November 19, 2020

Structural and temporary factors of economic growth in Russia

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- **The outlook update mainly consists of improving expectations for the rate of economic recovery in 2021–2022 in the base case scenario.** The degree of expected monetary policy softness has also been adjusted. Short-term and long-term market rates will be lower than previously expected, as inflation may deviate downward from the target value for a significant period. The ruble will strengthen relative to mid-November levels in all three scenarios (by 4–15%), but timetables will vary. Fiscal policy will remain stimulating throughout 2021, but large deficits in 2020–2021 will gradually decrease with a return to the budget rule.

- **Because of anti-pandemic restrictions and falling external demand, the Russian economy will continue to operate below its potential in 2021.** On average, the annual deviation of GDP from the potential level will be about -8%, compared to -4.5–5% in 2019. Approaching the potential level in 2021–2022 will come mainly from recovery in employment and capacity utilization. This will be possible thanks to significantly less stringent restrictions imposed during repeated waves of the pandemic, as well as a gradual improvement in the external environment. As a result, the economy will grow faster than its potential.

- **The potential economic growth rate will exceed 2% after 2023.** This will be possible due to the expected temporary increase in available labor resources (due to the baby boom of the 1980s and the effect of pension reform), as well as the Russian market continuing to adapt to the shock of 2014–2015. The positive effects of government policies and the long-term consequences of the pandemic are likely to be comparatively less noticeable.

- **The current economic downturn is almost incomparable to the previous three Russian crises in term of depth and severity.** Regarding the downturn in business activity, the current crisis is more severe than previous ones, but features more stable prices in the main macro markets (credit, currency, and labor markets). Because the adaptation process is concentrated in individual industries, the long-term consequences of the crisis may be small by historical standards.

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Updating outlook indicators

See ACRA's macroeconomic forecast Questions and lessons from the 2020 economic crisis from April 21, 2020.

The assumptions and dynamics of base case indicators in the macroeconomic forecast have remained largely unchanged compared to the previous version. Qualitative changes in the base case scenario affected two elements:

1. The dynamics of economic recovery in 2021–2023 have become more realistic. ACRA has left its assessment of the depth in the 2020 downturn unchanged, but re-estimated the contribution of structural and cyclical factors. The greater impact of the latter implies a faster recovery (*pages 4–6*). In particular, GDP in real terms may grow by more than 3.5% in 2021 due to significantly less stringent restrictions imposed during new waves of COVID-19. This has a positive impact on activity in the service sector, whose decline accounts for 60–70% of the overall decline in business activity in 2020.
2. ACRA has also revised its expectations regarding the Bank of Russia's monetary policy softness. The factors that made it possible to reduce short-term interest rates and the general logic of the regulator's decision-making are described in ACRA's study from June 5, 2020. The gradual return of the key rate to a neutral level is likely to begin no earlier than 2022 and may be prolonged if the average annual inflation rate remains at less than 4% for some time, which is possible if the prerequisites of the base case scenario materialize. ACRA believes that monetary stimulus would then manifest itself in a longer-term preservation of a moderately low key rate, rather than in a deep, but short-term reduction.

Table 1. Key indicators in the base case scenario of the macroeconomic forecast

Indicator	Unit of measurement	Actual			Estimate	Forecast			
		2017	2018	2019	2020	2021	2022	2023	2024
Urals crude oil price (annual average)	USD per barrel	53.5	70.1	63.6	40.7	45.0	50.0	52.0	55.0
Global GDP[1]	% y-o-y	3.3	3.0	2.5	-4.4	4.5	2.9	2.6	2.5
Russia's real GDP growth rate	% y-o-y	1.8	2.5	1.3	-4.3	3.8	3.3	2.8	2.2
Annual average USD exchange rate	RUB/USD	58.3	62.7	64.6	72.6	71.0	69.5	69.2	69.7
Real disposable income	% y-o-y	-0.5	0.1	0.8	-4.7	2.9	2.3	2.0	1.5
Unemployment rate	% of EAP[2]	5.2	4.8	4.6	5.8	5.6	5.1	4.8	4.5
Inflation (CPI[3])	% Dec/Dec	2.5	4.4	3.0	4.2	3.4	3.8	3.5	3.5
Key rate (at year end)	%	7.75	7.75	6.25	4.25	4.25	5.0	5.0	5.0
5-year zero-coupon OFZ rate (at year end)	%	7.2	8.5	6.1	5.4	5.8	6.0	5.5	5.5
Federal budget balance	% of GDP	-1.4	2.6	1.8	-5.0	-2.8	-1.5	-0.4	-0.5

Source: ACRA

In all three of ACRA's scenarios[4], the ruble strengthens in the medium term compared to exchange rates in mid-November 2020 (by 4–15%). This will be possible thanks to a gradual recovery in demand for the main products exported by Russian producers, as well as a reduction in the external risk assessment of investments in assets in developing countries. The pessimistic scenario also takes into account the effects of possible financial sanctions. The timing of the ruble strengthening to relatively stable levels varies from three months to two years, depending on the scenario.

[1] World Bank methodology, real increase.
[2] Economically active population.
[3] Consumer price index.
[4] The main indicators for all three scenarios are available in the Appendix.

The budget policy will be significantly stimulating throughout 2021 due to the temporary deviation of federal budget expenditures from marginal expenditures in line with the budget rule.

