RUSSIA

The economy is in recession. Falling oil prices, international sanctions and capital flight have reduced investment, domestic consumption and imports. The large depreciation of the ruble has pushed inflation to double digits and reduced real incomes, especially of the poorest. Recovery will be only gradual against the backdrop of an uncertain external environment and lack of structural reforms. Unemployment will rise from the current low levels. Growth is projected to turn positive in 2017 as exports strengthen and domestic demand recovers.

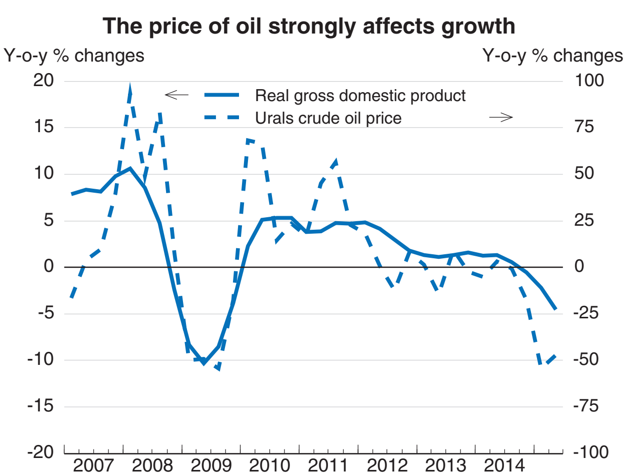
The accommodative fiscal stance is appropriate, given the size of the demand shock. Targeted income support to lower-income groups would reduce poverty risks from large falls in real wages. Fiscal consolidation is nevertheless needed in the medium term to adjust to lower oil prices and an ageing population. The scope for monetary policy easing will depend on declines in inflation and inflation expectations. Weakening bank balance sheets should be monitored closely to arrest the build-up of non-performing assets. Measures to combat corruption, reduce the role of the state in the economy and to reinforce skills and innovation would raise potential growth.

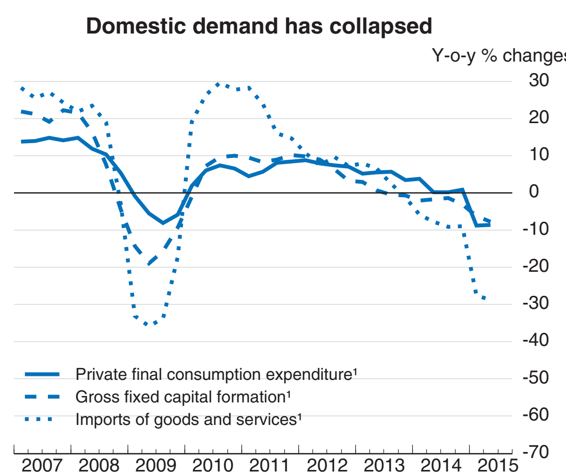
Energy intensity is high and Russia is one of the world's largest emitters of greenhouse gases. Low air quality contributes to a high premature mortality rate. Attaining the goal of a 40% reduction of the energy intensity of GDP from 2008 levels by 2020 will be challenging. Energy intensity could be substantially reduced by eliminating high fuel subsidies (costing 2% of GDP), which would improve energy efficiency in transport, housing and industry.

Domestic demand has collapsed due to the low oil price and lower real incomes

The dramatic fall in the oil price has greatly reduced export and fiscal revenues. Investment has declined strongly due to general uncertainty, high financing costs and

Russia





1. In volume.

Source: OECD Economic Outlook 98 database; and Thomson Reuters (2015), Datastream Database.

StatLink http://dx.doi.org/10.1787/888933296463

Russia: **Demand, output and prices**

	2012	2013	2014	2015	2016	2017
	Current prices Russian Ruble trillion	Percentage changes, volume (2008 prices)				
GDP at market prices	62.2	1.3	0.6	-4.0	-0.4	1.7
Private consumption	31.3	4.9	1.2	-9.8	-0.9	0.9
Government consumption	11.7	1.1	-0.1	-0.3	-0.4	0.0
Gross fixed capital formation	13.1	0.6	-2.1	-7.2	-0.1	3.9
Final domestic demand	56.1	3.1	0.2	-6.9	-0.3	0.0
Stockbuilding[1]	1.6	-1.8	-1.1	-5.7	-0.2	0.0
Total domestic demand	57.7	1.2	-1.0	-13.4	-0.9	1.4
Exports of goods and services	18.4	4.6	-0.1	1.1	1.6	3.8
Imports of goods and services	13.9	3.8	-7.9	-27.3	-0.4	3.7
Net exports[1]	4.5	0.5	1.8	6.6	0.6	0.4
Memorandum items						
GDP deflator	_	5.0	7.2	7.2	8.2	5.6
Consumer price index	_	6.8	7.8	15.6	9.5	6.1
Private consumption deflator	_	6.4	8.3	18.4	10.0	6.3
General government financial balance[1,2]	_	0.3	0.3	-4.0	-3.2	-1.8
Current account balance[1]	_	1.7	3.2	6.6	6.6	6.2

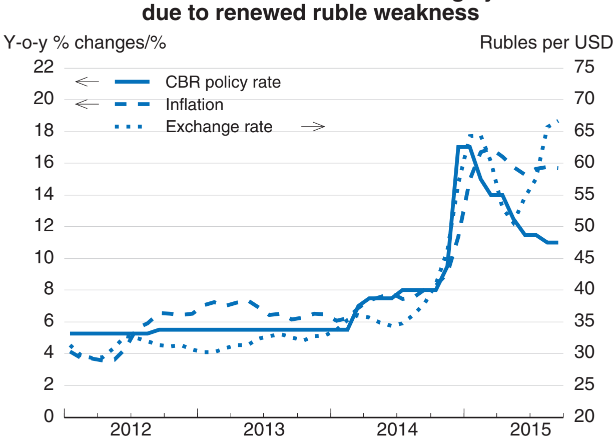
1. As a percentage of GDP at market value.
2. Consolidated budget.
Source: OECD Economic Outlook 98 database.

