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Overview of the Russia Economy 3Q19

Temporary boost in economic growth

November 11, 2019

Sinikka Parviainen, Analyst Dr. (Econ.)

- Russian macroeconomic indicators
- Kazakhstan, Ukraine and Uzbekistan
- Outlook 2019-2021: 4 Key issues that determine Russia’s future growth

Key takeaways

Recent events in 3Q19 for the Russian economy

- **GDP growth in 3Q19 estimated at 2 %.** First estimate of GDP growth shows accelerated growth for 3Q19 compared to the first half of the year. Growth appears to be driven by temporary factors as stocks have accumulated fast.
- **Industrial production growth maintained at 2.9 % (y/y).** A stronger manufacturing (+2.9 %) sector compensated for the deceleration in the extractives sector to 2.9 % in 2Q19 (from 3.3 % in 2Q19). Oil production remains subdued due to the OPEC+ production cut agreement. Agricultural sector was one of the strong drivers of growth with 5.1 % (y/y) growth.
- **Rouble stayed relatively stable despite attacks on oil production.** The RUB remained roughly at the level of the previous quarter in 3Q19 as oil prices were only temporarily affected by the attacks on Saudi oil production and the sabotage of the Druzhba oil pipeline. Russian state bonds also kept their popularity amongst foreign investors despite new U.S. sanctions on new Russian state debt.
- **Inflation drops below the CBR target amid weaker private consumption.** Inflation accelerated sharply in the first months of 2019 to 5.3 % due to a VAT rate increase but decelerated to 4.7 % (y/y) already in June.
- **CBR lowered its key rate to 6.5 % in October as inflation drops below target.** CBR's move aimed at stimulating the weaker than expected consumption demand.
- **Producer sentiments diverging between sectors.** Manufacturing PMI dropped to its lowest value in a decade possibly reflecting a weak outlook globally while services PMI improved markedly led by a stronger real income.
- **Consumer sentiment improved.** Consumer sentiment has developed positively in 3Q19 but the approval of the president has remained at a low level.
- **Current account surplus contracts due to a weaker trade balance.** Export value decreased by -8 % (y/y) in 3Q19 due a lower oil price compared to a year ago and the OPEC+ production cut agreement, while imports continued to grow supported by a stable currency.
- **Disposable incomes growing with their fastest rate since 2014**. Real disposable incomes grew by 3 % led by continued real wage growth, decelerated inflation and a very low base level from previous years. Real disposable incomes remain at -9% below the 2013 level. Real incomes increased by 3.3 % and real wages by 2.4 % (y/y) in 3Q19.
- **Unemployment remains record low but workforce declining faster.** In Sept 2019, the unemployment rate remained at a record low level of 4.5 % partly due to the accelerated contraction of the workforce. MinEcon estimates that between Jan-Aug 2019, Russia has suffered a loss of 1.1 million people from its workforce.

Outlook for the Russian Economy 2019-2020

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		2019	2020
Updated outlooks	Consumption	↘	↗
	Investment	→	↗
	Industry	→	↗
	Exports	→	→
	Imports	↗	↗

” The rating is one thing, but reality is another: the situation is not completely described by [Doing Business] *formal indicators. A significant part of problems in business lies in the field of relations with governors and surveillance and security agencies”*

(Economist Andrei Klepach, commenting on Russia’s 28th place in the World Bank’s Doing Business study.)

- **Russian economic growth will be significantly slower than 2018 in 2019 as household purchasing power is constrained and the global economic cycle is slowing down.** Growth is expected to be driven by revival of private consumption as inflation remains weak and wage income maintains growth as well as increases in public investments and only the necessary investments in industry. For 2019, some experts are predicting surprises from the construction sector as seen in 2018 (Yamal LNG project statistics came late) that could give an unexpected boost to the GDP growth rate.
- **Real GDP growth will decelerate to 1-1.3 % in 2019 followed by a improved outlook for 2020.** Manufacturing sector has been accumulating stocks that are at a historical maximum, which spells lower productions for the next few years. Crucial factor both in the short and middle term is to invigorate investments into production capital that cannot rely only on state subsidies. Also, the decline in the labour force will limit economic growth for years to come.
- **External threats are likely to outweigh the positive factors affecting Russian economic development.** Deceleration of global growth cycle is exacerbated by decelerating growth in the EU area and China. On the other hand, a partial truce in the US-China trade war reached promise a milder deceleration of global economic growth

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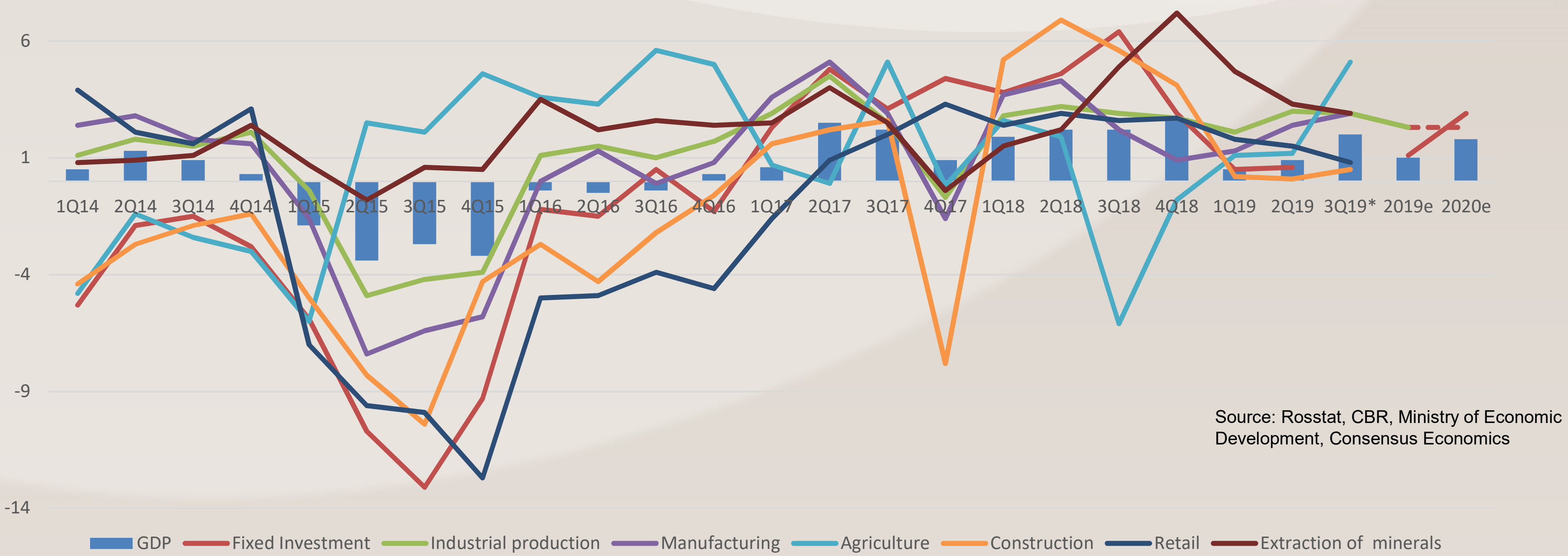
Stronger growth in 3Q19 but driven by temporary factors

Real economy indicators (1Q14-3Q19), % growth y/y



Real GDP growth estimated at 2 % (y/y)

- In 3Q19, real GDP growth has accelerated more than expected (vs. 0.9 % in 2Q19) driven by a good yield in the agricultural sector (5.1 %) and stronger manufacturing, but most of the growth seems to have accumulated firms' reserves instead of real sales. Thus, the growth boost 3Q19 is estimated to be only temporary and growth is likely to decelerate in 4Q19.
- Industrial production growth remained at same pace from the previous quarter (2.9 %, y/y) in 3Q19 driven by an improved manufacturing sector growth (2.9 % (y/y) vs 2.4 % (y/y) in 2Q19) that compensated for the slower growth in extractives (2.9 % (y/y) vs 3.3 % (y/y) in 2Q19)
- Retail growth, whicg has been the main driver of growth in the last years, in 3Q19 continued to weaken to 0.8 % (y/y) (vs. 1.6 % in 2Q19).

