NATIONAL RESEARCH UNIVERSITY HIGHER SCHOOL OF ECONOMICS DEVELOPMENT CENTER

Commentary on State and Business

150

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Composite Leading Indicator

1. Composite Leading Indicator

In February 2018 the Composite Leading Indicator (CLI) was virtually unchanged at a relatively high level (3.8% compared with 3.7% in January). It is possible that the positive developments observed in many sectors at the start of the year will prove more stable than initially thought.

The most positive impulse came from oil prices. Urals oil averaged $63/barrel in February, 18% higher than in the same month of last year. With oil prices at this level, Russia will avoid any adverse scenarios this year.

According to OECD surveys, new orders rose for a fourth month a in a row in February. This trend is looking increasingly stable, suggesting a recovery in domestic demand, the most important factor in economic growth. The expanding money supply and falling interest rates are also providing tailwinds.

The CLI suggests that another recession is not imminent. On the other hand, there are currently no grounds to forecast a transition to sustained and dynamic growth. Currently, the most likely scenario is weak growth with short positive and negative fluctuations.

Regional Economic Indicator

2. The Composite Index of Regional Economic Activity: Broad-Based Growth, but for How Long?

In January 2018, the Composite Index of Regional Economic Activity (REA) rose to 66.8%, its highest level since the start of 2013. After a year of treading water, this is a relatively large change. If this change is sustained, it will indicate that Russia's regions are finally coming out of their local recessions. Four out of five key sectors of the economy and all eight federal regions recorded a score above 50%, which suggests a broad-based improvement, at least on a geographic basis.

The only problematic sector in January 2018 was construction, where the REA stood at 40%, indicating weaker performance in a majority of regions compared with last year. In the other sectors the REA index was significantly higher: in wholesale trade it stood at 63% in industry and paid services, 71%, in retail trade it was 89%.

On a Federal district level, the best performance in January was in the Volga Federal District (76%); a similar score was recorded in the Urals Federal District (75%), the North Caucasus Federal District (74%) and the Central Federal District (72%). Growth in the Siberian Federal District and the

Southern Federal District was weaker (58% and 55% respectively), but here also economic activity rose compared with last year.

On a regional level, the January REA exceeded 50% in 68 federal subjects out of 82. There were no regions where none of the sectors recorded growth, and the number of regions where only one sector recorded growth fell from nine to four. The number of regions where four or five sectors recorded growth rose from 21 to 38. The share of regions in which four or five sectors of the economy recorded growth was close to the level expected during a phase of moderate economic growth.

The four most problematic regions with a REA of 0 or 20% accounted for just 2.7% of Gross Regional Product. The most successful regions in January were Belgorod Oblast, Kostroma Oblast, Tambov Oblast, Leningrad Oblast, Penza Oblast, Sverdlovsk Oblast, Ingushetia and Chechnya. All five sectors recorded growth in these regions. A further 30 regions recorded growth in four out of five sectors. These two groups account in total for 37% of Gross Regional Product.

Real Economy

3. Investment and Economic Growth: Which Comes First?

Fixed capital investment grew by 4.2% in 2018. This rate of growth will not deliver an increase in the share of investment in GDP to 25% by 2025 as President Vladimir Putin has instructed the government and Central Bank to deliver. However, international experience shows that investment is often not only a precondition but also a consequence of economic growth. Increasing investment is an important goal, but there are also other important factors which are not directly linked to investment that could stimulate economic growth.

According to Rosstat, growth in investment in fixed capital in 2017 including the informal economy was 4.2% year on year (after falling by 0.2% in 2016). However, growth was uneven: investment rose by 1.4% year on year in the first quarter, 5% in the second quarter, 2.2% in the third quarter and 6.4% in the fourth quarter. Overall, Rosstat's figures and our estimates of seasonally adjusted quarterly growth point to a pick-up in investment growth from the start of last year, which slowed somewhat in the second quarter. Earlier statistical adjustments were significant, and estimated growth rates exceeded the figures based on financial data provided by large and medium-sized enterprises. Nevertheless, the final investment estimate for 2017 for all companies and the estimate excluding small businesses did not differ significantly from the estimate prepared using indirect statistical methods – at 4.4% and 4.2% respectively. We conclude that investment activity not captured by direct statistical methods did not grow by more than 5%.

Nevertheless, we continue to view the pick-up in investment in 2017 as fragile and unsustainable in view of the divergent trends in investment finance and rising risks, despite increased support for investment from the banking sector in the second half of the year. Bank lending to the non-financial sector rose by more than Rb800bn in the fourth quarter in nominal terms, after growing by less than Rb450bn in the third quarter. While balance sheet profits in the economy rose over this period by almost Rb240bn in nominal terms, they were down compared with the previous year (by 22% in the fourth quarter and by 7.8% over the year as a whole).

