NATIONAL RESEARCH UNIVERSITY HIGHER SCHOOL OF ECONOMICS DEVELOPMENT CENTER

Commentary on State and Business

141

October 4–31, 2017

Where is the growth – other than in oil prices?

Despite a favourable oil price environment, the economic growth remains weak. Brent exceeded $60/barrel at the end of October, 20% higher than at the same point last year and 6% higher than in the second quarter. Nevertheless, the macroeconomic data deteriorated across a range of indicators compared with April-June. Growth was recorded only in agriculture and construction on a seasonally adjusted basis, while industrial output, freight and wholesale trade all contracted. Retail trade and services continued to stagnate.

Despite the fact the resource sector has expanded its share of the economy, the pre-crisis model, in which rising hydrocarbon revenue drives domestic demand and consumption, has not been re-established. This is due to the policy of fiscal consolidation and the new temporary budget rule. While federal budget revenue in January-August rose by 17.9%, expenditure increased by just 4.3%. Profits of energy companies have outstripped the growth in budget revenue from the hydrocarbon sector. This is driving investment demand but has a limited impact on household incomes and consumption.

It remains unclear whether the new budget rule can act as a stimulus for the development of the non-hydrocarbon economy. At present the oil sector continues to dominate, however it is possible that diversification may become evident with more time. The resumption of capital outflows from enterprises, which had been low since mid-2016, is a concern. Formally, the investment climate in Russia is improving – Russia has risen to 35th in the latest World Bank Ease of Doing Business report, thanks principally to improved macroeconomic indicators and procedures for cross-border trade. However, as the ranking produced by the World Economic Forum shows, Russia continues to lag in a range of areas, from the quality of roads to the integration of technology and the independence of the judicial system.

1. *The Composite Leading Indicator*

The Composite Leading Indicator (CLI) rose in September (to 1.4%, from 0.2% in August) but remained close to zero. The biggest driver was the higher oil price, which averaged $55/barrel in September, compared with $44.4/barrel in the same period of last year. The RTS stock-exchange index was up by 15% year on year, but it should be noted that the unusually low base period has flattered the figures.

Domestic demand remains weak; indicators for new orders and stocks were both negative in September. Growth is unlikely to pick up without a revival in domestic demand, and the CLI is therefore likely to remain in only weakly positive territory until the end of the year, reflecting a

slowdown in the growth rate. The base effect will be exhausted by December, at which point growth may again start to falter unless the oil price continues to rise.

2. *The real sector – euphoria is subsiding, structural problems remain*

The recovery in industry weakened in the third quarter. In view of the high base period in the fourth quarter of 2016, industry and the economy as a whole are likely to stagnate in the fourth quarter of 2017. The Russian economy needs structural changes to achieve a high and stable growth rate.

Industrial output growth slowed to 0.9% year on year in September, from 1.5% in August. Over the third quarter it stood at 1.4%, compared with 3.8% in the second quarter. Seasonally adjusted data support our previous expectations that industrial production is slowing. Overall industrial production rose by 1.8% in January-September 2017 year on year, with mining expanding by 2.8% and manufacturing by 1%.

Our model, which is based on Rosstat survey data, suggests an acceleration in industrial production may be recorded in October, after which growth is expected to be around 1% year on year. Seasonally and calendar adjusted data are therefore likely to show a stagnation in industrial output. One of the reasons for this will be a fall in oil output in the fourth quarter compared with the same period of last year, when production recorded a new high before the agreement with OPEC to limit production came into force. Oil output has risen by 0.5% in January-September year on year, but it was down by 2.6% in September compared with the same month last year. The contraction in output could exceed 3% in October.

Overall, the same negative trends witnessed during the period of the oil boom in the 2000s continue to dominate. The extractive sector continues to make a large contribution to growth. Of the 1.5% growth in added value in the first half of 2017 year on year, we calculate that 0.8 percentage points were linked to growth in mineral extraction and wholesale trade (which retail trade continues to stagnate). The share of mineral extraction in GDP rose by 1.5% over this period, while the share of manufacturing output and agriculture declined by 0.4%.

