Russia – Recent trend of weaker real GDP growth expected to continue over 2020

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1. Introduction

Real GDP growth in Russia has averaged just 0.6% YoY from 2015 to 2019 after 3.1% in the previous five years. The economy has been affected by a number of longer-term structural weaknesses that have detracted from higher real GDP growth, from the decline of the working age population, low private sector investment to weak productivity growth. Whilst in the near term, the country has also had to contend with the short-term effects of the 2015-16 oil price decline and economic sanctions, as well as the recent global economic slowdown.

The trend of recent slower economic growth is expected to continue over 2020, despite a number of positive policy changes made by the government over recent years, and the expected steady roll-out of national projects after delays in 2019. This report will discuss the continued rebuilding of fiscal buffers and economic reforms, and the recent real GDP growth momentum looking into both domestic and external factors.

2. Policy Changes Enacted After Oil Price Shock

Over recent years, the Russian government has made a number of policy changes in order to first, mitigate the negative impacts from economic shocks, in particular oil price declines, and second, to provide a firm foundation for more resilient and higher real GDP growth in light of weak real GDP growth.

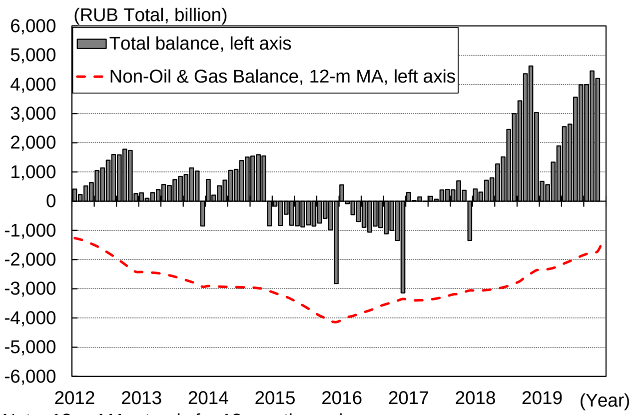
The oil price decline from 2015 to 2016 was particularly sharp and caused a recession in Russia, placed pressure on the exchange rate and led to a decline of fiscal and external buffers, among other impacts. Consequently, due to these effects the government decided to introduce a new fiscal rule from early 2018, and greater exchange rate flexibility, as part of an improved macroeconomic policy framework to support stronger real GDP growth.

Together with the new fiscal rule, which was introduced to reverse the decline in fiscal buffers, the government also made a number of taxation changes to contain the fiscal deficit. The taxation changes included measures to increase tax compliance, and more recently, the increase of the VAT rate in early 2019. The government has also introduced retirement age changes[1], to contain expenditures.

Subsequently, thanks to the fiscal changes and improved oil price, there has been a marked improvement in the total government fiscal balance as well as a rebound of fiscal buffers (Chart 1 and 2). The non-oil budget deficit declined to 6% of GDP in 2018 from 9.4% in 2013 with the federal budget breakeven oil price falling to USD43/b from USD110/b over the same period. Meanwhile, fiscal buffers have continued to be rebuilt, in particular thanks to the new fiscal rule which results in the accumulation of fiscal buffers when the oil prices are above USD 40 per barrel. As oil prices have averaged higher than this level, in 2019, government deposits reached 16.3% of GDP while the National Wealth Fund (NWF) touched 7.3% of GDP.

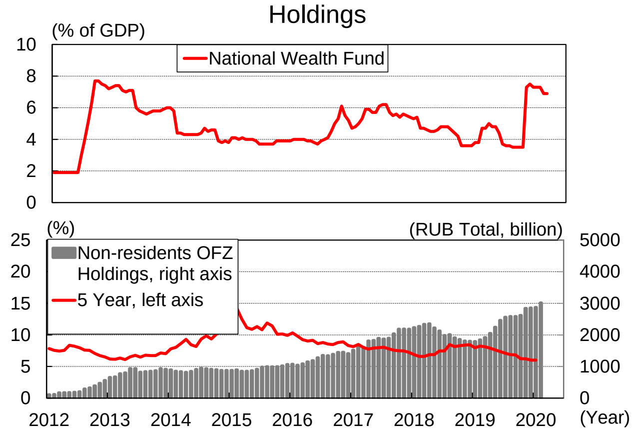
The net result of both the wider improvement to the macroeconomic policy framework and the fiscal improvements has been increased economic resilience (to an extent) and a decline of fiscal risks. The Russian economy has weathered US sanctions and the global recession in manufacturing. By the same token, fiscal risks have declined and are low, as evidenced by 5-year and 10-year government bonds yields which have continued to fall over the course of 2019. Non-resident OFZ holdings have also rebounded after a drop in 2018.

