RUSSIA

Highlights

- **The economy has slowed in 2019.** After growing by 2.3 per cent in 2018, the economy expanded by just 0.7 per cent year-on-year in the first half of 2019, with the slowdown explained by declining energy exports and the impact of rising inflation on household consumption.
- **The macroeconomic situation remains stable.** Helped by the ongoing conservative fiscal policies, fiscal and current account surpluses remain healthy. Pre-emptive increases in policy rates by the Central Bank of Russia (CBR) towards the end of 2018 helped contain the inflationary impact of an increase in value-added tax (VAT). A more neutral policy stance is now being adopted in order to support growth.
- **There was some progress in the past year in the area of structural reforms, mainly in the form of an ambitious investment plan.** The government unveiled plans to spend 25.7 trillion roubles (US$ 390 billion) on physical and social infrastructure over the next five years.

Key priorities for 2020

- **Reforms to improve the business environment need to be undertaken.** Priorities include reducing the state's role in the economy, addressing physical infrastructure gaps and implementing business-friendly measures to enhance private-sector competitiveness.
- **Asset quality and concentration risks in the banking sector need to be addressed**. Efforts to consolidate the sector need to be sustained, while steps should be taken to address the high concentration of assets in large state banks and the persistently high level of non-performing loans (NPLs).
- **Planned public investments need to be well targeted to contribute to growth in the long term.** Areas that need improvement include coordination among public institutions and inclusion of stakeholders in the planning and implementation phases of public investments.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	-2.8	-0.2	1.5	2.3	1.1
Inflation (average)	15.5	7.1	3.7	2.8	4.7
Government balance/GDP	-3.4	-3.6	-1.5	2.9	1.5
Current account balance/GDP	4.9	1.9	2.2	6.8	5.9
Net FDI/GDP [neg. sign = inflows]	1.1	-0.8	0.5	1.4	-0.5
External debt/GDP	37.8	39.5	32.8	28.9	n.a.
Gross reserves/GDP	26.8	29.1	27.4	28.3	n.a.
Credit to private sector/GDP	57.3	52.9	77.9	76.0	n.a.

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Macroeconomic performance

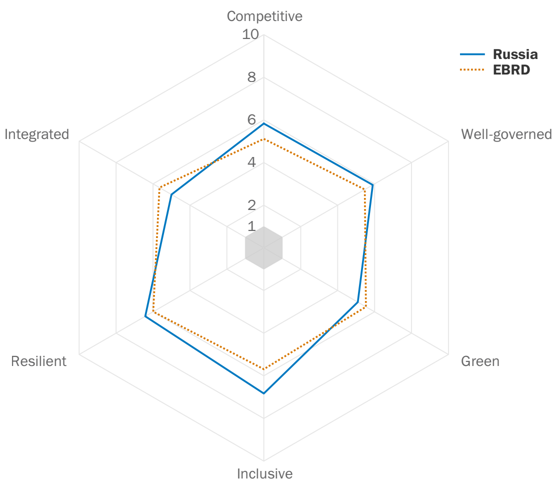
The economy is slowing down after moderate expansion in 2018. The economy grew by 0.7 per cent year-on-year during the first half of 2019, following growth of 2.3 per cent in 2018. Weaker external demand, lower oil prices and a stronger rouble since the start of the year have negatively affected net exports. Ongoing international sanctions and continuing tight fiscal policy constrained public and private investment, while household consumption growth was sluggish due to declining real wage growth and a two percentage point increase in VAT, which was introduced in January 2019.

Fiscal and current account surpluses have been maintained despite declining oil prices, thanks to conservative macroeconomic policies. Driven by the decline in oil prices, a stronger rouble and weaker external demand, the current account surplus has started to decline after peaking in March 2019. Meanwhile, the government has continued to abide by the fiscal rule that was adopted in 2017, which mandates transferring oil revenues in excess of the threshold, corresponding to US$ 40 per barrel to the National Wealth Fund. Budget performance has improved following advancements in tax collection and changes in tax regulations that came into force in January 2019, which include a VAT increase of two percentage points.

