Faster-than-expected return to growth for the Russian economy

Russian Economy in 2Q21

August 13, 2021

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Russian economy in 2Q21

Strong upswing in the economic cycle mark the return of high inflation and labour shortages

Key takeaways

Recent events in 2Q21 for the Russian economy

- **Russian economy reached above pre-pandemic levels in June.** According to first estimates, the Russian real GDP grew by 10.1 % (y/y) in 2Q21 driven by non-extractives such as manufacturing and recovery in household demand.
- **Geopolitical pressures on the Rouble have stabilized but still luring in the background.** Despite a surge in oil prices, the Rouble has not strengthened accordingly, which points to strong opposite tendencies that maintain capital outflow. Easing of the OPEC+ oil production cuts is moderating the Rouble's appreciation potential.
- **Inflation accelerating to new highs that could hamper recovery**. Consumer price inflation has accelerated to 6.5 % in June - highest level in 5 years. Increase in food pries has stabilized, whereas non-food products especially imported goods are raising inflationary pressure.
- **Central Bank has raised the key interest rate by 1 %-point to 6.5 % in July**. If inflation levels especially in foods continue to stabilize, the key rate is expected to remain at the current level. Large risks to this forecast remain from extreme weather conditions to the Duma elections.
- **High inflation in input prices for industry hampering production due to global supply shortages.** Input prices for industry are 31 % higher than a year ago and causing disruptions in production, especially in production dependent on imported inputs.
- **Unemployment 22 % (y/y) lower in June.** Due to fast recovery in the economy as a whole unemployment rate is already below 5 % in 2Q21 and strong recovery is expected to turn to labour shortage unless immigration recovers**.**
- **Real incomes growing by 7.7 % (y/y) in 2Q21 and real disposable incomes by 6.8 %.** Purchasing power remains below pre-pandemic levels but fast recovery in the jobs market is supporting further improvements despite higher levels of inflation.
- **Shortage of labour force in many sectors could become a serious bottleneck already in 2021.** Lack of immigrants in many sectors as well as serious demographic situation is overheating the jobs market.

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Russian economy above pre-pandemic levels in June

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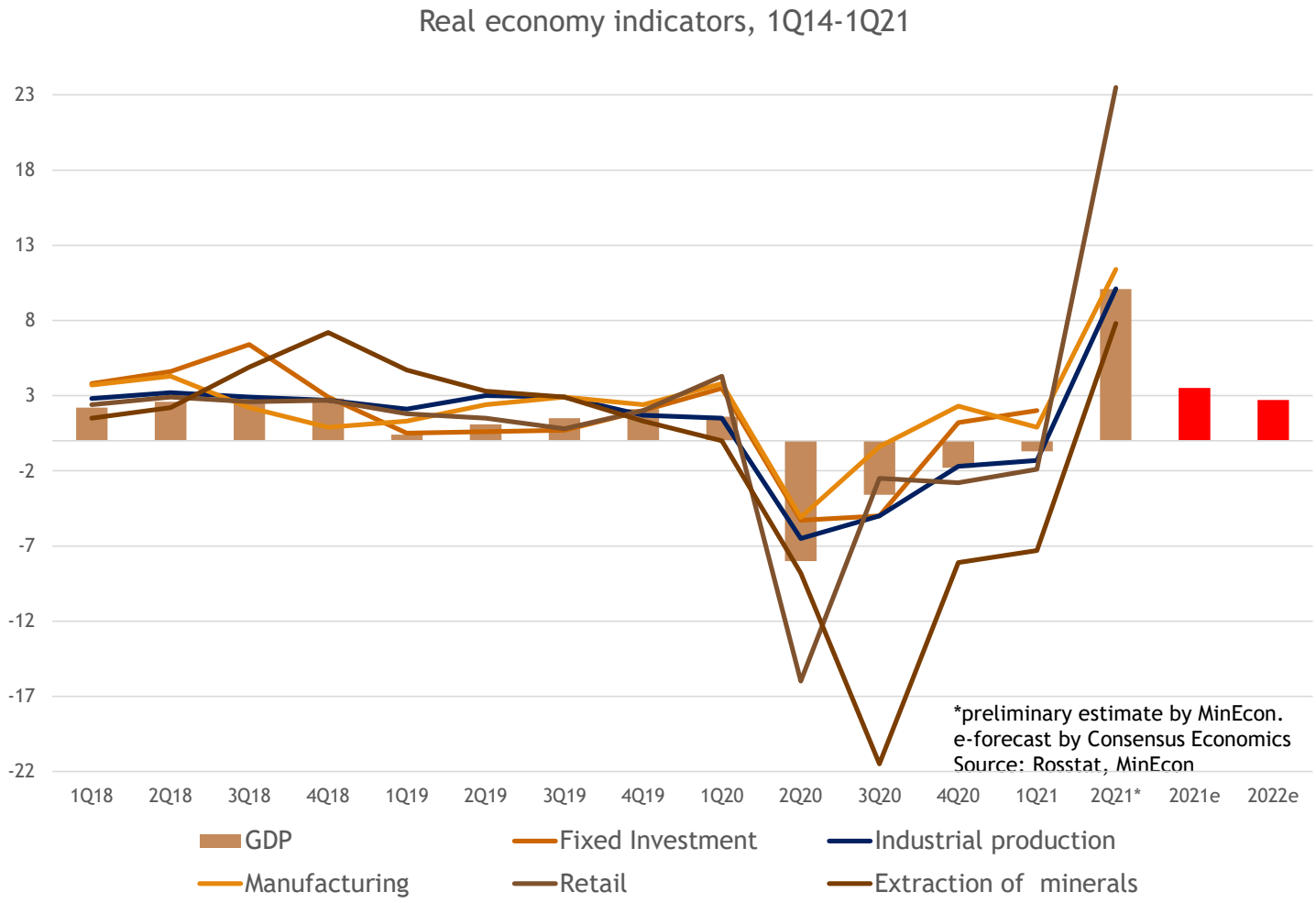

Russian economy recovering faster than advanced countries driven by non-resource sectors

- In June 2021, manufacturing, agriculture and construction sectors had already surpassed pre-pandemic levels (5 % on average), whereas the extractives' sector remains -2 % below pre-pandemic levels.
- New wave in infections since May/June has not slowed down recovery despite low vaccination coverage and new restrictions.
- Real GDP growth in 2Q21 is estimated at 10.1 % (y/y) boosted by strong performance in manufacturing, domestic household demand and jobs market recovery. The strongest push in industry came from machine-building, chemicals (pharmaceuticals), wood and food processing.
- Growth in the retail sector has played a significant role in the economic bounce-back (+23.5 % (y/y) in 2Q21) but growth has slowed down after April.
- Foreign trade has had a negative effect on GDP as import growth has been faster than export growth due to heated global price conjuncture especially in raw materials.

