

# Economics Group

## Special Commentary

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# Russian GDP Growth Jumps in Q2

## Executive Summary

Real GDP growth in Russia climbed to 2.5 percent on a year-ago basis, topping expectations and marking the first print above 1 percent since the oil price slide began back in 2014. The past couple of years have been challenging for the Russian economy, as the plummeting ruble and skyrocketing inflation led to a rapid tightening in monetary policy and a severe recession. More recently, commodity prices and the ruble have stabilized, and inflation has receded. This in turn has allowed the central bank to bring its main policy rate back down, helping to plant the seeds for the budding economic recovery that has taken root.

Despite the recent acceleration, economic growth in Russia is unlikely to return to the 4 percent growth rates that Russia achieved in 2010-2012, let alone the 7 percent annual average growth rate that the country was able to rack up between 2003 through 2008. Still-low commodity prices, economic sanctions and a declining working-age population will likely weigh on capital and labor growth, restraining the nation's capacity to sustainably increase production over time.

## GDP in Q2 Accelerates to Fastest Pace in Nearly Four Years

Data released today showed that real GDP in Russia accelerated to 2.5 percent year-over-year growth from the 0.5 percent pace registered in Q1, marking the best print since Q4-2013 (Figure 1). A breakdown of the real GDP data into its underlying demand components is not yet available, but real net exports likely played a role in boosting GDP growth in the second quarter. We do not have monthly data on exports and imports on a real basis, but the trade surplus widened on a nominal basis in the second quarter on a year-ago basis. Furthermore, real consumer spending on goods and services likely added positively to GDP growth in the second quarter as growth in real retail sales edged back into positive territory in Q2 after two years of sharp declines (Figure 2).

**Real GDP in Russia accelerated to 2.5 percent year-over-year growth, the best print since Q4-2013.**

**Figure 1**



**Figure 2**



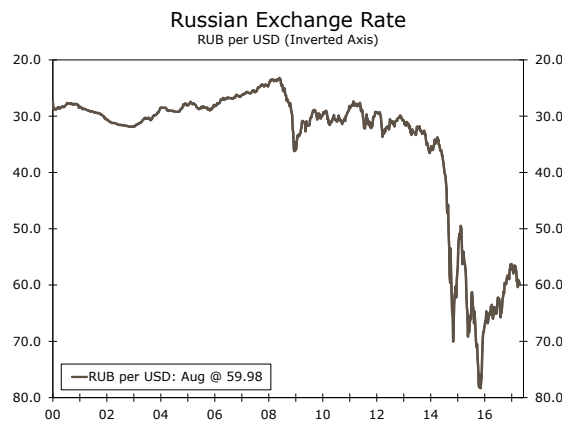
Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities



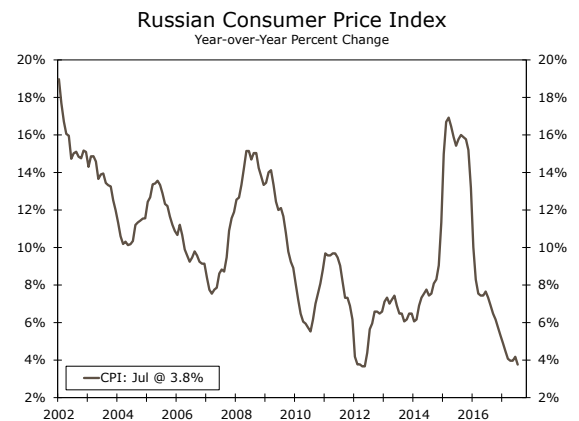
**Ruble depreciation caused the CPI inflation rate in Russia to skyrocket in 2015.**

The value of the Russian ruble nosedived in 2014 (Figure 3). Not only did the Russian invasion and annexation of Crimea early in the year dent foreign sentiment toward Russia, but the collapse in oil prices in the second half of 2014 also weighed sharply on the Russian currency. This depreciation of the ruble improved the price competitiveness of Russian goods and services vis-à-vis foreign goods and services, thereby helping to strengthen Russian exports. However, it also had important indirect effects on consumer and investment spending. Ruble depreciation caused the CPI inflation rate in Russia to skyrocket in 2015 (Figure 4), which caused a swoon in real disposable income that led to marked weakness in consumer spending (Figure 2). In an effort to stabilize the value of the ruble and to keep inflationary expectations in check, the central bank jacked up its main policy rate from 5.50 percent in early 2014 to 17.00 percent by the end of that year. The downturn in consumer spending in conjunction with weakness in investment caused a deep recession in Russia.

