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Research:
The Russian Federation

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Credit Ratings

Local currency	BBB-/Stable/A-3
Foreign currency	BB+/Stable/B

Rating History
Long-term local and foreign currency ratings raised to 'BBB-' and 'BB+, respectively, on Jan. 27, 2004; short-term local currency rating raised to 'A-3'.
Long-term local and foreign currency ratings raised to 'BB+' and 'BB', respectively, on Dec. 5, 2002.
Long-term local and foreign currency ratings raised to 'BB-' on July 26, 2002.
Outlook on local and foreign currency revised to positive on Feb. 22, 2002.
Long-term local and foreign currency ratings raised to 'B+' on Dec. 19, 2001.
Outlook on local and foreign currency revised to positive on Oct. 4, 2001.
Short- and long-term local and foreign currency ratings raised to 'B'/'B' on June 27, 2001.
Long-term foreign currency rating raised to 'B-' from 'SD' on Dec. 8, 2000.
Default History Since 1975
Russia defaulted on Treasury bills (GKOs) in August 1998. On May 14, 1999, there was a default on U.S.-dollar-denominated MinFin bonds series III, which were rescheduled in November 1999. Russia rescheduled its debts to the London Club of commercial creditors, first in December 1997 and then in February 2000. In 1999, Russia rescheduled US$8 billion of Soviet-era debt payments due to the Paris Club in 1999 and 2000. Negotiations with the Foreign Trade Organization (FTO) were completed in November 2002.
Year
2004
Population
143.9 million
Per Capita GDP
US$3,506
Current Government
Vladimir Putin is president.
Mikhail Kasyanov is prime minister.
Election Schedule
PARLIAMENT
Last: December 2003
Next: December 2007
PRESIDENTIAL
Last: March 2000
Next: March 2004

Rationale

The ratings on the Russian Federation are constrained by:

- An unfinished reform agenda. This is demonstrated by legal, institutional, and administrative weaknesses that are still significant despite ongoing advances. The risk to the pace of reform implementation stems from the social costs entailed and resistance from entrenched industrial and public-sector interests.
- The economy's high dependence on the natural resources sector, which is the main driver of economic growth. Unpredictable policy enforcement and regulatory actions depress foreign direct investment and domestic investment in sectors other than the energy sector. Progress in restructuring natural monopolies and the banking sector has remained slow. In turn, this hinders the reform and modernization of large, loss-making, energy-intensive industrial enterprises as well as the development of modern small and midsize enterprises.
- Unresolved governance and administrative issues. The quality of political institutions and public

governance needs to be improved. Political tensions and uncertainties—as well as bureaucratic intervention in the economy—prevent the timely and efficient implementation of reforms.

The ratings are supported by:

- Prudent economic management and ongoing structural changes and reforms. However, legislation alone has not been sufficient for the efficient implementation of many structural reforms, reflecting long development times, the need for administrative and judicial reform to increase the effectiveness of other structural measures, or both.
- Comparatively strong external financial and fiscal flexibility. This reflects current high oil prices and underlying increases in oil output. General government surpluses since 2000 and strong economic growth have reduced the general government debt to 38% of GDP at year-end 2003 from more than 110% at year-end 1999. Foreign exchange reserves are almost double short-term external debt (on a conservative estimate) and almost 4x Russia's gross external financing requirement (current account plus short-term debt plus medium- and long-term debt amortization) in 2004. Based on these indicators, Russia compares favorably with the medians for the 'BB' and 'BBB' rating categories, though its medium-term vulnerability to commodity prices is significantly higher than in similarly rated countries.

The 'BBB-' long-term local currency rating reflects the government's stronger capacity to service ruble-denominated debt, enhanced by a successful tax reform, with the shallowness of domestic debt markets.

Outlook

The stable outlook reflects the expectation that the reform process will continue. The effective implementation of further reforms is needed both to improve Russia's economic flexibility and to address persistent structural weaknesses, which continue to constrain the foreign currency ratings at the speculative-grade level. However, near-term risk is minimized by the country's very strong external liquidity position and the government's short-term fiscal flexibility.

Table 1 Russia Selected Indicators

						BB Median
	2005f	**2004e**	**2003**	**2002**	**2000-2002**	**2003**
Per capita income ($)	4,034	3,509	3,069	2,385	2,095	1,964
Real GDP (% change)	4.7	5.2	7.0	4.7	6.3	3.9
Real GDP per capita (% change)	5.4	5.0	7.3	4.7	6.4	2.2
General government balance (% of GDP)	(0.5)	0.4	1.3	1.0	3.0	(3.1)
Net General government debt (% of GDP)	31.5	33.7	33.7	38.5	51.4	42.2
General government interest expenditure/Revenue (%)	5.2	5.1	5.1	6.6	8.2	13.4
Domestic credit to private sector and NFPE* (% of GDP)	27.6	24.1	20.7	18.4	15.9	31.9
CPI (average % change)	10.3	11.5	13.8	15.8	19.4	3.2
Gross external financing requirement/Foreign exchange reserves	60.9	43.6	26.5	22.5	(12.8)	93.0
Net public-sector external debt/CARs	15.0	18.8	24.9	56.2	75.6	35.8
Financial-sector net external debt/CARs	(0.7)	(0.7)	(1.3)	(4.9)	(5.9)	2.0
Nonfinancial private-sector net external debt/CARs	(3.5)	(5.8)	(7.9)	(22.0)	(26.3)	5.7

*NFPE-Nonfinancial public enterprises. CAR-Current account receipt. f-Forecast. e-Estimate.

Comparative Analysis

- Russia's ongoing commitment to both prudent macroeconomic policies and structural reform has supported its fast-improving creditworthiness since 2000.
- Nevertheless, like its peers, Russia continues to face important transitional and structural challenges that constrain its creditworthiness at the speculative-grade level.
- Russia's short-term fiscal flexibility and its current international liquidity position are stronger than those of most of its peers.

Political stability, competent macroeconomic management, achieving broad macro-stabilization, and reducing government total and external debt to relatively moderate levels supported Russia's fast-

improving creditworthiness since the crisis in 1998. However, weak political and legal institutions, Russia's economy's high dependence on resource-based sectors, and remaining economic structural and regulatory shortcomings constrain its creditworthiness at the noninvestment-grade level. In terms of prospective ratings and policy record, Russia's closest peers are now Republics of Bulgaria (BB+ long-term foreign currency sovereign credit rating/Outlook Stable), Kazakhstan (BB+/Stable), and Romania (BB/Positive) among transition economies. The Kingdom of Morocco, Hashemite Kingdom of Jordan, and the Republics of Philippines and India (all rated 'BB/Stable/B'), among other sovereigns, are also good peers, reflecting these countries' significant structural and political changes over the past decade, even though the ratings on these countries are now one notch below the Russian foreign currency rating.

The political and policy environment is stronger but is still less predictable than in many of its peers.

