Russian Economy in 1Q20

Positive start of the year to be followed with an unavoidable crash

May 8, 2020

Analyst, Dr (Econ) Sinikka Parviainen

Key takeaways

Recent events in 1Q20 for the Russian economy

- **COVID-19 infections started to rise strongly also in Russia and by end of April there were already over 150 000 confirmed cases and Moscow went into lockdown.** Especially Moscow mayor Sobyanin has stepped to the fore in managing the crisis, while president Putin has remained surprisingly invisible and at the background.
- **GDP growth in 1Q20 estimated at 1.8 %.** Real GDP growth remained surprisingly strong in Jan-March led by strong retail and manufacturing. Only services sector contracted in 1Q20 and declined by -4.4 % y/y.
- **Industrial production growth halted in March.** Favourable conditions still present in Jan-Feb resulting in a 1.5 % growth in industry for 1Q20. Virus restriction started to affect to through decreasing demand and industrial production halted to 0.3 % growth in March. Especially manufacturing upheld economic activity while extractive induties were hit by decline oil prices.
- **Rouble depreciated due to the oil price war and low external demand caused by corona virus.** Following a steep decline of oil prices by -30 % due to an oil price war between Saudi-Arabia and Russia, RUR lost over 20 % of its value. In April, following strong FX interventions by the state, the RUR gained back 10 % despite continued fall by oil prices.
- **Inflation remained modest at 2.5 % despite a weaker currency.** Inflation is expected to accelerate in 2020 due to constrains in production caused by the virus restrictions and a weak RUR.
- **CBR lowered its key rate to record low of 5.5 % to boost lending.** The cut in the key rate is probably not enough to increase economic activity given the severity of the COVID-19 crisis but further cuts could threaten the RUR to weaken further.
- **Sentiments in services and manufacturing are at a historically low levels.** In April, the Purchasing Managers Index (PMI) fell to its lowest level in record and manufacturing PMI dropped to its lowest since 1997.
- **President's approval rating hits rock bottom.** Putin's approval rating decreased to 59 % in April decreased to its lowest level as president.
- **Real waged showed strong growth in 1Q20 that upheld strong retail figures.** Real disposable incomes at the same time contracted by -0.2 y/y.
- **Unemployment could nearly double in 2020.** Ministry of Employment projects that there will be 6 million unemployment from Russia, when in 1Q20 there were 3.5 million.

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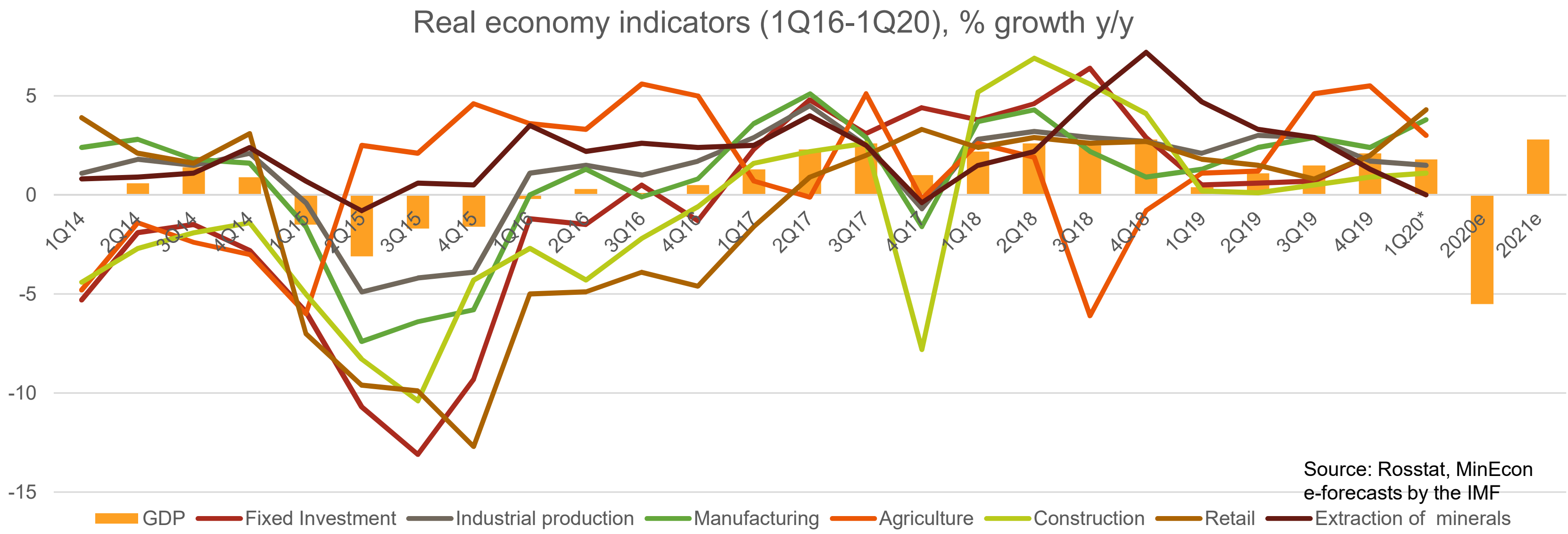
Russian economy in 1Q20

Calm before the storm

Retail and manufacturing boosting the economy in 1Q20 with some signs of decline visible in March



Relatively positive results in 1Q20 in many sectors, effect of virus restrictions showing in March

- Others sectors except services agriculture and extractive industry, 1Q20 showed positive dynamics. The growth drivers were retail and processing industries, namely, wood processing. Retail sector showed its highest growth rates since 2013: growth accelerated to 4.3 % following strong growth in real wages. At the same time services sector contracted by -4.4 %. Surveys to industrial enterprises in April by the Gaidar Institute show a decline in demand comparable to 2009 crisis.
- Construction sector also raised its output by 1.1 % after many sluggish quarters in 2019. Manufacturing sector growth (1.5 % y/y) maintained close to the levels of the previous quarter (1.7 % y/y in 4Q19).
- Extractive sector that is the most vulnerable to external conditions was brought down by declining global demand in commodities and the followed decline in the crude oil price.