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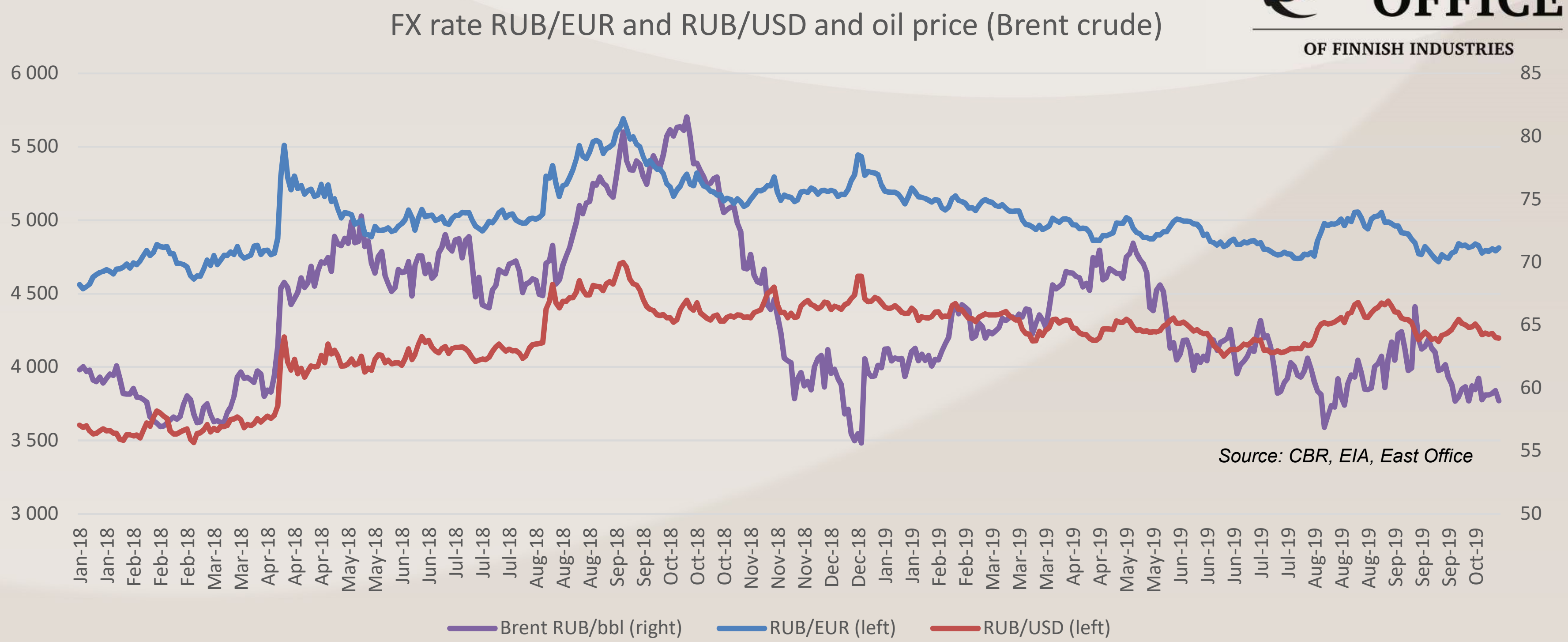
A moderately stronger Rouble



Rouble stable in 3Q19

- The RUB has appreciated led by a higher oil price since March. Also, increased demand for Russian state bonds contributed to a stronger RUB but to a lesser extent. In Aug 2, the US imposed second round of sanctions related to the Skripal poisoning incident but RUB devalued only moderately.
- RUB is expected depreciate moderately towards the end of the year due to weakening global growth prospects and no expected hikes in the oil price. US-China trade war escalation that has been the single largest threat to global economic growth was prevented in Sept-19 after a deal was reached on a limited range of products.
- Drone attack on Saudi production site increased the oil price but the effect was short-lived. There are risks related to conflict in the Middle East that could affect the oil price but these shocks are mitigated by the increased US shale oil production, which will supply the market if oil price rises.
- In June, Russia agreed with OPEC to continue oil production curbs until March 2020.

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Weaker than expected inflation led to large rate cuts by the CBR

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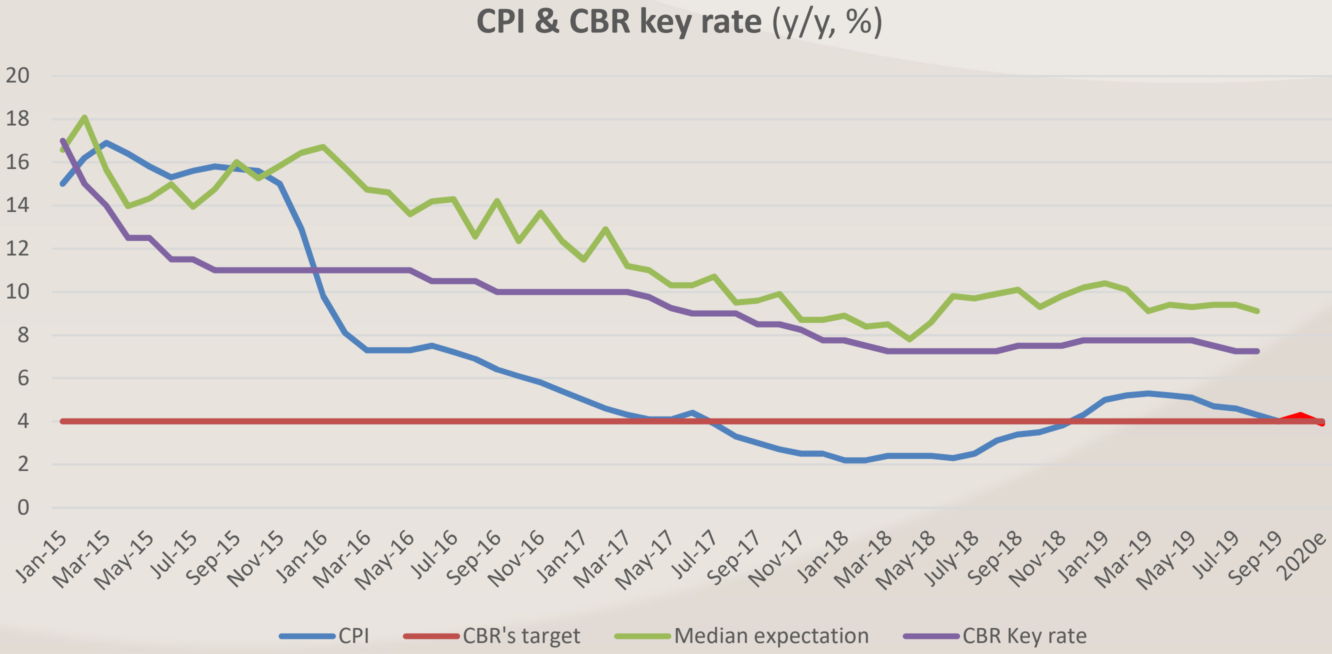

Oct-2019 % Y/Y	
CPI	3.8
Food	4.2
Non-food	3.2
Services	3.8

Source: Rosstat, CBR, Consensus Economics

Inflation decelerated to below the Central Bank's target in October (3.8 %)

- Inflation did not accelerate as feared due the VAT rate hike since the start of 2019 due to weaker than expected economic activity and in August-September the seasonal reduction in food prices decelerated consumer inflation added to the deceleration. Also, a slightly stronger RUB contributed to weaker inflation.
- Inflationary pressures could intensify again in the second half of 2019 due to planned increases in public spending.

Key rate decisions

- CBR lowered its Key interest rate for the fourth time in a row in Oct 28th by 0.5 %-points to 6.5 % to boost weakening economic activity. The size of the cut came as a surprise to most experts and is a sign of weaker than expected private consumption.
- On the other hand, the possibility to lower the Key rate to such a low rate reflects the relative stability of the Russian macroeconomic environment due to mostly prudent fiscal policies and a credible monetary and exchange rate policy that cannot be said for most of the other emerging economies.

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Geopolitical tensions largely absent from merchandise trade

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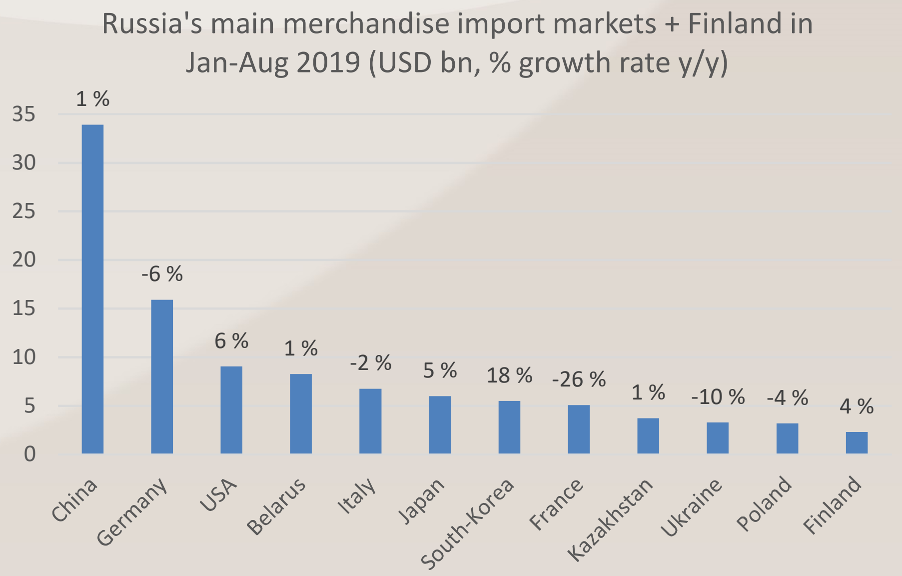

Source: Russian Customs Service (FTS)

Export to USA strongly increasing in Jan-Aug 2019

- Merchandise trade with China weakening after while trade with the USA increasing at the fastest rate of all the largest export markets (15 %).
- Trade with the EU declining further by 7.3 % with the exception of the Netherlands that is known as a clearing house for commodity and other merchandise trade (e.g. Rotterdam port). EU is still Russia's largest merchandise export market with a total share of 42 % of trade volume.
- Trade with South-Korea has been expanding fast in the last year and

Import from the EU continues to decline

- Imports from the USA growing fast despite more sanctions imposed in 2019.
- EU imports has have continued to decline (-6.3 %) despite a stronger currency in 2019. Imports from Finland are growing almost solely due to import of pipes related to the building of Nord Stream 2.
- Trade with South-Korea has been expanding fast in the last year and together with China and India, S-Korea has emerged a clear competitor to products from the EU.

