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From crisis economy to shortage economy

Russian Economy in 3Q21

November 18, 2021

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Key takeaways

Recent events in 3Q21 for the Russian economy

- **Russian economic growth slowing down in 3Q21 as the low base level fades.** In 3Q21, real GDP is estimated to have reached around 4.3 % (y/y) compared to 10.5 % (y/y) in 2Q21.
- **Rouble appreciating in 3Q21 driven by high commodity prices, geopolitical tensions rising.** Rouble has appreciated by 9 % since the beginning of the year but less than the high energy prices would imply. The Central Bank's tightening of monetary policy was also supportive for a stronger RUB. Geopolitical tensions between Ukraine and Russia and on the Polish-Belarus border could cap the RUB's appreciation in the coming months.
- **Inflation driven by global shortages and increasingly by domestic supply shortages in food.** Consumer price inflation has accelerated to 8.1 % in October and the main driver was accelerated by food price inflation (10.9 %) driven by a weak harvest and a severe epizootic situation in cattle.
- **Unemployment rate back to record low levels, real incomes constrained by high inflation.** Growth in real wages has decelerated due to rampant inflation levels and posited growth of only 1.5 % (y/y) in August. Growth of real disposable incomes has accelerated to 8.1 % (y/y).
- **Credit booming despite a higher interest rate level.** Credit continues to expand fast in Russia (+14% y/y in 3Q21). Especially, mortgages have been growing in popularity (+27 % y/y in Jan-Sep 2021) despite a more limited state mortgage support program since July.
- **Russian current account surplus at a historical high as commodity prices boom.** Russia's quarterly export revenues have reached their highest level since 4Q13. Also, the value of imports has increased considerably to its highest level since 1Q14 but import growth has decreased considerably in 3Q21. Capital flight has increased in the first 9 months of 2021 to $34bn, which is the highest level in 3 years.
- **Services' Purchasing Managers Index (PMI) drops to negative due to new Covid-19 restrictions, manufacturing sector showing higher activity levels.** Manufacturing sector PMI signalled growth after 5 months of decline reflecting a slight upturn in new orders and more hiring. At the same time, supply chain disruptions continued to constrain production but cost pressures alleviated compared to previous months.

Economic growth slowing down in 3Q21 after a strong recovery burst

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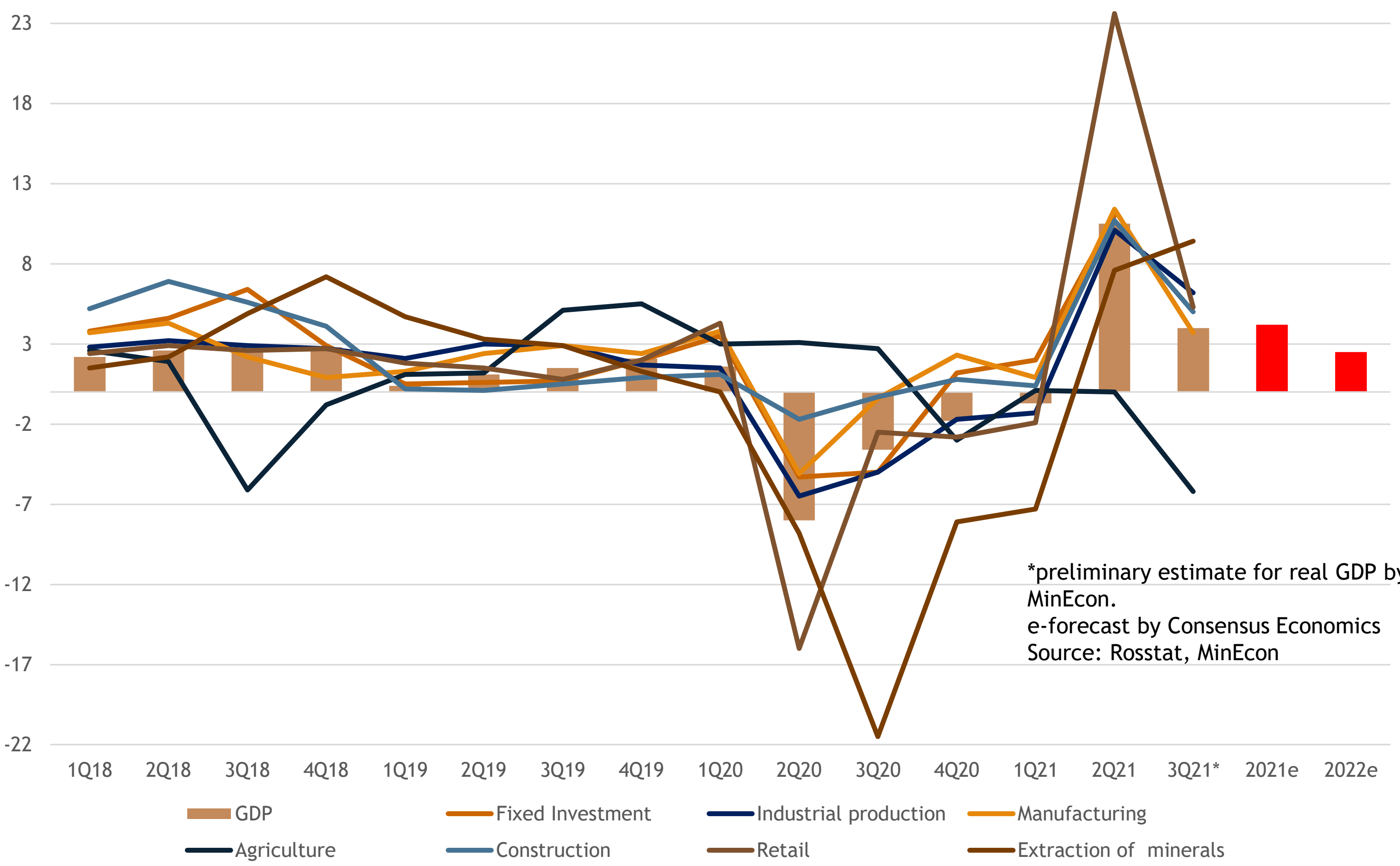
Real economy indicators, 1Q18-3Q21

