Russia

AUSTERITY CUSHIONS

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Putin's annual state of the nation address last week majored on announcements of new handouts to pensioners and poor families. This reflects a major risk theme: the new economic growth strategy is friendlier to markets than it is to the Russian public.

- The risk of the public's patience snapping and the derailment of the present policy framework is being addressed by a new approach to social policy.
- This involves much more disciplined targeting of transfers and benefits at the most sensitive groups – both socially (i.e. the poorest groups), and politically, as exemplified by the focus on non-working pensioners.
- The risk from disaffected youth is lower than may seem, with repression in the form of internet content controls being part of the policy response.
- The fiscal price of latest measures is a manageable 0.17% of GDP, but the groundwork is already being laid for a more material fiscal loosening ahead of the important political test of the Duma election in 2021.
- The overall approach will "work" – but at an economic cost which is linked to the relative losers of the re-distribution strategy being the 'productive middle'.
- Aside from this overall cost, specific policies associated with this political insurance premium point to some enhanced investment opportunities such as private healthcare.

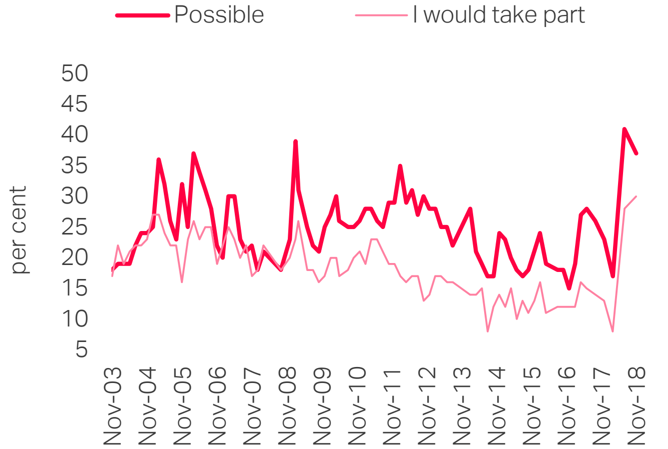
The "jam tomorrow" challenge

From the point of view of Russian households, the Putin administration's economic growth strategy boils down to a promise of "jam tomorrow". Policy is firmly focused on easing structural supply-side limitations to potential growth. Much of the agenda accordingly hinges on ensuring the conditions for increased productivity-enhancing investment in fixed capital. Labour supply – both quality and quantity – is another important focus. Several of the thirteen new national projects are relevant here, such as the ones on healthcare, demography, education, housing and bringing about labour productivity improvements over and above those that stem from capital investment.

The signature policy of Vladimir Putin's new presidential term to date has been the increase in the pension age. This measure straddles the whole agenda. It is essential for sustainable public finances, and this boost to Russia's credit fundamentals contributes to overall macroeconomic stability and a lower cost of capital, in turn enhancing investment incentives. This pension reform also counters demographic headwinds to growth. It cushions two effects of the decade-long decline in the working-age population, by adding back some incremental labour supply and consequently restraining wage inflation pressure stemming from the tight labour market.

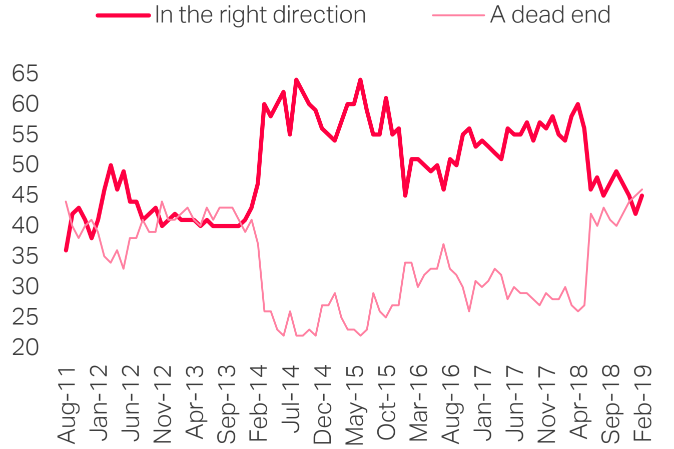
This last point leads to the final way in which the pension age increase catches the 'spirit of the times' in Russia. It exemplifies the reality that households are required to do the 'heavy lifting' required by this growth strategy. This spells persistent public disenchantment that could cause protest to spill sporadically into the streets (left-hand chart below) and protest votes in elections. The simple version of this story is by now a staple of media commentary: that is, the pension age hike has popped the 'Crimea euphoria' bubble in Putin's public approval rating and triggered a reversal in the public mood to net negative. This last point is shown in the widely followed series by the authoritative independent pollster, Levada (right-hand chart below).

