CENTER FOR MACROECONOMIC ANALYSIS
AND SHORT-TERM FORECASTING
Tel.: (+7499) 129-17-22, fax: (+7499) 129-09-22, e-mail: mail@forecast.ru, http://www.forecast.ru

Development of the Russian Economy in 2016–2017 and Forecast for 2018–2019

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

Summary

The Russian economy has shifted towards highly conservative rates of economic growth (1.5% in 2017, and in 2018, as estimated), and this is in the conditions of quite favorable external economic conditions. Such a low dynamic comes with an underlying important reason—a combination of a fairly harsh monetary and budget policy (budget surplus is expected this year). In turn, this policy was associated with the idea of securing unquestionable budget stability and balance of payments in the conditions of uncertainty tied to the dynamic of global energy and construction materials demand, and with the expansion of the economic sanctions against Russia. Indirectly, it resulted in achieving the uniquely low for our country inflation rates (2017: 2.5%, 2018: 3.4%, with the Bank of Russia's goal set at 4.0%, December to December).

1. Recent Trends

In the last year (3rd quarter of 2017–2nd quarter of 2018), the economic situation has featured the following:

– low and unstable rates of economic recovery extremely dependent on the external shocks (first of all, market shocks associated with oil prices), and the shocks of economic policy (key rate, above all);
– companies transitioning to self-financing of their development in the conditions of poor financial sustainability of companies;
– a very low, near-stagnant dynamic of the households income and consumption;
– exhaustion of the import substitution effect and the return of imports to markets;
– improvement, however unstable, on the labor market, tendency to a decrease in unemployment and moderate growth of real wages
– orientation of monetary and credit policy mostly toward controlling inflation and the exchange rate risks (the strict regulatory policy was basically pursuing the same goals).

1.1. Progress of Economic Development

Overall, the Russian economy is slowly coming out of recession. In 2017, GDP growth was 1.5%, and it is estimated to be the same for 2018. Therefore, the recession episode that occurred in 2016 was both limited by time (one year), and insignificant in terms of its scope (2016: -0.2%).

In the past year, there were two problems with growth:

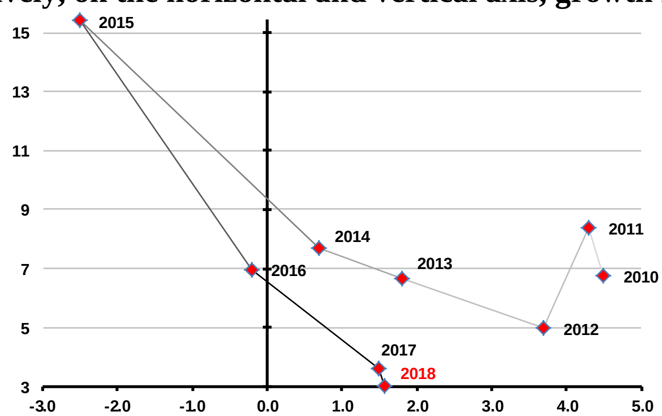
Problem one: a very moderate, near-stagnant scale of economic expansion occurred during a time of unexpectedly high prices on energy resources. So, the oil prices jumped by one and a half times (from USD 42 a barrel on average in 2016 to USD 53 a barrel in 2017, and USD 69 a barrel in the first six months of 2018). It seems that this is caused by a combination of fairly harsh interest rate policies and budget policies, essentially discouraging economic growth for the sake of ensuring a margin of safety in the budget system and lowering inflation.

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

Problem two: economic recovery has been quite uneven. Last year midyear, the Russian economy was growing at a fairly sustainable rate of approximately 2.5% year over year, making a rapid crisis recovery, but by the end of the year there was a setback. In the fourth quarter, the GDP growth measured only 0.9% as compared to the same period of last year. From a tactical standpoint, this was caused by a purely situational factor—a drop in oil exports due to the impact of the excessively tight quotas taken up by Russia as part of the OPEC+ agreement.

An important feature of the economic development in 2017–2018 was the combination of a near-stagnant dynamic and low inflation, which in 2017 reached its all-time low—2.5% (December to December). The wave of inflation associated with ruble devaluation and the 2014–2015 “sanctions war” was fully suppressed in 2015–2017, overcoming the recession. But no further acceleration of growth followed; on the contrary, our economy has been balancing on the verge of a lengthy stagnation. In 2018, growth will stay at 1.4–1.7%, while inflation, year over year, is expected to be at the 2.7–3.1% level. It should be noted that on the points corresponding to years 2015, 2016, 2017, and 2018 (estimate) are positioned almost on a single vector.

Figure 1. Economic Growth and Inflation
(respectively, on the horizontal and vertical axis, growth rates, %)



As previously noted, this situation is caused by the fact that the economic policy is oriented towards “stabilization” (of the inflation and the exchange rates first of all) as its main strategic goal. Hence the super-tough rate policy that ensured slowdown of inflation at the expense of stagnation in the economy, and the harsh budget policy aimed at building up reserves in case there is a considerable drop in global oil prices (below USD 40 per barrel).