The optimistic scenario still suggests a faster end to the pandemic restrictions. The pessimistic scenario, in turn, in addition to more stringent restrictions, assumes that an effective medical response (development of a vaccine that has passed all necessary checks and its mass distribution) may take more than two years from the start of the pandemic, and also includes a period of increased financial stress.

Table 2. Qualitative assumptions for macroeconomic scenarios in Russia

	Impact on the Russian economy	Optimistic	Base case	Pessimistic
1. Duration of pandemic measures [5] in Russia	Very strong	Not applicable starting in 2021	**5–6 months with breaks in 2020; 1–2 months in 2021**	6–7 months with breaks in 2020; 3–4 months in 2021 (+ stricter restrictions)
2. Deviation in the volume of exported Russian goods in 2021 compared to 2019	Strong	-1%	**-3–4%**	-8–9%
3. Reduction in bank deposits due to lower confidence in 2021	Strong	-	**-**	+
4. Sufficient liquidity support in vulnerable industries	Strong	+	**+/-**	-
5. Coordination of oil exporting countries' policies to limit production during 2020/after 2020	Medium	+/-	**+/+(easing)**	+/+
6. China's debt crisis in 2021	Medium	-	**-**	-
7. Budget or financial crises in individual EU countries in 2021–2022	Weak	-	**+/-**	+
8. New economic or financial sanctions	Weak	-	**-**	+

Source: ACRA

[5] Restrictive measures implies not only self-isolation or quarantine for the population, but also bans imposed on a wide range of organizations and public institutions, holding mass events, and some passenger transportation.

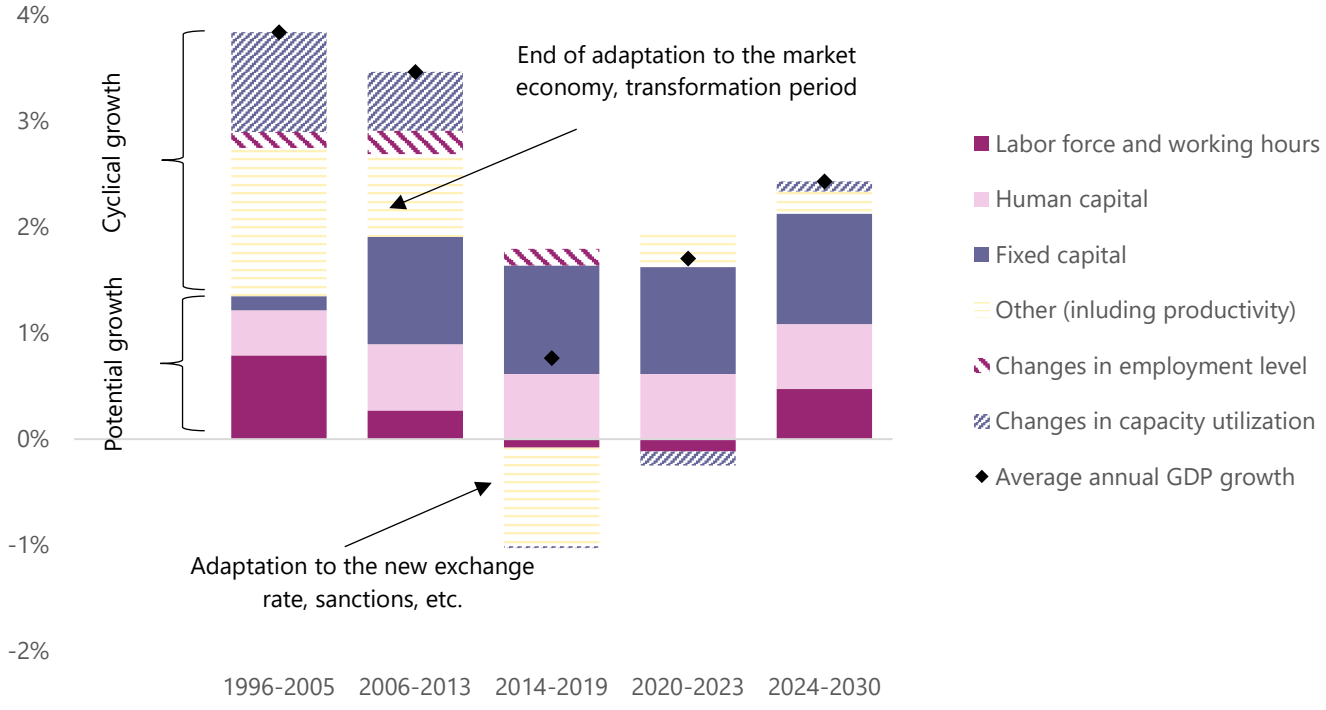
Economic growth: structural and temporary

For more information on the challenges of catching up in term of growth, see ACRA's macroeconomic study [World trade tensions may escalate to economic downturn by late 2019](#) from July 23, 2019 (section "For middle-income economies, it may become harder to show catching-up growth in the next 10 years")

Due to pandemic restrictions and falling external demand, the Russian economy is operating below its potential[6] in 2020. Consistent underemployment and capacity utilization are likely to continue for at least most of 2021. In the absence of new shocks, economic activity is subsequently expected to recover to around its potential level, which will no longer be directly limited by the pandemic.

