BOFIT Forecast for Russia
25 March 2014

BOFIT Russia Team

BOFIT Forecast for Russia 2014–2016

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Russian GDP growth of 1.3 % last year undershot forecasts, due to a tangible slowdown in domestic demand. There was a steep decline in fixed capital investments of state enterprises and the state. Consumption growth slowed. Despite a pickup in global economic growth and world trade, growth of the Russian economy will slow further this year as the events in the Crimea cause the postponement of investments. Imports will take a slight dip. In 2015 and 2016, we do not expect the oil price to rise, butt growth in Russia will pick up slightly as the global economy continues to revive. As long as the effects of the Crimean events stay contained, the economy should still grow about one and a half per cent p.a. in 2015 and 2016. Import growth should run at a couple of per cent p.a. Output growth may become constrained by the capital stock and low productivity gains due to weak fixed capital investments. The forecast is subject to substantial downside especially as regards the effects of the Crimean situation. Russia's leadership could respond to weak growth with higher state spending and boosting credit via the banking system. In the longer term, Russian economic growth will stay at about a 2 % p.a. trend, if Russia does not move ahead with necessary systemic reforms faster and on a broader basis than in recent years.

Persisting low growth

Just two years ago, the Russian economy was growing at nearly 5 % p.a. A year ago, the pace of growth had fallen to about 1.5 %. The subsequent further weakening of growth undershot forecasts. Lower growth in domestic demand accounted entirely for the slowdown.

Although private consumption growth abated, it was still brisk thanks to substantial public-sector wage hikes. Private-sector wage growth slowed to near the inflation rate as profitability eroded and Russia's tight labour market began to slacken. Household borrowing declined. Inflation, which eats away at consumer purchasing power, held above 6 %. Growth of public consumption stopped.

Growth in fixed capital investment halted, despite growth of private investments. In addition to state investments, investments of state-owned enterprises (particularly state companies in the energy sector), contrary to government targets, fell even more than in 2012 as many large infrastructure projects were completed. The lack of investment incentives depressed corporate borrowing in domestic markets. The ruble's exchange rate weakened as companies continued to export much more capital than they imported. Inventories continued to shrink.

Foreign trade developments supported economic growth. Russia enjoyed a second-half acceleration in export volume growth on recoveries in exports of natural gas, petroleum products and certain metals. Import growth slowed. However, higher spending by Russian travellers abroad helped keep overall import growth at 6 % p.a.

The impact of export prices on Russian economic growth has faded because export prices have not risen in more than two years and actually declined last year. Last year, ruble depreciation was no longer sufficient to make export prices increase in ruble terms.

Economic growth to slow further; recovery likely to be gradual and modest

We expect economic growth to slow further this year. Growth is supported by recoveries in the global economy and world trade, but is constrained by a slight decline of the oil price. In any case, these impacts pale against the rise in uncertainty caused by the Crimean events, even if it stays relatively contained both with respect to market reactions and the scope of possible sanctions and counter-sanctions. This uncertainty will reduce private investments. If the drop in investments of state-owned companies and the state can be halted, investments overall may slip rather moderately. Growth in private consumption will slow substantially, partly due to ruble weakening. No increase in public consumption is likely and export growth will be tepid. Imports will contract slightly this year as the recent slide of the ruble has been steeper than earlier.

In 2015–2016, growth of the economy will recover slightly as growth of the global economy picks up. However, growth in Russia will remain at one and a half per cent p.a., due to the impact of the Crimean events and a gradual decline in the oil price (about 10 % during our forecast period). Even reaching this rate of growth assumes the Crimean effects stay contained. Economic growth may also become constrained because the dry spell in investments holds back growth of the capital stock and limits productivity gains.

Getting serious about stimulus and reforms?

