

April 4, 2018

## Six investment drivers in Russia

Russia 2022 Economic Outlook Update

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*The forecast is prepared in accordance with ACRA's [General Principles of Socioeconomic Indicators Forecasting](#).*

- **The economic policy will focus on growth through investments,** however, direct governmental expenses and milder monetary policy will not be used as support tools. Investment growth possibilities are rather of industry nature and connected with the two driver groups: structural (social and economic changes, government policy) and short-term (financial conditions and growth of an industry, availability of financial resources).
- **Almost all large industries have structural drivers for investments.** The six key drivers include expected growth in certain internal or external markets, ability to compete with imports, ability or necessity to cut costs, deterioration of manufacturing capacities and liabilities before the state. Absence of a noticeable growth in the share of investments within the GDP may be explained by the "mosaic" nature of short-term attractiveness of industries. In all sectors, except the transport and logistics, investments may be limited by either low observable profitability or heightened risk or obscure prospects for growth.
- **Regardless that the short-term interest rates have almost reached a neutral level (6–7%), the level may change in the nearest future.** A decline may be caused by a potential decrease in the world economy growth rates, demography, budget rules, less volatile oil prices. A push up may be caused by protectionist measures in the world trade, population ageing, sanctions. By 2021, the equilibrium key rate may go below 6%.
- **The forecast update for 2018–2022 mostly covers long-term consequences of protectionist measures in the world trade and the equilibrium short-term interest rates in Russia.** The equilibrium rate of unemployment has been revised downwards. Updating the macroeconomic forecast of October 2017, we preserve the long-term growth benchmark of the Chinese economy, but we expect somewhat longer transition period.

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Table 1. Key Russian and global economy figures in 2015–2022

Indicator	UoM	Actual			Estimate	Forecast			
		2015	2016	2017	2018	2019	2020	2021	2022
<b>Key external environment indicators</b>									
Urals price	USD/bbl	51.3	42.3	53.5	58.0	59.2	60.3	61.6	62.8
Global GDP <sup>1</sup>	% y-o-y	2.8	2.5	2.6	2.4	2.2	2.2	1.9	1.8
US GDP	% y-o-y	2.9	1.5	2.3	2.0	1.9	1.8	1.7	1.7
China GDP	% y-o-y	6.9	6.7	6.8	5.6	4.9	4.4	4.0	4.0
EU GDP	% y-o-y	2.3	2.0	2.4	1.9	1.6	1.6	1.7	1.7
<b>Production indicators</b>									
Market GDP	RUB bln	83,234	86,044	92,082	96,358	102,742	109,067	114,645	121,518
Real GDP growth rate	%, y-o-y	-2.5	-0.2	1.5	1.6	1.5	1.5	1.5	1.7
Fixed investments	RUB bln	13897	14749	15967	17254	18553	19912	21287	22734
Fixed investments real growth rate <sup>2</sup>	%, y-o-y	-10.1	-0.2	4.4	3.7	3.1	2.7	2.6	2.9
Industrial output index <sup>3</sup>	%, y-o-y	-0.8	1.3	1.0	1.4	0.9	0.8	0.9	1.2
Retail turnover	RUB bln	27,538	28,317	29,804	31,562	33,519	35,564	37,591	39,659
<b>Balance of payments indicators</b>									
Export of goods	USD bln	341	282	354	377	389	397	403	424
Import of goods	USD bln	193	192	238	247	260	269	278	297
Annual average USD exchange rate	RUB/USD	61.3	67.2	58.3	58.3	58.8	59.7	60.5	60.2
Annual average EUR exchange rate	RUB/EUR	68.0	74.4	65.9	70.0	73.4	74.6	75.6	75.2
<b>Labor market and income</b>									
Average wage	RUB/month	34,012	36,740	39,148	42,587	45,219	48,439	51,586	54,885
Real disposable income	%, y-o-y	-3.2	-5.9	-2.0	3.0	2.1	2.0	1.8	1.6
Population	mln	146.3	146.6	146.8	147.1	147.3	147.5	147.7	147.8
EAP <sup>4</sup>	mln	76.6	76.6	76.1	75.4	74.8	74.3	74.0	73.7
Unemployment	% of EAP	5.6	5.5	5.2	5.2	5.3	5.4	5.4	5.4
<b>Financial market prices and indicators</b>									
Inflation (CPI <sup>5</sup> )	%, Dec/Dec	13.2	5.4	2.5	4.1	4.1	4.0	3.9	3.8
Key interest rate (as at year-end)	%	11.0	10.0	7.75	6.75	6.25	6	5.75	5.5
5-year zero-coupon OFZ rate	%	9.9	8.3	7.2	6.6	6.4	6.4	6.2	6.1
Private deposit rate (> 1 year)	%	9.4	7.8	6.7	6.1	5.8	5.7	5.5	5.4
Non-financial sector bank lending rate (> 1 year)	%	13.7	12.5	8.6	8.2	8	7.7	7.7	7.6
<b>Budget</b>									
Federal budget balance	% of GDP	-2.3%	-3.4%	-1.8%	-0.9%	0.2%	0.3%	0.4%	0.8%

