 October 2005
IMF Country Report No. 05/377

Russian Federation: 2005 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 2005 Article IV consultation with the Russian Federation, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 3, 2005, 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 August 16, 2005. 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 7, 2005 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 7, 2005 discussion of the staff report that concluded the Article IV consultation.

The documents listed below have been or will be separately released.

Selected Issues Paper
Statistical Appendix

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

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

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INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation
with the Russian Federation

Approved by Michael Deppler and Carlos Muñiz

August 16, 2005

- Article IV consultation discussions were held in Moscow during May 24–June 3, 2005. The mission met Deputy Prime Minister Zhukov, Minister of Finance Kudrin, Central Bank of Russia Governor Ignatiev, 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. Figliuoli and Zebregs, Ms. Oomes (all EUR), Mmes. Ilyina (ICM) and Nkuzu (PDR), and Mr. Lohmus (MFD), 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 September 1, 2004, Directors commended the authorities' good management of the economy, but warned that in light of the strong oil price outlook and persistent inflationary pressures, fiscal policy should not be eased and exchange rate policy should be more flexible. They also urged the authorities to reinvigorate structural reforms in order to maintain competitiveness and diversify the economy.

- Russia has accepted the obligations of Article VIII, Sections 2, 3, and 4. Restrictions on current account transactions identified at the time of the 2003 Article IV consultation and not approved by the board have been removed, although a new restriction has emerged (Appendix I).

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

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EXECUTIVE SUMMARY

Background. GDP growth has slowed since mid-2004, despite high oil prices, but remains robust. The slowdown reflects mainly a sudden deceleration in the growth of oil output and investments last summer, most probably due to supply disruptions and jolts to the investment climate. The slowdown has also been due to emerging resource constraints. Fiscal policy has so far offset much of the stimulus arising from the large terms of trade gains, but a major relaxation is now underway as high oil prices and the swelling stabilization fund are undermining support for the current policy for saving the oil revenue windfall. Monetary policy has remained accommodative as the CBR has continued to resist ruble appreciation through large unsterilized interventions. Meanwhile, structural reforms outside the banking system have come to a virtual standstill.

Outlook. GDP growth is projected to amount to 5½ percent in 2005, compared to 7¼ percent in 2004. The main downside risk is a weakening in consumption growth. On the other hand, the fiscal relaxation that is currently in the pipeline could temporarily boost GDP growth closer to last year's level. Inflation is almost certain to exceed the official target again this year, although the CBR is likely to allow just enough exchange rate flexibility to prevent it from increasing above last year's level. Vulnerabilities are likely to remain low, but a sharp correction in the oil price could cause significant distress in the banking sector.

Policy discussions. The discussions focused on the following issues:

- The amendment of the 2005 budget entails a significant relaxation of fiscal policy in the face of emerging resource constraints and buoyant consumption. Staff warned that this would to add to inflationary pressures and that further relaxation should be delayed until cyclical pressures ease. The authorities felt that the risks were still manageable.

- There is significant room for fiscal relaxation over the medium term. Stressing that the oil wealth should be harnessed in support of reforms and other spending that promise to bolster potential GDP growth, staff argued that there is little scope for increasing such spending at this juncture without risking waste, due to the flagging reforms.

- Staff advocated increased exchange rate flexibility, and warned that resisting appreciation as fiscal policy is being relaxed poses a risk to stability. CBR officials disagreed, saying that they would continue to pursue both inflation and exchange rate targets. Staff expressed concern about the fact that the admission into the new deposit insurance scheme had not entailed as strong a break with regulatory forbearance as hoped for. CBR officials disagreed.

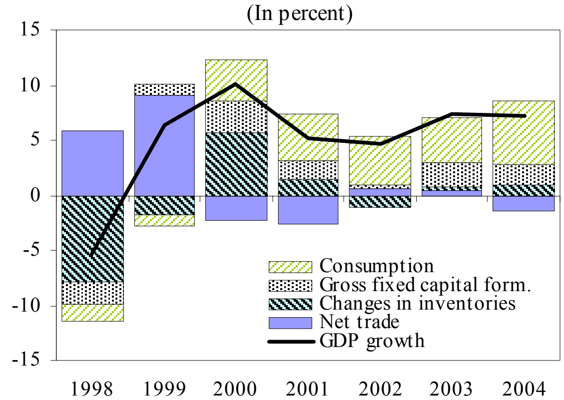
- All key reformers within the government agreed with staff that reforms are at a standstill and that the Yukos affair had damaged the investment climate. They also agreed that complacency in this regard was due to high oil prices. Kremlin officials insisted, however, that the delays in reforms are due to administrative obstacles that will soon be overcome.

I. BACKGROUND

A. Recent Economic Developments

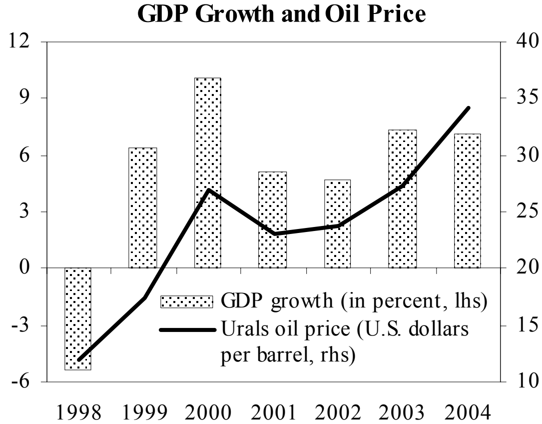
1. **Russia is in its seventh year of robust GDP growth.** Even as the import substitution that powered the recovery from the 1998 crisis began to peter out—and partially reverse—large and sustained terms-of-trade gains, in combination with increased political and economic stability, helped propel a broad based recovery, which is still running its course (Table 1). Higher oil output and investments have been the main conduits in this regard. Rising oil prices have prompted not only an immediate oil output response, but also allowed companies to bypass the weak financial system and use their own resources to introduce technology that increases extraction from existing wells, reversing the decade-long contraction in Russian oil output. Meanwhile, higher investments outside the oil sector have fueled growth in total factor productivity and real wages, spurring consumption. This suggests that a somewhat broader based, less commodity dependent recovery in productivity and growth is taking hold, although this conclusion must be tempered by evidence that much of the investments economy-wide have been by commodity based conglomerates or their owners. Growth in small and medium-sized enterprises remains limited, as do foreign direct investments outside the energy sector, and concerns about the investment climate persist.

Contributions to GDP growth
(In percent)



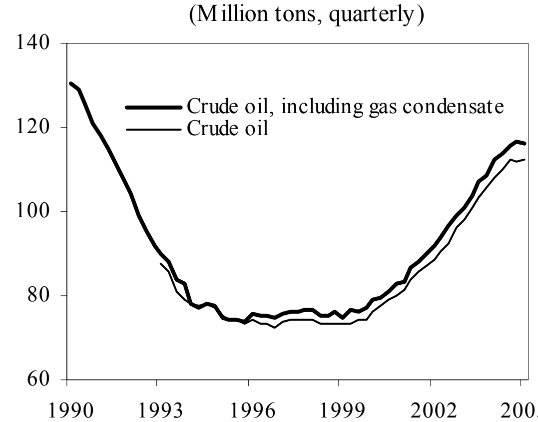
Source: Authorities; and IMF staff calculations.

GDP Growth and Oil Price



Source: Bloomberg; and IMF staff calculations.

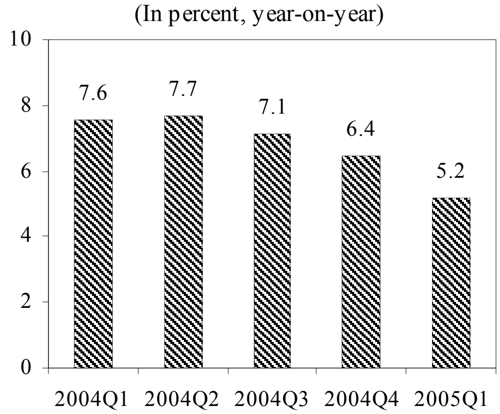
Crude Oil Production, SA
(Million tons, quarterly)



Source: OECD; and Federal State Statistics Service.

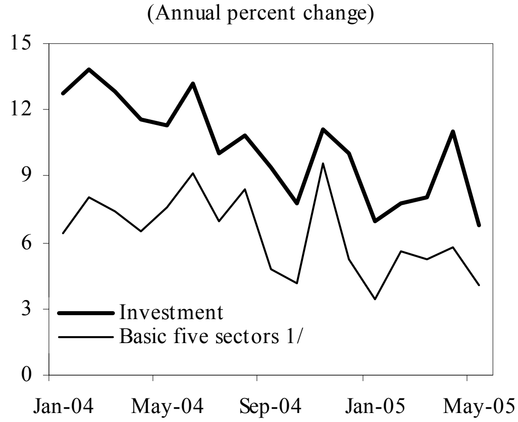
2. **Although still robust, real GDP growth has slowed by a third since mid-2004, despite record high oil prices.** It decelerated from 7½ percent in the first half of 2004 to a provisional 5½ percent in the same period of 2005 (year-on-year). The slowdown mainly reflects a sudden deceleration in the growth of oil output and investments from the third quarter of 2004, with no clear evidence yet of a recovery. More recently, real wages and consumption growth have appeared to be weakening as well, suggesting that all the main sources of growth in recent years are now softening.

Real GDP Growth
(In percent, year-on-year)



Source: Authorities; and IMF staff calculations.

Investment and Five Basic Sectors
(Annual percent change)



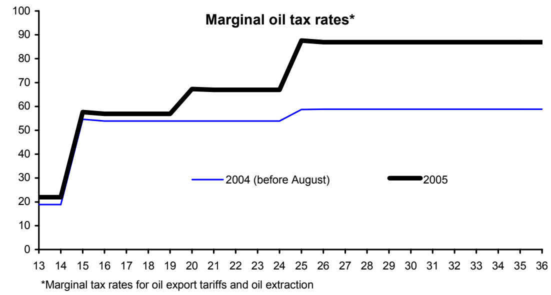
Source: Authorities; and IMF staff calculations.
1/ Industrial production, construction, agriculture, freight transportation, and retail trade.

3. **The softening is widely attributed to the confluence of policy induced supply disruptions and jolts to the investment climate**. The Yukos affair has been associated with accusations of heavy-handedness on the part of tax authorities and other agencies and broader concerns about state interventionism and backtracking on reforms. Such concerns have been reinforced by the failure to reinvigorate reforms after the elections. The sharp rise in marginal tax rates in the oil sector, to almost 90 percent at prices above $25 per barrel (Box 1), might also have taken a toll on oil output and investments. While the impact of the tax rise on profitability has been limited inasmuch as oil prices have continued to rise, the increase in the share of the oil revenue windfall that is being taxed has reduced the impetus to GDP growth from recent increases in the oil price. Meanwhile, the supply disruptions caused by the change in ownership of Yukos last fall have not yet been fully reversed.

Box 1. Oil Taxation and the Oil Stabilization Fund

Oil Taxation
The Russian oil sector is taxed mainly through:

- the *mineral extraction tax*, which is levied on all extracted oil at a rate of 22 percent of the excess over $9 per barrel;
- the *export customs duty on oil*, which applies to oil exports only when the Urals c.i.f. price exceeds $15 per barrel. The rates are proportional to the level of the price of Urals. When the price is between $15 and $20 per barrel the marginal rate is 35 percent; when the price is between $20 and $25, the marginal rate is 45 percent; and when the oil price is beyond $25 per barrel, the marginal rate is 65 percent.



The combined marginal rate for these taxes is 22 percent for prices below $22 per barrel but increases rapidly with the oil price to reach 88 percent when the price is above $25 per barrel. The rates of these two taxes were substantially increased in August 2004 and again in January 2005; especially for oil prices above $25 per barrel.[1] The chart compares the increase in marginal rates at the beginning of 2004 and 2005.

In addition, to the aforementioned taxes, oil companies are also subject to the *profit tax*, which is levied on profits of all companies at a fixed rate of 24 percent. Oil derivatives are also subject to excises.

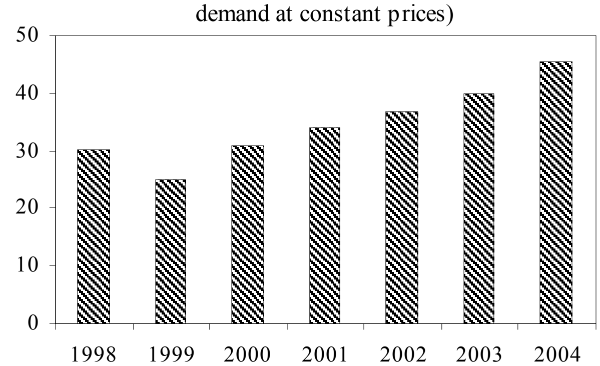
Oil Stabilization Fund
The oil stabilization fund (OSF) was introduced in January 2004 with the aim of saving the fiscal windfall coming from the exceptionally high oil price. Revenues from the mineral extraction tax and the export custom duty on oil in excess of the reference price of the OSF, which is currently $20 per barrel, are earmarked for the OSF. At the current rate of extraction and export, each additional dollar in the oil prices above $25 per barrel increases revenues earmarked for the OSF by about Rub 55 billion. In addition, the oil stabilization fund is financed with the unspent fiscal surplus of the previous year, amounting to Rub 106 billion in 2003, and Rub 218 billion in 2004.

By law, the resources of the OSF may be used to finance the federal budget deficit when the current oil price is below the reference price, and also for other purposes such as repaying foreign debt, if resources exceed Rub 500 billion. Thus far, the government has used OSF resources to prepay the IMF (Rub 93.5 billion) in January 2005 and to prepay US$ 15 billion to Paris Club creditors. As a supposedly temporary measure, resources from the OSF will be used to finance the gap in the pension fund in 2005 that emerged due to the cut in the unified social tax. The reserves of the OSF are currently deposited in an unremunerated account with the central bank.

[1] The increase of the mineral extraction tax in January 2005 was implemented to offset the cost to the budget of the repeal of the VAT on oil and natural gas exports to CIS countries. Such exports were previously taxed at the standard rate of 18 percent; starting in January 2005, they became subject to a zero percent Russian VAT rate as are all other Russian exports.

4. **Resource constraints were becoming evident even before last year's slowdown in economic growth.** As discussed at the time of the last Article IV consultations, excess capacity had gradually been soaked up during the prolonged period of relatively high GDP growth. The room in the near term for continued fast expansion of production in the oil sector appears to have been all but exhausted, reflecting bottlenecks in the transportation network and the fact that investment in the exploration of new oil field has been limited thus far. The emerging resource constraints became apparent when the acceleration in domestic demand in 2004 spilled over entirely into much higher imports, while leaving GDP growth unchanged compared to the previous year. This is broadly in line with staff calculations suggesting that the output gap has been virtually closed and that at present GDP cannot grow by more than 5-6 percent without causing higher inflation.[1]

Import Leakage
(Imports in percent of domestic demand at constant prices)

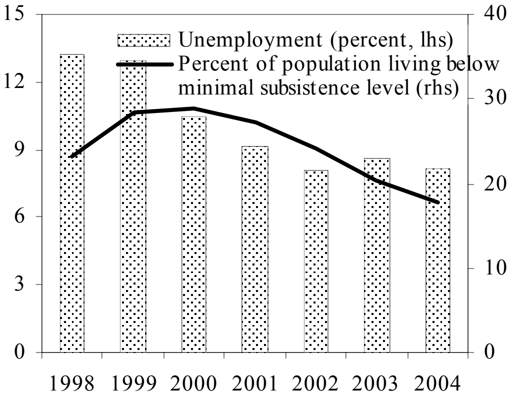


Source: Authorities; and IMF staff calculations.

5. **Labor market conditions have also continued to tighten**. Real wages grew by 11¼ percent in 2004, catching up with productivity gains in recent years and bringing unit labor costs in rubles to broadly the same level as before the 1998 crisis. The rate of unemployment fell to 7½ percent with reports of labor shortages in high-growth areas like Moscow and St. Petersburg, where unemployment rates have dropped to 1½ percent and 2¾ percent, respectively. Labor market mobility remains limited, owing to severe housing shortages among other reasons.

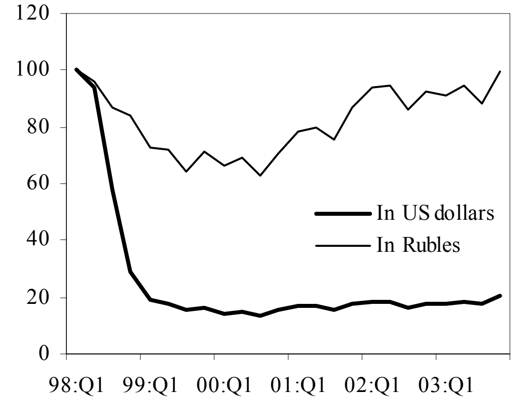
[1] Estimates of the output gap are discussed in Chapter I of the accompanying Selected Issues Paper.

Unemployment and Poverty



Source: Goskomstat.

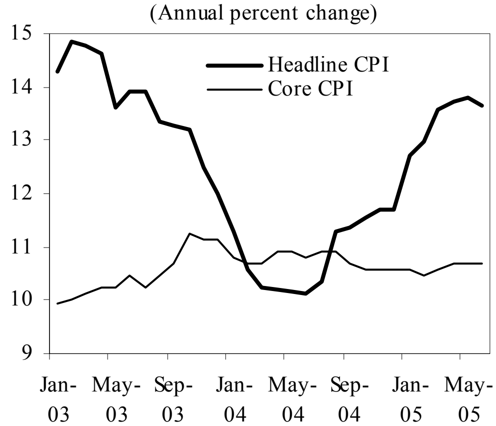
Economy-wide Unit Labor Costs
(Index, 1998 Q1=100)



Source: Authorities; and IMF staff calculations.

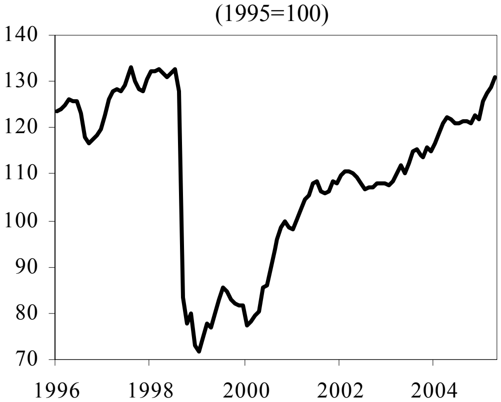
6. **Core inflation remains entrenched despite the continued appreciation of the ruble in real terms.** Headline inflation climbed from 10 percent in June 2004 to 13¾ percent in June 2005. This was largely the result of unseasonably high food prices and large increases in administered prices—following their pre-election lull—while core inflation has been entrenched at 10–11 percent since 2002. The ruble has continued to appreciate in real terms, by 6¾ percent in the first half of this year compared to the same period last year.

