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## **Russian Federation: Growth stumbles – how much and for how long?**

***In Russia economic growth has been slowing down as industrial production and investment stagnate. A drop in energy prices and export revenues owing to the expected 'shale gas price shock' has cast a dark shadow over Russia's growth prospects. Together with the persistent crisis in the euro area, all those factors point to the urgency of the attempts to diversify, modernise and restructure the Russian economy. wiiw has revised its GDP growth forecast downwards and continues to expect an unspectacular GDP growth rate during 2014-2015. Simultaneously, the annual CPI inflation will settle down at 5% p.a., the budget will remain balanced and the rate of unemployment stable at some 6%.***

Russian economic growth has been slowing down during the past five consecutive quarters. Between the first quarter 2012 and the first quarter 2013 the GDP growth rate sacked from 4.8% to just 1.5%. Industrial production and investment are de facto stagnant while the volume of goods transport is even falling. GDP growth is currently fuelled only by rising household consumption as real disposable incomes (+5.3%), consumer expenditures (+4.4%) and retail trade turnover (+3.9%; all figures for the first quarter 2013, year-on-year) are growing. The collapse of investment growth is particularly worrying; it is not surprising that the search for a 'new growth model' has recently intensified – in particular given declining export revenues and falling current account surpluses with prospects for worse (see below). Falling energy prices and export revenues owing to the expected 'shale gas price shock' cast a dark shadow on the future Russian growth outlook. Together with the lasting crisis in the euro area all these factors make the attempted (yet so far largely absent) diversification, modernisation and restructuring of the Russian economy ever more urgent.

The current and expected rates of GDP growth have been revised downwards – below (in 2013) respectively close to 3% (2014-2015) per year at best. As in the recent past, growth will be driven mainly by consumer spending. The contribution of net exports to GDP growth has been negative already for nearly a decade (with the exception of 2009) because import volumes have been growing faster than those of exports. Though there are still sizeable trade and current account surpluses (the latter is estimated at about 3% of GDP in 2013),

given the projected paths of export and import revenues even the Central Bank of Russia is now expecting that the current account will turn into a deficit in a couple of years. The share of investment in GDP is planned to be increased from the current rate of about 22% to 27% by the year 2018 in one of the official economic programmes. With this target in mind, a substantial improvement in the investment climate is required. In order to foster this improvement, new privatisation plans have been announced. Unfortunately (as mentioned repeatedly in our previous assessments), the recent years have not been used for launching economic restructuring and institutional reforms which would bring about the badly needed improvements in the business and investment climate; the expected positive effects of WTO accession in August 2012 are yet to materialise.

Foreign exchange reserves have so far remained constant (about USD 530 billion in May 2013), despite sizeable capital flight: after more than USD 85 billion in 2011 and USD 63 billion in 2012. These outflows are partly linked to genuine outward FDI, partly they are due to the lasting political uncertainties. Sizeable net FDI inflows (more than USD 60 billion) are reported by the CBR for the first quarter 2013; these inflows are probably somehow linked to the Cyprus financial crisis. The consolidation of the banking sector continues, with credits to both households (including housing mortgages) and enterprises growing sharply. The share of non-performing loans on mortgages fell below 4% of the total as of April 2013.

Lacking progress of diversification and modernisation, growing public apathy and widespread corruption, together with the recent slowdown in economic growth and dismal prospects, are all mutually interlinked features of Russia's current development problems. These came to the fore upon Putin's return to the presidency one year ago. More assertive domestic and external policies represent another unpleasant feature of the Medvedev-Putin tandem reshuffle. Mr Medvedev's weakness (and also a general retreat from liberal values which he tried to pursue during his presidency with mixed success) came repeatedly to the open during the first year of Putin's new presidency. Tensions within the ruling tandem reappeared in varying reactions to the harsh sentence for the punk group Pussy Riot, Putin's criticism of the draft 2013 budget, the sacking of Deputy Prime Minister Vladislav Surkov over corruption allegation related to the Skolkovo technology park, and Medvedev's general cabinet performance in April 2013. A strange coalition between the Orthodox Church and the political leadership which is gambling on the support from conservative parts of Russian society raises uneasy feelings among the liberal opposition yet it is popular with the nationalists and populists. On the external front, Russian relations with the United States and the EU further worsened (Syria, Russian ban of USAID and other restrictions on foreign-supported NGOs, etc.).

