CENTER FOR MACROECONOMIC ANALYSIS AND SHORT-TERM FORECASTING

Tel.: (7495) 129-17-22, fax: (7495) 129-09-22, e-mail: mail@forecast.ru, http://www.forecast.ru

Russia's Economic Development in 2015-2016 and 2017-2019 Outlook

D. Belousov, E. Abramova, A. Apokin, K. Mikhaylenko[1]

1. Current Trends

This year's (Q3 2015 - Q2/Q3 2016) economic situation in Russia had the following characteristics worthy of note:

- the existence of two pronounced phases: a) a slow-down in Q4 of 2015 and Q1 of 2016 related to a slump in oil prices, a devalued rouble, and a stricter monetary policy followed by an unstable crisis-like dynamic; and b) a level-off as of mid-2016.
- a considerable shrinkage in consumer income and spending (unlike the previous crisis) and a greater economic inequality;
- moderate inflationary effects resulting from the weaker rouble related both to decisive action by the Bank of Russia and an overall slump in economic activity and demand for money;
- chronic tension in Government finances;
- a gradual adjustment of the monetary sector to much more difficult exterior economic conditions.

1.1. Review: Russian economy as of mid-2016

A year ago, by mid-2015, there were expectations that the Russian economy would begin to recover. These were based on the fact that for the previous two years, banks and corporations had adapted to crisis conditions, companies had optimized their business, and corporations had accumulated considerable liquidity.

However, investment did not recover as expected, and there is no evidence economic recovery commences. Rather, what happened was another wave of recession (see Figure 1 and Figure 2). It was initiated by the price of oil that started to decrease in the summer and fall of last year. At the lowest point, oil had lost over half its value (from \$63.4 per barrel in July 2015 to \$28.5 in January 2016, see Figure 3). At the same time, most other commodities accounting for the bulk of Russian exports lost value.

The direct result was a dwindling inflow of "petroleum revenues" into the Russian economy and a crisis of expectations which led to a correction of corporate investment programs and, most importantly, accelerated proactive cost optimization. An indirect result is a clear perception by the Bank of Russia of the risk of a bound of inflation. End result: a very high key rate up until recently (June 14). A radical disparity between business profitability in most sectors (3%-7%) and money market interest rates, especially given the higher risks, has prompted companies to hoard financial resources and reduce investments accordingly.

At the same time, a less friendly business environment[2] has resulted in attempts to save more on labor costs (primarily, by cutting back on real wages with unemployment levels remaining virtually unchanged). Consequently, lower individual consumption became a new and unexpected recession factor (unknown during the 2009-2010 crisis) for the Russian economy (see Figure 4). In 2015, this

[1] We thank E. Penukhina, O. Solntsev for assistance in the preparation of the material.

[2] Let us note that the negative trend was not broken until Q3 2016 with Q2 of 2016 remarkable only for the record number of bankruptcies in the manufacturing sector.

factor accounted for 5.1 percentage points of the slump (with the cut-back in investment accounting for 2.3%); this compares to -1.9% in 2016.

The principal unpleasant surprise, though, was the very modest growth in exports despite the weaker rouble. In 2015, the growth volumes of fuel and primary commodity exports did almost nothing to compensate for lower prices. It stands to reason that, statistically, the economic situation has improved in 2015 thanks to the decrease in imports due to sanctions and «countersanctions» (reciprocal limitations on trade); however, but only a small number of industries saw this reduction offset by production growth (significant growth was observed in agriculture and the manufacture of components for the defense sector).

Mid-2016 was marked by greater system-wide stability. The 2015 situation was repeated: as a result of previous measures, corporate cost structures became more efficient, bank balances increased. Higher oil prices improved corporate revenues as well as expectations.

There was a corresponding leveling off or improvement in the fundamentals (such as investment, real wages, retail trade) in July through September. According to Russia's Ministry of Industry and Trade, the number of new, mostly small and medium-sized, businesses increased significantly. Overall, it could be said at this time that the Russian economy is in a state where it is "waiting to grow".

