Russia

LABOUR FIX

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The OECD's latest long-term forecasting exercise casts a pall of gloom over Russia, which comes out as the very worst in a 46-country pack. Demography is the obvious culprit. The OECD's policy prescriptions for Russia focus on governance. But the real policy action lies elsewhere – and this is not just a long-term growth theme: it matters also for the immediate rates outlook and equity valuations.

- The CBR thinks that the NAIRU has been reached, but it still signals rate cuts. There is a more fundamental resolution to this apparent paradox than present favourable inflation trends – underlined by the March CPI print just out..
- The key is active labour market policies aimed at redistributing labour now inefficiently hoarded in the public sector.
- This policy promises sweeping benefits: increased productivity in the public sector, more defensible corporate profit margins with top lines meanwhile supported by sustainable domestic demand growth.
- A rate cut is coming no later than June.

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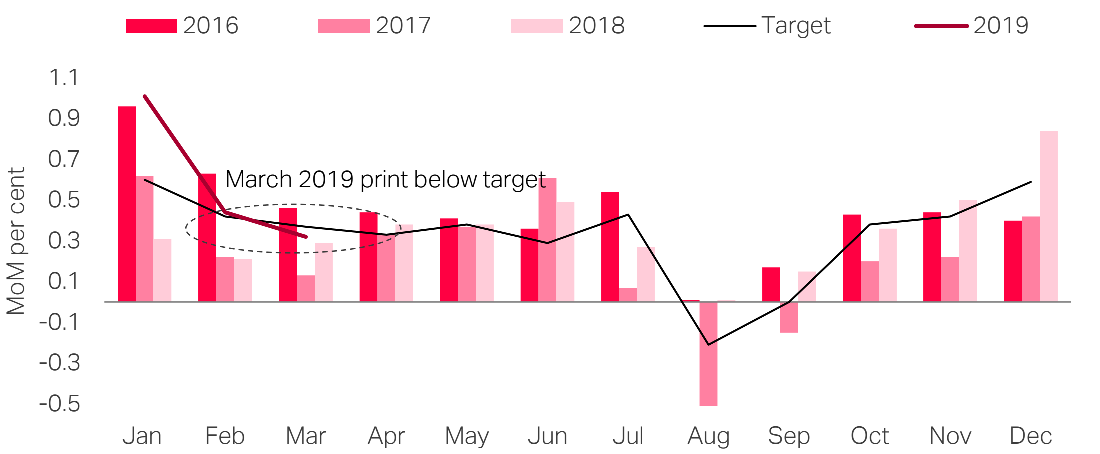
Positive inflation surprise: no wage pressure

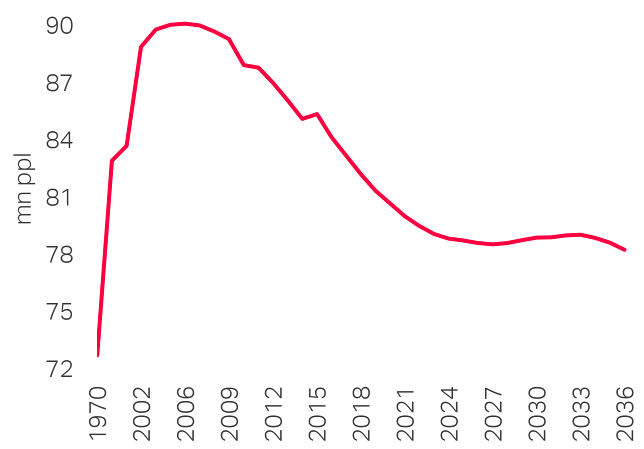


Source: Rosstat

CBR – complacent or coy?

