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Feasible Scenarios of Social and Economic Development of the Russian Federation in 2011–2013

The following factors will determine main macro-economic parameters of the development of the Russian economy in 2011 – 2013: the situation in the world economy, the status of the internal institutional environment and business climate, the budget policy of the RF Government and the monetary policy of the Bank of Russia. In this section we focus on the analysis of the external development factors (the world economy) and the budget (general parameters of the budget and the national debt) and monetary policy.

In the world economy perspective, the main factors and sources of economic growth of Russia are: the level of prices and physical scope of demand for basic raw materials of the Russian export on the world market (oil and other raw materials), the access to capital on the world financial market for Russian borrowers, growth rates of the world economy and demand for non-raw materials exported from Russia.

Risks and restrictions of the economic growth in Russia are determined by the lengthy recovery of the leading world economies from the crisis, suspended expansion of the physical demand for raw and non-raw materials of the Russian export, a faster growth rate of new emerging markets and enhancement of competition between the BRICS countries on the world capital market; all these can reduce the access to capital for Russian companies and minimize opportunities for expansion of the Russia's internal market; this, in turn, makes impossible for Russia to develop with a focus on the internal market only (as China and India), without being involved in the global economy, and may cause emergence of new centers of recession on the developing and developed markets.

Should the world economy demonstrate successful development, the leading economies might overcome the crisis of 2007–2009 by 2012, and in 2013 the growth rates of the world economy can reach 4.0-4.5%.

The main conditions for implementation of this scenario are:

A responsible and tough policy of the leading world countries to cut their budget deficits and to carry out a coordinated monetary policy. However, in the mid-term, the leading countries will come out of the crisis and develop in the environment of an extremely high debt burden on their national budgets; this means they will have to reduce expenditures for their social programs and maintain internal demand; also they may face new challenges in their economies. The higher debt load and the growth of pension costs may become a long-term problem for the world economies to sustain their economic growth.

Reaching agreements within G8 and G20 regarding new requirements to the global financial market, improvement of quality of regulation of financial institutions, formation of a new system of setting and supporting exchange rates of the key world currencies and, possibly, transformation of the "reserve" notion towards more flexible and broader currency portfolio and other financial assets.

Resolution of the issue of global macroeconomic imbalances on the principles of mutual benefits, consideration of interests of all parties concerned and objective economic conditions and competitive advantages; removal of non-market restrictions on capital reallocation, and adherence to non-discriminative terms in the international trade.

We believe, in such context the world oil prices will remain almost unchanged in terms of constant prices or will have a slight positive trend. The developments in the Arab countries early 2011 may have a short-term uplifting effect, and by the mid of the next year the "Arabic factor" will cease to play an important role in the setting prices on the world oil market.

There is an alternative scenario associated with pessimistic developments in the world and in the Russian economy, as a consequence. The main assumption underpinning this scenario is possible implementation of the mentioned risks and emergence of a new crisis in the world economy. The assumptions include:

1. Mistakes made by the developed economies at the stage of recovery, the absence of coordination of actions, inability of the governments to lever a further step up of the budget deficit, etc.

2. Low efficiency of the fiscal incentives in China: with account of stagnating external demand, this can lead to a sharper slowdown of the development of the Chinese economy with possible negative social and political implications, and to a decline of the aggregated demand for raw materials on the world market.

3. Development of significant, for the financial world, local or regional crisis on the developing markets, and/or a "traditional" crisis (as in the 1990'es) in the developing countries.

Regardless of specific reasons and the time of a new recession, if this scenario is realized, it would reduce average annual growth rates of the world economy in 2011 – 2013 (down to 3% - 4%). .

For Russia, the development of this scenario would mean high volatility of prices on raw materials, lower volumes of exported raw materials and an extremely limited access to the world market. Note that in terms of the ratio of the leading world currencies, this scenario may demonstrate the highest degree of uncertainty since one of the possible conditions for its implementation is a crisis of a reserve currency in one of the issuing countries.

The budget policy of the RF Government affects the prospects of the economic growth by the following channels:

shaping expectations of economic agents (a degree of a long-term budget balance under various levels of oil prices, the size and ways to finance the Pension Fund deficit, etc.); formation of the macro-economic environment (affecting the interest rate, inflation rate, etc.);

meeting budget social obligations;

implementation of most important strategic infrastructure projects. .

