BOFIT Forecast for Russia
15 March 2019

BOFIT Russia Team

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Summary

Russian economic growth gathered steam in 2018. Rising oil prices and ruble depreciation combined to boost budget revenues and net export earnings. Russia's hosting of the 2018 FIFA World Cup international football tournament boosted demand in the tourism and restaurant industries. Large investment projects in the natural gas industry also advanced faster than expected. The contraction of the corporate credit stock ended, while growth of the household credit stock accelerated appreciably – a shift that was reflected in improved profitability of the banking sector. Rosstat's first estimate of 2.3 % GDP growth last year exceeded the high end of most forecasts.

Lower economic growth should return this year, however. The hike in value-added taxes and a mild pick-up in the inflation rate are impeding growth in household consumption. Moreover, there are no signs of an across-the-board recovery in fixed investment, meaning net exports will continue to be an important growth driver in 2019. The launch of massive state investment projects in 2020 and 2021 should slightly boost the pace of economic growth, particularly in 2020. BOFIT expects Russian economic growth to settle in at around 1.5 % annually in coming years.

Baseline assumptions of this forecast

Our forecast, as always, rests on assumptions about prevailing economic conditions in the years ahead. Our fundamental assumption is that Russia will continue to pursue its current economic policies geared to achieving macroeconomic stability and economic independence. This implies public sector surpluses, a ruble exchange rate set by the market and an inflation targeting central bank. Economic independence implies favouring domestic products and services over imports, as well as maintaining policies that restrict import competition.

Our second basic assumption concerns global oil prices. The Bank of Finland does not forecast oil prices, so we use the March 6, 2019 closing future contract prices for Urals crude as our baseline. The future prices indicate that crude oil price will remain fairly close to its current level throughout the three-year forecast period, i.e. slightly above $60 a barrel. This view comports with the general view that global economic growth should be fairly stable over the next three years.

Additionally, we assume that there will be no major shifts in EU-Russia or US-Russia relations. While the current sanctions regime is expected to remain in place, we do not see either side imposing new wide-ranging restrictive measures. The risk of a flare-up in geopolitical tensions, of course, is ever-present.

Lower private consumption growth

A substantial acceleration in the rise in real wages last year was reflected in fairly robust retail sales growth. The wage increase was driven largely by president Putin's commitment in his 2012 inaugural May Decree to increase public sector wages and the minimum wage within the next six years of his term. No similar wage hikes are expected in coming years. Low public sector wage growth and a modest pick-up in inflation imply that the rise in real wages will continue to slow in the years ahead. Private consumption has been further curtailed by a two-percentage-point hike in value-added tax rates at the start of this year. For the last two years, private consumption was supported also by growth in household borrowing. Concerns about the sustainability of this trend have be raised, however, as the household credit stock rose by 22 % last year. It is unlikely that growth in household indebtedness accelerates further.

While the levels of pensions and other social entitlements have not increased, income from owning property and entrepreneurship has declined. These factors largely explain the pitiable trend in Russian real disposable household incomes. Real incomes have now fallen for five consecutive years, standing 14 % below their 2013 level. Some 13 % of the Russian population still get by on incomes below the subsistence minimum. This figure has remained almost stagnant over the past ten years.

Steady general government surpluses

Not only did Russia's public sector deficit vanish in 2018, but the federal budget surplus climbed to 2.7 % of GDP. Given our oil price assumption, federal budget revenues in the forecast period should increase only slightly. Under the current fiscal rule this implies only modest growth in real federal budget spending. The incremental increase in the retirement age, which started at the beginning of this year, is also expected to help hold down spending growth. The federal budget should show large surpluses throughout our forecast period. The surpluses will be transferred to the National Welfare Fund.

Revenues and expenditures of other parts of the public sector (consolidated regional and local government budgets and off-budget social funds) should remain nearly in balance. Even if a few regions have had to resort to borrowing to cover current expenditures, regional budgets as a rule tend to carry relatively low debt burdens. While the approved national priority projects for 2019–2024 will increase regional spending pressures in such areas as education and health care, regional budgets are expected by and large to remain close to balance. As a result, Russia's public finances overall are expected to stay in surplus. Public consumption should increase only slightly.

Fixed investment boom not yet on the radar

The first estimate of 2018 GDP released by the Russian Federal State Statistics Service (Rosstat) shows an increase in fixed investment of 2.3 % last year. Growth in gross capital formation, the combination of fixed investment and changes in inventories, was only 1.5 % in 2018. Investments in machinery, equipment and structures have increased over the past three years, and their level now roughly matches the 2012 level. Fresh figures on construction activity suggest that projected fixed investment figures may have to be adjusted upwards. Major government-led projects such as construction of FIFA-standard football stadiums and the Kerch Strait Bridge have clearly boosted investment figures. What remains unclear is how much economic benefit such investments eventually generate. Most other fixed investment will continue to be focused on the oil & gas sector. About a third of all fixed investment goes to mineral extraction industries (which includes oil & gas), oil refining and pipeline transmission.