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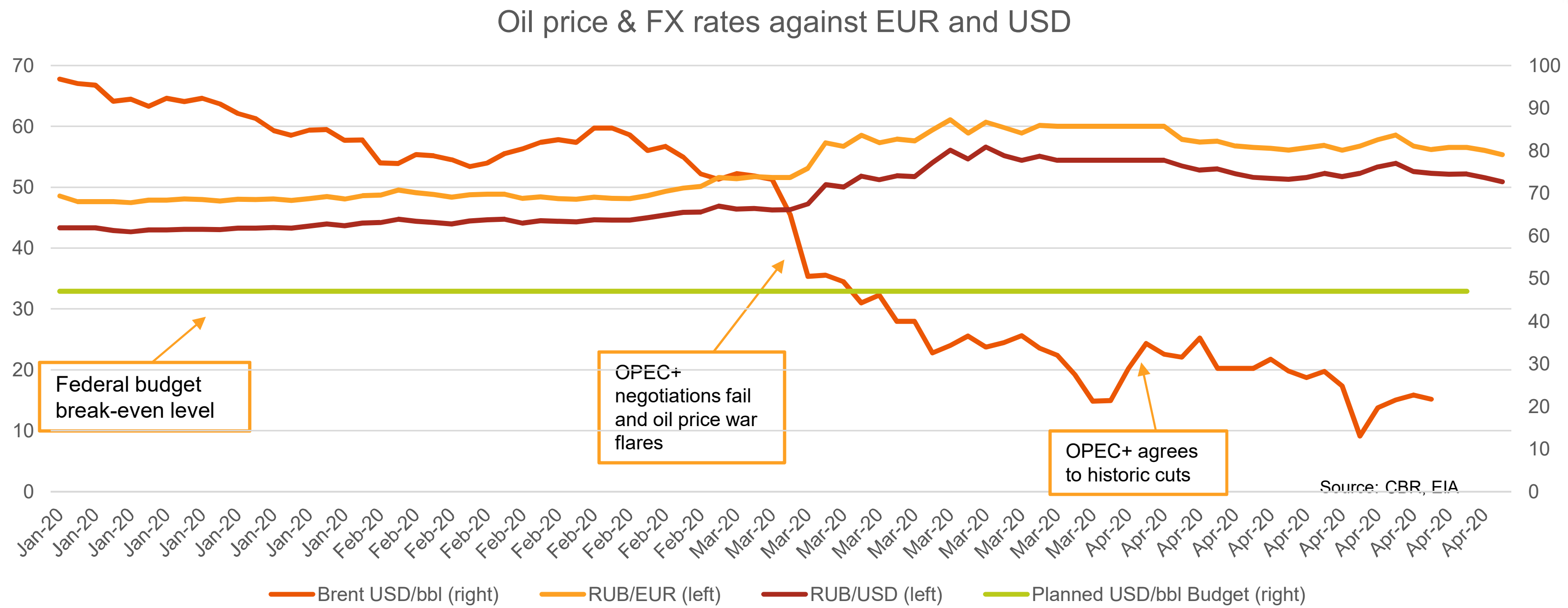
Global demand decline and the oil price war weakened the Rouble



Rouble has devalued due to an oil price war and lower global demand but less than expected

- Rouble devalued slowly from the start of 2020 as demand from China nearly halted after strict quarantine measures and closing of the Russo-Sino border end of January.
- The falling demand from China and the spread of the virus have not however, given a heavy blow to the RUR on their own. The oil price after the OPEC negotiations failed in March and weakened the RUR against the USD by 20 % during March. An agreement on 10 mbbl cuts was reached on April 10th, but that was not enough to calm the markets.
- The Central Bank has engaged in April in unprecedented operations on the FX markets to support the RUR and the efforts seem to have been successful as the RUR has not weakened as much as the oil price.
- After the lows of March 18th, the RUR strengthened again by 10 % in April and is expected to remain at around 80 against the EUR.

Inflation expected to accelerate modestly in 2020

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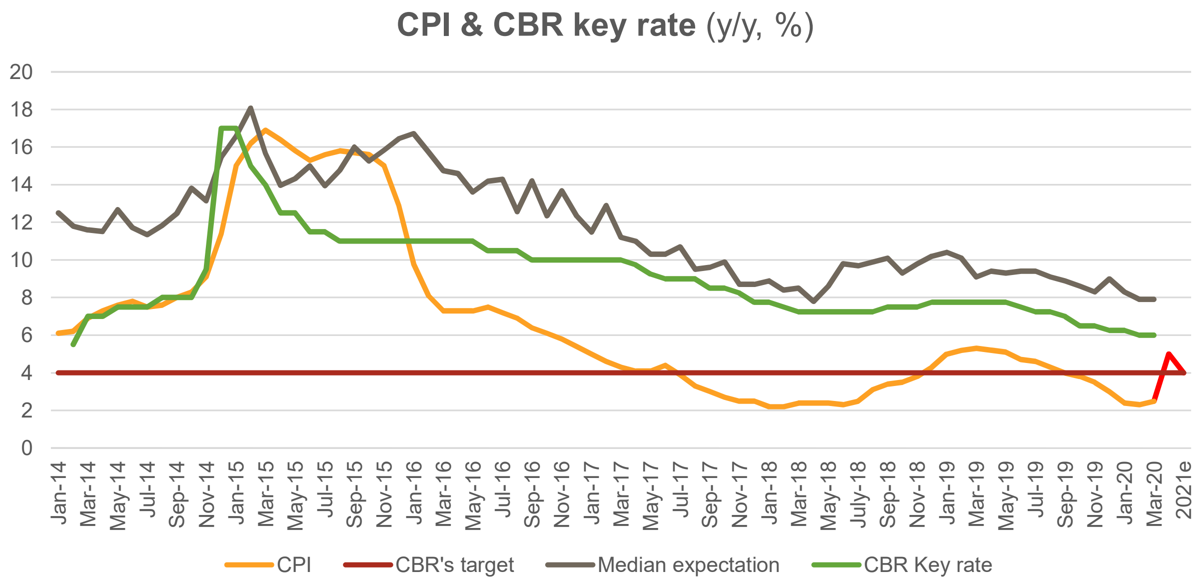