New statistics reveal the ultimate investing countries behind tax havens

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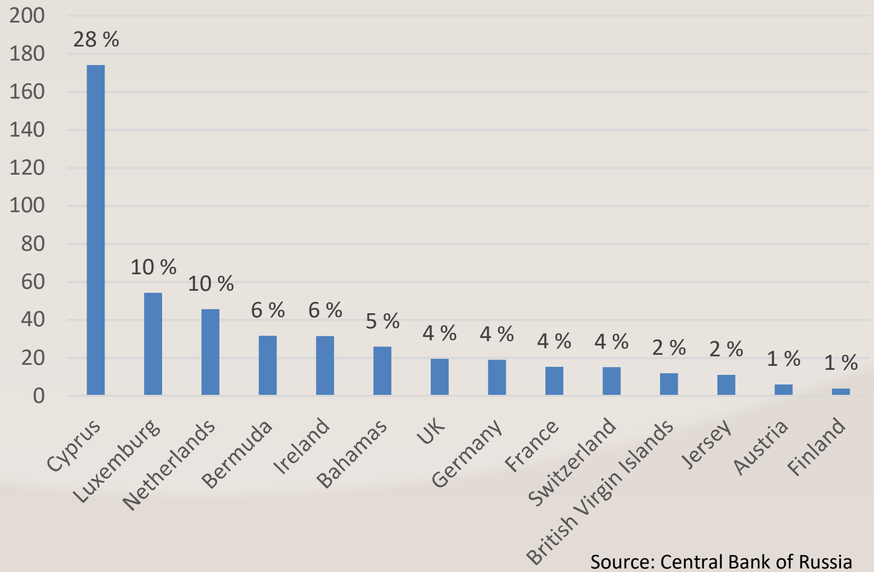
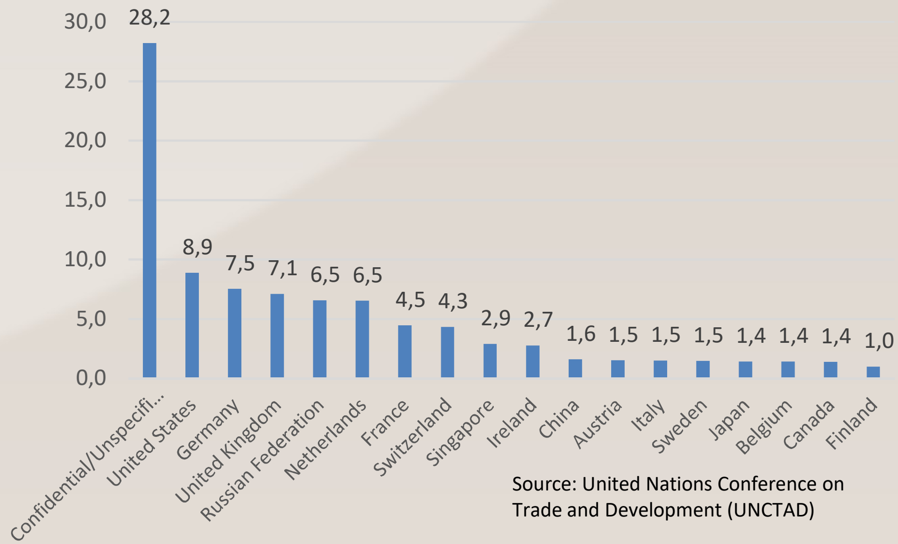
FDI stock by largest investor countries (bn USD) and share (%) of total FDI to Russia by end of 2017



Source: Central Bank of Russia

Share (%) of FDI stock to Russia by estimates of ultimate owner in 2017



Source: United Nations Conference on Trade and Development (UNCTAD)

- Investments by the U.S. are significantly larger according to new estimates of the real sources of FDI to Russia (graph o the right). According to official statistics, the U.S. does not even measure in the list of largest investing countries in Russia (left graph).
- Due to goepolitical tensions, Western investments to Russia are transferred via tax havens and off-shores where the ultimate source of the funds can be diluted from official statistics.
- The relatively large share of U.S. and UK-origin investments has been a surprise to many experts, whereas this statistical discrepancy has been known. Most of the off-shore origin FDI were thought to have been Russian.
- In nearly 30 % of inward FDI to Russia, the ultimate source still remains hidden.

Disposable incomes growing at their fastest rate since 2014

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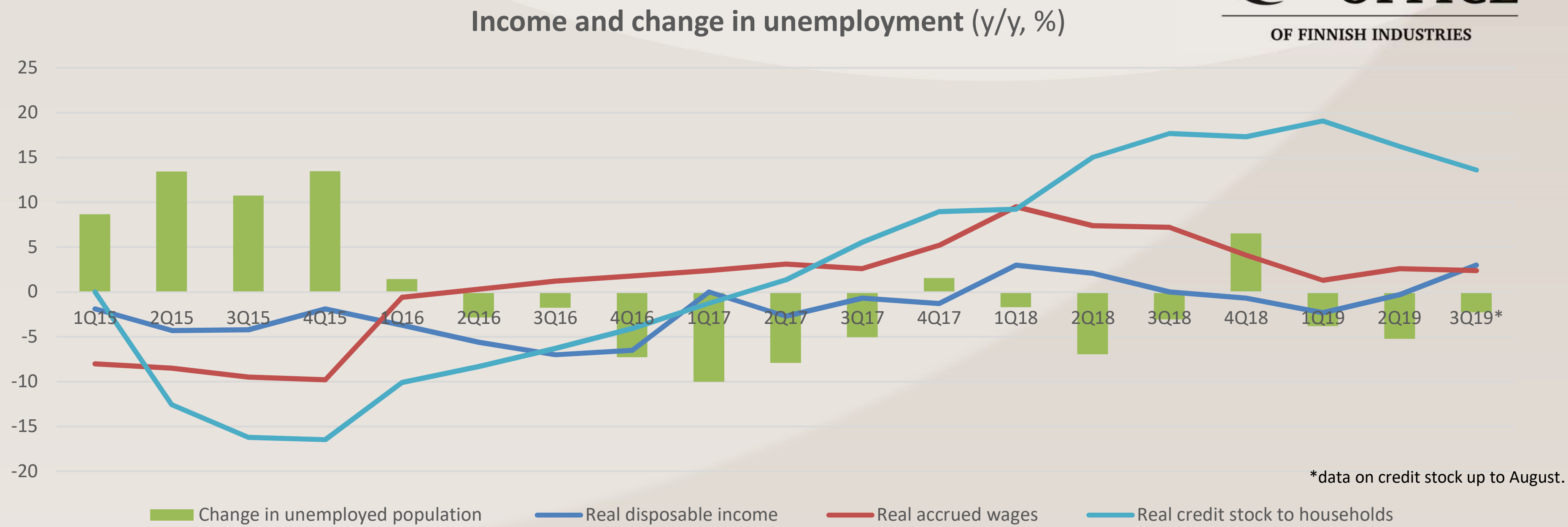
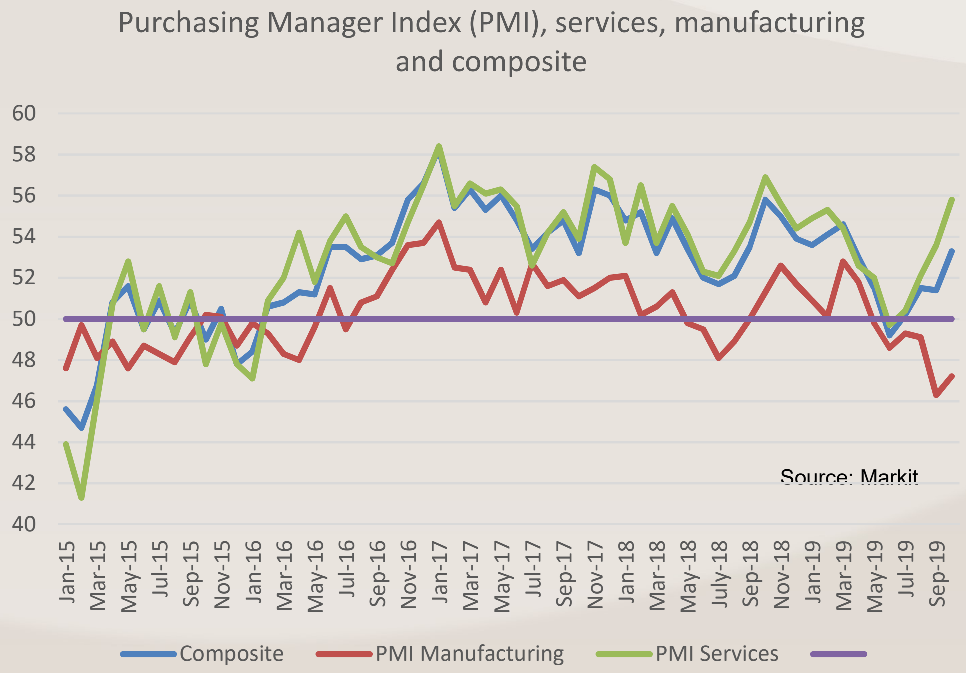