In the field of economic policy, there have been clear signs that more anti-liberal approaches start to gain the upper hand – at least at the level of ongoing discussions (the eventual implementation may face a similar fate as the previously attempted modernisation efforts) though the ultimate outcome is uncertain.<sup>1</sup> The new economic reform strategy which aims at ‘achieving sustainable growth in a period of global instability’ has been drafted by an expert team headed by Putin’s newly appointed advisors, academicians Sergei Glazyev and Alexander Nekipelov, who both hold more ‘interventionist’ views regarding economic policies. Their expert group will present specific policy recommendations aiming at significantly boosting economic growth, presumably by recommending a stronger role of the state in the economy, more interventionist industrial policies and the relaxation of monetary policies. The authors of the new Russian pro-growth reform strategy reject the previous ‘imported’ development models à la Washington Consensus and doubt the usefulness of restrictive monetary and fiscal policies, of trade and price liberalisations and of privatisation. Instead, they call for an increased role of the state and for a significant breakthrough in investment activity with the aim to create a ‘technologically advanced manufacturing industry which has a strong export potential and relies on high-technology innovative companies’. As previous ingenious successful modernisation examples they quote the electrification plan GOELRO of the 1920s, the industrialisation and post-war reconstruction drives of the 1930s-1940s, the Soviet nuclear and space programmes of the 1950s-1960s and the exploitation of northern Russian energy resources of the 1970s. As external successful modernisation examples they quote the industrial policies of post-war Japan and present China. The acceleration of GDP growth (to at least 5% per year) should be accompanied by a significant boost in investments (lifting their share in GDP to at least 30-40% in the medium perspective) in order to accomplish economic restructuring and modernisation. R&D expenditures should increase substantially as well (to at least 4% of GDP). The financing of such a massive investment programme should proceed from existing savings, in particular by using reserves accumulated in foreign exchange and reserve funds. Moreover, monetary policies should be relaxed, liquidity increased and interest rates cut.<sup>2</sup> Other elements of the monetary policy include targeting a ‘stable real exchange rate’ and the introduction of capital flow controls. In order to stimulate innovation activities various tax incentives and preferential depreciation schemes should be used; external financing is to be gradually cut.

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<sup>1</sup> The highly publicised defection of one of the leading liberal and well-connected economists Sergei Guriev at the end of May 2013 (he resigned from his position as the rector at the respected New Economic School in Moscow) and his subsequent election into the supervisory board of Sberbank represents the latest peak in the murky political infighting.

<sup>2</sup> The new Chairman of the Russian Central Bank, Elvira Nabiullina, replaced Sergei Ignatiev in June 2013. Ms Nabiullina (a former Minister of Economic Development in Putin’s cabinet) may pursue more accommodative monetary policies.

In the current baseline scenario, the wiiw has revised its GDP growth forecast for 2013 downwards (below 3%, in line with most other forecasters) and continues to expect an unspectacular growth rate of GDP during 2014-2015. This scenario assumes no abrupt policy changes or external shocks and is charged with substantial downside risks. In particular, a more severe recession in Europe would have serious consequences, largely via falling export (and fiscal) revenues. In the baseline scenario, export revenues grow slowly due to stagnating volumes of exported oil and gas, while there will be not much else to export since progress in export diversification will be limited. Simultaneously, import volumes are expected to grow at a faster rate as household consumption and investment will gradually pick up, both fuelled by the ongoing real currency appreciation. In the medium and long run, economic reforms and investment (including FDI) may be stimulated by WTO membership induced reform efforts. In summary, we stick to a relatively optimistic scenario of stable yet unspectacular GDP growth of around 3% per year. This implies a continuation of the negative contribution of real net exports to GDP growth and, in nominal terms, gradual reductions of the trade and current account surpluses. Simultaneously, the annual CPI inflation will settle at 5% p.a., the budget will remain balanced and the rate of unemployment stable at some 6%.