Figure 1. GDP (Growth Rates, %)

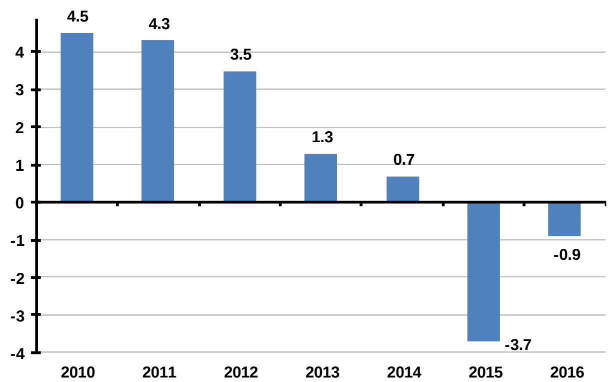


Figure 2. Quarterly GDP (2010=100%)

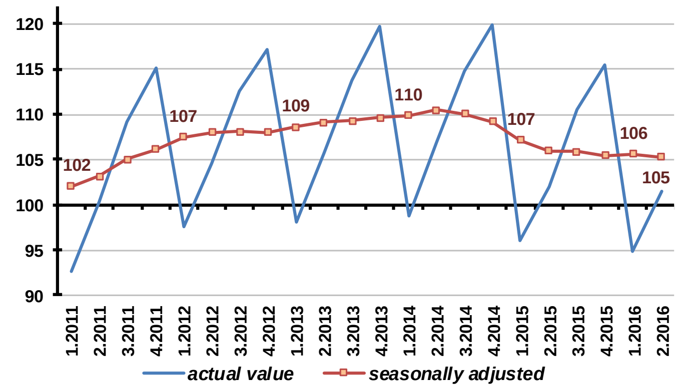


Figure 3. Urals Oil Prices
(USD per barrel)

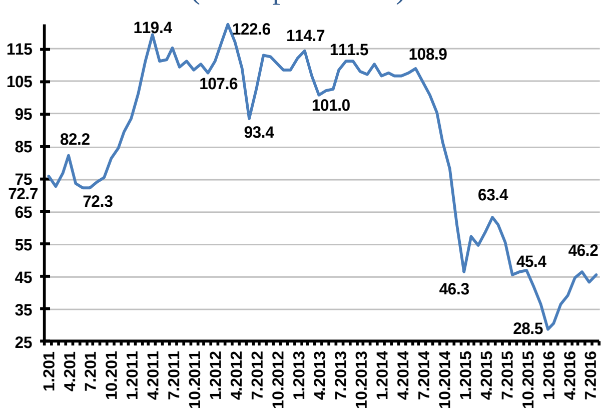
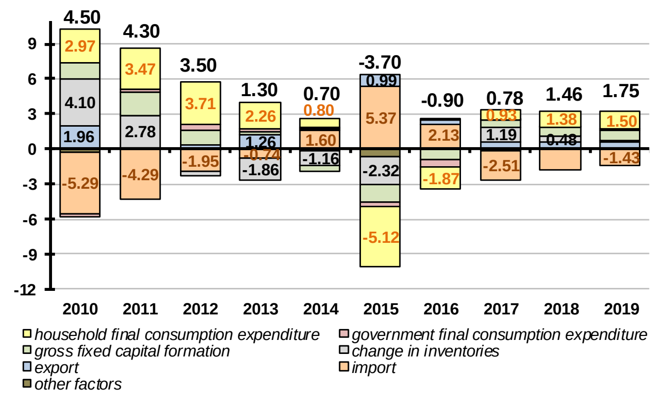


Figure 4. Contributions of the factors to GDP growth
(% of GDP growth)



1.2. Household Income and Consumption Crisis

As stated previously, a sustained shrinkage of real wages (resulting from a corporate effort to optimize labor costs, see Figure 5) and consequently, public consumption were a notable feature of the situation that arose in 2015-2016.

Household consumption was further hurt by a credit crisis that followed the 2010-2014 consumer "credit boom". As a result, during the worst of the crisis (2015 - mid-2016), consumer loan payments exceeded new credit, and the effect of consumer credit on consumption became negative.

One property of the current situation that is of great interest is the atypical structure of the decrease in retail turnover. Contrary to past practices and logic, it was due to the consumption of food (see Figure 6 and Figure 7) and not non-food items (which were supposed to have been strongly affected by the contraction of credit among other things).