The CBR has loosened monetary policy in response to softening inflation and growth. The inflationary impact of the VAT increase has been more modest than expected, having been contained by policy rate increases towards the end of 2018. Having peaked in March 2019 at 5.3 per cent, inflation has been declining as a result of weak real household incomes and a stronger rouble. Declining inflation and weaker expected output led the CBR to cut its policy rate by a total of 125 basis points since June 2019.

Growth will remain moderate in the absence of comprehensive structural reforms or a change in the sanctions regime. The growth outlook is expected to improve slightly, starting with the second half of 2019, thanks to more supportive monetary policy and a stronger fiscal impulse. However, private investment is likely to remain weak, given the continuing negative impact of sanctions imposed by the European Union and the United States of America, and exports are likely to be held back by the weaker global trade environment. A growth rate of 1.1 per cent is expected for 2019, followed by 1.7 per cent in 2020. The key risk to the outlook is the possibility of more severe sanctions being imposed.

Assessment of transition qualities (1-10)



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Major structural reform developments

The government is increasingly developing domestic industries in order to hedge against the impact of international sanctions. This has manifested itself in the increased pursuit of import substitution policies, albeit with mixed success. With the aim of reducing transactional dependence on the US dollar, the government signed a deal with China in June 2019 to settle trade transactions in national currencies. It also made agreements with foreign banks to use the national payment service in order to bypass US sanctions affecting the Society for Worldwide Interbank Financial Telecommunication system. A bill requiring internet service providers to route internet traffic through servers in the country was introduced, enabling the government to prevent access to foreign servers.

The government announced a major investment programme aimed at implementing 13 “National Projects”. The National Projects were a key element of the decree signed by the President in May 2018 and comprise strategy documents laying out key development targets for the period 2019-24 in the social, economic and environmental sectors. The projects have an estimated cost of 25.7 trillion roubles (US$ 390 billion) over the period 2019-24. Around half of the projects’ costs are planned to be borne by the central government, with the rest shared by regional governments and the private sector.

The authorities continued their efforts to consolidate the banking sector. In the past year, the government has continued to close down badly managed and under-capitalised banks, and more than 500 banks have been closed down since 2013. Meanwhile, the government continues to provide funding and capitalise the large private banks it has taken over, two of which (Otkritie and BN Bank) were successfully merged in January 2019. However, the consolidation process has led to an increasing concentration of the banking sector in state hands, with around 60.0 per cent of bank assets being owned by state-owned or state-controlled banks. While the system-wide capital adequacy ratio is stable at around 12.0 per cent, asset quality remains a problem, with the NPL ratio standing at 10.4 per cent in March 2019, while fast-growing unsecured household credit is raising concerns.

Pension reforms introducing a higher retirement age were launched in January 2019 but have been controversial. The reforms increased the retirement ages for men and women to 65 and 63, respectively. The changes were introduced to address fiscal pressure arising from demographic issues, but met widespread protest. This resulted in some softening of the measures, including a reduction in the proposed retirement age for women to 60.

The authorities made efforts to improve the business environment. In collaboration with the business community, the authorities have prepared a Transformation of Business Climate Plan that aims to ease tax administration, utilities registration, business establishment and resolution and customs processes. In addition, in June 2019, the government adopted a “regulatory guillotine” reform aiming to significantly reduce the number of business regulations. Progress in the business environment is reflected in an improvement in the country’s ranking in the World Bank *Doing Business 2020* report, moving from 31st to 28th place out of 190 countries.

