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RUSSIA: IN A BETTER POSITION TO DEAL WITH AN OIL PRICE SHOCK THAN IT WAS FIVE YEARS AGO

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SOLID MACROECONOMIC FUNDAMENTALS

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ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

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The Covid-19 crisis will not be without its consequences for the Russian economy, which faces twin supply and demand side shocks against the background of collapsing commodity prices. According to forecasts from the IMF and the Russian central bank, economic activity could contract by between 4% and 6%. Macroeconomic fundamentals are likely to worsen, but without undermining the government's ability to meet its obligations. However, this latest shock will weaken a banking sector that is in full restructuring mode and could delay the important government development projects that will be essential to boosting growth over the medium term. Against this background, on 2 June the government announced a new plan of RUB 5 trn (4.5% of GDP) to support the economic recovery and sustain potential growth. It remains to be seen whether it will be of such a nature as to raise potential growth. To date, no details are yet available on the content and modalities of its implementation between Q3-2020 and Q4-2021.

The Covid-19 crisis will not be without its consequences for the Russian economy, which faces twin supply and demand side shocks against the background of collapsing commodity prices.

The current crisis will affect the Russian economy through three vectors: the lockdown introduced at the end of March will result in a contraction of domestic demand; the fall in the oil price (37.5% lower in the first four months of 2020 than in the same period in 2019) will hit business investment; agreements with OPEC+ signed in April will result in oil production being 20% lower over 2020 as a whole.

Therefore all components of growth are likely to see a fall in 2020 compared to 2019 levels. Having grown by 2.8% in 2019, domestic demand could shrink by more than 5% in 2020, under the combined effect of lower spending by consumers, government and private investors. The contraction in exports, caused by the fall in global trade and the reduction in oil production under OPEC+ agreements will not be offset by the drop in imports resulting from lower domestic demand.

According to International Monetary Fund (IMF) estimates, GDP could contract by 5.5% over the course of 2020 (assuming that the Brent crude price is 42% lower at USD37/barrel) before recovering by 3.5% in 2021. The central bank, meanwhile, forecasts a contraction in GDP of between 4% and 6% in 2020 (with the Urals crude price down 58% to USD27/barrel) followed by a recovery of between 2.8% and 4.8% in 2021.

Macroeconomic fundamentals are likely to worsen, but without weakening the government's ability to meet its obligations. However, this latest shock will weaken a banking sector that is in full restructuring mode and could delay important government development projects. These projects would have helped boost potential growth, which has been falling steadily since 2008. The announcement on 2 June of a new plan of RUB 5trn (4.5% of GDP) may support potential growth. However, to date, no details are yet available on the content and modalities of its implementation between Q3-2020 and Q4-2021.

Solid macroeconomic fundamentals

Since the 2014-15 crisis, the Russian economy has consolidated. The macroeconomic fundamentals have been strengthened, the dependence of the public finances on oil revenue has been reduced, currency reserves have almost returned to their level before the crisis and the banking sector, though still fragile, has grown stronger. However, growth remains weak, and in 2019 there were still 20 million people living in poverty[1] (some 13.5% of the population).

Robust public finances

Russian public finances are robust and the risks to the refinancing of government debt are contained.

In 2019, the general government posted a surplus and government debt remained modest. The government's short-term refinancing requirements were more than fully covered by the sovereign wealth fund. In addition, the economy's dependence on oil and gas revenues has been reduced since 2017, although it remains high as in all commodity exporting countries. The breakeven oil price has been halved in five years. The risk to public finances created by a long-lasting fall in oil prices is mitigated by the possibility of recourse to the sovereign wealth fund.

• Budget surplus against a background of rising receipts other than from oil and gas

In 2019, for the second consecutive year, the federal government posted a surplus. This said, at 1.7% of GDP it was smaller than the 2.4% surplus recorded in 2018, due to an increase in public spending. The surplus for general government was 1.9% of GDP.

In 2019, the government's fiscal receipts were equivalent to 18.3% of GDP. Moreover, dependence on oil and gas revenues has fallen sharply, representing only 39% of total revenues, from more than 50% in 2013.

GOVERNMENT REVENUES AND EXPENDITURES (% OF GDP)

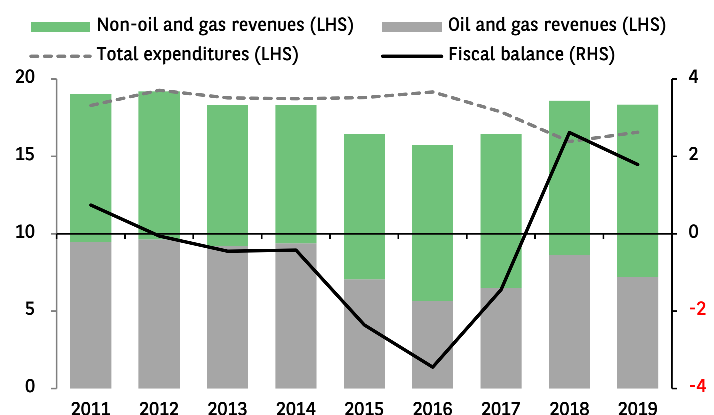

CHART 1 SOURCE: MINISTRY OF FINANCE

1 According to the World Bank, a person is considered to be living in poverty if they are living with less than USD1.90 per day.

