NATIONAL RESEARCH UNIVERSITY HIGHER SCHOOL OF ECONOMICS DEVELOPMENT CENTER

# Commentary on State and Business

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## 1. Optimism alone is not enough

**Industrial output recorded no growth year on year in October, and fell by 0.1% month on month (seasonally adjusted).** The performance of the economy has therefore not improved from the third quarter, when industrial production and GDP started to decline quarter on quarter.

It is highly likely that the 2.5% growth recorded in the second quarter of 2017 marked the high point of Russia's near-term growth trend. This acceleration was the result of temporary factors, a gradual rise in oil prices and brief improvement in expectations in response to optimistic forecasts by the Ministry of Economic Development.

**As noted in Bulletin 141, tight fiscal policy is constraining growth from rising oil revenues.** At the same time, the prospects for structural changes in the economy looks uncertain. On the one hand, the Central Bank of Russia appears to have won the confidence of the analytical community, as shown by our recent survey of forecasters, the majority of whom expect inflation to remain close to the 4% target in the coming years. On the other hand, the population does not yet believe the reduction in inflation is sustainable. Banking data shows that short-term deposits are falling, because low interest rates cannot cover the expected inflation rate.

**Detailed analysis of the ease of business environment rankings shows a mixed picture.** The World Bank's Ease of Doing Business report and the World Economic Forum Competitiveness Report show improvements in the macroeconomic environment (owing to lower inflation), connecting to electricity, and external trading conditions. However, Russia's ranking in other areas has not improved or has deteriorated (for example acquiring construction permits and tax administration). The continued trend towards the narrowing of the market economy should also be noted. This is shown by the banking sector, where state-owned banks now account for 65% of enterprise deposits, and 71% of household deposits (compared with 65% half a year earlier).

**While the budget situation in Russia as a whole is sustainable, there are a cluster of problematic regions struggling with high debts accumulated during the crisis.** Without significant support from the centre, which is uncertain in the context of broader budget consolidation, the gap in the quality of public services between these regions and the relatively better-off regions will continue to grow.

## 2. GDP correction in the third quarter

***GDP rose by 1.8% year on year in the third quarter. Seasonally and leap year adjusted, we calculate that output declined by 0.3% in the third quarter compared with the second quarter, although demand continued to recover. The growth estimate for 2017 has been cut to 1.6%, from 1.9% previously. GDP is around 6% below the pre-crisis trend. Economic activity also fell in October.***

GDP rose by 1% quarter on quarter in the first half of the year thanks to rising oil prices and the one-off increase in pensions. The correction in the third quarter was clearly linked to the exhaustion of these factors.

The index of basic sectors calculated using the Development Centre's own estimate of industrial production fell by 0.2% quarter on quarter in the third quarter. Private domestic demand rose by 0.8%, growing for the third quarter in a row. While retail trade and services rose only slightly, construction grew by 3.2%. Industrial production declined by 0.3%, primarily owing to weaker performance in the mining sector, freight fell by 0.5% and wholesale trade by 4%. As usual we regard the figures for wholesale trade as unreliable, however it is likely that the GDP correction was driven primarily by this sector. It is notable that economic activity in the third quarter would have been 0.3% lower had it not been for the strong harvest, which led to agricultural growth of 5.4%.

If in the fourth quarter GDP level stays the same as in the third quarter, annual growth will be 1.6% (against 1.9% if GDP level of the second quarter is retained), which is below the Development Centre Consensus Forecast. The economy has only made up half of the output lost from the high point in 2014 (in the second quarter of 2016, output was 3.5% below the average level in 2014). Compared with an assumed potential growth rate of 1.5% a year from 2014, GDP is 6% below the pre-crisis trajectory. The negative impact of the crisis is even worse when taking into account the federal budget deficit of 2-2.5% of GDP.

Growth may be supported by the traditional economic drivers next year. The price of Urals crude has risen from $51/barrel in the first three quarter to $62/barrel in the first half of November. If prices remain at this level, growth should be around 1.5%. However, this level is driven to a significant degree by the tense political situation in Saudi Arabia, and there is a risk prices will fall back, with a consequent negative impact on the Russian economy.

