1.4	-1.2
Of which:						
Disbursements	0.8	0.7	0.5	0.7	0.0	0.0
Amortization	-4.9	-4.9	-19.8	-26.5	-1.4	-1.2
Other investment	-1.5	-1.8	11.0	2.9	0.0	0.0
Local Governments	0.0	0.2	-0.3	0.2	0.3	0.2
Private sector capital	8.0	-1.8	11.3	40.7	72.0	57.6
Direct investment	-1.7	1.7	-0.8	10.8	3.7	11.7
Portfolio investment	-1.5	-0.9	-3.3	10.8	17.7	13.2
Commercial banks	10.9	4.6	7.9	24.1	23.3	24.4
Corporations	15.1	16.2	40.9	16.8	49.4	31.5
Other private capital	-14.7	-23.4	-33.5	-21.8	-22.2	-23.2
Errors and omissions, net	-9.7	-6.7	-8.8	1.1	0.0	0.0
Of which: valuation adjustment	-2.8	-2.4	3.8	-14.0	0.0	0.0
Overall balance	27.8	46.7	64.4	108.7	128.1	92.6
Financing	-27.8	-46.7	-64.4	-108.7	-128.1	-92.6
Net international reserves	-28.3	-46.9	-64.9	-107.5	-128.1	-92.6
Gross reserves (- increase)	-26.4	-45.2	-61.5	-107.5	-128.1	-92.6
Net Fund liabilities	-1.9	-1.7	-3.4	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	1.9	1.7	3.4	0.0	0.0	0.0
Arrears and rescheduling	0.5	0.2	0.6	-1.2	0.0	0.0
Memorandum items:						
Current account (in percent of GDP)	8.2	10.0	11.0	9.6	5.1	2.9
Gross reserves 1/	76.9	124.5	182.2	303.7	431.8	524.4
(in months of imports of GNFS)	8.9	11.4	13.3	17.4	19.8	20.6
(as a percent of short-term debt) 2/	128	198	161	348	434	517
(as a percent of public debt service)	594	371	550	3103	3710	7735
Net private capital outflows (in percent of trade)	0.8	3.0	-0.7	-8.9	-13.7	-9.9
World oil price ($barrel) (WEO)	28.9	37.8	53.4	64.3	60.8	64.8
Terms of trade (percent)	12.4	15.6	16.7	11.3	-5.1	2.0
Public external debt service payments 3/	16.9	13.0	33.5	33.1	9.8	11.6
(percent of exports of goods and services)	11.1	6.4	12.5	9.9	2.8	3.1
Public external debt	106.0	105.6	82.1	49.0	43.2	35.2
(percent of GDP)	24.6	17.8	10.7	5.0	3.6	2.4
Private external debt (incl local gov't)	80.0	108.9	175.1	260.7	375.2	469.4
Total external debt	186.0	214.5	257.2	309.7	418.4	504.5
(percent of GDP)	43.1	36.2	33.7	31.4	34.8	34.7

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

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

Table 3. Russian Federation: Indicators of External Vulnerability, 2003−06
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006
Financial indicators				
Public sector debt 1/	29.6	22.3	14.8	8.5
Broad money (percent change, 12-month basis)	51.6	35.8	38.6	48.8
Private sector credit (percent change, 12-month basis)	46.6	46.7	34.2	48.6
Moscow InterBank Actual Credit Rate (MIACR, from 8-30 days, percent p.a. for rouble credits)	5.5	4.9	3.9	4.1
Moscow InterBank Actual Credit Rate (MIACR, from 8-30 days, percent p.a. for rouble credits, real)	-8.1	-6.0	-8.8	-5.6
External Indicators				
Exports (percent change in US$)	25.8	33.8	31.9	24.5
Imports (percent change in US$)	22.2	27.1	25.7	27.3
Terms of Trade (percent change, 12 month basis)	12.4	15.6	16.7	11.3
Current account balance (in billions of US$)	35.4	59.0	83.8	94.5
Capital and financial account balance (in billions of US$)	2.1	-5.6	-10.7	13.1
o/w: Inward portfolio investment (debt securities etc.)	-2.3	4.4	-0.8	12.4
Other investment (loans, trade credits etc.)	5.4	-8.4	2.9	0.5
Gross official reserves (in billions of US$)	76.9	124.5	182.2	303.7
Liabilities to the Fund (in billions of US$)	5.0	3.5	0.0	0.0
Short-term foreign assets of the financial sector (in billions US$)	13.4	14.8	20.9	33.5
Short-term foreign liabilities of the financial sector (in billions US$)	9.1	9.1	9.8	20.7
Foreign currency exposure of the financial sector (in billions US$)	7.6	7.4	1.9	-12.1
Official reserves in months of imports GS	8.9	11.4	13.3	17.4
Ruble broad money to gross reserves	1.4	1.2	1.2	1.1
Total short term external debt to reserves	81.8	91.1	47.8	32.7
Total external debt (in billions of US$)	186.0	214.5	257.2	309.7
o/w: Public sector debt (in billions of US$)	106.0	105.6	82.1	49.0
Total external debt to exports GS (in percent)	122.2	105.4	95.8	92.7
External interest payments to exports GS	5.8	5.5	4.6	4.8
External amortization payments to exports GS	20.2	19.7	21.7	23.2
Exchange rate (per US$, period average)	30.7	28.8	28.3	27.2
REER depreciation (-) (12-month basis)	3.0	7.8	8.7	9.5
Financial Market Indicators				
Stock market index 2/	567.3	614.1	1125.6	1921.9
Foreign currency debt rating 3/	BB	BB+	BBB	BBB+
Spread of benchmark bonds (basis points, end of period) 4/	257.0	213.0	118.0	99.0

Source: Russian authorities; and IMF staff estimates.

1/ Gross debt of the general government.
2/ RTS index, end of period.
3/ S&P long-term foreign currency debt rating, eop.
4/ JPMorgan EMBIG Russia Sovereign Spread.

Table 4. Russian Federation: External Debt Sustainability Framework, 2002-12
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	44.1	43.1	36.2	33.7	31.4	**34.8**	**34.7**	**34.7**	**34.7**	**34.6**	**34.7**	**-2.5**
Change in external debt	-3.6	-1.0	-6.9	-2.6	-2.2	3.4	-0.1	0.0	0.0	-0.1	0.1	
Identified external debt-creating flows (4+8+9)	-13.8	-16.8	-22.2	-19.1	-18.2	-7.2	-5.7	-3.0	-0.6	1.1	2.3	
Current account deficit, excluding interest payments	-10.9	-10.3	-11.8	-12.6	-11.2	-6.9	-4.9	-2.3	-0.3	1.4	2.4	
Deficit in balance of goods and services	-10.6	-11.3	-12.2	-13.5	-12.6	-7.4	-4.8	-2.1	0.1	1.7	2.6	
Exports	35.0	35.3	34.4	35.1	33.9	29.2	25.8	22.4	20.1	18.4	17.1	
Imports	24.4	23.9	22.2	21.6	21.3	21.8	21.0	20.4	20.2	20.1	19.8	
Net non-debt creating capital inflows (negative)	0.0	0.2	-0.6	0.0	-1.1	-0.3	-0.8	-0.7	-0.6	-0.6	-0.5	
Automatic debt dynamics 1/	-2.9	-6.7	-9.8	-6.5	-5.9	0.0	0.0	0.0	0.3	0.3	0.4	
Contribution from nominal interest rate	2.5	2.0	1.9	1.6	1.6	1.8	2.0	2.0	2.0	2.0	2.1	
Contribution from real GDP growth	-2.0	-2.6	-2.3	-1.8	-1.7	-1.8	-2.0	-1.9	-1.8	-1.7	-1.7	
Contribution from price and exchange rate changes 2/	-3.4	-6.2	-9.4	-6.4	-5.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	10.2	15.8	15.4	16.5	16.0	10.6	5.6	2.9	0.6	-1.3	-2.2	
External debt-to-exports ratio (in percent)	126.0	122.2	105.4	95.8	92.7	119.4	134.9	154.9	172.8	188.0	202.5	
Gross external financing need (in billions of US dollars) 4/	12.9	10.3	7.7	4.4	20.9	25.5	56.6	95.3	142.9	195.9	240.6	
In percent of GDP	3.7	2.4	1.3	0.6	2.1	2.1	3.9	5.5	7.1	8.4	9.1	
Scenario with key variables at their historical averages 5/						**34.8**	**31.2**	**24.9**	**15.9**	**4.7**	**-7.6**	**0.0**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.7	7.3	7.2	6.4	6.7	7.0	6.8	6.6	5.9	5.7	5.5	
GDP deflator in US dollars (change in percent)	7.6	16.4	28.0	21.3	20.8	13.9	13.2	11.6	10.2	9.0	7.4	
Nominal external interest rate (in percent)	5.9	5.8	6.0	5.8	6.3	6.9	6.8	6.8	6.8	6.8	6.8	
Growth of exports (U.S. dollar terms, in percent)	6.7	25.8	33.7	31.9	24.5	4.8	6.7	3.6	4.5	5.4	5.6	
Growth of imports (U.S. dollar terms, in percent)	13.6	22.2	27.1	25.7	27.3	24.8	16.4	15.4	15.5	14.7	11.6	
Current account balance, excluding interest payments	10.9	10.3	11.8	12.6	11.2	6.9	4.9	2.3	0.3	-1.4	-2.4	
Net non-debt creating capital inflows	0.0	-0.2	0.6	0.0	1.1	0.3	0.8	0.7	0.6	0.6	0.5	

