

**Strategic Choice
Advisory**
Strategy and Transactions

Russia Macro Foresight

Word of the Year 2022: Hustle.
Russian Economy Regains its Footing

February 2023



Liquidity, external sector indices recover surprisingly, but budget deficit widens at year-end

MONETARY AGGREGATES

- **Growth of national-definition (RUB) money supply accelerated notably over H2**, reaching 24.4% y/y in full-2022 vs. 16.8% in H1, 13% in full-2021, and 13.5% in 2020. Solid growth is seen in both cash in circulation (16.9% in 2022), and bank deposits (26.2%)
- Also, growth of broad-definition monetary base (including FX funds) rebounded to 20.1% y/y in full-2022 after contracting 0.7% in H1 and rising 10.1% in 2021 and 9.8% in 2020. **Altogether, it shows resumed trust in the local banking system and broader economy**

EXTERNAL SECTOR

- **The current account surplus swelled by more than USD 100bn y/y to USD 227.4bn in 2022 vs. USD 122.3bn a year ago.** At that, **the indicator declined steadily throughout the year** - from USD 78.5bn in Q2 to USD 48bn in Q3 and USD 31.4bn in Q4, as oil&gas prices receded, and export restrictions were introduced against Russia. The overall goods and services trade surplus hit USD 282.3bn vs. USD 170.1bn in 2021. The income deficit worsened marginally from USD 47.8bn to USD 54.9bn. Federal Customs Service and CBR stopped publishing breakdowns by type of goods and services, thus it is not possible to make more detailed conclusions at this point
- **Incredibly, FDI seem to have recovered over the course of 2022.** Total accumulated inbound investment dipped from USD 497.7bn at end-2021 to USD 422.5bn at end-Q1, but then surged all the way to USD 590.5bn at end-Q2 before receding to USD 457.6bn at end-Q3, matching the average level of the last few years. **Corresponding dynamics is seen in total accumulated outbound investment**, which slid from USD 374.6bn to USD 288.6bn (capital repatriation), before rebounding to USD 373.3bn and then slipping back to USD 326.1bn over respective periods. True, there are accounting issues for Russian funds and investments abroad, but **in any case, this can explain the recovery in market liquidity.** Also, both local investors and those from what Russia calls “friendly countries” **rushed to take over assets of departed companies, while many foreign investors actually re-invested in Russia via new jurisdictions**
- Meanwhile, **external debt contracted by just over USD 100bn y/y to USD 381.8bn**, with an especially precipitous drop taking place in H2. **A welcome decline was seen across all key segments, including state, banking sector, and corporate debt**
- **FX & gold reserves** have declined since the start of the military operation in Ukraine (USD 643.2bn on Feb 18, 2022), but **rebounded to USD 601bn as of Feb 3, 2023** from USD 540.7bn on Sep 30, 2022. This does not account for the fact roughly USD 300bn worth of reserves have been blocked by international sanctions, but the data shows Russia’s international reserves are recovering now
- **RUB strengthened a whopping 25.8% y/y in real terms vs. the trade-weighted currency basket in 2022**, and 21.9% in nominal terms. **CBR even had to reverse excessive RUB appreciation in H2**, which had started affecting export competitiveness and budget revenues amid declining oil&gas prices, intervening to weaken the RUB against both USD and EUR

PUBLIC SECTOR

- **The federal budget saw a large deficit in H2**, after a sizable surplus in H1. **In full-2022, the deficit made up RUB 3.3tn (2.3% of GDP).** Both revenues and spending exceeded targets. Authorities are keen on meeting spending goals, especially for infrastructure and social welfare, while funding war-related items and economic stimuli. **National Welfare Fund** still provides a safety cushion at RUB 10.4tn (7.8% of GDP), but **has shed over RUB 2tn in recent months amid end-year outlays.** We must note that revenues may be partially underreported to shield from sanctions, but generally, the numbers provide an accurate picture of key economic trends

Banking sector sees robust growth, supported by government money and rebound in client funds

