BOFIT Forecast for Russia
14 March 2013

BOFIT Russia Team

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The Russian economy grew 3.4 % last year. Growth slowed considerably in the second half of 2012 with GDP growth dipping below 3 % after growing at a 4.5 % pace in the first half. Russian imports grew rapidly until the end of the year, and were up nearly 9 % for 2012 overall. Our forecast sees GDP rising 3.4 % this year and next. Growth will slow in 2015 if, as we expect, the oil price does not rise. Import growth will subside this year and next to around 5 % a year, and then pick up a bit in 2015. Growth in private consumption, though brisk, will be slightly slowing. The volume of Russian exports will increase modestly due to weak development of energy exports. Fixed investment growth should pick up gradually, but investments are still subject to substantial uncertainty both domestically and in international markets.

Economic growth set to continue, but at lower rates

Russian economic growth slowed significantly in the second half of 2012. While part of the slowdown can be attributed to last year's poor harvests, growth of the rest of the economy slowed to just over 3 % in the second half. Growth in private consumption slowed as the year wore on, but was still quite brisk. Private consumption was supported by large public sector wage hikes in the second half as well. Public consumption (public procurement of goods and services) was flat. Exports recovered as Russia boosted exports of refined petroleum products, but growth overall was slow. Revival of fixed capital investments continued, albeit at a slowing pace; investments surpassed the pre-crisis level of 2008. Import growth picked up still in the autumn, but moderated in the final months of the year.

Weakening of the ruble's external value increased the ruble-denominated earnings of the export sector providing some prop to the economy. On the other hand, the substantial net outflow of private capital from Russia continued all last year and firms wound down borrowing from domestic banks. Public sector finances, in contrast, were supporting economic growth. The consolidated state budget surplus declined quite notably for the first time since the 2009 financial crisis on a brisk rise in budget spending. The social tax contributions imposed on employers were reduced at the start of 2012 to 30 % of the employee's wage.

We expect GDP to grow 3.4 % this year. The growth rate reflects our assumption that the oil price should gradually decline by about 15 % over the forecast period. GDP growth is expected, however, to pick up slightly in the course of this year as economies in Europe and elsewhere begin to recover. In the light of Russia's budget framework, growth is still supported by state spending, even if the support is less than last year and the consolidated budget balance is expected to turn into a smaller deficit than anticipated in last summer's budget frame. Despite the anticipated slow decline in oil prices, GDP growth should remain at about the same level next year as growth will be propped by recoveries in the world economy and global trade. The expected drop in oil prices and the pick-up in imports in 2015 should drive GDP growth to near 3 %.

Russia's WTO membership, which finally became reality in August 2012, will ultimately add to economic growth. Even so, the effects in our mid-term forecast period are modest. Economic reforms have proceeded slowly for several years now and no additional growth impact is expected to come from the reform front during the forecast period. Given Russia's weak international rankings as a place to do business, president Putin has given impetus to measures to better the business climate in Russia. The "roadmaps to reform" that have been worked out include over 20 areas for improvement. These will most likely result in various reform measures, but many observers expect implementation by the multiple agencies and authorities affected to take time.

Decent consumption growth; slack export growth

Consumer sentiment remains relatively high. Growth in private consumption is expected to remain fairly brisk, even with a slight slowdown. Unemployment has fallen to a record low (5.5 % of the labour force), and it is challenging to further increase employment. This constrains the economy's wage sum but also stimulates wage increases in the private sector. On the other hand, and similar to what has been seen over the past two years, tighter profitability of companies generates pressure to hold real wage increases approximately in line with the rise of productivity.

The rapid rise in public sector wages in conjunction with last year's presidential election should slow, but still exceed the pace of wage hikes in the private sector. Pensions are scheduled to keep up with inflation and GDP growth. Inflation should slow gradually from the current level of over 7 %, which should help slightly bolster purchasing power. Factors that maintain the pace of inflation include the decision of authorities to proceed with hikes in retail-level rates for energy at a faster pace than earlier.

The sharp increase in household borrowing has plateaued and saving has increased. The slowdown in growth of household borrowing is partly due to the situation where consumer credit debt held by households, rather than mortgages, has risen to levels found in many European countries (in relation to income levels). The short repayment times for consumer loans and the steep interest rate charges have begun to siphon off tangible shares of household income.

Under a new budget rule, growth in public sector spending (currently 37 % of GDP) will be tied to the oil price over several previous years. Growth in spending (estimated at 10 % p.a. in nominal terms in Russia's budget frame) will mostly support private consumption. As earlier, increases in public consumption spending will probably be largely eaten by rapid inflation which in this segment reached 15 % y-o-y in 2011–2012 (public consumption is about a fifth of Russian GDP).

Export growth is expected to remain quite low in light of the weak outlook for Russian energy exports. Crude oil exports are expected to rise in the forecast period only slightly as output levels remain essentially flat. Exports of petroleum products should decline despite increased production as an increasing share of refinery products goes to meeting domestic demand. Growth in natural gas exports this year should recover from last year's dip, but grow at only about 1 % a year in 2014 and 2015 with the appearance on the world market of substantial supplies of shale gas and liquefied natural gas (LNG). Exports of non-energy goods and services (which account for nearly 40 % of export earnings from goods and services) should take up some of the slack.

Fixed capital investment growth is expected to revive gradually during the forecast period. The usage of production capacity is nearly the same as during the pre-crisis boom years, so further production growth will require new capacity. Moreover, the degree of capital being outdated has increased since the recession. Industrial firms have had rather gloomy outlooks about their investment plans in recent months in light of uncertainty and perceived risks. Construction companies, on the other hand, are somewhat more positive. The situation for fixed investments overall should improve bit by bit as uncertainty in the global economy and global trade abates. Reforms aimed at improving the investment climate in Russia are currently focused on such issues as streamlining burdensome and costly building permit processes.

