38. RUSSIAN FEDERATION

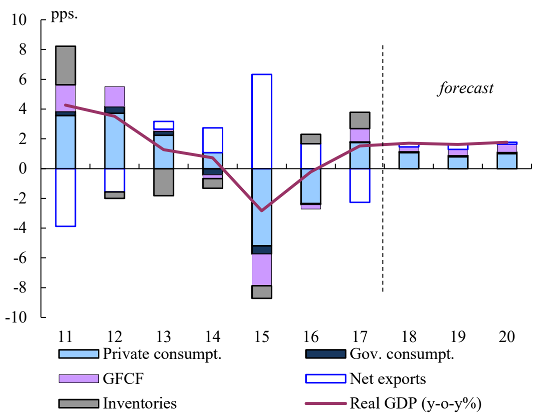
Higher oil revenues and public investments support growth

The economic recovery has been progressing gradually as authorities were pursuing tight monetary and fiscal policies and using the more benign external environment to rebuild buffers and increase resilience to macroeconomic shocks. This is likely to change going forward, as fiscal and structural reforms are being introduced and the government is more likely to use the current oil price surge to boost public spending and economic activity.

Recovery in the oil market buoys growth

Economic activity in Russia rebounded marginally after a weak end of 2017, with real GDP growth rising from 0.9% (y-o-y) in 2017-Q4 to 1.9% (y-o-y) in 2018-Q2. Domestic demand edged down as recent bouts of US sanctions undermined investor confidence and investments, though private consumption remained resilient driven by rising disposable incomes and increasing credit supply.

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



Going forward, higher oil prices are set to boost domestic demand. At the same time increasing oil output and depreciating currency should support foreign trade, though increased uncertainty and higher financing costs related to the deteriorating geopolitical situation and ongoing turmoil in emerging markets are likely to undermine the scale of the recovery. All in all, real GDP is forecast to increase by 1.7% in 2018 and growth is expected to edge down to 1.6% in 2019, reflecting an increased tax burden, subdued productivity growth and growing disintegration from global value chains and financial markets. Economic activity is set to rebound towards the end of the forecast horizon, with real GDP growth accelerating to 1.8% in 2020, reflecting higher infrastructure spending and a positive, albeit marginal, pension-reform-driven improvement in the potential growth.

Public spending boosts investments

Higher consumption taxes, rising retirement age and limited increases in pensions and public sector wages are likely to dent private consumption outlook, despite rising real wages in the private sector. Higher corporate credit growth is likely to support private investment outlays, though increased uncertainty related to the sanctions and declining global investors' risk appetite cloud the outlook. However, significant public investments into transport and energy infrastructure are likely to materialise in the second half of 2019 and thereafter boosting overall investment growth rates.

On the external side, import growth is likely to decelerate rapidly from double digit growth in 2017 reflecting much weaker currency, before recovering somewhat in the outer year of the projection amid a pick-up in public investments. Export growth is set to remain robust as oil production cuts agreed with OPEC have been relaxed and oil and gas production is booming. All-in-all, the contribution of external trade to real GDP growth is forecast to turn marginally positive over the forecast horizon.

Rapid fiscal consolidation is over

Headline inflation increased to 3.4% in September 2018, driven by rebounding food prices and weakening currency. Going forward, inflation is expected to pick up to around 5% in 2019 on the back of VAT rate hike, weaker currency and increasing inflation expectations, before subsiding to the central bank target of 4% in 2020. Heightened uncertainty about sanctions, elevated inflation expectations and a planned increase in the VAT rate prompted the central bank in September 2018 to raise the key policy rate by 25 bps to 7.5%.

On the fiscal side, higher oil and gas revenues are set to result in an improvement from a deficit of 1.5% of GDP in 2017 to a surplus of 1.8% of GDP in 2018. Rapid fiscal consolidation is likely to end in the outer years of the forecast horizon as additional spending into infrastructure, human capital and social support kicks in in 2019. Higher expenditures are projected to be partly funded by increased VAT rates and some relaxation of the fiscal rule allowing for higher market borrowing. The increase in the pension age to 65/60 for men/women should also bring some fiscal savings already in 2019. All in all, the fiscal balance is likely to remain in surplus of around 1.5% of GDP towards the end of the forecast horizon.

