EXECUTIVE BOARD MEETING

SM/16/158
Correction 1

June 28, 2016

To: Members of the Executive Board

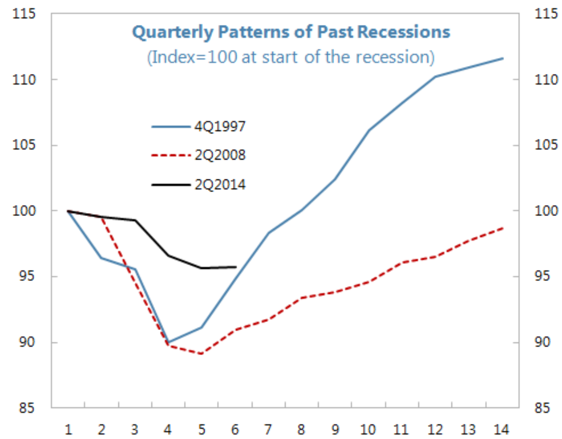
From: The Secretary

Subject: **Russian Federation—Staff Report for the 2016 Article IV Consultation**

Board Action:	The attached corrections to SM/16/158 (6/15/16) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 4, 11, 12**
Questions:	Mr. Ramirez Rigo, EUR (ext. 34340) Mr. Belhocine, EUR (ext. 37075) Mr. Painchaud, EUR (ext. 34310)

CONTEXT: NAVIGATING THE CHALLENGE OF PERSISTENTLY LOWER OIL PRICES

1. **An effective policy response has cushioned the economy from the dual shocks of lower oil prices and sanctions.** The 45 percent decline in oil prices between 2014 and 2015 and the continued quasi closure of international financial markets to Russian entities depressed economic conditions. The economic contraction is nonetheless shallower than previous recessions as a stronger external position and the authorities' economic package—a flexible exchange rate regime, banking sector capital and liquidity injections, limited fiscal stimulus, and regulatory forbearance—cushioned the shocks, helped restore confidence and stabilized the financial system.



2. **The anti-crisis measures introduced in December 2014 have been phased out or not renewed.** The government's capital support program was completed and most regulatory forbearance measures were lifted. The temporary and limited fiscal stimulus in 2015 supported growth. Normalization of monetary policy proceeded for most of 2015, following the emergency 650bp rate hike in December 2014, as confidence improved and inflation came down. Finally, the CBR has progressively raised the cost of its FX facilities while banks proceeded to repay about half of their FX borrowing.

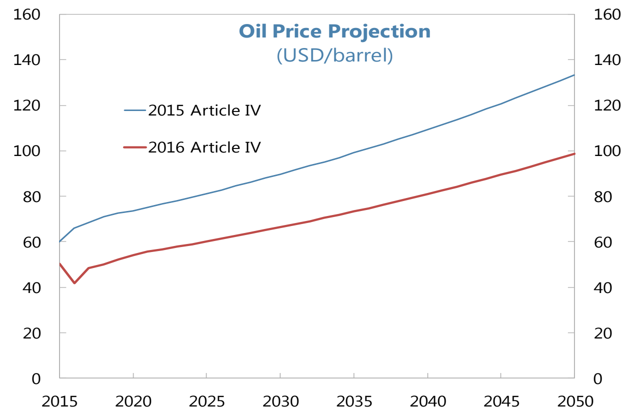
3. **The external adjustment has been progressing rapidly.** In spite of falling oil prices, the current account improved in 2015 due to import contraction, improvement in the services' balance deficit, and a narrowing of the income account deficit. Despite the ruble's significant adjustment towards a lower equilibrium, the response of non-energy exports has so far been limited to a few specific sectors (Annex II and Box 1). Meanwhile, external deleveraging, triggered by sanctions, has reduced external private debt by USD ~~200~~ 176bn over the past two years. Finally, capital outflows declined in 2015 to half their 2014 level, reflecting the return of confidence and a reduction in exchange rate pressures.

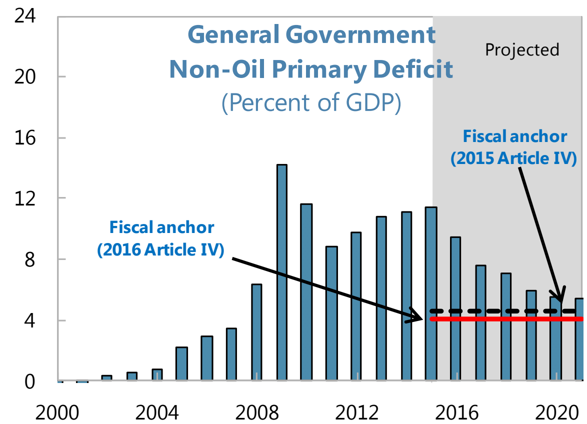
4. **Increased headwinds have delayed the recovery (Figure 1).** After some signs of improvements in mid–2015, the renewed slump in oil prices throughout the second half of 2015 dampened economic prospects. As a result, the federal government introduced new spending cuts to the 2016 budget while the ruble depreciation led the CBR to pause its monetary easing in August 2015. Given the fragile economic situation, the banking sector has remained weak although financial stability concerns have subsided.

