BOFIT Forecast for Russia
30 March 2017

BOFIT Russia Team

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After two years of decline, we see Russian GDP growth, supported by higher oil prices, rising to 1.5 % this year. Growth is led by private domestic demand which also stimulates imports. Russian growth should remain sluggish in coming years as the economy is already operating near full capacity and needed structural reforms are still nowhere in sight.

Higher oil prices support recovery this year

With oil prices climbing last autumn and realised growth outperforming earlier expectations, BOFIT has slightly revised upwards the forecast for Russian GDP growth this year. Oil prices spiked late last year after several oil-producing countries reached agreement on production ceilings. The price of Urals-grade crude oil this year has averaged around $52 a barrel. The markets currently expect the oil price to remain near this level through the end of 2019. Under these assumptions, the average oil price this year will be nearly 30 % higher than in 2016.

Rosstat's latest figures suggest that the contraction of Russian GDP in recent years was less severe than earlier indicated. Rosstat's preliminary figures for all of 2016 show GDP shrank by just 0.2 % last year, which was much less than its 1-3Q GDP figures were predicting. Rosstat also revised downwards its estimate of GDP contraction in 2015. These revisions have surprised many observers as their origins are not yet fully clear. The revised data suggest, however, that Russia's economic recovery is moving faster than predicted last autumn, thereby supporting higher growth this year.

Higher domestic demand drives growth

After contracting by a total of 14 % over the past two years, household consumption this year is finally expected to show gradual recovery. Real wages and real household disposable incomes have begun to rise in recent months and unemployment has declined. Consumer confidence has improved and household borrowing has recovered slightly. Private consumption may get a boost at the start of this year with the government's one-time pay-out to pensioners and a return to the full inflation-adjustment for most pensions. Retail sales indeed showed signs of improvement in January-February. Even so, the uncertain economic outlook restrains consumption growth and a moderate recovery is expected in coming years.

While fixed investment contracted for the third year in a row, the drop last year was just 1 %. Fixed investment is expected grow slightly this year. Industrial production capacity is nearing full utilisation and indicators of business confidence have risen. Corporate profits have developed favourably, but demand for corporate borrowing remains weak. Although financing costs are still relatively high, investment demand is mainly inhibited by the weak growth outlook and poor business environment. These factors collectively suggest that the recovery in fixed investment over the coming years is likely to be quite modest.

Public spending to be adjusted

The impact of public sector spending on economic growth continues to wane. The approved 2017–2019 budget framework foresees only minor increases in public sector spending. Given that inflation should run at around 4–5 % p.a., public sector spending is expected to contract in real terms. The budget includes no more economic crisis programmes as in recent years. The budget will be gradually adjusted to reduce the deficit from about 4 % of GDP in 2016 to 1 % of GDP in 2019. The approaching next year's presidential elections may, however, increase pressures to boost public sector spending.

Budget deficits in recent years have gobbled up a large share of Russia's national savings from oil earnings. As of end-February, Russia's oil reserves held just over $60 billion (4 % of GDP) in liquid assets. The 2017–2019 budget framework calls for exhausting almost all these assets over the coming years to cover budget deficits. The budget framework assumes, however, a price range for Urals crude of 2,700–2,800 rubles a barrel. The average Urals price this year has been 3,100 rubles a barrel. If oil prices and the ruble's exchange rate remain at current levels, Russia would collect more budget revenues, giving the government the option of reducing the deficit or raising spending.

Ruble recovery bolsters imports

The volume of Russian exports grew by over 2 % last year on record-high oil production, a bumper grain harvest and support from a weak ruble in the first half of 2016. In coming years, export growth should slow as these effects fade. In contrast, the volume of imports, which has dropped by 35 % over the past three years, should bounce back this year. Import growth will be supported by the gradual recovery in demand and robust appreciation of the ruble in recent months, but is restricted by import bans on several food items and public procurements. Russia's current account surplus contracted last year to less than 2 % of GDP. Even with import volumes rising faster than exports, the current account should remain solidly in the black in coming years.