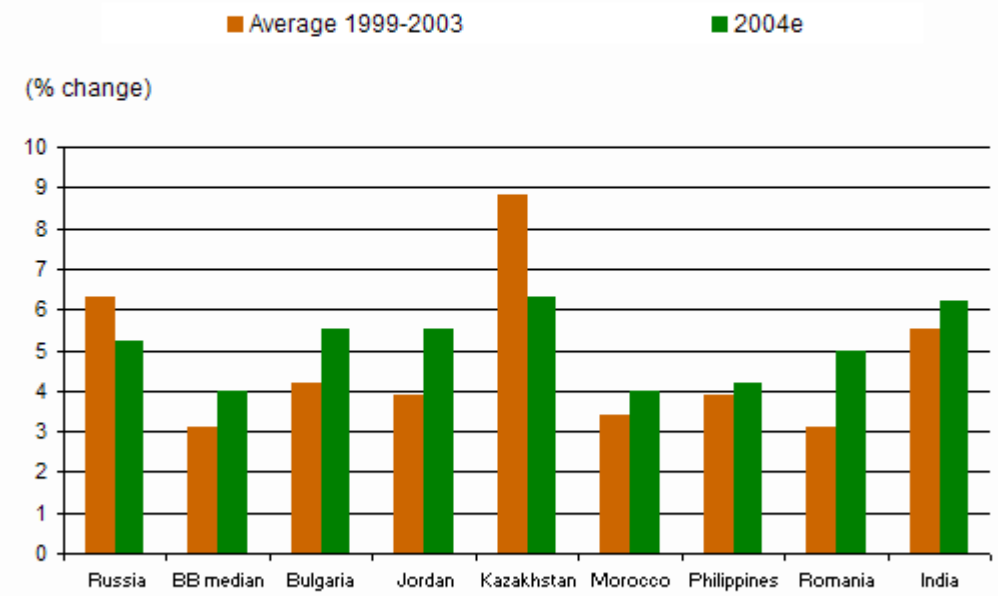
Reflecting sound presidential leadership during the past four years, Russia has been rapidly developing a more reliable political environment. However, similar to Kazakhstan, it has weaker political, legal, and institutional frameworks than other transition peers. Bulgaria's and Romania's upcoming membership in NATO and their expected membership in the European Union over the medium-term provides these countries with important institutional and political anchors, ensuring political and policy continuity, perhaps above that of Russia. In Russia, the concentration of political power, limited political maturity, and open debate reduce political and policy predictability. This is quite well demonstrated by the international transparency rankings intended to measure the quality of legal, administrative systems, corruptions, etc. In October 2003, Russia placed 86 out of 133 countries, well below Jordan (43), Bulgaria (54), and Morocco (70) and slightly below Romania (83) and India (83) but above the Philippines (92) and well above Kazakhstan (100). Economic power remains concentrated in Russia, Kazakhstan, and the Philippines compared with a more diversified ownership of capital in Bulgaria, Romania, Jordan, Morocco, and India. The economic interests of these wealthy businessmen do compromise policy and political decisions at times and as such could make the policy environment less predictable than in other countries.

A weak economic structure continues to constrain the ratings.

Political stability and consistency of economic management have supported relatively strong growth over the past four years that has been driven by high oil prices. Russia's cumulative growth of more than 25% during the past four years (see Chart 1) more than doubled its per capita income to US$3,069 in 2003, restoring it to slightly above the pre-crisis 1997 level. This is higher than in all peers (see Chart 2). It is also higher than the 'BB' median at US$1,964. However, it continues to be well below the 'BBB' median of US$ 5,204. In contrast with all other peers, Russia suffers from a relatively sharp decline in population growth, which boosts its per capita income growth. Russia's significant progress in macroeconomic stabilization and legislation of various structural reforms has been a significant factor behind its fast-improving creditworthiness in the past three years, similar to its transition peers. However, Russia, similar to all the peer transition countries as well as the other similarly rated peers, still faces many structural challenges. These include further fiscal reform to support long-term sustainability of recent strong fiscal performance, economic modernization of its non-energy sectors, utility infrastructure restructuring, and further economic and financial liberalization to support the development of small and midsize companies. The banking sector in Russia is much weaker than that of all other peers, as demonstrated by its very limited role in monetary intermediation (see Chart 3). Overall, a weak economic structure continues to constrain Russia's creditworthiness below investment grade, as it does to some extent in all its peers.

