Russia: Households face multiple headwinds in 2022

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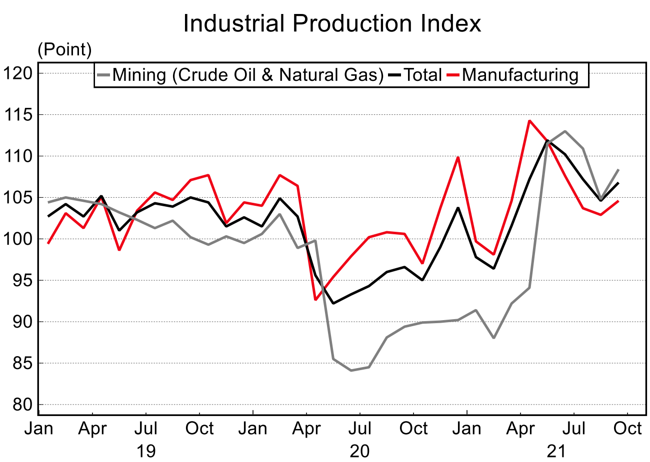
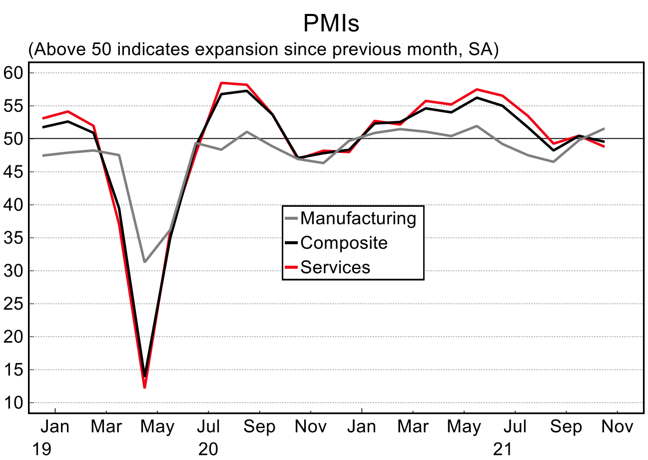
Growth Set to Moderate in 2022

We forecast real GDP growth to moderate to 2.2% in 2022, after a stronger-than-expected rebound this year now estimated at 4.2% YoY. Private consumption has been the main driver of the rebound in 2021. This is supported by stronger real wage growth and higher employment, which is now just below its pre-pandemic level. Meanwhile, there has been a rebound in industrial production which has provided a firm contribution to real GDP.

However, from Q3 2021, momentum has started to slow. The composite PMI suggests a month-on-month contraction in October, driven by a decline in the services sector. Meanwhile, households are faced with higher inflation which is likely to drag on real wages, as well as the continued threat of further COVID-19 waves. Consumer demand growth was always likely to slow after the strong initial post-pandemic rebound, but recent headwinds (slower real wage growth) are likely to be a more persistent drag on output. Meanwhile, manufacturers too could face tougher tests ahead given the recent increase of energy prices on top of current global supply-side issues such as semiconductors shortages. Russia is among the top 15 countries globally for auto production which has been affected by shortages.



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office



Source: IHS Markit, MUFG Bank Economic Research Office

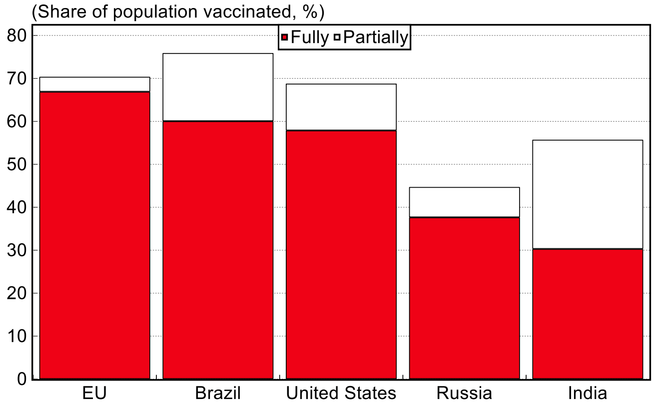
Rising COVID-19 Caseload Could Be Dampener on Output in Near-term

At present, less than 40% of Russia's total population is fully vaccinated. This is low by international comparisons, and not exactly expected given the fact that Russia was one of the world's first countries to develop an effective vaccine. In the EU and US, around 70% and 60% respectively are fully vaccinated, while a number of major developing markets are not far behind. Brazil has fully vaccinated over 60% of its population. One of the main reasons for low vaccine coverage in Russia is high vaccine hesitancy. A lack of trust in domestic vaccine producers may be a key factor. Russia has not approved any non-Russian vaccines. Meanwhile, a Levada poll highlighted that 45% of Russians are still not ready to get the vaccine. A rapid improvement in the situation seems unlikely in the absence of government interventions such as widespread mandatory vaccine requirements.