While construction is nearing completion on Russia's current major pipeline projects (Power of Siberia, Turkish Stream and Nord Stream 2), as well as the giant natural gas liquefaction plants and shipping terminal on the Yamal Peninsula (Yamal LNG), they still could provide a boost to this year's investment figures. Major government-sponsored investment projects outlined in the new national priority projects for 2019–2024 are likely to get started only in 2020–2021.

To attract new investment, the government is expected to continue supporting domestic production, raising domestic sourcing and content requirements, as well as guiding large firms to participate in funding of national priority projects. The overall business environment will, however, continue to suffer from a range of uncertainties and structural issues specific to the Russian economy. For these reasons, any acceleration in the pace of investment is expected to be short-lived.

Can high export growth continue?

While the volume of Russian exports grew by 3 % in 2016, 5 % in 2017 and 6.3 % last year, it is unlikely such vibrant export growth continues. Natural gas and wheat, in particular, drove growth in export volumes in recent years. Given that the 2018 harvest was smaller than in previous years, exports of agricultural products should fall slightly this year. While there with be high growth in LNG exports this year, growth will essentially plateau out thereafter. The completion of a major natural gas pipeline to China, however, could increase gas exports overall in 2020–2021.

While Russia, OPEC and other oil-producing countries have entered into a voluntary arrangement that caps growth in oil output, a collapse of this agreement would hardly lead to any significant increase in Russian output or exports. Observers say it is unlikely that Russia has any significant additional available oil production capacity at the moment. The volume of crude oil exports rose to 260 million metric tons last year, a peak not seen since 2004. In contrast, exports of petroleum products have shown no increase in recent years.

We expect import growth to continue to slow slightly with the weakening growth in domestic demand. While the effect of net exports during the forecast period should be positive, its impact on GDP growth will likely be marginal towards the end of our forecast period.

Table. Realised on-year change in GDP volume (2017–2018), BOFIT forecast (2019–2021), %[1]

	2017	2018*	2019	2020	2021
GDP	1.6	2.3	1.4	1.7	1.6
Final consumption expenditure	3	1.9	1.0	1.3	1.4
Gross capital formation	6.5	1.5	1.5	2.5	2.0
Exports of goods and services	5	6.3	3.0	2.5	2.2
Imports of goods and services	17.4	3.8	2.5	2.5	2.2

Note: The composition of Russia's GDP in 2018 prices was 67 % final consumption expenditure, 23 % gross capital formation (21% fixed investment) and 10 % net exports (31 % exports and 21 % imports). * Rosstat first estimate released on Feb 4, 2019.

Upside and downside risks

Due to floating exchange rate and adherence to the fiscal rule Russian economic performance has become less dependent on oil price movements. However, large changes in the price of Russia's top export commodity remain hugely important. Any significant rises or falls in crude oil prices will be reflected in the ruble exchange rate, and will thereby affect Russia's financial markets, cost of investment funding and net exports.

The sanctions imposed by the West have had distinctly negative impacts, particularly on Russian financial markets. During our forecast period, the US could adopt further sanctions and also the EU may consider another round of restrictive measures against Russia. Such measures would undoubtedly have a negative, albeit relatively small, impact on Russia's medium-term growth outlook. New sanctions or threats of sanctions are likely to weaken ruble's exchange rate, which would boost federal budget revenues and reduce growth in imports.[2]

Our assumptions about growth in fixed investment are quite modest. Industrial capacity utilisation remains extremely high and unemployment is low. Even a slight improvement in the investment climate could lift investment growth towards the end of the forecast period.

The largest source of uncertainty for the current forecast relates to net exports, because forecasting Russian export and import volumes has become quite challenging. Russia's overall economic growth in recent years has been supported by extremely rapid growth in export volumes. While a further surge in volumes of Russia's biggest export commodities (crude oil, petroleum products and natural gas) is unlikely, the opening of new energy routes to China and rapid growth in certain metal industry exports could hold positive surprises. The trend in import volumes will depend largely on import prices, which in turn depend on the ruble's exchange rate.

[1] We post a range of useful statistical data on Russia's economic performance on our website: https://www.bofit.fi/en/monitoring/statistics/russia-statistics/

[2] The impacts of sanctions imposed by the European Union and United States on the Russian economy are discussed in two recent BOFIT Policy Briefs: Gould-Davis (2018), https://helda.helsinki.fi/bof/handle/123456789/15832; and Korhonen-Simola-Solanko (2018), http://urn.fi/URN:NBN:fi:bof-201805301586