RUSSIAN FEDERATION

Growth has picked up, supported by surging commodity prices, and domestic demand is expected to strengthen in the near term. Output is projected to grow by nearly 5% in 2011 and by 4½ per cent in 2012. As the effect of last year's food price shock dissipates, disinflation should resume. The budget is projected to return to surplus this year, as revenues will exceed projections by a large margin due to higher-than-expected oil prices, but the non-oil deficit will remain large.

The budgeted reduction of the non-oil fiscal deficit over 2011-13 is sensible. Pressure to spend the oil price windfalls should be resisted, not because fiscal sustainability is in immediate danger, but to avoid fiscal policy becoming procyclical and, more generally, to reduce the budget's dependence on fluctuations in commodity prices. Restoring a fiscal rule would be helpful in this regard. Even in the absence of financing needs, the government should pursue its privatisation agenda, while also undertaking other structural reforms to reduce entry barriers and improve the business climate.

Growth momentum has returned

Supported by rising prices for oil and other export commodities, real GDP increased by 4% in 2010, with a strong pickup in the fourth quarter to more than 11% (annualised rate). Gross capital formation in 2010 advanced particularly strongly, mostly on account of inventories. Notwithstanding very strong imports, the current account surplus widened as the terms of trade improved. The preliminary GDP estimate for the first quarter of 2011 indicates a slowdown to 2½ per cent annualised. Pronounced weakness in fixed investment appears to have undercut demand growth in the first quarter, although most high-frequency indicators pointed to continued strong expansion.

Inflation appears to have peaked

Having hit a post-Soviet era low of 5.5% in July 2010, inflation picked up to 9.7% year-on-year in January before stabilising. The upsurge was largely driven by food price increases resulting from the heat and drought

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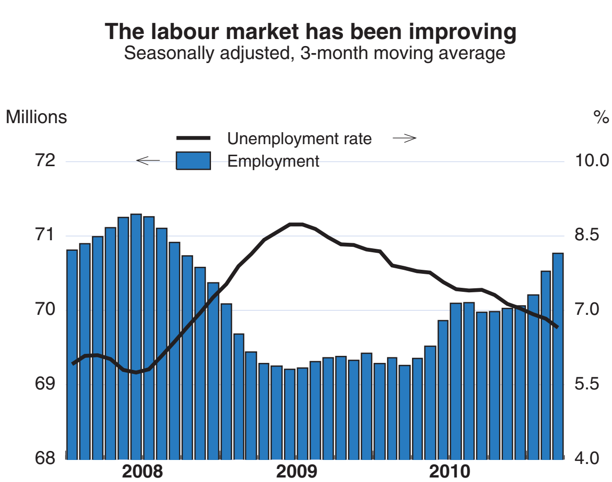
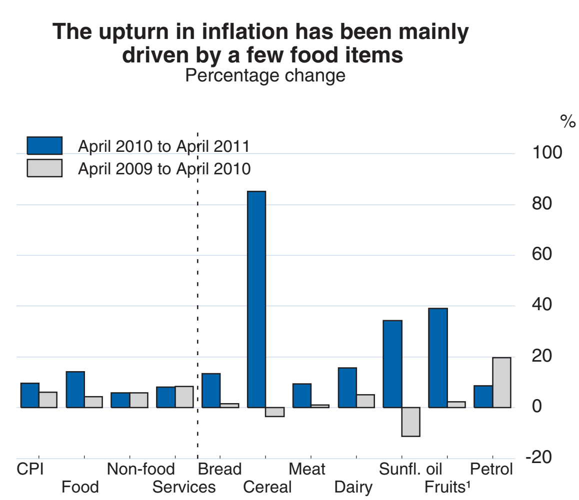




1. Fruits and vegetables.

Source: OECD calculations based Russian Federal Service for State Statistics and Central Bank of Russia.

StatLink http://dx.doi.org/10.1787/888932430039

Russian Federation: **Macroeconomic indicators**

	2008	2009	2010	2011	2012
Real GDP growth	5.2	-7.8	4.0	4.9	4.5
Inflation (CPI), period average	14.1	11.7	6.9	9.4	6.4
Fiscal balance (per cent of GDP)[1]	7.2	-6.8	-4.3	0.2	0.3
Current account balance (per cent of GDP)	6.1	3.9	4.8	6.8	5.8

1. Consolidated budget.
Source: OECD Economic Outlook 89 database.

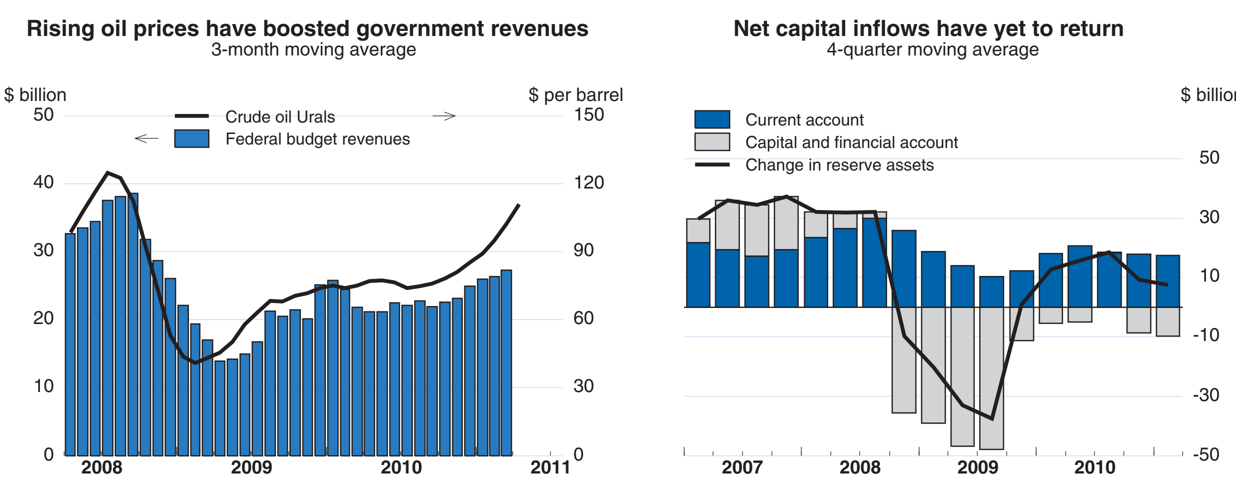
StatLink http://dx.doi.org/10.1787/888932431293

