Deloitte.
Insights

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]

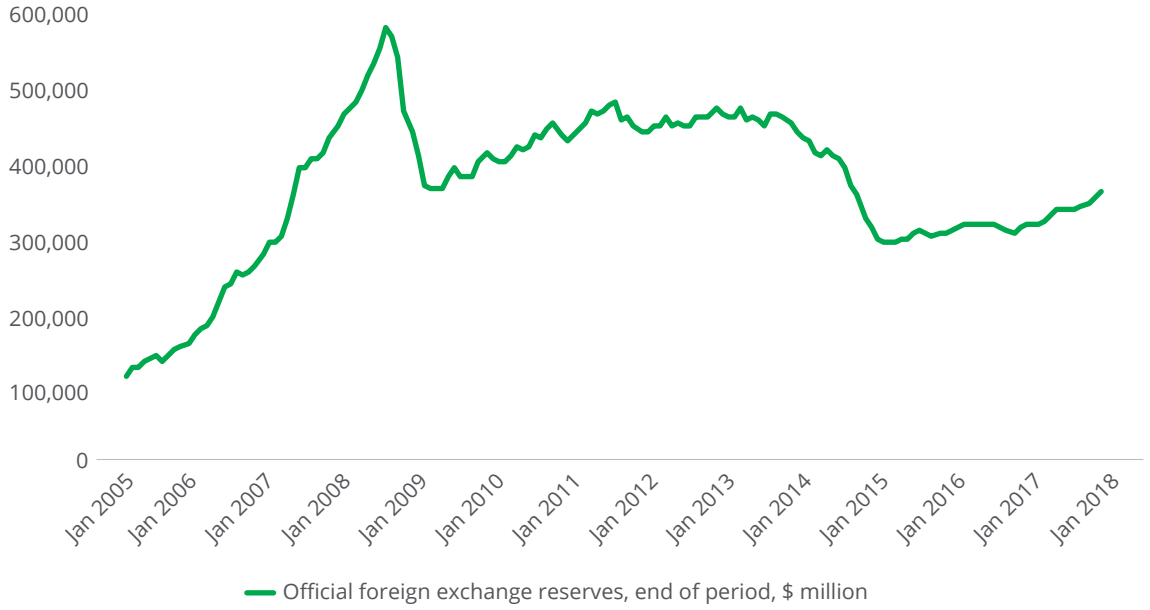
Higher commodity prices have also helped boost the metals and mining sector, second only to the oil and gas sector in importance to Russia's overall economic health. US President Donald Trump's plan to impose tariffs on the import of steel and aluminum is unlikely to significantly dampen sentiment among 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

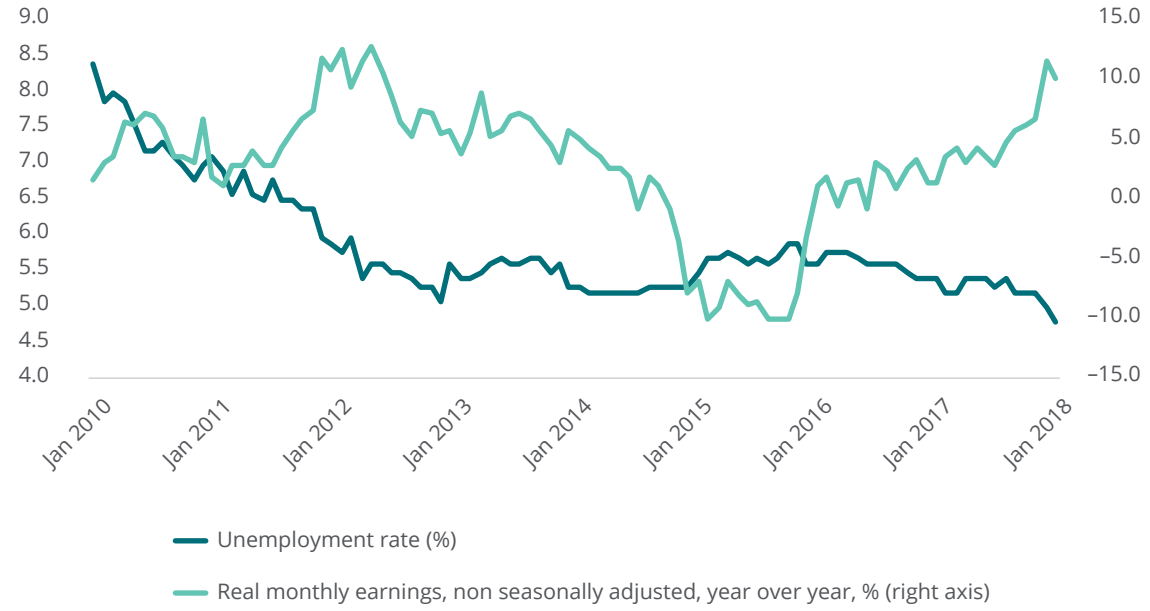
Figure 1. Russia rebuilds its foreign exchange reserves



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

Deloitte Insights | deloitte.com/insights

Figure 2. The Russian labor market gains



Source: Federal State Statistics Service via Haver Analytics.

