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Explaining Russia's New Normal

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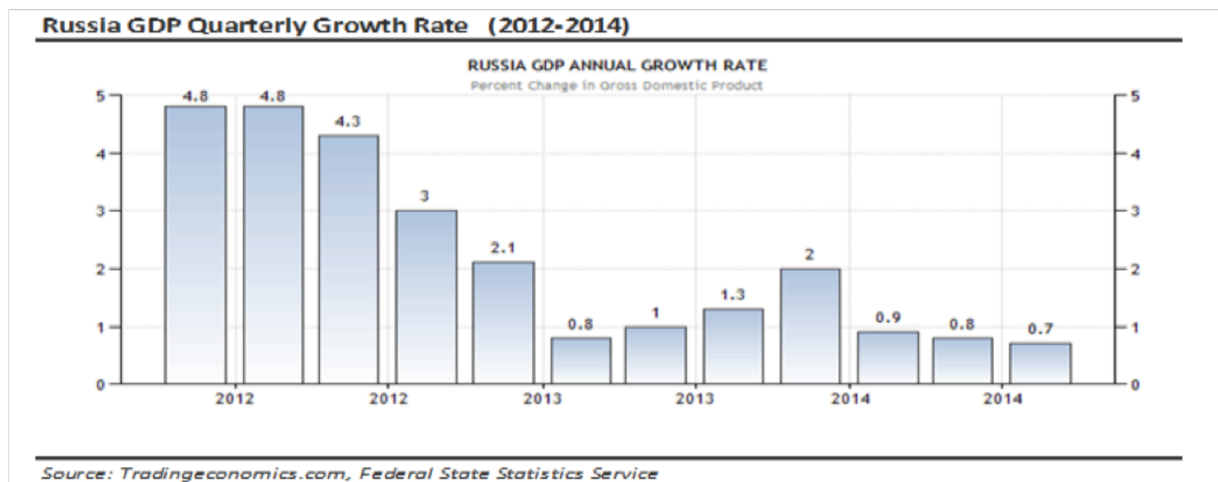
One of the slogans now regularly deployed to describe Russia's current economic condition and what comes next is the "new normal". The casual interpretation of that phrase simply means that growth in the future will be less than it has been in the past. That of course is true, and hardly comes as a major revelation. Russia's economy grew at an average in excess of 7% annually between 2000 and 2012 because of a combination of rising oil and gas wealth, trickling down to the population and into state programmes, set against a very low starting point. The value of the country's economy at the start of 2000 was just under $200bn and over the following dozen years hydrocarbon export earnings exceeded $3tn. Hence, a major reason why the value of the economy exceeded $2tn by 2012.

Clearly that strong growth was always going to slow down as the economic base broadened and especially as the trickle-down oil and gas wealth was not used to create new industrial drivers, but went mainly into state sector industries and into consumption. Hence a shift to lower growth was inevitable. Something similar is currently taking place in China's economy as annual growth of close to 10% has given way to slower, but still a world average beating, 6%-plus. That's hardly a "new normal" – it is simply maturing.

"New normal" is something different. It is more than just maturing or getting bigger; it represents fundamental change in how an economy is managed and how businesses and investors need to look at opportunities and risk.

The cynics will be tempted to conclude that any talk of change is simply a temporary reaction to the current slowdown that will (again) fade when the oil price recovers. No doubt, if that option were still on the table, then it would likely be taken. But that is not the case. The graph below shows the trend in quarterly GDP growth through 2012 and 2013. Growth started to slow sharply from mid-2012 and, in 2013 GDP grew at only 1.3%. That was less than one-third the growth of two years earlier and was despite the fact the price of Urals crude averaged $109 per barrel and there were no geopolitical issues. The clear message from that graph is that an oil price recovery alone is not going to save the economy or push asset prices higher.



So, in practical terms, what might the "new normal" look like for businesses and investors? We can break the impact into a number of risk and opportunity categories.

More competitive Russia

This crisis has already brought a significant change in monetary policy and a greater awareness that the country needs to create a more competitive environment with which to encourage manufacturing and service sector growth. In 2012, 66% of exports were oil and gas. An additional 15% was made up of other minerals and metals, while another 10% was accounted for by grains and defence equipment. Approximately only 10%, or $50bn, was made up of other goods and services. At the same time over 50% of imports, or $170bn, was made up of consumer goods and services. The hydrocarbon wealth had made the country lazy.

