CENTER FOR MACROECONOMIC ANALYSIS
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Development of the Russian Economy in 2016–2017 and Forecast for 2018–2019

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1. Recent Trends

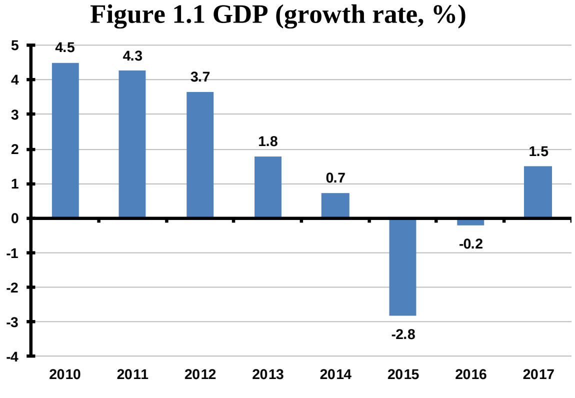
In the last year (3rd quarter of 2016-3rd quarter of 2017), the economic situation featured the following:

- slow and unsteady economic recovery leaning mostly on increased fixed capital investments;
- depletion of the effect of import substitution, suspended export growth and emerging import revival;
- unstable improvement on the labor market, tendency to a decrease in unemployment and moderate growth of real wages;
- slow growth of household consumption, albeit with a clearly negative social impact (increase in social gap, reduction of the consuming capacity among the poor);
- orientation of the monetary policy toward controlling inflation and exchange rate risks (the strict regulatory policy was basically pursuing the same goals).

1.1. Progress of Economic Development

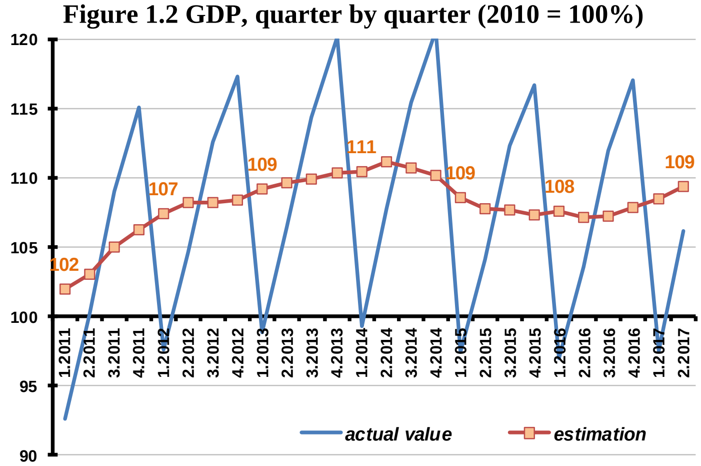
The gradual recovery of the Russian economy has undoubtedly become the most distinctive feature of the year. In fact, the trough of the crisis ended in the second quarter of the last year, and since then, the GDP has experienced a slow and gradual growth. In the end, the Russian GDP level in the first six months of this year gained 1.5% as compared to the previous year (see Figures 1.1 and 1.2; year estimate: +1.7-2%).

Figure 1.1 GDP (growth rate, %)



data for 2017 – first half of 2017 vs first half of 2016, %

Figure 1.2 GDP, quarter by quarter (2010 = 100%)



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

But the problem is in the not-so-stable balance of factors encouraging and halting economic growth.

The first signs of economic buoyancy were noticed, as previously mentioned, already in the second half of last year (it was then that oil prices rose, which supported the ruble and aided stabilization of the economy, see Figure 1.3). At that time, the growth was mostly supported by the consequences of a large-scale ruble depreciation in 2014–2015. For the first time in a long time, starting in 2014, there was a decrease in imports (which had a *positive* impact on economic growth), and an increase in non-resource-based exports in 2015–2016. These factors (along with the state's efforts in infrastructure upgrades) resulted in the revival of the investment process, leading company managers to develop favorable expectations (of a more or less quick recovery).

Finally, the unusually large harvest of 2016 played a positive role.

On the other hand, the second half of 2016 for the first time in a long time saw continued decrease in household consumption, which started in 2014.

It seemed we were at the brink of overcoming the crisis, should the export growth slightly increase and the dynamic of the consumer demand recover, yielding a new wave of investments, this time from the private sector.

Everything changed in 2017.

First, the previous ruble depreciation potential was depleted: the real effective rate had almost returned (90%) to the 2013 pre-crisis level (see Figure 1.4).

This led to import returning to markets (investment products most of all). And the export dynamic, on the contrary, slowed down significantly.

At the same time, consumer demand was recovering (the contribution to economy gain during the first quarter was 1.4 percentage points, see Figure 1.5).

On the one hand, officially the structure of growth factors has become much more balanced—the investment in fixed capital, household consumption, and company inventories have been increasing gradually (this contribution to economic growth is the largest of all factors, i.e. 2.0 percentage points; essentially, this is a good indicator of the end of the crisis).

On the other hand, a number of factors indicate that the "borderline stagnation" scenario has taken a strong hold over the expectations of the key economic players; therefore, the recovery most likely will be both slower and less stable than anticipated only a year ago.

Figure 1.3. Dynamic of Oil Prices (Urals, dollars per barrel)

