# Russia’s economy and imports to contract further

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In the wake of a second export price shock late last year, the Bank of Finland now expects Russian GDP to contract 3% in 2016. Our new forecast assumes the price of oil averages slightly over $40 a barrel this year, about 60% below the 2014 average. With the economy shrinking and depressed export earnings, Russian imports should fall another 10% this year.

Following the collapse in oil prices in 2014, Russia’s domestic demand last year fell by about 10%, while gross domestic product contracted 3.7%. Oil prices fell again in the second half of 2015. Russian imports slumped by 30% in 2014–2015.

With relatively high inflation eating away at purchasing power, we see domestic demand shrinking substantially in 2016, including a reduction in government spending in real terms.

While a gradual rise in oil prices will bring economic respite and revive imports in 2018, economic growth remains low due to uncertainties and Russia’s poor business environment. The central risks in the forecast involve oil prices and changes in imports.

## Domestic demand and imports hit hard last year

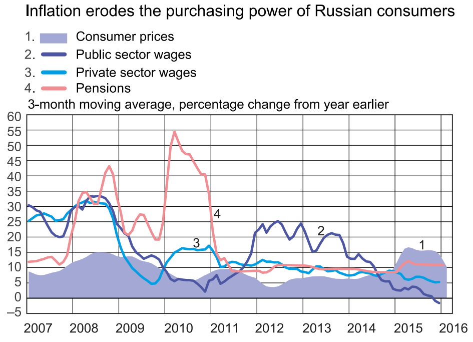
Besides dealing with the existing burdens of systemic deficiencies and uncertainties, the Russian economy had to start digesting a major export price shock in the second half of 2014. The price of oil was halved, dragging down export prices of oil products and natural gas along with it. Russian export prices in 2015 declined about 30% y-o-y in dollar terms and 20% in euro terms. Due largely to these events, the ruble fell sharply. While the ruble’s decline cushioned the impact of the oil price shock, it stoked inflation in winter 2014–2015 to its highest pace since 1999, lifting average prices last year to a level 15–16% higher than in 2014. High inflation eroded purchasing power in both the private and public sectors.

Domestic demand fell in every category last year (and there have yet to emerge any clear signals this year that the contraction is ending). Besides high inflation, Russians saw a tame rise in private sector wages, while public sector wage growth ceased due to wage restrictions and wage freezes. Real household incomes declined (Chart 1). Meagre wage growth combined with a sharp rise in household savings to drive down private consumption by 10% last year, a markedly steeper decline than during the 2009 recession.

Public consumption shrank 2% last year, while fixed investment slumped nearly 8% (even if growth in investment in oil & gas production remained strong). As in the 2009 recession, inventories fell considerably. Among the main categories of demand, only export volumes increased in 2015 as exports of oil and oil products defied expectations and rose significantly. Gas exports also began a sharp recovery last summer.

Russian GDP contracted 3.7% last year. However, oil sector exports and growth of defence spending (which soared to nearly 30% in nominal rubles and some 10–15% in real terms) supported domestic production. High growth in government spending faded over the course of the year, and spending in real terms was down substantially for the year as a whole.

The 25% drop in imports last year (down 6% in 2014) was exceptionally steep relative to the economic contraction overall. The fall in imports mainly reflected the ruble's collapse in winter 2014–2015. Ruble depreciation was significantly larger than in the 2009 recession (the ruble's average nominal exchange rate in 2015 was about 25% lower than in 2014, while the real exchange rate was down about 15% against the euro and the Central Bank of Russia's trade-weighted currency basket). Falling export prices severely cut into Russia's export earnings (down 20% in euro terms). Outflows of private capital were substantially larger than capital flows into Russia, even if the difference narrowed considerably from 2014.



Sources: Rosstat and Bank of Finland (BOFIT).
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Chart 1

## Further contraction in economy and imports this year

Growth in world trade will improve during the 2016–2018 forecast period. We assume no change in geopolitical tensions related to Russia's actions involving Ukraine, the consequent foreign sanctions, Russian counter-sanctions and other concrete restrictions on market function, as well as the resulting uncertainty they generate and other uncertainties specific to the Russian economy.