Now that balance has to change. It means there must be a greater effort to promote industrial growth and to cut imports of products and services that are capable of being sourced inside the country. There has been a lot of discussion about import-substitution, or localisation, and the evidence is that this policy is to be at the core of the government's post-crisis recovery and longer-term growth strategy. This is at least a more realistic and achievable strategy compared to the often vague reform agenda talked about in the past.

To give the policy a realistic chance of success, the Central Bank of Russia (CBR), undoubtedly with Kremlin persuasion, has completely changed its ruble stance and will now pursue a weak ruble policy. We have already heard from the CBR that, should the oil price rally, it will sanitize surplus oil revenues at a ruble-dollar rate of RUB55 and rebuild foreign exchange reserves. Through August we also saw that the CBR has no intention of using financial resources to try to prevent the ruble from weakening with a falling oil price. We may see some modest intervention in the future if, for example, oil were to collapse further, but only to avoid the risk of a panic contagion and not to halt the decline. If the price of Brent were to test its 2009 low of $42 per barrel, then we should expect to see the ruble-dollar rate trade at RUB75.

Apart from the monetary policy change, we have also heard from the Ministry of Finance that the budget will no longer provide for automatic real wage growth in the public sector, which accounts for almost one in five workers employed in the country. This is also a positive move, as rising state sector salaries previously forced private sector employers to compete and pay high wages.

That combination of strong ruble and rising real wage growth greatly contributed to the reliance on imported goods and services, and the lack of competitiveness in the economy. Bringing an end to these two factors should help permanently cut imports and encourage investment into manufacturing business focused not only

on the domestic market, but on exports also. It means that many foreign businesses which had made a lot of money exporting to Russia may not be able to recover that market or to a much less lucrative extent.

Sector rotation

Import-substitution and the new monetary backdrop, ie. weaker ruble, will also have some impact on earnings growth for individual sectors and will create more opportunities for investors. As mentioned, it is not realistic to assume that post-crisis, and even assuming an oil price recovery, life will return to normal. The days of large numbers of free-spending Russians roaming Western cities are gone, or at least will change radically, and Western exporters will not return to an uncrowded market as they had previously.

The weaker ruble policy, in combination with lower average wage growth, will mean less foreign travel and a growing demand for internal tourism and leisure spending. The restriction on a large number of state officials from travelling overseas, assuming it lasts for several years, also adds to this opportunity.

Demand for domestically produced goods and services is also bound to rise, especially as the state is also supporting this with procurement legislation, and that should also help boost revenues and profits for businesses, either locally or foreign owned, with a domestic location. Transport logistics, packaging and distribution, and warehousing are amongst the sectors that should gain from this rotation towards domestic originated goods and services. Longer term, the ports and rail companies will gain from the expected increase in exports of goods outside of extractive industries.

Financial services is another sector that should benefit from this crisis as an automatic resumption of previous relationships and ways of providing financial services is most unlikely. Russian companies will need to rely more on domestic services, as Western regulators and risk managers are likely to retain a poor perception of risk for many years beyond the end of sanctions. The major boost to this sector will, however, come when the state finally starts to address the question of pension reform. Not only is this long overdue in terms of budget adjustment, but it will also eventually create a pool of domestic investment capital which, at least in theory, should help create more entrepreneurial opportunities.

The main sectors to benefit from import-substitution will be in those sectors already targeted as priorities by the Kremlin. These are agriculture, food processing, medicines and healthcare, machinery and parts manufacturing. Companies in these areas should expect to get clearer state support, administrative and financial, and will benefit from the domestic-sourced preference shift.

On the flip side, extractive industry sectors are likely to continue to suffer from poor Russia risk perception for a long time post-sanctions. These sectors are too closely associated with the state and with the so-called “Asia-pivot”, which to many investors smacks of desperation rather than optimal expansion. Utilities are also expected to suffer from lower tariff growth as the state tries to keep inflation pressure as low as possible for the post-crisis recovery years.

By now it has also become clear that the banking sector needs a radical overhaul. There are still far too many licensed banks in the country, probably a surplus of 500 at least, so consolidation will need to pick up a pace. Most likely that will require a change in how risk is recognized and all banks will need to boost capital. When done, the sector will undoubtedly be in better shape and the major banks should attract a better valuation because of both the growth opportunities from Russia’s expected new economic direction and also because risk uncertainties should be reduced.

The other EU

The Eurasian Economic Union (EEU) is also part of the "new normal" for businesses. The core principles include the free movement of people and goods, and an improvement in the regulation of financial markets. It means that businesses can opt to locate their factory or services centre in any one of the other EEU countries and still qualify as "domestic" under Russia's localization policy.

