RUSSIAN FEDERATION: From stagnation to recession and back

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Russia was in the direst straits even before the Ukraine crisis erupted on a grand scale. Current sanctions have deterred investments still further, instigated capital flight and boosted inflation. The oil price slump and the related collapse of the rouble have inflicted additional pain. Assuming that the sanctions and oil prices remain at their current levels, the wiiw baseline scenario reckons with a 4% drop in GDP in 2015, followed by weak recovery resulting from a gradual revival in government-sponsored investment.

Russian economic growth stayed just above zero in 2014. This reflects a modest expansion of industrial production (1.7%) and agricultural output (3%) and a drop in construction (-5%). Household consumption grew by less than 2% and real wages even declined owing to accelerated inflation. Fixed capital investment dropped by 2.5%, already reflecting the increased risks owing to heightened geopolitical tensions. The growth contribution of real net exports remained positive with imports declining more than exports, not least due to sluggish domestic demand, sanctions and the weakened rouble. In nominal terms, both the trade and current account surpluses widened, the latter exceeding 3% of GDP, while net capital outflows surged above EUR 100 billion. FDI inflows and foreign exchange reserves dropped; the rouble exchange rate sharply depreciated in line with falling oil prices towards the end of the year.[1]

In these circumstances – and with the dramatically changed geopolitical situation – the long overdue 'new growth model' has become even more urgent. Lasting vulnerabilities owing to the excessive reliance on energy export revenues (still 65% of goods exports in 2014 yet only 60% in the last quarter of that year) came once more out in the open. Exports dropped by more than 5% in nominal USD terms while imports declined by 10% in 2014. The trade turnover with the EU contracted by 8%, in particular with Finland, Poland, France, Spain, Slovakia and the United Kingdom. Trade with Ukraine was cut by nearly 30% and many important technological linkages, not only in defence-related sectors, seem to be irreparably broken. In this situation of elevated risks and generally worsened conditions of external trade and financing, which are unlikely to change soon, the already existing broadly acknowledged obstacles to investments – the poor investment climate and reform stalemate – will be extremely difficult to overcome. The repeatedly underlined necessity to improve the institutional, administrative and infrastructure prerequisites for investments in order to support growth, to restructure, modernise and diversify the economy has become more challenging under the changed geopolitical climate with spiralling sanctions and recently also reduced energy export revenues.

[1] Early 2015, all three major rating agencies subsequently downgraded Russia's credit rating. The loss of the investment grade by S&P is probably justified, while Moody's downgrade from 20 February to Ba1, mentioning endangered servicing of sovereign debt, is not. As of September 2014, the total external debt to GDP ratio amounted to 33%, debt service to GDP just to 8%. At the beginning of 2015, total external debt dropped below USD 600 billion (of which USD 171 billion were owed by banks and USD 376 billion by other sectors). Government debt (including the Central Bank) amounted to just USD 52 billion. Total debt service due in 2015 amounts to some USD 130 billion according to the Central Bank of Russia.

Facing the acute prospect of a severe economic recession, the government rushed to work out urgent 'anti-crisis measures'.[2] The current plan is to spend immediately up to RUB 2400 billion (3.3% of GDP or more than EUR 30 billion) on a bank recapitalisation scheme, on financing import substitution programmes, inflation-adjusted indexation of pensions and family welfare benefits, on agricultural and interest rate subsidies, credit guarantees, etc. About half of the envisaged spending will be used for supporting the banks (RUB 1000 billion); the recapitalisation will be financed from last year's budget revenues which were originally assigned to the Deposit Insurance Agency. Additional budget expenditure will thus amount to just RUB 300 billion, another RUB 550 billion will be withdrawn from the National Welfare Fund, and RUB 160 billion will be raised by the issue of new government bonds. The revised government budget for 2015 will reckon with cutting most expenditures by 10% (except defence outlays, social benefits, agricultural subsidies and meeting international obligations), thus saving about RUB 2000 billion. In the medium run, annual government spending should be cut by at least 5% in real terms in order to balance the budget by 2017 given the expected lower (energy) export revenues.

