ANALYSIS

Forecasting the Russian Economy for 2010–2012

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Abstract

After an exceptionally deep recession, the Russian economy has returned to growth.[1] The Bank of Finland expects that this expansion will, as previously forecast in March 2010, remain robust. Also Russia's imports are expected to grow quickly. Most likely, the growth rates of both aggregate production and imports will slow over the forecast period, but GDP growth is projected to remain at almost five per cent and import growth at more than ten per cent. Thus, while quick in international comparison, future growth will not reach the speed seen in the long growth spurt of 2000–8 that preceded the crisis. The level of Russia's aggregate production will reach the pre-crisis peak of 2008 in mid-2011. As always, there are uncertainties to this forecast.

The Impact of the 2008 Crisis on Russia

In a previous paper, I emphasized the uncertainties in trying to forecast how Russia will fare in the Great Recession that began in Autumn 2008 and reached Russia almost immediately (Sutela 2009). At the time, the Bank of Finland forecast for 2009 was among the most pessimistic, expecting Russia's GDP to shrink by two per cent and imports to fall 13 per cent. In fact, the situation turned out to be much worse. GDP dropped by nearly eight per cent and imports plunged by a whopping 27 per cent. Given the relatively modest decline expected, it was only natural to forecast that the recovery in 2010 would also be slow, with GDP rebounding by one per cent and imports by two per cent. We now know that improvement in 2010 will be much faster, but from a lower base than had been expected in early 2009. One has to ask why such forecasting errors occurred, at the same time noting that the Bank of Finland's mistakes where by no means among the worst. In March 2009 the GDP forecasts covered by the Consensus Economics forecast varied from plus two to minus four per cent.

The crisis reached Russia through three paths. First, the oil price peaked at almost 150 US dollars per barrel in summer 2008, and some generally respected analysts expected the price to soon climb to the 200 dollar level. In fact, the price dove to less than 50 dollars by the end of 2008, but then recovered to 70–80 dollars, where it has remained since. Given the price formulae generally used in European natural gas imports, it was understood that the gas price would follow this trend with an average lag of 6–9 months. With an anticipated slowdown in the global economy, Russia faced a double whammy: Not only were hydrocarbons the key income item in Russia's budget and export revenue, but metal prices were expected to follow the downward trend. What is worse, Russian export volumes were expected to drop. This was especially true for steel, which is the crucial commodity in business-cycle-sensitive activities, like car manufacturing and construction. European steel demand was halved almost overnight, which hit both Russia and especially Ukraine hard.

Second, export prices and some volumes were bound to fall. Expectations of this imminent decline had a quick impact on Russia. In fact, however, the expectations were overly dark. Though the oil price decline was steep, prices remained at their lowest levels for a shorter period than originally thought. This was due to another unexpected fact. The Great Recession almost did not affect the GDP growth rate of the large emerging economies of Asia. In China, GDP growth may well have stalled by the end of 2008, but the regime quickly launched a government-led expansion. Such a response was possible because China had accumulated huge cash reserves and clearly had more-or-less ready blueprints on how to react. Even before the crisis struck, Chinese leaders already had an understanding that in order to maintain robust growth, China's economy had to be re-oriented towards domestic demand, particularly consumption. Emphasizing the home market would help to remedy the global imbalances that were at the root of the Great Recession. Scholars will continue to debate whether the imbalances were due to excessive US demand for finance, brought about by general overconsumption and new financial instruments in the housing sector, or were caused by excess finance available from China and other surplus-generating countries, or whether the crisis was due to the failure of the international financial system and particularly the US Federal Reserve to manage the global financial flows. Available evidence points—as it usually does—to a combination of factors. Interest rates had been extremely low and finance easily available, which clearly points the finger at excess supplies of finance by the surplus-generating countries. At the same time it is difficult to deny that market structure and supervision left much to be desired. Whether the situation will change in the future

1 This article is largely based on the Bank of Finland forecast for Russia in 2010–2012, released on 29 September 2010. Any errors in additional facts and interpretation are the sole responsibility of the author.

depends on a wide variety of technical and political factors. Presently, there are fewer calls for closer supervision as observers begin to grapple with the awesome technical complexity of the problem.

