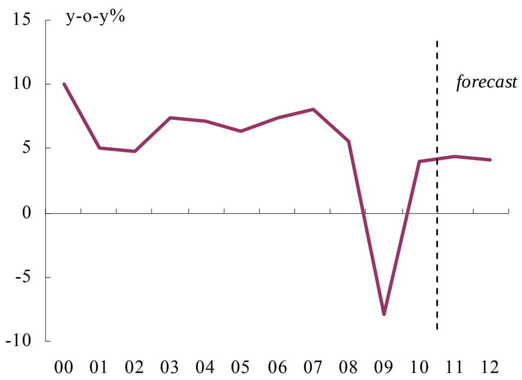
37. RUSSIAN FEDERATION
V-shaped recovery continues

The Russian economy grew by 4% in 2010, after contracting by -7.9% in 2009. Russia's recovery is V-shaped, with growth rebounding to an expected 4.5% in 2011 and to 4.2% in 2012. Economic growth has been increasingly supported by recovering domestic demand (consumption and investment). Because of higher external demand, export growth accelerated as well, but to a lesser degree than imports, resulting in a negative contribution from net exports in 2010. Growth in 2011 is likely to be negatively affected by sluggish growth in the advanced economies, Russia's main trading partners. Looking ahead, with Russia being one of the largest oil and gas exporters in the world, the pace of the recovery is likely to depend on commodity price developments.

Graph II.37.1: **Russia - GDP growth**



Growth continues to improve

The expansion of domestic demand was a major factor of economic growth in 2010. Growth in consumer spending and investment activity increased in 2010 and both are foreseen to continue increasing further.

Despite strongly increasing imports of goods due to strengthening domestic demand, Russia's trade surplus increased compared to 2009, as it grew by 24.7% in 2010. The strong increase in exports, supported by higher oil prices, and increasing external demand, resulted in a rise in the current-account surplus from 4% of GDP in 2009 to 5.8% in 2010 (around USD 71.1 bn). Expected high energy prices are the main reason behind the large current-account surplus throughout the forecast horizon. Oil and gas account for two thirds of Russia's export receipts. However, export volume growth of the oil and gas sector is limited by sluggish productivity and lack of further investments in maintenance. According to estimates from the Central Bank of Russia (CBR), the current-account surplus fell to USD 33.8 bn, increasing 4.5% y-o-y in the first quarter of 2011. Overall, the current-account surplus is foreseen to increase to around 7.4% of GDP in 2011 and to 7.8% of GDP in 2012, mainly on the back of high oil prices.

The labour market has continued to improve. The unemployment rate, which shot up from 5.8% in August 2008 to 9.4% in February 2009, has been coming down rapidly. In 2010, the total number of unemployed declined to 7.2% of the economically active population from 8.2% as of the end of 2009. After a crisis-induced decline in real wages in 2009, real wage growth has resumed. Wage and pension increases contributed 4.3% to growth in household real disposable income.

A large output gap, temporarily falling food prices until July 2010, and continuous rouble appreciation, have kept a lid on inflation, which fell for twelve consecutive months, from 12% in July 2009 to a post-Soviet-era low of 5.5% a year later. Inflation edged up to 9.5% in March 2011, largely driven by higher food prices, as a result of the summer 2010 heat wave, while growth in non-food goods prices slowed from 9.7% in 2009 to 5% in 2010.[88]

Accommodative monetary policy has been tightened

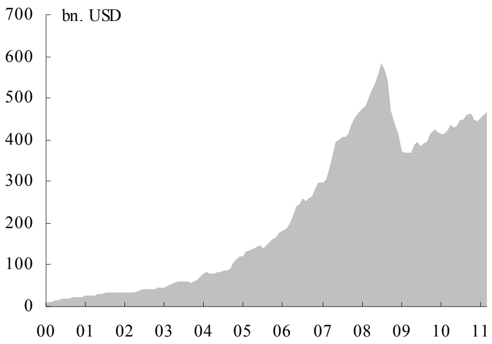
The Central Bank of Russia manages the rouble against a dollar/euro basket, in which the dollar weighs 55% and the euro 45%. In 2010, as the exchange rate stabilised, the CBR scaled back its intervention in currency markets and started replenishing foreign exchange reserves. In March 2011 the CBR intervened again, with monthly FX purchases still well below the levels seen in spring 2010. The rouble now lies within the central bank's range of 33.4-36.4 against the basket.[89] As of end-

(88) Food prices represent about 40% of the CPI basket in Russia.

