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HELPING YOU PLAN FOR A CHANGING GLOBAL ECONOMY.

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We aim to deliver state-of-the-art macroeconomic research to improve the performance of companies.

# RUSSIA.

## Sanctions will magnify the long term deflationary trend

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Stress Free Country Monitoring, April 2018

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## OUR HIGHLIGHTS.

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### GDP.

Key forecasts  
GDP  
Inflation

Investment  
Industrial production  
Wages

Labour market

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### BUSINESS CYCLE.

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## LONG-TERM STRUCTURAL CONSIDERATIONS.

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Competitiveness  
Indebtedness  
Interest rates  
Money growth

Housing market  
Balance of payments  
Fiscal position

Budget rule effects  
Reserve funds  
Exchange rate

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### POLITICS.

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### DISCLAIMER.

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## KEY FORECASTS.

	2013	2014	2015	2016	2017E	2018F	2019F
<b>Real GDP</b>	1.9%	1.4%	-2.5%	-0.2%	1.5%	1.3-1.5%	1.2-1.5%
<b>Households</b>	4.4%	1.0%	-8.6%	-2.7%	3.4%	3.8%	2.9%
<b>Government</b>	0.8%	-1.4%	-2.9%	0.8%	0.4%	0.2%	-0.5%
<b>Investment</b>	-3.5%	0.2%	-13.5%	-1.7%	7.4%	4.3%	3.1%
<b>Exports</b>	4.0%	0.8%	3.6%	3.6%	5.1%	5.4%	3.5%
<b>Imports</b>	3.6%	-8.1%	-23.7%	-4.3%	17.4%	6.2%	6.1%
<b>Nominal GDP (USD bn)</b>	2294	2080	1373	1296	1285	1416	1487
<b>USD/RUB avg</b>	31.09	31.84	38.38	60.94	67.06	65	65
<b>CPI, avg</b>	6.8%	7.8%	15.6%	7.1%	3.7%	4.0%	3.5%
<b>Policy rate</b>	5.50%	17.00%	11.00%	10.00%	7.75%	6.25%	4.25%
<b>Budget balance % of GDP</b>	0.9%	-0.9%	-2.3%	-2.2%	2.0%	-1.7%	-1.3%
<b>Debt to GDP</b>	11.0%	13.8%	14.1%	13.8%	17.4%	17.7%	18.2%

Sources: : CEIC, MACROBOND, ADA ECONOMICS LTD

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## THE BOTTOM LINE.

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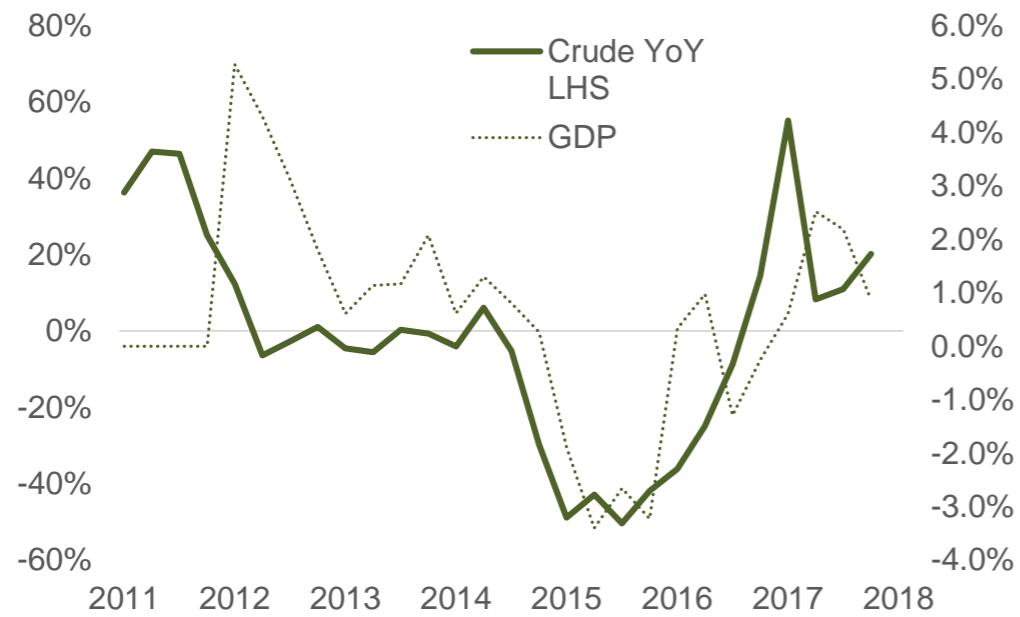
- **The business cycle:** The latest round of sanctions announced by the US surprised us in terms of intensity leading us to modestly reduce our projections for this year and mildly increase the outlook for inflation. That being said, in our view none of the key parties involved: Russia/US/Europe have an interest in fully escalating the situation, so we may have hit the “worst spot”. As a result, whilst in the eurozone we are confident that we have passed the peak of the business cycle, in Russia the best may be ahead.
- **Monetary policy:** The pace of the interest rate easing ahead is likely to be slower given the recent RUB and market weakness but we think there is ample scope for reducing the policy rate and thus retail borrowing costs in Russia in coming years.
- **Exchange rate:** We have lifted our expectation for RUB from 60/USD to 65/USD as a result of the sanctions announcement. Even if the geopolitical tensions were to subside, we think a meaningful recovery of the RUB appears highly unlikely in the coming year.
- **Long-term considerations:** Fundamentally the economy is going through a multi-year period of balance sheet restructuring of the non-financial corporate sector. International experience shows this is a process that lasts around 5 years (in which case Russia has 1-2 more years to go) that depresses the labour market but in the end delivers significant improvement in competitiveness. This process is what allows the CBR to gradually cut interest rates – more than what analysts expect in our view – going forward.

Ongoing reduction in the CBR’s policy rate will be a catalyst for improving housing market affordability, this in our view is a structural improvement for Russia.

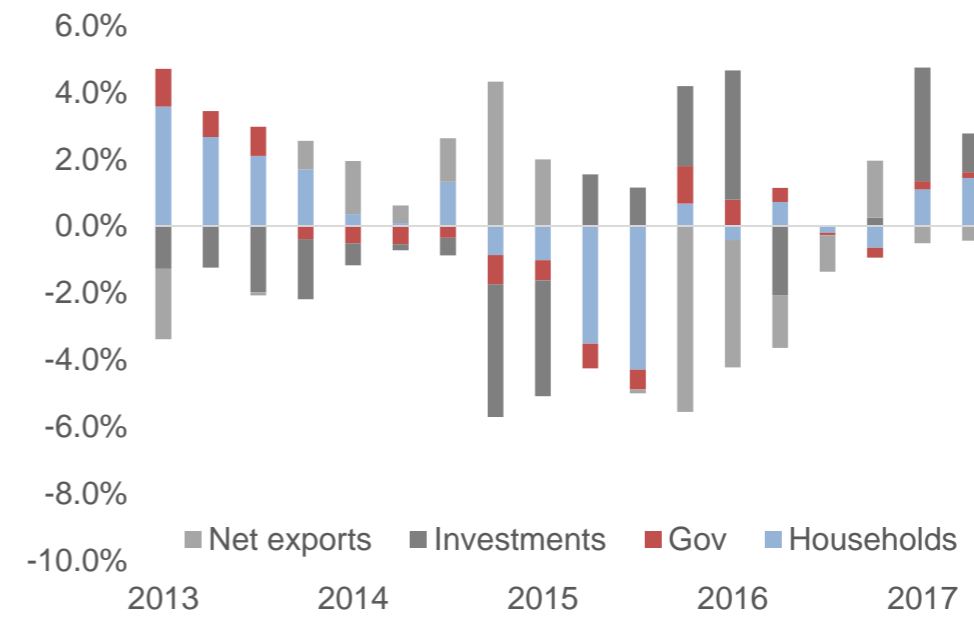
Global rankings on some competitiveness measures show that Russia is falling behind on education.

GDP: SANCTIONS DON'T CAHNGE THE TREND.

Growth rebound driven strongly by inventories (and thus oil prices).



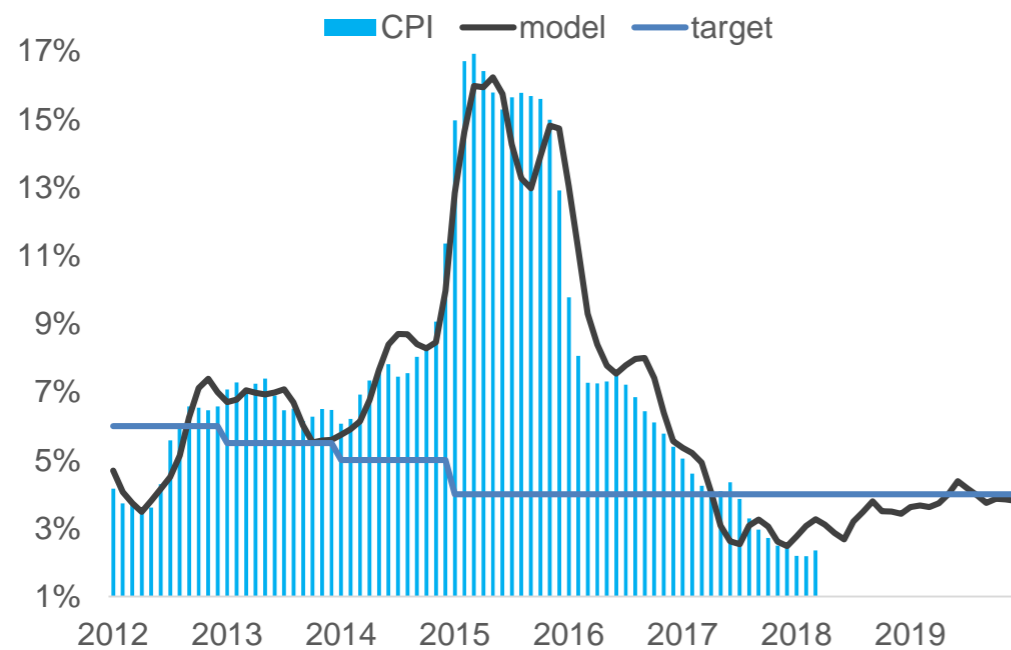
Contributions to yoy growth by key component.



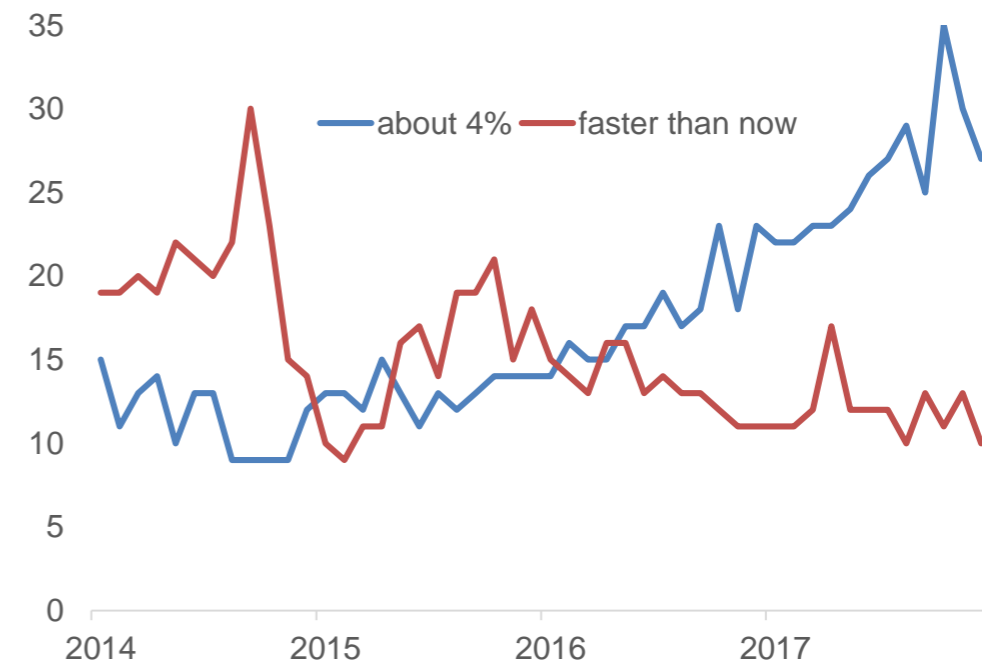
Sources: MACROBOND, ADA ECONOMICS LTD

## INFLATION: SLIGHTLY WORSENING, BUT STILL LOW.

Inflation expectations aligning with the CBR's target.



Contributions by key component to yoy inflation.



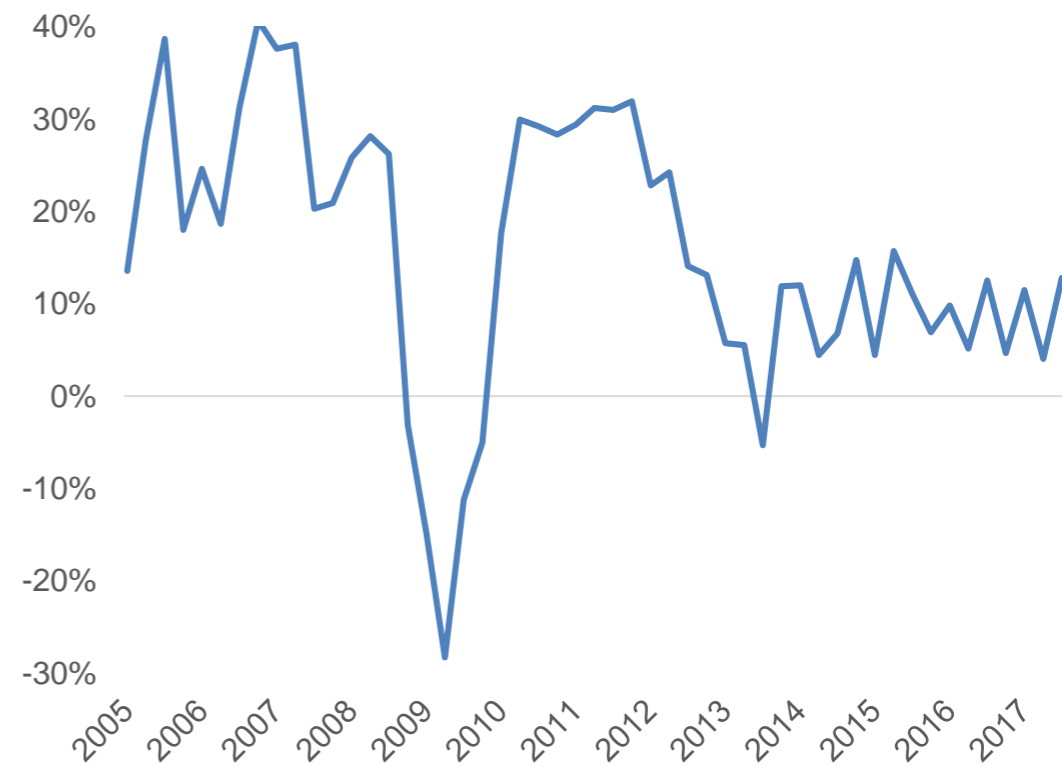
Sources: CEIC, ADA ECONOMICS LTD

## INVESTMENT: MODEST, BUT UP.

Capacity utilisation (% lha) and fixed capital formation growth (yoy, rha).



