BOFIT Forecast for Russia
17 September 2020

BOFIT Russia Team

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With the coronavirus pandemic and drop in global commodity prices proving more severe than foreseen in the baseline of our March forecast, we have substantially lowered our outlook for Russian GDP growth. The Russian economy is now expected to contract by 4 % this year and return to moderate growth next year. Russia's economic prospects remain uncertain as the on-going pandemic and commodity markets could see turns for the worse.

Russian economy witnessed sharp contraction in the spring

The Russian economy has had to endure the combined effects of the Covid-19 pandemic and an upheaval in oil markets. The lockdown and other restrictions imposed in late March to deal with the spread of the coronavirus remained at least partly in place until June. With much of the economy shut down and movement severely restricted, consumption, in particular, appears to have declined precipitously. Preliminary figures suggest that Russian GDP contracted by 8 % y-o-y in 2Q20. For the entire first half of the year, GDP shrank by 3.4 % y-o-y. As the coronavirus pandemic has eased in Russia and other countries since spring, we expect the economy to begin recovering in the months ahead, even if several thousand new infections in Russia are still identified daily.

The price of crude oil hit its lowest point in two decades this spring with the collapse in global demand and a brief period in which the parties to the OPEC+ agreement on production ceilings was allowed to expire without a new deal in place. As OPEC+ members settled on cuts of unprecedented magnitude and the global demand outlook brightened, the price of oil has gradually stabilised. In the first eight months of this year, the price of Urals-grade crude oil averaged $41 a barrel, down 38 % from a year earlier. Markets now expect the Urals price to rise gradually to around $50 a barrel at the end of 2022 as the global economy gradually recovers from a historically deep dive. While the slight rise in oil prices will support Russia's recovery, Russia's commitments under its OPEC+ agreement imply substantial production cuts this year that will have distinctly negative economic impacts.

Substantial declines in private consumption and fixed investment

The restrictions imposed to corral the coronavirus in Russia have had particularly strong impacts on consumer demand. Consumption has also been affected by a sharp decline in real incomes and increased unemployment. Retail sales contracted by 6 % y-o-y in January-July, while the real household disposable incomes have declined by 4 % y-o-y this year. The unemployment rate has risen briskly, reaching 6.3 % in July.

Since the lifting of most corona restrictions a brisk recovery in consumption appears underway. Consumption has been bolstered by public-sector support measures and money left in household budgets from an inability to travel abroad. The recovery in consumption is expected to continue through the end of this year, but slow gradually. While the sharp drop in consumption this spring virtually assures that consumption growth this year finishes in deep negative territory, it should return to positive growth next year.

Preliminary data show fixed investment declined by 4 % y-o-y in the first half of this year. Fixed investment could, however, deteriorate more with a lag due to continued spending on completing projects underway before the crisis. Uncertainty about the future makes firms reluctant to invest in new capital projects. Despite monetary policy easing, the sharp drop in corporate profits in the first half of this year has made financing of investment more difficult for firms. Public-sector investment is constrained by reorientation of some spending for investment to social issues to relieve the economic impacts of the coronavirus pandemic on households. For example, the implementation schedule for national projects has been pushed back to 2030.

Substantial contractions in exports and imports

The volume of Russian exports shrank in the first half of this year as the pandemic chewed through the global economy. In recent months, however, export volumes of key commodities such as crude oil and petroleum products have begun to rise. The improvement in goods exports has been supported by the brisk recovery of the Chinese economy. Russian exports should come back gradually and grow modestly next year as global commodity demand revives.

Russian imports are expected to fall substantially this year on a contraction in domestic demand. In particular, the pandemic has caused a spectacular collapse in tourism abroad that is only expected to recover slowly. In addition, ruble depreciation has dampened import development. The ruble’s real effective, or trade-weighted, exchange rate (REER) was down by 3 % y-o-y for the first seven months of this year. Imports should return to modest growth next year, but the volume of imports throughout the entire forecast period will remain well below the last peak in 2014.