Source: Federal State Statistics Service, Bank of Russia, Federal Treasury, Ministry of Finance, World Bank, national statistics agencies, ACRA estimates

<sup>1</sup> Real growth rate according to the World Bank Methodology.

<sup>2</sup> Physical volume growth index corrected by the investment deflator.

<sup>3</sup> Under the new methodology after adoption of the Russian Classification of Economic Activities 2.

<sup>4</sup> Economically Active Population.

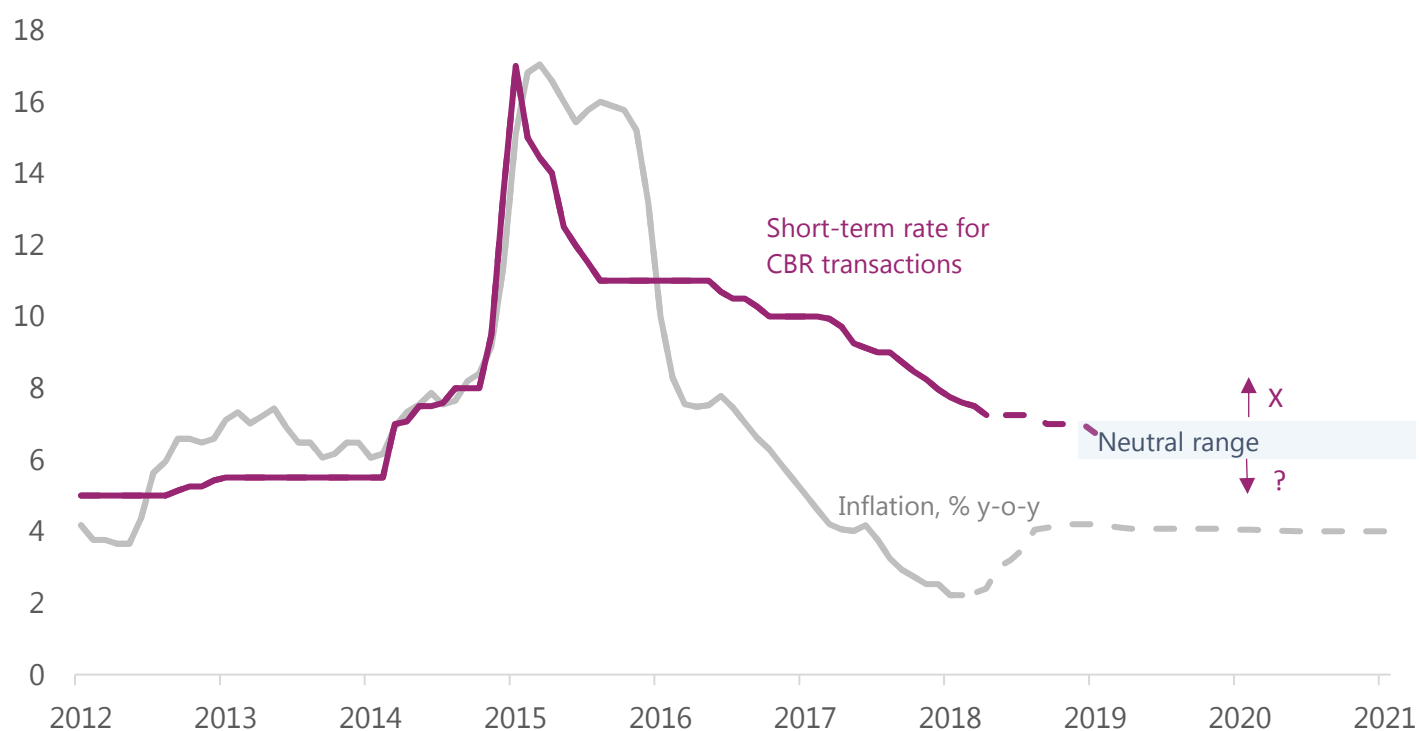
<sup>5</sup> Consumer Price Index.