The structure of the economic growth factors has acquired the following characteristic features over the past years:

– return of imports to the markets. The period of import substitution linked to ruble devaluation and the “sanctions war” ended back in 2016. After that, imports were expanding more or less aggressively, to the extent of ruble weakening/strengthening and market dynamics. Consequently, the resumed expansion of imports started “taking out” between two to four percentage points from the economic growth;
– export orientation. The expansion of exports became an important economic factor. Its contribution to GDP growth comes to approximately 1.5 percentage points over the past quarters;
– a substantial, but with the potential to decline, contribution of households consumption. Partially due to the policy of raising wages in the public sector, in the second half of 2017 the households consumption grew quite rapidly, contributing to the GDP growth at about two percentage points. The problem, however, is that in 2018, the wages in the public sector not only remained the same, but also started to shrink, while the private sector kept salaries at the same level due to the

problematic financial health of the companies. Thus, in the second half of this year, it seems that the households consumption dynamic and its contribution to growth is going to decrease;

– moderate contribution of fixed capital accumulation to growth. A very low dynamic of investment seems to be the main feature characterizing the modern Russian economic situation as a near-crisis one (see below). For all of 2017, the contribution of fixed capital accumulation to growth was approximately one percentage point, but in the first quarter of 2018, it went down to a mere 0.3 percentage points;
– the post-crisis recovery of economic asset levels, completed in the middle of 2017. If in the second and third quarters of last year, asset growth ensured contribution to GDP growth of about 2–2.5 percentage points, at the end of 2017 and first quarter of 2018, the contribution from asset growth to GDP growth became negative. In some way, this result is tied to a completion of economic post-crisis recovery, and to some extent it is associated with the level of interest rates that limit opportunities for an increase in working capital.

1.2. Fixed Capital Investments and Companies Incomes Issues

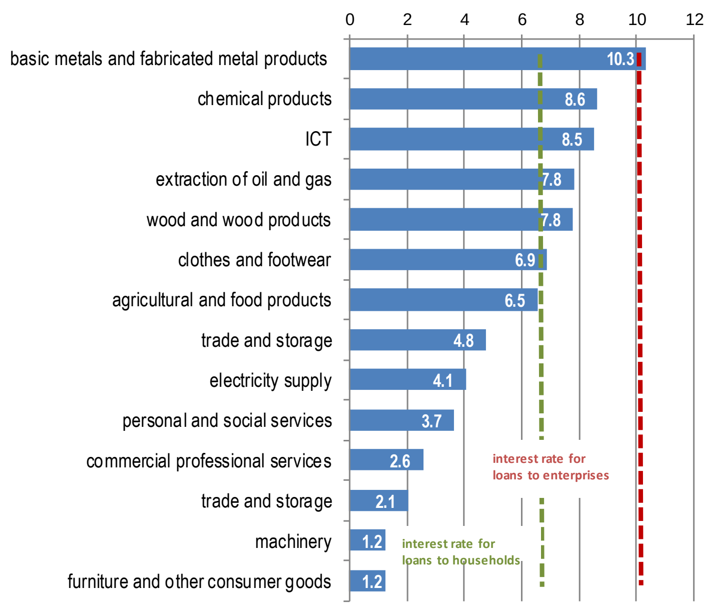
Overall Situation

The past two years featured a fairly moderate dynamic of fixed capital investments (2017: +4.4%, year 2018, estimate: 4.0–4.4%).

As previously noted, this situation, as it seems, was in many ways tied to the harsh interest rate policy of the Bank of Russia.

On the one hand, a gap emerged between the profitability of the real assets in most of industries and the financial assets (See Figure 2). In the end, the accumulation of financial assets—a less risky operation than investing in industrial projects—ended up being even more lucrative for the enterprises (and, actually, given the slowdown in investment growth, companies' bank account balances have increased).

Figure 2. Return on Assets, Average Weighted Interest Rate for Loans to Enterprises and Households (excluding sight deposit and Sberbank)

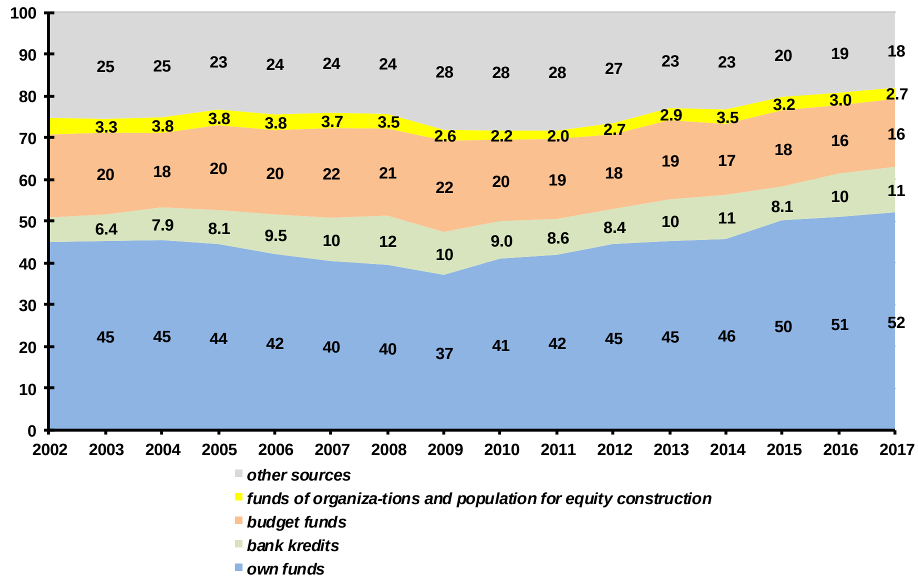


On the other hand, when it comes to funding costs, credit resources became unavailable to most of the manufacturers, except perhaps certain royalty-based resource industries.

