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**RUSSIAN ECONOMY IN 2016  
TRENDS AND OUTLOOKS  
(ISSUE 38)**

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The review provides a detailed analysis of main trends in Russian economy in 2016. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and budget spheres; financial markets; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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## 4.2. Decomposition of Russia's GDP growth rates in 2016–2019<sup>1</sup>

In his Annual Presidential Address to the Federal Assembly on 30 November 2016, Russian President Vladimir Putin underscored Russia's goal to catch up with the world average growth rates by 2019–2020. As a reminder, the IMF projects 3.7% for the average annual growth rate of the global economy in the coming three years.<sup>2</sup> Earlier in November, Russia's Ministry of Economic Development (MED) updated its forecast for Russia's socio-economic development for 2017–2019<sup>3</sup> whereby a 0.6% decline is projected for Russia's GDP in 2016, while its baseline scenarios (see below) predict that economic growth rates will be barely higher than 2% by 2020 amid low crude oil prices and a lack of structural reforms.

Shortly after the MED's updated forecast was released, the IMF upgraded its forecast for Russia's GDP growth in 2016: while earlier in October the IMF projected a 0.8% year-over-year downturn for the Russian economy in 2016, the revised IMF forecast matches the abovementioned MED's projection of 0.6%. The IMF notes in its comments on the forecast that Russia's economy has managed to withstand the double shock of lower crude oil prices and imposition of sanctions, and there are signs of the economy entering a recovery phase.<sup>4</sup> IMF analysts projected a 1.1% growth for Russia's GDP in 2017, with the growth being driven in part by higher crude oil prices.

Furthermore, the year-end 2016 findings that Russian official statistical agencies published in early February 2017 have come to be even more optimistic: GDP growth rate in 2016 was only 0.2% below the value seen in 2015, according to Rosstat's initial assessment.

We will consider the foregoing MED's forecast for 2017–2019, as adjusted for the 2017 official findings and for the data on previous periods revised by the Rosstat. As was the case with previous forecasts, this one comprises three scenarios – baseline (aka conservative) scenario, “baseline +” scenario and target scenario.

The MED notes that the underlying scenarios of the forecast rest on the assumption that the policy of sanctions against Russia and Russia's countermeasures will continue over the entire projected period, as well as there will be no geopolitical and economic shocks. The forecast presumes macroeconomic and financial sustainability as long as social and foreign economic commitments are honored.<sup>5</sup>

The baseline scenario presumes that Russia's economy will operate amid consistent external factors, while an allowance is made for a worsening of the foreign-policy environment and other conditions. This, as noted above, is a conservative scenario whereby the economic development model is not expected to undergo drastic changes. According to the baseline scenario, stagnation will give way to a recovery in 2017, and GDP will be up 0.6% year-over-year, to 2.1% by 2019. The recovery will take place amid rather low global crude oil prices (the Urals crude oil is traded at USD 40 a barrel over the entire projected period) and growth in capital outflows, from USD 18bn in 2016 to USD 25bn by 2019. The MED predicts stable

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<sup>2</sup> <http://www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx>

<sup>3</sup> <http://economy.gov.ru/minec/activity/sections/macro/2016241101>

<sup>4</sup> <https://www.vedomosti.ru/newsline/economics/news/2016/11/29/667422-mvf-prognoz-vvp>

<sup>5</sup> <http://economy.gov.ru/minec/activity/sections/macro/2016241101>

investment activity by mid-2017 and further growth in investment in 2018, to 1.3% in 2018–2019, due to growth in private investment amid a decline in public investment.

The “baseline +” scenario presumes that Russia’s economy will face a benign foreign-economic environment in 2017–2019. For instance, the Urals crude oil is expected to be traded at 48 USD a barrel in 2017, to USD 55 by 2019. The same scenario presumes an increase in household incomes and a consumer demand recovery. It also predicts that capital outflows will take a more subdued pace, down to USD 15bn in 2019. In this context, according to the MED, fixed investment are projected to recover at a faster pace than expected by the baseline scenario: fixed investment are anticipated to increase 2.9% in 2019 due to private and infrastructural investments. Hence the scenario predicts that GDP will raise from 1.1% in 2017 to 2.4% in 2019.

