BOFIT Forecast for Russia
29.9.2009

BOFIT Russia Desk

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Russian GDP apparently bottomed out in the summer and turn up in the latter half of 2009, driven by modest growth in consumption and export demand. Exports will be supported by a moderate recovery in the world economy, and consumption demand will get a boost from higher oil prices. Investment is not expected to pick up until next year. The modest growth in GDP will also promote a modest recovery in imports. For 2009 as a whole, both total output and imports are expected to decrease substantially, due to the weak performance in early part of the year, but to turn up in 2010–2011.

Consumption is driving economic growth - investment recovering more slowly

The international economic crisis also hit Russia hard. The notable decline in the price of oil, the seize-up of international financial markets, and a general mood of uncertainty led to a very weak economic performance in the early part of this year. In the first half of the year Russia's total output fell 10.4% on the year-earlier period, albeit the second-quarter performance has shown signs of stabilization.

The drop in GDP was primarily due to a shrinking of capital formation. Investment declined by more than 20% year-on-year in the first half of 2009. With firms' brighter demand prognosis and improved financing possibilities, investment is expected to shift gradually into growth mode in the course of next year, albeit robust growth is not in the offing, as public sector investment is set to decrease in 2010. Inventory adjustment has been a key factor in the feeble GDP result in the first half of the year. Inventories have climbed to lofty levels in Russia in recent years, and now they are being brought down with abandon. The initial phase of inventory adjustment may be winding down, and so the GDP-impact of inventories may well become positive by the end of this year. But the impact is extremely difficult to predict, especially for Russia, where the fluctuations are large.

Consumption has also declined in Russia, in response to weakened income developments and rising unemployment. Moreover, the household savings ratio has jumped in recent months, due largely to debt repayment and households' credit stock has declined. The volume of retail sales, a reflector of consumption developments, was in fact down 3% year-on-year in the first half of 2009. The rise in unemployment however leveled off during the summer months, and income developments have stabilized. Russian households' indebtedness is on average very modest, which bodes well for the recovery of consumption. Public-sector measures have also been employed in order to buoy households' income. The intent is to shift the emphasis of such measures next year to social policy. It is expected that consumption will recover gradually in the waning months of this year and to once again be the engine of economic growth in 2010–2011.

Foreign trade could pick up in the latter part of the year

The volume of Russian exports declined sharply in the early part of this year because of the soft demand for raw materials and, inter alia, the gas dispute with Ukraine. Total gas deliveries in fact declined 40% year-on-year in the first half of 2009, in contrast with the volume of oil exports, which remained at the previous year's level, and oil product exports, which actually increased. In recent months, Russian export performance has shown signs of a pick-up as the world economy has gradually gained traction, and export activity is expected to help return the economy to growth in the waning months of the year. However, export growth will slow toward the end of the forecast period, as growth prospects for Russian gas and oil production are strictly limited at least in the short run.

In the early part of 2009 import volume also decreased by a third on the previous year, due to weak demand and rouble depreciation. The biggest declines were in imports of investment goods and durable consumer goods. Because imports declined by considerably more than exports, the contribution of net exports to GDP was positive for the first time in years. It is expected that imports will gradually start to increase in the closing months of the year, spurred by a pick-up in consumption demand. Imports are also buoyed by the near-return of the rouble's real exchange rate to the year-earlier level. Already during the period 2010–2011, imports should be increasing notably faster than GDP. Despite the pronounced depreciation of the rouble in the early part of this year, Russia has not witnessed any significant degree of import substitution. Thus it is expected that the propensity to import will gradually return to its pre-crisis level.

Shrinking of the surplus will reduce the manoeuvrability of economic policy

The notable decline in the price of oil and the capital outflow from Russia led to heavy downward pressure on the rouble's external value toward the end of 2008. The Central Bank of Russia devalued the rouble stepwise in an effort to ease the adjustment of companies and banks with heavy foreign debts to the weakening exchange rate and to maintain stable economic conditions. But at the same time, the central bank was forced to use up a third of the country's foreign currency reserves to support the rouble.

During the spring months, the downward pressure on the rouble has eased, and it has no longer been necessary for the central bank to intervene notably in the currency markets. Russia's current account has remained slightly in surplus due to the rise in the price of oil and sharp decline in imports. The small current account surplus is expected to remain in place, as the price of Urals oil is projected to climb gradually to USD 70-75 a barrel in 2011 (based on developments in the futures market). For the present at least, the outflow of capital appears to have subsided, as the financial account became moderately positive in the second quarter of this year. In recent months, Russia's foreign currency reserves have stabilized in the vicinity of USD 400 billion. Despite persistently high inflation, the rouble's trade-weighted real exchange rate has already nearly climbed to the year-earlier level. But if inflation does not subside in the remaining months of 2009, this could subject the rouble to renewed downward pressure. Inflationary pressure will be eased in the remaining part of the year as the devaluation effect recedes, but accommodative monetary and fiscal policies are having the opposite effect. The Central Bank of Russia has also signaled that volatility in the rouble exchange rate might increase.

