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Global Economic Outlook and Implications for Russia

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Let me begin by introducing myself. I am the new head of the Resident Mission of the International Monetary Fund in the Russian Federation. Thank you for joining me for this press briefing—the first of many, I hope, where I will present to you the IMF's perspectives on the global economy and their implications for Russia.

This briefing comes at an opportune moment. Just last week, Finance Ministers and Central Bank Governors from 188 member countries of the IMF met in Washington, DC, for our Annual Meetings. These discussions—bilateral, in small groups, and in large plenary sessions—focused on challenges facing the global economy and the role each has to play to ensure a strong and sustainable recovery. To underpin these discussions, the IMF staff released their three semi-annual flagship publications around the same time.[1] In addition, Russia also hosted in Washington, DC, the last G-20 Ministerial meeting under its Presidency.

Today, I will outline how the IMF sees the global outlook, and how Russia is placed in that broader context. I will highlight policy challenges faced by advanced as well as emerging economies, noting the implications for Russia's economic policies. I will also flag the results of our annual economic health check-up for Russia, the so-called Article IV report, which was discussed by the IMF's Executive Board a few weeks ago and will be published later this week.

After my remarks, I am of course happy to take your questions.

[1] The IMF flagship documents comprise the World Economic Outlook (WEO), the Global Financial Stability Report (GFSR), and the Fiscal Monitor (FM). In addition, the policy imperatives for the IMF membership, and for the IMF, are outlined in the Managing Director's Global Policy Agenda (GPA) presented to the IMF's International Monetary and Financial Committee (IMFC).

Global economic outlook remains subdued

The IMF's World Economic Outlook (WEO) notes that the world economy has entered yet another transition—the advanced economies are gradually strengthening, while growth in the emerging market economies has slowed. The WEO now projects the global economy to grow at 2.9 percent in 2013 and 3.6 percent in 2014, slightly weaker than the last forecast released in July. Growth in advanced economies—at 1.2 percent in 2013 and 2 percent in 2014—remains unchanged relative to July WEO projections; this is due to private demand in the United States remaining strong, a temporary rebound in Japan, and a recovery from recession in the euro area. On the other hand, many emerging market economies are coming off their cyclical highs and, while their growth remains stronger than in the advanced economies, they are projected to be below the elevated levels seen in recent years. As a whole, emerging market economies are expected to grow at around 4.5 percent in 2013 and 5.1 percent in 2014, about ½ a percentage point lower in each year relative to what was projected back in July.

The WEO points out that risks remain to the downside, with those relating to emerging market economies the more prominent. The recent tightening of financing conditions following talks of the United States Federal Reserve unwinding its quantitative easing measures embodies these risks: several emerging market economies saw large capital outflows, long-term interest rate increases, and exchange rate depreciations. The IMF's Global Financial Stability Report (GFSR) notes that management of these risks would be a paramount challenge for policymakers in the period ahead. In the very near term, decisions regarding U.S. fiscal policy remain very important—with significant consequences for the U.S. economy and, given spillovers, on the global economy. While the period of negative growth in the euro area has seemingly ended, growth there is expected to be subdued, perhaps not providing as strong a support for emerging European economies as desired.

Now, turning to Russia

It is in this context that the revised forecasts for Russia should be seen. We currently project Russian growth to be at 1.5 percent for 2013 and 3 percent for 2014. The projection for 2013, in particular, stands in contrast to 2.5 percent projected in July and

3.4 percent projected in April. However, this reflects the slow growth seen in the first half of the year and is broadly in line with consensus among analysts. Strong real wage and retail credit growth in the first half supported consumption, but faltering investment—particularly in manufacturing and construction—was a key drag. While oil prices have remained high, a weakening external environment has also contributed to this slowdown. A better agriculture harvest and other factors are expected to lead to a rebound in the second half, though the extent of such a rebound remains to be observed. These revisions imply a small negative output gap for the year (just over ½ percent of GDP), though so far unemployment remains close to historic lows, capacity utilization high, and inflation remains at the upper end of the target range.

