April 21, 2020

Questions and lessons from the 2020 economic crisis

Russian economy: updating the forecast through 2024

— **The forecast update for 2020–2024 considers the negative effect of the coronavirus pandemic**, the consequences of the termination and relaunch of the OPEC+ agreement on the oil market, and the impact of compensatory measures taken by Russia's Government and the Bank of Russia on the Russian economy. The unavoidable quarantine measures taken in the fight against the pandemic have led to a sharp decline in activity in the service sector and disrupted production chains in most countries of the world. This situation will continue at least through 2020 and will worsen the effect of the 2019 industrial downturn in some countries. The duration and depth of the crisis will depend primarily on the duration of the acute period of the pandemic. If this acute period drags out, a lot will depend on the sufficiency of state support for companies and the general public, as well as the effectiveness of the banking systems in the affected countries.

— **The base case scenario for Russia assumes a 4–4.5% decline in GDP in 2020** and a 2–3% recovery in 2021. This scenario is based on the assumption that quarantine measures will be repeated from time to time and will be lifted completely only if an effective treatment is developed or after the majority of the population goes through the disease or gets vaccinated, thereby developing immunity. The length of the recovery is critically dependent on the extent to which the banking system is capable of closing liquidity gaps in the affected labor-intensive industries as well as on whether the government extends its measures to support consumer demand. The pessimistic scenario assumes a 7–7.5% slump in real GDP and a recovery commencing only in 2022.

— **Some conclusions can already be drawn from the current economic crisis.** The main parameters of Russia's budget rule are finally tuned to absorb oil price shocks. However, in the event of a shock not related to the oil market, the flexibility of the budget rule may turn out to be insufficient. The way the crisis develops will depend on the ability of the banking sector to maintain the liquidity of small and medium-sized enterprises (SMEs), which in turn will require assistance from the government and the Bank of Russia. Finally, public health and healthcare is not just one of the factors of intangible welfare, but also an economic category that has a direct impact on production, income, and wealth.

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Table 1. Base case scenario of the macroeconomic forecast *

Indicator	UoM	Actual			Estimate	Forecast			
		2017	2018	2019	2020	2021	2022	2023	2024
Urals oil price (annual average)	USD/bbl	53.8	69.8	63.7	35	35	45	47	47
Global GDP[1]	% y-o-y	3.1	3.0	2.8	-2.6	3.6	2.7	2.4	2.5
Real GDP growth rate	% y-o-y	1.8	2.5	1.3	-4.5	2.2	3.5	1.8	1.5
Annual average USD exchange rate	RUB/USD	58.3	62.7	64.7	75.9	74.0	69.3	69.2	69.4
Real disposable income	% y-o-y	-0.5	0.1	0.8	-6.4	2.7	1.3	1.2	1.5
Unemployment	% of EAP[2]	5.2	4.8	4.6	6.7	5.9	4.5	4.5	4.4
Inflation (CPI[3])	% Dec/Dec	2.5	4.3	3.0	5.2	2.2	3.0	3.4	3.5
Key interest rate (as of end of year)	%	7.75	7.75	6.25	5.5	5.5	5.5	5.0	5.0
5-year zero-coupon OFZ rate (as of end of year)	%	7.2	8.5	6.1	8.3	6.9	5.4	5.3	5.2
Federal budget balance	% of GDP	-1.4	2.6	1.8	-5.6	-3.1	-1.5	-0.4	-0.5

* Indicators of the optimistic scenario are provided in *Appendix*.