Russia has already suffered tremendously from the pandemic. The country has suffered from around 930,000 excess deaths from COVID which puts it among the highest rate of excess mortality per 100,000 people globally. There are now signs that it could be another tough winter as COVID-19 cases have risen sharply over recent months. The government implemented a one-week work shutdown at the start of November in response, but in the absence of widespread vaccination coverage this may not be enough to prevent a further rise in COVID-related deaths and hospitalisations. Tighter measures may be required, which would drag on output and confidence through the winter.

Novel Coronavirus (COVID-19) Vaccinations

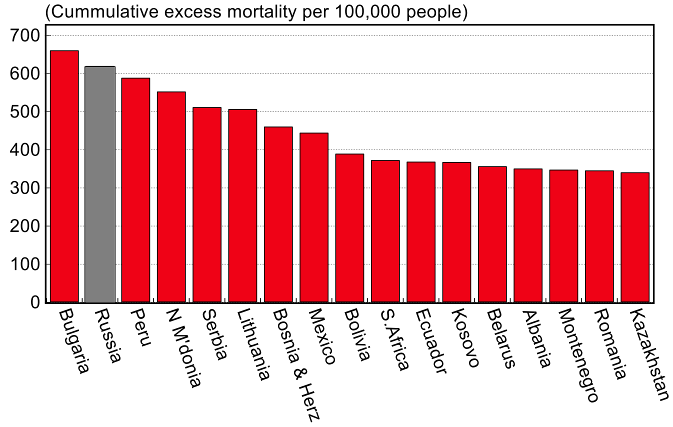
(Share of population vaccinated, %)



Source: Our World in Data, Macrobond, MUFG Bank Economic Research Office

Excess Deaths from COVID-19

(Cummulative excess mortality per 100,000 people)

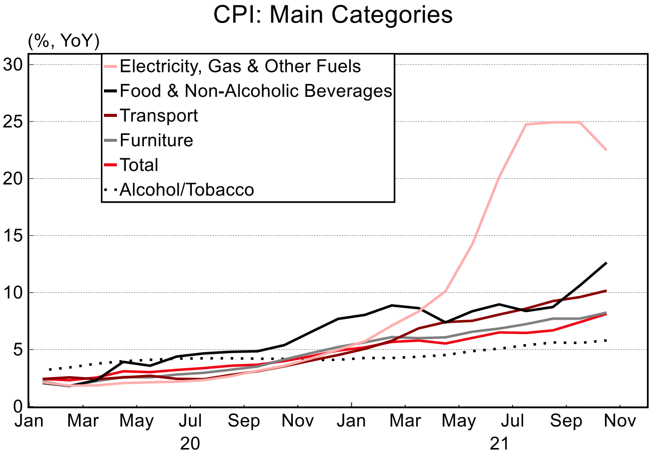


Source: The Economist, MUFG Bank Economic Research Office

Households Face Rising Costs

Households will also face multiple pressures from rising costs. For example, they have already been under pressure from higher living costs such as food and energy prices, while higher inflation has dragged on real wages and disposable incomes. But further ahead, they will face the effect of higher policy rates on borrowing and debt service costs, potentially tighter bank lending conditions and weaker retail lending.

The Central Bank of Russia (CBR) has raised its policy rates six times so far this year- a cumulative increase of 325 bps, after a 75 basis points (bps) increase to 7.5% on 20 October as inflation surged to 8.1%, its highest rate since 2016. At the same time, unsecured-debts are also estimated to have increased to a historical high this year (of around 11.0% of GDP). Combined, this will almost certainly affect household borrowing and debt service costs in 2022.



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

There are also no signs yet that inflationary pressures are set to subside. Global energy prices are likely to remain elevated for a while against a backdrop of strong demand. Meanwhile, recent PMI surveys suggest that firms are choosing to pass on higher costs to customers rather than squeeze their profit margins. The Ministry of Economic Development has just increased its annual CPI estimate for 2021 to 6.4% YoY after higher year-end inflation. Given the lengthy list of medium-term pressures there will inevitably be a slow-down of private consumption growth in 2022.

Limited Scope for Other Real GDP Drivers

There will also be further headwinds for households. The latest Russian government budget draft highlights a 3.0% of GDP cut to consolidated government expenditures in fiscal year 2022 (FY 2022). Government spending cuts are aimed at reducing Russia's fiscal breakeven oil price (a measure of fiscal dependence on the oil price) while also dealing with lower non-oil revenues to produce a small fiscal surplus in FY 2022 (that will likely exceed the estimated 0.6% of GDP surplus in FY 2021)[1]. This approach makes sense. Government revenues have been boosted by windfall energy revenues and non-oil revenues this year as a result of rebounding activity, which is likely to moderate in 2022.

