38. RUSSIAN FEDERATION

Moderate recovery supported by rising oil prices

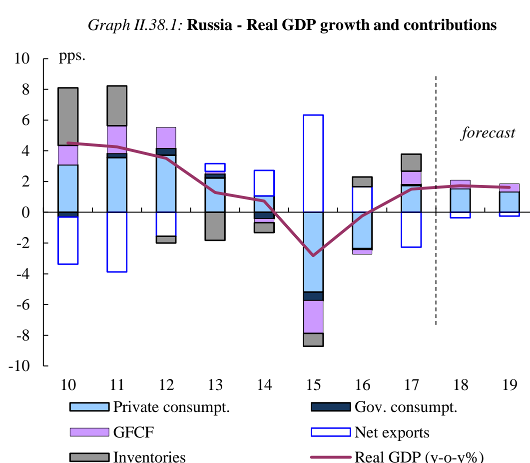
The effects of higher oil prices recirculate through the economy fuelling the recovery, while at the same time higher oil-revenues help to replenish fiscal buffers. Improved confidence, contained inflation and accommodative monetary policy are set to support domestic demand in the near term, although structural bottlenecks hamper stronger rebound.

Recovery held down by temporary factors

The economic activity in Russia expanded by 1.5% in 2017 as a whole as firming oil prices and falling inflation supported domestic demand. However, the economic activity has been lacklustre towards the end of 2017, with real GDP growth decelerating from 2.2% (y-o-y) in 2017-Q3 to 0.9% (y-o-y) in 2017-Q4. Domestic demand remained robust, driven by rising business and consumer confidence and increasing credit supply. Yet it led to a rapid expansion of imports, not least on the back of the appreciation of the national currency. Consequently, net exports and destocking contributed negatively to the country's GDP.

Going forward, the impact of higher oil prices recirculating throughout the economy is likely to further support domestic demand and thereby GDP which is expected to grow by 1.7% in 2018. Growth is expected to edge down slightly to 1.6% in the outer year of the forecast horizon, reflecting subdued productivity growth and lingering effects of sanctions.

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



Domestic demand still the main growth engine

After three years of declines, disposable incomes are expected to start increasing moderately driven by growing real wages and indexation of public employees' salaries. Rising disposable incomes and continued rebound in consumption credit are forecast to support private consumption spending, while public consumption growth is set to be lacklustre due to ongoing fiscal consolidation.

Gradual loosening of monetary policy, growing domestic demand and improving business sentiment are likely to fuel investment spending, as after several years of falling capital spending and increasing capacity utilisation the depleted capital stock requires significant replacement investment. Growth is set to be moderate, however, as the investment cycle of large infrastructure projects nears the end and weak business environment limits the attractiveness of investment outside of the energy sector.

On the external side, import growth is likely to decelerate, after rising by 17.4% in 2017, as exchange rate stabilises and pent-up demand is gradually saturated. Export growth is set to be contained as a result of oil production cuts agreed with OPEC and weaker price competitiveness of non-energy exports. All-in-all, the contribution of external trade to the real GDP growth is forecast to narrow compared to the very negative contribution of -2.3 pps. in 2017 but remain moderately negative over the forecast horizon. Decelerating import growth together with improving terms-of-trade are set to raise current account surplus to 3% of GDP in 2018, though it should shrink back to around 2½% of GDP in the outer year of the projection.

Monetary policy easing cycle comes to an end

Headline inflation fell to 2.3% in March 2018, well below the central bank target of 4%, driven by prolonged slowdown in food price inflation, flat regulated fuel and utilities prices and previous currency appreciation. Going forward, inflation is expected to pick up to around 4% reflecting a stabilising currency and strong wage growth. Still, the central bank's estimated target interest rate of

6%-7% gives some space for some monetary policy easing from the current level (7.25%).

On the fiscal side, higher oil prices, stronger growth and improved tax collection resulted in a sizable improvement in the budget deficit from 3.3% of GDP in 2016 to 1.6% of GDP in 2017. Going forward, higher oil prices will help to replenish off-budget reserves. The budget balance is likely to reach surplus at the end of the forecast horizon, driven mainly by higher budget revenues amid moderate consolidation on the expenditure side.

