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Russian Federation:
Slower growth, more state intervention to the rescue?

Russian economic growth was slowing down during 2012. The expected rate of GDP growth – below yet close to 4% in the coming couple of years – will be driven mainly by domestic demand. Any significant breakthrough in modernization and diversification of the economy is unlikely in the near future. The new role of shale gas and its impact on global energy prices may significantly affect Russia's export and budget revenues, its GDP growth and ultimately also the country's social and political stability in the medium and long run.

Russian economic growth was slowing down during 2012. Falling volumes of energy exports and the lack of progress in diversification are the main culprits for the disappointing growth performance, and our previous assessment regarding growth prospects remains broadly valid. Weaker demand in the euro area could be only partly overcompensated by buoyant household consumption and investments. In the short run – as long as the oil price stays near or even above USD 100 per barrel – Russia may comfortably live without any marked economic policy changes. However, the growth outlook may worsen due to the aggravated crisis in the euro area and, in the medium and long run, because of potentially declining energy prices as a result of shale and LNG gas effects. The expected rate of GDP growth – below yet close to 4% in the coming couple of years – will be driven mainly by robust domestic demand. The contribution of net exports to GDP growth is negative; it may even further deteriorate if import volumes grow faster than those of exports in case more shale gas is coming to Europe and little export diversification occurs. Though there is still a sizeable trade and current account surplus (the latter is estimated at more than 4% of GDP in 2012, about 1 pp less than in 2011), given the projected paths of export and import revenues and diminishing trade surpluses, even the Central Bank of Russia now reckons with a gradually deteriorating current account that will eventually turn into a deficit.

On the supply side, industry remained sluggish with a growth below 3% in 2012; construction output increased probably even less (both sectors were displaying a downward sloping trend in the course of the year 2012). Agricultural production declined last year as the strong upturn in 2011 could not be repeated. Bumper harvests boosted

GDP growth in 2011 and dampened consumer price increases, the carry-on effects have also been instrumental in the reduction of consumer price inflation. Indeed, consumer prices increased by just 5% in 2012 on annual average; even producer price inflation fell to single digits. These developments, together with a slight increase in employment (and the related drop in unemployment), as well as another fiscal surplus, have been the main positive economic developments in the past 12 months.[1]

With persistent trade and current account surpluses, foreign exchange reserves are being continuously replenished (they reached nearly USD 540 billion at the beginning of 2013), despite sizeable capital flight: after more than USD 85 billion in 2011, the outflow of capital from Russia was probably of a similar magnitude in 2012. These capital outflows are partly linked to genuine outward FDI, and partly due to tax evasion and the lasting political uncertainties. At the same time, FDI inflows somewhat diminished. Widespread corruption and the generally hostile domestic investment climate have also played an important role whereas the expected reform-enhancing effects of WTO accession are yet to materialize.[2]

The consolidation of the banking sector continues, with credits to both households (including housing mortgages) and enterprises growing (the latter less sharply than the former ones). The share of non-performing loans on mortgages fell below 5% of the total as of end-2012. However, bank loans are used to finance less than 10% of total investment outlays and the overall investment rate remains fairly low. Indeed, the share of investment in GDP is planned to be increased from the current rate of about 20% to 25% by the year 2015 and further to 27% of GDP by the year 2018. With these ambitious targets in mind, a substantial improvement in the investment climate is required. In fact, President Putin required that Russia's Ease of Doing Business investment climate ranking should be raised from 118 in 2012 to 20 in the next couple of years.[3] New privatization plans will also be fostered: The government has announced ambitious plans to privatize – either fully or by selling minority stakes – a number of state-owned companies such as Sovkomflot (sea transport), Sberbank, VTB, Rosnano, Russian Railways, Aeroflot, Sheremetyevo Airport, Rosneft, Transneft, etc. Rosneft's recent

1 Without revenues from oil and gas, the federal budget for 2012 would be in deficit amounting to more than 10% of GDP.

2 The recent (November 2012) corruption scandals involve the Ministry of Defence and the prestigious space navigation project GLONASS. German Gref, the head of Sberbank and former Economy Minister, has recently complained that there is very little familiarity with WTO rules even at the government level. He also pleaded for more economic reforms and accelerated privatization (see his recent interview before the World Economic Forum in Davos – *Neue Zürcher Zeitung*, 24 January 2013, p. 19).

