May 16, 2018

Economics Group

Special Commentary

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Macro Stability Returning in Russia

Executive Summary

Economic growth strengthened in Russia in Q1, rising to 1.3 percent year over year from the 0.9 percent pace seen to end 2017. Real GDP growth has been positive on a year-over-year basis for more than a year now, one of many signs that macroeconomic stability is returning to Russia. Consumer price inflation is down to a multi-decade low after skyrocketing a few years ago, and the central bank is in rate-cutting mode as pressure on the ruble has eased. Rising oil prices and a current account surplus also provide an encouraging near-term backdrop amid some emerging market volatility elsewhere in the world.

That said, the long-run prospects for the Russian economy remain relatively dim. The working-age population is contracting, and slow growth in foreign direct investment (FDI) and gross fixed capital formation are not supportive of sustained capital deepening and accelerating labor productivity. With geopolitical tensions still elevated and sanctions continuing to weigh on the investment backdrop in Russia, we do not expect the Russian economy to return to the supercharged growth rates of the past anytime soon.

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Real GDP Growth Strengthens in Q1

Preliminary data that were released today showed that real GDP in Russia rose 1.3 percent year over year, a bit below the Bloomberg consensus forecast of 1.5 percent. A breakdown into demand- or supply-side components is not available at this time, but the sharp slowdown in inflation has helped boost real income growth in Russia (Figure 2). When the GDP details are released next month, we may see that real consumption growth was lifted by improved purchasing power among Russian consumers.

Figure 1

Figure 2

Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

Some semblance of macroeconomic stability appears to have finally returned in Russia. Real GDP growth started slowing in 2012, eventually turning into outright contraction as international sanctions and the plunge in oil prices led to a nosedive in the value of the Russian ruble (Figure 3). Inflation spiked (Figure 4), eroding consumers' purchasing power and leading the Central Bank of the Russian Federation to sharply raise interest rates to stabilize inflation expectations and attract capital inflows. This toxic combination of destabilizing factors has since faded: oil prices have reversed, the ruble has generally stabilized, inflation is at multi-year lows and the central bank is cutting rates.

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In addition to these tailwinds, some structural factors underlying the Russian economy look relatively healthy. Russia's current account is in surplus, in contrast to some other emerging market economies that have faced macro challenges recently. The country also has a $367 billion war chest of foreign exchange reserves that can be used to combat financial instability, and the external debt-to-GDP ratio in Russia is relatively low at roughly 30 percent (it exceeded 40 percent leading up to the 1998 debt default).

Figure 3

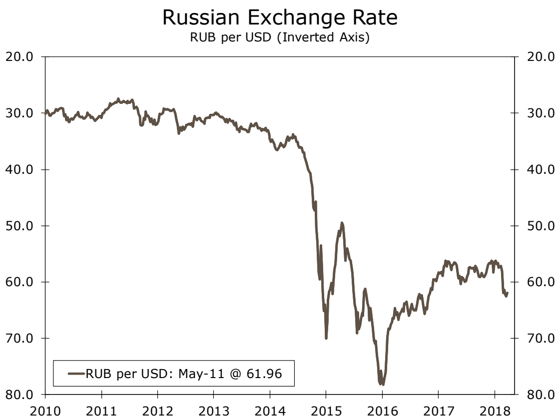
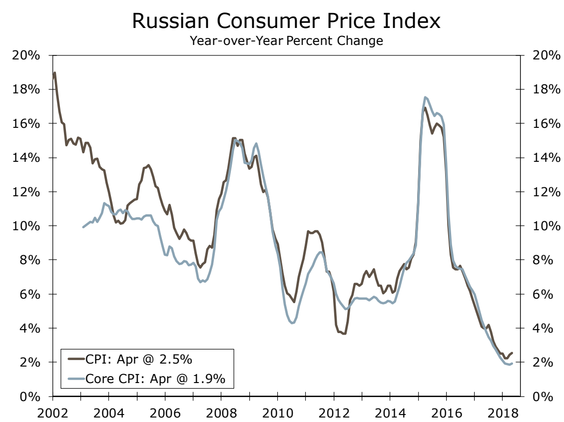