Headline and Core Inflation
(Annual percent change)



Source: Authorities; and IMF staff calculations.

Real Effective Exchange Rate1/
(1995=100)



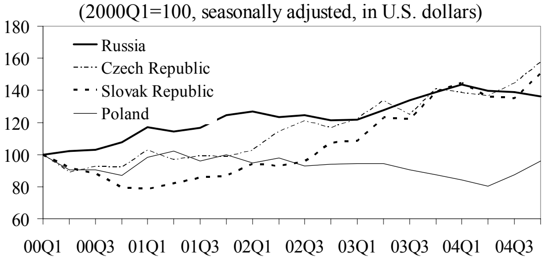
Source: IMF staff calculations.
1/ CPI-based.

7. **Competitiveness does not seem to be impaired, however**. Although the CPI-based real effective exchange rate is currently at almost the level prevailing prior to the August 1998 devaluation, it is likely still below its long-run equilibrium (Box 2). The considerable appreciation since 1999 has been in line with or even somewhat slower than the change in

Box 2. Competitiveness Indicators

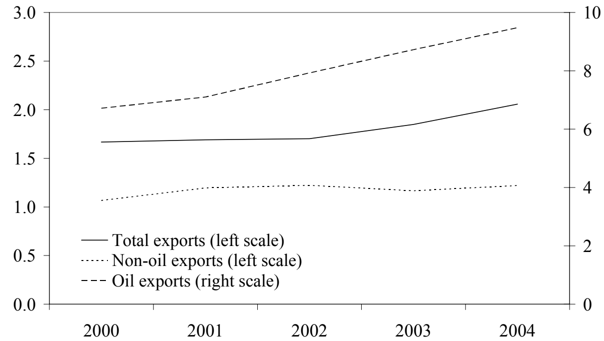
Neither developments in unit labor costs nor in export market shares indicate any problems with competitiveness:

Selected Transition Countries:
Unit Labor Costs in Industries 1/
(2000Q1=100, seasonally adjusted, in U.S. dollars)



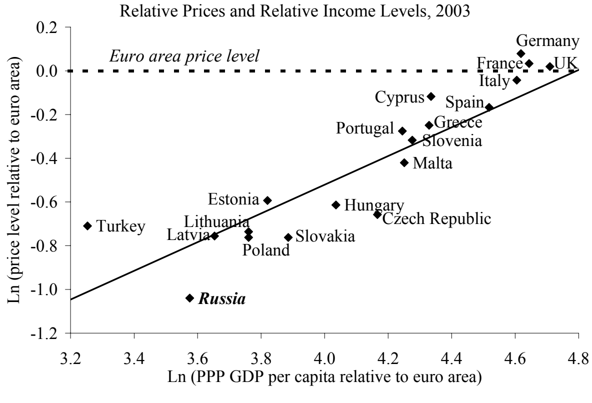
1/ Unit labor costs are calculated as nominal value added divided by the nominal wage bill. Unit labor costs for the Czech and Slovak republics, are based on the manufacturing sector instead of industries.

Russian exports as a share of world exports
(In percent)

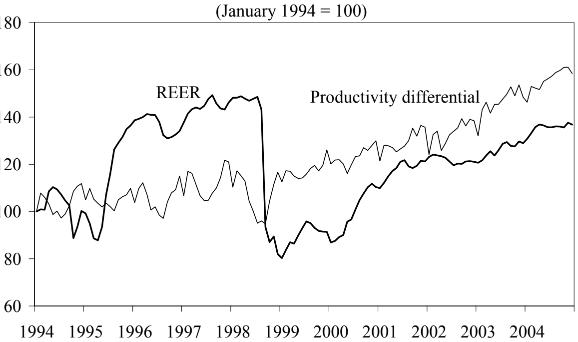


The real exchange rate is still below its equilibrium level. Compared with other transition economies with similar levels of income (such as the Baltic states and Poland), Russia's relative price level, or its deviation from PPP, is still well below the level that could be expected given Russia's relative income level, suggesting real exchange rate undervaluation. While the real effective exchange rate (REER) has appreciated substantially since 1999, it has not exceeded the growth rate of Russia's productivity differential, owing to the prudent policy of saving most of the permanent terms-of-trade gain in the oil stabilization fund.

Relative Prices and Relative Income Levels, 2003



Real Effective Exchange Rate and Productivity Differential 1/
(January 1994 = 100)

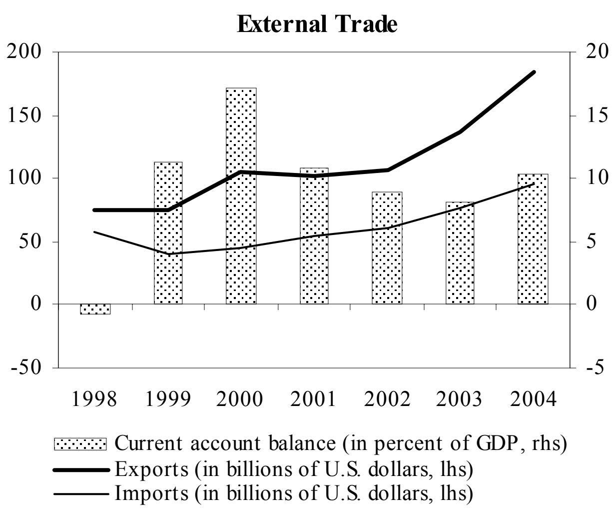


1/ Industrial productivity in Russia relative to average industrial productivity in the U.S. and the Euro area.

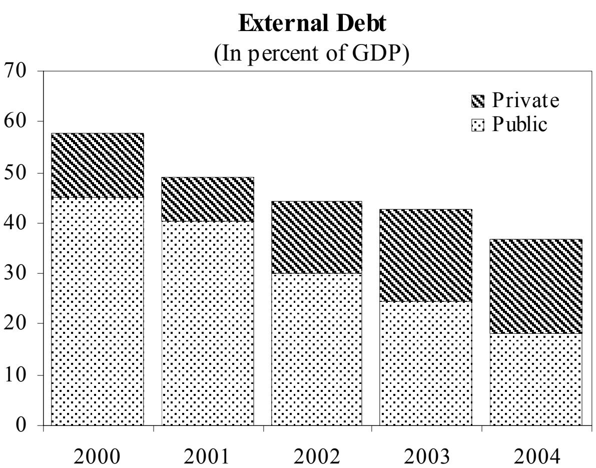
Russia's productivity differential with the Euro area and the United States. In recent years, unit labor costs in some non-fuel sectors appear to have increased faster than in the fuel sector, suggesting that the former may be suffering somewhat from the real appreciation. Yet, the share of the Russian non-fuel sector in world exports has remained broadly stable.

8. **Rising oil prices have further strengthened the balance of payments** (Table 2). Gross foreign reserves rose by $27 billion during the year through end-June 2005, to $152 billion, more than 3½ times short-term debt. Public sector debt net of foreign reserves has swung from a net liability of $140 billion shortly after the 1998 crisis to a net asset position of almost $30 billion, suggesting a significantly reduced external vulnerability.

- **Higher oil and gas prices, and some further increase in oil export volumes, boosted the current account surplus to 10 percent of GDP in 2004,** more than offsetting the impact of rapid domestic demand growth and real ruble appreciation.



Source: Authorities; and IMF staff calculations.

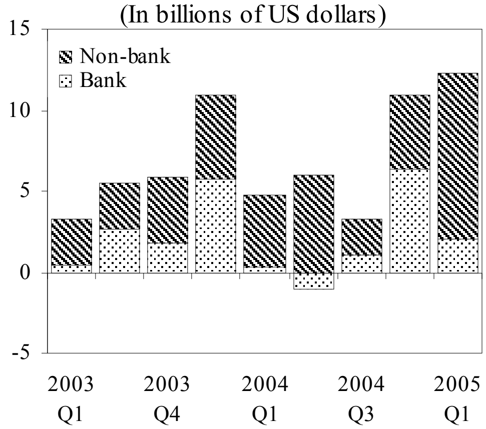


Source: Authorities; and IMF staff calculations.

- **Pre-payment of debt is causing the official capital account to turn sharply negative**. The authorities have reached an agreement with Paris Club creditors to pre-pay $15 billion of its debt. As a result, net public capital outflows will amount to about 2¼ percent of GDP in 2005, compared to a very small outflow in 2004. The authorities are considering prepayment of the remaining Paris Club debt of about $28 billion in 2006–07. (Russia made early repurchase of all obligations to the Fund subject to repurchase in March 2005.)

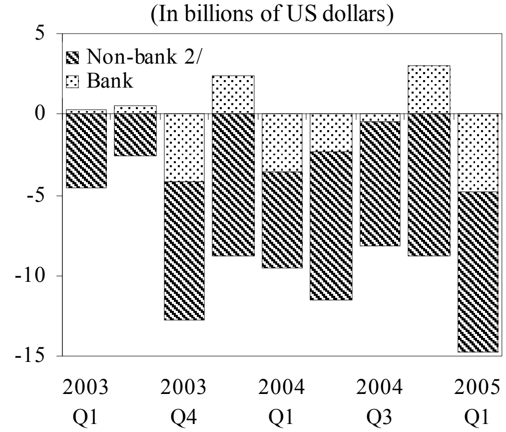
- **Net private capital outflows (including errors and omissions) rose considerably in 2004, to 2 percent of GDP**. The surge in outflows in 2004 was largely on account of increased capital flight, possibly reflecting the concerns about the business climate associated with the Yukos affair. However, the picture is mixed as capital inflows also increased. Russian banks and companies have continued to take advantage of narrowing spreads and increased market access to borrow on global capital markets. Upgrades to investment grade by major rating agencies during 2004 and early 2005 further improved confidence and access to international capital markets. Meanwhile, exchange rate policy has continued to contribute to the volatility in the capital account. In the last quarter of 2004, the capital account recorded large net inflows as investors were expecting an impending appreciation of the ruble. In the first quarter of 2005, inflows remained high owing in part to a $6 billion loan to Rosneft for the purchase of Yugansk, but outflows increased again.

Change in Foreign Liabilities 1/
(In billions of US dollars)



Source: Authorities; and IMF staff calculations.
1/ Excludes FDI.

Change in Foreign Assets 1/
(In billions of US dollars)



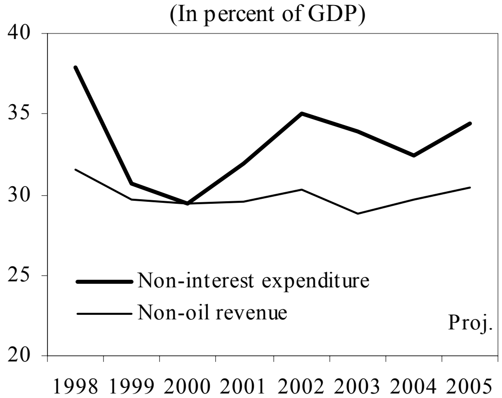
Source: Authorities; and IMF staff calculations.
1/ Excludes FDI.
2/ Includes errors and omissions.

B. Macroeconomic Policies

9. **Fiscal policy has so far offset much of the stimulus arising from the large terms of trade shock**. The headline general government surplus has increased every year since 2001 as the government has taxed and saved much of the rapidly increasing oil revenues (Tables 3 and 4). Under the current WEO assumption about oil prices for 2005, which translates into a price for Russian crude of $47 per barrel, the amended 2005 budget will entail an overall surplus of 7½ percent of GDP, compared to 5 percent of GDP in 2004.[2]

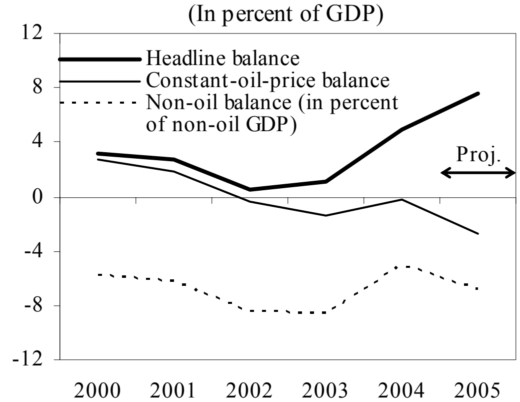
[2] The overall headline balance reflects improvements in the fiscal position that depend on the higher price of oil. In this sense, it does not provide a reliable estimate of the underlying fiscal stance, namely the impact on aggregate demand of fiscal policy had the latter not benefited from the oil windfall. To measure this, it is preferable to use the constant oil price balance or the non-oil balance. Changes in these two measures are meant to proxy the fiscal impulse to the economy if the budget had not been boosted by the oil windfall. Chapter II of the accompanying Selected Issues Paper discusses the various fiscal indicators.

General Government Finances
(In percent of GDP)



Source: Authorities; and IMF staff calculations.

General Government Balance
(In percent of GDP)



Source: Authorities; and IMF staff calculations.

10. **But the government has been gradually increasing its spending of the oil revenues, as evident from the increase in the non-oil fiscal deficit or the decline in the surplus on a constant oil price basis.** This surplus has declined in every year since 2001, except in 2004, having dropped sharply in the run-up to the elections in late 2003. This relaxation in the face of tightening resource constraints and buoyant overall demand is likely

Russian Federation: Summary Table

	2001	2002	2003	2004	2005 Proj. 1/
		(In percent of GDP)			
Federal government overall balance	2.7	1.3	1.6	4.4	7.5
General government overall balance	2.7	0.6	1.1	5.0	7.6
Federal government overall balance at constant 20 $/barrel	1.9	0.2	-1.0	-0.8	-2.6
General government overall balance at constant 20 $/barrel	1.8	-0.3	-1.5	-0.2	-2.7
General government non-oil balance	-4.8	-6.9	-7.6	-6.1	-9.4
Fiscal impulse 2/	-0.9	1.4	-1.5	-4.2	-2.9
Fiscal impulse (excluding oil sector) 3/	0.0	2.0	-4.6	-2.8	1.5
A. Change in energy exports	-0.4	1.1	4.2	4.6	5.8
B. Change in overall balance	-0.5	-2.1	0.5	3.9	2.7
A-B (combined impulse from oil export earnings and fiscal policy)	0.1	3.2	3.7	0.7	3.2

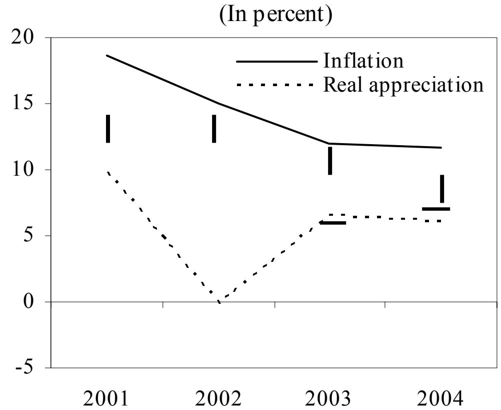
Sources: Russian authorities; and Fund staff estimates.

1/ The projection for federal expenditure in 2005 includes Rub 348 billion as a result of amendments to the budget.
2/ Defined as the yearly change in the fiscal stance.
3/ Defined as the fiscal impulse plus the yearly change in oil revenue. See Chapter II of the accompanying Selected Issues paper for more details on the calculation of the fiscal impulse.

to have added somewhat to upward pressures on prices and the ruble. Indeed, it has coincided with the period of core inflation becoming entrenched and the pace of real ruble appreciation picking up. Still, the relaxation has so far been measured inasmuch as the federal budget would still have balanced at a price for Russian crude oil of only $22 per barrel in 2004, suggesting that fiscal policy for the period 2001–04 as a whole did much to prolong the recovery, preventing early overheating by partially taxing and saving the large terms of trade windfall in the face of buoyant demand. As detailed below, however, the recent amendment of the 2005 budget and current plans for the 2006 budget point to a significant relaxation of this policy. The fiscal impulse excluding the oil sector has now turned notably positive (see Text Table).

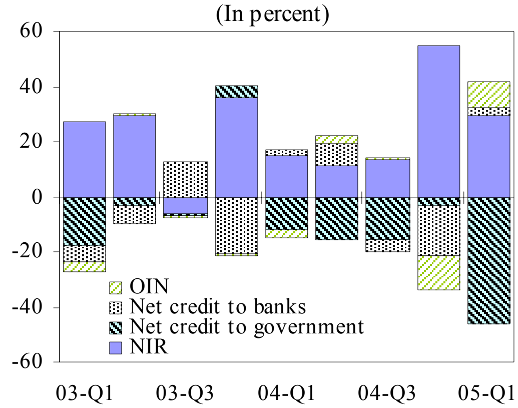
11. **Monetary policy has remained accommodative, notwithstanding some tightening since mid-2004**. Unsterilized interventions have caused large increases in reserve money in recent years, and the attendant rapid growth in bank credits has contributed to the buoyancy of domestic demand (Table 5). However, reserve money growth has slowed somewhat since mid-2004, mainly because of an accelerated build-up of government deposits with the CBR following the increase in oil taxation in mid-2004. The turmoil in the banking sector last year may also have contributed to the slowdown in credit growth. Yet, this slowdown is largely considered to have reflected weakening demand for credits as investment growth has decelerated. Rising inflation, declining nominal interest rates, and larger capital outflows, among other factors, suggest that monetary conditions have remained accommodative.

Inflation, Real Effective Appreciation and Targets 1/
(In percent)



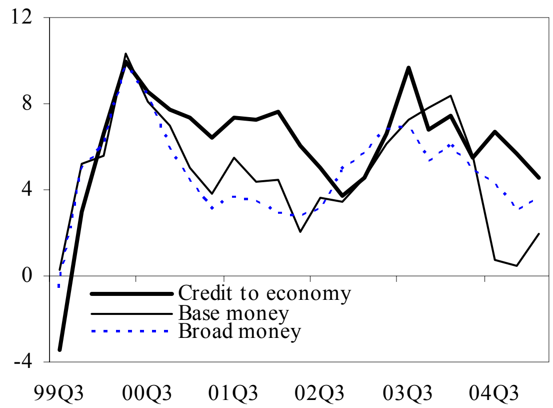
Source: Authorities and IMF staff calculations.
1/ Verticals bars are inflation targets, and horizontal bars are target ceilings for real appreciation.

