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Russia: New Momentum In Financial System Reforms – A Primer

Because of recent and near-term developments with regards to banking system and monetary policy reforms, this note takes the opportunity to summarize the background to these issues and outline some key aspects of the pending changes.

- **Russia's banking system reforms are gradually building momentum, driven to a large extent by the new Central Bank leadership installed in the spring of this year. In addition, the government has this winter announced the intention to focus in-depth on the wider and associated question of broadening and deepening Russian financial and capital markets.**

- **President Putin has also shown his support for actions in these areas, outlining a wish to have the new Law on Bank Deposit Insurance, seen as a vital pillar and instrument of the banking reforms, to be ready for submission to the Duma this week. Today, the government is expected to give its final approval to this Law. Also today, the government will discuss the Law On Currency Regulation And Control, setting out liberal reforms of currency market regulation.**

- **These sign are especially interesting, as this area has probably been one of the more disappointing among structural reforms over the last 3 years. The structural, institutional and governance challenges facing the banking system are significant.**

- **At the same time, a gradually building reform momentum comes on top of some positive dynamic changes in the banking sector over the last years, both in the loan and deposit areas. Across a range of banking indicators, pre-crisis (1998) levels have been restored and even exceeded.**

- **Alongside structural banking reforms, the Central Bank is also stepping up efforts at re-developing effective interest rate instruments, and will from November 18 next week launch a wider menu of refinancing and liquidity-management options such as repos and deposit auctions. These steps, together with above mentioned currency market reforms, should promote less volatility in rouble liquidity, enhance the CBR's monetary policy arsenal and lessen further the need for banks to go into foreign assets. Over time, the interest-rate sensitivity of the economy could grow and monetary policy could to some extent "ease" the stabilization burden currently mainly on fiscal policy.**

1. Background: new Central Bank leadership, new reform momentum

Russian financial system reforms have over the last quarters served as an example of a structural reform breakthrough - or at least the *preparation* for a breakthrough. Throughout the post-1998 period, banking reforms have been seens as being pursued without much conviction, and with little progress. With the early resignation this year of previous Central Bank Governor Geraschenko and his replacement with Sergei Ignatyev as the new Governor, and the subsequent appointments of Andrei Kozlov and Oleg Vyugin as two new First Deputy Governors and later Konstantin Korischenko as new Deputy Governor, new momentum has been found. The changes in the Central Bank leadership brought reform ambitions in line with the government, who for quite some time had been calling for a more committed approach to financial system reforms[1]. With the appointment of Ignatyev, Kozlov, Vyugin and Korischenko to the Central Bank, changes have already started, within only a few months, and covering both the structural banking system issues as well as monetary policies. An immediate and welcome change, both by the Russian and international banking community, has been a more open and direct market communication. Kozlov is responsible for banking system supervision and structural reform issues, with Vyugin responsible for monetary and exchange rate policies. In these fields, both Kozlov and Vyugin have set out early, in a clear and transparent manner, key aims and instruments for achieving these aims.

The Russian banking system is ripe for structural change. The sector is no longer in crisis, but at the same time, it is faced with major structural, institutional and governance challenges. Nevertheless, it is also necessary to recognize that the banking sector, alongside the overall improvement of the Russian economy, has undergone some dynamic change over the last three years, it has recovered most of the ground lost and there have been some qualitative positive developments[2]. The table below outlines key indicators over the last four years. As can be seen, pre-crisis (1998) levels have in most cases been reached and even exceeded, e.g. with regards to assets and capital. Notably, credits to the real economy *have grown substantially*, and amounted to over 43% of banking sector assets by mid-year – the highest level of this indicator since 1995[3]. On the whole, though, bank lending to the real economy plays still a small role for industry, with the share of bank lending of industry's financing needs no more than around 12%, with the industrial sector over the last years mainly financing out of own resources. Retail deposits have nearly moved back to where it was in 1998, as a percentage of liabilities. According to the Central Bank, 75% of banks were increasing their assets during 2001, and some 90% of banks reported profits (although in the absences of full international accounting standards across all banks, this has to be seen in context). The increase of banking sector assets in 2001 was over 3 times *higher* than the growth rate of GDP.

