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RUSSIA: IMPACT OF SANCTIONS

SEPTEMBER 17, 2022

RUSSIA: 2022 CONTRACTION, 2023 COLLAPSE?

2022 Growth: temporary stabilization after initial sanctions shock, but still deep contraction even on official forecasts. After the initial shock of sanctions hit the Russian economy hard in March-April, driving the CBR to hike rates to 20% and introduce capital controls, high oil and gas revenues and the collapse of imports have temporarily shielded the economy, driving the RUB higher, reducing inflation and allowing the CBR to reverse its rate hikes. Still even the CBR expects a 5% contraction this year and a contraction next year – cumulatively a ~15% contraction compared to pre-war forecasts.

2023 Growth: Likely breaking point ahead as sanctions bite. Russia is dependent on oil and gas revenues, which account for over 60% of exports and over 40% of budget revenues. With the European oil embargo and the price cap widening the discount on Russian oil and reducing volumes, and gas sales to Europe reduced to a trickle, Russian oil and gas revenues should fall below a critical point – around $150 bn per annum – next year. At this point, Russia's underlying financial fragilities in the currency and at banks will likely resurface, constraining Russia's ability to continue financing the war, and forcing the CBR to decide between hiking rates to defend the RUB and stop inflation (monetary stability), or providing liquidity to support the banks (financial stability).

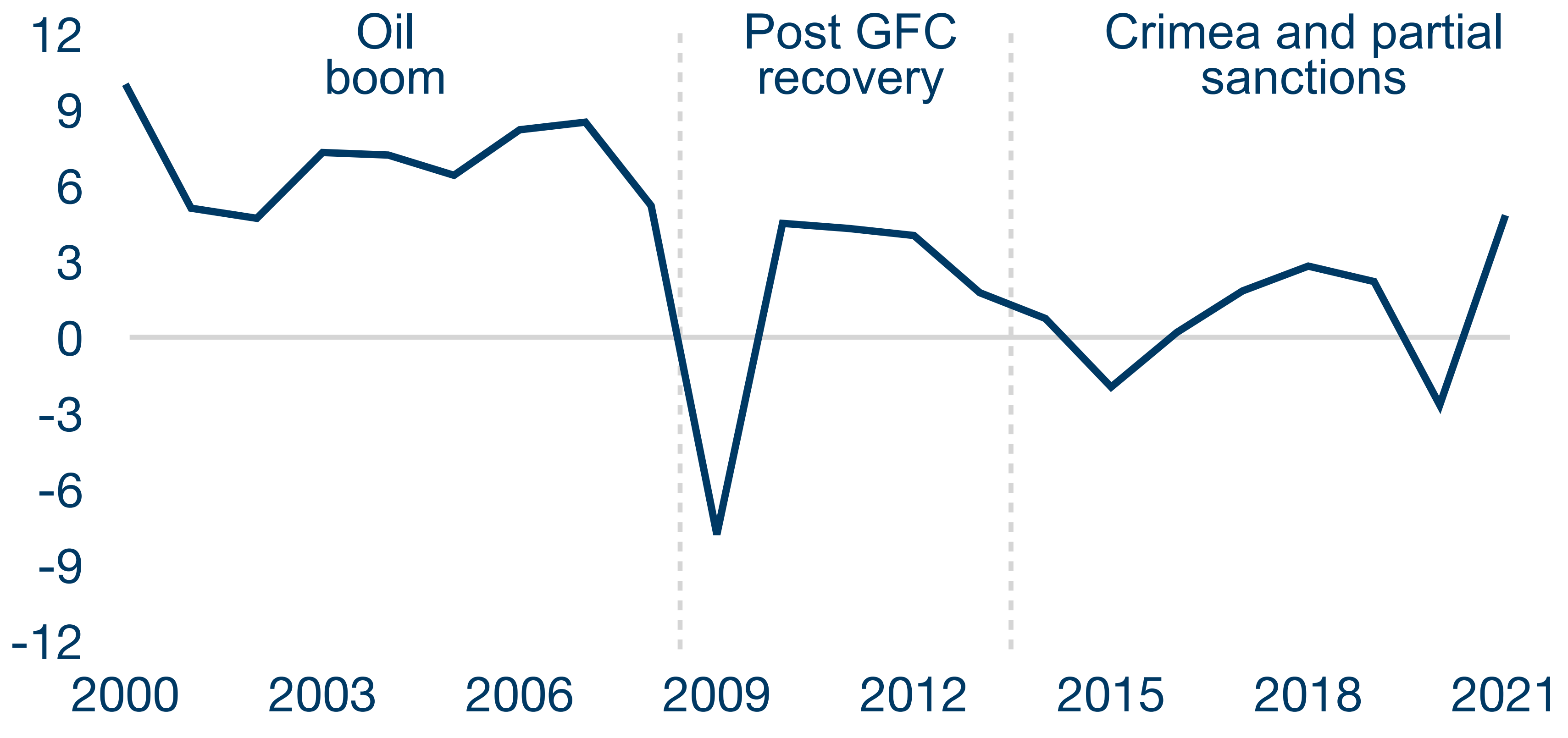
Budget: Looking stretched even at high oil and gas prices. The recent news that the YTD fiscal surplus has disappeared and that the Russian MinFin is introducing a 10% across the board funding cut in non-protected items illustrates a sharper than expected fall in revenues, given oil around $100 and gas at record levels.

GROWTH OUTLOOK

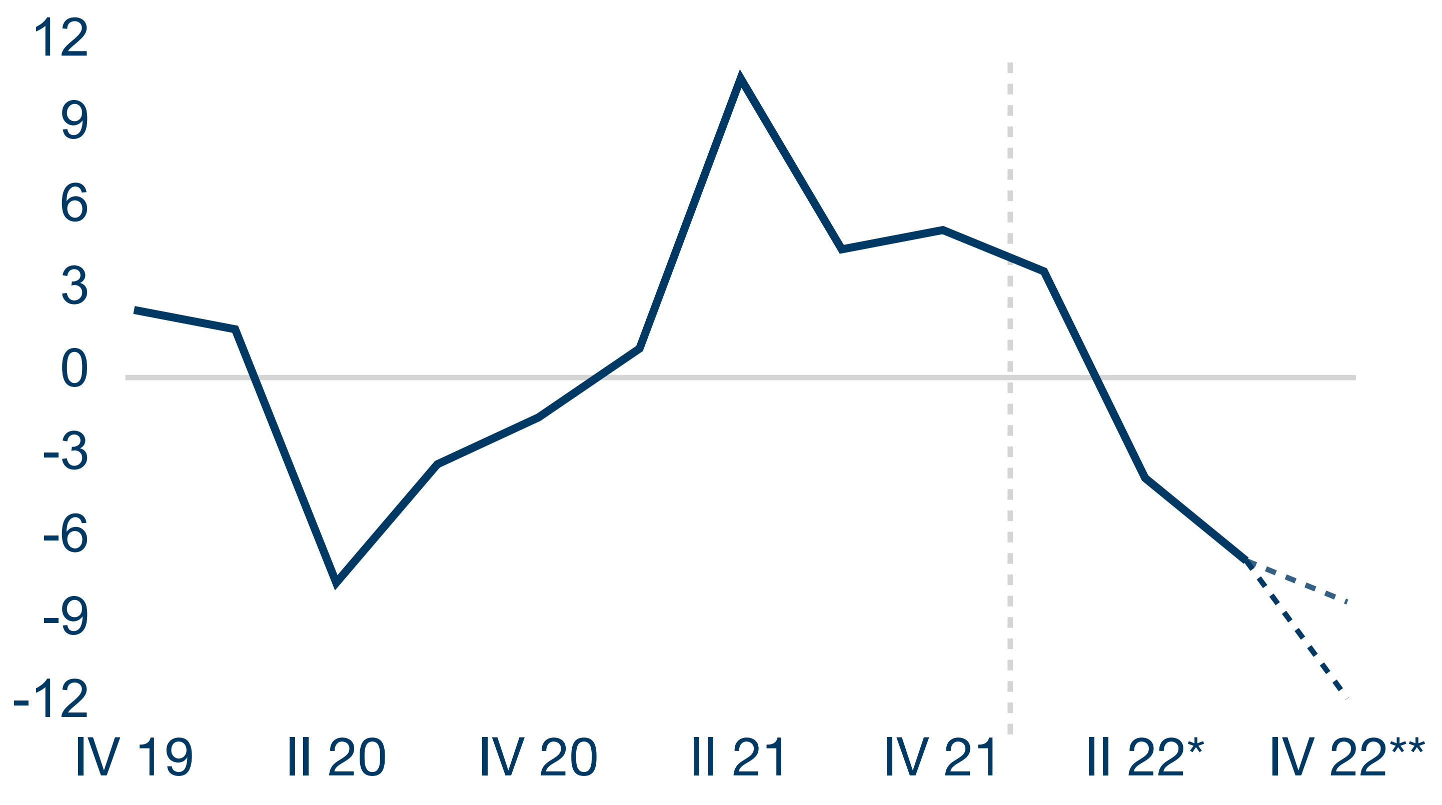
GDP growth forecasts for 2022 (2023)

CBR (Jul)	-4.0 to -6.0% ((-4,0)-(-1,0%))	IMF (Jul WEO)	-6% (-3.5%)	S&P	-8.5% (0.3%)
CBR (Apr)	*-8.0 to -10.0% ((-3,0)-0,0%)*	*IMF (Apr WEO)*	*-8.5% (-2.3%)*	Barclays	-12.4% (-3.5%)
RF MinEcon (May)	-7.8% to -8.8% ((-2.9)-(-0.7%))	EBRD	-10.0% (0%)	Fitch	-8.0% (-0.2%)
RF MinEcon	*-8.8% to -12.4%*	World Bank	-8.9% (-2.0%)	Capital Economics	-12 %
CBR Survey (Sep)	-4.2% (-1.8%)	*World Bank (Apr)*	*-11.2% (0.6%)*	Goldman Sachs	-10 %
CBR Survey (Jul)	*-6.0% (-1.3%)*	FocusEconomics	-10.2% (-1.1%)	IIF	-15% (-3%)
CBR Survey (Jun)	*-7.5% (0%)*	Morgan Stanley	-12.0% (1.5%)	IIF Chief Econ.	-30 %
EU Commission	-10.4% (1.5%)				