According to MED’s documents, the target scenario focuses on achieving target values of socio-economic development and on addressing strategic planning objectives. The scenario presumes that in the medium term Russia’s economy will enter a pathway of sustainable growth at a pace not slower than the world average growth rate while macroeconomic equilibrium is secured.<sup>1</sup> GDP is expected to grow at a higher rate, from 1.8% to 4.4% in 2017–2019. The target scenario focuses on an external environment similar to that of the “baseline +” scenario (in particular, crude oil price dynamics), however, the target scenario parameters can hardly be achieved, according to the MED, unless Russia’s economic development model is transformed to an *investment-based model*, which implies a moderate growth in consumption spending in the first few years of the projected period, as well as lower costs for businesses. Economic growth under the given scenario will facilitate business environment, and hence it will help discourage net capital outflows which are expected to stop in 2019. The target scenario’s active investment policy should facilitate average annual growth in fixed investment, up to 5.2% annually in the period between 2017 and 2019, which will be driven by a higher-than-anticipated growth in private and infrastructural investments.

In our view, given the above preconditions and external factors, the parameters of all the scenarios, excluding the target scenario that, according to the MED, does not expect drastic changes in the growth model, can be met through serious structural changes to internal conditions for the development of Russia’s economy. This assumption holds true based on the findings of decomposition of projected GDP growth rates using a method developed by the Gaidar Institute. The method employs the algorithm of decomposition of GDP growth rates into structural, foreign-trade and cyclical components that is applied in developed countries (OECD). We modified the method so that it could capture the specifics of the Russian economy that is heavily reliant on terms of trade.<sup>2</sup> The decomposition was performed using the key parameters of the updated scenario-based forecasting for Russia’s socio-economic development for 2016–2019 (see the above-described scenarios of the forecast).

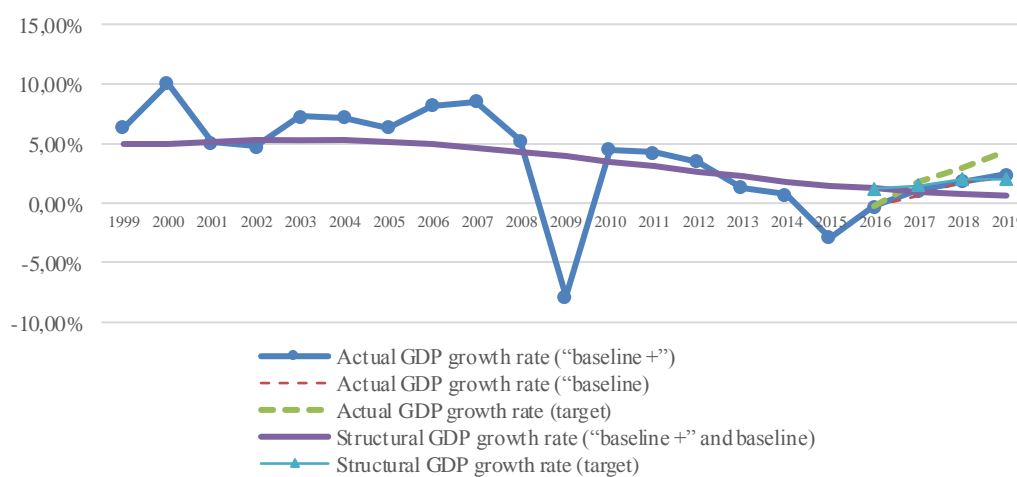
*Fig. 11, 13–15* show the dynamics of Russia’s actual GDP growth rate, as well as the dynamics resulting from decomposition of its structural, foreign-trade and cyclical (the sum of business cycles and random shocks components) components for the period between 1999 and 2019 for all the above three scenarios, as adjusted for Rosstat’s data on the -0.2% decline in 2016.