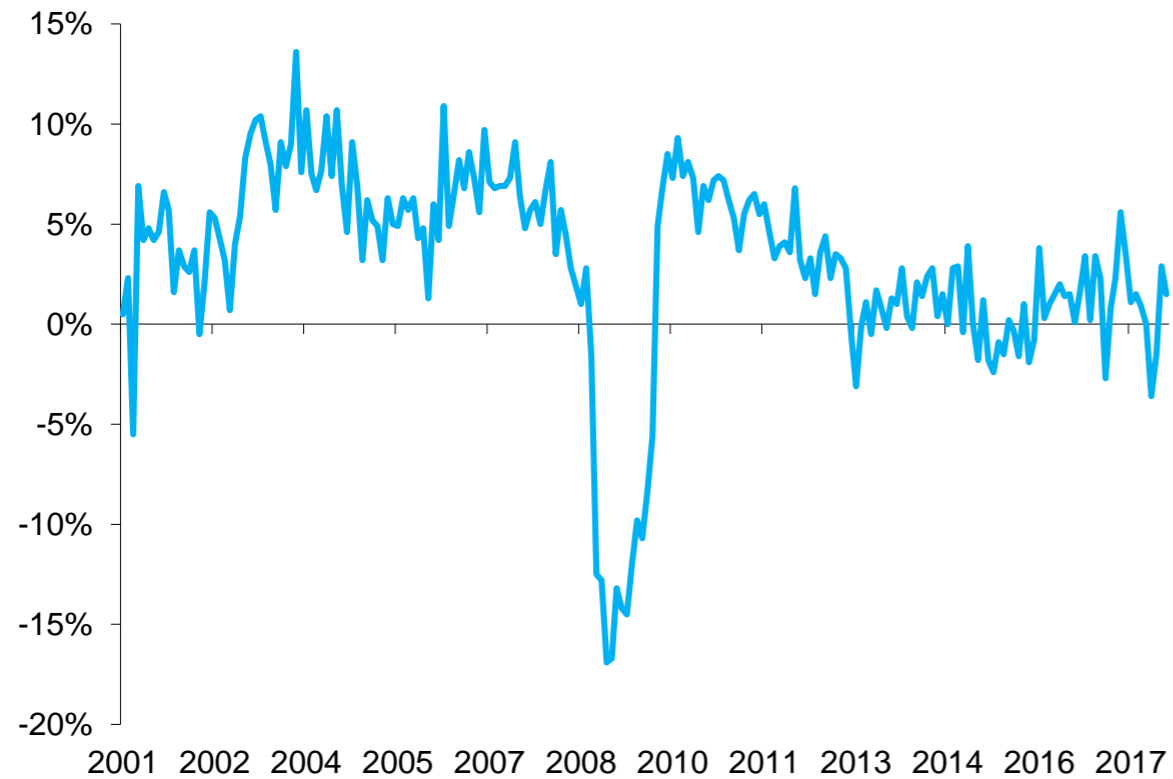
Big-medium enterprises internal funds investment



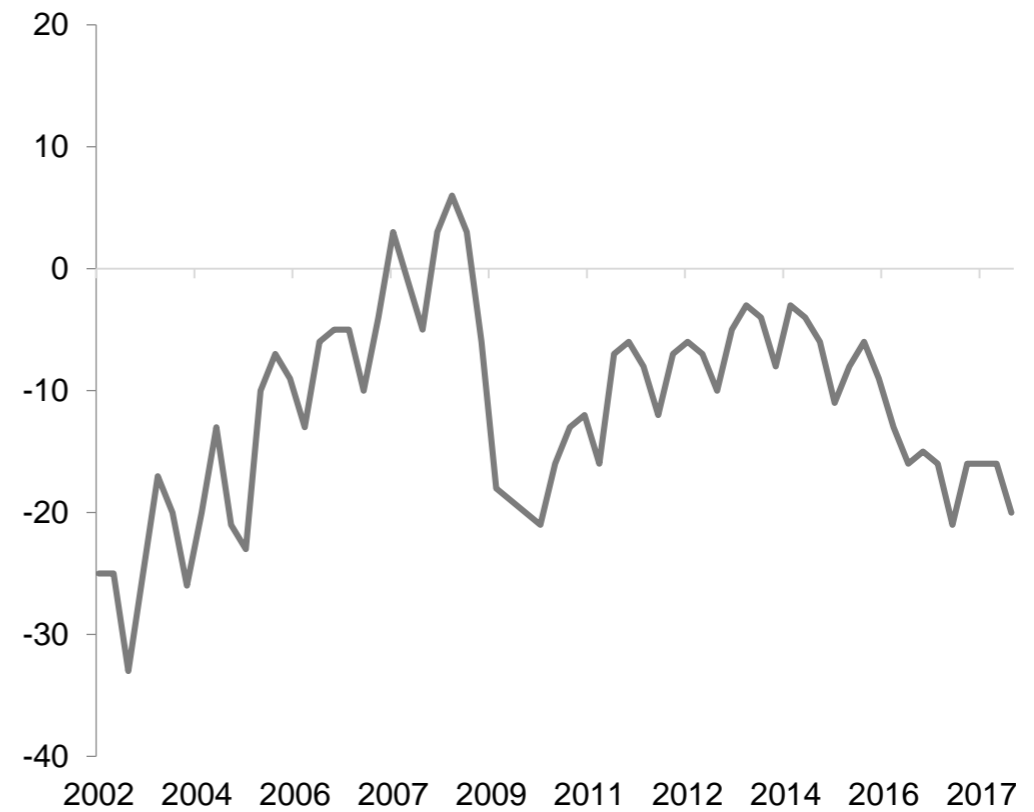
Sources: CEIC, ADA ECONOMICS LTD

## INDUSTRIAL PRODUCTION AND CONSTRUCTION SENTIMENT.

Yoy change in Industrial Production.



Confidence indicators.



Sources: MACROBOND, ADA ECONOMICS LTD



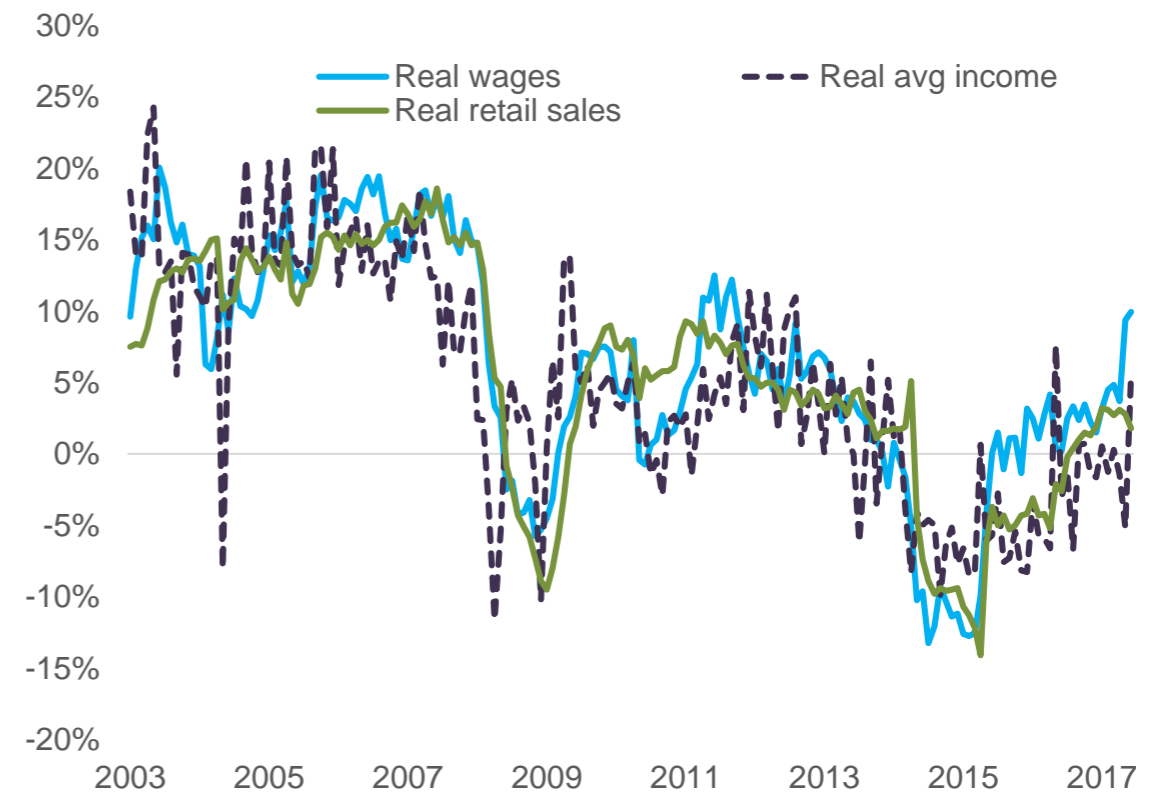
## WAGES: UP LATELY BUT DOWNSIDE RISKS.

In Russia, there are various ways of measuring incomes, and wages include a variable bonus, which can swing significantly from year to year

The chart shows that basic wages, deflated by CPI, have improved thanks to the fast drop in inflation

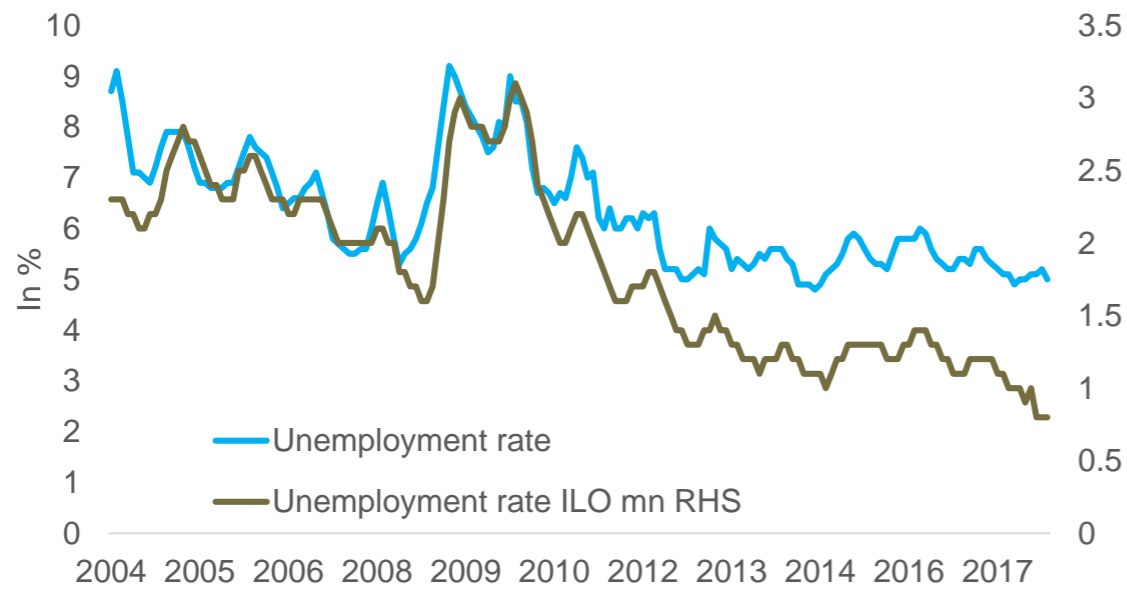
However, the broader measures of incomes, such as disposable income, have shown much slower growth in both nominal and real terms

The low disposable income is a constraint on inflation and ultimately caps the spending recovery

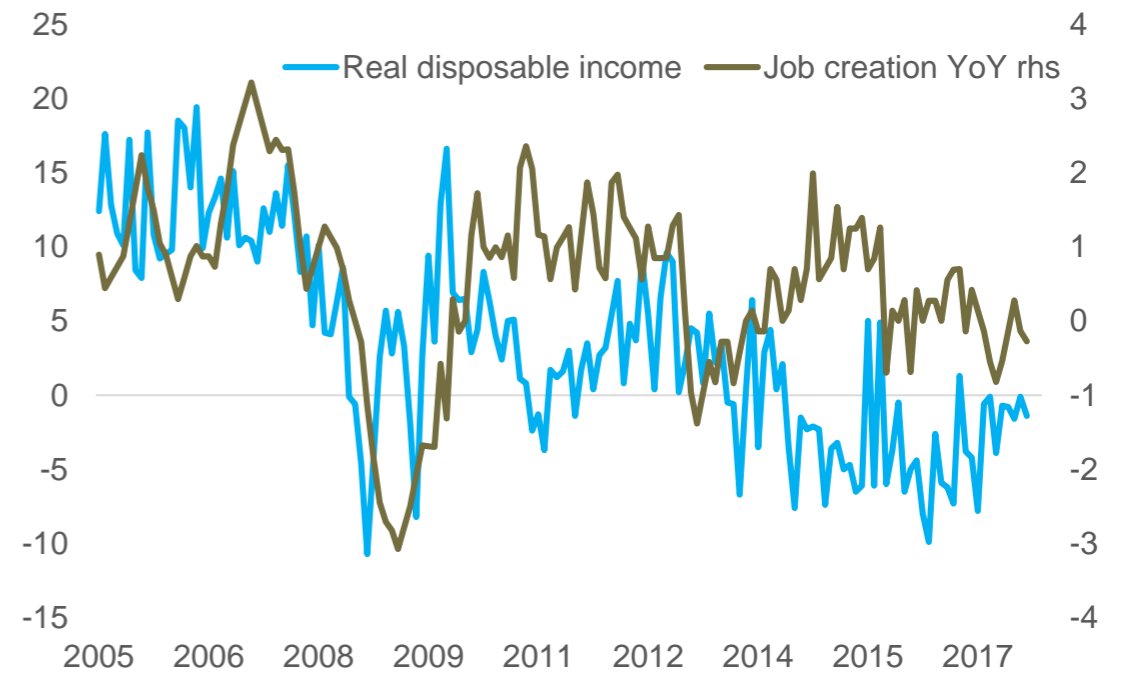


## LABOUR MARKET: SANCTIONS WILL WEAKEN IT.

Unemployment rate in historical context.



