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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/77-3

2:36 p.m., September 7, 2018

3. Russian Federation—2018 Article IV Consultation

Documents: SM/18/199 and Correction 1; and Supplement 1; and Supplement 1, Correction 1; and Supplement 2; SM/18/200; and Correction 1

Staff: Ramirez Rigo, EUR

Length: 48 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	D. Mahlinza (AE)
	H. Razafindramanana (AF)
A. Armas (AG)	
	G. Khurelbaatar (AP), Temporary
A. Tombini (BR)	
Z. Jin (CC)	
C. Hurtado (CE)	
	A. McKiernan (CO)
M. Erbenova (EC)	
H. de Villeroché (FF)	
	K. Merk (GR)
	P. Dhillon (IN), Temporary
	M. Psalidopoulos (IT)
M. Kaizuka (JA)	
	M. Daïri (MD)
H. Beblawi (MI)	
	R. Doornbosch (NE)
	K. Virolainen (NO)
A. Mozhin (RU)	
H. Alogeel (SA)	
J. Agung (ST)	
	P. Inderbinen (SZ)
	S. Vitvitsky (US), Temporary

C. McDonald, Acting Secretary
S. Maxwell, Summing Up Officer
D. Daly, Board Operations Officer

Also Present
World Bank Group: D. Nowak. Communications Department: O. Stankova. European Department: M. Arena Duffoo, J. Ramirez Rigo. Legal Department: C. El Khoury, J. Swanepoel. Monetary and Capital Markets Department: M. Erbenova, F. Vitek. Research Department: Y. Hashimoto. Strategy, Policy, and Review Department: Z. Murgasova, J. Yu. Executive Director: J. Mojarrad (MD). Alternate Executive Director: A. Castets (FF), C. Just (EC), P. Moreno (CE), L. Palei (RU). Senior Advisors to Executive Directors: Y. Danenov (SZ), A. Del Cid-Bonilla (CE), N. Jost (NE), W. Kuhles (GR),

T. Nguema-Affane (AF), T. Ozaki (JA), C. Sassanpour (MD), A. Tolstikov (RU), C. Williams (CO). Advisors to Executive Directors: P. Al-Riffai (MI), A. Arevalo Arroyo (CE), X. Cai (CC), M. Chen (UK), J. Essuvi (AE), D. Fadhel (MI), D. Hart (CO), Y. Minoura (JA), S. Potapov (RU), I. Skrivere (NO), Z. Smirnova (RU), P. Snisorenko (RU), N. Vaikla (NO), D. Vogel (AG), A. Zaborovskiy (EC), K. Hennings (BR), J. Montero (CE), A. Clark (UK), A. Sode (FF).

3. RUSSIAN FEDERATION—2018 ARTICLE IV CONSULTATION

Mr. Mozhin, Mr. Palei and Ms. Smirnova submitted the following statement:

My authorities appreciate constructive discussions with staff during Article IV consultations and the high-quality analysis in the staff report and the Selected Issues Paper. They largely agree with this analysis, including the assessment of risks to financial stability, which are mainly associated with external developments. They are also in broad agreement with policy recommendations in the staff report.

In particular, there are no major disagreements on desirable fiscal and monetary policies. The authorities appreciate the recognition by staff of the significant progress achieved in Russia in fostering macroeconomic stability under the most challenging external circumstances. Such major structural reforms as the introduction of inflation targeting regime and transition to freely floating exchange rate as well as the introduction of the new fiscal rule and the large fiscal consolidation effort after the collapse of international oil prices have been the crucial pillars of macroeconomic stability in Russia over the last several years.

Outlook

The Russian economy is still at the early stage of transition to the new growth model. Before the first episode of the major oil price decline in mid-2008 the Russian economy had been struggling with the effects of the Dutch disease. By the end of this period the oil price had reached exceptionally high levels, which had driven the ruble exchange rate to also become very strong, so that non-energy tradable sector in Russia had become uncompetitive. In the period between 2008 and 2014 oil prices had partially recovered and the effects of the Dutch disease had largely returned. Only the second episode of the oil price decline in 2014 had resulted in the permanently new exchange rate environment. This whole story makes any comparisons between recent economic developments in Russia and those in the countries of Central and Eastern Europe rather meaningless.

In the new growth model import substitution driven by the permanently lower exchange rate environment is certainly expected to play a major role. This process will take time, although some early signs of such economic diversification have already been seen in rapid growth in agriculture, food industry, chemical industry and so on. We are also witnessing a rather steady increase in the share of non-energy and non-mineral exports. At the same time, the authorities fully recognize that the new growth model will require significant investments and will need to be supported by far-reaching structural reforms. In fact, if taken together, policy recommendations formulated in the staff report already amount to a multi-year, far-reaching structural reform agenda. The authorities are in broad agreement with most of them.

When talking about import substitution we do not mean any recourse to protectionism, but the permanently more competitive exchange rate and the disappearance of the effects of the Dutch disease. This should open opportunities for the development of many other tradable sectors. For these opportunities to be realized the authorities have initiated far-reaching structural reforms aimed at enhancing efficiency and productivity in the Russian economy, its technological modernization, and, eventually, increasing both potential and actual growth. In particular, the authorities decided to boost investments in infrastructure, education, and healthcare. One of the key objectives set out in the May 2018 Presidential Decree is to increase the share of investments in the Russian economy from 21-22 percent to at least 25 percent of GDP.

Currently, the Russian economy is continuing to demonstrate moderate growth, with GDP continuously growing in the last six quarters and reaching 1.8 percent growth in Q2 2018 on an annual basis. Staff projection for 2018 growth is 1.7 percent, which is within the range expected by the authorities. Since 2014, in terms of GDP per capita growth, Russia exhibited dynamics broadly similar to the developments in other commodity exporters. At the same time, the level of per capita PPP GDP in Russia is already above that of several advanced economies, and we expect income conversion to continue.

Fiscal Policy

Since late last century highly responsible fiscal policy has firmly taken hold in Russia. The level of public debt in Russia is the second lowest among the G-20 countries.

In 2014 Russia experienced major negative terms of trade shock, which was broadly seen as a permanent change in economic conditions. Hence, the authorities’ medium-term strategy was aimed at a steady fiscal consolidation. While in the past staff recommended Russia to slow down fiscal consolidation in order to protect growth, they now seem to agree that our more ambitious fiscal strategy has been largely appropriate. Over the past several years the rate of unemployment remained low, while fiscal multipliers proved to be moderate. Public debt remained stable at a low level of about 16 percent of GDP. General government non-oil fiscal balance has improved by about 3 percentage points of GDP from the level close to 11 percent of GDP in 2015. In 2019, it is expected to shrink further to only 6.4 percent of GDP.

The authorities have already started to implement the recently adopted fiscal rule, which is tied to the price of oil. This fiscal rule is simple and transparent. They also took a decision to replenish the National Wealth Fund (NWF). These measures will allow to maintain strong fiscal position as well as overall macroeconomic stability and will further enhance the effectiveness of the monetary policy framework. The authorities are committed to prudent fiscal policy, keeping public debt low and expenditures under control. At the same time, as it has already been mentioned, the authorities intend to significantly increase spending on infrastructure, education, and healthcare.

On the revenue side, for several years the authorities have refrained from increasing the tax burden in the non-energy sector maintaining it at a relatively low level. At the same time, they continued to rely on some of the earlier introduced changes, such as the successful property tax reform, which was essential for a more stable local tax base. However, more recently the authorities announced a moderate increase in indirect taxes, and the VAT rate will increase from 18 percent to 20 percent effective next year.

Staff suggested to reduce VAT and PIT exemptions. The authorities generally agree with this recommendation and the Ministry of Finance has been working on it. The estimate of the cost of tax expenditures cited in the staff report (2.8 percent of GDP) was made by the Ministry of Finance back in 2012. Since then the number of tax exemptions has declined. At the moment, over 70 percent of overall tax expenditures is directly attributable to the oil and gas sector tax exemptions. These tax exemptions will be gradually reduced. The VAT and PIT exemptions are much smaller and account for only about 3 percent of consolidated tax revenues.

The major reform of taxation in the oil and gas sector has already been approved. Besides the gradual reduction of export duty from 30 percent to zero in six years (by 5 percentage points each year) while increasing the mineral extraction tax, this reform also includes measures that allow to differentiate taxation depending on the level of capital expenditures required for each field. One of the main objectives of the reform is to eliminate tax exemptions.

The recent announcement of the pension reform with parametric changes will allow to gradually increase the currently rather low replacement ratio. The formulation of this reform took many years of consultations between many interested stakeholders to come up with a broadly acceptable option. Of course, pension reform has been long advocated by staff, and over the past years various options have been thoroughly discussed in various chapters in the Selected Issues papers on Russia. Also, the authorities agree, that spending on social assistance programs should become better targeted. Possible measures are under consideration, but they require careful planning and broad social discussion.

On top of many structural reforms implemented in the fiscal area well-described in the staff report, Russia is among the leaders in fiscal transparency, as evidenced in the IMF papers on this topic and illustrated by Russia's strong position in the Open Budget Index Rankings. Our authorities continue to improve already strong fiscal framework. For example, over the past several years they have strengthened the Chamber od Accounts, which is performing many of the functions of the independent fiscal council, in line with the general IMF advice.

Monetary Policy

The Central Bank of Russia (CBR) continues strengthening the inflation targeting framework. The period of gradual monetary easing started in June 2016, and the Central Bank has gradually reduced its policy rate from 11 percent to 7.25 percent in March of this year. Since June the key policy rate has been on hold. Annual inflation is currently running at around 3 percent, which is close to the official target of 4 percent. Inflation is expected to pick up in response to the increase in the VAT rates and due to the recent ruble depreciation in line with the currencies of other emerging market economies.

The inflation targeting framework has performed very well, with inflation expectations now much better anchored. While inflation expectations of professional analysts are anchored at around 4 percent, those of households and businesses are also gradually converging to the official target. The pass-through effect is moderating further, as the credibility of the CBR is growing over time. Going forward monetary policy will continue to remain data dependent.

While the CBR has not been intervening in the foreign exchange market to influence the exchange rate since late 2014, it has been conducting rules-based interventions on behalf of the government. This approach has led to the increase in foreign exchange reserves from $376.3 billion at the beginning of 2017 to $457 billion currently.

As staff recognized in their report, successful transition to inflation targeting regime has been supported by the improved communication policy of the CBR as well as by the collection of more comprehensive and timely data. Prudent fiscal policy and continuing strengthening of the financial sector contribute to improvements in the monetary transmission mechanism.

Strengthening the Financial Sector

The CBR has continued the major overhaul of the financial sector.

Several years ago, the CBR embarked on a comprehensive clean-up of the banking sector. The number of credit institutions in Russia has declined from 923 at end-2013 to 561 by end-2017. This process is complex and politically challenging, as it is affecting powerful vested interests. According to the CBR, the completion of this clean-up will require another three years. Importantly, the initiation of this clean up coincided with the comprehensive FSAP update carried out by the IMF and World Bank. Staff recommendations contributed to the design of many measures aimed at strengthening the financial sector.

To improve supervision and make a better use of early warning indicators, the CBR had undertaken a massive internal restructuring effort transferring all supervision functions from its regional branches to headquarters and ordering financial institutions to provide all of their reporting in an on-line everyday format. The first measure is helping to eliminate the risks of a possible negative impact of entrenched personal relations between regional supervisors and supervised banks, which had been witnessed before. The second measure allows to execute early warning signs analysis on an everyday basis.

Also, the CBR is changing regulation by moving towards proportionate regulation for broad range of financial institutions (banks, insurance, companies, etc.), and at the same time developing cross-sector and consolidated approach in its supervision. These measures will stimulate competition between financial institutions while also strengthening the resilience of the financial system.

Finally, the CBR (as well as the Ministry of Finance) is making a lot of efforts in enhancing financial literacy of Russian citizens and improving access to financial services. “Strategy for financial literacy 2017-2023” was adopted in 2017 and many steps have already been taken, such as circulation of textbooks and introduction of classes on basic financial literacy at schools, classes on how to avoid fraud and how to use modern technologies for older people.

Also, the YouTube channel with regularly uploaded short educational videos on various topics, the website with information in a Q&A format on various events that require making finance decisions have been created. Recent examples of steps, undertaken to improve access to financial services also include introducing – together with market participants – of technical solutions that allow credit institutions to implement remote identification. Such solutions will allow people living in the remote places and those with disabilities to apply for financial services.

We welcome the thought-provoking analysis of the effectiveness of Russian banks in a special chapter of the Selected Issues paper. At the same time, we would suggest interpreting the conclusions in this chapter with some caution. For example, in this chapter staff described the Moscow Exchange group as a private entity, while, in fact, it is public, with only about 6 percent of its shares owned by the not state-controlled institution (actually, the EBRD). In addition, most private banks included in the analysis have gone through the process of restructuring in late 2017 – early 2018, and, for that reason, may not be suitable for comparisons with the peer group of European banks.

Other Structural Reforms

While the authorities agree with staff that the structural reform agenda needs to be further invigorated, it is difficult for them to accept that structural reforms have been stalled for a long period of time. On top of fundamental structural reforms in the fiscal, monetary, and banking sector areas, many other structural reforms have been successfully implemented.

Quite a few such structural reforms have been implemented with the help of a rather extensive cooperation with the World Bank. Such reforms have allowed to significantly reduce the red tape, simplify regulation, improve governance, and reduce corruption. Over the past several years, in the WB Ease of Doing Business ranking Russia has moved to the top quartile of the list. For example, in the component of starting a business Russia ranks number 28, with a score 93 out of 100.

Each year we read in the staff report about insufficient protection of property rights in Russia. In this respect, it is worth mentioning that, according to multiple surveys organized in 2014-2017 by the Russian Union of Industrialists and Entrepreneurs, which is the main lobby group of Russian businesses, the main two obstacles encountered by Russian businesses are price and tariff growth (40-50 percent of respondents) and shortage of the adequately skilled workforce (30-40 percent), whereas protection of property rights was seen among the least important factors (13-15 percent of respondents). This is not to say that there is no need for further improvements in protecting property rights.

Another advice offered by staff is related to promoting greater involvement in international trade. Again, the authorities fully agree with this recommendation and make strong efforts in this area. Russia joined the WTO six years ago, and today it is close to the completion of the 8-year trade liberalization program designed at the time. Academic research on the effects from joining the WTO generally point to substantial positive effects on growth.

The authorities are closely involved in improving trade relations within the Eurasian Economic Union. They are also actively pursuing other multilateral and bilateral initiatives.

The development of the e-government was another successful structural reform implemented by the authorities. The way of delivering public services has changed dramatically: instead of going back and forth to many government institutions, citizens now just need to apply via an on-line application or through the website. In the 2018 ranking of countries by the United Nations, Russia was among the leaders in the e-government development.

After long and extremely difficult debates, the authorities have introduced the major pension reform initiative. The reform stipulates an increase in the retirement age from 55/60 to 63/65 (recently amended to 60/65) women/men correspondingly. It was passed in the first reading by our parliament. Under the government proposal, the retirement age will be increased by half a year each year, beginning from 2019. The increased retirement age for early retirement categories is also envisioned.

Finally, on the footprint of the state. The authorities are very grateful to staff for addressing this topic in the special chapter of the Selected Issues paper. After the publication in 2014 of the IMF report on Fiscal Transparency Evaluation the ridiculous number of 70 percent of GDP as the share of state in the Russian economy has been widely disseminated with the reference to this report. In the above-mentioned chapter of the SIP this highly regrettable and damaging outcome is described as the result of misinterpretation. Let me quote from page 8 of the 2014 report: "The public sector accounts for a considerable share of economic activity with revenues of at least 71 percent of GDP, expenditures of at least 68 percent of GDP, and an estimated surplus of 3 percent of GDP". How else this statement could have been interpreted?

According to the chapter in the current SIP, the true number for the footprint of the state in the Russian economy is about 33 percent, or less than half of the previously quoted number. This number may still seem to be on the high side, although the large resource sector in the Russian economy is part of the explanation. The authorities highly appreciate the recognition by staff of the potentially strongly negative effects of any efforts at hasty and ill-prepared privatizations, such as the possible further increase in the level of concentration in certain sectors and so on. At the same time, the authorities have firm intention to gradually reduce the footprint of the state in the Russian economy.

Mr. Beblawi and Ms. Abdelati submitted the following statement:

Prudent policies have helped steer the economy on its way to recovery from the 2015-16 recession. Inflation—which has been lower than targeted, reflecting the slower than expected recovery, lower oil prices, tighter monetary policy and stable exchange rate—is expected to bounce back before year end. The external position is strengthening as oil prices rebound. The discussions motivated the urgent need to accelerate structural reforms focused on the risks to medium-term growth prospects and the stalled convergence with OECD countries. In this regard, there is a concern that the higher oil prices may weaken the resolve to implement reforms on multiple fronts. We, therefore, welcome assurances in Mr. Mozhin's balanced buff statement.

