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How much will the sanctions cost?

The sanctions introduced by the USA on April 6th on 15 Russian companies and several Russian businessmen and officials will have a noticeable but limited impact on the macroeconomic situation in Russia in the short term. The forced sell-off of shares in sanctioned companies has hit financial markets and had a negative impact on capital flows. In 2018, increased net capital outflows (roughly estimated at $20bn, taking total net outflows from $29bn to $49bn) and direct export losses will push the dollar exchange rate up by 3.5-4 roubles, from Rb57:$1 to Rb60.5-61:$1 (here and below we assume an average Urals oil price of $67/barrel). The depreciation of the rouble will cause the inflation rate to rise from 3.6% December to December (prior to the latest sanctions) to 4.1-4.3%, which is nevertheless close to the Central Bank's target. Given the increased risk of financial destabilisation and higher inflation the Central Bank is likely to keep its policy rate close to 7.25% until the end of the year. Lending rates to the non-financial sector are likely to be slightly higher than they would have been in the absence of sanctions owing both to the higher Central Bank policy rate and the increased risk premium.

In light of these factors, we are trimming our GDP forecast for 2018 from 1.9% to 1.7%. At the same time, in the absence of further shocks, the rise in capital outflows, the decrease in exports, currency depreciation and elevated interest rates will all be temporary. As with the first wave of sanctions, the short-term impact of these sanctions will dissipate in 1-2 years. Nevertheless, sanctions will continue to have a negative impact on economic growth on a more fundamental level owing to lower foreign investment, increased difficulties in moving into external markets etc, which will impact on the overall competitiveness of the country's economy, depressing long-term growth rates.

There are downside risks to this forecast. First, the outlook will worsen if Russia imposes countersanctions. Russia's economy is many times smaller than that of the USA, meaning that sanctions that have any meaningful impact on the US will impact Russia much more significantly. Second, the USA appears willing to impose further sanctions in response to the situation in Syria. Third, capital outflows caused by the most recent sanctions could significantly exceed $20bn. Fourth, Russia's exports could decline by more than $3-4bn, as it remains unclear which companies and countries will follow US recommendations.

The indirect effect of sanctions may exceed the direct effect, in part as other Russian exports could be indirectly hit. However, there are compensatory mechanisms that may reduce the negative impact of sanctions. First, exports banned by the US may be redirected to other markets. Second, if capital outflows rise, the Central Bank could resume hard-currency REPO operations, as it did in 2014-15. It is less likely that the Ministry of Finance will stop purchasing foreign currency in line with the budget rule. Even if events unfold according to the "favourable" scenario – that is, with no further escalation on either side – the Russian state will likely have to provide financial support, and the position of sanctioned and associated companies is certain to worsen, which could lead to a risk in social tensions in what is already a challenging post-crisis period. Whether financial support comes from the budget or state banks, it is unlikely to match the losses incurred. Assistance to sanctioned companies will reduce resources available for long-term goals, such as the development of infrastructure and human capital. The renewal of the sanctions war further increases the isolation of Russia's economy, which will increase the technological lag and consolidate Russia's low-growth trajectory.

Composite Leading Indicator

1. Composite Leading Indicator: More sanctions ahead?

In March 2018 the Composite Leading Indicator (CLI) remained at a relatively high level (2%, versus 3.1% in February). Other than a decline in new orders, there were no other negative signals in March. In April, unfortunately, these appeared.

In March, as in previous months, the main positive driver was the oil price. The average Urals oil price in March was $64/barrel, which is 27% higher than a year earlier. At this price level, the Russian economy should avoid any very negative scenarios. Nevertheless, the recent anti-Russian sanctions have significantly changed the outlook: the sustainability of Russia's growth is being put to the test. It is possible that the current turmoil on the currency and financial markets will be short-lived, and the impact on the real economy will be limited. However, the notable decrease in new orders, after only a short period of expansion, suggests a different scenario is plausible. It is currently difficult to forecast the macroeconomic consequences of the sanctions, particularly as the current geopolitical situation increases the likelihood that they will be tightened further. One can only state with confidence that the likelihood of a weakening in the economy has significantly increased in recent weeks.

Composite Leading Indicator

2. Regional Economic Activity: A successful start to the year

In February 2018 the Composite Index of Regional Economic Activity (REA) remained above 65%, its highest level since the start of 2013. On a regional level, therefore, the fallout from the recession of 2015-16 has now been overcome.