The reason seems to be a significant increase in income inequality (partially confirmed by opinion polls): the decrease in the standard of living and consumption turned out to affect primarily the low-income strata of the population whose consumption is "skewed" in favor of food items. Previously, these groups were gradually pushing back from the poverty line thanks primarily to massive Government spending (see below). Ongoing budget consolidation and a sharp increase in food prices (partially, as a consequence of the "war of sanctions") resulted in decrease in food consumption.

Figure 5. Real wage per employee (% to monthly average of 2012)

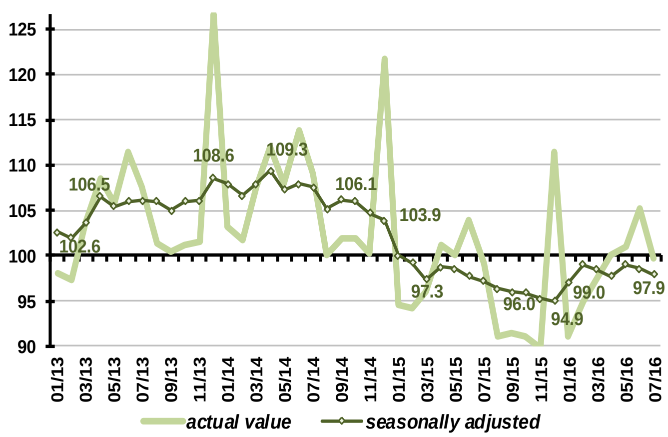


Figure 6. Retail trade turnover of food items (% to monthly average of 2012)

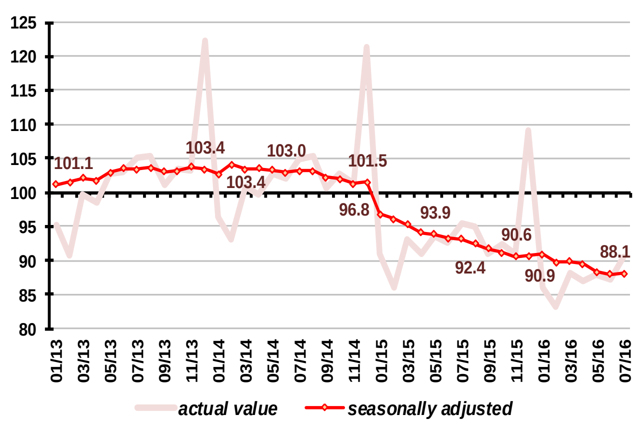
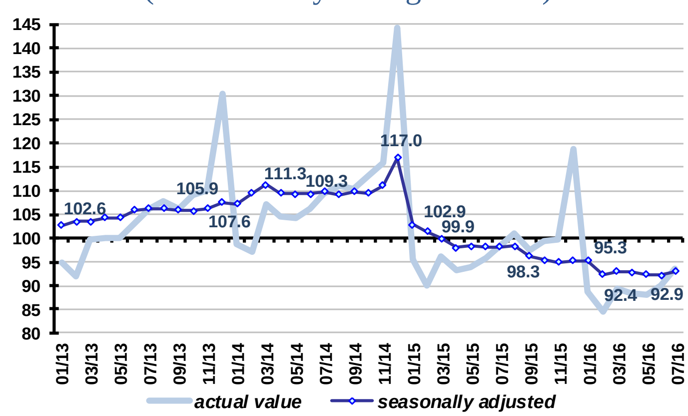


Figure 7. Retail trade turnover of non-food items (% to monthly average of 2012)



1.3. Unexpected Disinflation

Despite a weakening of the rouble in the second half of 2016, inflation remained almost at the same level initially and then slowed down noticeably. At the present time (mid-September 2016), the rate of inflation is only 6.3% for the year.

Factors causing this slow-down include:

- consumer demand crisis along with an overall slow-down in economic activity .

- a tight monetary policy with high positive interest rates that offset the inflationary effect both from the devaluation and the resulting fiscal deficit;
- a small increase in controlled rates in January and July 2016;

1.4. Adjustment in Public Sector Spending

The 2016 situation in the public sector is largely defined by two key factors:

- an unfavorable exterior economic environment that continues to persist (according to a CMASF estimate, an average barrel of the Urals Blend will sell for $41 in 2016);
- a continuing recession in the Russian economy (-0.9% based on 2016 results, according to CMASF, following 3.7% in 2015).