during last summer. The crop losses and the panic which set in pushed the price of cereals up by 85% in the year to April 2011, an increase that was then passed on to a number of other food items, such as meat and sunflower oil. Monetary factors also played a role, as a significant amount of liquidity was injected into the economy via only partially sterilised foreign exchange interventions and the running down of government deposits at the central bank to finance the budget deficit. Although underlying inflation pressures appear to be contained, given the negative output gap and broadly unchanged core inflation, the government has resorted to a number of interventions to bring the headline rate down, such as curtailing petrol exports, selling grain from reserves and holding down tariff increases for natural monopolies.

Labour market conditions are improving

Employment losses were limited during the crisis due to the adjustment in working hours and real wages, but the labour market recovery has lagged the rebound in output. Recent labour market developments show gradual improvement, with the unemployment rate

Russian Federation



Source: OECD calculations based on Datastream, Russian Federal Service for State Statistics, Central Bank of Russia and Economic Expert Group.

StatLink http://dx.doi.org/10.1787/888932430058

Russian Federation: **External indicators**

	2008	2009	2010	2011	2012
			$ billion		
Goods and services exports	522.9	345.4	444.5	620	676
Goods and services imports	367.7	251.0	320.9	429	487
Foreign balance	155.2	94.4	123.6	190	190
Invisibles, net	- 51.7	- 45.7	- 52.5	- 57	- 60
Current account balance	103.5	48.6	71.1	133	130
			Percentage changes		
Goods and services export volumes	0.6	- 4.7	7.1	4.1	5.8
Goods and services import volumes	14.8	- 30.4	25.6	21.3	10.9
Terms of trade	15.6	- 29.5	18.5	21.4	1.0

Source: OECD Economic Outlook 89 database.

StatLink http://dx.doi.org/10.1787/888932431312

continuing its downward trend and employment picking up in the first part of 2011.

The budget is likely to return to surplus this year

The federal budget deficit narrowed to 4% of GDP in 2010, down from 5.9% in 2009, and the 2011-13 budget foresees a further moderate fiscal tightening, with the large non-oil deficit gradually decreasing from its 2010 level of around 13% of GDP. Rising oil prices have boosted revenues and have improved the fiscal position faster than envisaged by the government, however. Based on current oil prices and spending plans, the headline budget deficit should be eliminated this year; the budget was already in surplus in the first four months of the year. Before the surge in oil prices, the government intended to divest its stakes in a number of large companies and banks. These privatisation plans should be pursued, even in the absence of financing needs, as this is one of the measures needed to reduce state control over economic activity.

The central bank has allowed greater exchange rate flexibility

The central bank continues to balance the objectives of disinflation and limiting excessively rapid appreciation of the rouble. It has at times intervened in the foreign exchange markets to mitigate rouble appreciation in the wake of strong current account inflows linked to rising oil prices. At the same time, it has also been allowing more exchange rate fluctuation than in the past and is trying to use its constellation of policy rates and reserve requirements to smooth market interest rates and bring inflation down to low and stable levels. This more flexible exchange rate policy has, however, not yet been tested by large-scale foreign currency inflows through the financial account as, contrary to the pre-crisis period, rising oil prices have not been accompanied by increasing net capital inflows. Instead, Russian corporations and banks have so far chosen to improve their net foreign asset positions.

Positive growth momentum is expected to be sustained

Notwithstanding the growth slowdown in the first quarter indicated by the preliminary estimate, domestic demand is expected to be strong in the near term, given the surge in oil prices which will feed through to higher incomes and faster credit growth. Bank lending has already been boosted by abundant liquidity and the improved creditworthiness of large resource-based companies. Given a high income elasticity of imports, faster growth in absorption should translate into import volume growth which will significantly outpace growth in export volumes this year and next. The current account surplus will nonetheless widen this year to about 7% of GDP due to higher oil prices before narrowing slightly next year. Output growth is projected to approach 5% in 2011, before moderating to 4.5% in 2012. Annual average inflation will exceed 9% in 2011, but then fall to 6.4% in 2012 as the impact of the food price shock fades away.

The key risk factors relate to commodity prices and capital flows

The prices of export commodities, in particular oil and gas, remain the key risk factor. Higher-than-projected commodity prices would give a stronger impetus to domestic demand and further improve the fiscal and external positions. Private capital inflows may resume, fuelling demand but also complicating the conduct of monetary policy. In the context of the 2011 parliamentary and 2012 presidential elections, some fiscal loosening is likely, which would be unhelpfully procyclical. Growth prospects would be robust to a small fall in oil prices from the levels assumed in this projection, but a large decline would pose a significant downside risk.