BOFIT Forecast for Russia
16 September 2014

BOFIT Russia Team

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Bank of Finland
BOFIT – Institute for Economies in Transition

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PO Box 160
FI-00101 Helsinki
Phone: +358 10 831 2268
Fax: +358 10 831 2294
bofit@bof.fi

www.bof.fi/bofit

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Russian economic growth slowed to a crawl in the first half of 2014, even if transient factors supported domestic output and consumption. Our latest, slightly lowered forecast sees no GDP growth this year with the Ukraine crisis continuing to stoke uncertainty that is particularly hard on private investment. Imports will remain at a reduced level. While assuming the oil price does not rise during 2015–2016, the Russian economy should begin to recover gradually as growth in global trade and the world economy picks up.

Even a slow recovery assumes that financial market responses to the instability heightened by the Ukraine crisis are limited and that there is no further escalation and prolongation of sanctions. If so, we also expect a decent recovery in imports in 2016. The conditions for economic growth and development deteriorate, however, as private firms continue to postpone investment and the state stresses spending on defence and national self-sufficiency in production over market reforms and competition. The downside risks to our prognosis are very significant, wide-reaching and heavily driven by the Ukraine crisis and uncertainties in Russia with respect to investment and imports. The recovery could also be brisker than our forecast if the government moves to stimulate the economy through hikes in government spending or credit via the banking system.

Near-zero growth

After growing just 1.3 % p.a. last year, Russian GDP growth slowed further in the first half of 2014 to less than 1 % y-o-y. Seasonally adjusted GDP grew only a couple tenths of a percent in the first half, despite transient boosts to production and consumption partly related to the Ukraine crisis. Industrial output, saved last year already from a decline by defence industry in the first place, has been buoyed further this year by very strong growth of defence spending. Some industrial branches benefited from the drop in the ruble's real exchange rate, which fell from March 2013 until March 2014. Households also accelerated purchases in anticipation of higher inflation and rising uncertainty. The back-story for private consumption, however, has been a slowdown in the rise of wages and pensions. The acceleration of inflation to over 7.5 % meant real growth in private sector wages came to a standstill. Household borrowing continued to decline, while employment growth returned to slightly positive territory.

Fixed capital investment contracted, despite investment by large energy companies turning to growth. In particular, the contraction in investments in machinery and equipment, which started last year, continued. Net corporate sector capital flows remained in the outbound direction.

Growth in the overall export volume fell to some 2 % as growth of energy exports slowed and metal exports dwindled further. As in 2013, economic growth was dragged down by lower export prices. Imports were clobbered as the ruble sank.

Slow recovery likely

Our forecast has been slightly lowered from the previous one. Increased uncertainty over the Ukraine crisis should impact Russia's real economy to such an extent that it effectively quashes GDP growth this year. We assume that financial market reactions to the instability will be limited and that sanctions will not escalate further and will be lifted in about a year's time. Uncertainty, however, will continue to depress private investment and drag down private consumption growth. While current sanctions and Russian counter-sanctions would hardly reduce much further Russian imports overall from their already depressed levels, imports will be considerably lower this year than last given the weaker ruble.

The economy should begin to revive gradually in 2015 and 2016 as growth in global trade and the world economy picks up. The price of oil is assumed to fall only slightly (down some 5 % during our forecast period). Despite Russia's increasing emphasis on self-sufficiency, only a relatively small amount of new production capacity is likely to be operational within the next two years. Growth in private consumption should pick up a bit and investment should start to recover at the end of the forecast period. The volume of Russian exports will rise very slowly. Imports should begin to recover in 2016.

Stimulus possible, prerequisites for growth weaken

The use of monetary policy measures to support economic growth has proven difficult in Russia. On the inflation-fighting front, the central bank has raised its key rates this year. In response to reduced funding of Russian banks, however, the CBR has increased bank liquidity in the form of lengthier loans than earlier. At the same time, uncertainty from the Ukraine crisis has driven up interest rates on loans from domestic banks and further reduced domestic corporate borrowing.

