

# **RUSSIAN ECONOMIC REPORT**

**November 2004**

## RUSSIAN ECONOMIC REPORT – NOVEMBER 2004

### INTRODUCTION

Economic growth in Russia continued through the first half of 2004 at roughly the same pace as in 2003. Compared with last year, this growth was also more diversified, with many non-resource sectors of the economy growing at a faster pace than the oil sector. The average standard of living of Russian citizens has been increasing and rates of poverty continue to decline. A new Russian government assumed power under these rather favorable conditions, and is preparing a new Medium-Term Strategy for Social and Economic Development. A strategic vision will be important. Russia now finds itself in the midst of a number of complicated structural reforms, including government administration, state budgeting, interbudgetary relations, the banking sector, and the re-organization of the electricity industry. The successful implementation of all of these very ambitious measures, as well as other key structural reforms, will require significant efforts and perseverance over a number of years.

A marked slowdown in growth in industry, construction, and transportation in the third quarter of 2004 has reignited debates over the question of how to enhance and maintain competitiveness in the Russian economy outside of the oil and gas sector. These debates often focus on the proper role of the government in facilitating diversification and the future management of surplus budgetary resources that are now accumulating in the fiscal Stabilization Fund. The future role of government in the Russian economy remains uncertain, and this fundamental uncertainty has complicated the investment climate. Improving this climate is a key task. Despite significant growth in recent years, absolute levels of investment remain low for achieving Russia's objective of doubling GDP in the next decade. Maintaining the momentum in growth will require that restructuring and productivity increases keep pace with the continued real appreciation of the ruble.

The section on Recent Economic Developments in this issue of the Russian Economic Report gives particular attention to possible causes of the slowdown in the third quarter and their implications. The recently observed volatility in short-term capital flows and money demand are also discussed, along implications for monetary and macroeconomic policy, including the management of the Stabilization Fund.

The second part of this RER turns to the specific question of state deposit insurance in the banking sector. This piece seeks to clarify some of the complicated issues that surround the introduction of deposit insurance in Russia. It explains why the success of deposit insurance will depend on upholding significant power and authority of the Central Bank and Deposit Insurance Agency to limit participation in the program, expand the monitoring of participating banks, and take immediate actions to resolve problems in individual banks.

The final section turns to the problem of poverty in Russia. It summarizes some of the key results from the recently published World Bank Poverty Assessment of Russia. This Assessment provided new alternative measures of poverty, a breakdown of the poverty profile across Russia, and a critical assessment of current social benefit programs from the point of view of poverty reduction.

## I. Recent Economic Developments

*The acceleration in economic growth and other positive trends that emerged in 2003 have carried into 2004. GDP increased by an estimated 7.4 in the first half of 2004 relative to the same period in 2003, while investment and real disposable income grew at even faster rates. Nevertheless, a measurable slowdown in growth in the third quarter of the year has raised some concerns within the Russian government and economics community. A number of competing explanations have been advanced on the causes of this slowdown. It appears that some enterprises may be feeling the effects of significant increases in production costs during the year, while uncertainties over the direction of government policy continue to hinder the investment climate. While the expansion of domestic demand in the fourth quarter may once again boost the pace of economic growth, the issues surrounding this slowdown are likely to persist in Russia's economic future, and thus require attention. Competitive pressures from real appreciation continue to mount.*

*Consumer price inflation has remained close to that in 2003, and somewhat above the official target of 10 per cent. 2004 demonstrated a potential strong volatility in money demand. Following a change in monetary policy, strong short-term capital inflows to Russia in fourth quarter of 2003 reversed to outflows in the first half of 2004, thereby causing some liquidity problems in the banking sector. In the presence of high and potentially volatile balance of payments inflows and uncertain money demand, the fundamental goals of controlling inflation and preventing excessive real appreciation of the ruble present a challenge that still exceeds the capacity of monetary policy in Russia. The fiscal Stabilization Fund therefore remains a critical element of stabilization policy.*

*The new Russian government, while still adjusting to the major administrative changes made in March 2004, is drafting a new Medium-Term Economic Program. Debates have surrounded this program on the desired nature of the government's role in the economy and plans for the management or spending of surplus federal revenues beyond the ceiling of the Stabilization Fund. The government would profit from signaling its intention to continue the active pursuit of the basic strategy since 2000 of promoting private business and investment as the primary engine of growth through better regulation and less unwarranted government interference in the economy.*

**Table 1. Main Macroeconomic Indicators**

	9M-2003	9M-2004
GDP growth (data for H1), %	7.7	7.4
Industrial production growth, %	6.8	6.5
Capital investment growth, %	11.9	11.6
Trade balance, USD billion	44.4	58.1
Real disposable income growth, %	14.1	9.8
CPI inflation, %, within period	8.6	8.1
PPI inflation, %, within period	10.5	23.4
Federal Budget Surplus, % of GDP	2.3	4.9

Source: Rosstat, CBR, MinFin

### **GDP and Industrial Production**

By preliminary estimates, GDP grew by 7.4 percent in the first half of 2004 relative to H1 2003, with stable dynamics in both the first and second quarters (Table 2). Output of the main sectors of the economy increased by an estimated 7.9 percent during this period, but declined steadily in the third quarter, registering at 5.4 percent. Estimated 2.8 percent output growth in September can be compared to 9.5 percent in September, 2003. A substantial decrease in growth rates is observed in industry, construction and transportation.

**Table 2. Output Growth in 2004 (% to the same period of the previous year)**

	Q1-2004	H1-2004	Q3-2004	M9-2004
Gross Domestic Product	7.5	7.4	N/A	N/A
Output of the Main Sectors	7.9	7.9	5.4	6.9
Industry	7.6	7.4	4.8	6.5
Agriculture	-1.4	-1.2	2.4	0.1
Retail trade	10.4	11.1	12.3	11.5
Construction	13.8	14.2	6.8	11.1
Transport	7.5	7.3	5.9	6.8

Source: Rosstat

While the expansion of resource industries outpaced manufacturing in 2003, the opposite has been true in 2004 (Table 3). The manufacturing sub-sector grew by 6.7 percent from January through September 2004 on average, while the resource-based industries reported 6.0 percent growth. Growth in machine-building has been particularly rapid at 12.7 percent for the first nine months of the year. Chemicals also grew by 7.9 percent, while fuel and energy expanded at an estimated pace of 7.7 percent. But the slowdown in the third quarter affected especially the non-resource branches of industry. Eleven out of fifteen industries surveyed by Rosstat continued to report positive growth in September. Yet eight of these industries reported a decline in growth rates. The most noticeable decline was registered in the chemical industry, machine building and non-ferrous metals (Table 4).

**Table 3. Growth Rates in Resource and Manufacturing Industries (% to previous period)**

	1999	2000	2001	2002	2003	9M-2004
Non-ferrous metals	10.0	15.0	4.9	6.0	6.2	3.6
Ferrous metals	17.0	16.0	-0.2	3.0	8.9	5.2
Fuel and energy	2.4	5.0	6.1	7.0	9.3	7.7
Wood and processing	18.0	13.0	2.6	2.4	1.5	3.6
<b>Weighted average</b>	<b>9.3</b>	<b>10.4</b>	<b>4.2</b>	<b>5.5</b>	<b>7.8</b>	<b>6.0</b>
Electricity	-1.0	1.8	1.6	-0.7	1.0	0.2
Chemical	24.0	15.0	5.0	1.6	4.4	7.9
Machine building	17.0	20.0	7.2	2.0	9.6	12.7
Construction materials	10.0	13.0	5.5	3.0	6.4	5.9
Light industry	12.1	21.0	5.8	-3.4	-2.3	-5.9
Food	4.0	14.0	8.4	6.5	5.1	4.4
<b>Weighted average</b>	<b>10.6</b>	<b>14.3</b>	<b>6.3</b>	<b>2.5</b>	<b>5.6</b>	<b>6.7</b>

Source: Rosstat, WB staff estimates

**Table 4. Growth in Industries (% to the same period of 2003)**

	Jan-Aug 2004	Sep-2004
Non-ferrous metals	4.1	0.5
Machine building	13.6	5.1
o/w cars	13.8	7.1
Chemical	9.0	2.3
Fuel and energy	8.0	5.9
o/w oil extraction	9.5	7.7
Gas	4.7	-2.0
Construction materials	7.7	3.1
Electricity	0.6	-1.6

Source: Rosstat

A number of hypotheses have been advanced on the causes of the apparent slowdown in growth in the third quarter of 2004. These include problems in the banking sector, excessive fiscal sterilization, increasing competitive pressures in manufacturing from imports and rising

domestic costs (real appreciation of the ruble), and regulatory uncertainty and taxation of the oil sector. The first two of these listed factors have probably not been very significant.

