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Russian Federation: 2009 Article IV Consultation—Staff Report; Staff Statement; 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 2009 Article IV consultation with the Russian Federation, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 1, 2009, with the officials of the Russian Federation on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 13, 2009. 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 July 27, 2009, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 27, 2009 discussion of the staff report that concluded the Article IV consultation.

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

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INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2009 Article IV Consultation

Prepared by Staff Representatives for the 2009 Article IV Consultation
with the Russian Federation

Approved by Marek Belka and Aasim Husain

July 13, 2009

- **Discussions for the 2009 Article IV consultation were held in Moscow during May 21–June 1**. The mission comprised Mr. Thomsen (head), Messrs. Takizawa and Tiffin, Ms. Zakharova (all EUR); Mr. Goldsworthy (FAD), Mr. Kisinbay, Mr. Tuya (both MCM), Ms. Kozack (RES), and Mr. Brekk (resident representative). Mr. Mozhin, Executive Director, also participated in the discussions. The mission met with First Deputy Prime Minister Shuvalov, Deputy Prime Minister and Minister of Finance Kudrin, Central Bank of Russia (CBR) Governor Ignatiev, other senior officials, and representatives of financial institutions, corporations, and think tanks.

- **Summary**. Russia has been hit hard by the dual shocks of declining oil prices and capital flow reversals. The banking system is under strain from rising overdue loans, and credit to the private sector is contracting. Despite a substantial fiscal response, economic activity is projected to decline sharply in 2009 and to recover only tepidly in 2010. Against this background, staff made the following recommendations:

    - On financial sector policies, staff called for a proactive and comprehensive plan—guided by systemic stress tests—to restore the health of the banking system and reinvigorate credit growth. It also underscored the need to develop contingency plans to bolster the authorities' ability to proactively address potential future problems in the banking system.

    - On monetary policy, staff agreed that there was scope to lower interest rates, but suggested that the authorities proceed cautiously in doing so. Over the medium term, monetary policy should be refocused on inflation control, in the context of a flexible exchange rate policy.

    - On fiscal policy, staff questioned the reversibility and effectiveness of the planned relaxation. It noted that a smaller and better targeted stimulus could have a similar impact on growth, given the larger fiscal multipliers, but would avoid a permanent change in the budget structure. A smaller non-oil deficit in 2009 would also create room to maintain the fiscal stimulus next year, if needed. With this in mind, staff advised the authorities to scale back the stimulus in 2009 and improve its targeting.

- **Exchange rate regime**. Russia's exchange rate regime has been reclassified from "stabilized arrangement" to "other managed arrangement" effective November 1, 2008 to reflect the managed depreciation of the ruble, and higher day-to-day exchange-rate fluctuations. The Russian Federation accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement with effect from June 1, 1996. The exchange system is free of restrictions on payments and transfers for current international transactions.

- It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

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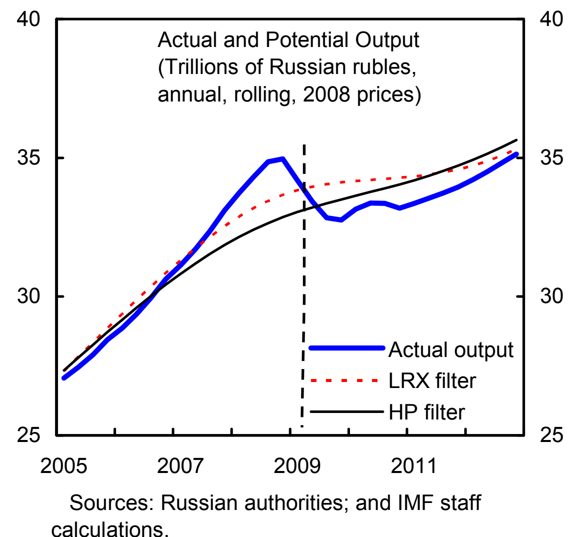
I. From Overheating to Crisis[1]

A. Deteriorating Macroeconomic Situation

In the wake of the global financial crisis, the Russian economy has been hit hard by dual shocks—a collapse in oil prices and a sudden reversal of capital flows. Real GDP contracted sharply in the first quarter, as Russia's investment boom came to an abrupt end. As a result, inflation pressures are easing. More recently, although rising oil prices and renewed capital inflows have provided some support to the ruble, the economy has continued to falter.

1. **Following an extended period of overheating, the Russian economy is now contracting sharply**. Prior to the global financial crisis, large terms-of-trade gains and surging capital inflows amid accommodative monetary and procyclical fiscal policies had fueled rapid credit growth and lifted output well above potential by mid-2008. However, the two key external drivers of Russia's prolonged boom—rapidly rising oil prices and massive capital inflows—sharply reversed last summer, triggering an abrupt contraction in domestic demand. Fixed investment plummeted, shattering the nexus of high growth in investment, productivity, and real wages that had powered consumption and the economic boom. Real GDP contracted by 9¾ percent in Q1 2009 (year-over-year), while falling domestic demand led to a steep drop in imports.

Sources: Russian authorities; and IMF staff calculations.

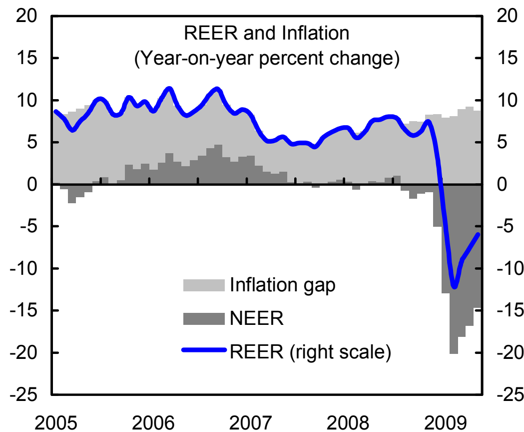


Sources: Russian authorities; and IMF staff calculations.

2. **Since the onset of the crisis in September, the ruble has depreciated by around 15 percent against the U.S. dollar-euro basket, but remains broadly in equilibrium**. The

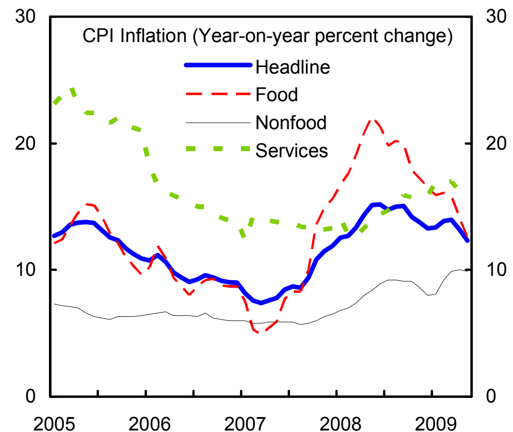
[1] The mission's concluding statement can be found at: http://www.imf.org/external/np/ms/2009/060109.htm.

currency first depreciated by about 30 percent over December-January, but has since recovered. Mirroring the evolution of the nominal rate, the ruble initially depreciated by some 15 percent in real effective terms, before reversing course in February, when it was close to equilibrium based on CGER analysis. Since then, it has appreciated somewhat, leaving it 5 percent more depreciated than its pre-crisis level. Even now, however, staff analysis suggests that the ruble remains broadly in equilibrium, as the recent increase in projected medium-term oil prices has implied a parallel appreciation of the equilibrium real effective exchange rate (Annex I).



Sources: Russian authorities; and IMF staff calculations.

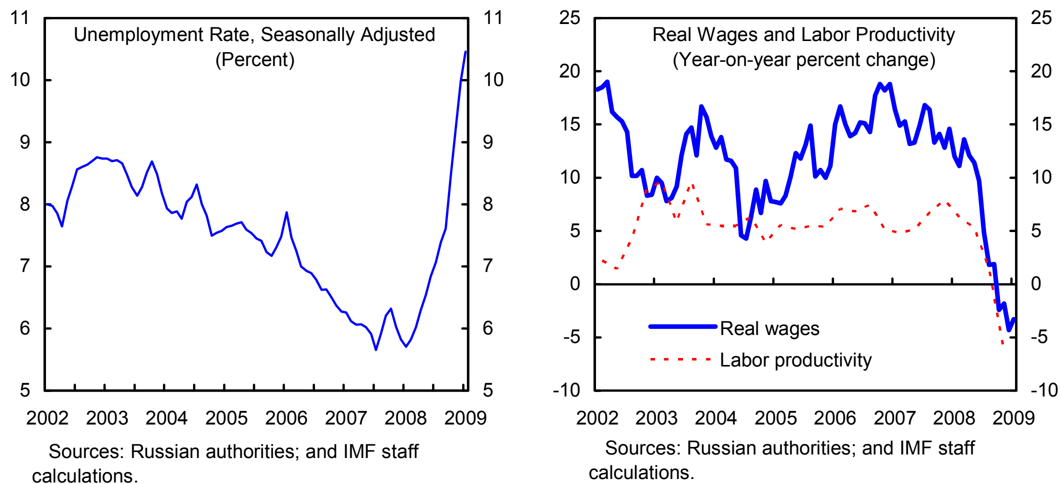
3. **Inflation is moderating gradually as the output gap is widening**. CPI inflation remains stubbornly high, in part reflecting the depreciation of the ruble and an attendant rise of tradables inflation (excluding food). Nevertheless, declines in food and energy prices and faltering domestic demand have brought about some reduction in headline inflation—after peaking at 15.2 percent (y/y) in June 2008, it fell to 11.9 percent in June 2009.



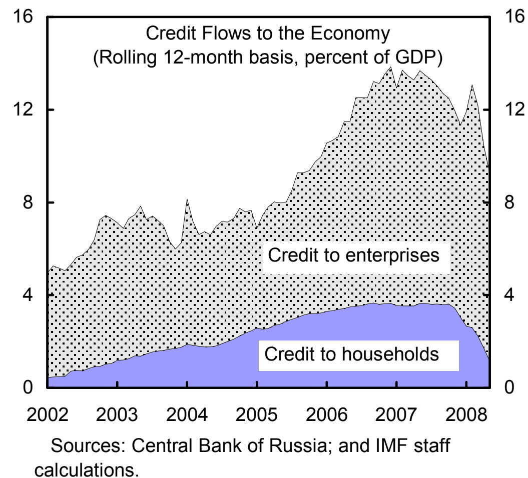
Sources: Russian authorities; and IMF staff calculations.

4. **Labor market conditions have eased considerably, dampening growth in real wages and unit labor costs**. Labor utilization rates had reached record highs at the onset of the crisis, while real wages had been growing well above productivity on average for almost a decade. Since early 2009, however, employers have been shedding workers, pushing the unemployment rate to 9.9 percent in May. Labor productivity growth—measured as growth of real GDP per unit employment—has turned negative,

exerting significant downward pressures on real wages. As a result, unit labor cost growth is slowing rapidly.

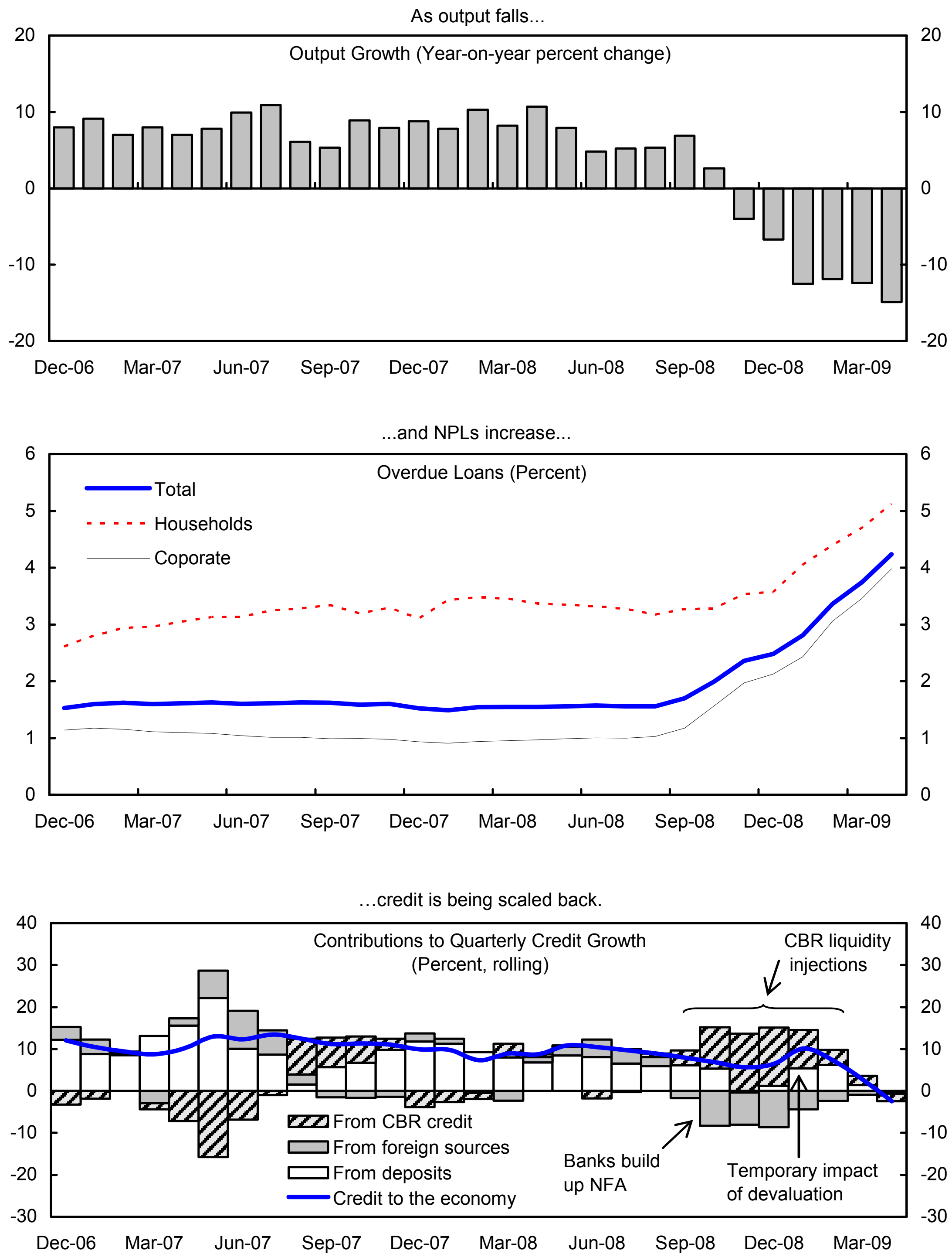


5. **Bank balance sheets are under increasing strain, and private sector credit is contracting** (Figure 1). As the macroeconomic situation has deteriorated, the level of overdue loans has more than doubled since January, reaching 4.6 percent of total loans in May despite regulatory forbearance and anecdotal evidence suggesting substantial evergreening of loans. Moreover, in an environment of high uncertainty, banks have exhibited a strong preference for liquidity. Since monetary policy was abruptly tightened in January, the stock of credit has been falling, for the first time since end-2004. Indeed, controlling for the depreciation's impact on the ruble value of foreign-exchange loans, credit fell by 1 percent over the first quarter. The contraction has affected both the household and corporate sectors, but particularly the former.



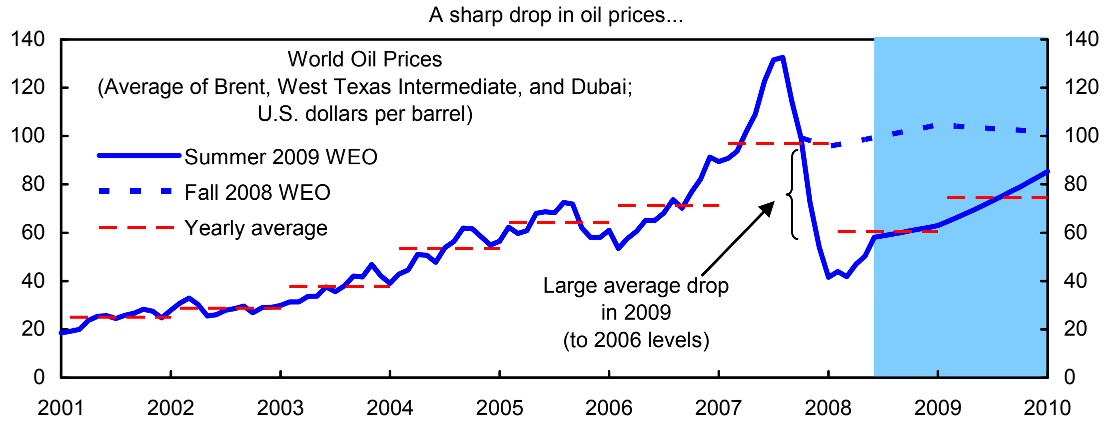
6. **After a period of significant pressure, the balance of payments has stabilized** (Figure 2). Following a tightening of monetary policy and a large one-step devaluation in January, reserve losses stopped and the ruble began to recover. Rising oil prices have further strengthened the balance of payments since then.

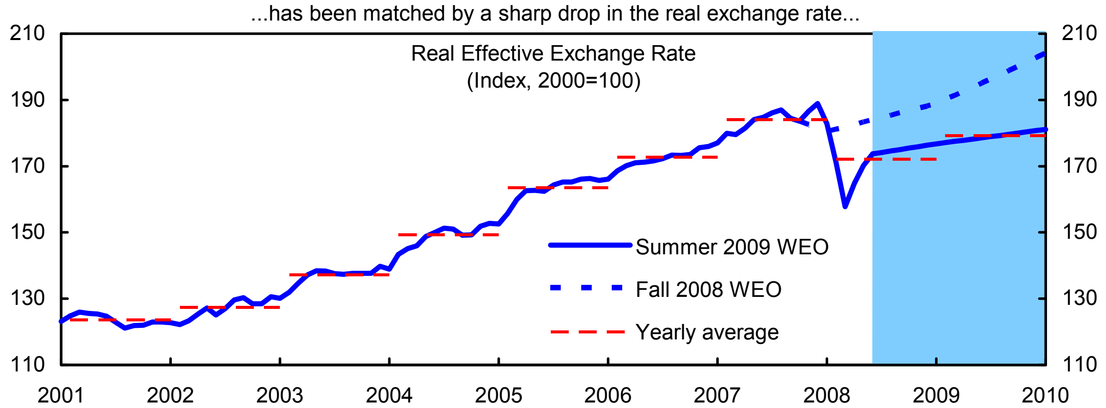
Figure 1. Russia: Credit Indicators, 2006–09

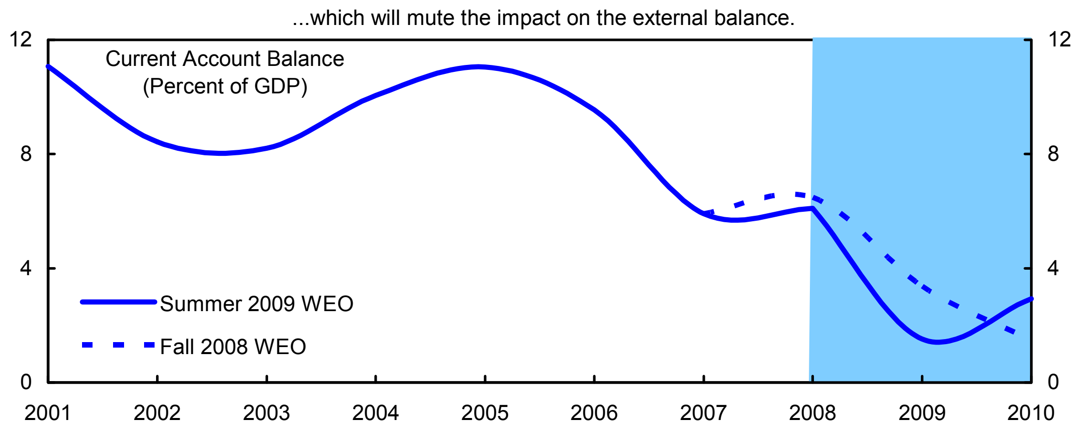


Sources: Central Bank of Russia; Rosstat; and IMF staff calculations.

Figure 2. Russia: Oil Prices and External Stability, 2001–10

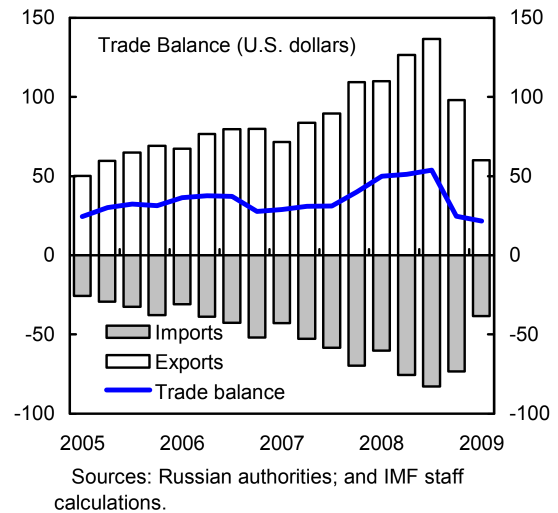






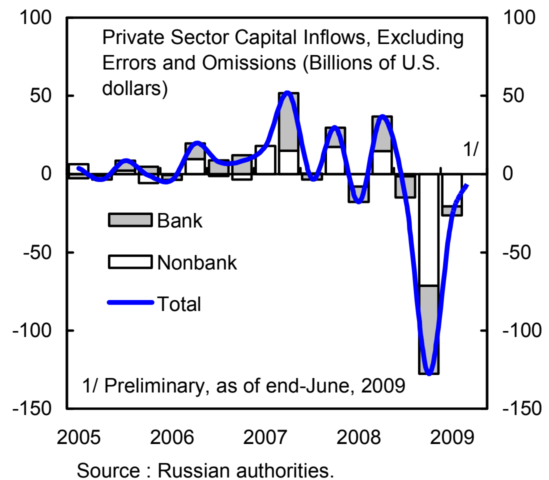
Sources: Haver Analytics; and IMF staff calculations.

- The current account surplus has stabilized, after an initial decline. With oil export volumes stagnant, the drop in oil prices from last summer's record highs has resulted in a notable fall in export values. However, rapid import growth, which had caused the current account surplus to steadily unwind even as oil prices were surging, has reversed abruptly owing to a steep contraction in domestic demand and the ruble depreciation. As a result, the current account balance has largely stabilized at around $8 billion.



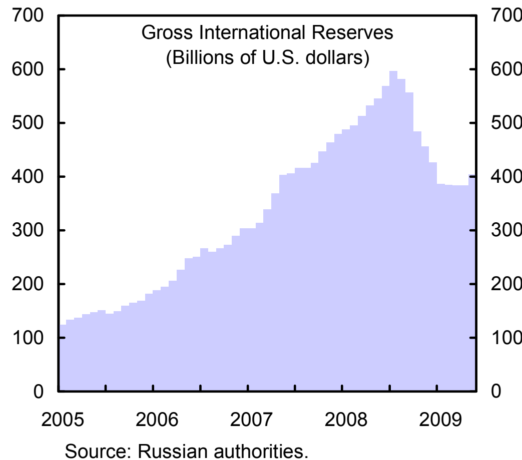
Sources: Russian authorities; and IMF staff calculations.

