Strategic Choice Advisory

Strategy and Transactions

Russia Macro Foresight

Russian Economy Turns the Corner in 2023. Inflation Picks Up, But Market Players Nonchalant

February 2024

Real sector growth rebounds strongly in most sectors, but some industries still struggling (1/2)

- In H2/2023 **the positive trends** we noted last time **became further entrenched in most key sectors**, as there were very few output declines, and even those marginal, across the board. According to RosStat's preliminary estimate, **real GDP growth made up 3.6% y/y in 2023** after 1.2% contraction the previous year. Fixed capital investment surged 10% y/y, final consumption gained 5.4% (households - 6.1%, government - a more modest 3.6%). Gross savings jumped 19.8%!
- **Industrial output rose 3.5%, of which manufacturing soared 7.5%.** Growth in the latter segment slowed a bit to 7.8% y/y in Q4 vs. 10.5-10.8% in Q2-Q3, but was still remarkably high. **Construction managed to overcome a recent slump,** with volumes rising strongly in practically all key segments. Albeit, **growth in housing construction has cooled,** as government downsized mortgage loan programs and hiked the key rate to combat rising inflation. **Cargo transport remained affected by various sanctions an restrictions,** but auto transport shot up, as market players worked to reroute both exports and imports. **Retail trade resurged, as purchasing power recovered.** The HoReCa sector gained 12.5% after growing 7.6% in 2022

Indicator, % y/y	2020	2021	2022	2023
Industrial production	-2.1	6.3	0.7	3.5
Cargo transp. turnover:	-4.7	5.6	-2.3	-0.6
Railway	-1.9	3.7	-0.1	0.0
Automobile	-1.3	5.0	5.8	22.1
Agriculture	1.3	-0.4	11.3	-0.3
Retail trade	-3.2	7.8	-6.5	6.4
Paid services	-14.8	16.7	5.0	4.4
Construction, o/w:	0.7	7.0	7.5	7.9
Housing	0.2	12.7	11.0	7.5
Fixed capital investment	-0.5	7.7	4.6	10.0*

** - Jan-Sep 2023*

Segment, % y/y	2021	2022	2023	Segment, % y/y	2021	2022	2023
Food products	4.2	1.1	5.9	Chemicals	7.1	-2.4	4.6
Beverages	7.6	6.7	1.4	Rubber & plastic products	10.5	0.2	9.2
Textiles	15.1	-3.8	0.6	Pharmaceuticals	14.3	9.3	1.9
Apparel	7.4	9.1	4.1	Coke & oil products	3.6	-0.6	2.6
Metallurgy	1.7	-0.8	3.3	Machines & equipment	17.1	-0.7	4.5
Wood products	11.9	-10.0	-0.2	Electrical equipment	7.7	1.1	19.0
Furniture	17.7	10.7	20.7	Automobiles	14.6	-44.2	13.6
Building materials	9.3	3.9	2.6	Computers & electronics	9.9	9.4	32.8

Real sector growth rebounds strongly in most sectors, but some industries still struggling (2/2)

- In manufacturing, **the upsurge is partly owed to war-related spending.** Production of items such as steel and other metal structures; metal wires; fences and safety nets; uniforms and other menswear; boots; tents and other outdoor camping equipment; hygiene products, of which most notably bandages and other sanitary supplies; radio and navigation equipment; other transportation equipment (where most military vehicles are included), and etc., rose markedly in 2023
- However, this is only part of the story. **The main driver has evidently been import substitution.** But while this sounds like an old trope, we would like to remark that now **Russia is moving toward increasing production of higher value-added products.** This is seen in the outpacing growth of such items that Russia has been lacking in recent decades as computers & electronics, electrical equipment, semiconductors (+21.1%), fiber-optic cables (+30.9%), refrigerators (+18.3%), medical equipment (+14.6%), electrodes (+72.8%), locomotives and other rolling stock, resins, plastic film and sheets, mechanical instruments for machine tools, pumps, metal-working equipment, and etc. **A new theme is outcompeting and squeezing out Chinese manufacturers in various segments**
- Among other outperformers are products such as fertilizers (+10.3%), pesticides, overall plastics, pipes and fittings, non-ferrous metal products, LPG, fruit & vegetable products, and IT & communication services. Welcome turnarounds after weak performance in 2022 have taken place in fish and seafood processing, overall chemicals, paper, automobiles, and wholesale trade
- **Segments that are yet to recover from sanctions and disruptions of supply chains and sales networks** are wood products, building materials (even though some items such as prefabricated wooden homes, up 22.1%, and wallpaper are growing strongly), tires, turbines, and extraction (especially metals and natural gas). Dynamics in pharmaceuticals remain mixed, and it seems the sector is still struggling in general, despite various government stimuli
- Interestingly, **health & wellbeing seems to be the new gold.** While vodka and wine production decreased notably, and soft drinks and beer rose only marginally, mineral water production continued surging (+16.4%). Among paid services, stellar growth was posted in cultural activities (15.6%), tourism (9%), and fitness and sporting activities (7.6%)
- On a separate note, agricultural production edged down in 2023 amid colder weather after soaring in 2022, in part caused by war-driven global demand. Husbandry appears to be somewhat stagnant (even if well-off in terms of profit). Egg and poultry deficits were widely reported in H2, leading to exorbitant price hikes. Growth in vegetables and sunflower oil remains minimal, however potatoes, cereals and legumes are now red-hot
- Importantly, **the decline in total sales** in H1 (as opposed to output), that we expressed concern about last time, **was reversed in H2.** The indicator grew 9.7% in full-2023. The few underperformers thus far are wood products, coal, paper, chemicals (-4.4%, despite resumed growth of production), and wholesale trade
- Meanwhile, **total corporate profit grew a solid 30.2% y/y in Jan-Nov**, as the share of loss-making entities slid to 26.1%. At that, **profit in manufacturing declined 3.3%**, with steep drops posted in chemicals and pharmaceuticals. Robust increases were seen in resins & plastics, building materials, metal products, and computers & electronics. Profit in extraction rose 8% on high prices, despite output declines in key segments. Profit in construction surged 69.7%, IT & communication services – 62.6%, transport & storage – 34.5%, healthcare – 32.9%. Profit in HoReCa rose 10.4%, retail trade - just 3.9%. Profit in agriculture dipped 1.5%

