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Overview of the Russia Economy 4Q19

Economic growth in 2019 pressed by weak consumption and falling exports

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Key takeaways

Recent events in 2019 for the Russian economy

- **Russian government resigned in January and President proposed changes to the Constitution.** New PM is Mikhail Mishushtin, a former Tax Office chief with a strong reputation as an efficient digitalization-oriented technocrat. Changes to the Constitution are seen as a start to the transition process leading to 2014, when Putin needs to step down. Constitutional changes will be put under a public vote most likely in April.
- **GDP growth in 2019 estimated at 1.3 %.** First estimate of GDP growth shows significant deceleration compared to 2018 (2.3 %) mostly driven by contraction of household demand in the first half due to the VAT rate hike and falling exports. Agriculture was the only sector showing stronger growth in 2019.
- **Industrial production growth adversely affected by both domestic and foreign low demand and lagging state investments. E**xtractives sector growth fell the most in 2019 due to the high base level from oil exports last year, OPEC+ production cut agreement and turmoil in commodity prices affected by the US-China trade dispute.
- **Rouble stronger and more resilient in 2019.** Rouble appreciated in 2019 around 11 % against the dollar and has remained surprisingly stable throughout the year given the fluctuations in oil price, most recently due to the coronavirus outbreak.
- **Inflation fell to 3 % in December driven by weaker increase in food price and a stronger currency.** A sumptuous yield, strong RUB and has decelerated inflation in in the second half of. Inflation is expected to accelerate during 2020 due to large increases in public expenditure.
- **CBR lowered its key rate to 6.0 % in January as inflation decelerates close to record lows.** CBR's move aimed at stimulating weakening household demand and investment activity.
- **Current account surplus contracts due to a weaker trade balance.** Export value decreased by -6 % (y/y) in 2019, while imports continued to grow (2.5 %) supported by stronger currency.
- **Disposables income growth remains weak at 0.8 (y/y) for 2019 despite a low base level from the previous years**. Real disposable incomes still remain below 2013 levels. Real wages growth decelerated considerably to 2.5 % in 2019 compared to 7.4 % in the previous year. President has promised extensive monetary support for low income families that should boost disposable incomes in 2020-2024.
- **Unemployment remains record low and workforce declining faster. T**he unemployment rate remained at a record low level of 4.5 % since September partly due to the accelerated contraction of the workforce.

Outlook for the Russian Economy 2020-2021

		2020	2021
Updated outlooks	Consumption	↗	↗
	Investment	↗	↗
	Industry	↗	↗
	Exports	→	→
	Imports	↗	↗

”I see two reasons for this: either ineffective planning, or the poor quality of the managerial staff that was involved in this”

(New PM Mishustin analysing the reasons for the sluggish implementation of the National projects at a meeting with his deputy PMs, Kommersant Feb 10, 2020)

- **Russian economic growth will accelerate in 2020 to 1.6-1.9 % as household spending, construction and possibly other sectors start to benefit from the influx of state stimulus.** The hikes in disposable incomes and real wages is likely to come in 2021 at least ahead of the Duma elections. 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.
- **Real GDP growth should settle close to Russia’s potential of 2 % in 2021, whereas the state-aspired growth rates of 3 % are unlikely.** Crucial factor is to invigorate investments into production capital that can rely on state stimulus only for the short term. Investor confidence needs to be revived through credible changes in the institutional environment (e.g. trust in the rule of law, judiciary reform) and by alleviating political uncertainty especially related to the transition of power. Also, the decline in the labour force will limit economic growth for years to come but its effect should phase out in the next 4-5 years.
- **Hopes for faster growth in 2021 rest on the National Projects as the external environment will not be supportive at least in the short term.** Deceleration of global growth cycle is exacerbated by decelerating growth in the EU area and China and these will affect global commodity prices. Despite advances in Normandy format negotiations on Ukraine any significant alleviations to sanctions are not likely but any changes in the geopolitical situations will depend on the results on the US presidential elections in 2020.

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- Russian macroeconomic indicators
- Kazakhstan, Ukraine and Uzbekistan
- Future growth, national projects and the risks ahead

Economic growth drops in 2019 amid weak consumer demand

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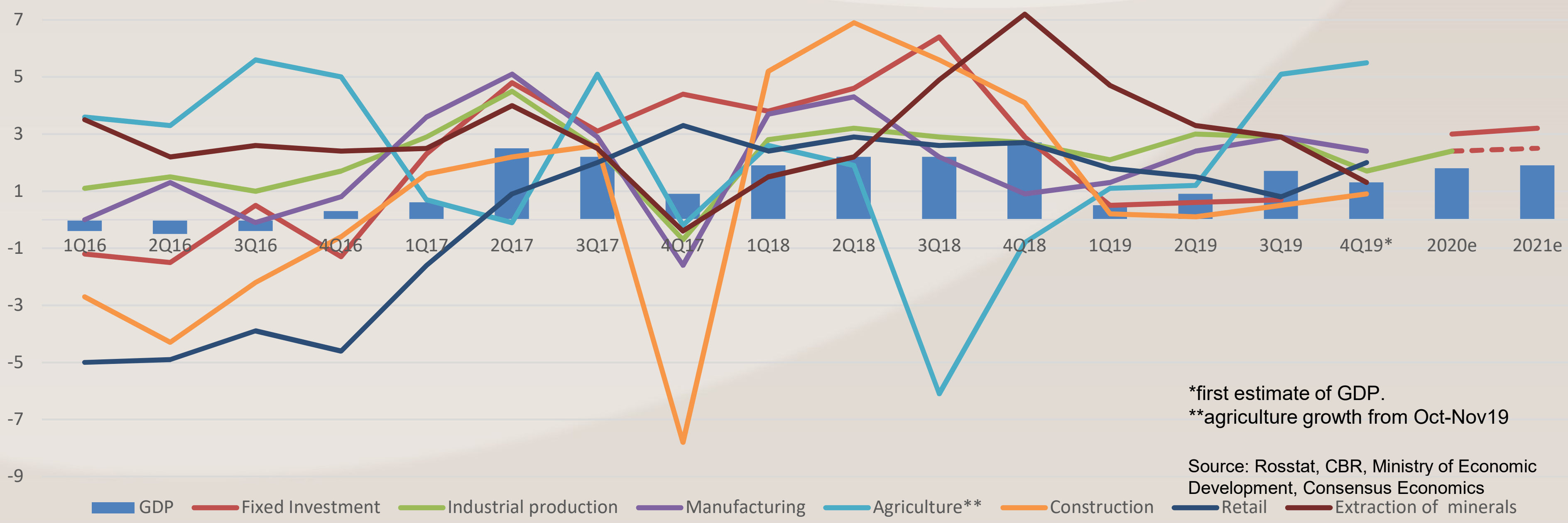
Real economy indicators (1Q16-4Q19), % growth y/y



