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Economic Outlook and Policy Challenges for Russia in 2012

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This morning I will start with introductory remarks on how the International Monetary Fund sees the economic outlook for Russia in 2012 and over the medium term, against the backdrop of the worsened global economic situation, and what the implications are for Russia's economic policies. After my remarks, I will be pleased to answer your questions.

Global economic outlook and policy priorities

The International Monetary Fund released revised projections for the world economy two days ago, in an Update of our World Economic Outlook.[1] Since the last WEO, issued in September 2011, we have seen global financial conditions deteriorating, growth decelerating, and downside risks increasing. The WEO Update underscores that the global recovery is threatened by intensifying strains in the euro zone, and also by weaknesses elsewhere. All told, the IMF now expects growth in the world economy to slow down, from 3.8 percent in 2011 to 3.3 percent in 2012. This overall figure masks important variations across countries, with emerging and developing countries growing by 5.4 percent and advanced economies by as little as 1.2 percent—and among these, the euro area would see a decline in GDP of 0.5 percent in 2012.

Projected growth has been adjusted down for all regions of the world, which is a reminder—if one was needed—of how intertwined the world economy has become, underscoring the need for a consistent policy response across countries. The most immediate

[1] The IMF released Updates of its three flagship publications this week: the World Economic Outlook (WEO), the Global Financial Stability Report (GFSR), and the Fiscal Monitor (FM). All Updates may be found on the IMF website: www.imf.org.

policy challenge is to restore confidence and put an end to the crisis in the euro area by supporting growth, while sustaining fiscal adjustment, containing deleveraging, and providing more liquidity and monetary accommodation. In other major advanced economies, the key policy requirements are to address medium-term fiscal imbalances and to repair and reform financial systems, while sustaining the recovery. In emerging and developing economies, near-term policy should focus on responding to moderating domestic growth and to slowing external demand from advanced economies.

Russia: Economic outlook and policies for 2012 and the medium term

The Russian economy has by now broadly recovered from the 2008-09 crisis. However, Russia's recovery has been aided by high oil prices, and has not gained consistent strength. In the WEO Update released this week, we have revised down our growth projection for Russia: real GDP growth is now projected to slow from 4.1 percent in 2011 to 3.3 percent in 2012.

Spillovers from the euro area to Russia have been manageable so far, but net capital outflows have intensified, being to some extent a natural counterpart to a larger current account surplus under a more flexible exchange rate regime, but also reflecting a global "flight to safety" and perhaps a renewed focus on Russia's adverse business climate. A further escalation of the euro area crisis would pose considerable downside risks to Russia, however, spilling over especially through effects on commodity prices, but also through external trade and disruptions in financial markets.

Looking beyond the short term, Russia's economic outlook will be determined by the policy choices of the new government, and the work on Strategy 2020 will provide important input into the decision making in this regard. The IMF's analysis underscores that the policy choices really will matter for whether Russia will see growth or stagnation in the years ahead.

Let me start with medium-term economic policy priorities

The high oil prices provide a window of opportunity for Russia to take action to strengthen its economy and its economic defenses. A broad consensus exists on where Russia should go over time: namely, towards an economy that is less reliant on energy and commodities—and therefore less exposed to swings in international commodity and financial markets—and one that more effectively harnesses Russia's human capital to realize its growth potential.

It is not surprising that such a consensus has developed. When you compare the Russian economy with those of peers—such as the BRICs, other EMs, countries in CEE, or commodity producers—it becomes clear Russia has stood out in terms of instability in economic activity and high inflation. This is a problem that, left unaddressed, will deter investment and undermine growth and diversification going forward. Russia's instability can be traced back to two intertwined factors: (i) its economic structure, which has become increasingly reliant on petroleum and other commodities, and (ii) its lack of strong and firmly anchored economic policy frameworks, including for fiscal and monetary policy.

This in turn calls for determined implementation of a medium-term economic strategy aimed at promoting stability, and thereby growth and diversification. Let me comment briefly on the priorities in each policy area:

- *Medium-term budgetary policies*. To make room for private investment, the Russian government will need to carry out a major budget consolidation over time, as it is now faced with a budget deficit excluding oil revenue—the so-called non-oil deficit—of as much as 10 percent of GDP. Firmly anchoring the medium-term budget should involve setting a medium-term target for the non-oil deficit, and formulating and implementing annual budgets with this target in mind. A well-established "fiscal rule" like this would help organize the work on medium-term fiscal policy within the government and also send a clear signal to markets and engender confidence. Formally, Russia's budget code already includes a fiscal rule, which in fact is defined in terms of the non-oil balance of the federal government and set at a deficit of 4.7 percent of GDP (but this rule has been suspended). Research by the IMF indicates that this is an appropriate medium-term target, and we have recommended that the government aim to meet this target by 2015. Besides creating room for private investment, such a strategy would also help rebuild the Reserve Fund, thus strengthening the government's financial buffers. Our analysis suggests that the required reduction in the non-oil deficit is technically doable, but will require fundamental reforms of the public sector, including Russia's pension system.

- *Monetary policy*. Russia's monetary policy needs to be anchored more firmly on inflation. This is because low and stable inflation is key to mobilizing resources domestically, and channeling them to productive investment and other uses. Bank of Russia has announced its intention to move to fully-fledged formal inflation targeting, in the context of a flexible exchange rate, by 2014. We agree with this approach and are encouraged by Bank of Russia's progress, over the last couple of years, in preparation for this move. Looking ahead, it will be important to continue the progress towards a more flexible ruble exchange rate, and at the same time further strengthen Bank of Russia's monetary policy toolkit and communications policy. In terms of the inflation target itself, our analysis suggests that a medium-term target range for inflation of 3-5 percent would be appropriate. While headline inflation gradually came down during the second half of 2011, reaching 6.1 percent in December, this primarily reflected a deceleration in food prices, while core inflation remained stubbornly high, at 7½-8 percent on our estimates. This suggests that absent a renewed economic downturn or further monetary policy action the headline inflation rate is unlikely to continue declining toward the 3-5 percent range. While the increased uncertainties globally and in Russia justifies Bank of Russia's cautious approach regarding policy interest rate increases at this stage, the Bank should stand ready to tighten policies further if the downside risks from an intensification of the euro area crisis do not materialize.

