

Russian Federation

From Stabilization to Growth

IMF MOSCOW OFFICE

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Summary: Two Stories

- **Stabilization of the Economy** is proceeding, helped by appropriate policies. Oil price decreases early this year postponed the recovery for late 2016 and 2017. No room for a strong cyclical rebound.
- **Increasing long-term growth** requires further reforms. Given demographics, market size will expand if investment and productivity support per capita growth. In absence of reforms, growth will be low.

Story 1: Stabilization

Levels and Changes

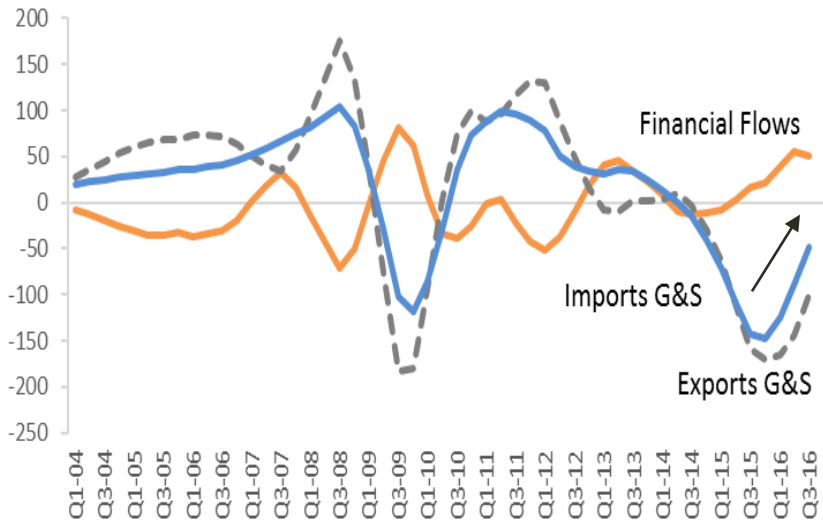
- $\text{Income} - \text{Expenditure} = \text{Change in Assets} - \text{Change in Liabilities}$
- **How do we assess Stabilization?**
- Income in 2016 minus Income in 2015 (= Change in Income in 2016) has to be close to zero (or approaching zero), in real terms.
- Same applies to Expenditure (i.e. Consumption plus Investment)
- **Here is where it gets trickier...**
- $\text{Change in Income} - \text{Change in Expenditure} = \text{Change of the Change in Assets} - \text{Change of the Change in Liabilities}$

Stabilizing after External Shocks

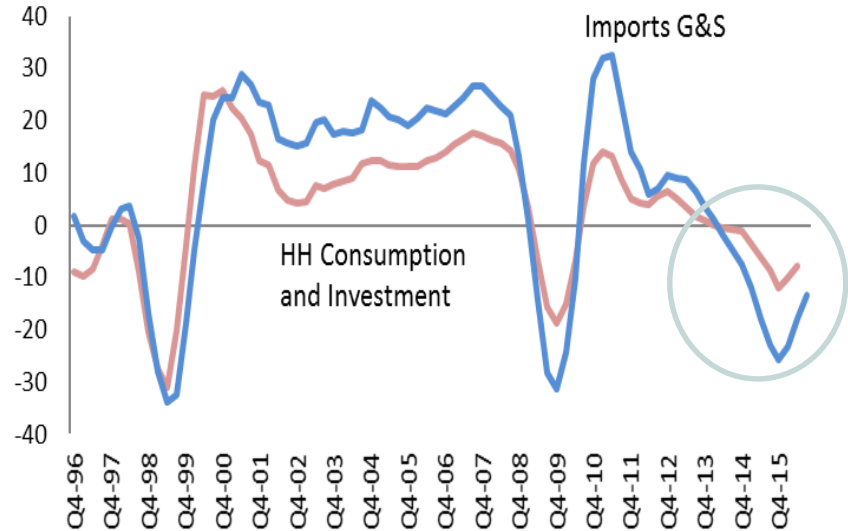
Changes in net external financial flows are contributing to import stabilization...

...suggesting that domestic demand is stabilizing too...