While Russia's leaders have been increasingly discussing and outlining measures for economic stimulus, they have so far not taken broader action. The state budget deficit target has been slightly increased, but the government is still sticking to its budget rule of keeping the deficit to about 1 % of GDP. If the government follows the budget rule, the already low growth in budget revenues will lock in low public spending growth. There has been no enthusiasm for monetary stimulus, since inflation still exceeds the desired pace. Moreover, the impacts of monetary policy measures on bank lending rates and borrowing are uncertain. Money markets have faced an effect of tightening as a result of the Central Bank's ruble-buying to limit ruble depreciation driven by market pressures. Proposals for new measures to support firms are under preparation for the government. The proposals will supplement last summer's list of rather scattered measures with fairly limited in scope, e.g. price controls.

Over the longer term and under more peaceful conditions, we calculate the outlook for the economy is 2 % trend growth, if systemic economic reform does not pick up from its current pace. Implementation of reforms under the "road maps" approved by the government is proceeding slowly. Certain targeted measures have been implemented promptly, although they are part of the underlying rather mechanical targeting, laid down in president Putin's decree, to lift Russia rapidly in the World Bank's international ranking for *Doing Business* which compares the business environments in countries' business capitals.

Consumption growth slows, uncertainty clouds investment outlook

Growth in household incomes and private consumption, though still moderate, should slow significantly. The rise in private sector wages will remain rather slow as feeble economic growth subdues corporate profitability. After the downward turn of employment, pressures to raise private-sector wages will diminish. Given the bleak prospects for state finances, public-sector wages (some of which have been frozen for this year) and pensions will rise more slowly than until now. Whether household borrowing will start rising again is unclear as lending rates remain quite high and household debt burdens are large due to high interest rates and short payback times. Due to the ruble's slide, disinflation that would support purchasing power seems increasingly uncertain, despite slowing demand growth and limits on rate hikes for household energy. The volume of public consumption will grow slowly or not at all. Rapid price growth in the public consumption arena is not likely to moderate; it will instead continue to eat away at increases in state spending allotted to public consumption.

Although a recovery in global trade will support growth in Russia's export volumes, exports overall will grow slowly as the outlook for growth in the Russian energy export volumes remains weak. This is especially true for petroleum products, which are increasingly consumed domestically.

Growth in fixed capital investment is likely to recover only gradually. Pressure for investments has eased as capacity utilisation has declined and the uncertainty stemming from the Crimean events will not fade away completely during the forecast period. While the leadership has frozen corporate tariffs on energy and rail freight for this year to encourage firms to invest, the freeze has added to uncertainty surrounding investments of state-owned energy companies and railways. To deal with this problem, the leadership has resorted to "manual steering" aimed at improving the efficiency of state enterprises and even limiting the price-setting by firms that supply goods and services to state enterprises. The starts of transport megaprojects that will be partly financed by the state are getting delayed, and their implementation schedules extend beyond the forecast period.

Slow growth for imports

The Russian economy's propensity to imports should remain rather high. After this year's dip, imports should return to growth of a couple of per cent p.a. Import growth should not face very strong headwinds as the ruble is not expected to depreciate substantially in real terms as Russian inflation is running well above the inflation rates of its main trading partners. The ruble's nominal exchange rate will gradually decline as the current account surplus evaporates and the direction of net capital flow remains outbound.

Exceptional downside risks

The negative impacts of Crimean events could become wider than assumed in our forecast, both with regard to investor reactions and trade and economic sanctions. Even without these complications, domestic uncertainty surrounding investments of private companies, state companies and the state already poses significant risks to the forecast. If these negative risks materialise, Russian economic growth this year could be considerably weaker than our forecast.

Lower-than-forecast world economic growth would impact the volumes and prices of Russian exports of energy and other basic commodities. On the other hand, the oil price would rise, for example, if there were disruptions in the global oil supply.

There could be a steeper-than-expected slowdown in consumption growth if weak economic growth dampens state budget revenues and the leadership is unwilling to increase the budget deficit. Strong depreciation episodes of the ruble would fuel inflation and depress consumption further. This would occur if higher-than-expected capital outflows appear, for example, because other countries tighten their monetary policy. Severe ruble depreciation would also curtail imports more than forecast. Inflation spikes in Russia could also result from production disruptions in global agriculture.