Consequently, this marked a clear transition to financing investments using the companies' own funds. In 2017, the proportion of self-financed investments reached an all-time maximum of 52% (before the crisis, it was approximately 45% in 2012–2014), while the "other" investment sources, the majority of them being funds attracted from the financial markets, have shrunk from 23–27% in 2012–2014 to 18% (see Figure 3). This, in turn, is determined both by the effect the sanctions had on the financial market and the high interest rates on the money market as a whole, with their respective consequences in terms of the companies' ability to attract funds on the open markets.

Clearly, this model of self-financing the investment process could not have escaped substantial restrictions, especially in a situation where the enterprises' finances were in the "zone of instability."

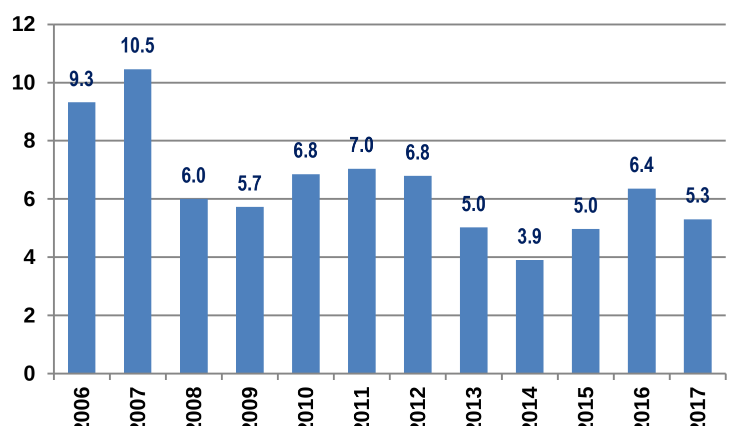
Figure 3. Fixed Capital Investments by Sources of Financing, %



The Problem with Corporate Incomes

In terms of changes in the financial health of the companies in the real sector, the most important trend shaped over the past year is the decrease in the profitability of businesses. The level of return on assets in 2017 was only 5.3%, which is among the lowest values in recent years (Figure 4).

Figure 4. Return on assets dynamics for the whole economy, %



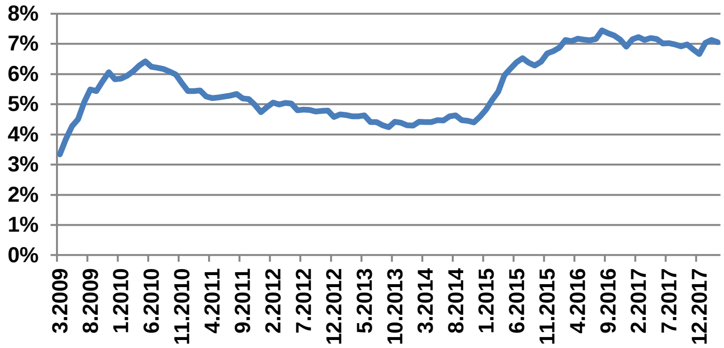
There are two things that need to be mentioned.

First of all, an already traditional structural misalignment continues to persist: the most favorable standing has been noted in the case of manufacturers oriented towards exporting of raw materials, while those serving the domestic final demand are in a noticeably more difficult position.

Secondly, there is a sector that stands out among final goods manufacturers as being in a seriously critical financial state. These are industries oriented towards the investment demand (including consumer demand with regard to income-flexible goods): the construction complex and the machine-building industry[2]. The situation in the commercial services sector also remains quite challenging.

Attention is also called to an exceptionally slow, almost invisible reduction in the level of enterprise overdue loans (Figure 5).

Figure 5. Overdue Loans of Legal Entities and Individual Entrepreneurs Ratio (%)



Assessments of the Economic Situation by Company Managers

One of the key factors behind the issues in the investment sector was a change in self-awareness among company managers. Given a surge in expectations of rapid recovery from the economic crisis, the PMI index of the manufacturing industries experienced an unjustified spike, almost up to 55%—to the pre-crisis level of 2011. Basically, this resulted in hopes for an expedited crisis recovery based on "overblown expectations." But, as we know it, this did not happen.

At first, the economy shifted, in our opinion, towards stabilizing on a more adequate PMI level of 51–52%, and managed to stay at this level for almost all of 2017. This level no longer allowed us to expect the economy to "leap", but, apparently, gave us hope for a sustainable, although moderate, growth. But in early 2018, for the first time in two years, the PMI went into the negative (less than 50%) for two months.

