Russia
Political news overshadows economic performance

By: Lester Gunnion

Introduction: Russia’s return to growth

Russia continues to be featured in the news. Politics dominates the headlines—the reelection of Vladimir Putin as president for an unprecedented fourth term, continued tensions with Europe and the United States, the expulsion of Russian diplomats from several countries, and a growing list of international sanctions on Russia are some of the trending topics of discussion. Every now and again, the soccer world cup, to be hosted by Russia in June, makes the news. All of this often takes the spotlight away from Russia’s economy.

In this article, we look at the state of the Russian economy after it returned to growth in 2017. Relatively higher oil and commodity prices have helped boost economic activity and have replenished state coffers. The labor market has tightened and real wages are on the rise as salary increases for state workers, promised in 2012, were put into effect before the presidential election and as inflation remains dormant due to a relatively stronger ruble. Monetary policy has been eased and there is likely room for further loosening.
Russia has also climbed the ranks in terms of competitiveness and ease of doing business. On the surface, the Russian economy is doing better than in the recent past. However, there are always risks—the banking sector commonly remains a cause for concern, Russia’s labor force is shrinking, productivity appears stagnant, and the economy continues to be heavily dependent on hydrocarbons.

The gears of the Russian economy are in motion . . .

The Russian economy grew 1.5 percent in 2017 after contracting for two years.¹ An agreement with the Organization of Petroleum Exporting Countries (OPEC) to cut oil production appears to have helped global oil prices climb since mid-2017. The success of the OPEC-Russia production cut agreement over the last year has sparked talk of a longer-term agreement spanning at least a decade. An uptick in oil prices is usually key to Russia’s recovery, since almost 70 percent of GDP is either directly or indirectly dependent on oil.²

Higher commodity prices have also helped boost the metals and mining sector, second only to the oil and gas sector in importance to Russia’s overall economic health. US President Donald Trump’s plan to impose tariffs on the import of steel and aluminum is unlikely to significantly dampen sentiment among Russia’s metal producers since global demand remains strong.³ Exposure to the US market is likely greater for Russia’s aluminum exporters than for its steel exporters. The United States imports 91 percent of total demand for aluminum but only 34 percent of total demand for steel.⁴ Russia accounts for 11 percent of the United States’ total aluminum imports and 9.5 percent of its total steel imports.⁵ In addition to tariffs, Russia’s largest aluminum producer must deal with sanctions that might prove to be a burden in the short term. Nonetheless, both aluminum and steel producers are unlikely to face a major setback as strong global demand might allow exports to be shifted to rapidly growing regions such as Southeast Asia. Furthermore, Russia ranks among the top 10 countries in terms of the production of nickel and palladium. (It is the sixth-largest producer of nickel and the largest producer of palladium.)⁶ Ongoing trends such as the rapid adoption of electric vehicles in emerging markets such as China and India are likely to benefit Russia’s nickel miners since nickel is a key component of batteries for electric cars.⁷ Additionally, Russia’s palladium miners are likely to gain from Europe’s move away from diesel vehicles as palladium is used in catalytic converters to reduce harmful emissions in petrol and hybrid vehicles.⁸ It is, therefore, not surprising that capital expenditure in each of Russia’s six largest listed metal companies is expected to rise in 2018.⁹

Higher oil and commodity prices have also helped Russia rebuild its foreign exchange reserves (see figure 1). At the end of February 2018, Russia’s reserves stood at $363.3 billion, up 22 percent from three years ago when a large portion of foreign exchange was spent on propping up the ruble as oil and commodity prices collapsed and international sanctions took effect.

Another beneficiary of the uptick in oil and commodity prices is Russia’s labor market (see figure 2). In February, unemployment was at an all-time low of 4.7 percent and nominal wages were 12.1 percent higher than a year ago. The sharp increase in nominal wages in January and February is linked to salary increases for state workers (initially promised in 2012 under the “May decrees”) that were put into effect before the presidential election in March.¹⁰ Inflation continues to fall mainly due to strengthening of the ruble. Like unemployment, inflation in February was at an all-time low of 2.2 percent. Higher nominal wages and lower consumer prices means higher real wages for Russian consumers. Real wages in February were 9.7 percent higher than a year ago and retail sales volumes have increased year over year every month since April 2017.