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With the increase in VAT rates by two percentage points (pp) on 1 January 2019, non-oil and gas revenue increased by 1.1pp to 11.1% of GDP in 2019, its highest level since the period from 2000 to 2009 when growth was running at an average rate of 7%. The deficit before oil and gas revenue was just 5.4% of GDP, compared to 9.4% of GDP in 2013.

In 2019, for the first time in ten years, the government's structural expenditure increased as a result of the country's medium-term development framework (hitting 94% of the target). Public spending reached 16.7% of GDP, a 0.7pp increase relative to 2018. The main increases came in infrastructure, education and health. Debt service costs, meanwhile, came down slightly, to just 0.7% of GDP. Interest payments thus represented only 2.1% of government revenue.

- **Government debt is contained and has a low-risk structure**

Russia has a low level of public sector debt. It stood at just 14.7% of GDP in 2019 (12.3% for government debt alone), the equivalent of 43% of government revenue. Moreover, its structure is low-risk. At end-2019, 67% of debt was held by residents, although the share held by foreign investors increased by 10pp over the course of 2019, reflecting the Russian economy's resilience in the face of international sanctions and attractive yields. In addition, only 21.5% of Russia's debt, or less than USD55 billion, is denominated in foreign currencies.

The repayment schedule for 2020 and 2021 is under control. Repayments are estimated at USD 17 billion and USD 23 billion respectively, or an average of 1% of GDP, with only USD 4 billion falling due in dollars, with generous coverage by the sovereign wealth fund.

Excluding the effects of the current crisis, public sector debt is unlikely to increase by more than 5pp over the medium term, in line with investment under the 2019-24 development programme.

PUBLIC DEBT (% OF GDP)

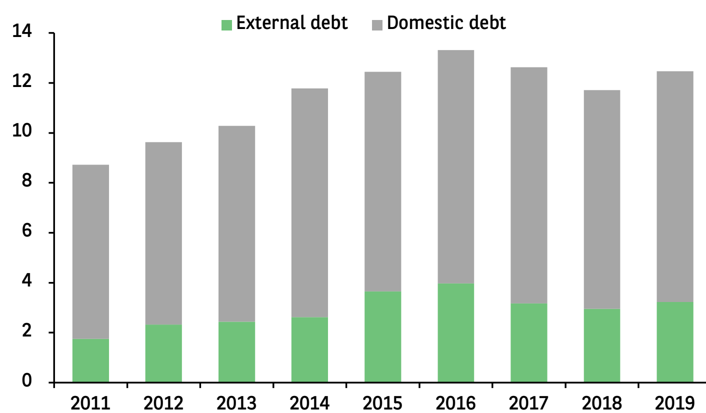

CHART 2 SOURCE: MINISTRY OF FINANCE

- **Rapid expansion of the sovereign wealth fund**

The government's dollar financing needs are more than adequately covered by the National Wealth Fund (Russia's sovereign wealth fund) the value of which had risen to USD168 billion, or 11.9% of GDP, at end-April 2020, from just 4.1% of GDP at end-2017. The fund's expansion was made possible by the adoption in January 2017 of a fiscal rule that requires any surplus revenue generated by an oil price of over USD40/barrel (+/-2% US inflation) to be used to buy foreign currencies. Thus over the course of 2019, the central bank purchased USD45.8 billion on behalf of the Finance Ministry.

The government's aim is to use the fund in part to protect against any future negative shock to international oil prices and in part to fund structural expenditure in the economy once the fund exceeds 7% of GDP. The Finance Ministry was thus, in April 2020, able to use the fund's surplus resources to buy the 50% +1 shares in Sberbank held by the central bank for the sum of RUB 2.1 trillion. Part of the RUB 1,050 billion profit on this sale will be transferred over four years to the Finance Ministry's account to help fund additional social security spending announced by President Putin in January (estimated at RUB 4.13 trillion, or 3.5% of GDP, over 2020-24).

SOVEREIGN FUNDS (USD BILLION)

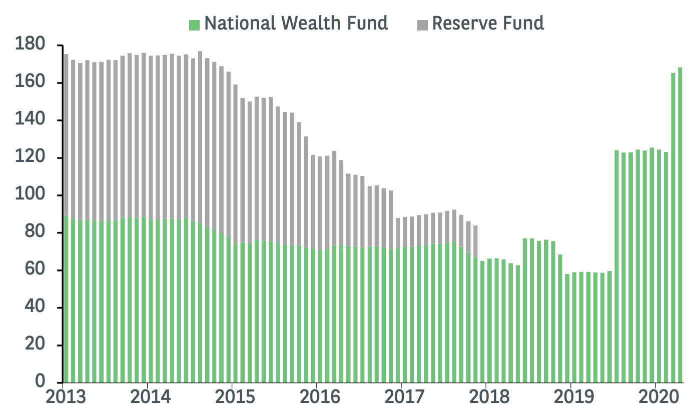

CHART 3 SOURCE: MINISTRY OF FINANCE

- **What are the risks from falling oil prices?**

Over the first four months of the year, the government ran a small deficit (0.2% of GDP) despite the collapse of oil and gas revenues (down 18%) and the sharp increase in spending (up 26%).

