Will the Oil and Sanctions Reality Check Force Russia to Create a More Competitive Economy?

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When asked about how Russia's economy has performed in the two years since the start of sanctions and twenty months since the start of the oil price slide a common answer from most pragmatic government officials is "it could have been worse". And they are right, it could have been. While many observers predicted a steeper recession and a near bankrupt state by this time. Russia today appears to be far from that doomsday scenario.

So just how did the economy side-step those dire predictions and why were the doomsayers wrong? Secondly, let us look at the current state of the economy and consider just how stable is it and under what conditions or assumptions? Thirdly, what are the implications for both strategic and portfolio investors and what areas should they focus on in the years ahead?

In late 2014, just after the oil price started to collapse and sanctions were considerably tightened, there were plenty of predictions that the economy would slide by at least 10 percent in 2015 and the government would run out of money by early 2016. The country was headed for bankruptcy. In fact some sectors of the economy did collapse by 10 percent or close to that level in 2015. Retail sales, for example, fell 10 percent as households suffered an almost equally big collapse in incomes while inflation spiked to double digits and the Central Bank (CBR) pushed up its benchmark Key Rate by almost three times, to 17 percent, by the end of the year. The retail sector, along with construction, which fell by over 7 percent, had been amongst the most important drivers of the boom which lasted through the noughties.

But while these previous growth drivers did collapse the headline rate of decline in the economy was only 3.7 percent. Still bad, but it could have been worse. The reasons why it was not worse was because of A) the complete abandonment of the CBRs previous currency management regime, B) much greater policy flexibility by the government and some state organisations than had been expected and C) budget restraint.

The CBR moved to a full free-floating ruble in March 2015. That action has had wide-ranging consequences, most of which have been very positive, for the economy. After March the ruble-dollar exchange rate was closely correlated with the price of oil. Over the full year the ruble lost 21 percent against the dollar while the price of Urals fell 28 percent. The effect of that was to A) reduce the appeal of imported goods and services, which became increasingly expensive, B) help the Finance Ministry better manage the budget deficit as lower dollar based taxes were offset by the weaker ruble, C) the value of the country's foreign exchange reserves stabilized near the March 2015 level.

The collapse in imports, the value of which has more than halved since early 2014, plus the impact of Russia's retaliatory ban on imported food, helped such sectors as agriculture which reported an increase in volume of over 3 percent in 2015.

Another positive action was the budget spending restraint. It would have been easy simply to boost social spending and public sector worker salaries in an effort to maintain social stability and support for the Kremlin's foreign policies. But the greater fear for the Kremlin was to run out of money especially as the financial sector sanctions had effectively locked the entire country out of western capital markets. Running out of money, or even raising the prospect of such would have weakened the country's geo-political position. Passing the burden to households and industry was the lesser of evils.

The other surprising policy response has been a greater effort to reduce wasteful and excessive spending in state organisations and in the regions. Part of the message also appears to be to officials to stop stealing, or at least not as much or as blatantly as they used to under better economic conditions. More than two dozen regional governors lost their jobs in 2014 and 2015 because they either refused or were unable to comply with that directive. The others got the message. It was a similar story in the big state organisations.

Russia will likely remain in recession for a second year in 2016. It certainly will do so during the first half. But the pace of decline is slowing and the full year range between optimistic and pessimistic scenarios is quite narrow between growth of 0.5 percent and a contraction of 1.8 percent. The data for the first quarter gives greater hope to the optimistic side of that scale but clearly it is far too early to be confident. The main point, however, is that the economy has almost stabilized, albeit at the bottom. One of the other saving factors for the economy is that the bulk of people who lost their jobs during 2014 and 2015 were workers from Central Asian states who went home and not onto the unemployment register. It means that the rate of unemployment is less than 6 percent, a relatively small number for an economy into its second year of recession.

Today Russia's financial position is best described as manageable rather than comfortable. It is in no danger of the bankruptcy scenario many had predicted. Again, the major reason for that was the 180 degree turn in monetary policy. It means that the Current Account actually rose in 2015, up to $66 bln from $58 billion the year before. Capital outflow, which totalled over $150 billion in 2014 dropped to less than $60 billion last year or "normal" in terms of trade activity. The cynics are entitled to caution that this decline is because most nervous money has already gone to foreign bank accounts and indeed the total capital outflow of the past twenty years can be estimated close to $1.2 trillion or just over 100 percent of current GDP. Nevertheless the situation did not continue to deteriorate in 2015 and is much more stable today.

One of the positive consequences of financial sector sanctions is that the country has had to go "cold-turkey" in terms of external debt repayment. Russian banks and enterprises have had to repay external debts as they fell due and were not been able to raise new debt until late last year. But even then the total has been small as lenders apply a Russian risk premium even to non-sanctioned entities. The effect of this forced repayment is that the country's total external debt has fallen to just over $500 billion at end April from $740 billion before Crimea weekend in March 2014. Stated another way, almost 25 percent of GDP has been used to reduce debt rather than being made available for investment into the economy. Another of those lesser of evils actions over which there was no other choice.