- Lax monetary policy alongside an inflexible exchange rate led to huge capital outflows during the second half of 2008, as rapidly declining oil prices quickly reversed exchange rate expectations. This, in turn, brought about a massive drive by the highly indebted corporate sector to hedge foreign currency exposure, alongside a reversal of the carry trade by foreign investors. Capital outflows, which reached $131 billion in the fourth quarter, took various forms: large portfolio withdrawals; increased holdings of cash foreign currency (including shifts from ruble to foreign currency deposits); rising bank net foreign asset positions; and loan repayments by the nonbank corporate sector. More recently, monetary policy tightening alongside ruble devaluation, resurgent oil prices, and an increase in investor risk appetite for Russian assets (including through the carry trade) have led to a limited resumptions of capital inflows. Indeed, in the first quarter of 2009, corporates were able to roll over nearly all of their foreign debt, while banks drew down their foreign assets to reduce foreign liabilities.



Source : Russian authorities.

- Gross international reserves declined from a peak of $598 billion in August 2008 to a trough of $375 billion in March 2009, before ticking up to over $400 billion by end-June.



Source: Russian authorities.

7. **The sharp economic slowdown in Russia is having an adverse impact on its regional partners**. It is spilling over to neighboring countries through trade, financial, and remittance channels.[2] Although direct trade links with Russia and several countries in Central Asia and the Caucuses have weakened in recent years, such links remain strong with Belarus, Finland, Kazakhstan, Moldova, and Ukraine. Turkmenistan has also been hit hard, as gas exports to Russia have declined in response to the fall in European demand for Russian gas. With respect to financial channels, regional partners appear to have benefited from spillovers related to Russia's vast oil-driven external savings earlier this decade, but those benefits have now been reversed. Some countries (Kazakhstan) have also suffered losses on investments in Russia. The remittance link is especially strong for countries in Central Asia (Tajikistan and Kyrgyz Republic) and the Caucasus (Georgia and Armenia) as well as in Belarus, Moldova and Ukraine. As the crisis has caused a particularly sharp decline in construction—where employment of foreign migrant workers is very high—it has prompted a large reverse migration. This has contributed to unemployment pressures and added to the demand for social services in home countries.

[2] Some of the analysis in this paragraph is based on "How Russia Affects the Neighborhood: Trade, Financial, and Remittance Channels," by Fahad Altuki, Jaime Espinosa-Bowen and Nadeem Ilahi, forthcoming IMF Working Paper. See also Box 5 in April 2009 MCD REO.

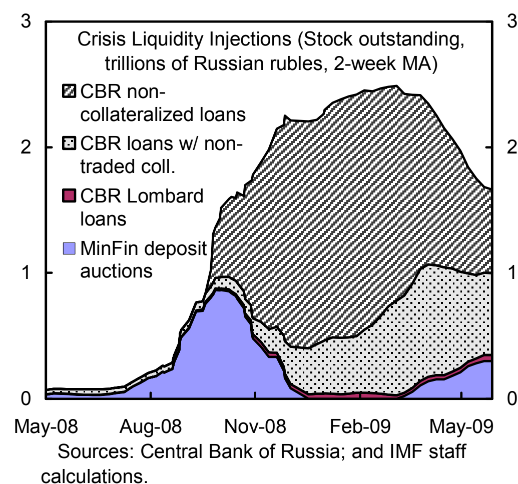
B. Policy Response to the Crisis

The authorities' response to the crisis that erupted in the fall was swift and substantial, reflecting concerns that weaknesses in the banking and corporate sectors could lead to a full-fledged crisis. As a result, policy interventions initially focused on maintaining external and financial sector stability. However, as reserve losses mounted and capital outflows surged, the ruble was devalued and monetary policy tightened. The authorities also announced a large fiscal stimulus aimed at supporting domestic demand.

Monetary and Financial Policies

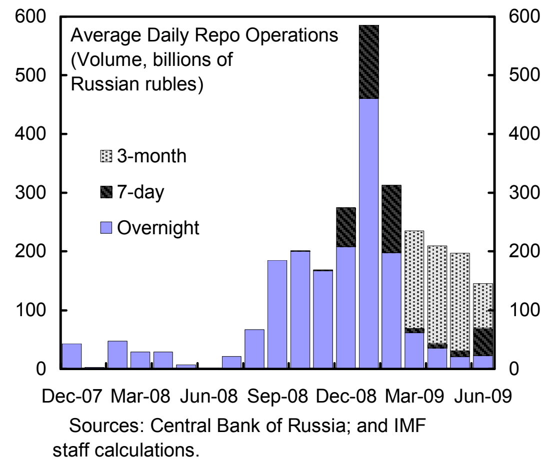
8. **As the crisis intensified in the fall, the authorities' policy response was aimed at avoiding a disorderly exchange rate depreciation and maintaining financial sector stability**. The response was rapid, but was circumscribed by a number of policy-induced vulnerabilities that built up prior to the crisis. In particular, the authorities' earlier focus on exchange-rate stability had encouraged substantial foreign-currency borrowing, and had contributed to unsustainably high rates of credit growth. Combined with supervisory shortcomings, this had left Russian banks and corporates particularly vulnerable to a reversal of inflows. Thus, the sudden change in exchange rate expectations triggered by the collapse in oil prices led banks and corporates to seek to hedge their foreign currency exposures, exacerbating pressure on the ruble. With the banking system under added pressure on account of deposit outflows and some bank failures, the policy response focused on maintaining stability and occurred in three distinct phases—accommodation, devaluation and tightening, and gradual easing.

- ***Accommodation***. Initial efforts were aimed at providing significant liquidity at low interest rates while keeping the exchange rate stable to offset to abrupt loss of foreign financing. The government auctioned excess budgetary funds to banks, while the CBR provided an ever-widening array of liquidity facilities, including uncollateralized loans. The CBR also offered guarantees for interbank lending to qualifying banks, covering losses in the event that the licenses of a counterparty is withdrawn. To bolster confidence in the banking system, the authorities also raised the deposit-insurance limit. However, the sizable liquidity provisions fueled further capital outflows. By mid-January, the pace of reserve loss had reached over $50 billion per month, while the total reserve loss since August amounted to over $200 billion.



Sources: Central Bank of Russia; and IMF staff calculations.

- ***Devaluation and tightening***. Confronted with surging reserve losses, the ruble was devalued sharply and monetary policy tightened (Figure 3). Toward the end of January, the CBR allowed a one-off 10-percent weakening of the effective exchange-rate band, and declared that it would defend the ruble at the weak bound of this band. In addition, it started to curtail its liquidity support, allowing interest rates to rise to more market-based levels—at their peak, overnight interbank rates reached 28 percent. Repo interest rates increased by almost 300 bps in February to around 12 percent, while rates on unsecured loans rose by almost 500 bps to around 18 percent. In the event, pressure on the exchange rate eased almost immediately and reserves leveled off at around $380 billion.



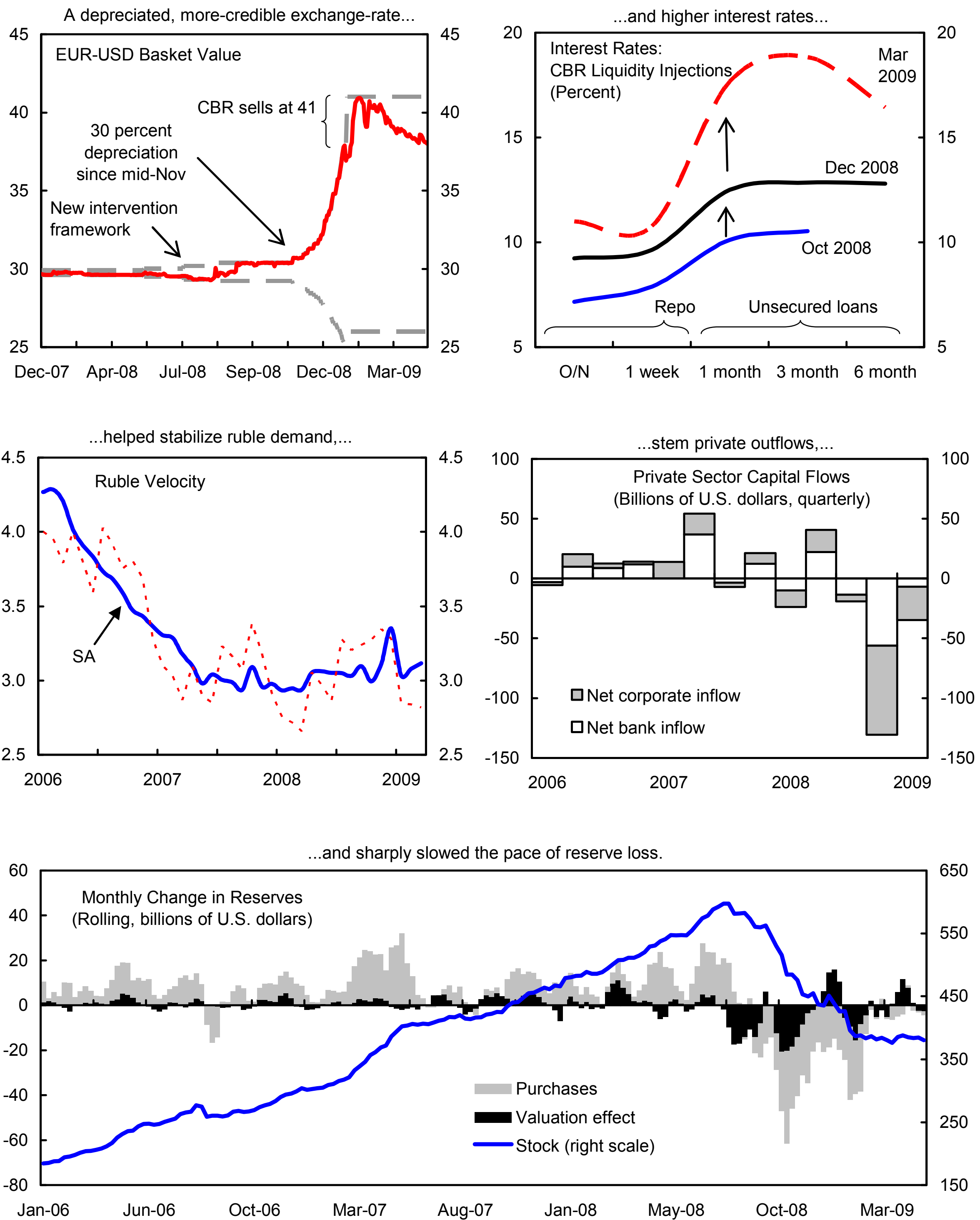
Sources: Central Bank of Russia; and IMF staff calculations.

- ***Gradual easing***. In light of a more stable currency and rising oil prices, monetary policy has subsequently been gradually eased. Repo rates have come down, reaching 8¾ percent by late June. Moreover, with renewed inflows, local liquidity conditions and interbank lending have improved, while the stock of uncollateralized loans provided by the CBR at the height of the crisis is being rapidly repaid ahead of schedule. As oil prices have risen, the ruble has appreciated in nominal terms against the dollar-euro basket and reserves have increased. However, banks remain cautious, preferring to hold deposits at the CBR rather than extend credit.

9. **The sharp economic downturn is testing the resilience of the banking system, which remains reliant on CBR support and regulatory forbearance**. The CBR introduced regulatory forbearance by easing loan classification and provisioning requirements. Moreover, the use of non-standard definitions for nonperforming and restructured/renewed loans has further masked the extent of deterioration in banks' loan books, particularly given that evergreened loans are not reported as delinquent.[3]

[3] International best practice requires that loans 90 days past due are reported as nonperforming and placed on (interest) non-accrual status. By contrast, CBR regulations are more flexible, requiring only that loans classified in categories IV and V be placed on non-accrual status—a less rigorous standard. Transparency is also reduced because banks are not required to report as overdue the entire principal outstanding of an overdue loan, but rather they may choose to report only the amount of the overdue payment.

Figure 3. Russia: Monetary Tightening in the First Quarter, 2006–09



Sources: Central Bank of Russia; and IMF staff calculations.

Financial Sector Support Operations, 2008–09 1/

Program	Announced amount (billion)	Actual use as of June 12, 2009	Gross Treasury financing need	Operations
Deposit insurance	200	200	200	Government will widen remit of deposit insurance agency by injecting Rub 200 billion from the budget.
Purchase of assets	200	0	0	Purchase of mortgages from banks up to Rub 200 billion. Financed from the National Welfare Fund.
Capital injection by MOF	505	205	505	Government capital injection in the State Mortgage Agency amounts to Rub 60 billion in the 2008 supplementary budget and Rub 20 billion in the 2009 supplementary budget; Rub 180 billion to VTB, Rub 45 billion to Rosselhozbank, and Rub 25 billion to Rosagroleasing in the 2009 supplementary budget. Public capital has also been injected to VEB: Rub 75 billion in the 2008 supplementary budget and Rub 100 billion in the 2009 supplementary budget.
Central bank lending	1,309	1,309	0	The central bank's new uncollateralized lending facility on top of Rub 200 billion rolled over via daily repos has eased local liquidity. As of June 12, Rub 720 billion. Central bank also provided other loans (nontraded collaterals) of Rub 589 billion.
Bank loan/recapitalization	1,787	839	0	Subordinated loans and other unkown form of capital to VTB, Sberbank, Rosselhozbank and others from VEB and the Central Bank of Russia. Collateralized lending of $2 billion to Alfa group from VEB.
Liquidity support from MOF	300	155	0	Government deposit to commercial banks, must be repaid by year-end.
Total	4,301	2,708	705	

Sources: Press statements; and the government's anti-crisis program.

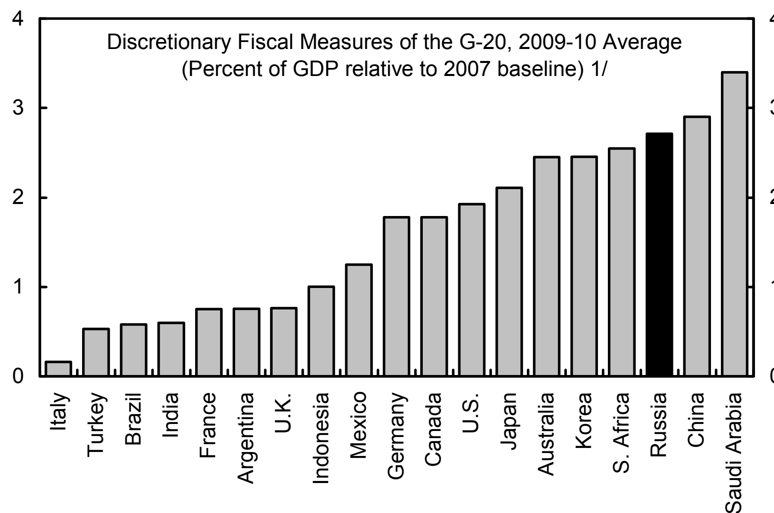
1/ New facilities created as part of the government's reponse to the 2008-09 financial crisis.

The CBR has also taken steps to loosen accounting standards to limit banks' mark-to-market losses and to expand access to its unsecured loan auctions—with the latter increasing credit risk to the CBR. Although a number of small- and medium-sized banks have been taken into receivership, the combination of CBR liquidity provision and regulatory forbearance has allowed the banking system to weather the early stages of the crisis relatively well.

Fiscal Policy

10. **Fiscal policy was expansionary in the second half of 2008, but the stimulus was withdrawn in the first quarter of 2009**. With budgetary expenditures heavily backloaded—some 38 percent of expenditures were executed in the fourth quarter—fiscal policy provided a large demand stimulus toward the end of 2008. However, following the seasonal spending pattern observed in previous years, considerable retrenchment took place in the first quarter of 2009. The non-oil deficit of the general government fell from some 6 percent of annual GDP in the fourth quarter of 2008 to roughly ¾ percent of annual projected GDP in the first quarter of 2009—a withdrawal of over 5 percent of GDP.

11. **In April of 2009, as the economy continued to contract, the government passed a large supplementary budget to support flagging domestic demand**. The budget includes large discretionary increases in defense and security spending; along with a package of anti-crisis measures aimed at stimulating economic activity by reducing taxes, extending support to strategic sectors, and enhancing social assistance. As result, total expenditure is expected to increase by some 5 percent of GDP (text table). Excluding budgetary support to the financial sector, Russia's announced discretionary fiscal stimulus is one of the highest in the G-20.



Sources: G-20 meeting, Global Economic Prospects and Effectiveness of Policy Response, June 27, 2009, Basel, Switzerland; and IMF staff estimates.

1/ Excluding financial sector support measures.

Federal Budget Expenditure
by Functional Classification 1/

	2008 Prel.	2009 Budget	Change
	(Percent of GDP)		
Total expenditures 2/	18.7	23.9	5.2
National economy	2.5	4.0	1.6
Defense and security	4.5	5.5	1.0
General public issues	2.0	2.5	0.5
Social policies	0.7	1.1	0.4
Education	0.9	1.0	0.1
Health	0.7	0.8	0.2
Intergovernmental transfers	6.4	8.5	2.1
Other 2/	1.1	0.5	-0.6
Memorandum items:			
Nominal GDP (billion of Russian rubles)	41,668	40,512	...

Sources: Budget documents; and IMF staff calculations.

1/ Based on 2009 Supplementary Budget.
2/ Includes the disbursement for the Housing Fund in 2008 (0.6 percent of GDP).

II. Near Term Outlook and Risks

The Russian economy is projected to experience a deep recession in 2009, followed by a sluggish recovery. With the banking system expected to remain under strain, credit growth would turn negative and impede a robust rebound. Risks around this outlook are to the downside.

12. **GDP growth is likely to recover only slowly**. Going forward, the external environment is likely to remain challenging, as the subdued outlook for global growth implies only a gradual recovery in commodity prices. Moreover, global deleveraging by financial institutions suggests that capital inflows to emerging economies, including Russia, are unlikely to return to their pre-crisis levels any time soon. Against this background, real GDP is expected to contract by 6½ percent in 2009, after expanding at an annual rate of 7-8 percent before the crisis. Growth is projected to recover only slowly over the course of 2010, despite oil prices that are significantly higher than previously expected.[4]

[4] Since the mission, the IMF's oil price baseline for 2010 has been revised upward from $62.5 per barrel to $74.5 per barrel. This led to a slight upward revision of the 2010 growth forecast relative to the April 2009 World Economic Outlook, from ½ percent to 1½ percent.

Key Economic Indicators

	2008	2009	2010
		Proj.	
Real GDP (percent change)	5.6	-6.5	1.5
Current account (percent of GDP)	6.1	1.5	2.9
Inflation (e.o.p., percent change)	13.3	11.0	9.0
General government overall balance (percent of GDP)	4.3	-5.5	-5.0
World oil price (U.S. dollars per barrel)	97.0	60.5	74.5
Net capital inflows (billions of U.S. dollars)	-133.0	-67.9	-25.8

Sources: Russian authorities; and IMF staff projections.

- Compared to before the crisis, much lower oil prices and a sharp turn-around in capital flows are expected to exert a significant drag on domestic demand. In particular, with capital flows projected to remain limited, the investment-consumption nexus that underpinned Russia's impressive economic performance in recent years is likely to be severed. Fixed investment would remain subdued in the face of heightened uncertainty and reduced credit availability. With sluggish investment growth dampening labor productivity, real wages are likely to remain stagnant. While the planned large fiscal stimulus is expected to provide temporary support for private consumption, weak labor market conditions would continue to weigh on private consumption well into 2010.

- The current account surplus would decline in 2009 before improving modestly in 2010. Imports are projected to fall steeply in 2009, with import growth turning weakly positive in 2010, in line with domestic demand. This, combined with the expected gradual recovery of oil prices, would lead to an improvement in the current account balance. Taking into account the planned large-scale monetization of the fiscal deficit, capital outflows are expected to remain relatively high at $68 billion. With an overall balance-of-payments deficit of about $50 billion in 2009, reserves would decline to some $375 billion by end-year.

- Uncertainty regarding the state of bank balance sheets, including the extent of bad assets and the potential capital shortfall, and the impact of the recession on the corporate and household sectors is expected to significantly increase banks' liquidity preferences and limit the expansion of credit. As a result, nominal credit is projected to remain relatively flat for the rest of the year, implying a drop of some 10 percent in real terms.

- Inflationary pressures are expected to ease substantially as the output gap widens. However, headline inflation is expected to decline only slowly during the remainder of 2009 on account of base effects, falling to 11 percent by year-end. A further decline is expected in 2010.

13. **Risks around this highly uncertain outlook are to the downside**. Continuing uncertainty about the depth and duration of the global financial crisis implies a wide range of potential outcomes on either side of staff's baseline projection. The current projection takes into account the authorities' strong countercyclical fiscal stance, and assumes a gradual bottoming-out and a slow recovery in Russia. However, a more protracted global downturn—and an attendant decline in commodity prices—would result in a delayed recovery and even lower growth, particularly in 2010. Moreover, the planned fiscal relaxation might fail to stimulate private consumption in the face of significant uncertainty about future income. In addition, absent a more determined policy intervention, there is a risk that banks will continue to struggle to adjust balance sheets, stifling credit expansion and impeding a recovery. Finally, in the context of large external debt amortization coming due to 2009 and 2010 (text table), a renewed bout of global risk aversion could strain bank liquidity and add to funding pressures facing corporates, with an attendant risk that growth could be lower.

Projected Amortization of External Debt, 2009–10

(Billions of U.S. dollars)

	2009	2010
Total	124.3	98.9
Banks	52.7	34.1
Nonbanks	71.6	64.8

Sources: CBR and IMF staff estimates.

III. Policy Discussions

A. Financial Sector Policies

While the regulatory and supervisory framework has improved significantly in recent years, remaining weaknesses—including the lack of comprehensive consolidated supervisory powers—have hampered the CBR's ability to ascertain the full extent of the deterioration in banks' portfolios. Overdue loans are expected to rise further as the economy continues to falter, increasing pressure on banks' capital adequacy. Thus, a proactive and comprehensive plan to address the looming overhang of bad assets and associated capital shortfalls is urgently needed to lay the foundation for a resumption of credit growth.

14. **Despite significant improvements, ongoing limitations in Russia's regulatory and supervisory framework are impeding a full assessment of the problems in the banking system**. The CBR's monitoring of systemic risks has improved in recent years, as it has made extensive efforts to bolster its financial stability analysis capabilities. Clear progress has also been made with respect to day-to-day supervision over institutions and the supervisory staff has been strengthened. That said, generous accounting and provisioning rules continue to hamper the CBR's ability to gauge the quality of assets and the adequacy of their loan-loss reserves, heightening uncertainty about the creditworthiness of Russian banks. Given

shortcomings in reporting requirements for consolidated financial statements, there is significant uncertainty regarding the activities of banks' off-balance sheet activities—including the extent to which they are being used to offload bad assets. This weakness is compounded by the lack of adequate powers afforded to the CBR to monitor and supervise bank holding companies and sanction bank officers and directors. These issues were highlighted in the 2008 FSAP update.

15. **Overdue loans are expected to increase sharply over the course of the year, denting capital adequacy**. Although Russian banks appear to be relatively well capitalized, the need for increasing loan-loss provisions will likely result in sizeable losses to banks' profits and capital adequacy. The scale and scope of possible capital shortfalls remains somewhat uncertain, given the flexible restructuring standards and the difficulties in ascertaining the extent of bad assets. The government has set aside Ruble 500 billion (1¼ percent of GDP) to support bank recapitalization and the modalities for such support are in the process of being finalized.

16. **Staff strongly encouraged the CBR to develop a proactive and comprehensive plan to deal with problem banks, guided by systemic stress tests and contingency plans**. On the basis of such stress tests—which need not be made public—viable banks should be recapitalized, merged with healthy banks, or restructured. Absent a systematic analysis of individual banks, it is unclear whether the funds set aside for recapitalization will be sufficient.