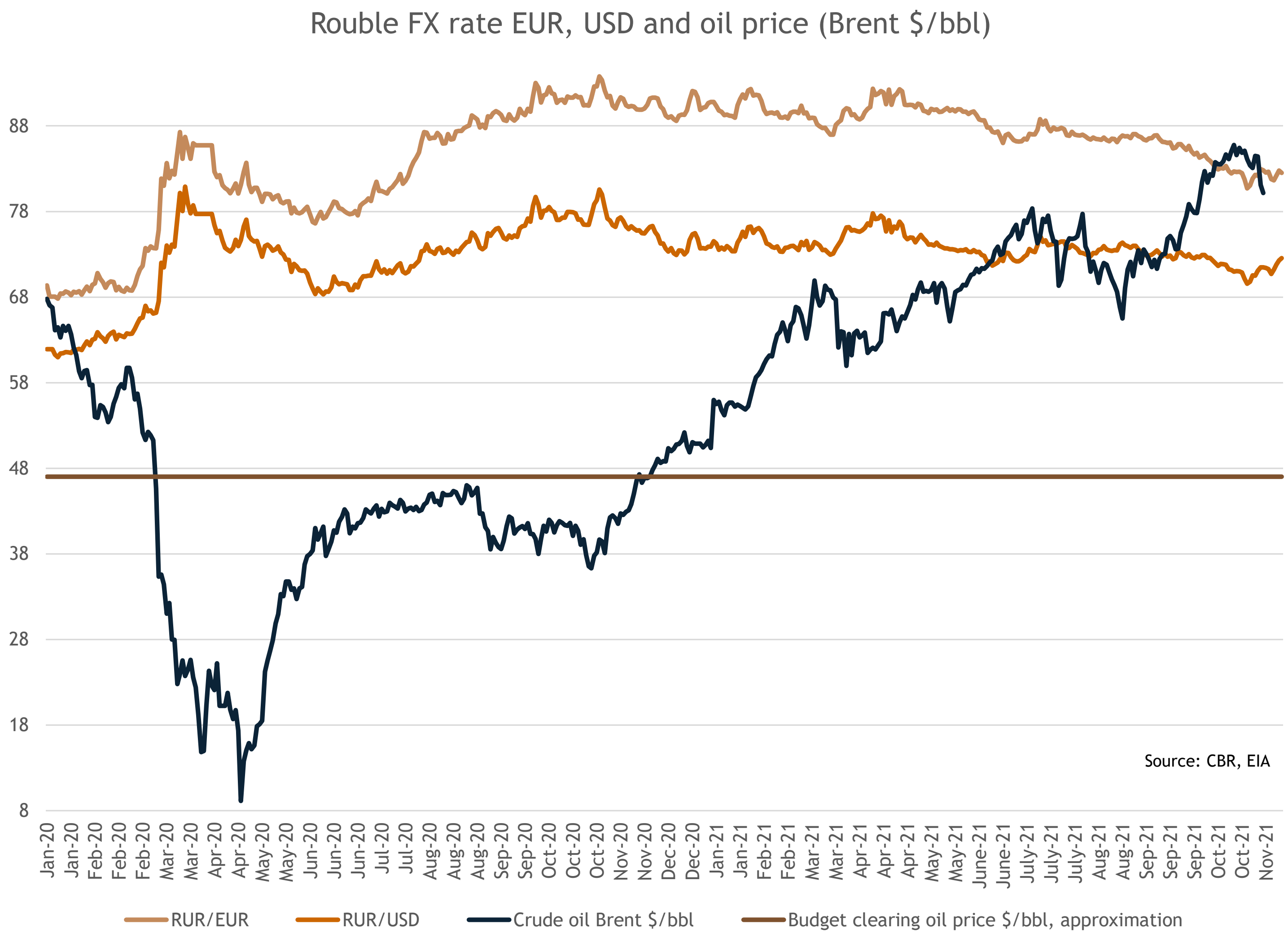


*preliminary estimate for real GDP by MinEcon.
e-forecast by Consensus Economics
Source: Rosstat, MinEcon

Growth drivers shifting to extractives from manufacturing and consumer demand

- Russian economic growth decelerated in 3Q21 in yearly terms against a higher base from a year ago. In 3Q21, real GDP is estimated to have reached around 4.3 % (y/y) compared to 10.5 % (y/y) in 2Q21.
- Industrial production growth in 3Q21 slowed down (6.2 % vs 10.1 % (y/y) in 2Q21). Deceleration was driven by manufacturing growth slowdown to 3.7 % from 11.4 % (y/y) in 2Q21. This slowdown is expected to continue in the coming months due to global supply chain disruptions and limited consumer demand due to new COVID-19 restrictions.
- The extractives sector was one the few sector showing higher growth rates in 3Q21 vs 2Q21, in addition to construction. Mineral extraction is benefiting from the high commodity prices as well as the gradual alleviation in the OPEC+ agreement mandated oil production levels.

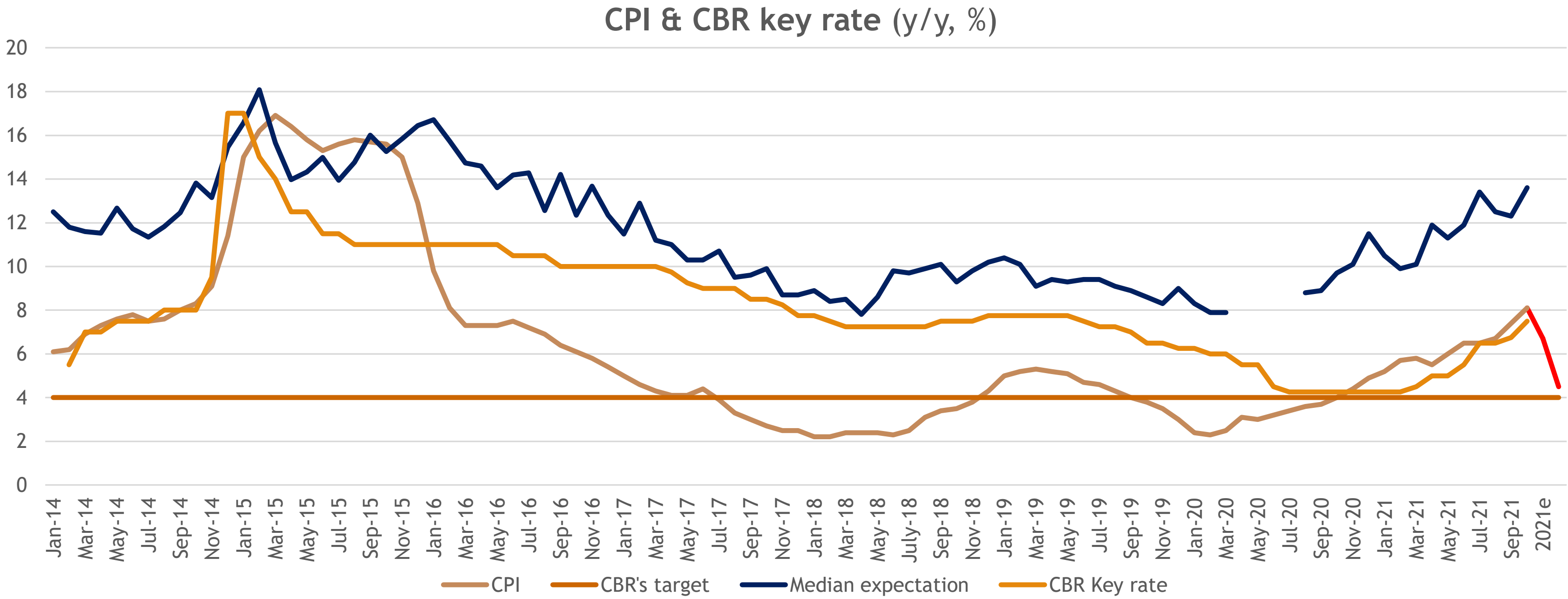
Rouble strengthening with high gas and oil prices



Rouble appreciating in 3Q21 but less than expected

- Rouble has appreciated by 5 % in 3Q21 and by 9 % since the beginning of the year. Higher energy prices, including for oil and gas, as well as the CBR's tightening of monetary policy were both supportive for the RUB.
- Despite the recent appreciation, the level of oil prices and high gas prices would suggest an even stronger currency especially against the EUR when Europe is struggling with energy supplies. The appreciation appears to be capped also by capital outflow that has risen to its higher level in 3 years.
- Geopolitical tensions are again shadowing the RUB's good performance, albeit having only a moderate impact so far. Namely, tensions have risen in November due to reports of a presence of 100,000 Russian troops on the Ukrainian border and due to the transportation of large numbers of immigrants by Belarus to the Polish border.

