Russia: Rebounding activity but external risks may rise further ahead

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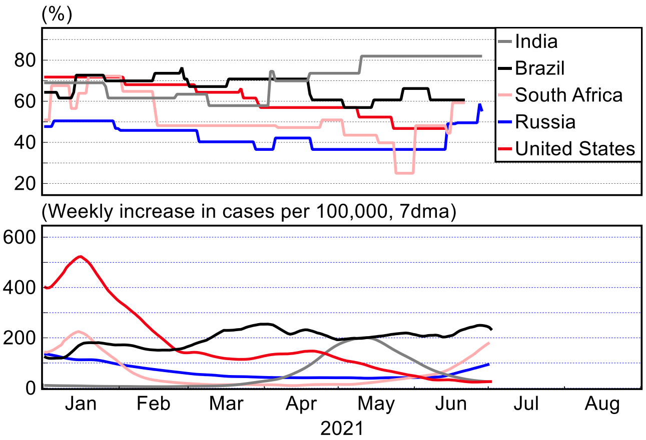
09 JULY 2021

Improved Growth Outlook

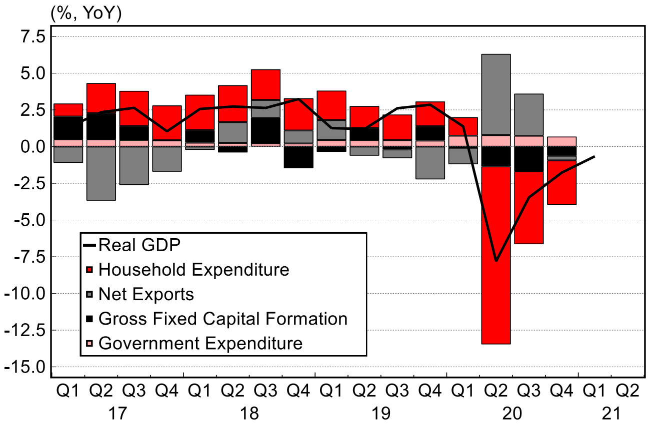
We expect real GDP growth of 2.8% in 2021. After the 3.0% fall in 2020, this would leave output short of its pre-pandemic level. However, the picture is improving. We have upgraded our 2021 figure by 0.3pp after the Q1 decline this year (-1.0% QoQ) was less severe than feared. We expect the momentum to be carried over into next year with annual growth of around 2.5% in 2022. The main contributor to real GDP will be private consumption together with a small positive contribution from government expenditures as the Russian government continues to roll out infrastructure projects. Private consumption will benefit from improving consumer trends underpinned by Russia's vaccination programme which aims to fully vaccinate 69 million people (48% of the total population) by August. There could be some bumps on the way such as the recent increase of the COVID-19 caseload together with the more infectious Delta variant. Russian authorities have also re-introduced lockdown measures, and are actively encouraging greater uptake of vaccines given high rates of vaccine hesitancy, both of which should help the vaccine roll-out. Nonetheless, the private sector is more resilient to lockdown measures this time around and activity is likely to continue to improve.

Lockdown Stringency Index & COVID-19 Cases



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

Real GDP Contributions



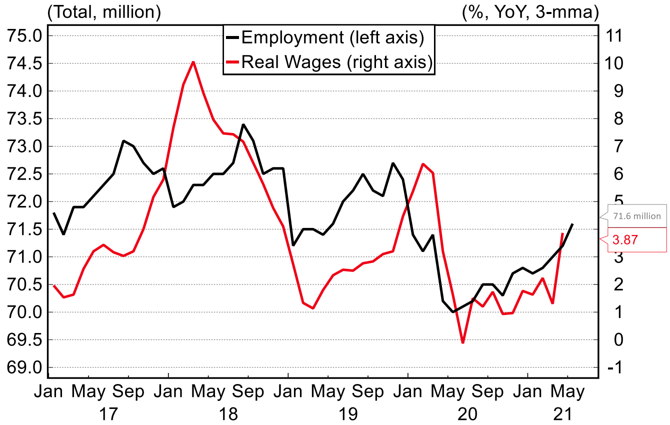
Source: Macrobond, MUFG Bank Economic Research Office

