Strategic Choice Advisory
Strategy and Transactions

Russia Macro Foresight

Strong Recovery Takes Place in 2021, Despite Pandemic and Rampant Inflation, but is it the Calm before the Storm?

February 2022

Welcome broad-based rebound observed in 2021. Growth in some sectors cools due to high base effect and easing of pandemic-driven demand

- The Russian economy recovered strongly across the board in full-2021, offsetting the pandemic-induced contraction of 2020. **Industrial output, transport, construction, retail trade all posted robust growth figures. Investment surged,** paid services sprung back to life, and only **agriculture was set back by very hot weather and market saturation** in some key segments, especially grain
- Encouragingly, **economic diversification continued apace,** with segments from various chemicals and building materials to machinery and electronics all benefiting from increased investment and import substitution. At the same time, as we predicted earlier, **some segments that had been supported by pandemic-driven demand,** like textiles and pharmaceuticals, **saw growth normalize**, while **others were simply affected by the high base** factor (which, by the way, is likely to push down 2022 figures)

Indicator, % y/y	2018	2019	2020	2021
Industrial production	2.9	3.4	-2.1	5.3
Cargo transport turnover:	2.7	0.7	-4.7	5.3
Railway	4.2	0.2	-1.9	3.4
Automobile	2.3	6.3	-1.3	5.0
Agriculture	-0.2	4.3	1.3	-0.9
Retail trade	2.8	1.9	-3.2	7.3
Paid services	1.4	0.5	-14.8	17.6
Construction, o/w:	6.3	2.1	0.7	6.0
Housing	-4.5	6.2	0.2	12.7
Fixed capital investment	5.1	2.1	-1.4	7.6*

** - Jan-Sep 2021*

Segment, % y/y	2020	2021	Segment, % y/y	2020	2021
Food products	3.1	3.2	Chemicals, overall	7.3	6.0
Textiles	9.7	7.5	Resins & plastics	6.2	7.7
Apparel	0.3	3.0	Pharmaceuticals	20.9	11.5
Leather & products	-11.9	11.4	Coke & oil products	-5.0	3.6
Metal products	4.2	3.4	Machines & equipment	9.6	13.8
Wood products	-1.7	7.9	Electrical equipment	-0.8	6.3
Furniture	6.7	14.1	Automobiles	-12.1	13.8
Building materials	-0.3	7.5	Computers & electronics	3.3	7.9

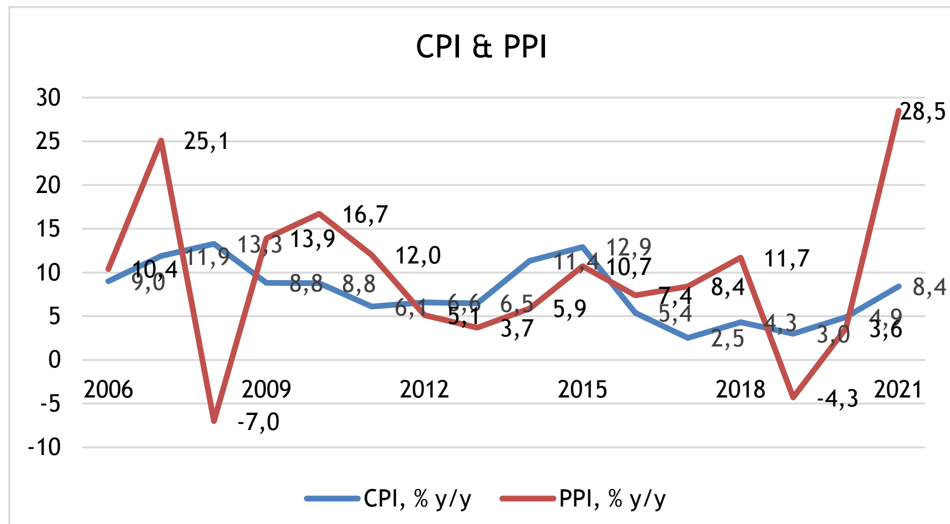
Real income growth picks up, boosting consumption, but inflation revs up, endangering further economic expansion

