BOFIT Forecast for Russia
25.3.2009

BOFIT Russia Desk

BOFIT Forecast for Russia 2009-2011

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

BOFIT Forecast for Russia 2009-2011
BOFIT Russia Desk

25.3.2009

BOFIT Russia Desk

BOFIT Forecast for Russia 2009-2011

The growth forecast for Russia has been substantially scaled down since last autumn in the wake of a pronounced deterioration in the external environment. The crash in oil prices is markedly squeezing domestic incomes, and capital can no longer be obtained from the international markets. Growth in consumption is expected to fade and investment to decline markedly. Weak international demand is having a modest contractionary effect on export volumes. Import volume will decline much more dramatically, in line with the depreciation of the rouble and soft demand. Total output is projected to decline slightly this year and then to gradually recover in 2010–2011 as the world economy gains momentum.

Domestic demand subsiding

The international financial crisis did not have a major impact on Russia's real economy until the waning moments of last year. For the whole of 2008 total output grew by 5.6 %. But the forecast for this year calls for a full 2 % decline, due to a decidedly more jaded outlook for economic performance - internationally and domestically - compared to last year. Based on gradual recovery in the world economy and a moderate rise in oil prices assumed on the basis of future markets, Russia's output too should return to marginally positive growth (1%) in 2010 and accelerate to 3% in 2011.

Consumption growth, driven by economic growth, appears to have slowed substantially. In January the annual growth rate of retail sales fell to 2 %. The prospects for consumption growth are dampened by weaker wage developments and rising unemployment and layoffs. Russian households, on the other hand, are not on average heavily in debt, and wealth effects of the financial crisis are quite moderate for the households. This provides a good basis for a recovery of consumption. Consumption is estimated to decline slightly this year but then to shift into moderate growth.

Investment fell 16 % in January, compared to a year earlier, as credit became more expensive and harder to obtain, and company profits declined. The poor investment result was also closely reflected in construction and industrial production, which receded at the same pace. Easing demand and financial problems have forced companies to cut production and scale back investment programmes. Public-sector investment is also set to decline in the context of budget cuts. Investment is thus estimated to decrease sharply this year, after which it should gradually resume positive growth in the coming years.

Exports and imports declining

The growth of Russian export volume slowed further in 2008, nearly to zero. Crude oil production fell slightly last year after several years of sluggish growth, and the export volume dropped by 6 %. However, export volumes of oil products and natural gas rose slightly. In value terms, Russian exports again posted robust growth for the year as a whole, thanks to lofty raw materials prices in the early part of the year. However, in the last few months of 2008, substantially weaker price developments notably reduced the value of exports. In the coming years, Russian export performance will be determined largely by demand in the world markets, so that the volume of exports is expected to decline slightly this year and to recover gradually in 2010–2011.

The volume of imports continued to post rapid growth last year – nearly 18 % - despite a marked slowing toward the end of the year. The value of imports also grew apace up until the waning months of the year. Fading demand and a weaker rouble are having a constraining effect on imports. Russia's imports are heavily weighted toward durable consumer goods and investment goods, whose purchases are postponed when income is squeezed. Moreover, the weak rouble increases the competitiveness of domestic producers, so that some of the usual import products can be replaced by cheaper domestic products. Russia's imports are expected to decline sharply this year, but as demand recovers in the following years imports too should return to moderate growth.

Currency now flowing out of Russia

Due to record-high raw materials prices in the early part of the year, Russia's current account surplus stayed at peak levels last year, albeit easing notably toward year-end. In the final quarter, the surplus fell to USD 8 billion, on a par with the years 2002–2003. Because the price of Urals oil, based on the futures market, is estimated to remain in the range of USD 40 to USD 55 in the coming years, Russia's export revenues are set to decline from recent-year levels. Imports also appear to be adjusting swiftly to the weaker rouble. We can therefore say goodbye for now to the surpluses of prior years; but the present situation does not point to huge current account deficits emerging as a problem for Russia.

Nor, in the present situation, can the lost export revenues be offset by capital flows. In the last quarter of 2008, a record amount (USD 130 bn) of capital fled the country. The capital outflow has been abetted by a general lack of confidence in the Russian markets, pay-downs of foreign debt, and conversion of domestic asset holdings from roubles to foreign currencies. Russia's international reserves declined by a third from last year's peak level to USD 384 billion at the start of March. Of the reserves, USD 220 billion is in the oil funds.

Weakened rouble

Downward pressure hit the rouble already in the early autumn as oil prices fell sharply, and in November the central bank began a step-by-step widening of the corridor of the currency basket, weighted at 0.55 USD and 0.45 EUR. Expectations of rouble depreciation induced economic actors to convert rouble assets into foreign currency-denominated ones. Moreover, the credit markets froze up and some of the public-sector money provided to the banks was probably used to buy foreign currency, which put further downside pressure on the rouble. At the end of January the central bank announced the fixing of the limit of the currency basket at 41 roubles for the time being, which corresponds to a one-quarter reduction in the rouble's external value compared to what it was at the start of the phased devaluation.

The central bank has also reduced the amount of liquidity offered to the banks, and the broad rouble money supply has begun to shrink. Moreover, the key policy interest rates have been raised in an effort to stem the capital outflow and restrain inflation, which has remained in the range of 14 % per annum. It appears that the downside pressure on the rouble eased in February-March. But, because inflation has remained high, the central bank is finding it difficult to lower interest rates in order to stimulate the economy.