This means that it will be quite difficult to expect further revival of the investment process.

1.3. Employment, Income, and Households Consumption

A combination of tensions in the corporate finances and the growing burden on companies' own incomes has required them to move towards reducing expenses.

This affected the job market, income, and welfare of households to the fullest extent.

For the first time in recent years, the aggressive process of job creation first stabilized (in 2017), and then decreased almost in parallel with the PMI for the first time in recent years.

At the same time, the dynamic of real wages came to a stall. In 2017, its growth was 2.9%, and in 2018, on paper it was much higher, estimated at 5.2–5.5%. However, the problem is that this growth is not

[2] Within the industries remaining in a fairly good condition, there are sectors facing issues, for example, air transportation in the commercial services sector.

the result of salary increases in the current year, but a product of an almost "step-by-step" increase in wages in the public sector at the end of last year.

Given that under the currently established conditions, the government was unable to ensure an expedited raise in pensions and social benefits, real disposable households income decreased by 1.7% in 2017. In 2018, its growth is estimated at 2.8–3.1%.

Such a minor increase in the real income of households was obviously unable to break the tendency toward the spread of mass poverty mentioned in the surveys of 2015 and 2016. The proportion of the population living in extreme poverty ("not enough money even for food") and the proportion of poor people ("enough money only for food") holds a combined stable position on a very high level at 39% (compared to 19% in 2014).

Obviously, this situation could not but affect the dynamic of the households consumption as well.

Last year, the retail trade turnover growth was only 1.3%, and the estimated growth for the current year is 3.1–3.4%. At the same time, stagnation in the households income during the first half of 2018 put limitations on the growth of consumer markets. And no change in the near-stagnant trend of the retail trade turnover dynamic is currently there (February 0.0%, March and April: 0.2% each, May: 0.0%, June: 0.5%, seasonally adjusted), with stagnation encompassing both food and non-food markets. It should be noted that based on data provided by Romir Research Holding, the average nominal value of a purchase receipt has been decreasing for two months in a row—in both April and May (in May a 1.7% decrease in the nominal value, and a more than 2% decrease in the real value)[3].

1.4. The Federal Budget: A Search for Resources to Stimulate Growth In Conditions of Harsh Budget Restraints

In 2018, the policy of budget consolidation seeking to ensure sustainability of the budget against potential external shocks continues. Overall, out of the three taxation and budget policy functions, stabilization[4], redistribution,[5] and stimulation of economic growth, only the first one, and, up to a point, the second one, were fully executed.

The risk of federal budget income falling due to price fluctuations on resource markets have been partially redressed by a budget rule that keeps a tight lid on spending, which continues to decrease with regard to the GDP (See Figure 6). At the same time, this basically "shut off" budget spending from being among the drivers of economic growth and limited opportunities to combat the pressing social problems (including poverty among public sector employees and retirees) at the government expense. The completion of large-scale government investment projects (construction of 2018 World Cup facilities and the Kerch strait bridge, including a sharp decrease in the scale of Russian military operations in Syria at the end of 2017) played a significant role in the saving of budget funds.

It is expected that current policy will lead to closing the year with a budget surplus for the first time in six years.

Considering the growth of prices on the commodity markets, reserves are being accumulated from the additional oil and gas revenues (the difference between the income forecast given the price of oil included in the budget and the actual income), which previously helped mitigate the effects from external shocks (See Figure 7).

[3] http://romir.ru/studies/521-rubl

[4] Providing conditions for a smooth, sustainable execution of the budget system functions in the conditions of potential shocks.

[5] Given that this is Russia, redistribution of excess profits from royalty industries and industries obtaining profits from devaluation, which balanced their performance conditions with the rest of the country's economy.

Figure 6. Revenue, Expenditure Deficit (–) / Proficit (+) of Federal Budget, % GDP*

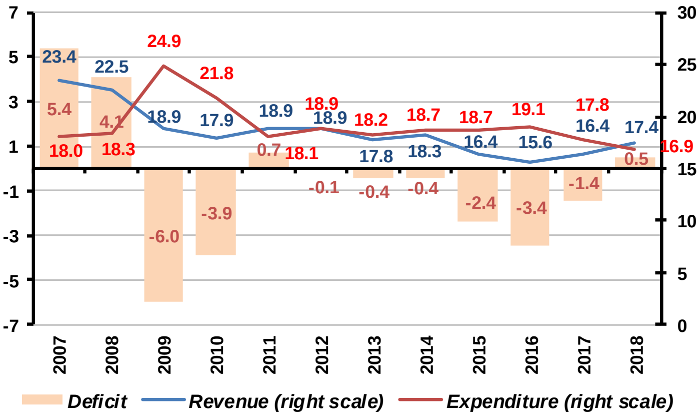
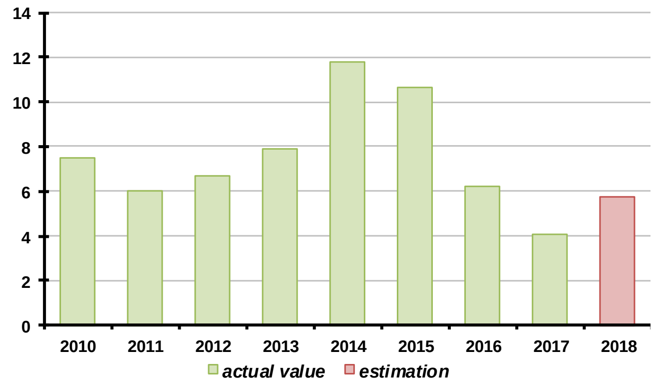


Figure 7. Volume of Oil and Gas Funds at Year's End, % GDP



** data for 2018 – estimation*

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. Monetary Side

The continued growth of global oil prices and other exported raw materials led to strengthening of Russia's balance of payments at the end of 2017 and the first six months of 2018.