Their effect largely defines the dynamic both for the Government's oil and gas and non-petroleum revenues and forces a more frugal fiscal policy.

The expected contraction in Federal Government revenues from 16.9% of GDP in 2015 down to 15.5% of GDP in 2016 will cause the deficit to grow to over 3% of GDP and, likely, current year's expenses to be partially sequestered (sequestration is expected to be passed in the fall). In the event that a sell-off of 19.5% of Rosneft's stock to private investors in 2016 is successful, the Government stands to take in some RUB 900 billion (1% of GDP) in additional revenue which will help avoid sequestration as well as reduce deficit. However, it appears most likely at this time that the approved Federal Government 2016 spending will be cut 3% down to 18.6% of GDP, and that the year will conclude with a deficit of about 3.1% of GDP (see Figure 8).

The Reserve Fund remains the primary source of funding for the Federal Budget deficit in 2016 same as the year before. The expected withdrawals from the Fund stand at RUB 2.2 trillion, or 2.6% of GDP (in 2015, RUB 2.6 trillion, or 3.2% of GDP were withdrawn from the Reserve Fund for the same purpose). As a result, the total volume of oil and gas funds will have shrunk to 7.1% of GDP by the end of the year (including 5.7% in the National Wealth Fund, 39% of which is invested in non-liquid assets and cannot be used to offset the fiscal deficit, see Figure 9).

The sovereign funds accumulated in 2016 enable the fiscal authorities to pursue a flexible loan policy which is especially important in a high interest rate environment. In 2016, the outstanding amount of rouble-denominated Government securities will only amount to 0.4% of GDP (total amount of Russian debt is equivalent to 10% of GDP[3]). In the medium term, given the expected depletion of the Reserve Fund in 2017 and the existing limitations on taking out foreign loans, borrowing in the domestic market will grow rapidly becoming the principal method of paying off the fiscal deficit.

[3] Assessment as of year's end without consideration of Government guarantees.

Figure 8. Federal Budget Deficit (-) / Surplus (+) (% of GDP)

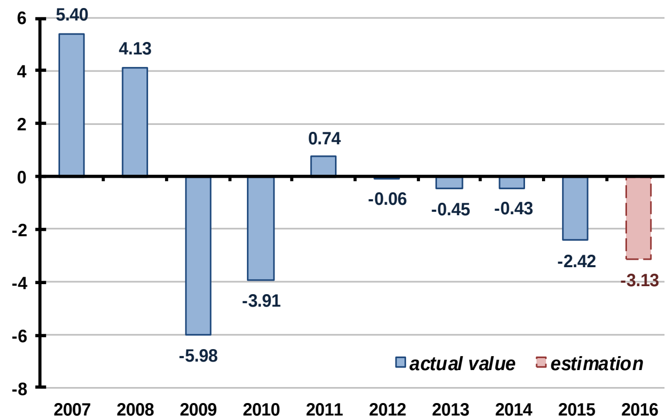
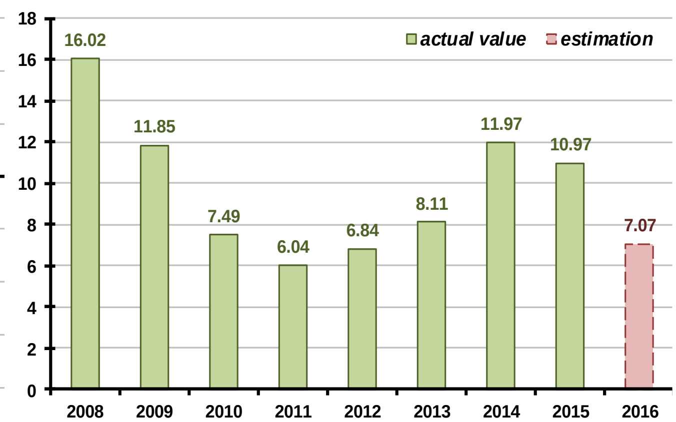


Figure 9. Oil and Gas Funds Volume at the End of the Year (% of GDP)