<sup>1</sup> <http://economy.gov.ru/minec/activity/sections/macro/2016241101>

<sup>2</sup> This method is described in detail in S. Sinelnikov-Murylev, S. Drobyshevsky, M. Kazakova. Decomposition of Russia’s GDP growth rates in 1999–2014 // *Ekonomicheskaya Politika [Economic Policy]*. 2014. No. 5. PP. 7–37, as well as a monograph on Decomposition of Russia’s GDP growth rates / S. Sinelnikov-Murylev [et al.]. - M.: Gaidar Institute Press, 2015. – 128 ps.: (Scientific Works Series / Gaidar Institute for Economic Policy; No. 167P).

Our estimates show that if the baseline scenario and the “baseline +” scenario materializes, the structural component of GDP growth rate would constantly slow down since 2005, to 0.6% in 2019 (and is apt to stabilize at this level beyond the projected period). A slower pace of the structural component of economic growth is driven by negative dynamics of its fundamental (structural) factors, namely a decline in the employment (the labor factor) due to demography downtrends and slower growth rates in fixed assets in volume terms (proxy variable for the capital factor).

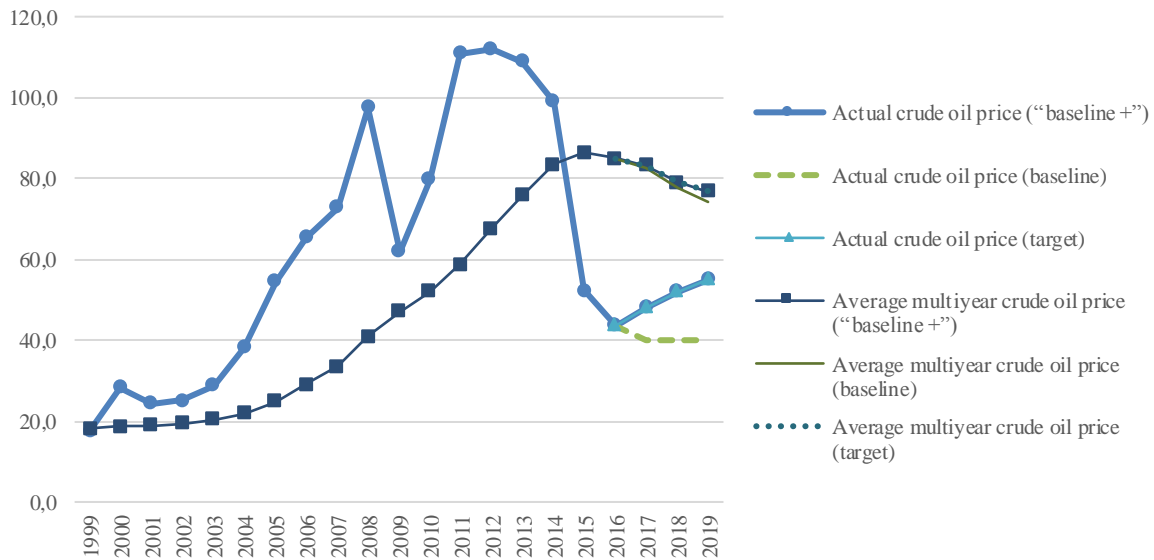
If the target scenario materializes, that, as shown above, allows for transition to a new economic growth model in Russia, that is, growth in structural factors, then the structural component of GDP would go up to 1.5% in 2017, to stabilize at 2% in 2018–2019 (see *Fig. 11*).