Russia. Exports, Imports and Financial Flows
(12-month changes, US\$ billion)

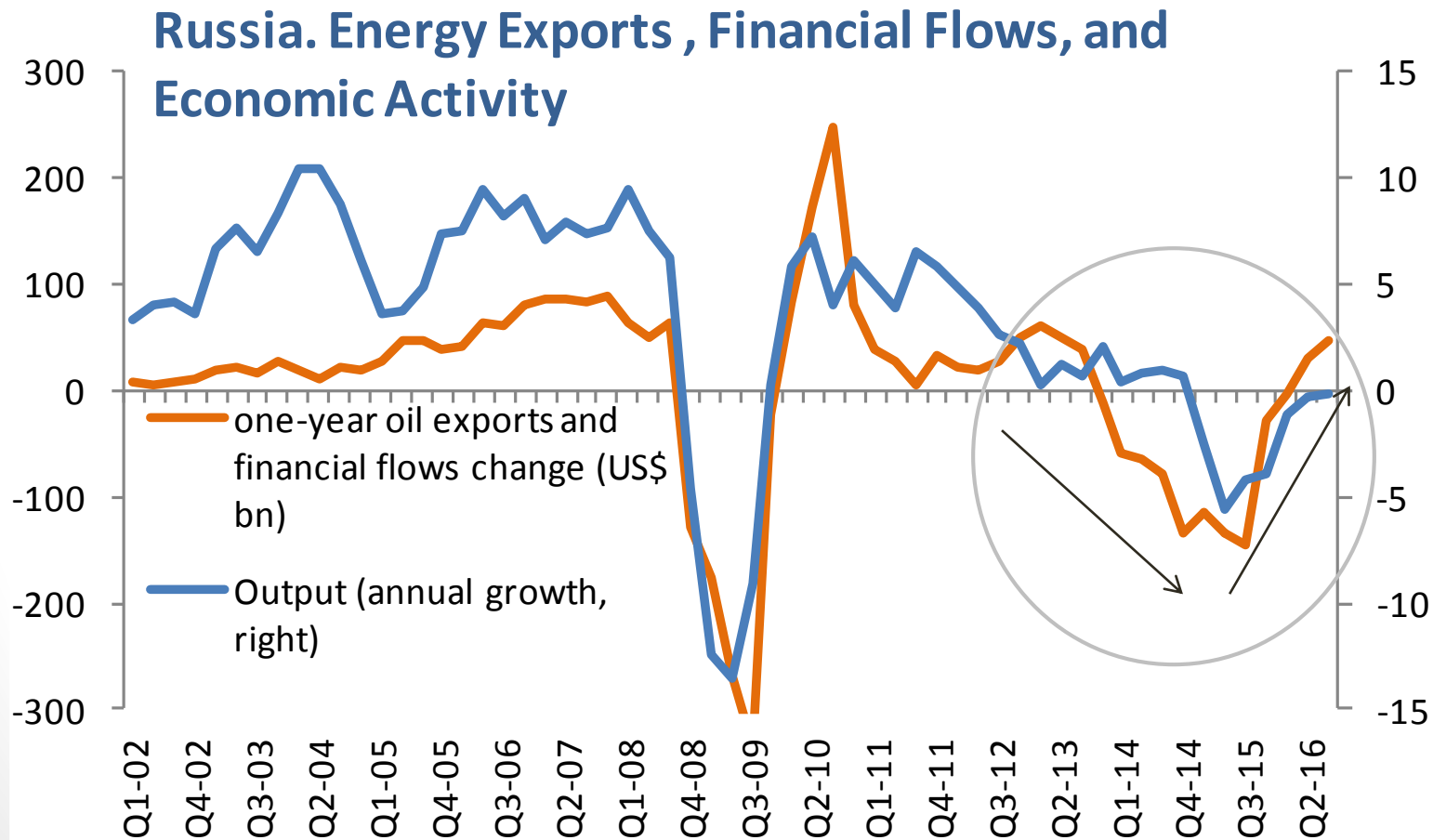


Russia. Domestic Absorption and Imports
(annual real percentage change)



Stabilizing after External Shocks...