Table RU

## Russia: Selected Economic Indicators

|   | 2009    | 2010    | 2011    | 2012 <sup>1)</sup> | 2012<br>1st quarter | 2013    | 2013<br>Forecast | 2014<br>Forecast | 2015   |
|---|---------|---------|---------|--------------------|---------------------|---------|------------------|------------------|--------|
| Population, th pers., average <sup>2)</sup>                   | 142797  | 142861  | 142961  | 143202             | .                   | .       | 143000           | 142500           | 142000 |
| Gross domestic product, RUB bn, nom. <sup>3)</sup>            | 38807   | 46309   | 55800   | 62599              | 13802               | 14900   | 69200            | 76600            | 84000  |
| annual change in % (real) <sup>3)</sup>                       | -7.8    | 4.5     | 4.3     | 3.4                | 4.8                 | 1.6     | 2.4              | 3.1              | 3.2    |
| GDP/capita (EUR at exchange rate)                             | 6200    | 8000    | 9600    | 10900              | .                   | .       | .                | .                | .      |
| GDP/capita (EUR at PPP)                                       | 11700   | 12500   | 13300   | 14000              | .                   | .       | .                | .                | .      |
| Consumption of households, RUB bn, nom. <sup>3)</sup>         | 20986   | 23618   | 27165   | 30543              | 6825                | .       | .                | .                | .      |
| annual change in % (real) <sup>3)</sup>                       | -5.1    | 5.5     | 6.4     | 6.6                | 9.1                 | 5.0     | 4.5              | 5.0              | 4.5    |
| Gross fixed capital form., RUB bn, nom. <sup>3)</sup>         | 8536    | 10014   | 12076   | 13768              | 2018                | .       | .                | .                | .      |
| annual change in % (real) <sup>3)</sup>                       | -14.5   | 5.9     | 10.2    | 6.0                | 15.5                | -0.2    | 2.0              | 5.0              | 6.0    |
| Gross industrial production <sup>4)</sup>                     |         |         |         |                    |                     |         |                  |                  |        |
| annual change in % (real)                                     | -9.3    | 8.2     | 4.7     | 2.6                | 4.0                 | 0.0     | 3.0              | 4.0              | 5.0    |
| Gross agricultural production                                 |         |         |         |                    |                     |         |                  |                  |        |
| annual change in % (real)                                     | 1.4     | -11.3   | 23.0    | -4.7               | 4.0                 | 2.3     | .                | .                | .      |
| Construction output   |         |         |         |                    |                     |         |                  |                  |        |
| annual change in % (real)                                     | -13.2   | 3.5     | 5.1     | 2.5                | 5.0                 | 0.6     | 4.0              | 5.0              | 5.0    |
| Employed persons, LFS, th, average <sup>2)</sup>              | 69410.5 | 69933.7 | 70856.6 | 71545.4            | 70076.0             | 70899.3 | 71500            | 71000            | 71000  |
| annual change in % <sup>2)</sup>                              | -2.2    | 0.8     | 1.3     | 1.0                | 0.8                 | 1.2     | -0.1             | -0.7             | 0.0    |
| Unemployed persons, LFS, th, average <sup>2)</sup>            | 6284.0  | 5544.0  | 4922.0  | 4131.0             | 4702.7              | 4355.3  | 4300             | 4300             | 4300   |
| Unemployment rate, LFS, in %, average <sup>2)</sup>           | 8.3     | 7.3     | 6.5     | 5.5                | 6.3                 | 5.8     | 6.0              | 6.0              | 6.0    |
| Unemployment rate, reg., in %, end of period                  | 2.9     | 2.1     | 1.7     | 1.4                | 1.8                 | 1.4     | .                | .                | .      |
| Average gross monthly wages, RUB                              | 18637.5 | 20952.2 | 23369.2 | 26690.0            | 24407.0             | 27339.0 | .                | .                | .      |
| annual change in % (real, gross)                              | -3.5    | 5.2     | 2.8     | 7.8                | 10.3                | 4.5     | .                | .                | .      |
| Consumer prices, % p.a.                                       | 11.8    | 6.9     | 8.5     | 5.1                | 3.9                 | 7.1     | 7.0              | 6.0              | 5.0    |