The liquidity problems experienced by the banking sector in the spring may have had a temporary negative effect on the availability of commercial credit in the economy. Yet this effect appears to have been quite limited. Measures that injected significant additional liquidity into the banking sector in response to these problems supported a continued rapid expansion of credit to the non-financial sector throughout the first nine months of the year. Estimated growth in internal commercial credit to the non-financial sector during this period amounted to 28 percent, only slightly lower than the very rapid 35 percent growth during the same period of 2003.

Given the fiscal policy stance of the government, balance of payments developments (see below) have indeed led to a higher degree of sterilization of inflows than was the case in 2003. Although aggregate balance of payment inflows were actually lower in the first half of 2004 than in 2003, a much greater share of these inflows have come from the current account, especially from exports of oil and natural gas. As revenues from these exports are taxed at a high rate, a greater share of inflows has been implicitly absorbed into the federal budget at the same time that the share of federal expenditures in GDP has also been reduced. This generated an estimated federal budgetary surplus of 4.9 percent of GDP for the first three quarters, which can be compared to 2.3 during the same period in 2003. This additional sterilization has helped to relieve pressures for inflation and real appreciation during 2004.

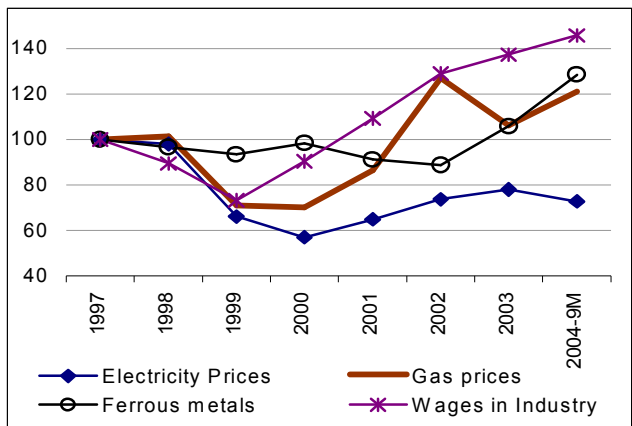
Has the fiscal sterilization been excessive? As indicated above, the rapid expansion of commercial credit has continued in 2004. Also, most indicators of liquidity do not show a decline in 2004. For example, the stock of payable arrears declined by an estimated Rub 160 from January to August 2004, while the estimated share of non-cash transactions in sales fell to 10.5 percent in the first half of 2004, as opposed to 14.2 percent in 2003. Despite the temporary liquidity crunch in the spring and summer months, the real average monthly value of voluntary deposits held by commercial banks at the CBR in excess of required reserves was actually 35 percent higher in the first 10 months of 2004 relative to the same period in 2003. A strengthening of the balance of payments and a seasonal accelerated disbursement of budgetary outlays should augment liquidity still further in the fourth quarter of the year.

In fact, greater fiscal sterilization may have actually supported higher growth by limiting the deterioration of competitiveness in Russian manufacturing from rapidly rising costs and real appreciation during 2004. Cost increases have been particularly significant for energy and metals (Figure 1). While consumer price growth was limited to 8.1 percent in the first nine months of the year, producer prices grew by 23.4. Consequently, as illustrated in Figure 2, the producer price (PPI-based) effective real exchange rate appreciated at an accelerated rate (22 percent) in the first nine months of 2004, as opposed to slower appreciation during the previous years of 2002 and 2003. The ruble now stands at roughly 80 percent of its real pre-crisis value in 1997.

In this context, competition from imports has been notably increasing. The dollar value of imports increased by an estimated 25 percent in the first nine months of 2004 relative to the same period in 2003. According to Rosstat data, imports of machinery and equipment increased by 46 percent in January-August 2004, following a 22.1 percent increase reported for the same period of 2003. Import of cars increased 2.7 times, compared to 26.4 percent a year ago. The rapid expansion in imports, along with growth in non-tradable services, is one reason why increases in real income and trade turnover did not weaken along with the slowdown in manufacturing in the third quarter of 2004. Retail and wholesale trade grew by 11.5 and 10.7 percent, respectively, in the first three quarters of 2004 compared to 8.7 and

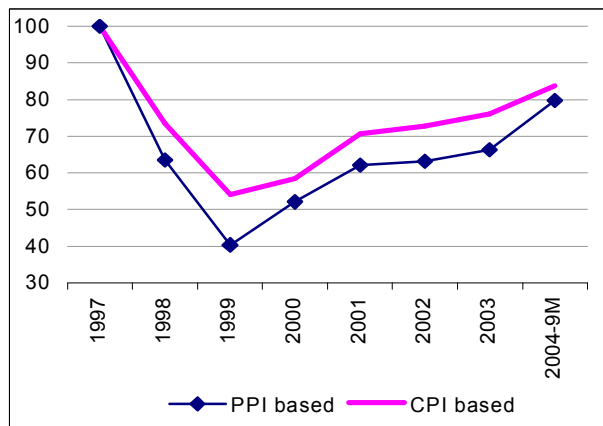
16.0 percent growth during the same period of 2003. In the third quarter, retail and wholesale trade grew by an estimated 12.3 and 14.4 percent, respectively, relative to 7.2 and 10.1 percent growth in the third quarter of 2003.

Figure 1. Real Input Prices (average)



Source: Rosstat, WB staff calculation

Figure 2. Real Effective Exchange Rate Index (average)



Source: CBR, Rosstat, WB staff estimates

Thus, it is possible that the recent slowdown in growth could be related to rising production costs and rapid real (PPI-based) appreciation of the ruble in 2004. On the one hand, import growth makes a positive contribution to consumption, investment, and incentives for restructuring in Russian manufacturing. On the other hand, the priority of economic diversification necessitates some measures to combat the effects of real appreciation on the tradable manufacturing sectors. The gradual appreciation of the real exchange rate and rising real wages are consistent with continued rapid growth and development as long as restructuring and productivity increases can continue at the same pace. This can be achieved through a combination of measures that both limit the extent of real appreciation and improve the climate for private business and investment. On this note, part of the basic strategy pursued by the Russian government for this purpose appears to be sensible. Tax rates for the non-energy sector of the economy have been reduced and are due to be reduced further in the future. At the same time, the Stabilization Fund has protected both the economy from excessive currency appreciation, and the federal budget from a potential oil price shock. Ideally, the lower tax burden could help offset a stronger ruble due to high commodity exports at “average” oil and gas prices at the same time that the Stabilization Fund prevents volatility. Yet the ability of Russia to maintain or accelerate the pace of restructuring will also depend on the completion of other key structural reforms and policies to improve the climate for private business and investment.

The oil sector of the economy presents another set of critical policy questions. While high rates of taxation on this sector of the economy make sense in general, it is important that tax and other regulatory conditions remain consistent with strong incentives and financial opportunities for the healthy development of the industry. Some analysts claim that marginal taxation in this industry has become excessive from this point of view, and this question requires careful attention. In addition, incentives in the oil sector currently suffer from an overall high degree of uncertainty over future tax and regulatory conditions. The investment climate would certainly profit from a clarification of stable conditions for the future division of profits between oil companies and the government.

## Balance of Payments, Monetary Policy, and Inflation

Consumer price inflation registered at 9.3 percent for the first ten months of 2004, and will most quite likely exceed the annual target of 10 percent. The pace of inflation has nevertheless been somewhat slower in 2004 than in 2003, despite the stronger current account inflows from higher-than-expected oil prices and a monetary policy stance that prevented nominal appreciation of the ruble against the dollar for most of the year. A primary reason for this lies in the capital account of the balance of payments. Strong short-term capital inflows to the banking sector in the final quarter of 2003 turned to outflows in the first half of 2004. Thus, despite the strengthening of the current account, the overall balance of payments weakened in the first half of 2004. This can be associated with a slower accumulation of foreign reserves by the CBR and slower money supply growth than in the first half of 2003.

