BOFIT Forecast for Russia
4 October 2018

BOFIT Russia Team

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GDP growth in Russia is projected to remain below 2 % this year. Growth will decelerate slightly next year to around 1.5 % as long as the oil price stays reasonably close to current levels. Growth of the economy will remain relatively slow as there are too few signs of moving ahead with market-friendly systemic reforms that are needed to foster higher growth. The rapid recovery of Russian imports from a deep slump slowed significantly in spring, and the revival is expected to continue at relatively slow pace during the forecast period.

Russian economic growth to remain quite slow

The recovery of the Russian economy that began in late 2016 has continued this year. On-year GDP growth in the first half was 1.7 %. Seen against the substantial rise in global oil prices, the recovery of the Russian economy was slow.

The slow rise in GDP this year can only be attributed in part to Russian policy rules meant to dampen the impacts of oil price fluctuations on the economy. Unlike last year, the ruble's floating exchange rate this year has not appreciated with higher oil prices. Instead, the ruble has been dragged down in the spring and late summer by new rounds of sanctions imposed by the United States and threats of further sanctions. The federal budget fiscal rule introduced at the start of the year also links government spending partly to a low computational oil price. However, a notable increase in spending was possible on good performances of other budget revenue streams.

The volume of Russian exports continued to rise rapidly this year e.g. due to ruble depreciation. In contrast, the recoveries in household consumption and fixed investment have been relatively sluggish. The rapid recovery of Russian imports from a deep slump slowed significantly in the spring.

Oil prices expected for the rest of this year and 2019−20 have risen. Oil prices this year and next are assumed to be fairly close to the price of recent months, i.e. for Brent crude around $75 a barrel (over one third higher than in 2017), and then fall slightly in 2020. Despite anticipated higher oil prices, Russian GDP is expected to grow by less than 2 % in the entire 2018, with growth slowing further to around 1.5 % next year, a level roughly equalling the economy's potential growth rate. The pace of economic growth is limited as there are too few signs of market-friendly systemic reforms needed to foster higher growth. President Putin's inaugural Decree of 7 May listed a range of tasks to the government, to be completed by 2024. They consist of so-called national programmes and projects for improving education, healthcare, roads and major transport corridors, digitalisation and productivity in a targeted group of companies. These projects, obviously aimed e.g. at fostering conditions for higher economic growth, could bring effects depending on their success mainly for the next decade.

Gradual recoveries in private consumption and fixed investment

While household consumption has gradually recovered from a deep slump for nearly two years, consumption levels are still only on par with those of 2012. Inflation this year has no longer eroded household purchasing power by more than around 2.5 % p.a. Corporate sector wages have risen briskly. Government budget sector wages have soared thanks to Putin's inaugural Decree issued over six years ago (7 May 2012) when he instructed substantial wage increases for various employee groups by 2018. Thus, the wage hikes were brought to target quickly in spring. The minimum wage was raised by over 40 % from end-2017 by 1 May. On the other hand, pension payments and other social security payments did not increase, which was the biggest reason for the modest gains in real household incomes. In contrast, household borrowing supported the recovery in consumption.

Consumption is expected to continue growing rather slowly. The increase in the value-added tax from 18 % to 20 % at the start of next year will drive up consumer prices and bite purchasing power. The state plans to raise real pensions quite slowly, especially next year, and has not promised increases for government sector wages in real terms. The gains in corporate sector wages should better reflect productivity gains and also face the fact that the gradual increase in the official retirement age from the start of next year means that slightly fewer wage-earners than earlier expected will be retiring. The rapid growth of household borrowing for consumption is foreseen to slow.

Fixed investment has recovered over the past two-and-a-half years and stands at a level similar to that of 2011. With the peak phases of various large and partly government-led investment projects behind, recovery slowed in the first half of this year. Fixed investment is expected to increase fairly slowly. Given the age and amount of wear on the existing capital base, and as utilization of industrial capacity has risen to peak levels, there are needs for firms to make basic investments. Not only will government budget spending be allocated to national projects listed in president Putin's May Decree of this year, but state-owned and large private firms will also be guided in their investment to the projects. By current estimates, implementation of the projects will likely get underway closer to next summer. It is unclear how much the planned guidance of corporate investment will increase corporate investment overall. Uncertainties in the business environment have increased also due to new foreign sanctions and threats of sanctions. The prospect of at least a slight acceleration in inflation will limit easing of monetary policy.

Higher government spending

Higher government budget revenues have been buoyed this year by both oil & gas tax revenues and increases in other budget revenue streams. Budget spending has also risen, outpacing inflation notably, due especially to the hurried final to implement Putin's wage hike decree from more than six years ago. The state has continued to amass extra oil tax revenues for saving, i.e. additional revenues generated when the oil price exceeds the federal budget rule's computational oil price – the base oil price (about $41/bbl this year). Deficit of the consolidated government budget has vanished.