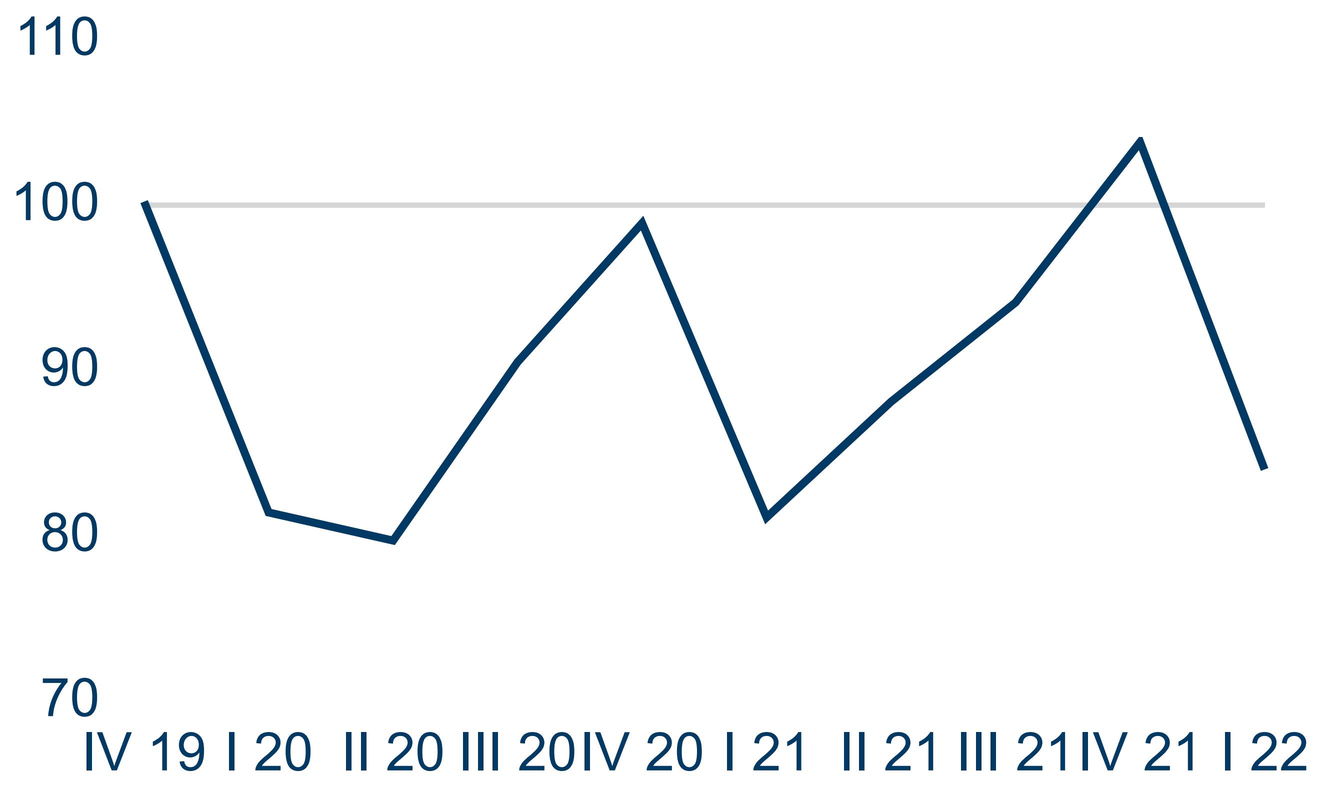
GPD growth, %, YoY



GPD growth, quarterly, %, YoY



GPD growth, IV 19 = 100

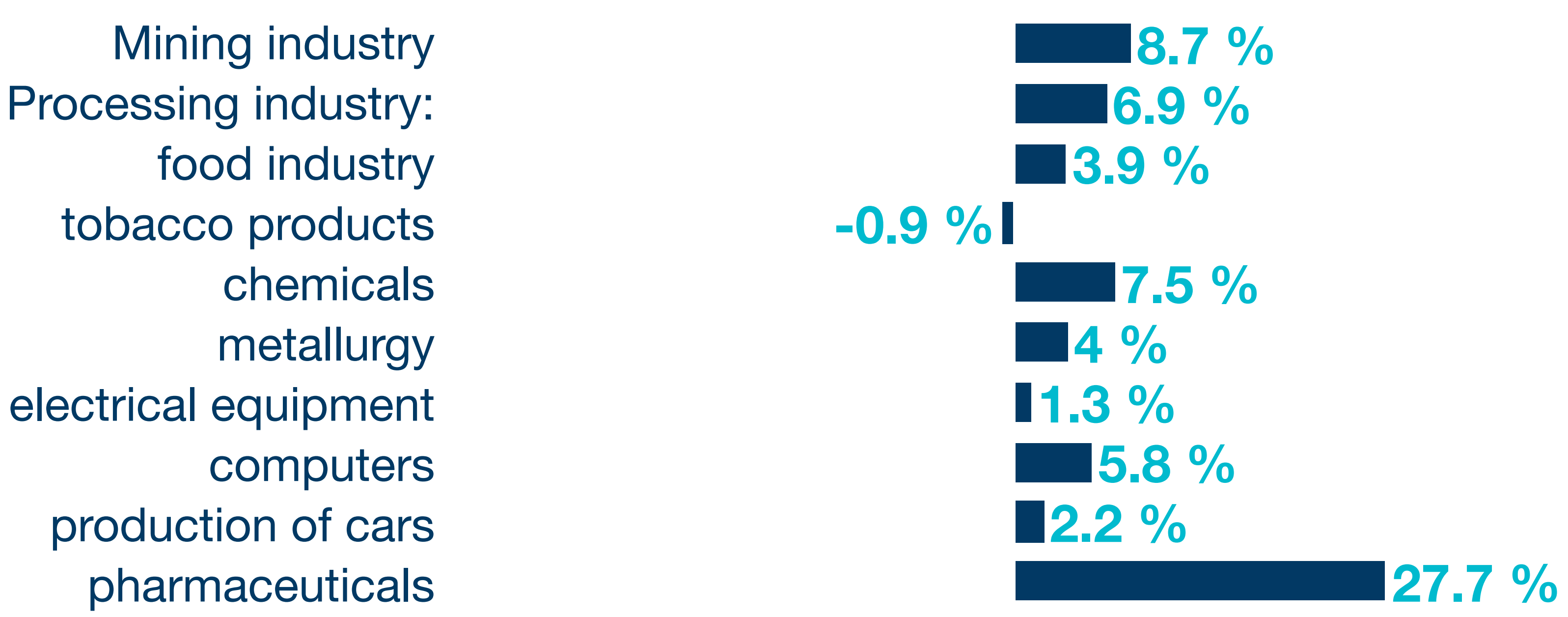


* Rosstat assessments
** CBR forecast

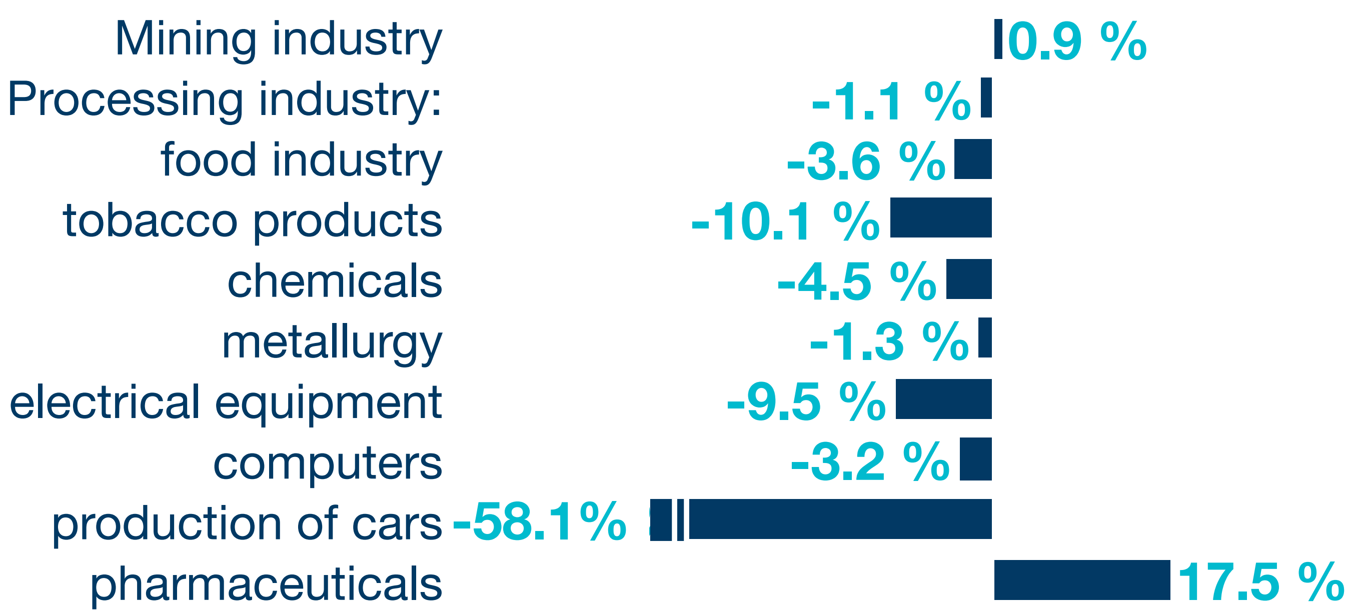
PRODUCTION & SURVEYS

Output in selected industries:

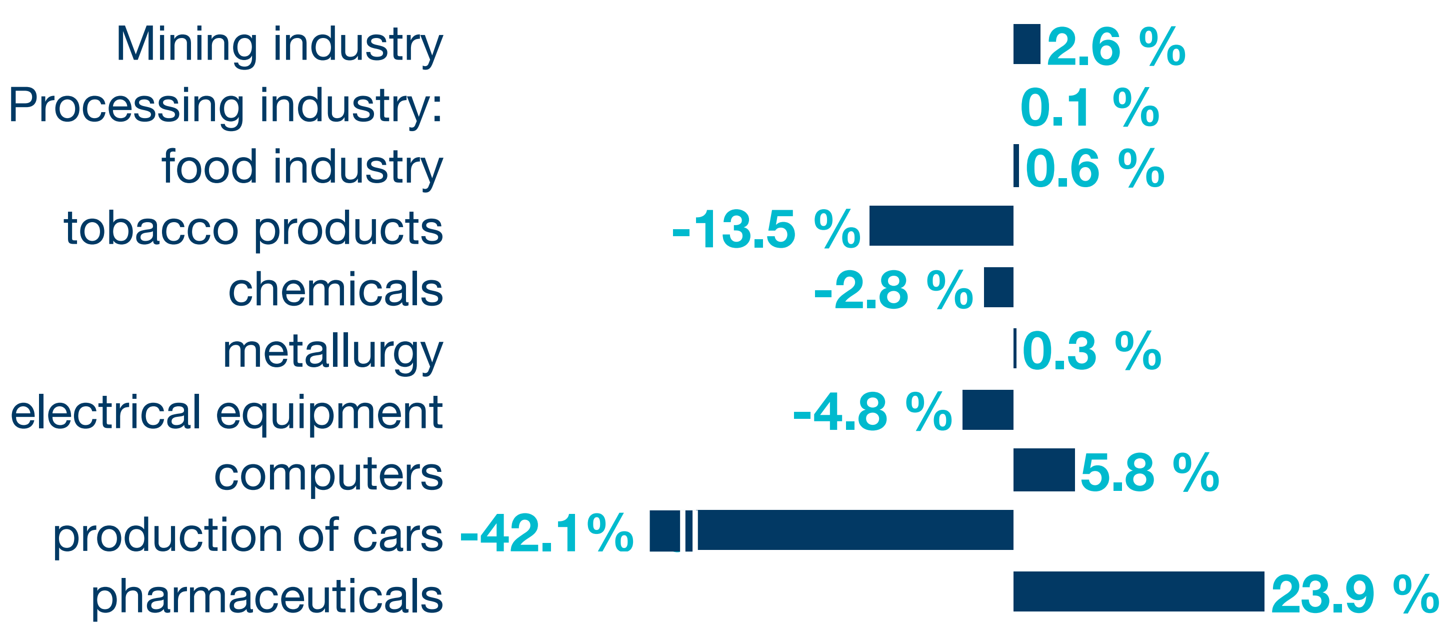
Feb 2022, %, YoY



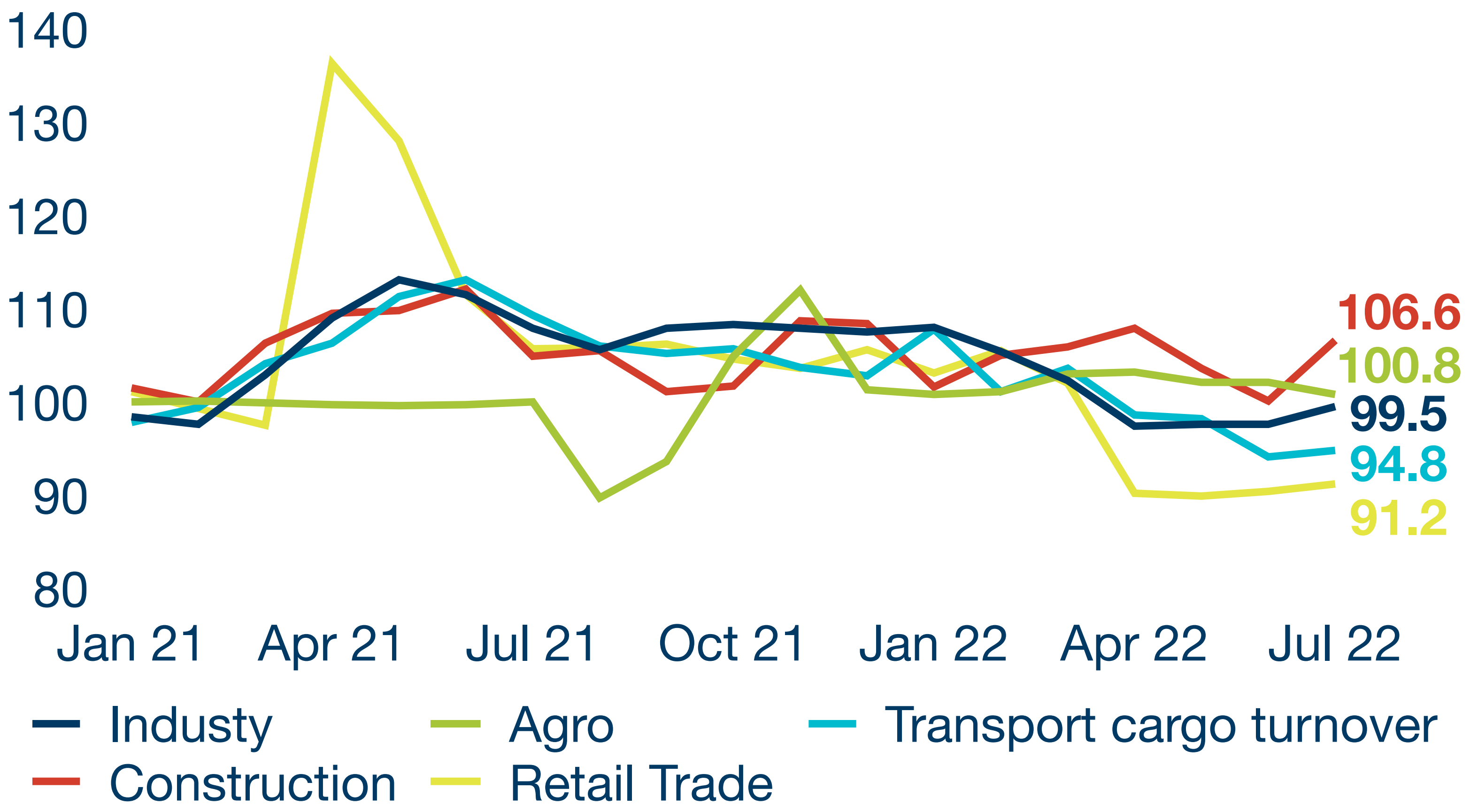
July 2022, %, YoY



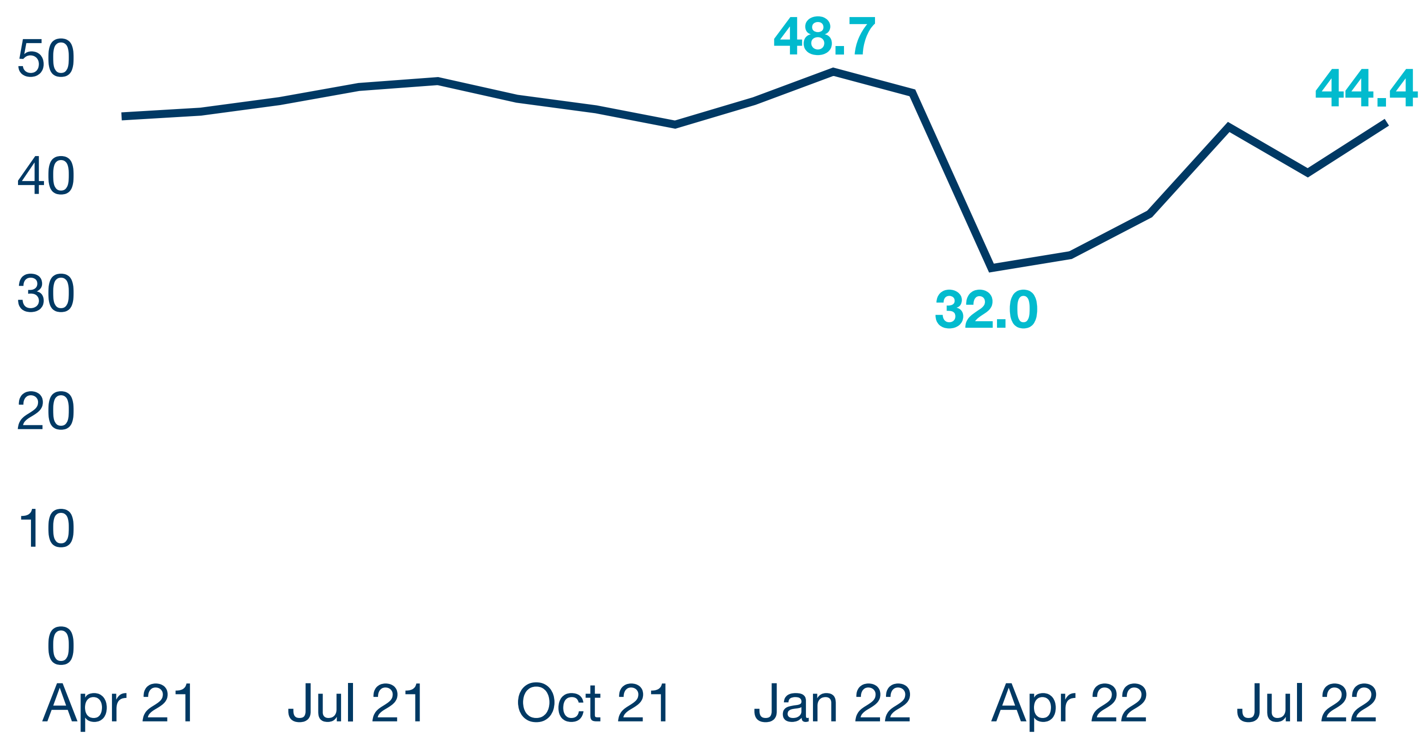
Jan-Jul 2022, %, YoY



Change in production of key sectors, YoY

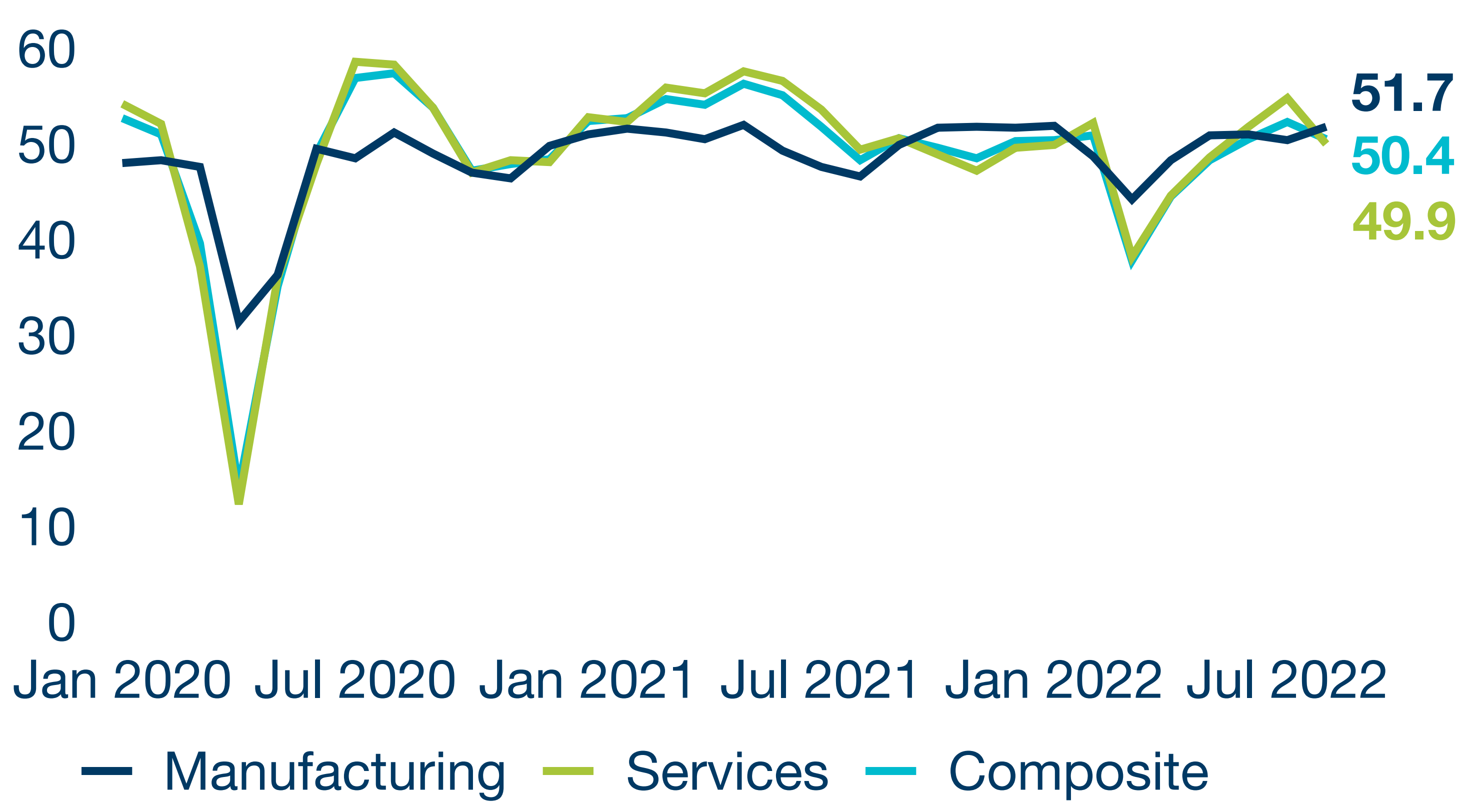


Business Environment Index



Max value = 50 points
Fall means deterioration of business environment

PMI



Source: Rosstat, Russian Union of Industrialists and Entrepreneurs (RSPP), S&P Global

BALANCE OF PAYMENTS

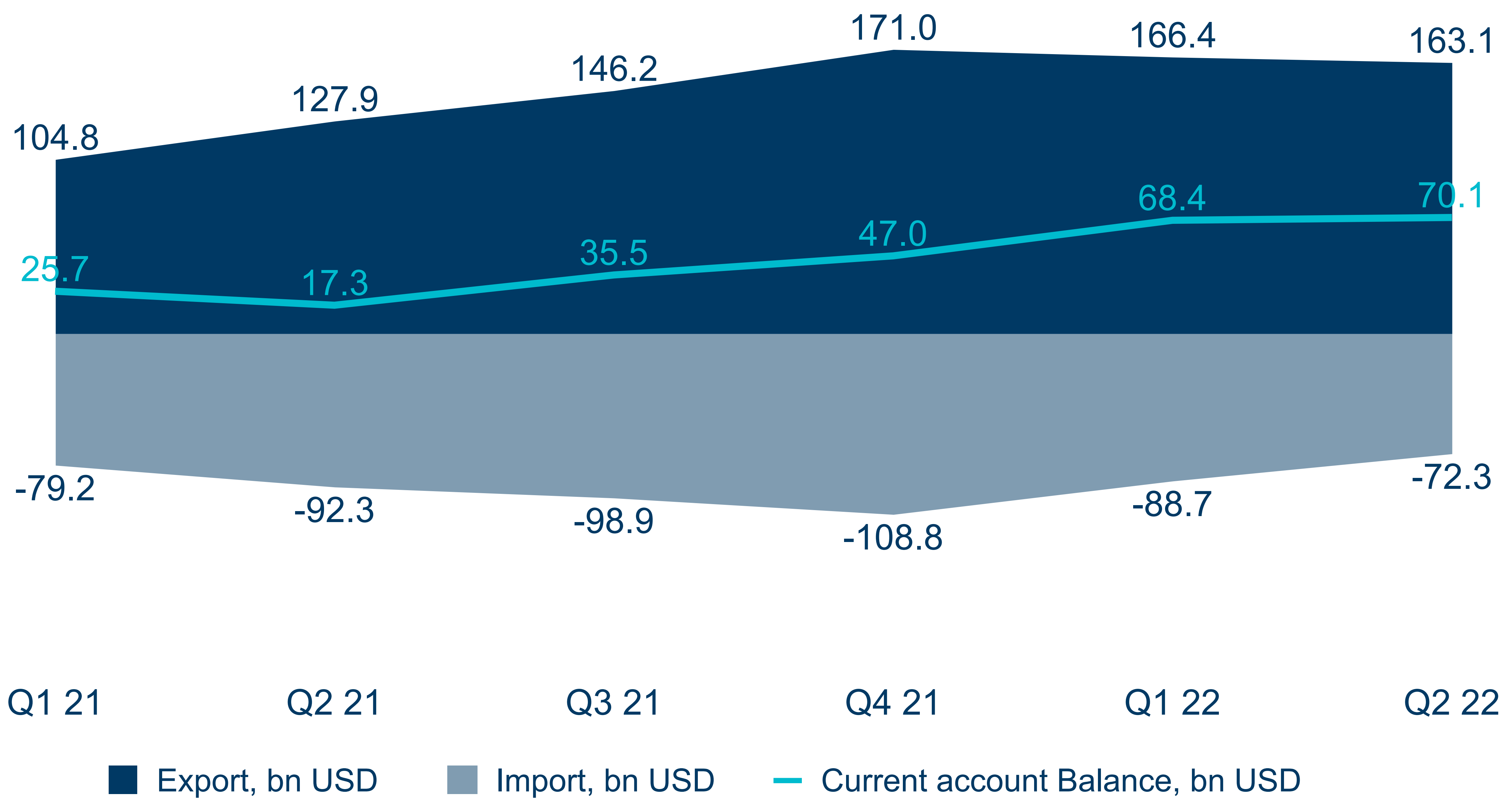
According to the CBR, in Q2-22, Russia's current account surplus widened to $70bn, a new historical record.

The main factors contributing to this expansion include: (1) increase of Russia's exports of goods and services by 19.7% YoY due to high energy prices, (2) contraction of Russia's imports by 22.4% due to sanctions.

RF Current account and trade balance in 2021 and 2022, bn USD

	2021					2022			Growth, YoY	
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q2 (review numbers	Q1	Q2
Exports of goods and services	104.8	127.9	146.2	171	550	166.4	153.1		58.8 %	19.7 %
Imports of goods and services	79.1	93.2	98.9	108.8	379.9	88.7	72.3		12.1 %	-22.4 %
Trade balance in goods and services	25.7	34.8	47.4	62.2	170.1	77.7	80.7	89.4	202.3 %	131.9 %
Current account	22.4	17.3	35.5	47	122.3	68.4	70.1	76.5	205.4 %	305.2 %

RF Current account balance, bn USD



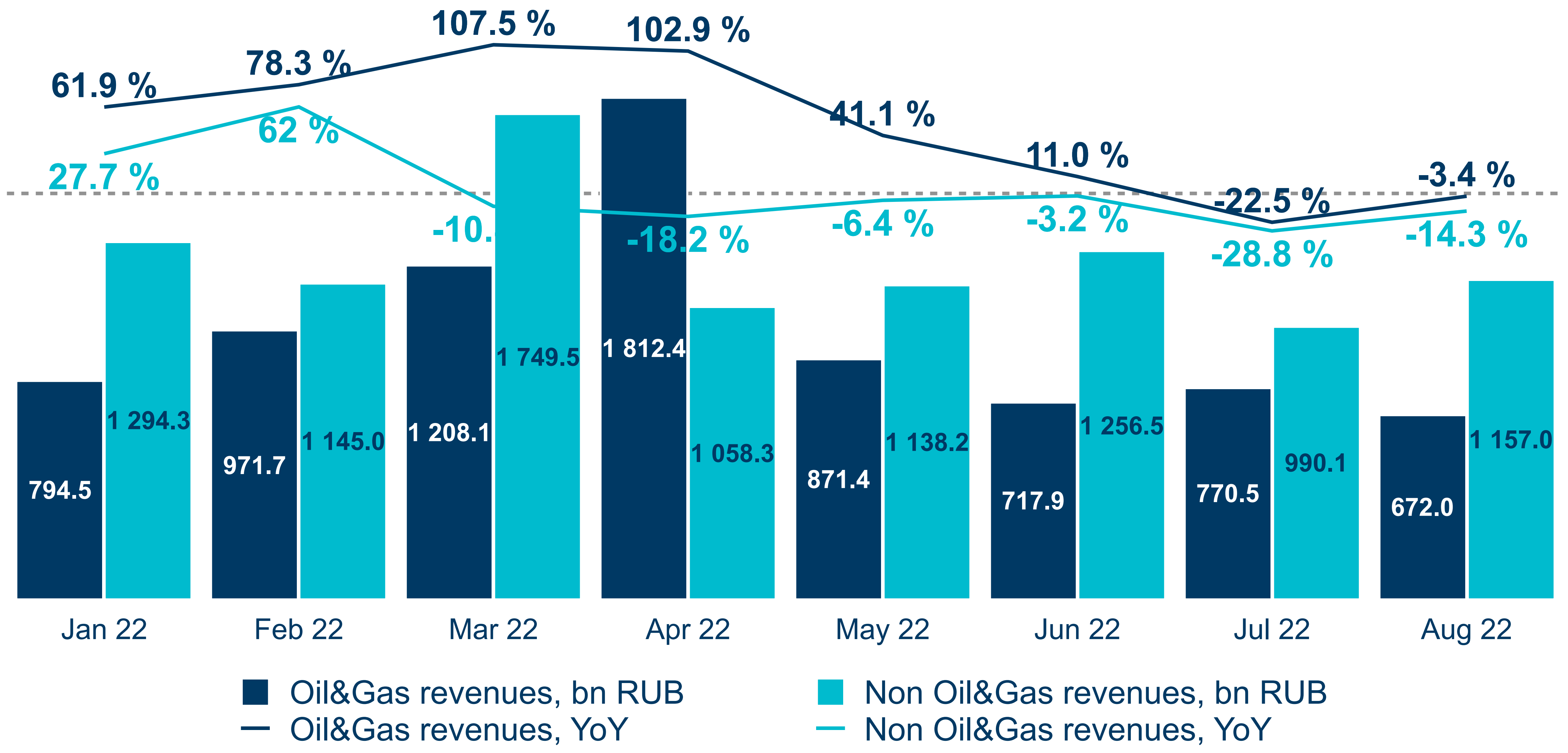
Source: CBR

BUDGET: REVENUES

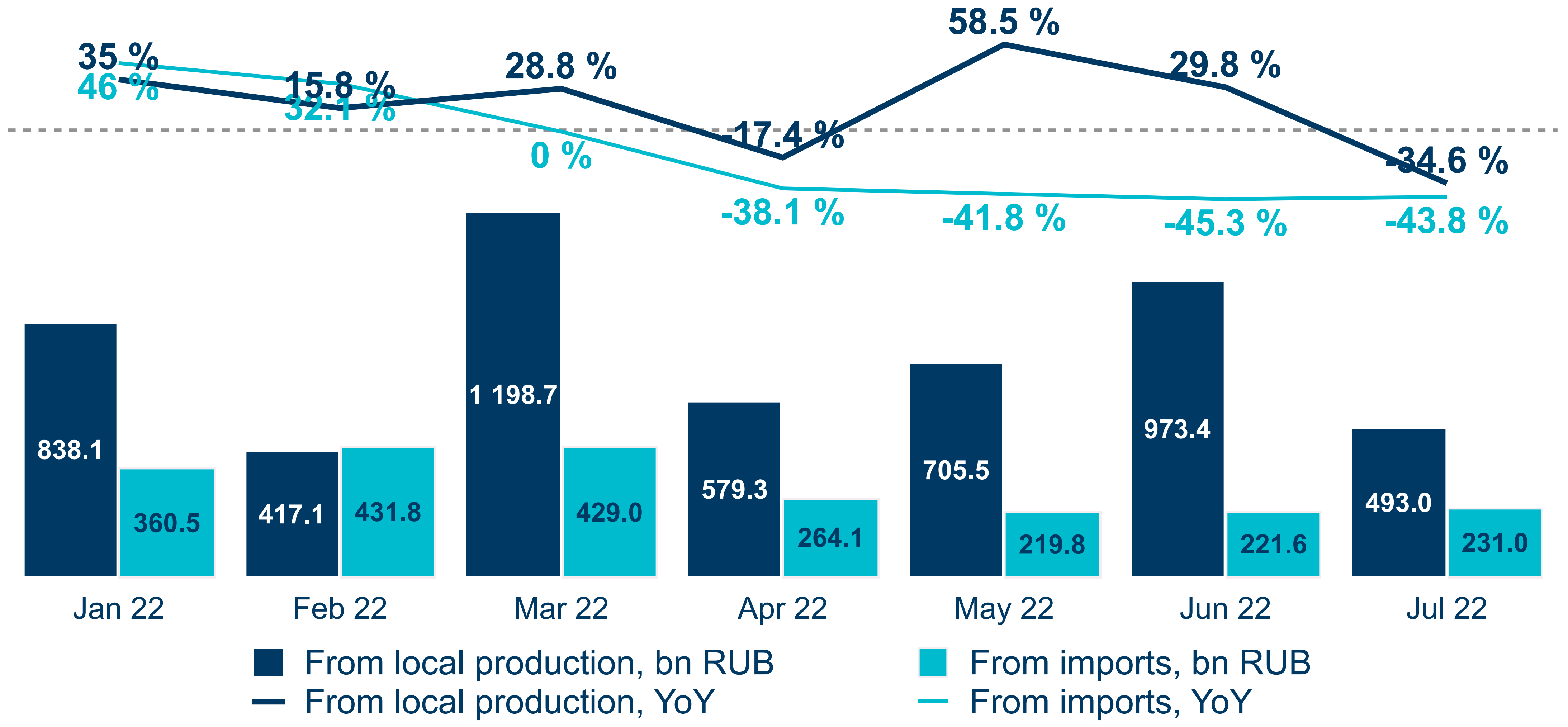
After rocketing in April, Oil&Gas revenues began to fall — even though high energy prices still allow Russia to earn on their energy resources, their revenues are falling due to collapse of export volumes.