This said, the overall government expenditure cuts will come from wider regional spending including federal support to regions and social funds. Given the fact that spending on social security comprises a sizeable chunk of Russian government funding in 2021, cuts are likely to affect households. Meanwhile, the budget proposal is light on measures to support consumers against a backdrop of rising prices. Household disposable income growth has been predominantly driven by the public sector in recent years, but under current budget proposals will be reliant on the private sector- something that looks unlikely given the list of medium-term pressures facing businesses (e.g. rising prices and supply disruptions) which do not point to an imminent reversal of this trend.

[1] The Urals oil price is assumed to fall to USD 62 per barrel in 2022 and USD 56-58 per barrel in 2023-24 from an estimated average of USD 66 per barrel this year.

For the economy as a whole, household consumption growth could falter in the absence of an improvement in private sector wages. The government would then be under pressures to announce a more gradual easing of fiscal consolidation measures. We note, given Russia's low government debt level, there is still plenty of scope for this but there would likely to be a lag before any significant change in policy.

While household spending is the main driver of GDP growth in Russia, there are efforts to increase public investment. In particular, Russia's national investment program, which focuses on 12 major infrastructure areas, continues to make steady progress[2]. There have been institutional changes to increase the roll-out of the program but we are doubtful that these will have much of an effect. There has been a recent small positive contribution to real GDP from gross fixed capital formation but further work needs to be done to boost investment (as a percent of GDP) to levels seen in faster growing developing economies.

Real GDP Moderation Expected in 2022

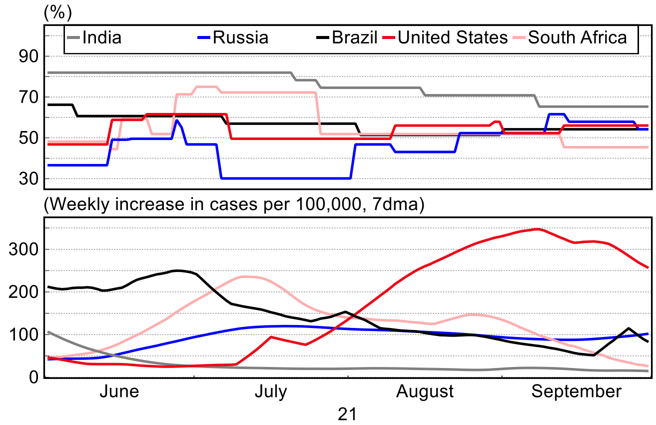
All-in-all, we forecast real GDP growth to slow to 2.2% YoY in 2022, from an estimated 4.2% in 2021. The Russian economy has recovered faster than expected in 2021, but given pressures, growth is likely to continue to moderate over coming years. Households will face a lengthy list of medium-term pressures, from the effects of further COVID-19 waves and possibility of more stringent lockdown measures, to increased inflationary pressures and higher interest rate costs. The recent 2022-24 draft budget offers little to ease these burdens. Firms are facing similar medium-term pressures and so significant pay growth across the economy as a whole seems unlikely. This challenging outlook might force the Russian government to reduce the speed of its fiscal consolidation efforts.

There could yet be other drivers of real GDP growth such as improved export performance, most likely on the hydrocarbon side, or stronger investment program roll-out, but there are limits to how much these areas can boost real GDP growth over the short term. Global demand for oil and gas will remain strong, but Russia will remain tied to OPEC + oil production targets. Meanwhile, the national projects program has a long lead-up time, and is more likely to see a gradual increase of expenditures. So, in sum, we expect a moderation of real GDP growth next year and further ahead but there is some upside potential to this if fiscal consolidation measures are eased.

[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.