Private Consumption to Drive Rebound

The real GDP rebound in 2021 is likely to be largely driven by a gradual recovery of private consumption growth. A lot of the positive momentum for private consumption is set to come from an improving labour market. Since its peak in August 2020, unemployment has fallen by a full percentage point to 5.4% in March 2021, and on current trends could reach the pre-pandemic rate (4.6%) by the end of this year. The services and manufacturing sector PMIs for employment prospects have also improved in recent months highlighting increasing business confidence, in particular in the services sector, which will likely play a larger role in the employment recovery this year.

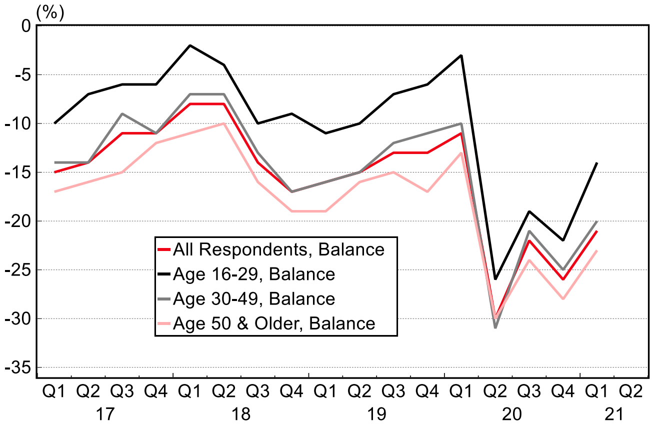
By sector, retail trade, health and social services, construction together with manufacturing sectors will be the most important for the jobs recovery. These sectors experienced the largest declines of employment of around 350,000-400,000 each in 2020 and in turn should see most of the jobs rebound this year. In turn, the jobs recovery should help to bolster real wage growth momentum, which already saw an improvement in Q1 2021. Consumer confidence still remains fairly depressed but, as incomes rise again, some of this drag should start to dissipate, and as it does retail trade and private consumption should improve.

Wage Growth Should Pick-up as Employment Recovers



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

Consumer Confidence Indicators

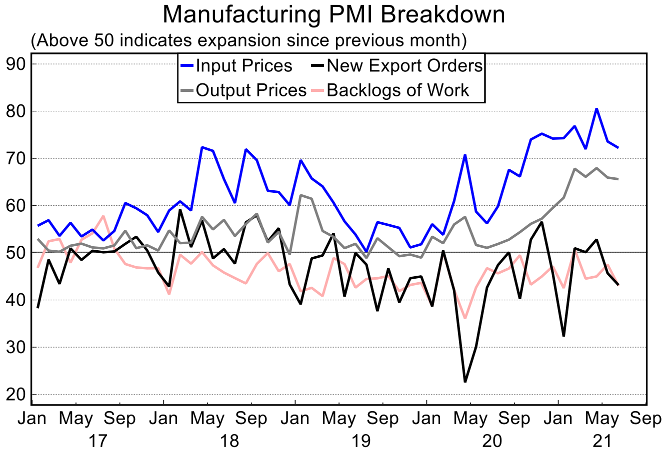


Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

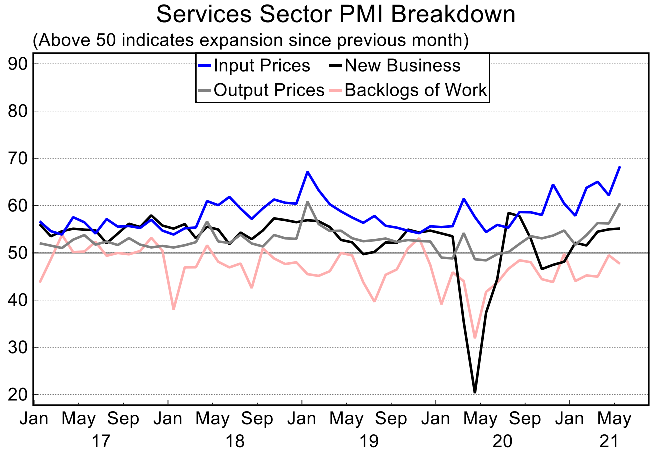
Rising Price Pressures Could Affect Private Sector Investment