Real GDP growth estimated at 1.3 % for 2019

- All sectors with the exception of agriculture decelerated in growth compared to 2018. However, despite initial warnings by MinEcon, the Russian economy in 2019 evaded recession that was projected due to the VAT rate increase.
- In 2019, retail sector growth decelerated to 1.6 % (from 2.8 % in 2018) due to weak disposable incomes and increase in the VAT rate.
- Manufacturing sector growth decelerated (2.3 vs 2.6 % in 2018) and the extractives' sector (3.1 % vs 4.1 %) due to lower oil exports compared to 2018.
- Construction sector, which provided one of the big positive surprises last year, disappointed with growth of 0.4 % in 2019 (vs 2.6 % in 2018). Construction sector results for 2019 could still change as the output from SME companies come once a year.

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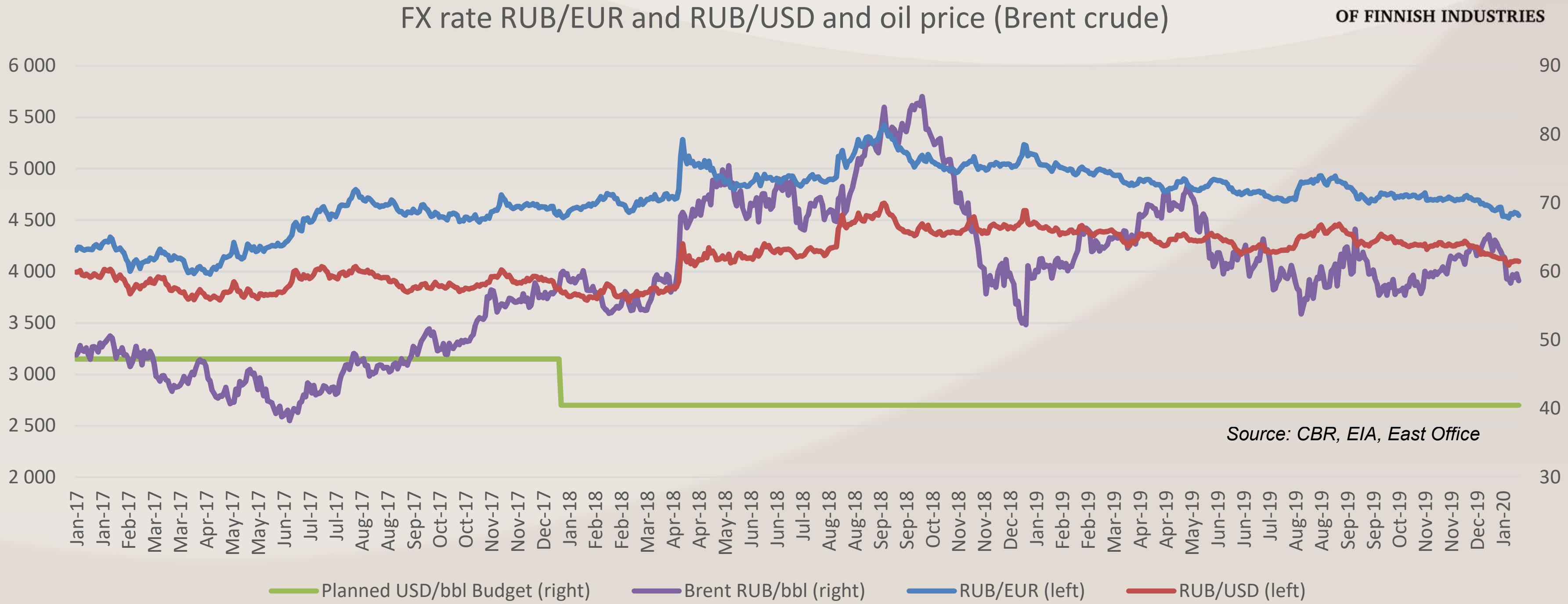
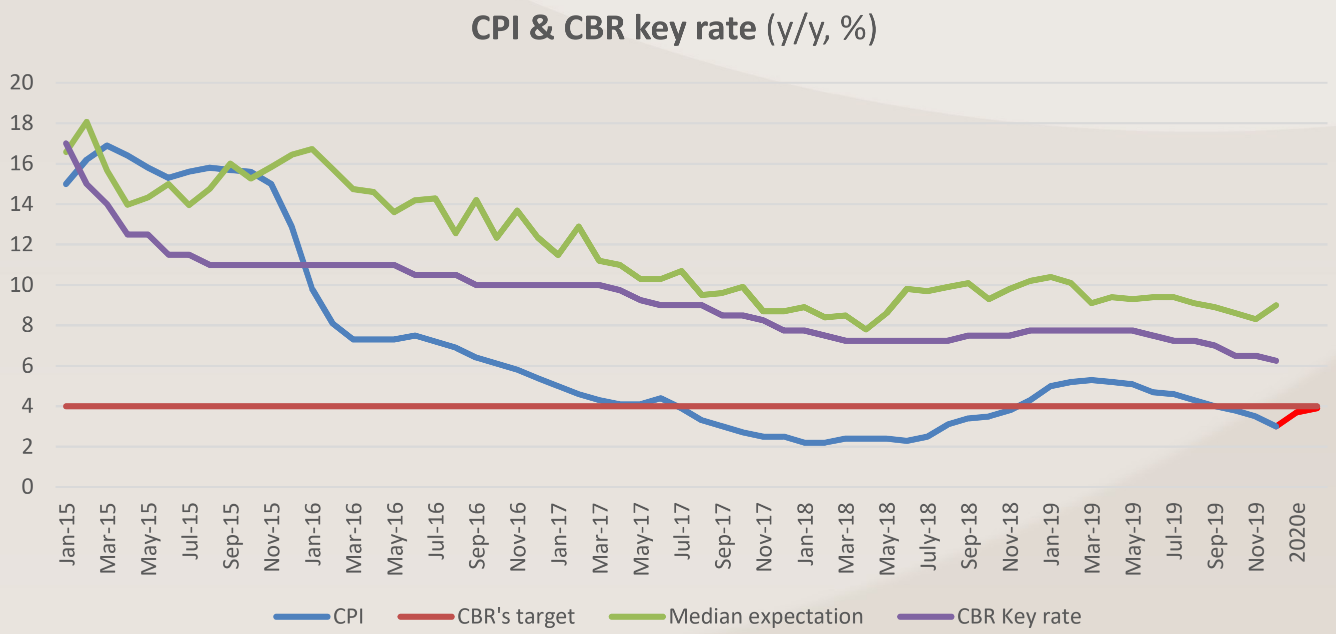
A stronger Rouble in 2019