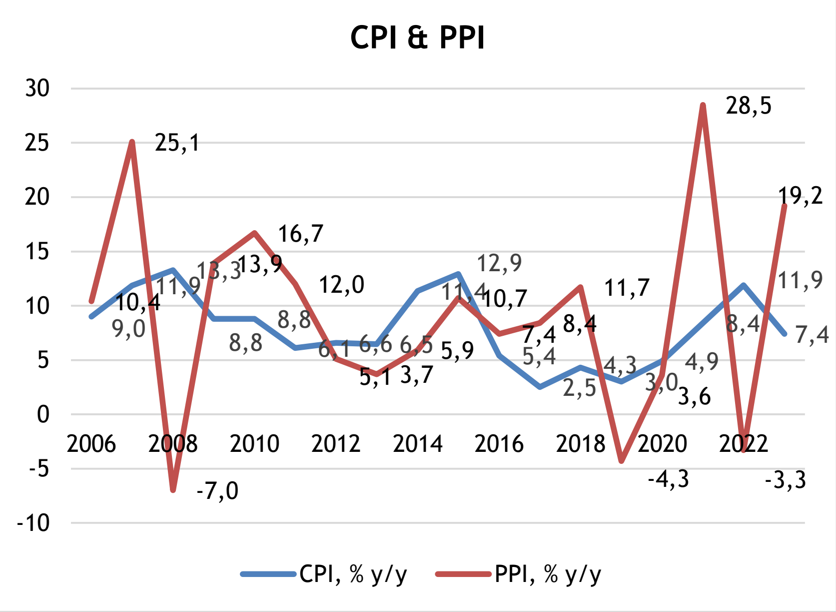
Real income and wage growth shoots up as CPI inflation slows and labor deficit remains intact. PPI inflation accelerates again, but companies feel they can pass on costs to customers

- On the other side of the equation, things are looking up as well. **Real wage and real disposable income (RDI) growth returned into positive territory**, with growth reaching multi-year highs. Apart from slower (but still high) CPI inflation, a major factor driving real wage growth is the **shortage of highly-skilled workers in a transforming economy.** The deficit was exacerbated as millions of people left Russia after the start of war and subsequent launch of the mobilization (conscription) campaign. Although significant return migration into Russia is now observed, the staff shortages stay in place
- Worth noting, **in H2 the share of entrepreneurial income rose notably,** while the share of government benefits decreased, according to RosStat. Government support remains important, but apparently there is less need for it now, while the state budget deficit also reduces funding availability
- Positively, total employment rose 0.4% in 2023, as the 0.1% decline in full-time staff was offset by 1.2% growth in part-time staff and 18.3% in contractors. Both unofficial (3% of workforce) and ILO-definition unemployment (0.6%) slid further, as absolute figures declined 18.5% and 26.5%, respectively

Indicator, % y/y	2020	2021	2022	2023
Real disposable income	-2.0	3.2	-1.0	4.7
Real wages	3.8	2.9	0.3	7.6*
Nominal wages	7.3	9.8	14.1	13.8*