In 2002-16, the share of mining and oil refining in GDP rose by 2.6 percentage points, while manufacturing declined by 2.8 percentage points. The share of education and healthcare in GDP is 1.5 times smaller than countries with a similar level of development. Meanwhile, state administration and security now account for 7.1% of GDP, against 4.5% in 2002.

3. *The Central Bank of Russia is supporting the rouble*

Increased capital outflows from the private sector combined with a balanced current account has led to a deficit in foreign currency liquidity. In these circumstances, the CBR has turned to short-term foreign loans to support the rouble.

The CBR estimates that the current account recorded a surplus of $1.2bn in the third quarter, and revised upwards its estimate for the second quarter to a surplus of $2.8bn. Adjusting for seasonality, the current account over the last five quarters has moved in a relatively small range of a surplus of $8-11bn. Several factors have kept the current account in surplus. Overall, we expect a current-account surplus of $8-10bn in the fourth quarter.

- The value of exports has grown, led by a rise in the value of gas exports, supported by record European demand. Non-energy exports have also grown for five consecutive quarters. The share of non-energy exports in the total stood at 47% in the third quarter, the highest level since mid-2002.
- Import growth has slowed. In the third quarter imports rose by 2.7% (seasonally adjusted), compared with 11% at the start of the year, largely due to exchange-rate dynamics. Service imports have also fallen, in particular spending on foreign travel. Household expenditure appears to be increasingly oriented to the domestic market.

Capital outflows in the third quarter stood at $5bn, compared with a small net inflow in the second quarter. On the positive side, companies' external debt rose for the second quarter in a row to $14bn, despite higher repayments. However, "other" outflows, including those classified as errors and omissions, rose to $8bn; this may be linked to the withdrawal of assets from certain banks (Jugra, Otkrytiye, B&N Bank).

Companies' demand for foreign currency was in part met by banks, which reduced their foreign assets by $16bn; only three times has the quarterly reduction in banks' foreign assets been so large. Some banks facing a shortage of foreign currency raised funds from the CBR through foreign currency swaps at an interest rate of 2.7%.

The CBR significantly increased its short-term borrowing abroad. At the end of September, the CBR's short-term borrowing had reached a record level of $11.5bn. At the same time, Russian sovereign bonds remain attractive for foreign investors; we estimate foreign investors hold $32bn in Russian sovereign bonds, over one third of the total in nominal terms. The short-term nature of these investments could be a significant challenge for the monetary authorities.

The CBR is therefore actively supporting the rouble through relatively high interest rates and short-term borrowing on foreign markets, while avoiding drawing down on its foreign-currency reserves. Without this support, given the debt repayments due to the end of the year, the rouble could significantly depreciate. On the other hand, the Ministry of Finance continues to accumulate foreign currency in accordance with the budget rule. Foreign currency purchases may reach $12bn this year.

4. *The rich are also feeling the pain – and more so than the poor*

The socio-economic crisis of 2015-16 led to a fall in real household incomes. The recovery in growth has so far only slowed the rate of contraction. Which groups have suffered most from the unfavourable socio-economic situation in 2015-16?

In the first nine months of 2017 real disposable household resources fell by 1.2% compared with the same period of 2016. However, this contraction has not fallen evenly between different social groups.

In 2015 the level of disposable resources fell most sharply – by 16.8% – among the wealthiest group (the fifth quintile), owing largely to a fall of 9.7% in monetary income, and a fall in expenditure financed by savings and loans (by 45.6%). The reduction in disposable resources of the poorest social group in the first quintile, by contrast, was just 4%. This was due to a fall in income of 4.5%, while spending financed by savings or loans rose by 3.9% compared with 2014. The value of non-monetary income rose by 4.7% for the first quintile and by 16.7% in the fifth. Expenditure on final consumption contracted by 4.8% in the first quintile, and by 15.7% in the fifth.

Data on changes in disposable household resources in 2016 compared with 2015 show that income of the wealthiest households have started to rise but have not yet recovered to the 2014 level, while the incomes of the least well-off household fell further.

For 2017, data on the distribution of household incomes is only available for the first quarter. Disposable resources of the wealthiest population quintile continue to contract faster owing to the higher rate of decline in incomes and constraints on borrowing and the use of savings. The socio-economic position of the poorest population quintile is improving, but more data is needed for the second and third quarters of 2017 to assess whether this improvement is sustainable.