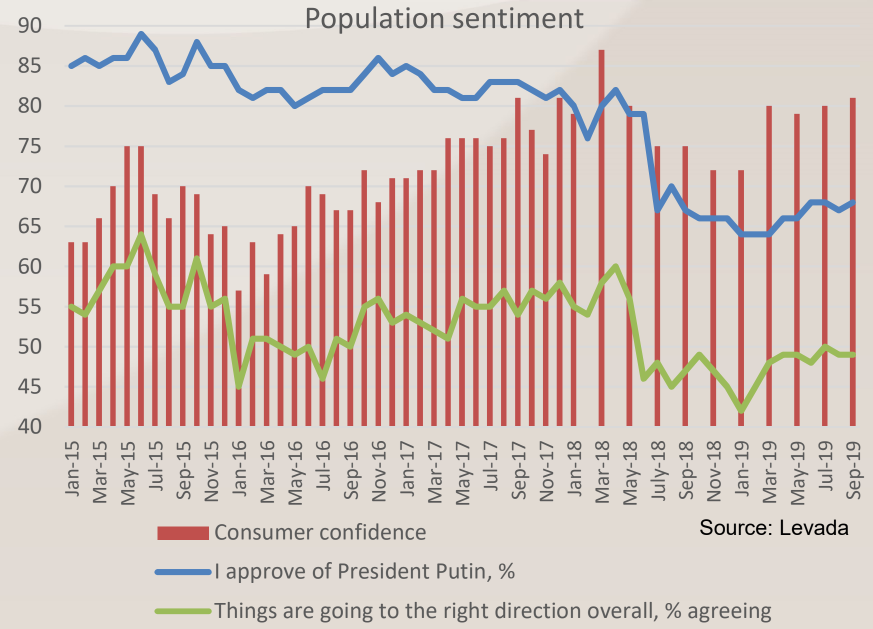
Source: CBR, Rosstat, East Office

Disposable incomes increase by 3 % (y/y) in 3Q19

- The accelerated growth is attributed to growth in wages (nearly 80 % of disposable incomes), decelerated inflation and the low base level from last year. In the first 9 months of the year, disposable incomes grew by 0.2 % (y/y) and are estimated to be 9 % below the 2013 level. Some experts have cast doubt on the validity of the strong sudden growth in disposable incomes after Rosstat reformed its calculation methods on incomes in 2019 after MinEcon took direct control of its operations.
- Real wages continued to grow at a slightly lower rate of 2.4 % (y/y) compared to 2Q19 due to the high base level from last year. Real incomes increased by 3.3 % in 3Q19.
- At the same time, unemployment rate remained at a historical low of 4.5 % (seasonally-adjusted) also driven by the accelerating pace of decrease in the workforce. According to MinEcon, the workforce has decreased by 1.5 % in August and an estimated 1.1 million people in Jan-Aug 2019.
- Real credit to households were increasing a lower rate from the start of the year while still at a double-digit rate (14 %). Recent interest rate cuts are expected to keep credit growth strong despite a slight increase in bad debt.

Industry sentiment mixed while population confidence moderately improved





- In 3Q19, the services and manufacturing sentiment indeces have sharply diverged.
- Manufacturing PMI index fell to its lowest figure since 2009 in September concurrent with weak private investment activity and the resulting worsening production capacity.
- The services sector recovered from its worst figure since 2016 in May following the subsiding inflationary pressures and moderate increase in consumer demand.

- The president's approval ratings have improved marginally to 68 %.
- The share of people seeing that Russia is going in the right direction has remained at a higher level since March, while still below the levels prior to the re-election of Pres. Putin.
- Consumer sentiment has recovered in recent months to a relatively high level, which can be reflection of a weakening inflation and maintained growth in wages.

Trade balance continues to deteriorate and fixed investments at a standstill

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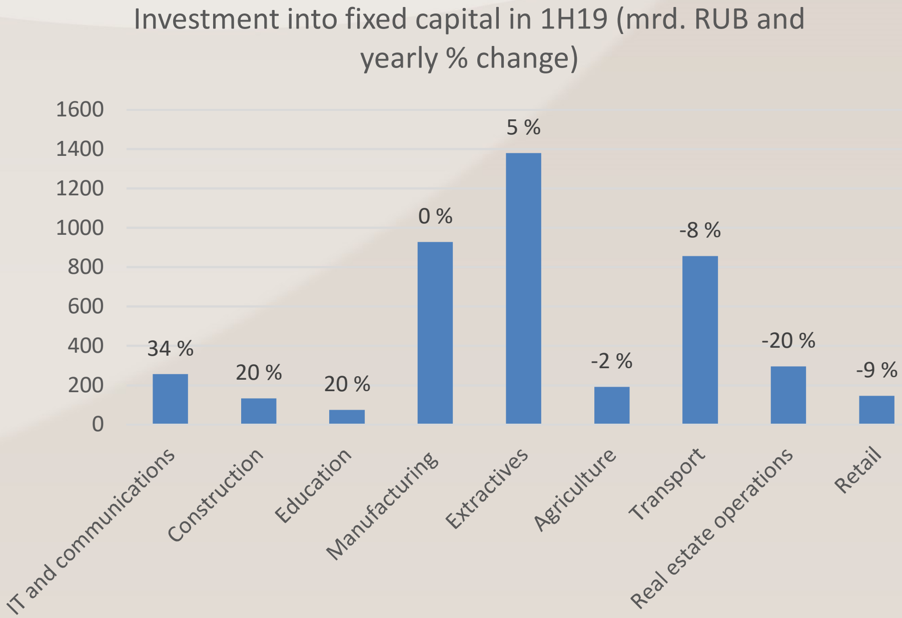
*first estimate by CBR
Source: CBR



Current account balance 53 % lower than a year ago

- In 3Q19, deterioration of the trade balance (-24 % y/y) was the main reason for the weaker current account. At the background was the exceptionally high volumes of oil exports, high oil price and a favorably low currency in 2018.
- Export revenue decreased by 8 % (y/y) mainly due to a lower oil price. Imports increased at the same time by 3.5 % especially in services' imports aided to a relatively stable currency.

Investments to fixed capital by large and medium companies decreasing

- In the first half of 2019, fixed investments decreased by -1.1 % (y/y) (excl. small firms) and total fixed investments by +0.5 %.
- Fixed investments in the extractives sector comprise of nearly 30 % of all fixed investments and most of these are directed to crude oil and natural gas. Fixed investments in manufacturing failed to grow at all compared to last year
- Investments into IT and communication increased 34 % (y/y) and reached a share of 5% of total fixed investments in 1H19.

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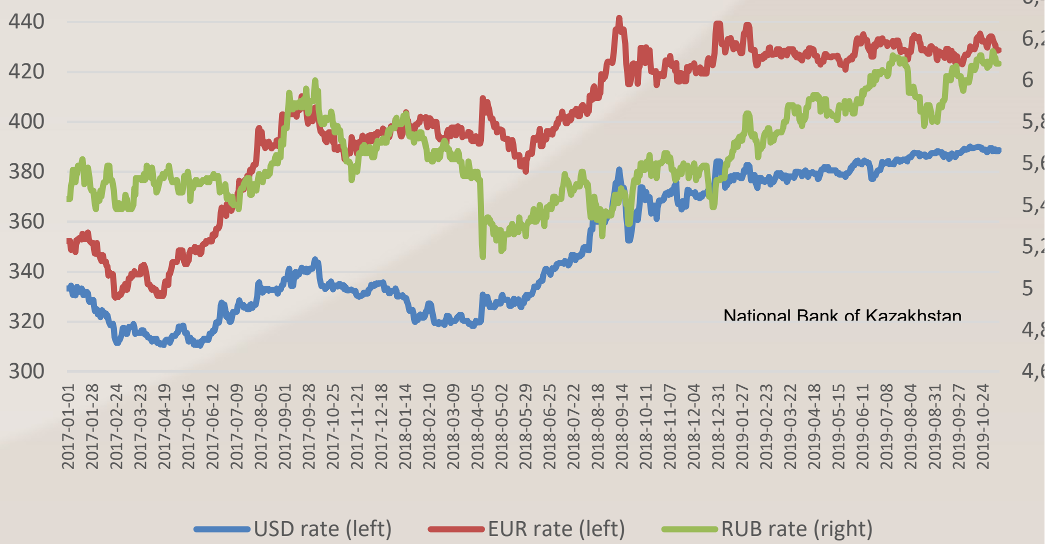
Kazakh economic growth kept strong by state supported household demand

Kazakh economic growth has continued to show positive dynamics and the short-term economic indicator that covers 60 % of the economy expanded by 5.4 % in 3Q19 (vs 4.3 in 1H19) driven by an upbeat industry. The state has also contributed by stimulating demand. Main measures have been increasing the minimum wage and a lower income tax rate. The fiscal expansion was especially visible in excellent results in retail and construction.

This increase in government spending in turn has led to a worsening fiscal stance, increased current account deficit, accelerated inflation that needs to be counter-balanced with a tougher monetary stance from the National Bank also to protect the Tenge from depreciating too much.

The new president Tokayev has pledged that the government will continue to increase social spending in 2019-2020, which will increase household demand further. Given the lower oil prices, the emphasis on social spending has increased he need for external debt especially as there were maintenance halts on Kazakh oil production this year that have had an impact on oil revenues.

