38. RUSSIAN FEDERATION

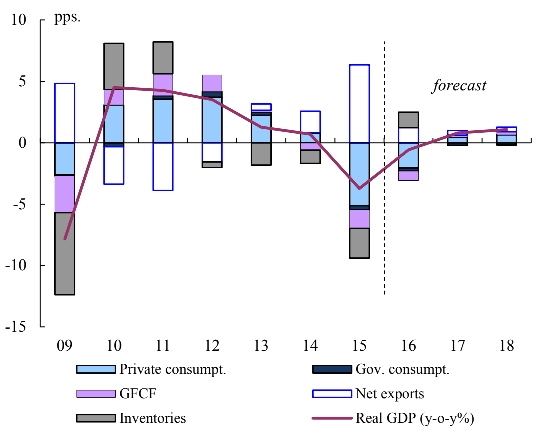
Oil prices rally brings some respite

The outlook for the Russian economy has improved over recent months, driven largely by a stabilisation in oil prices and the rouble exchange rate. Economic activity is expected to return to growth in 2017 and 2018, albeit at a very moderate pace due to ongoing fiscal consolidation efforts and only limited room for monetary policy easing; while persistent structural weaknesses should also limit the scale of the upswing.

The end of recession nears

Russia's economy is slowly emerging from recession, with real GDP growth outturns showing gradual improvement throughout 2016. This recovery has largely resulted from a bottoming-out of domestic demand and a pick-up in exports at the end of 2016. Going forward, growth in domestic demand components is expected to turn somewhat positive in 2017 before accelerating further in 2018, as real incomes recover in line with the rouble's appreciation and falling inflation. The rebound in global oil prices is set to prop up exports and provide a boost to confidence. However, the macroeconomic policy mix is likely to limit the scale of the rebound. Fiscal consolidation is expected to proceed; while the central bank's commitment to lowering inflation implies only limited scope for monetary policy easing in the near term. Overall, GDP growth is estimated to have reached -0.6% in 2016, and should turn positive at 0.8% and 1.1% in 2017 and 2018, respectively.

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



Increasing commodity prices support recovery

Recent improvements among short-term indicators (PMIs, industrial output), driven by the brighter oil prices outlook, underline the gradual turnaround currently under way in the domestic economy. Real wage growth turned positive towards the end of 2016 and is likely to accelerate steadily going forward as inflationary pressures subside. Combined with an expected improvement in consumer sentiment as economic conditions continue to stabilise, this should facilitate a return to modest private consumption growth. Aside from wage growth, however, real disposable income continues to contract, reflecting consumers' reliance on falling real social transfers; while precautionary savings are still increasing. These factors will constrain the scale of the rebound in consumption.

Fixed investment should benefit from improved macroeconomic stability, including the banking sector's return to modest profitability. Nonetheless, ongoing weak demand throughout the domestic economy and relatively high financing costs are set to limit the recovery of investment in the near term. Higher oil prices and new oil extraction capacities coming online should provide some support to exports, while import demand is likely to recover in line with modest increases in domestic demand and a strengthening currency. All in all, the contribution of external trade is set to be positive throughout the forecast horizon.

Fiscal consolidation set to dampen rebound

The rapid decline in oil-related revenues and the shrinking value of the liquid reserves in the past two years necessitates budgetary consolidation in the near term. Despite low public debt levels, access to external financing remains somewhat restricted, while domestic market funding entails high costs for the issuer. Given the anticipated size of revenue shortfalls, existing extra-budgetary funds are forecast to decline further, forcing the authorities to proceed with consolidation on the expenditure side. Budgetary plans announced at the end of 2016 set out fiscal consolidation at the federal level amounting to 1.0 pp. of GDP annually from 2017 onwards. Public expenditure as a share of GDP is forecast to decline throughout this period, compensating further declines in revenues.

The pace of consolidation is subject to uncertainties, including on the one hand possible over-performance of fiscal revenues relative to the government's conservative oil price assumptions (of 40 USD per barrel), but also on the other hand the need to sustain social spending in the run-up to the elections. In light of this, the consolidation of the general government balance is anticipated to be somewhat less ambitious, with the general government deficit falling by 0.3 pps. and 0.6 pps. of GDP in 2017 and 2018, respectively.

Monetary policy likely to ease gradually

The Central Bank of Russia's (CBR) has committed to achieving a 4% inflation target by end-2017, thus limiting scope for rapid monetary easing. Inflation fell consistently during 2016, reflecting negative base effects, strong food harvests and subdued domestic demand. However, high inflation expectations and recent increases in import prices are expected to slow disinflationary pressure; while 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.

Current-account surplus picks up

The current-account surplus, driven mainly by the large surplus on the trade balance of goods is expected to have fallen significantly from over 5% of GDP in 2015 to around 2% of GDP in 2016, principally as a result of lower commodity prices and rouble depreciation. It is forecast to pick up slightly to above 3% of GDP towards the end of the forecast horizon. The increase is driven mainly by an improvement in terms-of-trade and stronger commodities exports. However, higher imports of tourism services are set to raise the deficit of the balance of services.

Continued vulnerability to external shocks

Key sources of uncertainty are linked with oil price dynamics, the evolving nature of geopolitical tensions, and a possible prolongation of sanctions. A re-emergence of volatility (driven by normalisation of monetary policy in the US or changes in global trade policies) among emerging markets could also entail adverse spillovers for the Russian economy.

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	80804.3	100.0	4.2	1.3	0.7	-3.7	**-0.6**	**0.8**	**1.1**
Private Consumption	43663.8	54.0	6.4	4.3	1.5	-9.5	**-3.8**	**0.8**	**1.2**
Public Consumption	15403.4	19.1	1.3	1.4	0.2	-1.8	**-1.3**	**-1.0**	**-1.0**
Gross fixed capital formation	17100.0	21.2	6.3	0.8	-3.0	-7.3	**-3.6**	**0.9**	**1.2**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	23863.0	29.5	5.2	4.6	0.6	3.6	**0.9**	**2.5**	**2.8**
Imports (goods and services)	17135.5	21.2	9.4	3.6	-7.6	-25.7	**-4.6**	**1.5**	**1.9**
GNI (GDP deflator)	78504.3	97.2	4.1	0.8	1.0	-3.3	**-1.3**	**0.8**	**1.2**
Contribution to GDP growth: Domestic demand			4.7	2.7	0.3	-7.0	**-3.1**	**0.4**	**0.7**
Inventories			0.1	-1.8	-1.1	-2.4	**1.3**	**0.0**	**0.0**
Net exports			-0.6	0.5	1.7	6.4	**1.2**	**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	4.8	9.0	7.7	**3.2**	**6.6**	**4.3**
Consumer-price index			-	6.8	7.8	15.5	**7.2**	**5.2**	**4.4**
Terms of trade goods			5.1	-6.6	-4.5	-24.2	**-11.7**	**7.4**	**0.0**
Trade balance (goods) (c)			11.7	8.2	9.3	11.1	**9.3**	**10.0**	**10.1**
Current-account balance (c)			7.2	1.4	2.8	5.2	**1.9**	**2.9**	**3.1**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			7.3	1.4	2.8	5.2	**1.9**	**2.9**	**3.1**
General government balance (c)			-	-0.2	-1.0	-2.7	**-3.8**	**-3.5**	**-2.9**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			-	13.1	15.9	16.4	**16.9**	**17.0**	**17.7**

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