Source: ACRA

Table 2. Key indicators of the pessimistic scenario of the macroeconomic forecast

Indicator	UoM	Actual			Estimate	Forecast			
		2017	2018	2019	2020	2021	2022	2023	2024
Urals oil price (annual average)	USD/bbl	53.8	69.8	63.7	25	35	45	47	47
Global GDP	% y-o-y	3.1	3.0	2.8	-3.8	0.8	2.7	2.4	2.5
Real GDP growth rate	% y-o-y	1.8	2.5	1.3	-7.5	0.5	3.9	2.5	1.5
Annual average USD exchange rate	RUB/USD	58.3	62.7	64.7	86.2	77.0	68.5	69.2	69.4
Real disposable income	% y-o-y	-0.5	0.1	0.8	-9.9	2.7	2.1	1.8	1.5
Unemployment	% of EAP	5.2	4.8	4.6	8.9	7.2	5.1	4.5	4.4
Inflation (CPI)	% Dec/Dec	2.5	4.3	3.0	7.7	1.3	2.2	3.5	3.5
Key interest rate (as of end of year)	%	7.75	7.75	6.25	8.0	6.0	5.0	5.0	5.0
5-year zero-coupon OFZ rate (as of end of year)	%	7.2	8.5	6.1	9.8	6.5	5.0	5.1	5.2
Federal budget balance	% of GDP	-1.4	2.6	1.8	-8.5	-4.2	-1.8	-0.4	-0.5

Source: ACRA

[1] Real growth rate according to the World Bank's methodology.
[2] Economically active population
[3] Consumer price index

Four main factors of uncertainty in determining which scenario is most likely for 2020

According to the official website that provides information about the coronavirus pandemic in Russia, стопкоронавирус.рф, initial trials of the vaccine will be completed in mid-June, with the vaccine itself becoming available in 11 months.

1. **How will the coronavirus situation develop?** All scenarios have one thing in common: the spread of coronavirus, being the main factor of the current economic crisis, will not end in a month or in 2020, and a vaccine will be ready in 2021 at best.

   The optimistic scenario assumes that either by the summer of this year the virus will become less deadly, or random tests will show that in fact a significant part of the population has already survived the disease in a mild or asymptomatic form. If either of those assumptions turn out to be true, a significant part of the quarantine measures could become redundant in the summer. Otherwise, quarantine measures will continue to restrict economic activity, and the situation could then develop in two different ways.

   The base case scenario assumes lifting a significant part of the restrictions while reducing active cases of coronavirus to a minimum, similar to China after the third month of quarantine. However, quarantine measures can be introduced again in the case of a suspected new outbreak of the disease. This development is also possible if the virus demonstrates seasonality and its spread naturally decreases in the summer. In the cases described, the restrictions are likely to be repeated periodically (once or twice a year) and will be completely lifted after an effective drug is developed or when a large part of the population has either survived the disease or is vaccinated, thus gaining immunity. At the same time, the need to quickly respond to possible new outbreaks may lead to the partial preservation of restrictions on intercity passenger transport and Russia's closed border policy for passengers.

   The pessimistic scenario also assumes significant restrictions in the "social" services sector until most of the population becomes immune to the virus.

   The scenarios described above correspond to three of ACRA's macroeconomic scenarios and directly affect the depth and duration of the crisis (*Table 3, line 1*). The pessimistic scenario, in addition to imposing tighter restrictions, assumes that an effective medical response (vaccine or medication) may take more than two years from the time the pandemic started.

The term "social" services refers to a conditionally allocated group of services including ground passenger transport, entertainment, education, etc. This essentially coincides with the list of industries most affected by the pandemic, which is used by the Government of the Russian Federation and the Bank of Russia.

2. **How ready is Russia's banking sector to support SMEs?** In contrast to 2014-2015, when the crisis of liquidity and confidence arose in the banking system and its own stability was in question, the current crisis of liquidity arose primarily in the passenger transport sector, the sphere of "social" services, as well as SMEs in various industries.

   Since the amount of payments to the consolidated budget for the pre-crisis year (including contributions to state social funds) from the most quarantined industries accounts for about 3-3.5% of GDP, this is the amount that limits the maximum possible support for these industries in the form of tax incentives. In the current environment, the amount of support is even smaller; it represents the amount of accrued taxes and part of contributions to state social funds for Q1 2020, which corresponds to approximately 0.6-0.7% of GDP. This is due to the fact that since mid-February, the main tax bases in vulnerable sectors have shrunk significantly, which means that taxes for Q2 would have already become low and would no longer be a significant area of liquidity outflow even without tax deferrals.