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[1] Note that CBR Governor Ignatyev was one of the First Deputy Ministers of Finances to Deputy Prime Minister/Minister of Finance Kudrin when he accepted the new post as CBR Governor. In the Ministry of Finance, Ignatyev was responsible for macroeconomic policy issues, and was involved on an ongoing basis in policy discussions with the monetary authorities. Both Kozlov and Korischenko are previous senior Central Bank officials, much respected by the markets, and which thus have now returned to the Central Bank. Vyugin is one of Russia's most high profile and respected economists, and was for many years a senior minister in the Ministry of Finance, involved in macroeconomic issues, before leaving for the private sector.

[2] For perhaps one of the more substantial overall studies into the development of the Russian banking system over the past four years and likely scenarios over the coming 3 years, see Tsentr Razvitia, *Modernizatsiya bankovskoi sistemy Rossii na etape ekonomicheskovo rosta*, August 2002.

[3] See also the studies by Tsentr Razvitia, *Aktyualnye voprosy strategii I mekhanizmov bankovskoi reformy*, November 2002, mimeo, *Rossiiskie banki v 2001 godu: klyuchevye tendentsii razvitiya I sostayanie osnovnykh grupp bankov*, October 2001 and *Rossiiskaya bankovskaya sistema v kontse 2001 – nachale 2002: novy povorot?*, April 2002, mimeo, as well as TSMAKP, *Tendentsii razvitiya bankovskoi sistemy v VI kvartale 2001 g – I kvartale 2002 g*., Obzor 1, June 2002. It could be noted also that the move to surplus budgets after 1998 and a great caution in the government towards re-developing the rouble government bond market have probably helped to support this growth in credits to the real economy.

The Russian Banking System 1998-2002 – Summary Of Main Indicators

	July 1, 1998	April 1, 1999	April 1, 2002	July 1, 2002
Assets of the banking sector, % of GDP	30.1	41.1	35.3	36.4
Capital of the banking sector, % of GDP	4.6	2.1	5.1	5.4
Credits to the real economy (including overdue credits), % of GDP	8.5	12.2	13.5	15.8
Credits to the real economy % of assets of the banking sector	28.1	29.8	38.4	43.4
Retail deposits, % of liabilities of the banking sector	25.2	17.9	22.7	24
Retail deposits, % of incomes of the population	11.9	11.7	14.5	N/A
Corporate deposits, % of GDP	5.8	11.3	9.4	N/A
Corporate deposits, % of liabilities of banking sector	19.2	27.4	26.6	25
Securities held by banking sector, % of assets of banking sector	31.7	22.4	17.9	17.6

Source: The Central Bank of Russia, Tsentr Razvitia, Citigroup

Despite positive developments listed above, the structural and institutional problems of the financial system are many, of which the first one is a low credibility of the legal system and the institutional framework – an economy-wide aspect Russian authorities have outlined as a key reform challenge[4]. Bank capitalization is low in an international comparison. The banking system, in many respects, remains dominated by state/CBR-controlled banks, and as such the nexus of the Central Bank and the banking system is almost like the "fourth natural monopoly". There is a need to restructure and decrease the role of state/CBR-controlled banks in the system, an issue that is recognized by the government[5]. The banking system is also highly segmented in other ways, with a number of large "conglomerates" controlling much of the flows in the financial system, with the consequence that a large part of lending takes place "inside" these industrial-financial groups, using "house banks" and related institutions. Excluding Sberbank and VTB, the Central Bank estimates some 40-45% of the total credit portfolio of the banking sector is connected party lending, "intra-conglomerate" lending. As in the corporate sector, to improve "corporate governance" is an imperative also in the banking system. Signs are indeed that over recent times, efforts have intensified in the banking system to put "connected" lending or lending to large entities on pure market basis, and the Central Bank has been pushing lately for established lending normatives to be observed.