Box 2. Revisions to the Fiscal Anchor Estimate

Given the lower oil price outlook since the last Article IV consultation, staff has updated its analysis of long-term fiscal benchmarks for Russia, consistent with the methodology presented in "Russia's Fiscal Framework and the Oil Price Shock". For simplicity, this presents the results for the "real annuity", which is a constant real transfer of resources over a fixed period of time (50 years) after which all resource wealth is exhausted.

While the impact of projected lower oil prices is partially offset by a more depreciated exchange rate, the updated analysis indicates that Russia would need to reduce its projected non-oil primary deficits to be consistent with the real annuity. For example, in the 2015 Article IV, a real annuity starting in 2021 and amounting to 4.6 percent of GDP was consistent with Russia's estimated oil wealth. Lower projected oil prices have reduced this real annuity to 4.1 percent of GDP, implying a need for an overall stronger fiscal effort of about 0.5 percent of GDP by 2021 relative to the original baseline envisaged in the 2015 Article IV consultation.





B. Monetary Policy: Returning to Normalization

18. Policy rates have remained constant since August 2015 due to inflation risks (Figure 4). After lowering rates by ~~650~~ 600bps during January-August to a new level of 11 percent, the CBR paused its easing cycle in August to assess the impact of the ruble depreciation on inflation. The renewed pressures on the exchange rate from lower oil prices at year-end extended the pause, despite the weak economy and the additional fiscal tightening, with the CBR assessing the balance of risks skewed towards higher inflation risks. Since the beginning of 2016, the CBR has emphasized uncertainty over the fiscal policy outlook, reflecting the lack of clarity over government income policies for 2017. The CBR remains committed to reaching its 4 percent inflation target by end–2017.

19. Staff recommended resuming normalization of monetary policy at a prudent pace to support the economy. Inflation has been coming down on a sequential basis and is expected to continue to decline as a result of the negative output gap and slow nominal wage growth—in the context of freeze of public sector salaries for a second year in a row and partial pension benefit indexation. In addition, inflation expectations have continued to come down. Moreover, the exchange rate is broadly in line with fundamentals (Annex II), limiting further depreciation pressures that may fuel inflation. And, with headline inflation falling to ~~7½~~ 7.3 percent in May and unchanged nominal policy rates, real policy rates have increased. In addition, the monetary stance is tight as the policy rate is well above estimates of the neutral rate, which on balance suggest the CBR could resume its easing cycle. However, the pace of easing should be gradual given past strong links between volatile oil prices, the exchange rate and this inflation, factors that should condition the size and timing of interest rate cuts. Indeed, an aggressive monetary policy easing could lead to capital outflows, deposit withdrawals, and possibly destabilizing dollarization. In addition, uncertainty over the fiscal stance next year calls for a cautious approach to easing. Finally, unexpected policy tightening in the US and/or capital flow volatility related to concerns over the outlook for China would further limit CBR's room to ease (see RAM Annex III).

Authorities' Views

20. The authorities agreed that monetary policy normalization should proceed at a cautious pace. The CBR viewed the weak inflation readings in early 2016 as potentially transitory, due among other things to falling world food prices. It indicated that its moderately tight monetary stance was necessary to build credibility as a new inflation targeter and help bring down inflation to about 5 percent by end–2016 and to target by end–2017. Finally, the CBR argued that lowering policy rates should be cautious and given the uncertainty over future fiscal policies and still above-target inflation expectations, should be undertaken only once more clarity over the drivers of inflation is ascertained.

C. Macro-Financial: Improving the Institutional Framework to Secure a Higher Contribution to Growth

21. The banking system is likely to require additional capital. After adjusting for the lower quality of restructured loans, misclassifications, and transfer of distressed assets to affiliated off-balance sheet entities, the FSAP assessed that NPLs might be higher than reported by some 3.5 percentage points resulting in a capital shortfall of about 0.5-1 percent of GDP. Under stress scenarios, the shortfall could reach up to about 4½ percent of GDP.

22. Macro-financial risks remain as the economy adjusts to lower oil prices (Box 3). Ruble depreciation has cushioned the revenues of energy exporters from lower oil prices (Figure 6). In addition, energy companies have remained profitable given that their cost structure is primarily in rubles and that they are among the lowest-cost producers globally. However, the corporate sector as a whole shows signs of weaknesses. Debt servicing capacity has been falling, while smaller companies show weaker returns on assets and higher leverage. At the aggregate level, about half of corporate debt is denominated in FX. However, FX risks appears contained as corporate net foreign currency denominated debt to the banking system amounts to 4 percent of GDP while the private sector's short-term external assets exceed its short-term liabilities by about USD 65 bn. Most