Low inflation also allowed the Bank of Russia to cut interest rates by 25 basis points in February and by a further 25 basis points in March. If inflation persists below the target rate of 4.0 percent, the central bank will likely have sufficient room to
Figure 1. Russia rebuilds its foreign exchange reserves

Source: Central Bank of the Russian Federation via Haver Analytics.

Figure 2. The Russian labor market gains

lower interest rates further in the near term. However, a sharp drop in the value of ruble due to the imposition of fresh sanctions on Russia (at the time of writing) could lead to higher prices if the ruble stays weak or falls further. This scenario is unlikely as the fundamentals supporting the ruble—oil prices and economic growth—remain firm. The possibility of lower interest rates in the near to medium term is likely to provide an additional boost to consumers, while a weaker ruble stemming from lower interest rates is likely to boost the competitiveness of energy and commodity exports.

In fact, Russia improved by five ranks in the latest global competitiveness index with much of the improvement being attributed to improved macroeconomic conditions. However, Russia also climbed the ease of doing business rankings in 2017, indicating that policies enacted to create a more conducive business environment are being recognized. The World Bank reports 23 separate business-friendly reforms that Russia has enacted since 2012.

... but risks likely lurk below the surface

Though the Russian economy provides reason for cheer relative to a couple of years ago, there are risks that can spoil the party. Arguably the most immediate risk is the state of Russia’s banks. Russia embarked on a mission to clean its banking sector in 2013. Since then, more than 300 private banks with bad loans and inadequate capital have been shuttered. However, the extent of the rot is not clear. In 2017, the central bank took control of three large private banks (including Russia’s largest private bank by assets at the time) burdened by bad debt. A prominent rating agency estimates that the central bank has spent 2.7 trillion rubles ($46 billion) on rescuing the banking sector so far. While the central bank has likely averted a complete collapse of Russia’s banking sector, low confidence in the banking system is likely to hamper business growth and weigh down on economic development. Furthermore, the public sector’s stake in the banking system is now as high as 65 percent. This means less competition and a conflict of interest as the central bank plays the role of regulator and owner. Rebuilding Russia’s private banking system is likely to extend well into the medium term.

Russia also has longer-term problems to deal with—such as a shrinking labor force and stagnant productivity. Russia’s birth rate of 1.7 percent is below the required replacement rate of 2.1 percent. In fact, Russia’s birth rate has fallen in each of the last three years. A shrinking population will eventually result in a shrinking labor force. The only way to drive stronger economic growth with a smaller labor force is through gains in productivity. However, output per employed person has remained relatively flat over the last five years (see figure 3).

And finally, Russia’s economy continues to rely heavily on the export of hydrocarbons. Russia’s geopolitical maneuver toward the East, particularly toward China, pivots on the export of energy. Russia is currently constructing a 3,000 kilometer gas pipeline from eastern Siberia to the
Chinese border. While the pipeline will connect the world’s largest energy exporter and the world’s largest energy consumer, it also helps reinforce Russia’s economic reliance on the export of hydrocarbons in the future. If economic restructuring away from a dependence on oil and gas does not materialize, then Russia’s economic performance will likely continue to be dependent on the price of hydrocarbons. At current energy prices, the World Bank projects that Russia’s economy will grow just 1.7 percent in 2018, still behind the 3.0 percent average rate of growth of the global economy.
1. All statistics in this article, unless otherwise mentioned, are taken from the Federal State Statistics Service via Haver Analytics, accessed April 3, 2018.


5. Ibid.


8. Ibid.

9. Ibid.


15. Ibid.

16. Ibid.

17. Ibid.


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Lester Gunnion is an economist, who primarily covers Singapore, Vietnam, and Russia—economies strongly dependent on trade. He also focuses on topics of interest in the US economy such as business investment and productivity.
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