Mar-2020 % y/y	
CPI	2.5
Food	2.2
Non-food	2.5
Services	3.0

Source: CBR, HSE Zentr Razvitya

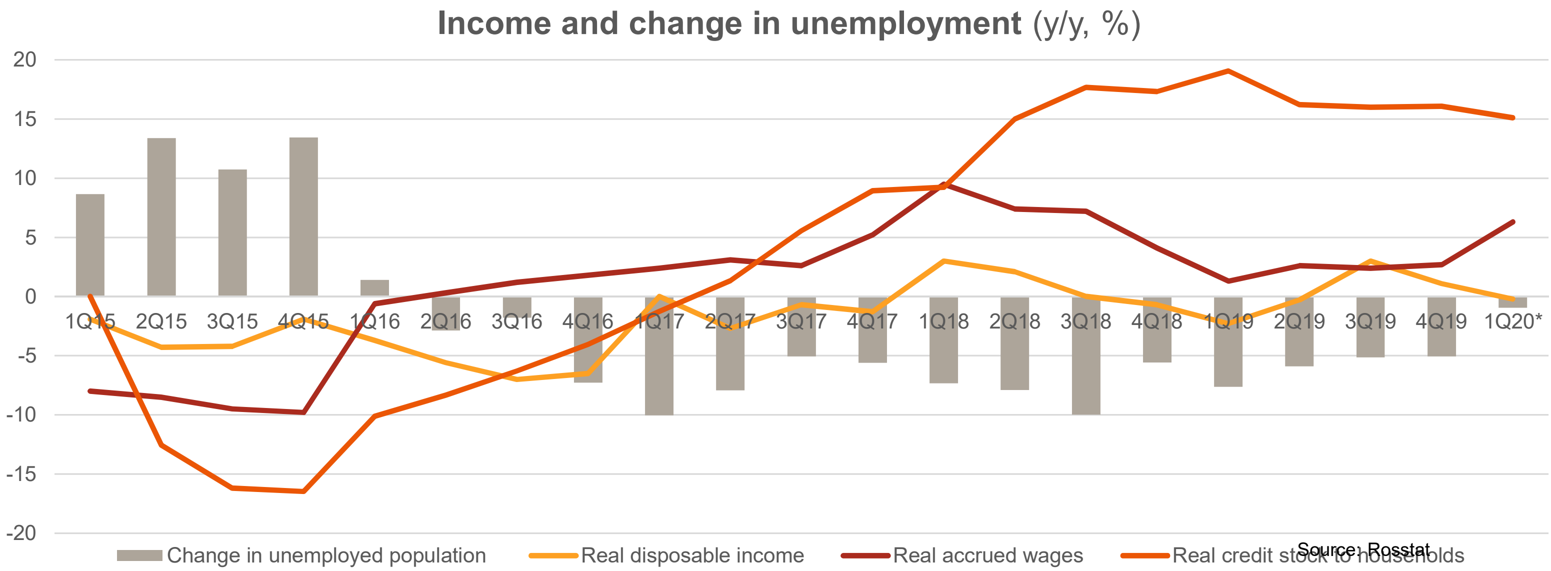
Inflation has modestly decelerated but remained modest in 1Q20

- Inflation has remained below the CBR inflation target of 4 % in 1Q20. Growth in consumer demand was strong and lower food prices driven by an excellent yield. Strong depreciation of the RUR in March contributed to an acceleration in inflation from 2.4% in Feb to 2.5 % in March.
- Most forecasts expect inflation to speed up above the CBR target in 2020 due to the weakening currency in 2020 but inflation is likely to remain below 6 %. In addition to the continuation of the quarantine measures, the uncertainty regarding agricultural yield that could be less than optimal due to a projected hot summer, create uncertainties to the forecast.

Key rate decisions

- CBR lowered its Key interest rate in Apr-20 by 0.5 %-points to 5.5 % to boost weakening economic activity.

Unemployment expected to nearly double in 2020



Real wages growing faster in Jan-Feb but disposable incomes decreasing

- Real wages grew by 6.5 % (y/y) in Jan-Feb following expansive policies by the state.
- Unemployment has continued to decrease in the beginning of the year and unemployment rate (4.7 %) remains modest.
- Preliminary information from April implies layoffs and decreased working hours across many sectors as the mandatory paid holiday was extended. Large increases in employment not expected as firms usually prefer cutting working hours and wages to layoffs.
- Ministry of Employment estimates that there will be 6 mill unemployed by the end of 2020 (from the current 3.5 mill.). The most virus-affected industries such as restaurants and hospitality services employ at least 5.3 million people.
- 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.