We commend the adoption of a fiscal rule that prudently targets a zero primary balance at a benchmark oil price of $40 per barrel. We support staff's call for continued consolidation, consistent with the need to preserve intergenerational equity, through a shift towards a more growth friendly composition of spending and taxes. We also support the call for a smaller footprint of the state with greater transparency of SOE activities. We found useful staff's selected indicators on pages 10-11 that compare the Russia's key infrastructure, health, education, and social assistance to OECD countries, EM's, and CESEE. Nevertheless, the planned higher spending on social sectors and infrastructure may well raise potential growth, even if staff cannot estimate that at this time. The additional cumulative spending of 3.5 percent of GDP on infrastructure over the next six years should be manageable in view of the fiscal space, sustainable debt position—even if it is financed by debt and would require a temporary breach of the newly adopted fiscal rule. We support staff's call for limiting across the board spending cuts and seeking savings from pension reforms, eliminating some tax expenditures under VAT and PIT. For the latter, we would appreciate staff response to the authorities' explanation in the buff that they have declined and now account for less than 3 percent of consolidated tax revenue. We would also like to know how much they expect to generate from a shift to oil extraction taxation?

Staff makes a convincing case for the need to parametric pension reform, including a higher retirement age and lower social security contributions (to reduce informality). Clearly the number of pensioners is high and projected trends put the system's sustainability at risk. Ongoing consideration of pension reform is welcome, and we would welcome hearing more of what is under consideration. We, therefore, welcome the recent Parliamentary approval of raising the pension age, as mentioned in the buff statement.

We support CBR's gradual easing of monetary policy towards a neutral stance, which remains appropriate. Staff's assessment of the strength of the external position is subject to considerable uncertainty, as noted in the Annex.

The large share of state banks, their low profitability, and the failure of three large private banks raise concerns. It is not clear if these failures and the need to strengthen transparency of reporting bank performance, and strengthening supervision were items identified in the FSAP as they do not figure prominently in Annex IV. Staff's analysis is illuminating, including the information on the differential pace of credit growth across various segments. We, therefore, welcome the CBR's move to increase the risk weights on consumer loans and mortgage lending, and the consideration of tighter concentration limits. Staff's informative analysis shows that most private banks perform better than most state banks, but the large Sberbank of Russia appears to outperform private banks, including those in comparator countries. The bank failures, weaker performance of some banks, and loan concentrations all call for stronger supervision. It is, therefore, regrettable that the State Duma is currently reluctant to grant the necessary legal immunity for supervisors to effectively carry out their work, and trust this will be soon addressed.

Structural policies and the new government's comprehensive plan to raise growth rates sets ambitious targets, but the specifics of how this will be achieved remains unclear. We take positive note of staff's work to estimate the size of the state and its links to sector concentration. However, it is difficult to see from the data presented that the state footprint in the banking sector is larger than for some Nordic countries. We want to commend staff for providing informative analysis of structural reform and impediments to higher growth without mechanical reliance on Third Party Indicators and would call on other country teams to do the same. Having said that, we could not read the charts on page 20 and don't know if this included TPIs. We also welcome the additional information provided in the buff statement on e-government, improvement in doing-business indicators, Russia's trade liberalization program, and the firm intention to gradually reduce the footprint of the stte in the Russian economy.

Overall, we commend the authorities for establishing a strong macroeconomic framework in recent years and wish them success in completing planned reforms and achieving their growth goals over the next few years.

Mr. Virolainen and Mr. Vaikla submitted the following statement:

We thank staff for comprehensive report and Mr. Mozhin for informative buff statement. The Russian economy is slowly recovering from the recent recession supported by energy production and the authorities' appropriate policy response characterized by tight fiscal and monetary policies. Yet, the economy is very dependent on global oil price developments and the state's large share in the economy, together with structural bottlenecks, cap potential growth in the long run. As a result, the Russian economy's catch up to advanced economy income levels has halted and lags behind peers in Eastern Europe, as emphasized by staff. We broadly agree with staff's appraisal and make the following comments for emphasis.

Downside risks related to external developments dominate Russia's economic outlook. While the domestic demand continues to recover, Russia's commodity export-oriented economy remains vulnerable to economic effects from sanctions, recent turbulence in emerging markets, and potential escalation in trade tensions. Weakness in the ruble could also raise risks related to foreign currency denominated external debt. Therefore, we agree with staff that monetary policy should be normalized gradually to further anchor inflation expectations and ensure the credibility of inflation targeting. Could staff elaborate on the main channels through which the most recent US sanctions affect the Russian economy and financial sector?

A strong macroeconomic policy framework has served Russia well. Russian authorities have implemented a prudent fiscal rule, that together with inflation targeting and flexible exchange rate form a strong macroeconomic policy framework. We take note of the authorities' ambitious spending plans on infrastructure, health, and education in order to enhance potential growth. While large investments are needed, we urge the authorities to stick to the fiscal rule. Relaxing the rule, although only temporarily, would make the fiscal policy procyclical, raise inflationary pressures, and weaken the credibility of current prudent macroeconomic framework. Instead, we encourage authorities to take advantage of improving revenues from the oil sector and continue to build fiscal buffers, which mitigate vulnerabilities to external shocks.

Implementing structural reforms is the key challenge in the medium term. Russia´s low growth rates stress the need to tackle challenges and raise potential growth. We thank staff for the thorough analysis on the state´s footprint in the Russian economy, underlining that it is large by international standards, nearing close to 40 percent for the formal sector. We encourage the authorities to gradually privatize SOEs thereby supporting competition in the market and increasing overall efficiency gains. Furthermore, we emphasize the need to enhance governance, decrease regulatory burden and strengthen property rights. Although politically challenging, we encourage the authorities to implement the pension reform to tackle negative demographic trends.

Mr. Alogeel and Mr. Rouai submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative buff statement. The economic recovery in Russia is proceeding and the robust buffers and stronger policy framework have contributed to strengthening the resilience of the economy. However, the transformation of the Russian economy and its diversification away from energy and mineral exports will take time as recognized in the buff. To their credit, the authorities are cognizant of the challenges ahead and have recently introduced many of the reforms identified under their new growth model that prioritizes investments in infrastructure, education, and healthcare.

Against this background, we welcome the supplementary information provided by staff, detailing the legislations recently adopted, including the increase in the main VAT rate, the modification in the oil sector taxation, the establishment of an infrastructure fund, and the initiation of parametric pension reform. In this regard, we would appreciate if staff could clarify if these policy initiatives are consistent with the alternative scenario detailed in Box 1? While we understand staff's assumption that potential growth under the alternative scenario is unchanged from the baseline, we agree with the authorities that the package of reforms will have a positive impact on potential growth.

We welcome staff work in the SIP on the States' Footprint in the Economy and note that it is now estimated at 33 percent of value added in 2016. While this level seems high, it is more realistic than the 70 percent indicator included in the 2014 Fiscal Transparency Evaluation. In addition, we welcome the authorities' commitment to gradually reduce this share, promote stronger competition from the private sector, while avoiding further economic concentration. In the same vein, we note from the buff that Russia has undertook several structural reforms, in close cooperation with the World bank, that have contributed to reduce red tape, simplify regulations, and improve governance. These reforms were critical in improving Russia's ranking and score in the World Bank's Ease of Doing Business and we wonder why staff did not include in their analysis other indicators, beyond those on trade. Staff elaborations would be welcome.

On fiscal policy, we welcome the continuation of the implementation of the ambitious expenditure-based consolidation, supported by the new fiscal rule. Following the reduction of the budget deficit in 2017, a large surplus is expected starting this year and trending over the medium-term which will contribute to further strengthening buffers and reducing Russia's vulnerability to fluctuations in oil prices and other external shocks. In view of the critical importance of the pension reform, could staff confirm our understanding that some of the parameters included in Supplement 2 to the staff report have been revised, in particular the proposed retirement age for women (60 instead of 63). And does this modification improve the chances for the approval by the Duma of the final package?

On financial sector issues, important progress has been achieved in the restructuring and clean-up of the banking sector and in strengthening supervision and modernizing regulation. As pointed out by staff, however, the failure of three large private banks in 2017 weakened the banking sector's overall performance and contributed to a sizable increase in NPLs. On this latter point, staff indicates that NPLs increased from 9.7 percent in March 2017 to 10.7 percent in March 2018. How this increase is consistent with Table 7 which shows an NPL level of only 6.2 percent at end 2017? We encourage the authorities to further strengthen supervision and regulation to address the issues of risk concentration and lending to connected parties.

With these remarks, we wish the authorities further success.

Mr. Mahlinza and Ms. Gasasira-Manzi submitted the following statement:

We thank staff for the comprehensive reports and Mr. Mozhin, Mr. Palei and Ms. Smirnova for their insightful buff statement.

The Russian economy has continued to recover from the 2015-16 recession supported by the authorities' effective policy responses as well as higher domestic demand and firming oil prices. The authorities' pursuit of a strong macroeconomic policy mandate, which includes a prudent fiscal rule, inflation targeting and a flexible exchange rate, has helped to cushion against uncertainties and external shocks. Notwithstanding, medium term vulnerabilities remain elevated including, geopolitical risks, global trade tensions and delayed implementation of structural reforms. In this regard, we urge the Russian authorities to address remaining structural bottlenecks in order to accelerate attainment of inclusive and sustainable growth. We broadly agree with the staff assessment and make the following comments for emphasis.

Prudent fiscal policy remains important to rebuild buffers and maintain fiscal sustainability. In this regard, we commend the authorities for implementing an ambitious fiscal consolidation plan, appropriately focused on adjusting to lower oil prices, rebuilding buffers and based on a credible fiscal rule. While we support the authorities' objective to increase spending on infrastructure, health and education, we agree with staff that the temporary relaxation of the fiscal rule to accommodate this expenditure, may undermine policy credibility. In this regard, further revenue-enhancing measures should be explored as well as an efficient use of the available fiscal space. That said, we welcome the pension reform and the authorities' consideration of possible measures for better targeted social assistance programs as discussed in the buff statement.

Monetary policy has been appropriately geared towards disinflation and anchoring inflation expectations. With the Central Bank of Russia (CBR) gradually easing its policy stance since June 2017, we see merit in completion of the transition to a neutral stance, although further policy action should be carefully anchored on inflation expectations. At the same time, the authorities should continue strengthening the inflation targeting framework, strengthening credibility and developing an effective communication strategy.

A strong regulatory and supervisory framework is necessary to safeguard financial stability and reduce banking sector vulnerabilities. To this end, we welcome the measures by the authorities to clean up the banking sector and maintain financial stability and macroprudential policies to mitigate threats. However, we emphasize the need to reduce concentration in the banking sector and increase competition and efficiency. While the failure of the three large banks contributed to the rise in Non-Performing Loans (NPLs) and the erosion of profits and capital buffers, credit continued to expand, particularly in retail, consumer and mortgage lending segments. Against this background, we view close monitoring of consumer debt as warranted and the CBR's increase in risk weights on consumer and mortgage lending, as appropriate. We would appreciate staff's comments on the plans for the divestment of the rescued banks and the options to reduce the state's footprint in the banking sector. The authorities' efforts to strengthen the AML/CFT framework are also welcomed.

Structural reforms remain key to supporting inclusive and sustainable growth. To this end, we welcome structural reform efforts and the new growth model adopted to boost growth potential. We urge the authorities to intensify efforts to create a conducive business environment for private sector development, including through promoting market competition, reduction of regulatory barriers, support to small and medium enterprises (SMEs) and addressing weaknesses in governance. Furthermore, operations of State-Owned Enterprises (SOEs) and banks should be closely monitored, and their governance, transparency, accountability and profitability strengthened. That said, we welcome the authorities' intention to reduce the footprint of the state in the Russian economy.

Ms. Erbenova and Mr. Zaborovskiy submitted the following statement:

We thank staff for the informative set of papers and Mr. Mozhin, Mr. Palei and Ms. Smirnova for their helpful buff statement. Russia is emerging from a recession, but its long-term growth potential remains subdued because of heightened geopolitical uncertainty, structural bottlenecks and a prolonged period of tight macroeconomic policies. We broadly concur with staff's assessment and policy advice but note that staff's baseline scenario does not include the recently announced fiscal reforms and the balance of risks to the outlook remains highly uncertain, complicating the assessment of the economy's cyclical position.

Risks to the Russian economy's outlook are tilted downwards due to recent external developments, which calls for deeper analysis of the authorities' possible policy responses and their spillovers. The already imposed and impending new sanctions, the elevated uncertainties in emerging markets and tightening of global financial conditions may have a stronger impact than projected by staff and weigh on Russia's economic growth and business investment already in the near term. We would have therefore preferred staff providing more specific recommendations on a desirable policy response. We agree that the tightening of the macroeconomic policy mix and the exchange rate adjustment proved to be instrumental in mitigating the negative external shocks. Nevertheless, given the ample policy buffers, we wonder whether a more growth-friendly policy response would be more advisable to cushion the negative impact on potential growth and contain outward spillovers to counties with close economic ties with Russia. Staff's comments are welcome and ideally more in-depth analysis should be included in the next Reginal Economic Outlook.

Growth-friendly structural fiscal reforms, underpinned by a credible fiscal rule, are essential to boost economic potential and diversification. We support the target of a zero primary balance by 2019 at the benchmark oil price, but would like to learn staff's view on the selected benchmark price of US$ 40 per barrel. How is this consistent with the possible relaxation of the fiscal rule as mentioned in the supplementary information to the staff report? We support the authorities' view that higher spending on physical and human capital is desirable to raise productivity, potential growth and economic dynamics. Can staff elaborate on their assumption of zero impact of this spending made in the Box 1 of the report which appears extremely conservative? Further improvements in expenditure management, including more targeted social assistance, are critical to increase budget efficiency. In this regard, could staff comment on the cost-recovery level for main tariffs subsidized by federal and local governments, as well as elaborate on the authorities' plans in this area? As the main parameters of the tax and pension reforms are already known, we would also appreciate staff's assessment of their implications for the budget.

The Central Bank of Russia (CBR) should stay vigilant in adjusting the monetary stance to evolving external and internal conditions. A flexible exchange rate and the inflation targeting regime have brought major dividends in terms of cushioning external shocks and taming inflation. But inflation expectations of households and businesses are not yet firmly anchored, while the economic outlook is clouded by rising external risks, the recent ruble depreciation and the inflationary impact of planned fiscal policy changes, including the secondary effects of the VAT rate hike and the shift in oil sector taxation. Considering the recent developments, we wonder whether staff continues to advocate an easing of the monetary stance in 2018? We support staff's call for further refining the CBR's communication strategy, and welcome the steps already taken. However, transparency and clarity could be increased further by reinforcing the link between monetary policy decisions and inflation forecasts (rather than actual inflation).

Continued efforts are called for to further strengthen banking supervision, improve the bank resolution framework and lower the state's footprint and concentration in the financial sector. We welcome the authorities' actions to support financial stability and share staff's view that additional efforts are necessary. We encourage the authorities to continue with the implementation of the 2016 FSAP recommendations, including a comprehensive asset quality review (AQR), effective implementation of the AML/CFT framework and the gradual privatization of state-owned commercial banks as conditions permit. Taking into account the significant costs (estimated by staff at over 2 percent of GDP) of the banking system's clean-up, we wonder if staff has any estimations of the remaining contingent liabilities stemming from the banking system? What prevents the authorities from conducting a full-fledged AQR? It is also important to have a credible strategy for returning rehabilitated banks into private hands in a way that is consistent with increasing competition and improving the allocation of capital as well as eliminating the inherent conflicts of interests and inefficiencies in the state-dominated banking system.

Reforms aimed at boosting competition, supporting private business and tackling long-standing structural weaknesses remain vital to accelerate convergence to advanced economy income levels. We welcome the detailed analysis of the role of the state in the Russian economy, and in the banking sector particularly. We are encouraged that the authorities concur with staff's advice on lowering the state's footprint in the economy and appear committed to far-reaching structural reforms. The sequencing of these reforms is critical as ill-prepared and ill-executed privatization may have detrimental consequences as rightly pointed out by staff as well as in the buff statement. Staff's comments on the authorities' privatization strategy are welcome. A comprehensive and well-sequenced reform package which includes labor and product market reforms as well as the strengthening of the governance and institutional architecture, development of small and medium private enterprises are instrumental for ensuring coherent and consistent policy implementation. We also support plans to create more competition between public and private companies in public procurement. The role of the Federal Anti-Monopoly Service should be as independent as possible, and the use of internet auctions and tenders should be preferred in order to increase transparency of public procurement. The share of small and medium-sized enterprises can be increased by setting mandatory minimum limits (where deemed effective).

Mr. Sembene and Mr. Nguema-Affane submitted the following statement:

We thank staff for a set of informative reports and Mr. Mozhin for his helpful buff statement.

We welcome the recovery of the Russian economy from the 2015-2016 recession, with economic output now growing. The improved macroeconomic policy framework together with positive oil developments contributed to strengthening macroeconomic stability, with notably stronger fiscal and external positions, inflation falling below the central bank's target and inflation expectations more firmly anchored around that target. We note however that geopolitical risks have increased uncertainty around the economic outlook, thereby underscoring the need to increase reform momentum and foster private sector development and economic diversification. While we take note of the authorities' commitment to reforms, we share staff's call for maintaining the reform momentum, notwithstanding the projected improvement in the oil market. Going forward, the policy mix should be geared towards further consolidating macroeconomic stability and confidence in the policy framework, while pressing ahead with structural reforms to increase growth potential.