For 2020 as a whole, the central bank expects that the deficit will be limited to 5% of GDP, based on a Urals crude price of just USD27/barrel (down 58% on 2019), below the level seen at the end of May.

Under these conditions, government debt is likely to increase by 5pp of GDP over 2020, taking it to just under 20% of GDP.

Russia's public finances are much less exposed to an oil price shock than they were at the onset of the 2014-15 crisis.

In 2019, the oil price required to balance the budget was just USD 42/barrel, well below the figure of USD 110/barrel needed in 2015 or the level needed by other central Asian countries (USD 57.8/barrel in Kazakhstan). Moreover, the government has the sovereign wealth fund to help smooth any loss of revenue resulting from the oil price falling below the level determined in the budget for the year in question.

According to the fiscal rule in force (2017), the sale of the fund's liquid assets can finance the investment expenditure set out in the 2020 budget if fiscal receipts are affected by an oil price below the level set in the budget for the current year (USD42.2/barrel for 2020). This has been the case since the Covid-19 crisis began, with Urals crude at an average of USD 25/barrel. Therefore, between 11 March and 29 May 2020, the central bank sold the equivalent of USD 9.6 billion in assets on behalf of the Finance Ministry, with the price of Urals crude averaging USD 25.9/barrel, compared with USD 64/barrel in 2019.

MONTHS OF DEPLETION OF THE NATIONAL WEALTH FUND DEPENDING ON OIL PRICE

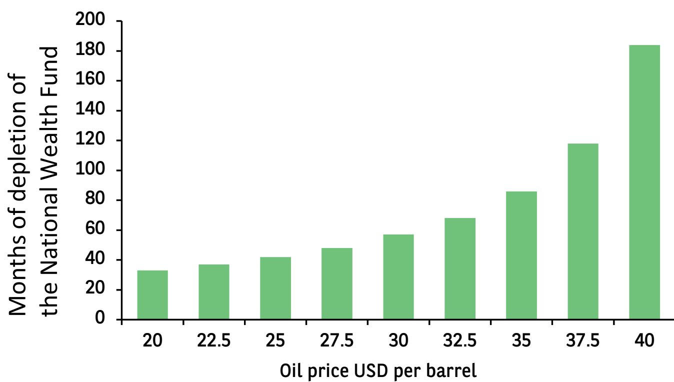

CHART 4 SOURCE: MINISTRY OF FINANCE

However, this strategy is not sustainable over the long term if oil prices settle at a low level for a long period. With an average oil price of USD 30/barrel, the sovereign wealth fund would be drained after 57 months. In addition, according to the fiscal rule in force, if the value of liquid assets in the fund falls below 5% of GDP, the government cannot use more than the equivalent of 1% of GDP per year.

Robust external accounts

Since the crisis of 2014-15, Russia's external accounts have strengthened. The country has become more resilient. Following the introduction of sanctions, a substitution of domestic production for imports has taken place, although this still remains quite limited[2]. External debt has fallen by 34% from its high point of mid-2014, dependence on dollar financing has eased and the rouble and the oil price are no longer as tightly correlated. However, diversification of Russian exports is still limited and FDI has fallen significantly, in line with the introduction of international sanctions.

- **Consolidation of external accounts**

Russia is a net creditor with regard to the rest of the world. In 2019, it had a credit position equivalent to 21.7% of GDP, 7 points higher than in 2014. This consolidation reflects the sharp fall in private sector external debt, on the one hand, whilst on the other it has been driven by strong growth in currency reserves, following the introduction in February 2017 of the fiscal rule that all revenues above USD 40/barrel (+/- 2% US inflation) will be used to buy foreign currency.

In 2019, the current account surplus was 4.2% of GDP, lower than the 6.8% of GDP recorded in 2018, due to the combined effects of prices and volumes (with lower oil production under OPEC+ agreements). The trade surplus fell by more than 16% in 2019, as a result of lower exports (particularly oil products) and a slight increase in imports due to higher investment spending.

At the same time, the balance on the financial account, excluding changes in currency reserves, showed a surplus. Foreign investment picked up, boosted by a more stable geopolitical situation for the country and despite the fact that it remains under international sanctions.

Since 2017, currency reserves have increased significantly, bringing them back close to their levels before the 2014 crisis. Although they have fallen since March, they still stood at USD439 billion in April 2020

EXTERNAL POSITION OF RUSSIA (% OF GDP)

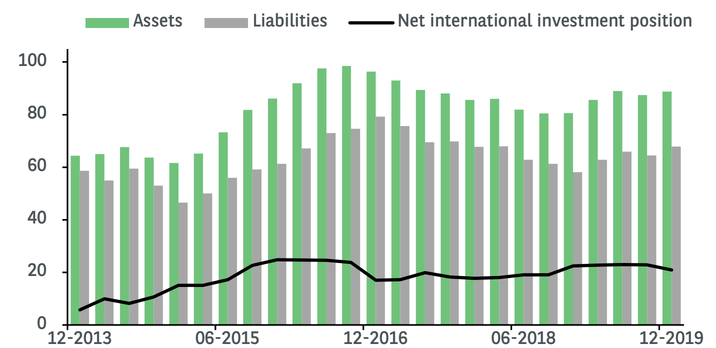

CHART 5 SOURCE: CBR

BALANCE OF PAYMENTS (% OF GDP)