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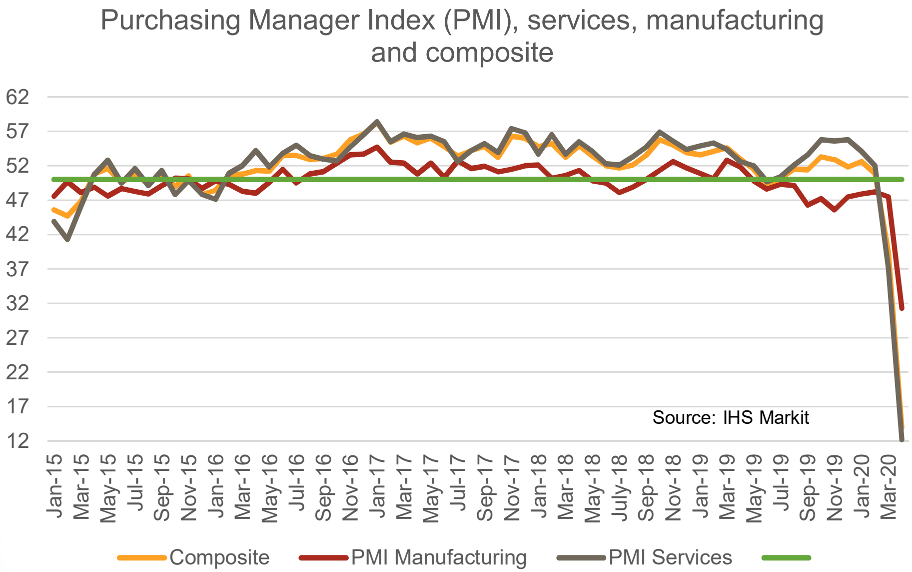
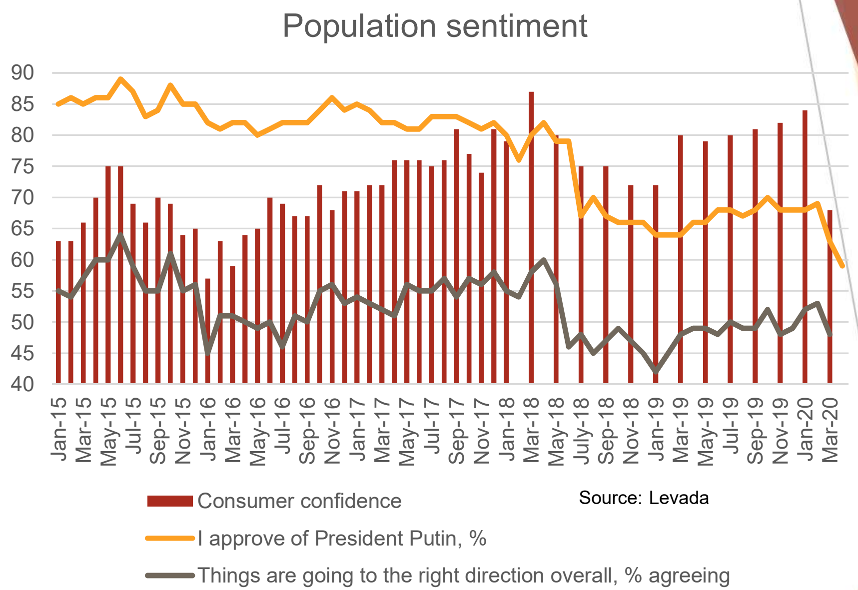
Sentiment in services to plunges to historical lows and Putin's popularity falls to the 1999 level





- Sentiment in services in April dived to its deepest level in history and to a half of the last major in dip in 2009.
- Manufacturing sentiment in April plunged to its lowest level in nearly 25 years after lock-down spread to most regions in Russia.
- Main concerns in 1Q20 were related to falling demand and stricter quarantine rules started to directly hamper production.

- Putin's approval ratings have decreased to his lowest level as president. The last time the rating was lower than 59 % was in 1999 when Putin acted as Prime Minister.
- The share of people seeing that Russia is going in the right direction has remained relatively high despite the advancing virus in Russia.
- Unsurprisingly, consumer confidence has fallen as job losses and shutdowns became evident in March.

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Kazakstan, Ukraine and Belarus

Varying responses to the COVID-19 crisis

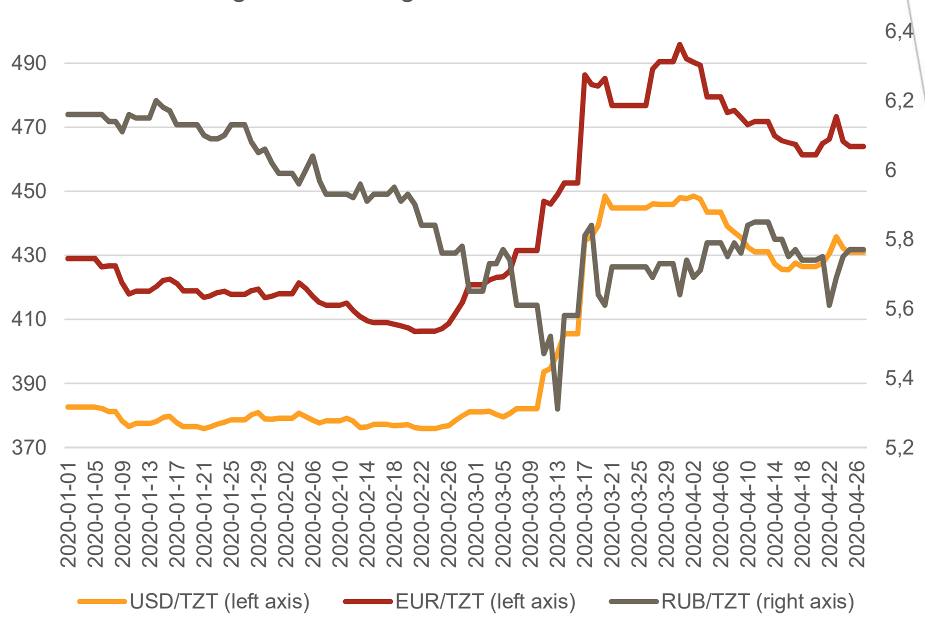
Kazakh economy will fall into a recession for the first time in more than two decades

In 1Q20, real GDP growth amounted to 2.7% compared to the corresponding period of 2019. Investments in fixed assets increased by 5.1%. The IMF expects the Kazakh real GDP to contract by 2.5 % in 2020, as external demand for crude and manufactured goods fall notably and pandemic measures decrease consumer demand and investment. In 2020, Kazakhstan is projected to endure its first full-year recession since 1998 due the coronavirus outbreak, the collapse of global oil prices and fragile government finances.

On May 2020, President Tokayev signed a decree against all expectations, which ended the senatorial mandate of ex-president Nursultan Nazarbayev's daughter Dariga, who has served as a speaker of the senate since Nazarbayev stepped down a year ago. Dariga was long expected to be a successor to her father and the position she held was second most powerful in the country. Reshuffling of officials is nothing new to the political landscape of Kazakhstan and the powerful position of the first president Nazarbayev remains. The main question is whether the dismissal was done with Nazarbayev's consent or knowledge.

COVID-19 may prove to be an important test for Tokayev, who has taken centre stage during the crisis while Nazarbayev has moved backstage. On one hand, it is a major risk as the country is facing serious problems with its oil depended economy and health care system. On the other hand, this is an unprecedented opportunity for Tokayev to prove his capability as leader of the country.

