



Commentary on State and Business

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The 2018-2020 Budget – Consolidation and only Consolidation

The draft budget submitted to the Duma priorities fiscal consolidation and aims to reduce federal spending from Rb16.9trn in 2017 to Rb16.5trn in 2018 and Rb16.4trn in 2019. The Ministry of Finance does not anticipate that it will be possible to raise expenditure in nominal terms before 2020.

The existing expenditure framework will be retained, characterised by high spending on the security services and social transfers, and the underfinancing of education and health. Over the past decade Russia's budget priorities have moved in the opposite direction to those of the OECD. From 2007-15 health expenditure in OECD countries rose from 17% to 18.7% of the total, whereas in Russia it fell from 12.1% to 10.8%. Spending on education averaged 13% over this period across the OECD, while in Russia it declined from 11.8% to 9.9%. Maintaining the current expenditure framework while reducing total expenditure as a share of GDP will increase the gap between Russia and developed countries, and move it closer to the budget profile of the third world.

Despite the tight spending plans, there are significant risks that non-hydrocarbon revenues will be lower than projected. The budget projection has been drawn up on the basis of an oil price of \$40/barrel (in constant prices) and a largely unchanged tax burden. Based on the government's oil price forecast, the projection that real GDP will grow by 2% a year, and investment by 5-6% a year does not appear realistic. Based on an oil price of \$50-60/barrel in 2018-20, we forecast growth of 1-1.5% a year. As a result, there is a risk that VAT and other revenues will be lower than projected by the Ministry of Finance.

To date the government has not succeeded in establishing an effective system of control over the investment and dividend policy of state-owned companies. Mid-year amendments to the 2017 budget illustrate the difficulties the Ministry of Finance continues to encounter in extracting planned dividends from state-owned companies. The budget will receive Rb200bn less this year in dividends than previously forecast. It is therefore uncertain whether the dividend forecast set in the 2018-20 budget will be met.

Efforts to reduce the size of the informal economy are unlikely to increase competition and productivity. The size of the shadow economy is smaller in the transport and industrial sectors, where productivity is held back by the low level of competition, dominance of state-owned enterprises, and high state subsidies. By contrast, levels of informality are high in more competitive sectors, such as property, services and IT.

1. Regional Economic Indicator

In August 2017 the Composite Regional Economic Activity (REA) Index fell to 53.2% from 56.6% in July, but remained above the critical 50% level separating growth from recession. The number of regions in recession and the depth of the recession experienced by these regions is gradually declining. The economy is improving, but the transition to a post-crisis level of growth, characterised by the steady expansion in economic activity is not yet evident.

Across Russia as a whole, the REA index was above 50% in three of the five main sectors, and six of eight federal regions. The industrial REA index stood at 70% in August, which points to stable expansion in economic activity in this sector of the economy. Significant growth was also recorded in wholesale and retail trade (57-62%). August was the fourth successive month of growth after 28 months of consecutive decline. There is little reason to doubt the sustainability of the positive trend in consumer demand. However, the service sector continues to struggle (the REA index stood at 41% in August, against 57% in July), and construction, at 35%, is far from overcoming the decline that began at the end of 2012.

On a regional level, the REA index exceeded 50% in 48 of 82 regions. However, the number of regions where all, or all but one, of the five main sectors recorded a contraction in activity rose from 11 to 14. The worst performing regions are Kurgan and Tomsk, where all five sectors recorded a contraction in output. Output declined in four of five sectors in 12 regions. However, these 14 regions account for just 7% of Gross Regional Product. The four worst performing regions over the past three months were Kurgan Oblast, Karachaevo-Cherkessia, Zabaikalsky Krai and Tomsk Oblast.

The number of regions where all or four out of five of the sectors recorded growth fell from 24 to 18. The best performing regions include the city of Sevastopol, Ingushetia, Nizhny Novgorod oblast and Penza oblast, where all five sectors recorded growth. 55 regions recorded growth 'on average' in June-August, or 67% of the total. The most successful region over the past three months was the city of Sevastopol.

2. Macroeconomic Outlook and the Real Economy

August saw a recovery in economic activity after a significant correction in the previous month. Most economic sectors recorded growth, with the exception of construction and possibly also industry. Based on Rosstat data, the rate of growth of the index of primary sectors stood at 2.6% in July-August year on year. Using our alternative estimate of industrial activity, output rose by 3.2% year on year. Growth in economic activity has been supported by the rising price of oil. Consumer demand continues to stagnate, but freight turnover and gas production reached historic highs. Overall, we continue to forecast real GDP growth of 2% in 2017. The Development Centre's alternative estimate of industrial production suggests that the expansion in industrial production recorded from the start of 2016 to the first quarter of 2017 may have come to an end.

The Index of Economic Output calculated by the Development Centre using Rosstat data rose by 1.5% in August, following a 2.1% fall in June-July (unless otherwise indicated, figures are month-on-month, seasonally adjusted). Output of the main economic sectors returned to the positive trend and again exceeded the average level recorded in 2014. An alternative output measure calculated by the Development Centre recorded somewhat lower growth of 1% in August (the difference between the two indexes is that the second does not include statistically unreliable components). The biggest contribution to output came from wholesale trade, which rose by 4.1%, after falling by 7.1% in July.

The index of domestic private demand (a weighted index of retail trade, paid services and construction) was unchanged in August. Overall, since the start of the year household demand has continued to stagnate along with real earnings. By contrast, construction offers more cause for optimism – although output fell by 0.5% in August, over the last six months it has risen by 9%, and is half-way to reaching its 2013 peak. However, the sustainability of the recovery remains in doubt given the volatility of this indicator.

