NATIONAL RESEARCH UNIVERSITY HIGHER SCHOOL OF ECONOMICS DEVELOPMENT CENTER

Commentary on State and Business

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Macroeconomy

1. Growth is not so simple

GDP rose by 1.5% in 2017 in real terms. However, past experience suggest that it may be revised up to 1.9% within the next two years. The drivers of growth were increased oil prices and a pick up in the global economy. Higher domestic demand largely went into imports, but domestic producers benefitted from record external demand.

According to Rosstat's first estimate, real GDP rose by 1.5% in 2017, after declining by 0.2% in 2016 and 2.5% in 2015. The return to growth was driven by the improved external environment. Thanks to the OPEC+ agreement, the Urals oil price rose by one quarter, from $42 to $53.3 per barrel. External demand for domestic goods and services reached the highest level since 2011, supported by an increase in global growth from 3.2% in 2016 to 3.7% last year (IMF estimate), the fastest rate of growth in six years. At the same time, the adoption of a new budget rule and the moderately tight monetary policy of the Central Bank acted as a brake on growth.

Both domestic and external demand rose in 2017, with private household expenditure rising by 3.4% year on year, after falling by 2.8% in 2016 and 9.4% in 2015. Retail sales volumes and services rose by just 1.2% and 0.2% respectively, suggesting that much of the rise in domestic consumption was directed to foreign goods and services (because of the stronger rouble). However, this factor alone is insufficient to explain the divergence in growth rates. It is likely that domestic household consumption was higher than the services and retail sales volumes data would suggest.

Gross capital formation rose in 2017 by 3.6% and inventories also contributed 1 percentage point to GDP growth. Public consumption fell by 0.9% owing to ongoing budget consolidation. Overall, domestic demand contributed 3.4 percentage points to GDP growth in 2017. The growth in domestic demand was accompanied by a rise in import volumes of 17%, supported by a 16% appreciation in the real effective rouble exchange rate. After accounting for imports, we calculate that no component of domestic consumption made a significant contribution to GDP growth. All of the 1.5% growth in GDP in 2017 was driven by goods and services exports, which rose in real terms by 5.4%, largely owing to increased sales of food, metals, gas and services.

Looking at GDP by production, growth was supported by the majority of the sectors of the economy: industry, trade, transport, commercial services etc. Almost half of the growth in GDP came from wholesale and retail trade, and transport and storage, which rose by 3.1% and 3.7% respectively. Gross value added (GVA) declined slightly in construction, education, and health owing to budget consolidation.

Quarterly GDP data are only available up to September 2017, and may not entirely match the annual estimate. Nevertheless, the seasonally adjusted figures show a correction in GDP in the third quarter after 1% growth quarter by quarter in the first half of the year (not annually adjusted). The index of basic economic sectors, which is calculated on the basis of preliminary Rosstat data, shows that economic activity fell in both the third and fourth quarters of 2017 as a result of a decline in industry and cargo turnover. This may reflect a decline in external demand and lower investment.

The weak performance in the second half of 2017 clearly held back the annual GDP figure. However, it should be recalled that this is Rosstat's first estimate for 2017 growth. Rosstat often makes significant adjustments to its estimates, in the majority of cases leading to an upward revision. Since 2005 GDP was only revised down on one occasion (by 0.4 percentage points in 2008; on three occasions it was left unchanged). In all other cases, the upward revision was between 0.1 and 1.5 percentage points. The average revision in 2005-16 was +0.4 percentage points. It is likely that 2017 GDP will be revised up from 1.5% to 1.9%.

The Real Economy

2. Russian Industry: stuck in the starting blocks

Bulletin 144 examined the trend towards stagnation in Russia's economy. Year-end results show the trend was not just of stagnation, but even of decline. Russian industrial output fell towards the end of the year. However, some indicators give some cause for optimism.

