April 2002
IMF Country Report No. 02/74

Russian Federation: 2001 Article IV Consultation and Post-Program Monitoring Discussions—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 2001 Article IV consultation and Post-Program Monitoring discussions with the Russian Federation, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation and Post-Program Monitoring discussions, prepared by a staff team of the IMF, following discussions that ended on **December 11, 2001,** 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 February 15, 2002.** 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 **March 8, 2002** updating information on recent economic developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 8, 2002 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper and 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 2001 Article IV Consultation and Post-Program Monitoring Discussions

Prepared by the Staff Representatives for the 2001 Consultation with the Russian Federation

Approved by Gérard Bélanger and Leslie Lipschitz

February 15, 2002

- The discussions were held in Moscow during November 28 to December 11, 2001. The staff team met with: Mr. Kudrin, Deputy Prime Minister and Minister of Finance; Mr. Gref, Minister for Economic Development and Trade; Mr. Bukaev, Minister for Taxation and Fees; Mrs. Paramonova, First Deputy Chairperson of the Central Bank; Mr. Illarionov, Economic Advisor to the President; other senior government and central bank officials; and representatives from the Duma, research institutes, trade unions, and domestic and foreign financial institutions.
- The staff team comprised Messrs. Bélanger (head), Tiwari, Ms. Banerji, Messrs. Laursen, Robinson, Spatafora, Stavrev (all EU2), Chua (FAD), Santos (PDR), Sensenbrenner (MAE), and Ms. Pammu (assistant, EU2), as well as Moscow Office staff consisting of Messrs. Thomsen, Barnard, Kwon, and Välilä and Ms. Malysheva (assistant). Mr. Morozov (World Bank) also participated in the mission. Mr. Mozhin (Executive Director) and Mr. Lushin (Alternate) attended the policy discussions. The mission overlapped with a joint IMF-World Bank mission to discuss the modalities of Russia's participation in the FSAP.
- A 17-month Stand-By Arrangement in an amount of SDR 3.3 billion (55.5 percent of quota) expired on December 27, 2000. Russia has made early repurchases of obligations under the CCFF. Outstanding obligations to the Fund at end-December 2001 amounted to 99.5 percent of quota.
- In completing the last Article IV consultation on September 15, 2000, Executive Directors commended the authorities on the strong recovery from the crisis, including the strengthening of fiscal policy. They stressed the importance of a broad-based acceleration of structural reform and noted the need for monetary policy to focus on controlling inflation. These concerns were reiterated at the Executive Board discussion of the PPM report on May 29, 2001.
- Russia has accepted the obligations of Article VIII, sections 2, 3, and 4, of the Fund's Articles of Agreement, but maintains restrictions that are subject to Fund approval, as described in Appendix I. Relations with the World Bank are described in Appendix II.
- Russia does not subscribe to the Special Data Dissemination Standards. Data quality is generally sufficient to conduct effective surveillance, though a number of areas of concern remain (see Appendix III on Statistical Issues).
- It is proposed that the next Article IV consultation for Russia be conducted on the standard 12-month cycle.
- This staff report was prepared by Messrs. Tiwari and Robinson with contributions from other members of the team.

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EXECUTIVE SUMMARY

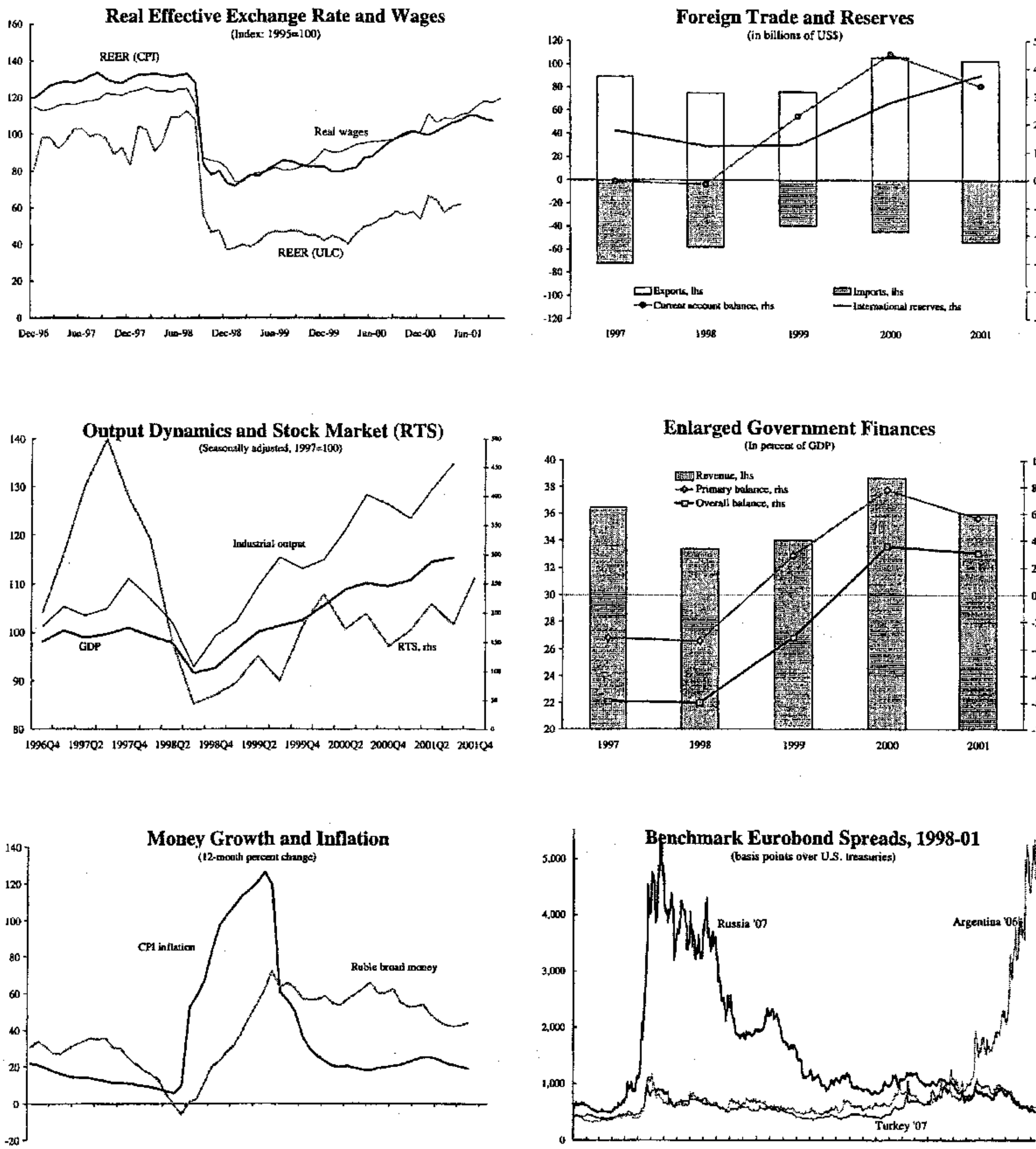
Economic recovery has been underpinned by sound macroeconomic policies. Despite the slowdown in the world economy, growth in Russia was robust and has been an important factor in sustaining growth in the region. The large real depreciation of the ruble in 1998 and high oil and gas revenues contributed to large current account surpluses and a significant strengthening of the international reserve position, enabling Russia to discharge in advance its obligations to the IMF under the CCFF. The inflows from the balance of payments were largely sterilized by the continued strength of the public finances, easing the burden on monetary policy to contain inflation.

Structural reforms accelerated markedly in 2001. Key advances were made in the areas of tax, pension, land, labor, and judicial reforms, as well as business deregulation. Broad strategies were also elaborated for restructuring natural monopolies (in the railways and electricity sectors) and the banking sector. Looking ahead, the authorities need to resolutely implement the recently enacted legislation and push ahead with the remaining legislative agenda prior to the onset of the next election cycle.

Improved economic performance and reduced external vulnerability were reflected in a strengthening of financial market indicators in 2001. The Russian stock market doubled in U.S. dollar terms, bond spreads narrowed significantly, and ratings agencies upgraded Russia's debt. Events in Turkey and Argentina had only a limited impact and non-sovereign borrowers returned to the market.

The near- to medium-term outlook remains favorable. The recent successes in building up strong external and fiscal positions should enable Russia to deal with the current less favorable external environment with the prevailing policy framework. Moreover, through a combination of policy adaptations and financing (reserve loss), Russia should be able to withstand a further substantial external deterioration without resorting to exceptional financing either from the Fund or other creditors.

Figure 1. Developments Before and After the Crisis



I. Recent Developments

1. **Macroeconomic performance—despite a worsening external environment—was very strong in 2001, and outcomes in most areas were better than targeted by the authorities early in the year**. Output grew at a healthy pace driven by domestic demand. The federal budget ran a large surplus due to strong revenues and continued expenditure restraint. The current account surplus narrowed significantly but remained large. In the face of a strong balance of payments, large-scale partially sterilized interventions prevented a nominal appreciation of the ruble but led to a rapid growth of monetary aggregates. Consequently, the targeted reduction in inflation did not materialize. The pace of structural reform accelerated with significant progress in a broad range of areas, including tax, pension, land, labor, judicial reform, and business deregulation. Reflecting the strong macroeconomic outcomes, an improving investment climate, and political stability, Russia's stock market increased dramatically and spreads on sovereign Eurobonds narrowed sharply.

Key Macroeconomic Indicators, 2000-01

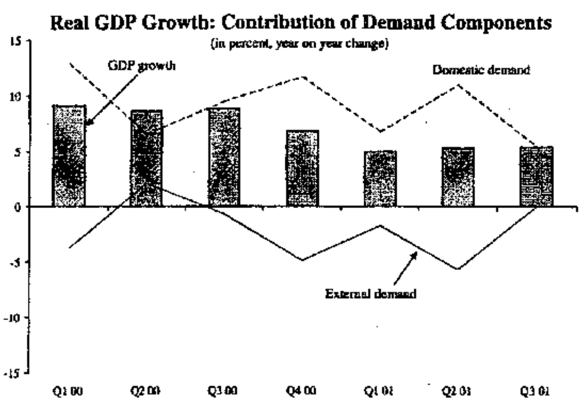
	2000	2001	
		PPM1/	Est.
Real GDP growth (in percent)	8.3	4.0	5.2
Inflation (e.o.p., in percent)	20.1	14.0	18.6
Federal government, cash basis			
Primary balance (percent of GDP)	4.5	3.4	5.3
Overall balance (percent of GDP)	1.9	0.3	2.7
Current account ($ bn)	45.3	35.6	33.8
(percent of GDP)	18.0	12.0	11.0
Gross official reserves ($ bn)	28.0	35.5	36.5
(months of import cover)	4.6	5.3	5.5
(ratio to short-term debt)	188	396	298
Russian oil price ($/barrel, c.i.f.)	26.8	22.5	22.5
WEO oil price	28.2	24.3	24.3

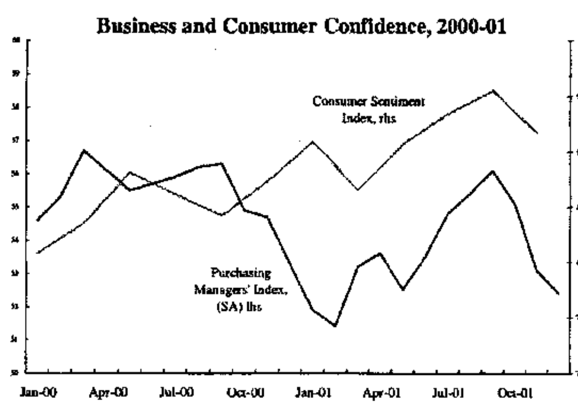
1/ Report on Post-Program Monitoring (PPM) discussions (EBS/01/74).

2. **Developments in Russia contributed importantly to the strong macroeconomic performance throughout the CIS region** (Box 1).

Output and employment

3. **The economy's rapid expansion has slowed considerably**. Output growth in 2001 was driven by domestic demand as the contribution from net exports and government consumption was negative. Real private consumption increased steadily in line with the recovery in real wages, and indicators of consumer confidence have remained buoyant.





Box 1. Russia's Role in the Region

Economic developments in Russia are key for many countries in the region and, as a result, the resumption of growth in Russia since late 1998 has supported economic recovery throughout the region. Russia's influence reflects both the relatively large size of the Russian economy—Russia accounts for about 75 percent of the region's GDP—and the close trade linkages between the countries. The CIS (Commonwealth of Independent States) is formally a free-trade area, but a customs union, comprising Belarus, Kazakhstan, Kyrgyz Republic, Russia, and Tajikistan, has emerged that provides for close harmonization of tariff and customs legislation and procedures. Cross-border financial linkages between a number of the countries are also significant. In the past, financial flows mainly took the form of trade-related credits, in particular relating to energy trade, but in recent years cross-border direct investment flows have increased with improvements in the investment climates. Further, the recent market-oriented reform policies in Russia are in some cases spilling over to other countries in the region, most notably in the area of tax reform.

Growth in the CIS region—averaging some 6 percent in both 2000 and 2001—reflects in part the impact of the Russian economy on the rest of the region but also increasing domestic demand within each country. Exports to Russia were important in sustaining growth in many countries in 2000. The growth in exports was in response to the strong growth of demand in Russia and real depreciations against the ruble in each of the countries, as part of the competitiveness gain experienced by Russia in late 1998 was reversed. The slowdown of GDP growth in Russia and in the EU, combined with declining commodity prices, has reduced the significance of exports in driving growth in many of the countries in the region, and export volumes fell in several countries in 2001. Growth momentum has been sustained by a strong increase in domestic demand—both domestic investment and private consumption—driven by the relative stability of the region and improvements in both macroeconomic and structural policies, including a strengthening of fiscal discipline that has enabled the repayment of some government social arrears.

Most of the countries in the region are quite sensitive to a change in the rate of output growth in Russia. The countries generally have relatively open economies, with Russia the main export market for almost all of the CIS countries, while the Baltics have closer trade links with Europe. Export-to-GDP ratios are typically in the range of 40–50 percent, and on average the share of other CIS countries' exports to Russia amounts to more than 25 percent (40–50 percent in Belarus, Moldova, and Turkmenistan). Staff estimates suggest that a 2 percentage point slowdown in growth in Russia would reduce growth in other CIS countries by an average of ½ percentage point. The largest impact would be in the countries that have the closest trade linkages with Russia (growth in Belarus and Moldova could slow by 1 percentage point, with an even larger decline in Turkmenistan). On the other hand, the impact on growth in Azerbaijan, Tajikistan, and Uzbekistan would be negligible.