3 In the 2013 ranking, Russia's position improved to 112 – see www.doingbusiness.org.

purchase of TNK-BP from BP and AAR involving cash and shares settlement with BP may be considered as a specific kind of privatization since BP's share in Rosneft was raised to nearly 20% as a consequence of this transaction.[4] Unfortunately (as mentioned repeatedly in our previous assessments and elsewhere), the recent years have not been used for pursuing economic restructuring and institutional reforms which would bring about the badly needed improvements in the business climate. Russia is as dependent on exports of commodities as ever: oil and gas account for about two thirds of overall exports and for more than 10% of federal budget revenues. Restructuring, modernization and the 'innovation development' preached by former President Medvedev over a number of years and formulated in 'several reform strategies' have so far remained largely on paper. The latest economic reform blueprint aiming at 'achieving sustainable growth in the period of global instability' is currently being elaborated by an expert team headed by Putin's academic advisors S. Glazyev and A. Nekipelov. Their expert group should present specific policy recommendations for boosting economic growth, probably by recommending more interventionist economic policies (in particular increased public investments, R&D spending, government spending and overall efficiency). The new reform blueprint shall be presented to the government by the end of March 2013.[5]

The deteriorating political and societal developments after the Medvedev-Putin tandem reshuffle are becoming more apparent; tensions within the ruling tandem have reappeared (visible e.g. in the varying reactions to the harsh sentence for the punk group Pussy Riot, in Putin's criticism of the draft 2013 budget, etc.). The 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 USA and the EU further worsened (conflict in Syria, Russian ban of USAID, child adoption and restrictions on foreign-supported NGOs, etc.). Russia also became more assertive in energy issues with pressures on Bulgaria, Moldova and Ukraine and Gazprom's disputes with the EU. On the more positive side, some political reforms (such as the reintroduction of regional governors' elections and easier registration of political parties) have been introduced as well. The opposition remains weak and split, it has not managed to gather any visible support.

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[4] See *Vedomosti*, 23 October 2012.

[5] See *Vedomosti*, 18 January 2013. In the meantime, the key economic policy tasks have already been adopted by the government (at the end of January 2013) – http://www.government.gov.ru/media/2013/2/4/54690/file/FINAL_N_16.pdf.

Any significant breakthrough in modernization and diversification is unlikely in the near future. Furthermore, both economic and political uncertainties have recently increased and Mr Putin's current presidency is assumed to be much weaker than the previous ones; his approval ratings are diminishing while challenges – economic and otherwise – have been on the rise. External risks have also increased: a more pronounced recession in Europe and a slowdown in the global economy may result in lower oil prices. The new role of shale and LNG gas and its impact on global (and European) energy prices may significantly affect Russia's export revenues and budget in the medium and long run.[6] The wiiw baseline scenario assumes that oil prices will stay close to USD 100 per barrel in 2013 and thereafter. The 'horror scenario' (for Russia), with oil prices falling below USD 70 per barrel and the resulting severe consequences for Russian export and fiscal revenues, is unlikely – although the government allegedly makes contingency plans based on a scenario which assumes oil prices falling to USD 60 per barrel.[7] In our baseline scenario, a robust (yet unspectacular) growth rate of GDP of close to 4% during 2014-2015 is expected. This scenario assumes no abrupt policy changes or external shocks and is obviously charged with substantial downside risks. Export revenues grow slowly (if at all) due to stagnating volumes of exported oil and gas. Simultaneously, import volumes are expected to grow at a much faster rate as household consumption and investment continue to expand, both fuelled by the ongoing real currency appreciation. In the medium and long run, economic reforms and investment (including FDI) may eventually be stimulated by WTO membership effects.

6 For example, Germany, Poland, Italy, Turkey and recently also Bulgaria have already succeeded in obtaining a rebate on gas purchases from Gazprom.

7 A sudden and sustained drop in oil prices is one of the scenarios elaborated by the expert group for the 2013 World Economic Forum in Davos. In this situation, the expert group expects the government to 'strengthen its hold on the economy …, opening a range of uncertainties about the country's long-term economic future' – see www.weforum.org/issues/strategic-foresight.