In November 2017 the Index of Industrial Production (IIP) fell by 3.6 percentage points compared with November 2016. In December the IIP declined by 1.5 percentage points. The decline affected all major areas of production. The main contributor to the growth in production in 2017 was mining, which suggest there are significant constrains on further growth in output in this sector and in the economy as a whole. At the same time, seasonally adjusted industrial production in the final two quarters of 2017 fell on a quarterly basis according to both Rosstat data and our own estimates. In particular, according to Rosstat industrial output fell in the third quarter by 1.5 percentage points and in the fourth quarter by 1.2 percentage points. We estimate a decline of 2.7 percentage points and 2 percentage points respectively. It is too early to talk of anything other than a technical recession at this stage given the volatility of this data. There are clearly objective reasons for the slowdown: the conclusion of construction of infrastructure for the World Cup, reduced budget financing for the defence sector, and a reduction in the contribution of inventory accumulation to overall output. Rosstat surveys show that both mining and manufacturing enterprises regard their current inventory levels as too low (in a clear contrast with the situation in 2009), however they are not building them up in the hope of high demand in the second half of the year. While 2008-9 saw a typical inventory recession, in this case there is only a technical recession of negative sentiment, driven in part by uncertainty.

The pharmaceutical and automotive industries were the fastest growing sectors. The low base year played an important role for the automotive sector, but state support and more expensive imports were also significant. A number of consumer sectors recorded significant growth in output, such as furniture and textiles. The decline in oil and gas extraction, which began in Autumn, continued in the final months of the year. Given the large share of hydrocarbon extraction in industry, this sector may move from being a driver of growth to a brake on economic expansion.

In contrast to 2015-16, 2017 saw rapid growth in the production of textiles, cars and other finished goods, which reflects both ongoing import substitution on the supply side, and a recovery in household borrowing on the demand side. While consumer lending stagnated in 2016, in 2017 it grew by more than Rb1.27trn, or around 11% (as of 1st December 2017). This has led to a revival in the production of consumer goods despite a further decline in real disposable income in 2017 (admittedly at a much slower pace than in 2015-16).

A similar situation is evident in the investment goods market. According to Rosstat, investment in fixed capital grew by 4.2 percentage points in January-September compared to the same period of 2016. This was despite a fall in balance-sheet profits of 4% (in January-November). Investment was supported by the financial sector, in the form not of bank lending (as with households) but increased bond placements. The value of corporate bond placements increased by more than Rb1.27trn in 2017, five times more than the increase in bank lending to the corporate sector.

An important determinant of the outlook for 2018 will be whether bank credit and bond issuance continues to grow, or whether consumer borrowing will come to a halt, perhaps as a result of tightening lending conditions (as representatives of the Central Bank have hinted). Several international organisations, including the Bank of International Settlements (BIS), have noted the potential for further lending growth, given the negative credit-to-GDP gap. BIS data show that bank lending to the non-financial sector was 80% of GDP in mid-2017, compared to an average for developing markets of 190%. However, these estimates are only indicative, and credit growth depends not only on the Central Bank's monetary policy but also on the general investment climate.

There are two significant obstacles to credit-driven growth. First, the economy remains closely linked to oil prices, which could fall rapidly in the event of a double shock (of both demand and supply). A supply-side shock could come from China, where there are indications of overheating in the lending market, and overheated property markets in a number of countries. A demand-side shock could arise from a further rapid increase in production in the USA. Second, significant economic uncertainty means the problem is not so much of supply as demand for investment to restructure production, continue import substitution and expand export markets.

The rise in the oil price should lead to a recovery in industrial growth, although the impact of the higher oil price may be dampened slightly by the new budget rule. The recent weakening of the rouble, the multiplicator effect of inventory accumulation, and the rise in business confidence (leaving aside fears over further US sanctions) could lead one to suppose that Russian industry is on the threshold of a new growth cycle.

However, this new cycle has been delayed for now. In January, according to Rosstat data, the seasonally adjusted index of producer confidence in the manufacturing sector fell significantly. While the rate of decline in oil production slowed to -1.5% year on year, against -2.3% in September-December on average in 2017, the growth in coal production slowed in January to 1.8%, compared with average growth of 6.8% in September-December. Gas production in January 2018 fell to 3.2% compared with the same period of last year.