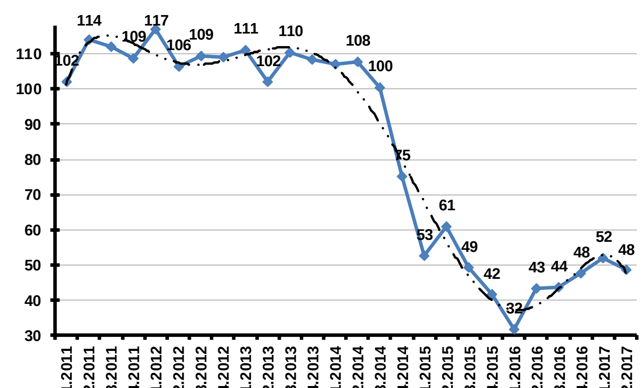


Figure 1.4. Dynamic of Ruble's Real Effective Exchange Rate

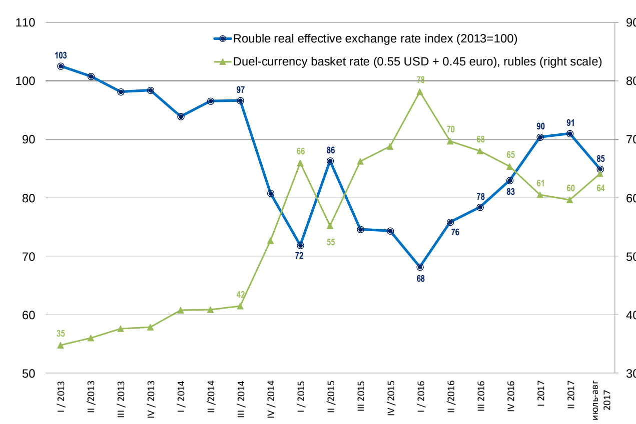
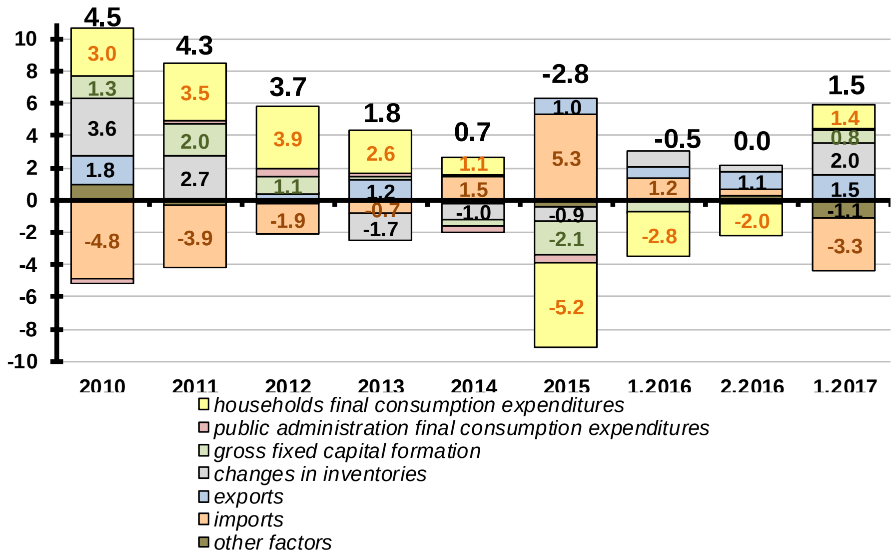


Figure 1.5. Contribution of Economic Growth Factors to GDP Growth (GDP percentage points)



1.2. Management Expectations and Fixed Capital Investments

A rapid change in management expectations became a key factor defining the distinctive features of the entire development of the Russian economy last year.

Early in the year, with the macroeconomic stabilization that had already been established, the growth of oil prices, and the anticipated slow repair of relations with the new U.S. administration, the situation was marked by an abrupt and largely unsubstantiated improvement in the expectations of company managers (the PMI index reached the peak values of 2011, when the economy was rather overheated, see Figure 1.6). This situation offered hope that the Russian economy was on the brink of recovery, but also created risks of facing an extremely aggressive correction in the event of a fairly feasible decline in the foreign or domestic market conditions.

Mid-year, the situation changed—the unbridled optimism shifted to moderate and the PMI index decreased to the current level of 51-53. This means that companies "have grown accustomed" to the crisis and the slow recovery. There are no more inflated expectations potentially ending in correction, but an expectations-based economic surge is no longer possible either.

In this situation, investments began to grow (see Figure 1.7), which is possibly the most reassuring event of the situation at hand (current year assessment: +3.6-4%). With this, the private investment deficit is covered by the state stepping up their investments (including investments from the subjects of the Russian Federation with the authority to oversee construction of the transportation infrastructure).

This explains the irony: the construction output began growing both earlier, and faster, and in a more stable way than did the production of machinery and equipment for the domestic market (the growth of the latter resumed only in the past two months, although, essentially, at the end of the crisis you get an "inexpensive" modernization of the production facilities first, and the building spree emerges once the economic recovery becomes sustainable, see Figures 1.8 and 1.9).

Figure 1.6. Procurement Management PMI Index of Markit (seasonally adjusted)

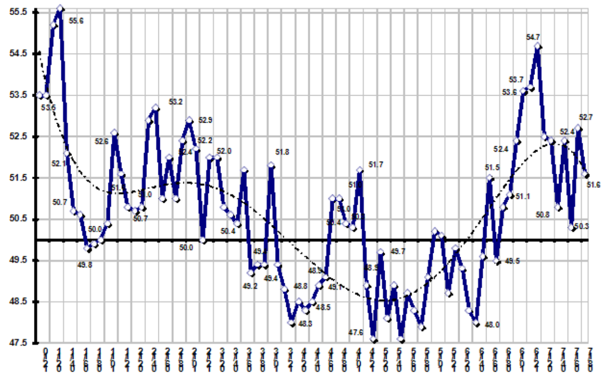


Figure 1.7. Fixed Capital Investments (% to annual average for 2012)

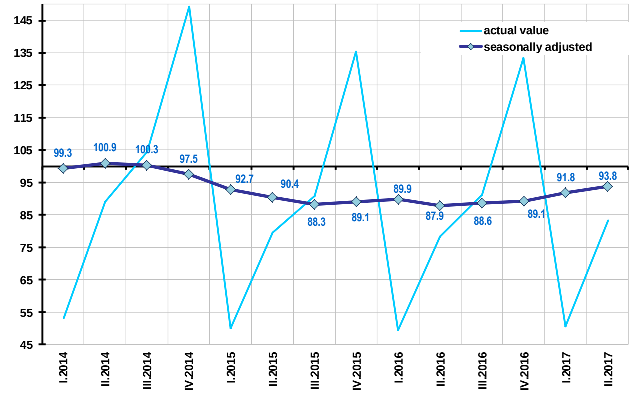


Figure 1.8. Construction Output (% to monthly average for 2012)