Industrial output rose by 1.1% in August, after falling by 3.7% in June-July. Manufacturing continues to stagnate. Output from the extractive sector continued to move back to trend, despite the rapid growth in gas production - gas output in August was up by 22% compared with the 2015 average. This rapid growth is linked to a decline in gas storage in 2016 and a recovery in supplies to the domestic market as a result off the return to economic growth. Assuming stable exports, we expect gas production to fall by 12-15% in the next two-three quarters (from 64mn cu m a month in August to 55mn cu m, seasonally adjusted), which is equivalent to a decline in the industrial production index of 0.5 percentage points. Given the constraints on oil production, this will hold down the overall level of industrial production in the coming six months.

To date in 2017, mining has accounted for half of the growth in industrial production, while manufacturing accounts for just one quarter. The two principle drivers of manufacturing growth were chemical and food production, which accounted together for 0.55 percentage points of year-on-year growth in January-August. The recovery in the automotive sector, which expanded by 12% year on year, contributed 0.16 percentage points.

Rosstat surveys of industrial enterprises indicate that output is stagnating across many enterprises, and demand is slowing, which suggests that the recovery in industry in the first half of 2017 was linked to the replenishment of inventories and may soon come to an end. It is also evident that enterprises' assessment of the overall economic situation in both the manufacturing and mining sectors is worsening. At the same time, capacity utilisation has been stable in the extractive sector since 2014, and in the manufacturing sector since 2015. Given falling inflation expectations in both sectors, it is unlikely that the recent significant cut in the key policy rate will push up inflation.

It is unclear whether further interest rate cuts will drive a further the recovery in industry. Two factors will impede this. First, the multiplier effect from the accumulation of inventories is time limited, and as it falls away output growth will slow. Second, growth will be held back by the traditional weaknesses of the Russian economy, including the low level of diversification and the large disparities in wealth and income. As underlined by the latest World Economic Forum Competitiveness Report, Russia continues to suffer from a weak financial sector and low goods market efficiency, in part owing to low competition in state procurement. Russia also scores poorly for the quality of institutions and business sophistication (the quality of corporate management). These weaknesses prevent Russia from taking full advantage of its strengths, including the size of the market, the level of education and relatively good infrastructure.

3. Corporate Profits in January-July 2017 – Mining to the Rescue

The state's reliance on profits from the resource sector remains high. In the first half of 2017 profits from the mining sector recorded the fastest rate of growth. As a result profits in the extractive sector were almost level with those recorded by the manufacturing sector, despite the appreciation of the rouble. By contrast, in the first half of 2016, profits from the mining sector lagged those in the manufacturing sector by Rb340bn.

Net corporate profits before tax fell by 6.7% year on year to Rb5.7trn in January-July 2017. This was largely the result of a fall in profits in the service sector of 20.6%. This was due above all to a 40% fall in the profits from retail trade and trade in the automotive sector. Profits in the goods-producing sector rose by 3.1%, despite a decline in profitability in the agricultural sector (of 8.7%) and construction (of 30%). This was offset by a rise in industrial profits, particularly in mining, which recorded a 17% rise in profits. Profits in the oil and gas sector rose by 1.3 times, and in the coal mining sector by 3.1 times. This was due both to a rise in prices and increased production. As a result, the share of industry in overall profits before tax rose by 6.5 percentage points to 61%.

In the first half of 2017, profits on sales fell by 2.2%, while net corporate profits before tax fell by 10.9%. As a result, the return on production (calculated as the ratio of net profits to turnover) fell from 8% in the first half of 2016 to 7% in January-June 2017, which underlines the low level of solvency across the economy as a whole. Profitability in some sectors is much higher, including fishing (27%), mining (20%), international passenger rail (37%) and telecoms (19%). The wide range of profitability is the product of both longstanding features of the economy, such as the high level of monopolisation of some sectors and state subsidies (in the case of fishing, agriculture and automotive production), as well as temporary factors, such as high demand for rail travel owing to problems in the aviation sector.

4. The Balance of Payments – Will Rising Imports Wipe out the Trade Surplus?

The gradual improvement in the economy has led to a recovery in import demand. As a result, seasonally adjusted goods imports have risen by 60% over the past year and a half. The rate of growth in imports has been high relative to the rate of growth of exports and domestic demand. Further growth in imports could push out domestic producers from the market, and raise questions over the stability of the balance of payments. Without a rise in the value of exports the rouble is almost certain to depreciate.

Import growth has been supported by the strengthening of the rouble. Over the past eight months the real effective exchange rate of the rouble has appreciated by 22%, and by 28% since January 2016, when imports reached their lowest point. In May-August the rouble depreciated by more than 10%, which has slowed the rate of growth in imports. After reaching a 12-month peak in March, the value of exports started to drift downwards. A recovery is likely in September owing to the rise in the oil price, but overall the value of exports has tended to be flat. The stagnation in export values combined with growing imports has led to a decline in the trade surplus in July-August to \$4-5bn a month, the lowest level since August last year (when the rouble depreciated by 1.9%), and the winter of 2008-09 (when the rouble depreciated on average by 5.7% per month). We estimate that the current-account balance recorded a deficit of \$1-2bn a month in July-August and was almost fully financed by net inflows of capital from the private sector. Given falling interest rates and the potential for a further tightening of western sanctions, there are questions over the stability of the current structure of the balance of payments, characterised by a current-account deficit and financial account surplus.