FOCUS

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Russia – from recession to recovery, but to what extent and how fast?

Between 1999 and 2008, Russia's GDP grew by an average of almost 7% per year. In 2009, the fall in oil prices led to a severe recession (-7.8%). Subsequently, the effect of factors that had supported growth ceased. The further fall in oil prices in the mid-2010s, coupled with an unfavourable international context (declining demand in Europe, sanctions, etc.), led to a contraction in activity for two consecutive years (-2.8% in 2015 and -0.2% in 2016). Between 2009 and 2016, the average annual growth rate was close to zero and the growth forecasts for 2017, again positive, remain very low (1% according to Coface forecasts).

However, in their medium-term development plan[1], the Russian authorities are aiming for a minimum annual growth of 5%. The need for a change in growth model, dictated by the changing international environment (a sustained lower level of oil prices) seems to be well accepted by the country's authorities. It is also urgent for Russia to regain a sufficient pace of growth in activity to halt the deterioration in the standard of living of its population, whose proportion of living below the poverty line exceeded 13% in 2015, compared to less than 11% in 2012.

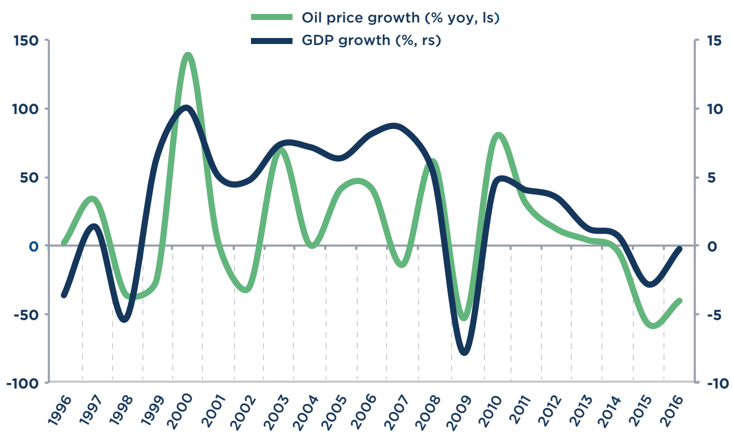
Nevertheless, the political situation, both national and international, as well as structural and cyclical constraints, are not conducive to change and conditions for an upturn in activity seem far away: even if growth is expected to increase, it should hardly exceed 1.5%, especially in the absence of lifting sanctions and of measures to improve governance. Yet, activity should be more dynamic in some sectors, such as agri-food and chemicals. Furthermore, the rise in automotive sales observed early 2017 points to a more positive trend for this sector in 2017.

1 - *« Strategy 2020. New Global Model, New Social Policy ».*

While the outlook for the oil sector is not very favourable, the diversification of the Russian economy faces major structural constraints

The correlation between Russian growth and changes in the price of oil is very strong *(chart 1)*: the hydrocarbon sector accounts for less than 10% of GDP, but accounts for half of the federal budget's revenues and around 65-70% of export revenue. During the «good years» (1999-2008), marked by an average increase in oil prices of nearly 30% over ten years, oil and gas revenues fostered wage increases, public investment and fuelled growth.
According to different quantitative studies[2] assessing the impact of the price of oil on growth, elasticity could vary between 0.15 and 0.25. Therefore, about half of the average growth in the period 1999-2008 (3 to 3.5% of the 6.9% observed) would be due to the massive influx of external resources, with the intrinsic characteristics of the Russian economy explaining the other half of the growth rate.

CHART 1
GDP and oil price (Brent Spot FOB) growth rate



Sources : FMI, Datastream

With a hydrocarbon-based economy, Russia is facing changes in markets and internal constraints that challenge the sustainability of its growth model based on this sector. Despite the price recovery in early 2017, hydrocarbon prices are expected to remain at a low level, with medium and long-term forecasts by the World Bank and OPEC, for example, not suggesting levels above $80 a barrel by 2020-2025. Thus, Russia can no longer rely on a sustained increase in prices and revenue.

Moreover, Russian production (around 11 million barrels per day in 2016) is not expected to increase significantly. Reserves are very high (just over 5% of the world's reserves), but fields in Western Siberia (about 66% of production) have passed their peak production and only the exploitation of new deposits (unconventional sources, reserves in the Arctic), would boost production. However, such an operation would require significant investments, the profitability of which is called into question by the persistence of low oil prices. Furthermore, the sanctions imposed since 2014 following the Ukrainian crisis have limited access to finance and foreign technology.
The vulnerability of Russia's medium-term growth lies in its excessive reliance on the extraction sector. The country's authorities are aware of this and diversification is one of the scenarios of the Russian State's strategic plan and a goal set by President Putin to «make Russia a world leader in economic and social development [...][3].»
However, this ambition faces obstacles that are difficult to overcome in the medium term.

Major demographic constraints

Since 2010, Russia has seen a decline in its working-age population (aged 15-64). This trend is all the more worrying as it will continue in the years to come, as and when the people born in the 1990s, a period marked by both a falling fertility rate and rising mortality, reach this category. The use of immigrant labour (especially from Central Asia) is still possible but will not necessarily offset the reduction in local labour by around 5% expected by 2020.

