BOFIT Forecast for Russia
27 March 2018

BOFIT Russia Team

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We expect Russian GDP to continue reviving, increasing by nearly 2 % this year. If the oil price remains near its current levels, growth will slow to around 1.5 % p.a. in 2019 and 2020. While growth in Russia's imports remains fairly brisk, we see the recovery in imports this year slowing substantially from last year's strong rebound and a bit further thereafter. Growth of the economy will remain relatively slow as proper reforms that would support generation of income and growth are not in sight.

Russia's slow recovery grinds on

With GDP rising by 1.5 % last year, the Russian economy started to pull out of recession. Relative to the changes in global oil prices, the recession was rather mild and the recovery has been slow as fluctuations in the ruble's floating exchange rate for the first time have significantly dampened the ups and downs in the oil price in ruble terms. In addition, the government set aside tax revenues generated by higher oil prices. Russia's export volumes rose rapidly. Private consumption and fixed investment began to recover from deep slumps and induced a strong recovery especially in imports, which were battered during the recent recession.

We have adjusted the forecast for this year's GDP revival slightly upwards from last autumn's forecast to nearly 2 % because the oil price rose sharply in the second half of 2017 and the expected oil price this year will be substantially higher than assumed last autumn. The average oil price this year is $64–65 a barrel, 18 % higher than last year. GDP this year will be slightly larger than at its peak in 2014. Growth will slow next year towards its 1.5 % potential as the price of oil is expected to remain around $60 a barrel.

Large parts of economic development and reform discussions in Russia quite often concentrate on government measures that involve adjusting the sharing and allocation of funds that the state collects from the economy. Higher growth, however, would require reforms that improve the economy's ability to generate income. One should hope that such reforms will be undertaken now that the presidential election is over. If such reforms are implemented, they could support economic growth even significantly next decade through e.g. substantially stronger increases in fixed investment than the current pace.

Recovery in private consumption and fixed investment to continue

While household consumption began to recover last year, it was still at the 2012 level. Consumption was supported by a significant slowdown in inflation, higher wages and social payments to households, as well as increased borrowing and lower savings rates. However, other household income streams diminished, and real household incomes started to improve only during the first months of this year. Consumption is expected to rise fairly moderately. This year, consumption will get a bit of added support as a final spurt is made to bring to target the large multi-year wage hikes prescribed by president Putin back in spring 2012 to certain government sector employee groups, and as the minimum wage is raised sharply. On the other hand – unlike in the election years 2008 and 2012 – the general increases in public sector wages and pensions are still quite meagre this year. The increases in the next few

years are anticipated to be slightly larger in real terms, while corporate sector wages are expected to rise reasonably relative to improvements in productivity. Uncertainty about the future will likely contain household borrowing.

Fixed investment also recovered last year, with an increase in domestic corporate borrowing after a few years' pause. The increase was largely driven by investment in oil & gas production and pipeline transmission capacity. Total fixed investment in 2017 only matched the levels of 2011 and 2008. Fixed investment is expected to increase as Russia's relatively worn-out capital stock requires investment for replacement, high utilisation of capital calls for investment in capacity and the central bank's line of gradually easing monetary policy supports downward movements in interest rates. However, rapid growth is not expected as the major investment phases of various large projects are already past and appetite for new investment is still limited by high real interest rates on corporate loans and especially the defective business environment.

Government spending is constrained under new budget rule

Government sector revenues increased rapidly last year with rising oil prices, economic recovery and improved tax collection. Spending grew more moderately as the state set aside most of the excess oil and gas tax revenues brought by higher oil prices. The money will be transferred to the state reserve fund (National Welfare Fund) by next autumn. The budget deficit contracted significantly to 1.5 % of GDP. The new federal budget rule sets a maximum federal budget deficit at about 2 % of GDP this year and about 1 % of GDP thereafter. If the oil price remains roughly at the current level and spending is limited according to the budget rule, the budget seems on track to show a surplus.

Government sector spending is expected to increase slowly as the budget rule limits federal budget spending within the framework of the maximum deficit and computational revenues. In the rule, oil and gas tax revenues are computational, and for that purpose the price of Urals crude is set at around $41–42 a barrel over the next few years. Should the oil price exceed that basic calculation price, excess revenues are to be channelled to the state reserve fund. Other budget revenue streams, which are not defined by the budget rule, are no longer likely to rise rapidly with the forecasted GDP and as improving tax collection is becoming more difficult. As usual, spending of regional and local budgets, as well as the state social funds, is limited by their considerable dependence on transfers from the federal budget and very limited opportunities to take on debt.

Recovery in imports will slow but still proceeds fairly briskly

Growth in the volume of Russian exports accelerated last year to over 5 %, due mostly to exports of basic commodities and services. Export growth is expected to slow in the forecast period as the ruble remains fairly strong and Russian energy exports likely increase slowly.

Ruble appreciation and the recovery in domestic demand led a strong recovery in imports that rose by 17 % last year from a deep slump. We have slightly raised this year's import forecast from last autumn as higher oil prices will increase domestic demand and Russia's export revenues. The recovery in imports, however, will slow significantly this year and slightly further next year as the increase in export earnings fades. While the pace of import recovery will still be rather brisk in the forecast period, imports will only climb close to the 2012 level in 2020, but not yet to the 2013 peak. The share of imports in the economy will remain about the same as in all years of the current decade.

