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R95 **Russian Economy in 2018. Trends and Outlooks. (Issue 40**) / [V. Mau at al; ed. Editors – Alexei Kudrin, doctor of sciences (economics), Alexander Radygin, doctor of sciences (economics), doctor of sciences Sergey Sinelnikov-Murylev, doctor of sciences (economics)]; Moscow: Gaidar Institute Publishers 2019. – 616 pp. – ISBN 978-5-93255-556-9

The review “Russian Economy. Trends and Outlooks” has been published by the Gaidar Institute since 1991. This is the 40th issue. This publication provides a detailed analysis of main trends in Russian economy, global trends in social and economic development. The paper contains 6 big sections that highlight different aspects of Russia's economic development, which allow to monitor all angles of ongoing events over a prolonged period: the socio-political issues and challenges; the monetary and budget spheres; financial markets and institutions; the real sector; social sphere; institutional changes. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts confirming the conclusions.

Reviewer: Lev Yakobson, Doctor of sciences (economics), professor, first pro-rector, NRU-HSE.

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Decomposition of economic growth in the Russian Federation through 2024[1]

In 2018, the growth rate of GDP in Russia (2.3 percent) represents a record high of per annum economic growth rate since 2012. This year-end result is notably above the estimates offered by a majority of international financial organizations (the IMF, World Bank, the OECD), as well as by Russian banking analysts and experts. The volume of GDP in nominal terms surged above RUB 100 trillion, to RUB 103,626.6 billion (or approximately USD 1,657 billion when recalculated at the annual average RUB-to-USD rate). Growth was also displayed by most of the basic indicators: thus, the industrial production index in 2018 gained 2.9 percent, freight turnover – 2.9 percent, retail trade turnover – 2.6 percent. Special note should be made of the movement pattern of fixed investment: according to preliminary estimates released by *Rosstat*, its annual growth index amounted to 4.3 percent. Considering the fact that, in 2017, the amount of fixed investment in constant prices increased by 4.8 percent, it can be said that over the period 2017–2018, the investment sphere indeed experienced intense growth; however, the main contribution to that growth was made either by budget-funded investments (the completion of building construction projects in preparation for the World Cup; the construction of the bridge to the Crimea; the Sabetta Airport and Seaport; and infrastructure in the city of Moscow), or investments by state-owned companies (Nord Stream 2 natural gas pipeline; Yamal LNG; etc.)

At the same time, the RF Ministry of Economic Development explains the fact of GDP growth in 2018 by the impact of 'one-time factors'[2], and is still oriented, in its forecast, to a slowdown in the economic growth rate in Russia in 2019 to 1.0–1.3 percent (depending on a particular scenario).

In order to assess the current situation in the Russian economy and the potential for achieving the established development targets, we analyzed the year-end structure of GDP growth rate for 2018. For this purpose, we applied the methodology for decomposition of GDP growth adapted to Russia's conditions[3,4], which analyses the observed GDP growth rate as a combination of the structural, foreign trade and cyclical components. The structural component is responsible for long-term GDP growth rate and is determined by the movement patterns of fundamental production factors: labor, capital, total factor productivity. The foreign trade component is shaped by the fluctuations of a country's trade conditions, and in the case of Russia, it closely

[1] This section is authored by: S. Drobyshevsky, Gaidar Institute, RANEPA; P. Pavlov, RANEPA.

[2] https://www.rbc.ru/economics/13/02/2019/5c6378929a79471f926430ef

[3] Drobyshevsky S.M., Idrisov G.I., Kaukin A.S., Pavlov P.N., Sinelnikov-Murylev S.G. Decomposition of Russian GDP growth rates in 2007–2017 and forecast for 2018–2020. // Voprosy Ekonomiki. 2018. No 9. P. 5–31.

[4] The methodology is based on decomposition of GDP across the OECD, see Giorno C., Richardson P., Roseveare D. and van den Noord P. 1995. Estimating Potential Output, Output Gaps and Structural Budget Balances. OECD Economics Department Working Papers. No. 152. OECD Publishing, Paris.

correlates with the global prices for tradable raw materials: oil, natural gas, metals, etc. The cyclical component is the sum of domestic business cycle and accidental shocks.