Recovery in oil prices driving the Rouble moderately stronger as geopolitical tensions stabilize

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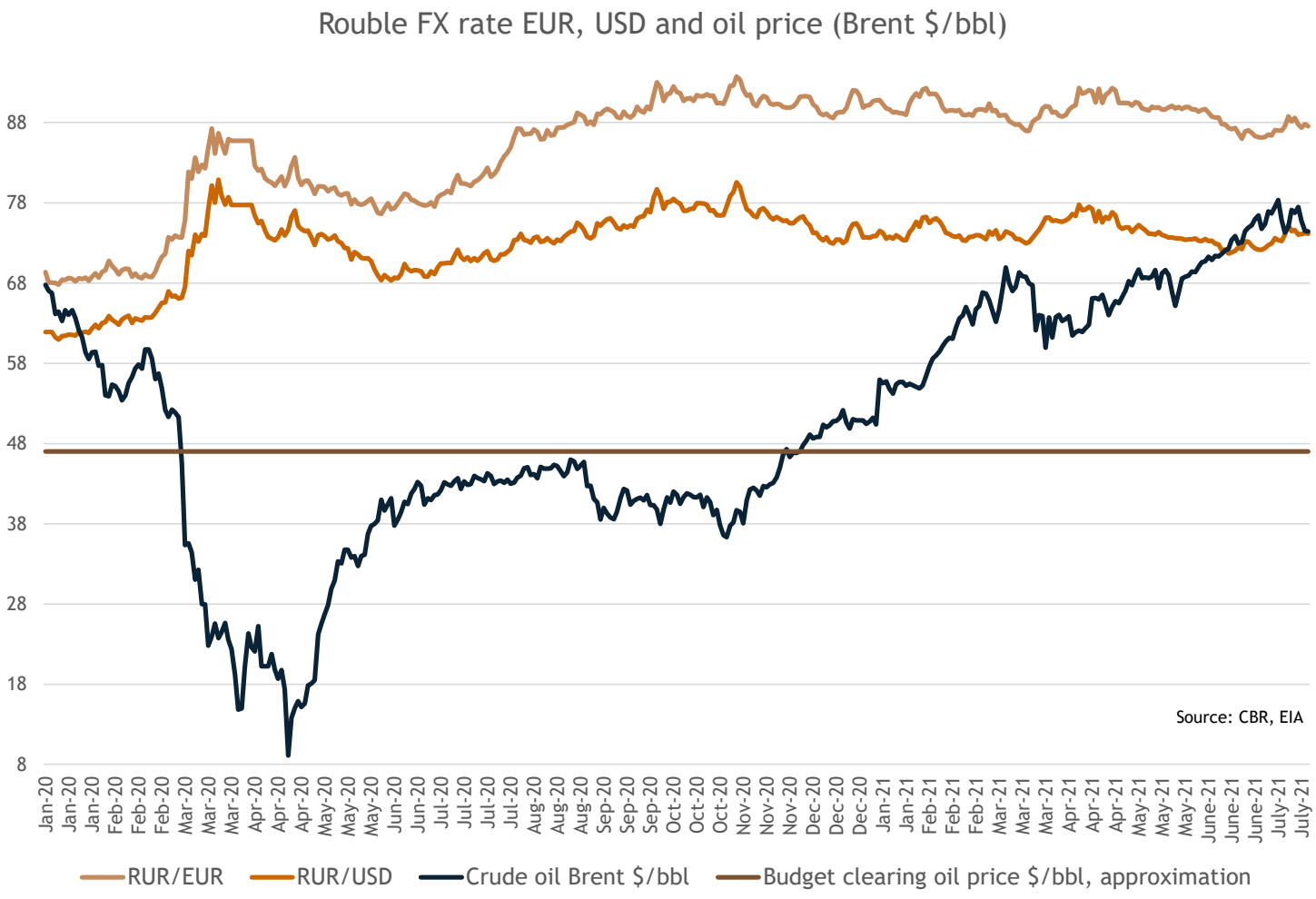

Geopolitical tensions seem to have subsided in May-June

- Oil price has increased strongly driven by the global commodity boom. On the other hand, the Rouble has not appreciated as rapidly as the oil price rise would imply. There are 3 factors affecting RUB value:
  1. **Geopolitical premium**: In anticipation of the meeting by presidents Putin and Biden in June, geopolitical tensions that were pressing on the RUB since Autumn 2020 alleviated and did not accumulate after the meeting despite slim concrete results from the meeting. Geopolitical tensions could still escalate rapidly (e.g. Belarus or Duma elections).
  2. **OPEC+ oil production cut agreement**: In July 18, new OPEC+ deal was reached to increase global oil production, which weakened the RUB moderately but promotes both global and Russian economic growth. More increases could be on the way.
  3. **Budget rule mandated FX purchases:** when the oil price is above the federal budget clearing level: the rule maintains budget stability and dampens RUB volatility (thus, also weakening appreciation).

Inflation continues to accelerate even as food price growth stabilizes

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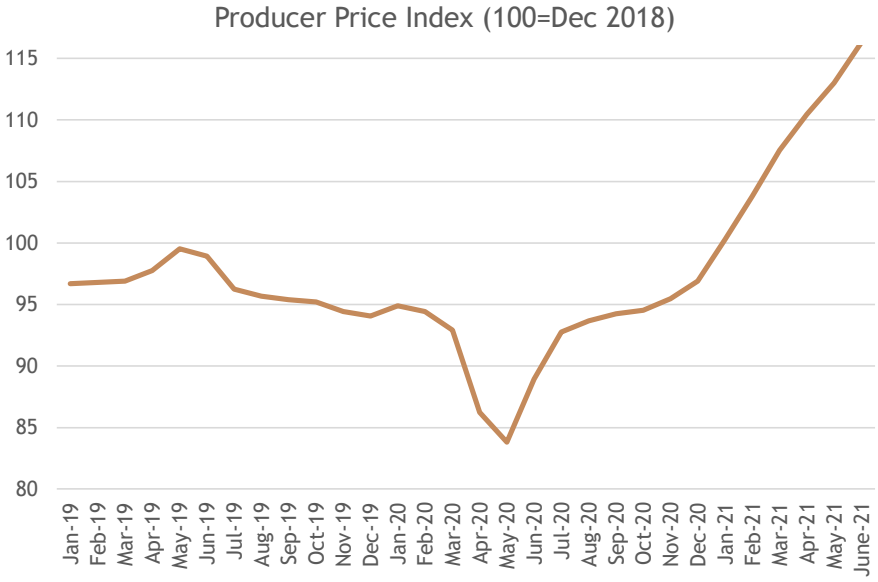

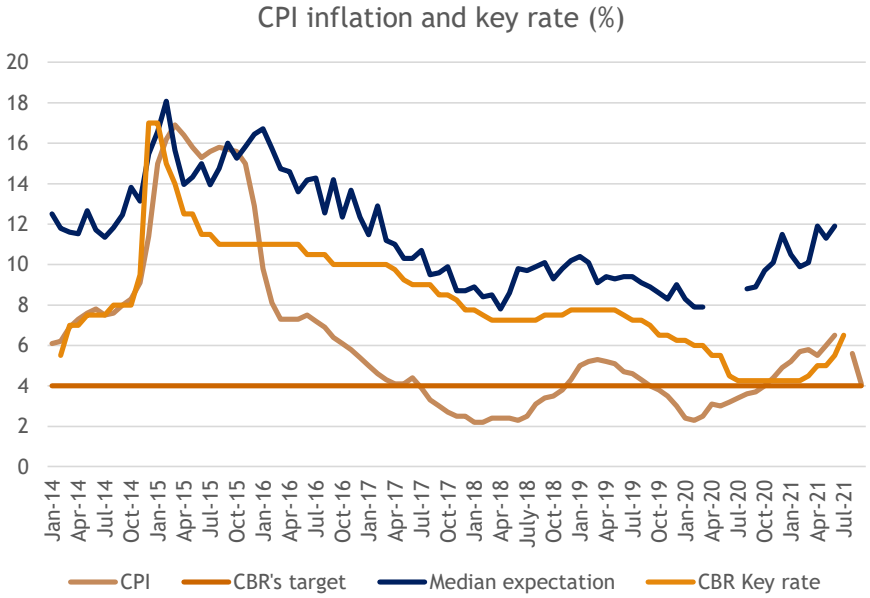

June-2021 % y/y	
CPI	6.5
Food	7.9
Non-food	7.0
Services	4.0

Source: CBR

Accelerated food prices growth maintained high inflation in 1Q21 but in 2Q21 main driver for inflation is in non-food products

- Since December 2020, inflation in food prices accelerated fast but its monthly growth has stabilized in May. Main driver for higher inflation is in non-foods, especially in imported products and construction materials despite a stabilization in the exchange rate. Inflation is expected to decelerate but to remain above the 4 % CBR target. New harvest could alleviate inflation levels but given the extreme heat conditions, it is unlikely.
- Strong acceleration in producer price inflation is plaguing Russia industry (+31 % y/y) in June. The acceleration is driven by the low base level as well as very strong global recovery that is expected to moderate towards the end of 2021.