Economic protest



Source: Levada-center

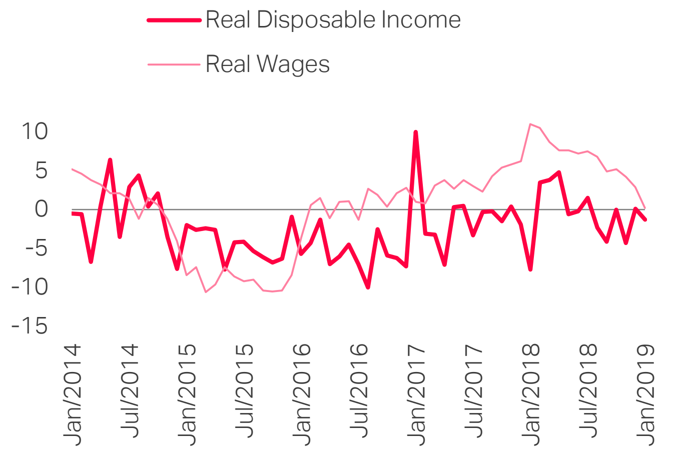
Where is the country heading?



Source: Levada-center

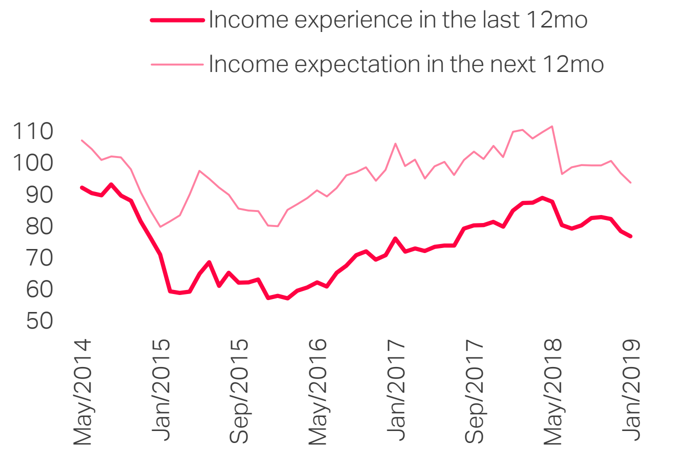
Focusing on the unpopular pension reform might even understate the risks of the overall strategy. It is not as if the public would have no complaints if only they could still expect to retire at the same age. The logic of any supply-side policy bias and associated drive to raise the investment rate implies compressing household consumption and boosting savings. In a previous comment on the first official estimate of 2018 GDP growth at 2.3%, we highlighted the surging net export contribution to this surprise outturn at the expense of domestic demand (especially consumption), while the wage share in GDP fell by 1.4ppt from its 2017 level to 45.7% and the shares of taxes and profits correspondingly rose. These effects are amplified by sanctions pressure, encouraging precautionary reserves accumulation which shifts the burden of adjustment to domestic demand.

