December 2006
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Russian Federation: 2006 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Russian Federation, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 26, 2006, 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 September 27, 2006. 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 October 18, 2006 updating information on recent developments; and

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 18, 2006 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper
Statistical Appendix

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

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

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INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation
with the Russian Federation

Approved by Michael Deppler and Michael Hadjimichael

September 27, 2006

- Article IV consultation discussions were held in Moscow during June 14-26, 2006. The mission met with Deputy Prime Minister Zhukov, Minister of Finance Kudrin, Central Bank of Russia Governor Ignatiev, other senior officials, members of the Duma, representatives of the business and academic communities, and the press.

- The staff team comprised Mr. Thomsen (head), Messrs. Figliuoli, Takizawa, and Zebregs, Ms. Basu (all EUR), Mr. Balassone (FAD), Ms. Kozack (PDR), and Mr. Lohmus (MFD), and was assisted by Mr. Mates (Moscow Office). Mr. Mozhin, Executive Director for Russia, participated in the discussions.

- During the last Article IV Consultation discussions, concluded on September 7, 2005, Directors commended the strong performance of the Russian economy. However, in light of the emerging capacity constraints and persistent inflationary pressures, they recommended that fiscal policy not be loosened further, and that the CBR allow the ruble to appreciate if inflation runs above the targeted path. Directors were concerned that large oil revenues were causing complacency about structural reforms.

- Russia has accepted the obligations of Article VIII, Sections 2, 3, and 4. Staff is consulting with the authorities to determine whether the restriction on current account transactions identified at the time of the 2005 Article IV consultation has been removed as part of Russia's full liberalization of capital account and exchange restrictions.

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

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

Contents

Appendices

EXECUTIVE SUMMARY

Background. Propelled by large terms-of-trade gains, GDP growth has accelerated and is running close to potential. The demand pressures associated with the large terms-of-trade gains are reflected in a fast real appreciation of the ruble, although more of this has come through nominal appreciation during the last year. This somewhat more flexible exchange rate policy, in combination with one-off measures, has allowed some reduction in inflation. Still, inflation remains high as large unsterilized interventions to stem ruble appreciation continue to fuel money growth. With capacity constraints looming, more inflation pressures would emerge quickly in the absence of a change in the underlying fundamentals or in the prevailing policy mix.

Outlook. Real GDP is projected to grow by 6½ percent in 2006 and 2007, the same rate as in 2005. The risks to the outlook are evenly balanced and depend mostly on oil price developments.

Policy discussions. The discussions focused on the following issues:

- A notable fiscal relaxation has been underway since early 2005, as calls for more spending of oil revenues have mounted in the face of a ballooning oil stabilization fund and upcoming elections. Fiscal relaxation will continue in 2007, despite the economy being close to full capacity. The Ministry of Finance agreed with staff's concern that fiscal relaxation at this juncture is exacerbating demand pressures, but calls from other parts of the government for more spending from oil revenues are strong as such revenues continue to swell.

- Current policies raise medium-term risks. There is considerable scope for increased fiscal spending once demand pressures associated with the large terms-of-trade gains ease, but—pointing to the rapid and ill-targeted relaxation during the last 1½ year—staff warned about the risk of a gradually emerging non-oil deficit and a spending structure that cannot be sustained if oil prices were to drop sharply, raising the specter of pro-cyclical fiscal tightening and the real exchange rate overshooting its long-term equilibrium. Staff, therefore, advocated that any increase in the non-oil fiscal deficit be used for advancing structural reforms that would support faster potential growth.

- Staff welcomed the greater focus on inflation control, but cautioned that additional exchange rate flexibility would be needed to meet the end-2006 target, especially at a time when demand pressures are exacerbated by fiscal relaxation. The CBR could not commit to such flexibility and acknowledged that the inflation target might be missed.

- Structural reforms outside the banking sector remain very slow. The authorities agreed that structural reforms are behind schedule and claimed that high oil prices and robust growth make it difficult to mobilize political support for reforms.

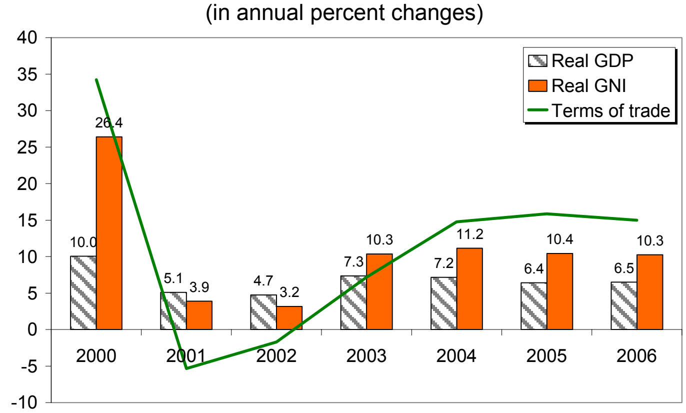
- Staff expressed concerns about regulatory forbearance and warned that the favorable macroeconomic environment might be disguising vulnerabilities. It commended the CBR for its determination in withdrawing licenses of banks engaged in money laundering and other illegal activities, but expressed concern about the limited number of deposit taking institutions barred from the new deposit insurance scheme. The CBR agreed that a sharp drop in oil prices could cause turmoil, but did not believe that risks were systemic.

I. Background

A. Recent Economic Developments

1. **Propelled by large terms-of-trade gains, real GDP growth has accelerated and is becoming better balanced, but running close to potential** (Table 1 and Figure 1). It has recovered from the slowdown that began in mid-2004, having gained strength steadily during 2005 and the first half of 2006, punctured only by inclement weather in early 2006. From an annualized rate of about 5 percent in early 2005, growth is now running at about 7 percent, broadly the same pace as before the 2004 slowdown.

Production, Income, and Terms of Trade Gain
(in annual percent changes)

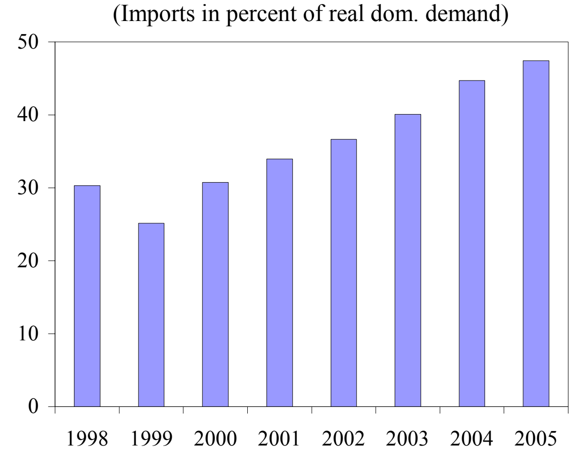


2. **The renewed momentum reflects a recovery in investments.** A confluence of negative factors that suppressed investments in the second half of 2004—notably banking sector turbulence, reduced oil sector profitability due to a tax hike, and the souring of the investment climate during the end-phase of the Yukos affair—waned during 2005, against the backdrop of the continued terms-of-trade gains. While fixed investment remains low, at about 18 percent of GDP, a slow trend increase is discernible.

3. **But consumption is still the main source of growth**. Consumption growth remained robust even as real wage growth weakened when the economy slowed in 2004–05. This partly reflected a change in the fiscal stance in early 2005 that—in contrast to 2004—allowed a substantially larger share of the terms-of-trade gain to translate into higher demand, in particular consumption, see below.

4. **Domestic resource constraints are tightening, causing increased leakage through the balance of payments and continued strong real ruble appreciation.** Following six years with robust GDP growth and low investments, measures of capacity utilization are at historical highs. Staff analysis suggests that potential GDP growth is about 6½ percent and the output gap close to eliminated (Box 1). Constraints are particularly evident in the oil sector. Having

Import Leakage
(Imports in percent of real dom. demand)



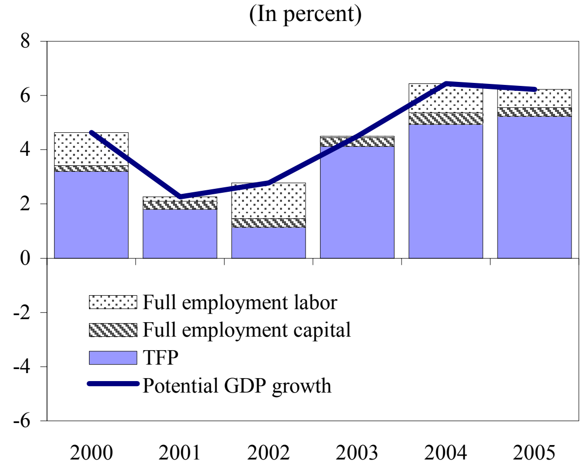
Source: Authorities; and IMF staff calculations.

increased by about 10 percent annually through 2003, the increase in crude oil production has slowed sharply, and appears now to have stabilized at 2–3 percent. This translates into a reduction in the energy sector's contribution to GDP growth of more than one percentage point. The emerging resource constraints have been reflected in a steady increase in the leakage through the balance of payments—imports relative to GDP in constant prices increased by 3 percentage points in 2005, to almost 50 percent—and in a rapid real ruble appreciation—9 percent (year-on-year) by June 2006.

5. **Labor markets are also tightening.** The official unemployment rate has fallen to very low levels in major cities (0.8 percent in Moscow and 2.2 percent in St. Petersburg) and real wage growth has rebounded sharply since the beginning of 2005 and is now running at more than 10 percent (year-on-year). There is evidence of large unregistered immigration of workers from other CIS countries; fewer obstacles to internal labor migration than previously thought; and substantial inter-sectoral mobility as industry and other slow growing sectors continue to shed labor.

6. **Potential output growth reflects mainly large gains in total factor productivity.** Staff analysis suggests that the labor force and the capital stock together only accounted for about one percentage point of the 5¾ percent of growth of potential GDP during 2003–05, with the balance due to TFP (Box 1). The rapid TFP growth is likely to reflect relatively easy efficiency gains that exist in the catch-up phase of transition as equipment and technologies are upgraded and resources reallocated to faster growing sectors. While subject to notable caveats, this analysis under-scores that growth is being driven not so much by rising investment levels, but by realization of catch-up potential.

Contribution to Potential GDP Growth
(In percent)



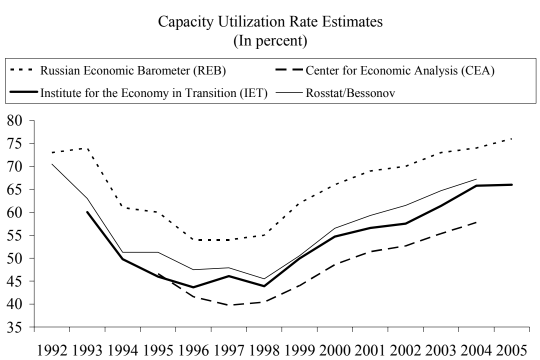
Source: Authorities; and IMF staff calculations.

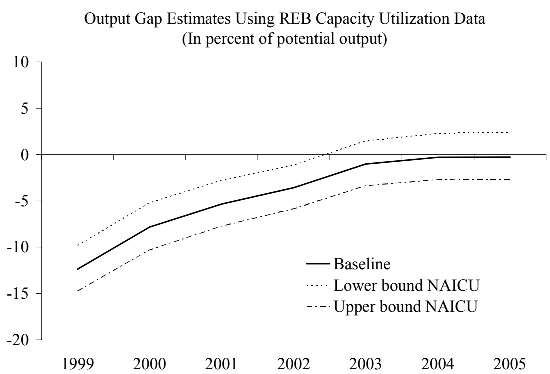
Box 1. Potential GDP and Output Gap

With an estimated output gap close to zero, GDP growth of 6½ percent or more will be increasingly difficult to achieve without fueling inflationary pressures.

Based on a production function approach, annual growth of potential GDP is estimated at about 6¼–6½ percent at present. Potential GDP is calculated as the level of output that is produced when capital and labor are employed at their natural rates of capacity utilization (i.e. the non-accelerating inflation rate of utilization) and TFP is at its trend. The non-accelerating inflation rate of capital utilization (NAICU) is estimated by running a regression of changes in core CPI inflation on several explanatory factors, including the rate of capital utilization, while the non-accelerating inflation rate of labor utilization (NAILU) is estimated based on available utilization data from labor surveys. [1] [2] Trend TFP is estimated by fitting an exponential trend to the TFP that is derived from data on actual GDP and utilization-adjusted levels of labor and capital. The estimation results indicate that potential GDP growth accelerated during 2002–2005 and was driven largely by potential TFP growth. Staff's findings are in line with those of the authorities.

Estimates of potential GDP indicate that the output gap in Russia has been mostly eliminated. The rate of capital utilization has risen steadily since 1998 and is currently close to the estimated NAICU. The increase in capital utilization has been a key factor in the narrowing of the output gap in recent years. The remaining small negative output gap suggests that the scope for growth above the potential rate without an acceleration of inflation is becoming increasingly limited. However, the results need to be interpreted with considerable caution because estimates of the output gap and potential GDP are subject to a more than usual degree of uncertainty in an environment of rapid structural changes such as in Russia. Data quality is also an issue, not least the estimates of capacity utilization.





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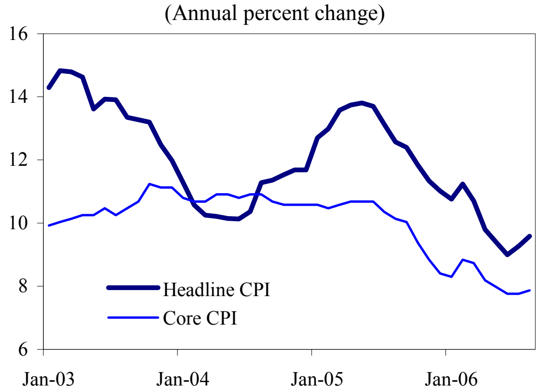
[1] See IMF Working Paper 06/68 for technical details of the estimation.

[2] Several sources of capital utilization data are available. The estimates of the NAICU used here are based on data from Russian Economic Barometer (REB). Labor surveys are conducted by the Institute for the Economy in Transition (IET) and Russian Economic Barometer (REB).

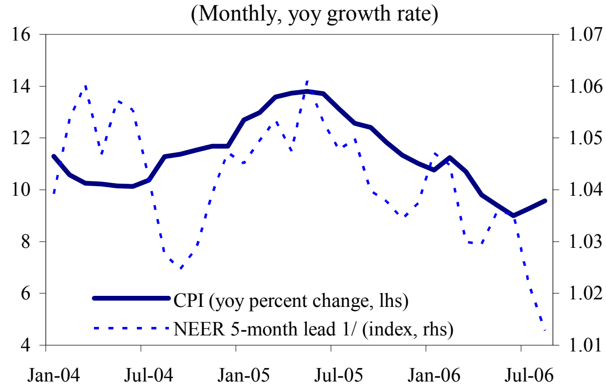
7. **Inflationary pressures have eased somewhat, but remain strong.** While overshooting the 2005 end-year target of 8½ percent, headline CPI inflation moderated from 13½ percent in May 2005 to 9 percent in June 2006, before rebounding slightly in recent months, to 9½ percent in August (year-on-year). This partly reflects a monetary tightening and an attendant NEER appreciation, which has ensured that, by comparison to previous years, more of the fast real exchange rate appreciation associated with strong demand pressures has been brought about through nominal appreciation rather than inflation. The decline in inflation also reflects, however, a good harvest, reduced duties on importation of beef above quota, lower increases in administered prices, and a cap on petroleum prices. While it is difficult to quantify the impact of these one-off factors, disaggregated data suggest that it is likely to be non-negligible.

Headline and Core Inflation
(Annual percent change)



Source: Authorities; and IMF staff calculations.

Inflation and Nominal Effective Exchange Rate
(Monthly, yoy growth rate)



1/ Increase in index represents a depreciation of the ruble in nominal effective terms.

8. **Higher prices of energy and other primary commodities have strengthened the balance of payments and reserves further** (Table 2 and Figure 2). Gross international reserves rose by $57 billion during 2005, despite large debt pre-payments, and by almost $85 billion during the first seven months of 2006, to $267 billion.

- **The latest round of oil price increases is boosting the current account surplus and masking the adjustment to the large terms-of-trade gains of previous years.** The headline current account surplus has increased to about 11½ percent of GDP on an annual basis from 11 percent in 2005. But the surplus in terms of constant oil prices is declining relatively fast, by 3¾ percent of GDP in 2005, as a result of rapid import growth. Indicators of export competitiveness have however not deteriorated: the real appreciation of the ruble has been broadly in line with the change in the differential between productivity in Russia and average productivity in the U.S. and the Euro area; unit labor costs have increased in U.S. dollar terms, but broadly in parallel with other countries in the region; and non-primary commodity exports have maintained market shares (Box 2).

- **Private capital inflows are rising.** They amounted to a net inflow of $27 billion during the year through mid-2006, compared to $7 billion during the previous year, reflecting among other factors larger borrowing by Russian corporates and SOEs, especially in the form of syndicated loans from international banks. The large increase compared to 2005 partly reflects a recovery from the temporary compression of net inflows associated with the Yukos affair. Moreover, FDI has finally begun to rise, in terms of both gross and net inflows, although they remain low by comparison to other emerging market economies. Yet, there has been only a limited improvement in the overall capital account as the government has been taking advantage of the swelling oil stabilization fund to prepay Paris Club creditors, by $15 billion in the second half of 2005. Russia has prepaid another $22 billion in 2006, the remainder of its outstanding debt to Paris Club creditors.

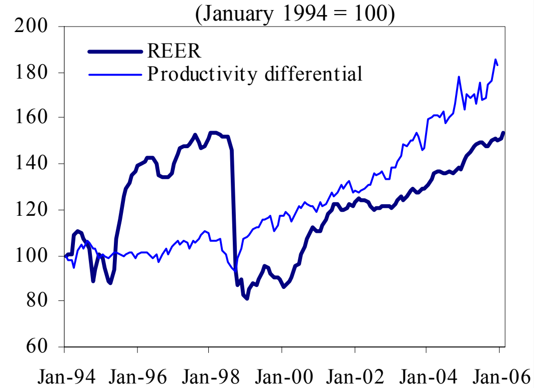
Box 2. International Competitiveness and Exchange Rate Considerations

Russia has experienced large terms-of-trade gains in recent years, which have resulted in considerable upward pressure on the real effective exchange rate. This has raised concerns about Russia's international competitiveness.

Several indicators suggest that Russia's international competitiveness has remained broadly unchanged.