In addition to easing regulations, the Bank of Russia has given SMEs from vulnerable industries the opportunity to defer interest payments for six months and has launched a program to support SME lending (4% rate to raise funds for this purpose).

Business support via tax incentives amounting to 0.6-0.7% of GDP covers only a small part of the real liquidity needs of companies. ACRA believes that in the absence of a crisis in Q2 about 3-5% of GDP in total would have to be spent in these vulnerable industries on wages, rent payments, and debt service (the sum not covered by deposits). However, companies cannot fully cover recurring payments with internal sources of liquidity. The volume of operating activities in Q2 fell, tax incentives will no longer have a significant impact in Q3, and businesses are not ready to sell real estate or equipment as a source of liquidity, given the long-term consequences of such actions.

While large businesses can receive targeted liquidity support directly from the government, numerous SMEs that do not have direct contact with the government can receive financial assistance only through banks. Therefore, the depth of the current economic crisis in Russia depends on the penetration level of banking services and the effectiveness of the banking sector (in this case, the ability to correctly assess and take on the credit risks of small businesses and the service sector). If banks cannot quickly close the liquidity gap with the support of the Bank of Russia and the government of the Russian Federation, then vulnerable industries will become the epicenter of bankruptcies, defaults, and unemployment. This would lead to a reduction in aggregate supply, which would quickly turn into a fall in demand.

The macroeconomic scenarios under consideration differ from each other in terms of how successful supporting supply through bank lending can be. In the pessimistic scenario, this success is minimal and for some companies the liquidity crisis will turn into a solvency crisis with consequences in the longer term (*Table 3, line 5*).

3. **Will the state support consumer demand?** The direct economic effect of the quarantine measures is that the population cannot spend money on "social" services, transport, and a range of goods, while in certain industries workers cannot be physically present at their workplaces due to the self-isolation regime. If this were the only effect of the quarantine, then economic activity would recover rapidly (within a few weeks) after the lifting of restrictions. However, with the extension of quarantine measures, the likelihood of unemployment growing increases along with the volume of lost income, and this negatively affects aggregate demand. In this case, it may take months or even quarters for unemployment to fall and demand to recover due to the search for a new balance in the labor market.

   Credit holidays for households are theoretically the most significant demand support measure that has been announced so far. However, the effect of this measure may not be sufficient to compensate for losses: ACRA estimates the maximum possible amount of transferred payments for consumer loans at 1.1–1.4% of GDP, while the cumulative reduction in cash income under the pessimistic scenario may exceed 3% of GDP in 2020.

   The Russian government has never supported demand using unemployment benefits comparable to labor income or direct transfers to wide categories of the population. The state is most likely to resort to these measures in the event of the pessimistic scenario materializing, in which the size of the shock will clearly exceed the compensating effect of the measures announced by mid-April. ACRA does not expect such decisions to be made in the optimistic or base case scenarios (*Table 3, line 4*).

4. **Is the coordination of the efforts of different countries in the oil market sustainable?** A third to half of the decline in oil prices in March 2020 was triggered by the termination of the OPEC+ deal. The new production cut agreement, which was reached in mid-April, will improve the oil price situation in 2020 relative to the sharp increase in production. However, the future of this agreement is not clear, despite the dates that have been outlined. The strategic goals of the governments that are part of the cartel are generally in line with each other: limiting the opportunity of shale oil producers in the long term while maintaining medium-term sustainability of national budgets. The budgets of the OPEC+ countries are balanced under different conditions (price, production and export volumes) and therefore achieving a consensus is only possible when the absence of coordination is a real threat to achieving at least one of the abovementioned goals for the majority of participants. The future of the agreement will be the result of decisions taken by countries outside OPEC+ (for example, the introduction of import duties in the United States will significantly aggravate competition and make it difficult to maintain the agreement in its current form), as well as the depth of the economic crisis. It is worth mentioning that coordination in the oil market should be maintained due to the unfavorable forecast with regard to demand across all the scenarios in 2020.

