

2016–2017 FORECAST: RUSSIA'S RECESSION CONTINUES

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Preliminary data on Russia's economic results of 2015, as well as the current trends in the global energy market, give grounds for revising down possible scenarios for Russia's economy in 2016–2017. For instance, a scenario of yearly average oil prices staying at \$35 a barrel in 2016 is now the baseline scenario, whereas \$50 a barrel is considered optimistic (Russia's 2016 budget was made on the assumption of \$50 a barrel). Simulation of the key macroeconomic indicators in 2016–2017 under the selected scenarios have revealed that Russia's recession will continue during the projection period, and growth can only be expected if oil prices are steadily above \$50–55 a barrel.

The second half of 2015 saw new signs of a worsening economic slowdown in Russia. Rosstat, Russia's Federal State Statistics Service, reports that real GDP in the third quarter declined slightly slower than in the second quarter, down 4.1% from Q3 2014. In our view, however, it is too premature to wait for a reverse trend. The other indicators showed negative dynamics too. Industrial output contracted by 4.2%, investment were down 6.8%, retail sales turnover declined 9.5%, real disposable income shrank by 3.9%. The Consumers Price Index stood at 1.7% in the third quarter and at 10.3% in the first nine months of 2015. Crude oil saw further decline in price. Another headwind is the worsening geopolitical context due to the conflict between Russia and Turkey over the downed Russian warplane in Syria.

The Urals yearly average price was \$51.1 a barrel, and GDP, according to our estimates, was down 4% at the 2015 year-end. GDP decomposition using a method developed at the Gaidar Institute² has shown that the 2015 decline in GDP can be attributed to the foreign trade component (down 1.3 p.p.) (oil prices are currently below the years-long average), cyclic economic slowdown (down 1.6 p.p.), economic impact of Western sanctions (down 1.5 p.p.), mounting uncertainty and negative expectations due to the rouble devaluation between 2014 and 2015 (down 0.7 p.p.). The structural component of GDP growth rates in 2015 was not higher than 1.1 p.p.

The forecast is based on the assumption that the Urals crude price will average \$35 a barrel in 2016 (not higher than \$30 in Q1 2016) and \$40 in 2017. Note that the assumption implies that Russia's economy will face troublesome terms of trade in the next two years, oil prices will be lower than the years-long average and rebound (in constant dollars) to the level seen in the early 2000s. The optimistic scenario assumes that the Urals yearly average price will go up to \$50 a barrel in 2016 and then see some growth to \$55 in 2017.

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² Methodology of the decomposition of Russia's GDP growth rates as well as interpretation of the results are given in S.Sinelnikov, S.Drobyshevsky, M.Kazakova. "The Decomposition of Russia's GDP Growth Rates in 1999–2014". *Ekonomicheskaya politika*. 2014, № 5, pp. 7–37.

Given these preconditions, we anticipate that under the baseline scenario Russia's economy in 2016 will shrink further by 1.4% and by 0.4% under the optimistic scenario. The negative dynamics (down 0.3%) in the baseline scenario will remain in 2017, whereas the optimistic scenario expects a small growth of 0.9% on condition that relatively favourable developments are seen in 2017. All these trends in the Russian economy stem from slow structural reforms and the lack of foreign trade's extra contribution to the economic growth amid relatively low crude oil prices.

Additionally, our estimates show that the structural component of GDP growth will continue to decline, down to 0.4–0.6 p.p. a year, in response to a working capital contraction by 5–10 p.p. (due to a contraction of new investment, inability to replace retired fixed assets, a decline in fixed asset utilization) and a 2m workforce shrinkage within two years, a decline of 2.5% from 2015. Additionally, we assume that the bulk of Western sanctions and Russia's retaliatory sanctions will remain in place at least until late 2016.

The rest of the economic activity characteristics behave in the same manner. In 2015, fixed investment are expected to decline by 8.6%, retail sales turnover by 10%, real disposable cash income by 4%. The baseline scenario anticipates all these indicators to decline further in 2016 (fixed investment are expected to fall by 4.9%, retail sales turnover by 4.1%, real disposable income by 3.6%) and in 2017 (fixed investment and retail sales turnover are down 3% and 0.5%, respectively), except real disposable cash income (slightly up 0.4%). The optimistic scenario predicts that the same indicators will see a smaller decline in 2016: fixed investment (down 1.2%), retail sales turnover (down 1.8%) and real disposable cash income (down 2.2%), but in 2017 they are expected to grow up by 1.2%, 1.4% and 1.7%, respectively.

The Consumers Price Index in 2015 stood at 12.9%, according to Rosstat. The CPI is expected to stay at 9.5% in 2016 and at 7% in 2017 under the baseline scenario and it will be 6.2% and 5.5%, respectively, under the optimistic scenario.