Import growth settles at moderate rates

Russia's propensity to import was already high since the early 2000s until the 2009 recession, but in the post-crisis years of 2010 and 2011, imports have roared back even much faster. Growth in imports is expected to remain reasonable this year and in 2014, rising at about 5 % a year. Imports equal more than a fifth of GDP, the same as at their peak in 2008, which may limit Russian import growth. On the other hand, the ruble's real exchange rate appreciation since the 2009 recession is anticipated to start increasing the rate of import growth towards the end of the forecast period. The impact of Russia's WTO accession should also begin to support imports.

The ruble's real effective exchange rate could still appreciate a bit as Russian inflation has climbed well above the inflation rates of its trading partners. Appreciation pressure on the ruble's nominal effective exchange rate caused by the current account surplus should diminish as Russia's current account surplus shrinks. Nevertheless, the nominal exchange rate is subject to considerable uncertainty, and could gain if recovery of the global economy causes a substantial shift in private capital flows in Russia's favour.

Downside and upside risks

Events elsewhere in the world naturally bear on our projections for the Russian economy. The price of oil could slide faster or stay higher than our assumptions. Russian export volumes are also dependent on global upside and downside risks. Exports of basic non-energy commodities could react more than perceived even if the global recovery is on track with the forecast.

Private consumption growth will exceed the forecast if the current policy of hiking wages in select parts of the public sector spreads more widely to the public sector. Negative inflation surprises domestically or from abroad, especially with regard to food prices, would hurt household purchasing power. Moreover, the willingness of Russian households to take on more debt in the midst of uncertainty is difficult to predict.

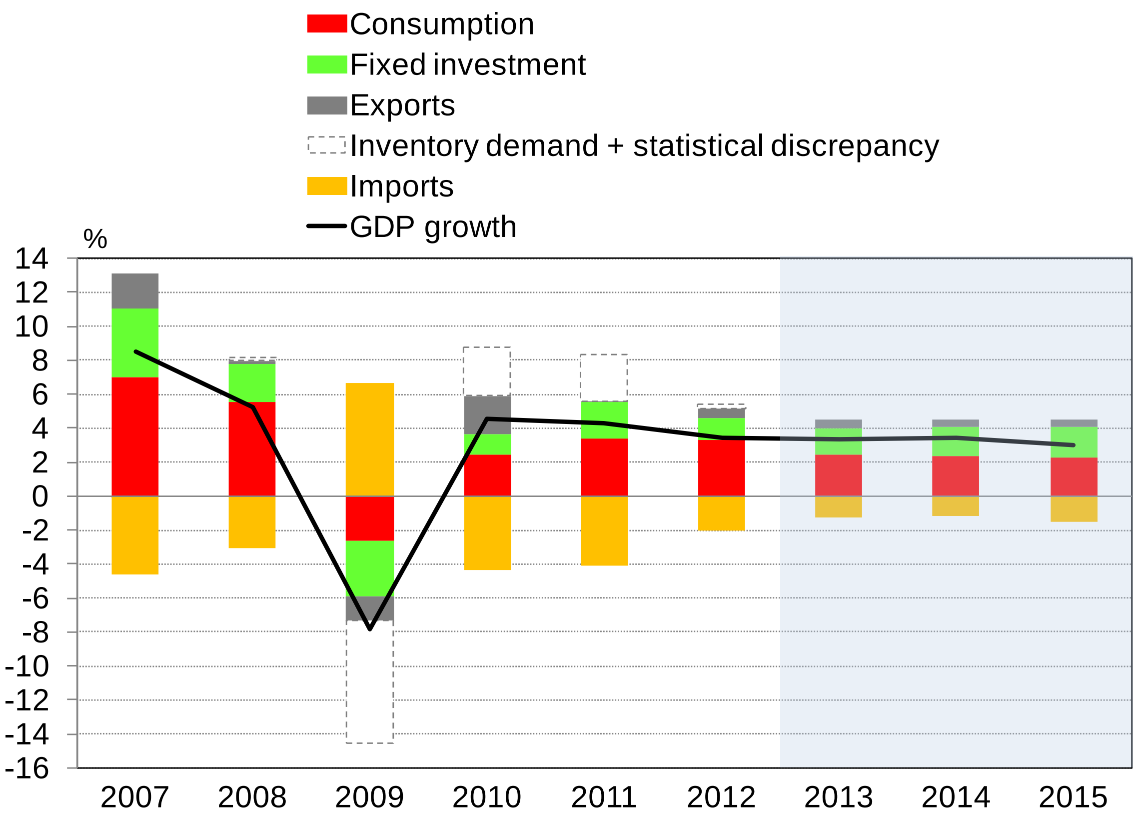
Growth in imports could exceed our forecast if the demand emphasis shifts more towards imported goods as domestic inflation is continuously higher than the rise of import prices. Realisation of the consumption-related risks would also impact the pace of import growth.

Growth of Russian GDP and import volume (%)

	2008	2009	2010	2011	2012	2013f	2014f	2015f
GDP	5.2	-7.8	4.5	4.3	3.4	3.4	3.4	3.0
Imports	15	-30	26	20	9	5	5	6

Sources: Rosstat, BOFIT Forecast for Russia 2013–2015 (f = forecast)

Russian GDP growth (%) and the shares of demand components and imports in GDP growth (percentage points)



Sources: Rosstat, BOFIT Forecast for Russia 2013–2015