Tenge FX rates against RUB (right axis), USD, EURO (left axis)



Main economic indicators	Real		Forecast	
	2018	Jan-Sep 19	2019	2020
GDP, % y/y	4.1	4.1*	3.8	3.5
Industrial production, % y/y	4.1	3.3	2.2	3.1
Inflation, % y/y	6.0	5.3	5.4	5.4
Current Account Balance, bn USD	0.9	-2.8	-2.4	-3.6

*1H19.
Source: Ministry of National Economy of the Republic of Kazakhstan Committee on Statistics
Forecasts from Consensus Economics October 21st

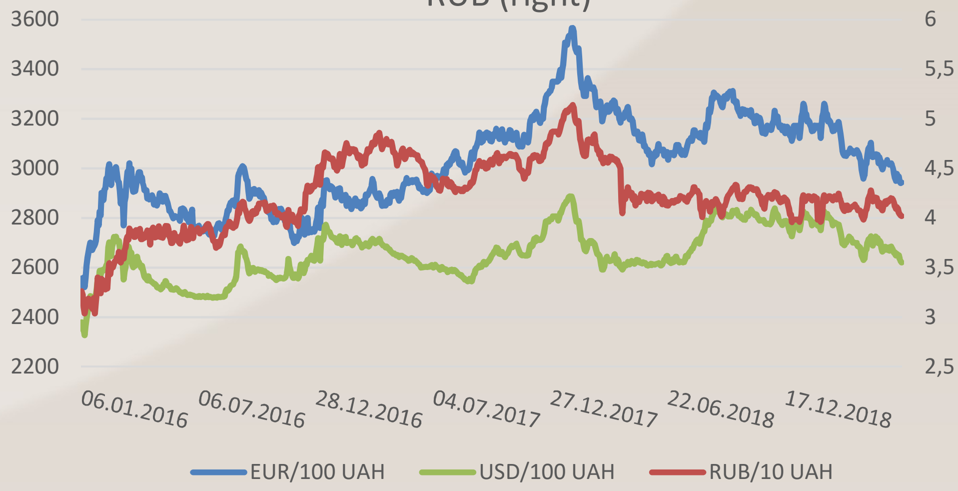
Ukrainian economy upbeat in 3Q19 due to strong agriculture and consumer confidence

Economic growth has accelerated in 3Q19 despite weaker prices for many of Ukraine's main export products (iron ore, steel). In Jan-Sep, the strong agricultural yield (sector growth of 5.9 % (y/y)), retail (9.8 %) and construction sector (20.5 %) invigorated economic growth. However, for Jan-Sep as a whole industrial production growth failed to grow at all.

Due to positive developments foreign investors have returned to the Hryvna-denominated state bond market. In Jan-Sep, the share of foreign holdings of Hryvna state bonds rose from 1 % to 12 %, which led the hryvna to appreciate. There are significant risks to growth, namely the payback of IMF loans and weaker global growth.

Pres. Zelensky of Ukraine is determined to reach peace with Russia backed separatist in its Eastern territories, Donetsk and Luhansk. The retreat of Ukrainian forces has been slower than planned. Parts of the Ukrainian military, veterans, nationalistic groups and the paramilitary groups fighting in the Ukrainian side are opposed to the Minsk agreement and Steinmeier formula, the latter of which would mean organizing a referendum in the separatist regions on autonomy.

Hryvnia FX rate against EUR, USD (left) and Russian RUB (right)



National Bank of Ukraine

Main economic indicators	Real		Forecast	
	2018	Jan-Sep 19	2019	2020
GDP, % y/y	3.3	4.6*	3.1	3.1
Inflation, % y/y	10.9	7.5	8.5	6.8
Industrial production, % y/y	1.1	0.0	1.4	2.4
Current Account Balance, bn USD	-4.5	-1.1	-4.8	-5.1

*2Q19. Source: National Bank of Ukraine
Forecasts from Consensus Economics October 21st

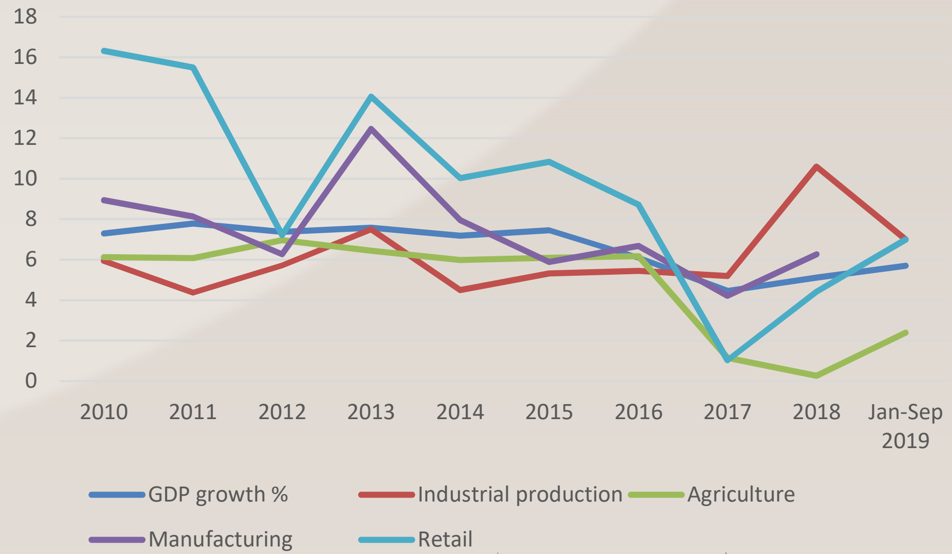
Uzbekistan taking its place in the global value chains with some growing pains

In the last 3 years, Uzbekistan has changed from one of the most closed countries to the fastest growing economy in the CIS region. Wave of reforms have been started in the country such as a change to a freely floating currency and eradication of visa requirements for all EU countries. In 2016, the country's first authoritarian president Karimov died and chose a successor Rahmat Mirziyoyev, who against all expectations turned out to be a reformer.

After an initial slump in 2017, surge of foreign investments and structural reforms (namely tax cuts and social safety nets for the poor) have resulted in stronger growth in 2018-19. On the down-side, inflation has erupted as people's income's are increasing. In 2019, Uzbekistan current account deficit has widened sharply as the population have gained access to imported goods through the currency market liberalization while export growth has decelerated. Unfortunately, the validity of the statistics remains weak but there are on-going reforms to change to the IMF standard.

Uzbekistan's 33 million population is young, 40 % under 25 years of age. The country still suffers from many of the developing country problems such as use of child labour, weak status of women, weak judicial system and a large shadow economy (half of GDP).

Real GDP and main sectors, % growth (y/y)



Main economic indicators	Real		Forecast	
	2018	Jan-Sep 19	2019	2020
GDP, % y/y	5.1	5.7	5.4	5.1
Inflation, % y/y	17.5	13.6*	15.5	12.2
Industrial production, % y/y	14.4	7.0	6.8	7.2
Current Account Balance, bn USD	-3.5	-0.7**	-3.5	-3.5

*June 2019.**2Q19. Source: Central Bank of Uzbekistan, State Committee for Statistics Forecasts from Consensus Economics July 15th survey

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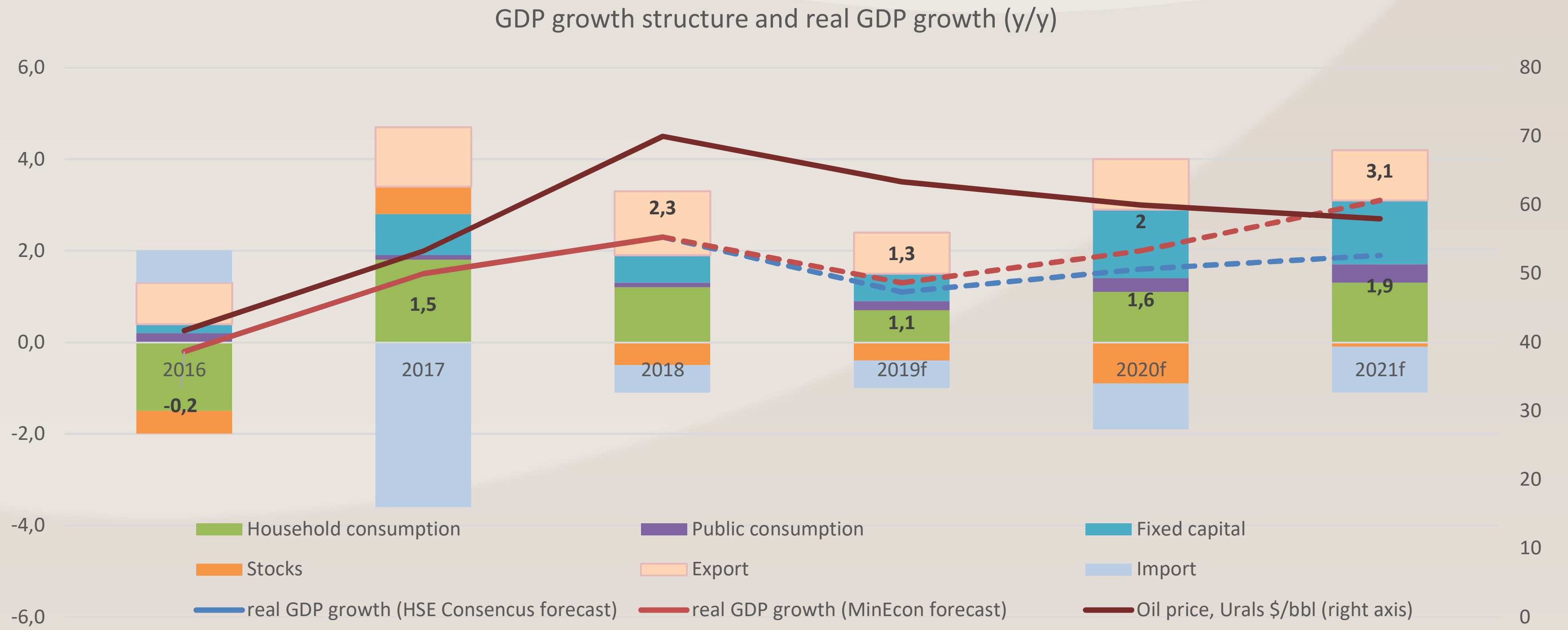
Outlook 2019-2021:
4 Key issues that determine Russia's future growth



Source: Rosstat, MinEcon, Higher School of Economics Zentr Razvitiya, East Office calculations.
f-forecasts.