What is the potential for economic growth and, consequently, expected long-term growth? According to ACRA, with full employment and capacity utilization, as well as the absence of disruptions in productivity caused by shocks, the average growth rate of the Russian economy could be permanently close to 1.5–2%. Moreover, growth rates could be close to those in the 2000s. ACRA's economic growth model[7] allows it to analyze the impact of individual factors: about 2/3 of potential growth could come from a stable contribution of physical capital accumulation, and about 1/3 from human capital (*Fig. 1*). The increased growth in the 2000s was almost half due to Russia emerging from the transformational period of the 1990s, during which partially idle production facilities were gradually activated, unemployment decreased, and a long–term adaptation to the market economy and the new structure of foreign trade relations took place. In this regard, the growth was largely cyclical, temporary, so it is difficult to confidently expect such rates in the future.

Figure 1. Decomposition of average annual economic growth by structural and cyclical factors



Source: ACRA

[6] For the purposes of this study, potential GDP is considered to be its estimated level, which is achieved when the unemployment rate is 4.5–5.5%, capacity utilization corresponds to the industrial 64%, and there are no negative productivity shocks associated with one of the previous crises. This definition is not related to ACRA's assessment of unemployment that does not accelerate inflation or the need for stimulating policies, and is chosen for clarity.

[7] The model is similar in structure to the one described in the following article: Economic growth in Russia taking into account demographic changes and the contribution of human capital, Akindinova N. V., Chekina K. S., Yarkin A.M., Economic journal of the Higher school of Economics. 2017. Vol. 21, No. 4, pages 533–561.

Productivity implies what in literature is most often called total factor productivity (TFP). In the model used, its change is defined as a part of economic growth that cannot be explained by other factors. ACRA considers it a cyclical component because we interpret its fluctuations as temporary losses in the distribution efficiency of available resources as a result of economic shocks.

What is the contribution of productivity and why is it uneven? Productivity, or rather its cyclical part (included in "other" in *fig. 1*), made a significant positive contribution to economic growth until 2014. This is largely due to its equally significant failure in the 1990s. Disruptions in production chains and monetary circulation made the full use of the economy's potential impossible for a long period. However, by the early 2010s, these effects had faded. A similar sequence of negative shocks and gradual adaptation of productivity seems to have occurred after 2014, when the contribution of other factors on average reduced economic growth by 1 percentage point per year for several years. Assuming that there is an adjustment to the new level of energy prices, the exchange rate, and the sanctions and counter-sanctions regime that will eventually allow for a full recovery from the drop in productivity, this should support economic growth for some period. ACRA estimates the duration of this recovery at 15–25 years from the beginning of the shock (for example, import substitution of complex engineering and electronic products). In this regard, ACRA estimates the average annual contribution of adaptation at +0.2–0.3 percentage points in 2020–2030.

The consequences of the pandemic, according to ACRA, will not fully manifest in 2020–2022 in terms of impact on economic growth. Although for the most part, they will temporary deviate from potential employment and capacity utilization levels in these years. ACRA also expects a productivity shock. This, however, will not be comparable in magnitude to similar shocks in the 1990s or after 2014. ACRA came to this conclusion based on a quantitative comparison of the structure of the last four economic downturns (*pages 7–9*). The processes that potentially affect productivity, signs, and period of their impact are listed in *Table 3*.

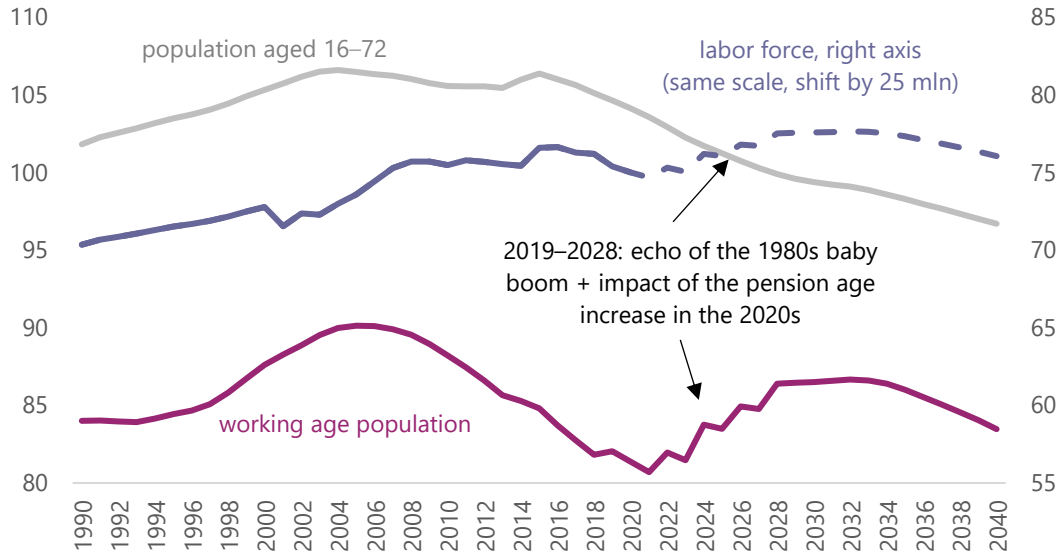
Table 3. Processes associated with the pandemic that have the potential to most strongly affect productivity

	Cyclical component (impact in 2020–2023)	Potential component (long-term impact)
1. New health standards for transport and other public places	(-/+) temporary excessively tight restrictions	(-) fewer services in the same areas and capacities, costs of maintaining social distance and disinfection
2. Transition of some professions to remote work	(-/+) efficiency losses during the transition period	(+) new expertise => impact on human capital
3. Transition of part of educational services to online mode	(-/+) efficiency losses during the transition period	(-) services not provided in 2020–2022 => impact on human capital
4. Bankruptcy, flow of labor from industries affected by restrictions	(-/+) efficiency losses during the transition period	(0)
5. Rapid changes in exchange rates, interest rates, and relative prices of goods and services	(-/+) efficiency losses during the transition period	(0)

Source: ACRA

Are there any prospects for an acceleration of potential growth? The potential economic growth over the next few years following 2023 will be close to 2% or even slightly higher due to an additional contribution of a larger labor force (around 0.5–0.6 pps on average in 2024–2030). Its growth will be related to an echo of the 1980s baby boom and also the impact of the pension reform, the transition period of which ends in 2028 (*Fig. 2*). Despite the fact that historically there has been limited labor force elasticity of working age individuals, we believe that other factors, such as the change in the share of working pensioners, will be less pronounced in the 2020s, and therefore the increase will be noticeable.