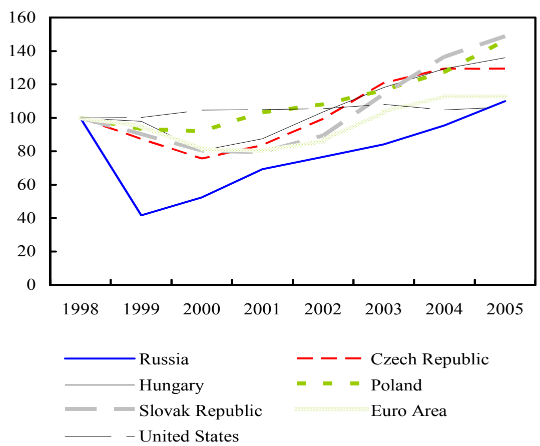
- The appreciation of the CPI-based real effective exchange rate has been matched by productivity gains.
- Unit labor costs have increased, but mostly in tandem with those in other countries in the region.
- The export market share of manufactured goods has been maintained.

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



Source: Authorities; and IMF staff calculations.
1/ Industrial productivity in Russia relative to average industrial productivity in the U.S. and the Euro area.

Unit labor costs in US dollars[1]
(Index, 1998=100)

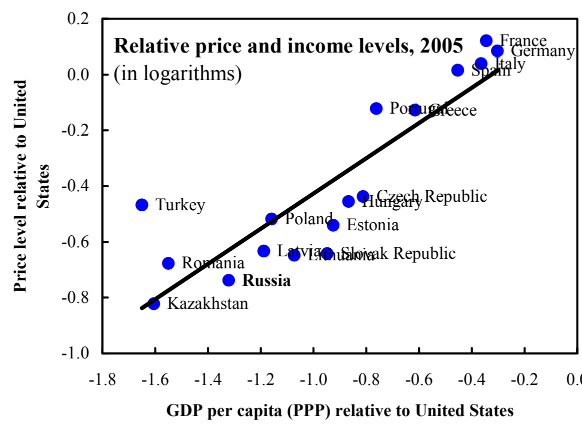


Sources: Russian authorities; WEO; IFS; and staff estimates.
[1] For manufacturing sector, except Russian ULC, which is for industries.

Russia's exchange rate appears to be undervalued. Estimates by the Fund's research department suggest that the undervaluation of the real effective exchange rate is about 15 percent. Another measure of exchange rate misalignment is the deviation of a country's relative price level from the level that might be expected on the basis of its relative income. This measure also suggests that the exchange rate is undervalued.

Russia's Export Market Share
(Russian exports in percent of total world exports to its major trade partners)

Source: Direction of Trade Statistics; COMTRADE; and IMF Staff Estimates.



9. **Equity and real estate prices are rising sharply.** The stock market had increased more than 40 percent since end-2005 before tumbling by 30 percent in late spring, during the turmoil in emerging markets worldwide. Since then, the market has recovered strongly, to almost the same level as before the turmoil, and equity prices have doubled in real terms since mid-2005. Real estate prices in the Moscow-region rose by 25–30 percent annually in real terms in 2004–05, and have reportedly continued their sharp upward trend in 2006.

B. Economic Policies

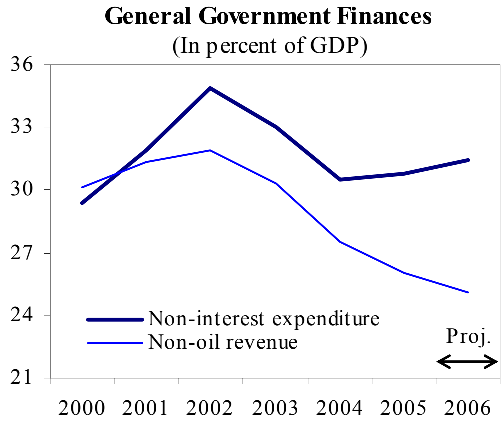
10. **A notable fiscal relaxation has been underway since early 2005** (Tables 3 and 4)**.** The headline surplus of the general government has continued to increase during this period as oil prices have risen sharply, reflecting marginal tax rates with respect to oil prices of almost 90 percent. However, the non-oil primary deficit is set to increase by almost 3 percent of GDP in 2005–06 as oil revenues are being used to reduce taxes and increase expenditures. Thus, in terms of the combined net impact of changes in energy exports and the headline government surplus, a negative impulse of about ¼ percent of GDP in 2004 was followed by a stimulus of about 2 percent of GDP in 2005. A further stimulus of 2 percent of GDP is in store for 2006, possibly more if the budget is amended, as is currently expected, see below.

Russian Federation: Summary Table

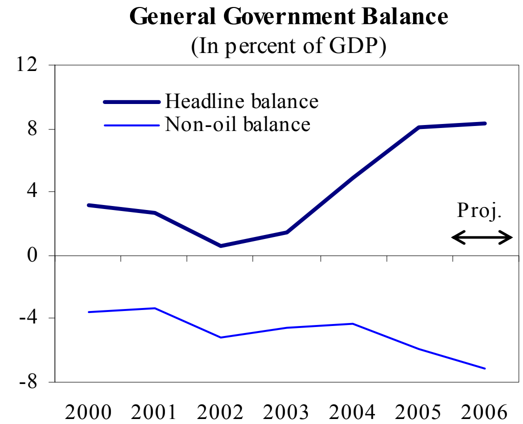
	2001	2002	2003	2004	2005	2006 Proj.
	(In percent of GDP)					
Federal Government						
Overall Balance	2.7	1.3	1.7	4.3	7.5	8.5
Non-Oil Balance	-1.2	-2.7	-2.7	-3.1	-3.6	-4.7
Fiscal Impulse 1/	0.0	2.2	0.4	-2.0	-2.9	-0.6
Non-Oil Fiscal Impulse 2/	0.3	2.3	0.8	1.0	0.8	1.4
General Government						
Overall Balance	2.7	0.6	1.4	4.9	8.1	9.2
Non-Oil Balance	-3.3	-5.2	-4.6	-4.3	-5.9	-6.9
Fiscal Impulse 1/	2.9	3.2	0.3	-2.8	-2.9	-0.5
Non-Oil Fiscal Impulse 2/	2.1	3.0	0.6	0.4	1.8	1.6
Terms-of-trade Gain 3/	-1.4	0.1	2.2	3.8	5.0	4.7
A. Change in Energy Exports 3/	0.4	2.2	3.8	3.7	6.2	4.6
B. Change in General Government Overall Balance 3/	0.1	-1.6	0.9	3.8	4.2	2.6
Combined Contribution to GDP growth (A-B)	0.3	3.8	2.9	-0.2	1.9	2.0

Sources: Russian authorities and Fund staff estimates.

1/ Defined as the yearly change in the fiscal stance. See Chapter II of the 2005 Selected Issues paper for a discussion of alternative definitions of the fiscal impulse.
2/ Defined as the fiscal impulse plus the yearly change in oil revenue.
3/ As a percent of current year GDP.



Source: Authorities; and IMF staff calculations.



Source: Authorities; and IMF staff calculations.

11. **Monetary policy remains accommodative despite some tightening during the last year** (Figure 3 and Table 5). Faced with a pick-up in base money growth as the government began to spend more of its oil revenues and with inflation already running well above target, the CBR modified its intervention policy and began to allow some limited ruble appreciation. In nominal effective terms, the appreciation during the year through mid-2006 was 3 percent, compared to a depreciation of about one percent during the previous 12-month period. This, in combination with the increased output growth since early 2005, has entailed a limited tightening of monetary conditions, halting the decline in interest rates. However, this change notwithstanding, very large unsterilized interventions to stem ruble appreciation have remained the prominent feature of monetary policy, and monetary aggregates have continued to grow rapidly, with banking sector credit expanding by almost 45 percent during the year through April 2006.

12. **Financial soundness indicators are generally favorable, although rapid credit growth is beginning to strain bank liquidity** (Table 7). Profitability in the banking system is robust and has improved, even as foreign banks have entered the market and increased competition. Capital adequacy ratios are at comfortable levels by international standards, but have been falling since 2004 and, for some systemic banks, are now close to the minimum requirement of 10 percent. This decline is in part the result of rapid credit growth, with some banks finding it difficult to raise enough capital externally as their business expands, notwithstanding strong profitability. Several banks are not meeting the minimum requirement on the basis of international financial reporting standards (IFRS/IAS), which have yet to be fully implemented.

13. **Concerns about regulatory forbearance and poor prudential data persist.** The CBR has moved decisively to close a large number of small banks involved in money laundering and other illegal activities, but concerns remain about its enforcement of prudential standards for the banking system at large. These concerns were reinforced by last

year's admission of banks accounting for 98 percent of total deposits into the new deposit insurance scheme. Although the new scheme catalyzed improvements in the banking system and in regulatory practices, several shortcomings remain, including concentrated lending and lending to related parties. Moreover, while official data show that the overall non-performing loan ratio is low and declining, except for a considerable increase in past-due loans to households, questions remain about the quality of this data, reflecting in part problems of connected lending, accounting weaknesses, and corporate governance more generally. A possible indication of underreporting of nonperforming loans is the fact that foreign banks report considerably higher provisions against loans to households than domestic banks.

14. **Structural reforms are progressing only slowly.** Although technical preparations have advanced and the legislative and institutional framework have been strengthened in important areas, actual implementation has been slow, not least by comparison to the government's own goals upon assuming office. This includes reforms of the health and education sectors, the civil service and public administration, and the natural monopolies. A case in point is the growth in the number of civil servants, which, despite the authorities' intentions to reduce it, has increased by almost one third since 2001 and by 10 percent in 2005. Meanwhile, the forced acquisition of Yukos' largest asset by Rosneft and the purchase of Sibneft by Gazprom have fueled concerns that the state is reassuming control over this strategically important sector.

II. Short-Term Outlook

15. **Demand pressures are expected to remain strong in 2006–07, most likely intensifying** (Table 6). Staff projects growth of 6½ percent in both years, slightly above the consensus forecast, but close to estimated potential growth. Growth in consumption and investment is expected to remain strong, possibly accelerate, consistent with the WEO forecast of an increase in the average oil price of $16 per barrel in 2006, and a further, smaller increase in 2007. These demand pressures also reflect a substantial impulse that is still coming from the cumulative terms-of-trade gain of 11 percent of GDP during 2003–05, as spending plans are adjusting only gradually to these gains, not least in the oil sector. The increase in the oil price is driving a further rise in the current account surplus to above 12 percent of GDP in 2006. But as oil price increases start to taper off, the underlying increase in the non-energy current account deficit will begin to be reflected in a reduction in the headline surplus, to about 11 percent of GDP in 2007. The authorities will struggle to reach their inflation target of 8½ percent by end-2006.

16. **The short-term projections are subject to notable uncertainty.** The main non-policy risks pertain to assumptions about oil prices and GDP growth already running at or above potential. The main policy uncertainties arise from the possibility that: (i) a supplementary 2006 budget and the 2007 budget will entail a combined relaxation of the non-oil primary deficit of more than one percent of GDP; and (ii) the CBR will not allow sufficient exchange rate flexibility to meet the inflation target. While risks are, in staff's

view, evenly balanced for GDP growth—in particular since the oil stabilization fund mechanism provides a significant short-term cushion against movements in the oil price—they appear to be skewed to the upside for inflation, as discussed below.

17. **While Russia's external vulnerability is low, corporate and financial sector vulnerabilities remain** (Figure 4 and Tables 7–9)**.** With international reserves almost four times short-term debt, public debt low and declining rapidly, and a current account surplus of 11 percent of GDP, Russia's balance of payments position is exceptionally strong, providing the authorities ample time to undertake corrective policy measures in the event of severe shocks. However, while there are no significant macro-economic external risks, the rapid increase in corporate foreign borrowing in recent years, including by de facto state-controlled companies in the energy sector, is a matter of some concern due to the still weak corporate governance. Moreover, as discussed below, the banking sector remains vulnerable.

III. Report on the Discussions

18. **The overarching issue during the discussions was how to ensure that Russia's oil wealth is used to spur economic growth without fueling inflationary pressures and exchange rate overshooting.** Two key issues serve as reference points in this regard:

- **There is considerable scope for increased fiscal spending or lower taxation over the medium term, once demand pressures ease.** Despite the recent relaxation, the 2006 budget is still balanced at an oil price of about $30 per barrel, suggesting that Russia is currently taxing and saving what amounts to large permanent terms of trade gains, even under a conservative medium-term outlook for oil prices. An illustrative staff analysis of the long-term spending envelope using a general equilibrium framework suggests that this envelope could be relaxed by at least 5 percent of GDP over the long run (Box 4).[1] An even larger increase would be possible according to a standard debt sustainability analysis (Figure 5 and Table 10).

- **But excessive and ill-targeted fiscal relaxation could cause the real exchange rate to overshoot its long-term equilibrium.** Although the process of adjusting to the large permanent income gain has begun, as reflected in the decline in the non-energy current account balance and the notable real ruble appreciation, there is still ample room for the this balance to decline further and the still undervalued exchange rate to appreciate towards its new equilibrium. In this regard, and in view of the fast real ruble appreciation and the notable increase in the non-oil government deficit that are underway, a key topic for discussion with the authorities was the possibility of the exchange rate overshooting its long-term equilibrium. This could happen if the non-oil deficit is relaxed too quickly

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[1] See Chapter I of the accompanying selected issues paper for a sensitivity analysis.

and by more than is consistent with the permanent income gains from the oil windfall. Such risks would be further heightened if the relaxation is in support of spending and tax cuts that do not boost potential growth and if flagging structural reforms prevent a steady appreciation of the economy's equilibrium real exchange rate.

Box 3. Policy Implementation and Past IMF Recommendations

Fiscal policy: A key policy recommendation by the staff has been to tax and save the oil revenue windfalls as long as cyclical pressures persist. Fiscal policy had been broadly in line with the staff's suggestions until 2005–06 when the non-oil primary balance of the general government widened by a cumulative 3 percent of GDP. Staff have also urged that VAT reform be delayed or, at least, be revenue-neutral to avoid exacerbating inflationary pressures. The authorities have decided to postpone this reform until 2009. Much of the far-reaching structural changes with regard to the tax system and expenditure control are in line with the considerable Fund TA advise given to Russia in these areas.

Monetary policy: Staff has recommended that monetary policy be primarily focused on inflation control, unburdened of exchange rate considerations. Starting in 2005, the CBR has begun to put somewhat greater emphasis on inflation control and has allowed some increase in exchange rate flexibility. The change has, however, been limited and large unsterilized interventions have continued to fuel rapid growth of monetary aggregates.

Banking sector reforms: The authorities have implemented many of the recommendations provided by the large number of Fund-Bank TA missions since the 1998 crisis, but some key problems remain to be addressed, including full IFRS accounting, concentrated lending, lending to related parties, and the development of strategic plans for the still dominant state banks. Staff has supported the introduction of the deposit insurance scheme on grounds that this would provide the authorities with an opportunity to strengthen prudential standards, abandoning the regulatory forbearance that has characterized supervision in the past. Staff agrees that deposit insurance has catalyzed important structural changes in the banking system, but remains concerned that regulatory forbearance lingers.

Structural reforms: Staff has called for structural reforms that boost long-term GDP growth and has found the government's long-term structural reforms program to be comprehensive and well-targeted, not least its focus on improving the investment climate. However, staff have also found that the implementation has been disappointing. Developments since the last consultation discussions have reinforced such concerns.

Box 4. Long-Term Fiscal Sustainability and Alternative Fiscal Policies

Russia's large oil and gas reserves play a key role in its economic development, but also pose challenges to macroeconomic policies. One such challenge is to avoid that current spending out of oil and gas wealth will necessitate a sharp fiscal correction in the future.

Staff analysis suggests there is considerable room for fiscal relaxation over the medium term without compromising long-term fiscal sustainability.[1] The analysis produced estimates of the additional fiscal room relative to actual primary expenditures in 2005 under three alternative spending rules. These spending rules are consistent with a long-run (i.e. beyond 2055) equilibrium in which there is no need for fiscal adjustment when oil and gas reserves are depleted. Under the **permanent consumption rule**, expenditure is fixed over time in such a way that initially the government runs surpluses to build up financial assets, the return on which subsequently finances the primary deficits that emerge when resources are depleted. Two variants of this rule were simulated: one in which expenditure is held constant as a share of overall GDP, and one where expenditure is held constant as a share of non-oil GDP. Under the third, the **bird-in-hand rule**, the government invests all hydrocarbon revenues in financial assets and uses the return on these assets to finance the primary deficit, which is thus allowed to grow over time as more assets are accumulated. Under each spending rule, there is room for fiscal relaxation over the long term, but there are differences in the short and medium term. Clearly, relaxing more in the short to medium term limits the additional room in the long term. However, the scope for fiscal relaxation in the near term should also be evaluated against the cyclical position of the economy. It may be consistent with fiscal sustainability to relax in the near term, but not with sound macroeconomic demand management. Such cyclical considerations are not taken into account here.

The data in the table are mainly for illustrative purposes. A more detailed analytical framework as well as better estimates of Russia's oil and gas wealth are needed to arrive at more precise estimates of the spending envelopes under the different rules.

Changes in spending envelopes relative to 2005 actual primary expenditure (in percent of GDP)[1]

Scenarios:	Permanent consumption rule[2]		Bird-in-hand rule
	Variant A	Variant B	
Short-term	4.9	-2.0	-4.3
Medium-term	4.9	0.6	-1.4
Long-term	4.9	6.9	8.1

[1] A positive number indicates more fiscal room relative to the 2005 actual outturn.
[2] Variant A assumes constant expenditure in percent of overall GDP; Variant B assumes constant expenditure in percent of non-oil GDP.

The analysis is based on the following projections of government revenues from both hydrocarbon and other taxes. Revenue projections are the same under all three alternative spending rules.

- ***Oil and gas prices***. In line with WEO projections, Russia's nominal crude oil price increases to $72 per barrel in 2007 and edges down to $65¾ per barrel in 2011, after which it is assumed to remain constant in real terms at the 2011 level. The gas price is assumed to follow a similar profile, with the price from 2011 onward assumed to remain constant relative to the oil price.
- ***Oil and gas production***. Oil output growth is assumed to pick up gradually over 2006-11 to reach 4 percent per year in 2011–12, then decelerate gradually. After 2020, output declines. The stock of proven, probable, and possible reserves is assumed to be depleted in 50 years. Gas output growth is assumed to be 2 percent per year until 2011, 1 percent per year for 2012–16, and zero afterwards. The stock of proven and unproven reserves is projected to not be depleted for another 300 years.
- ***Hydrocarbon taxes.*** The tax burden for the hydrocarbon sector as a share of estimated hydrocarbon GDP remains unchanged at 57 percent (2005 value). Hydrocarbon tax revenue steadily declines from 14 percent of GDP (2005 value) to zero in 2106.
- ***Non-hydrocarbon tax*** revenue as a share of non-hydrocarbon GDP is assumed to remain unchanged at the 2005 level. Accordingly, it increases gradually from about 27 percent of GDP (2005 value) to 35 percent of GDP (in constant prices) in the long run, in step with the rise in the share of non-hydrocarbon GDP in total GDP.