This situation in the banking system mirrors a wider structural problem of the Russian economy, where a number of large entities in particular the export-oriented sector tends to dominate, and where small and medium-sized enterprises in the domestic sector has yet to show strong dynamics. Much of the banking, which takes place in the context of this structure, is currency operations, processing and managing export revenues of large entities in the export sector. It is estimated that about 44% of all borrowing of the corporate sector goes to the export sector, the remaining divided between domestic entities and non-industrial entities, which is even higher than in the pre-crisis period[6]. Studies indicate that banks' reliance on a few large entities have grown, with estimates showing that as of end-2001 the share of large credit risks, as a percentage of banking assets, was some 33%, up from about 25% pre-crisis[7]. In addition, the banking sector lacks a developed credit risk evaluation

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4 For a comprehensive – and lively – discussion and views from policy-makers and Russian bankers, with many excellent analyses, see the report *Bankovskaya sistema Rossii: puti reformirovaniya*, Fond Liberalnaya Missiya, November 2001, mimeo.
5 For example, over the last year the Russian government has focused on how to move forward on privatizing a large number of smaller banks in which authorities have a stake, and there is a medium-term strategy to reform Vneshtorgbank and Vneshekonombank, a process which has started and which could involve attracting foreign institutions to Vneshtorgbank (e.g. the ongoing discussion with the EBRD).
6 See Tsentr Razvitia, *Modernizatsiya bankovskoi sistemy Rossii na etape ekonomicheskovo rosta*, August 2002.
7 See Tsentr Razvitia, *Modernizatsiya bankovskoi sistemy Rossii na etape ekonomicheskovo rosta*, August 2002.

culture. There are also still too many banks, and there is a need for consolidation, although this need must be balanced with ensuring viable small and medium-sized banks can operate[8]. As a result of all of these aspects, the time horizon in banking relations is rather short, and short-term credits dominate. Indeed, the burgeoning rouble corporate bond market is in itself an indication of the lack of a functioning bank loan market.

Given all of the above, a systematic assessment of the role of the banking system in today's Russian economy suggest the following: in the short- to medium-term, the banking system does not involve a "systemic risk" to the rest of the economy, but in the long-term, a failure to promote the emergence of a deeper and developed financial system and associated financial intermediation could become a significant obstacle to sustainable economic growth[9]. Due to the still relatively limited role banks play for the real economy (both on the corporate side and on the household side – as indeed the 1998 crisis showed), the "systemic risk" would rather run *from the real economy to the banks*, than from the banks to the real economy. One such channel would be e.g. over-reliance on a limited number of associated corporate entities, or poor credit evaluation processes. As for the longer term potential growth constraint coming from a failure to promote the emergence of a well-functioning financial and banking system, both the experience of Central and Eastern Europe as well as wider cross-country studies tend to identify the quality of the financial system as one of the key factors behind economic growth. Studies for transition economies have in particular emphasized the banking and financial system's importance for providing funding for new business creation (across transition economies, the experience is that ultimately economic growth is supported by new firms, rather than previously existing firms)[10].

In a major presentation in June this year in St.Petersburg, First Deputy CBR Governor Kozlov outlined three general scenarios the Russian banking system could follow over the next three years[11]. The *first* scenario, the inertial path, is one in which the government and Central Bank-controlled banks continue to dominate the sector, and where a de facto mono-bank system persists. The *second* scenario is essentially one proposed some time ago by the lobby organisation *the Union for Industrialists and Entrepreneurs*, bringing together most of the leading Russian business executives. In this scenario, which we also can call the "conglomerate scenario", large industrial-financial structures continue to expand, while the possibilities for medium-sized banks will be restricted. Finally, the *third* scenario, the one the new Central Bank leadership and the government would like to embark on, is the competitive scenario. In this path, consolidation will be encouraged, but competition possibilities for medium-sized banks will be preserved. The role of government and Central Bank-controlled banks will clearly be reduced, and entities privatized.

The Russian Banking System By 2004/2005: Three Scenarios

	Inertial scenario	The scenario of the Union of Industrialists and Entrepreneurs	The competitive scenario
Assets of the banking sector, % of GDP	39-40	37-38	40-42
Credits to the real economy, % of GDP	18-19	16-17	19-20

Source: The Central Bank of Russia

[8] As of November 1, 2002, there were 1331 "credit organizations" in Russia, up from 1319 at the beginning of the year.

