BOFIT Forecast for Russia
28 September 2017

BOFIT Russia Team

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Our latest forecast sees Russian GDP rising by 1.5 % p.a. through 2019 on the assumption that oil prices remain roughly at current levels. Growth will be driven by recovering domestic private demand, which also is expected to support a brisk recovery in imports. Russian economy is already growing close to its potential and achieving faster sustainable growth would require major structural reforms that are currently not in sight.

Russian economy returning to low-growth path as expected

Our outlook for the Russian economy has not changed substantially since the spring forecast, which saw GDP rising at an annual rate of 1.5 % during the 2017–19 period. As expected, the average price of Urals-grade crude oil this year has been about 50 dollars a barrel, 26 % higher compared to a year earlier. According to market expectations oil prices should remain around current levels through 2019.

Russian GDP rose at an annual rate of 1.5 % in the first half of this year. Growth accelerated significantly in the second quarter, but the factors causing the pickup were largely transitory. Moreover, growth seems to have slowed in recent months. Both domestic and export demand have recovered slightly faster than expected this year, but supported to a large extent import rebound rather than higher levels of domestic production. Growth in domestic production has largely been limited to a few branches, especially oil & gas production and related transports and infrastructure construction.

Domestic private demand drives growth

After two consecutive years of contraction (down 14 % for the period), household consumption this year has shown signs of a gradual recovery. Household consumption increased by nearly 3 % y-o-y in the first quarter. Further recovery of retail sales suggests that growth has continued also in recent months. Real wages have been on the rise, unemployment is low and consumer confidence is up. The household savings rate has declined and credit demand has revived slightly. The uncertain economic outlook, however, continues to restrict consumption growth, which is only expected to recover sluggishly in the years ahead.

After three consecutive years of contraction, fixed investment rose by nearly 5 % y-o-y in the first half according to preliminary data. Growth relied on a few large infrastructure projects and the Rosstat estimate of unrecorded investments which contains small firms and grey economy. A gradual recovery in investment in production capacity is expected in coming months, as Russian industry is already operating near full capacity and business confidence indicators are up. Corporate profits are somewhat off last year's highs, but still relatively strong. Companies have been more active in raising money from bond markets, while corporate demand for bank credit has remained modest. Even with fairly high interest rates and Western sanctions limiting access to international lenders, the biggest factors depressing investment demand are the uncertain economic outlook and difficult business environment. Any recovery in investment in the years ahead will likely be quite tepid.

Public spending plans moderate

Public sector revenues have exceeded budget estimates this year due to higher-than-expected oil prices. The government will spend some of the additional income this year and set the rest aside to cover next year's budget shortfall. Even with the additional spending, however, public sector expenditures are not expected to increase in real terms this year. Moreover, the preliminary draft of the 2018–20 budget framework anticipates even harsher spending discipline. Pressures to boost public sector spending could increase with the approach of the presidential election next spring.

The public sector deficit is planned to be about 2 % of GDP this year and should shrink gradually to about 1 % of GDP by the end of 2019. The deficit this and next year will still be covered largely out of the state's oil funds, implying that liquid assets in the oil funds at the beginning of 2019 would slightly exceed 40 billion dollars, or 2.5 % of GDP. As always, the oil price development causes uncertainty for Russian budget plans. Russia's finance ministry estimates that this year's federal budget would be balanced with the price of Urals oil at 60–65 dollars a barrel.

Imports recover swiftly on ruble strengthening

The volume of Russia's total exports increased by 7 % y-o-y in the first quarter and growth seems to have continued in recent months. However, with export volumes of oil and natural gas already at historically high levels and strengthened ruble eroding competitiveness of other exports, growth is expected to slow down. The volume of imports rose in January-March by nearly 17 % y-o-y and growth has remained robust in recent months on the recovery in demand and the stronger ruble. Based on the larger-than-expected rebound in the beginning of the year we have adjusted sharply upwards our 2017 projection for import growth. We expect the pace of growth to settle gradually as imports climb closer to pre-crisis levels and the impact of ruble appreciation wanes. Russia's current account surplus over the past year has been running at around 2 % of GDP. The current account is expected to remain on surplus through the forecast period.

The current account surplus has supported the ruble's external value. The ruble's real effective (trade-weighted) exchange rate was in January-August over 20 % higher than in the same period a year earlier. Pressures on the ruble's nominal exchange rate have abated as oil prices are expected to remain near their current levels and capital outflows from the country also appear to have ceased. Since Russia is likely to experience slightly higher inflation that that of its main trading partners, the ruble's real exchange rate should face slight appreciation pressure. Inflation has slowed in recent months close to the CBR's target of 4 %. The central bank has signalled that it may continue to gradually lower its key rate from its current level of 8.5 % if inflation pressures remain subdued.