## CBR's key rate may go below 6%

The current, almost 3-year, cycle of a fast decline in short-term rates is almost over, as the rates has virtually reached a neutral range, which is currently determined by the Central Bank at 6–7% (see Fig. 1). In the opinion of the Bank of Russia, such range may stay unchanged if the economy growth rate remains close to its potential and the inflation is close to the target. However, at the forecast horizon, changes may occur in both the CBR's opinion on the non-observable level and the level itself, which may further push down long-term rates too.

In 2017–2018, the average benchmark established by the regulator for short-term rates has already declined: the publicly announced range has changed from 2.5–3% to 2–3% in real terms. The CBR's research papers also referred to an estimate of 1.0–3.2%, with a lower average rate<sup>6</sup>. According to recent statements, currently, the Bank of Russia applies a model where equilibrium rates are internal rates that are on real parity with external rates<sup>7</sup> (see Fig. 2).

Figure 1. Current view of the Bank of Russia on the economically neutral key rate



Source: Federal State Statistics Service, Bank of Russia, ACRA estimates

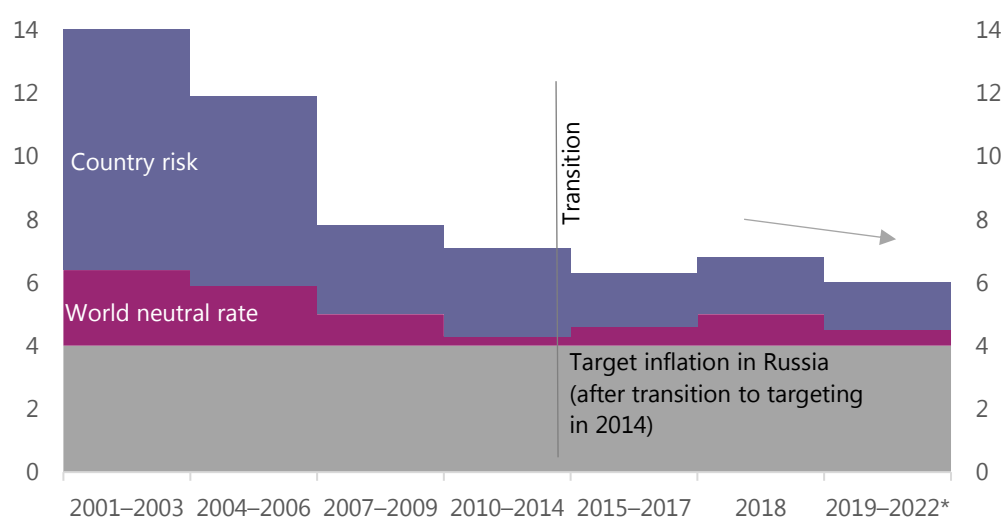
<sup>6</sup> Kresptsev, D., Porshakov, A., Seleznev, S. and Sinyakov, A. (2016). The Equilibrium Interest Rate: A Measurement for Russia. Economic Research Working Paper, Central Bank of Russia.

<sup>7</sup> See Transcription of the press conference following the meeting of the Bank of Russia board of directors dated March 23, 2018: <http://cbr.ru/press/st/2018-03-23/>.