TURKEY

Highlights

- **The economy entered recession in 2018 but a stimulus has led to a return of growth in 2019.** The recession was primarily driven by a currency depreciation in summer 2018, caused by significant macroeconomic imbalances, along with the policy tightening implemented to address these imbalances. Various forms of stimulus lifted private consumption and helped the economy exit recession at the beginning of 2019. Similar stimulus measures continue to be applied in the face of weak domestic sentiment and the deteriorating external environment.
- **The economy has seen a rebalancing of the external account.** Within the space of a year the current account has moved from a large deficit to a balance. However, this has been a cyclical phenomenon, the result of import compression associated with the economic slowdown and a pickup in exports due to the depreciation of the currency.
- **The past year has seen limited progress in structural reforms.** A prolonged election period and a challenging macroeconomic environment have absorbed much of the authorities' attention. However, the approval of the 11th Development Plan in mid-2019 was a positive step.

Key priorities for 2020

- **Efforts to return the economy to growth need to be balanced with containing fiscal and external risks.** Improving confidence and macroeconomic stability need to be prioritised without allowing slippage from fiscal targets. The credibility of the central bank needs to be preserved to increase the effectiveness of monetary policy.
- **Rules for the recognition of non-performing loans (NPLs) should be tightened.** Lending by private banks is being inhibited by asset quality problems, most notably in the energy, real estate and construction sectors.
- **Structural reforms need to be enacted to ensure a genuine rebalancing of the economy.** The low real exchange rate and an election-free period of four years create an opportunity to enact reforms to improve workforce skills, firm-level innovation and global value chain integration.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	6.1	3.2	7.4	2.8	-0.2
Inflation (average)	7.7	7.8	11.1	16.3	15.7
Government balance/GDP	-1.0	-1.3	-1.5	-1.9	-3.0
Current account balance/GDP	-3.7	-3.8	-5.6	-3.5	-1.0
Net FDI/GDP [neg. sign = inflows]	-1.6	-1.3	-1.0	-1.2	-1.2
External debt/GDP	46.4	47.4	53.4	57.1	n.a.
Gross reserves/GDP	13.1	12.3	12.6	11.8	n.a.
Credit to private sector/GDP	66.8	69.9	70.9	68.5	n.a.

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Macroeconomic performance

The economy experienced a sharp slowdown. Tight monetary policy, currency depreciation and a credit crunch took their toll on growth in 2018, with the economy growing by 2.8 per cent in the year as whole but declining in the second half of the year by 0.3 per cent year-on-year. Fiscal stimulus measures and state bank-driven credit growth helped the economy exit recession in the first quarter of 2019 but ongoing private sector deleveraging indicates that recovery will be slow.

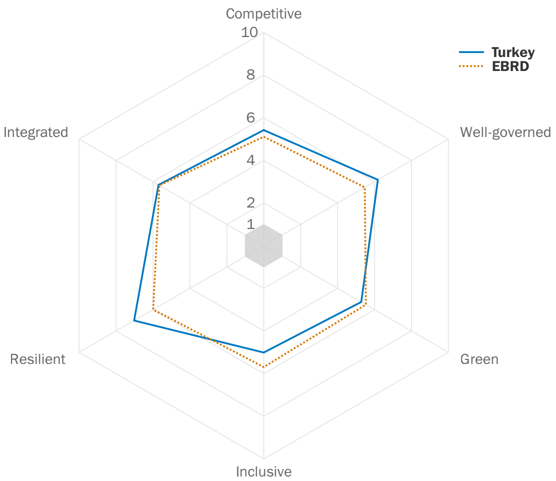
The slowdown resulted in a rebalancing of the external account. The 12-month current account balance has turned from a deficit of US$ 58 billion in May 2018 to a surplus of US$ 5 billion in August 2019, driven by a sharp contraction of imports and a pickup in exports as a result of currency depreciation and declining domestic demand. However, this has been a cyclical adjustment driven by the downturn, and, in the absence of structural reforms, the deficit will likely reappear when growth picks up again.

