RUSSIAN FEDERATION: Stagnation and isolation ahead

PETER HAVLIK

The Russian economy is languishing in a prolonged slump. The country was already 'stuck in transition and stagnation' before the outbreak of the Ukraine crisis. The current sanctions deter investments, foster capital outflows and boost inflation. Turning inwards and developing import substitution strategies using accumulated domestic resources may prevent an outright recession, but it will not kick-start the requisite modernisation drive. The wiiw baseline scenario – assuming no further escalation of the Ukraine conflict – reckons with a meagre acceleration of GDP growth based on a gradual revival of investment. The above notwithstanding, the conflict over Ukraine will have a lasting impact on trade, investments and integration with Europe.

Russian economic growth is hovering just slightly above zero. The preliminary GDP growth reported for the first half of 2014 – an increase by 0.8% – reflects a modest expansion of industrial production (1.5%), agricultural output (3.5%) and goods transport (1.3%). Household consumption – judged by developments in retail trade turnover, real incomes and wages – weakened compared to the previous year. Fixed capital investment and construction output dropped by 2.5% and 1.5%, respectively, in both cases representing a marked deterioration over the previous year. The collapse of investment growth is particularly worrying, though not surprising given the increased risks and heightened geopolitical tensions resulting from Western sanctions and Russian retaliatory measures.[1] The growth contribution of real net exports became positive with export growth flattening and imports declining, not least due to the weakened rouble. In the first half of 2014, the current account surplus, contrary to previous expectations, widened, exceeding 4% of GDP, while net capital outflows more than doubled, to nearly EUR 60 billion in the first half of the year.

In these circumstances – and with the changed geopolitical situation – the search for a 'new growth model' has become even more urgent. Previous concerns regarding declining export revenues and falling current account surpluses remain though these have been overshadowed by the present tensions: imports declined by more than 5% in the first half of 2014, in particular from Germany, Finland, Italy, Poland and France. Imports from Ukraine were cut by 25%. In this situation of elevated risks and generally worsened conditions of external trade, which is unlikely to change soon, the already existing and broadly acknowledged obstacle to investments – the poor investment climate – will be extremely difficult to overcome. The previously underlined necessity to markedly improve the institutional, administrative and infrastructure prerequisites for investment in order to support growth, restructuring and diversification of the economy has become both more urgent and difficult under the changed geopolitical climate and spiralling sanctions.

[1] For a more detailed analysis of the sanctions' impact see the Special Section of this Forecast Report.

All these factors require another downward revision of the GDP growth forecast. As of October 2014 GDP growth is expected to fall to 0.5% this year and stay below 2% in both 2015 and 2016.[2] Consumer spending remains the main – albeit stuttering – engine of GDP growth for the time being, but a further slowdown is around the corner as the growth of incomes is eroded by higher inflation. Investments are expected to drop in 2014 and remain more or less flat thereafter, even under the working assumption that the current financial and trade sanctions will be lifted in the course of 2015. Furthermore, the contribution of net exports to GDP growth will 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 exports in the medium run, and assuming only a one-off downward adjustment of imports in 2014, the present sizeable trade and current account surpluses will gradually diminish.

ESTIMATED DIRECT ECONOMIC COSTS OF THE UKRAINE CONFLICT FOR RUSSIA

The combined effects of higher geopolitical tensions, increased credit risks and financing costs of investments, trade sanctions and other frictions between Russia, Ukraine and the West result in a lower GDP growth in the short and medium term (2014-2016). Estimated annual GDP losses due to lower investments, higher inflation and capital outflows are presented below. A crude estimate of direct costs of the Ukraine conflict for Russia (based on comparing pre-conflict and current GDP growth forecasts) yields around 1 percentage point of foregone Russian GDP annually during 2014-2016 (nearly EUR 20 billion per year at 2013 prices and the exchange rate in 2014). In nominal terms (taking into account forecast changes of GDP growth and exchange rate effects), the estimated cumulated loss of Russian GDP would amount to more than one hundred billion euro over the period 2014-2016.

	2013	2014	2015	2016
wiiw Forecast Report Spring 2014 (March)				
(1) GDP, RUB bn, curr. Prices	66,689	70,000	74,800	80,500
(2) GDP, EUR bn, curr. Prices	1,576	1,555	1,626	1,713
(3) Annual change in % (real)	1.3	1.6	2.3	3.0
(4) Exchange rate, RUB/EUR	42.3	45	46	47
(5) GDP, EUR bn, at 2013 prices and ER	1,576	1,601	1,639	1,688
wiiw Forecast Report Autumn 2014 (November)				
(6) GDP, RUB bn, curr. Prices	66,755	72,000	77,500	83,000
(7) GDP, EUR bn, curr. Prices	1,578	1,440	1,462	1,509
(8) Annual change in % (real)	1.3	0.5	1.3	1.9
(9) Exchange rate, RUB/EUR	42.3	50	53	55
(10) GDP, EUR bn, at 2013 prices and ER	1,578	1,583	1,603	1,634
Costs of the conflict, annual, EUR bn (based on difference between March and November forecasts (5)-(10))	.	18	36	54

Source: Own estimates and projections.