In the same time, non-Oil&Gas revenues started to surge in annual terms since March followed by a huge collapse in July (-28.8% YoY), when both revenues from local production (-34.6% YoY) and revenues from imports (-43.8%) dramatically fell. Such dynamics confirms problems with local production and other non-Oil&Gas sectors as a result of imposed sanctions.

RF Budget revenues, monthly



Non-Oil&Gas revenues, monthly



Source: RF MinFin

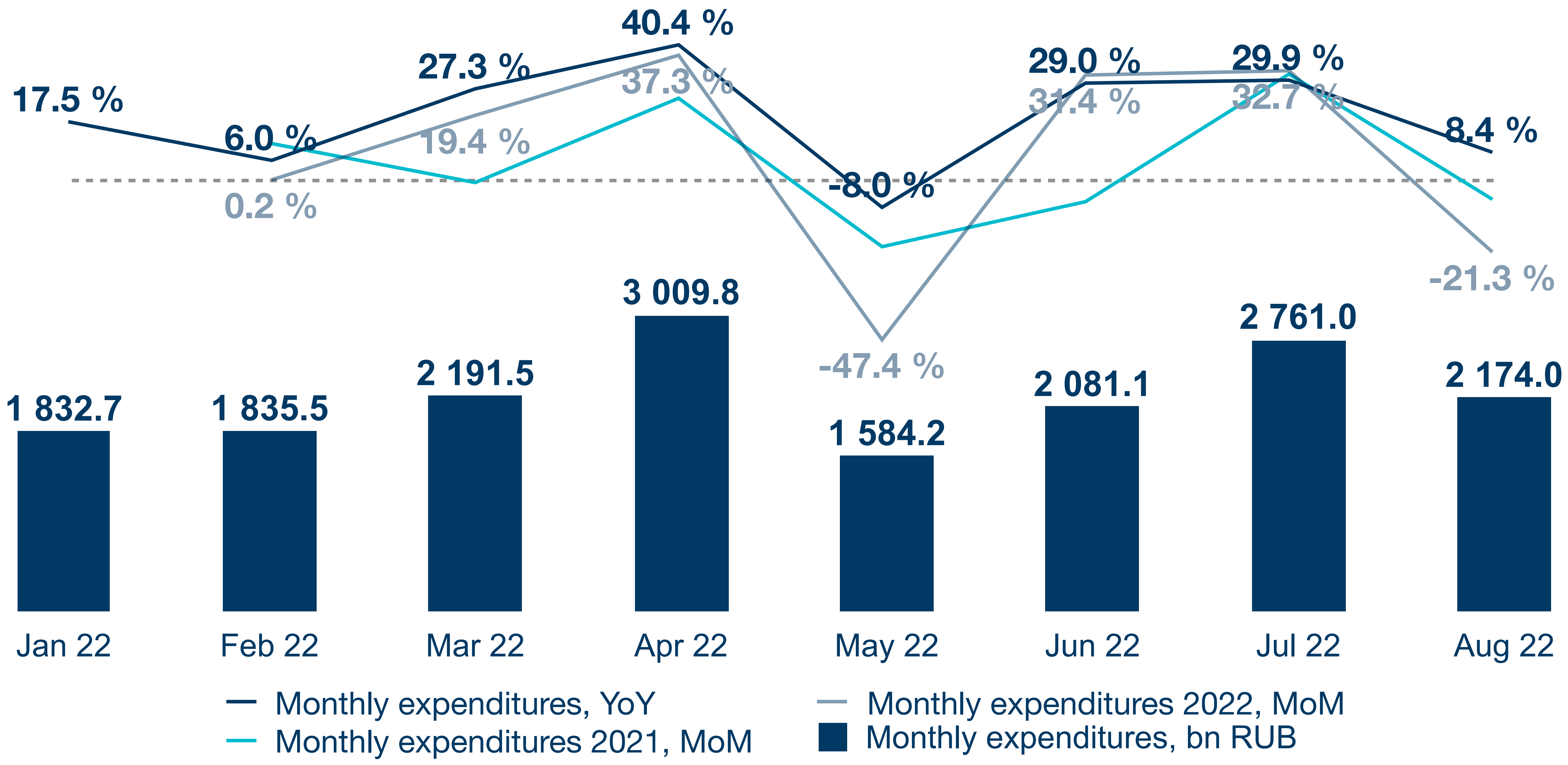
BUDGET: SPENDINGS AND BALANCE

For 3 months in a row the Russian budget has rune a deficit. But Jan-Aug cumulative date still shows a surplus of 481.9 bn RUB.

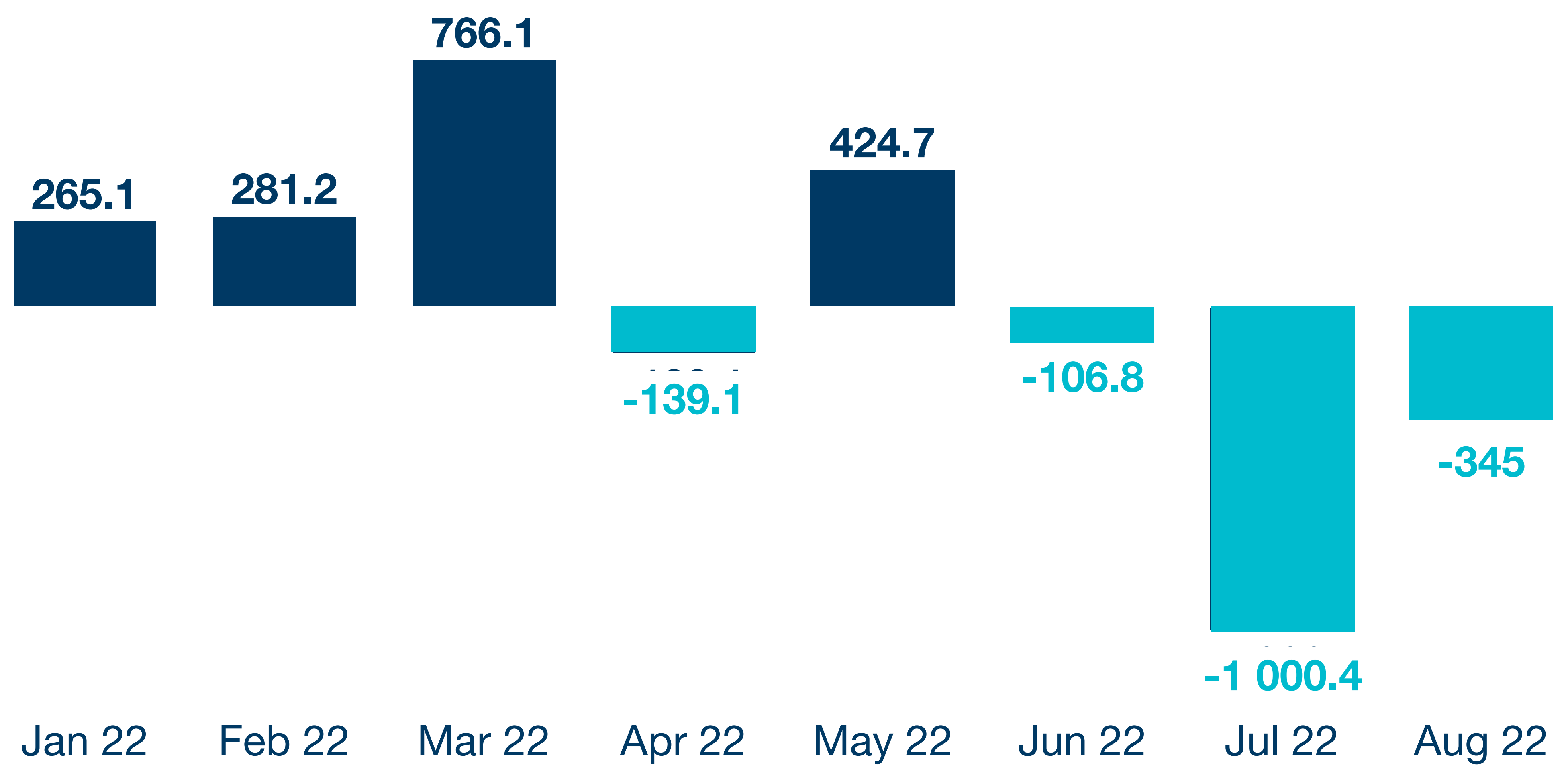
The RF MinFin expects the budget deficit to reach from 1.2% to 2% of GDP in 2022 with the bulk of the expenditures to occur in the second half of the year. To cover the deficit, about RUB 3-4 trln (~$50-66bn), Russian authorities plan to use the funds of the NWF.

As a result of revenue collapse that have not been seen since at least 2011, the Russian GoV for the first time since the pandemic is launching a massive sequestration of the federal budget — the reduction of expenditures by 10% in 2022-2023 is planned according to Russian media.

RF Budget expenditures, monthly



RF Budget Surplus (-Deficit), monthly, bn RUB

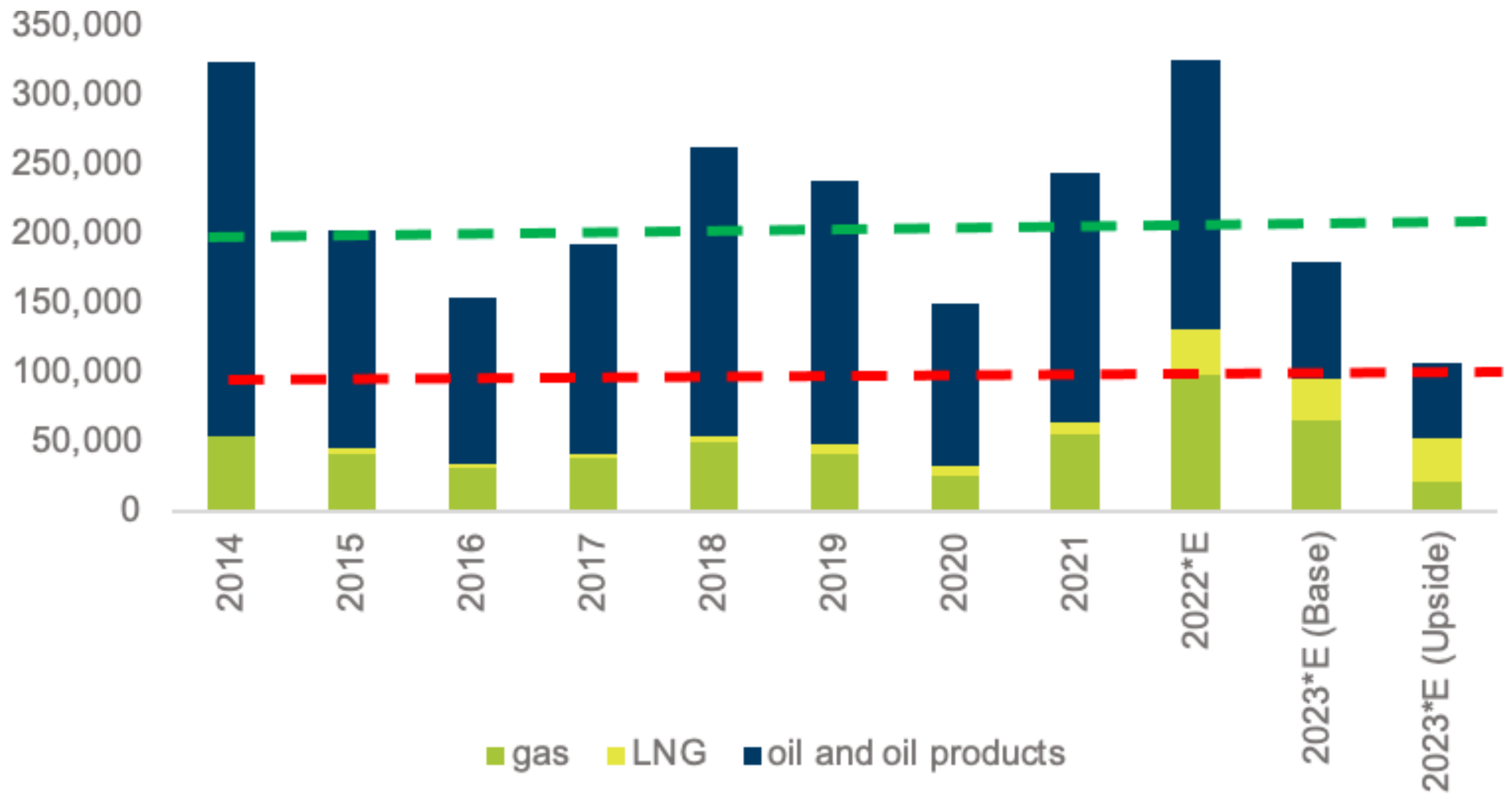


Source: RF MinFin

OIL AND GAS

Next year Russia will experience a massive drop in Oil&Gas revenues as the European oil embargo comes into force, with revenues falling by over 40% from around $325 bn in 2022 to $180 bn in 2023 in our base case, and running at around the critical $150 bn a year pace by the end of 2023

Russian oil and gas export earnings 2014-2023, USD mln



Green and red lines show adequacy of external balance

Source: KSE Institute estimates

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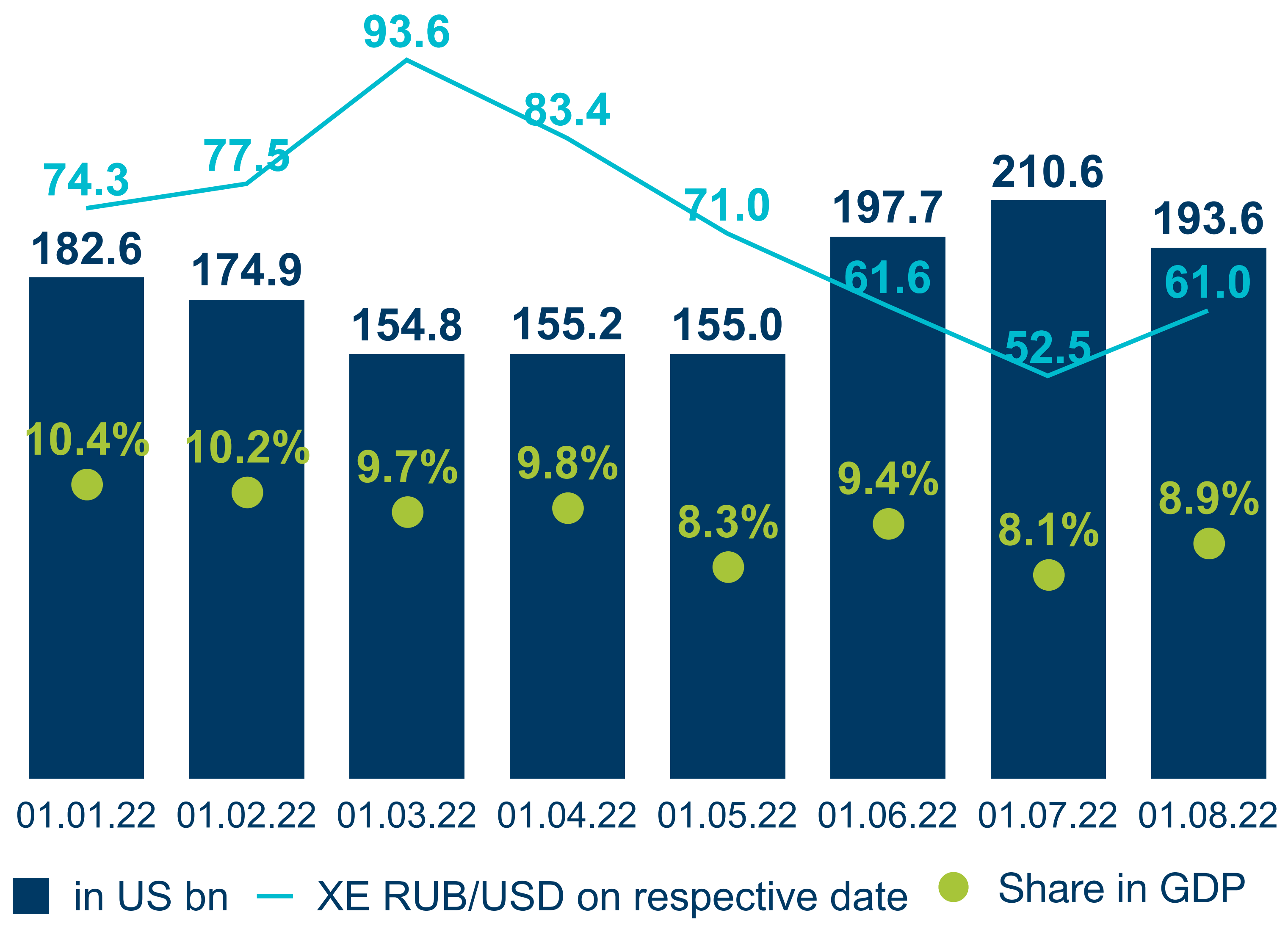
NATIONAL WEALTH FUND

As of August 1, the NWF equaled $193.6bn or 8.9% of GDP. Although its absolute value increased as a result of ruble appreciation and revaluation of the Fund's assets, the NWF has lost 1.5 p.p. if measured as a share of GDP since the beginning of year.