1.5. Monetary Environment

In late 2015 - early 2016, the rouble suffered another noticeable loss of value resulting from a reduction in global petroleum prices (see Figure 10). At the same time, the rouble's loss against other currencies was half as significant although comparable in scale to the one observed in late 2014 - early 2015. The less drastic response of the rouble exchange rate to the oil prices is explained by:

- a sharp reduction in the goods and services imports;
- reduced foreign debt payments resulting from gradual debt amortization;
- accumulation of considerable foreign exchange assets by individuals and banks, devaluation of free rouble assets held by individuals and corporations (with respect to foreign currencies) which results in lower overall demand for new foreign exchange assets.

Consequently, individual and institutional investment into foreign exchange fell rather than grew at the moment of shock. Thus, there was no large-scale capital outflow out of the country (see Figure 11).

This enables us to make the statement that Russia's payment balance has adjusted overall to fit the new less favorable exterior economic conditions. As a result, a basis has been established for a medium-term trend towards a stronger rouble (which does not preclude the possibility of significant short-term exchange rate fluctuations about this medium-term trend).

Overcoming the devaluation expectations coupled with the low level of consumer optimism has caused a sustained growth in retail deposits. Therefore, the banks' resources grew sustainably faster than effective demand for credit. This, in turn, has initiated recovery of liquidity in the banking system's.

Growing Government deficit alongside the withdrawal of funds from the Reserve Fund and their introduction into circulation has become an additional factor in improvement in the banking system's liquidity.

On the one hand, increased banking system liquidity is prompting banks to resume ramping up the issuance of loans to the economy.

On the other hand, the tight interest rate policy pursued by the Bank of Russia, the high percentage of "bad debts" (see Figure 12) and the banks' low capital adequacy ratio (see Figure 13) are hindering this credit recovery.

So far, the credit market remains sluggish (see Figure 14) which holds back the transition to a positive economic growth trend.

Figure 10. Dual-Currency Basket Rate and Oil Price

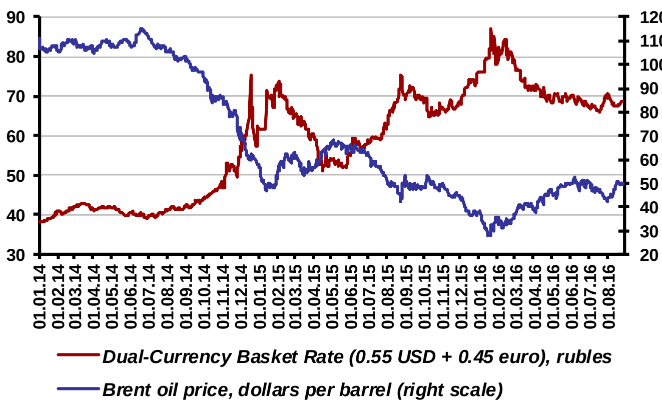


Figure 11. Balance of Payments Main Indicators (bln. USD)

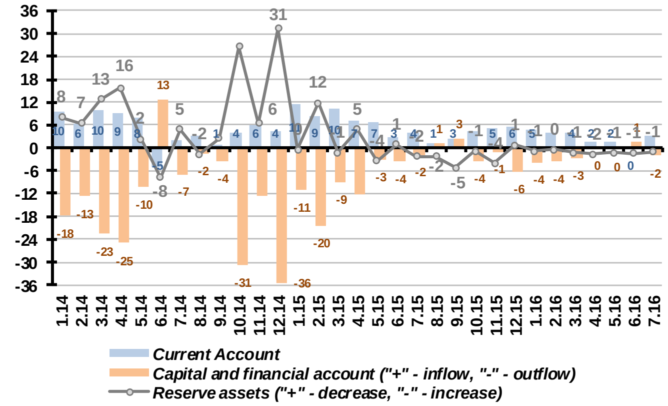


Figure 12. Share of Overdue Credits in Credit Portfolio (Excluding Sberbank, VTB and the Bank of Moscow, %)

