Strategic Choice Advisory

Strategy and Transactions

Russia Macro Foresight

Russian Economy Springs Back to Life in H1/2023, but Liquidity and Inflationary Pressures Loom

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Most key sectors and manufacturing segments see evident rebound in H1/2023, but some industries still ailing (1/2)

- After an expectedly rocky 2022, marked by the outbreak of war in Ukraine, the Russian economy started to regain its footing by year-end, we had remarked in our previous report from Feb 16, 2023. This time, analyzing H1/2023 data, **we can see a clear upward trend in most key sectors.** According to RosStat's preliminary estimate, real GDP surged 4.9% y/y in Q2 after contracting by a modest 1.8% in Q1. This brought the H1 result into positive territory with 1.5-1.6% y/y growth after a 2.1% decline in full-2022. CBR expects full-2023 growth to reach 1.5-2.5% y/y, while **President Putin and PM Mischustin say growth should top 2% this year**
- **At the same time, certain sectors slumped in H1** after holding up fairly well or even witnessing brisk growth throughout last year. Notably, **fixed capital investment barely rose in Q1** (+0.7% y/y), after growing quite strongly in 2022 and exceeding recent annual average readings. The high- and low-base effect from 2022 obviously affected H1/2023 numbers across industries, but **the overall trend is definitely encouraging.** We examine the sector and overall economic performance in more detail further in the report

Indicator, % y/y	2020	2021	2022	H1/2023
Industrial production	-2.1	6.3	-0.6	2.6
Cargo transp. turnover:	-4.7	5.6	-2.3	-2.5
Railway	-1.9	3.7	-0.1	1.4
Automobile	-1.3	5.0	1.8	8.6
Agriculture	1.3	-0.4	10.2	2.9
Retail trade	-3.2	7.8	-6.5	1.1
Paid services	-14.8	16.7	5.0	3.8
Construction, o/w:	0.7	7.0	5.2	9.2
Housing	0.2	12.7	11.0	-0.9
Fixed capital investment	-0.5	7.7	4.6	0.7*

** - Q1/2023*

Segment, % y/y	2021	2022	H1/2023	Segment, % y/y	2021	2022	H1/2023
Food products	4.2	0.4	**5.3**	Chemicals	7.1	-3.8	2.1
Beverages	7.6	3.1	**2.0**	Rubber & plastic products	10.5	-0.8	6.1
Textiles	15.1	-8.3	**-0.9**	Pharmaceuticals	14.3	8.6	-7.3
Apparel	7.4	2.1	**5.9**	Coke & oil products	3.6	-0.4	5.4
Metallurgy	1.7	-0.8	**4.9**	Machines & equipment	17.1	1.9	-5.3
Wood products	11.9	-12.5	**-9.8**	Electrical equipment	7.7	-3.7	22.0
Furniture	17.7	-2.6	**14.5**	Automobiles	14.6	-44.7	-10.7
Building materials	9.3	-0.2	0.1	Computers & electronics	9.9	1.7	30.4

Most key sectors and manufacturing segments see evident rebound in H1/2023, but some industries still ailing (2/2)