[1] Chapter I of the accompanying Selected Issues paper discusses the results and the analytical framework of the analysis in more detail.

A. Fiscal Policy

19. **Fiscal relaxation will continue in 2007.** Staff estimates, based on the preliminary 2007 budget discussed with the mission, indicate that noninterest expenditures of the general government will rise by 1½ percent of GDP in 2007[2], while the non-oil primary deficit will widen by about ½ percent of GDP. This will bring the deterioration in the non-oil deficit of the general government since the current fiscal easing began in early 2005 to 3¾ percent of GDP (compared to 2004). Officials explained that the relaxation is likely to be larger as the 2006 budget is expected to be amended, although the size of the increase and the extent to which it will carry over to even higher expenditures next year is unclear. Excluding such an amendment, staff estimates that the combined impact of additional terms of trade gains and changes in the fiscal stance will amount to a stimulus of 1¼ percent of GDP in 2007.

20. **The planned fiscal relaxation reflects a trade off between short- and medium-term considerations.** Officials of the Ministry of Economy considered it to be measured in view of the scope for relaxation over the medium term and of spending needs. They did not believe that cyclical pressures were set to increase and found the relaxation to be, if anything, too cautious. Officials of the Ministry of Finance, however, were concerned about such pressures, noting that the relaxation during the last 1½ years had been associated with a notable acceleration in the pace of real ruble appreciation. They believed that the further relaxation would keep the ruble appreciating at a faster-than-desirable pace in real terms. On the strength of the increased exchange rate flexibility, they hoped that inflation could nevertheless be kept on the targeted downward path, but saw some upside risks. Still, in their view, such risks remained manageable, and the proposed fiscal stance was the best that could have been hoped for considering that the surging oil stabilization fund and the favorable outlook for oil prices were fuelling calls for accelerated spending of oil revenues. Ministry of Finance officials were more concerned about pressures for additional relaxation over and above what was being planned, in the run-up to next year's elections and beyond.

21. **The authorities were confident that the increase in spending was efficient.** Compared to 2005, non-interest expenditures were set to increase by 1¼ percent of GDP in 2006–07 at the federal level, and by 2¼ percent of GDP at the general government level. This included spending of about ¾ of a percent of GDP on a new National Priority Program (NPP) in 2006–07, consisting of four programs aimed at improving services in the healthcare, housing, education, and agricultural sectors. Much of this spending is for targeted wage increases, which the authorities considered essential to facilitate reforms. A similar

[2] Noninterest expenditures by the federal government are projected to increase by 1 percent of GDP. The difference with the general government reflects an assumption by the staff that local governments maintain a balanced budget.

rationale justified large wage increases in sectors not covered by the NPP, notably the military and judicial sectors. While a considerable part of the increase was thus accounted for by wages and other current expenditures, the authorities noted that the 2007 budget also entailed a rise in capital spending.

22. **Staff expressed concern about the pace and composition of fiscal relaxation.** Since 2003, the policy of taxing and saving oil revenues had been key to preventing serious overheating in the face of unprecedented terms-of-trade gains, and staff expressed concern that the rapid increase in the non-oil deficit during the last 1½ years suggested that support for this important policy was flagging. As to 2006–07, with GDP growth already close to potential and additional large terms-of-trade gains in the offing, further fiscal relaxation would unhelpfully exacerbate cyclical pressures. Staff suggested that any significant increase in the non-oil fiscal deficit should be postponed until demand pressures ease. While acknowledging the scope for higher fiscal spending or lower taxation over the medium term and the need to balance cyclical considerations against the benefit of spending more on reforms and investments that could boost potential growth, staff questioned the efficiency of the increase in spending in 2006–07. It pointed to the notable increase in wages and other current expenditures, and doubted the effectiveness of targeted wage increases in sectors such as health and education at a time when comprehensive reforms in these sectors have been put on hold. Overall, while agreeing that the implications of the fiscal relaxation would be limited, provided the exchange rate remained sufficiently flexible, staff was concerned that recent trends foreshadow a slow but steady increase in the non-oil deficit and the gradual emergence of a government spending structure over the medium term that can not be sustained in the face of a large drop in oil prices.

23. The authorities are considering important changes to the tax system, the budgetary framework, and the administration of the Stabilization Fund**:**

- **Oil sector taxes will be changed.** While the authorities considered the tax burden on the oil sector to be in line with the practice in other major oil producing countries, they felt that Russia's heavy reliance on taxation based on physical quantities rather than on profits may discourage investments. To improve incentives, they are considering a ten-year tax holiday for new oil fields in East Siberia and offshore and tax rebates for existing oil fields that are more than 80 percent depleted. Staff cautioned that this administratively complex scheme could exacerbate inherent compliance problems and instead suggested to improve incentives through accelerated depreciation. The authorities felt that staff's alternative proposal suffered from similar compliance problems as it would be difficult to monitor the investments upon which depreciation allowances would depend.

- **VAT reforms are on hold.** Despite strong pressures for a cut in the general rate, VAT reforms have been postponed, partly because of concerns about political support in the run-up to the elections for offsetting a cut in the general rate with an elimination of the preferential rate and of exemptions. Staff welcomed the postponement of the reduction in the rate, reiterating that the VAT is among the least distortionary taxes in Russia. A stronger case could in the staff's view be made for reform of the Unified Social Tax (UST), which introduces a large wedge between net and gross salaries. Noting that the cut in the UST tax rate in 2005 had failed to improve compliance, the authorities explained that further reforms of this tax were not on the agenda.

- **The authorities are considering changes that could buttress the fiscal policy framework**. The Ministry of Finance has gained some support for suggestions to more explicitly take into account the implications for the non-oil deficit when determining the headline budget limit. Moreover, starting in 2007, the federal budget is being framed in the context of rolling three-year budgets with a detailed expenditure breakdown. Staff agreed that these initiatives could help focus budgetary discussions on productive use of the oil wealth in a medium-term context, especially if linked to implementation of the structural reform program. Nevertheless, staff cautioned that the rolling three-year budget framework, while in principle providing a stronger anchor for the main parameters of the annual budgets, would not be effective if these budgets are regularly revised, as it has been the case in recent years. The authorities also explained the new investment strategy for the Stabilization Fund, according to which its balance at the CBR is to be converted from rubles into foreign currency, with a remuneration determined by the yield on a basket of first-rate foreign sovereign bonds. As this merely entails a redenomination of the CBR's liabilities to the Stabilization Fund, it will not affect the foreign exchange position of the CBR.

B. Monetary Policy

24. **CBR officials were confident that inflation will continue to decline.** They believed that the planned fiscal relaxation discussed with the mission is consistent with a downward inflation path that will get close to the official 8½ percent target for end-2006 and to the lower end of the 6½–8 percent target range for end-2007. They stressed that the tightening of monetary policy during the past 12–15 months reflected a gradual shift toward increased focus on inflation reduction, and a heightened political awareness that some ruble appreciation is inevitable in the current circumstances. They cautioned, however, that political support for exchange rate flexibility is still fragile, and that an increase in inflationary pressures resulting from an even larger fiscal relaxation than currently planned would seriously test such support. In view of this, they were not prepared to give priority to meeting the inflation target by committing to scale back interventions as needed to meet this target.

25. **Staff welcomed the renewed decline in inflation, but cautioned that additional exchange rate flexibility would be needed to consolidate and extend this decline.** It commended the CBR for the somewhat more flexible exchange rate policy, recognizing that

even this very limited change had been politically difficult, partly reflecting the sizeable negative wealth effect of ruble appreciation due to large foreign exchange savings. Staff noted, however, that much of the reduction in inflation had been due to one-off supply-side measures and that monetary policy remained very accommodative. With fiscal policy set to exacerbate strong cyclical pressures, staff believed that inflation would exceed the end-2006 target unless the CBR allowed accelerated appreciation. In any case, in view of the uncertainties affecting the short-term outlook, the CBR should stand ready to scale back its interventions and allow the ruble to appreciate as needed to meet the inflation target. Responding to the CBR's reluctance to commit to this, staff cautioned that the risk to inflation is rising as slack in the economy is being soaked up. Staff reiterated that the CBR should seek to strengthen confidence in its determination to reduce inflation by refraining from announcing exchange rate targets, not least by avoiding to set real exchange rate targets in its annual forward-looking report on monetary policy. While agreeing that formal inflation targeting is still premature, staff also suggested that the CBR could strengthen its monetary policy framework by focusing on a continuous inflation path rather than an end-year target.

26. **Looking beyond the near-term, CBR officials were concerned about their ability to meet the liquidity needs of the banking system.** They noted that liquidity injections had almost entirely resulted from foreign exchange interventions in recent years, and believed that they did not have the instruments necessary to provide sufficient credit through the central bank's domestic window in case the current account surplus waned. They were, therefore, considering to expand the range of collateral to include high-rated corporate paper. Staff urged the CBR to exercise great caution in refinancing through use of corporate collateral. It also argued that a gradual reduction in the current account surplus could likely be offset by additional capital inflows, attracted by the stable macroeconomic environment, robust growth, and limited external vulnerability. In this regard, it welcomed the recent initiative to liberalize the remaining capital account restrictions.[3]

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[3] In the context of the 2005 Article IV Consultation, staff determined that Russia maintained only one exchange restriction under Article VIII. This exchange restriction arose from the provision of an unremunerated reserve requirement for the payment of commission and the compensation of expenses when acquiring some foreign securities. (The reserve requirement gave rise to an exchange restriction to the extent that the commission or compensation of expenses paid by a resident is for the remuneration of services provided by nonresidents, because it then interferes with payments for a current international transaction). With the abolition of capital account restrictions implemented on July 1, 2006, the requirement to make unremunerated reserves were also abolished. However, staff is now ascertaining whether this abolition also applies to the payments of commissions or expenses related to the purchase of external securities acquired before the effectiveness date of the new law (i.e., July 1, 2006) as the new provisions are somewhat ambiguous on the issue. Clarification of the matter from the authorities is imminent.

C. Banking Sector

27. **CBR officials regarded recent developments in the banking system as favorable.** They noted the robust profitability and explained that stricter prudential requirements—spurred by the introduction of the deposit insurance scheme—have fostered transparency and buttressed resiliency. They considered the high rates of credit growth as generally healthy and posing limited risk to the system, since the financial sector is still relatively small and household and corporate indebtedness is still comparatively low. They also noted that there were no indications of banking system stability being jeopardized, as attested by low and declining non-performing loan ratios. Nevertheless, they acknowledged that this expansion warrants close monitoring. They were also carefully watching the decline in the capitalization rate in the banking system, although it is still high by international comparison. A planned increase in the minimum capital requirement to Euro 5 million effective from 2007 was expected to support bank consolidation.

28. **CBR officials explained that banking supervision had continued to improve and considered the regulatory framework to be broadly adequate.** The strengthening of prudential regulations in 2004–05 had enabled them to withdraw a large number of banking licenses. They planned to further strengthen prudential oversight by tightening enforcement of capital adequacy ratio requirements and broadening the definition of related party lending. More generally, officials were satisfied that the current legislative framework provides them with sufficient authority to intervene in commercial banks, including by removing bank management. One remaining concern was the CBR's still limited ability to impose bankruptcy on commercial banks.

29. **CBR officials found that risks of a systemic crisis remain low.** Stress tests conducted by the CBR suggest that the system is resilient to large, but plausible, shocks. The pessimistic scenario assumes shocks similar to the 1998 crisis and no economic growth. For the 200 largest banks, total losses would amount to 2.9 percent of GDP under this scenario. In view of these findings, CBR officials believed that banks are generally well capitalized and sufficiently provisioned. Since profitability and asset quality are also good, they considered the possibility of a systemic crisis as remote, although episodes of turbulence as in 2004 cannot be ruled out.

30. **Staff welcomed the improvements in banking supervision, but cautioned that weaknesses remain.** It agreed that the introduction of the deposit insurance scheme had been a step forward, not least because banks had strived to improve their operations ahead of entering the admission process. However, noting that the withdrawals of licenses mostly related to infringement of money laundering and capital control regulations, and that banks accounting for only a negligible share of deposits had been denied access, staff reiterated its concern about regulatory forbearance. Pointing to the continued delays in adopting IFRS, dealing effectively with connected lending, and addressing problems of corporate governance more generally, staff also questioned the quality of data on loan loss provisions

and the value of collateral. Against this background, and considering the favorable macroeconomic environment at this time, staff was concerned that stress tests might underestimate potential vulnerabilities.

31. **Staff recommended a further strengthening of supervision.** Priority should be given to supervising banks on a consolidated basis, thoroughly assessing internal credit-risk models, and ensuring that banks maintain adequate capital levels to cover direct and indirect risks in their portfolios. A swift move to full IFRS reporting was important in this regard. The legal and regulatory basis for supervision should also be reinvigorated by: (i) widening the definition of connected parties; (ii) reinforcing the powers of financial supervisors to conduct fit-and-proper tests for owners and managers; (iii) improving transparency of bank ownership; and (iv) strengthening non-bank financial sector supervision. It was agreed that the Financial Sector Assessment Program Update scheduled for early 2007 would provide a timely opportunity for an in-depth review of vulnerabilities.

D. Long-Term Growth Prospects and Structural Reforms

32. **Russia's long-term growth prospects hinge on an improvement in the investment climate.** The authorities concurred with staff's analysis that TFP had been the main driver of potential output growth in recent years, while the contribution of capital accumulation had been negligible. They also noted that labor force growth was becoming increasingly constrained by Russia's demographics. Looking forward, there was agreement that scope for realizing large TFP gains remained, although the authorities were somewhat more optimistic in this regard than staff. There was also agreement, however, that Russia would need to boost investment from the current low levels in order to sustain strong growth in potential GDP over the long run. In this connection, the authorities pointed to the need to strengthen infrastructure—especially power generation and the pipeline network, where bottlenecks were already now becoming evident—in addition to advancing the structural reform agenda more generally.

33. **The authorities pointed to recent advances in reforms.** These include: (i) energy sector reform, with the imminent break-up of RAO UES and steps to attract more private investment; (ii) judicial reform, with the drafting of a new law to enhance the independence of judges and the transparency of rulings; and (iii) administrative reforms, with the adoption of an action plan for streamlining and improving the quality of government services. The authorities also pointed to several measures to improve incentives for foreign investment in Russia, including the promulgation of the law on concession agreements and the creation of special economic zones. Other important initiatives affecting competition and the business climate include planned changes to: (i) the law on tax administration, aimed at reducing excessive discretionary powers of tax inspectors, among other objectives; (ii) taxation of the oil sector, to improve investment incentives (paragraph 23); and (iii) the subsoil and strategic sectors law, to clarify modalities for foreign investment, including ceilings on foreign ownership, in particular in the natural resource sectors. The authorities agreed that

uncertainties regarding the latter needed to be resolved quickly as investors were in doubt about the government's intentions.

34. **Acknowledging that important changes had taken place, staff found that overall progress remained disappointing, not least in view of the very favorable environment.** Staff welcomed the decision to speed up the long-delayed reforms of the electricity sector and agreed that judicial and administrative reform would be key to improving the investment climate over the long run. It noted, however, that several of the changes mentioned by the authorities were not part of comprehensive reforms, and it felt that the focus continued to be on changing the legislative and regulatory frameworks, while actual implementation was still slow. The authorities acknowledged that it had proven difficult to mobilize political support for implementation as high oil prices and robust growth appear to foster complacency.

35. **Staff urged the authorities to give priority to reforms that are important for the investment climate**. Key reforms in this regard are the restructuring of natural monopolies and the streamlining and strengthening of the public administration and civil service. Such reforms would, in turn, need to be carefully sequenced with other comprehensive reforms of the communal services, military, judiciary, health, and education sectors. Staff raised concerns about the increased state ownership in the oil sector, questioning whether this would allow this sector to regain growth momentum and again become an important source of GDP growth. It felt that the poor performance of the state controlled gas sector was a sobering reminder in this regard.

36. **The authorities had expected early WTO accession.** However, Russia has yet to conclude bilateral agreements with four countries, including the United States. Key outstanding issues related to: (i) procedures and measures under Russian legislation for veterinarian control, an issue that is also outstanding in multilateral negotiations and has been at the heart of recent trade disputes with several neighboring countries; and (ii) the application to the service sector of WTO rules for state trading companies, which would in particular affect Gazprom and Transneft. The authorities were confident that other substantive issues had been successfully resolved, and that good progress was being made in addressing concerns about the protection of intellectual property rights. Staff welcomed this progress, noting that WTO accession could help catalyze reforms and enterprise restructuring.

37. **The authorities explained that a number of new restrictions on imports from neighboring countries had been imposed for health reasons**. Staff encouraged the authorities to adhere to a transparent process for imposing such restrictions and to seek a rapid resolution of disputes, noting that these restrictions have a significant adverse impact on the affected neighboring countries because of their smaller economies. The authorities took note of staff's concerns.

IV. Staff Appraisal

38. **While oil prices have clearly been a major driver of the economy, the supply response has been impressive.** Even though the economy may struggle to maintain satisfactory growth if oil prices dropped sharply, the private sector has taken advantage of the large external inflows associated with the high oil price to upgrade equipment and technologies and to expand into new activities. These developments are being reflected at the macro level in strong growth in productivity, real wages, and consumption, and, as such, the oil windfall has helped to improve the efficiency and growth potential of the Russian economy.

39. **However, long-run growth prospects depend on progress in strengthening the investment climate and initiating delayed reforms.** The strong growth performance is being driven largely by increases in total factor productivity rather than by rising investment and employment levels. This reflects the still significant scope for productivity gains by upgrading equipment through limited investments and by reallocating resources to more dynamic sectors. With such catch-up potential not yet exhausted and oil prices likely to remain high—and with the stabilization fund providing much cushion in case they do not—near-term growth prospects are good, even without major changes in the investment climate. But the catch-up potential will inevitably start to diminish, at which point potential growth will become increasingly dependent on raising investments from their low level. Russia's unfavorable demographic trends, which suggest that the labor force will soon start declining, lend added urgency to the need for improving the investment climate. It is from this long-term perspective that staff considers recent developments to be less reassuring.