[9] An excellent analysis capturing some of these aspects is M. Dmitriev and S. Vasiliev (eds.), *Krizis 1998 goda I vosstanovlenie bankovskoy sistemy*, Carnegie, 2001.

[10] See e.g. A.M.Warner, "Twenty Growth Engines for European Transition Countries", *the European Competitiveness and Transition Report 2001-2002*.

[11] See the material and analysis contained in *Voprosy modernizatsii bankovskoi sistemy Rossii*, presentation by First Deputy Central Bank Governor A. A. Kozlov, at the St. Petersburg International Banking Congress, June 6, 2002, mimeo.

2. Russia's banking system – the structural reform agenda

Prior to the changes to the Central Bank leadership in April this year, the Russian government had already approved a full banking system reform program. In general, it is this program which authorities will seek to implement. The table below summarizes the main aspects of the overall reform strategy of the financial system, as it was approved in late December 2001.

Russia: The Financial/Banking System Reforms – The Formal Action Plan

Key reform measures
Amendments to the Civil Code and to the law on bankruptcy, to enhance the protection of creditors
A new law on deposit insurance
Prepare new law on currency regulation and currency control
Prepare for the transition to international accounting standards (to happen gradually in the period to 2004)
Draft proposal regarding the future of the government's participation in the capital of specific financial institutions
Prepare new law on accounting, based on international accounting standards
Prepare new law on the exit of the Central Bank from the capital of Vneshtorgbank
Prepare proposals for changes to the Tax Code, taking into account international accounting standards (by the fourth quarter, 2002)
Prepare amendments to the law on the Central Bank and to the law on banks and banking activity, in order to create a normative framework for banking groups
Prepare new law on abolishing the tax on purchase of foreign currencies, and on abolishing the tax on securities operations
Prepare a package of measures to support the expanded presence of foreign banks in Russia
Prepare amendments to the law on bankruptcy of financial institutions
Additional measures
Conclude the process of bank restructuring under the auspices of ARKO (expected by 2003)
Conclude the preparation of normative acts necessary to implement the new law on combating illegally acquired capital
Prepare amendments to the law on banks and banking activity, to tighten the rules for presenting information on the real owners of financial institutions
Prepare amendments to the law on the protection of competition in financial services, in order to develop and strengthen the legal basis for banking services.
Prepare amendments to existing legislation to pave the way for creating a corporate liquidator of financial institutions
Prepare amendments to the law on the Central Bank, outlining the possibility for the CBR to exchange information with regulatory organizations of foreign countries
Prepare a new law to create a credit bureau
Prepare amendments to the law on banks and banking activity, to abolish restrictions of issuance of bonds by financial institutions
Prepare new law to regulate the issuance and circulation of mortgage securities
Prepare the new laws on transfer of cash funds, and on electronic documents
Enlarge the list of liquid assets, allowed to be used as security for CBR refinancing
Prepare amendments to the law on the Central Bank and to CBR normative acts, in order to improve the system of obligatory norms
Approve decision that financial institutions need to be formed as a credit organization in accordance with Russian Federation legislation in order to carry out banking operations
Take measures to enhance the control of the Supervisory Council over the commercial activities of Sberbank
Amend CBR normative acts in order to improve the procedure to increase the charter capital of financial institutions
Draft and approve ethical principles of banking activities (a Code)

Source: *Pervoocherednye meropriyatiya realizatsii polozhenii Strategii razvitiya bankovskovo sectora Rossiiskoi Federatsii*, The Ministry of Finance.

Our discussions with the new Central Bank leadership have stressed their intention to avoid being bogged down in formalistic, administrative work, slowing changes down. In the early weeks in office, the Central Bank revoked a number of bank licenses, cases which had been pending for quite a while, a move signaling that if required, the Central Bank would now act more resolutely in these issues. The Central Bank has also recently followed up on public indications it would not tolerate certain state/CBR-controlled banks to violate lending normatives regarding exposure to one entity, and has set a deadline of mid-2003 for such banks to move back in to line with established lending normatives.