BANKING SECTOR

- Mirroring monetary and external sector trends, the **banking sector sprung back to life in H2, as growth of most key indices accelerated even past 2021 levels**. CBR has resumed publishing some of the indices it had concealed after the start of the military conflict, including aggregate profit and overdue debt. However, methodologies for some indices have changed, making year-on-year comparisons more difficult. Still, as detailed methodology notes have been provided, the underlying trends can be made out quite clearly
- **Corporate loans grew 14.3% in 2022, posting the highest growth in years**. According to another CBR data set, the indicator rose around 17% in 2021, but the revised figures exclude issued eurobonds and some other instruments, and are more representative in current circumstances. **Retail loans rose just 9.5% vs. 25.1% a year ago, but this is actually a welcome development**, as this segment had started to overheat with the easing of the pandemic. Looking more closely, mortgage loans surged around 20% (CBR is now out to curb excessive growth in this segment), while consumer loans inched up 2.7%. Taking into account also the marginal increase in the share of bad retail loans (from 7.7% to 8.8%), we can say people are becoming more cautious and do not want to fall in trouble with banks during this difficult period. **The share of bad loans in the overall credit portfolio slid 0.6pps to 7%** (latest figure is for Dec 1, 2022)
- On the liability side, **growth of both corporate and retail funds picked up noticeably, ensuring supply of liquidity to banks. A key driver was government funds (up 37%)**, but both corporates' and individuals' funds also gained strongly. The divergence in deposit maturities we noted last time, still persists. Funds on corporate correspondent and shortest-term accounts skyrocketed, as companies avoid making long-term deposits (at that, individual entrepreneurs' long-term deposits still grew nicely). Retail clients prefer medium-term deposits, shunning long-term ones, while increasing funds on current accounts marginally
- **Positively, RUB liquid assets surged 25.3% in 2022, providing healthy 39% cover of RUB client funds**. FX liquid assets provide 59% cover of client FX funds and 55% cover of FX liabilities. FX loans slid 18.2% y/y, as the currency structure has got readjusted
- Also encouragingly, **aggregate banking sector profit rebounded in H2, offsetting a RUB 1.5tn loss in H1** and ending the year at a positive RUB 203bn reading. The full-year result is a tiny number, and the share of loss-making banks has risen several pps to 23%. But overall, **the sector is starting to overcome the macro turbulence, supported by the nascent economic recovery**

Indicator, % y/y	2019	2020	2021*	2022*
Loans to individuals	18.6	13.5	25.1	9.5
Loans to corporates	5.8	9.9	10.6	14.3
Individuals' funds	9.7	4.2	3.1	6.9
Corporates' funds	4.7	14.4	16.7	20.6

* - Due to data revisions and methodology adjustments by CBR, 2021 and 2022 data in various timeseries may not be directly comparable with previous years. E.g. loans to corporates do not include issued eurobonds, unlike in previous years

Real sector growth holds up in most industries, as companies rush to redesign supply chain and sales geographies, seize import substitution opportunities (1/2)

- **Real sector data for full-2022 is surprisingly positive.** Slowdowns or only modest declines are seen in most industries, but the **overall degree of deceleration is much lower than expected.** Real GDP declined only 1.6% y/y in Jan-Sep. Fixed capital investment rose a solid 5.9% y/y through Jan-Sep, mostly driven by import substitution. This is just below the full-2021 breakout result, and way above the annual average in recent years
- At that, **different sectors witnessed completely different dynamics throughout the year.** Some were spurred by panic buying and crisis import substitution early in the year (e.g. pharmaceuticals, beverages, building materials), then turning to slight contraction late in the year as the markets became saturated. Others fell through the floor at first (e.g. apparel, oil products, metal products), but then recovered and turned to solid growth toward year-end. Another group tried to make the most out of the situation, and never looked back. **The net result is quite a sustainable situation across the board, instilling cautious optimism for this year**

