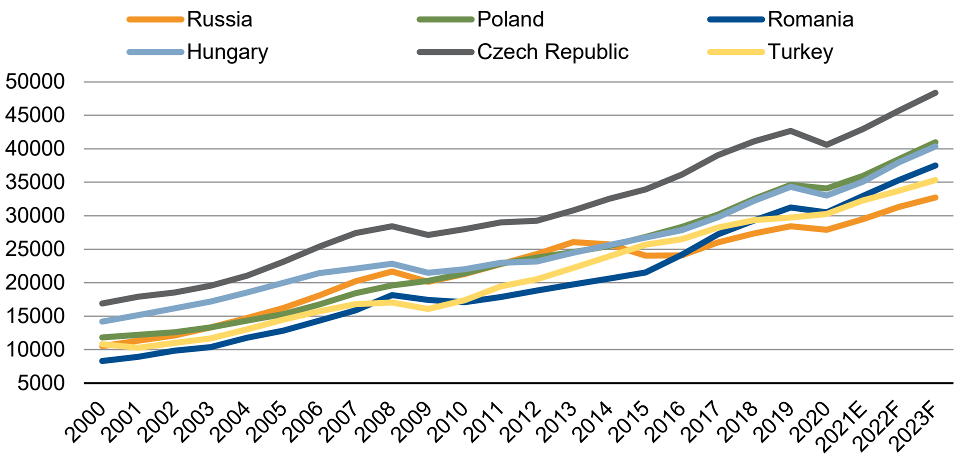
Russia: near-term economic stabilisation contrasts with slow reform momentum, climate challenges

Prudent macroeconomic policies have reinforced Russia's resilience to external shocks, but a coherent plan is needed to address long-term structural challenges, including the carbon-intensity of the domestic economy. The recently proposed carbon levy by the EU, Russia's biggest trade partner, could have a sizeable impact on Russia's budget which relies heavily on oil and gas exports.

Russia's strengthened public finances and accumulation of foreign exchange reserves have enabled the economy to withstand the imposition of international sanctions and the Covid-19 crisis relatively well. Russia's economy contracted 3% in 2020, lower than most large economies. Higher oil prices have allowed the government to support the short-term recovery with emergency fiscal stimulus. Russia's economy has already recovered to close pre-pandemic levels. Russia's GDP should grow 4-4.5% this year, revised up from 3% under our June forecast, and 2.7% next year.

Greater stability in the near-term, however, has coincided with overlooking the economy's structural weaknesses. Real disposable income of Russians has declined by almost 10% between 2013-2020. Russia's growth prospects over the next decade are weak, at 1.5-2% annually despite relatively low per capita incomes (**Figure 1**). Global climate policies make addressing environmental issues a priority for the government.

Figure 1: GDP per capita, purchasing power parity, USD



Source: IMF, Scope Ratings GmbH

Structural reforms will be crucial to increase Russia's long-term growth prospects:

- Total investment made in the Russian economy, running at slightly more than 20% of annual GDP over the past two decades, is lower than in most of EU's central and eastern European countries, such as Hungary and Romania, which maintained investment ratios of close to 30% for several years (**Figure 2**). Low investment will constrain Russia's growth for years to come.
- Russia's slow growth in part is due to the declining labour force. The proportion of the total population of working age (20-64) has declined to 61.5% in early 2021 from 64.5% in 2016. This share is projected to continue falling (**Figure 3**).
- Productivity growth is constrained by economic sanctions, which, by design, are intended to put long-term pressure on the Russian economy, for example by denying Russian oil companies the access to Western technology needed to modernise.
- Lack of ambitious policy mechanisms to address climate change exposes Russia's medium-run budget and growth to global policies to limit carbon emissions and could substantially increase transition-related costs for Russia's main exports.