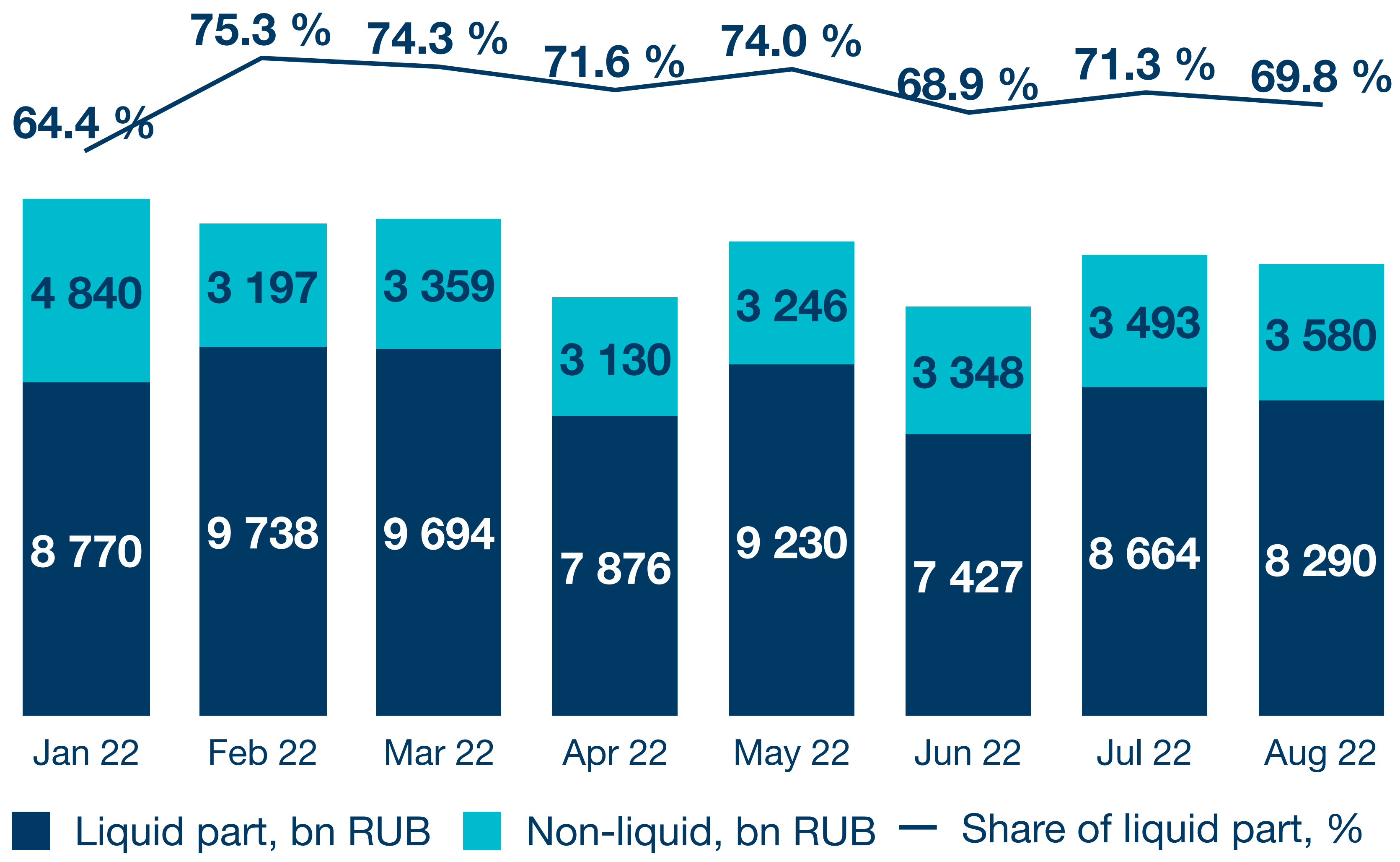
This confirms, that the RF is actively using the NWF to support the economy and state budget. The value of purchases since the start of full-scale invasion of shares, privilege shares and bonds of Russian companies already reached 475 bn RUB.

NWF is at risk to be reduced to zero in two year, if the Russian authorities continue to use it for economy and budget support measures without any restrictions, reports Russian media referring to leaked information from strategic meeting of members of the Cabinet of Ministers and CBR.

NWF dynamics



Structure of NWF



Support of Russian business from NWF during war:

	bn RUB*
DOM.RF	50
Russia Railway	250
Gazprombank	50
Aeroflot	52.5
JSC Siberia Airlines	11.9
GTLK	58.3
Ural Airlines	2.3

Source: RF MinFin, The Moscow Times
* Value of shares / privileged shares / bonds purchased at the costs of NWF

LABOR MARKET

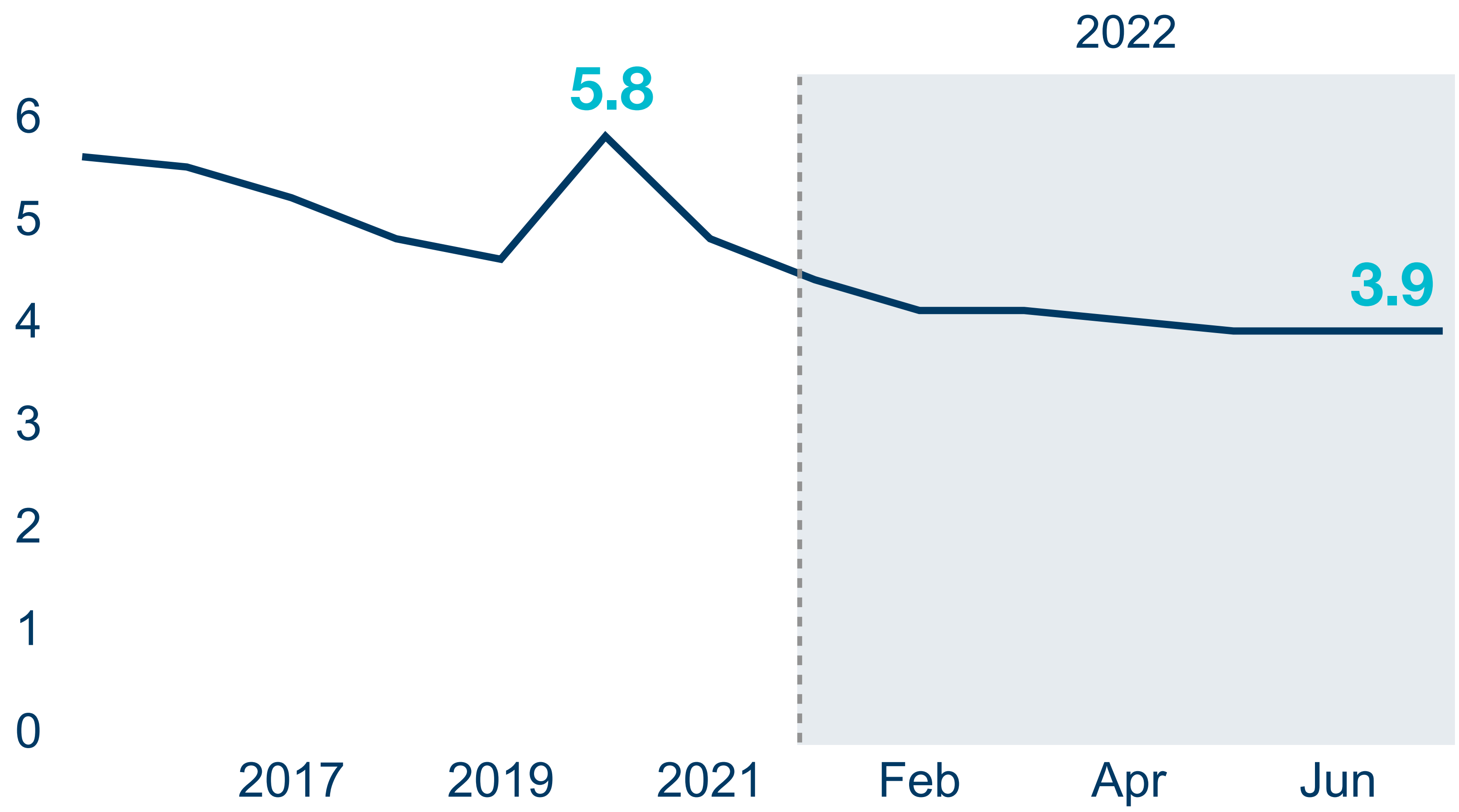
Effects of sanctions on the labor market have not yet fully materialized. In July, for the third month in a row, unemployment in RF equaled 3.9% or 2.9 mln people, which is a historically low level for Russia. Average value for Q1 22 equaled 4.2%.

In April, IMF forecasted unemployment in RF to reach 9.3% in 2022, which would equal ~3.8 mln additional unemployed persons.

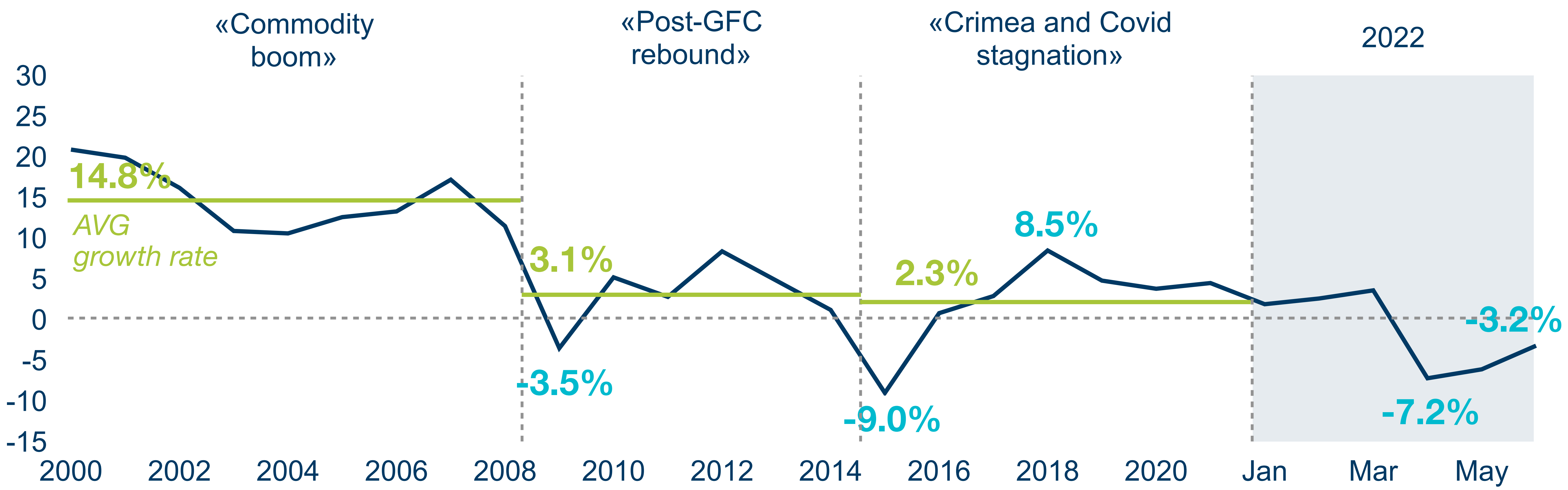
According to KSE analysis*, companies that have already exited RF market hired 244K people, while companies that are now in the process of exiting employed 319K people, who are now at risk of becoming unemployed.

In June, the fall of real wages slowed down to -3.2%, while in April the fall reached record level to -7.2% YoY (for the first time since Apr 2020 and maximum for the last 7 years). In its May report, RF MinEcon projected the real wage to decrease by 3.8% and real disposable income by 6.8% in 2022.

Unemployment, %, YoY



Real wage, %, YoY



Source: Rosstat

* As of September 12, based on data available for ~1300 TOP public companies operated/operating in RF

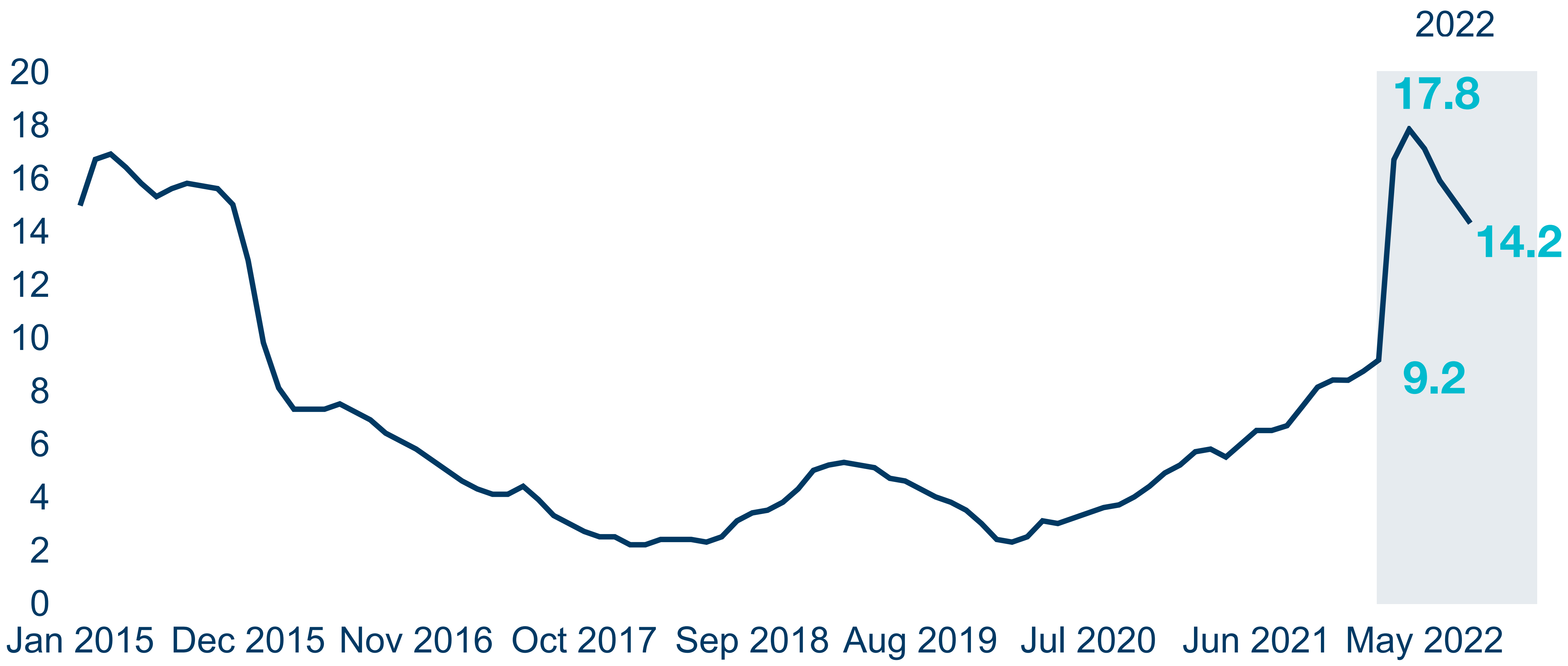
INFLATION

Annual inflation in Russia slowed to 14.2% YoY in August, after peaking in April at 17.83%. Among reasons for slowing down — a reduction in demand after a surge in March, as well as the strengthening of the ruble and one-off factors in the fruit and vegetable market.