[2] This corresponds more or less to the baseline scenario published by the Central Bank of Russia in September 2014. Alternative scenarios reckon with prolonged sanctions, somewhat higher inflation and somewhat lower GDP growth (see: http://www.cbr.ru, 12 September 2014).

Weaker economic growth notwithstanding, the labour market remains strained with employment nearly flat and unemployment declining (the LFS rate of unemployment was 5% in June 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. The shadow side of the tight labour market – growing employment of migrant (both legal and illegal) workers and the related social, political, nationalist tensions and even racist sentiments – is posing new challenges to the authorities. According to some estimates there are more than 10 million migrant workers in Russia, the majority of them from the former Soviet republics. The new challenge – though probably less complicated owing to cultural similarity – will be the labour market integration of several hundred thousands of (mostly qualified) Russian-speaking Ukrainian refugees from Donbass who may ease the labour market shortages.

In the changed geopolitical and macroeconomic framework, the earlier plans that the main growth stimulus should come from a revival of investment will hardly materialise. Russia is turning inwards and intends to mobilise domestic investment resources and implement an import substitution strategy instead of FDI. Disputes about new, more expansionary directions of monetary and fiscal policies flared up anew. Officially, the Central Bank of Russia (CBR) monetary policy focuses on inflation targeting with the complete switchover to the free float from the earlier practice of exchange rate targeting to be completed in the course of 2014. As a reaction to increased inflationary pressures, the CBR also revised inflation targets upwards in September 2014.[3] The key policy rate was stepwise increased in the course of the year, most recently to 8% at the end of July 2014. The CBR's restrictive monetary policy is being attacked, most prominently by Sergey Glazyev, who serves as Putin's advisor for regional integration. He also is one of the fiercest critics of the EU-Ukraine Association Agreement (and figures prominently on the Western sanctions list). Mr Glazyev argues that in order to counter external financing restrictions domestic credits must become cheaper, calling for a more expansionary monetary policy and measures to introduce capital controls.[4]

Apart from the worsened investment climate, it is the missing progress in diversification and modernisation that has been the main obstacle to a revival of economic growth. The escalating conflict over Ukraine and ever more assertive domestic and external policies represent another modernisation bottleneck. Nevertheless, Russia succeeded in proceeding with the establishment of the Eurasian Economic Union (EEU) on the basis of the Customs Union with Belarus and Kazakhstan which exists since 2010. The corresponding EEU agreement, imitating the EU and signed in Astana on 29 May 2014, is expected to come in force 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 and Kyrgyzstan are expected to join the EEU in 2015 as well). Coordinated economic policies among EEU members will use 'Maastricht-like' indicators such as limits on budget deficit, government debt, inflation and interest rates.

Summing up, Russian growth prospects have markedly deteriorated as Western sanctions – not largely symbolic ones anymore – result in a further deteriorating investment climate, higher risks, capital

[3] Originally, CPI inflation was planned to drop to 5% in 2014, 4.5% in 2015 and 4% in 2016 (within a corridor of +/-1.5 pp). For the new inflation targets see http://www.cbr.ru/today/publications_reports/on_2015(2016-2017)pr.pdf.

[4] See www.gazeta.ru, 5 September 2014. Calls for more interventionist policies appeared already early 2013 – see *Vedomosti*, 18 January 2013 and *wiiw Current Analyses and Forecasts*, No. 11 (March 2013), p. 129 for the emerging conservative trends in Russia. For a more comprehensive overview of the recent economic policy discussions in Russia see A. Yakovlev (2013), 'Russian modernisation: Between the need for new players and the fear of losing control of rent sources', *Journal of Eurasian Studies*, Vol. 5, No. 1, pp. 10-20.

outflows, inflation and depreciation of the rouble. Compared to previous forecasts, GDP growth for the coming years was scaled down, largely owing to falling investments. 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.[5] Hopes that a more serious damage to relations with the EU and other Russian neighbours could be avoided have unfortunately 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 – 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.

[5] The Russian government intends to tap resources accumulated in the National Welfare Fund (RUB 3100 billion or nearly 5% of GDP) in order to compensate effects of Western financial sanctions – see *Vedomosti*, 15 September 2014.

