RUSSIAN FEDERATION

The economy is bottoming out, barely avoiding a recession. The falling oil price and the tensions regarding the conflict in Ukraine are undermining investor and consumer confidence. The rouble has sharply depreciated as a result of both factors, which has cushioned the economy to some extent. The strength of the recovery will depend on the flexibility of the economy and its ability to increase trade with non-sanctioning countries. Such a redirection of trade takes time, and real GDP is accordingly projected to stagnate next year, before slowly accelerating to around 1½ per cent in 2016 in the wake of an import-substituting investment recovery.

Monetary policy has moved to full inflation targeting earlier than planned. Inflation has been driven up by sanctions-related price increases and the pass-through of rouble depreciation. The termination of the peg of the rouble to the dollar and the euro will give the monetary authorities greater freedom to adjust the policy stance for domestic requirements. The fiscal rule does not provide much room for stimulus. This difficult combination of weak growth and higher inflation highlights the need for structural reforms.

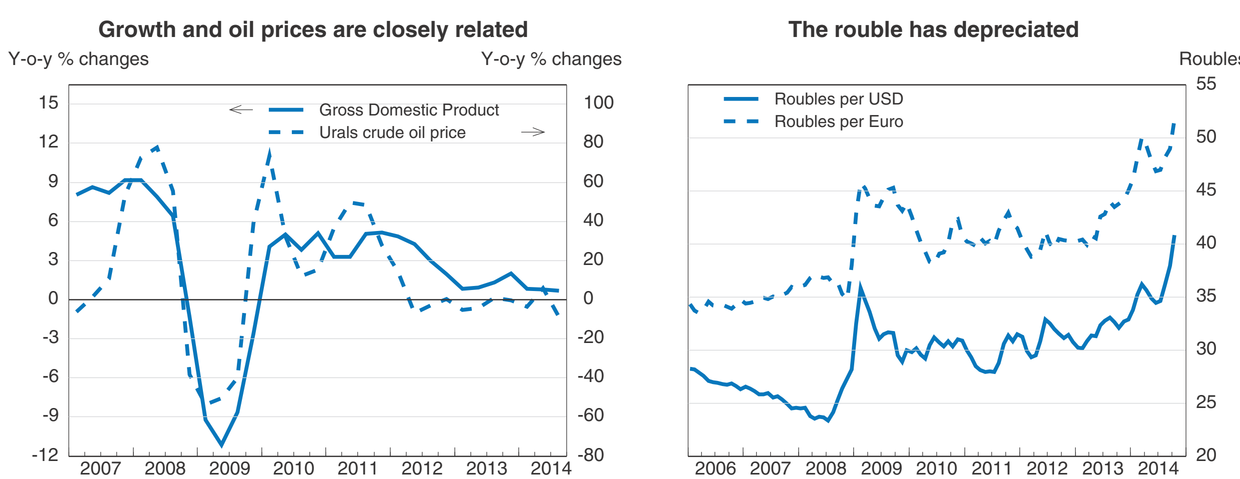
Falling oil prices and weakening trade flows weigh on growth

The economy grew by less than 1% (year-on-year) during the first three quarters of 2014 with a decelerating tendency, aggravated by bad weather in important agricultural production areas. Export earnings declined in line with falling oil prices. Domestic demand collapsed as investment continued to fall; non-military, non-food industrial production shrank; and consumption decelerated sharply. Consumer confidence and investor sentiment are rapidly deteriorating and credit growth to non-financial institutions is also slowing. Inflation jumped from 6% to 8.3% following the rouble depreciation.

Sanctions hit an already weak economy

As a reaction to the geopolitical tensions related to the Ukraine conflict, trade and financial sanctions were imposed against Russia. Most importantly, exports of military equipment and dual-use items, participation in Arctic oil exploration, and long-term financing of selected

Russian Federation



Source: Rosstat; Central Bank of Russia; and Datastream.

StatLink http://dx.doi.org/10.1787/888933169889

Russian Federation: **Macroeconomic indicators**

	2012	2013	2014	2015	2016
Real GDP growth	3.4	1.3	0.3	0.0	1.6
Inflation (CPI), period average	5.1	6.8	7.4	7.7	6.1
Fiscal balance (per cent of GDP)[1]	2.0	0.6	0.4	-0.5	-0.5
Current account balance (per cent of GDP)	3.5	1.6	3.0	1.7	1.8