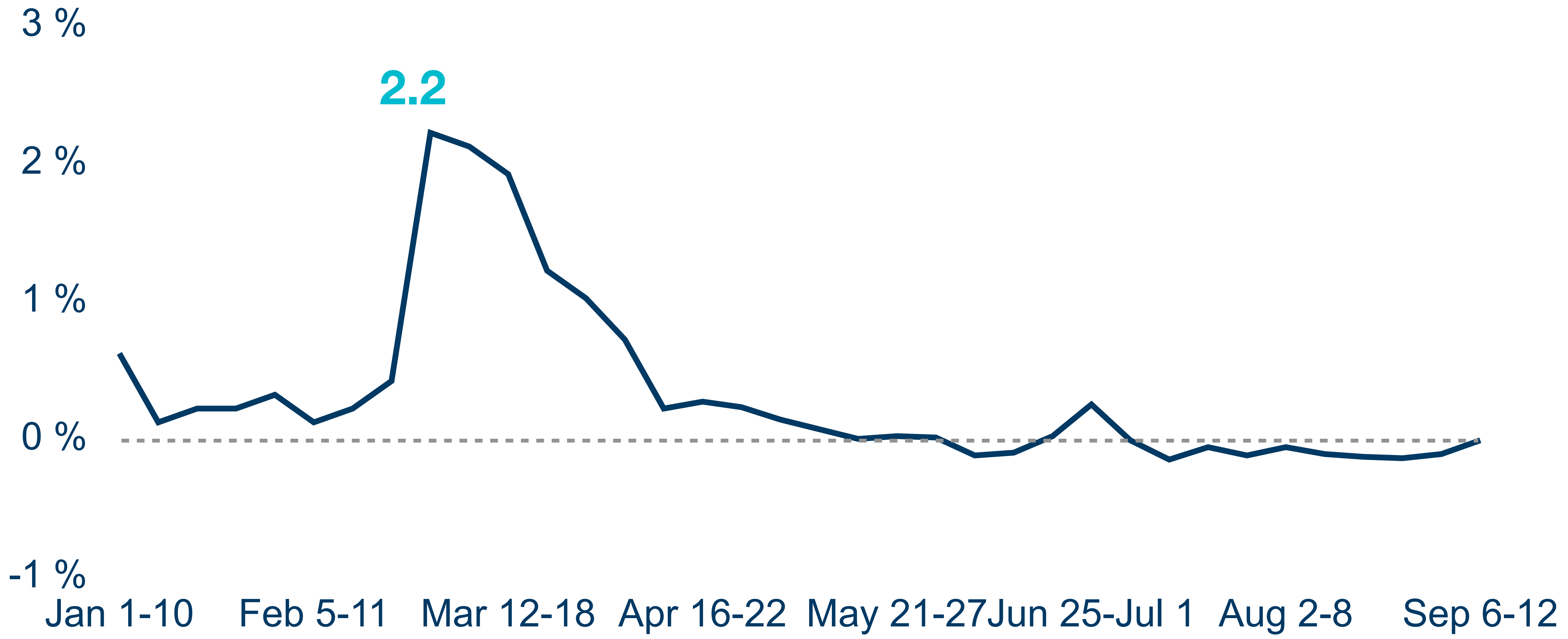
Inflation forecasts for 2022 (2023), CBR inflation target = 4%

CBR (Sep)	11,0–13,0% (5.0–7.0%)	CBR Survey (Sep)	12.9% (6.0%)	EC	20.5% (10%)
CBR (Jul)	*12.0-15.0% (5.0–7.0%)*	*CBR Survey (Jun)*	*15% (6.1%)*	IMF	21.3% (14.3%)
CBR (Jun)	*14.0-17.0% (5.0–7.0%)*	*CBR Survey (Apl)*	*21.3% (14.3%)*	Fitch	18% (15%)
CBR (May)	18.0-23.0% (5.0–7.0%)	CBR Survey (Mar)	22% (13%)	World Bank	22% (13%)
RF MinFin (Apr)	*~20% (6.2%)*				
RF MinFin (May)	17,5% (6.1%)				

Inflation, %, YoY



Weekly CPI (to previous registered date)



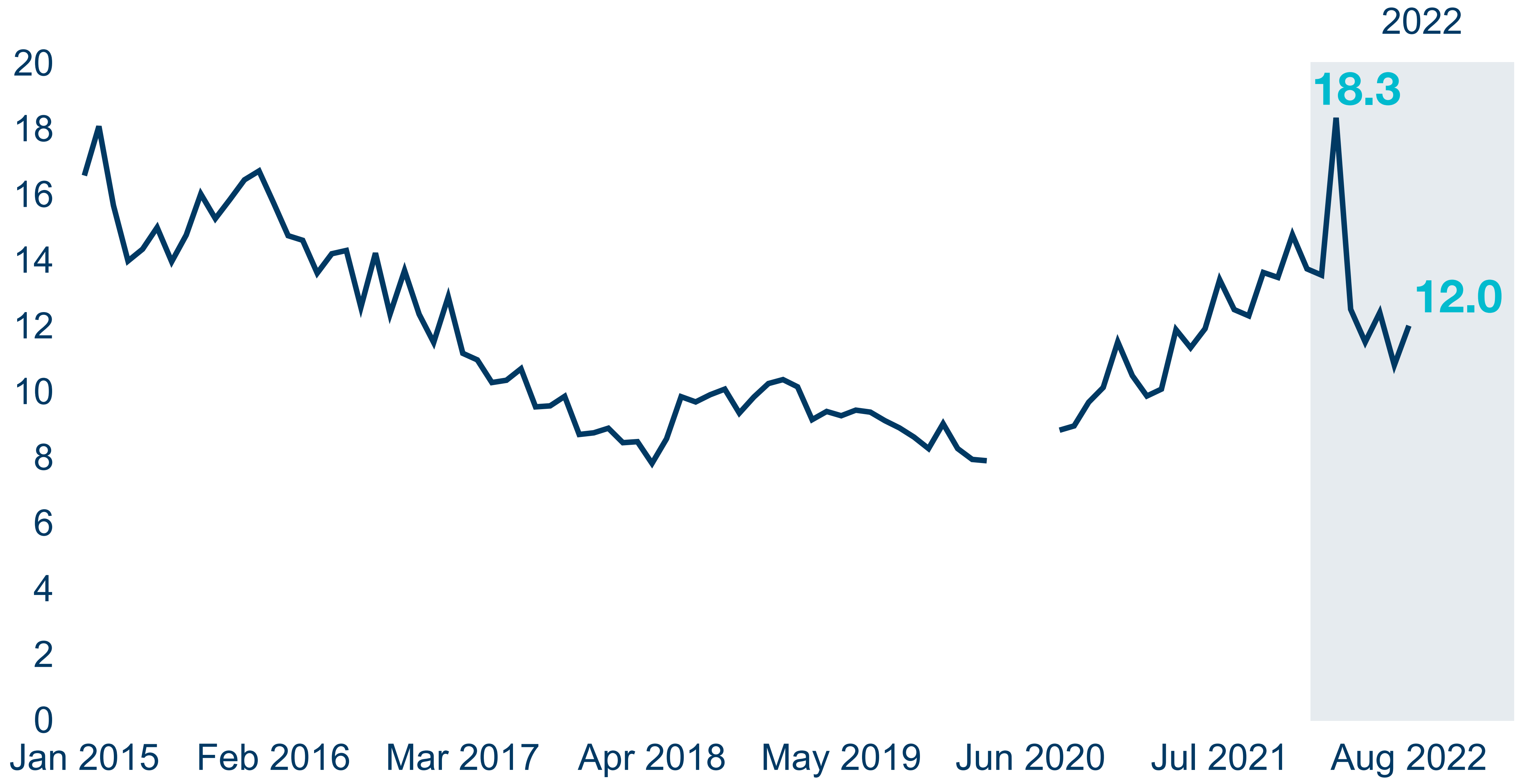
Source: Rosstat

INFLATION EXPECTATIONS

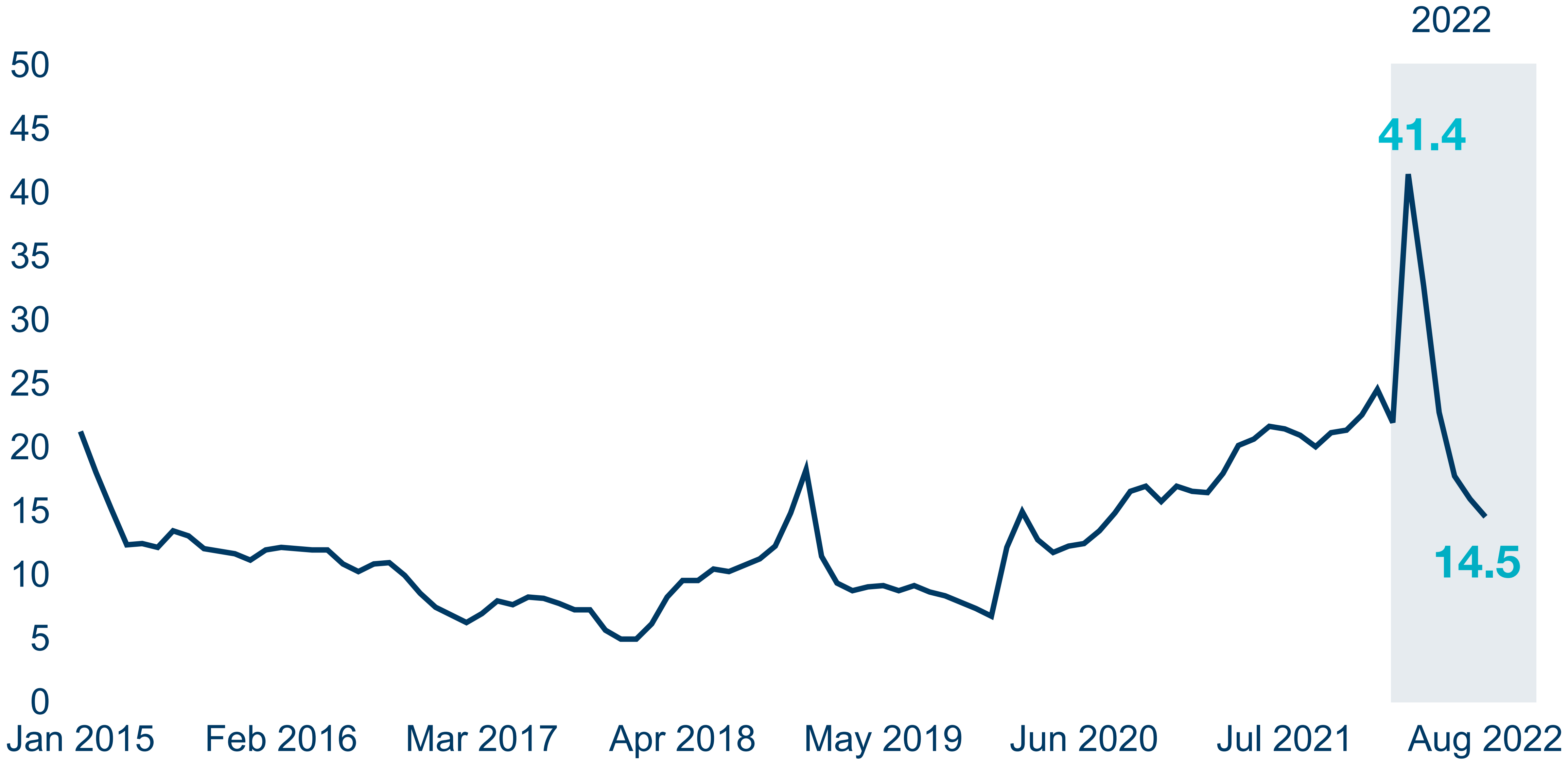
In August, inflation expectations of the population and price expectations of enterprises moved in opposite directions.

Consumers expectation increase to 12.0% (+1,2 p.p. to June). Inflation expectations rose in August only in the subgroup of respondents without savings, and most strongly among respondents with the lowest incomes as reported. While balances or responses of enterprises in August continued to decline, returning back to to mid-2020 values.