40. **The pace of economic reforms is disappointing.** Improving the investment climate will require reinvigorating reforms that are currently stalled or moving only very slowly, in particular reforms of the highly inefficient and under-capitalized natural monopolies, and Russia's overreaching civil service and public administration. These, in turn, must be carefully sequenced with a broad range of other reforms many of which are also advancing in a hesitant and piecemeal fashion. Since most of these reforms will be socially sensitive, they should be advanced now while high energy prices and large productivity gains are boosting growth and real incomes. And while many of them will be costly to the budget, not least because of the need to alleviate associated social problems, this cost is well within the scope for fiscal relaxation over the medium term, suggesting that Russia's oil wealth offers an enviable opportunity to accelerate reforms. It is in view of this favorable environment that Russia should set an ambitious reform agenda for itself and that the somewhat fitful pace to date is disappointing.

41. **Growth prospects depend much on the strategically important oil and gas sector**. Its contribution to GDP growth has declined in recent years. Changes to the tax regime designed to improve investment incentives in this sector are therefore welcomed, but the increased state ownership in the oil sector give rise to concern about its future dynamism.

Such concerns are illustrated by the way in which private Russian oil companies took advantage of the steady rise in energy prices from 1999 to increase investments—achieving a sharp reversal of the decade-long contraction in output—a development that stands in stark contrast to the virtual stagnation in the state-controlled gas sector during the same period. There is a risk that the energy sector might not succeed in again becoming a key engine of growth if the state retains a strong presence.

42. **The banking sector is strengthening but significant vulnerabilities remain.** Profitability in the banking sector is strong and improving, and direct exposures to market risks are low. However, banking sector risk management is still weak. Moreover, while the CBR's plan for bringing prudential standards and requirements in line with international best practices is generally ambitious, and the supervisory framework is strengthening, concerns remain about implementation. In particular, while the CBR has been admirably determined to withdraw licenses in case of infringement of anti-money laundering and capital control provisions, the very limited number of deposit-taking institutions barred from deposit insurance has reinforced concerns about regulatory vigilance. In this context, the favorable macroeconomic environment could be masking underlying vulnerabilities.

43. **The fiscal relaxation is excessive.** The policy of taxing and saving oil revenues has served Russia well, and the rapid rise in the non-oil deficit now underway raises concerns about a premature relaxation of this policy. The relaxation in store for 2006-07, when cyclical pressures are set to remain strong, and possibly increase, is likely to cause inflation to exceed the targeted path and keep the pace of real ruble appreciation well above what is politically palatable. While well-targeted expenditures could boost long-term growth, the current relaxation does not appear efficient as much of it is supporting higher wages and other current expenditures. More generally, staff is concerned about the effectiveness of the rapid increase in the spending of oil wealth during a period when the government is struggling to reinvigorate its structural reform program.

44. **The improved inflation performance is much welcomed, but more exchange rate flexibility is needed for the progress to be sustained.** While the decline in inflation partly reflects one-off supply-side factors, it also owes much to the increased willingness to allow more of the inevitable real exchange rate appreciation associated with strong demand pressures to take place through nominal appreciation rather than inflation. However, exchange rate flexibility is still limited. Unsterilized interventions continue to cause a very accommodative monetary policy, and staff believes that an accelerated pace of ruble appreciation would be required to reach the end-2006 inflation target. Looking beyond the current year, the CBR should be mindful of the fact that tensions between short- and medium-term fiscal objectives are likely to persist, suggesting that fiscal policy is set to continue to exacerbate cyclical pressures. In such an environment, a policy of resisting the attendant ruble appreciation imparts a potentially destabilizing inflationary bias to the macro-economic policy mix. In this context, the CBR should give explicit priority to keeping

inflation on a downward path by stating that it stands ready to scale back interventions and allow ruble appreciation if needed to keep to this path.

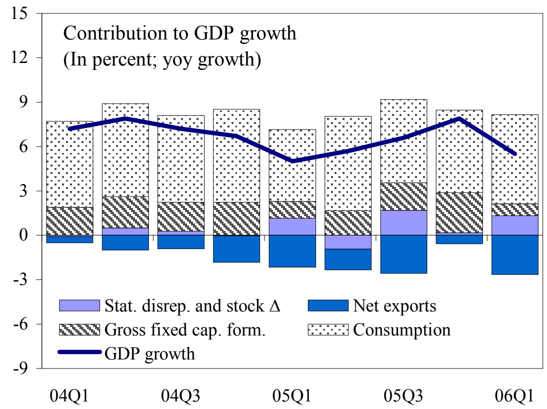
45. **Overall, risks lie mainly in the medium term.** While macroeconomic tensions are likely to rise in the short term, a major deterioration is unlikely and risks are limited. Indeed, while the adverse impact of entrenched, high inflation would deserve greater policy attention, it is reassuring that the authorities have clearly demonstrated no tolerance for rising inflation and have taken corrective actions if an increase gets underway. Staff's main concern is with the pace of the fiscal relaxation and real ruble appreciation against the backdrop of strong pressure for higher public sector wages and limited support for reforms. In terms of fiscal policy, the risk is of the gradual emergence of a non-oil deficit and a structure of public spending that cannot be sustained with oil prices at their long-term trend. Thus, notwithstanding that both the non-oil deficit and real exchange rate are currently below their long-term levels, a broad reinvigoration of reforms is needed to prevent the overshooting of these levels.

46. **From the perspective of imbalances in the global economy, the main concern is with the investment climate in the energy sector.** Considering Russia's vast oil and gas reserves, policy changes that would reverse the decline in output growth could have a significant impact on world energy prices over the medium term, contributing importantly to reducing global imbalances.

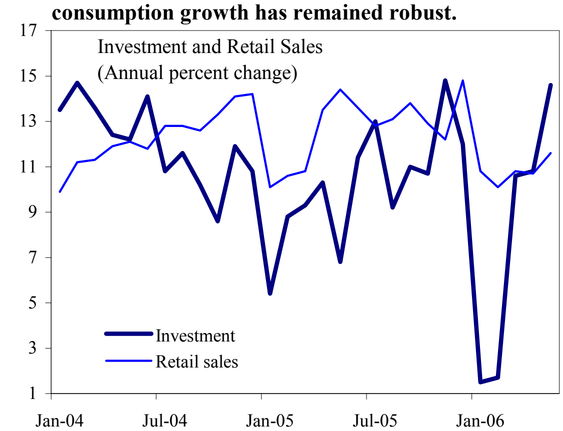
47. It is recommended that Russia's next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Russian Federation: Economic Activity

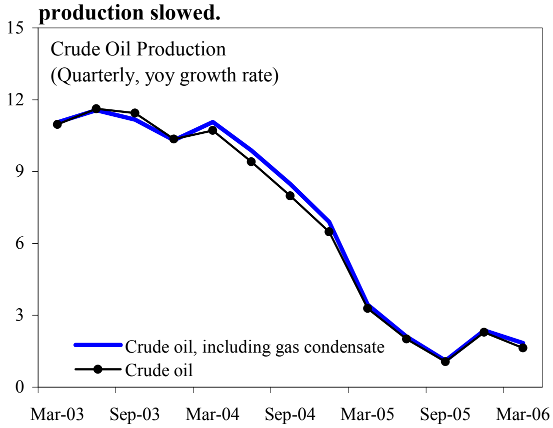
Notwithstanding a weather related deceleration in Q1 2006, growth has rebounded...



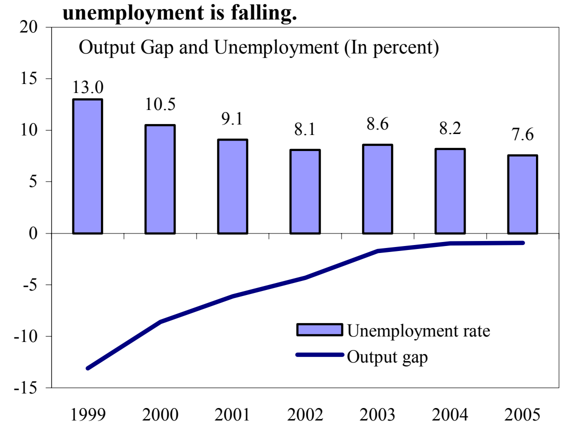
... helped by a pick up in investment, while private consumption growth has remained robust.



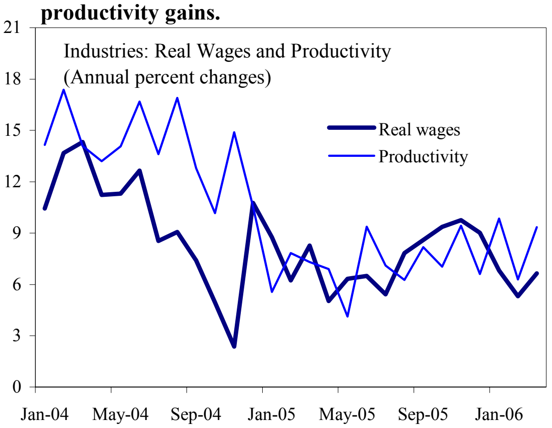
Exports were the main drag on growth as oil production slowed.



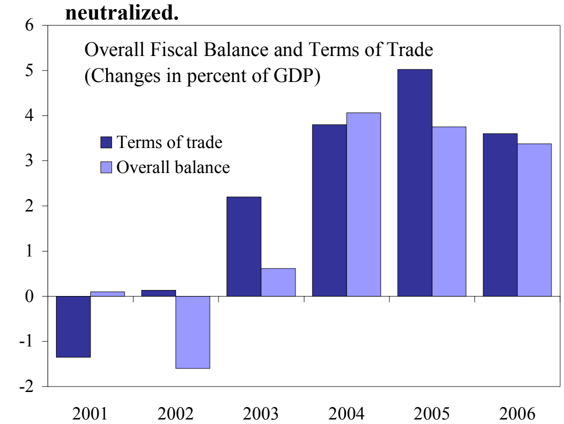
The economy is close to full capacity and unemployment is falling.



Real wage growth is high, but is being matched by productivity gains.



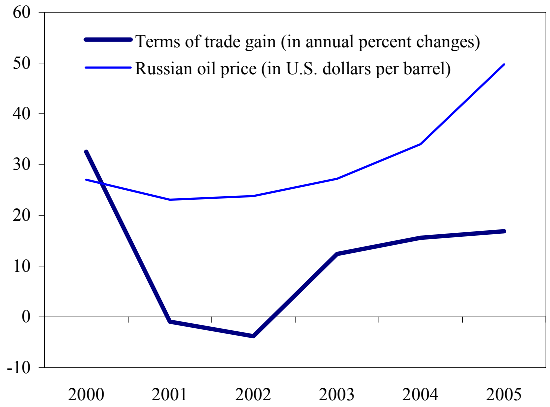
Large terms of trade gains are only partially neutralized.



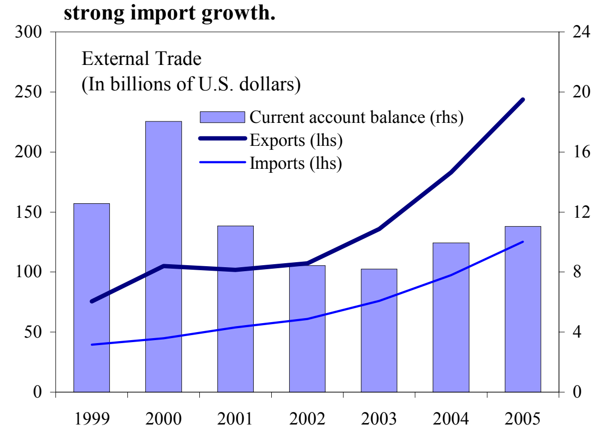
Source: Authorities; Russia Federal State Statistics Service; OECD; and IMF staff estimates and calculations.

Figure 2. Russian Federation: External Developments

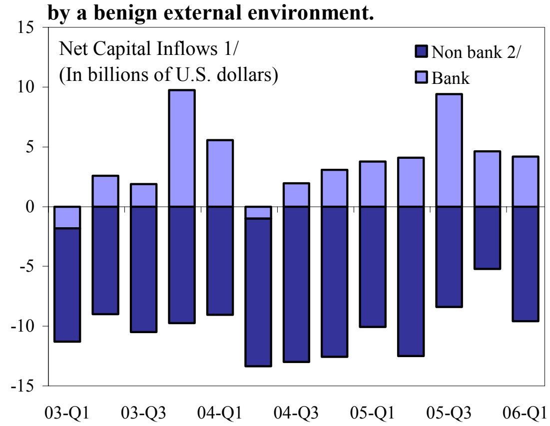
The terms of trade improved once again...



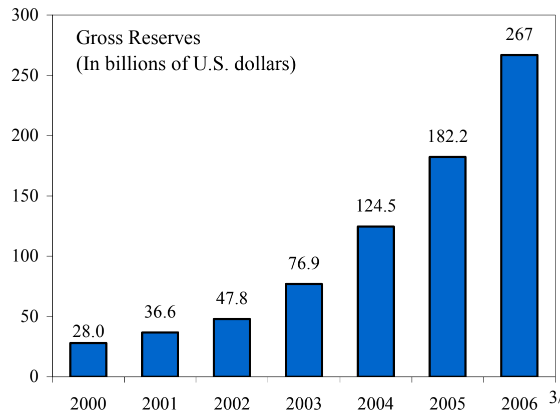
... pushing up the current account surplus, despite strong import growth.



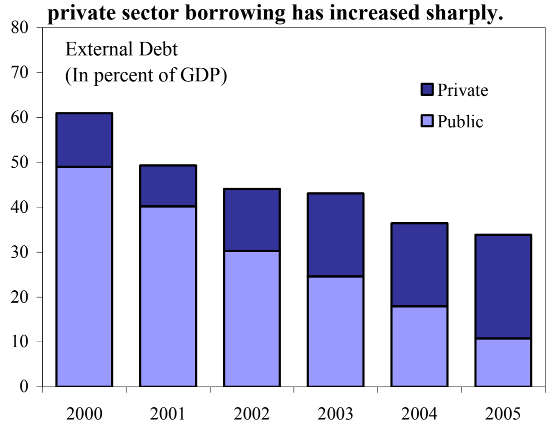
Net private capital inflows have increased helped by a benign external environment.



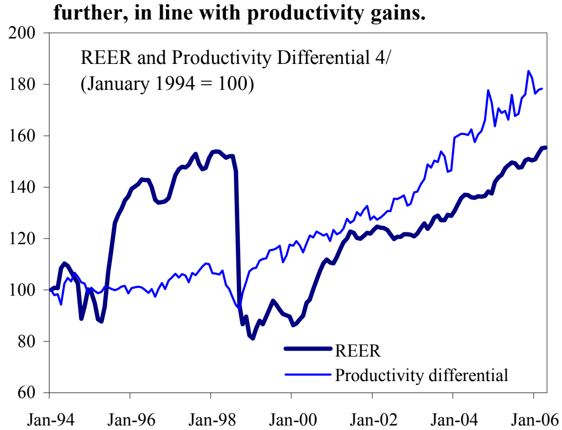
Reserves have continued to swell.



The external debt-to-GDP ratio has declined, but private sector borrowing has increased sharply.



The real effective exchange rate has appreciated further, in line with productivity gains.

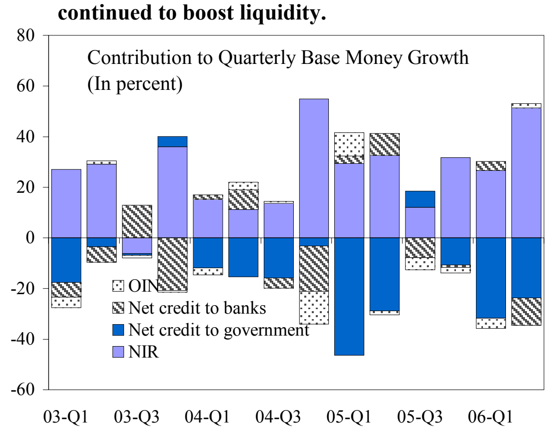


Source: Authorities; Central Bank of Russia; and IMF staff estimates and calculations.

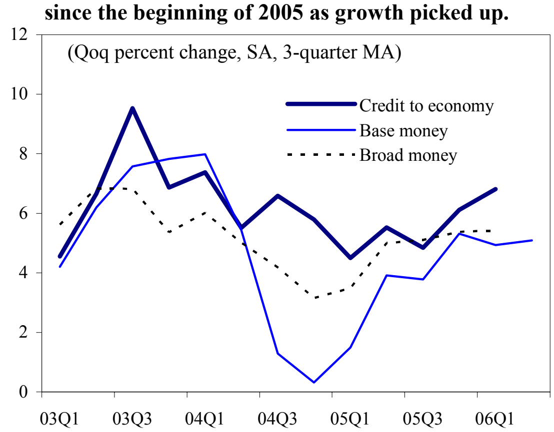
1/ Excludes FDI. Cumulative sum for the trailing 4 quarters.
2/ Includes errors and omissions.
3/ As of end-July, 2006.
4/ Industrial productivity in Russia relative to average industrial productivity in the U.S. and the Euro area.

Figure 3. Russian Federation: Monetary Developments

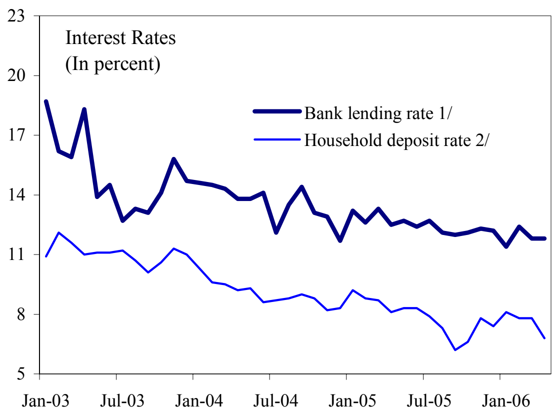
Large foreign exchange interventions have continued to boost liquidity.