Russia’s current account surplus for the last four quarters combined was $44 billion, or roughly 3 % of GDP. Although this year’s current account surplus is expected to largely evaporate, it will nevertheless remain slightly on the positive. If the trend in oil prices follows current market expectations, it will not cause additional pressures on the ruble's exchange rate, but huge uncertainty continues in the markets. The ruble’s REER could appreciate slightly next year as Russia's inflation is expected to run higher than in its main trading partners.

Public sector measures have supported the economy

The three-year budget framework for 2020–2022, which was approved by the cabinet prior to the coronavirus pandemic, anticipated large increases in government spending. As the pandemic grinds on, budget spending is to be increased further this year to support the economy, implying a temporary deviation from the fiscal rule. From the start of next year, however, fiscal policy is planned to moderate again, reducing the supportive effect from public spending on the economy.

Led by the collapse in global oil prices, Russian budget revenues have diminished substantially. As a result, government finances should finish this year deeply in the red. The government will cover some of the deficit with money set aside from oil earnings in the National Welfare Fund, and by increasing domestic debt. Some National Welfare Fund assets this year have already been used to cover budget shortfalls, but as of end-August the Fund still had liquid assets of $120 billion (nearly 8 % of GDP). The Russian government can also afford to take on more debt as the central government debt only amounts to about 15 % of GDP.

The Central Bank of Russia has taken measures to ease problems created by the coronavirus pandemic. The key rate is now at a historical low of 4.25 %, while the CBR expects consumer price inflation to remain close to the target rate of 4 % this year and next year. It has pumped additional liquidity into the market, temporarily eased banking regulations and provided support to the ruble's exchange rate through announced currency selling operations that follow the fiscal rule and finance ministry guidance. Although the CBR sold about $15 billion in foreign currency between March and August, the value of Russia's foreign currency and gold reserves as of end-August was still at a close to record level of just under $600 billion.

Downside risks remain sizeable

The forecast is again subject to large downside risks. Considerable uncertainty is still related to the development of the coronavirus both globally and in Russia. The jitters in global oil markets continue. If the coronavirus pandemic or the situation in the oil markets worsen significantly, Russia's economic outlook can deteriorate substantially.

The recovery of the Russian economy could be slightly stronger than in our baseline forecast, if consumption resumes faster than expected despite the severe drop in real incomes. Moreover, the fall in fixed investment could prove milder than expected if the economic crisis is perceived to blow over soon. Specifically, state-majority-owned enterprises might hold more stringently to their investment commitments. Corporations could also interpret recently approved constitutional amendments that enable president Putin to remain in office after his current term ends in 2024 as clarifying the future business environment.

The new economic crisis could, however, degrade Russia's long-term growth outlook further. The official schedule for meeting economic development targets has been pushed back to 2030. Long-term growth is already limited by the Russian economy's structural challenges such as inadequate property protection, corruption and the state's over-sized role in the economy. There is no evidence at the moment that the government will move ahead with the major reforms needed to deal with Russia's structural economic issues.

Table 1. On-year Russian GDP growth and oil price: realised and forecast (f), %

	2017	2018	2019	2020f	2021f	2022f
GDP	1.8	2.5	1.3	-4.0	2.4	2.2
Consumption	3.4	2.8	2.4	-4.4	2.9	2.5
Investment	4.7	0.2	1.5	-6.5	2.5	2.5
Exports	5.0	5.5	-2.3	-6.0	2.5	2.0
Imports	17.3	2.6	3.4	-10.0	4.0	3.0
Oil price (Brent, bbl)*	$54	$71	$64	$42	$45	$48

* Forecasted oil prices based on the average for oil futures contracts for the ten days preceding September 14, 2020. The price of Urals crude this year has averaged 0.95 that of Brent crude.
Sources: Rosstat and BOFIT.