Tenge FX rates against EUR, USD and RUB



Main economic indicators	Real		Forecast	
	2019	1Q20	2020	2021
GDP, % y/y	4.5	2.7	-2.5	4.1
Industrial production, % y/y	3.8	5.8	na	na
Inflation, % y/y	5.4	5.3	8.1	6.5
Current Account Balance, % GDP	-3.6	na	-6.8	-5.5

*first estimate.
Source: Ministry of National Economy of the Republic of Kazakhstan Committee on Statistics
Forecasts from the IMF and Sberbank CIB Research

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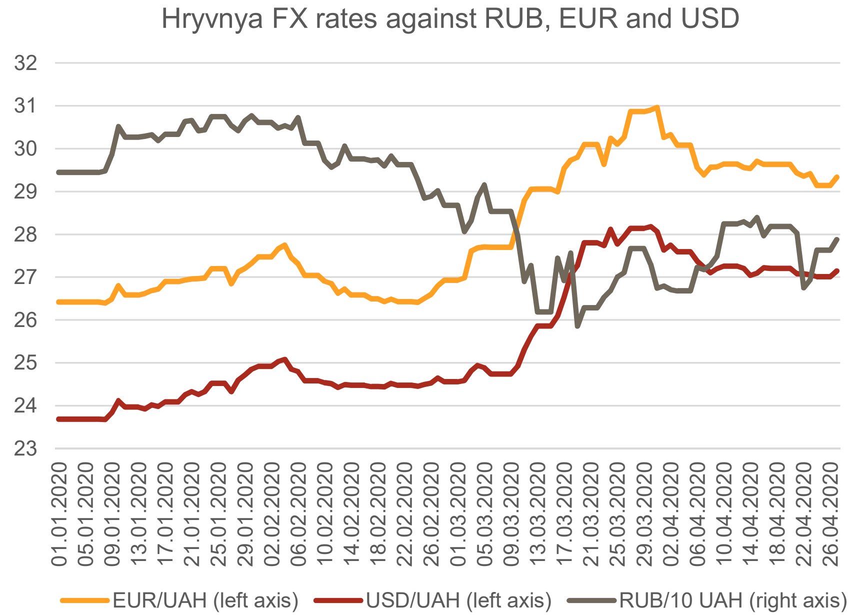
Analysis by Sinikka Parviainen and Sanna Hentunen

Progress made in debt payments hampered by virus restrictions and political infighting in the Ukraine

Ukrainian economy has contracting already since end of 2019 and the contraction has continued to deepen with contraction of -7.7 % in March. Increasingly adverse development was attributable to a steeper drop in manufacturing output (8.5% y/y March), which was in turn most likely due to the quarantine measures and weak external demand. Meanwhile, mining and quarrying output decreased by 4.3% y/y in March. Other sectors also showed worsening dynamics. Agricultural output dropped 5.2% y/y in March after 1.0% growth in February. At the same time retail trade growth remained at 6.1% growth despite halving from February (15.7%). The COVID-19 outbreak started in Ukraine slightly earlier than in other CIS countries and thus, some believe that recovery will start slightly earlier than neighbouring countries such as Russia and Belarus.

The political situation remains volatile: governmental crises have been followed by new ministerial appointments and President Zelensky has witnessed not only fast shifts in parliamentary support for himself but also the collapse of his one-party majority. Importantly though, Zelensky got the parliament majority behind two crucial votes earlier this spring, which paved the way for a possible agreement with IMF. Before the coronavirus outbreak Ukraine was on track to service its huge debt payments but the virus has reversed the good progress made. To unlock the critical IMF aid package (5-8 billion $), Zelensky still needs to pass the Bank reform bill in May.



Main economic indicators	Real		Forecast	
	2019	1Q20	2020	2021
GDP, % y/y	3.2		-7.7	3.6
Inflation, March % y/y	7.9	2.3	7.7	5.9
Industrial production, % y/y	1.1	-5.0	na	na
Current Account Balance, % GDP	-0.7	0.2	-2.0	-2.4

* For 2019. Source: National Bank of Ukraine, UkrStat
Forecasts from the IMF and Sberbank CIB Research

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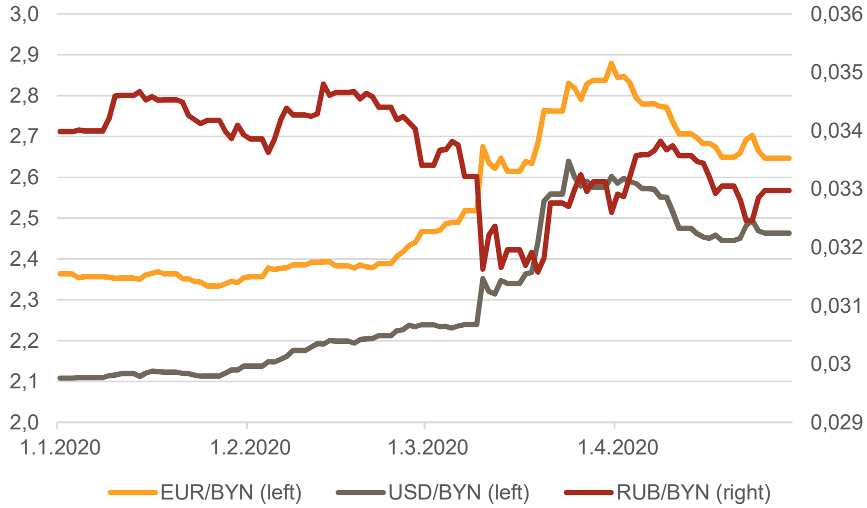
COVID-19 management in Belarus creating uncertainty that will hit the economy with a lag

Belarus' economy in 1Q20 contracted by a mere 0.3 % (y/y) that is much less than in many other countries in the region. In 1Q20, Russia and Belarus also enaged in another bitter dispute on oil prices for Belarus' important oil refineries that was resolved in April by the falling global oil prices. One reason for the relatively positive results can traced to lack of any formal restrictions despite a spreading virus. In the next quarters to come, Belarus is however expected to be hit with both the low global demand and the coronavirus that will decrease consumer confidence as the government has not imposed nearly any protective measures. Belarus is thus, expected to start recovery later than its neighbours and ignorance towards the virus could keep foreign investors at bay.