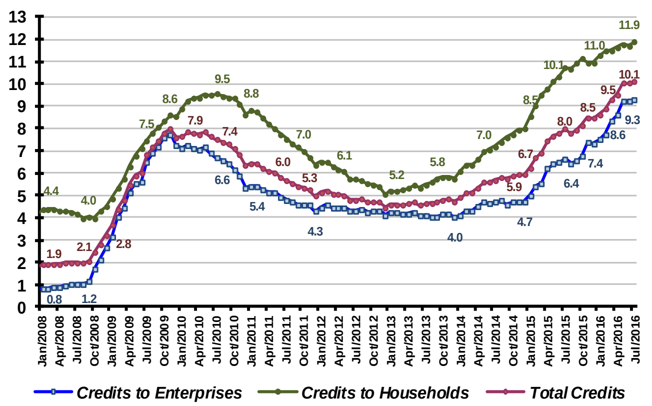


Figure 13. Capital to Assets Ratio (%)

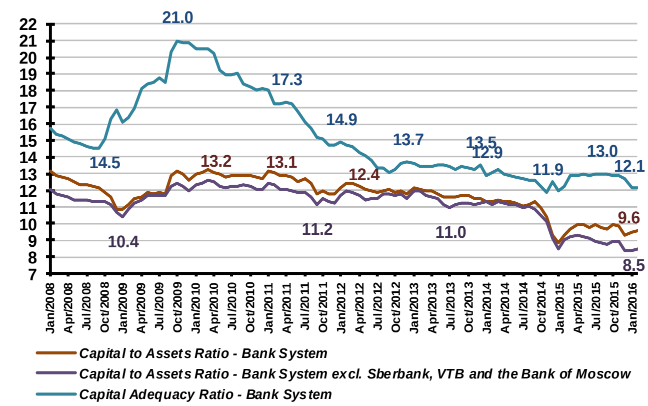
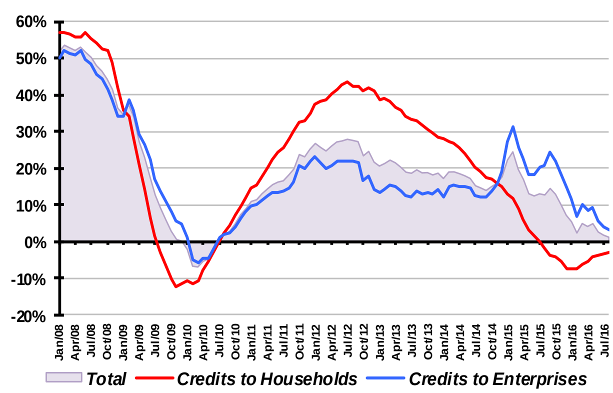


Figure 14. Banks credit portfolio growth rates (year to year, %)



2. Factors Influencing Economic Policy and the External Environment

The forecast assumes current tight monetary policy continues. The Russian Central Bank's key rate will be significantly (2 to 4 points) higher than the rate of inflation, and therefore, the banks' interests rates for retail borrowers would be even less affordable.

In the medium term, an extremely aggressive fiscal contraction is expected as well as a transition to a gradual budget consolidation (with the moratorium on higher taxes holding). Spending indexation will lag far behind inflation which, given the expected full indexation of social expenditure, implies a "freeze" or a nominal cut back on other lower priority non-social expenses.

Companies will continue to be cautious in their remuneration policies. Real wages will increase approximately in line with increases in productivity.

The price of oil will increase slowly (partially, as a result of policy coordination between Russia and other oil-exporting nations) from $41 per barrel (of Urals) in 2015 to $45 in 2017, and $52 in 2019 (for reference, the 2015 price was $51.1).

3. Forecast Summary

Real wage increases are going to shadow productivity gains (2017: 1.1%-1.4%, 2018-2019: about 2-2.5% a year). Given the gradual slow revival of consumer credit, retail trade turnover may stand at 1.5%-1.8% in 2017 and about 2.5%-3% in 2018-2019 (see Figure 15). Given the realized drop in the individual standard of living, paid services demand will take longer to recover. The latter will increase by 1.0% to 1.3% in 2017, and about 2%-2.5% a year in 2018-2019.

The full adjustment to the new economic situation and labor cost optimization will help corporations implement the investment plans they have been putting off for past few years. Investment is estimated to grow 2.3%-2.7% in 2017, and 3.3%-4% a year in 2018-2019 (see Figure 16).