Lower net financial outflows together with stabilizing oil prices have allowed economic activity to stabilize



...the CA deteriorated, on the back of lower oil prices *and* better financial flows

Russia. Balance of Payments

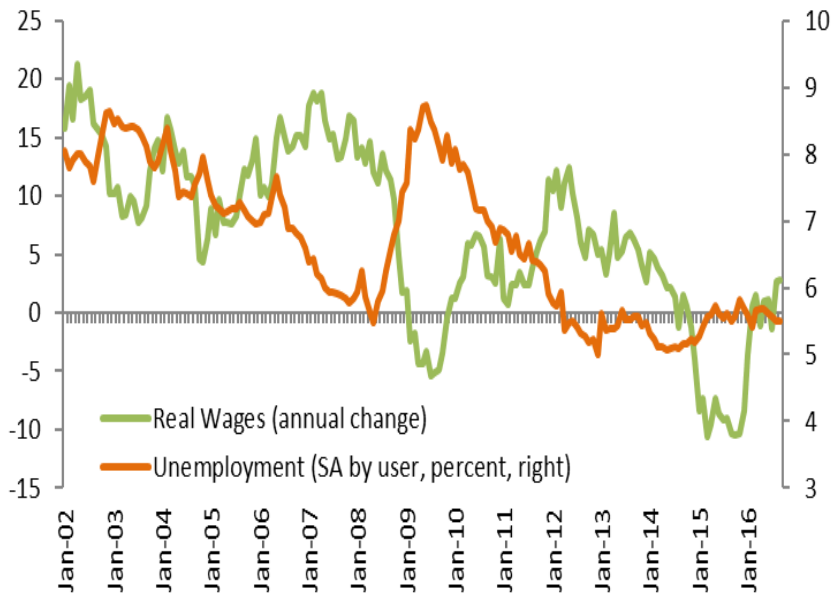
(1-year cumulated flows, US\$ bn.)

	2014	2015	2016
	Q4-14	Q4-15	Q3-16
Current Account	57.5	69.0	30.2
Trade Balance	188.9	148.5	93.4
Oil and Gas Exports	324.4	198.9	151.7
Other Exports	172.4	142.6	128.4
Imports	307.9	193.0	186.7
Services (net)	-55.3	-36.9	-25.0
Tourism (net)	-38.7	-26.5	-16.8
Income (net)	-76.1	-42.6	-38.1
Investment Income (net)	-58.0	-31.9	-29.5
Remittances (net)	-10.1	-5.1	-2.5
Capital and Financial Flows	-173.1	-71.2	-19.5
Capital Account	-41.5	-0.7	-1.9
Net Financial Liabilities	-49.8	-72.2	-28.5
General Government	-12.2	-6.4	5.4
Banks	-37.5	-60.0	-29.1
Non Bank-Non GG	-0.2	-5.8	-4.8
Net Financial Assets	81.8	-1.8	-11.0
General Government	-39.4	2.2	-0.3
Banks	48.5	-25.8	-36.2
Non Bank-Non GG	72.6	21.9	25.5
Errors and Omissions	8.0	3.9	3.5
Reserve Assets	-107.5	1.7	14.3

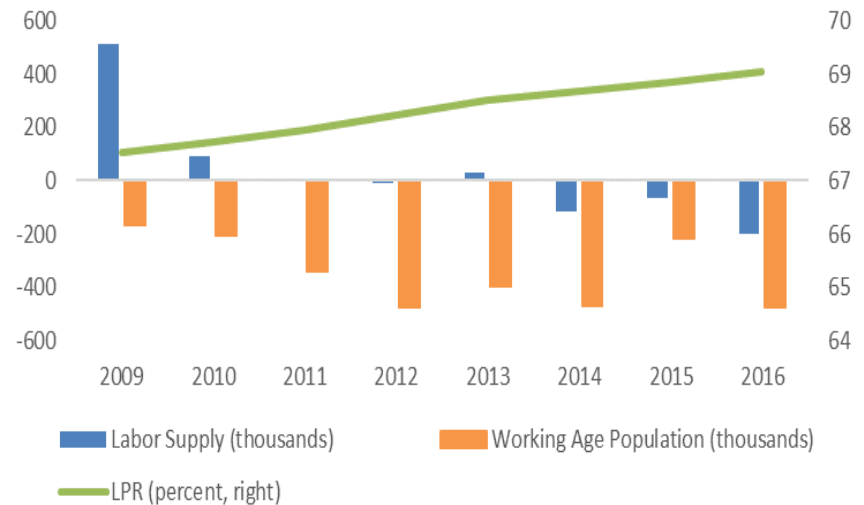
Stabilizing after External Shocks...