What's next? The government clearly cannot afford to sit around and wait for the national-economic equivalent of a lottery win.

At least one cannot expect that to happen twice. Russia got lucky in 2000-2012 when the country earned $3 trillion from exporting hydrocarbons and that fuelled growth via consumer sector expansion and budget spending. But, as 2013 showed, that phase is over. That year GDP only expanded by 1.3 percent even though oil averaged $110 per barrel all year and there were no geo-political issues. Doing nothing this time runs the risk of muddle-through economics down-shifting to stagnation. After delivering a golden age to Russian consumers from 2000-2012 and promising even more, no government can walk away from that without risking social and political consequences. The stability evident today would very likely change within a few years if that were to be the case.

Focusing on what can be done the good news is that nobody in government is talking about vague and discredited general reforms. Such rhetoric meant nothing in the boom years and would be even less credible today. Instead, almost two and a half years into the economic slump we are starting to see a more credible discussion and some evidence of a new industrial policy. Initially, as a reaction to sanctions, that policy was routinely referred to as Import-Substitution. Then it evolved into the broader theme of Localization, which focused not only on permanently displacing imported goods but on creating a manufacturing base in Russia to grow exports. Latterly the phrase Competitive Economy is being used more and more.

Competitive Economy is not just about creating better manufacturing conditions in Russia, albeit that appears to be a big part of the formula at least initially. It is about changing the way the economy works. Today, as a result of both the forced changes and the effective policy changes Russia is a lower cost producer than China and many other developing economies. The key will be to maintain that status when the economy starts to recover there is greater budget flexibility. But even assuming that the government is serious about creating and developing this new industrial model, it will be years before the benefits will be seen in terms of headline growth. Most manufacturing industries are poorly developed after two decades of neglect. Most plants require a complete modernization even before one considers other efficiency measures.

Creating a competitive economy also means improving the environment for private sector investment and for SMEs to grow unimpeded by bureaucracy and corruption. Despite progress over the past couple of years a great deal more needs to be done. But at least now the reality that the oil boom years are over, regardless of where oil trades next, is accepted by a broader number of people in policy making positions. They are also more aware of the consequences of doing nothing or poorly executing the next phase of Russia's economic evolution.

Russia faces a slow recovery to targetted growth through the next presidential term*

Key Indicators	2015	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E
GDP, nominal, US$ bln	$1,249	$1,166	$1,359	$1,561	$1,779	$2,064	$2,320	$2,380	$2,453	$2,736	$3,035
Growth, real, % YoY	-3.7%	-0.6%	1.5%	2.0%	3.0%	3.4%	3.7%	4.0%	4.5%	4.0%	3.5%
Agriculture output, % change YoY	0.0%	0.0%	0.0%	0.0%	4.0%	4.5%	4.0%	3.5%	3.3%	3.0%	3.0%
Retail sales, % YoY	-10.0%	-4.0%	2.0%	4.0%	4.5%	5.0%	5.5%	6.0%	7.0%	6.5%	6.0%
Budget balance, % of GDP	-2.6%	-4.0%	-3.0%	-1.5%	0.0%	0.5%	0.5%	0.0%	-0.5%	-0.5%	-0.5%
CPI - year-end, % YoY	12.9%	9.0%	7.0%	6.0%	5.0%	4.8%	4.5%	4.0%	4.0%	3.7%	3.4%
Real disposable income, % YoY	-6.5%	-3.5%	1.0%	2.0%	2.5%	3.0%	3.5%	4.0%	3.5%	3.0%	2.5%
Unemployment, % EOP	5.6%	5.9%	5.5%	5.3%	5.2%	5.0%	4.8%	4.8%	4.7%	4.6%	4.4%
Trade balance, US$ bln	$135.0	$100.0	$120.0	$130.0	$150.0	$160.0	$165.0	$155.0	$150.0	$160.0	$160.0
Current account, US$ bln	$65.8	$30.0	$45.0	$55.0	$65.0	$75.0	$75.0	$65.0	$65.0	$70.0	$65.0
FDI, gross US$ bln	$25.0	$20.0	$25.0	$40.0	$60.0	$80.0	$100.0	$90.0	$100.0	$90.0	$100.0
Total foreign debt, % of GDP	41%	41%	38%	35%	32%	30%	31%	35%	38%	38%	39%
RUB/US$, year-end	73.5	68.0	66.0	60.0	58.0	55.0	55.0	58.0	60.0	56.0	55.0
RUB/EUR, year-end	79.7	76.0	75.0	68.0	68.0	65.0	66.0	72.0	69.0	63.0	60.0
Average Urals, US$ p/bbl	$54	$42	$66	$80	$90	$100	$100	$90	$90	$90	$90

Source: Federal Statistics Service, Central Bank of Russia, Macro-Advisory estimates
** from March 2018 to May 2024*
Note: Excludes the Crimea population and GDP contribution