

The economy of Russia after three years of crisis

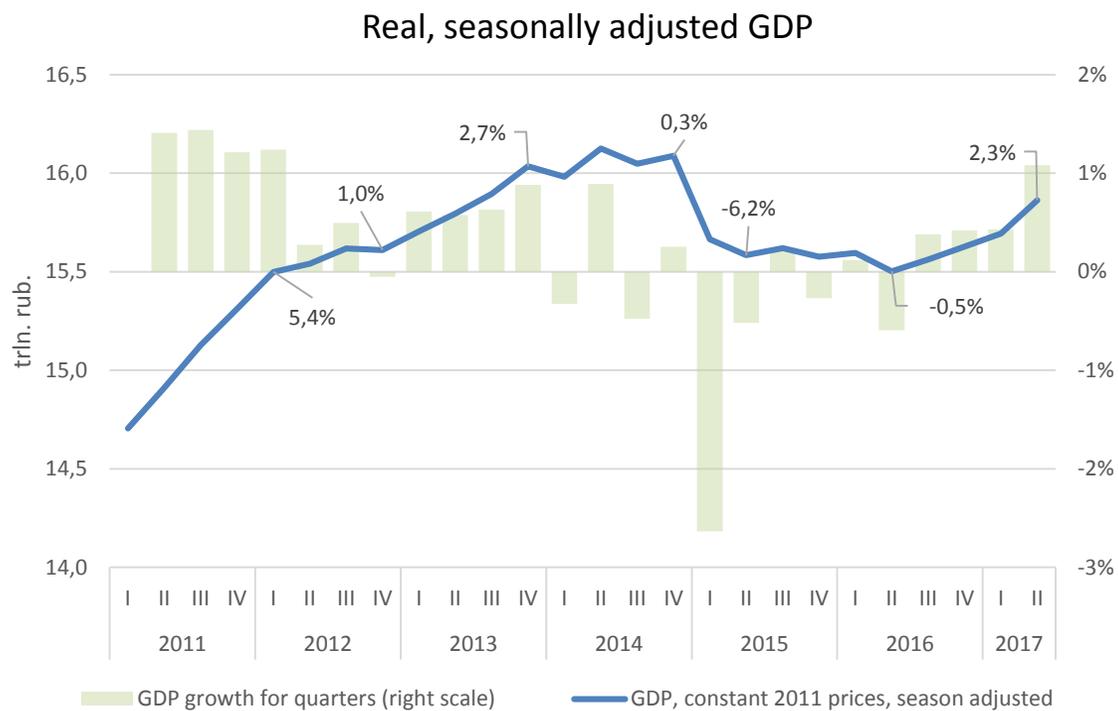
Three years ago, Russia faced an economic crisis caused by a large drop in oil prices and exacerbated by the sanctions of the USA and the EU. The economic situation remains complicated; the imbalances accumulated during the crisis can slow down the pace of recovery.

The economy starts to recover

The Russian economy enters a period of recovery. Over the past year, the average annual GDP growth rate was 2.3%.

Considering the industries separately, one can see a multidirectional picture. Since 2012, the strongest growth was in agriculture, supported by the response to the sanctions and the fall of the ruble. Despite the accumulated since 2012 growth, Financial activity remains a lot below the 2014 levels.

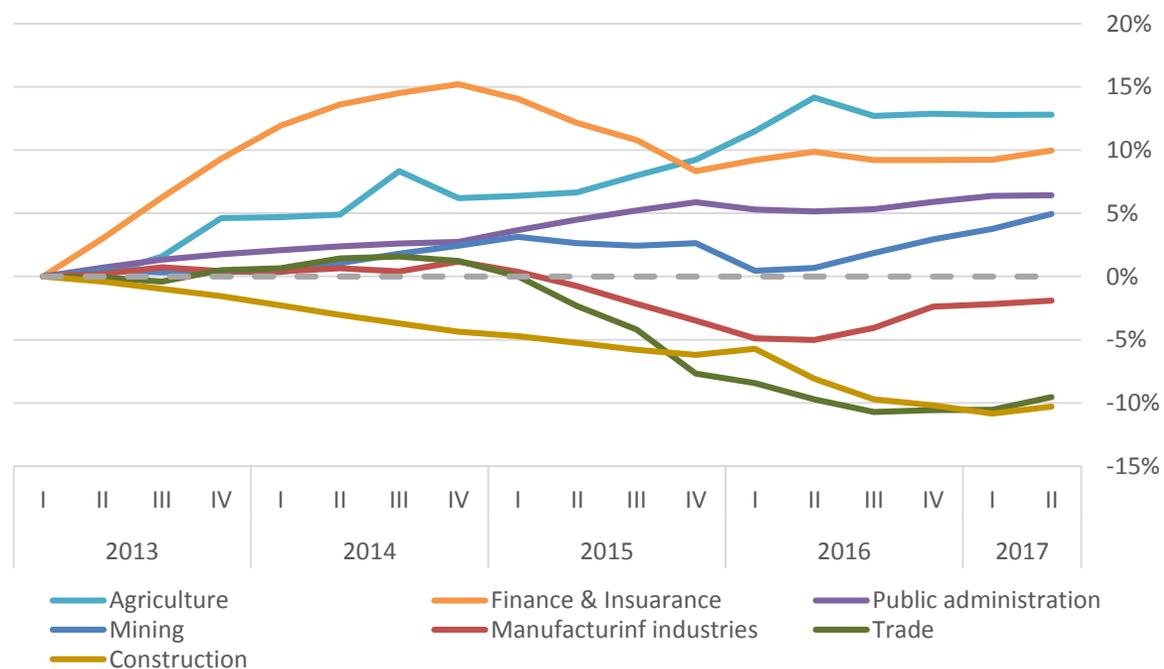
In fact, the economic growth in the last year is provided only by the extraction of minerals, which comes to life against the backdrop of rising oil prices.