In the absence of a new growth model, any recovery in growth in Russia will be unstable. The oil price could quickly fall in response to either a geopolitical shock or a slowdown in the global economy. The IMF and World Bank forecast that the output gap in developed countries will drive an acceleration in growth in the global economy in 2018. However, when this factor is exhausted, growth will return to its potential level, determined by the weak investment activity in recent years and slowing productivity growth. Growth will be around 1 percentage point lower than over the past decade, which will weigh on the oil price. Rising US interest rate will also impact growth in developing countries.is

An alternative to debt-driven growth, which is risky for a commodity-exporting economy, is a growth model built on foreign direct investment (which is characteristic for commodity economies that have experienced a sharp currency devaluation). However, foreign investment in Russia remains far below the pre-crisis level of $69bn in 2013. Developing such a model requires a reduction in uncertainty, which is an equally large challenge for both Russian and foreign investors. Reducing uncertainty (beyond reducing geopolitical tensions) requires the development of a clear and long-term development strategy to improve the business climate and simplify procedures for starting and winding up businesses.

Balance of Payments

3. A deficit of direct investment

According to Central Bank estimates, the current-account surplus in the fourth quarter of 2017 rose to $18bn (up 73% year on year) and exceeded $40bn for the year as a whole (2.5% of GDP compared with 2% a year earlier). This was a result of the positive trade balance and a slowdown in the deficit for non-trade transactions. Increased currency inflows on the current account were largely absorbed by higher private capital outflows, which stood at $15bn in the fourth quarter and $31bn in 2017 as a whole.

Goods exports stood at $354bn in 2017. Exports of other goods (excluding fuel) picked up at the end of the year. Seasonally adjusted figures show that this goods category grew by 8.6% in October-December (quarter on quarter) compared with 5.7% in the third quarter. Non-fuel exports (more than a quarter of which are metals, machinery and chemicals, each of which accounts for around 18% of the total, along with 15% for food) have been growing for two years, and their value has reached a historic maximum, mainly because of higher prices.

Annual imports stood at $238bn, up 24% year on year. Imports accelerated in the final quarter of the year. The value of imports rose by 4.8% compared with the third quarter on a seasonally adjusted basis, after a slowdown in quarterly growth from 10% in the first quarter to 3% in the third quarter. The main source of import growth was machinery and vehicles. The growth in imports reflects both the gradual recovery in private demand and the weakness of import substitution policies. The seasonally adjusted non-trade deficit in the fourth quarter of last year fell by more than 5%, fully offsetting the weak growth in the previous two quarters. Services and income flows recorded similar deficits during most of 2017. The rise in the service deficit was largely the result of higher flows of Russian tourists abroad, particularly after the removal of restrictions on tours to Turkey. The reduced income deficit was the result of the rapid paying down of external debt, particularly by banks.

Alongside these factors, the rise in the value of fuel exports in the second half of last year led to an increase in the current-account surplus. Overall, the current-account surplus stood at $40bn, up by 1.5 times compared with a year earlier.

The counterpart to the rising current-account surplus in the context of a favourable external environment was an outflow of capital. Over the last three years around 80% of the current-account surplus has been matched by net capital outflows. In the fourth quarter of last year capital outflows reached $15bn (83% of the current-account surplus) and over the year as a whole they exceeded $31bn (78% of the current account, the same level as 2016 but slightly lower than the 84% recorded in 2015). Capital outflows were equivalent to 2% of GDP against 1.5% of GDP in 2016, which was a record low for the past ten years.

Net capital outflows in the fourth quarter came from both banks and enterprises, but the former was larger. Alongside debt service, this could reflect the withdrawal of funds from several major banks (Yugra, Otkrytiye, B&N Bank, Promsvyazbank). A fall in capital outflows from other sectors is likely the result of the elimination of "grey" capital outflows (the sum of 'suspicious flows,' 'other operations,' and also 'net errors and omissions.' This has been helped by the Central Bank's moves to clean up the banking sector.

The rise in capital outflows from the private sector at the end of last year was a result of both an increase in foreign assets and a reduction in foreign liabilities. Both enterprises and banks built up foreign assets, however only banks have been reducing their foreign liabilities, which fell to $105bn at the start of 2018 (a halving compared with the record level of four years ago). Enterprise external debt has barely changed over the last three years, remaining at $350bn. However, foreign direct investment flows to the real sector turned negative for the first time, recording a net outflow of $1.6bn. It is possible that this is linked to the acquisition of a 14.16% share in Rosneft by CEFC from the Swiss commodity trader Glencore and the Qatar investment fund QIA. The overall value of the deal was $9.1bn, including a $5bn loan from VTB against Rosneft shares. Excluding this transaction, net FDI inflows may have been $3.5bn. However, taking into account reinvested income, which we estimate at $2.6-4.4bn, it seems likely that in the best case there was no new direct investment, and in the worst a small net outflow.