Acceration in inflation driven by higher food prices



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Oct-2021 % y/y	
CPI	8.1
Food	10.9
Non-food	8.2
Services	4.4

Source: CBR

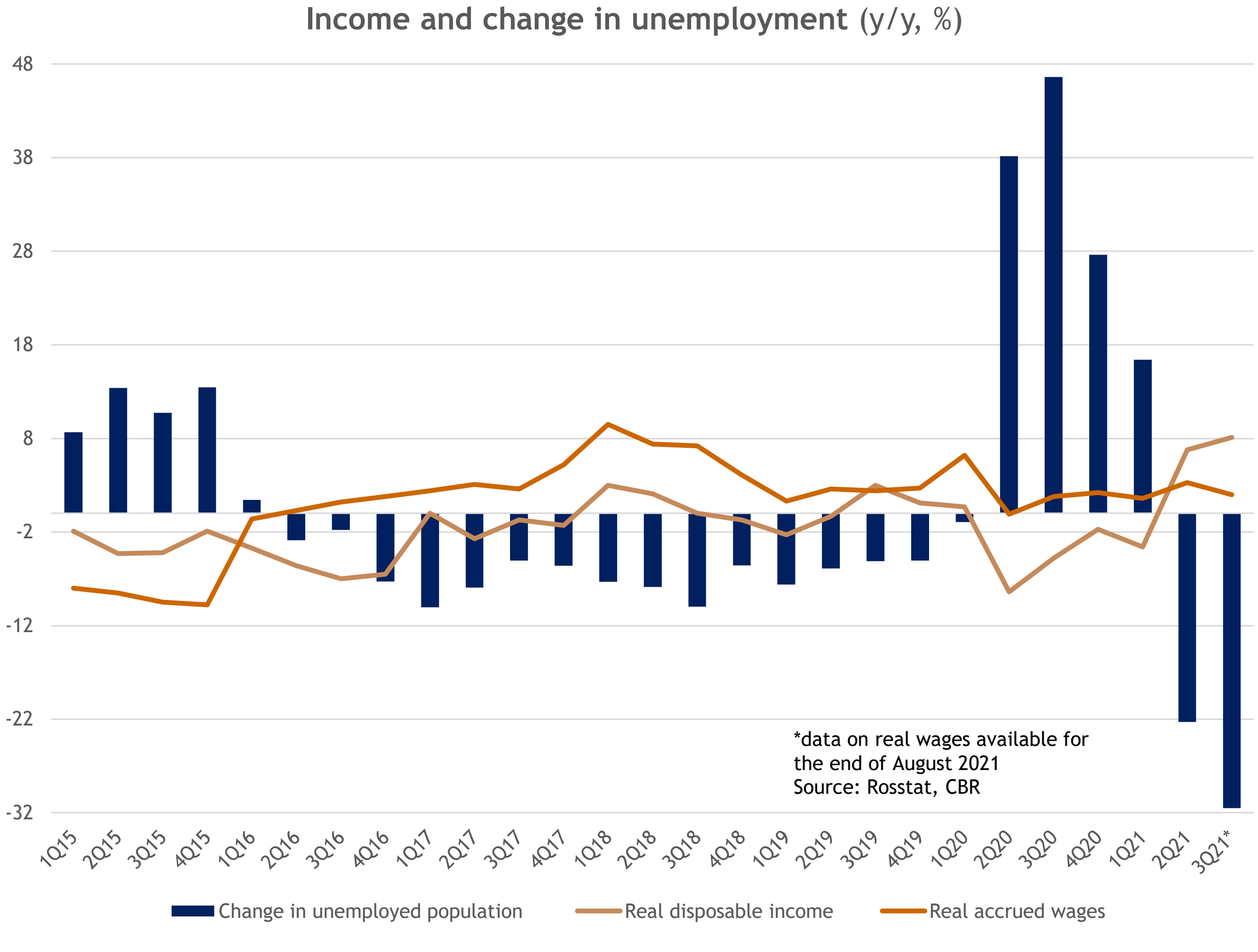
Inflation driven by global shortages and increasingly by domestic supply shortages in food

- In 3Q21, inflation has continued to speed up first due to growth in non-food products' prices but since August food prices have again accelerated stronger than other product categories or services. In the non-food segment, gasoline prices were driving inflation higher but stronger currency had a, albeit small, decelerating effect.
- Most forecasts still insist that high inflation is not a permanent phenomenon but just less transitory than first assumed. Now inflation levels are expected to ease closer to the Central Bank (CBR) target of 4 % by the end of 2022.

Central Bank more hawkish on inflation

- As inflation levels are likely to persist in 2021, the CBR will keep on rising its key interest rate at least up to the first half of 2022. The CBR raised its key rate more strongly than expected by 0.75 %-points on October 25th to 7.5 %, which shows a more hawkish stance by the CBR in combatting inflation.

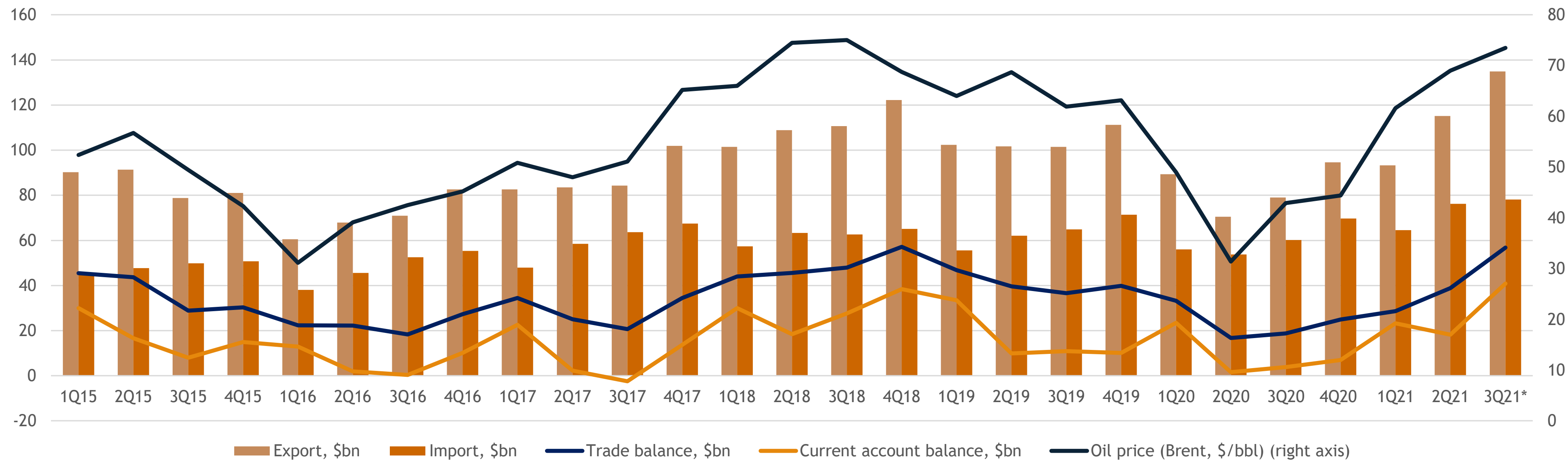
Unemployment rate back to record low levels, real incomes constrained by high inflation