While aspects of the outlook are improving, some headwinds are likely to remain this year. Most notably, private sector investment will probably remain weak throughout 2021. Input prices in the manufacturing sector have peaked at their highest level in seven years while the services sector has also been affected. At the same time, output prices have not risen to the same extent. With firms seemingly willing to absorb transitory price increases rather than pass these onto consumers, it is likely that corporate profits will take a further hit in Q2 2021 after a fairly dismal 2020 as a result of COVID-19 disruptions. Retained earnings are one of the main sources for investment. Financing may also be affected by higher domestic policy rates, which have been increased to tackle the recent rise of inflation. On the external side, financing may also be less favourable if inflation fears lead to higher policy rates globally in H2 2021.

In line with higher input price pressure, inflation has also been rising in recent months and topped 6.0% YoY in May on the back of higher food and energy prices. At the same time, core inflation has also risen to its highest in two years as a result of wider price pressures. As a consequence, the Central Bank of Russia (CBR) raised policy rates by 50 basis points (bps) on two separate occasions recently with the main rate now standing at 5.5%. Nonetheless, food and energy price inflation is likely to remain elevated for a while at least, which means further policy rate rises remain a possibility.

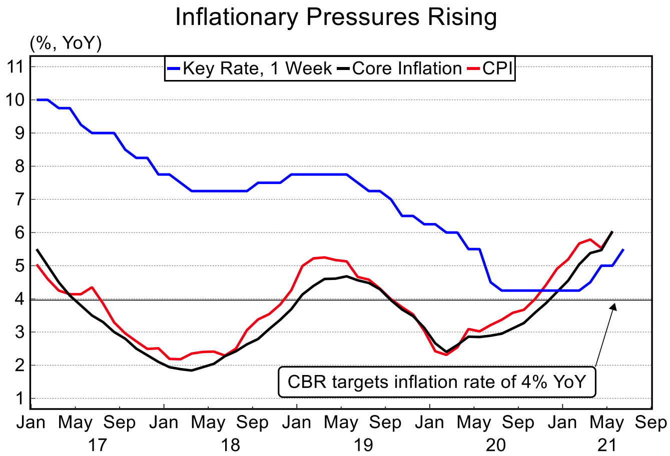


Source: IHS Markit, MUFG Bank Economic Research Office

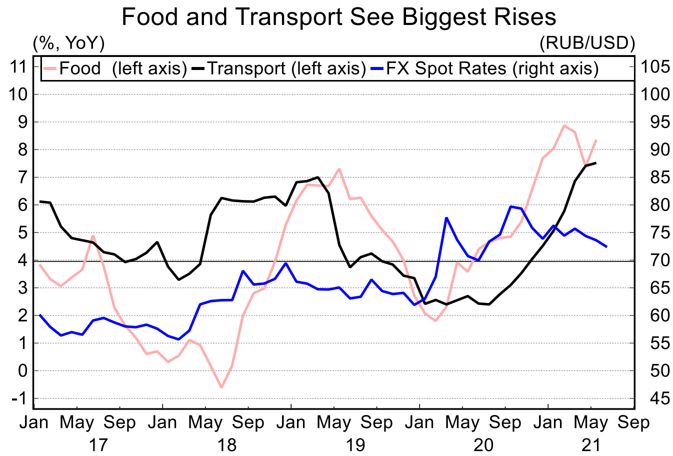


Source: IHS Markit, MUFG Bank Economic Research Office

We also note the CBR may wish to remain hawkish as the exchange rate could face further pressures later this year if the international monetary policy backdrop tightens. The CBR was among one of the first major emerging market central banks to raise rates. Meanwhile, the initial recovery in the US has been stronger than expected, which has led to increased investor concerns over inflation. The Fed may turn increasingly hawkish if there are suggestions that price pressures may not be transitory.