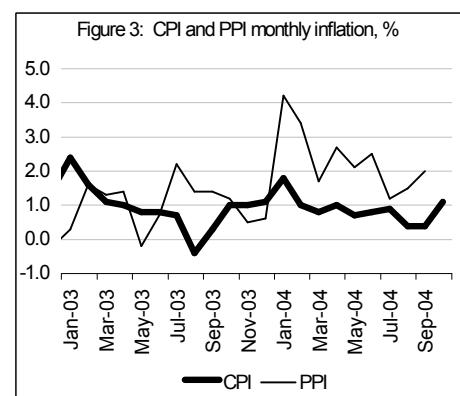
**Table 5. Balance of Payments (USD billions)**

	2003		2004	
	H1	9 M	H1	9 M
Current Account Balance	19.7	27.1	23.9	35.9
Trade Balance	28.9	44.4	36.9	58.1
Capital and Financial Account	-0.9	-7.6	-11.0	-16.5
Errors and Omissions	-3.2	-6.5	-1.1	-1.0
Change in Reserves (+' -decrease, '-' -increase)	-15.6	-13.0	-11.8	-18.3

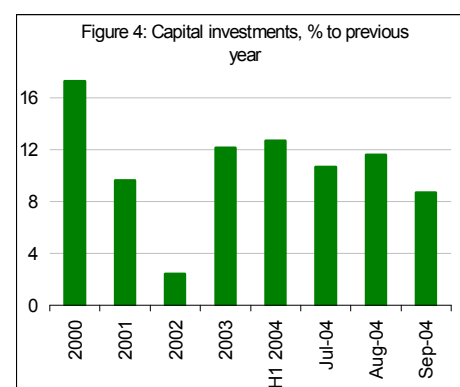
Source: CBR

By preliminary estimates, a 31 percent increase in the trade surplus strengthened the current account in the first nine months of 2004 to USD 35.9 billion, as compared to USD 27.1 billion for the same period last year. The trade balance widened due almost entirely to much higher prices on Russian commodity exports, particularly oil and gas. The recent dynamics of oil prices suggest that the trade surplus is likely to stay at the same high level in the fourth quarter of 2004, and the current account may exceed USD 45 billion for the whole year.

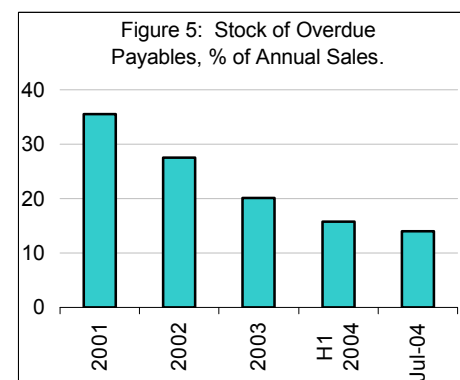
Net capital outflows from the private sector reached an estimated USD 10.9 billion for the first three quarters of 2004, as compared to 3.8 billion for the same period in 2003. This volatility in short-term capital flows was concentrated in the banking sector. Over USD 10 billion in net inflows to the banking sector in 2003 reversed to an estimated 6.5 billion in outflows for the first half of the year (Figure 7). A number of factors may have contributed to this shift, including the protracted Yukos affair and related uncertainty in the investment climate. Yet the most important trigger for these short-term capital movements appears to be the monetary (exchange rate) policy stance of the Central Bank. As shown in Figure 7, net capital movements in the banking sector have been highly correlated with the nominal exchange rate of the ruble relative to the dollar.



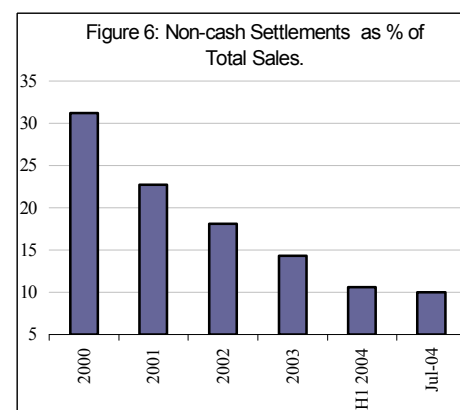
Source: Rosstat



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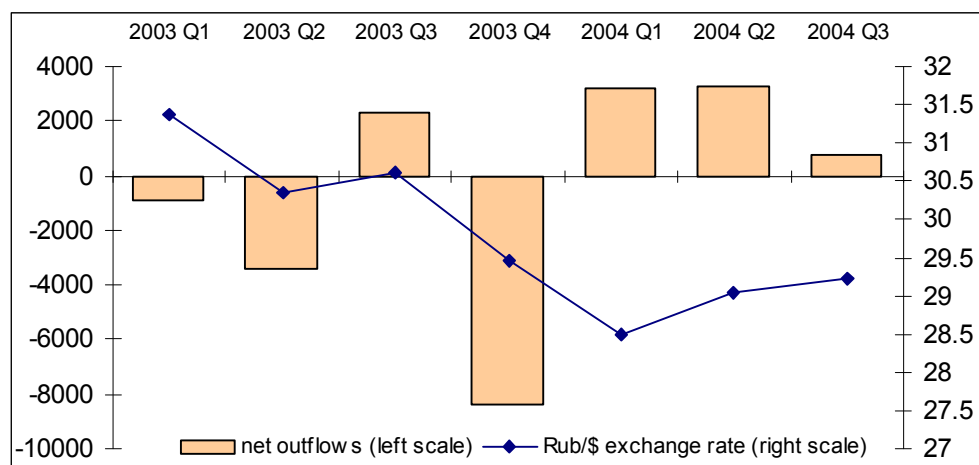


Source: Rosstat



Source: Rosstat

**Figure 7. Net Outflows from the Banking Sector (USD millions) and the Ruble exchange rate**



Source: CBR

The decision by the Central Bank to allow the nominal appreciation of the ruble apparently ignited a strong speculative movement toward ruble-denominated assets that came to an end along with the decision in early 2004 to end this practice. The liquidity problems in the banking sector were partly a consequence of these rapid outflows, and these banking problems, in turn, may have had a self-reinforcing effect on the overall trend.

In contrast to short-term capital, inflows of direct foreign investment continued to increase in the first half of 2004 relative to the same period of 2003, although they remain at rather low absolute levels. Balance of payments data actually show a decline of FDI during this period relative to 2003, but this is due to the inclusion of re-investment in firms with greater than 10 percent foreign ownership in these statistics (Table 6). The marked decline in estimated foreign re-investment may be partly associated with current losses in Yukos. BoP figures on gross inflows in the first half of 2004 are quite similar to the alternative figures of Rosstat, and show FDI increasing from USD 2.4 billion in H1 2003 to USD 3.8 billion in H1 2004 (Rosstat figures are 2.5 and 3.4 billion, respectively).

**Table 6. Estimates of Gross Direct Foreign Investment (USD billions)**

	H1-2003	H1-2004
FDI from balances of payments data (CBR)	6.6	5.4
Of which new inflows to Russia	<b>2.4</b>	<b>3.8</b>
Of which reinvestment of profits	4.2	1.6
FDI inflows (Rosstat)	<b>2.5</b>	<b>3.4</b>

Source: Rosstat, CBR

The experience of 2003 and 2004 raises some interesting questions for the conduct of monetary policy in Russia. The primary instrument of monetary policy remains forex market interventions to affect the nominal exchange rate. Given the strong balance of payments inflows, the fundamental tradeoff in monetary policy today is often characterized as “nominal appreciation and lower inflation” versus “no nominal appreciation, higher inflation, but somewhat less real appreciation.” Yet it is notable that the experience of 2003-2004 is not entirely consistent with this tradeoff.