Source: Rosstat

The figures show the average annual growth rate after the end of the previous trend

The largest sectors of GDP produced (accumulated changes since 2012)

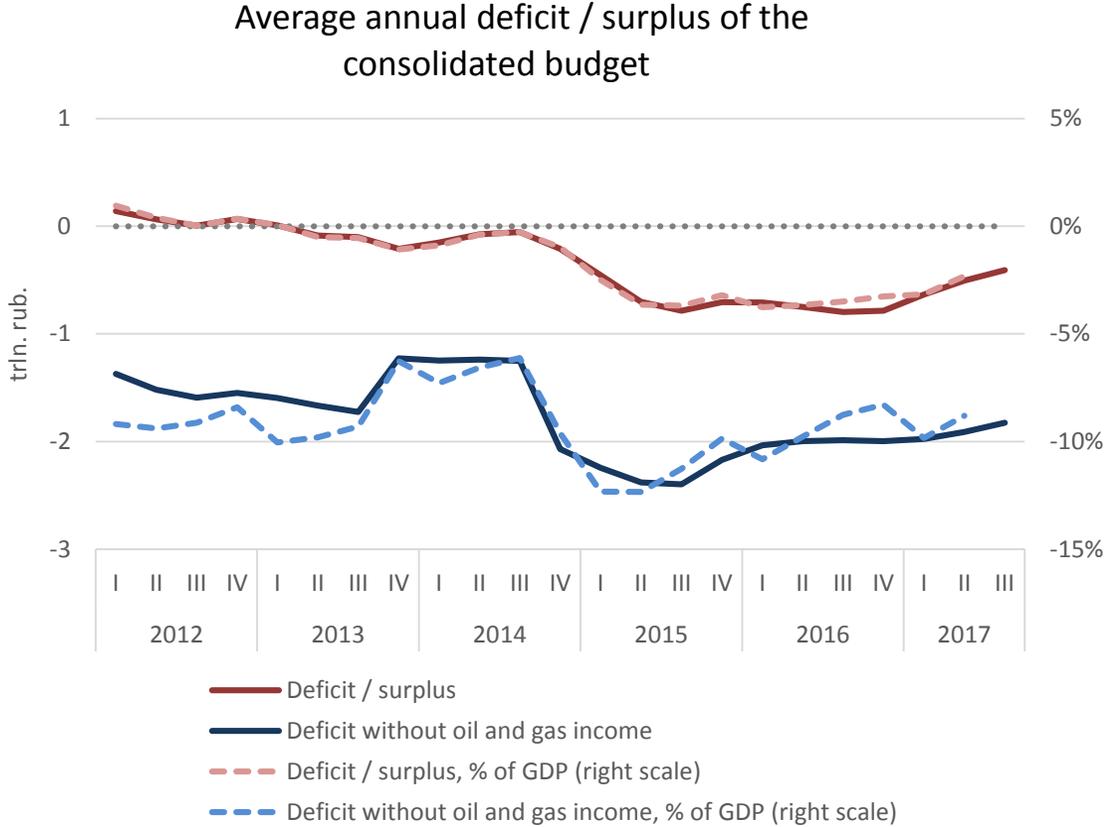


Source: Rosstat

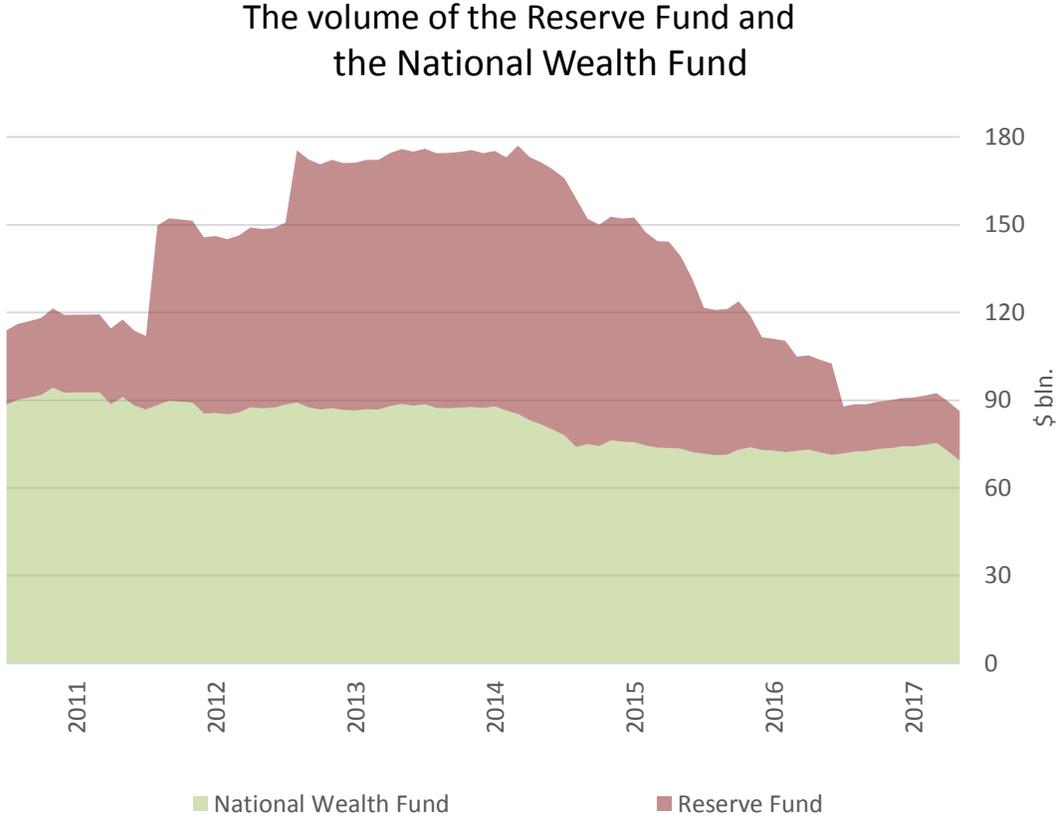
During the crisis, the public administration sector, along with agriculture, has become almost the only driver of the Russian economy. The government preferred not to reduce the growth rate of expenditures, despite the growing budget deficit.

The Reserve Fund helped government to increase spending in the conditions of declining incomes, of which \$75 billion was spent during the crisis. Currently, about \$17 billion is left in the Reserve Fund. The Ministry of Finance announced that it intends to spend the Reserve Fund completely, and then to start spending money from The National Welfare Fund.

Industries of the real economy such as manufacturing, trade and construction are depressed, still not capable to exceed the financial results of 2012. There are several reasons for this, from the increased tax burden to too expensive credits.



