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Realizing Russia's Growth Potential –
Priorities for Economic Policies in the Short and Medium Term

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Thank you for joining us for this press briefing—on the implications of international economic developments for the Russian economy and for the economic policy challenges facing the new government. The IMF recently published an update of its World Economic Outlook (WEO), and our Executive Board completed its annual review—the so-called Article IV consultation—of the Russian economy last week. My opening remarks will lay out the main conclusions from these exercises, and I will take your questions at the end.[1]

Let me start with the headlines. The challenges facing Russia's new government are, *in the short-term*, to manage domestic demand in order to avoid an overheating of the economy and, *in the longer term*, to fully realize Russia's growth potential by maintaining macroeconomic stability, strengthening economic policy frameworks, and making decisive progress on structural reforms. I will elaborate on each of these.

But, first, the international backdrop and short-term outlook for Russia

As described in the WEO update, the international backdrop has deteriorated: since the last WEO was published in April, the global recovery has weakened and financial market and sovereign stress in the euro area periphery have increased. Moreover, important EM countries—notably China, India and Brazil—have registered lower growth, not only because

[1] The IMF released Updates of its three flagship publications in mid-July: the World Economic Outlook (WEO), the Global Financial Stability Report (GFSR), and the Fiscal Monitor (FM). The Public Information Notice for the 2012 Article IV consultation with Russia was published yesterday. The documents may be found on the IMF website: www.imf.org.

of international developments but also because of a softening of domestic demand. All told, the IMF now projects global growth of 3.5 percent in 2012 and 3.9 percent in 2013. These are baseline forecasts predicated on policy actions sufficient to allow financial conditions in the euro area periphery to ease gradually. The measures announced at the EU leaders' summit in June are steps in the right direction, and their timely implementation, together with further progress on banking and fiscal union, should be a priority. In the United States, avoiding a sharp fiscal contraction as currently embedded in legislation (the so-called "fiscal cliff"), raising the government debt ceiling, and developing a medium-term fiscal plan will be essential steps to safeguard the recovery. The baseline also assumes that recent policy easing in emerging market economies will gain traction. With all this in mind, it is clear that the downside risks to the baseline remain large, importantly reflecting the potential for delayed or insufficient policy action.

What do these updated projections and increased uncertainty mean for Russia ? The weaker global conditions—combined with easing concerns about geopolitical oil supply risks and stepped-up OPEC production—have led to a substantial fall in expected oil prices. In our baseline scenario, *we are nevertheless projecting Russia's real GDP to expand by about 4 percent both in 2012 and 2013*, essentially the same as in the April 2012 WEO. The projected growth is driven mainly by domestic demand, especially private consumption.

At the same time, *we remain concerned about inflation*. The Russian economy has now recovered from the 2008-09 downturn and is running at close to if not above its capacity, which means that underlying inflationary pressures are building up. Indeed, underlying inflation remains high and headline inflation has recently rebounded, as the temporary factors that helped reduce it to the historical low of 3½ percent in May this year have been reversing. We now project inflation at 6½ percent both this year and next, in other words above the Bank of Russia's targets of 5-6 percent for 2012 and 4½-5½ percent for 2013.

Moreover, while Russia's vulnerabilities to spillovers from global developments are reduced from the situation in 2008, they remain considerable. On the positive side, the flexible exchange rate and the more solid external position of banks and companies should help insulate Russia. Moreover, the financial system has been recovering, as indicated by higher profitability and lower NPL ratios, although concerns remain about asset quality in the context of rapid credit growth. At the same time, the government budget is heavily reliant on oil revenues—the government's "non-oil deficit" stands at 10 percent of GDP, with little prospect for reduction—while the Reserve Fund is down to about 3 percent of GDP, which means that the room for a fiscal response is much more limited than in 2008.

Now, second, what does this imply for Russia's immediate economic policy priorities ?

As we see it, the immediate challenge for the government is to manage domestic demand to avoid overheating and to keep underlying inflation on a downward path, and to prepare for any possible spillovers from adverse international developments:

- *Both budget and monetary policy should help contain domestic demand:*

    - ✓ *An ambitious fiscal consolidation is needed*, starting with a reduction in the nonoil deficit by some 1½ percent of GDP in 2012 to 9 percent of GDP. Withdrawing of the 2009 crisis-related subsidies to enterprises and reducing tax exemptions would make important contributions here.

    - ✓ *A gradual tightening of monetary policy is necessary to keep underlying inflation on a downward path and for the Bank of Russia to reach its headline inflation targets.* Credit is growing at close to 30 percent annually, which is high. Given the lags in the transmission mechanism, timely policy action is necessary to contain the expected rebound in inflation and anchor medium-term inflation expectations. Delivering on the inflation targets is all the more important for the Bank of Russia to quickly establish its credibility as it sets out to adopt inflation targeting.