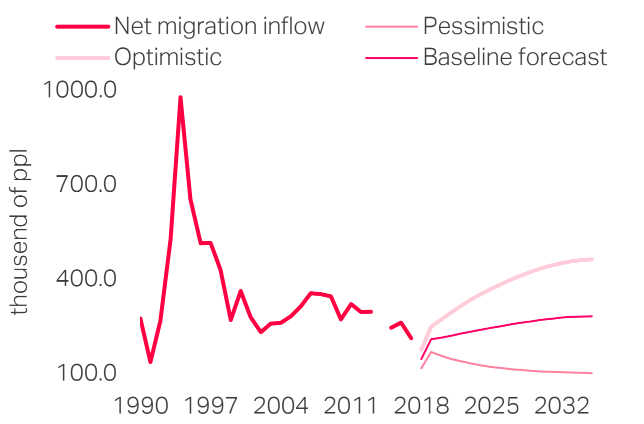
Demographic headwinds are a well-known constraint on Russia's growth potential: but what about the effect on the shorter-term rates outlook? In its various publications and statements, the central bank (CBR) does not disguise the reasons for potential concern. The Finance Ministry predicts the share of the workforce in the total population to continue falling by 0.5ppt per year until 2025. In absolute terms, that means three million fewer working-age people than in 2018. Rosstat estimates the total absolute decline in 2017-30 – the negative period of the 'demographic wave' – to reach four million people (left-hand chart below). These forecasts reflect the cushion of net immigration (coming mainly from other FSU countries) now being much thinner than it was during Russia's previous demographic shock of the 1990s (right-hand chart below).

Working age population



Source: RosStat

Net migration inflow and forecasts



Source: RosStat

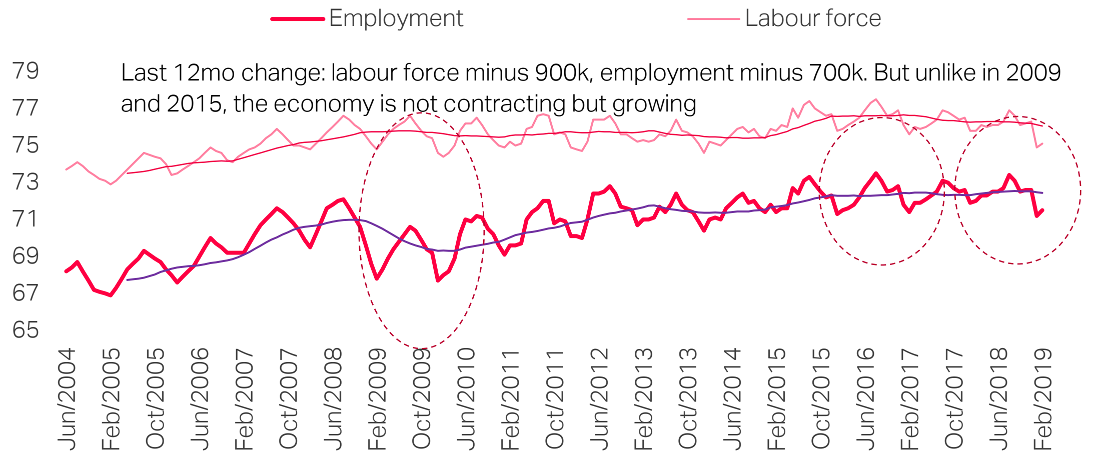
The NAIRU has been reached. Even with the bulk of the working-age population decline still to come, unemployment has already fallen to an all-time record low of 4.7-4.8% recorded in February. Commenting on this in its latest quarterly Monetary Report published on 29 March, the CBR attributed the reduction in unemployment more to structural than cyclical factors – that is, the main driver here is demography rather than the return to real growth since 2017. More important for the rates outlook, this report went on to state that the present low unemployment rate has reached the CBR's estimate of the NAIRU.

Since all this points – other things being equal – to a threat of structural wage inflation, it may seem surprising that the CBR is signalling rate cuts this year. Put another way, the CBR shows no sign of revising up its estimate of the neutral level for the real interest rate being in the range of 2-3% or even of being reluctant to cut rates in the short run on the grounds that this would stimulate demand for labour with the economy already at full employment – causing immediate inflationary pressures. The press release accompanying the CBR's latest interest rate decision on 22 March contained standard relaxed language on the labour market – i.e. the CBR said that it did not see worrying inflation risks coming from that source. With inflation set to return to the 4% target next year, this implies potential for at least 75bps of rate cuts from the present 7.75% level of the policy rate. Is the CBR being complacent here? Or perhaps it knows something that is not so evident to the naked eye?