In a programmatic speech, Kozlov outlined in some details the Central Bank's main

thinking, suggestions and priorities for banking reforms at the St. Petersburg International Banking Congress on June 6, 2002[12]. **The structural banking sector reforms will in the near-term focus on moving from form to substance with regards to supervision, optimize rules and normatives, re-construct the way in which Central Bank inspections of banks are made, optimize liquidation procedures, the move towards international accounting standards by January 1, 2004 will be pushed for, and, importantly, the emerging deposit insurance scheme will be used an instrument for structural change** (more on that below). The CBR has in particular signaled it will already in the near-term work on encouraging banks to "come clean" with regards to reported own capital, an area where the CBR feels there is much non-transparency and misreporting.

Russia's Banking System Reforms: Near-Term Priorities

Prepare and approve a number of legal changes: to the laws on banks, on the bankruptcy of banks, deposit insurance law	In the autumn/winter of 2002
Draft and introduce new methods for analyzing banks	By end of 2002
Reorganize banking system inspections	By end of 2002
Conduct reviews of all Russian banks in the context of preparing the deposit insurance system (the Law on Bank Deposit Insurance), prepare other aspects of the deposit insurance system	During 2002-2004
Encourage "cleaning up" of capital reporting	Ongoing basis
Optimize and reform the Central Bank's supervisory procedures	Ongoing basis
Full transition to international accounting standards	By 2004

Source: The Central Bank of Russia

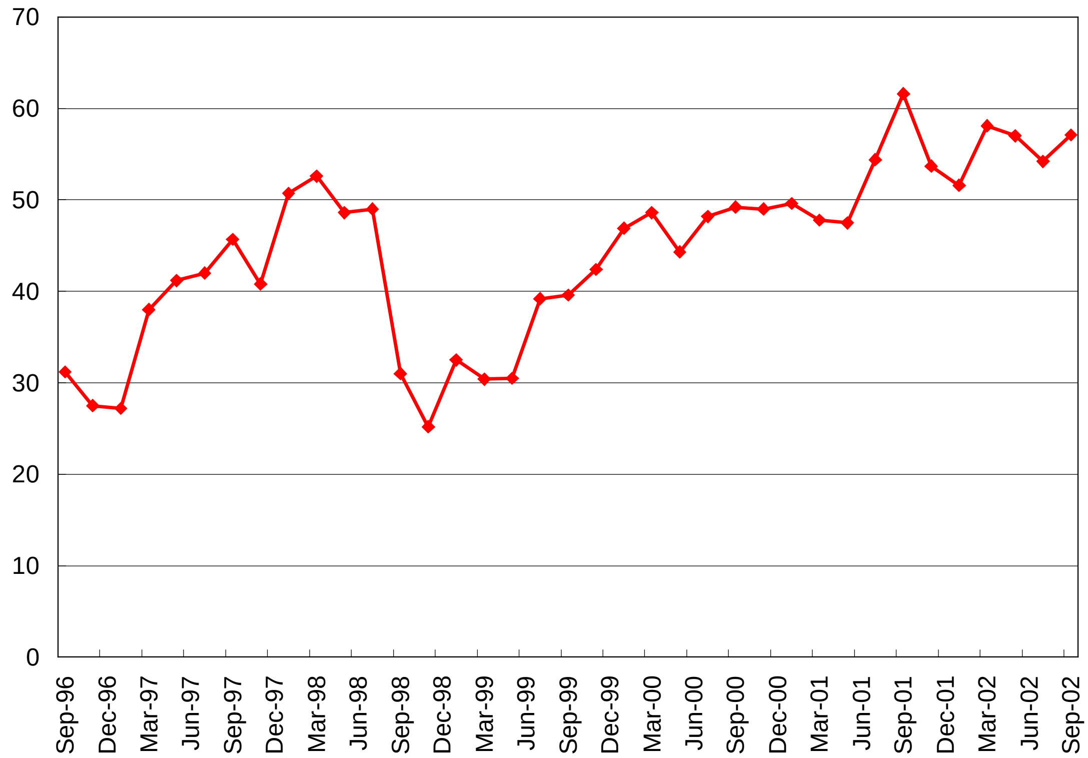
Of the many priorities, the Law on Bank Deposit Insurance stands out. It is seen by the CBR as one of the key priorities and pillars of modernising Russia's banking system, and it will be used as an agent of restructuring the banking system. Many Russian bank managers, as evidenced in polls, also view positively a deposit insurance system, seeing it as potentially enabling banks to attract a higher share of savings currently not in the banking system[13]. The CBR leadership sees the Law as a litmus test of whether Russia is ready to move forward to seriously reform and modernise the financial system. Note this progress in formal banking reforms comes at a time when Sberbank's share of household deposits is "organically" decreasing (as of September 1, it was 69.4% down 2 percentage points since the beginning of the year), and at the same time as opinion polls indicate the population sees the attractiveness of making savings growing (the index measuring the attractiveness of making savings has grown 11% since the beginning of this year, and 22% since January 2000)[14].