## 3. Some conclusions from the latest international competitive rankings

***Russia came 35th in the latest World Bank Ease of Doing Business rankings released in mid-2017. In the 2012 May Decrees, the president set the target of improving Russia's rank to 20th by 2018. Further progress requires a clear understanding of the priority target areas, while also taking into account factors not included in the survey. This includes corruption, which was again identified as the biggest business concern in the latest World Economic Forum survey.***

Russia's rating is based on the business climate in Moscow and St Petersburg, with a weighting of 70% and 30% respectively. Russia rose five places in the latest Ease of Doing Business ranking out of 190 countries. However, it should be noted that the methodology was adjusted last year, to include not only a country's performance across a range of indicators, but also the number of

reforms adopted. Taking into account the change in methodology, Russia improved by just one place, from 36th to 35th.

Although all indicators are equally weighted, we surmise that in reality some indicators have a greater influence than others on improvements in a country's rating, which depends not only on the speed of changes in the country itself, but also on the speed of reform of competitor countries. To test this hypothesis, we conducted a regression analysis, using a country's improvement in the ranking as the independent variable. We used three samples: the top 50 countries in the 2017 Doing Business rating, including Russia; the 50 countries that in aggregate recorded the most significant improvement; the 50 countries which, like Russia, are in the upper-middle income category.

This exercise showed that for all three samples, improvements in the following areas were particularly significant: construction permits; obtaining an electricity connection; access to credit; and protection for minority investors. Of these indicators, improvements in the categories of obtaining an electricity connection and access to credit drove the biggest improvement in Russia's rating. International trade also made a large contribution to Russia's improvement, despite the fact that it was not highlighted as a key indicator by our regression analysis. This may be due to Russia's very low starting point for this indicator. For Russia to further rise up the rankings, it needs to make additional progress on international trade and construction permits, where it lags far behind the best performing countries.

According to the WEF's survey, executives see corruption as the main barrier to business. Corruption has often been cited as the most serious impediment to business, although last year inflation was highlighted as the biggest risk. It is important to note that inflation remains one of the biggest concerns for business, given that many commentators have questioned the significance of the reduction in inflation for economic growth. High tax rates and access to finance are also identified as major impediments to business.

The indicators that rose the most in significance over the past year were corruption, labour shortages and tax administration. The indicators that recorded the least change were government stability, poor working practices, and the health of the labour force. Progress was most notable in the reduction in inflation and a small improvement in the indicators relating to crime, access to finance, and tendency to innovate.

Both ratings show that some positive changes in Russia's economy are taking place – the fall in the price of oil and the subsequent crisis appear to have encouraged government regulators to implement some reforms. But these changes are not sufficient or effective as it has not led to a significant recovery in economic growth. October data on industrial production suggest the economy is stagnating rather than growing, putting in doubt the positive expectations for the fourth quarter.

Positive changes in the economy are happening slowly, and many serious problems have yet to be resolved. Russia is not currently able to take full advantage of fundamental positive factors such as infrastructure, good basic education standards, resource wealth etc. Targeted measures are needed to remove the factors that are holding back growth "here and now", rather than more general problems highlighted by cross-country regressions, which tend to link growth to various macro-indicators and reforms.

## 4. Profits in January-August 2017: decline continues

***According to Rosstat data, the total balanced financial result (profit less loss) of organisations stood at Rb6.4trn in January-August 2017, a reduction of 8.5% year on year at current prices. The profits of profit-making organisations fell by 5%. At the same time, Rosstat data show that the economy is growing! Output of the basic economic sectors rose by 2.5%, turnover of organizations - by 7.9%, producer prices rose by 7.6%.***

Balanced profits (loss) before tax in the economy in January-August 2017 (in current prices) fell by Rb590.5bn. The main drag on profits was the service sector, which recorded a fall in profits of Rb654bn (-22.7%), of which Rb396bn related to trade (down 34.1%).

Trade profits are determined by the margin on wholesale and retail trade, in other words on the level and dynamics of producer and consumer prices. In January-August, producer prices exceeded consumer prices by 1.8 times (7.6% against 4.2%), while in the previous year the ratio was the reverse (which was advantageous for trade). As a result, wholesale profits declined by 32%, and retail sales by 42% and the rate of return (calculated as the ratio of balanced profit (loss) to turnover) fell to 2.5% and 1.7% respectively.