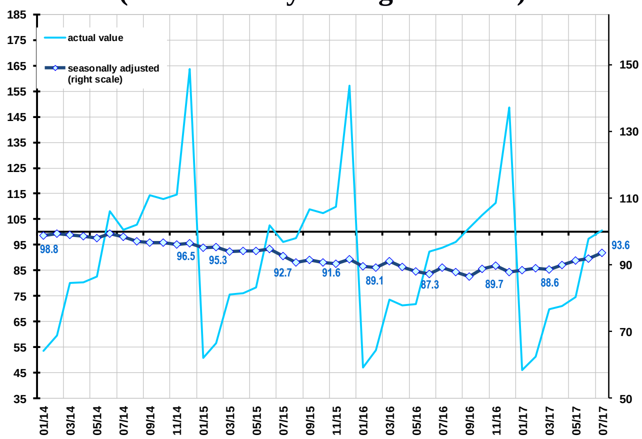
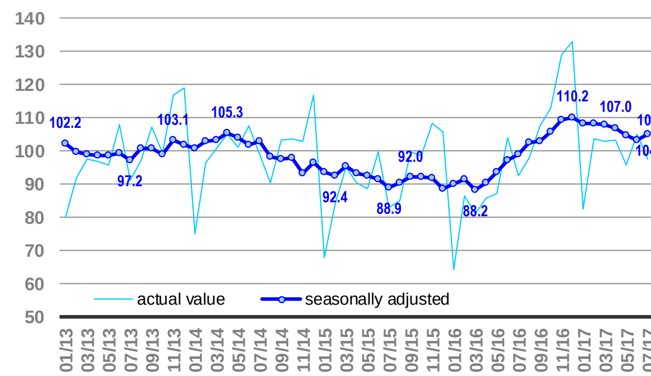


Figure 1.9. Production of Machinery and Equipment for Domestic Markets (2013 monthly average=100)



1.3. Employment, Income, and Population Consumption

The delayed recovery created a need for companies and the state to follow exceptionally cautious policies with regard to managing labor expenses.

On the one hand, the employment rate went down pretty fast, which is completely normal for the recovery stage. On the other hand, the number of those employed, which overall has been rising throughout the last year, began to decline steadily in 2017 (see Figure 1.10).

Most likely, the key to this irony is that ruble depreciation (accompanied by a tougher stance on migration policy) caused an outflow of migrant workers from Russia, followed by certain work place closures. A crisis in the small business sector tied to an increase in fiscal pressure on a regional level became another contributing factor.

At the same time, the end of the crisis allowed companies to increase real wages gradually (see Figure 1.11, annual estimate: +1.9-2.2% which is an accurate reflection of the observed labor productivity dynamic in the Russian economy). Considering that budget policy is more geared towards supporting budget consolidation under new conditions, the situation with pensions and social benefits is noticeably worse than it is with real wages. Hence the gap in the dynamic of the real wages and real disposable income of the population (annual estimate: +1.3-1.6%).

This situation, in turn, couldn't help but impact both the consumption and the living standard of the population.

The retail trade has gradually started its slow recovery (annual estimate: +0.8-1.1%). At the same time, only at the end of this year did we see the reversal of a strange tendency, when the sales of food products are rather stable or dropping, the sales of non-food products are increasing, even though slowly (see Figures 1.12 and 1.13), and the volume of paid services is expanding aggressively (annual estimate: +1.8-2.1%)[2].

The adverse social changes are behind this picture—a combination of stabilized budget payments and high food price inflation in 2014–2016 [3] led to the strengthening of the social gap. By mid-2017, the proportion of people living in extreme poverty ("not enough money even for food") grew by almost 3.3 times as compared to the middle of 2014 (from 3% to 10%), and the proportion of poor people ("enough money only for food") grew by 1.8 times (from 16% to 29%). At the same time, high-income groups managed to partially grasp the effect of ruble depreciation; over the same time period, the proportion of rich people grew from 2% to 3% (see Figure 1.14).

Figure 1.10. Unemployment Rate (% of Labor Force) and Number of Employed (mln. persons, right-side scale), seasonally adjusted

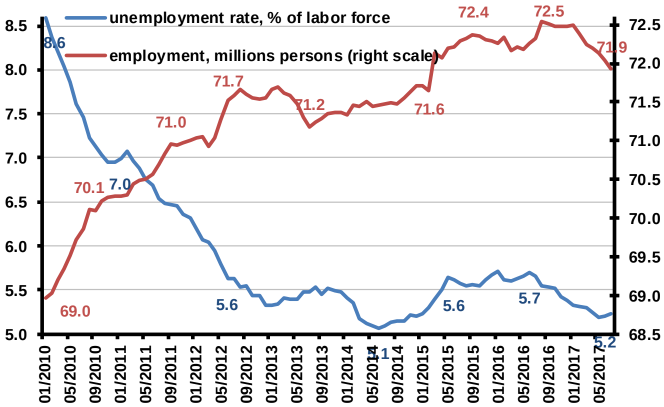


Figure 1.11. Real Wage per Employee (% to monthly average for 2012)

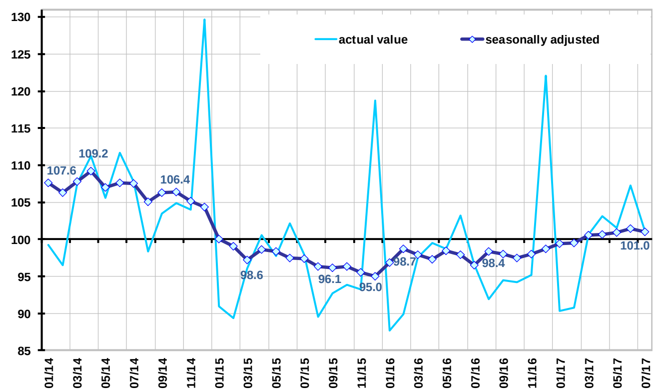


Figure 1.12. Food, Beverage, and Tobacco Retail Trade Turnover (% to monthly average for 2012)

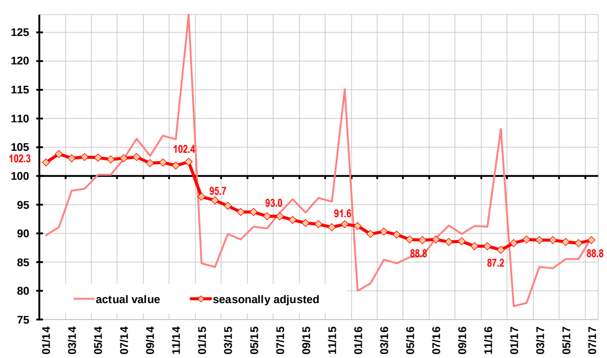
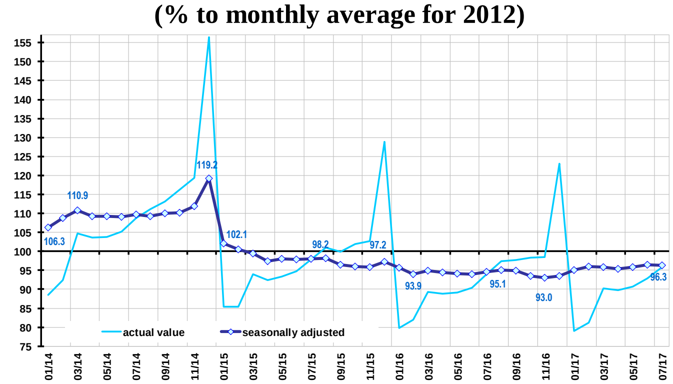