   In the event of an especially deep economic shock the countries will be inclined to work together for a longer period of time, whereas economic recovery will make the deal less beneficial for all parties (*Table 3, line 6*). Consequently, production limitations will either be eased or fully removed in 2021 depending on the macroeconomic scenario that develops. In 2020, the average annual oil price will be 25/35/35 USD/bbl in the pessimistic, base case and optimistic scenarios, respectively.

Table 3. Qualitative prerequisites of the macroeconomic scenarios for Russia

	Influence on Russia's economy	Optimistic	**Base case**	Pessimistic
1. Duration of restrictive measures[4] related to the spread of coronavirus in Russia	Very strong	3 months (March-May 2020)	**5–6 months with breaks in 2020; 1–2 months in 2021**	6–7 months with breaks in 2020; 3–4 months in 2021 (+ tougher restrictions)
2. Fall in volume of exports of Russian goods in 2020	Strong	-5%	**-10%**	-20–25%
3. Significant decline in bank deposits due to reduced trust in 2020	Strong	-	**-**	+
4. Increased state support of consumer demand	Strong	-	**-**	+
5. Sufficiency of liquidity support measures in vulnerable sectors	Strong	+	**+/-**	-
6. Oil exporting countries' joint efforts to limit exports in 2020/after 2020	Moderate	+/-	**+/+(easing)**	+/+
7. Debt crisis in China in 2021	Moderate	-	**-**	+
8. Return to the topic of speeding up the state's investment in infrastructure	Moderate	Early 2021	**Late 2021**	After 2022
9. Fiscal crises in some EU countries in 2021	Weak	-	**+**	+
10. New anti-Russian economic or financial sanctions	Weak	-	**-**	-

Source: ACRA

[4] Restrictive measures include not only quarantines, but also bans on particular types of economic activity and major events, as well as passenger transport restrictions.

The base case scenario anticipates GDP falling by 4–4.5% in 2020, while the pessimistic scenario envisages a decline of 7.5% and recovery in 2022

ACRA understands the complexity of forecasting the growth of the Russian economy as a whole and various economic indicators in particular, given the current uncertainties: the expected duration of the coronavirus pandemic, the extent of measures to support the economy, and competition in the oil market. ACRA sets out hard-to-predict parameters in the scenario prerequisites (*Table 3*), while the degree of influence of the quarantine or self-isolation on economic activity serves as key information for all scenarios.

ACRA assesses the decline in production relative to the historical norm on the basis of preliminary data from the countries that faced the economic consequences of quarantine measures earlier than others (China, Italy, Germany, France, and the US), and also takes into account some preliminary data for Russia (the countries whose indicators were used in the calculations are indicated in parentheses):

These are the deviations from the norm on a monthly average basis during the restrictions connected to COVID-19.