Chart 1

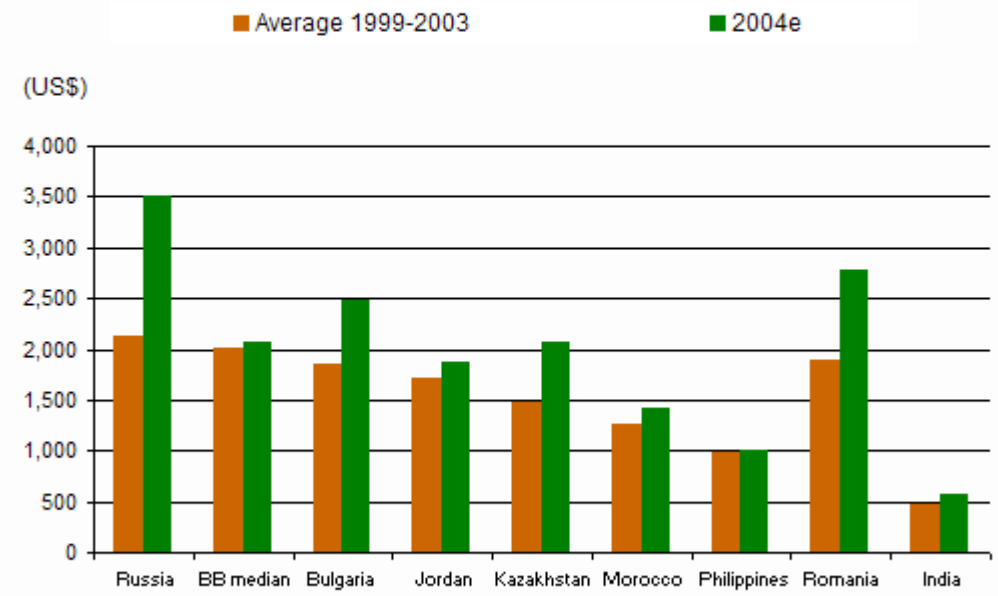
Real GDP



e-Estimate

Chart 2

GDP Per Capita



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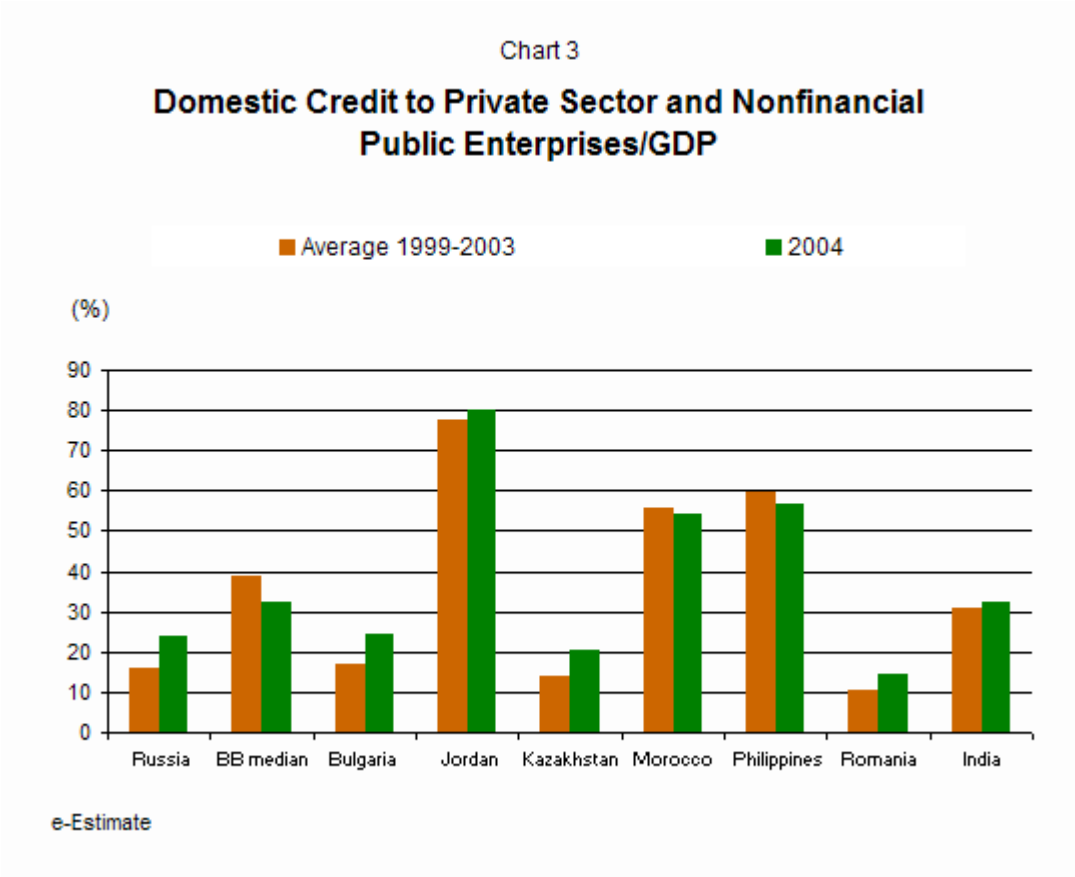
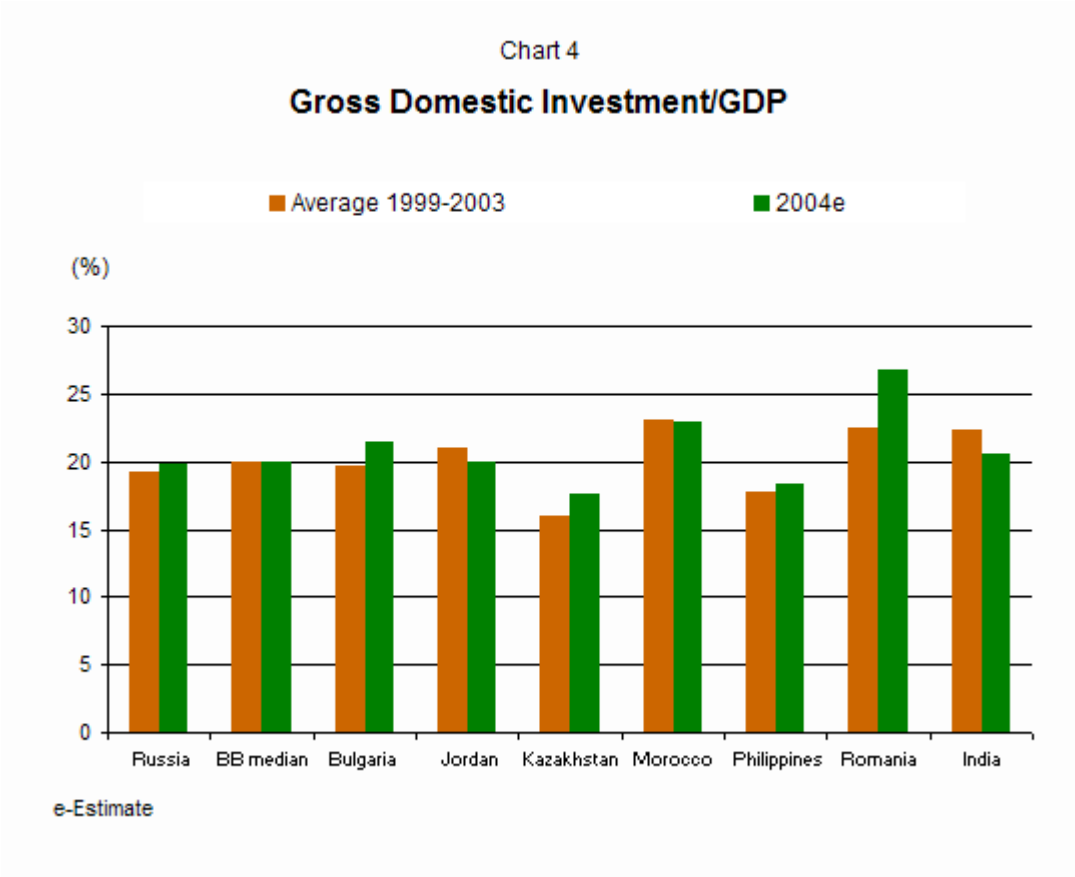


Economic growth has been strong, but its base and investment must strengthen.

The Russian economy, similar to that of Kazakhstan, remains narrowly based, dependent on commodities, and more vulnerable to external shocks than those of Romania and Bulgaria and other peer countries. In addition, experience from other transition economies indicates that an important component of achieving rapid and self-sustained growth is development of new small and medium-sized companies. In this area, Russia lags significantly behind all of its peers, perhaps reflecting the role of government, especially at the sub-national level, which is still quite intrusive despite the recent attempts to liberalize and deregulate the business environment. In addition, sustainable long-term growth performance in Russia, similar to all of its peers, could be constrained by bottlenecks in infrastructure and by high modernization costs. Relative to the latter, the level of investment in Russia as well as in all of its peers is rather low. The ratio of gross domestic investment increased to just over 20% of GDP in 2003, up from 15% of GDP in 1999. However, Russia's overall level of investment is still relatively low, though comparable to that of the 'BB' median (20%) and peer countries (see Chart 4).



Russia's fiscal performance and general government debt burden are better than those of most of its peers.

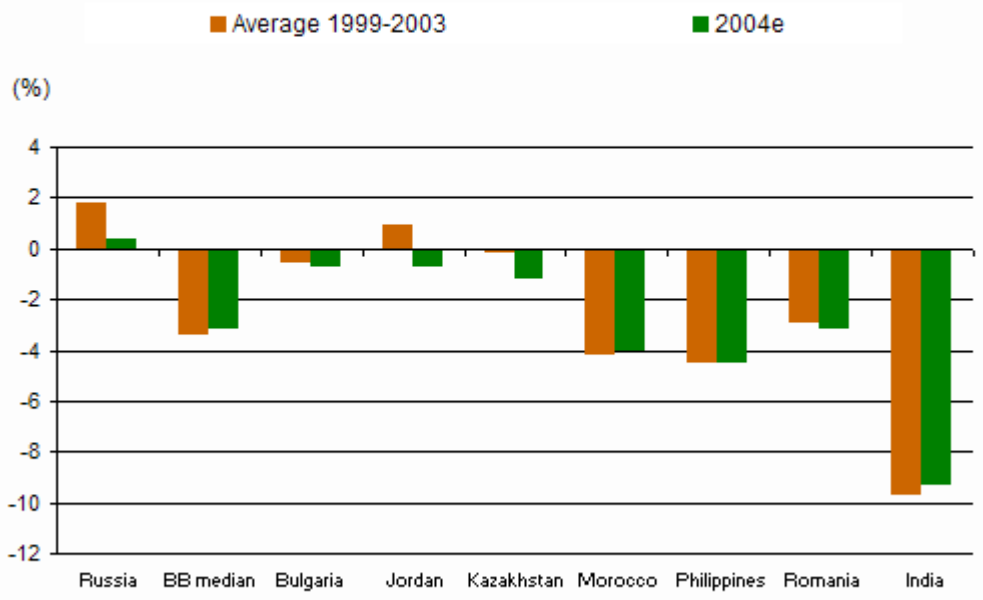
Significant improvement in fiscal management and transparency has been one of Russia's main achievements over the past four years. In this area, Bulgaria and Kazakhstan also performed well, though Bulgaria's fiscal flexibility is constrained by the Currency Board Arrangements. All of these three transition countries as well as Jordan have performed better in the past few years than Morocco and, even more so, the Philippines and India (see Chart 5). Russia has run a general government surplus over the past five years (similar to Jordan), though if corrected for recent high oil prices, the underlying trend of fiscal performance is significantly weaker, especially in 2002-2003. Bulgaria has run small deficits, below 1% of GDP, during the same period, while Kazakhstan's performance was more varied between strong surpluses and small deficits. In contrast, Romania ran moderate fiscal deficits each year, averaging less than 3% during the same period. Morocco's and the Philippines' deteriorating fiscal stance is one of the main factors constraining the ratings on those countries, similar to India's long tradition of very high deficits.