Figure 1.13. Non-Food Retail Trade Turnover (% to monthly average for 2012)



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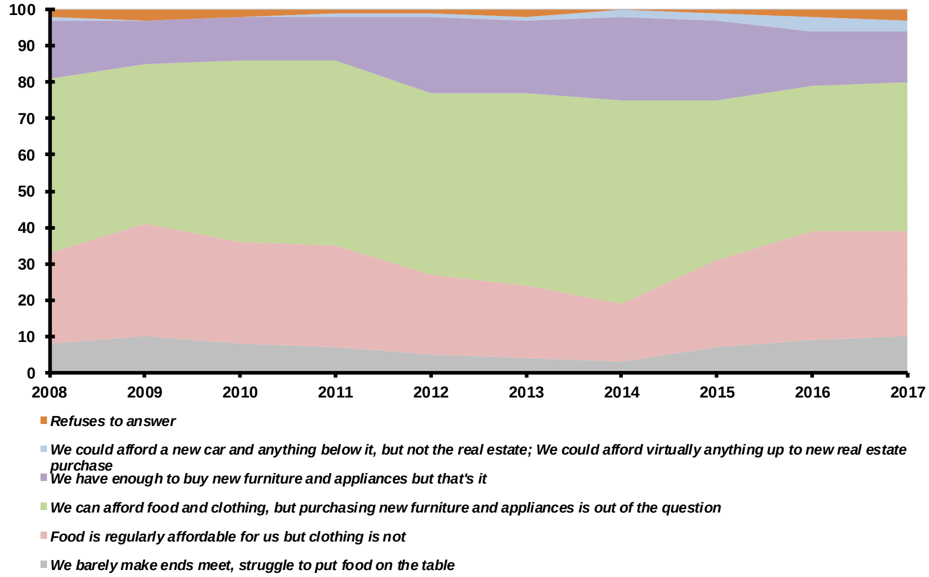
[2] An even more vivid feature of the paradoxical nature of the situation is possibly the booming automotive market. "The results of the first eight months of 2017 show the growth of the Russian automotive market by 9.6% to 980,921 cars, according to data from the Association of European Businesses. <...> the fact that the recovery is going forward in sure steps and for six months straight is what's most important right now. Overall, the market is definitely in high spirits, with similar expectations for the remaining year. The AEB will update the forecast for 2017 next month, once September results become available. To refresh the memory, according to the current forecast from the association, in 2017 the Russian automotive market could grow by 4% to 1.48 mln. vehicles, thereby breaking out of the 4-year falling cycle." https://www.autostat.ru/news/31312/ © Autostat.

[3] It is worth noting that this tendency was reversed in the summer of 2017, when food market prices dropped.

Figure 1.14. Subjective Self-Assessment of Households' Financial Situation (% from the number of polled households, monthly average values for May of the relevant year)



Source: Press-release No. 3407 by VCIOM [Russian Public Opinion Research Center] (https://wciom.ru/index.php?id=236&uid=116289)

1.4. Federal Budget: Mechanisms of Adaptation

By 2017, the Russian budget system was able to adapt to the new economic reality, anticipating the continuation of unfavorable foreign economic conditions into the mid-term, and the economy's stepping into a course of sustainably slow rates of economic growth.

Basically, such adaptation was driven by the transition to a strict budget consolidation policy (targeting a reportable zero primary budget deficit as early as 2019 even with a conservative approach to budget planning; see Figure 1.15).

Curbing an increase in budget spending became the key mechanism of adaptation. As per the previously announced tax increase freeze until 2018, the principal tax rates for non-resource based businesses, on the contrary, managed to remain on the same level, while certain measures of income mobilization included revenue growth mostly due to improved administration and an increase in non-tax income.

The oil and gas funds accumulated over the past years (see Figure 1.16) made it possible to anticipate a transition period in the budget consolidation process, which will (most likely) prevent a nominal reduction in budget spending.

But overall, despite the already expected federal budget balance mid-term, the new design of the fiscal policy does not allow the budget to be used as one of the instruments for economic support. Such an approach to budget planning bears the risk of long-term conservation of the stable, slow economic growth rates.

Figure 1.15 – Deficit (–)/Proficit (+) of Federal Budget, % GDP

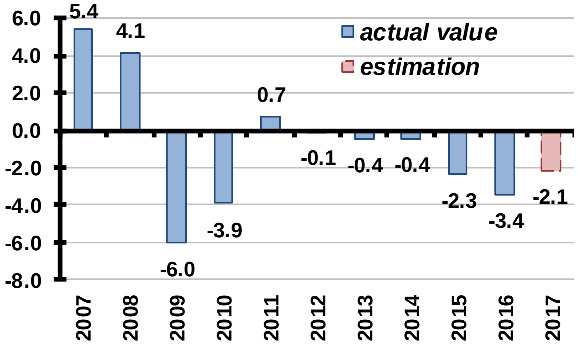
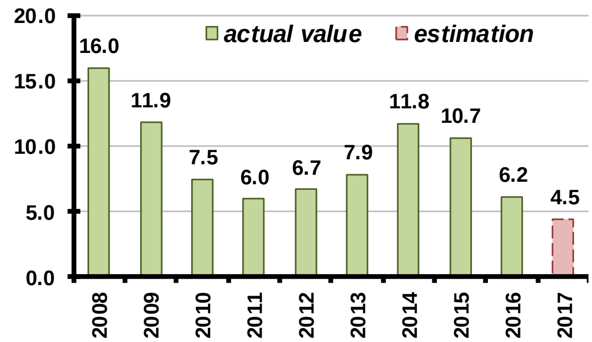


Figure 1.16 – Volume of Oil and Gas Funds at Year's End, % GDP



Source: Ministry of Finance of the RF, Federal Treasury, Rosstat [Federal State Statistics Service], forecast by CMASF [Center for Macroeconomic Analysis and Short-Term Forecasting]

1.5. Unexpected Disinflation

Despite the semi-stagnant situation in the economy, the monetary policy of the Bank of Russia over the relevant period aimed almost exclusively for stabilization—reduction of inflation within the framework of inflation targeting, and indirectly (through cost of credit), securing the sustainability of the foreign exchange rate and the balance of payments.