Apart from spending cuts, the government reiterates once more the necessity to launch structural reforms in order to diversify the economy and stimulate economic growth in the medium run (this mantra has been repeated for years, so far without any apparent results). The current plan mentions again conditions for the growth of private investments (including improvements in the doing business climate), using industrial policy instruments for import substitution, export support and SME development schemes, attracting 'substantial amounts' of FDI, promotion of innovation developments, etc. There is an (incomplete) list of some 200 strategic enterprises that will enjoy government support (companies with foreign participation may face obstacles in receiving support). Besides, several huge investment projects will receive financing totalling RUB 500 billion from the National Welfare Fund (e.g. construction of the Yamal LNG plant, the third Moscow Ring Road, modernisation of the BAM and Transsib railways, preparations for the 2018 Football World Cup, a Space Launch Centre and, last but not least, the construction of the Kerch Bridge to Crimea). A number of additional individual measures and their financing should be specified in the coming weeks.

Obviously, the official expectation is that both low energy prices and a 'difficult geopolitical environment' are here to stay for some time. Under these assumptions, both the government and the Central Bank of Russia elaborated several scenarios of economic growth, depending on the expected oil price developments and sanctions regime. More optimistic assumptions (regarding oil prices) currently appear less likely and the respective forecast scenarios worked out last year are already obsolete.[3] Neither is the oil price expected to return to its previous level (USD 98/bbl on average in 2014) nor will sanctions be rapidly abolished (although the latter factor impacts GDP forecasts much less).

All these factors require another substantial downward revision of the GDP growth forecasts.[4] Household consumption (which used to be the main engine of growth until recently) is expected to shrink in real terms owing to the spike of inflation. Also government consumption will drop owing to necessary

[2] See RF Government decree No 98 from 27 January 2015 (www.kommersant.ru/Doc/2655295). Already last year the government intended to tap resources accumulated in the National Welfare Fund (at that time RUB 3100 billion or nearly 5% of GDP) in order to compensate effects of Western financial sanctions – see *Vedomosti*, 15 September 2014.

[3] For example, the CBR reckoned in its 'baseline scenario' from November 2014 with an oil price of USD 95/bbl by mid-2015 and sanctions lasting until end-2017. GDP growth would be positive in 2015 unless the oil price drops below USD 90/bbl (www.cbr.ru from 11 November 2014).

[4] In October 2014 wiiw still expected GDP growth close to 2% in both 2015 and 2016.This corresponded more or less to the baseline scenario published at that time by the Central Bank of Russia (see http://www.cbr.ru, 12 September 2014).

spending cuts. Despite the announced additional financing, gross fixed investments are expected to drop sharply in 2015 as the necessary project preparations will take time. Moreover, we doubt the efficiency of state-sponsored industrial policies and stay generally sceptical towards re-launched reform declarations. We are especially sceptical with respect to the success of 'new' FDI, austerity, import substitution and innovation strategies and believe that without (now apparently abandoned or at least much more difficult) cooperation and integration with the EU economic growth will remain more or less flat in the foreseeable future. An inward-looking development strategy, even under the working assumption that the current financial and trade sanctions will be eventually lifted, will hardly yield the envisaged modernisation results (admittedly, low energy prices over a sustained long period might support the necessary reform pressure on economic diversification). Furthermore, the contribution of net exports to GDP growth is expected to become negative again (as has been the case already for nearly a decade with the exception of the crisis years 2009 and 2014). Given the prospects for stagnating (real) exports in the medium run, and assuming only a one-off downward adjustment of imports in 2014/2015, the present sizeable trade and current account surpluses may eventually diminish.

Weaker economic growth notwithstanding, the labour market remains strained with employment nearly flat and unemployment declining (the LFS rate of unemployment was just 5% in 2014). Sectoral and regional labour market shortages persist (e.g. in retail trade and construction), especially in big cities such as Moscow and St. Petersburg, but so do also huge efficiency reserves. The shadow side of the tight labour market – sizeable employment of migrant (both legal and illegal) workers and the related social, political, nationalist tensions with even racist sentiments – are posing a number of difficult challenges to the authorities. According to some estimates there have been more than 10 million migrant workers in Russia, the majority of them from the former Soviet republics.[5] The new challenge – though probably less complicated owing to cultural similarity – will be the labour market integration of (mostly qualified) Russian-speaking Ukrainian refugees who may ease the labour market shortages and replace some migrant workers from Central Asia.