- Economic growth in 2017-18 has been mainly due to household consumption and export revenue, but the recent MinEcon forecasts (October 2019) downplay the role of consumption and net exports for 2019-2021 and rely much more on accelerating private investment.
- For 2019-21, Russia's future growth pattern is subject to **stimulating private investment**, which hopefully speeds up productivity growth; **increases in real incomes**; changes in **commodity markets**; and solving the **Ukraine and the geopolitical** conundrum that seems to be in motion at the moment.

1. Investments into production technology need to increase...

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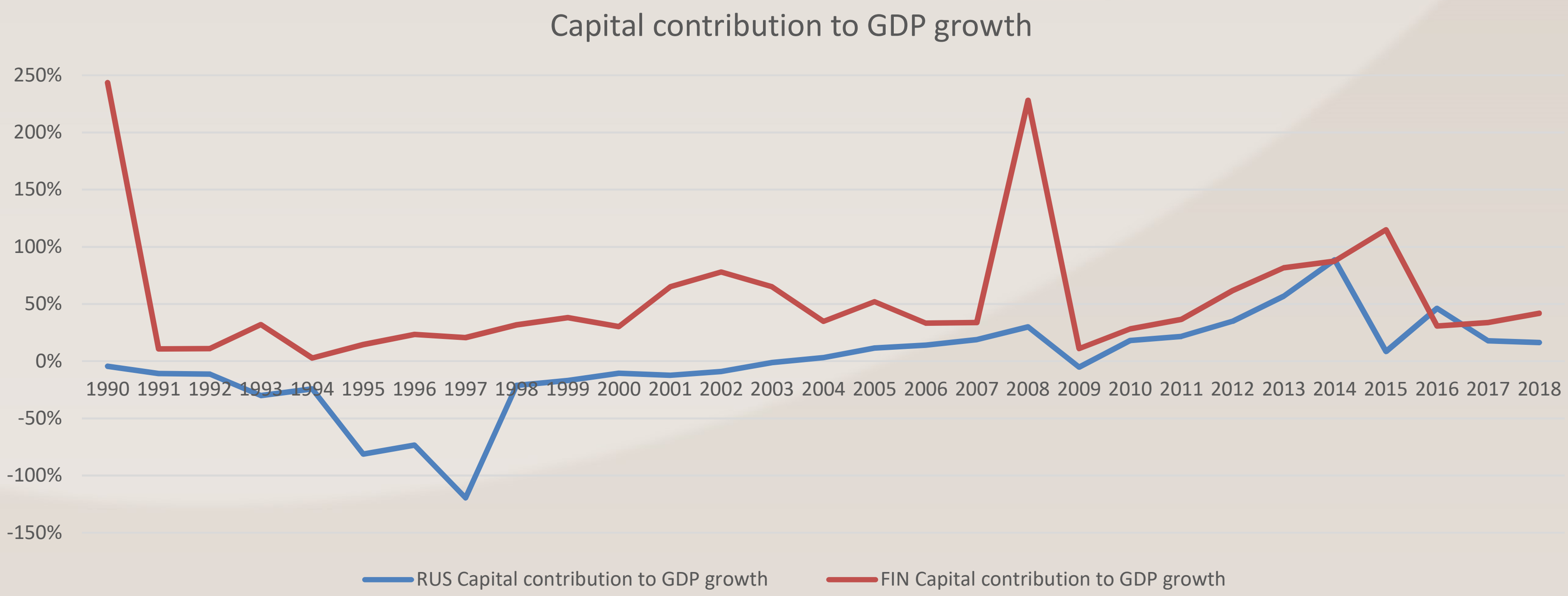
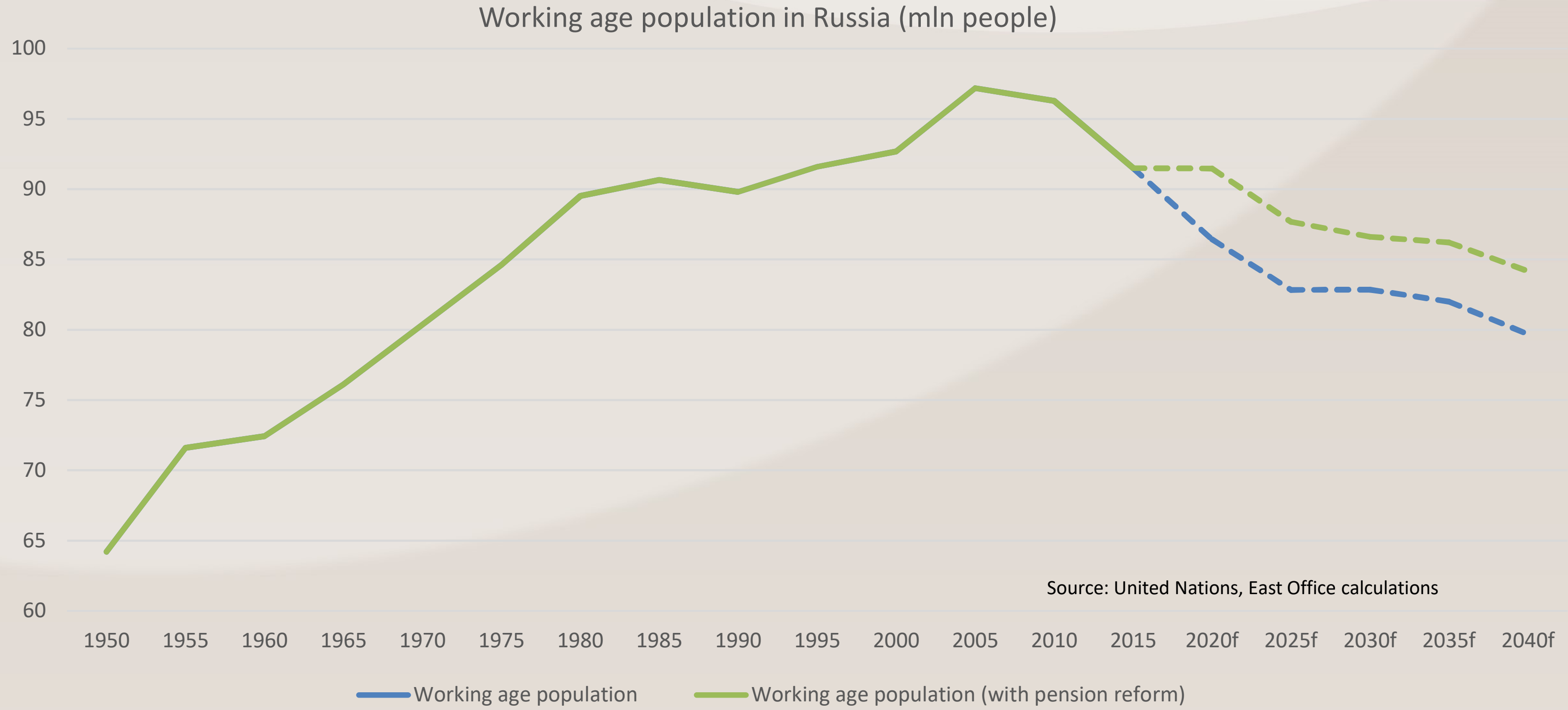


- Investment can increase potential growth rates directly through capital accumulation that raises work productivity and potential output. World Bank has estimated that Russia's investment needs are enormous at 75 % of 2015 GDP.
- In Russia investment growth has slowed down markedly in the last years, even though investment share of GDP has increased. In many commodity exporters such as Russia, investments have declined due to deterioration in terms of trade, slowing growth in China and geopolitical isolation in the case of Russia.

…to compensate for the decline in workforce…



- If growth is to continue (or become sustainable) crucial factor is to increase investment into production capital especially because workforce is declining and production capacity is becoming out-dated.
- Most recent UN population estimates show larger than previously expected reduction in the working-age population. Even with the pension reform in place workforce would decline by over 4 % during 2021-25. Immigration is not expected to significantly change the outlook.