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,

ε = nominal appreciation (increase in dollar value of domestic currency), and α = 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/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 5. Russian Federation: Fiscal Operations, 2004-08
(In percent of GDP)

	2004	2005	2006	2007	2008
				Proj.	Proj.
General government					
Total revenue	36.6	39.7	39.7	36.5	34.6
Of which : Oil revenue	7.8	12.7	12.8	10.2	9.4
Tax revenue	34.1	37.6	36.9	34.1	32.2
Corporate profit tax	5.1	6.2	6.2	6.2	6.2
Personal income tax	3.4	3.3	3.5	3.5	3.5
VAT	6.3	6.8	5.6	7.3	6.3
Excises	1.4	1.2	1.0	1.0	1.0
Custom tariffs	5.0	7.5	8.4	6.9	6.4
Resource extraction tax	3.4	4.5	4.7	3.9	3.8
Social security taxes	7.3	5.4	4.1	3.3	3.2
Other	2.1	2.7	3.4	2.0	1.8
Non-tax revenue	2.5	2.1	2.8	2.4	2.4
Total expenditure	31.7	31.6	31.3	31.5	31.8
Interest	1.2	1.0	0.7	0.6	0.5
Non-interest	30.5	30.6	30.6	31.0	31.3
o/w Education	3.5	3.7	3.9	3.9	4.0
Health	2.2	2.6	4.0	4.1	4.1
Housing & communal services	1.7	2.2	2.4	2.4	2.4
Other social expenditure	6.7	6.2	8.4	8.5	8.6
Primary balance	6.1	9.1	9.2	5.5	3.3
Overall balance	4.9	8.2	8.4	4.9	2.8
Non-oil primary balance	-1.7	-3.6	-3.6	-4.7	-6.1
Non-oil overall balance	-2.9	-4.6	-4.4	-5.3	-6.6
Federal government					
Total revenue	20.1	23.7	23.4	22.7	21.1
Of which : Oil revenue	6.5	10.4	11.2	9.0	8.4
VAT	6.3	6.8	5.6	7.3	6.3
Excises	0.7	0.5	0.4	0.4	0.4
Corporate profit tax	1.2	1.7	1.9	1.7	1.7
Custom tariffs	5.0	7.5	8.4	6.9	6.4
Other revenue	6.9	7.1	7.1	6.3	6.3
Total expenditure	15.8	16.2	16.0	18.0	18.6
Interest	1.1	0.9	0.6	0.4	0.3
Non-interest	14.7	15.3	15.4	17.5	18.2
o/w Wages	3.0	3.2	3.2	3.5	3.7
Primary balance	5.4	8.4	8.1	5.2	2.9
Overall balance	4.3	7.5	7.4	4.7	2.5
Non-oil primary balance	-1.1	-2.0	-3.1	-3.8	-5.5
Non-oil overall balance	-2.2	-2.9	-3.8	-4.3	-5.9
Memorandum items:					
World oil price	37.8	53.4	64.3	60.8	64.8
Russian oil price	34.4	50.6	61.1	57.6	61.6
Russian oil price balancing the budget:					
General government	20.0	26.0	29.0	34.0	47.0
Federal government	17.5	21.5	26.0	31.0	44.0
General government debt	22.3	14.8	8.5	6.7	5.0
GDP (billions of rubles)	17,048	21,620	26,781	30,676	35,918

Sources: Russian authorities; and IMF staff estimates.

Table 6. Russian Federation: Federal Government Budget, 2006-10 1/
(In percent of GDP)

	2006		2007		2008		2009		2010	
	RevBud	Actual	RevBud	Proj.	Budget	Proj.	Budget	Proj.	Budget	Proj.
Revenue	22.7	23.4	22.9	22.7	19.0	21.1	18.8	20.8	18.1	20.2
o/w Oil revenue	…	11.2	…	9.0	6.8	8.4	5.9	7.2	5.2	6.2
Expenditures	16.3	16.0	20.3	18.0	18.8	18.6	18.8	20.6	18.1	19.9
Overall balance	6.4	7.4	2.6	4.7	0.2	2.5	0.0	0.2	0.0	0.3
Non-oil overall balance	…	-3.8	…	-4.3	-6.6	-5.9	-5.9	-7.0	-5.2	-6.0
Memorandum items:										
Oil Stabilization/Reserve Fund	…	8.7	…	12.4	10.0	10.0	10.0	10.0	10.0	10.0
National Welfare Fund	…	…	…	…	1.8	2.6	1.4	2.2	1.3	2.5
World oil price	…	64.3	…	60.8	…	64.8	…	64.5	…	64.3
Russian oil price	65.0	61.1	61.0	57.6	53.0	61.6	52.0	61.3	50.0	61.1
Russian oil price balancing the budget	…	26.0	…	31.0	…	44.0	…	62.0	…	62.0
GDP (billions of rubles)	27,220	26,781	30,670	30,676	35,000	35,918	39,690	41,882	44,800	48,466

Sources: Russian authorities; and IMF staff estimates.

1/ For differences between the authorities' and staff's projections, see footnote 2 of paragraph 18.

Table 7. Russian Federation: Monetary Accounts, 2004–08
(In billions of rubles, unless otherwise indicated)

	2004	2005	2006				2007		2008
	Dec.	Dec.	Mar.	June	Sept.	Dec.	Mar.	Dec.	Dec
								Proj.	Proj.
Monetary authorities									
Base money	1,746	2,299	2,172	2,511	2,706	3,208	3,082	4,368	5,688
Currency issued	1,670	2,195	2,061	2,387	2,566	3,062	2,943	4,128	5,369
Required reserves on ruble deposits	76	103	111	125	141	146	139	240	320
NIR 1/	3,358	5,245	5,857	6,974	7,361	7,998	8,867	11,371	13,808
Gross reserves	3,456	5,245	5,857	6,974	7,361	7,998	8,867	11,371	13,808
Gross liabilities	98	0	0	0	0	0	0	0	0
GIR (in billions of U.S. dollars)	*124.5*	*182.2*	*203.5*	*242.3*	*255.7*	*303.7*	*336.8*	*431.8*	*524.4*
NDA	-1,612	-2,946	-3,685	-4,463	-4,655	-4,789	-5,785	-7,003	-8,120
Net credit to enlarged government	-840	-2,221	-2,950	-3,463	-3,485	-3,696	-4,419	-3,763	-3,890
Net credit to federal government 2/	-692	-2,000	-2,567	-3,039	-3,008	-3,350	-3,853	-3,356	-3,388
CBR net ruble credit to the federal government 1/	-617	-1,643	-2,233	-2,643	-1,219	-752	-865	541	1,248
Foreign exchange credit	251	92	92	89	89	81	81	81	81
Ruble counterpart 2/	-326	-449	-425	-485	-1,878	-2,679	-3,069	-3,978	-4,717
CBR net credit to local government and EBFs	-148	-221	-383	-425	-477	-346	-566	-407	-502
CBR net credit to local government	-79	-115	-251	-277	-335	-212	-363	-293	-388
CBR net credit to extrabudgetary funds	-69	-106	-132	-147	-142	-134	-202	-114	-114
Net credit to banks	-585	-552	-468	-706	-712	-810	-1,055	-2,540	-3,179
Gross credit to banks	4	5	19	3	1	28	2	28	28
Gross liabilities to banks and deposits	-589	-557	-487	-709	-713	-838	-1,057	-2,568	-3,208
Of *which:* correspondent account balances	-480	-509	-319	-431	-444	-638	-518	-768	-895
Other items (net) 3/	-186	-174	-268	-293	-458	-283	-311	-699	-1,050
Monetary survey									
Broad money	5,298	7,224	7,440	8,390	8,998	10,152	10,921	14,701	19,081
Ruble broad money	4,363	6,046	6,169	7,092	7,758	8,996	9,413	13,440	17,767
Currency in circulation	1,535	2,009	1,929	2,233	2,401	2,785	2,741	3,840	4,985
Ruble deposits	2,829	4,036	4,241	4,859	5,357	6,211	6,671	9,600	12,782
Forex deposits 1/	935	1,178	1,271	1,298	1,241	1,156	1,508	1,261	1,314
Net foreign assets 1/	3,180	4,900	5,601	6,420	6,436	6,895	8,009	9,653	11,448
NIR of monetary authorities	3,358	5,245	5,857	6,974	7,361	7,998	8,867	11,371	13,808
NFA of commercial banks	-177	-345	-257	-554	-925	-1,102	-858	-1,717	-2,359
In billions of U.S. dollars	*-6.4*	*-12.0*	*-8.9*	*-19.2*	*-32.1*	*-41.9*	*-32.6*	*-65.2*	*-89.6*
NDA	2,118	2,324	1,840	1,970	2,563	3,257	2,912	5,048	7,633
Domestic credit	3,974	4,107	3,836	4,013	4,781	5,471	5,447	8,076	11,012
Net credit to general government	-386	-1,743	-2,471	-3,044	-3,109	-3,221	-4,028	-3,288	-3,415
Net credit to federal government	-231	-1,489	-2,015	-2,475	-2,444	-2,777	-3,262	-2,783	-2,814
Net credit to local government and EBFs	-155	-254	-455	-569	-664	-444	-766	-506	-601
Credit to the economy	4,360	5,851	6,307	7,057	7,889	8,692	9,475	11,365	14,427
Other items (net)	-1,856	-1,784	-1,997	-2,043	-2,218	-2,214	-2,534	-3,029	-3,379
Memorandum items:									
Nominal GDP (in billions of rubles)	16,966	21,598	...	...	...	26,781	...	30,676	35,918
CPI inflation (eop, 12-month change)	11.7	10.9	10.7	9.0	9.5	9.0	7.4	8.0	7.0
Ruble broad money velocity	4.5	4.2	3.7	3.6	3.7	3.4	2.8	2.6	2.3
Annual change in velocity	-1.7	-7.2	-16	-19	-11	-19.7	-24.5	-23.3	-11.4
Real ruble broad money (rel. to CPI, 12-month change)	21.6	24.9	24.5	32.1	33.9	36.5	42.1	38.3	22.4
Nominal ruble broad money (12-month change)	35.8	38.6	37.9	43.9	46.6	48.8	52.6	49.4	32.2
Base money (12-month change) 4/	24.9	31.7	30.6	36.2	38.7	39.6	41.9	36.1	30.2
Real credit to the economy (12-month change)	31.4	21.0	29.2	33.6	35.5	36.3	39.9	21.1	17.5
Ruble broad money multiplier	2.5	2.6	2.8	2.8	2.9	2.8	3.1	3.1	3.1
Real exchange rate (average annual change) 5/	7.8	8.7	...	...	...	9.5	...	9.9	8.1