First of all, we are talking about a substantial increase in the current account surplus. With regard to similar periods in the previous year, the surplus increase was USD 9 billion in the first quarter of 2018 and USD 21 billion in the second quarter.

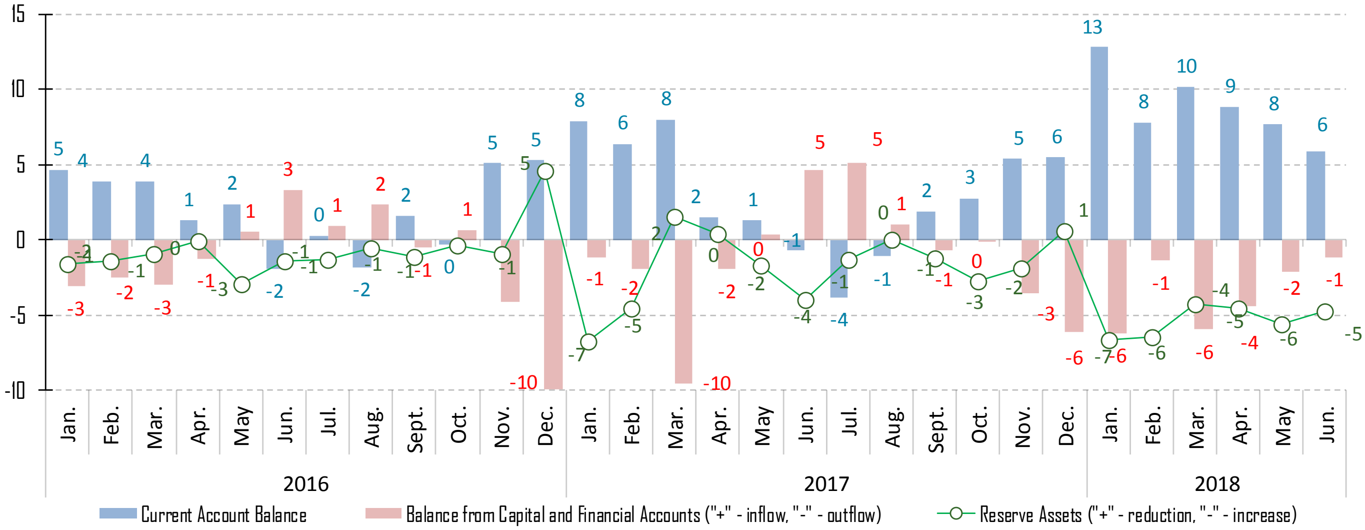
The surplus in capital account and financial instruments has somewhat declined under the three new rounds of sanctions that the US imposed on the Russian economy[6], but not as significantly as could have been expected initially. In comparison to similar periods in the previous year, a substantial decline did not occur until the second quarter of 2018: the surplus deficit grew by USD 17 billion (from this point on, the effect of the RF Central Bank foreign loans taken for the purposes of managing the official gold and currency reserves has been excluded[7]). At the same time, the net outflow of the capital (USD 4 billion) peaked in April, with the announcement of the last round of economic sanctions, after which it started to shrink fast (See Figure 8).

A decline in direct foreign investment inflow and a withdrawal of funds from Russian government bonds by foreign investors became the principal factors of the increase in net outflow of capital. At the same time, this outflow for the most part was mitigated by a counter-flow of financial contributions repatriated by the Russian banks and companies from abroad (affected by re-evaluation of the level of political risks). An additional stabilizing factor was a reduction in the burden of repaying foreign private debt, which occurred due to its significant decrease in the previous period.

[6] In August 2017, February 2018, and April 2018

[7] the RF Central Bank from time to time attracted currency liquidity in foreign markets on the security of other foreign assets (as part of REPO operations), which has formally led to a change in the value of the capital transactions and financial instruments account on Russia's balance of payments. In essence, these operations are not related to the cross-border movement of capital, but have to do with the management of the official gold and currency reserves.

