BOFIT Forecast for Russia
24.9.2015

BOFIT Russia Team

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With the collapse of oil prices in 2014, the Russian economy has contracted this year. Assuming the oil price is slightly below $55 a barrel, our forecast sees Russian GDP shrinking around 4 % this year. Fixed investment is depressed by uncertainty, while last winter's surge in inflation continues to discourage private consumption. Government spending is set to contract in real terms. Russia's oil exports are experiencing unexpectedly robust volume growth. Imports have fallen and are expected to be about 25 % lower this year than in 2014. For 2016–2017, we assume a moderate rise in the oil price while the effects of the 2014 price collapse will continue to weigh on the economy still in 2016. We expect GDP and imports to contract slightly in 2016 and then make a slow recovery. Thereafter, growth will remain low as opportunities for growth have been curtailed by low fixed investment and systemic deficiencies that have not been addressed. Tensions in eastern Ukraine, sanctions, and lack of clarity about measures to restrict economic activity and trade in Russia will sustain uncertainty. Implementing stimulus has been difficult through monetary policy, and budget constraints limit the government's options on the fiscal side. The forecast is surrounded by large risks, especially with respect to fixed investment and imports.

Domestic demand and output have dropped, imports have fallen

Russian economic growth is constrained by two pre-existing burdens, i.e. the economy's unaddressed systemic deficiencies and rising uncertainty especially since 2014. The latter stems from Russia's intermeddling in Ukraine and the subsequent financial and trade sanctions, as well as Russia's measures that restrict market-based economic activity and foreign trade (e.g. countersanctions).

Moreover, the prices of oil and Russia's other major basic export commodities have fallen sharply during the past year and a half. As a result, Russian domestic demand has contracted strongly. Retail sales, by far the largest component of private consumption, plummeted nearly 10 % in volume terms at the start of the year, and remained depressed since then. The drop reflects declining real household incomes that have been battered by last winter's surge in inflation, which boosted 12-month consumer price inflation to around 15–16 %. Similar to the 2009 recession, Russian households have been paying down their bank loans faster than taking new bank loans. The slide in fixed capital investment has also continued. Fixed investment was down 6 % y-o-y in the first eight months of the year and down about 8–9 % from the same period two years ago (despite the fact that investment in oil and gas production increased rapidly over the period). A strong reduction of inventories also continued.

Russian GDP declined over 4.5 % y-o-y in the second quarter (and about 3.5 % in the first half). Russia has avoided a worse performance, however, thanks largely to two demand factors. First, the volume of exports of Russian oil and petroleum products has increased considerably this year, defying the predictions of both Russian and international energy authorities. Second, government spending was up in the first half of this year almost 20 % in nominal terms, lifted by heavy increases in defence and social spending (up by a third).

Russian export earnings have declined (down in the first half of the year by nearly 30 % y-o-y in dollar terms and over 10 % in euro terms and in terms of the ruble's trade-weighted basket currency). Private capital flight from the ruble and out of Russia has intensified, especially last winter. The result has been a sharp depreciation of the ruble. Russian imports have dropped dramatically due to the weak ruble, lower domestic demand and increased restrictions on certain imports. The volume of imports of goods and services in the first quarter of 2015 contracted by a quarter on year and the value in the first half was down by about a fifth on year (in euros).

GDP and imports still set to contract slightly before slow recovery

Oil prices rose last spring, before sliding again from mid-summer. Our forecast assumes the average oil price for 2015 will be slightly below $55 a barrel, i.e. slightly over half of the 2014 average oil price. Uncertainty will depress private investment. Private consumption will also remain slack as household purchasing power will have to endure last winter's burst of inflation. Government spending will fall in real terms, especially in the second half of 2015, if the finance ministry's mid-summer forecast for the year plays out. Russia's oil sector exports, in contrast, will increase fairly robustly this year.

We expect the Russian GDP to contract by around 4 % this year. Russian imports are in a slump and likely to be about 25 % less than in 2014.

While growth of global trade is set to improve in 2016–2017, we assume the oil price will increase only moderately (to just under $60/bbl). The collapse in oil prices that began in mid-2014 will continue to weigh on the Russian economy through 2016. Tensions from the conflict in eastern Ukraine and sanctions, which are expected to remain in force for a relatively long while, as well as the unpredictability surrounding Russia's restrictive economic and trade measures will maintain uncertainty. In 2016, private and public consumption, fixed investment, GDP and imports will shrink a bit before entering a weak recovery. Exports will grow slowly. Looking further ahead, GDP growth will remain low as growth opportunities have been curtailed by low fixed investment and Russia's systemic deficiencies that have not been addressed.