A business climate that does not contribute to boosting investment

The diversification of the economy could be fostered by the input of foreign capital, notably as part of the privatisation programme, relaunched in 2016. But the process is slow and the sanctions, as well as gaps in governance, limit the attractiveness of investors for Russian assets. According to the World Bank's indicators, the ranking of Russia has progressed little overall and is deteriorating in terms of regulatory quality, political freedom and corruption. In this area, Russia lost twelve places in Transparency International's ranking between 2015 (119th) and 2016 (131st).
The lack of attractiveness of foreign investors to Russian assets has led to a decline in foreign direct investment (FDI), which was very marked in 2014 and 2015 (-70% per year). Despite a recovery in 2016, they remain well below those observed until 2013.
Moreover, beyond the weakness of foreign investment, a significant proportion of Russian capital is also no longer oriented towards the national economy. For many years, Russia has been confronted with large outflows of private capital. Between 2008 and 2015, the cumulative amount of capital was about USD 630 billion. Net flows were lower in 2016 (around USD 19 billion), due to a combination of lower external debt repayment maturities and repatriation incentives of Russian assets abroad. But deposits with banks are increasing, suggesting that Russian economic players favour savings to investment.

In the face of these structural constraints, can Russia find drivers for competitiveness?

2 - *Kuboniwa, 2012 ; Rautava, 213 ; Ito, 2008 ; Korhoen et Ledyaeva, 2010 ; Suni, 2007, cité dans l'article "A new growth model for the Russian economy", A. Kudrin, E. Gurvich, Russian Journal of economics (2015) 30-544.*
3 - *See the Julien Vercueil article: Russia: the «2020 strategy» in question: An analysis of the productive and financial substrate of the industrial policy. Review of East-West comparative studies, CNRS, 2013, 44 (1), pp.169-194.*

Russia must find means to increase its competitiveness

Progress in terms of structural competitiveness
The competitiveness of Russia has risen sharply, according to the World Economic Forum (Global Competitiveness Index[4]), from 67th place in 2012-13 to 43rd (out of 138 countries) in 2016-2017, thanks to improvements in the institutional framework. This ranking has been relatively stable over the last two years, with a level of education and scientific research among the country's strengths. The continuation of this progress will depend in particular on the increase in education spending in the budget and in research and development. In this area, innovations could be slowed down by sanctions that limit the transfer of skills with Western countries.

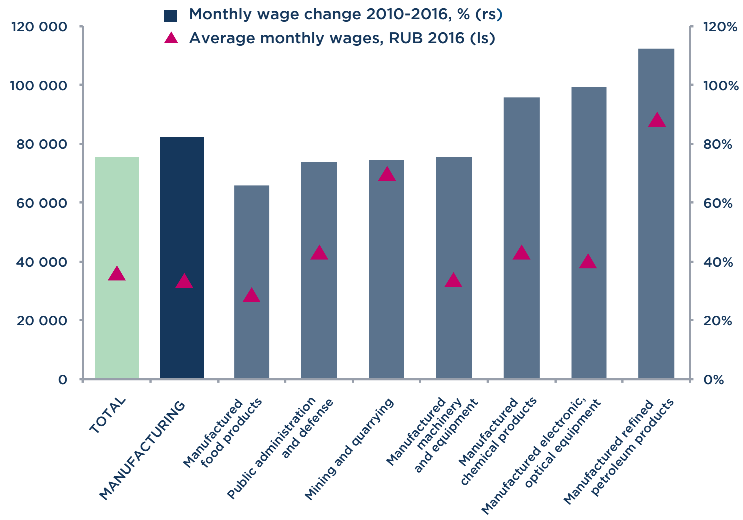
The lack of investment curbs the improvement in the use of production tools
The average capital utilisation rate would be around 66%, close to the maximum rate estimated for Russia (70%). The increase in the means of production or their output implies investments that companies do not have the financial means for (lack of income accentuated by the restriction, following sanctions, of access to finance), nor the motivation to carry it out.
According to a study published in May 2016 by Deloitte[5], manufacturing companies are particularly concerned about the risks of depreciation in the rouble, regulatory deficiencies, geopolitical risks (sanctions, embargo, etc.) and insufficient financial support from the State. Moreover, the factors that they cite as being able to promote the development of their activity are not currently present, in particular, growth in local demand (still in negative territory at the beginning of 2017) and better access to financing.
Therefore, the current climate seems unlikely to increase production capacity and private investment, which began to fall in 2013, even before the drop in hydrocarbon prices and the Ukrainian crisis, is expected to remain weak.