Incomes and wages statistics …



Source: RosStat

… and people's perception



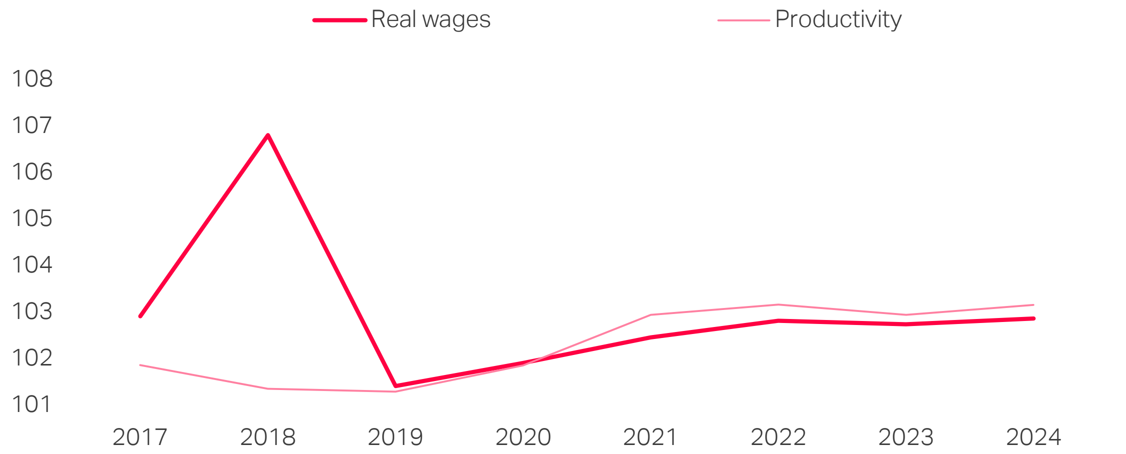
Source: FOM for CBR

The most eye-catching indicator for this risk is the Rosstat series on real disposable incomes (RDI). Despite government hopes of a turnaround last year, RDI remained in negative territory for 2018 as a whole – with a headline decline of over 0.2% on 2017 (the latest revised figure has not been released), making for the fifth consecutive annual decline. Largely owing to this year's inflation uptick, 2019 is set to make that six straight years of falling RDI.

In some media commentary, these headlines are used to exaggerate the gloom. Last year's yoy outturn would have been positive (+0.1%) but for the one-off Rb5,000 pension bonus paid out in January 2017. The RDI decline has come despite a healthy rebound in real wages (left-hand chart above) and has been caused – among other reasons (such as the drive to legalize the grey sector) – by higher household debt service on the back of rapidly expanding retail credit since 2016 that has brought forward consumption.

Nevertheless, the outlook is not one to quicken the Russian consumer's pulse. As the right-hand chart above shows, household income expectations are depressed. On a longer forward view, the government both expects and intends that real wage growth will be much slower than the rebound since 2016. The chart on the next page captures the bounce from pre-election public sector wage hikes a year ago and the official forecast that from now on real wage growth should remain in lock-step with the pace of productivity gains. There will be no easy wins: higher living standards will have to be earned.

Wages growth will not exceed productivity insuring ULC stability



Source: Ministry of Economy

To sum up: in the last phase of his rule, Putin has launched Russia onto an arduous high road towards sustainably higher growth, in effect inviting the public to wait patiently for gains which, when they eventually come, will hardly seem euphoric. For as long as it remains in place, this strategy promises a favourable backdrop for fixed income investment in Russia and, as for equities, decent earnings growth in tradable sectors – especially export-oriented, while import substituting companies also stand to benefit. The core risk, however, is that public patience may snap, derailing the present economic course.

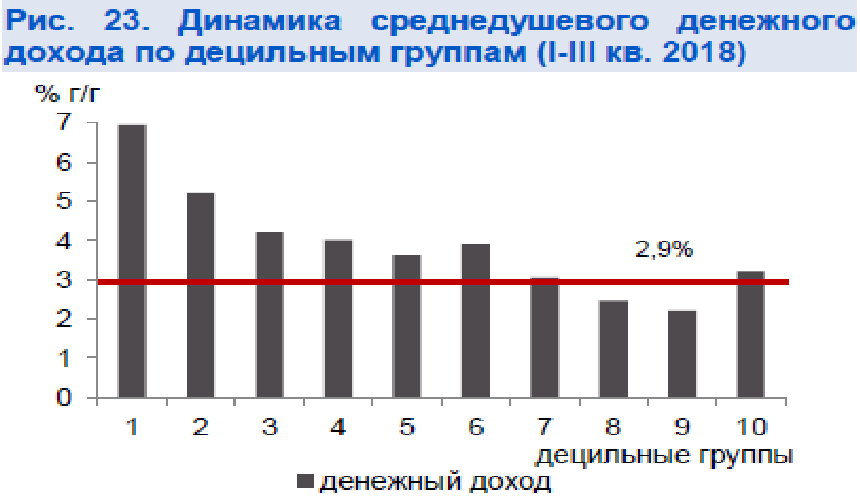
In other words, and returning to our "jam tomorrow" catch line", "tomorrow" remains a way off; and when it does come, the jam rations will be meagre.