StatLink http://dx.doi.org/10.1787/888933297312

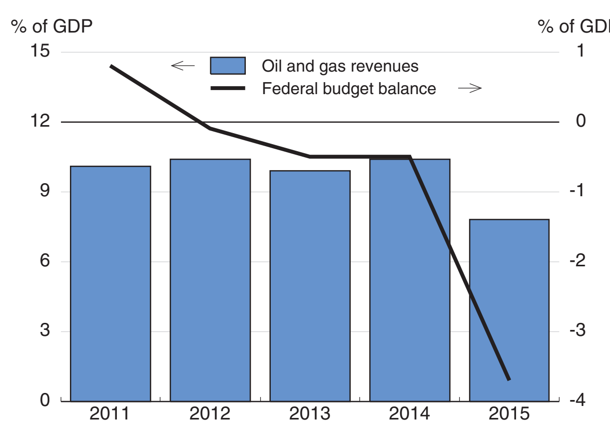
limited access to international finance. Consumption has been hit by a large cut in real wages, loss of confidence and tighter financing conditions for consumer loans. Imports have declined sharply in response to weak demand and external sanctions, while exports held up in real terms, aided by the sharp depreciation of the ruble.

Russia

Central bank moderated the easing cycle due to renewed ruble weakness



The fall in oil prices poses fiscal challenges



Source: Russian Ministry of finance; OECD Economic Outlook 98 database; IMF International financial statistics database; Bank of Russia; and Thomson Reuters (2015), Datastream Database.

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The large ruble depreciation has pushed up inflation. Food prices have increased even more. A sharp drop in real wages that were not fully indexed to inflation has helped labour market adjustment and unemployment rose only a little from low levels. However, it also cut real incomes and raised poverty risks. Pensions and social benefits were also only partially indexed to inflation, eroding purchasing power of vulnerable groups. The poverty rate has increased significantly, from 11% in 2013 to 15% in the first half of 2015, with around 22 million people living in poverty.

The large drop in imports has improved the current account despite lower oil prices, but it reflects the collapse in incomes and domestic demand. External sanctions have raised uncertainty, triggered capital outflows and aggravated ruble depreciation. With international financing cut off, Russian borrowers have been unable to roll over their external debt, although banks and companies were able to draw on their foreign currency assets and the central bank provided foreign exchange liquidity.

Monetary and fiscal policy are constrained by high inflation, negative growth and low oil revenues

The large depreciation has absorbed part of the oil shock by reducing the cut in oil and gas revenues in ruble terms. To defend the ruble and arrest capital flight, the central bank raised interest rates to a 10-year record high of 17% in December 2014. Ruble depreciation fuelled inflation, and the central bank faced a difficult environment of negative growth and soaring inflation. The central bank is more clearly focused on achieving a medium-term inflation target of 4%, and accordingly slowed monetary easing in response to the exchange rate depreciation and associated spike in inflation. It has kept the policy rate at 11% for the last three months. If inflation and inflation expectations fall, as expected, the central bank will be able to further reduce interest rates.

The central bank should be vigilant with respect to foreign exchange liquidity provisions for banks and avoid propping up insolvent institutions. To prevent a crisis, the authorities introduced a capital support programme for banks, while at the same time many small insolvent institutions were closed down. The authorities should remove credit growth targets and weakening bank balance sheets should be monitored closely to avert a build-up of non-performing assets.

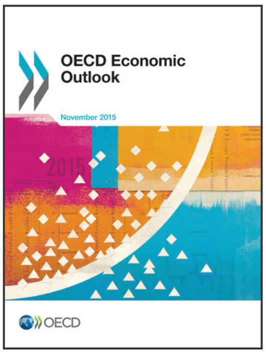
Fiscal policy has become increasingly expansionary as the recession has deepened. Low oil prices have cut revenues, while outlays on social programmes, economic subsidies and national defence spending have been raised.

In this challenging environment, it is appropriate to let the automatic stabilisers fully operate. The fiscal deficit will be partly financed from the Reserve Fund, while the National Wealth Fund is being used to recapitalise banks and fund investment. However, the two oil funds cannot support deficits for long, and policy will therefore need to adjust to a potential new reality of lower oil prices and rapid ageing by lowering and restructuring public expenditure. At the same time, means-tested benefits will be needed to protect incomes of the poorest, and more focus on supporting education and providing a fertile environment for innovation is needed to help growth and raise non-oil fiscal revenues. Reducing corruption by raising transparency and accountability in the public sector and judiciary, easing administrative barriers and lowering state involvement could make growth more inclusive for all.

Growth will return in 2017

The economy is projected to stagnate in 2016 and return to weak growth in 2017. The dissipation of the negative impact of current account shocks, improved macroeconomic stability and lower inflation will help domestic demand to gradually recover. At the same time, global growth will help sustain exports. Unemployment is projected to remain higher than before the crisis.

Projections assume the current low levels of oil prices, a constant low value of the ruble and the continuation of sanctions. Improvement in any of these areas would materially strengthen growth. If geopolitical tensions eased significantly, investment and growth would increase and financing would become easier, but if they were to deteriorate the Russian economy would face further pressures. Meanwhile, scarce resources are used for import substitution, and there is a risk that under current difficult circumstances banks will evergreen non-performing assets, ultimately undermining financial stability. A global slowdown, especially in China, would reduce Russian exports and growth.



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