- **Real disposable income** (RDI) grew 3.1% y/y in 2021 after contracting 2% the previous year. This was actually the strongest growth over the last 8 years since tensions with the West flared up over Ukraine in 2014
- **ILO-definition unemployment slid to 4.3% in Dec 2021 after peaking at 6.4% in Aug 2020**, while official unemployment dipped to just 1% after hitting multi-year high 4.9% in Sep 2020
- **These positive trends obviously underpin consumption, which is recovering quickly,** in part supported by international travel restrictions diverting more spending into the local economy. With labor market deficits forming in many key sectors, **strong wage growth is expected to continue**

Indicator, % y/y	2018	2019	2020	2021
Real disposable income	0.1	1.0	-2.0	3.1
Real wages	7.4	4.8	2.5	2.8*
Nominal wages	10.3	9.5	6.0	9.5*

** - Jan-Nov 2021*

- At the same time, continuing a very dangerous trend, **CPI inflation sped up further to 8.4% y/y in Dec 2021** vs. 4.9% y/y in Dec 2020 and 3% in Dec 2019. Price growth acceleration was observed across the board, as food prices rose 10.6% vs. 6.7% in 2020, non-foods – 8.6% vs. 4.8%, and services – 5% vs. 2.7%. Key groceries, including cereals & beans, pasta, meat & poultry, eggs, and fruits & vegetables saw the strongest price growth. Among non-foods, the biggest increases were witnessed in building materials, electronics, household chemicals, and gasoline
- Meanwhile, **PPI inflation shot through the roof,** as we had predicted, **reaching 28.5% y/y in Dec 2021** (down slightly from 31.1% in Jun 2021**).** Looking at the segment breakdown, **producer prices grew the most in extraction** (almost 60% y/y, including 3.6-fold in coal, and almost 80% in oil&gas), **and other lower value-added segments,** including wood products (44%), metals (31%), etc.
- Robust inflation was already seen in further downstream sectors such as chemicals (51%), resins & plastics (31%), furniture (18%), etc., but was still not that high in key segments like building materials (11.3%), investment goods (7.8%), and machines & equipment (4.6%). This shows **the worst is yet to come in terms of input price pressure**, and while high inflation does support some sectors, **it will surely dampen overall growth this year**



External, public, and monetary sector indices resurge, and FDI finally rebounds. Banking sector indices improve notably, and even overdue debt contracts amid economic amelioration

EXTERNAL SECTOR

- Russia's **current account surplus rebounded 3-fold y/y to USD 120.3bn in 2021,** as the trade surplus surged 2-fold to USD 185.9bn. The share of crude oil and natural gas in goods exports edged up to 33.6% on higher prices; adding oil products and LNG as processed goods - stayed at 49.1%. Federal Customs Service Jan-Nov data shows the share of metal products rose 0.5pps y/y to 10.6%, driven by robust world price growth; chemicals – 0.4pps to 7.6%, as export volumes rose 6.7% y/y. Exports of machines & equipment grew 31.7% in value terms. Interestingly, the share of foods declined 1.4pps to 7.3% after strong growth. **Another interesting trend was the increase of EU's share of foreign trade turnover by 2pps to 35.9%, while APR dipped 0.5pps to 34%,** reversing the dynamics seen in recent years
- Positively, **external debt rose just 2.4% y/y,** as state debt declined 3.8%, corporate debt – 4.8%, but CBR debt jumped 2.6-fold
- Very encouragingly, **FDI soared 3.8-fold to USD 30.7bn in 2021,** according to preliminary CBR data, after a prolonged steep decline

PUBLIC SECTOR

- **The federal budget was executed with a surplus in 2021, for the first time in several years,** making up RUB 515bn or 0.4% of GDP, after the deficit had widened to 3.8% in 2020. Revenues overshot the target by 34.8%, while spending was 15.1% above plan. Maintained fiscal prudence and focus on economic diversification and infrastructure development should further support public finances and economic growth

MONETARY AGGREGATES

- **After slowing in H1, growth of monetary aggregates picked up again in H2,** reaching levels seen in 2020. Thus, broad-definition monetary base rose 10.1% in 2021 vs. 9.8% in 2020, national-definition money supply – 13% vs. 13.5%. Worth noting, cash in circulation grew just 5.4% vs. 29.7% in 2020, when people were making massive withdrawals after the start of the pandemic. RUB deposits gained 15% in 2021, while banks' deposits with CBR jumped 2.3-fold. On one hand, this supports savings, but on the other, shows investment stays constrained