The improved fiscal situation in 2017 is welcome but care should be taken to avoid that improved oil revenue performance in 2018 leads to procyclical fiscal policy. We welcome the authorities' strong commitment to the fiscal rule and encourage them to pursue their fiscal consolidation efforts and rebuild buffers consistent with the fiscal rule, while increasing the available fiscal space for higher priority spending, as contemplated by the authorities. We support staff's recommendation to better target social spending and make further strides in reducing poverty. Fiscal reform efforts to increase nonoil revenue mobilization and reduce dependence on oil should continue, notably by streamlining exemptions and expanding the tax base. We take note of the authorities' commitment to implement parametric pension reform and further improve competition in public procurement and look forward to progress in these areas.

We commend the authorities for their prudent monetary policy and the progress made in strengthening the monetary policy framework and the communication policy, with notably the publication of the first monetary policy information notice. Going forward, we agree that given the low inflationary pressures monetary policy easing should continue to complete the transition to a neutral policy stance. We take note of the upside risks to the inflation outlook stemming from the recent currency depreciation and delayed fiscal consolidation plan. However, it is not clear to which extent further monetary policy easing could affect inflation. Staff comments are welcome. We look forward to further progress in the implementation of the central bank communication strategy.

We welcome the continued soundness of the financial sector. We commend the authorities for the progress made in cleaning up the banking sector and strengthening the supervisory and regulatory framework, with notably the establishment of the Risk Analysis Service within the central bank. The recent private bank failures highlight the importance of pursuing the cleanup and structural reforms in the sector to strengthen financial stability. We take note of the authorities' intention to deal with the bad assets of failed private banks as well as their plan to divest rescued private banks to private investors. We call staff to elaborate further on the causes of the declining SME lending and potential remedial actions to reverse that trend.

Reinvigorating the reform momentum will be essential to achieve the ambitious policy objectives set for the next six years. We agree with staff on the importance to further improve the business environment by tackling structural constraints to private sector development and competition. We welcome the authorities' focus on expanding and upgrading infrastructure and their agreement with staff on the need to reduce the considerable state's presence in the economy and improve the governance and efficiency of public enterprises, especially in the banking sector. We share the authorities' view on the need to ensure an appropriate sequencing of reforms.

Mr. Tombini and Mr. Pinheiro de Melo submitted the following statement:

We thank staff for the reports and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative statement. Supported by sizeable buffers and sound macroeconomic policies, Russia has weathered a protracted recession and the economy has returned to growth. External uncertainties notwithstanding, the country is in a better position to adjust the policy mix towards a more neutral stance – with the favorable oil prices providing room for rebuilding fiscal buffers. Internal challenges remain mostly in the medium and long term: unleashing Russia's growth potential seems ultimately to depend upon well-sequenced and well-implemented structural reforms, able to generate a more investment-friendly and growth-inducing environment.

Despite the positive economic performance in 2017, the baseline outlook in the medium term remains relatively weak. Staff foresees real GDP growth this year at 1.7 percent and at 1.5 percent during 2019-23, which will represent an average yearly real growth below the one observed since the global financial crisis. Russia's average GDP growth during 2010-16 was somewhat larger, even though the latter period includes two years of outright recession – with the country having to endure large negative shocks of economic sanctions and a collapse in oil prices. While concurring with staff about Russia's weak long-term growth drivers in the absence of structural reforms – a view shared by authorities – we wonder if the baseline scenario is not too bleak, recalling that the country's performance has been understated before.

Inflationary pressures have remained subdued and inflation is expected to converge to the target. Despite a closing output gap, headline inflation has remained well-behaved and is expected to converge towards the 4 percent target in 2019. While conceding that the Central Bank of Russia (CBR) should keep a gradual and data-driven approach, as fiscal and external risks have increased, staff considers that there would be space for some monetary easing. We would argue that, although interest rates are still far from historical lows in Russia, recent external developments may have considerably reduced the space for monetary easing. The normalization of global monetary conditions and, most of all, intense pressures currently over many emerging market currencies – including the ruble – would call for maximum prudence in the monetary front. Staff's comments are welcome.

Hefty international reserves, strong external position and relatively low debt levels are expected to continue to provide important buffers against external shocks. Considering Russia's large reliance on oil revenue, we see merit in staff's call for a strict observation of the conservative fiscal rule. That would guarantee a swift rebuilding of fiscal buffers, helping to isolate the economy from oil price volatility. However, considering the expected large current account results in the baseline, mostly comfortable fiscal perspectives and low debt levels, we were a little puzzled by the assessment that Russia has only some fiscal space. We missed a more thorough analysis regarding the authorities' commitment to boost spending on infrastructure, health, and education. Although staff informs that this could substantially change the baseline and result in faster growth over the next few years, the initiative is quickly dismissed. Taking into account the favorable external and internal balances, we would imagine Russia to have considerably more fiscal space than it seems to be the case. Staff comments are welcome.

Despite the sheer number of banks, the financial sector is not strictly competitive – a more efficient sector would enhance considerably the channeling of savings to productive private investments. Although last year's bank failures were not systemically significant, they delivered a clear signal of prevailing risks to financial stability and contingent liabilities for public finances. While welcoming the positive steps taken by the authorities – such as the creation of a special division for independent quality evaluation of assets in the CBR – we would expect that completely closing existing gaps in supervision and regulation might take some time. The authorities should concentrate efforts on tackling a pervasive practice of related-party lending, which not only increases risks of suspicious failures but contributes to the overall low efficiency of the banking sector.

Russia has showed resilience and capacity to withstand severe shocks, but structural deficiencies continue to cloud the country's outlook. Building a more diverse economy and lowering the traditional reliance on the energy sector are challenges recognized and embraced by the authorities. Increasing Russia's growth potential and economic dynamism will require the development of a larger, stronger and internationally competitive private sector. Moreover, there is considerable space for improving transparency and governance standards in the corporate sector in general. Enhancing the accountability and governance framework of state owned enterprises (SOE) would be a good start and act as a catalyzer for raising the standards for the whole economy.

Mr. Gokarn and Mrs. Dhillon submitted the following statement:

We thank the staff for the informative reports and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for the candid buff statement.

Russia's economy continues to emerge from recession with growth projected at 1.7 percent in 2018. Amid higher oil prices, macro stabilization, improved business and consumer confidence and a challenging external environment, Russia's economy is expected to keep growing, albeit modestly at 1.5 percent. The authorities have articulated a set of ambitious policy objectives for the next six years for raising GDP growth above the global average, reducing poverty and increasing investment to 25 percent of GDP. With sound macro fundamentals reflected by broadly stable REER, credible fiscal rule and low inflation already in place, the authorities' commitment to build upon reforms will bolster investor confidence and enhance growth prospects.

On the fiscal side, the ambitious fiscal strategy has delivered results. We take positive note of the low level of public debt in Russia which is the second lowest among the G-20 countries. Going forward, the authorities' efforts to keep public debt low and control expenditures would provide fiscal space to support spending on infrastructure, education, and healthcare. To meet this goal, we join staff in urging the authorities to strengthen tax compliance and reduce tax expenditures under VAT and PIT on the revenue side. Major reform of taxation in the oil and gas sector is a welcome step as are the recent announcements of pension reforms. Beyond this, Box 1 Alternative scenario mentions that the authorities expect the extra infrastructure investment and improved spending mix to have a positive impact on potential GDP. Have staff held discussions with the authorities on the portfolio and composition of financing options?

Monetary policy has remained consistent with the inflation targeting regime, and the staff recommendation for a gradual easing of monetary policy appears appropriate. Inflation is now at record low level and is even below the CBR's target of 4 percent. We appreciate the improved communication policy of the CBR and note that the authorities do not see a need for now to publish a path for projected interest rates. We would like to hear staff views on the implications for this.

The banking sector is stable and liquid. The authorities have made substantial progress both with the clean-up of the banking sector and the implementation of structural reforms in this sector. Private sector credit grew by about 11 percent in April 2018 and lending activity in the retail sector has been expanding. Moving ahead, further improvements in the regulatory framework and supervision, especially for deepening the financial markets must continue. We appreciate the staff's analytical work on the role of the State in Russia's banking sector. However, in the backdrop of the recent failures of private banks and the ongoing cleaning-up efforts in the banking sector, we wonder if the privatization of the banking sector in the present conjecture would offer more stability. Could staff elaborate?

Finally, to fully reap the socio-economic benefits and return to solid growth, Russia will need to implement policies that foster rapid transformation. We are encouraged to note that several structural reforms have been implemented with the help of extensive cooperation with the World Bank to reduce red tape, simplify regulations, improve governance, and reduce corruption. Further reforms, to address the remaining weaknesses in the investment climate and addressing skill mismatches would greatly enhance long-term growth prospects.

With these comments we wish the authorities the best in their endeavors.

Ms. Barron and Mr. Khurelbaatar submitted the following statement:

We thank staff for the report and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative buff statement. A strong macroeconomic policy framework and the positive global energy prices supported the stabilization and recovery of the economy. We note the robust progress made in reducing the fiscal deficit, stabilizing inflation and moving towards a more freely floating exchange rate. However, the medium-term growth outlook is subdued given the still heavy reliance on energy exports and structural weaknesses that are holding down potential growth. We support staff's recommendations to continue to build buffers and undertake structural reforms in the opportunity presented by the current level of low debt, positive global energy prices and significant foreign reserves.

Fiscal consolidation efforts resulted in a decrease of the budget deficit, both in primary and non-oil primary balance. Actions planned for 2019 such as increasing the VAT rate from 18 to 20 percent, reducing tax exemptions, introduction of tax reform in the oil and gas sector and better targeting of fiscal expenditure will further enhance fiscal consolidation. We note the progress made in reducing the non-oil primary budget deficit from 11 percent of GDP in 2015 to projected 6 percent of GDP in 2019. We commend the authorities for adopting a fiscal rule tied to the oil price and which targets a zero primary balance. The fiscal rule also acts as protection against Dutch disease and can contribute to intergenerational equity. We agree with the staff that revisiting the fiscal rule before it is fully implemented could reduce the credibility of macroeconomic policy and urge the authorities to fully comply with the rule.

SOEs account for a relatively large part of the economy. The staff report notes that SOEs operate in almost every sector of the economy and that the SOE sector underperforms compared to the private sector. Improving the efficiency of SOEs will be essential to generate stronger growth, whether that is achieved by privatization or corporatization. The level of competition in the economy should also be increased to improve the efficiency of SOEs and private firms.

Mr. Doornbosch and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative buff statement. We welcome the authorities' efforts to strengthen the macroeconomic policy framework and their prudent fiscal policy stance, in line with past Article IV recommendations. Efforts remain necessary in structurally reforming the economy, addressing institutional weaknesses and strengthening the financial sector. Downside risks, including those pertaining to international developments, persist and need to be closely monitored.

The introduction of a fiscal rule underlines the efforts to strengthen the macro-economic policy framework. We agree with staff that Russia should continue its prudent fiscal policy and use the revenues from higher energy prices to rebuild buffers to be able to counteract downside risks, including those stemming from reduced cross-border integration and sustained geopolitical tensions.

We appreciate that staff recalls the importance of intergenerational equity considerations and the fact that their recommendations take into account a longer time horizon. This is particularly pertinent in the case of a commodity-producing nation, as also mentioned by Directors during the Board discussion on the updated fiscal space framework. In this sense, we support the authorities' practice of maintaining reserve funds and agree with staff's support for the parametric pension reform that is currently under discussion. In the Risk Assessment Matrix, staff judges lower energy prices to be a low probability/high impact scenario. Does staff consider the risks from reliance on revenues from finite fossil resources to be low in the medium- and long-term as well?

We welcome the authorities' aim to direct funds towards improving infrastructure, health and human capital. These efforts are necessary and contribute to improving potential growth and attract investment. They are also likely to help reduce still high poverty and inequality levels. Here, we agree with staff that such efforts should not come at the expense of relaxing the recently implemented fiscal rule. A temporary freeze of the fiscal rule would not only jeopardize the effectiveness of the rule itself but the credibility of the fiscal consolidation strategy altogether. Rather, funds should be made available by reprioritization and increasing efficiency of existing programs. Similarly, structural reforms are necessary to enhance the business climate, among other things by improving competition and addressing institutional weaknesses.

While we welcome actions taken to support financial stability, we share staff's view that additional efforts remain vital. High levels of NPLs need to be tackled. AML/CFT efforts should be stepped up to increase transparency in the financial sector. We also encourage the authorities to carry out an Asset Quality Review, in line with the FSAP recommendations. We encourage the authorities to follow up on other FSAP recommendations as set forth in Annex IV of the staff report, including, but not limited to those on financial oversight and regulation.

Finally, we thank staff for their appreciation of the impact of the April 2018 sanctions against Russia. Since April, other steps have been taken and/or announced by trading partners, including by the United States. How does staff assess the likelihood and impact of potential additional sanctions—some of which are currently under consideration—including on the financial sector?

Mr. Leipold, Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for the well-written set of documents and Mr. Mozhin, Mr. Palei and Ms. Smirnova for their helpful statement. We share staff's analysis of the challenges and risks that the Russian economy is facing and their policy recommendations, and we welcome that the Russian authorities are in broad agreement with them. We would like to add the following comments.

A strengthened macroeconomic policy framework has improved the economy's resilience, but real growth remains subdued amidst structural weaknesses and external uncertainties. Geopolitical tensions and recent turbulence in emerging economies' financial markets amplify the importance of solid policy frameworks and fundamentals, especially in the face of increased uncertainty weighing on business investments. The introduction of a new fiscal rule, the floating of the ruble and the central bank's success in the disinflation of the economy have been important steps to decoupling economic and fiscal performance from oil price movements. However, similar progress in overcoming structural constraints to higher productivity levels and a diversification of the economy is urgently needed. We note with concern that some of these impediments have intensified in recent years, as regards, for example, the role of the state in the banking sector.

The planned increased allocations for health, education and capital spending can contribute to boosting long term growth. Investments in particular had been contracting for years even before the recession. The information provided in the buff statement seems to indicate that this additional spending would be budget neutral, through a combination of an increase in the VAT rate and a reduction in tax exemptions for the energy sector. Has staff prepared an update of its baseline fiscal scenario in light of the recently approved fiscal reforms? While the pace of fiscal adjustment appears broadly appropriate in the coming years, we agree with staff that the fiscal rule should be preserved, and that the quality of the adjustment could be improved.

We welcome the authorities' commitment to a parametric pension reform. In this respect, besides the relevant public finance sustainability concerns, any revision of the effective retirement age should also be gradual and take into consideration that life expectancy in Russia, especially for the male population, is particularly low, also reflecting the level of public health expenditure. Staff comments on the policy measures to address this trade-off in the Russian context, and more generally in countries showing similar demographic characteristics, are welcome.

With inflation below target, we agree with staff that the monetary stance should continue to be gradually eased, aiming at establishing credibility and firmly anchoring inflation expectations. In this regard, we welcome the fact that the CBR has moved to a medium-term average target, as it could increase the flexibility of monetary policy without compromising its credibility.

The cleanup and the consolidation in the banking system has helped to improve its resilience but additional efforts remain necessary. Some initial steps have been taken to improve supervision and transparency after the failures of three large private banks. In this respect, we are encouraged by the introduction of the limits for related-party exposure and we support staff's call for further upgrading this framework, as much as for the AML/CFT framework. Maintaining financial stability has nonetheless entailed some non-negligible fiscal costs and has led to an even larger footprint of the state in the sector, risking the exacerbation of competitiveness, as well as efficiency problems well highlighted in the staff's SIP. With the special CBR unit in charge of independent asset quality evaluations now established, we expect that asset quality reviews and stress testing exercises would be carried out swiftly. To further enhance supervision, the CBR should be enabled to exercise professional judgement.

We support the recommendation for a clear-sequenced strategy aimed to enhance competition and thereby to reduce state ownership in the banking as well as industrial sectors. While state property need not be viewed as a negative issue in itself, it can become problematic when its low efficiency negatively affects the overall productivity and efficiency, entails high quasi-fiscal costs, discourages entrepreneurship and hampers integration in the global economy. The first step in the staff's roadmap, i.e. lowering market power concentration by facilitating entry/exit can be supported by a more level playing field in public procurement, and we agree that more far-reaching institutional and governance reforms are needed to reinvigorate investment and improve the business climate.

Mr. Agung and Mr. Sumawong submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Mozhin, Mr. Palei and Ms. Smirnova for their insightful buff statement. We commend the Russian authorities for their effective policy responses, which have helped the economy recover quickly from the recession. Growth has become positive with low and better-anchored inflation expectations. Nevertheless, heightened geopolitical tensions and tighter global financial conditions pose risks to the outlook. Medium-term growth prospects are also constrained by the infrastructure gap, lack of competition due to dominance of state-owned enterprises (SOEs) and demographic pressures. Against this background, macroeconomic policies should continue to focus on safeguarding macroeconomic stability together with structural reforms to raise growth potential. We broadly agree with the staff appraisal and limit our comments to the following points for emphasis.

