

September 12, 2016

Russian economy: no knock out to recession yet

Russia 2020 economic outlook update

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- **Fresh data had little impact on our view of Russian economy's five-year prospects.** In our forecast "[Russian economy: absence of usual conditions for growth offset by impetus for structural change](#)" published March 21, 2016, we outlined the following main long-term trends: government's redistributive and investment role in the economy weakening, demography restraining economic growth, a possible kick-start of a declining labor costs period, and inflation and interest rates on the downside. Even with oil prices high, a potential Russia's GDP growth is expected to be capped by 1.0-1.5% in the next five years.
- **Recession may last until early 2017.** Near-zero annual growth rates in mid-2016 are due mainly to a low base effect. The "first wave" of shock absorption by the economy has manifested itself in an inflation burst and played out by early 2016. A damped chain reaction of decaying incomes has been stretched in time: declining costs of one group of economic agents affect the costs of all the others and that continues to squeeze domestic demand, with longevity of the process depending on population's credit activity and the fiscal consolidation pace.
- **Real household incomes to continue descent until 2018.** A restrained wage growth in the private sector in 2016 will not compensate for stagnation in the public sector, with its continuing decline in real pensions, social benefits and other government payments that together make up about 35% of population's total income. Slowing inflation coupled with a partial normalization in lending activity will offer a weak support to final consumption.
- **The outlook revision was mostly focused on the dynamics of raw material extraction and impacted 2016 estimates.** Production decline in the consumer segment was mitigated by higher raw materials extraction late in 2015, but this trend will be much less pronounced in the long term. The effect of investments delayed post-2014 will affect production dynamics after 2018.

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Table 1. Key Russian and global economy figures in 2013-2020

Indicators	Measurement unit	Actual numbers			Estimate	Forecast			
		2013	2014	2015	2016	2017	2018	2019	2020
Key external environment indicators									
Urals price	USD/bbl	108	98	51	41	43	44	45	45
Global GDP ¹	%, y-o-y	2.4	2.6	2.5	2.1	1.9	1.8	1.7	1.7
US GDP	%, y-o-y	1.7	2.4	2.6	1.5	1.2	1.4	1.5	1.6
China GDP	%, y-o-y	7.8	7.3	6.9	5.8	5.6	4.8	4.5	4.0
EU GDP	%, y-o-y	-0.3	0.9	1.7	1.7	1.5	1.4	1.3	1.2
Production indicators									
Nominal GDP ²	RUB bln	71,017	77,893	80,804	83,413	88,496	94,301 ³	100,467	106,660
Real GDP growth rate	% y-o-y	1.3	0.7	-3.7	-1.5	-0.1	0.5	0.7	0.9
Fixed investments	RUB bln	14,357	16,651	17,668	18,268	19,193	20,398	21,695	22,829
Fixed investments real growth rate ⁴	%, y-o-y	0.9	-2.6	-7.6	-5.2	-4.5	1.2	1.2	0.2
Industrial output index	%, y-o-y	0.4	1.8	-3.3	-0.1	0.7	1.0	0.5	0.5
Retail turnover	RUB bln	23,686	26,356	27,538	28,200	29,355	30,754	32,686	34,888
Balance of payments indicators									
Export of goods	USD bln	523	498	341	285	302	308	315	328
Import of goods	USD bln	341	308	193	180	207	208	207	212
Annual average exchange rate	RUB/USD	31.8	38.5	61.3	68.0	69.4	68.1	68.6	69.9
Income and labor market									
Average wage	RUB/month	30,141	32,629	34,012	36,010	38,230	40,010	41,200	42,750
Real disposable income	%, y-o-y	4.0	-0.7	-4.3	-4.1	-1.1	-0.8	0.6	1.1
Population	mln	143	146	146	147	147	147	147	147
Economically active population (EAP)	mln	76	75	77	76	75	74	74	73
Unemployment	% of EAP	5.5	5.2	5.6	5.9	6.1	6.0	5.7	5.5
Financial market prices and indicators									
Inflation (CPI)	%, Dec/Dec	6.5	11.4	12.9	6.6	6.0	5.2	5.1	5.0
Producer price index	%, Dec/Dec	3.6	5.7	10.8	4.0	6.3	4.5	4.8	4.2
Annual average key interest rate	%	5.5	7.4	12.6	10.6	8.1	6.5	6.0	5.5
5-year zero-coupon OFZ rate	%	6.7	9.2	11.6	8.9	7.7	7.3	7.1	7.1
Private deposit rate (> 1 year)	%	7.9	8.1	10.2	8.8	6.5	6.2	6.0	6.3
Non-financial sector bank lending rate (> 1 year)	%	11.5	11.6	15.0	13.5	12.8	12.3	10.8	10.3
Budget									
Federal budget balance	% of GDP	-0.5	-0.4	-2.4	-3.9	-3.1	-2.2	-1.5	-0.7
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: Federal State Statistics Service, Bank of Russia, Federal Treasury, Ministry of Finance, World Bank, national statistics agencies, ACRA estimates