- Detailed reviews and mandatory systemic stress tests—utilizing similar assumptions and the same point-in-time balance sheets—should be undertaken for large- and medium-sized banks to contribute to a more comprehensive assessment of banks' financial health, including estimates of viability and capital needs. While different options would need to be considered for recapitalizing viable banks—including the scope for burden sharing between the private and public sector—it is critical that the authorities move quickly and convincingly. Moreover, regulatory guidance should be developed to provide banks with a roadmap of the supervisory actions that the CBR intends to implement as banks' capital deteriorates and the level of problem loans increases. This would enable banks to plan early to either increase capital from private sources or to attempt to find a buyer. Staff noted that the CBR may require additional resources to undertake labor-intensive stress tests and to intensify monitoring of systemically important banks.

- Staff and the authorities concurred on the need to develop contingency plans and resolution strategies. This would bolster the authorities' ability to proactively address potential future problems in the banking system. In light of the potential for a significant increase in bank resolutions, the DIA should develop plans for the orderly disposition of large volumes of assets from liquidated banks or from DIA-assisted mergers, as well as a possible rise in deposit payouts. Moreover, given the CBR's intention to roll back

regulatory forbearance, staff encouraged the development of a communication strategy to explain how the rollback would be implemented and the procedures that the CBR would adopt for determining compliance with capital requirements after the rollback.

- Staff welcomed Russia's participation in international fora—including its membership in the Basel Committee on Banking Supervision—aimed at improving international coordination in the areas of regulation, resolution, and information sharing. The authorities' efforts to coordinate with home-country supervisors might help to avoid an abrupt unwinding of foreign exposures in Russia, and foster a better understanding of the potential vulnerabilities in Russian banks' cross-border positions.

17. **The CBR agreed that the situation in the banking system was deteriorating, but viewed the problems as manageable**. It did not expect a renewed bout of severe stress. Although CBR officials concurred that the need for increased transparency in bank reporting and the lack of consolidated supervisory powers hampered their ability to obtain a comprehensive picture of the situation in the banking system, they believed that emerging problems could be handled within the existing framework for bank regulation and supervision. In particular, they did not see the need for systemic stress tests of banks, underscoring that ad-hoc stress tests were already conducted as part of their regular supervision activities. Moreover, since August 2008, the CBR has stepped up the intensity of supervision, including by supplementing the on-site work of its regional branches and by collecting detailed information from the 34 banks that had received government funds. Draft legislation is under review within government to expand the CBR's consolidated supervision authority and is expected to be presented to Duma later this year.

B. Fiscal Policy

Despite persistent underexecution, fiscal policy had become increasingly pro-cyclical in the years preceding the crisis. This reflected growing political pressures to spend more of Russia's oil wealth on investment and other strategic projects, as well as a failure to curb current expenditures. In view of these pressures, and considering the importance of saving much of this wealth in order to avoid excessive real appreciation as private consumption returns to normal, staff is concerned that the significant planned relaxation will be difficult to reverse. Thus, while a large fiscal stimulus is justified at this juncture, its size should be limited and its composition reoriented toward expenditures that are better-targeted and self-reversing.

18. **A large fiscal expansion is underway**. The headline balance is expected to swing from a surplus of 4¼ percent of GDP in 2008 to a deficit of about 5½ percent in 2009—a turnaround of nearly 10 percent of GDP. Oil revenues are projected to fall by about 4¼ percent of GDP at current WEO oil prices. The remainder of the decline in the general government balance reflects a large fiscal stimulus, with expenditures set to rise by over

5 percent of GDP in the second half of the year. As a result, the non-oil deficit of the general government is projected to increase by 5½ percent of GDP—reaching 13¾ percent of GDP. The deficit will be monetized by drawing down the oil Reserve Fund, except for domestic borrowing of up to 1 percent of GDP.

19. **The composition and size of the fiscal stimulus raise questions about its reversibility and effectiveness**. In particular, the current expenditure and tax structure could become entrenched. This would make it difficult to achieve the authorities' medium-term fiscal target, implying an eventual return to a highly procyclical fiscal stance with upward pressures on prices and the real exchange rate.

- Given the 2009 budget, bringing the non-oil deficit down to the authorities' 4.7 percent of GDP medium-term target would require an adjustment in expenditure or non-oil revenues of some 9 percent of GDP over the next four years. Taking into account budgetary financing of critical reforms to the pension system (averaging 3 percent of GDP annually[5]), as well as costs associated with support to the banking sector, the required adjustment could exceed 11 percent of GDP. Moreover, looking ahead, staff calculations, based on a permanent oil income model, suggest that additional adjustment, beyond the 4.7 percent of GDP non-oil deficit limit, may be needed to ensure long-term fiscal solvency (Annex II). With an already high tax burden, and with non-statutory federal spending amounting to only 7¼ percent of GDP, fiscal adjustment on this draconian scale would only be possible with deep and comprehensive public sector reforms.

- In view of these considerations, staff believes that the change in the non-oil deficit should be kept to 2–3 percent of GDP in 2009 and its composition improved. A better targeted, yet smaller, stimulus could have a similar impact on economic activity, given the larger fiscal multipliers, but would reduce the risk of causing a permanent change in the tax and expenditure structure. In particular, expenditure savings could be achieved by reducing support to strategic enterprises and streamlining non-essential defense outlays. Staff also recommends reorienting the stimulus toward a temporary increase in social transfers targeted on credit-constrained households, and suggests a frontloading of infrastructure projects for which preparations are advanced alongside a strengthening of procurement procedures. This improvement in the composition of fiscal spending would also facilitate the withdrawal of stimulus once private demand recovers, as many of the measures would be self-reversing. In this regard, plans for frontloading the pension reform are appropriate, as long as the additional outlays are accommodated by reducing other, less efficient, spending.

[5] The average cost of bringing the replacement rate to 30 percent from the current 24 percent has been estimated at 3 percent of GDP annually (see Evsey Gurvich, 2007, "Prospects for the Russian Pension System," Voprosy Economiki, No. 9/2007). The required pension transfer would gradually increase from 0.9 percent of GDP in 2009 to 4.2 percent of GDP in 2027, and decline thereafter.

- Looking to 2010, if a smaller non-oil deficit is targeted in 2009, there would be scope to maintain the fiscal stimulus next year if needed. The desirability of maintaining, rather than withdrawing, the stimulus in 2010 depends critically on the growth outlook, which is highly uncertain. Under the current outlook, and assuming the 2009 stimulus is scaled back and reoriented as described above, maintaining the stimulus next year would provide important support to domestic demand. However, if the growth outlook improves, some withdrawal of stimulus (of around 1 percent of GDP) would be appropriate in 2010.

20. **The authorities and staff agreed that it would be difficult to unwind the fiscal stimulus in 2010 in its current form**. Officials at the Ministry of Finance were particularly concerned that spending pressures would continue next year, especially if the economy did not recover quickly. They also viewed the composition of the stimulus as suboptimal, noting that fiscal multipliers were likely to be small. Moreover, given that the stimulus package was approved only in April, they were concerned that it would be difficult to implement effectively such a large stimulus in the remaining 6–7 months. As a result, it was possible that the planned stimulus would be underexecuted in 2009. However, there were no plans to introduce a supplementary budget aimed at reducing the size of the stimulus. In view of the exceptionally large uncertainties surrounding the outlook for 2010, the authorities have decided to delay the submission of the 2010 budget to the Duma until the fall.

21. **To facilitate the large fiscal adjustment needed over the medium term, staff and the authorities agreed that reinvigoration of public-sector reforms was a matter of priority**.

- Staff welcomed the authorities' commitment to advancing reforms in the health and education sectors. IMF research suggests that Russia has scope to achieve significant budgetary savings by improving expenditure efficiency, without compromising the quality of services.[6] Such savings could be particularly large in healthcare and social protection, but public sector reforms in other areas, including civil service, military, and education, would also be instrumental in creating the much-needed fiscal space.

- Staff also supports the authorities' plan to gradually replace the current revenue-based oil taxation regime with a profit-based system (Annex III). Such a system would be more closely tailored to differences in costs over time and across fields, and would better balance the need to ensure a sufficient oil revenue take by the government against the desirability of creating strong incentives to invest in oil exploration and production. However, it was agreed that a necessary precondition for adopting such a system would

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[6] David Hauner, 2009, "Benchmarking the Efficiency of Public Expenditure in the Russian Federation," IMF Working Paper No. 246.

be the introduction of transfer-pricing legislation consistent with OECD guidelines and a strengthening of enforcement capacity.

C. Monetary Policy

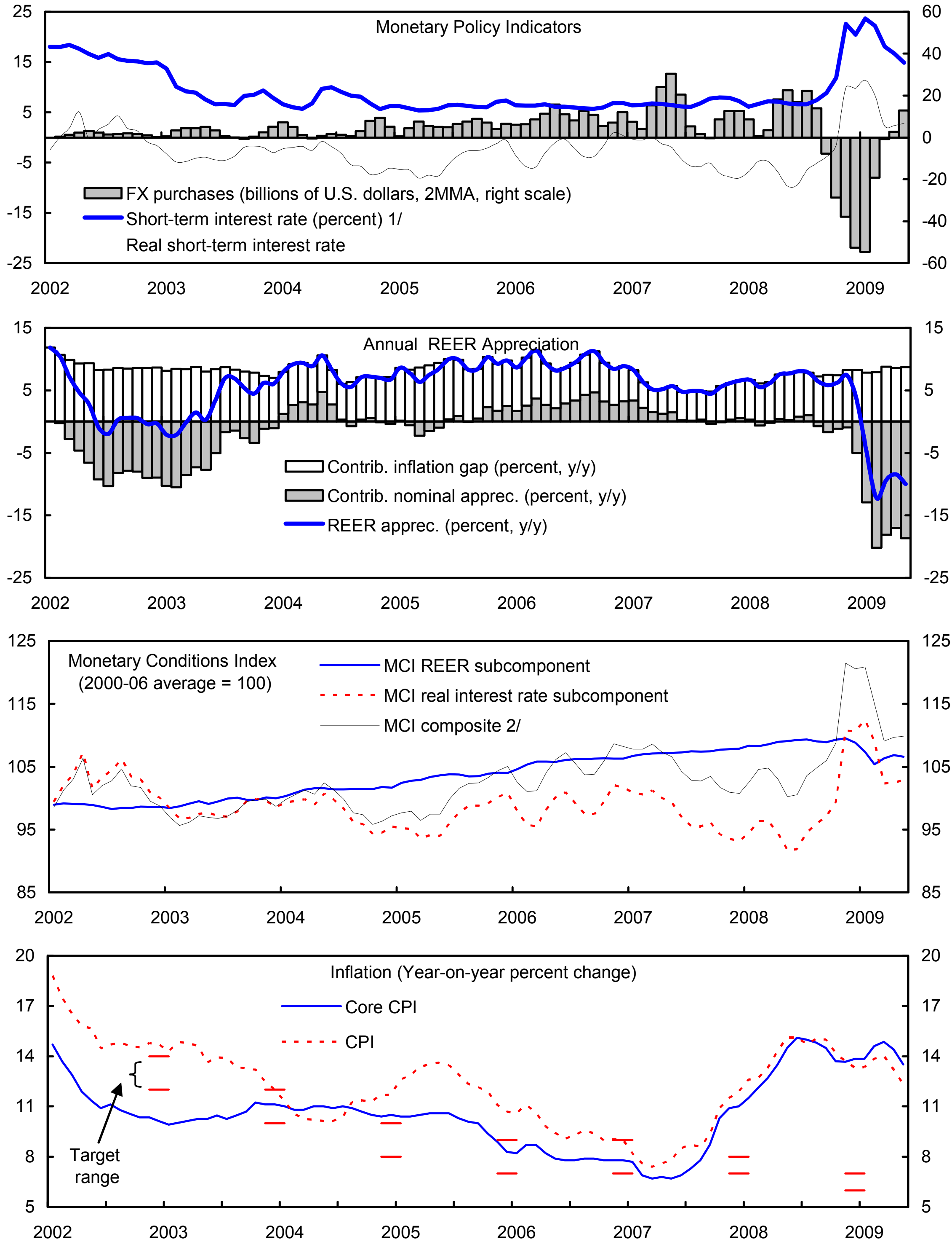
With inflation declining, there is room to ease further the monetary policy stance. However, given that the large liquidity injections associated with monetization of the fiscal deficit may create risks to external stability, the CBR should move cautiously in reducing interest rates. Looking farther ahead, the challenge for monetary policy will be to bring down entrenched high inflation, with a view to bolstering Russia's capacity to mobilize domestic savings to fund much-needed investment.

22. **There is scope for a more accommodative monetary policy stance** (Figure 4). Staff and the authorities agreed that there is room to cut policy interest rates in light of a widening output gap and declining inflation. However, the direct impact of lower interest rates on domestic demand would likely be somewhat limited at first. Banks facing mounting overdue loans and rising credit risk were likely to scale back the supply of credit as they attempted to build liquidity and strengthen their balance sheets. At the same time, general uncertainty about the economic situation was likely to reduce the demand for credit. Nonetheless, lower interest rates should help reduce bank funding costs and support the financial system.

23. **Staff and the authorities agreed that the challenge for monetary policy in the short run will be to strike the right balance between domestic and external stability**. Monetization of the fiscal deficit by drawing down the oil Reserve Fund would represent a substantial injection of liquidity—amounting to around 70 percent of base money during the remainder of 2009, under the assumption that the budget is fully executed. Although the CBR expects a large portion of this to be sterilized, in part through the repayment of the uncollateralized loan stock, staff still projects a net liquidity injection of around 35 percent of base money.[7] This is a significant injection into a banking system that is already liquid and that is likely to continue to have strong liquidity preferences on account of high uncertainty. This points to the risk that an excessive reduction in interest rates, or renewed expectations of ruble depreciation in the face of a reversal of the recent oil price increase, might induce banks and investors to shift out of rubles and into foreign exchange, putting excessive downward pressures on the exchange rate. In view of this, staff believes that the CBR should move cautiously in reducing policy rates. For their part, CBR officials noted that they stood ready to halt the reduction in interest rates as needed to preserve external stability.

[7] The gradual unwinding of the uncollateralized loan stock has the added benefit of reducing risks to the CBR's financial soundness.

Figure 4. Russia: Monetary Policy Indicators, 2002–09



Sources: Central Bank of Russia; Haver analytics; and IMF staff calculations.

1/ 3-month MIBOR; real rate deflated by most-recent 3-month CPI inflation (annualized, s.a.)

2/ $MCI_t = MCI_{t-1} \times [1+(r_t - r_{t-1}) + a_t \times \log(REER_t / REER_{t-1})]$, where r_t is the real 3-month interest rate, and a_t is the time-varying average of the export and import-to-GDP ratios.

24. **Staff welcomed the CBR's policy of increased exchange-rate flexibility and urged the CBR to keep monetary policy focused on reducing inflation**.

- Staff noted that the resumption of short-term capital inflows—most notably the carry trade—underscored the importance of allowing the ruble to move flexibly, in both directions, to avoid exacerbating short-term speculative inflows associated with one-way bets on the currency. Staff acknowledged that an abrupt and dramatic shift in exchange rate expectations and a reversal of capital inflows—perhaps associated with a rapid decline in oil prices—could be cushioned by drawing on Russia's substantial international reserves. But ultimately, the authorities should stand ready to let the exchange rate move in line with longer-term fundamentals.

- Staff urged the CBR to refocus monetary policy on inflation control. It noted that the crisis has laid bare the cost of orienting monetary policy toward nominal exchange rate stability, as it has allowed high inflation to remain entrenched, at levels well above those of G-20 peers. The consequences of this policy may be particularly severe in an environment of limited external financing which is likely to prevail in the years to come. In particular, the capacity of Russia's financial system to mobilize long-term financing to fund much-needed investment is likely to remain limited as long as inflation stays high, impeding an expansion of the Russia's productive capacity. Concerns in this regard are heightened by the risk of continued procyclicality in fiscal policy even as GDP growth begins to recover, which could spark renewed upward pressure on the real exchange rate. This risk makes maintaining exchange rate flexibility particularly important, as it will be critical that such real exchange rate pressures are not reflected in higher inflation.

25. **The authorities agreed with the importance of reducing inflation and expected to achieve steady progress in this regard**. In particular, they were committed to the maintaining the higher degree of exchange rate flexibility seen since the beginning of the year. However, given the importance of primary commodities to the balance of payments and the volatility of commodity prices, they felt that it was pre-mature to commit to allowing the exchange rate to fully respond to changing fundamentals at this stage. In this regard, while much of the technical preparatory work is now in place, the authorities felt that it was too early to commit to a timetable for moving to inflation targeting.

D. Structural Reforms

Boosting Russia's long-term growth potential depends critically on advancing structural reforms, including through accession to the WTO. However, the accession process appears to be loosing momentum.

26. **Staff inquired about the prospect for reinvigorating reforms that would help bolster Russia's investment climate, including membership in the WTO**. It noted that

Russia continues to score poorly on cross-country comparisons of the investment climate, not least because of what is perceived to be heavy government interference in the economy. Moreover, limited competition and lack of new entries are seen to be encouraging rent seeking. Staff noted that important reforms in this regard appear to have stalled during the period of high and rising oil prices—not least civil service and public administration reforms—and it also expressed concern that support for early WTO accession seemed to be loosing momentum. In this regard, staff noted that, as the scope for catch-up gains in productivity begins to diminish, long-term growth will become increasingly dependent on boosting investment, including by improving Russia's still relatively poor investment climate. The fact that the labor force is set to decline steadily, because of unfavorable demographical factors, adds to the urgency of bolstering long-term growth by encouraging investment. Staff also encouraged the authorities to maintain an open trade regime and avoid protectionist measures.

27. **The authorities agreed on the need to move ahead with structural reforms**. In this regard, they confirmed that many reform aimed at improving the investment climate and bolstering institutions were technically relatively well-advanced. However, as far as implementation is concerned, the focus would be on areas critical to controlling public spending, notably reforms to the health and education sectors. While stressing that WTO accession remained an important goal, officials expressed frustration about the prolonged process, acknowledging that it appeared to have lost some momentum. Indeed, shortly after the mission, Russia suspended its bilateral bid for WTO membership, seeking instead to join in partnership with Belarus and Kazakhstan as part of a customs union.

IV. Staff Appraisal

28. **The Russian economy has been hard hit by dual shocks as the two key drivers of its prolonged boom—rapidly rising oil prices and massive capital inflows—have suddenly reversed**. Indeed, the swing in growth has been much stronger in Russia than in its G-20 peers—despite a much larger fiscal stimulus than in many of these countries—and prospects for an early recovery also appear less promising, barring an unexpected strong rebound in the global economy and an attendant rally in commodity prices. The depth of the crisis, but also the large scope for countercyclical policies, should serve as reminders of long-standing strengths and weaknesses in economic policies.

29. **Financial sector weaknesses and large external exposures have circumscribed the policy response to the crisis**. Faced with bank failures and deposit withdrawals, the authorities initially provided low-interest rate ruble credits and intervened heavily to slow the currency's depreciation. This deliberate policy of cushioning the impact of the crisis likely prevented a wave of corporate bankruptcies, stabilized the situation in the banking system, and generally improved prospects by allowing cheap hedging of excessive foreign exposures against ruble devaluation. But the unsustainable pace of reserve losses eventually forced the

authorities to abandon this costly policy—which clearly exacerbated capital outflows—and prompted a significant tightening of monetary policy and a large depreciation of the ruble. This policy shift has brought banking sector problems to the fore, revealing and exacerbating pressures that had begun building with the sharp slowdown in the economy. Thus, banks' financial situation and loan portfolios are now deteriorating at a notably faster pace. The key immediate challenge facing the authorities at this time is how to deal with these mounting problems.

30. **The authorities need to take a more proactive and concerted approach to tackling the problems in the banking sector**. Absent such an approach, there is a notable risk of a prolonged credit freeze, as uncertainty about counterparty risks continue to linger and banks become increasingly undercapitalized. A more proactive approach should include mandatory, bottom-up stress tests of larger banks; a roadmap laying out the likely supervisory responses as bank's capital deteriorates and the level of problem loans increases; and a strengthening of the CBR's supervisory authority, not least by granting it broader consolidated powers. Considering the exceptionally large number of small banks—and taking advantage of the existence of comprehensive deposit insurance—the CBR should, in the view of staff, be more willing to compel bank closures and consolidation. Importantly, despite the explosive credit growth in recent years, the banking system is still small with credit-to-GDP at about 40 percent. This implies that the potential cost of recapitalizing systemically important institutions is unlikely to pose a major fiscal burden.

31. **The planned fiscal relaxation is excessive**. Taking into account the projected cost of urgently needed pension reforms, the relaxation will increase the non-oil deficit by some 11-13 percent of GDP above the level prescribed by the government's medium-term fiscal framework. With non-statutory federal spending of only some 7¼ percent of GDP, fiscal consolidation on this draconian scale will require unprecedented deep public sector reforms. With little evidence of support for such reforms, and considering the spending pressures that led to increasingly pro-cyclical policies before the crisis, staff would urge the authorities to scale back the fiscal stimulus, from 5½ to about 2½ percent of GDP, and reorient its composition toward measures that are self-reversing. Thus, while there is a case for a strong discretionary relaxation, there is a need to better balance short-term cyclical considerations and the medium-term objective of ensuring prudent spending of oil wealth. Without such rebalancing, there is a risk that fiscal policy will become highly procyclical once private demand normalizes, causing excessive real appreciation and stifling the diversification of the economy away from its dependence on primary commodities.

32. **As to monetary policy, there is a case for continuing to reduce policy rates**. While a large-scale monetization of fiscal deficits is in store, staff agrees that the CBR should be able to manage this by allowing the large stock of maturing uncollateralized credits to expire. Still, banks will be highly liquid—reflecting a strong liquidity preference on their part in the current highly uncertain environment—and the reduction in interest rates should proceed

slowly, taking into account the impact on ruble. In this regard, staff would also agree that the CBR should stand ready—in the event that unexpected developments, notably a renewed drop in oil prices, unsettle exchange rate expectations—to support the ruble, allowing a further reduction in reserves. However, the increased exchange rate flexibility since the beginning of the year has helped stabilize the balance of payments, and interventions should be only temporary.

33. **Looking beyond the immediate policy response to the crisis, recent developments point to important lessons regarding the macroeconomic policy mix and objectives and the urgency of structural reforms.**

- The prudent policy of taxing and saving most of the oil revenue windfall during the good years, and the attendant large buildup of reserves, has left Russia with ample room to allow for a significant countercyclical fiscal expansion, including a large discretionary stimulus. It also allowed monetary policy to cushion the initial shock, giving the private sector time to adjust.

- But the pre-crisis policy of controlled ruble appreciation, alongside regulatory shortcomings, encouraged excessive foreign currency borrowing at a time when high oil prices increased foreign appetite for Russian assets. The result was an oil-price related surge in capital inflows and an associated credit explosion. Thus, while prudent fiscal policy did prevent the commodity boom-and-bust through the current account, policy weakness in other areas in effect allowed it through the capital account.

- The inflexible exchange rate policy also led to entrenched high inflation as the inevitable large real appreciation associated with the terms-of-trade gains was taken through price adjustment. This has severely constrained the availability of long-term ruble financing and left the financing of long-term investment projects dependent on foreign sources. Thus, the cost of entrenched inflation is becoming increasingly evident now that access to foreign financing is likely to be limited for some time as the process of global deleveraging plays out.