Source: CBR, Rosstat, Macrobond, MUFG Bank Economic Research Office

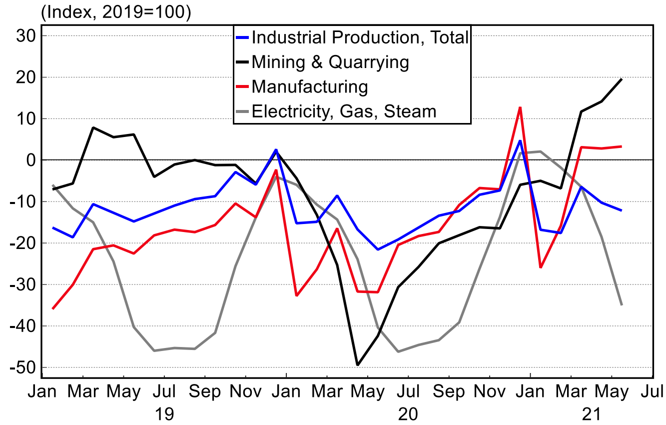


Source: CBR, Rosstat, Macrobond, MUFG Bank Economic Research Office

Gradual Recovery of Industrial Production

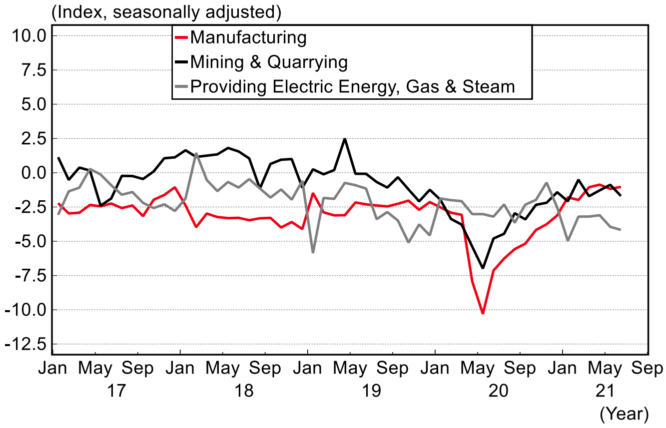
On the production side, the industrial sector is still recovering after the severe shock last year due to the initial wave of COVID-19 and sharp fall in oil prices. Industrial production had started to rebound up to the start of 2021 driven by a broad based recovery, but since then its performance has been volatile as a result of softness in the manufacturing and electricity generation sectors (which tends to be more seasonal). More recently, manufacturing has since recovered back to its 2019-level, while the mining and quarrying sector have continued on an upward trend thanks to an improved oil price outlook and global demand. But industrial production still remains 12.5% lower than its 2019-level in May. Leading business confidence indicators are also weak. Altogether this suggests a gradual recovery by the end of this year. There could also be headwinds for the oil sector given oil production will be limited by OPEC plus oil production cuts which will act as a cap on oil production in the near-term.

Industrial Production



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

Business Confidence Picking up



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

Some Pressures on External Side Likely in Q4 2021

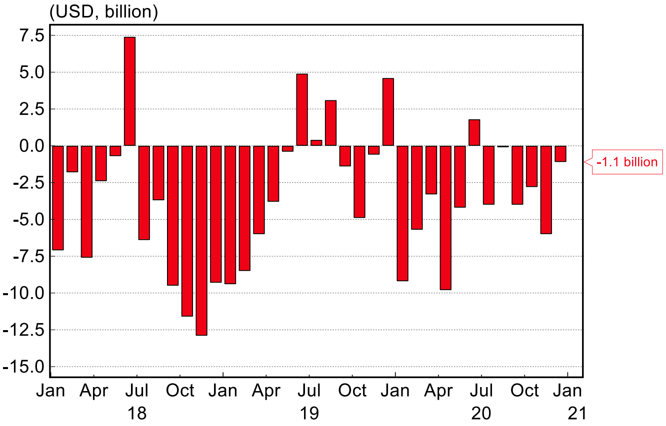
The imposition of further US sanctions together with continued net private capital outflows in Q1 2021 led to greater pressures on the rouble against the USD. Since then, the rouble has strengthened somewhat. This has been helped by improved current account performance (facilitated by extended foreign travel restrictions[1]), FDI figures and a higher oil price. But further ahead pressures on the rouble are likely to rise. As the real GDP recovery strengthens and private consumption rebounds, imports are likely to bounce back. Foreign travel restrictions will also be eased (Russia is a net importer of travel services) which will further weaken net exports. On top of this, the global monetary policy backdrop might also become less benign for developing markets. Taken together, this could result in greater pressures on the Russian rouble. That said, in the short-term, these pressures should be manageable.