In terms of the drive against inflation, the success was unexpected. A combination of a strict monetary policy that has stipulated a decline in core inflation over a course of several months in a row and a seasonal reduction in the prices of fruits and vegetables led to, for the first time since 2011, deflation in August and early September of 2017 (see Figure 1.17; it should be noted that in the last year inflation almost always ended up below its long-time average annual level, see Figure 1.18). In the end, the plan of reducing inflation to 4% (December 2017 to December 2016), which the Ministry of Finance itself deemed challenging, was, as it seems, exceeded. The annual level of inflation (using the corresponding month in 2016) in August and September is estimated at 3.3% (annual estimate - 3.3-3.6%, December to December).

Such a situation, considering the high price the economy pays for the strict monetary policy, objectively poses a question for the Bank of Russia on the feasibility of reducing the key rate, and the possibilities and risks associated with that.

Figure 1.17. Inflation on Consumer Market (growth rate, %)

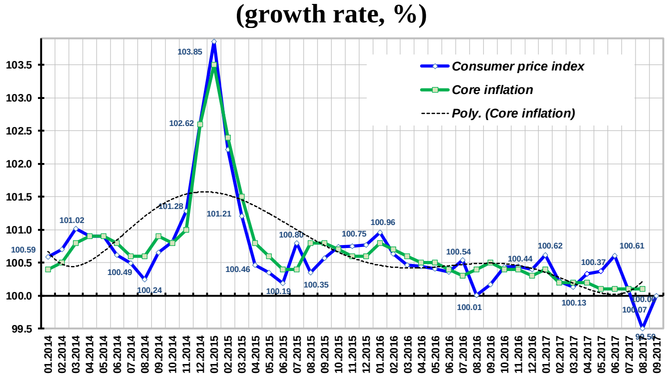
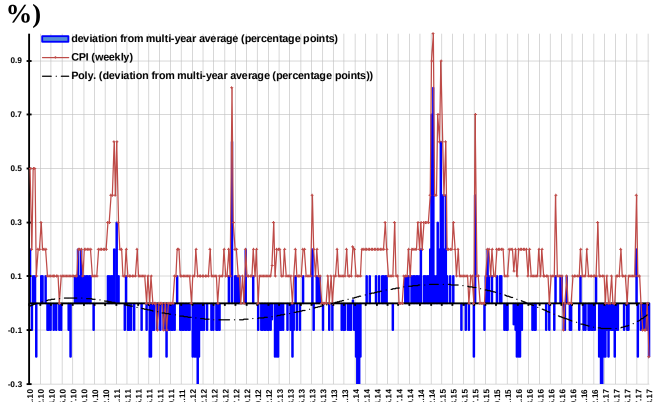


Figure 1.18. Weekly Consumer Price Index and its Excess Over Long-Time Average Annual Level (CPI, growth rate, %)



1.6. Situation on Monetary Side

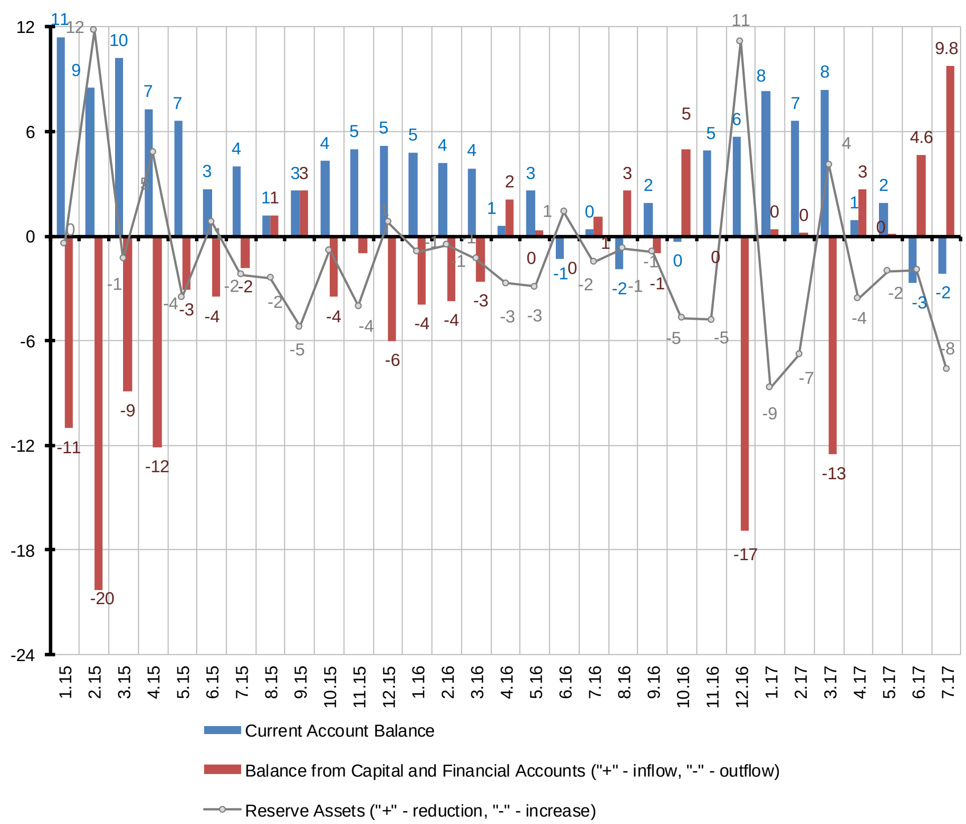
The recovery of global oil prices stipulated the increased influx of foreign currency into the Russian market through current account in late 2016-early 2017 (see Figure 1.19). It, in turn, formed a tendency for appreciation of the ruble during this period.

However, by the middle of 2017, the potential for current account balance growth, and the consequent further appreciation of the ruble, was largely exhausted. The latter was stipulated by accelerated expansion of import volumes of goods and services influenced by the prior growth of the real exchange rate of the national currency.

Next, we should expect the ruble to transition to “sideways” fluctuations: the potential continued import expansion will not allow the ruble to appreciate greatly, while a decrease in the net capital outflow will not let it weaken extensively either.

