Strategic Choice Advisory

Strategy and Transactions

Russia Macro Foresight

Growth Slows in Full-2019, Budding Consumer Demand Recovery Still Weak, Thus Authorities Turn to Political Reform

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Economic growth slows in 2019, with B2B-oriented sectors turning sour, yet some B2C-oriented sectors rebounding. Still, slower wage growth and weak real income growth curb spending

- According to RosStat's preliminary estimates, **real GDP growth slowed notably to 1.3% y/y in 2019 vs. 2.5% in 2018.** Authorities had warned that the **2018 number was boosted by the launch of the massive Yamal-LNG plant** (hence also stronger construction and capital investment), while 2019 growth would return to more or less the average level since the start of the sanction crisis in 2014
- In fact, GDP growth was slightly below authorities' and analysts' expectations. We would not be overly concerned about that, as warmer weather reduced growth in utilities, while OPEC limitations affected oil extraction, a key sector. **Our concern is that growth stays weak overall, failing to reignite for several years running**
- The sector breakdown continues to confirm the conclusion we voiced in our previous reports (e.g. from Aug 1, 2019), that **B2B demand has slumped, while B2C demand is starting to recover** (as evident by comparing railway vs. auto transport, industrial vs. housing construction, etc.). **Very disappointing was the much slower growth of capital investment,** the worst reading since 2016
- **Retail trade growth slowed less markedly,** from 2.8% y/y in 2018 to 1.6% in 2019, **but still disappointed.** It shows consumers are still reluctant to step up spending

Indicator, % y/y	2016	2017	2018	2019
Industrial production	1.3	2.1	2.9	2.4
Cargo transport turnover, o/w:	1.8	5.5	2.7	0.6
Railway	1.6	6.4	4.2	0.2
Automobile	0.4	2.3	2.3	5.8
Agriculture	4.8	3.1	-0.2	4.1
Retail trade	-4.6	1.3	2.8	1.6
Construction, o/w:	-4.3	-1.2	6.3	0.6
Housing	-6.0	-1.3	-4.5	4.9
Fixed capital investment	-0.6	4.4	5.1*	0.7**

** - Jan-Sep 2018, % y/y || ** - Jan-Sep 2019, % y/y*

- It is no wonder that **consumer demand keeps underperforming,** despite the improvement after steep drops in 2014-2016. **Real disposable income** (RDI) did post its second consecutive above-zero growth, but **was only marginally better than the previous year: 0.8% vs. 0.1%**
- Nominal wage growth slowed visibly, while real wage growth tanked, even despite lower CPI inflation. **Slower growth of RDI and real wages can be attributed to the mounting consumer debt burden,** growth of which authorities are working to limit now
- **Positives can be found in the drop in wage arrears and further decline of ILO-definition unemployment, which support demand**

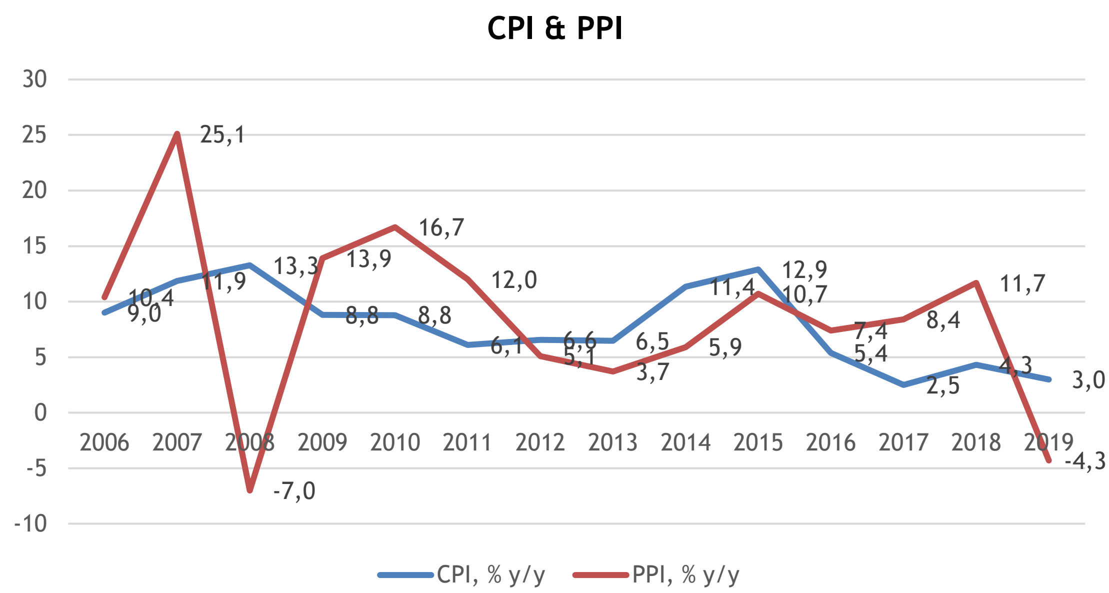
Indicator, % y/y	2016	2017	2018	2019
Real disposable income*	-4.5	-0.5	0.1	0.8
Real wages	0.8	2.9	7.4**	2.5***
Nominal wages	7.9	6.7	10.3**	7.2***