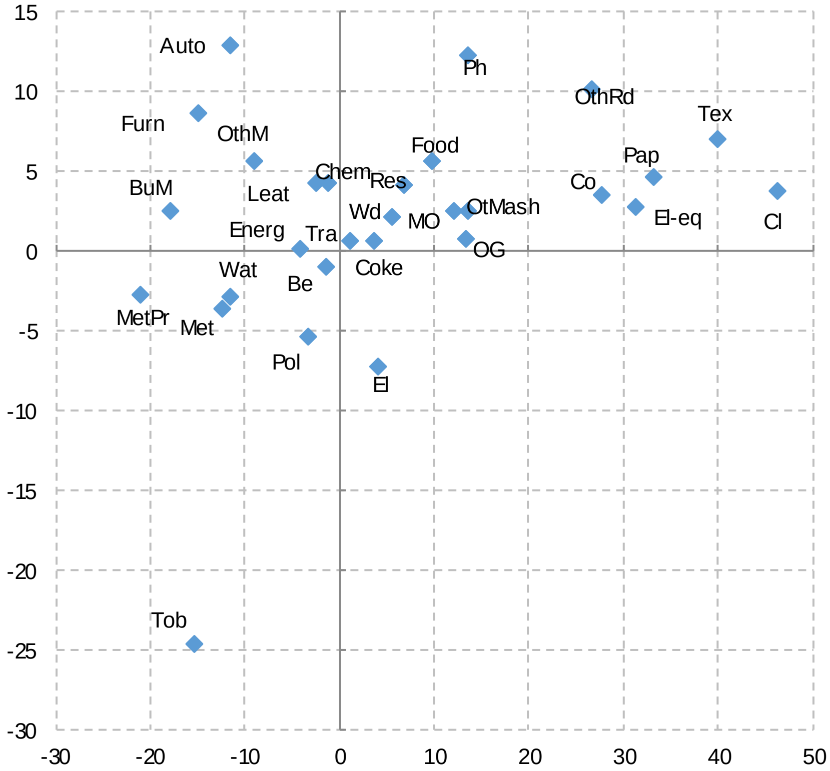
President Putin has instructed the government and Central Bank to prepare measures to raise the investment rate to 25% of GDP by 2025. What is needed to achieve this? In 2016, capital investment was 20.7% of GDP; in the first three quarters of 2017 it averaged 18.3% of GDP. If we assume investment in 2017 as a whole was 21% (taking into account the strong fourth quarter), and GDP growth of 3.8% a year (exceeding by 0.3 percentage points the rate of growth in the global economy, which we assume will be 3.5% a year), we estimate that investment must grow at around 6% a year, significantly higher than the 2017 growth rate. Below we present a baseline three-year forecast using an econometric model. This shows that investment will continue to grow but will be insufficiently high to meet the target set by the president. Of course, if Russian GDP grows by less than 3.5% a year it will be easier to achieve this goal. If GDP were to grow by 2% a year, investment growth of 4.2% a year would be sufficient to meet the target. However, we assume in this exercise that raising GDP growth to a level above the global average is a higher priority.

How realistic is an investment growth rate of 6% a year or higher? It should be noted that investment growth was uneven on a sectoral level. While investment in the extractive sector was almost flat in the first three quarters, it grew strongly in the final quarter of the year. Over the year as a whole, investment in the sector rose by 13.4%, contributing 2.2 percentage points to overall growth in investment in the economy.

Investment in manufacturing was only slightly higher than investment in the oil and gas sector alone (Rb1921bn and Rb1873bn respectively: overall investment in the extractive sector was Rb3025.5bn). The manufacturing sector overall made a negative contribution to the investment trend. The worst trend was recorded in metallurgy, where investment fell by 16.7% compared with 2016. The crisis in the metallurgy sector is a global phenomenon owing to overcapacity, low profitability and stagnation of consumption. Investment was also low in the automotive sector, falling by 11.6% year on year.

Certain manufacturing sectors have performed well, however, including producers of medicines, oil products, and some types of machinery. Investment in the production of medicines has long been at a relatively high level. Production of peat coal and oil products (sectors directly connected with raw materials) and electronic and electrical goods have also performed well. Transportation and storage remain attractive sectors given the prospects for investment in railway and pipeline infrastructure. In the service sector, the biggest contribution comes from insurance and financial services.