On the other hand, investment growth slowed in 2001 as rising real wages and the real appreciation of the ruble reduced enterprise profitability. Business confidence, as represented by the manufacturing sector, improved for much of the year before dipping sharply in the fourth quarter. At the sectoral level, growth in sectors related to investment spending (construction) or tradables (industry, agriculture, freight transportation) slowed. In contrast, retail trade—the closest proxy for private consumption—was buoyant in 2001.

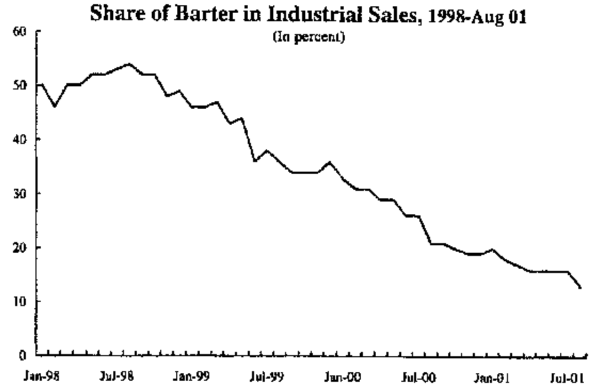
Real Growth of Output of Basic Sectors
(Year-on-year percent change)

	2000 Jan-Nov	2001 Jan-Nov
Basic Sectors	10.8	5.7
Memo: GDP growth 1/	*8.8*	*5.0*
o/w Tradable		
Industry (adjusted for working time)	12.3	5.2
Freight transportation	5.3	3.2
Retail sales	8.7	10.6
Agriculture	7.4	6.0
o/w Nontradable		
Construction	11.4	9.2

Source: Goskomstat
1/ January - September

4. **The use of barter declined as budget constraints hardened throughout the economy**. The share of noncash payments in industrial sales—which exceeded 50 percent in early 1998—fell to well below 20 percent. Similarly, the cash collection rates of the large natural monopolies remained close to 100 percent throughout the year, with a particularly strong improvement by Gazprom.

Share of Barter in Industrial Sales, 1998-Aug 01
(In percent)



5. **Labor productivity increased strongly as employment growth lagged the recovery in output**. Employment has increased by 2 percent since end-1999, relative to real GDP growth of 15 percent; the implied sharp improvement in labor productivity—in part a reflection of labor hoarding in earlier years—helped alleviate the drag on enterprise profitability from increasing real wages and the appreciation of the real exchange rate. The unemployment rate fell below 8½ percent, a reduction of 4 percentage points in the last two years.

Fiscal policy

6. **The recent record of fiscal consolidation continued**. Fiscal policy was strengthened further in 2001, with the federal budget primary balance at constant oil prices improving by 1¼ percent of GDP.[1] Revenue collections—the highest since the dissolution of the Soviet Union—resulted from an across-the-board improvement in tax compliance,[2] the strong contribution of the energy sector, and high VAT collections from the robust consumption demand.

Fiscal Developments, 2000-01
(In percent of GDP, cash basis)

	2000	2001	
		PPM	Est.
Federal government			
Revenue	16.0	15.6	17.1
Expenditure	14.1	15.3	14.4
Noninterest	11.5	12.2	11.8
Primary balance	4.5	3.4	5.3
Overall balance	1.9	0.3	2.7
Enlarged government			
Primary balance	6.4	3.7	5.5
Overall balance	3.8	0.6	2.9
o/w Local governments	0.6	0.0	0.0
o/w Extrabudgetary funds	1.3	0.3	0.2
Memorandum item:			
Budget balances at constant oil prices ($19 a barrel)			
Federal primary	3.5	3.1	4.7
Federal overall	0.9	0.0	2.2
Enlarged primary	5.1	3.4	4.9
Enlarged overall	2.5	0.3	2.3

7. **Expenditure restraint continued despite the strong revenue performance**. Federal

[1] The constant oil price balance is an approximation to the underlying structural balance. It is calculated by holding the oil price constant and does not correct for second round impacts on GDP, exchange rate, or oil volumes. Data are not currently available for more sophisticated estimates of structural balances, such as the non-oil balance.

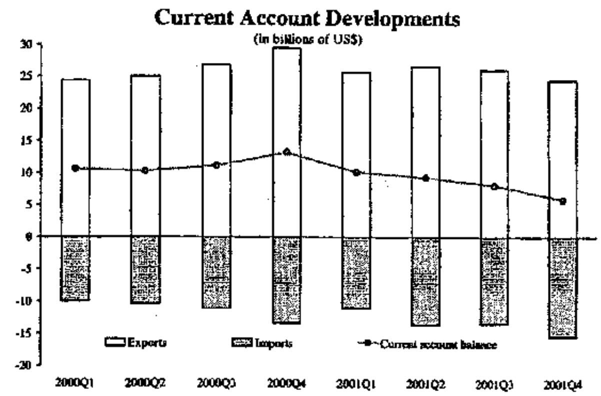
[2] This can be attributed to the 2001 tax reform aimed at broadening the tax net, simplifying the tax structure, and improvements in tax and customs administration. More details on tax reform and the revenue implications are contained in the "Tax Reform in Russia since 1999" chapter in the accompanying *Selected Issues* paper.

noninterest expenditures increased modestly, largely a result of increased transfers to the regions and greater social spending to compensate for the revenue centralization that occurred during the tax reform. Civil service wages were increased by an average of 50 percent effective December with the increase targeted at those groups, notably teachers, whose wages had fallen relative to other federal and local employees since 1998.

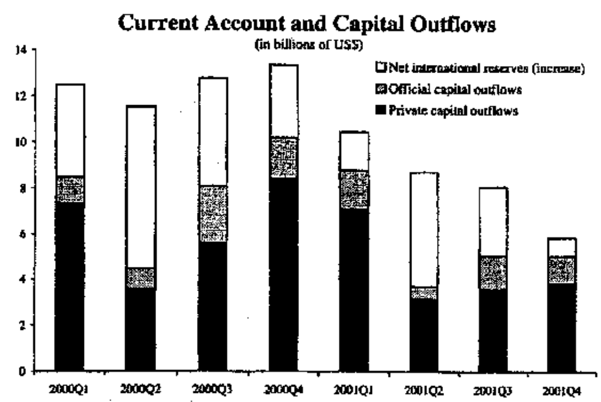
8. **Balances of the enlarged government, however, deteriorated** as the surplus of the extrabudgetary funds (mainly the Pension Fund) weakened due to increases in pensions/social benefits to partially offset the real decrease in these payments since the crisis.

External sector developments

9. **As anticipated, the current account surplus narrowed significantly with the brisk recovery of imports.** Energy exports declined modestly as falling energy prices were partially offset by rising export volumes, while non-oil exports stagnated due to depressed commodity prices and slowing demand in key trading partners. The recovery of imports reflected the continued appreciation of the real exchange rate and robust consumption demand.



10. **Net private capital outflows have slowed but remain large and continue to offset a significant portion of the current account surplus.** The reduction in net private capital outflows (including errors and omissions)—both in absolute terms and relative to total trade—is likely the result of an improvement in the investment climate and decreased returns in both mature and other emerging markets. Official capital outflows remained modest. Consequently, there was a healthy accumulation of international reserves.



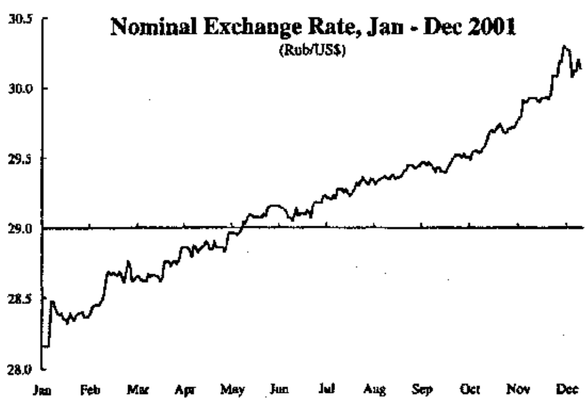
11. **Progress was made on regularizing relations with external creditors.** Arrears incurred to Paris Club creditors at the beginning of 2001 were cleared by mid-year. Restructuring agreements were reached with London Club creditors in 2000; with holders of FTO debt in April 2001; and an agreement in principle with COMECON-era creditors (IIB

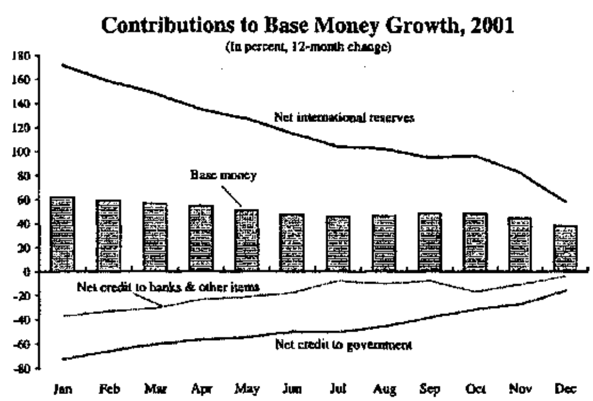
and IBEC debts) in early September.[3] A debt restructuring agreement was reached with the Czech Republic, and discussions are continuing on remaining unresolved claims held by Germany and a number of non-Paris Club creditors.[4]

12. **As regards the exchange system, a number of measures were introduced that liberalize both current and capital account transactions.** Export surrender requirements were reduced from 75 percent to 50 percent in July (the 100 percent repatriation requirement was unchanged). In addition, regulations on the system of nonresident ruble accounts were modified to provide greater flexibility in the use of existing balances, including repatriation of interest earnings and trading amongst non-residents. Capital transactions mostly affecting outward flows were also liberalized.[5]

Exchange rate, monetary policy, and inflation

13. **For most of the year, the strong fiscal performance eased the burden on monetary policy to rein in liquidity.** Notwithstanding the strong balance of payments, the CBR allowed the ruble to depreciate, in nominal terms, modestly throughout the year, with the pace of depreciation picking up somewhat in the fourth quarter. The accompanying liquidity injections were partially offset by the build-up of public sector deposits at the CBR.





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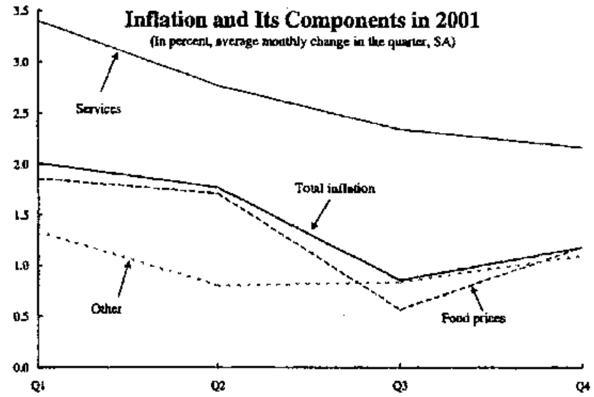
[3] The FTO debt represents claims held by uninsured commercial suppliers accumulated during the Soviet era. The outstanding claims are to be converted in the first half of 2002 into around $2 billion in Eurobonds maturing in 2010 and 2030 with a similar level of debt reduction as in the London Club agreement completed in early 2000. The IIB and IBEC (CMEA banks) restructuring offer is on similar terms to the FTO agreement and is expected to be completed during 2002.

[4] The terms of the agreement with the Czech Republic have not been made available as yet.

[5] These relate to relaxing restrictions on outward direct investment to CIS countries, easing restrictions on the attraction of foreign credits, permitting resident individuals to make overseas foreign exchange transfers, after informing the Ministry of Taxation and Fees, of up to $75,000 per person per year, as well as to open accounts abroad in 34 OECD/FATF countries.

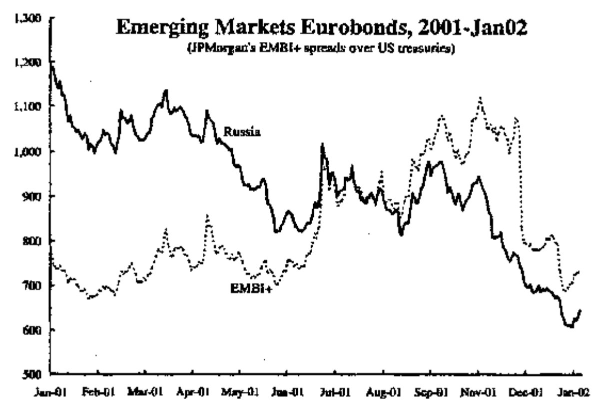
For its part, the CBR conducted only modest sterilization operations, with infrequent and small adjustments in the rates available on its deposit facility and very limited placements of its own bonds. This, however, resulted in a sharp increase in liquidity at year-end when, for a second year in a row, the drawdown of public deposits strongly outpaced the central bank's efforts to withdraw liquidity.

14. **Inflation fell during the year but exceeded the authorities' target.** Inflation picked up in the initial months of 2001, fueled by the surge in liquidity at end-2000 as well as administered price increases. At mid-year, however, inflation declined, aided by a bumper harvest that led to sharp decreases in food prices. Inflation picked up again late in the year due to an easing of liquidity.



Capital markets

15. **Spreads on Russia's Eurobonds narrowed sharply in 2001 as Russia's standing within its asset class improved and ratings agencies provided a number of upgrades.** The strength of the Russian market and difficulties in other emerging markets led to spreads on EMBI Russia index falling below the EMBI+ index—the total decline in spreads amounted to 600 basis points in 2001. Russia's first sovereign Eurobond was paid on schedule on November 27. Ratings agencies provided a series of upgrades during the year.[6] Non-sovereign borrowers returned to the market, with the City of Moscow placing Eurobonds in October–December and some of the larger Russian corporates (mostly energy companies) also regaining access to Eurobond and syndicated loan markets.



[6] For example, S&P rated Russia as CCC-/Selective Default from the crisis until December 2000, at which time Russia was upgraded to B-. Additional upgrades occurred in June 2001, to B, and in December 2001, to B+.

Structural policies

16. **Structural reforms have focused on strengthening the investment climate through a combination of tax reform, deregulation, strengthening property rights, and developing financial markets and institutions.**[7]

- **Tax reform aims to simplify the tax system, reduce the tax burden, and broaden the tax base**. Key elements include reduction in and consolidation of social fund contributions, improvements to VAT, sharp reduction in turnover taxes, the introduction of a flat personal income tax at a reduced average rate, strengthened excise taxes, amendments to the profit tax that reduce the rate while eliminating most exemptions, and a new simplified system for the taxation of mineral resources.
- **Deregulation and strengthening property rights have advanced in a broad range of areas**. The main changes include new laws on business registration, licensing, and inspections that, inter alia, introduce explicit criteria for refusal of registration and significantly reduce the number of business activities requiring a license; a new Land Code that establishes the general principle of land ownership (including for foreign citizens) for urban land that will significantly reduce uncertainty related to fixed investment and reduce interference by local authorities; and a new Labor Code that liberalizes the hiring and firing of workers but also clarifies employees' rights. The government also approved reform strategies for railways and the electricity sector that aim to restructure, liberalize, and privatize potentially competitive segments of these markets.
- **Progress was also made with financial sector reform**. Amendments to banking legislation were approved that strengthen the legal framework for banking supervision and restructuring, including by introducing insolvency as a criterion for bankruptcy and raising minimum capital requirements for new banks (domestic and foreign) to EU levels. A pilot scheme was initiated for adoption of IAS and anti-money laundering legislation was adopted. The CBR and the government also adopted a concept paper for the development of the banking system at end-December, but concrete proposals are yet to be developed in this area.