Professional and scientific-technical services recorded a sharp fall (by 2 times, or Rb214bn), which recorded a broad and unexplained variation in profit dynamics across sub-sectors. Profits in consulting and management fell in January-August 2016 by 10 times, while legal and accountancy services profits doubled, and architectural and engineering and technical design services increased by six times. This form of economic activity has not been recorded in this way before 2017. Although Rosstat insists that its data (growth rates to the previous year) are comparable, questions remain.

Goods production profits rose by just Rb64bn in January-August 2017 (1.6% year on year), The main contribution came from mining, where profit rose by Rb291bn (+21%). Manufacturing recorded output growth of 1%, however prices pulled down profits of the previous year leaders. The chemical and metallurgical industries recorded a decline in profits of 40% and 30% respectively. Prices in the chemical industry fell in absolute terms, and price growth slowed in metallurgy, while output also declined. By contrast, oil refining increased profits by 1.8 times thanks to a 15% rise in producer prices.

Profits also rose in the machine-building sector by 9.8%. Profits for vehicle production rose by Rb30bn, (thanks to a rise in production of 12% and an increase in prices of 5.6%); in computing and electronics sector rose – by 12%. However, production of machinery and equipment recorded a decline in profits of 43%, in part owing to rapid growth in imports, which has put domestic producers under pressure. Overall, the manufacturing sector recorded a decline in profits of Rb214bn (-10.7% compared with January-August 2016).

Profits in the construction sector have started to improve. The decline in January-August 2017 slowed to 26% year on year, compared with 63% in the first half of 2017. The rate of return remained very low, at 1.7%, however.

The only stable driver of profit growth in the economy remains the energy complex. The situation in other sectors is unstable, and profits depend heavily on price dynamics, rather than output volumes. This is particularly the case with regard to retail trade, given weak domestic demand and in the absence of trade turnover growth. The sector has encountered difficulties as a result of rising producer prices, which it has not been able to pass on to the consumer.

## 5. Balance of payments: import growth stagnates

***Import values stood at $21.6bn in October, up by just 2.7% on the previous month according to our estimates. This only partially compensated for the fall in imports in the previous month. Import growth appears to have been replaced by stagnation.***

The value of imports has barely grown over the past three months. Month-on-month growth has been in the range of 0.1-0.4% in August-October, whereas in the first seven months import growth was 1-3% a month. This points to a stagnation in both consumer and investor demand.

Imports from the CIS have continued to grow, while those from the far abroad (90% of the total) have fallen over the past three months. The value of investment imports has started to decline, in particular machinery (52% of imports from the far abroad in October), possibly because of new US sanctions on Russia. Machinery imports have fallen by 1.7-2.4% a month. Mechanical and electrical equipment imports have declined, along with railway locomotives and ships. Imports of tools and optic equipment have stagnated. However, imports in the transportation sector continue to grow. Imports of transport goods has been driven by spare parts. This is unsurprising, as a large proportion of foreign brands are now assembled in Russia. Imported cars account for 18% of total sales, compared with 80% in September 2008. Passenger car import volumes continue to decline, but production of some foreign models which was halted during the crisis has resumed.

Food imports have also declined despite the gradual removal of Russian sanction on Turkey. Imports of textiles and footwear have stagnated. Only imports of chemical products have grown, three-quarters of which are intermediate goods.

The appreciation of the rouble has supported imports over the past two months. The real effective rouble exchange rate rose by 2.2% and 1.2% respectively in September and October. However, the rouble started to depreciate in November despite rising oil prices in November as a result of an increase in capital outflows. This will constrain the import of foreign cars. We do not expect a significant recovery in goods imports before the end of the year; the total value of imports this year is likely to reach $235bn a rise of 23% year on year.

## 6. Budget – Regions appeal for help

At the end of October, the Supreme Council of the Republic of Khakasia appealed to the Duma and the Russian government for financial assistance.

At the end of 2016 total regional and municipal debt stood at Rb2.7175trn, equivalent to 32.6% of consolidated regional budgetary income excluding transfers from the federal budget. Total regional and municipal debt was equivalent to 3.2% of GDP, which is low by international standards. However, the ratio of debt to income varies significantly across the regions. At the end of 2016 it exceeded 100% in five regions, in 54 regions it exceeded 50%. The debt ratios of the worst affected regions at the end of 2016 are shown in table 1.

