



# Commentary on State and Business

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## ***1. Overview of 2017: Incomes continued to decline, risks for investors rose***

2017 showed that the rebound from the low point of the crisis lasted only a year, from mid-2016 to mid-2017. This was followed by a downturn in macroeconomic trends, with industrial production and domestic demand stalling. It is notable that the most recent deterioration in economic performance took place against a backdrop of an almost steady rise in oil prices in the third and fourth quarters of 2017. This does not reflect a significant change in the economy's dependence on revenues from hydrocarbon exports, but rather a change in the distribution of additional export revenues within the economy.

Under the temporary budget rule, hydrocarbon revenue generated by a rise in the oil price above the baseline set in the budget is saved by the Ministry of Finance. At the same time, planned budget expenditures are financed by increased domestic borrowing, resources in the National Welfare Fund, and funds on account. This operation allowed the Ministry of Finance to limit the impact of additional hydrocarbon revenues on demand and the rouble exchange rate.

Tight fiscal policy, a reduction in the volatility of the rouble along with a cautious approach to interest rate cuts created the conditions for a reduction in inflation below the Russian Central Bank (RCB) target. The RCB has more than fulfilled its target for macroeconomic stabilisation, which has thrown into sharper relief the factors constraining recovery growth from mid-2017.

Over the past year it has become clear that the wager made in 2015-16 that higher domestic profits could support investment despite the high risks of doing business in Russia, has not led to an increase in efficiency or exports. We estimate productivity grew by 1.6% in 2017, and non-hydrocarbon exports, which has been traditionally limited to metals, chemicals, grain and weapons, are not showing signs of diversifying. In January-September 2017, the total balanced financial result (profit less loss) of large and medium-sized enterprises fell again, by more than Rb0.7trn. At the same time, the concentration of profit in the extractive sector increased. In the first three quarters the total balanced financial result rose year-on-year in just three major sectors: coal mining, oil refining and machine-building, which is reliant on state orders. In other sectors, profits were either unchanged in nominal terms or fell. The growth in investment recorded in the first and second quarters of 2017 supported by profits made in 2016 was unsustainable and came to an end in the third quarter.

The fall in profits was not due to a rise in costs. Wage costs at large and medium-sized enterprises grew by less than 5% in nominal terms (the average wage rose by 7.1% in January-November, however the number of employees fell by 2.4% in January-October according to available data). Taking into account employment at small enterprises, individual entrepreneurs, and the informal

sector, wages rose by only 3% in nominal terms, and so declined in real terms. Combined with the weak performance of pensions (the growth in which was almost entirely accounted for by the one-off payment in January 2017) and income from business activity and property, this led to a decline in real disposable income (of 1.4% in January–November 2017 year on year).

Despite a limited recovery in household lending, retail trade grew insignificantly (by 1% in January–November), which reversed only around a fifteenth of the decline recorded in 2015–16. Alongside the clear risks of doing business in Russia and demand constraints, investors' negative outlook has been shaped by expectations of a new round of American sanctions against major Russian businesses. Given the above factors, and assuming that the current geopolitical context remains in place, we expect growth in real GDP in 2018 of around 0.5% with oil prices remaining at their average 2017 level.

## ***2. Macroeconomy in 2017: A halting rebound***

Real GDP rebounded from the low point recorded in 2016, but this growth proved unsustainable. The RCB's success in controlling inflation, which fell to 2.5%, was an indisputable macropolitical success. After falling by 2.5% in 2015 and 0.2% in 2016, GDP rose in the first three quarters of 2017 by 1.6% year on year, and we expect the same rate of growth for the full year, assuming output in the fourth quarter remains at the same level as the third quarter.<sup>1</sup> The rebound was driven primarily by a rise in the price of Urals crude oil from \$42/barrel in 2016 to \$53/b in 2017. Even so, the economy has made up only half of the loss in output from the 2014 level (which can be considered the pre-crisis high point), and output is 6% below the pre-crisis trajectory (assuming real GDP growth of 1.5% a year).

