RUSSIA

After two years of recession, the economy will return to growth in 2017, as higher real wages boost private consumption and lower interest rate support investment. However, structural bottlenecks continue to hinder further diversification of the economy. The strength of the recovery will also remain dependent on the rebound of oil prices. The poverty rate, which increased from 11% in 2014 to 13% in 2015, will progressively decline as the labour market strengthens and inflation slows down.

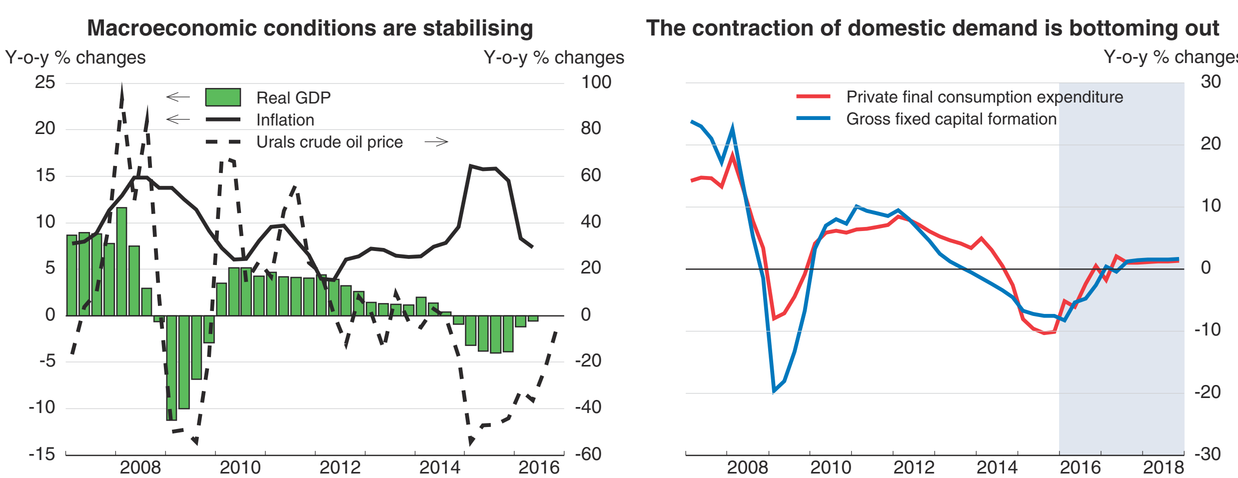
Tight monetary policy has successfully brought down inflation, and now can be eased further to support the recovery, especially investment. Fiscal policy has been rightly accommodative during the recession. Fiscal consolidation plans for 2017 and 2018 aim at reducing the headline deficit by about 1% of GDP per year on average. A less tight fiscal policy is projected, as considerable economic slack remains and the electoral cycle may push up public spending.

Public investment needs in education, innovation and infrastructures are high, and meeting them will be essential to boost growth and ensure that all Russians benefit from rising prosperity. However, by themselves, oil revenues can no longer be counted on. Additional revenue should be raised with reforms to the VAT, the taxation of state-owned enterprises, higher taxation on the hydrocarbon sector and higher excise taxes. Over the medium term, re-establishing fiscal rules that limit the pro-cyclical use of oil revenue would contribute to raise fiscal room for bad times.

On the road to recovery

The recession is bottoming out as oil prices have rebounded since the beginning of the year and the rouble has stabilised. The stronger rouble has contributed to bring inflation down close to its pre-crisis level. Business activity has resumed, as evidenced by positive industrial production growth, after 13 months of consecutive contraction. The purchasing managers index has also returned to expansionary territory, suggesting stronger business confidence.

Russia



Source: OECD Economic Outlook 100 database; and Thomson Reuters.

StatLink http://dx.doi.org/10.1787/888933437885

Russia: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices RUB trillion	Percentage changes, volume (2011 prices)				
GDP at market prices	71.0	0.7	-3.7	-0.8	0.8	1.0
Private consumption	38.3	1.5	-9.5	-3.4	0.5	1.2
Government consumption	14.0	0.2	-1.8	-1.7	-1.5	-1.3
Gross fixed capital formation	13.9	-3.0	-7.3	-5.3	0.7	1.5
Final domestic demand	66.2	0.2	-7.5	-3.1	0.0	0.0
Stockbuilding[1]	0.8	-1.1	-2.4	2.0	0.4	0.0
Total domestic demand	67.0	-1.0	-10.1	-1.4	0.5	0.8
Exports of goods and services	18.9	0.6	3.6	0.6	3.0	3.2
Imports of goods and services	14.9	-7.6	-25.7	-5.4	2.6	2.7
Net exports[1]	4.0	1.7	6.4	1.3	0.3	0.3
Memorandum items						
GDP deflator	_	9.0	7.7	5.9	6.9	6.2
Consumer price index	_	7.8	15.5	7.2	5.9	5.0
Private consumption deflator	_	7.7	15.2	10.1	6.4	5.4
General government financial balance[2,3]	_	-1.1	-2.4	-3.5	-3.0	-2.3
Current account balance[2]	_	2.8	5.2	3.0	4.2	5.2