- **Notable improvement took place in industrial production** (IP), where growth made up 2.6% y/y in H1, reaching 6.5% y/y by June. **Manufacturing expanded robustly by 6.2% in H1, as growth hit 12.8-13.1% y/y in May-June!** Overall IP growth was brought down by extraction, which declined 1.2% in H1 after inching up 0.8% in full-2022. In manufacturing, some sectors were obviously boosted by war-related items, e.g. apparel (uniforms being a clear outperformer), metallurgy, metal products (29.7% in H1), radio and navigation equipment, etc. But otherwise (and in these segments, as well), **the main drivers are still import substitution, which is taking place in a growing range of product segments, and new owners rushing to make use of the newly acquired assets of departed foreign companies.** Remarkable growth, well into the double-digits, was seen in computers (79.2% y/y!) & electronics, electrical equipment, turbines, furniture, non-auto transport equipment (22.1%), fruit & vegetable products, edible oils (19%), cheese, confectionery, sugar, mineral & bottled water (20.7%), fish & other seafood, synthetic fabrics (21%), lacquers and paints, detergents, pipes, plastic sheets & film, cables, LPG, luggage, footwear, wooden homes, non-ferrous metal products, electrodes (54.3%), ball bearings, elevators, metalworking equipment, medical equipment (16.6%), and communication equipment (32.6%). To name a few. And in most of these segments growth rates simply picked up from the already high figures of previous years, thus it is not owed to a low base (if only the historically low production base for Russia, but still this is an amazing upsurge)
- **Key underperformers were sectors that do not seem to have recovered yet from the turbulence that started last year.** This is mainly owed to the loss of equipment and raw material suppliers, logistic complications, and/or disruption of standard export markets. These include wood products, machines & equipment, fish & seafood processing, pharmaceuticals (after robust growth last year, it seems issues have emerged with foreign partners, even as the sector largely avoided foreign sanctions), printing services, woodworking equipment, tires, glass, various building materials (the sector is still quite shaky, on the whole, due to the departure of foreign market players, even though new investors are actively entering this sphere now), washing machines, agricultural equipment, cars (although the rate of contraction has decreased notably, while truck and bus production is growing strongly), etc.
- **Figures for other key sectors also mostly show a recovery taking place.** For example, even though cargo transport turnover is still in the red (-2.5%), **railway, automobile, and marine transport are growing again** (1.4%, 8.6%, and 8.8%, respectively). The overall number is pulled down by still weak pipelines and airlines, which have been seriously hit by sanctions. But even in the latter segment and altogether in the industry, passenger transport is surging, while transport safety data (even in airlines) shows vivid improvement y/y. By the same token, **even though housing construction inched down in H1 after rapid growth in 2022 (the high-base effect), total construction is surging.** Especially in roads, social infrastructure (despite a state budget deficit), manufacturing and agricultural facilities, etc. For example, even though pharmaceutical production declined in H1, construction of drug manufacturing facilities skyrocketed. At the same time, **trade and HoReCa real estate construction dropped**, despite these sectors posting strong growth lately. Time for new capacity will come later, then. **Growth in agriculture cooled after last year's rip'n'tear, but so did the weather, which is also much rainier this year.** Most key segments are still enjoying stable production growth
- Last but not least, **retail trade grew 1.1% in H1 after substantial contraction in 2022, and by as much as 10% y/y by June!** Tellingly, non-foods notably outpaced foods at 13.8% vs. 4.5% y/y in Q2, showing that **consumption is actively rebounding**. RosStat data shows consumer spending gained 7.9% y/y in H1. This will become a major growth driver, going forward

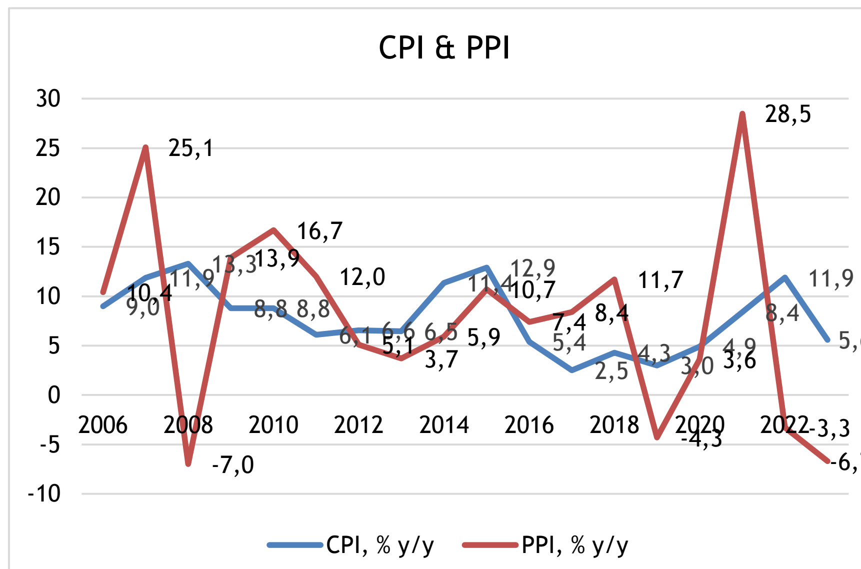
Real income and wage growth rebounds on lower inflation, but both CPI and PPI inflation acceleration is on the horizon