Sources: Russian authorities; and Fund staff estimates.

1/ Data calculated at accounting exchange rates.

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

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

4/ The increase in the multiplier in 2004 includes a reduction in reserve requirements from 7 to 3.5 percent in July 2004.

5/ Historical data from IFS. A positive number implies real effective appreciation.

Table 8. Russian Federation: Financial Soundness Indicators, 2002-07 1/
(In percent)

	2002	2003	2004	2005	2006	2007 2/
Capital						
Regulatory capital to risk-weighted assets	19.1	19.1	17.0	16.0	14.9	16.2
Regulatory capital to risk-weighted assets (Top 30)	19.7	16.8	15.9	15.1		
Asset quality						
Nonperforming loans to total gross loans	5.6	5.0	3.8	3.2	2.6	2.4
Sectoral exposures						
Sectoral distribution of loans to total loans						
Industry	36.7	33.3	28.0	22.1	20.5	19.4
Manufacturing	...	...	...	16.3	14.6	14.6
Extraction	...	...	...	3.5	3.9	3.0
Utilities	...	...	...	2.3	2.0	1.8
Agriculture	2.2	2.4	2.7	3.0	3.6	3.6
Construction	4.4	4.4	4.5	4.6	4.9	5.4
Trade and restaurants	21.6	20.6	18.8	23.9	19.6	20.2
Transport and communication	4.6	5.1	4.8	4.0	3.7	3.6
Others	22.4	22.7	24.9	22.8	21.3	21.6
Individuals	8.0	11.5	16.2	19.6	23.9	23.8
Regions						
Russia	41.1	54.2	54.0	47.4	35.9	32.5
U.K.	23.4	9.0	6.6	13.0	21.5	24.5
U.S.	6.2	8.2	6.7	9.0	7.7	5.0
Germany	5.9	2.4	7.2	9.5	7.9	8.2
Austria	5.7	6.8	6.1	5.2	7.0	5.6
France	1.5	1.6	3.1	3.0	3.8	3.2
Italy	1.6	1.0	1.8	1.2	1.2	4.1
Others	14.5	16.8	14.5	11.7	15.0	16.8
Profitability						
Return on assets	2.6	2.6	2.9	3.2	3.2	0.8
Return on equity	18.0	17.8	20.3	24.2	26.3	6.6
Liquidity						
Liquid assets to total assets	39.1	36.1	30.3	27.3	26.7	28.9
Liquid assets to short-term liabilities	90.6	90.4	78.0	73.8	76.8	80.3
Market risk						
Net open position in foreign exchange to capital	18.5	8.4	5.8	5.8	5.3	3.5
Other FSIs						
Loan loss reserves to total gross loans	6.3	5.9	5.3	5.0	4.1	3.9
Large exposures to capital	228.6	241.0	242.8	239.8	240.6	208.4
Interest rate risk to capital	6.9	9.9	13.3	13.3	19.3	18.2
Net open position in equities to capital	11.7	12.4	12.6	14.4	20.4	16.7
Customer deposits to total (noninterbank) loans	24.8	27.1	27.7	28.3	27.0	...
Assets to GDP	38.3	42.3	42.1	45.1	52.8	...

Source: Central Bank of Russia.

1/ Credit and depository institutions.

2/ Data as of April 2007.

Table 9. Russian Federation: Macroeconomic Framework, 2004-12
(In percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
						Projections			
I. Savings-Investment balances									
General Government									
Revenues minus Transfers, *of which*	23.6	26.5	28.6	27.0	25.8	24.5	24.3	23.7	23.0
Transfers	13.0	13.2	11.2	9.5	8.8	9.2	8.8	8.3	8.5
Net income from abroad	-0.4	0.1	0.8	1.1	1.3	1.4	1.4	1.3	1.1
Consumption	16.7	16.6	17.5	18.5	18.8	19.3	19.2	18.9	18.6
National savings	6.9	9.9	11.0	8.5	7.0	5.2	5.2	4.8	4.4
Gross investment	2.0	1.7	2.6	3.6	4.2	4.9	4.8	4.3	4.4
National savings - investment	4.9	8.2	8.4	4.9	2.8	0.3	0.4	0.5	0.0
Private Sector									
Consumption	49.3	49.2	48.2	51.5	53.4	55.3	57.3	58.9	60.0
Net income from abroad	-1.9	-2.6	-3.8	-3.3	-3.1	-3.1	-3.1	-3.0	-3.0
National savings	24.0	21.2	18.8	18.1	17.9	17.6	15.9	14.9	14.5
Gross investment	18.9	18.4	17.6	17.9	17.7	17.5	18.0	18.8	19.0
National savings - investment	5.1	2.8	1.2	0.2	0.1	0.1	-2.1	-3.9	-4.5
Overall Economy									
Consumption	66.9	66.4	66.3	70.4	72.7	75.0	76.8	78.2	78.8
Net income from abroad	-2.3	-2.6	-3.0	-2.2	-1.8	-1.7	-1.7	-1.7	-1.9
National savings	30.8	31.1	29.8	26.6	24.9	22.8	21.1	19.7	19.0
Gross investment	20.9	20.1	20.2	21.5	21.9	22.4	22.8	23.1	23.5
National savings - investment (current account)	10.0	11.0	9.6	5.1	2.9	0.3	-1.8	-3.4	-4.5
II. General government accounts									
Revenues	36.6	39.7	39.7	36.5	34.6	33.7	33.2	32.0	31.5
Expenditure	31.7	31.6	31.3	31.5	31.8	33.4	32.8	31.5	31.5
Noninterest expenditure	30.6	30.6	30.7	31.1	31.5	33.2	32.6	31.3	31.4
Overall balance	4.9	8.2	8.4	4.9	2.8	0.3	0.4	0.5	0.0
Primary balance	6.0	9.1	9.1	5.4	3.1	0.6	0.6	0.7	0.1
III. Balance of payments and external debt									
External current account	59.0	83.8	94.5	61.7	42.8	6.0	-35.3	-79.6	-118.7
In percent of GDP	10.0	11.0	9.6	5.1	2.9	0.3	-1.8	-3.4	-4.5
Change in external terms of trade (in percent)	15.6	16.7	11.3	-5.1	2.0	-1.5	-1.3	-1.8	-1.9
Change in Russian crude oil price (in percent)	26.5	47.1	20.8	-5.8	6.9	-0.4	-0.4	-0.8	-0.8
Official reserves	124.5	182.2	303.7	431.8	524.4	587.5	612.6	594.7	542.6
In months of imports	11.4	13.3	17.4	19.8	20.6	20.0	18.1	15.3	12.5
Public external debt service / exports of goods and services (in percent)	6.4	12.5	9.9	2.8	3.1	1.8	1.5	1.8	1.2
IV. Growth and prices									
Real GDP growth	7.2	6.4	6.7	7.0	6.8	6.6	5.9	5.7	5.5
CPI inflation, end of period	11.7	10.9	9.0	8.0	7.0	7.0	7.0	6.5	6.0
CPI inflation, average	10.9	12.7	9.7	7.7	7.5	7.0	7.0	6.7	6.2
Change in GDP deflator, average	20.1	19.2	16.1	7.0	9.6	9.4	9.3	8.5	7.5
Nominal GDP (billions of U.S. dollars)	592	764	985	1,201	1,452	1,728	2,016	2,321	2,631
Real effective exchange rate, average change	7.8	8.7	9.5	9.9	8.1	6.5	5.3	4.5	3.5

Source: Russian authorities; and IMF staff estimates.