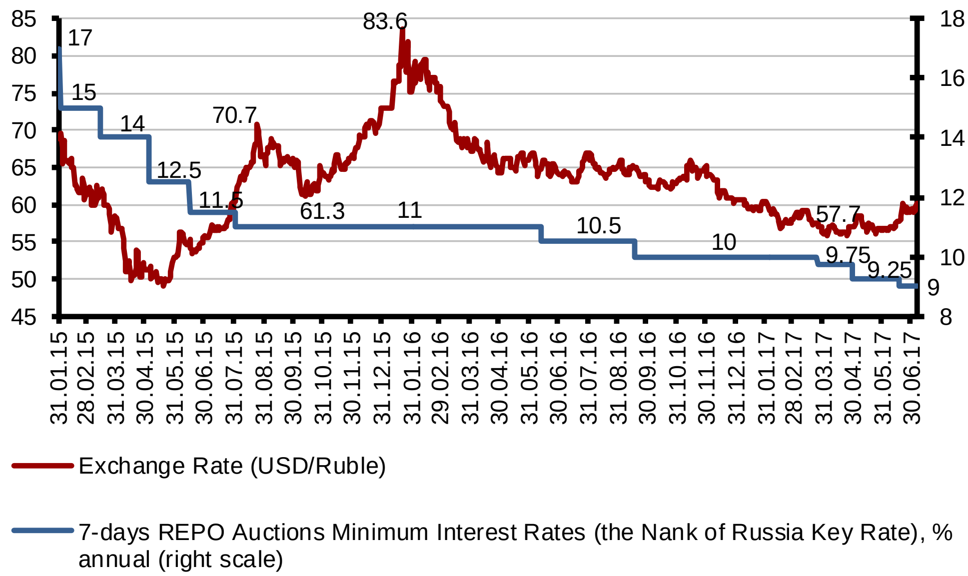
The decrease in the net capital outflow is in turn stipulated by economic agents’ regained trust in the ruble, and perhaps, fears of possible blocking of foreign assets once the new U.S. sanctions are in place (this is indicated by a sharp reduction in the foreign assets of Russian banks in June and July).

Figure 1.19. Key Aggregates of the Balance of Payments of Russia (billion dollars)



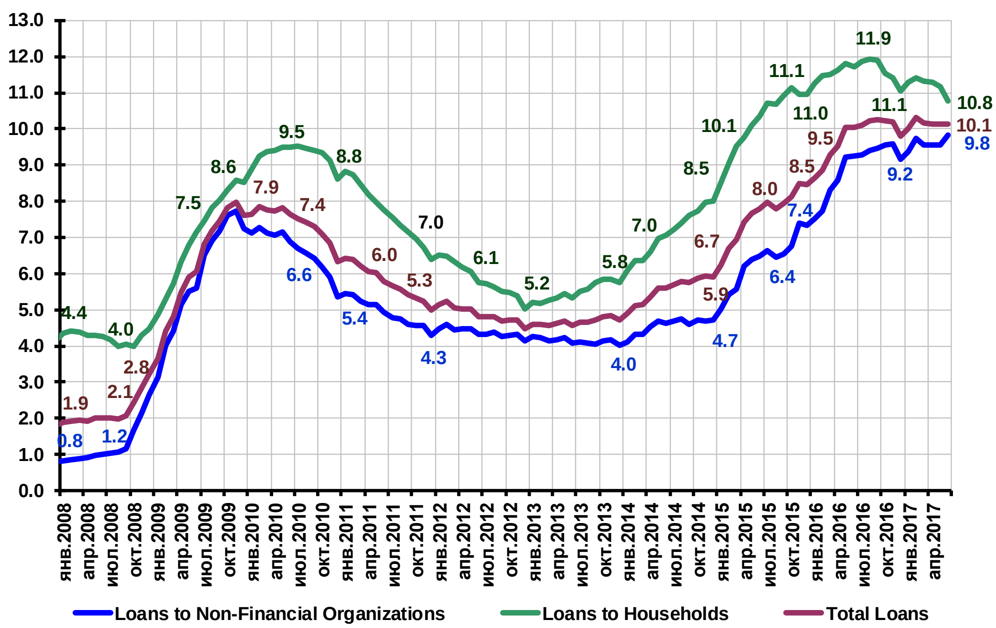
Although the Bank of Russia continued to follow a strict anti-inflation monetary policy, nonetheless, the relative stability of the foreign exchange market created conditions for resuming the key rate reduction (see Figure 1.20).

Figure 1.20. Ruble Exchange Rate and the Bank of Russia Key Rate



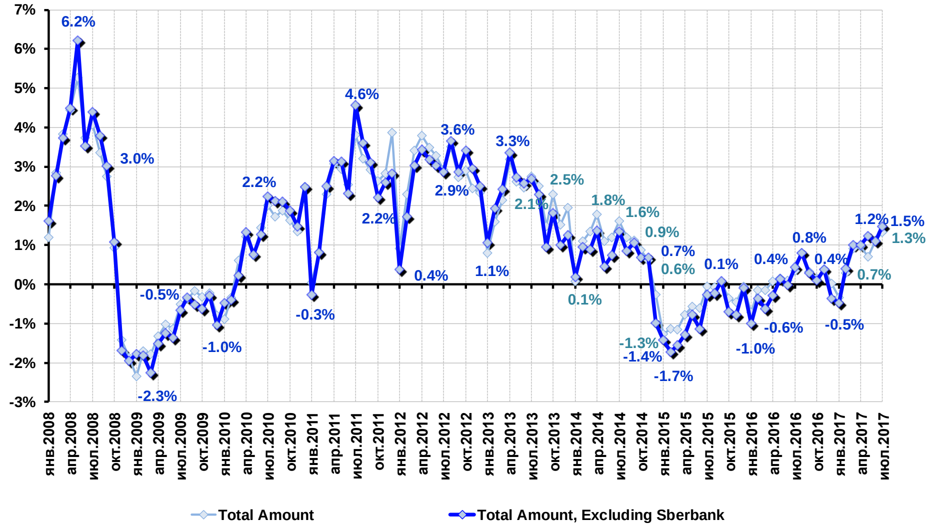
Stabilization of the economic situation has stopped the decline of the quality of corporate loan portfolios, and the quality of retail loan portfolios has started to improve (see Figure 1.21).

Figure 1.21. Overdue Loans Ratio (excluding Sberbank, VTB, and Bank of Moscow), %



The reduction of credit risks coupled with a gradual recovery of consumer confidence prompted the expansion of retail lending volumes instead of their reduction (see Figure 1.22). Under other similar conditions, this will somewhat support the consumption dynamic.