- Consumer activity resurgence is also evident from income and wage data. While nominal wage growth decelerated slightly off last year's (inflation-driven) peak, **real wage and real disposable income (RDI) growth finally turned the corner** due to inflation deceleration. Real wage growth hit 13.3% y/y in May, RDI growth – 5.3% in June. High wage growth is fueled by the **shortage of properly skilled workers in a transforming economy.** For example, people are needed to install and service new equipment, including that left behind by departed foreign players or that purchased to facilitate import substitution
- We must note **the wage situation is uneven across sectors**, as segments where output declined have minimal or negative wage growth, and vice versa. Still, **wage arrears are decreasing** even in the most troubled sectors, and are down 11.6% y/y overall through July, including -12.7% in corporates
- The continued decline of both unofficial (3.1% of workforce) and ILO-definition unemployment (0.7%) shows the labor market stays strong. Plus, the **demographic situation we had expressed concern about has ameliorated.** Total workforce rose 0.9mn ytd to 75.8mn people through June; both part-time staff and contractors surged; and **there is sizable return migration into Russia**

Indicator, % y/y	2020	2021	2022	H1/ 2023
Real disposable income	-2.0	3.2	-1.0	4.7
Real wages	3.8	2.9	0.3	6.0*
Nominal wages	7.3	9.8	14.1	12.4*

** - Jan-May 2023*

- So far, **both CPI and PPI inflation look rather tame.** CPI inflation slowed 2-fold to 5.6% y/y in H1, while PPI deflation reached 15-year low -6.7% y/y. **But under the surface, inflationary pressures are growing.** Producer prices are up 8.9% ytd, with a key driver being extraction (14.4%), and most other sectors within a 5.0-8.5% range. In y/y terms, building materials are up 11.6%, cargo transport – 25.5%, machines & equipment – 9.3%. This exerts serious input price pressure across the board, which **we expect to intensify in coming months, especially with rapid RUR devaluation.** Most players try not to hike prices too much, in order to regain, maintain or expand market share in the changed landscape, but this cannot last long
- Among consumer prices, biggest price hikes are seen in recreation services (domestic tourism is booming), overseas tourism, seafood, detergents, and pharmaceuticals. Prices have declined notably in cereals, home appliances & electronics, and building materials, but expect a trend reversal soon enough, as demand picks up again



Sales volumes fail to rise, despite production growth, as companies fight for market share and curb price growth. This affects profit margins, but companies still mostly optimistic

- There are other worrying signals underneath a pretty encouraging picture in the real sector. Something that is evidenced also by banking sector data further in the report. And that is **a forming liquidity shortage, even in a rapidly recovering and expanding economy.** According to RosStat data, **sales volume in current prices actually declined 2% y/y in H1. Sales in manufacturing slid 1.5%, extraction dropped 25.7%,** and so on. And this despite notable production increase in most sectors.

- We see the explanation in **companies lowering prices or limiting price growth to grab market share for new brands,** whether under new owners or as foreign companies forcedly rebrand their products, which makes them less recognizable. Also, many companies are starting to make new products, including in the framework of import substitution. This also requires marketing and promotion, often by way of lower prices at the first stage after roll-out. Again, this will not last forever, thus **inflation is indeed a significant risk for the budding economic upsurge**

- Unsurprisingly, despite generally positive production dynamics, **aggregate corporate profit declined 21.3% y/y in Jan-May**, according to RosStat. Last year companies used the opportunity to hike prices, but are now forced to lower them amid increased competition. Profit in agriculture is down 31.3%, fishing - 54.6%, extraction - 30.2%, manufacturing - 28.7%, trade - 55.7% (albeit retail trade profit is up 8.8% y/y).

- **On the other hand, profit in construction soared 2.4-fold, communication & information services - 4-fold, R&D - 4.2-fold (here's a key driver for modernization and expansion, going forward!).** Profit in transport & storage grew 14.2%, HoReCa - 10.4%. Notable increases were posted in diverse manufacturing segments as well. **The share of loss-making entities declined by 1 pp** to 28.9%, thus overall prospects for continued recovery and growth are quite positive

- Therefore, **the manufacturing business confidence index rebounded** to +5 in Jun-Jul after dropping to -7 in Jul-Aug 2022 from +4 in Dec 2021. Sentiment is still very negative in wood processing and quite bad in chemicals (although starting to improve now). It remains to be seen whether liquidity pressures will outweigh the increasingly positive expectations in the mid-term

Money supply growth and FDI stay strong, but current account weakens and RUB depreciates strongly, forcing CBR to hike key rate

MONETARY AGGREGATES

- Interestingly, **growth of both broad-definition monetary base (including FX funds) and national-definition (RUB) money supply sped up further in H1** to 30.1% and 25.4% y/y, respectively. Both cash in circulation and bank deposits as key components keep expanding steadily, with the former slightly outpacing the latter