Sensitive 'state of the nation'

The political leadership and policymaking elite are now displaying heightened sensitivity to this risk. President Putin himself turned out to be well briefed on the subject of real disposable incomes when explaining the indirect method of calculating this indicator during his big annual press conference last December. (His main argument was that the RDI are still improving – in the sense of becoming less bad.)

In its monthly economic comment for January, the Economy Ministry briefed defensively on this subject. The argument was that the negative headline RDI outturn belies more favourable distributional effects.

Average income dynamic by income decile groups for 9mo 2018
Red line shows average CPI for 9mo 2018



Source: Ministry of Economy calculation

To give a sense of how this has become a 'hot topic', we reproduce above the relevant chart in Russian from that MinEcon report. The falling RDI of the three highest income deciles dragged down the overall outturn owing to their weight (these top brackets receive 40% of all incomes). RDI remained flat for the fourth decile, while the rest – representing nearly two-thirds of the population – saw some real growth driven by higher pensions for non-working pensioners and an increase in the minimum wage. Although though there is no publicly available data against which to check these findings, they make sense. Higher income households would have felt the negative effects of reduced interest income following CBR rate cuts and the differentiated and progressive property tax. The only negative driver for poorer people was increasing interest payments on consumer loans, but such borrowing is being ever more tightly constrained by CBR macro-prudential measures.

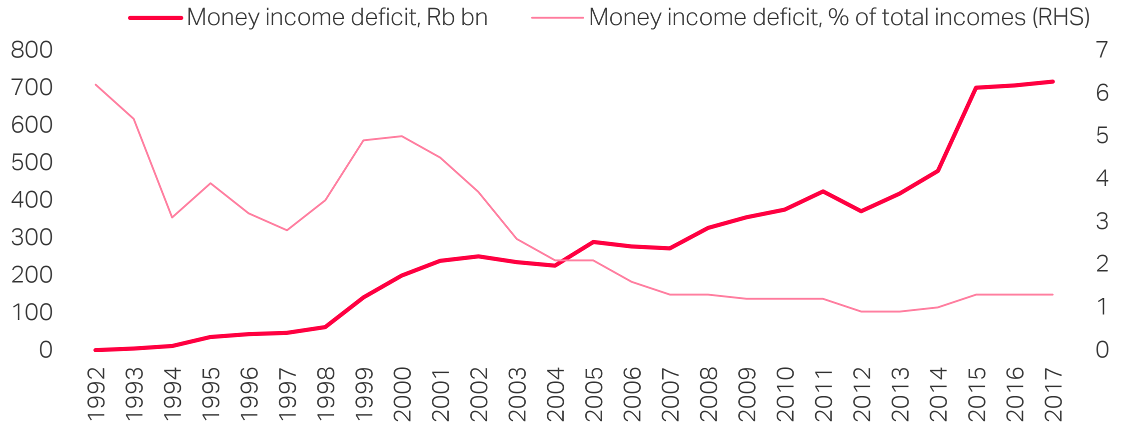
All such indications of sensitivity to social discontent were reflected and amplified in Putin's annual 'state of the nation' address on 20 February. The core of the speech contained announcements on increased social payments and transfers. The main measures came in two areas.

- **A hike in payments to non-working pensioners**. Backdated to the start of 2019, this measure removes an anomaly whereby the 2% real increase in pensions (i.e. the main existing measure designed to cushion the blow of the pension age increase) had been offset by a reduction in the top-up payments designed to prevent retirees' incomes falling below the subsistence norm in their regions. Now, those top-up payments will also be indexed.
- **Various new measures to help lower-income families with children**, where much poverty in Russia is concentrated. Alongside mortgage interest subsidies and property tax breaks, the headline here was an increase in the means-tested threshold for child benefits for the first and second child. The overlap with the demography 'national project' became even more explicit in an additional – and non-means tested – lump sum Rb450,000 mortgage principal repayment for families on the birth of their third child.