Figure 1 provides a scatter plot for industry, showing investment growth on the horizontal axis and production growth on the vertical axis. The top-right quadrant shows sectors where rising investment is accompanied by growth in production. The bottom left quadrant shows sectors where output is growing despite falling investment. These are sectors with spare capacity that currently do not require major investment or sectors with insufficient investment but high potential. The bottom-right quadrant contains sectors undergoing reorganisation (where investment is growing despite falling output), or sectors that are not capable of growing significantly. The lower-left quadrant contains sectors that are not attractive for investors, where output and investment are both falling.



The greatest number of sectors are in the top-right quadrant, where the upper boundary for investment and production is represented by clothing, textiles and manufacturers of other finished goods and medicines. The automotive sector recorded the highest growth despite falling investment. Furniture production and precious minerals extraction are in a similar situation. Metallurgy, printing, water supply, drinks manufacturers and tobacco manufacturers recorded both falling investment and output. Only electricity production recorded rising investment together with falling output.

There are no clear signs that industry is undergoing a period of restructuring. Investment growth is closely linked to current output levels. With the exception of electricity, there are no sectors where investment is being made with a view to future returns. A number of sectors are experiencing an output and investment crisis (metallurgy, printing, drinks and tobacco manufacture).

How will investment develop in the future? We have constructed an econometric regression model, with investment as the dependent variable, and GDP growth (as a proxy for capacity usage), oil prices, profit relative to GDP and lagged consumer inflation as the regressors. Our calculations show that oil prices do not have a significant impact on the current investment level: recall that investment started to slow when oil prices exceeded $100/barrel.

Our regression analysis shows that the most significant factor determining the investment rate is the current level of economic growth. The previous year's inflation rate and the industry saving rate are also significant. In other words, investment, as one would expect, depends on self-financing (company profitability) and price stability, and, more unexpectedly, may be consequence rather than a cause of economic growth.

This should not be a big surprise. Studies have shown that investment is not as a rule the main factor leading to an acceleration in growth – this is usually an increase in exports. However, investment is an important factor preventing a slowdown in economic growth. Of course, this is not an iron rule, but a stylised fact of global economic development. It is nevertheless worth keeping it in mind when seeking to increase the rate of growth to above the global average. While it would be beneficial to raise the investment rate to 25% of GDP, which will help to make growth sustainable in the medium and long-term, it is also important to identify the factors that can kick-start growth now.

Based on the baseline three-year forecast of the Ministry of Economic Development, investment is projected to grow by 5.5% in 2018 and 2019 and by around 5.7% in 2020, while GDP will rise by 2.1-2.3% a year and inflation will be 4%. Based on our econometric model, if GDP growth accelerates to 3.5% a year, investment growth will rise by no less than 1 percentage point a year. The question is how to raise economic growth now, acknowledging the importance of investment and also that there are other factors aside from the investment rate that are holding back growth. These include economic uncertainty and low demand, and a whole range of factors constraining exports. Export brings additional funds into the economy, encourages companies to compete with strong rivals and to move into rapidly growing segments of the global market (as opposed to the weakly performing Russian economy). As a result, creating conditions for the expansion of exports could serve as a useful benchmark for the new government.

Population

4. Incomes are Falling, Consumer Spending is Growing

A rise in real earnings and pensions in 2017 (by 3.4% and 3.6% respectively) led to the stabilisation of per capita real incomes in 2017. Per capita real income in 2017 was 99.9% of the 2016 level (despite a decline in real income from business activity and property by 2.6% and 15.4% respectively).

However, real *disposable* incomes continued to decline, although at a slower rate of 1.7% compared with 3.2% in 2015 and 5.8% in 2016. One of the reasons for this was the increase in compulsory payments and charges (by 5.3%). The decline in disposable income did not lead to a fall in real spending on goods and services, which rose by 2.6%. This growth was financed not only from current incomes but also by drawing down on savings, reducing currency purchases, and through borrowing. The fall in interest rates led to a pick-up in mortgage borrowing, the total volume of which rose by 37.2%. 11.9% more cars were sold than in 2016. The purchasing power of consumption of a wide range of basic goods rose. The composite consumer confidence indicator and private indicators of consumer expectations improved over 2017.

According to official statistics, the stabilisation of real household incomes in 2017 covered all parts of the population, so the social-economic differentiation of the population remained almost on the same level as in 2016. In 2017, earnings of junior medical staff and doctors rose (by 16.1% and 11.4 respectively, compared with an average earnings growth of 7.2%) and also of university lecturers (of 16%). Earnings of teachers and nurseries grew more slowly (by 4.7% and 5.6%). Growth in car sales was largest for Ladas, which indicates that not only high-income groups were increasing purchases. The high-end sector of the market recorded a decline in sales.