The REA stood at 65.1% in February, down slightly from 66.8% in January. If this improvement is sustained, it suggests that most of Russia's regions are emerging from their local recessions. Output exceeded 50% in four out of the five main economic sectors, in most cases significantly, and in all eight federal districts, which points to a broad improvement, at least on a regional level.

The only problematic sector in February was construction, where the index stood at 38%, indicating that output had declined in a majority of regions compared with a year ago. The index improved significantly in the remaining sectors: in wholesale trade it was 57%, in industry 71%, in paid services 76%, and in retail trade 84%.

The best performing federal districts were the Urals and North Caucasus Federal districts (80%). A high REA was recorded in the Privolzhsky (70%), Siberian (68%), Central (64%) and Far East (62%)

districts. The Southern (53%) and North-West (52%) districts performed comparatively weakly, but economic activity has nevertheless improved compared with last year.

In terms of individual regions (oblasts, krais and republics) the February REA exceeded 50% (indicating a year-on-year growth in economic activity) in 65 out of 82 cases. There were no regions where no sector of the economy recorded growth. The number of regions where one only sector recorded growth increased from three to five. At the same time the number of regions where four or five sectors recorded growth fell slightly from 37 to 35, but remains relatively high, suggesting moderate economic growth rather than stagnation.

The five most problematic regions were Oryol and Volgograd oblasts, the Republic of Komi, the Republic of Udmurtiya, and Khararovsk krai. In all, these account for 4% of Gross Regional Product (GRP). The most successful regions (REA=100%, indicating all five sectors recorded growth) in February were the Republic of Ingushetia, Kabardino-Balkaria, Mordovia, Chuvashia, Buryatia, Tyumen Oblast and Novosibirsk Oblast. In a further 27 regions four out of five sectors recorded growth. These two groups in total accounted for 57% of GRP. A further 30% of GRP was accounted for by regions where three out of five regions recorded growth.

Macroeconomics

3. Economic Activity: Recovery after Correction

The decline in GDP in the second half of 2017 was due to the fact that the phase of active replenishment of inventories had come to an end, and should not therefore be regarded as a recession. The economy recovered some of the losses in January-February 2018. Higher oil prices over the past half year combined with increased payments to government employees has improved the trend in wages and consumption. This has given a positive impulse to economic growth, which nevertheless remains modest.

According to Rosstat data from April, year-on-year GDP growth slowed from 2.5% in the third quarter to 2.2% and 0.9% in the third and fourth quarters respectively. We estimate that seasonally adjusted GDP declined by 1% in the second half of the year after growth. After growth of 0.9% in the first and second quarters, GDP fell by 0.2% and 0.7% in the third and fourth quarters respectively (quarter on quarter). Formally, a recession is defined as two successive quarters of GDP contraction; however this is too narrow a definition. A more comprehensive approach should consider both GDP and a number of other indicators of economic activity. The positive trend in real wages, household spending, construction, investment and the decline in unemployment in the second half of 2017 mean it would be inappropriate to label this a recession.

This is also supported by an analysis of the breakdown of GDP growth over this period. Looking at GDP in production terms, the decline in the third and fourth quarters was in industry (in each of the three sub-sectors), and also, to a lesser degree, in wholesale and retail trade and in transport and communication. The other sectors recorded growth. In GDP-by-expenditure terms, the main contribution to the slowdown in year-on-year GDP growth was a slower rate of accumulation of inventories. In year-on-year terms, inventories contributed 2.9 percentage points of growth in the second quarter, 1.5 percentage points in the third and -0.9 percentage points in the fourth quarter. Following the conclusion of the post-crisis transition from draw-down to accumulation, inventories are now making a negative rather than positive contribution to GDP, which is reflected in the decline in demand for domestic industrial products, and consequently for wholesale and transportation services. The decline in GDP should thus not be viewed as a recession, but rather a cyclical correction following the normalisation of the trend in inventories, which has no implications for the broader economy.

The index of output from the basic economic sectors, which we have calculated on the basis of Rosstat's official statistics for February, was very close to the GDP trend, whereas it had previously pointed to stronger growth. In the second half of last year the index fell by 1% quarter on quarter. In January-February it rose by 1.2% compared with the fourth quarter, which allows us to hope that GDP growth has also recovered over this period. The main contribution to the rise in economic activity came from industry, which indirectly supports our hypothesis that the negative impact of inventories on economic growth has come to an end. Although the index of the main economic sectors fell by 1.3% in February, this did not reverse the 2.2% growth recorded in January. It should be noted that the data have become more volatile since the adoption of the OKVED 2 classification system (the equivalent of the EU's NACE), particularly Rosstat's primary industrial data.