Consumption and investment stall, exports grow slowly

With a relatively slow easing in the inflation rate, private consumption will still shrink slightly in 2016. The rise in wages will stay tame as corporate profitability will be weak in the recession and public sector wage hikes have been capped, or even frozen. Russia's leadership is also considering lowering pension indexation to slightly below the inflation rate. Concrete decisions have been taken as well on reducing the number of workers in certain public sector categories. As in 2015, corporate layoffs may remain modest relative to the contraction of business activity, while pressures will be eased instead through temporary layoffs and moving workers to part-time status. Household borrowing will remain low and saving during the recession may remain considerable.

Despite improved growth in global trade, Russian exports should only grow slowly as energy experts see Russian oil exports declining in the forecast period. The export volume should be supported, however, by a recovery of gas exports and increased exports of certain basic non-energy commodities buoyed by the weak ruble exchange rate.

Fixed investment will decline slightly in 2016 on uncertainty about the Russian economy and the business environment. Fixed investment will recover slowly, also because the recession has freed up production capacity. Financing costs will remain relatively high due to the recession, risks and sanctions. State-supported large investment projects will proceed gradually.

Economy, export earnings, the ruble's exchange rate and inflation determine imports

Imports will recover slowly as the economic slide flattens and the economy gradually returns to growth. As financial sanctions constrain imports, it will be important for the recovery of imports that the moderately rising oil price and growth in export volumes gradually lift Russian export earnings.

Imports are also supported by the ruble's real exchange rate, which will appreciate as Russia's inflation, even with the slowdown, will be much higher than in its main trading partners (the difference in favour of trading partners this year is still over ten percentage points). The ruble's nominal exchange rate should remain relatively stable as import flexibility sustains a current account surplus that is assumed to cover net capital outflows from Russia. The Central Bank of Russia is no longer engaged in buying and selling operations in Russia's currency markets, apart from exceptional circumstances. Thus, rapid swings in the ruble's exchange rate may emerge from time to time, even if the country's leaders have sought since last winter to promote ruble stability through "manual steering," e.g. by instructing large state-owned exporting companies on their assets in foreign exchange.

Few opportunities for economic policy stimulus, restrictive policies on the rise

Stimulus through monetary policy faces challenges in Russia. A new platform for steering emerged last winter when the CBR sharply hiked its key rate in response to the ruble's sharp fall and the consequent burst of inflation. This year – in the middle of cross pressures between inflation and inflation expectations and the weakening economy – the key rate has been lowered gradually to below the inflation rate. Even so, the return of domestic deposits this year has been very important for the funding of Russian banks. That has helped interest rates on long-term bank loans to remain slightly below inflation. The desired policy outcome is still to appear as corporate borrowing is down from last year because investment enthusiasm has been otherwise weak.

Government finances are stretched. With the drop in oil prices, government revenues in the first half of the year were only slightly larger than a year earlier in nominal rubles, i.e. the revenues shrank dramatically in real terms. Revenues from taxes on oil & gas production and exports fell by a fifth in nominal terms, although the fall of the ruble partly offset the nominal ruble losses related to the dollar-denominated oil & gas taxes. Other government revenues overall were up by less than 10 %. The finance ministry expects the 2015 consolidated budget deficit to deepen to over 5 % of GDP, if the oil price averages slightly over $50/bbl and GDP contracts 3 %, and if spending rises by just over 10 % in nominal terms (omitting the large bank support lump sum of December 2014). Due to the sharp increases in defence and social spending, nominal growth of other spending would remain at just 5 % this year.

Financing the government's fiscal deficit has become more complicated. Dipping excessively into the Reserve Fund is rather unattractive as the fund is regarded as one of the economy's rare strengths (Reserve Fund assets at the start of 2015 amounted to 7 % of GDP). Foreign borrowing has become more expensive. Thus, the government has this year borrowed from domestic banks, which has been supported by low demand from private sector borrowers. However, the condition of banks may weaken, and government borrowing from banks risks crowding out private borrowers. With little room for stimulus, the government faces a need to cut spending on top of the weak 2015.