Central Bank tightening monetary policy to combat accelerating inflation

- The CBR has hiked its key rate now in three consecutive meetings, the last of which being the largest - an increase of 1%-point to 6.5 %. The CBR has hinted at decreasing its target rate to 2-3 % (no decision yet made), which would mean higher key rates in the end of the year than with current 4 % target. If inflation moderates according to current forecasts and target remains unchanged, key rate could be decreased down to 5.5 % at the end of 2021.

Higher inflation slowing down recovery in purchasing power but jobs market improving across all sectors

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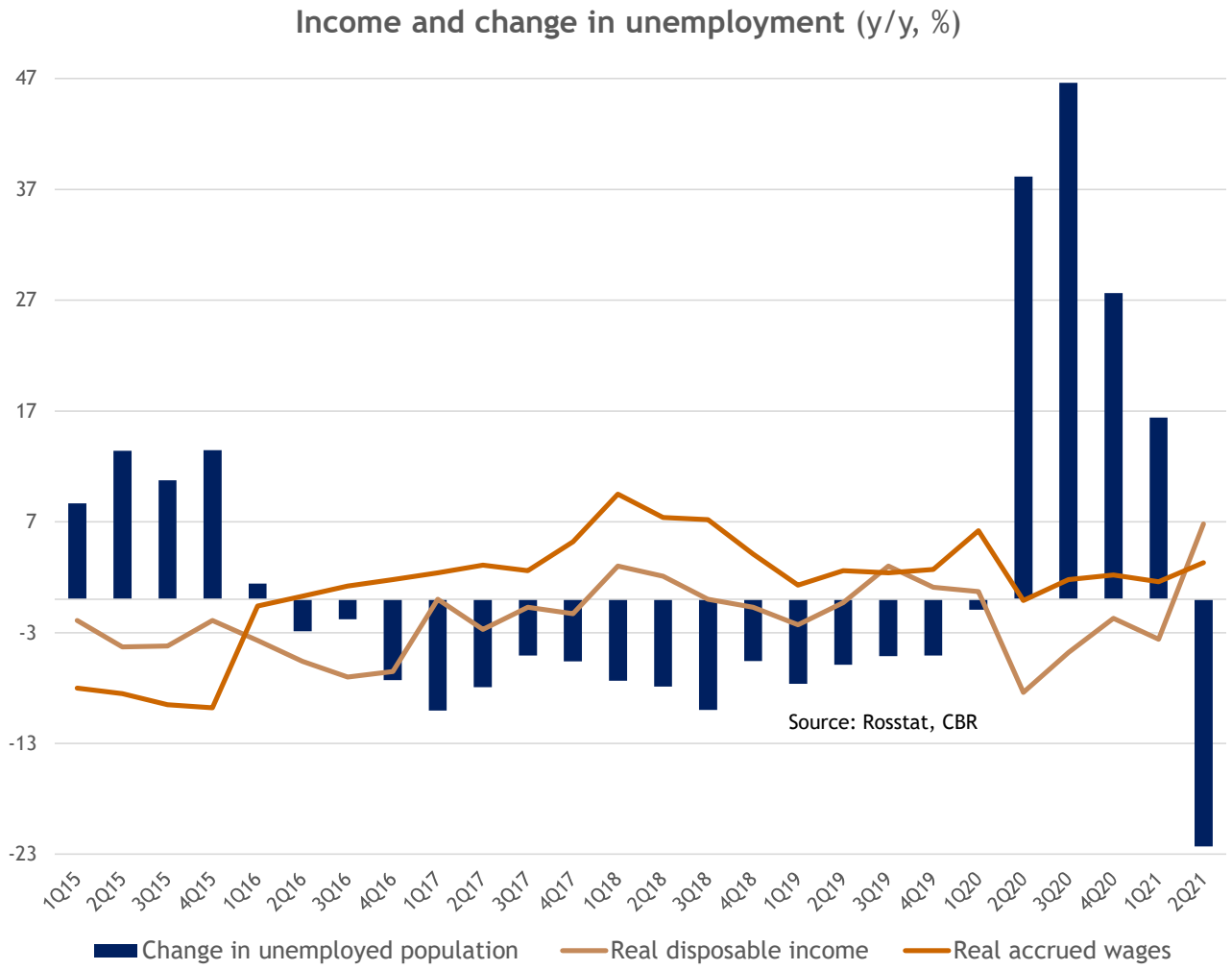

- Real monetary incomes of the population increased by 7.7 % (y/y) in 2Q21 driven by the low base from last year as well as slight recovery from non-salary incomes.
- Real wages growth accelerated in April to 7.8 % (y/y) and moderated to 3.3 % (y/y) in May. Decrease in disposable incomes shifted to growth in 2Q21 (+6.8 % y/y) but remain below pre-pandemic and 2013 levels
- The number of employed people in Russia has recovered swiftly and in 2Q21 there were 1.3 % more in employment than before the pandemic and 2 % more against 2Q20.
- Unemployment levels have dropped fast in Russia and in the end of June the number of unemployed was 22 % lower than a year ago. Given the adverse demographical situation in Russia and low levels of immigration, labour force shortages could become serious bottle-necks for growth already in the second half of 2021.

Industry sentiments imply a slowdown in business activity driven by high input prices and lower demand

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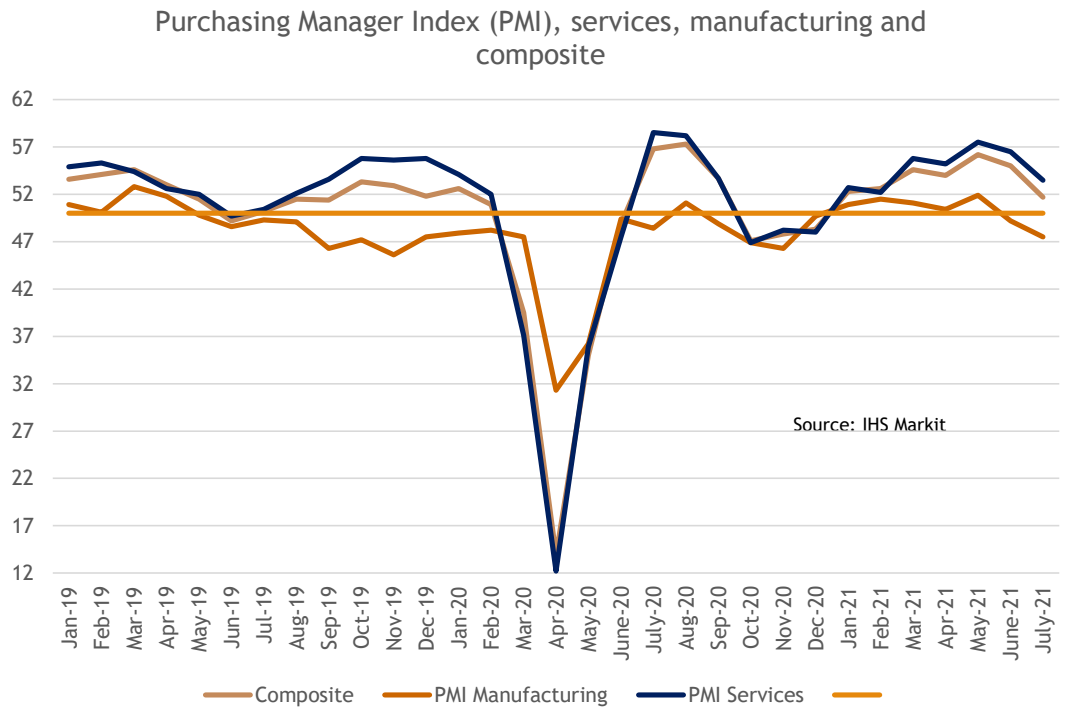