- Last but not least, the depth of the crisis is in part due to the failure to advance reforms aimed at improving the investment climate and promoting diversification of the economy. In particular, during the years of high oil prices, little progress was made in advancing the many reforms that are important to curtailing the still pervasive government interference in the economy and to increasing competition and reducing rent-seeking.

34. **Against this background, policy priorities—once the current crisis subsides—should be geared toward medium- and long-term objectives**. These include: refocusing fiscal policy on the non-oil deficit, which should be credibly anchored on a target that is sustainable from a long-term perspective; reorienting monetary policy toward controlling

inflation, in the context of a fully flexible exchange rate policy; and reinvigorating structural reforms, notably public administration and civil service reforms, reforms of the judiciary, and the drive to gain early accession to the WTO.

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2006–10

(Percent change, unless otherwise indicated)

	2006	2007	2008	2009	2010
				Proj.	
Production and prices					
Real GDP	7.7	8.1	5.6	-6.5	1.5
Consumer prices					
Period average	9.7	9.0	14.1	12.3	9.9
End of period	9.0	11.9	13.3	11.0	9.0
GDP deflator	15.5	13.9	19.2	4.0	13.6
Unemployment rate	7.2	6.1	6.4	...	...
Public sector					
General government					
Overall balance	8.3	6.8	4.3	-5.4	-5.0
Revenue	39.5	40.0	38.4	33.9	35.3
Expenditures	31.2	33.2	34.1	39.3	40.2
Primary balance	9.1	7.4	4.8	-4.9	-4.4
Non-oil balance	-4.5	-3.9	-8.3	-13.8	-14.7
Non-oil balance excl. Yukos 1/	-4.5	-5.5	-8.3	-13.8	-14.7
Federal government					
Overall balance	7.4	6.2	3.5	-5.5	-5.0
Non-oil balance	-3.9	-3.0	-7.5	-12.8	-13.6
Non-oil balance excl. Yukos 1/	-3.9	-4.6	-7.5	-12.8	-13.6
Money					
Base money	39.6	33.1	2.9	4.1	16.7
Ruble broad money	48.8	47.5	1.7	4.8	21.5
External sector					
Export volumes	5.8	4.6	-1.8	-9.1	2.8
Oil	0.7	5.4	-2.6	-1.3	-0.3
Gas	-3.1	-5.4	1.8	-15.0	5.0
Non-energy	17.8	7.3	-2.1	-15.7	7.2
Import volumes	24.0	26.0	16.7	-21.3	3.6
External sector					
Total merchandise exports, f.o.b.	303.6	354.4	471.6	278.4	320.8
Total merchandise imports, f.o.b.	-164.3	-223.5	-291.9	-199.8	-210.4
External current account	94.3	76.2	102.3	18.3	38.9
External current account (percent of GDP)	9.5	5.9	6.1	1.5	2.9
Gross international reserves					
Billions of U.S. dollars	303.7	478.8	427.1	375.7	397.2
Months of imports 2/	17.4	20.3	13.9	18.0	18.2
Percent of short-term debt	212	204	364	285	285
Memorandum items:					
Nominal GDP (billions of rubles)	26,904	33,111	41,668	40,512	46,718
Exchange rate (rubles per U.S. dollar, period average)	27.2	25.6	24.9	...	...
World oil price (U.S. dollars per barrel, WEO)	64.3	71.1	97.0	60.5	74.5

Sources: Russian authorities; and IMF staff estimates.

1/ Excludes one-off tax receipts from Yukos in 2007.
2/ Months of imports of goods and non-factor services.

Table 2. Russian Federation: Balance of Payments, 2006–10

(Billions of U.S. dollars, unless otherwise indicated)

	2006	2007	2008	2009	2010
				Proj.	
Current Account	94.3	76.2	102.3	18.3	38.9
Trade Balance	139.3	130.9	179.7	78.6	110.5
Exports	303.6	354.4	471.6	278.4	320.8
Non-energy	112.8	135.8	161.5	107.1	118.9
Energy	190.8	218.6	310.1	171.3	202.0
Oil	147.0	173.7	241.0	136.8	170.8
Gas	43.8	44.8	69.1	34.5	31.2
Imports	-164.3	-223.5	-291.9	-199.8	-210.4
Services	-13.7	-19.8	-25.0	-14.9	-11.2
Income	-29.7	-31.4	-49.3	-46.5	-61.1
Public sector interest (net)	7.8	16.0	17.4	7.6	7.6
Other	-37.5	-47.4	-66.6	-54.2	-68.7
Current transfers	-1.5	-3.5	-3.1	1.1	0.7
Capital and financial account	4.6	85.9	-138.5	-69.7	-17.4
Capital transfers	0.2	-10.2	0.7	0.7	0.7
Federal Government	-27.8	0.2	-15.4	-2.5	7.7
Local Governments	0.2	-0.1	-0.1	0.0	-0.1
Private sector capital	32.1	96.0	-123.8	-67.9	-25.8
Direct investment	6.6	9.2	18.0	0.0	7.0
Portfolio investment	9.1	10.9	-27.4	5.0	0.0
Commercial banks	24.1	29.4	-56.0	-20.8	-5.0
Corporations (loans)	16.8	90.3	53.1	-21.5	0.0
Disbursements	64.4	171.5	175.1	50.1	64.8
Amortizations	-47.5	-81.2	-122.0	-71.6	-64.8
Other private capital	-24.5	-43.7	-111.4	-30.6	-27.8
Errors and omissions, net	9.7	-13.2	-9.2	0.0	0.0
Overall balance	108.7	148.9	-45.4	-51.3	21.5
Financing	-108.7	-148.9	45.4	51.3	-21.5
Gross reserves (- increase)	-107.5	-148.9	45.3	51.3	-21.5
Memorandum items:					
Current account (percent of GDP)	9.5	5.9	6.1	1.5	2.9
Non-energy current account (percent of GDP)	-9.7	-11.0	-12.4	-12.7	-12.3
Gross reserves 1/	303.7	478.8	427.1	375.7	397.2
(months of imports of GNFS)	17.4	20.3	13.9	18.0	18.2
(percent of short-term debt) 2/	212	204	364	285	285
(percent of public debt service)	2,882	5,560	9,087	8,539	6,538
Russian oil price (U.S. dollars per barrel)	61.1	69.3	94.5	58.0	72.0
World oil price (U.S. dollars per barrel, WEO)	64.3	71.1	97.0	60.5	74.5
Terms of trade (percent)	11.4	3.4	21.1	-25.4	10.2
Public external debt service payments 3/	33.1	10.5	8.6	4.7	4.4
(percent of exports of goods and services)	9.9	2.7	1.6	1.5	1.2
Public external debt 4/	48.6	46.4	32.7	30.2	37.8
(percent of GDP)	4.9	3.6	2.0	2.5	2.8
Private external debt (including local government)	262.0	419.0	447.0	414.7	414.7
Total external debt	310.6	465.4	479.7	444.9	452.5
(percent of GDP)	31.4	36.0	28.6	36.8	34.0

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

1/ Excluding repos with non-residents to avoid double counting of reserves. Including valuation effects.
2/ Excludes arrears.
3/ Net of rescheduling.
4/ Includes indebtness of repos by the monetary authorities.

Table 3. Russian Federation: Fiscal Operations, 2006–10

(Percent of GDP)

	2006	2007	2008	2009 1/	2010 2/
				Proj.	
General government					
Total revenue; *of which:*	39.5	40.0	38.4	33.9	35.3
Oil revenue	12.9	10.7	12.6	8.4	9.8
Non-oil revenue	26.6	29.3	25.8	25.5	25.5
Corporate profit tax	6.2	6.6	6.0	4.1	4.5
Personal income tax	3.5	3.8	4.0	4.0	4.0
VAT	5.6	6.8	5.1	6.0	5.9
Excises	1.0	0.9	0.8	0.8	0.8
Custom tariffs	8.3	7.3	8.6	6.1	6.9
Resource extraction tax	4.7	4.0	4.5	3.1	3.8
Social security taxes	5.4	5.6	5.1	4.9	4.9
Other revenue	4.9	5.0	4.2	4.8	4.4
Total expenditure	31.2	33.2	34.1	39.3	40.2
Interest	0.7	0.6	0.5	0.5	0.5
Non-interest	30.4	32.7	33.6	38.7	39.7
Primary balance	9.1	7.4	4.8	-4.9	-4.4
Overall balance	8.3	6.8	4.3	-5.4	-5.0
Non-oil primary balance	-3.8	-3.3	-7.8	-13.2	-14.2
Non-oil overall balance	-4.5	-3.9	-8.3	-13.8	-14.7
Non-oil balance excl. one-off receipts 3/	-4.5	-5.5	-8.3	-14.2	-14.7
Federal government					
Total revenue; *of which:*	23.3	23.5	22.3	18.4	18.1
Oil revenue	11.3	9.2	11.0	7.2	8.6
Nonoil revenue	12.0	14.3	11.2	11.2	9.5
VAT	5.6	6.8	5.1	6.0	5.9
Excises	0.4	0.4	0.4	0.4	0.4
Corporate profit tax	1.9	1.9	1.8	0.5	0.6
Custom tariffs	8.3	7.3	8.6	6.1	6.9
Other revenue	7.1	7.1	6.3	5.4	4.3
Total expenditure	15.9	17.3	18.7	23.9	23.1
Interest	0.6	0.4	0.4	0.4	0.4
Non-interest	15.3	16.9	18.4	23.5	22.7
Primary balance	8.0	6.6	3.9	-5.1	-4.6
Overall balance	7.4	6.2	3.5	-5.5	-5.0
Non-oil primary balance	-3.3	-2.6	-7.2	-12.4	-13.2
Non-oil overall balance	-3.9	-3.0	-7.5	-12.8	-13.6
Non-oil balance excl. one-off receipts 3/	-3.9	-4.6	-7.5	-13.2	-13.6
Memorandum items:					
World oil price (U.S.dollars per barrel)	64.3	71.1	97.0	60.5	74.5
Urals prices (U.S. dollars per barrel)	61.1	69.3	94.5	58.0	72.0
Oil fund(s)	8.7	11.6	16.4	16.7	12.0
General government debt	9.1	7.4	6.5	7.3	7.8
GDP (billions of rubles)	26,904	33,111	41,668	40,512	46,718

Sources: Russian authorities; and IMF staff estimates.

1/ Based on the 2009 supplementary budget.

2/ Based on the authorities' target for the federal government overall balance of 5 percent of GDP and the Urals oil price of USD 72 per barrel.

3/ Excludes a one-off receipt of tax arrears from Yukos in 2007 and one-off transfers from Nanotechnology and Housing Funds in 2009.

Table 4. Russian Federation: Financial Soundness Indicators, 2003–09 1/

(Percent)

	2003	2004	2005	2006	2007	2008	2009 2/
Capital							
Regulatory capital to risk-weighted assets	19.1	17.0	16.0	14.9	15.5	16.8	16.9
Regulatory capital to risk-weighted assets (Top 30)	16.8	15.9	15.1	...	...	...	...
Asset quality							
Nonperforming loans to total gross loans	5.0	3.3	2.6	2.4	2.5	3.8	5.1
Sectoral exposures							
Sectoral distribution of loans to total loans							
Industry	33.3	28.0	22.1	20.5	18.3	19.6	21.6
Manufacturing	...	...	16.3	14.6	13.5	14.4	15.4
Extraction	...	...	3.5	3.9	3.1	3.3	4.3
Utilities	...	...	2.3	2.0	1.7	1.9	1.9
Agriculture	2.4	2.7	3.0	3.6	3.8	4.2	4.2
Construction	4.4	4.5	4.6	4.9	6.0	6.1	6.1
Trade and restaurants	20.6	18.8	23.9	19.6	18.0	17.4	18.1
Transport and communication	5.1	4.8	4.0	3.7	3.7	4.3	4.3
Others	22.7	24.9	22.8	21.3	23.3	23.3	22.3
Individuals	11.5	16.2	19.6	23.9	24.8	25.1	23.5
Including House mortgages	…	0.5	1.0	3.0	5.1	6.6	6.3
Geographical distribution of interbank loans and deposits							
Russia	54.2	54.0	47.4	35.9	40.0	27.1	27.2
U.K.	9.0	6.6	13.0	21.5	23.3	29.1	28.6
U.S.	8.2	6.7	9.0	7.7	4.1	7.1	5.3
Germany	2.4	7.2	9.5	7.9	6.8	7.5	8.5
Austria	6.8	6.1	5.2	7.0	6.1	5.7	5.4
France	1.6	3.1	3.0	3.8	3.5	4.0	4.8
Italy	1.0	1.8	1.2	1.2	1.7	1.5	1.3
Others	16.8	14.5	11.7	15.0	14.4	18.0	19.0
Profitability							
Return on assets	2.6	2.9	3.2	3.3	3.0	1.8	1.3
Return on equity	17.8	20.3	24.2	26.3	22.7	13.3	10.0
Liquidity							
Liquid assets to total assets	36.1	30.4	27.4	26.8	24.8	25.9	26.6
Liquid assets to short-term liabilities	90.4	78.0	73.7	76.8	72.9	92.1	103.9
Market risk							
Net open position in foreign exchange to capital	8.4	5.8	5.8	5.3	3.6	3.4	5.1
Other FSIs							
Loan loss reserves to total gross loans	5.9	4.9	4.6	4.1	3.6	4.5	5.5
Large exposures to capital	241.0	242.8	239.9	240.6	211.9	191.7	202.2
Interest rate risk to capital	9.9	13.3	13.3	19.3	24.3	16.4	29.4
Net open position in equities to capital	12.4	12.6	14.4	20.4	10.8	3.4	6.2
Customer deposits to total (noninterbank) loans	27.2	27.9	28.5	27.3	25.6	21.1	…
Assets to GDP	42.1	41.7	44.8	51.9	60.8	67.3	…
Regulatory Capital to Assets	14.6	13.3	12.8	12.1	13.3	13.6	…

Source: Central Bank of Russia.

1/ Credit and depository institutions.
2/ As of April 1, 2009.

Table 5. Russian Federation: Monetary Accounts, 2006–10

(Billions of rubles, unless otherwise indicated)

	2006	2007	2008				2009			2010
			Mar.	Jun.	Sept.	Dec.	Mar.	Apr.	Dec.	Dec.
									Proj.	Proj.
Monetary authorities										
Base money	3,208	4,269	4,020	4,323	4,386	4,392	3,674	3,820	4,573	5,336
Currency issued	3,062	4,119	3,794	4,077	4,294	4,372	3,658	3,805	4,515	5,264
Required reserves on ruble deposits	146	151	226	246	92	20	16	16	59	72
Net international reserves 1/	7,998	11,694	12,024	13,583	13,803	10,003	10,376	10,658	9,691	10,322
Gross reserves	7,998	11,694	12,024	13,583	13,803	10,683	11,470	11,472	10,716	11,348
Gross international reserves (billions of U.S. dollars)	303.7	476.4	489.8	553.4	562.3	435.2	390.4	390.5	364.7	386.2
Net domestic assets	-4,789	-7,425	-8,003	-9,260	-9,417	-5,611	-6,702	-6,837	-5,117	-4,986
Net credit to enlarged government	-3,696	-5,613	-6,600	-7,419	-8,053	-7,198	-7,265	-6,850	-4,508	-3,608
Net credit to federal government 2/	-3,350	-5,085	-5,712	-6,488	-7,015	-6,389	-6,175	-5,658	-3,699	-2,799
CBR net ruble credit to the federal government 1/	-752	-1,027	-1,626	-2,402	-2,408	-681	-795	-767	-169	270
Foreign exchange credit	81	118	118	116	148	189	168	162	168	168
Ruble counterpart 2/	-2,679	-4,176	-4,204	-4,201	-4,756	-5,897	-5,548	-5,053	-3,698	-3,236
CBR net credit to local government and EBFs	-346	-528	-888	-931	-1,037	-809	-1,090	-1,192	-809	-809
CBR net credit to local government	-212	-324	-644	-622	-744	-397	-576	-669	-411	-412
CBR net credit to extrabudgetary funds	-134	-204	-244	-309	-293	-412	-514	-523	-398	-397
Net credit to banks	-810	-1,124	-579	-935	-663	2,516	2,894	2,382	1,754	856
Gross credit to banks	28	49	158	50	217	3,692	3,501	3,028	2,800	1,600
Gross liabilities to banks and deposits	-838	-1,173	-738	-985	-880	-1,176	-606	-645	-746	-744
Of which: correspondent account balances	-638	-802	-596	-592	-702	-1,027	-431	-471	-565	-553
Other items (net) 3/	-283	-688	-824	-906	-702	-929	-2,332	-2,370	-2,363	-2,234
Monetary survey										
Broad money	10,151	14,638	14,998	16,005	16,021	16,235	15,737	15,892	18,428	22,062
Ruble broad money	8,996	13,272	13,383	14,245	14,375	13,493	12,112	12,339	14,147	17,194
Currency in circulation	2,785	3,702	3,475	3,725	3,904	3,795	3,278	3,410	3,905	4,642
Ruble deposits	6,211	9,570	9,907	10,520	10,470	9,698	8,833	8,929	10,242	12,552
Forex deposits 1/	1,155	1,366	1,615	1,760	1,646	2,742	3,625	3,553	4,280	4,868
Net foreign assets 1/	6,896	9,919	10,482	11,609	11,959	9,604	10,175	10,430	9,824	10,603
NIR of monetary authorities	7,998	11,694	12,024	13,583	13,803	10,003	10,376	10,658	9,691	10,322
NFA of commercial banks	-1,102	-1,774	-1,542	-1,974	-1,843	-399	-201	-228	134	281
Billions of U.S. dollars	-41.8	-72.3	-62.8	-80.4	-75.1	-16.3	-6.8	-7.8	4.6	9.6
NDA	3,255	4,719	4,516	4,396	4,061	6,631	5,562	5,463	8,603	11,460
Domestic credit	5,470	7,917	8,130	8,573	8,121	9,506	9,228	9,642	13,191	16,123
Net credit to general government	-3,221	-5,055	-6,119	-7,181	-8,631	-7,694	-8,536	-8,199	-5,296	-3,232
Credit to the economy	8,691	12,973	14,249	15,755	16,752	17,200	17,764	17,841	18,487	19,356
Other items (net)	-2,215	-3,199	-3,614	-4,178	-4,060	-2,876	-3,666	-4,179	-4,588	-4,664
Memorandum items:										
Accounting exchange rate (end od period, ruble per U.S. dollar)	26.3	24.5	24.5	24.5	24.5	24.5	29.4	29.4	29.4	29.4
Nominal GDP (billions of rubles)	26,880	32,987	...	...	...	41,789	...	...	40,513	46,719
CPI inflation (end of period, 12-month change)	9.0	11.9	13.3	15.1	15.0	13.3	14.0	13.2	11.0	9.0
Ruble broad money velocity	3.3	2.9	2.7	2.9	3.2	3.3	2.8	3.1	3.0	2.9
Annual change in velocity	-20.0	-11.4	-7.3	0.4	5.4	12.6	6.1	1.3	-7.5	-5.1
Real ruble broad money (rel. to CPI, 12-month change)	36.5	31.8	25.5	13.8	8.7	-10.3	-20.6	-18.3	-5.5	11.5
Nominal ruble broad money (12-month change)	48.8	47.5	42.2	31.0	25.1	1.7	-9.5	-7.6	4.8	21.5
Base money (12-month change) 4/	39.6	33.1	30.4	26.2	19.0	2.9	-8.6	-8.3	4.1	16.7
Real credit to the economy (12-month change)	36.3	33.4	32.7	28.4	22.0	17.0	9.4	7.1	-7.1	-3.9
Ruble broad money multiplier	2.8	3.1	3.3	3.3	3.3	3.1	3.3	3.2	3.1	3.2
Real exchange rate (average annual change) 5/	9.5	7.2	...	...	...	6.4	...	...	-8.6	7.4

Sources: Russian authorities; and IMF 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 drop in the multiplier in 2007 includes an increase in reserve requirements from 2.5 to 4 percent in July 2007.
5/ Historical data from International Financial Statistics (IFS). A positive number implies real effective appreciation.

Table 6. Russian Federation: Macroeconomic Framework, 2006–14

	2006	2007	2008	2009	2010	2011	2012	2013	2014
				Proj.					
I. Savings - investment balances	(Percent of GDP, unless otherwise indicated)								
General government									
Revenues minus transfers, *of which:*	30.2	29.0	26.2	21.1	21.1	21.7	21.5	22.0	21.6
Transfers	9.3	11.0	12.2	12.8	14.2	13.2	13.0	12.2	12.0
Consumption	17.8	17.8	17.3	21.8	21.3	20.3	19.3	16.2	16.4
National savings	12.4	11.2	8.9	-0.8	-0.2	1.4	2.2	5.8	5.2
Gross investment	4.1	4.4	4.6	4.6	4.7	4.3	4.1	3.2	3.2
National savings - investment	8.3	6.8	4.3	-5.4	-5.0	-2.9	-1.9	2.6	2.0
Private sector									
Consumption	47.9	48.0	48.1	51.8	50.3	51.5	52.9	55.9	57.0
Net income from abroad	-3.9	-3.9	-4.2	-4.4	-5.1	-3.8	-3.2	-3.4	-3.4
National savings	18.5	18.9	22.7	22.5	22.9	22.9	22.7	19.2	18.5
Gross investment	17.3	19.8	20.9	15.6	15.1	16.1	17.1	19.2	19.6
National savings - investment	1.2	-0.9	1.8	6.9	7.9	6.8	5.6	0.0	-1.1
Overall Economy									
Consumption	65.5	65.8	65.4	74.2	72.1	72.3	72.8	72.5	73.8
Net income from abroad	-3.2	-2.7	-3.1	-3.8	-4.5	-2.7	-1.8	-1.8	-1.8
National savings	30.9	30.1	31.6	21.8	22.7	24.3	24.8	25.0	23.7
Gross investment	21.4	24.3	25.5	20.3	19.8	20.4	21.1	22.4	22.8
National savings - investment (current account)	9.5	5.9	6.1	1.5	2.9	3.9	3.7	2.6	0.9
II. General government accounts									
Revenues	39.5	40.0	38.4	33.9	35.3	34.9	34.5	34.2	33.6
Expenditure	31.2	33.2	34.1	39.3	40.2	37.8	36.3	31.6	31.6
Noninterest expenditure	30.4	32.7	33.6	38.7	39.7	37.3	35.8	31.1	31.1
Overall balance	8.3	6.8	4.3	-5.4	-5.0	-2.9	-1.9	2.6	2.0
Primary balance	9.1	7.4	4.8	-4.9	-4.4	-2.4	-1.3	3.1	2.4
III. Balance of payments and external debt	(Billions of U.S. dollars, unless otherwise indicated)								
External current account	94.3	76.2	102.3	18.3	38.9	58.2	61.7	48.9	18.1
Percent of GDP	9.5	5.9	6.1	1.5	2.9	3.9	3.7	2.6	0.9
Change in external terms of trade (percent)	11.4	3.4	21.1	-25.4	10.2	2.2	0.5	-0.2	-0.1
Change in Russian crude oil price (percent)	20.8	13.4	36.4	-38.6	24.1	4.9	2.6	1.6	1.6
Private net capital flows (including errors and omissions)	51.6	69.6	-142.2	-67.9	-25.8	7.4	16.0	20.4	25.9
Private net capital flows	41.9	82.8	-133.0	-67.9	-25.8	7.4	16.0	20.4	25.9
Errors and omissions	9.7	-13.2	-9.2	0.0	0.0	0.0	0.0	0.0	0.0
Official reserves	303.7	478.8	427.1	375.7	397.2	460.7	536.3	603.5	645.4
Months of imports	17.4	20.3	13.9	18.0	18.2	18.9	19.5	19.5	17.9
Total external debt (public and private; billions of U.S. dollars)	310.6	465.4	479.7	444.9	452.5	485.1	528.4	578.3	635.0
Percent of GDP	31.4	36.0	28.6	36.8	34.0	32.5	31.6	31.1	30.1
Public external debt service / exports of goods and services (percent)	9.9	2.7	1.6	1.5	1.2	1.6	1.5	1.3	1.2
IV. Growth and prices									
Real GDP growth (percent)	7.7	8.1	5.6	-6.5	1.5	2.3	3.5	4.0	5.0
CPI inflation, end of period (percent)	9.0	11.9	13.3	11.0	9.0	8.0	7.5	7.0	7.0
CPI inflation, average (percent)	9.7	9.0	14.1	12.3	9.9	8.5	7.7	7.2	7.5
Change in GDP deflator, average (percent)	15.5	13.9	19.2	4.0	13.6	9.7	8.1	6.9	8.2
Nominal GDP (billions of rubles)	26,904	33,111	41,668	40,512	46,718	52,421	58,645	65,202	74,043
Nominal exchange rate, rubles per U.S. dollar, end of period	26.3	24.5	29.4	...	...	...	...	...	...
Nominal exchange rate, rubles per U.S. dollar, average	27.2	25.6	24.9	...	...	...	...	...	...
Real effective exchange rate, average change (percent)	9.6	5.7	6.5	...	...	...	...	...	...
World oil price (U.S. dollars per barrel, WEO)	64.3	71.1	97.0	60.5	74.5	78.0	80.0	81.3	82.5

Sources: Russian authorities; and IMF staff estimates.