Stabilisation policies reinforced but structural bottlenecks persist

The revised budget rule came into force in 2018 and set spending of oil and gas revenues according to a ceiling of USD 40 per barrel (rising 2% annually in line with US inflation), with receipts above this level saved in the National Wealth Fund. The rule, coupled with the inflation targeting regime, is likely to reduce the dependence of the Russian economy and public finances on global oil market cycles in the medium term, allowing Russian authorities more room to run macroeconomic stabilisation policies.

Diversification of the economy away from the extractive industries and related sectors (banking, transportation) is, however, progressing very slowly. Higher oil prices diminished the necessity to ease long-standing growth bottlenecks (poor business environment, low investment, labour market rigidities) that hamper the development of non-energy related industrial branches and result in potential growth hovering around 1½%. At the same time, appreciating currency dented part of previous cost competitiveness gains in the manufacturing sector.

The recent US sanctions are expected to weigh further on medium- and long-term growth prospects, most notably via increasing uncertainty in financial markets, hampering access to external finance and severing trade links.

Major risks remain

Uncertainties surrounding the geopolitical situation and the impact of the recent US sanctions on investors' confidence remain the key downside risk facing the economic outlook for Russia, while higher oil prices and stronger wage growth are the major upside risks for the growth outlook.

Table II.38.1

Main features of country forecast - RUSSIA

	2016		Annual percentage change						
	bn RUB Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP	86043.6	100.0	4.2	0.7	-2.8	-0.2	**1.5**	**1.7**	**1.6**
Private Consumption	44273.3	51.5	6.4	2.0	-9.7	-4.5	**3.4**	**3.0**	**2.6**
Public Consumption	15549.4	18.1	1.6	-2.1	-3.1	-0.5	**0.4**	**0.0**	**0.0**
Gross fixed capital formation	17169.5	20.0	7.0	-1.3	-10.4	-1.4	**4.3**	**2.8**	**2.6**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	22124.4	25.7	5.6	0.5	3.7	3.1	**5.1**	**4.6**	**4.2**
Imports (goods and services)	17685.8	20.6	9.7	-7.3	-25.8	-3.8	**17.4**	**7.5**	**6.4**
GNI (GDP deflator)	83763.6	97.4	4.1	1.1	-2.2	-0.3	**2.4**	**1.8**	**1.7**
Contribution to GDP growth: Domestic demand			4.9	0.4	-7.9	-2.7	**2.7**	**2.1**	**1.9**
Inventories			-0.1	-0.6	-0.8	0.6	**1.1**	**0.0**	**0.0**
Net exports			-0.5	1.7	6.3	1.7	**-2.3**	**-0.4**	**-0.2**
Employment			-	0.2	1.1	-2.1	**0.1**	**0.1**	**0.1**
Unemployment rate (a)			8.1	5.2	3.9	5.7	**5.4**	**5.2**	**4.9**
Compensation of employees / head			-	-	-	-	**-**	**-**	**-**
Unit labour costs whole economy			-	-	-	-	**-**	**-**	**-**
Real unit labour cost			-	-	-	-	**-**	**-**	**-**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			18.3	10.7	8.2	3.6	**6.1**	**4.8**	**3.8**
Consumer-price index			-	7.8	15.5	7.1	**3.7**	**3.7**	**4.0**
Terms of trade goods			5.3	-4.7	-24.0	-18.2	**12.0**	**4.9**	**0.0**
Trade balance (goods) (c)			12.0	9.0	10.7	7.0	**7.2**	**7.9**	**7.6**
Current-account balance (c)			7.3	2.6	4.9	2.0	**2.2**	**3.0**	**2.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			7.4	2.6	4.9	2.0	**2.2**	**3.0**	**2.6**
General government balance (c)			-	-2.3	-1.8	-3.3	**-1.6**	**-0.6**	**0.1**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			-	15.6	15.9	16.3	**15.4**	**13.8**	**11.8**

(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.