Table RU

Russia: Selected Economic Indicators

	2008	2009	2010	2011	2012 1)	2013	2014	2015
							Forecast	
Population, th pers., average 2)	141956	141902	142938	142961	143000	142500	142000	141500
Gross domestic product, RUB bn, nom. 3)	41277	38807	46322	55799	62357	69200	76600	84000
annual change in % (real) 3)	5.2	-7.8	4.5	4.3	3.4	3.6	3.8	3.7
GDP/capita (EUR at exchange rate)	8000	6200	8000	9500	10900	.	.	.
GDP/capita (EUR at PPP)	13000	11800	12500	13300	13900	.	.	.
Consumption of households, RUB bn, nom. 3)	19967	20986	23618	27168	30518	.	.	.
annual change in % (real) 3)	10.6	-5.1	5.5	6.4	6.6	4.5	5.0	4.5
Gross fixed capital form., RUB bn, nom. 3)	9201	8536	10014	12076	13767	.	.	.
annual change in % (real) 3)	10.6	-14.4	5.8	10.2	6.0	7.0	7.0	8.0
Gross industrial production 4)								
annual change in % (real)	2.1	-9.3	8.2	4.7	2.6	4.0	5.0	5.0
Gross agricultural production								
annual change in % (real)	10.8	1.4	-11.3	23.0	-4.7	.	.	.
Construction output								
annual change in % (real)	12.8	-13.2	3.5	5.1	2.5	4.0	5.0	5.0
Employed persons, LFS, th, average	70965.1	69284.9	69803.6	70731.8	71342.1	71500	71000	71000
annual change in %	0.6	-2.4	0.7	1.3	0.9	0.2	-0.7	0.0
Unemployed persons, LFS, th, average	4791.5	6372.8	5636.0	5020.0	4280.7	4300	4300	4300
Unemployment rate, LFS, in %, average	6.3	8.4	7.5	6.6	5.7	6.0	6.0	6.0
Unemployment rate, reg., in %, end of period	2.0	2.9	2.1	1.7	1.4	.	.	.
Average gross monthly wages, RUB	17290.1	18637.5	20952.2	23693.0	26690.0	.	.	.
annual change in % (real, gross)	11.5	-3.5	5.2	2.8	7.8	.	.	.
Consumer prices, % p.a.	14.1	11.8	6.9	8.5	5.1	5.0	5.0	5.0
Producer prices in industry, % p.a. 5)	21.4	-7.2	12.2	19.0	6.8	7.0	7.0	6.0
General governm.budget, nat.def., % of GDP								
Revenues	38.8	35.0	34.6	37.4	38.0	.	.	.
Expenditures	33.9	41.4	38.0	35.9	36.5	.	.	.
Deficit (-) / surplus (+)	4.9	-6.3	-3.5	1.6	1.5	0.0	0.0	.
Public debt, nat.def., % of GDP 6)	5.7	8.3	8.4	9.0	8.0	7.0	6.0	.
Central bank policy rate, % p.a., end of period 7)	13.00	8.75	7.75	8.00	8.25	.	.	.
Current account, EUR mn 8)	70546	34893	53588	70976	63245	50000	40000	40000
Current account, % of GDP	6.2	4.0	4.7	5.2	4.1	3.0	2.2	2.0
Exports of goods, BOP, EUR mn 8)	321353	217796	302039	374872	412840	440000	470000	500000
annual growth rate in %	24.2	-32.2	38.7	24.1	10.1	6.6	6.8	6.4
Imports of goods, BOP, EUR mn 8)	198876	137691	187448	232553	260913	300000	350000	400000
annual growth rate in %	21.8	-30.8	36.1	24.1	12.2	15.0	16.7	14.3
Exports of services, BOP, EUR mn 8)	34874	29859	33912	38797	49087	50000	55000	60000
annual growth rate in %	21.6	-14.4	13.6	14.4	26.5	1.9	10.0	9.1
Imports of services, BOP, EUR mn 8)	51424	44099	55550	64612	83937	95000	110000	130000
annual growth rate in %	21.1	-14.2	26.0	16.3	29.9	13.2	15.8	18.2
FDI inflow, EUR mn 8)	51107	26203	32635	37973	40000	50000	55000	60000
FDI outflow, EUR mn 8)	37882	31346	39598	48318	40000	40000	40000	40000
Gross reserves of CB, excl. gold, EUR mn	291920	290380	335251	350786	367368	.	.	.
Gross external debt, EUR mn	340692	325639	369524	417707	471094	.	.	.
Gross external debt, % of GDP	30.1	37.0	32.1	30.6	30.2	.	.	.
Exchange rate RUB/EUR, average	36.4	44.1	40.3	40.9	39.9	41	42	43
Purchasing power parity RUB/EUR 9)	22.4	23.1	25.8	29.4	31.3	.	.	.

1) Preliminary and wiiw estimates. - 2) Resident population. From 2010 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.