The index of private consumption has demonstrated a markedly positive trend from the fourth quarter of 2016, although it declined in February 2018 by 0.3%. The growth in demand has been supported by economic expansion and the appreciation of the rouble as a result of higher oil prices, however this marks only the start of a recovery following a sharp fall in the crisis. In January-February 2018, domestic demand was 9.1% below the 2014 level. The pick-up in real wages in the fourth quarter of 2017 and January-February 2018 has supported household consumption. Retail trade in December-February recorded steady growth, after stagnation during the rest of 2017.

After reaching a low in April 2017, construction is starting to recover, however it remains unclear whether growth will be sustained. In January-February it fell by 3.6% in total, taking output close to the April low. This appears to be caused by levels of financing from the budget as a result of fiscal consolidation and a surplus of supply.

As noted above, after growing in 2016 and the first half of 2017, industrial production fell in the second half of 2017, which in our view is linked to the normalisation of inventory levels. However, the start of 2018 saw a recovery in industry, mainly thanks to growth in manufacturing. According to our estimates based on disaggregated Rosstat's data, in December-February industry not only recovered following the correction but reached a historic maximum. Primary data from Rosstat, however, are less encouraging. Both approaches show that the recovery in industry has slowed following the collapse in 2015. This is likely due to weak domestic demand and the strengthening of the rouble in 2016-17.

Freight and transportation, as an intermediary form of economic activity, replicates the trend in industrial production, particularly when measured against our alternative index. After a decline in the second half of 2017, freight and transportation recovered in January-February thanks to greater volumes carried by pipeline and rail, the latter of which have been growing since the start of 2017. Wholesale trade, by contrast, has been declining steadily for almost a year, although the dynamics in this sector are always difficult to explain.

Overall, the performance in January-February was encouraging, but there is a significant risk of a deterioration. The strong performance at the start of the year is largely thanks to the oil price, which could be reversed. The latest round of sanctions, and the risk of counter measures, has further darkened the outlook.

Real Economy

4. Industrial production growth across almost all sectors – how long will it continue?

At the beginning of 2018, the performance of the industrial sector was stronger than in the favourable second quarter of 2017. In the first quarter around two thirds of industrial sectors recorded growth. However, forecasts based on business expectations show a possible weakening of industrial output in the near future.

Rosstat data indicated that industrial production had shown growth again at the start of 2018, rising by 2.2% year on year, after falling in the fourth quarter of 2017 by 1.7% year on year. In seasonally and calendar factor adjusted terms, industrial production fell by 1.3% in February 2018 compared to the previous month. However, given good performance in January (when output expanded by 2.4% compared to the previous month), this has still been a strong start of the year.

Given that the post-crisis recovery ended last year, the question is whether the improvement in industrial activity at the start of the current year points to a new phase of sustained growth of this key sector (from the point of view of tax revenue, foreign currency earnings and innovation) and the economy as a whole.

From a structural point of view, the positive shifts in the industrial sector are clear. In 2017 the main contribution to growth in industrial production (0.7 percentage points of 1% growth year-to-year) came from mining, whereas in January-February 2018 1.8 percentage points out of 2.2% growth came from manufacturing, principally the automotive sector, textiles, furniture, printed media, finished metal products etc. This is a positive development, as the expansion of the manufacturing sector enables diversification and increases the sustainability of overall economic growth.

However, it is unclear whether the improvement in industrial performance can continue. On the one hand, the range of sectors experiencing growth has broadened. We have calculated that 16 of 26 sectors demonstrated growth in the second quarter of 2017 (of more than 0.3% over the month), four of these recorded very high growth. At the start of 2018, 18 sectors showed significant growth, and ten very high growth.

According to our econometric model, a small growth in the industrial production index is possible in March-April, it will be of around 1.5% a month, but we expect a slowdown in May. Using seasonally adjusted data, we developed an ARMA (2.2) model that showed growth in January and a contraction in February. A calculation of long-term forecast using this model is not possible, but we expect a positive result in March.

The medium and long-term outlook for industrial output (and thus for the economy as a whole) remains unclear as a result of the high level of uncertainty (which remains at the same level as during the crisis and pre-crisis stagnation), a lack of domestic demand and significant structural impediments. Given that at least 1 percentage point of industrial growth came from inventories, which was driven by optimism arising from the election of Donald Trump as US president, then all other things equal, industrial production will be 1 percentage point lower this year.