Because the methodology for GDP decomposition applied in our study is sensitive to the specificities of a selected estimation period, the estimates based on the observations pertaining to the last few years, which are also those most relevant for our analysis, may be not quite correct, and they are often adjusted at a later date, when the macroeconomic time series are extended[1]. So, we need to plot certain economic development scenarios for several years forward. For this study, we applied the RF Ministry of Economic Development's socioeconomic development forecast for the period until 2024, which was included in the package of documents attached to the draft Federal Law 'On the federal budget for 2019 and the planning period 2020–2021'.

The forecast has been prepared in two versions (conservative and baseline). Under the baseline scenario, as said earlier, the growth rate in Russia's economy in 2019 is expected to amount to 1.3 percent relative to the previous year. However, the slowdown in economic growth will be only temporary, and later on, as a result of the successful completion of national projects in the framework of the main directions of Russia's socioeconomic development and implementation of measures designed to boost investment activity, the rate of GDP growth will follow a higher trajectory, thus creating appropriate conditions for achieving the main goals outlined in Presidential Executive Order No 204 dated May 7, 2018 'On National Goals and Strategic Objectives of the Russian Federation through to 2024'. Thus, in 2020, Russia's GDP will gain 2 percent relative to the previous year, and then from 2021 onwards it will increase at a rate above 3 percent, rising in 2024 to the level of 3.3 percent.

The conservative scenario of Russia's economic development is geared to the conditions of a significant slowdown in the global economic growth rate triggered by China hard landing, and a resulting shrinkage of the demand for energy carriers and other raw materials, followed by a plunge of world prices for these types of goods. In particular, it is predicted that by 2024, world oil prices will decline to USD 45.9 per barrel vs. USD 53.5 per barrel under the baseline scenario. As the forecast's authors have emphasized, the current macroeconomic policy followed by the government ensures that the domestic economy's parameters only rather weakly depend on the volatility of oil prices; however, if the conservative scenario should materialize, the source of negative effects for Russia's economy will become the low foreign demand for domestic exports.

For each of these scenarios, we did a scenario-based decomposition of the GDP growth rate for the period 2007–2024. *Fig. 39* shows the movement patterns of the structural, foreign trade and cyclical components under the RF Ministry of Economic Development's baseline scenario only, because the variance of values pertaining to the two scenarios is low, and the addition of the second scenario values does not fundamentally influence the final results of our analysis.

[1] Turner, D. et al. (2016). An investigation into improving the real-time reliability of OECD output gap estimates. OECD Economics Department Working Papers, No. 1294, OECD Publishing, Paris.