- *The authorities need to be prepared for spillovers if the international situation were to worsen*. The main channel for potential global spillovers is the international oil price; while a worsening of the situation in the euro zone may affect Russia also through an acceleration of capital outflows or increased funding problems for banks and corporates, we believe that Russia is better placed to handle such spillovers than in 2008-09. In particular, the flexible exchange rate should act as a shock absorber (as it did, for instance, when oil prices dropped this spring); and the positive net foreign asset position of banks means that they are less vulnerable to exchange rate swings than they were. At the same time, the Bank of Russia should stand ready to provide liquidity as needed to banks, as it has been doing. On the budget side, Duma passed amendments to the budget and other legislation in mid-July, authorizing the government to tap the Reserve Fund without amending the Budget Law, which would allow a more rapid response than in 2008-09. Moreover, to support the stability of the banking system, these legal amendments provide for recapitalization of banks using public funds. It is encouraging that the authorities are more alert to the risks and potential spillovers than they were in 2008, and have been planning accordingly.

Third and finally, what medium-term economic policies would be required to unleash Russia's economic potential?

The new administration has a clearly stated vision of the goals of economic policies in the years ahead. This vision was laid out in the President's speech to the St. Petersburg International Economic Forum in June, where he emphasized the need for new investment, economic diversification and job creation, and recognized that, in the medium term, these goals call for maintaining macroeconomic stability and improving the investment climate. Here, the IMF's long-standing recommendations remain relevant. Let me expand on how we see the priorities in each major policy area:

- *A medium-term anchor for fiscal policy should be promptly adopted*. Such an anchor should be designed to decouple the fiscal stance from short-term variations in oil prices and ensure intergenerational equity, while being transparent. Legislation now in Duma calls for an oil price-based fiscal anchor, which would be in effect starting with the 2013 budget. Adoption of this fiscal rule is a welcome step towards shielding the short-term budget stance from variations in oil prices. However, the specific oil-price rule currently being considered—based on a 10-year lagged average of oil prices—would leave the nonoil deficit in excess of what is needed to contain domestic demand pressures and ensure intergenerational equity. We have suggested that halving the non-oil deficit to some 5 percent of GDP by 2015 would be a desirable and achievable target, while the proposed oil price rule could leave the deficit at some 8½ percent of GDP that year. We therefore believe that a more conservative base oil price would have been appropriate. Ample scope exists for growth-friendly budget adjustment measures over time; in this regard, pension reform is indispensible, but other measures, such as better targeting of social transfers and improving the efficiency of government expenditures, should also contribute.

- *Building on the welcome progress in improving the monetary policy framework, further steps would help anchor inflation expectations and facilitate the transition to formal inflation targeting.* Over the last year or so, the more flexible exchange rate and attendant reduction in foreign exchange interventions have allowed the Bank of Russia to move to a symmetric interest rate corridor system that provides a clearer monetary policy signal. Building on this, by formally making the repo rate the primary policy interest rate, completing the transition to a narrower policy interest rate corridor—defined as the spread between the refinancing and deposit standing facility rates—to 200bp to cap interest rate volatility, and reducing the number of central bank liquidity instruments and interest rates would simplify the operational framework and thereby further strengthen the policy signals. In addition, continuing to bolster the Bank of Russia's communication policies, including the publication of inflation forecasts, would improve transparency and help in explaining the rationale behind monetary policy measures.

- *On the financial sector side, a stronger supervisory framework is needed to safeguard financial system soundness.* Recently, there have been welcome improvements in the Bank of Russia's financial stability analysis and macro prudential oversight framework. However, the Bank still lacks adequate authority to effectively supervise bank holding companies and related entities and to address connected lending. The Bank also lacks the necessary scope for exercising discretion based on its professional judgment in applying regulations to individual banks, which is an integral component of the Basel framework. The passing of the pending legislation in these areas therefore remains a high priority.

- *Structural reforms are crucial to increase investment, diversify the economy, and raise potential growth*. In this regard, Russia's WTO membership, expected to become effective this month, should be seized upon to strengthen the momentum for domestic reforms to make the business environment more predictable and rules-based. Other priority structural reforms include the reduction of corruption, strengthening the rule of law, and scaling back state involvement in the economy, including through transparent and more decisive privatization of state owned companies.

In his "Executive Order on Long-Term State Economic Policy" signed on May 7, the President set goals for growth, investment and job creation in the years ahead, and called on the government to develop concrete plans, over the next few months, in all the policy areas I have touched upon. This Order represents a welcome recognition of the need for action on a broad front. The concrete policy choices made as this process unfolds will matter a great deal: our analysis suggest that a continuation of past policies would entail moderate growth—perhaps of 3½-4 percent annually over the medium term—and a perpetuation of the reliance on commodities and the associated vulnerabilities and instability. In contrast, with a strengthening of policy frameworks and decisive structural reforms, the Russian economy could grow by as much as 6 percent annually over the medium term, while becoming more diversified and less vulnerable to swings in international commodity and financial markets.

Thank you.