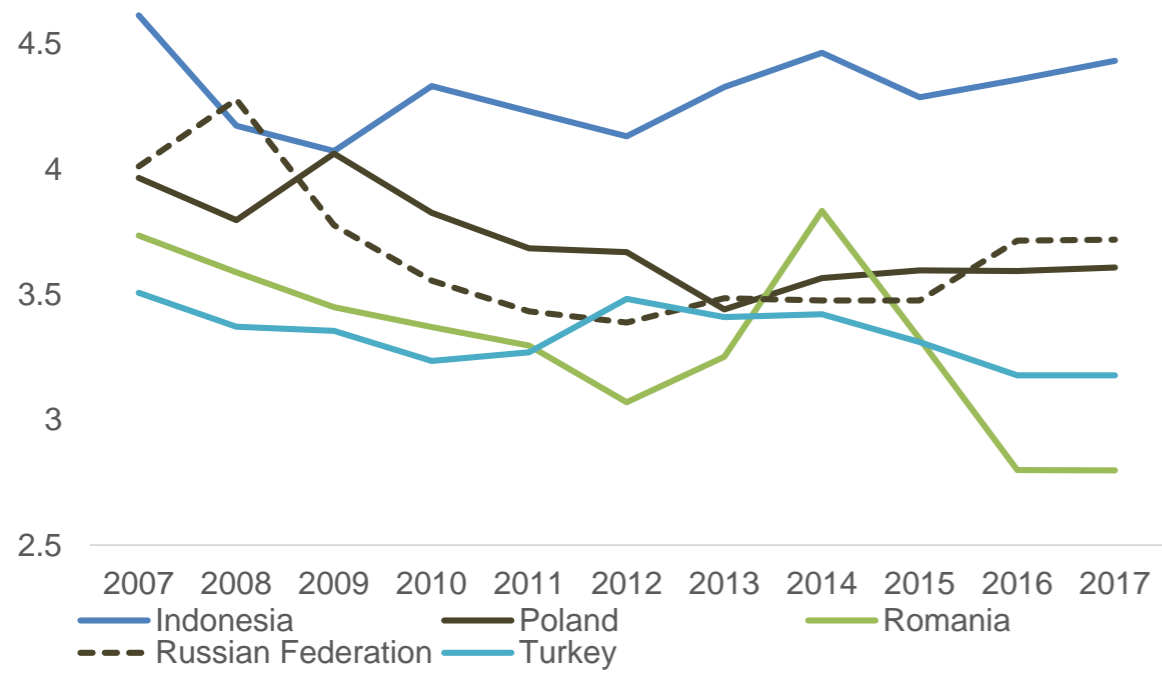
Job creation and real disposable income.



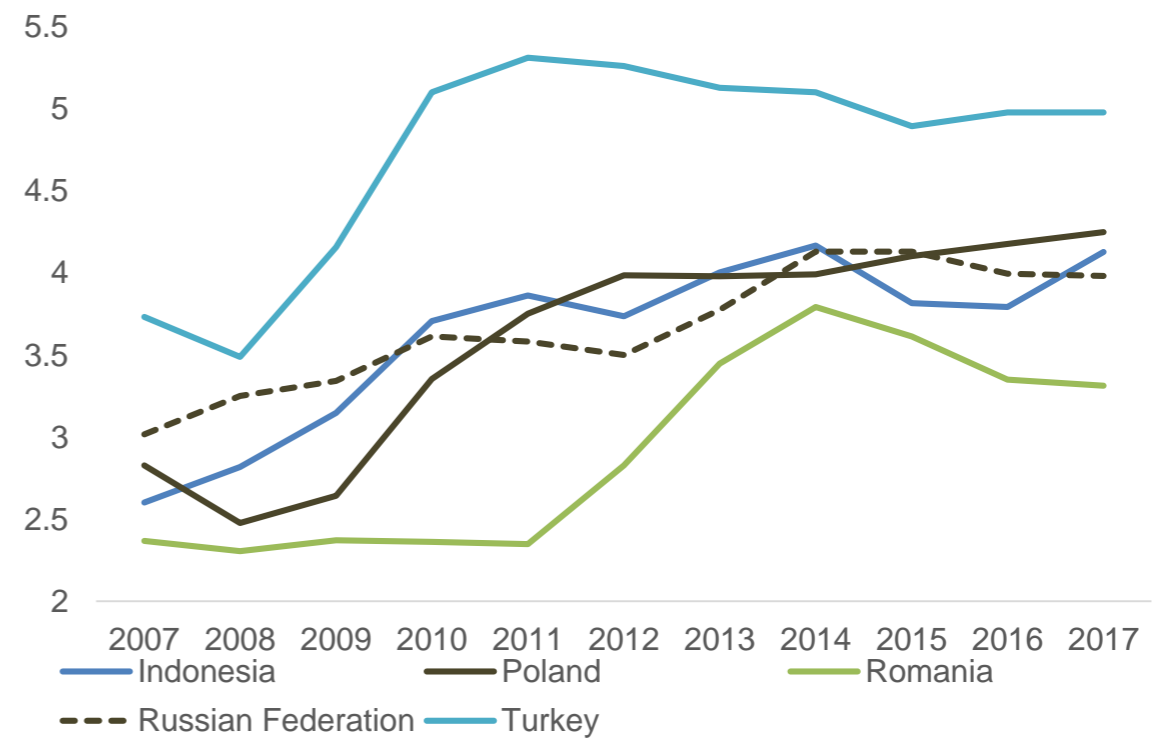
Sources: MACROBOND, BLOOMBERG, ADA ECONOMICS LTD

COMPETITIVENESS.

Quality of the education system.



Quality of overall infrastructure.

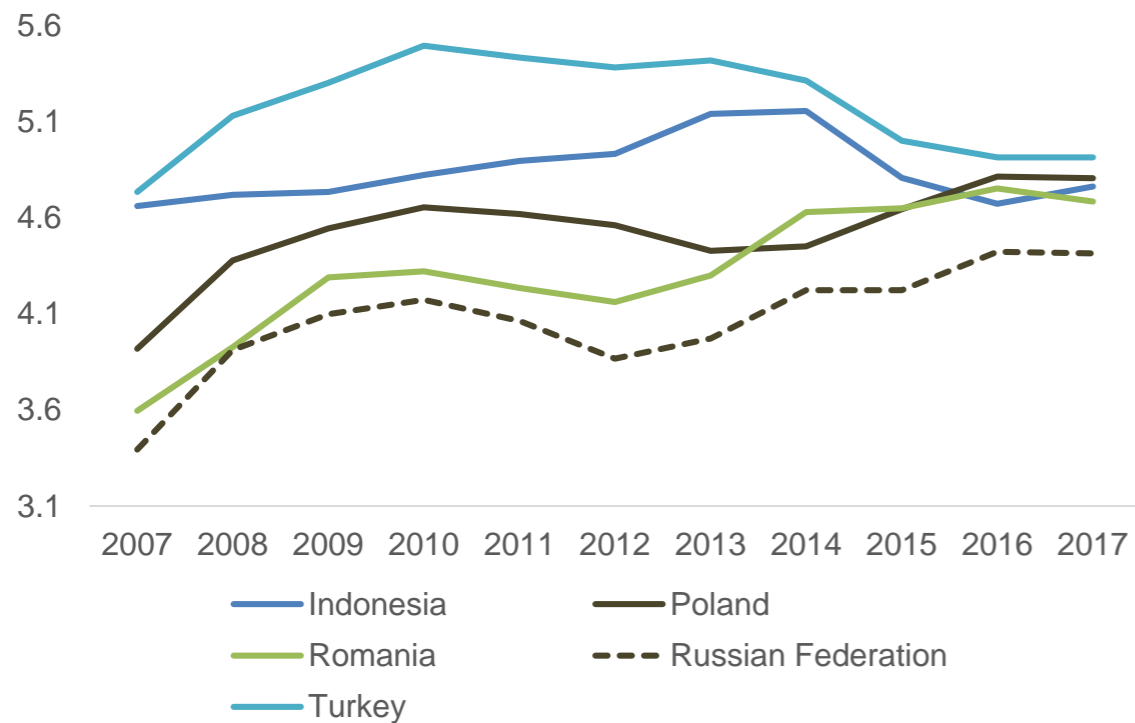


The charts above show the scores for Russia and peer countries on various indicators related to the competitiveness of the economy. The higher the number the better is the performance of the country, as assessed by the World Economic Forum.

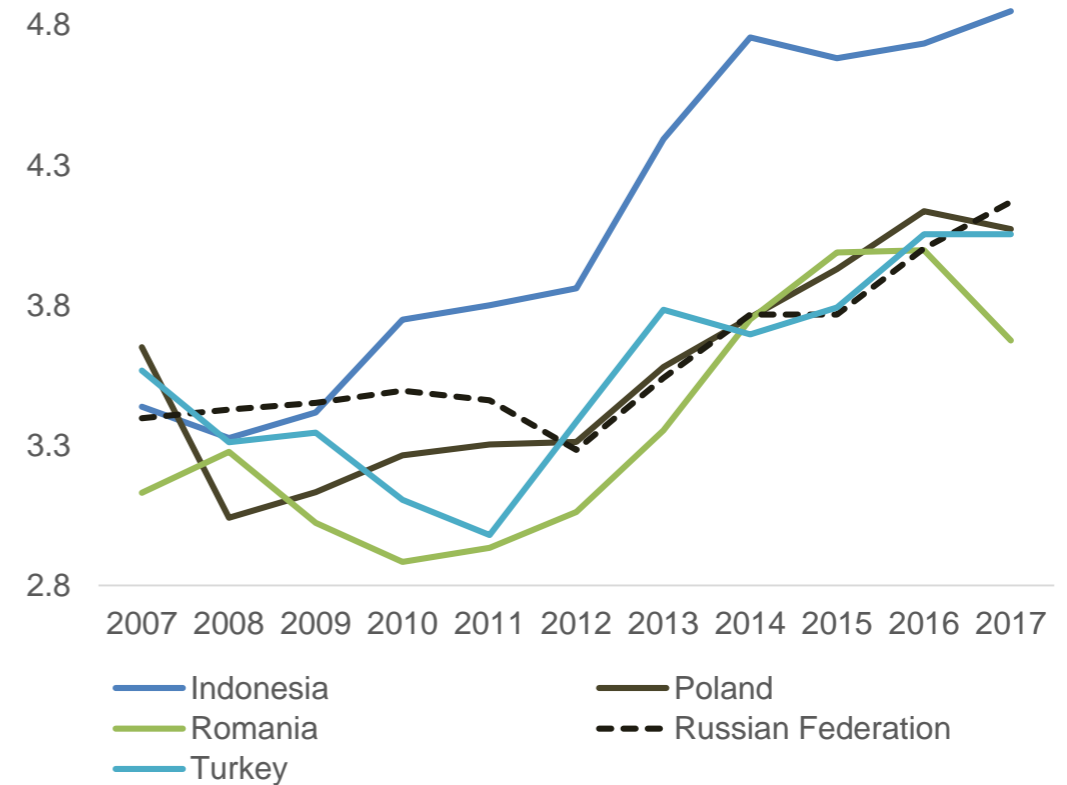
Sources: CEIC, WORLD ECONOMIC FORUM, ADA ECONOMICS LTD

## COMPETITIVENESS.

Availability of latest technologies.



Capacity for innovation.