We welcome the authorities' plans to increase spending on needed infrastructure and health and education, to support long-term growth. We acknowledge that a package of tax reforms including an increase in the VAT rate and a gradual elimination of tax exemptions has been recently approved in line with staff's recommendations, to help finance additional public expenditure. At the same time, the tax reform package includes a temporary relaxation of the fiscal rule to allow deficit financing for needed infrastructure spending. In this connection, we note the differing views between staff and the authorities on implications of temporary relaxing the fiscal rule and invite staff to comment. We are also encouraged by the authorities' commitment to pension reform which would help ensure the sustainability of the pension system and welcome the recent development in this area. Could staff share their preliminary assessment on the impact of raising the retirement age?

We agree that the pace of monetary easing should continue to be gradual given the upside risks to the inflation outlook. That said, we note the recent Central Bank of Russia's decision to maintain its policy rate and are of the view that any easing towards a "neutral stance" should remain data-dependent. In addition, we are of the view that greater clarity and transparency on the monetary policy stance would strengthen the central bank's credibility, which in turn would help further anchor inflation expectations. As such, we take positive note of improvement in the central bank's communication strategy which is partly in line with past Fund's recommendations and invite staff to elaborate on the authorities' rationale for shifting to the permanent 4 percent inflation target.

We note that the authorities have made considerable progress in strengthening financial stability. Nonetheless, banks have recently become less profitable, bank capital has shrunk, and non-performing loans have increased. Importantly, incidents related to private banks highlight the necessity and urgency of completing the cleanup of the banking system. We also encourage the authorities to implement the remaining FSAP recommendations, particularly on the asset quality review and bank resolution frameworks, to further strengthen the financial stability framework. We note that current market conditions are not favorable for privatization of state-owned banks but underscore that such privatization should be gradual and well-sequenced as highlighted in the Selected Issues Paper.

We agree that well-sequenced structural reforms are essential for higher growth. We note positively the new government's policy objectives to raise GDP growth and increase investment share. In addition to the planned physical and human capital investment, we support staff's recommendation for the authorities to address the large role of the state in the economy to lift growth potential. We also see merit in staff's recommendation on improving the governance and efficiency of SOEs. We are therefore encouraged by the authorities' commitment to promote competition and level the playing field for public procurement. More importantly, we commend the authorities for progress made in improving the business environment by reducing red tape, simplifying regulation and combating corruption as highlighted in the buff statement, which are essential to attract investment and lift potential growth.

With these remarks, we wish the authorities continued success in their future endeavors.

Mr. Inderbinen and Mr. Danenov submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative buff statement.

The Russian economy is recovering on the back of the increase in oil prices and thanks to effective policies, including a welcome strengthening of macroeconomic policy frameworks. The substantial fiscal consolidation and the budget surplus projected for 2018 are particularly welcome. However, considerable challenges weigh on growth prospects over the medium to long term, along with uncertainty in global trade and geopolitical tensions. Determined efforts to enhance potential growth, notably by reducing the role of the state in the economy and improving infrastructure, are thus a key priority. In addition, it is important that prudent and judicious monetary, fiscal and financial sector policies continue to foster resilience and ensure stability. We note that the authorities largely agree with staff's analysis and policy recommendations. We broadly support the staff appraisal and limit our comments to the following points:

We welcome the authorities' plans to increase spending on infrastructure, health, and education over the medium term. At the same time, we share staff's reservations regarding the financing of these objectives. We concur that it would not be advisable to relax the fiscal rule so soon after its implementation. This would weaken the hard-won credibility of the authorities' macroeconomic framework. Moreover, we share the staff's view that fiscal consolidation should continue in order to rebuild fiscal buffers and reduce Russia's vulnerability to external shocks. We welcome the recent pension reform that is essential to ensure the sustainability of the system and to limit pressures on the budget.

We agree with staff on the transition to a neutral monetary policy stance. However, we underscore that any further easing of monetary policy should be effected with due caution, given the closing output gap and the prospect of rising inflation. We share staff's view that inflation could also pick up as a result of ruble depreciation, higher energy prices, strong growth in real wages, and possible changes in the fiscal stance. In addition, we take good note that the CBR has continued to strengthen its inflation targeting framework and is working on further improving its communication policy.

We welcome the progress achieved in cleaning up the banking sector and in strengthening financial stability. We take good note of the creation of the Risk Analysis Service at the CBR responsible for an independent assessment of banking asset quality, and the adoption of a new regulation on related-party exposures. Nevertheless, we see the need for more efforts to strengthen supervision and regulation of the banking sector, also in light of the CBR's takeovers of several large private banks in 2017. We encourage the CBR to divest from the bailed-out banks, complete the clean-up of the banking sector and promote the build-up of capital and liquidity buffers.

Structural reforms to overcome longstanding impediments to growth and promote economic diversification are paramount. As in the banking sector, the state's role in the economy more generally needs to be reduced over time to increase Russia's growth potential. In this regard, we welcome the intention of the authorities to gradually reduce the footprint of the state in the economy. We concur with staff on the merits of a sequenced approach to avoid adverse effects, including economic concentration. Strengthening the institutional set-up and steps to increase competition are necessary prerequisites for successful privatization. Overall, we see a clear need to establish a level playing field for the private and public sectors. Also, transparency, accountability, and governance in the state-owned enterprise sector should be enhanced. Finally, we agree that improving the effectiveness of the AML/CFT regime will be important to address crime related to tax evasion and corruption.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their documents and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their insightful buff statement. Over the past two years, Russia's economy has recovered from the 2015-2016 recession. The introduction of a new fiscal rule, the modernization of the monetary regime and the ongoing restructuration of the banking sector have been instrumental to stabilize the economy. Nonetheless, we share staff's main concern about the lack of convergence of the Russian economy with advanced economies – which even appears as a clear divergence when Russia is compared to new European member states – and the rather dim prospects in terms of GDP growth going forward. Without an ambitious reform agenda to create the conditions for a more competitive and inclusive economic system, Russia will remain overly dependent on its extracting sector. We agree with the main recommendations outlined in the report and would like to highlight the following points.

Regarding fiscal stance, we welcome the new government's intention to increase infrastructure, health and education public spending. Well calibrated spending in these three areas has the potential to increase potential GDP and to reduce inequalities. While we understand staff's argument about the need to preserve the credibility of the new fiscal rule, we wonder whether debt-financing of these spending would not be optimal given the existing fiscal space in Russia. Could staff indicate if there is currently some room for maneuver within the boundaries set by the fiscal rule to finance this increase in public spending through debt? If not, could staff comment on the design of the fiscal rule, notably by discussing whether the rule could be excessively conservative? Concerning the pension reform, we agree with staff that a parametric reform is warranted to reduce the impact of ageing on public finances and ensure the sustainability of the pension regime. We encourage the authorities to finalize the reform under discussion and to ensure that it delivers the necessary adjustment while preserving the most vulnerable.

As we highlighted last year in our gray and during the board meeting, we are somewhat surprised by the fact that staff does not tackle in his report the issue of high income and wealth inequality and does not discuss how public policies could be more redistributive. A recent work by Thomas Piketty, Gabriel Zucman and Filip Novokmet[1], which combines Russian national accounts, surveys, wealth and fiscal data to assess the evolution of inequality in Russia arrives to some striking conclusions. The authors notably find that "top income shares are now similar to (or higher than) the levels observed in the United States […] inequality has increased substantially more in Russia than in China and other ex-communist countries in Eastern Europe […] the wealth held offshore by rich Russians is about three times larger than official net foreign reserves, and is comparable in magnitude to total household financial assets held in Russia". These findings point to a macro-critical level of inequality which could partly explain the low growth prospect of the country.

On the policy side, this high level of inequality, if confirmed by staff own analysis, would warrant a more in-depth assessment of the existing tax and transfer system. The choice of having a flat personal income tax, a feature that is particularly rare for a country of with this level of development, could notably be questioned. An assessment by the IMF of the impact of more progressive income and wealth taxes on growth and its distribution would be

[1] Novokmet, Piketty and Zucman (2017), "From Soviets to Oligarchs: Inequality and Property in Russia, 1905-2016". NBER Working Paper 23712

particularly valuable. Such progressive taxes could for instance help to finance much-needed physical and social infrastructures in a growth friendly manner. Similarly, the degree of progressiveness of the social safety net and more generally of public services delivery should be assessed more deeply. Could staff comment on the actual degree of redistribution operated by the tax and transfer system and whether it has discussed this point with the authorities?

Such high levels of inequality is also linked to the productive structure of the Russian economy and notably to the high concentration observed by staff in most sectors. The lack of competition, of which the state footprint in the economy is one factor, is detrimental to growth. By lowering incentives to create new businesses, to innovate or to invest in human capital, high economic concentration is both detrimental to productivity growth and to the sharing of the wealth created. In this regard, we agree with staff that lowering barriers to entry and encouraging competitive procurement by state-owned enterprises could help diversify the economy, sustain private sector development and in turn strengthen equality of opportunities for all. While we commend the Russian authorities for recent reforms in terms of e-government highlighted in Mr. Mozhin, Mr. Palei, and Ms. Smirnova buff statement, making the economic system fairer through broader governance reforms – such as by reinforcing the rule of law, by strengthening anticorruption policies and by intensifying the fight against illicit financial flows – could also trigger the change of economic model needed to deliver higher growth. We hope that the rolling out of the Fund's new governance framework will help to feed a constructive dialogue with the authorities on these issues and look forward to more in-depth analysis in the upcoming Article IV reviews. Regarding SoE reforms, we understand the authorities concerns about potential effects of an abrupt privatization process and we agree with staff's recommendation to proceed gradually. As a first step, we encourage the authorities to implement the OECD Guidelines on Corporate Governance of State-Owned Enterprises.

Mr. Armas and Mr. Lischinsky submitted the following statement:

We thank staff for the set of reports, particularly the Selected Issues (SI), and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their helpful buff statement.

The Russian economy is leaving behind the 2015-2016 GDP decline. The 2018 GDP growth rate as projected by the staff would be around 1.7 percent, from 1.5 percent in 2017. The authorities expect growth within that range even though it could be slightly higher following the 2Q2018 data and improvements in the second semester.

Several major structural reforms were introduced at the macro level: a floating exchange rate regimen under an inflation targeting framework and a large fiscal consolidation process under a new simple fiscal rule tied to the oil price. Thus, the authorities have maintained high fiscal responsibility through the years, and its commitment to prudent fiscal policy with a low public debt and controlling expenditures This effort brought the general government debt to 15.5 percent of GDP, including the public external debt of 4.5 percent of GDP in 2017. Furthermore, the National Wealth Fund will be replenished increasing in this way buffers, bringing more macroeconomic stability. We agree with Ms. Barron and Mr. Khurelbaatar’s Gray that the fiscal target of zero primary balance acts as protection against Dutch disease and can contribute to intergenerational equity.

Looking forward, we welcome the idea to change from social security contributions to consumption taxes to reduce labor informality. Could staff provide examples of countries that have adopted such approach? VAT rate is being analyzed to be raised, does the staff have any figure of VAT compliance or evasion?

We welcome the purpose to increase spending on infrastructure, health, and education over the next six years within the goal to increase investments from 21-22 percent to at least 25 percent of GDP. Alternative Scenario in Box 1 assumes potential GDP to be unchanged from the base line scenario given, as mentioned in the report, the difficulties surrounding the proper identification of high-return projects. However, we believe it is more suitable to make an assessment on potential GDP growth impact, although with high uncertainty, than to present a scenario without that effect. The estimation could be done based on Russian history or international experiences to have a better comparison of both scenarios. Staff comments are welcome.

Monetary easing continues since mid-2016, and the policy rate has gradually been reduced. The staff considers that further monetary easing appears appropriate. At 3 percent, the inflation rate is below the official inflation target of 4 percent but could increase temporally if the VAT rate is increased. However, according to the news from CBR authorities (source: Reuter), recent developments in EM financial markets may provide reasons for holding the policy rate or even raising. Could staff comment whether recent events may change its view about Russian stance on monetary policy?

On paragraph 21, staff mentions that the authorities do not see a need for now to publish a path for projected interest rates. What is the view of the staff about this communication option?

After the FSAP update, the authorities implemented the staff recommendations, among them a comprehensive clean-up which reduced the number of institutions in the financial sector by 40 percent in few years, and this process according to the buff statement is not finished and could take another three years. Furthermore, the CBR has centralized all supervisory functions in headquarters and required all financial institutions to report online daily operations to detect early warning signs of difficulties. Not less important are the steps taken to enhance financial literacy.

Regarding structural reforms, we take note of the comments in the buff that six years ago Russia joined the WTO and now it is close to completing the 8-year trade liberalization program. It is expected that this could lead to significant positive effects on growth. In improving trade relations, the authorities are taking important multilateral and bilateral steps. E-government is another central initiative taken. While pension reform is another extreme difficult proposal which was passed to parliament. Could staff provide information about the replacement rate in the Russian pension system?

With these comments, we wish the Russian Federation and its people every success in their future endeavors.

Mr. Kaizuka and Mr. Minoura submitted the following statement:

We thank the staff for the comprehensive reports and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative statement. It is encouraging that the Russian authorities have taken a strong macroeconomic policy framework and the economy is recovering from the 2015-16 recession. However, Russia still faces some challenges, including structural constrains, the lingering impact of sanctions and adverse demographics. In this light, we welcome that the new government has articulated a set of ambitious policy objectives for the next six years and encourage the authorities to continue their efforts on critical reforms to enhance potential growth. As we agree with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

We concur with staff that the authorities are encouraged to engineer a growth-friendly shift in spending and taxes while persisting with the fiscal consolidation. In this regard, we welcome the authorities' plan to boost spending on health, education, and infrastructure, as well as the recent legislation to increase in the main VAT rate and complete the shift in oil sector taxation from export duties to mineral extraction taxes over 2019-24. As for infrastructure, we note that the Budget Code has been amended to establish a temporary infrastructure fund which will be financed by relaxing the fiscal rule by 0.5 percent of GDP on average over a period of six years. Could staff elaborate more on the evaluation for this amendment, including its size and financing measure? At the same time, parametric pension reform, including raising the statutory retirement age and limiting early retirement, remains critical not only for the system's sustainability, but also for intergenerational equity. Against this background, we positively take note that the bill proposing a parametric pension reform has passed its first reading in the Duma and look forward to its early finalization. Staff also pointed out that social benefits could be better targeted, while Mr. Mozhin's buff statement mentions that possible measures are still under consideration. We would appreciate staff's elaboration on possible measures for better targeting of social benefits.

Monetary and Financial Sector Policy

We commend that Central Bank of Russia (CBR) has successfully geared monetary policy toward supporting disinflation and anchoring inflation expectation. Going forward, we agree with the staff's view that the CBR is encouraged to maintain its gradual and data-driven approach and refine further its communication strategy to strengthen its credibility.

As for the financial sector, we take note of the Russian banking sector's shortcomings revealed by the failure of three large private banks and encourage the CBR's further efforts to close the gaps in bank supervision and regulation, as well as in the provision of accurate financial statements. In this regard, it is encouraging that the authorities have taken further actions to support financial stability, including the establishment of the Risk Analysis Service and initiative of an Asset Quality Review (AQR) for the banking system. At the same time, it is important to improve the structure and governance of the banking system toward more competition and greater efficiency. Given the large footprint of the state and the uneven playing field between private and state-owned banks in the financial sector, the authorities are encouraged to reduce concentration in the sector and seek bank privatization in the long run. Could staff share the views on more specific measures of the governance reform? Further improvement in the effectiveness of the AML/CFT system, including in relation to politically exposed persons and the transparency and availability of beneficial ownership information of legal persons, are also encouraged, which will contribute to addressing financial crimes related to tax evasion and corruption.

Structural Policy

Given the structural obstacles including inadequate infrastructure, excessive regulation, governance and institutional weaknesses, and adverse demographic trends, we concur with the staff's appraisal that a wider reform agenda is necessary to lift potential output and accelerate per capita income convergence with advanced economies. In this sense, we commend the authorities' initiatives including the parametric pension reform and the shift in the taxation of the oil sector. Going forward, reducing the state's footprint and addressing weakness in governance are also essential to improve efficiency and capital accumulations over the medium term, while it should also be bear in mind that privatization itself is not an objective, but just one of possible methods.

Ms. Riach submitted the following statement:

We thank Staff for their work, and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their buff statement. We broadly share Staff's assessment of the outlook for the Russian economy, with growth expected to remain moderate and broadly in line with potential (around 1½ percent per year) in the near and medium term. We agree that medium to long term growth prospects will remain subdued in the absence of comprehensive structural reforms to raise weak productivity levels, and we welcome the attention that is given to these challenges throughout the report.

We agree with Staff's assessment that downside risks remain with regards to geo-political tensions and the retreat from cross boarder integration. In addition, that higher oil prices could weaken the commitment to implement structural reforms and any delays in the clean-up of the banking sector and a re-acceleration of credit growth, could lead to a build-up of non-performing assets if growth slows. More emphasis could be given to the importance of committing to anti-corruption measures and this coupled with greater transparency in public finances, enhancing competition and closer integration into global value chains would seem crucial for the long-term outlook.