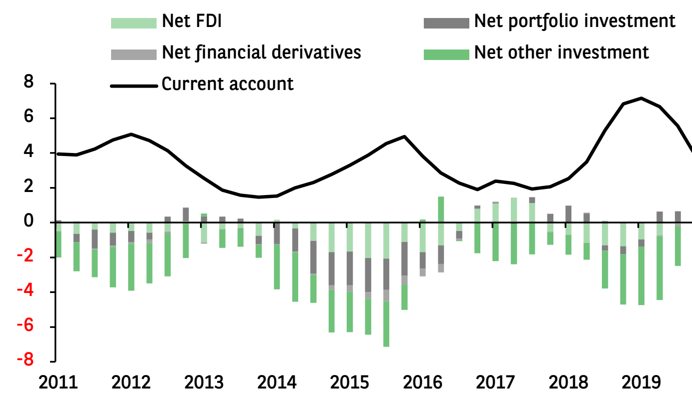

CHART 6 SOURCE: CBR

2 In particular, imports of food products have fallen since 2014.

(compared to USD486 billion at their peak in April 2013) and are more than adequate to cover the country's short-term financing needs.

External debt was just USD450 billion (29% of GDP in Q1 2020), USD 265 billion less than in March 2014. Excluding intra-group loans, external debt was only USD 332 billion at end-2019.

The fall in external debt mainly reflects the significant debt reduction by banks over the past five years. Their external debt was only 4.5% of GDP in 2019, having been 9.5% in 2014. Corporate debt remained stable overall, at 19.4% of GDP, whilst government debt rose just 2.1pp to 4.1% of GDP.

Indebtedness ratios have improved significantly over the past five years: external debt represents only 102% of exports (from 123% in 2014), external debt service costs are just 7.1% of GDP (from 10.3% in 2014), and currency reserves cover external debt service costs by a factor of 4.6 (compared to 2.1 in 2014).

The structure of external debt is also relatively low risk. Debt repayments between May and December 2020 are estimated at just USD 43 billion, with only a further USD 55 billion due in 2021. Moreover, the share of debt denominated in roubles increased by 9pp over five years, taking it to 30% of external debt in 2019. Lastly, dollar-denominated debt has fallen as a share of the total from 67% in 2014 to 48% in 2019. This was due not only to the sharp fall in dollar bank deposits but also to the government's policy of diversifying its debt.

- **However, dependence on oil remains high and FDI is still modest**

This improvement in external accounts since the 2014-15 crisis nevertheless needs to be taken in context.

First, Russia remains highly dependent on energy exports. Raw materials still represent 67% of Russian exports, with oil and oil products making up 46% of total exports. Excluding oil and gas, the current account was in deficit to the tune of 9.4% of GDP in 2019.

Secondly, foreign direct investment (FDI) has fallen steeply since sanctions were introduced in 2014. Between 2014 and 2019, new investment (excluding reinvestment of profits) ran at an average of only USD 4 billion per year, compared to USD 32.5 billion per year between 2008 and 2013.

According to the investment data produced by UNCTAD[3], the European Union is the biggest investor in Russia, followed by the USA. Even so, FDI from Europe and the USA fell by 88% and 41% respectively between 2015 and 2018, whilst investment from Asia increased by a factor of 5.2. The rapid decline in FDI from the west has hampered the diversification of the economy. FDI from Asia is tightly focused on the energy sector, whilst that from Europe and the US was more diversified.

FOREIGN EXCHANGE RESERVES (USD BILLION)

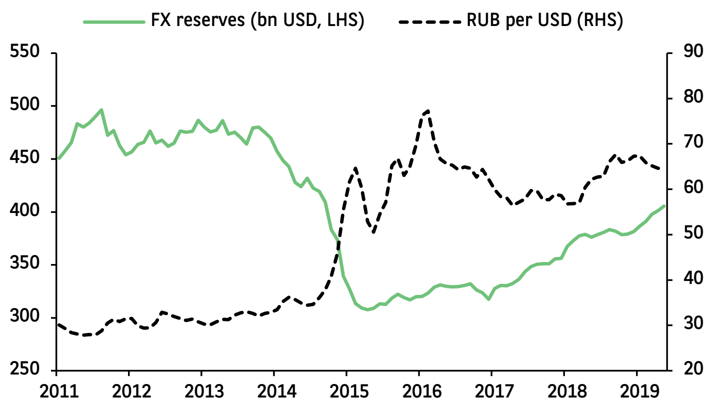

CHART 7

SOURCE: CBR

EXTERNAL DEBT OF ECONOMIC AGENTS (% OF GDP)