Contribution to Quarterly Base Money Growth
(In percent)



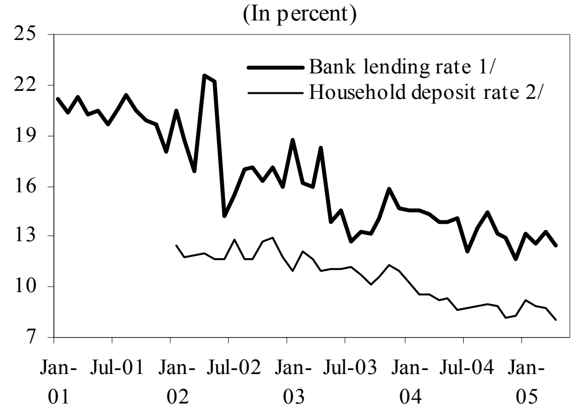
Source: Authorities and IMF staff calculations.

Real Credit to Economy, Monetary Base and Broad Money
(Qoq percent change, SA, 3-quarter MA)



Source: Authorities; and IMF staff calculations.

Interest Rates
(In percent)



Source: EMED.
1/ 31 to 90 days.
2/ Excluding demand deposits, all terms.

Box 3. Policy Implementation and Past IMF Recommendations

Fiscal policy: A key policy recommendation by the staff has been to tax and save oil revenue windfalls as long as cyclical pressures persist. Despite the gradual reduction in the non-oil deficit, fiscal policy has broadly been in line with the staff's suggestions during the period 2001–04. Staff have also urged that the VAT reform planned for 2004–05 be delayed or, at least, be revenue-neutral to avoid exacerbating inflationary pressures. The authorities have decided to postpone this reform. Much of the far-reaching structural changes with regard to the tax system and expenditure control are in line with the considerable Fund TA advise given to Russia in these areas.

Monetary policy: Staff has recommended that monetary policy be primarily focused on inflation-control, unburdened of exchange rate considerations. The CBR has disagreed with this advice, and continued to pursue dual targets with its monetary and exchange rate policies.

Banking sector reforms: The authorities have implemented many of the recommendations provided by the large number of Fund-Bank TA missions since the 1998 crisis, but key problems remain to be addressed, including full IAS accounting, strengthening of creditor rights, and the development of strategic plans for the still dominant state banks. Overall, in the staff's view significant progress has been made in this area. Staff has also supported the proposal for a deposit insurance scheme on the ground that this would provide the authorities with an opportunity to strengthen prudential standards, abandoning the regulatory forbearance that has characterized supervision in the past. CBR officials believe that the admission process has indeed achieved such a strengthening, as discussed in the report.

Structural reforms: Staff has found the government's long-term structural reform program to be comprehensive and well-targeted, not least its focus on measures to improve the investment climate. However, staff has also, since 2002, found that the implementation of this plan has been disappointing, in particular as far as civil service, public administration, and natural monopolies are concerned. Developments last year have reinforced the staff's concerns in this regard.

C. Structural Reforms

12. **Structural reforms are behind schedule**. The reforms of social benefits that came into effect in early 2005 were an important step toward overhauling Soviet-era entitlement programs, despite some dilution of the original plan and implementation problems. Other reforms, however, have progressed only slowly, if at all, and are running well behind the plans outlined by the government when it assumed office last year. In particular, the unexpectedly strong opposition to the social benefits reform appears to have reduced the resolve to move ahead with health and education reforms.

13. **In banking, implementation of the new deposit insurance scheme is well underway**. The first round of admissions into the deposit insurance scheme was completed at end-March, 2005. Out of 1,137 banks that applied, 824 were admitted. Most rejected banks were small as those admitted account for 98 percent of household deposits. Rejected banks may apply again in a second round of assessments, to be completed by end-September 2005.

II. Near-Term Outlook and Medium-term Framework

A. Near-Term Outlook

14. **Real GDP growth is set to remain robust in 2005, but is unlikely to return to the pace reached before last year's slowdown.** Staff projects GDP growth of 5½ percent for 2005 as a whole, broadly in line with private sector consensus, but less than recent government forecasts of almost 6 percent. Consistent with developments in early 2005, both exports and investment growth are expected to remain subdued compared with previous years, high oil prices notwithstanding, as concerns about the investment climate linger and supply constraints in the oil sector are unlikely to ease. Consumption continues to be the main engine of growth, supported by accommodating macroeconomic policies.

15. **The near-term outlook is shrouded in much uncertainty, however**. Activity and investment indicators have been very volatile, while consumption growth has eased recently, raising doubts about its projected strength. On the other hand, further fiscal relaxation this year, as discussed below, could boost GDP growth closer to last year's level than projected by staff. But a durable rise from recent levels is ultimately likely to be checked by resource constraints and increased expenditure switching to imports, especially in view of the slowdown in investments and the real appreciation of the ruble.

16. **Inflation is likely to exceed the official target again this year**. With emerging supply constraints but, buoyant demand, and year-on-year inflation of 13¾ percent through June, the official end-year target of 8½ percent is beyond reach. The staff's projection of 11½ percent by the end of the year assumes that the CBR will again permit only limited nominal appreciation, but no more than what would be needed to avoid year-end inflation from being higher than in 2004. Staff projects a real effective exchange rate appreciation of 11 percent in 2005, well above the official target of 8 percent.

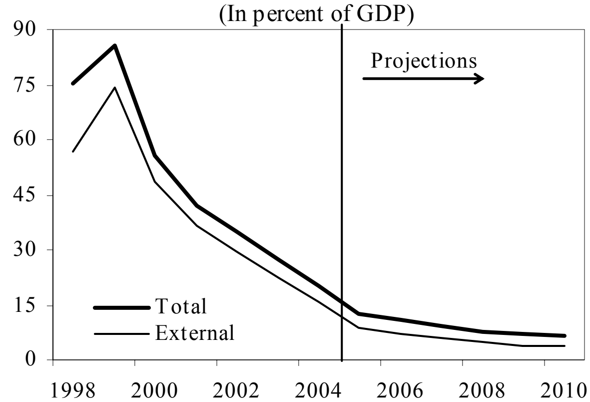
B. Medium-Term Framework

17. **Russia has the potential for sustained high growth over the medium-term, provided it accelerates structural reforms**. Since the 1998 crisis, Russia has realized significant gains in total factor productivity and attendant rapid increases in real wages and consumption, in spite of an investment-to-GDP ratio that is low compared to other emerging market economies and a concentration of investments in primary commodity sectors. This suggests considerable catch-up potential if policies succeed in accelerating and broadening investment growth over the medium term. Key ingredients in this regard are structural reforms and better public infrastructure, as well as decisive actions to reassure investors concerned about interventionism and the even-handiness of the state bureaucracy, as discussed below. Contingent on measurable progress in these areas, staff expects potential output growth to be 6–7 percent over the medium term. Without such progress, it expects growth to slow further in the coming years (Table 6).

18. **Balance of payments constraints are unlikely to restrict economic policies and GDP growth over the medium to long term.** Even conservative forecasts for oil prices are significantly above the new, higher benchmark price for the oil stabilization fund of $27 per barrel (see below), suggesting that Russia under current policies is still taxing and saving what is at least partially a permanent terms-of-trade gain. Thus, there is considerable scope for policies that will bring about or accommodate a gradual lowering of the savings-investment surplus, without jeopardizing balance of payments viability. This conclusion is reinforced by the fact that external vulnerability considerations weigh much less on economic policies following the decline in external debt to low levels and the sharp rise in foreign reserves (Table 7). As the current account adjusts to the terms-of-trade gain, the ruble should be expected to appreciate steadily in real terms (Box 2).

19. **Staff projections indicate there is considerable room for fiscal relaxation over the medium term**. Under conservative assumptions about oil prices, the projected headline primary surplus is about 6 percent of GDP higher than the debt-stabilizing primary surplus over the medium term. The staff's medium-term fiscal scenario assumes that part of this room is used for major structural reforms in line with the government's medium-term reform plans (Box 4). Under this scenario, the surplus in the primary balance gradually declines as oil revenues decline relative to GDP and as spending on structural reforms and public infrastructure increases by ½ percent of GDP each year, starting in 2007. Yet, public debt would continue to drop from an already low 20 percent of GDP to less than 10 percent of GDP by 2010. Taking an even longer term

Public Debt
(In percent of GDP)



Source: Authorities and IMF staff calculations.

perspective, by incorporating the implications of demographic changes, the fiscal position is also favorable, as detailed in Box 4.

20. **Macroeconomic vulnerabilities appear low, barring a major deterioration in macroeconomic policies**. A main risk is a much faster and deeper drop in oil prices than assumed in the staff's base-line scenario. Sensitivity analysis suggests, however, that the medium-term fiscal position is robust to sizable adverse shocks. Even a worse-case scenario—with a sharp fall in the oil price to $15 per barrel, an initial contraction in GDP of 2 percent, and a major devaluation of the ruble—would leave public debt at about 34 percent of GDP (Table 8). A similar quantitative exercise confirms that the external position is also robust to sizeable disturbances (Table 9 and Figure 1).

III. Report on the Discussions

21. **The discussions revolved around the policies needed to make best use of oil revenues.** The main topics were the reasons for the slowdown in economic growth and the attendant implications for macroeconomic policies in the near term; the optimal pace and timing of the fiscal relaxation warranted over the medium term and the associated linkages to the structural reform program; the changes to monetary and exchange rate policies needed to ensure that the fiscal relaxation does not jeopardize financial stability; and the prospects for banking sector reforms.

22. **The authorities are in the midst of a major reevaluation of economic policies**. The discussions took place against a backdrop of considerable uncertainty about the reasons for the sudden slowdown in investments and economic growth and much heightened uncertainty about the short-term outlook. Consensus has yet to emerge among key policy makers about the extent to which the slowdown was policy induced and about the need for policy corrections. Meanwhile, the expectation that oil prices will remain high over the medium term is leading to a fundamental reexamination of the current policy for taxing and saving oil revenues. The view that these savings should be spent is increasingly taking hold, but a medium-term strategy in this regard has yet to emerge. Finally, the unexpectedly fierce opposition to social sector reforms appears to have made the authorities more cautious, and expectations about the pace of reform have become notably less ambitious. Overall, there appeared to be somewhat less of a consensus about the direction of economic policies than at the time of the last Article IV consultations.

A. Fiscal Policy

23. **A major fiscal relaxation is under way.** The recently proposed amendment to the 2005 budget will raise expenditures by 1¾ percent of GDP relative to the original budget, financed by one-time back-taxes from Yukos and higher-than-budgeted revenues from oil taxes not earmarked for the stabilization fund (mainly profit and excise taxes from the oil sector). The increase is almost entirely on account of higher wages, pensions, transfers to regions, and other recurrent expenditures. While the 2006 budget is still under preparation

Box 4. Long-Term Fiscal Sustainability and Structural Reforms

Russia's structural reform program entails significant fiscal costs in the medium and long term. Key assumptions include:

- ***GDP growth*** falls gradually from a conservative 5 percent per year in 2006–10 to a long-run level of 2 percent per year, equivalent to that in the United States.
- In line with market expectations, staff assumes that the nominal oil price remains constant at around $50 per barrel until 2013, implying a gradual fall to $40 per barrel at 2004 prices, after which it will remain constant in real terms at this level (equivalent to around US$36.60 Urals).
- ***Energy taxes.*** The tax burden for the energy sector remains the same as in 2006, so that the ratio of energy tax revenues to GDP declines in line with the contraction in the share of energy GDP.
- ***Non-energy tax revenues*** gradually increase from about 28 percent of GDP, the level projected in 2006, to around 30 percent of GDP in 2050 reflecting the increase in the share of non-oil GDP.
- ***Non-reform public expenditure*** will be contained at 30 percent of GDP.

Six major structural reforms are contemplated. Associated fiscal costs amount to about 4½ percent of GDP.

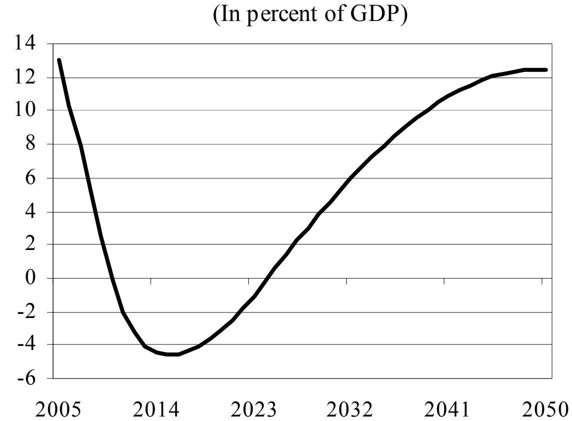
Civil Sector Reform. Public salaries need to be brought in line with those of the private sector, especially at the senior level. The government has started implementing this reform in 2004, but an additional 0.6 percent of GDP per year is necessary for further wage adjustments. In addition, civil employment should be reduced by at least one quarter by 2010 (World Bank).
Housing and Communal Service Reforms. These are necessary to provide appropriate incentives for improving efficiency. However, higher utility tariffs will raise costs for budget organizations by about 0.5 percent of GDP a year (World Bank).
Pension Reform. The pension system will require additional funding to maintain a replacement rate of 30 percent. In addition, the unified social tax cut has created an annual financing gap of about 1 percent of GDP, which will need to be financed with transfers from the federal budget. Demographic dynamics will reduce the support ratio, resulting in an additional need for transfers. Overall, expenditure on pensions increases by 2 percent of GDP per year by 2014 (World Bank).
Health and Education Reform. At present, the general government is spending about 7 percent of GDP on education and health. It is widely recognized that public wages have to be increased in these sectors; in addition, their infrastructure must be upgraded. Thus, expenditure on education and health should rise by 1.4 percent of GDP.

Contingent liabilities seem rather limited (the largest one would be associated with a major banking crisis through the deposit insurance scheme and is estimated at about 2–3 percent of GDP). In conclusion:

The endowment of natural resources allows costly structural reforms, provided non-oil revenues (or expenditures) offset in small part the trend decline in oil revenues to GDP. Energy-related revenue will be 4.1 percent of GDP in 2050 (down from 13 percent of GDP in 2005, as the price of oil declines and GDP increases). An increase in non-oil revenues (or cut in expenditures) by around 2 percent of GDP is sufficient to preserve sustainability. Public debt will not exceed 15 percent of GDP by 2050 and will remain stable afterwards.

However, fiscal sustainability will be compromised if the government implements these reforms while simultaneously cutting non-oil revenues. For instance, permanently reducing non-oil revenues by 2 percent of GDP compared to the baseline would increase public debt to over 100 percent of GDP by 2050.

Public Debt 1/
(In percent of GDP)



Source: IMF staff calculations.
1/ A negative number indicates a positive net position.

and key parameters are yet to be finalized, including the surplus target and the assumption about oil prices, planned investment incentives in the form of VAT and profit tax reductions will cost ¾ percent of GDP. Including the modest relaxation built into the original 2005 budget, the 2005 amendment and the plans for 2006 discussed with the mission will worsen the balance of the federal government on a constant oil price basis by about 3 percent of GDP compared to 2004 (1¾ percent of GDP in 2005 and 1½ percent of GDP in 2006). To fund this increased spending, the benchmark oil price above which revenues are saved in the stabilization fund will be raised from \$20 to \$27 per barrel. Taking into account the spending financed by the profit and excise taxes on the oil sector that are not channeled to the stabilization fund, staff estimates that the fiscal changes proposed by the government in recent months entail an increase in the oil price at which the federal budget is in balance from \$22 per barrel in 2004 to, at least, \$31 per barrel in 2006.

24. **Pressures to relax further are mounting.** These pressures are being fuelled by the swelling of the oil stabilization fund—to \$50 billion by end-2005 under current oil prices, despite prepayment of Paris Club debt—and the fact that the new benchmark price (\$27 per barrel) and the oil price assumption in the amended 2005 budget (\$35 per barrel) remain much below current prices. Proposals for using more of the oil revenue windfall range from accelerated increases in wages and social expenditures—President Putin has promised that public sector wages will be raised by 50 percent in real terms over the next three years (and that pensions will be increased significantly as well)—to increased funding of infrastructure and investment projects. While calls for further tax cuts have become somewhat muted as the focus of the public debate has switched to the expenditure side—the previously planned VAT reform has been postponed—the discussions showed that support for such cuts remain strong.

25. **Officials of the Ministry of Finance acknowledged that a fiscal relaxation at this juncture would increase inflationary pressures.** They agreed that the recent relaxation was large, but argued that the risks were still manageable. They also stressed that the relaxation was measured considering the demands that they had faced in this regard.

26. **Ministry of Finance officials were confident that there would not be any further large fiscal relaxations in 2005–06**. Explaining that the debate on the fiscal stance in effect had become a discussion about the appropriate benchmark price of the stabilization fund and the oil price assumption underlying the budget, officials were adamant that the benchmark price would remain at \$27 per barrel and the oil price assumption very conservative. Thus, while recognizing that a second amendment to the 2005 budget is likely this fall, they were confident that this amendment would be small. Similarly, while resources would have to be allocated in the 2006 budget for a new investment fund and for a down payment on the wage increases promised by the president, they believed, that the budgetary envelope—to be submitted to Parliament in August—would actually entail a small reduction in total expenditures relative to GDP, in line with long-standing plans. Staff questioned the realism of this, suggesting that the relatively small down payment might not be consistent with the expectations that have been raised in this regard, and warning that higher wage and pension

payments would require transfers to the pension fund and regional budgets much above those envisaged in the draft budget discussed with the mission.

27. **Staff agreed that there is ample room for fiscal relaxation over the medium term but argued that such relaxation should be delayed until cyclical pressures eased**. Under the current outlook, a relaxation at this time would entail allowing more of the terms-of-trade gain to translate into faster overall demand growth just as resource constraints were beginning to bite. This would add to the already rising inflationary pressures and increase the risk that the real ruble appreciation overshoot its long term path. In view of this, it would be preferable if there were no increase in the non-oil deficit in 2005–06, and staff warned that the increase reflected in the recent amendment of the 2005 budget and the preliminary plans for 2006 would increase inflationary pressures. Taking note of the authorities' view that the proposed amendment of the 2005 budget could not be reconsidered, staff urged that further fiscal easing be delayed until inflation is set on a clear downward path.