The Ministry of Economic Development's forecast for 2018-20 projects real wage growth of 4.1% (baseline scenario) and real disposable income growth of 2.3%. The real pension level will remain on the 2017 level. This is based on a GDP growth rate of 2.1% in 2018, and growth in real disposable incomes in 2017 of 1.3%. The Consensus-Forecast of the HSE Development Centre assumes a lower rate of growth in 2018 of 1.7%. There are therefore few grounds to expect a significant increase in real disposable incomes in 2018. Although a revival in consumption was recorded in 2017 despite declining real disposable incomes, this pick-up may come to an end in 2018 (for example, an increase in excise duties and scrappage charges could hold down car sales).

Balance of Payments

5. Current Account: Prospects for Non-Resource Exports

In his address to the Federation Council on March 1st, the President called for non-resource and non-energy exports to be increased to $250bn over the next six years, and to increase machinery exports to $50bn. According to our estimates, to achieve this would require annual growth in exports volumes must be no lower than the annual average over the past twenty years.

There is currently no formal definition of non-resource, non-energy exports. Under the Tax Code, resource goods include mineral products, chemical products, timber and timber products, charcoal, precious and semi-precious stones, precious metals, non-precious metals and products from them. The government is currently drawing up a list of product export codes that will be categorised as resource goods. However, the export figures quoted by the president are based on alternative methodology used by the Russian Export Centre. The main difference is that this methodology categorises some products from the metals, precious metals, chemical and pulp and paper industries as non-resource goods.

The value of non-resource exports according to this methodology is very similar to the value of non-energy exports. Below, we use non-energy exports as a proxy for non-resource exports. As of 2017, the value of non-energy exports was US$146bn. In 2001-07, non-energy exports grew by three times, while machinery exports doubled, food exports increased by six times and metal exports by three times. In other words, in the recent past there has been a six-year period where non-energy exports have increased by several times.

Four product groups account for the majority of non-energy exports: metal production (26% at the end of 2017, while the maximum share over the last two decades was 40%), machinery (19% and 23% respectively), chemical products (16% and 21%), food (the maximum level of 14% was recorded in the last two years). Paper and pulp, precious metals and stones, and also other export groups in total accounts for 24% of non-energy exports in 2017 (with a maximum over the last twenty years of 27%).

Russia's key trading partners for non-energy exports are China, Kazakhstan, Belarus, the US and Turkey. Other important counterparties are Egypt, the Netherlands, Ukraine, Algeria, India, Germany, Finland, Korea and Switzerland. Given tightening sanctions and rising trade protectionism, increasing non-energy exports to European countries, North America or Ukraine looks doubtful. At the same time, Russia's participation in the BRICS, EEU, SOC, and the possibility of their further expansion could help to expand exports to their member countries. Total non-energy exports to China, Kazakhstan, Belarus, Turkey, India and Egypt in 2017 exceeded the pre-crisis level and stood at $47bn, or 37% of the total. In 2017 non-energy exports to these six countries rose by 28%.

The highest rate of growth in the value of non-energy exports was recorded in Kazakhstan and Belarus, which have the closest trade relations with Russia within the EEU. Given strong competition in countries in the "far-abroad," Russia's share in total imports of the other four countries does not exceed 6%, and in the case of China is less than 1%. Russia must make significant efforts to expand or even maintain its position on western markets. India, which is traditionally a major importer of Russian arms, has recently sought to diversify its military imports and to increase the level of localisation of production.

The prospects for growth in the value of non-energy exports depend to a significant degree on growth in physical volumes. The average growth in price of the four largest product groups has been close to zero over the past twenty years.

Our calculations show that a doubling in non-energy exports in six years, as put forward by the President, is only possible if physical volumes grow at the same rate as over the last twenty years. If oil prices reach $80/barrel by the end of 2024, the value of exports according to our forecast could reach $538bn. Should non-energy exports double, they will account for 46% of total exports, compared with 41% in 2017. Several conditions must be met in order to achieve this.

In order to boost exports, the President has called for the removal of all administrative barriers and create a favourable environment for companies focused on foreign sales. However, rapid export growth requires modern products that are competitive in terms of quality and price. Achieving this requires above all else investment in fixed assets, the import of modern machinery and a favourable external environment.