Source: Ministry of Finance



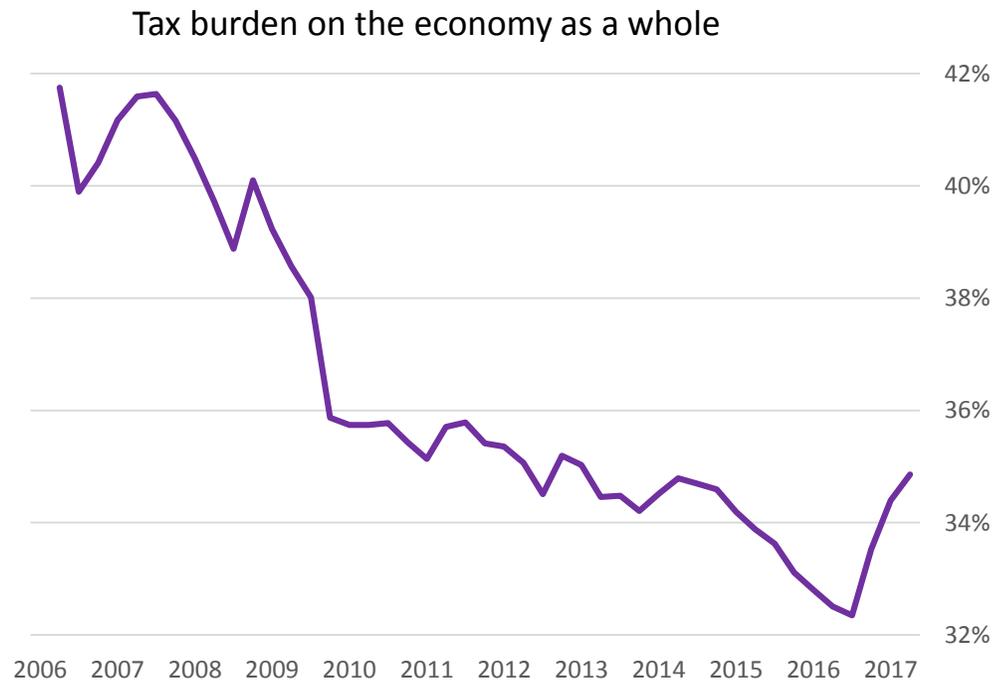
Source: Ministry of Finance

The tax burden

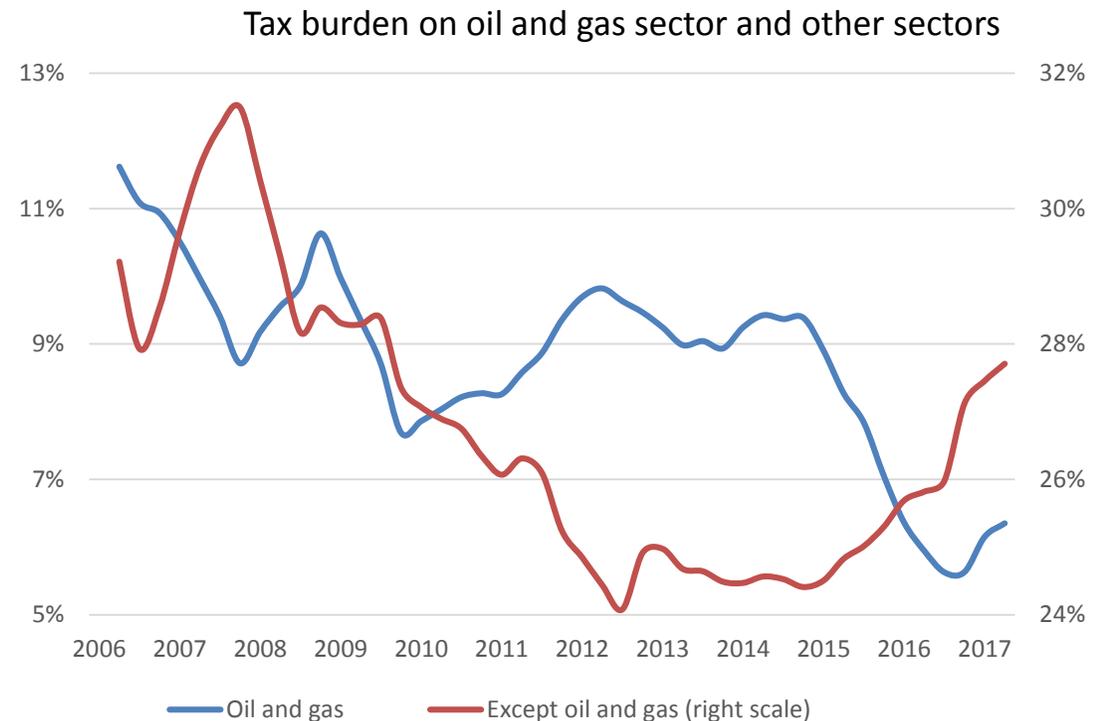
Income to the Russian budget consists of two main parts - revenues from the oil and gas sector and revenues from other sectors of the economy. The fall in oil prices in 2015-16 have negatively affected tax revenues from the oil and gas sector. However, at the same time began another process - more information has come to the fiscal bodies due to the introduction of new cash registers and the improvement of sales books. The volume of collected taxes from sectors not related to oil and gas began to grow.

In 2016, the situation on the oil market stabilized, which, given the continued increase in the collection of taxes from other sectors, caused a sharp increase in the overall tax burden. Thus, at the end of 2016, a long-term trend of the reducing tax burden on the economy was broken. During the year it increased from 32.5% to almost 35% (second quarter of 2017), returning to the pre-crisis level.

The tax burden on non-oil and non-gas sectors has increased even more, almost reaching the level of 2009. Of course, this creates pressure on the business, hindering the development of the economy.