As a result of fiscal discipline and real economic growth, the net government debt burden in Russia has declined continuously over the past few years. It stood at 34% of GDP at end-2003 compared with 42% for the 'BB' median. It is now somewhat lower than in Bulgaria (42%) but significantly higher than in Kazakhstan (1.2).It is also somewhat higher than in Romania (22%). Compared with other peers, however, Russia's position is significantly stronger (see Chart 6) and is the main reason that the Russian foreign currency rating is one notch higher.

The cost of servicing this debt in terms of revenue was 5.1% in 2003, which is significantly below the 13.4% for the 'BB' median, higher than in Kazakhstan (4.1%), and similar to that of Bulgaria (6%). Kazakhstan's relatively high servicing burden compared with both Russia and Bulgaria, despite its much lower debt, demonstrates its lower revenue base as a percentage of GDP (24%) than in both Russia (34%) and Bulgaria (35%). Philippines' interest payments in terms of revenue are very high at 35%, reflecting the country's high debt (87% of GDP) and low revenue base (15% of GDP) (see Chart 7).

Chart 5

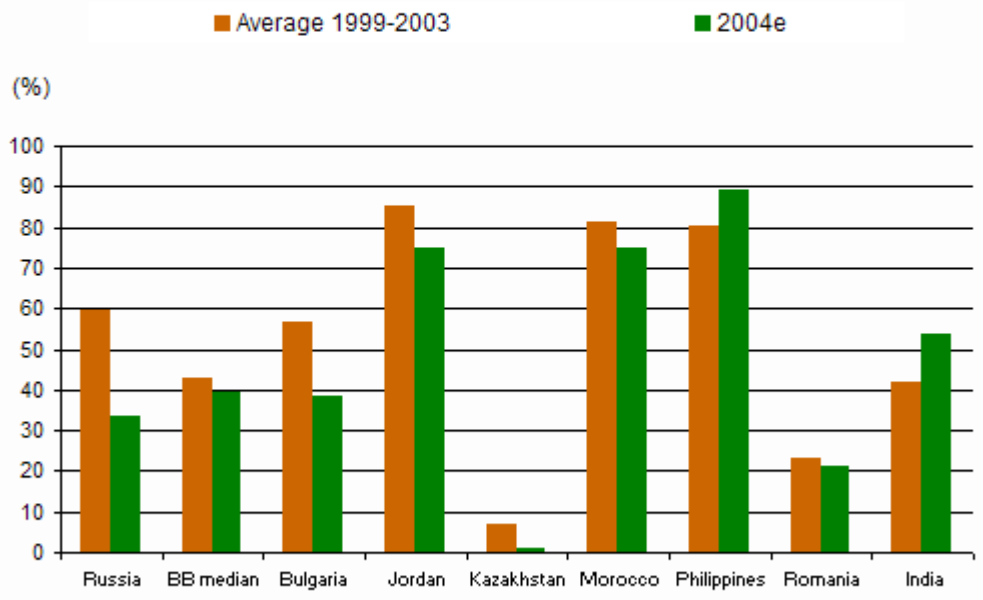
General Government Balance/GDP



e-Estimate

Chart 6

Net General Government Debt/GDP



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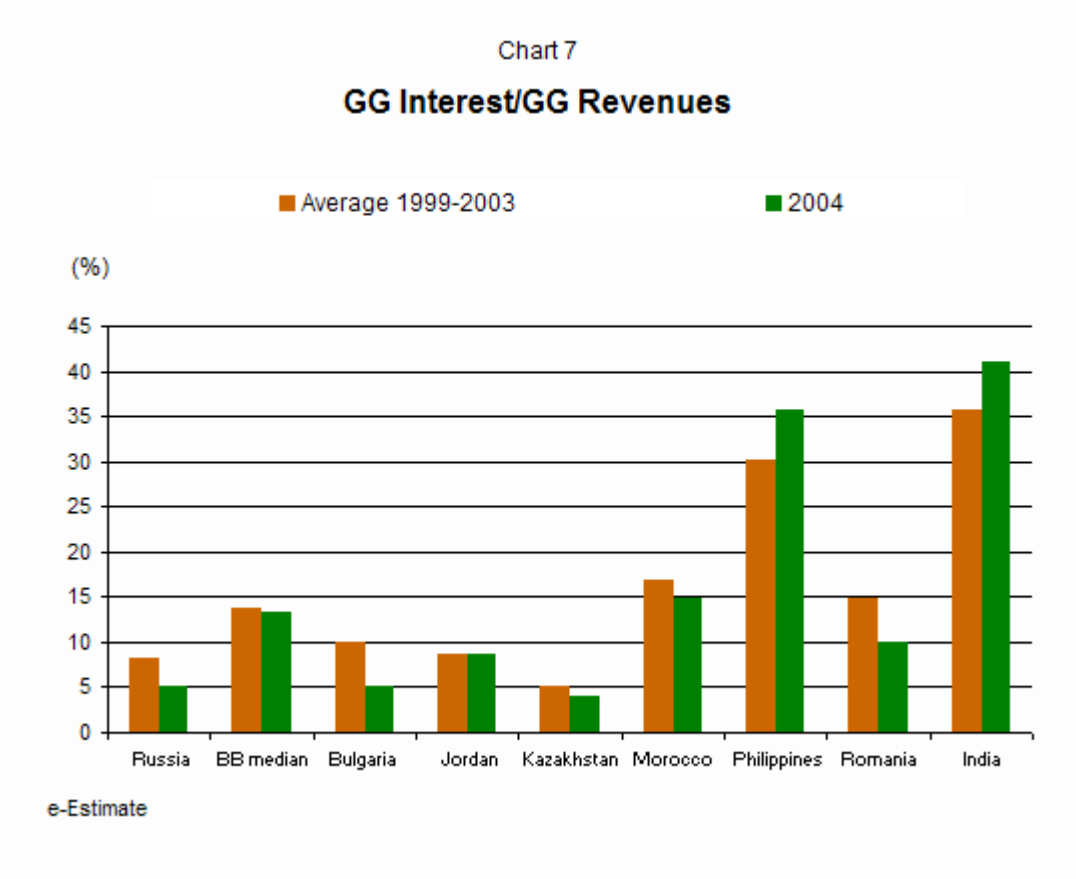
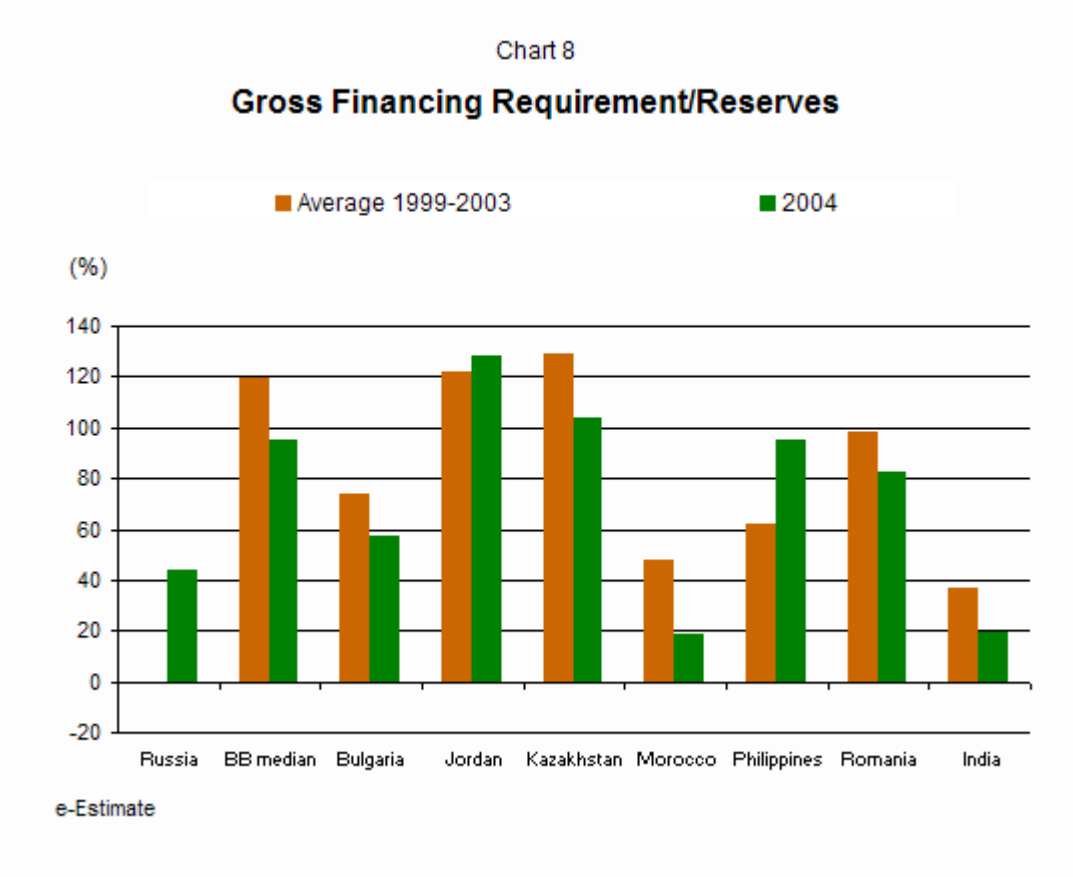
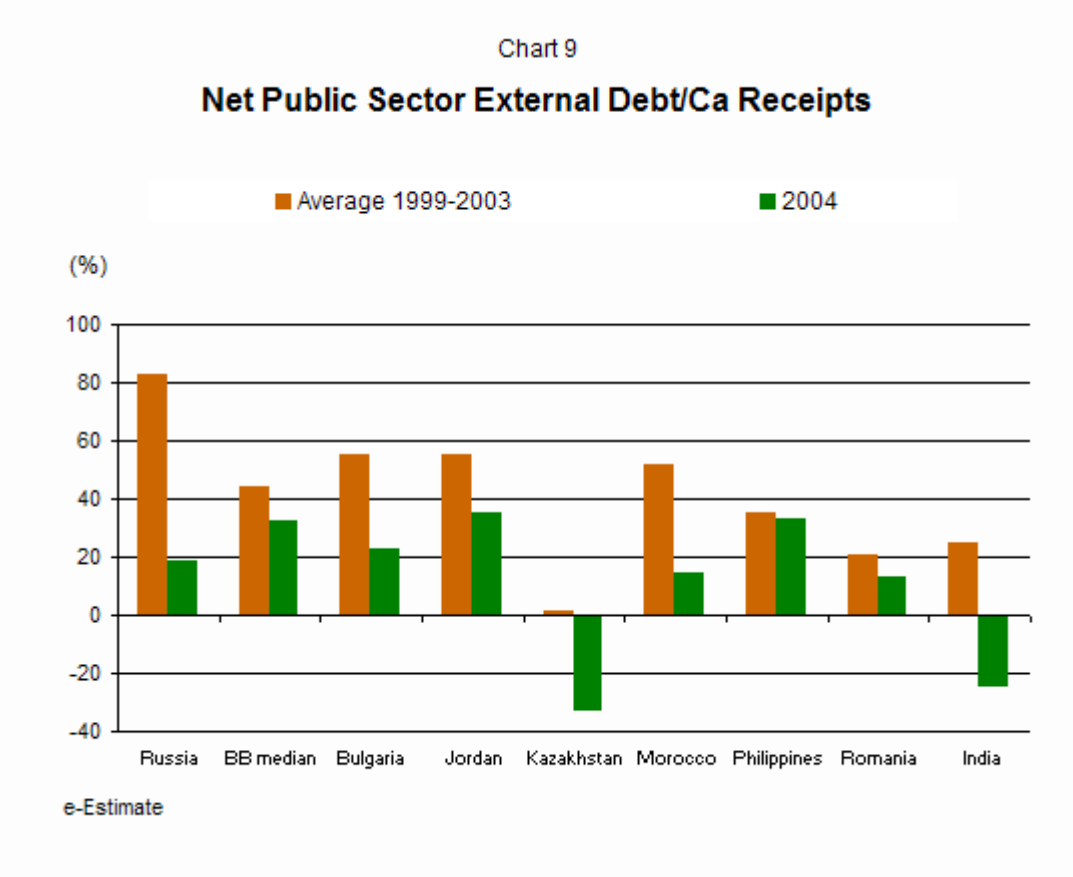


Russia's external liquidity is strong.

Russia's external liquidity is significantly stronger than that of the 'BB' median and all its peers except Morocco. Its gross financing requirement to reserves ratio was less than 43% in 2003, which compares favorably with the 'BB' median (95%). Kazakhstan (104%) and Jordan (110%) are the two weakest countries in the peer group (see Chart 8). On the other hand, reserve coverage of short-term debt is the strongest in Romania (more than 1,000%), Morocco (571%), and Bulgaria (340%), with Russia at 184%. Jordan is the weakest performer among the group (see Chart 8). In terms of accumulated stock of external debt, the Russian public sector's position is stronger than 'BB' median but comparable with all its peers (see Chart 9). Kazakhstan' public sector is a net external creditor.





Political Environment

- With recent parliamentary elections and presidential elections in March 2004, Russia's political stage has been filled with basic issues of underlying political maturity and the control of political