We welcome measures taken by the authorities to strengthen the macroeconomic policy framework (revised fiscal rule, inflation targeting, free-floating exchange rate). These policies helped to stabilize the economy during the period of severe stress (2014-2016), while also resulting in a tight macroeconomic policy stance during the recovery stage.

We welcome the authorities' commitment to its ambitious expenditure-based fiscal consolidation and to re-building the fiscal buffers, which we agree remain essential for reducing Russia's vulnerability to external shocks. We agree with staff that Russia should not revisit the fiscal rule so soon after its implementation. The fiscal rule has so far proven successful in helping to stabilise the economy, rebuild fiscal buffers and reduce vulnerability to external shocks including oil price fluctuations. Revisiting it at this time would risk weakening the authorities' credibility and would remove a buffer against oil price fluctuations.

We welcome the changes introduced to the monetary policy and exchange rate framework by the Central Bank of Russia (CBR) over the last few years. This has contributed to the substantial disinflation achieved in Russia and we broadly agree that the CBR's transition to a neutral policy stance should be completed in a cautious and gradual manner. We support Staff's call for further refining the CBR's communication strategy. We note staff's view that the measures taken by the CBR to improve the AML/CFT framework will support the authorities' efforts to address financial crimes related to tax evasion and corruption.

We welcome the detailed analysis of the role of the state in the banking sector, which is topical given the dominant role of the state in the sector and prominent private bank failures in 2017. We concur with Staff recommendations to complete the sector's clean-up and to increase the role of the private sector. Strengthening the institutional environment and accountability is appropriately highlighted as a first step, although more credible privatisation strategies should also be developed. Do staff have a view as to when market conditions would be favourable to continue gradual privatisation of State Owned Banks (SOBs)?

We agree with the staff's assessment on the role of Russia's state footprint and that existing policies to protect competition, including in state procurement need to be strengthened. Given Staff's assessment that policies to protect and promote competition are geared more at form than at substance and state procurement legislation does not appear sufficiently aimed at strengthening competition and support SMEs, what specific measures would staff recommend in terms of competition and procurement rules and regulations?

Ms. Horsman, Ms. McKiernan and Mr. Hart submitted the following statement:

We thank staff for their good report and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their helpful clarifying buff. We note that staff and the authorities mostly share the assessment of the outlook and risks, and broadly agree on the policy recommendations. With that in mind, we will limit ourselves to a few comments.

Russian authorities have made significant improvements to their macroeconomic policy framework in the wake of the 2014 oil price shock. This includes ongoing fiscal prudence, the introduction of a fiscal rule, and good progress towards an inflation targeting regime and a flexible exchange rate. The result is an economy that is likely to be more resilient to external pressures, both idiosyncratic and generalized. However, a significant and well-targeted structural reform effort is needed to overcome subdued prospects for inclusive growth over the medium-term.

Russia's fiscal stance is broadly appropriate, but the composition of spending could be more inclusive and growth-friendly. We welcome the authorities' intention to increase their investments in health, education, and infrastructure in light of Russia's structural and demographic challenges. To maintain the overall fiscal stance, the authorities should consider reprioritizing spending in other areas and raising revenues through a shift to more indirect taxation. We also welcome the authorities' commitment to reduce tax expenditures, particularly in the energy sector. We note staff's assessment that the new fiscal rule may help shield the economy from oil price fluctuations and support diversification efforts, but also agree that early deviations from the rule may undermine its effectiveness. We welcome the buff's indication that parametric reforms to the pension system were recently passed by the Duma. Can staff provide their preliminary views on the impact of these reforms?

We welcome indications that Russia's inflation-targeting regime is taking hold. Inflation expectations are converging towards the target. The Central Bank of Russia has strengthened its communications strategy and data-driven approach, which should help to establish credibility and anchor inflation expectations. We support staff's view that additional efforts are necessary to support financial stability, including strengthening bank supervision, limiting connected lending, and improving the effectiveness of the AML/CFT regime.

Finally, we welcomed staff's analysis of the role of the state in Russia's economy. While not definitive, the staff assessment provides useful indications that state-owned enterprises (SOEs) could be hampering inclusive growth and productivity, particularly in the banking sector. We agree with staff's recommendations to strengthen transparency, governance and accountability standards for SOEs, as well as strengthening competition.

Mr. Hurtado and Mrs. Del Cid-Bonilla submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Mozhin, Mr. Palei and Mrs. Smirnova for their informative buff statement.

The strong macroeconomic framework put in place in recent years, together with the recovery in oil prices, is allowing Russia to resume economic growth and to lower macro-financial risks. However, the medium-term outlook remains feeble and current turbulence in emerging markets as well as heightened geopolitical tensions have increased downside risks. Against this backdrop, continuing efforts to maintain financial stability and implement structural reforms are of utmost importance. The ambitious medium-term agenda adopted by the new government, aimed at achieving convergence to advance economies' income levels is in the right direction, as it intends to cut poverty in half by strengthening spending in infrastructure, health and education, and to reduce the state's footprint in the economy. We broadly share the thrust of the staff appraisal and will limit our comments on a few topics.

We welcome the update provided by staff on policies recently implemented by the authorities regarding the increase in the VAT rate, the shifts in oil sector taxation, and progress in the approval of a parametric pension reform. The authorities' decision to relax the fiscal rule by 0.5 percent of GDP over a period of six years to finance infrastructure projects should be careful monitored as it can pose risks to fiscal consolidation and monetary policy objectives. In this regard, we would like to hear from staff how the flexibilization of the fiscal rule affects fiscal projections; what could be the impact of this procyclical fiscal policy on monetary policy? Does staff envisage risks for financial stability?

We recognize the authorities' efforts and progress to clean up and consolidate the financial sector; the CBR has rescued several private banks in the last year under a new resolution framework at a high cost through several actions. As we understand that currently the resolution framework does not contemplate a clear and credible strategy to return recovered banks to the market or provisions for the use of budgetary funds to support resolution processes, could staff provide its view as to what extend this CBR intervention mechanism implies risks to monetary policy goals and the anchorage of inflation expectations? is the CBR implementing measures to neutralize liquidity expansion? How is the banking Sector Consolidated Fund (BSF) financed? Are there contributions from the banking sector?

Last year, failure of several large banks evidenced the need to continue strengthening banking supervision and regulation. We commend the authorities' efforts to achieve these objectives while encouraging them to conduct the asset quality review aligned to best international practices and to implement the pending FSAP's recommendations. In particular, we concur with staff on the need for additional tightening of connected lending regulation, upgrading the framework for bank's external auditors and enabling the CBR to exercise professional judgment as part of an explicit early intervention mechanism. Continuing improvement of the AML/CFT framework is equally important. We concur with staff and the authorities that reducing the state's footprint on the industry is crucial to increase competition and efficiency but that should be a gradual process; in the meantime, however, it is important to improve governance and risk management practices in the sector and level the playing field between private and state-owned banks. We would like to ask to what extent the authorities agree with staff recommendations on the size and performance of the SOBs and regulation and resolution issues.

The acceleration of structural reforms to raise potential growth is essential. We agree with staff on the importance of enhancing competition by promoting market entry and leveling the playing field in public procurement. Given the high concentration of SOEs, their rationalization is promising for efficiency gains. Is there agreement between staff and authorities on downsizing including gradual privatization of the SOE sector?

We encourage the authorities to continue efforts to eliminate red tape that hinders business and to continue tackling institutional and governance issues, including excessive regulations and customs procedures that complicate trade integration and prevent higher investment. With regard to transparency, accountability and governance standard in the SOE sector, we would like staff's comments on the status of the implementation of recommendations contained in the Fiscal Transparency Evaluation (FTE) of 2014. With this, we wish the authorities all success in their future endeavors.

Mr. Merk and Ms. Kuhles submitted the following statement:

We thank staff for the well-prepared documents and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative buff statement. We concur with the thrust of staff's analysis.

After the recession in 2015 and 2016 the Russian economy is still on a path of moderate recovery. Notwithstanding a relatively strong macro-economic framework and the ongoing clean-up of the banking sector, structural impediments and geopolitical risks weigh on the medium-term outlook and we continue to view downside risks to the outlook as elevated. In particular, external risks have regained prominence in recent weeks, with additional sanctions being implemented. Foreign currency denominated external debt is also a potential source of vulnerability given the depreciation of the ruble.

Adherence to the fiscal rule, which has contributed to strengthening fiscal discipline and reducing macroeconomic effects of a volatile oil price, remains of the essence. Despite the higher-than-expected oil price in the first half of 2018, we recommend retaining budget discipline and using fiscal space to build up additional reserves. This would be conducive to reducing vulnerabilities to external shocks. We also encourage the authorities to improve the composition of the budget in such a way that both productivity and economic growth is better supported.

The envisaged transition to a neutral monetary policy stance should proceed gradually, paying due regard to risks to the inflation outlook. Core risks include possible pressures on the ruble exchange rate, geopolitical tensions and persistent inflation expectations of households. Households' inflation expectations are still well above the targeted inflation rate. Additional risk factors include fiscal policy initiatives laid out in the May 2018 presidential decree, such as the impact of the planned main VAT rate increase on prices and a possible significant extension of net new borrowing. A consistent communication policy is necessary in order to anchor inflation expectations, especially the elevated expectations of households, at the level of the inflation target.

The stabilization and clean-up of the banking sector remains of great importance with regard to numerous resolutions and comprehensive support measures. Along the lines presented by staff, we support a stronger risk-oriented approach in banking supervision in order to identify risks earlier on the micro and macro level and to be better able to provide efficient support measures, if deemed necessary. This is particularly important to limit the costs of the authorities' efforts to preserve financial stability going forward. High costs have already materialized, including those in the context of preventing the collapse of three large banks in the second half of 2017. In the medium term it is important to have a credible and transparent strategy for returning rehabilitated banks to the private sector, not least in order to strengthen competitiveness within the sector and to reduce market concentration towards state-controlled banks observed over the past few years.

Comprehensive structural reforms are needed to raise productivity and longer-term growth prospects, and we welcome that significant attention is given to this issue throughout the report. We agree with staff that the Russian economy faces significant structural impediments to growth, including an ageing population, inequality and an oversized public sector. The planned reform of the pension system, though politically sensitive, is a step in the right direction, also in view of demographic developments and their foreseeable negative economic effects. It should be complemented by broader fiscal transition from direct to indirect taxation to incentivize labor supply, reduce informality and boost investment. In the medium-to-long term, a reduction of the size of the public sector in the economy, a diversification of the economy and the structure of exports, greater transparency in public finances, tackling corruption, enhancing competition and closer integration into global value chains also seem crucial to increase potential growth.

Mr. Jin and Ms. Cai submitted the following statement:

We thank staff for the informative reports and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for the helpful buff statement. Despite the challenging circumstances including external sanctions, the Russian economy continues to recover from recession. Macroeconomic indicators, such as inflation and fiscal and external balances, remain healthy, reflecting the authorities' sound macroeconomic management. We broadly agree with staff's appraisals and offer the following points for emphasis.

We take positive note that the budget deficit decreased to 1.5 percent in 2017, thanks to the ambitious expenditure-based fiscal consolidation. Given the public capital stock, quality of overall infrastructure and public health expenditure are all below the average level of emerging market economies, the authorities' policy initiatives, including increasing spending on infrastructure, health, and education over the next six years are welcome steps to unleash the growth potential. How the initiatives will be financed matters. We associate ourselves with staff that fiscal consolidation should continue to rebuild buffers, and implementation of these initiatives should not compromise fiscal rules. In Box 1, staff made projections under alternative scenarios, in which the initiatives are financed mostly by a higher main VAT rate as well as expenditure savings from a parametric pension reform. Could staff elaborate more on other possible ways to raise fiscal revenues besides increasing VAT rate and their feasibilities? We are encouraged to see that the authorities have introduced the major pension reform initiative, which stipulates an increase in the retirement age, and encourage the authorities to target social assistance expenditure better.

Monetary policy should be eased towards a neutral stance in a gradual manner. Inflation has fallen well below the CBR’s target since July 2017, while pressure remains given the ongoing domestic demand recovery and passthrough from the ruble depreciation. We encourage the authorities to closely monitor market developments and stand ready to adjust policy stance when necessary. Communication strategy should also be enhanced to better anchor inflation expectations.

The resilience of the banking sector should be further improved. State-owned banks (SOBs) represent over two-thirds of the banking system by assets. The high degree of concentration might reduce the level of competition and efficiency. We are glad to see that the SOBs have healthier balance sheets, although they are less profitable than privately-owned banks (POBs). We notice that the SOBs have access to much cheaper funding compared with POBs, while the net interest margin of SOBs are lower than POBs, and the ROE of SOBs are negative. Could staff elaborate more on the reason behind it? We welcome the authorities’ efforts to support financial stability, including the Asset Quality Review for the banking system, as well as the new regulation that limits related-party exposures. More needs to be done to enhance the structure and governance of the banking system, as well as increase the efficiency and competition of the whole industry.

Pushing forward the structural reforms is fundamental for inclusive and sustainable growth. We are glad to see that in the WB Ease of Doing Business ranking Russia has moved to the top quartile of the list, and in the component of starting a business Russia ranks number 28. We agree that reform priorities should focus on measures that are feasible and have a high productivity impact, including boosting investment in physical and human capital. Additional infrastructure expenditure could improve productivity if project selection targets the right sectors. We also encourage the authorities to strengthen transparency, accountability and governance standards in the SOE sector. We take note that the authorities are wondering whether a multiplicity of SOE objectives might be contributing to below-par performance. Has staff had any assessments in this respect?

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for a set of high quality papers, and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative and candid buff statement. We are pleased to note that the Russian authorities are in broad agreement with staff analysis and policy recommendations. We are also in agreement with the thrust of the staff appraisal and would like to offer the following comments for emphasis.

A strong macroeconomic policy framework—a prudent fiscal rule, inflation targeting and a flexible exchange rate—supported by the recovery of oil prices since early 2015, have helped Russia to weather the negative external factors, chiefly the 2014 and early 2018 sanctions, and build sizable foreign exchange buffers. The geopolitical risks and global trade tensions, however, continue to constrain the ability of Russia to benefit fully from a robust world economy and high commodity prices.

The authorities have already taken a number of budgetary initiatives, including an increase in the VAT rate, a shift in oil sector taxation and a parametric pension reform. We believe it is important that the revenue boosting measures have been identified and are in place ahead of implementing the medium-term plans to increase spending on infrastructure, health and education. We tend to agree with the authorities that a small and temporary relaxation of the fiscal rule and a deficit-financed increase in priority expenditure should not lead to an overheating of the economy, and would be warranted especially if it helps to increase potential output. We note the divergence of views between staff and the authorities on the size of the fiscal multiplier and welcome staff comments. Also, the extent of infrastructure gap is not clear from the information provided in the report. The authorities could also consider financing part of infrastructure spending by issuing debt that would also be prudent in view of Russia's low public debt. On social issues, the authorities intend to cut poverty in half by 2025 through a better targeting of social assistance without a major increase in the resource envelope. We invite staff to comment on the adequacy of measures to achieve the poverty objective.

We support the decision of the Central Bank of Russia (CBR) to keep the monetary policy stance moderately tight and to delay the transition to a neutral stance until inflation expectations are firmly anchored. While the recent readings of inflation are benign, and the latest consensus forecasts are in the vicinity of the CBR target, there are upside risks to inflation considering rising wages, the intended loosening of fiscal policy and the passthrough of the recent ruble depreciation, as well as the direct and indirect ramifications of further sanctions. We commend the CBR for maintaining a flexible exchange rate policy, but the benefits of favorable changes in relative prices can only be fully realized by easing the structural rigidities to improve external competitiveness. There has been important progress in strengthening the financial system. Noteworthy are: the establishment of the Risk Analysis Service; improving the AML/CFT framework; stronger macroprudential regulations to limit stability risks on household loans, and bank cleanups. The takeover by the CBR of several former private banks together with CBR backstop funding have contributed to financial stability, but at a relatively high financial cost. We welcome the authorities' intention to return these banks to private hands through IPOs after their merger and rehabilitation, but, as underscored also by staff, the process should be well sequenced and paced, and transparent.

While the planned infrastructure boost would be expected to raise potential output, Russia's convergence to income levels in advanced economies is held back by pervasive regulations, governance issues, institutional weaknesses, and the large "footprint" of state in most areas of the economy that is not conducive to greater efficiency and dynamism. We are encouraged by the authorities' intentions to improve SOE performance and efficiency and create a competitive market environment with a level playing field between public and private corporations, including in the area of public procurement. We invite staff to comment on the progress in implementing the recommendations of the 2014 Fiscal Transparency Evaluation on reporting the financial position and performance of public corporations. Other initiatives that would leave a positive footprint on growth and productivity are reducing barriers to trade and FDI. On a separate structural issue, we welcome staff comments on issues related to labor force participation, especially among youth and women, and labor market informality in Russia compared to peer countries.

We wish the authorities continued success.

Mr. Merk made the following statement:

We thank the staff for the well-prepared documents, and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their informative buff statement.

We welcome that the Russian economy is on a path of moderate recovery, and we positively note the relatively strong macroeconomic framework the authorities have established. This being said, structural impediments and geopolitical risks weigh on the medium-term outlook, and we continue to view the downside risks to the outlook as elevated.

