Global Economic Policy Lab

A Federation of Unequals: Inequality in Russia and the COVID-19 Shock

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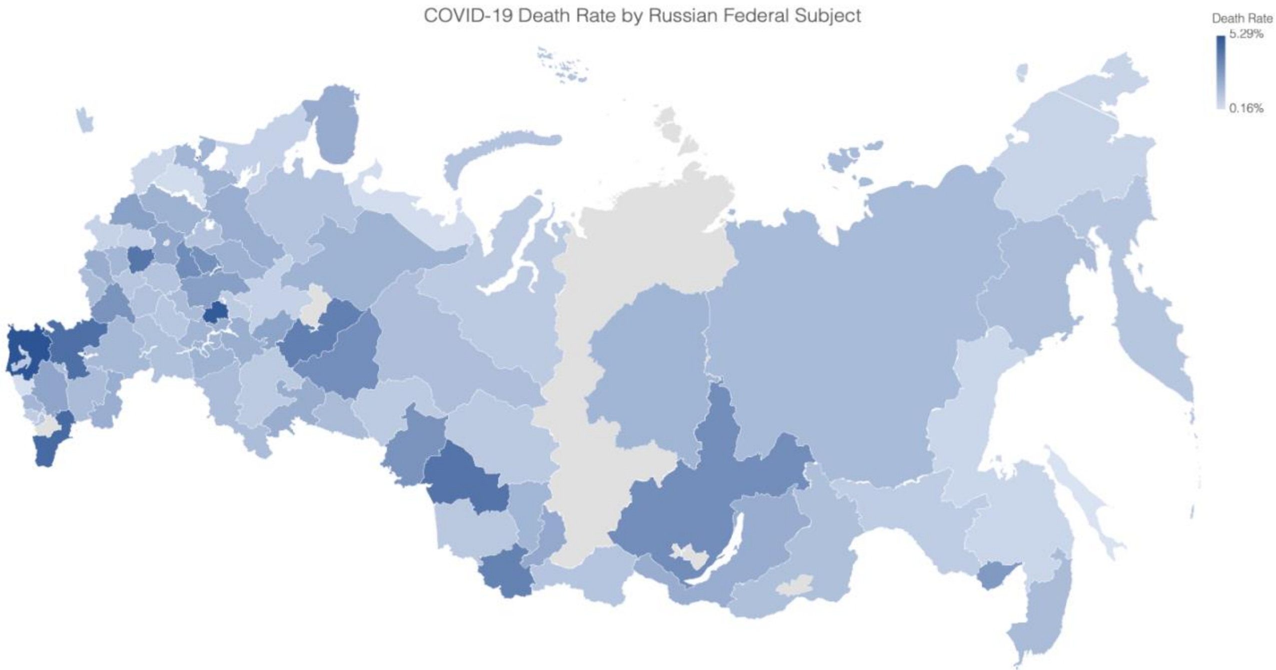
- COVID-19 is expected to widen existing Russian regional inequalities, with federal subjects on the periphery being forced to borrow
- Russia experiences relatively high inequality globally, and in terms of income and wealth
- GRP disparities between Russia's oil producing and agricultural regions have widened since the late 1990s
- The capacity to borrow of Moscow (Central Federal District) and economic importance of oil and gas regions (i.e., Ural Federal District) will ensure continued inequalities across Russian federal subjects
- Deep inequalities have generated considerable political resentment against Putin's rule, with implications for investors' country risk assessments