Figure 4



Source: IHS Markit and Wells Fargo Securities

Yes, recent U.S.-Russian tensions and the newest round of sanctions have put some renewed pressure on the ruble, but to a much lesser extent than seen in the 2014-2016 period. At its April 27 meeting, the Russian central bank noted in its statement that while "the April weakening in the ruble…will be a factor for consumer price growth…it does not create risks of inflation overshooting the target." In addition, this headwind on the ruble and growth has also likely been offset somewhat by the recent rally in oil prices; energy products account for roughly two-thirds of Russia's exports and 10 percent of the country's value added. Thus, absent some unforeseen shock, we do not worry about the Russian economy coming off the rails anytime soon.

The structural elements that underpin potential economic growth are underwhelming.

However, while factors that drive near-term macro stability appear relatively encouraging, the structural elements that underpin potential economic growth are underwhelming. As we have noted in previous reports, the working-age population has likely peaked, and the United Nations' projections expect this segment of the population to outright contract over the next several decades (Figure 5). Everything else equal, an economy can produce fewer goods and services (i.e., real GDP) if it has fewer workers.

Figure 5

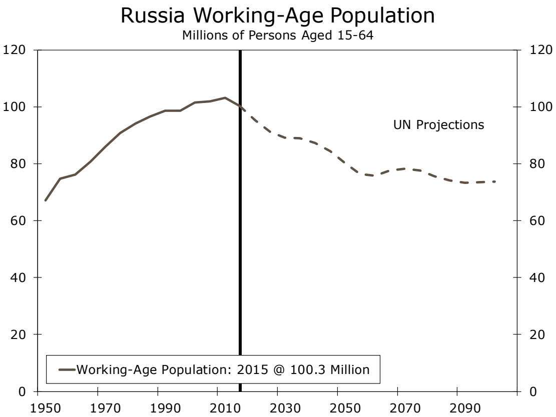


Figure 6

Source: United Nations, OECD and Wells Fargo Securities

Stronger growth in labor productivity (i.e., output per hour worked) could offset some of these demographic challenges. Surging energy prices, rising FDI and technological catch-up/trade liberalization helped drive robust productivity growth in the early- to mid-2000s. The recent trend has been discouraging, however, as labor productivity growth has been on a secular downtrend for the past decade (Figure 6). The fundamental drivers that would underpin a recovery in productivity growth do not suggest that a reversal is in the offing, at least not anytime soon. FDI remains relatively low, capital investment growth has been soft over the past few years, and the IMF expects the recent trendless pattern in the investment-to-GDP ratio to remain more or less intact in the years ahead (Figures 7 and 8). Given these factors, we do not expect the Russian economy to return to the supercharged growth rates of the past anytime soon.

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Figure 7

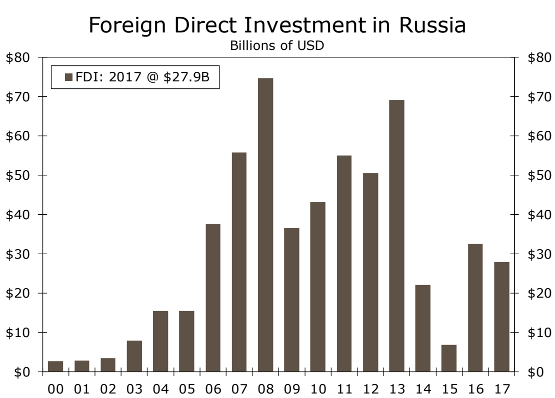

Figure 8

Source: IHS Markit, International Monetary Fund and Wells Fargo Securities

Conclusion

In the short run, sanctions placed on Russia will weigh on growth and investment, but the combination of higher oil prices, lower inflation, an easing central bank, a current account surplus and a relatively low external debt-to-GDP ratio should be enough to keep economic growth chugging along. A declining working-age population implies that labor productivity growth must carry the load to drive potential economic growth higher. With investment spending underwhelming, it would likely take a positive shock to total factor productivity to bring about a sustainable acceleration in real GDP. Absent this, we believe Russian GDP growth will continue along at roughly a 2 percent pace for the foreseeable future.

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