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Russian economy: absence of usual conditions for growth offset by impetus for structural change

Russia 2020 economic outlook

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- **Commodity prices will remain low.** Investments made in anticipation of rapid economic growth in emerging market countries resulted in excess capacity across most commodity markets. This is likely to remain unchanged over the next two to three years, contributing further to the slowing of global economic growth. Russian exports and imports are to halve in dollar terms compared to the past.

- **Government expenditures will contract over time.** A decline in oil-and-gas-driven budget revenues, coupled with the lag between changes in revenue and the ability of the government to implement expenditure adjustments, will deplete government reserves as budget deficits rise. Declining expenditures will also affect the Russian government's ability to redistribute income as well as its ability to target investment.

- **Economic growth will be slowed by unfavorable demographics**. The workforce will shrink as the generation born in the 1990s, a period when fertility dropped and mortality grew sharply, reaches maturity in Russia and in neighboring countries, which traditionally have provided migrant workers to the Russian labor market.

- **Unit labor costs will start declining.** After 15 years of wages growing faster than labor productivity, the trend may reverse, deprived of an important driver – outsized increases in salaries in the public and energy sectors. The new environment will benefit labor-intensive sectors.

- **Inflation will come close to Central Bank of Russia (CBR) targets by 2018** as the exchange rate pass-through and the food embargo's impact decline. Lagging price indexation by the country's natural monopolies (utilities and public transport) will also suppress price growth. Lower inflation will put downward pressure on long-term interest rates.

- **Despite the absence of economic growth, labor productivity may rise backed by new economic stimuli.** Low inflation will set the stage for extending investment-planning horizons and for the appearance of longer-dated maturities for financial market securities. An increase in the share of profits in national income will provide companies with new opportunities for investments from their own capital resources. Assuming a stable political environment, we may also see a surge in foreign direct investment.

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Table 1. Key Russian and Global Economic Indicators, 2013–2020

Indicators	Unit	Fact			Estimate	Forecast			
		2013	2014	2015	2016	2017	2018	2019	2020
The Global Economy									
Urals crude price	USD/bbl	108	98	51	39	43	44	45	45
Global GDP growth[1]	% y-o-y	2.4	2.6	2.4	2.1	1.9	1.8	1.7	1.7
USA GDP growth	% y-o-y	1.5	2.4	2.4	1.5	1.2	1.4	1.5	1.6
China GDP growth	% y-o-y	7.7	7.3	6.9	5.8	5.6	4.8	4.5	4.0
EU GDP growth	% y-o-y	-0.3	0.9	1.6	1.7	1.5	1.4	1.3	1.2
The Russian Economy									
GDP at market prices[2]	RUB bln	71,055	77,893	80,413	82,660	86,066	90,657	95,572	101,464
Real GDP growth	% y-o-y	1.3	0.7	-3.7	-1.8	-0.4	0.5	0.7	0.9
Capital investment	RUB bln	14,357	16,652	17,696	18,268	19,193	20,398	21,695	22,829
Real capital investment growth[3]	% y-o-y	0.9	-0.6	-7.6	-5.2	-1.0	1.0	1.2	0.2
Industrial production index (IPI)	% y-o-y	0.4	1.7	-3.4	-1.4	0.7	1.0	0.5	0.5
Retail turnover	RUB bln	23,686	26,356	27,576	29,537	29,355	30,754	32,686	34,888
Balance of payment									
Export of goods	USD bln	523	498	340	285	295	318	341	352
Import of goods	USD bln	341	310	194	180	207	208	207	212
USD/RUB rate (average annual)	RUB per USD 1	31.8	38.5	61.3	71.0	69.0	67.1	68.2	69.5
Personal Income and the Labor Market									
Average wages	RUB/month	29,792	32,611	33,925	33,992	34,224	34,682	36,474	38,629
Real disposable household income	% y-o-y	4.0	1.4	-4.0	-3.5	-1.1	-0.8	0.6	1.1
Population	pers. mln	144	145	146	147	147	147	147	147
Economically active population	pers. mln	76	75	77	76	75	74	74	73
Unemployment	% of EAP	5.5	5.2	5.6	6.6	6.2	6.0	5.7	5.5
Prices and Financial Markets									
Inflation (CPI)	% Dec/Dec	6.5	11.4	12.9	7.2	6.0	5.2	5.1	5.0
Producer price index (PPI)	% Dec/Dec	3.7	5.7	10.7	6.0	6.5	5.3	5.2	5.7
CBR's key interest rate (average annual)	%	5.5	8.0	12.5	9.6	7.3	6.5	6.0	5.5
5-year zero coupon OFZ-bond rate	%	6.7	9.3	11.6	8.9	7.7	6.9	6.8	6.7
Retail deposit rate (> 1 year)	%	7.9	8.1	10.2	8.9	8.2	7.5	7.2	7.1
Bank interest rate on loans to non-financial corporations (> 1 year)	%	11.5	11.6	15.3	12.8	12.3	11.9	11.7	11.8
The Budget									
Federal budget balance	% GDP	-0.5	-0.5	-2.6	-4.2	-2.9	-1.8	-1.0	-0.8
Reserve Fund	USD bln	87	88	50	14	0	0	0	0
National Wealth Fund	USD bln	89	78	72	72	55	50	46	46

