RUSSIA

Highlights

- **Russia's economy is emerging from recession.** GDP fell by 0.2 per cent in 2016, but growth returned in the first half of 2017, with GDP rising by 1.5 per cent year-on-year, on the back of stronger activity in the trade, mining and transport sectors.
- **A new fiscal rule has been adopted.** As a result of a counter-cyclical fiscal policy, the budget deficit surged to 3.7 per cent of GDP in 2016, from 1.1 per cent in 2014. The new fiscal rule, to be applied fully from 2019, is intended to reduce the effect of oil prices on the federal budget.
- **Inflation has fallen close to the Central Bank of Russia's target.** The disinflation has been supported primarily by weak domestic demand and rouble appreciation, allowing the Central Bank of Russia (CBR) to continue cutting the key policy rate.

Key priorities for 2018

- **Economic diversification away from extractive industries should stay high on the agenda.** Dependence of the economy on oil and gas has increased in the past two decades, creating significant economic volatility and suppressing private investment. More focus on the development of non-extractive tradeable industries and services, especially those with higher value added, would be desirable.
- **Compliance with the newly adopted fiscal rule would help reduce economic volatility.** The high correlation between oil prices and economic growth makes the economy particularly vulnerable to external shocks. The new fiscal rule could enhance resilience through smoothing the impact of oil price volatility on the budget and domestic demand.
- **Reducing state presence in the economy would support productivity and economic growth.** Russia has made steps forward in recent years in improving business and administrative procedures but the state's footprint has increased in the past decade. Faster and more transparent privatisation of state assets, and a reduction in the size and influence of public administration are needed.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.8	0.7	-2.8	-0.2	1.8
Inflation (average)	6.8	7.8	15.5	7.0	4.2
Government balance/GDP	-1.2	-1.1	-3.4	-3.7	-2.5
Current account balance/GDP	1.5	2.8	5.0	2.0	2.7
Net FDI/GDP [neg. sign = inflows]	0.8	1.7	1.1	-0.8	-0.7
External debt/GDP	31.7	29.1	38.0	40.1	n.a.
Gross reserves/GDP	22.2	18.7	27.0	29.4	n.a.
Credit to private sector/GDP	49.4	53.5	54.7	50.8	n.a.

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Macroeconomic performance

Russia's economy is growing again. After a recession in 2015 (when GDP dropped by 2.8 per cent) driven mainly by the fall in oil prices, GDP fell by just 0.2 per cent in 2016, which was much better than expected. The slow recovery of consumption has been supported by strengthening real wages and low unemployment (at around 5 to 6 per cent), but investment activity is still weak due to economic uncertainty and relatively high financing costs. The contribution of net exports to GDP growth stayed positive as exports benefited from a relatively stable external demand, while imports continued to fall (albeit at a slower pace due to strengthening of the rouble and emerging signs of a recovery in economic activity). GDP rose by 0.5 per cent year-on-year in the first quarter, primarily on the back of consumption recovery, and reached 2.5 per cent in the second quarter of 2017.

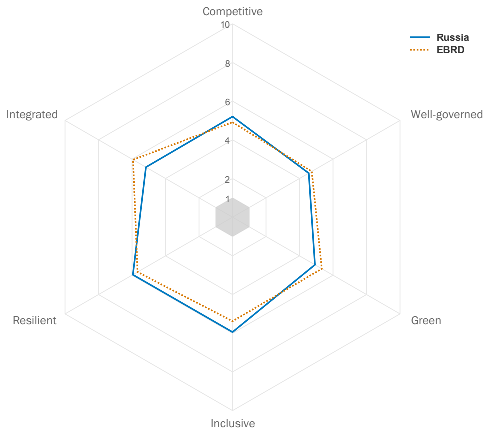
The exchange rate has strengthened as a result of the recovery of oil prices. The rouble depreciated from below 50 roubles to one US dollar in May 2015 to above 80 in January 2016 on weakening oil prices. Depreciation pressures have eased since then following the increase in oil prices, and the rouble recovered to around 60 roubles to one US dollar in August 2017.

With inflation falling towards the target rate, monetary policy has been eased further. The CBR cut the key policy rate by 1.0 percentage points in 2016 and a further 1.5 percentage points, from January to September, to 8.5 per cent. Supported by weak domestic demand, the strengthening rouble, a strong food harvest and base effects, inflation fell to 3.0 per cent in September 2017, from a peak of 16.9 per cent in March 2015. According to a Bank of Russia survey, inflation expectations have declined significantly. However, at 9.6 per cent in September 2017 they remain elevated.

Fiscal policy has acted counter-cyclically. The general government deficit surged to 3.7 per cent of GDP in 2016, from 1.1 per cent in 2014. Although budgetary plans for 2017-19 set out fiscal consolidation at one percentage point of GDP annually, the pace is somewhat uncertain due to the government's conservative oil price assumption of US$ 40 per barrel on the one hand (upside risk) and the need to sustain social spending in the run-up to the elections on the other (downside risk). The new fiscal rule, adopted in July 2017, is intended to reduce the effect of oil prices on the federal budget. Expecting that fiscal and monetary policy frameworks will further improve macroeconomic stability, Fitch upgraded its outlook on Russia's sovereign rating (BBB-) to positive in September 2017.