Current account surpluses boom amid higher oil and gas revenues

Current account surplus is set to improve significantly from 2.2% of GDP in 2017 to 5.6% of GDP in 2018 amid increasing oil and gas exports, booming oil prices and higher exports of other commodities (e.g. wheat, metals). It is set to gradually shrink over the forecast horizon to 4.9% of GDP in 2020, as a pick-up in public investments is expected to support imports.

Structural reform agenda progresses but major challenges are still unaddressed

Despite the recent rise in the retirement age and the announced increases in infrastructure and human capital spending, which should boost potential growth, the prospects of a significant acceleration in long-term growth are bleak. They are impeded by rapidly aging population, shrinking labour force, extreme geographical and social inequalities limiting the size of the domestic market, increasing reach of the State, heavy concentration in many sectors and a policy aimed at decoupling from the external world.

Global risks remain at the front

Risks to the forecast are broadly balanced. High geopolitical uncertainty and the prospect of further intensification of economic sanctions remain key downside risks to the outlook. In addition, domestic financial conditions might be affected by the stronger USD and outflows of foreign capital if the ongoing turmoil in emerging markets deepens. The major risks on the upside relate to higher oil prices and higher-than-assumed fiscal multipliers from the announced public investment spending surge.

Table II.38.1:

Main features of country forecast - RUSSIA

	2017			Annual percentage change						
bn RUB	Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP	92719.5	100.0	4.6	-2.8	-0.2	1.5	**1.7**	**1.6**	**1.8**
Private Consumption	47472.4	51.2	6.8	-9.7	-4.5	3.4	**2.1**	**1.6**	**2.0**
Public Consumption	16189.2	17.5	1.4	-3.1	-0.5	0.4	**0.5**	**0.6**	**0.6**
Gross fixed capital formation	18570.3	20.0	7.8	-10.4	-1.4	4.3	**1.5**	**2.0**	**2.7**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	23885.3	25.8	5.5	3.7	3.1	5.1	**5.2**	**4.0**	**4.0**
Imports (goods and services)	19115.2	20.6	10.5	-25.8	-3.8	17.4	**5.4**	**4.0**	**4.7**
GNI (GDP deflator)	91012.7	98.2	4.7	-2.2	-0.3	2.4	**1.8**	**1.7**	**1.8**
Contribution to GDP growth: Domestic demand			5.1	-7.9	-2.7	2.7	**1.5**	**1.3**	**1.6**
Inventories			0.3	-0.8	0.6	1.1	**0.0**	**0.0**	**0.0**
Net exports			-0.7	6.3	1.7	-2.3	**0.2**	**0.3**	**0.1**
Employment			1.3	1.1	-2.1	0.1	**0.1**	**0.1**	**0.1**
Unemployment rate (a)			7.6	3.9	5.7	5.4	**5.2**	**4.9**	**4.6**
Compensation of employees / head			-	-	-	-	**-**	**-**	**-**
Unit labour costs whole economy			-	-	-	-	**-**	**-**	**-**
Real unit labour cost			-	-	-	-	**-**	**-**	**-**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			17.8	8.2	3.6	6.1	**6.3**	**4.2**	**3.6**
Consumer-price index			-	15.5	7.1	3.7	**3.0**	**5.0**	**4.0**
Terms of trade goods			5.3	-24.0	-18.2	12.0	**10.9**	**-2.4**	**-0.5**
Trade balance (goods) (c)			12.1	10.7	7.0	7.2	**10.3**	**10.0**	**9.7**
Current-account balance (c)			7.4	4.9	2.0	2.2	**5.6**	**5.2**	**4.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			7.3	4.9	2.0	2.2	**5.6**	**5.2**	**4.9**
General government balance (c)			-	-1.8	-3.3	-1.5	**1.8**	**1.7**	**1.5**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			24.7	15.9	16.3	15.3	**14.3**	**14.4**	**15.0**

(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.