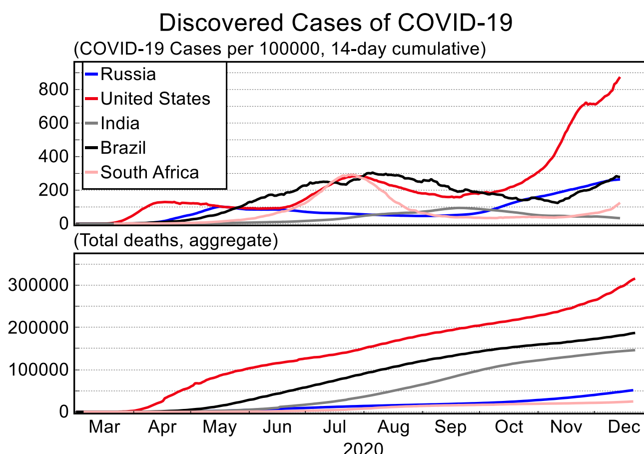
Russia: Real GDP trajectory weakens as early recovery starts to wear-off & Q4 output declines

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

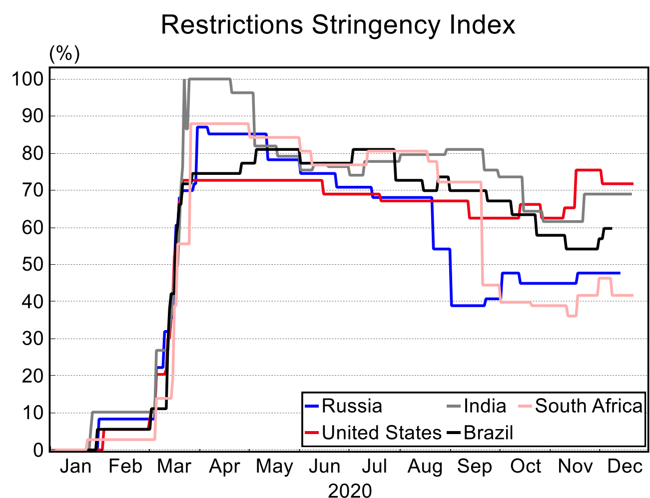
MUFG Bank, Ltd.
A member of MUFG, a global financial group

25 DECEMBER 2020

We expect real GDP growth of -5.0% YoY in 2020 before a rebound of 2.5% YoY in 2021. Despite the fact that output is set to slip back in Q4, this is an upgrade on our previous annual forecast for 2020 (-6%), owing to an upward revision to the Q2 figure (now -8.0% YoY) and a stronger than expected rebound in Q3. The real GDP rebound in Q3 (around 6% QoQ based on our own seasonal adjustment) was due to stronger private consumption which outweighed the negative effects of the OPEC+ oil production deal. In Q4, coronavirus cases have not surged in Russia to the same extent as elsewhere (such as the US and EU) so lockdown restrictions remain less stringent. This should limit the hit to real GDP. Nevertheless, we still expect that output will slip back due to (1) fading effects from the initial fiscal and monetary stimulus measures, (2) weaker labour market and consumer confidence, and (3) more limited fiscal stimulus over the medium-term as a result of fiscal consolidation.



Source: WHO, Macrobond, MUFG Bank Economic Research Office



Source: University of Oxford, MUFG Bank Economic Research Office

Economic Recovery Momentum Starts to Wear Off

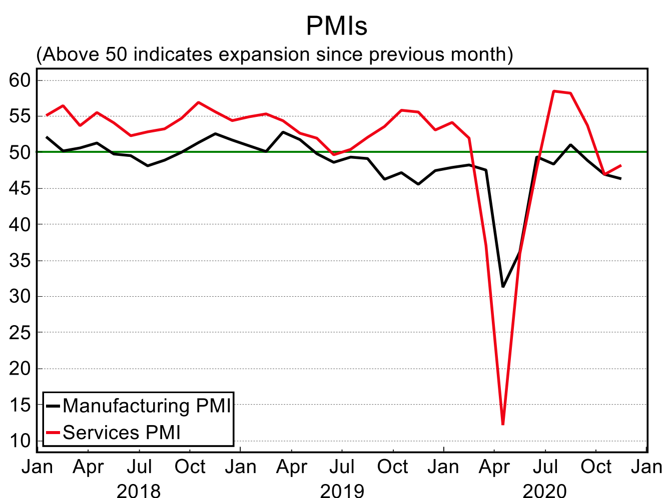
Survey indicators show weakening economic momentum in Q4. Both services and manufacturing PMIs have declined which points to an upcoming economic contraction in Q4. The labour market has also been weakening. Unemployment has swollen to 4.8 million in