*Fig. 11. Actual GDP growth rate and its structural component (all the three scenarios), year-over-year % change, 1999–2019*

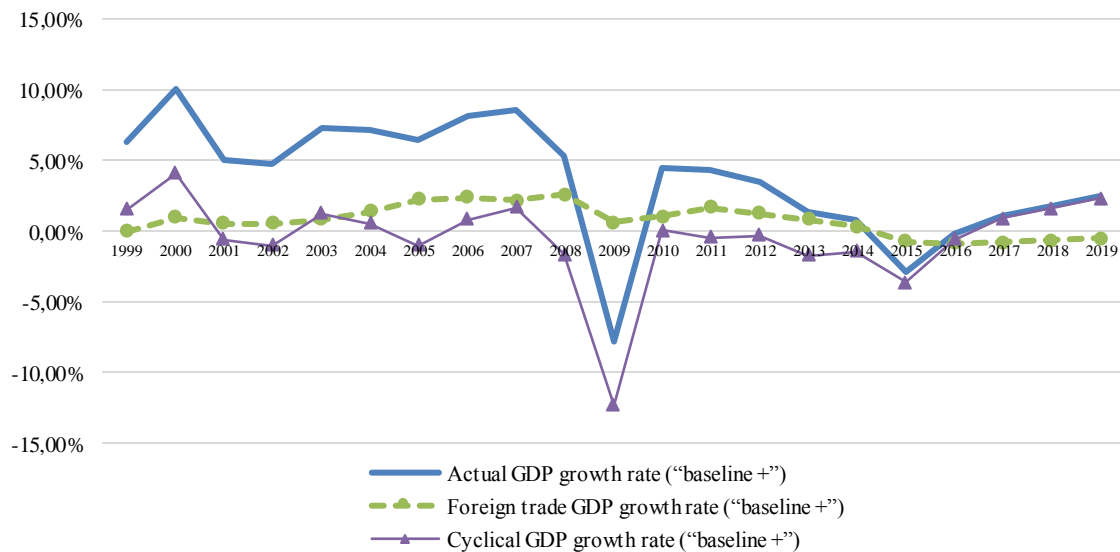
*Sources:* Rosstat, MED, IMF, own calculations.

Decomposition of projected GDP growth rates in 1999–2019 for all the three scenarios of socio-economic development in the Russian Federation reveals a negative foreign-trade component of GDP growth rates in 2016–2019 (see *Fig. 13–15*). The negative value is explained by the fact that all the three scenarios envisage global crude oil prices lower than average multiyear values within the given period (USD 74–85 a barrel, *Fig. 12*).



*Fig. 12. Actual and average multiyear crude oil price, USD/barrel, 1999–2019 (all the three scenarios)*

Sources: IMF, own calculations.



*Fig. 13. Actual GDP growth rate and its foreign-trade and cyclical components, year-over-year % change, 1999–2019 ("baseline +" scenario)*

Sources: Rosstat, MED, IMF, own calculations.