Adherence to the fiscal rule, which has contributed to strengthening fiscal discipline and reducing the macroeconomic effects of volatile oil prices, remains of the essence. In addition, the stabilization and cleanup of the banking sector remains of great importance. We support a stronger risk-oriented approach in banking supervision in order to identify risks earlier on a micro and macro level.

Comprehensive structural reforms are needed, as well, to raise productivity and longer-term growth prospects, and we welcome that significant attention is given to this issue throughout the report, as the Russian economy faces significant structural impediments to growth, including an aging population, inequality, and an oversized public sector. The planned reform of the pension system is a step in the right direction.

Ms. Erbenova made the following statement:

We thank the staff for the report and the answers to our questions, as well as Mr. Mozhin and his colleagues for the candid and informative buff statement.

We commend the Russian authorities for their strong policy response to unfavorable economic developments. The sound macroeconomic policy mix proved to be instrumental in mitigating the impact of recent external shocks. We are confident that the authorities will react in a similar, decisive fashion going forward.

In yesterday’s insightful Camdessus lecture, Governor Nabiullina noted that Russia will likely put monetary easing on hold. Earlier this week, the authorities announced a possible temporary relaxation of the fiscal rule.

Both measures would not be in line with the staff's recommendations, as outlined in the staff report. We would appreciate the staff's views on the desirability and appropriateness of a possible policy reversal in Russia.

The Russian growth outlook is highly uncertain, and we realize the complexity of assessing the Russian economy's cyclical position. As Mr. Mozhin pointed out in his buff statement, and as Governor Nabiullina noted yesterday, many downside risks are of a temporary nature, and ample policy buffers can help mitigate them. We broadly share this view; but as one old Russian proverb says: Nothing is more permanent than temporary situations. In this vein, we believe that deeper analysis of possible policy responses is warranted, should policy buffers become less ample.

Shocks to the Russian economy reverberate throughout the Eurasian Economic Union. As we suggested in our gray statement, the staff's analytical work on possible spillovers, perhaps a chapter in the Regional Economic Outlook (REO), which would focus on possible regional contingent channels, spillovers, and spill-backs, would fill a gap in the Fund's spillover analysis, and these countries would strongly benefit from it.

Referring again to Governor Nabiullina's speech, structural policy buffers are vital. We encourage the authorities to advance private sector development and economic diversification, and we welcome their plans to lower the state's footprint in the economy, including in the banking sector, stressing the importance of a comprehensive and well-sequenced package to ensure policies' consistency and coherence.

With these remarks, we wish the Russian Federation and its people every success in their future endeavors.

Mr. de Villeroché made the following statement:

We thank the staff for the interesting report. I commend the Russian authorities for what they have achieved in terms of macroeconomic and financial management over the last years. Prudent macroeconomic policies contributed to maintaining stability over the recent years. Maybe more should be done on the macro-financial front and on banking restructuration; but still, it is a great achievement.

The only difficulty we see is that stability is an important asset. I can understand how it is important for Russia. But stability does not mean growth. With the potential growth close to 1.5 percent, Russia may face what is called the middle-income trap. Or let us say it differently. In terms of GDP per capita, there is no convergence with Europe. This is a concern for a country that is as rich as Russia in terms of natural resources, with a high level of education. We believe that Russia needs to revisit some cornerstones of its economic model to escape this middle-income trap or risk of stagnation.

What should be done? We envision an increase in public investment, infrastructure, education, and health care. We believe there is some fiscal space for that, and it would be interesting to hear what the staff thinks about the current fiscal rules and whether more investment could accommodate these rules. Of course, the Russian authorities should follow best practices in terms of projects' selection, implementation, and follow-up.

More broadly, a change of the economic model will also come from an improvement in the business climate. The longstanding lack of productivity growth and of diversification, even after an important depreciation of the currency, is a major impediment for a middle-income country like Russia. It demonstrates that the current rules and incentive mechanisms are not sufficiently conducive to private sector development and innovation. A truly level economic playing field, streamlined and more efficient state pensions, and increased competition domestically and from abroad are absolutely needed. We look forward to a more extensive dialogue on governance in next year's Article IV consultation report, as we are confident that it could bring valuable insights.

I would like to raise a final issue on inequalities. This is a point I already made last year, and we believe the staff's analysis still lacks an assessment of the level of inequalities and the degree of redistribution of the tax and transfer system in Russia.

While we thank the staff for the answer to our written question on this issue, we have some doubts about the reliability of the Gini indicators that were used. Rigorous and cutting-edge academic work on income redistribution and work by Gabriel Zuckman and coauthors have shown that the survey-based data used to construct the indicators used by the staff tend to vastly underestimate the true level of inequality in Russia since 1990. In the face of such evidence, further analysis of inequality of income and wealth distribution, as well as policy dialogue with the authorities, appears warranted.

Mr. Tombini made the following statement:

I thank Mr. Mozhin and his colleagues for the insightful and candid buff statement and the staff for the reports, the answers provided, and the clarifications.

I have three points. First, Russia has put in place in a short time a sound macroeconomic policy framework that includes a flexible exchange rate, an inflation targeting regime, and transparent fiscal rules. However, improving the low potential growth still depends on successfully reforming the domestic economy and increasing Russia's integration into the global economy. I welcome the fact that the authorities are deeply committed to important structural reforms, such as the pension reform, and to continuing to improve the business environment.

Second, it would also be critical to have a leaner, well-supervised, and well-regulated financial system. Significant progress has also been made in this area, and weaker institutions have been closed at a fast pace in the last few years, as we saw yesterday from the lecture of Governor Nabiullina. Building an effective and stable financial system that is able to deliver a more efficient capital allocation will also be an important element to support the economic transformation being pursued in Russia.

Third, Mr. Mozhin has been a constant and ardent voice against the discontinuation of selected issues papers. I used to have a different view regarding this issue; but having read both chapters of the selected issues paper in this year's Article IV consultation report for Russia, which are of excellent quality, I can join him if we maintain the same standards for other bilateral surveillance.

With these words, I wish the Russian authorities all the best in their future policy endeavors.

Mr. Virolainen made the following statement:

I thank the staff for a good set of reports and Mr. Mozhin for the informative buff statement. We issued a gray statement, and I want to highlight a few issues for emphasis.

The Russian authorities have implemented a strong macroeconomic policy framework, which has served the country well. As underlined in the report, key challenges over the medium term are related to enhancing potential growth. Therefore, we encourage the authorities to address the issues related to structural bottlenecks, adverse demographic trends, and competitiveness issues.

We appreciate the staff's selected issues paper on the state's footprint in the economy. We share the view that measures to enhance stronger competition are required but in an appropriate sequence, as recommended by the staff.

Finally, we underline the importance of strengthening transparency, accountability, and governance, and improving the effectiveness of the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime and international cooperation.

Mr. Agung made the following statement:

We thank the staff for the report and Mr. Mozhin, Mr. Palei, and Ms. Smirnova for their buff statement.

We join other Directors in commending the Russian authorities for putting in place a strong macroeconomic framework, which has strengthened the resilience of the economy and helped it weather external shocks.

The Russian economy is at an important juncture, as it is transitioning toward a new growth model, as indicated in Mr. Mozhin's buff statement. In this regard, like other Directors, we welcome the authorities' plan to increase spending on physical and human capital investment, which can raise long-term growth. In contrast to the staff's recommendations, the authorities have already approved a temporary relaxation of the fiscal rule to allow debt financing for needed infrastructure investment. As such, we agree with Mr. Hurtado that it is important to monitor its impact on the fiscal consolidation effort and monetary policy objective. We are also of the view that well-sequenced structural reforms are needed to foster private sector development and promote economic diversification, which would help lift potential growth. Therefore, we welcome the authorities' intention to gradually reduce the state's footprint in the economy.

Mr. Kaizuka made the following statement:

I thank the staff for the comprehensive report and papers. I also thank Mr. Mozhin, Mr. Palei, and Ms. Smirnova for the informative buff statement.

My thanks also go to Ms. Erbenova and Mr. Tombini for their comments on the excellent lecture delivered by Governor Nabiullina.

We welcome Russia's strong recovery, supported by its strong macroeconomic policy framework. But taking a longer-term perspective, Russia has to fully engage in challenging structural reforms, which would enhance the country's potential growth.

I have two comments to make. We positively note that the authorities and the staff have agreed on the necessity of increasing spending on infrastructure, health care, and education, and also on the need for better targeted social benefits. However, the detailed policy designs have not yet been determined or at least have not yet been disclosed to us. We encourage the staff, in close consultation with the authorities, to share with the Board the concrete and detailed policy recommendations on this front.

Second, on the structural side, addressing the footprint of the state is a priority issue, and we appreciate the process of privatization and the closure of the non-viable institutions, especially those in the financial sector, as the Governor mentioned. However, there is a risk that outright privatization would likely result in more economic concentration. Thus, the success of the reform should be assessed in terms of how the markets could play a role to efficiently allocate resources, increase competition, and raise productivity. We hope the reform will proceed in this particular direction.

With this, we wish the Russian authorities every success in the reform process.

Mr. Jin made the following statement:

When I read the Article IV consultation report on Russia, I was impressed because before reading it, I could imagine what a harsh external environment the country has been facing. I had not expected that the economic indicators would be so good. The country has very low inflation, a very low fiscal deficit, a current account surplus, a very low public debt-over-GDP ratio. It has a flexible exchange rate and capital account convertibility. This has been maintained, even during the year of external sanctions. This reflects the great confidence of the authorities and the people.

I can also observe that there is a good, solid social security network, with free health care for most of the people, and also compulsory education.

All of this is impressive, so I would like to congratulate the country and the authorities for their excellent macroeconomic management.

The major challenge the country is facing is how to invigorate the economy from the micro level, how to increase competition, encourage private and public investment, and diversify the economy. In general, I believe Russia has great potential.

I wish the authorities continued success in their future policy endeavors.

Mr. Doornbosch made the following statement:

I would like to join others in congratulating the Russian authorities, via Mr. Mozhin, for their excellent macro policies over the last few years. But I also share the concerns expressed by Mr. de Villeroché on the inclusiveness of the growth model and the structural growth prospects and income convergence, and the improvement of the business environment that is needed.

I would like to ask the staff a question about the sanctions. We appreciated the analysis of the impact of the April 2018 sanctions. We were also thinking about how to assess the impact of the sanctions that are now under consideration in the U.S. Senate, particularly the ban on the buying of sovereign debt. Perhaps the staff could help us determine how to assess the possible impact of this given the current environment in the emerging markets.

Mr. Armas made the following statement:

I thank the staff for the excellent report and selected issues paper, and also Mr. Mozhin for the excellent buff statement.

I join other Directors in congratulating the Russian authorities for the good management of their macroeconomic policies. From the buff statement, it seemed that there has been a concern from the Russian authorities about the risk of Dutch disease. We believe that a fiscal rule with a zero primary balance target is a good way to face this situation; and in that way, to encourage the diversification of the economy.

On monetary policy, we had the opportunity to hear from the Russian Central Bank Governor about monetary policy developments and the challenges that the Russian authorities are facing. In that regard, we asked a question to the staff regarding how the recent events in the financial markets could change their recommendations or the views about monetary policy. We also asked a question regarding the communication recommendations.

It is mentioned in the Article IV consultation report that the staff recommends further improvements, which is a solid recommendation. But it was mentioned that the authorities do not agree for the time being with publishing the forecast policy rate that accompanies any central bank projections. In that regard, the answer from the authorities, which I found relevant for emerging market economies, is that there could be the risk of misinterpretation of the difference between a forecast and a final decision—particularly in a situation where there are changes in the markets.

We believe it is premature to make a recommendation regarding projections of policy rates, because the projection could change and then, instead of having better communications with the public—in particular, where one is talking about a market that is not mature—the result could be more confusion rather than clarity.

The staff representative from the European Department (Mr. Ramirez Rigo), in response to questions and comments from Executive Directors, made the following statement:[2]

The staff responded to most of the technical questions in writing. If we missed some, we would be happy to follow up bilaterally.

We will discuss the three broad topics that were brought up in the gray statements in terms of policies. One of them is the issue of geopolitical tensions, the impact of sanctions, and how we should think about them. Along with that was the policy response, which is linked to the fiscal space discussion. We have also just received a question about the fiscal rule and the interaction with fiscal space. Finally, we will address the question of whether our monetary policy recommendation is still valid.

In terms of the sanctions, the staff did evaluate the last ones as of April 6. Our assessment of its impact—together with the discussion with the authorities—is included in our baseline. But it is fair to say that the more significant sanctions, the ones that were put in place four years ago, have been

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

in the baseline since the 2015 Article IV consultation. I will explain how we have modelled them into our forecast, which gives one an idea about how we might think about whatever might come later.

The capital account sanction is like having a restriction on the capital account. Depending on the agents that get affected, the restriction is bigger or smaller. Russia is very linked to the global economy. It still has a significant amount of linkages through the capital account. That is an impact. The linkage to the economy will be through the higher cost of capital. Interest rates would be higher than they would have been otherwise. That would have an impact on investment. The impact on investment has an effect on the current conditions and future potential growth.

There are issues around technological transfer. Since there were and are some restrictions on dual purpose goods, that automatically might reduce the level of new technology being embedded in new investment. That has an impact on productivity and total factor productivity. It directs us toward a much lower medium-term potential. This is reflected in our 1.5 percent medium-term potential assumption in Russia.

There is also the issue of what the policy reaction should be. We cannot separate that from the discussion about oil. Oil is a major source of revenues and income for the government, for the country, for its external position. When the 2014 sanctions were imposed, there was also a large terms-of-trade shock for Russia, and these were the main factors behind all the turbulence that took place. But it is difficult to separate one from the other and quantify the size of each of the shocks.

That links to the policy response. Could it have been slower, or could it be different? It is true that there is some fiscal space in Russia. If one looks at Russia from a pure Debt Sustainability Analysis perspective, it is obvious that it has a very solid position. But if one extends the analysis, like we have done, to include intergenerational equity issues—because it is an oil-dependent country, it depends on a finite resource—if one also includes the future liabilities of the pension system in the assessment, then instead of significant fiscal space, we arrived at the idea that there is some fiscal space.

The next question one needs to ask, particularly at this current juncture, is whether the economy needs to make use of that fiscal space. That is a discussion about cyclical conditions. Russia is out of the recession. Russia is growing in line with what we consider to be potential at this point. Why make use of the fiscal space to provide procyclical fiscal policy inputs to the economy when there does not seem to be an issue of lagging domestic demand? Household consumption is growing. Credit to the household sector is growing. There does not seem to be too much need for fiscal policy to act at this point.

This leads to one of the questions about fiscal policy reversal. To an extent, the report does indicate that the authorities had a plan to relax the fiscal rule. We thought that the space to find the resources for the additional spending that we support—on health care, education, and infrastructure—was available within the rule. There was no need to relax it. At the end, the authorities thought that, for political economy reasons, a more balanced approach was to find some taxation for additional revenues but also some debt financing in the range of 0.5 percent per year. That is what is being done.

That takes us as to whether the fiscal rule would have included scope for fiscal space. The fiscal rule, as it was originally passed, included a small space for additional spending, as long as the non-oil revenue outpaced the growth that was assumed in the budget. Any changes in taxation—for example, like the one that they have proposed, like the VAT—would have automatically allowed, under the old fiscal rule, the deployment of those additional resources for any other type of expenditure. Any change on tax expenditures—and there are many—could have been spent under the old fiscal rule without the need to have recourse for additional debt financing.

Finally, this takes me to the issue of monetary policy. The Governor of the Central Bank of Russia was here yesterday. She led a good discussion about monetary policy in Russia, what they have done, the achievements they have made. In our discussion with the authorities, our recommendation is to continue the process of easing to go toward a neutral rate. Let me mention some of the reasons that we believe are still valid.

The economic picture is one of growth but not one of overheating. Inflation was at 2 percent at the time of the mission. Since then, it has increased to 3 percent, but the target is 4 percent. We are still below the target. The increase in inflation was expected in our forecast at the time as a result of the reversal of several temporary factors that were affecting inflation—food prices and very low energy prices. We expected those to turn around because, in our baseline, we already had higher oil prices from the *World Economic Outlook* at the Spring Meetings. For the moment, they are just validating what we were discussing with the authorities at the time.

In addition, the data—at least as of July—have started to be a bit less clear. We mentioned in our staff supplement that there now seems to be somewhat more downside risks to the economy. In terms of what is the neutral rate for Russia, the staff has been working with 5.5 to 6.5 percent nominal neutral interest rates. The authorities are more conservative, in the 6 to 7 percent range, probably closer to 7 percent, but the policy rate is still 7.25 percent. Essentially, at the current inflation rate, the policy rate is more than 4 percent in real terms. Taking into account the expected future inflation, it is in excess of 3 percent. That is quite a significant real interest rate, which still is not necessarily close to the neutral rate.

That has not been inconsistent with moving at a cautious pace, being data-driven, and taking into account the market volatility; but as long as this market volatility results in only a temporary shock, the authorities should probably continue the process of normalization.

Mr. Mozhin made the following concluding statement:

The staff have answered most of the questions. I do not have too much to add.