Analyst

Levon Kameryan
+49 69 6677389-21
l.kameryan@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Media

Matthew Curtin
+49 162 4364861
m.curtin@scopegroup.com

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Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Structural weaknesses remain unattended, constraining long-term growth prospects

State's significant footprint in the economy affects competition

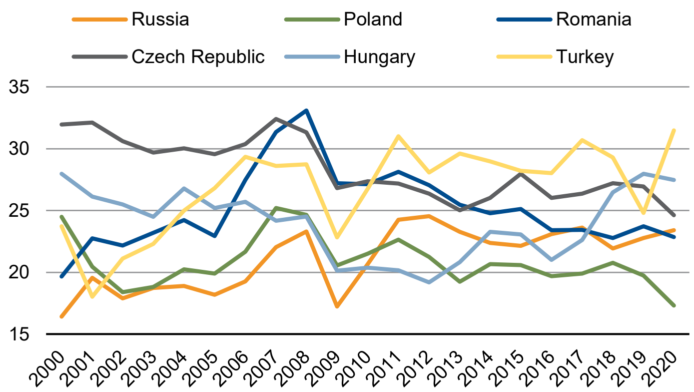
The absence of profound reforms to wean the Russian economy off its reliance on oil and gas industry and reduce the state's still large role in the economy has resulted in a lack of domestic competition and inefficiency, clouding the business climate and discouraging investment. The Russian state is estimated to account for about 40% of formal sector value-added and half of formal sector employment[1]. Reducing the overreliance of the economy on the commodities and energy sector and levelling the playing field between state-owned enterprises and private sector are key to enabling sustainable long-term growth. However, this is politically challenging to do, given the relative competitiveness of these industries over other tradeable sectors over the short term.

Ambitious investment targets; sluggish implementation

The government of President Vladimir Putin has, nominally, sought to address the problems of low investment and structural economic inefficiencies with a USD 360bn programme of national projects running until 2030 to raise medium-term growth by boosting public spending particularly on infrastructure, education, and healthcare, focused on developing regions. The national projects are primarily funded from the federal budget (~51%) and regional budgets (~19%). The plan envisages that around 29% of funds are raised from the extra-budgetary sources, that is, the private sector.

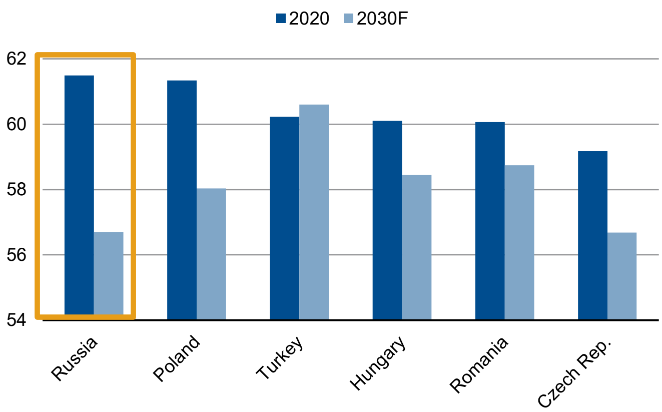
The implementation has so far been sluggish even allowing for economic shock of the pandemic. As of August 1, only half of the planned annual budget allocations for the implementation of national projects has been executed[2]. This reflects the political and administrative challenges that the Kremlin is facing alongside limited capabilities of Russian regions when it comes to managing projects of this size. Delays in the implementation of national projects will weigh down on the long-term health of the Russian economy.

Figure 1: Total investment, % of GDP



Source: IMF, Scope Ratings GmbH

Figure 2: Working-age population (20-64) as % of total population



Source: EC, UN, national statistical offices, Scope Ratings GmbH

Structural challenges limiting long-term growth prospects

Structural headwinds such as low investment and productivity growth contribute to the country's sluggish long-term growth outlook despite low per-capita GDP levels. Existing sanctions and the threat of more to come are contributing to the already weak business climate in Russia. Inbound foreign direct investment to Russia has dropped from an annual average of USD 55bn in 2010- 2013 to USD 20bn in 2015-2020.

