RUSSIA

Highlights

- **Russia faced a recession in the first half of 2015, driven by low oil prices and Western sanctions and exacerbated by long-standing structural weaknesses.** GDP growth decelerated from 0.6 per cent in 2014 to -3.4 per cent in the first half of 2015, mainly due to a sharp contraction in consumption. Private investment is also constrained by weak confidence, high domestic funding costs and lack of access to foreign capital markets.
- **Monetary and fiscal policies have been effective at stabilising macroeconomic balances.** Transition to a free-floating exchange rate regime helped preserve international reserves, while the sharp tightening of policy during excessive rouble volatility in December 2014, together with capital and regulatory support for the banking system built up confidence, supporting later monetary easing. Nevertheless, despite a higher fiscal deficit in 2015, policies could not prevent a deep compression of domestic demand.
- **Long-term growth prospects are weak without supply-side reforms.** The government's efforts to improve the business climate and access to finance for small and medium-sized enterprises (SMEs) are important steps, confirmed by Russia's improved standing in international rankings, but progress has been uneven, with significant gaps remaining in several areas.

Key priorities for 2016

- **A fast resolution of the geopolitical crisis is needed to boost business confidence and regain access to international financing.** While Western sanctions have largely resulted in weaker investments, Russian counter-sanctions have contributed to the surge of inflation (by increasing food prices).
- **Business climate reforms should proceed further, focusing more on consistent progress in all relevant areas.** Although Russia has improved its overall ranking in international surveys, progress in many areas has been slow and uneven, suggesting large remaining obstacles (including political interference) to doing business. The National Investment Climate Rating for Russian regions and the Regional Investment Standard launched by the Agency for Strategic Initiatives can support this process.
- **Private investment, especially in non-commodity-based sectors, should increase to support productivity and diversification of the economy.** Investment has been declining since 2012, constraining productive capacities and thus long-term growth prospects. Diversification from oil production would make the economy less vulnerable to external shocks and reduce economic volatility.

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Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	4.3	3.4	1.3	0.6	-4.2
Inflation (average)	8.4	5.1	6.8	7.8	15.5
Government balance/GDP	1.5	0.4	-1.3	-1.2	-5.7
Current account balance/GDP	5.1	3.5	1.6	3.2	5.1
Net FDI/GDP [neg. sign = inflows]	0.6	-0.1	0.8	1.8	1.0
External debt/GDP	27.6	26.5	35.2	32.2	n.a.
Gross reserves/GDP	26.9	26.6	24.5	20.8	n.a.
Credit to private sector/GDP	44.8	48.1	53.0	59.3	n.a.

Macroeconomic performance

Economic growth slowed significantly due to structural and cyclical factors. GDP grew by 0.6 per cent in 2014, decelerating steadily from its post-crisis peak of 4.5 per cent in 2010. After five years of positive growth, GDP declined by 2.2 per cent (year-on-year) in the first quarter and by 4.6 per cent (year-on-year) in the second quarter of 2015. The decline was aggravated by Western sanctions and falling oil prices that dampened business and consumer confidence as well as triggering capital outflows. Economic data from the first half of the year point to a sharp contraction in both household demand and corporate investments, as inflation has been cutting into real incomes, while sanctions and high interest rates made access to financing more difficult and costly. Retail sales declined by 10.4 per cent in September 2015 compared with September 2014, while real wages were down by 9.7 per cent. Unemployment, though, remains low at around 5 per cent as corporations generally prefer to cut wages first instead of shedding labour.

Inflation is decelerating as domestic demand falls rapidly. Year-on-year CPI inflation peaked in February 2015 at 16.9 per cent, reflecting pass-through from the rouble depreciation, rising food prices due to the introduction of the import ban, and other factors. Growth concerns and anticipation of further demand-driven disinflation, as evident from a strong decline in retail sales (-10.4 per cent year-on-year in September), have hampered further price growth, supporting monetary policy easing. As a reaction to somewhat-lower inflationary pressures the Central Bank of Russia (CBR) cut the policy rate from 17.0 to 11.0 per cent this year.

The current account surplus in the first half of 2015 has increased, mainly as a result of sharp adjustment in domestic demand as well as significant corporate deleveraging. The contraction in exports was more than offset by lower imports and interest payments abroad. External trade continues to be negatively affected by EU sanctions and the Russian food import ban as both sides extended their duration (until January 2016 and June 2016, respectively). Private sector capital outflows continued at a slower pace in the first half of 2014 (at US$ 50.3 billion in the first half of 2015 versus US$ 69.4 billion in the first half of 2014), mostly reflecting private sector deleveraging in 2015. There was a small inflow (US$ 5.3 billion) recorded in the third quarter.