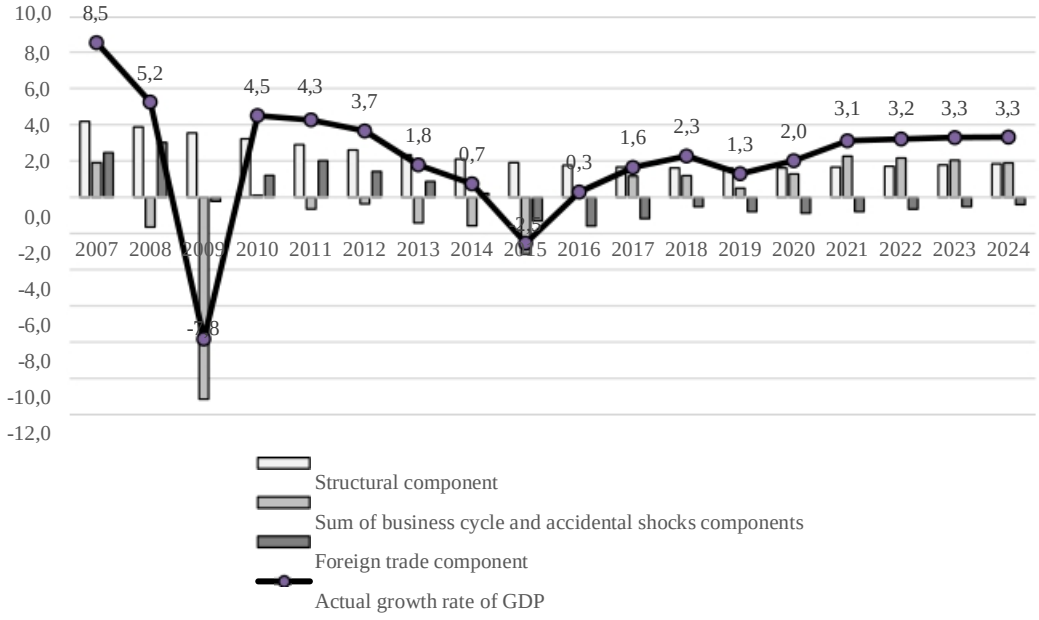

Fig. 39. Decomposition of the GDP rate growth over the period 2007–2024 (baseline scenario)

Sources: Rosstat; RF Ministry of Economic Development; own calculations.

As demonstrated by the graphs in *Fig. 39*, the biggest input in the growth rate of GDP in 2018 was made by its structural component, which we estimate to be gaining 1.6–1.8 pp. per annum, and which remains sufficiently stable throughout the entire period from 2016 through 2024. According to our estimations, the total factor productivity (TFP) was at its record low in 2015–2016, and then in 2018, the TFP index of Russia's economy roughly corresponded to its 2013 level (the year of a noticeable slowdown in the national economy, even in face of persistently high oil prices). Even under the baseline scenario of the Russian economy's development, the TFP index is not going to climb, by 2024, above its 2008–2009 level. The inputs of investment growth and fixed capital growth to the structural component's growth rate are almost totally offset by the decline in economically active population.

In spite of the rise, in 2018, of the average annual price of Urals to USD 69.6 per barrel from USD 53 per barrel in в 2017, oil prices are still staying below their multiyear average of the previous periods, and the input of the foreign trade component in the growth the of GDP in 2018 was negative (-0.5 pp.); however, the scale of the negative input of the foreign trade component over the course of last year was noticeably lower than in 2015–2017. It should also be noted in this connection that the cyclical component in 2018 remained at the same level as in 2017 (approximately 1.2 pp.), which is indicative of a persistent trend towards smooth cyclical economic growth.

Thus, the results of GDP growth rate decomposition demonstrate that in 2018, its growth was produced not by the combined inputs of one-time internal factors (as this must have translated into the acceleration of the cyclical component – or, due to the

methodology's shortcomings, that of the TFP index), but rather by the improving situation in global commodity markets. The movement patterns of the structural and cyclical components of GDP are rather smooth and compatible with the hypothesis of a slow but sustainable elimination, across the economy, of the consequences of the 2014–2015 crisis, and its adaptation to the conditions shaped by the imposed economic sanctions and the new (lower) hydrocarbon prices.

Since the RF Ministry of Economic Development, in its forecast, is oriented to a plunge in oil prices in 2019, and the current oil prices are indeed somewhat below their average annual index for 2018, the increasing negative input of the foreign trade component in the growth rate of GDP appears to be quite logical; however, for the rate of economic growth to plunge to the level of 1.0–1.3 percent, as seen from *Fig. 39*, a substantial slowdown of the cyclical component will be necessary (because the cyclical component of growth can be considered to be sufficiently stable, it could probably become slower only in response to some serious external and internal negative shocks), or a reversal of the current trend in the structural component's movement pattern (the TFP index, because the capital and labor force movement patterns are largely driven by inertia). In absence of such negative shocks on the part of its cyclical or structural components, the GDP growth rate in 2019 will remain within the range of 1.7–2.0 percent.

For the purpose of our analysis of the current situation in the Russian economy relative to its potential growth pattern, we estimated the output gap for GDP (*Fig. 40*). The output gap is understood as the difference between the actual GDP (projections for 2019–2024) in constant prices from structural GDP, i.e. the hypothetical GDP value calculated on the basis of its structural growth rate data derived by means of decomposing the GDP growth rate. So, the output gap increases (and shifts to positive zone) if the current rate of GDP growth (including its foreign trade and cyclical components) is higher than the structural rate of growth; and vice versa, it shrinks and moves to negative zone if the current rate of GDP growth in response to the negative inputs of its foreign trade and/or cyclical components plunges below the structural rate of growth.

