BOFIT Forecast for Russia
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BOFIT Russia Team

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*Last year, both the Russian economy and imports continued their recovery from deep recession. For all of 2011, GDP was up 4.3 % and imports climbed over a fifth, and by late 2011, Russian economic output and imports had recovered to their 2008 pre-crisis peaks. Economic growth of around 3.5 % p.a. is expected throughout our 2012−2014 forecast period. Imports should still rise at around 7 % p.a. Growth in private consumption and investment are expected to dip slightly this year in reaction to international and domestic uncertainties, but then recover in 2013. Growth of the economy is likely to slow towards the end of the forecast period if the oil price does not rise (a slight drop is anticipated). Increases in Russia's export volume should be quite slow as growth in export volumes of oil and petroleum products are expected to remain flat or decline slightly.*

## The economy has recovered, growth will slow

The Russian economy continued its climb out of deep recession last year. GDP growth picked up towards the end of the year and scored 4.3 % for the entire 2011, essentially matching the pace of 2010. In late autumn the GDP reached the 2008 pre-crisis level. Growth in private consumption surged to almost 6.5 %, while investment growth held at 6 % thanks to its revival late in the year. Although growth in public consumption remained below 1 %, it still represented a slight recovery. Growth of the export volume fell to just 1 % as the volume of exports of oil and petroleum products declined by several per cent.

The rebound of GDP last year was undergirded by a substantial recovery in the agriculture sector, which fell deep in 2010 due to drought and fire. In fact, agriculture posted remarkable growth numbers as it made up more than the drop suffered in 2010. Growth in the rest of the economy was below 4 %. The strong recovery in imports from a very deep drop was extended in 2011. Imports increased by over a fifth, and late last year imports approached the pre-crisis peak of 2008.

Prices of Russia's main export goods – oil, petroleum products, natural gas and metals – rose strongly from early 2009 to spring 2011 (natural gas prices extended their gains even later). Russian export prices were up over 60 % overall during the 2009–2011 period. The remarkable surge of substantial tax revenues from oil, petroleum products and natural gas has not find its way very quickly to the economy, which is partly why the rise in commodity prices has contributed relatively little to economic growth. Moreover, the net capital outflows from Russia continued in 2011 despite high oil prices. The large hike in the mandatory social security contributions of employers in early 2011 also restrained business activity somewhat.

Given the uncertainty in the global economy and Russia, we expect GDP growth to decline to 3.7 % this year. Another factor in the slowdown in growth is the simple fact that agriculture will not give such a large impulse upwards as last year. On the other hand, growth should be helped a bit by the government's decision to reduce the mandatory social security contributions of employers from the start of 2012.

Next year we expect growth to be supported by restored confidence, a recovery in the world economy and global trade, and a reduction in uncertainty in Russia to the extent that, following the presidential election held in March, policy lines start to clear up. On the other hand, we assume the oil price will fall about 10 % from the present to end-2014. That would restrain growth in 2013 to the same rate as in 2012.

## Domestic demand growth to dip; slow growth looks probable for exports

Consumer demand remains a crucial determinant for how Russian economic output and imports play out during the forecast period. Consumer confidence indicators generally suggest that towards end-2011 consumers did not see their personal economic situation improving any longer, although they foresaw no weakening either. We expect growth in consumer spending to slow slightly over the forecast period.

Increases in private sector wages may outstrip productivity gains, albeit rather moderately. Wage growth is supported by a decline in unemployment, which can still decrease somewhat. The military and national security agencies this year saw large wage hikes that will boost their purchasing power. Overall, the state budget policy framework for 2012–2014, adopted last year, limits the rise of the public sector wage sum to the inflation rate while allowing for real pension increases of several per cent a year. However, during his presidential campaign Prime Minister Putin promised substantial wage increases in coming years for public sector employees as well.

The moderation of inflation (to around 6 % p.a. at the end of 2011) helps preserve purchasing power. Inflation is expected to gradually slow further. One factor is the central bank's reduced need to get involved in currency market operations to stem ruble appreciation (ruble-selling tends to fuel inflation). This year the inflation figure will be exceptionally low, because hikes in state-regulated energy retail tariffs will be lower than normal and will be made in summer instead of the traditional first day of the year. The rapid growth in household borrowing may be curbed as real interest rates on short-term household credit (under a year) have risen to exceptionally high levels (nominal interest rates have risen since last summer even if inflation has fallen).

After three slow years, growth in public consumption is expected to pick up a bit as public spending rises while the economy ministry's forecast suggests public investment may develop modestly. The outlook for public consumption could change to lower increases due to election promises for public sector wages and Russia's armament program, if at the same time the oil price declines as assumed and the budget deficit is not allowed to exceed the currently scheduled level of 1–2 % of GDP. The authorities are thinking which taxes could be raised after this January's cut in the mandatory social security contributions of employers.

While exports correspond to over 30 % of Russian GDP, growth in the export volume is expected to remain low in the forecast period. Russian authorities have lowered their export estimates for crude oil and petroleum products for the coming years. They see oil exports holding the current level during 2012–2014, and exports of petroleum products dropping slightly as increased domestic oil consumption notably outstrips growth in domestic oil production. Thus, the volume of Russian oil exports would not gain from a global recovery. The impact on Russia will be moderated by the fact that there are growth prospects for its natural gas and other basic export commodities.

Growth in corporate fixed capital investment could dip this year amidst uncertainty. Production capacity utilisation has returned to near pre-crisis levels, but otherwise investment enthusiasm may remain mild until next winter. Nominal interest rates on corporate bank loans have also risen slightly since last autumn. Net capital outflows from Russia may continue this year until whether the uncertainty in international financial markets abates, and also depending on the extent the new government, to be formed this spring, takes measures related to improving Russia's investment climate. Investment should recover in 2013–2014 as uncertainty fades.