(89) The value of the bi-currency basket stood at 34.6525 roubles as of February 2011.

March 2010, Russia's foreign-exchange reserves reached USD 465.5 bn.

Graph II.37.2: **Russia - Foreign-exchange reserves**



After ten interest rate cuts in the last seven months of 2009, the CBR further reduced its refinancing rate four times in 2010, from 8.75% in February to a record-low 7.75% in June. Since then, the overnight rate has been kept unchanged and the CBR signalled that it had put an end to monetary easing. On 25 February 2011, in the light of high inflationary expectations and rising oil prices, the CBR increased the refinancing rate to 8%. Reserve requirements were also increased on 1 April 2011 to reach 5.5% for liabilities of credit institutions. Due to high inflationary risks, the refinancing rate will be increased to 8.25% as of 3 May 2011.

Spurred by aggressive monetary easing during the first half of 2010, domestic credit to the private sector started to recover in 2010. Non-performing bank loans rose during the crisis, but appeared to have peaked in the summer and declined to 6% by the end of 2010. The Russian banking sector seems to be in a relatively sound position to manage these non-performing loans, as the average capital adequacy ratio rose from around 13% in mid-2008 to around 18% by March 2011. The recent increase in inflation has pushed real interest rates into negative territory, which may slow down the growth in bank deposits, and thereby constrain bank lending.

Inflationary pressures are growing

The strengthening of the rouble, along with low import prices and sluggish demand, were the main reasons behind inflation tapering off until July 2010, when consumer prices stood at a record low of 5.5% (y-o-y). However, inflation picked up strongly afterwards, to 9.6% in January 2011. Food inflation remains the main factor pushing up inflation in Russia. Prices rose by 14.1% y-o-y as of March 2011 (after an increase by 6.9% on average in 2010). On top of elevated food prices, high oil and gas prices, budgetary expenditures and rapid growth of the money supply have also underpinned inflationary pressures. The overall inflation rate stood at 9.5% in March 2011. The recent upturn in inflation is expected to be temporary as the spillover from food prices to the rest of the CPI basket has been limited and a remaining substantial output gap is containing the transmission. Annual average inflation is forecast to increase to a yearly average of around 9.4% in 2011 and 8.2% in 2012, overshooting the CBR's inflation target.

Growth will remain below pre-crisis levels

GDP growth is expected to reach 4.2% towards the end of the forecast period and to remain well below the rates achieved before the crisis.

The economy's high (and increasing) dependence on the hydrocarbon sector will negatively impact the outlook. Energy-related output growth will remain sluggish, despite high energy prices, as existing fields are depleting and extraction becomes more complicated and more expensive. The assessment of risks remains highly correlated to changes in oil prices.

Investment recovery is mild and not strong enough to meet Russia's large investment needs to support higher potential growth. With a contribution to GDP in 2010 of around 20%, Russian investments remain well below many other emerging economies.

Over the forecast horizon, the strengthening of the labour market coupled with revived bank lending is expected to spur domestic demand. While unemployment is foreseen to decline to below 8% again towards the end of the forecast period, some risks remain.

Risks are tilted to the downside

Regional governments had stimulated employment during the crisis (under pressure from the central government) by keeping industrial workers on the payroll. However, they may lose the ability to continue supporting the labour market in the forecast years. Federal resources allocated last year to support regional governments are depleting and there will be fewer incentives for local businesses to continue paying for an excessive supply of workers.