Overview
Impact of COVID-19 on Regional Disparities in Russia

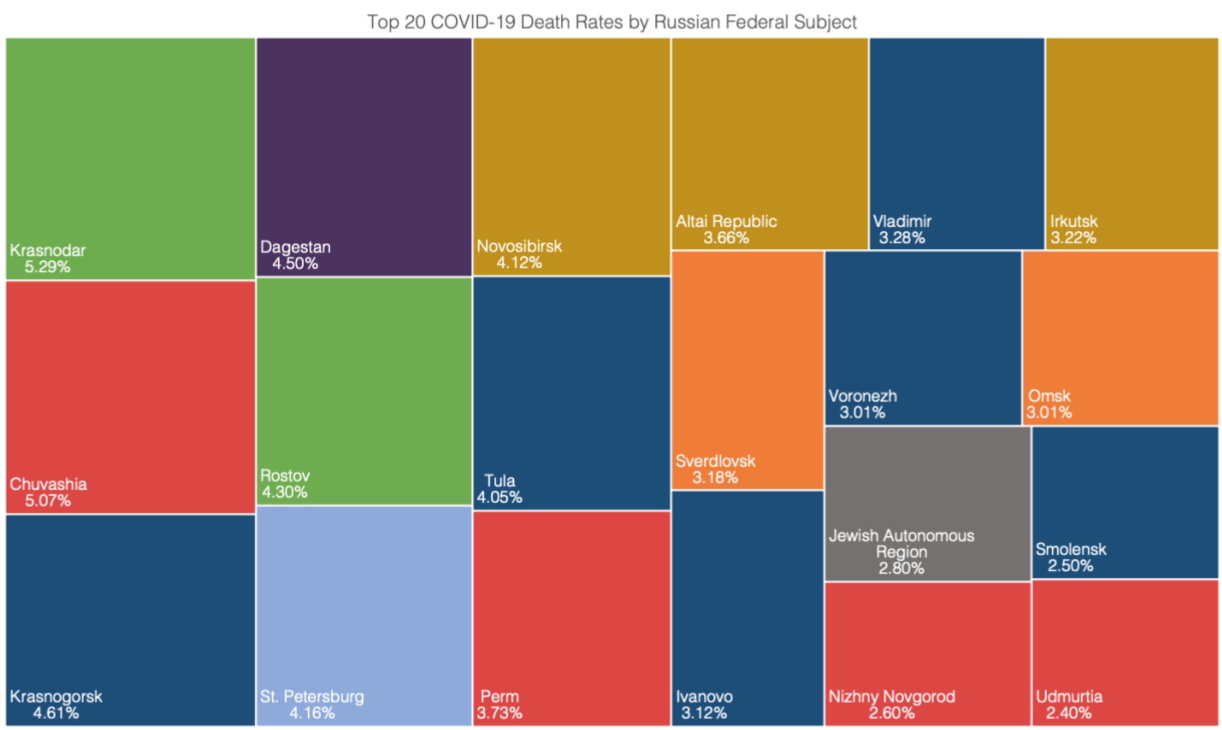
The COVID-19 pandemic is expected to widen existing regional disparities in Russia. In response to rising health care and other social costs, federal authorities have pushed regional governments to borrow more. Regions will increase their net borrowing by RUB 400 billion (USD 5.3 billion) next year, compared with almost zero in 2020. Moscow, with its average income four times higher than that of Russia's poorest regions, will borrow a similar amount on its own. The result will be further division in wealth and income between the rich and poor, urban and rural in Russia, with regions on the periphery being forced to fend more for themselves.

While the first coronavirus cases were reported on January 31, 2020, authorities had already begun preemptive containment measures in late December 2019. They progressively closed the border with China and Europe, mandated self-quarantine for people arriving from other countries and people at risk, closed public facilities, and encouraged remote work. These measures effectively halted Russia's services sector (comprising 54% of Russian GDP in 2019), causing GDP to contract by 8% in Q2 of 2020. The government's National Economic Recovery Plan, worth an estimated RUB 6.4 trillion (3.5% Russian GDP in 2020), included measures such as setting the standard unemployment benefit to equal the minimum wage for five months.

In spite of this fiscal response, the pandemic's impact was still felt the hardest in Russia's far-flung regions with underfunded healthcare systems. Among the 20 regions with the highest mortality rate over cases, 12 of them are located in the bottom half of Russia's poorest regions (five of which are among the country's poorest ten regions). In contrast, among the 20 regions with the lowest mortality rate, 11 are found in the top half of Russia's richest regions. Moscow's mortality rate is lower than the national average.