Social policy discovers risk management

These measures reflect an important shift in social policy. Instead of spreading the handouts thinly among all recipients of around 800 existing transfers, all such additional measures are being carefully targeted. The concentration on the poorest has the most obvious rationale. The official goal in this area for Putin's presidential term ending in 2024 is to halve the number of people living below the poverty line from the 2018 level of 13.2% of the population. The chart below shows the gap between this poorest group's incomes and the subsistence minimum. A recent RANEPA study showed that as many as 22% of the population can afford only the most basic food staples and must stint even on those if they need to buy medicines.

Money income deficit

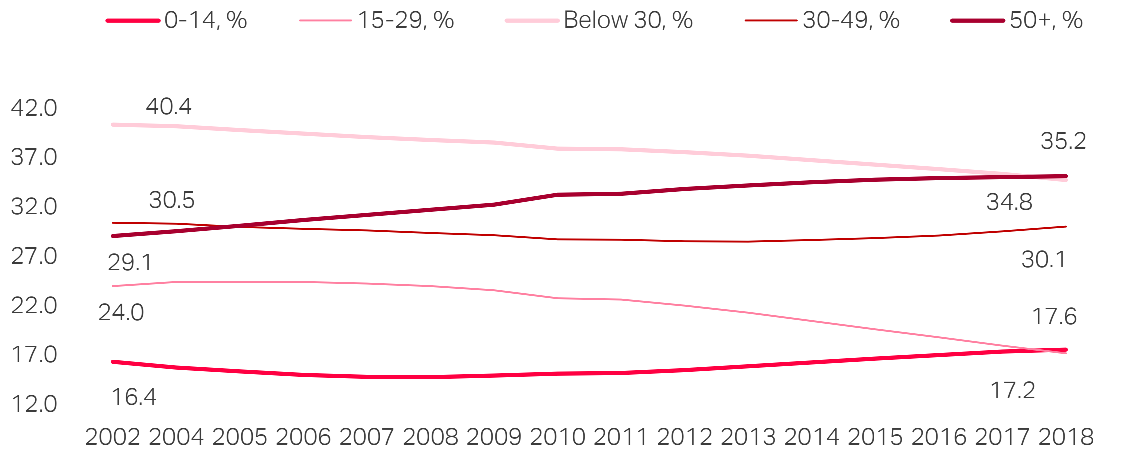


Source: RosStat

Another important poverty relief initiative is a scheme known as the "social contract". This involves tailored financial support to help members of the poorest households acquire skills, start micro-businesses or simply raise the output of their allotments (typically vegetables – here, incidentally, lies the bedrock defence against extreme poverty that became apparent in the worst periods of post-Soviet deprivation). Various versions of this approach have been applied in several Russian regions during the present decade. A recent study by researchers at the Higher School of Economics in Moscow found that by 2014 up to a third of targeted families had benefited in some way. The plan now is for a federally coordinated national roll-out, with a 90% positive impact rate. The key feature, again, is the targeting aimed at specific households.

The final main component of Russia's poor is non-working pensioners. We have already noted this being a focus of the latest measures announced by Putin. The rationale here goes beyond straightforward poverty reduction. Independent sociologists such as Denis Volkov of Levada have reported on focus groups revealing a sense of unfairness that pensioners have been asked to make sacrifices ("rather than oligarchs and officials"). The Kremlin staff has its own intensive focus group surveys (and Putin obliquely referred to that in his 'state of the nation' speech). There is a particular political danger for the Kremlin in a rising sense of injustice among pensioners. As shown in the chart on the next page, their share of the total population will be steadily rising – and, equally important, they are the voters most likely to go to the polling stations in all elections.

Population by age group



Source: RosStat

This chart shows that children and teenagers are the other age group with a rising share of the total population. Here lies another source of political risk for the authorities, as demonstrated by the success of the opposition leader Alexey Navalny in bringing millions of young people (including teenagers) into the street to protest against corruption.

In our view, however, this risk is less acute. The shortage of new labour market entrants will help young people find work and support their wages. Another factor here is repression. New legislative initiatives to ensure a "sovereign internet" point to ever-increasing state control of easily available content. The political incentive here came especially from the authorities' failure to block the Telegram messaging service. Other repressive measures are more broadly aimed. The chart on page 2 about economic protest shows an increasing divergence between people's expectations of protest and their own willingness to take part. That reluctance must stem from fear of prosecution and jail terms.