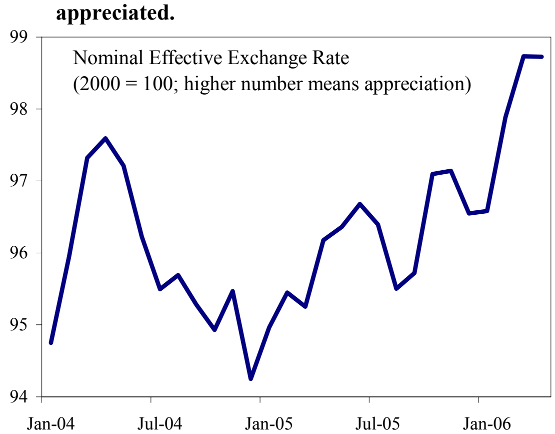
Growth in monetary aggregates has accelerated since the beginning of 2005 as growth picked up.



Yet, monetary conditions have slightly tightened as interest have stopped declining...



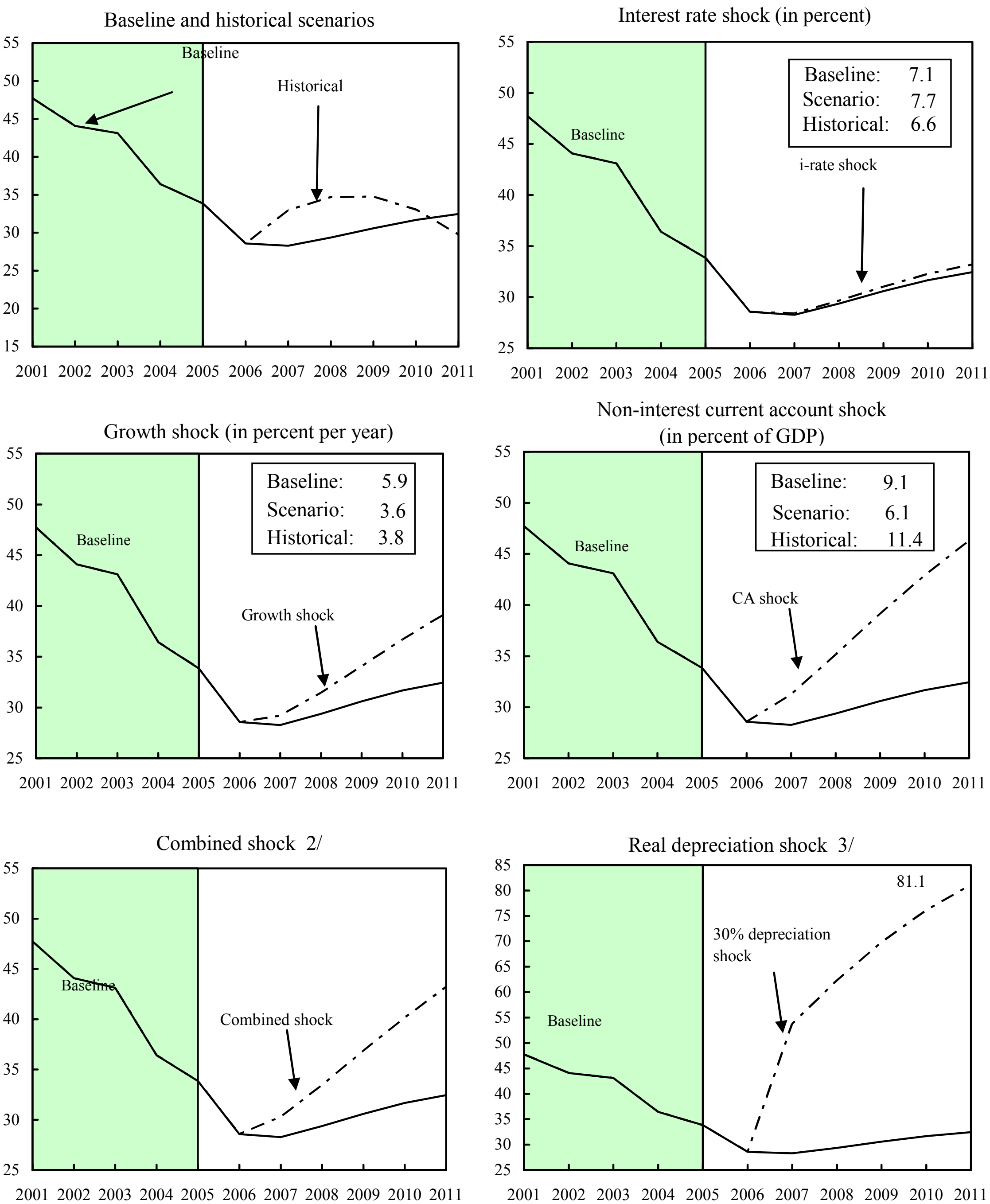
... and the nominal effective exchange rate has appreciated.



Source: Authorities; EMED; INS; and IMF staff estimates and calculations.

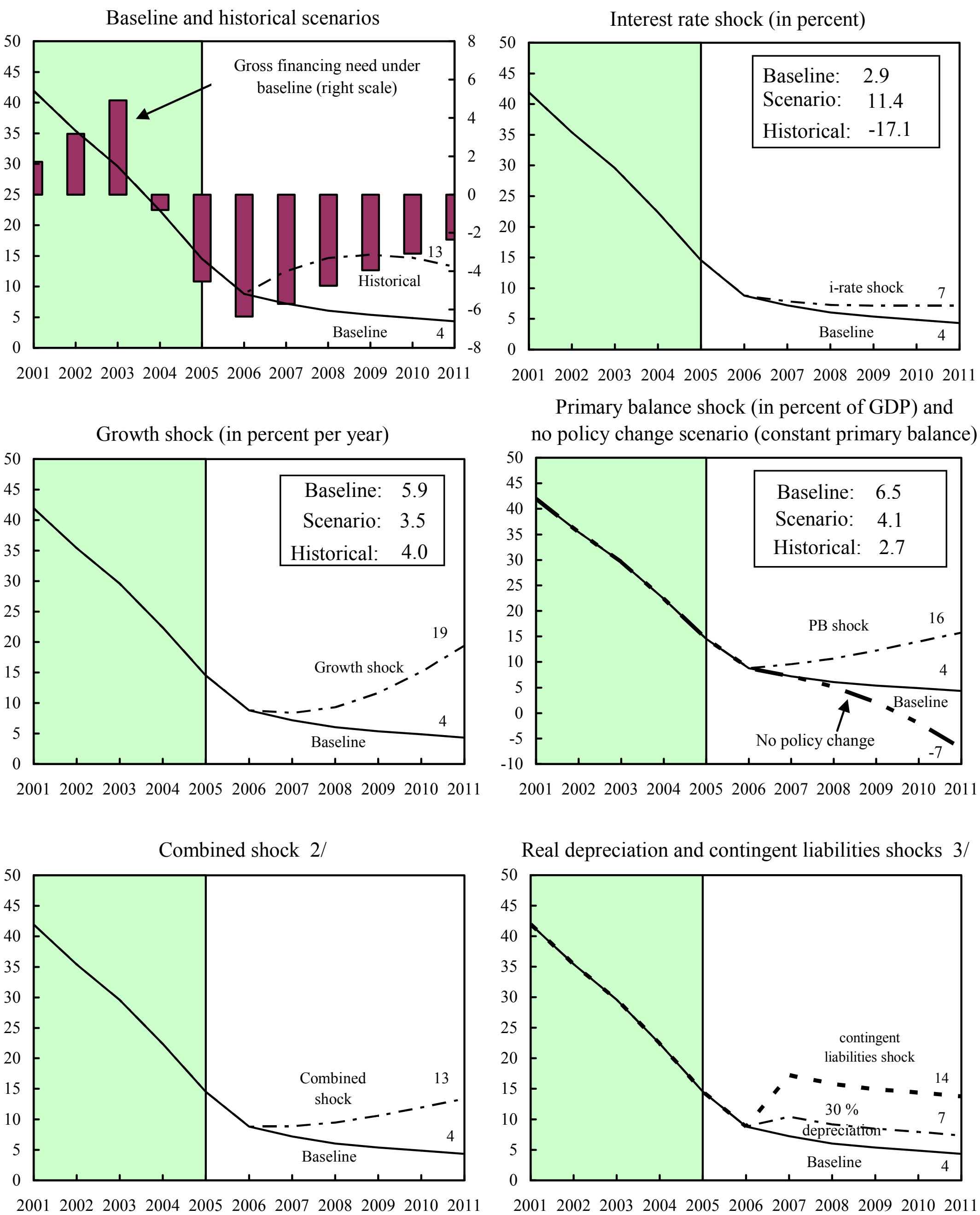
1/ 31 to 90 days.
2/ Excluding demand deposits, all terms.

Figure 4. Russian Federation: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Figure 5. Russian Federation: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



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

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

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2002–07

	2002	2003	2004	2005	2006	2007
		Actual		Est.	Proj.	
			(Annual percent change)			
Production and prices						
Real GDP	4.7	7.3	7.2	6.4	6.5	6.5
Consumer prices						
Period average	15.8	13.7	10.9	12.6	9.7	8.5
End of period	15.1	12.0	11.7	10.9	9.0	8.0
GDP deflator	15.7	14.0	19.5	19.6	15.6	8.9
			(In percent of GDP)			
Public sector						
General government						
Overall balance	0.6	1.4	4.9	8.1	9.2	8.2
Revenue	37.6	36.3	36.8	40.0	41.7	41.9
Expenditures	37.0	34.9	31.9	31.9	32.5	33.6
Primary balance	2.7	3.3	6.3	9.2	10.0	8.7
Nonoil balance (in percent of GDP)	-5.2	-4.6	-4.3	-5.9	-6.9	-7.2
Federal government overall balance	1.3	1.7	4.3	7.5	8.5	7.6
			(Annual percent change)			
Money						
Base money	30.4	49.6	24.9	31.7	39.1	31.9
Ruble broad money	32.3	51.6	35.8	38.6	41.9	33.1
			(Annual percent change)			
External sector						
Export volumes	7.1	12.4	10.5	4.8	4.6	4.5
Oil	15.5	17.2	11.3	2.7	3.4	3.7
Gas	3.0	2.0	5.5	3.4	2.0	2.0
Non-energy	2.4	12.1	11.1	8.0	7.0	6.4
Import volumes	10.9	24.4	21.3	18.5	19.0	15.8
			(In billions of U.S. dollars; unless otherwise indicated)			
External sector						
Total merchandise exports, fob	107.3	135.9	183.2	243.6	319.2	347.5
Total merchandise imports, fob	-61.0	-76.1	-97.4	-125.3	-158.5	-185.1
External current account	29.1	35.4	58.6	83.6	120.1	124.4
External current account (in percent of GDP)	8.4	8.2	9.9	10.9	12.3	10.7
Gross international reserves						
In billions of U.S. dollars	47.8	76.9	124.5	182.2	284.8	416.8
In months of imports 1/	6.8	8.9	11.4	13.3	16.7	21.3
In percent of short-term debt	135	128	198	172	394	511
Memorandum items:						
Nominal GDP (in billions of rubles)	10,831	13,243	16,966	21,598	26,586	30,820
Nominal GDP (in billions of U.S. dollars)	345	431	589	763	975	1,159
Exchange rate (rubles per U.S. dollar, period average)	31.3	30.7	28.8	28.3	27.3	26.6
World oil price (U.S. dollars per barrel, WEO)	25.0	28.9	37.8	53.4	69.2	75.5
Real effective exchange rate (average percent change)	2.8	3.0	7.9	8.7	10.1	7.0

Source: Russian authorities; and IMF staff estimates.

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

Table 2. Russian Federation: Balance of Payments, 2002-07
(In billions of U.S. dollars, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007
				Est.	Proj.	
Current Account	29.1	35.4	58.6	83.6	120.1	124.4
Trade Balance	46.3	59.9	85.8	118.3	160.6	162.4
Exports	107.3	135.9	183.2	243.6	319.2	347.5
Non-energy	51.1	62.2	83.0	94.7	120.1	125.3
Energy	56.2	73.7	100.2	148.9	199.1	222.2
Oil	40.3	53.7	78.3	117.2	158.9	180.4
Gas	15.9	20.0	21.9	31.7	40.2	41.8
Imports	-61.0	-76.1	-97.4	-125.3	-158.5	-185.1
Services	-9.9	-10.9	-13.4	-14.8	-16.5	-18.1
Income	-6.6	-13.2	-13.1	-18.7	-22.8	-18.7
Public sector interest (net)	-2.9	-2.7	-2.2	0.5	4.9	12.4
Other	-3.7	-10.5	-11.0	-19.2	-27.7	-31.1
Current transfers	-0.8	-0.4	-0.7	-1.1	-1.2	-1.2
Capital and financial account	-9.0	2.1	-5.6	-7.5	-17.6	7.7
Capital transfers	-12.4	-1.0	-1.6	-12.8	-1.3	-1.3
Federal Government	5.3	-4.9	-2.4	-9.8	-28.7	-5.8
Portfolio investment	0.2	-1.6	2.8	-1.6	-3.5	-4.5
Loans	-12.5	-1.8	-3.4	-18.3	-25.2	-1.3
Of which:						
Disbursements	0.7	0.8	0.7	0.5	0.0	0.0
Amortization	-11.9	-4.9	-4.9	-19.8	-25.2	-1.3
Other investment	17.6	-1.5	-1.8	10.2	0.0	0.0
Local Governments	-0.1	0.0	0.2	-0.3	-0.1	0.0
Private sector capital	-1.8	7.9	-1.8	15.3	12.5	14.8
Direct investment	-0.1	-1.8	1.7	1.8	11.8	12.4
Portfolio investment	3.2	-1.5	-0.9	-3.3	-3.3	-1.0
Commercial banks	1.9	10.9	4.6	7.9	9.5	10.9
Corporations	8.3	15.1	16.2	40.9	33.8	35.7
Other private capital	-15.1	-14.7	-23.4	-32.0	-39.2	-43.1
Errors and omissions, net	-6.5	-9.7	-6.3	-11.8	0.0	0.0
of which : valuation adjustment	0.2	-2.8	-2.4	3.8	0.0	0.0
Overall balance	13.6	27.8	46.7	64.3	102.5	132.1
Financing	-13.6	-27.8	-46.7	-64.3	-102.5	-132.1
Net international reserves	-12.9	-28.3	-46.9	-64.9	-102.5	-132.1
Gross reserves (- increase)	-11.4	-26.4	-45.2	-61.5	-102.5	-132.1
Net Fund liabilities	-1.5	-1.9	-1.7	-3.4	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	1.5	1.9	1.7	3.4	0.0	0.0
Arrears and rescheduling	-0.8	0.5	0.2	0.6	0.0	0.0
Memorandum items:						
Current account (in percent of GDP)	8.4	8.2	9.9	10.9	12.3	10.7
Gross reserves 1/	47.8	76.9	124.5	182.2	284.8	416.8
(in months of imports of GNFS)	6.8	8.9	11.4	13.3	16.7	21.3
(as a percent of short-term debt) 2/	135	128	198	172	394	511
(as a percent of public debt service)	283	594	371	539	3096	3803
Net private capital outflows (in percent of trade)	4.9	0.8	2.9	-1.0	-2.6	-2.8
World oil price ($barrel) (WEO)	25.0	28.9	37.8	53.4	69.2	75.5
Terms of trade (percent)	-3.8	12.4	15.6	16.8	17.8	3.3
Public external debt service payments 3/	20.7	16.9	13.0	33.5	33.8	9.2
(percent of exports of goods and services)	17.1	11.1	6.4	12.5	9.7	2.4
Public external debt	104.3	106.0	105.6	82.3	53.6	47.8
(percent of GDP)	30.2	24.6	17.9	10.8	5.5	4.1
Private external debt (incl local gov't)	48.0	80.0	108.9	176.1	225.0	279.9
Total external debt	152.3	186.0	214.5	258.4	278.6	327.7
(percent of GDP)	44.1	43.1	36.4	33.9	28.6	28.3

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

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

Table 3. Russian Federation: Fiscal Operations, 2003-07
(In percent of GDP)

	2003	2004	2005	2006 Proj.	2007 Proj.
General Government					
Total Revenue	36.3	36.8	40.0	41.7	41.9
of which: Oil Revenue	6.0	9.2	14.0	16.1	15.5
Tax Revenue	34.0	34.5	36.6	38.6	38.8
Corporate Profit Tax	4.0	5.1	6.1	7.4	8.2
Personal Income Tax	3.4	3.3	3.3	3.3	3.2
VAT	6.7	6.3	6.8	5.7	5.8
Excises	2.6	1.3	1.2	1.1	1.1
Custom Tariffs	3.4	5.1	7.5	9.0	8.7
Resource Extraction Tax	2.6	3.3	4.5	5.0	4.7
Social Security Tax	2.8	2.6	2.6	2.6	2.6
Other	8.5	7.5	4.5	4.4	4.4
Non-Tax Revenue	2.3	2.3	2.2	1.9	1.8
Total Expenditure	34.9	31.9	31.9	32.5	33.6
Interest	1.8	1.4	1.1	0.8	0.5
Non-Interest	33.0	30.5	30.8	31.7	33.1
o/w Education	3.6	3.4	3.4	3.5	3.7
Health	3.6	3.4	3.5	3.6	3.7
Housing & communal Services	1.9	1.8	1.8	1.9	2.0
Other Social Expenditure	9.7	9.1	9.2	9.5	9.9
Primary Balance	3.3	6.3	9.2	10.0	8.7
Overall Balance	1.4	4.9	8.1	9.2	8.2
Non-oil Primary Balance	-2.7	-3.0	-4.8	-6.1	-6.7
Non-oil Overall Balance	-4.6	-4.3	-5.9	-6.9	-7.2
Federal Government					
Total Revenue	16.8	17.6	22.5	23.6	23.4
of which: Oil Revenue	4.4	7.4	11.1	13.1	12.6
VAT	6.7	6.3	6.8	5.7	5.8
Excises	1.9	0.7	0.5	0.4	0.4
Profit Tax	1.3	1.2	1.7	2.2	2.6
Trade Taxes	3.4	5.1	7.5	9.0	8.7
Other Revenue	3.5	4.3	5.9	6.2	5.9
Total Expenditure	15.1	13.3	15.0	15.1	15.8
Interest	1.7	1.2	1.0	0.7	0.4
Non-Interest	13.4	12.1	14.1	14.5	15.4
o/w Wages	3.3	3.4	3.4	3.4	3.4
Primary Balance	3.4	5.5	8.4	9.1	8.0
Overall Balance	1.7	4.3	7.5	8.5	7.6
Non-oil Primary Balance	-1.0	-1.9	-2.7	-4.0	-4.6
Non-oil Overall Balance	-2.7	-3.1	-3.6	-4.7	-5.0
Memorandum items					
World Oil Price	28.9	37.8	53.4	69.2	75.5
Russian Oil Price	27.3	34.3	49.9	65.7	72.0
Oil price balancing the budget:					
General Government	24.1	20.0	26.0	30.5	35.0
Federal Government	19.1	17.5	21.5	27.5	32.0
GDP (billions of rubles)	13,243	16,966	21,598	26,586	30,820

Sources: Russian authorities and Fund staff estimates.