[12] Approved on his new post on April 16, Kozlov gave a speech to the Association of Russian Banks on April 24, and at the outset stated that he would present the main banking sector reform priorities at the St.Petersburg conference in June. See the material and analysis contained in *Voprosy modernizatsii bankovskoi sistemy Rossii*, presentation by First Deputy Central Bank Governor A. A. Kozlov, at the St. Petersburg International Banking Congress, June 6, 2002, mimeo.

[13] Polls referenced in the study Tsentr Razvitia, *Aktyualnye voprosy strategii I mekhanizmov bankovskoi reformy*, November 2002.

[14] By September 1, the Russian population's deposits (rouble and hard currency) in the banking system had grown by 31.4% (rouble deposits up by 26% and hard currency deposits up by 41.7%). In total, Sberbank still accounts for the vast majority of deposits, but its share is decreasing gradually, a trend in evidence over the last year. As of September 1, Sberbank held 69.4% of all household deposits, down 2 percentage points since the beginning of the year (the growth rate of total deposits in Sberbank during this period was 27.8%). Goskomstat also reports that of hard currency deposits, some 50.3% of all such deposits are in the Sberbank system.

Russia: The Attractiveness Of Savings, 1996-2002 (opinion polls, index)



Source: VTSIOM, Tsentr Razvitia, Citigroup.

The deposit insurance scheme, as expressed in the Law on Bank Deposit Insurance, is the result of cross-agency efforts, notably the Ministry for Economic Development and Trade, the Central Bank and the Ministry of Finance. As such, efforts to establish a deposit insurance system have been on the agenda for 7 years (!) now, with previous attempts languishing without conclusion in the political process. The situation is now much different, and there is broad support behind this measure, and it does appear likely it will soon be submitted to the Duma for the required readings. Essentially, 100% of the first 20 000 roubles and 75% of sums above that will be guaranteed by the special guarantee fund involved. The maximum will be 95 000 thousand roubles. The guarantee fund will be created on the basis of ARKO (currently the bank restructuring agency) and will be funded by contributions from banks. Initially, the federal budget will contribute some RUB 3 bn to this fund, and banks in the scheme will have to contribute 0.15% of average quarterly balances to the fund. Importantly, contrary to earlier versions of this latest Law, Sberbank will now participate from the beginning in contributing to the special guarantee fund (and will thus be the major contributor as it holds nearly 70% of all deposits). The idea is that inclusion of Sberbank in contributing to the fund from the beginning will raise the credibility of the system, compared to having Sberbank outside (recall Sberbank has 100% state guarantee at the moment – which will still be in place for a transition period of approximately a couple of years, after which Sberbank deposits are then insured by the new system)[15].