The economic logic is as follows. Interest rates reflect the opportunity cost of money lent. This value is equal to a certain combination of the real rate of return in a country and the external investment rate of return. In a situation when the external returns are higher than the potential internal returns, and under condition of free capital flows, a rational investor (econ) prefers external investments. Therefore, in order to compete with the external world for loans, businesses and population will, nevertheless, borrow internally at the external rate. Temporary fluctuations of internal rates against external rates drive equalizing cross-border financial flows.

Key assumptions for such model include possible equalization and the absence of expected changes in the real foreign exchange rate. Financial and trade sanctions may affect the freedom of cross-border capital flows and export-import flows. Stronger protectionism in the world trade, along with the relative growth in prices for commodities, may give raise to the expectations for real strengthening of currencies of commodity exporting countries. If significant, both factors push down the neutral range of rates.

**Figure 2. Possible assessment of neutral rates in Russia<sup>8</sup>**



If, notwithstanding the above restrictions, the real parity is deemed a reasonable estimation method for the neutral rate, it is possible that, by 2020–2021, the neutral rate will be about 2%, lower than the current estimations (see Fig. 2). Current 2–3% rate is obviously a result of the 0.8–1% global rate<sup>9</sup> and the 1–2.2% equilibrium country risk.

Demography, possible reconsideration of the growth in China and other factors (see Table 2), according to our estimates, may not only keep the global neutral rates at the current level, but also push them down to 0.5% in the foreseeable future<sup>10</sup>. The cost of Russian country risk in the same scenario is under the

<sup>8</sup> The neutral rate trend in global markets is based on the data from: Holston, Kathryn, Thomas Laubach, and John C. Williams. 2016. "Measuring the Natural Rate of Interest: International Trends and Determinants," Federal Reserve Bank of San Francisco Working Paper. The equilibrium country risk is derived from averaged long-term CDS 5Y for the last six years without recessions.

<sup>9</sup> 2.8% in the long-term, according to Holston, Kathryn, Thomas Laubach, and John C. Williams. 2016. "Measuring the Natural Rate of Interest: International Trends and Determinants," Federal Reserve Bank of San Francisco Working Paper. 3% in 2020 — long-term nominal benchmark mentioned after the Fed rate meeting on March 21 this year. In real terms — 0.8–1%, respectively.

<sup>10</sup> Main long-term drivers of the global real interest rate are taken from: Secular drivers of the global real interest rate, Lukasz Rachel, Thomas D Smith, Staff Working Paper No. 571, Bank of England.

pressure of uncertain world growth, but it is probable to stay within 1–1.5%, which gives us the neutral real rate range of 1.5–2% derived from 0.5% + (1 to 1.5%).

Taking the above scenario as a base case scenario, we expect that, on the forecast horizon, the key rate will go down to 6% and, possibly, lower. Further pressure may be caused by the expiration of the structured liquidity surplus period and a shift of short-term market rates to the upper part of the CBR's corridor of interest rate instruments.

**Table 2. Drivers of the neutral short-term interest rate in Russia**

Component of the neutral nominal rate	+	-
World neutral interest rate	<ul style="list-style-type: none"> <li>• Growing share of dependent population</li> </ul>	<ul style="list-style-type: none"> <li>• A decline in the expected world economic growth rates</li> <li>• Growing income inequality</li> <li>• Growing length of life and unemployable age</li> </ul>
Country risk	<ul style="list-style-type: none"> <li>• Stricter financial sanctions</li> <li>• Wider protectionist measures</li> </ul>	<ul style="list-style-type: none"> <li>• Budget rules and inflation targeting</li> <li>• Less volatile oil prices due to a shorter investment cycle of shale oil producers</li> </ul>
Target inflation in Russia	<p>Currently, we see no reasons for a change. The current 4% target was selected for the interregional discrepancies and the increased volatility of relative prices generally seen in developing countries not to result in deflation effects, leaving enough space for monetary instruments. On average, developed countries targeting the inflation prefer a target of 2–3%, while developing countries are aimed at 3–5%.</p>	

Source: ACRA

## Almost all industries have structural investment drivers, but industries attractive in short-term are scarce

Multiple proposals to increase the long-term economic growth in Russia include measures for higher investments. Such proposals are based on the observation that at the end of the 20<sup>th</sup> century and beginning of the 21<sup>st</sup> century, per capita GDP growth rates by country were on average 1 p.p. higher for every 4 p.p. of investment share in GDP.