- *Financial sector reform*. Developing a stronger and more advanced financial system over time will also be important for balanced economic growth. Russia's financial sector has been improving since the crisis, but has some ways to go. Also, remaining weaknesses in data reporting and banking supervision pose risks. As regards priorities for the near term, the focus needs to be on bolstering the supervisory framework. The authorities' 2011 strategic plan to improve regulation and supervision, including a strengthening of capital requirements, offers an opportunity to give momentum to the work on this side. Among the priorities identified by my colleagues are: (i) adopting and implementing the pending legislation on consolidated supervision and connected lending; (ii) giving Bank of Russia powers to issue binding guidance on risk management by banks; and (iii) empowering Bank of Russia to use "professional judgment" in interpreting laws and regulations and move away from more mechanical approaches that risk not addressing the substance of problems.

- *Investment environment*. Besides maintaining macroeconomic and financial stability, progress on a wider "micro-economic" agenda would help attract investment and direct this to productive areas. Key steps include (i) rolling back the role of the state through privatization, (ii) reforming the civil service and public administration to curtail the pervasive influence on economic decision making (i.e., reduce "red tape"), and (iii) ensuring that property rights are protected and that the playing field for investing is level. This agenda is well known, but progress on the ground has been slow. Of course, a welcome exception is that Russia is now moving towards WTO accession and should be a member by the middle of this year.

What will the policy choices of the new government in these areas imply for the Russian economy going forward? My colleagues have analyzed this question, and the conclusion is very clear: the economic policy choices will have potentially very significant effects on Russia's economic future. In a "baseline scenario" representing current policy plans, in particular a continued large non-oil government budget deficit and high inflation, Russia's economic growth would remain subdued over the medium term—in the 3½-4 percent range—and Russia would remain vulnerable to external shocks. In contrast, in a "reform scenario," Russia would experience substantially higher medium-term growth—around 6 percent per year. In terms of policies, the latter scenario entails stronger and more credible fiscal retrenchment, monetary policy taking control of inflation, a better developed and sounder financial system, and effective implementation of structural reforms. In this scenario, the short-term drag on growth from fiscal retrenchment would be offset by a more stable and business-friendly economic environment and greater credibility of government policies. This would boost investor confidence and support investment and an early return of productive capital inflows. The economy would also become less vulnerable to external shocks over time as it would be more diversified, and the authorities would have larger financial buffers.

Finally, let me move on to short-term economic policy priorities

Again, the high oil prices provide an opportunity for Russia to push ahead on the medium-term economic policy agenda, which should be taken. But what if the euro area crisis deepened, with broader spillovers to global growth? In this case, Russia's growth could also be dragged down—through lower commodity prices and nonoil exports, and also through financial channels.

In some ways, the Russian economy is in a better position to withstand external shocks than it was in 2008. Specifically, the economy is not overheating, which means that for a similar shock you would expect a less severe deceleration in GDP than in 2009. The more flexible ruble exchange rate should also help cushion the impact on economic activity, and banks in the aggregate have a sounder external position than pre-2008, which should limit the effect on credit extension. And, of course, when the 2008-2009 crisis hit, Bank of Russia and the government put in place procedures and instruments to respond—and did so successfully—which should help in the event of a future external shock.

But in other ways, Russia is more vulnerable than in 2008. In particular, there is now much less room for fiscal stimulus: the government budget balance is more exposed to an oil price fall, as suggested by a major increase in the non-oil deficit to 10 percent of GDP in 2011, and the Reserve Fund has been substantially reduced, meaning that the government would need to rely on market financing in the event of a crisis. Also, banks' NPLs are still elevated compared with the pre-2008 situation.

The Russian authorities need to be prepared to respond effectively if conditions were to worsen. In this regard, it is encouraging that they already have been thinking through systematically the potential spillovers and policy options. The goal of the response should be to limit the impact on the economy and maintain economic stability, focusing on four policy elements:

- Allow the more *flexible exchange rate* to act as a shock absorber as the ruble adjusts to new economic fundamentals, while using international reserves to smooth the transition;

- Utilize Bank of Russia's *emergency liquidity facilities* as needed to mitigate the impact on banks;

- Allow *monetary policy* to become more accommodating, provided inflation is in check;

- Postpone *fiscal consolidation* to 2013 and allow automatic stabilizers to operate to dampen effects on growth.

Let me conclude by summarizing our main points:

- The world economy is weakening and global downside risks have increased, calling for consistent and decisive policy actions in all regions of the world.

- While the spillovers from the euro area crisis to Russia have been manageable so far, the authorities' focus on how the Russian economy could be affected and what would be the best response is welcome. A key element of the response should be to let the ruble adjust to the new underlying economic conditions and mitigate the impact on the domestic economy.

- For Russia, the potential medium-term payoff for sound economic policies—specifically, an ambitious reduction in the government budget's reliance on oil revenue, low and stable inflation anchored through formal inflation targeting, and progress on financial and structural reforms—is substantial, both in terms of expected growth in the economy and in terms of its diversification and modernization. High oil prices provide an opportunity for Russia to move ahead on such a strategy, the weaknesses in the global economy notwithstanding.

Thank you