The growth prospects for government revenues have deteriorated considerably. Even with a slight increase in the consolidated government deficit (to 1.5–2 % of GDP), the finance ministry expects (apart from next year) zero spending growth in real terms. The government spending projections, as well as the push to increase government lending and loan guarantees have been taken into account in our forecast.

Given the government's low level of indebtedness and considerable reserve funds, as well as the large role of state banks, Russia's leadership in principle could stimulate the economy for several years. However, such a policy shift would mean delinking from the established, rather balanced, fiscal policy that provides a rare anchor for the economy in unstable times. Moreover, the piling on of additional government debt and the increased risk of sour loans that would arise from such channelled lending would eventually come home to roost.

Over the long term, the conditions for economic growth and development will be weakened as private investments are delayed and government spending is focused on defence, in particular, over the next few years. Russia's economic foundations will be further softened to the extent that plans to increase self-sufficiency in production are implemented (a recurring theme that has gained strength during the Ukraine crisis) and the state moves further away from market reforms and open competition. The legacy will consist of inefficient production and other activity that has been maintained and newly created by means of protection and subsidies. This could mean a decline in Russia's long-term economic trend growth, which BOFIT up to now has estimated at about 2 % p.a.

Consumption dips, investment falls

Growth in private consumption should slow considerably this year, and thereafter gradually recover. Gains in private sector wages are constrained by weaker corporate profitability, even if a slight pick-up in employment could induce pressure to raise wages. Growth of the economy's total wage sum is also limited because the chances to increase employment have become scarcer as the pool of unemployed and people outside the labour force who are still willing to work has dwindled to a relatively small number. The currently slower pace of hikes in public sector wages and pensions seems like an established phenomenon as long as the government sticks to its budget rule on government deficits. Household disposable incomes are set to erode from already-decided consumption tax hikes and high debt-servicing burdens. The high costs and short maturity of consumer credit will also limit household borrowing. Higher inflation induced by ruble weakness, increased uncertainty and sanctions will subside only gradually and continue to eat away at purchasing power. Public consumption is not expected to rise in the forecast period as long as the government maintains its current policy direction.

A global recovery is likely to support Russian exports. However, growth of Russian exports overall would be sluggish as e.g. Russian authorities expect energy exports to decline slightly in coming years. Western restrictions on exports of oil technology to Russia may also impact Russian energy production to a certain extent.

Investment is set to contract considerably this year and next as private investment is further postponed. To counterbalance this, the government is trying to boost investment by large state-owned enterprises. Giant transportation infrastructure projects, funded partly by state loans, could get underway next year. The government is also willing to increase government guarantees particularly to loans extended by state-owned banks to state-owned enterprises e.g. in the defence industry. Now that Russian banks and firms have difficulties accessing to international lenders, financing will come increasingly through domestic ways and means. In any case, with the unpredictability of the business environment aggravated by the Ukraine crisis diminishing only slowly over time, a general recovery in investment is not expected until the end of the forecast period.

Imports perk up gradually

This year's drop in imports should stabilise next year and imports should begin to recover towards the end of the forecast period as long as the ruble's exchange rate remains relatively stable. If so, the ruble's real exchange rate will gradually rise as Russia's inflation rate will remain notably higher than the inflation rates of its main trading partners. The ruble's nominal exchange rate is supported by a fairly good current account surplus, resulting from diminished imports. The surplus counteracts net capital outflow (and possible occasional flights from the ruble to other currencies) that will continue. Imports could also get a bit of support if, as assumed, sanctions are lifted within a year.

Larger risks to our forecast than earlier

Given the prevailing uncertainty in Russia with respect to investment and imports, the risks to the forecast this time around are very significant and broad-based. In particular, further deterioration of the Ukraine situation and heightened military action, as well as expectations of further sanctions and the uncertainty that generates, could lead to even more significant delays in private investment than anticipated. Capital outflows from Russia or away from the ruble would increase. This would cause depreciation of the ruble and further reduce imports.

A drop in export prices of oil and Russia's other basic commodities would impair the prospects of an economic recovery and further diminish government revenue streams.