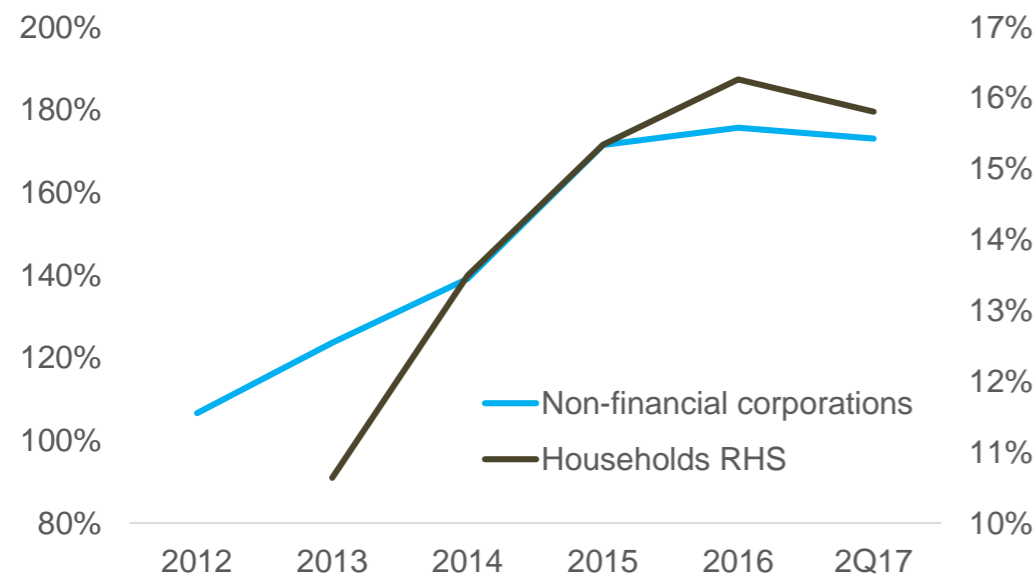


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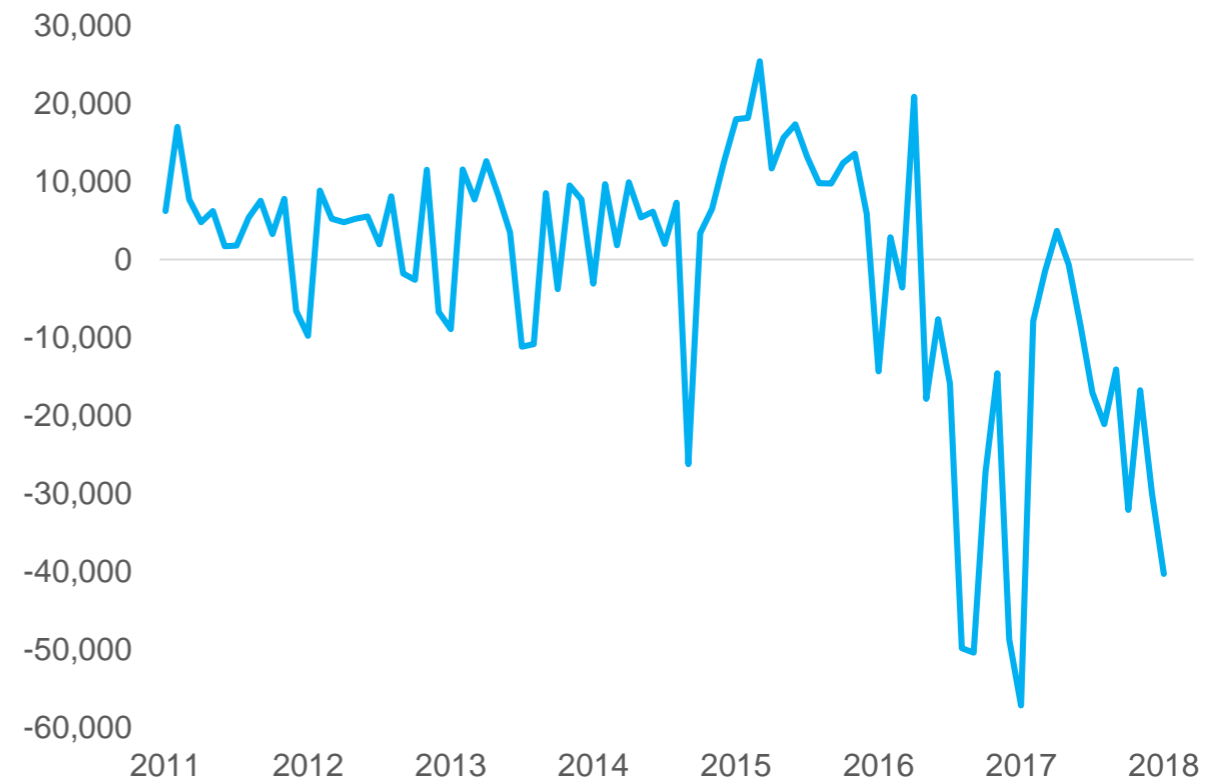
## INDEBTEDNESS.

Debt to GDP measures for companies and households.



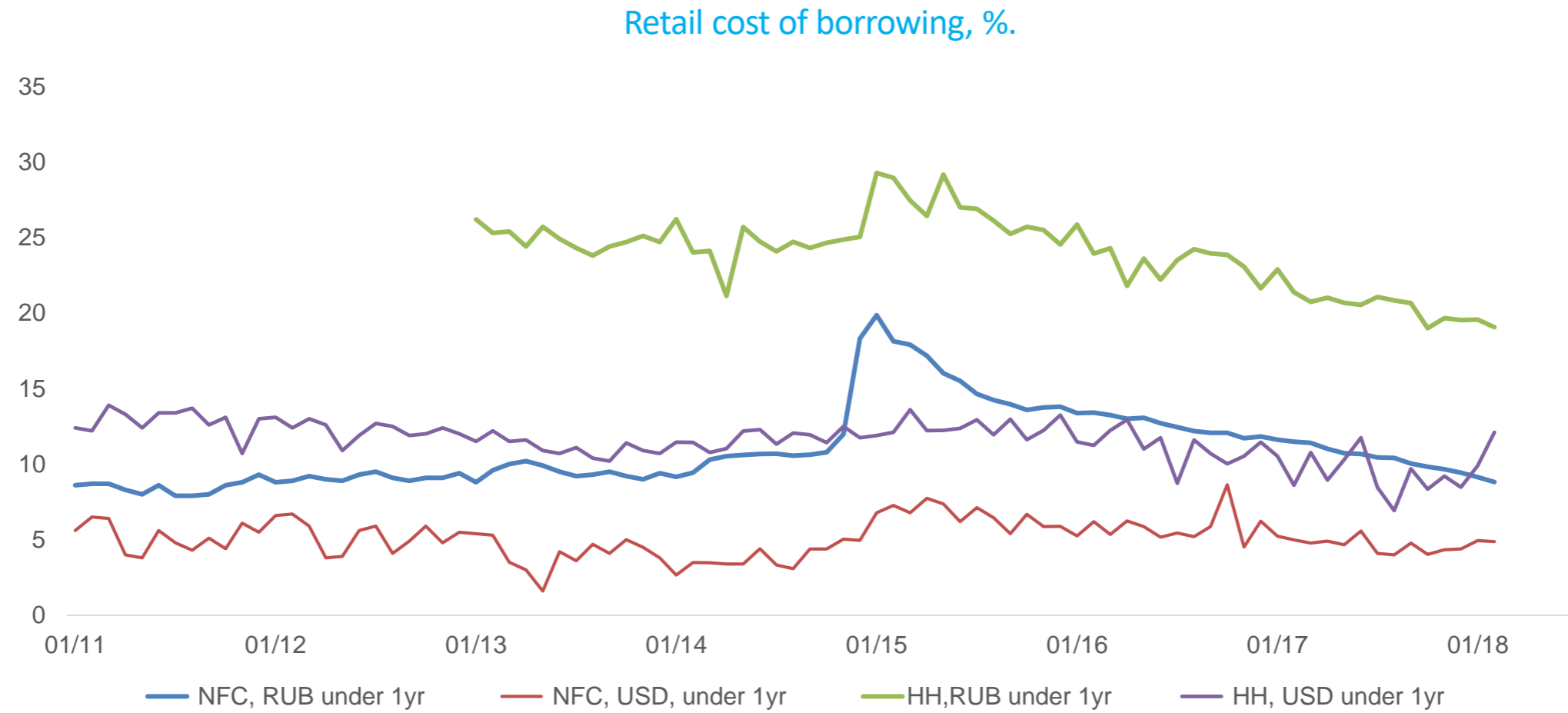
NFC (lha) passed from 100% in 2012 to a peak of 175% of GDP in 2016, while HH (lha) passed from 11% in 2012 to a peak of 16.3% in 2015.

Retail cost of borrowing%.



Sources: MACROBOND, CBR, ADA ECONOMICS

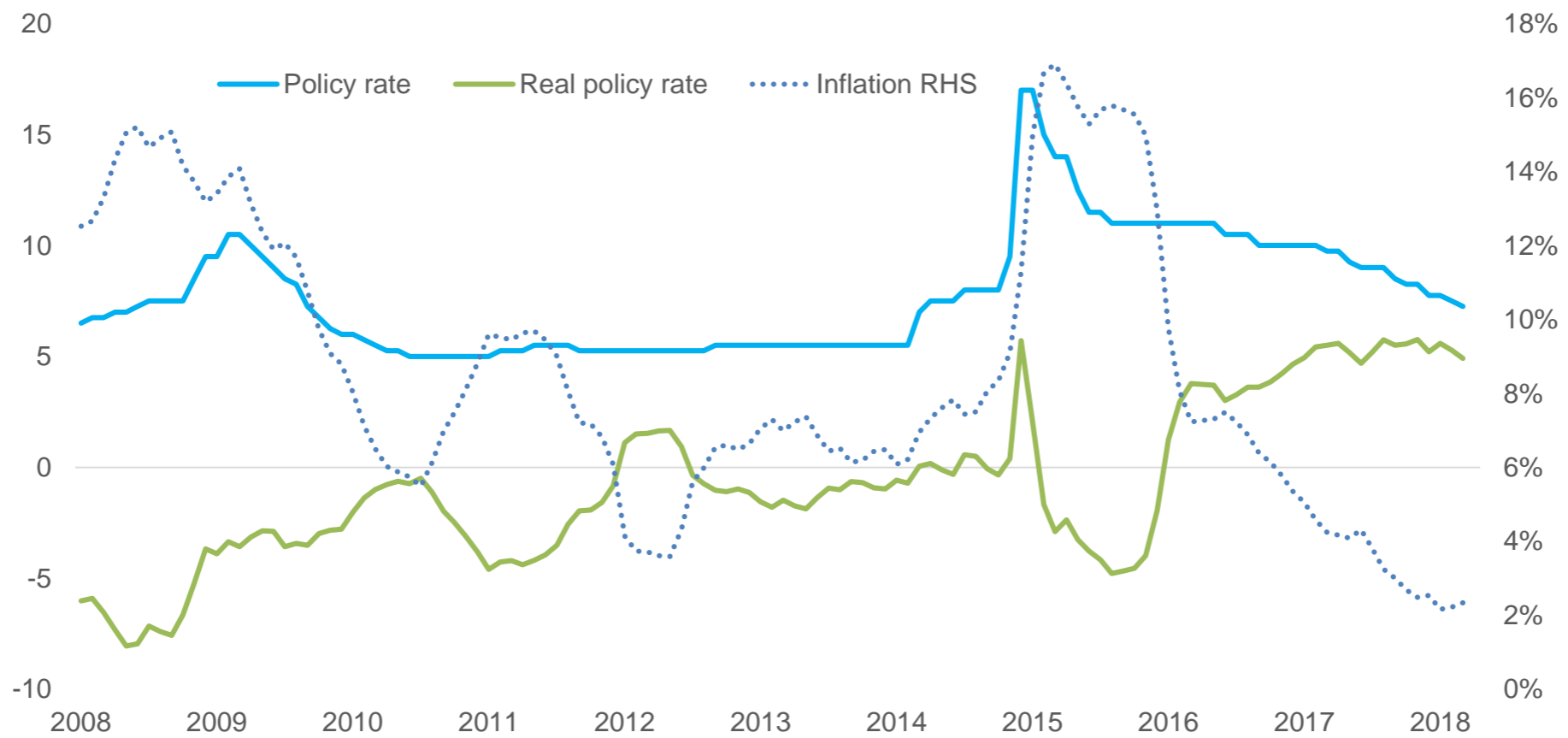
INTEREST RATES.



Sources: CEIC, ADA ECONOMICS LTD

INTEREST RATES.

Inflation expectations aligning with the CBR's target.



Sources: CEIC, ADA ECONOMICS LTD

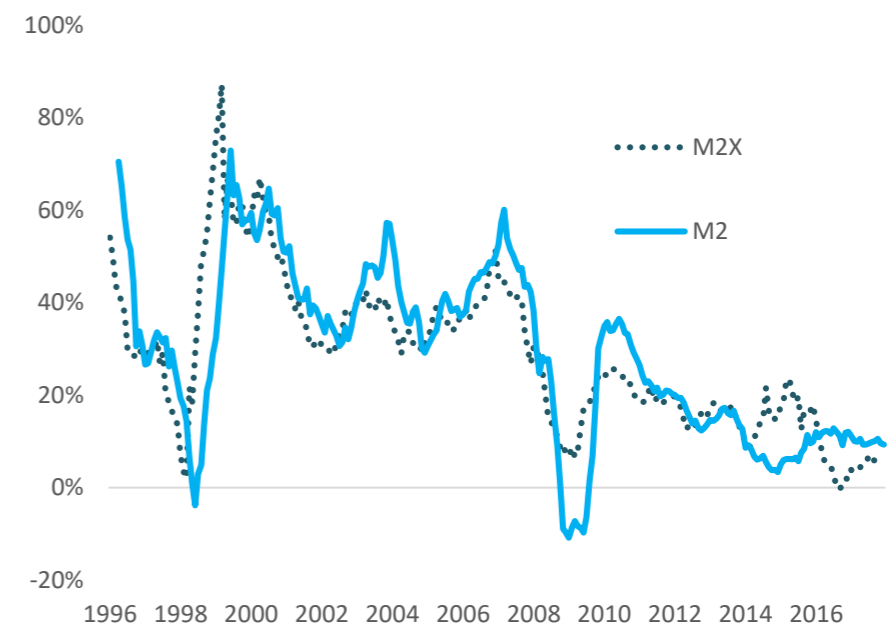
## MONEY GROWTH.

M2 is a very good leading indicator for real GDP growth in Russia and it seems stuck stubbornly at 10-12% yoy.

Without a significant pick up to 20% or more, it is hard for us to forecast growth above 1.5% as an average.

That said, in the past few quarters, some important dynamics are emerging outside of the M2 definition, which may affect the economy positively – please see the next slide.