Since the direct encouragement of investment demand by increasing government spending is limited by the budget rule, and the main goal of the Central Bank is, generally, to smooth out cyclical fluctuations, it is hardly to be expected that monetary policy will be used to push up investments.

Therefore, the opportunities for accelerating investment growth are rather sectoral in nature and are associated with two groups of drivers: structural (socioeconomic changes, state policy) and short-term (financial condition and growth of industries, availability of financial resources). Structural drivers are usually considered to be forward-looking (they are built on known and expected changes), but in respect of the short-term drivers, a backward-looking analysis is conducted (investors' expectations regarding the potential profitability of industry markets in most cases depend on current margins and risks).

Table 3 shows **structural drivers** for investments, i.e. main processes that require or create conditions for extension or change for certain companies in certain sectors on the forecast horizon. This component of investment decisions based on expectations or structural drivers does not depend on finance sources and methods.

**Table 3. Main structural investment drivers by sector**

Driver	2015–2016	2017–2018	2019–2022
Internal market growth	—	Healthcare, education, insurance, IT	
Export market growth	Gas production and transportation, chemical industry, transport infrastructure		
Import substitution	Agribusiness, food industry, household chemicals, tourism	+ Light industry, electric and electronic equipment, construction materials, pharmaceuticals	
Production cost cutting (price competition)	Retail trade, logistics, finance sector, IT		
Fixed assets maintenance	Infrastructure (electric power, heat power, roads), services (repairs and other services)		
State policy	Oil refining, electric power industry, railcar industry	Data storage, oil refining	

Source: ACRA

*Internal market growth* will be limited if growth rates of the economy and personal incomes remain low. But, as some markets (including insurance, IT, sports) are still unsaturated, it may drive the growth. Furthermore, new budget rule and lower budget expenditures drive private investments in those markets where government services dominate (healthcare, education).

*Export market growth* is connected with the historically high competitiveness of Russian commodity producers (oil and gas sector, metals, chemical industry, agribusiness) and extension of transport infrastructure (seaports, railroads and motor roads, pipelines) to increase exports.

Various *import substitution* drivers exist in the markets with a high import share. Such drivers have become stronger following ruble devaluation (light industry, construction materials), countersanctions (agroindustry) and industry policy (motor industry, aircraft industry, power machine building). In agroindustry, a traditional beneficiary of import substitution, this driver is close to exhaustion: the import share is minimal there.

Low economic growth rates and low inflation in industries where price competition is possible change the drivers — from extensive expansion of production capacities to investments into *cost cutting*. First of all, this relates to retail trade, logistics and finance sector.

Drivers to invest into *fixed assets maintenance* are related with historically insufficient investments (housing and utilities, roads), ageing cyclicity of fixed assets (e.g., in the USSR, the peak of power industry investments was in 1970–1980), higher prices for imported equipment and growing demand for repairs.

*State policy* may directly establish requirements for new investments, for example, Russian environmental standards (oil refining sector) and data storage standards. In the beginning of 2020s, a new power industry upgrade program is likely to be launched, similar to the capacity supply agreement mechanism applied currently.

The issue of **investment financing** is mostly considered from the backward-looking analysis, i.e. taking into account the short-term drivers. This is dictated, first, by that over 50% investments into fixed assets in Russia are financed by companies and depend, mainly, from their financial condition in the previous years. Second, investment financing decisions are often made based on extrapolation of current profitability trends, external conditions, and financial standing of companies.

For industry risk in rating analysis, see ACRA's [Methodology for Credit Ratings Assignment to Non-Financial Corporations under the National Scale for the Russian Federation](#).

Current short-term attractiveness of investments in certain industries has been analyzed by us on the basis of aggregated indicators of profitability, credit quality and observable growth of production volume. Table 4 shows relevant ranks of main sectors, in the descending order of medium ranks resulting from three indicators. Only 2017 data published by the Federal Tax Service, the Bank of Russia and Rosstat were used in calculations. A simplified indicator for credit risk does not use corporate rating analysis data — ranks derived only from bank arrears are shown.