Source: Ministry of Finance

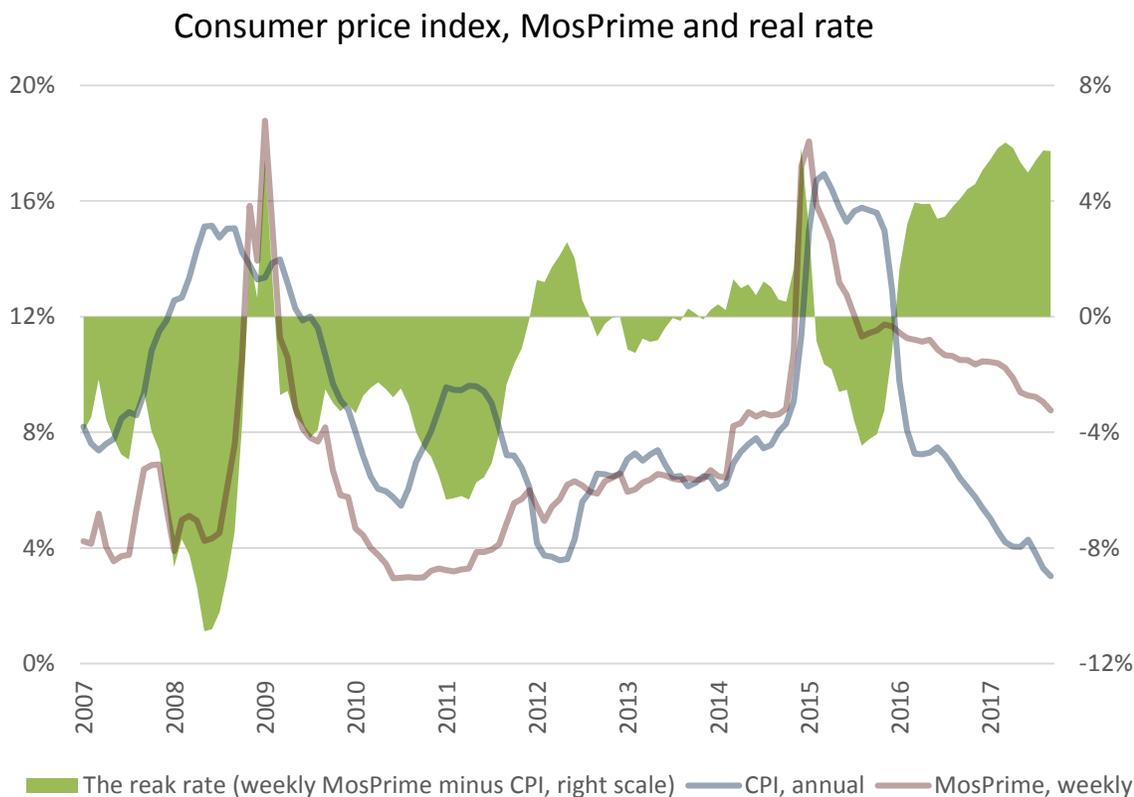


Source: Ministry of Finance

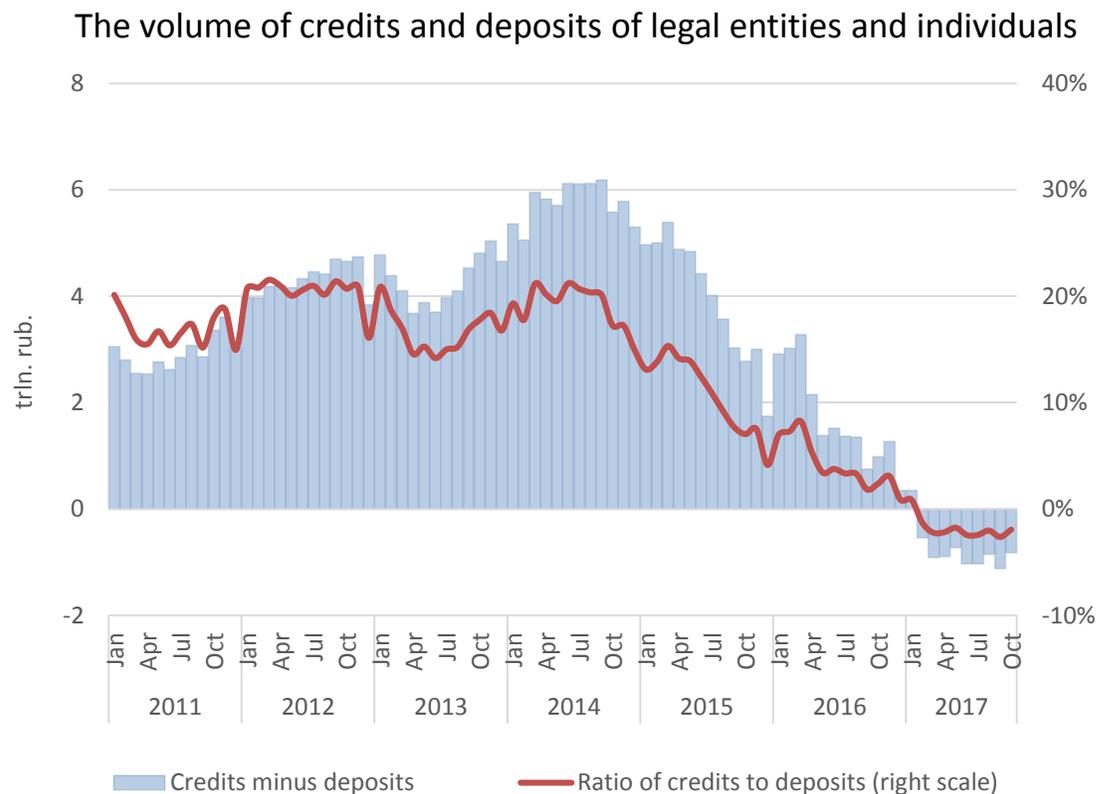
The real rate at the historical maximum

Since the end of 2014, the CB RF maintains a very strict monetary policy, which mainly is performed by keeping the key rate at a high level. Thus, the Central Bank wanted to curb high inflation in 2015-16 and stabilize the ruble exchange rate. The goals were achieved, the ruble exchange rate became relatively stable, inflation was even below the CB's target threshold of 4% by September 2017. But the Central Bank is in no hurry to dramatically lower the rate, fearing that the speculators using the carry trade strategy may exit from the Russian ruble.

