38. RUSSIAN FEDERATION
Slowly emerging from the doldrums

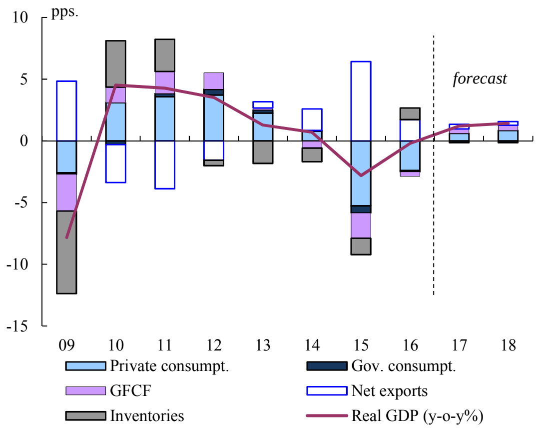
The economic situation in Russia has been gradually improving, as domestic demand has bottomed out amid a strengthening currency and falling inflation. The rebound is set to firm over the forecast horizon, driven by oil price stabilisation, albeit at a moderate pace, as fiscal consolidation and structural barriers are likely to limit the scale of the upswing.

Economic activity recovers moderately

The recovery in Russia has been taking hold throughout 2016, with real GDP growth moving into positive territory in the last quarter of the year. The rebound has resulted from a bottoming-out of domestic demand and strengthening exports, both driven by the recovering oil prices.

Going forward, increasing private consumption is set to fuel growth, as the appreciating currency limits inflation and boosts real incomes. The recovery in the global economy and stabilising oil prices are expected to lift exports and business confidence, while falling inflation allows for some monetary easing. However, fiscal consolidation is expected to proceed, despite risks of expenditure increase related to the electoral cycle. Overall, GDP growth is estimated at -0.2% in 2016, and should accelerate to 1.2% and 1.4% in 2017 and 2018, respectively.

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



Domestic demand picks up

Short-term indicators indicate that the recovery is firming, driven by the stabilising oil prices and improving confidence. Real wage growth is expected to accelerate gradually as inflationary pressures subside. After a slump of 15% over 2015-2016, private consumption is set to recover amid improving consumer sentiment, increasing real wages and indexation of pension payments that are expected to boost real disposable incomes. The scale of this pick-up is likely to be constrained by the continued increase of savings, driven by high real interest rates, and weak consumer credit growth.

Lower inflation, gradually increasing demand throughout the economy and increasing profitability of the corporate sector are expected to boost business confidence and support fixed investment, despite limited supply of corporate credit and its relatively high costs.

Stabilising oil prices and gradual recovery among trading partners should also provide some support to export growth, while import demand is set to accelerate reflecting the scale of pent-up demand for imported goods and an appreciating currency. All in all, the contribution of net exports is set to be marginally positive throughout the forecast horizon.

Diversification of the economy and medium term growth are hindered by structural factors

The economy's reliance on the oil and gas sector remains significant, despite the authorities' programme of import substitution and the past currency depreciation. Revival of the non-extractive industries and diversification towards new export destinations (China, rest of Asia) was, however, hindered by structural obstacles including a poor investment climate, high financing costs, labour market rigidities and weak competition in key sectors of the economy. These barriers limit medium-term growth prospects, as well.

Fiscal policy expected to be a drag on growth

The sharp increase in the budget deficit to 3.7% of GDP in 2016, amid rapid decline in oil-related revenues and shrinking value of the reserve funds triggered budgetary consolidation. Introduction of a temporary fiscal rule is likely to allow for a gradual replenishment of the reserves, but it should not have a direct impact on the size of the deficit. Budgetary plans set out fiscal consolidation at the federal level amounting to 1.0 pp. of GDP annually until 2019, though their implementation is subject to uncertainties, in particular given the need to sustain expenditure on social transfers during the electoral cycle. In light of this, consolidation is anticipated to be somewhat less ambitious, with the general government deficit falling by 0.7 pps. and 0.6 pps. of GDP in 2017 and 2018, respectively.

Falling inflation enables a gradual easing of monetary policy

Inflation has fallen below 5% in the beginning of 2017 from double digit figures in 2015/2016, reflecting an appreciating currency, subdued domestic demand and the recent reduction in inflation expectations. However, rising producer prices, increases in excise duties and rebounding domestic demand are major risks to further disinflation, constraining the space for rapid monetary policy easing. Therefore, the monetary policy of the Central Bank of Russia's (CBR), which has committed to achieving a 4% inflation target by end-2017, remains cautious with the recent cuts of the headline interest rate by 75 basis points, to 9.25%.

Current account surplus increases

The current account surplus has fallen to 1.9% of GDP in 2016, as a result of lower commodity revenues. It is forecast to pick up to almost 4% of GDP towards the end of the forecast horizon. The improvement is driven mainly by a terms-of-trade improvement and stronger commodities exports.

Risks are broadly balanced

Key sources of uncertainty are linked with oil price dynamics and geopolitical tensions and represent the primary downside risk to this forecast: while a stronger recovery of consumer confidence and higher social spending before the presidential elections in 2018 are the major upside risks.

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	81197.1	100.0	4.2	1.3	0.7	-2.8	**-0.2**	**1.2**	**1.4**
Private Consumption	43536.8	53.6	6.4	4.3	1.5	-9.8	**-4.5**	**1.1**	**1.6**
Public Consumption	15197.2	18.7	1.3	1.4	0.2	-3.1	**-0.5**	**-0.7**	**-0.8**
Gross fixed capital formation	16636.8	20.5	6.3	0.8	-3.0	-9.9	**-1.8**	**1.7**	**2.0**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	23914.1	29.5	5.2	4.6	0.6	3.7	**3.1**	**3.3**	**3.6**
Imports (goods and services)	17278.1	21.3	9.4	3.6	-7.6	-25.8	**-3.8**	**2.3**	**3.4**
GNI (GDP deflator)	79048.0	97.4	4.1	0.8	1.0	-2.2	**-0.2**	**1.2**	**1.4**
Contribution to GDP growth: Domestic demand			4.7	2.7	0.3	-7.9	**-2.9**	**0.8**	**1.1**
Inventories			0.1	-1.8	-1.1	-1.3	**0.9**	**0.0**	**0.0**
Net exports			-0.6	0.5	1.7	6.4	**1.7**	**0.4**	**0.3**
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	7.2	**2.0**	**6.6**	**3.9**
Consumer-price index			-	6.8	7.8	15.5	**7.2**	**4.4**	**4.0**
Terms of trade goods			5.1	-6.6	-4.5	-23.4	**-19.2**	**12.2**	**-0.2**
Trade balance (goods) (c)			11.7	8.2	9.3	10.8	**7.3**	**8.8**	**8.9**
Current-account balance (c)			7.2	1.4	2.8	4.9	**1.9**	**3.6**	**3.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			7.3	1.4	2.8	4.9	**1.9**	**3.6**	**3.7**
General government balance (c)			-	-0.2	-1.0	-2.7	**-3.7**	**-3.0**	**-2.4**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			-	13.1	15.9	16.3	**16.7**	**16.2**	**16.5**

(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.