38. RUSSIAN FEDERATION

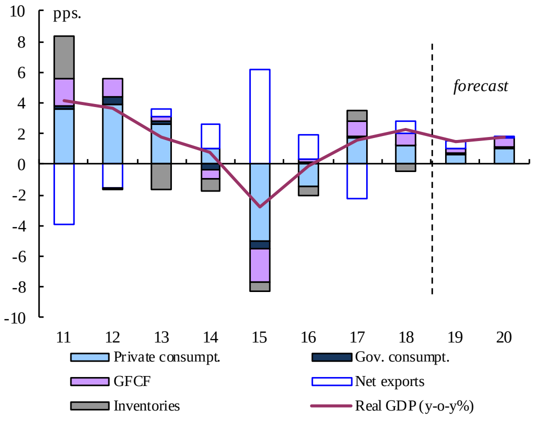
Output likely to recover from a temporary blip in 2019 as public spending accelerates

Since 2014 Russia's macroeconomic policy mix was relatively tight reflecting authorities conscious choice to rebuild buffers and increase resilience to external shocks at the expense of consumer incomes, productivity and growth. This policy is gradually being modified, as some fiscal and structural reforms are being introduced and the government is more likely to boost public spending leading to a moderate growth rebound towards the end of the forecast horizon.

Unexpectedly strong growth in 2018 was a temporary phenomenon

The economic activity in Russia surprised on the upside towards the end of 2018, with real GDP growth accelerating from 2.2% y-o-y in Q3-2018 to 2.7% y-o-y in Q4-2018. Domestic demand picked up due to a significant revision of construction data as a number of large-scale projects (e.g. Yamal LNG terminal), including state-controlled ones, were completed. Real GDP is estimated to have expanded by 2.3% in 2018 as a whole. The expansion was underpinned by robust oil and gas production and a strong pick-up in hydrocarbon related investment. At the same time depreciating currency and weakening private consumption dented imports.

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



Robust 2018 growth is unlikely to be repeated in the near term as potential growth remains subdued and economic activity is set to be dampened by a confluence of domestic and external headwinds. On the domestic side, lower oil prices and accelerating inflation are set to impinge on domestic demand while increased uncertainty and higher financing costs are likely to hamper investments. On the external side, export is likely to be hindered by lower hydrocarbon production and weaker external demand. Overall, real GDP growth is forecast to decelerate to 1.5% in 2019. Growth is expected to edge up to 1.8% in 2020, reflecting higher public investment spending and a marginal improvement in potential growth as retirement age is being gradually increased.

Public and energy sector investments support growth

Private consumption growth is likely to decelerate in the near term, despite rising credit, as lower nominal wage growth, higher inflation and higher consumption tax burden are projected to dent real disposable incomes. Elevated uncertainty related to the deteriorating geopolitical situation and higher financing costs are likely to undermine private investment outlook. At the same time, the authorities have announced a significant investment program, including comprehensive plan for modernisation and expansion of infrastructure, with the total spending envelope (including social and education spending) of ca. 1% of GDP annually for the next 6 years. These plans, which will be implemented from the second half of 2019, are expected to boost public consumption and investment spending.

On the external side, import growth is likely to decelerate further reflecting weaker domestic demand outlook, before recovering somewhat in the outer year of the projection amid a pick-up in public investment. In the near term, export growth is likely to be muted reflecting voluntary cuts in oil production and slowing food exports due to weak 2018 harvest. This is set to be partly counterbalanced by higher gas sales driven by the construction of the major LNG facility. In the medium term, the completion of new gas transmission infrastructure linking Russia with China should further boost non-oil exports. All in all, the contribution of external trade to real GDP growth is forecast to remain marginally positive over the forecast horizon.