EXTERNAL SECTOR

- External sector data reveals serious underlying problems. The **current account surplus made up USD 20.2bn in H1, a far cry from USD 147.6bn a year earlier and USD 236.1bn in full-2022.** The trade surplus shrank more than 3-fold to USD 54.3bn vs. USD 179.8bn a year ago, as exports dropped 32.9% y/y, while imports gained 19.5%. The service deficit jumped 2.2-fold to USD 16.1bn. It is clear **sanctions and oil price caps are taking their toll, together with the overall world oil price decline.** True, last year's exorbitant oil&gas prices swelled export revenues (easing the impact of sanctions), while imports dropped amid the sanctions and restrictions. But now the situation is vice versa, and the CA surplus is just tiny. **This should constrain liquidity growth and spending in the short- to mid-term**
- **RUB weakened dramatically vs. both USD and EUR in recent months.** The RUB/USD rate went from 70.34 at end-2022 (already much higher than 51.16 at end-June 2022, as CBR intervened to weaken the RUB to offset falling export revenues) to 87.03 at end-June 2023 and then passed 101 on Aug 14). The RUB/EUR rate rose more than 2-fold from 53.86 at end-June 2022 to almost 111 on Aug 14, 2023. On one hand, this supported export revenues and budget execution, but on the other, **it made imports all the more expensive. This is why CBR finally intervened on Aug 15, raising the key rate by as much as 3.5pps to 12%, with further upward potential.** Although this would curtail lending and limit new investment, we strongly welcome this decision. The RUB/USD rate thus dropped by more than 5 to under 96 shortly after the rate hike, with similar dynamics in RUB/EUR
- Meanwhile, **total foreign debt declined by another 8.9% ytd and is down 26.9% y/y at end-H1/2023.** Corporate and banking sector debt dropped 24.9% y/y, state debt – 50.4% y/y
- **FX & gold reserves** declined to USD 586.6bn as of Aug 4, after recovering to USD 601bn as of Feb 3, having plunged by over USD 100bn from USD 643.2bn before the war. Roughly USD 300bn worth of reserves are still frozen by sanctions, but last year's export revenues provide a security cushion. **CBR and FinMin intend to limit FX purchases to combat RUB weakening.** This can negatively affect FX/gold reserves, but of course monetary authorities are expected to keep a balance between filling government coffers and ensuring economic development. **National Welfare Fund rose 1.2% ytd in H1 after dropping in 2022, and makes up 8.4% of GDP**
- **Surprisingly, new FDI reached USD 8.4bn in Q1, roughly in line with or even slightly above recent quarterly averages.** FDI made up USD 26.9bn in full-2022, up 5.9% on 2021 (USD 25.4bn). As we noted last time, a lot of foreign investors that "left" orally have re-invested through other jurisdictions and/or partner firms. Also, many Russian investors that had been keeping funds abroad were either forced to repatriate them and find new investment targets, or simply jumped on the opportunity to buy new assets in the country, including those left behind by foreign investors. Plus, investors from both what Russia dubs "friendly countries", and some "unfriendly countries" as well, acting through third-country jurisdictions, have flocked in to grab this historic chance

State budget deficit stays significant, but banking sector activity picks up on renewed trust

PUBLIC SECTOR

- **A major concern has been the state budget deficit, which made up RUB 2.6tn in H1** after RUB 3.3tn (2.3% of GDP) in full-2022. Spending grew 19% y/y in H1. The H1 deficit is actually smaller than it was in Jan-Apr (RUB 3.05tn). Government's full-year forecast is RUB 2.93tn, and authorities have hinted it might end up slightly smaller. Still, **social infrastructure and welfare spending is being financed steadily.** But the **deficit will surely affect Russia's ability to fund economic transformation and modernization**