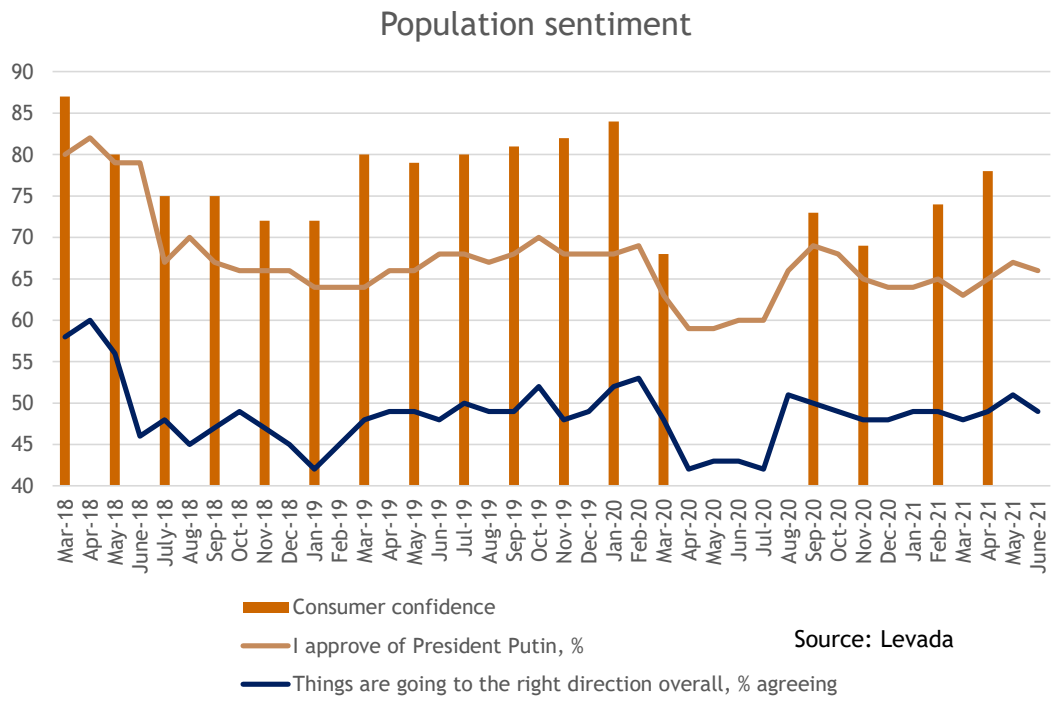

- Manufacturing PMI indicator is showing a decrease in business activity that is plagued by high producer price inflation.
- Service sector PMI business activity was still expanding from last month (PMI>50) but its growth has slowed down at a faster pace.
- This decline in sentiments is reflecting the slowdown in growth ahead already anticipated for 3Q21.

- President's approval ratings and the sentiments on how things are going overall have remained stable and the new rise in infections in June has affected these ratings only slightly.
- Consumer sentiment has been climbing up but still remains below the crisis levels.

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Outlook: 3 scenarios for Russia up to 2030

Will Russia continue to muddle through like a **Turtle**, leap forward like an **Amur Tiger** or blunder around like a **Dinosaur**?

3 Scenarios for Russia up to 2030

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Democracy

Autocracy

The Amur tiger is strong, dangerous, and has just barely averted extinction. It is well-adapted to the harsh climate of continental Eurasia but changes in its habitat are threatening its survival

Turtle is slow but surprisingly resilient. If the turtle feels threatened, it retreats inside its strong shell and it feels it does not need to change its course.

The dinosaur is big, aggressive and clumsy. The dinosaur knows that the climate has changed, but it does not know how to adapt to it. Others of its kind have already become extinct.

Concentration

Diversification

3 scenarios for Russia's future economic potential

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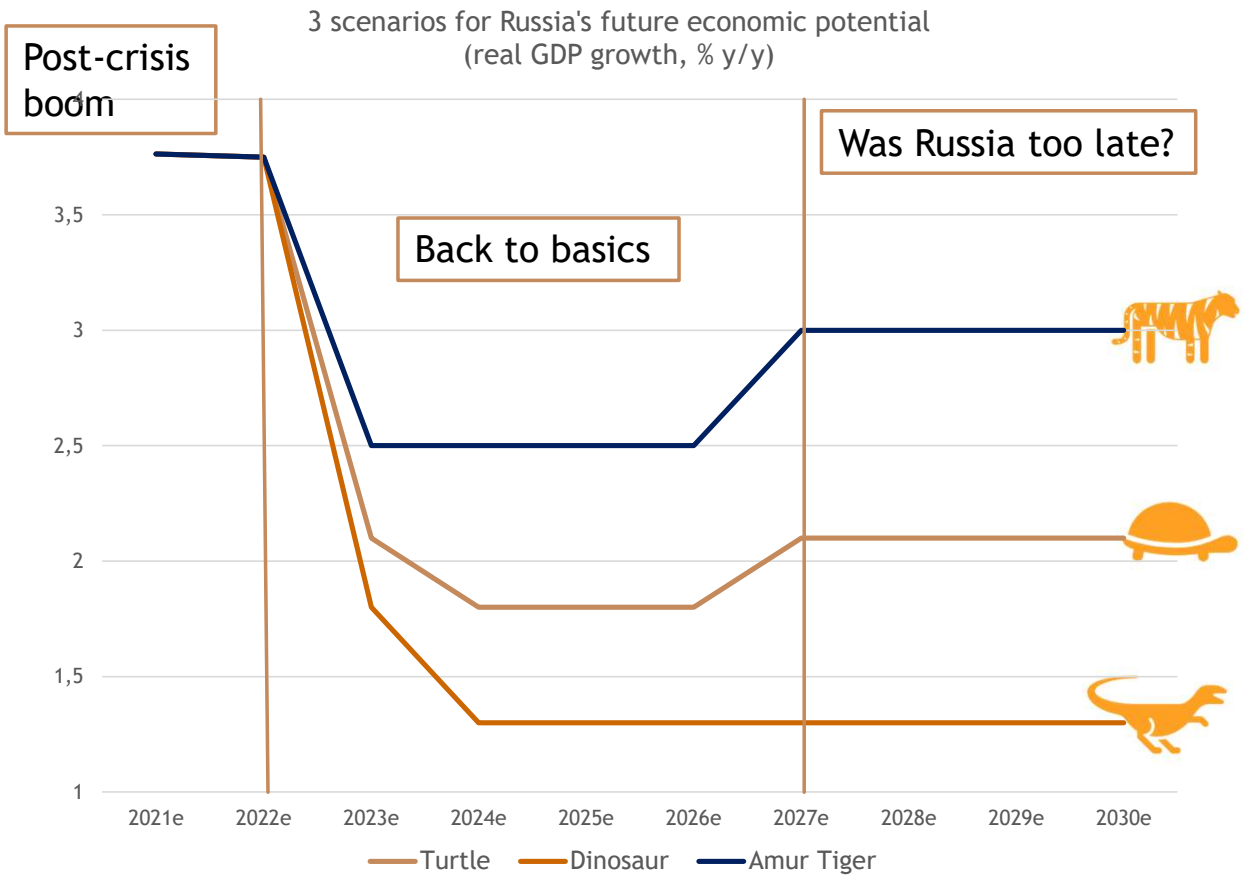

Sources: East Office, forecast for 2021-2022 from the IMF

- **2021-2022 – Recovery from the crisis:** strong growth driven by global resource boom, growth constrained by rise in costs, (lack of) vaccination coverage, labour force decline at its worst.
- **2023-2026 – Back to basics:** structural reforms and investment (also in climate efforts) imperative to accelerate growth, EU's carbon tax will hit Russia's exports, labour force declines.
- **2027-2030 – Was Russia too late?** Demand in carbohydrates decreasing strongly, impact to economy detrimental if climate and energy transition efforts were neglected, labour force decline alleviates.