As such, the scheme envisages a two-year transition period for fully introducing the deposit insurance system, with the system gradually coming into effect from the second half 2003 (see table below – although this approximate "timetable" could be stretched out

[15] The money in this fund could potentially be invested in market instruments, and the Law could set out the rules involved. There have been some indications among authorities that the fund could be able to invest in both rouble instruments and hard currency instruments, such as Eurobonds.

over the period to 2006). One aspect of this reform, which is important in terms of broader banking system reforms, is that the deposit insurance process will be used as *an instrument of change*. This means that those banks not deemed suitable (not meeting a certain set of criteria) for participating in the deposit insurance scheme will not be allowed to engage in bank deposits, and will loose their general banking license. These criteria will include a number of financial viability aspects to governance factors and transparency issues. Thus there is a strong incentive here for banks wanting to remain with general banking licenses to meet the criteria necessary to make the cut. In some sense, the process of establishing the deposit insurance system will almost be used as the Code of Corporate Governance in the corporate sector, to foster a self-interest in changing for the better.

Russia: The Deposit Insurance System: Road Posts Of A Structural Banking Reform, 2002-2005

The Central Bank prepares and announces the criteria for joining the deposit insurance scheme	By January 1, 2003
The Central Bank hands out new licenses to deal with retail deposits only to banks participating in the deposit insurance scheme	From January 1, 2003
Based on their readiness, banks individually submit to the Central Bank requests to take part in the deposit insurance scheme	Between January 1, 2003 and July 1, 2003
The Law on Bank Deposit Insurance formally in effect	From July 1, 2003
The Central Bank reviews all banks to participate in the deposit insurance scheme (as well as other banks)	To be completed by September 1, 2004
The Central Bank gives a second chance for banks, which submitted a request to take part in the deposit insurance scheme by July 1, 2003, to be approved	No later than September 1, 2004
The transition to the deposit insurance scheme is over, and banks which are not part of the scheme, will see their general banking licenses withdrawn (i.e. banks will only be allowed to deal with retail deposits if they are part of the scheme)	January 1, 2005

Source: The Central Bank of Russia

3. Monetary policy – re-creating effective monetary policy instruments

While exchange rate policy in principle is set to remain unchanged, **the CBR is seeking to re-create much-needed effective monetary policy instruments**[16]. This effort is in particular led by First Deputy Governor Vyugin and Deputy Governor Korischenko, both much respected by the markets. In addition, the new Law On Currency Regulation And Control, soon to be submitted to the Duma, will represent a liberal overhaul of currency market regulation.

As with the efforts of launching structural banking reforms, the ambition to re-develop effective interest rate instruments is a clear positive and should be welcomed by the markets. Many of these ideas are expressed in the 2003 monetary policy program[17]. The 2003 monetary policy program is a transparent product, perhaps the most transparent such program in post-Soviet Russia. The program focuses on three main areas: re-developing effective

[16] That is, exchange rate policy will remain that in the context of a floating rouble exchange rate regime, the CBR will continue to restrain real appreciation where it can in the face of ongoing large dollar inflows. Despite heavier debt service schedule in the second half of the year compared to the first half, CBR reserves have reached successive all-time highs in the third quarter, and was most recently on November 1, at USD 46.7 bn. This level represents some 10 months of imports, and 1.7 times the monetary base. At the same time, efforts at restraining the pace of real appreciation has been aided this year as the real effective exchange rate has *depreciated* for much of the months this year, bringing the October year-to-date real effective exchange rate *depreciation* to 4%. The government expects a real appreciation range of some 3-6% per annum in the 2003-05 period. In terms of nominal exchange rates, this translates it expectations of a rouble/US dollar average rate of 33.7-34 in 2003, of 35.8 in 2004 and of 36.7 in 2005. Note also that the CBR leadership has signalled it stands ready to sell dollars from reserves at year-end to counteract the traditional surge in rouble liquidity which occurs at this time due to budget payment trends. The CBR hopes to in this way moderate the impact on inflation, which has in the past tended to jump on a monthly basis in January due to the end-year surge in rouble liquidity.