Labour mobility key

The answer, we think, is a 'yes' to that second question. An initial clue came from remarks by CBR governor Elvira Nabiullina in her press conference following the CBR's interest rate-setting meeting last June that happened to fall the day after the government announced the pension age increase. Nabiullina said that while the higher pension age meant a welcome increase in the labour supply, the only reliable way to prevent labour shortages was to raise productivity. The chart below highlights indirect evidence of improved productivity performance. Last year saw the biggest falls in absolute levels of employment and the size of the labour force since 2009 and 2015 – but, those were years of deep recession whereas 2018 saw accelerating growth.

Productivity trend offsetting labour tightness



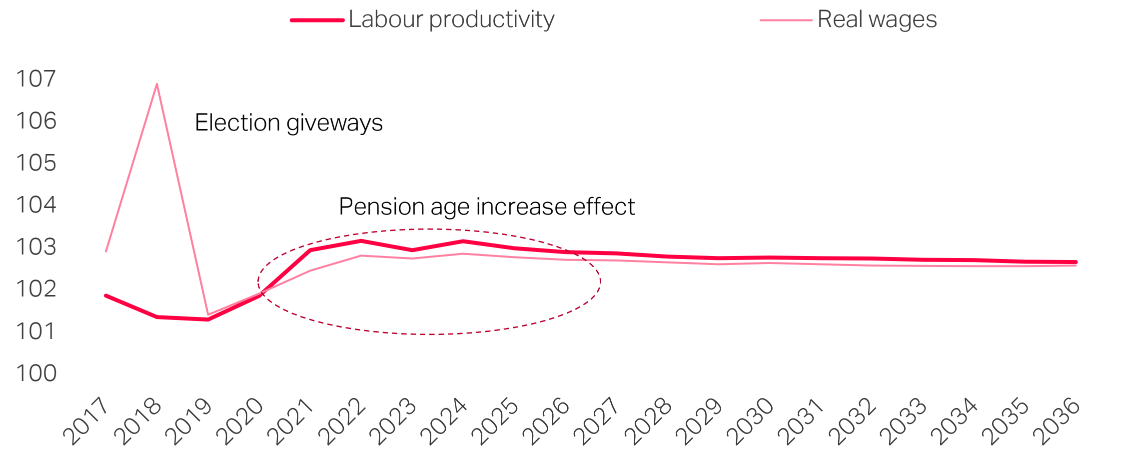
Source: RosStat

Yet this positive snapshot does not clinch the case for a sustainable gain in labour productivity. The clue to this key point comes in something else Nabiullina said back in June 2018. This was her stress on labour mobility – both geographical (i.e. internal migration) and between professions. Noting the present "equilibrium level" of unemployment, she said that progress on labour mobility would push down that level. Just such a reduction in the NAIRU is what the authorities are expecting. Buried in the Finance Ministry's long-term budget forecast to 2036 that appeared in public this week, we find this:

By the mid-2030s, the labour force will have three million more people than 2018 (79.2mn vs 76.2mn), and unemployment will be 4.3% (down from 4.8% at the end of 2018).

This optimism on labour mobility and, hence, productivity shows up in the forecasts of the one other important policymaking centre, the Ministry of Economic Development (MED). The MED forecast shown in the chart below sees labour productivity rising imminently to a new sustainable trend level of 2.5%, with real wages increasing at a similar pace.

Productivity growth set to outstrip wages, containing ULCs



Source: Ministry of Economic Development

This pretty picture – of a falling NAIRU creating scope for lower real interest rates in turn facilitating sustainable growth based on maintained competitiveness – is completed by a final detail in that Finance Ministry long-term forecasting exercise: adding the above-inflation pension increases to that 2.5% annual real wage gains produces a 3% trend growth rate in personal consumption. This is compatible with the goal of raising sustainable growth above the global average.