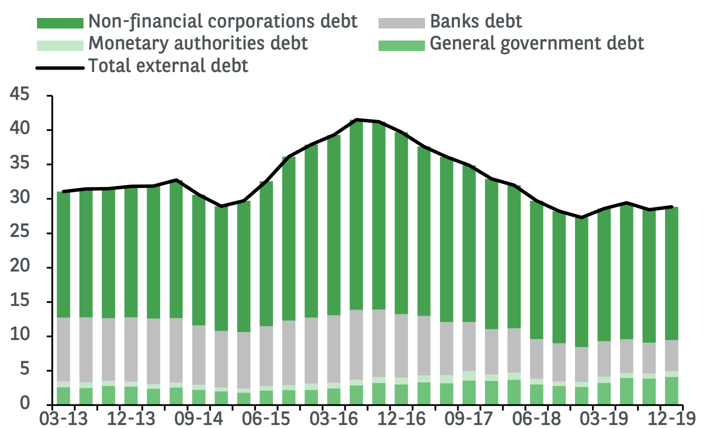

CHART 8

SOURCE: CBR

FDI EXCLUDING REINVESTMENT (USD BILLION)

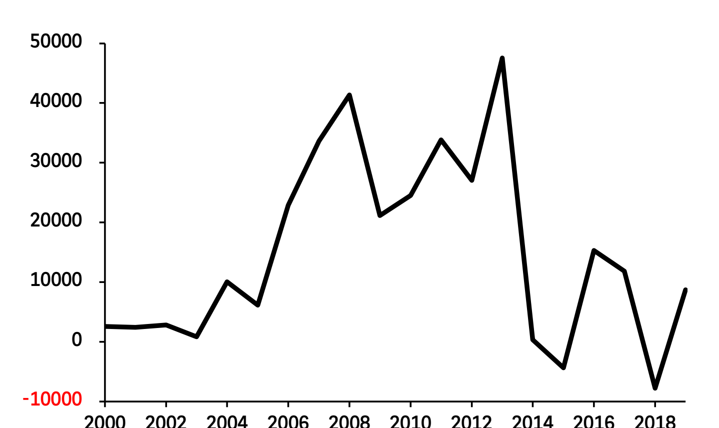

CHART 9

SOURCE: UNCTAD

3 UNCTAD data are processed to show only foreign investment. They are corrected for Russian investment moved through Cyprus.

Since the introduction of international sanctions, the profile of investments has changed. Investment in the energy and commercial (wholesale, retail, automotive) sectors has increased relative to that in the banking and financial services sector, which has contracted sharply. In 2019, more than 25% of FDI was focused on the commercial sector (up 4pp since the introduction of sanctions), 22% in the mining industry (up 13pp) and only 12% in banking and financial services (down 16pp).

- **The fall in oil prices will weaken external accounts but they will remain solid**

In 2020, Russia's external accounts will be weakened by lower oil production, the collapse of prices for exported commodities and the fall in foreign investment. Over the first five months of the year, tensions in the balance of payments emerged, forcing the central bank to intervene from 18 March to stabilise the currency, something it had not had to do since 2015. The rouble lost 15% against the dollar between 1 January and 22 May 2020, and currency reserves fell by USD8 billion.

According to initial estimates, the current account surplus shrank by nearly 42% over the first four months, in line with the fall of more than 37% in the price of Urals crude. Over the next few months, the balance of trade is likely to remain under considerable pressure. Under the agreements reached with OPEC+ in April 2020, Russia undertook to cut its production by 2.5 million barrels per day from 1 May for a period of two months. The cut in Russian production will then be eased to 1.991 million barrels a day from July to December 2020 and to 1.5 million between January and April 2021. Over the whole of 2020, therefore, Russian oil production will be 20.6% lower than in 2019.

According to the Central Bank of Russia, if the price of Urals crude averages USD27/barrel over 2020 (from USD64/barrel in 2019), the current account could show a deficit of USD 35 billion (surplus of USD 65 billion in 2019), and currency reserves could fall by USD 47 billion, taking them to USD392 billion by the year end. This would still be more than adequate to cover repayments of external debt by all economic actors through to the end of 2021 (USD 98 billion by end 2021).

In addition, foreign investors have scaled back their exposure to sovereign debt. The share of domestic debt held by non-residents fell by 3.2pp to 37.7% over the course of March and April. This said, it remains significantly higher than it was at the peak of the 2014-15 crisis, when foreign investors held only 17.9% of domestic debt. So far, investors have remained confident that the government is solvent.

Banking sector on a more solid footing to deal with the crisis

The banking sector was severely weakened by the 2014-15 crisis. Although it is still fragile, it has since consolidated significantly.

Over the past five years, banks' dollar debt has come down steeply, their liquidity has improved, and the level of dollarisation has been markedly reduced.

Meanwhile, since 2018 the quality of assets has improved, solvency ratios have been enhanced and profitability has increased.

However, despite these improvements, the economic contraction expected in 2020 and the depreciation of the rouble will weaken this sector which is in a period of major restructuring. A big jump in non-performing loans and a fall in profitability should be expected.

- **The consolidation of the banking sector**

The appointment of Elvira Nabiullina to head the Central Bank of Russia in June 2013 marked the beginning of the banking sector's consolidation.

By 1 April 2020 the number of banking institutions had been cut to 396, from 923 in 2013 and a peak of 1,344 in 2000.

Since the crisis of 2014-15, the debt of Russian banks has fallen by around 2pp (to 9.8% of GDP in 2019) and its structure has consolidated: dollar debt has fallen significantly, to just 3.2% of GDP at end-2019, from 9% 2013. Repayments due from Russian banks by end-2021 have been estimated at less than USD28 billion.

