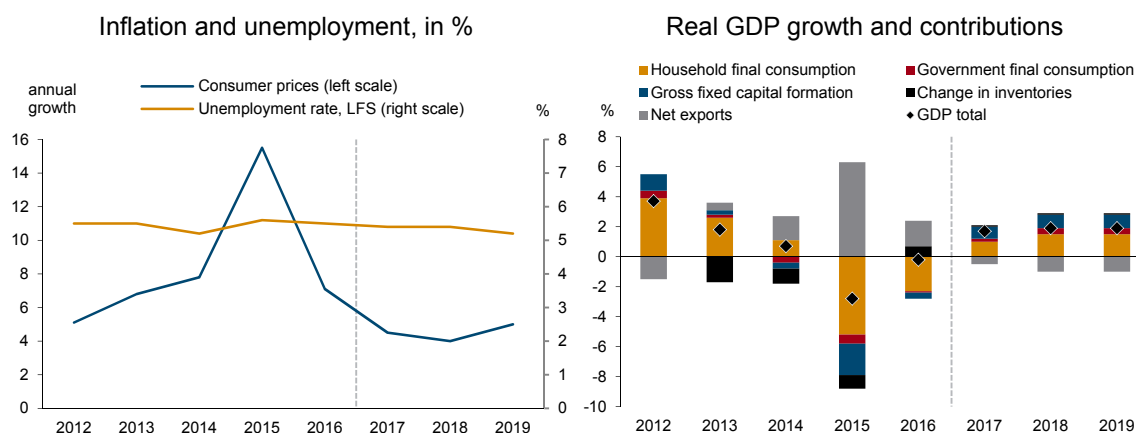


RUSSIAN FEDERATION: Growth without convergence

PETER HAVLIK

The Russian economy is growing again. The inflation target of 4% has been met and the rouble is appreciating. Yet the expected GDP growth will remain below 2% even in the medium run, and will lag behind most of the country's CESEE peers. No changes in economic policies are expected before next year's presidential elections. Sanctions and the poor investment climate are there to stay.

Figure 46 / Russian Federation: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Russian economy finally emerged from recession. GDP increased by 1.5% in the first half of the year, largely on account of modestly rising consumption and somewhat faster growth of investment. Along with the recovery of domestic demand, the contribution of real net exports to GDP growth is expected to become slightly negative as import volumes are growing faster than those of exports. On the supply side, industrial production (particularly the extraction industry) is growing again while agriculture, construction, trade and other services stagnate. Aggregate output of five basic industries (agriculture, industry, construction, transport and services) expanded by 3%; strong growth was recorded in the first half of 2017 in goods transport in particular.

Inflation slowed down and the envisaged inflation target (4% per year) was almost reached by mid-2017. In fact, annual CPI inflation in August was just 3.3% (producer price inflation is much higher) and the key interest rate of the Central Bank of Russia (CBR) was reduced to 8.5% p.a. in September.

Unemployment remains stable (and low) and sectoral/regional labour shortages occur, especially in higher skill segments.

Thanks to higher oil prices in the first half of 2017 (+20% compared to a year earlier), export revenues grew by one third (EUR based) and the rouble appreciated in both nominal and real terms by around 20% in January-August 2017 compared to the pre-year period with respect to both the US dollar and the euro. As a consequence, imports recovered strongly as well. Yet the growth of exports and imports will slow down as oil prices and the exchange rate will stabilise. The growth contribution of net exports will remain negative in the coming years while the current account surplus will be close to 3% of GDP in 2017.

A draft federal budget for the 2018-2020 period was submitted to the Duma in September 2017. It reckons with annual inflation of 4% and is based on a conservative forecast of the oil price (below USD 44 per barrel). The federal budget deficit for 2018 is projected at 1.3% of GDP, with subsequent further reductions below 1% of GDP in the rest of the decade – despite planned cuts in revenues related to rather conservative expectations regarding the oil price developments.

