Special Report

Russia – Demographic headwinds one of the main challenges facing the economy

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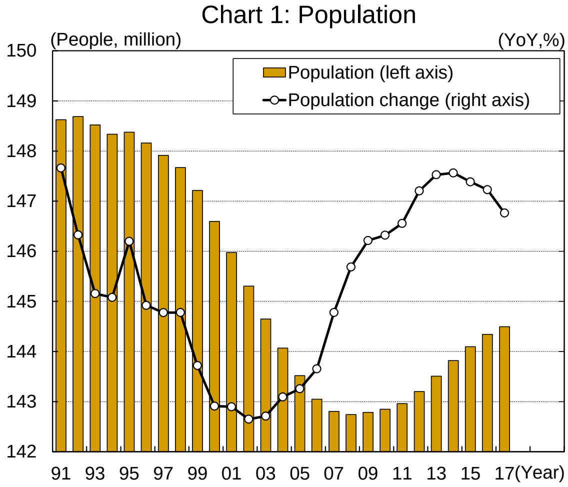
1. Introduction

Demographics remains both a current and longer-term issue and one of the main challenges facing the Russian economy. This is best highlighted by the recent history of decline of the working age population, despite the increase in the headline population figure. Authorities have started to take steps to address this, by increasing the retirement age as well as announcing an investment plan to boost longer-term growth, however impediments remain. Reform efforts have been supported by the rebuilding of fiscal and external buffers on the back of an economic recovery from the recession in 2015/16 and higher oil prices.

2. Demographics

According to the latest World Bank statistics, Russia's population stood at 144.5 million people in 2017, and has increased by 1.8 million since 2008 (Chart 1). However, for the previous 13 years, Russia's population declined, losing a total of 5.6 million from 1996 to 2008 due to high infant mortality and death rates (Chart 2). Improved life expectancy (71.6 years in 2016 from 65.5 in 2000) has aided Russia's recent population increase, though caveated with a decline in birth-rates in 2016.

Chart 1: Population



Source: World Bank, MUFG Bank Economic Research Office

Chart 2: Birth and Death Rates

Source: Rosstat, MUFG Bank Economic Research Office

This recent stabilisation and decline of birth rates is due to a combination of factors including longer-term social changes. There is also evidence to suggest that low spending on healthcare and education may be having an effect, less than 4% of national income was spent in 2017.

A key feature of demographic headwinds has been the downward trend of the Russian workforce. Looking at the age group from 15-54 (Russia's current pension age is 55 for women and 60 for men), after peaking at 89.0 million people in 2005, it has since declined by 12.4 million people as a result of aging demographics.

This is also highlighted by considering the ratio of '60-64' year olds to '15-19' year olds, which stands at 1.5, or 50% more of the older cohort. Typically, the former are retired by this point and the younger cohort are normally entering the work force. Recent pension age changes (women to 60 from 55 by 2034, men to 65 from 60 by 2028) will alleviate some of these stresses, but pressures will remain.

The decline of the working age population is having a near-term effect on domestic consumption. Prior to pension age increases, there was an estimated loss of around 1 million people every year (around a 1.3% decline) from the workforce. This has acted as a drag on growth with estimates of the likely effects on real GDP growth ranging from 1 percentage point (ppt) to 0.5 ppts off GDP growth each year: a significant chunk versus the current environment of weak growth potential at around 2% YoY and added to the lingering effects of sanctions.

Looking forward, the declining working age population will lead to worsening dependency ratios. The dependency ratio is calculated by dividing the population aged 65+ with those aged '20-64'. In 2017, the ratio stood at 20.7%, and is forecasted to rise to 41.2% in 2050 under assumptions of constant fertility used by the United Nations (UN).

Under the scenario of a worsening dependency ratio, there will be increased pressure on public finances; for example, through higher pension spending. Russia currently spends more on pension expenditures versus the OECD average, at 9.0% of GDP in 2017 compared to around 8.2% of GDP, the OECD average, and despite lower GDP per capita. The retirement age increase should alleviate some of the pressures on pension spending, which has been steadily increasing recently; however, stresses could remain.