The shift in monetary policy in 2003 toward nominal appreciation to relieve inflationary pressures was apparently offset by short-term capital inflows. Conversely, the shift away from nominal appreciation in the first three quarters of 2004 was offset in the same manner

by capital outflows. Thus, ironically, inflation has been lower in 2004 than in 2003, despite much higher current account inflows from high oil prices and a less restrictive monetary policy. (As noted above, lower inflation in 2004 is also related to the interaction of balance of payments changes with the current fiscal policy stance.) The volatility in money demand in Russia, combined with high oil and gas prices, speaks for the continued importance of fiscal policy (the Stabilization Fund) as a backbone for stabilization efforts to control both inflation and real appreciation. This also indicates the importance of developing more effective instruments for the Central Bank to manage liquidity in the economy. In this regard, the revival of bond issues by the CBR in September is a welcome addition to the monetary policy mix.

### ***Fiscal Policy and the Budget***

In the context of high oil and gas prices, the federal budgetary surplus for the first nine months of the year increased to an estimated 4.9 percent of GDP. Consolidated regional budgets showed an additional surplus of 1 percent of GDP during this period. . The Ministry of Finance now projects a federal budgetary surplus for the year of Rub 590 billion (3.6 percent of GDP), as compared with Rub 83 billion (0.5 percent of GDP) approved in the Budget Law.

Surplus revenues have been accumulating in the Stabilization Fund, which may even reach its targeted level (ceiling) of Rub 500 billion by the end of the year. According to the draft budget for 2005, the government is expecting additional revenues accruing to the Stabilization Fund in 2005 of almost Rub 390 billion. Of these additional revenues, Rub 168 billion could be used for external debt repayments and Rub 75 billion for financing the deficit of the Pension Fund. This deficit is expected due to the reduction in the unified social tax rate from current 35.6 to 26 percent. These calculations are based on the conservative assumption of oil at 28 dollars a barrel, however. Thus, actual surplus revenues are likely to be much higher.

Debates continue to rage in Russia over how expected surplus revenues will be spent in coming years. On the one hand, many areas in infrastructure and the social sphere could profit from a greater commitment of government resources. On the other hand, as emphasized above, the accumulation of surplus revenues in the Stabilization Fund remains a central element of stabilization policy in Russia. In November, the Ministry of Finance presented a compromise proposal that would prevent the expenditure of additional Stabilization Fund revenues on non-interest expenditures or the Pension Fund (after 2005), but would allow a slightly larger share of budgetary revenues from energy exports to accrue directly to the budget (as opposed to the Stabilization Fund), which could then be used to finance additional state investment projects.

### ***Income, Labor Market Indicators and Poverty***

The first three quarters of 2004 brought a continuation of strong growth in household disposable income, wages, and consumption. Rosstat estimates real wage growth at 13.3 percent in January-September 2004 relative to the same period of 2003, while real disposable income increased by 9.8 percent. For the fourth year in a row, the growth rates of both indicators continue to be substantially higher than GDP growth (Table 7). This has represented largely a “corrective” post-crisis adjustment of real incomes, which collapsed during the 1998 crisis (discussed in detail in RER6, part II).<sup>1</sup> Real wages in the budgetary

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<sup>1</sup> The RER6 can be found on the following web address: [www.worldbank.org.ru](http://www.worldbank.org.ru)

sphere grew at a faster than average rate in the first eight months of 2004, particularly in education and health (20 percent), while real industrial wages increased by an estimated 6.2 percent.

**Table 7. Output and income growth, %**

	2001	2002	2003	2004-9M	1998-2004 (cumulative)
Real disposable income	10.0	10.3	14.5	9.8	28.0
Real GDP	5.0	4.3	7.3	7.0e	39.4
Real wages	19.9	16.2	10.4	13.3	41.8

Source: Rosstat, WB staff estimates

Unemployment rates (ILO definition) have generally been remarkably stable during the recent years of strong economic growth. Yet the latest estimates suggest a measurable decline in unemployment in 2004. The usual seasonal decline in unemployment (during the second half of a year, and especially in the summer) was considerably higher in 2004 than in 2003: the average unemployment rate (ILO definition) decreased from 8.7 percent during the first five months of 2004 to only 7.5 percent in June-September (in 2003, the decline was only 0.7 percent, from 9.0 to 8.3 percent respectively). The reported seasonal decline in unemployment led to a noticeable decrease in the overall unemployment rate from 8.7 percent in January-September 2003 down to 8.2 percent in January-September 2004. If the unemployment dynamics repeat the pattern of last year, the overall unemployment rate for 2004 will likely fall below 8.0 percent, the lowest level since 1993.

Positive trends in earnings apparently resulted in a further reduction of poverty. According to the latest Rosstat data, the number of people living below the subsistence level (estimated at 2328 Rub in H1 2004 or USD 80) decreased from 35.6 million (24.8 percent of total population) in H1 2003 to 30.7 million (21.5 percent) in the first half of 2004. A substantial seasonal decline in the poverty levels, usually observed during the fourth quarter of each year, suggests that an overall poverty headcount for 2004 might be below 20 percent.

### ***The New Russian Government and Economic Strategy.***

The new Russian government has been busy adjusting to the major administrative changes that were introduced in mid-2004. For a number of ministries, the decision to reduce the number of deputy ministers to two has been a particular challenge for the subsequent division of responsibilities. The government is also currently drafting a new Medium Term Economic Program. A government decree of July 28, "General Directions for the Activity of the Government of the Russian Federation until the Period of 2008" suggests a much more active role for government and large-scale state investment programs in the economy. Yet many different opinions within the government exist on this subject, and the final content of the Medium Term Economic Program remains unclear. Major structural reform initiatives are being pursued in a number of areas, including the budgetary sphere, intergovernmental relations, administrative reform, banking sector reform, social policy, and the restructuring of the electricity sector. Some of these areas are discussed in this and other issues of the RER.

While Russia could certainly profit from some key infrastructural investment projects, the recent policy debates on more active government investment policies raise some concerns. First, "General Directions" appears to entertain an implicit assumption that the Central Bank can control both inflation and real appreciation in a manner that is essentially independent of fiscal policy and the management of the Stabilization Fund. For reasons explained in this

note, this assumption appears unrealistic for Russia at the present time. Second, government investment programs in infrastructure should be a compliment to, and not substitute for, private investment. Recent positive changes in incentives and institutional development can be related to the basic strategy of the government since 2000, which aims at promoting private business and investment as the primary engine of growth through better regulation and less unwarranted government interference in the economy. The new Russian government would profit from signaling its strategic intention to continue the active pursuit of this basic strategy.

## II. Banking and Deposit Insurance in Russia

The banking sector has been at the center of attention in Russia during 2004. The recovery, growth, and development of the Russian banking sector since the 1998 crisis has been quite impressive, despite the virtual absence of any major reform or restructuring measures. Growth in Russian banking has outpaced that of GDP. From 1998 to 2003, aggregate commercial bank assets increased from 31.5 to 42.2 per cent of GDP, bank capital from 4.8 to 6.1 percent, credit to the non-financial sector from 8.2 to 19.6 percent, and household deposits from 8 to 11.9 percent. But these positive trends were briefly interrupted in the first half of 2004 by a deterioration in liquidity and confidence that exposed remaining vulnerabilities in the banking system. Also in 2004, the Central Bank (CBR) and Russian government launched a major reform initiative that could fundamentally change the Russian banking sector and its structure over the next several years. A state insurance program for household deposits represents a primary element of this reform. Other key elements include new standards of accounting, disclosure requirements, bank monitoring, procedures for bank resolution, and the protection of creditor rights.

This note seeks to clarify a number of issues surrounding state deposit insurance that have resonated in recent debates within Russia. While deposit insurance has potential benefits for Russia, ensuring its success presents significant challenges to the Central Bank and Deposit Insurance Agency (DIA). These institutions must have the power to act in an independent, decisive, and impartial manner in (a) determining the eligibility of banks for participation in the program, (b) monitoring effectively participating banks, and (c) undertaking timely measures for resolving problems in individual banks. For this reason, the success of deposit insurance in Russia will be closely tied to other measures in the current Banking Sector Reform strategy, particularly those associated with improving accounting, monitoring, control, and procedures of bank resolution.