BANKING SECTOR

- Following the general economic recovery, **banking sector indices improved markedly in 2021. Sector profit resurged**, and key asset and liability classes posted strong growth
- At the same time, **we are concerned about rapid retail lending growth.** Overdue debt growth slowed notably, but remains too high for comfort. On a positive note, **corporate overdue debt receded in 2021 after rapid growth** in 2019-2020
- Corporate funds grew again strongly, as companies are cautious about investing in current market conditions. **High inflation is set to increase the cost of funding, limiting bank profit growth this year**
- **We must also note robust growth of investment in securities**, fuelled by banks' active promotion of various instruments to private investors. This will be an interesting trend to watch, going forward

Indicator, % y/y	2018	2019	2020	2021
Banking sector profit	**70.3**	**71.9**	-6.2	47.0
Total assets	**6.2**	**5.9**	12.5	15.9
Loans to individuals	22.7	18.6	13.5	25.1
Loans to corporates	7.3	5.8	9.9	17.0
Total overdue debt, o/w:	1.9	20.1	16.3	-3.8
Individuals	-10.4	0.5	22.0	8.1
Corporates	7.8	25.9	13.6	-12.8
Individuals' funds	6.3	9.7	4.2	5.7
Corporates' funds	5.4	4.7	14.4	17.0

All positive developments can be overturned by escalation of Russia-West conflict over Ukraine… How resilient will Russian economy be, if worse comes to worst?

- 2021 was a fairly good year for the Russian economy, as it managed to overcome the negative effect of the Covid-19 pandemic, despite a deadly Delta wave in the middle of the year. Businesses are not yet out of the woods, and although the Omicron variant appears to be generally lighter, there are accumulated debts and losses that may bog down or undermine the recovery of struggling enterprises. And while prospects of pandemic easing have improved, it is not clear where the pandemic will go from here, due to the risk of the emergence of more severe new variants
- The main question now is what will happen next in the standoff between Russia and the West regarding Ukraine, and more broadly, over further NATO expansion and its positions in Europe. Russia appears keenly intent on limiting NATO and the West's influence in the region, and aims to use its increased economic, political and military clout to shift the balance of forces in Eurasia and globally. The risk of renewed military conflict in Ukraine remains very high, as both Russia and Ukraine have accumulated significant military presence at the border, and Western military aid to Ukraine remains a major irritant for Russia
- It is extremely difficult to make any meaningful forecasts at this point, as the situation can develop in all kinds of different ways. In any case, the fallout will continue to affect foreign investor sentiment, limiting funding and liquidity availability for Russian companies. What appears certain is that Russia, and also China, not to mention a host of other nations at odds with the West, are eager to do some rebalancing of the world order, thus the tensions are unlikely to go away, regardless of how the situation over Ukraine plays out, and may further intensify in coming years
- Russia has definitely built itself a reputation of prudence and resilience in the face of economic crises and Western sanctions. This will no doubt be put to a serious test, should commodity exports and FX revenues be placed at risk with possible new sanctions in the case of military conflict in Ukraine, together with other measures aimed at limiting liquidity, investment and new technology inflows into Russia
- The country's external and fiscal positions thus far remain solid, while a strategic partnership/alliance with China and possibly other economic powerhouses might work to mitigate some of the FX and liquidity risks for Russia. China, of course, would not want to undermine its own worsening relations with the West, and has so far treaded carefully in financing projects in Russia, but would hardly miss the opportunity to help out Russia in exchange for various economic benefits
- If any military escalation does take place, Russia will likely continue to rely on its economic stimuli and import substitution programs to support local businesses. A crucial sector would then be electronics, which Russia is already actively trying to develop, to varying degrees of success. China's support could come in handy, but the issue will be what would Russia be willing to surrender in exchange, and how quickly it can work out solutions to support liquidity

Contact details

For additional information, please contact:

Andrew Afanasiev

Managing Partner, CEO

Mob. +7 (903) 745 7330
E-mail: aafanasiev@strategicchoice.org

Strategic Choice Advisory

20A Bronnaya M. str.,
Moscow, 123104, Russia

Tel.: +7 (495) 135 2830

https://www.strategicchoice.org