3. Reforms

The government has announced a program to increase investment in order to boost growth potential, as well as aforementioned changes to the pension system in an attempt to alleviate some of the growing pressures of population changes.

Labour productivity growth will be important to these reform efforts. In former years of high growth, this component contributed heavily to growth; however, in recent history it has underperformed (Table 1). This has played a role in stunting Russia's real GDP growth potential, which is now around 2% YoY, as well as GDP per Capita convergence to western peers.

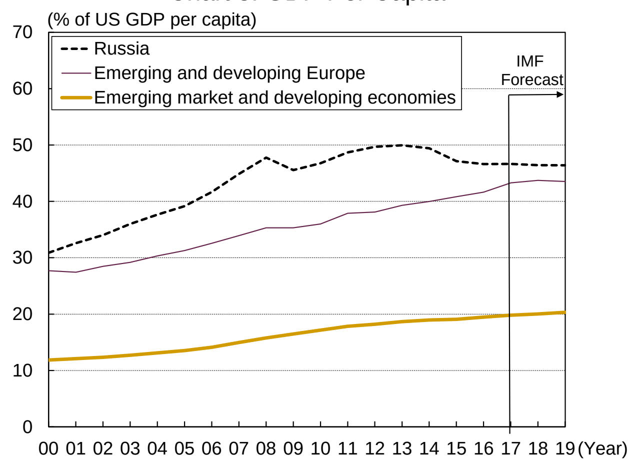
Russian GDP per capita, as a % of the United States, peaked at 50% in 2013, but has since dropped. When compared to a benchmark of 'Emerging and Developing Economies' and 'Emerging and Developing Europe', Russia had been out-performing both up to 2008 (Chart 3), but has since lost ground.

Table 1: Historical Growth Performance

(YoY,%)	2003-09	2009-15
GDP per capita	4.7	1.3
Labour utilisation	0.6	1.4
Labour force participation	0.7	0.8
Employment rate	0.0	0.5
Labour Productivity	3.7	1.0
Capital deepening	0.5	1.6
Total factor productivity	3.2	-0.5
Dependency ratio	0.3	-1.0

Source: OECD, MUFG Bank Economic Research Office

Chart 3: GDP Per Capita



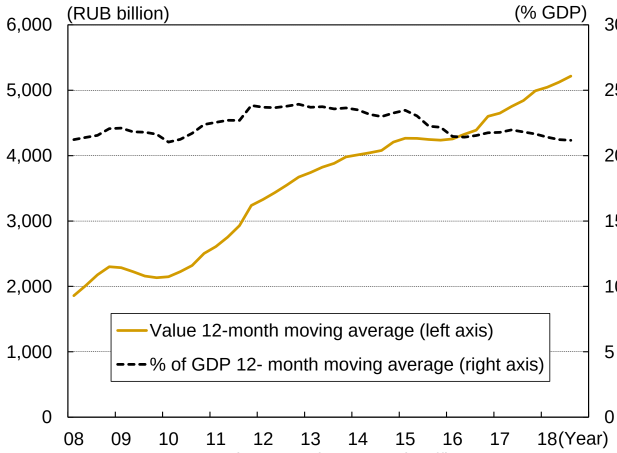
Source: IMF, MUFG Bank Economic Research Office

(1) Investment program

Authorities aim to boost annual real GDP growth up to 4% YoY by boosting investment. Under the plan, investment will be boosted by increasing the government's capital spending in order to bring the overall investment level from 21.9% of GDP in 2017 to 25% of GDP by 2024, and 27% of GDP in following years. A new fund of RUB 3.5 trillion (4% of GDP) will also be created to support infrastructure spending.