...as the economy stabilizes, real wages stopped decreasing, and unemployment ticked down, reflecting moderate slack and demographic trends

Russia. Labor Market



Russia. Demographics (3-year averages)



Fiscal Policy: A Balancing Act

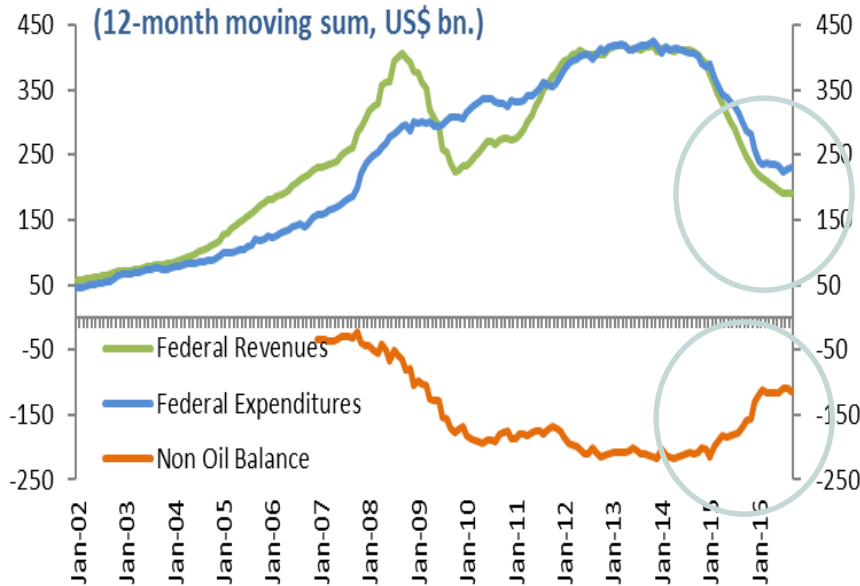
- Adapted to lower oil prices in 2015-16, but oil price rule and 3-year budget framework had to be temporarily suspended
- Going forward it will need to balance:
 - **Needed Fiscal Consolidation**, with
 - **Avoiding risking the nascent recovery**, with
 - **Preserving 'growth-friendly' spending**, with
 - **Anchoring RER expectations.**

Fiscal Policy: A Balancing Act

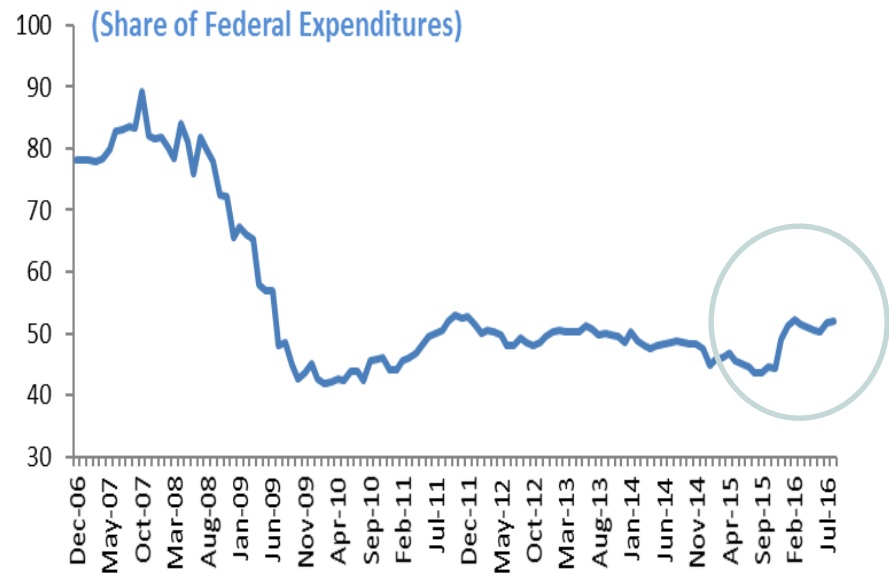
Federal expenditure stabilized in US\$-terms...