The dollarisation of the banking sector has fallen significantly, and Russian banks are thus less exposed than those of Kazakhstan or Azerbaijan to an exchange rate shock. In March 2020, 20% of loans and 25.6% of deposits were in foreign currencies, from 35% and 42% respectively in 2015. On top of this, at end-September 2019, the external position of the banking sector as a whole was substantially in credit, with external assets offering 1.65 times cover of external obligations; at the end of 2013, the sector was a net debtor.

Bank liquidity has also improved: liquid assets represent 1.8 times short-term obligations, compared to cover of just 0.8 times at end-2013.

Although the quality of assets has improved since mid-2018 it remains fragile, particularly in certain economic sectors. At the end of 2019, non-performing loans represented 11.1% of the total loan book[4] and the proportion of at-risk assets (non-performing and restructured loans) was still 17.5% in February 2020, even though this represented a 2.3pp reduction since the high point in January 2018. Part of this consolidation has come from the deleveraging of non-financial firms, and part from the transfer of at-risk assets from three private banks (Otkritie, B&N and Promsvyazbank) to the Trust Bank defeasance structure, under the rescue package put in place by the central bank in 2018. Provisions cover 81.4% of at-risk loans (from 75.6% at end-2013), and, at 12.5% in February 2020, the Capital Adequacy Ratio remains satisfactory. The sector's profitability improved in 2019, with earnings rising by more than 51% y/y in December 2019. Returns on equity (ROE) and returns on assets (ROA) reached the unprecedented levels of 18.9% and 2.1% respectively in February 2020.

- **Crisis expected to bring an increase in lending risk**

Although in a much more solid position than it was in 2018, the banking sector has only barely recovered from the 2014-15 crisis. Asset quality remains fragile and the level of dollarisation high.

The impact of the current crisis on the sector will depend in part on the support offered to households and SMEs.

The financial position of Russian companies is satisfactory overall. Their debt (60% of which is from state-owned companies) is slightly higher than it was in 2013, at 46% of GDP in 2019, but its structure is much less risky as it is mainly denominated in roubles. Dollar debt was less than 6% of GDP at end-2019 (from 20% at end-2013). Repayments due in 2020 are estimated at less than USD 60 billion.

The highest risk portfolios[5], according to the central bank, are concentrated in construction (where 29.4% of loans in roubles and 36.4% of foreign currency loans are considered to be at risk) and, to a lesser extent, in commerce and the water, gas and electricity sectors.

4 Defined as loans in categories IV and V by the CBR.
5 Loans in categories IV and V according to the central bank.

The companies likely to be hardest hit by the crisis will be SMEs, which are getting less government support than big state-owned companies. The most vulnerable will be those whose business is entirely focused on the domestic market. The oil companies remain profitable on prices for Urals crude of down to USD20/barrel.

Households will not be spared the effects of the crisis. Their indebtedness has increased substantially over two years (up 16.4% y/y in February 2020). However, it remained at only 17.6% of GDP in February 2020 and, according to the central bank, interest costs represented only 10.6% of disposable income in 2019 (from 9.7% in 2018). The share of consumer lending on the banking loan book remains under control, at 27.2% of total loans, and the non-performing loan ratio was 4.6% at end-January 2020. Even so, the situation needs to be watched closely, particularly for unsecured loans (50.4% of consumer loans), where the non-performing loans ratio is 8.4%.

To deal with the rise in lending risk, banks have increased their provisions (up 8.7% y/y in March), which will hit profits.

Support measures announced by the Russian government and central bank

The support measures announced by the Russian government and central bank are estimated at 1% to 1.5% and 1% of GDP respectively.

The government has deferred for six months tax payments (other than VAT) from the most vulnerable sectors: transport, culture, leisure, tourism, wholesale and retail. SMEs can delay payments of social security contributions and employer contributions, rent and loan repayments by six months. They will also benefit from a reduction in the social security contribution rate from 30% to 15% and will have access to loans at discounted rates to ensure that they can pay their employees.

Dividend payments will also be deferred for six months.

The self-employed can defer repayment of debts until the end of the year.
Unemployed and sick workers will receive the minimum wage until the end of the year. They will also qualify for payment holidays on loans (mortgages and other loans). Families with children will receive the equivalent of USD 44 per child per month.

Growth remains structurally low

Russia should be able to cope with the shock now taking shape for the year ahead. However, the crisis will delay the introduction of key measures to increase potential growth, which has been falling fast for more than ten years now.

Between 2013 and 2019 real GDP growth averaged 0.9% per year, and never exceeded 2.5%. This rate of growth was well below the average figures of 6.7% posted prior to the 2009 crisis.

The Conference Board analysis of the composition of growth points to structural constraints as the main explanation of the slowing of growth: a shrinking active population, declining educational standards, slower technological investment and a lack of technological progress.

Thus, according to the World Bank, Russia's potential growth dropped from 3.8% in 2008-09 to just 1.5% by 2018.

