RIA Novosti—Press Meeting

Economic Outlook and Policy Challenges for Russia in 2013

Odd Per Brekk
Senior Resident Representative
International Monetary Fund

February 20, 2013

Welcome to this briefing on the outlook for the Russian economy in 2013 and the medium term. I will start with a short overview of global economic perspectives, as presented in the IMF's World Economic Outlook (WEO) update published last month, and then turn to the implications for the Russian economy and for the policy challenges facing the government.[1] The recent discussion on economic policies in Russia has focused on how to get economic growth going again, and I will center my remarks on that question.

Global economic outlook [Slide 2]

The IMF now projects global growth to accelerate slightly, from 3¼ percent in 2012 to 3½ percent in 2013, and further to about 4 percent in 2014. Compared with our forecast in last October's WEO, this entails broadly unchanged growth for most large economies and regions. The main exception is the euro area, where we have lowered the growth forecast for 2013 from plus 0.2 percent to minus 0.2 percent, in other words a continued contraction this year, and from positive 1.2 percent to 1.0 percent in 2014.

These baseline projections assume continued economic policy progress internationally. This includes, in particular, further steps to deal with the euro zone difficulties—recognizing, of course, that substantial progress has already been made, with the European Stability Mechanism made operational, key elements of a European banking union agreed on, and the announcement of the Outright Monetary Transactions by the European Central Bank. The

[1] The IMF released an Update both of the World Economic Outlook (WEO) and an assessment of the Russian economy on January 23; the documents may be found on the IMF website: www.imf.org

projections also assume that the US will come to grips with the remaining risks associated with the so-called "fiscal cliff" and the federal government debt ceiling. Policy actions already taken have lowered the most acute risks in the euro zone and in the US. Nevertheless, possible lack of follow-through on the economic policy side represents a significant downside risk to the baseline forecasts.

Outlook for Russia [Slide 3]

What does this global outlook entail for Russia? The main spillover channel from international developments to Russia is through international oil prices, which have direct and substantial effects both on exports and on government revenue. Financial flows in and out of Russia might also be influenced by international developments, as Russia traditionally has been among the countries most affected by changes in general risk perceptions in global markets.

The revisions to the global growth projections have not had material effects on our baseline projections for Russia. While oil price expectations were lowered somewhat in the WEO Update, the slowdown in economic growth in Russia has mainly domestic causes. To put the recent performance in context, you may recall that Russia was the G20 country hardest hit by the global crisis, with GDP contracting by almost 8 percent in 2009. In 2010 and 2011, Russia made a reasonable recovery, mainly driven by private consumption, growing by about 4½ percent each of the years. However, in 2012, the recovery moderated, to an annual rate of 3½ percent. Turning to 2013, we now expect the Russian economy to grow in line with its potential, at a moderate rate of 3¾ percent. The uncertainties in the global economic outlook translate into uncertainties also for the outlook for Russia, with the risks predominantly on the downside. At the same time, core inflation remains high and, on current policies, headline inflation is projected to stay above the Bank of Russia's forward-looking target path, aimed towards 4-5 percent inflation by end-2014.

Understandably, against this backdrop, the government is placing renewed emphasis on economic growth, and has set 5 percent annual increase in GDP as its medium-term target.

At the same time, the currently low unemployment and high capacity utilization rates suggest that economic activity is now close to, if not above, its potential. Indeed, recent IMF research concludes that Russia's "growth model" of the last decade—which produced a decent 5-5½ percent average annual growth—may have run its course. This is because past growth was due mostly to increased capacity utilization and some improvements in efficiency, rather than investment in new and productive capacity, and also was boosted by rising oil prices. All told, the Russian economy is now pushing up against its capacity constraints.[2]

Implications for Russia's economic policies

This analysis highlights the economic policy challenges facing Russia, both in the short term and in the longer term. In the short term, Russia will need to prevent domestic demand from expanding at a pace exceeding the economy's potential, and at the same time build further flexibility and, especially, buffers and "fiscal space" to respond to possible external shocks. Furthermore, growth cannot be increased durably through stimulus to domestic demand, be it through budgetary or monetary policies. Attempts to do so would lead to pressure on the domestic price level and the balance of payments, and would eventually need to be reversed, possibly in a disruptive manner. Economic policies should instead aim to boost productive investment in new capacity over time; i.e., focus on the supply side of the economy.