To judge by the OECD view, all this might amount to no more than a banal case of policymakers embellishing their forecasts to meet domestic political imperatives. The view in question comes out of the OECD's latest five-yearly Long Term Scenarios for the World Economy to 2060 published last year. The OECD's baseline scenario highlights Russia's weak potential. It is one of only three countries (the others bring Italy and Spain) forecast to be more distant from the convergence frontier – US per capital GDP – in 2060 compared to 2018, and Russia is the worst of that 'losing' group. This negative outlook stems to a large extent from Russia's weak demography (labour market factors dominate their drivers of long-term per capita growth).

As usual with OECD papers, the baseline is designed to show the potential gains from positive policies. In this wide-ranging study covering all OECD member and accession countries plus the eight non-OECD members of the G20 Russia gets two specific mentions.

- Russia is singled out first for notably poor productivity potential, attributed to weak initial momentum towards convergence with the advanced economies. This point seems notably gloomy in that it implies little scope for policy-driven improvement.
- When it comes to policy, the paper contends that the BRIICS countries could increase per capita income by a third to a half through improved governance and educational attainments. Russia is mentioned as the best candidate for governance gains (a polite way of saying that the starting point is so bad in areas like corruption and the rule of law, public service effectiveness and office-holders' accountability).

The scope for improved governance and the resulting benefits are self-evident. A reminder – if one were needed – from a foreign investment perspective is the recent arrest on trumped up criminal charges of Michael Calvey, founder of the leading international private equity investment firm specialising in Russia. Yet the OECD analysts miss the most promising, realistic and, above all, relatively fast-acting policy tool for raising productivity and the growth speed-limit. This is active labour market policies designed to bring about the improved labour mobility which we have already noted being set by Nabiullina as a key objective.

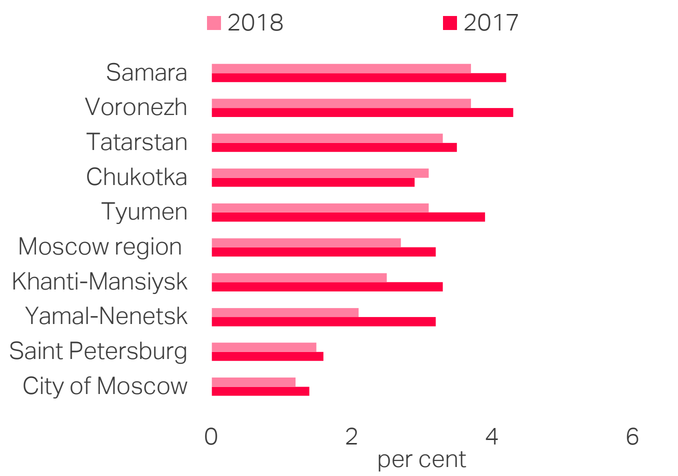
Discreet but determined push

As also noted above, labour market policies may not be too apparent. The OECD's oversight here is understandable: these policies are not being 'shouted from the rooftops'. The reason for this discretion is the social sensitivity. The focus is on what amounts to labour hoarding in the public sector. The single most important policy action is to release excess labour in the public sector. This will produce several benefits hinging on containing unit labour costs:

- Both wages and productivity will rise in the public sector – good news for sustainable growth.
- Structural wage inflationary pressures in the private sector caused by labour scarcity will be cushioned by the incremental supply of labour released from the public sector.