BANKING SECTOR

- **The situation in the banking system improved further,** entrenching the recovery seen late last year. **Growth of corporate lending sped up further,** while rapid growth of retail lending is even becoming a bit concerning. Luckily, **overdue debt grew only marginally** in H1, by 4.7% ytd, reaching 4.5% of the total loan portfolio. Overdue debt rose 5.2% and 5%, respectively, in corporate and retail segments, making up 4.8% and 4% of respective portfolios. **Mortgage lending development is no longer driven by government subsidies,** which have been phased out to avoid overheating, allowing for the segment's development on free market terms
- **Investment in securities is growing strongly again,** highlighting renewed investment appetites and availability of funds for investment
- On the liability side, **growth of retail funds sped up considerably,** as the indicator rose 10.4% ytd. Importantly, strongest growth was observed in both shortest-term and long-term (over 1-year) deposits, which **reflects improved trust in local banks.** Retail FX funds notably outpaced RUB funds due to RUB weakness. **A worrisome signal is the considerable decline in banks' FX liquid assets' cover of FX funds,** as banks have not yet readjusted their currency portfolios
- **Worryingly, corporate funds declined 1.7% ytd,** as y/y growth in H1/2023 slowed below the level of 2021. **This is another testament to the increasing liquidity pressure for local corporates.** Thus, long-term deposits dipped 7.4%, whereas medium-term ones (1-12 months) gained 31.9% ytd
- **Total banking sector profit jumped to RUB 1.64tn in H1 vs. a mere RUB 0.13tn in full-2022.** The share of loss-making banks receded considerably. **To a significant extent, the sharp rise in profit is attributed to upward revaluation of FX-denominated assets due to rapid RUB depreciation.** Core banking profit failed to rise meaningfully. CBR also still withholds part of the more sensitive sector data, and running our regular timeseries, allowing more in-depth analysis, is still not possible. **But at least the banking sector has definitely stabilized and is attracting additional funds to support general economic development**

Indicator, % y/y	2020	2021*	2022*	H1/2023*
Loans to individuals	13.5	25.1	9.5	17.3
Loans to corporates	9.9	10.6	14.3	19.8
Individuals' funds	4.2	3.1	6.9	12.8
Corporates' funds	14.4	16.7	20.6	16.2

** - Due to data revisions and methodology adjustments by CBR, data for 2021, and 2022 and H1/2023, respectively, in various timeseries may not be directly comparable with previous years*

Summary

- **The Russian economy appears to be undergoing not only recovery from last year's shakeup, but real transformation by broadening its production base.** Both commonplace and higher-value added products are starting to be manufactured in larger quantities inside the country, in sectors ranging from textiles and luggage to elevators, new chemicals, and computers & electronics
- **However, the situation is very uneven across sectors,** with a number of key segments that had supply chains and export channels disrupted, still ailing. Worth noting, **as soon as these sectors recover and resume expansion, overall economic growth may well accelerate to 5-6% y/y after 2024,** barring further major disturbances (even if the war in Ukraine continues raging and sanctions are not lifted in the foreseeable future). **Real GDP growth already turned positive in H1** (1.5-1.6% y/y), and may top 2% this year
- **Consumer activity is obviously rebounding,** boosting retail trade, HoReCa, as well as various other service segments and manufacturing. **Real income and wage growth finally turned strongly positive, as inflation has slowed,** and additional funds are freed for both spending and savings
- At the same time, **both CPI and PPI inflation is picking up again lately, aided by rapid RUB depreciation.** So far companies are lowering prices or avoiding large price hikes, in order to regain or expand market share, in many cases having had to rebrand as manufacturing and sales assets change hands. But this cannot last forever, and as input price pressure increases and companies' re-establish their market foothold, inflation is set to re-accelerate. **This will be a major challenge for the economic recovery and transformation, that authorities have only started to address, including via key rate hikes**
- **Another major impediment could be the already forming liquidity squeeze,** resulting from higher input prices and reduced profit margins as market players withhold price hikes amid increased competition. While production dynamics are indeed positive on the whole, **actual sales volumes in current prices declined y/y in H1. Still, manufacturing and other sectors' business confidence indices are trending up unmistakably,** as most companies stay optimistic
- Meanwhile, external, public, and banking sector data is mixed. **The current account surplus has all but dried up, however foreign debt continues declining significantly. The state budget deficit remains significant, but has stopped growing** in recent months, and the National Welfare Fund and FX & gold reserves provide considerable safety cushions. Also, **FDI stays remarkably strong,** despite all the turmoil, as both a large part of foreign investors continue working in Russia, whether through new jurisdictions or new partners, and Russian investors are jumping on the opportunity to acquire juicy assets across the board. Undoubtedly, new foreign investors from various countries are also joining the joyride, even if somewhat cautiously
- **The banking sector has stabilized and re-entered expansion mode,** boosting its total profits. That said, **corporates' funds in banks declined in H1, exposing the liquidity squeeze.** The key rate hike may further constrain lending and new investment, but for investors that have their eyes set on this lucrative market, **this is unlikely to derail their business development plans**

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