Table 7. Russian Federation: Indicators of External Vulnerability, 2004−08

(Percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008
Financial indicators					
Public sector debt 1/	23.1	14.2	9.1	7.4	6.5
Broad money (percent change, 12-month basis)	35.8	38.6	48.8	47.5	1.7
Private sector credit (percent change, 12-month basis)	46.7	34.2	48.5	48.5	38.3
Moscow InterBank Actual Credit Rate (MIACR, from 8-30 days, percent per annum for rouble credits)	4.9	3.9	4.1	5.4	9.0
Moscow InterBank Actual Credit Rate (MIACR, from 8-30 days, percent per annum for rouble credits, real)	-6.0	-8.8	-5.6	-3.6	-5.2
External indicators					
Exports (percent change in U.S.dollars)	34.8	33.1	24.5	16.8	33.1
Imports (percent change in U.S. dollars)	28.0	28.8	31.0	36.0	30.6
Terms of trade (percent change, 12 month basis)	15.6	16.7	11.4	3.4	21.1
Current account balance (billions of U.S. dollars)	59.5	84.4	94.3	76.2	102.3
Capital and financial account balance (billions of U.S. dollars)	-10.7	-12.3	4.6	85.9	-138.5
Of which: Inward portfolio investment (debt securities etc.)	4.4	-0.8	9.5	16.9	-26.1
Other investment (loans, trade credits etc.)	-13.5	1.3	-5.0	79.2	-113.1
Gross official reserves (billions of U.S. dollars)	124.5	182.2	303.7	478.8	427.1
Liabilities to the IMF (billions of U.S. dollars)	3.5	0.0	0.0	0.0	0.0
Short-term foreign assets of the financial sector (billions of U.S. dollars) 2/	14.8	20.9	33.4	42.7	...
Short-term foreign liabilities of the financial sector (billions of U.S. dollars) 2/	9.1	9.8	20.7	30.5	...
Foreign currency exposure of the financial sector (billions of U.S. dollars) 2/	0.0	1.9	-12.1	-18.9 ...	
Official reserves in months of imports of goods and services	11.4	13.3	17.4	20.3	13.9
Ruble broad money to gross reserves	1.2	1.2	1.1	1.1	1.3
Total short-term external debt to reserves	91.1	78.7	77.3	24.5	30.8
Total external debt (billions of U.S. dollars)	213.5	257.2	310.6	465.4	479.7
Of which: public sector debt (billions of U.S. dollars)	105.4	82.1	48.6	46.4	32.7
Total external debt to exports of goods and services (percent)	104.8	95.7	92.8	118.2	91.7
External interest payments to exports of goods and services	5.5	4.6	4.8	5.5	5.0
External amortization payments to exports of goods and services	19.6	21.7	23.2	22.8	24.5
Exchange rate (per U.S. dollar, period average)	28.8	28.3	27.2	25.6	24.9
REER depreciation (-) (12-month basis)	7.8	8.8	9.5	5.7	6.5
Financial market indicators					
Stock market index 3/	614.1	1,125.6	1,921.9	2,290.5	631.9
Foreign currency debt rating 4/	BB+	BBB	BBB+	BBB+	BBB
Spread of benchmark bonds (basis points, end of period) 5/	213.0	118.0	99.0	157.0	805.0

Sources: Russian authorities; and IMF staff estimates.

1/ Gross debt of the general government.
2/ Series discontinued in 2008.
3/ RTS index, end of period.
4/ S&P long-term foreign currency debt rating, end of period.
5/ JPMorgan EMBIG Russia Sovereign Spread.

Table 8. Russian Federation: External Debt Sustainability Framework, 2004–14

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	
Baseline: external debt	36.1	33.7	31.4	36.0	28.6	36.8	34.0	32.5	31.6	31.1	30.1	-2.2
Change in external debt	-7.0	-2.4	-2.3	4.6	-7.3	8.2	-2.8	-1.6	-0.9	-0.5	-1.0	
Identified external debt-creating flows (4+8+9)	-22.1	-19.1	-18.5	-15.5	-14.4	1.1	-4.0	-5.1	-5.1	-4.2	-2.6	
Current account deficit, excluding interest payments	-11.9	-12.7	-11.2	-7.6	-7.7	-3.5	-4.3	-5.2	-5.2	-4.4	-2.7	
Deficit in balance of goods and services	-12.4	-13.7	-12.7	-8.6	-9.2	-5.3	-7.5	-6.6	-5.4	-4.5	-2.7	
Exports	34.4	35.2	33.8	30.4	31.2	26.0	27.2	26.2	25.2	24.4	23.3	
Imports	22.1	21.5	21.1	21.8	22.0	20.8	19.7	19.6	19.8	20.0	20.6	
Net non-debt creating capital inflows (negative)	-0.3	0.1	-1.3	-2.2	-0.1	0.0	-0.5	-0.5	-0.4	-0.4	-0.4	
Automatic debt dynamics 1/	-9.8	-6.5	-6.0	-5.7	-6.6	4.6	0.9	0.6	0.5	0.7	0.5	
Contribution from nominal interest rate	1.9	1.6	1.6	1.7	1.6	2.0	1.4	1.3	1.5	1.8	1.9	
Contribution from real GDP growth	-2.3	-1.8	-2.0	-1.9	-1.6	2.6	-0.5	-0.7	-1.0	-1.1	-1.4	
Contribution from price and exchange rate changes 2/	-9.4	-6.3	-5.7	-5.5	-6.6	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	15.0	16.7	16.3	20.0	7.1	7.2	1.2	3.5	4.3	3.7	1.7	
External debt-to-exports ratio (percent)	104.8	95.7	92.8	118.2	91.7	141.5	125.1	123.8	125.3	127.4	129.6	
Gross external financing need (billions of U.S. dollars) 4/	6.7	3.6	21.0	68.1	132.5	134.5	92.7	81.1	90.3	116.4	161.8	
Percent of GDP	1.1	0.5	2.1	5.3	7.9	11.1	7.0	5.4	5.4	6.3	7.7	
Scenario with key variables at their historical averages 5/						36.8	22.6	12.1	2.6	-6.9	-16.5	1.6
Key macroeconomic assumptions underlying baseline												
Real GDP growth (percent)	7.2	6.4	7.7	8.1	5.6	-6.5	1.5	2.3	3.5	4.0	5.0	
GDP deflator in U.S. dollars (percent change)	28.0	21.4	20.2	21.0	22.7	-22.9	8.4	9.8	8.2	6.9	8.0	
Nominal external interest rate (percent)	6.0	5.8	6.3	7.0	5.6	5.0	4.1	4.2	5.3	6.4	6.8	
Growth of exports (U.S. dollar terms, percent)	33.9	31.9	24.5	17.7	32.8	-39.9	15.1	8.3	7.7	7.6	8.0	
Growth of imports (U.S. dollar terms, percent)	26.6	25.7	27.3	35.2	30.3	-31.9	4.7	11.5	13.0	12.2	16.8	
Current account balance, excluding interest payments	11.9	12.7	11.2	7.6	7.7	3.5	4.3	5.2	5.2	4.4	2.7	
Net non-debt creating capital inflows	0.3	-0.1	1.3	2.2	0.1	0.0	0.5	0.5	0.4	0.4	0.4	

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

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 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 9. Russian Federation: Public Sector Debt Sustainability Framework, 2006–14

(Percent of GDP, unless otherwise indicated)

	Actual			Projection						Debt-stabilizing primary balance
	2006	2007	2008	2009	2010	2011	2012	2013	2014	
Baseline: public sector debt 1/	9.1	7.4	6.5	7.3	7.8	7.6	7.5	7.4	7.2	-0.3
Of which: foreign-currency denominated	4.4	2.8	2.3	2.6	2.8	2.3	1.9	1.6	1.3	
Change in public sector debt	-5.1	-1.7	-0.9	0.8	0.5	-0.2	-0.2	-0.1	-0.2	
Identified debt-creating flows	-5.4	-2.9	-0.4	1.3	0.5	-0.2	-0.2	0.0	-0.2	
Primary deficit (excluding deposits in oil funds from revenue)	-2.7	-1.6	0.1	0.1	1.0	0.1	0.1	0.2	0.2	
Revenue (excluding deposits in oil funds)	33.1	34.2	33.5	38.6	38.7	37.2	35.7	30.9	30.9	
Primary (noninterest) expenditure	30.4	32.7	33.6	38.7	39.7	37.4	35.8	31.1	31.2	
Automatic debt dynamics 2/	-2.7	-1.4	-0.6	1.2	-0.5	-0.3	-0.3	-0.3	-0.4	
Contribution from interest rate/growth differential 3/	-2.1	-1.1	-1.0	0.7	-0.5	-0.3	-0.3	-0.3	-0.4	
Of which: contribution from real interest rate	-1.2	-0.5	-0.7	0.3	-0.4	-0.2	0.0	0.0	-0.1	
Of which: contribution from real GDP growth	-0.9	-0.6	-0.3	0.4	-0.1	-0.2	-0.2	-0.3	-0.3	
Contribution from exchange rate depreciation 4/	-0.7	-0.3	0.5	0.5	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 5/	0.3	1.2	-0.5	-0.5	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	27.5	21.7	19.3	18.8	20.1	20.5	20.9	24.0	23.4	
Gross financing need 6/	-7.5	-6.0	-3.5	5.8	5.3	3.2	2.2	-2.3	-1.7	
Billions of U.S. dollars	-74.3	-78.3	-58.5	69.8	70.2	48.2	36.2	-42.9	-35.4	
Stress tests for public sector debt										
Scenario with key variables at their historical averages 7/				6.3	6.2	6.1	6.0	5.9	5.8	-0.2
Scenario with no policy change (constant primary balance) in 2009–13				7.7	7.5	7.3	7.2	7.0	6.3	-0.3
Key macroeconomic and fiscal assumptions underlying baseline										
Real GDP growth (percent)	7.7	8.1	5.6	-6.5	1.5	2.3	3.5	4.0	5.0	
Average nominal interest rate on public debt (percent) 8/	6.5	7.8	8.7	8.0	8.0	7.8	7.8	7.5	7.3	
Nominal appreciation (increase in U.S. dollar value of local currency, percent)	9.3	7.3	…	…	…	…	…	…	…	
Inflation rate (GDP deflator, percent)	15.5	13.9	19.2	4.0	13.6	9.8	8.2	7.0	8.2	
Growth of real primary spending (deflated by GDP deflator, percent)	3.0	16.1	8.8	7.6	4.1	-3.8	-0.7	-9.7	5.2	
Primary deficit	-2.7	-1.6	0.1	0.1	1.0	0.1	0.1	0.2	0.2	

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).

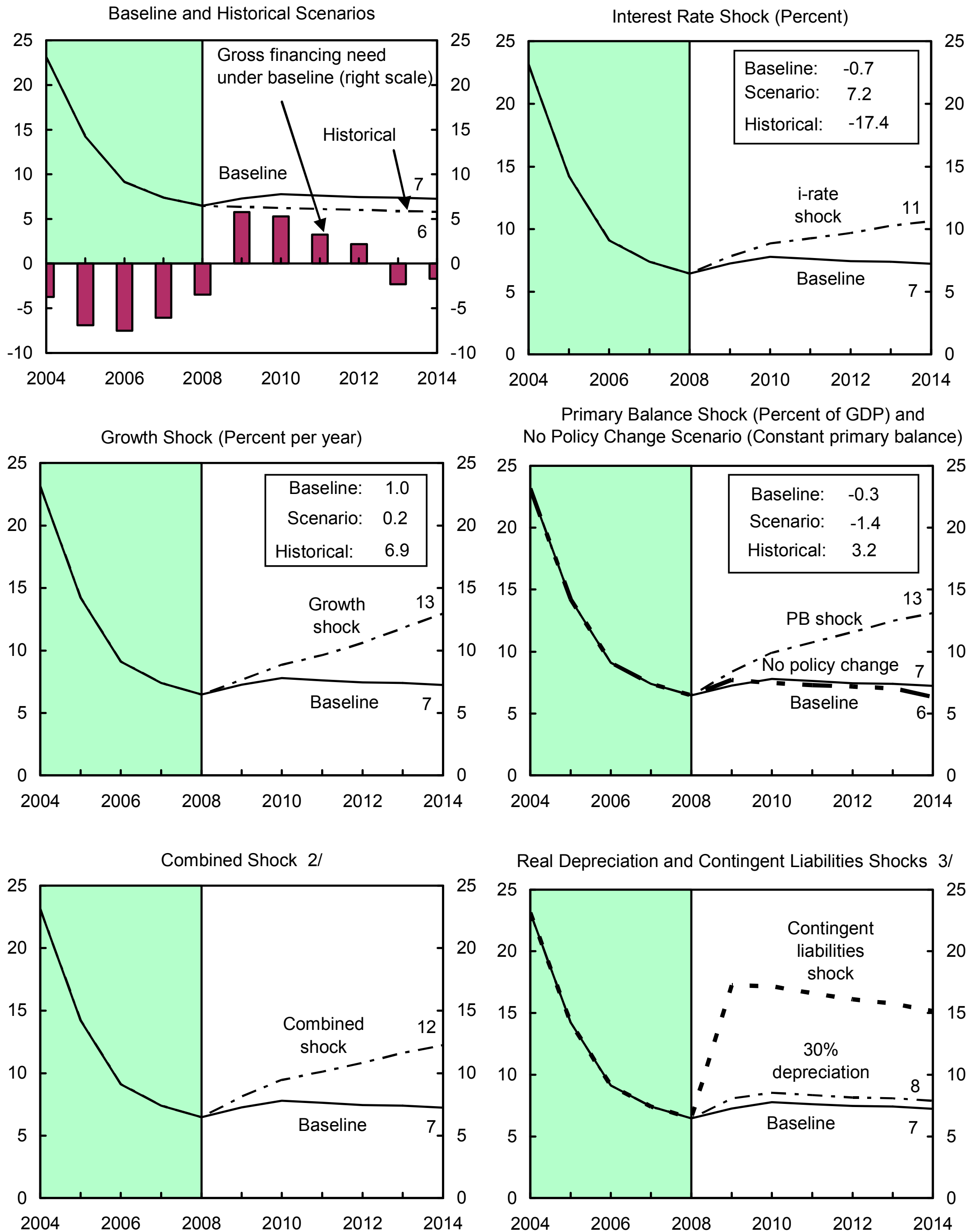
5/ For projections, this line includes exchange rate changes.

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.

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



Source: IMF 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 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

ANNEX I. RUSSIA'S EXTERNAL STABILITY AND COMPETITIVENESS[8]

Recent Developments

According to the results of the two most-recent CGER exercises, Russia's real exchange rate (RER) remains broadly in equilibrium. The Fall 2008 CGER exercise suggested that Russia's RER was in equilibrium. The Spring 2009 exercise also found that the RER was still in equilibrium, even though the real effective exchange rate (REER) had depreciated by around 12 percent.

CGER Results, 2008–09
(Percent deviation from estimated equilibrium)

	Fall 2008	Spring 2009
Macrobalance approach	1	-9
External stability approach	-13	-1
ERER approach	6	-1

These results, combined with additional empirical studies, confirm that the scale of the Ruble's real depreciation over December–January was appropriate, given the change in Russia's long-term fundamentals. In particular, between the two CGER exercises, projected long-term oil prices under the WEO had dropped by around 30 percent, from about $100 per barrel to $73 per barrel. In this context, recent studies of competitiveness in oil-exporting countries have suggested that the elasticity of a country's ERER with respect to the price of oil is typically around 0.4–0.5 percent.[9] Given the drop in projected oil prices, this implies a 12–15 percent fall of Russia's ERER, roughly equal to the ruble's actual REER depreciation over the same period. Most recently, oil prices and the exchange rate have reversed course. Projected long-term oil prices increased by 14 percent over March-May to around $83 per barrel, implying a 5–7 percent appreciation in the equilibrium RER. The actual REER, on the other hand, has appreciated over the same period by about 10 percent. Given the uncertainty typically associated with such an exercise, this suggests that Russia's exchange rate is still broadly in line with fundamentals.

[8] Prepared by Hajime Takizawa and Andrew Tiffin.

[9] For a good survey, see Korhonen and Juurikkala, "Equilibrium exchange rates in oil-exporting countries," *Journal of Economics and Finance* (2009) Vol.33, pp.71-79

Further Analysis

Arguably, the original CGER methodology, as outlined in IMF (2008)[10], is not ideally suited to the specific circumstances of an oil-exporting transition country such as Russia. Specific concerns include:

- ***Assessment of the underlying current account***: A key assumption of the original CGER approach is that the RER and current-account balance should return to equilibrium within a relatively short time frame. This can be problematic for transition countries that have typically experienced an extended period of trend real appreciation in the context of real convergence. The assumption also may not hold for oil exporting countries if, for example, macroeconomic policies are explicitly aimed at smoothing the effects of large terms-of-trade shocks over an prolonged horizon. In this regard, estimating the underlying current account by taking staff's medium-term current-account projection (2014) and then discounting for the projected real appreciation over this horizon may be misleading.[11]

- ***MB approach***. The sample used for estimating the current account norm in the original IMF (2008) MB regression includes few oil exporters, potentially underestimating the potential impact of a large change in oil prices for a country such as Russia.

- ***ES approach***. The traditional ES approach, as outlined in IMF (2008), takes the most recent NFA as a benchmark of a "sustainable" net foreign asset (NFA) level, and calculates the current account level that stabilizes the economy's NFA at that level. Again, this assumption may not be wholly appropriate for oil exporting and transition economies. On the one hand, oil exporting countries such as Russia have exhaustible resources, suggesting a more dynamic NFA profile, in which foreign assets are accumulated in the extraction phase to provide income in the future. On the other hand, significant catch-up productivity gains experience by transition economies imply sharply higher future incomes, and so may justify the opposite profile. In sum, determining the appropriate NFA benchmark for a country such as Russia is a challenge, and may require a more nuanced approach.

- ***ERER approach***. The IMF (2008) ERER approach uses fixed-effects panel techniques in estimating the equilibrium relationship between a country's RER and its fundamentals. This is necessary, as the dependent variable in the CGER regression is CPI-based index

[10] "Exchange Rate Assessments: CGER Methodologies," *IMF Occasional Paper 261*

[11] In this context, much of the projected appreciation may reflect a trend process of productivity growth and structural change. Rather than representing a drop in competitiveness, therefore, it represents the price impact of an *improvement* in competitiveness, and so should not impact the current-account balance in the same manner.

and so is not comparable across countries. One potential drawback of this approach, however, is that it implicitly assumes that the RER in each country has been, on average, in equilibrium over the sample period. For many countries, especially transition countries in the process of converging with their Western European neighbors, this assumption is somewhat heroic—their RERs are likely to have been undervalued initially, as communist-era prices and wages were often set below market-clearing levels and have only gradually converged to their full economic value.[12]

In this context, the CGER exercises for Russia in both Fall 2008 and Spring 2009 have been modified to account for some of these concerns. The modifications, together with additional analysis by staff, are outlined below.

- ***Underlying current account***. To avoid some of the potential issues associated with estimating the *underlying* current account based on medium-term projections, the underlying current account for MB and ES approaches can instead be estimated more directly by taking the actual 2008 balance and stripping it of all temporary factors.[13] In the case of Russia, this entails correcting the recorded balance of 6.1 percent GDP for: (i) unusually high oil prices; and (ii) the recent positive output gap. The resulting underlying balance is 3.9 percent of GDP, somewhat more conservative than the Spring 2009 CGER estimate of 5.2 percent. In assessing the degree of exchange-rate misalignment in Russia, this annex relies on the former estimate, implying that much of the analysis presented below is based on a lower underlying current account balance than that used in the most recent CGER exercise.

- ***MB approach***. The Spring 2009 CGER exercise for Russia addresses some of the potential weaknesses of the IMF (2008) methodology, by adopting a specification that allows different coefficients for oil-producing countries, and using a sample that includes more oil-producing countries. As an additional check, however, staff have estimated a series of

Exchange Rate Assessment under Alternative MB Specifications
(Percent deviation from estimated equilibrium)

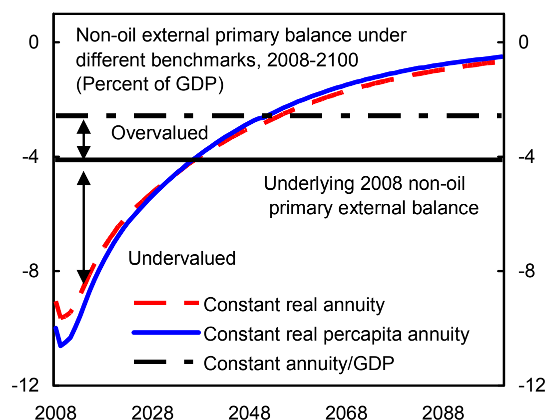
CGER Specification	-2
Oil-price specification	-4
Oil exporters only	-1

[12] The CGER regression does allow for some transition-specific undervaluation, by including a variable that captures the role of administered prices, and also allows for temporary off-equilibrium behavior by including a dummy variable to account for the 1998 Russia crisis. Quantitatively, however, these features may not capture the full scale of the trend appreciation exhibited by transition countries, which has exceeded 200 percent over the past decade for many countries in the region.