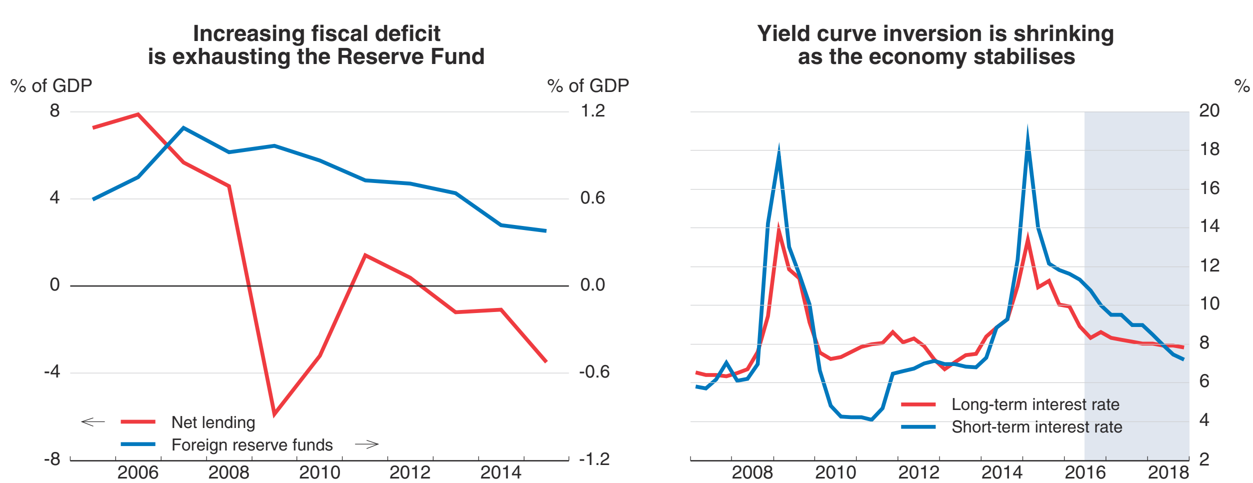
1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
3. Consolidated budget.

Source: OECD Economic Outlook 100 database.

StatLink http://dx.doi.org/10.1787/888933439282

However, the foundations for a solid recovery are still fragile. Real wage growth has turned positive and fuelled private consumption for workers, but, overall, real incomes have continued to fall, due notably to a partial indexation of pensions and a nominal freeze of income for specific categories (public-sector workers and pensioners who work).

Russia



Source: OECD Economic Outlook 100 database; and Thomson Reuters.

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The high level of capacity utilisation and profit margins have provided incentives for investment, but restricted access to international financial markets and high uncertainty continue to weigh on firms' decisions. This is especially the case for firms with foreign participation, which account for about a quarter of total fixed investment in manufacturing and trade sectors.

Export growth has been modest, as the rouble has slightly appreciated since March and a deterioration in the business climate (including high uncertainty, corruption and administrative burdens) combined with the high cost of imported investment goods and transport bottlenecks have limited the potential for diversification. Exports have been more dynamic in the chemical industry, and the mining and machine building sectors. The agriculture sector has also benefited from higher prices due to counter-sanctions measures.

Fiscal and monetary policy should be eased further

Expansionary fiscal policy has been appropriate given economic slack but the fiscal deficit has risen to 3.5% of GDP. The financing of the deficit through the Reserve Fund is not sustainable, as the Fund is expected to be exhausted by 2018. At the same time, the ambitious fiscal consolidation plan for 2017-2020, implying a freeze of nominal spending and a decline of the fiscal deficit by 1 percentage point of GDP per year, might delay the recovery. Fiscal policy is projected to be less stringent than planned in 2017-18. An important challenge for Russia is to find fiscal room in the new environment of lower oil prices.

Fiscal space could be found by issuing government bonds to take advantage of low interest rates and the very low level of public debt (18% of GDP). Measures to tackle the grey economy and to raise non-oil taxation, especially excise taxes, environmental taxes and VAT, would raise revenue on a sustainable basis. Regarding spending, the large subsidies to state-owned enterprises should be curtailed in favour of spending on education and health. In the medium term, re-establishing the three-year expenditure framework and the expenditure rule, both recently suspended, would limit pro-cyclical spending.

Monetary policy has been tight, and inflation has fallen from 15% at end-2015 to 6% in September 2016. Inflationary pressures have fallen with the stabilisation of the rouble, and hence the central bank should be ready to ease its stance as inflation expectations decline. Large liquidity inflows to state-owned enterprises and banks during the recession have resulted in fast credit growth and an increasing share of non-performing loans that now require attention.

The strength of the recovery will be limited by the lack of structural reforms

Economic growth is projected to turn positive at the end of 2016 and to slightly accelerate over the next two years as the macroeconomic environment improves further. Lower inflation and stronger wage increases, on the back of stronger business activity, will support consumption growth and business confidence. The assumed stabilised exchange rate and lower interest rates will boost investment. Export growth will rise on the back of a still weak rouble and stronger world trade. However, this boost will remain moderate as the lack of structural reforms and a poor business climate impede diversification. The rise in the poverty rate is expected to stabilise as growth accelerates at the end of the projection period.

The projections assume a stabilisation of oil prices at the level observed in mid-November. Upside risks are associated with stronger export growth than projected and the possible firming of oil prices if the major oil producing countries manage to limit supply. The projection also assumes renewed economic sanctions and no major structural reforms. An easing of sanctions would improve the business climate and potential growth. A stronger slowdown in China would weigh on exports and the normalisation of US monetary policy comes with the risk of renewed rouble depreciation and another burst of inflation.