Rouble has strengthened moderately despite turmoil in global oil markets

- The RUB has continued to appreciate in 4Q19 and has outperformed nearly all other emerging market currencies. In 2019, The RUB strengthened by 11% against the USD led by fading geopolitical threats and a first phase agreement in the US-China trade war. Also, more expansionary monetary policy has not affected RUB negatively.
- RUB is expected to appreciate further in 1Q20 due to Russia's seasonally high current account surplus and the expected hike in spending from the sovereign National Wealth Fund. Wealth Fund will be also used to buy a stake from Sberbank through FX sales over 3-7 years, which will support the RUB. Also, any thawing of the Russia-Ukraine relations should keep the RUB upbeat.
- In the beginning of 2020, the coronavirus outbreak in China has pressed on oil demand and will keep the price volatile and subdued at least for 1Q20 together with the OPEC+ production cut agreement agreed until end of March 2020.

Inflation decelerates close to record lows



Dec-2019 % Y/Y	
CPI	3.0
Food	2.6
Non-food	3.0
Services	3.8

Source: Rosstat, CBR, Consensus Economics

Inflation decelerated to 2.4 % in January

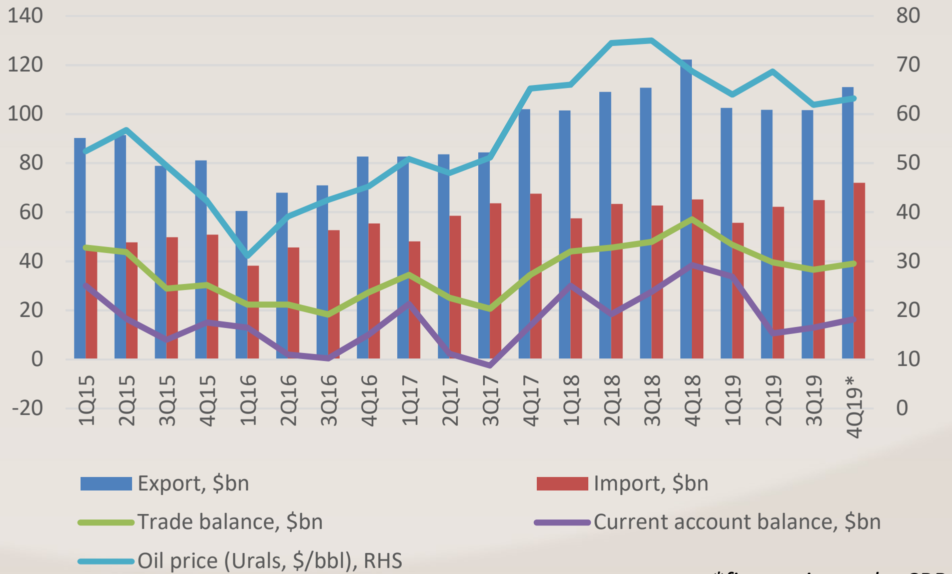
- After a short acceleration in the start of 2019, inflation has remained below the CBR inflation target since September. Modest growth in consumer demand, lower food prices driven by an excellent yield and a strengthening RUB contributed to weaker inflation.
- Household inflation expectations have increased in the Nov-19 and inflationary pressures are expected to increase in 2020 due to planned increases in public spending.

Key rate decisions

- CBR lowered its Key interest rate for the sixth time in a row in Feb-20 by 0.25 %-points to 6.0 % to boost weakening economic activity.
- CBR warns of large increases in public spending in 2020 that could inflate inflation. Spending increases are related to the National Projects that have not progresses as planned and additional social spending announced by the President in his yearly address on Jan 15, 2020. With the new PM Mishustin these are expected to be a primary focus of the new government.

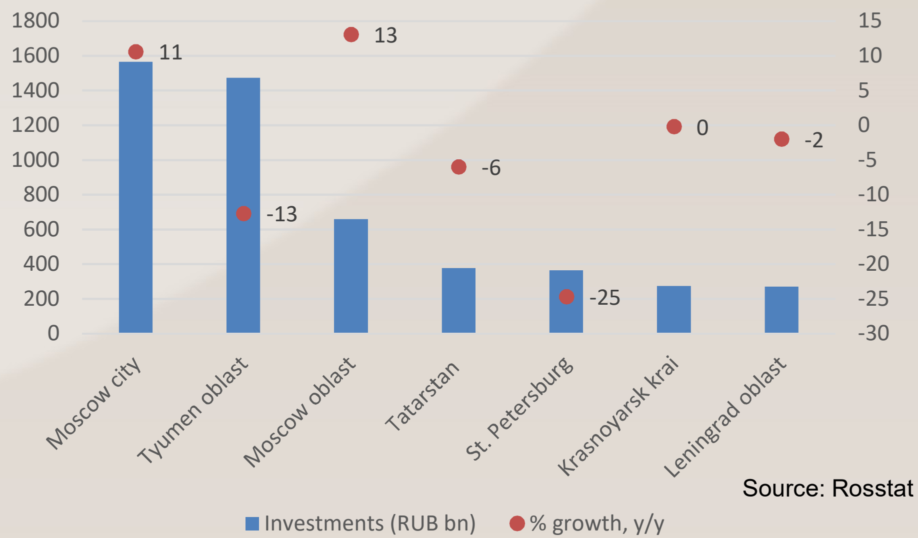
Trade balance continues to deteriorate and fixed investments at a standstill