Table 4. Relative short-term attractiveness of sectors, aggregated data

Industry	Medium rank	Current profitability	Short-term credit risk	Current growth
Transport and logistics	<b>5</b>	8	6	2
Machine building	<b>6</b>	15	2	1
Chemical industry	<b>7</b>	11	3	6
Power industry, water	<b>7</b>	1	4	15
Clothes and shoes*	<b>7</b>	6	11.5	4
Finances	<b>8</b>	3	15	7
Mass media and communications	<b>9</b>	2	6	19
Woodworking, printing industry	<b>10</b>	14	1	14
State services*	<b>11</b>	9	11.5	13
Mining industry	<b>12</b>	19	5	11
Metals and metal products	<b>12</b>	5	8	22
Trade	<b>12</b>	12	19	5
Agroindustry, hunting, forestry, fishery	<b>12</b>	7	17	12
Electronics and electric equipment*	<b>12</b>	4	11.5	21
Culture and sports*	<b>12</b>	22	11.5	3
HoReCa *	<b>13</b>	16	11.5	10
Food industry, including beverages and tobacco	<b>13</b>	10	9	20
Education*	<b>14</b>	13	11.5	16
Construction materials	<b>15</b>	18	21	7
Commercial services, real estate	<b>16</b>	20	20	9
Healthcare and social services*	<b>17</b>	21	11.5	17
Construction	<b>19</b>	17	22	18

<sup>10</sup> \* means sectors for which no aggregated data on loans overdue is publicly available. Therefore, a medium rank has been assigned to them on such indicator.

Source: ACRA

Calculations show that, currently, there are rather no prominent leaders in short-term investment attractiveness. The only exception is the transport and logistics sector. Other sectors have at least one indicator ranked below average. Such "mosaic" nature of short-term investment attractiveness is likely to contribute to the absence of fast economic growth driven by investments.



### Annex. Calculation methodology for Table 4 indicators.

In the table above, we combine industry data available to the broadest investment community, and therefore, that data is very likely to influence the majority of current investment decisions. The investment potential may be assessed using the standard risk/reward approach. As the long-term risk and return on investments visibly varies across industries, our goal was to demonstrate current level's deviation from the historic averages for an extended period. Hence, the term "short-term attractiveness". The word "relative" in the table title refers to ranking the industries by a specific indicator.

1. We use FTS data on corporate income tax collected in the consolidated budget (1-NOM reporting form) as a simplified indicator of the current profitability. First, we calculate the industry's average share in tax collection for 2011-2016. Then, we arrive at the share's deviation from the average value determined at the previous stage. In the table, ranks for this indicator are calculated in a descending order. The changes in activity classification codes used in the tax statistics were taken into account when analyzing the reporting form.

Rosstat (Federal State Statistics Service) data on the aggregate financial performance of the corporate sector could be used as an alternative to tax statistics; however, these data for 2017 is not yet finalized. In particular, unexplained discrepancies in numbers were identified (for a total of RUB 1.3 trillion across all industries<sup>11</sup>) in the references entitled "On financial performance of companies in 2017" and "Short-term economic indicators of the Russian Federation" both published by Rosstat.

It is worth noting that financial reporting data of public companies are generally consistent with the identified trends, though such data is recognized as not representative enough for trend analysis across all industries. Data control was performed using internal databases of ACRA.

2. We use deviation of overdue bank debt of industry companies from the long-term average figures as the investment risk perception indicator. Calculations are performed using the Bank of Russia data from the table "Overdue debt on loans to legal entities (residents and self-employed) in Rubles and foreign currencies with breakdown into types of economic activity and intended use of cash". The table ranks industries by this indicator in an ascending order.

3. The current physical growth figures are derived from the system of national accounts published by Rosstat: GDP generated (annual data with detailed breakdown), annual OKVED 2 data (Russian National Classifier of Types of Economic Activity). This way we obtain the gross added value dynamics. The table ranks industries by this indicator in a descending order.

<sup>11</sup> For more details, please see *Comments on State and Business*, Vol.150; published by HSE Centre of Development Institute.

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