Figure 2. Labor force dynamics as a factor of potential growth in 2023–2028



Source: ACRA

We associate the biggest prospects for growth in the share of investments in the economy in general with a change in the structure of the state's expenditures in favor of investment. In theory, the effects of the pension reform make it possible to do this while maintaining an approximate balance.

The long-term effects of government policies should also be considered. Social policies, which are directly or indirectly aimed at increasing the birth rate and prolonging the active life of the population, may have a considerable impact on labor resources if successful. However, this will be noticeable beyond the forecast horizon and mainly from 2030 onwards.

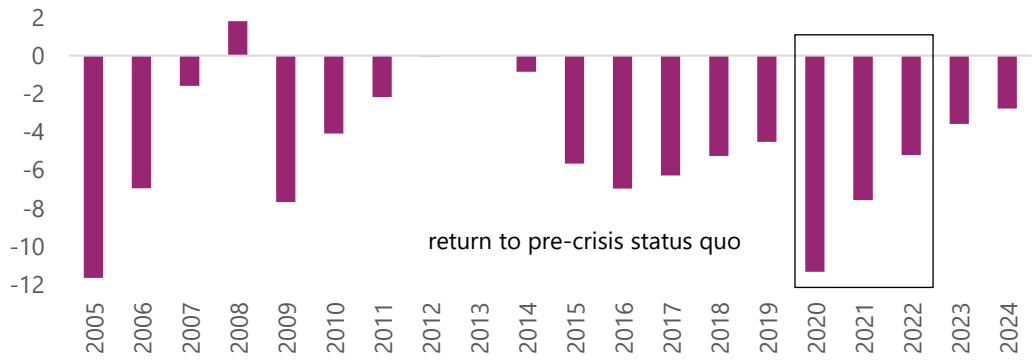
The government's measures to encourage investment in fixed capital may also produce a limited impact: in 2024–2030 we see the possibility of maintaining a historically high contribution of investment to GDP, and as a result, an additional effect on the volume of productive capital (taken into account in the corresponding component of potential growth).

Finally, the continuing development of the range of digitally-provided government services is an additional potential growth factor, given the state's size and role in the Russian economy. At the same time, it is difficult to quantify the effect that this process has on GDP, and therefore it remains a positive risk as part of our base case forecast.

Previously we talked about potential GDP growth rates. Fig. 3 shows the deviation of GDP level from its potential.

How fast can economic activity recover? A calculation based on assumptions we have selected shows that a return to the pre-crisis status quo may take place in 2022–2023 (year-on-year, *Fig. 3*).

Figure 3. Deviation of GDP from its potential in 2005–2024, %



Sources: ACRA

The current crisis is less severe in many ways, despite the sharp fluctuations in business activity

By comparing the dynamics of key macroeconomic indicators this year and those recorded during the crises of 1998, 2008–2009 and 2014–2015, we can draw the conclusion that certain macro markets in Russia are currently under much less pressure.

In particular, the internal FX market is far more stable (*Graph 3, page 8)*, despite the comparable price shock for exported goods (*Graphs 1–2*). In connection with this, the prices of imports are changing relatively little in relation to prices of local goods and not leading to a significant change in domestic production costs and higher inflation (*Graph 4*).

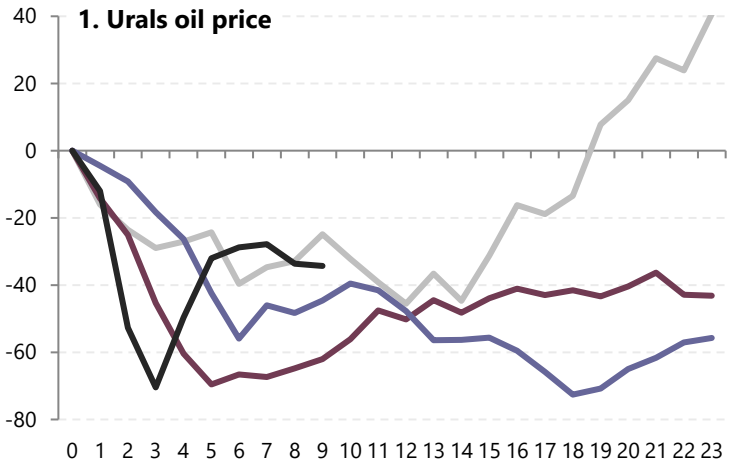
It appears that the new tax on interest generated by large deposits and also the introduction of escrow accounts for purchasing apartments also had a considerable impact on the incentives to place funds in bank accounts.