Indicator, % y/y	2019	2020	2021	2022	Segment, % y/y	2021	2022	Segment, % y/y	2021	2022
Industrial production	3.4	-2.1	6.3	-0.6	Food products	4.2	0.4	Chemicals, overall	7.1	-3.8
Cargo transport turnover:	0.7	-4.7	5.6	-2.6	Beverages	7.6	3.1	Rubber & plastic products	10.5	-0.8
Railway	0.2	-1.9	3.7	-0.1	Textiles	15.1	-8.3	Pharmaceuticals	14.3	8.6
Automobile	6.3	-1.3	5.0	1.8	Apparel	7.4	2.1	Coke & oil products	3.6	-0.4
Agriculture	4.3	1.3	-0.4	10.2	Metallurgy	1.7	-0.8	Machines & equipment	17.1	1.9
Retail trade	1.9	-3.2	7.8	-6.7	Wood products	11.9	-12.5	Electrical equipment	7.7	-3.7
Paid services	0.5	-14.8	16.7	3.2	Furniture	17.7	-2.6	Automobiles	14.6	-44.7
Construction, o/w:	2.1	0.7	7.0	5.2	Building materials	9.3	-0.2	Computers & electronics	9.9	1.7
Housing	6.2	0.2	12.7	11.0						
Fixed capital investment	2.1	-0.5	7.7	5.9*						

* - Jan-Sep 2022

Real sector growth holds up in most industries, as companies rush to redesign supply chain and sales, seize import substitution opportunities (2/2)

- **Among the worst performers** are segments where production and logistics processes have not yet recovered fully amid foreign producers' or equipment suppliers' departures, and various restrictions. These include **cars, home appliances, wood products, and most chemicals**. Still, **companies are gradually finding new equipment and raw material suppliers for chemicals (especially plastics), and electronics**. In other sectors, **production dipped due to previous over-saturation**, including textiles (non-woven materials production dropped with the easing of the pandemic), and railcars (market players are now breathing a sigh of relief, as there are still way too many railcars clogging up railways)
- Extraction grew 0.8% in 2022, but dipped 2.5% y/y in Q4, as oil&gas sanctions were toughened. Still, in full-2022 oil&gas rose 0.7%, coal declined only 0.8%, while non-metallic minerals (mainly used in building materials) soared, driven by a boom in construction. Metal ores were the biggest losers, dropping 4.5%. We suspect revenues and profit may be underreported, especially in oil&gas
- **Clear outperformers were agriculture, pharmaceuticals, and housing construction**, as market players jumped on opportunities arising from the turbulence or rushed to produce as much as they could “while supplies last”. Remains to be seen how well housing and commercial real estate construction will fare this year, but other segments (industrial, social, and tourism infrastructure) seem to be expanding undeterred, driven by import substitution, government funding for social welfare, and domestic tourism. **Import substitution is continuing apace** in computers & electronics, machinery (including marine vessels), medical equipment, building materials, cardboard boxes and other packaging (driven by eCommerce and logistics restructuring), hygiene products, footwear, etc.
- In agriculture, **crop production underperformed**, with sunflower, certain vegetables, corn, and some other crops seeing output declines, driven by reduction of sown area. However, this may be attributed to **producers switching to more lucrative crops, especially grains and potatoes**, amid acute export demand, and import substitution, respectively. Also, experts we have spoken to point to often murky reporting practices in the sector and many companies possibly engaging in tax evasion amid all the turmoil... Husbandry, milk & eggs, sea fish and crustaceans, and fish processing posted brisk growth
- **Transport held up surprisingly well**, including railway, automobile, and marine transport segments, with only gas pipelines and airlines suffering a “natural” blow. Oil and oil product pipeline export still grew strongly. Interestingly, while cargo load declined slightly in some segments, turnover still managed to grow, which shows distances increased, as **businesses reorient their sales geographies in favor of “friendly countries” further afield**
- **Retail trade turnover slid 6.7%, driven by non-foods (-11.1%)**. The departure of many market players made buying some products more difficult and drove up prices. But toward year-end, the situation appears to have stabilized, with consumers simply starting to make more rational choices. **Household consumption declined just 1.4% in Jan-Sep. Retail sector profit rose 16% in full-2022!**
- Paid services to the population continued growing throughout the year, showing that the purchasing power is still there. Domestic tourism shot through the roof, restaurants and catering stayed in the sun, and home appliances and electronics repair skyrocketed
- **As a result, total corporate profit declined just 11.4%**. Originally, the growth was driven mainly by oil&gas, which benefited from soaring prices and favorable FX rate dynamics, but then growth there subsided. Biggest aggregate profit was posted in construction, followed by HoReCa, transport & storage, real estate, utilities, and manufacturing (up 2.3%). R&D and fishing saw the biggest drops

