BOFIT Forecast for Russia
18.9.2013

BOFIT Russia Team

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Bank of Finland
BOFIT – Institute for Economies in Transition

EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland
BOFIT – Institute for Economies in Transition

PO Box 160
FI-00101 Helsinki
Phone: +358 10 831 2268
Fax: +358 10 831 2294
bofit@bof.fi

www.bof.fi/bofit

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The slowdown in Russian economic growth to around 1.5 % p.a. in the first half was significantly sharper than predicted. The drop largely reflects cuts in investment by state-owned enterprises and the public sector. We expect the Russian economy to pick up this year as recovery in the global economy gets underway. GDP growth for all of 2013 should reach nearly 2 %. If the oil price declines slightly during the forecast period as we assume, it will weigh on Russian economic growth. Nevertheless, GDP growth should slightly exceed 3 % p.a. in 2014 and 2015 as the recovery of world trade gives a small lift to Russian exports. Although household incomes will not rise as fast as earlier, lower inflation will slightly increase household purchasing power. Investment should return to growth as capacity constraints are not far. Growth in public sector spending will slow. Growth in Russian imports should pick up slightly to around 5 % p.a.

After a sharp slowdown, Russian economy set to recover

The sharp deceleration of the Russian economy in the first half of this year surprised all forecasters. GDP growth was about 1.5 % in the first quarter and just over 1 % in the second quarter. Import growth moderated significantly and was a few per cent in the second quarter. The slowdown in economic growth stemmed especially from a slight decline in fixed capital investment, which earlier had been rising. In particular, investments by large state-owned enterprises in charge of infrastructure declined, due in part to the completion of various major investment projects in the energy sector. Public sector (federal, regional and municipal) investment also decreased. Growth in export volumes was weak in the first half, even if exports recovered in the second quarter on higher exports of petroleum products. Inventory levels fell notably. The growth in private consumption remained brisk as public sector wages continued to rise rapidly.

At the background, the uplift from Russia's export prices on economic growth has faded as the rise of the oil price and the other export prices levelled off over two years ago. Since spring 2012, the export prices have declined. Company profitability has been on the decline for two years, and private sector wage growth has dipped below 10 % y-o-y. Household borrowing stopped rising last winter, while inflation accelerated until spring, further eroding purchasing power. Corporate borrowing from domestic banks has been falling for the past year and a half. Private capital has continued to flow out of the country this year in considerably larger amounts than capital inflows, even if the net outflow has diminished. The growth in public sector spending has been curtailed notably since the 2012 election cycle.

Economic growth is expected to pick up slightly in the second half of this year as the global economy and world trade revive. The volume of exports should rise slightly. The contraction in fixed capital investment should gradually end, even if Russian authorities still expect public sector investment and investment of large state corporations to fall this year. The 2013 grain harvest is also forecast to come in well above the long-term average. Thus, GDP growth for all of 2013 should be near 2 %. As the economy revives, import growth should pick up.

During 2014–2015, GDP growth should exceed 3 % p.a. as long as economies improve in Europe and elsewhere. On the other hand, economic growth will be restrained if our assumed gradual decline in the oil price (over 10 % for the forecast period) materialises.

A package of stimulus measures was approved by the government this summer. The measures are fairly scattered and seem likely to have limited impact. The effects of a possibly more relaxed monetary stance on interest rates on bank lending and the willingness of companies and households to borrow are uncertain. The state at least so far wants to hold down the government budget deficit, even if revenue growth has already slowed sharply and revenue growth expectations for coming years have been dialled back. These conditions portend an overall slowdown in state spending growth, whereas the state will embark on lending to finance a number of major transport projects.

The uncertainty in the operating environment for businesses in Russia could improve slightly during the forecast period. Measures to improve business conditions planned by central authorities and various regions proceed slowly. Over time, economic growth will gradually head towards its long-term trend, if the oil price does not rise. Our calculated long-term trend growth has taken a distinctly lower rate of about 2 % p.a. since the 2009 recession. A higher growth rate is not foreseen unless Russia accelerates implementation of measures to improve the business climate and attract more investment.