Table 4. Russian Federation: Federal Government Budget, 2004-07
(In percent of GDP)

	2004	2005		2006		2007	
	Actual	Budget	Est.	Budget	Proj.	Budget	Proj.
Revenue	17.6	21.2	22.5	21.6	23.6	20.9	23.4
o/w Oil revenue	7.4	…	11.1	…	13.1	…	12.6
Expenditures	13.3	15.4	15.0	15.2	15.1	16.4	15.8
Overall Balance	4.3	5.8	7.5	6.4	8.5	4.5	7.6
Non-oil Overall Balance	-3.1	…	-3.6	…	-4.7	…	-5.0
Financing (cash)	-4.3	…	-7.5	…	-8.5	…	-7.6
Foreign (net)	-1.1	…	-3.2	…	-2.9	…	-0.5
Gross	0.3	…	0.1	…	0.0	…	0.0
Repayments	1.4	…	3.3	…	2.9	…	0.5
Domestic	-3.2	…	-4.3	…	-5.5	…	-7.1
Monetary authorities	-3.6	…	-4.8	…	-6.1	…	-7.7
Other	0.4	…	0.5	…	0.6	…	0.6
Memorandum items							
Oil Stabilization Fund	3.1		7.0		10.6		16.3
World Oil Price	37.8	…	53.4	…	69.2	…	75.5
Russian Oil Price	34.3	43.0	49.9	62.0	65.7	58.0	72.0
Oil price balancing the budget	17.5	…	21.5	…	27.5	…	32.0
GDP (billions of rubles)	16,966	20,380	21,598	26,420	26,586	29,980	30,820
Real GDP growth	7.2	…	6.4	…	6.5	…	6.5

Sources: Russian authorities and Fund staff estimates.

Table 5. Russian Federation: Monetary Accounts, 2002–07
(In billions of rubles, unless otherwise indicated)

	2002 Dec.	2003 Dec.	2004 Dec.	2005 Dec.	2006 Mar.	2006 June	2006 Dec. Proj.	2007 Dec. Proj.
Monetary authorities								
Base money	935	1,399	1,746	2,298.8	2,172	2,511	3,197	4,216
Currency issued	814	1,225	1,670	2,195	2,061	2,387	3,049	4,017
Required reserves on ruble deposits	121	174	76	103	111	125	149	199
NIR 1/	1,313	2,117	3,358	5,245	5,857	6,974	8,210	12,025
Gross reserves	1,519	2,266	3,456	5,245	5,857	6,974	8,210	12,025
Gross liabilities	206	149	98	0	0	0	0	0
GIR (in billions of U.S. dollars)	*47.8*	*76.9*	*124.5*	*182.2*	*203.5*	*242.3*	*285.2*	*417.8*
NDA	-378	-718	-1,612	-2,946	-3,685	-4,463	-5,012	-7,809
Net credit to enlarged government	34	-181	-840	-2,221	-2,950	-3,463	-4,034	-6,600
Net credit to federal government 2/	102	-79	-692	-2,000	-2,567	-3,039	-3,630	-6,005
CBR net ruble credit to the federal government 1/	76	-21	-617	-1,643	-2,233	-2,643	-3,272	-5,647
Foreign exchange credit	257	261	251	92	92	89	92	92
Ruble counterpart 2/	-231	-319	-326	-449	-425	-485	-449	-449
CBR net credit to local government and EBFs	-68	-101	-148	-221	-383	-425	-404	-596
CBR net credit to local government	-30	-39	-79	-115	-251	-277	-206	-287
CBR net credit to extrabudgetary funds	-38	-62	-69	-106	-132	-147	-199	-309
Net credit to banks	-196	-406	-585	-552	-468	-706	-645	-580
Gross credit to banks	22	17	4	5	19	3	5	5
Gross liabilities to banks and deposits	-218	-422	-589	-557	-487	-709	-650	-586
of which: correspondent account balances	-170	-305	-480	-509	-319	-431	-522	-620
Other items (net) 3/	-216	-132	-186	-174	-268	-293	-333	-628
Monetary survey								
Broad money	2,841	3,962	5,298	7,224	7,440	8,390	9,898	12,852
Ruble broad money	2,120	3,213	4,363	6,046	6,169	7,092	8,576	11,415
Currency in circulation	763	1,147	1,535	2,009	1,929	2,233	2,781	3,659
Ruble deposits	1,356	2,066	2,829	4,036	4,241	4,859	5,795	7,755
Forex deposits 1/	722	749	935	1,178	1,271	1,298	1,322	1,437
Net foreign assets 1/	1,512	2,043	3,180	4,900	5,601	6,420	7,592	11,093
NIR of monetary authorities	1,313	2,117	3,358	5,245	5,857	6,974	8,210	12,025
NFA of commercial banks	199	-74	-177	-345	-257	-554	-618	-932
In billions of U.S. dollars	*6.3*	*-2.5*	*-6.4*	*-12.0*	*-8.9*	*-19.2*	*-21.5*	*-32.4*
NDA	1,330	1,918	2,118	2,324	1,840	1,970	2,306	1,759
Domestic credit	2,493	3,265	3,974	4,107	3,836	4,013	4,251	3,999
Net credit to general government	466	294	-386	-1,743	-2,471	-3,044	-3,564	-6,130
Net credit to federal government	544	379	-231	-1,489	-2,015	-2,475	-3,126	-5,500
Net credit to local government and EBFs	-78	-85	-155	-254	-455	-569	-438	-630
Credit to the economy	2,027	2,971	4,360	5,851	6,307	7,057	7,815	10,129
Other items (net)	-1,164	-1,347	-1,856	-1,784	-1,997	-2,043	-1,945	-2,240
Memorandum items:			(in percent, unless otherwise indicated)					
Accounting exchange rate (eop, ruble per U.S. dollar)	31.8	29.5	27.7	28.8	28.8	28.8	28.8	28.8
Nominal GDP (in billions of rubles)	10,831	13,243	16,966	21,598	...	...	26,586	30,820
CPI inflation (eop, 12-month change)	15.1	12.0	11.7	10.9	10.7	9.0	9.0	8.0
Ruble broad money velocity	5.7	4.6	4.5	4.2	...	...	3.1	2.7
Annual change in velocity	-6.9	-19.6	-1.7	-7.2	...	...	-25.8	-12.9
Real ruble broad money (rel. to CPI, 12 mnth change)	14.9	35.3	21.6	25.0	24.6	31.8	30.1	23.2
Nominal ruble broad money (12 month change)	32.3	51.6	35.8	38.6	37.9	43.9	41.9	33.1
Base money (12 month change) 4/	30.4	49.6	24.9	31.7	30.6	36.2	39.1	31.9
Real credit to the economy (12 month change)	18.1	30.9	31.4	21.0	29.2	33.3	22.5	20.0
Ruble broad money multiplier	2.3	2.3	2.5	2.6	2.8	2.8	2.7	2.7
Real exchange rate (12-month change) 5/	-0.3	6.0	6.8	9.3	7.1	4.7	9.0	6.3
Real exchange rate (average annual change) 5/	2.8	3.0	7.9	8.7	...	...	10.1	7.0

Sources: Russian authorities; and Fund staff estimates.

1/ Data calculated at accounting exchange rates.

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

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

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

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

Table 6. Russian Federation: Macroeconomic Framework, 2003-11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Projections					
I. Savings-Investment Balances									
	(In percent of GDP, unless otherwise indicated)								
General Government									
Consumption	17.6	16.5	16.5	15.9	15.9	15.8	15.6	15.4	15.1
Gross investment	2.8	2.8	3.2	3.3	3.5	3.8	3.8	3.8	3.8
Net income from abroad	-0.6	-0.4	0.1	0.5	1.1	1.5	1.9	2.1	2.3
National savings	4.2	7.7	11.3	12.5	11.7	11.0	9.5	8.5	7.6
National savings - investment	1.4	4.9	8.1	9.2	8.2	7.3	5.8	4.7	3.8
Private Sector									
Consumption	49.4	47.9	47.0	47.0	48.9	50.7	52.0	53.1	53.9
Gross investment	18.0	18.0	17.7	17.2	17.6	18.3	19.2	20.0	20.8
Net income from abroad	-2.5	-2.0	-2.7	-3.0	-2.8	-2.8	-2.8	-2.9	-2.9
National savings	24.8	23.1	20.6	20.4	20.1	19.7	20.4	20.8	21.3
National savings - investment	6.8	5.0	2.8	3.2	2.5	1.3	1.2	0.8	0.6
Overall Economy									
Consumption	68.1	65.5	64.5	63.9	65.8	67.5	68.6	69.4	70.0
Gross investment	20.8	20.8	20.9	20.5	21.1	22.1	23.0	23.8	24.5
Net income from abroad	-3.1	-2.3	-2.6	-2.5	-1.7	-1.3	-1.0	-0.8	-0.6
National savings	29.0	30.8	31.8	32.8	31.8	30.7	29.9	29.3	28.9
National savings - investment (current account)	8.2	9.9	10.9	12.3	10.7	8.6	7.0	5.5	4.4
	(In percent of GDP)								
II. General government accounts									
Revenues	36.3	36.8	40.0	41.7	41.9	40.9	39.3	37.9	36.8
Expenditure	34.9	31.9	31.9	32.5	33.6	33.6	33.5	33.2	33.0
Noninterest expenditure	33.2	30.7	31.0	31.8	33.2	33.2	33.1	32.9	32.7
Overall balance	1.4	4.9	8.1	9.2	8.2	7.3	5.8	4.7	3.8
Primary balance	3.1	6.1	9.1	9.8	8.6	7.7	6.2	5.1	4.2
	(In billions of U.S. dollars, unless otherwise indicated)								
III. Balance of payments and external debt									
External current account	35.4	58.6	83.6	120.1	124.4	111.1	100.2	88.5	77.4
in percent of GDP	8.2	9.9	10.9	12.3	10.7	8.6	7.0	5.5	4.4
Change in external terms of trade (in percent)	12.4	15.6	16.8	17.8	3.3	-2.6	-2.6	-2.9	-2.6
Change in Russian crude oil price (in percent)	15.7	26.5	47.1	31.3	9.5	-1.7	-2.8	-2.5	-1.8
Official reserves	76.9	124.5	182.2	284.8	416.8	538.7	656.7	766.1	864.8
in months of imports	8.9	11.4	13.3	16.7	21.3	25.3	28.7	31.1	32.9
Public external debt service / exports of goods and services (in p	11.1	6.4	12.5	9.7	2.4	2.9	1.6	1.4	1.7
	(In percent, unless otherwise indicated)								
IV. Growth and prices									
Real GDP growth	7.3	7.2	6.4	6.5	6.5	6.1	5.9	5.7	5.5
CPI Inflation, end of period	12.0	11.7	10.9	9.0	8.0	7.0	6.0	5.5	5.0
CPI Inflation, average	13.7	10.9	12.6	9.7	8.5	7.5	6.5	5.7	5.2
Change in GDP deflator, average	14.0	19.5	19.6	15.6	8.9	6.2	5.5	4.9	4.7
Nominal GDP (billions of rubles)	13,243	16,966	21,598	26,586	30,820	34,712	38,771	42,992	47,453
Nominal GDP (billions of U.S. dollars)	431	589	763	975	1,159	1,295	1,441	1,595	1,760
Nominal exchange rate, rubles per U.S. dollar, end of period 1/	29.5	27.7	28.8	26.9	...	...	...	...	...
Nominal exchange rate, rubles per U.S. dollar, average	30.7	28.8	28.3	...	...	...	...	...	...
Real effective exchange rate, average change	3.0	7.9	8.7	10.1	7.0	4.0	3.5	3.0	2.5

Source: Russian authorities; and Fund staff estimates.

1/ At end-July for 2006.

Table 7. Russian Federation: Financial Soundness Indicators, 2002-05 1/

	2002	2003	2004	2005
Capital				
Regulatory capital to risk-weighted assets	19.1	19.1	17.0	16.0
Regulatory capital to risk-weighted assets (Top 30)	19.7	16.8	15.9	15.1
Asset quality				
Nonperforming loans to total gross loans	5.6	5.0	3.8	3.2
Sectoral exposures				
Sectoral distribution of loans to total loans				
Industry	36.7	33.3	28.0	22.1
Manufacturing	...	...	...	16.3
Extraction	...	...	...	3.5
Utilities	...	...	...	2.3
Agriculture	2.2	2.4	2.7	3.0
Construction	4.4	4.4	4.5	4.6
Trade and restaurants	21.6	20.6	18.8	23.9
Transport and communication	4.6	5.1	4.8	4.0
Others	22.4	22.7	24.9	22.8
Individuals	8.0	11.5	16.2	19.6
Regions				
Russia	41.1	54.2	54.0	47.4
U.K.	23.4	9.0	6.6	13.0
U.S.	6.2	8.2	6.7	9.0
Germany	5.9	2.4	7.2	9.5
Austria	5.7	6.8	6.1	5.2
France	1.5	1.6	3.1	3.0
Italy	1.6	1.0	1.8	1.2
Others	14.5	16.8	14.5	11.7
Profitability				
Return on assets	2.6	2.6	2.9	3.2
Return on equity	18.0	17.8	20.3	24.2
Liquidity				
Liquid assets to total assets	39.1	36.1	30.3	27.3
Liquid assets to short-term liabilities	90.6	90.4	78.0	73.8
Market risk				
Net open position in foreign exchange to capital	18.5	8.4	5.8	5.8
Other FSIs				
Loan loss reserves to total gross loans	6.3	5.9	5.3	5.0
Large exposures to capital	228.6	241.0	242.8	239.8
Interest rate risk to capital	6.9	9.9	13.3	13.3
Net open position in equities to capital	11.7	12.4	12.6	14.4

Source: Central Bank of Russia

1/ Credit and depository institutions

Table 8. Russian Federation: Indicators of External Vulnerability, 2002−05
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005
Financial indicators				
Public sector debt 1/	35.4	29.6	22.4	14.5
Broad money (percent change, 12-month basis)	32.3	51.6	35.8	38.6
Private sector credit (percent change, 12 month basis)	36.0	46.6	46.7	34.2
Interbank credit rate (in percent) 2/	13.1	5.5	4.9	3.9
Real interbank credit rate (deflated with historic CPI; in percent) 2/	-2.7	-8.1	-6.0	-8.7
External Indicators				
Exports (percent change in US$)	5.3	26.7	34.8	32.9
Imports (percent change in US$)	13.4	24.8	28.0	28.7
Terms of Trade (percent change, 12 month basis)	-3.8	12.4	15.6	16.8
Current account balance (in billions of US$)	29.1	35.4	58.6	83.6
Capital and financial account balance (in billions of US$)	-9.0	2.1	-5.6	-7.5
o/w: Inward portfolio investment (debt securities etc.)	3.8	-2.3	4.4	-0.9
Other investment (loans, trade credits etc.)	-0.4	5.4	-8.4	6.1
Gross official reserves (in billions of US$)	47.8	76.9	124.5	182.2
Liabilities to the Fund (in billions of US$)	6.4	5.0	3.5	0.0
Short term foreign assets of the financial sector (in billions US$)	13.1	13.4	14.8	20.9
Short term foreign liabilities of the financial sector (in billions US$)	5.0	9.1	9.1	9.8
Foreign currency exposure of the financial sector (in billions US$)	11.4	7.6	7.4	1.9
Official reserves in months of imports GS	6.8	8.9	11.4	13.3
Ruble Broad money to gross reserves	1.4	1.4	1.3	1.2
Total short term external debt to reserves	125.4	81.8	85.1	39.7
Total external debt (in billions of US$)	152.3	186.0	214.5	258.4
o/w: Public sector debt (in billions of US$)	104.3	106.0	105.6	82.3
Total external debt to exports GS (in percent)	126.0	122.2	105.4	96.4
External interest payments to exports GS	9.7	15.3	11.5	12.2
External amortization payments to exports GS	23.9	20.2	19.7	21.7
Exchange rate (per US$, period average)	31.3	30.7	28.8	28.3
REER depreciation (-) (12 month basis)	2.8	3.0	7.9	8.7
Financial Market Indicators				
Stock market index 3/	359.1	567.3	614.1	1125.6
Foreign currency debt rating 4/	BB	BB	BB+	BBB
Spread of benchmark bonds (basis points, end of period) 5/	478.0	257.0	213.0	118.0

Source: Russian authorities; and IMF staff estimates.

1/ Gross debt of the general government.
2/ Moscow interbank actual credit rate (MIACR) for 8-30 days (annualized).
3/ RTS index, end of period.
4/ S&P long-term foreign currency debt rating, eop.
5/ JPMorgan EMBIG Russia Sovereign Spread.