In 2015, export and import volumes of goods and services were worth \$389.3bn and \$280.8bn, respectively. Both scenarios anticipate that exports and imports will decline further in 2016 to respectively \$288.9bn and \$234.4bn under the baseline scenario and to \$337.8bn and \$268.4bn under the optimistic scenario. Export and import volumes in 2017 are expected to be worth \$314.6bn and \$231.9bn, respectively, under the baseline scenario and \$368.8bn and \$305.9bn, respectively, under the optimistic scenario.

Interest rates will remain high in 2016–2017. The Bank of Russia will lower the key rate with a time lag behind inflation, and the key rate will also depend on the foreign exchange market (the central bank will tighten its monetary policy amid lower crude oil prices and high pressure on the rouble). The baseline scenario predicts that the CBR key rate will not be higher than 9.0% per annum by the end of 2016 and 6.25% by the end of 2017. The optimistic scenario anticipates that Russia's central bank may lower the key rate to 6.5% in 2016 and to 5% by the end of 2017. The nominal interest rate on rouble-denominated loans in 2015 is therefore estimated at 15.7% per annum (the real interest rate at 0.5%). The nominal interest rate will be set at 12.2% in 2016 and 11.4% in 2017 (the real interest rate at 2.3 and 3.4%, respectively) under the baseline scenario and 10.6% and 8.7% under the optimistic scenario (the real interest rate at 2.6% and 3.0%, respectively). Higher real interest rates on loans will mirror still high risks of lending to real sector borrowers amid a recession.

The yearly average nominal rouble exchange rate in 2015 was 60.9 roubles per dollar. The rouble will see further depreciation in 2016 regardless of which of the scenarios is selected: 69.4 roubles per dollar under the baseline forecast and 64.6 roubles per dollar under the optimistic scenario. The rouble will strengthen in 2017 to a yearly average of 65.7 roubles per dollar under the baseline scenario and to 60.5 roubles per dollar under the optimistic scenario. Considering inflation changes in Russia, the real effective exchange rate in 2015 lost 7.6%. Both scenarios predict that the real exchange rate will begin to grow as early as next year, up 4.1% in 2016 and 6.8% in 2017 under the baseline scenario. The optimistic scenario forecasts that the real exchange rate will increase 10.9% in 2016 and 3.6% in 2017.

Since it is assumed that the Bank of Russia will hold on to an inflation targeting regime and pursue a tight monetary policy, we forecast a moderate growth in the money aggregates for both scenarios. The money supply (M2) in 2015 is preliminary estimated at 4.6%, and the monetary base decreased by 2.9% from 2014. In 2016, the money aggregate M2 will increase 8.3% under the baseline scenario and 8.4% under the optimistic scenario, and in 2017 it will be up 10.8% and 11.9%, respectively. Both scenarios expect the monetary base increase 4.5% and 6.1%, respectively.

Baseline scenario (Urals: 2015=51, 2016=35, 2017=40)	2015				2016				2017	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	year	year
	actual	actual	actual	forecast	forecast	forecast	forecast	forecast	forecast	forecast
Urals crude	52.0	61.4	49.3	41.8	30.0	35.0	35.0	40.0	35.0	40.0
GDP										
billion roubles	16,565	17,491	19,305	20,518	17,324	18,800	20,787	21,915	78,826	85,270
physical volume index on a year-over-year basis, %	97.8	95.4	95.9	95.4	98.5	99.5	100.5	96.0	98.6	99.7
Deflator	109.6	106.0	107.6	107.9	106.2	108.0	107.1	111.3	108.2	108.5
Fixed investment										
physical volume index	91.2	92.6	91.9	90.4	91.7	93.7	95.9	96.8	95.1	97.0
Retail sales turnover										
on a year-over-year basis, %	93.6	90.9	90.5	84.9	96.1	95.0	96.5	96.0	95.9	99.5
Real disposable cash income										
on a year-over-year basis, %	98.7	95.6	96.1	93.5	96.9	95.7	96.5	96.7	96.4	100.4
Exports										
billion US dollars	101.3	104.2	91.6	92.1	64.5	71.4	73.3	79.7	288.9	314.6
<i>Including</i>										
Exports of goods	89.5	91.1	78.4	80.4	55.8	61.6	62.9	70.0	250.3	277.6
<i>Exports of oil and gas</i>	54.2	54.9	45.8	43.1	30.0	30.2	29.6	33.5	123.3	134.0
<i>Other exports</i>	35.3	36.2	32.6	37.3	25.9	31.4	33.3	36.5	127.0	143.6
Exports of services	11.7	13.1	13.2	11.7	8.6	9.9	10.4	9.7	38.6	37.1
Imports										
billion US dollars	65.4	70.9	75.4	69.8	45.3	60.3	61.0	67.8	234.4	231.9
<i>Including</i>										
Imports of goods	45.3	48.2	50.1	51.0	29.9	41.4	40.8	48.5	160.6	165.2