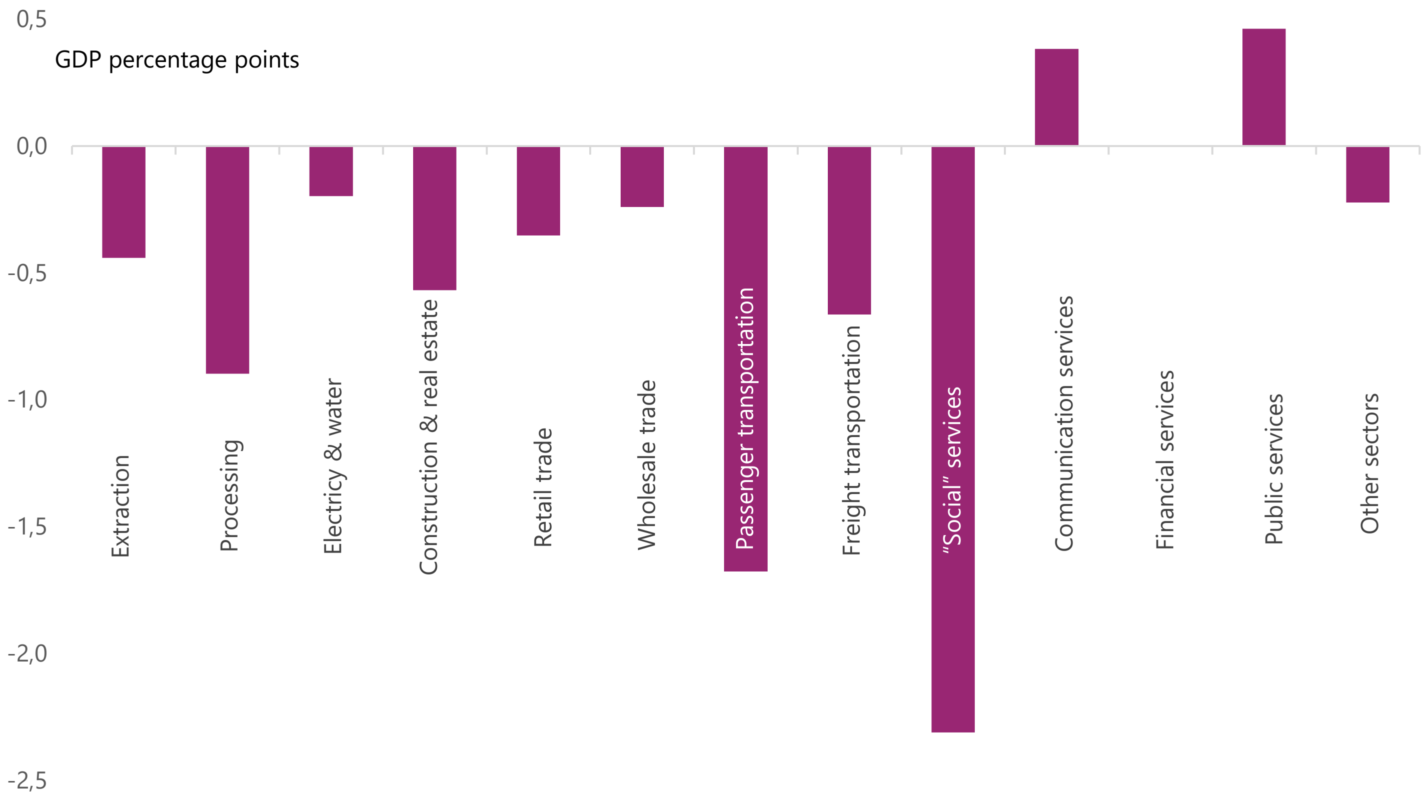
- Manufacturing sector: minus 15–20% (China).
- Electricity production: minus 10–30% (Germany, France, Italy — estimation based on power consumption peaks).
- Construction: minus 10–15% (expert assessment).
- Retail trade: minus 20–30% (China, Italy, Russia).
- Wholesale trade: minus 15–20% (expert assessment).
- Passenger air travel and tourism services: minus 80–100% (China, US, Italy, Russia).
- Other “social” services: minus 45–70% (expert assessment).

The estimation of the duration of each sector’s slump in Russia depends on the chosen scenario (*Table 3, line 1*). The sectors listed above are expected to recover steadily after the quarantine period ends. The speed of this recovery will depend on the level of unemployment and household income dynamics, which in turn will be influenced by the extent of support for the economy and the effectiveness of these measures.

In the base case scenario, ACRA believes that the rate at which external demand for products from the extractive sector changes will be generally similar to the dynamics observed from 2008 to 2009. The volume of production of consumer goods and services has been adjusted to take into account the fact that citizens who did not go on overseas vacations this year will continue to consume at home, although to a lesser extent.

Taking these assumptions into account, the base case scenario for Russia envisages a fall in real GDP of 4–4.5% in 2020 (*Fig. 1*) followed by a recovery to 2–3% in 2021. The pessimistic scenario provides for a drop in real GDP by 7–7.5% and economic recovery beginning no earlier than 2022.