17. **Notwithstanding the impressive progress made on a broad front on structural issues, less progress was achieved on the narrower reform agenda elaborated in the authorities' Statement on Economic and Financial Policies for 2001 (EBS/01/74).** The authorities' statement elaborated a set of measures concerning fiscal reform, banking sector, non-payment and barter, and governance and transparency in policy-making institutions.

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[7] For a detailed description of structural reforms, see the following chapters of the accompanying *Selected Issues* paper: for tax reform, see "Tax Reform"; for reforms concerning the energy sector (including electricity, gas, and the oil sector), railways, business deregulation, land, labor, housing and communal services, external trade, WTO accession, and judicial reform, see "Structural Reforms"; and for banking sector reforms, see "Selected Issues in Banking Sector Reform".

Identified steps in several of these areas were not achieved in 2001.[8] The staff is of the view that while the list of unfinished actions is important, it is indeed small when compared with the overall structural agenda that was adopted during the year.

II. Report on the Discussions

18. **Discussions focused on the appropriate policy stance in the face of a deterioration in the external environment of uncertain size and duration**. They were also shaped by staff's analysis that there is room to relax the underlying fiscal position by 3 percentage points of GDP over the medium term without threatening external or fiscal sustainability.[9]

19. The discussions thus centered on the following three issues:

- The room for fiscal easing over the medium term and the extent to which that should be used in 2002 to counter the slowdown in growth from the terms-of-trade shock.
- The balance between adjustment and financing in the event that there is a deeper and more protracted deterioration in the global environment.
- The government's priorities for structural reforms.

A. Macroeconomic Outlook and Risks

20. **Staff and the authorities broadly agree on the outlook for 2002–03**. The staff's baseline scenario—reflecting the December 2001 WEO—assumes that the global economy will continue to slow during most of 2002, with a clear turnaround only emerging in 2003. GDP growth in Russia would slow in 2002 as net exports continue to decline because of weaker energy exports, slower growth in trading partners, and the lagged effect of the real exchange rate appreciation.[10] Domestic demand is expected to continue to grow strongly,

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[8] Key areas where progress has been limited are: the completion of the strategic review of Sberbank with the participation of independent external consultants; elimination of the strategic list of entities that cannot be disconnected in the event of non-payments; publication of CBR's financial statements and review of reserve management practices of previous years; and, reporting of international reserves and foreign currency liquidity data to the Fund in the format of the SDDS template.

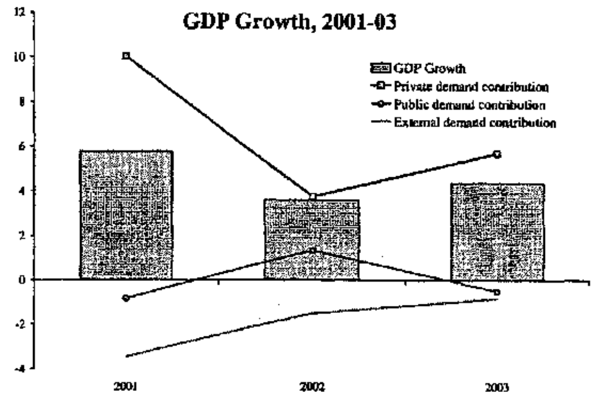
[9] See the "Fiscal Sustainability" chapter in the accompanying *Selected Issues* paper, that analyzes the determinants of sustainable fiscal balances in Russia, given existing debt ratios and uncertain access to capital markets.

[10] The staff's projections for 2002 assume that crude oil export volumes will decline by 3 percent over the level of 2001. Subsequent to the mission, Russia announced that it had agreed with OPEC to cut crude oil exports by 150,000 barrels per day during the first quarter of 2002. If maintained throughout 2002, this would imply a reduction in crude oil export volumes of around 5 percent. The macroeconomic impact would depend on the impact of the OPEC cuts on the oil price.

driven by increases in private consumption, and to a lesser extent investment, as well as some fiscal stimulus in 2002. The Russian economy will benefit from the pick-up in the global economy in 2003.

Key Macroeconomic Indicators, 2001-03

	2001 Est.	2002 Staff Projection	2003
Real GDP growth (in percent)	5.2	3.6	4.4
Inflation (in percent)	18.6	13.0	9.0
Federal government, cash basis			
Primary balance (percent of GDP)	5.3	2.6	2.6
Overall balance (percent of GDP)	2.7	-0.1	0.2
Current account ($ bn)	33.8	16.8	17.2
(percent of GDP)	11.0	5.2	5.0
Gross official reserves ($ bn)	36.5	36.5	37.4
(months of import cover)	5.5	5.0	4.8
(ratio to short-term debt)	298	229	334
Russian oil price ($/barrel, c.i.f.)	22.5	16.4	17.0
WEO (Dec 2001) oil price ($/barrel)	24.2	18.5	19.0



Fiscal policy

21. **The 2002 budget would remain in balance on the staff's baseline oil price of $16.4 a barrel (Russian price, c.i.f.).** While the budget was formulated assuming a Russian oil price of $23.5 a barrel, various provisions within the budget—including a large earmarked reserve and identified contingency expenditure reductions of ¾ percent of GDP—ensure that it remains financed at lower revenue levels or more limited availability of financing (Box 2). Appropriations to spending units would accordingly be backloaded, and expenditures will not be undertaken if revenues are below targets. In the staff's baseline projections, both the reserve fund and the identified contingency cuts in expenditures would be needed to keep the budget balanced. On a constant oil price basis, the overall balance of the enlarged government is projected to decline by 2 percent of GDP, comprising of 1 percent of GDP from an increase in noninterest expenditure at the federal level (largely attributable to a combination of a wage increase and expenditures on judicial and military reforms), ½ percent of GDP from federal revenues (largely due to the amendments to the profit tax), and ½ percent of GDP from a projected deterioration in the Pension Fund due to the impact of higher benefit payments related in part to the minimum wage increase.

Federal Government Budget
(Cash basis, in percent of GDP)

	2001	2002 Budget 1/	2002 Staff Projections	2003
Revenues	17.1	16.8	15.3	15.0
Expenditures	14.4	15.1	16.1	14.8
Interest	2.6	2.6	2.7	2.4
Non-interest	11.8	12.6	13.5	12.5
Primary balance	5.3	4.2	1.9	2.6
Contingency measures	...	...	0.7	...
Primary balance (after measures)	5.3	4.2	2.6	2.6
Overall balance	2.7	1.6	-0.1	0.2
Fiscal balance (constant oil price)				
Primary balance	4.7	2.9	3.3	3.2
Overall balance	2.2	0.3	0.7	0.9
Memorandum items:				
Enlarged government, overall balance	2.9		-0.6	-0.4
at constant oil prices	2.3		0.3	0.3
Russian oil price ($/barrel, c.i.f.)	22.5	23.5	16.4	17.0

1/ Includes the proposed supplementary budget for 2001.

Box 2. Fiscal Policy Measures for 2002

Key fiscal policy measures either contained in the budget law or which came into effect on January 1, 2002, include:

Revenue

- Profit tax rate reduction from 35 to 24 percent and elimination of most exemptions. Expected to reduce federal government revenues by more than ½ percent of GDP.
- A new mineral resource tax replaces the existing oil excise tax, subsurface resource tax, and fee for renewal of mineral resources. The federal government will retain 80 percent of the revenues, as opposed to about 37 percent under the old system. Expected to be broadly revenue-neutral at a Russian oil price of $17 per barrel.
- Federal share of revenue from the land tax increases (from 25 percent to 30 percent). All revenues from the personal income tax are assigned to subnational governments.

Expenditure

- Noninterest expenditures targeted to increase by 1 percent of GDP.
- Wage bill increases by ½ percent of GDP, reflecting the full year impact of the 50 percent average wage increase granted to civil servants on the unified tariff schedule, so as to bring them into line with other government employees and as part of a consolidation of allowances.
- No net increase is allowed in the number of federal government employees, employees of institutions and organizations in the budget sector, military personnel, and persons with equivalent status; subnational governments are recommended to do likewise.
- 0.3 percent of GDP is provided for military and judicial reform, including: pay increases for judiciary personnel; an increase in the judiciary of about 6,000; military retrenchment of 0.4 million; and the first phase of aligning military and civilian pay while reforming monetary allowances.
- The budget law includes a list of contingent expenditure cuts equivalent to about 0.7 percent of GDP. The proposed expenditure cuts include both current and capital spending and would affect transfers to regions, defense, transportation, law enforcement, education, health, and other social activities.
- A Regional Finances Reform Fund is established, with World Bank financing, to assist selected subnational governments to reform regional finances, develop social infrastructure, improve the efficiency and transparency of public spending, and support economic reforms.

Financing

- A Rub 110 billion financial reserve is planned, which can be used either to make up for shortfalls in anticipated sources of financing for the federal budget deficit, or to make payments to reduce the future debt obligations of the Russian Federation.
- The federal government would return to international capital markets, placing up to $2 billion in Eurobonds.

Execution of the Budget

- That portion of the Unified Social Tax which is earmarked to pay for the flat pension benefit is integrated into the budget.
- Federal, regional and local taxes and fees and other payments are to be posted to the accounts of federal treasury agencies before they are distributed among the federal and subnational budgets and extrabudgetary funds. An exception is made for subnational taxes and fees for territories which are not receiving subsidies in 2002.
- Federal and subnational government agencies which depend on the federal budget for financing, including those located abroad, must report fully on all their financial operations, including rental income.
- All off-budget accounts of federal budgetary institutions will be moved to the federal Treasury. Likewise, all Ministry of Defense transactions will go through the federal Treasury.

22. **The authorities broadly agreed with the mission's estimates** but noted the unusual degree of uncertainty surrounding the revenue forecasts, stemming from the impact of the large-scale tax reform and lower oil prices on the economy and the ability to maintain existing compliance levels, including for social security contributions. If growth weakens more rapidly than anticipated, the staff recommended that automatic stabilizers should be allowed to operate in full, provided that neither domestic nor foreign financing are a constraint.

External sector

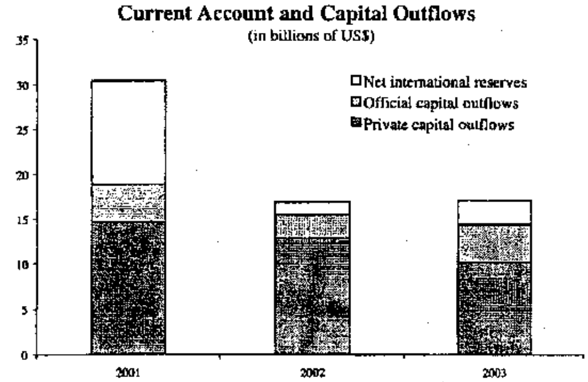
23. **The balance of payments is expected to weaken substantially in 2002.** The current account surplus is likely to fall sharply in 2002 as exports decline due to weak global demand and lower commodity prices while imports rise because of increasing domestic demand within Russia. The capital account should strengthen, however, with a continuation of the recent slowdown in net private capital outflows and Russia's return to international capital markets with a new Eurobond placement. As a result, the overall balance will likely register a small surplus, with gross reserves remaining flat. Overall prospects for 2003 are similar, assuming a continued reduction in private sector outflows and a partial rollover of maturing official debts.[11]

Balance of Payments, 2001-05
(In billions of US$)

	2001	2002	2003	2004	2005
Current account	33.8	16.8	17.2	16.4	15.4
Exports	102.7	93.2	98.6	104.0	110.1
Energy	50.6	38.5	38.2	38.1	38.0
Non-energy	52.1	54.7	60.3	65.9	72.1
Imports	-53.6	-59.5	-64.9	-70.5	-76.9
Services	-15.5	-17.1	-16.7	-17.3	-17.9
Public sector interest	-6.3	-6.9	-5.9	-5.8	-6.1
Capital account	-18.9	-15.4	-14.5	-9.3	-7.5
Public sector	-4.2	-2.6	-4.2	-0.4	0.1
Amortization	-5.3	-5.2	-8.4	-4.1	-6.7
Private sector	-18.7	-12.8	-10.2	-8.9	-7.6
Overall balance	10.9	1.4	2.7	7.1	7.9
Memorandum items:					
Current account (in percent of GDP)	11.0	5.2	5.0	4.4	3.7
Gross reserves	36.5	36.5	37.4	43.0	49.8
in months of imports of GNFS	5.5	5.0	4.8	5.0	5.3
in percent of short term debt	298	229	335	406	503
Terms of trade (percentage change)	-3.4	-10.3	1.0	0.2	0.5
External debt service payments	22.5	20.5	23.3	18.5	18.7
in percent of exports of GNFS	19.9	19.7	21.2	15.9	15.2
Public external debt	134	129	122	120	119
in percent of GDP	43.7	40.0	35.3	31.8	28.7

Source: Fund staff projections.

Current Account and Capital Outflows
(in billions of US$)



[11] In 2003, scheduled federal government external debt service (including the Fund) increases from \$13½ billion in 2002 to \$16 billion in 2003 with the spike caused by the maturing of a \$3½ billion bond issue (MinFin IVs). According to market participants, the authorities have undertaken buy-back operations to smooth the payments spike though the precise magnitude is not known, adding to the uncertainty surrounding the 2003 projections.

Exchange rate, monetary policy, and inflation

24. **For the last two years, macroeconomic policies have sought to deal with the strong balance of payments without endangering growth prospects.** The combination of the significant real depreciation (40 percent) following the crisis, the large terms-of-trade gains (40 percent), and a significant tightening of fiscal policy (by nearly 7 percentage points of GDP in the primary fiscal balance for the federal government since 1998) resulted in large current account surpluses and pressures for a nominal appreciation of the ruble. Though the authorities agree that the ruble will have to appreciate in real terms as the transition advances (Balassa-Samuelson), they are concerned that the pace of appreciation from the strong balance of payments not exceed gains in productivity, which would threaten development of the non-energy tradable sector. They have, accordingly, resisted a nominal appreciation through large-scale purchases of foreign exchange. These purchases were only partially sterilized as, given the uncertainty in the recovery of money demand, the CBR was reluctant to risk overly tightening monetary policy. With inflation running at around 20 percent, the real effective exchange rate is 15 percent below the pre-crisis level.