[1] IMF 2018, 'Russian Federation: Selected Issues'
[2] Ministry of Finance of the Russian Federation, 'Press Release 09.08.2021'

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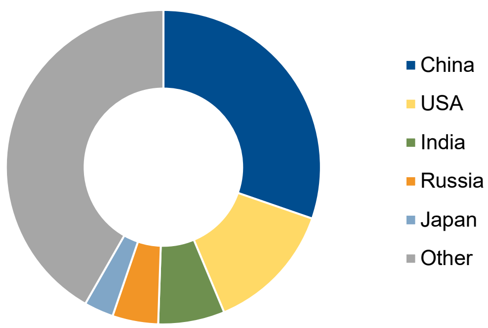
Adverse demographic trends in the form of an ageing population and shrinking working-age population are key factors that weigh on Russia's long-term growth potential and rating outlook. The planned gradual increase in retirement age by five years to 60 for women and 65 for men by 2028 and liberal immigration policies to attract Russian-speaking migrants from neighbouring states could potentially ease some of this contraction. The increase in retirement age could temporarily increase[3] the potential growth rate by up to 0.4pp over 2020-28, to still modest about 2%, by enlarging the workforce. After that, the impact of the reform on potential growth will be negligible. This suggests, that under a no-policy change scenario, the economy's potential for future growth will remain weak.

Global climate policies make environmental issues a priority

Russian policies required to follow global trend of cutting emissions

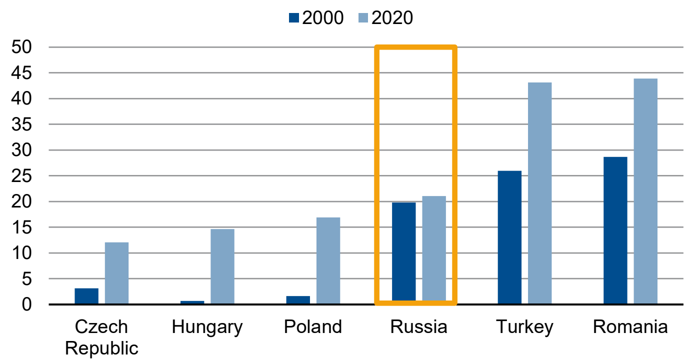
Russia is the world's fourth-largest carbon-emitter, accounting for 4.7% of the world's CO2 emissions[4] (**Figure 4**), nearly twice as much in per capita terms as EU 27 + UK average. The country is still heavily reliant on fossil fuels (60%) for energy production. The share of renewables[5], (including hydropower) in total electricity production has been unchanged at around 20% over the past two decades (**Figure 5**). The remaining 20% is sourced from nuclear power. The large scale of emissions makes the Russian economy and the budget vulnerable to Western environmental legislation. Moreover, Western institutional investors are increasingly looking at companies' environmental policies when deciding where to invest, which could potentially result in limitations for the Russian economy.

Figure 4: Fossil CO2 emissions, % share in the world



Source: EDGAR, Scope Ratings GmbH

Figure 5: Share of renewables* in electricity production, %



Source: Our World in Data, BP Statistical Review, Ember, Scope Ratings GmbH; *Renewables include electricity production from hydropower, solar, wind, biomass. and waste, geothermal, wave and tidal sources

EU's carbon levy to have a material impact on Russia's finances

The EU, Russia's largest trading partner, recently proposed a major new carbon levy (Carbon Border Adjustment Mechanism or CBAM) to incentivise a switch to a low-carbon energy mix, which could put significant downward pressure on global demand for fossil fuels. Russia's exports to the EU will be materially affected, considering their high carbon intensity. Assessments of the potential costs are around EUR 5.5bn-6bn a year[6] (~0.5% of 2020 GDP). This impact is still small in terms of the size of the Russian economy but could increase greatly should EU expand the mechanism to include oil and gas. Reducing Russian budget's structural reliance on energy revenue will not be easy. The oil and gas industry contributes around 40% of federal budget revenues.

Oil and gas will remain economically competitive in many sectors medium-term, supporting demand for Russian exports. But the upside for fossil fuel demand longer-term looks

[3] World Bank Group 2018, Y. Okawa, A. Sanghi, 'Potential Growth: Outlook and Options for the Russian Federation'
[4] EDGAR - Emissions Database for Global Atmospheric Research
[5] Our World in Data
[6] S&P Global Platts; Tass

increasingly limited. According to a recent estimate[7], the use of electric vehicles will increase greatly over the next two decades and will account for more than two-thirds of passenger vehicle sales in 2040.