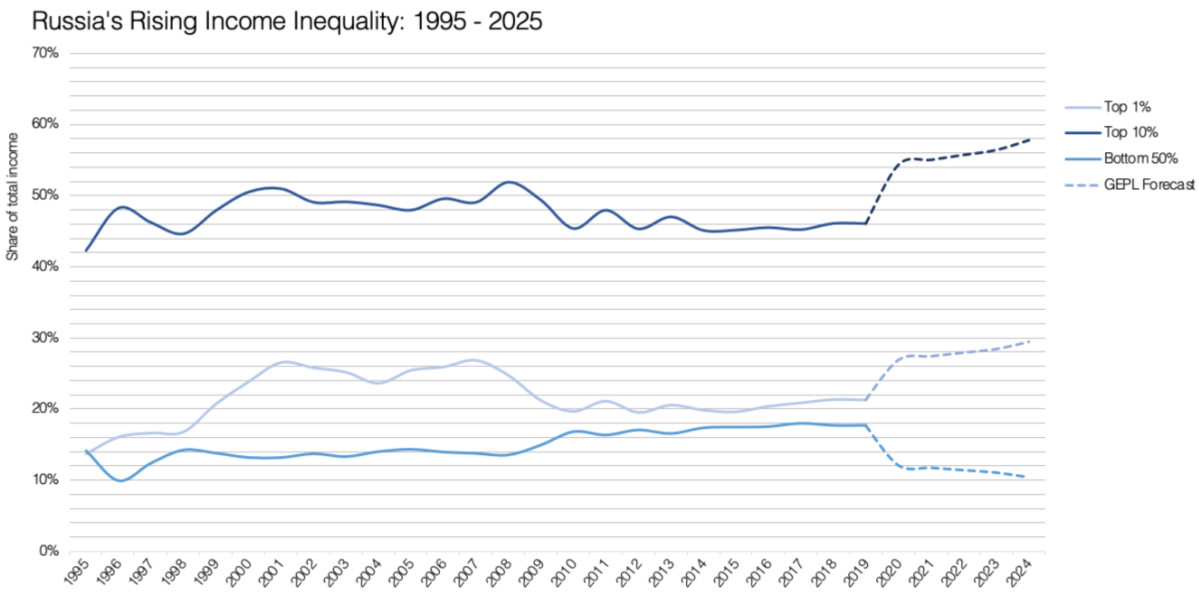
Source: Стопкоронавирус Operational Data, GEPL Calculations