Deloitte Insights | deloitte.com/insights

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.[11] 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.[12] The World Bank reports 23 separate business-friendly reforms that Russia has enacted since 2012.[13]

. . . 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.[14] 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.[15] A prominent rating agency estimates that the central bank has spent 2.7 trillion rubles ($46 billion) on rescuing the banking sector so far.[16] 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.[17] 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.[18] In fact, Russia's birth rate has fallen in each of the last three years.[19] 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

Figure 3. Labor productivity has stagnated

Source: Federal State Statistics Service via Haver Analytics.

Deloitte Insights | deloitte.com/insights

Chinese border.[20] 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.[21]

ENDNOTES

1. All statistics in this article, unless otherwise mentioned, are taken from the Federal State Statistics Service via Haver Analytics, accessed April 3, 2018.
2. Andrey Movchan, "Just an oil company? The true extent of Russia's dependency on oil and gas," Carnegie Moscow Center, September 14, 2015.
3. Polina Ivanova, "US tariffs may test their mettle, but Russian steelmakers safe," Reuters, March 2, 2018.
4. US Department of Commerce, *The effect of imports of aluminum on the national security*, January 17, 2018, and *The effect of imports of steel on the national security*, January 17, 2018.
5. Ibid.
6. US Geological Survey, *Mineral Commodity Summaries 2018*, January 31, 2018.
7. Henry Foy, "Russian metals producers forge ahead," *Financial Times*, March 26, 2018.
8. Ibid.
9. Ibid.
10. *Moscow Times*, "Russian state workers' salaries skyrocket since Putin's re-election bid," March 12, 2018.
11. Klaus Schwab, *The Global Competitiveness Report 2017–2018*, World Economic Forum, 2017.
12. World Bank Group, *Doing Business 2018*.
13. Shawn Donnan, Henry Foy, and Kiran Stacey, "Russia and India climb World Bank's Doing Business rankings," *Financial Times*, October 31, 2017.
14. *Economist*, "A purge of Russia's banks is not finished yet," November 23, 2017.
15. Ibid.
16. Ibid.
17. Ibid.
18. Kirill Zykov, "Birth rate hits 10-year low in Russia," *Moscow Times*, January 29, 2018.
19. *Kommersant*, "Russia's birthrate drops by 10.7 percent in 2017," January 29, 2018.
20. Henry Foy, "Russia's $55bn pipeline gamble on China's demand for gas," *Financial Times*, April 3, 2018.
21. Apurva Sanghi, "The Russian economy in 2018: The cart's still here today," World Bank, February 28, 2018. Note: The World Bank, in its Commodity Markets Outlook, in October 2017, projected the average price of crude oil to be $56 per barrel in 2018, up slightly from $53 per barrel in 2017.

ABOUT THE AUTHOR

LESTER GUNNION

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.

CONTACTS

Lester Gunnion
Deloitte Research
Deloitte Services LP
India
+1 615 718 8559
lgunnion@deloitte.com

Global industry leaders

Consumer & Industrial Products
Tim Hanley
Deloitte Services LP
USA
+1 414 688 2052
thanley@deloitte.com

Energy & Resources
Rajeev Chopra
Deloitte Touche Tohmatsu Limited
UK
+44 7775 785350
rchopra@deloitte.co.uk

Financial Services
Bob Contri
Deloitte Services LP
USA
+1 917 327 0828
bcontri@deloitte.com

Life Sciences & Health Care
Greg Reh
Deloitte Consulting LLP
USA
+1 215 680 8913
grreh@deloitte.com

Public Sector
Mike Turley
Deloitte Touche Tohmatsu Limited
UK
+1 44 7711 137213
mturley@deloitte.co.uk

Telecommunications, Media & Technology
Paul Sallomi
Deloitte Tax LLP
USA
+1 408 704 4100
psallomi@deloitte.com

US industry leaders

Financial Services
Kenny Smith
Deloitte Consulting LLP
+1 415 783 6148
kesmith@deloitte.com

Consumer & Industrial Products
Seema Pajula
Deloitte & Touche LLP
+1 312 486 1662
spajula@deloitte.com

Life Sciences & Health Care
Bill Copeland
Deloitte Consulting LLP
+1 215 446 3440
bcopeland@deloitte.com

Deloitte.
Insights

Sign up for Deloitte Insights updates at www.deloitte.com/insights.

Follow @DeloitteInsight

Deloitte Insights contributors
Editorial: Rithu Thomas, Nikita Garia, Preetha Devan
Creative: Mahima Dinesh
Promotion: Shraddha Sachdev
Artwork: Tushar Barman

About Deloitte Insights
Deloitte Insights publishes original articles, reports and periodicals that provide insights for businesses, the public sector and NGOs. Our goal is to draw upon research and experience from throughout our professional services organization, and that of coauthors in academia and business, to advance the conversation on a broad spectrum of topics of interest to executives and government leaders.

Deloitte Insights is an imprint of Deloitte Development LLC.