The CBR has already raised rates and now has some of the highest real interest rates in developed markets, which has probably helped to reverse some of the outflow of non-resident holdings of government debt. Russia also benefits from a fairly favourable external position which includes a current account surplus (2.2% of GDP in 2020), low external debt service and small foreign currency liabilities. But over the longer term, the possible combination of greater exchange rate pressures and higher policy rates is likely to shrink Russia's already-weak longer-term potential growth rate. Labour productivity has already been harmed by lower FDI since 2014 (when US sanctions were first imposed), and against a backdrop of greater external pressures and low foreign investment it may continue to disappoint. The private sector is also likely to remain reluctant to invest as it will clearly be concerned by recent exchange rate weakness which has already affected some of its input prices, while higher policy rates to counter this are likely to increase its cost of capital. At the same time, as noted above, profits

[1] The travel ban on outward tourism to Turkey has been extended to at least until the end of May, while tourism to Egypt is likely to commence from late May.

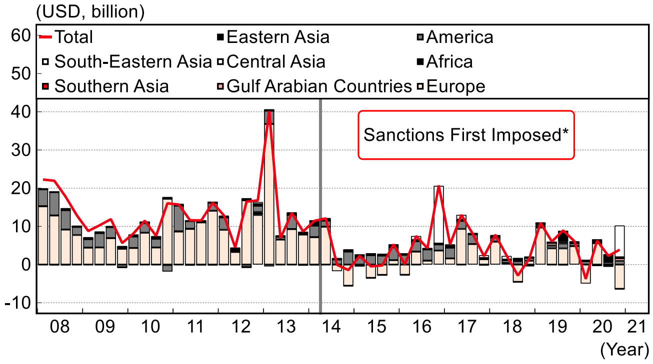
have been hit hard by COVID-19. Given the balance of factors and clear downside risks, we expect that investor caution will continue.

Net Flow of Capital, Private Sector



Source: Macrobond, MUFG Bank Economic Research Office

Foreign Direct Investment, By Region



*Note: The suspension of US/Russia trade/investment talks & military-to-military cooperation on 3rd March marked the first set of initial sanctions
Source: CBR, Macrobond, MUFG Bank Economic Research Office

Rebound, but no Recovery Until 2022

All-in-all, we expect a firm rebound this year, but note that the annual figure will be helped by better than expected real GDP in 2020 and Q1 2021. Our current forecasts imply that the Russian economy should have fully recovered from the COVID-19 shock by Q2 2022. The outlook will be driven by private consumption which should improve as the labour market recovers and real wages start to rise again. There is also likely to be a contribution from government expenditures and national infrastructure projects, helped by institutional changes[2].

However, the outlook for private investment is expected to remain weak. There are a number of headwinds facing the private sector at the moment, several of which could intensify later this year. The wider improvement to the economic outlook will clearly feed into better financial performance of the private sector, but, given the large hit to profits since March last year, it will take some time for all of these factors to be ironed out. Recent price pressures have also been having a negative effect on the sector, which could take a few more months at least before they dissipate. Meanwhile, the monetary policy backdrop is likely to be less favourable both domestically and internationally.

Given the balance of risks, pressures are likely to remain to the downside over 2021 and 2022, even before we mention the threat of further strains of COVID-19 and the fact that vaccines may prove less effective against these. Overall, the outlook has improved but the trajectory of real GDP is likely to remain one of gradual improvement, with risks to the downside.

[2] In a previous report from December 2020 (https://www.bk.mufg.jp/report/ecoeu2020e/MUFG-Economic-Brief-20201225.pdf) we mentioned 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. That said, we said that these changes are unlikely to make up for delayed national projects.