Apart from the sharply worsened investment climate, it has been the missing progress in diversification and modernisation that has been the main obstacle to a revival of economic growth. The conflict over Ukraine (which may be frozen with a ceasefire but not fully resolved) and ever more assertive domestic and external policies represent an even more serious modernisation bottleneck. Nevertheless, and despite rising tensions, Russia succeeded as planned in launching the Eurasian Economic Union (EEU) on the basis of the Customs Union with Belarus and Kazakhstan in January 2015. Besides the free trade area in goods (with some important exceptions such as energy), the agreement envisages also the free movement of labour, capital and services among participating countries (Armenia already joined the EEU in January 2015 and Kyrgyzstan is expected to join in mid-2015 as well). In theory, coordinated economic policies among EEU members will use 'Maastricht-like' indicators such as limits on budget deficit, government debt, inflation and interest rates. Needless to say, Russian policies towards Ukraine and the unilateral (without consent of other EEU partners) imposition of import restrictions elevated the conflict potential in EEU integration. The current recession affecting all EEU member states and trade disruptions due to unilateral Russian actions have not been instrumental to the smooth functioning of the EEU either.

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5 According to latest reports, migrant workers (and their remittances) started to decline owing to less attractive conditions (a combination of additional bureaucratic obstacles and rouble depreciation).

Summing up, Russia is currently facing a recession (GDP will drop by about 4% in 2015) and prospects for sustainable recovery have markedly deteriorated. Apart from lasting Western sanctions – which result in a sharply deteriorating investment climate, higher risks and capital outflows – it is especially the collapse of the oil price and accelerated rouble depreciation which cause the most economic damage. Even barring a further escalation of the conflict, modernisation ambitions will doubtlessly suffer also in the medium and long run due to lower FDI inflows and reduced imports of advanced technologies – despite efforts to mobilise additional domestic resources. Initial hopes that more serious damage to relations with the EU and other neighbours of Russia could be avoided have not materialised so far. Still, the resolution of the conflict at the negotiation table – where topics may include the implementation of the EU's Association Agreements with Georgia, Moldova, and Ukraine, as well as the cooperation between the EEA and the EU – remains preferable to further escalation.[6] In any case, the serious and probably lasting damage to Russian external relations with Ukraine and the West will be very difficult to repair, hindering the future development of the post-Soviet space.

6 The full implementation of the AA/DCFTA between the EU and Ukraine was delayed until end-2015 according to the trilateral agreement between Russia, Ukraine and the EU from 16 September – see http://europa.eu/rapid/press-release_STATEMENT-14-280_en.htm.