Let us review three possible cases of the social and political development of the Russian Federation in 2011 – 2013:

1. Base case
2. Optimistic case
3. Budget expansion case.

The base case in a number of its parameters corresponds to an innovation case (Inn2 option) of the project "Main scenario terms and main parameters of the long-term forecast of the social and economic development of the Russian Federation for the period up to 2030" developed by the Ministry for Economic Development of Russia. In particular, the nominal price on Urals is gradually increasing from 81 $/bbl in 2011 to 84 $/bbl in 2013, the USD/Euro exchange rate is fixed at 1.3 USD/Euro. However, unlike in the "Main scenario terms…." we suppose that the capital inflow into Russia under this scenario will not exceed 3% of GDP (equal to $45 billion in 2010) and the world economy growth rates will make up to 4.5% per year, as said before.

We believe that under this scenario, the federal expenditures in 2011 – 2013 will not exceed 19-20% of GDP; this is in line with Federal Law "On the federal budget for 2011 and the planning period of 2012 and 2013".

Under this scenario, the federal budget deficit is financed by the state market borrowings (the funds of the RF Reserve Fund will be exhausted in 2011 while the funds of the National Wealth Fund (NWF) will not be used for this purpose). We do not review an option to finance the federal budget deficit by the state property privatization proceeds since the terms and possible scope of proceeds from privatization cannot be assessed with a sufficient accuracy.

In **the optimistic case**, the Urals price is expected to be at 100 $/bbl in 2011 prices for the entire period and corresponds to 104 $/bbl in 2013 (the dollar devaluation rate is 2% per year). We assume here that the world economy growth rate can be as high as 5% per year while the capital inflow into Russia can reach 3.5% of GDP (corresponds to $50 billion in 2010). In 2011-2013, the federal budget expenditures are in line with the base case in nominal terms.

The budget expansion case is an option with additional federal budget expenditures related to possible adoption, in the pre-election period of 2011 – 2012, of new budget obligations, the beginning of full scale implementation of the announced State Program of weaponry procurement, the increase of monetary allowance of the servicemen, additional expenditures for the reform of the Ministry of Interior Forces, the increase of finances for the current federal target programs, etc. According to our estimates, the additional budget expenditures may reach 4-5% of GDP. In this case we also assume that the RF Central Bank will ensure, in spite of monetization of the federal budget deficit, a gradual decline of the growth rates of monetary supply at the expense of raising rates for deposits of commercial banks in the Bank of Russia and rates for reverse repo transactions and reserve requirements, etc.

A forecast of dynamic trend of the macroeconomic and financial variables and the indicators of the Russia's federal budget has been developed based on the structural econometric model of the Institute of Economic Policy named after E. T. Gaidar. The model presents a system of regression equations and identical equations describing dynamics of the main indicators of the social and economic development of Russia.

The calculation results of the main macroeconomic and financial indicators for the reviewed cases are shown in *Tables 22–24*.

Table 22

Base case

	2010	**2011**	**2012**	**2013**
1	2	3	4	5
Oil prices (Urals, in $/bbl)	78.2	81.0	83.0	84.0
Real GDP growth rate, %	4.00	2.80	2.90	2.90
GDP in nominal terms (RUR Billion)	44491	50183	55702	60928
GDP ($MM)	1465	1707	1934	2101
Investment surplus into fixed capital, %	6.00	3.90	3.50	2.90
Surplus of real income of the population, %	4.30	3.00	2.90	2.70
Federal budget revenues (% of GDP)	18.65	18.80	18.70	18.80
Federal budget expenditures (% of GDP)	22.67	21.24	20.18	19.98
Surplus (+) /deficit (–) of federal budget (% of GDP)	–4.02	–2.44	–1.48	–1.18
Exports ($billion)	398.0	411	422	430
Imports ($ billion)	248.8	313	359	388
Trade balance ($ billion)	149.2	97	63	42
Balance of current accounts ($ billion)	72.6	42	13	–18
Balance of capital transactions ($ billion)	–30.5	0.0	15.0	30.0

Balance of payments ($ billion)	36.8	37.3	22.6	7.2
External debt of the private sector ($ billion)	436.1	440.0	450.0	490.0

(continued) table 22

1	2	3	4	5
Debt/GDP ratio, %	29.8	25.8	23.3	23.3
International reserves ($ billion)	479.4	522	549	561
Nominal exchange rate RUR/USD	30.36	29.40	28.8	29
Nominal exchange rate RUR/EURO	40.27	38.22	37.44	37.70
Index of the real effective ruble exchange rate (July 1998 = 100)	122.6	134.0	141.8	145.5
CPI growth rate, %	8.8	8.1	6.8	6.3
Reserve funds growth rate, %	26.64	17.33	16.04	14.43
M2 growth rate, %	28.51	19.09	20.68	18.83
Monetization (M2/GDP), %	45.3	47.9	52.0	56.5
National debt (% of GDP)	8.8	11.5	12.8	13.9

