BOFIT Forecast for Russia
3 October 2019

BOFIT Russia Team

BOFIT Forecast
for Russia 2019–2021

Bank of Finland
BOFIT – Institute for Economies in Transition
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Russia’s high growth last year was spurred by transient factors, and growth is expected to subside to lower levels this year. The outlook for global economic growth darkened considerably over the summer and is reflected in the performance of the Russian economy. Growth slowed much more in the first half of this year than we anticipated in our April forecast. For all of 2019, we now expect growth of around 1 % p.a.

Otherwise, our outlook for the Russian economy in coming years is largely unchanged from earlier forecasts. Stagnating real incomes and decelerating growth rates in household borrowing should suppress private consumption growth. Government policies are unlikely to support private investments. In other words, growth in the years ahead will come largely from public consumption and net exports.

Investments stipulated by government’s national projects will lift economic growth slightly, especially in 2020. Growth slows towards 1.5 % p.a. at the end of the forecast period.

Forecast assumptions

The central assumption in our forecast is that Russia continues to pursue prudent economic policies. Thus, macroeconomic stability and pursuit of economic independence remain the keystones of economic policy. To achieve these priorities, the government will aim to keep public finances in surplus and the central bank will continue to focus on inflation targeting. Economic independence implies e.g. continuation of import-substitution policies favouring domestic goods and services and limiting competition from imports.

Our second core assumption has to do with world oil prices. The Bank of Finland does not produce its own oil price forecast, so we use the Brent future price as of the end of September. According to this market assumption, oil prices are expected to decline slightly in coming years, holding at levels slightly below $60 a barrel for most of the forecast period.

We assume no big changes in Russia’s relations with the EU or US, and expect the current sanctions regime to remain in force.

Growth in final consumption increasingly dependent on public spending

Growth in private consumption is likely to remain subdued. Growth this year has already been trimmed by the two-percentage-point hike in the value-added tax at the beginning of the year and slower growth in public sector wages. Over the past two years, private consumption has been supported by a rapid increase in household borrowing. Increasing concerns about excessive household indebtedness have prompted the Central Bank of Russia to apply regulatory measures to stem consumer credit growth. Accordingly, growth of the household credit stock has been slowing since its peak of 24 % y-o-y in April. In August 2019, household credit stock grew by 21 % y-o-y.

The expected mild pickup in economic growth is likely to support higher real wages in the coming years. This will support a slight recovery in private consumption growth. Even
so, the volume of private consumption in 2021, the final year of our forecast period, will still be lower than the 2014 level.

The slow economic growth and burgeoning reserve fund assets (National Welfare Fund) to more than 7% of GDP will exert pressure on the government to boost public spending. However, as we expect fiscal discipline to hold, we anticipate only modest growth in overall public-sector spending.

There are various estimates on the effectiveness of public spending in Russia. For example, an analytical note published by the CBR in 2018 found that the fiscal multiplier effect in Russia was around 0.2–0.3, a very low number by international standards. It implies that an increase of 1% of GDP in public-sector spending would only boost GDP growth by two- to three-tenths of a percentage point over the medium term.

Fixed investment needed

Over the past decade, Russia’s ratio of fixed investment to GDP has remained at around 21%. While comparable to the euro area, this level is well below that needed by an emerging economy to sustain the high growth and to catch up with more advanced economies. The need to boost investment and productivity, particularly since 2012, has figured prominently in presidential decrees and various sector-specific development plans. In recent years, the government has sought to attract investment by providing subsidies for domestic producers, increasing domestic-content requirements and strong-arming large firms to participate in the financing of national projects. At best, these efforts have produced only a minor positive effect on private investment.

No launches of major new projects in the energy sector are planned for the near future. All major pipeline projects are approaching completion, although the Power of Siberia gas pipeline, which runs from Eastern Siberia to China, will still boost investment figures this year. Most of the construction work on the gas liquefaction facilities and ports on the Yamal peninsula (Yamal LNG) was booked already in 2018. Several major liquefied natural gas projects are under consideration, but none is likely to break ground during the forecast period.

Fixed investment growth will rely increasingly on public sector activities. The national projects outlined in President Putin’s May 2018 decree called for significant public investment. The implementation of these national projects should support fixed investment growth in the coming years. Public investment should focus especially on road construction, education and health care, all areas indisputably in need of modernisation and upgrade.