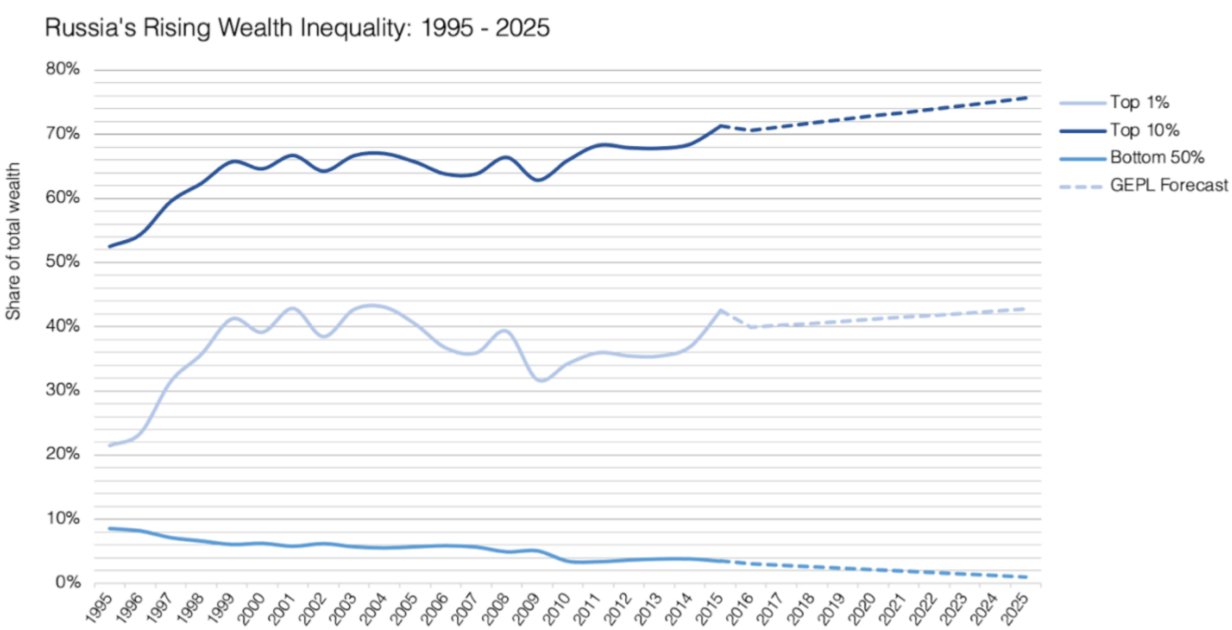


Source: Стопкоронавирус Operational Data, GEPL Calculations

Inequality in Russia

Russia, despite experiencing relatively positive real GDP growth since the mid 1990s, has been plagued with high inequality. Wealthy and upper-middle class people are earning more than they did in the USSR, while the poor are earning proportionally less: the top 1% and 10% share of income in 2019 was 21.3 and 46.1% respectively, compared to just 17.7% for the bottom 50%; conversely, shares of income in 1989 were placed at 5.4% for the top 1%, 23.7% for the top 10%, and 30.1% for the bottom 50%. This disparity is even more pronounced in terms of wealth inequality. For instance, the share of wealth for the top 10% of Russians was placed at 71.3% in 2015 — considerably higher than the mere 3.1% share for the bottom 50%.





Source: World Inequality Database, GEPL Calculations

This inequality permeates Russia at the subnational level. Russia is divided into eight federal districts, which are separated into a further 85 federal subjects (22 of which are semi-autonomous 'republics'). As illustrated by the GRP per capita of federal subjects, Russia was poorer overall in 1998. However, the country's wealth has since become significantly more concentrated in two regions of Russia's Ural province: Nenets and Yamolo. Given that the wealth of these regions is largely based in oil and natural gas, the country's wealth is clearly moving towards one industry that does not necessarily enrich the vast majority of Russians.

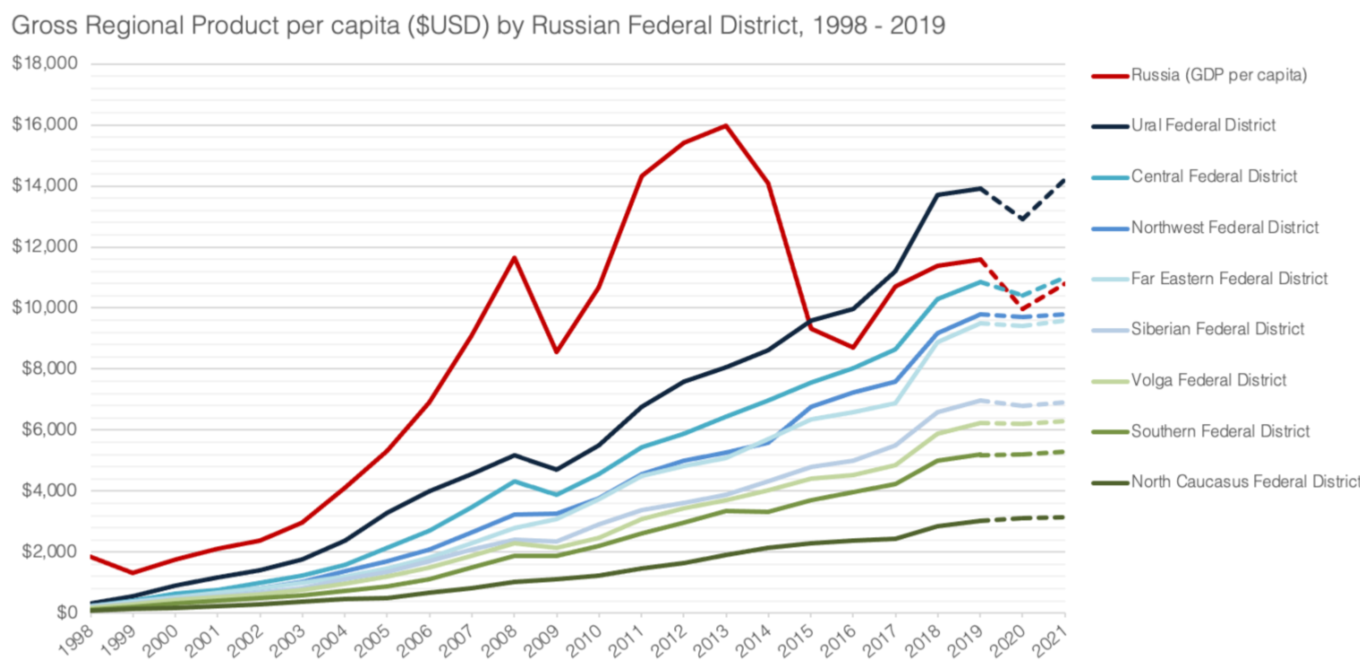
Gross Regional Product (GRP) per capita of Russian Federal Subjects (1998)