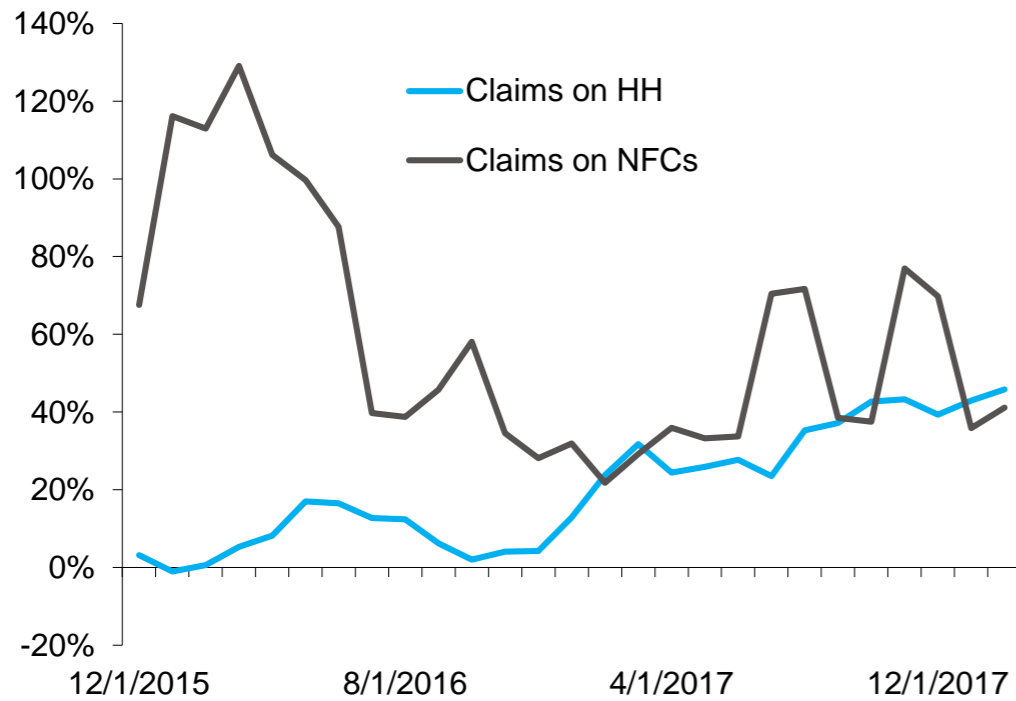
M2 and M2 X.



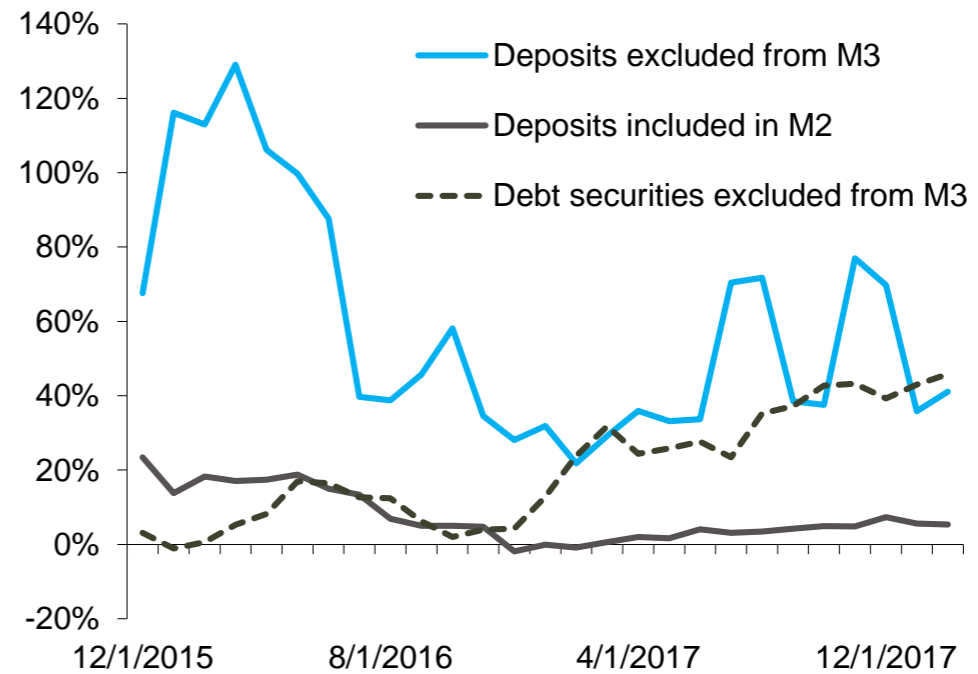


MONEY GROWTH.

Credit dynamics, yoy.



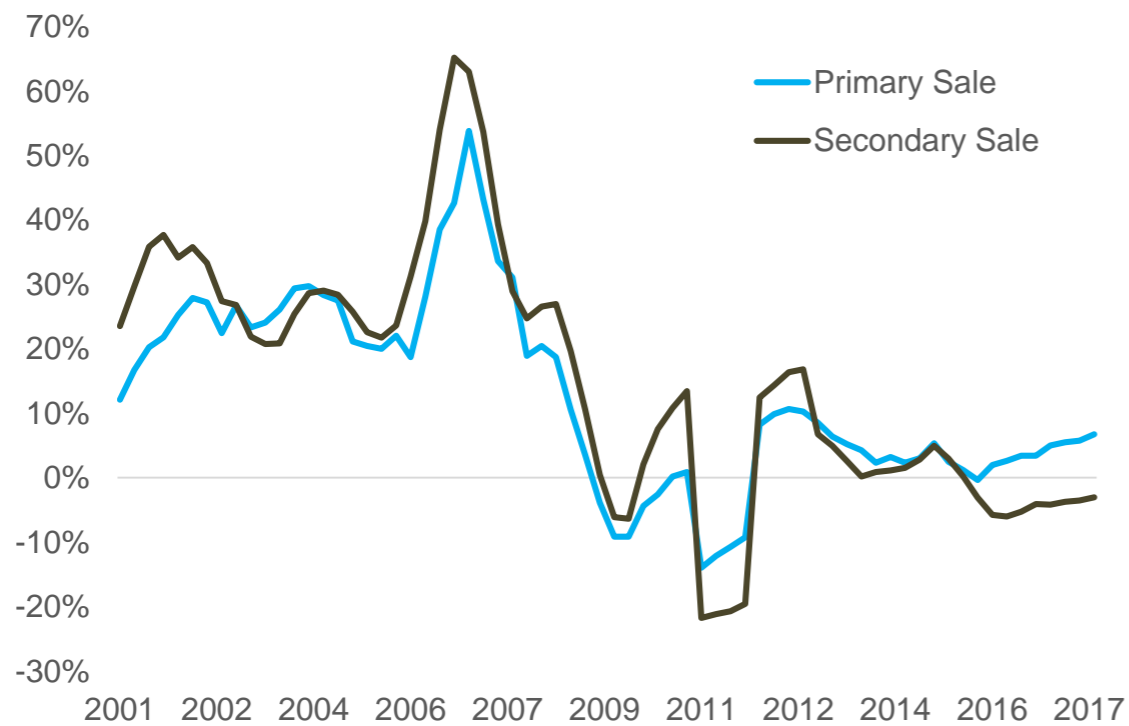
Credit dynamics, yoy.



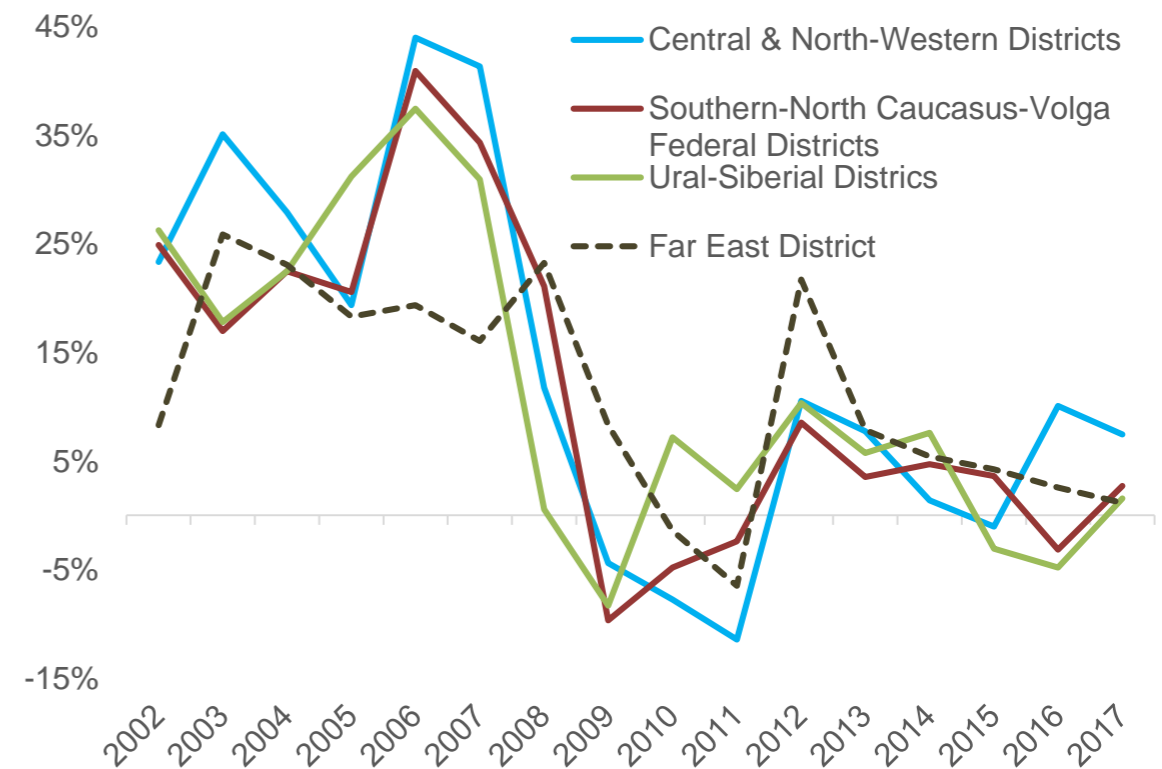
Sources: CBR, ADA ECONOMICS LTD

## HOUSING MARKET.

House prices, primary vs. secondary market, yoy change.



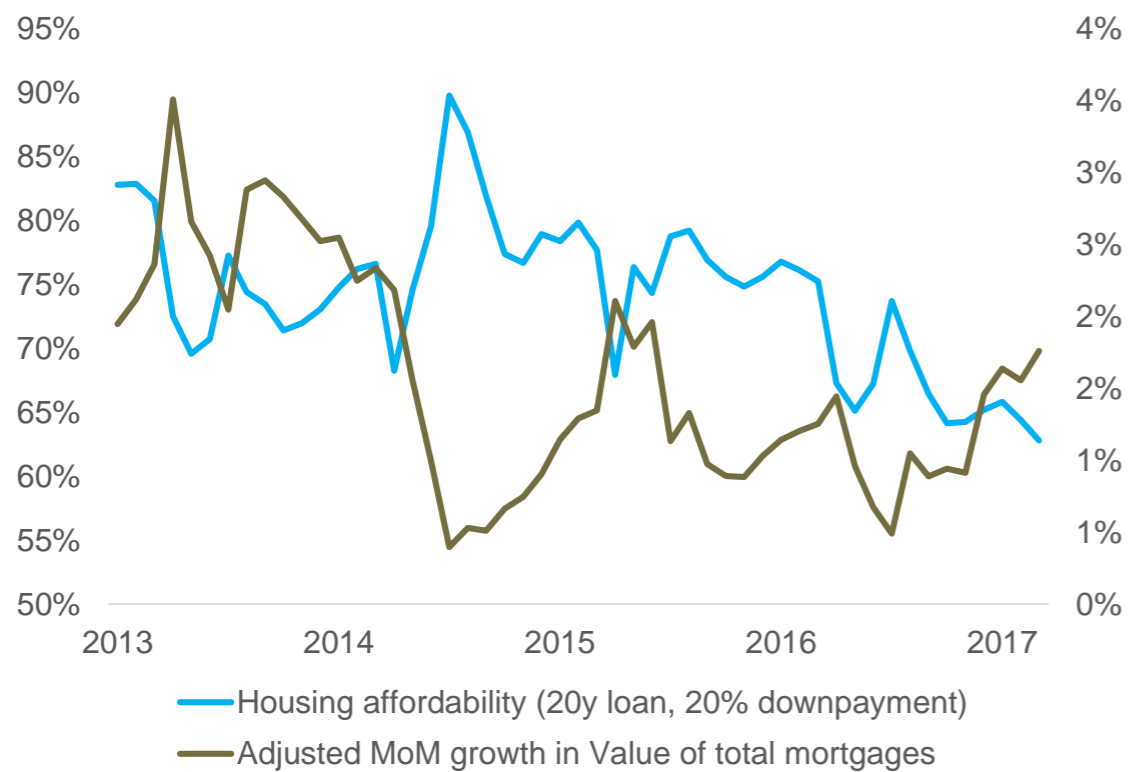
Price evolution in different regions of Russia.