As a result, a near-zero GDP dynamic (+0.6-0.9%) may be expected in 2017 with 1.5%-2% projected for 2018-2019, which is dramatically less than the pre-crisis rates.

Given its obvious undervaluation at the time of the correction in 2014-2015, the rouble may be expected to strengthen gradually over the next few years with respect to the currencies of the country's main trading partners. This will certainly put an additional brake on growth but (together with the tight monetary policy expected) will result in consistently lower inflation. Even as early as 2019, it may already approach the Central Bank's target rate of 4% by being 4.1%-4.4% (5.6%-5.9% December on December in 2017).

The ongoing adaptation of Government spending to the new external economic reality will cause the Federal Budget deficit to shrink gradually from 2.6% of GDP in 2017 to 1.8% of GDP in 2019. The Reserve Fund will be fully depleted as early as 2017 which will result in an increase in domestic borrowing. At the same time, Government debt will grow to 12% of GDP by the end of 2019 (as compared to 10% of GDP expected by the end of 2016).

Figure 15. Real Wage per Employee and Households Consumption (Growth Rates, %)

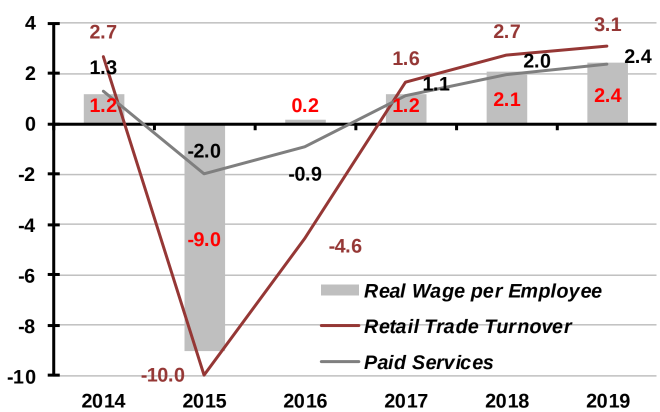
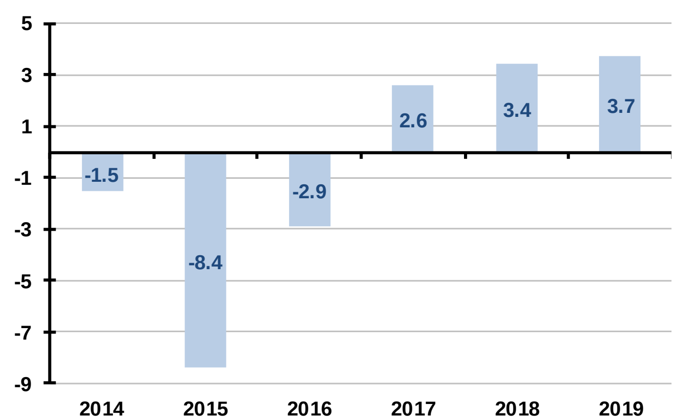


Figure 16. Fixed Capital Investments (Growth Rates, %)



4. Policy Issues and Uncertainties

The principal issue of current policy is how to combine stabilization measures with a policy that would stimulate economic growth.

The need for financial stabilization stems from the amounts of Government liabilities mostly incurred between 2011 and 2013, i. e. at a time when the situation in the international markets was favorable. However, Government revenues turned out to be much lower than expected because of moderate oil prices and protracted stagnation. Consequently, the Russian Government will proceed with a comprehensive consolidation of Government spending.

Accelerated growth in the money supply resulting from the spending of funds from Government accounts (see Figure 17) caused the Bank of Russia to develop a concern that it would not be able to meet the primary medium-term monetary policy target of bringing inflation down to 4% in 2017. To rein in this expanding money supply, the Bank of Russia has stopped lowering its key rate despite the fact that the foreign exchange market has stabilized and current inflation has become significantly lower (see Figure 18). As a result, current annual inflation is at 2013-2014 levels while the Central Bank's key rate is 1.5 to 2 times higher than at that time.