The rouble has remained volatile, mostly affected by the oil price and geopolitical developments. In the first half of 2015 the lower intensity of the geopolitical tensions, together with more favourable oil price dynamics, helped the rouble strengthen until June 2015, allowing the CBR to buy US$ 10 billion to replenish reserves. Depreciation pressures from lower oil prices since June have led to the CBR abandoning the policy of reserve accumulation.

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Fiscal policy has acted mildly counter-cyclically, allowing a higher deficit than in 2014. According to the IMF estimate from October's World Economic Outlook, the consolidated fiscal deficit is expected to increase to 5.7 per cent of GDP in 2015, from last year's 1.2 per cent, reflecting declining revenues due to lower oil prices and weaker economic activity, as well as increasing expenditures, most notably higher defence and social spending. Support to regional budgets has also increased, as the regions face mounting difficulties to finance commitments against tightening revenues and high interest rates. The new budget proposal for 2016 aims to reduce the deficit by limiting the growth of certain social payments (pension and wage indexation) and foresees a real cut in other expenditures. Fiscal discipline may also support much-needed disinflation, but potential cuts in public investment or education can negatively affect long-term growth.

The growth outlook remains weak according to EBRD estimates. The economy is forecasted to contract this year by 4.2 per cent and by 1.2 per cent in 2016, as oil prices may remain subdued, the geopolitical tensions may not be resolved soon and structural reforms may progress slowly. In addition, positive short-term effects of supportive fiscal and monetary policies could be offset by supply-side constraints due to low investment and outdated production capacities. As a result, Russia may face low growth in the medium to long term without significant supply-side reforms.

Major structural reform developments

Consolidation and recapitalisation of the banking sector have been advancing, but vulnerabilities remain. A 1 trillion rouble recapitalisation programme, which started in 2015, provides funds for mostly systemic and regional banks. Since the end of 2013 the CBR has closed some 150 banks with weak financial performance and poor corporate governance. The system is preparing for a gradual move between 2016 and 2019 towards Basel III standards. Increasing NPLs and relatively low capitalisation levels are among the main risks to the banking system while reduced but still-remaining forbearance measures may make proper risk assessments difficult.

A free-floating exchange rate regime was introduced. After gradually increasing exchange rate flexibility, the CBR effectively abandoned the exchange rate band from November 2014 but reserved and used the right to intervene in case of financial stability threats. The new regime should allow for better shock absorption and may support transition to inflation targeting in the long term. The redesigned monetary policy toolkit, refocusing from interventions to foreign exchange repos, also allows more refined management of foreign currency liquidity. The CBR again placed more emphasis on exchange rate management from May 2015 in order to replenish reserves and avoid over-appreciation of the rouble, but abandoned this policy when the rouble started weakening.

A number of measures have been introduced to improve the business climate for small businesses. The Federal Corporation for the Development of Small and Medium Enterprises, established in June 2015, aims at consolidating support for the SME sector. Two-times higher threshold values for annual turnover allow more enterprises to be eligible for federal/regional support programmes. The government also obliged state-owned and state-controlled enterprises to procure at least 18 per cent of their contracts' volume with SMEs. The three-year holiday from regular inspections, signed into law in July 2015, should reduce the administrative burden on SMEs. Under the new legislation, regional and federal authorities will not be allowed to conduct regular checks of small companies or individual entrepreneurs until the end of 2018. The effects of the measures will also depend on consistent implementation and progress in other areas.

Diversion of transfers to private pension funds has been extended in 2016. While this measure supports fiscal balances in the short term, it reduces available sources of long-term financing for the Russian economy. Earlier in 2015 the government decided to keep the funded pension pillar and compensate the funds for lost revenues after the funds were temporarily diverted to the pay-as-you-go system in 2014 to be converted into joint-stock companies and inspected by the CBR.

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Russia's ranking in international competitiveness ratings improved further, but progress remains uneven across different segments. Russia advanced from 54th to 51st place in the World Bank's *Doing Business 2016* report,[1] mainly due to improvements in access to electricity, access to finance and paying taxes. According to the new methodology Russia ranks particularly high in enforcing contracts (5th out of 189 countries) and registering property (8th). Remaining diversity of sub-indices shows uneven improvement and large obstacles in several areas, in particular in access to trading across borders (170th) and dealing with construction permits (119th). Russia's rating improved by eight positions (to 45th) in the World Economic Forum's *Global Competitiveness Report 2015-2016* as a result of financial market development and increased market efficiency.

[1] The rating for 2015 reflects the change in the methodology. According to the old methodology Russia was ranked 62nd in 2015.