For Russia, risks also continue to be tilted to the downside. So far, Russia has been affected much less than its emerging market peers by the recent financial turbulence, given its more limited connectedness and ample buffers. However the same undiversified economic structure—where energy exports account for about 65 percent of goods exports (with commodities in general accounting for 85 percent)—poses risks. Oil prices, though below their peaks (of March 2012), remain high, and that continues to support the economy. However, as you will see in the forthcoming Article IV report, a sharp and permanent drop in energy prices—for instance due to the shale oil/gas revolution—could have large implications for Russia's external and fiscal accounts, putting pressure on growth. Abrupt changes could deplete the fiscal buffers quickly, with possibly even higher capital outflows. Domestic risks could include the investment climate and slow progress with structural reforms that could undermine domestic demand and growth.

Given this, the main message of this year's Article IV report is: *to attain a higher growth trajectory, Russia needs a new growth model*. The model of the last decade—dependent on using spare capacity and rising oil prices—is no longer replicable. While policy frameworks have improved considerably in recent years—with much stronger fiscal and monetary institutions—Russia's weak business climate remains an obstacle to generating high investment, catalyzing diversification and resulting in growth. Policy choices in the period ahead will make the difference between a re-energized economy and continued stagnation.

Let me start with near-term policy priorities

The IMF's Managing Director's Global Policy Agenda (GPA) underscores that policy responses in the emerging markets should be anchored by an appropriate fiscal response, and a sound and credible monetary policy framework. In the case of Russia, it calls for cautious fiscal management to rebuild buffers.

Despite the economic slowdown (and resulting weaker non-oil revenues), higher-than-projected oil prices have yielded enough revenue to maintain the fiscal deficit at 0.7 percent for 2013. We estimate the non-oil fiscal stance to be broadly neutral this year and slightly contractionary next year. Given that Russia's output gap appears to be small, it may not be judicious at this juncture to consider additional stimulus, as it would provide—at best—a modest and temporary increase in growth, while possibly generating intensified inflationary pressures and greater exchange rate volatility. Given the risks to oil prices, continued prudent fiscal management would be most beneficial.

As for monetary policy, The CBR's policy stance has remained appropriately mindful of the trade-offs between output and inflation thus far. Inflation has declined more than anticipated in recent months, but still remains at the upper end of the 2013 central bank target. As a result, the central bank has kept rates on hold, and such caution remains appropriate in order to meet medium-term inflation targets. The incorporation of the regulatory function into the central bank—a mega-regulator, as it has been dubbed—should also provide an opportunity for a more complete supervision and regulation of the financial sector.

Recent changes in the central bank toolkit are also important developments. These include the streamlining of the liquidity toolkit and interest rate corridor, reforms in the methodology of intervention in the foreign exchange market, a broadening of the "non-intervention" exchange rate band, and improved communication. To a large part, success of an inflation-targeting framework relies on the credibility of the central bank to anchor inflation expectations, and these changes certainly go in the direction of preparing Russia to adopt the inflation-targeting framework by 2015.

So what do we make of the challenges in the short run? *Growth has indeed slowed down considerably but as the WEO points out, this is not specific to Russia alone*. Given improvements in Russia's policy frameworks since the global financial crisis, it is important to preserve those gains—domestic political pressures for near-term policy stimulus of various forms pose threats to these newly-minted macroeconomic anchors and should be avoided. The challenges Russia faces are indeed of the more longer-term variety.

Now, turning to medium-term economic policy priorities

Russia needs a new growth model—one that makes better use of natural advantages in the energy sector, while also growing and diversifying the non-oil sector. In the staff baseline, medium-term potential growth reaches only 3.5 percent, held back by supply-side constraints. That structural reforms are integral to relieving these constraints is not a novel view. But the window of opportunity provided by the high oil prices should be used to strengthen institutions and overcome these constraints, taking measures now that yield high payoffs over the medium-term.

Achieving growth that is "faster, higher, stronger" is not a concern unique to Russia. That is indeed the theme of the IMF's forthcoming *Regional Economic Issues* report for Central and South Eastern European countries. The general lessons the report highlights complement nicely the recommendations of the latest Article IV report on policies that could support growth, stability, and diversification of the economy.