Inflation expectations of consumers, %
(over the next 12 months)



Price expectations of enterprises for the next 3 months,
balance of responses in %



Source: CBR

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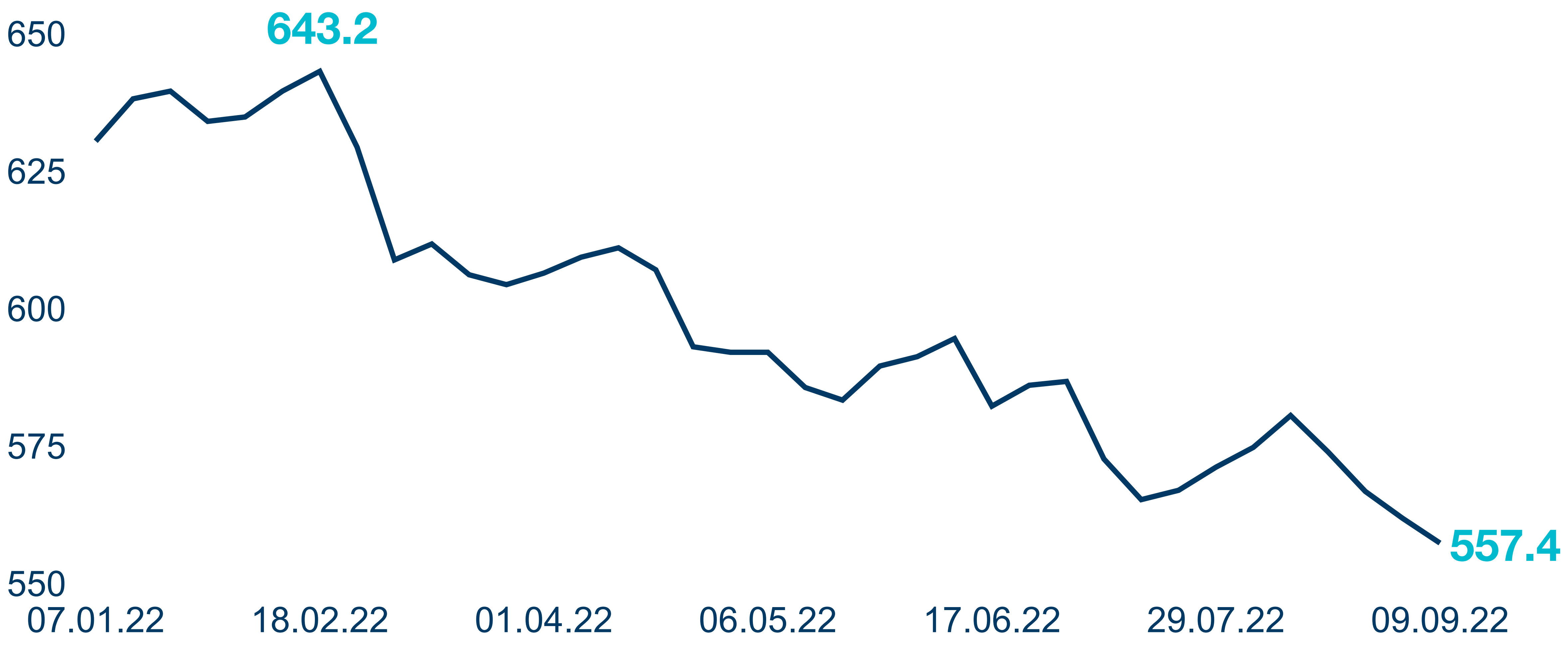
INTERNARTIONAL RESERVES

RF international reserves dropped from a historically high level of \$643.2bn to \$557.4bn (-\$85.8bn or -13%) over the six months of the war. Over half (~\$300bn) is frozen by Ukraine's allies and cannot be accessed *(REPO task force).*

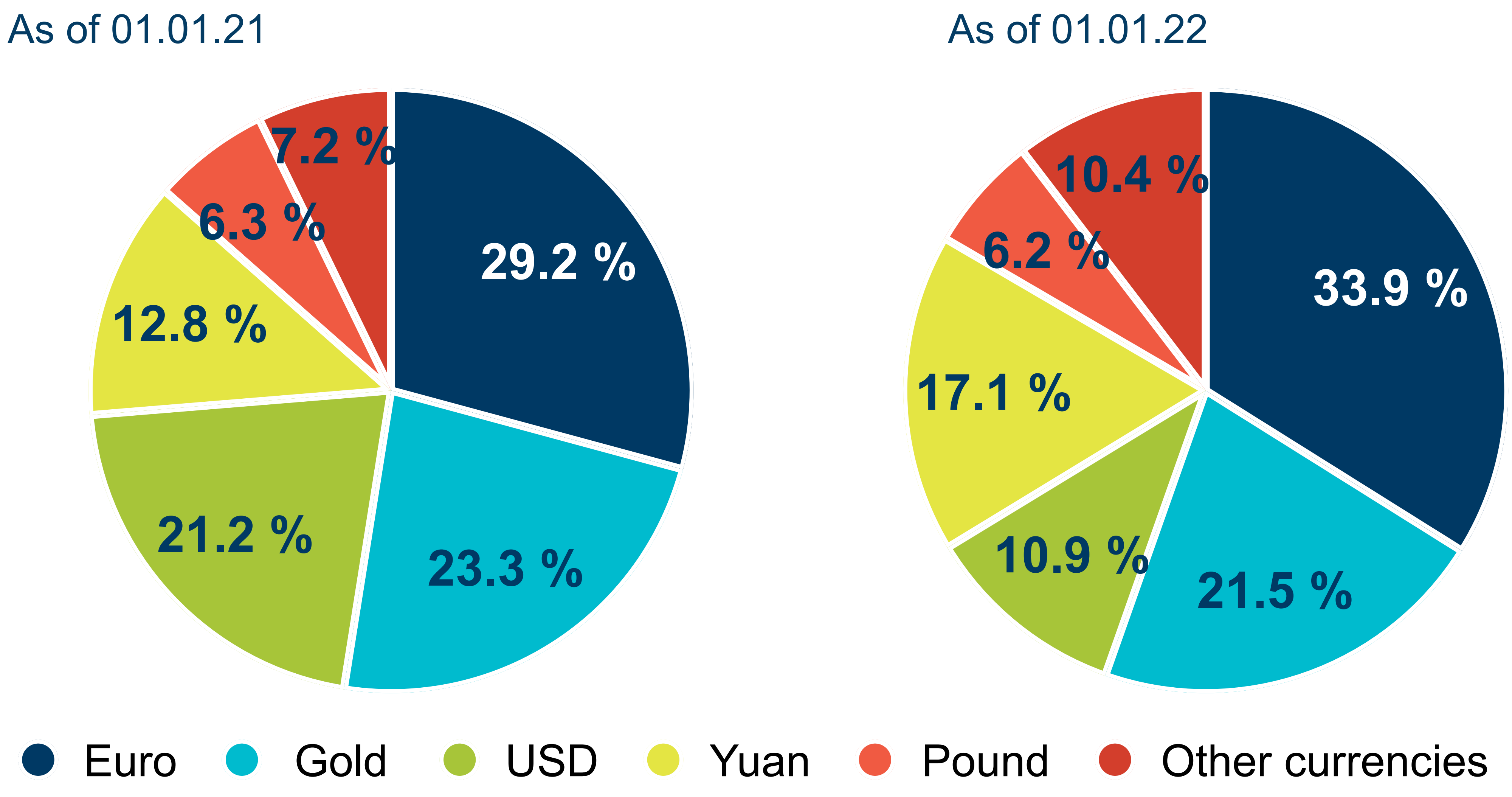
CBR itself admitted problems with accessing half of its reserves. According to the leaked presentation to Bloomberg, CBR will "require separate agreement with China, which will be very hard to get in a crisis" to access its unfrozen reserves in China, while planning to buy \$70bn in yuan and other "friendly" currencies this year to slow the ruble's surge.

On July 14, Putin signed a law, allowing to hide information regarding the value and structure of reserves by classifying as a state secret.

International reserves, bn USD



Structure of international reserves, %



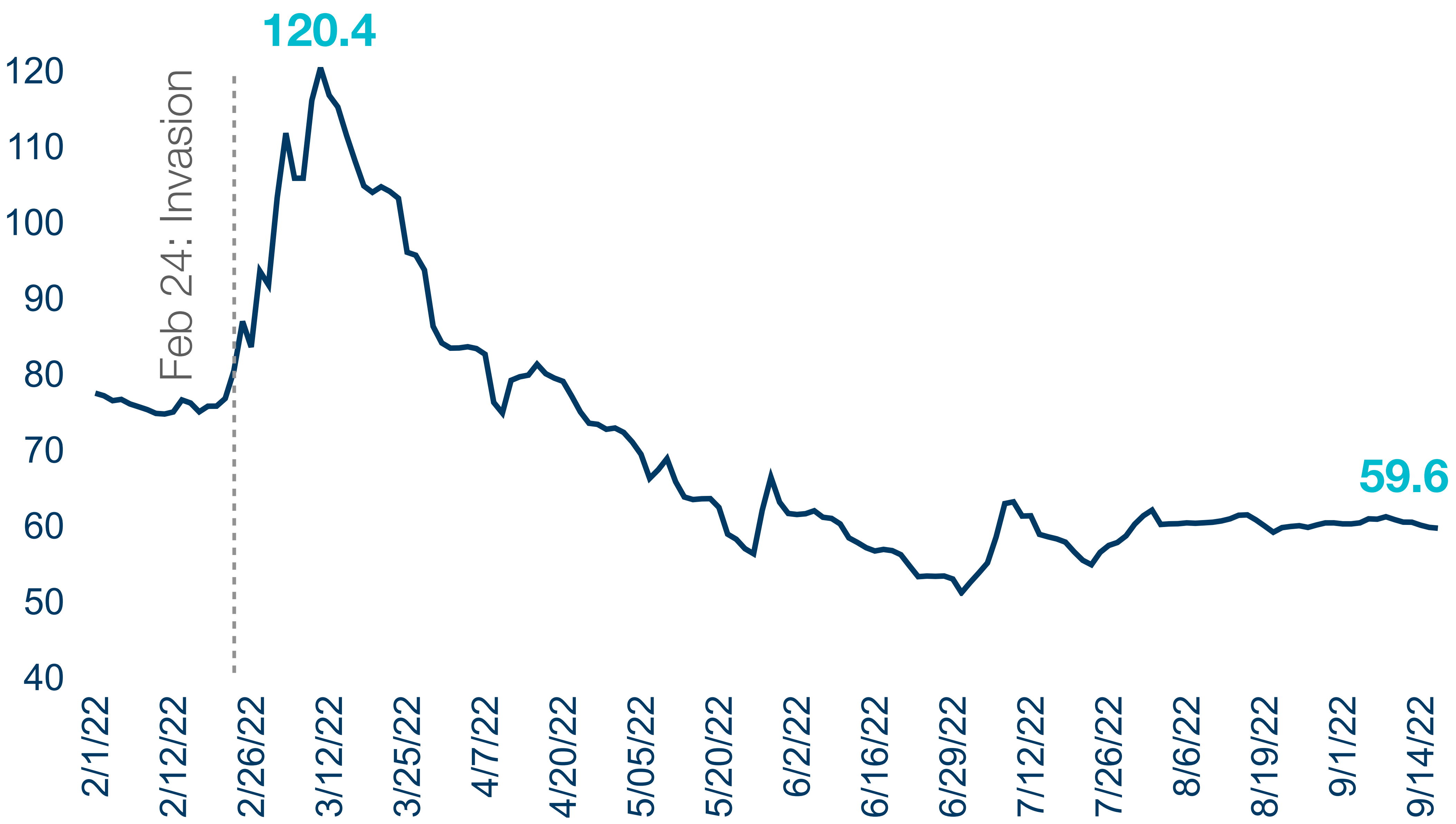
Source: CBR

MONETARY POLICY: RUB AND RATES

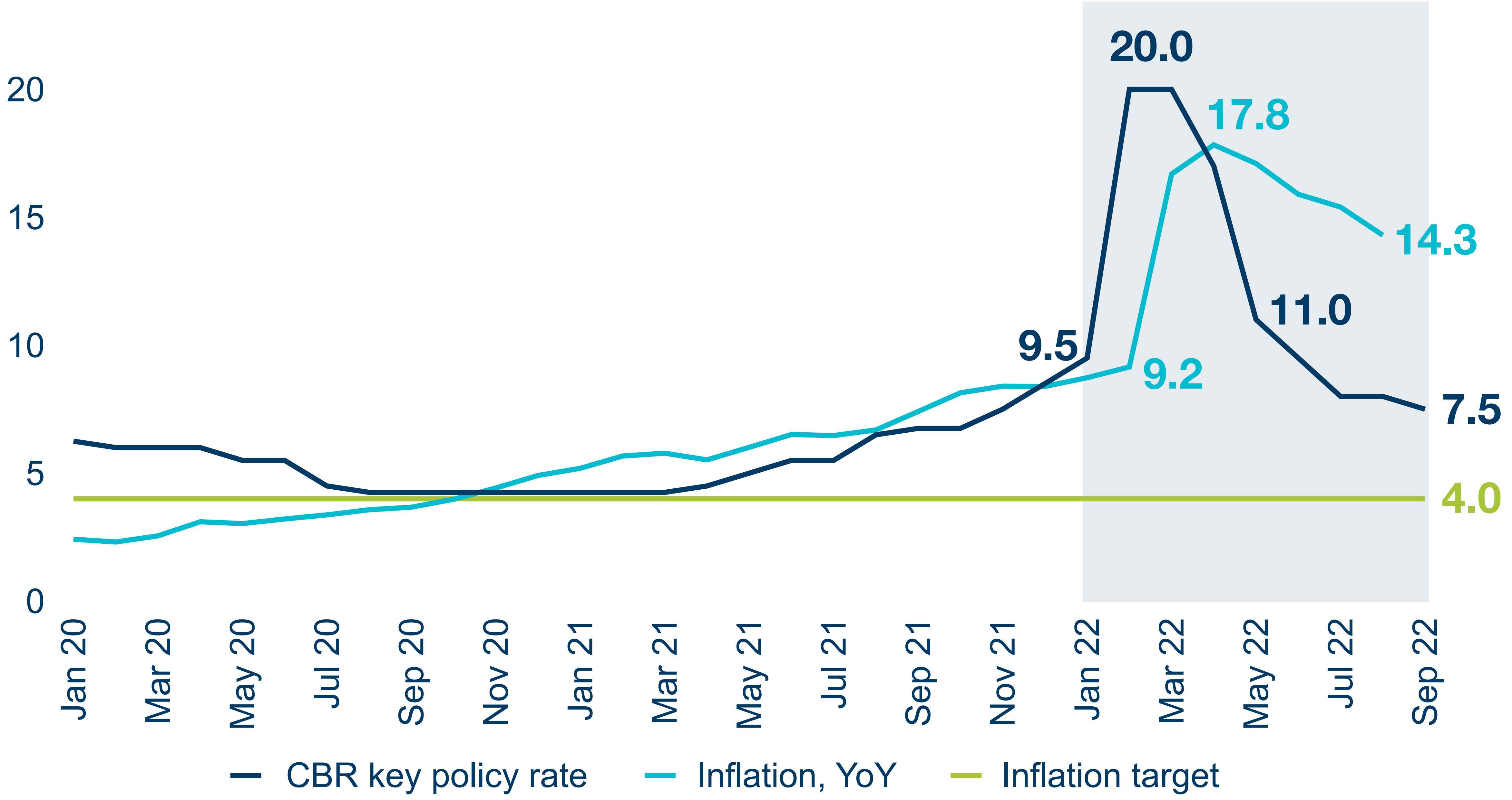
On the background of ruble over-appreciation due to a major trade shock (imports fell more steeply than exports due sanctions), RF authorities have eased almost all the capital and foreign exchange controls imposed at the beginning of the war.

Motivating by inflation slowdown (due to the restrained dynamics of consumer demand and the decrease in inflationary expectations of business and the population) and slower than expected decline in business activity, CBR continues to cut its key interest rate — the rate was decreased from peak of 20% to 7.5% from September 19th.