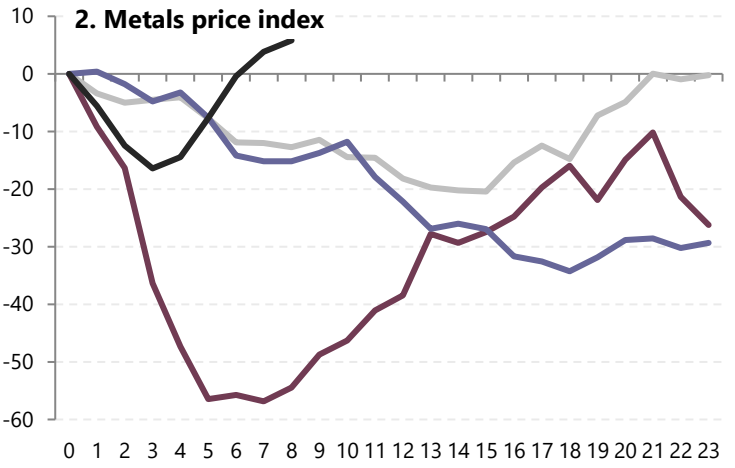
In addition, there are fewer reasons for the population and companies to withdraw funds from the banking system and convert ruble deposits in foreign currency, and this means that there is less pressure on the liquidity of banks. As a result, the level of financial stress is lower (*Graph 7*). In particular, the capital market is under less pressure, which is reflected in lower interest rate volatility (*Graphs 5–6*).

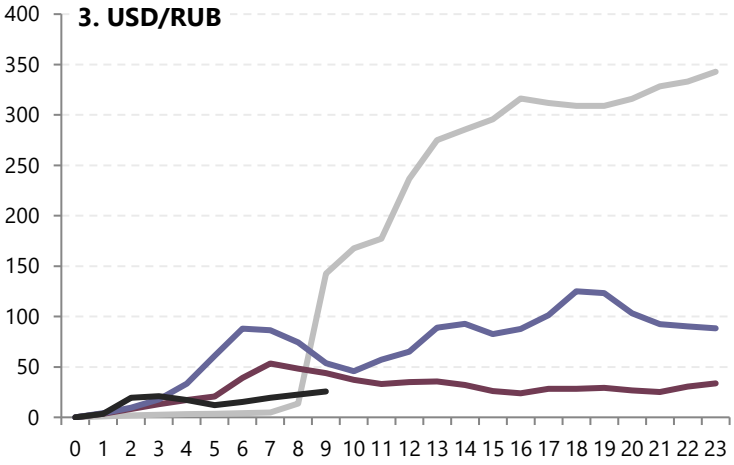
A key difference between the dynamics of the current crisis and previous ones is the sharpness of the downturn. At the first stage, declining consumption of the population triggered by regulatory limitations, and not economic incentives, resulted in the fastest decline of retail trade and the volume of services provided to the population in the history of Russian crises (*Graphs 10–11, page 9*). Therefore, despite the more stable industrial production (*Graph 9*) and construction by historical standards, overall business activity also declined at record rates.

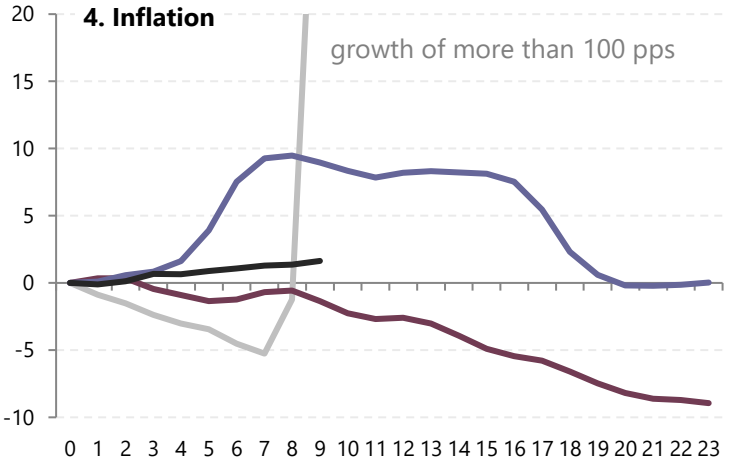
Due to deferred demand for goods and everyday services (although income declined, its use shifted heavily in favor of savings in deposits or in cash), the first phase of recovery also unfolded at a record pace. In addition, fiscal and monetary policy (*Graphs 12–13*) are contributing to this at a much larger extent than in previous crises. The aforementioned speed of recovery of activity and the impact of countercyclical policies explain why the spike in unemployment is currently at a historical low (*Graph 14*), i.e. the labor market is also more stable than in previous crises.

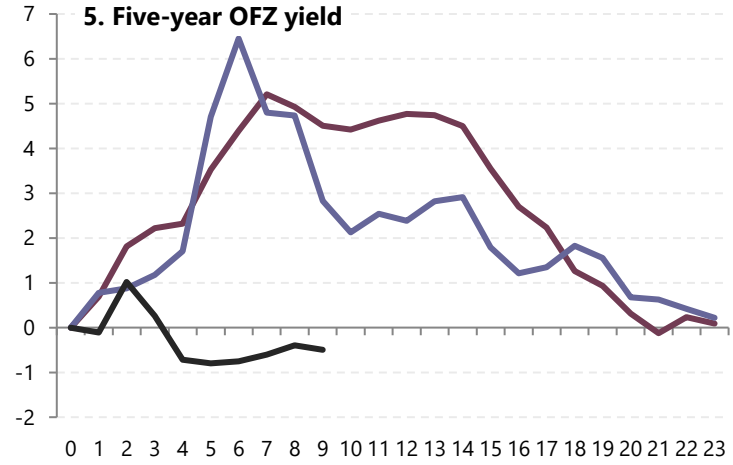
More stable macro markets and prices in them mean that temporary losses in the efficiency of production and distribution of goods and services related to the need to adapt to new conditions are not as significant as could have been expected going by the experience of previous crises. Therefore, unlike the 2014–2015 crisis, our base case scenario provides for the possibility of an almost complete adjustment of business and the population to the new conditions in 2020–2022 to a state in which labor productivity will be very close to the pre-crisis level already by 2023.