Output of the primary economic sectors index, calculated on the basis of data to November 2017, demonstrates a more positive dynamic compared with GDP. Annual growth is estimated at 1.8% after stagnation in 2016, which would imply that output has almost entirely recovered to the 2014 level. Strong growth was recorded in wholesale trade (5.8%) and goods transportation. Methodological problems mean the first indicator is not reliable, and is characterised by significant revisions, and it is therefore difficult to say to what extent its dynamic corresponds with reality. The second has risen owing to increased gas and oil exports, which has combined with a rise in domestic demand for these goods, in part due to a post-crisis replenishment of inventories, which will be a temporary factor. It is possible that the exhaustion of this factor led to a sharp fall in goods transportation in September–November, while gas extraction, after a temporary rise, returned to a level close to our model estimates. By contrast activity driven by domestic demand performed poorly in 2017. Domestic private demand, including retail trade, paid household services and construction grew by just 0.5%. After falling for two years (by 10% and 5% respectively in 2015 and 2016) retail trade grew by a modest 1.2%. Along with construction, it is one of the economic sectors that has suffered most in the crisis.

Paid services recorded no growth, despite an increase in real wages of 3.4%. It is possible that the growth in consumer demand was stronger in other areas, such as tourism and spending on goods abroad. It should be noted that national accounts data show that final household consumption, even after taking into account consumption of homemade products, grew by 3.5% in the first half of the year (more recent data is not yet available). It should be noted that there is nothing unusual

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<sup>1</sup> In what follows, annual estimates are provided for other indicators on the basis of a similar assumption of inertia: that the seasonally adjusted output level to the end of the year will not change from the last actual data point available.

in the divergence between the two indicators of domestic demand, which has also been recorded in previous years.

Construction is the only area of economic activity that started decline in 2014 and continued to contract in 2017. It fell by 2% in 2017, and by 10% in 2014-17. The depressed state of the sector is a result of an excess supply of property. However, conclusions should not be drawn regarding the overall investment level on the basis of the construction sector alone. Investment may have increased by 4% in 2017, recovering a third of the decline since 2014. Given the excess supply of property and stronger rouble, firms have started to invest more in equipment, in part with a view to increasing exports.

Growth in industrial production is estimated at 0.9%, as a result of growth in the extractive sector (+2%), which continued to expand during the 2015-16 crisis (at the end of 2017 it was up by 5.6% compared with the 2014 level). According to Rosstat, manufacturing output has not grown for three years. However, the HSE Development Centre's alternative index compiled on the basis of unaggregated data gives a somewhat different picture. The main difference from the official index relates to the fact that the latter does not include components of uncertain reliability, as a result of which the index is less volatile and, in our view, more accurate. This index showed that industrial output rose by 1.5%, which is only slightly more positive than the official figure, however the source of growth is not the extractive sector (up by 0.4%) but manufacturing (up by 2.6%), which at the end of the year is estimated to have exceeded the pre-crisis level by 2%. Both indexes show that although industry has recovered from its decline suffered during the crisis, it started to fall again in the second half of 2017. This is linked to the OPEC+ deal, the fall in gas extraction to more sustainable levels, and the weakness of internal demand for domestically produced goods.

The GDP correction in the third quarter indicates that the economic recovery is not unfolding as smoothly as might have been hoped, and the sharp decline in the index of primary economic sectors in the second half of 2017 reversed all the gains of the first half of the year. Current economic trends are not stable or uniform. Since 2014, only the resource sectors have recorded growth: agriculture (10%), mining (5.4%), cargo transportation (7.3%) and wholesale trade (2.6%). The rise in the price of Urals to \$63/barrel has increased optimism; however, even if prices remain at this level, they will not exert as a strong an influence on GDP in 2018 as in 2017 owing to the budget rule.