Chart 1: Consolidated Government Fiscal Balance



Note: 12-m MA: stands for 12-month moving average
Source: Russian Ministry of Finance,
MUFG Bank Economic Research Office

Chart 2: NWF, Gov Bond Yields & Non-resident OFZ Holdings



Source: Russian Ministry of Finance, Macrobond
MUFG Bank Economic Research Office

However despite resilient real GDP growth over the last couple of years as stated, it has been altogether weak. Russia's real GDP growth potential has been affected by a number of longer term-structural obstacles and government fiscal policy has also added very little to real GDP growth due to the fiscal consolidation. Against this backdrop, the government has been looking to build upon existing reforms and increase the level of real GDP growth. For example, in 2018, a series of national projects were announced. Nevertheless real GDP growth was still weak in 2019, as discussed in the next section.

Attention has turned to fiscal buffers and potentially using them to more directly finance some of these projects. However, at the current juncture this would require further changes. At present the flexibility in using the NWF for investments only widens once the liquid portion of the NWF hits 7% of GDP, at which point the NWF can be invested in higher yielding securities in order to diversify its assets.

[1] Explored in our previous report here: https://www.bk.mufg.jp/report/ecoeu2019e/specialreport_20190107.pdf

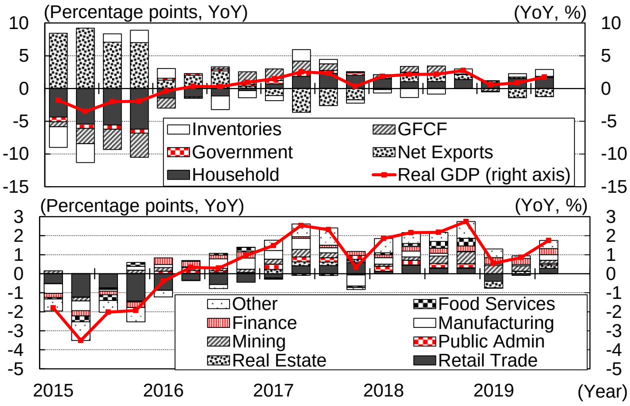
3. Real GDP Growth Momentum Remains Weak

Russia's recent economic weakness in 2019 stems from subdued real wage growth which has stunted stronger private consumption. The external environment has also been equally weak as net exports weighed on real GDP growth over the course of 2019 (due to a recession in manufacturing worldwide). Government expenditures have also only provided a very small positive contribution to growth, hampered by capital expenditure under execution (Chart 3).

The weak domestic environment resulted from muted real wage growth, due to a spike in inflation (caused by the rise of the VAT rate) and an increase in the retirement age. Most significantly, weak labour productivity has also continued to dampen real wage growth. With this in mind, despite an expected decline in inflation in 2020 (3.5% in 2020 after 4.5% in 2019), real wage growth is expected to remain fairly muted in 2020.

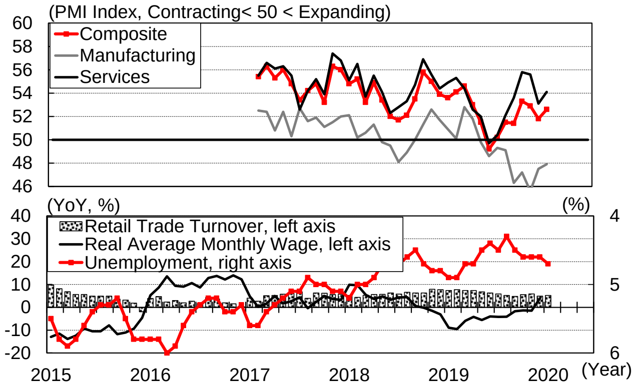
In 2019, the weak external environment was due to the global manufacturing slowdown. This is expected to remain the main risk to Russian real GDP growth in 2020, as stated by the central bank and confirmed by the latest manufacturing PMI, which was firmly in contraction territory (47.5 in December, shown in Chart 4). Although early signs of gradual recovery had been observed in manufacturing worldwide around the turn of the year with 2020 growth rates in the US and the euro area likely to be similar to last year, the recent outbreak of the coronavirus adds to new uncertainty[2].