Good consumption growth, fixed investment picks up

While consumer sentiment declined early in the year, it brightened somewhat in summer. Growth of private consumption should remain fairly brisk, although growth will slow slightly with moderating household income growth. There is less room for private sector wage increases as corporate profitability has sloped down, and a rapid turnaround is not expected. On the other hand, pressures to raise wages may arise from the employment front. The number of employed, despite a small drop recently, is at a post-Soviet high, and the share of employed of the population classified as working-age people is at its highest level in two decades. Unemployment remains low. As Russia's working-age population contracts the number of wage-earners declines, although the situation may ease somewhat if the already substantial participation of pension-age people in the work force will expand. Under the government budget framework drawn up this summer, public-sector wages (about 15 % of household income), as well as pensions and other social benefits (nearly a fifth of household income), will rise more slowly than earlier.

Russia's inflation rate has started to decline, and it should continue to fall gradually during the forecast period, giving some support to household purchasing power. Factors contributing to lower inflation include the state's decision to reduce scheduled hikes to household energy tariffs for the next few years. Household credit should at least return to slow growth, even if the costs of servicing short-term and very-high-interest consumer loans are already devouring a substantial share of income in certain households. Household savings levels are not expected to improve significantly over the next few years.

As the forecast for the economy has been lowered, the revenue outlook for the government is lower than estimated in the government budget framework. Cuts in spending plans are in preparation as the priority is to keep the budget deficit small. At the moment, cuts seem focused mostly on public procurement, which may reduce public consumption.

Growth in exports will remain quite low. The outlook for energy exports has further deteriorated slightly. In Russia, the volume of crude oil exports is expected to decline over the next few years as production remains flat. The targets for the volume of petroleum products exported have been raised a bit as refinery input/output ratios are to improve, but the export volumes are still expected to decline. The outlook for growth of natural gas exports is also guarded in light of the challenges posed in the international market by the shale gas boom and liquefied natural gas (LNG).

Growth in fixed capital investment should recover. Despite the slowdown in output growth, production capacity utilisation remains close to its pre-crisis levels. One stimulus measure the state has set for launch next year is a pack of massive transport infrastructure projects. The state will participate by providing long-term loans from the National Welfare Fund and pension savings.

Steady import growth

As the Russian economy was exceptionally susceptible to imports soon after the 2009 recession, we expect imports to rise at about 5–6 % a year during 2014 and 2015. Import growth should get some support from an expected modest appreciation of the ruble's real effective exchange rate. Russia's inflation rate should remain higher than the inflation rates of its main trading partners, although the difference may narrow. The appreciation pressure on the ruble's nominal exchange rate will subside as the current account surplus vanishes during the forecast period. The rise in imports in the next few years is further supported by Russia's WTO accession in summer 2012.

Limits on import growth emanate from the share of imports relative to GDP, which is already quite high despite the slowdown of import growth. The government's stimulus plan also has a few import-constraining features: Regulations to ban public procurement of certain products from outside the Russian-Belarus-Kazakhstan customs union are to appear soon. To support domestic production, the state has also decided to freeze planned hikes to energy and rail cargo tariffs charged to firms in 2014 and lower the hikes significantly for the following years.

Risks

If the predicted global recovery is delayed, the pick-up in Russian economic growth will also be delayed as e.g. export growth suffers. The outlook is further blurred by uncertainty over the direction of the oil price and prices of other Russian export commodities such as metals. A slight upside surprise is possible.

Our outlook for private consumption growth proves optimistic if wage growth slows more than anticipated. To the extent that growth in public sector revenues will undershoot earlier projections, regional and municipal governments may have to trim their spending plans concerning wage hikes as well, unless the budget rule is shelved. A lower-than-expected rise in wages could also cool the desire of households to take on more debt.

