BOFIT Forecast for Russia
21.3.2016

BOFIT Russia Team

BOFIT Forecast for Russia 2016–2018

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Following the collapse in oil prices in 2014, Russia's domestic demand fell by about 10 % last year. GDP contracted 3.7 %. Oil prices declined again in the second half of 2015. Given the oil export price shocks, we expect the Russian GDP to contract by 3 % this year if the oil price averages slightly above $40 a barrel (about 60 % below the average price in 2014). Russian imports slumped by 30 % in 2014–2015, and we expect imports to fall another 10 % this year due to the economic contraction and Russia's falling export earnings. With rather high inflation eating away at purchasing power, we see domestic demand shrinking substantially in 2016, including a reduction in real government spending. While a gradual rise in oil prices will bring economic respite and revive imports in 2018, economic growth remains slow due to uncertainties and Russia's poor business environment. The central risks in the forecast involve oil prices and changes in imports.

Economy contracted and imports fell in 2015

In addition to dealing with its existing burdens of systemic deficiencies and uncertainties, the Russian economy had to start digesting a major export price shock in the second half of 2014. The price of oil was halved, dragging down export prices of oil products and natural gas along with it. Russian export prices in 2015 were down about 30 % y-o-y in dollar terms and 20 % in euro terms. Due largely to this, the ruble fell sharply. While the ruble's fall cushioned the impact of the oil price shock, it also fuelled inflation in winter 2014–2015 to its fastest pace since 1999 and lifted the average price level of 2015 to 15–16 % higher than in 2014. High inflation eroded purchasing power in both the private and public sector.

Domestic demand fell in all categories last year, and so far this year there have been no clear signs that the contraction would be ending. Besides inflation, the tame rise in private sector wages and the path to a halt in public sector wage growth due to wage restrictions and freezes caused real household incomes to decline. Meagre wage growth combined with a sharp rise in household savings to drive down private consumption by 10 % last year, a markedly steeper decline than in the 2009 recession. Public consumption contracted by 2 %. Fixed investment declined nearly 8 %, even if growth in investment in oil & gas production remained strong. Similar to the 2009 recession, inventories shrank considerably last year. Among the main categories of demand, only export volumes increased in 2015 as exports of oil & oil products defied expectations and rose significantly. Gas exports experienced a sharp recovery starting last summer.

Russian GDP contracted 3.7 % last year. In addition to oil sector exports, domestic production was supported by defence spending, which grew ever faster, nearly 30 % in nominal rubles (some 10–15 % in real terms). The rapid growth in total government spending faded over the course of the year, however. For all of 2015, spending was down substantially in real terms. Imports plunged over 25 % (having declined 6 % in 2014), much more than the economy's contraction overall. The fall in imports was due mainly to the ruble's collapse in the winter of 2014–2015, which was significantly larger than in the 2009 recession (the ruble's average nominal exchange rate in 2015 was about 25 % weaker than in the previous year and the real exchange rate was down about 15 % against the euro and the Bank of Russia's trade-weighted currency basket). Underlying the ruble's plunge were the drop in export prices that severely reduced Russia's export earnings (down 20 % in euro terms) and outflows of private capital that were substantially larger than capital flows into Russia (even if the difference narrowed considerably from 2014).

Economy and imports set to contract further in 2016 before slow recovery begins

Growth in world trade will improve over the 2016–2018 forecast period. We assume that the geopolitical tensions related mainly to Russia's actions vis-à-vis Ukraine, the consequent foreign sanctions, Russian countersanctions and other restrictions that limit the functioning of markets, as well as the resulting and other uncertainties in the Russian economy will largely remain in place.

The oil price, however, is by far the most significant factor in our forecast – especially this year. In our September 2015 forecast, we noted that the impact on the Russian economy from the large drop in the oil price in the second half of 2014 would not be over in one year (the assumed 2015 average price was $54 a barrel, or 45 % below the 2014 average), which meant that the drop would diminish the GDP still in 2016 (GDP was projected to contract another 2 % this year). This view is based on results generated by BOFIT's Russia model.[1] In addition, the oil price fell again in the second half of 2015. As in our previous forecast, the oil price is assumed to rise only gradually during the forecast period. We currently assume that the oil price this year will average just over $40 a barrel (or 23 % lower than in 2015 and nearly 60 % lower than in 2014), and then climb to an average of $49 a barrel in 2018.