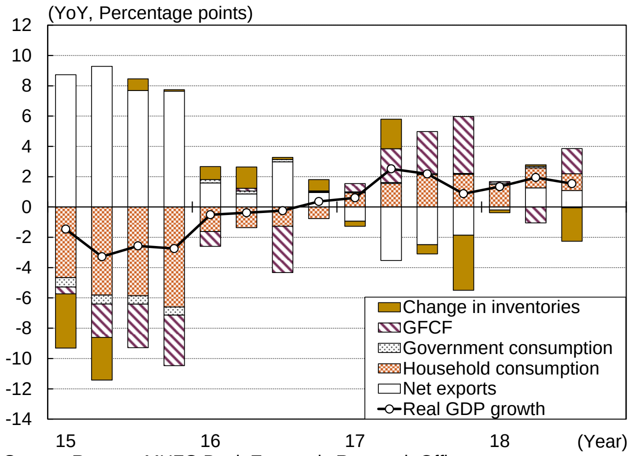
Gross Fixed Capital Formation (GFCF), as a % of GDP, is currently moderate (Chart 4). Over the last couple of years, based on official sources, GFCF has hovered around the 22% level (as a % of GDP). Looking at Chart 5, we can also see that the contribution of investment to GDP has also generally been varied (since 1Q 2015 in chart).

Chart 4: Gross Fixed Capital Formation



Source: Rosstat, MUFG Bank Economic Research Office

Chart 5: Contributions to Real GDP Growth



Source: Rosstat, MUFG Bank Economic Research Office

Factors limiting investment have included high interest rates, lack of finance and a weak business environment. This has also occurred despite Russia's recent efforts to improve its business environment, for example, Russia increased to 31st in 2018 from 35th in 2017 in the World Bank Doing Business ranking.

The new investment plan will be state-led and involve lending to state-owned companies, which, generally speaking, have a worse record of boosting total factor productivity (TFP) and wages, as well as inhibiting new market entrants, thereby further impeding TFP.

Typically, Russia's largest companies remain state-owned (state ownership ~33% of GDP) with recent trends highlighting a slight increasing role of the Russian state in the economy, as a result of recent bank bailouts. Previous plans to further privatisation have diminished, as oil prices have increased.

Private sector involvement will be key to boosting growth and TFP, without which, the benefits of the program will be capped. Furthermore, in order to fund this investment program, taxes will increase, which could hamper consumption, the main driver of growth. Moreover, there are concerns over the extent to which the investment program will lead to diversification of exports.

(2) Recent pension reforms

The raising of the retirement age was signed into law on the 3rd October by President Putin with the retirement age for women increasing gradually to 60 from 55 by 2034, with men's increasing gradually to 65 from 60 by 2028. Originally, an earlier proposal envisaged increasing the retirement age to 63 from 55 for women and 65 from 60 for men. However, this was scaled back after recent protests with women's retirement age now increasing to 60 years, but changes for men to remain. Protests also coincided with a dip in Putin's approval rating to 67% in September from 79% in June. The scaling back will reduce a significant proportion of the benefits of the proposed original plan.

(3) Increased population growth

Higher immigration and increased child benefits could help to alleviate worsening demographics. However, immigration may be limited due to some of the main source countries suffering from declining demographics too, such as Ukraine, Uzbekistan and Tajikistan. Here, improved standards of living are likely to entice workers to stay.

Additionally, a simple comparison of Russian rates of real GDP growth to CIS states' highlights the real GDP growth rate divergence between Russia and some of the faster growing central Asian republics, with less incentive for migration to Russia. Looking forward, it may become more difficult for Russia to entice these workers, especially in the context of recent declines in net migration numbers, which have been on a downward trend since 2008.

Another route could be through increased natural population growth rates. Authorities have taken steps to encourage higher birth-rates through allowances paid to parents for 18 months after they have had their first child, effective from January 2018 and equivalent to USD180 per month. Fertility has increased since 1998, on the back of the economic recovery since the collapse of the USSR.

4. Policy Framework Supportive to Reforms

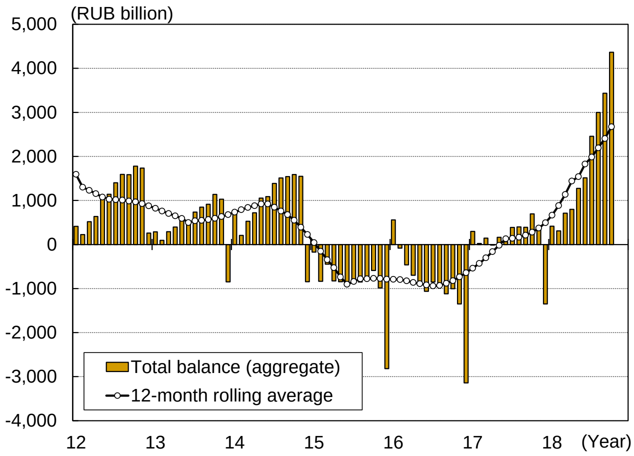
A key support for government reforms is the strong macroeconomic policy framework, improved public finance outlook and increasing buffers, both domestic and external. As reported by the IMF, the Russian authorities have established a 'strong macroeconomic policy framework' including 'prudent fiscal rule, inflation targeting, and a flexible exchange rate'.