Alongside the rebound in GDP, the other important development in 2017 was the fall in inflation below the RCB target. Inflation fell to 2.5% year on year in February, an outcome few would have thought possible one-to-two years ago. This was a result of the stronger rouble and the moderately tight monetary policy of the RCB. In 2018 inflation will start to pick up as a result of the loosening of monetary policy and the stable exchange rate, supported by the budget rule. The RCB is likely to be able to keep inflation close to the 4% target going forward.

### ***3. Is another recession on the way?***

***The growth in investment that began in the first quarter of 2017 slowed sharply in the third quarter (or even turned negative, on a seasonally adjusted basis). The modest revival in bank lending to the real sector has been accompanied by a fall in profits, which given the high level of risk and weak domestic demand increases the potential for a further decline in investment.***

Investment grew by 2.3% in the first quarter, 6.3% in the second quarter and 3.1% in the third quarter. Seasonally adjusted data show that investment contracted in the third quarter (by 2.2%

compared with the previous quarter, compared with growth of 5.6% in the first quarter). Alongside weak consumer demand and export growth, the fall in investment led to a decline in GDP on a seasonally adjusted basis. We estimate it fell by 0.3% compared with growth of 1% and 0.9% in the first and second quarters respectively.

It should be noted that the investment growth of 4.2% recorded by Rosstat in January–September is to a significant extent due to recalculations of the volume of investment by small enterprises, which are not recorded by direct statistical methods. Rosstat estimates this investment at Rb2,451bn, which is around 25% of total investment. According to official statistics, this type of investment is estimated to have grown by 12% compared with the same period last year. At the same time, investment by large and medium-sized enterprises, which is calculated directly on the basis of their accounts, grew in January–September in real terms by just 1.6% compared with the same period last year. Moreover, the coefficient used by Rosstat to recalculate investment is based on 2015 figures, which may be elevated given the stagnant economy. In any case, it is clear that investment growth is slowing, putting in doubt the sustainability of Russia’s recovery from recession.

In the manufacturing sector, traditionally considered the weak spot in Russia’s economy, the most notable decline in investment was recorded in the automobile and wood processing industries. The former is likely due to expectations of weak domestic demand. The latter sector is export-oriented and may have suffered as a result of sanctions. It should be noted that the decline in investment has not only affected manufacturing, but also such “strong performers” as oil and gas extraction, which recorded a decline of 0.9%. There are several reasons for the decline in energy extraction: the agreement with OPEC, and an expected decline (or halt in growth) in oil prices, and broader uncertainty on resource markets. Output in the energy sector has to a significant extent been supported by investment made several years ago.

Investment in production and distribution of gas and electricity fell. Public investment in communal services has long been inadequate, and the sector is clearly not of interest to private investors either. Construction investment declined by 6.1%, despite spending on major projects such as the Kerch bridge and sports infrastructure. Investment declined most in hotels and restaurants, reflecting the fall in household income and demand, and the ease with which these services can be substituted.

Investment rose in some sectors, most notably leisure and sport. Investment in railways and pipeline infrastructure remained at its traditionally high level. The former has been supported by the restructuring of Russian Railways, and the liberalisation of the passenger sector, which has driven an increase in purchases of new carriages. Investment in the financial sector grew substantially (49%) – insurance is an attractive sector during a crisis. Several types of manufacturing also recorded a growth in investment, including clothing, textiles and leather goods. The textile market has recovered significantly since the 2014–15 crisis and has seen high internal demand. Production of coke and oil products has also grown, along with chemical goods, medicines, electronic goods, machinery and equipment and furniture.

There are clear imbalances in the level of investment. Investment in the extractive sector and associated infrastructure associated with storage and transportation, if combined with electricity production, water supply and waste processing, is around double the level of investment in manufacturing. There are no signs of a structural shift; in other words growth in investment activity is closely linked to current output, and there is almost no forward-looking investment. Many sectors are experiencing a crisis of falling output and investment (metallurgy, printing, optics).