Gross Regional Product (GRP) per capita of Russian Federal Subjects (2019)

Source: Rosstat, GEPL Calculations

The amount of money that federal subjects receive from the federal government is based on their spending requirements: if they have a high debt, they will face borrowing constraints. The pandemic has disrupted federal cash transfers. Regional governors are suddenly finding themselves in a position where they need to support local economies and stimulate economic activity if they want to receive any revenue, and therefore must entertain the notion of increased borrowing. For example, St. Petersburg, damaged by a pandemic-induced tourism slump, raised its borrowing limit several times in 2020 to RUB 127 billion to cover budget losses. The ceiling will increase to RUB 225 billion next year. Poorer regions, often with underfunded healthcare systems, lack this borrowing capacity. Public debt ballooned during 2020 in the Republic of Ingushetia in the Caucasus, one of Russia's poorest regions. The Republic is dependent on transfers from the federal budget, which failed to cover excess spending required to help fight the pandemic this year. It now must contend with the difficult prospect of borrowing in a country facing wholesale budget constraints and drops in tax revenue after incomes sank by 4.3% this year.

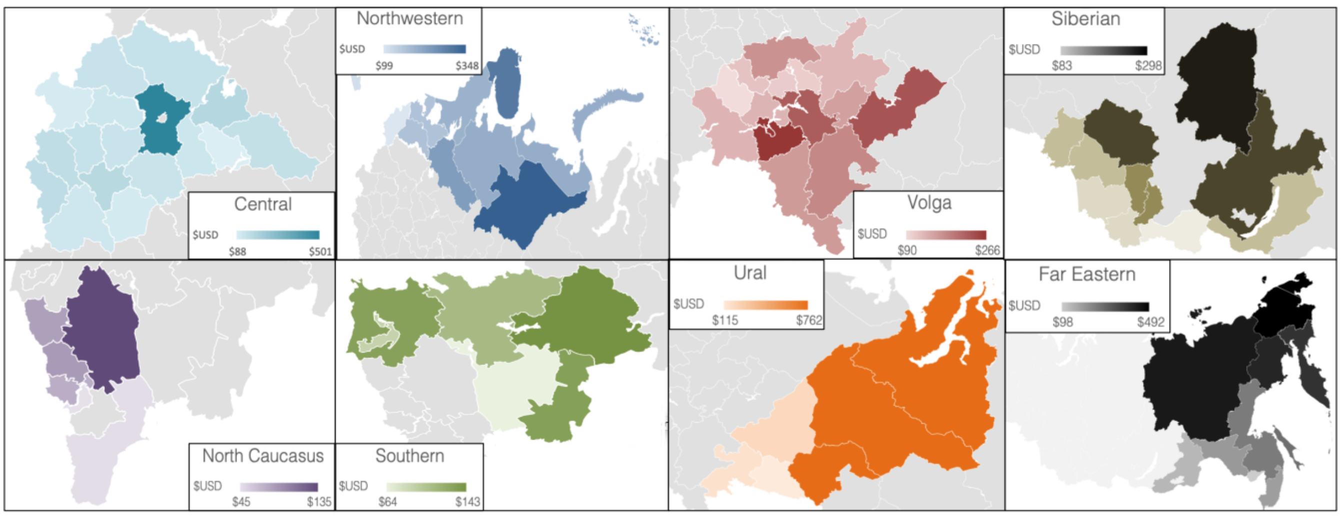
S&P Global Ratings estimates that regional budgets will run the widest deficits in two decades in 2020. Budget revenues decreased in 81 out of 85 regions, especially (by 35– 60%) in the oil and gas and metallurgical producing regions (Yamalo-Nenets Autonomous Okrug; Perm and Krasnoyarsk krais; the republics of Komi, Tatarstan, and Bashkortostan; Astrakhan, Vologda, Sakhalin, Murmansk, Sverdlovsk, Kemerovo, and Orenburg oblasts). While this reduction will theoretically narrow regional inequalities, the capacity to borrow of Moscow (Central Federal District) and economic importance of oil and gas regions (i.e., Ural Federal District) will ensure continued disparities across Russian federal subjects.



