Russia: Risk of weaker and more uneven recovery rises as nation continues to grapple with COVID-19

CHRIS J FINDLAY
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1712
E: christopher.findlay@uk.mufg.jp

MUFG Bank, Ltd.
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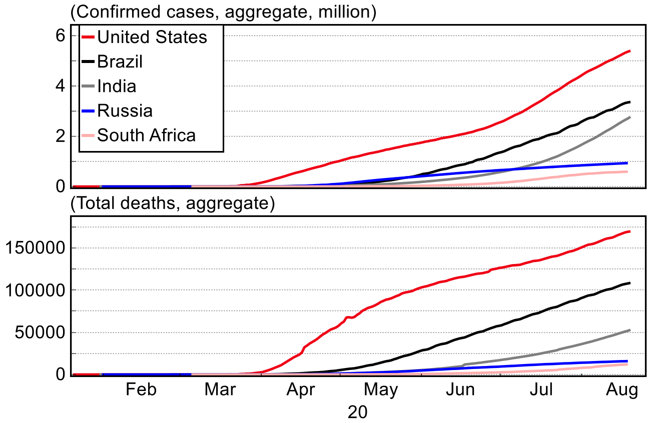
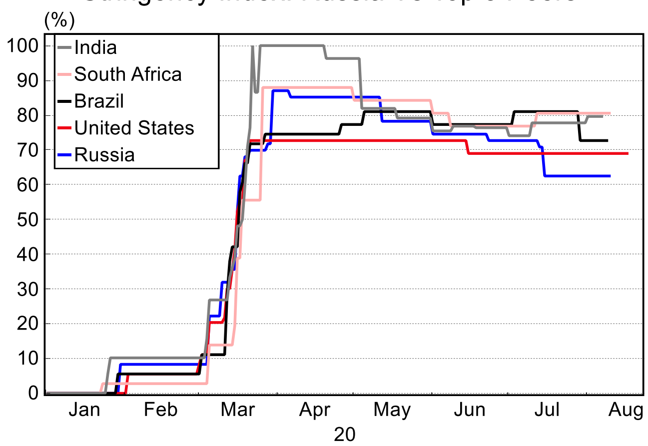
Russia has suffered the fourth largest outbreak of coronavirus in the world year to date, and while there has been a slight flattening of the curve in recent weeks, coronavirus cases continue to grow. Lockdown measures were significantly ramped up from end-February but were subsequently eased from 4th April. The impacts on the economy have been significant and this may have been a reason behind the easing of lockdown restrictions, with the low number of total deaths from coronavirus perhaps being another. Real GDP tanked in 2Q 2020, as all expenditure components were hit. Longer term, real GDP growth is also likely to be weaker and more uneven. Private consumption may take some time to fully recover, while the change in government's fiscal policy may hinder capex spending

Coronavirus Outbreak Comparisons, World Top 5



Source: WHO, Macrobond, MUFG Bank Economic Research Office

Stringency Index: Russia Vs Top 5 Peers



Source: University of Oxford, Macrobond, MUFG Bank Economic Research Office

Indeed, the path back to pre-coronavirus levels of real GDP will take a few years[1], but given the huge fall in activity, naturally most economic indicators are now showing tentative signs of a rebound as lockdown measures are eased and society adapts to the virus. We expect positive q-o-q real GDP growth in 3Q 2020 but risks to remain firmly to the downside in 2H 2020 given the sustained spread of the disease domestically and increase in global cases.

[1] Given that we forecast a real GDP drop of 6% YoY in 2020, followed by a recovery of 3% in 2021, real GDP may not reach back up to pre-coronavirus levels until 2022, at the earliest.

Real GDP Drop of 8.5% YoY in 2Q 2020

The hit to real GDP has been mostly confined to 2Q 2020 so far. Russian real GDP contracted by 8.5% YoY in 2Q 2020 as the impacts of coronavirus and lockdown measures affected private consumption, business investment and net exports. While a historically significant drop, other countries experienced notably worse outcomes last quarter. We also note this was less than the preliminary estimates suggested and better than consensus.

Real GDP figures for private consumption, the main driver of real GDP growth over recent years, are expected to show a substantial drop given the rise of unemployment to 2.7 million at the end of 2Q 2020, from 700k at the end of 1Q 2020, as well as the decline of retail sales by 13.7% YoY in 2Q 2020. Net exports are another source of pain, as external demand from Russia's main trading partners faltered. Such was the extent of the coronavirus shock globally that Brent, the global oil price benchmark, declined to a record low of USD 19.7 per barrel in the middle of April, and new OPEC + oil production limits were agreed to as a result.