As a result, the real rate for the first time ever stays at a consistently high positive level, over 5%. This negatively affects economic development, increasing the cost of credits. Since early 2017, the volume of credits to legal entities (except for credit institutions) and individuals has already become less than the similar volume of deposits. In the banking sector, there is excess liquidity, but business does not seek to borrow at this high rate, especially in the face of declining inflation.



Source: Rosstat, Central Bank of Russia



Source: Central Bank of Russia

Carry trade

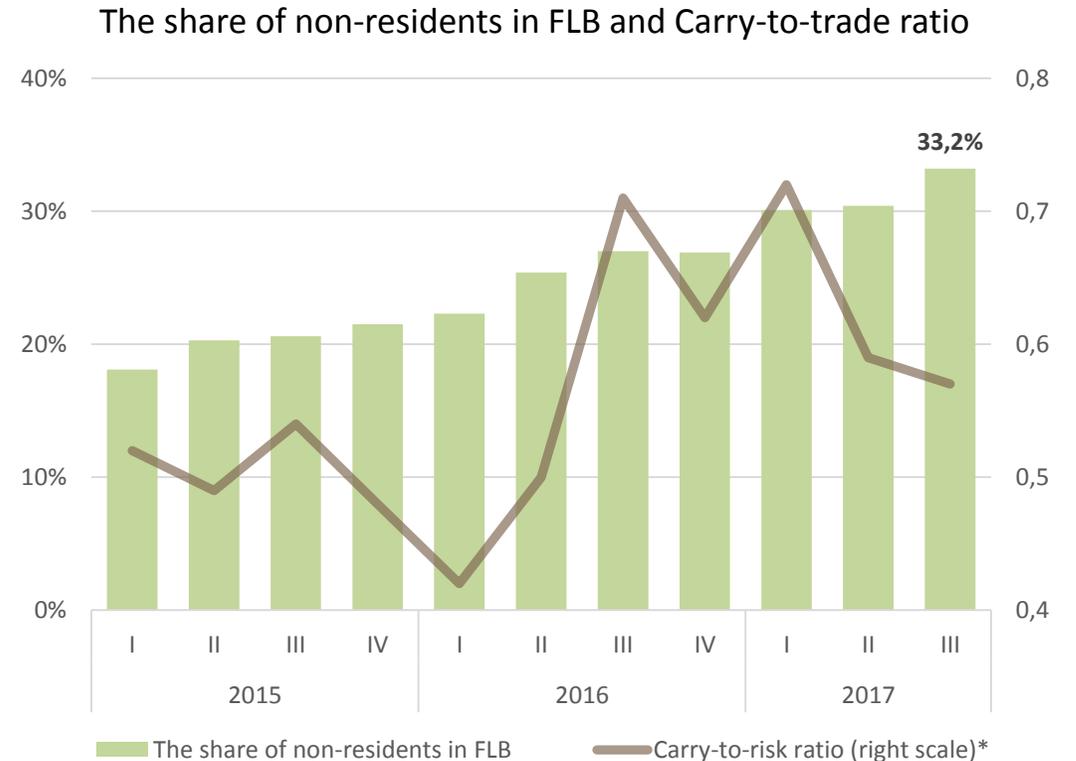
One of the most common speculative strategies in financial markets is called carry trade. Its essence is borrowing funds in low-interest countries and buying financial instruments in high-interest countries. In addition, for this strategy, the relative stability of the exchange rates of both countries is important, especially the absence of a weakening of the currency of the country with low rates.

After a sharp increase in the Central Bank of Russia key rate at the end of 2014, the Russian ruble became one of the most attractive currencies in the carry trade strategy. Foreign investors borrowed in euros, US dollars and currencies of other countries, where low rates were applied and invested in Russian instruments, mainly in federal loan bonds (FLB).

To assess the profitability of using carry trade, there is a special indicator called carry-to-risk ratio, which is calculated as the ratio of interest rate differentials in both countries to the imputed volatility of their currency rates. The higher this indicator, the more profitable carry trade.

The cycle of monetary policy easing, which began in Russia since June 2016, reduced the difference between the rates. At the same time, a decrease in the volatility of the ruble had a more significant impact on the carry-to-risk ratio. As a result, the carry-to-risk ratio has only grown. In autumn 2017, the share of non-residents in Russian FLBs reached a record level of 33.2%. It is difficult to judge unambiguously how many of them buy FLB in the carry trade, but according to estimates their share is very significant. US sanctions do not limit the possibility of buying a sovereign debt of Russia, the decision will be made only in February next year.

Thus, the Central Bank supports speculators at the expense of the Russian economy. If to continue to reduce the key rate, then the carry-to-risk ratio will decrease, which could lead to a massive sale of LBs and a fall in the ruble exchange rate.