Inflation is declining but there are concerns about the independence of the central bank. After peaking at 25.2 per cent in October 2018, inflation has been declining due to high policy rates, the negative output gap and base effects. However, the sacking of the governor of the central bank in July 2019 and subsequent policy rate cuts amounting to 1,000 basis points fuelled concerns about the independence of the central bank. Although there is scope to reduce nominal rates as inflation falls, Turkey needs to ensure real rates remain high relative to its peers in order to anchor inflation expectations and avoid capital outflows in the uncertain global environment, particularly given the authorities' reliance on unorthodox economic policies.

Fiscal policy has been loosened, leading the government to seek alternative sources of funding to meet budget targets. As a result of pre-election government spending and temporary tax cuts on durable consumer goods and real estate transactions, after six months the budget deficit had almost exceeded the original annual target, resulting in a substantial revision of the year-end deficit target. The government is tapping into the reserve fund of the central bank (and is planning to revise the borrowing limits) in order to close the funding gap.

Economic activity is expected to remain subdued in the second half of 2019, and recovery is likely to be slow. Despite some tailwind provided by the reversal of monetary tightening in the developed economies, a return to the high growth rates of recent years is unlikely in the short term due to constraints on bank lending and weakening external demand. A contraction of 0.2 per cent is expected for 2019, followed by 2.5 per cent growth in 2020. The main risk to the outlook is another round of currency depreciation related either to geopolitical risks or to policy measures that are perceived by investors to support growth at the expense of macroeconomic stability.

Assessment of transition qualities (1-10)



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Major structural reform developments

The 11th Development Plan was approved in July 2019 and is a blueprint for reform. The main goal of the plan is to help Turkey transition from a consumption- and debt-driven economy to a production- and export-driven one, financed by domestic savings. In order to achieve this, the plan aims at boosting competitiveness through innovation, upgrading workforce skills and promoting inclusion, redesigning the tax and social security system, promoting renewable energy use and increasing transparency and predictability in policymaking.

The authorities continue to take steps to improve the business environment. Reforms have been undertaken to streamline processes, time frames and costs for small and medium-sized enterprise operations. An amendment to the value added tax code was introduced in order to exempt certain capital investments, and the authorities took steps to facilitate property registration. These steps have helped Turkey improve its ranking in the World Bank *Doing Business 2020* report by 10 places to 33rd out of 190 countries.

There has been backsliding in the past year as regards governance and policymaking. The authorities have increasingly resorted to unorthodox policies, including frequent interventions in the market mechanism, which have resulted in concern among investors and Turkish citizens. This has resulted in increased dollarisation and volatility of capital flows with more than 50 per cent of domestic savings with banks now held in foreign currency. An increasingly centralised approach to policymaking saw the removal (as noted above) of the governor of the central bank from his post by the President on the grounds of disagreements over monetary policy.

Positive steps were taken to improve the financial sector's resilience, but rising corporate NPLs in certain sectors remained unaddressed. In January 2019, the government established a Financial Stability and Development Committee consisting of the representatives from government agencies and financial institutions. Amendments to the banking law facilitated the use of a framework for out-of-court restructuring of loans to troubled firms deemed capable of repayment. However, plans to address NPLs in the energy, real estate and construction sectors have yet to be finalised.

There has been an increase in restrictions to trading across borders. Import tariffs on a wide variety of products, including textiles industry inputs, were raised in January 2019, while the duty exemption for small quantity goods imported via e-commerce was removed in May 2019. In the same month, the United States of America removed Turkey from the Generalized System of Preferences, which had allowed for limited tariff-free access to the US market.

Reforms were made in the fields of waste reduction and renewable energy generation. Net metering was introduced in May 2019 to unlicensed solar energy producers, allowing for surplus electricity from residential and commercial rooftop solar energy systems to be sold back to the grid. In July 2019 the government passed a waste reduction regulation, mandating public and large private buildings to obtain "zero waste" certificates. Meanwhile, a charge for the retail use of plastic shopping bags was introduced at the beginning of 2019.