Finance is the third route through which the crisis hit Russia. Within Russia, a dual financial system had developed, with the large, generally creditworthy, export companies having easy access to international money markets, while domestic banks and financial institutions remained underdeveloped due to the widespread lack of trust and good customers. The Russian state was practically free of debt. Aggregate private debt also was low. Official currency reserves, among them the reserve funds accumulated since 2003, covered all foreign debt, putting Russia in an exceptional situation. On one hand, the little debt that existed was short-term and concentrated among a small number of Russian entities. That situation was understood, but most players failed to recognize the extent to which the counterparty finance of interbank markets came from abroad. In an approaching crisis, creditors have to concentrate on securing their home bases. When the global finance flows duly turned away from Russia, interbank markets, crucial to any economy, froze up, and the economy came to a sudden stop. Widely used forecasting models did not anticipate this impact and that failure caused many of the analytical errors seen worldwide.

Russia's Response

On a general level, Russia was prepared for a crisis somewhat like the one that occurred (Sutela 2010). Russian market players had no trust in international economic arrangements. Like most other resource dependent countries, Russia had accumulated major reserves to be used both for fiscal revenue stabilization and general fiscal adjustment in case of need. Though some money was set aside for the pension system, Russia's funds were basically intended for a rainy day, not for maintaining post-hydrocarbon living standards, like in Norway. Now the proponents of such policies, especially Prime Minister Vladimir Putin and Finance Minister Aleksei Kudrin, deem their past decisions well vindicated. Still the opportunity cost of fiscal conservatism, like the roads that could have been built but were not, remains.

Russian decision-makers made the crisis steeper through conscious policy choices whose goal was systemic stability. One example was the step-wise devaluation of the ruble in late 2008, a policy that Putin personally pushed, according to insider accounts. Currency reserves declined by a third, but households, companies and banks were given time to switch their ruble holdings into foreign currency at exchange rates known to be advantageous. Official reserves were partially privatized, but IMF analysts claim that the policy averted a banking crisis. The second key decision was to concentrate fiscal stimulus into large enterprises, including efforts to maintain one-company towns. Policy-makers recognized that this plan was economically inefficient since many of the large companies that received aid will never become competitive. But Russia's politicians thought it inevitable in order to preserve social and political stability. At the same time pensions were increased by a fourth on average in 2009 and almost by a half in 2010. As a consequence, Russian household incomes increased during the Great Recession, a situation unique in global comparison. One third of voters are of pension age, and they are among the most politically active groups. Even though pensions remain relatively low, they will impose significant spending pressure on future budgets, given that Russia mostly has a pay-as-you-go pension system financed from the budget. The future pension burden poses major fiscal challenges, as the pension system is already now basically bankrupt. Moreover, the number of young workers is shrinking—due to Russia's overall demographic problems—at the same time as life expectancy is increasing with incomes.

Existing data suggests that Russia has gone through an exceptionally sharp inventory adjustment. Statistics are unreliable here however. How large were the inventories pre-crisis, how steeply were they cut, and to what extent they have already been rebuilt to desired levels? Such seemingly technical issues are key to estimating how durable the upturn that was evident by mid-2009 actually is.

Recovery

Russia is being dragged away from the Great Recession by the same factors that took it into it. Export prices recovered, and so did many export volumes. The world economy is satiated with liquid finance now looking for profitable employment and again accepting a larger degree of emerging market risk. The economy has returned to a consumption-based growth path. Imports have truly surged. Of course, potential growth post-crisis will be slightly lower than before the crisis, but that is due to demography, not any immediate policy variable. Russian authorities judge that they have weathered the crisis well, and complacency is returning. In fact, they made no major mistakes.