It remains unclear in the current framework whether domestic demand and exports will increase sufficiently compared to last year - not only to compensate for the loss of the inventories factor, but also to drive a pick-up in growth.

Balance of Payments

5. Current Account: A lack of direct investment

According to the Central Bank, the current-account surplus in the first quarter of 2018 rose to $28.8bn (up by 29%). Increased inflows on the current account along with a $4bn financial account surplus to the state sector was largely offset by currency purchases by the Ministry of Finance (international reserves rose by $19.3bn) and an outflow of capital from the private sector (of $13.4bn).

The key factor driving the current-account surplus in the first quarter was the rise in goods exports to $99bn (up 20% year on year). Hydrocarbon exports rose to $59bn, up 20% year on year. This was almost entirely due to price factors, with oil averaging over $65/barrel over the quarter, the highest level in three years. In the short term, oil prices will depend on whether the OPEC+ agreement is extended further.

Other exports (excluding hydrocarbons) totalled just over $39bn, accounting for 41% of all exports. Seasonally adjusted, the value of exports was down by 2.5% compared with the fourth quarter of last year, making an end to two years of growth. However, exports grew by 13% in the previous quarter, and have risen by almost 150% over the past two years. It is therefore too early to speak of a change in trend, although the tightening of western sanctions and possible counter-sanctions could lead to a reversal. A rise in protectionism in the USA and a possible trade war will also have a negative impact on the global economy, which may lead to a decline in demand for Russian goods.

Import values rose to $57bn in the first quarter, but at a slower rate (up 18% year on year) than exports. Seasonally adjusted, imports rose by 3.4% quarter on quarter. The main driver of growth, in contrast to exports, was increased physical volumes. Import values have been rising for seven quarters in a row. However, from the middle of last year the rate has slowed as a result of a weakening of the real exchange rate. The rouble may weaken further as a result of sanctions, which could lead to a fall in imports.

In the first quarter other operations on the current account recorded a deficit of $13.5bn. Seasonally adjusted, the deficit was down by 1% quarter on quarter, after steady growth over the previous five quarters. The service sector continued to record a deficit as a result of high demand for foreign travel. However, the deficit on the investment income line narrowed, owing to lower payments to non-residents by Russian companies.

Faster growth in exports compared with imports led to rise in the current-account surplus to $29bn, its highest level in three years. The flipside of this high surplus is a growth in capital outflows, which exceeded $13bn. The rise in capital outflows is mainly due to increased export earnings, but increased investment risks in the context of tighter western sanctions mean that short-term investors may pull more funds out. Capital outflows were driven by the private sector, which increased their holdings of foreign assets. This was largely in the form of direct investment, while "grey" outflows (the sum of "suspect transactions," "other transactions" and "net errors and omissions") was close to zero. This has been helped but the clean-up of the banking sector by the Central Bank and the gradual tightening of western sanctions.

Direct foreign investment into Russia was $4.3bn in the first quarter. We estimate that almost all of this comprised re-invested profits, while there is almost no new direct investment. Net direct investment has been negative for the past three quarters. Banks made little contribution to outflows, in contrast to the first quarter of last year. Over the past two quarters banks have not been increasing foreign currency assets, while the rate of reduction in foreign debt has significantly fallen.

In the last two quarters, the private sector has been both building up foreign assets and paying down foreign liabilities, leading to a rise in capital outflows. In the context of tightening western sanctions and rising risk premia, it is becoming harder for companies and banks to borrow on external markets. Moreover, outflows from non-residents are increasing and foreign investment is falling overall. This negative dynamic may be partly offset by the repatriation of capital to Russia.

Sanctions have hit the secondary market for state debt. Investment from non-residents fell to $0.8bn in the first quarter, compared with $7.3bn and $1.4bn in the third and fourth quarters of last year. In this context, the Bank of Russia again raised $2bn in short-term credit to provide foreign-currency liquidity to Russian banks.

In the first ten days of April the rouble fell from Rb57:$1 to Rb63:$1 following the tightening of sanctions. The 10% fall in the value of the rouble was accompanied by a sharp fall on the stock market. However, a further weakening of the rouble, in our view, will be held back by the high price of oil. The price of oil could fall back in the second half of the year if the OPEK+ deal comes to an end. Given elevated capital outflows, the rouble could fall to Rb65-70:$1.