Figure 1.22. Loans to Households (excluding foreign currency revaluation, monthly growth rate, %)



But the corporate loan portfolio of banks continues to stagnate. This is partially linked to the problem with decapitalization of the majority of Russian banks as a consequence of a systemic banking crisis which emerged back in the end of 2014. The situation is worsened by the substantial hidden "holes" in the capital of the Russian banks which appeared even earlier and were stipulated by concealed financing of individuals associated with the bank owners.

It should be noted that the recent loss of solvency by a large private Russian bank (bank Otkritie) shows that the systemic banking crisis is far from being over.

2. Assumptions on National Policy and External Environment

In terms of external conditions, the forecast includes a slow, inflation-driven oil price increase from an average of 50–53 dollars per barrel in 2017 to 53–56 dollars per barrel in 2019 (see Figure 2.1).

At the same time, Russia is going to be extremely cautious when expanding deliveries of hydrocarbons to the already saturated global market (+3-6 mln. metric tons of oil and oil products, +1-3 billion cubic meters of gas per year, see Figure 2.2).

The increase in oil prices and a certain influx of foreign direct investments (obviously mostly from the Asia-Pacific Region, as well as repatriated Russian capital) against the backdrop of an increase in import volume will form an unstable balance at the foreign exchange market; the ruble will stabilize at 56–60 rubles to a dollar.

A budget consolidation policy will be taking place, namely, the level of budget investments will not exceed 1.9–2.3% of the GDP.

Figure 2.1. Dynamic of Global Oil Prices (dollar per barrel, Urals) and Ruble Foreign Exchange Rate

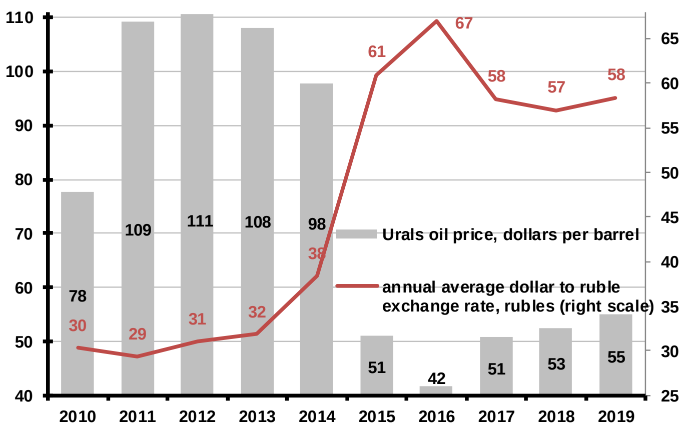
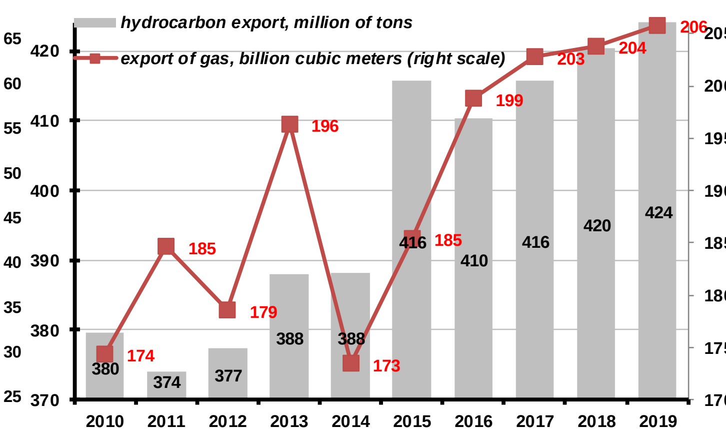


Figure 2.2. Dynamic of Hydrocarbon Export



3. Forecast Summary

Slow recovery of the Russian economy is expected in 2018–2019, at a growth rate of 1.8–2.1% (see Figure 3.1).

This being said, the most important driver of the growth will be the accumulation of fixed capital (the rate for which is going to be 4.1–4.5% in 2018 and 4.7–5.1% in 2019). This dynamic will be linked to the relaxation of monetary policy and the overall improvement of economic conditions, and the need for such a dynamic will be associated with increased import competition (see below). Therefore, the role of investments as the primary growth factor will most likely resume.

Household consumption, on the contrary, will clearly be a much weaker driver of economic growth than before. Considering harsher import competition, severe budget restrictions, and substantial fiscal pressure on the business community, the dynamic of real wages will be closing in on workforce productivity (the relevant elasticity here would be 1.2–1.5 times, while the pre-crisis wages had the potential of growing two or even three times faster than productivity). On the other hand, given the negative experience with loan payments during the crises of 2008–2010 and 2014–2016, neither banks, nor households will likely be up for plunging into consumer lending as they have done before. As a result, the dynamic of retail trade is not going to substantially exceed the growth of real wages (see Figures 3.2 and 3.3).

A lack of competitiveness of Russian non-energy products, as always, is becoming the most important issue limiting economic growth. As a result (considering the extremely low dynamic in hydrocarbon exports), the export dynamic for Russian products will not exceed 1.8–2.1%. At the same time, the import, as can be observed already, will continue to grow exponentially as compared to the overall dynamic of the economy (see Figure 3.4). This situation will both keep the mid-term economic growth under control and stipulate the risk of ruble rate destabilization which, in turn, would limit the Bank of Russia's ability to lower the key rate.

Ultimately, it can be expected that the ongoing success in the fight against inflation (based in part on the super-strict monetary policy and in part on decreasing the price of certain food products) will not replicate itself. Even in 2019, the annual average inflation level is unlikely to fall below 3.8–4.1% (see Figure 3.5).