Empirical studies generally support an important relationship between financial intermediation and economic growth. The institutional environment of the transition countries of Eastern Europe and the CIS has favored bank-dominated financial systems. Even so, the banking sector has so far played a rather modest role in financing investment in these countries, and retained earnings have provided the lion's share of such financing. On the other hand, instability in the banking sector has been a common problem, even in Eastern European transition countries that achieved significant growth and investment at a relatively early stage (Hungary, Czech Republic, Latvia, Lithuania). Effective bank regulation and monetary policy can be critical in minimizing this instability, avoiding systemic risk, and providing the foundation for the significant growth of market-based financial intermediation. Some recent studies argue that primary factors responsible for relatively successful experiences in the development of commercial banking in transition countries are similar to those in the non-financial sector, and related to so-called *hard budget constraints*, i.e. financial discipline and a credible commitment not to bail out failing organizations.<sup>2</sup>

The development of commercial banking in Russia since the late 1980s has been difficult and complex. Many banks were formed in the early 1990s to exploit temporary opportunities that largely disappeared in the second half of the decade (servicing directed Central Bank credits to the non-financial sector, speculating on inflation and currency markets, currency exchange with high spreads). The latter half of the 1990s witnessed the rapid consolidation of a group of larger Moscow banks that were oriented primarily toward servicing the government sector (government bonds (GKO), becoming "authorized (upolnomocheny)" banks for federal and

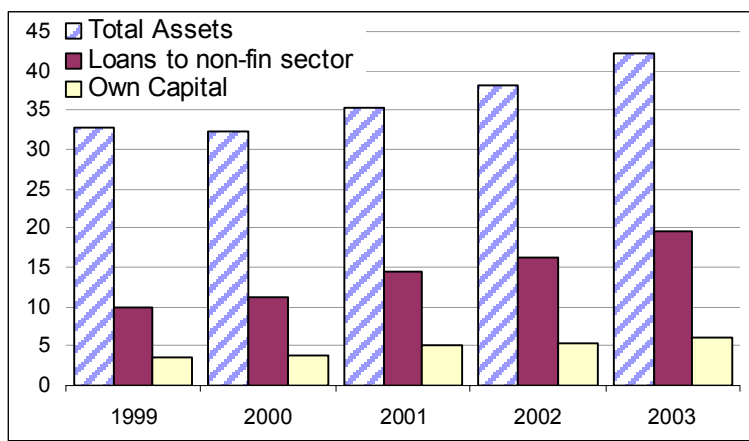
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<sup>2</sup> A strong such case is made in Berglof, Erik; Bolton, Patrick (2002) "[The Great Divide and Beyond: Financial Architecture in Transition](#)," *The Journal of Economic Perspectives*, vol. 16, No. 1, pp. 77--100

regional government accounts and programs). Extremely low liquidity and payment discipline in the enterprise sector, weak institutions for defending creditor rights, and high government bond yields kept commercial credit to the non-financial sector at very low levels. Macroeconomic instability and a mistrust of banks made paper dollars the preferred savings instrument for the population, and concentrated household deposits in the State Savings Bank, Sberbank.

The 1998 crisis brought the Russian banking sector to near collapse, yet the sector rebounded rather quickly even in the absence of major recapitalization or restructuring. (Figure 8). In fact, it can be argued that the primary positive contribution of the Central Bank and government to the development of Russian banking during this period is related more to what they *didn't* do than to what they did. There was no major bank recapitalization, no liberal allocation of refinance resources, far less opportunities for banks to profit from servicing the government, and no state deposit insurance. In these circumstances, banks were forced to fend for themselves in a tough competitive environment with limited profitable activities and low trust of the population. Banks in default to international creditors largely had to solve their own problems of credibility on international capital markets. At the same time, greater liquidity and profitability in the enterprise sector created opportunities for the development of loan portfolios with potential high returns. Thus, to avoid failure, Russian banks faced an immediate challenge of developing effective institutions for commercial lending to the non-financial sector. In other words, the Central Bank and Russia government made important progress in enforcing hard budget constraints for commercial banks, and bank incentives and institutions strengthened as a result. While the speed of asset and credit expansion in the banking sector in the still weak institutional environment of Russian financial markets may also raise some concerns, the overall trends since 1999 have been very positive.

**Figure 8. Aggregate Commercial Bank Assets, Credit, and Capital (as % of GDP)**



Source: CBR

Nevertheless, as acknowledged in the 2004 Strategy for the Development of the Banking Sector of the Government and Central Bank, Russian banking still suffers from a number of serious structural problems. In particular, the trust of the population in banks remains weak, bank liabilities typically consist of short-term and potentially volatile resources, the state-owned Sberbank occupies a monopoly position in the market for household deposits (over 60 percent), and state guarantees for household deposits in Sberbank impedes the development of competition on this market. In addition, the continued dominance of state-owned banks politicizes bank regulation in a manner that hinders the enforcement of hard budget constraints in an equal manner throughout the industry. The Strategy proposes major steps toward the resolution of these and other problems, including a deposit insurance program.

Deposit insurance exists in almost all developed economies. It has often proved an effective instrument for increasing the confidence of the public in banks, and in helping to prevent the self-reinforcing mass hysteria of bank runs. In addition, in the Russian context, a system of deposit insurance provides a potential key for creating a genuine competitive market for household deposits that would break the monopoly of Sberbank, also paving the way for its eventual privatization. Despite the de-dollarization of recent years, Russian households apparently continue to hold a huge share of their savings outside banks in foreign (paper) assets, which suggests a strong potential for additional financial intermediation if household confidence in banks can be improved.<sup>3</sup> Deposit insurance also appears to lower average interest rates at which banks can attract deposits, thereby potentially lowering the costs for borrowers as well.<sup>4</sup>

On the other hand, deposit insurance also has a negative side. The primary problem is that of *moral hazard*. The presence of deposit insurance can distort incentives in banks toward excessively risky investment strategies, and this particularly affects banks that operate with relatively little of their own capital. Under current circumstances, a poorly-capitalized bank without a strong reputation would typically have a very difficult time attracting household deposits due to a lack of trust. Thus, most banks of this type do not work much with household deposits, and might operate primarily with a select group of juridical persons on both sides of their balance sheets. If such a bank were to receive state insurance for household deposits, however, then it might suddenly be possible for this bank to attract household deposits, perhaps even through higher-than-market interest rates, and then use this money to engage in some very risky investments. If these investments pay off, the bank owners will become rich. If they fail, the bank will go bankrupt, lose only its own (small) capital, and the insurance fund or government (i.e. taxpayers) will compensate depositors. Fierce competition and declining interest spreads in the Russian banking industry can also increase the temptation for problem banks to resort to this sort of imprudent and destructive strategy.

Thus, ironically, deposit insurance does not necessarily decrease the risk of instability in the banking sector. While it generally has a positive impact on the confidence of depositors and can make bank runs less likely, it can also increase the riskiness of bank investment strategies, potentially leading to a larger number of bank failures. If these risks are correlated among banks, it becomes a system risk. Related problems have plagued even in some of the most developed economies. An often cited experience concerns US savings and loan organizations, many of which took advantage of deposit insurance and a deregulated environment in the 1980s to make speculative investments in the real estate market. Sharp increases in real estate prices turned many owners of savings and loan organizations into millionaires. But this speculative bubble eventually burst, and subsequent declines in real estate prices triggered large scale insolvencies that, due to deposit insurance, imposed costs of an estimated \$124 billion on US taxpayers.<sup>5</sup> More generally, recent empirical studies across many countries raise doubts that the presence of deposit insurance decreases the probability of a financial or banking crisis.<sup>6</sup> Depositor confidence in commercial banks is a positive phenomenon only in the event that this is not false confidence.

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<sup>3</sup> The recent OECD Economic Survey of the Russian Federation (2004) reports estimates of “mattress money” in Russia ranging from USD 40-80 billion, as compared to USD 48 billion in household deposits in commercial banks. OECD (2004) pp. 227.

<sup>4</sup> See Demirgüç-Kunt, Asli; Huizinga, Harry (2004), “Market Discipline and Deposit Insurance,” *Journal of Monetary Economics*, vol. 51, pp. 375-399.