Table 10. Russian Federation: Public Sector Debt Sustainability Framework, 2002-12
(In percent of GDP, unless otherwise indicated)

	Actual					Projection					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Baseline: Public sector debt 1/	35.4	29.6	22.3	14.8	8.5	**6.7**	**5.0**	**4.1**	**3.4**	**2.8**	**2.6**
o/w foreign-currency denominated	30.2	24.6	17.8	10.7	5.0	3.6	2.4	1.8	1.4	1.0	0.8
Change in public sector debt	-6.5	-5.8	-7.3	-7.5	-6.3	-1.8	-1.6	-0.9	-0.7	-0.6	-0.2
Identified debt-creating flows	-6.3	-9.8	-12.7	-12.3	-12.0	-6.3	-3.8	-1.0	-0.9	-0.9	-0.3
Primary deficit	-2.8	-3.1	-6.1	-9.1	-9.2	-5.5	-3.3	-0.7	-0.7	-0.8	-0.3
Revenue and grants	37.0	36.3	36.6	39.7	39.7	36.5	34.6	33.7	33.2	32.0	31.5
Primary (noninterest) expenditure	34.1	33.1	30.5	30.6	30.6	31.0	31.3	33.0	32.4	31.2	31.2
Automatic debt dynamics 2/	-3.5	-6.7	-6.6	-3.2	-2.9	-0.8	-0.5	-0.3	-0.2	-0.1	0.0
Contribution from interest rate/growth differential 3/	-5.2	-4.8	-5.4	-3.8	-2.1	-0.5	-0.5	-0.3	-0.2	-0.1	0.0
Of which contribution from real interest rate	-3.6	-2.6	-3.7	-2.6	-1.3	0.0	-0.1	0.0	0.0	0.1	0.1
Of which contribution from real GDP growth	-1.6	-2.1	-1.7	-1.1	-0.8	-0.5	-0.4	-0.3	-0.2	-0.2	-0.1
Contribution from exchange rate depreciation 4/	1.7	-1.9	-1.2	0.5	-0.8	-0.3	0.0	0.0	0.0	0.0	0.0
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
Residual, including asset changes 5/	-0.2	4.0	5.4	4.8	5.7	4.5	2.2	0.1	0.2	0.3	0.1
Public sector debt-to-revenue ratio 1/	95.8	81.5	60.9	37.3	21.3	18.3	14.5	12.2	10.2	8.6	8.2
Gross financing need 6/	1.5	1.3	-3.7	-6.9	-7.6	-4.1	-1.9	0.1	-0.1	-0.2	0.3
In billions of U.S. dollars	5.2	5.6	-22.1	-53.0	-74.9	-49.6	-27.7	1.2	-1.3	-5.4	7.1
Stress tests for public sector debt											
Scenario with key variables at their historical averages 7/						**9.3**	**8.0**	**4.7**	**2.2**	**0.3**	**-1.5**
Scenario with no policy change (constant primary balance) in 2007-12						**6.7**	**2.7**	**-2.9**	**-8.0**	**-12.9**	**-18.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	4.7	7.3	7.2	6.4	6.7	7.0	6.8	6.6	5.9	5.7	5.5
Average nominal interest rate on public debt (in percent) 8/	6.1	5.8	5.2	5.5	6.2	7.9	8.4	9.3	9.9	10.7	12.4
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-5.2	7.9	6.1	-3.6	9.3	…	…	…	…	…	…
Inflation rate (GDP deflator, in percent)	15.7	14.0	20.1	19.2	16.1	7.0	9.6	9.4	9.3	8.5	7.5
Growth of real primary spending (deflated by GDP deflator, in percent)	15.3	4.2	-1.3	6.7	6.6	8.4	8.1	12.3	4.1	1.6	5.6
Primary deficit	-2.8	-3.1	-6.1	-9.1	-9.2	-5.5	-3.3	-0.7	-0.7	-0.8	-0.3

1/ General government gross debt.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = 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 - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.

INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the European Department

July 13, 2007

Contents Page

APPENDIX I. RUSSIAN FEDERATION: FUND RELATIONS
(As of May 31, 2007)

- Article IV consultation discussions were held in Moscow during May 14–25, 2007. The mission met with Deputy Prime Minister Zhukov, Minister of Finance Kudrin, Central Bank of Russia Deputy Governor Ulyukaev, other senior officials, members of the Duma, representatives of the business and academic communities, and the press.

- The staff team comprised Mr. Thomsen (head), Messrs. Takizawa, Tiffin, and Zebregs, Ms. Ivaschenko (all EUR), Mr. Hauner (FAD), and Mr. Sadikov (PDR), and was assisted by Mr. Mates (Moscow Office). Mr. Mozhin, Executive Director for Russia, participated in the discussions.

- During the last Article IV Consultation discussions, concluded on October 18, 2006, Directors commended the strong performance of the Russian economy. However, in light of the buoyancy of demand and still strong inflationary pressures, they recommended that fiscal policy not be loosened further. They welcomed the improved inflation performance, but cautioned that more exchange rate flexibility would be needed for the progress to be consolidated. Stressing that long-run growth prospects depended on accelerating the implementation of structural reforms and strengthening the investment climate, directors were concerned about the slow pace of reforms.

- Russia has accepted the obligations of Article VIII, Sections 2, 3, and 4. The restriction on current account transactions identified at the time of the 2005 Article IV consultation has been removed as part of Russia's liberalization of the capital account. Russia, therefore, maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

- Russia's statistical database is adequate for surveillance, albeit with some shortcomings (Appendix III). Russia subscribed to the SDDS in January 2005.

- Russia's exchange rate regime is a managed float with the central bank intervening heavily in the foreign exchange market to limit nominal appreciation of the ruble.

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	5,708.96	96.02
Reserve position	236.46	3.98

III. **SDR Department**:	**SDR Million**	**Percent of Allocation**
Holdings	4.85	n.a.

IV. **Outstanding Purchases and Loans**: None

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-by	07/28/99	12/27/00	3,300.00	471.43
EFF	03/26/96	03/26/99	6,305.57	1,443.45
of which SRF	07/20/98	03/26/99	3,992.47	675.02
EFF	03/26/96	03/26/99	6,901.00	4,336.26

VI. **Projected Obligations to Fund**: None

VII. **Implementation of HIPC Initiative:** Not Applicable

VIII. **Implementation of MDRI Assistance:** Not Applicable

IX. **Exchange Arrangements**: Managed float with no pre-determined path for the exchange rate. 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 previously identified restriction arising from the reserve deposit requirement for the payment of commission or expenses related to the purchase of external securities acquired through R2 accounts has been lifted.

X. **Article IV Consultation**: Russia is on the standard 12-month consultation cycle. The last consultation was concluded on October 18, 2006.

XI. **FSAP Participation and ROSCs**

Russia participated in the Financial Sector Assessment Program during 2002, and the FSSA report was discussed by the Board in May 2003, at the time of the 2003 Article IV discussion (IMF Country Report No. 03/147). An MFD TA mission on key monetary, banking, and related issues took place in April 2004. An FSAP Update is scheduled for 2007. The first visit took place in May 2007. The second visit is scheduled for the fall 2007.

A Fiscal Transparency ROSC mission, headed by Peter Heller (FAD), visited Moscow in July 2003, and a new Data ROSC module was undertaken by a mission in October 2003, led by Armida San Jose (STA).

XII. **Resident Representatives**:

Mr. Neven Mates, Senior Resident Representative, since October 1, 2004.

APPENDIX II. RUSSIAN FEDERATION: RELATIONS WITH THE WORLD BANK GROUP

1. World Bank Group activities in Russia are guided by the recent three-year Country Partnership Strategy (FY07-09) which was endorsed by the Bank's Board in December 2006. The CPS reflects a strong commitment by both the World Bank Group and the Russian government to continue a close and productive relationship that is suitable to Russia's new conditions. While the federal government no longer needs the financial support of the World Bank, it still values highly World Bank knowledge, experience, and project management skills. New borrowing by the federal government will be limited over the period of this CPS, whereas the use of guarantees, sub-national borrowing and new fee-for-service arrangements for investment and policy advice are likely to grow. Given substantial developmental challenges in a large number of Russian regions, the federal government has encouraged the Bank Group to deepen its direct involvement in the regions. Correspondingly, a central theme of the CPS is the focus of Bank Group activities in select regions, including economic analysis (growth and business environment diagnostics), regional development strategies, and related investment projects. IFC and MIGA operations will remain substantial (Russia is IFC's and MIGA's largest exposure). The successful full transition to new modalities of cooperation with the Russian government will involve increased coordination among IBRD, IFC and MIGA.

2. The CPS envisions a partnership with the Russian government for the realization of four primary objectives: (a) sustaining rapid growth, (b) improving public sector management and performance, (c) improving the delivery of social services, and (d) enhancing Russia's global role. The first three pillars correspond closely to the pillars of the previous Country Assistance Strategy (CAS), and channel support directly toward the development challenges and policies elaborated in the government's Medium-Term Economic Program, with a particular focus on the regions. The fourth pillar forms the basis for a new area of assistance, and concerns Russia's integration in the world economy and donor community**.**

Major areas of Bank Group activities by CPS strategic pillars

(a) Sustaining rapid growth

3. The World Bank Group will assist Russia in various ways in meeting the challenges of sustaining rapid growth, including participation in macro-policy debates, monitoring the investment climate, supporting public investment and PPPs for growth and diversification, working with regions to identify and overcome barriers to growth, supporting investments in priority areas at the regional level, and providing direct assistance to the private sector:

- *Macroeconomic policy and the effective management of Russia's large external inflows:* The Bank will contribute to the macro-policy debate in Russia through the periodic Russian Economic Report, on-demand policy notes and knowledge sharing. Advisory services can include training and impact monitoring activities related to WTO accession. In addition, there is strong interest in the Bank's technical assistance in advising on alternative uses for the windfall oil revenues, including the development of an institutional framework for the effective management of a growing diversified portfolio of foreign assets. The World Bank Treasury has experience and expertise that can be valuable to Russia in this area and has held initial discussions with the authorities on possible support.