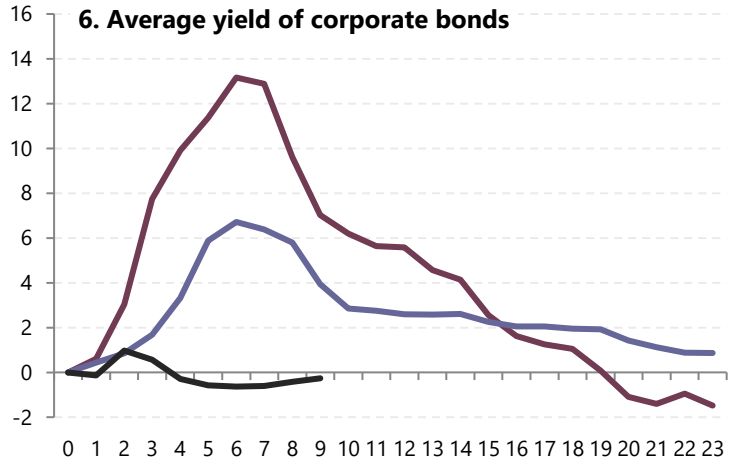


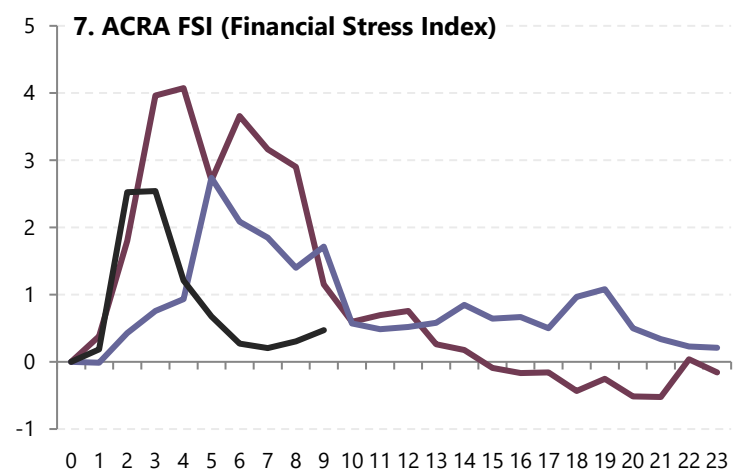








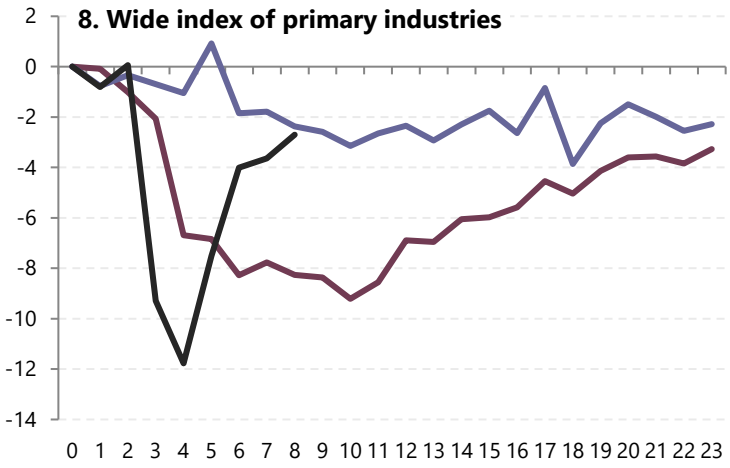


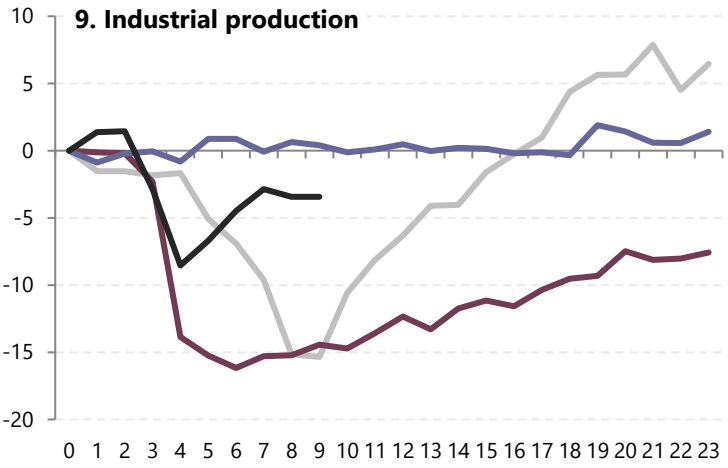


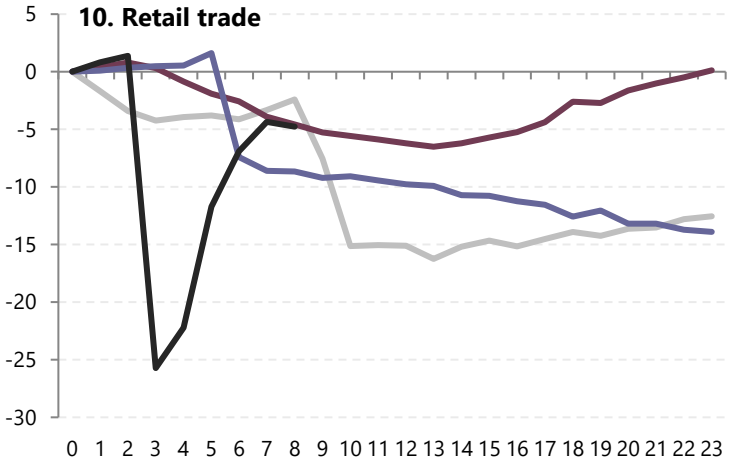
Dec 97 — Nov 99
July 08 — June 10
July 14 — June 16
Jan 20 — Dec 21

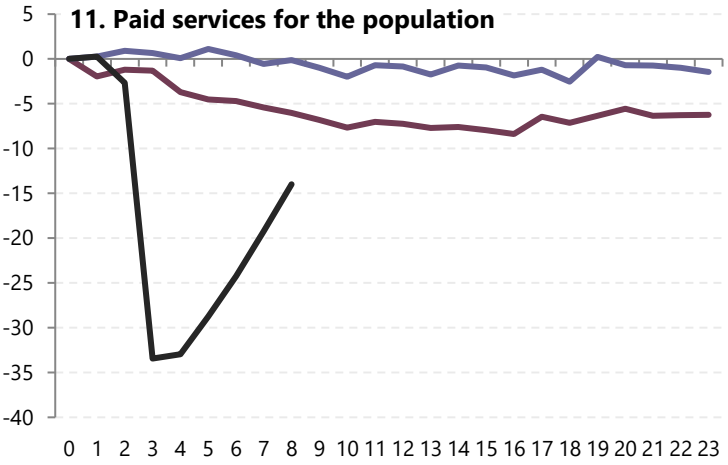
The graphs show the percentage increases in indicators compared to the zero month of each of the crises. If the indicator is initially measured as a percentage, the difference between the indicator value in the given month and in the zero month in percentage points is built. Seasonal indicators are seasonally-adjusted.