Let me comment on some of the medium-term imperatives for Russia:

- *Rebuild fiscal buffers*. Russia's non-oil fiscal deficit—that is, the budget deficit if one were to exclude oil revenue—remains above 10 percent. While the oil-price based fiscal rule is certainly a step in the right direction, shielding the economy from short-term swings in the oil price, the implied fiscal adjustment over the medium term remains insufficiently ambitious. The Article IV report shows that under the current framework, the rule would leave the Reserve Fund too low to play its role as a "rainy-day fund" in case of a large drop in oil prices. Generation of savings for the fund would require expenditure reductions backed by measures such as (i) parametric pension reform; (ii) improved efficiency of budget spending and in publicly-owned enterprises, including better assessment of investment spending and oversight and (iii) gradual privatization of state-owned enterprises, especially those with relatively low price-earning ratio. Such bold steps would not only build buffers, but also build confidence catalyzing the needed private-sector investor.

- *Continue momentum in monetary policy*. Indications that Russia's monetary policy would be firmly anchored within the inflation-targeting framework are quite welcome. Appropriate target-setting, judicious use of the toolkits, and clear communication to deliver low and stable inflation would be key to mobilize resources domestically—and to attract external resources—to facilitate productive investments. The goal to move to a fully-fledged inflation-targeting framework, in the context of a flexible exchange rate, by 2015 is feasible. It requires a dedicated adherence to the roadmap, to put required policy and institutional changes in place before then.

- *Finance for growth*. A well-regulated financial sector remains crucial in supporting growth and stability. The central bank has appropriately focused on addressing risks posed by rapid retail lending growth, largely in unsecured consumer loans. Further measures—such as a formal ceiling on the debt-service-to-income ratio and higher capital requirements for high credit concentration risks—may become necessary. Improvements in the supervisory framework are welcome, as are plans to adopt Basel 2.5 and 3 on schedule. The creation of a mega-regulator is also a significant step in enhancing the capacity to monitor systemic risks; implementation should pay attention to the need to address weaknesses in supervision of nonbanks. The medium-term agenda should focus on improving corporate governance, borrower information, creditor rights, and competition in the sector.

All of this is to create an investment environment that facilitates broader-based participation, where increased private investment can develop new engines of growth consistent with Russia's comparative advantage. This remains the key challenge for the medium term. Some important steps could comprise: (i) reducing the government's footprint in the economy through privatization, with swift and transparent implementation of plans; (ii) improving corporate governance, including through full disclosure of affiliated parties; (iii) enhancing property rights protection; and (iv) reducing "red tape" by curtailing the discretionary role of civil service and public administration in economic decision making. In addition to fulfilling commitments made under the WTO accession in 2012, using the OECD accession process to move this agenda forward would be welcome. These issues are discussed in the forthcoming Article IV report.

Finally, let me take a step back and summarize

- Global growth remains subdued, and there are downside risks, especially among emerging market economies. This calls for measures to increase the resiliency of existing policy frameworks, and to build buffers, to combat possible spillovers.

- Recent improvements in the policy frameworks in Russia are welcome. These gains should be preserved, resisting pressures for stimulus in the near-term.

- The focus in Russia should be on the medium term, beginning with actions now, to create a catalytic environment for a new growth model. Sound economic policies should be complemented with needed structural reforms to set Russia on a new growth trajectory.

The WEO, GFSR, and FM are all on the IMF website now, as is the MD's GPA. The 2013 Article IV Consultation Report will be published very shortly and should be available both on the main IMF website and on the website of the Resident Mission.

With that, I am happy to take your questions.

Thank you.

References to IMF documents

WEO: http://www.imf.org/external/pubs/ft/weo/2013/02/

GFSR: http://www.imf.org/External/Pubs/FT/GFSR/2013/02/index.htm

FM: http://www.imf.org/external/pubs/ft/fm/2013/02/fmindex.htm

MD's Global Policy Agenda: http://www.imf.org/external/np/pp/eng/2012/101312.pdf