** - Jan-Nov 2023*

- As we predicted, **CPI inflation slowed to 7.4% y/y in 2023, while PPI inflation shot up to 19.2% y/y** after deflation was observed in 2022. Importantly, inflation in investment goods slowed from 14.7% in 2022 to 10.1%, cargo transport - from 28.4% to 16.5%
- Among consumer goods, foods and services are outpacing non-foods at 8.2-8.3% vs. 6%. Biggest price hikes are seen in meat & poultry, eggs, and fruits & vegetables. Inflation in other items is minimal to tame. In services, inflation even in passenger transport, and hotels and recreation services has cooled and is now within 9.1-15.7%
- **Producer prices in extraction soared 40.9%,** including oil&gas - 50.5%, metals - 55.8%. **Prices in manufacturing surged 14.9%,** and while most products stay in the upper-single digits, oil & metal products, as well as equipment are growing more strongly. On one hand, players try to limit end price growth amid tough competition, but on the other, they still pass on input price pressures to consumers. Plus, as average annual PPI inflation made up just 8.6% over the last 6 years, **companies have grown rather inure and remain fairly upbeat**



Money supply growth slows sharply as CBR battles inflation. Export revenue inflows and FX & gold reserves stay solid, while foreign debt continues shrinking

MONETARY AGGREGATES

- **Growth of both broad-definition monetary base (including FX funds) and national-definition (RUB) money supply slowed notably** – from 30.1% in 2022 to 12.1% in 2023, and from 25.4% to 19.4%, respectively. Obviously, outflows from FX into RUB funds took place in H2 as RUB appreciated sharply after government tightened FX controls and CBR hiked the key rate from 7.5% to 16%
- Interestingly, while RUB deposits outpaced cash in circulation almost twofold at 21.4% vs. 11%, the opposite dynamics was seen in FX accounts, as cash soared 51.8%. Thus, **government's anti-inflation, pro-RUB measures are obviously having an impact, boosting RUB deposits and FX conversion into RUB**
- Another interesting story here is that while money supply growth has indeed slowed, the figures are still above multi-year averages. Broad-definition monetary base had fluctuated within 4.7-10.1% over the previous 4 years, national-definition money supply – within 9.7-13.5%, with both reaching their highest growth readings over this period in 2021. Therefore, **while liquidity is indeed becoming tighter for market players, we are still short of a real liquidity squeeze**

EXTERNAL SECTOR

- External sector data now looks a bit more encouraging. The **current account (CA) surplus made up USD 50.2bn in 2023** after bottoming out in H1, and while this is a steep drop from USD 236.1bn in 2022, that figure had been an outlier, as commodity prices shot up with the outbreak of war. The CA surplus has been fluctuating wildly – from USD 24.5bn in 2016 to its 2022 peak; an average of USD 87.7bn over the past 8 years, not dramatically higher than in 2023. The trade surplus made up USD 118.3bn, while the service deficit grew from USD 22.2bn in 2022 to USD 33.6bn (vs. an 8-year average of USD 27.6bn). Net errors & omissions also rose notably to USD 9.9bn. **These figures show the extra cost Russia has to pay amid sanctions,** being forced to restructure its trade and FX flows
- **FX & gold reserves made up** USD 586.4bn as of Feb 2, practically equal to where they were at the time of our previous report in Aug 2023. Reserves have stayed within an incredibly narrow band of USD 560-600bn for about a year now, as CBR maintains a delicate balance between filling budget coffers and allowing FX rate flexibility. The indicator was at USD 643.2bn just before the war, while about USD 300bn worth of reserves are still frozen by sanctions (although there is talk that Russia actually managed to restructure a significant chunk of that into assets in RUB and in "friendly countries")
- Meanwhile, the **National Welfare Fund declined 10% in 2023 in USD terms to USD 133.4bn due to RUB depreciation, but grew 15% in RUB terms to just over RUB 12tn.** It now makes up 8% of GDP vs. 7.8% in 2022. **Significant takeouts were made at year-end to cover the state budget deficit, however inflows also stay strong amid higher oil&gas prices**
- Positively, **total foreign debt declined another 14.9% in 2023**, as government and corporate debt slid 29% and 18%, respectively. A slight pent-up was seen in Q4 across all categories. But while long-term debt shrank over the full-year, short-term debt is growing now (up by about USD 10bn since Apr 1). This is not critical, but is noteworthy amid higher interest rates
- **Unfortunately, CBR has stopped publishing FDI data after Q1/2023.** The indicator reached USD 8.4bn then, slightly above recent averages, and USD 26.9bn in full-2022, up from USD 25.4bn in 2021, despite the sanctions. We had noted that **most foreign investors never actually left, only restructured shareholdings,** while many Russian and new foreign investors rushed to make use of the opportunity. **Judging by declining debt to foreign shareholders, though, FDI inflows have decreased now** (anecdotal evidence)