- *Investment climate monitoring and policy advice*: The Bank will continue periodic business environment and economic productivity (BEEPS) surveys, regional investment climate assessments, and administrative barriers studies undertaken by FIAS for interested regions. The Bank and MIGA can work at the regional level on capacity building and the development of investment promotion programs for attracting FDI, similar to the initiative currently underway in Rostov Region. WBI will continue capacity-building activities related to investment climate assessments.

- *Supporting Government investment and public-private partnerships (PPPs) for growth and diversification:* Two proposed projects in support of developing Special Economic Zones and IT Parks (both in FY07) have the goal of promoting the diversification and the agglomeration of economic activities in Russia. A microfinance infrastructure development project (FY08) focuses on financial cooperatives and their integration into the financial system of the country. On-going investment projects support land registration and the development of a national cadastre for securing property rights and the development of land markets. Possible partial risk guarantees of the Bank to the power sector could help attract investment to the electricity sector for modernization and substantial increases in capacity. And another partial risk guarantee instrument may be used to support the construction of an aluminum complex (SUAL) in Russia's Komi Republic, possibly alongside an IFC investment. In addition, regular and reimbursable TAs will support development of PPPs across sectors.

- *Working with regions to identify engines of growth, develop growth strategies, and remove barriers to growth*: The Bank will prepare a Country Economic Memorandum focused on relieving barriers to growth at the sub-national level and on questions of regional agglomerations. The development of fee-for-service arrangements with the regions would provide another avenue for supporting preparation of regional investment strategies and growth analyses, and provision of other analytical services.

- *Supporting investments in priority areas at the regional level*: The IFC/Bank Sub-National Development Program will support priority regional public investments. The government is interested in developing this financing mechanism further, as it involves direct lending to well-performing regions and municipalities without sovereign guarantees. One to three such sub-national operations per year are contemplated over the CPS. Infrastructure is also an important area of IFC investments. This concerns primarily transport and logistics, but also includes municipal infrastructure. MIGA can play a role in supporting foreign direct investment in infrastructure at the sub-sovereign level, including in the water and solid waste sectors.

- *Providing direct support to the private sector:* IFC will continue to support Russia's private sector growth agenda through a combination of financial and advisory services to promote the growth of the private sector and the diversification of the Russian economy. IFC will finance projects (1) with important spill-over effects to other companies, such as infrastructure and financial markets, (2) in sectors where Russia may have a comparative advantage, for example the processing of natural resources and those that promote the knowledge economy, and (3) those increasing the range and quality of products and services available in the Russian market, particularly outside of Moscow. Much of IFC's activities will remain concentrated in the financial sector, where priorities will be: (i) building long-term relationships with medium-sized independent private regional banks, so as to increase competition and the range of services available to the population. IFC financing, provided in the form of long-term senior loans and, in selected cases, subordinated loans, will help to strengthen the banks' balance sheets, reach new clients (including SMEs), attract more depositors, and consolidate their position as leading regional banks; (ii) supporting the introduction of specialized banking products, including mortgage financing, consumer finance and leasing; (iii) supporting the process of privatization of state-owned banks, as and when requested by the Russian Government; and (iv) supporting development and use of new financial instruments, such as partial guarantees of local currency bonds and securitization.

- *Continuing IFC advisory work through the Private Enterprise Partnership and FIAS:* This technical assistance will address the following objectives: (a) increasing the development impact of investments through strengthening local suppliers and engaging in community development work around large investments; (b) building the capacity of private banks to deliver new product lines, such as mortgage finance and financing for energy efficiency; and (c) improving corporate governance and environmental sustainability through work with banks and real sector clients, including IFC investees. FIAS will continue to work with select regions to improve the business climate by assisting in implementation of policies/instruments to kick-start functioning markets of land and commercial real estate.

- *MIGA will continue to support foreign investors through the provision of political risk guarantees:* Supporting foreign investment in infrastructure, in close coordination with the Bank, will remain an important area of MIGA's activity in

Russia. In the financial sector, the Agency will continue to explore opportunities to support capital markets transactions, including asset-backed securitizations. MIGA may also continue to promote the role and assist in the expansion of foreign banks in the Russian banking sector. Areas for potential further involvement in Russia include the manufacturing, agribusiness and services sectors.

(b) Improving public sector management and performance

4. Public sector management has been a particular area of strength of World Bank work in Russia, which will be further deepened in coming years. The Bank will remain engaged in supporting programs for modernizing selected public sector institutions, improving government administration, the judiciary, local self-government, and budgetary management at federal and sub-national levels. The Bank will expand its engagement in regions in these areas, in accordance with the federal priority for improving public sector performance at the sub-national level.

- *Modernizing selected public sector institutions:* The completion of on-going projects, together with a new project in the pipeline, will contribute to the modernization of public institutions and improved public services. These include tax modernization, customs development, cadastre and registration, fiscal federalism, performance-based budgeting, treasury development, and a statistical development project (FY08).

- *Supporting the government program in administrative reform:* The Bank will continue its close engagement with the government in the area of administrative reform at the federal and sub-national levels, including the coordination and implementation of substantial donor funds. The primary goal will continue to be bringing Bank and international expertise to bear on the implementation of the government's program for administrative reform, which currently places a strong emphasis on encouraging initiatives at the sub-national level. So far, the Bank has concentrated sub-national work in the Southern Federal Okrug and regions in the North-West. A possible project could be also developed to promote administrative reform in lagging regions.

- *Stepping up engagement on judicial reform:* Assistance on judicial reform also involves the coordination of donor funds and special cooperation at the regional level. A recently approved project supports judicial reform (FY07) with a focus on improving dispute resolution, the enforcement of laws, and the transparency of information.

- *Support for budgetary reforms:* The Bank will continue to respond to the demands of the federal and some regional governments for assistance in budgetary reform and the development of performance-based budgeting. In addition, the Bank will remain a partner to the government in the continued scaling up of the Fiscal Federalism Project (now financed by the Russian government) and its expansion to the municipal level.

- *Supporting the reform of local self-government:* The Bank will continue its dialogue with the government in this area, and in brining international experience to bear on this vital area of reform in Russia. A study has been launched for monitoring and assisting the development of local-self government in rural areas in the Perm, Penza, and Adygeya regions. The Bank will seek to engage directly with regions and municipalities in this area on the basis of new modalities, including a discussion of replicating the positive experience of the Fiscal Federalism Project model for building capacity at the municipal level.

- *Investments in municipal development:* On-going and possible future regional projects have significance for overall municipal development and the quality of municipal services. This includes the current Kazan and Saint Petersburg municipal development projects, a housing and communal services project under preparation (FY08, also see below), and possible regional projects on water and heating system upgrades.

- *Supporting anti-corruption initiatives:* As a coherent national-level anti-corruption program may begin to take shape, the Bank will explore avenues of possible constructive contributions to such anti-corruption initiatives.

(c) Improving the delivery of social and communal services

5. In addition to continued general cooperation with the federal government, the Bank will concentrate much of its support for improving social service delivery at the sub-national level. The Government has prioritized the social sector and social services in its medium-term program. Given that the primary responsibilities and initiatives for reform in these services will be at the sub-national level, the Bank will concentrate its focus on the regions. Main activities include the continuation of work in the areas of poverty, education, and health in cooperation with the regions. Additional activities include the monitoring of social trends and service delivery quality (joint with USAID) and special employment-related activities in the Southern Federal Okrug (the development of decentralized employment services, and labor integration of youth). Another critical area for improving living standards is provision of housing and communal services. The government places high importance on improving the performance of the housing and communal services (HCS) sector and on the delivery of high quality services by communal enterprises, and closely links service provision with improving the quality of life.

- *Continuation of the poverty work:* In addition to continued cooperation with Rosstat and federal ministries, the emphasis of the Bank poverty work (in cooperation with DFID) has moved to the regional level. The Bank is working, and will continue to work, directly with regions on monitoring poverty and improving social assistance programs, including labor market policies. Regional social protection strategies for Tver, Tomsk, Kalmykia and three other regions will be developed with Bank assistance. Successful models of cooperation can be scaled up to similar regions.

- *Improving the health of the population:* The Bank will continue its engagement with the government on adult health, and the development of a national strategy to improve the health of the population, with the goal of reversing the strongly negative trends in premature mortality and morbidity. As a follow up to earlier child welfare efforts and jointly with international donors the Bank will assist in design and implementation of practical mechanism for family support, preventive social welfare and child care at federal and regional level. Additional advocacy, public awareness and information sharing efforts jointly with government leaders, public figures, private sector and NGOs will be undertaken in support of critically needed government policies in this area. Another priority is to advise federal and regional authorities on appropriate risk pooling, insurance, and sustainable health financing. IFC will continue working with private companies on programs for occupational health, including HIV-AIDS issues. The Bank will implement on-going projects in the health sector and offer to scale up or modify existing models at the sub-national level as a service to regions. The development of public-private partnerships in the health sector could be supported jointly by TA from the Bank and direct financing by IFC to PPPs and/or purely private providers. Lessons from the TB/AIDS project could be applied through more focused interventions in interested regions through sub-national projects and TA. A few regional projects could be supported for removing environmental hotspots and addressing other environmental concerns posing major health risks to population.