[13] See also Romania: Selected Issues (IMF Country Report 08/210); and Jordan: Selected Issues (IMF Country Report 08/291)

further regressions, using samples that are more heavily dominated by oil exporting countries; and replacing the oil balance/GDP variable in the CGER specification with simple oil prices to avoid introducing potential endogeneity bias.[14] The results of the alternative specifications broadly agree, and indicate that Russia's underlying current account balance is generally in line with its fundamentals-based norm, thus confirming that Russia's RER is in equilibrium.[15]

- ***ES approach***. To take into account the fact that oil resources are exhaustible, an alternative variant of the ES approach looks beyond a country's recent NFA level, and considers instead its overall wealth, including the net present value of its future oil-related cash flows. As a current-account benchmark, then, the primary non-oil current account is set equal to the annuity value of this wealth. The Fall 2008 and Spring 2009 CGER exercises for Russia take this approach, and focus on the current account that would be consistent with a fixed annuity in real per capita terms. However, this is not the only possible benchmark. Within the fiscal literature, three different annuity measures are commonly considered: an annuity that remains constant relative to GDP; an annuity that remains constant in real terms; and an annuity that remains constant in real per capita terms. The estimated current-account norm depends closely on the measure chosen. Russia's total wealth is estimated by staff to be



Exchange Rate Assessment under Alternative ES Benchmarks

(Percent deviation from estimated equilibrium)

Constant annuity as a proportion of GDP	14
Constant annuity in real terms	-20
Constant annuity in real per capita terms	-24

[14] Details of the additional regressions, and discussion of potential endogeneity issues for countries where the current account is dominated by energy exports, is included in a report by the Working Group on Exchange Rate Assessments, Middle East and Central Asia Department.

[15] The exchange-rate results shown for the CGER specification are based on a comparison of the estimated CGER current-account norm (3.0 percent of GDP) to the estimate of the underlying current account derived in this annex (3.9 percent). Using instead the CGER's less-conservative estimate of the underlying current account (5.2 percent), the results would suggest a greater degree of undervaluation.

around 220 percent of GDP in 2008 prices, and the annuity value of this wealth ranges widely from 2–9 percent of GDP.[16] The implications for the exchange rate, therefore, also vary widely—depending on which benchmark is considered most appropriate, the exchange rate may be substantially overvalued or undervalued. Given that the choice of one benchmark over another is to some extent arbitrary, this alternative approach is still somewhat unreliable as a firm indicator to assess Russia's RER.

- ***ERER approach***. The IMF (2008) ERER methodology was used in both the Fall 2008 and Spring 2009 CGER exercises. As noted, however, an assumption underlying the standard ERER approach—that the RER in each country has been, on average, in equilibrium over the sample period—may not be appropriate in all cases. In light of this potential concern, staff has considered an additional regression that: (i) uses as a dependent variable USD wages, which *are* directly comparable across countries and serve as a useful cost-based proxy of the real exchange rate; (ii) draws from a wider sample of countries, and (iii) explicitly allows for the fact that most transition countries will not have been in equilibrium for most of the sample period. The alternative specification generally agrees with the conclusions of the CGER regression: it suggests that, following the recent real depreciation toward the end of 2008, USD wages in Russia were 2 percent below equilibrium, while the CGER approach suggests an undervaluation of 1 percent. Both confirm that the RER is now roughly in equilibrium.

Equilibrium Dollar Wage, 1990–2008

	1994	1996	1998	2000	2002	2004	2005	2006	2007	2008 1/
Actual Wage (U.S. dollars)	137	280	135	109	134	238	291	375	506	538
Equilibrium wage (U.S. dollars)	224	249	244	256	277	419	442	479	516	547
Equilibrium ratio (percent)	61	113	56	43	49	57	66	78	98	98

Source: IMF staff calculations.

1/ At December-2008 exchange rate.

[16] Oil and gas wealth estimates are based on proven and *likely* reserves. Sources: BP Statistical Review of World Energy, June 2008; and United States Geological Survey, World Petroleum Assessment 2000

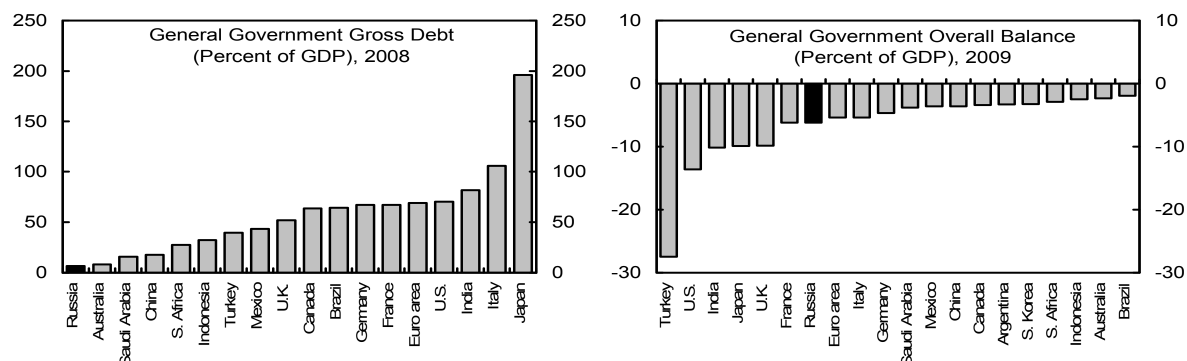
ANNEX II. ANCHORING LONG-TERM FISCAL POLICY[17]

The current crisis has necessitated a large deviation from the medium-term budget framework, resulting in a fiscal deficit that is not sustainable in the long run. This situation is further complicated by considerable emerging fiscal risks, including the large additional outlays associated with the pension reform, rising healthcare costs, and sizable infrastructure gaps. Against this background, there is a need for a credible fiscal anchor that would underpin a sustainable exit from the sizable fiscal stimulus currently underway. Long-term fiscal policy would also need to address the sustainable and equitable use of Russia's exhaustible oil wealth.

Background

The 2009 crisis necessitated a deviation from the original medium-term budget framework. In order to accommodate the sizable 2009 stimulus and allow for a realistic adjustment over the medium term, the authorities temporarily suspended the deficit limits set in the medium-term budget. In particular, the federal government non-oil deficit limit of 4.7 percent of GDP originally envisaged for 2011 was delayed until 2013. This limit reflects long-term considerations suggesting that the sustainable consumption of oil wealth is 3.7 percent of GDP and that borrowing should be limited to 1 percent annually.

While a temporary fiscal relaxation is an appropriate response to the crisis, the implied level of the non-oil deficit cannot be sustained in the long run. Given low public debt (6½ percent of GDP in 2008) and the sizable savings accumulated in Russia's oil funds (estimated at over 16 percent of GDP at the end of 2008), there is ample fiscal room for a temporary stimulus aimed at mitigating the impact of external shocks. However, the projected increase in the general government non-oil deficit to 13¾ percent of GDP in 2009 is clearly unsustainable as it results in an explosive debt dynamic (Figure 1).



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

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[17] Prepared by Daria Zakharova.

Establishing a credible long-term fiscal anchor

As the economy recovers post-crisis, it will be important to ensure long-term fiscal solvency by returning the non-oil deficit on a sustainable path. Russia's strong initial fiscal position and the authorities' prudent past management of the oil wealth allow for a number of credible adjustment scenarios, including some initial build up of public debt. However, taking into account a number of potentially serious fiscal risks, a conservative strategy that aims at preserving the government's net wealth would be advisable.

- **Considerable fiscal risks render conventional debt sustainability analysis (DSA) inadequate for assessing long-term fiscal solvency in Russia**. Given Russia's low initial debt level, a standard DSA could allow for a sizable increase in debt, as long as it is stabilized at a reasonable level in the long run.[18] However, such a strategy is prone to risk, not least because of the potentially large fiscal costs of the pension reform—estimated at 3 percent of GDP annually on average over the next 40 years[19]—and the long-term spending pressures from rising healthcare costs and sizable infrastructure gaps.[20] Moreover, as in other oil-exporting countries, there is a high degree of uncertainty regarding the long-term level of oil prices and the size of economically viable oil reserves.

- **In light of these risks, a more cautious approach to fiscal sustainability would be advisable**. As a conservative alternative to the DSA, a framework based on the permanent oil income model (POIM) that stabilizes government consumption out of oil and financial wealth could be used to anchor fiscal policy (Box A1). The POIM is well-suited for establishing a long-term fiscal policy benchmark for Russia. While this approach is arguably conservative (e.g., it does not allow for a build up of public debt), staff believes that it is appropriate for Russia in light of the considerable fiscal risks discussed above. The sustainable non-oil deficit level implied by the POIM is meant as an indicative benchmark to anchor fiscal policy over the long run. The framework could accommodate temporary deviations from the benchmark to respond to shocks, while the level of the benchmark should be periodically re-assessed in light of changing

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[18] Recent studies have identified a threshold of 40 percent of public debt to GDP (compared to the current ratio of 6.5 percent in Russia) to mark the limit where the risk of debt distress significantly increases (www.imf.org/external/np/pdr/sustain/2003/061003.htm).

[19] For a comprehensive discussion of potential costs and fiscal risks associated with the pension reform, see David Hauner, 2008, "Macroeconomic Implications of Pension Reform in Russia," IMF Working Paper No. 201.

[20] For a discussion of the trends and efficiency of public expenditure on health see David Hauner, 2007, "Benchmarking the Efficiency of Public Expenditure in the Russian Federation" IMF Working Paper No. 246. For further information on Russia's infrastructure needs see "Meeting Russia's Infrastructure Gap," a speech by Shigeo Katsu, World Bank Vice-President for Europe and Central Asia, September 2007.

macroeconomic and structural conditions. In addition, it is useful to carry out sensitivity analysis with respect to key underlying assumptions, such as the long-term oil price level and interest and growth rates.

Staff's calculations, based on the POIM, suggest that a non-oil primary deficit in the range of 1–2 percent of GDP would be sustainable. The POIM framework assumes a gradual adjustment in the general government primary non-oil deficit of about 1.9 percent of GDP per year until 2015 and limits government consumption in each period to the implicit return on government wealth thereafter. Under baseline projections of oil prices, and the long-term growth and interest rates, the framework implies a sustainable long-term level of the non-oil primary deficit of 1½ percent of GDP (Table 1 and Figure 2).[21] It is important to note, however, that the illustrative adjustment path presented here is one of many alternatives. For example, ceteris paribus, a more frontloaded consolidation could allow Russia to run a somewhat higher long-term sustainable level of the deficit. Conversely, delaying the adjustment by a few years would require a larger, and potentially more painful, consolidation down the road to an even lower sustainable deficit level.

The POIM framework implies that the 4.7 percent of GDP deficit limit stipulated in the Budget Code is not sustainable over the long run. While the authorities' non-oil deficit target of 4.7 percent of GDP could ensure low levels of public debt for some time, it cannot be sustained indefinitely. In particular, long-term simulations suggest that, as the country runs out of oil, public debt starts increasing at an unsustainable pace (Figure 2).

Nevertheless, the 4.7 percent of GDP deficit limit could serve as a useful intermediate target as the non-oil deficit is gradually reduced to sustainable levels. In this regard, the forthcoming medium-term budget will be key in signaling the authorities' commitment to ensuring long-term fiscal solvency, sustainable consumption of oil wealth, and intergenerational equity.

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[21] The baseline scenario assumes June 2009 WEO oil price projections and implies a sustainable non-oil deficit of about 1.6 percent of GDP. Stress tests based on the long-term real Urals oil prices of US$40 and US$100 per barrel yield the sustainable non-oil deficits of 1.1 and 1.9 percent of GDP respectively. The results are presented in relation to total GDP, as opposed to a more conventional measure of the non-oil GDP, due to lack of reliable non-oil GDP estimates for Russia. The results are broadly consistent with the estimates of sustainable government consumption in earlier work (Country Report No. 06/430).

Annex II. Box 1. The Permanent Oil Income Model

The POIM applies the permanent income hypothesis developed by Friedman (1957) to help to decide on how to allocate government wealth (including oil in the ground) across generations. Since natural resources, such as oil, are viewed as an endowment of the country and not a product of the effort of any given generation, the objective is to preserve the value of government wealth for future generations. This would require that consumption in each period is limited to permanent income or the implicit return on government wealth. The basic POIM yields a constant per capita level of the primary non-oil deficit financed by perpetual income from oil wealth.

While the POIM has some well documented drawbacks, including not allowing for intergenerational transfers of the non-oil wealth, it offers a simple and intuitive framework that could be used to construct a sustainability benchmark to guide fiscal policy over the longer term. Countries may deviate for some time from such a benchmark, e.g. due to unexpected shocks. However, a fiscal framework based on the sustainability benchmark would help to evaluate risks and alternatives for returning to the sustainable path with a view to avoiding a sharp and painful adjustment.[1]

[1] For further discussion of POIM and fiscal policy in oil exporting countries, see P. Medas and D. Zakharova, 2009, "A Primer on Fiscal Analysis in Oil-Producing Countries," IMF Working Paper 09/56.

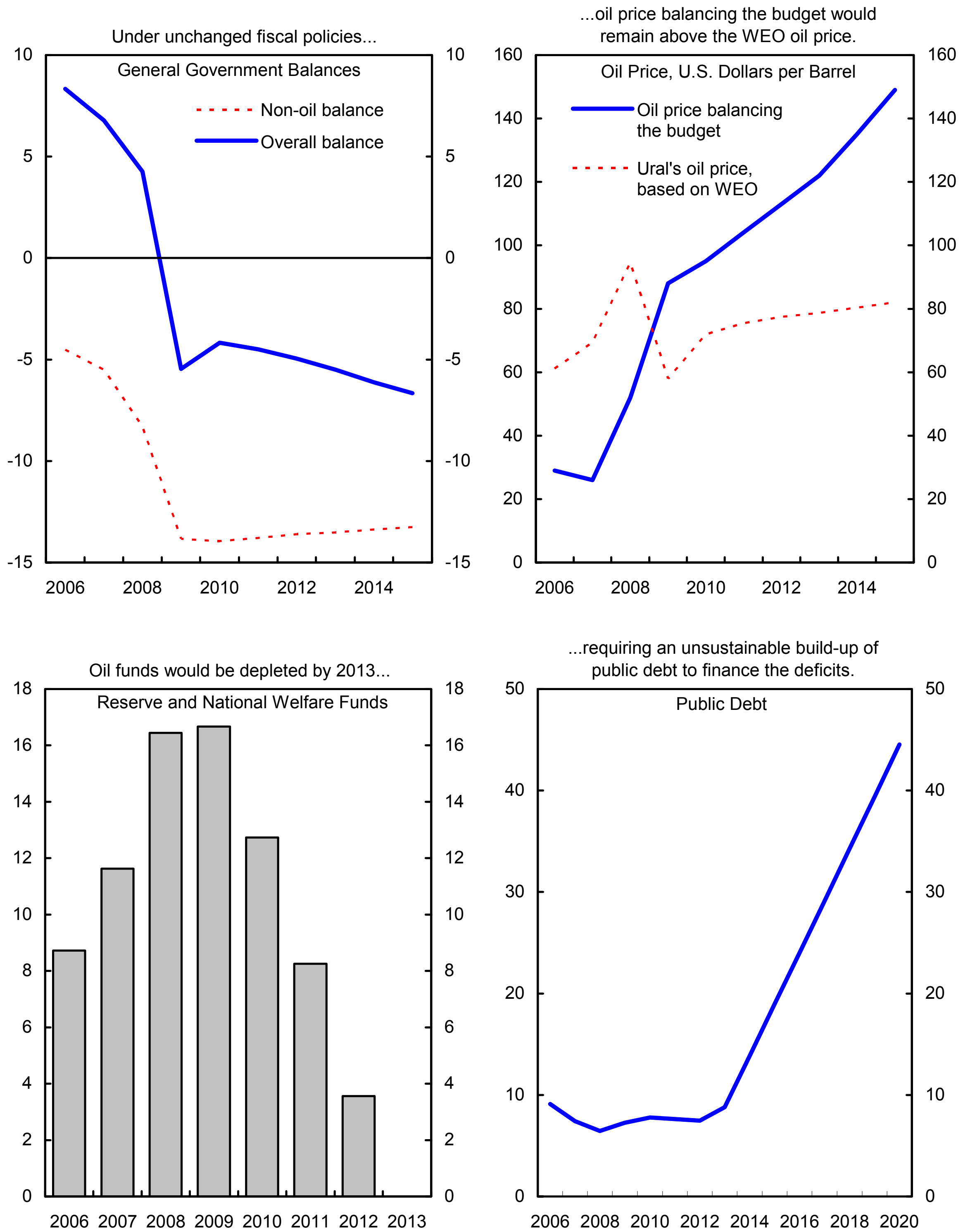
Annex II. Table 1. Russia: Permanent Oil Income Model Assumptions

Parameters	
Net financial assets (NFA; percent of GDP) 2008 1/	10
Real return on assets (percent)	4
Long-term GDP growth rate (percent)	3
Long-term Ural's oil price (U.S. dollars per barrel; based on WEO prices)	80
Long-term gas price (per 1000 cubic meters, WEO)	200
Calculations	
Oil sector	
Proven/unproven reserves (billions of barrels) 2/	156
Years until depletion	42
Present value 2008 of future oil cash flow accruing to government (billions of U.S. dollars)	2958
Gas sector	
Proven reserves (billions of cubic meters)	43300
Years until depletion	75
Present value 2008 of future gas cash flows accruing to government (billions of U.S. dollars)	403
Total	
Energy wealth (billions of U.S. dollars)	3362
NFA (billions of U.S. dollars)	168
Total net wealth (NFA plus energy; percent of GDP)	211

Source: IMF staff calculations.

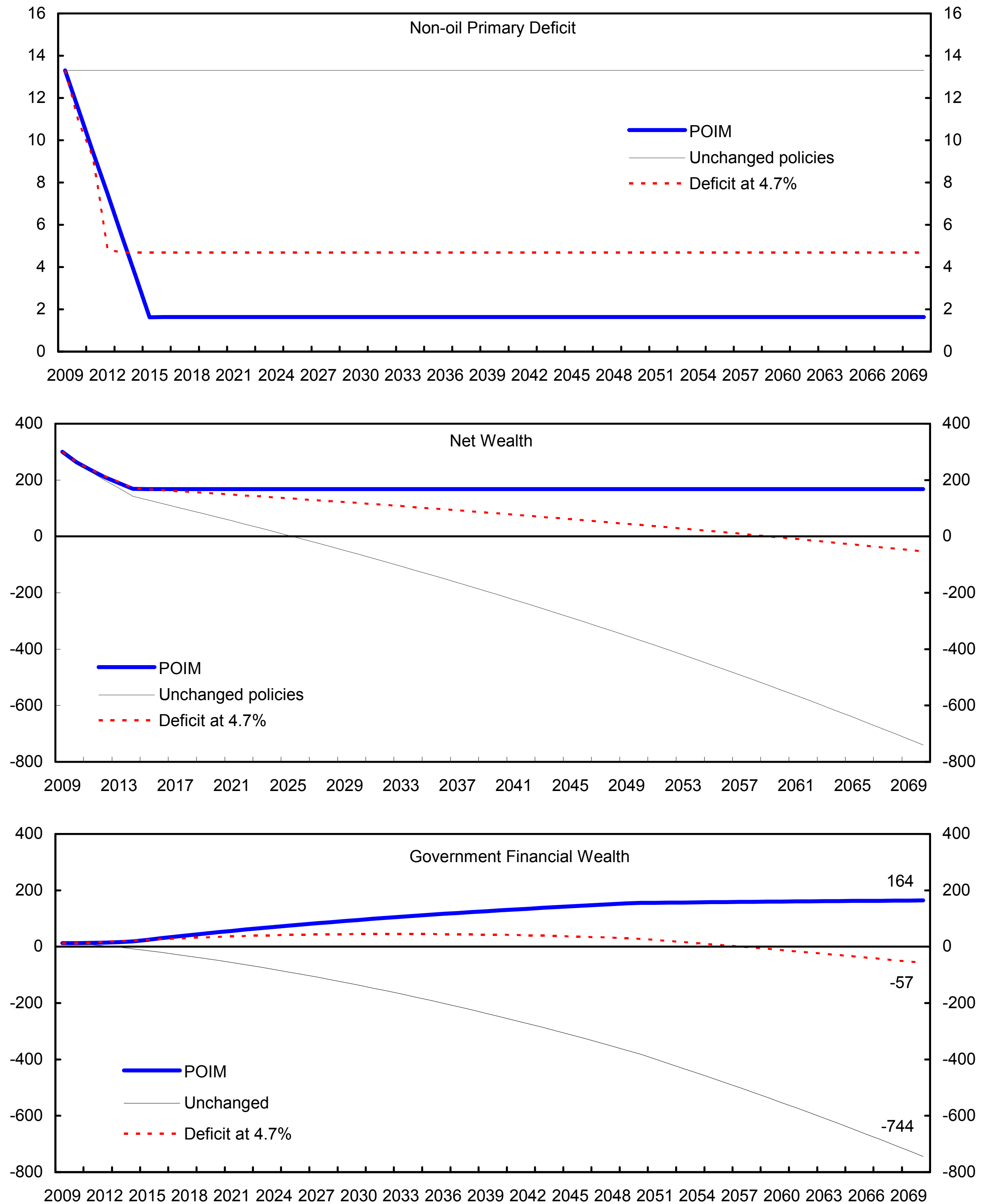
1/ Reserve and National Welfare oil funds net of public debt.
2/ Estimated based on proven oil reserves: 79.4 billions of barrels in 2008 (BP Statistical Review of World Energy, June 2009), and undiscovered reserves: 77.4 billions of barrels in 2000 (The U.S. Geological Survey, 2000).
3/ BP Statistical Review of World Energy, June 2009.

Annex II. Figure 1. Russian Federation: Fiscal Stance, 2006–20
(Percent of GDP, unless otherwise indicated)



Sources: Russian authorities; and IMF staff estimates.

Annex II. Figure 2. Russian Federation: General Government Deficits and Wealth, 2009–70 1/ (Percent of GDP)



Source: IMF staff calculations.

1/ POIM is based on the June 2009 World Economic Outlook oil prices; the "Unchanged policies" scenario assumes that the general government non-oil primary deficit stabilizes at its 2009 level; the "Deficit at 4.7%" scenario assumes that the deficit is stabilized at 4.7 percent of GDP from 2013.

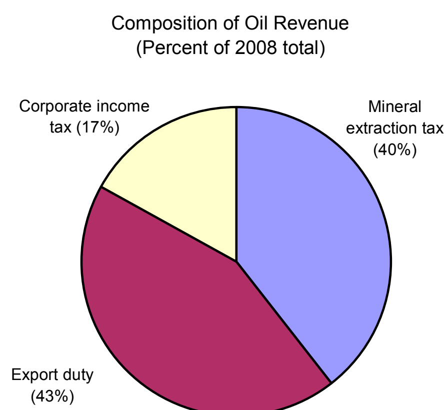
Annex III: Russia's Oil Taxation System[22]

Concerns over low investment, falling production, and the influence that the fiscal regime may be having on this have prompted a review of the oil taxation system. Some changes have already been made including providing partial tax holidays for new fields in non-traditional oil producing regions and reducing rates for heavily depleted fields.[23] This report uses a simulation model to evaluate Russia's oil taxation system and to suggest additional ways to make it more supportive of investment while still providing the government with an appropriate share of oil sector profits.

Background

The current oil taxation system is dominated by revenue-based instruments. Total revenue from upstream oil activity was 9.5 percent of GDP in 2008, most of which came from the mineral extraction tax and export duty (both of which are revenue-based), with the remainder coming from the corporate income tax. From these three taxes combined, the government receives 90 percent of each additional dollar of export earnings when the Urals oil price exceeds $25 per barrel for a field with oil depletion below 80 percent—this top marginal rate is high by international standards and is triggered by what is now considered a low oil price.

Composition of Oil Revenue
(Percent of 2008 total)



Sources: Russian authorities; and IMF staff calculations.