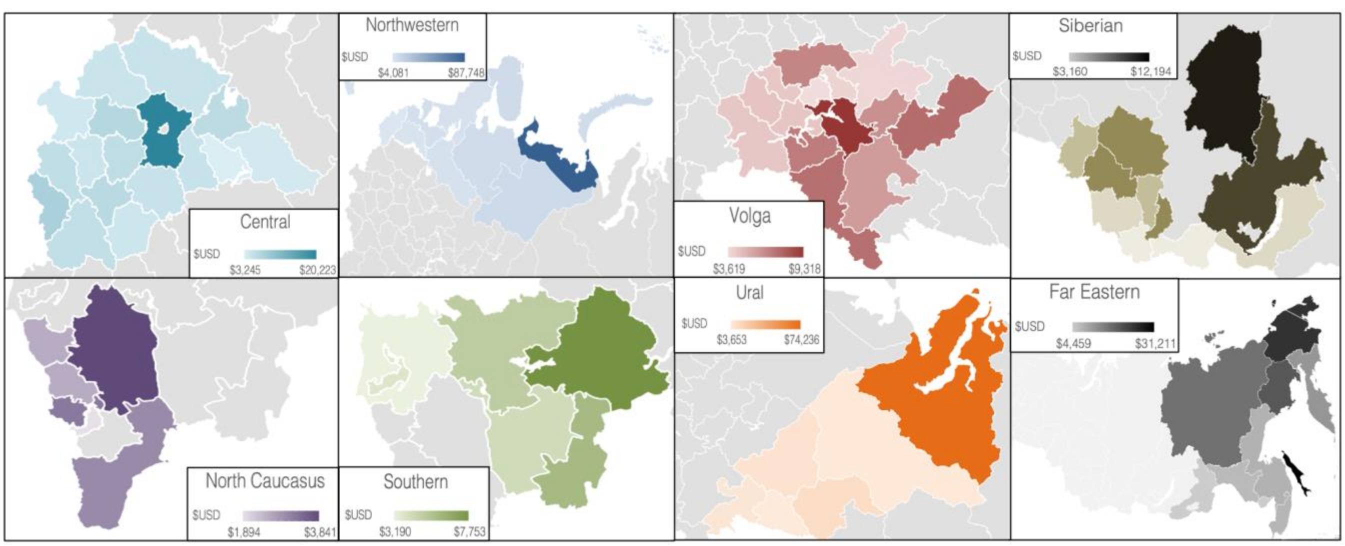
Source: Rosstat, GEPL Calculations

When examining the GRP per capita of Russian federal districts, there is a clear gap between the Ural, Central, Siberian, and Northwest regions, and the rest of Russia. For almost all federal districts in the upper tier, over half of their exports are oil. The poorest regions are primarily agricultural (i.e., wheat from the North Caucasus Federal District). Regional disparities have existed since the 1990s and are unlikely to disappear. In 1998, the GRP per capita of Russia's Ural Federal District (the country's wealthiest region) was 3.67 times higher than the North Caucasus' (Russia's poorest region) — USD 326 and USD 88, respectively. The gap between these two regions has steadily widened since. In 2019, Ural's GRP per capita was 4.61 times higher than the North Caucasus region (USD 13,917 and USD 3016, respectively). This trend is expected to continue as Ural's