machinery by the Kremlin.

- The new government to be formed following the presidential elections will face the challenge of bringing reform to the public sector. The powerful bureaucracy has not yet been touched by reforms and creates a serious barrier to effective implementation of other reforms.
- Medium-term prospects depend on how forcefully the pending reform agenda will be pursued.

Political context post Duma elections.

Russia's successful reforms of the last four years have depended heavily on the personal leadership of president Vladimir Putin and his constructive working relations with Duma, which was more reform oriented than during Yeltsin years. In the Russian environment, where traditional political structures were weak, the powerful executive, who was able to garner a strong support from a legislature, was a positive development. However, the results of the Dec. 7, 2003, parliamentary elections make the president's (expected to be re-elected in March 2004) instrumental role in political scene even more prominent than before at a time when deeper democratization of a political scene would be perhaps beneficial. Pro-Putin centrist United Russia won 304 seats in the 450-member parliament. The Communist party was the big loser (52 seats), with many of its votes taken by recently created left nationalistic party Motherland (Rodina; 38 seats). The ultra nationalistic Liberal Democratic Party performed better than expected and has 36 seats. The independent members of Duma hold 23 seats and three seats are to be still determined. The two pro-reform liberal parties—Union of Right Forces and Yabloko—failed to pass the 5% threshold.

The potential risks associated with the extreme concentration of executive power are numerous, including increased opportunities for corruption and less incentives and pressures on creating effective political structures and institutions, such as parties, sub-national governments, and legislative and judiciary powers. From this perspective, the outcome of Duma elections has been disappointing and—to many observers—even worrisome. The unfortunate ending for liberal parties (responsible for initiating and formulating many good legislations in the past four years) and strong support for nationalist parties, whose many supporters still doubt legitimacy of private business, are wary of foreigners, foreign investment, and capitalist institutions and generate some uncertainty about the direction of the reform process in Russia over the medium term.

