Russia is Being Forced to Face up to Harsh Economic Realities

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The headline results for Russia's economy though the 1st quarter, while confirming that the country will likely see a contraction of between 3 and 4 percent for this year, show a relatively better picture than had been feared late last year. As expected, the consumer sectors are taking the biggest hit in terms of growth with, e.g. retail sales volume declined by 6.7 percent year on year in the 1st quarter but by 8.7% in March. That is on the back of a decline of 9 percent in real wages in that period and the spike in inflation, from 11.4 percent at the end of December to just under 17 percent in late March, along with double-digit interest rates.

But, extending a trend we saw in 2014, the decline in the traditional growth drivers of the economy continues to be partially off-set with an increase in demand for domestic sourced goods and services. So-called import-substitution has been boosted partly because of the ban on some food items from the EU and also because the sharply weaker ruble. The currency fell by more than 40 percent over the last four months of 2014 and increased the cost of imported goods. It meant that, in the 1st quarter industrial production only fell by 0.4 percent overall and agriculture output rose by 3.5 percent year on year. It is of course still too early to simply extrapolate these early trends to the full year, but confidence is a lot higher that the decline in the economy may be limited in 2015 and a small recovery achieved in 2016.

The reason for that optimism is partly because the oil price has been more stable in the mid-$50's per barrel range and because of a hope that, if the Minsk-II peace deal survives, there may be an easing of financial sector sanctions in the summer. Optimism is also high because of the more effective response from the Central Bank and the Finance Ministry since the start of the year as the government has moved into full damage-limitation mode. Changes in the way the Central Bank administers the foreign exchange market has increased the supply of foreign currencies and, because of almost $30 billion of FX loans to the corporate sector, has also reduced demand. At the same time the Finance Ministry has converted some of the $90 billion Reserve Fund into rubles, thus also increasing ruble demand and foreign currency supply.

In late December the Finance Ministry moved 1 trillion rubles, or almost $18 billion, into the Deposit Insurance Agency to ensure the banking system avoided credit problems and to boost public confidence. The Central Bank has started to cut its benchmark Key Rate, which ended 2014 at a crippling 17 percent, on the back of confident forecast of slowing inflation and is expected to run negative real interest rates all year in an effort to improve confidence and generate more domestic activity.

But, while the previous predictions of destruction are now seen to be very wide of the mark, the underlying problem, which remains unaddressed, is that the pace of growth in the economy has been in decline for the past four years and a supplementary growth driver needs to be created. Otherwise the real danger for Russia is not a steep recession this year or next, but a lengthy period of low growth or stagnation.

Russia's economy grew by 4.5 percent in 2010, by 4.3 percent in 2011 and by 3.4 percent in 2012. These numbers were relatively good against the backdrop of uncertainty and sluggish growth in the EU, Russia's main trading partner, and in the broader global economy. But in 2013, as the rest of the world expanded by 3.3 percent, Russia's economy grew by only 1.3 percent. Last year, with the added pressure of sanctions and the consequences of lower oil revenues, GDP growth just managed to stay positive with an increase of 0.6 percent in real terms. That was a fourth straight year of declining growth. This year will see that losing streak extend to five years. So Russia's main economic problem is not all about the oil price decline or sanctions.

The key drivers of growth in the economy from 2001 have been the rapid expansion in the consumer sectors, and related service industries, and the steady increase in investment into manufacturing sector assets. The oil and gas wealth did not directly contribute a great deal to headline growth as it accounted for only about 20 percent of GDP. But oil and gas taxes contribute, on average around 50 percent of total budget revenues each year and two-thirds of the value of all exports. So the over $2.5 trillion which the country earned from exporting energy since 2000 did completely change the country's balance sheet and allowed for a more than doubling of federal budget spending.

Therefore it is fair to say that hydrocarbon earnings have been the big indirect driver of the country's growth as the boost to budget spending was a major driver of the consumer story. The state increased public sector worker wages and pensions in real terms every year since 2000, which forced the private sector to follow suit, and the recapitalization of the dominant state banks was a key factor in the rapid increase in retail credit. By 2012 Russia was already the world's fifth biggest consumer market, in US dollar terms, and quickly catching up with Germany.

The double-digit increase in investment into the manufacturing sector was also an important driver of growth in 2000-2012 as both local and foreign businesses bought into the long-term Russia story. Of course another reason for the average double-digit growth in the consumer, service and manufacturing sectors was the very low base effect. There was relatively little growth in the retail and manufacturing sectors during the chaotic 1990's, i.e. most of the action in that period was in the extractive industries or amongst the big state enterprises and even there the focus was on ownership and restructuring rather than on growth.