- Unemployment rate in July 2021 reached near record low levels of 4.6 % witnessed just before the crisis. At the same time, employment levels have remained at the same level of 59 % of labour force in 2021.
- Growth in real wages has decelerated due to rampant inflation levels and posited growth of only 1.5 % (y/y) in August. Growth of real disposable incomes has accelerated to 8.1 % (y/y). Recently projected economic growth rates for 2022-2023 are not enough to increase real disposable incomes to the 2013 level.
- Shortage of labour due to lack of returning immigrants and demographic challenges are becoming severe and are contributing to the rise in living costs in large cities.
- Despite higher interest rate levels, credit continues to boom in Russia (+14% y/y in 3Q21). Especially, mortgages have been growing in popularity (+27 % y/y in Jan-Sep 2021) despite a more limited state mortgage support program since July. The CBR is estimating mortgages to grow by 23-27% in 2021.

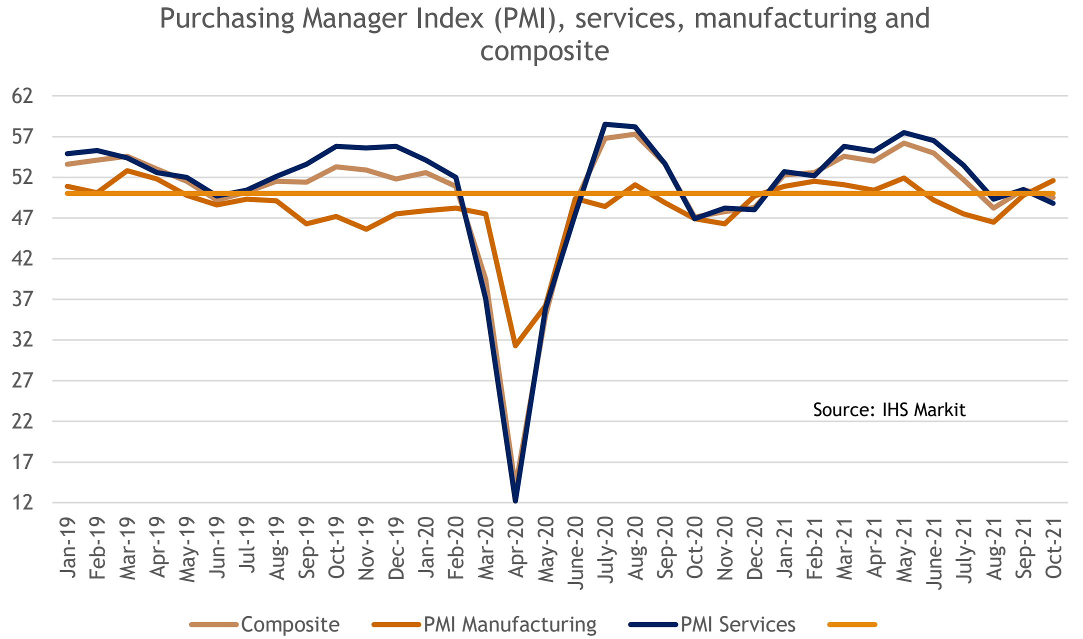
Russian current account surplus at a historical high as commodity prices boom

Russia's trade and current account balance

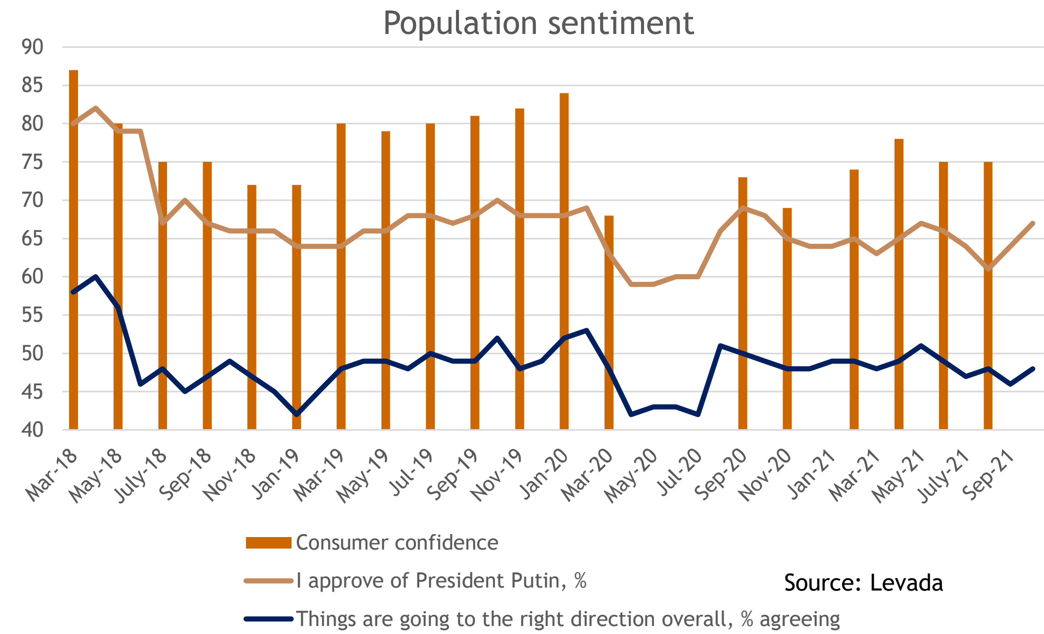


- Due to the global recovery tsunami especially for raw materials and energy, Russia’s quarterly export revenues have reached their highest level since 4Q13. Also, the value of imports has increased considerably to its highest level since 1Q14 but import growth has decreased considerably in 3Q21, which reflects a deceleration in economic activity.
- At the same time, capital flight has increased in the first 9 months of 2021 to $34bn, which is the highest level in 3 years. In the absence of severe geopolitical tensions (before November), reasons for the increased capital flight are uncertain; another signal of reduced investment attractiveness or a coincidence of large due payments abroad?

Services' sentiments negative due to new Covid-19 restrictions, manufacturing sector showing higher activity levels



- Firm sentiments turned negative due to lowered economic activity in services hit by peaked infection and mortality levels that resulted in new movement restrictions all around Russia.
- Services sentiments dropped to the lowed level since Dec-20 and signals a decline in turnover toward the end of the year.
- Manufacturing sector PMI signalled growth after 5 months of decline reflecting a slight upturn in new orders and more hiring. At the same time, supply chain disruptions continued to constrain production but cost pressures alleviated compared to previous months.



- President's approval ratings and the sentiments on how things are going overall have remained stable at a lower level since the middle of 2018 when the pension reform was announced in Russia. According to a separate Levada study in October, 47 % want to see Putin as the president also after 2024 (42 % do not). These sentiments have gradually turned more negative since 2017, when 67 % saw Putin's presidency after 2024 as desirable.
- Consumer sentiment has been climbing up since the Summer of 2020 but still remains below pre-crisis levels.

Outlook: What is behind high inflation in Russia and how long is this going to last?