oil economy grows (as predicted in previous GEPL Russia briefs), while the Caucasus is expected to remain poor unless there is significant growth in Russia's agricultural sector.

Gross Regional Product (GRP) per capita by Russian Federal District (1998)



Gross Regional Product (GRP) per capita by Russian Federal District (2019)

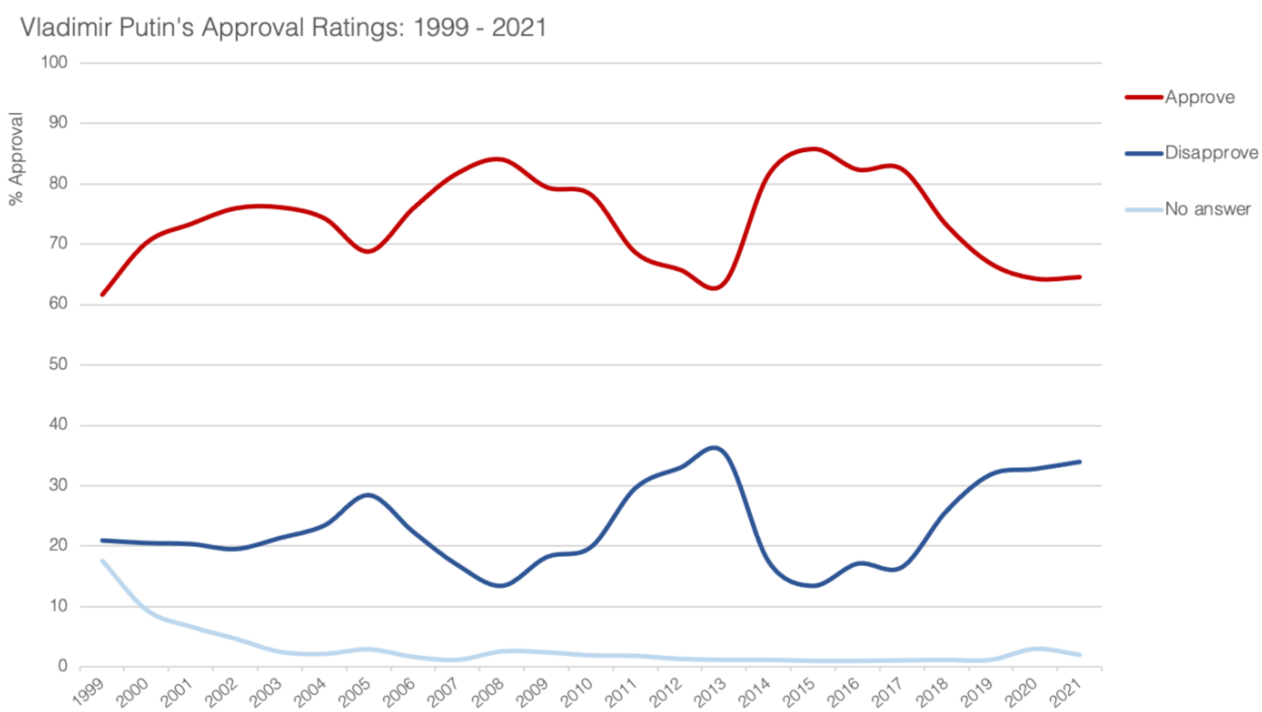


Source: Rosstat, GEPL Calculations

Inequality Projections and the Implications for Political Stability

GEPL expects that the formidable socioeconomic inequalities in the Russian economy, a key contributing factor to the current social unrest, will continue to erode domestic political stability. It must be noted that the COVID-19 pandemic had arrived at a time when Russia was still managing an inchoate economic recovery from 2014-2015, during which Western sanctions imposed over Russia's annexation of Crimea had contributed to a sharp decline in industrial output.

