BOFIT Forecast for Russia
20 March 2020

BOFIT Russia Team

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We have reduced substantially our forecast for Russian GDP growth to -1 % for this year due to notably lower commodity prices and a weakened outlook for the global economy. We expect Russian GDP to return to moderate growth next year. Higher government spending supports the economy. In the current situation risks are exceptionally large and Russia's economic development can turn out considerably weaker if the global uncertainty caused by the corona pandemic is prolonged. Given the unlikely prospects for major structural economic reforms, Russia's longer-term growth potential remains moderate.

Russian economy is expected to contract this year

Falling oil prices and weaker outlook in the global economy from the coronavirus pandemic have seriously eroded prospects of Russian economy. The average price of Urals-grade crude oil in March has been around 37 dollars a barrel, about 40 % lower than the average price in 2019. The current market expectation is that oil averages a price of roughly 39 dollars a barrel this year, and then gradually rises to 45 dollars a barrel in 2022. Forecasts for China and the global economy this year have also been generally reduced on the negative impacts from the coronavirus pandemic.

Russia's growth slowed down last year as expected. Preliminary data show that GDP was up by just 1.3 % last year. Growth was restrained by a slowdown in growth of private consumption from the hike in the value-added tax and shrinking exports. Oil price is still an important factor for Russia's economic development, but due to prudent fiscal policy and shift to floating exchange rate policy, Russia is now better equipped to deal with an oil price fall than before. Russia's new government is expected to largely continue with previous government's economic policy framework, emphasising economic stability and self-reliance. Under the policies laid out in Putin's January state-of-the-nation address, however, public spending on social issues should rise slightly more than we anticipated last autumn.

We have lowered our projection for Russian GDP growth substantially from our October forecast and now expect the economy to contract by 1 % this year. The economy is, however, supported by higher public spending. Growth is expected to revive next year as the outlook for the global economy recovers and Russia's public sector spending rises further. In the current situation forecasting is exceptionally difficult and the risk of a weaker-than-expected outcome is significant due to the high uncertainty in commodity markets and impacts from the coronavirus.

Public spending supports economy

If the weakening of the global economy remains temporary, Russia is expected to stick to current spending plans. Under the approved 2020–2022 budget framework, public sector spending will increase by 6–7 % a year in nominal terms. Spending on social issues in particular has been raised slightly from autumn, as outlined in Putin's January speech. Most of the spending increase, however, will be realised in coming years and thus contribute substantially to GDP growth only next year.

The economy's ability to deal with external shocks is supported by the Russian government's comfortable financial position. Fiscal policy has been fairly tight in recent years, with budgets typically showing surpluses. This year, the consolidated budget is, however, expected to turn to deficit with current oil price outlook. The Russian government carries little debt (just 14 % of GDP), but US sanctions restrict its ability to borrow internationally. Russia has also built up its sovereign wealth fund again. The National Welfare Fund now holds about 150 billion dollars in liquid assets (the equivalent of 9 % of GDP). National Welfare Fund assets can be used for financing budget expenditure in a downturn.

Private consumption and investment decline this year

We expect private consumption to turn to decline this year. Consumption is hampered by slower economic activity and factors related to the dispersion of the corona pandemic. Recent ruble depreciation is set to increase inflation and thus reduce purchasing power. In addition, consumption growth will be restrained by lower growth in consumer credit due to tighter regulation. In coming years, consumption growth is expected to pick up supported by a gradual rise in incomes, including the planned increases in social spending.

Fixed investment recovered slightly last year, growing by slightly more than 1 %. Several major infrastructure projects were completed, including the bridge over the Kerch Strait that now connects Crimea with the Russian mainland, the Power of Siberia natural gas pipeline that runs from central Siberia to China, and Yamal peninsula LNG project on the Arctic Sea. Fixed investment is expected to fall notably this year due to the deteriorating economic outlook over the near term. Fixed investment should gradually pick up, however, in coming years as spending on national projects gets into full swing. The growth in fixed investment is also highly reliant on the public sector and state-owned enterprises. Private investment should remain sluggish also in coming years.

The CBR's accommodative monetary policy has made it easier for firms to finance fixed investments. Inflationary pressures caused by the recent ruble depreciation may restrict possibilities of the CBR to continue monetary easing. For many Russian firms, however, the issue is not access to financing so much as Russia's poor business environment, particularly the lack of property right protections and corruption. The investment rate has averaged just 21 % in recent years and no sudden improvements are expected during the forecast period.

Exports and imports contract

Russian exports contracted last year by 2 % for the first time in decades. Much of the contraction was due to a decline in metal and grain exports. Exports are expected to contract even more this year due to the weakness in China and the global economy overall. Exports should recover gradually next year as demand returns.

Supported by ruble appreciation, Russian imports grew last year moderately. Imports are expected to contract notably this year, with growth constrained particularly by the recent ruble depreciation from lower oil prices. The ruble has been worth about 9 % less in March against both the dollar and the euro than its 2019 average. Imports should also be dampened by investment demand's public-sector focus, which favours domestic suppliers. Moreover, imports of tourism services are expected to fall substantially this year due to the corona pandemic. Imports are expected to return to growth next year, but the volume of imports is not expected to recover to the 2014 level during the forecast period.

Russia's current account surplus last year was 70 billion dollars (about 4 % of GDP). The current account is expected to continue on surplus but decline substantially this year due to the oil price fall. If oil price trends conform to current market expectations, the ruble's nominal exchange rate should not experience significant pressures further, but considerable uncertainty is related to the market development. The CBR's forex operations on behalf of the finance ministry to comply with the fiscal rule slightly dampen the impacts of oil price swings on the ruble's exchange rate. The ruble's real effective exchange rate could begin to appreciate slightly next year as Russian inflation is expected to return to a higher rate than the inflation rates of most of its trading partners.

Risks

In the current situation risks related to the forecast are exceptionally high. The oil price poses the biggest near-term risk to the Russian economy. If oil prices fall further for an extended period, Russian growth could severely undershoot our forecast. Moreover, Russia's economy could be hit harder by a weaker-than-expected performance of the global economy. In addition, GDP could decline more strongly, if private consumption would contract more than anticipated especially taking into account its high share in GDP.

Russia has the capacity to soften the impact of negative shocks through government support. The upcoming referendum on changes to the Russian constitution in late-April and the approaching Duma elections in 2021 could also put pressure on politicians to increase public sector spending. A stronger-than-expected fall in imports could mitigate GDP contraction.

Russia's long-term growth is still constrained by structural problems in the economy such as the lack of property right protections, corruption and the state's oversized role in the economy. There is currently no indication that the government is prepared to make the structural reforms needed to tackle these deficiencies.

Table 1. Russian GDP realised, preliminary (p) and forecast (f), %

	2017	**2018**	**2019p**	**2020f**	**2021f**	**2022f**
GDP	1.8	2.5	1.3	-1.0	1.5	1.8
Consumption	3.4	2.8	2.4	-0.9	2.0	2.2
Investment	4.7	0.1	1.4	-6.5	2.0	2.5
Exports	5.0	5.5	-2.1	-5.0	2.0	1.0
Imports	17.3	2.6	2.2	-10.0	4.0	3.0
Oil price (Brent)*	$54/bbl	$71/bbl	$64/bbl	$39/bbl	$41/bbl	$45/bbl

Sources: Rosstat and BOFIT.
* The forecasted oil prices are based on the average for oil futures contracts for the five days preceding March 19, 2020. The price of Urals crude during 2017–2019 averaged 0.99 that of Brent crude.