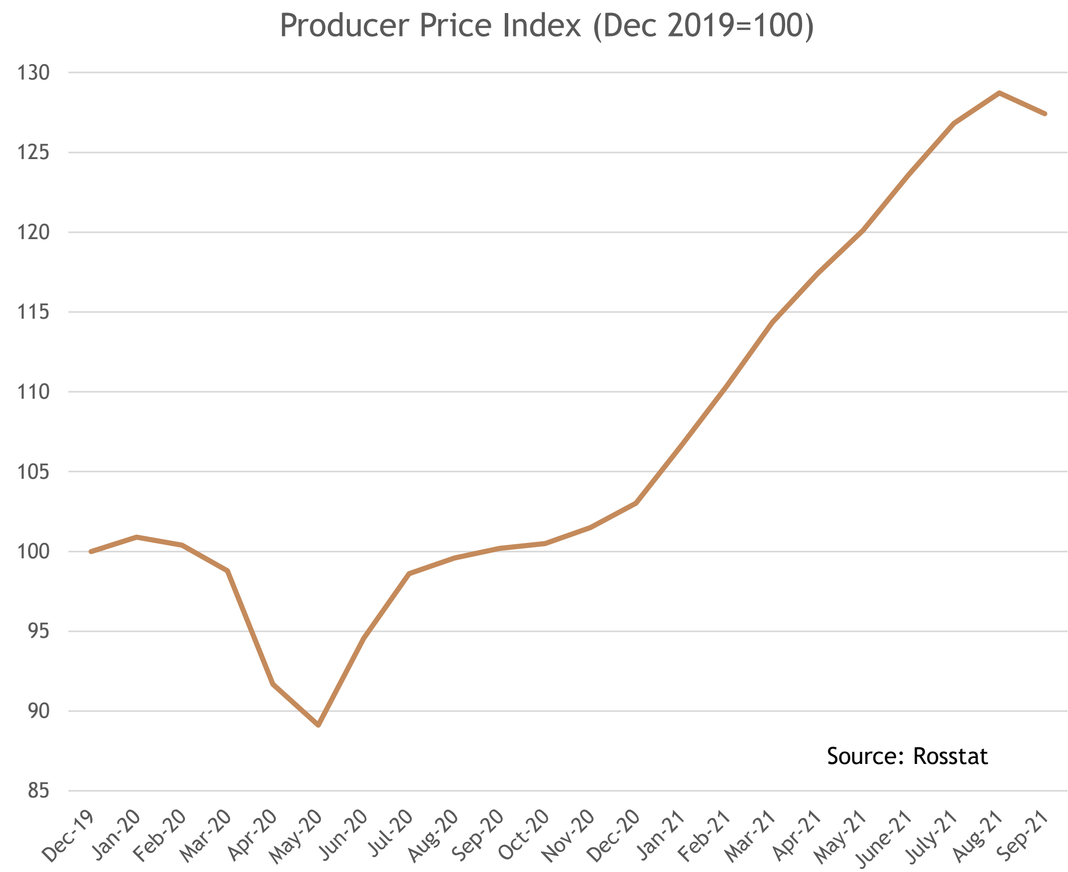
Russia is facing both high inflation and decelerating economic growth

Global context: Why is inflation so high now?

- Inflation has accelerated considerably in all continents due to very strong bounce-back in global economy after COVID-19 lock-downs. Simply, the strong demand bursts are not matched by supply. Economist are insisting that these inflation levels are transitory but less so than initially expected.
- Demand for commodities has been fueled by the **unprecedented fiscal and monetary support** measures, while supply has remained under pressure due to **logistical bottlenecks**, the **pandemic-related restrictions** still in place and **the inability of** companies to ramp up production to keep pace with demand. Dry bulk freight rates have risen to their historical high (data collected since 2007 by IHS Markit) and there are bottlenecks in every link of the supply chain and
  - virus border controls,labour, semi-conductor chip shortage, containers, shipping, ports, trucks, railroads, air and warehouses.
- **Weather** in many parts of the world has also been rough, resulting in a weaker than expected harvest. Cold weather has also contributed to a dramatic rise in energy prices, particularly prices for gas and coal.
- Another important factor is that **inflation expectations remain anchored** in advanced economies. Meanwhile, according to the IMF, lagged effects from higher food and oil prices mean that price pressure will remain elevated into 2022.
- According to some researchers, the world economy today is faced with **a transition to a new level of prices** within the framework of the global balancing of supply and demand. This is supported by the fact that the largest central banks have not yet resorted to raising the interest rate but wait for the balancing process to end. Another plausible reason is that the world's leading central banks (ECB, Fed) are fearing the consequences of cutting down on the asset purchasing policies in place for over a decade and when is the economy cycle strong enough for a interest rate hike.

Russia’s external and internal cost pressures: input prices

- In Russia, external inflation pressures were fueling inflation in the first phase of recovery. Especially, manufacturing/processing sectors that were faring well during 2020 suffered from high input prices.
- Most of these inputs are of Russian-origin (i.e. vertical integration inside Russia is common place) and the state responded with export bans e.g. for metals to shield processing sectors from the most severe acceleration.
- In addition to vertical integration, most of Russia’s industry is of the low value added type and thus, does not suffer as much as advanced countries from global trade disruptions and lack of foreign inputs e.g. semi-conductors.
- Producer prices actually deflated in August (y/y) but to claim that the input price rally is over could be premature and depends heavily on external factors.



Russia’s external and internal cost pressures: food prices

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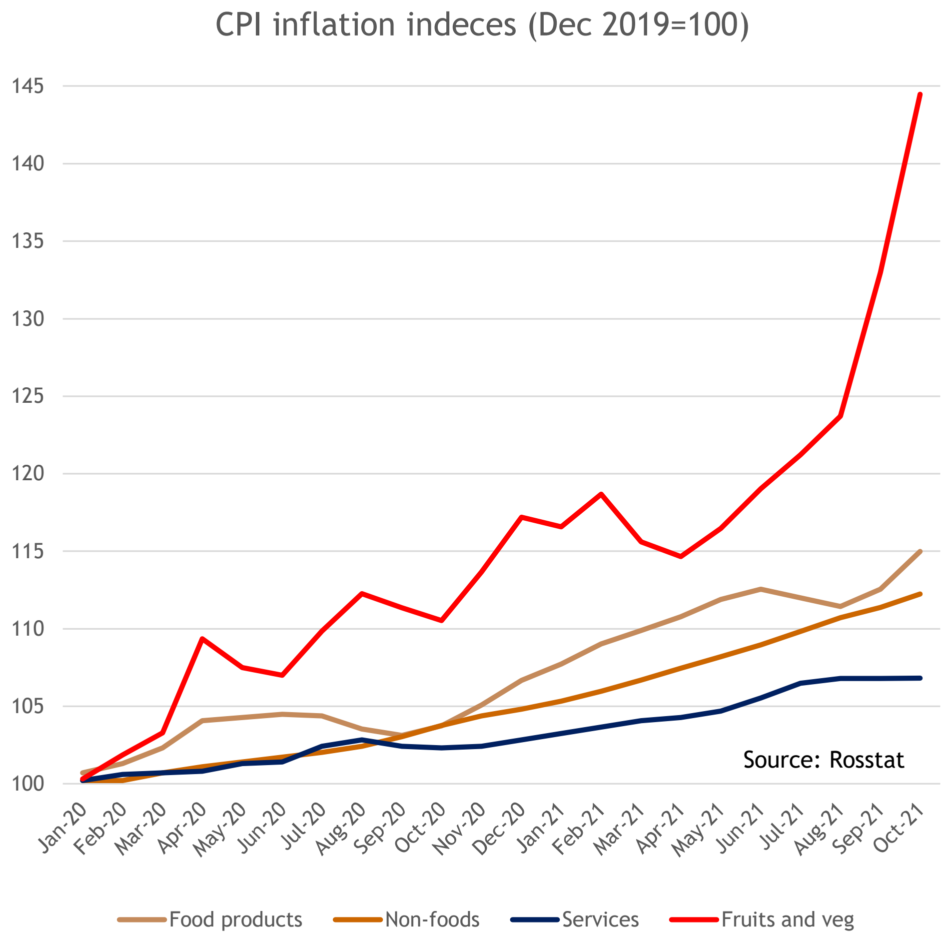
- Food prices have had the biggest impact on consumer (CPI) inflation since December 2020:
- First, the rise in global food prices were accelerating domestic prices and the agrisector preferred to export rather than sell their produce at home. The state responded with export bans (e.g. wheat, sugar, sunflower oil) and price caps for retailers that led to occasional shortages. The latter resulted in critical voices from many prominent figures, who argued that price controls should be imposed at the producer level not on the final customer.
- Second, in August-October, approximately half of the acceleration in inflation was driven by a failed harvest in fruits and vegetables and a fourth by supply shortages due to an adverse epizootic situation in animal origin products (meat, dairy).
- Food price inflation levels are significant for (at least) 3 reasons:

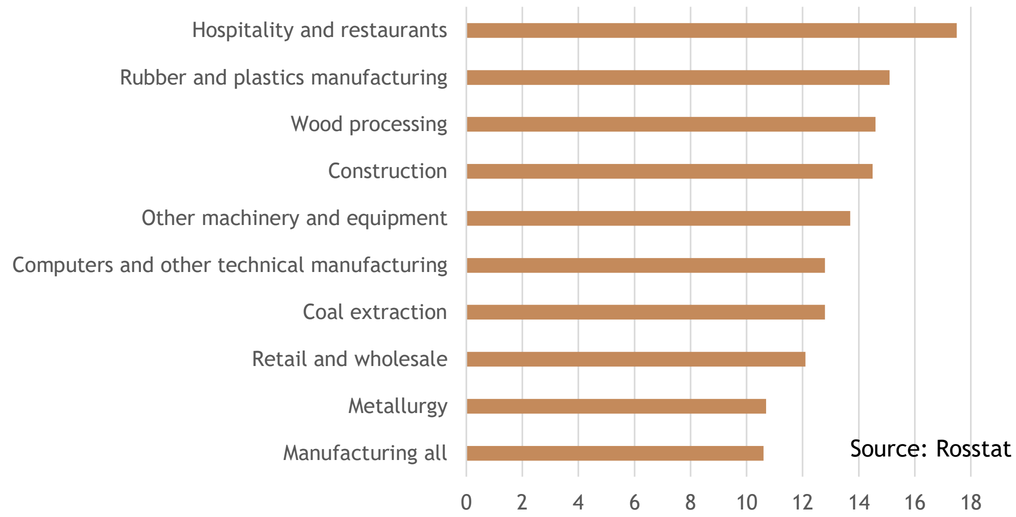
1. Consumers often anchor their inflation expectations based on food price inflation that can self-enforce higher inflation levels
2. Declined purchasing power and accelerating food prices together are a threat to Russian economy as a whole.
3. High political risk; rising prices largest perceived problem for Russian households (Levada)



Risks for permanently high inflation: **shortage of labour**

Vacancies and the unemployed*

Nominal wage increases Jan-Aug 2021 (% growth y/y)

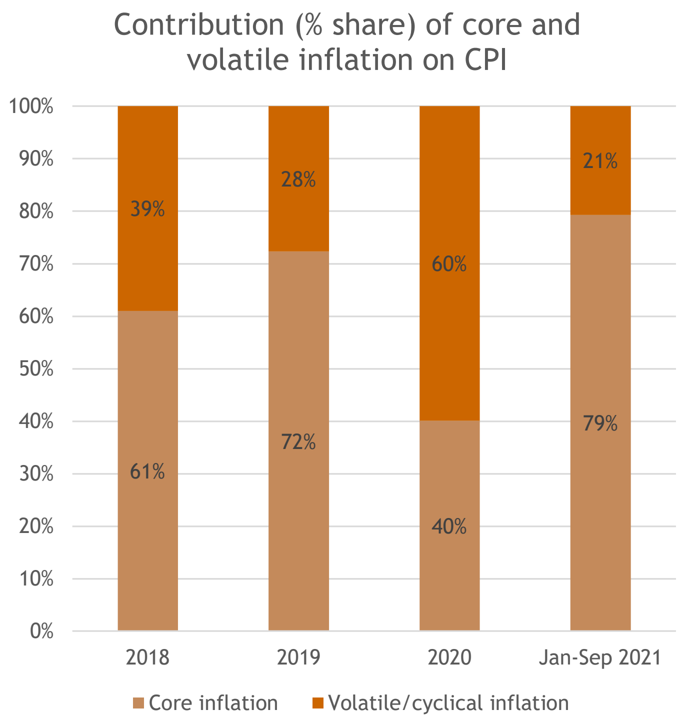


- Labour shortage in many sectors was already there before the crisis. Russia is experiencing a demographic crisis caused by the low birth rates and high mortality in the 1990s and exacerbated by the pandemic.
- Excess mortality since the start of the pandemic is estimated at 750 000 people and Russians life expectancy has decreased by 2 years, which makes it the worst affected of industrialized economies.
- Rampant inflation and outflow of workers from the worst affected sectors has resulted in large wage increases as demand has recovered fast to pre-Covid levels.
- Immigrants from Central Asian countries, who left in 2020, have not all returned to Russia, which are drinign up costs in services and sectors such as construction. According to official statistics approximately 4 million immigrants have not returned but many work in the unoffical sector

Risks for permanently higher inflation: **green transition/climate change**

- **Energy prices:** Strong increases in energy prices could persist but are unlikely to materialize in the short or middle term due to the limited ambition in Russia's green transition pledges. Discrepancies between energy supply and demand could appear and will materialize around 2030 unless infrastructure is in place for renewables production.
- **Metals:** Prices of many crucial metals (copper, nickel, cobalt) will remain elevated and have already induced the state to impose higher export duties to ensure sufficient supply for Russian manufacturers, which will not be continued in 2022 except for scrap metal. Exporting of metals (currently 19 % of Russia's exports) could slightly offset declining oil and coal exports and its impact on the state budget.
- **State investments:** In 2019, the Russian Audit Chamber warned of inflationary pressures if all the National Projects worth of $400 bn are implemented. Now, additional 42 goals announced in the Summer of 2021 and other infrastructure investment from the National Wealth Fund. At the same time, these investments are a great opportunity for Russia to diversify its economy.
- **Food prices:** More extreme weather conditions create high uncertainty in Russian food price inflation that comes with a high political cost. Risks are high even though climate change has allowed for farming in previously infertile areas. Also, Russia has fallen short of goals for replacing food imports with domestic production e.g. vegetable imports should have been cut by 70 % during 2013-2020 but the in reality the cut is only 27 % according to the National Rating Agency. During 2020-2021, the state has responded with automated price regulation system that could have unintended consequences by way of creating shortages.