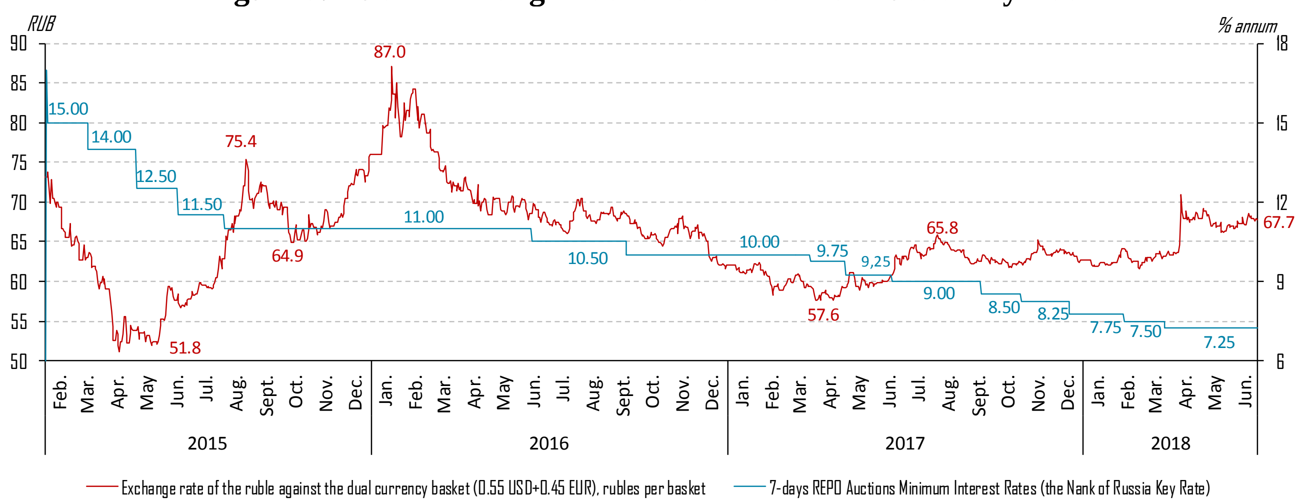
Figure 8. Key Aggregates of the Balance of Payments of Russia (billion dollars)



A massive increase in the influx of foreign exchange through current operations in the conditions of a moderate increase in the net outflow of the capital should have caused the ruble to strengthen. However, in reality it has weakened on some scale: the nominal ruble rate versus the dual-currency basket decreased by 7% over the second half of 2017 and the first half of 2018 (See Figure 9).

On some level, this is explained by the exchange rate "overshoot" effect impacted by the expectations of the market players (in the conditions of new sanctions and a tougher credit rate policy in the US). And partially this is explained by the Ministry of Finance expanding their currency purchases as part of a budget rule (over USD 30 billion in the first six months of 2018 alone)[8]. The latter is the result of a choice made by monetary authoriries for the benefit of preventing further ruble strengthening.

Figure 9. Ruble Exchange Rate and the Bank of Russia Key Rate



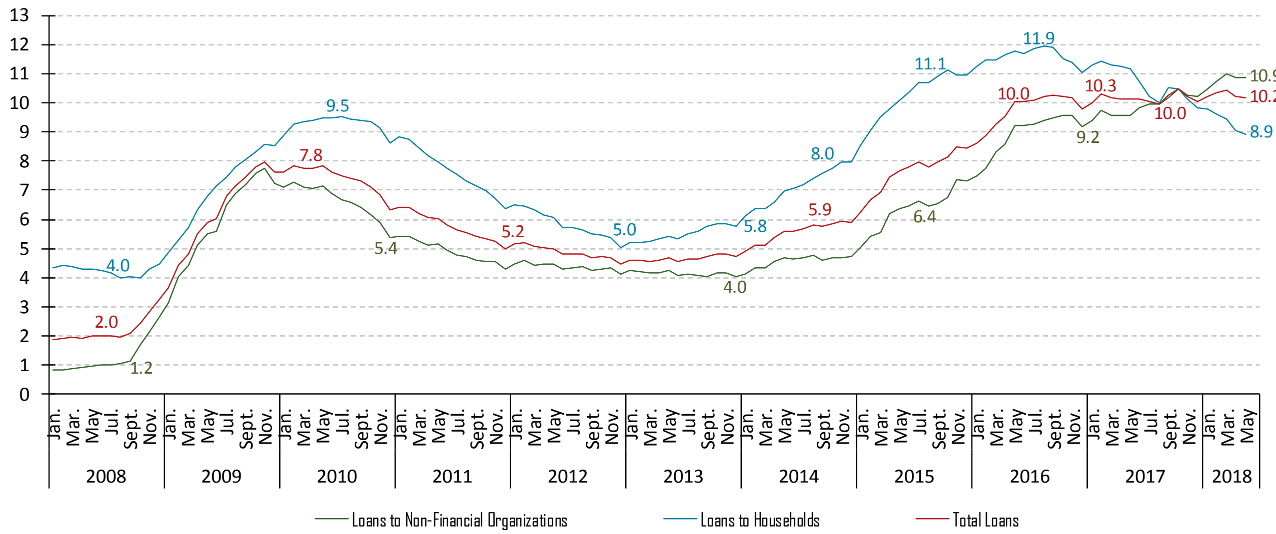
A decrease in the level of inflation significantly lower than the targeted yearly 4% in the conditions of maintaining a relatively stable situation on the foreign exchange market allowed the Bank of Russia to continue the process of decreasing the key rate. In the second half of 2017 this process had accelerated,

[8] These operations at the same time lead to replenishment of the official gold and currency reserves of Russia.

and in the first half of 2018 it slowed down a little, affected by the growing uncertainty on the foreign markets (see above).