While the current system has served Russia well it needs to adapt to the rising costs of oil production. Russia's oil taxation regime has been successful in providing the government with very large revenue. However, the high tax burden may have contributed to low levels of investment, with oil production declining in 2008 for the first time in many years. With the cost of producing oil in Russia likely to increase going forward—owing to maturing oil fields and the location of additional reserves in smaller, more remote, and more technically challenging fields—production may continue to decline since the current revenue-based system is particularly onerous on high cost fields.

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[22] Prepared by Brenton Goldsworthy, based on a forthcoming coming working paper by Brenton Goldsworthy and Daria Zakharova.

[23] As oil fields are depleted, extracting oil from them generally becomes harder and more expensive.

Model results

The advantages of a profit-based system can be illustrated using a simulation model. We use three oil field examples that broadly represent a low cost structure for a traditional field in West Siberia, a new high cost development in East Siberia, and a very high cost development on the continental shelf. The field examples are illustrative only. In order to benchmark the fiscal regime in Russia against international comparators, we evaluated the effect of imposing other countries' tax systems on three oil field examples. We also model the current regime for an oil field eligible for a partial tax holiday, the regime Russia had in place prior to 2007 ("Russia 2007"), and an alternative profit-based regime (Table 1). We assume WEO oil prices until 2014 and constant real prices thereafter.

Summary of Russia's Fiscal Regime

(Percent)

	Russia	Russia, 2007	Russia Alternative
Royalty	419 Russian rubles/mt * (Urals/bbl - $15) / 261	419 Russian rubles/mt * (Urals/bbl - $9) / 261	10
Export duty	0–65	0–65	0
Company income tax rate	20	24	30
Supplementary profit tax	0	0	R-factor based 1/
Proportion of profit-based revenue 2/	15	15	78

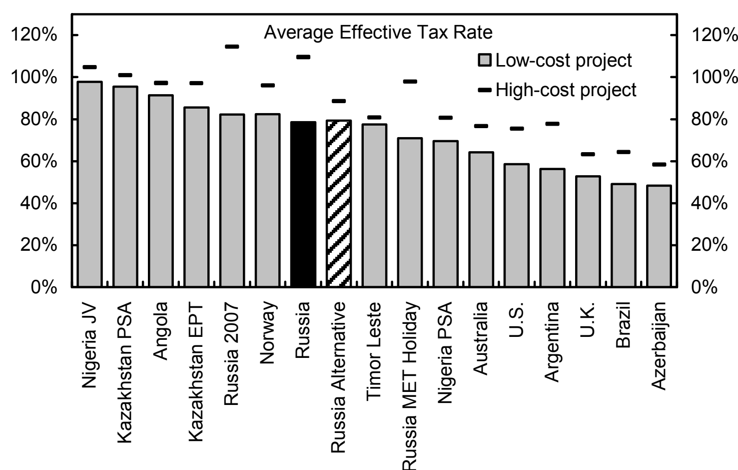
Sources: Russian authorities; and IMF staff calculations.

1/ R-factor is equal to the project's cumulative gross receipts to cumulative gross outlays. As the R-factor increases, so too does the marginal supplementary profit tax. The R-factor is used for illustrative purposes. Many other suitable alternatives are available (e.g., Norway, U.K., and Australia each have their own variant).

2/ Estimated from simulation model using the low-cost project and WEO-based Urals oil price projections.

The results suggest that:

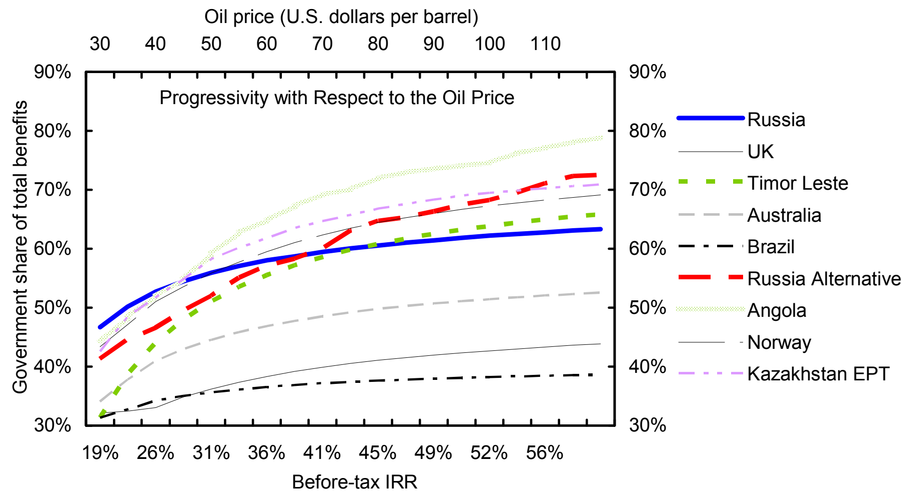
- ***Overall tax burden***. For the low-cost project, the current regime gives rise to a high average effective tax rate (AETR) but one that is below many other countries (figure). The alternative Russia regime has a very similar AETR. However, the rankings are quite different for the high-cost project. In particular, the AETR is substantially higher for the current regime—reflecting very



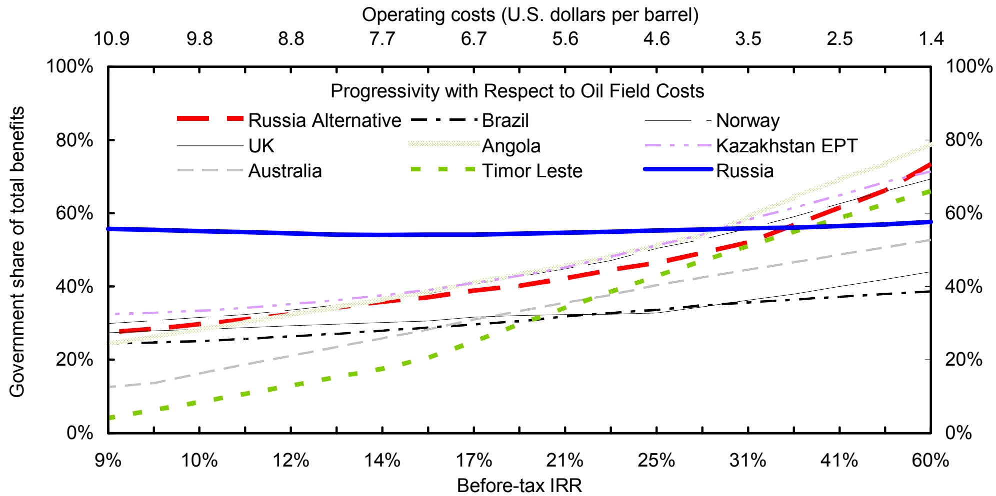
Source: IMF staff calculations.

little change in government revenue despite lower pre-tax net cash flows—and is now above all other countries in the sample. The AETR for the alternative regime is relatively unchanged due its reliance on profit-based instruments. The very high-cost project (not shown in the figure) is not economical under WEO oil prices for any of the regimes—the AETR exceeds 100 percent.

- ***Progressivity***. The degree of progressivity of the fiscal regime—the responsiveness of government revenue to project profitability—is important for both the government and investors. A more progressive regime allows the government to increase its share of revenue when the investment is highly profitable, while giving some relief to investors for projects with low rates of return. For Russia, the government "take" displays the desired progressivity only if the increase in profits is driven by oil prices (figures below). As profits rise on account of a fall in costs the government share under the current Russian system declines slightly (rather than increases) owing to the dominance of revenue-based instruments as a source of revenue. The alternative regime displays the desired responsiveness to costs.

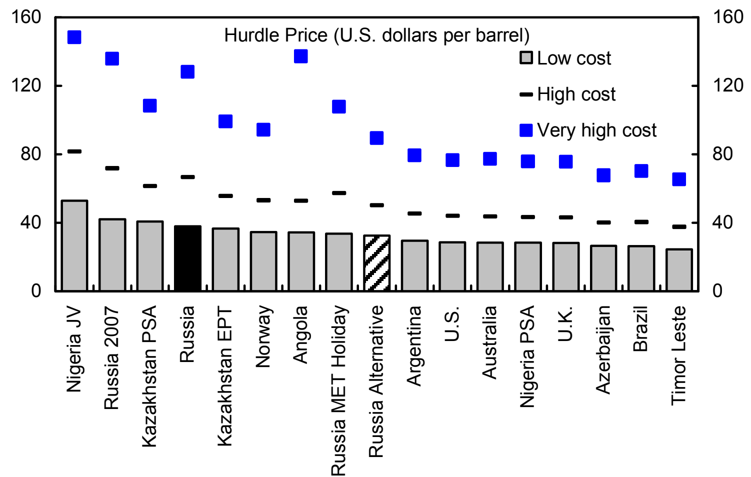


Source: IMF staff calculations.



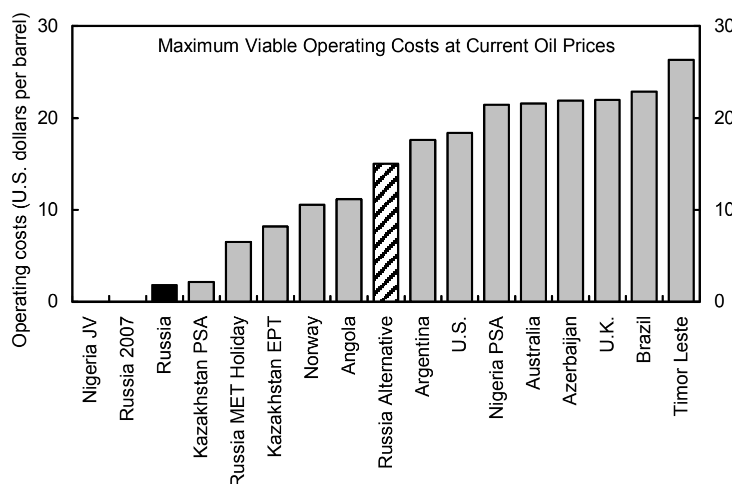
Source: IMF staff calculations.

- ***Investor risk***. The oil price necessary to deliver an after-tax rate of return of 12 percent[24]—the "hurdle price"—is an indicator of risk as it signifies how far the oil price can fall before the investor's after tax rate of return declines to the assumed required rate. The hurdle price under all regimes increases considerably as project costs increase (figure). The alternative regime yields a lower hurdle price, particularly for the very-high cost project. The maximum viable operating cost that would deliver an after-tax rate of return of 12 percent can also be viewed as a measure of risk. Given the exploration and development costs for the high-cost project, oil fields with operating costs above $1.80 per barrel are not viable under the current regime. This rises to $15 per barrel under the alternative regime (figure below). Other risk measures, such as the payback period and tax-induced risk of uneconomic outcomes, point to similar conclusions.



Source: IMF staff calculations.

[24] The required risk-adjusted after-tax rate of return from investors in established oil-producing countries is generally considered to be between 10 and 15 percent.



Source: IMF staff calculations.

- ***Summary of model results***. A profit-based regime could: broadly maintain or even increase the government take from highly profitable projects; expand the range of oil fields that are viable by reducing the tax burden on marginal projects; and reduce key measures of risk. In addition, the flexibility of the regime to automatically respond to changing price and cost conditions will reduce the number of discretionary changes needed (the current system has had to be amended numerous times), and thus provide greater certainty for investors.

Transition arrangements

The authorities see merit in moving towards a profit-based regime but they first need to strengthen their administrative capacity. Transfer pricing rules need to tightened and brought in line with OECD guidelines, and the administrative capacity to enforce the rules will need to be strengthened. To further safeguard revenue, the new regime could be applied to new fields only, maintaining the current system for existing fields. This would require the strict enforcement of ring fencing rules to prevent a company from transferring profits between fields operating under the different systems.

Given the time it will take to prepare for a profit-based system, an initial set of minimal yet important reforms could be implemented sooner. This could include the following: further lowering tax rates for fields located in frontier regions with higher cost of development and extraction; using other proxies for costs, in addition to oil field location and depletion, such as the size of recoverable oil reserves; and exploring whether some costs could be made deductible against the mineral extraction tax or export duty, as a means of transitioning to a profit-based regime.

INTERNATIONAL MONETARY FUND

RUSSIAN FEDERATION

Staff Report for the 2009 Article IV Consultation Informational Annex

Prepared by the European Department
(In consultation with other departments and the World Bank)

July 13, 2009

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ANNEX I. RUSSIAN FEDERATION: FUND RELATIONS
(As of May 31, 2009)

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	4,951.41	83.28
Reserve position	994.08	16.72

III. **SDR Department**:

	SDR Million	Percent of Allocation
Holdings	1.98	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**: The de jure arrangement is a managed float with no pre-determined path for the exchange rate. The Central Bank of the Russian Federation (CBR) sets and announces the official exchange rates of foreign currencies against the ruble on a daily basis. These rates are based on ruble quotes against the dollar on the internal foreign exchange market and on quotes of other foreign currencies against the dollar on the global exchange market. The CBR intervenes in both interbank currency exchanges and the over-the-counter interbank market to limit fluctuations in the exchange rate of the ruble against a basket of the euro and dollar in the short run. The dollar is the main intervention currency. As a result of the stability of the ruble against the Euro-dollar basket, the de facto exchange rate arrangement was classified as stabilized arrangement between April 30 and November 1, 2008. Since November 2008, the CBR has instigated frequent depreciation of the ruble against the Euro/dollar composite, while also allowing larger day-to-day fluctuations. On February 9, 2009, the CBR

established a trading band for the ruble. After stabilizing at the upper edge of the band, the ruble fluctuated inside the band as a result of the CBR intervention. Therefore, the exchange rate arrangement has been reclassified to other managed arrangement effective November 1, 2008. 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, *and maintains an exchange system free of restrictions on the making of payments and transfers for currents international transactions*.

X. **Article IV Consultation**: Russia is on the standard 12-month consultation cycle. The last consultation was concluded on August 1, 2008.

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 FSAP update took place in the fall of 2007, and the FSSA report was discussed by the Board in August 2008, at the time of the 2008 Article IV discussion.

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. Odd Per Brekk, Senior Resident Representative, since March 1, 2009.

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

1. World Bank Group activities in Russia are currently guided by the three-year Country Partnership Strategy (FY07–09) which was endorsed by the Bank's Board in December 2006. This productive and innovative period in the relationship is coming to a close. The next phase, from FY10–12, will build on many solid achievements. Details of the engagement are now under discussion with the Russian Federation but are likely to rest on (i) extension of the existing program, and (ii) possible new Bank support to the Government's anti-crisis and broader modernization agenda.

2. Extending the existing program would entail more intensive use of new instruments that leverage the World Bank Group's knowledge, project management skills, private sector expertise and AAA rating. In particular, the use of guarantees is expected to grow to help reduce the cost of borrowing in capital markets for public financing of infrastructure. The Federal Government is also expected to conclude the first text case of the "new modalities." These are projects financed under a Russian Federation budget line, together with fee-based services for project appraisal and implementation or technical assistance operations, at the federal or sub-national level.

3. Given pressure on Russia's fiscal reserves and external position due to the global financial crisis, the Russian Federation might seek some new financing from the World Bank to modernize the economy, increase the efficiency of public expenditures, and strengthen the position of Russia in the post-crisis period. Themes are likely to include the effectiveness of public expenditures, social programs, support to vulnerable groups, and management of sub-national public finance.

4. Substantial developmental challenges remain in a large number of Russian regions remain. As in the previous CPS, the federal government has encouraged the Bank Group to deepen its direct involvement in the regions. Correspondingly, a central theme of the extended CPS will continue to be in select regions, including economic analysis (growth and business environment diagnostics), regional development strategies, and related investment projects. Sub-national borrowing and new fee-for-service arrangements for investment and policy advice are likely to remain at current levels due to fiscal and liquidity constraints in the regions. IFC and MIGA operations are in very high demand yet face headroom constraints (Russia is IFC's and MIGA's largest exposure).

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

Major areas of Bank Group activities by CPS strategic pillars

(a) Diversifying the economy for sustainable development and growth

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

- *Macroeconomic policy, long-term fiscal sustainability, and the effective management of Russia's large external inflows:* The Bank will contribute to the macro-policy debate in Russia through the periodic Russian Economic Reports, on-demand policy notes and knowledge sharing. In addition, there is strong interest in the Bank's technical assistance in advising on alternative uses for the windfall oil revenues, including the development of an institutional framework for the effective management of a growing diversified portfolio of foreign assets. The Bank has finished a study on long-term fiscal risks and fiscal sustainability. In April 2008, the Bank of Russia and World Bank Treasury formally signed a fee-based services agreement whereby Treasury will provide technical support in internal investment management capacity for a period of 3 to 4 years. In addition, the Bank helped strengthen the financial sector through lending and TA for securities market regulation, financial sector strategy (government assets and liability management, including reserves and stabilization funds management), and insurance and banking sector supervision. On a fee basis, the Bank provided TA to the Central Bank to support payments system development and monitoring.

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

- *Supporting energy efficiency.* The World Bank jointly with the IFC recently completed a study on energy efficiency that provides senior Russian policymakers with a comprehensive and practical analysis of energy efficiency issues in Russia, its potential, benefits, and policy recommendations. At present, the World Bank together with IFC implement an energy efficiency advisory project in the North-West (NW) region of Russia. The project objective is to equip four oblasts of the NW region with methodology and tools to address the regional Energy Efficiency agenda in a comprehensive strategic manner.

- *Supporting Government investment and public-private partnerships (PPPs) for growth and diversification:* On-going investment projects support land registration and the development of a national cadastre for securing property rights and the development of land markets. In addition, regular and reimbursable TAs are now being provided to support the development of PPPs across sectors. In particular, the largest Bank's fee-for-service portfolio belongs to the City of St. Petersburg and includes such large scale infrastructure projects as Western High Speed Diameter, Orlovsky tunnel, NADEX and Pulkovo airport. The Bank would also continue cooperaration with Russia's Development Bank (VneshEconomBank-VEB) on both PPP joint activities and on potentially providing a partial credit guarantee of the Bank to the VEB in support of its efforts to raise funding for infrastructure investments. In addition, the Bank intends to support efforts of the Higher School of Economics of Moscow to develop an e-learning program on PPP for the audience including federal and regional stakeholder, including authorities and business community, in Russia as well as in several other CIS countries. Another area where the Bank is helping the Government to prepare an investment program is microfinance sector, with focus on financial cooperatives and their integration into the financial system of the country.

- *Working with regions to identify engines of growth, develop growth strategies, and remove barriers to growth and labor mobility*: The Bank held two major knowledge events on regional development strategies in early 2008: an early discussion of World Development Report on regional disparities and its implications for Russia, and Regional Development Strategies workshop for Russia's regional governments and other stakeholders of regional development. In addition, the Bank has finalized a Country Economic Memorandum focused on barriers to growth at the sub-national level and on issues of regional agglomerations. The development of fee-for-service arrangements with the regions would provide another avenue for supporting preparation of regional investment strategies and growth analyses, and provision of other analytical services. Also, the Bank is starting new analytical work on internal migration in Russia as part of a broader, CIS-wide engagement on migration issues and policies.

- *Supporting investments in priority areas at the regional level*: The IFC/Bank Sub-National Development Program will support priority regional public investments. The government is interested in developing this financing mechanism further, as it involves direct lending to well-performing regions and municipalities without sovereign guarantees. Three such sub-national operations have been completed to date, including two in the Chuvash Republic and one in Petropavlosk municipality (Kamchatka). In addition, one operation (Mariy El) has been approved by the Board and a credit agreement signed by the client, and another one (Mytischi) is supposed to be approved by the Board by the end of this fiscal year. Infrastructure is also an important area of IFC investments. This concerns primarily transport and logistics, but also includes municipal infrastructure. MIGA can play a role in supporting foreign direct investment in infrastructure at the sub-sovereign level, including in the

water and solid waste sectors. Regional infrastructure projects supported by the Subnational Program is another area where the Bank and IFC could partner with VEB for joint project preparation and support.

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

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

- *MIGA will continue to support foreign investors through the provision of political risk guarantees:* Supporting foreign investment in infrastructure, in close coordination with the Bank, will remain an important area of MIGA's activity in Russia. In the financial sector, the Agency will continue to explore opportunities to support capital markets transactions, including asset-backed securitizations. MIGA may also continue to promote the role and assist in the expansion of foreign banks in the Russian banking sector. Areas for potential further involvement in Russia include manufacturing, agribusiness and services sectors.

(b) Improving public sector management and performance

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

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

- *Supporting the government program in administrative reform:* The Bank will continue its close engagement with the government in the area of administrative reform at the federal and sub-national levels, including the coordination and implementation of substantial donor funds. The primary goal will continue to be bringing Bank and international expertise to bear on the implementation of the government's program for administrative reform, which currently places a strong emphasis on encouraging initiatives at the sub-national level. So far, the Bank has concentrated sub-national work in the Southern Federal Okrug and regions in the North-West. A fee-based advisory service supported Khanti-Mansiysk Okrug-Yugra on administrative streamlining and functional reviews. Similar fee-based advisory services may also be developed with other regions. Support for public administration and governance for selected regions which cannot afford fee-based services is being provided through a DFID Trust Fund which runs from 2007–10.

- *Providing analytical support on effectiveness of public expenditures, transparency and accountability.* At the request of the Ministry of Finance, the Bank has started work on a Public Expenditure Review (PER) focusing on the overall structure and efficiency of public expenditures with particular focus on the wage bill, education, and transportation expenditures. This could develop into programmatic exercise in the following years. Relatedly, and in close coordination, it is pursuing a social expenditures review focusing on subnational expenditures on education, health and social assistance.

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

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

- *Investing in municipal development:* On-going and possible future regional projects have significance for overall municipal development and the quality of municipal services. This includes the completed Municipal Heating, Municipal Water and Wastewater projects and on-going Saint Petersburg Economic Development Project, as well as the Housing and Communal Services project awaiting for government signature, possible regional subnational projects on water and heating system upgrades, and a proposed Cultural Heritage II project (FY09) aimed to use the cultural heritage and the cultural heritage tourism as a resource for economical and social development in the participating regions. The Stavropol pilot Local Initiatives Support project improves the quality of settlement level social infrastructure and the Bank is working with Ministry of Regional Development on scaling up the program nationally.

- *Stepping up engagement on judicial reform:* Assistance on judicial reform also involves the coordination of donor funds and special cooperation at the regional level. A recently approved project, which complements the 2007–11 Federal Targeted Program for judicial modernization, supports judicial reform (FY07) with a focus on improving the efficiency of dispute resolution and the transparency of judicial functioning. A complementary grant from the Government of Japan will provide support to Perm Krai and Leningradskaya Oblast on demand-side justice sector issues such as legal aid to the poor and juvenile justice. In addition, at the request of the Chairman of the Supreme Commercial Court the Bank plans to partner with it and the Ministry of Economic Development to support the drafting of framework legislation to strengthen administrative resolution of disputes and complaints handling, as well as individual bankruptcy law.

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

(c) Improving the delivery of social and communal services

8. In addition to continued general cooperation with the federal government, the Bank will concentrate much of its support for improving social service delivery at the sub-national level. The Government has prioritized the social sector and social services in its medium-

term program. Given that the primary responsibilities and initiatives for reform in these services will be at the sub-national level, the Bank will concentrate its focus on the regions. Main activities include the continuation of work in the areas of poverty, education, and health in cooperation with the regions. Most recent additional activities include monitoring of labor market developments (at the federal and regional levels), and technical assistance for design and monitoring of active labor market programs. Monitoring of social trends and project design for improvement of quality of social services at the local level will be continued in the Southern Federal Okrug and in other regions under fee-based services arrangements. Another critical area for improving living standards is provision of housing and communal services. The government places high importance on improving the performance of the housing and communal services (HCS) sector and on the delivery of high quality services by communal enterprises, and closely links service provision with improving the quality of life.