Inflation outlook and state control measures



Core inflation: Change in prices excluding products/services subject to seasonal changes in prices and administrative decisions. Effectively, this refers to the exclusion of oil products (gasoline), fruits and vegetables and regulated tariffs (housing and communal services).

Source: Central Bank of Russia

- In addition to high inflation itself, the recent high key rate hikes were based on the growth in the contribution of the so-called core inflation on inflation acceleration. **Higher share of core inflation (inflation of non-cyclical non-volatile products) signals less transitory inflation levels**.
- Forecasts predict a slowdown in 2H22 but **inflation will remain high (above the 4 % target) throughout 2022.**
- CBR chief Nabiullina has said that the **CBR will make inflation decelerate to 4 % *"at any cost".*** However, CBR indicated that 2-digit key rates are very unlikely.
- The CBR key rate will be held above the neutral rate (5-6 %) for a while after the return of inflation to target. Return of the key rate to the neutral range will not occur until mid-2023. At the same time, the CBR will be able to constrain consumer lending, which is showing signs of overheating, and at least mortgage growth has not responded to the previous hikes in interest rates.
- Fortunately for the CBR, **monetary policy has more significance compared to Western central banks**, which have currently very difficult decisions to make whether (and how much) to cut down on asset purchases and to increase interest rates when many countries are again struggling with high level of infections.
- The government has announced of a **new automated price control mechanism** for socially significant foodstuffs and other critical inputs. The mechanism will be algorithm-based triggering warnings when critical indicators move over/under a given limit and then, export bans or price caps would be imposed. Imposing direct price caps has received criticism from high level experts.

Kazakstan, Ukraine and Belarus

Decelerating growth for Ukraine and Belarus as the low base level fades, Kazakh economy showing higher growth rates

Kazakh economy strong in 3Q21 but deceleration ahead

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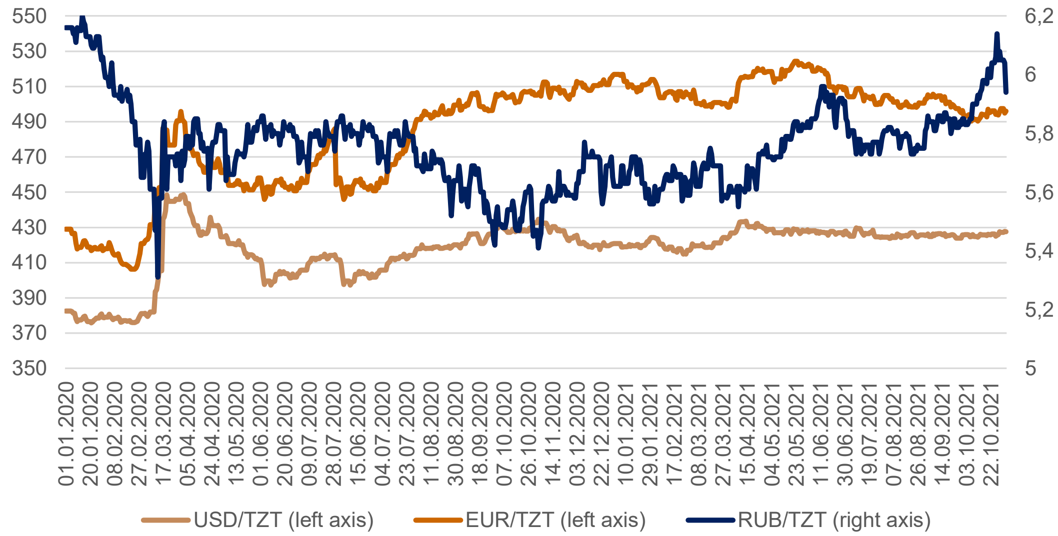
Economic growth has accelerated in 3Q21 for the Kazakh economy, due to stronger industrial output and retail sales. Within industry stronger manufacturing, mining and quarrying output drove the economy forward despite a contraction in the oil sector still in September. Also, retail sales improved and to 5.6% in September from 0.8% in August, most likely due to a low base level in September 2020. Other main sectors such as construction and agriculture showed lower dynamics during the same period. After a strong 3Q21, economic growth is set to slow down towards the end of the year following global growth trajectory despite an expected improvement from the oil sector.

Kazakhstan has become the second-largest bitcoin mining location after the US in the world since China banned all crypto transactions and mining earlier this year. This led many people to relocate the neighbouring Kazakhstan, which boasts some of the lowest electricity prices for households and businesses in the world. For energy-intensive Bitcoin mining, this is ideal, but for Kazakhstan, the development is becoming a problem: the energy-rich country is facing an energy crisis as it relies heavily on coal to produce electricity, and now the excessive pressure on natural resources is emptying its coal reserves faster than ever. The authorities say there has been an 8% increase in domestic electricity consumption after the miners from China arrived. The situation has led to the rationing of domestic supplies as the increased consumption weighs heavily on the country's power grid and has resulted in electricity shortages President Tokayev has instructed Energy Minister Mirzagaliyev at the end of October to identify illegal mining operations as soon as possible and regulate the sector.

Tenge FX rates against EUR, USD and RUR



Main economic indicators	Real				Forecast	
	9m21	1H21	1Q21	2020	2021	2022
GDP, % y/y	4.1*	2.4	-1.4	-2.6	3.8	4.5
Industrial production, % y/y	2.7	1.2	0.1	-0.7	3.5	4.4
Inflation, % (end of period, y/y)	8.9	7.9	7.0	6.8	7.7	6.5
Current Account Balance, USD bn		-2.4	-1.5	-6.5	-3.3	-3.8

*Short term indicators for the main sectors of the economy for 9m21.
Source: National Bank of Kazakhstan, Ministry of National Economy of the Republic of Kazakhstan Committee on Statistics
Forecasts from Consensus October 2021 survey