Source: Rosstat, Bank of Russia, Russian Treasury, Ministry of Finance, World Bank, national statistics agencies, ACRA estimates

[1] World Bank methodology.
[2] Russian Statistics new methodology based on 2008 SNA.
[3] Physical volume index, investment deflator used for adjustment.

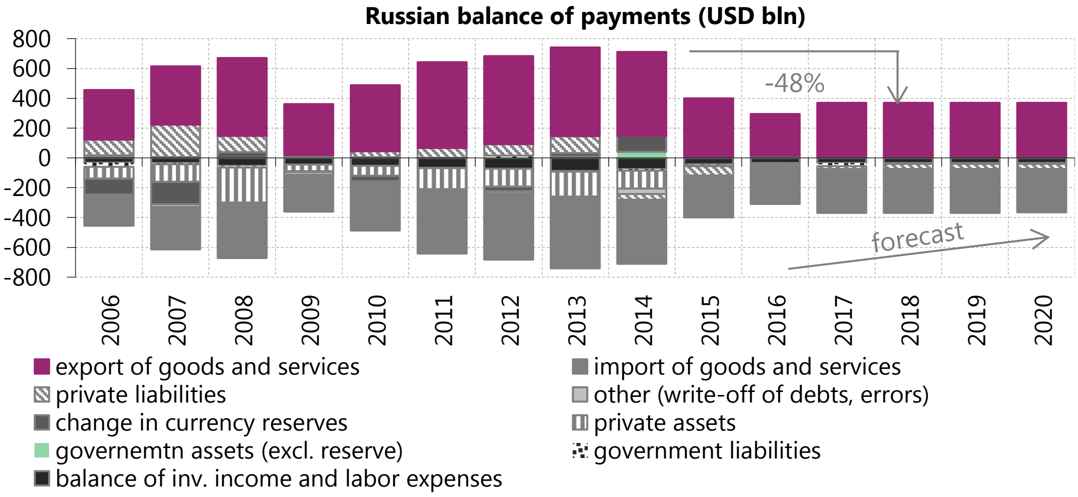
Commodity prices will remain low

Investments made in anticipation of rapid economic growth in emerging market economies resulted in excess capacity in many commodity markets, i.e. ferrous metals, base metals and energy, which consequently saw a price decline in 2014-2015, aggravated further by US dollar strengthening. Given further slowing in global economic growth, excess capacity will remain the norm in these sectors over the next two to three years.