<sup>5</sup> Curry, Timothy and Shibut, Lynn (2000), “The Cost of the Savings and Loan Crisis: Truth and Consequences,” *FDIC Banking Review* vol. 13, no. 2

<sup>6</sup> See Demirgüç-Kunt, Asli; Detragiache, E. (2002), “Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation.” *Journal of Monetary Economics* vol. 49, pp. 1373-1406

In light of these concerns, the degree of success from the introduction of deposit insurance in Russia will be conditional on exactly how it is implemented. The moral hazard problem can be alleviated and controlled both through selectivity in admission to the deposit insurance program and by regular effective monitoring of the risk position of participating banks. A bank that is well-capitalized will have less incentive to take excessive risks, as it would stand to lose a substantial amount of its own resources in the event of bankruptcy. Second, the Central Bank can enforce regulations that directly limit the risk components in the portfolios of commercial banks. Thus:

- ***State deposit insurance should be limited to banks that are well-capitalized and can be monitored effectively by the Central Bank.*** Poorly-capitalized banks or banks that lack financial transparency should not receive state deposit insurance, and this creates too great a distortion in incentives toward excessively risky investment strategies.
- ***State deposit insurance places a greater regulatory burden on the Central Bank (and Deposit Insurance Agency)*** to monitor effectively the risk positions of commercial banks who participate in this program, continually verify their capital adequacy, assess the overall quality of management and financial control systems, and take immediate action to correct what could be abusive behavior.

Given the above considerations, the basic logic of the current Strategy for the Development of the Banking Sector of the Russian Federation is understandable. On the one hand, the goal is to create a more level playing field for the development of a market for household deposits that could break the monopoly of Sberbank and give a major boost to the development of private banking and financial intermediation. On the other hand, the right to work with household deposits, and purchase state deposit insurance, will be limited only to banks that are well capitalized and can be monitored effectively by the Central Bank. The Strategy also contains additional measures for improving the monitoring of commercial banks and the ability of the Central Bank to resolve problems in a quicker and more effective manner.<sup>7</sup> The absolute level of deposit insurance is quite modest by international standards (100,000 rubles), although it will be possible for households to increase this sum by holding accounts simultaneously in a number of banks, or for a larger number of household members to open accounts. This seems to have been the case in Ukraine, where the recent introduction of deposit insurance led to a very rapid expansion of household accounts equal to exactly the specified insured limit.

The effective monitoring of bank capital and capital adequacy presents a particularly important challenge to the Central Bank. As emphasized above, the distortion in incentives from moral hazard becomes more serious to the degree that a bank has little of its own capital to lose in the event of bankruptcy. In the past, Russian banks have been able to manipulate artificially the book value of their capital through various schemes involving loans or purchases of equity with their affiliates. Thus, to monitor effectively the capital position of Russian banks, the Central Bank will need to obtain detailed information on bank owners their affiliates, and the consolidated accounts of the entire group. It is exceedingly difficult to monitor the actual capital position of a commercial bank in the absence of consolidated supervision.

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<sup>7</sup> This latter goal has been addressed in *Changes to the Federal Law on the Insolvency (Bankruptcy) of Financial Organizations* of 31 July 2004 (N121-F3).

To meet the new challenges, the Central Bank has been introducing a qualitatively new type of monitoring that places less emphasis on the fulfillment of specific prudential norms (which can often be manipulated), and involves a comprehensive qualitative risk assessment of individual banks based on international best practice. In addition to the standard measures of portfolio risk, diversification, capital adequacy, liquidity, profitability, and disclosures, the Central Bank now pays close attention to indicators such as the transparency of ownership structure and quality of bank governance. The Strategy for the Development of the Banking Sector in the Russian Federation also proposes changes in legislation consistent with the full implementation of Basle Core Principles, including those on effective preconditions for effective supervision. Thus, the Central Bank is indeed taking measures to increase its regulatory capacity to meet the new challenges created by deposit insurance. .

In the short term, the Central Bank and Deposit Insurance Agency will also need to make difficult decisions concerning the eligibility of commercial banks for participation in the deposit insurance program. The success of this program requires the exclusion of banks that are not well-capitalized or do not reveal information in a clear and transparent manner. Some such banks will most likely resort to political connections in an attempt to influence the outcome of this process. Therefore, a special effort will be needed to protect the independence and impartiality of the Central Bank at this crucial time for the reform and development of commercial banking in Russia. In general, it is very important that bank supervisory bodies (CBR and DIA) are well-funded and can function in an independent manner.

Deposit insurance can potentially play a key role in facilitating the growth, restructuring, and development of Russian banking over the medium and longer term. The Strategy for the Development of the Russian Banking Sector contains a comprehensive set of measures aimed at meeting the significant challenges that deposit insurance raises in bank regulation. The success of the reform will depend on the successful implementation of these measures though determination on the part of the Central Bank and Russian government.

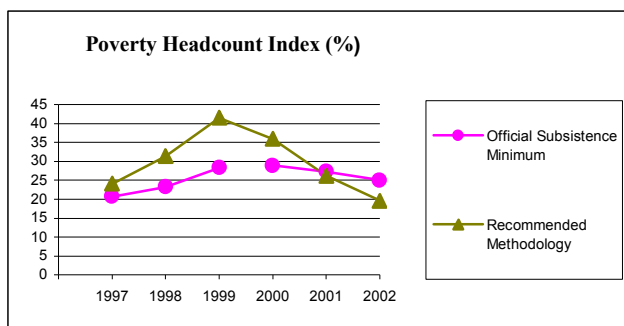
### III. A New Look at Poverty in Russia

This Section summarizes findings of the recent Poverty Assessment Report (PAR) prepared by the Bank for Russia.<sup>8</sup> The main advantage of this PAR relative to its predecessors (published by the Bank in 1995 and 2000) is twofold. First, all previous reports on poverty in Russia had to rely on the Russian Longitudinal Monitoring Survey (RLMS) data, and a few other publicly available irregular surveys. For the first time, a poverty assessment has been able to utilize the vast micro data of the Household Budget Survey (HBS), a regular Rosstat survey of forty nine thousand Russian households. In addition, the report presents practically the first poverty-related analysis of data collected under NOBUS - the Rosstat survey of household access to social services, which was carried out in 2002. This helped to prepare a more accurate poverty profile and assess the efficiency of social systems.

#### *Poverty Dynamics: Recent Successes and Future Challenges*

Russia succeeded in cutting poverty in half between 1999 and 2002, from 41.5 percent in 1999 to 19.6 percent in 2002 (Figure 9 ).<sup>9</sup> Yet one out every five people was still poor in 2002. This leaves no room for complacency on the part of the authorities, who want to further halve poverty incidence by 2007.

**Figure 9: Trends in Poverty, 1997-2002: Headcount Index (%)**<sup>10</sup>



Source: Rosstat, World Bank

This goal is potentially achievable but very difficult. It would take uniform per capita consumption growth of at least 5 percent per annum to achieve the desirable reduction in the incidence of poverty. This is likely to require even higher GDP growth rates, since we don't consider the current pattern of faster growth in consumption relative to GDP as sustainable. If consumption growth was only 3 percent per annum, poverty would be reduced by only about a third (Figure 10). Moreover, one should not take for granted that future economic growth would lead to the same magnitude of growth in per capita consumption as was observed during the post-crisis period. Simple extrapolations are risky because of changing sources and peculiarities of economic growth. The rapid rebound in wages after the crisis - one of key determinants of the poverty reduction pace - was made possible by a preceding collapse in

<sup>8</sup> A full text of the Report: Russian Federation, Poverty Assessment, 2004 can be found at [www.worldbank.org/ru](http://www.worldbank.org/ru)

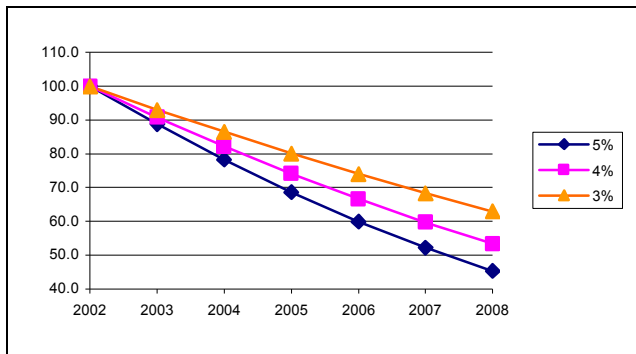
<sup>9</sup> The official estimates of poverty use the official poverty line for identifying poor households on the basis of their "money income," a measure adjusted to national accounts based on a model. The official poverty line (subsistence minimum level) was adopted in 1992 and used through 1999. A revised line has been used since 2000. Given the change in the official methodology for poverty estimation in the year 2000, which led to the higher poverty lines and therefore higher poverty estimates, the official estimates of poverty are not strictly comparable before and after the year 2000. The Bank report developed a methodology for poverty estimation that relied on data on household consumption from the household budget survey (HBS) and a regionally consistent poverty line based on household behavior observed in the HBS. The recommended poverty line varies by individual and region to take into account regional price variation, differences in needs due to climatic factors, as well as economies of scale. It averaged 1,056 rubles per capita per month in 2002. This is equal to \$3.54 per capita per day in purchasing power parity.