Economic discontent has, in recent years, contributed greatly to political dissatisfaction. In 2018, large-scale protests erupted after controversial changes were proposed to the national pension system. More recently, there has been a widespread perception that the government failed to adequately address economic issues and rising inequality during the pandemic. Regional discontent, in particular, was reflected in the 2020 gubernatorial elections, where the ruling United Russia (UR) party lost its majority in a handful of regional parliaments despite all incumbent governors remaining in power. As of February 2021, UR's popularity had hit a new low of 29.4% according to state pollsters, while public opinion for Putin was 64% — with only 48% of Russians preferring that he remain President after 2024.



Source: Levada Center, GEPL Calculations

The upcoming Duma elections in September 2021 will therefore be a litmus test for the continued popularity of UR, if not Putin himself, especially in the wake of large-scale protests in January. These have proven exceptional insofar that small cities and towns across the country, hitherto not known for political activism, saw considerable anti-government protests of their own, with the majority of participants being in their mid-twenties. The number of protesters arrested has also been unprecedented in Russia's recent history, with more than 2000 arrested in Moscow and St Petersburg alone, amidst numerous altercations between police and protesters. This reflects the generational divide within Russian politics: younger Russians are far less likely to support Putin or UR compared to their elders, who lived through the tumult of the Soviet period and the 1990s.

Investment Prospects for Russia

GEPL anticipates a greater degree of political risk involved for investors in Russia. Domestically, economic inequality is contributing to longer-term changes in Russian society itself, feeding into greater political discontent. Putin's regime — previously characterized by a focus on economic growth spurred by oil revenues, and now defined by an emphasis on nationalism and greater repression of dissidents — may therefore face considerable pressure in the long-term to improve the redistribution of economic wealth within the country, which will have implications on the long-term profitability of critical state sectors. While Russian consumer spending has rebounded in early 2021, to the point where the Bank of Russia has raised rates to counter inflation, structural socioeconomic inequalities will ensure that the recovery remains a lopsided one. Geopolitically, Russia faces a worsening external environment and the prospect of further Western sanctions, given the EU's recent "Magnitsky" sanctions and the more confrontational foreign policy of US President Joe Biden; consequently, Russian exporters are likely to be harmed for the short to medium-term. Although the risk of regime collapse remains remote, social discontent and unfavorable geopolitical conditions may well motivate greater changes to economic policy.

Notably, there is currently a considerable disconnect between the financial markets and broader geopolitical trends: Russian enterprises have benefited greatly from the current worldwide equity boom. (Western sanctions have thus far not targeted areas more critical to the Russian economy, such as sovereign debt.) Certain Russian sectors, such as retail, telecoms, and metals, currently appear to be undervalued, and there has been a considerable degree of optimism over local IT firms. Indeed, Russia's cyclically adjusted price-to-earnings ratio (CAPE), as of December 2020, was 9.73. This figure is considerably lower than that of any other major economy, which suggests that the market as a whole is undervalued. However, it is the view of the GEPL that *geopolitical risk* — especially given the volatility of oil and the prospect of technological decoupling between the West and countries such as China — and *domestic political risk* stemming from deep inequalities have been greatly discounted by the market, when they should instead factor more heavily into investment decisions in Russia over the next few years.

GEPL thus recommends that investors limit their exposure to the Russian equity market to an amount not exceeding 2 percent of their total global portfolio, owing to considerable country risk and an unfavorable domestic and international political environment.