On the fiscal side, while risks that may lead to sovereign crises remain low in Russia[2], the events of this year have left their mark on the country's public finances. Fiscal stimulus measures[3], the effect of the decline of real GDP on tax revenues and the fall in oil prices (Russia relied on 40% of its total annual revenues from oil and gas in 2019) have led to a government fiscal deficit of around 0.9% of GDP (or RUB 955.9 billion) in 1H 2020, from a decent surplus of 1.7% of GDP in 2019. Fiscal measures have also changed the composition of government fiscal expenditures for the worse. A higher proportion of government expenditure is now geared towards social spending. While plainly needed to help alleviate some of the worse impacts of coronavirus, these types of expenditures tend to be quite sticky and difficult to reverse once implemented.

Wider Recovery Now Underway

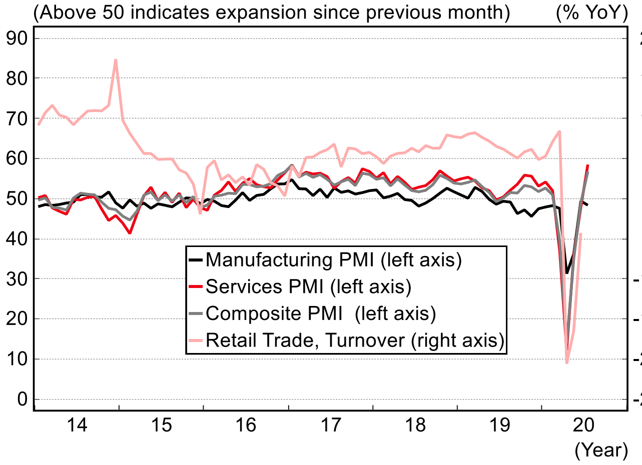
Given the drastic drop of real GDP in 2Q 2020 and the easing of lockdown measures, naturally most economic indicators have now started to rebound. However, the overall bag of economic indicators is mixed. Some indicators such as PMIs (which we note only indicates m-o-m improvement) and retail trade suggest a recovery. Russia's composite PMI reached 56.8 in July, while retail trade only declined by 4.3% YoY in June, and should hopefully turn positive again in July. On the other hand, industrial production figures remain much weaker and down 9.4% YoY in June. In particular, the mining and quarrying sector has suffered significantly in the wake of oil output cuts in May and the weaker oil price over recent months.

At any rate, the Central Bank of Russia (CBR) has maintained its dovish stance. On 24 July, the CBR cut its main policy rate by a further 25bps, taking the main policy rate to 4.25%, after a rather aggressive 1 percentage point cut at the end of June. The Governor of the Central Bank of Russia has indicated that a further rate cut could also be on the cards, given that CPI figures for June and July were under the CBR's target rate of 4% YoY. Yet the CBR is unlikely

[2] Government debt to GDP was only 14.7% of GDP in 2019, with the foreign currency share at just 20.1% of government debt. Government bond yields and CDS spreads have also reverted back to longer run averages.
[3] For a full breakdown of the main measures so far please access our previous report on Russia, found here: "Recession now expected in larger CEE countries and Russia in 2020" (published on 13th May 2020): https://www.bk.mufg.jp/report/econew/MUFG-Economic-Brief-20200513.pdf

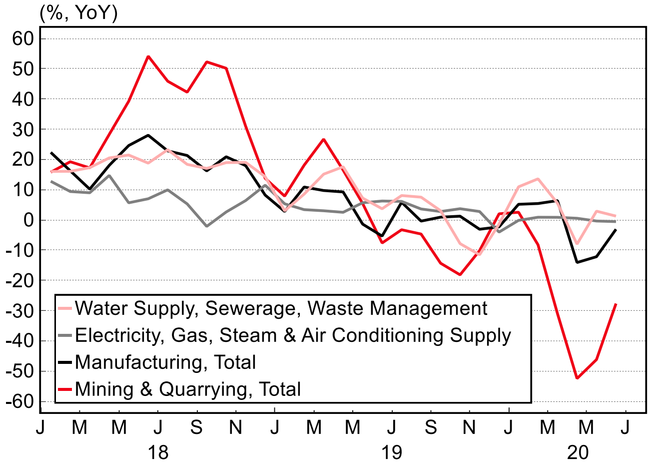
to go too much further given that Russia's real interest rate, estimated at around 0.9% in July, has rapidly fallen in recent months and is now just above some of its emerging market peers.

