BOFIT Forecast for Russia
29.9.2016

BOFIT Russia Team

BOFIT Forecast for Russia 2016–2018

Bank of Finland
BOFIT – Institute for Economies in Transition

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_en

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Russian GDP has so far this year contracted less than one per cent from a year ago. The decline has been constrained by a notable recovery in oil prices and a large fall in imports caused by a weak ruble. We now expect Russian GDP to shrink by 1 % for 2016 overall, with imports falling about 7 %. The oil price is expected to creep up from below $45 a barrel this year to just under $55 a barrel in 2018. While GDP recovers gradually in 2017, growth will be slow due e.g. to inadequate fixed investment and the fiscal challenges facing government at all levels. As the economy recovers and Russian export earnings increase, imports will grow moderately. The main forecast risks continuously involve oil prices, imports and government finances.

Even with only mild economic contraction this year, imports declined considerably

Russia's gross domestic product contracted less than 1 % y-o-y in the first half of this year. Lately there have been signs that the decline in output may come to an end. The drop was rather mild considering that the oil price was 30 % lower than in 1H15 and over 60 % lower than in 1H14). On the other hand, the oil price has revived in the course of this year and bolstered the economy.

For the other support factor, the contraction in output was softened significantly by a large fall in imports. As in 2014–2015, this year's decline in imports has been steep compared to the drop of the GDP. Imports in the first half were down by close to 10 % from 1H15 and roughly 40 % from 1H13 before the decline started. Nearly all the drop stems from a weak ruble. Following its downward slides in 2014–2015, the ruble's real exchange rate this year has been about 6 % weaker than a year ago (merely this drop is slightly larger than in the 2009 recession), nearly 30 % weaker than in the first months of 2013 and at the same level as it was in 2005.

Private consumption, by far the largest demand component, has continued to contract this year. Retail sales in January-August were down nearly 6 % y-o-y and off 14 % from January-August 2014. The slide continued in late summer. Real household incomes have plunged, as despite a slowdown, inflation is still rather high and continues to erode purchasing power. The public sector wage freezes and limited increases remain in place. The annual hike in pensions early this year was much less than specified by law (i.e. adjusted for inflation), and the pension law was amended so that working pensioners are denied pension increases altogether. Government revenues have fallen as a result of the nosedive in revenues from oil & gas taxes. The diminished revenue stream has forced the country's leaders to continue with severe budget-cutting measures in real terms, initiated last year.

Fixed investments continued their decline that began about three years ago, even if investment in oil & gas production increased again this year. The volume of investment in the first half of the year was down more than 4 % y-o-y and off more than 10 % from two years ago. Similar to earlier turns, the economy was supported by changes in inventories (the reduction in inventories has been slowing since last year). The volume of Russian exports declined because of a substantial drop in exports of oil products, while the weak ruble has not created any wide increases of exports in branches outside the oil & gas sector.

Production and imports recover slowly from recession

We assume oil prices will rise decently throughout our 2016–2018 forecast period. The annual average oil price will be below $45 a barrel this year (17 % lower than in 2015) and less than $55 in 2018. Based on our oil price assumption and developments in the first half of this year, GDP will contract this year by 1 % and recover gradually in 2017.

However, the economy will grow slowly judging by estimates of its long-term growth, which remain roughly unchanged (1–1.5 % p.a.). In addition to demographic and labour trends, growth is constrained by inadequate investments (now and in the next few years at least). The insufficiency, which stems largely from weaknesses and uncertainties in the economy and the business environment, retards development and diversification of the capital base as well as the rise of productivity. Growth would get a decisive lift if Russia moved ahead with systemic reforms that advance the functioning of markets and moved away from the currently dominating line of creating restrictions that insulate the economy and restrain market activity. If this forecast and the long-term estimates hold, by 2020 the GDP will recover to a level similar to that of 2014.

With the economy's contraction, significantly reduced export earnings and the ruble's feeble real exchange rate, Russian imports are expected to remain this year about 7 % below 2015. Imports will recover in 2017–2018 as the economy revives and the price of oil gradually increases the export earnings. The ruble's real exchange rate will gradually strengthen, as Russian inflation, despite further moderation, will remain slightly higher than in countries that are the sources of Russia's imports (the difference was 4.5–5 % in late summer). Import growth, however, is expected to remain moderate because the imports-to-GDP ratio (in nominal rubles) in the first half of this year was roughly as large as in 2013, i.e. before the decline in imports started. Russia's current account, as virtually always, is expected to show at least a small surplus as import reactions slightly lag changes in export earnings.

Domestic demand and exports revive gradually, but government finances limit growth

The gradual slowdown in inflation will support a recovery in private consumption. In central forecasts, consumer prices will still this year be 7–7.5 % higher than last year and increase 4–6 % next year. Private sector wage hikes this year have been based, among other things, on the weak ruble that has helped generate large profits in Russia's main export branches. Overall, the increases have exceeded actual productivity gains, and thus lack a sustainable basis. The strict line on holding down growth in public sector wages is expected to continue. Even if all pensioners are set to receive a one-time payment at the start of next year equal to about 3 % of the average annual pension, pension policy has been tightened. Pensioners that keep working (about 35 % of all Russian pensioners) will no longer be eligible for inflation adjustments. The numbers of underemployed and unemployed persons, which have increased during the recession, will gradually decline; this will support a recovery in household incomes.