Table 23

Optimistic case

	2010	**2011**	**2012**	**2013**
Oil prices (Urals, in $/bbl)	78.2	100.0	102.0	104.0
Real GDP growth rate, %	4.00	3.20	3.80	4.30
GDP in nominal terms (RUR Billion)	44491	51218	58186	64693
GDP ($MM)	1465	1742	2020	2270
Investment surplus into fixed capital, %	6.00	4.50	5.00	5.90
Surplus of real income of the population, %	4.30	3.50	3.50	4.00
Federal budget revenues (% of GDP)	18.65	19.40	19.60	19.90
Federal budget expenditures (% of GDP)	22.67	20.81	19.31	18.82
Surplus (+) /deficit (–) of federal budget (% of GDP)	–4.02	–1.41	0.29	1.08
Exports ($billion)	398.0	460	473	488
Imports ($ billion)	248.8	316	368	418
Trade balance ($ billion)	149.2	144	106	70
Balance of current accounts ($ billion)	72.6	89	56	10
Balance of capital transactions ($ billion)	-30.5	0.0	15.0	30.0
Balance of payments ($ billion)	36.8	84.2	65.5	35.5
External debt of the private sector ($ billion)	436.1	440.0	450.0	490.0
Debt/GDP ratio, %	29.8	25.3	22.3	21.6
International reserves ($ billion)	479.4	569	639	680
Nominal exchange rate RUR/USD	30.36	29.40	28.8	28.5
Nominal exchange rate RUR/EURO	40.27	38.22	37.44	37.05
Index of the real effective ruble exchange rate (July 1998 = 100)	122.6	134.2	142.7	149.3
CPI growth rate, %	8.8	8.3	7.3	6.6
Reserve funds growth rate, %	26.64	22.67	16.71	15.52
M2 growth rate, %	28.51	24.51	23.71	19.88
Monetization (M2/GDP), %	45.3	49.0	53.4	57.6
National debt (% of GDP)	8.8	9.3	8.5	8.0

Table 24

Budget expansion case

	2010	**2011**	**2012**	**2013**
1	2	3	4	5
Oil prices (Urals, in $/bbl)	78.2	100.0	102.0	104.0
Real GDP growth rate, %	4.00	3.10	3.60	4.10
GDP in nominal terms (RUR Billion)	44491	51452	58883	66139
GDP ($MM)	1465	1750	2045	2281
Investment surplus into fixed capital, %	6.00	4.20	4.50	4.90
Surplus of real income of the population, %	4.30	3.90	3.90	4.40
Federal budget revenues (% of GDP)	18.65	19.40	19.40	19.30
Federal budget expenditures (% of GDP)	22.67	24.80	23.55	24.65
Surplus (+) /deficit (–) of federal budget (% of GDP)	–4.02	–5.40	–4.15	–5.35
Exports ($billion)	398.0	460	473	487
Imports ($ billion)	248.8	319	377	425
Trade balance ($ billion)	149.2	141	95	62
Balance of current accounts ($ billion)	72.6	86	45	2

Balance of capital transactions ($ billion)	–30.5	0.0	0.0	0.0
Balance of payments ($ billion)	36.8	80.5	40.1	–2.8
External debt of the private sector ($ billion)	436.1	440.0	450.0	460.0

(continued) table 24

1	2	3	4	5
Debt/GDP ratio, %	29.8	25.1	22.0	20.2
International reserves ($ billion)	479.4	565	610	612
Nominal exchange rate RUR/USD	30.36	29.40	28.8	29
Nominal exchange rate RUR/EURO	40.27	38.22	37.44	37.70
Index of the real effective ruble exchange rate (July 1998 = 100)	122.6	134.9	144.8	150.9
CPI growth rate, %	8.8	8.9	8.3	7.9
Reserve funds growth rate, %	26.64	22.05	20.08	20.53
M2 growth rate, %	28.51	21.40	17.63	18.01
Monetization (M2/GDP), %	45.3	47.6	48.9	51.4
National debt (% of GDP)	8.8	13.0	16.9	21.4

Under **the base case**, the quantitative values of the main indicators of the social and economic development of Russia and the monetary sector show that the positive growth rates of real GDP will not exceed 3% by the end of 2013. By the end of 2013, the real GDP of Russia will exceed the level of 2008 by 4.3% only. In 2013, the per capita GDP (at the current exchange rate) with account of the growth of the ruble exchange rate and the forecasted reduction of the population is going to exceed the 2008 level by approximately 20%.