The ruble's exchange rate soared from last year's lows as world oil prices started to recover. If the ruble's real effective, or trade-weighted, exchange rate (REER) remains at the February level until the end of this year, it would have a roughly 25 % stronger performance than in 2016. Moreover, pressures on the ruble's nominal exchange rate have largely abated. The price of oil is expected to remain stable and capital outflows from Russia have subsided. Russia's slightly higher inflation relative to its main trading partners should sustain mild appreciation pressures on the ruble's REER. Russia's annual inflation slowed to below 5 % in February, but inflation expectations remain relatively high. The Central Bank of Russia has kept a relatively tight monetary stance, holding the key rate at nearly 10 % in order to reach its 4 % inflation target by the end of this year.

Risks

We expect the Russian economy to grow at a modest rate of 1.5 % p.a. over the next three years. The biggest short-term risk (upside and downside) to this forecast is the price of oil. A second risk factor is geopolitical tensions. If tensions would increase it could hit Russia's growth rapidly, while less tensions would favour growth. Approaching presidential elections may raise pressures to increase public spending contrary to current plans. While such spending could briefly support growth, it could also heighten Russia's fiscal vulnerabilities over the longer term. On the downside, import recovery after such a dramatic fall could be stronger than expected as the efforts of import substitution seem to have proceeded modestly. In this case, GDP growth would be lower than our basic forecast scenario.

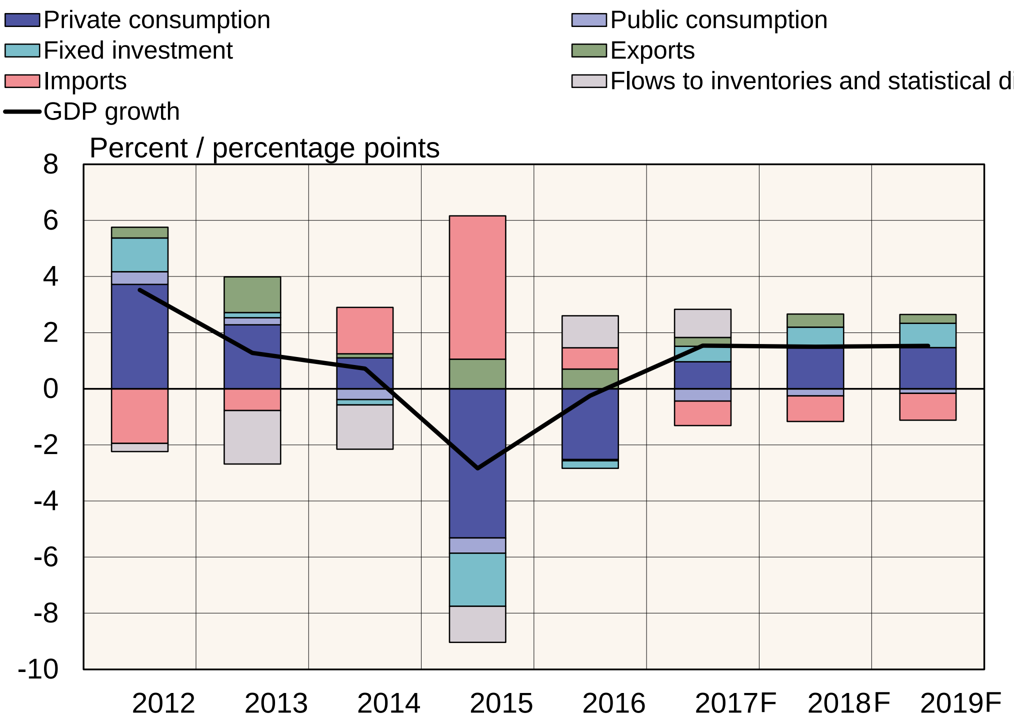
Our forecast sees Russian economy growing at its potential rate. Achieving faster sustainable growth would require structural reforms such as enhancing the business environment, adoption of new technologies and reducing the state's role in the economy. Implementation of such reforms would support investment activity and improve productivity. Structural reforms would also promote diversification of the country's production structure and decrease Russia's dependence on oil prices. 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 could be during the 2020s.

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

	2012	2013	2014	2015	2016	**2017f**	**2018f**	**2019f**
GDP	3.5	1.3	0.7	-2.8	-0.2	**1.5**	**1.5**	**1.5**
Imports	9.7	3.6	-7.6	-25.5	-5.0	**6**	**6**	**6**

Sources: Rosstat, BOFIT.

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



Sources: Rosstat, BOFIT.