Still uncertainties abound. Things may still go wrong in the international economy. The character of the inventory cycle is a question mark, and issues of fiscal sustainability loom. An import surge is putting pressure on the balance of payments and the ruble. Current excess capacities will soon be in use again. Future growth requires greater investment than before. As was evident even before the crisis, Russia must face two key issues: ensuring that its workers are employed in a diverse range of globally-competitive jobs and maintaining export capacity through greater domestic energy efficiency, as oil and gas production volumes will not grow much in the future. Russia's president and prime minister agree on the need to address these issues. Where disagreement arises is in defining the degree to which these challenges can be met in the absence of meaningful political democratization. Even here the differences are shades of grey and are internalized by most decision makers and advisors, rather than leading to conflict between individuals.

The current Bank of Finland forecast for Russia is available at www.bof.fi/bofit, and there is no reason to go into the details here. The headline figures are given in Figure 1 below. The forecast is fundamentally in line with the existing consensus. The main points of difference are in evaluating the damage caused by the exceptional winter and summer of 2010; how fast and by which path GDP growth converges towards the potential growth rate generally estimated to be around four per cent; and how strongly the ruble will appreciate in real terms, increasing Russia's import potential.

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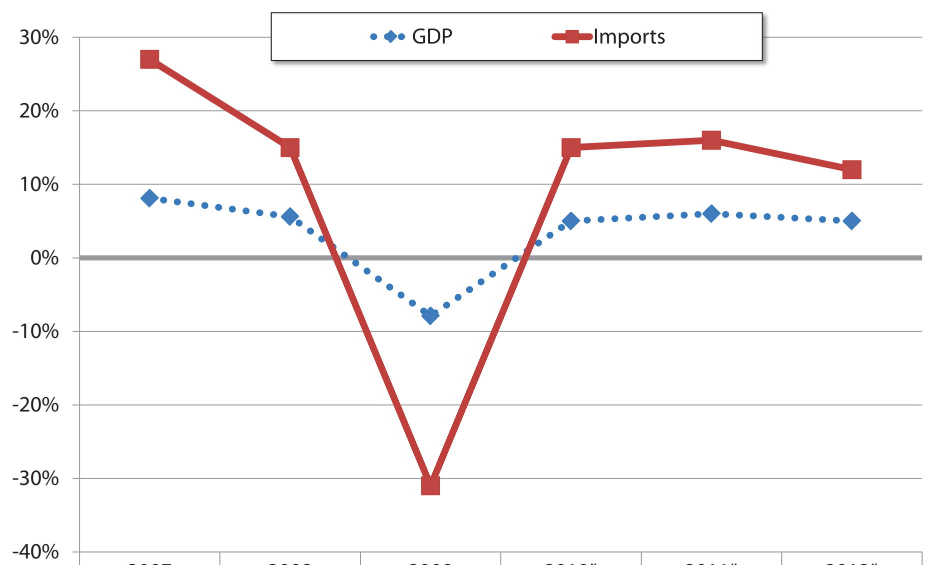
Recommended Reading:

- BOFIT Russia Desk: BOFIT Forecast for Russia 2010–2012, 29 September 2010, http://www.bof.fi/bofit_en/seuranta/ennuste/2010/brf210.htm
- Sutela, Pekka: Die wunderbare Schwierigkeit des Prognostizierens. [German language; "The Wonderful Difficulty of Prognostication"], Russland-Analysen No. 182, 8 May 2009, http://www.laender-analysen.de/russland/pdf/Russlandanalysen182.pdf.
- Sutela, Pekka: Russia's Response to the Global Financial Crisis. Carnegie Policy Outlook, July 29, 2010, http://carnegieendowment.org/files/russia_crisis.pdf.

Figure 1: Russia's Economic Development in 2007–2009 and the September 2010 Bank of Finland Forecast for 2010–2012, %



	2007	2008	2009	2010*	2011*	2012*
GDP	8.1%	5.6%	-7.9%	5.0%	6.0%	5.0%
Imports	27.0%	15.0%	-31.0%	15.0%	16.0%	12.0%

** forecast*
Source: BOFIT Russia Desk: BOFIT Forecast for Russia 2010–2012, 29 September 2010, http://www.bof.fi/bofit_en/seuranta/ennuste/2010/brf210.htm