Table 1 / Russia: Selected Economic Indicators

	2010	2011	2012	2013	2014 [1]	2015	2016	2017
							Forecast	
Population, th pers., average [2]	142,861	142,961	143,202	143,507	144,000	144,000	144,000	144,000
Gross domestic product, RUB bn, nom.	46,309	55,967	62,147	66,194	70,976	77,500	82,800	89,300
annual change in % (real)	4.5	4.3	3.4	1.3	0.6	-3.9	1.9	2.0
GDP/capita (EUR at exchange rate)	8,000	9,600	10,900	10,900	9,800	.	.	.
GDP/capita (EUR at PPP)	15,600	17,000	18,400	18,800	18,700	.	.	.
Consumption of households, RUB bn, nom.	23,618	27,193	31,019	34,672	38,099	.	.	.
annual change in % (real)	5.5	6.8	7.8	5.0	1.9	-6.0	2.0	2.5
Gross fixed capital form., RUB bn, nom.	10,014	11,950	13,639	14,487	14,690	.	.	.
annual change in % (real)	5.9	9.1	6.6	1.4	-2.5	-10.0	5.0	3.0
Gross industrial production [3]								
annual change in % (real)	7.3	5.0	3.4	0.4	1.7	1.0	3.0	3.0
Gross agricultural production								
annual change in % (real)	-11.3	23.0	-4.8	5.8	3.7	.	.	.
Construction output								
annual change in % (real)	5.0	5.1	2.5	0.1	-4.5	-10.0	5.0	5.0
Employed persons, LFS, th, average [2]	69,934	70,857	71,545	71,391	71,524	71,000	71,500	72,000
annual change in %	0.8	1.3	1.0	-0.2	0.2	-0.7	0.7	0.7
Unemployed persons, LFS, th, average [2]	5,544	4,922	4,131	4,138	3,889	4,000	4,000	4,000
Unemployment rate, LFS, in %, average [2]	7.3	6.5	5.5	5.5	5.2	5.3	5.3	5.3
Reg. unemployment rate, in %, end of period [2]	2.1	1.7	1.4	1.2	1.2	.	.	.
Average monthly gross wages, RUB	20,952	23,369	26,629	29,960	32,000	34,000	.	.
annual change in % (real, gross)	5.2	2.8	8.4	5.2	-1.0	-4.5	.	.
Consumer prices, % p.a.	6.9	8.5	5.1	6.8	7.8	11.0	8.0	6.0
Producer prices in industry, % p.a. [4]	14.9	17.3	6.8	3.4	6.1	6.0	5.0	5.0
General governm.budget, nat.def., % of GDP								
Revenues	34.6	37.3	37.2	36.9	37.2	.	.	.
Expenditures	38.0	35.7	36.7	38.2	38.3	.	.	.
Deficit (-) / surplus (+)	-3.4	1.5	0.4	-1.3	-1.2	-3.0	-5.0	-2.0
Public debt, nat.def., % of GDP [5]	8.4	9.0	10.0	10.5	11.8	15.0	15.0	13.0
Central bank policy rate, % p.a., end of period [6]	7.75	8.00	8.25	5.50	17.00	10.0	.	.
Current account, EUR mn [7]	50,853	69,855	55,452	25,701	42,665	30,000	35,000	40,000
Current account, % of GDP	4.4	5.1	3.6	1.6	3.0	3.1	3.2	3.1
Exports of goods, BOP, EUR mn [7]	296,041	370,131	410,300	393,911	371,423	320,000	330,000	350,000
annual change in %	38.8	25.0	10.9	-4.0	-5.7	-13.8	3.1	6.1
Imports of goods, BOP, EUR mn [7]	185,221	228,764	261,202	256,951	231,763	200,000	220,000	240,000
annual change in %	40.3	23.5	14.2	-1.6	-9.8	-13.7	10.0	9.1
Exports of services, BOP, EUR mn [7]	37,062	41,680	48,495	52,787	50,115	45,000	47,000	50,000
annual change in %	12.7	12.5	16.4	8.8	-5.1	-10.2	4.4	6.4
Imports of services, BOP, EUR mn [7]	56,753	65,706	84,736	96,657	91,200	80,000	80,000	85,000
annual change in %	24.7	15.8	29.0	14.1	-5.6	-12.3	0.0	6.3
FDI inflow (liabilities), EUR mn [7]	32,545	39,557	39,353	53,187	20,000	20,000	30,000	50,000
FDI outflow (assets), EUR mn [7]	39,668	48,008	37,980	65,275	45,000	50,000	60,000	50,000
Gross reserves of CB, excl. gold, EUR mn [8]	335,251	350,786	367,323	341,787	279,383	.	.	.
Gross external debt, EUR mn [7]	369,219	416,416	480,440	530,481	493,528	.	.	.
Gross external debt, % of GDP	32.1	30.4	30.9	33.9	35.1	.	.	.
Exchange rate RUB/EUR, average	40.3	40.9	39.9	42.3	50.5	80.0	75.0	70.0
Purchasing power parity RUB/EUR [9]	20.7	23.1	23.6	24.5	26.4	.	.	.

1) Preliminary and wiiw estimates. - 2) According to census October 2010. - 3) Excluding small enterprises. - 4) Domestic output prices. - 5) wiiw estimate. - 6) From 2013 one-week repo rate, refinancing rate before. - 7) Converted from USD and based on BOP 6th edition. - 8) Including part of resources of the Reserve Fund and the National Wealth Fund of the Russian Federation. - 9) wiiw estimates based on the 2011 International Comparison Project benchmark.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.