I would like to thank everyone who has participated in the discussion, who has issued gray statements or made oral remarks. This is greatly appreciated, and I will not fail to convey the essence of these comments to the authorities. I do not need to thank Mr. Ramirez Rigo again, since I have already done so in my written statement.

This was a useful, constructive, productive, important round of Article IV consultation discussions. As is the case in other countries, the authorities in Russia are facing a long list of dilemmas, which is typical. It was helpful for the authorities to hear professional, high-quality analysis from the Fund's staff.

One thing I regret is that this year, the gap between the time of the mission and the Board discussion was large. The mission was in May, and this discussion is taking place in September. It is the first time in my memory—and my memory is long—that there has been such a large gap. That is what created a number of questions, which should not normally be raised.

The only topic I would like to comment on is the footprint of the state. First, I am glad that this footprint is assessed at 33 percent of the economy, rather than 70 percent of the economy, which was the number in one of the previous Fund documents and the number which was immediately taken up by all commentators, both externally and domestically. This also shows how helpful and useful selected issues papers can be, which is a point made by Mr. Tombini.

Regarding the substance of the issue, the staff assessed the footprint of the state to be on the high side. I have not seen numbers for other countries, so I do not know whether the figure is much lower than 33 percent in other countries. The fact that the resource sector is so big in the Russian economy makes a difference. We are not planning to privatize every resource company. In fact, when I look at the list of oil producers, there is Rosneft, which is the largest one, which is publicly owned. LUKOIL and Surgut, the second- and third-largest, are privately owned. There is Gazprom. It is a mixed bag. Even among those that are publicly owned—including the banks, which are often publicly controlled—there is significant participation of the private sector. There are shares that are traded. This is a rather diverse picture of different animals living in the Russian economy, so to say.

On privatization, the authorities have every intention to get rid of many of these public-sector assets. There is no disagreement at all with Fund staff on that matter. The question is that the circumstances are not seen as promising at the moment. We made many mistakes in the area of privatization in the 1990s. That is how we single-handedly created an oligarchy. This may be something Mr. de Villeroché would be interested to hear because of his concern about inequality. To a great extent, that resulted from the privatizations that were mishandled in the 1990s. All of them were made in the presence of a sequence of Fund-supported programs. There is no ideological difference between the staff and the authorities. It is a matter of how to take practical steps in this area.

I have a few other points. There is a discrepancy between the buff statement and the staff's written responses on the size of tax expenditures in different sectors, whether it is VAT, personal income tax, or tax expenditures in the oil and gas sector. We are probably discussing different time periods, but that is a technical matter and we will continue to discuss it bilaterally.

My final point is on the publication. There is an intention to make the whole set of documents public right away. There is a list of comments we received from the central bank, which draws attention to a few minor factual errors, such as different numbers or dates for when the central bank started to publish certain statistics. This may require a delay of one or two days for publication, but we will be in touch on that matter.

The Acting Chair (Mr. Furusawa) noted that Russia is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for establishing a strong macroeconomic policy framework that has strengthened economic resilience. Directors noted that despite the ongoing recovery, the medium-term outlook remains subdued. This reflects uncertainty stemming from geopolitical tensions and shifting global trade and financial conditions. The large footprint of the state, governance and institutional weaknesses, and insufficient infrastructure constitute structural reform priorities. Directors emphasized the importance of implementing structural reforms to boost productivity and the supply of labor and capital to enhance medium-term growth.

Directors agreed that the fiscal rule helps shield the economy from fluctuations in oil prices and anchors fiscal policy. They emphasized the importance of preserving the hard-won credibility of the macroeconomic policy framework. Directors encouraged continued fiscal consolidation to rebuild buffers and reach a position consistent with sharing equitably Russia's natural resources with future generations.

Directors welcomed the authorities' plans to boost spending on health, education, and infrastructure, with most emphasizing that this could be achieved within the confines of the fiscal rule. They supported the authorities' plans for parametric pension reform, which could help to offset negative demographic trends. Directors called for better targeting of expenditure on social assistance and strengthening tax compliance and reducing tax expenditures. They encouraged the authorities to engineer a growth-friendly shift from social security contributions to consumption taxes which could incentivize labor supply, reduce labor informality, and attract new investment.

Directors welcomed the Central Bank of Russia's (CBR) plans to maintain its gradual and data-driven approach in setting monetary policy, as inflation expectations are not yet firmly anchored and risks to the inflation outlook have increased. They broadly agreed that further monetary easing could be appropriate if headline inflation remains below the 4 percent target and underlying inflationary pressures stay low. Continued efforts to refine the CBR's communications strategy were encouraged.

Directors commended the progress made to restructure the banking sector. However, they noted last year's failure of several large banks and pointed to significant shortcomings in the sector. In this regard, Directors urged the authorities to complete the cleanup of the banking sector, close the gaps in bank supervision and regulation, including addressing related-party lending, and further efforts to complete the asset quality evaluations. They underscored the importance of having a credible strategy for returning rehabilitated banks to private hands in a way that is consistent with increasing competition and efficiency. Continued efforts to strengthen the AML/CFT framework were also encouraged.

Directors noted that raising growth requires stronger competition in domestic markets, a leaner state, and a more vibrant private sector. They supported measures to reduce the footprint of the state, particularly in banking and other sectors with limited rationale for public ownership in a gradual manner in line with a strengthened institutional architecture. Directors recommended strengthening transparency, accountability, and governance standards in state-owned enterprises and the corporate sector more generally to improve the business environment. They noted that the authorities could accelerate productivity growth by persisting with their efforts to strengthen competitiveness, promote trade integration, and further diversify exports.

It is expected that the next Article IV consultation with the Russian Federation will be held on the standard 12-month cycle.

APPROVAL: March 3, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***While concurring with staff about Russia's weak long-term growth drivers in the absence of structural reforms – a view shared by authorities – we wonder if the baseline scenario is not too bleak, recalling that the country's performance has been understated before.***

- While the near-term growth outlook of the Russian economy is positive, the long-run outlook remains weak given declining demographic trend, low productivity growth, and insufficient investment.

The Authorities' Fiscal Package

2. ***Can staff elaborate on their assumption of zero impact of this spending made in the Box 1 of the report which appears extremely conservative?***

3. ***However, we believe it is more suitable to make an assessment on potential GDP growth impact, although with high uncertainty, than to present a scenario without that effect. The estimation could be done based on Russian history or international experiences to have a better comparison of both scenarios. Staff comments are welcome.***

4. ***Beyond this, Box 1 Alternative scenario mentions that the authorities expect the extra infrastructure investment and improved spending mix to have a positive impact on potential GDP. Have staff held discussions with the authorities on the portfolio and composition of financing options?***

5. ***We missed a more thorough analysis regarding the authorities' commitment to boost spending on infrastructure, health, and education. Although staff informs that this could substantially change the baseline and result in faster growth over the next few years, the initiative is quickly dismissed.***

- According to the projections presented in Box 1 in the Staff Report, the authorities' proposed fiscal package has a substantial impact on actual GDP. However, the impact on potential GDP is assumed to be zero, since staff was unable to estimate it, given the lack of detail about particular measures and projects. The authorities agreed that given the scarcity of information about the composition of additional spending, staff's assumption of no impact on potential GDP is understandable.

- The Government is currently working on a list of projects in 12 areas aimed at improving the demographic situation, investing in human capital, raising productivity, developing infrastructure, supporting SMEs, facilitating digital transformation of the Russian economy, etc. However, details are missing and are expected to become available in time for budget discussions in the fall.

- Staff plans to explore the impact of these projects on potential GDP during a staff visit tentatively planned for mid-November.

- In the meantime, staff's assumptions of no impact on potential GDP are not out of line, given the difficulties surrounding the proper identification of high-return projects as targets for public sector investment. And in any event, the impact on actual GDP will exceed the impact on potential GDP, implying a positive output gap.

- The financing options for the package were extensively discussed during the mission and those discussions are summarized in the staff report. Staff agreed with the authorities that higher spending on physical and human capital is desirable to lift productivity. However, staff recommended that this should be done within the confines of the fiscal rule.

6. ***Against this background, we welcome the supplementary information provided by staff, detailing the legislations recently adopted, including the increase in the main VAT rate, the modification in the oil sector taxation, the establishment of an infrastructure fund, and the initiation of parametric pension reform. In this regard, we would appreciate if staff could clarify if these policy initiatives are consistent with the alternative scenario detailed in Box 1?***

7. ***As the main parameters of the tax and pension reforms are already known, we would also appreciate staff's assessment of their implications for the budget.***

8. ***Has staff prepared an update of its baseline fiscal scenario in light of the recently approved fiscal reforms?***

- Some of the authorities' policy initiatives are broadly consistent with the alternative scenario sketched out in Box 1 of the staff report, including the increase in the main VAT rate and the creation of a debt-financed infrastructure fund. The shift in oil sector taxation and pension reform are only partially consistent with the box, since both have been revised in the meantime and would require additional evaluation and calibration.

- Note also that the package is not yet finalized: pension reform is still being negotiated and the shift in oil sector taxation might be revisited. Nevertheless, staff is currently updating the macro framework with a more granular view of the entire package. The updated macro framework should be published in the fall WEO.

Pension Reform

9. ***Ongoing consideration of pension reform is welcome, and we would welcome hearing more of what is under consideration."***

10. ***In view of the critical importance of the pension reform, could staff confirm our understanding that some of the parameters included in Supplement 2 to the staff report have been revised, in particular the proposed retirement age for women (60 instead of 63). And does this modification improve the chances for the approval by the Duma of the final package?***

- The reform's main pillar is an increase in the statutory retirement age. The version which passed its first reading in the State Duma would raise the retirement age from 55 (60) to 63 (65) years for women (men). The second and third reading are expected in the fall.

- In the meantime, President Putin has publicly proposed increasing the retirement age for women to 60 years, rather than 63. He has also proposed several other measures, including:

- earlier retirement for mothers with three or more children;

- earlier retirement for women with pensionable service of 37 years and men with pensionable service of 42 years;

- retirement six months earlier for those who expected to retire within the next two years;

- increased unemployment benefits for the pre-retirement age population;

- tax breaks and utility subsidies for women older than 55 years and men older than 60 years; and

- benefits for those employed in agriculture and for small and indigenous ethnic groups in the Russian north.

- We expect that these proposed modifications will be approved by the State Duma.

11. ***In this respect, besides the relevant public finance sustainability concerns, any revision of the effective retirement age should also be gradual and take into consideration that life expectancy in Russia, especially for the male population, is particularly low, also reflecting the level of public health expenditure. Staff comments on the policy measures to address this trade-off in the Russian context, and more generally in countries showing similar demographic characteristics, are welcome.***

- The planned increase in the retirement age is indeed gradual. See also above, for the list of measures recently proposed by President Putin.

- Life expectancy at birth is low in Russia, but life expectancy at 55 or 60 is a bit higher. The latter is the relevant one to look at in the context of pension system design. However, more broadly, raising life expectancy remains a challenge in Russia, particularly for the male population, and would require a better-funded and higher-quality health care among other policy measures. The government is already planning to increase health spending as part of its policy package for the next 6 years.

12. ***We are also encouraged by the authorities' commitment to pension reform which would help ensure the sustainability of the pension system and welcome the recent development in this area. Could staff share their preliminary assessment on the impact of raising the retirement age?***

13. ***We welcome the buff's indication that parametric reforms to the pension system were recently passed by the Duma. Can staff provide their preliminary views on the impact of these reforms?***

- As it currently stands, the pension reform would be a major step in the right direction.

- However, it is too early to provide a numerical assessment, as the pension reform bill has passed only the first of three readings in the State Duma, and President Putin proposed substantial revisions last week (see above).

14. ***While pension reform is another extreme difficult proposal which was passed to parliament. Could staff provide information about the replacement rate in the Russian pension system?***

- According to Rosstat, the replacement rate (measured as the ratio between the average pension to the average wage of formal sector employees) was around 34 percent in 2017. According to estimates by the Accounting Chamber, in the absence of pension reform the replacement rate will decline to 26.5 percent by 2035 (compared to 40 percent recommended by the ILO). According to the same estimates, an increase in the retirement age to 63 for women and 65 for men should be sufficient to maintain the replacement rate at current levels through 2028, and allow its increase to 35.6 percent by 2035.

Fiscal Rule

15. ***We support the target of a zero primary balance by 2019 at the benchmark oil price, but would like to learn staff's view on the selected benchmark price of US$ 40 per barrel. How is this consistent with the possible relaxation of the fiscal rule as mentioned in the supplementary information to the staff report?***

16. ***While we understand staff's argument about the need to preserve the credibility of the new fiscal rule, we wonder whether debt-financing of these spending would not be optimal given the existing fiscal space in Russia. Could staff indicate if there is currently some room for maneuver within the boundaries set by the fiscal rule to finance this increase in public spending through debt? If not, could staff comment on the design of the fiscal rule, notably by discussing whether the rule could be excessively conservative?***

- The fiscal rule leaves no space to issue more public debt than what is consistent with the zero primary balance.

- The authorities decided to keep the benchmark oil price of $40 (in real 2017 terms, adjusted for US inflation). However, their recently modified fiscal rule now requires a primary deficit of 0.5 percent of GDP at that price, rather than a primary balance.

- The benchmark price is appropriately conservative, given volatile oil prices, the need to rebuild fiscal buffers, and the need for intergenerational equity in sharing Russia's finite oil wealth.

- The authorities derived the $40 benchmark by looking at the average oil price over the past several decades. Staff had recommended a more forward-looking benchmark, one that incorporates oil price futures. See last year's Article IV staff report and selected issues paper.

- While Russia's public debt is low, its fiscal space is rather constrained by contingent liabilities, including large unfunded pension liabilities, and Russia's reliance on finite resource wealth.

17. ***As for infrastructure, we note that the Budget Code has been amended to establish a temporary infrastructure fund which will be financed by relaxing the fiscal rule by 0.5 percent of GDP on average over a period of six years. Could staff elaborate more on the evaluation for this amendment, including its size and financing measure?***

18. ***At the same time, the tax reform package includes a temporary relaxation of the fiscal rule to allow deficit financing for needed infrastructure spending. In this connection, we note the differing views between staff and the authorities on implications of temporary relaxing the fiscal rule and invite staff to comment.***

- Given Russia's infrastructure gaps, staff agrees that higher spending on physical capital is desirable.

- However, staff believes that the recent revision of the fiscal rule (to pay for infrastructure spending) was counter-productive, as it might be procyclical at this juncture and could also weaken the hard-won credibility of the macroeconomic framework. The fiscal rule shields the economy from fluctuations in oil prices, should facilitate economic diversification, and anchors fiscal policy by providing a credible fiscal path. Relaxing the rule precisely when oil prices are high would make it more difficult to achieve these objectives.

19. ***We would like to hear from staff how the flexibilization of the fiscal rule affects fiscal projections; what could be the impact of this procyclical fiscal policy on monetary policy? Does staff envisage risks for financial stability?***

- As we illustrate in Box 1, the relaxation of the fiscal rule could result in some procyclical fiscal policy. This would increase demand pressures, and the CBR is likely to perceive higher risks to inflation. At the same time, macroprudential regulations would continue to be tightened to address risks in the credit market if lending continues to increase at fast pace.

Fiscal Policy

20. ***We support staff's call for limiting across the board spending cuts and seeking savings from pension reforms, eliminating some tax expenditures under VAT and PIT. For the latter, we would appreciate staff response to the authorities' explanation in the buff that they have declined and now account for less than 3 percent of consolidated tax revenue. We would also like to know how much they expect to generate from a shift to oil extraction taxation?***

- Our estimates of tax expenditures are based on the authorities' survey of tax expenditure which is part of their annual draft guidelines for fiscal policy. According to the latest version (July 2018), total tax expenditures add up to 3.1 trillion rubles in 2018 (about 3.1 percent of GDP), of which half is due to VAT. These numbers are broadly unchanged from the numbers in the 2017 version of the document, which were cited in our staff report.

- According to the authorities' estimates, they expect the shift in oil sector taxation to generate about 1.1-1.6 trillion rubles cumulatively over the next 6 years (about 0.9-1.4 percent of GDP).

21. ***In this regard, could staff comment on the cost-recovery level for main tariffs subsidized by federal and local governments, as well as elaborate on the authorities' plans in this area?***

- Government regulates the tariffs of natural monopolies, including household utilities, at the federal level, taking into account not only cost recovery but also the investment needs of the companies. The authorities plan to continue the policy of tariff indexation at projected inflation or less. An additional indexation is expected in 2019 to account for the forthcoming VAT rate increase. Lower-income households as well as other population groups like pensioners, war veterans, and handicapped individuals receive subsidies from the budget to pay for utilities. The government views these subsidies as an important part of the social safety net. People reaching the current retirement age will remain entitled to subsidies during a transition period despite the planned retirement age increase.

22. ***Taking into account the favorable external and internal balances, we would imagine Russia to have considerably more fiscal space than it seems to be the case. Staff comments are welcome.***

- The assessment of "some fiscal space" was made during the 2017 Article IV Consultation. While Russia's public debt is low, that does not take into account contingent liabilities, including unfunded pension liabilities, which the 2014 Fiscal Transparency Evaluation estimated at 282 percent of GDP. In addition, given Russia's finite resource wealth, intergenerational equity requires that the country saves a substantial portion of it.