- *Modernization and improvement of the education system and vocational training:* The Bank will complete current projects in education designed to modernize the system and improve vocational training. As is the case of health, the Bank will seek to meet demands of regions for special support at the sub-national level for education reform. Regional TA and possible projects could focus on improving systems for professional and vocational education, accompanied by parallel assessments of local labor markets with an eye to improving the quality of local professional labor supply. The recently completed Youth Strategy by the Bank provides recommendations for improvements in youth policies, with possible applications to Russia for forwarding the dialogue on youth policies in the area of education and training.

- *Improvement in the provision of housing and communal services:* The Bank's support in the infrastructure sector will largely focus on improving quality of utility services and housing. The Bank has a large portfolio focused on improving heating, water, electricity, and other municipal services in selected regions. This includes the current Kazan and Saint Petersburg municipal development, municipal heating, municipal water and electricity reform projects. A housing and communal services project (FY08) in support of reforms and investments in HCS on grant basis allocated to regions on a competitive basis, and an electricity generation guarantee (FY08) will continue Bank efforts on improving quality of utilities and housing services. Also, a large share of sub-national lending is expected to focus on improving these services.

- *Housing finance and energy efficiency through IFC's PEP program:* IFC's PEP program is currently focusing its work on two new product platforms in Russia: housing finance and energy efficiency, both of which are complemented by IFC investments in this area**.** The Primary Mortgage Development Project is working to streamline the mortgage lending process in Russia. IFC's Sustainable Energy Efficiency Program in Russia combines IFC's advisory and investment capacity. The project makes credit lines available to banks for on-lending for energy efficiency projects, and provides technical assistance to banks and private companies in order to raise the lending volumes available for energy-saving projects. The program has already disbursed its first credit line to Center Invest Bank in Rostov, and currently has a US$60 million pipeline of potential deals across all regions of Russia. IFC also runs a number of additional programs in Russia, including support for corporate governance in the banking sector, for improvement of forestry management practices in the Northwest, and for development of local suppliers to the mining sector in the remote region of Magadan.

(d) Enhancing Russia's global role

6. The Bank has a strong commitment to support Russia's increasing global role, and assist the country in fulfilling its global commitments. The Bank will continue cooperation with the Russian government in support of its emergence as an international donor and active member of multilateral organizations. In addition, the Bank will assist in establishment of mechanisms and implementation of specific actions arising from Russia's global engagements, such as the Climate Change and Biodiversity Conventions, and pandemic diseases initiatives. During the CPS period, the Bank will also seek to share with Russian experts its analysis (and advocacy) that is currently directed towards the traditional DAC donors. Specific areas for Bank's engagement in Russia are:

- *Assistance in the formulation of an ODA strategy for Russia as emerging donor:* The Bank will continue to assist Russia as an emerging donor, and will cooperate on the design of Russia's development aid strategy and the establishment of a national ODA system. Specific Bank support includes training/capacity events, information sharing, and advisory services. The Bank will remain engaged with Russia on international policy initiatives developed under Russia's G-8 presidency, including on Russia's priority themes for international assistance – quality of education, energy poverty, and the spread of infectious diseases.

- *Providing access to the Bank's instruments for channeling Russian developmental assistance:* The Bank will help in arranging an Africa debt-for-development swap, the establishment of an Avian Flu Trust Fund, the implementation of the Education For All/Fast Track Initiatives and Russia's participation in the Global Village Energy Partnership. It will also facilitate expanding Russia's role in IDA. Beginning with a high-level Emerging Donor Meeting in April 2006, the Bank is assisting Russia in organizing development aid seminars and international events. The Bank will also seek opportunities for increased engagement of Russian experts in development policy debates, their participation in the Bank's work in other countries, and "staff secondments" for building capacity within the Russian Government for aid allocation and management.

- *Fulfilling international obligations related to global goods:* The Bank will assist Russia in developing procedures and mechanisms for implementing specific activities in the framework of the Climate Change and Biodiversity Conventions**.** TA is currently being provided on the introduction of low-carbon technologies and climate change mitigation. If the government moves ahead with the introduction of financial instruments for low-carbon technologies in Russia, the Bank would be ready to support the preparation and implementation of a number of carbon-finance projects. There are three GEF projects in the Bank's pipeline awaiting the establishment of a legal and institutional framework for their introduction at the regional level with federal oversight. Additional projects on biodiversity and climate change could also be prepared. The Bank will continue participation in the Ministerial Conference on Forest Law Enforcement and Governance in Europe and North Asia.

- *Linking Russian companies to global markets:* IFC and MIGA activities are also relevant to the expansion of Russia's global role. In keeping with its global strategic objective to encourage investment across emerging markets (South-South investment), IFC will continue to actively support strong, reputable Russian clients in investments elsewhere in emerging markets. Consistent with its strategic objective to support South-South investments through the provision of guarantees, MIGA will continue to proactively engage Russian companies planning to invest in emerging markets.

Focus on Russian regions

7. The Bank is working with the federal government in identifying a small sub-set of 6–10 regions that may become the target of concentrated work programs with the Bank. Regions are being chosen from wealthier, middle income, and poorer areas. Important criteria for the selection of regions for Bank engagement are (i) the willingness and commitment of the regional administration to work with the Bank; (ii) a past history of successful cooperation; (iii) the reform-orientation and competence of the regional administration; (iv) strategic importance of the region for Russian development and the

existence of other similar regions for possible scaling up of successful cooperation; and (v) the region's creditworthiness and potential interest in Bank operations (for wealthier or middle income regions). Following initial engagement of selected regions, the strategic directions and modalities of cooperation with the Bank will be included in a joint Memoranda of Understanding, to be signed with the leaders of the focus regions. As noted, Bank involvement at the regional level would involve a combination of targeted AAA on diagnostics of the local economy and investment climate, and development of regional strategies, coupled with selected lending operations to address key challenges.

8. *The World Bank Group will concentrate some work in poorer Russian regions, which are often in most need of development assistance.* The list of priority regions will include some such poorer regions. IBRD engagement in poorer regions that lack creditworthiness will depend significantly on opportunities for participation in federal programs or the coordination of donor funds. IFC will make special efforts to support private sector activities in poorer areas. For some poorer Russian regions which have achieved creditworthiness, potential opportunities exist for fee-for-service activities or sub-national lending without sovereign guarantees. Discussions on the development of new instruments will give particular attention to facilitating Bank work in poorer areas.

APPENDIX III. RUSSIAN FEDERATION: STATISTICAL ISSUES

1. Economic and financial data provided to the Fund are considered broadly adequate for surveillance purposes. Russia has a reasonably comprehensive and timely statistical database, but difficulties remain in terms of data accuracy and frequent data revisions. 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. 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 (IFS), Government Finance Statistics Yearbook, the Direction of Trade Statistics,* and *the Balance of Payments Statistics Yearbook.*

2. A draft ROSC on data dissemination practices was prepared in 1999–2000, but never published. A new data ROSC was prepared in October 2003 and the authorities approved the publication of the report on the IMF website in April 2004.

3. Since January 31, 2005, the Russian Federation is a subscriber to the SDDS. However, data on general government operations (GGO) in the National Summary Data Page (NSDP) currently refer to 2003. The Russian Federation has not provided certification of its metadata.

4. Reserves template series are available on http://www.imf.org/external/np/sta/ir/colist.htm, and external debt series are available on http://www.worldbank.org/data/working/QEDS/sdds_countrydata.html.

National accounts

5. The Federal State Statistics Service (Rosstat) compiles and publishes quarterly and annual national accounts data on a timely basis, using the *1993 System of National Accounts*. Rosstat introduced chain-linking into their quarterly and annual national accounts in 2006. Chain-linked data have been published for 2003 onwards. Source data are obtained from surveys of businesses and households, including financial surveys of businesses and employment surveys of households, and are supplemented by administrative data. Efforts are underway to improve coverage, but further progress is needed to cover small and medium enterprises. The estimates of GDP are compiled by type of economic activity and expenditure category; however, the estimates by type of activity are considered more accurate. The statistical discrepancy between the production and expenditure approaches is generally no more than 2 percent, which is acceptable by international standards. The data are also presented by income category, but estimates of the financial account by institutional sector are not compiled.

6. The delay in finalizing a modern statistics law—requiring firms to provide data with credible penalties for noncompliance, together with a guarantee of confidentiality—is an

impediment to further improvement of national accounts data. Furthermore, revisions to the data are not flagged when they are disseminated. As a result, it is difficult for users, including the Fund, to maintain consistent time series.

Prices

7. Rosstat compiles a national consumer price index (CPI) of good quality, which was developed with Fund technical assistance. Following a moderation of inflation, Rosstat stopped the weekly publication of headline inflation in January 2003, retaining only monthly reports. In addition, Rosstat has begun 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—and by the current efforts to improve the treatment of seasonal items in the index. World Bank and TACIS assistance is available in these areas. Rosstat also publishes a producer price index, and the State Customs Committee has initiated the development of foreign trade price indexes.