There have been some estimates on whether the corona virus pandemic could be a serious crack in Lukashenko's regime. Lukashenko has repeatedly lied and belittled the threat, but people have taken to themselves to activate precautionary measures such working from distance. The country is only a few months away from the next presidential elections, and despite the speculations, it seems almost certain, that Lukashenko will win by landslide.

Lukashenko has repeatedly complained that Moscow pressures his country into closer integration or even towards unification, in exchange for cheap energy. This has somewhat surprisingly brought Lukashenko and his opponents closer together first time in years since their interests coincide. This truce between the authorities and the opposition ended with the onset of the COVID-19 pandemic – Lukashenko's chosen management style has caused a storm of criticism.

Belarusian rouble FX rates against EUR, USD and RUB



Main economic indicators	Real		Forecast	
	2019	1Q20	2020	2021
GDP, % y/y	1.2	-0.3	-6.0	3.5
Inflation, % y/y	4.7	4.9	6.5	4.9
Industrial production, % y/y	1.0	-0.7	na	na
Current Account Balance, % GDP	-1.8	na	-2.9	-2.5

Source: Belstat, National Bank of Belarus
Forecasts from the IMF and Sberbank CIB Research

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How bad can it get in 2020?

Russia is facing a double shock from oil and COVID-19

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Russian economy in 2020-2021: Oil and Covid-19

- Russian economy is facing a double crisis: very low oil prices and the coronavirus crisis.
- Oil price has lost nearly a half of its value and Russia is expected to loose all its oil revenues in the federal budget. 50 % of federal revenues are from oil and gas.
- Russia closed its Eastern border already in January and imposed quarantine rules behind the rest of Europe in April.
- Now Russia is the country with the fastest growth in infections in Europe and 5th mos infections in the world.
- Russian leadership is pledging for gradual opening up of the economy in mid-May with regional differences. Moscow will continue self-isolation until May 31st but industrial enterprises and construction work can resume next week.
- Opening up is due to the simple fact that the population cannot cope with any more ”non-working/non-holiday weeks” as the state support is not sufficient, e.g. 12 000 RUR (150 EUR) benefit for the unemployed and same sum as subsidy for wages to SMEs if they refrain from laying off more than 10 % of their staff; people aged above 65 will receive a approx. 70 euro payment/month of quarantine ex post for staying at home; postponement of tax payments.

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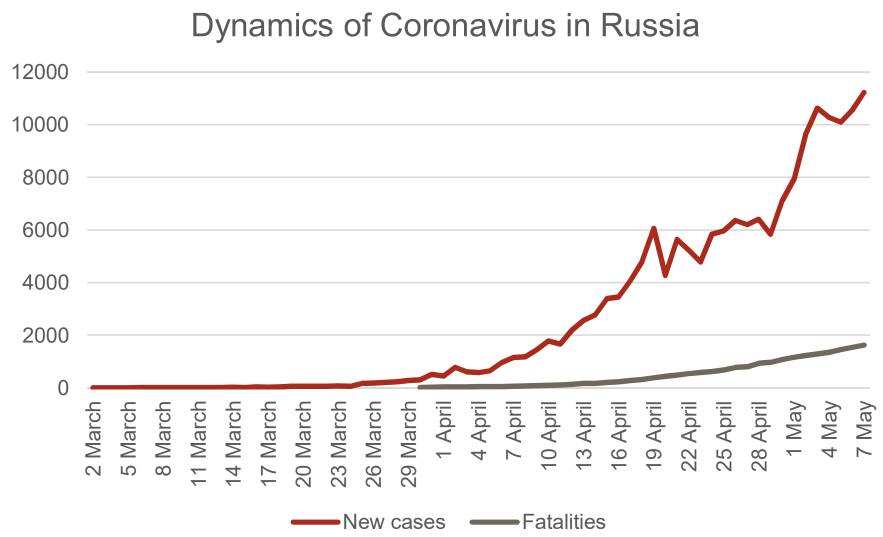
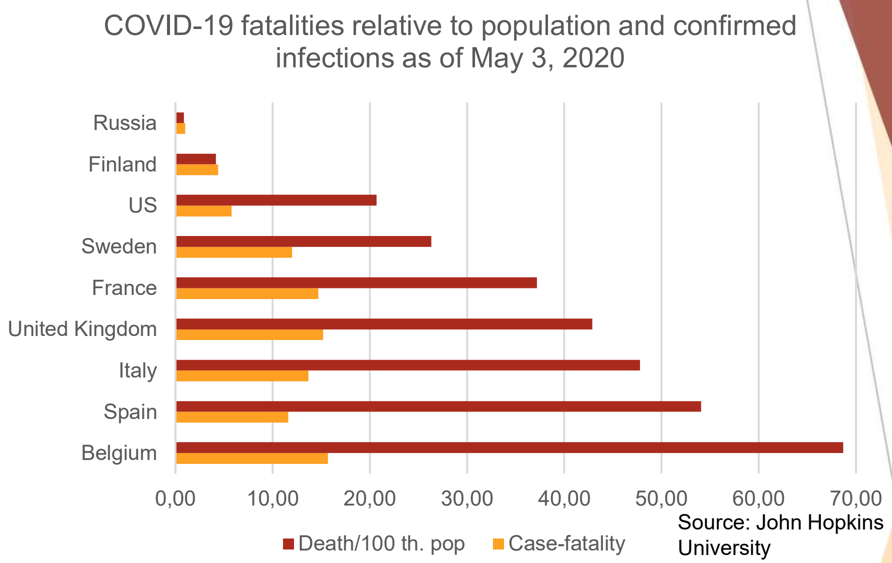
Where is Russia at in the epidemic?
Official statistics show a low relative death toll for Russia





Source: John Hopkins University

- Numbers of infections are not comparable as such between countries due to e.g. testing, registering of illnesses and age structure. Part of the the accelerated growth rates in last weeks could be attributed to increased testing.
- Experts say that comparing the relative number of fatalities can help to determine how deeply spread the virus is in the population. Low number of deaths are raising concerns over Russian coronavirus statistics and the Doctors Union in Russia claims the death toll is heavily underestimated. In addition to possible cover up of fatalities, one reason could be that the epidemic is really at a very early stage while testing is aggressively increased at the same time.
- Most plausible reason for the low fatality rate is how causes of death are categorised. Fatalities as a whole and related to respiratory problems can be compared to a “normal year”, which might be indicative of how far spread the virus is. For example, Moscow recorded 7,312 cases of pneumonia in Feb-20, 53 % (y/y) and 37 % (y/y) in Jan-20. On April 27, Moscow deputy mayor, Rakova, announced on that the number of patients hospitalized with pneumonia had risen by 70 % in a week.
- However, the WHO has commended Russia for implementing all its recommendations so far.