Russia's trade and current account balance



**first estimate by CBR*
Source: CBR

Investment into fixed capital Jan-Sep 2019



Source: Rosstat

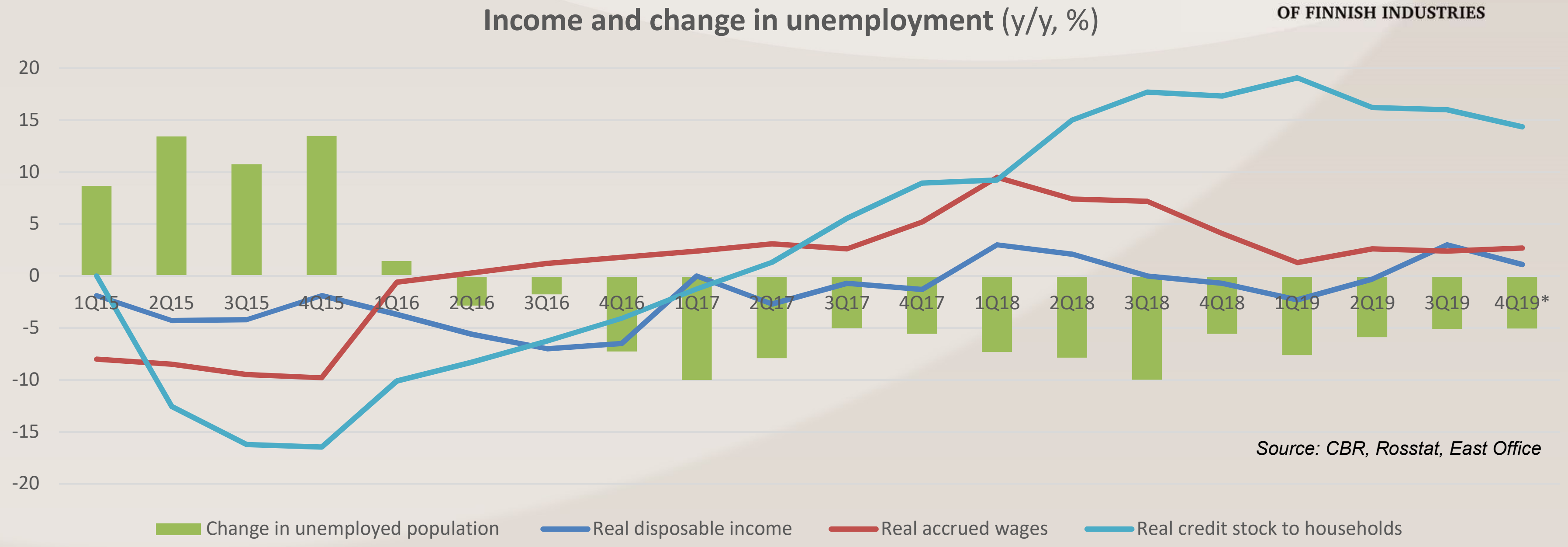
Trade balance down by 46 % (y/y) in 4Q19

- Historically high base level of exports from 2018 and stronger growth in imports were the main driver of weaker trade balance. Consequently, the current account surplus stood at at 70 bn USD in 2019 compared to 114 bn USD last year.
- Export revenue decreased by 10 % (y/y) in 4Q19 and 6 % (y/y) for 2019 driven by volatility caused by the trade war especially evident in metals and wheat exports. Imports increased at the same time by 10 % for 4Q19 and 2.5 % for 2019 aided by a stronger currency.
- Capital outflow narrowed to 27 bn USD after 63 bn outflow in 2018 reflecting improved investor confidence toward Russia.

Investments to fixed capital grew by 0.7 % (y/y) in Jan-Sep 2019

- In Jan-Sep 2019, fixed investments by medium-sized and large firms decreased by -2.2 % (y/y) (excl. small firms). Moscow city and oblast accounted for nearly all of the growth of investments in Russia during these 9 months.
- Fixed investments in manufacturing increased by 5.7 % (y/y) but at the same investments in the extractives sector declined by 8.4 % possibly due to the high base level from last years.
- Investments in IT and Communication increased by 28 % but the sector still only comprises 5 % of total fixed investment.

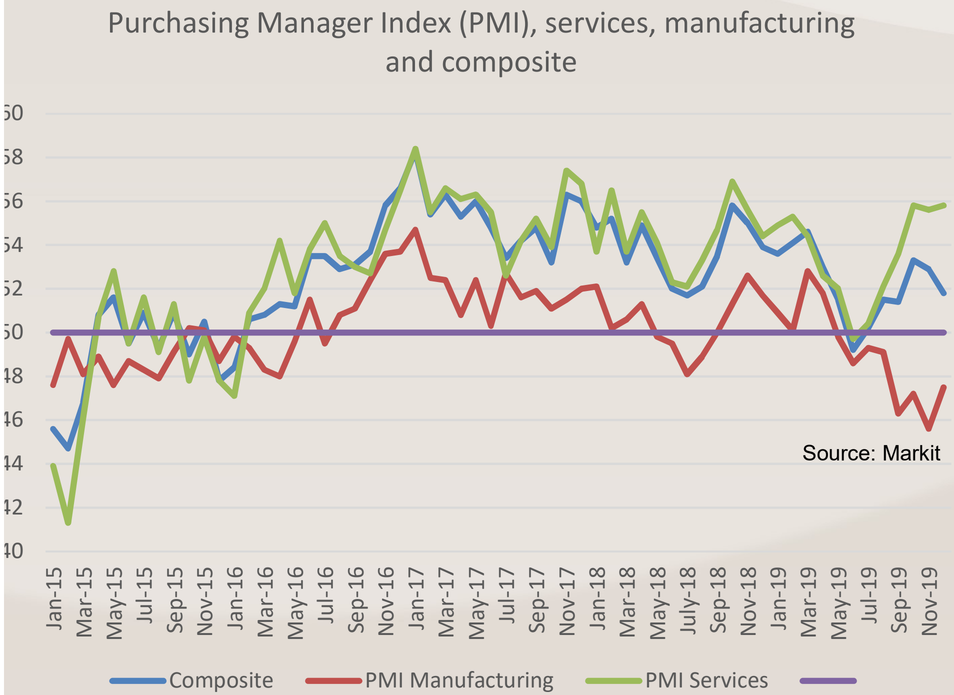
Purchasing power modestly improved in 2019