The economy will revive due to stable oil prices (in the comfortable range for Russia) and the renewed inflow of foreign capital thus ensuring financing of the investment demands of the Russian companies. As for investments into fixed capital, the recession will not be overcome by the 2013 end. In 2013, the investments into fixed capital will reach 98.3% vs the 2008 figure. At the same time, in 2011 – 2013, the real incomes of the population are going to increase by approximately 15.9% vs the pre-crisis level.

We assume that the oil prices will be within a sufficiently "comfortable" range (that would not trigger a currency or a financial recession) but not in the best range possible, and therefore the national financial situation will remain tense, under this case. Assuming that the nominal federal expenditures are kept at the level set by Federal Law "On the federal budget for 2011 and for the planning period of 2012 and 2013", the budget deficit is likely to remain in the entire period of consideration. The Reserve Fund can support financing of the budget deficit in 2011 only.

We do not suggest using NWF funds to finance the budget deficit, and believe NWF will accumulate funds worth about 5% of GDP.

One of the most important assumptions for restoring the positive growth rate of real investments into fixed assets and the GDP real growth is that Russian companies and banks will return to the world capital market, and the inflow of direct foreign investments into Russia will be sustained. According to the estimates made, to support the set rates of investment growth, a stable net flow of private foreign investments into Russia should start not later than 2012 and reach $15 – 30 billion per year.

We forecast, for the reviewed period, that the services negative balance will go up as well as payments balance for production factors and interest payments. Accordingly, in 2013 we expect a negative current accounts balance of $15 – 20 billion in Russia.

As we assume that the RF Central Bank while moving to inflation targeting policy reduces its presence on the currency market, the Bank of Russia will accumulate its international reserves but very slow. By the end of 2013, according to our estimates, the reserves will reach $550 – 600 billion – this is below the maximum levels of 2007 – 2008.

Before 2013, the positive payment balance (in 2011 – 2012 due to the positive balance of the current accounts while in 2013 – due to the capital inflow) will support a stable exchange rate of the ruble currency in the currency basket (we believe that in the bi-currency basket, USD and EURO ratio remains at 0.55:0.45). In such case, a change of the USD/EURO ratio may be triggered by a change in mutual quotations of the reserve currencies on the world market. As a result of a softer influence of the Bank of Russia on the exchange rate, the growth of ruble volatility vs USD and EURO currencies would not be reflected in the summary annual exchange rate values as the differently directed fluctuations absorb each other.

Simultaneously, the reduction of the annual CPI growth rates to 6.0 – 6.5% will obviously slow down the rates of the real strengthening of the ruble currency. In particular, by the end of 2013, the real effective rate of the ruble will strengthen by 20% vs the mid of 2008 or by 25% vs the end of 2008. We expect that the positive dynamics of the Russian exports against stagnation of world prices on raw materials will be maintained. Imports will grow faster than exports during the considered period and will exceed the record breaking values of 2007 as early as in 2011.

The model predicts serious changes in the monetary sector of the Russian economy. As mentioned before, the model demonstrates a visible slow down of inflation.

Secondly, the change of the monetary policy by the Bank of Russia means that the Bank will expand transactions on the market of state securities (prompted by necessity to finance the federal budget deficit not only by the Reserve Fund or external borrowings) and will actively re-finance commercial banks against securities (e.g. corporate bonds) bought for the Bank portfolio and issue credits secured by pledge to commercial banks for long terms (at least for one year).

As a consequence of such change of the main fiscal tools, real interest rates in the economy must grow. Thus, real interest rates for credits issued to a non-financial private sector for up to one year will fall within the range 1.5–2.0% in 2011–2013. We expect the growth of a monetary multiplier up to 2.6 – 2.7% (M2/reserve money). In other words, the bank sector is going to resume its credit expansion most actively as it was before the 2008 crisis.

Summarizing **the base case**, the following characteristics should be outlined:

1. The real GDP volume will be restored up to the pre-crisis level by the end of 2012 only; the volume of real investments will not return to the 2008 indicators;
2. Russian companies will come back to the world capital markets;
3. An obligatory transition to new mechanisms of security of the monetary supply of the RF Central Bank, and the growth of real money value in the economy will occur;
4. The conditions for keeping the federal budget deficit, the full use of the Reserve Fund and an extremely slow accumulation of funds in the NWF will be maintained;
5. Inflation rates will obviously fall down against strengthening of the real effective rate of the ruble currency and high growth rates of the monetary stock and monetization of the Russian economy.