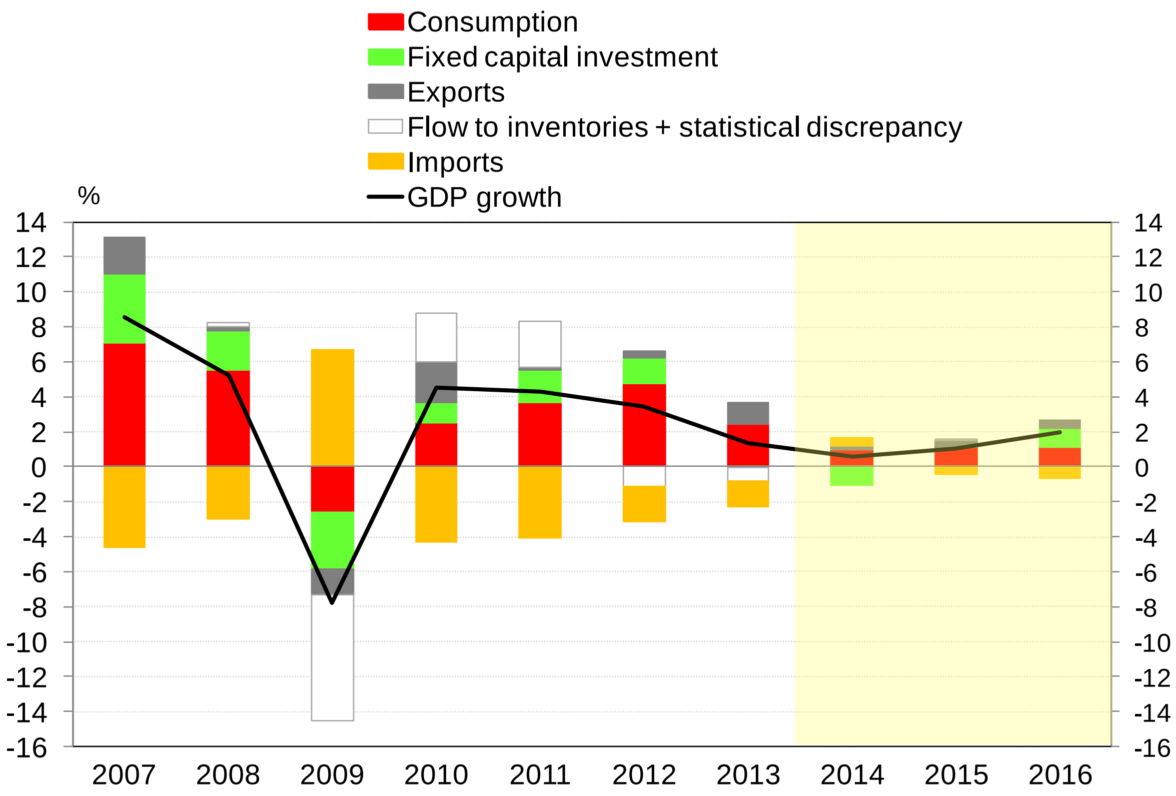
Substantial measures aimed at stimulus may be undertaken in Russia. Spikes in inflation could result in new price controls. To deal with weak economic growth, the leadership has plenty of leeway to take on additional government debt. If necessary, the banking sector could also be employed. Here, the central bank would extend credit to banks and state banks (which hold over half of total banking sector assets) that would then lend to companies and households. Lifting price controls and paying down debt would naturally be suspended to the future.

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

	2009	2010	2011	2012	2013	2014f	2015f	2016f
GDP	-7.8	4.5	4.3	3.4	1.3	0.5	1	2
Imports	-30	26	20	9	6	-2	2	3

Sources: Rosstat, BOFIT Forecast for Russia 2014–2016 (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 2014–2016