...but non-oil revenues still cover only about 50 percent of federal expenditures...

Russia. Federal Budget
(12-month moving sum, US\$ bn.)



Russia. Non-Oil Revenues
(Share of Federal Expenditures)

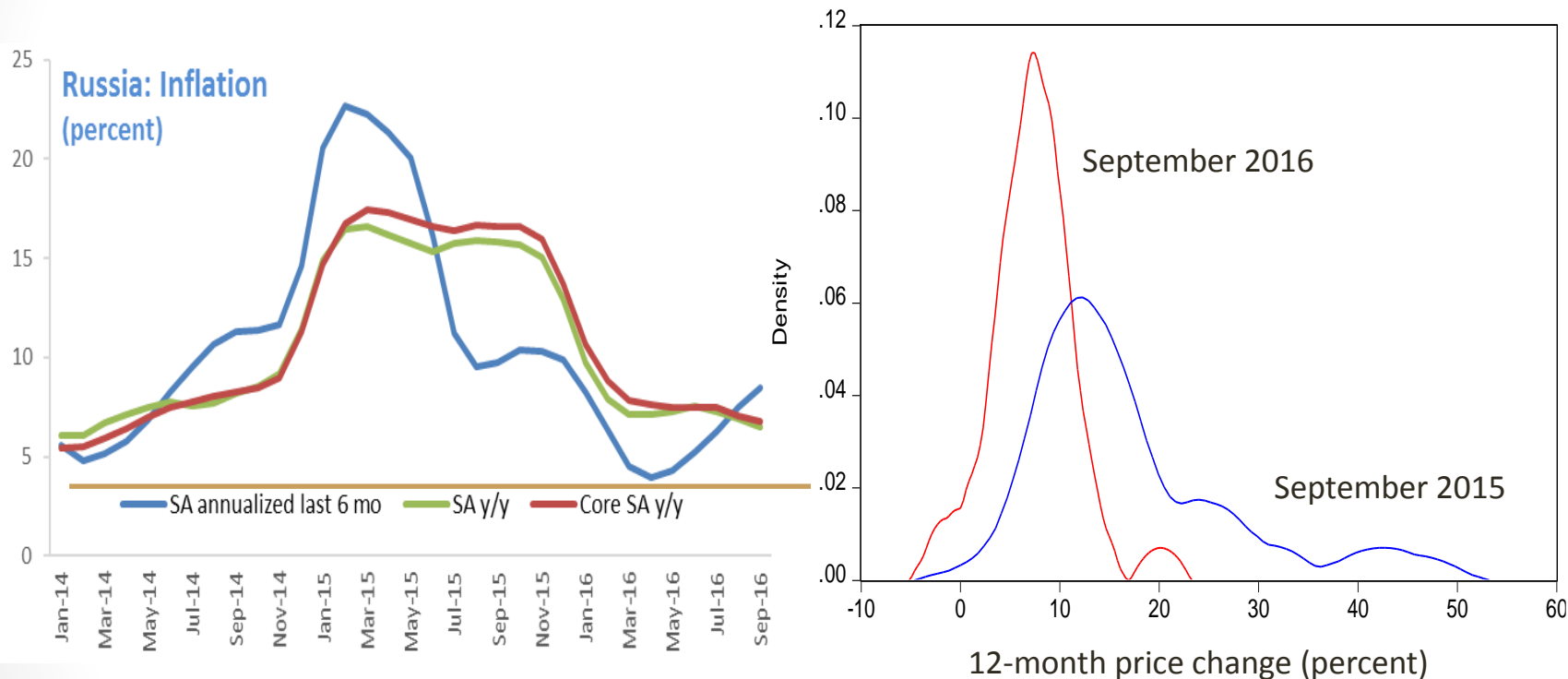


Monetary Policy: Gradual Normalization

- **Adequate policy decision making** in a difficult context is contributing to lower both headline and inflation expectations
- **Guidance through end-2016 is adequate** given recent uptick in SA inflation
- With inflation decreasing towards the CBR target, **there will be room to continue normalizing rates during 2017**
- **Containing fiscal risks is essential** to support monetary policy going forward

Monetary Policy: Gradual Normalization

As the relative price change subsides, y/y inflation is decreasing, with annualized 6-month inflation at around 5 percent by 2016Q2, but picking up in Q3



