SUR/07/114

September 14, 2007

The Acting Chair's Summing Up
Russian Federation—2007 Article IV Consultation
Executive Board Meeting 07/79
September 12, 2007

Executive Directors agreed with the thrust of the staff appraisal. They commended the strong performance of the Russian economy in recent years, noting that this has been due not only to high oil prices and large capital inflows but also to good macroeconomic management. In particular, the policy of saving the large oil revenue windfall has provided a considerable measure of stability. However, Directors noted that Russia continues to face tensions in the policy mix designed to reduce inflation while preserving exchange rate stability.

Directors noted that demand pressures appear to be intensifying, driven by acceleration in investment and strong growth in private consumption. With output close to potential, upward pressures on prices and the real exchange rate are likely to persist.

Against this background, Directors noted that the planned fiscal relaxation in the next few years would provide an undesirable fiscal stimulus. This would increase pressures for real ruble appreciation and make it more difficult to reduce inflation. It is also likely to exhaust most of the remaining margin of competitiveness, raising the risk of the real exchange rate overshooting its equilibrium level. Directors therefore called on the authorities to avoid increasing the non-oil deficit during the remainder of 2007 and in 2008.

Directors emphasized the need to control public spending, and to pay more attention to the quality and efficiency of expenditures. In this regard, they welcomed the new framework for spending of oil revenues, which is close to best practice for management of natural resource wealth. They cautioned, however, that the back-loading of spending cuts in socially sensitive areas in 2010–11, in the run-up to elections, is risky. Such cuts might not be feasible unless efficiency-enhancing social and public sector reforms are reinvigorated. Most Directors also advised against extending the government's mandate to areas where private sector participation might be more efficient.

Directors noted that the recent rise in inflation stemmed from the return to a less flexible exchange rate policy since mid-2006, a change that led to large unsterilized interventions in the face of surging capital inflows. They stressed that keeping inflation on the targeted path would require returning to a more flexible exchange rate policy. In this regard, Directors welcomed the authorities' willingness to accept appreciation, as was evident from June until August this year. They urged the central bank to stand ready to scale back interventions as needed to keep inflation within target, noting that greater focus on the inflation target while allowing more exchange rate flexibility could help curb one-way bets and reduce speculative capital inflows.

Directors welcomed the rapid development of Russia's financial sector, but cautioned that high rates of credit growth might also increase vulnerabilities. In particular, the rapid increase in consumer lending, corporate-bond issuances, and open foreign-exchange positions should be kept under close review. While Russia has weathered the recent turmoil in financial markets relatively well, the tightening of access to foreign capital markets could increase the vulnerability of a number of banks. Directors welcomed the current Financial Sector Assessment Program update, which provides a timely opportunity for a review of vulnerabilities.

Directors observed that the key long-term challenge will be to improve Russia's investment climate. Although recent investment growth has been impressive, they noted that the level of investment is still relatively low and that Russia still ranks poorly in international comparisons of the business climate. Raising investment levels is particularly important in light of the projected decline in the labor force and the declining prospect for continued high productivity gains over the medium term. In this regard, Directors observed that progress on important reforms in public administration and the civil service has been limited. The challenge facing the new government would be to reinvigorate such reforms.

The next Article IV consultation with the Russian Federation is expected to be held on the standard 12-month cycle.