…or at least investments should envigorate productivity growth

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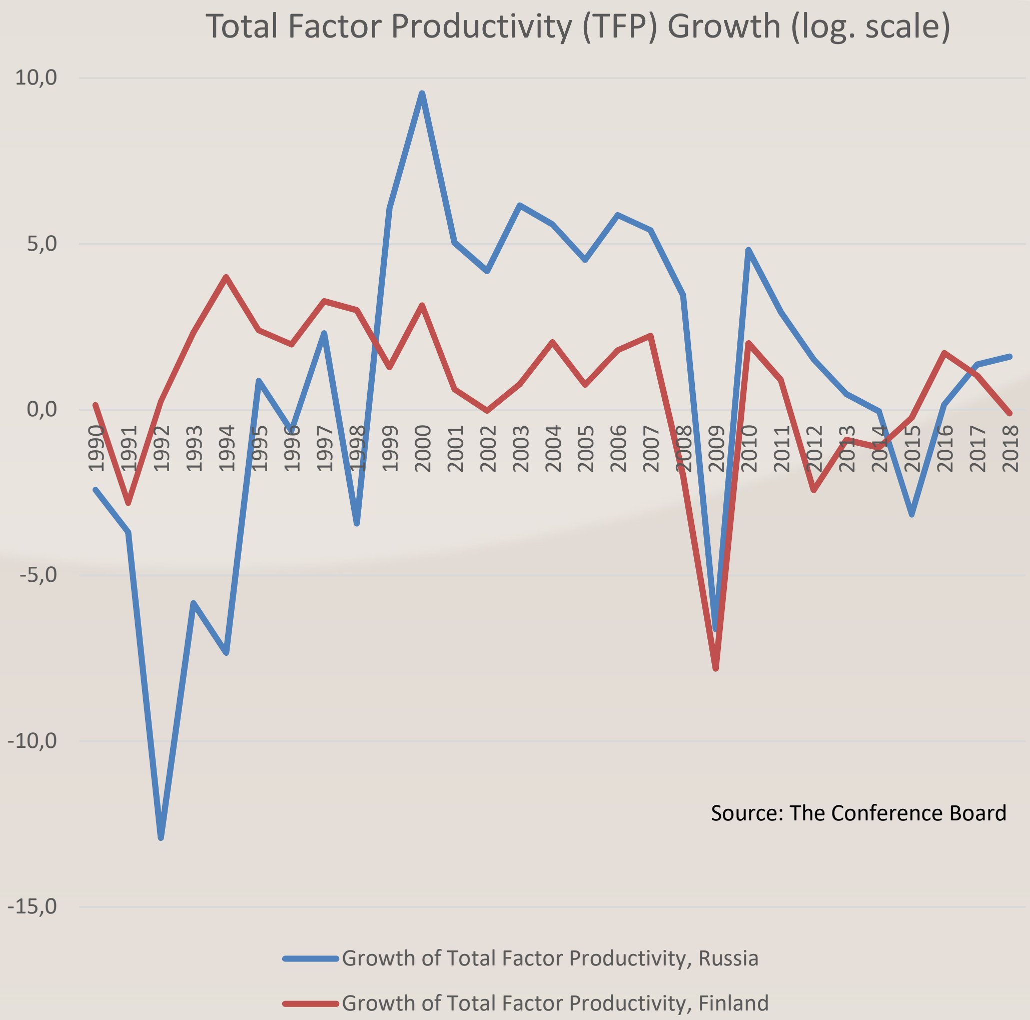
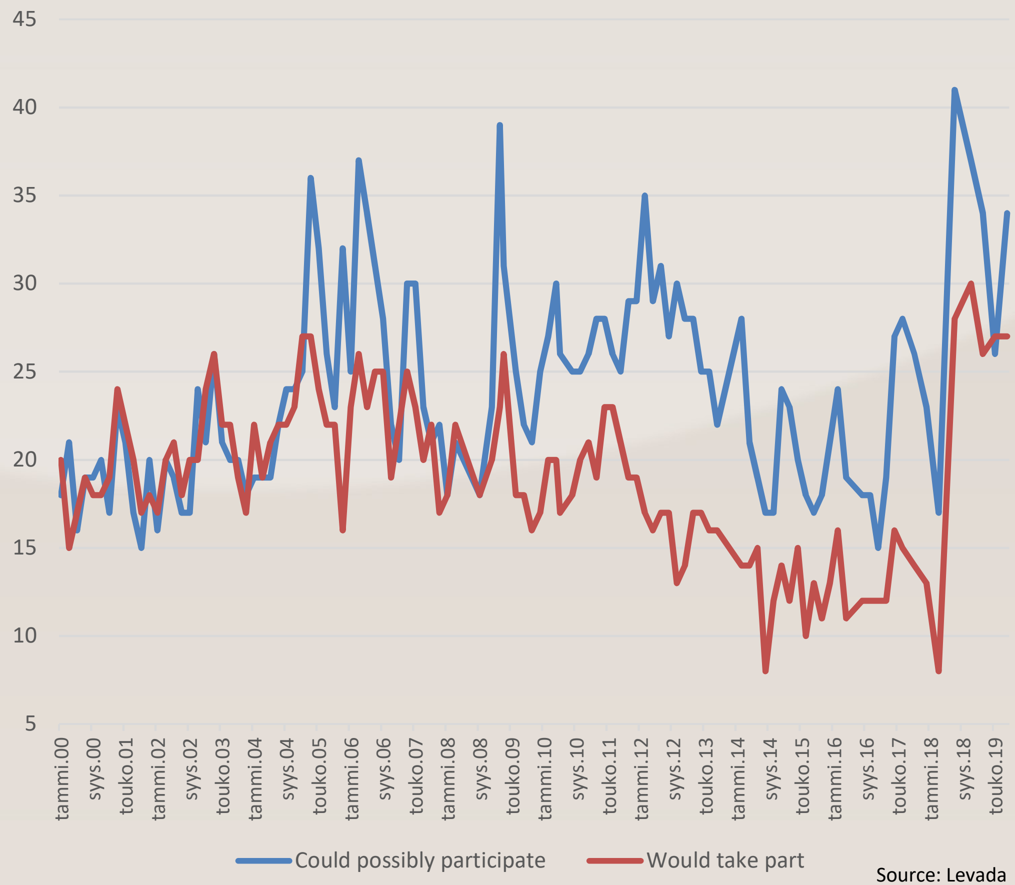


- Investments can increase productivity through adoption of new technologies, more efficient processess or changes in management practices that can create benefits larger than the simple sum of inputs (called Total Factor Productivity or TFP).
- Underinvestment (including depletion of production capital) has contributed to the fall of Russia's TFP.
- TFP growth is an important driver for per capita growth and is driven by e.g. TFP in Russia was higher than in advanced economies (such as Finland) in 2000-09 reflecting a transition process of excess capacity to more productive sectors.
- Since the global financial crisis, TFP growth has decelerated gloabally and in Russia. The growth decline in Russia is attributed to the effects of the first generation reforms wore off, legacy of the crisis, demographics and the changing composition of investment from machinery to buildings.

2. Unpopularity of the regime and falling incomes

Willingness to participate in protests due to economic reasons, 2000-August 2019

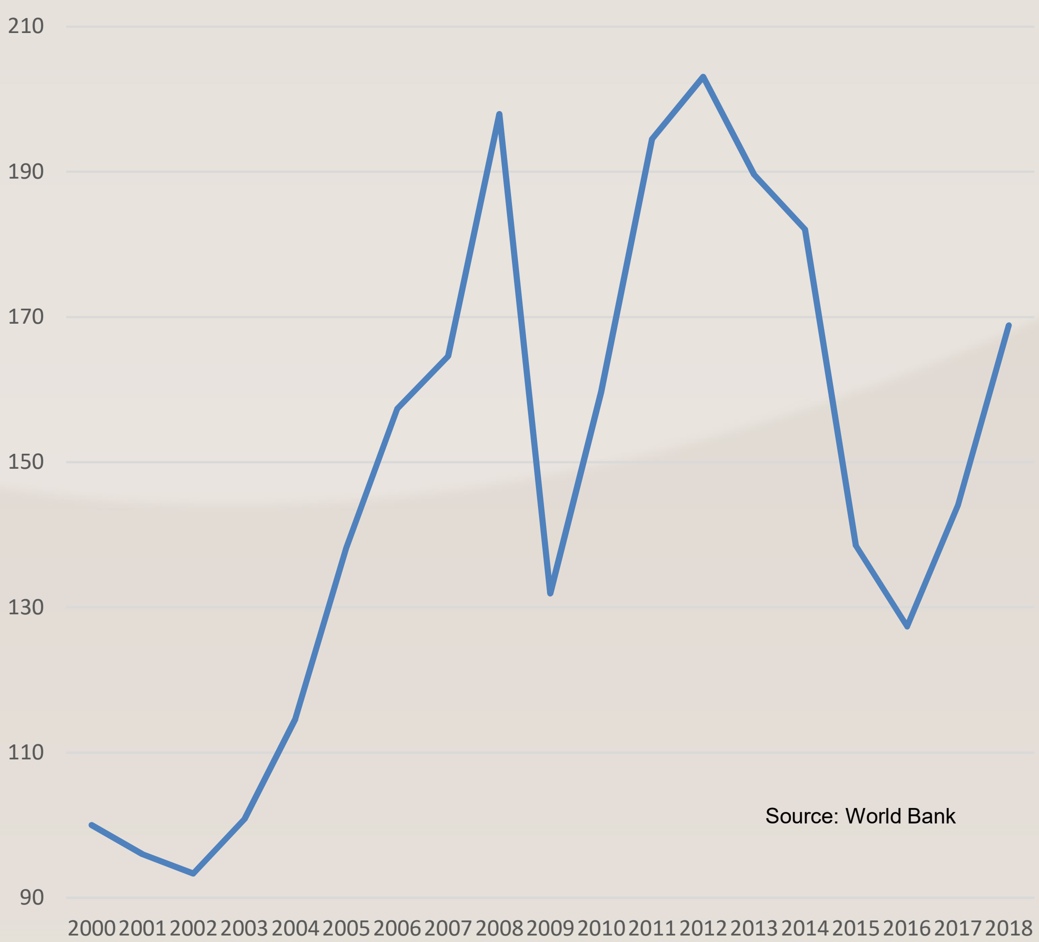


Source: Levada

- Protest sentiment is at its highest level in 21 years and has been sharply increasing since Putin's re-election in March 2018.
- Negative sentiment is driven by the falling real disposable incomes of the population of 5 years in a row. When at the same time state money is spent on wars efforts in the Ukraine and Syria, megaprojects (FIFA world cup) and the elite's extravagant lifestyle is angering the population.
- According to Rosstat, 49 % of Russians spend all their income on food and clothing and poverty has increased to 14 %, which is a higher than before Crimea.
- Redistribution of wealth in Russia has been occuring due to sanctions and countersanctions: Russian economists estimated that the Russian countersanctions have cost the Russian consumer 445 bn RUB every year since 2013. This corresponds to 4.8 % (or 3000 RUB/consumer annually) of the subsistence minimum consumption basket.
- 84 % of the 445 bn RUB is the subsidized production to Russian producers and 3 % is transferred to suppliers for more expensive foreign alternatives. This results in 13 % loss to the Russian economy as a whole.