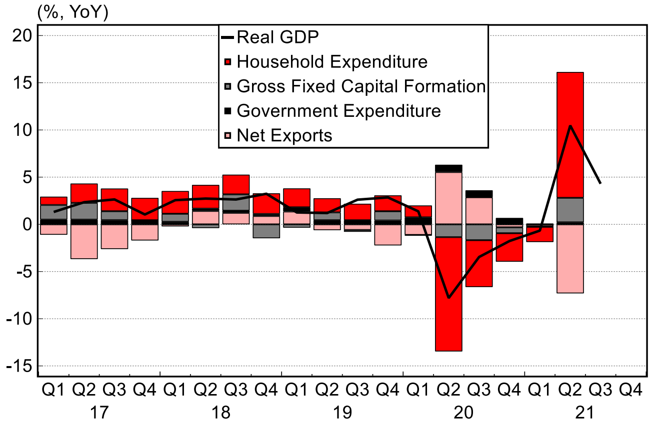
Economic Snapshot: Select Charts

Lockdown Stringency Index & COVID-19 Cases



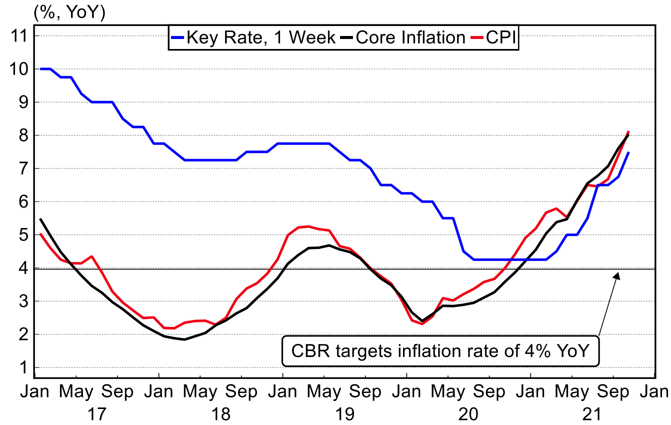
Source: Macrobond, MUFG Bank Economic Research Office

Real GDP Contributions



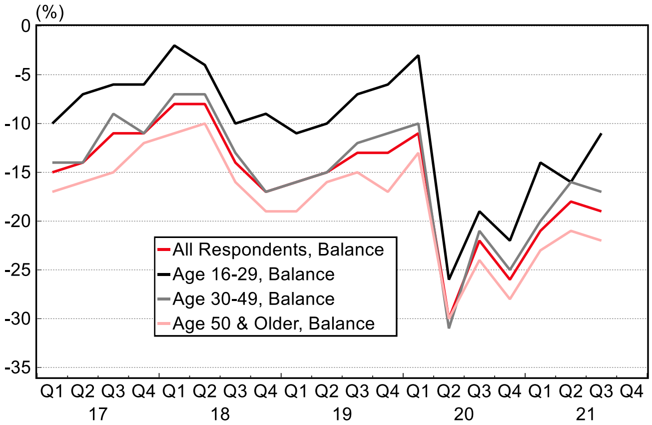
Source: Macrobond, MUFG Bank Economic Research Office

Policy Rate and Inflation



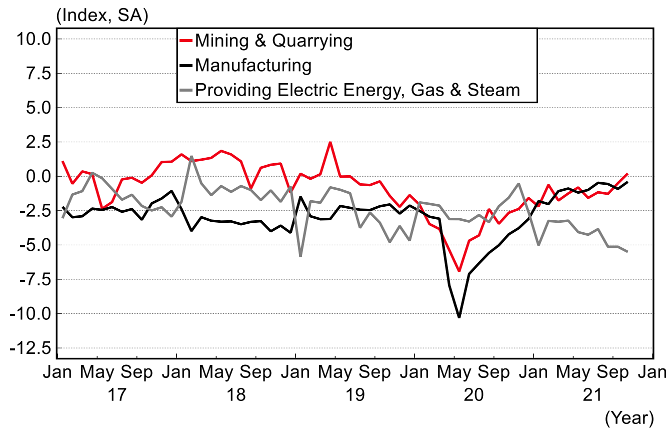
Source: CBR, Rosstat, Macrobond, MUFG Bank Economic Research Office

Consumer Confidence Indicators



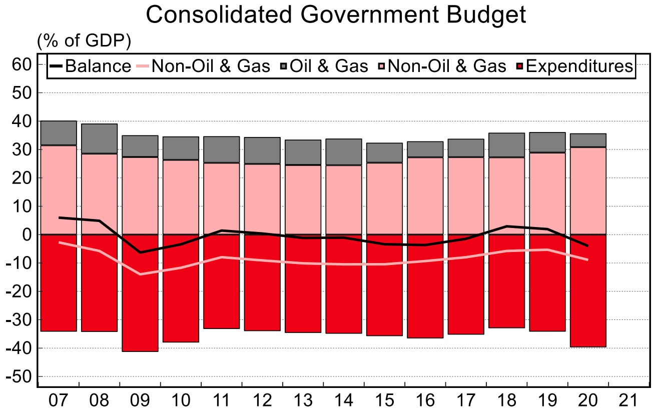
Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

Business Confidence



Source: Rosstat, Macrobond, MUFG Bank Economic Research Office

Consolidated Government Budget



Note: Revenues represented above 0-line, with expenditures below
Source: Russian Ministry of Finance, Rosstat, Macrobond, MUFG Bank Economic Research Office