1.Turtle scenario. From Recovery to Stagnation

Turtle is slow but surprisingly resilient in keeping its chosen path in the forest, despite a bumpy and thorny path**.** If the turtle feels threatened, it retreats inside its strong shell. On its path, the turtle will often trample on smaller animals and insects. When facing larger animals, the turtle can try to bite, which can cause pain but is rarely lethal. Others have underestimated the resilience of the turtle before. Because of its hard shell the turtle believes it can persevere any hardships in the forest and it feels it does not need to change.

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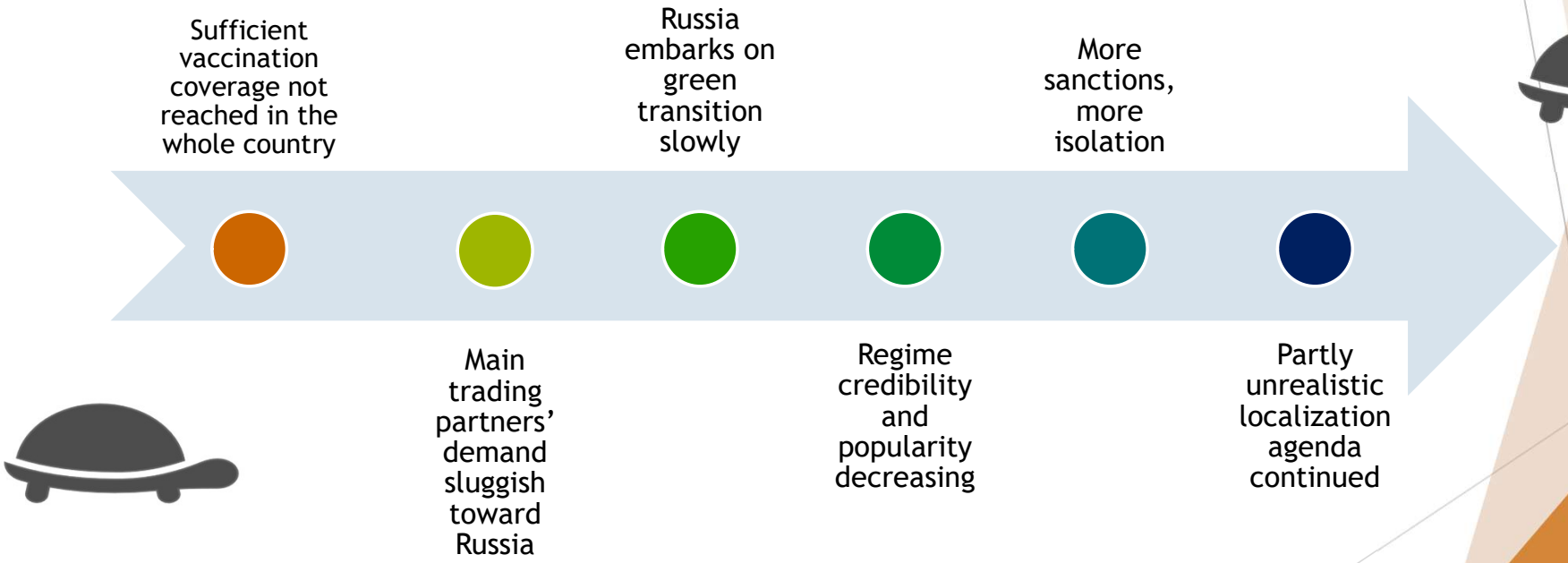
MAINTAINING THE TURTLE

Push-factors



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Turtle scenario:
From Recovery to Stagnation

Internal economic environment

Resource boom in 2021-2022 fueling growth in traditional export sectors. **Slowdown after 2023** despite some state efforts for structural change.

Russia embarks on green reform scared by strong green transition in the EU and China but any progress is hampered by vested interests and lack of real structural reform to boost productivity or painful transition.

Russian economy more under state control.

Industry invests in only the very necessary production technology and productivity gains remain limited

Real disposable incomes decreased and remain below 2013 levels.

Internal political development

Vaccination scepticism and mutations threatening the otherwise successful vaccination program.

People treated 'like children': Discontent grows over patronising attitude by the elite, declining real incomes and deteriorating living conditions but all serious outbursts are contained by the officials.

Putin's popularity remains low but no serious contender arises or is allowed to arise. Population more polarized in support for Putin's new term after 2024.

A decade of declining real disposable incomes creates a lost generation.

2. Amur Tiger scenario. From Recovery to Sustainable Growth

The Amur Tiger is strong, dangerous, and has just barely averted extinction. The Amur Tiger remains high up in the food chain of the forest and can administer deadly blows to any animal that attempts to challenge its leadership in the territory under its control. It is well-adapted to the harsh climate of continental Eurasia but changes in its habitat are threatening the Tiger's survival in the future and the Tiger knows it needs to change.

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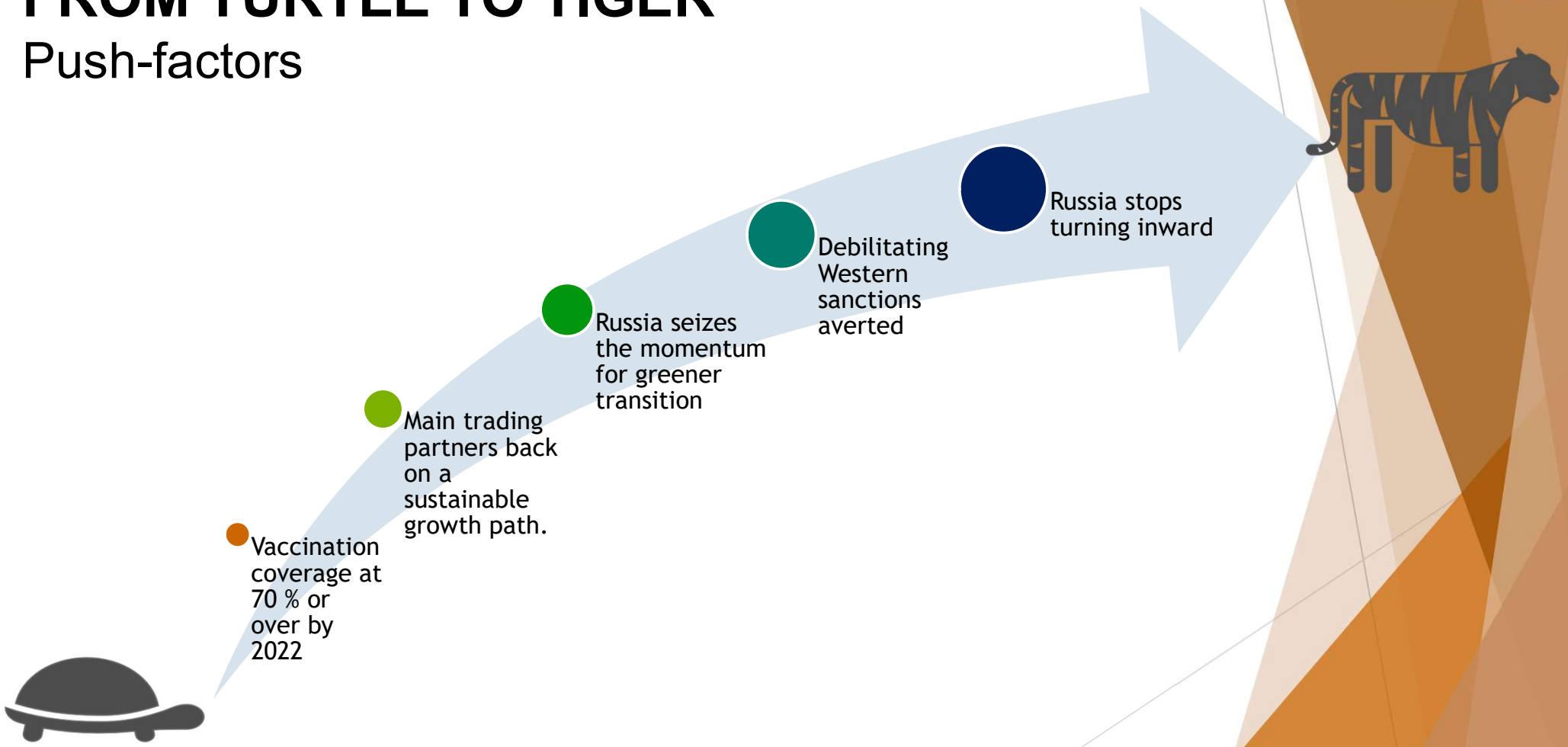
FROM TURTLE TO TIGER