Table 9. Russian Federation: External Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	47.7	44.1	43.1	36.4	33.9	**28.6**	**28.3**	**29.4**	**30.6**	**31.7**	**32.5**	**-1.8**
Change in external debt	-13.9	-3.6	-1.0	-6.7	-2.6	-5.3	-0.3	1.1	1.2	1.1	0.8	
Identified external debt-creating flows (4+8+9)	-20.9	-13.8	-16.8	-22.1	-19.5	-15.2	-13.4	-11.1	-9.4	-8.0	-6.8	
Current account deficit, excluding interest payments	-14.2	-10.9	-10.3	-11.8	-12.6	-14.1	-12.4	-10.4	-8.8	-7.5	-6.4	
Deficit in balance of goods and services	-12.7	-10.6	-11.3	-12.3	-13.5	-14.8	-12.4	-9.8	-7.9	-6.3	-5.0	
Exports	37.0	35.0	35.3	34.5	35.1	35.8	32.7	29.6	27.0	24.8	23.0	
Imports	24.2	24.4	23.9	22.3	21.6	21.0	20.3	19.7	19.1	18.5	17.9	
Net non-debt creating capital inflows (negative)	-0.4	0.0	0.2	-0.6	-0.3	-1.2	-1.1	-1.0	-0.9	-0.9	-0.8	
Automatic debt dynamics 1/	-6.3	-2.9	-6.7	-9.6	-6.6	0.1	0.1	0.2	0.3	0.4	0.5	
Contribution from nominal interest rate	3.1	2.5	2.0	1.9	1.6	1.8	1.7	1.8	1.9	2.0	2.0	
Contribution from real GDP growth	-2.7	-2.0	-2.6	-2.3	-1.8	-1.7	-1.6	-1.5	-1.6	-1.6	-1.6	
Contribution from price and exchange rate changes 2/	-6.8	-3.4	-6.2	-9.3	-6.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	7.0	10.2	15.8	15.4	16.9	10.0	13.1	12.2	10.7	9.1	7.6	
External debt-to-exports ratio (in percent)	129.1	126.0	122.2	105.4	96.4	79.8	86.4	99.3	113.4	127.7	141.3	
Gross external financing need (in billions of US dollars) 4/	-1.7	12.9	10.3	7.7	4.7	-14.1	-52.1	-29.5	-15.5	3.5	24.3	
in percent of GDP	-0.5	3.7	2.4	1.3	0.6	-1.4	-4.5	-2.3	-1.1	0.2	1.4	
Scenario with key variables at their historical averages 5/						**28.6**	**32.9**	**34.7**	**34.8**	**33.1**	**29.7**	**-1.5**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.1	4.7	7.3	7.2	6.4	6.5	6.5	6.1	5.9	5.7	5.5	
GDP deflator in US dollars (change in percent)	12.3	7.6	16.4	27.4	21.8	20.0	11.6	5.3	5.1	4.7	4.6	
Nominal external interest rate (in percent)	6.0	5.9	5.8	6.0	5.8	6.7	7.0	7.0	7.1	7.1	7.1	
Growth of exports (US dollar terms, in percent)	-1.1	6.7	25.8	33.7	31.8	30.3	8.5	1.0	1.6	1.8	2.1	
Growth of imports (US dollar terms, in percent)	21.7	13.6	22.2	27.1	25.6	24.6	14.5	8.7	7.7	7.4	6.9	
Current account balance, excluding interest payments	14.2	10.9	10.3	11.8	12.6	14.1	12.4	10.4	8.8	7.5	6.4	
Net non-debt creating capital inflows	0.4	0.0	-0.2	0.6	0.3	1.2	1.1	1.0	0.9	0.9	0.8	

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

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

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

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

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

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

Table 10. Russian Federation: Public Sector Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing primary balance**
Baseline: Public sector debt 1/	42.0	35.4	29.6	22.4	14.5	**8.8**	**7.2**	**6.0**	**5.4**	**4.9**	**4.3**	**0.0**
o/w foreign-currency denominated	36.2	30.2	24.6	17.9	10.8	5.5	4.1	3.1	2.5	2.1	1.6	
Change in public sector debt	-14.8	-6.5	-5.8	-7.2	-7.9	-5.7	-1.6	-1.2	-0.7	-0.5	-0.5	
Identified debt-creating flows (4+7+12)	-11.5	-5.5	-8.4	-12.6	-13.2	-11.9	-9.4	-8.1	-6.4	-5.3	-4.3	
Primary deficit	-5.4	-2.7	-3.3	-6.3	-9.2	-10.0	-8.7	-7.8	-6.3	-5.2	-4.3	
Revenue and grants	37.3	37.6	36.3	36.8	40.0	41.7	41.9	40.9	39.3	37.9	36.8	
Primary (noninterest) expenditure	31.9	34.9	33.0	30.5	30.8	31.7	33.1	33.1	33.0	32.7	32.5	
Automatic debt dynamics 2/	-6.1	-2.8	-5.1	-6.4	-4.0	-1.9	-0.7	-0.3	-0.1	-0.1	0.0	
Contribution from interest rate/growth differential 3/	-7.7	-5.2	-4.6	-5.1	-3.7	-1.9	-0.7	-0.3	-0.1	-0.1	0.0	
Of which contribution from real interest rate	-5.3	-3.6	-2.5	-3.5	-2.6	-1.2	-0.2	0.1	0.2	0.2	0.2	
Of which contribution from real GDP growth	-2.4	-1.6	-2.1	-1.7	-1.1	-0.8	-0.5	-0.4	-0.3	-0.3	-0.2	
Contribution from exchange rate depreciation 4/	1.6	2.4	-0.5	-1.2	-0.3	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-3.4	-1.0	2.6	5.5	5.3	6.1	7.9	6.9	5.7	4.7	3.8	
Public sector debt-to-revenue ratio 1/	112.5	94.2	81.5	60.9	36.3	21.1	17.2	14.8	13.7	12.8	11.8	
Gross financing need 6/	1.7	3.2	4.9	-0.8	-4.5	-6.4	-5.7	-4.8	-4.0	-3.1	-2.3	
in billions of U.S. dollars	5.1	10.8	22.1	-4.9	-34.0	-63.2	-66.5	-60.9	-57.4	-49.0	-41.5	
Scenario with key variables at their historical averages 7/						**8.8**	**12.5**	**14.6**	**15.2**	**14.7**	**13.2**	**-2.6**
Scenario with no policy change (constant primary balance) in 2005-2010						**8.8**	**7.2**	**5.1**	**2.1**	**-2.0**	**-6.9**	**0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.1	4.7	7.3	7.2	6.4	6.5	6.5	6.1	5.9	5.7	5.5	
Average nominal interest rate on public debt (in percent) 8/	5.8	6.1	6.4	5.9	6.3	6.9	6.5	8.6	9.8	9.7	9.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-10.7	-9.6	-7.6	-13.6	-13.4	-8.7	-2.4	2.4	4.4	4.8	5.3	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.6	-6.9	2.1	6.6	1.8	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	16.5	15.7	14.0	19.5	19.6	15.6	8.9	6.2	5.5	4.9	4.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	14.2	14.4	1.5	-1.0	7.5	9.5	11.4	5.9	5.6	4.9	4.9	
Primary deficit	-5.4	-2.7	-3.3	-6.3	-9.2	-10.0	-8.7	-7.8	-6.3	-5.2	-4.3	

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

APPENDIX I: RUSSIAN FEDERATION: FUND RELATIONS

As of July 31, 2006

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

II. **General Resources Account**:

	SDR Million	Percent of Quota
Quota	5,945.40	100.00
Fund holdings of currency	5,791.24	97.41
Reserve position	154.19	2.59

III. **SDR Department**:

	SDR Million	Percent of Allocation
Holdings	4.66	n.a.

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

V. **Latest Financial Arrangements**:

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

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

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

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

IX. **Exchange Arrangements**: Managed float with no pre-determined path for the exchange rate. The exchange rate of the ruble is determined in the interbank foreign exchange market, which was unified on June 29, 1999. The interbank market electronically links exchanges across the country. The official rate of the ruble is set equal to the previous day's weighted average rate in the interbank market.

The Russian Federation accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement with effect from June 1, 1996. At the time of the last Article IV consultation on September 7, 2005, the Russian

Federation maintained only one exchange restriction subject to the approval of the Executive Board under Article VIII, Sections 2 and 3 without the Board approval.

X. **Article IV Consultation**: Russia is on the standard 12-month consultation cycle. The last consultation was concluded on September 7, 2005.

XI. **FSAP Participation and ROSCs**

Russia participated in the Financial Sector Assessment Program during 2002, and the FSSA report was discussed by the Board in May 2003, at the time of the 2003 Article IV discussion (IMF Country Report No. 03/147). An MFD TA mission on key monetary, banking, and related issues took place in April 2004. In addition, a long-term advisor on banking supervision resides in Moscow.

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

XII. **Resident Representatives**:

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

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

1. The current Country Assistance Strategy (CAS) was approved by the Bank's Board in June 2002, and the CAS Progress Report (CASPR) was approved in April 2005. A new Country Partnership Strategy (CPS) until 2009 is under preparation in 2006. Overall, the Bank strategy envisages continued emphasis on support to implementation of structural reforms at the federal and sub-national levels. In particular, the current CAS emphasizes the need to (1) improve the business environment in order to encourage new firm growth; (2) strengthen public sector management (including civil service reform, intergovernmental finance reform and support of judicial reforms); and (3) safeguard against the social and environmental risks of transition. The CASPR further emphasizes four areas for collaboration with Russia for the remainder of the CAS period (through mid-2006) and for a subsequent Country Partnership Strategy: (1) design and implementation of complex federal-level institutional reforms, (2) regional development, (3) the establishment of an efficient framework for developing private-public partnerships, and (4) Russia's integration into the G-8 framework. The World Bank Group (WBG)'s work in each of these areas is described in more detail below. Further cooperation until 2009 includes the areas of macroeconomic stability, the investment climate, diversification, public sector management, regional development, social services, and assistance with Russia's growing global role in the international and donor community. Given limited needs in borrowing by the federal government, World Bank work will be concentrated increasingly in the regions on the basis of direct cooperation with selected Subjects of the Federation. Operations will be based largely on new modalities of cooperation, including direct operations in the regions, co-financing, and fee-for-service.

Contribution to progress on CAS strategic pillars

Improving the business environment and enhancing competition

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

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

Moscow Higher School of Economics. This study is based on a survey instrument that provides information on many questions related to the competitiveness of Russian industry. The Foreign Investment Advisory Service of the International Financial Corporation (IFC) has been conducting special recent work on administrative barriers to access to land. A new stage of work on the Country Economic Memorandum examines barriers to growth at the regional level.

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

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

Strengthening public sector management

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

- ***Administrative and budget reform****:* The Bank is working closely with the government on administrative and civil service reforms. This includes on-going TA on reforming government administration at the federal and regional levels. In addition, since 2004, the Bank has been providing technical assistance on the design of a performance-based budgeting system. The Bank has also worked to improve monitoring and analytical capacity in the public sector, including a multi-year project on Improving Measurement, Monitoring, and Analysis of Poverty.

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

- ***Fiscal federalism****:* jointly with the ministry of finance, the Bank has developed and piloted an effective federal-level fiscal instrument for supporting economic, budgetary and fiscal improvements at the regional level. Under the Fiscal Federalism and Regional

Fiscal Reform loan, the Regional Fiscal Reform Fund provided incentive-based fiscal grants to 15 participating regions that have implemented broad-ranging reforms of their fiscal and asset management, and budget execution, and have adopted more transparent regulations for equalizing transfers and tax sharing. As of 2006, this project has expanded to the municipal level.

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

Mitigating social and environmental risks

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

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

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

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

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

Government current priorities and CASPR/CPS focus areas

5. Russia's strong fiscal position and access to financial markets limit the need for sovereign borrowing, while at the same time the country still faces major tasks on many fronts. Some, like housing and communal reform, are related to an unfinished transition, while others, like public-private partnerships, aim at creating new drivers for economic diversification and growth. Progress in transformation across a vast country is understandably uneven, and attention must be focused on the growing gap between prosperous and lagging regions. Capacity and financial constraints slow down local implementation of well-designed reforms. Tackling these constraints on a large scale requires all the resources Russia can mobilize domestically and internationally.

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

Design and implementation of complex federal-level institutional reforms

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

Regional development

8. At the sub-national level, the development agenda is huge, and demand by local authorities for stable project financing and project management expertise is far from being saturated even in the most prosperous of regions. Work at this level will concentrate on a small number of regions agreed with the government and be supported by a three-pronged

approach in order to address the diverse economic, social and human development needs of Russia's regions:

- Well-performing and creditworthy regions may benefit from fee-for-service arrangements or lending without sovereign guarantees. This opportunity currently exists through the IFC municipal development facility, and a first operation has been completed in the Chuvashia Republic. Russia has expressed an interest in developing cooperation further these lines, and the WBG is currently considering the adoption of a new instrument that could expand the scope for such cooperation.

- For those regions that are making progress, but lack significant resources or creditworthiness, regional will proceed on the basis of cooperation with the federal government, donors, and (to a limited extent) the Bank's own resources. A current project in the Southern Federal Okrug with a particular focus on government administration is an example of such cooperation.

Establishing efficient framework for developing private-public partnerships

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

Russia's integration into the G-8 framework

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

11. In terms of operational modalities, discussions with the government indicate strong interest in more flexible access to a broad menu of Bank instruments (AAA, TA, lending, fee-for-service, guarantees). The Bank-supported projects at the federal level are to be fully integrated into the Russian Federation budget, including its Federal Targeted Programs, with

a three to five year planning horizon to better support the government's mid-term development programs. The government is interested in flexible co-financing arrangements that would minimize sovereign borrowing. More specifically, the government is already moving to increase its share of financing (up to 90 percent) under some of the on-going and future projects, and expresses strong interest in the development by the Bank of a facility for sub-national lending without a sovereign guarantee. Other instruments of significant interest include investment loans with contingent disbursements, partial credit risk guarantees, and fee-for-service work with no borrowing requirements.

APPENDIX III. RUSSIAN FEDERATION: STATISTICAL ISSUES

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

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

3. Since January 31, 2005, the Russian Federation is a subscriber to the SDDS. However, data on general government operations (GGO) in the National Summary Data Page (NSDP) currently refer to 2003.

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

National accounts

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

6. The delay in finalizing a modern statistics law—requiring firms to provide data with credible penalties for noncompliance, together with a guarantee of confidentiality—is an impediment to further improvement of national accounts data. Furthermore, revisions to the data are not flagged when they are disseminated. As a result, it is difficult for users, including the Fund, to maintain any form of consistent time series.

Prices

7. Rosstat compiles a national consumer price index (CPI) of good quality, which was developed with Fund technical assistance. Following a moderation of inflation, Rosstat stopped the weekly publication of headline inflation in January 2003, retaining only monthly reports. In addition, Rosstat has begun publication of monthly core inflation data. Further improvements could be made on the basis of a new household budget survey—which has been under consideration for some time—and by the current efforts to improve the treatment of seasonal items in the index. World Bank and TACIS assistance is available in these areas. Rosstat also publishes a producer price index, and the State Customs Committee has initiated the development of foreign trade price indexes.

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

Government finance statistics

9. The staff is provided with monthly information on revenues, expenditures, and financing of the federal government and annual information on revenues, expenditures, and financing of local governments and extrabudgetary funds. The published functional classification of expenditure differs slightly from international standards. Expenditure data, classified by economic type, need improvement. Presently, annual data are compiled with a long delay. Data on domestic and external federal debt are compiled monthly, but are made public only in summary form on a quarterly basis. In addition, there is no unified debt monitoring and reporting system. In the context of a work program for statistical improvement agreed with STA, there have been ongoing improvements in the coverage and quality of GFS data, although expenditure data remain poor. The reform of budgetary accounting is well advanced and includes the introduction of accrual accounting for the whole of government. In the 2005 Government Finance Statistics Yearbook (GFSY), data for the central, local and general government were reported to 2004 on both accrual and cash basis in accordance with the *Government Finance Statistics Manual 2001 (GFSM 2001*) methodology. The Treasury has been reporting aggregate government finance data for publication in *IFS* on a cash basis since April 1996.

Monetary statistics

10. Monetary data are reasonably comprehensive and generally in accordance with international standards. Classification and sectorization are in line with the methodological guidelines, except that financial derivatives (which are at an initial stage of development) are not included in the instrument classification. The basis of recording broadly follows methodological recommendations. Since 2006, monetary gold is valued at current quotations set by the CBR. Following the 2003 data ROSC recommendations, the authorities included

all non-operational credit institutions in the coverage of the monetary statistics and reclassified their deposits as restricted deposits. The Central Bank of Russia (CBR) intends to revise further its compilation procedures to conform fully to the guidelines of the *Monetary and Financial Statistics Manual 2000*.

11. Analytical accounts for the monetary authorities and commercial banks are reported for publication in *IFS* with a lag of one month. Timely interest rate data are available. The CBR has yet to conclude compilation of monetary data using new Standardized Report Forms (SRFs). At the request of the authorities, a TA mission is slated to visit Moscow in April 2007 to assist in expanding the coverage to include other (non-depository) financial corporations and to facilitate the completion of the SRFs.

External sector statistics

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

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

14. As noted, Russia disseminates the data template on international reserves and foreign currency liquidity. However, published historic series on reserves have not been corrected for changes in definitions. Headline data on reserves are reported to the Fund and the markets on a weekly basis with a four-business day lag. The Fund receives additional detail on reserves and reserve liabilities through the central bank balance sheet, but this is not as comprehensive as the reserve template, which is disseminated with a lag of twenty days.

15. Quarterly external debt data are now published by sector, maturity, instrument, and currency, with a lag of one quarter as prescribed by the SDDS. However, while improvements have been made, there are a number of gaps in data, notably the lack of a debt service schedule and historical external debt data for pre-2003 periods. Information on gross external payments, for example, for the banking system, is needed for monitoring liquidity

risk. There is also a need to monitor corporate sector off-balance sheet obligations and more generally, information on interest and exchange rate exposure of the sector.

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

RUSSIAN FEDERATION: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

As of September 7, 2006

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality Accuracy and reliability[8]
Exchange Rates	9/7/06	9/7/06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	8/25/06	8/31/06	W	W	W		
Reserve/Base Money	8/28/06	9/1//06	W	W	W	O, LO, LO, LO	O, O, O, O, O
Broad Money	7/1/06	8/7/06	M	M	M		
Central Bank Balance Sheet	8/1/06	8/7/06	M	M	M		
Consolidated Balance Sheet of the Banking System	7/1/06	8/7/06	M	M	M		
Interest Rates[2]	9/7/06	9/7/06	D/W/M	D/W/M	D/W/M		
Consumer Price Index	Aug 2006	9/5/06	M	M	M	LO, LO, LO, LO	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	June 05	A	A	A	LNO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	February 2006	April 06	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4/05	April 06	Q	Q	Q		
External Current Account Balance	Q1 2006	07/10/06	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Q1 2006	07/10/06	Q	Q	Q		
GDP/GNP	Q1 2006	8/9/06	Q	Q	Q	O, O, LNO, O	LO, LO, O, O, O
Gross External Debt	Q1 2006	6/30/06	Q	Q	NA		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

[7] Reflects the assessment provided in the data ROSC published on May 2004 and based on the findings of the mission that took place during October 8–23, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
October 18, 2006

Since the issuance of the staff report there has been a significant decline in oil prices and the government has changed proposals for the supplementary 2006 budget and the 2007 budget.

1. The new WEO oil price projections imply a decline in the average oil price of 7¼ percent in 2006 and 17 percent in 2007, compared to the assumptions in the staff report. Despite this decline, the average oil price is still projected to be more than 20 percent higher in 2006 than in 2005. Approximately two-thirds of the lower oil revenues will automatically be absorbed by lower savings in the oil stabilization fund. Moreover, as discussed in the staff report, a significant impulse continues to arise from previous years' large terms-of-trade gains as spending plans have not yet fully adjusted to such gains. In this regard, recent high frequency data confirm that the momentum in real GDP growth remains strong. Against this background, staff has maintained its projections of real GDP growth at 6½ percent in both 2006-07, but has lowered its projections of the current account surplus and reserve accumulation (Table 1).