In Russia, investment levels are determined to a large extent by the potential for self-financing – for the economy as a whole, the tendency to finance investment from retained profits (the relationship of investment to profit) is equal to 100%. In manufacturing, this figure is 56%, which indicates that external sources of long-term financing are very important for this sector. There were signs of a pick-up in lending in the second and third quarters of 2017: credit to the real sector turned positive after five quarters of decline. However, this growth is uneven: whereas lending reached Rb1,082bn in the second quarter, in the third quarter it fell to Rb443bn. Given weak figures for profits, there is little prospect of significant growth in investment activity. In the context of weak balance-sheet profits in the second and third quarters, when it fell compared with last year by 28% and 2.5% respectively, there are no clear prospects for significant investment growth.

Given the close relationship between output and investment, the prospects for increased investment demand are closely linked to the prospects for an overall rise in output (drawing on spare capacity), and as a result on factors constraining this growth. According to Rosstat, in November 2017 the factors most constraining growth in the extractive and manufacturing sectors were the uncertain economic outlook (which makes many long-term investment projects appear high risk) and weak internal demand. For electricity generation and other infrastructure sectors, the key factor is obsolete or deficient machinery and a lack of financing. If the surveys are compared with January 2017, it is clear that the constraints on growth have only declined in the extractive sector, while they have deteriorated for manufacturing, electricity generation and other infrastructure sectors. Given the weak outlook for growth in the extractive sector, this suggests the Russian economy is not in a position to escape stagnation and raises questions over the prospects of a new recession. It is too soon to talk of the start of a new recession, but increased attention should be given to monitoring the current state of the economy.

#### ***4. Profits in January-September: Contradictory Trends***

***In January-September 2017, despite production and sales costs growing faster than revenue, profits from sales rose; profits of profit-making organisations fell, but profit tax revenues increased; construction, whose performance improved in the first eight months, saw a sharp fall in performance in September; machine-building, by contrast, saw a two-digit rise in profit growth in September. Are these strange trends due to statistical quirks, or are other factors at play?***

According to Rosstat, revenue from sales in January-September 2017 stood at Rb117.4trn, an increase of 17.6% year on year. The cost of goods sold rose significantly faster (by 20.7% year on year), mainly owing to the rapid growth in producer prices in the extractive sector (up 14.6%), compared with processing (up 5.8%). Owing to an insignificant increase in commercial and managerial expenditure (up 3.1%), growth in expenditure on production and sales exceeded growth in revenue by 1 percentage point (up 18.6%). As a result, expenditure as a share of revenue increased to 93.3%, from 92.5% a year earlier. However, profits from sales increased by 4.9% year on year.

Despite the rise in profits from sales, the total balanced financial result (profits before tax) in January-September 2017 fell by Rb714bn or 8.8% year on year, after growing by Rb1.366trn (20.3%) in 2016. The difference in performance between 2016 and 2017 was due to the contribution of “other” income and expenditure in the overall figures, which was negative in 2017 and positive in 2016.

In 2014-16 the balance of “other” income and expenditure depended to a significant extent on the exchange rate. A weaker rouble boosted revenue in the oil and gas sector and reduced it in the manufacturing sector, while a stronger rouble had the reverse effect. As there are no data on profits from sales in the first quarter of 2017 by main types of economic activity (with the exception of the extractive sector) it is not possible to establish if this relationship has continued to apply. However, data from the extractive sector suggests that it remains in place.

The average interest rate fell by 15% on loans of up to one year, and by 18% on loans of more than one year. At the same time, lending increased by 12% year on year. As a result, in January-September 2017 total interest payments declined slightly by 1.2% to Rb2.38trn (30% of total profits).

One of the key profit indicators is the total balanced financial result (balanced profit before tax), which is calculated as the difference between two terms: the profit of profitable organisations and the losses of loss-making organisations. In January-September 2017, the profit of profit-making organisations fell by 7.8%, while the losses of loss-making organisations, by contrast, rose by 4.5%. In 2016, the situation was exactly the reverse: a rise of 13.5% in profit-making organisations and a fall in losses of loss-making organisations of 33.6%.