25. **The staff noted that while the CBR had been successful in rebuilding reserves through its intervention policy, the targeted reduction in inflation had not materialized.** In recent years, in the face of a strong balance of payments, the staff has taken the view that a fairly stable exchange rate is a reasonable compromise between pressures for nominal appreciation, the authorities' concern that too rapid an appreciation would jeopardize output recovery, and uncertainty surrounding the recovery in money demand. In light of this, the first line of defense to contain inflation was timely sterilization operations. The staff noted that the CBR had been slow to sterilize the liquidity injections resulting from its intervention policy until there were clear signs that inflation was rising. The CBR noted that, on balance, its conduct of monetary policy was appropriate, with the larger-than-targeted inflation due to the impact of administered price changes.

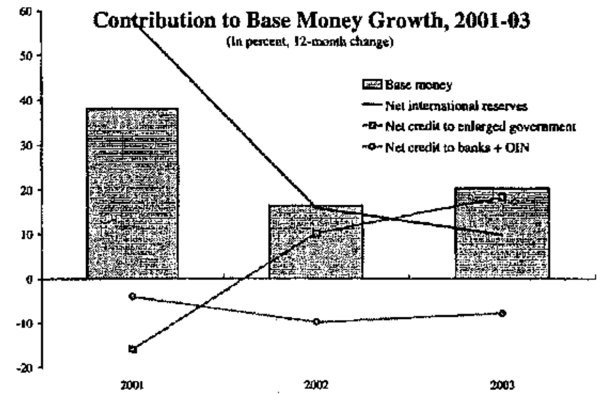
26. **In 2002, the weaker external environment will ease the policy conflicts experienced in the past as intervention and the consequent need for sterilization would be sharply reduced.** Notwithstanding the envisaged weaker fiscal performance, the staff's projection of money demand suggested that net credit to the economy could increase modestly in real terms. The staff noted that progress had been made in expanding the range of instruments available to the CBR, in particular the easing of restrictions on the CBR's use of its own bonds, but encouraged the

Monetary Authority Accounts, 2001-03
(In billions of rubles)

	2001	2002	2003
Base money	683	835	1004
Net international reserves	833	875	956
Net domestic assets	-150	-40	48
Enlarged government	1	109	262
Banks	-127	-117	-190
Other items (net)	-24	-32	-24
Memorandum items:			
Base money growth (in percent)	37	22	20
Net international reserves (US$ bn)	27.8	29.2	31.9
Ruble broad money growth (in percent)	32	22	21
Growth in credit to the private sector (in percent)	41	17	10

Source: Fund staff projections.

CBR to employ these instruments flexibly to keep liquidity under control. However, this will not lessen the need for coordination between the monetary and the fiscal authorities so that large surges in liquidity, as has happened in the past, can be avoided.



27. **The staff acknowledged that forecasting inflation has been a major challenge.** In particular, the limited experience with the compilation and analysis of indices of core inflation, the uncertain assessment of the impact of administered prices on the price level, and the considerable uncertainty regarding the robustness of money demand equations—as well as the transmission mechanism—have complicated the assessment of the monetary stance and the design of appropriate responses to liquidity developments. This has led to periods of price surges as well as deflation beyond what can be explained by monetary/seasonal factors.[12,13] For 2002, the staff's projection for headline inflation is in the range foreseen by the authorities, but there is some uncertainty as to the achievability of the target absent a decision, to be made in early 2002, on the magnitude and timing of administered price increases. The CBR estimated that a headline inflation target of 12–14 percent would imply a significant reduction in core inflation from the estimate of 12 percent for 2001.

28. **The authorities expressed strong concern that the proposed amendments to the Central Bank Law could result in an inappropriate loss of operational independence of the CBR.**[14] While acknowledging that the amendments would strengthen the existing legislation in some areas, the authorities noted that these proposals risked that monetary policy guidelines and the CBR's operational budget (including for monetary operations) may be determined by the NBC. The staff shared these concerns and noted that, as these proposals go through various stages in the Duma, it is necessary to maintain the delicate balance between the accountability and independence of the CBR.

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[12] Administered prices include the tariffs of natural monopolies. Their precise weight in the CPI is difficult to calculate due to differing price control arrangements in the various regions, but is estimated to be in the range of 10–16 percent.

[13] Factors contributing to the uncertainty in money demand include: the structural shifts in the economy; the extensive use of money substitutes; currency substitution; and difficulty in gauging near-term output developments. See "Money Demand" in the accompanying *Selected Issues* paper.

[14] Draft amendments to the Central Bank Law approved by the Duma's Banking and Budget Committee would: create a new National Banking Council (NBC) consisting of members appointed by the government, the Duma, and the President; clarify the legal status of the CBR; permit the CBR to divest itself of its subsidiaries; and broaden the objectives of the CBR to include the stability of the ruble/U.S. dollar exchange rate.

Risks

29. **The staff and the authorities agreed that, apart from the external environment, the principal risk to the baseline scenario was that domestic demand may prove to be less robust than projected by the staff.** Growth prospects depend crucially on the resilience of domestic private sector demand in the face of lower international energy prices. While the direct impact of lower energy prices on growth is quite small, the secondary impact through investment demand could be significant in both 2002 and over the medium term (Box 3). The authorities considered that other risks, such as a resurgence in barter and nonpayments as the economy slows down or instability in the banking system (see Box 4), appeared modest. In the case of nonpayments, sufficient progress had been made with the legislative environment and budgetary practices to limit the risk of a widespread resurgence.

30. **Local government finances could pose an important risk to the achievement of the budgetary objectives.** The combination of the federally mandated public sector wage increase and the centralization of revenue assignments under the tax reform would likely require reductions in non-wage expenditures at the local government level to avoid a build-up in arrears. The authorities noted that although this was entirely feasible, in particular by accelerating reforms on housing and communal services, certain regions could face a sharp deterioration in their financial position. Thus, the federal government has strengthened its monitoring of local budgets[15] and it plans to develop a mechanism for providing federal loans to particularly vulnerable regions.

B. Policy Response to a Deeper and More Protracted Deterioration in the External Environment

31. **Possible policy responses were discussed in the event that—relative to the baseline scenario—the recovery in the global economy is slower, the decline in commodity prices is larger, and access to international capital markets is more limited.**[16] The staff noted that, while a temporary modest shock could simply be financed by running down reserves, a shock of a larger magnitude and longer duration carried the potential to induce speculative pressures on the balance of payments, and some adjustment to signal to the market that the authorities were being pro-active in protecting public finances and the reserves position would be prudent.

[15] The number of regions whose budgets are executed through the Federal treasury was increased in the 2002 Budget Law from 14 to 31 of the 89 regions.

[16] These assumptions underlie the alternative scenario discussed in the December 2001 World Economic Outlook.

Box 3. The Impact of Energy Prices on the Economy

The energy sector is a key component of the Russian economy, accounting for about 17 percent of total value-added (oil and gas extraction account for 6 percent of GDP, energy-related transportation services and pipelines for 9 percent of GDP, and other fuels for 2 percent of GDP). Further, petrochemicals as a whole, including crude oil, fuel oil, other oil products and natural gas, account for more than one-half of Russian exports, and the energy sector contributes about a quarter of consolidated government revenues.

A $1 a barrel decline in Russian oil prices from current levels is estimated to have the following impacts on the key macroeconomic accounts:

- GDP growth declines by about 0.5 percentage points;
- Federal budget revenues decline by around $1 billion (0.3 percent of GDP) with a further 0.1 percent of GDP decline at other levels of government;
- A reduction in export revenues of about $2 billion.

The impact on **growth** is mostly via investment. In the last few years, the energy sector has accounted for around 40 percent of total investment, largely financed from retained earnings (on the supply side, this will be reflected in output changes in the sectors producing equipment for the energy sector). Energy-sector post-tax profits would decline by about $1 billion (0.3 percent of GDP), and investment by about one-half that amount. Export volumes would not be expected to adjust significantly in the short run—unless production cuts were agreed in response to the price decline. The impact via consumption is also likely to be limited due to the slow and unclear links between sectoral profitability and wages. In addition, the price decline may have indirect, potentially offsetting effects through both a reduction in government revenues (see below), and a real exchange rate depreciation, with the implied stimulus to export volumes. The magnitude of these effects depends on the policy response and are thus difficult to quantify *ex ante*.

The decline in **federal revenues** is largely due to reduced collections from the mineral extraction tax and in export tariffs with each accounting for about two-fifths of the total impact. The remaining amount reflects a reduction in profit tax receipts, and the likely downward adjustment in energy excises. The impact at the general government level arises from the revenue-sharing formulas for the mineral extraction taxes and profit taxes—local governments receive almost one-fourth of the former and two-thirds of the latter. Energy price declines also have an indirect effect on revenues through overall growth, which could increase the sensitivity of consolidated revenues by up to 0.1 percent of GDP.

Export revenues are directly affected for crude oil, oil products, and natural gas (comprising around 50 percent, 20 percent, and 30 percent respectively of energy exports)—the price of natural gas exports to Europe is established in long-term contracts through a formula based on the oil price. The overall impact on the current account would be moderated by a decrease in imports due to reduced investment in the sector and lower transit fees in the services account. In the capital account, investment inflows would likely decline, but the magnitude and direction of the impact on other private capital flows are dependent on factors outside the energy sector.

There are though important **nonlinearities at low oil prices**. The effect on growth could become much larger as higher cost producers become unprofitable and reduced profits constrain investment more broadly. However, government revenues become less sensitive as export tariffs become zero at prices below $15 a barrel.

Box 4. Financial Sector Vulnerability

The banking system remains small in terms of standard indicators of financial intermediation. However, while starting from very low levels, the rate of growth in credit to the economy has been very high—in part a reflection of a shift in the composition of bank assets as a consequence of the fiscal surpluses run in the last few years. The current strength of the macroeconomic recovery and improved liquidity throughout the economy have been reflected in a clear downtrend in nonperforming loans and improvements in most indicators of the health of the financial system. Bank earnings have recovered with GDP growth and the associated reduction in loan loss reserves, but remain low by international standards. With the exception of Sberbank, returns on bank capital (on the order of 12 percent for the larger private banks) do not seem to compensate for the risks in the Russian environment. Moreover, the recent earnings reflect to an extent higher risks taken on in expanding lending, the cost of which may materialize in a cyclical downturn.

Financial Sector Vulnerability Indicators

	1998	1999	2000	2001 1/
Banking system				
Assets/GDP (in percent)	40	38	36	36
M2/GDP (in percent)	13	11	12	12
M2 growth (in percent)	21	57	62	44
Growth of credit to the private sector (in percent)	33	51	64	57
NFA of commercial banks (US$ bn)	0.9	5.5	8.1	10.1
Share of foreign currency loans in total loans (in percent)	57	40	29	27
Share of foreign currency deposits in total deposits (in percent)	44	40	37	37
Share of ruble demand deposits in total ruble deposits (in percent)	62	60	63	60
Prudential Indicators for 30 largest banks				
Share of nonperforming loans (in percent)	24	23	13	10
Reserves for loan loss provision (in percent of required reserves)	50	71	99	100
Net open foreign currency position (in percent of capital)	60	42	25	13

1/ End-October

Key risks include:

- Concentration of lending and funding as many private banks are not significantly diversified outside the financial-industrial groups they typically belong to.
- Concerns about the adequacy of risk assessment and management practices that could create problems in the event of a macroeconomic downturn, especially given the recent rapid increase in credit.
- Legal risk stemming from uncertainties in both the existing legislation concerning creditor rights and in the implementation of the legislation.
- Limited disclosure of financial information and uncertainties surrounding accounting standards and auditing procedures complicate the analysis of banking data both for market participants and banking supervisors.
- Lack of progress in strengthening corporate governance, including improvements in disclosure and accounting practices.

Stress simulations based on partially estimated 2001Q3 balance sheets suggest that the system is undercapitalized in light of the underlying credit risks, despite the recent improvements in capital levels and profitability.[1] However, the extent of system-wide capital shortfall in the event of a 1998-style shock appears broadly manageable, on the order of 2–6 percent of GDP depending on whether publicly-funded rescue operations extend beyond Sberbank—no other bank is currently of systemic importance. Risks appear to be proportionately higher in the large private banks, followed by Sberbank, and then the private smaller banks, largely reflecting the relative size of lending across these categories.

	Current Conditions			Stress	
2001Q3	Assets Percent of GDP	Leverage Ratio RAS 1/	Implied Leverage Ratio IAS 2/	Extreme Shock Capital Shortfall in Percent of GDP	Medium Shock Capital Shortfall in Percent of GDP
Sberbank 3/	8	8	5	1.8	0.7
Next 15 banks 4/	8	19	10	2.3	1.3
Sample of private banks 5/	2	17	23	0.2	0

1/ Basel-type CAR not used because of uncertainties in the measurement of capital, risk weights, and asset classification.
2/ Implied IAS derived by applying RAS-IAS conversion factors to the major asset categories and to capital. Conversion factors reflect differences between RAS and IAS, such as valuation effects, consolidation, and asset reclassification by external auditors.
3/ Sberbank represents 24 percent of system assets.
4/ Excluding Vneshtorgbank which has a capital/asset ratio of 40 percent. These banks represent 25 percent of system assets.
5/ These banks represent 4 percent of system assets, or 8 percent of system assets excluding the top 16 banks.

1/ The stress simulations are described in more detail in "Selected Issues in Banking Sector Reform" in the accompanying *Selected Issues* paper. The extreme shock scenario approximates the 1998 event. The medium shock scenario is more representative of a normal cyclical downturn. The capital shortfall calculations assume that banks would need fresh equity sufficient to achieve a 10 percent leverage ratio.

32. **The authorities agreed that a combination of a depreciation of the exchange rate, a modest run-down of reserves, and a tightening of the structural fiscal position was the appropriate policy response under the illustrative alternative scenario.** The alternative scenario assumes that the deeper global decline in 2002 will return to the baseline scenario by end-2003. A depreciation of the exchange rate would be a key component of the policy package in order to support output growth, limit the reserve loss, and boost revenues. Nonetheless, reserves are envisaged to decline in both 2002 and 2003, with the cumulative reserve loss totaling $8 billion. Fiscal policy is assumed to adjust to raise the underlying primary balance by ½ percent of GDP while letting the actual deficit widen slightly—in light of the revenue gains from the depreciation, additional measures of ¼ percent of GDP beyond the contingencies already incorporated in the 2002 budget would likely need to be implemented to achieve this target.

