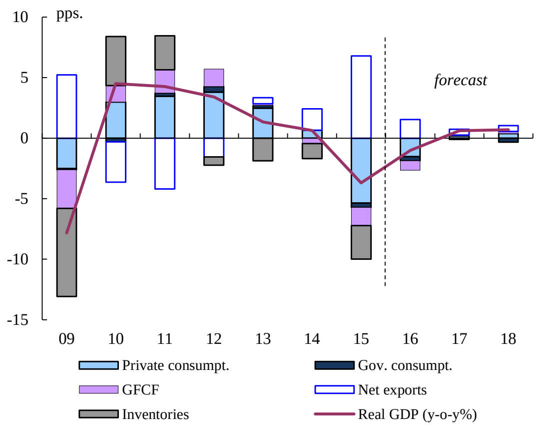
38. RUSSIAN FEDERATION

A gradual upturn in activity but numerous uncertainties remain

Russia's economy is set to continue to contracting in 2016, albeit at a much more moderate pace as there are increasing signs that the recession is bottoming-out. Growth should to turn positive from 2017 onwards, although the recovery is expected to be only gradual as structural impediments to growth persist, aggravated further by tightening fiscal policy and only limited space for monetary easing.

Russia's recession should continue into 2016, although GDP outturns for 2016-Q1 (-1.2% y-o-y) and 2016-Q2 (-0.6% y-o-y) point to greater resilience than initially anticipated. However, the significant contribution to growth coming from inventory investment (2.2pps. in Q1; 1.5pps. in Q2) may not be sustainable in the near term, and therefore caution is required in interpreting the economy's recent upturn. At the same time, both private consumption and fixed investment continue to contract at substantial rates. Going forward, growth in private consumption and investment is set to turn mildly positive in 2017 and 2018 as real incomes begin a modest recovery. A tightening fiscal policy stance, offset only in part by a gradual continuation of the monetary policy easing cycle, is expected to place a constraint on the economy's rebound as public consumption contracts throughout the forecast horizon. Export growth, while moderating in line with more stable exchange rate dynamics, should continue to contribute positively to growth. Overall, GDP growth is estimated at -1.0% in 2016, and should turn positive at 0.6% and 0.8% in 2017 and 2018, respectively.

Graph II.38.1: **Russia - Real GDP growth and contributions**



Domestic demand to lead a weak recovery

Despite some improvement over recent months, most short-term indicators (PMIs, industrial output, retail sales) underline the continued weakness in the domestic economy. Real wage growth is expected to turn consistently positive in late-2016 and early-2017 as inflationary pressures begin to subside. Combined with a cautious improvement in consumer sentiment as economic conditions stabilise, this should facilitate a return to modest private consumption growth. However, only partial indexation of public salaries and social transfers, as well as continued high levels of precautionary savings, should restrain the potential rebound.

Investment should also benefit from relative macroeconomic stability and continued output growth in agriculture and extractive industries. Nonetheless, high interest rates and still weak demand in the domestic economy are set to act as a counterbalance to growth across almost all sectors.

Fiscal consolidation will weigh on growth...

The rapid decline in the value of the Reserve Fund, which is expected to be fully exhausted by early-2017, will require consolidation on the expenditure side as the public finances adjust to lower oil prices. Alternative extra-budgetary funds (the National Welfare Fund) and privatisation proceeds will continue to finance the deficit, but still-limited access to external financing and relatively shallow domestic capital markets provide with little space to delay this adjustment further. Budgetary plans announced in October set out fiscal consolidation at the federal level amounting to 1 pp. of GDP annually from 2017 onwards. Nominal expenditure is forecast to remain broadly constant throughout this period, implying declines in real terms with public consumption expected to continue falling over the outer years of the forecast. The pace of consolidation is subject to uncertainties, including the possible over-performance of fiscal revenues relative to the government's conservative oil price assumptions, as well as the need to sustain expenditure on social transfers. In light of this, consolidation at the general government level is anticipated to be somewhat less ambitious, with the general government deficit falling by 0.2 pps. and 0.5 pps. of GDP in 2017 and 2018, respectively.

...while monetary policy should also remain tight.