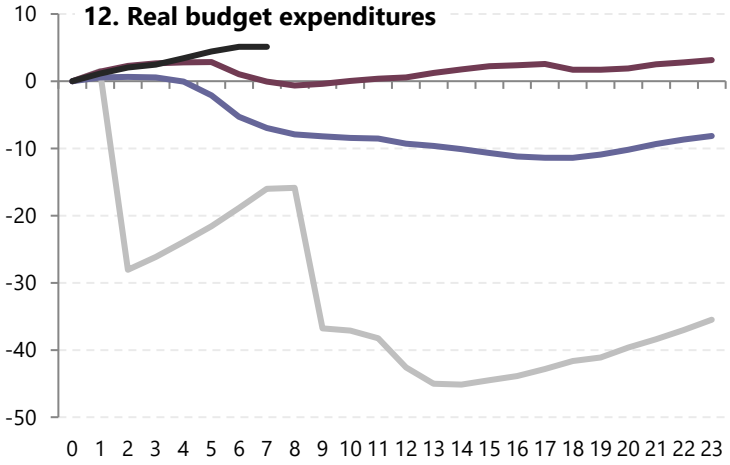
Sources: Bank of Russia, Rosstat, Ministry of Finance,

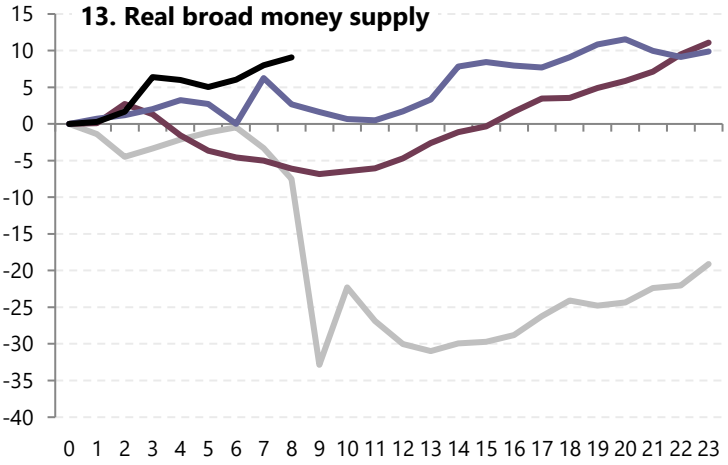


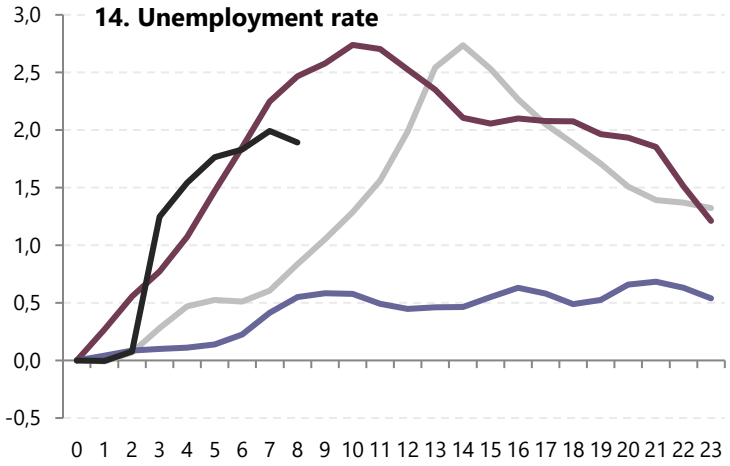












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The graphs show the percentage increases in indicators compared to the zero month of each of the crises. If the indicator is initially measured as a percentage, the difference between the indicator value in the given month and in the zero month in percentage points is built. Seasonal indicators are seasonally-adjusted.