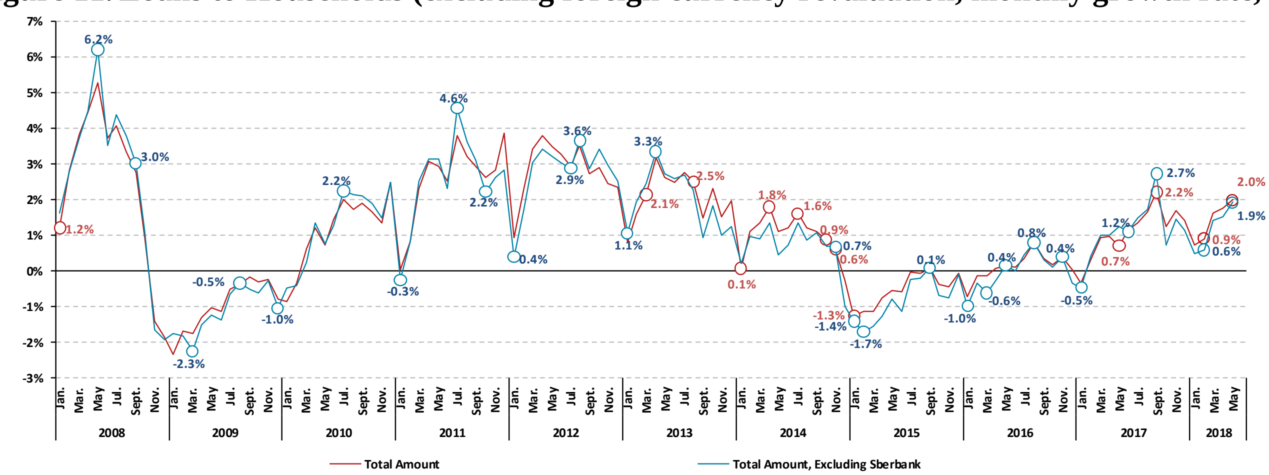
But, despite this decrease, the level of the real key rate for the monetary regulating authority in Russia remains one of the highest among the countries with medium and large economies. One of the consequences of the relative toughness of the Bank of Russia's interest rate policy is the stagnation of the demand for credit from Russian companies, a high level of corporate bankruptcies, and, as a result, a new increase of bad loans in enterprise borrowings (see Figure 10).

Figure 10. Overdue Loans Ratio (excluding Sberbank, VTB, and Bank of Moscow), %



At the same time, a decrease in unemployment levels, an increase of real wages in the second half of 2017, and the associated growth of consumer optimism stimulated a new and rapid increase in the loans to households (see Figure 11). It is possible that this, given other equal conditions, will help support consumer demand and housing purchases.

Figure 11. Loans to Households (excluding foreign currency revaluation, monthly growth rate, %)



1. Предпосылки экономической политики и внешней среды (Assumptions on National Policy and External Environment)

In terms of the external conditions for the forecast, the following is expected:

– a moderately conservative forecast of oil prices, with their stabilization at a level of USD 60 per barrel (see Figure 12);
– a careful, within the framework of the OPEC+ agreement, policy of expanding of oil exports (approximately +3 million metric tons a year, see Figure 13). A moderate growth of natural gas exports, taking into account the effect of sanctions on implementation of pipeline projects (+1 billion m3 a year).

With these conditions, it is expected that there will be a gradual weakening of the balance of payments, compensated by a weakening of the ruble (by 2–4 rubles per dollar annually).

It is expected, that the current budget policy oriented towards fiscal stabilization will continue in 2019–2021. An increase in the tax burden on the businesses is expected in 2019 (a decision has been made on increasing the base VAT rate by 2 percentage points). This will potentially lead to an increase in inflation pressure, leading to an even more conservative interest rate policy by the Bank of Russia. At the same time, a pension reform is about to start, which is supposed to lower the pressure on the federal budget due to an increase in the retirement age.

Figure 12. Dynamic of Global Oil Prices (dollar per barrel, Urals) and Ruble Foreign Exchange Rate

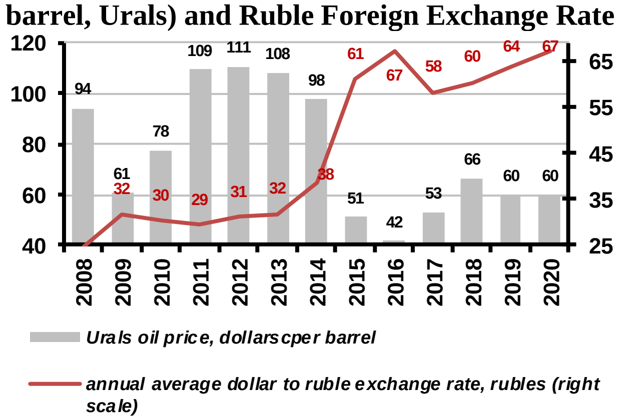
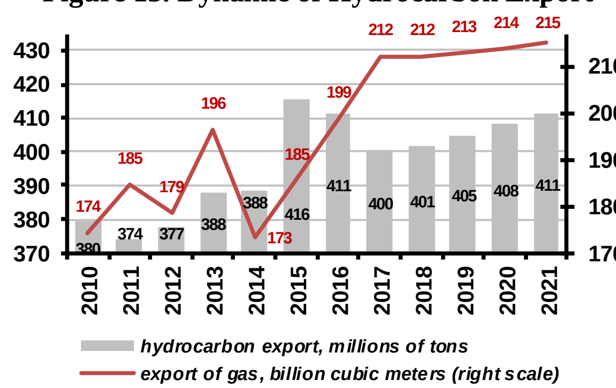