Push-factors



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Amur Tiger scenario:
From Recovery to Sustainable Growth

Internal economic environment

During the resource boom in 2021-2022 structural reforms are not forgotten. **Vast state investment in reforms attract private investment** in new productive technologies.

Increased environmental awareness and external pressure force Russia to invest heavily in green transition and painful structural transition advances. Green transition also opens new trade and business opportunities that provide promising avenues of growth for Russia's economy.

Resumed growth also precipitates to increase in purchasing power in middle and lower income groups.

Internal political development

Vaccination coverage reached, Russians feel safe from the virus and the borders open. Vaccines provide protection from the mutations and/or virus evolves to less fatal forms.

Middle class and young professionals see increasing opportunities in Russia.

Putin reverts even more from operative leadership of the country and the resulting power vacuum is filled without conflict.

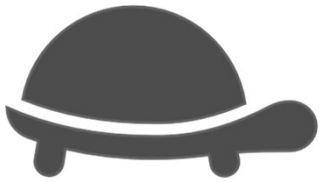
Court system reform takes baby steps led from the arbitration courts and perception on the rule of law slightly improved.

3. Dinosaur scenario. From Recovery to Gradual Crumbling

The dinosaur is big, aggressive and clumsy. All the others of its kind have already become extinct but for some reason this one dinosaur has persevered in the forest. The dinosaur knows that the climate has changed for worse and it does not know how to adapt. The animals and plants it used to feed itself on are becoming scarcer and the dinosaur is often hungry and feels weakened. If the dinosaur is faced with another animal, it uses its remarkable size to try and trample on smaller animals just to show that it is still big and dangerous. The dinosaur is, however, too clumsy to protect itself from the other more agile, even smaller, animals in the forest.

FROM TURTLE TO DINOSAUR

Push-factors



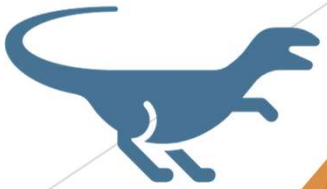
Several mutations of COVID-19 create uncertainty on the effectiveness of vaccines.

Global economic growth slow after recovery

Reforms stalled and state too concerned about budget stability and external threats

Tough sanctions on major Russian businesses, severe self-isolation ensues

Momentum for green transition is lost and Russia's export revenues diminish



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Dinosaur scenario:
From Recovery to Gradual Crumbling

Internal economic environment

After recovery, Russia continues to isolate itself from rest of the world, insists on hydrocarbon driven growth and is unable to reform until it is too late.

Russian export values drop with increasing speed as **China and EU transition into greener energy and Russia is left behind.**

Russia is too frugal to provide real stimulus to the economy and does not resort to foreign debt until it is too late.

Production capacity becomes increasingly outdated, only real modernization in military capacity.

Real purchasing power continues to decline and foreign companies flock out of Russia.

Internal political development

Vaccination scepticism and mutations threatening the otherwise successful vaccination program year after year.

Welfare gap between Moscow and the regions widens.

Generations clash over support for Putin. Youth openly discontent towards Kremlin.

People not treated with 'dignity': Putin's popularity drops even lower and appears out of touch with the reality. Fears mount over a possible power struggle inside the elite.

People protest *en masse* both in social media and the streets over falling incomes and wellfare.

Kremlin becomes uneasy and imposes even stronger control measures (often with brute force) over political rights, social media and cooperation with foreigners.

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Kazakstan, Ukraine and Belarus

Global boom accelerating recovery, outlook in Belarus shadowed by EU sanctions

Kazakh economy above its pre-pandemic levels in 1H21

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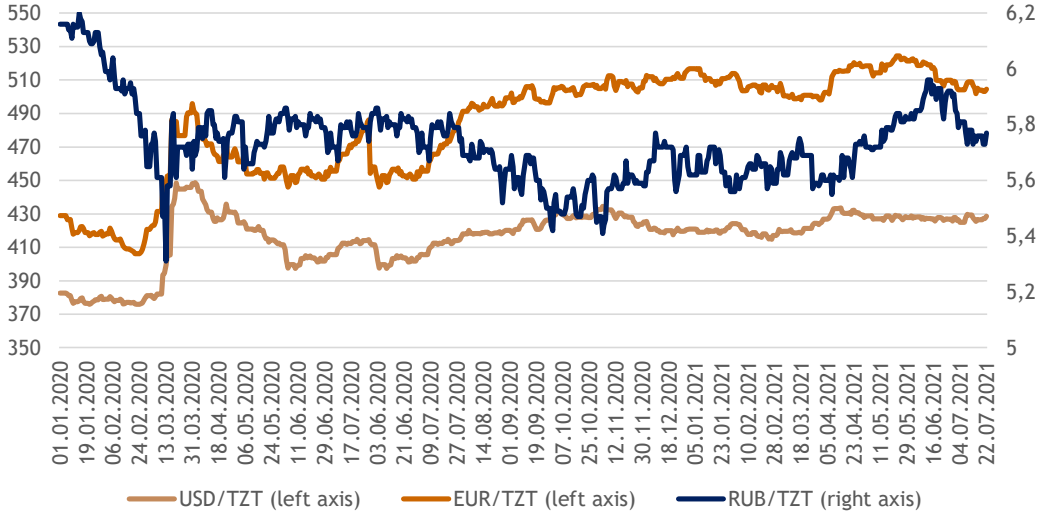
Kazakhstan has already reached pre-pandemic production levels in the first half of 2021 driven by strong commodity prices. The economy continued to grow strongly in 2Q21 given low base level from last year but slow-down is projected in 3Q21 as the base effect fades. Consequently, the sectors that suffered the most during the pandemic showed the strongest growth levels, such retail (16.9% y/y), wholesale (8.5%) and construction (9.9%). Annual consumer price index (CPI) inflation in Kazakhstan stood at 7.9 % in June, according to data published by the country's statistics office. Inflation officially surpassed the 6 % boundary in March 2020 and continued to rise because of the global coronavirus pandemic. Inflation in prices of services registered at 5.6 % in June, up from 5.1 % in May.

Interesting investment project was announced by German company Svevind that is planning new massive hydrogen project in Kazakhstan, which would produce annually 3 million tons of green hydrogen. The project is still at the planning stages, but if completed the plant would be world's largest green hydrogen plant. The hydrogen would be utilized in country's ammonia, steel and aluminum industries. Otherwise, Kazakhstan is unlikely to meet country's Paris climate commitments, which were to reduce emissions by at least 15 % by 2030. Instead, current 2030 projections in Kazakhstan are close to a "business as usual" scenario with few effective mitigation policies in place. 1st of July 2021 new environmental law came to affect, which aims make Kazakhstan carbon neutral by 2060.

By the end of July, the Kazakhstan officials had reported 617 387 confirmed cases of COVID-19 with 9 077 deaths. 20,5% of the total population has been fully vaccinated against the virus. In middle of July Kazakhstan reported the highest amount of daily new COVID-19 cases since the beginning of the pandemic.