3. Oil market structures are not what they used to be

Net terms of trade index (2000 = 100) for Russia



- Net terms of trade (ratio of export to import prices) has been declining since 2012 as well for as other energy exporting countries (2018 is believed to be an anomaly), which means lower returns for Russia.
- Short-term fluctuations aside, the fundamentals of global oil production have changed:
  - U.S. shale oil revolution has made U.S. the largest oil producing country globally (also the largest consumer).
  - Global demand is weakening as demand especially from emerging Asia is falling and shift to renewables is slowly but surely gnawing at fossil fuel demand in the West.
- U.S. Energy Information Agency estimates that oil prices will stay relatively flat in 2019-21 where the lower bound is set by OPEC+ production cuts and the upper bound by U.S. shale oil supply (U.S. oil extraction cost is roughly multiple compared to Saudi/Russian oil).

4. Geopolitics, Ukraine and sanctions

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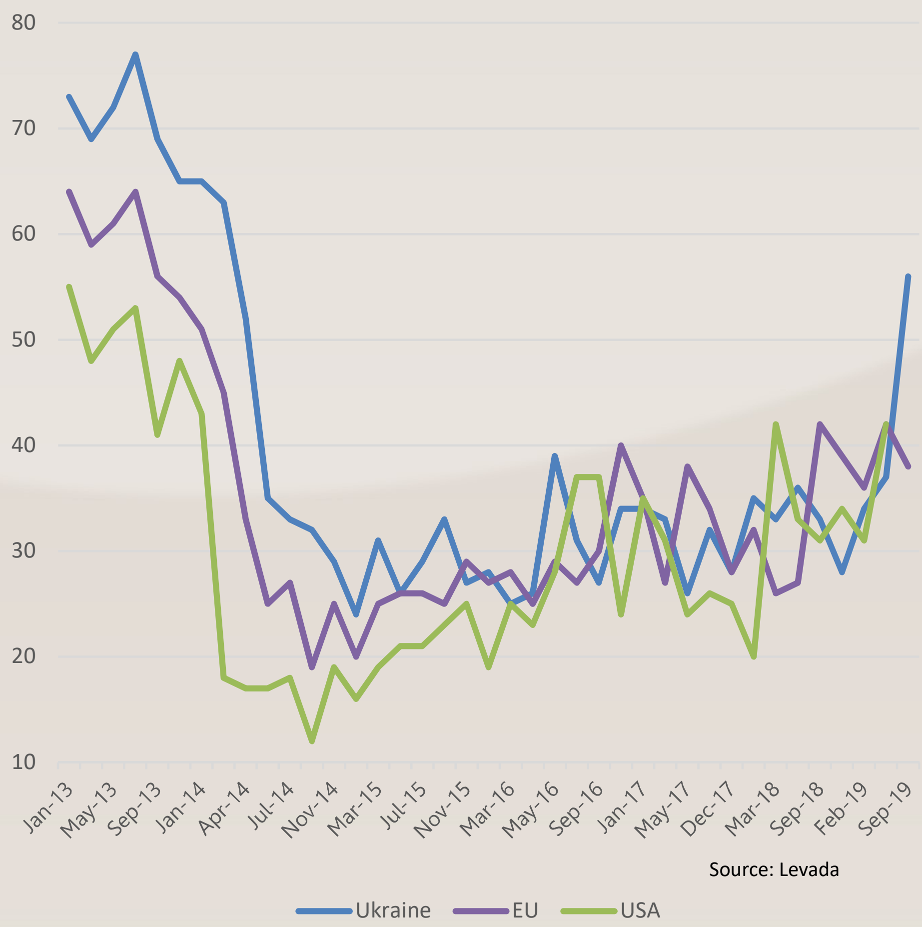
Share of Russians with a positive attitude towards Ukraine, EU and the USA



Source: Levada

- Pres. Zelensky of Ukraine is determined to reach a peace deal (Minsk 2 with the Steinmeier formula) and rapprochement has been successful in many respects.
- If successful, EU sanctions that are related to Minsk agreement are lifted, while Crimea sanctions stay.
- However, US sanctions that are more ambiguous by construction, will probably stay as the main problem in the US is related to meddling in the 2016 and 2018 elections irrespective of whether there is a Democrat or a Republican in the White House. (Democrat president may cooperate more with European partners).
- Brexit: When Brexit actually realizes (new deadline end of Jan 2020), will the UK impose its own sanctions? UK has been hawkish towards Russia due to the Skripal poisoning and other incidents.
- Will anything change if EU sanctions largely eradicated, whereas US sanctions stay? Dollar-domination in global transactions will make sure that US sanctions need to be adhered to.

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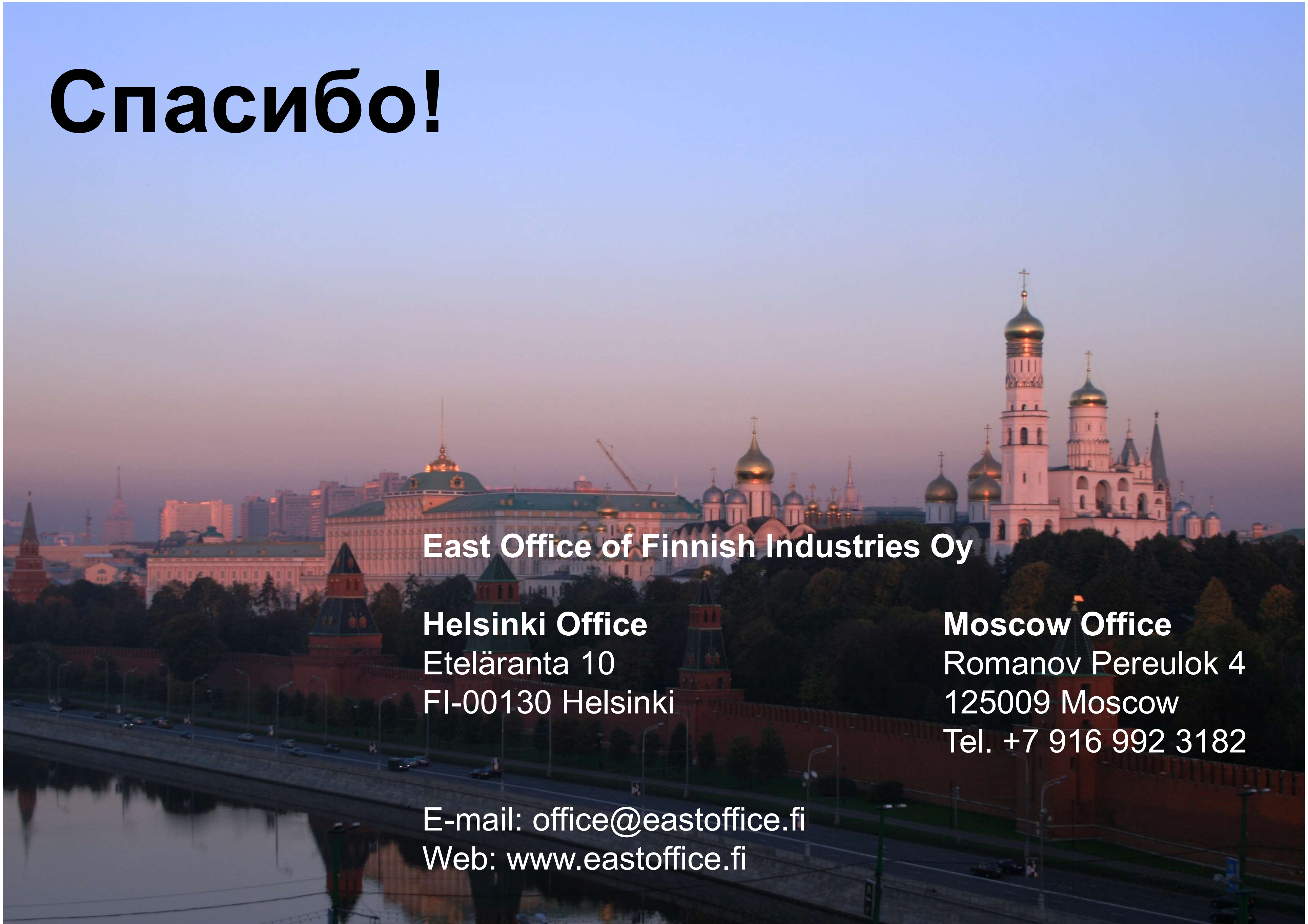
Спасибо!



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