At the same time, revenue from tax on profits in the first nine months of 2017 rose by 16% year on year, compared with 2% last year. The sharp slowdown in 2016 and pick-up in 2017 was driven by changes in the sectoral structure of tax revenue. Over the first nine months of 2016, the biggest fall was recorded in the extractive sector of Rb112bn (-26%), and Rb127bn in the economy as a whole; the biggest growth in profit was recorded in the financial sector, of Rb181bn (a rise of 95% year on year), and the increase in the economy as a whole was Rb326bn. Over the nine months of 2017, the aggregate decline in profits was just Rb35bn, while aggregate growth in profits was Rb424bn. Tax arrears were insignificant and could not impact on the overall trend.

On average in 2006-16, profits in January-September account for 73% of total annual profits. On this basis, we expect that a balanced financial result of Rb9.9-10.4bn in 2017. Given the increase in the tax burden, organisations’ profits after tax in 2017 are expected to be 8% lower than in 2016, and just 1% higher than in 2015. This will clearly have a negative impact on investment trends.

## ***5. Balance of Payments – Excess Foreign Currency Earnings Flow Abroad***

***According to the RCB, the current-account surplus in January-November 2017 stood at \$35.6bn, and net capital outflows from the private sector reached \$28bn. Foreign currency inflows on the current account have increased in recent months. This has been offset by increased demand from the private sector for foreign currency. Oil prices have stabilised; if capital outflows remain at this level it may put pressure on the rouble in 2018.***

The main driver of the increased current-account surplus has been exports, owing to the rise in oil prices. At the same time, the value of non-hydrocarbon exports has barely changed. We estimate total exports in 2017 stood at \$353bn, while imports are estimated at \$237bn (growth of 24% year on year). As a result of the oil price rally, the value of exports outstripped imports, leading to a rise in the trade surplus. At the same time, other net outflows on the current account fell, leading to a rise in the current-account surplus, which we estimate could total \$43bn in 2017, or 1.7 times the 2016 figure.

Capital outflows picked up in from Autumn 2017. The RCB estimates that as of November outflows totalled \$4bn. This is a natural response to the higher current-account inflows. The key question is how sustainable these outflows will be. The outflows were mainly from the banking sector, which has experienced a surplus of foreign currency liquidity. Banks have continued to pay off their external debts, while also reducing foreign assets. However, outflows have also been driven by the fact that non-financial companies and individuals have increased their foreign currency purchases. These transactions tend to exhibit inertia. In mid-2017, foreign exchange cash assets held by the non-financial sector reached a record level of \$54.6bn. Foreign exchange holdings have increased steadily since the start of 2016 despite falling real incomes and the appreciation of the rouble.

The Ministry of Finance has also played an important role in currency markets, as rising oil prices have led to increased currency purchases by the ministry. From February to November the Ministry of Finance purchased \$10.3bn, and we estimate purchases of \$14bn in 2017 as a whole. However, this was fully offset by sales of sovereign rouble-denominated debt to non-residents. In other words, the Ministry of Finance's operations were neutral for the exchange rate.

In 2018, we expect the oil price to stabilise in the range of \$50-60/barrel. As a result, export values are likely to stagnate, while imports will continue to grow even with weak domestic demand, leading to a narrowing of the trade surplus by 1.5-2 times. At the same time, we expect net outflows to remain steady at a similar level to 2016-17, as a result of further cuts in the RCB's policy rate, and rising external interest rates, which will reduce the attractiveness of Russian assets. Foreign currency purchases are unlikely to decline given ongoing economic uncertainty. Non-resident purchases of sovereign debt may fall in the context of tightening western sanctions. As a result, we expect increased pressure on the rouble in the near future. However, sharp shifts in the exchange rate are unlikely, as the RCB is able to meet rising foreign currency demand through tried-and-tested mechanism of foreign exchange Repo auctions.