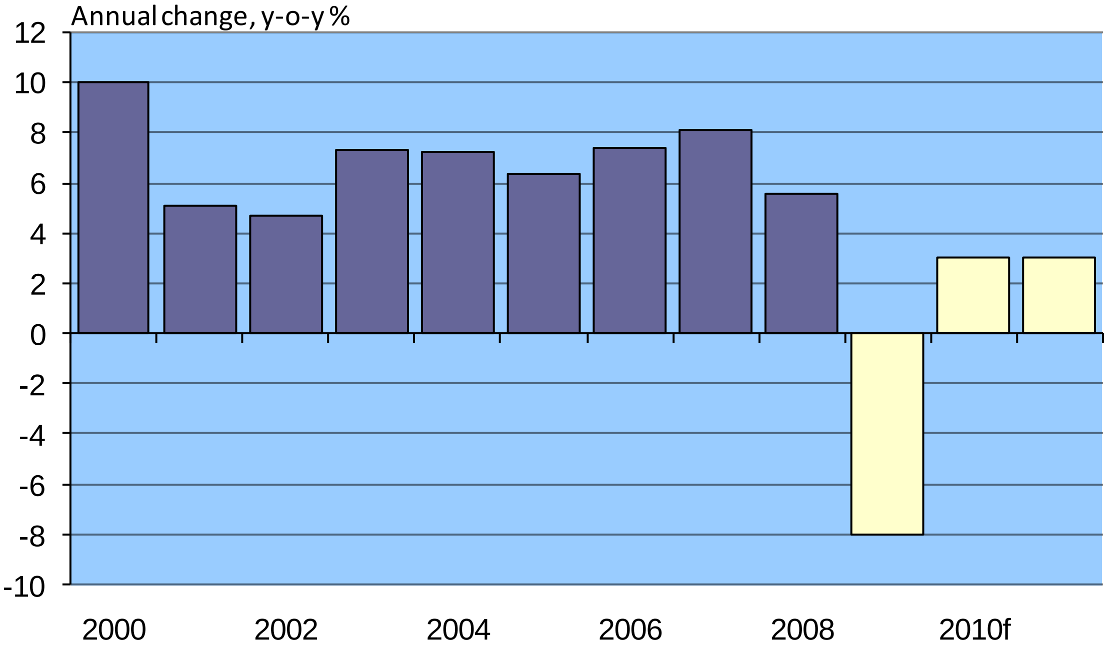
Given the sizeable stimulation measures, the Russian public sector will slip into deficit this year for the first time in the 2000s. The 2009 federal budget deficit is predicted to exceed 9% of GDP. According to the approved budget framework for 2010–2012, the deficit is to decline gradually to 3% of GDP. The budget deficits in 2009 and 2010 are to be covered mainly by money from the reserve and welfare funds. Each of these funds contained about USD 90 billion (together, ca 14% of GDP) at the start of September. The reserve fund is expected to be used up next year, and the intention is to partially debt-finance the deficit. At present, the Russian state is carrying a very small debt, amounting to just 7% of GDP.

Russia' economic growth may slow down in the long run

Russia's economic performance in the coming years will depend largely on the recovery of the world economy, which will impact Russia's export prices and demand.Still of prime importance for Russia is what happens to the price of oil, although in the exceptional circumstances of the global crisis other factors have also had a major impact. Any decline in the price of oil in the latter part of 2009 would clearly impact the economy and could lead to a much weaker path of economic performance. On the other hand, a faster-than-forecast rise in the price of oil might speed up the recovery of the Russian economy. Uncertainty is also linked to consumption developments. If income again moves into a weaker mode and unemployment begins to rise, Russian economic restoration could take much longer than forecasted. If the development of the financial sector should deteriorate, that could also hamper the recovery of Russian economy. Moreover, there is much uncertainty concerning inventory changes. Because these are rather significant for Russia's overall economic performance, they could have an important effect – plus or minus - on GDP.

In connection with the international crisis, there is also a substantial risk that Russia's long-run annual economic growth rate could slow down from the pre-crisis level of 4-5 %. The international economic crisis could dampen investment growth in particular over a long period of time because of the difficulties and costliness of obtaining finance. However, investment is key to Russia's long-run growth prospects because of shortages and aging of the capital stock, so that any delays here would weaken the prospects for future economic growth. At least for now, we are not seeing an upgrading of economic efficiency in Russia in connection with the crisis, and the government's support measures have been criticized for being aimed primarily at sustaining current inefficient structures instead of at reforming the economy, which also increases the likelihood of more protectionism. The economic crisis may also acerbate Russia's already-negative demographic situation. But Russia still has vast potential for economic growth and so will probably grow faster than the developed market economies also in coming years.

Annual Russian GDP growth rate, 2000–2011



Sources: Rosstat 2000–2008, BOFIT forecast 2009–2011

Forecasted annual real growth rates for Russian GDP and imports,%

	2008	2009f	2010f	2011f
GDP	5.6	-8.0	3.0	3.0
Imports	15.0	-28.0	6.0	9.0

Sources: Rosstat 2008, BOFIT forecast 2009–2011