Rouble depreciation will not notably improve Russian companies' competitiveness in the export markets because of the energy-weighted structure of exports. Companies that export energy products do however gain some advantage from their lower rouble-denominated costs. Domestic industry can also benefit to an extent from import substitution. On the other hand, a weak rouble adds to the inflationary pressure and reduces households' purchasing power. And the costs of servicing foreign debt rise, which is especially troublesome for some large companies. At the start of October Russia's foreign debt amounted to USD 540 billion and was concentrated in the corporate sector. Total repayments and interest payments for this year are estimated to amount to at least USD 140 billion.

Support measures push the federal government into the red

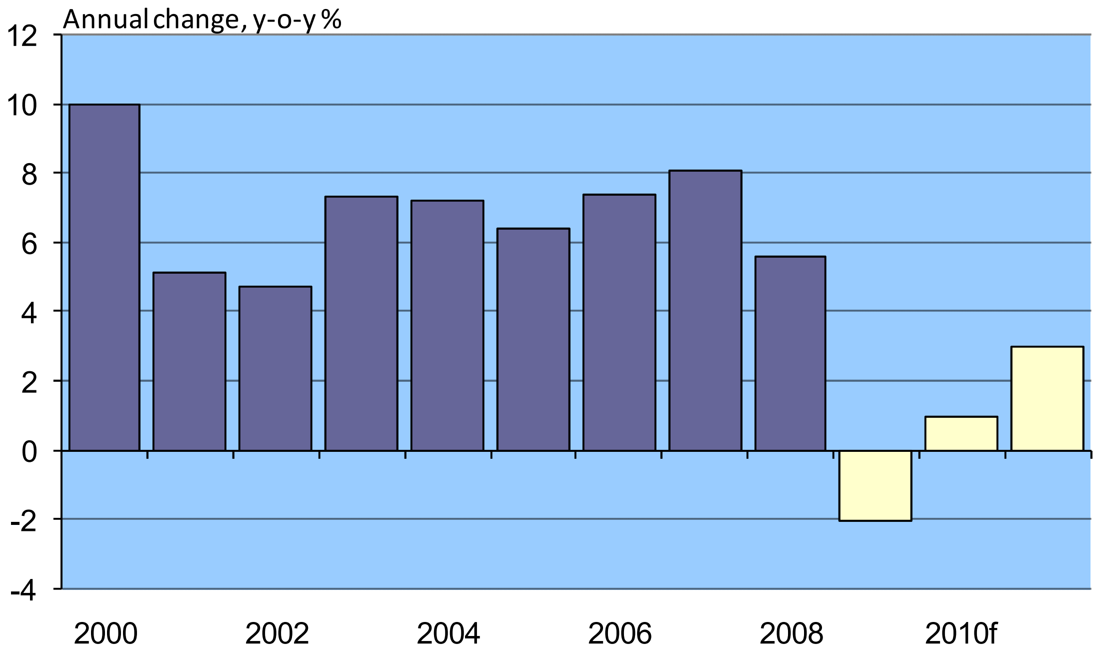
The Russian federal government has also commenced support operations, mainly to stabilize conditions in the financial sector. According to the finance ministry, 1.5 trillion roubles (4 % of GDP) was granted to the financial sector last year. Numerous plans exist for additional support for both the banking sector and the real economy, but precise information is not yet available as to the amounts and timing of the aid. The banking-sector aid is aimed at unfreezing the flow of credit, but so far it has not had the desired effect. However, the measures could become more effective, if the rouble stabilizes. Companies in the real sector are aided eg by tax cuts, federal government purchase orders and state guarantees, as well as by trade-policy measures. The economic effects of these aid measures will however be visible only later. Other measures in support of consumption and living standards include increases in public-sector wages and pensions as well as in unemployment compensation.

The support operations are being financed largely by budget deficits and, due to the sharp fall in budget revenues because of the low price of oil, a federal-government deficit of 8 % of GDP is projected for this year. The deficit is to be financed via the oil funds and borrowing. If the deficit were financed totally from oil funds, this would eat up almost half of the funds' total assets. But it is intended that these funds should also cover the financial needs of future years.

Russia's performance depends on the world economy

Russia's economic outlook depends heavily on what happens in the world economy through both oil prices and financial-market developments, which adds to the forecast risk. If the recession in the world economy elongates and deepens and the price of oil falls further, the situation in Russia will worsen. Lower oil prices would increase the downward pressure on the rouble and further destabilize the economy. Shrinking purchasing power due to a weaker rouble, high inflation, and declining incomes could also lead to unrest among the populous. Moreover, the freezing up of domestic financial markets could further dampen the economic outlook if, despite the support measures, money does not start to flow in the markets. Flows of foreign capital into Russia are not expected before the international financial markets recover and investors are again able to take on risk. Considering the combined effects of all the risk factors, it is possible that Russia's realized economic performance will be far below forecast in the coming years. Alternatively, a swift recovery of the world economy and a bounce in the oil price could set the stage for an above-forecast economic performance.

Annual change in Russian GDP, 2000–2011



Source: Rosstat 2000–2008, BOFIT forecast 2009–2011.

Annual real growth forecast for Russian GDP and imports, %

	2008	2009f	2010f	2011f
GDP	5.6	-2.0	1.0	3.0
Imports	17.7	-13.0	2.0	7.0

Source: Rosstat 2008, BOFIT forecast 2009–2011.