A slide in export prices would depress the external value of the ruble, and in turn hit consumption and imports.

Reduced opportunities to increase employment and the lack of investment, which e.g. hampers productivity gains and labour mobility, could turn out to be surprisingly large restraints on Russian output growth.

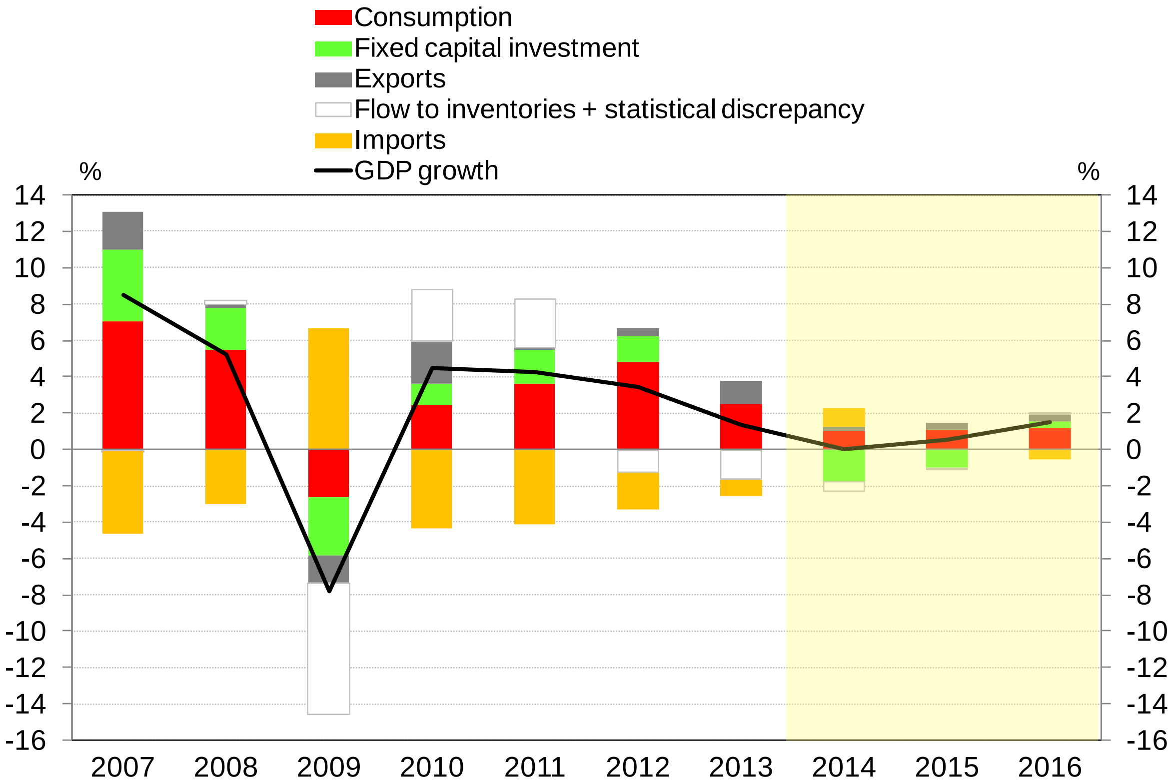
On the upside, economic growth during this rather short forecast period could revive faster than we forecast if Russia's leaders decide to move ahead with a wider economic stimulus that involves higher government spending or central bank money channelled into the economy via state banks. The simplest approach would be to raise public sector wages and pensions, which would spur consumption (though that would also benefit imports to a degree). The leadership could also be capable of inducing large state-owned enterprises to increase their investments temporarily (and in some cases perhaps substantially) with such investments likely funded primarily through loans from state banks.

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	0.5	1.5
Imports	-30	26	20	9	4	-8	0	2.5

Sources: Rosstat, BOFIT Forecast for Russia 2014–2016

Russian GDP growth, realised and projected (%), and the shares of demand components and imports in GDP growth (percentage points)



Sources: Rosstat, BOFIT Forecast for Russia 2014–2016