Reform challenges lie ahead in 2004.

Russia's future economic and political potential and its creditworthiness depend on advancement of the reform agenda, including administrative, banking, and utilities reforms as well as implementation of legal and procedural reforms that would ensure rule of law, property-right protection, and better public and private governance. Despite impressive progress in recent years, much must still be done to ensure that Russia creates a stable environment for sustainable growth. Reform of the government has been the slowest, as the government employees who have the most to lose from rationalizing and reducing the state bureaucracy must execute the reform. Similarly, interest groups within the utility sector are so powerful that they have been resisting the earnest reform for quite some time. The absence of a viable banking sector, low labor mobility, slow progress in demonopolization, and weak institutional structures make the Russian economy and politics vulnerable.

The composition of the next government, which will be created soon after the presidential election on March 14, 2004, will be crucial in determining the speed and direction of the reform process. At this point, it is unclear what changes will be instituted, including the matter of whether the prime minister will be replaced and, if so, when. An open question also remains regarding whether nationalist members of the Duma would be represented in the next government. Risks to timely legislation of the outstanding reforms as well as efficient implementation of already enacted reforms remain high, reflecting their high social costs and vested interests of bureaucracy and politicians, especially at the sub-national level.

Economic Prospects

- Russia's economic structure benefited from reforms, but serious weaknesses still exist and need to be addressed swiftly to diversify and modernize the economy.
- The economy's strong dependence on mineral products makes it vulnerable to a decline in oil prices and challenges its current strong growth record over the longer term. Growth of 4%-5% can be supported at an Ural oil price of US$20-US$22 per barrel.
- The 2004 budget assumes real growth of 5.2% this year (see Table 2), down from 7% in 2003. Most other forecasts project similar growth based on a likely decline in Ural oil price by about $5 per barrel from its high of $27 in 2003. The longer-term growth prospects depend on the speed

and quality of the reform process.

Table 2 Russia Economic Indicators						
(% change)	2005f	2004e	2003	2002	2001	2000
Real GDP	4.7	5.2	7.0	4.7	5.1	9.1
Real domestic demand	6.4	5.4	8.3	6.2	8.8	14.4
Real investment	6.3	5.6	11.3	3.5	10.5	17.4
Real private consumption	5.0	5.5	7.2	8.5	8.7	9.4
Real exports	5.0	5.5	9.5	3.2	2.0	7.0
Unemployment (%)	7.5	7.9	7.9	8.0	8.8	9.8
Real GDP per capita	5.4	5.0	7.0	4.7	5.6	9.0
GDP per capita (US$)	4,034	3,509	3,069	2,385	2,116	1,783
e-Estimate. f-Forecast.						

Economic structure: the economy needs to diversify.

The many reforms initiated in Russia during the past four years created a real potential for significant improvement in the economy's structure, if efficiently implemented. However, there is a lag time between enacting structural reform, its implementation and its impact on economic performance. In the meantime, growth was helped by high international oil prices, rising metal prices, and a competitive real exchange rate. In the longer term, to ensure sustainable growth, Russia needs to invest and modernize other sectors. Russia's economy is driven by the extraction and export of natural resources, mainly oil and gas (58% of exports and 23% of GDP in 2003) and metals (17% of exports). The need to reallocate financial resources that are generated by the export–oriented sectors to the rest of the economy is one of the key challenges facing the country. Currently, the economy is really controlled by 23 oligarchs whose economic activity is organized in holding companies that account for more than 80% of exports. Exporters benefit from low domestic costs and high profits from foreign trade. Tangible advancement in politically difficult banking reform, restructuring of major monopolies, and cross subsidization will be important to shift the value added from this limited number of exporters to the rest of the economy.

The banking sector is weak, though improving, and controlled by the state. The government-owed Sberbank, the country's largest bank, the liabilities of which are guaranteed by the government, still controls about 70% of the retail market. Vneshtorbank, the second largest, is also state controlled. As a result of such dominance, lending is channeled primarily to large, resource-based existing enterprises at the expense of new enterprises. The extent of financial intermediation is minimal though fast growing. The banking system finances only about 5% of investment activity. The Russian financial markets are too weak to filter significant oil windfalls to the rest of the economy and contribute to higher growth in other sectors. The deposit insurance law legislated by the Duma in its final session on Nov. 30, 2003, (after eight years on legislative agenda) is an important step forward to improve the concentration issue in the banking sector. The introduction of International Accounting Standards and strengthened supervision should address the issue of weak capital quality.

In addition, because Russia's unaccountable bureaucracy constrains efficient and flexible responses to the market forces and continues to limit non-energy private-sector growth prospects, the administrative reform is crucial to effectively implement recent efforts of the government to deregulate and liberalize the economy. This will help to promote a modern small and medium-sized sector, whose role in the economy is still minimal.

Economic growth.

In the past four years (2000-2003), Russia's real GDP grew rapidly, rising on average by about 6.3% annually (see Table 2). The increase stemmed from a dramatic increase in oil prices and the continuing, though diminishing (especially in 2003), benefits of depreciation. In 2003, with an average Ural oil price of US$27 (up from US$23 per barrel in 2002), real GDP increased by 7%. It is estimated that every US$1 increase in prices for Russian Ural oil adds about 0.3% to real GDP growth. However, the relationship is not linear because at higher production levels, some bottlenecks (transport) constrain further increase in physical output and exports. On the other hand, when the price for Urals exceeds US$25 per barrel, there is additional growth from increased investment activity related to new oil exploration. In general, the impact on growth from oil price fluctuations is quite complex and passes to the economy through various channels (exports,

investment, exports, etc.).

On the demand side, investment grew rapidly last year, rising in real terms by more than 11%, up from a modest 3.5% in 2002. The growth was stimulated by the rapid increase in construction, a build-up in stocks, and significant investment in the oil sector. Private consumption continued to grow rapidly, reflecting a real increase in disposable income approaching 14%. The rate of growth slowed, however, to about 7.2% in 2003, down from 8.5% in 2002, 8.7% in 2001, and 9.4% in 2000. The net negative contribution to real growth of the external sector increased as imports grew faster (20% in real terms) than exports (12%), reflecting significant real effective appreciation of ruble of about 4%. Overall, growth in 2003 was somewhat better balanced than in 2002, with some of stimulus to growth coming from an increase in productivity (related to ongoing restructuring of some medium-sized companies) and more investment. On the production side, the fastest-growing sectors were construction (14.4%), trade (8%), transport (7.4%), and industry (7.0%).

Russia's real GDP is projected to rise by 5.2% in 2004 if the average oil price for Ural is US$22 per barrel and by 3.9% if the oil price declines to US$18.50 per barrel. Under both scenarios, real investment is forecast to grow faster than real GDP, a positive trend, though it is unlikely that the growth of investment will be broad-based. Private consumption will also continue to rise faster than real GDP growth, though the gap is projected to diminish.

Looking forward, future sustainable growth depends upon continued progress in reform. Sustaining 4%-5% growth rates and achieving even stronger growth over the longer term in the context of lower oil prices hinge on securing productivity gains by shifting production from old, obsolete, loss–making enterprises in heavy industry (43% of enterprises were still loss-making in 2002) to the small and medium-sized sectors, creating conditions for greater competition into the goods, services, and labor markets and attracting foreign direct investment.

Fiscal Flexibility

- Creation of the a mechanism that would capture windfall oil revenues in a fund insulated from current spending pressures is the recent single most important accomplishment in public finances area.
- Fiscal performance produced federal budget and general government surpluses in 2003 and in the previous three years. However, there has been a significant fiscal easing last year, which implies an underlying fiscal deficit if oil prices returned to a more standard level.
- Strengthened debt management and the decline in the government debt burden continued in 2003. The trend of declining debt burden is projected to stabilize this year.