8. Monthly CPI and PPI, both Laspeyres indices (2000=100), cover all regions of the Russian Federation. In addition to the general CPI index, Rosstat publishes indices for the foodstuffs, non-food products, and services. However, the weights of the CPI components have been made available since 2006 while PPI components are not disclosed, rendering time series analysis difficult.

Government finance statistics

9. The staff is provided with monthly information on revenues, expenditures, and financing of the federal government and annual information on revenues, expenditures, and financing of local governments and extrabudgetary funds. The published functional classification of expenditure differs slightly from international standards. Expenditure data, classified by economic type, need improvement. Presently, annual data are compiled with a long delay. Data on domestic and external federal debt are compiled monthly, but are made public only in summary form on a quarterly basis. In addition, there is no unified debt monitoring and reporting system. In the context of a work program for statistical improvement agreed with STA, there have been ongoing improvements in the coverage and quality of GFS data, although expenditure data remain poor. The reform of budgetary accounting is well advanced and includes the introduction of accrual accounting for the whole of government. In the 2006 Government Finance Statistics Yearbook (GFSY), data for the central, local and general government were reported through 2005 on both accrual and cash basis in accordance with the *Government Finance Statistics Manual 2001 (GFSM 2001*) methodology. The Treasury has been reporting aggregate government finance data for publication in *IFS* on a cash basis since April 1996.

Monetary statistics

10. Monetary data are reasonably comprehensive and generally in accordance with international standards. Classification and sectorization are in line with the methodological guidelines, except that financial derivatives (which are at an initial stage of development) are not included in the instrument classification. The basis of recording broadly follows methodological recommendations. Since 2006, monetary gold is valued at current quotations set by the CBR. Following the 2003 data ROSC recommendations, the authorities included all non-operational credit institutions in the coverage of the monetary statistics and reclassified their deposits as restricted deposits. The Central Bank of Russia (CBR) intends to revise further its compilation procedures to conform fully to the guidelines of the *Monetary and Financial Statistics Manual 2000*.

11. 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. The CBR has yet to conclude compilation of monetary data using new Standardized Report Forms (SRFs). At the request of the authorities, a TA mission visited Moscow in April 2007 to assist in expanding the coverage to include other (nondepository) financial corporations and to facilitate the completion of the SRFs.

External sector statistics

12. Balance of payments statistics are compiled on the basis of the fifth edition of the *Balance of Payments Manual (BPM5).* Though significant improvements have been made to enhance the quality of balance of payments statistics, there remains scope to improve the coverage of certain components of the current and the capital and financial accounts. In particular, improving the detail of data on the financial account would facilitate the analysis of relatively complex flows.

13. The State Customs Committee needs to improve substantially the coverage and valuation of exports and imports. Merchandise imports data published by the State Customs Service are subject to large adjustments for under recording, especially for “shuttle trade” by individuals, smuggling, and undervaluation. Large differences between partner country and customs data on imports persist, although statistical agencies are seeking to reconcile the data with those of partner countries. The CBR has developed a methodology for calculating export and import transactions that are unrecorded by the customs authorities. There is a need to improve the coverage and quality of surveys on direct investment, and trade in services including travel. The CBR has moved toward direct data collection to address these limitations.

14. As noted, Russia disseminates the data template on international reserves and foreign currency liquidity. However, 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 information which is not as comprehensive as the reserve template, which is disseminated with a lag of twenty days.

15. Quarterly external debt data are now published by sector, maturity, instrument, and currency, with a lag of one quarter as prescribed by the SDDS. Furthermore, the CBR started publishing quarterly debt service projections by sector and instruments.

16. The CBR has commenced publishing an annual international investment position for all sectors with data starting in 2000. The international investment position for the banking sector has been available on a quarterly basis since 2001Q1 and published with a three-month lag.

RUSSIAN FEDERATION: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of June 18, 2007)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	6/15/07	6/15/07	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/8/07	6/14/07	W	W	W		
Reserve/Base Money	6/11/07	6/18/07	W	W	W	O, LO, LO, LO	O, O, O, O, O
Broad Money	5/1/07	6/7/07	M	M	M		
Central Bank Balance Sheet	6/1/07	6/7/07	M	M	M		
Consolidated Balance Sheet of the Banking System	5/1/07	6/7/07	M	M	M		
Interest Rates[2]	6/15/07	6/15/07	D/W/M	D/W/M	D/W/M		
Consumer Price Index	May. 2007	6/5/07	M	M	M	LO, LO, LO, LO	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2006	Feb. 2007	A	A	A	LNO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2006	Feb. 2007	M	A	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4/06	Feb. 2007	Q	Q	Q		
External Current Account Balance	Q1 2007	4/5/07	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Q1 2007	4/5/07	Q	Q	Q		
GDP/GNP	Q1 2007	6/15/07	Q	Q	Q	O, O, LNO, O	LO, LO, O, O, O
Gross External Debt	Q4 2006	3/30/07	Q	Q	NA		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on May 2004 and based on the findings of the mission that took place during October 8–23, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and valid.

Statement by the IMF Staff Representative
September 12, 2007

1. This statement summarizes information that has become available since the staff report was issued. The thrust of the staff appraisal remains unchanged.

2. **The economy has gained additional momentum.** Recent figures suggest that output grew by 7.8 percent year-on-year in the first half of 2007, well above both the authorities' and staff's estimates of potential. High frequency indicators point to even stronger output growth in recent months. Such indicators also suggest that growth continues to be powered by very buoyant domestic demand, reflecting a surge in investments and continued strong growth in private consumption. Real wages increased by 17 percent during the first half of 2007, compared to the same period of last year. In light of these developments, the Ministry of Economy has announced that it will increase its 2007 forecast for real GDP growth, from 6.5 percent to 7.2–7.4 percent, while the consensus forecast has increased to 7.1 percent. Staff has for now maintained its forecast of 7 percent for 2007, but agrees that the risks are now mainly on the upside.

3. **The current account surplus is continuing to decline at a relatively rapid pace.** In the second quarter of this year, the current account surplus relative to GDP almost halved compared to the same period of 2006, even with oil prices at broadly the same level during these two periods.

4. **Inflation has continued to increase.** Since the issuance of the staff report, headline inflation (year-on-year) has risen above the official end-year target of 8 percent, from 7.4 percent in March to 8.6 percent in August. As discussed in the staff report, this trend mainly reflects the return to a more fixed exchange rate policy from mid-2006, a policy change that has been associated with a surge in capital inflows and unsterilized interventions. Since June, in an effort to stem the increase in inflation, the CBR has again allowed slightly greater exchange rate flexibility, with the ruble appreciating until mid-August, when capital outflows and downward pressures on the ruble associated with the current turmoil in financial markets prompted the CBR to intervene to support the currency (see below). While these outflows have eased short-term pressures on monetary policy, staff believes that the risks remain biased toward an overshooting of the end-year inflation target of 8 percent.

5. **The authorities are still planning a notable fiscal relaxation in the context of a supplementary 2007 budget.** Duma approval is now expected in October. The parameters of the supplementary budget remain as described in paragraph 18 of the staff report.

6. **Russia has weathered the recent turmoil in world financial markets relatively well.** Compared to the beginning of August, sovereign spreads increased by about 50 bps to about 150 bps, but have now stabilized. Similarly, after an initial drop of about 8 percent

over the first half of August, the local stock market firmed after the Fed's action on the U.S. discount rate, and ended the month down by only 5 percent. As foreign investors reduced their Russian exposure, the CBR acted intermittently to smooth downward pressure on the exchange rate, and there was a small loss of official reserves during August. However, despite this loss, reserves have increased by $113 billion so far in 2007, and currently stand at $416 billion.

7. **Liquidity in the banking system has been restored.** The CBR's sales of foreign exchange, combined with significant end-August tax obligations, resulted in a domestic liquidity squeeze. Overnight money-market rates doubled from about 4 percent to 8 percent, prompting the CBR to inject a growing amount of liquidity via the one-day repo facility. At the peak of the liquidity squeeze, rolled-over repo operations reached a historic high of Rub 272 billion ($10.6 billion). Now that the tax-payment period is over, however, money-market rates have dropped to 5–6 percent, and repo operations are again minimal.

8. **The turmoil in financial markets has increased the vulnerability of some banks.** Staff remains particularly concerned that Russia's fragmented and inefficient interbank market may leave some individual regional or mid-size banks vulnerable to a deterioration of credit conditions. Thus, some banks with limited access to the interbank market have relied on foreign borrowing as a key source of funds, and may face difficulty as the cost of this funding rises. An FSAP-update mission is scheduled to visit Moscow in October.

9. **Recent developments have reinforced the thrust of the staff appraisal.** In particular, staff continues to believe that further fiscal relaxation should be avoided at this juncture when the economy is gaining additional momentum spurred by strong domestic demand, and when inflation is already rising and the ruble is appreciating rapidly in real terms.