2. Since the issuance of the staff report, the authorities have changed the proposed supplementary budget for 2006, which is expected to be submitted to the Duma later this year, and the 2007 budget, which has already passed the second reading by the Duma. The changes imply increases in spending of about ¼ percent of GDP in 2006 and ½ percent of GDP in 2007, compared to the projections in the staff report, and an increase in the oil price at which the 2007 budget is balanced to $40 per barrel (Table 2). In addition, as a result of the lower oil price assumptions, government revenues are also projected to be considerably lower than in the staff report. Staff estimates that these changes entail an additional impulse of ½ percent of GDP in 2006 and ¾ percent of GDP in 2007 in terms of the combined effect of changes in the terms-of-trade and in the fiscal stance (Table 3). Thus, the relaxation of the fiscal stance more than compensates for the negative impact of lower oil prices. In view of this, staff has increased its inflation projection by ¼ percentage points for both 2006 and 2007, compared to the staff report.

3. The thrust of the staff appraisal has not changed. At the same time, the revisions have reinforced staff's concerns that the relaxation in the non-oil fiscal balance at a time when private sector demand remains very buoyant will add to inflationary pressures, and that there will emerge over the medium term a non-oil deficit and structure of public spending that cannot be sustained.

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2002–07

	2002	2003	2004	2005	2006	2007
		Actual		Est.	Proj.	
	(Annual percent change)					
Production and prices						
Real GDP	4.7	7.3	7.2	6.4	6.5	6.5
Consumer prices						
Period average	15.8	13.7	10.9	12.7	9.7	8.6
End of period	15.1	12.0	11.7	10.9	9.3	8.0
GDP deflator	15.7	14.0	19.5	19.6	14.4	7.5
	(In percent of GDP)					
Public sector						
General government						
Overall balance	0.6	1.4	4.9	8.1	7.6	4.7
Revenue	37.6	36.3	36.8	40.0	39.8	37.9
Expenditures	37.0	34.9	31.9	31.9	32.3	33.2
Primary balance	2.7	3.3	6.3	9.2	8.4	5.2
Nonoil balance (in percent of GDP)	-5.2	-4.6	-4.3	-5.9	-7.4	-8.3
Federal government overall balance	1.3	1.7	4.3	7.5	6.9	4.0
	(Annual percent change)					
Money						
Base money	30.4	49.6	24.9	31.7	47.6	42.5
Ruble broad money	32.3	51.6	35.8	38.6	50.5	43.8
	(Annual percent change)					
External sector						
Export volumes	7.1	12.4	10.5	4.8	4.7	4.7
Oil	15.5	17.2	11.3	2.7	3.4	3.7
Gas	3.0	2.0	5.5	3.4	2.0	2.0
Non-energy	2.4	12.1	11.1	8.0	7.0	6.7
Import volumes	10.9	24.4	21.3	18.5	19.1	17.1
	(In billions of U.S. dollars; unless otherwise indicated)					
External sector						
Total merchandize exports, fob	107.3	135.9	183.2	243.6	307.8	317.9
Total merchandize imports, fob	-61.0	-76.1	-97.4	-125.3	-158.6	-187.4
External current account	29.1	35.4	58.6	83.2	108.2	93.3
External current account (in percent of GDP)	8.4	8.2	9.9	10.9	11.2	8.2
Gross international reserves						
In billions of U.S. dollars	47.8	76.9	124.5	182.2	273.6	377.2
In months of imports 1/	6.8	8.9	11.4	13.3	16.0	19.1
In percent of short-term debt	135	128	198	172	388	486
Memorandum items:						
Nominal GDP (in billions of rubles)	10,831	13,243	16,966	21,598	26,297	30,101
Nominal GDP (in billions of U.S. dollars)	345	431	589	763	966	1,132
Exchange rate (rubles per U.S. dollar, period average)	31.3	30.7	28.8	28.3	27.2	26.6
World oil price (U.S. dollars per barrel, WEO)	25.0	28.9	37.8	53.4	64.4	63.3
Real effective exchange rate (average percent change)	2.8	3.0	7.9	8.7	10.3	7.0

Source: Russian authorities; and IMF staff estimates.

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

Table 2. Russian Federation: Summary of Federal Government Budget, 2005-07
(In billions of rubles and in percent of GDP in italics)

	2005	2006				2007			
		Budget		Staff		Budget		Staff	
		Staff Report	September 1/	Staff Report	September 1/	Staff Report	September 2/	Staff Report	September 2/
Revenues 2/	4,856.4	5,710.0	5,850.0	6,274.9	5,886.2	6,272.0	6,596.3	7,226.5	6,306.8
	22.5	*21.6*	*21.5*	*23.6*	*22.4*	*20.9*	*21.1*	*23.4*	*21.0*
Expenditure	3,244.7	4,024.0	4,080.0	4,024.0	4,080.0	4,925.0	5,094.5	4,881.0	5,094.5
	15.0	*15.2*	*15.0*	*15.1*	*15.5*	*16.4*	*16.3*	*15.8*	*16.9*
Balance	1,611.7	1,686.0	1,770.0	2,250.9	1,806.2	1,347.0	1,501.8	2,345.5	1,212.3
	7.5	*6.4*	*6.5*	*8.5*	*6.9*	*4.5*	*4.8*	*7.6*	*4.0*
Oil price balancing the budget (US$)									
Federal government	21.5	...	...	27.5	29.5	...	...	32.0	39.5
General government	26.0	...	...	30.5	32.3	...	...	35.0	39.8
GDP	21,598.0	26,420.0	27,220.0	26,585.6	26,297.3	29,980.0	31,220.0	30,819.9	30,101.3
Russian oil price (US$)	49.9	62.0	65.0	65.7	60.9	58.0	61.0	72.0	59.8

Source: Ministry of Finance; and staff calculations.

1/ Reflects the expected amendment to the 2006 budget as formulated by the authorities.
2/ Reflects the draft 2007 budget as approved by the Duma in the first reading on September 22.

Table 3. Russian Federation: Summary Table (revised) 1/

	2001	2002	2003	2004	2005	2006		2007	
						Proj.		Proj.	
						Staff report	October	Staff report	October
	(In percent of GDP)								
Federal Government									
Overall Balance	2.7	1.3	1.7	4.3	7.5	8.5	6.9	7.6	4.0
Non-Oil Balance	-1.2	-2.7	-2.7	-3.1	-3.6	-4.7	-5.3	-5.0	-6.5
Fiscal Impulse 2/	0.0	2.2	0.4	-2.0	-2.9	-0.6	1.0	1.2	3.2
Non-Oil Fiscal Impulse 3/	0.3	2.3	0.8	1.0	0.8	1.4	2.1	0.6	1.5
General Government									
Overall Balance	2.7	0.6	1.4	4.9	8.1	9.2	7.6	8.2	4.7
Non-Oil Balance	-3.3	-5.2	-4.6	-4.3	-5.9	-6.9	-7.4	-7.2	-8.3
Fiscal Impulse 2/	2.9	3.2	0.3	-2.8	-2.9	-0.5	1.1	1.4	3.4
Non-Oil Fiscal Impulse 3/	2.1	3.0	0.6	0.4	1.8	1.6	2.1	0.8	1.4
Terms-of-trade Gain 4/	-1.4	0.1	2.2	3.8	5.0	4.7	3.7	0.6	-0.9
A. Change in Energy Exports 4/	0.4	2.2	3.8	3.7	6.2	4.6	3.4	1.6	0.0
B. Change in General Government Overall Balance 4/	0.1	-1.6	0.9	3.8	4.2	2.6	0.9	0.3	-1.9
Combined Contribution to GDP growth (A-B)	0.3	3.8	2.9	-0.2	1.9	2.0	2.5	1.2	1.9

Sources: Russian authorities and Fund staff estimates.

1/ Revised text table, paragraph 10 of the staff report.
2/ Defined as the yearly change in the fiscal stance. See Chapter II of the 2005 Selected Issues paper for a discussion of alternative definitions of the fiscal impulse.
3/ Defined as the fiscal impulse plus the yearly change in oil revenue.
4/ As a percent of current year GDP.

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

IMF Concludes 2006 Article IV Consultation with the Russian Federation

On October 18, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Russian Federation.[1]

Background

Propelled by large terms-of-trade gains, GDP has regained momentum. Growth has recovered from a yearly rate of about 5 percent in early 2005 to about 7 percent at present, broadly the same pace as before the 2004 slowdown. The renewed momentum reflects a recovery in investments, as a confluence of negative factors that depressed capital spending in the second half of 2004 has waned against the backdrop of continued terms-of-trade gains. Consumption remains, however, the main source of growth, supported by strong real wage growth and a fiscal relaxation that began in early 2005.

GDP growth is running increasingly close to potential. Domestic resource constraints are tightening, causing increased leakage through the balance of payments and accelerated ruble appreciation. Following six years with robust GDP growth, but relatively low investments, measures of capacity utilization are at historical highs. Constraints are particularly evident in the oil sector. Having increased by about 10 percent annually through 2003, the increase in crude oil production has slowed sharply, and appears now to have stabilized at 2–3 percent.

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[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.

Labor markets are also tightening, reflected in very low unemployment rates in key regions and strong real wage growth.

Adding to the demand pressures is a notable fiscal relaxation. In 2004 fiscal policy had been saving most of the oil windfall to mitigate the pressures arising from the large terms-of-trade gains, but the non-oil primary deficit is set to rise by almost 3 percent of GDP in 2005–06, as oil revenues are being used to reduce taxes and increase expenditures. The draft 2007 budget entails a significant further easing.

Despite some tightening, monetary policy has remained accommodative. The Central Bank of Russia (CBR) has allowed somewhat more nominal exchange rate flexibility, and this has helped to reduce inflation from a yearly rate of 13½ percent in May 2005 to 9 percent in June this year. However, while inflation has eased, unsterilized foreign exchange interventions have remained high, leading to an acceleration in the growth of monetary aggregates. Recently, there has been a renewed pick up in inflation.

Progress with structural reforms outside the banking sector has been generally somewhat slow. This includes reforms of the health and education sectors, the civil service and public administration, and the natural monopolies.

Demand pressures are expected to remain strong in 2006–07 and possibly intensify. Staff projects GDP growth of 6½ percent in both years. Growth in consumption and investment is expected to remain robust, partly on the strength of high oil prices. The strong demand also reflects the substantial impulse that is still coming from the cumulative terms-of-trade gains of 11 percent of GDP during 2003–05, as spending plans are adjusting only gradually to these gains, not least in the oil sector. Inflation, which was already 7 percent in the first eight months of this year, is likely to exceed the official end-year target of 8½ percent once again. A large current account surplus, rapidly increasing foreign exchange reserves and declining external debt point to low external vulnerability.

Executive Board Assessment

Directors commended the strong performance of the Russian economy in recent years, reflected in robust real GDP growth, strong external and fiscal positions, and growth in productivity and consumption. They attributed this not only to high oil prices, but also to significant supply responses from the private sector in the context of generally prudent macroeconomic policies, not least the policy of taxing and saving the large oil windfall.

Directors expected robust growth to continue in 2006 and 2007 under the current outlook for oil prices, but—with the economy running close to potential—saw a more challenging macroeconomic environment going forward. In these circumstances, Directors noted the importance of refraining from further fiscal relaxation in the near term considering the buoyancy of demand and still strong inflationary pressures and of increasing the focus of monetary policy on inflation control, supported by more exchange rate flexibility.

Directors stressed that long-term growth prospects depend on accelerating the implementation of structural reforms and strengthening the investment climate. They noted that the rise in investment and employment levels has been limited and the strong growth performance so far has been mainly based on increases in total factor productivity, reflecting still significant scope for efficiency gains through equipment upgrade and resource reallocation. Directors cautioned that this catch-up potential will inevitably start to diminish, leaving growth increasingly dependent on raising investment and instituting reforms over the medium term.

Against this background, most Directors were concerned that the pace of economic reforms has remained slow. A reinvigoration of reforms in the inefficient and undercapitalized natural monopolies as well as the public administration is particularly urgent. Directors observed that these reforms should be carefully sequenced with other reforms, including reforms of the communal services, judiciary, health, and education sectors. Recognizing that these are socially sensitive areas, they encouraged the authorities to advance reforms now while favorable energy prices and large productivity gains are boosting growth and real incomes.

Directors emphasized the importance of the oil and gas sectors for growth prospects. In this connection, they welcomed the recent changes to the tax regime designed to stimulate investment in these sectors. They expressed concern, however, that the increased state ownership in the oil sector might negatively impinge on the future dynamism in this sector. The disappointing performance of the state-controlled gas sector during recent years, despite record high energy prices, was seen as a sobering reminder in this regard.

Directors were encouraged by the strengthening of the banking sector, but expressed concerns about regulatory vigilance. They noted that profitability is high and direct exposure to market risk low, and welcomed the gradual emergence of a better supervisory framework. However, they observed that risk management by commercial banks needs to be improved. Directors congratulated the CBR for its steadfast determination in recalling licenses of banks that have violated anti-money laundering provisions. Nevertheless, they expressed concern that the limited number of deposit-taking institutions barred from deposit insurance might reflect insufficient regulatory vigilance. In light of this, Directors cautioned that the favorable macroeconomic environment could be masking vulnerabilities that might become evident in the event of a major drop in oil prices. Greater attention should also be paid to the implications of the de-dollarization process that is currently under way. Directors welcomed the planned FSAP update as providing a good opportunity for a further analysis of banking sector vulnerabilities and the measures needed to bolster the regulatory framework.

Directors noted that the policy of taxing and saving oil revenues in the face of surging oil prices has served Russia well, preventing overheating amid strong demand pressures from the large terms-of-trade gains. They were concerned, therefore, about a premature relaxation of this policy, and urged the authorities not to weaken the non-oil balance further at this juncture.

While acknowledging that there is considerable scope for additional, growth-oriented expenditures in the medium term, Directors were concerned that the rapid loosening since early 2005 has mainly supported higher wages, recurrent expenditures, and tax cuts that are unlikely to boost potential growth. They cautioned that such spending, together with sluggish structural reforms, could cause the exchange rate to overshoot its long-term equilibrium and lead to the emergence of an unsustainable non-oil deficit and spending structure. They stressed that harnessing Russia's oil wealth in support of policies that will strengthen long-term growth would require reforms to be reinvigorated. The authorities were encouraged to move toward a medium-term budgetary framework with clear rules, including an explicit role for the non-oil balance.

As to monetary and exchange rate policies, Directors welcomed the decline in inflation in the first half of 2006, but most cautioned that more exchange rate flexibility would be needed for the progress to be consolidated. The renewed increase in inflation pressures in recent months was a timely reminder of the risks in this regard. Directors urged the CBR to give clear priority to its inflation target, standing ready to scale back interventions and allow ruble appreciation if inflation exceeds the targeted path.

Directors welcomed the elimination of all capital account restrictions and the concurrent elimination of the one outstanding restriction on current account transactions, arising from regulations accompanying the 2004 Federal Law on Foreign Exchange Regulation and Foreign Exchange Control.

Directors noted the Russian authorities' assurances that a number of restrictions on imports from neighboring countries had been imposed for sanitary reasons. The authorities were encouraged to seek a rapid and transparent resolution of these issues.

Directors were disappointed that Russia's accession to the WTO has again been delayed. They looked toward a swift resolution of outstanding issues holding up bilateral agreements. Directors urged the authorities to resist calls for prolonged transition agreements, noting that WTO accession would promote structural reform and boost trade and investment.

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

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2002–07

	2002	2003	2004	2005	2006	2007
		Actual		Est.	Proj.	
	(Annual percent change)					
Production and prices						
Real GDP	4.7	7.3	7.2	6.4	6.5	6.5
Consumer prices						
Period average	15.8	13.7	10.9	12.7	9.7	8.6
End of period	15.1	12.0	11.7	10.9	9.3	8.0
GDP deflator	15.7	14.0	19.5	19.6	14.4	7.5
	(In percent of GDP)					
Public sector						
General government						
Overall balance	0.6	1.4	4.9	8.1	7.6	4.7
Revenue	37.6	36.3	36.8	40.0	39.8	37.9
Expenditures	37.0	34.9	31.9	31.9	32.3	33.2
Primary balance	2.7	3.3	6.3	9.2	8.4	5.2
Nonoil balance (in percent of GDP)	-5.2	-4.6	-4.3	-5.9	-7.4	-8.3
Federal government overall balance	1.3	1.7	4.3	7.5	6.9	4.0
	(Annual percent change)					
Money						
Base money	30.4	49.6	24.9	31.7	47.6	42.5
Ruble broad money	32.3	51.6	35.8	38.6	50.5	43.8
	(Annual percent change)					
External sector						
Export volumes	7.1	12.4	10.5	4.8	4.7	4.7
Oil	15.5	17.2	11.3	2.7	3.4	3.7
Gas	3.0	2.0	5.5	3.4	2.0	2.0
Non-energy	2.4	12.1	11.1	8.0	7.0	6.7
Import volumes	10.9	24.4	21.3	18.5	19.1	17.1
	(In billions of U.S. dollars; unless otherwise indicated)					
External sector						
Total merchandize exports, fob	107.3	135.9	183.2	243.6	307.8	317.9
Total merchandize imports, fob	-61.0	-76.1	-97.4	-125.3	-158.6	-187.4
External current account	29.1	35.4	58.6	83.2	108.2	93.3
External current account (in percent of GDP)	8.4	8.2	9.9	10.9	11.2	8.2
Gross international reserves						
In billions of U.S. dollars	47.8	76.9	124.5	182.2	273.6	377.2
In months of imports 1/	6.8	8.9	11.4	13.3	16.0	19.1
In percent of short-term debt	135	128	198	172	388	486
Memorandum items:						
Nominal GDP (in billions of rubles)	10,831	13,243	16,966	21,598	26,297	30,101
Nominal GDP (in billions of U.S. dollars)	345	431	589	763	966	1,132
Exchange rate (rubles per U.S. dollar, period average)	31.3	30.7	28.8	28.3	27.2	26.6
World oil price (U.S. dollars per barrel, WEO)	25.0	28.9	37.8	53.4	64.4	63.3
Real effective exchange rate (average percent change)	2.8	3.0	7.9	8.7	10.3	7.0

Source: Russian authorities; and IMF staff estimates.

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