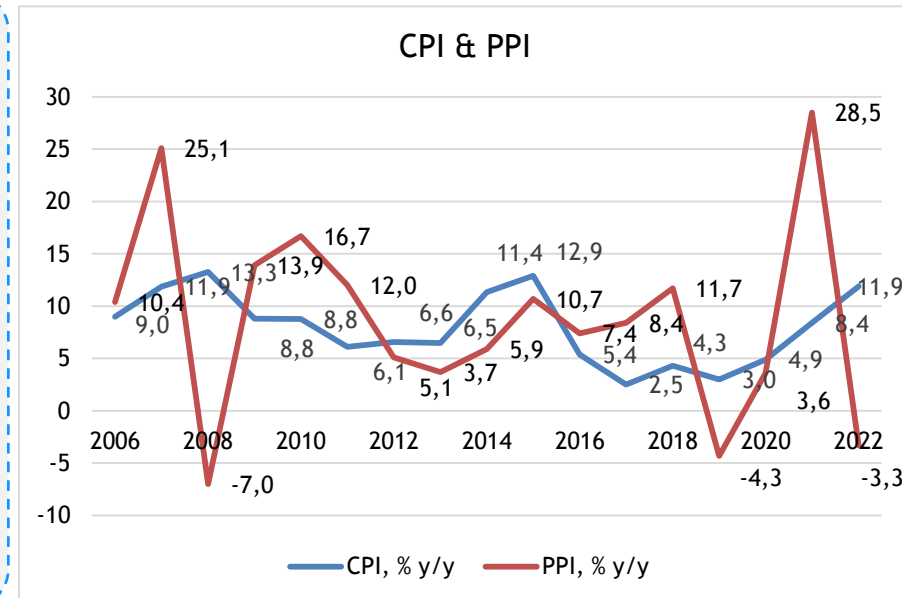
Real income declines marginally amid turmoil, affecting consumption, but people just become more choosy. CPI inflation slows notably in H2; PPI deflation observed toward year-end

- Because of higher inflation, real wages and income did decline in 2022, but rather just inched down, as **nominal wage growth sped up**. **On the job market, employees still have the upper hand** amid numerous new openings and a shortage of corresponding candidates
- **Public welfare seems to have suffered little**. ILO-definition unemployment slid further to 3.7%, official unemployment - to a meager 0.75%. The number of unemployed dropped 29.8%. Wage arrears shrank 18.1% in 2022
- Fears that departed companies' staff would be laid off after long redundancy periods did not materialize, as the assets were swiftly bought over by new investors or management, or are in the process of changing hands
- Interestingly, while the number of full-time and part-time staff rose strongly, the number of contractors plunged. **We wonder if contractors were first to jump ship and leave Russia due to the war and mobilization campaign?**
- A major concern is demography, as the population shrank by 544thsd people after suffering even bigger pandemic-driven declines in previous years. Emigration increased by around 390thsd. **The workforce contracted 0.6%...**

Indicator, % y/y	2019	2020	2021	2022
Real disposable income	1.0	-2.0	3.2	-1.0
Real wages	4.8	3.8	2.9	-1.1*
Nominal wages	9.5	7.3	9.8	12.7*