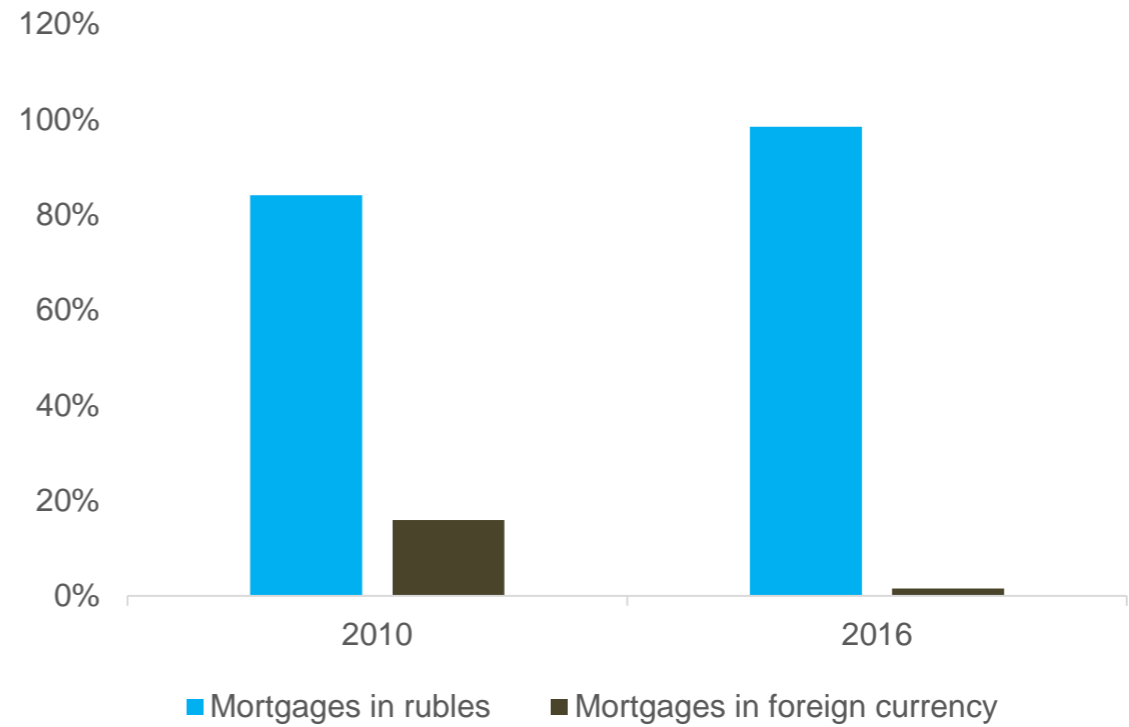
Sources: CEIC, ADA ECONOMICS LTD

## HOUSING MARKET: RECOVERING!

Housing affordability relationship with growth in mortgages value.



Change in mortgages currency during the 2010-16 period.



Sources: CEIC, ADA ECONOMICS LTD

## HOUSING MARKET: IMPROVING AFFORDABILITY.

We estimate lower debt-servicing costs in 2018E and 2019E.

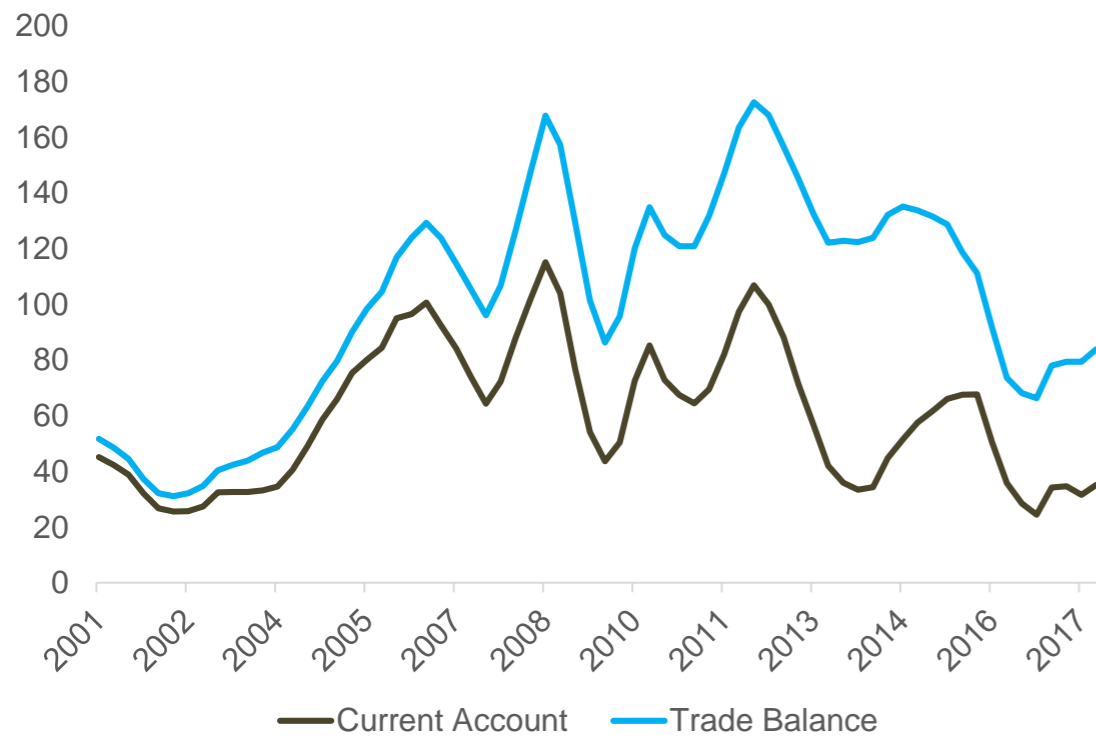


For our debt-servicing costs estimates, we assume an average downpayment of 20%, a 20-year mortgage, average mortgage interest rates in RUB, and the average price of a small (50sqm) apartment outside the centre of a major Russian city. For our 2018/2019E forecasts, we derived the change in mortgage rates from the difference in the Central Bank's key rates easing in past years, which we expect to lead to average mortgage rates down to 8.5% at the end of 2018E, in accordance with our key rate "frozen conflict" estimates. Finally, we assume yearly average sqm prices growth of 3%, consistent with the past five years of the samples we analyzed. Furthermore, we expect real salaries to grow at an average rate of 9% in 2018E and 6% in 2019E.

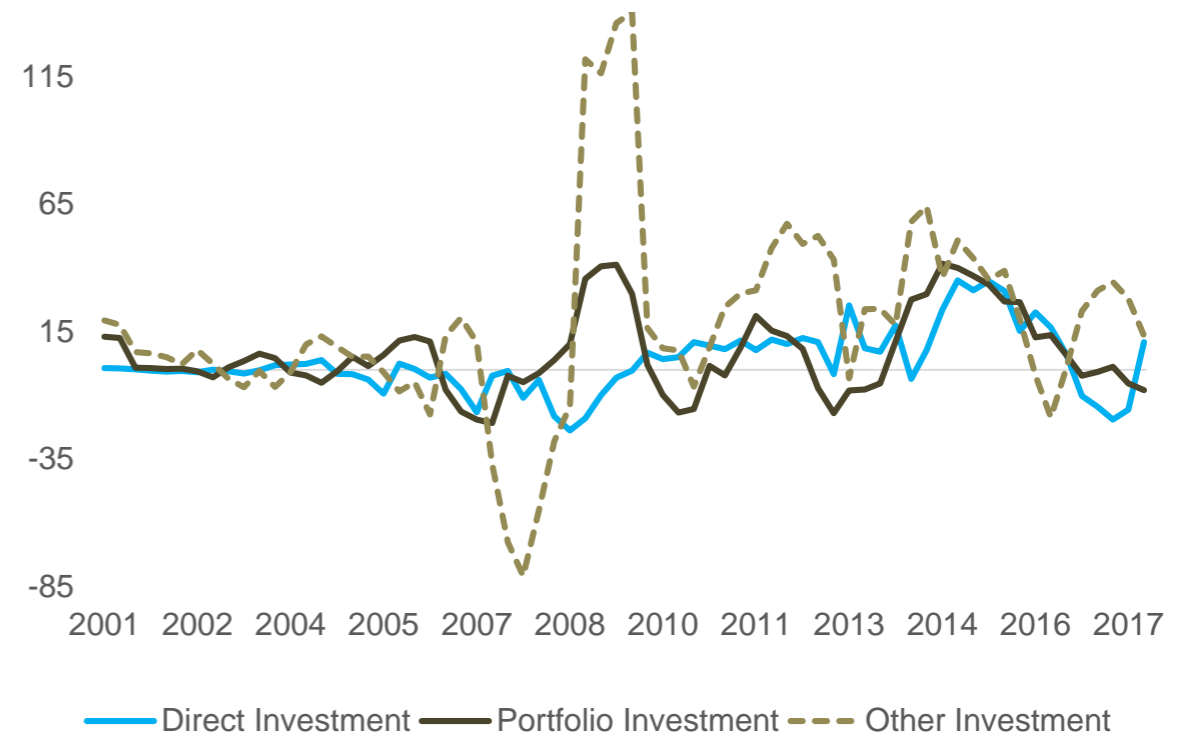
Sources: CEIC, ADA ECONOMICS LTD

BALANCE OF PAYMENTS.

Current Account and Trade Surplus, rolling sum.



Funding breakdown.

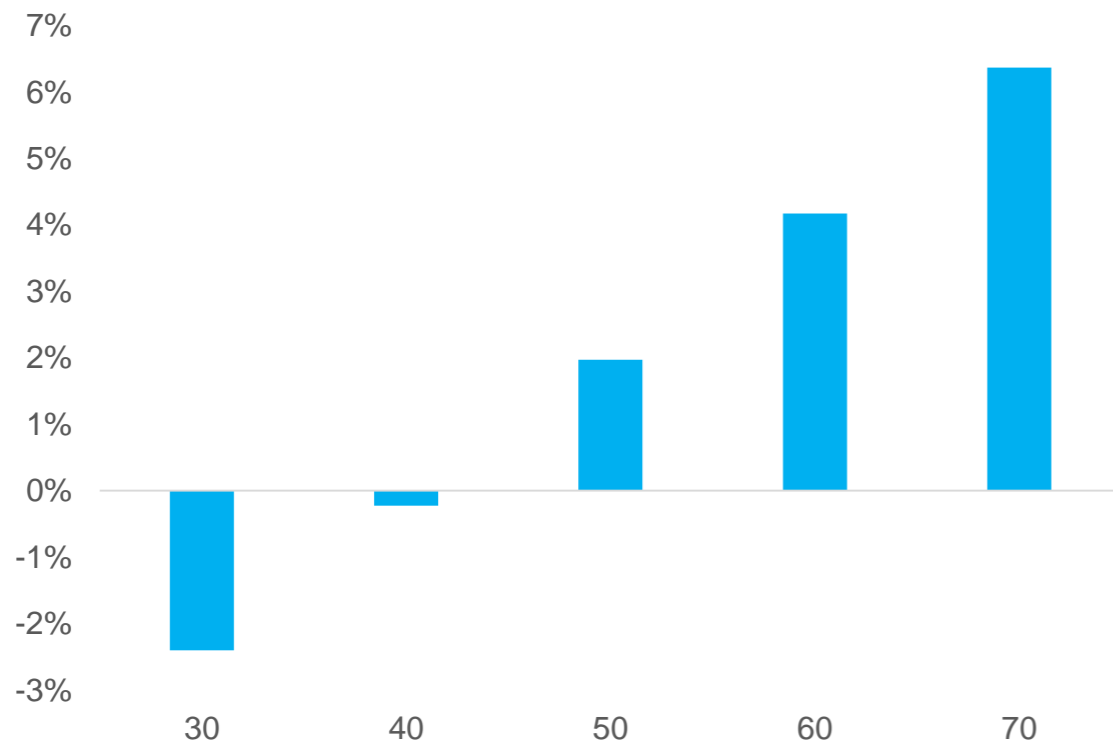


Direct investment, a stable source of funding during the past years, has been deteriorating recently.

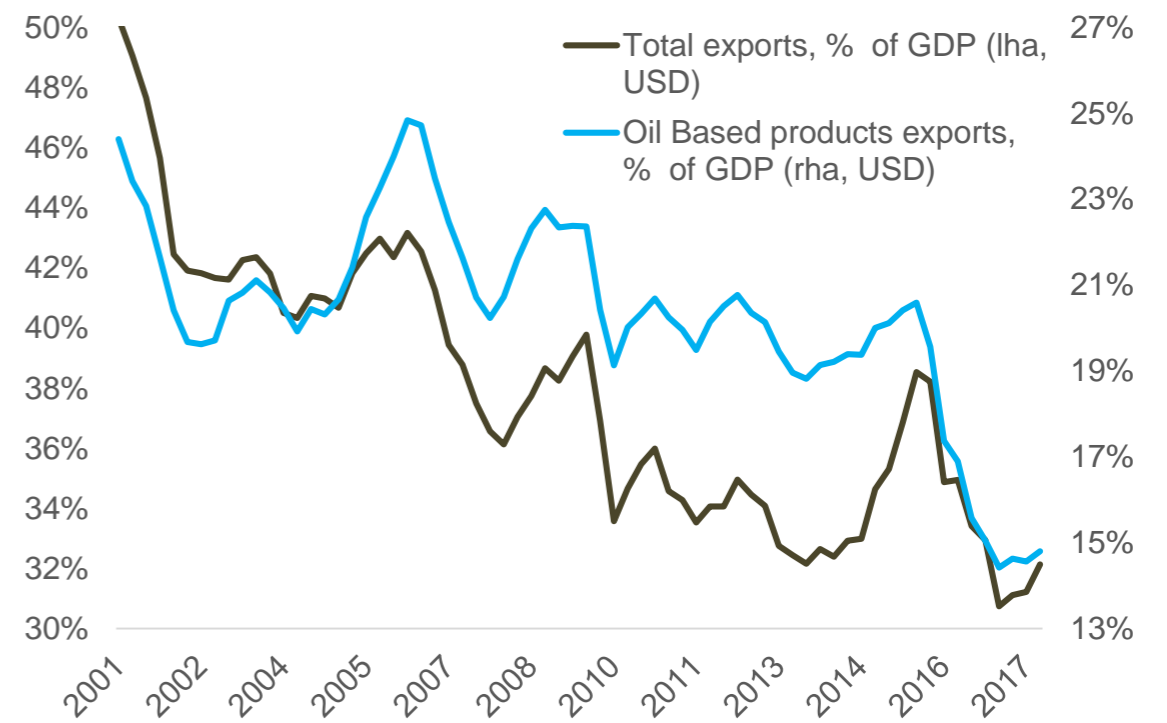
Sources: CEIC, MACROBOND, ADA ECONOMICS LTD

BALANCE OF PAYMENTS.

Impact of budget rule of BoP, CA (no rule) – CA (rule), % of GDP.