Government sector spending will rise this year in real terms. In order to implement the national projects covered by Putin's May Decree, spending will rise further next year. On the other hand, the expected pick-up in inflation, which may also be supported by increased budget spending, will depress real spending growth. Added spending will be financed by the VAT hike and by relaxing the federal budget rule (letting the deficit at the above-mentioned base oil price exceed the budget rule's ceiling). The oil price assumed in the budget (just over $60/bbl) and current expenditure plans create a track where the federal budget and the entire consolidated government budget show surpluses in the next few years.

Growth in exports, moderate recovery in imports

Increased exports of grains, primary industrial products and services have accounted for most of the growth in the volume of Russian exports this year. The relatively low real effective (trade-weighted) exchange rate (REER) of the ruble will support a continued good pace of export growth, even if growth is expected to slow on the tame outlook for Russian energy exports and a grain harvest well below last year's record harvest.

The rapid recovery of Russian imports from a deep recessionary slump continued in the earlier months of this year, but slowed sharply in the spring on the ruble's weakness and fairly sluggish recovery in domestic demand. In the first half of this year, the volume of imports grew by about 6 % y-o-y. Against this backdrop, we have slightly lowered our import forecast, particularly for this year. As the ruble's REER is expected to remain quite stable if our forecast for oil prices holds and Russian inflation only picks up rather moderately, we expect the pace of import growth to remain quite steady throughout the forecast period. As forecasted spending on imports will remain substantially smaller than Russia's export revenues, Russia's current account surpluses in the forecast period should be larger than usual.

Considerable external and internal risks

Despite a decline in the Russian economy's sensitivity to oil price changes to some degree, the possibility of larger shifts in oil prices remains a core risk in this forecast. Most of the risks associated with the growth outlook for the global economy are on the downside. If they materialise, it affects Russian economic growth both directly and via lower oil prices. Geopolitical risks as well as other risks associated with international relations, e.g. new unexpected sanctions imposed on Russia, are constant possibilities.

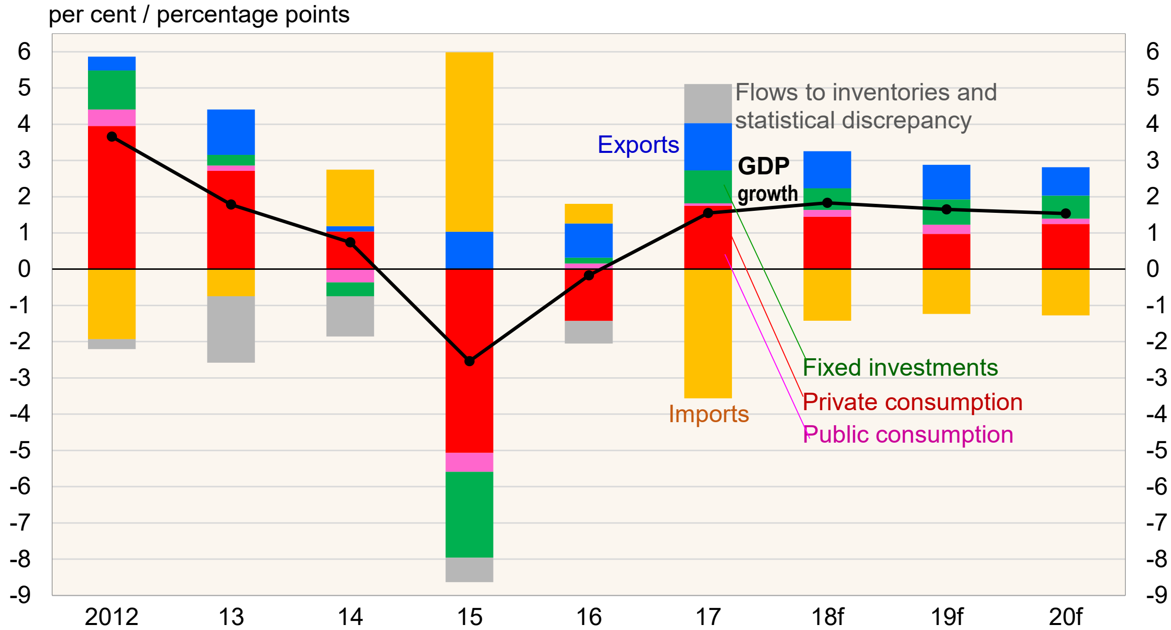
Russian government budget spending increases could drive higher-than-expected domestic output growth during the forecast period. On the other hand, production capital could lead to tighter-than-expected constraints on production growth. In addition, the increased uncertainty in the business environment could have larger-than-anticipated impacts on corporate investment.

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	17.5	**6**	**5**	**5**

Sources: Rosstat, BOFIT.

Russian GDP growth (per cent) and contributions of demand components as well as imports to GDP growth (percentage points), realised and forecast (f)



Sources: Rosstat, BOFIT.