Baseline scenario (Urals: 2015=51, 2016=35, 2017=40)	2015				2016				2017	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	year	year
	actual	actual	actual	forecast	forecast	forecast	forecast	forecast	forecast	forecast
Urals crude	52.0	61.4	49.3	41.8	30.0	35.0	35.0	40.0	35.0	40.0
Import of services	20.2	22.7	25.3	18.8	15.4	18.9	20.2	19.3	73.9	66.8
CPI										
as a % over the previous period	107.4	101.0	101.7	102.3	103.9	102.2	101.1	102.0	109.5	107.0
Period-average rate on rouble-denominated loans, % per annum										
real interest rate	1.5	0.8	-1.2	0.1	3.4	1.4	1.9	2.3	2.3	3.4
nominal interest rate	18.6	16.2	14.3	13.0	12.8	12.1	11.9	12.0	12.2	11.4
Dollar-Rouble exchange rate										
average nominal for the period	62.2	52.6	62.8	65.9	70.9	70.3	68.9	67.7	69.4	65.7
Rouble's real effective exchange rate										
Period end as a % over the previous period end	-10.8	20.3	-13.7	-0.2	-3.7	2.4	2.4	3.1	4.1	6.8
Monetary base										
trillion roubles	9.7	9.7	9.8	11.0	10.0	10.2	10.2	11.5	11.5	12.2
Money aggregate M2										
At period end, trillion roubles	31.6	32.5	33.0	33.6	33.0	33.8	34.0	36.4	36.4	40.3
gain as a % over the previous period	-1.5	2.7	1.4	2.0	-1.7	2.5	0.5	7.0	8.3	10.8

Optimistic forecast (Urals: 2015=51, 2016=50, 2017=55) Urals crude	2015				2016				2017	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	year	year
	actual	actual	actual	forecast	forecast	forecast	forecast	forecast	forecast	forecast
GDP	52.0	61.4	49.3	41.8	35.0	54.0	54.5	56.5	50.0	55.0
billion roubles	16,565	17,491	19,305	20,518	17,338	19,121	21,173	22,459	80,090	83,990
physical volume index on a year-over-year basis, %	97.8	95.4	95.9	95.4	99.5	100.3	99.4	99.2	99.6	100.9
Deflator	109.6	106.0	107.6	107.9	105.2	108.9	110.4	110.3	108.9	103.9
Fixed investment										
physical volume index	91.2	92.6	91.9	90.4	93.3	96.4	100.0	101.5	98.8	101.2
Retail sales turnover										
on a year-over-year basis, %	93.6	90.9	90.5	84.9	98.3	97.2	98.8	98.5	98.2	101.4
Real disposable cash income										
on a year-over-year basis, %	98.7	95.6	96.1	93.5	97.2	96.5	98.3	99.1	97.8	101.7
Exports										
billion US dollars	101.3	104.2	91.6	92.1	67.8	84.3	89.9	95.8	337.8	368.8
<i>Including</i>										
Exports of goods	89.5	91.1	78.4	80.4	59.0	73.6	78.3	84.8	295.7	326.4
<i>Exports of oil and gas</i>	54.2	54.9	45.8	43.1	33.1	42.3	45.1	48.4	168.9	183.2
<i>Other exports</i>	35.3	36.2	32.6	37.3	25.9	31.3	33.2	36.4	126.8	143.1
Exports of services	11.7	13.1	13.2	11.7	8.8	10.7	11.6	11.1	42.1	42.5
Imports										
billion US dollars	65.4	70.9	75.4	69.8	51.3	67.2	72.2	77.7	268.4	305.9
<i>Including</i>										
Imports of goods	45.3	48.2	50.1	51.0	35.0	47.2	50.3	56.9	189.4	225.6

Optimistic forecast (Urals: 2015=51, 2016=50, 2017=55) Urals crude	2015				2016				2017	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	year	year
	actual	actual	actual	forecast	forecast	forecast	forecast	forecast	forecast	forecast
Import of services	20.2	22.7	25.3	18.8	16.4	20.0	21.9	20.8	79.1	80.3
CPI										
as a % over the previous period	107.4	101.0	101.7	102.3	103.2	101.6	99.9	101.3	106.2	105.5
Period-average rate on rouble-denominated loans, % per annum										
real interest rate	1.5	0.8	-1.2	0.7	3.9	1.7	2.1	2.7	2.6	3.0
nominal interest rate	18.6	16.2	14.3	13.8	12.8	11.0	9.6	9.1	10.6	8.7
Dollar-Rouble exchange rate										
average nominal for the period	62.2	52.6	62.8	65.9	67.9	67.5	61.5	61.2	64.6	60.5
Rouble's real effective exchange rate										
Period end as a % over the previous period end	-10.8	20.3	-13.7	-0.7	-0.5	1.7	8.2	1.3	10.9	3.6
Monetary base										
trillion roubles	9.7	9.7	9.8	11.0	10.0	10.2	10.2	11.5	11.5	12.2
Money aggregate M2										
At period end, trillion roubles	31.6	32.5	33.0	33.6	33.1	34.2	34.0	36.4	36.4	40.7
gain as a % over the previous period	-1.5	2.7	1.4	2.0	-1.6	3.3	-0.5	7.1	8.4	11.9