Key Macroeconomic Indicators, 2002-03

	Baseline		Alternative	
	2002	2003	2002	2003
Real GDP growth (in percent)	3.6	4.4	2.0	3.8
Inflation rate (e.o.p., in percent)	13.0	9.0	17.0	12.0
Current account ($ bn)	16.8	17.2	14.6	18.1
(percent of GDP)	5.2	5.0	4.9	5.8
Gross reserves ($ bn)	36.5	37.4	30.5	28.8
(months of imports)	5.0	4.8	4.4	3.8
(ratio to short-term debt)	229	335	191	258
Federal government				
Overall balance (percent of GDP)	-0.1	0.2	-0.4	0.0
Primary balance (percent of GDP)	2.6	2.6	2.5	2.8
(constant oil price)	3.3	3.2	3.9	3.8
Memorandum items:				
Russian oil price ($/barrel, c.i.f.)	16.4	17.0	13.5	16.0
Terms of trade (in percent)	-10.3	1.0	-16.4	6.1
World real GDP growth (in percent)	2.4	4.4	1.5	3.4

Source: Fund staff projections.

33. **While the projected reserve loss is sizable, the staff argued that the resulting reserve coverage would still be adequate and that attempts to target a smaller reserve loss through a larger fiscal adjustment would endanger output.** The reserve loss in 2002—ahead of the debt service spike in 2003—is clearly a concern, but reserves would not dip significantly in terms of accepted measures of reserve adequacy. Greater fiscal adjustment could help protect reserves but it would further weaken domestic demand and therefore run the risk of delaying the output recovery. The balance of risks would need, however, to be kept under constant review and the authorities would need to act resolutely if there were signs of an imminent loss of confidence in the ruble or if the output recovery did not materialize.

34. **While broadly agreeing with the proposed policy package, the authorities highlighted key uncertainties in the staff's projections.** In particular, they felt that the response of energy exports to the price decline could be larger as high cost oil fields became unprofitable. In addition, the reaction of private sector capital—the staff had assumed that private sector outflows would increase due to the perceived increase in risk on Russian assets and the deteriorating fundamentals—was difficult to gauge. Noting that the policy response would ultimately depend on the precise nature of the shock, the authorities commented that it would be difficult to undertake additional fiscal adjustment in 2002 beyond that already embedded in the budget and that further fiscal adjustment, if needed, may be postponed to 2003. There was also a range of views of whether a larger depreciation of the exchange rate may be preferable as a means of moderating reserve loss.

C. Structural Reform

35. **The authorities are developing a broad and ambitious agenda for 2002.** The focus of reforms will be twofold. First, to complete major reforms started last year, notably pension and judicial reforms, secure passage of secondary legislation and issuance of government regulations to ensure the effective implementation of legislation enacted last year. Second, to introduce new legislative initiatives whose aim is to improve the investment climate and making legislation WTO-compliant. For 2002, the key legislative priorities—outside tax and financial sector reform—are:

- **Reform of the Customs Code** will unify and simplify the current legislative framework which is fragmented and complex. The new code is intended to be WTO-compliant.
- **Law on Bankruptcy** will strengthen the role of arbitration managers and introduce stricter criteria for initiating bankruptcy proceedings to eliminate the current scope for using this process for corporate take-over and asset-stripping.
- **Law on Standardization and Certification**, which would curtail the scope of obligatory standardization and certification requirements and transfer quality control issues to self-regulating organizations, is part of the broader business deregulation initiative, as well as an important element in bringing Russian legislation in line with WTO requirements.
- **Law on Electricity Sector,** which stipulates the future structure of electricity markets, as well as establishes the regulatory framework for the sector, and is a key element in implementing the agreed strategy to deregulate the sector.
- **Law on Turnover of Agricultural Land** would extend the scope of the land reform to cover trade in agricultural land as well.
- **Legislation on mandatory medical and social insurance.** As a step toward an insurance-based social security system, mandatory insurance is envisaged for the case of illness, employment-related injuries, professional diseases, and also unemployment.
- **Other** priority areas where the legislative agenda is less advanced include housing sector reform and foreign exchange liberalization.

Tax reform

36. **Supporting the development of small enterprises will be the centerpiece of tax reform efforts.** A priority in this regard will be the reform of small business taxation that simplifies the methodology for the assessment of the tax base and introduces a federal (instead of the current regional) ceiling for the imputed tax. In other areas, the authorities are also planning amendments to Part I of the Tax Code to regulate transfer pricing; new legislation on Production Sharing Agreements; a special tax regime for agriculture; and modifications to the Unified Social Tax (UST).

37. **A further reduction in the tax burden is under consideration over the medium term**. Specific proposals under discussion would involve a unification of the VAT rates and elimination of exemptions, involving a reduction of the existing top rate, and the harmonization of the corporate income tax rate (currently 24 percent) with the UST rate (currently 35 percent). The authorities indicated that concrete action in this area will be shaped by their assessment of the success with the new Unified Profit Tax.

Financial sector issues

38. **While the joint government-CBR concept paper provides a comprehensive framework for developing the banking system, important details still need to be spelled out.**[17] The staff emphasized the need to develop an ambitious action plan focusing on the future role of state banks which currently dominate the financial system; deposit insurance; and consolidation of the banking system. It noted that efforts must be made to run state banks on a commercial basis and to consolidate the banking system to allow for effective supervision of banks.

39. **As for deposit insurance, the authorities view its introduction as a key measure to put private banks on par with state banks**—state banks currently have an explicit full, zero cost, guarantee on household deposits. The staff sees merit in the eventual introduction of limited deposit insurance, because it will support financial intermediation, consolidation, and efforts to run state banks commercially. However, staff noted that the design of such a scheme depends critically on the envisaged role of state banks. In terms of timing, a strengthening of (on-site and off-site) supervision, (IAS) reporting, and better risk management needs to be implemented prior to the introduction of a deposit insurance scheme.

40. **New anti-money laundering legislation that addresses FATF concerns has been enacted and the authorities are now focusing on ensuring the implementation of the new regulations** (Box 5). The authorities were confident that the issues raised by FATF concerning the legislative base and institutional infrastructure had been addressed. While the law came into effect on February 1, 2002, the authorities observed that full implementation would be a challenge as a number of technical issues needed to be resolved, including in reporting agencies. In early January 2002, new legislation was approved to facilitate increased cooperation between intelligence services and to strengthen surveillance over banks by law enforcement agencies as part of the response to prevent funding for terrorist groups.

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[17] The objective of the concept paper is to lay out a strategy to increase competition, increase intermediation and strengthen the stability of the financial system. Key aspects include measures to level the playing field between banks by eliminating distortions between state and private banks and between domestic and foreign banks, steps to further strengthen banking supervision, a move towards International Accounting Standards, and measures to strengthen risk management and internal audit practices at commercial banks.

Box 5. The Russian Federation's Anti-Money Laundering Efforts

In June 2000, the Financial Action Task Force on Money Laundering (FATF) included Russia on its initial list of 15 countries deemed to be non-cooperative in the fight against money laundering. At that time, it was determined that Russia met 10 of the FATF's 25 Criteria for Defining Non-Cooperative Countries or Territories, with the most important defects comprising the **lack of an anti-money laundering law and the related absence of institutions and procedures.** More specific concerns raised by FATF in its June 2000 report included the need for: comprehensive customer identification requirements; an efficient mandatory reporting system for suspicious transactions; a fully operational financial intelligence unit (FIU) to coordinate anti-money laundering efforts; and international cooperation in money laundering prosecutions.

Comprehensive anti-money laundering legislation, prepared in close consultation with leading FATF members, was enacted in August 2001. At the same time, amendments to the Criminal Code, the Law on Banks and Banking, and the Securities Law were approved in order to bring them into compliance with the new anti-money laundering legislation and to address the more specific weaknesses identified by the FATF.

The framework for international cooperation in money laundering prosecutions was strengthened through the ratification (on May 28, 2001) of the Council of Europe's Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime.

The **progress in strengthening the legislative base was acknowledged by the FATF** in its September review of non-cooperative countries and territories, when it withdrew its call for member countries to impose counter-measures against Russia. **It did, however, retain Russia on the list of non-cooperating countries pending full implementation of the legislation**, which came into effect February 1, 2002.

Implementation of these initiatives has begun, with a view to making the anti-money laundering legislation effective from February 1, 2002. In particular, an FIU—the Committee of the Russian Federation on Financial Monitoring—was established in November 2001 to coordinate the anti-money laundering effort. The CBR has issued regulations to establish procedures for banks to supply information to the FIU, to document and store such information, and to establish internal control procedures with similar regulations for non-banks under preparation by the government. The joint CBR-government strategy for the banking sector approved in December includes commitments to amend legislation to facilitate the exchange of information with other countries' financial supervisors, to improve banks' accounting and reporting to the central bank, and to encourage improvements in banks' internal controls and corporate governance.

41. **The authorities have volunteered to participate in the FSAP**. In light of the wide range of issues currently under discussion, the staff and the authorities agreed that the scope of the FSAP would be fairly broad and would be designed to assist the authorities in refining their strategy for the development of the financial sector. In particular, in addition to the usual assessments relative to standards and codes to identify areas of weakness in the existing financial system, the FSAP would examine issues related to the timing and modalities of the introduction of deposit insurance, the appropriate sequencing of capital account liberalization, progress with combating money laundering, procedures for sovereign debt management, and other developmental issues.

Exchange and trade system

42. **The authorities took steps to liberalize the exchange system during 2001, but exchange restrictions subject to approval under Article VIII still remain. The authorities have adopted a cautious approach to further liberalization of the capital account.** Measures taken to improve the workings of the exchange system are detailed above (paragraph 16). Notwithstanding this improvement, six exchange restrictions were identified that are subject to approval under Article VIII (see Appendix I). The authorities are at an early stage of identifying a timetable for their removal. In other areas, the reduction in surrender requirements and relaxation of restrictions on capital outflows had, as expected, not had a noticeable impact on financial markets. The capital account is de facto relatively open, although controls exist over a broad range of transactions. In light of the global uncertainties and potential risks from premature liberalization with an underdeveloped domestic financial system, the staff supported the adoption of a cautious approach to further capital account liberalization.

43. **WTO accession is a high priority for the authorities.** Discussions on WTO accession intensified during 2001 supported by the revisions to the tariff schedule that became effective at the beginning of 2001—the revisions reduced the average tariff rate to 11.3 percent. However, the authorities noted that 20–30 percent of tariff lines remained to be agreed and that amendments to a significant number of legislative acts would need to be approved.

III. Medium-Term Scenario and External Vulnerability

44. **The strong macroeconomic outcomes recorded in recent years have substantially reduced Russia's external vulnerability** and, provided that the momentum of structural reform can be maintained, there are good prospects that the economy is entering a period of sustained growth (see Box 6). The main conclusions of the staff's medium-term projections are:

Key Macroeconomic Targets, 2002-15

	2002	2003	2004	2005	2006-15
Real GDP growth (in percent)	3.6	4.4	4.7	5.0	5.6
CPI inflation (e.o.p., in percent)	13.0	9.0	7.5	7.5	7.5
Federal government overall balance (in percent of GDP)	-0.1	0.2	-0.2	-0.1	-0.7
Federal government debt stock (in percent of GDP)	46	41	37	33	23
External current account ($ bn)	16.8	17.2	16.4	15.4	-1.4
Russian oil price ($barrel, c.i.f.)	16.4	17.0	17.0	17.0	17.4
Official reserves ($ bn)	36.5	37.4	43.0	49.8	87.4
(months of import cover)	5.0	4.8	5.0	5.3	5.5
(ratio to short term debt)	229	335	406	503	675

Source: Fund staff estimates.

- **Medium-term growth will be driven by investment and total factor productivity growth** resulting from the success of the government's structural reform agenda on strengthening the investment climate.
- **The external current account is expected to deteriorate over the medium term,** as Russian oil prices are projected to recover modestly, the real exchange rate appreciates,

Box 6. External Vulnerability

Russia's external vulnerability has been substantially reduced over the last few years. Reserves are at record levels, and the strong fiscal position has eliminated the need for new access to international capital markets. Reflecting the strong macroeconomic performance, credit rating agencies have progressively upgraded Russia's existing debt instruments and, reflecting pressures in other emerging markets, Russia's weight in the EMBI has increased to 17.6 percent at end-2001, the third largest weight in the index after Brazil and Mexico.

External Sector Vulnerability Indicators, 1998-2001

	1998	1999	2000	2001 1/
Exports (US$ bn,12 month growth)	-16	1	40	-3
Imports (US$ bn, 12 month growth)	-19	-32	14	19
Current account (US$ bn)	-1.6	22.7	45.3	33.8
(percent of GDP)	-0.5	12.4	18.0	11.0
Russian oil price ($/barrel, budget)	12.5	17.2	26.8	22.5
Gross official reserves (US$ bn)	10.9	12.5	28.0	36.5
(months of imports of GNFS)	2.5	2.4	4.6	5.5
(ratio to short-term debt)	...	112	188	298
(ratio to reserve money)	85	77	107	153
NFA of commercial banks (US$ bn)	0.9	5.5	8.1	10.1
Public sector external debt (US$ bn)	161	158	143	134
(in percent of GDP)	51	86	57	44
External debt service/exports of GNFS	27.6	20.3	14.3	19.9
Foreign currency debt rating (S&P)	CCC-	CCC	B-	B+
Spread of benchmark bond	3823	1419	1174	579
EMBI Russia index	5361	2432	1172	669
REER CPI based (12 month change)	-43.8	12.3	22.0	6.8
REER ULC based (12 month change)	-55.2	13.3	28.1	15.4

Source: Fund staff estimates and projections.
1/ Projected or latest available.

The external debt stock has fallen sharply since 1998. The stock of Russian era debt has fallen with the timely servicing of debt obligations (including a sovereign Eurobond), the pre-payment of certain obligations to the Fund, a modest amount of new financing from official creditors and no new borrowing from the market (due to a combination of lack of access and lack of need in light of the strong fiscal position). The stock of Soviet-era debts has also declined as a result of the debt restructuring agreement with London Club creditors which, together with the earlier Paris Club restructuring, also extended the maturity of the debt obligations thereby limiting near-term pressures.

Apart from the impact of energy prices, other near-term risks appear modest:

- Temporary loss of access to international capital markets would have little impact as the government's gross borrowing requirement—on both domestic and international markets—is small.
- Contagion via the banking system is unlikely. Foreign banks account for just 5 percent of banking sector assets, commercial banks have substantially improved their net foreign asset positions since the 1998 crisis, and the overall vulnerability of the banking system is low (as described in Box 4, above).
- The exchange rate has appreciated significantly in real terms since 1998, but the ULC-based REER remains well below its pre-crisis level. For 2002, the projected weakening in energy prices would also offset pressures for a further real appreciation.

- and imports expand to meet the growing investment needs. The capital account will strengthen through a combination of foreign direct investment, a reduction in private capital outflows, and renewed access to international capital markets. Official reserves would be maintained at a comfortable level while public external debt levels would decline to around 20 percent of GDP.