Chart 3: Real GDP Growth Contributions



Source: Russian Federal State Statistics Service (Rosstat), MUFG Bank Economic Research Office

Chart 4: PMIs, Labour Market and Retail Trade



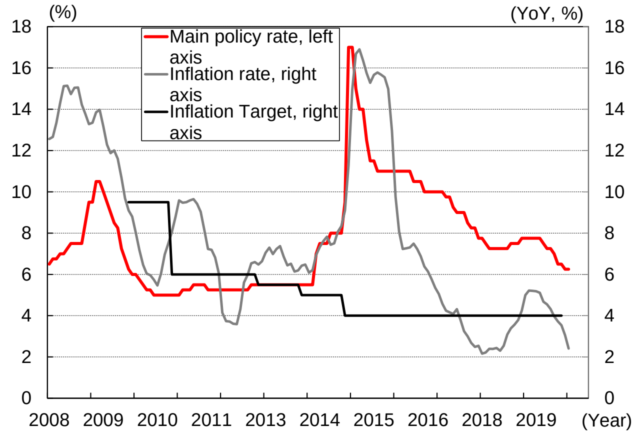
Source: Russian Federal State Statistics Service (Rosstat), Central Bank of the Russian Federation (CBRF) MUFG Bank Economic Research Office

The roll-out of national projects to modernise infrastructure, although delayed in 2019, is likely to make a small, marginal positive contribution to GDP growth. However, we should note that the roll-out of national projects is unlikely to achieve the original objective to boost real GDP growth up to 3.5% YoY, by increasing gross capital formation to 25% of GDP. This will remain a tall order, particularly in light of capex under execution in 2019 and the potential limited role of the private sector (especially from abroad). Greater private sector involvement would entail a larger multiplier effect but FDI in Russia was just 0.5% of GDP in 2018 and likely remained low in 2019. By the same token, the current external backdrop and sanctions environment will also make this difficult.

[2] See here: www.bk.mufg.jp/report/ecoglb2019e/outlook_global20191129e.pdf

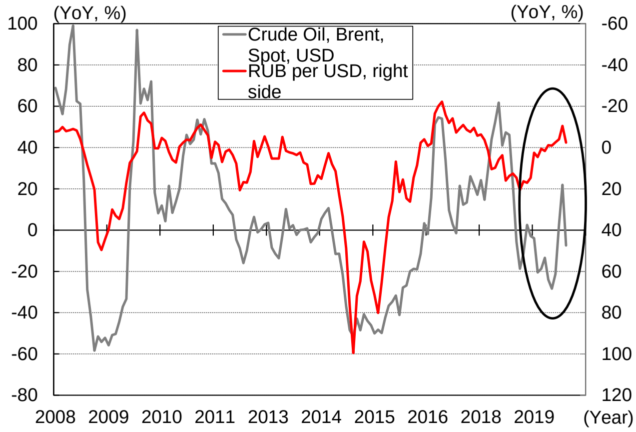
Turning to monetary policy, the Central Bank of the Russian Federation (CBRF) has reduced its main policy rate from 7.75% in June to 6.25% in December (Chart 5) as inflation has slipped below the 4% target. One factor contributing to lower inflation is the stable rouble and that is the result of an improved macroeconomic policy framework (Chart 6). If inflation remains below the central bank's target rate over the first half of 2020, there is scope for the policy rate to be lowered further. However, the impacts of any further rate cuts, which could help to increase investment marginally, is expected to remain small due to the current sanctions environment and the external backdrop, especially in light of the outbreak of the coronavirus.

Chart 5: Main Policy Rate and Inflation



Source: Russian Federal State Statistics Service (Rosstat), Macrobond
MUFG Bank Economic Research Office

Chart 6: Exchange Rate and Oil Price



Source: Russian Federal State Statistics Service (Rosstat), Macrobond
MUFG Bank Economic Research Office

4. Real GDP Growth to Remain Subdued in 2020

Overall, we expect that real GDP growth will accelerate from 1.1% YoY in 2019 to a still fairly-weak 1.6% in 2020. However, we note, against a backdrop of the still fragile external environment, the uncertain impacts of the coronavirus on world real GDP growth. Faster-than-expected implementation of public investment would help, but after the difficulties in releasing capital in 2019 we think this is unlikely. Longer-term, plenty of risks will linger despite the improved macroeconomic policy framework and improved fiscal and external buffers. Moreover, question marks will remain over the longer term boost to real GDP growth from the roll-out of national projects, and whether or not it will match the authorities' initial objectives in the first place.