To maintain macroeconomic stability in the short term, we have recommended that Russian policymakers:

- [Slide 4] First, aim for a somewhat more ambitious fiscal policy tightening in 2013 than the ½ percent of GDP envisaged in the budget (measured by the non-oil deficit). Besides containing domestic demand, this approach would help build "fiscal space" to respond to any adverse spillovers from international developments.

---

[2] The research papers may be found on the IMF's website: www.imf.org.

- [Slide 5] Second, keep monetary policy on hold, but with a tightening bias. This is because the key monetary policy objective, as the Bank of Russia is transitioning to a fully-fledged inflation targeting regime, should be to bring inflation credibly onto a path towards the official targets. The Bank of Russia is making laudable progress in putting in place the foundations for a successful transition, notably a more flexible exchange rate policy. Building credibility as an inflation fighter will be especially important for the Bank in the short period leading up to the transition to fully-fledged inflation targeting, planned for end-2014.

Looking beyond the short term, it is commonly understood that in order to put economic growth on a higher path, Russia needs investment in new and productive capacity, and therefore needs to become more investment friendly. In the IMF's view, the strategy to this end should stand on three legs: [Slide 6]

- First, *macroeconomic stability*. Here, Russia has chosen the right approach, comprising the adoption of the new "fiscal rule" based on long-run oil prices, the gradual shift to a formal inflation targeting framework for monetary policy aimed at anchoring inflation at a low and stable level, and the more flexible exchange rate policy. This set of macroeconomic policies should over time provide the "policy anchors" needed for economic stability that Russia has been missing.

    - That said, the fiscal framework could be further strengthened. While the new fiscal rule should help shield the budget and, by extension, the economy from short-term fluctuations in international oil prices, it will not bring about adequate fiscal adjustment over time in view of the large public sector liabilities—notably pension related—and the expected decline in petroleum revenues. Moreover, full adherence to the rule and transparency in its implementation need to be given top priority.

    - On the monetary policy side, the Bank of Russia is making commendable headway in preparing for the transition to fully-fledged formal inflation targeting. Concretely, the increased flexibility of the ruble exchange rate and scaled-back foreign exchange interventions have freed the Bank to focus squarely on inflation in its conduct of monetary policy, and also helps buffer the Russian economy from turmoil in international markets. Moreover, the Bank has been improving its monetary policy instruments, notably with a narrowing of the interest rate corridor providing a clearer policy signal. We fully endorse the Bank's plans to further strengthen monetary policy instruments, money markets, communication, and inflation projections, to be ready for the adoption of inflation targeting by the end of next year.

- Second, *a more developed and stable financial sector*. Granting the Bank of Russia adequate authority to effectively supervise bank holding companies and related entities and address connected lending, as well as sufficient powers to exercise discretion based on its professional judgment in applying regulations to individual banks, would bring Russia's supervisory framework in line with international standards. As regards the more immediate challenges, we share the Bank of Russia's concerns about the rapid growth in unsecured retail credits, and therefore support the prudential measures in this area that the Bank has announced so far and agree that additional measures may be needed if excessive credit expansion were to persist.

- Third, *an improved "investment climate"* will be critical to lifting Russia's growth onto a higher trajectory. Russia's recent move from 118th to 112th place in the World Bank's "Doing Business" ranking is welcome, but the ranking also underscores that much work lies ahead. In this regard, Russia's WTO accession should help make the climate more rules-based and predictable, and should be seized upon to strengthen the momentum for domestic reforms. The government's renewed focus on privatization is also welcome in this context, and should be supplemented by efforts to strengthen property and minority shareholders' rights, scale back unnecessary bureaucratic procedures, address corruption, and generally strengthen the rule of law.

What are the implications for Russia's growth outlook ? Our analysis suggests that, on current policies, the Russian economy would continue to grow by some 3¾ percent annually over the medium term (the "baseline" scenario). Meanwhile, the economy would remain vulnerable to external shocks (the "adverse" scenario illustrates the effects on GDP of a drop in international oil prices to US$80 per barrel). But our analysis also suggests that with a stronger set of policies in place (the "reform" scenario)—standing on the three legs just sketched out—the Russian economy could grow by as much as 6 percent annually over the medium term, on the back of a rise in productive investment. Which scenario will materialize will depend on the government's economic policy choices.

Thank you [Slide 7]