- **Russia is expected to be able to meet its obligations to the Fund in a timely manner.** The early repurchase of obligations under the CCFF have reduced Russia's scheduled debt service to the Fund, including in 2003. Scheduled debt service to the Fund, on existing obligations, peaks at $2.2 billion in 2003, less than 6 percent of gross official reserves.

Indicators of Debt Service to the Fund, 2002-06

	2002	2003	2004	2005	2006
Debt service ($bn)	1.7	2.2	1.7	1.2	1.1
Charges	0.3	0.3	0.2	0.1	0.1
Repurchases	1.4	1.9	1.5	1.1	1.0
In percent of:					
Exports of goods & services	1.6	2.0	1.4	1.0	0.8
Total debt service	8.2	9.3	9.0	6.6	6.0
Gross official reserves	4.6	5.8	3.9	2.5	1.9
Memorandum item:					
Outstanding debt to the Fund in percent of quota	81.7	57.4	38.6	24.3	11.3

Source: Fund staff estimates.

45. **Key risks for the medium term** include: a protracted period of weakness in international energy prices, which could also impinge on Russia's access to international capital markets; slippages in implementing structural reforms that would sustain the economy's dependence on a narrow range of commodities with historically volatile prices; and delays in financial sector reform, which is key to enhancing the intermediation between the energy and non-energy sectors of the economy, especially the small to medium-sized enterprises and between the household and enterprise sectors. In addition, the pension reforms introduced at end-2001 represent a significant risk to the fiscal position over the medium term.[18] The transition to the new system is likely to require the use of existing Pension Fund reserves and transfers from the federal budget in the order of ½ percent of GDP per year. It is, thus, likely that additional modifications to the pension system will need to be taken to ensure its financial viability over the long run.

IV. Staff Appraisal

46. **The Russian authorities can be justifiably proud of a track record of impressive macroeconomic performance as well as the recent surge in structural reforms.** The economy grew strongly for a third year in a row aided by earlier gains in competitiveness and the strength of energy exports. Growth in Russia was an important factor in sustaining recent growth in the CIS region. The large current account surpluses of recent years have led to a strong reserve position, enabling Russia to discharge its obligations under the CCFF in advance. A major fiscal consolidation has underpinned recovery and eased the burden on monetary policy. These developments have been critical in insulating Russia from pressures emanating from other emerging markets. As regards structural policies, key advances have been made in several major areas—tax, pension, land, labor, and judicial reform. Looking ahead, the staff believes that the large current account and fiscal surpluses of recent years have placed the Russian economy in a strong position to deal with a less favorable external environment.

47. **As regards exchange rate policy, while it is to be expected that the real value of the ruble will appreciate over the medium term in line with improvements in productivity, the staff supports the authorities' aim to limit the pace of the real appreciation of the ruble**, in light of the volatility of energy prices and their large impact on the economy. Such a policy would enhance growth prospects in the non-energy sector, the latter being essential for medium-term growth.

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[18] Legislation has been approved that establishes a multi-pillar pension system through the introduction of a mandatory fully funded pillar alongside a modified version of the existing pay-as-you-go (PAYG) system. The PAYG system has been modified to include a basic, inflation-indexed flat rate pension and an earnings-related component. The latter will be funded initially through diverting 2 percentage points of the total 28 percent contribution rate to a notional defined contribution scheme administered by the Pension Fund, with this amount rising by 1 percentage point per year to 6 percentage points in 2006. Persons above the age of 50 will not participate in the new pillar. The funded pillar will initially be managed by the Pension Fund, with investments restricted mainly to domestic government securities.

48. **The staff is of the view that monetary policy should target a lasting reduction in inflation.** In the past, against the backdrop of large balance of payments surpluses, the conduct of monetary policy has been complicated by concerns of not jeopardizing output recovery through a nominal appreciation of the exchange rate. In the absence of determined sterilization operations, the inflation target has not been met. Looking ahead, however, with the weakening of the external environment this conflict is likely to lessen. If on the other hand, the balance of payments is stronger than anticipated, the staff is of the view that the burden of containing inflation will rest on the CBR, although it should be aided by the government saving higher fiscal surpluses. In any event, the authorities should eschew temptations to postpone justified increases in administered prices to suppress inflation.

49. **The staff supports the envisaged easing of fiscal policy in 2002.** Staff analysis shows that the strong external and fiscal position of recent years provides room for the relaxation of the underlying fiscal position over the medium term without threatening fiscal or external sustainability. In view of the uncertain cost of a yet to be implemented large structural agenda, this room needs to be used wisely; nonetheless it is appropriate to use some of this leeway already in 2002 itself, given the weakening external environment. While supporting growth prospects and unwinding some of the expenditure compression that occurred in the aftermath of the crisis, such easing will not place undue sterilization demands on the CBR, nor crowd out the private sector. It is also consistent—with appropriate tightening of monetary policy—with the targeted reduction in inflation. Also, in the current environment of weak global demand, indications of a slowdown in the fourth quarter, and with prospects in neighboring countries importantly affected by developments in Russia, it is advisable to err on the side of not unduly contracting demand. The staff also welcomes the flexibility embedded in the budget so that fiscal policy can automatically respond to unanticipated declines in revenues, including from lower oil prices.

50. **Fiscal developments will need to be monitored carefully**. The downside budgetary risks stem from a sharper-than-expected slowdown in economic activity, weaker-than-projected energy prices, and difficulties in achieving expenditure reduction at subnational levels. The main risk from weakening economic activity lies in reduced tax compliance at all levels of the government, which would require heightened efforts on the tax collection front. In a similar vein, the authorities will need to guard against a reversal of the hard fought gains in containing and eliminating the non-payment/barter problem, and new measures will need to be instituted in the event of slippages on this front. As regards the subnational budgets, an economic slowdown would bring pressures on local governments beyond those emanating from the recent large increase in wages. The staff welcomes the authorities' intention to strengthen the federal Treasury and its monitoring of local government finances and that the planned extension of the federal Treasury to regions with weak financial positions will be completed soon.

51. **Uncertainties about developments in the external environment and over the underlying strength of the economy require that the overall policy stance be kept under constant review.** This is especially important since the impact of the global economic

environment on the domestic economy—in particular domestic demand and private capital outflows—makes growth prospects and balance of payments developments particularly vulnerable. While the appropriate policy response will depend on the size and the duration of the terms-of-trade shock, the strong reserve position provides considerable room to maneuver. A depreciation of the exchange rate, a modest loss of reserves, and some fiscal tightening would likely be required in case of a large and sustained external shock. The staff is of the view that—with the appropriate policy adaptations—Russia is well placed to deal with adverse external developments without the need for exceptional financing.

52. **The authorities recognize that the remaining structural agenda is large, and its speedy completion as well as Russia's integration into the world economy are prerequisites for sustainable growth**. The staff welcomes the recent marked acceleration of structural reforms with emphasis on improving the investment climate for the private sector and on the achievement of long-term sustainability of the public finances. Key to this effort are the enactment of tax reform, deregulation, strengthening property rights, and developing financial markets and institutions—areas where progress was made during the year. The authorities recognize that a broader set of reforms—beyond those necessary for macroeconomic stability alone—are essential to integrate Russia into the world economy. The main challenges include the initiation of reforms in electricity and railway sectors; the implementation of business deregulations, pension, labor, land, and housing and communal services reform; the adoption of customs and remaining judicial reforms; and, the formulation of reforms in the areas of banking, foreign exchange liberalization, gas sector restructuring, and intergovernmental relations. As for timing, while there continues to be widespread support for reforms, the staff urges the authorities to use the window of opportunity available over the next 12–18 months to implement legislation enacted during 2001 as well as to get new legislation through the Duma before the electoral cycle of 2003–04 gets fully under way.

53. **The reform agenda poses significant implementation challenges and its fiscal implications will need to be carefully managed**. Perhaps the main challenge—as well as the risk—is the consistent implementation of the reform agenda across Russia. Many of these reforms will have significant fiscal implications, and it will be necessary to ensure that they do not begin to unwind the success of recent years in achieving fiscal consolidation. In this connection, the staff would urge the authorities to be cautious about entering into commitments to further lower the tax burden until medium-term expenditure needs associated with the structural reforms have been fully costed.

54. **In the area of financial sector reform, while the government-CBR concept paper is an appropriate statement of broad policies, important details need to be worked out.** In particular, the main challenge ahead is to develop a clear strategy for the future role of state banks to stimulate competition within the banking system. This work is a prerequisite for developing proposals regarding deposit insurance, the latter being a key objective of the concept paper. The staff would caution against the premature introduction of deposit insurance pending a significant strengthening of regulatory and supervisory capacities.

55. **Transparency of CBR operations needs to be enhanced without threatening its independence**. As various versions of the CBR Law go through the legislative process, it will be important to ensure that the principal objective of the CBR must be to achieve low inflation, and the CBR must have autonomy in the conduct of monetary policy to achieve this objective.

56. **The staff welcomes the decision of the Russian authorities to volunteer for the FSAP**. Reform of the financial system remains a key area where limited progress has been made to date, and the authorities' decision to opt for a broad-based FSAP augurs well for laying the groundwork for comprehensive reform in this area. The FSAP's forward-looking approach will support the authorities' ongoing efforts to reform the banking system. The exercise could also contribute to refining proposals for deposit insurance and developing the program for further capital account liberalization.

57. **Russia's efforts to join the international community in fighting money laundering and the use of the international financial system to finance acts of terrorism are welcomed**. The enactment in August 2001 of the new money laundering legislation, which envisages the establishment of an agency to fight financial crimes, strengthens the legislative base and institutional infrastructure. The staff urges the authorities to proceed with the implementation of the measures now in place and ensure that the new agency functions effectively. The staff recommends to the authorities to continue in their efforts to fight money laundering and the use of the international financial system to finance acts of terrorism.

58. **The staff urges the authorities to proceed with the removal of exchange restrictions**. In the aftermath of the 1998 crisis, some of the restrictions (like non-convertibility of S accounts and repatriation restrictions on residents that did not participate in the GKO novation scheme) were akin to capital controls and provided some breathing room to the authorities while a coherent set of financial and structural policies were being put in place. The authorities have used this opportunity well: international reserves have risen to record levels and Russia's position in its asset class has improved considerably, making it easier for Russia to tap international markets. In light of these developments, the authorities are advised to put forward a time-bound plan for the removal of the restrictions.

59. **In sum, developments since the last Article IV consultations have been very positive and attest to the underlying strength of the Russian economy as well as the appropriateness of economic policies being implemented by the authorities**. The authorities and staff agree on the stance of macroeconomic policies for the period ahead, as well as on the bold pursuit of a broad-based structural reform agenda. These efforts are essential to ensure high medium-term growth as well as to reduce Russia's vulnerability to adverse external developments. The staff looks forward to Russia's close cooperation with the Fund in this new surveillance relationship.

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

Table. Russian Federation: Macroeconomic Framework, 1999-2015

	1999	2000	2001	2002	2003	2004	2005	Average 2006-15
					Projections			
			(In percent of GDP, unless otherwise indicated)					
I. Savings-Investment Balances								
General Government								
Consumption	14.7	13.6	12.8	13.4	12.5	12.1	12.0	12.1
Gross investment	8.7	8.0	7.3	7.6	7.0	6.7	6.5	6.1
Net income from abroad	-4.4	-2.9	-2.0	-2.1	-1.7	-1.5	-1.4	-1.0
National savings	5.5	11.5	10.4	7.0	6.6	6.5	6.4	5.4
National savings - investment	-3.2	3.6	3.1	-0.6	-0.4	-0.2	-0.1	-0.7
Private Sector								
Consumption	53.7	48.1	54.7	58.1	59.0	59.7	60.3	63.1
Gross investment	6.4	9.3	12.2	13.7	14.9	15.6	16.1	17.6
Net income from abroad	-0.4	-0.2	0.0	0.0	0.0	0.0	0.1	0.2
National savings	21.4	23.7	20.1	19.5	20.3	20.1	19.9	18.6
National savings - investment	15.0	14.4	7.9	5.8	5.4	4.5	3.8	0.9
Overall Economy								
Consumption	68.4	61.7	67.5	71.5	71.5	71.9	72.3	75.2
Gross investment	15.1	17.2	19.5	21.3	21.9	22.2	22.6	23.8
Net income from abroad	-4.7	-3.1	-2.0	-2.1	-1.7	-1.5	-1.4	-0.8
National savings	26.9	35.2	30.6	26.5	26.9	26.6	26.3	24.0
National savings - investment (current account)	11.8	18.0	11.0	5.2	5.0	4.4	3.7	0.2
			(In percent of GDP, unless otherwise indicated)					
II. Federal government accounts and debt indicators								
Revenues	12.8	16.4	17.1	15.3	15.0	15.1	15.0	13.9
Primary balance, commitments	1.8	5.9	5.5	2.6	2.6	2.1	2.0	0.8
Overall balance, commitments	-4.3	1.7	2.9	-0.1	0.2	-0.2	-0.1	-0.7
Foreign financing 1/	0.2	-0.9	-1.5	-1.0	-1.7	-0.1	0.0	0.2
Domestic financing 1/	1.1	-1.0	-1.2	1.1	1.5	0.3	0.1	0.5
Total federal govt debt	94.3	64.6	49.1	45.8	40.9	36.8	32.8	23.0
Domestic	12.3	7.9	5.3	5.8	5.5	5.0	4.1	3.4
External	82.0	56.7	43.7	40.0	35.3	31.8	28.7	19.5
External federal govt debt service / revenues (%) 2/	35.6	25.3	24.7	27.3	33.8	22.5	24.6	18.8
External federal govt debt service / expenditures (%) 2/	32.3	29.5	29.4	27.1	34.2	22.2	24.4	17.8
			(In billions of U.S. dollars, unless otherwise indicated)					
III. Balance of payments and external debt								
External current account	22.7	45.3	33.8	16.8	17.2	16.4	15.4	-1.4
Change in external terms of trade (%)	7.0	34.0	-3.4	-10.3	1.0	0.2	0.5	0.7
Change in Russian crude oil price (%)	40.5	66.7	-16.8	-24.8	2.7	0.0	0.0	2.1
Change in export volumes (%)	9.4	5.3	3.4	2.0	3.6	4.2	4.2	4.8
Change in non-energy export volumes (%)	14.6	12.6	4.0	2.6	6.2	7.1	6.7	6.8
Change in import volumes (%)	-15.6	19.6	21.5	9.0	7.9	7.6	8.0	8.7
Private net capital flows (including errors & omissions)	-21.9	-25.8	-18.7	-12.8	-10.2	-8.9	-7.6	7.9
o/w gross FDI inflows	3.3	2.7	3.3	6.1	8.6	11.3	14.5	36.3
Official reserves	12.5	28.0	36.5	36.5	37.4	43.0	49.8	87.4
in months of imports	2.4	4.6	5.5	5.0	4.8	5.0	5.3	5.5
External debt service / exports of goods and services (%)	20.3	14.3	19.9	19.7	21.2	15.9	15.2	12.7
Balance of payments: exceptional financing / financing gap 3/	6.3	4.9	0.0	0.0	0.0	0.0	0.0	0.0
			(In percent, unless otherwise indicated)					
IV. Growth and prices								
Real GDP growth	5.4	8.3	5.2	3.6	4.4	4.7	5.0	5.6
TFP Growth	2.0	6.7	2.3	2.0	2.5	2.8	3.1	3.5
CPI Inflation, end of period	36.6	20.1	18.6	13.0	9.0	7.5	7.5	7.5
Real effective exchange rate, period average, change	-29.3	12.2	20.1	3.9	0.6	2.0	2.0	2.0
Real effective exchange rate, end of period, change	12.3	22.0	12.8	-1.0	2.0	2.0	2.0	2.0

Source: Staff estimates and projections based on official data.