28. **Staff cautioned that the inflationary risks associated with the fiscal relaxation pointed to the urgency of a change in macroeconomic policy mix**. It noted that spending more of the terms of trade gain will inevitably cause an accelerated real appreciation of the ruble. Therefore, continuing to gear monetary and exchange rate policies towards resisting such appreciation would exacerbate the inflationary risks associated with the fiscal relaxation. In the staff's view, the authorities' confidence that the risks associated with the 2005 amendment were manageable hinged crucially, on a tightening of monetary policy enabled by an increase in exchange rate flexibility, as discussed below.

29. **Besides its concerns regarding the cyclical conjuncture, staff argued that the case against fiscal relaxation also rested on the limited scope for spending the oil revenues effectively at this juncture.** Oil revenues should be spent over the medium term on reforms and other outlays that promise to raise potential GDP growth. Considering that the total annual cost to the budget of the main structural reforms that still lie ahead amount to only 2–3 percent of GDP over the next five years, which is well within the potential for fiscal relaxation over this period, staff stressed that Russia's oil wealth provides a welcomed opportunity for accelerated modernization of the economy. It also noted that there is some scope for lowering of the tax burden over the medium term without jeopardizing budgetary resources for other reforms. However, with structural reforms mostly at a standstill, there was only limited scope for increased spending on reforms at this time. Noting that the 2005 amendment is overwhelmingly for public sector wages and other recurrent spending, staff acknowledged that there is a need for increased spending on wages, pensions and many social services, but doing so without accompanying public sector reforms risked wasting resources. Staff pointed to the delayed civil service, health and education reforms and noted that public sector employment continued to increase steadily, contrary to the government's objective. In the staff' view, current policies suggest that Russia's oil wealth is not being mobilized in support of reforms and investments that will raise potential growth over the medium term. This led to the conclusion that a key challenge facing the authorities as far as medium-term plans are concerned is to prepare an integrated program for accelerated structural reforms and increased spending of oil revenues.

30. **Looking to the long term, the challenge is to decide how to distribute the consumption of oil wealth over time**. Staff suggested several possible criteria[3] that would provide guidance in this context. The choice between such criteria is in the end a political decision, but two criteria calculated by staff indicate that the sustainable non-oil balance[4] would be approximately 5–6 percent of GDP higher than the current actual non-oil balance. In this connection, staff noted that a reform of the OSF that limited the scope for discretionary adjustment in the trigger price in the context of short-run oil price developments would facilitate better fiscal management.

31. **The authorities explained that they are taking steps to improve the allocation of public funds among different programs.** Specifically, they are: (i) developing a three year budgetary framework; (ii) enhancing expenditure control mechanisms; (iii) adopting a new government procurement law; (iv) revising procedures related to the compilation of the federal budget, including the reduction of number of readings of the draft budget.

B. Monetary Policy

32. **CBR officials believed that the current monetary policy stance is appropriate.** They considered the end-year target of 8½ percent to still be achievable and argued that the increase in inflation to 13¾ percent in June 2005 mainly reflected supply side shocks, notably increases in administered prices and shortages due to quotas on certain meat imports. On the assumption of more measured increases in administered prices and favorable seasonal factors during the second half of 2005, they did not see a need for monetary tightening at this time. More generally, they were less concerned about demand pressures than staff and did not believe that the fiscal relaxation now in store would significantly increase the burden on monetary policy.

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[3] One such criterion is to ensure stability of public debt as a share of GDP. In this context, the difference between the actual primary surplus and the debt stabilizing primary surplus determines how much public expenditure can increase (or non-oil revenues decrease), while keeping constant the debt ratio. As shown in paragraph 20 , this difference amounts, on average, to 6 percent of GDP in the medium term, entailing a non-oil federal deficit as high as 11 percent of GDP (it is about 5 percent of GDP now). Another criterion would be to generate a permanent stream of income by preserving the stock of wealth associated with oil and gas resources, as in the case of Norway. This requires that a fraction of the oil wealth be saved and turned into financial wealth, so as to keep total oil wealth constant, while oil resources are exploited and the value of oil in the ground declines. Staff estimates that the sustainable non-oil deficit corresponding to this rule would amount, in the medium term, to about 10 percent of GDP. However, this ceiling could be increased to the extent that government spending adds to human or physical capital, in which case total wealth remains unchanged even as energy wealth declines.

[4] The sustainable non-oil balance defines what the government can afford to spend over the medium (or long) term without exhausting its energy assets.

33. **Staff argued that monetary policy was too accommodative, pointing to rising inflationary pressures, declining interest rates, and large capital outflows, among other factors**. It did not believe that seasonal price changes and limitations on administered price increases would be sufficient to bring about the deceleration in headline inflation required to meet the end-year target. In this regard, it warned against using a policy of reduced increases in administered prices to bear down on inflation and noted that headline inflation had exceeded the target in recent years even when administered price increases had been delayed.

34. **Staff advocated increased exchange rate flexibility**. It was concerned that the end-year inflation target could be missed by a considerable margin without such flexibility. More generally, staff urged the CBR to subordinate its exchange rate target to the inflation target, by standing ready to scale back interventions whenever inflation exceeds the charted course. In this regard, the pace of inflation reduction was less important than the need to firmly signal that the inflation target would not give way to the exchange rate target. Staff worried that the spill-over of unsterilized interventions into inflation was set to quicken as spare capacity was being soaked up, and stressed that increased exchange rate flexibility could no longer be delayed now that fiscal policy is being relaxed if inflationary risks are to be contained. Staff also argued that making clear to markets that monetary policy would be firmly focused on reducing inflation rather than on limiting ruble appreciation will in time increase short-term exchange rate uncertainty, discouraging speculative capital flows.

35. **CBR officials saw only limited scope for more exchange rate flexibility**. Acknowledging that the large interventions were making it difficult to control the monetary aggregates, they accepted that some additional appreciation of the ruble could become necessary if headline inflation does not recede as expected during the second semester. However, they were reluctant to subordinate exchange rate policy to the achievement of the end-year target. Stressing that limiting real ruble appreciation remained an important political objective, CBR officials explained that monetary policy would continue to pursue dual targets.

C. Financial Sector Issues

36. **CBR officials acknowledged that the rapid changes in the banking system have increased vulnerabilities, but stressed that the risks of a systemic crisis remain low.** The increasing competition and declining margins, not least due to the renewed access to foreign capital markets, have forced banks into new activities. Consumer lending and mortgages are picking up, as is lending to small- and medium-sized enterprises. In this regard, CBR stress tests indicate that credit risk has increased somewhat even while non-performing loan ratios have stayed low. A shock comparable to the 1998 crisis would result in a loss of 2¾ percent of GDP in 2004 compared to 2¼ percent a year earlier. Equity and interest rate risks have also edged up, and liquidity ratios—while still high by international standards—have declined, amplified by increasing maturity mismatches and a segmented interbank market. However, stressing that banks are generally well capitalized and sufficiently provisioned, and that profitability and asset quality are good on average, CBR officials were confident that a systemic crisis was very unlikely, although turbulence as in 2004 could not be excluded.

37. **Officials were satisfied that supervision and the framework for dealing with problem banks had improved**. The process for admission into the deposit insurance scheme had resulted in a substantial reduction in the number of banks and strengthened prudential standards. They were determined to tighten standards further, including by addressing shortcomings in connected lending limits and consolidated supervision. Further banking consolidation was also an important objective, and CBR officials expected the next round of consolidation to start in 2006 in preparation for the increase in the minimum capital requirement for banks to EUR 5 million effective in 2007. As to the framework for addressing bank difficulties, it was still lacking in important areas, but had improved significantly since last year's turmoil due the adoption of the new Bankruptcy Law for Financial Institutions in 2004. This will speed up the bank liquidation process, mainly by circumventing clogged-up courts and preventing liquidators from abusing their positions.

38. **Staff welcomed the improvements, but noted that key reforms are delayed and that the favorable environment could be masking more serious vulnerabilities**. It argued the current macroeconomic environment was ideal for tackling problems in the banking system, and expressed concern about the much delayed adoption of international accounting standards, the failure to address long standing problems in the judicial system, not least regarding creditor rights, and the continued absence of a strategic plan for what to do with the still dominant state banks. Moreover, noting that banks accounting for 98 percent of total deposits had been admitted to the new deposit insurance scheme, staff questioned whether the admission process had entailed the hoped for break with the regulatory and supervisory forbearance of the past. CBR officials were adamant that they had adhered to strong prudential standards during the admission process and assured staff that their resolve in this regard had not been weakened by the widespread criticism of the CBR's handling of last year's turmoil. They intended to continue to strengthen supervision and felt that they had strong political support. While agreeing with staff that there was much uncertainty, not least due to inadequate accounting standards and more general problems of corporate governance, they were confident that the banking system would prove to be robust even in the event of a notable deterioration in the environment, especially much lower oil prices, and reiterated that any problems that might arise would be manageable.

D. Structural Reforms

39. **The authorities acknowledged that reforms were generally running well behind target.** Some officials candidly attributed the delays to political complacency about reforms, in part due to high oil prices, and were generally reserved about the prospects for a major acceleration of the pace of reforms. Others argued that limited administrative capacities had been more of a constraint than expected, and were confident that the pace would pick up as the constraints were overcome.

40. **Officials stressed that progress had been made in several areas.** This included the railroad sector, where current operations had been separated from management of infrastructure and private operators had been granted access; the electricity sector, which had seen the separation of transmission and distribution networks from production activities and

the establishment of an internal wholesale market for electricity; and housing sectors, where use of mortgages had been facilitated, among other changes. There was general agreement that reform of Gazprom was at a standstill.

41. **The fierce resistance to social benefit reforms had come as a surprise and was tempering the pace of further reforms in the social area.** This was a main reason for delays in health and education reforms. Key officials stressed that concerns about the social impact of reforms were now clearly weighing more on policy makers and that reforms in this area were not only going to be slower than foreseen last year, but also require more budgetary resources than previously expected.

42. **The mission welcomed the removal of the exchange restrictions and multiple currency practices on current transactions identified in mid-2004**. It urged the authorities to avoid regulations and procedures of implementation of the 2004 Federal Law on Foreign Exchange Regulation and Foreign Exchange Control that could lead to new restrictions. It also encouraged the authorities to remove the deposit requirements on international payments of commissions and expenses channeled through R2 special bank accounts as they give rise to an exchange restriction subject to Fund approval (Appendix I).

43. **Russia's trade regime remains somewhat restrictive, but WTO accession is expected to further liberalize the system**. As to the accession negotiations, agreements have been reached with trading partners accounting for almost 85 percent of Russia's external trade. The authorities indicated that upon entry into the WTO the average import tariff on industrial products will be reduced from 10¼ percent to 7 percent and that on agricultural products from 21 percent to 20 percent. There are still outstanding differences, however, pertaining mostly to Russia's dual energy pricing, subsidies to agriculture and aviation, quotas on meat and poultry, and inadequate protection of intellectual property rights. Staff urged the authorities to work towards an early resolution of these differences holding up Russia's WTO accession.

44. **The process of establishing the Common Economic Space (CES) has recently run into opposition.** Russia, Ukraine, Belarus and Kazakhstan agreed in 2003 to establish the CES as a free trade area combined with an agreement to unify technical regulations and standards affecting trade, and creating coordination mechanisms for the cooperation in macroeconomic policies and economic legislation. However, Ukraine has reservations on the ground that participation could interfere with its intentions to seek closer cooperation with the EU and eventually EU accession. The delay in agreeing on the CES could increase the role of the Euro-Asian Economic Community, established by Russia, Belarus, Kazakhstan, Kyrgyzstan, and Tajikistan.

IV. Staff Appraisal

45. **Russia's robust growth to date owes much to how high oil prices have been handled by good policies, most notably by the gradual escalation of the taxation and saving of oil revenues.** This policy has served Russia well in that it has prevented the

windfall from causing demand pressures that could have exacerbated inflationary pressures, due to the still limited productive capacities in the non-tradable sectors.

46. **It is therefore a matter of concern that this policy is being relaxed just as investment is slowing and resource constraints are emerging, as evident in part from the upward pressures on inflation and the ruble.** Allowing more of the oil windfall to translate into higher demand at this juncture will only exacerbate such pressures and at best elicit a temporary output response. Until recently, the Ministry of Finance has been relatively successful in resisting calls for a relaxation of this policy. But decisions since the spring of this year have amounted to a weakening of the fiscal position by some 3 percent of GDP, entailing an increase in the oil price required to balance the budget by almost 10 dollars per barrel. This points to an unfortunate weakening of political support for the current policy of saving oil revenues.

47. **Staff believes that the surplus on a constant oil price basis should not be reduced further in 2005 and 2006.** While the relaxation already entailed by the amendment of the 2005 budget will increase inflationary pressures, staff agrees that such pressures are likely to be manageable provided that the exchange rate policy becomes much more flexible, as discussed below. A further relaxation of the non-oil balance should be postponed, however, until inflation is on a clear downward path. In terms of the ongoing debate within Russia about what to do with the oil revenue windfall, this implies that the benchmark price for the stabilization fund should not be increased again, and that there should be no further use of the resources of this fund, except for prepayment of debt. Higher revenues from oil sector taxes not covered by the stabilization fund should also be saved.

48. **Russia's oil wealth offers a unique opportunity for accelerated modernization if harnessed in support of reforms, including tax reforms, and investments that promise to raise potential GDP growth.** Even conservative medium-term forecasts suggest that the scope for fiscal relaxation, once cyclical pressures ease, is well above the projected budgetary cost of the key reforms that still lie ahead. This presents an enviable opportunity to move boldly forward, one unavailable to most other emerging economies. However, the scope for spending more on structural reforms in the near term without wasting resources, including by spending more on infrastructure projects, is limited due to the slowness of reforms in recent years. In this regard, while there is ample room for raising low public sector wages and pensions, and strengthening basic public services over the medium term, not least those that could alleviate poverty, doing so at this juncture where civil service, health and education reforms are stalled risks being wasteful. While there is a case for a measured increase in infrastructure spending that does not compete with the private sector, the capacity to do so at a more accelerated pace also appears to be constrained by administrative capacities not least by the slow civil service and public administration reforms. Spending the oil wealth in ways that do not augment the productive capacity of the economy will at best be a missed opportunity; at worst, it could force a deep pro-cyclical tightening if a sharp drop in oil prices exposes unsustainably high public consumption and social transfers. This points to a need for an integrated medium-term fiscal and structural reform plan for how to spend Russia's oil wealth.

49. **Inflation is running above target and the CBR is unlikely to be able to set it on a steady downward path without increased exchange rate flexibility.** The pace of inflation reduction is less important than clearly signaling that the CBR will give priority to its inflation target, standing ready to scale back interventions and allow ruble appreciation whenever inflation exceeds the targeted path. Recent years have demonstrated that the CBR can only curtail real ruble appreciation temporarily as interventions are ultimately reflected in higher inflation. With pass through to inflation set to quicken as resource constraints become more binding, continuing to allow real exchange rate considerations to have a significant bearing on monetary policy even as fiscal policy is being relaxed points to an increased inconsistency in the macroeconomic policy mix. Real appreciation is unavoidable as the terms of trade gain is increasingly being spent and continuing to resist such appreciation would pose a risk to macroeconomic stability.

50. **Banking reforms are progressing, but concerns about regulatory forbearance persist.** The process of admitting banks to the new deposit insurance scheme appears to have strengthened prudential standards. But the fact that banks accounting for more than 98 percent of deposits have been admitted gives rise to doubts at to whether regulatory forbearance is now entirely a thing of the past. While staff agrees with the authorities that systemic risks are low and manageable at this stage, the rapid rise in banks' balance sheets suggests that such risks could rise without supervisory vigilance. In the staff's view, the banking system remains an important vulnerability, not least in the event of a major drop in oil prices.

51. **Most of the government's other reform priorities are running much behind schedule, with many at a stand still.** A concern in this regard is that the opposition to the social benefit reforms appears to have reduced the resolve to push ahead with key reforms in the health and education sectors. Looking further back, only very limited progress has been made since 2001–02 in areas where reforms are strongly opposed by vested interests, suggesting that complacency due to high oil prices and attendant robust economic growth are a main reason for the apparent lack of urgency about structural reforms. The recent slowdown is a timely reminder that high growth can ultimately not be sustained even in an environment of record high oil prices, without much faster progress on structural reforms. The priorities should be to advance reforms that promise to bolster the investment climate, not least civil service and public service administration reforms, and reforms of the natural monopolies.

52. **The Yukos affair has, rightly or wrongly, raised the specter of interventionism and increased heavy-handedness by regulatory and law enforcement agencies**. Despite much welcomed attempts by senior officials to reassure investors, concerns about the ability to control Russia's pervasive bureaucracy linger. A determined acceleration of structural reforms is in the staff's view critical to overcoming such concerns and repairing the damaged investment climate.

53. **Russia's economic and financial statistics are broadly adequate for surveillance purposes.** However, frequent revisions have raised concerns about data accuracy,

particularly in the real sector. Among other issues, the components of the CPI and PPI are not readily available, and the weights are not disclosed, rendering the analysis difficult.

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

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2001−06

	2001	2002	2003	2004	2005	2006
	Actual				Proj.	Proj.
	(Annual percent change)					
Production and prices						
Real GDP	5.1	4.7	7.3	7.2	5.5	5.3
Consumer prices						
Period average	21.5	15.8	13.7	10.9	12.9	10.8
End of period	18.6	15.1	12.0	11.7	11.5	10.0
GDP deflator	16.5	15.5	14.0	18.0	21.4	10.8
	(In percent of GDP)					
Public sector						
General government (commitment basis)						
Overall balance	2.7	0.6	1.1	5.0	7.6	6.5
Revenue	37.3	37.7	36.7	38.6	43.2	41.0
Expenditures	34.6	37.1	35.6	33.6	35.6	34.5
Primary balance	5.4	2.7	2.8	6.2	8.8	7.4
Overall balance at constant oil price 1/	1.8	-0.3	-1.4	-0.2	-2.7	-4.7
Federal government overall balance (commitment basis)	2.7	1.3	1.6	4.4	7.5	6.6
	(Annual percent change)					
Money						
Base money	38.1	30.4	49.6	24.8	36.6	32.1
Ruble broad money	40.1	32.3	51.6	35.8	41.2	36.4
	(Annual percent change)					
External sector						
Export volumes	2.8	6.5	6.7	9.7	7.6	5.7
Oil	9.1	15.5	8.3	14.7	6.2	5.5
Gas	-6.7	3.0	-0.7	-7.4	1.5	1.5
Non-energy	2.5	1.4	7.9	10.6	11.2	7.6
Import volumes	24.3	10.7	8.9	15.6	24.0	14.1
	(In billions of U.S. dollars; unless otherwise indicated)					
External sector						
Total exports, fob	101.9	107.2	135.9	183.5	248.8	271.7
Total imports, fob	-53.8	-61.0	-76.1	-96.3	-127.4	-147.0
External current account	33.4	30.9	35.4	59.9	91.7	92.2
External current account (in percent of GDP)	10.9	9.0	8.2	10.3	11.9	10.2
Gross international reserves						
In billions of U.S. dollars	34.5	47.8	76.9	124.5	188.7	274.0
In months of imports 2/	5.0	5.6	7.1	8.9	11.8	15.3
In percent of short-term debt 3/	113	245	330	349	528	724
Memorandum items:						
Nominal GDP (in billions of rubles)	8,944	10,818	13,243	16,752	21,459	25,019
Nominal GDP (in billions of U.S. dollars)	307	345	431	582	774	903
Exchange rate (rubles per U.S. dollar, period average)	29.2	31.3	30.7	28.8	27.7	27.7
World oil price (U.S. dollars per barrel, WEO)	24.3	25.0	28.9	37.8	50.7	53.0
Real effective exchange rate (average percent change)	18.7	3.3	3.5	7.5	10.5	8.6

Sources: Russian authorities; and Fund staff estimates.