The combination of spending consolidation and a tighter monetary policy are having a devastating effect on the prospects of economic recovery. At the moment, the transition method is not defined, and a discussion is underway on the principles of jump-starting this recovery. It is relatively easy to jump-start by stimulating household income and consumption. However, even in the short term, private business and Government financial resources are insufficient for the task. In addition, there is medium-term risk: growing labor costs lead to a loss of competitiveness and a subsequent growth in imports and devaluation of the currency.

The alternative is the idea to stimulate fixed investment. However, for a stagnant consumer market, such an investment incentive can only be supported by subsequent greater exports or import substitution.

The primary strategic dilemma is that of new status of Russia in the international system of economic relations and the division between stimulating evolutionary (based on existing competitive advantages and joining global manufacturing value chains headed by foreign companies) or revolutionary (based on establishing new global competitive advantages and international projects headed by Russian companies) development. These issues are in the focus of a discussion on Russia's development strategy for the coming decade that has been going on for the past several months.

So far, several of measures of a revolutionary nature have been announced and are being implemented to create potential nuclei of highly competitive manufacturing facilities in Russia for emerging technology markets (National Technology Initiative).

Key uncertainty factors in the Russian economy include: prices for fuel (oil and gas), metal, and grain, as well as the trends in the relevant markets;

- the amounts of capital transfers given the economic sanctions and the strategic economic dialog with the Asia-Pacific region that is being established;
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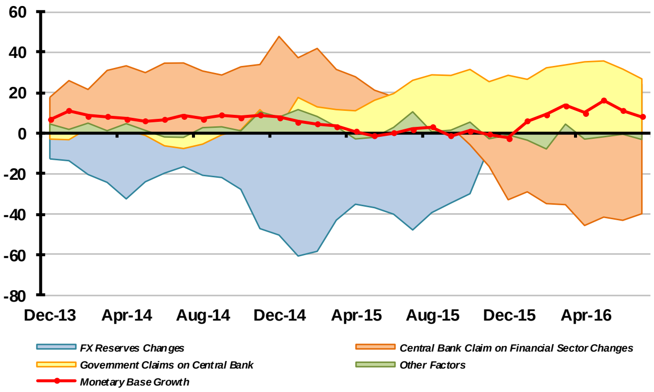
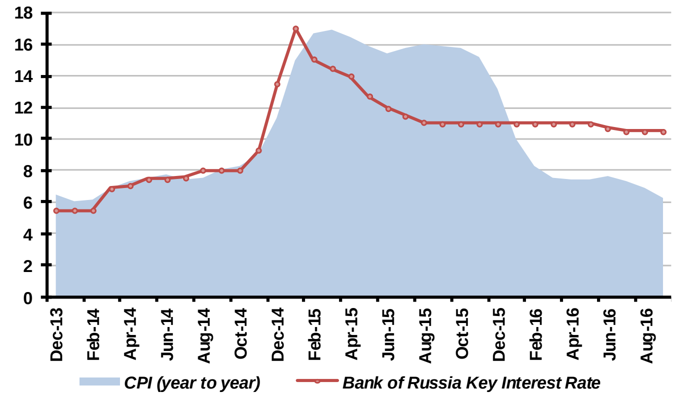
Figure 17. Main Drivers of Broad Monetary Base Growth (Moving Year, Accumulated, Adjusted for Exchange Rate Dynamics)

Figure 18. The Bank of Russia Key Interest Rate and Consumer Prices Inflation, %





5. Summary Table for Forecast

Main macroeconomic indicators forecast (growth rates, %)

	2016	2017	2018	2019
CPI (end of the year)	6.3	5.7	4.5	4.2
GDP	-0.9	0.8	1.5	1.8
Industrial output	0.4	0.8	1.5	1.9
Fixed capital investments	-2.9	2.6	3.4	3.7
Real wage per employee	0.2	1.2	2.1	2.4
Real disposable household income	-3.8	2.0	2.4	2.6
Retail trade turnover	-4.6	1.6	2.7	3.1
Paid services	-0.9	1.1	2.0	2.4
Export, bln. USD	281	307	336	352
Import, bln. USD	188	206	231	251
Trade balance, bln. USD	93	102	105	101
Ruble exchange rate, annual average, rubles per USD	70.0	63.3	58.8	55.8
Urals oil price, USD per barrell	40.6	45.0	50.0	52.0