COMPONENTS OF GROWTH

	2000-2008	2010-2018
Growth	6.7	1.9
Labour quantity	0.7	0.3
Labour quality	0.2	-0.1
Total capital	0.3	0.6
Of which ICT	0.4	0.1
Of which non-ICT	-0.1	0.5
TFP	5.5	1.1

Fall in the active population

According to official figures, Russia's population only started to decline in 2018. However, the active population has been falling for more than ten years—it is now 4% lower than the 2008 peak—and is likely to fall by a further 25% over the next 40 years on UN forecasts. The dependency ratio has increased by nearly 10 points over 10 years, taking it above 48% by 2018. The ageing population and the fall in the active population have hit public finances and potential growth. To offset the effects of a shrinking active population, the government has conducted a pro-immigration policy for a number of years and at the end of 2018 introduced reforms of the pension system. From 2019, the retirement age will be increased by one year each year until 2023. The World Bank estimates that this reform, and increased openness to immigration, should add between 0.3 and 0.4 percentage points to potential growth between 2020 and 2028. But this will not be enough to fully make up for the natural shrinkage of the active population.

Decline in productive investment

Over the past decade, the investment rate in Russia has remained relatively stable at an average of 21.3%, a satisfactory level for the development of the economy even though the Putin government aims to lift this figure to 34% by 2028. At first sight, the slowing of potential growth will be a consequence not of inadequate investment so much as the lower level of productivity growth. However, this latter factor seems in part to result from a lack of investment in technology, resulting in a fall in the growth contribution from technological progress.

Investment in information and communication technology (ICT) fell by 18% between 2009 and 2016, having grown by 95% between 2000 and 2008[6]. However, this trend has not been uniform. Some business sectors, such as chemicals and oil, but also automotive and commerce, have continued to invest massively in ICT.

The state remains too involved in the economy

Overall, the government's weight in the economy has not increased significantly over the past ten years. It nevertheless remains high (the IMF puts it at 33% of GDP[7]) and if one excludes the "informal" economy, the state could account for up to 40% of economic activity and 50% of employment. Moreover, the state's presence is greater in certain key areas of the economy such as the banking, oil and gas sectors.

Excessive government involvement can strangle growth[8]. First, the excessive involvement of the state in an economy affects the optimal

6 Data from the University of Groningen, available for the period 1995 to 2016.
7 Di Bella, Dynnikova, Slavov, IMF working paper, 2019.
8 Barro (1991), Armey (1995) and Friedman (1997).

allocation of resources (if investments are focused on sectors with low levels of productivity and/or limited positive externalities), and the survival of unproductive or weakly productive state-owned companies can soak up financing that more productive (private) companies could make better use of. Secondly, the concentration of state companies in certain sectors limits competition, which is generally a brake on the quest for productivity gains[9]. Private firms do not enjoy the same financing terms or support from the government. The Russian government is seeking to promote competition in the domestic market, most notably through the National Plan for Development of Competition, covering the period 2021 to 2025.

According to the World Bank, reduced government involvement could boost potential growth by 0.3pp.

Russia's business environment remains a strong constraint

Overall, the business environment has improved over the past five years. However, the quality of governance[10] remains mediocre and is depressing private domestic and international investment.

According to the World Bank's Ease of Doing Business index, the country ranked 28th out of 190 countries, with the protection of minority investors identified as one of the main weaknesses in doing business in Russia.

In terms of competitiveness, the country ranked 43rd of 141 in the latest Global Competitiveness Report. The quality of institutions was most significant factor weighing on the country's competitiveness.

Russia's main weakness remains the quality of governance, which has improved very little over the past five years. According to World Bank indicators, Russia was 160th out of 211 countries in 2019, well behind certain other CIS members such as Kazakhstan. Its main weaknesses are in control of corruption and the rule of law. Transparency International ranks Russia 137th out of 180 countries for corruption.

A lack of economic diversification

Over the past five years, and despite the sanctions imposed by Europe and the USA in 2014-15 and strengthened since, the structure of Russia's economy has remained largely unchanged. It remains dependent on oil and gas and although the direct weight of the oil sector in the economy remains modest, per capita GDP is 92% correlated to the price of oil (expressed in roubles). This relationship has, however, loosened slightly since 2017.

The share of agriculture (at constant prices) has remained stable at 4% and that of manufacturing has increased only slightly (0.4pp), to 13.2% in 2019. The share of the extractive industries (71% of which consists of the oil and gas sectors) has increased slightly, taking it to 9.6%. Within manufacturing industry, more than 50% of production remains concentrated in the processing of commodities (including more than 21% in the production of refined oil products) with just 22% in machinery and capital goods. The country still has to import its capital goods, as illustrated by the tight correlation between investment and capital goods imports.

It is of particular note that domestic production of machinery and capital goods has not yet replaced imports.

GDP PER CAPITA AND THE OIL PRICE IN ROUBLES

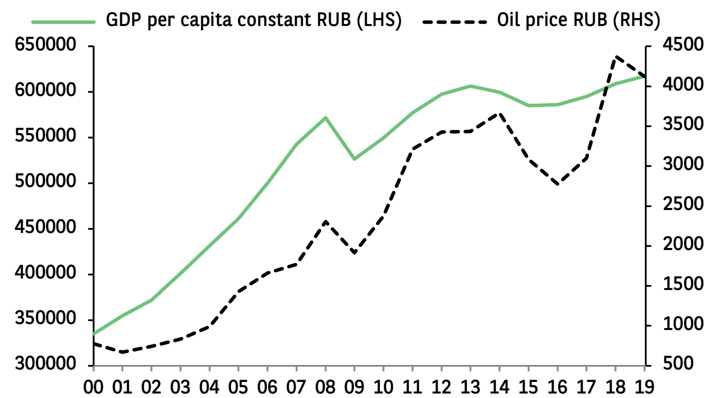

CHART 10 SOURCE: WEO, CEIC

INVESTMENT AND IMPORTS (Y/Y, %)