No experts expect the global economy to reach the pre-crisis growth rate in the medium term. The low growth potential of the Russian economy and western sanctions will constrain investment. Low domestic demand will limit import growth. In this context, it is unlikely that machinery production will grow again by several times in the coming six years. There is also a significant risk of further sanctions, increased protectionism and a sharp slowdown in growth in the global economy.

Budget

6. An Assessment of Regional Budgets in 2017

In 2017 the consolidated budget of the regions recorded a small deficit off Rb52bn. This was thanks to an increase in the number of regions that ended the year with a surplus compared with 2016 and 2015 and the cautious spending policies of the majority of regions. Nevertheless, a significant number of regions face serious problems balancing their budgets.

Expenditure of Russia's regions rose by 8.8% in 2017 in nominal terms, and by 4.9% in real terms. Real expenditure growth in 2017 followed a sharp fall in 2015 and 2016. It is too early to speak of a recovery in expenditure in real terms to the pre-crisis level. Regional expenditure in 2017 was 10% lower than in 2012. Many regions have set their spending policies around the need to stop or limit the growth in regional debt.

The difficult financial situation in the regions led to a reduction in investment spending, but also affected the social sphere. In 2017, expenditure on education rose by 4.9% in nominal terms, and by 1.8% in real terms. As a result, in 2017 spending in real terms was the same level as in 2011. In other words, in six years there has been no increase in education spending.

The aggregated regional budget deficit in 2017 was equivalent to 0.06% of GDP. In 2016 it was 0.015% of GDP. Formally, the budget is much better balanced than in 2013-15, when the deficit was respectively 0.9%, 0.6% and 0.2% of GDP. In 2016, a major factor reducing the budget deficit was the significant surplus recorded by Moscow (Rb116bn). In 2017 the surplus in Moscow fell to almost zero, but other regions significantly reduced their deficits. Whereas in 2015 76 regions recorded a budget deficit, in 2016, this had fallen to 56 regions and in 2017 it was down to 47. Nevertheless, the budget position of a number of regions has deteriorated.

The majority of regions that had problems balancing their budgets in 2018 had similar problems in 2016. The exceptions are Leningrad Oblast and Chukotka Autonomous Region, which in 2016 recorded budget surpluses. In the majority of problematic regions, the relative size of the budget deficit rose in 2017. The regions that recorded a budget deficit in 2017 include relatively developed regions such as St Petersburg, Leningrad Oblast and Moscow Oblast, which do not have the largest debt burdens relative to income. At the same time, there is a cluster of problematic regions with a high relative level of debt and chronic budget deficits. As of January 1st 2018 the overall debt of these regions and municipalities was Rb2683bn, 1.3% lower than at the start of 2017.

The structure of regional debt over the past six years has been characterised by a significant increase in the share of budget credits in 2016-17. In 2017 several regions returned to the debt markets or increased their presence on them, which is a positive structure change. This is the case for Moscow Oblast, St Petersburg and Krasnodar Krai.

The regional debt burden is calculated as the relationship between the debt level and tax and non-tax receipts. In Russia as a whole at the end of 2017 the debt burden of Russia's regions stood at 30%. It exceeded 50% in 42 regions, and in four regions it exceeded 100%. These four regions are the Republic of Mordovia, Kostroma Oblast, the Republic of Khakassia, and the Republic of Karelia. The debt burden in Mordovia reached 200%. Half of the 20 regions with the highest debt budgets also recorded the largest budget deficits. This supports our view that a cluster of problematic regions has emerged that are struggling to reduce their debt levels with support from the federal centre.

Across Russia as a whole, the ratio of the budget deficit to regional budget revenues in 2017 compared with 2016 rose slightly. In Russia as a whole all types of revenue rose in 2017 compared with 2016, however budget expenditure also increased. Moscow played a significant role here. Overall regional expenditure rose by 8.8% in 2017, whereas it increased by 21% in Moscow.

Overall in 2017, regions were able to significantly increase their tax and non-tax revenues in part by removing tax breaks. Transfers from the federal budget continued to decline as a share of regional income. Regional expenditure rose slightly in real terms compared with 2016, but is just 88% of the 2012 level. The rise in expenditure in real terms in 2017 was driven by rapid growth in expenditure in several major regions, in particular Moscow and St Petersburg. The number of regions ending the year with a budget deficit compared with last year fell significantly. At the same time, a cluster of depressed regions has emerged which suffer from chronic budget deficits and need additional state support. Overall, the figures point to a slow improvement in the economic and budget situation in the regions. But if the improvement continues at this pace, it will take a long time to recover to the expenditure level of five years ago.