¹ According to the World Bank Methodology.

² According to the new Federal State Statistics Service Methodology, based on System of National Accounts - 2008.

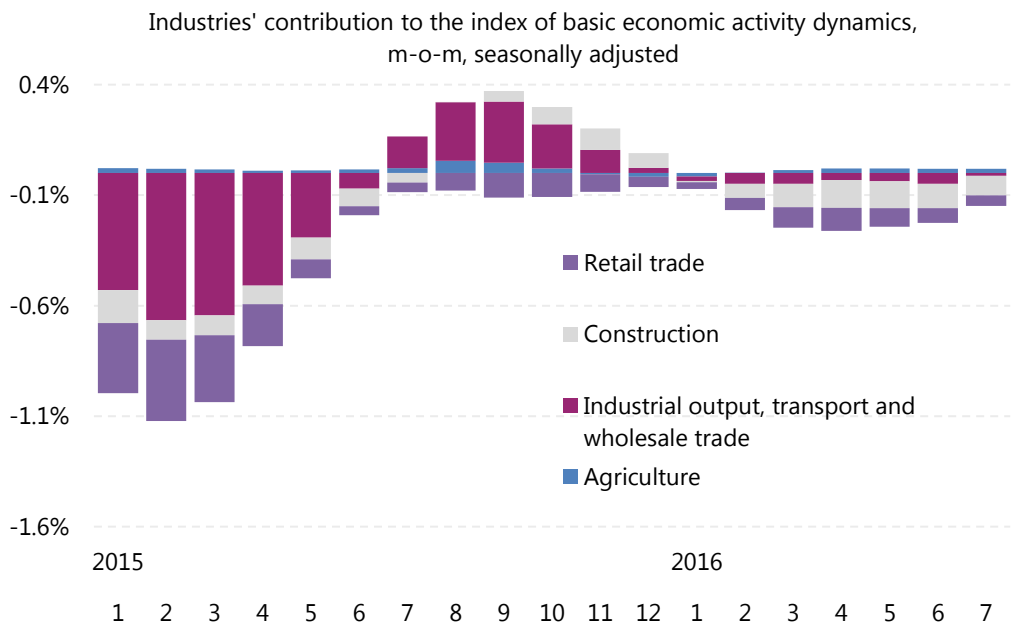
³ The font color marks the main adjustments to earlier forecasts.

⁴ Physical volume growth index corrected by the investment deflator.