1. Consolidated budget.
Source: OECD Economic Outlook 96 database.

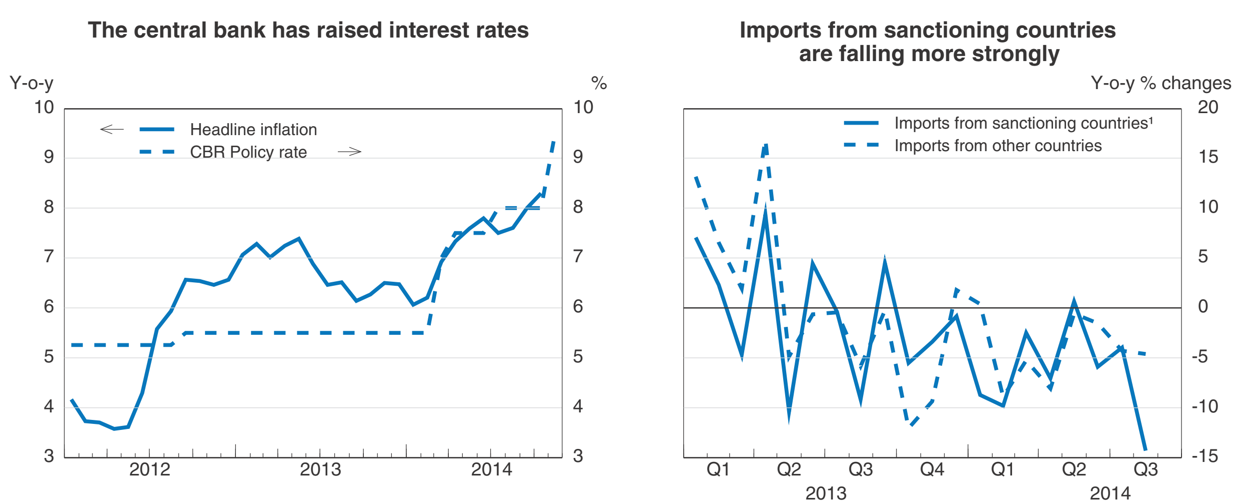
StatLink http://dx.doi.org/10.1787/888933170651

Russian banks and companies were banned. In response, Russia prohibited the importation of selected agricultural and food items from sanctioning countries. The direct growth effect of these measures has so far been limited, but, even so, imports from sanctioning countries are falling much more than from non-sanctioning countries. The rouble has depreciated about 25% against the USD/EUR basket since the implementation of new sanctions beginning of August, although some of this reflects the falling oil price. On the other hand, the sanctions had only a small impact on stock exchange valuations of Russian enterprises. The first signs of import substitution are appearing in food and some military goods industries, replacing supply mainly from Ukraine.

Monetary policy reacted sharply to rising inflation

The central bank has moved to a free floating exchange rate regime and advanced its calendar for transition to full inflation targeting within a band of 3-6% consumer price inflation. Since the beginning of the year the main policy rate has been hiked several times and it now stands at 9.5%. Given the tight labour market, little unused capacity and low trend productivity growth, the recent rise in prices might raise inflation expectations. In addition, the current inflation target band may now be

Russian Federation



1. Imports from EU, United States, Canada, Japan, Australia and Ukraine.
Source: Rosstat; Central Bank of Russia; and Federal Customs Service.

StatLink http://dx.doi.org/10.1787/888933169897

Russian Federation: **External indicators**

	2012	2013	2014	2015	2016
			$ billion		
Goods and services exports	593.4	594.4	557.4	448	465
Goods and services imports	446.0	471.4	424.9	347	365
Foreign balance	147.4	123.0	132.6	101	101
Invisibles, net	- 76.1	- 88.9	- 74.5	- 74	- 69
Current account balance	71.3	34.1	58.1	27	32
			Percentage changes		
Goods and services export volumes	1.4	4.2	0.6	0.9	2.0
Goods and services import volumes	8.8	3.7	- 6.4	- 3.1	1.8
Terms of trade	2.5	- 5.6	- 3.3	- 5.3	- 1.5

Source: OECD Economic Outlook 96 database.

StatLink http://dx.doi.org/10.1787/888933170669

too narrow as the reasons for higher imported inflation stemming from sanctions and depreciation are most likely temporary. The central bank should therefore use freedom gained from moving to full inflation targeting and consider widening its tolerance band temporarily.

Sanctions make investment financing more dependent on government

Russian companies and banks have large refinancing requirements which they can no longer roll over on foreign financial markets. Consequently, these borrowers have to turn to the government. While the government has sufficient foreign currency reserves and liquid assets and the current account is projected to remain in surplus, this might nevertheless open another channel to increase the already high state influence in the economy.

Structural policies could provide a much needed boost for the economy

In a situation in which the economy is supply constrained and macroeconomic stimulus is therefore likely to be ineffective, structural reforms should become a priority. Reforms, as outlined in past *Economic Surveys,* need to focus *inter alia* on widening the rule of law, reducing entry barriers, including by uneven implementation of business regulation on the regional level and removing excessive red tape.

Falling oil prices will further delay a recovery

As a result of the falling oil price and trade disruptions, the economy will stagnate until much of 2015. A recovery in 2016 will depend on a normalisation of the external environment and an improvement of the domestic business climate, which can facilitate more broad based import substitution in response to rouble depreciation.

Downside risks dominate in the short run

Russia would fall into a recession if oil prices continue to decline. A significant tightening of sanctions could also hurt growth. Further accelerating capital flight could force the authorities to re-introduce capital controls with serious consequences for investor confidence. On the other hand, successful import substitution could provide some boost for the economy. A sustainable solution for the conflict on gas supply for Ukraine would help easing tensions overshadowing the trade relations between Russia and European Union countries.

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