Figure 3.1. Dynamic of Main Macroeconomic Parameters (growth rate, %)

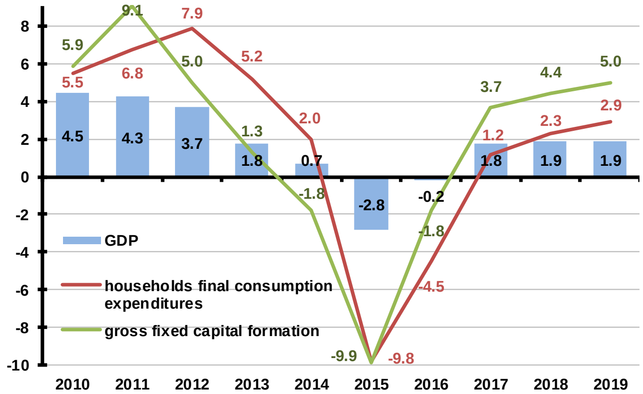


Figure 3.2. Dynamic of Real Wage per Employee and Household Consumption (growth rate, %)

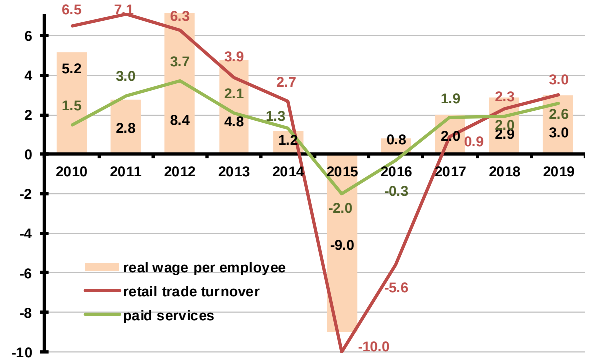


Figure 3.3. Real Wages and Labor Productivity Ratio

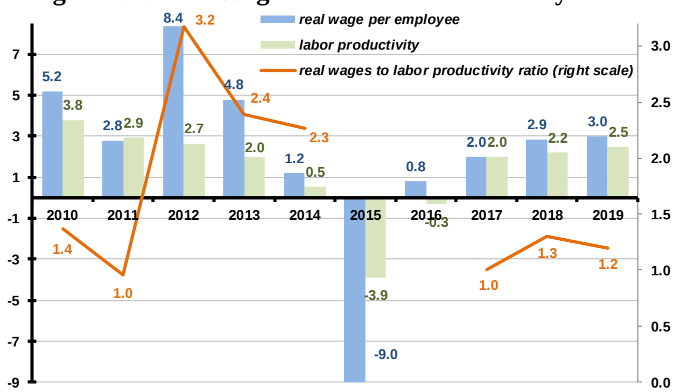


Figure 3.4. Dynamic of Goods and Services Export and Import (actual volumes, growth rate, %)

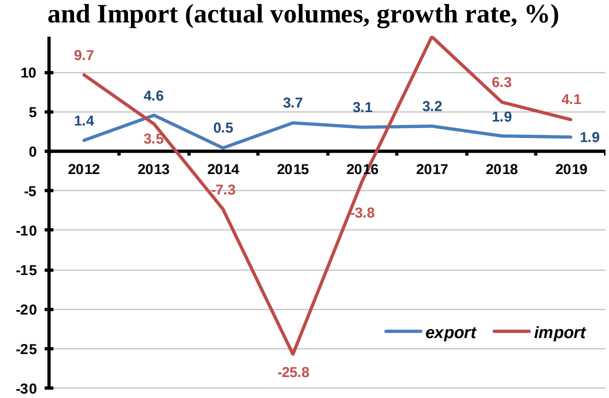
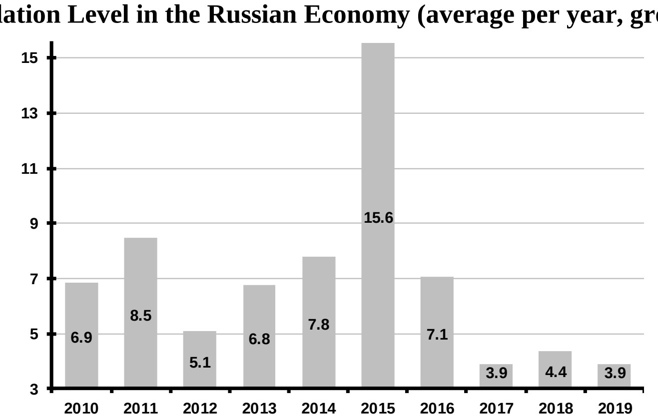


Figure 3.5. Inflation Level in the Russian Economy (average per year, growth rate, %)



4. Policy Issues and Uncertainties

A key external factor contributing to uncertainty is the level of global oil prices, with the "crisis" states in the Middle East (Libya, Syria, Iran) facing unclear prospects of returning to the oil markets, and with unclear U.S. policy on mining and export of domestic hydrocarbons, plus the corresponding responses from other exporting countries.

Domestic uncertainty in economic policy is linked, first and foremost, with the policy of the Bank of Russia. The bank most likely will have to lower the key rate, but it is hard to say what would be feasible here, due to both concerns of cheaper money potentially flowing into the foreign exchange market causing its disruption, and the fact that over the last year the high rates of Russian financial instruments have become an important incentive for attracting foreign financial investors (the so-called Carry Trade). Lowering of rates together with their profitability can lead to a rapid exit of profiteers from the Russian market[4], which is certainly not acceptable for our financial authorities.

Domestic behavioral uncertainty is associated with the behavior of private firms choosing between increasing wages (which allows for competition[5] in an ever increasingly deficient labor market and motivates the employees, but leads to increased labor costs and reduces competitiveness with regard to imports) and expanding of fixed capital investments (for which a quick expansion of the final foreign and domestic markets including consumer markets would actually be desirable).

5. Summary Table for Forecast

Main macroeconomic indicators forecast (growth rates, %)

	2016	2017	2018	2019
CPI (end of the year)	5.4	3.5	4.1	4.1
GDP	-0.2	1.8	1.9	1.9
Industrial output	1.3	2.0	1.8	2.4
Fixed capital investments	-0.9	3.7	4.4	5.0
Real wage per employee	0.8	2.0	2.9	3.0
Real disposable household income	-5.9	1.4	2.4	2.8
Retail trade turnover	-4.6	0.9	2.3	3.0
Paid services	-0.3	1.9	2.0	2.6
Export, bln. USD	282	344	358	377
Import, bln. USD	192	227	245	259
Trade balance, bln. USD	90	117	113	118
Ruble exchange rate, annual average, rubles per USD	67.1	58.3	57.0	58.4
Urals oil price, USD per barrell	41.6	50.7	52.5	55.0

[4] It's a different matter that at least some of the rate reduction risk has already been included by the investors in their Russian market strategies.

[5] It should be noted that Russia is scheduled to hold presidential elections in 2018; a possible increase in wages for certain categories of public sector employees (by lowering budget consolidation or internal redistribution of resources) could additionally increase competition on the labor market and create a substantial “signal effect” for the private sector.