Financial Policies: Gradual Normalization

- **Appropriate policies helped to maintain stability of the banking system**
- **The system is moving from liquidity deficit to surplus, but credit growth will remain modest in the near term**
- **Bank supervision should monitor quality of bank assets to ensure a healthy sector**
- **Recession and weak growth pose risks to the banking sector; external factors pose additional risks**

Summary: Stabilization

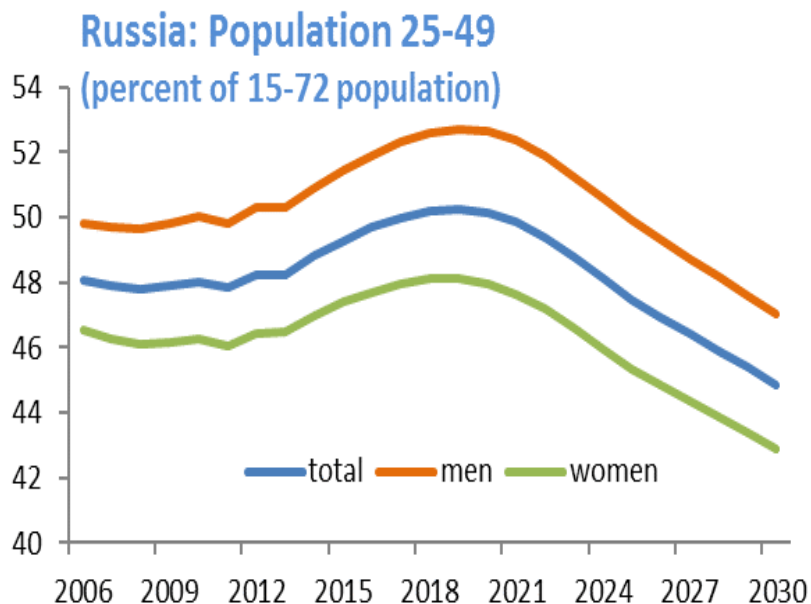
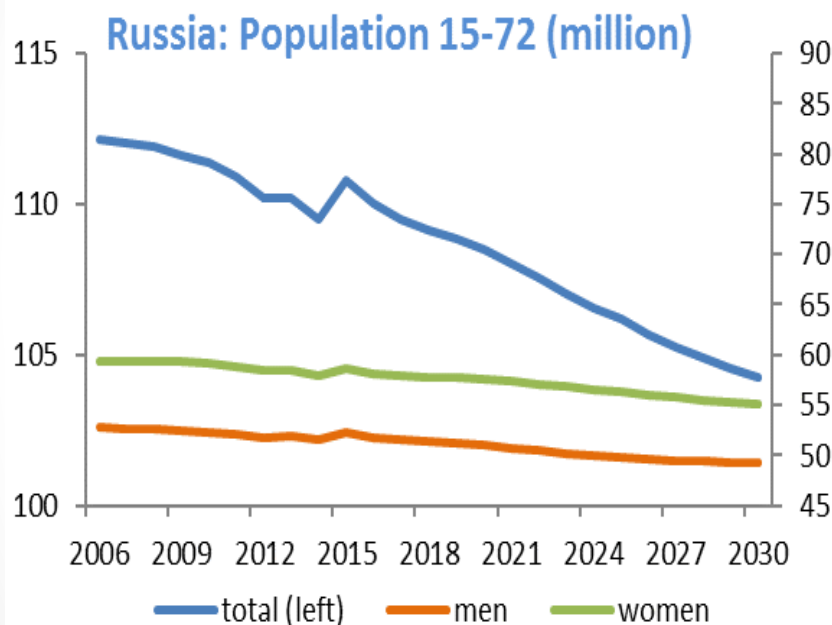
- **Right and Timely Economic Policies** smoothed out adjustment and lay the ground for more diversified growth going forward
- **Adoption of inflation targeting - Floating Exchange Rate** eases adaptation to external shocks
- **GDP growth to resume in 2017** and to converge gradually to 1.5 percent
- **Inflation will continue to gradually decrease** towards CBR target