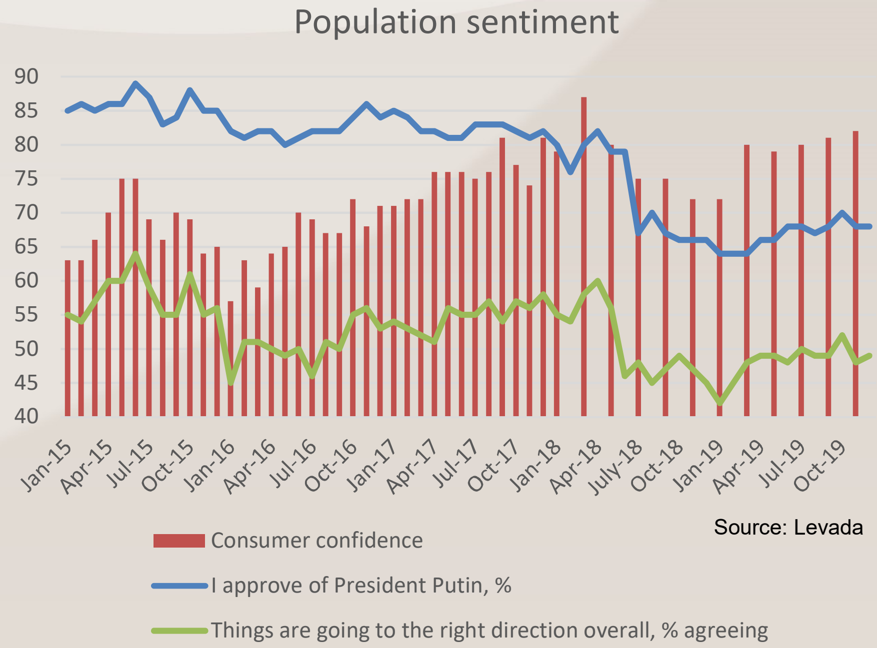


Unemployment maintained at low levels

- Real disposable incomes of the population grew by 0.8 % (y/y) in 2019 as a whole and remain below the 2013 levels. Real wages increased by 2.5 % in 2019, which marks a significant slowdown from last year (7.4 %).
- Disposable incomes are expected to improve judging from the promises Putin made in his yearly speech on Jan 15th, when ”unprecedented” support for low-income families and increase in the maternity capital estimated to cost 4 trillion RUB were announced.
- Unemployment has remained record low at 4.5 % for two quarters. Decrease in the workforce especially due to the 1990s demographic crisis will continue to exacerbate the shortage of labour in many sectors.
- Growth in real household debt has continued strong while decelerated and driven by consequent cuts in the Central Bank’s Key interest rate resulting in record low mortgage interest rates at the end of 2019.

Industry sentiment remains polarized while population confidence stable





- In 4Q19, the services and manufacturing sectors still assess the business environment very differently despite some convergence in Dec-19.
- Manufacturing PMI index fell to its lowest figure since 2009 in November concurrent with weak processing industry output and high levels of stocks.
- The services sector recovered from its worst figure since 2016 since May.

- The president's approval ratings have improved marginally since the start of the year but far from the highs of 2014-2017.
- The share of people seeing that Russia is going in the right direction has improved marginally following the president's ratings.
- Consumer sentiment has recovered in 2019 to a relatively high level, which can be reflection of a weakening inflation and maintained growth in wages.

- Russian macroeconomic indicators
- Kazakhstan, Belarus and Ukraine
- Future growth, national projects and the risks ahead

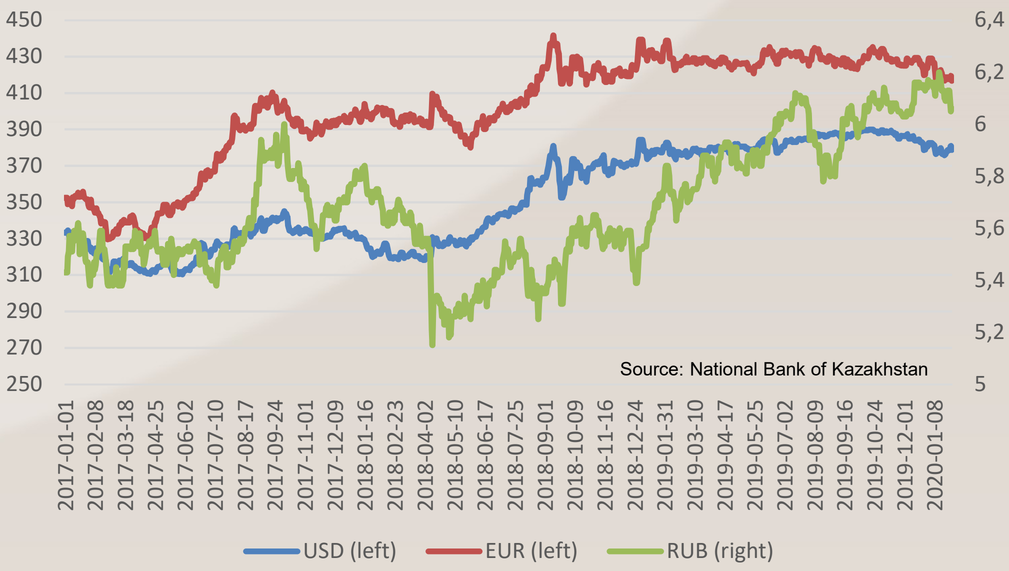
Kazakh economic growth strong in 2019 due to state stimulus as oil exports face disruptions

Kazakh economic growth has accelerated in 2019 to 4.5 % despite disruptions in oil supply and volatility in global commodity prices. Much of the growth was supported by strong state stimulus that boosted retail (5.8 % y/y) and construction (11 %) growth. Wage hikes have kept inflation high also in 2019. Due to this, the National Bank has maintained tight monetary policy (key rate at 9.25 % in Dec-19) despite pressure from the government to cut rates.