The volume of Russian exports will recover after a dip this year, due e.g. to improving growth of global trade. Growth in the forecast period, however, is likely to be sluggish, if the predictions of energy experts of a slight contraction in Russia's oil sector exports materialise. Outside the energy sector, exports are constrained by uncertainty that may continue to dampen the appetite of export firms for investment in new capacity. Similarly, growth in total fixed investment is expected to remain tepid.

The bleak outlook for government finances will constrain the economy's recovery. Under our oil price assumption and the GDP forecast, government budget revenues will rise only slightly faster than inflation in 2017–2018. Even if the decline in spending moderates in real terms from this year (thanks to lower inflation), the decline will continue to the extent the announced targets to shrink the budget deficit are pursued. The consolidated government deficit in 2015 amounted to about 3.5 % of GDP and should be roughly the same this year. To finance the deficit, the government can withdraw money from the Reserve Fund, and if needed, the National Welfare Fund. The combined liquid assets of the two funds stand below 7 % of GDP. Government debt amounts to little over 13 % of GDP.

With e.g. inflation remaining above the Central Bank of Russia's target (4 % at the end of 2017), it will be difficult to stimulate economic growth significantly through monetary policy measures. The stance has not provided much easing, with the key rate, for example, remaining quite positive in real terms. Moreover, given the risky environment, it is uncertain to what degree even a fairly tangible easing would encourage banks to lower their lending rates in real terms or cause firms to increase their borrowing from the low levels seen this year and last.

Forecast risks remain large

Besides uncertainty over the track of oil prices, geopolitical risks cannot be ruled out. As earlier, such changes as well as other events that increase uncertainty could affect the ruble's exchange rate, inflation and imports very quickly. Changes in the oil price would also be felt in government finances.

The recovery in imports could be more rapid, similar to periods that followed Russia's previous recessions. On the other hand, Russia could increase its restrictions on imports, which it has stepped up in the recent past. For example, further import restrictions go into effect for procurements of state majority-owned enterprises at the beginning of 2017.

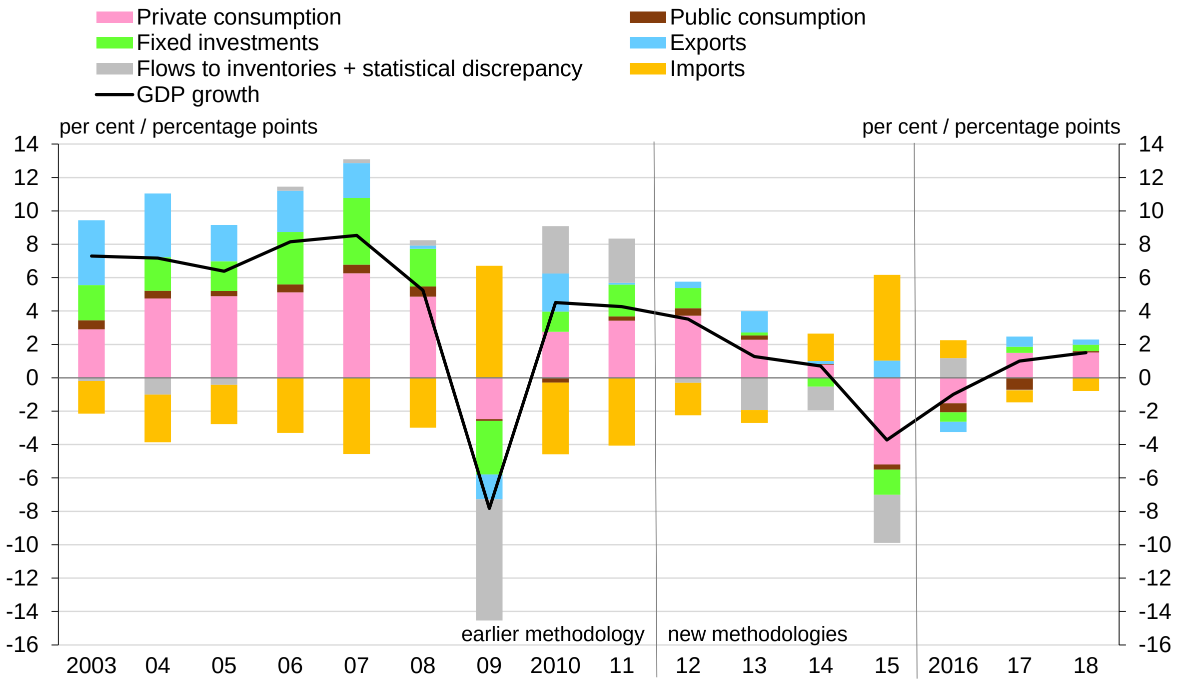
The drop in the people's living standards and possible political pressures felt by the leadership may lead to gentler budget expenditure policies than scheduled now, which would support the economy for a while. Households this year have turned from paying down bank debt to taking on small amounts of credit, and have also saved slightly less than last year. A strengthening of these changes would increase private consumption more than expected.

Growth of Russian GDP and import volumes (actual and forecast), %

	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	–1	1	1.5
Imports	–30	26	20	10	4	–8	–26	–7	5	5

Sources: Rosstat and BOFIT forecast for 2016–2018.

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



Sources: Rosstat) and BOFIT Forecast for Russia 2016–2018.