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IMF Executive Board Concludes 2007 Article IV Consultation with the Russian Federation

On September 12, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Russian Federation.[1]

Background

Russia's economic growth remains robust. High oil prices, a strong catch-up potential, and sound fiscal policy underlie Russia's long spell of robust growth. Several years of double-digit terms-of-trade gains, reinforced by rapidly developing financial markets and much-improved access to foreign borrowing, have underpinned strong investment growth, punctured only by a soft spot in late 2004. Nevertheless, the level of investment has remained low, and capital and labor have accounted for less than half of the increase in GDP since 2003, with the balance due to higher total factor productivity. Robust growth has thus owed much to Russia's still considerable catch-up potential, as resources are reallocated to more dynamic sectors in the economy. The resulting nexus of strong productivity growth, rising real incomes, and higher consumption has been a key source of self-sustaining growth, especially in recent years as capacity constraints have slowed energy exports.

Despite the broad stabilization of oil prices since mid-2006, GDP growth has strengthened, rising from 6.7 percent in 2006 to 7.8 percent for the first half of 2007. Moreover, much of this momentum reflects a pickup in investment, suggesting that growth in Russia is now becoming

[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.

more evenly balanced. Consumption nonetheless remains the main engine, spurred by real income growth of over 10 percent.

With surging growth, the economy is running increasingly close to capacity. Domestic resource constraints are tightening, not least in the labor market, causing increased leakage of demand into imports and renewed inflationary pressures. From a peak of almost 14 percent (year-on-year) in mid-2005, inflation dropped to 7½ percent in March 2007. However, inflation has since firmed to over 8½ percent as of August, standing above the end-year target of 8 percent. Following six years of robust GDP growth, measures of capacity utilization are at historical highs. The constraints are particularly evident in the oil sector. Having increased by about 10 percent annually through 2003, the increase in oil production slowed sharply in 2004–05, and appears now to have stabilized at about 2–3 percent.

Russia's balance of payments has strengthened. The current account surplus has narrowed as a result of accelerating import growth and slowing energy exports. But, this has been more than offset by sharply higher capital inflows—as of early September, reserves increased by a record $113 billion in the year to date, reaching a total of $417 billion. With a still-substantial current account surplus, rapidly increasing foreign exchange reserves and declining external debt, Russia's external vulnerability is low, although non-government debt is rising rapidly.

The overall fiscal surplus has continued to increase because of higher oil revenues. However, fiscal policy has since 2005 allowed an increasing share of Russia's oil-revenue windfall to pass through to the economy. This relaxation has been reflected in a continued deterioration in the general government's non-oil balance. Staff projects that the non-oil balance will decline further under the 2007 budget, by 0.9 percent of GDP.

Monetary policy has become more accommodative over the past year, reflecting the CBR's resumption of a more steady exchange rate policy in mid-2006. This represents a reversal of the policy introduced in early 2005, wherein the CBR had allowed some, albeit limited, appreciation. The return to a more stable exchange rate policy has been associated with a surge in capital inflows, record-high interventions, and a sharp acceleration in base-money growth to 40 percent through July (year-on-year). Importantly, in the context of a year-end inflation target of 8 percent, rising inflationary pressures and market expectations of a possible appreciation have exacerbated capital inflows, not least through the banking system. Since June, however, the CBR has allowed for greater exchange-rate flexibility to help stem inflation. Additionally, the worldwide market turmoil of August has eased the pace of capital inflows.

Notwithstanding currently unsettled conditions on world markets, demand pressures are expected to remain strong in 2007. Russia's terms-of-trade are projected to ease slightly in 2007, but the overall environment will still remain broadly supportive. As in 2006, the balance of payments is expected to strengthen further, with capital inflows more than offsetting a lower current account surplus. Overall, staff projects GDP growth of around 7 percent over the near term, driven by robust consumption and investment demand. This outlook also reflects a substantial fiscal impulse in 2007 along with a rapid expansion of consumer credit. In light of recent trends, inflation threatens to exceed the official end-year target of 8 percent.

Executive Board Assessment

Executive Directors commended the strong performance of the Russian economy in recent years, noting that this has been due not only to high oil prices and large capital inflows but also to good macroeconomic management. In particular, the policy of saving the large oil revenue windfall has provided a considerable measure of stability. However, Directors noted that Russia continues to face tensions in the policy mix designed to reduce inflation while preserving exchange rate stability.

Directors noted that demand pressures appear to be intensifying, driven by acceleration in investment and strong growth in private consumption. With output close to potential, upward pressures on prices and the real exchange rate are likely to persist.

Against this background, Directors noted that the planned fiscal relaxation in the next few years would provide an undesirable fiscal stimulus. This would increase pressures for real ruble appreciation and make it more difficult to reduce inflation. It is also likely to exhaust most of the remaining margin of competitiveness, raising the risk of the real exchange rate overshooting its equilibrium level. Directors therefore called on the authorities to avoid increasing the non-oil deficit during the remainder of 2007 and in 2008.

Directors emphasized the need to control public spending, and to pay more attention to the quality and efficiency of expenditures. In this regard, they welcomed the new framework for spending of oil revenues, which is close to best practice for management of natural resource wealth. They cautioned, however, that the back-loading of spending cuts in socially sensitive areas in 2010–11, in the run-up to elections, is risky. Such cuts might not be feasible unless efficiency-enhancing social and public sector reforms are reinvigorated. Most Directors also advised against extending the government’s mandate to areas where private sector participation might be more efficient.

Directors noted that the recent rise in inflation stemmed from the return to a less flexible exchange rate policy since mid-2006, a change that led to large unsterilized interventions in the face of surging capital inflows. They stressed that keeping inflation on the targeted path would require returning to a more flexible exchange rate policy. In this regard, Directors welcomed the authorities’ willingness to accept appreciation, as was evident from June until August this year. They urged the central bank to stand ready to scale back interventions as needed to keep inflation within target, noting that greater focus on the inflation target while allowing more exchange rate flexibility could help curb one-way bets and reduce speculative capital inflows.

Directors welcomed the rapid development of Russia’s financial sector, but cautioned that high rates of credit growth might also increase vulnerabilities. In particular, the rapid increase in consumer lending, corporate-bond issuances, and open foreign-exchange positions should be kept under close review. While Russia has weathered the recent turmoil in financial markets relatively well, the tightening of access to foreign capital markets could increase the vulnerability of a number of banks. Directors welcomed the current Financial Sector

Assessment Program update, which provides a timely opportunity for a review of vulnerabilities.

Directors observed that the key long-term challenge will be to improve Russia's investment climate. Although recent investment growth has been impressive, they noted that the level of investment is still relatively low and that Russia still ranks poorly in international comparisons of the business climate. Raising investment levels is particularly important in light of the projected decline in the labor force and the declining prospect for continued high productivity gains over the medium term. In this regard, Directors observed that progress on important reforms in public administration and the civil service has been limited. The challenge facing the new government would be to reinvigorate such reforms.

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2003–08

	2003	2004	2005	2006	2007	2008
	Actual				Proj.	
	(Annual percent change)					
Production and prices						
Real GDP	7.3	7.2	6.4	6.7	7.0	6.8
Consumer prices						
Period average	13.7	10.9	12.7	9.7	7.7	7.5
End of period	12.0	11.7	10.9	9.0	8.0	7.0
GDP deflator	14.0	20.1	19.2	16.1	7.0	9.6
	(In percent of GDP)					
Public sector						
General government						
Overall balance	1.4	4.9	8.2	8.4	4.9	2.8
Revenue	36.3	36.6	39.7	39.7	36.5	34.6
Expenditures	34.8	31.7	31.6	31.3	31.5	31.8
Primary balance	3.1	6.1	9.1	9.2	5.5	3.3
Non-oil balance (in percent of GDP)	-3.9	-2.9	-4.6	-4.4	-5.3	-6.6
Federal government overall balance	1.7	4.3	7.5	7.4	4.7	2.5
	(Annual percent change)					
Money						
Base money	49.6	24.9	31.7	39.6	36.1	30.2
Ruble broad money	51.6	35.8	38.6	48.8	49.4	32.2
	(Annual percent change)					
External sector						
Export volumes	12.4	10.5	4.7	5.8	4.7	5.0
Oil	17.2	11.3	3.2	0.3	3.5	2.9
Gas	2.0	5.5	3.7	-2.5	-0.8	3.8
Non-energy	12.1	11.2	6.9	18.2	8.1	8.1
Import volumes	24.4	21.3	18.3	24.0	22.4	20.3
	(In billions of U.S. dollars; unless otherwise indicated)					
External sector						
Total merchandise exports, fob	135.9	183.2	243.8	303.9	315.2	332.6
Total merchandise imports, fob	-76.1	-97.4	-125.4	-164.7	-210.3	-249.2
External current account	35.4	59.0	83.8	94.5	61.7	42.8
External current account (in percent of GDP)	8.2	10.0	11.0	9.6	5.1	2.9
Gross international reserves						
In billions of U.S. dollars	76.9	124.5	182.2	303.7	431.8	524.4
In months of imports 1/	8.9	11.4	13.3	17.4	19.8	20.6
In percent of short-term debt	128	198	161	348	434	517
Memorandum items:						
Nominal GDP (in billions of U.S. dollars)	431	592	764	985	1,201	1,452
Exchange rate (rubles per U.S. dollar, period average)	30.7	28.8	28.3	27.2	...	...
World oil price (U.S. dollars per barrel, WEO)	28.9	37.8	53.4	64.3	60.8	64.8
Real effective exchange rate (average percent change)	3.0	7.8	8.7	9.5	9.9	8.1

Source: Russian authorities; and IMF staff estimates.

1/ In months of imports of goods and non-factor services.