Table 3 Russia Fiscal Indicators

	2005f	2004e	2003	2002	2001	2000
(% of nominal GDP)						
General government revenue	32.1	32.6	33.6	34.1	34.7	36.9
General government expenditures	32.6	32.2	32.3	33.1	30.0	33.8
General government balance	(0.5)	0.4	1.3	1.0	4.8	3.1
of which: central government	(0.2)	0.6	1.7	1.3	3.0	1.4
of which: social security	0.0	0.0	0.0	0.0	1.6	1.6
of which: local government	(0.3)	(0.2)	(0.4)	0.0	(0.1)	0.5
General government gross debt	35.2	37.8	38.4	44.3	52.3	71.1
(as a % of general government revenue)						
General government balance	(1.4)	1.2	2.5	2.8	13.8	8.5
General government interest payments	5.2	5.1	5.1	6.6	7.9	10.3
Memo item: Nominal GDP (Rbl billions)	17,450.0	15,300.0	13,318.0	10,834.0	8,944.0	7,302.0
e-Estimate. F-Forecast.						

Revenue, expenditure, and fiscal balances.

The consolidation and reform of public finances continues to be the single most important

stabilization and reform achievement. Creation of a mechanism that would capture windfall oil revenues in a fund insulated from current spending pressures was the most important accomplishment in public finances area in 2003. It was legislated by the Duma at its last session and became effective on Jan. 1, 2004. The fund will accumulate windfall oil revenues until it becomes large enough (estimated at Rbl500 billion or US$17 billion) to finance three years of budget deficit at times the oil price would be lower than US$15 per barrel. Thus, until the fund reaches Rbl500 billion, it can be used only if the oil price falls below US$15 per barrel. The revenue from all three taxes (export duties on oil, export duties on oil products, and an extraction tax) generated when the oil price exceeds US$20 per barrel will be directed to the stabilization fund. Accumulated fiscal reserves amounted to an estimated Rbl170 billion (about US$ 5.5 billion) at the end-2003. It is expected that Rbl90 billion of the reserves will be transferred to the stabilization fund.

The process of rationalization of tax regime has continued. The recent changes, effective January 2004, include a reduction in a value–added tax to 18% from 20% and an elimination of the 5% sales tax collected by regional governments. These cuts will amount to an estimated Rbl100 billion rubles (about 2% of GDP). The increased extraction tax on oil and gas as well as an additional export tax will cover some of the reduction. Overall, the structural changes in tax regime have been significant over the past few years, and Russia has now one of the lowest income taxes (flat at 13%) and one of the simplest profit tax laws (24%; divided into regional, 16%; federal, 6%; and municipal, 2%).

However, expenditure rationalization has lagged behind. Social policy has been poor, as illustrated by ever-deteriorating demographic and health statistics. Weak social infrastructure and high income inequality increase pressures on public finances and will require greater resources for education and health than are currently allocated. Most social spending is currently provided at the regional and local levels, where there has been an increasing problem of growing spending mandates without appropriate allocation of resources. The problems reflect new reform of federal/regional relations to match administrative and budgetary responsibilities. Although the functional division of expenditure has progressed well, revenue matching fell short of expectations. The great disparity among Russia's regions is also a serious fiscal problem.

Large oil-stimulated revenues produced federal and general government surpluses in 2003 despite significantly relaxed fiscal stance (see Table 3). In general, fiscal accounts have been in surplus in the past four years, largely because of the revenue windfall from high oil prices. However, there had been a relaxation of fiscal stance in each of the past three years. Thus, if adjusted for the high oil prices, there had been deterioration in fiscal balance amounting to about 4.3% of GDP (from a notional surplus of 2.7% of GDP in 2000 to a notional 1.6% deficit in 2003 at US$20 per barrel oil price). The extent of potential fiscal deterioration in the face of a lower oil price will hinge on politically sensitive rationalization, cuts in current spending, and an ability to generate more non-oil revenue. Looking forward, oil prices are expected to soften only gradually, keeping fiscal accounts in balance or in modest deficits.

Russia's budget is sensitive to oil price changes: two scenarios for the 2004 budget.

The budget in 2004, similar to the 2002 and 2003 budgets, envisages two scenarios for the price of oil. At US$22 per barrel, the real GDP growth is assumed to be 5.2%, and the federal budget will be able to generate a small (0.5% of GDP) surplus. With the lower oil price (US$18.5), 3.9 % real GDP growth will not generate enough revenues to maintain a surplus, and the federal budget will shift into a small deficit.

The sensitivity of the budget to oil prices is very high. It affects tax revenue both directly, via rising export duties and profits of exporters, and indirectly, via the increased ability of enterprises to pay taxes. It is estimated that a US$1 decline in oil price would reduce revenue by about Rbl35 billion. A US$20 price per barrel of Ural is the break-even point for the federal government's budget, which shifts into deficit if the price falls lower. At US$22 per barrel, the 2004 budget will be balanced net of transfers to the stabilization fund. At US$15 per barrel, the budget deficit is projected to rise to about 2% of GDP. Because fiscal prudence is now widely accepted by the political elite, it is expected that as the oil price declines, policymakers will start cutting expenditures to contain the budget deficit at no more than 3% of the GDP.

Debt and interest debt burden.

Over the past three years, recovery in real economic growth and budgetary surpluses reduced the debt and, especially, net debt in terms of GDP. The trend continued in 2003 as well, though at a slower rate, and will stabilize in 2004-2005. The net central government debt to GDP is estimated to decline to 32% of GDP by end-2003 and to stabilize at 31% of GDP in 2004-2005, down from an estimated 42% at year-end 2002 and compared with 98% in of GDP in 1999. Reflecting an increase

in revenue, the cost of servicing central government debt decreased to 8.8% of central government revenue, down from 12.3% in 2002 and compared with 23% in 2000. The same ratio is projected to stabilize at just below 9% in 2004-2005. Net general government debt to GDP declined to 34% at end-2003, down from 38% in 2002 and compared with 109% in 1999. General government interest to general government revenue fell to 5.1% in 2003, down from 6.6% in 2002 and compared with 11% in 1999. The ratio is projected to stabilize at about 5% in 2004-2005.

Off-budget and contingent liabilities.

The banking sector is very weak, but the extent of monetization and intermediation is low, though rising fast, amounting to an estimated 24% of GDP at end-2004. Under a reasonable worst-case scenario, gross problematic assets would total about 15% of GDP in 2004. However, reflecting the dominant role of state-owed banks their lending accounts for at least half of all exposure. There is no guaranteed debt.

Monetary Policy

- Monetary and exchange-rate management continues to be difficult, reflecting a large balance of payment surplus.
- Given the limited choice of monetary policy instruments, the foreign exchange markets and build-up of reserves continued to serve as major tools of monetary policy.
- Inflation has continued to decline.

Table 4 Russia Monetary Indicators

	2005f	2004e	2003	2002	2001	2000
CPI average	10.3	11.5	13.8	15.8	21.5	20.8
Refinancing rate	10.0	14.0	16.0	21.0	25.0	25.0
Real effective exchange rate	6.0	6.0	4.1	2.6	18.0	12.8
Domestic credit to private sector and NFPE* (% of GDP)	27.6	24.1	20.7	18.4	16.4	12.9
Domestic credit to private sector and NFPE* (% change)	31.0	33.6	38.1	35.9	56.0	65.5
M2 (% change)	20.4	22.9	21.8	23.5	36.1	58.3
Official forex reserves excl. gold ($US bil.)	95.0	88.0	73.2	44.1	32.5	24.3

*NFPE-Nonfinancial public enterprises. CAR-Current account receipt. F-Forecast. e-Estimate.