Current figures show no end to recession

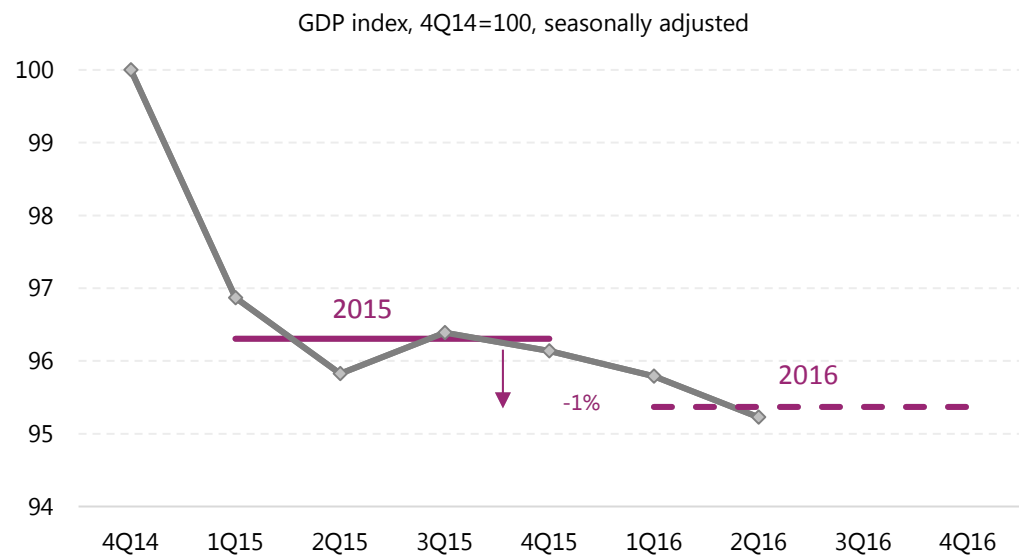
Social and economic statistics for January-July, 2016, show that the recession has not ended de facto. Current growth rates of the most important flows, being seasonally adjusted⁵, remain negative (see Figure 1). The last five months saw mining, manufacturing, construction and other basic sectors showing a decline. A dramatic increase in physical volumes of oil and coal production late in 2015 could have supported related industries and the economy as a whole for a while, but in general a long-term raw-material extraction growth trend looks hardly sustainable.

Figure 1. Rapid oil and coal production growth at end 2015 failed to swing industry and “basic” GDP back to sustainable growth



Source: Federal State Statistics Service, ACRA estimates

Figure 2. Even if GDP stops declining, its year end fall will run into 1%



Source: Federal State Statistics Service, ACRA estimates

⁵ Monthly increments are taken from the seasonally adjusted series of index levels, the method X12-ARIMA adjusted for calendar effect.

Recession continues, as domestic demand adjustment is still incomplete

"Flexible" indicators (exchange rate, prices, imports) quickly adjusted to new conditions, while "hard" ones (consumer spending, employment, the budget) smoothen adaptation, but increase its time lapse.

Read more about the effect of an interest rate cut in an [ACRA research published July 5, 2016, and titled "Lowering interest rates to provide modest impetus to consumer lending"](#).