No major reforms are on the horizon, at least before the presidential elections which are scheduled for March 2018. Vladimir Putin has not officially announced his candidacy yet, but his next-term presidency is taken for granted and no change in tandem similar to that in 2000 is expected (in fact, Prime Minister Dmitry Medvedev may lose his job after the elections). The Russian economy has seemingly adjusted to the 'new normal' of sanctions and to mediocre growth. After the recent bankruptcies of several major companies and banks (Bank Otkrytie, Binbank, airline VIM Avia, etc.), the government stepped in to rescue them and took the remaining assets under its control. Competition is being restricted and the conditions for doing business, especially for SMEs, remain poor. The huge FDI flows officially reported in 2016 and the first half of 2017 (both inflows and outflows) reflect to a large degree transactions with offshore destinations resulting either from a few big deals or portfolio investments. The shares of Cyprus and other offshore tax havens in total FDI stocks remain extremely high (around 50% of the total). This is a reflection, inter alia, of the poor domestic investment climate, including sanctions. The positive dynamics of FDI inflows continued in the first quarter of 2017. The reported increase in FDI inflows is again connected with several huge transactions such as the sale of a 10% stake in the Russian petrochemical holding Sibur to the Chinese Silk Road Fund, or the launch of the construction of a Mercedes-Benz passenger car plant by the German company Daimler (this project is so far the largest Western investment in Russia after the introduction of sanctions). Moreover, the Russian import substitution strategy may partly contribute to an increase in FDI inflows, particularly in the food processing industry.

The overall assessment of Russian economic prospects has not changed very much in the last couple of years, although the current growth forecast was revised slightly upwards owing to the higher than previously expected oil price. GDP growth will remain sluggish (below 2%) also in the medium term, constrained by shortages of labour, capital and especially reforms. Owing to the lack of investments, both domestic and foreign, the structure of the economy is not expected to change. The CBR will proceed with a prudent monetary policy and the cleaning of the banking sector. Official CBR baseline forecasts of GDP growth range between 1.5% and 2% in the medium-term horizon (2018-2020). Alternatively, an oil price above USD 55/bbl would stimulate somewhat higher GDP growth and a faster expansion of credits while the annual CPI inflation is projected to remain at 4%. wiiw's GDP

growth forecast was revised slightly upwards, largely on account of higher oil price expectations, but it will remain below 2% in the forecasting period. With this growth rate the Russian economy will not catch up with its more advanced EU-CEE peers.

Without marked productivity improvements, Russia is facing a prolonged period of near stagnation in economic, political and societal developments alike (the latter may even deteriorate). However, productivity will not improve without structural reforms aiming at the improvement of the business climate and stimulating investment, restructuring and modernisation (this mantra has been repeated for years without any visible effect). Sanctions are expected to stay, but the Russian economy has already largely accommodated to the sanction regime. Financial restrictions hurt, but innovative ways how to avoid some of the pain, for example via offshore financing vehicles, seem to help (e.g. Rosneft). Still the expected GDP growth will remain below 2% per year in the medium term and the process of economic convergence will stall. This is a disappointing performance for an emerging economy – especially given the fairly robust growth in the EU, China and elsewhere.

A resuscitation of a dialogue with the EU could happen after a new coalition government has been formed in Germany, yet a normalisation of Russian relations with neighbours (Ukraine, Baltics) will be difficult and the damage incurred so far will last. A reset of the Minsk process and an agreement on more OSCE involvement in Ukraine would be helpful. Whether Putin's next presidency will bring any change in domestic economic policies remains to be seen. With respect to external policies, no major turnaround is expected and many uncertainties (relations with the EU and US, Donbas, future of the Eurasian Economic Union, etc.) will persist.