Investment growth is surrounded by considerable uncertainty about future demand and the business climate facing e.g. the energy and manufacturing sectors, which together account for 45 % of fixed capital investment. The high employment rate could also constitute a limit to economic growth. To ameliorate the situation, people employed in low-productivity branches should be encouraged to move to sectors with higher productivity, which would be supported by an environment that offers better prospects for starting and growing businesses, and public sector reforms.

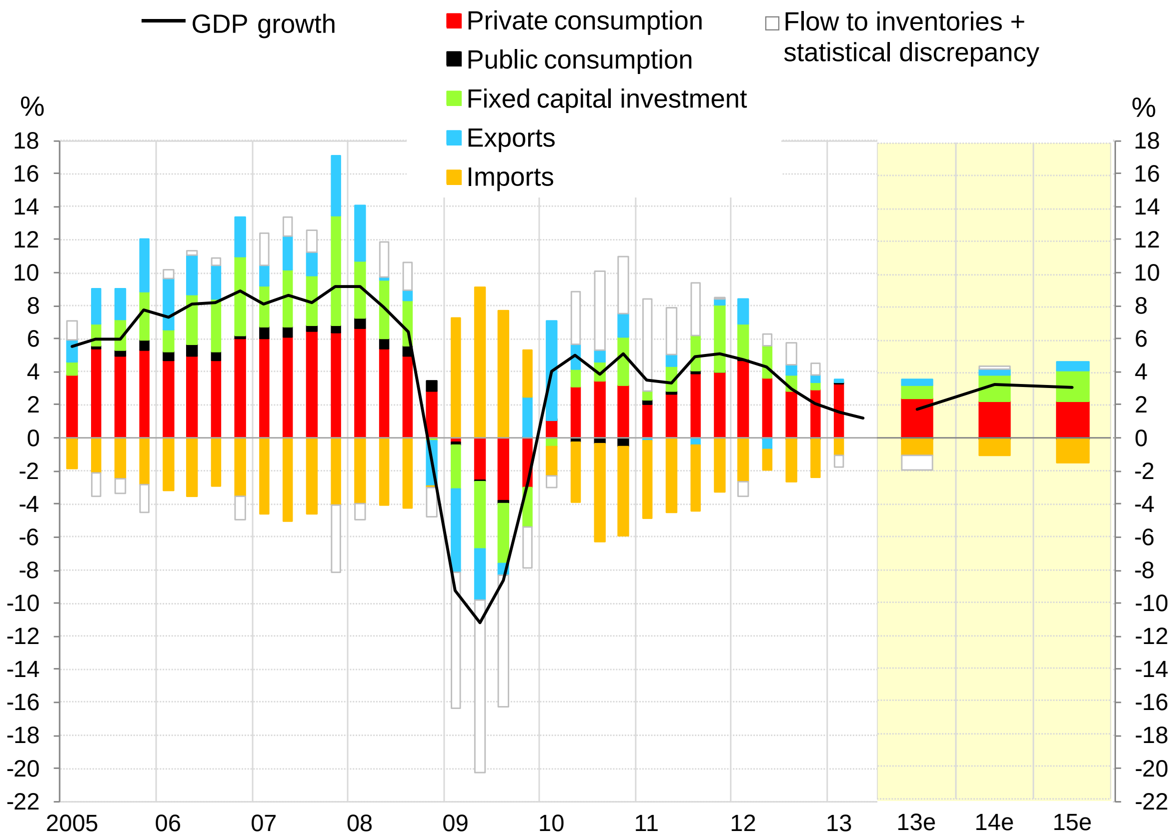
The ruble's nominal exchange rate, which impacts imports, is driven partly by hard-to-predict shifts in capital flows in and out of Russia.

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

	2008	2009	2010	2011	2012	2013f	2014f	2015f
GDP	5.2	-7.8	4.5	4.3	3.4	1.8	3.3	3.2
Imports	15	-30	26	20	9	4	5	6

Sources: Rosstat, BOFIT Forecast for Russia 2013–2015 (f = forecast)

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



Sources: Rosstat, BOFIT Forecast for Russia 2013–2015