23. ***In the Risk Assessment Matrix, staff judges lower energy prices to be a low probability/high impact scenario. Does staff consider the risks from reliance on revenues from finite fossil resources to be low in the medium- and long-term as well?***

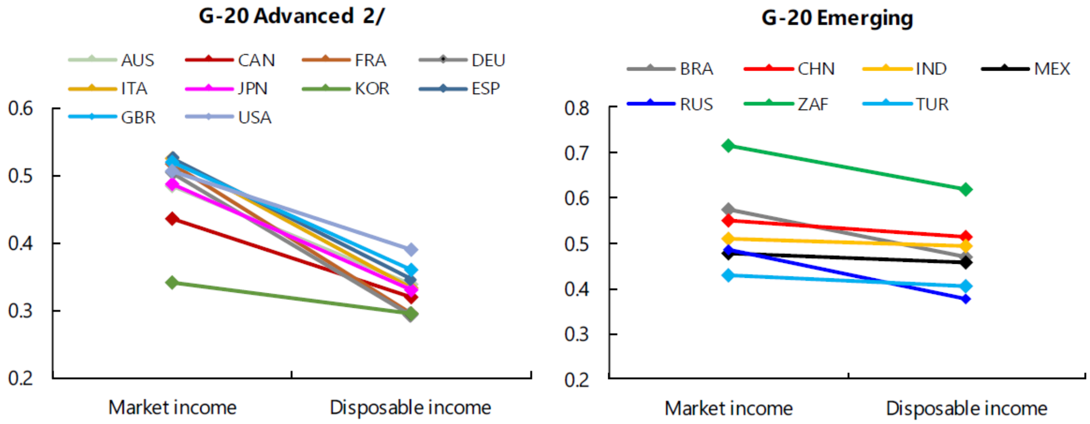
- The low probability assigned to lower energy prices comes from the G-RAM.

- Staff believes that Russia's finite resource wealth poses a serious challenge in the medium and long term, and limits the country's fiscal space (as discussed in staff's reply to the previous question).

24. ***Could staff comment on the actual degree of redistribution operated by the tax and transfer system and whether it has discussed this point with the authorities?***

- Our understanding is that inequality in market income in Russia is not particularly high compared to other large emerging markets. In addition, according to OECD data, the tax-and-transfer system in Russia results in the lowest Gini coefficient for disposable income among large emerging markets. A recent cross-country analysis by the World Bank for a sample of low-income and developing countries also suggested that the system of cash and in-kind transfers in Russia contributes to reducing both poverty and income inequality.

Figure 15. Inequality reduction through tax and transfer systems (2015) 1/
(Gini coefficient)



Source: OECD.
1/ Data for AUS and MEX is from 2014; BRA from 2013; JPN from 2012; CHN, IND, and RUS from 2011.
2/ ESP is a permanent invitee.

- Russia's social protection system consists of different types of transfers granted to a wide range of beneficiaries. The system is governed by a large number of legislative acts and it focuses on specific measures of support, rather than on categories of population in need. The decentralization of the social protection system carried out in 2005 enabled many regional administrations to carry out their own social support programs which vary in coverage and volume.

- Over the years, staff has discussed with the authorities the need to make the social safety net better targeted. While the government spends 13-14 percent of GDP on social benefits, they appear to be too broadly and thinly spread, with some sources claiming that up to 70 percent of the Russian population currently get some form of social benefits.

25. ***Looking forward, we welcome the idea to change from social security contributions to consumption taxes to reduce labor informality. Could staff provide examples of countries that have adopted such approach? VAT rate is being analyzed to be raised, does the staff have any figure of VAT compliance or evasion?***

- Many other countries in Eastern Europe have shifted their tax systems from direct to indirect taxation over the past 20 years.

- Russia raises less revenue from VAT than other countries in Eastern Europe, even after adjusting for its relatively low (current) main VAT rate and the low share of consumption in GDP. Compliance gaps play some role, but are considered to be low. In recent years, the authorities' efforts to improve VAT administration, including the introduction of a computer-based administration system, resulted in an increase of VAT revenues from 4.8 percent of GDP in 2013 to 5.6 percent in 2017.

- Regarding the policy gap, there are numerous tax expenditures. According to Government estimates, VAT tax expenditures cost around 1.5 percent of GDP in 2018.

26. ***We would appreciate staff's elaboration on possible measures for better targeting of social benefits.***

- Staff proposals to improve the targeting of social spending include:

- means-testing of existing benefits in a number of pilot programs (the authorities have been working on the design of pilot programs, including in consultation with the World Bank, but implementation has lagged);

- an expenditure review that identifies possible overlaps in social programs; and

- a better definition of eligibility for social programs.

27. ***With regard to transparency, accountability and governance standard in the SOE sector, we would like staff's comments on the status of the implementation of recommendations contained in the Fiscal Transparency Evaluation (FTE) of 2014.***

28. ***We invite staff to comment on the progress in implementing the recommendations of the 2014 Fiscal Transparency Evaluation on reporting the financial position and performance of public corporations.***

- There have been no updates to the 2014 Fiscal Transparency Evaluation.

29. ***In Box 1, staff made projections under alternative scenarios, in which the initiatives are financed mostly by a higher main VAT rate as well as expenditure savings from a parametric pension reform. Could staff elaborate more on other possible ways to raise fiscal revenues besides increasing VAT rate and their feasibilities?***

- The authorities' most recent survey of tax expenditures (July 2018) estimates them at around 3.1 percent of GDP. That number excludes tax expenditures under PIT, including various deductions and exemptions.

- There is also some scope to increase excises on fuel, tobacco, and alcohol.

30. ***We note the divergence not views between staff and the authorities on the size of the fiscal multiplier and welcome staff comments. Also, the extent of infrastructure gap is not clear from the information provided in the report.***

- Our sense is that the divergence of opinion between staff and the authorities on the impact of the fiscal package is less about multipliers and more about the impact of the package on potential GDP.

- Regarding the infrastructure gap, it is covered in the chart panel on page 10 of the staff report.

31. ***On social issues, the authorities intend to cut poverty in half by 2025 through a better targeting of social assistance without a major increase in the resource envelope. We invite staff to comment on the adequacy of measures to achieve the poverty objective.***

- While the authorities have indeed declared their intentions to cut poverty in half by 2025, specific measures and policies are yet to be announced at this point.

Monetary Policy

32. ***We appreciate the improved communication policy of the CBR and note that the authorities do not see a need for now to publish a path for projected interest rates. We would like to hear staff views on the implications for this.***

33. ***On paragraph 21, staff mentions that the authorities do not see a need for now to publish a path for projected interest rates. What is the view of the staff about this communication option?***

- The CBR has strengthened its effectiveness and credibility in a very short period of time, as reflected by a steady decline in inflation expectations, and continues reinforcing its forward-looking communications (to explain that the CBR's policy decisions are targeting inflation forecasts rather than current inflation). In that context, the CBR considers that the publication of the projected interest rate path could be misinterpreted as the forecast that would be followed by the CBR under any set of circumstance.

34. ***As such, we take positive note of improvement in the central bank's communication strategy which is partly in line with past Fund's recommendations and invite staff to elaborate on the authorities' rationale for shifting to the permanent 4 percent inflation target.***

- The CBR considered different target types (point, target range, or targets with tolerance bands) and sought the one that could deliver a relatively clear message on its monetary policy goal. The CBR decided that the point inflation target is the easiest to communicate. Given that it would be impossible to keep inflation at exactly 4 percent at all times and slight inflation fluctuations around the target are natural, the CBR has set its inflation target as "near 4 percent", where "near" allows for some fluctuations in headline inflation. Our understanding is that the CBR choice of 4 percent inflation is due to the specifics of the Russian economy, including the development of competition and market institutions, production effectiveness and diversification, consumption structure and price volatility in certain groups of goods and services.

- With respect to the horizon, the CBR decided to abstain from setting specific dates or time periods for delivering on the inflation target given that price stability means consistently low inflation, seeking to permanently keep inflation close to 4 percent, although clarifying that "permanently" does not mean that in case of deviation from the target inflation will get back within months (time is needed for the CBR's decision to have effect on the economy).

Financial Sector

35. ***Taking into account the significant costs (estimated by staff at over 2 percent of GDP) of the banking system's clean-up, we wonder if staff has any estimations of the remaining contingent liabilities stemming from the banking system? What prevents the authorities from conducting a full-fledged AQR?***

- Since the 2016 FSAP, staff has not been able to estimate contingency liabilities due to data limitations. The CBR does not plan to conduct comprehensive AQRs, as recommended by the FSAP, but instead they plan off-site asset quality analysis and stress tests by loan products, which, according to the CBR, are expected to provide analytical support for macroprudential policies and a comprehensive view of banks' capital needs.

36. ***However, in the backdrop of the recent failures of private banks and the ongoing cleaning-up efforts in the banking sector, we wonder if the privatization of the banking sector in the present conjecture would offer more stability. Could staff elaborate?***

37. ***Do staff have a view as to when market conditions would be favorable to continue gradual privatization of State Owned Banks (SOBs)?***

- As discussed in the Staff Report, we recognized that in the current environment it would be difficult for the authorities to seek out responsible stewards for bank privatization, including reputable foreign investors with long-term interests, and this will only be possible in the long-term. Moreover, staff argues that the right sequencing to increase private sector participation is critical, and the first step should be to strengthen the institutional and legal framework (transparency, accountability, and governance standards) to avoid further concentration of economic power after privatization.

38. ***We notice that the SOBs have access to much cheaper funding compared with POBs, while the net interest margin of SOBs are lower than POBs, and the ROE of SOBs are negative. Could staff elaborate more on the reason behind it?***

- This result holds for public banks excluding Sberbank. A potential explanation is that the POBs, excluding Sberbank, are not behaving according to a profit-maximizing business model. Even though they are not, formally, classified as development banks, different or multiple objectives could be affecting their operational results.

39. ***We would appreciate staff's comments on the plans for the divestment of the rescued banks and the options to reduce the state's footprint in the banking sector.***

- The authorities expect that the merge of two major banks under open resolution (Otkrytie FC and B&N) could be finalized in early 2019, a previous step before privatization. However, the authorities also recognize that in the current environment, it might be difficult to find strong investor interest for this asset. They are considering the possibility of doing an IPO such that the bank is not acquired by one or two domestic financial groups, which could increase the degree of concentration of economic power after privatization.

40. ***As pointed out by staff, however, the failure of three large private banks in 2017 weakened the banking sector's overall performance and contributed to a sizable increase in NPLs. On this latter point, staff indicates that NPLs increased from 9.7 percent in March 2017 to 10.7 percent in March 2018. How this increase is consistent with Table 7 which shows an NPL level of only 6.2 percent at end 2017?***

- Thanks for the comment. The correct number is 10 percent. A correction will be issued.

41. ***We call staff to elaborate further on the causes of the declining SME lending and potential remedial actions to reverse that trend.***

- Corporate credit growth experienced a decline after the shocks to the economy in 2014 and 2015. In particular, credit growth to SME suffered a significant decline, due to the impact of economic activity on SMEs and banks' tighter lending standards. However, SME credit growth has been recovering in recent months. The Central Bank reported an acceleration in SME lending in January-July 2018, outpacing growth in lending to non-financial organizations (NFOs). Concretely, in H1-2018 loans to SME expanded by 8.8 percent (y/y) while loans to NFO grew by only 1.9 percent. The acceleration in SME lending is also the result of efforts by banks - primarily largest state-controlled banks – in servicing SME clients and in improving credit risk assessments for this class.

42. ***Given the large footprint of the state and the uneven playing field between private and state-owned banks in the financial sector, the authorities are encouraged to reduce concentration in the sector and seek bank privatization in the long run. Could staff share the views on more specific measures of the governance reform?***

- The ownership of Russian SOBs is complex and scattered compared to other jurisdictions. The lack of centralization of the ownership of SOBs has resulted in the inconsistent application of corporate governance across the SOB sector. In this context, a unified ownership through a general centralized agency or a specialized SOB ownership entity could offer a more consistent approach towards corporate governance and more coherent ownership strategy for the sector.

43. ***We would like to ask to what extent the authorities agree with staff recommendations on the size and performance of the SOBs and regulation and resolution issues.***

- The authorities pointed out that Sberbank is an example of a public bank that shows efficiency and that is competitive in the system. However, the authorities did not comment on the overall efficiency and/or competitive behavior of (aggregate) SOBs.

44. ***As we understand that currently the resolution framework does not contemplate a clear and credible strategy to return recovered banks to the market or provisions for the use of budgetary funds to support resolution processes, could staff provide its view as to what extent this CBR intervention mechanism implies risks to monetary policy goals and the anchorage of inflation expectations? is the CBR implementing measures to neutralize liquidity expansion? How is the banking Sector Consolidated Fund (BSF) financed? Are there contributions from the banking sector?***

- The Banking Sector Consolidation Fund (BCF) is formed with money of the CBR, separated from other assets of the CBR. This resolution mechanism does not entail risks to monetary policy goals through monetary expansion. In case of a liquidity surplus, the Bank of Russia carries out operations to absorb excess liquidity in order to maintain money market interest rates near the key rate. The instruments used are regular deposit auctions, standing deposit facilities, auctions in coupon bonds issued by the Bank of Russia, and the averaging mechanism for required reserves. Banks make contributions to the deposit insurance scheme (DIA), but not to the BCF.

Structural Issues

45. ***Given Staff's assessment that policies to protect and promote competition are geared more at form than at substance and state procurement legislation does not appear sufficiently aimed at strengthening competition and support SMEs, what specific measures would staff recommend in terms of competition and procurement rules and regulations?***

- A number of initiatives in public procurement could go a long way toward supporting a more competitive market place, as well as the development of SMEs. Some of them include:

- amending the definition of SMEs so that small subsidiaries of large state or privately-owned conglomerates do not qualify to fill the quotas assigned to SME by the procurement laws;

- revising the use of the 15 percent price advantage for Russian suppliers, in order to identify and limit the instances where given supplier/s use that advantage repeatedly;

- limiting the extent to which *ad hoc* procurement contracts can be used by SOEs, which usually result in limiting competition;

- extending the use of electronic auctions for all tenders;

- continuously strengthening the tendering process to avoid as much as possible single-supplier procurement; and

- tracking the concentration of public suppliers and establishing methods to diversify the number of suppliers in instances in which concentration is high and the main players remain unchanged for long periods of time.

- The Federal Anti-Monopoly Service (FAS) administers and enforces the implementation of anti-monopoly regulations and laws, but does not create policy. In this regard, a better feedback from enforcement to regulation could contribute to a legal framework that is more dynamic and more geared toward plugging regulatory loopholes. A case in point is the use in SOE procurement of more than 5000 different procurement types during 2017. The use of special procurement contracts is allowed by law, but otherwise the law intends to promote transparent and competitive procurement and special contracts should be used only in exceptional circumstances. An example of feedback from monitoring/enforcement to law is the recent amendment of SOE procurement law to itemize competitive and non-competitive procurement methods, which should allow for better monitoring by the state.

- Given that FAS should monitor the implementation of the competition laws in the public sector, it should produce and maintain an up-to-date list of all government/state-owned entities, to which competition laws apply. Such a list should be disseminated at least annually.

46. ***In the same vein, we note from the buff that Russia has undertook several structural reforms, in close cooperation with the World bank, that have contributed to reduce red tape, simplify regulations, and improve governance. These reforms were critical in improving Russia's ranking and score in the World Bank's Ease of Doing Business and we wonder why staff did not include in their analysis other indicators, beyond those on trade. Staff elaborations would be welcome.***

- Staff recognizes the progress made by the authorities in structural reforms, and these have been discussed in staff reports in previous years. However, there remain substantial structural obstacles to address. This year's report focuses on the footprint of the state. Staff plans to tackle governance issues in next year's Article IV consultation as part of the Fund-wide exercise.

47. ***We want to commend staff for providing informative analysis of structural reform and impediments to higher growth without mechanical reliance on Third Party Indicators and would call on other country teams to do the same. Having said that, we could not read the charts on page 20 and don't know if this included TPIs.***

- The spider chart on page 20 compares Russia's trade and FDI regime with those of other G20 countries and emerging markets. Some of the indicators rely on Third Party Indicators and are used in line with the Fund's policy on the use of TPIs.

48. ***The sequencing of these reforms is critical as ill-prepared and ill-executed privatization may have detrimental consequences as rightly pointed out by staff as well as in the buff statement. Staff's comments on the authorities' privatization strategy are welcome.***

- See answer to Question 39 regarding the strategy for two major banks under open resolution.

49. ***Is there agreement between staff and authorities on downsizing including gradual privatization of the SOE sector?***

- Authorities agreed that SOEs need to improve and increase their efficiency and productivity, and that the use of key performance indicators could drive good performance. Also, they agree that current conditions are not appropriate for privatization.

50. ***We take note that the authorities are wondering whether a multiplicity of SOE objectives might be contributing to below-par performance. Has staff had any assessments in this respect?***

- Staff has not done specific assessments on this topic. A potential example of this situation could be given by the operational results of SOBs as explained in Question 38.