Story 2: Growth

Demographics trends are not supportive of growth...

Working age population will continue to decrease...

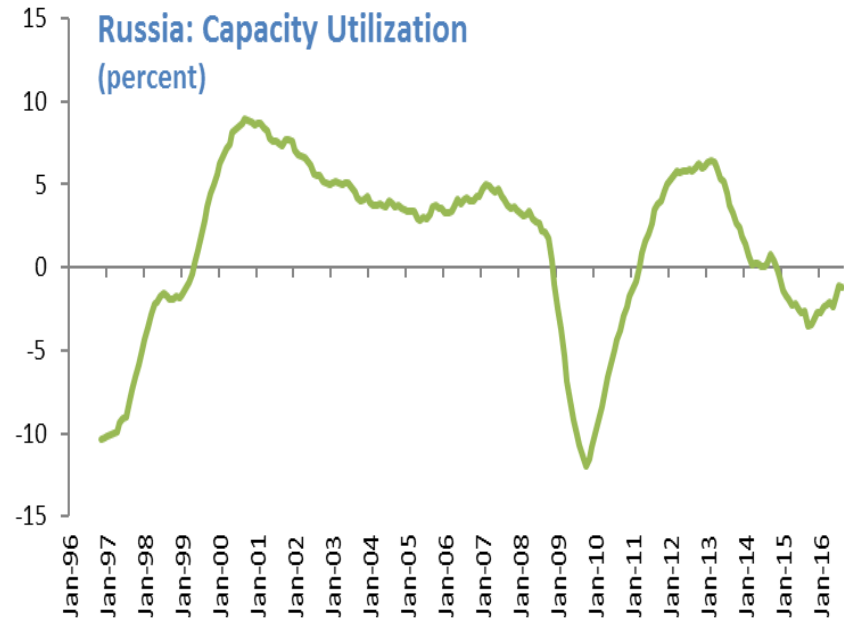
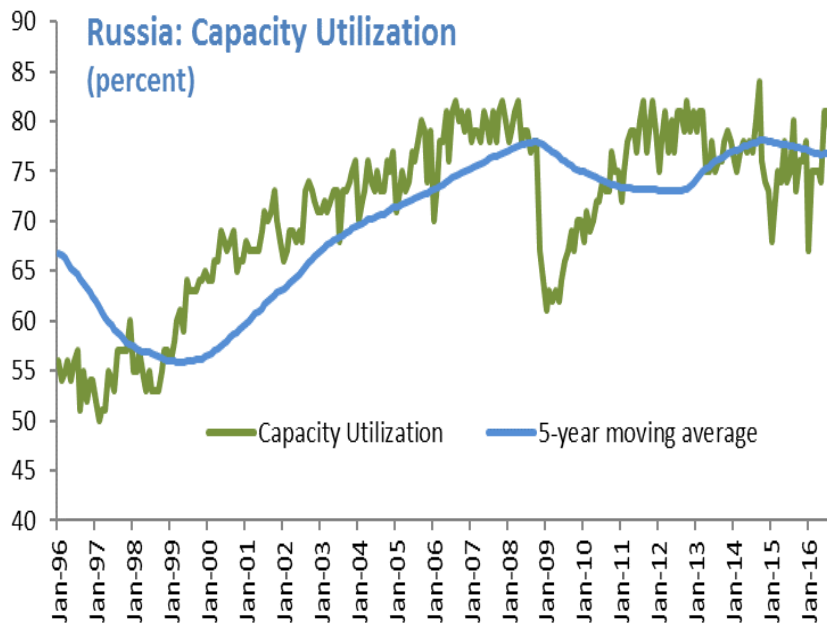
...and increases in LPRs may be constrained by shrinking share of "prime age" workers



...capacity utilization increases will not provide a lasting boost....