** - Methodology still under review by RosStat; further adjustments may be possible*

*** - Jan-Nov 2018, % y/y || *** - Jan-Nov 2019, % y/y*

Producer prices drop, alleviating inflationary pressures, but indicating poor demand and weaker profitability. Still, manufacturing holds up fairly well, with a number of bright spots

- As we predicted several reports ago, **PPI inflation has crashed through the floor.** Actually, the 2019 result - 4.3% y/y deflation - was the lowest reading since the 2008 financial crisis
- **CPI inflation also slowed - to 3% from 4.3%, but we still doubt this indicator.** Noticeable food and non-food price growth is observed, and authorities finally plan to review the consumer price basket
- **Weak inflation does curb input price pressure,** thus supporting profitability. **But it also highlights weak demand** - a key concern, going forward
- Indeed, **pre-tax corporate profit rose just 9.1% y/y in Jan-Nov 2019, slowing abruptly.** After solid growth in Jan-Apr, profits slid y/y in May-Nov
- **Manufacturing, transport and trade profit rose strongly, though, instilling some hope**



- **Manufacturing output growth made up 2.3%, just slightly lower than 2.6% in 2018**
- Mirroring the upsurge in agriculture, **foods stayed robust**. Also, **stellar growth continued in medical equipment and pharmaceuticals**, as well as **furniture, toys** (all consumer-oriented sectors); **building materials** (B2B and B2C), **metal products** (mostly B2B), and **chemicals** (B2B, B2C)
- **Fulfilling our long-standing prediction, growth in computers & electronics revved up,** proving their investment attractiveness
- However, **confectionery, textiles & apparel; footwear; cars and trucks, and electrical equipment slipped after solid growth**

Segment, % y/y	2018	2019	Segment, % y/y	2018	2019
Food products	4.9	4.9	Textiles	3.6	-1.1
Bottled water	14.3	17.6	Apparel	4.1	0.6
Chemicals	2.7	3.4	Footwear	3.7	-5.8
Fodder feed	3.4	2.8	Confectionery	5.6	-0.6
Medical equipment	43.3	36.7	Machines & equipment; related:		
Pharmaceuticals	8.2	19.6	Electrical equipment	2.9	0.6
Computers & electronics	-1.5	8.0	Tractors	-2.1	-8.1
Washing machines	2.4	5.1	Metal-cutting equipment	2.6	-0.1
Metal products	1.3	8.9	Automobiles	13.3	-1.9
Wood products	10.6	5.3	Car tires	6.9	-9.3
Non-metallic mineral products	4.4	4.6	Truck tires	1.9	-16.6

Overall liquidity situation deteriorates slightly, although government maintains control, and FDI rebounds. Banking sector growth slows, as overdue debt soars, while liquidity indices worsen

EXTERNAL SECTOR

- **The current account surplus stayed significant at USD 70.6bn in 2019, but decreased considerably vs. USD 113.4bn in 2018,** as world oil prices declined, and the service deficit widened by 16.4% to USD 34.8bn
- **Exports were also held back by real exchange rate appreciation of 2.5% y/y in full-2019, and as much as 8.5% y/y in Dec 2019**
- **Alarmingly, total foreign debt lurched up by USD 26.8bn (5.9%)** to USD 481.5bn. Government foreign debt surged 58% to USD 69.5bn, while corporate foreign debt growth moderated to 2.6% after the previous sharp increase
- **Positively, FDI rebounded to USD 25.9bn in Jan-Sep 2019 after hitting a historic post-Soviet low of USD 8.8bn in full-2018.** The indicator had stood at USD 26.4bn in Jan-Sep 2017 (USD 28.6bn in full-2017)

MONETARY AGGREGATES

- **Broad-definition monetary base grew 4.9% in 2019 vs. 9.3% the previous year,** as banks' accounts with the Central Bank (CBR) soared, reflecting somewhat higher economic activity, but deposits contracted sharply, showing banks' lower liquidity. Banks also started to borrow a lot more from CBR. **National-definition money supply growth also eased to 9.6% vs. 11.3% in 2018**

PUBLIC SECTOR

- **The federal budget surplus stayed at a solid 1.8% of GDP in 2019**, as taxes and customs collection strengthened further. This shows maintained fiscal prudence, but also causes outcries from many an economist over insufficient economic stimuli