The debt and budget profiles of these problematic regions varies, but they are characterised by a relatively low level of transfers from the federal budget as a share of their total budget. Transfers did not exceed the 40% mark in any of the regions, which is the basis for a special agreement with the Ministry of Finance. All the problematic regions recorded budget deficits in 2016; the share of spending used to service debt was significantly above the national average. Khakassia was not the

most indebted region relative to income in 2016, but this region had the lowest share of budget credits in its debt stock, and as a result the highest share of spending on debt service.

These regions' debt problems did not emerge in 2016. Table 2 provides a breakdown of the impact of changes in income and expenditure in 2016 on the budget balance by changes in revenues from profit tax, income tax, transfers, other taxes, and also the rise in budget expenditures, including education. A positive number in the first column indicates a reduction in the budget deficit in the regions in 2016 compared with 2015. As table 2 shows, the majority of regions reduced their budget deficit in 2016. Nevertheless, they remained in deficit and debt continued to accumulate. The deficit widened in four regions in our selection (Kostroma, Khakassia, Udmurtiya and Orlov Oblast). Reasons vary for the budget deficit, but in all cases federal budget transfers were reduced in 2016 compared with 2015. This was the main cause of deterioration in the budget in Khakassia and Orlov Oblast in 2016. In Udmurtiya and Kostroma, the rise in the budget deficit was linked to the rapid (compared to the Russian average) rise in expenditure. It should be noted that in all four regions the budget deficit grew despite rises in revenue from income tax and profits.

What is the debt position this year? Regional budget data is available for January-August, and regional debt data is available up to October. However, this data is not fully comparable as a large share of regional expenditure comes at the end of the year, and federal transfers are not dispersed evenly through the year. Nevertheless, some broad conclusions can be drawn. As table 3 shows, a significant share of the problem regions were not able to improve their budget positions in the first eight months of 2017. Overall, Russia's regions recorded a significant surplus, equivalent to 10% of income. Nevertheless, in seven of 11 regions in our selection, the budget was in deficit. It is likely that the budget position in these regions will only deteriorate to the end of the year (owing to the uneven spending over the course of the year).

While the overall regional debt level fell in the first ten months of 2017 by 5.5%, in the majority of the problematic regions debt levels continued to grow. In Kostroma it rose by 22.5%, in Mordovia by 15.2%, in the Jewish Autonomous Oblast by 11.2%, in Khakassia by 8.7%.

This study indicates that during the crisis and weak economic recovery a cluster of regions has emerged with a high level of debt relative to income. The latest data in 2017 show that the majority of these regions are continuing to accumulate debt. This will inevitably impact on their financial stability. This will have an impact on the level and quality of public services offered by these regions. The federal centre may push these regions to increase their revenue base, but the only real solution to the problem is an increase in financial support from the federal budget, the resources for which must be found in the context of budget consolidation.

## *7. Banking statistics*

Borrowing by non-financial corporations rose by 1.2% in September month on month, the fastest rate of growth since August 2015. Nevertheless, the credit stock is down by 0.5% year on year. Rouble loans rose by 1.7% month on month (5.6% year on year), while enterprise loans in foreign currency fell by 0.9% (9.1% year on year). Given that enterprises have excess assets of over Rb3trn, rapid growth in corporate demand for loans is unlikely.

The nationalisation of the banking sector is acquiring an irreversible character. The most significant event of the last few months was the collapse of two banking groups, headed by Otrytiye and B&N Bank. These were among the largest private credit organisations. In order to avoid a domino effect,

the Central Bank of Russia decided to effectively nationalise them. As a result, the share of enterprise assets held on deposit in state banks rose to 65%. At the start of October, the share of household deposits held in state banks rose to 70.8% of the total. This could have a critical impact on the remained of the banking sector, for which household deposits are a key source of funding.

Household lending rose by 1.3% in September month on month, and by 8.8% year on year. For the first time since April 2015, lending growth was higher than deposit growth (8% year on year). Household demand deposits continued to fall as a share of total assets. This indicates that households are unwilling to invest their money at the current interest rates. As a result, private banks will have to raise their deposit rates in order to compete with state banks, which will reduce profitability.