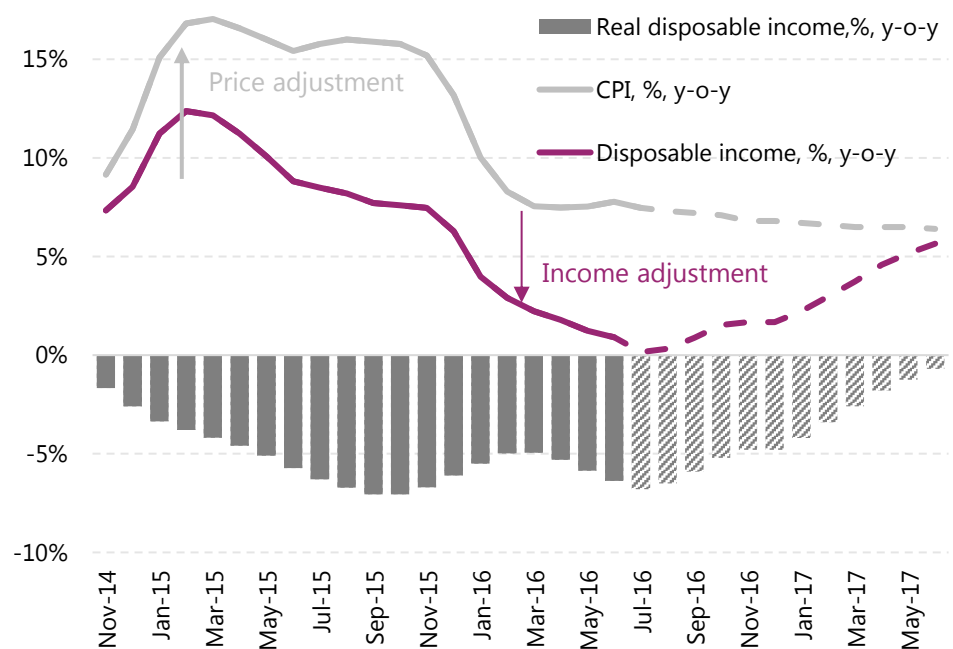
Read more about consumer demand adjustment in an [ACRA research published June 6, 2016, and titled "Consumption: absence of growth to be offset by quality change"](#).

The commodity price shock seen in 2014-2015 still directly impacts the Russian economy, although the "first wave" of adjustment is completed. "Flexible" indicators (exchange rate, imports, consumer prices) have generally come into equilibrium with the new balance of payments structure by mid-late 2015. They served as main transmission channels and shock absorbers for "harder" intrinsic indicators.

The "second wave" of economic adaptation came in the form of "harder" indicators adjustment (consumer spending, employment, the budget). It manifests itself as damped self-sustained oscillations in internal demand, with declining real expenditures of economic agents in one category leading to an income fall in the other forcing the latter to reduce consumption and, consequently, making the former face a further income drop.

The longevity of the "second wave" arises from economic agents' aspirations and ability to smoothen expenditures and consumption relative to income dynamics. This trend may well be exemplified by the government – its ability to cover a sudden budget deficit by debt or reserves allows to stretch real spending cuts for several years. On the other hand, individuals that hold credit cards may afford maintaining for some time the level of consumption similar to the one they enjoyed earlier, when their real income was higher. Opportunities related to delayed spending cuts offer support to incomes of other economic agents. All in all, the adjustment of domestic demand to the new environment gets strongly stretched in time (see Figure 3), which distinguishes the current recession from, for example, the one seen in 1998.