BANKING SECTOR

- **Most key indices showed sharp deterioration,** although the growth rates improved somewhat in H2/2019
- **Especially worrying is the sharp slowdown in loans to corporates, coupled with the rapid increase of overdue debt**
- While **retail loan growth slowed just slightly, overdue debt rose only 3.1%. Still, the latter reverses the decreases** of 2016-2018
- Growth of retail deposits eased slightly, while **corporate deposits barely grew**, as the broader economy stayed weak
- **Sector profit surged in 2019, but this was inflated by dubious loan loss reserve reductions under newly introduced IAS 9**
- Also worryingly, **liquidity indices (use of short-term liabilities to form long-term assets; and liquidity coverage deficit) worsened noticeably,** signaling trouble up ahead

Indicator, % y/y	2016	2017	2018	2019
Banking sector profit	**4.8-fold**	**-15.1**	**70.3**	**51.5***
Banking sector assets	**-3.5**	**6.4**	**10.4**	**2.7**
Loans to individuals	1.1	12.7	22.4	18.5
Loans to corporates	-3.6	1.8	10.8	1.2
Total overdue debt, o/w:	-5.1	3.5	0.2	19.8
Individuals	-0.7	-1.0	-10.4	3.1
Corporates	-8.9	2.7	7.8	27.9
Individual deposits	4.2	7.4	9.5	7.3
Corporate deposits	-10.1	2.1	12.7	0.5

** - Inflated by IAS 9 upward profit adjustments (expected loan losses reduced)*

Viewing a stagnant economy and strong public dissent, president Putin launches far-reaching constitutional reform, trying to appease the masses. Leaving politics aside, we are concerned about the general population's over-reliance on authorities and lack of business initiative

This January, during his address to the Federal Assembly, president Vladimir Putin announced key changes to the country's political system. As reported by the media, **the authority of the next president** (Putin confirmed he will be stepping down when his term expires in 2024) **will be decreased in favor of parliament.** The president will retain key controls, including the right to dismiss the PM and government members, but the PM would now be appointed by parliament. Also, Putin announced the role of the State Council (until now, a consultative body consisting of governors and other key politicians) will be widened. Putin himself serves as chairman of the State Council. **The changes are now to be voted on by the general population,** after a specially assembled group promptly develops corresponding amendments to the Constitution.

After Putin's announcement, PM Dmitry Medvedev announced his and the cabinet's resignation, to make way for the latest policy changes. While public discontentment with the government has been growing, **Putin did not say the resignation was caused by his dissatisfaction with the government**, only noting that "nobody is perfect" and praising government for its achievements and steadfast approach. Medvedev has now become deputy chairman of the State Council, thus keeping his role as Putin's loyal sidekick.

As widely known, **Russia's parliament has been largely the "rubber stamp" type under Putin's rule, thus it will be business as usual, in our view.** The changes had been rumored and reported by political observers and the media, although no details had been made available by Russia's state propaganda machine, thus the general public was caught by surprise.

Notably, **Putin also focused on key social issues in his speech, noting weak real income dynamics**, and introducing several measures aimed at expanding government support. **The new government's main focus will now be boosting real incomes**, Putin promised. We would not label these initiatives as populist, and can actually say **they are quite smart from a political perspective, and very well-targeted.** Authorities have been under significant pressure lately, as the economy has largely remained stuck since the start of the "sanction crisis" (despite the positive trend of import substitution), and Putin and the government's ratings had dropped considerably.

Unsurprisingly, **public reception of Putin's initiatives has been very positive (Putin the old mastermind!), as opinion polls indicate 65-85% support** for the announced measures (including the shift of authority in favor of parliament and the State Council). Putin's ratings have also started to recover. Leaving the political aspect aside, **our concern is that there is practically no talk** by either Putin or the newly minted PM Mikhail Mishustin (until now, head of the fearsome Federal Tax Service) **about the way the local economy should change, in order to be able to generate the higher incomes…** Of course, there are the structural National projects, which Putin promises to step up, but as we wrote earlier, they are rather vague, and their transformative role will be limited.

Reading into other types of opinion polls, we can see **the population still tends to rely on the "good czar" and their employers,** and would (think about it for a second) start to work harder, IF their wages are increased significantly... No wonder **the share of SMEs in the Russian economy declined by 1.8pps to 20.2% in 2019**, remaining very low by global standards. Yes, one can blame the poor economic climate, over-regulation, and what have you, but **it is also a mentality issue.** For some of our ideas on what can provide that thrust, that impetus for a much-needed breakthrough, you can refer to our previous reports, e.g. from Aug 1, 2019, or Aug 23, 2018, etc. But in the meantime, **we remain in wait-and-see mode, only left to hope for the better** (ourselves continuing to work hard)…

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