Oil exports from Kazakhstan suffered from contamination problems through the Russian Druzhba pipeline and the Atasu-Alanshankou pipeline to China, the first of which Russia will compensate $15 mln in losses. Kazakh state has intensified the push to localize production inside Kazakhstan as 90 % of consumer goods are imported which could keep new foreign investors at bay. Privatization of Kazakh state companies (e.g. energy giant KazMunaiGaz) was announced yet again but investors are not optimistic due to previous false starts.

President Tokayev in 2019 the powerful former president Nazarbayev faced off in 2019 with the result that Nazarbayev now controls all the senior appointments. Tokayev in turn has made some changes to his cabinet and passed decrees to increase political freedom in Kazakhstan (e.g. freedom of assembly) following protests over social inequality.

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



Main economic indicators	Real		Forecast	
	2018	2019	2020	2021
GDP, % y/y	4.1	4.5	3.8	3.9
Industrial production, % y/y	4.1	3.8	3.6	3.7
Inflation, % y/y	6.0	5.3	5.3	5.1
Current Account Balance, bn USD	0.9	-3.6*	-3.6	-4.4

*first estimate.
Source: Ministry of National Economy of the Republic of Kazakhstan Committee on Statistics
Forecasts from Consensus Economics January 20, 2020

Belarus' economy suffering again from disputes with Russia

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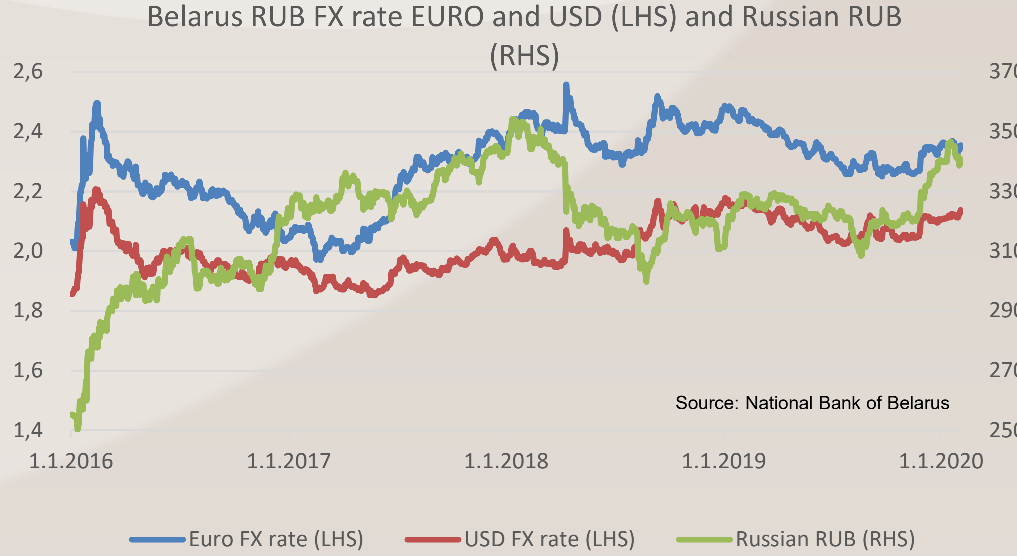
Economic growth more than halved in 2019 from 3.1 % in 2018 to 1.2 % in 2019. All sectors of the economy slowed down with the exception of agriculture. Especially industrial production was the main drag on economic growth (5.7 % vs 1 %). Belarus' main export industry oil refining that is heavily dependent on the flow of crude material from Russia suffered from a reoccurring dispute with Russia.

Also retail sales decelerated significantly from to 4.2 % (vs 8.3% in 2018) despite robust growth in disposable incomes (6.3% (y/y) in 11m19) that were supported by state subsidies and increases in public service wages. Construction sector barely managed the 2018 levels with growth of 0.1 % in 11m19.

Russia supplies Belarus with 80 % of the energy it uses and processes to final fuel products. Russia has frequently used this as leverage to influence Belarusian economic and political decisions with one of the most disputed issues being the integration of the two countries into one state. Again in Jan 2020, Russia cut off oil supplies to Belarus due to price dispute and Belarus turned to other countries such as Norway for crude oil. Belarus has tried to fight off Russian advances and has been for years striving to build economic structures circumventing Russian energy and subsidies with limited success.



Main economic indicators	Real		Forecast	
	2018	2019	2020	2021
GDP, % y/y	3.0	1.2	1.5	1.6
Inflation, % y/y	4.9	4.7	5.5	5.3
Industrial production, % y/y	5.7	1.0*	2.6	2.5
Current Account Balance, bn USD	0.0	-0.9	-1.3	-1.4

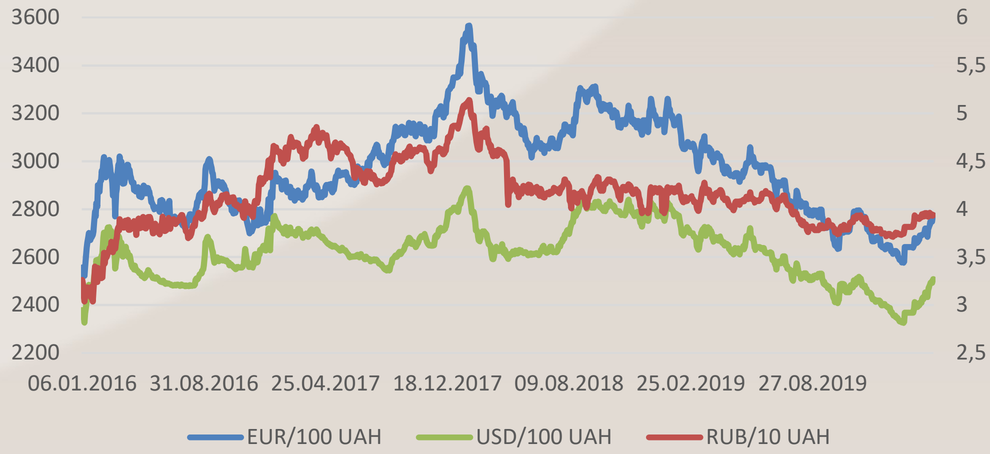
*First estimate by Belstat. Source: Belstat, National Bank of Belarus
Forecasts from Consensus Economics January 20, 2020

Ukrainian economy supported by consumer demand but investment is lagging

Ukrainian economic growth in 2019 ended roughly at par with the previous year with a growth rate of 3.5% (y/y) for the first 11 months of the year. In the first half of the year, growth was strong especially in consumer demand supported sectors such as retail. Consumer demand was driven by strong increases remittances as well as in real wages in the private sector as an answer to increasing emigration and Ukrainian economic growth slowed down towards the end of the year. Furthermore, growth was supported by the ever-important agricultural sector that is the other main export sector in Ukraine in addition to raw metals. The deceleration of industrial growth (-8.3 % y/y) in economic growth in the end of 2019, for which the weak growth from mining and quarrying (+0.8%) was not able to compensate for. Furthermore, manufacturing output fell by 4.7 % y/y in 2019.