Sources: Bank of Russia, Rosstat, Ministry of Finance, Reuters, Cbonds, ACRA

Appendix. Key indicators of the macroeconomic forecast scenarios

Table 1. Key indicators of the base case scenario of the macroeconomic forecast

Indicator	Unit of measurement	Actual			Estimate	Forecast			
		2017	2018	2019	2020	2021	2022	2023	2024
Urals crude oil price (average annual)	USD/bbl	53.5	70.1	63.6	40.7	45.0	50.0	52.0	55.0
Global GDP[8]	% y-o-y	3.3	3.0	2.5	-4.4	4.5	2.9	2.6	2.5
Russia's real GDP growth rate	% y-o-y	1.8	2.5	1.3	-4.3	3.8	3.3	2.8	2.2
Dollar to ruble exchange rate (average annual)	RUB/USD	58.3	62.7	64.6	72.6	71.0	69.5	69.2	69.7
Real disposable income of the population	% y-o-y	-0.5	0.1	0.8	-4.7	2.9	2.3	2.0	1.5
Unemployment rate	% of EAP[9]	5.2	4.8	4.6	5.8	5.6	5.1	4.8	4.5
Inflation (CPI[10])	% Dec/Dec	2.5	4.4	3.0	4.2	3.4	3.8	3.5	3.5
Key rate (at year end)	%	7.75	7.75	6.25	4.25	4.25	5.0	5.0	5.0
Five-year coupon-free OFZ rate (at year end)	%	7.2	8.5	6.1	5.4	5.8	6.0	5.5	5.5
Federal budget balance	% of GDP	-1.4	2.6	1.8	-5.0	-2.8	-1.5	-0.4	-0.5

Source: ACRA

Table 2. Key indicators of the pessimistic scenario of the macroeconomic forecast

Indicator	Unit of measurement	Actual			Estimate	Forecast			
		2017	2018	2019	2020	2021	2022	2023	2024
Urals crude oil price (average annual)	USD/bbl	53.5	70.1	63.6	40.7	35.0	39.0	47.0	47.0
Global GDP	% y-o-y	3.3	3.0	2.5	-4.4	0.8	3.1	2.4	2.3
Russia's real GDP growth rate	% y-o-y	1.8	2.5	1.3	-5.3	0.5	4.3	3.9	2.7
Dollar to ruble exchange rate (average annual)	RUB/USD	58.3	62.7	64.6	72.6	77.2	76.1	72.4	72.5
Real disposable income of the population	% y-o-y	-0.5	0.1	0.8	-4.7	-1.0	3.0	2.2	1.5
Unemployment rate	% of EAP	5.2	4.8	4.6	5.8	7.2	6.0	5.2	4.5
Inflation (CPI)	% Dec/Dec	2.5	4.4	3.0	4.2	5.8	3.2	3.1	3.5
Key rate (at year end)	%	7.75	7.75	6.25	4.25	7.00	5.5	5.0	5.0
Five-year coupon-free OFZ rate (at year end)	%	7.2	8.5	6.1	5.4	6.5	6.5	5.5	5.5
Federal budget balance	% of GDP	-1.4	2.6	1.8	-5.0	-4.2	-1.8	-0.4	-0.5

Source: ACRA

[8] World Bank methodology, real increase.
[9] Economically active population.
[10] Consumer price index.

Table 3. Key indicators of the optimistic scenario of the macroeconomic forecast

Indicator	Unit of measurement	Actual			Estimate	Forecast			
		2017	2018	2019	2020	2021	2022	2023	2024
Urals crude oil price (average annual)	USD/bbl	53.5	70.1	63.6	40.7	50.0	55.0	65.0	65.0
Global GDP[11]	% y-o-y	3.3	3.0	2.5	-4.4	5.3	3.1	2.7	2.7
Russia's real GDP growth rate	% y-o-y	1.8	2.5	1.3	-3.9	5.1	2.9	2.7	2.5
Dollar to ruble exchange rate (average annual)	RUB/USD	58.3	62.7	64.6	72.6	66.0	64.5	63.9	62.4
Real disposable income of the population	% y-o-y	-0.5	0.1	0.8	-4.7	3.9	2.1	1.9	1.6
Unemployment rate	% of EAP[12]	5.2	4.8	4.6	5.8	4.7	4.5	4.5	4.5
Inflation (CPI[13])	% Dec/Dec	2.5	4.4	3.0	4.2	4.0	3.6	3.6	3.5
Key rate (at year end)	%	7.75	7.75	6.25	4.25	4.75	5.0	5.0	5.0
Five-year coupon-free OFZ rate (at year end)	%	7.2	8.5	6.1	5.4	5.3	5.3	5.5	5.5
Federal budget balance	% of GDP	-1.4	2.6	1.8	-5.0	-1.0	-0.4	-0.3	0.1

Source: ACRA

[11] World Bank methodology, real increase.
[12] Economically active population.
[13] Consumer price index.

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