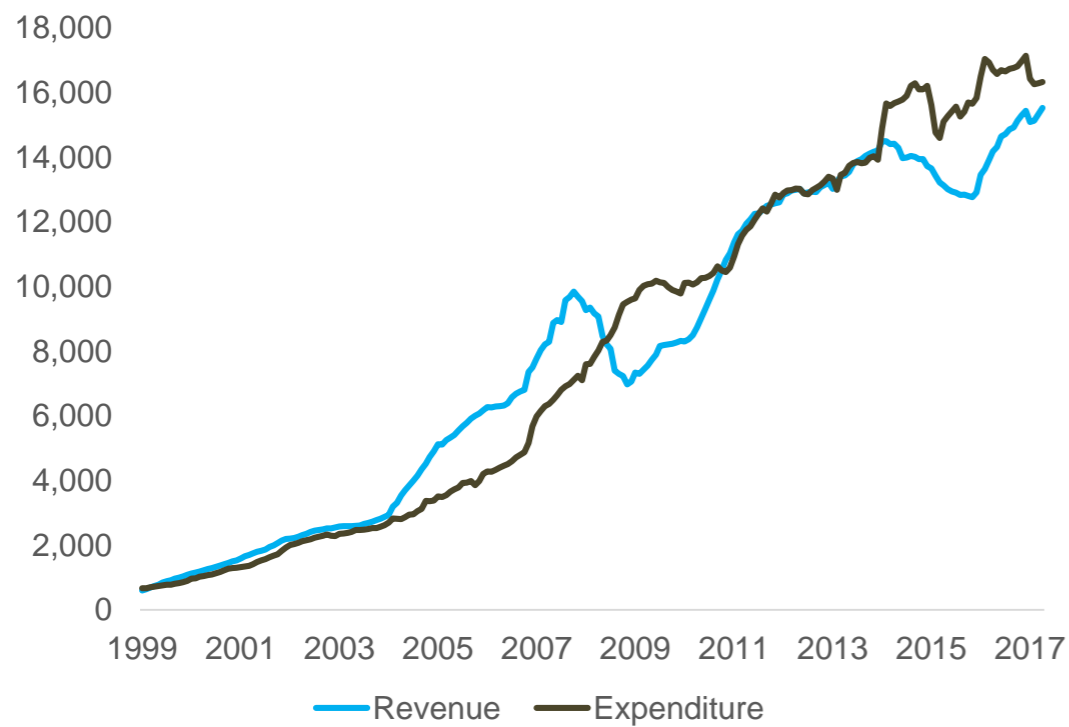
Trend of oil-based exports vs. total exports.



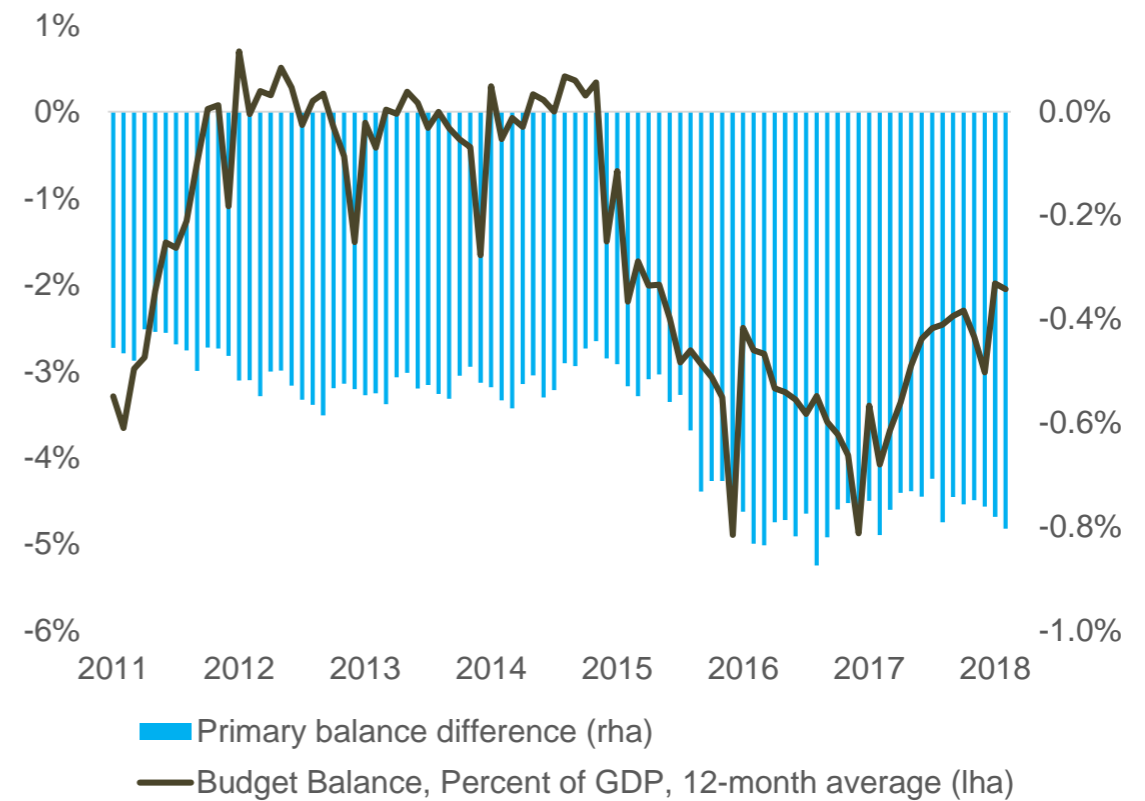
Sources: CEIC, ADA ECONOMICS LTD

## FISCAL POSITION.

Revenue and expenditure growth (RUB bn).



Budget balance, % of GDP, monthly rolling average.

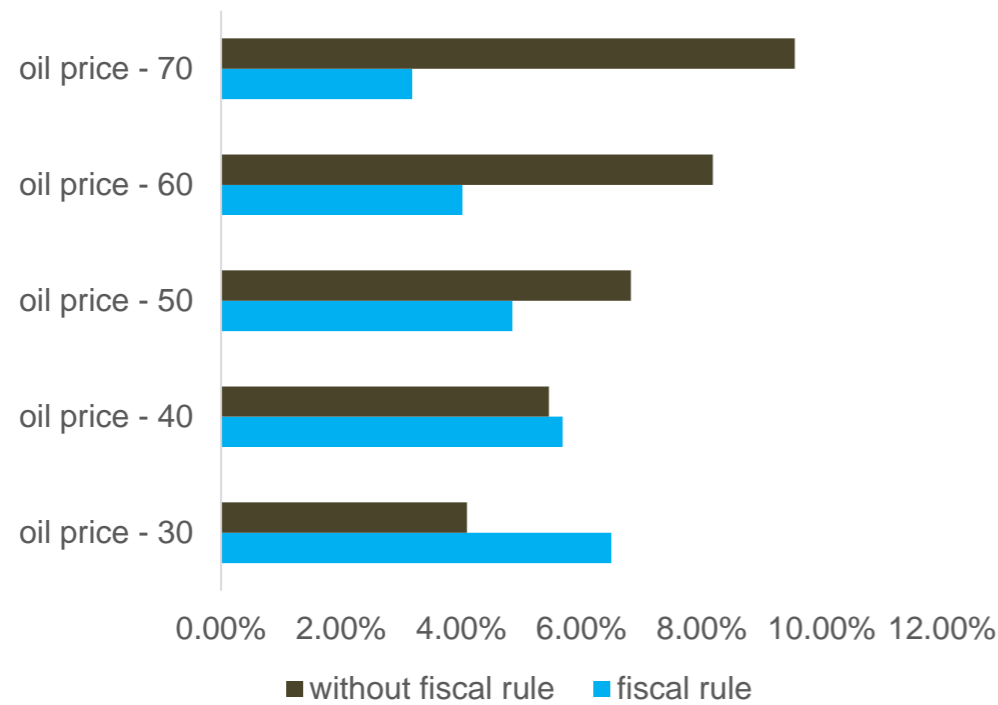


After 2014 sanctions, differences between primary budget balance and budget balance deteriorated down to -0.8% of the GDP.

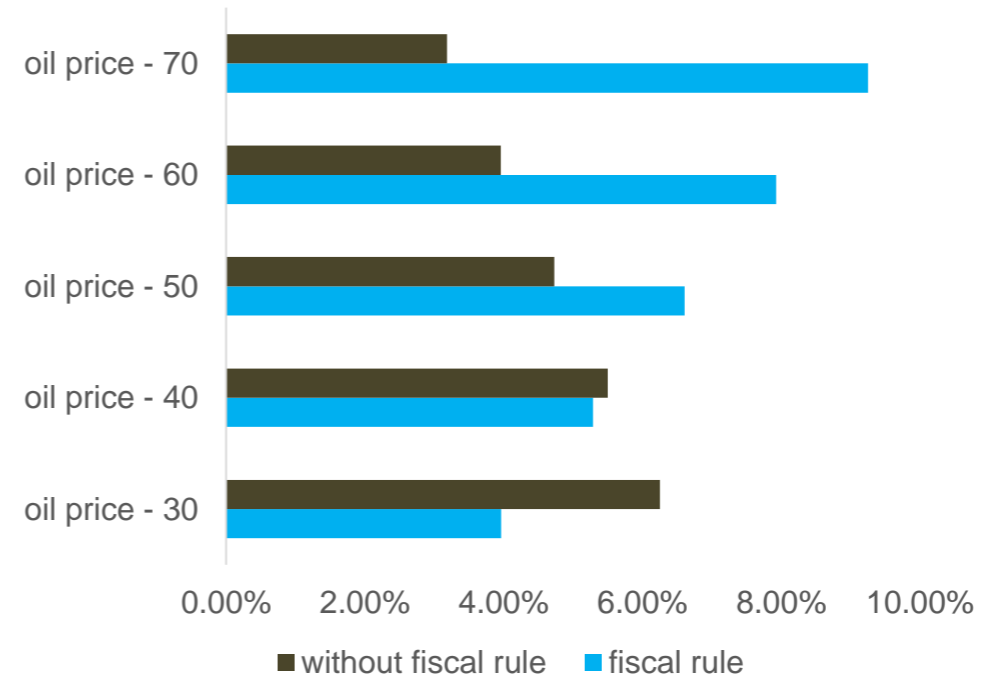
Sources: CEIC, ADA ECONOMICS LTD

BUDGET RULE EFFECTS.

Fiscal Rule – Budget effect 2018\*.



Fiscal Rule – Budget effect 2019\*.



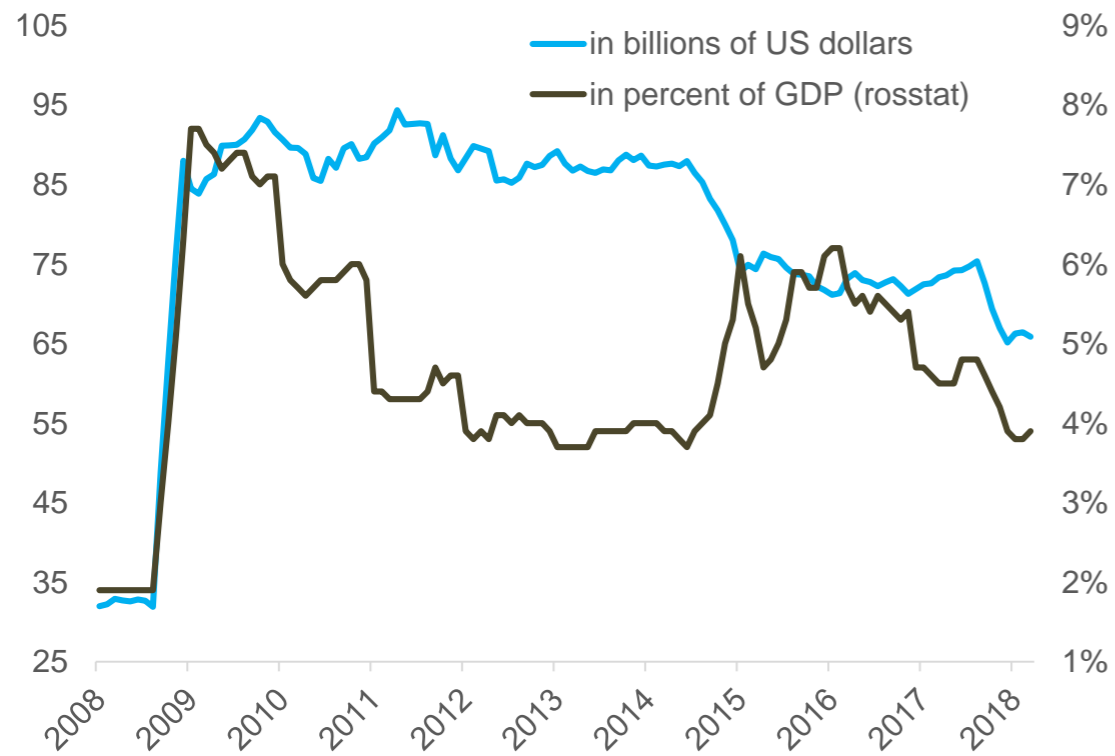
Estimation completed using MinFin and CBR estimates, following an ideal case of the RUB/USD fixed at 60.