1/ Net Fund financing is included in domestic financing, as a component of MA credit; foreign financing therefore excludes the Fund.
2/ From 2001 onward, before any rescheduling. Excludes debt service in kind ($1.2 billion per annum until 2010).
Includes debt service to the Fund.
3/ For 2000 and before, refers to the (identified) exceptional financing. For subsequent years, refers to the (unidentified) financing gap.

Russian Federation: Fund Relations

As of December 31, 2001

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

II. **General Resources Account**:	SDR million	%Quota
Quota	5,945.40	100.0
Fund holdings of currency	11,859.20	199.5
Reserve Tranche position	1.14	0.0
Holdings Exchange Rate		

III. **SDR Department**:	SDR million	%Allocation
Holdings	2.29	N/A

IV. **Outstanding Purchases and Loans**:	SDR million	%Quota
Stand-By Arrangements	471.43	7.9
Extended Arrangements	4,634.71	78.0
Systemic Transformation	808.71	13.6

V. **Latest Financial Arrangements**:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
Stand-By	07/28/1999	12/27/2000	3,300.00	471.43
EFF	03/26/1996	03/26/1999	13,206.57	5,779.71
Of which SRF	07/20/1998	03/26/1999	3,992.47	675.02
Stand-By	04/11/1995	03/26/1996	4,313.10	4,313.10

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

	Overdue	Forthcoming				
	12/31/01	2002	2003	2004	2005	2006
Principal		1,057.7	1,445.9	1,117.4	850.8	772.9
Charges/Interest		153.7	118.1	81.5	54.7	31.5
Total		1,211.4	1,564.0	1,198.9	905.5	804.4

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

The Russian Federation accepted the obligations of Article VIII, sections 2, 3, and 4 of the IMF Articles of Agreement with effect from June 1, 1996. The Russian authorities, however, presently impose a number of exchange measures that are subject to approval under Article VIII. Many of these were imposed in August 1998 in order to stem capital flight and stabilize the exchange rate. Russia's restrictions under Article VIII are as follows:

- **Suspension of conversion operations through nonresidents' S-accounts** (exchange restriction and multiple currency practice). These are special accounts used for GKO/OFZ-related transactions. Before balances arising from such transactions can be repatriated, funds have to be either transferred to a noninterest bearing transit account or invested in special short-term GKOs that are convertible at maturity. As a result, the repatriation of interest earnings and other current proceeds from GKO/OFZ investments would be made with possibly a long delay and at unfavorable terms. Fund approval granted on September 15, 2000, and temporary extensions on September 21, 2001, and January 25, 2002.
- **Repatriation restrictions on ruble balances of nonresidents not participating in the GKO/OFZ novation** (exchange restriction and multiple currency practice). The rules governing the repatriation of ruble balances are similar to those described above with respect to the S-accounts. They apply to ruble balances arising from GKO/OFZ investments which matured before December 31, 1998. Fund approval granted on September 15, 2000, and temporary extensions on September 21, 2001, and January 25, 2002.
- **Restrictions on advance import payments** (exchange restriction). The authorities do not freely permit the making of all advance payments that are required under valid import contracts. Fund approval not granted.
- **Restrictions on certain advance payments to Latvian residents** (exchange restriction). Fund approval not granted.
- **Restrictions on nonresidents' N-accounts** (exchange restriction). These are nonresident bank accounts used for trade and some bond-related transactions. Existing restrictions limit the ability of nonresidents to effect moderate amounts of amortization from the proceeds of bond transactions.
- **Use of a more depreciated exchange rate for repatriation of S-account balances** (exchange restriction and multiple currency practices). Non-residents who participated in the GKO/OFZ novation are allowed to repatriate part of the proceeds by purchasing foreign currency in special auctions arranged by the CBR.

VIII. **Article IV Consultation:** Russia is on the standard 12-month consultation cycle. The last consultation was concluded on September 15, 2000.

IX. FSAP Participation and ROSCs

Russia has volunteered to participate in the Financial Sector Assessment Program during 2002.

The following ROSC modules—issued to the Executive Board in 2000—are currently being updated:
-- Data Dissemination, September 13, 2000, SM/00/209.
-- Fiscal Transparency, September 13, 2000, SM/00/209.
-- Transparency in Monetary and Financial Policies, September 13, 2000, SM/00/209.

X. Resident Representatives

Mr. Poul Thomsen, Senior Resident Representative, since January 20, 2001.
Mr. Geoffrey Barnard, Resident Representative since July 17, 1999.
Mr. Goohoon Kwon, Resident Representative, since September 14, 2001.
Mr. Timo Välilä, Resident Representative since October 2, 2000.

RUSSIAN FEDERATION: RELATIONS WITH THE WORLD BANK GROUP

IBRD

1. As of January 1, 2002, IBRD commitments (net of cancellations) were $9.44 billion in 50 operations, 26 of which were active projects, including two GEF Grants and Special Initiative, and two Guarantees. Of this, just over $8 billion has been disbursed, including $5.1 billion in the form of fast disbursing adjustment loan proceeds.

2. The Bank is currently developing its new Country Assistance Strategy which is expected to be discussed by the Bank's Board in April 2002. The most recent CAS was discussed by the Bank's Board in December 1999 with a follow-up CAS Progress Report discussed in February 2001. Overall, the strategy envisages continued emphasis on Bank support to deepen structural reforms. In particular, the current CAS emphasizes the need to (i) to improve the business environment in order to encourage new firm growth (including financial sector reform, improvements in the licensing and regulatory environment and continued efforts at lowering the incentives for corruption), (ii) to strengthen public sector management (including civil service reform, intergovernmental finance reform and support of judicial reforms), and (iii) to safeguard against the social and environmental risks of transition (including improving health care systems and education, and developing appropriate instruments to mitigate environmental hazards). The Bank is also working with the government on monitoring the implementation of the structural reform program, in particular those designed to improve the business and investment climate.

3. The new CAS also emphasizes the need to re-engage in in-depth analytical work. To this end, the Bank is starting a CEM designed to pull together economic sector work from sectors in which the Bank is actively engaged, including analytical work on the financial sector, Russia's industrial structure, SME growth, macroeconomic vulnerability, agriculture, public investments, budgetary management, education reform and the economic costs of contagious diseases (TB and HIV).

IFC

4. As of December 2001, IFC's total portfolio held on its own account was $247.9 million, of which $199.3 million was disbursed and $48.6 million was pending disbursement. Of the disbursed portfolio, $119.2 million was in loans (net of cancellations and repayments) and $80.1 million was in equity and quasi-equity.

5. In FY01, the IFC approved nine projects in Russia in banking services, automotive, retail, glass manufacturing, health services, air transport, breweries, and mining. Currently, more than 20 projects are under preparation, focusing particularly on financial services, manufacturing, communications technology, and agribusiness.

These projects would require about $423.5 million in financing, $368.5 million for IFC's own account and $55 million in financing by participants (total project cost is estimated at $1.4 billion).

6. The IFC is expanding its activities in the financial sector, working with small private banks and introducing new financial products. Most of these are with Russian sponsors. The IFC is seeking to strengthen small and regional banks, which can then act as leaders in the sector, and introducing new products to Russia, including financial leasing, mortgage finance, and subordinated debt.

7. The IFC's ongoing technical assistance activities in Russia include an agribusiness project, a forest sector project (working in coordination with the IBRD's forestry loan), and a leasing sector development program. In addition, the IFC launched a technical assistance program in corporate governance in March 2001. The IFC is planning several new technical assistance projects in Russia, including supply chain projects in mining (linked to the IFC's gold mine investment in Magadan), automotive parts (linked to the IFC's investment in Ford's assembly plant), and furniture manufacturing (linked to the IFC's investment in IKEA). These initiatives will be closely linked to the ongoing corporate governance program. In addition, the IFC is planning a technical assistance project for medium-size banks, to provide targeted pre- and post-investment support.

MIGA

8. Russia has MIGA's fourth largest exposure, accounting for approximately 5 percent of MIGA's total gross exposure. MIGA's outstanding portfolio in Russia consists of ten contracts of guarantee, with a total gross exposure of $263.5 million and net exposure of $144.2 million. The total amount of foreign direct investment facilitated by MIGA in Russia is $1.2billion. Investors have expressed interest in MIGA's coverage for a total investment potential of $760million in the agribusiness, financial, mining, oil and gas, services and telecommunications sectors. MIGA has not received any claims in Russia. MIGA obtained a waiver from the Russian government with respect to the moratorium of the Central Bank on capital transactions (August 15–November 15, 1998). During the period of the moratorium, transfers of funds by clients with MIGA coverage were executed without delay.

9. MIGA is in the final stages of implementing the Privatization Link Russia project—an initiative to develop on online investment information service for domestic and foreign investors interested in Russian privatization opportunities. In this effort, MIGA has partnered with the Canadian International Development Agency, which has provided $483,000 for the requisite field work, software development and project promotion.

Russian Federation: Statistical Issues

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

2. An IMF Resident Statistical Advisor that assisted the Russian authorities in improving macroeconomic statistics finished his assignment in June 2001. An EU/Tacis advisor assists the national statistical agency, the Statistical Committee of the Russian Federation (Goskomstat or GKS).

3. A draft ROSC module on data dissemination practices has been prepared and will be revised to take in account the final round of comments recently received from the authorities. Further, the authorities' agreement is being sought for its eventual publication.

National Accounts

4. Goskomstat compiles and publishes discrete quarterly and annual national accounts data on a regular, timely basis, based on the *1993 System of National Accounts*. Source data are obtained from surveys of businesses and households, supplemented by reports from other agencies. There has been much effort to improve coverage, but the basic data are widely considered to substantially understate economic activity. The official estimates of gross domestic product (GDP) incorporate approximate adjustments for gaps in coverage and for under-recording—based in part on surveys of informal markets and comparisons of different statistics—amounting to around 20 percent of GDP. There is no hard evidence at hand to conclude that, on balance, there is a systematic bias in the official GDP estimates. The production-based estimates of GDP are considered more reliable than those derived from the expenditure and income approaches, but the differences between the production and expenditure approaches are generally no more than 5 percent. More effort would be desirable to expand data coverage, improve presentation of the data (with an eye to highlighting data revisions, and facilitating time series analysis), and ease access to the data. Full financial accounts by institutional sector are also needed. The delay in finalizing a modern statistics law—requiring firms to provide data and with realistic penalties for noncompliance, together with a guarantee of confidentiality—is an impediment to the further improvement of the national accounts data.

5. The quarterly volume measures, however, follow a non-standard approach. They are compiled and presented at the prices of the same quarter of the previous year and, typically, with a year-on-year growth rate, rendering time series analysis impossible. Moreover, long time series with quarterly estimates are not published and revisions to the data are not flagged in their publications, nor in the data posted on their web site. As a result it is difficult for users, including the Fund, to maintain any form of consistent time series.

Prices

6. Goskomstat compiles a good quality national consumer price index (CPI), developed with Fund technical assistance. With the substantial reduction in inflation since 1996, the full index is now only calculated on a monthly basis, with weekly estimates based on a limited number of items. Further improvements could be made on the basis of a new household budget survey, which has been under consideration for some time, from current efforts to improve the treatment of seasonal items in the index and to standardize specifications of items. World Bank and Tacis assistance is available in these areas. Goskomstat also publishes a producer price index. The State Customs Committee has initiated the development of foreign trade indexes.

7. However, the CPI, as well as the producer price index, data are not published in a time series format, rendering time series analysis difficult. The main focus is on a set of derived measures of change, presented for each month as a percentage of a previous month (the previous month and the same month in the previous year). The presentation differs substantially from practice in the rest of the world of presenting index levels and derived percentage changes. Data on the components of the CPI are not published.

Government Finance Statistics Data

8. 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 are compiled on an annual basis but are not published. 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. The statistical capabilities of the Ministry of Finance are being strengthened to meet these deficiencies. A government finance statistics (GFS) unit has been formed in the Federal Treasury and with technical assistance from STA has developed a two-year work program for statistical improvement. The Treasury has been reporting aggregate government finance data for publication in *IFS* since April 1996. The latest detailed data published in the Government Finance Statistics Yearbook are for 2000.

Monetary Statistics

9. Monetary data are reasonably comprehensive and generally in accordance with international standards. The new plans of accounts that were introduced in the beginning of 1998 for the central bank and commercial banks are fairly adequate for the compilation of analytically sound monetary statistics directly from accounting records. However, consolidated accounts for the central bank and its subsidiaries, both domestic and foreign, are not produced which would provide a more comprehensive view of the stance of monetary policy. The September 2000 money and banking statistics mission made recommendations on several important methodological issues that have not been properly addressed in the compilation of monetary data, such as the appropriate treatment of: (i) repurchase agreement operations with nonresidents; (ii) accounts of insolvent banks with revoked licenses; and (iii) foreign-owned banks operating in the Russian Federation and branches of Russian commercial banks that are officially licensed abroad and carry out regular banking activities. With a few exceptions (e.g., the treatment of repurchase agreement operations), all recommendations have been implemented. 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.

Balance of Payments Statistics

10. The balance of payments is compiled on a *Balance of Payments Manual (Fifth Edition)* basis. In cooperation with the Fund, significant progress has been made with regard to balance of payments statistics. More detailed data have been published, new data sources have been developed, and the Central Bank of Russia (CBR) has published an international investment position for the banking sector. Though significant improvements have been made to enhance the quality of balance of payments statistics, there is further scope to improve the coverage of certain components of the current and the capital and financial account.

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

12. Goskomstat needs to improve the coverage and quality of surveys on direct investment, and trade in services including travel.

13. Data on international reserves are not reported on the template on international reserves and foreign currency liquidity.

14. Efforts will need to be made to improve the measurement of nonbank corporate sector debt (including off-balance sheet obligations), private debt service and short-term capital flows.

Special Data Dissemination Standard

The authorities have indicated that they would like to subscribe to the Fund's Special Data Dissemination Standard.