If Kazakhstan is seen to be successful from its planned more aggressive plan to reform its business and investment climate, ie. if it starts to attract more businesses setting up and using the country as their base to work within the EEU, then pressure will increase on Moscow to replicate those changes in order to compete.

Politics

There is no doubt that the deteriorated relations between Russia and the West is set to remain for a long time even when tensions over Ukraine and sanctions start to ease. Also, while there is a hope that the bulk of sanctions can start to ease once a deal covering the future of eastern Ukraine is agreed, the sanctions associated with Crimea will stay indefinitely.

Russian officials have been very clear that they wish to make a distinction between politics and business, and that the country is not only open for foreign investment but is actively encouraging inward investment and joint ventures. For foreign businesses, the fact that some sanctions and poor political relations will hang in the background means they will have to be more careful of exposure in Russia and will have to conduct a higher level of due diligence with potential trade partners and other local investment or business partners than was the case pre-2014.

Political issues could continue to disrupt markets and sustain volatility in capital markets, because in the future even after a calming in eastern Ukraine, the legacy of the events of the past two years will mean less trust and more frequent disputes between Moscow and Western governments

Stronger state means slower recovery

The state sectors have become more important in the economy over the past two years and, according to rough estimates, now account for almost 60% of the total economy. The share accounted for by small and medium-sized enterprises (SMEs) is reported to have fallen to approximately 20%, down from 30% in early 2012. The fact that SMEs have all but been locked out of accessing new debt and/or the cost of servicing existing debt has risen so much, has squeezed the sector badly.

It means that, despite the monetary policy changes and the greater commitment to creating a more competitive domestic base in order to encourage import substitution, the recovery in headline growth will be slow. There cannot be a return to previous high annual average growth rates until growth starts to emerge in sectors such as food and machinery, etc. and the financial services sector is restructured. Some sectors, especially in the still fast growth areas such as IT, e-commerce and some other consumer-oriented activities will continue to deliver strong double-digit growth. But headline growth will be impacted by the less efficient and dominant state sectors for a long time to come.

The forecasts in the table below assume that the weak ruble policy remains for at least five years and that financial sector sanctions start to be removed from the second half of 2016. But even with those conditions and assuming a more determined effort by the Russian government to push ahead with such programmes as import-substitution, it is likely that the economy will not return to 3%-plus growth until early in the next decade. Such is the scale of the transformation that needs to take place.

New Russian econonomic model - slow recovery

	2007	2014	2015F	2016F	2017F	2018F	2019F	2020F	2021F	2022F	2023F	2024F	2025F
GDP, nominal, US$ bln	**$1,660**	$1,850	$1,271	$1,357	$1,449	$1,743	$1,949	$2,142	$2,360	$2,619	$2,972	$3,359	$3,651
Growth, real, % YoY	**8.5%**	0.6%	-3.0%	0.5%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	4.0%	4.0%
Industrial production, real, % YoY	**6.8%**	1.7%	1.0%	2.5%	4.0%	4.5%	4.0%	5.0%	4.0%	3.5%	4.0%	3.5%	3.0%
Retail sales, % YoY	**10.6%**	2.5%	-6.0%	0.0%	2.0%	3.0%	2.5%	3.0%	3.0%	3.5%	3.0%	3.2%	3.0%
Budget balance, % of GDP	**4.1%**	-0.5%	-2.5%	-1.5%	-1.0%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%	-0.5%
CPI - average, % YoY	**9.1%**	10.0%	14.0%	9.0%	7.0%	6.0%	5.5%	4.9%	4.7%	4.9%	4.7%	4.6%	4.7%
Real disposable income, % YoY	**8.0%**	-1.0%	-6.0%	0.0%	0.5%	1.5%	2.0%	1.5%	2.5%	2.0%	2.5%	2.0%	2.0%
Current account % of GDP	**4.3%**	3.1%	3.0%	2.3%	2.9%	2.5%	2.4%	1.8%	2.2%	1.8%	1.5%	1.2%	1.3%
Total foreign debt, % of GDP	**32%**	32%	41%	38%	38%	38%	37%	39%	37%	38%	35%	33%	33%
RUB/US$, average	**25.5**	38.6	62.0	67.0	66.0	58.0	56.0	55.0	54.0	53.0	51.0	49.0	49.0
Average Urals, US$ p/bbl	**$70**	$100	$55	$60	$70	$80	$80	$90	$90	$90	$100	$100	$100

Source: Federal Statistics Service, Central Bank of Russia, Macro-Advisory estimates

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