Risks

The Russian economy is expected to grow at a modest pace of 1.5 % a year over the next few years. In the short term, the biggest uncertainty of this forecast is the price of oil. Changes in oil prices may boost or hinder growth. Heightened or reduced geopolitical tensions may also alter forecast trends. The presidential election next spring could increase pressures to raise public spending more than planned. While higher government spending could initially support growth, it might hurt public finances over longer term. This year's growth might also be slightly higher than expected if the recovery in demand would be re-oriented more towards domestic production instead of imports during the rest of the year. The difficulties experienced by some large Russian banks in recent months appear largely related to the particular activities of individual banks, but they may add to the perceived uncertainty about the Russian economy. Over the longer term, restructuring of distressed banks is important for the development of the banking sector and the economy.

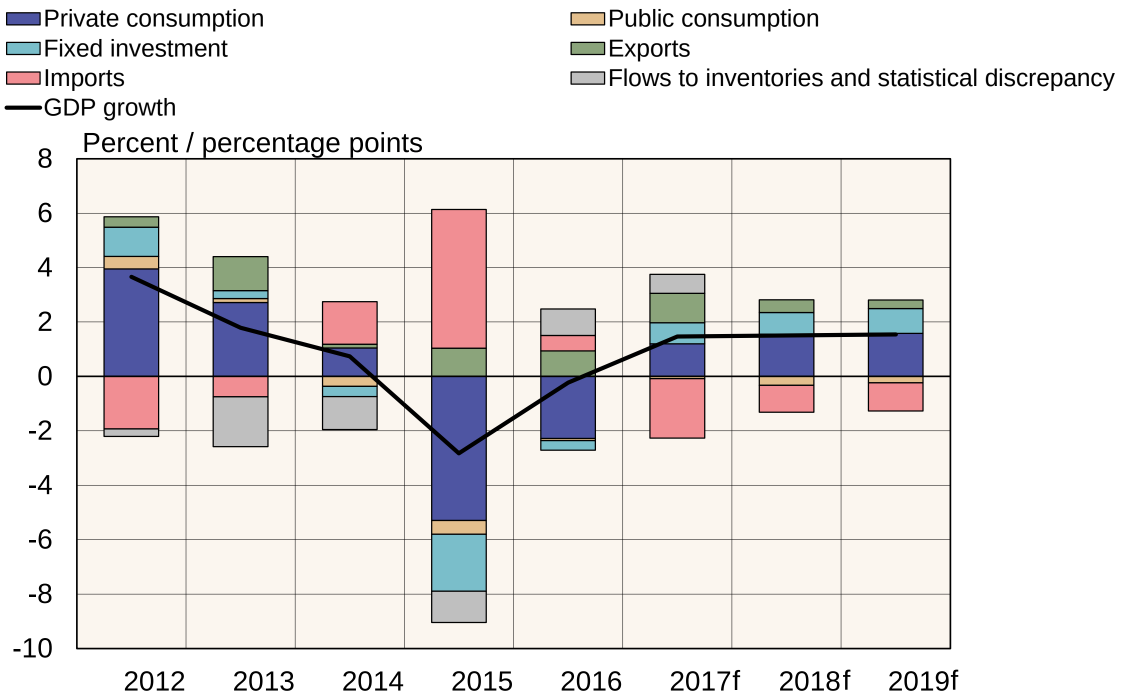
Our forecast sees Russian economy growing at its potential long-term growth rate. Raising that rate requires major structural reforms such as improving the business environment, effective adoption of new technology and diminishing the state's involvement in the economy. Such reforms would enhance Russia's attractiveness for investment and improve productivity. Reforms would also support diversification of the country's production structure and thereby reduce the country's dependence on oil exports. Such reforms are not expected at least until after the 2018 presidential election. Thus, the earliest we might see higher sustained growth of the Russian economy would be during the next decade.

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

	2012	2013	2014	2015	2016	**2017f**	**2018f**	**2019f**
GDP	3.7	1.8	0.7	-2.8	-0.2	**1.5**	**1.5**	**1.5**
Imports	9.7	3.5	-7.3	-25.8	-3.8	**15**	**6**	**6**

Sources: Rosstat, BOFIT.

Russian GDP growth with forecast (f), contribution of demand components and imports to GDP growth, %/%-points



Sources: Rosstat, BOFIT.