This trend is equally pronounced in the oil market, which showed some structural changes as well. On the supply side, it has been mainly affected by low-cost shale oil producers emerging in the US. Starting in 2014, these new players became key marginal producers. Estimated at USD 30-60/bbl (including transportation) and concentrated mostly at around the USD 50/bbl mark, their average production costs are showing a tendency to decline further, for instance they already dropped by 40% between 2013-2016. Current oil prices are below medium-term sustainable levels due to extra pressure by such short-term factors as ample global inventories and the lifting of trade sanctions on Iran. We expect these factors to play out by the end of 2016. Nonetheless, in the medium term oil prices are likely to remain low, i.e. under USD 55/bbl.

For Russia, such prospects imply a lower level of exports, with a corresponding decline in imports of goods and services. Imports are expected to halve versus 2013's peak level and skew towards cheaper CIS and Asian sources. The effect of import substitution will be most pronounced in relatively labor-intensive agricultural and consumer goods sectors. At the same time, less replaceable and more capital-intensive investment imports of machinery and equipment are likely to face hard times, as import substitution here will be seen only in selected projects supported by the government.

Figure 1. Consumption of imported goods and services is bound to halve compared to levels seen before the oil price slump



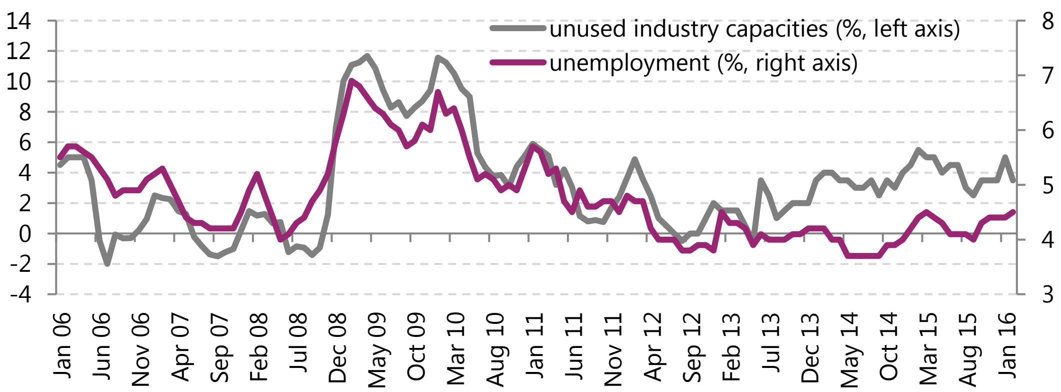
Source: ACRA estimates

Intrinsic limitations for rapid growth – the workforce and capacity utilization

A return to rapid economic growth may be considerably constrained by unfavorable demographics, most notably a decline of the economically active population. The previous decade saw a peaking of workforce numbers resulting from the large age cohort born in the 1980s reaching maturity. Economic growth in coming years will be mainly affected by the demographic crisis seen during the period of social turmoil in the 1990s. We expect a 6-7% decline in the population aged between 16-60 by 2020.

This negative trend's effect on production could be reduced by reemploying the retired (many pensioners prefer to work if able to do so), stimulating immigration and increasing employment (this third option, as discussed below, is highly unlikely). People aged 61-75 could compensate for about half of the expected workforce outflow from the labor market. Another 10% of the gap may be bridged by immigration, although it will be constrained by a relatively cheap ruble and similarly negative demographics seen all across the former USSR. Finally, employment at its current record high of 94.2% is unlikely to grow further, as residual unemployment most likely has a structural or frictional nature related to a mismatch between workforce qualifications and employer requirements, or stemming from voluntarily extended job searches. Following an expected modest rise in 2016, unemployment should revert to its norm. Employment will eventually decline by around 3% by 2020, or less than half of the decline in the traditional workforce.