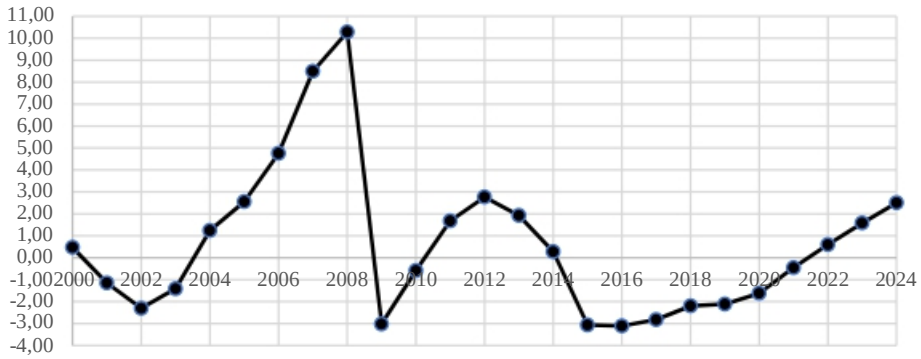

Fig. 40. The output gap in 2000–2024 (as percentage of GDP, baseline scenario)

Source: own calculations.

As seen from *Fig. 40*, from 2015 onwards the Russian economy has been demonstrating a negative output gap (in spite of a slowdown in the structural growth rate), and the output index of the national economy is approximately 2.0–3.0 percent below its potential value. In such a situation, the government policy appears to be quite logical, and primarily the budgetary policy, which aims at increasing budget-funded investments and promoting the investment activity of state-owned companies subordinated to development institutions and companies with controlling state stakes.

In accordance with the RF Ministry of Economic Development's baseline scenario, the negative output gap is expected to completely disappear in 2021–2022 – that is, during the first few years after the Russian economy has achieved its desired rate of growth not lower than 3.0 percent per annum. In 2022–2024, the output gap is to become positive, and then to promptly increase to 2.5–3.0 percent, which is comparable with the situation in 2011–2013 when the Russian economy began to rapidly lose its external and internal competitive capacity due to the quickly depleting growth factors and the increasing domestic production costs. However, the output gap will become totally different in nature: in 2011–2013, the economy overheating was caused by high prices for oil and other Russian exports, whereas in 2022–2024, in face of a moderate external situation, growth in the economy above the fundamentally substantiated values may occur only in response to positive phase of the business cycle. The latter is extremely sensitive to any increases in labor costs resulting from the unemployment rate decline below its natural level, deficit of investment resources in the domestic financial market (in conditions of externally imposed financial sanctions), low consumer activity, and so on. In other words, over the period 2022–2024 the Russian economy will be faced with a situation where, even if the growth rate is relatively low (below 3.5 percent per annum), any additional stimuli or accidental acceleration of economic growth (as a result of an unforeseen positive shock) may promptly translate into a noticeable 'overheating' and, consequently, into a sharp slowdown in the cyclical component growth rate and a threat of a new plunge of the growth rate of GDP below 3.0 percent.

The risk of rapid overheating of the economy can be avoided, and sustainable economic development with the growth rate of GDP not lower than 3.5–4.0 percent per annum ensured only through increasing the growth rate of the structural component. It is obvious that over the next 3 to 5 years, the long-term demographic trends will impose strong constraints on the labor market input in the structural growth rate, and it is unlikely that alongside the continuing financial and economic sanctions the growth rate of fixed investment may rise above its target index set in the baseline scenario of the RF Ministry of Economic Development and the indices applied in our calculations (6.5–8.0 percent per annum). So, the main factor capable of invigorating the structural component of economic growth rate in the Russian Federation over the period under consideration can only be the growth of total factor productivity, including a radical increase in the efficiency of government expenditure and the performance of state-owned companies, as well as the use of state-of-the-art technologies in boosting private entrepreneurial initiatives.