Figure 13. Dynamic of Hydrocarbon Export



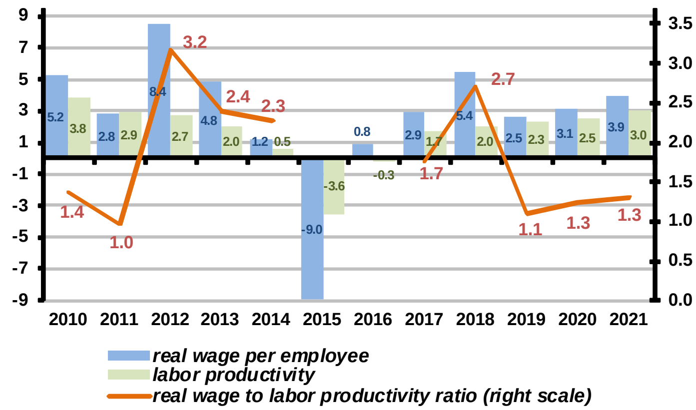
2. Forecast Summary

Moderate economic growth is expected—about 1.5% a year in 2018–2019, and 2.5% a year in 2020–2021 (see Figure 14).

The following tendencies are supporting this economy trend:

– an extremely moderate dynamic of household consumption (about 2.5% a year in 2018–2019 and 3.5% in 2020–2021 versus 5–6% a year in 2010–2012), and moderate, although growing rates of fixed capital investments (from an annual 4.5% in 2018–2019 to 6–6.5% in 2021);
– the deficit in company incomes will become the most important factor halting economic growth (including due to VAT increase). One of the things it will lead to is companies beginning to save on work-related expenses, while the dynamic of the real wages will be fairly moderate (about 3% a year, with the real wages elasticity to labor productivity remaining at 1.1–1.3 times);
– the export of goods curbed both by moderate dynamics of the world energy and raw material markets, and the consequences of sectoral sanctions (non-ferrous metals), will increase by 1.2–1.5% a year;
– due to flexible exchange rate, the weakening of the balance of payments will lead to the weakening of the ruble, resulting in curbing of import growth;
– limiting inflation will remain an important priority of economic policy. Even in the conditions of an increase in VAT, the level of the annual average inflation will not exceed 4–4.2%, which meets the goal of the Bank of Russia (4.0%).

Figure 14. Real Wages and Labor Productivity (growth rate, %)



3. Policy Issues and Uncertainties

A key external factor contributing to uncertainty is global oil prices. They may decrease significantly if crisis events emerge in the global economy, and/or expansion of the supply from Venezuela, Iran, Iraq, or Libya, and also a decrease in the "risk component" in the price in the event of crisis resolution in the Middle East.

Moreover, the Russian economy may be negatively affected by both potential expansion of sectoral sanctions, and the growth of protectionist practices on certain global markets (ferrous and non-ferrous metals, for example).

In terms of the internal market conditions, there are two factors of uncertainty:

– a set of issues associated with the pension reform (to what extent will the increase in the retirement age affect companies' behavior and the welfare of the population);
– will a system be put together to stimulate economic growth as outlined in the Russian President's Address on March 1, 2018 (in which an actual objective of the annual economic growth has been set to 4–4.5% in 2020s), or will the economic policy remain mostly conservative and oriented towards budget and financial stabilization.

4. Summary Table for Forecast

Main macroeconomic indicators forecast (growth rates, %)

	2017	2018	2019	2020	2021
CPI (end of the year)	2.5	3.4	4.3	3.9	3.6
GDP	1.5	1.5	1.5	2.3	2.7
Industrial output	2.1	2.0	2.5	3.0	3.1
Fixed capital investments	4.4	4.3	4.4	5.2	6.3
Real wage per employee	2.9	5.4	2.5	3.1	3.9
Real disposable household income	-1.7	3.0	2.1	2.7	3.3
Retail trade turnover	1.3	3.2	2.8	3.5	3.9
Paid services	0.2	1.5	1.3	2.2	3.3
Export, bln. USD	354	416	395	401	409
Import, bln. USD	238	260	274	285	302
Trade balance, bln. USD	115	157	121	117	107
Ruble exchange rate, annual average, rubles per USD	58.3	60.5	63.7	67.3	69.7
Urals oil price, USD per barrell	53.1	66.4	60.0	60.0	60.0