MUFG

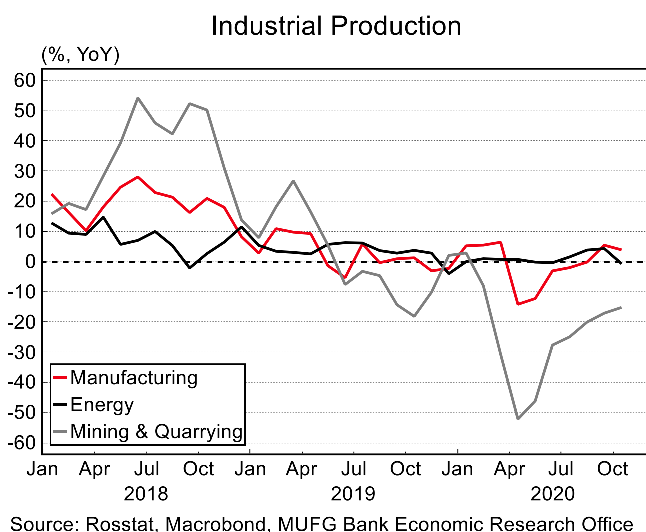
October (an increase of approximately 1.3 million since the start of the pandemic), while the unemployment rate now stands at 6.3% (up from 4.6% in February 2020).

We expect some headwinds for consumer confidence ahead. While not as stringent as in other countries, COVID-19 restrictions have still been increased in Russia to combat the renewed spread of the virus. The government remains reluctant to increase lockdown measures much further given the need to protect fiscal buffers, economic growth and wider living standards. This said, reports suggest that hospital capacity is critically low in several regions hence restrictions may need to be tightened on a more local scale, and perhaps nationally later on too. Meanwhile, it will take some time before coronavirus vaccines can be widely distributed throughout the country.

Faced with the same headwinds, the outlook for industrial production is similarly weak. In particular, the recovery in the oil sector is likely to remain gradual due to oil production cuts, which is acting as a cap for oil production. Meanwhile, global demand for oil is still rebounding, despite the recent oil price rally after positive announcements regarding the successful testing of coronavirus vaccines. We do note that industrial production experienced a larger shock during the initial wave of the virus due to the weakness in oil prices, which could mean there is further for the rebound effect to go, but risks are clearly to the downside.



Source: IHS Markit, MUFG Bank Economic Research Office



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

Draft Budget Highlights Fiscal Consolidation Ahead

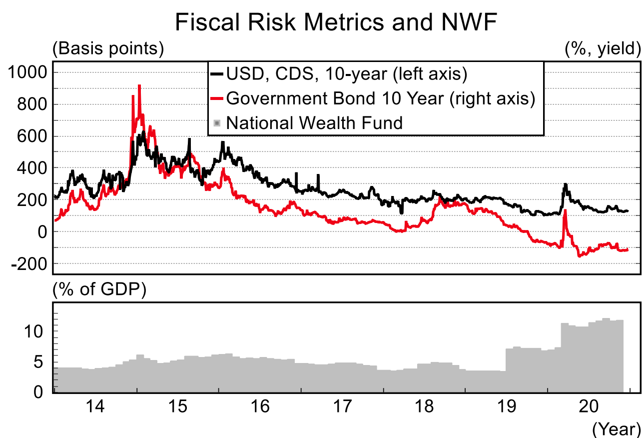
Given the shock to public finances caused by COVID-19 this year, the government has announced a fairly strong fiscal consolidation ahead. It expects that a budget deficit of 4.5% of GDP in 2020 will fall to 2.4% in 2021, before declining further to around 1% in the following years. The government hopes that the fiscal consolidation plan will help contain government debt to below 20% of GDP by spreading infrastructure expenditures over a longer time period, while increasing some taxes in the meantime to help keep fiscal revenues in check.