Macroeconomic policy to become more accommodative in 2020

Headline inflation increased to 5.2% y-o-y in February 2019, driven by base effects from the exchange rate depreciation and the recent increase in the VAT tax rate. Going forward, annual average inflation is set to climb temporarily above 5% in 2019 on the back of a consumption tax rate hike, weaker currency and elevated inflation expectations. It is forecast to decline to the central bank target of 4% in 2020. The central bank lifted the main interest rate to 7¾% in December 2018, though turned more dovish in its forward guidance in Q1-2019 amid lower pass-through from VAT hike to inflation and a more dovish Fed stance.

On the fiscal side, higher hydrocarbon-related revenues and improved tax collection resulted in an improvement from a deficit of 1.5% of GDP in 2017 to a surplus of 2.7% of GDP in 2018. Despite significant additional spending into infrastructure, human capital and social support, fiscal surplus is projected to decline gradually to around 2% of GDP in 2020. At the same time, off-budget fiscal buffers are set to be rebuilt further as public spending is expected to be funded by additional borrowing and pension-reform-related savings.

Hydrocarbon revenues support current account

After a more-than-decade high of 6.8% of GDP in 2018 the current account surplus is expected to moderate a bit in 2019, amid lower oil exports volumes and prices. It is projected to further shrink in 2020 to around 5% of GDP, as a pick-up in public investments is forecast to fuel a rebound in imports, while annual average oil prices are assumed to remain below 2018 levels.

Risks to the forecast are broadly balanced

Major downside risks to the outlook include high geopolitical uncertainty and the prospect of further intensification of economic sanctions, which would impinge on business spending. In addition, lower than expected oil prices would affect the exchange rate, external funding costs and foreign trade. 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	92037.2	100.0	4.7	-2.8	-0.1	1.5	**2.3**	**1.5**	**1.8**
Private Consumption	48213.8	52.4	6.8	-9.3	-2.8	3.3	**2.3**	**1.2**	**2.0**
Public Consumption	16548.9	18.0	1.3	-3.1	0.9	0.4	**0.3**	**0.6**	**0.6**
Gross fixed capital formation	19372.4	21.0	7.8	-10.5	0.8	4.7	**3.4**	**1.6**	**2.8**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	23966.1	26.0	5.5	3.7	3.2	5.1	**5.6**	**2.7**	**3.5**
Imports (goods and services)	19041.1	20.7	10.5	-25.1	-3.6	17.4	**3.2**	**1.9**	**4.5**
GNI (GDP deflator)	89793.9	97.6	4.7	-2.2	-0.1	1.8	**2.4**	**1.5**	**1.8**
Contribution to GDP growth: Domestic demand			5.2	-7.7	-1.2	2.8	**2.0**	**1.0**	**1.7**
Inventories			0.3	-0.6	-0.6	0.7	**-0.5**	**0.0**	**0.0**
Net exports			-0.7	6.2	1.6	-2.3	**0.8**	**0.5**	**0.1**
Employment			1.3	1.1	-0.6	0.0	**0.0**	**-0.2**	**-0.1**
Unemployment rate (a)			7.6	3.9	4.3	4.1	**4.0**	**4.0**	**3.9**
Compensation of employees / head			-	-	-	-	**-**	**-**	**-**
Unit labour costs whole economy			-	-	-	-	**-**	**-**	**-**
Real unit labour cost			-	-	-	-	**-**	**-**	**-**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			17.6	8.4	3.4	5.2	**7.5**	**3.4**	**3.6**
Consumer-price index			-	15.5	7.0	3.7	**2.9**	**5.2**	**4.0**
Terms of trade goods			5.3	-23.0	-17.9	12.9	**15.9**	**-4.9**	**-0.5**
Trade balance (goods) (c)			12.0	10.7	7.0	7.3	**11.8**	**10.7**	**10.3**
Current-account balance (c)			7.3	4.9	2.0	1.8	**6.8**	**5.5**	**5.0**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			7.2	4.9	2.0	1.8	**6.8**	**5.5**	**5.0**
General government balance (c)			-	-1.8	-3.7	-1.5	**2.7**	**2.6**	**2.1**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			24.4	15.9	16.2	15.1	**13.0**	**13.1**	**13.4**

(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.