[17] *Osnovnye napravleniya yedinoi gosudarstvennoi denezhno-kreditnoi politiki na 2003 god*, the Central Bank of Russia. On August 14, the cabinet discussed the 2003 monetary policy program, presented by CBR Governor Ignatyev, his first in his new post. The program was then approved by the CBR board on August 23 and submitted to the Duma on August 26, where a final approval is likely by December 1.

monetary policy instruments and benchmark interest rates, pursuing structural banking system reforms, and ensuring continued gradual disinflation. On the last point, a key goal is to see inflation below 8% in three years' time, and in a 9-12% range already next year. The program contains two basic scenarios, closely mirroring the government's conservative and optimistic scenarios underlying the 2003 budget (see table below). The 2003 monetary policy program is one part of a broader effort at developing more precise and transparent forecasting and reporting vehicles for the Central Bank. It includes the explicit effort, from next year, to start publishing core inflation time series, and to essentially make core inflation – inflation stripped of seasonal food influences and natural monopoly tariffs – a key definition of the CBR's inflation ambitions.

The main novelties of monetary policy (starting already this year) will be in the sphere of instruments, particularly refinancing instruments. Rouble liquidity remains volatile, and a deficit and shallowness of refinancing instruments hamper the development of longer-term lending. In dealing with this situation, the new CBR leadership is aiming to both focus on actively developing repo operations and deposit auctions, thus both instruments for providing and soaking up liquidity. This will begin already from November 18, when the CBR plans to expand the menu of refinancing instruments starting with one-day repos and deposit auctions. The move to develop frequent deposit auctions, apart from the now existing deposit facility, will act as an instrument to soak up excess liquidity as well as it will be a market-established interest rate (being an auction) and this move could prevent excess liquidity from otherwise being placed in foreign assets. The other side of this development, as has been evident over the last years, is that the CBR will maintain an inactive role on the government securities market (at least given the current state of this market). There have also been discussions about looking more into FX swap activity (started in September this year) and re-activating Lombard auctions, but the focus of the CBR's efforts will rather be on the repos and deposit auctions.

One result over time of these monetary policy developments could be that the interest-rate sensitivity of the economy increases. If also governance and structural problems are dealt with alongside an increasing interest rate sensitivity, this could promote not only more effective and transparent monetary policy (less volatility in rouble liquidity) but also improved financial intermediation. In addition, it could lead to an "easing" of the stabilization burden, currently mainly on fiscal policy.

Russia: The 2003 Monetary Policy Program (The Central Bank): Estimates And Scenarios

	2002 estimates	2003 – pessimistic scenario	2003 – optimistic scenario
Inflation	14	9-12	9-12
Monetary base growth	27.7	19	25
M2 growth	27-28	20	26
Exchange rate, annual average, RUB/USD	31.3	34	33.7
CBR reserve growth, USD bn	9.5	0	7
GDP growth	3.9	3.5	4.4
Industrial production growth	4.1	3.2	4.1
Investment growth	4	6.3	7.5
Retail trade		6	7
Real incomes	6.9	5	6
Exports, USD bn		103.1	111.6
Imports, USD bn		61	63
Urals, dollar per barrel		18.5	21.5

Source: *Osnovnye napravleniya yedinoi gosudarstvennoi denezhno-kreditnoi politiki na 2003 god*, the Central Bank of Russia.

Finally, there are changes afoot with regards to currency market regulation and

legislation. These efforts are concentrated in the new Law on Currency Regulation and Control, which could be finally approved by the government and submitted to the Duma shortly. It has been a multi-agency effort and compromise between the Central Bank, the Ministry of Finance and the Ministry for Economic Development and Trade, with President Putin repeatedly indicating he would be looking for a liberal policy in this area. As a result, the new Law will be a transparent and liberal product, maintaining only a couple of potential instruments of controlling short-term portfolio capital inflows (including the possibility of pre-deposit for 2 months) and only over a transition period (up to 2007). It will do away with a number of bureaucratic obstacles to currency market transactions. This Law will also include the provision that the rule on export revenue repatriation will fall to 30% from the current 50% immediately on coming into effect. Furthermore, the Law will most likely includes the proposal to abolish all remaining so-called S-account restrictions, and if this is followed through on, the CBR will naturally not hold further dollar repatriation auctions in 2003. However, one more such auction might be conducted before the end of this year (recall the last two auctions showed much less demand for dollars compared to the amount of dollars on offer).