Figure 2. Extensive intrinsic growth hampered by limited available capacity



Source: ACRA estimates

Even a drastic improvement in the external environment and sufficient workforce substitution would provide only for limited economic growth because of significant capacity constraints. In Russia, capacity utilization of approximately 70 percent is considered "full capacity." Current average capacity utilization in primary and manufacturing industries is around 66.5 percent, or just 3.5 percentage points short of full capacity. In 2009, capacity utilization was 60 percent, or about 10 percentage points below capacity constraints.

Without structural changes to the economy, given labor productivity limitations, discussed above, the likely outcome is stagnant economic growth over the next 5 years.

Government to limit its presence in economy

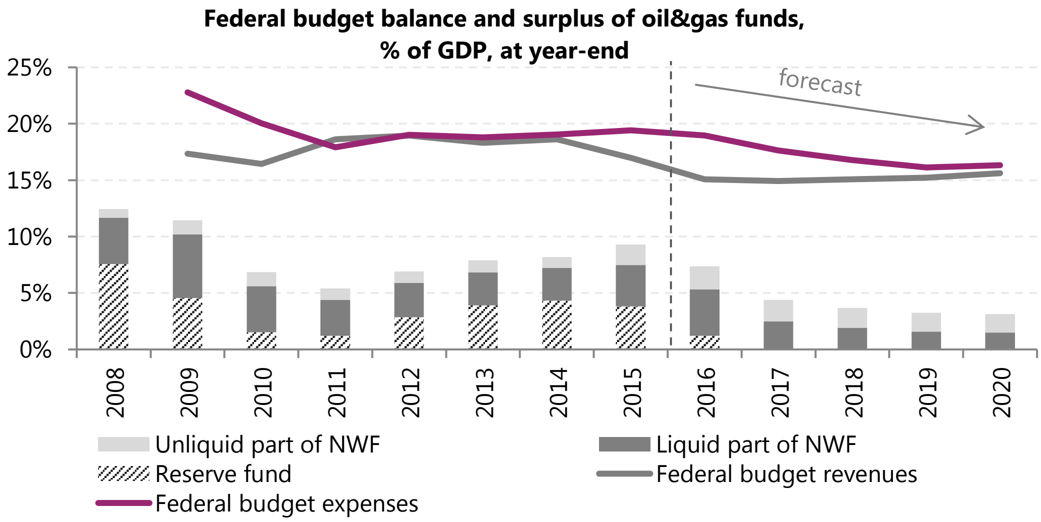
Shrinking oil-and-gas budget revenues will not be compensated for by other income items in coming years, as key tax rates are likely to remain unchanged at least until 2018. The inertial momentum towards social commitments and large government-financed investment projects will prevent an adequately dramatic cut in spending. The lag between revenue changes and expenditure adjustments, discussed above will result in budget deficits. As a result, the federal budget may face an accumulated deficit in 2016-2017 of up to 4% of GDP.

The Reserve Fund and the National Welfare Fund will finance this deficit until both are eventually nearly depleted. Further financing will require local borrowing in rubles. Starting in 2018, the deficit will be mainly financed through the accumulation of market debt. However, declining real expenditures should push the budget back into balance by then, with deviations not exceeding 1% of GDP.

A relative reduction in expenditures coupled with possible privatizations will partly relieve the budgetary system from its traditional distributive and investment functions, with some of them being transferred to the banking sector. The share of security and defense spending may also partly revert back to their former lower levels. However, the main burden of budget cuts until 2020 will fall on social and human capital expenditures, i.e. pensions, education and healthcare.

After 2017, limited budgetary reserves will not allow the government to assume a countercyclical role in case of any negative external trends or a local cyclical crisis. However, in a benign environment, reserves accumulation will resume, as prior reserve accumulation proved to be useful during the crises of 2008-2009 and 2015.