## In the wake of a strong recovery, import growth now set to moderate

After rebounding strongly from the recession, import growth eased in recent months. We expect import growth to average around 7 % a year (a growth pace far below pre-crisis levels) in the forecast period. The import growth rate reflects lower GDP growth but at the same time almost the same level of propensity to GDP growth feeding into imports as before the recession. We expect the share of imports in GDP to remain unchanged as the pre-crisis level has already been attained.

The real exchange rate of the ruble should plateau or appreciate only slightly. The projected shrinking current account surplus should alleviate appreciation pressure on the ruble's nominal exchange rate, and we expect the current account surplus to disappear entirely by end-2014. On the other hand, net capital flows should turn back in Russia's favour during 2013–2014, which will add to appreciation pressure on the ruble. The earlier impact of Russia's higher inflation rate relative to its trading partners (taken as a whole) on the ruble's real exchange rate has been subsiding since Russian inflation began to decline last year.

## Domestic and international risks

Most of the risks facing the Russian economy are on the downside. For example, the current relatively good mood of Russian consumers could weaken even if the global economy did not weaken more than under our base scenario. There could also be a larger pull-back in corporate investment activity if the prevailing global and domestic uncertainty does not abate over this year. Export volumes could grow more slowly than we currently expect if major international assessments that Russian oil production is set to go into slight decline proved correct.

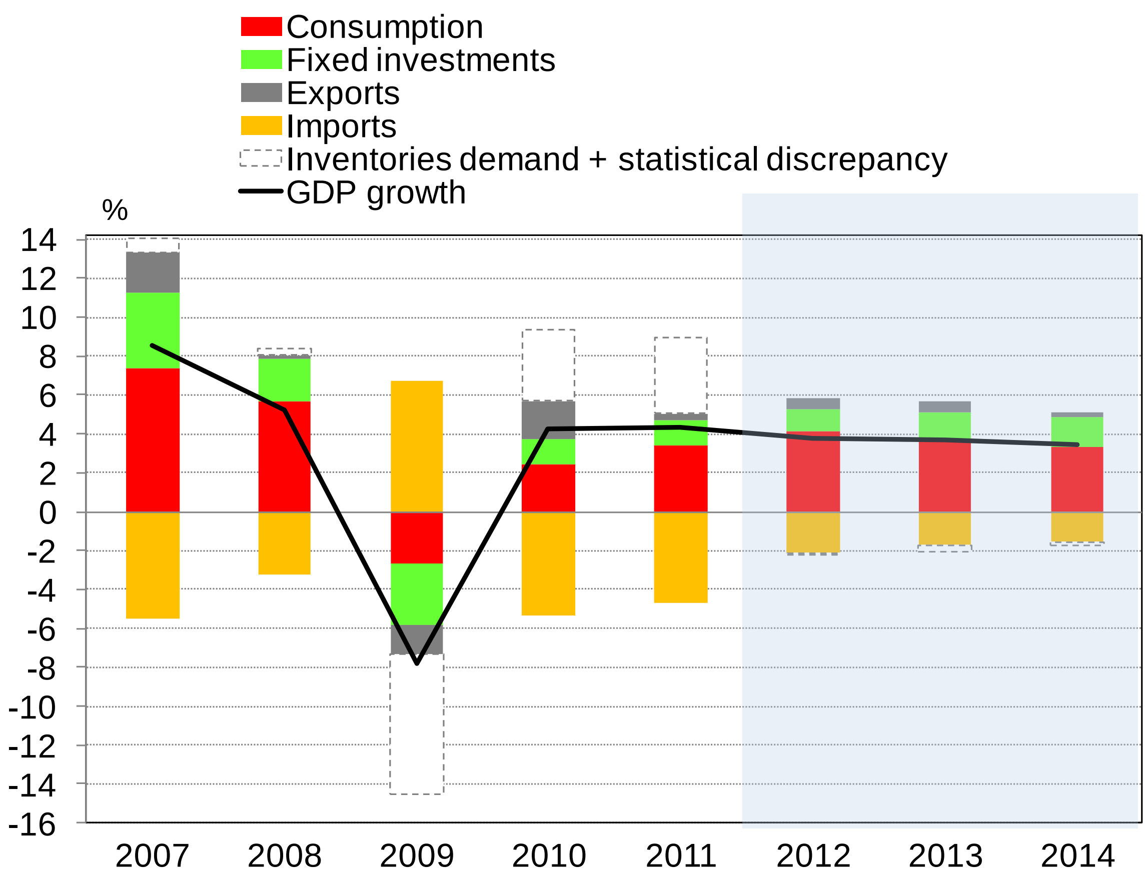
If a deeper dip in the world economy caused a drop in oil prices or uncertainty on financial markets increased, this would rather quickly have an effect on the Russian economy. Russia's leadership can be expected to respond, as necessary, with economic stimulus − as it did during the previous recession. The state has reserve funds to dip into, and it can borrow considerably (the state is essentially debt-free in net terms). Moreover, the state can induce economic stimulus by guiding the central bank, and it can also propose to state banks that they purchase state bonds and extend credit to firms and households.

Russian GDP and import volume growth, % (includes BOFIT Forecast for Russia 2012-2014)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012e | 2013e | 2014e |
|---|---|---|---|---|---|---|---|---|
| GDP | 8.5 | 5.2 | -7.8 | 4.3 | 4.3 | 3.7 | 3.7 | 3.4 |
| Imports | 26 | 15 | -30 | 26 | 22 | 8 | 6 | 6 |

Sources: Rosstat, BOFIT Forecast 2012–2014

Russian GDP growth (%) and the share of demand components and imports in GDP growth (%-points)




Sources: Rosstat, BOFIT Forecast 2012–2014