Russia has run notable current account surpluses in recent years as the ruble's exchange rate and imports have reacted rather swiftly to changes in Russian export earnings, including downward movements. We expect the current account to remain in surplus, even if the projected growth of imports and the expected oil price will diminish the surplus towards the end of the forecast period. The ruble's real effective exchange rate will remain largely unchanged due to the current account surplus, an expected relatively low level of capital outflows and Russia's only slightly higher inflation relative to its trading partners.

Risks from many sides

Oil prices present a continuous risk and element of uncertainty to Russian economic growth. Oil prices can deviate up or down from this forecast's expectation of a quite stable price. This forecast is also subject to risks facing the good global growth outlook, which overall point to weaker-than-projected growth. In recent years, significant unexpected geopolitical events and other international incidents have come to the fore, and developments in the next few years will affect the Russian economy directly or via the global economy.

Recent years suggest growth in Russia's export volumes of basic non-energy commodities could exceed expectations. On the other hand, as the utilisation rate of production capital in Russia is near its earlier peaks, production capital could constitute a greater constraint on Russia's basic exports than expected, and also more broadly on growth in domestic production. This setup stems from the uncertainty continuously surrounding investments in production.

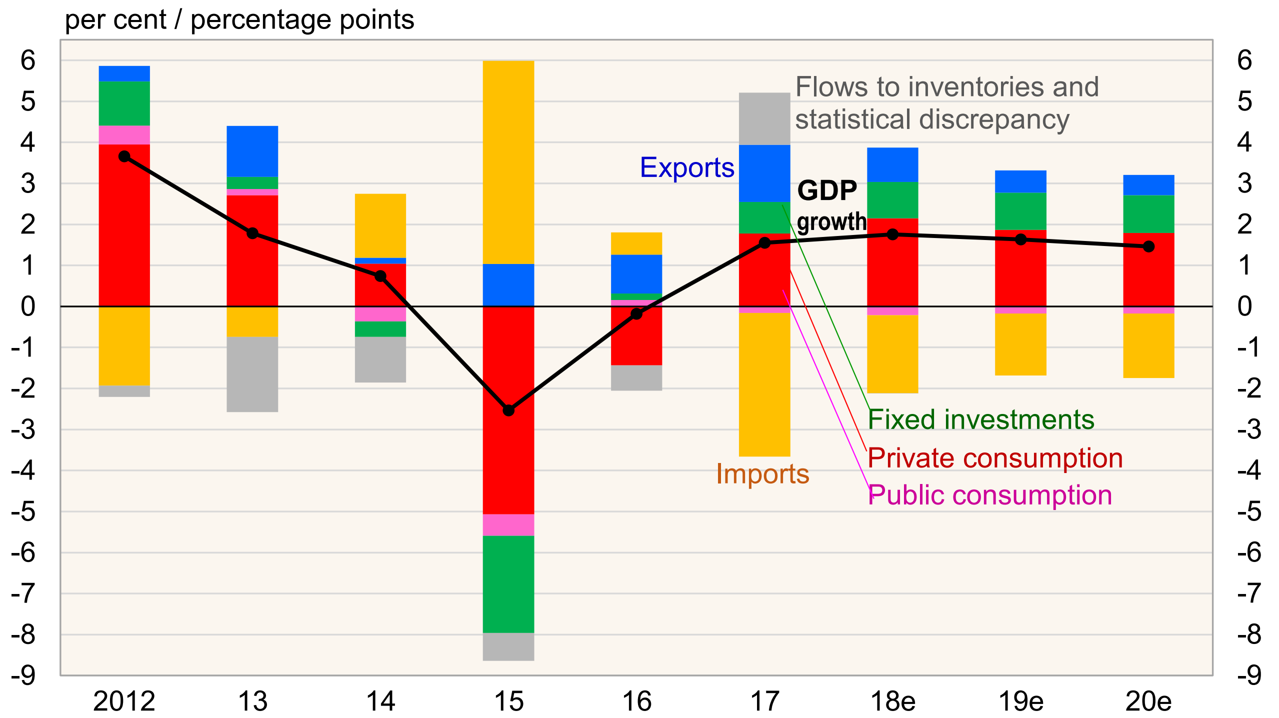
With the presidential election now over, Russia may move ahead with a scheduled tax reform, while the overall impact of the reform would be uncertain. The reform's VAT increase could slow down growth in private consumption and the decrease of social taxes that are based on wages could bolster domestic production. The risk that government budget spending would not stay within frameworks has been significantly reduced with the introduction of the budget rule as it largely insulates spending from shifts in the oil price.

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

	2013	2014	2015	2016	2017	**2018f**	**2019f**	**2020f**
GDP	1.8	0.7	-2.5	-0.2	1.5	**1.8**	**1.6**	**1.5**
Imports	3.5	-7.3	-25.1	-3.6	17.0	**8**	**6**	**6**

Sources: Rosstat, BOFIT.

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



Sources: Rosstat, BOFIT.