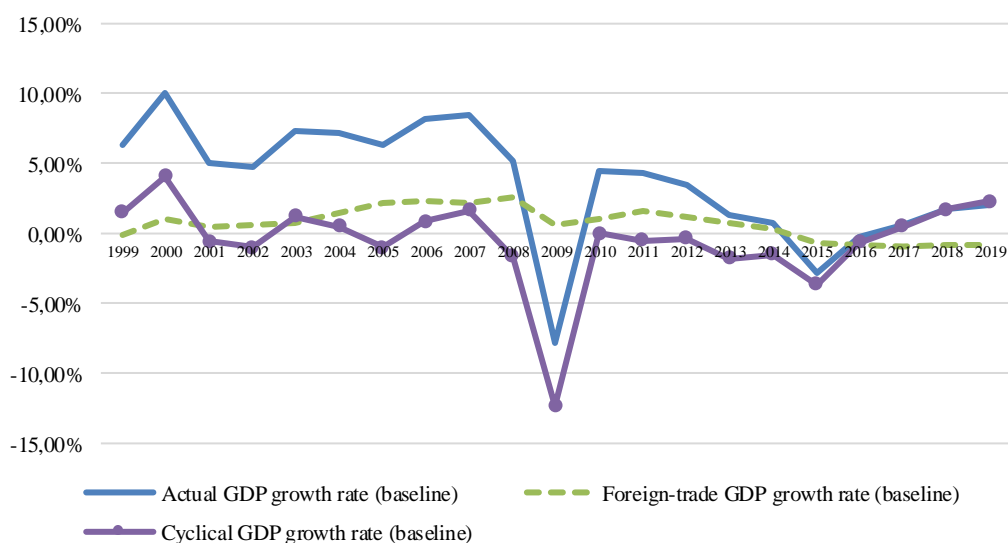


Fig. 14. Actual GDP growth rate and its foreign-trade and cyclical components, year-over-year % change, 1999–2019 (baseline scenario)

Sources: Rosstat, MED, IMF, own calculations.

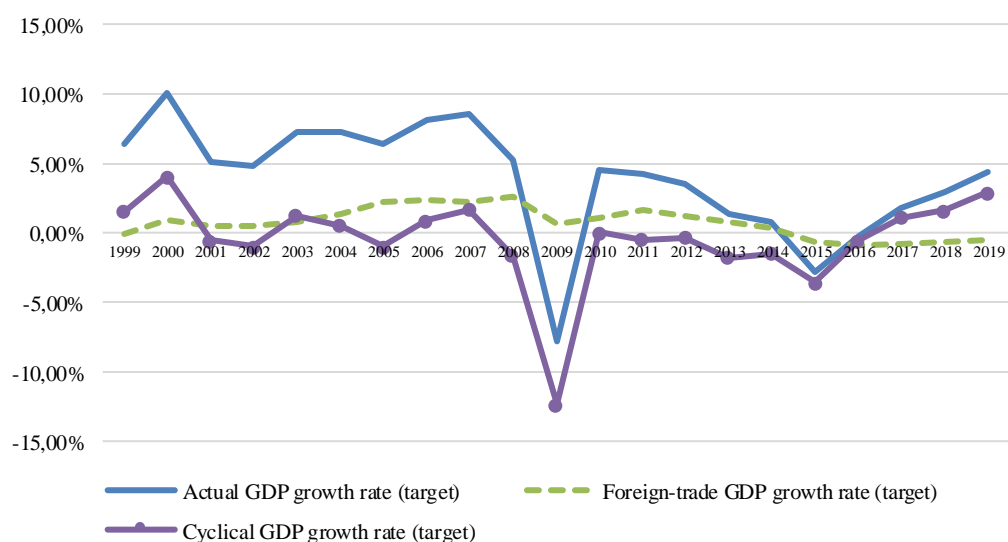


Fig. 15. Actual GDP growth rate and its foreign-trade and cyclical components, year-over-year % change, 1999–2019 (target scenario)

Sources: Rosstat, MED, IMF, own calculations.