Uncertainty surrounding the reform and the IMF loan agreement is still pressing on investor confidence despite a free movement of people and goods between the EU and Ukraine. Investment demand remains constrained by tight interest rate policy of the National bank that has, on the positive side, constrained inflation in 2019. This could help Ukraine reach income levels in its neighbouring countries that have been a popular destination of brain drain from Ukraine: some estimates claim that Ukraine has lost as much as 10 mln people since the start of the war.

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



Main economic indicators	Real		Forecast	
	2018	2019	2020	2021
GDP, % y/y	3.4	3.5*	3.3	3.5
Inflation, % y/y	10.9	4.1	5.1	5.2
Industrial production, % y/y	1.1	-1.8	1.7	2.5
Current Account Balance, bn USD	-4.4	-4.2*	-5.2	-5.7

*Jan-Nov2019. Source: National Bank of Ukraine, UkrStat
Forecasts from Consensus Economics Jan 20th 2020 survey

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Future outlook: modestly increased growth ahead fueled by state spending

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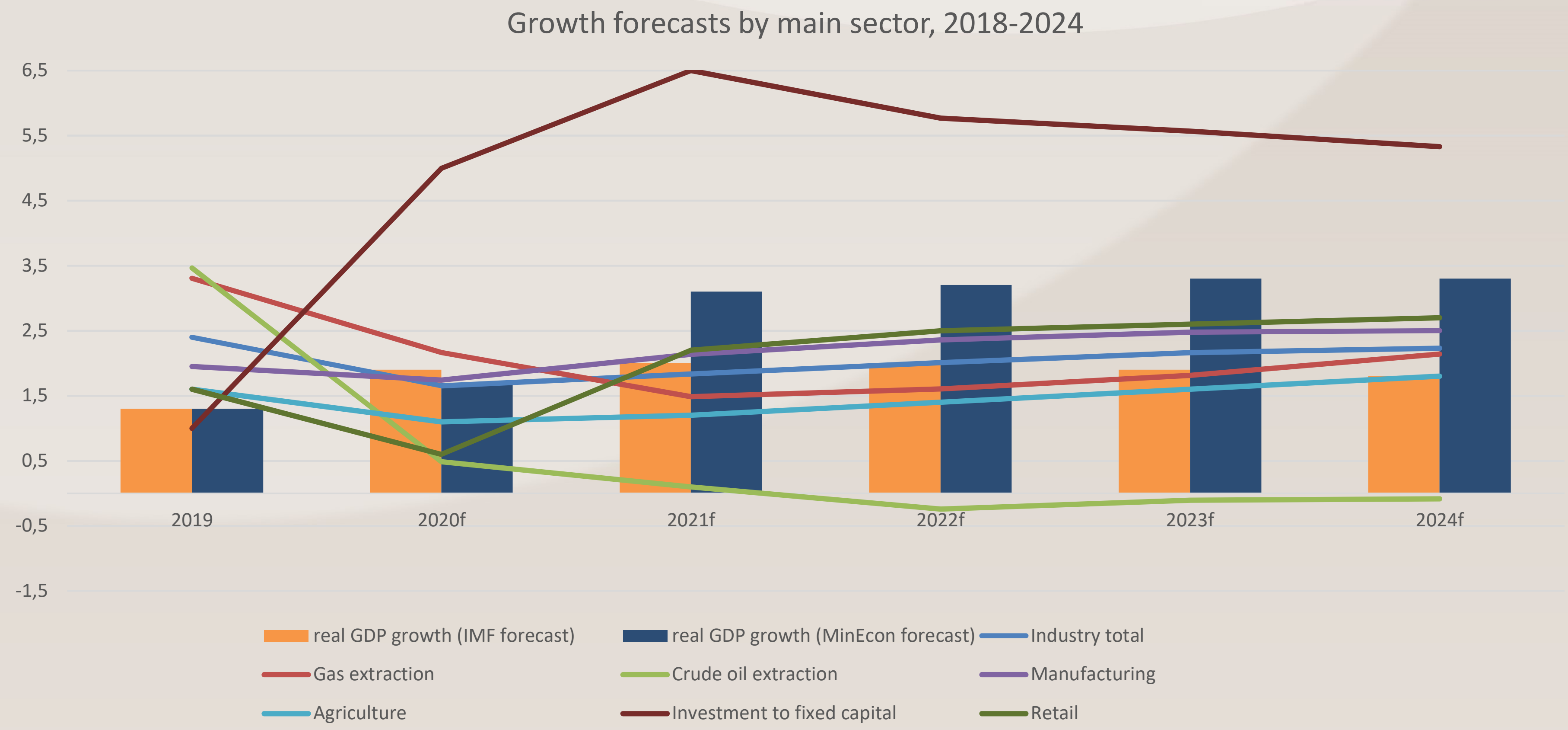

- Official MinEcon forecasts expects growth to nearly double by 2021 boosted by public investment and growth is to stem from investments fueling manufacturing and private consumption from 2021 but oil extraction will decline. Natural gas production will continue to grow.
- Independent forecasters (e.g. IMF) also prognose the decline of oil extraction and rise of processing industry but with only a half of the growth rates as in the official forecasts.