2021 pinch point

A final important feature of this risk management strategy concerns timing. A pinch point for this whole strategy of cushioning the arduous path to sustainably stronger growth will come in the form of the parliamentary (State Duma) election in September 2021. The ground is already being laid for this in the form of an upgrade of the minimum subsistence basket (or, more accurately, a reversal of a steady downgrade during this decade, as a result of which those people classified today as being below the poverty line are even worse off than their counterparts ten years ago). This change will go live at the start of 2021, triggering automatic pension and minimum wage increases.

Those prospective measures will also offset the social impact of the planned start (also in January 2021) of the other key leg of the pension reform: employee contributions to pension investment pots (the so-called "Individual Pension Capital" project). Timing is the key here too. In addition to being quasi-voluntary, the deductions from monthly pay packets will be introduced gradually in 1% annual increments spread over six years. This should reduce the potential for this reform – vital to the whole growth strategy – to become an additional focus of social discontent.

Will it work? Yes, but at a cost

The fiscal price tag is lower than the potential economic price. At the time of writing, Anton Siluanov (Finance Minister and First Deputy Prime Minister) has just updated the cost of the additional social spending measures announced by Putin last week. This cost is now expected to be Rb180bn/year – higher than our initial official estimate of 155bn based on preliminary official guidance – but still a very tolerable 0.17% GDP/year of extra spending. Given the tax revenue gains from the constant sanctions pressure on the ruble, this extra spending will be comfortably accommodated within the existing budget framework. It might be regarded as compensating the hit of the inflationary effects of ruble weakness on the poor (all the more accentuated now that food inflation is rising fastest)

This low budget cost might suggest that the measures are less likely to have the desired effect of assuaging social discontent. The least that can be said is that this strikes a balance between blunting protest sentiment and maintaining the economic strategy – especially this year, which will see the completion of the adjustment of the public finances to the new fiscal rule based on $40/bbl.

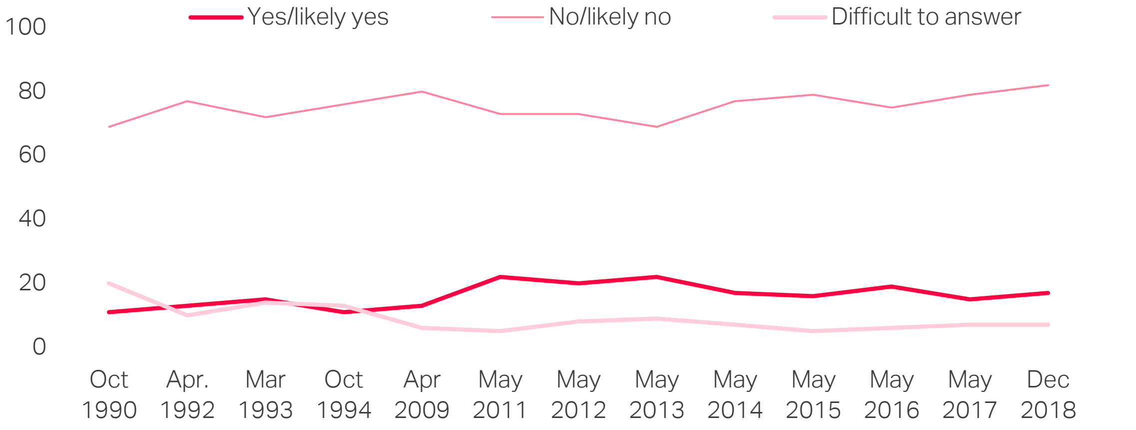
Perhaps more important than the risk of social discontent is the economic cost of blunting that discontent. The key point to stress once again is the sharper targeting of social measures. They amount to re-distribution for the sake of social stability. While there will be some economic benefit from, for example, the "social contract" scheme increasing labour participation and consumption among the poorest groups, several negative economic effects will also make themselves felt. This might be seen as the "insurance premium" cost of the kind of risk averse policymaking that has long been visible to investors in the conservative fiscal and monetary policy stance ever since the oil price and geopolitical shocks of 2014.