Case for Optimism: PMIs and Retail Trade



Source: IHS Markit, Rosstat, MUFG Bank Economic Research Office

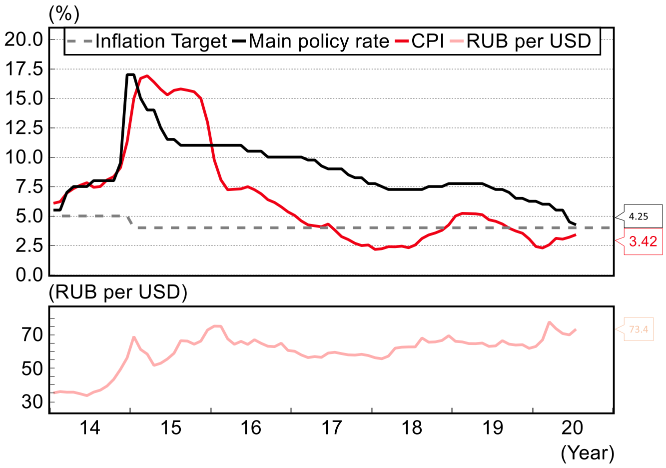
Case for Pessimism: Industrial Production



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

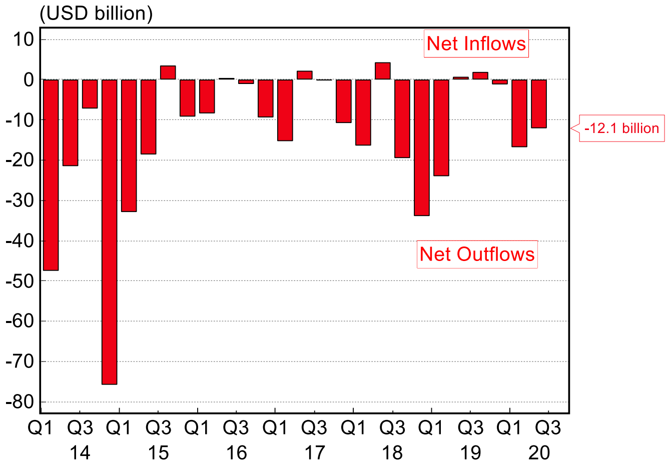
The CBR may also be concerned by the recent weaker EM market risk sentiment, higher US-Russia tensions and recent higher local market government bond issuance. Net outflows of private sector capital have continued over 1H 2020. Moreover, while the inflation outlook is expected to remain weaker in the near-term, as a result of weaker private consumption and strengthening of the global oil price (a stronger global oil price tends to lead to a stronger Ruble, which reduces prices of imported goods), inflation is likely to rise again next year. The CBR estimates the long run neutral interest rate at 5.0-6.0% hence this will remain a factor.

Inflation, Monetary Policy & Exchange Rate



Source: CBRF, Rosstat, MUFG Bank Economic Research Office

Net Flow of Capital, Private Sector



Source: Macrobond, MUFG Bank Economic Research Office

Turning to the fiscal side, a longer term adjustment is now likely. The government has announced that it will extend the deadline for its national projects program by a further six years to 2030. The original program envisaged a USD 363 billion fund (RUB 25.7 trillion or

~23.5% of 2019 GDP) that would be channelled into 13 key areas[4]. Initially we had been expecting the roll-out of projects to be fairly negligible this year, but to pick-up slightly thereafter. This is no longer the case. There is less room to surprise to the upside, as well as the added risk that real GDP growth is likely to rely solely on just one component of growth, private consumption (which may remain weakened for years to come). Real GDP growth potential is likely to be affected given the fact that national projects would focus on growth enhancing areas.

Long Path Back till Real GDP Recovers Pre-2020 Levels

Taking the better than expected retail sales figures for June with weaker industrial production into account together, we maintain our forecasts of a 6.0% YoY decline of real GDP this year, followed by a recovery of 3.0% in 2021. We note, while retail sales in June have surprised to the upside, they are still weak in YoY terms in June (down 4.2% YoY), and given that there are still risks, consumers may be reluctant to return to shops and restaurants. Unemployment has also risen very sharply in the near term too which may further dampen the recovery of private consumption, which we think will be gradual.

Given that coronavirus cases continue to grow in Russia, as well as globally, both private consumption and net exports will remain subject to the impacts of further lockdowns; albeit further lockdowns, if needed, are far more likely to be on a local scale in 2H 2020. Lower oil prices will also lead weaker exports, and affect Russia's net exports. Added to this, investment will remain weak, given low oil prices and the extension of national projects by a further 6 years till 2030, which we had been relatively gloomy about at any rate. In sum, this will mean that real GDP may not reach back up to pre-coronavirus levels until 2022, at the earliest, and the recovery may be weaker and more uneven.

[4] The main targeted areas of the program include modernisation of infrastructure and higher quality roads (RUB 11.1 trillion or 10.2% of GDP), ecology (RUB 4.0 trillion or 3.7% of GDP), demography (RUB 3.1 trillion or 2.8% of GDP), and healthcare (RUB 1.7 trillion or 1.6% of GDP).