Source: Central Bank of Russia, Bloomberg

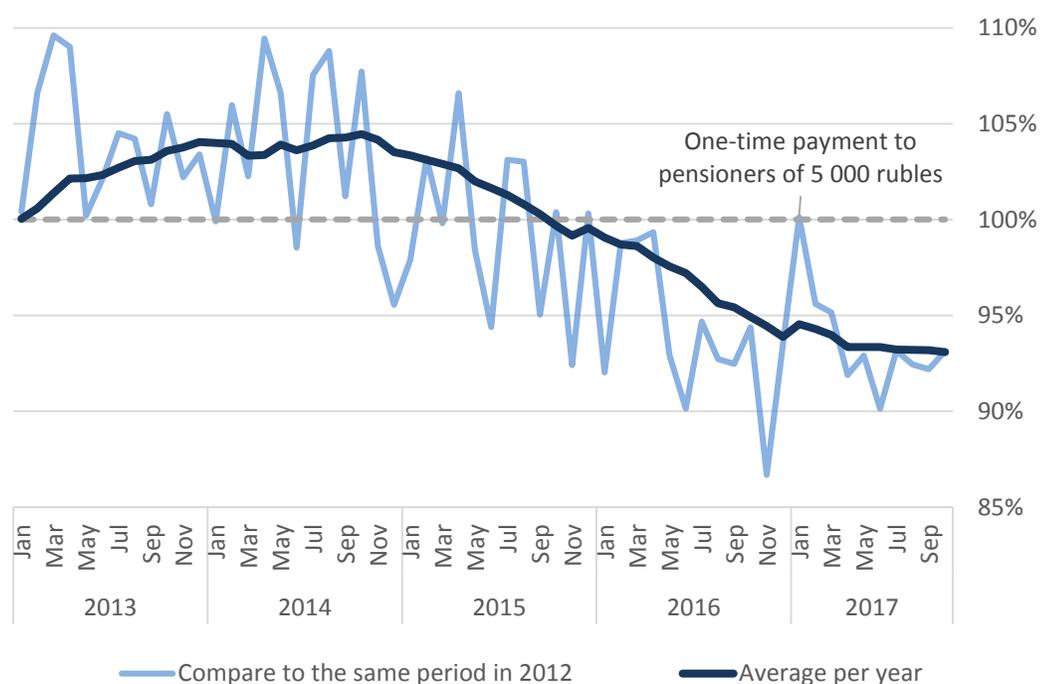
* ratio of the difference in interest rates for 3-month deposits to the level of volatility of the national currency

Population incomes and retail trade

The population of Russia is fully aware of the crisis in the economy. Real disposable income of the population has not yet recovered to pre-crisis levels. The beginning of economic growth only stopped their decline.

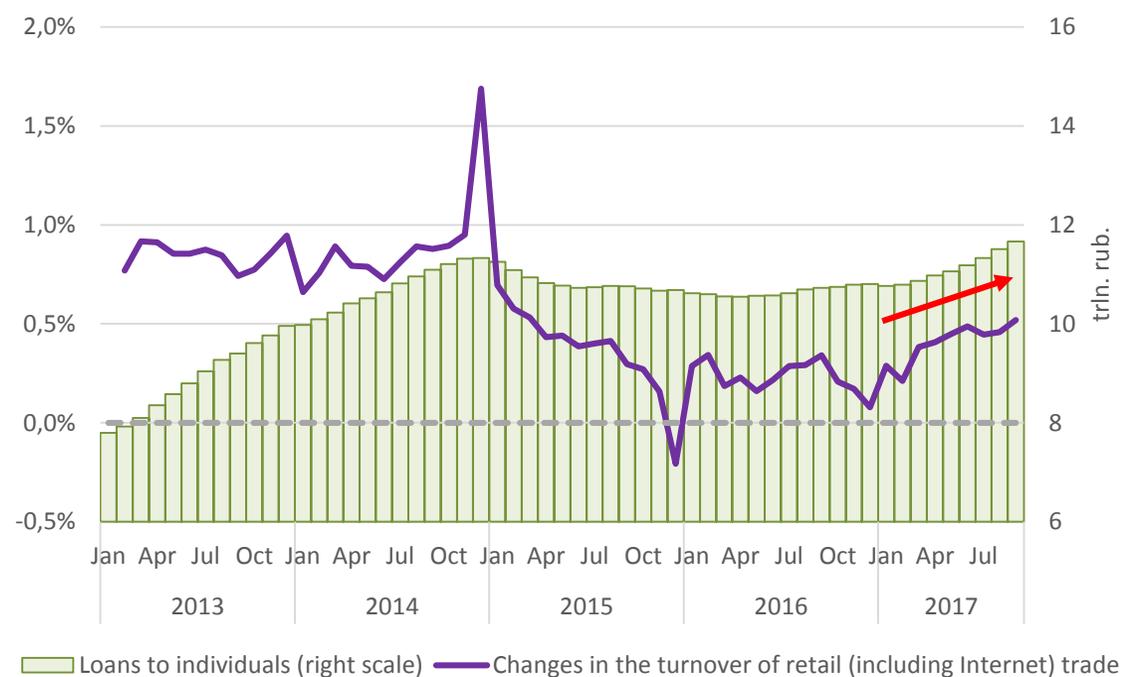
The stagnation of income is another factor hampering the growth of the economy. Companies focused on domestic demand, hardly increase turnover in such conditions. In the autumn of this year, the retail trade turnover exceeded the levels of 2012, but still remains below 2013-14. And the growth of retail trade in 2017 is due to an increase in the volume of credits. The population is gradually moving away from the anti-crisis savings model of behavior, but without increasing the revenues there will not be sustainable growth in the retail sector.