The Central Bank of Russia's (CBR) commitment to achieving its 4% inflation target by end-2017 implies only limited scope for further monetary policy easing (policy rates are currently at 10.0%). Core inflation has been falling over recent months, albeit helped in part by base effects, and is expected to fall further in line with weak domestic demand, fiscal consolidation measures and output remaining below potential. Nonetheless, high inflation expectations remain deeply entrenched and this will likely lead to inflation coming in slightly above the CBR's target. Continued progress is subject to risks regarding the rouble's exposure to crude oil price volatility and its consequent pass-through to inflation. As such, the space for further monetary policy easing appears constrained in the near term.

Gradual shift to non-energy related output...

The economy's reliance on the oil and gas sector remains significant, and a transition towards alternative sectors is expected to be very gradual as the government's programme of import substitution proceeds. This reorientation remains impeded by the continued presence of structural impediments to growth, including a poor investment environment, adverse demographics and labour market participation rates, and high financing costs. The persistence of these constraints provides that growth is not expected to accelerate substantially in 2018.

...as financing constraints remain in place.

The banking sector's near-term stabilisation has been secured due to numerous emergency policy measures. However, despite its recent return to modest profitability, the sector's capacity to finance economic recovery remains severely limited by poor credit quality and high levels of non-performing loans in both the corporate and household sectors. Subdued domestic credit growth is accompanied by limited access to external financing (due in part to sanctions) and this too should restrain growth going forward.

Continued vulnerability to external shocks

Key sources of uncertainty remain oil price dynamics and a possible prolongation of sanctions, while a re-emergence of volatility among emerging markets could also entail adverse spillovers.

Table II.38.1:

Main features of country forecast - RUSSIA

	2015			Annual percentage change						
bn RUB	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	72862.5	100.0	4.2	1.3	0.6	-3.7	**-1.0**	**0.6**	**0.8**
Private Consumption	40167.7	55.1	6.4	4.9	1.2	-9.4	**-4.1**	**0.4**	**0.8**
Public Consumption	15049.7	20.7	1.3	1.1	-0.1	-1.8	**-1.1**	**-0.9**	**-1.0**
Gross fixed capital formation	13702.4	18.8	6.3	0.6	-2.1	-7.8	**-4.5**	**0.7**	**1.1**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	23110.7	31.7	5.2	4.6	-0.1	3.7	**0.5**	**2.1**	**2.1**
Imports (goods and services)	16381.3	22.5	9.4	3.8	-7.9	-25.7	**-4.4**	**1.1**	**1.3**
GNI (GDP deflator)	70462.5	96.7	4.1	0.9	0.9	-3.4	**-0.9**	**0.8**	**1.0**
Contribution to GDP growth: Domestic demand			4.7	2.8	0.2	-6.9	**-3.3**	**0.2**	**0.4**
Inventories			0.1	-1.9	-1.2	-3.1	**1.1**	**0.0**	**0.0**
Net exports			-0.6	0.5	1.8	7.0	**1.1**	**0.4**	**0.4**
Employment			-	-0.2	0.2	-0.7	**-0.3**	**-0.2**	**-0.1**
Unemployment rate (a)			-	5.5	5.2	5.6	**5.7**	**5.7**	**5.6**
Compensation of employees / head			-	-	-	-	**-**	**-**	**-**
Unit labour costs whole economy			-	-	-	-	**-**	**-**	**-**
Real unit labour cost			-	-	-	-	**-**	**-**	**-**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			19.0	5.0	7.2	6.0	**5.3**	**6.3**	**5.4**
Consumer-price index			-	6.8	7.8	15.7	**7.3**	**5.2**	**4.2**
Terms of trade goods			5.1	-6.6	-4.0	-25.9	**-9.1**	**1.0**	**0.0**
Trade balance (goods) (c)			11.7	8.8	10.1	10.8	**9.7**	**10.1**	**10.1**
Current-account balance (c)			7.2	1.6	3.2	5.5	**5.0**	**5.6**	**5.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			7.3	1.6	3.1	5.5	**5.0**	**5.6**	**5.8**
General government balance (c)			-	1.9	1.3	-1.3	**-2.3**	**-2.1**	**-1.6**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			-	14.0	17.1	18.7	**21.4**	**23.3**	**24.5**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.