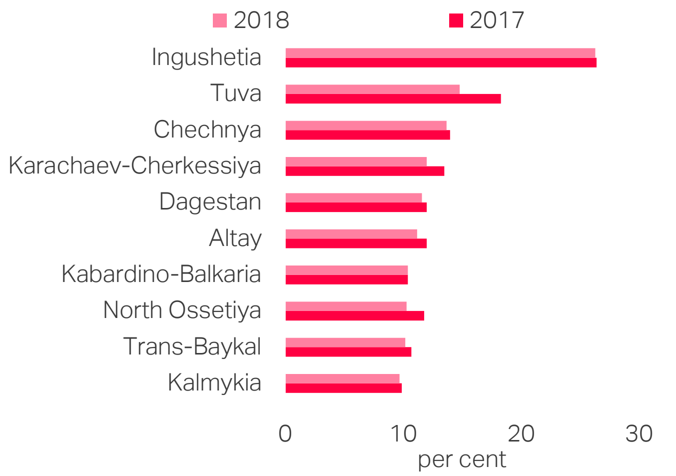
The sensitivity arises from the hard reality that many public sector workers made redundant will not be easily employable in the private sector – and many of those that do find new jobs may be earning less than they did before. In the end, however, the tightness of the labour market and resulting high level of vacancies should be sufficient to prevent this labour redistribution causing serious social tension. The charts below show the demand for labour in the largest regions (left-hand chart) but also the regional disparities (right-hand chart), highlighting the importance of improving the conditions for internal migration, notably through new policies on homebulding and mortgages that we reviewed in a detailed note last December.

Top ten regions with lowest…



Source: RosStat

. . . and highest unemployment



Source: RosStat

Public sector rationalization

The political mandate for headcount cuts is in place. The policy goal will not be to drain labour from those backward regions but to promote labour mobility within those regions. Meanwhile, the missing labour supply in the low unemployment regions starting with Moscow and St Petersburg will come from another source: the public sector. Cutting headcounts in the public sector now has political cover in the form of Putin's mandate of achieving 5% annual labour productivity growth in large and medium-sized enterprises by 5%. An analytical note by the Labour Ministry foresees 230,000 jobs being cut in Q1/19. This caused a mini-sensation in the media – and explains why official statements in this policy area are non-existent. The guidance, instead, is oblique. The MED has set 3% growth KPIs for regional leaders; and achieving this will depend on redistributing labour.

To start with some concrete examples (in ascending order by scale).

- **VEB.** This is the Russian government's financing arm under the new management since last May of Igor Shuvalov, a core top economic official in Putin's team. Shuvalov announced last month that one third of a targeted core headcount reduction of 2,500 people had already been carried out, with the remainder due to be completed by next May. The headline cut of 5,000 people includes the staff of a bank (Svyaz Bank) that was bailed out by VEB in the 2008 crisis and will be now transferred to the CBR's bank rehabilitation arm which will doubtless prune that lender's headcount. Further rationalizations involve synergies with other development institutions and relocating staff in a lower-cost regional office (Voronezh).
- **Post Office.** A new law enacted late last year has changed the legal status of the Post Office from a "unitary state enterprise" (more below on that archaic form of legal entity) to a wholly state-owned JSC. Although mass redundancies were officially ruled out (smoothing that law's parliamentary passage), this opens the way to 'rationalization' of this organization's huge workforce of 350 thousand employees.
- **Russian Railways.** This is another giant employer with a present headcount, including subsidiaries, of nearly 850,000. The company is planning to cut 55,000 jobs by 2025. This plan seems to strike a balance between achieving some material cuts and avoiding social tension (with quite heavy reliance in this case on natural wastage). The company also stresses the scope created by this rationalization to increase the pay of the remaining employees – by nearly a third.

This last point is a big emphasis of the equivalent plans afoot in the federal civil service. The Finance Ministry announced last month headcount cuts of 10% this year in central offices and of 15% (divided between 5% this year and 10% next year) in federal agencies' regional offices. All the cost savings will be ploughed back into salary increases for remaining staff.

Even the army and prison service are getting in on the act of raising public sector productivity. The Defence Minister Sergey Shoigu said this week that soldiers would be drafted in to construction work on the planned new railway link into the ethnic Mongolian region of Tuva (his home region). As for prisoners' labour, the declared goal is to increase its economic usefulness.