Analysis by Sinikka Parviainen and Jasmiina Driksna

Tenge FX rates against EUR, USD and RUR



Main economic indicators	Real			Forecast	
	1H21	1Q21	2020	2021	2022
GDP, % y/y	2.0	-1.4	-2.6	3.8	4.4
Industrial production, % y/y	1.2	0.1	-0.7	3.6	4.5
Inflation, % (end of period, y/y)	7.9	7.0	6.8	7.1	6.2
Current Account Balance, USD bn	na	-1.3	-6.3	-3.9	-3.7

*Short term indicators for the main sectors of the economy for Jan-May 2021.
Source: National Bank of Kazakhstan, Ministry of National Economy of the Republic of Kazakhstan Committee on Statistics
Forecasts from Consensus July 2021 survey

Ukrainian economic growth accelerating against the low base level as corona situation improves

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Ukraine's Ministry of Economics predicts that the country's economy will have 6% GDP growth in the second quarter when compared to the previous year. According to the National Bank of Ukraine the business confidence has returned to pre-pandemic levels and has spread to all sectors of the economy. In July, Ukraine launched the long-awaited farmland market reform, which was widely regarded as one of the most consequential reforms in recent years. The reform removes obstacles that have previously forbidden the sale of farmland.

Germany and the U.S. reached an agreement on the Nord Stream 2 gas-pipeline, Ukrainian press quickly described the deal as "betrayal" because Russia could now avoid Ukraine in its natural gas transfers to Germany. U.S has vowed that Nord Stream 2 cannot be used against Ukraine and insisted it as a precondition for the deal with Germany. President Biden will meet with Ukraine's President Volodymyr Zelensky 30th of August in Washington to discuss the issue. Also, EU's new economic sanctions against Belarus will have an adverse effect on Ukrainian economy as well as Ukraine is dependent on some important input materials such as petrol and potash from Belarus.

By the end of July, Ukrainian official have reported 2 251 869 confirmed cases of COVID-19, 52 930 deaths and 4.6% of the total population have been fully vaccinated against the virus. On July 16th, the EU announced that it will allow travel from Ukraine due to the improved COVID-19 situation. Ukraine was also added to EU's list of epidemiologically safe countries. High state officials declared in July that approximately 40% of Ukraine's population is immune to COVID-19, as 33% of the population had already had the virus. However, lifting of COVID restrictions is still not insight.

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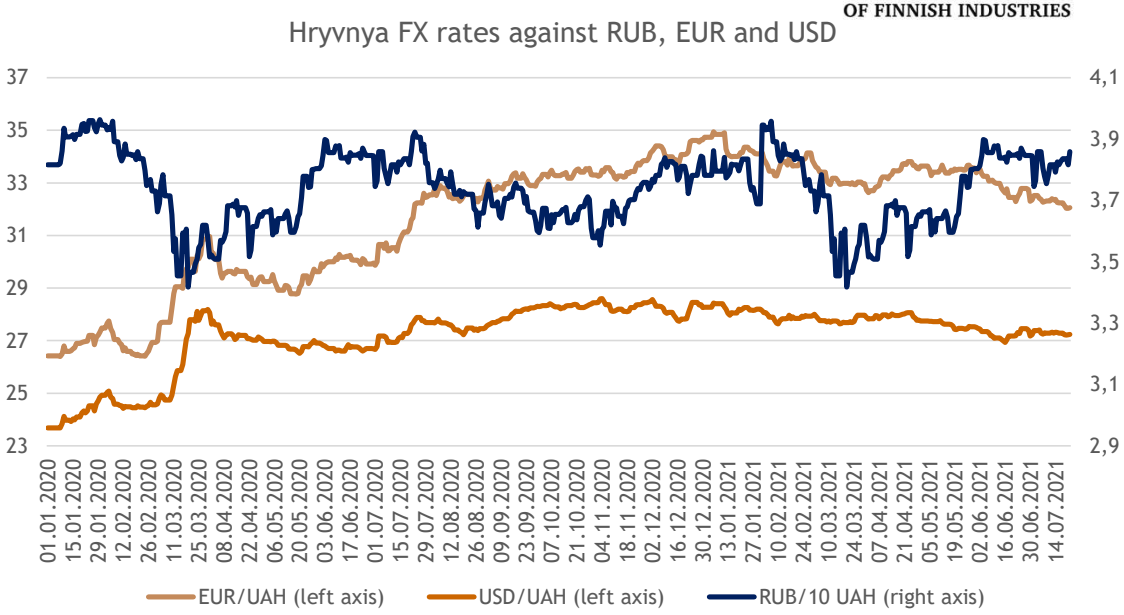

Main economic indicators	Real			Forecast	
	1H21	1Q21	2020	2021	2022
GDP, % y/y	na	-2.2	-4.0	3.9	4.0
Inflation, % (end of period, y/y)	9.5	8.5	2.7	8.6	6.3
Industrial production, % y/y	2.2*	-2.0	-4.5	2.9	3.4
Current Account Balance, bn USD	0.12*	-1.0	5.2	-1.5	-2.7

*Data for Jan-May 2021. Source: National Bank of Ukraine, UkrStat
Forecasts from Consensus Economics July 2021 survey

Growth prospects lower for Belarus as faces sectoral sanctions from the West

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Economic growth in Belarus accelerated to 3.3% (y/y) in 1H21 driven by recovery in the most pandemic-stricken sectors, wholesale trade (9.5% y/y in 1H21) and industrial production (10.4%), as well as the resumed supply of crude from Russia that was disrupted yet again last year. were. However, GDP growth will slow as the low-base effect fades over the remainder of the year and new economic sanctions will hamper Belarus' export-oriented industries, especially the previously thriving IT-sector. Many foreign-owned IT companies in Minsk are leaving the Belarusian market.

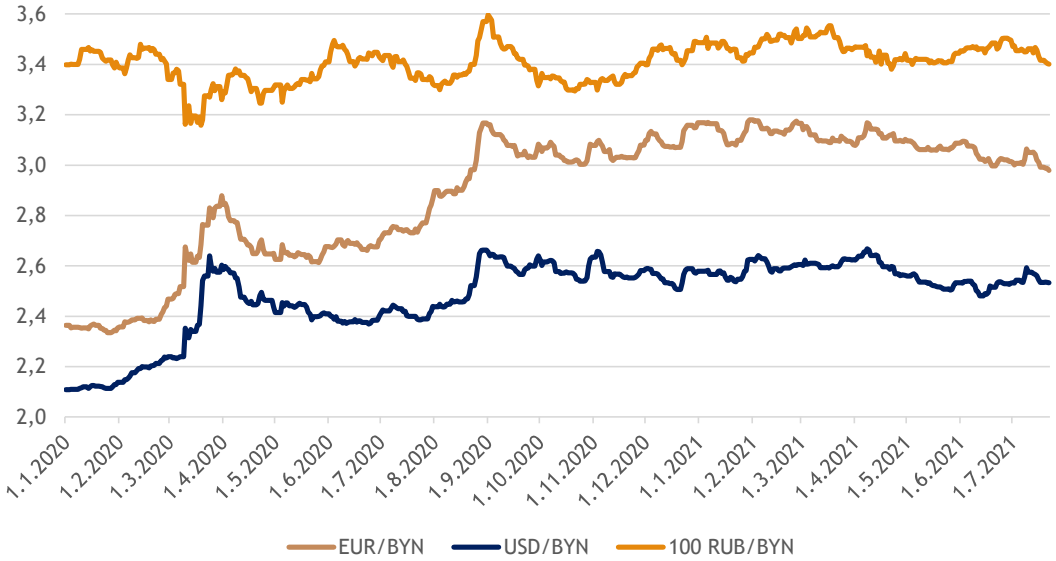
Overall, EU-Belarus relations are at a new low and President Lukashenko is driven to seek Russia's support despite previously complicated relationship. Presidents Putin and Lukashenko met is June and pledged for closer cooperation. Before meeting Putin, Lukashenka had threatened to restrict the transit of German made goods via Belarus to Russian and Chinese markets.

