RUSSIA

Highlights

- **Russia's economy has returned to modest growth.** After a two-year recession, GDP grew by 1.5 per cent in 2017 and 1.6 per cent year-on-year in the first half of 2018. Growth has been driven primarily by recovering household consumption and exports.
- **Inflation fell to an historical low, but picked up recently.** The strong disinflationary trend continued in 2017 on the back of falling food prices and the strengthening rouble, with inflation reaching a record low (since 1993) of 2.2 per cent in January 2018. However, following the rouble depreciation, inflation accelerated somewhat in the third quarter of 2018.
- **The country has embarked on several structural reforms.** The government has begun tax and pension reform, and is initiating significant new investments in infrastructure over the coming years.

Key priorities for 2019

- **The recovery of oil prices should not delay further business environment reforms and diversification of the economy.** These reforms include limiting the state footprint on the economy, ensuring fair competition, as well as improving regulatory frameworks.
- **SMEs' (small and medium-sized enterprises') access to finance should be improved.** Enhanced financial inclusion and better access to financial products, including leasing and factoring, would be important steps forward.
- **Banking sector supervision should be stepped up in light of recent bank failures.** The clean-up of the banking system has progressed significantly in recent years but further efforts are needed to reduce systemic risks from the concentration of assets, especially among large state-owned banks.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	0.7	-2.5	-0.2	1.5	1.5
Inflation (average)	7.8	15.5	7.1	3.7	2.8
Government balance/GDP	-1.1	-3.4	-3.6	-1.5	2.0
Current account balance/GDP	2.8	4.9	1.9	2.2	6.2
Net FDI/GDP [neg. sign = inflows]	1.7	1.1	-0.8	0.5	1.0
External debt/GDP	28.8	37.8	39.5	32.8	n.a.
Gross reserves/GDP	18.5	26.8	29.1	27.4	n.a.
Credit to private sector/GDP	53.5	56.4	53.4	52.7	n.a.

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Macroeconomic performance

The economy has started to expand moderately. After a recession in 2015-16, GDP started to recover in 2017, growing by 1.5 per cent. This was driven by domestic demand on the back of rising oil prices, improved economic confidence and falling inflation. The FIFA World Cup, hosted by Russia in 2018, also contributed to a temporary increase in public investment. However, stronger domestic demand, together with the rouble appreciation, fuelled the rise in imports (17 per cent) leading ultimately to a negative contribution of net exports to overall growth. In the first half of 2018, the economy grew 1.6 per cent year-on-year. The main drivers were exports and private consumption, the latter boosted by several favourable developments (lower inflation, faster real wage growth, a falling unemployment rate, and credit growth).

The rouble has decoupled from oil price movements. The recovery of oil prices was accompanied by the rouble's appreciation against the US dollar in 2017 (around 15 per cent) and in early 2018. However, foreign exchange interventions set by the new fiscal rule, together with the new US sanctions against Russia (which triggered a sell-off of Russian financial assets), have exerted downward pressure on the exchange rate since April 2018. In September 2018 the rouble was around 16 per cent weaker than six months earlier. In August 2018, the Central Bank of Russia (CBR) decided to temporarily suspend foreign exchange purchases on behalf of the Ministry of Finance.

Monetary tightening has started amid rising inflationary pressures. The broad-based disinflation process advanced, supported in 2017 by the strengthening rouble, as well as favourable weather conditions and a record-beating harvest. In mid-2017 the inflation rate slid below the central bank target of 4.0 per cent, reaching 2.2 per cent in January 2018, the lowest rate since 1993. In the following months it rose only slightly (to 2.3 per cent in June), but picked up in the third quarter, to 3.4 per cent in September. Falling inflation and lower inflation expectations enabled continuation of monetary easing by the CBR until March 2018. In September 2018, the CBR raised the key policy rate by 25 basis points, to 7.5 per cent.

Higher oil prices have alleviated fiscal pressures. Recovering growth and oil prices have supported the reduction in the budget deficit from 3.6 per cent of GDP in 2016 to 1.5 per cent in 2017. While government revenues increased on the back of growing oil and gas receipts, expenditures were reduced due to lower defence spending as well as the extension of the freeze in pension contributions and civil servant salaries. The new fiscal rule, adopted in 2017 and devised to act as a buffer against oil price volatility, has been slightly softened in the draft budget framework (2019-21), to be adopted in autumn 2018. Under the new framework, the structural primary budget deficit is limited to 0.5 per cent of GDP (originally 0 per cent). In February 2018, Standard & Poor's upgraded Russia's sovereign rating to BBB-, primarily on the back of new fiscal rules. It was the second rating agency after Fitch to rate Russia at investment grade.

Moderate short-term growth will likely continue while long-term growth prospects remain heavily dependent on structural reforms. In 2018 and 2019, the growth rate is expected to stay at the same level as in 2017 (1.5 per cent). It will be driven by recovering private consumption and investments, and supported by higher oil prices, with a negative effect from the US and EU sanctions. Without significant reforms, however, Russia's long-term economic growth may remain stuck at around 1 to 2 per cent annually due to outdated production capacities and low investments, as well as unfavourable internal structural factors (weak demographics, obsolete infrastructure and discouraging institutional characteristics of the economy).