[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 [1]	2013	2014	2014	2015	2016
					January-June			Forecast	
Population, th pers., average [2]	142,861	142,961	143,202	143,507	143,400	143,800	144,000	144,300	144,500
Gross domestic product, RUB bn, nom.	46,309	55,967	62,218	66,755	30,625	33,689	72,000	77,500	83,000
annual change in % (real)	4.5	4.3	3.4	1.3	0.9	0.8	0.5	1.3	1.9
GDP/capita (EUR at exchange rate)	8,000	9,600	10,900	11,000	.	.	.	.	.
GDP/capita (EUR at PPP)	15,700	17,300	18,200	18,600	.	.	.	.	.
Consumption of households, RUB bn, nom.	23,618	27,193	30,832	34,399	15,957	17,552	.	.	.
annual change in % (real)	5.5	6.8	7.9	4.7	5.0	2.2	1.0	1.0	2.0
Gross fixed capital form., RUB bn, nom.	10,014	11,950	13,605	14,334	5,195	5,214	.	.	.
annual change in % (real)	5.9	9.1	6.5	-0.1	-0.9	-4.6	-5.0	2.0	3.0
Gross industrial production [3]									
annual change in % (real)	7.3	5.0	3.4	0.4	3.4	0.4	1.0	2.0	3.0
Gross agricultural production									
annual change in % (real)	-11.3	23.0	-4.8	6.2	1.0	1.4	.	.	.
Construction output									
annual change in % (real)	5.0	5.1	2.4	-1.5	2.4	-1.5	-1.0	3.0	5.0
Employed persons, LFS, th, average [2]	69,934	70,857	71,545	71,391	71,150	71,135	71,300	71,500	72,000
annual change in %	0.8	1.3	1.0	-0.2	0.2	0.0	-0.1	0.3	0.7
Unemployed persons, LFS, th, average [2]	5,544	4,922	4,131	4,138	4,207	3,968	4,000	4,000	4,000
Unemployment rate, LFS, in %, average [2]	7.3	6.5	5.5	5.5	5.6	5.3	5.3	5.2	5.0
Reg. unemployment rate, in %, end of period [2]	2.1	1.7	1.4	1.2	1.3	1.1	.	.	.
Average monthly gross wages, RUB	20,952	23,369	26,629	29,960	28,614	31,537	.	.	.
annual change in % (real, gross)	5.2	2.8	8.4	5.2	4.7	3.0	.	.	.
Consumer prices, % p.a.	6.9	8.5	5.1	6.8	7.2	7.0	7.5	7.0	6.0
Producer prices in industry, % p.a. [4]	12.2	19.0	6.8	3.4	3.4	6.2	6.0	5.0	4.0
General governm.budget, nat.def., % of GDP									
Revenues	34.6	37.3	37.1	36.6	37.1	37.6	.	.	.
Expenditures	38.0	35.7	36.7	37.9	35.4	34.4	.	.	.
Deficit (-) / surplus (+)	-3.4	1.5	0.4	-1.3	1.7	3.2	-1.0	-1.0	-1.0
Public debt, nat.def., % of GDP [5]	8.4	9.0	10.0	10.4	9.7	9.7	10.0	10.0	11.0
Central bank policy rate, % p.a., end of period [6]	7.75	8.00	8.25	5.50	8.3	7.5	.	.	.
Current account, EUR mn [7]	50,853	69,855	55,452	25,701	20,419	29,797	45,000	50,000	45,000
Current account, % of GDP	4.4	5.1	3.6	1.6	2.7	4.2	3.1	3.4	3.0
Exports of goods, BOP, EUR mn [7]	296,041	370,131	410,300	393,911	192,113	186,242	390,000	400,000	410,000
annual change in %	38.8	25.0	10.9	-4.0	-4.9	-3.1	-1.0	2.6	2.5
Imports of goods, BOP, EUR mn [7]	185,221	228,764	261,202	256,951	122,553	111,477	230,000	230,000	240,000
annual change in %	40.3	23.5	14.2	-1.6	3.1	-9.0	-10.5	0.0	4.3
Exports of services, BOP, EUR mn [7]	37,062	41,680	48,495	52,787	25,210	23,573	50,000	50,000	53,000
annual change in %	12.7	12.5	16.4	8.8	13.3	-6.5	-5.3	0.0	6.0
Imports of services, BOP, EUR mn [7]	56,753	65,706	84,736	96,657	43,567	42,081	90,000	90,000	100,000
annual change in %	24.7	15.8	29.0	14.1	19.4	-3.4	-6.9	0.0	11.1
FDI inflow (liabilities), EUR mn [7]	32,545	39,557	39,353	53,187	32,115	17,347	25,000	30,000	40,000
FDI outflow (assets), EUR mn [7]	39,668	48,008	37,980	65,275	47,640	23,995	60,000	60,000	60,000
Gross reserves of CB, excl. gold, EUR mn	335,251	350,786	367,323	341,787	363,872	316,970	.	.	.
Gross external debt, EUR mn [7]	369,524	416,416	480,440	530,481	541,923	536,557	.	.	.
Gross external debt, % of GDP	32.1	30.4	30.8	33.6	34.3	37.3	.	.	.
Exchange rate RUB/EUR, average	40.3	40.9	39.9	42.3	40.8	48.0	50.0	53.0	55.0
Purchasing power parity RUB/EUR [8]	20.8	23.1	24.1	25.7	.	.	.	.	.

1) Preliminary. - 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) wiiw estimates based on the 2011 International Comparison Project benchmark.

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