1/ At an oil price of $20 per barrel.
2/ In months of imports of goods and non-factor services.
3/ Short-term debt on a residual maturity basis, excluding prepayment of Paris Club debt.

Table 2. Russian Federation: Balance of Payments Projections, 2002-10
(In billions of U.S. dollars, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Projections					
Current Account	30.9	35.4	59.9	91.7	92.2	75.6	56.6	41.6	29.2
Trade Balance	46.3	59.9	87.1	121.3	124.7	111.1	95.9	85.2	77.6
Exports	107.2	135.9	183.5	248.8	271.7	275.8	278.2	285.0	294.2
Non-energy	51.8	62.2	83.0	103.2	107.7	107.2	107.1	109.1	112.2
Energy	55.5	73.7	100.4	145.6	164.0	168.6	171.1	175.9	182.0
Oil	39.6	53.7	78.6	114.4	126.4	130.1	133.1	138.2	144.3
Gas	15.9	20.0	21.9	31.2	37.6	38.5	38.0	37.7	37.7
Imports	-61.0	-76.1	-96.3	-127.4	-147.0	-164.7	-182.3	-199.7	-216.6
Services (net)	-15.0	-24.1	-26.4	-28.8	-31.6	-34.6	-38.4	-42.6	-47.4
Nonfactor services	-9.1	-10.9	-13.4	-16.4	-20.1	-24.3	-28.6	-32.5	-36.2
Factor services	-6.0	-13.2	-13.0	-12.5	-11.6	-10.3	-9.8	-10.1	-11.2
Public sector interest	-5.6	-5.2	-5.1	-4.8	-4.5	-4.4	-4.3	-4.0	-3.9
Other factor services	-0.3	-7.9	-7.9	-7.6	-7.1	-5.9	-5.5	-6.1	-7.3
Current transfers	-0.3	-0.4	-0.8	-0.8	-0.9	-0.9	-0.9	-1.0	-1.0
Capital and financial account	-10.9	0.9	-2.4	-15.2	-6.9	-4.3	-2.1	5.4	5.2
Capital transfers	-0.5	-1.0	-1.6	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4
Federal capital	-6.6	-4.4	-0.3	-18.2	-1.8	-2.2	-4.1	0.8	-1.7
Budgetary	-4.9	-7.4	-2.9	-19.8	-3.5	-4.3	-6.5	-1.9	-1.7
Disbursements	0.9	0.8	1.6	2.3	2.7	3.1	3.5	3.9	4.3
Amortization	-5.7	-8.2	-4.5	-22.1	-6.3	-7.3	-9.9	-5.8	-6.0
Non-budgetary	-1.8	3.0	2.6	1.5	1.8	2.0	2.4	2.7	0.0
Local Governments	-0.5	0.0	0.2	0.4	0.5	0.5	0.6	0.7	0.7
Private sector capital	-3.3	6.3	-0.7	4.1	-4.1	-1.2	2.9	5.4	7.7
Direct investment	-1.2	-1.7	2.1	2.4	2.7	3.0	3.3	3.6	3.9
Portfolio investment	2.0	-0.8	0.8	0.8	0.9	0.9	0.9	1.0	1.0
Commercial banks	2.2	10.3	3.6	8.3	8.9	9.6	11.4	12.3	13.2
Corporations	8.3	12.0	17.2	18.6	20.0	21.4	23.0	24.6	26.3
Other private capital	-14.7	-13.4	-24.5	-26.0	-36.7	-36.2	-35.7	-36.0	-36.8
Errors and omissions, net	-7.5	-5.7	-9.9	-8.8	0.0	0.0	0.0	0.0	0.0
Overall balance	12.5	30.5	47.7	67.7	85.3	71.3	54.5	47.0	34.4
Financing	-12.5	-30.5	-47.7	-67.7	-85.3	-71.3	-54.5	-47.0	-34.4
Net international reserves	-13.0	-31.2	-49.3	-67.7	-85.3	-71.3	-54.5	-47.0	-34.4
Gross reserves (- increase)	-9.4	-29.1	-47.6	-64.2	-85.3	-71.3	-54.5	-47.0	-34.4
Net Fund liabilities	-1.5	-2.0	-1.7	-3.5	0.0	0.0	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-1.5	-2.0	-1.7	-3.5	0.0	0.0	0.0	0.0	0.0
Other liabilities	-2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Valuation adjustment	-0.8	2.8	2.4	0.0	0.0	0.0	0.0	0.0	0.0
Arrears and rescheduling	1.3	-2.1	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0						
Memorandum items:									
Current account (in percent of GDP)	9.0	8.2	10.3	11.9	10.2	7.4	4.9	3.2	2.0
Gross reserves 1/	47.8	76.9	124.5	188.7	274.0	345.3	399.8	446.8	481.2
(in months of imports of GNFS)	5.6	7.1	8.9	11.8	15.3	17.5	18.5	19.1	18.9
(as a percent of short-term debt) 2/	141	286	231	528	724	845	1064	...	...
(as a percent of public debt service)	319	910	408	1752	2326	2422	4079	...	...
Net private capital outflows (in percent of trade)	6.4	-0.3	3.8	1.3	1.0	0.3	-0.6	-1.1	-1.5
World oil price ($barrel) (WEO)	25.0	28.9	37.8	50.7	53.0	51.8	50.3	49.5	49.0
Terms of trade (percent)	-4.1	4.3	12.3	18.1	2.1	-3.8	-4.5	-2.7	-1.9
Public external debt service payments 3/	11.4	15.0	8.5	30.5	10.8	11.8	14.3	9.8	10.0
(percent of exports of goods and services)	9.5	9.8	4.1	11.2	3.6	3.9	4.7	3.1	3.1
Public external debt	103.3	104.7	104.0	80.7	77.2	72.9	66.5	64.6	62.8
(percent of GDP)	29.9	24.1	17.9	10.4	8.6	7.1	5.8	5.0	4.4
Private external debt (incl local gov't)	48.8	81.2	111.1	142.6	176.5	212.8	252.7	295.5	341.4
Total external debt	152.1	185.9	215.1	223.3	253.6	285.7	319.2	360.1	404.2
(percent of GDP)	44.1	42.8	37.0	28.9	28.1	27.9	27.7	27.9	28.2

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

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

Table 3. Russian Federation: Fiscal Operations, 2002-06 1/
(in percent of GDP)

	2002	2003	2004 Est.	2005 Proj.	2006 Proj.
General Government					
Total revenue	37.7	36.7	38.6	43.2	41.0
Tax revenue	35.1	34.1	36.1	40.8	38.6
Corporate profit tax	4.3	4.0	5.2	6.9	6.1
Personal income tax	3.3	3.4	3.4	3.9	3.9
VAT	7.0	6.7	6.4	6.3	5.4
Excises	2.4	2.6	1.5	1.6	1.6
Customs tariffs	3.0	3.4	5.1	8.2	8.0
Resource extraction tax	2.2	2.6	3.5	4.3	4.0
Social security taxes	8.0	7.8	7.8	6.5	6.4
Other	5.0	3.5	3.2	3.2	3.2
o/w: Budgetary funds	1.2	0.9	0.8	0.8	0.8
Nontax revenue	2.5	2.6	2.5	2.4	2.4
Total Expenditure	37.1	35.6	33.6	35.6	34.5
Interest	2.1	1.7	1.2	1.1	0.9
Non-interest	35.0	33.9	32.4	34.4	33.5
of which					
Education	3.8	3.6	3.4	3.6	3.6
Health	3.7	3.6	3.5	3.7	3.6
Housing & communal services	2.4	1.9	1.8	2.0	1.9
Other social expenditures	10.6	9.7	9.2	9.8	9.6
Primary balance	2.7	2.8	6.2	8.8	7.4
Overall balance	0.6	1.1	5.0	7.6	6.5
Financing	-0.6	-1.1	-5.0	-7.6	-6.5
Foreign	-1.6	-1.7	-0.5	-2.5	-0.3
Domestic	1.0	0.6	-4.5	-5.1	-6.2
Monetary Authority	-0.6	-1.2	-4.3	-5.6	-6.7
Commerical Banks	1.0	0.4	0.0	-0.1	0.0
Other	0.6	1.4	-0.3	0.6	0.6
Arrears/Rescheduling	0.0	0.0	0.0	0.0	0.0
Memorandum items:					
Non-oil primary balance	-4.8	-5.9	-4.9	-8.2	-9.5
Non-oil overall balance	-6.9	-7.6	-6.1	-9.4	-10.4
Federal Government					
Revenue	17.2	16.7	17.8	22.1	21.1
VAT	7.0	6.7	6.4	6.3	5.4
Excises	2.0	1.9	0.7	0.9	0.9
Profit tax	1.6	1.3	1.2	1.6	1.9
Trade taxes	3.0	3.4	5.1	8.2	8.0
Other	3.7	3.5	4.4	5.1	4.9
Expenditure (cash)	15.9	15.2	13.5	14.6	14.5
Interest	2.1	1.7	1.2	1.1	0.9
Noninterest	13.8	13.5	12.2	13.4	13.6
Memo items:					
Wages	3.3	3.3	3.3	3.3	3.3
Transfers to regions and population	4.0	4.7	4.0	4.3	4.6
Primary balance (cash)	3.4	3.3	5.6	8.7	7.5
Overall balance (cash)	1.3	1.6	4.4	7.5	6.6
Memorandum items:					
GDP (billions of rubles)	10,818	13,243	16,752	21,459	25,019
World oil price ($ / barrel)	25.0	28.9	37.8	50.7	53.0
Russian oil price ($ / barrel, cif)	23.5	27.3	34.3	47.3	49.5
Nonoil balance / nonoil GDP	-5.5	-6.0	-4.9	-6.1	-7.0
Oil revenue	5.7	6.3	8.2	12.3	12.1
Non-oil revenue	11.5	10.5	9.6	9.8	9.0
Non-oil primary balance (commitments)	-2.3	-3.0	-2.7	-3.7	-4.6
Non-oil overall balance (commitments)	-4.4	-4.7	-3.9	-4.8	-5.5

Sources: Russian authorities; and Fund staff estimates.
1/ Presented on a commitment basis.

Table 4. Summary of General Government Budget, 2004-06

(In percent of GDP)

	2004		2005		2006
	Budget	Est.	Budget	IMF Proj. 1/	IMF Proj. 2/
Federal Government					
Revenues (excluding unified social tax)	14.8	17.8	16.3	22.1	21.1
of which exceptional revenues (i.e. Yukos)		0.5		1.1	
Expenditures	14.2	13.5	14.9	14.6	14.5
Non-Interest	12.4	12.2	13.5	13.4	13.6
of which mid-year amendment				1.2	
Interest	1.9	1.2	1.4	1.1	0.9
Balance	0.6	4.4	1.5	7.5	6.6
Local Governments					
Revenues (own)	11.8	12.9	13.3	14.6	13.5
Expenditures (net of federal transfers)	11.8	12.8	13.3	14.5	13.6
Balance	0.0	0.2	0.0	0.1	-0.1
Extrabudgetary Funds					
Revenues (own)	7.6	7.8	6.3	6.5	6.4
Expenditures (net of transfers)	7.6	7.4	6.9	6.5	6.4
Balance	0.0	0.4	-0.6	0.0	0.0
General Government					
Revenues	34.2	38.6	35.9	43.2	41.0
Expenditures	33.6	33.6	35.1	35.6	34.5
Non-Interest	31.7	32.4	33.7	34.4	33.5
Interest	1.9	1.2	1.4	1.1	0.9
Balance	0.5	5.0	0.8	7.6	6.5
Memorandum items:					
GDP (billions of rubles)	15,300	16,752	18,720	21,459	25,019
Real GDP growth		7.2	6.3	5.5	5.3
Russian oil price ($ / barrel, cif)	22.0	34.3	28.0	47.3	49.5
Budget at constant 20 $/barrel					
Federal Government	-0.1	-0.8	-1.5	-2.6	-4.0
General Government	-0.2	-0.2	-2.2	-2.7	-4.7
Oil price that would balance the budget					
at federal level	20.2	22.3	24.2	27.4	31.1
at general level	20.5	20.5	25.8	27.1	32.4

Sources: Russian authorities; and Fund staff estimates.

1/ The projections for federal expenditure in 2005 include Rub 348 billion as a result of amendments to the budget.

2/ The projections for federal expenditure in 2006 are taken from the draft budget proposal.

Table 5. Russian Federation: Monetary Accounts, 2002–2005

(In billions of rubles, unless otherwise indicated)

	2002	2003	2004	2005			
	Dec.	Dec.	Dec.	March	May	June	Dec.
	Revalued	Revalued	Revalued				Proj.
Monetary authorities							
Base money	935	1,399	1,746	1,664	1,773	1,844	2,387
Currency issued	814	1,225	1,670	1,579	1,686	1,756	2,277
Required reserves on ruble deposits	121	174	76	84	87	88	110
NIR 1/	1,313	2,117	3,358	3,871	4,225	4,413	5,237
Gross reserves	1,519	2,266	3,456	3,871	4,225	4,413	5,237
Gross liabilities	206	149	98	0	0	0	0
GIR (in billions of U.S. dollars)	*47.8*	*76.9*	*124.5*	*139.5*	*152.3*	*159.0*	*188.7*
NDA	-378	-718	-1,612	-2,208	-2,453	-2,569	-2,850
Net credit to enlarged government	34	-181	-840	-1,649	-1,982	-2,128	-2,048
Net credit to federal government 2/	102	-79	-692	-1,377	-1,622	-1,823	-1,868
CBR net ruble credit to the federal government 1/	76	-21	-617	-1,187	-1,132	-1,324	-1,369
Foreign exchange credit	257	261	251	251	251	251	251
Ruble counterpart 2/	-231	-319	-326	-441	-740	-749	-749
CBR net credit to local government and EBFs	-68	-101	-148	-272	-359	-305	-179
CBR net credit to local government	-30	-39	-79	-177	-202	-185	-111
CBR net credit to extrabudgetary funds	-38	-62	-69	-95	-158	-120	-68
Net credit to banks	-196	-406	-591	-540	-427	-396	-611
Gross credit to banks	22	17	4	4	21	20	20
Gross liabilities to banks and deposits	-218	-422	-595	-544	-448	-416	-631
of which: correspondent account balances	-170	-305	-486	-327	-272	-283	-449
Other items (net) 3/	-216	-132	-180	-18	-44	-46	-191
Monetary survey							
Broad money	2,841	3,962	5,298	5,497	5,731	...	7,293
Ruble broad money	2,120	3,213	4,363	4,475	4,689	...	6,164
Currency in circulation	763	1,147	1,535	1,482	1,582	...	2,082
Ruble deposits	1,356	2,066	2,829	2,993	3,106	...	4,082
Forex deposits 1/	722	749	935	1,022	1,042	...	1,129
Net foreign assets 1/	1,512	2,043	3,180	3,762	4,138	...	4,830
NIR of monetary authorities	1,313	2,117	3,358	3,871	4,225	...	5,237
NFA of commercial banks	199	-74	-177	-109	-87	...	-407
In billions of U.S. dollars	*6.3*	*-2.5*	*-6.4*	*-3.9*	*-3.1*	... ...	*-14.7*
NDA	1,330	1,918	2,118	1,735	1,592	...	2,463
Domestic credit	2,493	3,265	3,974	3,194	3,090	...	4,326
Net credit to general government	466	294	-385	-1,216	-1,589	...	-1,613
Net credit to federal government	544	379	-231	-885	-1,126	...	-1,427
Net credit to local government and EBFs	-78	-85	-155	-331	-462	...	-186
Credit to the economy	2,027	2,971	4,360	4,410	4,679		5,939
Other items (net)	-1,164	-1,347	-1,856	-1,459	-1,498		-1,863
			(in percent, unless otherwise indicated)				
Memorandum items:							
Accounting exchange rate (eop, ruble per U.S. dollar)	31.8	29.5	27.7	27.7	27.7	27.7	27.7
Fourth-quarter nominal GDP (in billions of rubles)	3,016	3,677	4,723	...	...	...	6,041
CPI inflation (eop, 12-month change)	15.1	12.0	11.7	13.6	13.8	13.7	11.5
Seasonally adjusted ruble broad money velocity	5.7	4.6	4.3	4.2	4.5	...	3.9
Annual change in velocity	-6.9	-19.6	-5.4	-2.0	-3.8	...	-9.5
Real ruble broad money (rel. to CPI, 12 mnth change)	14.9	35.3	21.6	18.4	18.5	...	26.7
Nominal ruble broad money (12 month change)	32.3	51.6	35.8	30.4	33.0	...	41.3
Base money (12 month change) 4/	30.4	49.6	24.9	16.2	18.7	...	36.7
Real credit to the economy (12 month change)	18.1	30.9	31.4	20.4	21.0	...	22.2
Ruble broad money multiplier	2.3	2.3	2.5	2.7	2.6	...	2.6
Real exchange rate (12-month change) 5/	-2.3	4.1	4.7	5.3	6.9	8.4	...
Real exchange rate (average annual change) 5/	1.6	0.8	6.1	...	...	...	10.5

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 CBR. A positive number implies real effective appreciation. Monthly data for 2005 are Fund staff estimates.