Analysis by Sinikka Parviainen and Sanna Hentunen

Ukrainian economic growth slowing down as tensions with Russia escalate again

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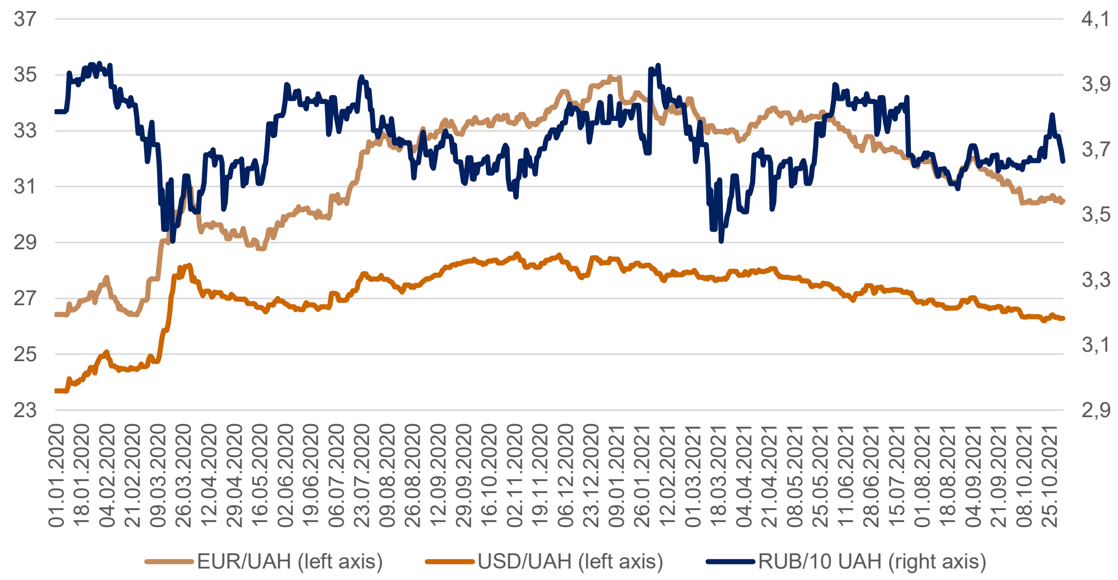
Ukrainian economic growth more than halved in 3Q21 (2.4 % y/y) compared to the previous quarter (5.7 % y/y). Economic growth was dragged down by weak performance in the manufacturing sector suffering from high input prices. At the same time, agricultural and construction sectors managed to improve their performance in 3Q21. Given the fading of the global economic cycle, most forecasters estimate that Ukraine will not be able to reach its pre-pandemic GDP levels in 2021. Also, the launch of the Nord Stream 2 pipeline, approval of which has been suspended in Germany, probably at the end of this year will mean that Ukraine will loose at least $2bn in gas transfer revenues. However, Germany has promised compensation for part of the losses according to a deal made with the US earlier this year.

Concerns over Russian military activities in and around Ukraine have once again risen both in Ukraine and in western countries. According to NATO, there is a “large and unusual concentration” of Russian forces close to Ukraine's borders in recent weeks. Foreign ministers of Germany and France among other leaders from both US and EU, have expressed their concerns and warned Russia against harming Ukraine's territorial integrity. Russia has dismissed all the Western suggestions and turned the table around towards Washington, which it accuses of aggressive moves in the Black Sea, where Ukraine and the United States have held major military drills in recent months.

The latest turn for worse happened on November 15, when Putin signed a decree allowing goods produced in Eastern Ukraine to be sold more easily in Russia. According to Ukraine, this “contradicts Russia’s obligations under the Minsk agreements” and “clearly demonstrate Russia’s purposeful policy to drag the temporarily occupied territories of Ukraine to its economic, political, electoral and informational space”. Analysis by Sinikka Parviainen and Sanna Hentunen

Hryvnya FX rates against RUB, EUR and USD



Main economic indicators	Real				Forecast	
	3Q21	2Q21	1Q21	2020	2021	2022
GDP, % y/y	2.4	5.7	-2.2	-4.0	3.5	3.9
Inflation, % (end of period, y/y)	11.1	9.5	8.5	2.7	9.2	6.7
Industrial production, % y/y	1.4	2.2	-2.0	-4.5	2.6	3.4
Current Account Balance, bn USD	-1.4	-0.7	-1.0	5.2	-1.5	-3.4

Source: National Bank of Ukraine, UkrStat
Forecasts from Consensus Economics October 2021 survey

Belarus economy better than expected with Russia's backing

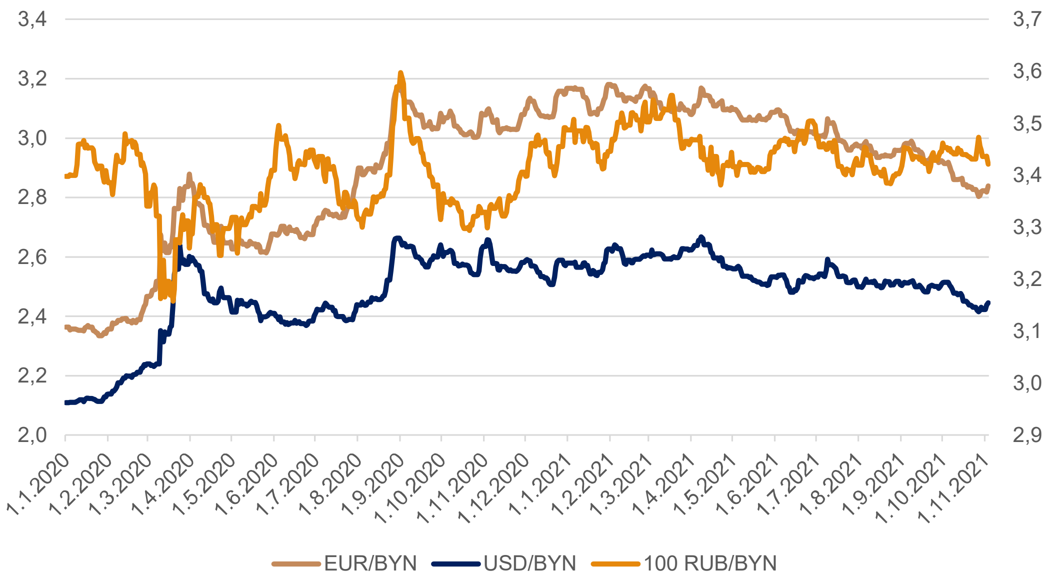
The year 2021 has been a turbulent one for Belarus due to EU sanctions that cut some of its major export routes (e.g. fertilizers). Belarusian economy has managed better than expected and no imminent liquidity crises are foreseeable due to support from Russia, the Eurasian Development Fund and the access to Russian capital markets. In 3Q21, economic activity has slowed down due to a lower base effect and all sectors, except for retail, showed decelerating growth levels month for month. The main driver for increased household consumption was due to a more robust growth in real disposable income (2.9% y/y in 8m21). As the base effect will weaken further in 4Q21, growth rates in most sectors will continue to decelerate.

Belarus-EU border crisis has escalated quickly during the past few weeks. Already last summer, Lukashenka began to offer unrestrained passage for migrants from Iraq, Syria, and several African countries into Europe by way of looser visa requirement and increased number of flights from the Middle East to Minsk by the state-run airline. Consequently, thousands of people took the opportunity and flew to Europe. After arriving in Minsk, immigrants were quickly pushed to EU Borders, especially to the border of Poland. Now thousands of people are trapped, sleeping outside in freezing temperatures and facing the fact that neither side will allow them to leave the "no man's land". More than 10 people have already died.

The situation has been described an act of hybrid warfare and a deliberately created humanitarian crisis. So far, the EU has stood unilaterally behind Poland and other affected members. At the same time, Belarus has irritated its main benefactor, Russia, as it announced that it will cut gas supplies to Europe that flow through its territory when Russia and namely Gazprom was trying to mend ties with its European customers.

Analysis by Sinikka Parviainen and Sanna Hentunen

Belarusian rouble FX rates against EUR, USD and RUB



Main economic indicators	Real				Forecast	
	9m21	1H21	1Q21	2020	2021	2022
GDP, % y/y	2.7	3.5	1.1	-0.9	1.8	1.7
Inflation, % (end of period, y/y)	10.2	9.9	8.5	5.5	9.3	7.5
Industrial production, % y/y	7.9	10.4	9.2	-0.7	5.9	2.6
Current Account Balance, USD bn		0.12	-1.0	-0.3	-0.3	-0.7

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