Official RUB/USD exchange rate



CBR key policy rate, Inflation, Inflation target, %



Source: CBR

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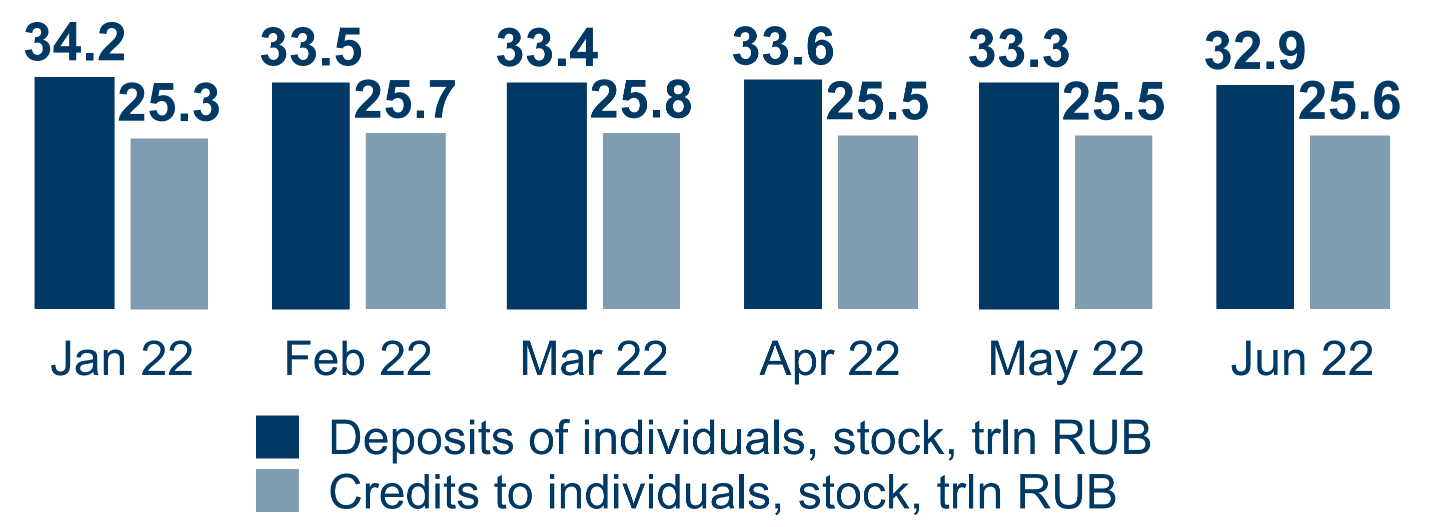
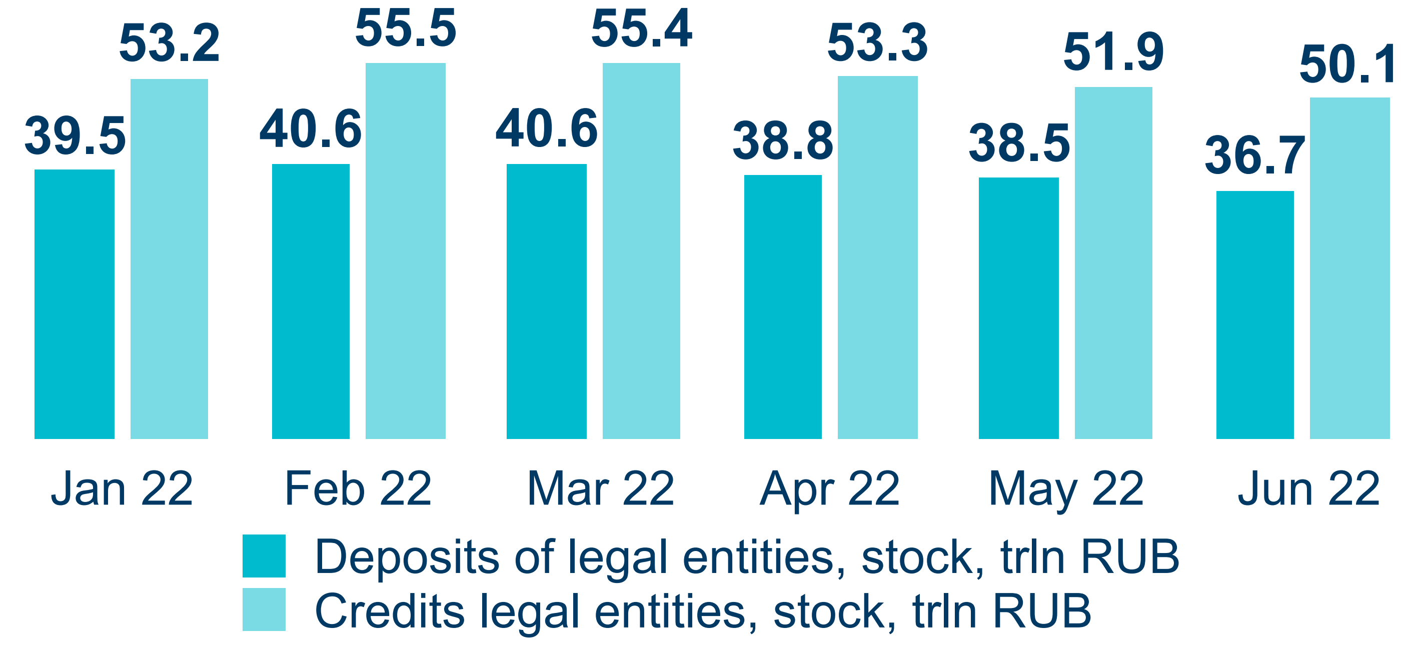
BANKING

CBR has played a key role as a backstop to the banking system through this crisis, stepping in to provide additional liquidity, including through accepting additional collateral, providing longer term funding and a higher volume of funding, and through a wide range of regulatory easements.

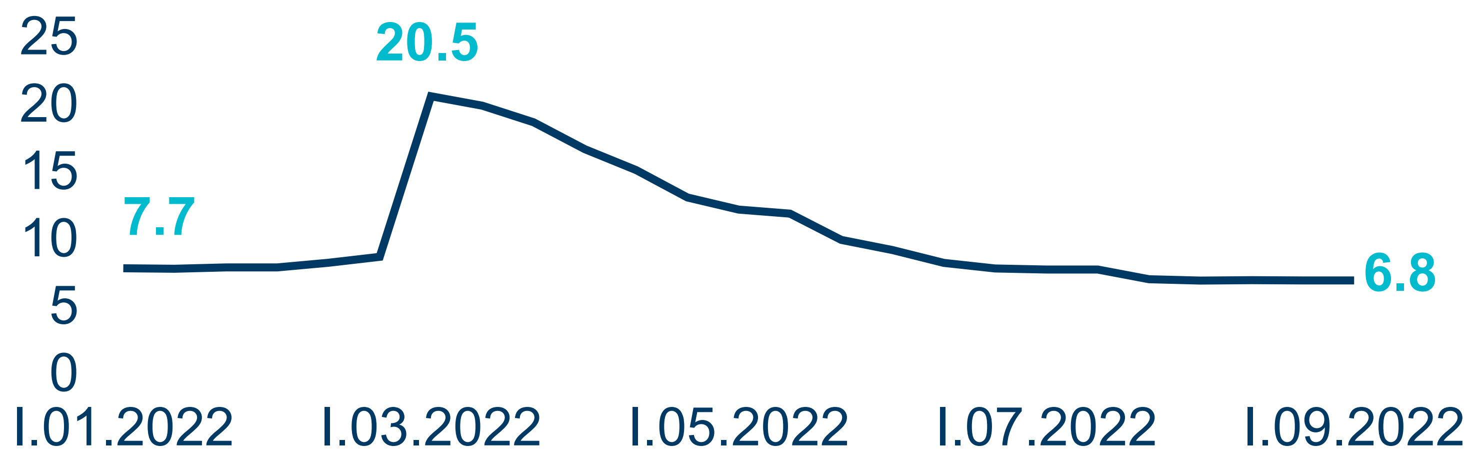
This implies that the central bank balance sheet will be at risk as the impact of sanctions feeds through into bad loans and defaults.

Deposits & Loans in Russian bank system, trln RUB

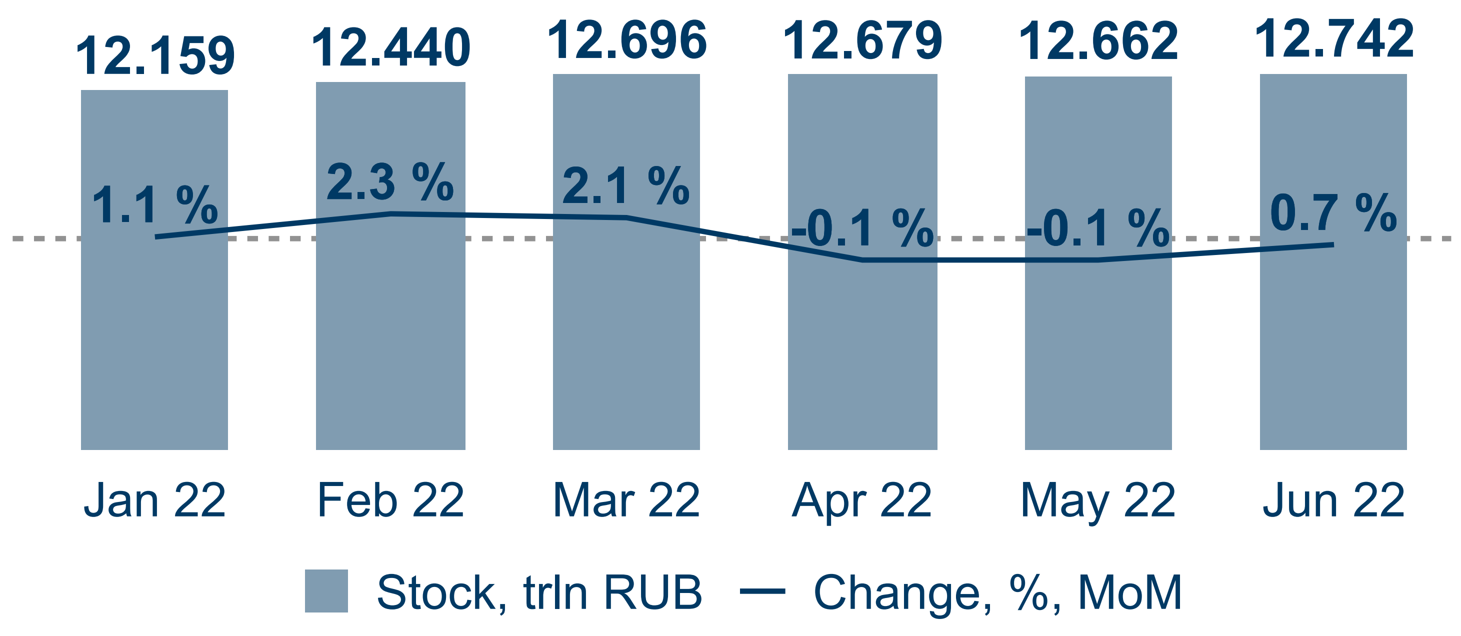




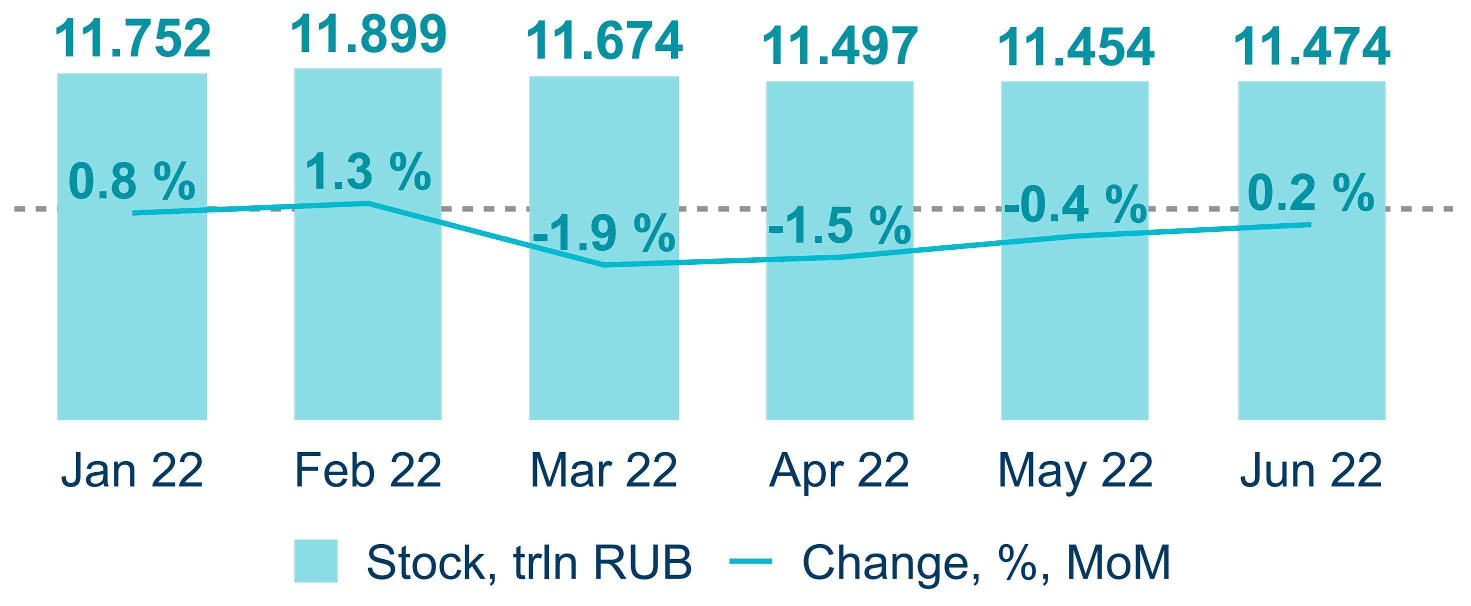
MAX interest rates on deposits in RUB, %



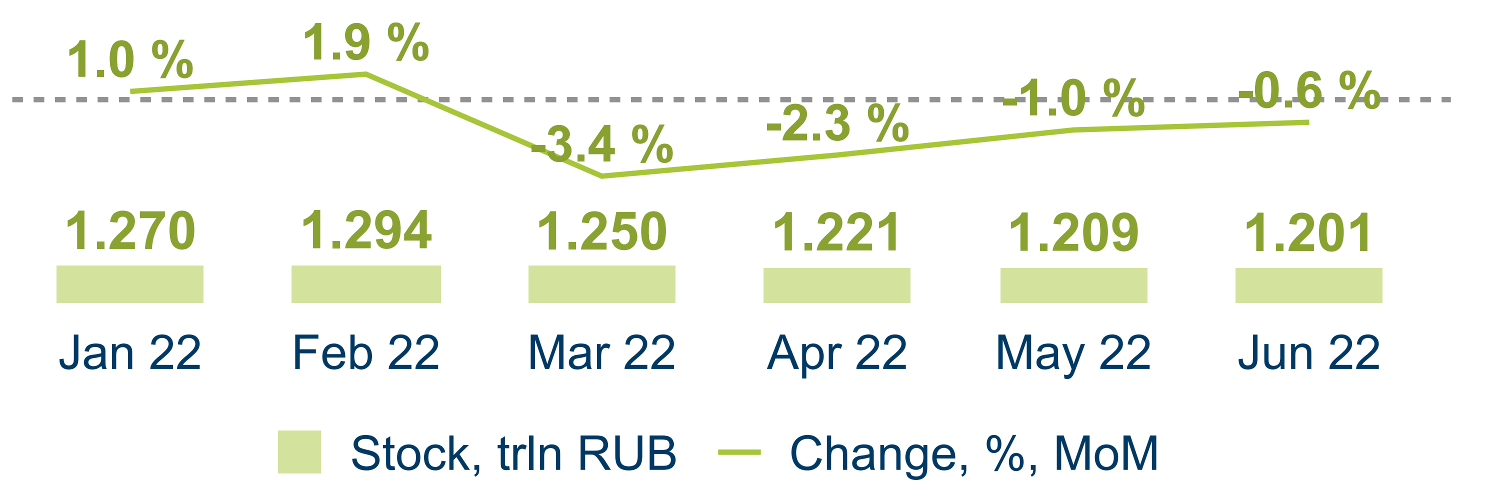
Mortgage loans



Consumer loans



Car loans



Source: CBR