BOFIT Forecast for Russia
25.3.2010

BOFIT Russia Desk

BOFIT Forecast for Russia 2010–2012

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Russia's aggregate output dropped last year by a record 8% even though the economy bottomed out already in the second quarter and posted positive growth in the third quarter. Russia's aggregate output and imports are now estimated to grow faster than envisaged in the BOFIT forecast of autumn 2009 supported by the low comparison basis and strong consumption demand. The growth rate could decline in 2011–2012, but it is expected to remain in the region of 4%.

Oil price rise supports consumption growth

Following a decade of robust growth, the Russian economy came to an abrupt halt in 2009. The decline in prices of oil and other raw materials, a scarcity of financing, and widespread uncertainty led to an 8% drop in aggregate output. Capital formation was particularly hard hit, as investment fell by nearly 20% compared to 2008. Export volume declined by about 5% and imports by 30%, compared to 2008. Inventory adjustments also had a huge impact on the collapse of output, as companies let their stocks - bloated in recent years - run down. Private consumption fell sharply last year due to poor income performance, reduced credit supplies, and rising unemployment. The general uncertainty also boosted the household savings ratio. Unemployment, however, did not rise as much as feared, nor did households' real income decline in 2009 even thought income growth paled compared to recent years.

In the current year, however, the calming of the international economic situation and developments in raw material prices will brighten the outlook for demand on the part of consumers and companies. Annual growth figures will also get a boost from last year's extremely low comparison level. Russian households are on average not at all heavily in debt, which bodes well for a quick recovery of consumption. Consumption is projected to increase at a robust pace and, in conjunction with high oil prices, to spur the growth of the Russian economy.

With the gradual normalization of the financial markets, companies are expected to gradually raise the level of investment. Nonetheless, the growth of investment will be very modest, and the majority of projects will not commence until 2011–2012. It is estimated that the bulk of the inventory adjustment is over, so that the inventory-effect on aggregate output is likely to turn positive in the course of the current year. It is however extremely difficult to predict developments in inventory items in Russia, as the fluctuations have been extreme in recent years.

Imports increasing apace

The volume of Russian exports declined last year by 5% compared to the previous year. In fact, in the early part of the year the decline was in the region of 15%, but the later part of the year saw the export volumes, particularly for natural gas, coal and metals, return to growth. In the current year, Russia's exports are clearly on the rise, but – looking ahead - capacity constraints are likely to reduce growth rates considerably. Some 60% of Russia's exports are in energy products, and no significant changes are foreseen in the structure of exports. Exports of oil and related products are projected to increase only moderately during the forecast period. Natural gas exports fell so sharply last year that marked growth in export volumes is a real possibility. But over the longer term, the export potential also for gas will be constrained by a fading out of the major sources and a dearth of new investment.

Imports declined last by 30% from the previous year. Particularly sharp decreases occurred in imports of investment goods and durables. Because of the marked decrease in total imports, the contribution of net exports to GDP was positive for the first time in six years. Imports are however set to turn sharply upward this year driven largely by consumption demand. Import demand has gained strength from a modest appreciation of the ruble, whose real exchange rate has firmed to roughly where it was prior to the devaluation in early 2009. The forecast calls for imports to grow considerably faster than exports, which will return the growth-contribution of foreign trade to negative territory in the years 2010–2012.

Because of the decline in export prices, the value of Russian exports fell last year by about a third, ie by nearly as much as the value of imports. In 2009 the current account posted a surplus of EUR 35 billion (4% of GDP). In the course of the forecast period, the current account balance is expected to decrease but to remain in surplus.

Federal government returns to the debt market

In 2009 federal budget posted a deficit for the first time in ten years. Total revenues were 25% lower than in 2008, in nominal terms, while expenditures exceeded the 2008 level by 28%. The deficit amounted to 6% of GDP. Outlays increased largely because of stimulation measures taken in response to the recession and to additional spending to cover a continually widening shortfall in pension funding. The bulk of the deficit was financed from a reserve fund accumulated from oil and gas revenues. The reserve fund totaled RUB 1 830 billion (EUR 42 bn) at the end of the year. Another state buffer fund – a national welfare fund – amounted to RUB 2800 billion (EUR 64 bn) at year end. It is intended the latter fund will be used to cover the shortfall in the pension fund.

The budget for 2010 is based on the Ministry of Economic Development’s fairly pessimistic forecast, which – given the underlying assumptions – projects a deficit of 7% of GDP. The Russian Government is prepared to borrow as much as USD 17 billion (EUR 12 bn) from the international markets this year to finance the deficit, but in all likelihood only a fraction of that amount will be needed. The return to the international debt market is based largely on a desire to promote contacts with international lenders.

This year’s deficit will be covered largely by the reserve fund, which will be virtually wiped out in the course of the year. This means that in future the need for borrowing from both domestic and foreign sources will become real. The Russian central government is now, practically speaking, free of debt and so has a fairly good credit rating. Therefore financing the deficit via debt instruments should not be a problem so long as the Government is successful in its efforts to gradually reduce the deficit.

Budget surpluses are not likely outcomes for Russia in the coming years, which means that financial buffers such as the reserve fund are no longer on hand. This will reduce the maneuverability of economic policy. Russia will surely try to return to its highly conservative fiscal policies of 2000–2007, but substantial cuts in budget outlays will be extremely difficult to achieve.

The forecast risks

The forecast is based on the prognosis that oil prices will ascend slowly but continuously. Another basic assumption is that world trade too will return to a growth path, which will lead to higher consumption of raw materials and energy and thus to an increasing demand for Russia's key exports. But weaker-than-expected price developments in raw materials would be immediately reflected in Russia's consumption demand and economic growth.

The slow but steady normalization of financial markets and fairly expansive monetary policy in the developed countries have turned the flow of capital to the developing markets. The state's steady financial position may also make it easier for large (often state-controlled) Russian companies to obtain financing. But another disturbance in the financial markets would swiftly impact Russian companies' financing possibilities and markedly delay the start-ups of investment projects. In like manner, larger-than-expected expansion of state borrowing could upset the balance in financial markets and push companies out of range for bank loans.

Positive surprises are also possible. Countries in south and southeast Asia, especially China, are growing rapidly, and this could boost demand and prices in the raw material markets above the forecasted figures. Many investment projects put on ice in Russia because of the crisis could be restarted more quickly than forecasted if the general outlook becomes more optimistic and lenders' risk-acceptance increases. For industries outside of the oil sector, the drop in output has been so pronounced that even rapid growth in the next few years should not be hindered by capacity constraints.

Over the longer term, the key risks for the Russian economy relate to structural matters. Efficiency improvements and the adoption of new technologies could keep the Russian economy on its growth path of roughly 4% pa. Economic policy, however, will weigh heavily in the growth outcome. For Russia in particular, the economic crisis has led to protectionist leanings and to support for sectors that were in trouble even earlier. There is little proclivity to see the crisis as an opportunity for removing the economy's old rigidities and creating something new. The current economic model - calling for more regulation and state intervention in the economy - clearly does not increase the potential for economic growth.

Table 1. Annual growth forecast for Russian GDP and imports, real terms, %

	2007	2008	2009	2010f	2011f	2012f
GDP	8.1	5.6	-7.9	6	5	4
Imports	27	15	-31	13	10	13

Sources: Rosstat 2007–2009; BOFIT forecast 2010–2012.