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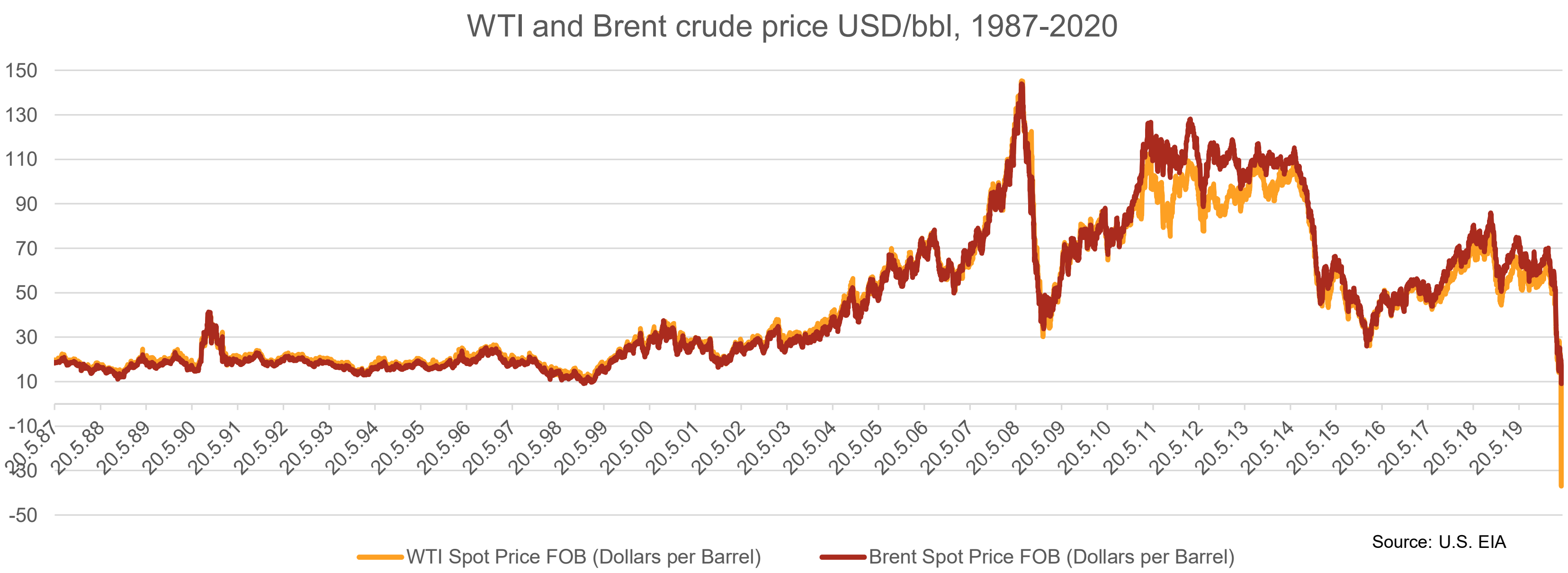
Unprecedented oil market turmoil



- Coronavirus has led to an unprecedented decline in oil demand as the crisis has hit fuel dependent industries such as transport.
- Lack of understanding on the severity of the corona crisis and a will to finally push out the U.S. shale producers, Russia and Saudi-Arabia initiated an oil price war in March 6th after the OPEC+ oil production cut agreement negotiations ended in vain and led to a 30 % drop in the oil price. Luckily, an agreement was reached on April 10th on unprecedented oil production cuts also due to increasing pressure from the U.S.
- U.S. WTI oil brand dropped to negative for the first time in history in April as the U.S. producers, who had expanded their extraction heavily in recent years when oil prices have been historically high, ran out of storage space and were forced to dump the excess to the market.
- The drop in oil prices nearly at the level of the credit-crunch crisis but in a shorter period of time.

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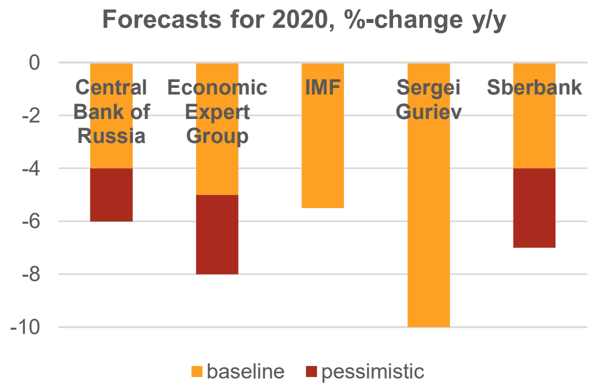
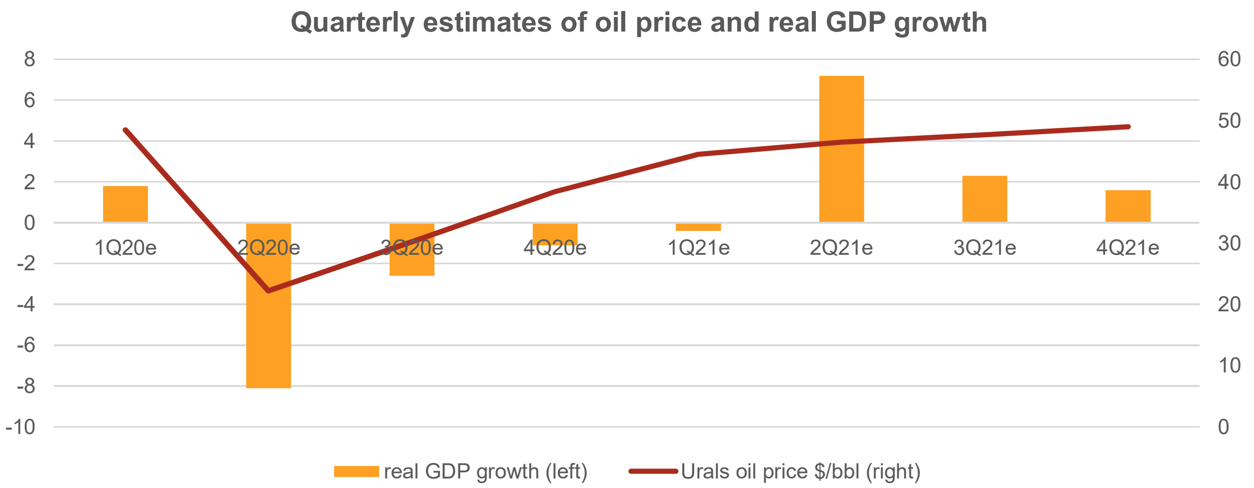
Rough estimates on the impact of virus restrictions and decline in oil price