<sup>10</sup> Headcount index measures proportion of the population living below the selected subsistence minimum.

wages (see Figure 11). Yet whether further wage increases of a similar magnitude are sustainable remains an open question.

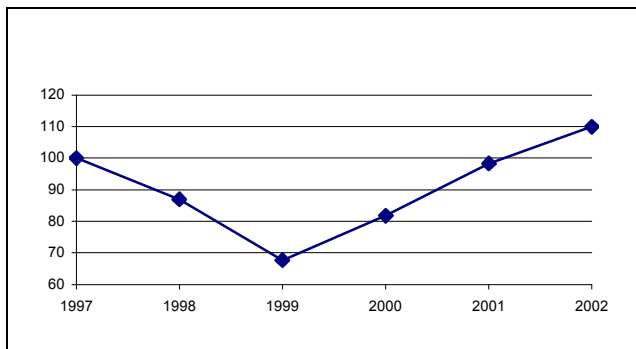
Besides, if future growth is accompanied by an increase in inequality, its impact on poverty reduction will even be lower than shown in Figure . Russia is already at the high end of inequality among the CIS countries, even if its inequality is still moderate by broader international standards. In 2002, the Gini index for consumption inequality in Russia (adjusted for the large spatial variations, different needs of the household, and household's economies of scale) was about 33 percent.<sup>11</sup>

**Figure 10. Simulation of Poverty Trends for Different Consumption Growth Scenarios (Headcount Index,1997=100)**



Source: Rosstat, World Bank

**Figure 11. Real Average Wage Rate Index (1997=100)**



Source: Rosstat, World Bank

***Understanding the Nature of Poverty and its Profile Can Help Shape a Poverty Alleviation Strategy.***

To assess whether sustainable growth would alone suffice to achieve a desirable reduction in poverty incidence, it is important to understand who the Russian poor are, and why they are poor. In particular, identifying the most vulnerable groups is important for designing policies that would reach deep pockets of poverty that may be resilient to benefiting from general economic improvements. The World Bank poverty assessment provided a detailed comparison data across different categories, as summarised below.

<sup>11</sup> Unadjusted Gini index was 37 percent in 2002. Yet we consider a 33 percent level more accurate. Inequality estimates based on nominal, rather than real per capita consumption or income, tend to be higher, given that the cost of living is higher in richer areas. Official estimates of inequality are not corrected either for regional price variation, or for type and the size of a household.

- **Rural populations are more likely to be poor.** About 30.4 percent of the rural population was estimated to live in poverty, while only 15.7 percent of the urban population lived in poverty.
- **Living in small and remote towns carries a higher risk of poverty than does living in large urban areas.**<sup>12</sup> In Moscow City, a much smaller fraction of 6.6 percent was estimated to live in poverty, while other urban areas had a poverty incidence of 17 percent.
- **Children have a higher risk of falling into poverty.** Children younger than 16 years old have a much higher incidence of poverty than average - 26.7 percent. Younger children have an even higher risk of falling into poverty than older children. This provides a poverty rationale for child welfare projects and for targeting part of social assistance to families with children.
- **The unemployed are more likely to be poor than the employed.** One out of every three unemployed persons is poor compared to one out of every five persons in the population at large.
- **In urban areas, higher education pays off.** In Russian cities, those with at most primary education are 50 percent more likely to be poor than the general population.

However, each of the vulnerable groups identified above generally constitutes a small fraction of the population at large. Therefore, we need to also look at the aggregate level – in other words, define categories of poor people that contribute most to the total number of the poor. This approach results in a different poverty composition:

- **The majority of the poor are in working families, where one or several members work.** About 88 percent of poor individuals live in households where at least one member works.
- **About one-third of the poor live in households with no children,** another third live in households with one child, and the remaining third live in households with two or more children. Hence poverty programs based solely on targeting households with many children will miss a large number of the poor.
- **A majority of the poor live in urban areas.** About 58.5 percent of the poor live in urban areas. This is a reflection of the fact that, while a rural individual is almost twice as likely to fall into poverty as an urban person, the majority of Russia's population (73.2 percent) live in urban areas.

To summarize, the most acute problems of poverty are related to the following social groups: rural and small urban settlements dwellers, unemployed, and children, whereas the majority of the poor people are working urban families with children, where bread-earners receive wages that are not sufficient to ensure consumption above the poverty line for the entire household.

**There are large regional differences in the incidence of poverty,** which varied in 2002 between 3.1 percent and 55.6 percent. While some of these differences are attributed to different characteristics of the regions in terms of urbanization, education, and employment,

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<sup>12</sup> This finding is based on the NOBUS survey, which clearly shows that the smaller the size of the urban community, the greater is the incidence of poverty.

large regional differences continue even when these characteristics are accounted for. Persons with the same characteristics are three time more likely to be poor in Tuva Republic compared with persons in the rich city of Moscow.

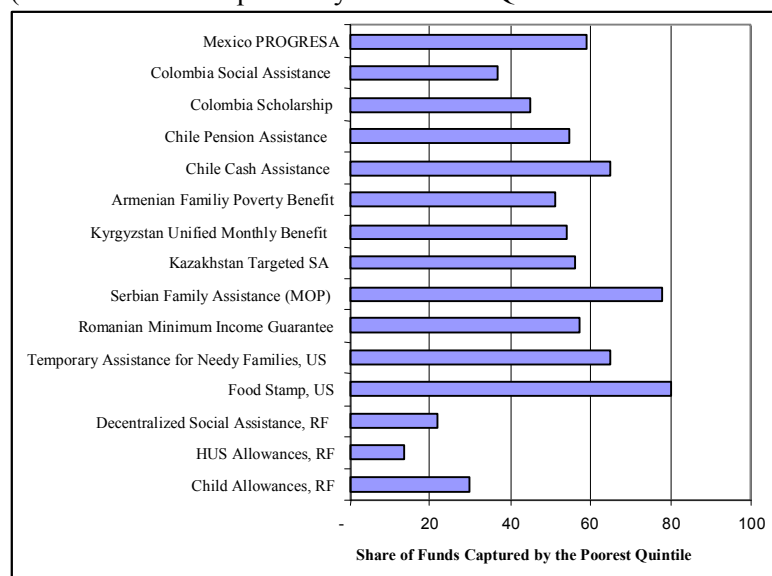
**However, regions did not diverge during the post-crisis recovery, which was broad-based and benefited both rich and poor regions.** Inequality among regions remained stable in 1997-2002, and even declined somewhat. Overall inequality in consumption can be decomposed into two components: inter-regional inequality and intra-regional inequality. It can be shown that the inter-regional inequality was high in the 1997-98 period, but declined subsequently. Moreover, the richer regions did not grow more rapidly with the recovery, nor did households in richer regions increase their consumption more rapidly than those in poorer regions.

***Poverty Alleviation Should Complement the Focus on Growth with Improved Targeting of Social Policies and the Design of Specific Interventions for Deep Pockets of Poverty.***

The poverty assessment concluded that **economic policies that facilitate growth** remain, as in the past couple of years, the most effective approach to reaching the target of cutting poverty in half by 2007, and should form the **first pillar** of a poverty alleviation strategy. At the same time, the report demonstrated that the government has huge untapped potential to reduce poverty through redistributive social spending. Privileges that benefit the rich more than the poor account for about 4 percent of GDP. Phasing out these regressive subsidies, and substituting them with **targeted social assistance** should constitute the **second pillar** of the government poverty alleviation strategy.