| Producer prices in industry, % p.a. <sup>5)</sup>             | -7.2    | 12.2    | 19.0    | 6.8                | 7.8                 | 4.3     | 6.0              | 5.0              | 5.0    |
| General governm.budget, nat.def., % of GDP                    |         |         |         |                    |                     |         |                  |                  |        |
| Revenues  | 35.0    | 34.6    | 37.4    | 37.0               | 38                  | .       | .                | .                | .      |
| Expenditures  | 41.4    | 38.0    | 35.8    | 26.6               | 34                  | .       | .                | .                | .      |
| Deficit (-) / surplus (+)                                     | -6.3    | -3.4    | 1.5     | 0.4                | 3.9                 | 1.3     | 0.0              | 0.0              | .      |
| Public debt, nat.def., % of GDP <sup>6)</sup>                 | 8.3     | 8.4     | 9.0     | 9.6                | 8.1                 | 8.6     | 7.0              | 6.0              | .      |
| Central bank policy rate, % p.a., end of period <sup>7)</sup> | 8.75    | 7.75    | 8.00    | 8.25               | 8.0                 | 8.3     | .                | .                | .      |
| Current account, EUR mn <sup>8)</sup>                         | 34893   | 53588   | 70976   | 63245              | 29878               | 21103   | 45000            | 40000            | 35000  |
| Current account, % of GDP                                     | 4.0     | 4.7     | 5.2     | 4.0                | 8.6                 | 5.7     | 2.7              | 2.2              | 1.8    |
| Exports of goods, BOP, EUR mn <sup>8)</sup>                   | 217796  | 302039  | 374872  | 412840             | 100402              | 95078   | 420000           | 440000           | 460000 |
| annual change in %  | -32.2   | 38.7    | 24.1    | 10.1               | 23.0                | -5.3    | 1.7              | 4.8              | 4.5    |
| Imports of goods, BOP, EUR mn <sup>8)</sup>                   | 137691  | 187448  | 232553  | 260913             | 55896               | 57258   | 280000           | 300000           | 330000 |
| annual change in %  | -30.8   | 36.1    | 24.1    | 12.2               | 17.7                | 2.4     | 7.3              | 7.1              | 10.0   |
| Exports of services, BOP, EUR mn <sup>8)</sup>                | 29859   | 33912   | 38797   | 49087              | 10097               | 11573   | 53000            | 55000            | 60000  |
| annual change in %  | -14.4   | 13.6    | 14.4    | 26.5               | 19.0                | 14.6    | 8.0              | 3.8              | 9.1    |
| Imports of services, BOP, EUR mn <sup>8)</sup>                | 44099   | 55550   | 64612   | 83937              | 16442               | 19061   | 95000            | 105000           | 120000 |
| annual change in %  | -14.2   | 26.0    | 16.3    | 29.9               | 30.5                | 15.9    | 13.2             | 10.5             | 14.3   |
| FDI inflow, EUR mn <sup>8)</sup>                              | 26203   | 32635   | 37973   | 40000              | 9791                | .       | 32000            | 40000            | 50000  |
| FDI outflow, EUR mn <sup>8)</sup>                             | 31346   | 39598   | 48318   | 39719              | 8644                | .       | 40000            | 40000            | 40000  |
| Gross reserves of CB, excl. gold, EUR mn                      | 290380  | 335251  | 350786  | 367368             | 348683              | 372700  | .                | .                | .      |
| Gross external debt, EUR mn                                   | 325639  | 369524  | 416385  | 476940             | 423250              | .       | .                | .                | .      |
| Gross external debt, % of GDP                                 | 37.0    | 32.1    | 30.5    | 30.4               | 27.0                | .       | .                | .                | .      |
| Exchange rate RUB/EUR, average                                | 44.1    | 40.3    | 40.9    | 39.9               | 39.7                | 40.2    | 41               | 42               | 43     |
| Purchasing power parity RUB/EUR <sup>9)</sup>                 | 23.1    | 25.8    | 29.4    | 31.2               | .                   | .       | .                | .                | .      |

1) Preliminary. - 2) According to census October 2010. - 3) According to SNA'93 (FISIM reallocated to industries, real growth rates based on previous year prices etc). - 4) Excluding small enterprises. - 5) Domestic output prices. - 6) wiiw estimate. - 7) Refinancing rate of Central Bank. - 8) Converted from USD with the average exchange rate. From 2012 BOP 6th edition, 5th edition before. - 9) wiiw estimates based on the 2005 International Comparison Project benchmark.

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