While economic stimulus is difficult, restrictive policies to protect domestic producers and substitute imports have come to the forefront in Russia. Yet, the resulting substitution structures will be unsustainable over the long term.

Large risks remain in the forecast

A central risk in our forecast comes from a significant shift up or down in the oil price compared to the assumed track. Moreover, conditions in eastern Ukraine could degenerate or also improve. Either way, such shifts would influence fixed investment, but probably differently in terms of time. Negative events could quickly weaken sentiments among private investors further. Positive steps, in turn, would restore investor confidence more slowly, whereby the improvement would not be felt much during the slightly over two years covered by our forecast period. The same configuration also applies more generally to effects of possible changes in restrictive policies (or reform policies) on fixed investment.

The essential risk to the import forecast consists of negative events that would drive capital out of Russia and thus weaken the ruble further. The resulting acceleration in inflation would erode e.g. consumption, which would also depress imports as well as domestic production. For the latter, the effects of increases in exports from a weak ruble would likely remain smaller than the harm via bitten domestic demand.

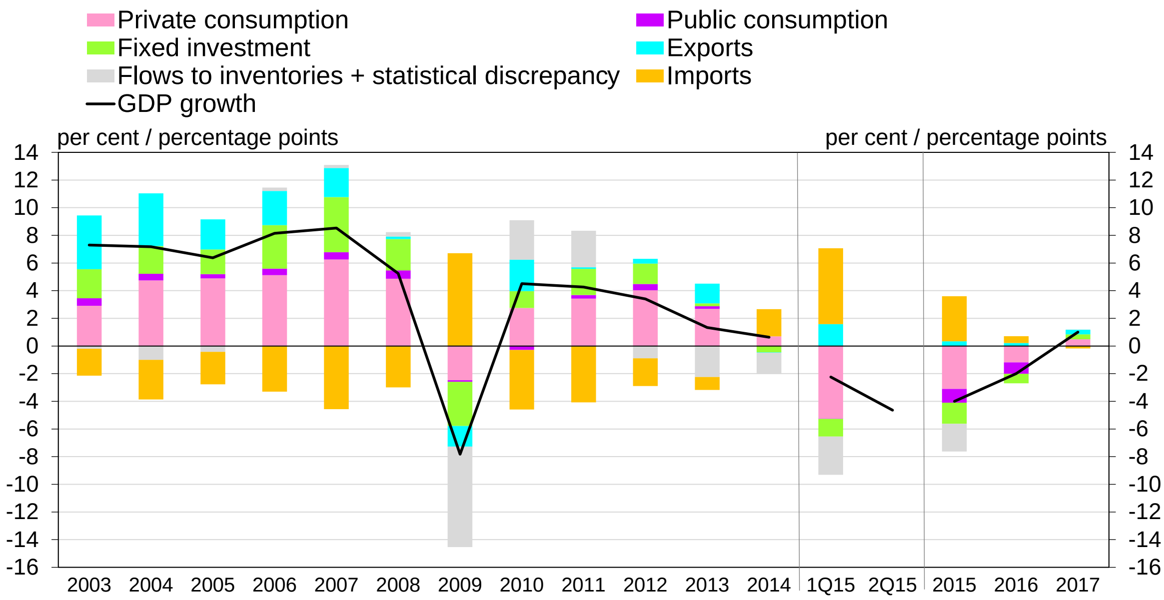
Despite scarce means to finance the government budget deficit, Russia’s leaders could become inclined to increase government spending, if social pressures rose tangibly ahead of the Duma election in autumn 2016 or on the way to the presidential election in March 2018. Increased spending could improve some of the economy’s figures during our forecast period, but e.g. stimulating consumption with government money would reduce the room for government spending further down the road without providing much ground for economic development in the future.

Russian GDP and import volumes, realised and forecast growth (%)

	2009	2010	2011	2012	2013	2014	2015f	2016f	2017f
GDP	–7.8	4.5	4.3	3.4	1.3	0.6	–4	–2	1
Imports	–30	26	20	9	4	–8	–25	–4	1

Sources: Rosstat, BOFIT Forecast for Russia 2015–2017.

Russian GDP volume, realised and forecast growth (% y-o-y), and the shares of demand components and imports in GDP growth (percentage points)



Sources: Rosstat, BOFIT Forecast for Russia 2015–2017.