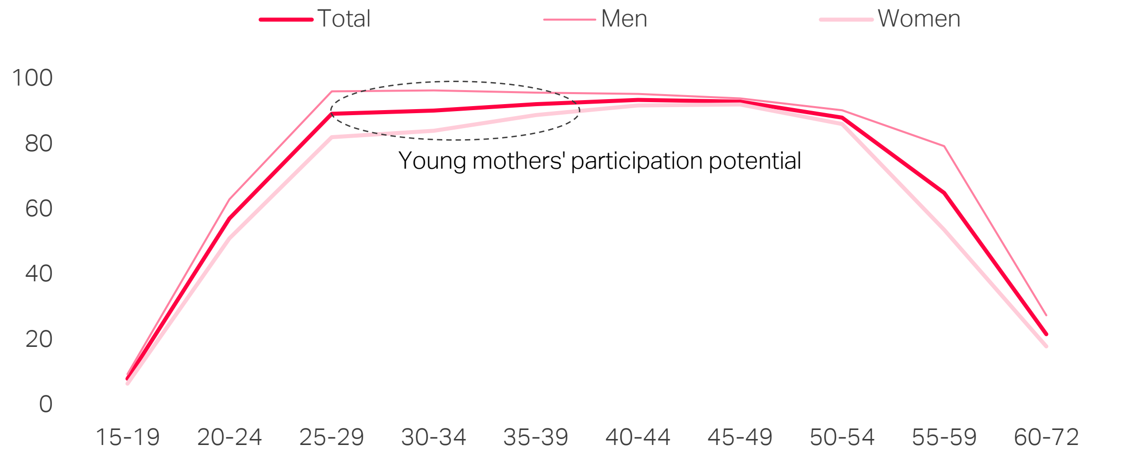
Underlying all these specific areas is an important structural reform – targeting the above-mentioned "unitary enterprises". Typically found among public sector service providers, this Soviet-legacy type of legal entity involves using, but not owning, state property for carrying on business. As of January 2018, no less than 18,624 such entities existed on the federal and municipal levels. Average labour productivity in these organizations is estimated by the Federal Anti-Monopoly Service to be 4.5 times below all other types of enterprise. Talking of areas of relatively lower productivity, another important one is the informal sector – which the Finance Ministry has been steadily squeezing through tax reforms since 2016.

This large and murky world is characterized by suppression of competition and corrupt rent extraction. It was no surprise then to see furious opposition to the draft law submitted by the government to the State Duma last year that would force a reorganization of all these "unitary enterprises" either into budgetary institutions or JSCs. After much argument, this bill passed its first reading in the Duma last December, and the government has now proposed some concessions ahead of the decisive second reading, including a postponement of the deadline for this reorganization from January 2021 until January 2023, and exempting sensitive sectors like defence, security and civil protection.

Increasing participation

Alongside the release of labour from the public sector, the other main set of policies with the same aim are those designed to raise labour participation. We have reviewed in previous reports the main exhibits here: the pension age increase and a planned nationwide roll-out of a targeted approach to poverty reduction known as social contracts, an important component of which is helping out-of-work members of poor households find their footing in the labour market.

Labour participation rates by generation cohorts



Source: RosStat

A final policy with potential to 'move the needle' targets female labour participation rates – specifically, the mothers of young children. The goal here is to increase childcare capacity (nurseries) and subsidized pre-school (kindergarten) places. The target for nurseries is aggressive: 70,000 new places by 2021. By international standards, female labour participation in Russia is respectable; but as the chart above shows, there is still room for improvement.

Investment conclusion

Rates

This whole area of active labour market policies is not only a background theme relevant to long-term growth potential: it also has immediate market relevance. With the redistribution of public sector labour underway, the CBR is running out of excuses to delay its promised return to monetary easing. By coincidence, the latest monthly CPI print just out – 5.3% – shows that the present inflation uptick has now peaked, and, on a sequential basis, has already returned to target. While it may be premature for the CBR to affirm that labour market policies have already lowered the NAIRU, the direction of travel is clear. At any rate, the positive inflation surprise (see chart on the front page) reflects weak domestic demand, especially on the consumer side – in turn indicating the absence of wage pressures.

Equities

Turning from the rates outlook to equities, the labour market policies discussed in this note will contain labour costs, thus protecting margins, while also helping to boost top lines by underpinning sustainable real wage gains – starting in the rationalised (but still large) public sector.

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