Applying this assumption, our forecast for GDP contraction in 2016 deepens slightly, to around 3 %, with zero GDP growth in 2017. Thereafter, as the impact of the drop in the oil price fades and the price gradually rises, the economy recovers, but quite slowly due mainly to uncertainties and Russia's weak business environment. If our forecast and various estimates of Russia's GDP growth over the long term (currently 1−1.5 % a year) materialise, GDP in 2020 will be about 3 % smaller than in 2014. With the economy's contraction and falling export earnings, Russia's imports are projected to decline about 10 % this year and return to slight growth towards the end of the forecast period. Imports this year would be 37 % below their 2013 level and several per cent above their level during the 2009 recession.

The volume of Russian exports is expected to increase slowly during the forecast period. Domestic demand should fall significantly in 2016 as regards private consumption, public consumption, fixed investment and inventories. This year, at least, government spending in real terms will contract substantially.

[1] Jouko Rautava: Oil Prices, Excess Uncertainty and Trend Growth. https://www.oenb.at/Publikationen/Volkswirtschaft/Focus-on-European-Economic-Integration/2013/Focus-on-European-Economic-Integration-Q4-13.html

Domestic demand pressed down by inflation and weak government finances

Several inflation projections for 2016 have increased (consumer price inflation to around 8 %), and the erosion of purchasing power will thus be slightly more severe than thought earlier. The economic contraction weakens corporate profitability and reduces the ability of companies to raise wages. Freezes and other restrictions of public sector wages will go on, and Russia's leaders rather recently lowered the 2016 increase of pensions to 4 % and no increase for pensioners who are working (over 35 % of Russia's roughly 40 million pensioners, according to official figures). Employment will decline, which will be reflected as increases in unemployment and/or underemployment. Households are not expected any time soon to change their emphasis from saving to borrowing.

Government spending this year will fall substantially in real terms. In addition, the country's leadership is trying to reduce spending further as the drop in oil prices is severely depressing revenues in real terms. Lower government spending implies cuts to public consumption. Russia's export volume should grow very slowly as key experts predict that growth in oil sector export volumes will plateau this year and the volumes will then start to decline. A recovery in exports outside the oil & gas sector from last year's dip should partly shore up the situation. Fixed investment is foreseen to keep decreasing due to unused capacity, falling demand and uncertainty clouding corporate planning. Moreover, the government will have less money for investment. Inventories, which traditionally contract sharply in Russia during a recession, should continue to decline.

Tensions in the import outlook persist

Besides economic contraction, a sensitive chain of other effects powerfully determines the outlook for Russian imports. The oil price and Russian export earnings, and capital flows in and out of Russia all affect the ruble's exchange rate. The ruble, in turn, affects imports directly and indirectly via inflation and domestic demand. Thus, after the fall of imports this year, the gradual economic recovery begins to support imports, while the gradual recovery in the oil price increases Russia's export earnings, making concrete room for imports. On the other hand, international financial sanctions somewhat restrict the extent of import growth. Also limiting imports is the ratio of imports to GDP, which last year (despite the fall of the import volume) was the highest since 2003 as the value of imports in rubles has risen faster than GDP. The ruble's real exchange rate will appreciate gradually as inflation remains higher in Russia than in the countries supplying goods and services to Russia (the inflation gap between Russia and its main trading partners was still 6 % in the first two months of this year).

Less room to manoeuver on the economic policy front

Banks amassed considerable household and corporate deposits last year, whereas borrowing by banks from the central bank fell substantially. Bank lending focused in roughly equal measure on financing the public sector and the corporate sector. Corporate lending, in fact, diminished significantly from 2014, and firms financed their reduced investment plans increasingly out of pocket. The impact of monetary policy on corporate borrowing remains unclear. The central bank has kept its key rate at 11 % since August, while 12 month inflation rate moderated this winter from 15 % to 8 %.

The government's fiscal situation has tightened further. Government revenues remained essentially unchanged last year in nominal ruble terms (with oil & gas tax revenues down by 20 %), which meant real revenues were down substantially. The government deficit increased to over 3.5 % of GDP, even as spending also fell in real terms. The budget outlook for this year is nearly as austere as last year if the oil price assumption and GDP projection in our forecast are realised. Using the finance ministry's latest spending estimate, the deficit should increase to nearly 4 % of GDP this year. At the moment, the government is attempting to raise revenues by increasing minor taxes and dividends from state enterprises, as well as to sell off stakes in state firms. Increased taxation of oil companies has also been under discussion. Russia's leaders have set targets for spending cuts (notably excluding cuts to social spending, the largest spending category by far). Decisions on taxes and spending cuts are expected over the course of this spring. If our forecast's assumption of the oil price and the GDP projection hold, the fiscal outlook for 2017 is somewhat better, but there will still be a slight government deficit even if government spending remained unchanged from this year in nominal terms. Thus, there is little room for real stimulus in the public arena over the forecast period.

