RUSSIA

Highlights

- **The economy experienced a second year of recession, driven by low oil prices and sanctions and exacerbated by long-standing structural weaknesses.** Both household demand and corporate investments contracted sharply in 2015 adjusting to external shocks, as inflation has been cutting into real incomes, while the rouble depreciation, heightened domestic funding costs and a lack of access to foreign capital markets hurt business prospects.
- **Monetary and fiscal policies remained effective at stabilising macroeconomic balances.** The combination of a free-floating exchange rate regime, capital and regulatory support for the banking system and tighter bank supervision have all supported market confidence. At the same time, foreign exchange reserves increased to the level of the end of 2014 and the public external debt remained negligible.
- **Russian firms are returning to global capital markets.** Eurobond issuances and syndicated lending have picked up in 2016, but are still far below pre-2014 levels.

Key priorities for 2017

- **The economy needs to keep adjusting to the persistently low level of oil prices.** Capital formation has been declining since 2012, despite a surge in investment (without inventories) in the extractive industries, constraining productive capacities and thus long-term growth prospects. Further business environment reforms supporting the investment climate and trade openness could encourage private investment, especially in non-commodity-based sectors.
- **Consolidation and recapitalisation of the banking sector should advance further to tackle remaining vulnerabilities.** Consolidation of the banking sector should focus on capital increases (potentially via privatisation in some cases), closures of undercapitalised banks, and support for early resolution of increasing NPLs.
- **Further privatisation may help short-term budget financing and reduce the state's footprint in the economy.** The government has sold several companies as the financing of the fiscal deficit has become more difficult. If privatisation is executed transparently and fairly it can help reduce the role of the state in some sectors and improve economic efficiency.

CONTINUES

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	3.5	1.3	0.7	-3.7	-0.6
Inflation (average)	5.1	6.8	7.8	15.5	7.0
Government balance/GDP	0.4	-1.2	-1.1	-3.5	-4.0
Current account balance/GDP	3.3	1.5	2.8	5.2	3.1
Net FDI/GDP [neg. sign = inflows]	-0.1	0.8	1.7	1.2	0.5
External debt/GDP	29.3	32.7	29.5	39.1	n.a.
Gross reserves/GDP	24.8	22.8	19.0	27.8	n.a.
Credit to private sector/GDP	44.7	49.4	54.3	56.4	n.a.

Macroeconomic performance

Russia has entered its second year of recession. After four years of decelerating growth from 4.0 per cent in 2011 to 0.7 per cent in 2014, the economy entered a recession in 2015 as real GDP declined by 3.7 per cent. The drop was aggravated by Western sanctions and declining oil prices that, apart from their direct effect on growth, dampened business and consumer confidence. The GDP contraction continued in the first half of 2016 (a fall of 0.9 per cent year-on-year) as oil prices fell to their lowest levels since 2003. A sharp contraction in both household demand (4.1 per cent) and corporate investments (7.1 per cent) continued in 2016, as inflation was still cutting into real incomes, while sanctions and high interest rates made access to financing more difficult and costly. Unemployment remains low at around 5 to 6 per cent as corporations generally prefer to freeze wages instead of shedding labour.

Russia's strong external position was supported by a sharp adjustment in domestic demand and significant corporate deleveraging. The current account surplus increased in 2015 mainly as a result of lower imports and interest payments abroad which more than offset the contraction in exports in value terms. Despite the improvement in competitiveness resulting from the sharp depreciation of the rouble, export gains up to now were limited to some sectors including agriculture, food (also benefiting from the imports ban), chemicals, rubber and plastics. At the same time the rouble depreciation improved the profitability of major domestic exporters of oil, gas, refined petroleum products and metals. Private sector capital outflows decreased considerably in 2016 (US$ 10 billion in the first three quarters of the year) in comparison to 2014 (US$ 152 billion) and 2015 (US$ 57.5 billion). Russian issuers are returning to global markets in 2016 as evidenced by increased Eurobond issuances and syndicated borrowing (US$ 22 billion in the first three quarters of 2016, including US$ 1.75 billion sovereign, versus US$ 12 billion in the whole of 2015) but external funding is still well below pre-2014 levels.

Exchange rate changes in 2016 mostly mirrored oil price developments. The rouble depreciated from below 50 roubles to one US dollar in May 2015 to above 80 in late January 2016 on weakening oil prices. Depreciation pressures eased from February following the increase in oil prices, and the rouble recovered to around 60 roubles to one US dollar in October 2016.