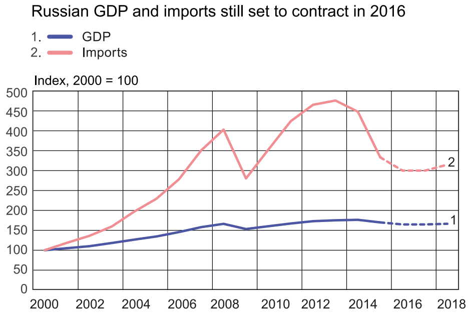
The oil price is the most significant factor by far in our forecast – especially this year. In our September 2015 forecast, we noted that the impact on the Russian economy from the large drop in the oil price in the second half of 2014 would extend beyond a year (the assumed 2015 average price was $54 a barrel, or 45 % below the 2014 average). With that oil price assumption, our forecast was that GDP would diminish 2% in 2016, which was based on the results generated by BOFIT's Russia model.[1] The oil price fell again in the second half of 2015, and, as in our previous forecast, our assumption is that the oil price will rise only gradually during the forecast period. Thus, we now assume the oil price this year to average just over $40 a barrel (or 23% below the 2015 average and nearly 60% below the 2014 price) and $49 a barrel in 2018.

Applying this revised assumption, the forecast GDP contraction becomes slightly more severe in 2016 (around 3%) and GDP growth is essentially zero in 2017 (Chart 2). Thereafter, as the impact of the drop in the oil price fades and the price gradually rises, the economy recovers, albeit slowly due to uncertainties and Russia's weak business environment. If our forecast and various estimates for Russia's long-term GDP growth (1–1.5% a year) materialise, Russian GDP in 2020 would be about 3% less than in 2014.

With a contracting economy and falling export earnings, Russia's imports are projected to decline about 10% this year and return to slight growth towards the end of the forecast period. Imports this year would be 37% below their 2013 level and several per cent above their level during the 2009 recession.

The volume of Russian exports is expected to increase slowly during the forecast period. Domestic demand should fall significantly in 2016, both with regards to private consumption, public consumption, fixed investment and inventories. For this year at least, government spending is set to contract substantially in real terms.

[1] Jouko Rautava: Oil Prices, Excess Uncertainty and Trend Growth.



Sources: Rosstat and Bank of Finland (BOFIT).
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Chart 2

## Inflation and weakened government finances reduce demand

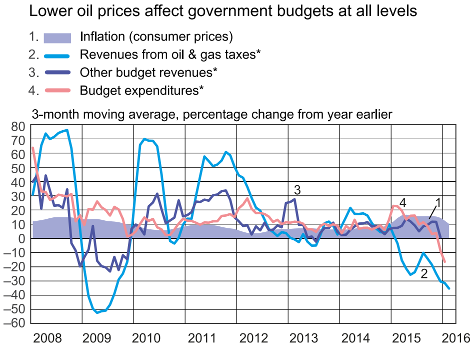
Given higher inflation projections for 2016 (consumer price inflation raised to around 8%), the erosion of purchasing power will be slightly more severe than in our earlier forecast. Moreover, the economic contraction hurts corporate profitability and reduces the ability of companies to raise wages. Freezes and other restrictions on public sector wages will remain in place. Russia’s leaders have even lowered the slated 2016 pension increase to 4% – with no increase for working pensioners (official figures estimate working pensioners represent over 35% of Russia’s roughly 40 million pensioners).

The decline in employment will be reflected as increases in unemployment and/or underemployment. Households are not expected to change their emphasis from saving to borrowing any time soon.

Government spending this year will fall substantially in real terms. Because lower oil prices reduce revenues in real terms, Russia’s leaders are considering further spending reductions (Chart 3). New cuts would further depress public consumption.