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

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

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

- *Improvement in the provision of housing and communal services:* The Bank's support in the infrastructure sector will largely focus on improving quality of utility services and housing. The Bank has a large portfolio focused on improving heating, water, wastewater, and other municipal services in selected regions. This includes the recently completed Municipal Heating, Municipal Water and Wastewater projects and approved by the Board and awaiting for government signature the Housing and Communal Services project that aims to support reforms and investments in HCS on grant basis allocated to regions competitively. Also, a large share of sub-national lending is expected to focus on improving these services.

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

(d) Enhancing Russia's global role

9. The Bank has a strong commitment to support Russia's increasing global role, and assist the country in fulfilling its global commitments. The Bank will continue cooperation with the Russian government in support of its emergence as an international donor and active member of multilateral organizations. In addition, the Bank will assist in establishment of

mechanisms and implementation of specific actions arising from Russia's global engagements, such as the Climate Change and Biodiversity Conventions, and pandemic diseases initiatives. During the CPS period, the Bank will also seek to share with Russian experts its analysis (and advocacy) that is currently directed towards the traditional DAC donors. Specific areas for Bank's engagement in Russia are:

- *Assistance in the formulation of an ODA strategy for Russia as emerging donor:* The Bank will continue to assist Russia as an emerging donor, and will cooperate on the design of Russia's development aid strategy and the establishment of a national ODA system. Specific Bank support includes training/capacity events, information sharing, and advisory services. This work will be supported by Russia as a Donor Initiative DFID TF. The Bank will be implementing an "externally funded staff development program" for building Russian Government capacity for aid policy development and aid management. The Government counterparts will be involved in policy dialogue on global food crisis and climate change. Beginning with a high-level Russia-WB-OECD Emerging Donor Meeting in April 2006, the Bank is assisting Russia in organizing development aid seminars and international events. The Bank will participate in preparation and delivery of Spring 2010 international conference on Emerging donors jointly with Russia and OECD.

- *Providing access to the Bank's instruments for channeling Russian developmental assistance:* The Bank will remain engaged with Russia on international policy initiatives developed under Russia's G-8 presidency, including on Russia's priority themes for international assistance—quality of education, improved access to energy by the vulnerable groups, and controlling the spread of infectious diseases. The Bank will help in preparation of contributions in multilateral TFs such as Global Emergency Food Facility, the Education-For-All/Fast Track Initiatives, and ensure effective implementation of Russia supported programs like Malaria control in Africa, Global Village Energy Partnership, Quality of Basic Education (READ). The Bank will expand preparation of joint Russia-Bank aid initiatives in support of economic and human development in Central Asia, including blood banks and labor migrants support. Following increased Russia's contributions to IDA15 the Bank will further work on strengthening ownership of IDA among Russian policy makers.

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

be prepared. The Bank will continue participation in the Ministerial Conference on Forest Law Enforcement and Governance in Europe and North Asia.

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

Focus on Russian regions

10. The Bank is working with the federal government in identifying a small sub-set of 6–10 regions that may become the target of concentrated work programs with the Bank. Regions are being chosen from wealthier, middle income, and poorer areas. Important criteria for the selection of regions for Bank engagement are (i) the willingness and commitment of the regional administration to work with the Bank; (ii) a past history of successful cooperation; (iii) the reform-orientation and competence of the regional administration; (iv) strategic importance of the region for Russian development and the existence of other similar regions for possible scaling up of successful cooperation; and (v) the region's creditworthiness and potential interest in Bank operations (for wealthier or middle income regions). Following initial engagement of selected regions, the strategic directions and modalities of cooperation with the Bank will be included in a joint Memoranda of Understanding, to be signed with the leaders of the focus regions. As noted, Bank involvement at the regional level would involve a combination of targeted AAA on diagnostics of the local economy and investment climate, and development of regional strategies, coupled with selected lending operations to address key challenges.

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

ANNEX III. RUSSIAN FEDERATION—STATISTICAL ISSUES APPENDIX
(as of May 2009)

I. Assessment of Data Adequacy for Surveillance

General: Data provision has some shortcomings, but is broadly adequate for surveillance. There are weaknesses in government finance statistics, and external debt statistics and in terms of data accuracy.

National Accounts: Source data for the system of national accounts are obtained from surveys of businesses and households, and are supplemented by administrative data. Inadequate reporting by firms has constrained improvement of the national accounts. The lack of balance sheet data continues to be an obstacle to staff efforts to analyze balance sheet vulnerabilities. At the request of the authorities, a TA mission visited Moscow in November 2008 to review the framework for the compilation of national accounts statistics. It noted the Federal State Statistics Service (Rosstat) in general follows 1993 SNA, but found the imputed rental services of owner-occupied dwellings clearly undervalued. It also noted the need for methodological improvements in the calculations of volume measures of the production-based GDP estimates, including estimates of the output of financial intermediation services indirectly measured (FISIM).

Price statistics: Data are broadly adequate for surveillance, but time series analyses involving detailed CPI components are difficult to perform because of the lack of accurate time series data on CPI weights. Monthly CPI and PPI, both Laspeyres indices (2000=100), cover all regions of the Russian Federation. In addition to the general CPI index, Rosstat also publishes indices for the foodstuffs, non-food products, and services. However, the weights of the CPI components have been made available since 2006 while PPI components are not disclosed, rendering time series analysis difficult. Consumer spending data, used to calculate the CPI, are posted on Rosstat's website annually. In 2009, the basic structure of household's consumer expenditures, underlying the CPI calculations, has been made available on the website. Further efforts to improve the treatment of seasonal items in the core inflation index and a new household budget survey—which has been under consideration for some time—could significantly strengthen data quality.

Government finance statistics: The timeliness and quality of the data could be improved. 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. The published functional classification of expenditure differs slightly from international standards, while data on the economic classification of expenditures are available with a considerable lag. The lack of timely data on economic classification makes it difficult to assess the size of transfers to the general public, and thus to estimate the likely channels though which government expenditure affects demand components of the national accounts. In the context of a work program for statistical improvement agreed with STA, there have been ongoing improvements in the coverage and quality of government finance statistics; there remains, however, scope for improvement of expenditure data.

Monetary statistics: At the request of the authorities, a TA mission visited Moscow in April 2007 to assist in expanding the coverage of monetary and financial statistics to include other (nondepository) financial corporations and to facilitate the completion of Standardized Report Forms (SRFs). The mission recommended that the authorities reconsider the possibility of compiling data in full accordance with the SRFs framework. Since July 2008, the Bank of Russia submits to the IMF summarized data on the Central Bank Survey, the Other Depository Corporations Survey, the Depository Corporations Survey, Other Financial Corporation Survey and Financial Corporations Survey. In the context of the current global turmoil, analysis of balance sheet effects has been hindered by a lack of *consistent* data on the currency and maturity breakdown of banking-sector assets and liabilities.

Balance of payments: While balance of payments data are broadly adequate for surveillance as significant improvements have been made to enhance data quality, there remains scope to improve the coverage of certain components of the current, capital, and financial accounts. Improving the detail of supplemental data on the financial account would facilitate the analysis of relatively complex flows. For example, supplemental data on gross flows of long-term external debt (i.e., drawings and repayments) have been published for non-financial enterprises, but similar data for banks are not available, which have hampered staff efforts to analyze vulnerabilities resulting from external debt. Some data quality issues continue to affect the reliability of data. While the balance of payments is compiled according to an IMF-developed unified framework fully adequate for capturing economic transactions between residents and non-residents, the reliance on partial data from a variety of sources necessitates the use of estimates and adjustments to improve data coverage. In particular, the CBR makes adjustments to merchandise import data published by the State Customs Service to account for "shuttle trade," smuggling, and undervaluation. At the same time, Russian compilers are seeking to reconcile their data with those of partner countries. Some improvements have been made in the coverage and quality of surveys on direct investment, and the CBR has informed the Fund of its intention to participate in the Coordinated Direct Investment Survey. Headline data on reserves are reported to the Fund and the markets on a weekly basis with a four-business day lag. The Fund receives additional detail on reserves and reserve liabilities through the central bank balance sheet, but this information is not as comprehensive as the Reserve Template, which is disseminated with a lag of twenty days.	
II. Data Standards and Quality	
Participant in the Special Data Dissemination Standard (SDDS) since January 31, 2005.	A data ROSC prepared in October 2003 was published on the IMF website on May 14, 2004.
III. Reporting to STA (Optional)	
Data are being reported for publication in the *International Financial Statistics (IFS)*, *Government Finance Statistics Yearbook, the Direction of Trade Statistics*, and *the Balance of Payments Statistics Yearbook*.	

RUSSIAN FEDERATION: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(As of May 31, 2009)

	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	5/12/2009	5/12/2009	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/1/09	5/8/09	W	W	W		
Reserve/Base Money (narrow definition)	5/4/09	5/8/09	D	W	W	O, LO, LO, LO	O, O, O, O, O
Reserve/Base Money (broad definition)	5/4/09	5/8/09	D	M	M		
Broad Money	March 2009	4/28/09	M	M	M		
Central Bank Balance Sheet	April 2009	5/4/09	M	M	M		
Consolidated Balance Sheet of the Banking System	March 2009	5/5/09	M	M	M		
Interest Rates[2]	5/12/09	5/12/09	D/W/M	D/W/M	D/W/M		
Consumer Price Index	April. 2009	5/5/2009	M	M	M	LO, LO, LO, LO	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	April, 2009	5/12/2009	M	M	M	LNO, LO, LO, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	April, 2009	5/12/2009	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q1 2009	Apr. 2009	Q	Q	Q		
External Current Account Balance	Q1 2009	4/3/2009	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Q1 2009	4/3/2009	Q	Q	Q		
GDP/GNP	Q4 2008	4/2/2009	Q	Q	Q	O, O, LNO, O	LO, LO, O, O, O
Gross External Debt	Q1 2009	4/7/2009	Q	Q	NA		
International Investment Position	2008	7/1/2009	A	A	A		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

Russian Federation: Table of Common Indicators Required for Surveillance (concluded)

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

INTERNATIONAL MONETARY FUND

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

IMF Executive Board Concludes 2009 Article IV Consultation with the Russian Federation

On July 27, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Russian Federation.[1]

Background

In the wake of the global financial crisis, the Russian economy has been hit hard by dual shocks—a collapse in oil prices and a sudden reversal of capital flows. Fixed investment plummeted, significantly weakening the nexus of high growth in investment, productivity, and real wages that had powered consumption and the economic boom prior to the crisis. Against this background, real GDP contracted sharply in the first quarter, while labor market conditions eased considerably, dampening growth in real wages. As the output gap widens, inflation pressures are easing. Following an initial sharp depreciation, a recent modest increase in oil prices and renewed capital inflows have provided some support to the ruble, which remains broadly in equilibrium.

The banking system is under increasing strain, and private sector credit is contracting. As the macroeconomic situation has deteriorated, the level of overdue loans has more than doubled

[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.

since January, despite regulatory forbearance. Moreover, in an environment of high uncertainty, banks have exhibited a strong preference for liquidity. Since monetary policy was abruptly tightened in January, the stock of credit has been falling, for the first time since end-2004.

The authorities' response to the crisis has been swift and substantial, driven by concerns that weaknesses in the banking and corporate sectors could lead to a full-fledged crisis. In particular, the authorities' pre-crisis focus on exchange-rate stability had encouraged substantial foreign-currency borrowing, encouraging unsustainably high rates of credit growth. Combined with supervisory shortcomings, this had left Russian banks and corporates particularly vulnerable to a reversal of inflows. As a result, policy interventions at first focused on maintaining external and financial sector stability by providing significant liquidity at low interest rates while keeping the exchange rate stable to offset the abrupt loss of foreign financing. However, as reserve losses mounted and capital outflows surged, the ruble was devalued and monetary policy tightened. More recently, as exchange rate stabilized and oil prices started to tick up, monetary policy has been gradually eased.

In April 2009, as the economy continued to contract, the government passed a large supplementary budget to support flagging domestic demand. The budget includes large discretionary increases in defense and security spending; along with a package of anti-crisis measures aimed at stimulating economic activity by reducing taxes, extending support to strategic sectors, and enhancing social assistance. As a result, the non-oil deficit of the general government is expected to widen by 5½ percent of GDP in 2009—reaching 13¾ percent of GDP. The deficit will be monetized by drawing down the Oil Reserve Fund, except for domestic borrowing of up to 1 percent of GDP.

Despite the substantial fiscal stimulus, recovery will be slow in coming with important downside risks weighing on economic outlook. Going forward, the external environment is likely to remain challenging, as the subdued outlook for global growth implies only a gradual recovery in commodity prices. Moreover, global deleveraging by financial institutions suggests that capital inflows to emerging economies, including Russia, are unlikely to return to their pre-crisis levels any time soon.

Against this backdrop, real GDP is expected to contract by 6½ percent in 2009, after expanding at an annual rate of 7—8 percent before the crisis. With the banking system expected to remain under strain, credit growth would turn negative and impede a robust rebound. As a result, the economy is projected to recover only slowly over the course of 2010, with inflation gradually falling. The current account surplus would decline in 2009 before improving modestly in 2010, reflecting a gradual recovery of oil prices. Taking into account the planned large-scale monetization of the fiscal deficit, capital outflows are expected to remain relatively high at $68 billion.

Executive Board Assessment

Russia has been hit hard by dual shocks—a collapse in oil prices and a sudden reversal of capital flows. Directors commended the authorities for a swift and substantial policy response to these developments, but noted that macroeconomic management has proved challenging with worsening external circumstances, and economic activity is projected to decline sharply in 2009. Despite some recent tentative signs that the economy may have reached a turning point, it is expected to recover only gradually in 2010. The near-term outlook hinges critically on a sustained rebound in the global economy and commodity prices as well as on the pursuit of appropriate domestic policies going forward.

Directors noted that Russia's pre-crisis policies have had important implications for the scope and effectiveness of the authorities' response to the adverse external environment. On the one hand, Russia's prudent policy of taxing and saving its oil wealth during the good years has created room for a large fiscal stimulus. On the other hand, the pre-crisis policy of controlled ruble appreciation—combined with the lack of long-term domestic funding—contributed to excessive foreign currency borrowing as high oil prices helped inflate investor appetite for Russian assets, and left Russian banks and corporates vulnerable to a reversal of inflows.

Against this background, Directors saw stabilization of the banking sector as the immediate, but a complex, challenge facing Russian policymakers. Sizable liquidity injections and heavy interventions slowed the pace of ruble depreciation early in the crisis and likely prevented corporate bankruptcies and reduced strains on banks. The ensuing reserve losses, however, forced the authorities to allow a large depreciation of the ruble and to significantly tighten monetary policy. Directors noted that the tighter monetary conditions have exacerbated pressures in the banking sector, with banks' loan portfolios now deteriorating at a notably faster pace.

Directors encouraged the authorities to take a more proactive and concerted approach to tackling the problems in the banking sector. They considered that regulatory forbearance has made it difficult to assess accurately the state of asset quality and credit risks. Directors therefore stressed that policy actions should include mandatory, bottom-up stress tests of the larger banks, embedded in a holistic analysis of the banking sectors' risk profile. They also recommended a roadmap laying out the likely supervisory responses in the event that a bank's capital deteriorates, and a strengthening of the supervisory authority of the Central Bank of Russia (CBR).

On fiscal policy, most Directors questioned the size and reversibility of the stimulus currently underway. Directors expressed concern that the large stimulus may become entrenched, leading to a renewed bout of excessive real appreciation and lower competitiveness, once the

economy recovers. They recommended scaling back the fiscal stimulus and reorienting its composition toward measures that are self-reversing.

With declining inflation, most Directors saw merit in continuing the more recent easing of monetary policy. However, they advised that the reduction in interest rates should proceed cautiously, taking into account the potential impact on the ruble and the intention to transition to an inflation targeting regime. Directors highlighted the risk that the forthcoming liquidity injections from the monetized fiscal deficit, combined with lower interest rates, might induce a shift into foreign exchange, putting excessive downward pressure on the exchange rate. In light of Russia's still-substantial international reserves, Directors agreed that the CBR should stand ready to support the ruble in the event that unexpected developments unsettle exchange rate expectations. While noting the increased exchange rate flexibility since the beginning of the year, Directors observed that the interventions should be only temporary and that the exchange rate should ultimately reflect Russia's underlying fundamentals. A number of Directors stressed that greater exchange rate flexibility would help limit speculative capital flows and signal a credible commitment to price stability.

Directors welcomed the authorities' intention to reinvigorate structural reforms in the health and education sectors. However, they regretted the delays in implementing other reforms critical to improving Russia's investment climate and promoting economic diversification. A few Directors were concerned that the process for WTO accession appears to be losing momentum.

Looking forward, Directors emphasized that—once the current crisis subsides—policy priorities should be geared toward medium- and long-term objectives. These would include refocusing fiscal policy on the non-oil deficit and anchoring it on a target that is sustainable from a long-term perspective; reorienting monetary policy toward controlling inflation, supported by a flexible exchange rate; and reinvigorating structural reforms.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2009 Article IV Consultation with the Russia is also available.

Table 1. Russian Federation: Selected Macroeconomic Indicators, 2006–10

	2006	2007	2008	2009	2010
				Proj.	
	(Annual percent change)				
Production and prices					
Real GDP	7.7	8.1	5.6	-6.5	1.5
Consumer prices					
Period average	9.7	9.0	14.1	12.3	9.9
End of period	9.0	11.9	13.3	11.0	9.0
GDP deflator	15.5	13.9	19.2	4.0	13.6
	(Percent of GDP)				
Public sector					
General government					
Overall balance	8.3	6.8	4.3	-5.4	-5.0
Revenue	39.5	40.0	38.4	33.9	35.3
Expenditures	31.2	33.2	34.1	39.3	40.2
Primary balance	9.1	7.4	4.8	-4.9	-4.4
Non-oil balance	-4.5	-3.9	-8.3	-13.8	-14.7
Non-oil balance excl. Yukos 1/	-4.5	-5.5	-8.3	-13.8	-14.7
Federal government					
Overall balance	7.4	6.2	3.5	-5.5	-5.0
Non-oil balance	-3.9	-3.0	-7.5	-12.8	-13.6
Non-oil balance excl. Yukos 1/	-3.9	-4.6	-7.5	-12.8	-13.6
	(Annual percent change)				
Money					
Base money	39.6	33.1	2.9	4.1	16.7
Ruble broad money	48.8	47.5	1.7	4.8	21.5
External sector					
Export volumes	5.8	4.6	-1.8	-9.1	2.8
Oil	0.7	5.4	-2.6	-1.3	-0.3
Gas	-3.1	-5.4	1.8	-15.0	5.0
Non-energy	17.8	7.3	-2.1	-15.7	7.2
Import volumes	24.0	26.0	16.7	-21.3	3.6
	(Billions of U.S. dollars, unless otherwise indicated)				
External sector					
Total merchandise exports, fob	303.6	354.4	471.6	278.4	320.8
Total merchandise imports, fob	-164.3	-223.5	-291.9	-199.8	-210.4
External current account	94.3	76.2	102.3	18.3	38.9
External current account (percent of GDP)	9.5	5.9	6.1	1.5	2.9
Gross international reserves					
Billions of U.S. dollars	303.7	478.8	427.1	375.7	397.2
Months of imports 2/	17.4	20.3	13.9	18.0	18.2
Percent of short-term debt	212	204	364	285	285
Memorandum items:					
Nominal GDP (billions of U.S. dollars)	989	1,294	1,677	1,208	1,329
Exchange rate (rubles per U.S. dollar, period average)	27.2	25.6	24.9	…	…
World oil price (U.S. dollars per barrel, WEO)	64.3	71.1	97.0	60.5	74.5
Real effective exchange rate (average percent change)	9.6	5.7	6.5	….	…

Sources: Russian authorities; and IMF staff estimates.

1/ Excludes one-off tax receipts from Yukos in 2007.
2/ In months of imports of goods and non-factor services.

Statement by the IMF Staff Representative on the Russian Federation
July 27, 2009

1. This statement contains information that has become available since the Staff Report was circulated to the Executive Board on July 14, 2009. It does not alter the thrust of the staff appraisal.

Recent Developments

2. **The latest data provide more information on the nature of the output contraction over the first quarter, and also provide tentative signs that the economy may have recently reached a turning point**. As noted in the staff report, the first quarter of 2009 saw a dramatic collapse of investment and an abrupt decline in consumption, offset in part by a parallel drop in imports. A large part of the first-quarter downturn, however, reflected a sharp drawdown of inventories—accounting for 8½ percentage points of a total GDP decline of 9¾ percent (y/y). For the second quarter, high-frequency data suggest continued weakness in activity, despite increased government spending. CPI inflation is also falling, and is currently 11.9 percent (y/y) in June. Over the near term, it is expected that firms will start rebuilding inventories, and there are some reports that this process may already have started. The latest data for June suggest that industrial production and investment have finally stabilized. The rate of contraction of consumption also appears to be moderating in June. This confirms staff's assessment that the economy will experience only a gradual recovery after the very deep drop in output in the first quarter.

3. **Recent exchange-rate volatility has underlined the need for a cautious approach to interest-rate policy**. In the context of a continuing buildup of bank deposits with the central bank, the CBR cut policy interest rates by 50 bps on July 13—bringing the cumulative drop since mid-April to 200 bps. However, the cut also coincided with a fall in world oil prices, leading to a sudden ruble depreciation (of about 3½ percent) and a loss of reserves of around $3–4 billion. This occurred despite the CBR's commendable efforts to improve its communication strategy on monetary policy by issuing its first ever statement explaining its decision to reduce interest rates. Oil prices have since improved, and the exchange rate has strengthened, but the banking system continues to exhibit a strong preference for liquidity over new lending, and the short-term carry trade remains an important source of foreign inflows. Thus, concerns about the currency's fragility persist.

Bank Recapitalization

4. **The authorities are finalizing their plan to recapitalize the banking system.** A law outlining the key points of the recapitalization plan has been signed by the President, but detailed parameters are still being discussed between the relevant government institutions.

The broad plan is to issue government securities (OFZ) equivalent to Rub 150 billion and Rub 310 billion, in 2009 and 2010 respectively. The OFZs would then be exchanged with banks in return for preferred shares, and would count as Tier 1 capital. The goal of the plan is to restore credit growth as soon as possible, and the focus is therefore on banks that are sound (the state-owned banks, including VTB and Sberbank, are being recapitalized under separate arrangements). Banks with severe capital shortfalls, on the other hand, will be dealt with separately via the Deposit Insurance Agency's (DIA) bank-resolution framework. The DIA currently has 18 banks under rehabilitation, and still has undisbursed funds available from an initial Rub 200 billion budget allocation earlier in the year. The authorities therefore do not expect that the DIA will require further funding for this purpose.

Fiscal Policy

5. **Recent data suggest that the fiscal stimulus came on stream toward the end of the second quarter**. Indeed, the non-oil deficit in the second quarter widened to 3¼ percent of GDP compared with about 1 percent of GDP during the same period last year. Looking forward, the authorities are in the process of formulating fiscal policies for 2010 and the medium term. Additional preliminary information since the mission suggests that they are likely to base the medium-term budget on lower oil price and growth assumptions—and thus lower revenues projections—than those used by staff, implying still-high overall and non-oil deficits. However, this process remains at an early stage, and the macroeconomic assumptions and revenue and expenditure projections are still being refined.