Russia’s domestic business environment continues to be plagued by uncertainty and several structural challenges. Additionally, sanctions continue to restrict Russian firms’ access to international financial markets, which raises also the costs of domestic financing. Thus, acceleration in investment growth is likely to be short-lived.
Net exports support higher growth

The exceptionally high growth in the volume of exports in recent years has bolstered growth of the Russian economy as a whole. The volume of exports rose by 3% in 2016 and by 5% per year in 2017–2018. Much of this growth came from increased export volumes of natural gas and grains.

The pace of growth was expected to slow, but somewhat unexpectedly, export volumes in many key branches contracted in the first half of 2019. At least part of the decline in export volumes can be attributed to last year’s meagre grain harvest, the voluntary crude oil production quota agreement with OPEC+ countries and the contamination and interruption of operations of the Druzhba oil export pipeline in spring 2019. We now forecast export growth to slow significantly this year.

The trends in coming years will depend on both the opening of new export routes and fluctuations in global demand. With the new natural gas liquefaction plants and shipping terminals on the Yamal peninsula coming on stream, LNG exports will rise sharply this year and thereafter plateau. The Power of Siberia natural gas pipeline to China will begin transmission next year, potentially boosting Russia’s pipeline gas exports in 2020–2021. The launch of the Turk Stream gas pipeline, which will run from the Krasnodar region along the bottom of the Black Sea to the Thrace coast of Turkey, could slightly increase pipeline gas exports in coming years. Rapid export growth for some metal producers and fabricators could provide a positive surprise, but exports overall are expected to grow at approximately 2% y-o-y in the medium term.

With the slowing in domestic demand, import growth this year is expected to remain near zero. We expect imports to recover in 2021–2022, especially on rising fixed investment demand. Import substitution policies and rising domestic-origin requirements will curb growth in imports, but also reduce opportunities to take advantage of best globally available technologies and support services. Net exports in the forecast period will remain positive, but the impact on GDP growth will be small.

The impacts of sanctions on Russian economic growth

Evaluation of the impacts of the first round of sanctions imposed on Russia by the EU and US in 2014 is challenging as their imposition coincided with the global collapse in oil prices and Russia’s shift to a floating exchange rate. Moreover, Russian economic growth began to slow already in 2012. With the sanctions regime now in force for over five years, a reasonable quantity of statistical data is available for assessing their efficacy. Our recent BOFIT Policy Brief 2/2019 provides a concise survey of research on this topic.

Studies surveyed in the Policy Brief note that economic sanctions targeting financial markets have had the most widespread effects on the Russian economy. These measures are largely responsible for the roughly 25% contraction in Russia’s foreign debt between 2014 and 2018. Several studies conclude that foreign debt deleveraging, higher debt-servicing costs and uncertainty from sanctions have decreased GDP growth rates by about 0.1–0.2 percentage points annually. The economic effect of sanctions has clearly been negative.
Table 1. On-year change in GDP volume, 2017–2018 and BOFIT forecast for 2019–2021, %

<table>
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<th>2017*</th>
<th>2018**</th>
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<th>2020</th>
<th>2021</th>
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<td>1.8</td>
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<td>Final consumption expenditure</td>
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<td>Private consumption</td>
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<td>Public consumption</td>
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<td>Fixed capital formation</td>
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Note: * Rosstat third-round estimate (released 2 April 2019), ** Rosstat second-round estimate (released 2 April 2019).

Risks

Our baseline scenario assumes that the Russian government holds to current fiscal policies, i.e. it adheres to its fiscal rule and largely refrains from using assets from the National Welfare Fund on domestic projects. If economic growth is weaker than expected, however, political pressure to boost public-sector spending and investment is likely to increase, especially ahead of the Duma elections in autumn 2021. Increases in public spending will not, however, result in significant or long-term acceleration in economic growth.

Given the Russian economy’s reliance of primary commodities, fluctuations in raw material prices on world markets always pose large risks. Even if the Russian economy is somewhat less dependent than earlier on oil prices, any significant moves in the export oil price has huge implications for short-term growth. A sharp increase or decrease in the price of oil is reflected immediately in the ruble’s exchange rate and quickly feeds through to financial markets, funding costs and net exports.

There is also a risk of heightened geopolitical tensions. Western sanctions have had a distinctly negative impact on Russia, particularly with respect to financial markets and the subsequent dampening of economic growth. Further sanctions (or even the threat of another round of sanctions) would fuel uncertainty and weaken the investment outlook, potentially having a negative impact on the growth outlook. On the plus side, a new round of sanctions or threat of sanctions would weaken the ruble and thereby increase federal budget revenues and slow import growth.

1 We provide regularly updated Russian economic data in the “Russia statistics” section of our website: https://www.bofit.fi/en/monitoring/statistics/russia-statistics/