Table 21 / Russia: Selected economic indicators

	2013	2014	2015	2016 ¹⁾	2016 January-June	2017	2017 Forecast	2018 Forecast	2019
Population, th pers., average	143,507	146,091	146,406	146,675	146,600	146,789	146,500	146,400	146,300
Gross domestic product, RUB bn, nom.	73,134	79,200	83,233	86,044	39,246	41,782	91,900	97,400	104,200
annual change in % (real)	1.8	0.7	-2.8	-0.2	-0.5	1.5	1.7	1.9	1.9
GDP/capita (EUR at PPP)	19,300	18,700	17,700	16,900
Consumption of households, RUB bn, nom.	38,465	42,016	43,243	43,941	20,912	22,276	.	.	.
annual change in % (real)	5.2	2.0	-9.8	-4.5	-5.1	3.5	2.0	3.0	3.0
Gross fixed capital form., RUB bn, nom.	15,926	16,828	17,266	18,112	6,820	7,358	.	.	.
annual change in % (real)	1.3	-1.8	-9.9	-1.8	-3.8	4.6	4.0	4.0	4.0
Gross industrial production ²⁾									
annual change in % (real)	0.4	1.7	-0.8	1.3	1.3	2.0	2.0	3.0	4.0
Gross agricultural production									
annual change in % (real)	5.8	3.5	2.6	4.8	3.4	0.2	.	.	.
Construction output									
annual change in % (real)	0.1	-2.3	-4.8	-4.3	-6.8	0.2	.	.	.
Employed persons, LFS, th, average	71,392	71,539	72,324	72,393	71,850	71,722	72,300	72,300	72,200
annual change in %	-0.2	0.2	-0.4	0.1	-0.1	-0.2	-0.1	0.0	-0.1
Unemployed persons, LFS, th, average	4,137	3,889	4,264	4,243	4,404	4,077	4,100	4,100	4,000
Unemployment rate, LFS, in %, average	5.5	5.2	5.6	5.5	5.8	5.4	5.4	5.4	5.2
Reg. unemployment rate, in %, eop ³⁾	1.2	1.2	1.3	1.2	1.3	1.1	.	.	.
Average monthly gross wages, RUB	29,792	32,495	34,030	36,746	35,708	38,635	39,600	42,800	47,200
annual change in % (real, gross)	4.8	1.2	-9.3	0.7	-0.2	3.8	3.0	4.0	5.0
Consumer prices, % p.a.	6.8	7.8	15.5	7.1	7.9	4.3	4.5	4.0	5.0
Producer prices in industry, % p.a. ⁴⁾	3.3	6.4	13.5	4.2	4.1	9.2	6.0	5.0	4.0
General governm.budget, nat.def., % of GDP									
Revenues	33.4	33.8	32.3	32.8	31.9	34.7	35.0	35.0	35.0
Expenditures	34.6	34.9	35.7	36.4	34.6	34.6	37.5	38.0	38.0
Deficit (-) / surplus (+)	-1.2	-1.1	-3.4	-3.7	-2.7	0.2	-2.5	-3.0	-3.0
Public debt, nat.def., % of GDP	10.3	13.0	13.2	12.9	12.4	12.5	13.0	14.0	15.0
Stock of loans of non-fin.private sector, % p.a.	17.1	25.9	7.6	-6.9	6.3	-3.9	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	3.5	3.8	5.3	5.2	5.7	5.4	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	5.50	17.00	11.00	10.00	10.50	9.00	8.0	6.0	6.0
Current account, EUR mn ⁷⁾	25,164	43,477	61,898	23,064	13,344	23,513	39,000	41,100	25,100
Current account, % of GDP ⁷⁾	1.5	2.8	5.0	2.0	2.7	3.5	2.9	2.9	1.7
Exports of goods, BOP, EUR mn ⁷⁾	392,827	375,561	307,040	254,498	115,047	153,585	300,600	330,700	353,900
annual change in %	-4.3	-4.4	-18.2	-17.1	-29.0	33.5	18.1	10.0	7.0
Imports of goods, BOP, EUR mn ⁷⁾	256,901	232,739	173,585	172,996	75,022	98,472	210,700	236,000	266,700
annual change in %	-1.6	-9.4	-25.4	-0.3	-8.9	31.3	21.8	12.0	13.0
Exports of services, BOP, EUR mn ⁷⁾	52,787	49,700	46,491	45,648	20,664	25,221	51,800	54,400	57,100
annual change in %	8.8	-5.8	-6.5	-1.8	-6.6	22.1	13.5	5.0	5.0
Imports of services, BOP, EUR mn ⁷⁾	96,643	91,487	79,694	67,163	30,296	36,943	74,400	78,100	82,000
annual change in %	14.1	-5.3	-12.9	-15.7	-20.4	21.9	10.8	5.0	5.0
FDI liabilities, EUR mn ⁷⁾	52,107	16,655	6,163	29,381	6,752	16,085	17,000	.	.
FDI assets, EUR mn ⁷⁾	65,120	43,151	19,861	20,149	13,550	14,807	20,000	.	.
Gross reserves of NB excl. gold, EUR mn ⁷⁾⁸⁾	341,787	279,383	292,467	301,871	297,124	300,675	.	.	.
Gross external debt, EUR mn ⁷⁾	530,481	493,861	474,681	488,752	473,355	466,457	446,000	423,500	446,600
Gross external debt, % of GDP ⁷⁾	30.7	31.7	38.6	42.2	40.9	34.5	33.0	30.0	30.0
Average exchange rate RUB/EUR	42.27	50.77	67.76	74.26	78.39	62.70	68.0	69.0	70.0

Note: From 2014 including Crimean Federal District (for LFS and wages from 2015, growth rates for employment and real wages from 2016).

1) Preliminary. - 2) Excluding small enterprises. Until 2014 according to NACE Rev.1. - 3) In % of labour force (LFS). - 4) Domestic output prices, in 2013 according to NACE Rev.1. - 5) According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. - 6) One-week repo rate. - 7) Converted from USD. - 8) Including part of resources of the Reserve Fund and the National Wealth Fund of the Russian Federation.

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