Real disposable income of the population



Source: Rosstat

Retail turnover and the volume of loans to individuals



Source: Rosstat, Central Bank of Russia

International trade

The situation is stable in the area of foreign trade. The balance of payments retains its traditional proportions - the current account has shrunk, but still remains surplus. The financial account is still generally deficit, which implies a continuing outflow of capital.

The balance of payments



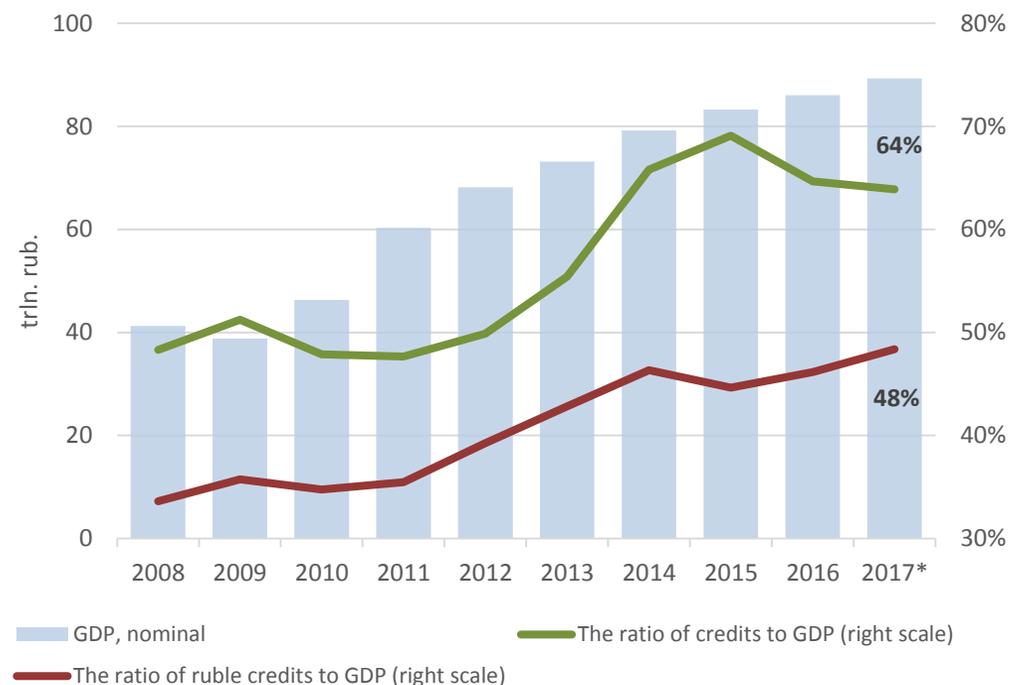
- Current account
- Financial account (without reserve assets)
- Net errors and omissions
- Capital account
- Changes of reserve assets

Source: Central Bank of Russia

Saturation of the economy with credits

One of the key indicators of the development of the economy is its saturation with credits. In Russia, this indicator is quite low even in comparison with developing countries (link to review No. 7). This is due to the very strict policy of the Central Bank, both monetary and clearing the banking sector. Due to the high volatility of the ruble in the last four years, it is more correct to look at the dynamics of the ratio of ruble credits to GDP.

The ratio of credits to GDP



Source: Rosstat, Central Bank of Russia
 GDP for the first two quarters (seasonally adjusted),
 the volume of credits for August

The current condition of the Russian economy can be characterized by the following theses:

- Due to the transition to the floating exchange rate of ruble a stable macroeconomic situation is maintained, in particular a surplus of current transactions and a relatively small budget deficit.
- The pressure on business is growing due to the increasing tax burden, an unprecedentedly high real rate and a general decrease in the volume of credits.
- The last year GDP is growing almost exclusively due to the mining industry, which is reviving due to price increases.
- Agriculture and state administration, which supported the economy in the first years of the crisis, now do not show such confident growth rates and are close to stagnation.
- The largest component of Russian GDP - trade - begins to slowly grow. However, this growth is due to an increase in credits to the population against its stagnant income.

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