Unlike in the early 2000s capacity utilization is high...

...and thus, its increases will not provide a lasting boost to growth



...and thus, increasing growth and domestic market size will require...

- **Increasing and improving Infrastructure**, particularly important in Russia, given geography
- **Supporting human capital formation**, through continued improvements in education and health (at federal and regional level)
- **Strengthening the business environment**, through carefully sequenced reforms
- **Ensuring stability of Relative Prices**, through a well-designed fiscal rule
- **Creating conditions for increased investment**, better productivity is embedded in state-of-the machinery and equipment

Policy Actions and Authorities' views on Reform, 2000-15

Right Diagnostics

- Large footprint of the state in the economy and insufficient market competition.
- Lack of diversification
- Burdensome administrative barriers
- Transparency and governance problems
- **Right Recommendations**
 - Strengthen property rights and the business climate
 - Increase market competition, including by reducing trade barriers
 - Promote innovation to diversify the economy out of oil
 - Reform Public Administration, tackle corruption and increase transparency

Effectiveness of Policy Actions

- **Timing of Policy Actions:** Sustained “action” on institutions, health and basic education, supporting market size and innovation; other actions are concentrated in specific periods.
- **Oil Price Cycle matters:** Authorities views’ on the oil price cycle appear relevant to understand prioritization and timing of policies (macro, labor, banks)
- **Reform Determinants:** Effective improvement in competitiveness indicators is associated with the price of oil, oil price volatility, and initial conditions
- **Lack of progress recognized as challenge:** In particular for some indicators within institutions, market competitiveness, diversification.

Achievements and Challenges

- **Achievements**

- Convergence: in absolute and relative terms, and with respect to OECD (23% of indicators improving moderately and 27% strongly)
- Russia in the upper third when considering all countries

- **Challenges**

- Competitive advantages have not changed
- 70% of indicators still 20 pp or worse than OECD averages
- OECD accession talks on hold due to geopolitical tensions

Some Thoughts Going Forward: Fiscal Policy

- **RER level supports diversification but fiscal consolidation essential**
 - Should allow Russia to keep its advantage on Macro
- **Fiscal consolidation raises risks to competitiveness**
 - Means-tested spending on Basic Health, and Education, and Infrastructure should be maintained
 - Revenues measures should not affect incentives to invest, promote better distribution of income
 - Gradual pension reform should both support fiscal consolidation and labor supply

Some Thoughts Going Forward: Other Reforms

- **Taking advantage of Market Size**
 - Requires supply adjustment and *international integration*
- **Diversification requires action in slow-progress areas:**
 - *Market Competition* (transparency, footprint of state in economy, localization rates, procurement rules)
 - *Technological Readiness* (breadth of value chain, availability of domestic suppliers)
 - *Innovation* (availability of latest technology, affected by RER and for some sectors by lack of access to financing)
- **Challenge: The right diagnostics and policy actions have been at times not effective**
 - Prioritization, Sequencing, Measurability, Accountability, Transparency

Russia: Risks and Mitigating Factors

External risks: Oil price and financial market volatility (Fed's Policy, China) and geopolitical tensions.

Domestic risks: Mainly linked to fiscal policy implementation

1. **Mitigating Factors (Stocks):**

- Low public debt ratios
- Positive External Investment Position
- High levels of External Reserve Buffers
- Relative Prices broadly aligned with fundamentals

2. **Mitigating Factors (Flows):**

- Current Account Surplus
- Floating Exchange Rates
- Fiscal Deficits that are still manageable (provided consolidation proceeds).

Большое Спасибо