Alternatives for real GDP %-change without any mitigating factors	Oil price Urals (annual average)		
Lenght of lock-down	20 $/bbl	35 $/bbl	50 $/bbl
Lock-down for April-June and then gradual exit	-13.5	-10.5	-7.5
Lock-down until Mid-May and then gradual exit	-10.5	-7.5	-5.0

Source: East Office

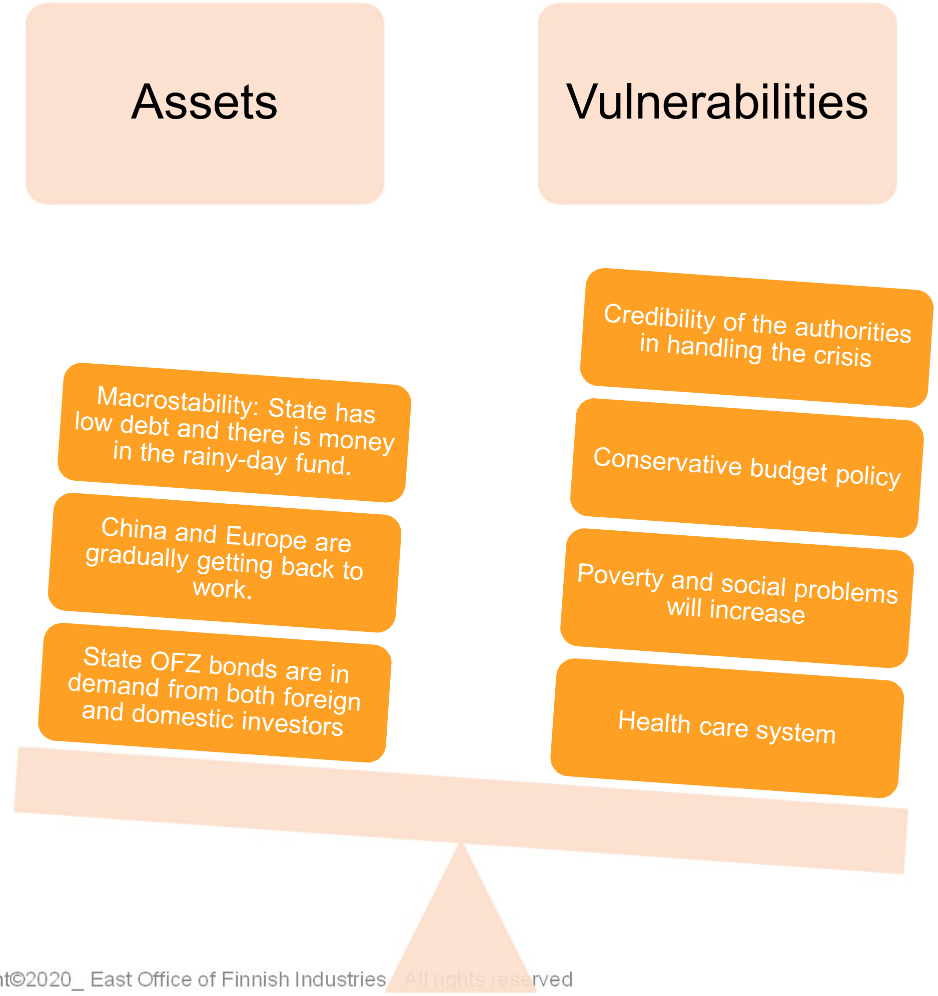




Source: Consensus estimates collected by HSE Tsentr Razvitya

- Impact of the coronavirus restrictions come in the short-term through the government imposed restrictions and through uncertainty related to the credibility of the government actions.
- In Moscow, self-isolation will not end in Mid-May but industrial production and construstion sites are allowed to work.
- Based on European experience, a month of lock-down decreases real annual GDP by 2-4%. Differences come from severity of lock-down (and how rules are followed) but also from the ability of the workers/sectors to switch to distance work.
- Effect of the decline oil price well-documented in the Russian case. Empirically, -10 % in the Urals oil price, would approximately result in -1% of annual real GDP.

Russia is not well-prepared for the double crisis, but the impacts may be mitigated as the rest of the world is opening up



- Russia is well-prepared for a negative oil price shock but the virus has exposed other vulnerabilities:
  - 2/3 of Russians have no savings, half can only afford food, housing and clothes and 42 % say that their financial situation has deteriorated due to the crisis.
  - Health care system inadequately resourced and protected outside of Moscow.
  - Low trust in the authorities hampers crisis management but still 46 % say the measures have sufficient.
  - Forgetting the (informal) migrant workers and the homeless can reverse the fight against the outbreak.
- Russia has 10 % of GDP worth of liquid assets in the National Welfare Fund, which are used to defend the RUR and were partly earmarked to fund the National Projects. Support measures have been modest so far (2-3 % of GDP) and mostly subsidized lending.
- Russian leadership would also need a change of mind-set from conservative fiscal policy to a heavily expansive one, also to ensure the popularity of the regime. Leading economists are calling for more direct handouts to people and businesses.

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Thank you

Any comments or questions?

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