That started to change in 2013 as growth in the economy slowed while the rest of the world recovered and the price of oil averaged $110 per barrel. It had become obvious that the country needed a new, or supplementary, driver of growth and that would have to be based on a sustainable increase in investment. President Putin acknowledged this at his annual Federal Assembly Address, aka the state of the nation speech, in December 2013. Unfortunately that was within weeks of the start of the conflict with the west over Ukraine. Today, and for much of 2014, the government is almost entirely focused on containing the crisis and preventing credit or bank sector problems. Strategies aimed at boosting growth will have to wait at least until financial sector sanctions start to ease.

The question is whether the slowdown in 2013 plus the impact of the sanctions and oil price collapse, will lead to a greater effort to attract investment and diversify the economy or, whether the events of the past year will hinder such efforts and lead to, e.g. more of a focus on nationalism and anti-western politics. In that latter event there would likely be little progress towards reforms and economic diversification.

For now the evidence is quite encouraging that this crisis may finally be the one which forces the country onto a new economic path. The mantra from government is increasingly about import substitution, or self-reliance. For many years the Kremlin has been complaining that the country is far too reliant on imports of goods which could be manufactured at home. But little progress has been achieved. Coming into this crisis Russia was importing more than 50 percent of food and medicine consumption and well over 90 percent of consumer electronics, such as smart phones, laptops and TVs. Sanctions, and the threat of even tougher actions against the country by the major western nations has greatly invigorated the debate over import vulnerability and the need for greater self-reliance. This has now become something of a patriotic cause as well as good economic policy.

The state has already created a number of investment agencies with money to be made available for projects which fall under this strategy. But, given the well known problems which the country has with an overly-cumbersome bureaucracy and a suspicion about legal rights enforcement and corruption, progress will inevitably be slow, even if the current political enthusiasm for import-substitution investment is sustained once the peak of this crisis passes.

It also means that even as the political rhetoric with the west deteriorates, and will likely remain on bad terms for a very long time ahead, Russia desperately needs to keep western companies engaged and to be part of the import-substitution process. Although the pivot to China is very real in terms of politics and investment will flow into extractive industries and infrastructure, Asian companies are able to compensate for their more experienced western peers in such fields as agriculture and pharmaceuticals.

The Kremlin, therefore, faces a very tricky balancing act in terms of geo-politics and strategic business relationships. It also needs to improve the domestic business climate and reduce both barriers and timelines for investment. But the need to do exactly that has become as clear as the need for change was back at the last great turning point in 1999. If this crisis is taken an opportunity for real change then Russia's economy may again see 4 to 5 percent annual growth within a few years. Hardly sooner than that. Regardless of where oil trades and when sanctions are removed there will be no string "V" shaped recovery this time.

Russia: Macro Trends & Medium Term Forecasts

	2011	2012	2013	2014	2015E	2016E	2017E
Growth, real % YoY	4.3%	3.4%	1.3%	0.6%	-3.5%	0.5%	1.5%
CPI - year-end, % YoY	6.1%	6.6%	6.5%	11.4%	12.0%	7.0%	6.0%
Gross fixed investment, real % YoY	10.2%	6.0%	-0.3%	-3.5%	-10.0%	-2.0%	2.5%
Industrial production, real % YoY	5.0%	3.4%	0.4%	1.7%	1.0%	2.5%	4.0%
Retail sales, % YoY	7.2%	5.9%	3.9%	2.5%	-6.0%	0.0%	2.0%
Central Bank Key Rate, %				17.0%	10.5%	7.5%	7.0%
Budget, balance % of GDP	0.8%	0.0%	-0.5%	-0.5%	-2.5%	-1.5%	-1.0%
Current account, % GDP	5.1%	3.7%	1.6%	3.0%	2.5%	1.8%	2.0%
RUB/US$, year-end	31.4	30.8	32.9	61.4	62.0	55.0	50.0
RUB/EUR, year-end	41.5	40.3	45.3	72.0	64.0	60.0	55.0
RUB/EUR, average	41.0	40.0	42.3	51.5	62.0	60.0	55.0
Urals, US$ p/bbl, average	$109	$110	$108	$100	$55	$70	$80

Source: State Statistics Agency, Central Bank, Macro-Advisory estimates