**Figure 3**



**Figure 4**



Source: IHS Global Insight and Wells Fargo Securities

**The ruble has stabilized over the past year, inflation has receded, and the central bank has reduced its main policy rate from its 2015 peak.**

### Rate of Economic Growth in Russia Likely Will Remain Modest

The adjustments in the Russian economy that these shocks put in place appear to have largely run their course. The ruble has stabilized over the past year and inflation has receded. Not only has the decline in inflation been associated with a rebound in real disposable income growth, but it has allowed the central bank to reduce its main policy rate from 17.00 percent in early 2015 to 9.00 percent at present. After contracting by 2.8 percent in 2015 and 0.4 percent last year, we forecast that real GDP in Russia will grow 1.4 percent this year and 2.0 percent in 2018. But these forecasted growth rates are well short of the 4 percent growth rates that Russia achieved in 2010-2012, let alone the 7 percent annual average growth rate that the country was able to rack up between 2003 through 2008.

In our view, Russia will not come close to realizing those sorts of growth rates, at least not for the foreseeable future. For starters, the Russian economy depends, at least in part, on the extraction of raw materials. Energy products (*i.e.*, petroleum and natural gas) account for roughly two-thirds of Russia's exports. The mining and quarrying sector, which includes oil and gas extraction as well as the mining of minerals, accounts for roughly 10 percent of value added in the Russian economy.<sup>1</sup> Due to the collapse in commodities prices over the past few years, strong investment in the mining and quarrying sector does not seem likely in the next few years, which will constrain the overall rate of economic growth in Russia. In that regard, oil production in Russia ramped up sharply from about 6 million barrels per day (bpd) in the late 1990s to 10 million bpd in 2008. Oil production in Russia has trended higher over the past few years, but the rate of increase has slowed significantly relative to its pre-crisis rate. Russia currently produces about 11 million bpd of crude oil.

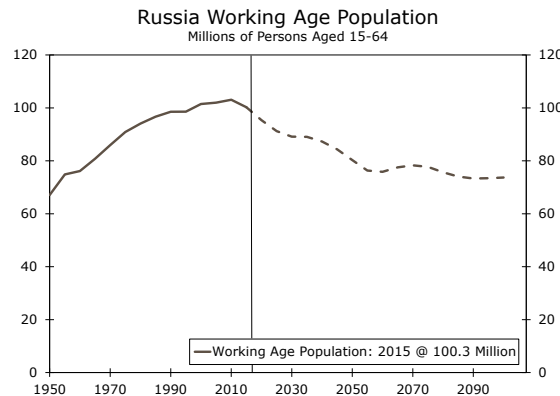
<sup>1</sup> The mining and quarrying sector accounts for about 2 percent of valued added in the U.S. economy.

Moreover, there are some factors that likely will weigh on the rate of Russian economic growth in the medium-to-long run. Foreign direct investment (FDI) poured into the resource-rich Russian economy as commodity prices soared during the past decade (Figure 5). However, the collapse in commodity prices and the foreign sanctions that have been imposed on Russia caused FDI to fall to a 13-year low in 2015. Although FDI rebounded somewhat last year, it remained well short of its previous peak. It is difficult to envision a significant rebound anytime soon in Russian FDI in the current economic and geopolitical environment. Everything else equal, lackluster FDI inflows should restrain the overall rate of GDP growth in Russia.

**Figure 5**



**Figure 6**



**Source: IHS Global Insight, United Nations and Wells Fargo Securities**

Furthermore, the working-age population in Russia peaked in 2010 and it declined about 3 percent over the subsequent five years (Figure 6). The United Nations projects that the working-age population in Russia will fall more than 10 percent further over the next two decades. Everything else equal, an economy can produce less goods and services (*i.e.*, real GDP) if it has fewer workers. We currently do not forecast Russian GDP growth beyond 2018, but the International Monetary Fund forecasts that the Russian economy will expand at an annual average rate of only 1.5 percent between 2019 and 2022. These low forecasted growth rates for the Russian economy seem to be reasonable to us.

**Conclusion**

A more stable ruble has helped bring inflation down from double digit growth rates in Russia. As a result, the central bank has loosened its grip on interest rates, helping to move monetary policy from a headwind towards a tailwind for economic growth. The turnaround has begun to gather momentum, as today's real GDP print was the strongest since Q4-2013. Our outlook is for the Russian economy to continue to improve through the end of our forecast horizon in 2018 as growth rebounds from the 2015-2016 recession. Secular trends, however, will likely prevent a further acceleration in the Russian economy that would allow a return to the supercharged growth rates of the past. Still-low commodity prices and economic sanctions have depressed investment, and an aging population will weigh on labor force growth. Given these headwinds, economic growth in Russia over the long-run is more likely to register a pace more in-line with the developed economies of the world.

***The working-age population in Russia peaked in 2010.***

***Economic growth in Russia over the long-run is more likely to register a pace more in-line with the developed economies of the world.***

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