Figure 3. Incomes to continue falling, despite inflation slowdown



Source: Federal State Statistics Service, ACRA estimates

Public sector to restrain household income dynamics

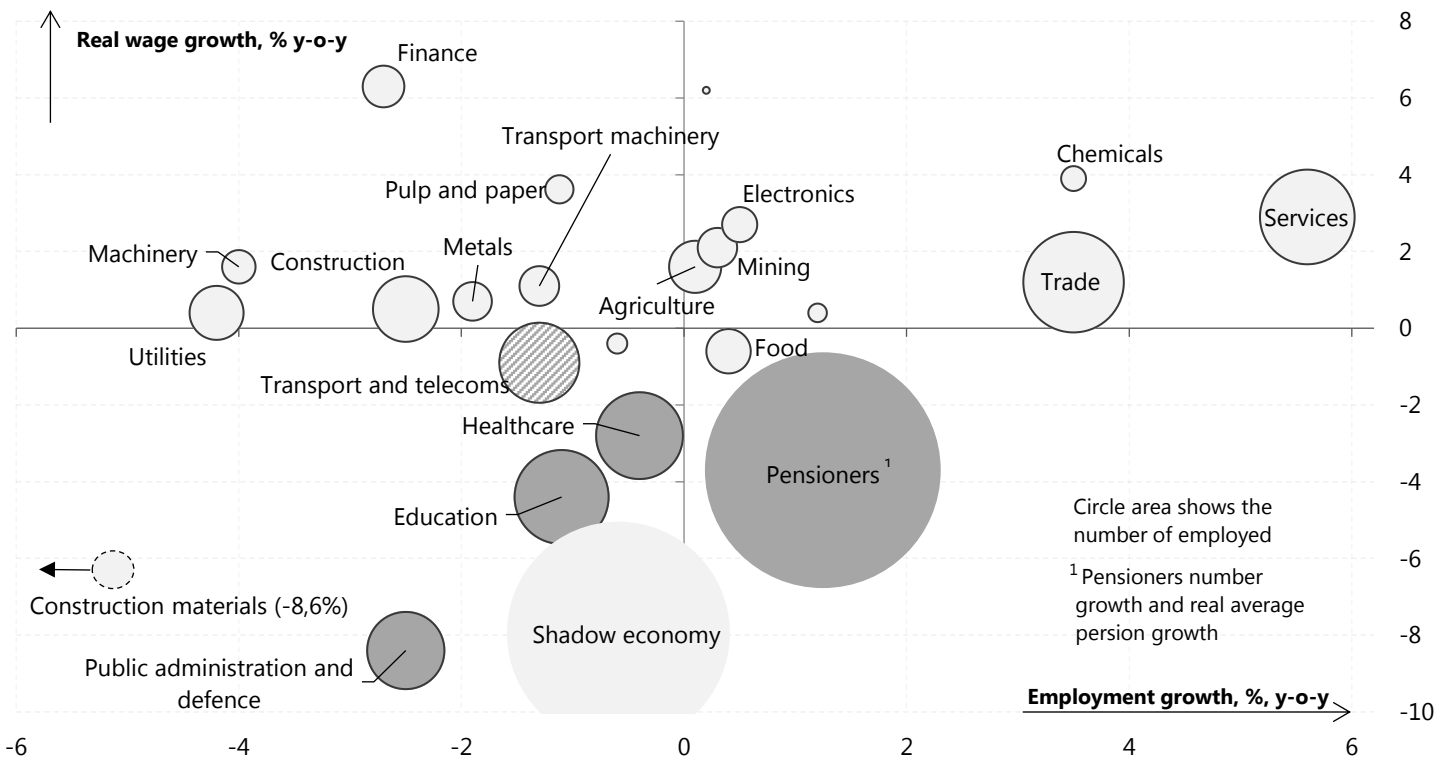
The structure of employment as one of the "hard" indicators adjusts to new conditions with a big lag. A deferred unemployment increase is possible in 2017-2018

Although the labor market seemingly lacks flexibility, its intersectoral labor force flows provide for unemployment remaining low. Reduction of employment in manufacturing, construction and electricity is being compensated by its growth in trade and services sectors. Thus, the structure of employment in the private sector adjusts to the new conditions relatively fast, although the observed flows may not be as productive as it seems. Over the past year, despite employment growth, these sectors saw no activity growth to say the least (in fact trade lost 10%, while services showed a 2% decline). Recipient industries suffer from declining labor productivity.

The situation on the labor market shows that fiscal consolidation will have a delayed negative impact on domestic demand. About 35% of household income that directly depends on economic or redistributive activities of the state is likely to decline in real terms throughout the entire adjustment period of real state expenditures, i. e. probably until 2018-2019. In the public sector, wages are more flexible than employment in the short term, but in the medium term, the lagging indexation of wages in the public sector, which is observed even now (see Figure 4), will create prerequisites here for employment waning.

Labor force "buffering" to the non-growing trade and services sectors, coupled with public sector contraction, can cause a deferred rise in unemployment.

Figure 4. Consistently low unemployment is achieved by workforce flow to trade and services sectors (data for January-May, 2015 and 2016)



Source: Federal State Statistics Service, ACRA estimates

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