Future outlook: Restarted National projects aiming to boost Russia's economic growth

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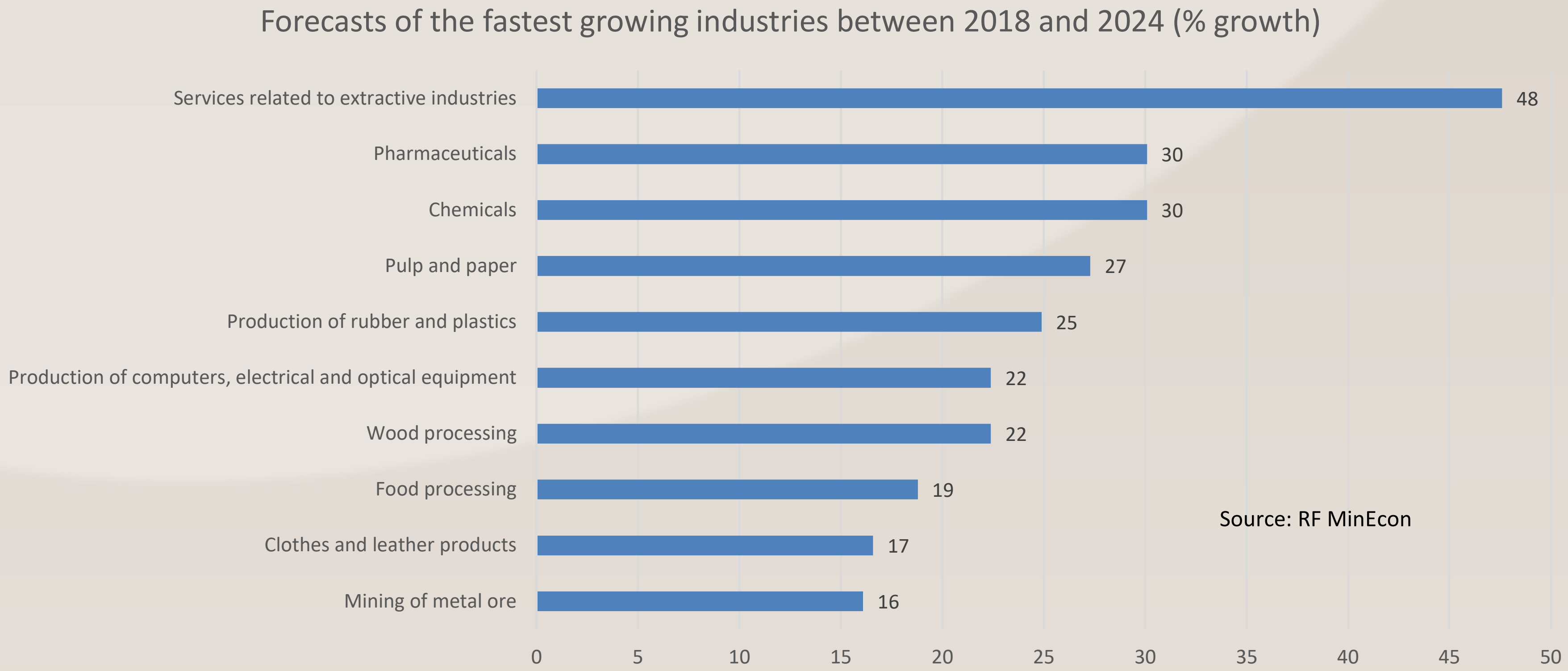
- Approximately 26 trillion RUB (410 bn USD) of public investment by 2024 will be pumped through the National projects directed at e.g. infrastructure, digitalization and education.
- The projects have not advanced as planned: 88 % of the planned funds were actually invested in 2019 and only 54 % of the Digitalization project funds.
- Additional 4 trillion RUB promised by Putin in January 2020 for social spending (support for families with small children, maternity capital)
- A failure to advance the National Projects was probably what finally toppled Medvedev's cabinet in January.
- Many of the same faces appear in the Mishustin government but noteworthy is that a former Putin advisor and an architect of the National Projects, Andrey Belousov, was appointed as the first deputy PM to oversee the projects.
- However, these efforts may be diluted by a lack of reform of the judicial system and trust-building between private sector (consumers and firms) and state officials. Naturally, failure to succeed in the outspoken goals will exacerbate the lack of trust.

National Project	Budget (bn RUB)	Share of total
Improvement of Critical Infrastructure	7001	27 %
Road Safety and Development	4480	17 %
Ecology	4041	16 %
Demography	3108	12 %
Digitalization	1578	6 %
Health Care	1552	6 %
Better Housing and Living Environment	1066	4 %
International Cooperation and Export Promotion	889	3 %
Education	785	3 %
Science	636	2 %
SME Development	478	2 %
Culture	117	0.5 %
Labour Productivity and Employment	51	0.2 %
Total	25781	

Source: Audit Chamber of RF

Russia aims toward a shift to processing and to export its extractives' know-how



- The fastest expanding sectors up to 2024 according to the official forecasts are sectors related to Russia's natural riches but with a higher degree of processing.
- These sectors are identified with the highest potential but some of them can be seen as the focus areas for government support in the next four years. For example, machinery and food processing have enjoyed generous state subsidies after the imposition of sanctions and counter-sanctions in 2014.

Main risks to growth arise from global slowdown, weak execution of the revived National Projects…

- Weakening growth from China: Coronavirus epidemic can amplify Chinese slowdown and if the the epidemic continues past the first quarter, Russia is one of the most affected countries. Also, the US-China trade war could fare out again in 2020.
- Weak growth from the EU: growth in large EU countries at a standstill but could improve moderately in 2020-2021.
- National Projects may prove unsuccessful even despite the additional pressure and the new government: uncertainty would continue to subdue the investment climate.
- Large public spending could make inflation surge but unlikely at least 2020 given the low inflation and weak economic activity wittnessed in 2019. Deputy PM Belousov has announced that 300 bn RUB could be spent from the National Wealth Fund without posing a threat to price stability.

…and Russia's adaptation to sanctions

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– Does Moscow have enough incentives to remove sanctions?
  - Powerful industries may have more to loose from the removal sanctions than additional ones and these structures are strenghtened every day sanctions are in place. Some industries would thus, prefer to remain protected by the sanctions and fear exposure to global markets, which can maintain inefficiencies.
  - Low levels of FDI (and diffusion of the newest technology etc) could still create pressure for easing geopolitical tensions as China has not invested into Russia as hoped even though merchandise trade has surged in the last 20 years.
  - Some of the sanctions (mostly US sanctions) are written without a way out for the perpetraitor (Russia in this case), which may reduce the willingness to correct its actions.