**Programs specifically aimed at the poor need to be dramatically improved through better targeting.** Currently, the two programs with the largest share of poor among their beneficiaries are the child allowance program and the decentralized social assistance programs. Yet even these programs have only about 30 percent and 28 percent, respectively, of their beneficiaries from the poorest quintile, i.e. over two-thirds of budget funds allegedly targeting the poor end up in non-poor households. Moreover, with the exception of child allowances, the average benefit received by the rich is larger than the average benefit received by the poor. Figure 12 illustrates the fact that targeted assistance programs in Russia perform poorly vis-à-vis targeted programs in other countries.

**Figure 12. Comparative Targeting Performance**  
(Share of Funds Captured by the Poorest Quintile in Selected Countries)



Source: World Bank

The report recommends introducing proxy-means testing as an instrument to substantially reduce the current leakage of funds to the non-poor.

**Social spending should also become more targeted to address emerging problems in access to such public services as education and healthcare.** If these issues are not tackled in earnest, a vicious circle could develop that replicates a poor underclass. The most worrisome indication in this respect is that, despite Russia's strong position in terms of compulsory education enrolment and completion, children from poor households have less access to pre-school and post-compulsory education, which is increasingly determined by income and wealth. This should become a serious concern for policymakers because children who begin behind their peers in terms of basic learning skills have a tendency to remain behind. Moreover, children from lower income households in Russia are also more likely to discontinue their education after the compulsory levels. The lowest income adult populations had two to three years of schooling less than the highest income populations in 2003. This has a direct negative impact on their chances in life. As returns to education have been decompressed, children of the poor have a higher than average risk of becoming poor adults.

Similarly, deprivation of quality health services bears a risk of making poverty rigid. Already today, the Russian poor have worse health outcomes than the rest of the population. This situation reflects causality in both directions: poverty breeds ill-health, and ill-health keeps poor people poor. All types of health services currently require fees, both formal and informal. Private expenditures are estimated to be from 30 percent to 55 percent of the total spending on health. And for the poor and lower income groups, out-of-pocket payments constitute a higher share of consumption, regardless of service or care setting. Hence the lower income groups are disproportionately hurt by the recent developments in healthcare provision.

Not surprisingly, all of the above problems are even more acute for the most vulnerable groups. Hence, **targeted interventions to reach deep pockets of poverty** should become a **third pillar** of the poverty reduction strategy. The beneficiaries of such interventions would include children, people living in small towns, rural areas, and depressed regions.

The next stage of the World Bank's poverty assessment will support the design of specific interventions aiming at eliminating the persistent incidence of poverty. To do so, we need more extensive knowledge of the poverty profile and mapping in specific regions. Developing this knowledge will also include an analysis of the likely impact on poverty of the new initiatives by the government in the social area. In particular, we will carry out an analysis of impact on poverty from the monetization of privileges, and monitor the impact of the redistribution of responsibilities for social protection between the federal and sub-national governments.

**Table 8. Main Macroeconomic Indicators**

	2000	2001	2002	2003	2004									
					Янв	Фев	Мар	Апр	Май	Июнь	Июль	Авг	Сен	Окт
<b>Output Indicators</b>														
GDP, % change, y-o-y 1/	10.0	5.1	4.7	7.3	-	-	7.5	-	-	7.4	-	-	-	-
Industrial production, % change, y-o-y	11.9	4.9	3.7	7.0	7.5	8.7	6.6	6.7	5.5	9.2	4.4	6.8	3.5	3.5
Fixed capital investment, % change, y-o-y	17.4	8.7	2.6	12.5	13.7	13.2	12.6	12.5	12.5	11.8	10.7	11.6	8.7	
<b>Fiscal and Monetary Indicators</b>														
Federal government balance, % GDP 1/	2.3	3.0	2.3	1.7	9.6	2.1	3.6	3.2	3.8	4.4	0.0	4.6	4.9	3.8
Primary balance, % of GDP 1/	4.7	5.5	4.4	3.4	10.6	4.3	5.9	4.9	5.3	5.8	0.0	6.1	6.4	4.1
M2, % change, p-o-p	58.8	44.6	34.1	44.8	0.0	3.8	2.6	1.8	1.2	4.6	-1.4	0.6	1.9	
Inflation (CPI), % change, p-o-p	20.2	18.6	15.1	12.0	1.8	1.0	0.8	1.0	0.7	0.8	0.9	0.4	0.4	1.1
Nominal exchange rate, % change, p-o-p / (-) appreciat/	4.3	7.0	5.4	-7.3	-3.2	0.1	-0.1	1.4	0.4	0.1	0.3	0.5	-0.1	
Real effective exchange rate, July 1998=100	66.9	79.4	82.0	84.9	88.0	89.7	91.3	92.0	91.8	91.2	91.1	91.4		
Real effective exchange rate, % change, p-o-p	7.3	18.7	3.3	3.5	1.4	1.9	1.8	0.8	-0.2	-0.7	-0.1	0.3		
Reserves (including gold) billion \$, end-o-p	28.0	36.6	47.8	76.9	84.0	86.3	83.4	82.7	85.6	88.2	88.6	88.7	95.1	107.3
<b>Balance of Payment Indicators</b>														
Current Account, billion \$	46.3	35.1	32.8	35.9	-	-	11.0	-	-	22.6	-	-	35.9	
Trade Balance, billion \$	60.7	48.1	46.3	60.5	6.5	5.6	6.0	6.4	5.9	5.9	6.3	8.0	8.4	
Exports, billion \$	105.6	101.9	107.3	135.9	11.8	12.0	13.6	14.2	13.4	13.8	14.5	16.2	16.5	
Imports, billion \$	44.9	53.8	61.0	75.4	5.3	6.4	7.6	7.8	7.4	7.9	8.3	8.1	8.1	
Average export price of Russia's oil, \$/bbl	24.0	20.9	21.0	23.9	25.0	24.8	26.1	27.0	29.7	30.5	31.4	35.0	35.8	37.5e
<b>Financial Market Indicators</b>														
CBR refinancing rate, %, end-o-p	25.0	25.0	21.0	16.0	14.0	14.0	14.0	14.0	14.0	13.0	13.0	13.0	13.0	13.0
Average deposit rate for enterprises, %	8.7	8.5	6.9	4.4	3.9	3.6	4.5	4.1	5.4	9.2	3.4			
Average lending rate for enterprises, %	24.3	17.9	15.8	13.1	12.4	12.2	11.8	12.1	12.9	11.7	11.1			
Real average rate for Ruble loans, % (deflated by PPI)	-15.8	-1.1	3.9	-2.2	-4.2	-6.2	-6.9	-7.8	-9.2	-11.8	-11.4			
Net credits to real sector, R billion	-15	486	479	898	-14	70	123	158	52	116	103			
Share of long-term credits to entrepr. in total, %	25	21	25	30	29	29	29	28	28	28	28			
Stock market index (RTS, ruble term)	142.4	260.1	359.1	567.3	611.1	670.1	752.7	631.1	581.1	583.3	540.3	584.7	631.4	663.7
<b>Enterprise Finances</b>														
Share of loss-making companies 1/	41.6	38.4	43.4	41.3	38.6	39.5	42.9	42.7	41.3	40.2				
Profitability (net profit/sales), % 1/	32.7	25.6	17.4	20.7			28.9			25.2				
Non-cash settlements (% of total sales)	30.7	22.3	18.0	14.2	11.0	8.8	11.7	10.5	10.7	11.0	10.0			
<b>Income, Poverty and Labor Market</b>														
Net change in gov't wage arrears, %, p-o-p	-51.4	-26.5	-5.2	-34.4	20.8	15.1	-15.6	-9.2	12.3	8.1	7.5	-10.3	-5.8	
Real disposable income, 1999 = 100	112.0	121.7	135.5	154.1	155.3	159.5	169.1	175.4	159.6	179.7	183.6	180.2	188.8	
Average dollar wage, US \$	80.2	112.4	138.6	179.4	208.2	210.1	230.7	227.0	226.9	211.1	216.0	207.3	221.0	
Share of people living below subsistence, % 1/	28.9	27.3	24.2	20.6	-	-	22.1	-	-	21.5	-	-		
Unemployment (% , ILO definition)	10.4	8.7	7.9	8.4	9.2	9.6	9.0	8.3	7.6	7.5	7.5	7.5	7.4	

1/ Cumulative from the year beginning

Source: Goskomstat, CBR, EEG, IMF, WB staff estimates.