Figure 1. Assessment of how the quarantine and reduction of external and domestic demand will impact Russia's GDP in 2020 (base case scenario)



Source: ACRA

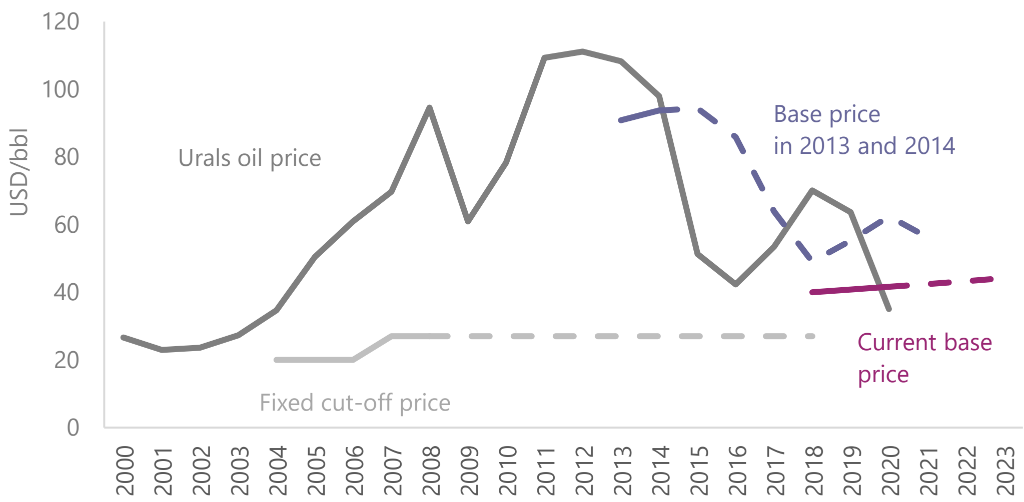
What lessons can already be learned from the 2020 crisis?

The current formula for maximum federal budget expenditures (fiscal rule) is documented in the Budget Code of the Russian Federation (Article 199).

The current crisis, like all the crises that came before it, will influence the economic policy of the state, the way the population saves money, and economic expectations in the very widest sense. The crisis is far from over, but a number of conclusions can already be drawn from it.

1. **The choice of the base oil price under the budget rule can be considered reasonable...** In 2018–2019, there was a public discussion about the conservative nature of this formula, however, the current collapse in oil prices shows that the price of Russian oil may fall to practically zero in the short term. However, at least 50% of the current drop in oil prices has been caused by a temporary decrease in demand, so the price of a barrel of Urals oil at USD 45 (budget base price set for 2023) should not be seen as an optimistic forecast. In each of ACRA's three macroeconomic forecast scenarios, which take into account oil companies' costs and the specifics of the competitive environment, a return to the specified price level or higher is expected to take place no later than 2022. Therefore, unlike in 2014, when the long-term oil price benchmark was revised, the Government of the Russian Federation will probably not need to carry out a fundamental consolidation of the budget following the current crisis. This should allow the risks of declining government consumption and the constraining effect on economic growth to be avoided.

Figure 2. The base oil price is neither conservative nor optimistic



Sources: Bank of Russia, IMF, ACRA

For more information about the fiscal rule, see ACRA's research "New fiscal rule to lower Russia's budget's oil & gas dependence" from June 6, 2017.

2. **...however, due to the way the fiscal rule is worded, opportunities for countercyclical economic stimulus may not be sufficient in the current environment.** Judging by public statements, the Russian Ministry of Finance is continuing to adhere to the fiscal rule for the federal budget. This rule does not provide for an increase in expenditures in excess of additional non-oil and gas revenues and additional revenues from privatization (Article 213 of the Budget Code of the Russian Federation) even in the conditions of a recession. ACRA does not expect such revenues in 2020, with the exception of the return of part of the funds spent on acquiring the stake in Sberbank (around 0.3% of GDP).

   The lack of a formal opportunity to compensate the non-oil and gas component of the economic downturn by increasing expenditures is leading to tax incentives being used as the primary budget support measure in Russia (comparable only with guarantees). As of April 2020, this practice is noticeably different to the approaches taken by other major economies (mostly outside the EU), where the share of tax incentives is lower. The budget rule may be suspended if, as the crisis develops in the Russian economy, a decision is made to expand state support.