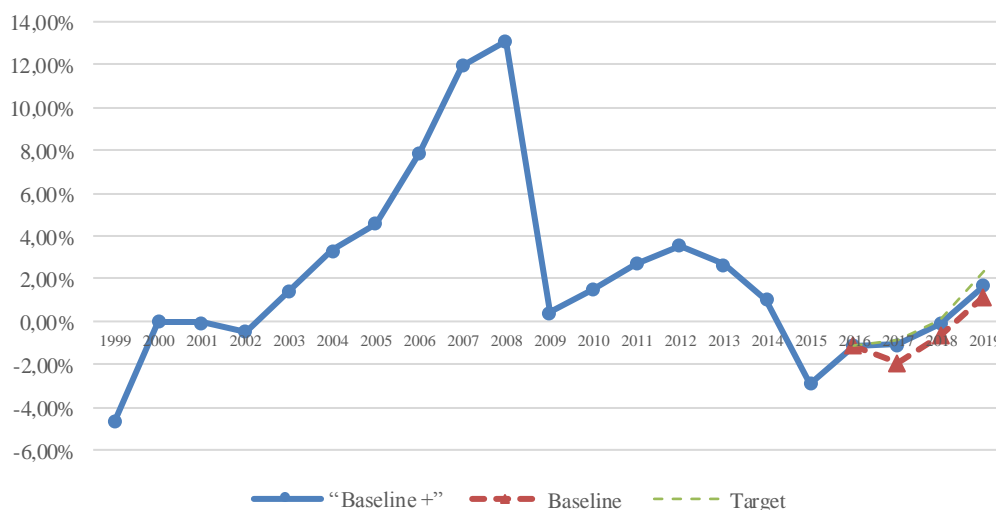
The cyclical component of Russia’s GDP growth rate has since 2008 been negative, as shown in Fig. 13–15. It appears that the downward dynamics was driven by raised uncertainty and risks to Russia’s economy amid a highly volatile ruble exchange rate and, since 2014, a combined shock of adverse effects of economic sanctions and countersanctions, higher inflation and deteriorated access to fundraising.

The findings of decomposition of Russia’s GDP growth rates in 2016–2019 in context of the “baseline +” and baseline scenarios of MED’s forecasting of Russia’s socio-economic

development whose key parameters are described above, lead to the conclusion that the above scenarios – including projected GDP growth rates amid crude oil prices lower than average multiyear prices, a lack of growth in the fundamental factors of economic development and the total factor productivity (TFP) (and hence a lower structural component of growth) – cannot materialize unless there is an upsurge of the cyclical component (to about 2.3% by 2019), which, in our view, may happen as a result of an upsurge in cyclical GDP after the negative shock of 2015 is gone, or on the assumption that the economy will stay at the bottom (lower phase) of the business cycle, a marked positive shock of unclear nature.

The target scenario could materialize provided that the cyclical component is slightly higher (to 2.9% by the end of the projected period), however, in such a case, as noted above, Russia’s economy would operate under a brand new investment model, which implies a higher structural component of GDP growth whose dynamics is driven by fundamental factors.

We used decomposition of Russia’s economic development growth rates to estimate an output gap (i.e., the deviation of actual GDP from a potential output volume), as shown in *Fig. 16*. According to our estimation, in 2015 the output gap went negative under the baseline and “baseline +” scenarios and would stay negative within a range of -1–2% till 2018. The gap would be positive in 2019 under the above scenarios. As regard the target scenario, the gap would stay negative till 2017, and would regain positive values in 2018, to 2.4% by 2019.



*Fig. 16.* Gap in Russia’s economic output (%), 1999–2019 (all the three scenarios)

*Source:* own calculations.

The findings lead to the question of what factors that could facilitate the implementation of the parameters envisaged by the above scenarios, except the target scenario. First, as shown above, the Russian economy cannot count on favorable terms of trade because a rather moderate level of crude oil prices, a way below the average multiyear level, is expected over the entire projected period.

Second, neither can the cyclical component facilitate growth rates of that high level because, as noted above, none of the above scenarios envisage preconditions for its growth.

Therefore, it is only through the growth of the structural component – the transition to a new economic development model focused on investment as a key factor – that the desired economic



growth rates can be achieved, as provided for by solely the target scenario. In other words, the best-case scenario for the Russian economy, namely sustainable GDP growth rates at a pace of worldwide average growth rates by 2019 (about 4% year-over-year), can materialize subject to a significant upsurge of GDP fundamental factors. According to our estimates, with the TFP as it is now (this precondition appears to be realistic amid continuing sanctions and a lack of foreign capital, as described by the MED), this goal can be achieved by engaging extra labor resources (about 4.5 million persons), as well as extra Rb 40 trillion of fixed investment in the period between 2016 and 2018.