Table 6. Russian Federation: Macroeconomic Framework, 2002-10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Projections					
I. Savings-Investment Balances									
	(In percent of GDP, unless otherwise indicated)								
General Government									
Consumption	17.7	17.6	16.5	17.5	17.3	17.5	17.5	17.4	17.0
Gross investment	3.2	2.8	2.8	3.2	3.3	3.5	3.8	3.8	3.8
Net income from abroad	-1.6	-0.8	-0.6	-0.4	-0.3	-0.2	-0.2	-0.2	-0.1
National savings	3.8	3.9	7.8	10.8	9.8	9.3	9.2	8.6	8.3
National savings - investment	0.6	1.1	5.0	7.6	6.5	5.8	5.4	4.9	4.5
Private Sector									
Consumption	50.0	49.4	47.7	47.2	49.1	51.5	53.8	55.5	56.9
Gross investment	16.9	17.6	18.3	17.1	17.3	17.6	17.8	18.1	18.3
Net income from abroad	-0.2	-2.3	-1.8	-1.3	-1.1	-0.8	-0.7	-0.7	-0.7
National savings	25.3	24.7	23.6	21.3	21.0	19.2	17.3	16.4	15.8
National savings - investment	8.4	7.1	5.3	4.2	3.7	1.6	-0.5	-1.7	-2.5
Overall Economy									
Consumption	68.9	68.2	65.3	65.7	67.4	70.0	72.2	73.7	74.8
Gross investment	20.1	20.4	21.1	20.2	20.6	21.1	21.6	21.9	22.0
Net income from abroad	-1.8	-3.1	-2.4	-1.7	-1.4	-1.1	-0.9	-0.9	-0.8
National savings	29.0	28.6	31.4	32.1	30.8	28.5	26.5	25.1	24.1
National savings - investment (current account)	9.0	8.2	10.3	11.8	10.2	7.4	4.9	3.2	2.0
	(In percent of GDP)								
II. General government accounts									
Revenues	37.7	36.7	38.6	43.2	41.0	40.1	39.2	38.6	38.1
Expenditure	37.1	35.6	33.6	35.6	34.5	34.3	33.8	33.7	33.6
Noninterest expenditure	35.0	33.9	32.4	34.4	33.5	33.6	33.1	33.1	33.1
Overall balance	0.6	1.1	5.0	7.6	6.5	5.8	5.4	4.9	4.5
Primary balance	2.7	2.8	6.2	8.8	7.4	6.6	6.1	5.5	5.0
	(In billions of U.S. dollars, unless otherwise indicated)								
III. Balance of payments and external debt									
External current account	30.9	35.4	59.9	91.7	92.2	75.6	56.6	41.6	29.2
in percent of GDP	9.0	8.2	10.3	11.8	10.2	7.4	4.9	3.2	2.0
Change in external terms of trade (in percent)	-4.1	4.4	12.3	18.1	2.1	-3.8	-4.5	-2.7	-1.9
Change in Russian crude oil price (in percent)	2.2	16.0	25.8	37.9	4.8	-2.5	-3.1	-1.6	-1.1
Official reserves	47.8	76.9	124.5	188.7	274.0	345.3	399.8	446.9	481.3
in months of imports	5.6	7.1	8.9	11.8	15.3	17.5	18.5	19.1	18.9
Public external debt service / exports of goods and services (in percent)	9.5	9.8	4.1	11.2	3.6	3.9	4.7	3.1	3.1
	(In percent, unless otherwise indicated)								
IV. Growth and prices									
Real GDP growth	4.7	7.3	7.2	5.5	5.3	5.0	5.0	5.0	5.0
CPI Inflation, end of period	15.1	12.0	11.7	11.5	10.0	9.0	8.0	6.5	5.0
CPI Inflation, average	15.8	13.7	10.9	12.9	10.8	9.5	8.5	7.3	5.8
Change in GDP deflator, average	15.5	14.0	18.0	21.4	10.8	7.9	7.2	6.9	5.7
Nominal GDP (billions of rubles)	10,818	13,243	16,752	21,459	25,019	28,349	31,901	35,810	39,751
Nominal GDP (billions of U.S. dollars)	345	431	582	774	903	1,023	1,152	1,293	1,435
Nominal exchange rate, rubles per U.S. dollar, end of period	31.8	29.5	27.7	27.7	27.7	27.7	27.7	27.7	27.7
Nominal exchange rate, rubles per U.S. dollar, average	31.3	30.7	28.8	27.7	27.7	27.7	27.7	27.7	27.7
Real effective exchange rate, average change	3.3	3.5	7.5	10.5	8.6	6.4	5.8	4.8	3.4

Sources: Russian authorities; and Fund staff estimates.

Table 7. Russian Federation: Indicators of External Vulnerability, 2002−04
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004
Financial indicators			
Public sector debt 1/	34.5	27.8	21.7
Broad money (12-month percent change, end-year)	33.9	39.4	33.7
Private sector credit (12-month percent change, end-year)	36.0	46.6	46.7
Treasury Bill Rate (short-term, average) 2/	12.7	5.4	3.1
Treasury Bill Rate (short-term, real, deflated by actual CPI inflation) 2/	-3.1	-8.3	-7.5
External Indicators			
Exports (percent change in US$)	5.3	26.7	35.0
Imports (percent change in US$)	13.4	24.8	26.6
Terms of Trade (12-month percent change)	-4.1	4.3	12.3
Current account balance (billions of US$)	30.9	35.4	59.9
Capital and financial account balance (billions of US$)	-10.9	0.9	-2.4
Gross official reserves (in billions of US$)	47.8	76.9	124.5
Liabilities to the Fund (in billions of US$)	6.6	4.6	3.1
Short term foreign assets of the financial sector (in billions of US$)	13.1	13.4	14.8
Short term foreign liabilities of the financial sector (in billions of US$)	5.0	9.1	9.1
Foreign currency exposure of the financial sector (in billions of US$)	13.7	9.8	...
Official reserves in months of imports GS	5.6	7.1	8.9
Ruble broad money to reserves	1.4	1.4	1.3
Total short term external debt to reserves	40.3	30.3	28.7
Total external debt (in billions of US$)	152.1	185.9	215.1
o/w: Public sector debt (in billions of US$)	103.3	104.7	104.0
Total external debt to exports GS (in percent)	126.4	122.2	105.6
External interest payments to exports GS	6.3	5.1	4.7
External amortization payments to exports GS	18.2	8.3	2.0
Exchange rate (per US$, period average)	31.3	30.7	28.8
Real effective exchange rate (12-month percent change, + means appreciation)	3.3	3.5	7.5
Financial Market Indicators			
Stock market index 3/	359.1	603.7	656.6
Foreign currency debt rating 4/	BB/Stable	BB	BB+
Spread of benchmark bonds (basis points, end of period) 5/	374.0	202.0	120.0

1/ External and domestic debt.
2/ The data for 2004 are for the average over the first 9 months.
3/ RTS index, end of period.
4/ S&P long-term foreign currency debt rating, eop. Fitch upgraded its rating from BBB- to BBB on August 3, 2005.
5/ 2007, 10-year Eurobond in US$, spreads over treasuries, eop.

Table 8. Russian Federation: Public Sector Debt Sustainability Framework, 1998–2010
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
		Actual					Prelim.			Projections			
					I. Baseline Medium-Term Projections								
Public sector debt 1/	75.4	96.0	57.6	48.5	34.5	27.8	21.7	14.1	12.0	10.4	8.9	8.0	7.3
o/w foreign-currency denominated	56.6	85.0	50.3	39.9	29.9	24.3	17.9	10.4	8.5	7.1	5.8	5.0	4.4
Change in public sector debt	22.9	20.6	-38.4	-9.0	-14.1	-6.7	-6.0	-7.6	-2.2	-1.6	-1.5	-0.9	-0.7
Identified debt-creating flows	93.5	-19.7	-33.2	-10.2	-7.1	-9.2	-11.9	-12.4	-8.5	-7.2	-6.6	-5.9	-5.3
Primary deficit	3.6	-2.9	-7.5	-5.4	-2.7	-2.8	-6.2	-8.8	-7.4	-6.6	-6.1	-5.5	-5.0
Revenue and grants	34.3	33.6	36.9	37.3	37.6	36.7	38.6	43.2	41.0	40.1	39.2	38.6	38.1
Primary (noninterest) expenditure	37.9	30.7	29.4	31.9	34.9	33.9	32.4	34.4	33.5	33.6	33.1	33.1	33.1
Automatic debt dynamics 2/	90.0	-16.8	-25.8	-4.8	-4.4	-6.4	-5.7	-3.6	-1.1	-0.6	-0.5	-0.4	-0.3
Contribution from interest rate/growth differential 3/	-1.1	-28.3	-28.3	-7.8	-6.4	-4.6	-4.6	-3.6	-1.1	-0.6	-0.5	-0.4	-0.3
Of which contribution from real interest rate	-3.6	-25.7	-21.9	-5.4	-4.5	-2.5	-3.0	-2.7	-0.5	-0.1	0.0	0.0	0.1
Of which contribution from real GDP growth	2.5	-2.6	-6.4	-2.4	-1.9	-2.1	-1.6	-0.9	-0.6	-0.5	-0.5	-0.4	-0.4
Contribution from exchange rate depreciation 4/	91.1	11.5	2.5	3.1	2.0	-1.8	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Denominator = $1+g+\pi+g\pi$	1.1	1.8	1.5	1.2	1.2	1.2	1.3	1.3	1.2	1.1	1.1	1.1	1.1
Residual, including asset changes (actual change in debt -identified change)	-70.6	40.3	-5.2	1.1	-7.0	2.4	5.8	4.8	6.3	5.6	5.1	5.0	4.6
Public sector debt-to-revenue ratio 1/	219.6	286.1	156.1	130.0	91.6	75.7	56.3	32.7	29.2	25.9	22.7	20.8	19.3
Gross financing need 5/	8.2	3.1	2.3	1.6	3.2	5.2	-0.8	-4.0	-3.5	-3.1	-2.7	-2.9	-2.8
in billions of U.S. dollars	22.2	6.1	5.9	5.0	11.0	22.5	-4.8	-31.3	-32.0	-31.2	-31.4	-37.9	-39.6
General government budget deficit	8.2	3.1	-3.1	-2.7	-0.6	-1.1	-5.0	-7.6	-6.5	-5.8	-5.4	-4.9	-4.5
Key Macroeconomic and Fiscal Assumptions													
Nominal GDP (local currency)	2,630	4,823	7,306	8,944	10,834	13,243	16,752	21,458	25,017	28,344	31,894	35,801	39,740
Real GDP growth (in percent)	-5.3	6.3	10.0	5.1	4.7	7.3	7.2	5.5	5.3	5.0	5.0	5.0	5.0
Average nominal interest rate on public debt (in percent) 6/	9.9	14.5	6.8	5.7	5.2	6.0	5.6	6.8	7.6	7.4	7.4	7.2	6.7
Average nominal interest rate on forex debt (in percent) 6/	5.2	2.8	6.0	6.1	5.3	5.5	5.8	5.7	7.0	7.3	7.5	7.5	7.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-8.7	-58.0	-30.8	-10.7	-10.4	-7.9	-12.5	-14.6	-3.2	-0.5	0.2	0.3	1.0
Nominal appreciation (increase in US dollar value of local currency, in percent)	-71.1	-23.5	-4.1	-6.6	-5.2	7.9	6.1	0.2	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	18.6	72.5	37.6	16.5	15.7	13.9	18.0	21.4	10.8	7.9	7.2	6.9	5.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-16.0	-13.8	5.4	14.1	14.7	4.2	2.4	12.1	2.5	5.1	3.6	4.9	5.0
Debt-stabilizing primary surplus 7/	0.3	-7.6	-3.9	-1.8	-1.6	-0.7	-0.8	-0.8	-0.2	-0.1	-0.1	-0.1	-0.1
					II. Stress Tests for Public Debt Ratio								
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2005-2010								**19.3**	**18.5**	**17.2**	**15.7**	**14.5**	**13.3**
2. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**24.9**	**33.0**	**30.3**	**27.9**	**26.2**	**24.8**
3. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**16.8**	**16.7**	**14.9**	**13.2**	**12.1**	**11.2**
4. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**30.1**	**41.3**	**38.2**	**35.5**	**33.4**	**31.7**
5. Combination of 2-4 using one standard deviation shocks								**31.7**	**44.5**	**35.5**	**28.0**	**21.1**	**15.2**
6. One time 30 percent real depreciation in 2005 8/								**28.2**	**24.9**	**22.7**	**20.6**	**19.2**	**18.1**
7. Fall in the oil prices to 15 US$ per barrel in 2005 and 2006 and to 20 US$ afterwards 9/								**31.0**	**33.3**	**33.4**	**33.3**	**33.5**	**34.1**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2005-10
Primary deficit	-1.4	4.3	-6.6
Real GDP growth (in percent)	2.9	5.5	5.1
Nominal interest rate (in percent) 6/	9.7	4.7	7.2
Real interest rate (in percent)	-30.0	39.4	-2.8
Inflation rate (GDP deflator, in percent)	39.8	41.2	10.0
Revenue to GDP ratio	36.5	1.9	40.0

1/ Gross debt of the general government.
2/ changes in debt stock deriving from changes in interest rates, inflation, GDP growth, exchange rate. These changes are not due to fiscal policy
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as $-g$.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Primary surplus which stabilizes the debt for the current real GDP growth and interest rates
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
9/ The oil shock also includes a contraction of GDP by 2 percent in 2005 with a moderate growth of 3 percent in the following years, a devaluation by 30 percent in 2005, and a one-time increase in debt-generating expenditure equivalent to 5 percent of GDP in 2005

Table 9. Russian Federation: External Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	60.9	49.4	44.1	42.8	37.0	**28.9**	**28.1**	**27.9**	**27.7**	**27.9**	**28.2**	**-1.4**
Change in external debt	-30.1	-11.5	-5.3	-1.2	-5.9	-8.1	-0.8	-0.2	-0.2	0.1	0.3	
Identified external debt-creating flows (4+8+9)	-39.3	-20.1	-14.1	-16.6	-21.7	-13.7	-11.8	-8.9	-6.4	-4.7	-3.6	
Current account deficit, excluding interest payments	-21.3	-13.7	-11.2	-10.0	-11.9	-13.2	-11.6	-8.8	-6.4	-4.8	-3.6	
Deficit in balance of goods and services	-20.6	-13.0	-10.8	-11.3	-12.7	-13.6	-11.6	-8.5	-5.9	-4.1	-2.9	
Exports of goods and services	44.1	36.8	34.8	35.1	35.0	35.3	32.9	29.5	26.4	24.1	22.5	
Imports of goods and services	23.5	23.8	24.1	23.8	22.3	21.7	21.3	21.0	20.6	20.1	19.6	
Net non-debt creating capital inflows (negative)	0.2	0.1	0.4	0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	
Automatic debt dynamics 1/	-18.2	-6.5	-3.3	-7.0	-9.4	-0.1	0.1	0.2	0.3	0.3	0.3	
Contribution from nominal interest rate	4.2	2.8	2.2	1.8	1.6	1.4	1.4	1.5	1.5	1.5	1.6	
Contribution from real GDP growth	-6.9	-2.6	-2.1	-2.6	-2.3	-1.5	-1.3	-1.2	-1.2	-1.2	-1.3	
Contribution from price and exchange rate changes 2/	-15.4	-6.7	-3.4	-6.2	-8.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.3	8.6	8.8	15.3	15.9	5.6	11.0	8.8	6.2	4.9	3.9	
External debt-to-exports ratio (in percent)	138.1	134.1	126.4	122.2	105.6	81.8	85.3	94.7	104.9	115.4	125.5	
Gross external financing need (in billions of US dollars) 4/	-25.2	-3.6	-0.5	-10.2	-36.6	-37.7	-56.4	-37.7	-15.7	-4.0	9.6	
in percent of GDP	-9.7	-1.2	-0.1	-2.4	-6.3	-4.9	-6.3	-3.7	-1.4	-0.3	0.7	
Scenario with key variables at their historical averages 5/						**28.9**	**32.4**	**33.0**	**30.7**	**27.1**	**22.1**	**-1.0**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	10.0	5.1	4.7	7.3	7.2	5.5	5.3	5.0	5.0	5.0	5.0	
GDP deflator in US dollars (change in percent)	20.5	12.3	7.5	16.5	25.8	26.0	10.9	7.9	7.2	6.9	5.7	
Nominal external interest rate (in percent)	6.1	5.5	5.0	5.1	5.2	5.0	5.6	5.8	6.1	6.2	6.4	
Growth of exports (US dollar terms, in percent)	35.4	-1.7	6.8	26.5	33.9	34.0	8.8	1.5	0.9	2.5	3.3	
Growth of imports (US dollar terms, in percent)	15.5	19.5	13.8	24.2	26.0	29.3	14.6	11.6	10.3	9.4	8.3	
Current account balance, excluding interest payments	21.3	13.7	11.2	10.0	11.9	13.2	11.6	8.8	6.4	4.8	3.6	
Net non-debt creating capital inflows	-0.2	-0.1	-0.4	-0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) 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 [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflat

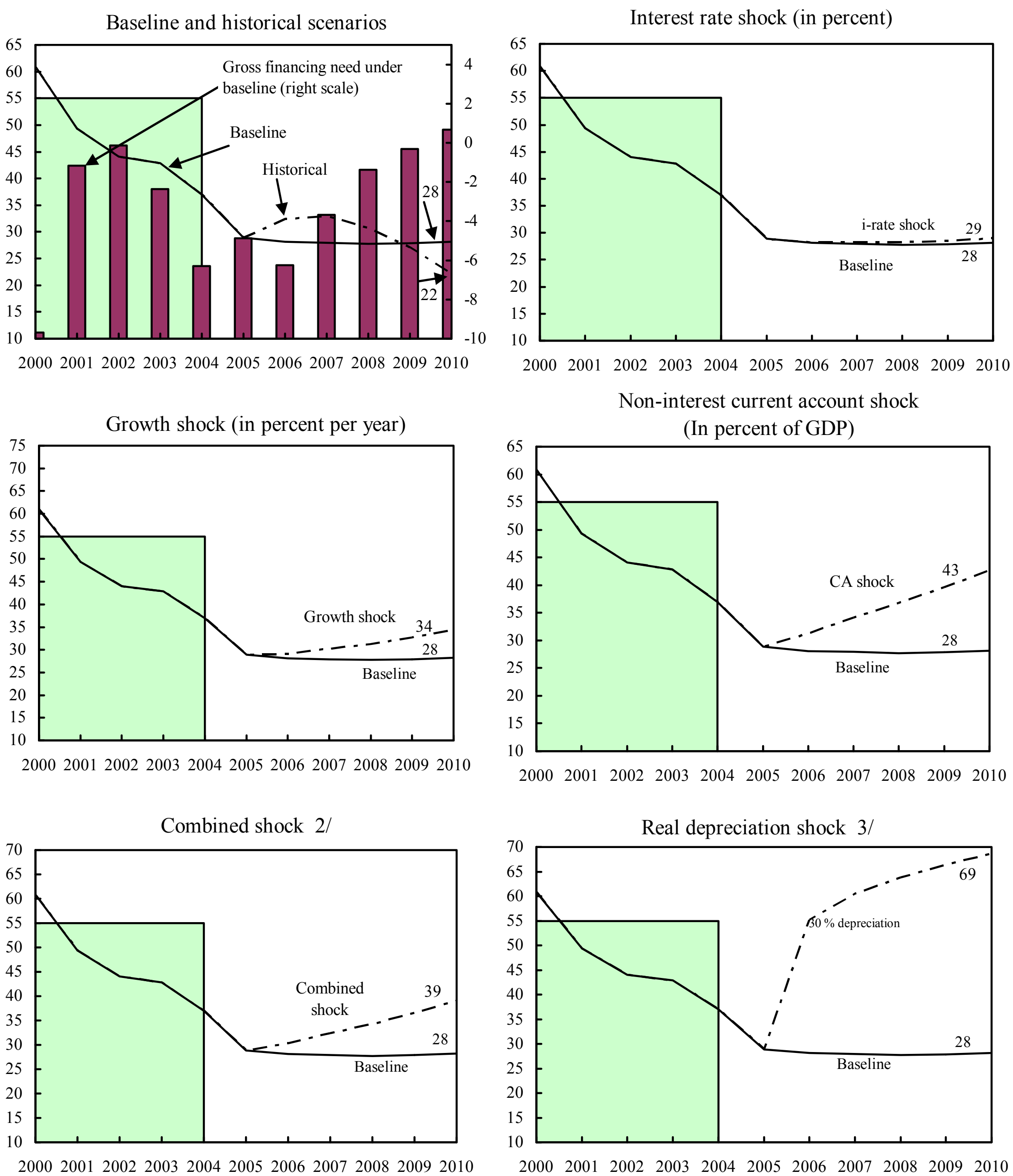
3/ For projection, line includes the impact of price and exchange rate changes.