The current outlook suggests the government would not have to exhaust the Reserve Fund this year to cover the deficit. For a worse-case scenario, it has been proposed that unallocated assets in the National Welfare Fund could be used to cover a part of the deficit (the other part of National Welfare Fund assets is tied to subsidies for banks and loans granted to investment projects and corporations). With these financing options, the government might not necessarily need to borrow.

Risks to the forecast have not diminished

The oil price remains an important risk factor in this forecast, because deviations in the price upwards or downwards from the track assumed would naturally affect the economy, as well as the ruble's exchange rate, inflation and imports. Changes in geopolitical tensions may emerge, either positive turns with rather slow effects or negative shifts with more rapid impact. There is also the ever-present risk of other events that could induce increased capital flows from Russia and press down the ruble and imports.

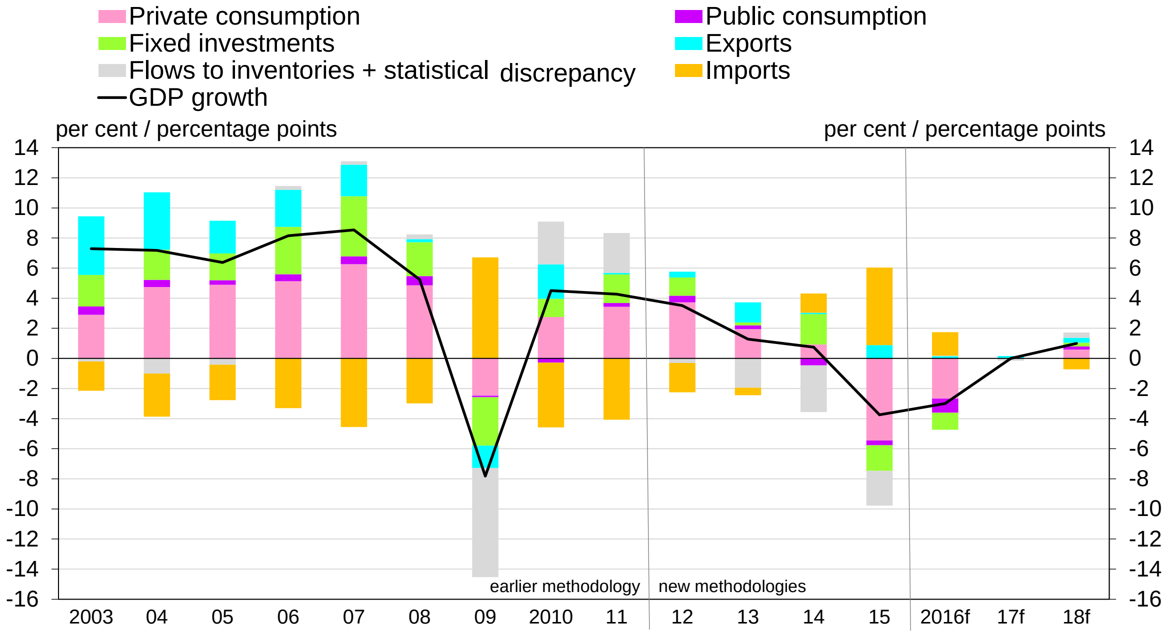
If households make a turnaround from last year's savings binge, private consumption would increase more than we predict, even this year. Supplemental budget spending, despite the declared reduction targets, is possible as Duma elections in September 2016 and the presidential election in March 2018 are approaching. Such spending would provide only a relatively short-lived boost to the economy, however, and would require even stronger budget-cutting later to deal with the country's fiscal adjustment needs.

Russian GDP and import volumes, realised and forecast growth (%)

	2009	2010	2011	2012	2013	2014	2015	2016f	2017f	2018f
GDP	–7.8	4.5	4.3	3.5	1.3	0.7	–3.7	–3	0	1
Imports	–30	26	20	10	2	–6	–26	–10	0	5

Sources: Rosstat and BOFIT forecast for Russia 2016–2018.

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



Sources: Rosstat and BOFIT forecast for Russia 2016–2018.