While oil prices steadily rose from the middle of the year (from $45/barrel in June to $68/b in January 2018), the value of the rouble was more volatile, (moving within a corridor of Rb56-61/$1), although there was a clear trend of appreciation. The further strengthening of the rouble in 2018 will be constrained by growing outflows of capital from the private sector (in particular because of more rapid monetary easing as a result of low inflation); higher foreign currency purchases by the Ministry of Finance (up to $46bn if oil prices average $63/barrel); double-figure growth in domestic demand for imported goods and services.

A tightening of sanctions could lead to increased rouble volatility. However, these could lead to both an outflow of capital held by non-residents from the Russian economy and a reduction in foreign investment, as well as the repatriation of capital from abroad. Given high oil prices, the pressure on the rouble in the coming months is likely to be limited. However, we expect the oil price to fall in the second half of the year as production picks up in the US and inventories start to accumulate. Given this, the most likely scenario is a depreciation of the rouble to Rb60-65/$1 by the end of the year.

Budget

4. A year of budget consolidation

According to preliminary data, in 2017 federal revenue was Rb15.1trn, up 12.1% year on year, while expenditure was almost unchanged in nominal terms. The Ministry of Finance is continuing to reduce the budget deficit. While the Reserve Fund has been wound down, the Ministry of Finance has built up significant reserves through the budget rule; however tight fiscal policy is acting as a break on fiscal policy.

Relative to GDP, revenue rose by 0.7 percentage points to 16.4%. The biggest contribution came from hydrocarbon revenues, which rose by 23%. The share of hydrocarbon income in total revenue stood at 39.6% (compared with 37% as projected in the budget).

Non-oil revenues rose by 5.8% year on year. VAT revenue from domestic sales rose by 15.5%, while revenue from duties increased by 44% (helped by the redistribution of duty on motor fuel in favour of the federal budget). Profit taxes rose by 51%, in part owing to a redistribution of 1 percentage point of the tax rate to the centre (from 2 to 3 percentage points). VAT on imports increased by 8%, revenue from import tariffs rose by 3.4%.

Federal expenditure in 2017 stood at Rb16.4trn, almost unchanged from 2016 in nominal terms, and down by 1.3 percentage points as a share of GDP. Expenditure has been falling in real terms for three years – in 2017 it was down by 3.6% in compared with 2016, and by 14% compared with 2012. The federal budget deficit in 2017 stood at Rb1.3trn, or 1.45% of GDP. This was funded in part by domestic borrowing of Rb1.1trn. Rb617bn was drawn down from the National Welfare Fund (NWF) to cover the deficit in the pension fund, and Rb1trn was withdrawn from the Reserve Fund, which ceased to function at the start of 2018. In total, therefore, the ministry of finance accumulated funds of Rb2.7trn. From February to December the Ministry of Finance spent Rb827bn to purchase foreign currency in line with the new budget rule. A further Rb126bn was used to pay down foreign debt. Thus, resources in the NWF and Reserve Fund allowed the ministry of finance to finance part of the budget deficit, build up foreign currency reserves equivalent to around US$14bn, and increase its funds on account to Rb450bn. Despite the winding down of the Reserve Fund, therefore, the Ministry of Finance has other reserves alongside the NWF.

The reduction in spending fell primarily on the defence sector, reducing expenditure to the 2014 level of 3.1% of GDP, which is still relatively high (the higher expenditure in 2016 was partly linked to the need to pay down loans taken on by the defence sector). Spending on health fell as a share of GDP from 0.6% in 2016 to 0.5% last year – almost half the 2012 level. Social spending continued to climb, reaching 5.4% of GDP, from 4.4% in 2014 despite the fact that second-pillar pension contributions have been frozen, and pensions for working pensions have not been indexed to inflation. Further measures are required to prevent pension payments swallowing all federal expenditure.