Under the recently revised budget proposals for 2011-13, the federal budget deficit is set to shrink to 3.6% of GDP in 2011 and to less than 3% of GDP by 2013. This is more optimistic than the forecast here: a deficit of 4.6% and 3.2% of GDP in 2011 and 2012, respectively are projected. Despite improved fiscal rules and continuous budgetary surpluses in the years preceding the crisis, the gradual pace of consolidation poses the risk that fiscal policy could become pro-cyclical. The key challenge will be to withdraw the large fiscal stimulus and avoid excessive exchange rate volatility and high inflation. According to the Medium Term Expenditure Framework, the budget is expected to return to balance by 2015.

The Reserve Fund, which was set up to save part of the oil windfall and to reduce the vulnerability of the budget against oil-price volatility, is being depleted. As a result, 2011-12 budget deficits will increasingly be financed through issuing domestic debt.

The rouble is being given somewhat higher exchange rate flexibility against the basket. The CBR scaled down interventions on the exchange market and increased the role of the policy rate in slowing inflation. Wage growth is expected to continue but to remain moderate and definitely slower than before 2009. Additional fiscal spending associated with the election cycle will remain in 2011 and 2012, creating an upside risk on inflation. However, should upward pressures on the rouble intensify, there is a risk that priority might again be given to exchange rate considerations.

Table II.37.1:

Main features of country forecast - RUSSIA

		2009			Annual percentage change					
	bn RUB	Curr. prices	% GDP	92-06	2007	2008	2009	2010	2011	2012
GDP		39100,7	100,0	-	8,5	5,2	-7,9	**4,0**	**4,5**	**4,2**
Private consumption		21319,5	54,5	-	14,2	10,7	-7,7	**2,7**	**3,0**	**3,6**
Public consumption		7871,3	20,1	-	2,7	2,8	2,0	**0,7**	**2,3**	**2,1**
Gross fixed capital formation		8075,9	20,7	-	21,1	9,5	-16,1	**3,5**	**4,3**	**7,7**
of which : equipment		3024,2	7,7	-	-	-	-	**3,5**	**0,9**	**8,0**
Exports (goods and services)		10844,0	27,7	-	6,3	0,6	-4,7	**11,8**	**7,6**	**4,5**
Imports (goods and services)		7964,0	20,4	-	26,2	14,8	-30,4	**11,7**	**7,8**	**7,1**
GNI (GDP deflator)		37862,3	96,8	-	9,2	4,6	-8,1	**3,6**	**4,8**	**4,1**
Contribution to GDP growth :	Domestic demand			-	11,2	7,7	-6,9	**2,3**	**2,9**	**3,7**
	Inventories			-	0,8	0,6	-6,0	**1,0**	**0,3**	**0,4**
	Net exports			-	-3,4	-3,0	5,2	**0,9**	**0,7**	**0,0**
Employment				-	2,4	-0,3	-1,8	**-0,8**	**1,9**	**2,9**
Unemployment rate (a)				-	5,7	7,0	8,2	**8,0**	**7,7**	**7,5**
Compensation of employees/head				-	-	-	-	**-**	**-**	**-**
Unit labour costs whole economy				-	-	-	-	**-**	**-**	**-**
Real unit labour costs				-	-	-	-	**-**	**-**	**-**
Savings rate of households (b)				-	12,7	11,5	-	**-**	**-**	**-**
GDP deflator				-	13,8	18,4	2,5	**9,5**	**8,6**	**4,9**
Harmonised index of consumer prices				-	9,0	14,1	11,7	**6,9**	**9,4**	**8,2**
Terms of trade of goods				-	2,8	15,3	-32,6	**8,0**	**4,9**	**4,9**
Trade balance (c)				-	10,1	10,7	9,0	**10,7**	**11,7**	**12,2**
Current-account balance (c)				-	6,0	6,1	4,0	**5,8**	**7,4**	**7,8**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				8,0	5,2	6,1	3,0	**5,0**	**6,7**	**7,1**
General government balance (c)				-	-	-	-	**-4,6**	**-3,2**	**-2,6**
Cyclically-adjusted budget balance (c)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (c)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	-	-	-	**9,9**	**9,2**	**9,8**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.