Short-term growth will continue but long-term growth prospects are weak and remain heavily dependent on oil price developments. Growth is expected to pick up in 2017 to 1.8 per cent, driven by higher oil prices, recovering private consumption and investments, and stay at a similar level in 2018 (1.7 per cent). Although risks to the 2017 projection are tilted to the upside, without significant reforms, long-term growth may remain stuck at around 1 to 2 per cent annually due to outdated production capacities and low investments, as well as less favourable internal structural factors (weak demographics, outdated infrastructure and unfavourable institutional characteristics of the economy).

Assessment of transition qualities (1-10)



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Major structural reform developments

Russia's competitiveness has improved over the past year. The country moved up five places, to 35th (out of 190 countries) in the World Bank's *Doing Business 2018* report, with advances in registering property, trading across borders and getting credit. It ranks particularly high in getting electricity (10th), registering property (12th) and enforcing contracts (18th), while sizeable obstacles are present in trading across borders (100th) and dealing with construction permits (115th), despite the improvements acknowledged in the former recently. Russia's rating improved by five positions (to 38th out of 137 countries) in the World Economic Forum's Global Competitiveness Report 2017-2018, mostly on the back of an improving macroeconomic environment. Financial market development and institutions remain the weakest links, while corruption, tax rates and access to finance persist as the most problematic factors for doing business.

Banking sector stability has been maintained despite the recession but asset concentration at state-owned banks is rising further. The overall capitalisation rate of the Russian banking sector (at 12.9 per cent in June 2017) remains above the regulatory minimum, with some banks facing capital constraints. The CBR continued for the fourth year to close banks that were performing weakly and had poor corporate governance. In September 2017, there were 574 banks operating in Russia, around 380 fewer than in mid-2013. Bank closures have led to the depletion of the deposit insurance fund, which is now mostly financed by CBR loans, while asset concentration at state-owned banks has increased somewhat due to deposit outflows from private banks to large, mainly state-owned banks. The four largest banks in Russia (all state-owned) account for over 50 per cent of total assets in the sector. After moving in the negative zone from July 2015, household loan growth turned slightly positive in late 2016, while non-performing loans (NPLs) are relatively low in both the corporate and household sectors (at 6.1 and 7.5 per cent, respectively, in September 2017). On the other hand, the Russian rating agency, ACRA, estimates the (more broadly defined) NPL ratios at 12 to 15 per cent, with private banks recording the highest levels.

Two large banks are to enter receivership under the new bank resolution legislation. The new rules, effective from mid-June 2017, envisage the CBR operating the framework instead of the Deposit Insurance Agency (DIA). Previously, the CBR provided cheap loans to problem banks chosen by the DIA to rehabilitate them. Under the new framework, the newly established Bank Consolidation Fund (BCF), to be financed and managed by the CBR, is providing resolution funding, but only after the controlling shareholders' claims are bailed-in. The first Russian banks to enter receivership under the new regulations are Otkritie and BinBank, both among the top 10 banks in terms of assets, which created some market uncertainty.

A new fiscal rule should enhance government savings and reduce volatility. The new rule, adopted in July 2017 and coming into effect in 2019, is expected to ensure higher fiscal savings and reduce the impact of oil price volatility on the economy. The rule limits budget expenditures to the sum of oil revenues at the reference oil price, non-oil revenues, interest expenses on sovereign debt, and carryover budget balances. The transition period effectively allows a 1 per cent primary budget deficit at the reference oil price in 2018. The oil windfall will be saved into the Reserve Fund and the fund will be used when the oil price is below the reference price, but it will not be used to compensate for lower non-oil revenues, as was the case previously. The Reserve Fund and the National Wealth Fund will be merged, as the government plans to fully deplete the Reserve Fund by the end of 2018 amid low oil prices. The merged fund's main goals include ensuring financing for the pension system, deficit financing for the federal budget, and co-financing for private pension saving plans.

The privatisation programme for 2017-19 was scaled down as fiscal pressures abated. The 2016 privatisation revenues were at a record high of RUB 407 billion (€6 billion), which included revenues from the sale of Bashneft to Rosneft at RUB 330 billion (€4.8 billion) in October 2016. In 2017, the privatisation proceeds are projected at only RUB 42 billion (€0.6 billion), down from RUB 138 billion (€2 billion) in the previous version of the budget, due to the postponement of the sale of a 10.9 per cent stake in VTB Bank. The 2017-19 privatisation plan envisages, among other smaller deals, the sale of minority stakes in the diamond producer Alrosa, the Novorossiysk port and Sovkomflot fleet operator. The privatisation of VTB Bank has been postponed until Western sanctions are lifted.