Given that key experts predict growth in oil sector export volumes will plateau this year and then start to decline, any increase in Russian total export volume will likely be quite modest. A recovery in exports outside the oil & gas sector from last year’s dip should partly shore up the situation.

Fixed investment should continue to decrease due to idle capacity, falling demand and uncertainty clouding corporate planning. The government also will have less money for investment. Inventories, which traditionally contract sharply in Russia during a recession, should continue to shrink.



* Consolidated government budget (includes federal, regional and municipal budgets plus state social funds)
Sources: Russian Ministry of Finance and Rosstat.
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Chart 3

## Tensions persist for imports

Along with economic contraction per se, a sensitive chain of other effects powerfully influences the outlook for imports. The oil price, Russian export earnings and capital flows in and out of Russia all affect the ruble's exchange rate. The ruble's exchange rate, in turn, affects imports directly and indirectly via inflation and domestic demand.

While imports will still decline this year, economic recovery will gradually set the stage for higher imports. A moderate rise in the oil price increases Russia's export earnings, creating space for import growth. International financial sanctions will limit the rise in imports, however. Import growth is also limited by the ratio of imports to GDP, which last year (despite dramatically lower import volumes) was the highest since 2003 as the value of imports in ruble terms has risen faster than GDP. The ruble's real exchange rate will appreciate gradually as inflation remains higher in Russia than in countries supplying goods and services to Russia (the inflation gap between Russia and its main trading partners was 6% in the first two months of this year).

## Little room to manoeuver in economic policy

Banks amassed considerable household and corporate deposits last year, while the amount banks owe to the central bank fell substantially. Banks directed their lending in roughly equal measure on financing the public and corporate sectors. Lending to corporations actually diminished significantly from 2014.

Firms have cut back their investment plans and increasingly finance investments out of pocket. The impact of monetary policy on corporate borrowing remains unclear. Although 12-month inflation moderated this winter from 15% to 8%, the central bank has kept its benchmark "key rate" unchanged at 11% since August.

The government faces increasingly tighter fiscal constraints. With revenues essentially unchanged last year in nominal ruble terms (including a 20% drop in oil & gas tax revenues), real revenues were down substantially. The government deficit increased to over 3.5% of GDP, even if spending also fell in real terms. The budget outlook for this year is nearly as austere as last year if our oil price assumption and GDP projection hold. Based on the finance ministry's latest spending estimate, the deficit should increase to nearly 4% of GDP this year.

The government is attempting to raise revenues through a variety of measures that include hikes in minor taxes and dividends of state enterprises, as well as selling off stakes in state firms. Higher taxation of oil companies has also been under consideration. Russia's leaders have reduced targets for government spending (which notably exclude social spending, the biggest spending category by far). Their decisions are expected before summer. The fiscal outlook for 2017 is somewhat better – even if there is still a slight deficit if nominal government spending remains unchanged from this year. There is little room, however, for real stimulus in the public sphere during the forecast period.

The government will likely not need to exhaust the Reserve Fund this year to cover the deficit. In the worst-case scenario, it has been suggested that unallocated National Welfare Fund assets could be used to cover part of the deficit (some National Welfare Fund assets have already been allocated or distributed for bank subsidies and loans granted to investment projects and corporations). With these financing options available, the government might avoid the need to borrow.

## Forecast risks remain substantial

The oil price remains an important risk factor in our forecast. Deviations from the assumed price track will naturally impact economic growth, the ruble's exchange rate, inflation and imports.

Shifts in geopolitical tensions could also occur, either positive with rather slow effects or negative with more rapid impact. There is also the risk from unexpected events that could cause capital outflows from Russia to surge, thereby depressing the ruble and imports.

If households make a turnaround from last year's savings binge, private consumption already this year would start to outperform the forecast. Despite the government's declared reduction targets, supplemental budget spending is not out of the question with the approach of Duma elections in September 2016 and the presidential election in March 2018. Such spending would boost the economy temporarily but would eventually require greater budget cuts to deal with the country's fiscal adjustment needs.

### Tags

forecast, Russia, BOFIT