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.

Figure 1. Russian Federation: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2006.

RUSSIAN FEDERATION: FUND RELATIONS
As of June 30, 2005

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	5,943.54	99.97
Reserve position	1.95	0.03

III. **SDR Department**:

	SDR Million	Percent of Allocation
Holdings	3.89	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	07/28/1999	12/27/2000	3,300.00	471.43
EFF	03/26/1996	03/26/1999	13,206.57	5,779.71
of which: SRF	07/20/1998	03/26/1999	3,992.47	675.02
Stand-by	04/11/1995	03/26/1996	4,313.10	4,313.10

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

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

The Russian Federation accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement with effect from June 1, 1996. In 2004, a new Federal Law on Foreign Exchange Regulation and Foreign Exchange Control (No. 173-FZ), as well as the implementing regulations of the Central Bank of Russia (CBR) and the government came into effect. These effectively eliminated a number of exchange restrictions introduced by the authorities after the 1998 Russian crisis: a) conversion operations through nonresidents' S accounts; b) repatriation restrictions on ruble balances of nonresidents not participating in the GKO/OFZ novation; c) restrictions on advance import payments; d) restrictions on nonresidents' N-accounts; and e) use of a more depreciated exchange rate for repatriation of S-account balances. At the same time, the passage of the new law and its implementing regulations gave rise to a new exchange restriction subject to the approval of the Fund: the requirement by residents to use a special bank account "R2" to conduct transactions relating to external securities and to comply with an unremunerated reserve requirement (URR) in rubles equivalent to 25 percent of the amount of a transaction for 15 calendar days. These rules apply to resident payments of commissions and expenses to a nonresident third party for the handling or acquisition of these external securities.

VIII. **Article IV Consultation**: Russia is on the standard 12-month consultation cycle. The last consultation was concluded on September 1, 2004.

IX. **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. In addition, a long-term advisor on banking supervision will be in Moscow until October 2006.

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).

X. **Resident Representatives**:

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

RUSSIAN FEDERATION: RELATIONS WITH THE WORLD BANK GROUP

1. The current Country Assistance Strategy (CAS) was approved by the Bank's Board in June 2002, and the CAS Progress Report (CASPR) was approved in April 2005. Overall, the Bank strategy envisages continued emphasis on support to implementation of structural reforms at the federal and sub-national levels. In particular, the current CAS emphasizes the need to (1) improve the business environment in order to encourage new firm growth; (2) strengthen public sector management (including civil service reform, intergovernmental finance reform and support of judicial reforms); and (3) safeguard against the social and environmental risks of transition. The CASPR further emphasizes four areas for collaboration with Russia for the remainder of the CAS period (through mid-2006) and for a subsequent Country Partnership Strategy: (1) design and implementation of complex federal-level institutional reforms, (2) regional development, (3) the establishment of an efficient framework for developing private-public partnerships, and (4) Russia's integration into the G-8 framework. The World Bank Group (WBG)'s work in each of these areas is described in more detail below.

Contribution to progress on CAS strategic pillars

Improving the business environment and enhancing competition

2. Bank support for improving the business environment has taken several forms, touching on the enabling environment for the private sector and supporting infrastructure. In particular:

- A Bank-supported survey (run by the Center for Economic and Financial Research, or CEFIR) has been informing the investment community of improvements in the investment climate due to implementation of the "de-bureaucratization" package. Investment climate diagnostics in ten Russian regions, coordinated by the Foreign Investment Advisory Service of the Bank and IFC, have helped to develop regional strategies for improving the business climate. The Bank flagship analytical product—Russia Country Economic Memorandum (CEM) 2004 *From Transition to Development*—was devoted to the analysis of constraints to the development of the competitive environment in Russia. *Russian Economic Reports*, which have been issued regularly by the Bank, provide an independent assessment of economic and social developments in Russia, including reviews of the government's reform effort. These reports have attracted significant attention from key media as well as investors.

- The Multilateral Investment Guarantee Agency (MIGA) has provided guarantees that aim at increasing foreign investment and industrial restructuring. It has also continued to work with several Russian regions on the development of investment promotion programs. The International Finance Corporation (IFC) has continued its strategic presence in several sectors, most importantly manufacturing, infrastructure, and the financial sector.

- As a result of the Land Reform Implementation Support (LARIS) project, some 14 percent of all the districts (*rayons*) in Russia were supplied with automated land registration systems and about 90 percent of all land in those districts is now inventoried for purposes of the state cadastre. Over 60 percent of all cadastre enterprises were supplied with modern digital equipment.

Strengthening public sector management

3. The Bank has significantly contributed to the government's effort to strengthen public sector management in several areas:

- ***Administrative and budget reform****:* The Bank is working closely with the government on administrative and civil service reforms. In 2004, the Bank provided technical assistance on the design of a performance-based budgeting system. The Bank has also worked to improve monitoring and analytical capacity in the public sector, including a multi-year project on Improving Measurement, Monitoring, and Analysis of Poverty.

- ***Tax, treasury and customs****:* there are three projects under implementation that assist the government in the development and upgrade of its administrative, methodological and human capacity to deliver core government functions: collecting taxes and duties, and managing budgetary flows through the federal treasury. The Tax Modernization loan is helping the authorities to launch a country-wide modernization effort. The Customs Development loan pilots ways to accelerate customs clearance—and hence improve trade facilitation by customs—while improving the efficiency of collecting fiscal revenues. The Treasury Development loan assists the government in increasing the efficiency of processing budget flows, and improving financial control over them.

- ***Fiscal federalism****:* jointly with the ministry of finance, the Bank has developed and piloted an effective federal-level fiscal instrument for supporting economic, budgetary and fiscal improvements at the regional level. Under the Fiscal Federalism and Regional Fiscal Reform loan, the Regional Fiscal Reform Fund provided incentive-based fiscal grants to 15 participating regions that have implemented broad-ranging reforms of their fiscal and asset management, and budget execution, and have adopted more transparent regulations for equalizing transfers and tax sharing.

- ***Public service delivery at the local level***: the Bank has been a major provider of financing for investment in local services. The Municipal Water and Heating Systems loans aim to significantly increase the efficiency of communal services delivery in participating regions, upgrade infrastructure, and alleviate the financial burden on municipalities. The completed Community Social Infrastructure Project developed and tested a model of the regional social infrastructure development fund.

Mitigating social and environmental risks

4. During the CAS period, the Bank has been involved in various aspects of social policy development and implementation at the federal and regional levels:

- ***Health care:*** Bank support to government reform in the health sector has two main objectives: (i) helping Russia establish a health care system that is accessible, affordable, and efficient; and (ii) strengthening the public policy response to premature mortality and the risks of HIV/AIDS. Through the Health Reform Implementation loan, the Bank is assisting the government to design and pilot methods of health sector restructuring, new financing mechanisms, and medical protocols. The Bank is supporting the government's implementation of its Strategy on the Prevention and Control of Social Diseases. A US$150 million project is enhancing the country's capacity to prevent the spread of HIV/AIDS.

- ***Education:*** in the education sector, the Bank has successfully supported (i) reform of university level social science education, (ii) development of secondary school textbook provision (Education Innovation Project), and (iii) development and piloting of regional models for secondary education upgrade (Education Reform Project). The education reforms supported by the Bank have led to the introduction of a single entrance exam for all institutes of higher education in 16 regions and have helped universities introduce better governance systems and increase efficiency in the use of resources. The pioneering E-learning in Schools project is ensuring better access to quality education for students in several remote destinations.

- ***Strengthening the social protection system***: the Bank is concentrating on the design of upgraded social assistance and on reforms of social service provision for vulnerable groups (the poor, children at risk, residents of the North). The Bank completed an analysis of the labor market and child welfare policies at the regional level. The Northern Restructuring Pilot Project is providing support in an efficient and affordable manner for migration from the North.

- ***Environment:*** until a few years ago, Russia was one of the world's largest producers of ozone depleting substances. This is no longer the case thanks to the Bank-funded program and the Global Environmental Facility administered by the Bank. The Sustainable Forestry project has supported drafting of the new Forestry Code, increasing efficiency of the forest management institutions, and revising the forest lease policies.

Government current priorities and CASPR focus areas

5. Russia's strong fiscal position and access to financial markets limit the need for sovereign borrowing, while at the same time the country still faces major tasks on many fronts. Some, like housing and communal reform, are related to an unfinished transition, while others, like public-private partnerships, aim at creating new drivers for economic diversification and growth. Progress in transformation across a vast country is

understandably uneven, and attention must be focused on the growing gap between prosperous and lagging regions. Capacity and financial constraints slow down local implementation of well-designed reforms. Tackling these constraints on a large scale requires all the resources Russia can mobilize domestically and internationally.

6. Russia is interested in defining a partnership with the World Bank that would respond to the country's strengths and remaining challenges. This would follow the path of the Bank's involvement in other middle-income countries. Consultations in the course of preparation of the CASPR have indicated that the government remains committed to collaborating with the Bank as a source of development knowledge and project implementation capacity. At the same time, the Russian authorities express strong preference for a more flexible arrangement that would allow them to tap Bank skills through a wide menu of instruments and services. The government's priorities for further collaboration with the WBG are discussed below.

Design and implementation of complex federal-level institutional reforms

7. At the federal level, demand for the Bank's assistance is now limited to high complexity areas where there is a benefit from the Bank providing an efficient framework for tapping international experience, and, even more importantly, efficient project implementation mechanisms. One of possible options is that the Bank would provide only the start-up and pilot financing and would help to set up project implementation mechanisms for Federal Targeted Programs. Scaling up such projects would become the government's responsibility. Such a project framework may significantly increase the efficiency of government spending on investment and structural reforms, if relatively large volumes of government co-financing would leverage the Bank funds.

Regional development

8. At the sub-national level, the development agenda is huge, and demand by local authorities for stable project financing and project management expertise is far from being saturated even in the most prosperous of regions. Work at this level will concentrate on a small number of regions agreed with the government and be supported by a three-pronged approach in order to address the diverse economic, social and human development needs of Russia's regions:

- Well-performing and creditworthy regions may benefit from lending without sovereign guarantees currently available through the IFC municipal development facility (demand for such lending is significant, and Russia is interested in the WBG developing further the instruments required for an increased regional involvement).

- For those regions that are making progress, but are not at the cutting edge of reforms, the Bank will continue to support programs that use a competitive model for accessing funds, and will provide technical assistance and—if necessary—project finance to support this approach.

- For the poorer and less advanced in terms of reforms regions, support for efficient and effective design and implementation of federal targeted programs will remain the main instrument. In all three types of regions, subnational-level projects will become a tool for strengthening implementation of national reform efforts, and improving local restructuring capacity.

Establishing efficient framework for developing private-public partnerships

9. Public-private partnerships (PPPs) represent a new dimension in the government's efforts to improve competitiveness and achieve a range of public policy goals. The WBG will assist the government in designing and implementing programs to facilitate emergence of public-private partnerships, including the necessary legal and regulatory structures. These partnerships would help improve efficiency in targeted sectors, tap many sources of finance, and provide better service to consumers. Infrastructure projects (transport and the housing and communal sector) will initially be the primary focus. Yet the Bank will also put effort into providing assistance to formation of PPPs in other key sectors, e.g., in education, healthcare, science and technology. Given an apparent regional dimension of PPPs formation. Support by the WBG will include advisory services, the use of guarantees and project finance.

Russia's integration into the G-8 framework

10. Ratification by Russia of the Kyoto Protocol, approaching accession to WTO, and Russia's upcoming chairmanship at G-8 present opportunities for the use of Bank technical expertise and development experience. The mechanisms under the Kyoto Protocol offer Russia unique opportunities to upgrade its energy infrastructure. The Global Environment Facility (GEF) and carbon finance instruments and advisory services will present the key avenues for engagement. With regard to WTO accession, the Bank will continue analytical work and technical assistance to facilitate knowledge creation on accession opportunities and costs, in particular in the Russian regions. The Bank will also provide analytical support on global development issues for Russia's chairmanship of the G-8, in line with previous experience with other G-8 countries.

11. In terms of operational modalities, discussions with the government indicate strong interest in more flexible access to a broad menu of Bank instruments (AAA, TA, lending, guarantees). The Bank-supported projects are to be fully integrated into the Russian Federation budget, including its Federal Targeted Programs, with a three to five year planning horizon to better support the government's mid-term development programs. The government is interested in flexible co-financing arrangements that would minimize sovereign borrowing. More specifically, the government is already moving to increase its share of financing (up to 80 percent, and, possibly, even more) under some of the on-going and future projects, and expresses strong interest in the development by the Bank of a facility for sub-national lending without a sovereign guarantee. Other instruments of significant interest include investment loans with contingent disbursements, partial credit risk guarantees, and fee-for-service work with no borrowing requirements.

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. Data are provided on a timely basis, albeit with a few exceptions. Russia produces a wide range of regular, timely publications on financial and economic statistics. The authorities report data for the Fund's *International Financial Statistics (IFS), Government Finance Statistics Yearbook, the Direction of Trade Statistics, and the Balance of Payments Statistics Yearbook.*

2. A draft ROSC module on data dissemination practices was prepared in 1999–2000, but never published. A new ROSC data module was prepared in October 2003 and the authorities approved the publication of the report on the IMF website on April 25, 2004, which was posted in May 2004.

3. On January 31, 2005, the Russian Federation became the 60th subscriber to the SDDS, marking a major step forward in the development of the country's statistical system. However, data on central government operations have not been updated since the Russian Federation subscribed to the SDDS and their National Summary Data Page (NSDP) is currently disseminating data only for the reference periods of October and November 2004.

4. The Russian Federation is redisseminating historic data on the reserves template on the following IMF webpage: http://www.imf.org/external/np/sta/ir/colist.htm, and historic data on its external debt on the following World Bank webpage: http://www.worldbank.org/data/working/QEDS/sdds_countrydata.html.

National accounts

5. The State Statistics Committee (Goskomstat) compiles and publishes quarterly and annual national accounts data on a timely basis, using the *1993 System of National Accounts*. 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. There has been much effort to improve coverage, but further progress is needed in covering small and medium enterprises. The estimates of gross domestic product (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. Estimates of the financial account by institutional sector are not compiled although these estimates are needed.

6. The delay in finalizing a modern statistics law—requiring firms to provide data and with realistic penalties for noncompliance, together with a guarantee of confidentiality—is an impediment to further improvement of national accounts data.

7. The authorities do not publish separate data on export and import volumes. Revisions to the data are not flagged when the data are disseminated. As a result, it is difficult for users, including the Fund, to maintain any form of consistent time series.

Prices

8. Goskomstat compiles a good quality national consumer price index (CPI), developed with Fund technical assistance. Since January 2003, as a result of achieving moderate inflation in the recent years, Goskomstat has stopped the weekly publication of headline inflation and continued only with monthly reports; in addition, Goskomstat has started the publication of monthly core inflation data. Further improvements could be made on the basis of a new household budget survey—which has been under consideration for some time—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. Goskomstat also publishes a producer price index. The State Customs Committee has initiated the development of foreign trade price indexes.

9. Since November 2003, the monthly CPI and PPI are presented in two formats: (i) as an index using annual average prices for 1995 as the reference (1995=100) and (ii) as a percentage of a previous month (the previous month and the same month in the previous year). However, data on the basic components of the CPI and PPI are not readily available in time series format, and the weights of the CPI and PPI components are not disclosed, rendering time series analysis difficult.

Government finance statistics data

10. The staff is provided with monthly information on revenues, expenditures, and financing of the federal and local governments and quarterly information on revenues, expenditures, and financing of extrabudgetary funds. The published functional classification of expenditure differs slightly from international standards. Expenditure data, classified by economic type, need improvement. Presently, they are compiled with a long delay on an annual basis, with a publication lag of one year. Data on domestic and external federal debt are compiled monthly, but are made public only in summary form on an annual basis; in addition, there is no unified debt monitoring and reporting system. In 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. Its objectives include the introduction of accrual accounting for the whole of government. The latest data provided for publication in the *GFS Yearbook* for 2002 were reported on an accrual basis, in accordance with the methodology of the *Government Finance Statistics Manual 2001*. The Treasury has

been reporting aggregate government finance data for publication in *IFS* on a cash basis since April 1996.

