Strategic Choice Advisory

Strategy and Transactions

Macro Foresight

Economic Recovery Continues, Import Substitution Spreading Across Sectors, But Long-Term Funding Solutions Remain to Be Found

June 2017

Upsurge in output growth spreading across economic sectors, driven by import substitution. Moreover, growth in higher value-added goods accelerating, as economy starts diversifying

Industry sector	Full-2016, % y/y	Jan-Apr 2017, % y/y	Industry sector	Full-2016, % y/y	Jan-Apr 2017, % y/y
Raw materials and primary processing			**Clothing & footwear**		
Coal	6.6	6.5	Fabrics	19.3	10.2
Natural gas	0.0	9.0	Apparel	7.1	7.4
Wood processing	2.8	3.1	Footwear & leather products	5.1	6.6
Paper	5.1	8.7	**Chemical manufacturing**		
Wood pellets	5.2	37.9	Overall chemical manufacturing	6.3	6.9
Metallurgy			Pharmaceuticals	7.0	12.1
Pipes for oil&gas industry	N/D	17.5	Plastics & resins	6.3	4.2
Prefabricated steel structures	0.1	9.9	**Machines & equipment**		
Agriculture and food manufacturing			Electrical equipment	-1.0	4.0
Meat & poultry	0.6	3.1	Cars	-7.4	22.3
Eggs	4.3	2.3	Buses	18.6	36.0
Processed food manufacturing	**2.4**	**3.1**	Cargo railcars	28.8	2-fold
Sausages	-0.2	7.2	Tractors	16.1	16.8
Vegetable & mushroom preserves	-17.3	43.5	Sowers	16.0	18.3
Confectionery	2.2	9.3	Food processing equipment	N/D	7.3
Cereals	3.6	11.2	Mining equipment	-12.1	71.4
Fish fillet	16.3	20.8	Furniture	-7.8	4.0

1. Strong growth persists or is intensifying in key sectors, complemented by a revival in a widening range of new segments
2. Encouragingly, growth in deeper processing tiers and higher value-added goods is starting to pick up across the board
3. Growth in raw materials and primary processing tiers is also accelerating, underpinning the overall economic recovery

Consumption and public welfare indices show signs of improvement, but are still weak. Consumer confidence is recovering, but so far not enough to drive an economic rebound

Indicator	Full-2015, % y/y	Full-2016, % y/y	Jan-Apr 2017, % y/y
Retail trade	-10.0	-4.6	-1.4
Real disposable income	-3.2	-5.9	-2.2
Nominal wages	-5.1	7.7	7.0
Real wages	-9.0	0.6	2.4
Wage arrears	+35.8	-23.7	+41.2
Total unemployment	+7.4	-0.5	-5.5

1. Nominal wages continue growing, and importantly, this takes place in sectors with increasing production (e.g. those highlighted on the previous slide). This shows that companies try to attract and retain staff, which helps improve consumer confidence for employees in these sectors and, overall, bodes well for a recovery in consumption
2. Real wage growth has turned positive thanks to slowing CPI inflation (4.1% y/y in May 2017)
3. Still, real disposable income growth stays negative, even despite the number improving after last year's slump. Although consumer confidence has improved strongly, according to various surveys, this shows that the basis for a more noticeable recovery is still not there
4. This is also evident in retail trade data, which shows the sector continues contracting, albeit at a much slower pace than in 2015-2016
5. Total unemployment has declined markedly, but the latest resurgence of wage arrears only highlights the maintained weakness of population income

External and banking sector dynamics fairly positive, but banking sector profit driven mostly by FX trading, as loans and deposits underperform visibly. Long-term funding availability remains problematic, risking constraining economic growth after the current recovery

BANKING SECTOR

- Key banking sector indices have practically frozen: as of May 1, 2017, total assets were down 0.7% y/y, loans to corporates +1.3% (an improvement vs. -4.1% y/y as of Jan 1, 2017), loans to individuals +0.8%, individual deposits +1.3%, corporate deposits -1.3%, investment in securities – 5.7%. This shows fundamental problems with core banking sector activities
- Banking sector profit rose an incredible 3.6 times y/y in Jan-Apr 2017 after a similar increase in full-2016, which shows overall liquidity should be plentiful. But only on the surface, as a no less staggering 92.6% of total revenues and costs are attributed to… FX trading. With FX rates now more or less stable, prospects of further profit generation remain rather dim
- Also, despite the Central Bank driven reduction of the total number of banks by 28.3% since the start of 2015 by the end of Apr 2017 (from 833 to 597), the share of loss-making banks is still a worrying 30%. Further bank runs are not excluded
- Also worryingly, the share of long-term highly-liquid assets is decreasing, while the share of short-term liabilities is rising

MONETARY AGGREGATES

- Broad-definition monetary base is up 6.4% y/y as of Jun 1, 2017, but is roughly unchanged from the level of the start of 2015
- Seasonally-adjusted broad money supply is up only 2.5% y/y as of May 1, 2017, but has grown 25.5% since the start of 2015, as the stronger RUB has drawn additional speculative investments into the local currency

PUBLIC SECTOR

- The state budget remains in a strong deficit (1.7% of GDP). The deficit made up around 10% of revenues in Jan-May 2017
- The State Reserve and National Welfare Funds are getting replenished recently thanks to higher oil prices, but have declined significantly in recent years. Upcoming general and presidential elections are expected to exert additional pressure on these Funds and the state budget, limiting availability of funding for economic development initiatives

EXTERNAL SECTOR

- The current account surplus shrank to USD 25bn in 2016 vs. USD 68.9bn in 2015 and USD 57.5bn in 2014. The figure rose again sharply to USD 22.8bn in Q1/2017 (preliminary estimate) vs. USD 12.9bn a year earlier, as oil prices rebounded
- State and private sector foreign debt decreased significantly to USD 254.8bn and USD 258.6bn, respectively, as of end-2016, vs. the peaks of USD 379.6bn and USD 353.2bn, respectively, at the end of H1/2014. This shows a reduced debt burden, on one hand, but on the other, significant foreign funding problems due to Western sanctions. Foreign debt figures have started rising again this year fueled by the economic recovery. But the share of short-term debt is growing, causing concern

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