Insufficient labour productivity and relatively high cost
By 2015, labour productivity (estimated by output per worker) was almost twice as high as the BRICS average, but more than seven times lower than in the United States and more than five times lower than in the European Union (EU with 28 members). Moreover, the productivity of Russian employees increased by less than 10% between 2009 and 2015, whereas it had increased by almost 50% between 2000 and 2008. By 2015, this indicator has even fallen by 3%. It is far from the target set by the Russian president in 2008 to multiply by four labour productivity by 2020.
Furthermore, since 2000, the unit labour cost (ULC) has increased significantly more in Russia than in other countries. Between 2009 and 2015, the average annual increase in the Russian ULC exceeded 10%, compared with less than 7% in South Africa and just over 1% in the EU and the United States.
The highest wages and the sharpest increases over the period 2010-2016 are observed in the extraction sector and the processing of hydrocarbons and mining products *(Chart 2)*.
Wage developments in the manufacturing sector are less pronounced, but the level of wages is relatively high in the chemicals and optical equipment sectors, which are supported by the State.

Given the low unemployment rate (5.3% in December 2016) and the rise in poverty, wage growth is expected to continue, although it is slowing down in the public sector (where the average wage was higher in 2016 than in the majority of manufacturing sub-sectors) by the constraints of controlling public spending.

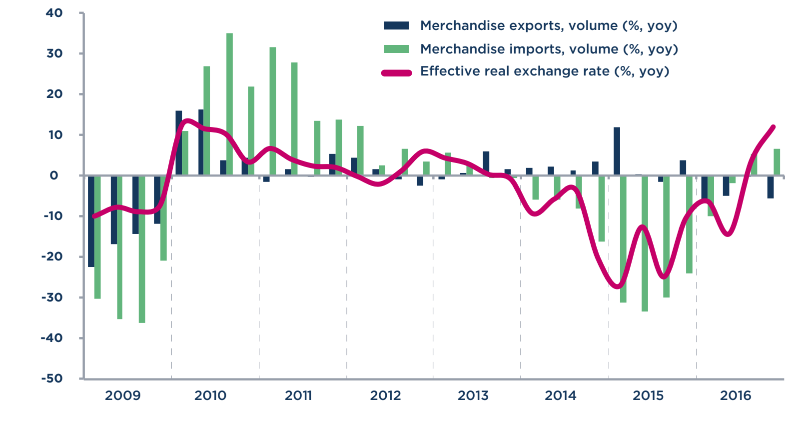
Impact of the exchange rate is not neutral but limited
The implementation of a floating exchange rate system at the end of 2014 and the fall in oil prices have accentuated the volatility of the rouble, which has adjusted sharply downwards. Given the weight of commodity exports, which are not very sensitive to the impact of exchange rate fluctuations on price competitiveness, exports of goods rose moderately during the 2014-2015 depreciation period *(chart 3)*. On the other hand, imports fell sharply.

CHART 2
Average wages per business sector



Source : Fed State Stat Service

CHART 3
Change in the real effective exchange rate and import/export flows

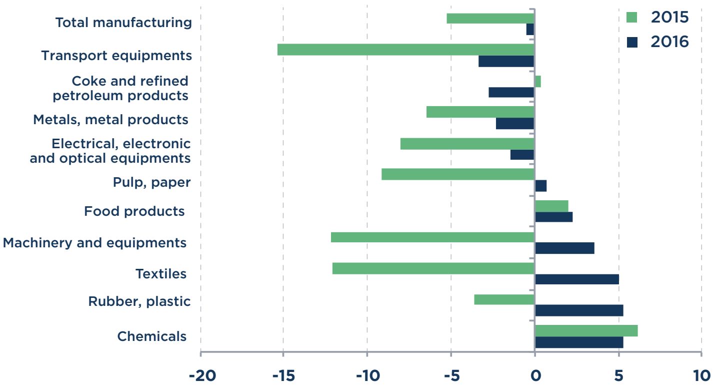


Sources: CNUCED, Datasteam

4 - https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1.
5 - "Russian manufacturing industry overview" Deloitte, mai 2016.

The price effect was not the only factor (fall in consumption due to unfavourable changes in income, embargo on certain agricultural products), but the fall in the rouble exchange rate improved the competitiveness of Russian goods compared to those purchased abroad, allowing a certain degree of substitution to imports. However, this has been achieved only in a small number of sectors, including agri-food, chemicals, rubber/plastics, which have been given priority and which have been the subject of specific support measures. Overall, production in the manufacturing sector fell in 2015 and 2016 *(chart 4)*.

CHART 4
Manufacturing output - Average of monthly changes



Source : Fed State Stat Service

The production of transport equipments (primarily automotive), metals and higher value-added goods were particularly affected during these two years, notably that of electronic and optical equipments, which had though recorded an average annual increase of over 17% between 2002 and 2008.

Against a backdrop of stable oil prices, which is strongly correlated with the RUB/USD exchange rate, the strong and lasting appreciation of the rouble price, which handicaps exports of goods and favours imported products to the detriment of locally manufactured goods, is unlikely. The pressures on the exchange rate appear to be more oriented downwards, event moderately, in the medium term (appreciation of the dollar, low net inflows of capital, etc.). But the effect of a further depreciation in the competitiveness of the Russian manufacturing sector would in any case be limited.

Whereas the activity should remain relatively buoyant in 2017 in agri-business and chemicals in particular, an upturn is expected in the automotive sector: sales, which contracted severely in 2015 (-36%) and 2016 (-11%) increased in March (+9.4% yoy) and April 2017 (+7%). These sectors should support the return of economic growth in Russia.

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