Monetary statistics

11. Monetary data are reasonably comprehensive and generally in accordance with international standards. The data ROSC mission in 2003 identified the following methodological issues: (1) the scope of monetary statistics did not include financial institutions issuing deposit substitutes, such as mutual funds and financial companies, and credit institutions in the process of liquidation; (2) classification and sectorization were in line with the methodological guidelines, except that securities repurchase operations of credit institutions with nonresidents (currently at insignificant levels) were not treated as collateralized loans, and financial derivatives (which are at an initial stage of development in Russia) were not included in the instrument classification; and (3) the basis of recording broadly followed methodological recommendations, except that monetary gold and securities for investment purposes were not valued at current market prices. In addition, accrued interest was not included in the underlying instrument. Following the data ROSC, the authorities included all unoperational 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 with the guidelines of the *Monetary and Financial Statistics Manual 2000*.

12. 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.

13. In October 2004, STA requested the CBR to carry out a pilot compilation of monetary data using new Standardized Report Forms (SRFs). This project has not been concluded yet by the CBR.

External sector statistics

14. The balance of payments is compiled on the basis of the fifth edition of the Fund's *Balance of Payments Manual (BPM5).* In cooperation with the Fund, significant progress has been made with regard to balance of payments statistics. More detailed data have been published and new data sources have been developed. Though significant improvements have been made to enhance the quality of balance of payments statistics, there remains room to improve the coverage of certain components of the current and the capital and financial account. In particular, there is scope to improve the detail of data available to the public especially on the financial account to analyze the relatively complex flows.

15. The State Customs Committee needs to substantially improve 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, persistent differences between partner country and customs data on imports remain, although statistical agencies are seeking to reconcile the data with those of partner countries. The CBR has developed a methodology for

calculating components of export and import transactions unrecorded by the customs authorities. Goskomstat needs to improve the coverage and quality of surveys on direct investment, and trade in services including travel. The CBR has moved toward direct data collection to address these limitations.

16. Russia is disseminating 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 is not as comprehensive as the reserve template, which is disseminated with a lag of twenty days.

17. Quarterly external debt data are now published by sector, maturity, instrument, and currency, with a lag of one quarter as prescribed by the SDDS. Moreover, while improvements have been made, there are a number of gaps in data, notably the lack of a debt service schedule. For surveillance purposes, information on gross external payments, for example, for the banking system, is needed for monitoring liquidity risk. There is also a need to monitor corporate sector off-balance sheet obligations and more generally, information on interest and exchange rate exposure of the sector.

18. The CBR has commenced publishing an annual international investment position for all sectors with data starting in 2001. The international investment position for the banking sector is now available on a quarterly basis.

TABLE A1. RUSSIAN FEDERATION: COMMON INDICATORS REQUIRED FOR SURVEILLANCE
As of August 3, 2005

	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]	Data Quality Accuracy and reliability[8]
Exchange Rates	8/3/05	8/3/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	7/28/05	7/28/05	W	W	W		
Reserve/Base Money	7/25/05	7/29/05	W	W	W	O, LO, LO, LO	O, O, O, O, O
Broad Money	7/1/05	7/26/05	M	M	M		
Central Bank Balance Sheet	1/7/05	7/7/05	M	M	M		
Consolidated Balance Sheet of the Banking System	1/6/05	7/7/05	M	M	M		
Interest Rates[2]	8/3/05	8/3/05	D/W/M	D/W/M	D/W/M		
Consumer Price Index	June 2005	7/6/05	M	M	M	LO, LO, LO, LO	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3 2004	3/25/05	Q	Q	Q	LNO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Feb 2005	4/25/05	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	8/1/05	8/1/05	M	M	M		
External Current Account Balance	June 2005	7/4/05	Q	Q	M	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	June 2005	7/4/05	M	M	Q		
GDP/GNP	Q1/05	7/5/05	Q	Q	Q	O, O, LNO, O	LO, LO, O, O, O
Gross External Debt	June 2005	6/30/05	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 validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
September 7, 2005

The following information on fiscal developments, which has become available since the release of the staff report, does not alter the thrust of the staff appraisal.

1. Since the issuance of the staff report, the Russian authorities have formulated a second supplementary 2005 budget, which will be submitted to the Duma later this year, and have submitted a draft 2006 budget to the Duma. The discussion in the staff report reflects only the first supplementary 2005 budget and key assumptions for 2006 are different from those of the draft budget. The following summarizes the main changes and their implications, based on a preliminary assessment of the information available as of last week.

2. The oil price assumptions for both 2005 and 2006 have been revised upward resulting in higher revenue projections and hence larger headline fiscal surpluses (see Table 1). However, spending plans have also been increased in light of the higher revenues, thereby increasing the deficit on the basis of a constant oil price in both years. As a result, the oil price at which the overall budget would balance has increased to almost $29 per barrel in 2005 and almost $34 per barrel in 2006 (to be compared with the $27 and $31, respectively, shown in the staff report).

3. Staff estimates that the second supplementary budget for 2005 entails an additional fiscal impulse (excluding the oil sector) of about ½ percent of GDP (see Table 2).

4. The revisions do not change the thrust of the staff appraisal, notably the staff's concern that the policy for taxing and saving oil revenues should not be relaxed at this juncture when supply constraints are emerging and upward pressures on inflation and the ruble are already intensifying.

Table 1. Summary of Federal Government Budget, 2004-06 [1/]
(In billions of rubles and in percent of GDP in italics)

	2004	2005					2006			
		Budget			Staff		Budget		Staff	
		Original	Staff Report [3/]	August [4/]	Staff Report	August	Staff Report	August [4/]	Staff Report	August
Revenues [2/]	2,987	3,060	4,319	4,705	4,742	5,025	4,128	4,744	5,279	6,172
	17.8	*16.3*	*21.2*	*22.4*	*22.1*	*23.4*	*17.7*	*19.5*	*21.1*	*24.7*
Expenditure	2,257	2,781	3,129	3,238	3,129	3,238	3,628	3,968	3,628	3,968
	13.5	*14.9*	*15.4*	*15.4*	*14.6*	*15.1*	*15.5*	*16.3*	*14.5*	*15.9*
Balance	730	279	1,190	1,467	1,613	1,787	500	776	1,651	2,204
	4.4	*1.5*	*5.8*	*7.0*	*7.5*	*8.3*	*2.1*	*3.2*	*6.6*	*8.8*
Balance at const. oil prices	*-0.8*	*-1.5*	*-2.7*	*-3.1*	*-2.6*	*-3.0*	*-3.3*	*-3.7*	*-4.0*	*-5.0*
Oil price balancing budget (US$)	22.3	24.2	27.6	28.5	27.4	28.7	29.1	29.9	31.2	33.8
GDP	16,752	18,720	20,380	21,000	21,459	21,459	23,380	24,380	25,019	25,019
Russian oil price (US$)	34.3	28.0	43.0	48.0	47.3	50.7	35.0	40.0	49.5	58.3

[1/] Source: Ministry of Finance and Staff computations. Billions of rubles and percentage of GDP in italics.
[2/] Net of Federal share of Unified Social Tax.
[3/] The projection for expenditure includes Rub 348 billion as a result of the June amendment to the budget. The projections for revenues reflects the authorities' forecasts as of the beginning of June.
[4/] The August column reflects the draft 2006 budget presented to the Duma on August 26, and the expected second revision to the 2005 budget as formulated by the authorities.

Table 2. Russian Federation: Summary Table (revised) 1/

	2001	2002	2003	2004	2005	
					Proj.	
					Staff report	August
	(In percent of GDP)					
Federal government overall balance	2.7	1.3	1.6	4.4	7.5	8.3
General government overall balance	2.7	0.6	1.1	5.0	7.6	...
Federal government overall balance at constant 20 $/barrel	1.9	0.2	-1.0	-0.8	-2.6	-3.0
General government overall balance at constant 20 $/barrel	1.8	-0.3	-1.5	-0.2	-2.7	...
General government non-oil balance	-4.8	-6.9	-7.6	-6.1	-9.4	...
Fiscal impulse 2/	-0.9	1.4	-1.5	-4.2	-2.9	-3.8
Fiscal impulse (excluding oil sector) 3/	0.0	2.0	-4.6	-2.8	1.5	2.0
A. Change in energy exports	-0.4	1.1	4.2	4.6	5.8	7.2
B. Change in overall balance 4/	-0.5	-2.1	0.5	3.9	3.1	3.9
A-B (combined impulse from oil export earnings and fiscal policy)	0.1	3.2	3.7	0.7	2.7	3.3

Sources: Russian authorities; and Fund staff estimates.

1/ Revised text table, paragraph 10 of the staff report.
2/ Defined as the yearly change in the fiscal stance.
3/ Defined as the fiscal impulse plus the yearly change in oil revenue. See Chapter II of the accompanying Selected Issues paper for more details on the calculation of the fiscal impulse.
4/ Reflects general government balance in 2001-2004 and federal government balance in 2005.

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IMF Executive Board Concludes 2005 Article IV Consultation with the Russian Federation

On September 7, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Russian Federation.[1]

Background

Russia is in its seventh year of robust economic growth. This strong performance was ignited by the sharp depreciation in the wake of the 1998 crisis, and subsequently sustained by large terms-of-trade gains, in combination with increased political and macroeconomic stability. Higher output and investment in the oil sector have been key conduits of the broad based recovery, which is still running its course.

While still vibrant, the economy has softened notably since mid-2004, despite record high oil prices. Yearly GDP growth decelerated from 7½ percent in the first half of 2004 to 5½ percent in the same period this year, mainly owing to lower growth in oil production and investments. Consumption has remained buoyant and has been the main source of domestic demand growth, fueled by continued rapid increases in real wages.

The softening mainly reflects a confluence of policy induced supply disruptions and jolts to the investment climate. The Yukos affair has triggered serious concerns about state interventionism and the government's commitment to reinvigorate flagging structural reforms. The sharp rise in oil taxation since the middle of last year might also have taken a toll on oil output and investments, although profitability in the oil sector has remained high amid rising oil prices.

The softening is also likely to have been due to the gradual tightening of resource constraints that has been evident for a number of years, not least in the oil sector and in labor markets in high-growth areas. Reflecting such resource constraints, the acceleration in domestic demand

[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.

growth in 2004 as a whole spilled over into much higher imports, but left GDP growth unchanged compared to 2003.

Fiscal policy has offset much of the stimulus arising from the large terms of trade shock. The headline surplus of the general government has increased every year since 2001 as the government has taxed and saved much of the rapidly increasing oil revenues. Under the current oil price outlook, staff projects that the budget will entail an overall surplus of 7½ percent of GDP in 2005, up from 5 percent of GDP in 2004, and 6½ percent of GDP in 2006.

However, the underlying fiscal stance is being relaxed, until recently gradually, and now more rapidly. The fiscal surplus on a constant oil price basis has been declining, except in 2004, as the government has gradually increased spending of oil revenues. This relaxation has taken place at a time of tightening resource constraints and buoyant overall demand and has therefore contributed to inflationary pressures and a faster pace of real ruble appreciation. Still, the relaxation was measured until recently, but is set to quicken significantly following the amendment of the 2005 budget. Preliminary plans for 2006 entail a further relaxation. The relaxation has required an increase in the benchmark price below which oil revenues are not saved in the stabilization fund from US$20 per barrel to US$27 per barrel.

Monetary policy remains relatively lax. While reserve money growth has slowed somewhat since mid-2004, mainly because of an accelerated build-up of government deposits with the Central Bank of Russia, it remains high, as do the increases in broader aggregates. Rising inflation, declining interest rates, and large capital outflows point to a continued accommodative stance.

The economy is expected to continue to grow robustly, although not at the pace seen before last year's slowdown. Staff projects GDP growth of 5½ percent in 2005, fuelled by consumption. Both exports and investment are expected to remain subdued compared to previous years, high oil prices notwithstanding, as concerns about the investment climate linger and supply constraints in the oil sector are unlikely to ease in the near future. Inflation, which was already running at an annual rate of 7¾ percent in the first half of 2005, is likely to exceed the official target again this year. External vulnerability has been greatly reduced since the 1998 crisis owing to a very favorable balance of payments position and large foreign reserves of more than 3½ times short term debt.

Executive Board Assessment

Directors commended the strong performance of the Russian economy in recent years, which has been due not only to high oil prices, but also to a generally prudent fiscal policy stance. Under the current outlook for oil prices, Directors expected economic growth to remain robust and external vulnerabilities low over the near term. Directors saw the strong fundamentals as creating a window of opportunity to propel forward the structural reform agenda, which is lagging behind in key areas.

Directors considered that the policy of gradually escalating the taxation and saving of oil revenues as oil prices have surged has served Russia well, by preventing over-heating in the face of limited productive capacities in the non-tradable sectors. At the same time, a number of Directors recognized the growing pressures to relax the fiscal stance against the background of the country's social and infrastructure development needs and large oil revenue inflows. Nevertheless, noting emerging capacity constraints in some sectors, Directors were generally concerned that the recent significant and pro-cyclical relaxation of fiscal policy, with amendments to the 2005 budget and plans for 2006 that would weaken the non-oil fiscal balance, would exacerbate already-rising inflationary pressures and quicken the pace of real ruble appreciation.

Directors therefore strongly advised that fiscal policy not be loosened further. To that end, the benchmark price above which oil revenues are saved in the Oil Stabilization Fund (OSF) should not be increased again; the use of the OSF should continue to be limited to the prepayment of debt; and additional higher-than-budgeted revenues from oil should be saved. Directors also pointed to the risks associated with increasing spending while key reforms are lagging. While they acknowledged the need to raise public sector wages and pensions, bolster infrastructure investment, and strengthen poverty-alleviating public services, they were concerned that the necessary reforms to modernize and rationalize related social and public administration infrastructure to ensure spending efficiency in these areas were not yet in place. Directors also cautioned that steadily increasing recurrent expenditures that do not raise potential growth rates could worsen the risk of having to undertake a sharp pro-cyclical fiscal tightening in the event of a large drop in oil prices.

Directors recognized that, over the medium term, and once cyclical pressures ease, there will be scope for fiscal relaxation, even over and above the expected budgetary cost of the needed structural reforms. They observed that Russia's oil wealth, if utilized to underpin reforms that raise potential growth rates, including tax reforms, can lay the basis for accelerating the modernization of the economy. More broadly, Directors encouraged the authorities to develop an integrated medium-term fiscal and structural reform plan for utilizing Russia's oil resources.

Regarding monetary and exchange rate policies, most Directors considered the practice of targeting both inflation and the exchange rate to be unsustainable, and called on the Central Bank of Russia to clearly signal to markets that the inflation target takes precedence over other objectives. They urged the CBR to allow the ruble to appreciate if inflation runs above the targeted path. In that vein, most Directors expressed concern that continuing to let real exchange rate concerns bear on monetary policy, even as fiscal policy is being relaxed, will impart an inflationary bias into the macroeconomic policy mix.

Directors were encouraged by the progress made in banking sector reforms. Systemic risks are low and appear manageable, and the process of determining the eligibility of banks for the new deposit insurance scheme appears to have strengthened prudential standards. However, many Directors were concerned with the consequences of continuing regulatory forbearance; in this regard, they noted that in some cases, the standards for admitting banks to the insurance scheme may have been interpreted too leniently. Directors cautioned that, without supervisory vigilance, the rapid increase in banks' balance sheets could raise systemic risks, particularly in the event of a major drop in oil prices.

Directors were concerned that, with ample oil revenues, complacency has set in and key structural reforms have come to a virtual halt. They saw the recent weakening in investments and slowdown in economic growth even as oil prices have surged as a sign that high growth may be difficult to sustain over the medium term without a more determined effort to accelerate reforms. In this regard, priority should be given to reforms that could bolster the investment climate, nurture new private enterprises, and promote economic diversification, especially civil service and public administration reforms.

Directors observed that the Yukos affair had given rise to concerns about state intervention and heavy-handedness on the part of regulatory and law enforcement agencies. They welcomed attempts by senior officials to reassure investors, but noted that concerns in this regard are likely to linger as long as reforms lag.

Directors welcomed the removal of the exchange restrictions and multiple currency practices on current transactions that had been identified previously. However, they urged the authorities to remove quickly the new restrictions that have resulted from implementing regulations accompanying the new Federal Law on Foreign Exchange Regulation and Foreign Exchange Control.

Directors welcomed Russia's subscription to the Special Data Dissemination Standard in January 2005. They noted that Russia's economic and financial statistics are broadly adequate for surveillance purposes, but expressed some concern about data accuracy and the frequency of data revisions.

Directors welcomed the prepayment of all of Russia's outstanding financial obligations to the Fund, and its participation in the Fund's financial transactions plan.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with the Russian Federation may be made available at a later stage if the authorities consent.

The Russian Federation: Selected Economic Indicators

	2002	2003	2004 Est.	2005 Proj.
	(Annual percent change)			
Production and prices				
Real GDP	4.7	7.3	7.2	5.5
Consumer prices				
Annual average	15.8	13.7	10.9	12.9
End of period	15.1	12.0	11.7	11.5
GDP deflator	15.5	14.0	18.0	21.4
	(In percent of GDP)			
Public sector				
General government 1/				
Overall balance	0.6	1.1	5.0	7.6
Revenue	37.7	36.7	38.6	43.2
Expenditures	37.1	35.6	33.6	35.6
Interest	2.1	1.7	1.2	1.1
Non-interest	35.0	33.9	32.4	34.4
Primary balance	2.7	2.8	6.2	8.8
Federal government overall balance 1/	1.3	1.6	4.4	7.5
	(In billions of U.S. dollars)			
External sector				
Total exports, fob	107	136	183	249
Total imports, fob	-61	-76	-96	-127
External current account (deficit -)	31	35	60	92
Stock of public external debt	103	105	104	81
Gross reserves coverage (in months of imports of GNFS)	5.6	7.1	8.9	11.8
Memorandum items:				
Nominal GDP (in billions of rubles)	10,818	13,243	16,752	21,459
Exchange rate (rubles per U.S. dollar, period average)	31.3	30.7	28.8	...
Russian oil price (U.S. dollars per barrel)	23.5	27.3	34.3	47.3

Sources: Russian authorities; and IMF staff estimates.

1/ Commitment basis.