Untapped potential, held back by unambitious policy agenda

Nevertheless, Russia is among the few countries in Europe alongside the Nordics, that have a biocapacity reserve. Russia has one-fifth of world forests - providing high CO2 absorption capacity – which, combined with the importance of atomic energy in the country's production of electricity, ensure that the country's biocapacity exceeds the population's ecological footprint. This fact, together with Russia's vast potential to generate wind and solar energy, represents an opportunity to shift exports on to a more sustainable path. For now, the potential is held back by differences in environmental-policy mechanisms between the EU and Russia.

We would expect that, mindful of these challenges and opportunities, the Russian government should diversify its environmental policies and the country's exporters will increasingly target clean technologies to remain internationally competitive. In his April state of the nation address, President Vladimir Putin included climate change as a significance for the country's development for the first time.

In recent months, the Russian government has been forced to focus on climate issues more intently as it faces the prospect of new regulation of its key export markets. The government plans to reduce net GHGs emissions to 1.19bn tons of CO2-equivalent by 2050 under a baseline scenario, from 1.58bn in 2019[8]. The Russian government has introduced mandatory carbon reporting for companies starting from 2023 to limit greenhouse gas emissions to government-set targets, thereby responding to the EU's and other players' carbon-market policies. In addition, Russia will start measuring the CO2 absorption capacity of its forests. The aim is to sell carbon units abroad, which could potentially alleviate losses under the CBAM. The Kremlin's plan would let companies contract parts of the forest from the Russian government to plant trees and to increase the CO2 absorption capacity to generate a carbon credit, which could then be sold.

Russia's outlook

Improved macroeconomic resilience supports credit outlook

Daunting as these long-term challenges are and the questions hanging over the government's willingness to address them, Scope's stable Outlook for Russia takes into account the country's external resilience, increased exchange rate flexibility and low public finance risks.

Russia's improved monetary policy supports the country's credit outlook, as reflected in the 100bps market-friendly, above-expectation rate hike in July. Regarding Russia's more robust external and fiscal position, international reserves stood at USD 601bn at the beginning of August, equivalent to nearly five times maturing external debt within one year. The National Wealth Fund had assets of USD 187.6bn (11.7 % of GDP) as of 1 July. We project gross general government debt to stabilise at low 20% of GDP over 2021-22 on the back of slight fiscal deficits.

Domestically, beyond the planned national projects and retirement age change, there is little other evidence of the government's efforts to address the long-term constraints facing the economy. Nor are there compelling incentives – domestic or international – for the Kremlin to change course. The recent rise in the value of energy exports helps offset unfavourable political and economic impact from international sanctions and the pandemic crisis.

[7] Bloomberg
[8] Tass

Sanctions in themselves are far from comprehensive. Western countries differ on how punitive an approach to adopt. In Europe, despite geopolitical tensions, economic ties between Russia and the EU remain close. While EU-Russia trade has grown only marginally since 2014, Russia remains strategically important in the energy sector as the recent US-German agreement over the Nord Stream 2 gas pipeline linking Europe's biggest economy with Russia shows.

Russian climate policy to be driven by global and EU initiatives

Russia is likely to gradually adapt its policies to address the climate change challenge. This will be shaped to a large degree by EU's policy initiatives and the introduction and possible expansion of carbon pricing mechanisms globally. The financial and political additional cost of these changes on Russia will depend on, among others, how Russia responds. We expect to see efforts, domestically, to address climate change at a more strategic level, and, externally, to take on EU policy – both by seeking opportunities for cooperation with Brussels which might lead to a more lenient approach by the EU toward Russia on the CBAM and/or by mounting legal challenges against EU's mechanism and other environmentally related trade measures at the World Trade Organization.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
111 Buckingham Palace Road
London SW1W 0SR

Phone +44020-7340-6347

info@scoperatings.com
www.scoperatings.com