Figure 3. Budget to regain balance due to spending cuts



Source: ACRA estimates

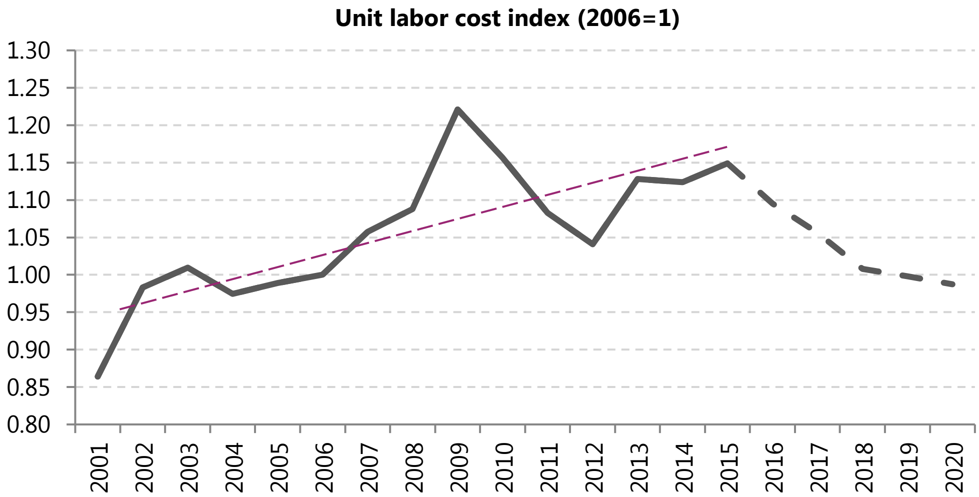
Cheap labor to open new investment opportunities

An increase in labor costs over the last 15 years was mainly driven by a rapid rise in wages in the energy, IT and the public sectors. The government redistributed part of export revenues as salaries to stimulate consumption and eventually bolster economic growth.

Now that real budget expenditures are expected to decrease, wage growth in the public sector will slow significantly. Modest prospects for oil and gas exports will limit salary growth in the energy sector. If both these developments occur, they may break a long-term trend, and for the first time in 20 years, result in a sustainable period of declining unit labor costs. Declining unit labor costs will lead to a growth of profits as a share of gross income.

Cheap labor will be a new positive for most labor-intensive sectors. However, the most labor-intensive ones – trade, construction and services – will also come under pressure from stagnating demand, so lower costs will only partly compensate for the negative trends. Cheaper labor will noticeably support only those sectors with high labor costs where internal demand is stimulated by increasingly expensive imports, i.e. agriculture, consumer goods, electronics and electric engineering.

Figure 4. Unit labor costs may decline



Source: ACRA estimates

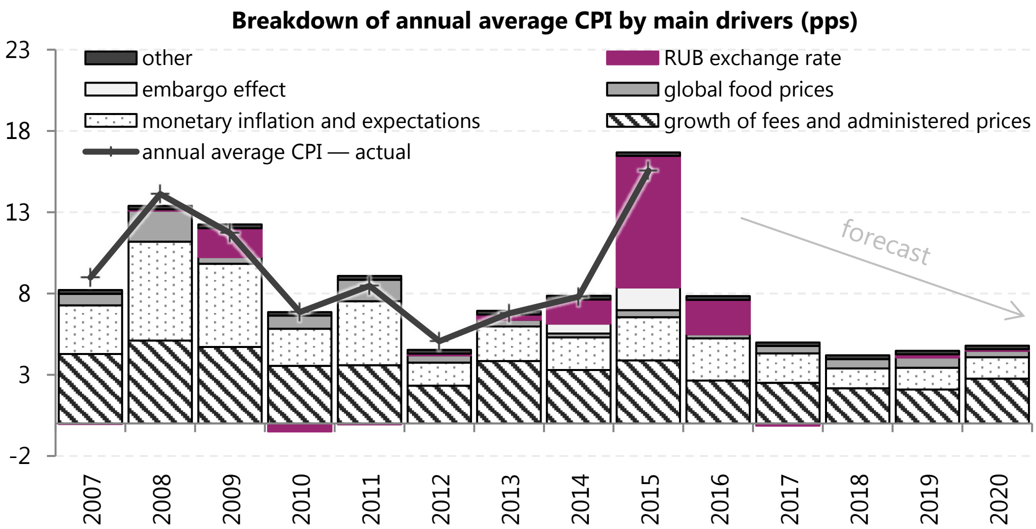
Inflation and long-term interest rates to decline