Sources: CEIC, ADA ECONOMICS LTD

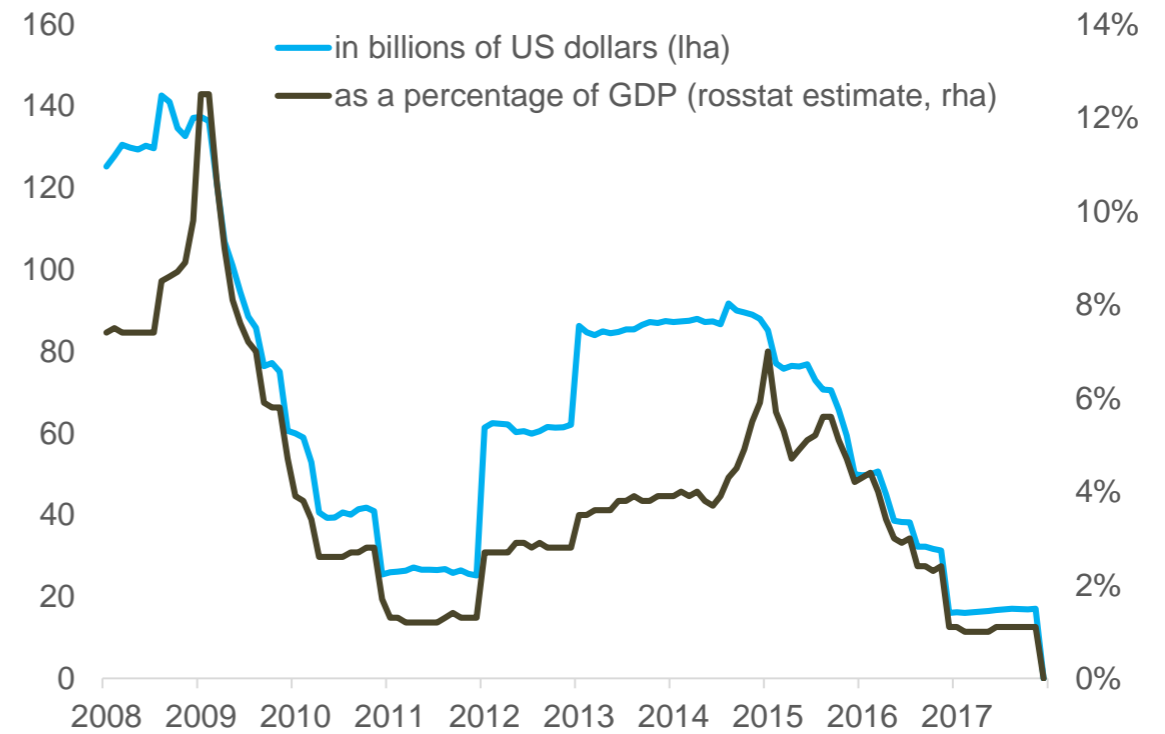


## RESERVE FUNDS.

### National Welfare Fund.



### Reserve Fund.

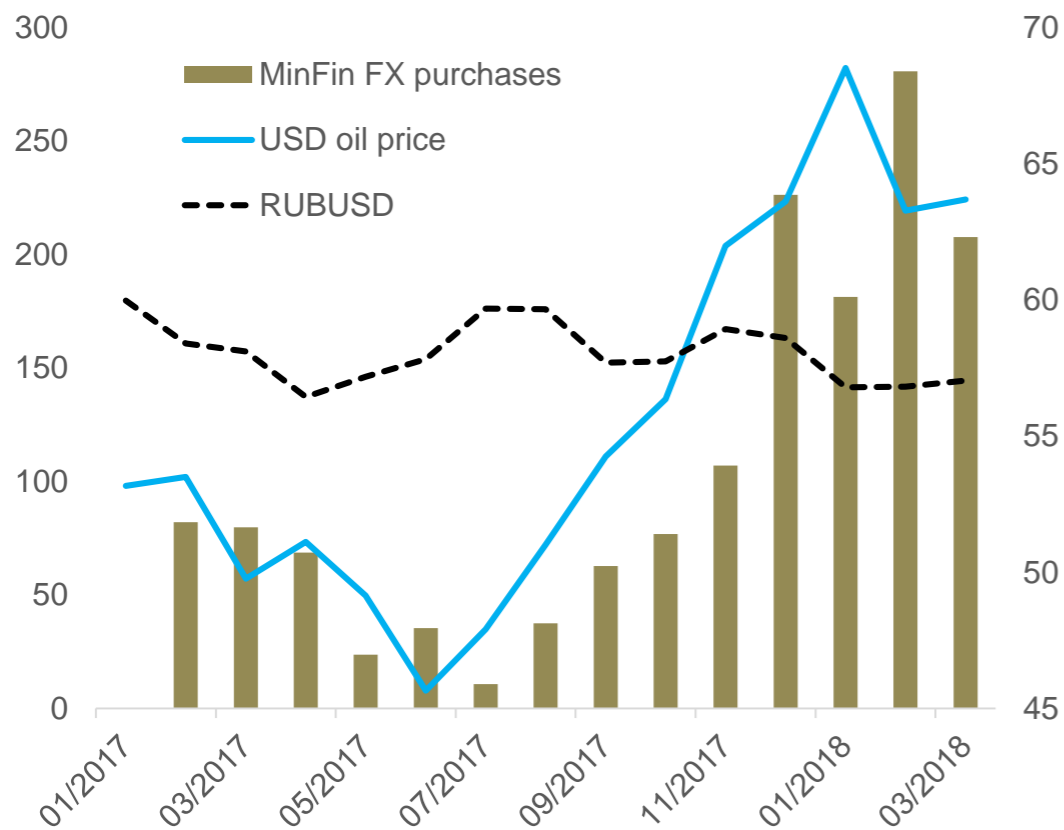


The reserve fund was completely spent in January 2018, future focus will be on the NWF.

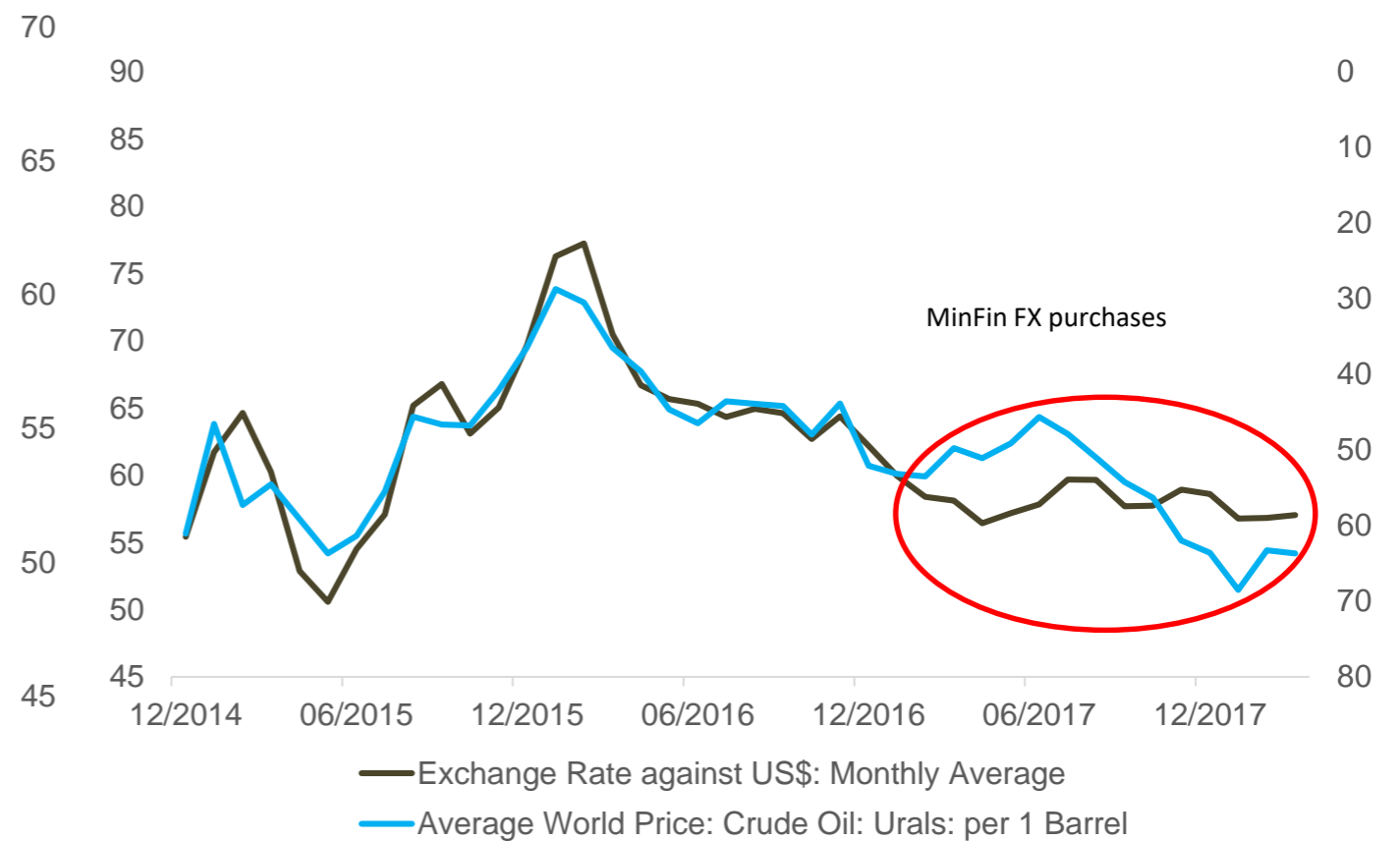
Sources: RUSSIAN MINISTRY OF FINANCE, ADA ECONOMICS LTD

EXCHANGE RATE.

MoF FX purchases (lha), oil price and USD/RUB.



Relationship between RUB and USD Crude Oil (inverted, 1 barrel, Urals).



The MinFin FX purchases from 2017 effectively stabilized the ruble against oil price movements.

Sources: : CEIC, ADA ECONOMICS LTD

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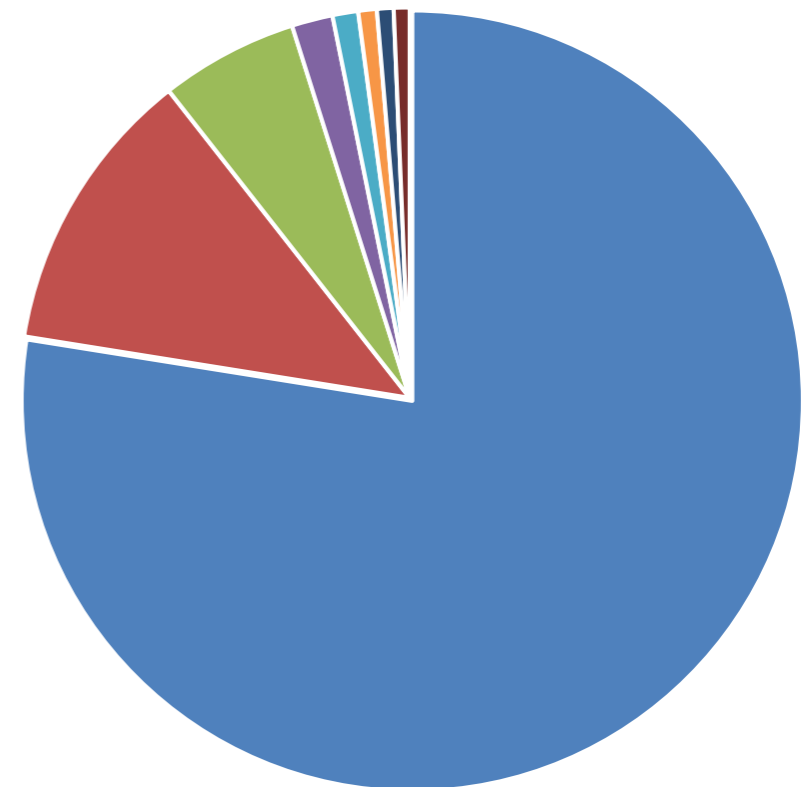
## POLITICS.

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### Latest developments.

- Presidential elections were held in Russia on March 18, 2018. The current president, Vladimir Putin, won the second consecutive election (fourth overall) term in office with 77% of the vote, increasing its approval rate of 10% in the past 6 years.
- The government is going to be presented the first week of May, more focus is expected on productivity and education, along with support for young families
- The press supported the idea that, over the next weeks, a significant infrastructure plan will be presented (10 trillion rubles, 162 USD bn).
- The expansionary fiscal policies in these areas are expected to be compensated through a spending review and possible tax hikes

- Vladimir Putin-Independent
- Pavel Grudinin-Communist Party
- Vladimir Zhirinovskiy-Liberal Democratic Party
- Ksenia Sobchak-Civic Initiative
- Grigory Yavlinsky-Yabloko
- Boris Titov-Party of Growth
- Maxim Suraykin-Communists of Russia
- Sergey Baburin-Russian All-People's Union



Sources: MACROBOND, RT, BLOOMBERG, ADA ECONOMICS LTD

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## SANCTIONS.

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As the latest round of sanctions surprised us in their intensity, we created three scenarios that should be helpful in guiding investors on mapping the impact of future sanctions developments. Our central scenario is that we are in the “frozen” conflict option.

### 1. A de-escalation of tensions

- This would lead to a recovery of the currency to RUB 50 per dollar by late this year/next year, which would turn it to an additional drop in inflation and interest rates. The growth outlook would improve, especially for 2019E, although it would not change materially in terms of pace: fundamentally, the economy would still have to deal with the corporate restructuring that is lurking in the background.

### 2. Frozen conflict

- This would lead to more challenges in financing external liabilities, but not to the point of triggering a solvency or financial crisis risk at the country level. Interest rate would continue declining at a lower pace, and the RUB should remain at around 60 per dollar. Overall, the outlook would not change substantially.

### 3. One where Iran-magnitude sanctions are put in place

- This would probably push the currency to or beyond the previous peak of RUB 80 per dollar, forcing the economy into recession, notwithstanding crude prices assumed at USD 65/bbl. Non-resident holdings of local debt rose to 33% of the total as of February 2018; thus, forced liquidation will pose material challenges for policymakers. Our inflation projections in this scenario jump to 7% on average this year (but to 10% in the near term), delaying the rate cycle mostly to next year.

	De-escalation		Frozen conflict		Maximum sanctions	
	2018E	2019E	2018E	2019E	2018E	2019E
<b>Real GDP growth</b>	2.00%	2.50%	1.3-1.5%	1.2-1.5%	0.8-1%	-1.00%
<b>Inflation</b>	4.00%	2.00%	4.00%	3.50%	7.00%	6.00%
<b>Policy rate, eop</b>	6.00%	4.00%	6.25%	4.25%	7.00%	6.00%
<b>USD/RUB, eop</b>	60	50	65	65	80	80

*Source: Macrobond, ADA Economics*

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