New EU sanctions include a prohibition on trade in petroleum products, potash and goods used in the production of tobacco, as well as restrictions on access to EU capital markets. These new restrictions mean that Belarus and its state budget will be more and more dependent on Russia for funding and support. Last December, Belarus received a loan of $1.5 bn and additional 0.5 bn in May, which has alleviated the acute shortage of funds. Also, as new Eurobond issuance are prohibited now, Belarus is likely to issue Rouble-denominated loans in the Moscow Exchange.

In July, Belarussian officials have reported 443 864 confirmed cases of COVID-19 in Belarus. 3 435 people have died due to the virus. By the end of July, 9,1% of the entire population has been fully vaccinated.

Analysis by Sinikka Parviainen and Jasmiina Driksna

Belarusian Rouble rate against EUR, USD and EUR



Main economic indicators	Real			Forecast	
	1H21	1Q21	2020	2021	2022
GDP, % y/y	3.3	0.9	-0.9	1.4	1.7
Inflation, % (end of period, y/y)	9.9	8.5	5.5	8.5	6.6
Industrial production, % y/y	10.4	9.2	-0.7	4.4	2.2
Current Account Balance, USD bn	-0.86*	-1.0	-0.2	-1.0	-1.4

*Data for Jan-Apr 2021. Source: National Bank of Belarus, Sberbank
Forecasts from Consensus Economics July 2021 survey

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Moscow city and St. Petersburg

Recovery nearly completed but battle against infections intensifying

Robust economic growth in Moscow and mandatory vaccinations introduced

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Moscow is leading recovery in the country and nearly all crucial sectors were over 2019 levels. For example, industrial production, which did not decline during the pandemic, showed 13.9 % (y/y) growth in 1H21. Also, investment activity has remained strong in 2020 and continued to do so in 1Q21, which spread over to strong growth in construction in 1H21 (+35 % y/y). Important retail sector has also surpassed pre-pandemic levels by expanding by 15.1 % (y/y) in 1H21. However, the city's extensive services sector is still behind pre-pandemic levels despite strong growth (20.2 y/y in 1H21).

Third wave of the virus has been more serious than second wave and in the end of July, Moscow had 3 300 new daily cases of COVID-19 infections. As a response, Moscow rolled out one the world's most ambitious mandatory vaccination schemes, requiring 60 % of all service sector workers (over 2 million people) to be fully vaccinated. Entrepreneurs, however, doubt the success of the vaccination campaign, unless the rules around foreigners receiving vaccines are relaxed.

In the Duma elections in September, Moscow is one of the six cities in where it is possible to vote electronically. In the countdown to the elections, crack-down on opposition candidates is intensifying also in liberal Moscow. In July, a prominent opposition figure and a Navalnyi supporter, Ilya Yashin, announced he is stepping down as a chairman of a local assembly blaming pressure from officials. A former presidential candidate from the Communist party, Pavel Grudinin, is the latest high-profile opposition figure to be disqualified from running in the September elections.

Analysis by Sinikka Parviainen and Jasmiina Driksna

	Russia 2Q21	2Q21	2020	2019	2018
Inflation, CPI % y/y	6.5	5.5	3.8	3.4	4.3
Unemployment rate*, (% end of period)	4.9	2.8	2.6	1.4	1.2
Nominal wage, average monthly RUB	56 171*	105 246*	100 322	93 866	83 581
Nominal wage growth, % y/y	9.5*	13.8*	6.9	12.3	14.3
Share of loss-making firms, % (average for the period)	30.4**	30.5**	30.1	24.5	24.3

*Data for May 2021. **Data for Jan-May 2021. Source: Rosstat

Recovery strong in St. Petersburg despite a serious wave in infections

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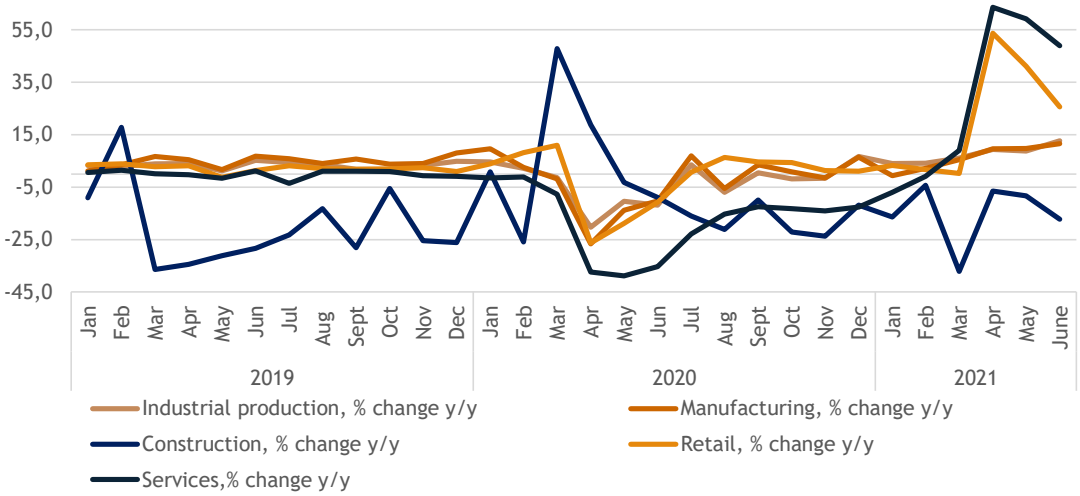
Industrial production was 8 % (y/y) in 1H21 and has thus, out passed its pre-pandemic levels. Also, retail sector turnover has strongly bounced-back (18.6 % y/y in 1H21) and services have recovered to pre-pandemic levels (+23.1 y/y). However, investment activity remains low, which is showing as adverse development in construction (-15.7 %).

According to St. Petersburg officials, the epidemic has not settled, and the number of hospitalized patients are at the same level as at the end of May (around 400 patients). Moreover, the highest number of deaths since the beginning of the pandemic were recorded in June. At the same time, vaccination coverage is gaining popularity and at the end of July, 1.3 million people had been vaccinated in St. Petersburg, with over a million people fully vaccinated. By the end of July, St. Petersburg is estimated to be among the cities, which are close to achieving a 60% collective coronavirus immunity according to the Deputy Prime Minister Tatiana Golikova.

Ahead of the Duma elections in September, authorities have been tightening the screws on dissent with arrests, detentions and raids against opposition politicians and activists. For example, the leader of the opposition party Yabloko in St. Petersburg, Boris Vishnevsky is facing two “fake” opponents with the same name to confuse his voters. He has also previously faced what appeared to be a coordinated smear campaign by the pro-Kremlin backers. Recently, the St. Petersburg election commission banned the former head of jailed Kremlin’s critic Alexei Navalny’s headquarters, Irina Fatyanova, from running in elections to the city’s legislative assembly on the pretext of leading an extremist organization.

Analysis by Sinikka Parviainen and Jasmiina Driksna

Main economic sectors in St. Petersburg, %-growth y/y



	Russia 2Q21	2Q21	2020	2019	2018
Inflation, CPI % y/y	6.5	7.0	4.7	3.0	3.9
Unemployment rate, (% average for the period)	4.9	2.2	2.9	1.4	1.5
Nominal wage, average monthly RUB	56 171*	73 944*	68 409	63 235	60 225
Nominal wage growth, % y/y	9.5*	15.1*	8.2	5.0	10.9
Share of loss-making firms, % (end of period)	30.4**	25.6**	23.7	18.6	19.4

*Data for May 2021. **Data for Jan-May 2021. Source: Rosstat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