MUFG

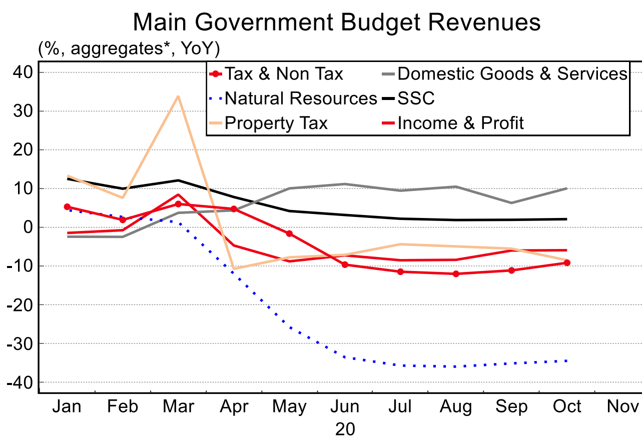
On the expenditure side, the government has announced that it will extend the deadline for national projects[1] by a further 6 years till 2030. This will lead to capex being more evenly spread over the next ten years thus helping to reduce pressures on the government fiscal deficit, however in the interim will reduce real GDP growth. On the government revenue side, the government has announced that it plans to increase the top rate of personal income tax in 2021 from 13% to 15% on incomes that exceed RUB 5 million ($65,034)[2], while also making some changes to taxation of oil and gas companies such as tripling the mineral extraction tax (MET) rate.

The government plans to fund its fiscal deficit predominantly from borrowing a total of RUB 10 trillion (USD 135 billion) up to 2023, which looks feasible. At the same time, the government does have its National Wealth Fund, which is set to stand at RUB 12.5 trillion by the end of 2020. We judge that sovereign default risks in Russia are low at present, as sovereign bond yields and CDS spreads remain stable.

Nevertheless, fiscal changes are unlikely to reduce existing vulnerabilities such as high reliance on oil and gas revenues[3] and government expenditures that, in the aftermath of the initial COVID-19 outbreak, are likely to remain more geared towards social spending. Government fiscal deficit figures in both 2020 and 2021 include measures worth 9% of GDP to deal with the COVID-19 outbreak and economic shock. In sum, fiscal consolidation will clearly strengthen public finances, but vulnerabilities will remain, and there will also be risks to government revenues if real GDP growth proves weaker than expected.



Source: Russian Ministry of Finance, Macrobond, MUFG Bank Economic Research Office



*Aggregate for specific month, is sum of all months from Jan plus that month
Source: Macrobond, MUFG Bank Economic Research Office

Real GDP Trajectory Weakened Again

Given waning fiscal measures, the hit to economic output in Q4, weaker trajectory of government infrastructure spending, and tougher labour market conditions as evidenced by higher unemployment, the trajectory for real GDP from 2021 is set to weaken further. The

[1] 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. 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).
[2] This has currently been approved by the Russian State Duma, which is the lower house.
[3] Russia relied on 40% of its total annual revenues from oil and gas in 2019.

MUFG

extension of the national projects deadline is likely to be most significant for the growth outlook as fiscal stimulus measures will be spread across a longer time horizon.

Meanwhile, the increase in the top rate of personal income tax (from 13% to 15%) may also be a headwind for consumer spending, on top of pressure from the uptick in unemployment mentioned above. Indeed, as a result of a weaker real GDP trajectory, Prime Minister Mikhail Mishustin has announced some institutional changes to Russia's development agencies in order to reduce inefficiencies within Russia's complex network of 40 development agencies. A total of 8 development agencies will be abolished. However, these sorts of institutional changes are unlikely to make up for delayed national projects. Altogether, we think that it may be 2022 before real GDP returns to its pre-coronavirus levels, with risks expected to remain to the downside over the forecast horizon.

MUFG Bank, Ltd. ("MUFG Bank") is a limited liability stock company incorporated in Japan and registered in the Tokyo Legal Affairs Bureau (company no. 0100-01-008846). MUFG Bank's head office is at 7-1 Marunouchi 2-Chome, Chiyoda-Ku, Tokyo 100-8388, Japan. MUFG Bank's London branch is registered as a UK establishment in the UK register of companies (registered no. BR002013). MUFG Bank is authorised and regulated by the Japanese Financial Services Agency. MUFG Bank's London branch is authorised by the Prudential Regulation Authority (FCA/PRA no. 139189) and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of MUFG Bank London branch's regulation by the Prudential Regulation Authority are available from us on request.

This report shall not be construed as solicitation to take any action such as purchasing/selling/investing in financial market products. In taking any action, each reader is requested to act on the basis of his or her own judgment. This report is based on information believed to be reliable, but we do not guarantee, and do not accept any liability whatsoever for, its accuracy and we accept no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this report. The contents of the report may be revised without advance notice. Also, this report is a literary work protected by copyright. No part of this report may be reproduced in any form without express statement of its source.

MUFG Bank, Ltd. retains copyright to this report and no part of this report may be reproduced or re-distributed without the written permission of MUFG Bank, Ltd. MUFG Bank, Ltd. expressly prohibits the re-distribution of this report to Retail Customers, via the internet or otherwise and MUFG Bank, Ltd., its subsidiaries or affiliates accept no liability whatsoever o any third parties resulting from such re-distribution.