Table. Russian Federation: Core Statistical Indicators
(as of January 28, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve / Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	GDP/ GNP	External Debt / Debt Service
Date of Latest Observation	1/28/02	1/20/02	1/20/02	1/20/01	11/30/01	1/28/02	12/01	11/01	9/01	9/30/01	Q3/01	9/01
Date Received	1/28/02	1/24/02	1/24/02	1/24/02	1/15/02	1/28/02	1/6/02	1/2/02	12/01	12/15/01	11/20/01	12/01
Frequency of Data	D	W	W	W	M	D	W	M	Q	M	Q	Biannual
Frequency of Reporting	D	W	W	W	M	D	W	M	Q	M	Q	Biannual
Source of Data	MAR	F, C	C	C	C	MAR	GKS	C	C	F	GKS	C
Mode of Reporting	E	E	E	E	E	E	E	E	E	V	E	F
Confidentiality	U	Gross-U Net-C	C	U	U	U	U	U	U	U	U	C
Frequency of Publication	D	W	N/A	W	M	D	W	Q	M	M	Q	N/A

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

Statement by the IMF Staff Representative
March 8, 2002

This statement updates recent economic developments described in the staff report for the Article IV Consultation and Post-Program Monitoring Discussions (EBS/02/26). These developments do not alter any conclusions and recommendations contained in the staff report.

Output (real GDP) growth for 2000 has been revised upward from 8.3 percent to 9.0 percent reflecting a revision of the weighting procedure. As for 2001, a preliminary figure of 5.0 percent has been announced relative to a projection of 5.2 percent in the staff report.

With regard to the fiscal accounts, the overall and primary cash surpluses of the federal government for 2001 are estimated at 2¾ and 5½ percent of GDP respectively. While the aggregate figures are similar to those in the staff report, the details differ. In particular, the domestic borrowing requirements of the federal government were higher than previously anticipated. Revenues in December were better by almost ½ percent of (annual) GDP—this was mainly due to arrears repayments to the federal budget by the energy companies including in particular RAO UES. In December, the Government's payments of external obligations were ½ percent of (annual) GDP higher than envisaged. At the same time, a spending surge in late December equivalent to ½ percent of (annual) GDP raised monthly non-interest expenditures beyond the levels projected in the staff report. The December fiscal overrun was reversed in January when the federal government ran an estimated cash surplus equivalent to about ½ percent of (annual) GDP as revenues were higher than expected largely due to one-off factors and expenditures were significantly below the monthly budget limit.

Base money increased sharply in December owing to the above-mentioned surge in fiscal spending during the last week of the month. Annual base money growth in 2001 was 7 percentage points higher than the projection in the staff report. The end-year increase in liquidity was largely reversed in January with the budget cash surplus enabling the federal government to build up deposits at the CBR. These developments—which are similar to past patterns—again point to the need for improved budgetary execution and better coordination between the monetary and fiscal authorities so that large surges in liquidity can be avoided.

Monthly inflation reached slightly more than 3 percent in January (nearly 2 percent seasonally adjusted) partly in reflection of the above developments as well as the impact of administered price increases (about ½ percentage point). However, data for February suggests that monthly inflation (seasonally and non-seasonally adjusted) has slowed sharply to about 1¼ percent, bringing cumulative inflation for January–February to 4¼ percent in 2002.

The exchange rate has continued to depreciate since end-2001, with the CBR making modest net purchases that have kept gross reserves largely unchanged despite a clustering of debt service payments. Eurobond spreads have continued to decline—at end-February, the spread on the benchmark bond was down 136 basis points this year to 432 basis points.

Utility tariff increases for the year have been set slightly lower than expected. There is an ongoing review of natural monopolies' investment programs, which reflects increasing support for the view that tariff increases should be tied to reforms of these natural monopolies. A second round of increases at mid-year is still possible.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/40
FOR IMMEDIATE RELEASE
April 4, 2002

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

IMF Concludes 2001 Article IV Consultation with the Russian Federation

On March 8, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Russian Federation.[1]

Background

Despite a weaker external environment, macroeconomic performance was very strong in 2001. Output grew steadily, the federal budget registered a large surplus and the current account surplus, while narrowing significantly, remained large. The strong balance of payments led to a large accumulation of reserves. The net external inflows were partially sterilized which prevented a nominal appreciation of the ruble but led to a rapid growth in monetary aggregates. As a result, inflation exceeded the authorities' target of 14 percent. Structural reforms accelerated with significant progress in a broad range of areas. As a result of the strong macroeconomic performance, improved investment climate, and political stability, Russia's stock market index increased dramatically and spreads on sovereign Eurobonds narrowed sharply as ratings agencies provided a series of upgrades. Russia's first sovereign Eurobond was paid on schedule and negotiations with holders of some Soviet-era claims advanced with restructuring agreements reached with a number of creditors. Non-sovereign borrowers regained access to international capital markets.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the March 8, 2002 Executive Board discussion based on the staff report.

Output grew by 5.2 percent, driven by domestic demand as the contribution from net exports and government consumption was negative. Growing real wages and buoyant consumer confidence fostered growth in real private consumption. Investment growth, however, slowed as rising real wages and the real appreciation of the ruble reduced enterprise profitability. Hardening budget constraints produced a decline in barter, and the unemployment rate fell below 8½ percent.

Fiscal policy strengthened further with an overall surplus of about 2½ percent of GDP. Budget revenues increased due to improved tax compliance, strong energy exports, and high VAT collection from robust consumption demand. Expenditure continued to be restrained, with a modest increase in federal noninterest expenditures due to increased transfers to the regions and greater social spending. Balances of the enlarged government, however, deteriorated due to smaller surpluses of extrabudgetary funds as pensions/social benefits were increased to partly offset the real decrease in these payments since the crisis.

The current account surplus narrowed sharply to 11 percent of GDP as the continued real exchange rate appreciation and robust consumption demand led to higher imports. The decline in energy exports was modest as rising export volumes partly offset falling energy prices. Non-oil exports stagnated due to depressed commodity prices and slowing world demand. Net private capital outflows, though still large, slowed, possibly due to an improved investment climate and lower returns in mature and other emerging markets. As a result, there was a healthy accumulation of international reserves which reached US$36.5 billion (5½ months of imports) at year-end.

For much of the year monetary policy attempted to deal with the strong balance of payments without endangering growth prospects, against the backdrop of an uncertain increase in money demand. In this setting, the Central Bank of Russia (CBR) attempted to moderate the pace of the appreciation of the real exchange rate by partially sterilizing external inflows. This process was aided by the strong fiscal performance as well as the sterilization operations conducted by the CBR. Inflation during the year amounted to 18.6 percent, exceeding the authorities' target of 14 percent, due to the above factors as well as increases in administered prices.

Structural reforms focused on strengthening the investment climate through a combination of tax reform, deregulation, enhancing property rights, and developing financial markets and institutions. Tax reforms simplified the tax system, reduced the tax burden, and broadened the tax base. New laws were introduced on business registration, licensing, and inspections; a new Land Code established the general principle of land ownership for urban land; and a new Labor Code liberalized the hiring and firing of workers and clarified employees' rights. Reform strategies for the railways and the electricity sector were approved, aiming to restructure, liberalize, and privatize potentially competitive segments of these markets. A number of measures were introduced to liberalize both current and capital account transactions. Progress was also made with financial sector reform: amendments to banking legislation were approved strengthening the legal framework for banking supervision and restructuring, a pilot scheme was initiated for introduction of International Accounting Standards (IAS) and anti-money laundering legislation was adopted. The CBR and the government also approved a concept paper for the development of the banking system, but concrete proposals are yet to be developed in this area.

Executive Board Assessment

Executive Directors commended the authorities for Russia's impressive macroeconomic performance in 2001, which followed earlier gains in competitiveness and strong energy exports that had boosted growth in the three years since the 1998 crisis. Directors also welcomed the authorities' strong record of fiscal consolidation. The large fiscal and external surpluses have led to a significant buildup in reserves and have positioned the Russian economy to weather the more recent pressures generated by a less favorable external environment. Encouraging progress has also been made in advancing structural reforms in several key areas including tax, pension, land, labor, and judicial reform.

Directors supported the thrust of the policy stance for 2002, and agreed that the authorities' main priorities for the period ahead should be to continue prudent macroeconomic policies while making a determined effort to ensure the timely implementation of key structural reforms. Looking ahead, they also considered that continued vigilance and readiness to adjust the overall policy stance as needed, together with the cushion provided by the strong external reserve position, should allow the authorities to cope with possible adverse developments.

Directors noted that the recent strength in Russia's fiscal and external positions has created room for a prudent relaxation of the underlying fiscal stance over the medium term without jeopardizing fiscal or external sustainability. The proposed relaxation of fiscal policy in 2002 should serve to support growth in the face of an external environment that is likely to be weaker than in recent years. The envisaged fiscal easing will allow a partial unwinding of the expenditure compression that occurred in the aftermath of the crisis and, in the context of the expected weakening of the external position, this easing should not place undue sterilization demands on the CBR that could crowd out the private sector. Directors welcomed the various provisions included in the budget that would ensure that it remains financed, including through automatic expenditure adjustments, in the event of unanticipated declines in oil revenues.

Directors noted that fiscal developments remain subject to risks emanating from lower than anticipated growth, lower energy prices, and difficulties in achieving expenditure reduction at subnational levels, which will require careful monitoring. In particular, if economic activity turns out weaker than anticipated, it will be important to take timely action against any weakening of tax compliance or resurgence of nonpayment/barter practices. Directors cautioned that the room for fiscal relaxation should be used prudently, as many of the remaining structural reforms will have significant fiscal implications. A number of Directors also stressed the need for wage moderation in the public sector. Noting the importance of sound local government finances for achieving the budgetary objectives, Directors welcomed the authorities' intention to strengthen the federal Treasury's monitoring of local government finances, and they looked forward to the completion of the extension of the federal Treasury to regions with weak financial positions. They also supported the authorities' intention to introduce a three-year fiscal plan.

Directors were of the view that monetary policy should target a lasting reduction in inflation. They noted that the conduct of monetary policy is now less likely to be complicated by the large current account surpluses and the upward pressures on the ruble that could have jeopardized output recovery in previous years. Directors urged the CBR to hold firm on containing inflation, including through sterilization if the balance of payments were to turn out stronger than anticipated. In the latter case, the government should support monetary policy by saving higher fiscal surpluses, as it has done in the past. Directors also cautioned against delaying justified increases in administered prices to suppress inflation.

Directors considered that, over time, the real value of the ruble should be expected to appreciate in line with productivity gains. In light of the significant impact of volatile energy prices, most Directors recognized that the authorities' policy of limiting the pace of real appreciation of the ruble remains appropriate, given the need to protect growth prospects in the nonenergy tradable sector, which is vital for fostering medium-term growth.

Directors welcomed the recent impetus to structural reforms, but noted that the remaining agenda is vast, and sustained implementation of reforms remains a key challenge. They endorsed the authorities' focus on reforms directed at enhancing long-term growth prospects and economic diversification through improvements in the investment climate that would help to attract greater foreign direct investment and encourage the development of small- and medium-sized enterprises. Directors singled out financial sector reform and strengthening property rights through judicial and land reform as being particularly important. More broadly, the authorities should continue to make progress on improving public sector administration and corporate governance, including through reporting according to International Accounting Standards. They also noted that reform of the natural monopolies, in particular of the energy and railway sectors, and of housing and communal services, will be essential components of a successful restructuring of the economy. Directors were encouraged by the priority that the Russian authorities attach to joining the World Trade Organization.

Directors welcomed the government-CBR concept paper on financial sector reform, and encouraged the articulation of this statement of broad policies into a clear, operational strategy to be implemented consistently. They highlighted, in particular, the importance of broad-based measures to stimulate competition within the banking system, including the development of a clear strategy for the future of the state banks. Directors cautioned against the premature introduction of deposit insurance in the absence of a significant strengthening of regulatory and supervisory capacities. They welcomed the authorities' decision to participate in a broad-based Financial Sector Assessment Program, whose forward-looking approach should lay the groundwork for future reforms in the financial sector.

Directors stressed that initiatives to amend the Central Bank Law should not undermine the CBR's independence in conducting monetary policy nor burden the CBR with potentially conflicting objectives. Any amendment should ensure that the task of achieving low inflation remains the primary objective of the CBR, and that the CBR has sufficient autonomy in the conduct of monetary policy to achieve this objective. Several Directors urged the CBR to enhance the transparency of its operations and to divest its holdings in commercial banks. A few Directors suggested that, over time and when the necessary institutional framework is in place, the adoption of an inflation-targeting framework could greatly enhance the transparency and effectiveness of monetary policy.

Directors welcomed Russia's efforts to fight money laundering and combat the financing of terrorism. With new money laundering legislation—which strengthens the legislative base and institutional infrastructure—now in place, Directors urged the authorities to ensure the full implementation of the newly enacted measures, and to take the steps needed to freeze terrorist assets.

Directors welcomed the steps taken by Russia to liberalize exchange restrictions in 2001, and encouraged the authorities to develop a time-bound plan for the removal of the remaining exchange restrictions. They commended the authorities' progress in regularizing relations with external creditors and looked forward to continuing good performance in this area.

Directors also encouraged the authorities to take additional steps to strengthen data collection and transparency, particularly with regard to the national accounts.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with the Russian Federation is also available.

Russian Federation: Macroeconomic Indicators, 1999–2002

	1999	2000	2001 Est.	2002 Proj.
	(Annual percentage changes)			
Production and prices				
Real GDP	5.4	8.3	5.2	3.6
Consumer prices				
Annual average	85.7	20.8	21.6	14.1
End of period	36.6	20.1	18.6	13.0
GDP deflator (annual average)	64.7	37.1	21.6	10.2
	(In percent of GDP)			
Public sector				
Enlarged government balance	-3.2	3.6	3.1	-0.6
Federal government				
Overall balance (commitment basis)	-4.3	1.7	2.9	-0.1
Primary balance (commitment basis)	1.8	5.9	5.5	2.6
Revenue	12.8	16.4	17.1	15.3
Expenditure (commitment basis)	17.1	14.7	14.2	15.4
Interest	6.0	4.2	2.6	2.7
Noninterest	11.0	10.5	11.6	12.8
	(In billions of U.S. dollars unless otherwise indicated)			
External sector				
Total exports, fob	76	106	103	93
Total imports, fob	40	45	54	60
External current account (deficit -)	23	45	34	17
Stock of federal government external debt	158	143	134	129
Gross reserves coverage (months of imports of GNFS)	2.4	4.6	5.5	5.0
Memorandum items:				
Nominal GDP (billions of rubles)	4,757	7,063	9,038	10,318
Exchange rate (rubles per U.S. dollar, period average)	24.6	28.1	29.2	...
Russian oil price ($/barrel, c.i.f.)	17.2	26.8	22.5	16.4

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