(1) Strong macroeconomic policy framework

Highlighting prudent fiscal policy, latest consensus forecasts show a forecasted fiscal surplus of 1.2% of GDP in 2018, rising to 1.4% of GDP in 2019 thanks to better tax revenues, higher oil revenues and continued low growth of expenditure. Furthermore, consolidated monthly revenues increased by 18.6% YoY in July 2018, with expenditures only increasing by 6.7% YoY leading to the improving fiscal surplus, shown in Chart 6.

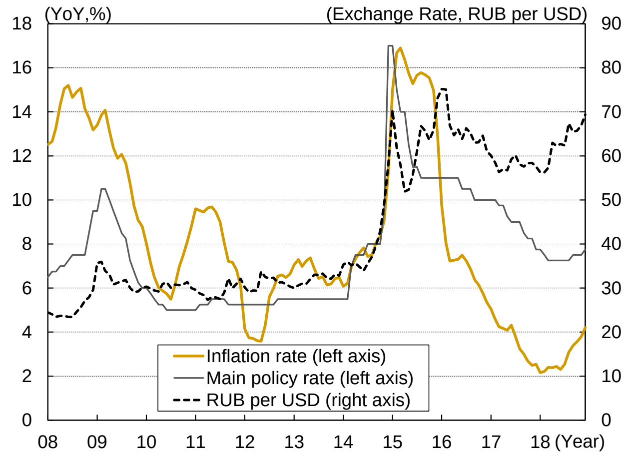
Inflation targeting has also been part of the strong macroeconomic policy framework with the main policy rate increased recently by 25 basis points to 7.75% in December, as shown in Chart 7. US Fed rate increases and a less benign global environment mean the Central Bank of Russian Federation (CBRF) will keep policy tight. Inflation expectations have been picking up recently, highlighting increasing pressures, as the RUB has experienced weakening versus the USD since the summer.

Chart 6: Consolidated Government Fiscal Balance



Source: Ministry of Finance, MUFG Bank Economic Research Office

Chart 7: Policy Rate, Inflation and FX



Source: CBRF, Macrobond, MUFG Bank Economic Research Office

Public finances will be anchored by Russia's new fiscal rule over 2019-20. The rule will require a 'zero primary balance at the conservative benchmark oil price of USD40 per barrel'. If the oil price exceeds USD40 per barrel, the proceeds will be converted into foreign currency and put into the National Welfare Fund (NWF). Additionally, from 2019 to 2021, spending on infrastructure, health, support for Small and Medium Enterprises (SMEs) and non-oil exports will increase by around 1% of GDP. Over the same period, government revenues are expected to increase as the VAT rate is increased to 20% from 18% on 1 January 2019.

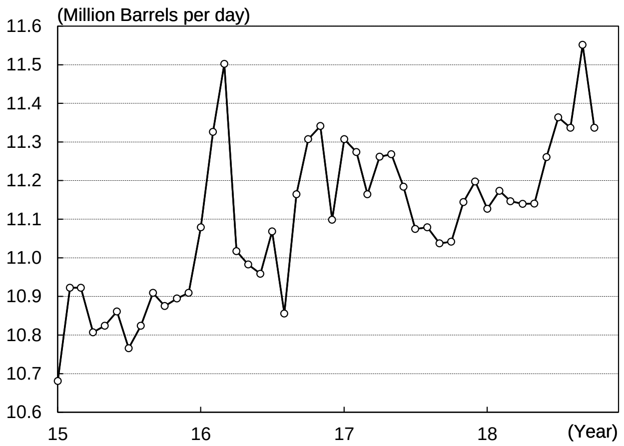
(2) Continued economic recovery

The policy framework has supported the ongoing economic recovery, which has maintained a moderate pace since 2Q 2017, after emerging from its 2-year recession in 2015/16. The recession was due to the drop in oil prices and international economic sanctions affecting consumption and gross fixed capital formation.