Monetary policy has been focusing on supporting disinflation and avoiding excessive exchange rate volatility, while fiscal policy has been countercyclical. The Central Bank of Russia (CBR) cut its key policy rate by 0.5 percentage points in June and September 2016, after a long respite since August 2015. Weak demand and base effects have supported disinflation; the annual change in the Consumer Price Index dropped to 6.4 per cent in September 2016 from a peak of 16.9 per cent in March 2015. Meanwhile, fiscal policy has acted counter-cyclically, with the general government deficit at 3.5 per cent of GDP in 2015 after 1.1 per cent in 2014. The 2016 budget aims to keep the deficit at 3.7 per cent of GDP, but the actual outcome might be higher.

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The growth outlook remains weak in case structural reforms are not carried out. Domestic demand remains weak in 2016, but the stronger rouble will continue to support imports and reduce the trade surplus. Increasing oil prices will underpin the economic recovery in the second half of 2016; resulting in GDP growth of -0.6 per cent. In 2017 growth is expected to pick up to 1.2 per cent, supported by higher oil prices, recovering private consumption and investments. Long-term growth, without significant reforms, may remain at around 1 to 2 per cent annually due to low investments and outdated production capacities.

Major structural reform developments

Banking sector consolidation continues, but weak economic growth is taking a toll on profitability. The government's capital support programme, introduced in December 2014, was completed in 2015 and most regulatory forbearance measures were lifted by April 2016. Although overall capitalisation of the Russian banking sector (12.5 per cent in August 2016) remains above the regulatory minimum, a number of small and mid-sized banks face capital constraints. Since mid-2013 the CBR has closed around 250 banks that were performing weakly and were experiencing poor corporate governance. Bank closures led to depletion of the deposit insurance fund, which is now mostly financed by the CBR loans. Household loan growth has remained negative in 2016, while NPLs have been increasing in both the corporate and household sectors. The banking system is moving towards Basel III standards – minimum capital requirements were lowered from 10 to 8 per cent and higher risk weights have been introduced in line with the Basel Accord's recommendations. The CBR also published a strategy for financial market development in December 2015 which aims to support the financial sector in the coming years by improving market regulation.

The privatisation process was re-launched to support fiscal spending. The government sold a 10.9 per cent stake in diamond producer Alrosa in July 2016. It has also announced the sale of Russia's largest shipping company Sovcomflot; and the VTB bank; as well as a controlling stake in the oil company Bashneft (sold eventually to another state oil company, Rosneft). However, the government may be reluctant to proceed with the sales given the still-weak market conditions.

Measures have been taken to improve the business climate for small and medium-sized enterprises (SMEs) which face a challenging environment. In June 2016 the government adopted a strategy for supporting SMEs by 2030 which aims to ease access to finance, improve infrastructure and reduce the tax burden. The government also adopted a decision on minimum procurement orders for SMEs (18 per cent of total) from an expanded list of regulated companies including state-owned banks. According to the government, purchases of state-owned companies and natural monopolies exceeded RUB 1 trillion in 2016. While these measures may support SMEs, so far the volume of bank loans to SMEs declined by 3.8 per cent in January to August 2016. In addition, despite the three-year holiday from regular inspections, the number of inspections per SME actually increased in 2015.

Other sectoral measures have been introduced. Recent government policies have focused on support for the tradeable sector. An anti-crisis package for 2016, adopted in March, envisages support for local production in sectors with export potential. The Russian Export Centre started its activities in 2016 as a one-stop shop agency providing all financial and technical services required by domestic exporters. A new special Agency for Technological Development was created in May 2016 to foster technology transfer from the research and development (R&D) sector, both within Russia and from abroad, to domestic enterprises. However, the telecommunications sector has been affected by the new anti-terrorism law which requires all providers to store customers' data, including emails and call logs. The government also initiated a public administration reform which should include "rightsizing", reduced holidays for state officials and a wage freeze for public servants.

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The contributions to the mandatory pillar will be used to fund the pay-as-you-go system until 2019. Although initially introduced as a temporary measure, the majority of private pension fund contributions have been channelled to prop up the pay-as-you-go pillar since 2014. While this measure supports fiscal balances in the short term, it reduces available sources of long-term financing for the Russian economy. A pension reform proposed by the Ministry of Finance and CBR aims to create a scheme for voluntary savings.

Russia's ranking has not changed much in international competitiveness ratings. Russia moved from 36th to 40th place in the World Bank's *Doing Business 2017* report as other countries advanced faster with reforms.[1] Improvements were acknowledged in starting a business and dealing with construction permits. Russia ranks particularly high in enforcing contracts (12th out of 190 countries) and registering property (9th). Sizeable obstacles still remain in several areas, in particular in access to trading across borders (140th) and dealing with construction permits (115th). Despite worsening in the macroeconomic environment and financial market development Russia's rating improved by two positions (to 43th) in the World Economic Forum's *Global Competitiveness Report 2016-2017*, mostly as a result of improved institutions, innovation capacity and technological readiness.

[1] The rating for 2016 reflects the change in the methodology. According to the old methodology Russia was ranked 51st in 2016.