State budget deficit overshoots target slightly, despite strong revenue growth. Banking sector activity stays robust, but CBR's war on inflation drives up interest rates

PUBLIC SECTOR

- **The state budget deficit made up RUB 3.24tn (1.9% of GDP) in 2023** vs. RUB 3.35tn (2.3% of GDP) in 2022. The target of RUB 2.9tn was overshot as additional outlays were made at year-end. Revenue and spending grew 4.7% and 4%, respectively. Non-oil&gas revenues surged 25%, with VAT and profit tax inflows growing 21.6% and 14.9%, respectively. Oil&gas revenues declined 23.9% amid lower world prices and oil price caps imposed by the West. Still, oil&gas revenues were RUB 822bn above target
- Social welfare and infrastructure spending is still being financed steadily, with government notably increasing domestic borrowing. **Some experts attribute this to the upcoming presidential elections in March, and expect spending cuts thereafter.** Also, **military spending stays substantial,** and is not expected to decrease anytime soon. This will continue exerting pressure on public finance, but **luckily, debt interest rates are starting to come down now.** There is some concern about regional budgets, though

BANKING SECTOR

- **The banking system stayed quite robust, as practically all key figures saw solid growth over 2023**. Total profit rebounded to RUB 3.3tn after a tiny RUB 0.2tn loss in 2022, although the 2-year average is still 27% below the level of 2021. Own funds rose by RUB 2.2tn
- **Corporate lending growth accelerated to 20.1%,** driven by strong economic activity, and corporates borrowing to finance acquisitions of departed foreign companies' assets, refinance external debt and offset lower transfers from the state budget at year-end. Retail loans jumped 23%, driven by both consumer and mortgage loans, but this is clearly too high for comfort. **CBR is now actively suppressing retail loan growth via tougher requirements and curtailing of mortgage loan programs.** Fortunately, **corporate overdue debt declined 8.3%, as the share of problem loans decreased 0.3pps to 5.1%.** Retail overdue debt rose marginally by 4%, with problem loans receding 0.1pps to 7.8% of non-collateralized consumer loans (4.3% of the overall retail loan portfolio)
- As we noted last time, **investment in securities grew a solid 14.1%,** revealing increased risk tolerance and availability of funds for investment. **Corporates are actively going public and attracting extra funds**, with placements getting heavily oversubscribed
- **Growth of retail funds shot up almost 3-fold to 19.7%**, as customers were attracted by higher rates and regained economic stability. However, **growth of corporate funds slowed 5.9pps to 14.7%** (just below annual averages). **Apparently, this is owed to the key rate hike increasing the cost of funding for corporates, and higher PPI inflation eating into profits.** Strongest growth, of around 50-60%, was seen in both retail and corporate medium-term deposits (1-12 months), while short- and long-term deposits stayed roughly flat

Indicator, % y/y	2020	2021*	2022*	2023*
Loans to individuals	13.5	25.1	9.5	23.0
Loans to corporates	9.9	10.6	14.3	20.1
Individuals' funds	4.2	3.1	6.9	19.7
Corporates' funds	14.4	16.7	20.6	14.7

** - Due to data revisions and methodology adjustments by CBR, data for 2021-2023 in various timeseries may not be directly comparable with previous years*

Summary

- The Russian economy stays in pretty good shape, with an evident recovery taking place in most sectors that were affected by turbulence after the outbreak of war. Manufacturing is seeing brisk growth, and construction has overcome its recent slump. Even CBR's efforts to curb mortgage lending are so far not derailing investments in housing construction. Cargo transport seems to have stalled in terms of cargo load and turnover growth, but is thriving thanks to much higher tariffs

- At the same time, the higher cargo transport and transaction costs, caused by the rerouting and restructuring of external trade and financial flows, together with surging producer prices, are affecting profit margins and liquidity. Market players are so far largely unperturbed, though, as higher income and wage growth, slower CPI inflation, and generally solid corporate profits, are allowing to pass these costs on to consumers

- Among the major impediments to economic growth are also the recent key rate by the CBR, which drives up borrowing costs and constrains money supply growth, and the sizable state budget deficit, which affects funding availability for various government initiatives. Supporting factors are the state's deep cash pockets and low overall external debt, together with maintained solid export inflows

- Meanwhile, the banking sector appears to be in a good spot, as problem loans stay in check despite rapid lending growth, bank profits are soaring, and deposit inflows stay strong as customers are drawn in by the high interest rates. Investment in securities keeps growing apace amid active public offerings. A key thing to watch would be growth of corporate funds, which has slowed lately as monetary authorities siphon the excess liquidity out of the financial system

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