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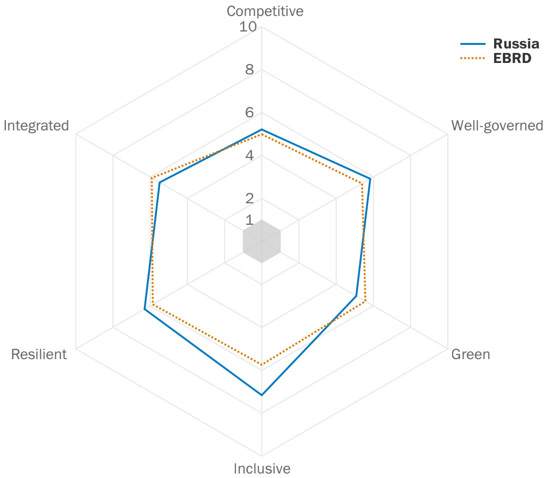
Assessment of transition qualities (1-10)



Major structural reform developments

The business environment has improved slightly. Russia climbed four positions in the World Bank *Doing Business 2019* report and now ranks 31st out of 190 countries. The biggest improvement has been in the area of construction permits (thanks to the faster process of obtaining permits and improved quality control during construction), where the country now ranks 48th (versus 115th last year). Progress has also been made in getting electricity (faster and less expensive) and trading across borders (shorter times to import and export), but the country still scores worst in the latter (99th). Russia's rating also improved slightly in the World Economic Forum's *Global Competitiveness Report 2018*. Russia ranks 43rd out of 140 countries[1] (up two places from the previous year), with the weakest areas being the financial system (especially with regard to financing SMEs), product and labour markets, and institutions.

Tax reforms have advanced. In July 2018 the parliament approved a VAT rate hike and oil sector reform, effective from 2019. The VAT rate has been increased to 20 per cent from 18 per cent, while the reduced rate (10 per cent) remains in place for the same goods as previously (that is, food, children's products, books, medicines). The measure is expected to bring around Rb 3.5 trillion (around US$ 52 billion) to the federal budget over the next six years, which may be used to finance some spending envisaged by the May 2018 presidential decree "on National Goals and Strategic objectives of the Russian Federation through to 2024".[2] The bill also foresees measures to speed up VAT reimbursement and simplify procedures. The second major revenue-boosting measure is related to the bill on oil sector taxation, adopted in July 2018. This bill provides for the gradual elimination of the oil export duty (from 30 per cent currently) and its replacement by a higher natural resource tax, shifting (and effectively widening) the tax base from oil exports to oil production. The reform would add Rb 1.3 to Rb 1.6 trillion (US$ 19 to US$ 24 billion) to the federal budget over the next six years, according to official projections.

A pension reform bill has been adopted. Another reform announced after the May presidential decree was pension reform, consisting primarily of the increase in the retirement age. According to the bill, adopted in October 2018, the retirement age will be gradually raised from 60 to 65 for men (by 2028) and from 55 to 60 for women (by 2034). Despite the last-minute softening, the changes to the pension system are in the right direction as Russia is facing the challenges of a shrinking workforce and an increasing number of retirees.

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[1] The rating for 2017 reflects the change in the methodology. According to the old methodology, Russia was ranked 38th in 2017.
[2] The decree implies implementation of a wide range of measures across multiple areas (including infrastructure, health care, education, small and medium-sized enterprises, digital economy, demography), with the aim of improving citizens' quality of life and advancing the socioeconomic development of the country.

The new economic programme calls for higher spending on infrastructure. The government has announced the creation of a new development fund of Rb 3.5 trillion (US$ 52 billion), which will be financed from additional domestic borrowing of Rb 500 to Rb 600 billion (US$ 7.4 to US$ 8.9 billion) annually. The goal is to invest Rb 6.3 trillion (US$ 97 billion) over the next six years in transport infrastructure. Another fund to support investments is the existing Russian Fund for Direct Investments (RFDI) but it remains to be seen if it would be able to attract significant investment from other sovereign wealth funds and private investors into infrastructure projects.

The CBR has continued to close banks with weak performance and poor corporate governance. In September 2018, there were around 508 banks operating in Russia, 66 fewer than in September 2017 and around 450 fewer than in mid-2013. The overall capitalisation rate of the Russian banking sector (at 12.2 per cent in August 2018) remains above the regulatory minimum, but non-performing loans were relatively high at 10 per cent as of the end of 2017. New bank resolution rules from mid-2017 enabled the CBR to acquire troubled banks and recapitalise them via the Bank Consolidation Fund before re-selling. Accordingly, in August, September and December 2017 the CBR acquired control over three large private banks (Otkritie Bank, Binbank and Promsvyazbank, respectively), recapitalised them and provided them with deposits. By June 2018, the CBR had used over US$ 45 billion (or 3 per cent of GDP) to support the three banks. The CBR plans to continue the process by moving bad assets from all banks under rehabilitation towards the “bad” bank, while good assets will go to Otkritie and Binbank, which should merge by 1 April 2019, with the rehabilitated bank sold back to the private sector in three to five years. As a result of bank closures and resolutions, the share of state-controlled banks (including those under rehabilitation) in total bank assets was over 70 per cent at the beginning of 2018, up from around 50 per cent in 2013.