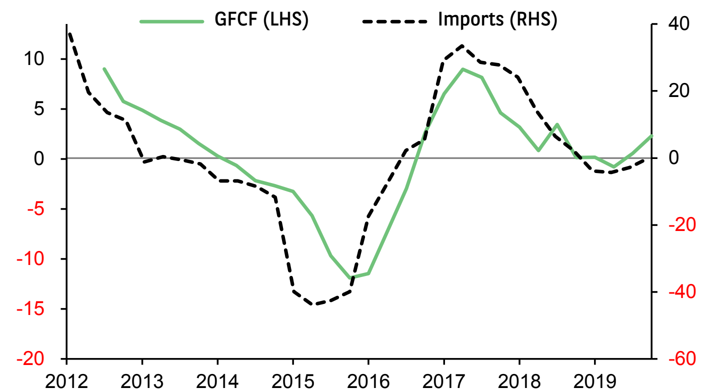

CHART 11 SOURCE: CEIC

Since the introduction of international sanctions, the share of exports other than oil and gas has increased by 10pp (to 48%), but without any move up the value chain. Exports of goods with a high level of technological content[11] only accounted for 11% of manufactured goods exports in 2018 (from 10.7% in 2013).

Since the introduction of sanctions, domestic investment has not diversified, whilst foreign investment (excluding reinvestment) has fallen and remains focused on the same business sectors and the same regions of the country.

9 Various studies have demonstrated a strong positive relationship between the level of competition and growth in labour productivity.
10 According to the IMF, "Governance is a broad concept covering all aspects of how a country is governed, including its economic policies, regulatory framework, and adherence to rule of law. Poor governance offers greater incentives and more opportunities for corruption—the abuse of public office for private gain."
11 Source: Comtrade. High technology products include aerospace, IT, telecommunications equipment, pharmaceuticals, scientific instruments and arms.

Development programmes could be delayed

Before the crisis triggered by the Covid-19 pandemic, the expected increase in fiscal room to manoeuvre thanks to the fiscal rule looked set to help the planned development of sectors other than oil and gas.

Following his re-election in May 2018, and alongside the announcement of an increase in retirement age, President Putin announced a major development programme (the May Decree) for the period from 2019 to 2024, with a total budget of RUB 8 trillion over six years (equivalent to 1.1% of GDP each year over the period). The plan was to boost spending on education, health and infrastructure to bolster potential growth. Other social measures, with a value of RUB 4.13 trillion, were announced in January 2020 for the period 2020-24.

The World Bank estimates that if all these measures are introduced and the institutional framework is improved, Russia's potential growth could be lifted to 3% by 2028.

In 2019, the government spent 94% of its target spending under this development plan. However, spending for 2020 could be delayed, even though this was not the case in the first quarter of the year. Given the economic shock that seems to lie ahead, the government might not meet the targets of its development plan, thus holding back improvements in potential growth.

The announcement on 2 June of a new plan of RUB 5 trn (4.5% of GDP) between the third quarter of 2020 and the end of 2021 could support the economic recovery and sustain potential growth. However, to date, no details are yet available on the content and modalities of its implementation.

PRODUCTION AND IMPORTS OF MACHINERY AND CAPITAL GOODS (Y/Y, %)

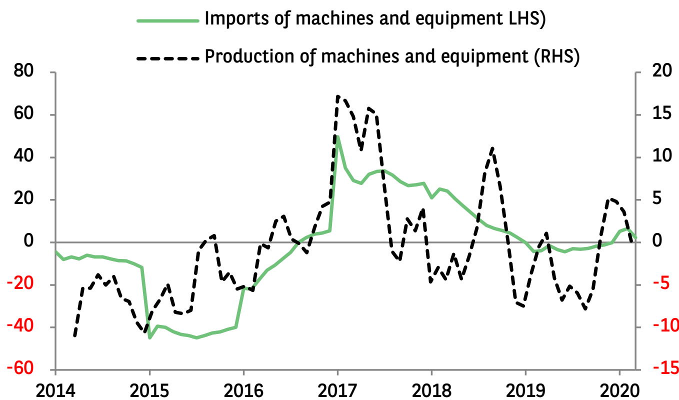

CHART 12

SOURCE: CEIC

Conclusion

Russia is on a more solid footing than it was in 2014 to tackle the Covid-19 crisis. Its macroeconomic fundamentals have improved, and companies are in a better state than they were five years ago. In particular, the country is much less dependent on dollar financing now than it was then.

This does not mean that the current crisis will be free of consequences for the Russian economy. It will weaken the banking sector in the middle of its major restructuring and delay the introduction of essential measures to increase potential growth, which has been falling fast for more than ten years now. The shrinking active population, declining educational standards, slower technological investment and a lack of technological progress are additional factors that are holding back growth. Lastly, the withdrawal of the state will be a determining factor in ensuring a better allocation of resources.

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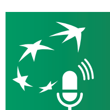

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