This economic cost stems from the targeting strategy. The focus on non-working pensioners means continued real erosion of the pensions received by people of pensionable age who remain in formal employment. The many and various transfers in non-priority areas will not be abolished, as that would be perceived by the large parts of the affected public as a 'slap in the face' (this lesson was learned in the fraught 2005 episode of the monetization of in-kind benefits when Putin's approval rating fell to an all-time low). Instead, such benefits and transfers will not be indexed, and thus allowed to 'wither on the vine'. In general, the heaviest lifting of all is being left to the middle-aged middle class.

This presents a striking contrast between the present economic strategy and the "Strategy 2020" prepared for Putin's previous presidential term. The contrast has, first of all, a strong presentational aspect. The national projects at the heart of the 2018-24 agenda were presented on 11 February in smart, word-lite infographics (as can be seen even by non-Russian speakers from a quick view here). The "Strategy 2020" was a stodgy 500-page document coordinated by two senior professors.

The contrast extends to the content of these successive strategies. Today's national projects are stock-full of measurable KPIs – none of which have a direct bearing, however, on household incomes and consumption. A central plank of the old strategy was to expand the middle class. The idea was that rising incomes in this group drive demand for education and higher quality products. That would result in the creation of new value-added with the productivity growth that comes from a better quality of labour force. The new strategy in effect accepts disadvantages for the middle, creative and most-productive class. The government will try to offer at least some faster social lifts for the most active people (for example, “young leaders” programmes), but such lifts will remain sparse.

Suitcase mood: “Would you like leave the country?”



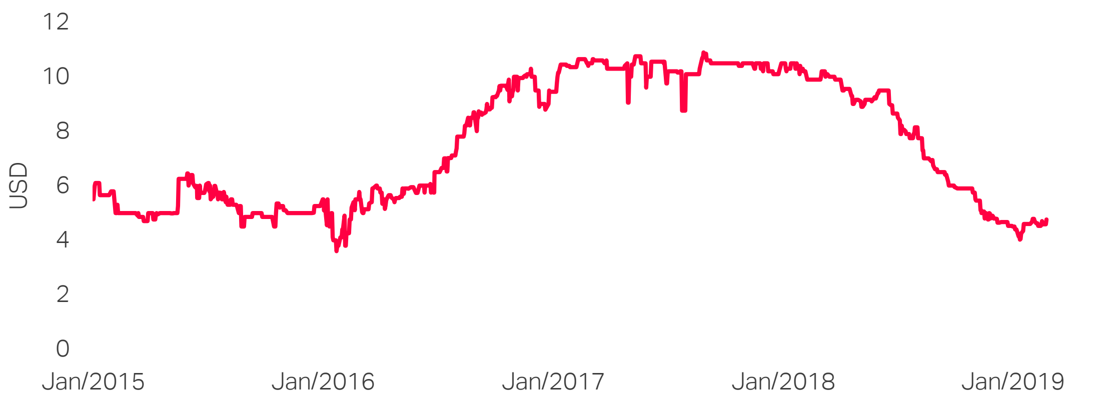
Source: Levada-center

All in all, efforts to manage social and political risks will have a net negative effect for growth potential. One way in which this cost will make itself felt is through the emigration of more productive people. The chart above shows that inclinations to emigrate are rising again as the “Crimea euphoria” recedes.

Investment implications

Despite the economic drag from the political insurance premium, our conclusion is that the overall strategy will remain on the rails. The investment implication has long become clear: Russian exposures, especially in equities, should be weighted in favour of companies in tradable sectors, especially exporters, rather than to companies oriented to domestic consumption. One exception – homebuilding and retail (mortgage) banking – was the subject of detailed report that we published last December.

MD Medical Group share price



Source: Bloomberg

Another exception is private health clinics. In his address last week, Putin promised to prolong VAT breaks for medical and cultural services beyond their previously planned expiry at the start of next year. This bodes well for extending the scope of such tax-free services for consumers to treatments in private clinics that are covered by mandatory public insurance. The chart above illustrates this theme through the relatively depressed MD Medical share price.

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