   Among the results of the 2008–2009 crisis were the "second-generation fiscal rules"[5] introduced by different countries. They explicitly set out conditions during which the fiscal rule can be suspended, or contain countercyclical components that allow fiscal policy to be considerably softened during a crisis. Consequently, the softening of policy takes place without amending or breaching fiscal legislation, which in the long term increases trust in the fiscal rule and the state in general. ACRA assumes that the Russian fiscal rule may develop in this way.

3. **The future role of the banking system and the insurance sector must be strengthened to ensure the sustainability of the economy.** It has already been mentioned that during the current crisis, the banking system should probably become the main vehicle for providing state support to the sectors most affected by the pandemic (if the state does not resort to directly supporting demand). However, the ability of banks to provide financing may be limited if credit

[5] See for example, Eyraud, L., X. Debrun, A. Hodge, V. Lledó, C. Pattillo (2018), Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability, IMF Staff Discussion Note.

For more information about the development of the insurance market, see ACRA's research "Development in the insurance sector reflects the country's economic welfare" from February 20, 2020.

penetration in a sector was relatively small at the start of the crisis (as making a decision on lending to a new borrower in crisis conditions is much more difficult). Besides the banking system, extended market insurance should help non-financial companies overcome liquidity crises and continue operating without interruption. ACRA considers so-called self-insurance (independent creation of provisions or savings by companies and the public to cover unforeseen losses or expenses) and state guarantees for compensation of damages (formal or informal), which are both common in Russia, to be less effective forms of insurance.

4. The health of the population and healthcare system are vital factors of a country's economic wellbeing. The current crisis shows that in a globalized world, the quality of healthcare directly influences the production potential of an economy. According to ACRA's estimates, a difference of 5 percentage points in the mortality rate of a disease (for example, 10% of confirmed cases die versus 5%), which infects the entire working population of a country over several years, has a direct negative impact on the GDP level in the long term of up to 0.6 percentage points (only due to the difference in the size of the labor force). In the short term, countries that are not able to effectively control and diagnose a disease at the early stage of an outbreak (or repeat outbreak) are forced to resort to longer and harsher quarantines. The first months of the fight against coronavirus show that such quarantine measures are very expensive economically and lead to increased unemployment and lower incomes.

Appendix. Key indicators of the optimistic scenario of the macroeconomic forecast *

Indicator	UoM	Actual			Estimate	Forecast			
		2017	2018	2019	2020	2021	2022	2023	2024
Urals oil price (annual average)	USD/bbl	53.8	69.8	63.7	35	45	50	65	65
Global GDP[6]	% y-o-y	3.1	3.0	2.8	0.5	4.3	2.8	2.7	2.7
Real GDP growth rate	% y-o-y	1.8	2.5	1.3	-0.8	1.8	1.8	2.3	2.3
Annual average USD exchange rate	RUB/USD	58.3	62.7	64.7	72.1	66.0	64.5	63.9	62.4
Real disposable income	% y-o-y	-0.5	0.1	0.8	-1.3	1.6	1.6	1.6	1.6
Unemployment	% of EAP	5.2	4.8	4.6	4.8	4.7	4.5	4.5	4.5
Inflation (CPI[7])	% Dec/Dec	2.5	4.3	3.0	3.9	3.5	3.6	3.6	3.5
Key interest rate (as of end of year)	%	7.75	7.75	6.25	6.0	5.75	5.5	5.25	5.0
5-year zero-coupon OFZ rate (as of end of year)	%	7.2	8.5	6.1	7.8	5.9	5.5	5.4	5.2
Federal budget balance	% of GDP	-1.4	2.6	1.8	-2.5	-1.0	-0.4	-0.3	0.1

* The base case and pessimistic scenarios are provided on *page 2*.

Source: ACRA

[6] Real growth rate according to the World Bank's methodology.
[7] Consumer price index.