The factors, which caused a surge in consumer prices in 2014-2015, will gradually fade and will no longer affect inflation in 2016 and 2017. On the back of sustainably low oil prices and a relatively stable trade balance, the exchange rate pass-through to commodity prices will be generally low. Subject to a consistent exchange rate and informational policies by the CBR and provided that episodes of panic at the currency market are avoided, we expect the exchange rate pass-through to commodity prices to drop from 9.8 to 0.3-0.8 percentage points. Counter-sanctions on food have already been fully priced in and their cancellation, if any, will only slow inflation further.

In Russia, since most contracts have traditionally been indexed according to the prior year's CPI, indexation has been generally backward looking. However, as inflation has slowed considerably, there is growing pressure to use forward-looking inflation expectations to adjust contracts. This will likely cause inflation to fall further over time. This may cause problems in specific sectors, especially regarding heating costs since these costs are expected to outpace inflation considerably after the election season of 2017-2018. Price increases are required in order to finance the renovation of fixed assets, which are presently in a critical condition. Slower utility price increases, declines in pension payments and wages paid from the budget – a trend reflecting a weakening role of the state in the economy – may dampen inflationary pressures even further. Overall, inflation may drop from 6.5 percent to 3.0 percent by 2020.

In view of the revised prospects for demand from emerging market economies and given the excess capacity existing in many markets, global food and commodity prices are bound to stagnate or even decline, except for unexpected weather factors or other natural disasters.

Figure 5. Exchange rate pass-through and counter-sanctions to fade out



Source: ACRA estimates

The factors discussed above will likely moderate inflation further bringing its annual figure down to 5% by 2018, which is close to the CBR target (4%).

Slower inflation will have a dramatic effect on inflationary expectations, as long-term interest rates on ruble borrowings may decline by 3.0-3.5 percentage points by 2020.

Possible emergence of new economic stimuli to encourage labor productivity growth

Economic growth based on increased utilization of factors of production (such as labor and capital) or economic growth relying on a more benign external environment both seem less plausible, which brings forward labor productivity as the only driver capable of reviving the economy.

A. Capital-intensive operations are more productive.

Imports of investment goods have become and will remain very expensive due to ruble depreciation. In order to support and build up production assets in the medium term, corporate funds or retained earnings available for investment will have to compensate for declining capital goods imports. This development may be prompted by structural changes in the economy or by direct foreign investment inflows.

1) An increase in the share of profits in national income (resulting from lagging labor expenses) coupled with a relative decline in the tax burden will provide companies with new opportunities for investments from their own internal resources.

2) Slower and relatively stable inflation will result in longer planning horizons for private savings and corporate investments, which will bolster the development of new financial market instruments and stimulate longer-term borrowings, with the latter facilitating investments financed by debt.

3) Relatively low production costs supported among other things by ruble depreciation may stimulate direct investment by international companies into potentially export-oriented sectors outside the raw-materials universe. However, to realize this potential, a change in regulations has to take place in order to lower barriers to entry. In addition, policies aimed at ensuring additional protection of property rights may be required.

B. Private enterprise may operate in the sectors traditionally dominated by the state.

1) Private owners are usually more efficient property managers, so privatization of some government assets may result in these assets showing higher productivity.

2) An aging population and shrinking social expenditures are stimulating growth in private social services (medical care and education) and private insurance.

C. Non-growing, non-monopolized markets will see stiffening competition on the back of stagnating household income.

This should result in better cost control and eventually promote higher overall business efficiency.

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