Monetary management is difficult.

The primary goal of the central bank during most of the post-crisis period was to accumulate reserves and prevent nominal appreciation of the ruble despite the large current account surpluses. In 2003, the trends in monetary and exchange-rate management were similar to those pursued in 2000-2002. Given continued large current account surplus, Central Bank of Russia's continued active intervention in the currency market (buying $2billion-3 billion monthly) to reduce the real effective appreciation of the ruble. Still, a real ruble appreciated against dollar by 19.1% in 2003, up from 6.2% in 2002 and by 4.1% against the basket of currencies, up from appreciating by 2.6% in 2002 (see Table 4).

Large purchases of U.S. dollars by CBR resulted in foreign exchange reserves rising to a new record of more than US$70 billion as of year-end 2003. Similar to 2000-2002, the accumulation of reserves was the most important source of monetary growth last year. Since CBR does not really have any sterilization instruments, large fiscal surpluses and the resulting increase in government deposits at CBR served as the main method of sterilizing large foreign exchange inflows. Nevertheless, the sterilization has been insufficient to keep the ruble from real appreciation. As a result, by year-end 2003, the real effective exchange rate appreciated to a level only about 10% below its pre-crisis level.

Inflation continues to decline, but its deceleration has slowed in 2003-2004.

The year-end 2003 inflation of 12% (down from 14.5% at year-end 2002) was within the government targets of 10%-12%. Average 2003 inflation is estimated at 14%. Reducing inflation was an important goal but secondary to ruble management. Policymakers hope to reduce inflation to about 8%-10% by year-end 2004. Inflation last year would have been higher if not for keeping administrative prices steady. An increase in prices charged by natural monopolies (electricity, gas, and railroads) is needed, however, to force many inefficient, energy-intensive enterprises to restructure.

External Finances

- Russia's liquidity indicators remain strong, though recent strong borrowing by banks and the corporate sector have weakened them.
- The significant improvement in capital account reflects declining capital outflows.
- Russia's ability to service all its debt in the short-term remains relatively strong.

Table 5 Russia External Indicators						
	2005f	2004e	2003	2002	2001	2000
(as a % of nominal GDP)						
Exports of goods and services plus net transfers	25.1	29.3	35.9	36.9	39.1	46.7
Current account balance	2.4	4.7	8.8	9.0	11.4	18.2
Net foreign direct investment	(0.6)	0.0	(0.1)	(0.1)	0.0	(0.2)
(as a % of exports of goods and services plus net transfers unless noted otherwise)						
Trade balance	27.7	31.8	37.5	36.3	40.2	50.1
Current account balance	9.5	16.0	24.6	24.4	29.2	39.1
Net external liabilities	17.6	25.7	33.2	56.6	63.3	72.0
Gross external debt	140.9	129.3	109.9	125.7	130.4	137.2
Net external debt	10.9	12.4	15.8	29.4	41.7	58.7
Net general government external debt	15.0	18.8	24.9	56.2	76.9	93.5
Net private nonfinancial sector external debt	(3.5)	(5.8)	(7.9)	(22.0)	(29.0)	(28.1)
Net financial sector external debt	(0.7)	(0.7)	(1.3)	(4.9)	(6.2)	(6.7)
Net external interest payments	9.3	7.1	5.4	4.8	5.8	7.6
External debt service including short-term debt	64.0	53.5	45.4	40.3	36.7	34.6
External debt service excluding short-term debt	26.3	21.3	18.9	16.4	15.9	16.4
Principal payments	13.8	11.2	11.0	9.1	7.8	7.4
Reserves/imports (months)	9.3	9.1	7.9	6.2	5.2	4.5
Reserves/financing gap	164.3	229.3	377.4	444.2	(4,489.9)	(170.2)
Reserves/short-term debt	183.3	195.0	184.0	159.5	145.8	125.5
Memo item: Nominal exports (US$ millions)	6,175	5,450	4,850	3,900	3,338	3,236
Memo item: Nominal GDP (Rbl billions)	17,450	15,300	13,318	10,834	8,944	7,302
e-Estimate. F-Forecast.						

External flexibility and liquidity.

The key trends affecting current account balances last year have been growing export volumes both for goods and services and a strong improvement in terms of trade. Imports continued to grow at a stronger rate than exports, reflecting both growing incomes and real appreciation of ruble. Import elasticity to both of these factors is strong. However, with a significant increase in oil prices, trade and current surpluses reversed a declining trend. Trade surplus increased to US$59 billion (13.4% of GDP) in 2003 from US$46 billion (13% of GDP) in 2002. Current account surplus increased to US$39 billion (8.8% of GDP) in 2003 from US$31 billion (9% of GDP) in 2002 (see Table 5).

Reflecting a continued very high current account surplus as well as fast-declining net capital outflows, international reserves hit a record high of US$73 billion at year-end 2003. Net capital inflows from the private sector amounted to about US$2 billion in the first half of 2003 compared with net outflows of US$8 billion in 2002, US$15 billion in 2001, and US$25 billion in 2000. However, in the second half of 2003, net outflows increased so that an overall outflow for the whole year was about US$3 billion.

The current account surplus will decline by about a third in 2004 to US$23 billion (assuming an average price for Ural oil at US$22 per barrel, down from an average of US$27 per barrel in 2003). Combined with continued rising short-term debt repayment and only a modest increase in reserves, the liquidity indicator will deteriorate but will remain very strong at 229% reserve coverage of gross external financing needs (down from 377% in 2003). In 2005, the liquidity ratio variables will continue

to be weaker, with the ratio declining to a still-high 164%. This ratio is based on current account projections, assuming a further decline in the average price for Ural oil of US$20 per barrel. The ratio is also based on the assumption that the banks will continue to be able to borrow only short-term and that 50% of the outstanding fast-rising corporate debt is also due within the year.

Public-sector external debt.

Russia's public external debt was US$117.2 billion of the total US$174.7 billion debt at end-2003. Except for just US$1.2 billion, public external debt consists of the debt of the federal government. Net public external debt declined rapidly over the past four years, reflecting both declining debt and a fast rise in government external assets. Net external public debt to current account receipts declined even faster, reflecting a strong increase in exports, especially in 2003. It declined to 25% at year-end 2003, down from 57% at year-end 2002 and a high of 165% at year-end 1998.

External debt management improved. The government established a unified debt-management agency in 2002, which is managing all outstanding sovereign debt. This includes verifying the total amounts outstanding, restructuring some portions, and securitizing others. In particular, the government just restructured US$2.7 billion of eligible debt of former Soviet Union (Foreign Trade Organization; FTO) debt along London Club debt restructuring terms. The second tranche of FTO and to the two banks will mean the issuance of another US$1.56billion in combined 2010 and 2030 Eurobonds early in 2004. In terms of new capital market transactions, the government is likely to issue up to US$3 billion in Eurobonds in 2004.

Private-sector external debt.

The banking sector is a net creditor, though net assets of the sector have been declining fast recently. This reflects an increased ability of the Russian banking sector to borrow abroad, even though the sector is weak. In the future, the CBR intends to limit the banking sector's ability to borrow abroad. The corporate sector has continued to accumulate significant foreign liabilities. Corporate bond issuance on international capital markets increased to US$ 7 billion in 2003, almost double the US$ 3.5 billion in 2002 and up from just US$600 million in 2001. Although growing fast in absolute terms, this growth is much less pronounced relative to current account receipts. However, a lot of the big loans are collateralized by export earnings, though there is no data available to indicate the extent of it. Also, there has been an increasing demand for obtaining escrow account license from the CBR (estimated at $1 billion in 2003). Recent estimates (see International Investment Position in IFS) provide an estimate of corporate sector assets abroad. Overall, corporate sector remains a small net creditor.