The **optimistic case** provides for increase of average oil prices (Urals) up to 100 $/bbk in 2011 and 102-104 $/bbl in 2012 – 2013. This will allow increasing the growth rates of the Russian economy up to 3.5–4.5% per year. Thus, by the end of 2013, the real GDP will be approximately by 7% higher than in 2008. In 2012, the per capita GDP (in USD at the current rate) will increase by about 40% up to $16 – $16.5 thousand vs 2007.

Under this case, the real volume of investments into fixed assets will be restored to the pre-crisis level in 2012-2013.

High prices on the world raw markets will generate federal budget revenues sufficient to fund the federal expenditures at the target level. Moreover, in 2012 – 2013, a surplus of the federal budget (up to 1% of GDP) may occur, and funds will continue to be accumulated in the Reserve Fund.

A favorable foreign economic situation under this case creates conditions that will sustain the stable situation with the national payment balance. The payment balance and its two main components will remain positive during the entire period of review. In particular, the payment balance will be from $35 to $85 billion per year, and the annual inflow of private capital into Russia will reach $ 30 billion.

With this scenario, the Bank of Russia will not be able to avoid a sizable growth of international reserves returning to the policy of curbing the nominal strengthening of the ruble. Thus, by the end of 2013, the international reserves of the Central Bank of Russia will exceed the 2008 level growing up to $670 – 680 billion.

The nominal exchange ruble rate will increase up to 28.0 – 28.5 RUR/USD or approximately by 10% vs the 2010 average annual rate in 2011 – 2013. At the same time, the inflation (CPI) l continues to decrease but still remains at a higher level than in the base case (6.5 – 7.0%). As a result, the ruble will continue to be stabilized successfully, and by the end of 2013, the real effective ruble rate will exceed the 2008 summer level by 26% - 27%.

In this case, we assume that the RF Central Bank will move to inflation targeting policy and use interest rates as a main working tool (though with a greater focus on the currency market), the real money value is expected to grow as well. According to our estimates, the real interest rate for one-year credits issued to the non-financial sector may be 1.0 – 1.5%. Monetization of the economy is going to build up to approximately 60% of GDP as in the base case.

Thus the main differences between **the optimistic and the base case** are:

1. A faster recovery of the GDP real volume that will exceed the pre-crisis level in terms of investments into fixed assets.
2. A favorable situation with the payment balance and its constituent components, fast accumulation of international reserves.
3. Return to the policy of the federal budget surplus and concentration of funds in the Reserve Fund.
4. Slow decline of the inflation rates, fast real and nominal strengthening of the ruble currency against high growth rates of the money stock and monetization of the Russian economy.
5. Restricted opportunities of the Bank of Russia in moving to inflation targeting policy, the need to place a greater focus on the currency market situation.

The budget expansion case, in spite of the favorable external situation, will preserve the budget deficit at 5 – 5.5% of GDP which may negatively impact the economic growth rates and real investments. Thus, the real GDP growth rates and investments into fixed assets are by appr. 0.5 – 1.0% lower than in the optimistic case.

Financing of the federal budget deficit at the expense of the market borrowings leads to a higher real interest rate for the borrowers (up to 2.5 – 3 pp. at the internal market), higher rates of inflation (due to final monetization of the debt by the authorities) and a slow credit activity of the banks. The CPI growth rates in this case will not drop below 7.9%. Even if the Central Bank curbs the nominal strengthening of the ruble currency, the real exchange rate of the ruble will exceed by 28% the level of 2008 summer by the end of 2013. The national debt will reach 21 -21.5% of GDP late 2013, this is close to critical values (in terms of the ability to serve the debt if the market situation changes) for such country as Russia whose national finances and the assessment of the country risks greatly depends on the oil price fluctuations.

The strengthening of the ruble also negatively influences the national payment balance. Due to the fast growth of imports, the current accounts balance expects to become zero in 2013; given the absence of inflow of capital (as a result of low investment activity inside the country and enhancement of risks associated with the debt growth) this may lead to a negative payment balance and stabilization of the international reserves volume close to the pre-crisis maximum - $610 billion.

Summarizing the **budget expansion case**, we can note that this scenario suggests dependency of the RF economy on the oil prices and creation of conditions for a budget crisis in future. The imbalance of the RF budget system within the period under review (up to 3 years) is going to negatively affect the rates of economic growth, the payment balance, the speed of inflation reduction and the situation in the money circulation sector.