Recent quarterly figures highlight the continuing recovery with an increase of quarterly GDP YoY of 1.5% in 3Q 2018, 1.9% in 2Q 2018 from 1.3% in 1Q 2018. This has been sustained by consumption (helped partly by the football world cup), higher oil production as well as improved oil prices. With oil production increasing strongly in 2H 2018 (Chart 8).

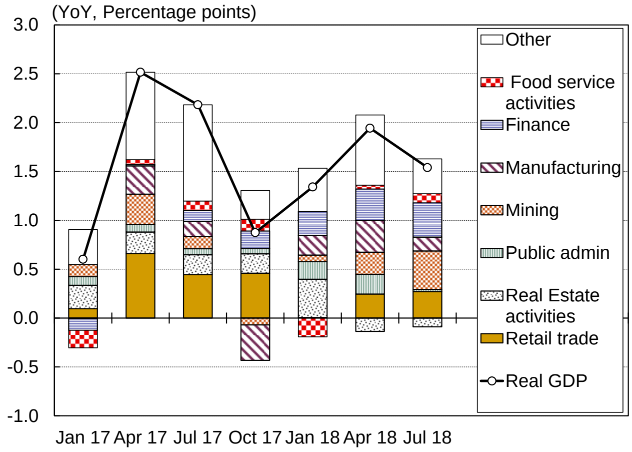
Growth was generally quite broad-based in 3Q 2018, as can be seen from the production side with finance and mining both contributing 0.4 percentage points YoY in 3Q 2018, and retail trade adding a further 0.3 percentage points each (Chart 9). Capacity utilisation rates now stand at 71% in December 2018, from 69% in January 2018.

Chart 8: Total Crude Oil Production



Source: JODI, MUFG Bank Economic Research Office

Chart 9: Contributions to Real GDP Growth



Source: Rosstat, MUFG Bank Economic Research Office

Real annual GDP growth is expected to expand by 1.8% in 2018, falling slightly to 1.6% in 2019 from 1.5% in 2017, according to latest consensus forecasts, though risks are to the downside. Consumption is expected to be a key driver of growth. However, rising VAT rates from January 2019, sluggish labour productivity and increasing inflation could also act as a dampener on domestic consumption. The threat of further sanctions could also affect confidence, though the economy has been resilient so far.

Under the scenario of further sanctions, longer-term growth potential could be further dampened, and there may be some risks for private sector access to foreign financing as well as financing flexibility for the sovereign (depending upon which sanctions are implemented). This has taken place after Russia's alleged use of 'chemical or biological weapons in violation of international law' in the UK. Further measures are also being discussed.

(3) Buffers increase

Official reserves have been on an upward trajectory since 1Q 2015, increasing to USD 463.6 billion in December 2018 from USD 350.5 billion in April 2015, thanks to an increase of gold holdings, capital inflows and FX intervention. The rebound in commodity prices has boosted export earnings, leading to an improving current account surplus which increased to USD 23.3 billion in 2Q 2018 from USD 16.3 billion in 2Q 2017.

Russia had also been rebuilding its fiscal buffers up to September 2018, however latest figures show that the NWF took a dip recently in November, though still remaining at 4.6% of GDP.

5. Conclusion

Demographic trends in Russia are worsening despite recent increases and stabilisation of the headline population figures. As such, demographics will remain one of the greatest challenges affecting Russian politics, society and economy. This has already acted as a drag on economic growth; however, recent pension changes will alleviate some of these headwinds and public finance pressures.

Plans to boost investment should also help to alleviate some of these concerns. However, to reap the full benefits of this program the private sector will be needed. Further risks come from sanctions, though increased fiscal and external buffers increase the room for manoeuvre and support the ongoing economic recovery and reforms. The policy framework has underpinned the recent improvements.