* - Jan-Nov 2022

- Inflation has largely subsided after shooting up in early 2022. **CPI inflation slowed to 11.9% y/y in December after exceeding 17% in Apr-May**. Surprisingly for a major agricultural producer, food prices shot up, joined by some services, including, of all things, utilities in a major energy producing country; healthcare, tourism, and insurance. Plus, certain non-foods, first of all detergents and other household chemicals, home appliances, and apparel. But price growth in fruits and vegetables, gasoline, footwear, and telecom products and accessories was minimal, thanks to import substitution and/or competition among new suppliers from "friendly countries"
- After soaring in 2021, **PPI turned to deflation mode by December** (-3.3% y/y). Annual average PPI inflation still made up 11.4% y/y. Biggest price hikes were seen in automobiles and other transport equipment, building materials, machines & equipment, cargo transport, healthcare, and trade; biggest price cuts - in wood, metal and oil products; agriculture; and extraction. Overall, **logistics costs have turned into a key impediment to economic development**



Conclusions

- All in all, the Russian economy appears to be getting back to form. The shock from the start of the military operation, which quickly evolved into all-out war in Ukraine, faded rather quickly. Even the partial mobilization campaign of Sep-Oct, which sent scores of people fleeing Russia, has failed to derail economic restructuring processes that were already in play. All year long, companies have been busy rearranging their normal routines, from procurement and logistics, on to manufacturing and sales networks, and even choice of various service providers. Matter of fact, businesses in Russia have grown inure to hardships and crises, starting from the trials of transferring to a market economy in the '80s and '90s, on to the global financial crisis of the late noughties, then the start of the conflict in Ukraine in 2014, then the pandemic and now start of war in Ukraine, plus all other disturbances in between. One can say, the pandemic vaccinated the local business community and people in general to be able to change everything rapidly and adapt to whatever new circumstances
- Moreover, many companies have learned to see crises as new opportunities, rushing to design and provide new services, distribute or manufacture new products. Much like in the wild '80s and '90s, but in a more civilized manner. For most, it is not a matter of “evading sanctions” or “violating regulations”, but simply continuing their normal business activities or leading their daily lives, despite the complications imposed on them by someone else’s unilateral decisions
- Negatively, though, most companies have resorted to enormous price hikes, which consumers had no choice but to put up with, or find alternative providers. This has upheld corporate profits in these times of adversity. Luckily, competitive pressures are already starting to curb or even reverse price growth, something we hope will continue. Meanwhile, logistics costs remain a major constraint for both Russian exports to and imports from new places
- Not all companies in all industries have managed to find adequate new suppliers, sales channels or logistics solutions, but these are being worked out more effectively. Windfall export revenues, complications for certain imports, and active import substitution have restored trust in the local economy. Together with takeovers of departed companies’ local assets, this has replenished market liquidity and revived bank lending. Russian government support also aids the economic recovery. And looking through sector data, we can see only scattered evidence that “the war machine” is upholding economic growth. It is mostly just companies across the board hustling and bustling their way out of this major shakeup
- Speaking of departed companies, various firsthand accounts, our own observations, and numerous surveys suggest many foreign players have either stayed on or handed their assets over to partner firms, mostly continuing to support their local businesses with supplies and services. Quite a few continue to control these assets through third parties or from other jurisdictions. Many of the assets have been bought by new investors from “friendly” or even “unfriendly countries”. New market entrants from “friendly countries” (coming from what is supposed to be a global market economy) are all over the place, eager to grab a piece of the mouthwatering Russian pie. Often enough, foreign players simply remove some most recognizable brands, hike prices for the remaining products, and reap record profits
- And there is an important disclaimer we have to make. The assessments in this report are based on available data and observations at the time of writing. It would be too irresponsible to claim everything will progress as suggested by current trends. Should the war in Ukraine intensify further (as it might with the next wave of military equipment from the West and Russia’s imminent response, plus major offensives by both Russia and Ukraine come spring), things can unravel or otherwise develop unpredictably. Surely enough, even in this case Russian market players and the general public will continue to adapt. Hustling their way through, as usual.

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